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Kirshni on point

Life in the time of coronavirus

By KIRSHNI TOTARAM

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

4 MONTHS, 2 MILLION AND STILL RISING ...

"All we know is still infinitely less than all that remains unknown." – William Harvey (16th century English physician)

What a long year these last three months have been. Few natural disasters threaten more loss of life, economic disruption and social disorder than large-scale disease outbreaks. It's been four months since Covid-19 first emerged, with more than two million people infected at the time of writing; and the subsequent pandemic has changed all of our lives drastically in a short space of time – obsessive handwashing, Zoom calling and wearing a mask in public.

I am writing to you at an unprecedented time in our global history when billions of people around

the world are sheltering at home. I am sure many of you, like me, have spent hours watching the news, which has been filled with eerie scenes from the now-quiet cosmopolitan cities of New York, Rome and London.

And with this new way of life we are facing a compound set of challenges that I, for one, couldn't have imagined in my wildest dreams – the disease itself, quarantine and isolation, remote schooling, working from home and, of course, having to suit up like a stormtrooper before heading out to get bread and milk.

It has become increasingly clear that this is one of the greatest pandemics since the Spanish flu wreaked havoc on the global population 102 years ago, and it will leave lasting scars on the global economy. Experts predict that this year we will see the greatest economic contraction since the Great Depression ended 80 years ago.

March has been a historically bad month for the global economy. The market pandemonium has been surreal to witness. But we know that the true scale of the hit to the real economy is yet to become painfully clear.

There is no doubt that we are currently dealing with a public health-driven humanitarian crisis. The lockdowns have been an important short-term emergency lever to prevent a catastrophic death toll. We have thankfully bought some time in the global fight against this pandemic, but at a significant cost as we prepare ourselves to deal with an economically driven humanitarian crisis next.

LOOKING BACK A FEW SHORT MONTHS AGO ...

The first case of (the as yet unknown) Covid-19 infection was reported in December 2019, and on 31 December, the Chinese government alerted the World Health Organisation (WHO) to a rise in cases of pneumonia (coronavirus) of an unknown origin in Hubei Province. On 7 January 2020, Covid-19 was identified, Wuhan was quarantined on 23 January, and on 11 March the WHO declared it to be a pandemic that was likely to become global in scale (at the time there were 118 000 cases reported across 114 countries).

Leadership responses have varied. One of the most exacerbating factors of this pandemic has been its exponential rate of growth. This means that if leaders miss two or three doubling infection cycles due to delayed responses, the problem will be eight to nine times worse by the time governments eventually tackle the spread of the disease. >

When it comes to assessing and acting quickly and decisively in response to the looming public health crises, some leaders stood out. These include Tsai Ing-wen of Taiwan, Jacinda Ardern of New Zealand, Angela Merkel of Germany and our own President, Cyril Ramaphosa.

Not only were they quick and decisive in their reactions, but they were also truthful with their citizens about the risks faced and persuaded many people to act for the public good through their own example.

Unlike the other countries mentioned above, South Africa is a developing country, and like many other developing nations, we do not have the resources or money to assist in this fight. We are unsure as to how practical a lockdown is to enforce, and we know that financial instability and a looming depression will inflict huge harm on developing countries like ours.

Regardless of these tough choices and their worrying impacts on our society, I am proud of how our country has responded to the pandemic. South Africans have come together to implement a nationwide wall of defence. Much of it is not easy. We are a unique country and we need a unique approach. Unclear of the future, our initial actions have served to contain the spread of the virus and, in the process, bought us some valuable time to allow better preparation of the healthcare sector and better decisions about what comes next. Our economy cannot afford a long shutdown and hence our exit strategy from the current lockdown is complex and critical.

But this is not something that we are uniquely struggling with. All countries are dealing with how to phase a reopen of their economies, with the decision being informed by extensive testing and tracing (something that is easier said than done, given the global shortage of the equipment required). And above all, to ensure that a reopen is done in a manner that does not restart an aggressive rate of infection. As we are dealing with so many unknowns, there is simply no way of knowing exactly what a perfect response should be. But any responses in a swiftly evolving and complex crisis are likely to be imperfect at best. We need to learn to accept this.

Lessons learned along this journey will inform many of the decisions that governments make for society, and that we make as individuals, businesses and communities in the near term, medium term (until effective medical treatments become available) and the long term (until a vaccine becomes available).

When do we return to normal? Probably never to the way of life we knew before. I have no idea what the near-term future looks like, but I am very sure that some of our behaviours have been altered forever (and hopefully for the better); and that we will be called upon to reimagine our business and community interactions for, at the very least, the next 12 to 18 months. One thing is for sure, we won't be shaking hands for some time to come.

THIS IS A UNIQUE EDITION ...

Our entire edition for this quarter has been adjusted to talk through the virus and its impact on our client portfolios. Our lead article, "A time of crisis", written by CIO Karl Leinberger and John Parathyas, was published earlier this month. It summarises our team's extensive research on the virus and the short- and medium-term economic impacts of the global response. We have updated it to reflect new information as the crisis has evolved over the past two weeks (a long time in the life of this pandemic).

In her very sobering article, economist Marie Antelme weighs the costs of the global economic shutdown, while head of fixed income, Nishan Maharaj, provides a deep dive into the arena of credit, income and debt.

In his article on Naspers, portfolio manager, Adrian Zetler, discusses why we continue to find that the position has an attractive investment case in this troubled time and demonstrates its resilience during this time of extreme disruption. For the rest of this edition, we have taken the opportunity to publish the full strategy comments for our main portfolio streams, in which our portfolio managers share their thoughts on the current crisis, its market impact and how they have positioned their portfolios for context.

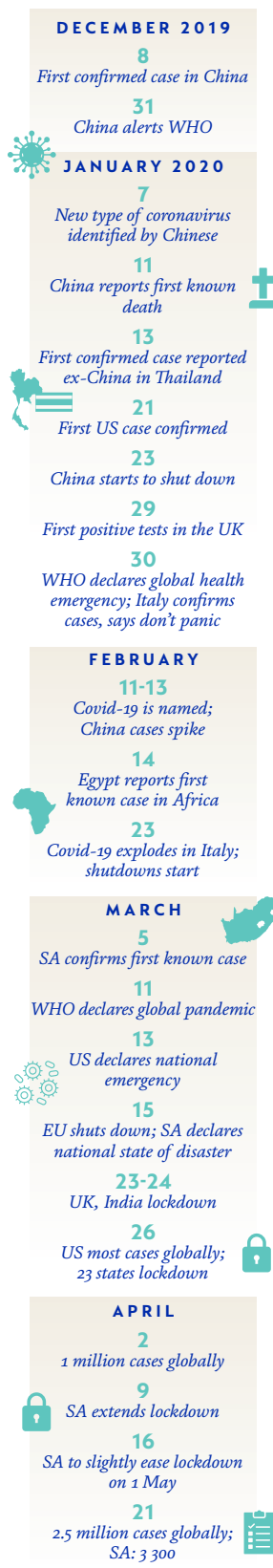
MAINTAINING OUR SERVICE TO YOU ...

The Presidency identified financial services companies as providing essential services during the Covid-19 lockdown and we remain operational during this time.

You can trust that we have worked hard to ensure an uninterrupted and high-quality service to you. At the same time, as always, our first priority has been to ensure the well-being and safety of our clients and staff.

This means that we invoked our robust business continuity plans and extensive remote working capabilities. All of these have been in operation for more than a month, with about 85% of our employees working from home. We expect this to continue. However, there are understandably

FROM WUHAN TO PANDEMIC: A COVID-19 TIMELINE*



*Note: Dates differ across data sources, so may differ elsewhere.

Sources: The Presidency of SA, SA Department of Health, NICD, British Foreign Policy Group, Medscape.com.



certain vital functions that need to be performed by certain team members in a highly controlled environment and our key staff performing these vital functions will be in the office daily.

IT'S ALL ABOUT SOLIDARITY

The nature and extent of Covid-19's impact are pervasive and require strong cooperation between government and business. We continue to engage regularly as an industry participant and business to ensure that we collaborate with businesses, professional bodies and policymakers in South Africa to respond appropriately to the challenges we now all face.

At the very beginning, as a corporate and as individuals, we made financial contributions to the Solidarity Fund, as we believe that it is positioned to deliver maximum impact and relief to those most vulnerable to the harsh effects of this pandemic.

On Thursday 9 April, President Ramaphosa became the first world leader to announce that both he and his Cabinet were taking a one-third salary cut for the next three months, with the proceeds being contributed to the Solidarity Fund. He challenged all business executives in the country to heed his call and follow suit. Corporate South Africa has responded quickly, and I am very proud to announce that Coronation's business leadership (consisting of 15 individuals), our non-executive directors and an additional 25% of our employee complement have voluntarily opted for a salary cut, with the proceeds being contributed to the Solidarity Fund.

Unlike the virus, humans make choices. Times are brutal – in our country and across the world. This pandemic, which took us all by surprise, is already taking a heavy toll – financial, social, emotional and mental. I give a special shout out to those parents, like me, feeling the strain of juggling working from home (and sometimes at the office), home-schooling kids, remote family care and home admin.

Coronation deeply values our continued partnership with our clients, which allows us to face this challenge together. We are indeed in uncharted waters. I believe that crises tell us a lot about the essence of people – their true nature. Some will disappoint. Others show immense courage, grit and compassion. The mark of the strength of any society is the ability to stay united in tumultuous times.

The one striking and exceptional thing that I have learned about South Africans is that our society and our people are remarkably resilient. We find ways to adapt, thrive and bounce back from adversity. This gives me great hope that by working together in a sensible and considered manner, we will navigate through this crisis.

I wish you, your family and your colleagues strength, fortitude and good health during these extraordinary times. Above all, make wise choices and I look forward to the time when we meet again in person.



A time of crisis

A butterfly flaps its wings in Wuhan, China

By KARL LEINBERGER and JOHN PARATHYRAS



Karl is Chief Investment Officer and has 19 years of investment industry experience.



John is an investment analyst with eight years of investment industry experience. He holds an MSc. in Genetics.

This article is updated from the original publication date of 3 April 2020.

THE COVID¹ PANDEMIC is first and foremost a human tragedy. At the time of writing, there have been more than 2.5 million confirmed cases and more than 170 000 confirmed deaths. As we all become increasingly numb to these large numbers, we need to keep reminding ourselves that behind each of those numbers is a human story.

As the coming weeks pass, the depth of the economic devastation and full impact of the virus and its containment measures will be revealed. For those who argue that human lives come first and economics second, the evolution of the economic fallout into a humanitarian crisis will become increasingly clear.

The Covid pandemic is a unique event that is unprecedented in modern times. Consequently, we must be careful, as deeply frustrated citizens, when we harshly judge the decisions made by governments. Although life is always more uncertain than we like to acknowledge, in this case there is just so much we don't know. We have had 22 calls with epidemiologists since early February.

¹ Note from the authors: for simplicity we have used the term Covid to describe both the virus ("SARS-CoV-2") and the disease ("COVID-19") caused by the virus.

The most striking outcome for us has been not what we know about the virus, but what we don't – with a last count of 14 important unknowns.

What does seem clear is that Covid is a virus with a set of characteristics that makes it highly transmissible and fiendishly effective at overwhelming healthcare systems and killing a not insignificant number of people that it infects. And, given that it is a novel virus, humans have no herd immunity, nor do we have any effective treatments or vaccines against it. But, if you don't have the answers to the most basic questions, such as how many people have already been infected, the infection fatality rate, how seasonal the virus is, or whether or not those infected gain immunity, how does a government make the impossible choice between suppression strategies over the alternative – pursuing herd immunity by allowing the virus to spread through the population?

How does the government of a low-income country, without a social safety net, manage the balancing act of controlling the virus and keeping the economy going, especially since these are fundamentally competing interests? In some of these countries, will the all-in damage to society of a national lockdown exceed that of simply letting the virus run its course? How do you even measure these things?



Countries have managed the epidemic in very different ways. This matters enormously, for both the long and the short term.

Due to the lack of any immunity or treatments, governments have resorted to 'non-pharmaceutical interventions' to limit the spread of the virus. These range from targeted measures such as large-scale testing for the virus, isolation of infected individuals, contact tracing of people with whom they have come into contact, and quarantining people who have been exposed to the virus; to more indiscriminate measures such as social distancing. The most extreme form of this is restrictions on the movement of all people via regional, or even nationwide, lockdowns.

The choice of which measures to implement, and when, has varied across countries. First prize is the early use of targeted measures, which, if executed well, reduce the need for more heavy-handed and indiscriminate measures later. This is the path taken by most of Asia (China, Hong Kong, Japan, Singapore, South Korea and Taiwan). Responses differed, but the region has, to date, handled the epidemic well and, consequently has added to our conviction that Asian equities offer great value. The region benefited from:

- The experience it had with the outbreaks of SARS in 2002/2003 and MERS in 2015;
- More compliant societies (often with less civil liberties); and
- Superior surveillance capabilities and very digitised societies (for example, in China, a QR code on your smartphone changes from green to red if someone you have been in close contact with subsequently tests positive).

South Korea and Taiwan have thus far avoided the extent of lockdowns seen across much of the world by acting early (crucially important given the exponential transmission of the virus) and decisively. They deployed widespread testing, contact tracing and quarantine measures in a very effective manner. Singapore has done a similarly exemplary job, only instituting stricter social distancing measures in early April.

China was initially slow to react and therefore had to implement a combination of the measures used by South Korea and Taiwan, and some drastic restrictions on the movement of people in the affected areas. All of these Asian territories have thus far controlled their outbreaks, with much fewer cases per capita than some hard-hit western countries, despite having been nearer to the initial epicentre of the pandemic. Across

parts of Asia, freedom of movement is improving, and economies are slowly recovering.

The main reason for Asia's success is that they acted early and with the full gamut of targeted interventions, especially the widespread testing of suspected cases. Countries that do not, or cannot, do something similar are at risk of much more extensive outbreaks. The cruel feedback loop is that the worse the outbreak becomes in a country, the exponentially more difficult it becomes to control. And as it overwhelms the healthcare system, the worse the disease's infection fatality rate is likely to become.

This has left many countries with seemingly little option but to enact unprecedented restrictions on the movement of people. The US is a great example of this. It wasted precious time and squandered its many advantages, and is likely to be a case study of government failure in crisis management:

- Being further from the epicentre, it had more time to take decisive action early on.
- Although wealthier than South Korea (with a roughly 50% higher GDP per capita on a purchasing power parity basis) and with deep institutional knowledge of the control of infectious diseases, it failed to roll out the necessary testing, contact tracing and quarantining processes.

The US is now seeing rapid growth in case numbers. This has left it with little option but to use lockdowns to contain the outbreak. As we write, more than 90% of Americans are now under orders to stay at home, causing significant disruption to everyday life and the economy.

In the UK, the government initially proposed a strategy of gradual restrictions to allow for herd immunity to build up in its population. It then swiftly changed course, adopting strict social distancing measures when it became evident from epidemiological modelling that their initial strategy could quite easily overwhelm their healthcare system. The UK subsequently entered a three-week lockdown on 23 March, which on 16 April was extended by a further three weeks to 7 May.

Both the US and the UK wasted precious time and squandered an opportunity to respond to the virus in a manner much less damaging than the measures they have ultimately been forced to take.

Developing countries, most of which are in earlier stages of their outbreaks, face substantial challenges. Although they have the benefit of younger >

populations and a slight headstart in preparing for the virus' arrival, in many instances these countries are unlikely to have the resources to carry out mass testing of suspected cases as well as other measures, such as contact tracing and isolation/quarantining, at the necessary scale. Many also have high disease burdens, and health-care systems that are more fragile and with less spare capacity to absorb the added burden from a flood of Covid patients.

As such, developing countries have fewer tools available and may be more inclined to resort to heavier-handed tactics, and sooner in their outbreak timelines. For example, on 24 March, India declared a three-week nationwide lockdown of all 1.3 billion of its citizens, despite having only around 500 confirmed cases of Covid at the time. This was later extended by a further three weeks. This is a staggering move by the world's second most populous country.

It is also an unfortunate reality that many developing countries don't have the ability to implement the unprecedented fiscal and monetary stimulus being deployed in many developed countries. The citizens of these countries are also, in general, less able to insulate themselves from the economic fallout that measures such as lockdowns will unleash. And, regarding the question of social unrest, although lockdowns may be effective in developed countries, one must question whether this is possible in the more cramped and unsanitary conditions of many emerging nations.

Sadly, unless their demographic advantage turns out to be material, many developing countries are likely to see significant damage from a public health and economic perspective. Some may have little option but to prioritise their economies and choose the herd immunity route that the UK abandoned.

HOW THE PANDEMIC IS LIKELY TO PLAY OUT

Many decisionmakers around the world are now grappling with what happens next. The first point we should make here is that no-one knows how this will play out. Anything could happen. The only way, therefore, that we can think about it is probabilistically.

Lockdowns in most countries look likely to go on for longer than their initial three-week goal (for context, the lockdown in Wuhan lasted for more than two months before slowly unlocking). Prolonged lockdowns are likely to be ruinous for the global economy though, and many are now asking if the remedy is not worse than the

disease. The conundrum is obvious: if restrictive social distancing measures are relaxed too far or too fast then, as has been seen in past pandemics, there will be second 'waves' of infection. There is no easy way out.

The ultimate exit is a vaccine; this will provide the necessary herd immunity to protect the global population, especially the most vulnerable within it, without having to rely on them having been infected with the virus itself. There are currently a few dozen vaccine candidates in development, some already in clinical trials in humans. There is a high probability that an effective vaccine will be developed; the problem, though, is how long it will take.

Vaccine development timelines are typically measured in years, not months, with the average vaccine taking eight to 10 years to develop. There are numerous measures being implemented, as well as unprecedented amounts of capital available, to compress this significantly. Experts are relatively confident that there will be, with a bit of luck, a Covid vaccine within 18 months. It may take some time beyond that to scale its production to a global level. There are newer vaccine technologies that are being looked at that could yield a vaccine sooner than this, although they are relatively unproven in humans and their likelihood of success is lower (and regulatory scrutiny is higher) than traditional vaccine approaches.

There are also numerous existing drugs (for example, antiretrovirals used in HIV patients) that are being explored for 'repurposing' as a treatment for Covid infection. They have the benefit of already having been approved by regulators for treating other diseases, so, if effective against Covid, they could be approved and rolled out rapidly. These treatments will not prevent infection, but only treat it and, in so doing, improve patient outcomes – they are only a stopgap, we will likely still need a vaccine.

A few of these drugs have displayed promising results in lab and animal studies, and some even in small-scale human clinical trials, but more trial data is required before we will know for sure if any of them will work. This data should start being released in the weeks ahead.

If one or more of the above treatments prove effective, it could materially change the current status quo. But it is not a given that any will be successful; drug research and development is an endeavour with a notoriously high failure rate. If none prove to be a game-changer, then the only light at the end of the tunnel is a vaccine.

MANY DEVELOPING COUNTRIES ARE LIKELY TO SEE SIGNIFICANT DAMAGE FROM A PUBLIC HEALTH AND ECONOMIC PERSPECTIVE.



UNLOCKING THE LOCKDOWNS

Must we all now sit at home for 18 months waiting for a vaccine? This isn't an option. Most likely we will see a period of rolling restrictions on movement that snap on and off when certain triggers (e.g. ICU bed utilisation rate or growth of new case numbers) are breached. We wonder whether societies have the endurance this would require. The economic and social costs will likely be staggering. Conversely, allowing the virus to spread unfettered would almost surely be a public health disaster and carry with it its own social and economic costs. Barring a breakthrough on the treatment front near-term, there is seemingly no obvious way to break this impasse.

The lockdowns won't end the pandemic, but they will buy us time. Much will depend on which countries use the time well. Those that use it to build the infrastructure and processes needed to contain future spread of the virus when lockdowns are eased and to win citizens over, will come through this immeasurably better.

