corospondent

The Institutional Quarterly

Turning points

CORONATION

TRUST IS EARNED™

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IN THIS ISSUE

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On the cover: To herald the turning of the decade, we take a look at the world from a broad perspective as the impact of geopolitics is being felt in both global economic policy and the markets. That said, while cognisant of these events and their impact on sectors and regions, we remain committed to our bottom-up, valuation-driven investment approach.

Kirshni on point

Pause and reflect.

By **KIRSHNI TOTARAM**

Kirshni is Global Head of Institutional Business. She joined Coronation in 2000.

HAPPY 2020 AND welcome to the first edition of *Corospondent* of the new decade. I know it's a cliché, but it really is scary how quickly time has gone by and, by that measure, how many of us in this industry have matured. For me, entering this new decade offered a moment's pause to reflect on the last 10 years and the experiences that have shaped us and left us, hopefully, wiser.

REFLECTING ON THE HIGHS AND LOWS

The start of 2010 was still very much characterised by the aftermath of the Global Financial Crisis. This hangover continued to mar investor confidence for the whole of the last decade, leaving trust levels in the financial services sector at an all-time low.

There was no Spotify, Uber or Netflix (I really can't remember how I binge-watched those series – DVD box sets, I think!). And of course, neither chasing likes on Instagram nor venting through the 140-character limit on Twitter. The tech revolution materially shaped the last 10 years. While it has mostly acted to improve friction points in our daily lives, it has, of course, given rise to other issues.

Sporting highs shaped the beginning and end of this last decade. 2010 was all about 'Ke Nako' ('it's time'), and hope and euphoria filled our streets as we hosted a very successful Football World Cup. The vibrancy of our national spirit was shared with the world one vuvuzela at a time. And let's not forget last year's fantastic win by the Springboks who proudly brought home the Webb Ellis trophy, reminding us that we are indeed #StrongerTogether.

But despite these exhilarating moments, the last decade has also been a truly dark and depressing one for our country.

A dark decade for South Africa

And I don't just mean loadshedding! The 2010s was a troubling decade for local politics, with systemic corruption epitomised by #ZuptaMustGo and #PayBackTheMoney – neatly describing deeply entrenched State Capture and the gross mismanagement of State-owned entities. The hope and potential that were heralded by being included in the rising BRICS grouping has faded, and we currently stare economic ruin firmly in the face. The full costs of rebuilding our economy, and the repercussions of these years of corruption on society and investor confidence will have a material impact on the country for the next decade at the very least.

The global environment has gone through immense change

Globally, we have seen a decade of unprecedented monetary stimulus, resulting in the longest bull market in US history, and taking global stock markets to lofty valuations.

In 2020, we move into an election year in the US, following the December 2019 election in the UK. One cannot help but reflect on the stark contrast between the Obama/Cameron leadership combination and the Trump/Johnson duo currently occupying office. Both incumbents are controversial characters, arguably elected through harnessing the power of social media and targeting disenfranchised voters who feel left behind in this disrupted world.

When the G20 gathered in London in 2009, only a small minority of world leaders would have fitted the right-wing populist mould. Fast forward >

the decade and radical-right populist parties are securing an increasing number of votes and parliamentary seats across the globe – a marked shift for the first time since WWII.

One leader who has managed to maintain his grip on power throughout is Russia's Vladimir Putin, who has led the country since 1999! His efforts to reassert his global influence and return to superpower status have endured, but his attempts to revitalise Russia's economy have languished.

The rise and rise of China

China delivered the most remarkable economic transformation in history over the past decade – transitioning from an emerging market to the second-largest economy in the world. Its large, successful companies such as Huawei, Tencent and Alibaba, have shown great innovation, expanding to now operate head-to-head with US giants such as Apple, Alphabet (then Google) and Amazon.

It is because of China's rise and subsequent dominance that we expect global geopolitics to remain tenuous, despite the fragile trade truce reached with the US in January 2020.

Climate change and the Greta effect

Global concern for the environment grew through the decade. And when the teenage Swedish activist Greta Thunberg launched her solo climate protest outside her country's parliament building in 2019, her defiant action sparked a global movement that established her as a powerful influencer on climate change and saw her being nominated for a Nobel Peace Prize. The impact she has made in such a short time through lobbying political leaders and rallying her supporters is extraordinary. Now we need to see actual policy change that adequately deals with the significant challenges we currently face.

A clear illustration of the devastating impact of climate change must certainly be the Australian bushfires that have ravaged the country since September 2019. Governments around the world surely don't need more of a wake-up call.

Trust is Earned

Of course, no reflection is complete without looking back at our own organisation over the past 10 years. Our purpose and passion have remained steadfast – not just in the last decade, but in the entire 26 years since we opened our doors. We help millions of people achieve their long-term financial goals – such as a better retirement. It's a privilege we never take for granted. Our organisational values have stood the test of the ups and downs and continue to endure today.

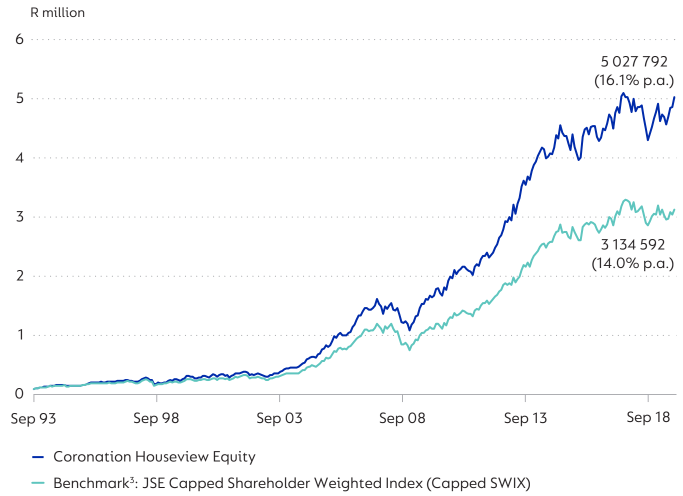
Our role in uplifting communities through our CSI initiatives and ensuring that our own business reflects the demographics of our country are also deeply important to us.

And it is with great pride that I note that we finished this decade as we did the last, with very strong returns for our clients' portfolios, continuing to show the strength and resilience of our long-term, active investment approach. The long-term track records across all our strategies have delivered meaningful value to our clients, with 97%[1] of our institutional client assets experiencing positive outperformance since inception.

Figure 1 shows the long-term returns produced by Coronation's flagship Houseview Equity Strategy since its inception in September 1993. As you can see, our active investment approach has resulted in investors earning 16.1% p.a.[2] on their investment over this period.

Figure 1

CORONATION HOUSEVIEW EQUITY



Source: Morningstar

This is an important consideration, given the massive and disruptive rise of index investing over the decade – most recent indications show that index investing now accounts for in excess of 50% of assets in the US, compared to less than 10% in 2010.

[1] as at 31 December 2019, funds with a 10-year + history.
[2] Gross of fees
[3] FTSE/JSE Capped Shareholder Weighted Index from 01 May 2017. Previously 50 Low Resources (inception to 31 January 2002) and FTSE/JSE Shareholder Weighted Index (01 February 2002 to 30 April 2017).

Putting our clients first

During the decade, we showed in tangible ways how we prioritise the needs of our clients. An excellent example is when we closed our South African institutional book to new clients in 2012. This was the largest and longest close ever by a South African asset manager. It was a pre-emptive move to ensure that we did not take on additional client assets and impair our ability to outperform. We re-opened our strategies to new clients in 2017.

Going global

Another milestone during the last decade was welcoming our first global clients. Since launching our global franchise in 2008, we have established world-class track records across our entire range of global developed, emerging and frontier markets. All our global strategies, with a track record of more than a decade, have outperformed meaningfully since inception. We are pleased with the strong performance of our Global Emerging Markets and Global Equity strategies over 2019, which demonstrates the discipline maintained throughout the tougher performance periods in prior years.

Supporting black business and enterprise development

This decade, we made some significant strides forward in supporting black businesses in our industry. Pre-dating black economic empowerment legislation in South Africa, we pioneered a number of corporate initiatives that continue to contribute to transformation and the development of skills in our industry.

In 2006, we launched the Coronation Business Support Programme, a ground-breaking initiative to grow emerging black stockbrokers. We allocated a minimum of our South African equity brokerage to a group of black-owned stockbrokers annually. Since 2005, we have allocated in excess of R300 million in brokerage to programme participants. For both the industry and the companies themselves, the transformation has been remarkable.

In 2017, we also supported the creation of the first black-owned and managed administration business in the industry and the country, Intembeko Investment Administrators. Now in its second year of operation, Intembeko continues on its journey to become a world-class service provider.

MAPPING OUT THE LANDSCAPE FOR THE FUTURE

In President Ramaphosa's New Year's message, he reflected that South Africa still has "many mountains to climb and many treacherous rivers to cross". The hardships endure for South Africans and the low expected growth forecast for South Africa in 2020 is woefully inadequate if the country is to solve the triple challenge of unemployment, poverty and inequality successfully.

As we look ahead to 2030 and beyond, we are entering a decade – or even two decades – of lower expected investment returns. For the South African looking ahead across the years to their own retirement, what should their strategy be to thrive in this low-return environment?

Our nation desperately needs to develop a stronger culture of saving. And it will require behavioural change at the individual level. The key for any saver is to start to put money away for their future as early as they can. It is simply not possible to play catch up later in such a muted return environment. We will endeavour to educate South Africans through our various channels to help them understand the necessity and benefits of saving consistently over one's life.

And of course, we are all hoping that the lights don't go out permanently.

Another decade of gratitude

Thank you for your ongoing support over the years. We would not be here without you. I wish you a happy and successful year ahead and, in true Coronation style, a prosperous and positive next 10 years.

While, our country does not seem to be heading in the desired direction at this point and is a source of frustration and despondency for us, I am reminded of the timeless words of Dr Martin Luther King Jnr. – "If you can't fly then run, if you can't run then walk, if you can't walk then crawl, but whatever you do, you have to keep moving forward."

Sound advice for us all as we head into the next decade.

Good luck out there!

Kirshni

INSIGHTS

The investment case for South African equities

Significant opportunities may underlie a bleak outlook

By **NEVILLE CHESTER**

THE QUICK TAKE

Fiscal consolidation and meaningful policy implementation is essential to restore investment confidence and a meaningful growth path

Corruption, SOE failure and high debt levels have hamstrung the economy and the aftermath is likely to continue to do so

It is in conditions such as these that remarkable opportunity can arise and some SA stocks are worth watching

Neville manages Coronation's Aggressive Equity Strategy and has 23 years of investment experience.

THE OUTLOOK FOR domestic equity in the period ahead is an exceptionally challenging call to make, given the two vast extremes that will potentially drive market returns and how one should be positioned.

On most metrics, the FTSE/JSE All Share Index (ALSI) shows up as extremely cheap compared to its history. Like all averages, this hides a number of desperately cheap shares and some that are still looking fully valued.

Companies that have been able to deliver consistent earnings growth despite the challenging environment trade at eye-watering valuations. At the high end of the spectrum, Clicks and Capitec are estimated at forward price-to-earnings (P/E) ratios of 33 times and 22 times, respectively; whereas companies that have had a more challenging time are trading on multiples that we haven't seen in well over a decade. This is reflected in sectors such as the clothing retailers, where Truworths, for example, is trading at eight times earnings and an equivalent 8% dividend yield; and in the large banks, where one can invest in a bank like Nedbank, which is trading at seven times earnings and a 7% dividend yield.

The reason for the very low rating of South African companies is obvious to all who live here. The economy is in a dire state and the political environment remains one where, despite all the obvious challenges and problems, change remains marginal at best and the status quo prevails. Policies to truly step up growth are spoken about and alluded to, but we remain stymied in a low-growth environment, made much worse by the failure, both financially and operationally, of Eskom.

NOT ALL THOSE WHO WANDER ARE LOST

Much like Robert Frost's paths in the forest, we face two divergent roads ahead. Should we fail to deal meaningfully with the economic challenges we face, the country is doomed to a low-growth future and all the attendant financial and social risks that will come with it. In that case, these low single-digit P/E multiples will have proved to be appropriate, pricing for an environment where real earnings will continue to decline in perpetuity.

However, should we see signs of the country choosing to take the path 'less travelled', one with short-term challenges, but ultimately leading to a better state where fiscal consolidation occurs, confidence returns and economic growth picks up, there are unbelievable bargains to be had in the local equity market at the moment.

The challenge is being able to assess the probability of which route South Africa is likely to follow, how much is actually priced into company valuations and which companies can potentially grow under either scenario. As mentioned earlier, investors who are unimpressed by the trajectory of the South African economy, but want to maintain some local exposure, are prepared to pay incredibly high multiples for the perceived safety of shares that have shown consistent earnings growth the past few years; and the consensus view is that they will continue. They are priced for this growth, and then some, and should they disappoint, the gap between expectation and reality will be enormous. A stock re-rating from an expected 33 times earnings to our assessment of a normal rating for an average South African business would result in a 62% decline in its share price.

The brutal and all-encompassing nature of the derating of the local market has meant that there are companies which we believe are above-average quality businesses, trading today at ratings we think are overly pessimistic. These are companies that should be able to defend their earnings base in real terms in a low-road scenario and, if we follow a better path, could deliver real earnings growth that is not being priced for. These make excellent investments where the pay-off profile is skewed to the upside.

THE OPPORTUNITIES FOR PATIENT INVESTORS, SHOULD WE RECOVER OFF THE LOW LEVELS TO WHICH WE HAVE FALLEN, ARE SIGNIFICANT.

UNCHARTERED TERRITORY

However, the future is unlikely to look much like the past decade in South Africa (refer to economist Marie Antelme's article on page 8). Years of profligate spending by government and rampant corruption meant that there was a lot of money sloshing around in the economy, a situation that is not going to recur. To make matters worse, the debts incurred in the last decade need to be repaid, which means that a much tighter fiscal policy must be maintained. In plain English, this means that money will actually be taken out of the economy to service and settle the staggering debt run up by government and State-owned enterprises.

The upshot of this is that businesses that seemed to be able to grow their earnings regardless of the economic cycle in past times, may not be able to repeat that performance in the years ahead. And therein lies the challenge: identifying investments that offer both upside potential and relative downside protection.

