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The Coronation Fund Managers Institutional Quarterly

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is an authorised financial services provider.  
7th Floor, MontClare Place, Cnr Campground & Main Roads,  
Claremont 7708. PO Box 44684, Claremont 7735.  
Telephone: 021 680 2000

[www.coronation.com](http://www.coronation.com)

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## NOTES FROM MY INBOX

### AN ACTIVE APPROACH

By Kirshni Totaram



*Kirshni is global head of institutional business. She is a qualified actuary and a former manager of the Coronation Property Equity Fund. Kirshni joined Coronation in 2000.*

The news cycle has accelerated of late, with one breathtaking event after another. From the UK's shock and (under prime minister Theresa May) strengthening bid for isolationism, to exploding cellphones and the Mexican peso emerging as the key gauge of who is winning a US presidential debate, abnormal is the new normal.

In SA, the headlines have been equally alarming. Every day brings more shock news of fraud and politicking, as well as scenes of burning universities and protest. The current mood is akin to the social unrest that plagued our country in the years leading to the first democratic elections in 1994.

It sometimes feels difficult to remain optimistic and to keep perspective. Still, ours is a noisy and vibrant democracy, and growing ever stronger. This was demonstrated by the local government elections in August, which delivered historic shifts in support as citizens expressed their discontent.

Fact is, the political and economic noise worldwide will not die down. Some of the developments will have long-term implications and require a recalibration of expectations. But Coronation's investment philosophy allows us to block out the short-term commotion and single-mindedly pursue the most rewarding opportunities. This has underpinned our meaningful investment outperformance over the long term.

#### DECODING THE PASSIVE SALES PITCH

In this edition, we provide an active manager's response to the massive push toward passive investing over the past five years. Passive investing has created inefficiencies and mispricing in the market, offering opportunities for true active investors like ourselves. No wonder our CIO Karl Leinberger writes in the following article that index rebalancing days are his favourite days in the office.

Still, the fundamental flaws of index tracking as an investment strategy are becoming increasingly apparent. Its sales pitch is based on instant gratification and the need for a known cost, which are taking precedence over the actual goal of retirement investing: to have sufficient income to live on after

retirement. That should be the goal, and not the short-term volatility of performance gains against benchmarks or the short-term ranking of returns relative to the outperforming peer funds of the day. But it is not hard to see why investors fall for the sexy sales pitch: with so much information and choice out there, it is difficult to define the real issues and what lies hidden in the marketing spiel.

Karl helps clarify this confusion in his article, and challenges the conventional thinking behind the sales pitch. From the true cost of these products to the integral shortcomings of a passive investment strategy (which forces investors to buy high, sell low), he finds that key realities are often glossed over. This is a must-read for all investors!

As Karl also explains, tracking the index can be hazardous in a concentrated market like SA. Often investors end up with the very antithesis of the passive proposition: single-stock risk. With so few shares dominating the market, many investors are oblivious to the fact that they are dangerously exposed. Elsewhere in this edition, we explore the other problems with benchmarks, particularly in emerging and frontier markets. We have long argued that benchmarks are often not a true and accurate reflection of the investable universe of those countries and their economic drivers, nor the best companies that investors could invest in (at the right price).

The benchmark indices in these markets are typically skewed towards lower-quality companies, which have larger weightings due to their free floats. On page 9, the head of our global frontiers team, Peter Leger, explains why active, clean-slate investing is a less risky way to access the best opportunities in these markets. We are not concerned with an arbitrary tracking error to flawed benchmarks. Instead, we are focused on avoiding the permanent loss of capital and, more importantly, ensuring that we deliver a rate of return that reflects the risks inherent in the different markets.

In addition to our quarterly contributions on the economy and markets, you will find a number of investment cases in this edition, including for Anheuser-Busch InBev (ABI). Following the SABMiller takeover announcement, our SA strategies



were early investors in the Brazilian beer behemoth on the strength of existing coverage and fundamental analysis from our global investment team. Our analysts are frequent visitors to Brazil, and have over the years done extensive research into ABI.

### BEST AFRICA FUND MANAGER

Coronation was recently named the Best Africa Fund Manager at the annual Ai Capital Market Index Series Awards held in New York. We are proud to have received the award three times in the eight years since the inception of our Africa strategies. This, we believe, is testament to the value that has been created for our clients and the success of replicating our proven investment philosophy and process across emerging, developed and frontier markets. The Africa Frontiers strategy is managed by the same team as our Global Frontiers strategy. You can read more about our Global Frontiers strategy in the Fund Factfile on page 29.

### COROSPONDENT APP

As many of you may already know, we recently launched an exciting new app that will make the reading of this newsletter more convenient for those of you who are constantly on the move. Now you can access and bookmark our insights and thought leadership pieces anytime and anywhere from

your smartphone or tablet. In the next few months you will also be able to download our latest strategy factsheets as they become available. To download our app, simply search for *Corospondent* in the Apple or Google Play app stores.

We hope you enjoy the read. ■

### MARKET MOVEMENTS

	3rd quarter 2016 %	Year to date 2016 %
All Share Index R	0.5	4.8
All Share Index \$	7.7	18.2
All Bond R	3.4	15.0
All Bond \$	10.8	29.7
Cash R	1.8	5.5
Resources Index R	8.1	35.9
Financial Index R	0.8	2.5
Industrial Index R	(2.0)	(1.9)
MSCI World \$	5.0	6.1
MSCI ACWI \$	5.3	6.6
MSCI EM \$	9.0	16.0
S&P 500 \$	3.9	7.8
Nasdaq \$	10.7	7.2
MSCI Pacific \$	8.6	5.5
Dow Jones EURO Stoxx 50 \$	6.3	(2.4)



# THE FLAWS IN THE CASE FOR PASSIVE INVESTING

## BY AN ACTIVE FUND MANAGER

By Karl Leinberger

Karl was appointed CIO in 2008. He joined Coronation in 2000 as an equity analyst and was made head of research in 2005. He manages the Coronation Houseview portfolios.



In recent years, passive investment products have gained significant market share across the world. In my view, John Bogle, long considered the godfather of passive investing, did the savings industry a great service, because there are many incontrovertibly good things that passive investing brings to the market:

- Passive products **increase choice for the consumer** – this is always a good thing.
- The case for passive products **is premised on low fees**, which puts pressure on active managers who charge inappropriately high fees (fees that are not justified by the value they have added in their funds over time).
- It **threatens active managers who have not delivered outperformance or who do not produce truly active portfolios** (that is, they construct portfolios that hug benchmarks).
- **Passive strategies genuinely make sense for some investors.** Examples include:
  - Investors who have not done the due diligence themselves, or have not taken the advice needed, to select skilled active managers.
  - Those who do not have the long time horizon needed to prosper in financial markets. (Unfortunately, these investors tend to churn out of the active manager who has recently underperformed in favour of the active manager who has recently outperformed. In the process, they end up chasing yesterday's winner, buying high and selling low, and ultimately destroying lots of value.)

**However, notwithstanding these positives, I think that many investors in passive products are seduced by the sales pitch without fully understanding some of the deep flaws intrinsic to the passive proposition.**

**This article outlines a number of these flaws. (Please note that these points do not need to be read in any particular order, but in our opinion are all worth considering.)**

### 1. INACTIVE (PASSIVE) INVESTING ACTUALLY DOES NOT EXIST

*The bad news is that all investment actions require an active decision. No matter how artfully the passive sales pitch is presented, all passive investments fundamentally require an active decision. This is something of a fly in the ointment, as it is at odds with the seminal idea of passive investing – that clients are unable to identify which managers will make the correct active decisions and should therefore select an alternative that requires no active decisions (and thereby get the return of the market).*

There are countless examples that demonstrate this point. Equity funds are a good place to start. A market cap weighted benchmark is the only true passive benchmark because it is the only index that all investors can buy. Yet the proliferation of passive equity benchmarks in all major markets is bewildering. In the US there are more equity benchmarks than there are large-cap stocks. This crushes the very foundation on which the case for passive investing rests, because investors do not simply get the return of the market when they invest in passive equity products. Instead, they get the return of the equity benchmark they have selected **after** fees and other costs incurred. And the active decision taken in choosing a benchmark can result in a materially different outcome for investors over long periods.

The SA equity market today provides an instructive case study. The most widely used passive products in the retail market are domestic equity funds. Once a client decides to allocate capital to a passive SA equity product, he/she then needs to choose a specific fund (benchmark). The bad news is that there are many options, each of which yield a very different outcome over long periods of time. In the retail market, the FTSE/JSE Top 40 Index funds initially attracted the lion's share of the SA equity money. However, over the last few years, SWIX 40 Index funds have outperformed the FTSE/JSE Top 40 Index funds. A significant part of this return differential has come from a lower weighting to commodity stocks in





the SWIX 40 Index. In 2015, this resulted in a big net inflow (R1.4 billion) to SWIX 40 Index funds and a large net outflow (R1.4 billion) from the ALSI 40 Index funds. Clients in these products believed they were following a passive strategy and getting the return of the market. Yet, in having to make the seemingly simple choice between the SWIX 40 Index and the FTSE/JSE Top 40 Index, they were unwittingly putting themselves into the position of having to make the most difficult active investment decision in the SA market: how much to allocate to commodity stocks?

The numbers tell the story. Index funds are forced to track the market. Consequently, they owned lots of commodity stocks at the top of the cycle, when prices were high (by June 2008, the SWIX 40 Index funds had 51% invested in commodities while the FTSE/JSE Top 40 Index funds had 61% invested), and they owned very little at the bottom of the market when prices were low (by December 2015, the SWIX 40 Index funds had 8% invested in commodities while the FTSE/JSE Top 40 Index funds had 12% invested).