WHAT DOES THIS ALL MEAN FOR SOUTH AFRICA?

The spread of the epidemic to South Africa sparked a market crisis that has felt just as serious and existential as the Global Financial Crisis (GFC) did in 2008/2009. For a few days, South Africa was the only major country in the world to have announced Covid suppression measures without the requisite fiscal and monetary emergency measures that any modern economy requires if it is to survive an economic full stop of this nature.

At work we found ourselves, for a brief period, having to navigate a simultaneous paralysis of four systemically important markets (the interbank, the repo rate, and the corporate and government bond markets).

Nonetheless, as stressful as financial markets and the lockdown period have been, we are bracing ourselves for greater difficulties ahead. We see the period of virus containment as more akin to a marathon than a sprint. For South Africa, this makes for a long and difficult road ahead given:

1. **A long list of obvious vulnerabilities**, namely high levels of poverty that compel people to work through illness; densely populated townships; large numbers of people with compromised immune systems; a dependence on crowded public transport; a limited social safety net; a public healthcare system that was already failing before this; and finally, the

onset of winter (notwithstanding uncertainty of how seasonal the virus is, winter isn't good for respiratory diseases).

2. **Use of the lockdown period.** As mentioned, a lockdown cannot stop an epidemic, all it can do is buy time. In the case of South Africa, we question whether government has the funding and the organisational structures needed to execute the testing, contact tracing and quarantine infrastructure that it will need if it is to successfully release society from a national lockdown.
3. **Managing the epidemic after the lockdown.** Aside from our doubts that we lack the testing, contact tracing and quarantine infrastructure to execute on a national scale, the bigger question is probably: with so many people on the breadline, would we have the societal endurance for a prolonged fight against the epidemic anyway (while we await a medical breakthrough)?
4. **The economy and government finances were on a knife-edge before this.** This is the one that worries us the most. In contrast to the healthy growth that most of the rest of the world was enjoying, South Africa has been in recession for some time. Job losses, fiscal deficits and government levels of indebtedness were all at alarming levels to start with. As a consequence, we simply don't have the financial wherewithal needed to absorb and counter the coming economic and humanitarian fallout. Will this end up dwarfing the Covid crisis? Is the cure worse than the disease itself? It's a question we too ask ourselves every day.

This is not to say that South Africa has no chance in fighting this:

1. We had the precious headstart of time because the virus took longer to hit Africa. This is crucially important when you are fighting an exponential growth curve. Recent infection data confirm this, with South Africa stacking up well against other countries.
2. We have a very young population by global standards (fatality rates are very low for people under the age of 50).
3. Our hospital bed/population ratio stacks up well against international peers.
4. We have been encouraged to see the government acting more decisively of late (perhaps because the crisis has made it easier to put aside the worst of its paralysing factionalism). There >

WE SIMPLY DON'T HAVE THE FINANCIAL WHEREWITHAL NEEDED TO ABSORB AND COUNTER THE COMING ECONOMIC AND HUMANITARIAN FALLOUT.

even appears to be a determination to use this crisis to drive through some of the structural reforms that South Africa desperately needs.

5. The public and private sectors are working well together to fight this, something that we never really got right in the past.

PORTFOLIO POSITIONING AND CONCLUDING THOUGHTS

Notwithstanding a barrage of bad news since the client note (18 March) we wrote almost a month ago, I'm sure it would surprise many to hear that, at the time of writing in mid-April, most markets have delivered strong positive returns (the S&P +17%, the FTSE/JSE Capped Shareholder Weighted All Share Index +21% and the All Bond Index +6%). In times of crisis, the market always acts as an efficient discounting machine, hence the ruthless manner in which the Covid tragedy was priced into risk assets, with all sorts of records broken by the extent and the speed with which markets collapsed in February/March.

Many clients have asked us whether one shouldn't prioritise preservation of capital in these uncertain and trying times. This is a difficult question to answer, regardless of what we think the right answer is. This is not an easy time for anyone. Tragedy surrounds us all. Every stakeholder in our society (citizens, business, government) faces unprecedented uncertainty as they watch their incomes dwindle and their balance sheet stresses build. In times like this, watching one's life savings get hammered is a galling experience.

The temptation to give in to one's emotions is enormous. But to do so would be a big mistake. Investing is always an exercise in conquering one's emotions. In times of bad news, asset prices will almost always be low. The primary objective of investing is to own more when prices are low and to own less when prices are high. As tempting as it is to 'go to cash', we do not believe that this is the right answer. As tragic as the Covid epidemic is, we will come out the other side. And when that happens, most economies will benefit from pent-up demand, unprecedented fiscal and monetary stimulus, and record-low oil prices. Markets always rally when we all least expect it. Will it be a medical breakthrough (which could happen at any time)? Was it the point of peak infections? Will it be the lifting of lockdown? Who knows?

A long time horizon has been the cornerstone of Coronation's success of many decades. Every crisis we have lived through (and the list

is getting long!) has presented an outstanding opportunity for those investors prepared to take the long view. We currently find ourselves swimming in stunningly cheap assets. We have been astounded by some of the long-term opportunities that have been on offer in the last few weeks. The list of stocks, in both domestic and global markets, that our analysts believe offer more than 100% upside (to their underlying intrinsic value) is a long one. This valuation process has been updated for our entire universe of stocks, fully capturing our best estimate of the economic downturn, and the path dependence that companies with stretched balance sheets often experience in times of stress.

Although positions will vary, the following key features are common across our portfolios:

In our multi-asset class strategies we have moved from an underweight to an overweight equity position. We have closed out the puts that protected us from the worst of the early declines and bought some equity exposure at lower levels. Notwithstanding this, we don't feel that we have reached the point of capitulation quite yet, and we have therefore put cash aside to buy in more meaningful size, should that point come.

We believe that both domestic and global equities are attractive to any long-term investor. This is in contrast to our view throughout 2019, where we felt that global equities were fully priced.

The current turmoil is providing a unique opportunity to buy high-quality stocks at great prices. This is the case across both domestic and global markets, and we have taken advantage of it across all our equity mandates. It is not often that one gets the opportunity to buy great businesses, with excellent management teams, at low prices. We are confident that these stocks will give investors good risk-adjusted returns, even if the tough economic environment endures. As an example, the Coronation Houseview Equity Strategy currently has a 77% exposure to high-quality companies. This is the highest it's been in 20 years.

In our multi-asset class strategies, we have held, and even increased, our domestic bond holdings. These now offer double-digit yields. The risks are clearly high, given worryingly high levels of government indebtedness, but we think this is compensated for in yield.

We remain concerned by thin credit spreads in the local fixed income market. Elsewhere in the

EVERY CRISIS WE HAVE LIVED THROUGH HAS PRESENTED AN OUTSTANDING OPPORTUNITY FOR THOSE INVESTORS PREPARED TO TAKE THE LONG VIEW.



world, credit spreads have blown up, as investors who were reaching for yield are being forced to price in a significantly higher risk of default. In South Africa, the market is thinly traded, and fairly limited re-pricing has happened. If the market does become stressed, we would actively look to deploy cash into attractively priced credit, be it new issues or credit that has to be sold in the secondary market. The GFC provided a once-in-a-lifetime opportunity to do just that. We hope to get that chance again.

We remain extremely negative about developed market bonds. We are very uncomfortable with government levels of indebtedness and we

question whether future generations will be able to service this level of debt.

And, finally, inflation. We have become concerned that the very long-term consequence of all this fiscal and monetary stimulus will be monetary debasement. We have all lived through two decades of declining inflation. Most central bankers have never experienced inflation. Their jobs have become one of stimulating economies and bailing markets out of crises. The risks feel very asymmetrical to us and we think it makes sense to avail oneself of long-term inflation protection, even if it is not something that is likely to be rewarded in the next year or two. +

ECONOMIC COMMENT

What will be the cost?

“Battles are never the end of the war” – former US President James Garfield

By MARIE ANTELME

THE QUICK TAKE

End-March data from around the world show the devastating economic fallout of Covid-19

China and developed markets may partially recover by end of Q2-20; emerging economies will bear the brunt

SA's already considerable headwinds have intensified; our fiscal position is precarious

Will this be the impetus for the policy action that has thus far been lacking?



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

THE CORONAVIRUS IS at once a health crisis and an economic crisis, which has already pushed the world economy into a recession. By trying to limit the human cost of the virus, governments are imposing a massive economic cost through lockdowns that close economies, which may well have longer lasting and more deeply damaging consequences that we cannot yet foresee. It's possible that the ultimate socioeconomic price that the economic crash exacts will be hard to balance with the actual human cost of the virus. This is the tragedy we face.

The sudden halt in economic activity over the past three months is unprecedented, and there is enormous uncertainty about the path ahead. With the oil price collapse, further demand-shock complexity is added to the mix. Early activity indicators have recently been published, showing the depth of the economic impact. Most charts look like the latest data point is an error (Figure 1, page 13). At the time of writing, China's GDP for the first quarter of 2020 (Q1-20) contracted -6.8% year on year (y/y).

In the US, data measuring initial weekly jobless claims – the first indication of applications for unemployment benefits – double-spiked to never-before-recorded levels, dwarfing all crises since 1967 when the data starts. Cumulatively, weekly claims increased to over 22 million over the past four weeks, implying a spike in US unemployment to 20% in April – a level last seen in the Great Depression (Figure 2, page 13).

In response, economists who started revising global growth forecasts lower when China was hit by the virus at the start of the year, assuming supply chain and demand-related disruptions, are now in an ongoing cycle of downward forecast revisions. This latest set of data will show a deepening deterioration in coming months, given the tightening policy response that is widening the net of lockdowns during that time.

This places us squarely in the realm of the unknown, with not much more than (educated) guesswork informing forecast revisions.



Figure 1

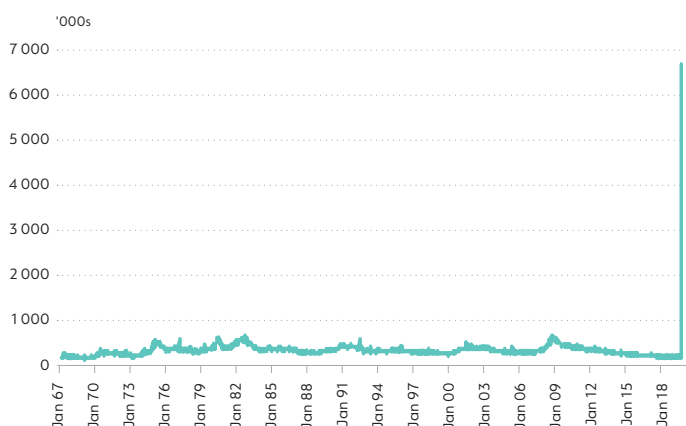
US ECONOMIC ACTIVITY INDEX



Source: New York Federal Reserve Bank

Figure 2

US WEEKLY JOBLESS CLAIMS



Source: St Louis Federal Reserve Board

WHAT WE THINK WILL HAPPEN

Part of the challenge in assessing the economic impact of these shocks is, first and foremost, the ‘novel’ aspect of this virus: it’s new, and we simply don’t know how the pandemic will evolve. It’s also extremely difficult to untangle the complex inter-relationships between the uncertain evolution of both the severity and the duration of the economic shock, and what these mean for future recovery. Further, the effects of the swift and unprecedented global monetary and fiscal responses need to be considered, and the degree to which these measures can protect underlying economic resilience and assist recoveries on the other side.

What we know about the economic crisis currently unfolding is broadly shaped by the following assumptions:

- 1. Asia**
China’s economic growth collapsed in Q1-20. Early data suggests a modest second-quarter

(Q2-20) recovery. Countries within Asia that are closely integrated into Chinese supply chains and trading patterns should suffer coincident weakness, but to varying degrees. For instance, with the early enactment of containment policies, South Korea and Taiwan have shown relatively lower infection rates and, to date, less severe cases, and stand to benefit as China recovers.

2. The developed West

Western Europe and the US are likely to see the depth of their economic slowdowns straddle Q1-20 and Q2-20. Growth had probably already contracted in Q1-20, based on what we are seeing in PMI and employment data. However, the intensity of the weakness is most likely to be felt in Q2-20 (and perhaps beyond), as public policies aimed at containing contagion were implemented at different paces and with different intensities in these regions.

3. Non-Asian emerging markets

The impact on non-Asian emerging markets remains uncertain, but these countries will certainly not be immune. The full impact on Southern Hemisphere countries is mostly yet to be seen. Initial transmission lagged, and government responses have varied widely. Emerging economies have different socio-economic profiles but, broadly, have weaker healthcare systems; lower quality institutions (including financial); and large proportions of the population – whose immune systems are more likely to be compromised – living in close proximity, making social distancing almost impossible. In addition to the social challenges, emerging markets are facing tighter financial conditions and are more likely to suffer the consequences of a return-to-normal demand sooner than developed economies. It’s very likely that the economic impact on emerging economies will be more enduring than for their developed counterparts and may linger through year-end.

UNPRECEDENTED STIMULUS

It also isn’t clear that the depth of the economic downturn will be any real guide to its recovery; this will depend on the effectiveness of interventions to contain and treat the virus. Importantly, global policymakers have mobilised enormous fiscal and monetary resources, estimated at close to 6% of global GDP. These interventions primarily aim to:

1. Ensure that financial markets are liquid and continue to function – these are the lifeblood of the global economy;



2. Ensure that companies don't close, forcing a permanent loss of economic capacity; and
3. Protect jobs.

While the depth and breadth of these interventions are unprecedented, it's still too early to estimate their effectiveness. In some cases, the announced policies have yet to be implemented. But the most important issue is that these policy responses aim to mitigate the demand shock that has come as a result of lockdowns.

Mitigating the supply shock, namely enabling people to return to work, requires a resolution to the health crisis. At this stage, this would require a much broader base of testing for the virus so that governments, companies and households are comfortable enough to start a slow pace of normalisation. Again, we are hostage to its unknown prevalence, and this remains a weak link in any assessment of an economic recovery.

The IMF recently published its *Spring World Economic Outlook*. Amidst great uncertainty and predicated on a moderate recovery in the second half of 2020, global GDP is expected to shrink -3.0% in 2020, and then recover to an above-trend 5.8% in 2021. Within advanced economies, the US economy is forecast to contract -5.9% in 2020 and then recover to growth of 4.7% in 2021. In Europe, the impact of the pandemic has been more severe, with a recession measuring -7.5% this year, to recover 4.5% in the next. The uncertainty regarding emerging markets is acute – in many cases the worst is likely still to come, with considerable health and economic vulnerabilities. Emerging market growth is expected to contract 1.0% in 2020, and to rebound 6.6% in 2021, led by a 9.2% growth recovery in China. Despite these strong growth recovery forecasts, neither developed nor emerging market GDP is expected to recover to pre-crisis levels over the forecast period.

THE LOCAL SITUATION

South Africa faces these same challenges, but with even greater health crisis uncertainty and an unfolding economic crisis against which we have very little defence, due to our already weak economic position. Even before the lockdown, most economists had lowered growth forecasts due to severe electricity constraints, and GDP was broadly forecast at below 0.5% in real terms, following a paltry 0.2% growth in 2019.

In February, the Minister of Finance warned that the fiscal deficit would amount to 6.8% of GDP, and that the total funding of this deficit and other fiscal obligations would be even bigger, at 8%. On

23 March, President Cyril Ramaphosa announced a three-week lockdown starting 26 March to 'flatten the curve' of infection. The decision will most certainly limit the ultimate human cost and better prepare the fragile healthcare services sector for an inevitable escalation in infection. As elsewhere, however, the economic cost may be higher and longer lasting than the health crisis. The lockdown effectively cripples about 45% of the productive economy. While some essential services and small parts of the retail sector remain open, tourism and related industries are not only completely shut, but will take a long time to recover. The export sector will also be hard hit, including agriculture.

Since then, the lockdown has been extended a further two weeks to the end of April, with few changes to the imposed restrictions. Some parts of the mining and agriculture sectors, as well as industries associated with essential services, have seen some conditions lifted, but the lockdown on the rest of the economy, for now, is acute.

Forecast revisions to account for such an unprecedented shock suggest GDP may contract by between 5% and 10% in 2020. Recently, the South African Reserve Bank (SARB) released updated forecasts, which now see GDP contracting -6.1% in 2020, with a modest rebound to 2.2% in 2021. Our estimates suggest a -13% y/y contraction in Q2-20, and a weak recovery into year end, given the uncertain progress of the pandemic, both globally and at home. At Coronation, our expectations are for a marginally tighter contraction of -6.4% in 2020 and a more 'robust' rebound of 3.8% in 2021. Again, this still implies that the level of GDP at the end of 2021 will be below where it was in 2019 (Figure 3, page 15).

Such weak economic growth, coupled with a much lower oil price, should keep inflation at low rates in the short to medium term, although some pass-through from the weaker currency and supply disruptions seem likely as things normalise. Consumer price inflation is forecast to average 3.4% in 2020 and 4.0% in 2021.

POLICY ACTION

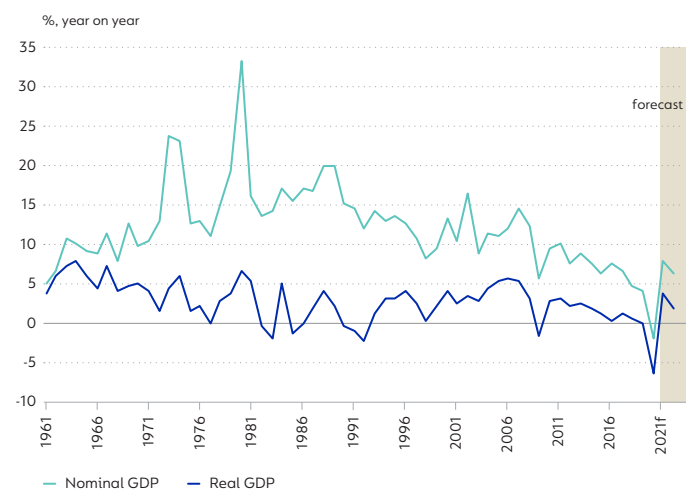
Policymakers have been quick to respond. The SARB's Monetary Policy Committee announced a cumulative 225-basis point cut in the repo rate this year, from 6.50% to 4.25%, enabled by weak economic growth, low inflation and well-anchored expectations. In addition, the SARB has acted to ensure that the financial markets continue to function properly and that there is sufficient liquidity to meet cash demand. The SARB has introduced twice-daily repo operations and increased the term of its refinancing operations

THE SARB HAS ACTED TO ENSURE THAT THE FINANCIAL MARKETS CONTINUE TO FUNCTION PROPERLY AND THAT THERE IS SUFFICIENT LIQUIDITY TO MEET CASH DEMAND.