A COLD COMING WE HAD OF IT

Why are we even bothering if the outlook is so clouded and the risks are so high? Because the opportunities for patient investors, should we recover off the low levels to which we have fallen, are significant. The last time South Africa was in a similar situation was back in 2002/2003 when the outlook for the country was equally pessimistic, and the world was still recovering from the shocks of the Dotcom bubble and the 9/11 terrorist attacks. The rand had weakened significantly, and domestic shares were trading on ratings very similar to where they are today.

What followed was a period of very strong returns for domestic shares, as the situation normalised and economic growth returned, with the ALSI delivering a total return of 29.5% per annum for the next four years. This is by no means guaranteed to be repeated, but given where valuations are currently trading, one has to take a serious look at domestic companies as potential investments for the next decade.

A PROFESSIONAL GUIDE MAKES THE JOURNEY

Our key strength and the pillar that supports our investments at Coronation is our intense focus on proprietary research. This will, once again, be absolutely crucial in determining which companies will be the future winners and losers, not in the next 12 months, but over years. All in, the above reinforces the oft-repeated view that while investing is simple in theory, it is incredibly difficult in practice. ✚

ECONOMIC COMMENT

South Africa's at risk of falling into a debt trap

Let us not waste another crisis

By **MARIE ANTELME**

THE QUICK TAKE

A crisis is an opportunity to turn poison into medicine, and it takes discipline not alchemy

SA's fiscus requires the most urgent attention; it's almost as if we're back to square one

The remedies that were available to SA in the 1990s have all but dried up

The increased attractiveness of other emerging economies is not helping the situation

Marie is an economist with 19 years of experience in financial markets.

CRISES FORCE US to re-evaluate, to think differently, and to seek solutions that challenge the status quo. They are circumstances where all paradigms are up for debate and there is greater latitude to question leadership and existing norms.

In South Africa, we are not responding to the current crisis. Not limited to Eskom, the economic and fiscal ramifications of weak growth have become critical. GDP growth has averaged 0.8% over the past five years (2019 estimate) and is unlikely to come in much above 0.3% in 2019.

This compares to a post-democracy, pre-Global Financial Crisis average of 3.6%. Importantly for the current fiscal position, nominal GDP growth is running at 4.7%, compared to 12% over the same period.

FISCAL WOES TOP AGENDA

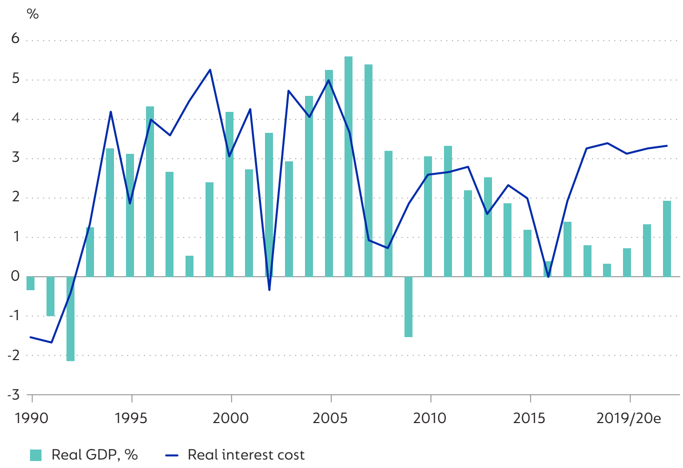
The biggest economic casualty has been the country's fiscal position that had improved from a very low base in 1993/1994, a condition not very different to the one we're in now, to one of notable strength in early 2009. This has since reversed due to several interconnected and reinforcing causes, namely low nominal growth; failing confidence and investment; increasingly complicated economic policies; institutional decay and State Capture; and, definitely not least, the prevailing and intensifying crisis at Eskom. These events have combined to enforce the reality that South Africa remains one of the world's most unequal economies with respect to both income and wealth. This is a gap that is exacerbated by diminishing resources with which to address this compound crisis.

This is not the first time we have been here. Some of the metrics are different, some of the causes and consequences are too, but in 1993/1994, South Africa was struggling out of a three-year recession, exacerbated by a prolonged drought.

The fiscal position was under strain as a combination of weak growth and a sharp escalation in expenditure saw the deficit balloon to -6.3% of GDP, from -1.2% three years earlier. Debt jumped from 30.5% of GDP to 36.9%, heading up, and debt service costs climbed steadily to above 5% of GDP.

Figure 1

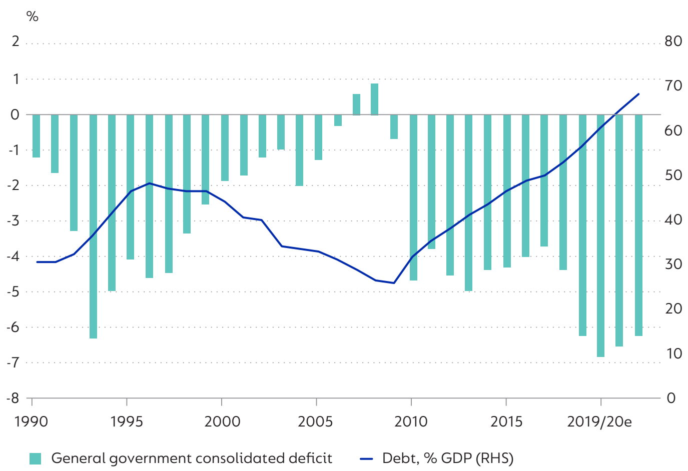
REAL INTEREST COST VERSUS REAL GDP



Sources: SARB, Coronation

Figure 2

GENERAL GOVERNMENT MAIN BUDGET BALANCE



Sources: Coronation, National Treasury

In 1993, the South African Reserve Bank (SARB) published a paper[1] titled, "Is South Africa in a debt trap?" The parallels to today are sobering. While the paper concluded that it was impossible to assess categorically that the country was in a debt trap, by most indicative measures, the economy was close to this critical position.

BACK TO THE FUTURE

The details beg further analysis, and comparisons to today's position are worth highlighting – both the risk and the potential for remedy. To start, it is important to describe two important concepts. First, 'sustainable debt' is debt that stabilises or diminishes relative to output (GDP) over a reasonable forecast horizon. The official forecasts published in the October 2019 Medium-Term Budget Policy Statement (MTBPS) see gross government debt rise from an estimated 60.8% in the current fiscal year to 71.3% in 2022/2023, in the absence of any remedial interventions. This trajectory is unsustainable.

The second is a 'debt trap' – this happens when real (nominal) interest payments exceed real (nominal) GDP growth over a sustained period of time. This results in an 'explosion' in the government debt-to-GDP ratio, which can no longer be prevented because of limited remedial capacity. Essentially this means that the State cannot effectively raise revenue or cut expenditure in a politically practicable manner, and this dynamic creates a self-perpetuating and compounding increase in government debt.

The SARB paper compared the domestic data at the time to the IMF's debt sustainability criteria, which state that government debt will continue to rise if the ratio of the primary balance to GDP is smaller than the ratio of government debt to GDP, multiplied by the real cost of debt (interest rate) minus real GDP growth rate. The rationale is that a government cannot indefinitely run deficits if the real rate of growth is below the real cost of financing its debt.

The study found that while the government was able to finance its deficit in a sustainable manner at the time, it raised serious concerns about the risk of the economy falling into a debt trap. Importantly, the risk of interest-cost growth relative to GDP (see Figure 1) could be a key driver of debt accumulation. The fiscal assessment can then be summarised as follows:

1. The large deficit, although partly reflecting cyclical factors, was high relative to potential GDP, making a recovery harder to realistically forecast. In the 1970s, when the deficit had ballooned before, potential growth was estimated at nearly 4%. In 1993, this was closer to 1% to 2% – slightly above the 1.1% that the SARB currently estimates for 2020, implying an increasingly unsustainable position.
2. The increase in debt stock, albeit from relatively manageable levels, implied a further rise in the interest burden on tax revenue, which would persist should growth remain low.
3. Low domestic savings could raise borrowing costs, crowding out the private sector and widening the current account deficit.
4. Concerns about public willingness to fund increased borrowing, and at what cost, implied further upside risk to long-term interest rates.

[1] E.J. van der Merwe, "Is South Africa in a debt trap?" South African Reserve Bank Occasional Paper No 6, May 1993

5. Lastly, the report raised the possibility that, as the debt burden increased, "authorities will be unable to prevent the financing of their budgetary deficits by means of an increase in the money supply and monetary base of the economy". Under such circumstances, the SARB warned, government debt will increasingly have to be monetised, destroying the ability of the Central Bank to contain inflation.

POINT OF NO RETURN?

There are clear parallels with South Africa's position today. The recent deterioration in the government deficit to an estimated 6% of GDP (6.2%: 2019/2020 MTBPSe), *ceteris paribus*, is well in excess of potential growth. The expected increase in debt stock and the concomitant debt service burden suggest a return to interest payments of close to 5% of GDP. There is some upside risk to this estimate should borrowing costs rise off the currently low (global) base.

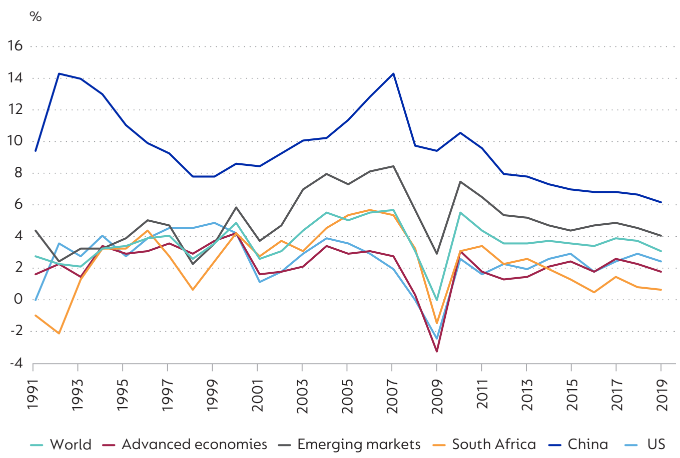
Figure 3

SOUTH AFRICA INTEREST PAYMENT, % GDP

Source: SARS

Figure 4

WORLD REAL GDP, % YEAR ON YEAR



Source: IMF

Ongoing government dissaving has, and will continue to, put pressure on the current account, making the fiscus and currency vulnerable to a sudden stop in funding flows. Lastly, it could be argued that the relative underperformance of South African fixed income to that of other emerging markets in a very supportive global environment already reflects the early onset of a 'loss of faith' in government's ability to implement sufficient remedial fiscal and policy action to avoid a debt trap.

With debt service costs already the fastest growing expenditure item over the medium-term expenditure framework, with tax revenue as a percentage of GDP at already high levels and stagnating growth, there are enough red flags to raise grave concerns about South Africa's ability to avoid a debt trap.

A LEAF FROM HISTORY

In the early 1990s, and even more visibly from the early 2000s, a combination of nominal growth recovery and institutional reform enabled the government not only to avoid a debt trap, but also to rehabilitate the fiscal position to one of outright health. Despite the emerging market crises between 1997 and 2000, South Africa managed to capitalise on a steady improvement in global growth, materially boosted by the growth acceleration in China.

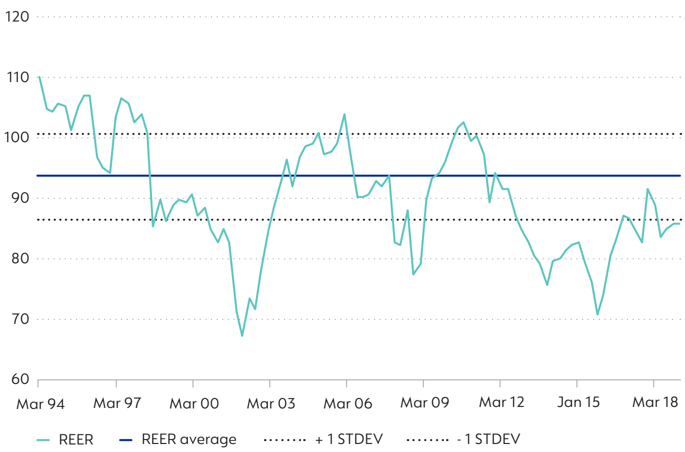
The domestic currency crisis in 2001 added momentum to the recovery, because it left South Africa with a severely undervalued currency. The boost to domestic terms of trade saw export prices rise meaningfully. This prompted a recovery in manufacturing production and an improvement in employment, and provided government with much-needed revenue windfalls.

During this time, South Africa also enjoyed several positive institutional changes, which not only facilitated an improvement in growth and thus revenue collection, but also in confidence and in policy implementation:

- The Constitution was gazetted on 18 December 1996.
- The National Treasury presented the first MTBPS in December 1997, preparing the way for the first multi-year Budget determination in February 1998.
- The SARB implemented inflation targeting, announced in September 1999 and starting in 2000.
- Mr Pravin Gordhan was appointed as Commissioner of the South African Revenue Service in 1999.

Figure 5

REAL EFFECTIVE EXCHANGE RATE VALUATION



Sources: SARB, Coronation

In line with global inflation, spurred by the recovering exchange rate and facilitated by the new SARB mandate, domestic inflation (and borrowing costs) fell from 14% in 1993 to -0.7% in 2004. The now more disciplined fiscal process, improved activity and the associated revenue benefits all helped to reduce the inherited fiscal deficit and debt stock.

The fiscal deficit narrowed from -6% of GDP in 1994 via -7.0% in March 1997 to a small surplus of 0.3% in June 2002, with a full windfall from the weaker rand, high inflation and very high rand-based commodity prices. Some stimulus in 2003/2004 saw the deficit widen in the wake of slower growth in 2002, notably lower revenue, expanded social security and a big allocation to the contingency reserve out of the fiscus. With the narrowing of the deficit thereafter, government gross debt fell from 48.8% of GDP in June 1997 to a nadir of 26% in 2008/2009.

OUT OF RESERVE

Returning to the present day, the drivers of growth that saved South Africa from a debt trap in the 1990s have largely been drained. Their replenishment would require an innovative shift in domestic economic policy, or a recovery in global growth and commodity prices, and preferably both. It is possible that the currently elevated terms of trade and an uptick in global growth in the second half of 2020 will provide a catalyst for an acceleration in domestic growth momentum. But the structure of the economy has also changed, and mining and manufacturing are considerably smaller components of gross value added – together now 19% from 29% in 1993/1994, which limits the ability to fully capitalise on this improvement.