To give you a sense of the commodity conundrum faced by all active managers in SA today:

- Commodity markets are oversupplied and the outlook is bleak.
- Supply is still increasing due to projects that were committed to at the top of the market.
- Demand is anaemic and depends heavily on China (which is at risk of a hard landing).
- As a result, commodity stocks trade at depressed levels. At the beginning of the year, commodity markets became so stressed that we estimate that many of these stocks were trading at a quarter of their underlying value. This explains why so many of them have doubled or tripled since their January lows.
- Is the 2016 rally a dead-cat bounce and are we in fact only halfway through a decade-long bear market? Or have we seen the bottom and are commodity stocks still cheap enough to buy?

There is an inherent irony in passive investing. Clients buy into the argument that they do not know which active manager will get the big calls right. In a flawed leap of logic, they are then seduced into thinking that active decisions are not required. In so doing, they unwittingly put themselves into the position of having to make some of the big active decisions themselves (for example, how much to allocate to commodity stocks, as noted above).

*Given the fiduciary responsibilities that many advisers and boards of trustees have to the end investor, I question whether enough thought is given to the reality that active decisions cannot be removed from the investment process. This is the Achilles heel of passive strategies. Someone,*

*somewhere is making an active decision. First, this needs to be acknowledged. Then the decision needs to be made by a skilled and experienced professional who will be held accountable for the call.*

## 2. THE PASSIVE ASSET ALLOCATION PROCESS IS FLAWED

*Asset allocation is generally accepted to be the most important investment decision that any allocator of capital makes. The gains or losses from selecting the right or wrong equity manager will typically be dwarfed by the gains or losses stemming from the right or wrong asset allocation decision (for example, allocating too much to bonds and not enough to stocks). Asset allocation is the big call and you need to get it right.*

*Unfortunately, once again, there is no such thing as a passive asset allocation decision. The conceivers of passive products understand this, which is why passive multi-asset class products are typically 'hardwired' to make rules-based asset allocation decisions using passive building blocks. While they may pitch this asset allocation process as being passive, in truth, investors are buying a fundamentally active asset allocation strategy.*

As an example, many passive products use a fixed equity/bond allocation that is rebalanced periodically. Typically, the optimal allocations are arrived at by analysing history and back-testing alternative allocations to find the ones that worked best (in the past). The rebalancing process is rules based – it typically happens either monthly, quarterly or on an annual basis (usually whatever has worked best in the past!).

Make no mistake, this is fundamentally a very active investment strategy. The investment decision is based on historical performance data and implicitly assumes that the future will look like the past. I question whether this will be the case. There are many reasons for this, but to name just a few:

- Over the last five decades the JSE has produced extraordinary, once-in-a-generation returns that are unlikely to be repeated in the future.
- The JSE itself looks nothing like it did ten years ago. Three of the six largest stocks listed on the JSE were not even listed on our market ten years ago.
- Central bankers responded to the global financial crisis with quantitative easing. Eight years later, interest rates in many countries are now negative. This is a grand experiment that poses significant risk to economies and to the savings industry worldwide.
- I believe that quantitative easing has created a bond bubble; one that has massively inflated historical bond returns and will result in massive losses for bond investors at some point in the future.



### 3. PASSIVE PRODUCTS ARE NOT APPROPRIATE IN A HIGHLY CONCENTRATED MARKET SUCH AS SA

One of Bogle's strongest arguments in favour of passive investing is that investors in passive products remove stock-specific risk from their portfolios and simply get the return of the market. This is a compelling argument and it applies in many of the world's more mature and deep markets. Investors in a passive Standard & Poor's (S&P) 500 fund today have only 3% of their investment exposed to the single largest stock, while exposure to the ten largest stocks in their portfolio will amount to 18%.

Unfortunately, the SA equity market is highly concentrated. The largest stock in the SWIX 40 Index is Naspers, at an eye-watering 19%, while the top ten stocks in the index represent 47%.

*Accordingly, one of the strongest arguments in favour of passive strategies does not apply in the SA market. Not only does it not apply, it is actually the reverse - there is an unmanaged risk latent in most passive SA equity products today. Investors in passive SA equity products do not avoid single-stock risk. Often they end up with much more single-stock risk, and they do so without a skilled and experienced investment professional being accountable for the appropriateness of that weighting.*

We currently believe that Naspers is undervalued. For that reason, although it is a large weighting in our equity portfolios, it has been appropriately sized in accordance with our view of the risk-adjusted return that it offers. Fundamentally, however, it remains a risky stock. Most of its value comes from its Chinese internet holding, Tencent. The internet sits at the epicentre of creative destruction. Most of the world's biggest internet companies today barely existed ten years ago. Will the winners of today dominate the internet ten years from now? In China, the risks are even greater because Chinese internet companies are not faced with meaningful competition from the global gorillas (Facebook, Google, etc.), all of which are not allowed to operate in China. Thus the incumbents implicitly depend on the support of their regulators to thrive. Tencent is the kind of stock that can easily become overvalued and decline precipitously at any time. It is not the kind of stock that should be close to 20% of a retirement portfolio, certainly not without an active decision supporting it and an investment professional accountable for the call.

### 4. PASSIVE BOND FUNDS ARE ALARMINGLY FLAWED

Bond funds are perhaps the most flawed of the passive products. The conundrum of setting an appropriate

benchmark for a bond fund is even greater than that described for an equity fund. It is typically solved by adopting the well-known bond indices: the Citigroup World Government Bond Index (WGBI) for global bonds and the JSE All Bond Index for SA bonds.

*The problem here is that the more indebted an entity, the more bonds it has in issue. And the more bonds it has in issue, the greater its weight in the index. This is a very perverse outcome. Investors in passive bond funds end up, unwittingly, in products with a systemic bias to more indebted (riskier) entities. All other things being equal, the more indebted an entity, the less creditworthy it is, and the higher its weighting in a passive bond fund.*

The point is well illustrated by the WGBI today. Three countries stand out as having government debt levels that vary from worrying to terrifying: France, Italy and Japan. Their debt/GDP numbers are 97%, 133% and 248%, respectively. In the WGBI, Japan has a weighting of 23%, France a weighting of 8% and Italy a weighting of 7%. All three countries are at risk of a debt trap. Japan, in particular, continues to blithely rack up deficits with complete indifference to the country's own insolvency. And yet, the bigger those deficits, the more bonds these countries will issue, and the more of their bonds passive bond funds will have to buy.

### 5. PASSIVE IS BECOMING DISCONCERTINGLY ACTIVE AS SMART BETA PRODUCTS GROW IN NUMBER

*An interesting development in the passive industry is that, as passive has gained in acceptance and confidence, it has become more active. More and more active investment decisions are being designed into passive products (is the world not an amazing place?). The boundaries between active and passive are therefore becoming ever more blurred. All smart beta products are, in truth, semi-active products. Is this a bad thing? I think so:*

- The risk in these products is that clients believe they are getting a passive product - one that will track the return of the market (albeit with a few tweaks here and there that happened to have worked out very well in the past). These tweaks are always ones that delivered excellent results in the past. The back-testing results are always compelling. However, financial markets are daunting places that humble the best. If the formula for success were as simple as repeating what worked in the past, we could all fill our investment teams with algorithms and get on with life ...
- In many cases, clients do not realise that they are invested in products where far-reaching active decisions are in fact being made. This applies as much to the smart beta



building block funds (bonds, equities, properties) as it does to the passive asset allocation funds. In most cases these important active decisions are not being made by a team with the skills, the experience, the extensive research process and the granular understanding of the underlying securities that ought to support any active decision-making process.

## 6. THE PASSIVE SALES PITCH IS PREMISED ON LOW FEES. THIS IS OFTEN FAR FROM THE TRUTH.

Although we do not have access to fee data in the institutional market, I assume that many large pension funds secure fees below 0.2% per annum (which I consider to be a fair fee for passive).

In the retail market, however, passive products are surprisingly expensive. *In fact, many passive retail products seem to charge active-like fees for a passive service:*

- The total investment charge (TIC) for the five largest equity tracker unit trusts in the retail market are still very high, at 0.78% per annum on average.
- The equivalent number for the largest equity exchange-traded fund (ETF) in the market is lower, but still high, at 0.46% per annum. (This was arrived at by doing a like-for-like comparison to a unit trust, which includes the brokerage costs incurred in buying and selling ETFs. In this calculation we used the cheapest brokerage deal we could find and watered down those brokerage costs over a 20-year holding period.)
- The TICs for smart beta products are significantly higher than the pure equity trackers; in many cases these are close to those that genuinely active funds charge.

## 7. SOME PASSIVE PRODUCTS UNDERPERFORM THEIR BENCHMARKS BY A LOT MORE THAN THEIR EXPENSE RATIOS

*The passive sales pitch leaves one with the impression that a passive product will give its client the returns of the benchmark after fees. However, an analysis of the historical returns delivered by passive retail products/ETFs demonstrates that this is not always the case.*

Passive products underperform their benchmarks to the extent that they do not perfectly mirror their benchmarks, as well as due to the trading costs they incur. As more money flows into passive products, I think this underperformance will become more pronounced. Why?

- Flows into passive products result in an increased supply of scrip lending in the market. Passive products earn a fee income from scrip lending, but as supply increases, that fee income will decline.

- When indices are rebalanced (as stocks fall away or are added to the index), passive products will increasingly struggle to mirror their benchmarks as more and more money competes to do exactly the same trade.

An analysis of the retail market does not reveal a uniform experience across the different product providers. Some products have not suffered any performance drag at all, whereas for others it is as high as 0.5% per annum (this needs to be added to the fund's TIC to calculate total underperformance).