Figure 3

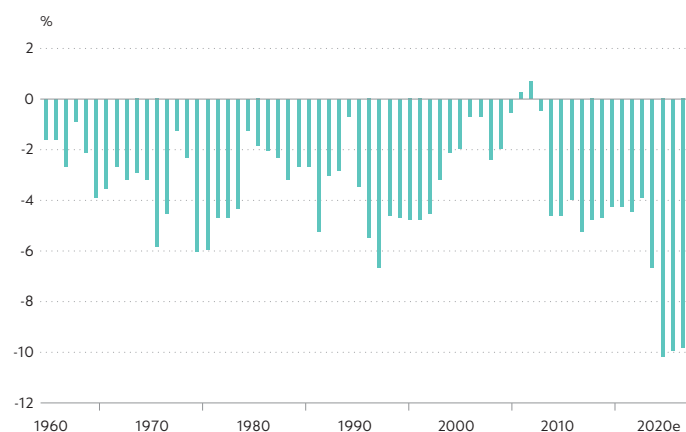
SOUTH AFRICA'S GDP AND FORECASTS



Sources: Statistics South Africa, Coronation

Figure 4

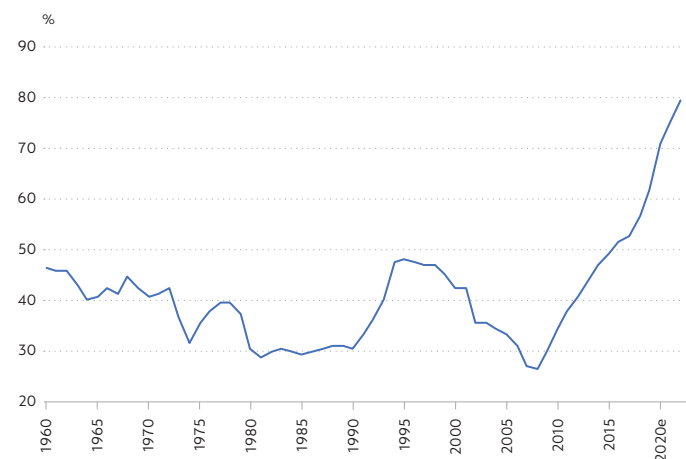
SOUTH AFRICA'S FISCAL DEFICIT, % GDP



Sources: National Treasury, South African Reserve Bank, Coronation

Figure 5

SOUTH AFRICA'S DEBT TO GDP



Sources: National Treasury, South African Reserve Bank, Haver, Coronation

by up to 12 months. It also announced that it will purchase government securities in the secondary market, should dislocations arise.

On the evening of 21 April, the President announced a R500 billion (~10% of GDP) government response package. This aims to meet a range of needs, including support for the vulnerable (extended Unemployment Insurance Fund (UIF) payments and direct transfers to households), wage support, protection for companies via loan guarantees and tax relief, municipal assistance, and financial support for the healthcare sector. Of the R500 billion, R200 billion is for a loan guarantee scheme, R100 billion is to create and protect jobs, and R70 billion will go towards tax relief through the granting of deferred payments.

Final funding arrangements have yet to be published by the Minister of Finance in a pending Appropriation Budget. But, as far as we can account, of the total R500 billion, R130 billion will be reprioritised from existing Budget allocations, while multi-lateral funding from a combination of loans from the IMF, the World Bank and the New Development Bank could yield about R120 billion. The loan guarantee scheme of R200 billion is through partnership with the local banks and the SARB. This is likely to be a contingent liability at first, with an uncertain drawdown – so the actual cost is uncertain, and the impact on government's contingent liabilities will also depend on whether the full scheme is taken up.

Future deficits will be affected by the proportion of loans that turn bad. The remaining resources include the UIF, which we think will fund some of the job protection and wage support allocations. Overall, additional funding is likely to be significantly less than the total package implies, but will, on balance, add to the large fiscal fall out of the crisis.

In addition, the ultimate fiscal cost will depend on the economic recovery after the lockdown, which is, in part, dependent on the duration of the lockdown. However, the fiscal intervention is a welcome support that should materially assist in limiting the downside risk to economic growth from this crisis.

FISCAL SQUEEZE

The fiscal implications of this are extremely negative. The fiscal deficit is expected to exceed 10% of GDP in our baseline and will be greater once we include the details of government's response the crisis (Figure 4). The sharp drop in revenue and the likely very-low nominal growth that follows a shock like this, makes funding the shortfall extremely difficult. Under our baseline, the public sector borrowing requirement will exceed 11% of GDP in each of the next three years (Figure 5). Government

debt will continue to accumulate, with nominal growth well below nominal funding costs, with the latter likely to rise.

A THREE-PEAK CHALLENGE

Policymakers are going to face three material challenges in coming months: the impact of the pandemic on the people and economy of South Africa, with a structurally damaged fiscal position that requires funding; ongoing pressure on capital flows from the financial account, which complicates that funding; and the likely pressure this will place on the financial system.

While government's crisis response is a necessary intervention, it remains to be seen whether it has enough credibility to anchor market expectations about the effectiveness of the programme and the likely impact on fiscal sustainability in the longer term. The SARB has shown willingness to respond timeously to financial constraints and has the capacity to do so. We expect these interventions to increase in coming months, but warn that they are not without risk, and we expect SARB policy to remain prudent. In this regard, some external funding arrangement(s) seem inevitable, both in the short and the longer term.

CAN WE FIND OUR FOOTING?

In such an uncertain environment, it's difficult to know what to do, but where possible – and especially in light of South Africa's fragile fiscal position – proactive contingency planning can go a long way to support confidence and reduce uncertainty. In the eye of the crisis, global financing institutions are more likely to respond more generously than they would otherwise, albeit not without the necessary conditionality.

We are encouraged by President Ramaphosa's timely intervention to mitigate the pandemic's damage; we are aware of the hard work being done by the National Treasury to prepare for the interventions that will be needed; and the partnering of private and public healthcare officials ahead of time will surely improve South Africa's ability to respond. Members of the private sector have also contributed generously to support policymakers, public efforts and small enterprises.

Let this also be an opportunity for government to accelerate and implement its growth strategy with critical vigour, because the best way to address these challenges is to help, by all means possible, the economy to grow. +



STOCK ANALYSIS

Naspers

Revisiting the investment case

By ADRIAN ZETLER

THE QUICK TAKE

Naspers' restructuring is a positive step that has created flexibility to unlock significant value for shareholders

Exposure to Tencent, which has proven remarkably resilient during the recent Covid-19-induced economic turmoil, is a significant plus

Tencent is set to capitalise on China's transition to a digital economy and we are very excited about its online payments and fintech business

Naspers trades at a large discount to its intrinsic net asset value and is being grossly mispriced by the market



Adrian is a portfolio manager with 10 years of investment industry experience.

Naspers has formed an integral part of our client portfolios for more than 15 years. Since we last wrote about the company in our September 2015 edition of *Correspondent*, it has been the best-performing share on the JSE (generating a return of almost 20% p.a.) and has contributed significantly to the performance of our portfolios. While the natural temptation after such a strong run is to lock in some of this outperformance, we continue to believe that Naspers is a company that is trading at a substantial discount to its intrinsic value and is one of the most attractive stocks in our market. As such, it remains the largest equity position across our domestic equity and multi-asset class portfolios.

THE CREATION OF PROSUS

In September 2019, Naspers undertook a major internal restructuring and injected all of its international internet assets (including Tencent, which comprised the bulk of its intrinsic value) into a new vehicle, Prosus, which is separately listed in Amsterdam with a secondary listing on the JSE.

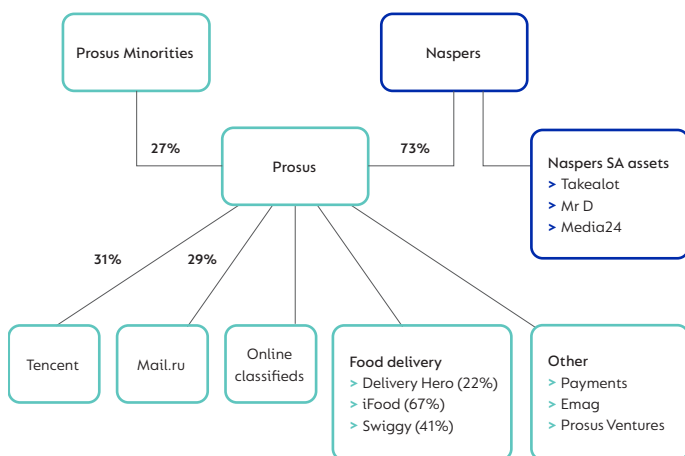
Naspers then proceeded to unbundle 26% of its shareholding in Prosus directly to its shareholders. We thought this restructuring initiative was a positive step, because, apart from providing Naspers with access to international capital markets, it also created a very tax-efficient entry point for investors to gain exposure to Tencent, as well as a portfolio of other high-growth internet assets in the online classifieds, payments, retail and food delivery sectors. Furthermore, the structure provides Naspers with additional tools to manage the large discount to intrinsic value at which it currently trades. This was highlighted when they recently sold a portion of their Prosus holding to execute a Naspers share buyback – thereby unlocking over R3 billion in value for Naspers shareholders. Naspers currently owns 72% of Prosus, which comprises virtually all of Naspers' intrinsic value.

TENCENT – THE JEWEL IN THE CROWN

Weixin (or WeChat), Tencent's main social network, is as central to the company as it is to Chinese life. It has over one billion monthly active users, and is used >

Figure 1

NASPERS GROUP STRUCTURE



Source: Coronation

THE GAMING BUSINESS OFFERS ATTRACTIVE EARNINGS POTENTIAL, WHICH WILL GENERATE SUBSTANTIAL FREE CASH FLOW TO FUND TENCENT'S OTHER GROWTH INITIATIVES.

for business and personal communication, content consumption, payments and utility services. It has become an indispensable tool for everyday life in China. The average user spends 77 minutes per day on the app and Weixin has a roughly 30% share of total internet time spent in China. Weixin's value to Tencent is primarily as a powerful distribution platform for its various other business lines, including gaming and payments.

Tencent has become the leading developer and publisher of PC and mobile games globally, and gaming currently generates c.30% of its revenue and 40% to 50% of its earnings before interest and tax, respectively. The company has been very successful in developing and publishing hit games such as 'Honour of Kings' and 'PlayerUnknown's Battlegrounds' (PUBG, or Peacekeeper Elite as it's called in China), both of which have exceeded a massive 50 million daily active users (DAUs). As the Chinese market leader, Tencent has a formidable position in gaming, but what many people underappreciate is that they now also own stakes in four of the most successful mobile game development studios in the world – Riot Games, Supercell, TiMi and Quantum, and currently has five of the top 10 DAU games in the world sitting in their portfolio. While the gaming business is undoubtedly exposed to increasing regulatory oversight in China, we still believe it can grow earnings in the mid-teen percentages over the next few years and, importantly, generate substantial free cash flow to fund Tencent's other growth initiatives.

The most exciting area within Tencent at present is undoubtedly its digital payments and financial service businesses. We believe that there is still a

huge misperception in the market that Tencent can't be profitable in payments. Our view is that Tencent is currently in an incredibly strong market position versus its competitor, Alipay, and has recently taken steps to increase commission rates and reduce channel fees to ramp up profitability. We think this business will contribute significantly to group profits over the next three to five years. Similarly, Tencent is rolling out other financial services products, such as banking, wealth management and insurance. Given Tencent's distribution capabilities, together with their enviable treasure trove of user data, we think they are very well positioned to build a substantial and very profitable business.

Tencent also owns a number of nascent businesses that are still being significantly undermonetised, as detailed below:

- It operates the largest online video, music and literature platforms in China, all of which are growing very strongly. It has a near monopoly in music and literature, but vies for leadership in video with iQiyi, a Baidu subsidiary. Video is still heavily loss-making, as Tencent is investing in premium content, and competition has kept subscription fees abnormally low (around \$2 per month). However, we believe it can be profitable over time as Tencent gains leverage on its content investments and the competitive environment stabilises. Netflix, which currently has 167 million users (versus Tencent Video's 106 million users), has a market cap of \$167 billion, highlighting the value that can be unlocked from this business in time.
- Weixin remains a largely untapped advertising opportunity. Tencent monetises Weixin at around 20% of Facebook's monetisation of its Asia Pacific audience, despite their much higher levels of engagement, suggesting significant upside potential.
- Cloud remains a very fast-growing segment within Tencent. Although they lag the market leader (Alibaba), they are particularly well placed to capitalise on the growing demand for cloud services driven by the gaming and online video industries. As this business scales, it will also turn to profitability.
- Tencent has quietly built up the largest internet/tech investment portfolio in China, with over 800 investments. This is currently contributing very little to group profitability, despite the company owning stakes in Chinese internet behemoths like Meituan-Dianping (food delivery), JD.com and Pinduoduo (etail),



58.com (classifieds), Didi Chuxing (taxi) and Kuaishou (video sharing), and also some global names such as Tesla and Snap. Over time we believe Tencent will realise significant value from this portfolio.

The Tencent share price has proven remarkably resilient this year (flat in US dollars and up 22% in rands). As the world's largest videogame company, their core business will be boosted by China's measures to contain the spread of the Covid-19 pandemic. While their advertising, payments and cloud businesses will not be immune to the short-term negative economic effects caused by Covid-19, we see these as transitory hurdles and we believe that recent events, which are a consequence of the pandemic (such as working from home, video meetings and online education), will actually accelerate China's shift to a digital economy. Furthermore, given Asian countries' relatively efficient handling of the pandemic outbreak, we expect economies like China to recover relatively more quickly than most other countries in the West, and therefore believe that the risk of Covid-19 undermining the Chinese economy and Tencent's business to be relatively low.

Tencent is currently trading on 28 times one-year forward earnings (23 times excluding its investment portfolio). This is attractive for a business that we believe can continue to compound revenues and earnings at 20%+ over the next five years.

ATTRACTIVE OPTIONALITY IN THE REMAINING PORTFOLIO

Outside of Tencent, Prosus primarily invests in three key areas – online classifieds, food delivery and payments/fintech. As a collective they are currently loss-making; however, we believe that this masks the true quality and long-term profit potential of this portfolio of assets:

- **Online classifieds:** Prosus has one of the broadest online classifieds' portfolios globally, with a presence in most major emerging markets, and dominant positions in Russia, Brazil and Poland. We believe the classifieds model is very attractive, as strong network effects, once dominant, allow the winner to enjoy high margins and low capital expenditure, and therefore high free cash flow conversion. The shifting of advertising budgets from offline to online continues to provide a structural tailwind for the business. In this vertical, there are also a number of consolidation and bolt-on merger and acquisition (M&A) opportunities that we believe can add significant value.

- **Food delivery:** This is the vertical that will attract the majority of Prosus' future capital investment. In food delivery, Prosus has three major assets: a 22% stake in Delivery Hero (Global), a 41% stake in Swiggy (India) and a 67% stake in iFood (Latin America, primarily in Brazil). Many of the markets in which these businesses operate lend themselves to a successful food delivery model, i.e. high income inequality and a well-developed culture of eating out. Food delivery has a large total addressable market and the runway for future growth is certainly long, but as yet unestablished. We also see the food delivery platform model as becoming a natural monopoly once clear leading positions are established; we are therefore very excited about the portfolio of assets that Prosus has established.

- **Payments (PayU):** Prosus has been growing its portfolio of payment service companies through the acquisition of regional gateway players and technology platforms that facilitate cross-border transactions, and by expanding into adjacent verticals such as lending, remittances and wealth management. India has now become PayU's largest and fastest growing market, and it offers merchants a solution that can accept and process many different forms of payment with the highest approval rates. The big opportunity for PayU is to leverage its strong position in payments into the large consumer and small to medium credit opportunity sets currently available in the Indian market. While many in the market might disregard the value of this vertical within Prosus, we think it could be a very attractive acquisition target to large global payments players.

THE NOTORIOUS DISCOUNT

Due to its holding company structure, many market participants believe that Naspers (and Prosus) should trade at a large discount to the value of its underlying assets. Our view is quite different. While a small discount can be justified to account for certain frictional costs inherent in the structure, we think it's important to remember that this is a company that is run by a management team with a proven ability in identifying and capitalising on major media and technological trends. Naspers pioneered pay-TV services in South Africa and was a founding investor in MTN, the largest mobile operator in Africa. It went on to become a major investor in Tencent and Mail.ru, two of the largest internet companies in China and Russia, respectively. More recently, they have embraced ecommerce and built fantastic online classifieds and food

FOOD DELIVERY HAS A LARGE TOTAL ADDRESSABLE MARKET AND HAS A LONG RUNWAY FOR FUTURE GROWTH.

delivery portfolios. Furthermore, we think that capital allocation discipline under CEO Bob van Dijk has been excellent. Some examples of this include:

- They have refined their investment portfolio and focused on verticals with the most attractive economics, large addressable markets and where they have the assets with which they can build market-leading positions. In this process they have exited the majority of their retail investments, specifically Allegro, Flipkart and Souq – all at very attractive prices.
- In 2019, Naspers unbundled 100% of Multi-Choice and 26% of Prosus to their shareholders.
- In 2018, they sold a small portion of their Tencent stake at a good price and raised US\$10 billion. They have been extremely disciplined in how they deployed this capital and today still have \$4.5 billion in cash on their balance sheet. This cash pile is incredibly valuable in the current environment and gives them significant financial flexibility, should attractive M&A opportunities arise.
- Naspers recently sold a portion of their Prosus stake (c.1.5% of Prosus) and used the proceeds (amounting to R22 billion) to fund a buyback of Naspers shares that were trading at a much larger discount to its intrinsic value than Prosus.

ESG ENGAGEMENT DRIVING SHAREHOLDER VALUE

As a large Naspers shareholder, we have engaged extensively with management and the Board of Directors on a number of environmental, social and governance (ESG)-related issues in recent years. One particular area of focus has been

executive remuneration and engaging with the Board in order to improve remuneration structures, transparency and disclosures around the Remuneration Policy.

In this regard, we note the significant improvements that have been made to date:

- management incentivisation is now more balanced between the value created within Tencent and the value created within the rest of the investment portfolio;
- significant improvements have been made with respect to disclosure and providing a clearer link between strategy, performance, remuneration design, and remuneration outcomes; and
- a share buyback programme has been implemented in order to neutralise the shareholder dilution of share options granted to management.

One ongoing point is that Naspers continues to use long-dated options in order to incentivise management. We believe such long-dated options are significantly more expensive for shareholders than shorter-dated options, and therefore continue to engage with the Board in order to shorten the tenure of such instruments.

CONCLUSION

Prosus currently trades at a c.35% discount to its intrinsic net asset value, while Naspers trades at c.50%. We find these discounts puzzling, given the long-term investment track record as discussed above. As such, we think the market is grossly mispricing these stocks at current levels and has therefore created a fantastic opportunity for long-term investors. +



BOND OUTLOOK

Getting ahead of the curve

South African government bonds remain attractive despite global shocks

By NISHAN MAHARAJ

THE QUICK TAKE

SA's already poor fiscal position was hit hard by the decline caused by Covid-19; the Moody's downgrade was mostly already priced

While the SARB has gone some way to increasing liquidity, we expect more rate cuts going forward

There is value to be found in South African bonds and we are poised to maximise opportunities on behalf of our clients



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

From mid-February 2020, the world experienced what can only be described as a near cataclysmic shock. The double crisis of a global oil price war and the rapid spread of Covid-19 across continents has seen shockwaves of fear and panic penetrating geographical and generational boundaries. Governments across the globe have reacted by enforcing either social distancing or more severe isolation through nationwide lockdowns. This is done in order to flatten the curve of infections in a bid to prevent healthcare systems from being overwhelmed and, hopefully, allow the pandemic to be better managed. The risk, they fear, is that it escalates into a global catastrophe.

The key unknowns in this global pandemic are how quickly the virus burns out (if at all), whether herd immunity will develop, what the most effective treatment for Covid-19 is and when (if at all) a vaccine will be ready. Financial markets have reacted fiercely to the economic uncertainty created by the required lockdowns. Over the last quarter, global stock markets are down 20%, most emerging market currencies are down between 15% and 20%, global credit markets are down at least

7%, and global listed property is down 28.3%. The magnitude of these moves has not been seen since the Global Financial Crisis (GFC) of 2008/2009, and, importantly, these moves have all occurred in a much shorter time period.

THE EFFECT ON SOUTH AFRICAN FIXED INTEREST ASSETS

No country has been insulated from this crisis and the concurrent slowing in growth and economic uncertainty. The South African Reserve Bank (SARB) reacted by cutting interest rates by 100 basis points (bps) in March, and in subsequent days also unveiled an unprecedented number of measures to keep liquidity in the banking sector. These included offering long-term repurchase agreements (repos) of up to one year on government bonds; buying government bonds in the secondary market so as to support market liquidity; lowering certain regulatory bank capital ratios to support the economy; and temporarily adjusting the funding mix in weekly government auctions towards shorter-dated government bonds. These measures helped calm the fixed income markets somewhat, but the downward adjustment in asset

prices was already quite severe. Year to date, the All Bond Index (ALBI), the Inflation-linked Bond Index and the All Property Index were all down (8.7%, 6.6% and 48.1%, respectively), bringing their one-year returns to -2.9%, -4.7% and -48.9%, respectively. Cash has been the only asset class to deliver positive returns over both the last quarter and one year, yielding 1.6% and 6.8%, respectively.