Early data for the fourth quarter of 2019 (Q4-19) suggest tentative signs of stabilising domestic output, with an annual rate of about 0.4% in reach for the year as a whole.

However, the onset of loadshedding in early December, with the unprecedented escalation to Schedule 6 and the persistence of a diminished energy availability factor, will also compromise this nascent recovery. A number of mining companies closed early, and there is anecdotal evidence that small and medium enterprises have battled to sustain business activity as a result.

More broadly, domestic sentiment was hit hard and confidence remains weak. The clear risk is that considerably weaker Q4-19 growth will bleed into 2020 as power uncertainty persists, dragging our 2020 outlook to 0.9% (1.1% previously) on the back of the ongoing inadequate energy availability factor.

With real GDP growth of less than 1% and real debt service costs heading for 5%, the interest burden is set to reach almost 15% of total expenditure. Unless the gap narrows, interest cost and debt will compound, and the rising debt burden will increasingly limit expenditure on all other essential goods and services.

IS IT TERMINAL?

The economy is in crisis. There really isn't the luxury of time. Until government creates policies that welcome innovation, innovation will not come. South Africa no longer has relative economic advantages to offset its challenges in attracting new investment, driving employment and enhancing productivity.

There are lots of emerging market alternatives that need skills and foreign savings, and which create policies to facilitate their participation. The progress of countries like India, China, Pakistan and Bangladesh in the World Bank *Ease of Doing Business* measures shows us this. South Africa's performance, which has deteriorated by 52 places, from 32 in 2008 to 84 currently (where the lower the rank, the better the score), speaks for itself.

A country that used to contemplate which policies could be used to best attract investment and was able to direct revenue to the most economically vulnerable, is struggling to grow. A fiercely developmental economic agenda is at odds with economic innovation and growth. Redistribution is not growth, but without growth, redistribution can only be limited. With growth, it could be limitless.

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POWER STATEMENT

The near-term answer may lie in a bafflingly overlooked commitment by the government in an opinion piece by President Cyril Ramaphosa that was published in December last year. 'A new era in energy generation'[2] opens with the progressive statement that, "In the wake of the hugely damaging power shortages of the last two weeks, government has agreed – in keeping with the Integrated Resource Plan (IRP) 2019 – to allow users to generate power for their own use and to accelerate the purchase of power from independent producers. In effect, the path has been cleared for the expansion and diversification of energy production on a significant scale".

[2] Daily Maverick Opinionista, "A new era in energy generation", Cyril Ramaphosa, 18 December 2019. www.dailymaverick.co.za/opinionista/2019-12-18-a-new-era-in-energy-generation/

This powerful commitment flies in the face of ongoing uncertainty and criticism that there is no ability or willingness to rethink private power generation in South Africa.

Stabilising energy availability; providing room for scheduled maintenance; and sending a signal, not only that there is a plan to manage the Eskom crisis (at least to stabilise chaotic load shedding), but also that government is willing to re-evaluate, to think differently, and seek solutions that challenge the status quo, despite inertia, vested interests and factional resistance, would be a grand step in the right direction to structural reform of the economy.

But words aren't enough, we need to see these commitments come to life. ✚

BOND OUTLOOK

Valuing South African debt

"The best time to plant a tree was 20 years ago. The second best time is now." – Chinese proverb

By **NISHAN MAHARAJ**

THE QUICK TAKE

- Local economic woes and policy inertia continue to weigh on SA bonds
- Monetary and fiscal policy, as well as global cost of capital, drive local yields
- The administration must urgently make some hard decisions, such as cutting the public wage bill
- Our analysis supports the inclusion of SA bonds in a portfolio

Nishan is head of Fixed Interest and has 17 years of investment experience.

THE LAST YEAR of the past decade, 2019, was the Chinese Year of the [Earth] Pig. Despite the images that might spring to mind, in Chinese astrology the pig represents wealth and treasure. Considering the amount of turbulence that was injected into financial markets by geopolitical game changers such as Brexit, the US-China trade war and the Hong Kong protests, the fortunes of the Earth Pig did shine on global equity markets as they closed 2019 up more than 25% in US dollars (as measured by the MSCI World and All Country World indices).

Global bond markets were no exception, as most bond markets saw their yields compress over the course of the year, driven by a slowdown in global growth and a dovish twist by global central banks. Emerging market bonds provided a total return of c. 14% in US dollars as the hunt for yield intensified in a world where $11.2 trillion worth of debt now trades at a negative yield.

This year is the Chinese Year of the [Metal] Rat, which symbolises renewal. For South Africans, this is both auspicious and apt, as few economies need renewal more than South Africa's. Despite the rally in global equity and bond markets, South African bond and equity markets underperformed their global peers. The local economy continued to slow due to concerns about deteriorating government finances and State-owned enterprises (SOEs), and specifically Eskom, as bouts of loadshedding continued to intensify. The All Bond Index (ALBI) produced a total return of 10.3% in rands (13.1% in US dollars), which was driven by a rally in the three- to 12-year area of the curve, as expectations of further interest rate cuts continued, given the low growth and contained inflation environment. The slow pace of policy change and implementation, and the requisite tough decisionmaking, will continue to weigh on the country into 2020. That said, the flower that blooms in adversity is the most rare and beautiful of all, so let's hope South Africa can learn and heal from its damaged past, rather than run from it.

FINDING THE SWEET SPOT

The only way a leopard can change its spots is by going from one spot to another. In 2020, the spotlight will be on South Africa's policymakers >

and their ability to change the course of the local economy and show marked progress in the right direction. As long-term investors, our key objective is to make sure that we price risk correctly and that our clients' portfolios are robustly positioned. We do this by ensuring that they are well diversified, avoiding the risks that accompany positioning towards a single-market outcome.

This implies that a great deal of time is spent on understanding the fundamental drivers of asset prices and whether the assets we hold on behalf of our clients are adequately priced with a sufficient margin of safety to buffer against short-term adverse volatility. For South African government bonds (SAGBs), this implies understanding the fundamental direction of the local economy and ensuring that they are priced to reflect prevailing and expected conditions.

THE ECONOMY OF SOUTH AFRICAN YIELD

There are three key drivers of SAGB yields:

1. Monetary policy expectations

Monetary policy is driven by inflation and the growth outlook. Inflation is expected to average close to 4.5% over the next two years, which is at the midpoint of the inflation targeting band, while growth is not expected to reach 1.5% until 2021 (South Africa's growth has averaged sub-1% since 2015), while global growth is expected to average just above 3%. The Monetary Policy Committee (MPC) has reiterated that it wants inflation to maintain the midpoint so that it can use monetary policy more effectively during times of crisis.

THIS SEEMS LIKE THE END OF THE WORLD, BUT WE SHOULD NOT FORGET THAT SOUTH AFRICA HAS A VERY DEEP AND LIQUID BOND MARKET.

South Africa's economy is struggling to grow, and although monetary policy is a blunt tool, it can be used to boost confidence and relieve some consumer pressure. Currently, real policy rates are above 2% and, if the repo rate does not move, the real policy rate will average 1.7% over the next two years. In previous cycles, when growth was this low, the real policy rate averaged close to zero. This suggests that there is room for the MPC to move policy rates at least 50 basis points (bps) lower over the next year.

2. Fiscal policy expectations

In South Africa, fiscal policy has been on a slippery slope since the Global Financial Crisis, as the administration has struggled to narrow the fiscal deficit and government debt has ballooned. The reasons for this are well known, but in recent years the slowdown in growth has decreased tax revenue, while expenditure has continued to increase to rescue ailing SOEs (Eskom, SAA and Denel). Eskom has been and remains the biggest risk to the local economy. Turnaround plans have been tabled and key personnel have been replaced, but due to the extent of a decade-plus of maladministration and corruption, operational turnaround has been slow. It is inevitable that financial support will be ongoing, and government will need to cut expenditure in other areas to keep the nation's ailing power supplier online.

The February 2020 Budget will be another watershed moment, as investors will again look to policymakers to make the hard, shorter-term decisions, such as freezing or cutting the government wage bill despite union objections. Most ratings agencies have given up hope on South Africa and moved us into subinvestment territory.

Moody's is the only agency that has retained South Africa at investment grade, which keeps us in the FTSE World Government Bond Index (WGBI). However, given the deterioration seen over the last year, it is very likely that they will downgrade South Africa in 2020, which should see outflows from the local bond market of between R70 billion and R120 billion. This seems like the end of the world, but we should not forget that:

a) South Africa has a very deep and liquid bond market.
b) The local savings industry is very large and sophisticated.
c) The fundamental deterioration and risks around it have been well flagged over the last two to three years, so investor positioning has adjusted accordingly.
d) South Africa comprises less than 1% of the WGBI, so at current valuations, investors might choose not to exit.

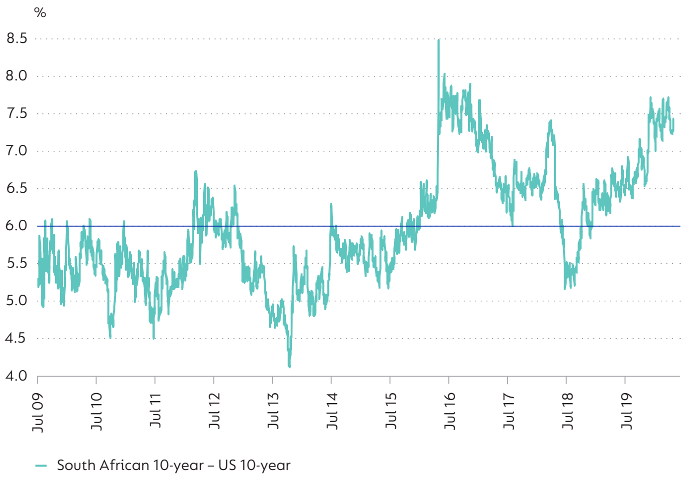
While we are likely to see some fiscal effort in the budget and some tough stances regarding SOEs, keeping the policy trajectory headed in the right direction, that doesn't rule out an exit from the WGBI. In the worst case scenario, government doesn't manage to paint a better scenario in 2020 and South Africa exits the WGBI, but that does not mean the end of the world for SAGBs, given the current risk premium embedded in assets (refer to the point below).

3. Global cost of capital

Global bonds are trading close to all-time lows due to the slowdown in global growth, the flight to safe-haven assets because of geopolitical uncertainty, and the dovish twist seen by global central banks in 2019.

Figure 1

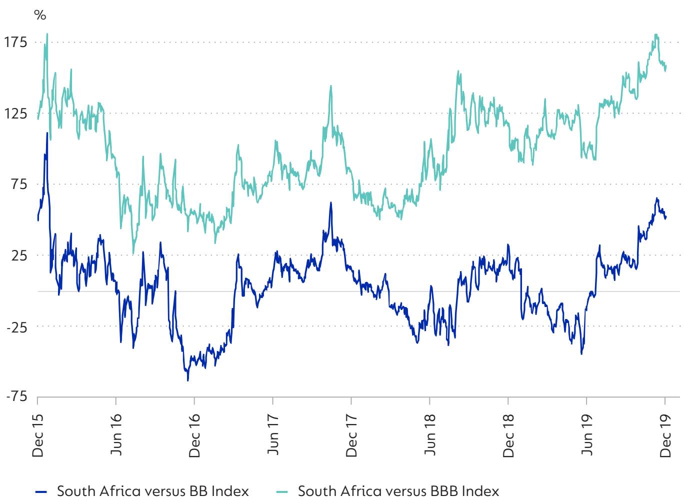
SOUTH AFRICAN 10-YEAR VERSUS US 10-YEAR SPREAD



Sources: Bloomberg, Coronation

Figure 2

SOUTH AFRICA'S CREDIT SPREAD VERSUS THE IG AND SUB-IG INDICES



Sources: Bloomberg, Coronation

It is inevitable that bond yields will move higher over the next five to 10 years; however, in the next two to three years, they could also move lower before moving higher. Global inflation remains low, with global growth set to remain sluggish.

Central banks around the world have continued to inject large amounts of liquidity into financial markets to keep crises at bay and will continue to engineer a soft landing for the global economy. This might not be the goldilocks economy of the early 2000s for emerging markets, but it will definitely be less turbulent than what we have seen previously. Until we see a turn in global inflation, one should not expect a ramp-up in global policy rates, which means that global bond yields should see only moderate fluctuation.

The backdrop for SAGBs is therefore mixed. Monetary policy should be supportive, fiscal policy will remain in the spotlight and the global cost of capital, although it should remain supportive in the short term, might be unfriendly over the longer term.

However, from a valuation perspective, these risks seem to be adequately priced. First, SAGBs' spread over the US 10-year (global risk-free) rate is quite extended (see Figure 1). This suggests enough room for SAGBs to absorb a move higher in global bonds. The follow-on question would surely be: if South Africa continues to deteriorate, should the breadth of the spread represent credit-worthiness? At current levels, however, South Africa's credit spread already trades very wide relative to both the investment grade (IG) and sub-IG indices (Figure 2), suggesting that further deterioration away from even sub-IG norms is being priced.

THE RIGHT PRICE?

Despite what might seem like an impressive return relative to cash in the local context, SAGBs have underperformed their peers considerably over the last five years due to a fundamental deterioration in South Africa. In the last five years, SAGB nominal yields have risen by 148bps, while the implied 10-year real yield has risen by over 200bps. This compares to the emerging markets average of a 61bps compression in nominal yields and a relatively small compression in implied real yields. As such, SAGBs are now the cheapest in the emerging market universe from an implied real yield perspective and the second cheapest from a nominal bond perspective (Table 1 on page 16).

Constructing a fair value for SAGBs using the global risk-free rate, inflation differentials (the difference between South African and US expected 10-year inflation – see Table 2 on page 16) and a measure of credit-worthiness for South Africa (the South African credit spread) also suggests that the South African 10-year bond, currently trading at 9%, is at inexpensive levels. Even adjusting current variables for expectations around a rise in the global risk-free rate brings one to a similar conclusion. The confluence of this evidence suggests that SAGBs are adequately priced for current risks.