**In the end, a thoughtful analysis of the passive sales pitch reveals many flaws that are glossed over by its proponents. As is so often the case in life, the theory is frequently very much at odds with the reality. Although passive undoubtedly has its place in the market, we observe that it comes with as many negatives as it does positives.**

## FINALLY, WHAT DOES THE GROWTH IN PASSIVE ASSETS MEAN FOR ACTIVE MANAGERS?

In my opinion, true active managers have nothing to fear. Passive investing leverages off active investing, because active managers make markets more efficient than they would otherwise be. The two strategies are, for this reason, complementary. Markets function best when there is a broad universe of investors with different strategies and time horizons. The growth in passive strategies actually increases the opportunity set for the genuinely active manager. It does this by increasing liquidity in the market. It also makes markets less efficient because it fundamentally biases the investment process towards buying high and selling low. It systematically gives higher weights to overvalued stocks and lower weights to undervalued stocks.

A good practical example would be index rebalancing days (these happen once a quarter and are my favourite days in the office because of the opportunity they provide to buy cheap stocks and to sell expensive stocks in size). On these days, passive products are forced to sell stocks that have performed poorly enough to fall out of their respective benchmarks and to buy those stocks that have performed well enough to move up into their respective benchmarks.

By definition, active managers cannot deliver out-performance if markets are efficient. They endeavour to buy low and sell high. In order to do so, they need someone on the other side of the trade. Passive money is here to stay. It no doubt adds to the stress levels of rational long-term managers (by definition the inefficient pricing of assets has to cause short-term underperformance in their funds). But ultimately it creates opportunity.

Many of our clients ask us to critique the passive proposition. Although this article was penned in answer to that request,



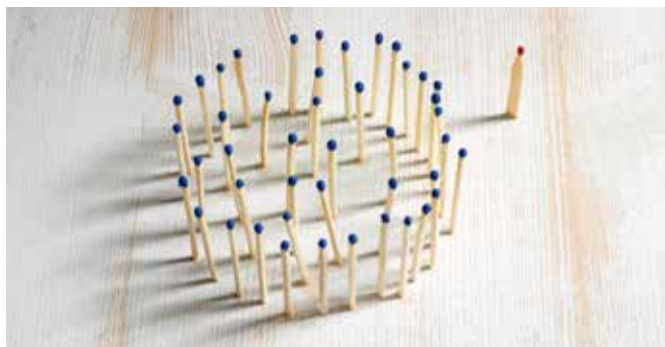


I think that as an active manager we ought to heed the wise words of Jeff Bezos, the founder of Amazon. He notes that most businesses spend too much time watching their competitors. Amazon has succeeded because of its relentless focus on its clients, not its competitors. The active manager that cuts out all the noise and delivers compelling results for clients over long periods of time (and charges a fair fee for that service) will prosper regardless:

- Over Coronation’s 23-year history, our institutional (pension fund) SA equity portfolios have outperformed their benchmarks by 3% per annum before fees. R100 million invested on the day we opened for business

in 1993 would be worth R3.8 billion today, after all fees and costs. That same amount invested in passive alternatives, at a fee rate as low as 0.2% per annum, would be worth R2.8 billion.

- Similarly, R100 000 invested in our SA equity unit trust on the day it launched in 1996 would be worth R3.1 million today, after all fees and costs. The same amount invested in a passive All Share Index-tracking unit trust fund at a TIC of 0.78% per annum (approximately what the two largest retail index tracker funds charge) would be worth only R1.3 million, and worth just R1.4 million if it had been invested in an All Share ETF (with an all-in cost of 0.46% per annum). ■



## BENCHMARKS

### THE RISK OF ZOMBIE INVESTING AND DEAD MONEY

By Peter Leger

*Peter is head of Coronation’s Global Frontiers investment unit and manages portfolios within the strategy. He has 18 years’ experience as both a portfolio manager and research analyst.*



I get it. Folk in finance spend their lives putting numbers to things. We love to measure and track and record. Whole industries are built on this and it comes with its own language. It helps us feel in control and that the quality of our decisions is more measured. And arguably, it does translate into better decisions.

The rise of the investment industry’s obsession with benchmarks and the tracking thereof is a case in point. Sure, it helps consultants and fund selectors to compare a manager’s abilities, and the importance of this goes without saying. The bigger question is whether this is really the best approach, especially in a world where the very nature of benchmarks can be quite arbitrary. Too often the accepted wisdom of the use of benchmarks goes unchallenged, and too little time is spent understanding the one thing that ultimately ends up defining a portfolio.

For Coronation, the more important question investors should ask is why they are participating in the markets they have chosen.

When it comes to frontier markets, the reason supporting their investment decision should not be because they want to outperform a benchmark. Returns in some of these markets can reach large negatives, and beating a benchmark in this instance is cold comfort. By hugging a benchmark, a

manager can be accused of lacking investment conviction and, quite frankly, courage.

Generally, when we make the above argument, we get accused of wanting to be rewarded for beta performance in a portfolio. Simply put, I (the portfolio manager) am trying to take credit for a general move in equity prices, rather than outperforming an equity benchmark. Nothing could be further from the truth. We believe there is far more value in trying to make sure that we focus on generating absolute returns for our investors, rather than outperforming a poorly constructed benchmark. And this is often no easy task.

In the frontier space, the most widely used benchmark is the MSCI Frontier Markets Index, measured in US dollars. This index includes 117 constituents and covers 85% of the free float-adjusted market capitalisation in each country. Sounds like a good effort. When building benchmarks, MSCI states that a strong emphasis is on index liquidity, investability and replicability.

The key words in the above paragraph are **investability** and **free float**. These two filters have major consequences and result in a significant distortion of the index. Why does this matter? The free float refers to the percentage of ownership of stocks held by shorter-term investors. By way



of example, British American Tobacco plc (BAT) owns 60% of the listed BAT Kenya. The free float is then put at 40%, and the benchmark weight of the index is downweighted accordingly.

If you do a screen of consumer stocks across frontier markets, a very common theme is that the global multinationals have beaten the investment community to the choicest consumer options. BAT, Heineken, Diageo, Nestlé, Unilever – the list goes on – all have claimed their stake in these markets. And as a result, the benchmarks receive a corresponding haircut. Banks, typically, do not have international parents. Or if they do, they have grown at a much slower rate. Banks, by their nature, issue shares as they grow. This has resulted in the free float of financial stocks being very high, and they have muscled in far greater representation in the index.

We prefer the more measured approach of investing in consumer stocks that fund growth through internal profit generation and those that come with greater comfort of an international parent. Why then would we choose to have a measurement (benchmark) that forces us to buy more of companies that display far less discipline when it comes to the use of their capital and the issuance of precious scrip? This is exactly what using the MSCI Frontier Markets Index forces one to do.

Let us take a look at how MSCI defines the space and the results thereof.

**TOP COUNTRIES IN THE MSCI FRONTIER MARKETS INDEX VS CORONATION PORTFOLIO POSITION**

Country allocation	MSCI Frontier Markets Index	Coronation Global Frontiers
Kuwait	17.2%	0%
Argentina	15.3%	0%
Pakistan	9.5%	8.3%

Sources: Coronation, Trustnet Offshore, MSCI

**TOP SECTORS IN THE MSCI FRONTIER MARKETS INDEX VS CORONATION PORTFOLIO POSITION**

Sector allocation	MSCI Frontier Markets Index	Coronation Global Frontiers
Financials	50.2%	19.7%
Telecommunications	13.1%	8.9%
Consumer staples	11.5%	37.3%
Energy	8.8%	1.3%

Sources: Coronation, Trustnet Offshore, MSCI

We maintain that investors who choose to put capital to work in frontier markets do so because they wish to compound their capital. They are not actively investing in what is often viewed as a risky asset class because of benchmark volatility. Accordingly, by constraining a portfolio around a benchmark such as MSCI Frontier Markets you run the inevitable risk of sizing investment positions relative to the benchmark, and not relative to the return opportunity on an absolute basis.

We are not suggesting that fund managers whose portfolios resemble the benchmark do not have a fundamental view of the position size in their respective portfolios. The only point we are trying to make is that a definite consequence of portfolios that are risk constrained against a particular benchmark is the inclusion of positions that are merely the result of benchmark referencing.

You should not own a frontier stock just because it happens to be large in a frontier markets benchmark. And constraining a frontier markets portfolio manager to a benchmark risks unintended consequences that will be in direct contradiction to the original reasons for choosing to invest in frontier markets.

As active, bottom-up stock pickers, we view this akin to zombie investing, and would rather avoid carrying dead money in our portfolios. ■



## ANHEUSER-BUSCH INBEV

### A BEER BEHEMOTH

By Dirk Kotzé

*Dirk joined Coronation in 1998 and currently co-manages a large segregated industrial mandate. His research background spans resources, heavy industry and consumer staples.*



*'Non est potestas Super Terram quae Comparetur ei.'* (There is no power on earth to be compared to him.)

*A Latin quote from the Book of Job describing the mythical beast Leviathan (or behemoth). The quote was featured on the frontispiece of the original 1651 edition of Leviathan by Thomas Hobbes. Leviathan was a feared sea serpent or monster. In Hebrew it simply means 'whale'.*

Thursday 29 September marked a sad moment in South Africa's corporate history. It was the last day of trading for SABMiller, which listed as the JSE's first industrial company in 1897. Over the past 119 years, South African Breweries grew to become the world's second-largest brewer, one of the top 100 companies listed in London and the second-biggest company on the JSE. Yet it was not too big to be acquired. In September 2015, Anheuser-Busch InBev (ABI), the world's biggest beer company, made an audacious offer for SABMiller. The combination of (mostly) cash and shares, bumped up by several sweeteners to a final \$112 billion, was accepted a year later. End of SABMiller. Fortunately for SA investors, ABI had to get the blessing of local regulatory authorities, one of the many hoops it had to jump through. It was clear early on that a JSE listing would go some way to smoothing that path. ABI duly became an inwardly-listed company in February this year. SA-based investors can thus still obtain exposure to the assets they once owned (and then some) through the shares of the acquirer. To many local investors, however, the 'new' company will feel big, foreign, unknown and a little scary, like the leviathan of legend. This note will do its best to demystify the beast.