FRAMING OUR ACTIONS

Former US President John F. Kennedy once reflected, "When written in Chinese, the word 'crisis' is composed of two characters. One represents danger and the other represents opportunity." We believe this observation holds true for this crisis as well. In assessing it, we need to both ascertain the short-term economic consequences that will manifest over the coming months and identify those investment opportunities that could benefit our client portfolios over the next five to 10 years. Coronation's bottom-up, valuation-driven research process aims to identify those assets that are mispriced for the underlying risks and that have a sufficient margin of safety. In the context of South African fixed income assets, we have reassessed our fundamental assumptions coming into this crisis in terms of what the unfolding situation means for these assumptions, how this filters into our asset valuations, and finally, how we position the portfolios in response to these changes.

OUR PORTFOLIO POSITIONING COMING INTO THE CRISIS

Pre-Covid-19, our key assumptions were that inflation in South Africa would remain under control (5% average), growth would remain subdued (0.2% for 2020 and 1.1% for 2021), and that government finances would remain constrained, but that the problems were being adequately addressed. We had expected interest rates to move lower by 50bps to 75bps to provide some offset to fiscal tightening and to lend support to growth.

Against this backdrop, we viewed nominal government bonds as attractive, specifically in the longer end of the curve; inflation-linked bonds (ILBs) in the two- to five-year area were offering good value relative to nominals and cash; and certain counters within the listed property space seemed reasonably attractive. We were very cautious on corporate credit, as we did not believe that valuations accurately reflected the higher risks associated with slowing growth. This was evident in the increased restructuring and probability of default on loans (credit loss ratios increased in the most recent bank results). Credit spreads compressed aggressively over the past 18 months due to a reduction in supply and a reach for yield by non-traditional

credit investors. In our view, this made the asset class very expensive and, hence, unattractive. Our portfolios therefore had a neutral allocation to government bonds with duration focused in the longer end of the curve, a moderate allocation to ILBs, a historically low allocation to selected listed property stocks and a low allocation to select corporate credit.

UNDERSTANDING THE IMPACT OF COVID-19

The Covid-19 crisis has been likened to the Great Depression of the 1930s, due to the expected effects on global growth. Global GDP declined by 27% during the course of the Great Depression, which lasted just under four years. Global growth is expected to decline by a similar magnitude in the second quarter of 2020 alone. It is the containment measures taken by governments around the world to mitigate the impact of the virus that have caused turmoil in financial markets, as they try to assess the economic consequences of such actions. During March, the ALBI was down 9.7%, ILBs were down 7.1%, listed property was down 36.6%, and the rand was down 12.6% against the US dollar.

One of the big learnings for authorities from the Great Depression and the GFC is the need to act quickly, lest markets lose confidence and the crisis blows up. Global authorities have responded very quickly by dropping interest rates back to zero and committing to large quantitative easing (QE) measures (much greater than those seen in the GFC). In addition, many developed markets have already committed to fiscal spending ranging anywhere from 2% to 10% of GDP, in order to soften the growth slowdown and foster a stronger subsequent recovery.

SOUTH AFRICAN GOVERNMENT BOND MARKET LIQUIDITY DRIES UP

South African assets reacted in lock step with the global risk aversion sell-off. However, South African government bonds (SAGBs) have been exceptionally volatile during this period and sold off materially. Next to cash, government bonds are the most liquid part of a portfolio. In times of crises, when cash is often required to meet margin calls on less liquid assets and to satisfy redemptions, government bonds are used as the natural funding source. The aggressiveness of the sell-off in global risk markets and the outflows globally from emerging market bond portfolios have meant that foreign investors into the local bond market have had to sell their holdings for this exact purpose. This created the first leg of the sell-off in our bond market. In addition, we saw the liquidity in the interbank market evaporate, as local banks (the sole intermediaries of SAGBs) pulled back on risk-taking due to reduced liquidity conditions.

GLOBAL GROWTH DECLINED BY 27% OVER FOUR YEARS DURING THE GREAT DEPRESSION; WE ARE EXPECTING A SIMILAR DROP IN Q2-20 ALONE.



In times like these, banks prefer to limit the cash lent in the interbank market and utilised in trading activities in financial markets, primarily to support their corporate and individual customers who may have funding and operational needs. This propagated the irrational market behaviour we have witnessed over the past few weeks. The SARB played a crucial role by stepping in and injecting liquidity into the market, restoring some calm. This included offering term repos on SAGBs and buying SAGBs in the secondary market.

MOODY'S DOWNGRADE TO SUBINVESTMENT GRADE

Moody's Investor Service downgraded South Africa to subinvestment grade on 27 March 2020, a day after we went into lockdown. This is not a new development and has been well flagged by the market for a few years. As suggested in previous articles, offshore investors have been decreasing their holdings of SAGBs for some time now, and the South African sovereign spread already trades at levels consistent with subinvestment-grade debt. Additionally, we have seen the South African risk premium steadily increase, suggesting that even before the onset of Covid-19, the downgrade was already significantly priced in. The one thing that has changed is that market volatility has increased and liquidity in the secondary bond market has decreased. This suggests that the mandated selling of SAGBs might result in a more significant move than initially anticipated. However, the FTSE, which administers the World Government Bond Index (WGBI), has allowed up to the end of April for funds to rebalance, which won't stop the selling but will allow it to be more gradual (previously, funds would have had to rebalance by the end of March).

In addition, with the SARB announcing its willingness to purchase SAGBs in the secondary market, the effect of this will be dampened. The more important question is whether this weakness represents a great buying opportunity, or whether fundamentals have shifted to such an extent that a more significant risk premium for SAGBs is justified.

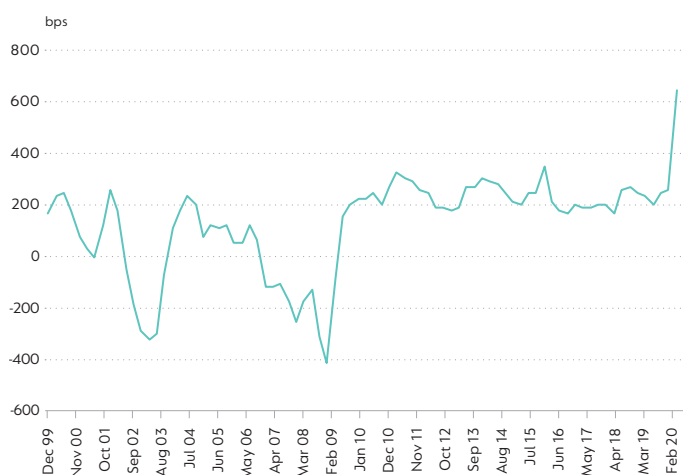
CHANGES TO FUNDAMENTALS

The Covid-19 crisis is still evolving, with many unknowns. Key is the length of time that nations will remain in lockdown and the subsequent economic disruption. This uncertainty is clear in market volatility and the decline in risk appetite. However, there are a few key conclusions that we can draw at this point. First, inflation and growth will be lower than our previous expectations. We expect inflation to average below 4% in South Africa over the next two years. This is due to the slowdown impact from Covid-19 and the lower

oil price. Growth in 2020 is likely to be anywhere from -4% to -7%, rebounding to just over 3% in 2021. The initial response of the SARB was to cut rates by 125bps in March. We said then that they had room to move policy rates another 100bps lower to 4.25%, which they subsequently did in an emergency Monetary Policy Committee meeting on 14 April. This will reduce the real yield materially but still keep it in positive territory, which would still compare favourably to the negative policy rates prevalent in most of the global developed economies. Unfortunately, given South Africa's poor fiscal starting point and now negative growth expectations, it is very likely that the debt-to-GDP ratio will increase towards 80% and the fiscal deficit will widen to between -8% and -10% of GDP.

Figure 1

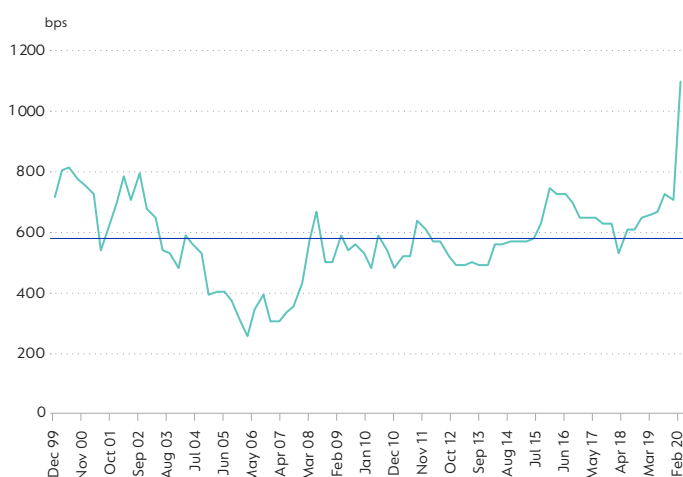
SOUTH AFRICAN 10-YEAR GOVERNMENT BONDS VERSUS THE REPO RATE



Sources: Bloomberg, Coronation

Figure 2

THE SOUTH AFRICAN 10-YEAR GOVERNMENT BOND VERSUS THE US 10-YEAR TREASURY BOND



Sources: Bloomberg, Coronation

Compounding this problem further will be the need for government to provide more fiscal support to aid the economy through these trying times and any additional support for ailing State-owned enterprises such as Eskom. On the positive side, however, lower growth implies lower energy intensity, giving Eskom time to deal with much-needed maintenance. We are hopeful that this situation allows for more drastic measures to be taken at Eskom in order to rectify its financial and operational position.

In many historical instances, crises are what necessitate change. South Africa has been plagued with a slow policy response to its many structural issues. However, the pragmatic approach to the current crisis will hold leadership in high esteem when we finally emerge from it. In an uncertain world, in an economy that has lost all hope, if the leadership used this crisis to make the necessary hard decisions, the country could very likely emerge stronger post-Covid-19. However, as investors, we cannot bank on hope and must instead ensure that we position our clients' portfolios for the risks and opportunities that are arising.

THE VALUATION OF SOUTH AFRICAN GOVERNMENT BONDS REMAINS ATTRACTIVE

10-year SAGBs currently trade at a yield of 11% compared to cash, which we expect to be around 4.25% by the end of this year. The spread between SAGBs and cash is at the widest it has been since the start of inflation targeting (2001) and implies that 10-year SAGBs can sell off 125bps over the next year before they start to underperform cash (Figure 1, page 23). In addition, with inflation expected to average close to 4% over the next two years, the implied real yield on the 10-year SAGB is close to 7%.

Global policy rates have moved to zero and are expected to remain there for some time to come. Several developed market central banks have restarted their QE programmes on a scale larger than those implemented during the GFC. The level of monetary policy accommodation and support that has been pushed into the global economy is unprecedented. Global developed market bonds either trade in deeply negative territory or very close to zero. 10-year SAGBs now trade in excess of 10% above developed market bonds (Figure 2, page 23).

Emerging market local currency bonds have all moved weaker during the crisis, but South Africa remains the cheapest real yield and cheapest tradeable nominal yield among its peers (Table 1).

The SARB's commitment to keep liquidity in the system and the National Treasury's adjustment to

Table 1

EMERGING MARKET YIELD MOVES

	Nominal yield	Implied real yield	5-year change in nominal yield	5-year change in real yield
Turkey	12.74	2.07	5.05 ▼	1.28 ▼
South Africa	11.65	6.79	4.15 ▼	4.89 ▼
Brazil	8.62	4.84	(3.34) ▲	(0.61) ▲
Mexico	7.96	4.37	2.04 ▼	2.06 ▼
Indonesia	7.84	4.44	0.15 ▼	2.80 ▼
Russia	7.06	3.36	(3.65) ▲	(0.44) ▲
India	6.13	2.00	(1.84) ▲	(0.73) ▲
Average	5.57	1.92	(0.07) ▲	0.37 ▼
Chile	3.87	0.74	0.700 ▼	0.87 ▼
Malaysia	3.30	1.50	(0.58) ▲	1.18 ▼
China	2.60	(0.10)	(0.94) ▲	(1.11) ▲
Hungary	2.27	(0.95)	(1.32) ▲	(1.92) ▲
Poland	1.80	(0.97)	(0.70) ▲	(1.96) ▲
Czech Republic	1.28	(1.12)	0.57 ▼	(0.09) ▲
Israel	0.95	(0.05)	(1.26) ▲	(1.04) ▲

Sources: Bloomberg, Coronation

Figure 3

THE 10-YEAR VERSUS THE 30-YEAR SOUTH AFRICAN GOVERNMENT BOND SPREAD



Sources: Bloomberg, Coronation

Table 2

SOUTH AFRICAN GOVERNMENT BOND BREAKEVEN RATES

Bond	Maturity	Yield	Breakeven relative to ALBI	Breakeven relative to R2030
R186	21 Dec 26	10.60%	(1.1%)	(1.4%)
R2030	31 Jan 30	11.68%	0.1%	
R2032	31 Mar 32	12.12%	0.4%	0.2%
R2035	28 Feb 35	12.24%	0.4%	0.2%
R2040	31 Jan 40	12.35%	0.4%	0.2%
R2044	31 Jan 44	12.35%	0.4%	0.2%

Sources: Bloomberg, Coronation



the funding profile over this period have seen the yield curve flatten quite aggressively past 20-year maturity (see Figure 3, page 24). In running our total return calculations, we believe that bonds in the 10- to 12-year bucket offer the most value. Table 2, on page 24 shows how much bonds can sell off before their return equals that of the ALBI, and how much they can sell off before they can match the return of 10-year SAGBs.

Globally, credit spreads have blown out. South Africa's sovereign credit spread was already trading at a level consistent with other subinvestment grade countries, but is now trading 100bps wider than even the Subinvestment Grade Index (Figure 4). Even if one assumes this is correct, the absolute level of sovereign credit spreads is very much elevated, suggesting potential room for compression.

In constructing a fair value estimate for 10-year SAGBs, we use the global risk-free rate (the US 10-year Treasury Bond), the inflation differential between South Africa and the US, and the South African sovereign credit spread. In Table 3, both based off current market variables and expected values for those variables, we believe 10-year SAGBs are trading at levels 120bps to 220bps above fair value. This is just one of the many models we use to determine the fair value for the 10-year SAGB, but it is the simplest and easiest to understand.

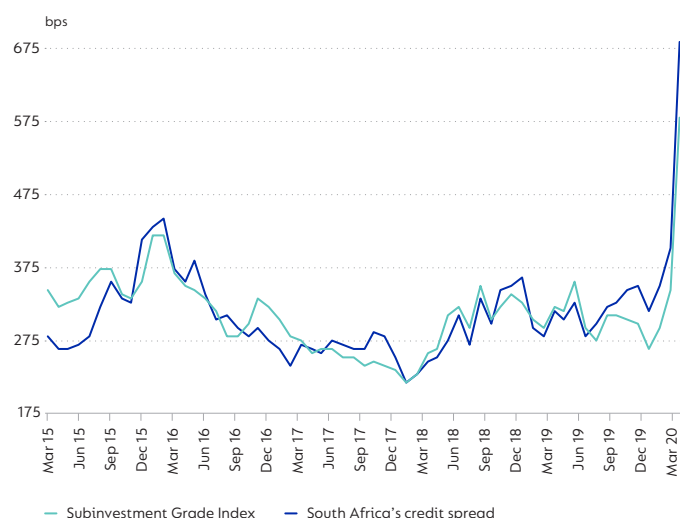
In the 'current' column, we have extracted all variable inputs based on current market levels, except for the 10-year SAGB inflation expectation, which we have adjusted to our expectations. In the normalised column, we assume a normalised value for the US 10-year Treasury Bond of 1.75% (down from 2.25% previously), normal US inflation of 2% (which the Federal Reserve Board targets), and a credit spread that is 100bps tighter than the current South African credit spread, in order to reflect a normalised global credit environment.

FIVE- AND 10-YEAR INFLATION-LINKED BONDS ARE ATTRACTIVE

ILBs have sold off, both in sympathy with nominal bonds and due to lower inflation expectations. However, given the higher modified duration of most of these bonds, they have underperformed their nominal counterparts. In Table 4, we list a few key ILBs, their current real yield, and their implied breakeven (where inflation has to average in order for their return to equal that of the nominal bond equivalent). In five- and 10-year ILBs, real yields are close to 6%, with breakeven inflation well below 5%. We consider these to be very attractive and they warrant a healthy allocation in our portfolios.

Figure 4

SOUTH AFRICA VERSUS THE SUBINVESTMENT GRADE INDEX



Sources: Bloomberg, Coronation

Table 3

SOUTH AFRICAN 10-YEAR GOVERNMENT BOND VERSUS US 10-YEAR TREASURY BOND FAIR VALUE

	Current	Normalised
US 10-year inflation expectations	0.68	1.75
South African 10-year inflation expectations	4.50	4.50
US yield	1.00	2.00
South Africa's credit spread	6.140	5.140
Fair value	10.320	9.390
Current South African 10-year	11.60	11.60
	1.28	2.21

Sources: Bloomberg, Coronation

Table 4

INFLATION-LINKED BOND YIELD AND BREAKEVEN

	Real yield	Implied breakeven inflation
2-year	3.4000	2.42
5-year	5.6000	3.04
9-year	6.2000	4.81
18-year	6.5500	5.44
30-year	6.3000	5.64

Sources: Bloomberg, Coronation

OUR BIGGEST CONCERN IS THE LOCAL CREDIT MARKET

Fundamentally, we believe that South African corporate credit spreads should already have been under pressure, given the poor economic fundamentals of the country and the clear evidence that the probability of default for most borrowers is on the rise. A clear indication of this >

was shown in the rising credit loss ratios reported by all our local banks during their last updates. However, there has been a drop in corporate issuance due to the poor growth backdrop and the lack of the funding needed by banks and corporates (due to the lack of investment in the country). Leading into the crisis, with issuance lower and a reach for yield in the local market spurred by the reduction in the return expectations of many other asset classes, local credit spreads compressed aggressively.

The economic fallout of the Covid-19 crisis will add further stress to the balance sheets of all South African companies, hence lowering their credit quality. As such, it is reasonable to expect a widening of credit spreads just based on the fundamental deterioration. Add to this the repricing we are seeing in global credit markets, the drop in risk appetite, an acceleration of redemptions from fixed income funds in lieu of cash and a tightening of credit spreads over the last 12 months, and one can easily see that this is a market that needs sobering.

Coronation's bottom-up, valuation-driven credit research process takes both fundamentals and liquidity into consideration in its assessment of risk and return. This ensures that we build a level of conservatism into our pricing expectations to deal with the illiquid nature of certain assets. In addition, liquidity plays a vital role in our portfolio construction process.

Over the last 18 months, we have endeavoured to reduce our exposure to listed credit by reducing our exposure to new-style bank subordinate debt (AT1 and AT2), certain bank senior issues and not actively purchasing new issues in the primary market. Our current holdings of credit instruments are shorter dated in nature, predominantly issued by the big four banks and are listed on the JSE, making them tradeable in some part.

Credit spreads globally have widened tremendously. The credit spreads of South African companies that issue offshore debt have widened. The Sasol two-year bond trades at a yield of 22% in US dollars, and Standard Bank and First Rand Limited Tier 2 sub-debt bonds now trade at yields of 10% in US dollars. In the local market, however, these bonds have not re-marked at all, with Sasol two-year debt still marked at 134bps over Jibar (6.8% all-in yield) and the banks' four-year sub-debt still marked at 250bps over Jibar (8.1% all-in yield).