FINDING VALUE

We believe that bonds at the longer end of the curve continue to offer the best value. To ascertain which point on the SAGB yield curve is the most attractive, we use a total return analysis with a three-year horizon period across >

various bond maturities. Table 3 shows how these bonds will perform if:

1. The yield curve moves parallel up 1%;
2. The yield curve moves parallel down 1%;
3. How much each bond can sell off before it breaks even with the ALBI; and
4. How much each bond can sell off before it breaks even with the 10-year bond (R2030).

The previous analysis, taken together with the fact that the difference between the 30-year and 10-year areas of the SAGB yield curve is close to the widest it has ever been (1.39% during the taper tantrum of 2013), suggest that bonds at the longer end of the curve continue to offer the best value in our view.

PORTFOLIO ALLOCATION

Inflation-linked bonds (ILBs), once again, underperformed nominal bonds in 2019, with a return of 2.6%. Only shorter-dated inflation-linked bonds provided a positive return, albeit below cash. A five-year ILB trades at a real yield of 3.6%. Using expected inflation of 4.5%, if one holds this bond for the next three years, the nominal return would be in excess of 8%, which compares very favourably to equivalent maturity nominal bonds.

In addition, with expectations for the real policy rate to move closer to 1%, it makes the carry-on shorter-dated ILBs even more attractive. At current levels, shorter-dated ILBs therefore do warrant a position in a bond portfolio.

The South African economy has been plagued with low growth, ballooning government finances and a volatile global geopolitical environment. Low growth and well-contained inflation suggest the trajectory for South Africa's policy rates to be lower over the next 12 months.

In addition, South African bonds have continued to underperform relative to their global and emerging market counterparts, suggesting an increased risk premium, given South Africa's precarious economic backdrop. At current levels, SAGBs seem adequately priced relative to underlying risks, which suggest a neutral allocation in portfolios. +

Table 1

SAGBs NOW THE CHEAPEST IN THE EMERGING MARKET UNIVERSE

	Nominal yield	Implied real yield	5-year change in nominal yield	5-year change in real yield
Turkey	11.9	0.4	4.22 ▼	(0.42) ▲
South Africa	**9.0**	**4.0**	**1.48** ▼	**2.14** ▼
Indonesia	7.1	3.5	(0.61) ▲	1.81 ▼
Mexico	6.9	3.3	0.96 ▼	1.02 ▼
Brazil	6.8	3.0	(5.17) ▲	(2.42) ▲
India	6.5	2.6	(1.42) ▲	(0.13) ▲
Russia	6.2	2.4	(4.54) ▲	(1.42) ▲
Average	**5.0**	**1.3**	**(0.61)** ▲	**(0.21)** ▲
Malaysia	3.3	1.4	(0.56) ▲	1.10 ▼
Chile	3.2	0.3	0.00 ▶	0.44 ▼
China	3.1	0.6	(0.41) ▲	(0.43) ▲
Poland	2.1	(0.5)	(0.39) ▲	(1.52) ▲
Hungary	2.0	(1.1)	(1.57) ▲	(2.03) ▲
Czech Republic	1.5	(0.7)	0.81 ▼	0.36 ▼
Israel	0.8	(0.4)	(1.36) ▲	(1.39) ▲

Sources: Bloomberg, Coronation

Table 2

SAGBs ADEQUATELY PRICED FOR CURRENT RISKS

	Current	Expected
US 10-year	1.92%	2.75%
South African 10-year expected inflation	5.04%	5.00%
US 10-year expected inflation	1.78%	2.00%
South Africa's credit spread	2.94%	2.94%
Fair value estimate	**8.12%**	**8.69%**

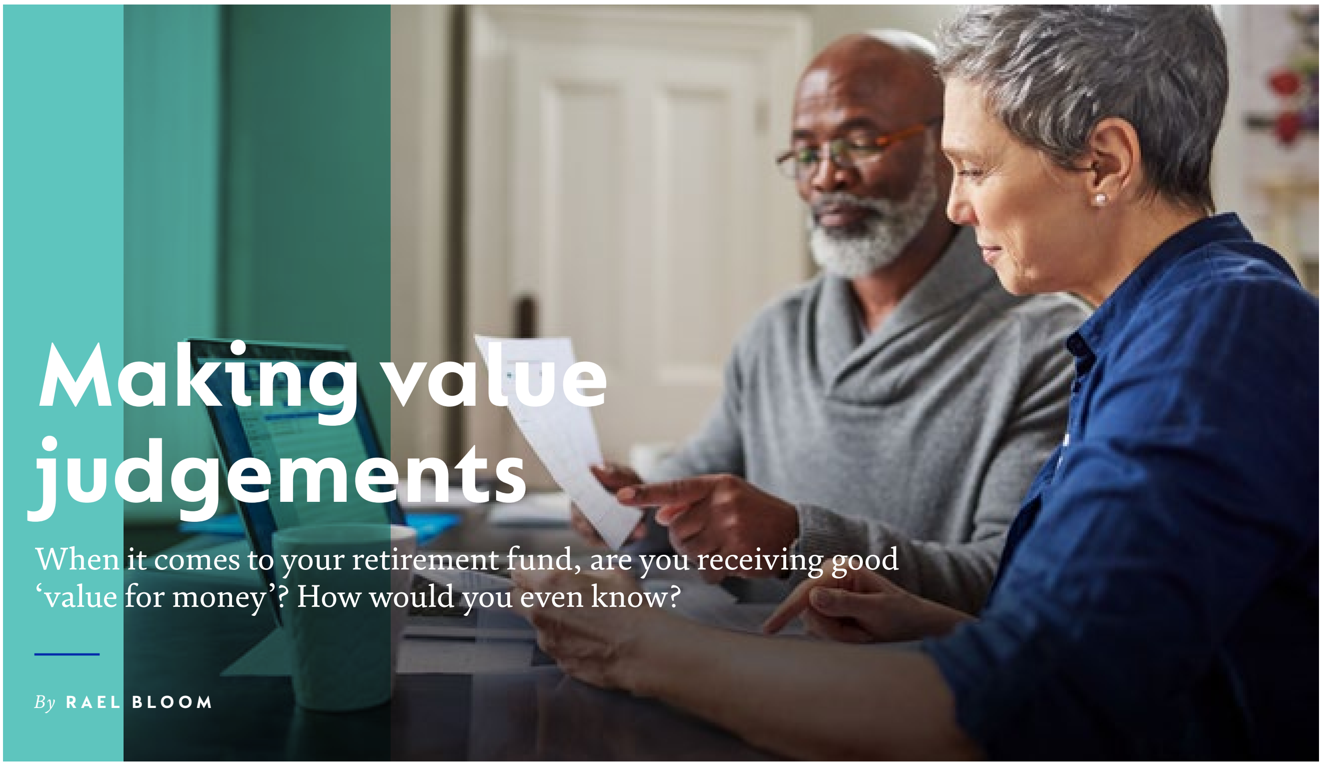
Sources: Bloomberg, Coronation

Table 3

TOTAL RETURN ANALYSIS (THREE-YEAR HORIZON)

			Total return			
Bond	Maturity	Current yield	Yield curve sells off by 1%	Yield curve rallies by 1%	Breakeven relative to ALBI	Breakeven relative to 10-year (R2030)
R186	21 Dec 26	8.25%	9.93%	7.86%	(1.41%)	(1.16%)
R2030	31 Jan 30	9.02%	11.43%	7.99%	(0.42%)	
R2035	28 Feb 35	9.73%	12.85%	8.18%	0.01%	0.13%
R2040	31 Jan 40	10.03%	13.51%	8.17%	0.11%	0.22%
R2044	31 Jan 44	10.10%	13.82%	8.08%	0.13%	0.23%

Sources: Bloomberg, Coronation



Making value judgements

When it comes to your retirement fund, are you receiving good 'value for money'? How would you even know?

By **RAEL BLOOM**

THE QUICK TAKE

- The retirement industry is about delivering value for money to its members
- Assessing value for money is not an exact science – informed judgement is required
- Costs are critically important and should be commensurate with the scope and quality of service provided
- Regulation, consolidation and improved transparency have increased our understanding of both value and cost

Rael is a product development actuary and has 16 years of industry experience.

VALUE FOR MONEY (VFM) is ultimately about deciding whether the benefit (i.e. the value) of buying something justifies the cost (the money). But we know that making VFM decisions is almost never straightforward. If you are buying a new smartphone, do you go for the cheapest option that does the job, or do you pay more for one with better features? What features are important to you? Is it size, build, battery life, display, camera, or perhaps it is the brand? And once you have an idea of how features compare, how do you weigh these up to decide which phone is best for you, given your needs and the price?

A RELATIVE GAME

With any purchase, value is in the eye of the beholder. Creating a shortlist is usually easy – discard the items that don't have the features you need and the ones that are unaffordable. But once you have that shortlist, you need to make a judgement call. We also know that it's very difficult to ever really know if you have maximised value for money – after all, nobody likes to miss out. Even though VFM is not an exact science, this does not mean that trying to evaluate VFM is pointless.

A VFM assessment is an important exercise, particularly for big financial decisions. To do this, you need a framework for making a decision that helps you to evaluate the importance of features and benefits, and how much you are prepared to pay for them.

THINGS TO CONSIDER

When it comes to saving for retirement, VFM is deceptively simple – invest in order to maximise after-fee outcomes, which include financial and non-financial returns. However, the devil is, as always, in the detail:

1. The players: There is a range of different roles within the retirement industry. These include fund sponsors, trustees, lawyers, auditors, administrators, consultants, investment managers, regulators and so on. Each of these provide and charge for their respective services, and together they form the retirement value chain.

2. No crystal ball: When you buy a smartphone, you know what you will get – push X (or ask Siri/Alexa/Google to do it for you) and Y will happen. >

However, when it comes to investing, the future is inherently unpredictable, and it is impossible to make a decision that will, with absolute certainty, maximise your future after-fee outcomes.

3. Fees are easier to understand: The difficulty with measuring VFM means that many commentators tend to look to past returns and narrow in on costs because this is the most predictable and measurable component of VFM. While we fully agree that inappropriately high costs can have a detrimental impact on retirement outcomes, we feel that the simple focus on fees alone does not provide a meaningful and accurate assessment of VFM.

4. Price check? A big challenge in assessing VFM is comparability across offerings given the different ways in which providers charge for their services. The industry has put in place measures to help improve transparency and comparability – more on this below.

VFM AND RETIREMENT SAVINGS

So how do you assess VFM when it comes to retirement fund matters? First, you need **clear objectives or goals** against which to measure outcomes. What are you trying to achieve, and how will you assess success? This is not about investment performance alone, but rather about requirements across the full value chain. This helps you to set out your requirements, considering:

- The **range and quality of services** that you need to assess the options available to you in the market.
- **The costs** of each component, including how and why they might change over time.
- Access to the **skills and experience** to evaluate and understand your options, for example, by employing the services of professional trustees and consultants.

There are few topics more emotive than costs. Costs are after all, a mathematical certainty – for any given return, the lower the cost, the better the outcome. Therefore, funds should be aiming for the lowest possible costs for their clients, right?

The reality is that it's a lot more complex than that. First, returns are not a certainty and vary significantly by approach. While attention to the appropriateness of costs are critically important, a focus on costs at the exclusion of everything else will lead to unintended consequences.

When it comes to costs, the questions that we should be trying to answer are whether fees are commensurate with the service provided, and whether they create the right incentives by aligning the long-term interests of retirement fund members and service providers.

INCREASING TRANSPARENCY

Costs disclosure has improved in recent years. In the unit trust market, this started with the introduction of Total Expense Ratios (TERs) in 2007 and, more recently in 2017, Effective Annual Charge (EAC) disclosures. In the institutional retirement industry, the Association for Savings and Investment in South Africa's (ASISA) Retirement Savings Cost (RSC) Disclosure Standard came into effect in 2019 and is designed to help employers make better cost comparisons between different umbrella funds. RSC separates out the cost components, including the costs of advice, administration, investment management and 'other' costs.

This should, in turn, help to separately assess the VFM of each component. ASISA has also released a standard for the disclosure of EACs to members of retirement funds, which will become effective in 2020. The Default Pension Regulations, which became effective in March 2019, require comprehensive disclosure on the costs of default investments and should further improve cost transparency, and hence allow for better assessment of value.

INVESTMENT MANAGEMENT COSTS

Investment costs are a significant contributor to the overall costs of running a retirement fund. Investment fees have come down over time, helped by increased competition and the consolidation of smaller funds into umbrella funds.

Consultants have also played an important role in driving competition within the investment industry by assisting their clients with selecting and monitoring managers and negotiating commercial terms.

Larger retirement funds generally benefit from economies of scale and stronger bargaining power. According to the Financial Sector Conduct Authority (FSCA), the number of South African retirement funds has reduced from 13 000 to just under 1 500 over the past 10 years. Going forward, the regulator would like to see further consolidation to simplify the regulatory regime and further improve economies.

LARGER RETIREMENT FUNDS GENERALLY BENEFIT FROM ECONOMIES OF SCALE AND STRONGER BARGAINING POWER.

Appropriately structured performance-based fees have been a prevalent feature of many of the larger retirement funds in South Africa for many years. This has ensured that the fees charged for active management are directly linked to performance delivered. Performance fee methodologies have evolved over time to ensure alignment, appropriateness, transparency and ease of understanding.

In addition, investment costs should always be seen in the context of the portfolio strategy. For example, some retirement funds invest in more expensive alternative asset classes (e.g. infrastructure), while high-equity portfolios are typically more expensive than low-equity portfolios. Fees also vary across different investment strategies – most notably whether a strategy is actively managed or tracks an index.

COST OF RUNNING A RETIREMENT FUND

So how much does it cost to run a retirement fund? While RSC data are not yet widely available, funds do produce financial statements. The Registrar of Pension Funds' Annual Report for 2017 provides a consolidated view of the retirement fund industry. Regulated funds had total assets under management (AUM) of approximately R2.4 trillion, with total 'expenses incurred in managing investments' of R7.4 billion (0.3% of AUM) and total administration (and other) expenses of R9.5 billion (0.4% of AUM).

The investment fee of 0.3% appears low and it is worth considering why. It is likely that the larger funds with the bulk of the AUM bring down the average. Similarly, some funds manage their investments inhouse or use lower-cost passive strategies.