Let us start with the people behind ABI. The company has its origins with three gentlemen named Jorge Paulo Lemann, Marcel Herrmann Telles and Carlos Alberto Sicupira. You probably know the story, but here is a recap. Lemann, Telles and Sicupira founded Banco Garantia, an avant garde investment bank, in Brazil in 1971, eventually selling it to Credit Suisse in 1998 for \$675 million. They had identified beer as a great business and used their capital to buy the Brazilian brewery Brahma. In 1999 they merged it with another brewing company, Antarctica, to form Ambev, the

biggest brewer in Brazil. This first big deal, done when Lemann was already 59 and with a heart attack under his belt, set them up for greater things. Within five years, and now under the leadership of Lemann's protégé, Carlos Brito, Ambev was big enough to merge with Interbrew, a prestigious but sleepy Belgian brewer. The cost savings that the aggressive Brazilians were able to extract from Interbrew astounded the market. The stock of the combined firm, now called InBev, rose 40% in 2005 alone. In 2008, at the height of the global financial crisis, InBev made a controversial \$46 billion bid for Anheuser-Busch, the US corporate doyen. To have raised such a sum given the global backdrop at the time was an unbelievable achievement. It worked and became the stuff of business legend, as recounted in many breathless books (*Dethroning the King*, by former *Financial Times* correspondent Julie MacIntosh among many others).

ABI was now the biggest brewer globally and owned Budweiser, the so-called 'King of Beers'. Again, cost savings were significant. They were to do it twice more. In 2012, ABI bought the 50% in Mexican brewer Modelo that it did not already own, for \$20 billion. To acquire SABMiller, it raised over \$60 billion of bond finance. Following the deal, ABI - already a global behemoth - is now the biggest consumer product goods company in the world by profits (ahead of Procter & Gamble and Nestlé). In brewing terms, it makes almost five times the profits of the next global brewer, Heineken. Leviathan indeed.

Make money, and the world will conspire to call you a gentleman, said Oscar Wilde. In joint control of ABI through a voting pool arrangement (with the Belgian families who used to own Interbrew), the Ambev founders are now among the world's most celebrated billionaires. How did they do it? Well, they are clearly very good dealmakers and financiers. But these are not asset strippers and paper merchants. They have improved the quality of the acquired businesses by simplifying them, scaling them up and removing costs. In almost all cases, the operating margins of acquired businesses have been increased by more than 10%. At the heart of this success lies a unique

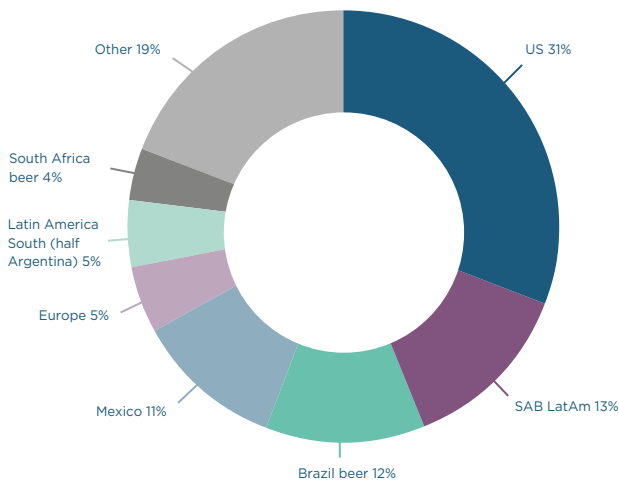


business culture ('dream, people, culture', in their words) which can be rendered as follows:

- ABI is very good at large-company basics like distribution, logistics, procurement and sales execution. Excellence, at scale, is powerful.
- Management structures are flat, allowing direct line of sight downward and feedback upward. Somehow they run businesses with fewer people than peer companies.
- Managers are heavily incentivised to reach outrageous stretch targets (the 'dream'), the idea being that they are then challenged to find innovative ways to bridge the 'expectation gap' to a higher level of performance. Incentives are largely through shares, aligning the interests of managers and shareholders.
- Budgeting is brutal and goals are set from the top. ABI is synonymous with zero-based budgeting. They are cost demons who fly economy and stay in gritty bed-and-breakfasts. To get a new ballpoint pen, you have to hand in your old one. Really.
- Simplicity. They drive hard, but mostly at things that can move the needle. The focus is to get things 80% right, but not to sweat the small stuff (the 80% effort that brings the last 20% reward).

Enough of the history. What are investors in ABI getting? The following pie chart shows where the earnings come from.

**ABI EARNINGS SPLIT**



Source: Coronation estimates

A massive 77% of earnings comes from the Americas, 33% from North and 44% from South. ABI's Latin American business is particularly powerful, and spread across 17 countries, with Brazil and Mexico prominent. The six ex-SAB countries add significant scale to this continental presence. At 9% (of which SA represents 4%), Africa still punches below its 30-country weight, but it offers both organic growth and the potential for mergers and acquisitions. To round off a truly global portfolio, Asia (China, Australia and South

Korea) comes in at 9% and Europe (nine countries) at 5%. Some 56% of ABI is exposed to faster-growing emerging markets, climbing to an expected 66% by the end of our forecast period. With a solid 30% of earnings from the US, and diversified as ABI is across continents and currencies, currency exposure is actually quite modest. Looking at things in aggregate, ABI sells one in four beers consumed worldwide and earns between 45% and 50% of all the profits in global beer. For the SABMiller deal, it raised \$60 billion in debt at a rate of 3.2%, with an average term of 13 years, a better rate than is available to some countries, including SA. Its prodigious financing capability is underpinned by an annual EBITDA (discretionary cash flow) of \$25 billion. Market capitalisation is \$260 billion, or R3.5 trillion. Leviathan.

How do you grow something that is already this big? There are many moving parts, but on the 80/20 principle, the things that will make the difference over the next five years are:

- \$1.95 billion of synergies to come from re-sizing SABMiller's (and the joint) cost base after the deal.
- ABI's important US business is presently struggling. Market conditions are tough and some key brands, especially Bud Light, are underperforming. To fix this, sales and marketing expenditure is currently elevated. A normalisation of these factors will add to earnings growth from here.
- The strong growth in the acquired SABMiller LatAm businesses will continue, aided by margin enhancement from ABI's logistics and efficiency initiatives.
- Mexico is turning into a brilliant market for ABI. A large, profitable duopoly with ABI in the lead role, it is growing strongly. Margins can still expand further.
- In China, ABI's premium beers have found a sweet spot as an affordable luxury, while mainstream beer and fancy spirits have battled. Profitability will more than double over the next five years.

If we consider the income statement at a group-wide level, from the top down, revenue should grow close to 10% in dollars in the medium term. This comes from a combination of 3% to 4% volume growth, 3% to 4% annual growth in price/mix and a bit of help from currency strength. The margins of a consumer staples company should rise gradually with greater scale and efficiency, taking growth in operating profit to over the 10% mark. Now add or subtract the effect of de-gearing (less interest as they lay off the acquisition debt), tax effects and gradual share buybacks, and one comfortably gets to 12% earnings growth. In dollars. Leviathan can indeed still grow.

We have here the opportunity to buy shares in a company with excellent, almost unbeatable fundamentals, one of the best in the world. It offers scale, market power, a strong balance sheet and a deep moat around the business, in the form of brands, relationships and market positions. Beer is a consumer staple with steady revenues, the portfolio effect



takes care of currency and country issues, and growth is guaranteed through exposure to emerging markets. To round it off, there is the stewardship of awesome capital allocators who are shareholders alongside us. Perfection comes at a price, however. ABI is priced at around 19 times what it should earn in a normal year. And for now, before the cost savings are reflected in earnings, the one-year price earnings stands at a daunting 26 times. Even a few years ahead, the price earnings comes out at the higher end of the peer spectrum. Too rich? It may be for some. This share has looked expensive many times in the past and still did well for shareholders. Perhaps the problem is that

the optionality from new deals cannot be accommodated in earnings forecasts. Or that natural conservatism means the forecast has upside.

Taking it all into account, I see a decent margin of safety between our valuation of the company and the actual share price of ABI, a stock SA investors should be willing to hold even if it were at fair value. Thus, it is not a buy or sell decision for me but rather how big the portfolio weighting should be. Most Coronation portfolios already have a sizeable position in ABI. It is likely to get bigger over time. Disregard Leviathan at thy peril. ■



## TRANSFORMATION DRIVING CHANGE

By Kirshni Totaram

*Kirshni is global head of institutional business. She is a qualified actuary and a former manager of the Coronation Property Equity Fund. Kirshni joined Coronation in 2000.*



Coronation has been committed to real transformation since we first opened for business in 1993.

Today, the majority of our employees are black. Together they own a direct and broad-based stake of more than 20% in the business (as measured in terms of the Financial Sector Code).

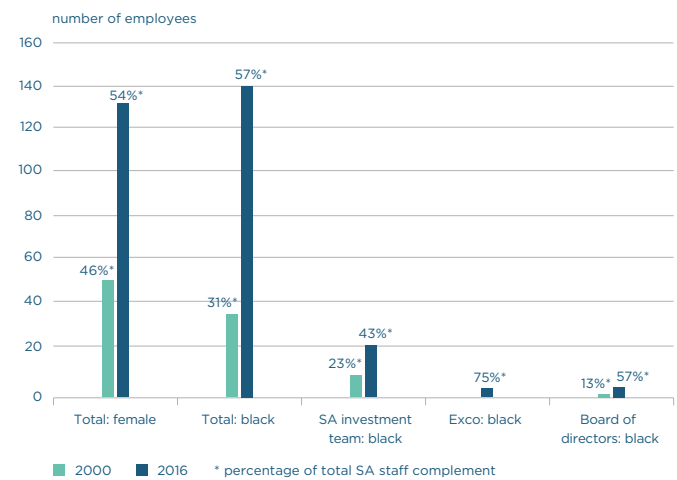
In addition, we pioneered a number of corporate initiatives that have contributed to transformation and the development of skills in the asset management and financial services industry in Southern Africa. This includes our deliberate intervention in the local black stockbroking industry over the past decade, which has created sustainable stockbroking houses with value-added offerings to the investment community as a whole.