These bonds are generally illiquid and are held by local institutions. We expect them to only re-mark in

the secondary market when they are sold. We view it as just a matter of time before we see a significant re-mark in these debt instruments as redemptions intensify and forced selling pushes spreads to levels like those seen in the offshore market.

LISTED PROPERTY LOOKS CHEAP AT FACE VALUE, BUT YOU NEED TO LOOK UNDER THE HOOD

The South African listed-property sector has grown tremendously over the last 10 years into a meaningful part of financial markets, with a market capitalisation of almost R300 billion. However, not all listed property companies are equal. Each one has varying exposure to different sectors (retail, office and industrial), varying underlying asset quality and varying financial constraints. In the last five years, many have chosen to diversify away from South Africa and enter highly leveraged plays on offshore property. This has resulted in a general rise in balance sheet risk across the sector.

The current crisis will reduce rental income, put pressure on asset values, increase the cost of borrowing for lower quality businesses and test inexperienced management teams. It is entirely possible that most of the companies will require additional capital and that dividends are suspended to preserve capital. Currently dividend yields are eye-watering, touching close to 30% in some of the large-cap names.

However, one must be cautious not to take these at face value and understand how the key issues mentioned above affect that yield. We believe there are a few select large-cap counters that satisfy our stringent conditionality. These include Growthpoint, Liberty Two Degrees and Redefine. These are all counters in which we currently have holdings across our multi-asset portfolios and in which we would take more meaningful stakes in time to come.

POSITIONING OF PORTFOLIOS

We view 10-year SAGBs as the most attractive asset in the fixed income suite, with five- to 10-year ILBs coming in a close second. Listed property looks attractive, but allocations need to be made on a stock-specific basis, with careful consideration paid to the issues outlined above. Credit markets are very unattractive, and we would wait for a significant widening in credit spreads before allocating more capital.

Given the compression in the 20- to 25-year area of the curve relative to the 10- to 12-year area and risks from further fiscal deterioration, we are switching our longer end bond (20- to 25-year area)

THE ECONOMIC FALLOUT OF THE COVID-19 CRISIS WILL ADD FURTHER STRESS TO THE BALANCE SHEETS OF ALL SOUTH AFRICAN COMPANIES, HENCE LOWERING THEIR CREDIT QUALITY.



exposure into the 12-year area of the curve. We would look to increase duration into weakness but are tempered by current volatility and pending outflows as a result of WGBI expulsion. Therefore, we would be more measured in our approach to adding duration.

ILBs are attractive, and we would look to further increase our holdings in the five- to 10-year area into weakness. These instruments carry a higher modified duration and are more illiquid than nominal government bonds. As such, we will be even more cautious in our approach to adding exposure.

We will not be adding any credit to our portfolios until we view spreads as cheap relative to our fundamental assessment, and would instead use the little credit that we have, given that it is shorter dated, as a funding source for the other more attractive asset classes.

The key lesson from 2019 was not to underestimate the degree to which lower economic growth hurts

property companies. This time, the problems are more severe, dividends could be suspended and a 30% yield could be zero. For now, we are not actively looking to add to our property holdings and are comfortable with our historically low allocation. There are very few counters that offer value and we will add to these at levels that we believe offer a large margin of safety, especially given the attractiveness of SAGBs and ILBs.

We remain committed to only adding assets to our clients' portfolios that we believe offer a sufficient margin of safety and are adequately priced for the underlying risk. We are constantly on the lookout for valuation dislocations relative to fundamentals, which we believe will benefit our client portfolios over the longer term. In this volatile period, asset price behaviour tends to be irrational, which will adversely affect short-term performance. It is during times like these that once-in-a-lifetime opportunities present themselves, and one has to stand ready to act with conviction to take advantage of these opportunities. +

STRATEGY UPDATE

Coronation Global Houseview Strategy

By KARL LEINBERGER, SARAH-JANE ALEXANDER and ADRIAN ZETLER



Karl is Chief Investment Officer and has 19 years of investment industry experience.



Sarah-Jane is a portfolio manager with 16 years of investment industry experience.



Adrian is a portfolio manager with 10 years of investment industry experience.

IN A CHALLENGING environment where most asset classes experienced sharp declines, the portfolio declined 14.3% for the first quarter of 2020 (Q1-20). Despite these trying conditions, the Strategy has performed well against its peer group and over longer periods.

Q1-20 provided investors with very few places to hide. Equity markets around the world experienced record declines during the quarter. Since January, the Covid-19 outbreak has overtaken our lives and transformed our world, presenting a medical, economic and human challenge that is unprecedented in our lifetime. The outbreak of this pandemic has impacted financial markets with a swiftness and ferocity normally only seen in a classic financial crisis. In a matter of weeks, global equity benchmarks fell from record highs into bear markets. The level of volatility experienced during this market sell-off has also been unprecedented; from 19 February to 23 March, the US stock market saw the quickest meltdown in history, with a cumulative loss of 33.9% on the S&P 500. The following three trading days saw gains of 17.5%, marking the best three-day stretch since the 1930s.

GLOBAL MARKETS

With investors fleeing risk assets, the MSCI All Country World Index ended the quarter down 21.4% in US dollars, and the MSCI Emerging

Markets Index was down 23.6% in US dollars. Developed market bond yields fell to record lows, with investors buying up debt as a safe haven amid fears of a Covid-19-induced recession. The FTSE World Government Bond Index appreciated by 2.0% in US dollars for the quarter. These record-low yields come at a time of unparalleled levels of government indebtedness and significant monetary policy expansion by central banks around the world, which carries the risk of stoking inflation in years to come. At this point, we are very negative on the outlook for global bonds, given their unattractive risk-versus-return payoff profile.

Given the sharp sell-off and their current valuation levels which we find attractive, we were more constructive on global equities during the quarter. While short-term news flow remains poor, once Covid-19 is behind us, corporates will be operating in an environment of unprecedented fiscal stimulus, record-low interest rates and the tailwind of low energy prices. Combined with pent-up consumer demand when lockdown measures are over, we believe that corporate profitability could look very different in 12 months' time. During the quarter, we moved from an underweight to an overweight total equity position as we closed out put options that protected us from the worst of the early declines, before buying some equity exposure at lower levels.



THE LOCAL MARKET

The All Bond Index ended the quarter down 8.7%. We are cognisant of the risks around South Africa's worsening fiscal position but believe that South African government bonds remain a reasonably attractive investment opportunity, given their high yields and absence of near-term inflation pressures in the local economy. The rand (-21.5% versus the US dollar) has been one of the worst-performing currencies this year as the global demand shock compounded South Africa's existing structural headwinds. Adding to the negative news, Moody's Investor Service finally joined Fitch and S&P in downgrading South African debt to subinvestment grade, with all three rating agencies also retaining a negative outlook.

The South African Reserve Bank's commitment to keep liquidity in the system and the National Treasury's adjustment to the funding profile over this period saw the yield curve flatten aggressively past the 20-year area. We took advantage of this flattening and shortened exposure from the longer end of the curve to the belly (10- to 12-year), reducing duration at the same time. Inflation-linked bonds (ILBs) sold off both in sympathy with nominal bonds and due to lower inflation expectations. This weak price action offered an opportunity to switch a decent portion of nominal bonds into ILBs, specifically the i2029, at very attractive real yields of c.6%.

Overall, the JSE experienced a very tough quarter, with the FTSE/JSE Capped Shareholder Weighted All Share Index declining by 26.6%, thereby dragging five-year rolling returns for the overall market into negative territory. No asset class was left unscathed, but the economically sensitive sectors such as property (-48.1%) and financials (-39.5%) bore the brunt of the pain as they sold off aggressively. Industrials (-8.4%) and resources (-25.3%) performed relatively better.

ATTRIBUTION

While we did not escape the brutal realities of a declining South African equity market, our large weighting in global equities, together with our bias for rand hedge stocks, and low exposure to domestic stocks, contributed to outperformance of the equity portion of the portfolio relative to the index during the quarter. Furthermore, in an environment with such extreme price moves, individual stock selection proved critical. Our two highest conviction ideas in the portfolio, Naspers/Prosus and British American Tobacco, both came through strongly during the quarter.

Naspers (+11%) and Prosus (+17%) benefited from their exposure to Tencent, whose business proved

incredibly resilient during the economic disruption caused by Covid-19. Demand for digital services, such as communication tools, social networking, mobile games, online video, and food and grocery delivery, exploded during the lockdown period. Outside of China, we are very encouraged by Tencent's growing international gaming business, which now makes up 23% of its total gaming revenues. Tencent has stakes in four of the top game developers in the world (TiMi Studios, Quantum, Riot Games and Supercell) and currently has five of the top 10 daily active user games in the world in their portfolio. We believe Tencent is very well positioned to build a dominant global gaming franchise.

However, the most exciting area within Tencent at present is undoubtedly digital payments and financial services. We think this business will contribute significantly to group profits over the next three to five years. Similarly, Tencent is rolling out other financial services products such as banking, wealth management and insurance. Given Tencent's distribution capabilities, together with their treasure trove of user data, we think they are very well positioned to build substantial and very profitable businesses.

Outside of Tencent, Prosus is primarily investing in three key areas (online classifieds, food delivery and payments/fintech), all of which are growing very rapidly. Prosus is currently trading at a c.35% discount to its underlying intrinsic net asset value, while Naspers in turn is trading at a c.25% discount to the market value of its Prosus stake. Encouragingly, Naspers announced a share buyback during the quarter after it raised cash from the sale of a small part of its Prosus stake. We believe steps such as this can create meaningful value for Naspers shareholders and help narrow the discount to intrinsic value over time. We continue to believe both Naspers and Prosus are being grossly mispriced by the market at current levels. For more details, please read our Naspers stock analysis on page 16.

British American Tobacco's share price (+2%) held up very well during the quarter. As expected, consumer demand for cigarettes has remained remarkably defensive during this unanticipated economic shock. British American Tobacco's steady growth algorithm of high single-digit revenue growth, driven by strong pricing power, continued cost savings and deleveraging, remains intact and is once again being appreciated by investors. The company is still trading on only 7.5 times one-year forward earnings and an 8% dividend yield. We still believe this to be very attractive for a stock of this quality and it remains the second biggest position in the portfolio.



**WE BELIEVE
TENCENT IS VERY
WELL POSITIONED
TO BUILD A
DOMINANT
GLOBAL GAMING
FRANCHISE.**



Stocks exposed to the domestic economy came under significant pressure during the quarter, as the announcement of South Africa's lockdown was another body blow for businesses already struggling in a 'no-growth' economic environment. Our preference for holding the high-quality defensive food retailers (Shoprite, Spar, Pick n Pay) together with Dis-Chem, versus the more economically sensitive clothing retailers, was well rewarded. The food and drug retail sector was down only 13% for the quarter, while the general retailer sector was down a whopping 44%.

Our underweight position in the banks also benefited the portfolio during the quarter. Although there is no doubt that their earnings will come under pressure as they struggle to grow advances and their net interest margins contract on the back of lower interest rates, their real pain will come in the form of higher credit losses as consumers and businesses buckle under the strain of being leveraged in a very weak economy. However, we have full confidence in the stability of our banking system and, given their conservative past lending practices together with their healthy capital adequacy levels, we believe the banks are well placed to handle the economic shock we are currently experiencing. Our preferred bank holding is FirstRand, which trades on nine times our assessment of normal earnings.

One of the big buys for the portfolio during the quarter was Anheuser-Busch InBev. Its share price collapsed on the back of poor results, which were compounded by the impact of Covid-19 (reduced beer consumption and weaker emerging market currencies), coupled with concerns around its high debt levels, which we think are easily manageable. We bought our position at a price of less than 10 times our assessment of normal earnings.

This is an incredible price for one of the world's best businesses, which is engaged in a stable and long-lived industry that has fantastic economics.

Other buying for the quarter was focused on adding to our existing high-conviction ideas such as Quilter, Anglo American and Shoprite on share price weakness. As funding, we sold down our Pick n Pay position and exited our Richemont position during the quarter. Notwithstanding the uncertainties that abound, our objective remains building diversified portfolios. We will remain focused on the long term and will seek to take advantage of this extreme market volatility to invest in attractive opportunities that the market may present to us and, in so doing, generate inflation-beating returns for our investors over the long term. We are happy with the current portfolio positioning and, given compelling valuations, we are excited about future return prospects. +



**ONE OF THE
BIG BUYS FOR
THE PORTFOLIO
DURING THE
QUARTER WAS
ANHEUSER-BUSCH
INBEV.**



STRATEGY UPDATE

Coronation Inflation Plus Strategy

By CHARLES DE KOCK and PALLAVI AMBEKAR



Charles heads up the Absolute Return team and has 34 years of investment industry experience.



Pallavi is a portfolio manager with 16 years of investment industry experience.

THE WORLD IS in an unprecedented crisis. We now have mandatory lockdowns in many countries, global travel has been banned and social distancing has become the norm. These actions will no doubt lead to a deep global recession. The depth of the recession is likely to be severe, but we cannot know the duration.

This uncertainty will weigh on investors' expectations of when a recovery might start. Investors have tried to find parallels with other global crises, such as wars and the 2008 Global Financial Crisis, but there is no easy comparison. We have never had such a long period of mandated economic inactivity.

Policymakers, led by the US Federal Reserve Board and the European Central Bank, have responded with aggressive monetary stimulus which has provided much-needed liquidity to panicked markets. Economies that can afford it have also introduced extraordinary fiscal measures. It is too early to say whether these measures will be successful or not, but the speed and co-ordination of global policy actions provide a small level of comfort.

Despite these measures, the economic implications of forced lockdowns are enormous. Do companies that are forced to close still pay rentals

to landlords? Do they pay interest on loans to banks, or rates and taxes to local authorities? Do they continue to pay employees and for how long? The answers will be different depending on the country and the company, but it has created huge uncertainty in the minds of investors as to how to value banks and property companies, for example.

Against this backdrop, the Strategy delivered a disappointing performance of -3.6% over the last year. We have not been able to protect capital, as most asset classes (except for cash) have delivered deeply negative returns. The swiftness and scale of asset price moves have been staggering, and the FTSE/JSE Capped Shareholder Weighted All Share Index declined 26.6% over the quarter, thereby dragging five-year rolling returns for the overall market into negative territory.

No asset class was left unscathed, but the economically sensitive sectors such as property (-48.1%) and financials (-39.5%) bore the brunt of the pain as they sold off aggressively. Industrials (-8.4%) and resources (-25.3%) performed relatively better. Fixed income assets did not fare better as the All Bond Index (ALBI) ended the quarter down 8.7% and the Barclays Government Inflation-linked Bond Index down almost 17%. Only cash generated a positive return of 1.6%. Internationally, global stock markets

are down 20% to 25%, emerging market currencies are down 10% to 13%, and global property is down 28% to 33%.

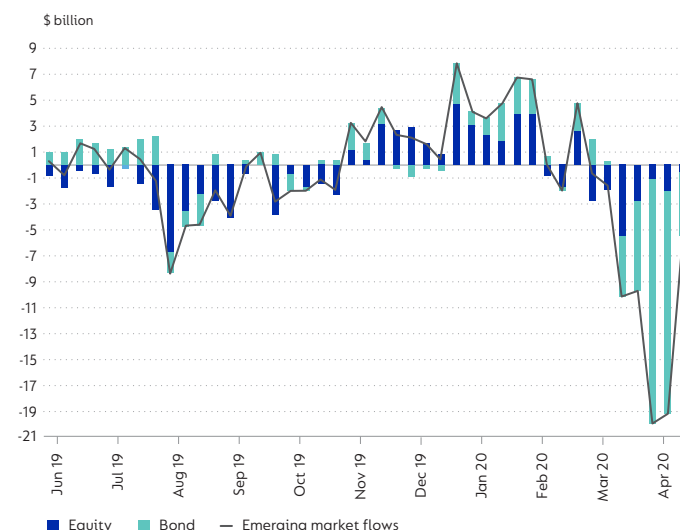
Going into this crisis, the Strategy was reasonably conservatively positioned. We were sitting at a below-maximum weighting in risk assets (equity and property) and well below our maximum 30% offshore exposure. This was because we felt that:

- Global equity markets were expensive after a number of years of strong multiple re-rating. In February, we felt that the market was being too complacent about rising Covid-19 risks, so we bought some put options on the S&P 500 Index.
- Global bond markets were yielding negligible to negative real returns.
- We were cautious on the earnings prospects of our domestic South African equity counters in a constrained growth environment. Within local equity exposure, the bulk of our holdings sat in the global rand hedge shares such as Naspers/Prosus and British American Tobacco/Reinet.
- We have been concerned about the ability of South African property companies to defend and grow their distributable earnings. Consequently, we had a very small exposure to local property, mainly focused on those counters with defensive balance sheets.
- Local fixed income bonds were offering us attractive real returns, with the carve-out yielding more than 9%. With long-term inflation expected to remain in the 4% to 5% range, this yield met our above-inflation return hurdle. The lower risk asset and offshore weighting was made up with the allocation to domestic fixed income.

Unfortunately, this positioning was not nearly cautious enough and did not provide the capital protection or stability in returns we expected. Extreme global risk aversion led to a scramble for safe-haven assets and punished not just traditional risk assets but led to wholesale outflows from emerging market bond funds (Figure 1). Foreign and local investors used relatively liquid South African fixed income assets as a source of funding. The volatility in the domestic bond space can be demonstrated by the 10-year South African government bond yield swinging from a 9.5% yield at the beginning of March to a high of almost 13% on 24 March. Our fixed income selection, which includes inflation-linked bonds (ILBs) and floating credit, performed far better than the ALBI, but was still negative for the quarter.

Figure 1

EMERGING MARKET EQUITY AND BOND FLOWS



Source: Barclays Capital

Within equities, our selection was also defensive. The Strategy's two largest holdings – Naspers and British American Tobacco – held up well, as did the food retailers. However, the banks were very weak and detracted from the returns. Positively, our equity portion delivered a better return over the past year compared to the FTSE/JSE Capped Shareholder Weighted All Share Index benchmark.

HOW ARE WE POSITIONED NOW AND WHAT CHANGES HAVE WE MADE?

1. We have increased our local fixed income allocation. With the repricing in yields and by adding to our exposure, our fixed income allocation is now sitting at a yield close to 11%, which we think is extremely attractive compared to a return from cash of c.4.25% by the end of this year. We also do not expect a material increase in inflation over the next year or two as the economy will be very weak. We acknowledge that domestic fundamentals have deteriorated with the Covid-19 crisis, but virtually every country in the world is facing a similar situation. Lower growth will contribute to an increased government debt burden and a widening fiscal deficit. We think South African bonds have more than priced in these risks. Spreads look attractive versus local cash and real yields look compelling when compared to emerging market and developed market peers. We have a balanced mix of exposure across government and corporate nominal bonds and ILBs.
2. We have removed our S&P 500 put position as markets fell away. Other than these moves, there has been no increase in our global or



local equity exposure yet. We will remain true to our investment style of adding to holdings where we see compelling long-term value. Once the contagion is brought under control, global equities could start to look past the short-term economic hit, especially with the support from large quantitative easing programmes, fiscal stimulus and low oil prices. Within local equities, equity selection will be critical. Many domestic companies will see their earnings bases severely re-set with the Covid-19-related restriction of economic activity and the slump in global trade. After struggling with a muted economy for many years, the ability to cut costs and capital expenditure even further is simply not there, or will materially hamper their recovery prospects. After rebasing our internal fair values, as well as our earnings and dividend expectations for the Covid-19 shock, our current basket of South African equity holdings gives us an upside to fair value north of 60%. This is still very much skewed to the global rand hedge shares and, if valuations are compelling, we will recycle some of this into domestic companies.

3. Global bonds remain terribly unattractive and, while property stocks have suffered an enormous derating, we have not added in this uncertain climate yet. As mentioned earlier, the knock-on effects of enforced lockdowns on landlords are still unclear and one of the consequences is far lower or no dividends for a period of time.