There is also often a high use of performance-based fees on their active mandates. Active management has struggled over the past five years, and it is likely that the lower fees paid by many retirement funds reflect the fact that their active managers have tended to underperform their benchmarks in recent times.

Furthermore, some of the fees incurred in pooled vehicles may not be included in these numbers. However, even if you adjust for this, it is reasonable to conclude that investment fees are probably lower than many would expect. Naturally there are funds that do pay inappropriately high fees on behalf of their members, and one of the FSCA's current goals is to identify those funds and ensure ameliorative action is taken.

If we dig a bit deeper, we find that most large retirement funds publish their own annual statements on their websites. Table 1 shows the fees incurred by a sample of large funds (with total assets greater than R20 billion) using each of their most recent published annual reports.

Table 1

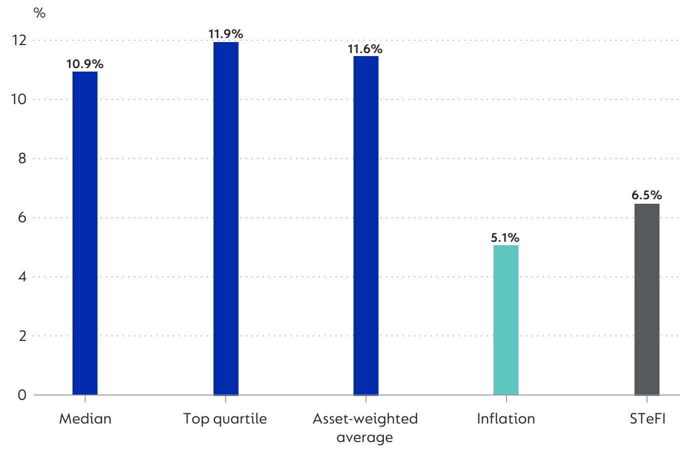
TOTAL COSTS VERSUS EXPENSES IN RETIREMENT FUNDS

Fund	Total costs (as % of average assets)	Expenses incurred in managing investments (as % of average assets)
Fund A	0.52%	0.36%
Fund B	0.66%	0.45%
Fund C	0.89%	0.45%
Fund D	0.80%	0.39%
Fund E	0.94%	0.65%
Fund F	0.80%	0.57%
Fund G	0.52%	0.34%

Source: Coronation research

Figure 1

ANNUALISED PERFORMANCE FOR THE 10 YEARS ENDING NOVEMBER 2019



Source: Alexander Forbes Large Manager Watch November 2019

Based on the sample data, investment costs varied between about 0.35% to 0.65%, and total costs (investment plus administration) varied between 0.5% to just under 1%.

VALUE CREATION

While value is created (and should be assessed) across all parts of the value chain, for simplicity we focus on investment performance. Figure 1 shows the performance of the Alexander Forbes Large Manager Watch over the past 10 years. This reflects the actual historic performance of the largest multi-asset class funds in South Africa used by retirement funds and is a reasonable representation of industry performance.

It is notable that the asset-weighted average is 0.7% per annum higher than the median manager, equating to 7.2% cumulatively over that 10-year period. What this suggests is that retirement funds have generally allocated well over time, because the bulk of the money >

has been invested with the better-performing managers. We see similar results when looking at a broader universe of investment managers in the survey. It also puts the range of investment costs (Table 1 on page 19) into perspective; the range of fees paid is relatively small in comparison to the potential performance impact of a fund's asset allocation and manager line-up, showing that it has been worth paying slightly higher fees for better returns.

ACTIVE MANAGEMENT VERSUS INDEXATION

No discussion on VFM is complete without looking at the difference between active and passive investing. While this is hugely topical worldwide, it is a debate we don't ventilate often because we are unashamedly active in our approach, but also agree that there is a place for index-based investing. We prefer to explain what it is that we do and how we go about it, and show the value that we have delivered for our clients over the long term. The allocation decision then naturally sits with the asset owner, where it belongs.

The pros and cons of each approach are generally well understood and do not need to be reproduced here. From a VFM perspective, the key point to reiterate is that the future is unknown, and no investment strategy can guarantee that it will outperform another. Investment markets perform in cycles and these cycles often last for long periods.

For example, index trackers have performed well (globally) since the end of the Global Financial Crisis in 2009. But cycles do eventually turn, even though it is impossible to know exactly when this will happen. Therefore, a VFM exercise that focuses on recent past performance may lead to sub-optimal decisions. A more effective approach to VFM may be to consider which strategies are appropriate for which markets, considering market efficiency, performance expectations and costs.

A blend of high-quality investment managers with sound philosophies, strong processes and skilled teams should, on a balance of probabilities, deliver good value to members over the long term. These blends may (or may not) include allocations to index strategies – based on the judgment of the asset allocator having regard for VFM, diversification and other factors. It is also worth noting from the section on fees above that the fee gap between active and index-based investing does not appear to be as high as traditionally thought, particularly where good performance fee structures are in place.

STEWARDSHIP AND ESG

The importance of retirement funds and their investment managers acting as responsible stewards of investor capital has grown rapidly over the past decade. In 2019 this kicked into high gear, with investors and regulators demanding even greater action to ensure that investments are made responsibly in order to ensure long-term sustainability.

Promulgated in 2011, regulation 28 (2)(b) of the Pension Funds Act requires trustees to consider environmental, social and governance (ESG) factors when setting out fund mandates; in 2019, the FSCA released a guidance note that sets out its expectations for how funds should go about meeting these obligations. This includes the requirement for funds to apply active ownership practices to encourage investee companies to behave in a sustainable manner.

Stewardship and engagement are beneficial because they enhance shareholder value and support investors in the execution of their fiduciary duty. This responsibility is usually delegated to investment managers, and funds therefore need to be satisfied that the managers that they appoint have robust ESG practices and can act as responsible stewards of their capital. This is another important VFM consideration. When evaluating an investment manager, funds should not only consider the traditional factors, such as performance, risk management and service, but also whether the manager will enable the fund to meet its sustainability obligations.

THE IMPORTANCE OF RETIREMENT FUNDS AND THEIR INVESTMENT MANAGERS ACTING AS RESPONSIBLE STEWARDS OF INVESTOR CAPITAL HAS GROWN RAPIDLY OVER THE PAST DECADE.

Active ownership is most effective when managers have informed dialogue with investee companies to influence meaningful long-term outcomes. It is therefore difficult to decouple company analysis from active ownership because of the need to understand the activities of the companies with which you engage.

ARRIVING AT GOOD VALUE

How do we bring all of this together? First, we need to be clear about the conditions required for ensuring good VFM:

- Be clear about the outcome you require and the services that you need to achieve this outcome. Focus on the total benefit and costs across the full value chain.

- For investments, understand that future returns are unknown and VFM decisions require informed judgement. Ensure that all aspects of investment management are covered, including the need for effective ESG practices.

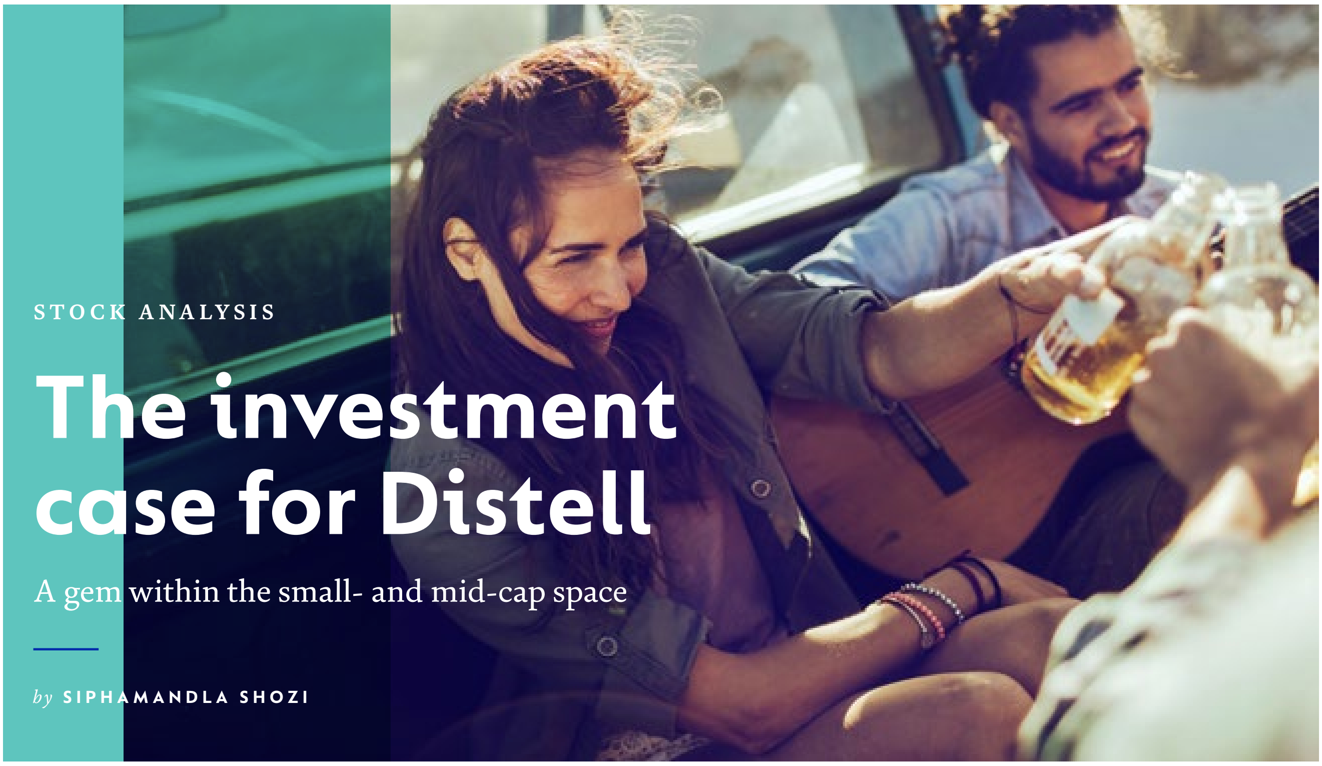
- Understand your costs and make sure that they are competitive and commensurate with the quality and scope of services provided, and create the right incentives for good member outcomes.

- Avoid conflicts of interest wherever they may create conditions that work against member best interests.

Ultimately, member interests (and hence VFM) are best served by a competitive, transparent and well-regulated market with low barriers to entry. While there is always room for improvement, the industry does by and large meet these criteria. Professional consultants foster competition and transparency between providers, and fee disclosures and comparability are improving.

Fund consolidation should improve efficiency – with the caveat that large funds should carefully manage any conflicts between the interests of sponsors and members.

At an industry level, if we want to significantly improve VFM, the bigger issues need to be addressed, such as ensuring that more people contribute higher amounts to retirement funds, preservation rates improve, and better decisions are made at retirement. The Default Regulations attempt to address many of these issues. Most members gravitate to defaults, which should reduce complexity and increase the focus on ensuring that defaults provide good VFM to members. However, the effectiveness of the Default Regulations will only become evident in time. ✚



STOCK ANALYSIS

The investment case for Distell

A gem within the small- and mid-cap space

by **SIPHAMANDLA SHOZI**

THE QUICK TAKE

- Distell boasts a diversified portfolio of brands, which generally rank first or second in their respective categories
- Exposure to the fast-growing cider market is a key driver for future growth
- For beverage companies, Africa presents a multiyear opportunity for growth
- Quality management and a clear strategy are key to unlocking value

Siphamandla is a portfolio manager with 15 years of investment experience.

THE SMALL- TO MID-CAP space is littered with a lot of poor-quality companies. Such companies tend to flourish under favourable economic conditions and struggle or cease to exist when conditions deteriorate. They also often exhibit a combination of the following characteristics: lack of scale, price taking, inexperienced management teams, weak balance sheets and lack of product diversification.

As a result of these factors, the market generally punishes the small- to mid-cap sector by awarding a discount to its rating relative to the market. So, when we find a small- or mid-cap counter that generally displays the opposite of the above characteristics but is priced attractively, we get very excited. We think Distell is one of those companies.

Distell is an alcoholic beverages business with its head office located in Stellenbosch. The company boasts a diversified portfolio of brands across several categories including ciders, spirits and wines, and generally ranks first or second in these categories. Production facilities are spread throughout South Africa as well as various countries on the African continent and in Europe. Some of Distell's well-known brands include Savanna, Hunter's, Viceroy and Klipdrift. Figures 1 and 2 show the split of profits by product categories and main geographies. The biggest contributor to profits is ciders (42%) and the biggest region is South Africa (74%).

TRENDS TIP THE BALANCE

The South African alcohol market is mature, exceeding R200 billion in annual spend and a relatively high per capita consumption. Overall market growth has been very pedestrian over the past decade, and changes in market share between categories and premiumisation have been the key drivers of growth.

The beer category has the largest market share, but has been losing ground to other categories, including ciders and spirits. Trends in the consumption of alcohol have been changing from single- to mixed-gender occasions, the rejection of beer by health-conscious millennials and a notable increase in female drinkers.

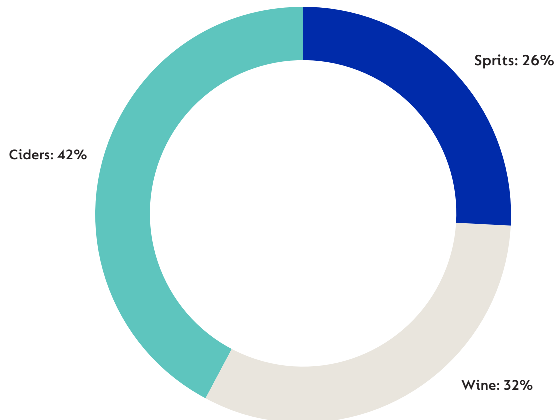
AN APPLE A DAY

This shift requires companies to have a broad portfolio of brands to cater to these trends. Luckily, Distell has a portfolio that is very well suited to these changing market dynamics. Over the past couple of decades, the growth in cider has been phenomenal, at two to three times the rate of beer. In South Africa, the category now occupies 9% of the market, compared to around 6% to 7% internationally, making it the second biggest cider market in the world after the UK.