### TRANSFORMING FROM WITHIN

Coronation is a meritocracy. Every employee has a meaningful and measurable contribution to make in ensuring the continued success of our business.

By following a disciplined recruitment and selection process, we have successfully recruited, trained and retained exceptional black talent, some of whom now hold critical management roles within the business. A key measure of the success we have achieved over the past 16 years is illustrated in the following graph.

### TRANSFORMATION FROM 2000 TO 2016



Source: Coronation

Highlights as at the end of September include:

- Three out of four executive committee members are black.
- Four out of seven board members are black.
- Close to 60% of our total SA staff complement are black, and more than half are female.
- Within the SA investment team of 47 individuals, 20 (more than 40%) investment professionals are black.
- 75% of the senior managers within the SA investment team are black.





- 50% of the portfolio managers within the SA investment team are black, two of whom are black females.

We continue to invest in black talent in the investment industry through a number of internship programmes and we also have dedicated black trainee analyst roles within our investment team.

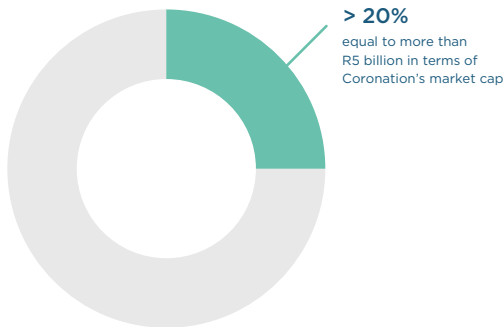
### TRANSFORMING THROUGH OWNERSHIP

Staff ownership is an integral part of our culture. We believe that being part-owners in our business, our people can make the right decisions for the long-term benefit of our clients and the business as a whole.

In 2005, we created SA's first staff-only black economic empowerment deal, the Imvula Trust (Imvula). Today, more than 20% of our business is directly owned by our black staff (comprising their holdings via Imvula as well as direct holdings in Coronation). When measured in terms of Coronation's market capitalisation, more than R5 billion is represented by this direct shareholding of our black staff.

#### DIRECT BLACK OWNERSHIP

(as measured in terms of the Financial Sector Code)



Source: Coronation

### TRANSFORMING AND GROWING OUR INDUSTRY

We believe we can have a great impact on transformation by focusing on the local stockbroking industry.

As an asset management company, we are responsible for the procurement of stockbroking services on behalf of many of our clients. In 2006, we used this 'purchasing power' to launch the Coronation Business Support Programme. Over the past decade, the programme has proven to be a sustainable and effective intervention to grow niche black stockbrokers. Since inception, the programme's allocation to participants has grown consistently, amounting to more than R200 million (in terms of new business). Were it not for the insights and hands-on support by Coronation management and staff as part of the programme, many of these stockbroking businesses would not be in existence today.

The transformation enabled by the programme has been both material and meaningful. More recently, it has inspired the launch of a broader industry programme with the aim of further transforming and strengthening the black stockbroking community. In collaboration with the Association for Savings and Investment South Africa (Asisa), four leading industry participants (sponsors), of which we are one, launched this new and exciting programme on 1 August 2016.

We believe the success of our approach to transformation rests with the fact that its principles have been consistent with our key values of owner-management, being performance-driven and a meritocracy. Our commitment to real transformation has also been embedded in our culture and how we do things on a day-to-day basis. For a more detailed account of our transformation journey over the past two decades, you can read more in our brochure on coronation.com. ■



# THE IMPORTANCE OF GROWTH

## AND WHY IT IS A KEY CONCERN FOR THE RATINGS AGENCIES

By Marie Antelme



Marie is an economist in the fixed interest team. She joined Coronation in 2014 after working for UBS AG, First South Securities and Credit Suisse First Boston.

It really is all about growth. Growth reduces poverty, lowers unemployment, creates incomes and generates taxes. In turn, this adds to revenues and allows governments to implement policies that improve the standards of living. Sustained periods of growth reinforce this virtuous cycle – creating economic room for wider government services, education, investment, innovation and ultimately improvements in productivity. Without growth, it is very difficult to achieve a sustained reduction in poverty. It also becomes unattractive for companies to invest or employ, and ultimately government coffers run dry. Without decent revenue income, governments are forced to raise debt in order to secure money to spend. The more debt governments raise, the more markets and investors demand to be paid for such funding. Over time, the cost of borrowing tends to increase, further limiting government’s options. This is why growth is so important, and why it is a key concern for those ratings agencies with pending reassessments of SA’s sovereign rating. In economic terms, there are only three ways in which an economy can grow. It can:

- absorb more labour by creating jobs and incomes;
- invest more in capital and create capacity; and
- especially once the gains from both of the above have been realised, combine its labour and capital in more creative ways to generate output through productivity.

It is perhaps easy to dismiss this ‘virtuous cycle’ as one that sounds nice in theory, but unlikely in reality. This is especially true in the current environment, where globally economies seem stuck in a low-growth and low-productivity rut, and both monetary and fiscal options seem limited. SA is facing the same challenge: growth has fallen to very low rates and potential (long-term) growth estimates have been steadily revised lower. This reflects diminished capacity within the economy to generate healthy, sustained growth at this stage, and through the deterioration, government has had to rely more heavily on raising debt to fund spending.

What is perhaps harder to remember is the fact that SA has seen periods where sustained growth did lift a significant number of people out of extreme poverty, where unemployment

fell and investment picked up, and government was able to implement social policies that improved standards of living. Importantly, SA was able to reduce the proportion of people living in extreme poverty during this period, and still managed to improve the fiscal position.

The World Bank defines ‘extreme poverty’ as those living on less than \$1.25 per day. At the time of writing, that would have amounted to about R17.50 – a little more than the cost of one night’s sleep in a homeless shelter in Cape Town. In 1993, the World Bank measured SA’s ‘extreme poverty’ headcount at 32% of the population. By 2011, this figure halved to 16.6%. If we use a slightly wider World Bank measure, the proportion of people living on less than \$3.10 per day in 1993 equalled 49.2%, and reduced to 34.7% by 2011.

SA: POVERTY AND GROWTH



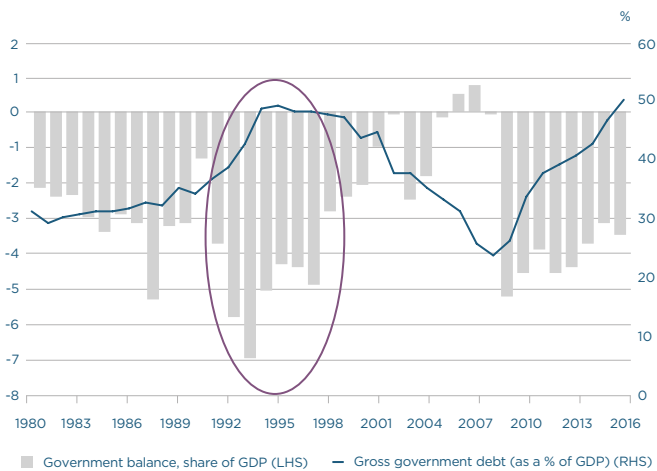
Sources: World Bank, SA Reserve Bank

This is no mean feat when considering the economic adjustment that took place in SA over this period. In 1994 the ANC government inherited an economy that was basically bust. There was no real growth, and the fiscus was in a terrible state. Government debt totalled 42% of GDP in 1993 (and would accelerate to 49% by 1995), and the deficit plummeted to -6.9% of GDP.



Between 1994 and 2000, government began to implement policies to stabilise the economy. It adopted a fiscal framework that was initially guided by the Reconstruction and Development Programme (RDP) and then, from 1996, by the Growth, Employment and Redistribution strategy (GEAR). The adoption of GEAR, in part, recognised that economic growth was too slow for government to implement the social objectives of the RDP. This meant that between 2001 and 2006, fiscal policy became visibly more expansionary. Expenditure increased from 19.7% of GDP to 23.1%, representing real growth of 8% on average over the period. During this time, revenue increased to more than 26% of GDP, buoyed by stronger nominal growth, a widening of the tax base and commodity price windfalls. Alongside steady fiscal consolidation, government started to build a social security safety net, which included a system of conditional and unconditional grants. The net effect was an increase in noninterest spending, but smaller deficits (as is clear from the graph below).

SA: FISCAL POSITION



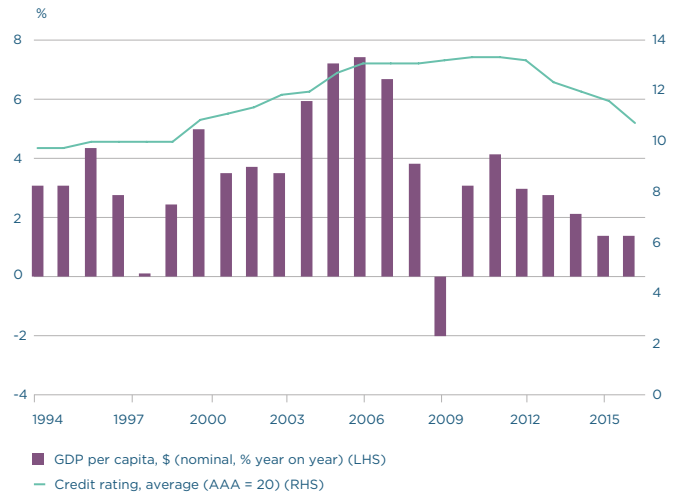
Source: National Treasury

Ratings agencies recognised the strong commitment to, and delivery of, more sustainable fiscal policy (and the decent growth that ensued), and awarded SA with investment-grade ratings - upgraded steadily from 2001 to 2009.