Social distancing measures, if enforced, should lead to a slowing in Covid-19 infection rates over the next month or so. It is hoped that it will spread the burden on the healthcare system and give more time for a combination of herd immunity to build, medical treatment and finally, a vaccine to be developed. At some point, a slow return to normality (although there are still likely to be some social distancing measures in place) will start. Markets are forward looking and will anticipate a recovery. Investors should not wait for good news to be clear. By then the markets will have rallied already. Many companies' share prices have reacted as though the current crisis is permanent and trade far below our assessment of fair value. There may well be more short-term pain but trying to time the exact bottom is impossible.

In conclusion, the lack of capital protection from the Strategy over the last year was deeply unsatisfactory, coming mainly from the adverse events over the last month. The fixed income component performance was especially disappointing. Our expectation from this point is for asset prices to normalise, which will allow the Strategy to recover materially. It has been a volatile time in markets, but attractive valuations and yields cannot be ignored. We remain committed to only adding assets to our clients' portfolios that we believe offer a sufficient margin of safety and are adequately priced for the underlying risk. +

STRATEGY UPDATE

Coronation Houseview Equity Strategy

By KARL LEINBERGER, SARAH-JANE ALEXANDER and ADRIAN ZETLER



Karl is Chief Investment Officer and has 19 years of investment industry experience.



Sarah-Jane is a portfolio manager with 16 years of investment industry experience.



Adrian is a portfolio manager with 10 years of investment industry experience.

IN A TRYING market where returns have been negatively impacted by COVID-19, the portfolio outperformed the FTSE/JSE Capped Shareholder Weighted All Share Index (Capped SWIX) by 5.9% on a year-to-date basis, and by 7.8% over the one-year period. Importantly, the portfolio has delivered alpha over both the medium and the longer term.

The first quarter of 2020 provided investors with very few places to hide. Equity markets around the world experienced record declines during the quarter. Since January, the Covid-19 outbreak has overtaken our lives and transformed our world, presenting a medical, economic and human challenge that is unprecedented in our lifetime.

The outbreak of this pandemic has impacted financial markets with a swiftness and ferocity normally only seen in a classic financial crisis. In a matter of weeks, global equity benchmarks fell from record highs into bear markets.

The level of volatility experienced during this market sell-off has also been unprecedented; from 19 February to 23 March, the US stock market saw the quickest meltdown in history, with a cumulative loss of 33.9% on the S&P 500. The following three trading days saw gains of 17.5%, marking the best three-day stretch since the 1930s. While we did not

escape the brutal realities of a declining South African equity market, our bias for rand hedge stocks and low exposure to South African domestic stocks contributed meaningfully to the strategy's outperformance during the quarter.

STOCK ATTRIBUTIONS

Overall, the JSE experienced a very tough quarter, with the Capped SWIX declining by 26.6%, dragging five-year rolling returns for the overall market into negative territory. No asset class was left unscathed, but the economically sensitive sectors such as property (-48.1%) and financials (-39.5%) bore the brunt of the pain as they sold off aggressively. Industrials (-8.4%) and resources (25.3%) performed relatively better.

In an environment with such extreme price moves, individual stock selection proved critical. Our two highest conviction ideas in the portfolio – Naspers/Prosus and British American Tobacco – both came through strongly during the quarter.

Naspers (+11%) and Prosus (+17%) benefited from their exposure to Tencent whose business proved incredibly resilient during the economic disruption caused by Covid-19. Demand for digital services such as communication tools, social networking, mobile games, online video, and food and grocery delivery exploded during the lockdown period.



Outside of China, we are very encouraged by Tencent's growing international gaming business which now makes up 23% of its total gaming revenues. Tencent has stakes in four of the top game developers in the world (TiMi Studios, Quantum, Riot Games and Supercell) and currently has five of the top 10 daily active user games in the world sitting in their portfolio. We believe Tencent is very well positioned to build a dominant global gaming franchise. However, the most exciting area within Tencent at present is undoubtedly digital payments and financial services. We think this business will contribute significantly to group profits over the next three to five years.

Similarly, Tencent is rolling out other financial services products such as banking, wealth management and insurance. Given Tencent's distribution capabilities, together with their treasure trove of user data, we think they are well positioned to build substantial and very profitable businesses.

Outside of Tencent, Prosus is primarily investing in three key areas – online classifieds, food delivery and payments/fintech – all of which are growing very rapidly. Prosus is currently trading at a c.35% discount to its underlying intrinsic net asset value, while Naspers in turn is trading at a c.50% discount to the market value of its Prosus stake.

Encouragingly, Naspers announced a share buyback during the quarter after it raised cash from the sale of a small part of its Prosus stake. We believe steps like these can create meaningful value for Naspers shareholders and help narrow the discount to intrinsic value over time. We continue to believe both Naspers and Prosus are grossly mispriced by the market at current levels.

British American Tobacco's share price (+2%) held up very well during the quarter. As expected, consumer demand for cigarettes has remained remarkably defensive during this unanticipated economic shock. British American Tobacco's steady growth algorithm of high single-digit revenue growth, driven by strong pricing power, continued cost savings and deleveraging remains intact and is once again being appreciated by investors. It is still trading on only 7.5 times one-year forward earnings and an 8% dividend yield. We still believe this to be very attractive for a stock of this quality and it remains the second biggest position in the portfolio.

Stocks exposed to the domestic economy came under significant pressure during the quarter, as the announcement of South Africa's lockdown was another body blow for businesses already

struggling in a 'no-growth' economic environment. Our preference for holding the high-quality defensive food retailers (Shoprite, Spar, Pick n Pay), together with Dischem, versus the more economically sensitive clothing retailers was well rewarded. The food and drug retail sector was down only 13% for the quarter while the general retailer sector was down a whopping 44%.

Our underweight position in the banks also contributed to the outperformance of the benchmark during the quarter. Although there is no doubt that their earnings will come under pressure as they struggle to grow advances and their net interest margins will contract on the back of lower interest rates, their real pain will come in the form of higher credit losses as consumers and businesses buckle under the strain of being leveraged in a very weak economy. However, we have full confidence in the stability of our banking system, and given their conservative past lending practices together with their healthy capital adequacy levels, we believe the banks are well placed to handle the economic shock we are currently experiencing. Our preferred bank holding is FirstRand which trades on nine times our assessment of normal earnings.

PORTFOLIO ACTIVITY

One of the big buys for the portfolio during the quarter was Anheuser-Busch InBev. Its share price collapsed on the back of poor results, which were compounded by the impact of Covid-19 (reduced beer consumption and weaker emerging market currencies), coupled with concerns around its high debt levels, which we think are easily manageable. We bought our position at a price of less than 10 times our assessment of normal earnings. This is an incredible price for one of the world's best businesses which is engaged in a stable and long-lived industry that has fantastic economics.

Other buying for the quarter was focused on adding to our existing high-conviction ideas such as Quilter, Anglo American and Shoprite on share price weakness. As funding, we sold down our Pick n Pay position and exited our Richemont position during the quarter.

Notwithstanding the uncertainties that abound, our objective remains to build diversified portfolios. We will remain focused on the long term. We will seek to take advantage of this extreme market volatility to invest in attractive opportunities that the market may present to us, and in so doing, generate inflation-beating returns for our investors over the long term. We are satisfied with the current portfolio positioning and, given compelling valuations, we are optimistic about future return prospects. +

**NASPERS
ANNOUNCED A
SHARE BUYBACK
DURING THE
QUARTER AFTER
IT RAISED CASH
FROM THE SALE
OF A SMALL PART
OF ITS PROSUS
STAKE.**





STRATEGY UPDATE

Global Emerging Markets

By GAVIN JOUBERT and SUHAIL SULEMAN



Gavin is Head of Global Emerging Markets and has 21 years of investment industry experience.



Suhail is a portfolio manager with 18 years of investment industry experience.

THE CORONATION GLOBAL Emerging Markets Strategy returned -23.1% during the first quarter of 2020 (Q1-20), slightly ahead of the -23.6% return of the benchmark MSCI Emerging Markets Total Return Index. The one-year return of the Strategy is -12.8%, which is 4.9% ahead of the benchmark. Over more meaningful longer-term periods, the Strategy has also outperformed by 2.5% p.a. over three years, 1.3% p.a. over five years, 3.0% p.a. over 10 years, and by 4.1% p.a. since inception almost 12 years ago.

We are pleased with the longer-term outperformance generated by the Strategy, especially if one considers that the return of the asset class over 10 years (less than 1% p.a. total return) will have been very disappointing for the average investor in emerging markets. The importance of generating alpha is therefore even more pronounced, as only with significant alpha over the last 10 years will one have generated a positive real return after fees.

The world has changed very quickly since our last commentary in early January. In the intervening three months, a previously unheard-of virus that originated in China has shut down the second-largest economy in the world and spread at a furious rate throughout the globe, prompting

sweeping shutdowns. The world seems to be on track for the biggest quarterly decline in GDP since the Great Depression and many countries will face tough months, if not years, ahead.

Our colleagues on the South African team have written extensively about our views regarding Covid-19 and how it will impact the world, so for the purposes of this commentary we will limit discussion to its impact on key emerging markets and the steps that some of them have taken, before moving on to the Strategy and its positioning.

Emerging markets are at different stages of preparedness for the impact of the virus. At the one end of the spectrum we have China, which brought its economy to a virtual standstill by keeping the country on enforced lockdown from the time of Chinese New Year in January until the end of the quarter. Having taken this pain upfront, something that is unlikely to be replicable in countries with more collaborative forms of government, China looks to be rebounding fairly quickly.

Other Asian countries, such as Korea and Taiwan, having learnt from episodes historically (SARS/MERS/Swine flu) have also managed to limit the spread of the virus by taking early, concrete action,



and so far look like they may come through this less affected than China. India and South Africa instituted lockdowns of roughly three weeks each (both of which have subsequently been extended) in the hope of limiting the initial spread among their populations and taking the economic pain upfront. It is hard to know how effective these lockdowns will be, given the dense living conditions of a large proportion of each country's population (particularly India), but these steps were probably necessary to slow the spread of the virus in order to prepare their healthcare systems for a potential deluge of cases.

At the other end of the spectrum (within emerging markets) are Brazil and Mexico, which have started taking measures very late (at a national level) and are likely to experience more negative outcomes on their healthcare systems as a result. Russia and Turkey would probably fall into this category too, although, in the case of Russia, the ability of the state to enforce a full lockdown is significant. Turkey has tried the middle-of-the-road approach of keeping workers active but forcing the elderly and children into isolation.

While all of the above information is useful as a backdrop, it is of relevance in this discussion only in the context of how it impacts the Strategy, its holdings and potential investments. Although markets have fallen by almost a quarter so far in 2020, this average disguises the fact that many stocks have fallen by far more, or far less, including those held in the Strategy. The actions taken in the Strategy therefore reflect our belief on how material the impact of the Covid-19 disruption will be on the long-term fair value of the companies held in the Strategy.

As a general principle, we have not added to all positions in the Strategy that have fallen disproportionately, but have generally been selective in adding only to those that we believe will recover quickly operationally; have the balance sheet to withstand a prolonged severe disruption; and where there hasn't been a material change to our long-term fair value as a result of this crisis.

The standout performer in the Strategy in the period was JD.com, the Chinese ecommerce retailer. JD was up 15% in the period and contributed close to 0.8% of alpha. The share has doubled since the post-IPO lows it reached in late 2018. The share did well due to great results for 2019 and a better-than-average outlook in China during the height of the country's lockdown. In 2019, revenues grew 25% and the company earned a profit after sustained losses since listing. Their outlook for Q1-20 (to end-March) guided to 10% revenue

growth, even though the country probably saw double-digit declines in GDP during this period – the peak of the Covid-19 crisis in China. One would expect the appeal of ecommerce to be enhanced in a world of social distancing, but over and above this, several innovative steps taken by management have underpinned this strong performance.

A good example is continued deliveries using their self-owned logistics network, even in the most affected province in China (Hubei), using drones for delivery where possible. The moat around the business continues to grow and because of the higher conviction we have, coupled with the large relative outperformance of JD compared to the Strategy as a whole, the position size has actually increased to 3.3% at quarter-end.

Other notable contributors were Wuliangye Yibin (Chinese baijiu spirits manufacturer), which declined 15% but contributed 34 basis points (bps) of alpha, as well as Philip Morris International, down 13% for a 33bps contribution to alpha.

Ping An Insurance Group and Yum China collectively contributed another 50bps of alpha, the latter recovering quite quickly operationally and recently announcing that up to 85% of its stores in China are now open. The Strategy does not own Petrobras, and the big share-price decline (both the Brazilian market and the oil price decline contributed to this) added 40bps to relative performance.

The biggest detractor for the Strategy was the underweight in Tencent, which it does not own directly. This cost 1.1% of relative performance, and even though the Strategy does own Naspers and Prosus, whose valuations are ultimately derived from Tencent, this was insufficient to offset not owning Tencent directly.

Naspers and Prosus collectively contributed 78bps to relative performance and comprise 7.7% of the Strategy. We own them in preference to a direct shareholding in Tencent due to the substantial discount at which they trade to Tencent, as this provides an additional margin of safety; Prosus trades at a discount of around 35% to its underlying net asset value (mostly Tencent) and Naspers at an additional 25% discount to the value of its stake in Prosus.

Management of both entities are actively pursuing strategies to reduce this discount in order to unlock value for shareholders. The very high look-through exposure to Tencent in the Strategy reflects our conviction in the strength of Tencent's business.



A NOTABLE CONTRIBUTOR TO THE STRATEGY WAS WULIANGYE YIBIN, WHICH DECLINED 15% BUT CONTRIBUTED 34BPS OF ALPHA.

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**AIRBUS IS A GOOD
EXAMPLE OF THE
EXTREME MARKET
REACTIONS THAT
HAVE TAKEN
PLACE.**

Among stocks owned, Airbus ended up detracting the most from performance, taking 85bps off relative performance. Airbus was a top 10 position (2.8%) at the beginning of the year and after holding up well early in the year, we started to reduce the holding significantly as the environment for world travel deteriorated. This aggressive reduction in the position size preceded a 60% collapse in the share price to as low as €49 at some stage, leaving the position at 1.6% at quarter-end.

Airbus is a good example of the extreme market reactions that have taken place. In the short term, the airline industry – Airbus’s customer base – is facing financial ruin, as airline travel has collapsed to a fraction of normal levels for this time of year. Airlines are cyclical, highly leveraged and thinly capitalised businesses (which is why we have rarely owned any in the Strategy historically) and will need to be recapitalised en masse in order for air travel to return to some semblance of normal.

The impact on Airbus in the short term will therefore be quite negative, as airlines delay receipt of orders for new planes they manufactured in the last few years and, in some cases, cancel them entirely. In the medium term, however, this crisis will pass, and air travel will recover, in our view. The short-term financial impact will be manageable – airlines make regular payments during the build stage of a plane and pay penalties for cancelled or massively delayed orders. They also outsource a large chunk of production to suppliers, so the pain of delayed orders is not solely theirs to deal with.

Overall, about 75% of costs are variable in nature, so the cash burn during this downturn can be managed and Airbus starts off in a significant net cash position of €12.5 billion (as at December 2019, the most recent results reported). This is 28% of current market cap and equivalent to two times last year’s (adjusted) operating profit.

We estimate that, due to their positive credit rating, they have straightforward access to an additional €12 billion of funding, if required, so even in a dire scenario where their working capital moves highly negative with no corresponding set-offs from clients and suppliers, they have ample liquidity to see them through a very depressed 2020 and 2021. There is also €3.3 billion of annual research and development expenses that could be scaled back if required.

The duopoly nature of the industry means that customers only really have two choices of supplier, and however tough things may be for Airbus, they pale in comparison to its only competitor, Boeing, which is highly leveraged and still dealing with the aftermath of the grounding of the 737 Max last year.

Although it is not without risk, we are very positive on Airbus long term and continue to hold it in the Strategy. By our estimates, even with a 50% decline in total deliveries over the 2020-2022 period, by 2022, Airbus will already be generating €4 billion in free cash flow, compared to a current market cap of €45 billion at the time of writing – close to a 10% free cash flow yield two years out. The company guided to a more benign outcome, with a projected reduction in output of one third starting from the second quarter of 2020.

The Indian financial companies HDFC (mortgages) and HDFC Bank (full-service banking) declined by 36% and 39% respectively, costing close to 1% of combined relative performance. In our view, these declines are excessive; the short-term impact of India’s shutdown does not reduce the fair value of these businesses by anywhere near this quantum. It is reasonable to expect bad debts to spike in India; however, we believe the risk is more pronounced in the corporate sector than the consumer sector, as consumers are likely to receive significant support from the government to help them through this crisis.

Because of our concerns about corporate exposure, we sold the small 50bps position held in Axis Bank in order to concentrate our Indian financial exposure in the higher quality names. In the case of HDFC (4.2% of Strategy), the mortgage book is fully secured by residential property (mostly primary residences), with very conservative loan-to-value ratios at loan inception. HDFC Bank (2.6% of Strategy) has more consumer exposure than any of its peers, with almost half in semi-urban and rural India, where the disruption from the lockdown is likely to be less severe than in urban areas, in our view.

Their balance sheet strength, consistent track record of navigating through previous crises (of which there have been many in India) and an excellent management team lead us to believe they will gain market share in this environment. The main competitors are either poorly run state-owned banks or private sector banks with company-specific issues to deal with. Most recent data on loan growth from the Reserve Bank suggest HDFC Bank is growing their loan book at 2.5 times the rate of the market as a whole.



PORTFOLIO ACTIVITY

There has been a high level of activity in terms of new buys and sales to zero in the Strategy during the quarter. Notable new buys in the quarter were the South African trio of Shoprite, Spar (both food retail) and Pepkor (entry-level clothing retail). Collectively, these are only 1.9% of the Strategy, but represent the first material domestic South African exposure in the Strategy in a few years. The trio is among the best businesses in the country, being predominantly cash retailers catering to the mass market. In a tough economic environment, they will benefit from downtrading by consumers and will weather the storm better than their peers, in our view.

All three have declined significantly by 30% to 50% over the last year, in addition to the 25% decline in the rand since the start of 2020. Relative to peers in emerging markets, they are now quite attractive, with valuations ranging from 12 to 14 times forward earnings and with 4% to 5% dividend yields. We acknowledge the well-publicised risks in South Africa today (the poor fiscal situation and the investment environment overall), but these are great businesses in their own right, and we manage the risk by limiting the overall exposure to sub-2% of the Strategy.

Another notable new buy is Indian tobacco business ITC, an affiliate of British American Tobacco and whose purchase was primarily funded by switching British American Tobacco exposure into ITC. The share price of ITC has halved since 2017 and is below the level of five years ago. This highly cash-generative business has declined from 30 times earnings a few years ago to 13 times today.

One can separately value ITC's non-tobacco businesses, which they started years ago in an attempt to diversify away from tobacco and which are marginally profitable, and strip this out of the overall valuation. On this basis it is even more attractive at eight times core (tobacco) earnings.

ITC has an almost 85% share of the formal tobacco market in India, making it a quasi-monopoly. The high level of illicit tobacco sales in India means that the burden of providing excise taxes to the government falls disproportionately on ITC, and in recent years, the government has not been shy to hike taxes on cigarettes, which is why the share price has continued to decline. Despite this government treatment, ITC continues to grow earnings at low double-digits and is likely to do better than this over time as the non-tobacco businesses improve profitability or are sold to realise value for shareholders.

With almost 20% of its market cap in cash and a 5% forward dividend yield, ITC is very attractive. Longer term, if the Indian government ever becomes serious about cracking down on the illicit market and informally produced thin sticks (known as 'bidis'), then ITC has substantial room to grow volumes as the formal market takes share within the country. We have covered it for years but never owned it, as it has always traded at 25 to 30 times earnings, and the continued share price decline provided us with an opportunity to buy this asset for the first time with a large margin of safety.