Distell produces Savanna and Hunter's, the number one and two brands on the market, with a combined share of over 80%. These ciders have led to an impressive growth in group volumes and revenue of 5% and 10% per annum, respectively, over the past 10 years. This stellar growth is even more impressive when one considers that growth in the spirits and wine categories has been lacklustre due to the maturity of these markets.

Figure 1

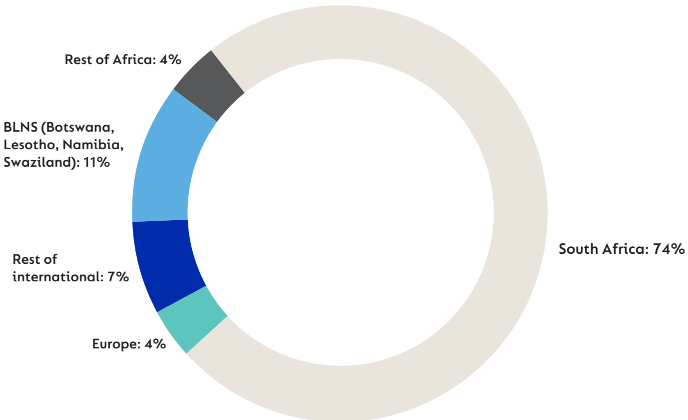
EBIT CONTRIBUTION BY PRODUCT



Sources: Distell Annual Reports, Coronation estimates

Figure 2

EBIT CONTRIBUTION BY REGION



Sources: Distell Annual Reports, Coronation estimates

THE COMPETITIVE EDGE

This growth has also attracted several competitors into the category. In South Africa, consumers tend to lump ciders together with other flavoured alcoholic beverages (FABs) as one category, thus creating a bigger pool for competitors to attack one another. The biggest competitors we worry about are Amalgamated Beverage Industries' (ABI) Flying Fish (a flavoured beer) and Heineken's Strongbow (a cider). While Flying Fish initially had some impact, it has faded, as ABI has been distracted by bedding down its acquisition of South African Breweries (SAB). On the other hand, Heineken, which boasts the largest cider brand (Strongbow) in the world, has had a negative impact, especially on the Hunter's brand.

However, Distell's overall market share has surprisingly increased during this period. The company has been able to innovate by introducing brands like Bernini, a wine cooler, which leverages its strength in the wine market into the FAB category. This innovation has allowed Distell to fend off narrow competition looking to attack some of its big brands. It also demonstrates the value of having a deep, diversified portfolio of brands to choose from. Given the low overall market share of the cider category, we believe the category has more legs for growth.

NETWORK OPTIMISATION

Due to historical reasons, Distell's distribution of production facilities has been below optimal. This has contributed to a significant number of inefficiencies in its supply chain. A massive project to correct this has been undertaken, which involved closing some facilities while relocating others closer to their respective markets. The benefits of this are multifold. Being closer to the markets allows better response times while reducing inventory holding time, thereby reducing the working capital cycle.

Moving production to bigger, scalable sites and decommissioning smaller, inefficient operations should also result in a lower unit cost of production. These changes should improve both margins and free cash flows over the next few years.

AFRICAN EXPANSION

Excluding the last five or so years, Distell's exports to African countries were booming, growing at double digits for several years. However, the slump in commodity prices led to currency fluctuations and a decline in demand for imported products in these countries. Some even raised import duties as they scrambled to fill gaps in their fiscal funding. This exposed the fragility of Distell's export model as markets such as Angola, >

which used to import in excess of 30 million litres of Distell's ciders, became miniscule. As a result, Distell has been evolving its Africa strategy. While previous exports had been pretty much split evenly between the three product categories, their main thrust will now be through mainstream spirits, with ciders and wine complementing this.

Mainstream spirits are one of the fastest growing alcohol categories in Africa. The category is still very fragmented, with a number of regional, privately owned players in the game. However, Distell has a lot of experience in the category, being the biggest producer of mainstream spirits in South Africa, and should be able to leverage this knowledge into developing the category in these markets.

In order to defend against import duties and currency fluctuations, Distell created in-country production facilities and increased local sourcing, while partnering with local operators to build a strong route to market. A couple of acquisitions, Best (Angolan) and KWA (Kenyan), were done to create critical mass and leverage existing production facilities. These are some of the fastest growing mainstream spirits companies in Africa.

Multicategory production facilities have already been built in these countries, including Nigeria, and should start ramping up over the next few months. This should enable the African business to be more resilient through the cycle while participating in the inherent growth potential of these markets. Recent results have been promising as revenue grew strongly by 19%.

We think Africa offers a multiyear opportunity from which patient investors should be able to reap rewards in the years ahead.

FRESH PERSPECTIVE

Just over five years ago, significant changes in management were implemented at Distell. Although previous management had led the company well for a decade and a half prior to that, it became clear that there was a need for fresh blood to take the company to the next level. The appointment of Richard Rushton who had previously worked at SAB in Latin America was a game changer for the business. He has executed on the strategy in an exemplary manner, improving production efficiencies, expanding distribution, strengthening the route to market, changing the Africa business model and reducing the international footprint, as well as selling underperforming brands like Bisquit. This led to an increased focus on margins, returns and capital allocation.

We had always believed in the potential of the brands under Distell, but felt that more could be done with them under a different management team. With the current management team, we have faith that the full potential of this homegrown business is being realised, some of which will become apparent to the market over time.

THE BOTTOM LINE

At the end of the day it all boils down to valuation. Distell trades at a forward multiple of 11 times to our assessment of normalised earnings, which is very attractive. As such we continue to be significant shareholders in Distell. ✚

GLOBAL EMERGING MARKETS

Demonetisation: India's bolt from the blue

What did this programme really achieve?

by **SUHAIL SULEMAN**

THE QUICK TAKE

- Demonetisation failed to punish beneficiaries of illicit activity/parallel market operators as intended
- Constraints on withdrawals relative to immediate high deposits led to excess liquidity in the banking sector
- Money market and similar instruments became attractive savings vehicles, with above-inflation interest rates
- The demonetisation process indirectly caused some of the issues that led to defaults by some non-banking finance companies

Suhail is a portfolio manager within the Global Emerging Markets investment unit.

IT'S BEEN JUST over three years since 8 November 2016 when, without prior warning, the government of India announced a cabinet decision that all existing Rs500 and Rs1 000 notes (then worth $7.50 and $15.00, respectively) would cease to be legal tender from midnight. In light of the deceleration of India's economic growth rate and liquidity issues in its banking sector, it is worth revisiting the impact of this 'demonetisation' programme on the intervening years.

At the time of the announcement, the government also laid out the path forward to manage this exercise. The following day, 9 November, would be a banking holiday when no deposits or withdrawals would be allowed. From 10 November, all holders of these notes would have to deposit them into a bank account or exchange them for either smaller-denomination notes or a new series of high-denomination notes before the end of the calendar year. The old notes could be used for a short time for a narrow range of transactions, with certain public services such as healthcare and train fares listed as exemptions, but by and large, the soon-to-be defunct denominations were essentially useless to holders.

I've looked for data as to what proportion of the total value of outstanding notes these cancelled notes represented at the time, and there is a wide variety of estimates.

Evidence suggests that the cancelled notes represented about 25% of total notes in circulation by volume. However, since these were the two highest denomination notes in the country, they represented over 90% of cash currency in circulation by value. Reserve Bank of India (RBI) figures show that the total value of notes in circulation at the time of the decision amounted to $260 billion, so something in the region of $240 billion needed to be deposited or exchanged by the end of December 2016.

THE ELEMENT OF SURPRISE

A variety of reasons was given by the government for this drastic measure. Most apparent was the need to curb tax evasion by mainstreaming the >

shadow economy. In theory, this move would either spook tax evaders and other holders of illicit funds for fear of having to disclose their source of income, causing them to cut their losses, or the money would leave the shadow economy and enter the formal economy under the oversight of the banking system and tax authorities. Other reasons cited were along the same lines, such as halting counterfeiting activities and weeding out the proceeds of corruption.

Both individually and as a collective, the aims were laudable, but of course the true measures of success for any policy are, first, whether it achieves its targets, and secondly, the overall cost of implementation. Economists refer to the latter as a 'cost-benefit analysis', and it has been the subject of much debate in India as to whether this exercise was a success overall.

THERE IS (ALWAYS) A WAY

As mentioned, the government expected a material proportion of the cancelled bank notes to be of dubious origin and to leave the system permanently, as their holders would not be able to explain the source of funds. On this metric, the demonetisation drive failed completely.

The RBI estimates that 99.3% of total cancelled notes were either deposited or exchanged. This is an astonishingly high proportion, both in absolute terms and relative to government expectations of 80% to 85%. In discussions with bank executives with whom our investment team meets when in India, the common theme was that people found a way to deposit their illicit money.

The most frequent tactic was to divide large sums into smaller amounts that fell below the suspicious threshold, and then have several 'friends' deposit the money into their own accounts, to be subsequently withdrawn and returned to the originator for a fee or commission.

There were also reports of many businesses accepting the cancelled notes as payment for goods and services, since the businesses could then deposit the money under the pretext of having been in possession of them before they were cancelled.

UNINTENDED CONSEQUENCES

As could be expected in a society where more than 95% of transactions are cash, the demonetisation programme had quite an impact on ordinary citizens. Even with flawless implementation, it would have been difficult to avoid large-scale disruption – and the implementation was far from flawless.

In the days and weeks that followed, India's national pastime became queuing at banks and ATMs to deposit money and withdraw new notes. The banking system was not prepared – there was an insufficiency of new notes and daily withdrawal limits meant that money deposited far exceeded the amount that could be withdrawn on a system-wide basis.

There was also a shortage of smaller-denomination notes, as most people did not want to withdraw Rs2 000 ($22.50) notes, which is a significant amount of money in a low-income country. Additionally, large notes are not readily accepted by merchants, many of whom found themselves struggling due to the lack of lower-denomination notes for their cash floats.

The temporary flood of liquidity into the banking system also had consequences. The shortage of notes and staggered withdrawal limits resulted in people 'parking' their money in fixed-term deposits or money market funds to get returns. Since one could earn interest rates higher than inflation in India (positive real rates), this made sense relative to withdrawing cash that earns nothing in the holder's hands.

A FATAL FLAW

Much of this money found its way into the wholesale funding market, allowing India's non-banking financial companies (NBFCs) to go on a lending spree just as the economy started to slow. One such NBFC, Infrastructure Leasing & Financial Services, defaulted on its debts in August 2018. The default was caused by poor lending practices and a mismatch between the long-term funding required for infrastructure and road projects, and the shorter-term nature of its borrowing book.

The default alarmed the market and led to a flight from the money- and wholesale-funding markets to regular savings accounts with banks, some of which was then withdrawn as cash. Other NBFCs have also since defaulted, most prominently Dewan Housing Finance Limited.

For now, the initial contagion seems to have been contained, but many of the weaker NBFCs have been forced to cut back on loan growth to preserve capital, as wholesale funding dried up for them, or at least was only possible at very high rates that squeezed their profit margins (net interest margins).

The recent slowdown in economic growth in the country is therefore partially attributable to the consequences of demonetisation.

MANY MERCHANTS FOUND THEMSELVES STRUGGLING DUE TO THE LACK OF LOWER-DENOMINATION NOTES FOR THEIR CASH FLOATS.

THE OPPORTUNITY

A positive by-product of the programme was seen in some of the smaller private sector banks that our analysts assess. These banks had been investing in growing their branch infrastructure for several years in the hope of attracting a greater proportion of their revenue from current and savings accounts (CASA). A higher CASA ratio is desirable, since the average interest paid on these accounts is lower than other potential sources of funding.

Customers who deposit money in a bank are also more likely to make use of any retail banking offering available, take out loans or purchase other financial products.

A good illustration is Yes Bank, which was India's fourth largest private sector bank at the time of the demonetisation exercise. In February 2016 (the financial year-end for most Indian businesses as it coincides with the tax year-end), CASA deposits made up 28% (see Figure 1) of Yes Bank's total deposits. By the time end-February 2017 came around, just four short months after the recall, CASA accounted for 36% of total deposits.

At the time, management attributed the spike to a rush of deposits by new customers who opened accounts at any bank they could to avoid dealing with the chaos at the bigger banks. Further, the lack of notes and the economic slowdown that followed demonetisation meant the average duration of deposits was longer than originally expected.

Another private sector bank we follow, with a more established retail franchise, also saw a significant jump in its CASA ratio. Axis Bank's ratio exceeded 50% for the first time in 2017 (see Figure 2), jumping 4% as a result of demonetisation-related inflows.

Figures 3 and 4 illustrate the impact demonetisation had on deposits and currency. Figure 3 tracks total deposits in the banking system and shows that there was a big spike in deposit growth when the programme started (it would have been even higher had no withdrawals been allowed), but collapsed completely thereafter as people were able to withdraw much of the money they had deposited.

Figure 4 shows how total currency in circulation collapsed before resuming its upward trend. This counters the argument that the programme would help the transition to a 'cashless' society over time.