In some ways we are faced today with similar challenges to those prevailing in 1994: the economy is likely to grow by only 0.3% this year and by about 1% in 2017. The medium-term budget policy statement should deliver a deficit forecast a little weaker than the -3.2% targeted in the February Budget, as the quality of revenue is weaker than expected and is a risk to the targeted fiscal deficit for the current fiscal year. Expenditure is also running a little ahead of budget, although early election-related spending may reverse and some evidence that government is managing to lower its wage costs could provide some relief. In the past, government has demonstrated its ability to hold fast

to an expenditure cap, and will have to keep a firm grip on its expenditure targets to deliver a sustainable improvement in the fiscal balance.

SA: GROWTH AND AVERAGE CREDIT RATING



Source: Oxford Economics

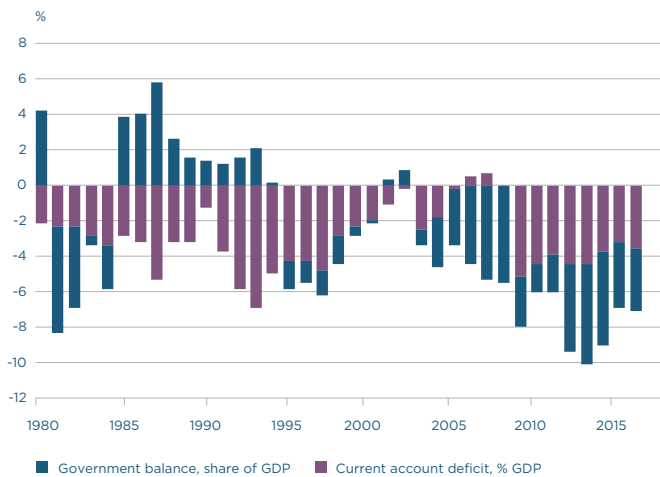
Gross loan debt has risen quite sharply from a low of 26% of GDP at the peak of the previous cycle in the first quarter of 2009, to 50.5% at the end of the 2015/2016 fiscal year. This is above the pre-democracy levels. Low interest rates have kept the cost of servicing debt reasonably contained, but certainly this is a risk going forward.

A rise in debt service costs will leave even less room for spending on social protection or investment. Overall, the fiscal position is constrained and National Treasury has a formidable task in coordinating ongoing consolidation. And instead of working towards achieving ever better investment-grade ratings, as was the case through the last decade, SA is trying to avoid a downgrade to junk status.

Looking ahead, there are reasons to be more optimistic as well as significant lingering concerns. On the positive side, some growth data look a little better: the second-quarter GDP rebound to 3.3% quarter-on-quarter (seasonally adjusted and annualised) is unlikely to be sustained, but better-than-expected trade data are driving net export growth, and the current account is at the margin less of a funding concern. In time, households should benefit from falling (food) inflation following the sharp rise in 2016. Even if the job market fails to recover, real household incomes should have some reprieve, and falling food inflation tends to alleviate more strain on low-income households. We expect the central bank to keep interest rates on hold at 7% for some time, but if inflation is well below the current SA Reserve Bank forecast for 2017 of around 5.7% on average, there should be room to cut rates late next year. Growth in 2017 should be closer to 1% in real terms, and possibly a little higher.



### SA'S JOINT FUNDING REQUIREMENT



Source: SA Reserve Bank

The political environment remains fluid, and uncertainty is no friend of growth. Consumer and business confidence is constrained. These are key ingredients of future growth dynamics – companies in particular may be able to spend on investment, but if they are unwilling to do so, growth will remain weak, and options limited. While ratings agencies may remain forgiving of weak (but improving) growth, their assessment of government’s willingness and ability to meet its debt obligations has become more uncertain with the pressure on state institutions, which has increased since the end of 2015. An end to this uncertainty would greatly improve SA’s growth prospects.



## BOND OUTLOOK

‘WE ARE CONTINUOUSLY FACED WITH GREAT OPPORTUNITIES BRILLIANTLY DISGUISED AS INSOLUBLE PROBLEMS.’ – LEE IACOCCA

By Mark Le Roux

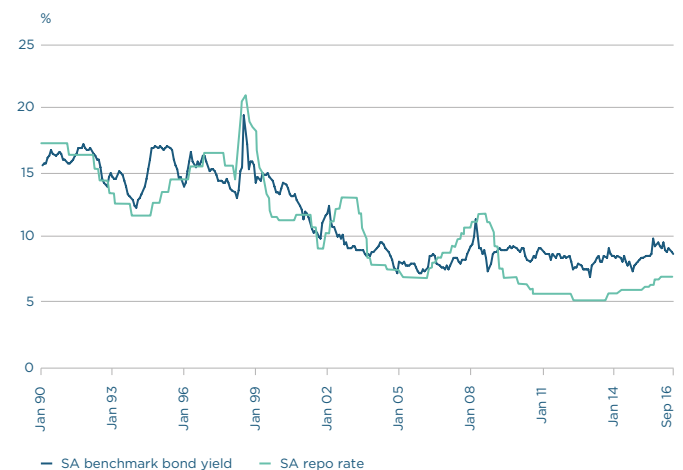


Mark is head of Coronation’s fixed interest unit. He joined Coronation in 2005 and has 25 years’ experience in the investment industry.

At the start of this year, the SA bond market was battered and bruised, having survived the turmoil of three finance ministers in one month. Yields were under pressure, confidence was at crisis levels and the outlook for 2016 seemed ominous. The benchmark government 10-year bond (commonly quoted as the R186) opened the year at almost a double-digit yield of 9.75% and the rand had blown out to a level of R15.50-odd to the US dollar. Expectations of a spike in inflation in the coming year were widely held and in January the SA Reserve Bank’s (SARB) Monetary Policy Committee (MPC) stepped in and hiked the policy (repo) rate by a full 50 basis points to 6.75%.

However, as is often the case, the best opportunities usually present themselves at times of crisis. At the time, fear of a very unstable domestic political economy presented a great buying opportunity in local bonds. Yields have rallied strongly over the past nine months to around 8.5%, with the bond market producing an eye-watering 15.5% year-to-date return. Throughout this period, finance minister Pravin Gordhan fought the good and righteous fight to steady the country’s fiscal ship, trying to block the patronage network at every turn and putting policies in place to try to avert a country downgrade to junk by the ratings agencies.

### SA LONG BOND YIELD VS SA REPO RATE



Sources: Reuters, Datastream

The bond market responded positively to these developments, an important vote of confidence in the outlook for sustainable fiscal policy. Importantly, lower yields also reduce the interest burden on the fiscus, allowing greater flexibility for expenditure on other things.

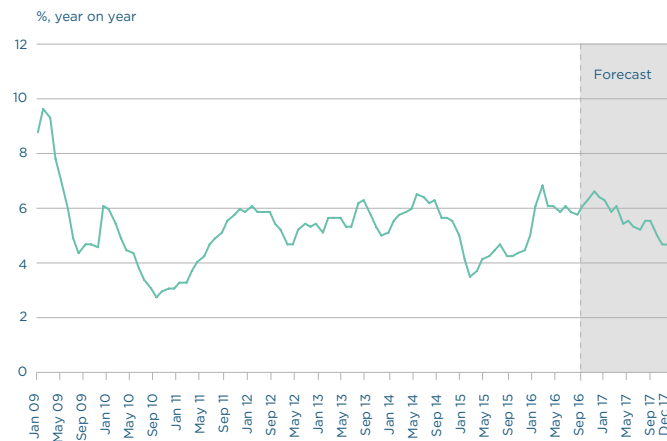


So where to for the local bond market from here? With yields around 8.5%, are there more gains to come?

While we are reasonably positive on the fundamental outlook for bond prices, the fluid political situation may affect political risk premium. Nonetheless, the underlying fundamentals should continue to dominate the valuation of these instruments. And the biggest fundamental driver of bond yields is the trajectory of inflation.

Inflation is expected to peak in the upcoming quarter at around 6.7% and then fall steadily into next year to average around 5.7% for 2017. The main driver is expected to be a relatively sharp deceleration in food price inflation, which now looks close to a peak. Our view is reinforced by the improvement in rainfall – perhaps increasing evidence that La Niña is coming and farmers are more likely to generate a more normal harvest this summer season after last year’s debilitating drought.

**HEADLINE CPI, INCLUDING FORECAST**



Sources: StatsSA, Coronation

The next strongest driver (and greatest potential uncertainty) is the relative stability seen in the exchange rate, despite ongoing bouts of political uncertainty. The rand has rallied around 11% to R14.20 versus the US dollar since the start of the year. Underlying improvements in the trade account added impetus to the rand’s performance after its big depreciation last year.

We think that the improved inflation outlook means that the SARB will not hike rates further. If sustained, it should also have a positive impact on inflation expectations. In the most recent MPC communiqué issued in late September, the MPC made it clear that if its inflation forecast is realised,

then the current hiking cycle is close to peaking. However, they did caution the market not to start pricing in rate cuts too soon because ‘the bar to monetary accommodation remains high’. Despite this, the suggestion that the hiking cycle may be over should provide underlying support to bond yields, also resulting in a flatter yield curve.

As always, nothing is straightforward and risks remain. We are concerned about two things. The first is a pending rate hike in the US and the possibility that it puts upward pressure on US bond yields which, in turn, would likely hurt the pricing of the bond yields in other countries, including here in SA.

**US 10-YEAR TREASURY YIELD**



Sources: Reuters, Datastream

The second is the still relatively high probability that SA’s sovereign rating is downgraded to junk status when the ratings agencies give their assessments before the end of the year. A ratings downgrade would be material to the pricing of our bond yields and could result in a major sell-off. Our view is that the odds are about even. If we do get a medium-term budget policy statement at the end of October that manages to hold the current fiscal line and the finance minister continues to demonstrate his fighting spirit, we could get a stay of execution into next year. This, in turn, may give a window of opportunity for policymakers to address some of the much-needed structural issues and reforms that would improve the outlook for growth in the longer term.