Elsewhere in India, we also bought a small (0.8%) position in Infosys, a global IT outsourcing services provider, to supplement our existing exposure to the industry via Tata Consultancy Services (1.1% of Strategy). Infosys declined by as much as 45% from mid-February and we built the position up gradually during the quarter. In the shorter term there will be significant headwinds to the industry as companies cut investment to cope with the downturn, but in the long term, the shift to outsourcing IT services in order to reduce permanent headcount will probably be helped by this crisis. Infosys trades on 14 times forward earnings (excluding its net cash position) with a 4% dividend yield.

Rounding up the list of new buys was Brazilian payments provider Stone Co. Stone has grown its market share in the payments space to 8% today, from 2% in 2016, by concentrating on small and medium-sized business that have historically been poorly served by the banks and merchant acquirers. With rising card penetration and increased innovation in the financial services space, it is our view that Stone will continue to take market share in a growing market and could reach 15% market share within a few years. Its highly scalable business model means that margins will improve significantly, with greater transaction volumes, and it will convert a high proportion of earnings into free cash. The share price has halved since the beginning of February, broadly in line with the decline in the Brazilian market, despite the relatively superior earnings growth prospects for the firm.

After six years in the Strategy, we sold Cogna (previously known as Kroton) in mid-February. We had been reducing gradually as it appreciated; however, the announcement by management of an equity raise to fund potential acquisitions in the education space in Brazil was, in our view, very negative. We had stressed in previous discussions with management our opinion that the share was very cheap and that an equity raise would be >



WITH RISING CARD PENETRATION AND INCREASED INNOVATION IN THE FINANCIAL SERVICES SPACE, BRAZILIAN PAYMENTS PROVIDER STONE SHOULD CONTINUE TO TAKE MARKET SHARE IN A GROWING MARKET.

value destructive. Given that management has been stressing an improvement in cash generation and that their debt level is manageable, we viewed this change in tactic as a warning sign. We therefore sold out once this equity raise was announced as the share price went up initially.

We also sold the small remaining positions in Taiwan Semiconductor Company and Samsung Electronics, as they held up quite well in the sell-off and were an attractive funding source for some of

the buys above. The final sale was that of 51 Jobs, the Chinese white-collar recruitment and business process outsourcing provider, which reached close to fair value in January.

Members of the team travelled to India, Brazil and Mexico during the quarter to meet current and potential portfolio holdings, before all travel was curtailed in light of global developments. We wish all our clients safety and good health in the weeks and months ahead. +



STRATEGY UPDATE

Coronation Global Absolute Strategy

By CHARLES DE KOCK and PALLAVI AMBEKAR



Charles heads up the Absolute Return team and has 34 years of investment industry experience.



Pallavi is a portfolio manager with Coronation's Absolute Return strategies, and has 16 years of investment industry experience.

THE WORLD IS in an unprecedented crisis. We now have mandatory lockdowns in many countries, global travel has been banned and social distancing has become the norm. These actions will no doubt lead to a deep global recession.

The depth of the recession is likely to be severe, but we cannot know the duration. This uncertainty will weigh on investors' expectations of when a recovery might start. Investors have tried to find parallels with other global crises, such as wars and the 2008 Global Financial Crisis, but there is no easy comparison. We have never had such a long period of mandated economic inactivity.

Policymakers, led by the US Federal Reserve Board and the European Central Bank, have responded with aggressive monetary stimulus which has provided much-needed liquidity to panicked markets.

Economies that can afford it have also introduced extraordinary fiscal measures. It is too early to say whether these measures will be successful or not, but the speed and coordination of global policy actions provide a small level of comfort.

Despite these measures, the economic implications of forced lockdowns are enormous. Do companies that are forced to close still pay rentals

to landlords? Do they pay interest on loans to banks, or rates and taxes to local authorities? Do they continue to pay employees and for how long? The answers will be different depending on the country and the company, but it has created huge uncertainty in the minds of investors as to how to value banks and property companies, for example.

Against this backdrop, the Strategy delivered a disappointing performance of -6.3% over the last year. We have not been able to protect capital, as most asset classes (except for cash) have delivered deeply negative returns. The swiftness and scale of asset price moves have been staggering, and the FTSE/JSE Capped Shareholder Weighted All Share Index declined 26.6% over the quarter, thereby dragging five-year rolling returns for the overall market into negative territory.

No asset class was left unscathed, but the economically sensitive sectors, such as property (-48.1%) and financials (-39.5%), bore the brunt of the pain as they sold off aggressively. Industrials (-8.4%) and resources (-25.3%) performed relatively better.

Fixed income assets did not fare better as the All Bond Index (ALBI) ended the quarter down 8.7% and the Barclays Government Inflation-linked Bond Index was down almost 17%. Only cash generated a positive return of 1.6%.

Internationally, global stock markets are down 20% to 25%, emerging market currencies are down 10% to 13% and global property is down 28%-30%.

Going into this crisis, the Strategy was reasonably conservatively positioned. We were sitting at a below-maximum weighting in risk assets and below our maximum 30% offshore exposure. This was because we felt that:

- Global equity markets were expensive after a number of years of strong multiple re-rating. In February we felt that the market was being too complacent about rising Covid-19 risks; we therefore bought some put options on the S&P 500 Index.
- Global bond markets were yielding negligible to negative real returns.
- We were cautious on the earnings prospects of our domestic South African equity counters in a constrained growth environment. Within South African equity exposure, the bulk of our holdings sat in the global rand hedge shares such as Naspers/Prosus and British American Tobacco/Reinet. We also protected some of our overall local equity exposure by owning domestic put options.
- We have been concerned about the ability of South African property companies to defend and grow their distributable earnings. Consequently, we had a very small exposure to the sector, which was mainly focused on those counters with defensive balance sheets.

- Local fixed income bonds were offering us attractive real returns, with the carve-out yielding more than 9%. With long-term inflation expected to remain in the 4% to 5% range, this yield met our above-inflation return hurdle. The lower risk asset and offshore weighting was made up with the allocation to domestic fixed income.

Unfortunately, this positioning was not nearly cautious enough and did not provide the capital protection or stability in returns we expected. Extreme global risk aversion led to a scramble for safe-haven assets and punished not only traditional risk assets but also led to wholesale outflows from emerging market bond funds (Figure 1). Foreign and local investors used relatively liquid South African fixed income assets as a source of funding. The volatility in the South African bond space can be demonstrated by the 10-year South African government bond yield swinging from a 9.5% yield at the beginning of March to a high of almost 13% on 24 March. Our fixed income selection, which includes inflation-linked bonds (ILBs) and floating credit, performed far better than the ALBI, but was still negative for the quarter.

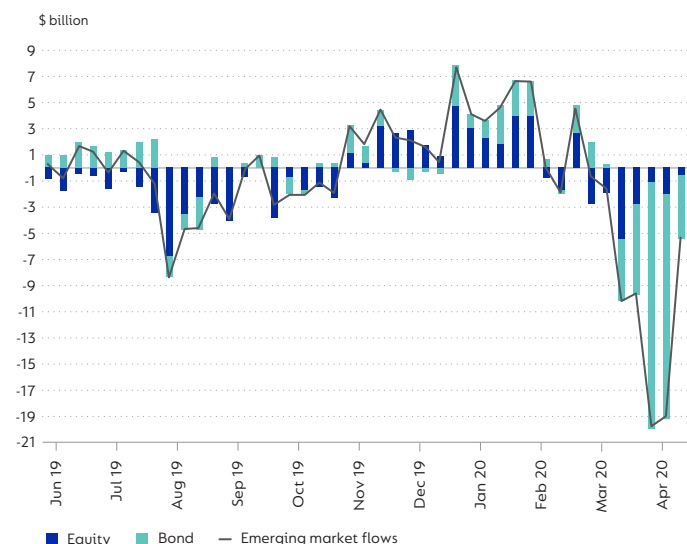
Within equities, our selection was also defensive. The Strategy's two largest holdings – Naspers and British American Tobacco – held up well, as did the food retailers. However, the banks were very weak and detracted from the returns. Therefore, our equity portion delivered a better return over the past year compared to the Capped Shareholder Weighted All Share Index benchmark.

HOW WE WERE POSITIONED AND WHAT CHANGES HAVE WE MADE?

1. We have increased our South African fixed income allocation. With the repricing in yields and by adding to our exposure, our fixed income allocation is now sitting at a yield close to 11%, which we think is extremely attractive compared to a return from cash of c.4.25% by the end of this year. We also do not expect a material increase in inflation over the next year or two, as the economy will be very weak. We acknowledge that domestic fundamentals have deteriorated with the Covid-19 crisis, but virtually every country in the world is facing a similar situation. Lower growth will contribute to an increased government debt burden and a widening fiscal deficit. We think local bonds have more than priced in these risks. Spreads look attractive versus local cash, and real yields look compelling when compared to emerging market and developed market peers. We have a balanced mix of exposure across government and corporate nominal bonds and ILBs.

Figure 1

EMERGING MARKET EQUITY AND BOND FLOWS



Source: Barclays Capital



2. We have removed our S&P 500 put position as markets fell away. Other than these moves, there has been no increase in our global or local equity exposure yet. We will remain true to our investment style of adding to holdings where we see compelling long-term value. Once the contagion is contained, global equities could start to look past the short-term economic hit, especially with the support from large quantitative easing programmes, fiscal stimulus and low oil prices. Within local equities, equity selection will be critical. Many domestic companies will see their earnings bases severely re-set with the Covid-19-related restriction of economic activity and the slump in global trade. After struggling with a muted economy for many years, the ability to cut costs and capital expenditure even further is simply not there or will materially hamper their recovery prospects. After rebasing our internal fair values, as well as our earnings and dividend expectations for the Covid-19 shock, our current basket of South African equity holdings gives us an upside to fair value of north of 60%. This is still very much skewed to the global rand hedge shares and, if valuations are compelling, we will recycle some of this into domestic companies.
3. Global bonds remain terribly unattractive, and while property stocks have suffered an enormous derating, we have not added in this uncertain climate yet. As mentioned earlier, the knock-on effects of enforced lockdowns on landlords are still unclear and one of the consequences is far lower or no dividends for a period of time.

If enforced and adhered to, social distancing measures should lead to a slowing in Covid-19 infection rates over the next month or so. It is hoped that it will spread the burden on the healthcare system and give more time for herd immunity to build, and for medical treatment and, finally, a vaccine to be developed.

At some point, a slow return to normality (although there are still likely to be some social distancing measures in place) will start. Markets are forward looking and will anticipate a recovery. Investors should not wait for good news to be clear.

By then the markets will have rallied already. Many companies' share prices have reacted as though the current crisis is permanent and trade far below our assessment of fair value. There may well be more short-term pain, but trying to time the exact bottom is impossible.

In conclusion, the lack of capital protection from the Strategy over the last year was deeply unsatisfactory, coming mainly from the adverse events over the last month. The fixed income component performance was especially disappointing. Our expectation from this point is for asset prices to normalise, which will allow the Strategy to recover materially. It has been a volatile time in markets, but attractive valuations and yields cannot be ignored. We remain committed to only adding assets to our clients' portfolios that we believe offer a sufficient margin of safety and are adequately priced for the underlying risk. +

STRATEGY UPDATE

Coronation Active Global Equity

By NEIL PADOA



Neil is Head of Global Developed Markets and has 12 years of investment industry experience.

IN LAST QUARTER'S commentary we discussed how "2019 was a strong year for equity markets, with the MSCI All Country World up 26.6%". However, we also cautioned that "after a sustained period of strong equity returns, declining interest rates, reduced tax rates, expanding profit margins and rising valuation multiples, investors should recalibrate return expectations lower. The conditions in place today are quite different to those in place a decade ago. We have no insight into short-term market moves but feel that absolute

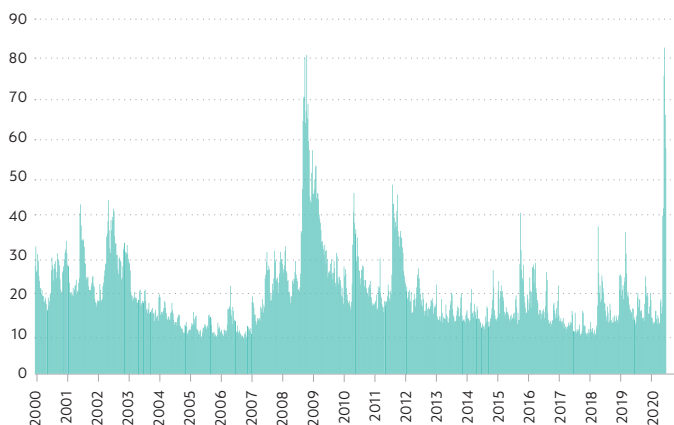
returns could very well be lower over the next 10 years compared to the last 10".

Well, we didn't have to wait long. Risk assets plunged over the quarter as the economic consequences of the Covid-19 pandemic started to become apparent. (For a full discussion, please see Coronation's commentary on page 6). Economic activity in many countries and sectors around the world has come to a halt. This unprecedented 'full stop' caused stress and market dislocations across the spectrum. Volatility was back with a vengeance, and in both credit and equity markets, indicators spiked to levels above those seen in the Global Financial Crisis, as shown in Figure 1.

With this as a backdrop, the Strategy returned -22.3% for the quarter, slightly behind the benchmark's -21.4%. Quarterly returns will inevitably be noisy, but we were cognisant of the high relative performance base coming into the year following a strong 2019, which delivered 12% outperformance, and are reasonably satisfied to have at least protected these relative gains. Markets have now delivered negative returns over the last 12 and 24 months, with the Strategy outperforming by 3.4% and 1% p.a., respectively. While it is short term in nature, it is hopefully some vindication of our valuation-driven investment approach. Since its inception in December 2014, the Strategy is 50 basis points behind the benchmark.

Figure 1

THE VOLATILITY INDEX (MEASURES EXPECTED VOLATILITY OF THE S&P500 INDEX)



Source: Bloomberg



KEY PORTFOLIO ACTIONS

Most of our large holdings going into the quarter were well positioned for the coming economic stress. In the top 10, Chinese internet businesses Tencent (via Naspers) and Alibaba are arguably net beneficiaries, being leaders in gaming and ecommerce, with strong balance sheets.

Charter Communications, a broadband provider in the US, is seeing much higher demand for their essential internet service, although the business is not immune, and cord-cutting will accelerate and subscriber growth slow as the unemployment wave hits. Tobacco businesses Philip Morris and British American Tobacco have seen stable demand. All of these businesses were among the top 15 contributors for the quarter.

Airbus is a good example of the extreme market reactions that have taken place. In the short term, the airline industry – Airbus’s customer base – is facing financial ruin, as airline travel has collapsed to a fraction of normal levels for this time of year. Airlines are cyclical, highly leveraged and thinly capitalised businesses (which is why we have rarely owned any in the Strategy historically) and will need to be recapitalised en masse in order for air travel to return to some semblance of normal. The impact on Airbus in the short term will therefore be quite negative, as airlines delay receipt of orders for new planes they manufactured in the last few years and, in some cases, cancel them entirely.

In the medium term, however, this crisis will pass, and air travel will recover, in our view. The short-term financial impact will be manageable – airlines make regular payments during the build stage of a plane and pay penalties for cancelled or massively delayed orders.

They also outsource a large chunk of production to suppliers, so the pain of delayed orders is not solely theirs to deal with. Overall, about 75% of costs are variable in nature, so the cash burn during this downturn can be managed, and Airbus starts off in a significant net cash position of €13 billion. This is 28% of current market cap and equivalent to two times last year’s (adjusted) operating profit. We estimate that, due to their positive credit rating, they have straightforward access to an additional €12 billion of funding, if required, so even in a dire scenario where their working capital moves highly negative, with no

corresponding set-offs from clients and suppliers, they have ample liquidity to see them through a very depressed 2020 and 2021. There is also €3.3 billion of annual research and development expenses that could be scaled back, if required. The duopoly nature of the industry means that customers only really have two choices of supplier, and however tough things may be for Airbus, they pale in comparison to those of their only competitor, Boeing, which is highly leveraged and still dealing with the aftermath of the grounding of the 737 Max airliner last year.

Although it is not without risk, we are positive on Airbus long term and continue to hold it in the Strategy. By our estimates, even with a 50% decline in total deliveries over the 2020-2022 period, by 2022, Airbus will already be generating €4 billion in free cash flow, compared to a current market cap of €45 billion at the time of writing, close to a 10% free cash flow yield two years out. The company guided to a more benign outcome, with a projected reduction in output of one third starting from this second quarter of 2020.

The Strategy took advantage of a few anomalies – good businesses that initially sold off in line with the market, but whose prospects had only changed marginally. Unilever is a case in point. The stock traded close to 14 times earnings, and with a dividend yield nearly 4.5% at the lows, which we thought provided good value – in particular when the potential range of outcomes for the average business had widened so considerably. Unilever ended the quarter as a top 10 holding.

Earlier in the quarter, we exited holdings that had performed strongly and approached our estimates of fair value. Adidas and Tsuruha (a leading Japanese drugstore business) were both sold. We also meaningfully reduced Blackstone prior to the market decline, but it remains a portfolio holding.

OUTLOOK

Markets could very well remain volatile as the nature of the pandemic evolves and progresses. As a team we are focused, as always, on researching individual businesses, assessing their long-term earnings power, understanding the potential impact this black swan event may have on the investment case, managing risk, and adjusting the portfolio accordingly. While the backdrop has changed dramatically, our process hasn’t. +

THE STRATEGY TOOK ADVANTAGE OF A FEW ANOMALIES – GOOD BUSINESSES THAT INITIALLY SOLD OFF IN LINE WITH THE MARKET, BUT WHOSE PROSPECTS HAD ONLY CHANGED marginally.

Coronation Global Managed Strategy

By NEIL PADOA



Neil is Head of Global Developed Markets and has 12 years of investment industry experience.

IN LAST QUARTER'S commentary we wrote, "2019 was a year to make money". However, we also cautioned that, "after a sustained period of strong equity returns, declining interest rates, reduced tax rates, expanding profit margins and rising valuation multiples, investors should recalibrate their return expectations lower. The conditions in place today are quite different to those in place a decade ago. We have no insight into short-term market moves but feel that absolute returns could very well be lower over the next 10 years compared to the last 10".

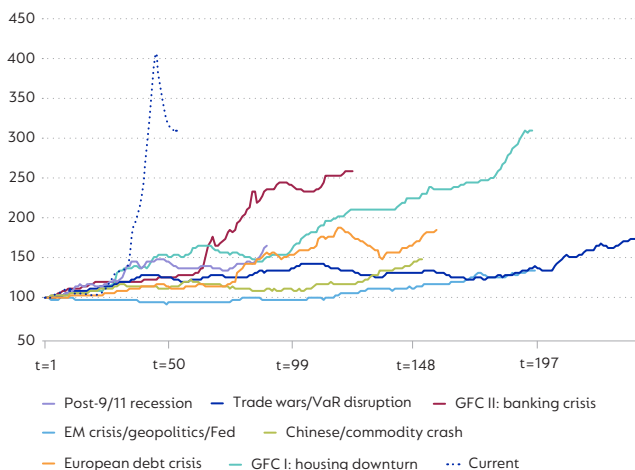
Well, we didn't have to wait long. Risk assets plunged over the first quarter of 2020 (Q1-20) as the economic consequences of the Covid-19 pandemic started to become apparent. Economic activity in many countries and sectors around the world has ground to a halt. This unprecedented 'full stop' caused stress and market dislocations across the spectrum. Volatility was back with a vengeance, and in both credit and equity markets, indicators spiked to levels above those seen during the Global Financial Crisis (Figures 1 and 2).