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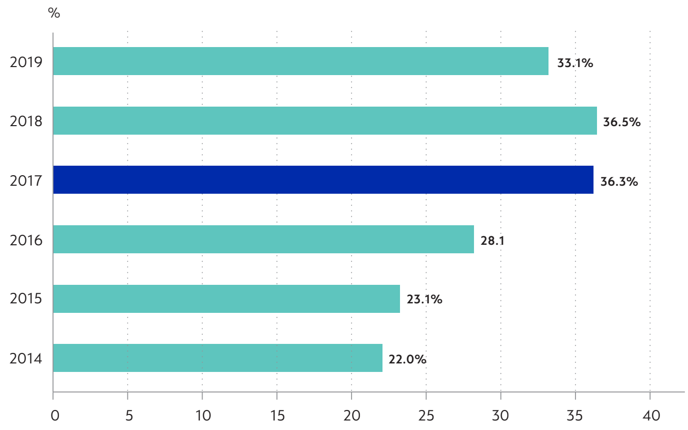
Figure 1

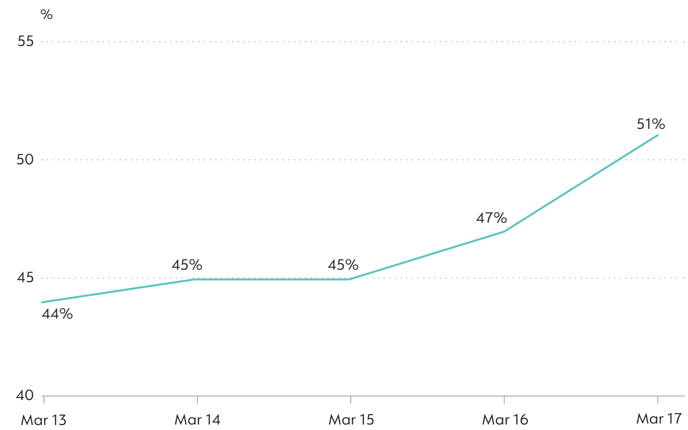
YES BANK: CASA RATIO (5-YEAR CAGR 35.7%)



Source: Yes Bank Annual Report for the year ended February 2019

Figure 2

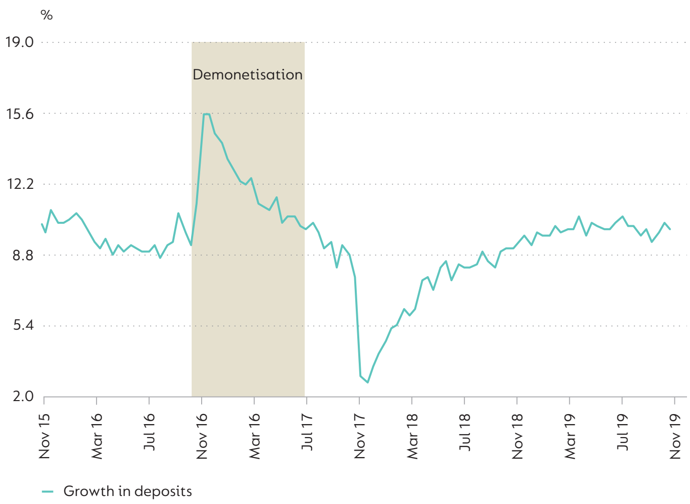
AXIS BANK: CASA RATIO AMONG THE BEST



Source: Axis Bank Investor Relations Presentation June 2017

Figure 3

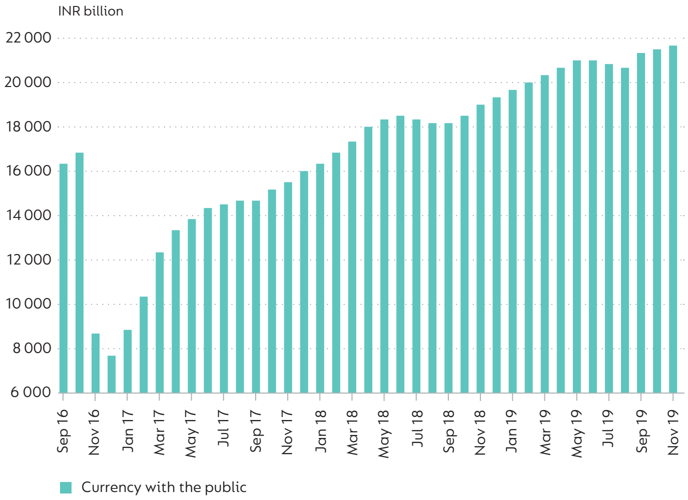
IMPACT OF DEMONETISATION ON DEPOSITS



Source: Edelweiss Financial Services, from RBI fortnightly data

Figure 4

IMPACT OF DEMONETISATION ON CURRENCY



Source: Edelweiss Financial Services, from RBI monthly data

BUT WAS IT WORTH IT?

Based on the evidence presented, it is my conclusion that the demonetisation exercise did not achieve what it set out to do, or certainly not what the government argued would be achieved at the time. When one considers the short-term disruption it caused to Indian society and the medium-term impact it had on the NBFCs, it is probably fair to state that the net impact on India was negative. ✚

CORONATION INSIGHTS

2019 fourth quarter in review

GLOBAL HOUSEVIEW STRATEGY

2019 was a positive year, with the portfolio delivering double-digit returns and outperforming the benchmark. The major building blocks of the portfolio (global and domestic equity, and domestic bonds) performed strongly, with alpha in all of them further lifting returns. The portfolio has performed well against its peer group over meaningful time periods.

Global markets respond to stimulus

After a very weak fourth quarter of 2018, global equity markets rose strongly in 2019 in response to trade war fears receding, combined with looser monetary policy in the US and Europe. The MSCI All Country World Index returned an incredibly strong 26.6% in US dollars for the year and 9% in the fourth quarter of 2019 (Q4-19). All eyes remain on US President Donald Trump as he stands for re-election in 2020 and the reverberating effect his policy will have on Chinese-American tensions.

Elections in the UK saw a stronger-than-anticipated majority for the Conservative Party under Boris Johnson and moved the country closer to a withdrawal from the EU in January 2020. Emerging markets also performed strongly, up 18.4% for the year in US dollars and 11.8% in Q4-19. Notable performances included Russia (+53%), Brazil (+26%) and China (+24%). The portfolio's exposure to emerging market equities benefited from strong market performance as well as some excellent stock picking.

The Bloomberg Barclays Global Aggregate Bond Index was up 6.8% in US dollars for the year and 0.5% in Q4-19. We remain cautious on global bonds given the very low yields at which they currently trade, high levels of government indebtedness and the risk of rising inflation.

Systemic woes remain a drag

In South Africa, the All Bond Index returned 1.7% for Q4-19, bringing annual performance to 10.3%. This compares favourably to other domestic asset classes.

South African investor confidence remains weak, as impatience has set in with the slow pace of much-needed reform. State-owned enterprises are fragile, with South African Airways entering business rescue in Q4-19 and the Passenger Rail Agency of South Africa placed under administration. The rebuilding of critical institutions is under way, with strengthened teams in place at the South African Revenue Service and the National Prosecuting Authority, and, most recently, the appointment of a new CEO at Eskom. The plight of Eskom remains concerning, as years of poor maintenance have resulted in an unstable power utility. Unplanned outages are very disruptive given the lack of spare capacity, and pose a major threat to economic growth prospects. The severe loadshedding experienced in December is expected to have taken a toll on retailers' Q4-19 earnings. Growth continued to disappoint, with a contraction in both the first and third quarters of 2019. Low domestic growth and low inflation (3.7% CPI for 2019) should lead to rate cuts.

However, the South African Reserve Bank was reluctant to cut rates, believing that dovish monetary policy would have a limited impact given the high structural impediments to growth. As a result, real yields of South African bonds are at very attractive levels and local bonds therefore have a meaningful role to play in the portfolio. We are more cautious on domestic property, where we expect companies to struggle to show distribution growth over the medium term, as rentals that have benefited from high escalations for many years come up for renewal and are rebased to market.

The FTSE/JSE All Share Index (ALSI) returned 12% for the year and 4.6% for Q4-19. While this was a better year for South African equities, longer-term returns for domestic growth asset classes remain low (ALSI 6% p.a. and JSE Listed Property 1.2% p.a. over a five-year period). The JSE's returns were boosted by the local resource sector, which performed strongly, overcoming fluctuating sentiment on global growth to finish the year up 28.5%. Industrials and financials were considerably weaker, delivering 8.9% and 0.6% respectively, with the higher domestic exposure of the financial sector weighing on performance. We continue to see value in South African-listed equities.

Within the Index, it was pleasing to see names that had detracted from performance in 2018 contributing strongly in 2019. Most notable among these were the platinum group metals (PGMs), with the portfolio's holdings in Northam (+183% for the year and +47% for Q4-19) and Impala (+291% for the year and +51% for Q4-19) up particularly strongly. Other notable performers for the year include our global holdings with Quilter (+39%), British American Tobacco (+36%), Naspers (+23%) and Anheuser-Busch InBev (25%) also doing well. The portfolio's underweight position in domestic businesses contributed positively, as the challenges of a lacklustre consumer environment and persistent structural cost inflation eroded earnings.

Portfolio activity

While our equity and balanced portfolios remain significantly exposed to offshore stocks, we have added to selected domestic holdings where we see value. Any near-term recovery in domestic stocks is likely to reflect a shift in sentiment rather than a dramatic improvement in earnings.

On the resources front, our large exposure to the PGM sector contributed meaningfully to portfolio performance for both the quarter and the full year. Platinum-group companies benefited from rising prices given growing demand (as emissions regulation requires higher vehicle PGM loadings) and a limited supply response. While we have cut our holdings into price strength, we still have meaningful exposure. Years of underinvestment in PGM mines mean that supply is unable to respond timeously. Significant capex with long lead times is required to change this.

Northam's strength also reflected an easing of investor concerns on the overhang of the broad-based black economic empowerment (B-BBEE) deal funding, which becomes less dilutive at a higher share price. Another meaningful contribution came from the portfolio's large position in Anglo American, which benefited from its ownership of Amplats (+149%) and Kumba Iron Ore (+65%). Both assets benefited from commodity price strength due to tight markets with an inability for supply response in the short term. We anticipate that the PGM deficit will be more enduring.

Sasol suffered a tumultuous year, collapsing on the back of further cost overruns relating to the Lake Charles Chemicals Project and a delay in its financial results. The board used this time to conduct a thorough review of internal controls and governance structures. Our underweight position during the year contributed to performance and we took the opportunity to add to the position at a time when investors had lost faith in the company. The previous joint-CEOs have now left the business and a new internal appointment has been made.

Additionally, the ethane cracker achieved its optimal run rate by year-end. The share has rebounded c. 20% off its recent lows. Risks in the company remain high and we continue to manage the position size carefully.

Within the financial sector, Quilter performed strongly in its second year of listing as the market bought into management's vision of building a focused, integrated UK wealth manager. The reduced uncertainty in the UK political

THE SEVERE LOADSHEDDING EXPERIENCED IN DECEMBER IS EXPECTED TO HAVE TAKEN A TOLL ON RETAILERS' Q4-19 EARNINGS.

backdrop also helped. Naspers had a busy year with the unbundling of MultiChoice; the establishment of Prosus, an Amsterdam-listed entity that houses its international assets; the unbundling of a portion of Prosus (26%) to shareholders; and a bid for Just Eat, a multinational food delivery player. Unfortunately, the restructuring had little impact on the discount at which Naspers (and now Prosus) trade to their underlying holdings.

Given the capital allocation track record of management, we think the market is taking an overly pessimistic view on the discount. Due to the attractiveness of the underlying assets and the holding company discount, Naspers and Prosus constitute a significant holding in the portfolio.

Their major asset, Tencent, is growing rapidly in online payments and financial services, a market segment many times larger than the gaming market they currently dominate. While strong incumbents and the regulated nature of financial markets do increase the risk profile, the financial services offering has the potential to be a very large and profitable business.

British American Tobacco continued to deliver on its strategy, growing revenues (despite falling volumes in traditional combustible tobacco), widening margins (helped by cost reduction) and showing strong cash conversion, despite a changing regulatory environment. US regulators are becoming increasingly concerned over youth recruitment and the potential harm of alternative tobacco delivery methods like vaping. The magnitude of the threat posed by this category to its traditional business now looks reduced.

While it was pleasing to see market recognition of the value inherent in some of the portfolio's larger positions during 2019, we continue to see attractive opportunities for disciplined, long-term investors that should generate inflation-beating returns over time.

GLOBAL EMERGING MARKETS

The Strategy returned +13.0% during Q4-19, which was 1.1% ahead of the +11.8% return of the benchmark MSCI Global Emerging Markets Total Return Index. In 2019, it returned 39.9%, which was 21.4% ahead of the market's return of 18.4%. This performance made it the Strategy's best relative year since its inception almost 12 years ago (the previous best relative year was 2013 when it outperformed the market by 19.4%) and its third best year from an absolute return point of view, behind 2009's +90.9% and 2017's +40.7%. It has now outperformed the market over one, three, five, seven and 10 years, and most importantly, is ahead of the market over long time periods, with outperformance of 2.8% p.a. over 10 years and 4.2% p.a. since inception 11.5 years ago.

All the right moves

There were several stocks in 2019 that contributed more than 1% each to this outperformance and only one that detracted by 1% or more. In terms of positive contributors, Wuliangye Yibin led the way (appreciating by 161% and contributing 3.6% to performance), followed by New Oriental Education (+121%, +2.5% contribution), JD.com (+67%, +1.3% contribution), Yduqs/Estácio (+95%, +1.2% contribution), Yandex (+59%, +1.2% contribution), Adidas (+58%, +1.1% contribution) and Li Ning (+194%, +1.0% contribution). The good performance in 2019 was partly a reversal of a poor 2018 – three of the five worst performers in 2018 (JD.com, British American Tobacco and Cogna/Kroton) were all top 15 positive contributors in 2019, but it was also aided by a number of long-held positions coming through, including Yduqs/Estácio and Adidas referred to above. In addition, the likes of Airbus (+54%) and Sberbank (+59%) also contributed meaningfully.

WE CONTINUE TO SEE ATTRACTIVE OPPORTUNITIES FOR DISCIPLINED, LONG-TERM INVESTORS THAT SHOULD GENERATE INFLATION-BEATING RETURNS OVER TIME.

Lastly, a number of more recent (calendar 2018) buys also played a large role, including Wuliangye, New Oriental and Li Ning. Of the seven largest positive contributors in 2019, we have totally sold out of one (Li Ning) as it reached our fair value, and we have materially reduced the position size of a few counters, including New Oriental (a 2.5% position in September 2019 to a 1.3% position December 2019) and Adidas (1.4% position September 2019 to a 1.0% position December 2019). In terms of negative detractors, it was only Taiwan Semiconductor (TSMC) that detracted by more than 1% (-1.1% impact). The Strategy did own TSMC, but the position size was smaller than that of the Index, and TSMC was a strong performer in 2019 (+62%).

Building exposure

There were four small new buys in the Strategy during the quarter (all 1% or smaller positions) and five sells to zero. In terms of new buys, we initiated positions in Tencent Music Entertainment (TME, 1% position), LG Household & Healthcare (LG H&H, 0.8% position), Midea and CP ALL (both 0.5% positions). In terms of sells, the Strategy fully sold out of Li Ning and China Resources Beer (+194% and +59%, respectively) during 2019, with both reaching and exceeding our estimates of their fair values. It also sold out of its remaining >

small positions in BB Seguridade after it reached fair value and Porsche, on the back of concerns about the long-term future of the traditional automobile industry. Lastly, it sold out of Cognizant, largely due to switching into its higher quality competitor Tata Consultancy Services, which was already a Strategy holding.