Although there are clear risks to domestic bond pricing, we do believe that the fundamental valuation argument provides a decent underpin at current levels. As such, our funds continue to hold and accumulate domestic government bonds at these yields. ■





# MARKET REVIEW

## NAVIGATING THROUGH THE NOISE

By Quinton Ivan



*Quinton is head of SA equity research and co-manages the Coronation Core Equity portfolios. He joined Coronation in 2005.*

For the third quarter of 2016, the MSCI All Country World Index and the MSCI Emerging Markets Index returned 5.3% and 9% respectively in US dollars. Locally, the JSE All Share Index returned 7.7% in dollars, but rand appreciation (in line with other emerging market currencies) meant that the rise in local currency terms was more muted at 0.5% over the same period. Commodity prices, in general, ended the quarter virtually unchanged in US dollars: oil was down 1.3%, platinum gained 0.3% and copper rose slightly by 0.2%. Notwithstanding the benign moves in commodity prices and strength of the rand, resource shares performed well: the local Resources Index returned 8.1% for the quarter, outperforming industrials (-2.1%) and financials (0.8%). The longer-term divergence in the performance of resources relative to industrials and financials remains significant. Not only has the Resources Index lagged industrials and financials over three, five and ten years, but it has also underperformed cash over these time periods.

### MARKET SUMMARY

Index	3rd quarter 2016	1 year	3 years	5 years	10 years
All Share	0.6%	6.8%	9.0%	15.5%	12.2%
Resources	8.1%	24.1%	(1.7%)	0.7%	2.7%
Financials	0.8%	(0.9%)	13.2%	19.4%	12.1%
Industrials	(2.1%)	4.5%	12.1%	22.3%	18.3%
SA Listed Property	(0.7%)	3.8%	14.4%	17.7%	17.4%
All Bond	3.4%	7.6%	6.8%	8.0%	8.5%
Cash	1.8%	6.8%	6.1%	5.7%	7.1%

Source: Deutsche Bank

Nearly eight years since the global financial crisis, interest rates remain close to zero in most major economies and even negative in others. The world's major central banks are committed to maintaining the status quo of unconventional monetary policy. The US Federal Reserve has once again delayed hiking rates, while the European Central Bank and

the Bank of Japan continue to apply quantitative easing. Highly accommodative monetary policy represses the cost of capital and serves as a tax on the savings industry. This lack of yield encourages risk-taking as capital scours the globe in search of the best opportunities. This has the effect of manipulating asset prices across the spectrum – equities, bonds, property and currencies – which has resulted in the current disconnect between strong financial markets and tepid growth in most major economies. While monetary policy has succeeded in buoying financial markets, very little of the heavy lifting by way of fiscal and social reform has taken place. While central bankers may have averted the great recession from becoming a depression, they are potentially sowing the seeds for another crisis in the years ahead.

At the time of writing, Theresa May, the UK prime minister, has announced that she will start formal negotiations for Britain to leave the EU by March 2017. Once she triggers Article 50, she will have two years to negotiate a new trade deal with the EU. This has once again rekindled uncertainty, as market participants speculate about the terms of such a deal. This uncertainty is likely to result in central bankers erring on the side of caution and keeping interest rates lower for even longer.

Domestically, economic growth remains subdued with risk to the downside given the backdrop of a weak global economy, instability caused by political infighting and the risk of a credit downgrade to junk status. Recent rand strength has improved inflation expectations and, together with weak economic growth, this means that the SA Reserve Bank is unlikely to hike interest rates further.

We believe domestic equities are moderately attractive. While the JSE All Share Index is near its peak in rand terms, it has basically tracked sideways for the last five years in US dollar terms. This is largely due to 48% of the JSE All Share Index constituents being rand hedges, which benefit from a depreciating currency. We believe the global businesses listed in SA are attractively valued and, as such, our portfolios have healthy weightings in stocks



such as Naspers, Steinhoff International Holdings, British American Tobacco and Anheuser-Busch InBev (you can read more about the latter's investment case on page 11). These businesses are exceptionally well managed and are diversified across numerous geographies and currencies, which make for a robust business model and protect the companies from an earnings shock in any single market.

Resource shares have performed strongly year-to-date as commodity prices recovered. Our funds were well positioned to capture this bounce, given our reasonable weighting in resource shares. Notwithstanding the recent outperformance, we believe resources remain attractive based on our assessment of fair value. However, given the vagaries around currencies, commodity price moves and Chinese demand, one has to manage these risks by ensuring that the weighting in our respective portfolios is sized appropriately. Our preferred holdings remain Mondi, Anglo American and the low-cost platinum producers, Northam and Impala Platinum. SA gold and platinum miners both face enormous challenges and cost pressures (such as real increases in electricity tariffs and labour costs without the corresponding gains in productivity). The SA platinum producers mine approximately 70% of the world's platinum supply. This affords them pricing power. Metal prices will have to adjust higher to reflect these cost pressures in order to incentivise platinum miners to expand production to meet demand.

The same is not true for gold. SA mines a tiny portion of the world's gold supply; the world does not need our gold. This means that SA gold miners are likely to absorb these cost pressures, adversely affecting their profitability. Prior to the recovery in the gold price, SA gold miners faced enormous pressure; balance sheets were under immense strain and many were either facing a rights issue or closure. This prompted management to run these businesses for cash – production was high graded (at the expense of the life of mine) and exploration capital expenditure was culled. While this is good for near-term cash flow and profitability, it is negative in the long term. Mines face a declining production profile – if they do not replace production (by sinking new shafts, as an example), unit costs will eventually blow out as lower production is spread over a similar fixed-cost base. This will be detrimental to profitability. We thus remain negative on SA gold miners.

Given the weak domestic economy, it will be a challenge for the average business to defend (let alone grow) earnings in

real terms. In such an environment, high-quality businesses thrive and take market share from the weaker ones. To this extent, we hold reasonable positions in food retailers and producers as well as selected consumer-facing businesses (Foschini and Woolworths). These businesses enjoy pricing power, are well managed and trade below our assessment of fair value.

Banks returned 10% for the quarter, outperforming the broader financial index. While banks are effectively a geared play on a weak domestic economy, we believe that this is more than discounted in the current share prices. Valuations are attractive on both a price-to-earnings and price-to-book basis. These businesses are well capitalised, well provided for and trade on attractive dividend yields. Our preferred holdings are Standard Bank, Nedbank and FirstRand.

Life insurers returned -1.5% for the quarter. Our preference remains Old Mutual and MMI Holdings, both of which trade on attractive dividend yields and below our assessment of their intrinsic value.

Listed property returned -0.7% for the quarter. We expect domestic properties to grow distributions at levels close to inflation over the medium term, even if one assumes an uptick in tenant vacancies. This real growth, combined with a fair initial yield, offers an attractive holding period return. We continue to hold the higher-quality property names which we believe will produce better returns than bonds and cash over the long term.

In a low-growth, low-yield environment, equities remain our preferred asset class for producing inflation-beating returns. We prefer global to domestic equities on the basis of valuation and remain at the maximum 25% offshore limit in our global balanced funds. We believe the current rand/dollar exchange rate to be fairly valued. At times, when we believe the rand to be oversold, we will lock in currency weakness by using futures, without physically selling global equities.

In conclusion, financial markets are fraught with uncertainty as investor sentiment reacts to the news of the day, which causes asset prices to gyrate. During these choppy markets, our long-term time horizon and valuation-driven investment philosophy act as a compass, allowing us to navigate through the noise and make the correct decisions for the benefit of our clients. ■



## INTERNATIONAL OUTLOOK

### GLOBAL GROWTH SHOULD PROVE SURPRISINGLY POSITIVE IN 2017

By Tony Gibson

*Tony is a founder member of Coronation and a former CIO. He established Coronation's international business in the mid-1990s, and has managed the Global Equity Fund of Funds portfolio since inception.*



Equity market performance saw a quick turnaround during the past three months, with volatility accelerating towards the end of the quarter. Equity markets in the US were again boosted by technology shares, which rose by 12%, while bank shares had a strong quarter across most major markets, including the US, Europe and Japan. Energy shares also had a positive three-month period following production cuts recently announced by OPEC.

Emerging markets had a strong quarter as well, both at the equity market level and in terms of positive currency movements. Brazil and Russia were the stand-out performers. Year-to-date, the MSCI Emerging Markets Index has posted a positive return of 16%. This compares to a return of only 6.1% for the MSCI World Index of developed market equities, which has raised hopes that emerging market equities have finally turned the corner. A number of factors as to why emerging market equities have rallied this year are highlighted below:

- Importantly, the rally started in February from relatively cheap equity valuation levels and oversold emerging market currency levels that reflected highly pessimistic investor sentiment.
- China surprised investors with massive stimulus that generated a recovery in commodity prices, which are key drivers of emerging market equities and currencies.
- The US Federal Reserve backed away from its plans to tighten monetary policy in March, which helped both commodity prices and emerging market currencies recover after sharp sell-offs in 2015.
- The Brexit shock to global markets late in June helped push developed market sovereign bond yields to new lows, which boosted the relative attractiveness of emerging market bonds and currencies. Firmer commodity prices have also supported upward revisions to expectations for emerging market earnings.

With regard to China – following the recovery in its real estate markets – commodity markets have benefited from stronger demand. Copper imports for the three months to June were up by 34% from a year ago. Domestic steel

prices in China have also risen by 52% since the end of November 2015, which has coincided with a strong rebound in JPMorgan's Emerging Market Currencies Index. As always, it remains unclear how robust (or sustainable) China's apparent stabilisation will be. Private sector investment has continued to slow down, while investment by state-owned enterprises (SOEs) has accelerated to a pace of 23.5% in the first half of this year (compared to relatively sluggish growth of 9.9% in the second half of 2015). The concern is that borrowing by unprofitable SOEs – a.k.a. 'zombie companies' – may be diverting credit from more productive uses in the private sector. But for the time being, the government seems to be prioritising stability at any cost.