With this as a backdrop, the Strategy returned -16.1% for the quarter compared to -13.3% from the benchmark. While the Strategy's equity holdings were marginally behind the benchmark, the underperformance was caused by its non-equity holdings. Here, the Strategy's lack of developed market government bond exposure was the primary culprit, as we had chosen instead to take some credit risk, which sold off as credit spreads increased. Importantly, these are mark-to-market losses, not permanent impairments, as we either still hold those securities or have rotated into issues with a more favourable risk-reward profile. Although we are never satisfied with underperformance, it should be considered in the context of:

- a very strong 2019 return of 25%, which was 6.4% ahead of the benchmark;
- long-term returns that remain satisfactory (5.9% p.a. over 10 years versus the benchmark return of 5.1%, which translates into a real return of 4% to 5%); and
- a much-improved opportunity set, which is most important for potential future returns.

Figure 1

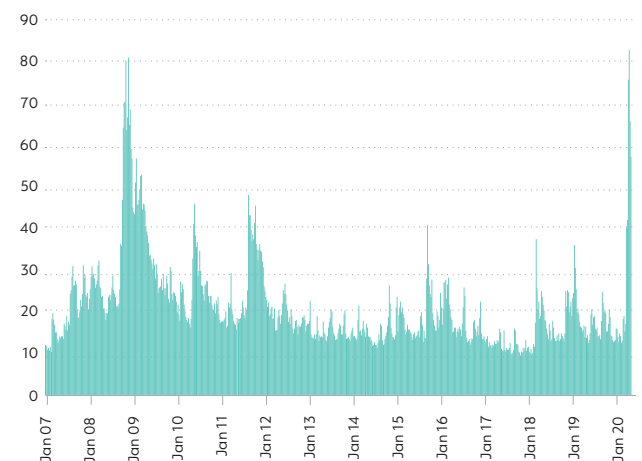
US INVESTMENT GRADE CREDIT SPREADS (RE-BASED TO THE START OF VARIOUS CRISES)



Source: ICE Bank of America

Figure 2

THE VOLATILITY INDEX (MEASURES EXPECTED VOLATILITY OF THE S&P500 INDEX)



Source: Bloomberg



DRIVERS OF STRATEGY MANAGEMENT

Following such a dramatic quarter, it is also worth reflecting on the additional aims for managing the Strategy, as outlined in last quarter's commentary:

1. Deliver attractive absolute returns (meaningfully ahead of inflation). After meaningful declines, expected long-term returns for both corporate credit and equity markets are now higher. In the short to medium term, however, the potential range of outcomes is much wider. Investors should not be surprised to see more volatility, to both the upside and the downside.

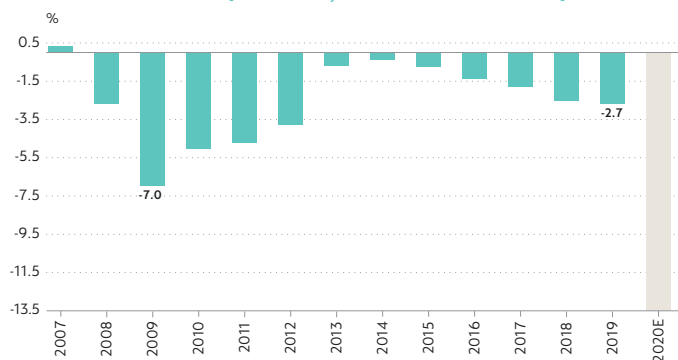
2. Offer some downside protection from equity market volatility (though with equities as a core building block, investors in the Strategy should not expect to be fully shielded from market sell-offs). Compared to equity markets, the Strategy delivered 94% of its positive return in 2019, while in Q1-20 it has delivered 75% of the negative return. In other words, the Strategy participated in almost all of 2019's upside, but only in three quarters of the recent downside.

3. Do not expose the Strategy to excessive risk, even if such exposures are large in the benchmark (such as developed market government bonds today). The fiscal and monetary response is unprecedented. Aggressive monetary measures are pumping vast amounts of liquidity into the system, causing central bank balance sheets to surge, while fiscal deficits are also set to explode once economic support is factored into government finances.

Data for the US is shown in figures 3 and 4, but it is mirrored (to varying degrees) in Europe, Japan, China and the UK.

Figure 4

US PRIMARY BALANCE (% OF GDP, CYCLICALLY ADJUSTED)



Sources: Haver Analytics, Morgan Stanley Research forecast

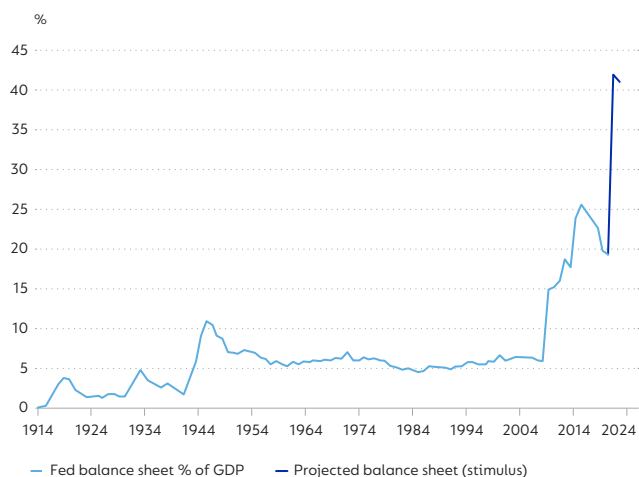
EVENTUALLY, THE WORLD WILL OPEN AGAIN

Notwithstanding the current recessionary conditions, which Morgan Stanley believes could be the fastest and steepest recession in history, resulting in spare capacity and economic slack, the world will eventually get back to work. From this low base of activity, pent-up demand (combined with huge stimulus) could be highly inflationary. In this scenario, the US experience after World War 2 is instructive and highlights the material underperformance and declining purchasing power of cash and government bonds (Figure 5). This is in stark contrast to the last few decades during which bonds have been the ultimate low-volatility, low-risk, uncorrelated and real-return generating asset:

- Since 1990 (30 years), the Bloomberg Barclays Global Aggregate Bond Index returned 5.7% p.a., less than 1% behind global equities, with a fraction of the volatility and drawdown risk.
- Since 2000 (20 years), this index has beaten equities by c.0.5% p.a.

Figure 3

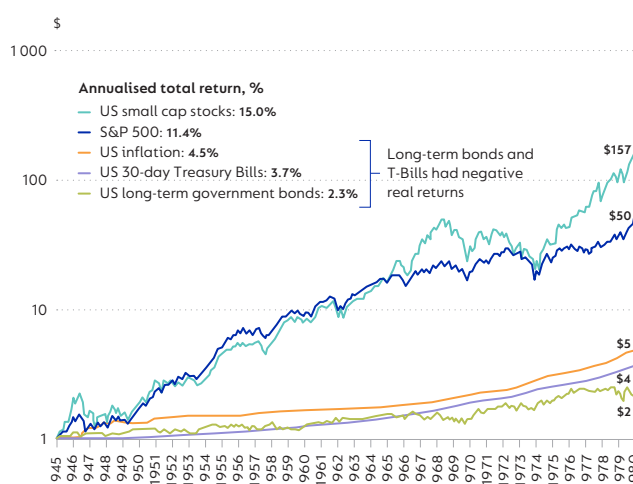
US FEDERAL RESERVE BALANCE SHEET (% OF GDP OVER LAST 100 YEARS)



Source: Bank of America Global Research

Figure 5

CUMULATIVE TOTAL RETURN OF \$1 FROM 1945-1980



Sources: Morgan Stanley Wealth Management GIC using data provided by Morningstar/@2020 Morningstar, Inc

As bonds approach the zero bound, the asymmetry of returns skews increasingly one way. Yields cannot be forever compressed, so the upside potential is limited (bond prices go up when yields go down). However, poor prospective returns from rates simply staying where they are, negative real returns from monetary debasement and negative absolute returns from a rise in interest rates are all possibilities.

While the inflationary scenario outlined above is only one potential outcome, it does inform the Strategy's positioning and we continue to hold no developed market government bonds. In turn, we have built positions in assets that should perform well in an inflationary environment. Aside from the allocation to risk assets (equity, property and infrastructure), which comprised 65% of the Strategy at quarter-end, we also have 10% of the portfolio in gold and inflation-protected securities.

KEY PORTFOLIO ACTIONS

1. Active management of equity exposure

Walking through the changes in a volatile quarter such as this will help to illustrate the process. The quarter started with 60% effective exposure to equities. On 27 February, with markets not far off their highs (the MSCI All Country World Index was 522), exposure troughed at 54.9% as we grew concerned about the potential fallout from the virus amidst fairly widespread complacency in the market. Equity exposure peaked at 63.6% on 25 March (index level 428, c.20% lower). Considering the decline in the markets and the increase in exposure, one can see that the Strategy was a meaningful net buyer into the decline. While we will never time these actions perfectly, with a disciplined, rational process and a valuation philosophy that is rooted in the long term, we aim to have lower equity exposure when risks and valuations are high, and higher exposure when prospective returns are higher. Simple, but not easy.

2. Changes in equity holdings

Most of our large holdings going into the quarter were well positioned for the coming economic stress. In the top 10, Chinese internet businesses Tencent (via Naspers) and Alibaba are arguably net beneficiaries, being leaders in gaming and ecommerce. Charter Communications, a broadband provider in the US, is seeing much higher demand for their essential internet service, although the business is not immune, and cord-cutting will accelerate and subscriber growth will slow as the unemployment wave hits.

Tobacco businesses Philip Morris and British American Tobacco have seen stable demand. Airbus is an obvious exception. With entire countries in lockdown and many airlines around the world facing bankruptcy, orders of new aeroplanes are being delayed and cancelled. The stock ended the quarter down more than 50%, however Airbus has a net cash balance sheet that should see it through this crisis. Deliveries will be cut substantially over the next couple of years, but looking through this extended period of disruption, our estimate of normalised earnings power justifies a significantly higher share price.

The Strategy took advantage of a few anomalies – good businesses that initially sold off in line with the market, but whose prospects had only changed marginally. Unilever is a case in point. The stock traded close to 14 times earnings and with a dividend yield nearly 4.5% at the lows, which we thought provided good value, in particular when the potential range of outcomes for the average business had widened so considerably. Unilever ended the quarter just outside our top 10 holdings.

3. Other changes

Within credit, the most meaningful portfolio actions centred on investment-grade credits to take advantage of dislocated credit spreads (Figure 5, page 47). While these actions don't dramatically change the return profile of the portfolio, they help at the margin. Examples of near-dated issues that were purchased include:

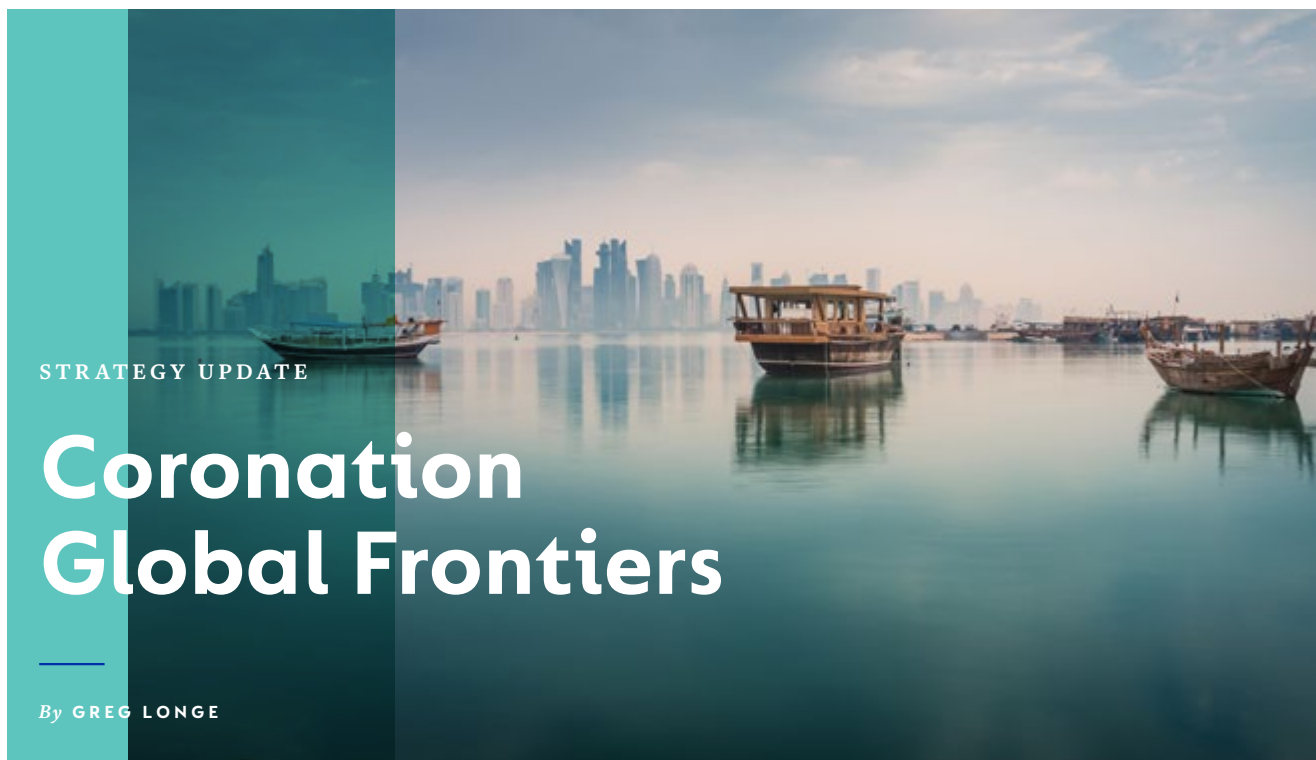
- Berkshire Hathaway (AA-rated) August 2021s at a credit spread of 250 basis points (bps) over Treasuries; and
- GlaxoSmithKline (A-rated) May 2022s at a credit spread of 290bps.

OUTLOOK

Markets could very well remain volatile as the nature of the pandemic evolves and progresses. As a team, we are focused (as always) on researching individual businesses, assessing their long-term earnings power, understanding the potential impact that this black swan event may have on the investment case, managing risk and adjusting the portfolio accordingly. While the backdrop has changed dramatically, our process hasn't. +



AIRBUS HAS A NET CASH BALANCE SHEET WHICH SHOULD SEE IT THROUGH THIS CRISIS.



STRATEGY UPDATE

Coronation Global Frontiers

By GREG LONGE



Greg is an investment analyst with seven years of investment industry experience.

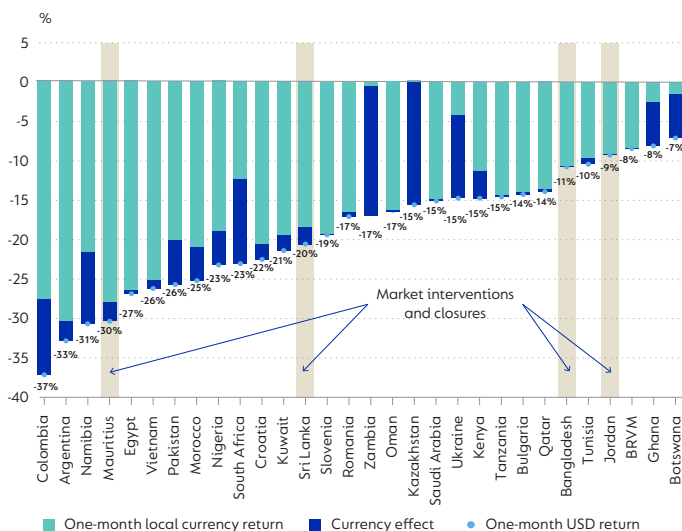
REVIEW FOR THE QUARTER

The start of 2020 has been an incredibly painful one. The combination of the Covid-19 pandemic and the oil price war has led to a bear market in virtually all global assets. Not even gold, traditionally a safe haven, has escaped. Global frontier markets have not been spared, with the MSCI Global Frontiers Index down 26.6% year to date. The Strategy's year-to-date performance was -19.7%, 7.0% ahead of the index.

Longer-term performance remains healthy, with the Strategy 3.1% p.a. ahead over three years and 2.0% p.a. ahead over five years. Even against the larger global emerging market universe, the Strategy is 0.4% p.a. ahead of the three-year MSCI Emerging Markets Index and 0.5% p.a. behind over five years. We remain focused on prioritising long-term performance above all else. With a five-year track record, we are now beginning to approach investment periods that we would classify as long term.

Figure 1

ONE-MONTH USD RETURNS, MARCH 2020, SPLIT BETWEEN LOCAL CURRENCY RETURN AND THE CURRENCY EFFECT



Source: Bloomberg

Figure 1 captures the (brutal) March performance of many of the markets in the Strategy's universe. All markets were negative, with relative better performance typically an indicator of a market that was closed, such as Jordan and Bangladesh; or simply small and illiquid, as is the case with Botswana, Ghana, Bourse Régionale des Valeurs Mobilières SA and Tunisia.

It has been one of the most painful months in the Strategy's history. The Strategy started the year with 20.5% in Egypt (-26.8% return), 11.0% in Jordan (-9.1% return), 9.1% in Kenya (-14.6% return) and 8.2% in Vietnam (-26.1% return).

Valuations have changed significantly over the quarter. In many markets, businesses with leveraged balance sheets and exposure to highly Covid-19-sensitive industries, such as tourism or quick-service restaurants, have sold off as much as companies

with strong balance sheets, stable demand and strong free cash flow generation. While all businesses are impacted by Covid-19 and its second-order economic effects, not all businesses are impacted equally.

We have reviewed our entire portfolio holdings and continue to run various sensitivity analyses to ensure that the businesses we own can survive the likely impact of social distancing and lockdowns. Strong balance sheets have become even more valuable this year. The market sell-off has also given us the opportunity to acquire positions in high-quality, compounder businesses that have typically traded at valuations we had considered too high in the past. As a result, the portfolio is looking stronger and higher quality than ever before.

The largest contributor for the period was Al Eqbal Investments, the largest position in the portfolio, which added 0.8% to performance. This came as the share rose 11.2% after being subject to a takeover from a consortium of shareholders that included the founding family and the largest institutional shareholder. The announced deal price of JOD16.0 is still above the EGP13.7 market price before the exchange went into lockdown. The following two largest contributors were Speed Medical, an Egyptian diagnostics business, and Dis-Chem, the South African health and beauty pharmacy chain.

The largest detractors were, unsurprisingly, some of our larger positions, including Eastern Tobacco (-1.6%), Dragon Capital's VEIL fund (-1.4% and British American Tobacco Kenya (-1.2%). Encouragingly, Eastern Tobacco has announced a share buyback equivalent to 3% of the company. The business is in a net cash position and it's positive to see the directors prioritising shareholder returns at this time.

Looking back over the past five years and four months since inception, it has certainly been a tough time to be invested in global frontier markets. The index has returned -4.0% p.a. over this period. The Strategy has returned -1.3% p.a.

The period now includes the Covid-19 pandemic, the oil price crashes in 2014/2015 and 2020, the float of the Egyptian pound and subsequent 50% move in the currency, the largest ever IMF deal in Argentina, and MSCI upgrades to United Arab Emirates, Qatar, Argentina and Pakistan.

Despite the macro headlines, many businesses across our universe continue to consistently compound US dollar earnings, generate free cash flow, improve corporate governance and deepen their moats. Unfortunately, share prices have not always compounded as well.

A mere three months ago we wrote: *"We have learnt that starting the year with valuations deeply discounted for companies growing earnings strongly, the odds are weighted in the investor's favour. 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."

Since then, valuations have become even more attractive. We remain excited about the businesses we own. In our view, upside to fair value in the Strategy (even after adjusting for the impact of Covid-19) is now the most attractive we have seen in the history of the Strategy. +

THE LARGEST CONTRIBUTOR FOR THE PERIOD WAS AL EQBAL INVESTMENTS, THE LARGEST POSITION IN THE PORTFOLIO, WHICH ADDED 0.8% TO PERFORMANCE.