In terms of geographic exposure over the quarter, the only meaningful change was the reduction in the Strategy's developed markets exposure (companies with at least 40% of revenue, profits or value coming from emerging markets), which went from 21.3% to 18.4% due to the sale of the Porsche position, as well as a reduction in the Adidas position. This 18.4% current exposure is largely in line with Strategy's average developed market exposure of 17.8% in the Strategy since inception just under 12 years ago and well below the Strategy's cap of 25% developed market company exposure. China remains the largest country exposure in the Strategy (32.3% but effectively 37% if the look-through Tencent exposure in Naspers/ Prosus is included), followed by India (10.2%) and Russia (9.3%).

Tencent Music Entertainment

TME is 58% owned by Tencent and has two main businesses: a) it is the leader in online music in China, with around 75% of market share; and b) it has a large online social entertainment business, which focuses on music-related live streaming and online karaoke. The online music streaming business is the better of the two in our view and is essentially the Chinese Spotify, which actually owns an 8.6% stake in TME. TME have c. 650 million online music users in China (as a reference point, Spotify globally has a total of around 250 million users), but both the proportion of users who pay anything and the average revenue per user of those who do are low, and should increase over time and drive the top-line.

Today the business makes a small loss at the operating level, but with continued revenue growth and the resultant leverage of the cost base, in our view, it will be very profitable in years ahead. Content costs are cheaper in China than elsewhere globally (partly due to a fragmented music industry) and this should result in higher operating margins than the likes of Spotify, for example, are likely to achieve.

Currently, the online music business contributes c. 30% of TME's revenue (and no profit) by our estimates, but over time we forecast that it will contribute c. 45% of TME's revenue and c. 35% of its profits. The online social entertainment business (70% of TME's revenue today and 100% of profit) is a very profitable business (earnings before interest and tax margins of c. 25%), but operates in a far more competitive area of the market where the barriers to entry are lower.

We still expect this business to do well going forward, but the jewel in the crown and the main driver will be the online music business, in our view. TME went public just over a year ago at $13 a share and we didn't participate in the initial public offering (IPO) at the time. The Strategy has only ever participated in one IPO (JD.com) in its 11.5-year history as IPOs are almost always priced very favourably for the seller. After completing our due diligence on TME and gaining conviction, with the share price doing little since the IPO, we built the Strategy's position one year later in December 2019 at an average price below $12. At the time of purchase, TME was trading on around 25 times forward earnings (c. 20 times forward price to free cash flow as the business converts c. 125% of earnings into free cash flow), which we believe is an attractive entry point for this asset.

LG Household & Healthcare

LG H&H is a South Korean-branded consumer company with c. 75% of profits coming from cosmetics and the other 25% from household personal care goods (similar to Unilever) and beverages (including the Coca-Cola rights in South Korea). The cosmetic business is the key driver and is what interests us most. The world-wide cosmetics industry has grown in excess of global GDP over the past decade (LG H&H has grown at between two and three times the industry), is economically resilient and is a prime beneficiary of the wealth effect and rising disposable incomes. This is particularly the case with the Chinese consumer and in this regard LG H&H is very well placed – today over half its sales come from the Chinese consumer (c. 15% in China itself and the balance from Chinese shopping, largely at duty-free stores in South Korea). LG H&H has been investing heavily in its main brand 'Whoo' for the past decade, as it has been particularly popular among Chinese consumers. This is both a continued opportunity and a threat going forward. Over the past decade, LG H&H has grown revenue at 13% p.a. and earnings per share at 18% p.a., and today, the business generates a return of earnings (ROE) of c. 20%. The Strategy purchased LG H&H on c. 22 times forward earnings, which we believe is attractive for this high-quality asset.

SOUTH KOREAN-BRANDED LG H&H'S COSMETIC BUSINESS IS ITS KEY DRIVER AND INTERESTS US MOST.

Midea

This leading Chinese household appliances manufacturer has a 34% market share in washing machines in China, 24% in air conditioners and 15% in fridges. The company is vertically integrated (R&D, manufacturing, sales, warehousing and delivery) and is expanding into and developing logistics and robotics capabilities, as we increasingly move towards a smart technology world. While China (58% of sales) is its biggest market by far, it also generates revenue by selling in 200 other countries. Over the past five years, 110% of earnings have been converted into free cash flow and the business generates an ROE of c. 25%. In our view, the share is attractively valued today, trading on c. 14 times forward earnings with a 3% dividend yield.

CP ALL

CP ALL is the third largest 7-11 (convenience store) operator in the world (behind Japan and the US) with 11 500 convenience stores in Thailand (c. 80% of group profits) as well as over 100 cash and carry stores (Makro generates 20% of group profits). The business continues to roll-out c. 700 new 7-11 stores a year in Thailand, as well as increase the contribution from higher margin categories such as coffee, ready-to-eat meals and banking services within its stores. As a result, our view is that the business can continue to grow at a low double-digit rate in the years ahead.

In addition to its core Thailand business, it has nascent cash and carry operations in Cambodia, Myanmar, India and China, and is in discussions for the 7-11 Master Licence in Cambodia and Laos. Once a market darling, the share has been flat for the past two years and recent concerns about a potential bid for Tesco's business in Thailand brought it into buying range.

Year-end composition

At the end of December 2019, the weighted average upside to fair value for the Strategy was around 30%. This is lower than the approximately 50% historical average; however, this is not abnormal after a period of strong absolute performance and we believe the absolute upside is still quite compelling. This is especially so when one considers that the quality of the companies owned in the Strategy is above average when compared to history.

FRONTIER MARKETS

Frontier markets are certainly no favourite. It is easy to see why, with the S&P 500 continuing to fire on all cylinders, delivering +31.5% in 2019 alone. Investors venturing beyond safe havens have not been rewarded. Outflows and fund closures, mainly in the Africa space, continue to impact the industry, with several funds winding down over the course of the year.

In this environment it is easy to forget that the shares in the portfolio are not simply numbers on a screen, but ownership stakes in actual companies. Have fundamentals changed? For many of the companies in our portfolio, the answer is: not much. They continue to grow, generating free cash flow and paying healthy dividends. Offering some insight, Table 1 below compares the fundamentals of some of the more meaningful positions in our frontier strategies to developed, emerging and frontier market indices.

OUTFLOWS AND FUND CLOSURES, MAINLY IN THE AFRICA SPACE, CONTINUE TO IMPACT THE INDUSTRY.

It shows that the investee companies:

- Trade at forward price-to-earnings multiples well below broader indices;
- Have grown in line to well ahead of the indices;
- Have generated higher returns on equity than the indices; and
- Bar Zimplats, 2019 share price performance is vastly removed from the earnings growth and return on equity (ROE) performance of EICO, Egyptian International Pharmaceutical Industries Co. (EIPICO) and British American Tobacco (BAT) Kenya.

With respect to Zimplats, the share price has increased significantly from a very low base; however, the company still trades on less than four times earnings.

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Table 1

COMPARISON OF FUNDAMENTALS ACROSS MEANINGFUL STRATEGY POSITIONS

	Country	Industry	PE(f)	Earnings growth	ROE	Share price performance
Portfolio company						
EICO	Global	Shisha molasses	9.8x	13.2%	35.6%	(5.4%)
Zimplatz	Zimbabwe	PGM miner	3.6x	23.7%	14.1%	84.8%
Eipico	Egypt	Pharmaceutical	7.7x	6.0%	27.4%	(13.1%)
BAT, Kenya	Kenya	Tobacco	8.0x	26.0%	45.0%	(30.7%)
Average			7.0x	14.3%	25.7%	22.1%
Indices						
S&P 500	Developed		18.6x	6.7%	15.1%	31.5%
MSCI EM	Emerging		13.1x	7.1%	11.4%	18.6%
MSCI Frontiers	Frontier		11.9x	-	14.5%	-
Average			14.5x	6.9%	13.7%	25.1%

Note: BAT, Kenya is held by Africa Frontiers only; EICO is held by Global Frontiers only.

Source: Coronation

All these businesses enjoy strong fundamentals, healthy growth prospects and incredibly attractive valuations, especially relative to some of the indices above. This is a rough measure, but when drilling into the portfolio that you hold, it quickly becomes apparent that it has been a year in which equity prices have declined or underperformed underlying company performance, and the upside to fair value for the portfolios has never looked this attractive.

Detractors

The main detractors and reasons for underperformance in 2019 can be grouped into the following categories:

Zimbabwe write-down (attribution: Global Frontiers -3.2%; Africa Frontiers -6.4%)

We have written at length about the decision and rationale to write down our Zimbabwe exposure. Despite the impact being incredibly painful and the main driver of this year's poor returns, we continue to believe that the decision was prudent and protects investors in the Strategy. Any improvement in the transactability of the country should see strong improvements in our realisable values and performance. Unfortunately, as at year-end, an improvement has yet to be seen.

Index concentration (attribution: Global Frontiers -5.4%; Africa Frontiers -5.2%)

With respect to Global Frontiers markets, the MSCI Frontier Markets Index is dominated by Kuwait, which makes up 30% of the Index, and to which the Strategy has no exposure. Kuwait had a strong year in 2019 and returned 28.6%. This was a result of the MSCI announcing that Kuwait will be upgraded to emerging market status in 2020. Kuwait was the most significant driver of Index returns in 2019, accounting for c. 50% of its total return.

In the African Frontiers context, the FTSE/JSE All Africa ex-South Africa 30 is dominated by the Egyptian bank CIB, which makes up 17% of the Index. CIB had a strong year in 2019, returned 59% in US dollars and accounted for c. 60% of the Index's total return. The Strategy had exposure to QNBA, an Egyptian bank exposed to the same underlying drivers as CIB. QNBA trades at a 50% discount to CIB, despite delivering stronger earnings growth. QNBA is not in the Index and thus less widely owned than CIB. Over the year, QNBA returned 35% in US dollars and was one of the Strategy's largest contributors (+2.2% contribution). However, the smaller position size and lower return relative to CIB still meant that CIB hurt our relative performance.

While relative performance to these indices, which we feel do not adequately reflect our investment universe, is not something we typically focus or comment on; given the outsized impact this year, it is worth understanding.

Divergence between valuations and fundamentals (attribution: Global Frontiers -2.7%; Africa Frontiers 3.0%)

In both strategies, several of our holdings have had very good years, reporting strong earnings growth and improved fundamentals. Unfortunately, share prices have largely ignored this and often declined significantly. BAT, Kenya (-1.2% contribution) is a prime example of this. Earnings were up 26% as at the end of the first half of 2019, and with the second half up against a flat base, the full-year numbers should be similarly healthy. Despite this, the share price fell c. 30% in US dollars and it now trades on an 8.9 times historic price earnings multiple and comes with a 9.0% dividend yield. Stanbic IBTC detracted (contribution Global -0.4%, Africa -0.7%) as the share fell 15% and EIPICO (-0.2% contribution, with the share down 13%). In the Global Frontiers Strategy, EICO detracted -0.9%, with the share down 6%.

This divergence between earnings growth or underlying business fundamentals and share prices is seldom cause for concern to the long-term investor. Over time, business fundamentals are what matter and a growing earnings stream in US dollars will result in share price growth. The key is to be patient enough to wait for this to happen.

OVER TIME, BUSINESS FUNDAMENTALS ARE WHAT MATTER AND A GROWING EARNINGS STREAM IN US DOLLARS WILL RESULT IN SHARE PRICE GROWTH.

In both Strategies, the largest contributor was Zimplats (+4.1% in Africa Frontiers; +2.4% in Global Frontiers), which had a very good year on the back of an increase in platinum group metal prices.

Global Frontiers Strategy

The past year has been a particularly challenging one for the Strategy, which increased 1.8% over the course of the year, underperforming the MSCI Frontier Markets Index, which was up 18.0%. The year saw vastly divergent returns across the global frontiers universe, with equity markets in Kuwait (+28.6%), Egypt (+19.5%), and Kenya (+19.1%) all incredibly strong. Conversely Bangladesh (-18.4%), Nigeria (-14.9%) and Argentina (-13.5%) experienced a year to forget. Despite an incredibly disappointing 2019, the Strategy's five-year and since-inception (1 December 2018) gross annualised returns of +2.8% p.a. and +3.0% p.a., respectively, are ahead of the Index's respective returns of +2.7% and +1.8%.

While these returns are well below our expectations, the Strategy is young, and we are very positive about its future.

Africa Frontiers Strategy

Our Africa Frontiers Strategy also experienced a particularly challenging year and declined by 5.6%. As a result, the Strategy underperformed the FTSE/JSE All Africa ex-South Africa 30 Index, which was up 16.5%. The Index was driven by strong returns in Egypt (+19.5%) and Kenya (+19.1%), with Morocco (+6.9%) and Nigeria (-14.9%) less impressive. Returns in Egypt were largely driven by strength in the Egyptian pound, while Kenya ended the year with a bang, rallying +17.2% in Q4-19, on the back of the interest rate cap repeal. Despite an incredibly disappointing 2019, the 10-year and since-inception gross annualised returns remain healthy, at +6.0% p.a. and +7.7% p.a., respectively. Despite 2019 being a torrid year, we have strongly outperformed the Index, which has returned +3.0% over 10 years and -0.3% since the Strategy's inception on 1 October 2009.

The past quarter has shown improved absolute performance, with the fund up 6.3%. The FTSE/JSE All Africa ex South Africa 30 Index was up 7.6%. During the quarter, we added to Nigerian Breweries and IDH, while selling out of Cleopatra Hospitals and trimming our Safaricom position due to valuation concerns.

Outlook positive

With the challenges of 2019 front of mind, we are not underestimating the headwinds that might come our way in 2020. However, the one thing we have learnt is that the odds are weighted in the investor's favour when you start the year with deeply discounted valuations for companies that are growing earnings strongly. We invest in thin markets, and capital flows exaggerate returns. 2020 certainly has the potential for a significant rerating, should there be any new flows to the asset class. Consequently, we are very excited about the year ahead. With the valuations of several high-quality businesses having reduced meaningfully over the past year, future returns should be healthy. ✚


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we can invest
in more of
what matters.
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