The macro risk that remains for emerging market equities overall is the potential for major industrial commodity prices to resume their multi-year bear market trajectory as the effects of China's stimulus begin to wear off. A look at a long-term chart of the inflation-adjusted Commodity Research Bureau's Raw Industrials Index provides some perspective, as this clearly illustrates a long-term downward trend since the late 1940s. This may well reflect the fact that, as Alan Greenspan once noted, the GDP of advanced economies has become notably 'lighter' over time as the share of services has increased, thereby reducing the share of materials-intensive heavy industries.

Moving on to the UK, the Brexit result of 23 June has brought about sharp downward revisions for growth, including for many of its European neighbours. According to a Bloomberg survey, economists cut their 2017 forecasts for UK real GDP growth from about 2.2% to 0.5% (essentially forecasting a recession) in the weeks that followed the vote. This growth forecast revision was accompanied by cuts to growth for 2017 ranging between 0.3% and 0.5% for many other European countries whose economies are exposed to trade with the UK.

In line with such forecast revisions, global bond yields fell on the view that central banks would need to either cut interest rates, as the UK has subsequently done, or signal that rates would be kept lower for longer. According to



a Fitch Ratings report, the amount of negative-yielding sovereign debt rose by 12.5% in June to a staggering level of \$11.7 trillion following the turmoil created by the Brexit vote. The drop in sovereign debt yields in developed markets has created a 'stretch for yield' trade that has boosted the relative attractiveness of emerging market debt, where yields generally remain higher than in developed markets. The result has been a resumption of portfolio capital flows into emerging markets following strong outflows through much of 2015. Data from the Institute of International Finance show a net flow into emerging markets of \$107 billion in the six months to end August. Although that rate of change does not look excessive relative to the persistent pace of flows into emerging markets in previous years, there must be some worries that capital flows into emerging markets are overheating and setting the stage for disappointing returns and renewed outflows.

As highlighted already, bond markets have had another very strong year thus far, delivering double-digit gains. Bond investors continue to implicitly believe that secular stagflation is inevitable and growth in much of the world is settling at below-trend levels. They are conveniently overlooking the fact that there is a very meagre cushion in the value offered by long-dated US bonds. A mere 0.2% increase in Treasury yields would wipe out a whole year's worth of interest income! Corporate bonds have been an even stronger performer over the quarter.

As we move into the fourth quarter of 2016, investors are essentially focusing on two key risks. One concerns the systemic risk in the financial system – related to the threat of a possible collapse of Deutsche Bank – while the second relates to US politics. Another risk that continues to cause concern is the fear that global economic growth – more specifically US economic growth – may falter. Naturally, this risk must be offset against the anticipation of a rise in US interest rates in the event that the US economy grows more robustly than anticipated. It is undoubtedly true that global equity and bond markets are in the late stages of a multi-year bull market, and this rightfully causes investors to be cautious. However, it is also true that since the 2008/2009 bear market, many money managers have viewed the equity bull market through the prism of mistrust that was caused by this painful experience.

Those equity investors who currently hold a negative view towards equities will argue that the stock market continues to be characterised by very high valuations and very low earnings growth. They believe that the only thing preventing this trend from setting off a bear market has been the equity-bulls' faith in global central banks keeping interest rates near, or below, 0%. Additionally, they will point out that, according to statistics provided by Standard & Poor's (S&P), the market valuation for the S&P 500 Index stands at around 25 times reported earnings per share (EPS) and 22 times operating EPS. At the same time, earnings growth

has been negative for the past seven quarters. Somewhat simplistically, it can be argued that in reality, most companies that are earnings 'challenged' trade at significantly lower levels than the current market multiple. As an example, Apple's growth has slowed sharply and it is trading at 13 times EPS. In turn, IBM has struggled with EPS growth and it is trading at 12 times earnings. If the S&P 500 was a stock, they would argue, it would not be trading on a multiple of 25 times. Implicitly, the risk therefore lies in those consumer staple stocks that trade on mid-20 multiples due to the belief that their earnings will continue to grow at steady and predictable levels. This might well prove to be an overly sanguine outlook.

A further cause for concern is that, while equity valuations in the US are back to 2007 levels, the constituent companies have leveraged up in order to facilitate share buybacks. Currently, companies are much more leveraged than in 2007, with gross and net leverage respectively 40% and 25% higher. This was made possible, for now, by lower current interest rates. The federal government has levered up as well. If one strips out the amounts that the government owes to Social Security and other agencies, the federal debt held by the public more than doubled, from 35% to 76%.

That all said, in our opinion, the single most important issue undermining investor confidence is that, as was the case a year ago, many observers and investors are concerned that cyclical weakening in the US late this year and into 2017 may drag the global economy towards stagnation, or even a deflationary recession.

We, however, believe that despite the tepid pace of the post-2009 recovery, the US economy is far more resilient than many perceive it to be, particularly when relative comparisons are made with other major economies. Our reasons for holding this view are as follows:

- Populations are ageing and contracting in Japan and Russia, and poised to contract across much of Europe. Simultaneously, working-age populations are contracting in many leading emerging economies, including China, South Korea, Taiwan and Singapore. Meanwhile, the US population continues to expand by about 2.5 million people per year, providing fuel for growth in the labour force and domestic consumption. Additionally, the core of the large millennial generation is now gaining a foothold in the workforce and is poised to trigger a 15-year rise in household formations, a new baby boom and robust demand for housing, consumer durables and family-related goods and services. As this secular catalyst for domestic demand gathers momentum, the demographic divergence between the US and most of Europe and East Asia will become more apparent and somewhat transform the global economy, trade and capital flows, and collective demand for energy and raw materials. While this dynamic will only be fully felt in the 2020s, over the



next 18 to 24 months, the momentum of cyclical recovery will dominate, led by resilience in US consumption and growth, modest growth in Europe and Japan, and the momentum of Chinese growth. This will also be fed by the late stages of urbanisation and government funding of infrastructure projects and financial support for leveraged SOEs.

- Looking more closely at the underlying demographic numbers, as the financial crisis began in 2007, full-time employment in the US peaked at 122 million. After falling to 111 million by the end of 2009, the gradual recovery over the past seven years has restored the 11 million full-time jobs lost and created an additional two million. Yet, from 2007 through to the present, the US population has increased by between 23 million and 24 million people, with the core of the huge millennial generation moving into the workforce.
- While some baby boomers have left the workforce over the past nine years, the net increase of only two million full-time jobs since the 2007 peak reflects several disparate factors. Many older workers were forced reluctantly into early retirement. Many young adults unable to find work out of high school or college chose to continue studying. Meanwhile, six million Americans seeking full-time occupation are working part-time hours, limiting their incomes and spending power. Reducing 'involuntary' part-time work over the next year is vital to continued resilience of the current US cyclical recovery. While the value of overall US workforce participation is being clouded by young adults continuing their education and the early retirement of baby boomers, a valuable barometer of new job creation is the trend among workers (aged 25 to 34) just entering the workforce. The participation rate of this young adult group bottomed out between 2013 and mid-2015, and has been rising over the past year. A resilient US economy should lift this rate even further towards a normal level of about 83% in 2017.
- Based on the current US population, 'normal' annual demand for existing homes should total 5.5 million to six million units. In the past year, sales have rebounded close to the lower end of this range and should rise further in 2017. While the surge in construction from 2005 into 2008 triggered a sharp jump in the supply of unsold existing homes, inventory has been drawn down to very low levels over the past three years. Tight supply and delays in ramping up new home construction have fed house price inflation in many markets across the US.

To meet the demand for new household formations, the rate of new home construction should be close to one million single-family units per year. While the number of homes built has risen over the past two years, delays in zoning and permits, as well as shortages of skilled labour, have kept this cyclical rebound far below the level needed to meet demand. The resulting upward pressure on residential construction will be a key driver of US economic resilience over the next three to four years.

In summary, the core of the huge millennial generation, born between 1983 and 1995, is now aged 21 to 33. The expected surge in new household formations was delayed by the deep recession of 2007 to 2011. However, over the next four to five years, pent-up demand from this group should drive new household formations up from 700 000 to 1.5 million units per year. In turn, this should trigger a positive ripple effect on the demand for property, housing and consumer-durable goods.

Turning to another key pillar of the US economy, while there is still considerable pent-up demand in the US for housing, the restricted demand for motor vehicles has largely been met. Yet, while total vehicle sales in the US have reached a cyclical peak, demand is likely to remain close to current levels for another 18 to 24 months before the reducing age of the fleet and other factors set in motion a reduction in new car and truck sales. US new vehicle sales for this year and the next are expected to be close to 17.6 million to 17.8 million units. In the shorter term, once we are past the uncertainty created by the presidential election, total US vehicle demand may surprise on the upside through year-end.

Looking at overall GDP growth in the US economy, the sharp drop in oil prices (since late 2014 and through to early 2016) triggered a significant drop in energy sector investment in the country. While consumers benefited from lower fuel prices, the drop in capital investment created a near-term drag on US GDP growth that heightened fears by late 2015 that the economy might slide into a recession. However, the drag on GDP growth from the energy sector has now run its course, setting the stage for a rebound in capital spending in 2017. Collectively, these near-term cyclical catalysts should support firmer than expected resilience in US economic growth over the next 12 to 18 months. Combined with near-term investment-led momentum in China, and a modest cyclical improvement in growth for Europe and Japan, the outlook for global growth should prove surprisingly positive in 2017. The US economy (and hopefully the political system) is more resilient than many fear or doubt. ■





# HARLEY-DAVIDSON

## LIVE YOUR LEGEND

By Ryann Dean



*Ryann joined Coronation in 2014 as a global developed markets analyst. He is a qualified chartered accountant and completed his articles in the financial services division of KPMG.*

Harley-Davidson (Harley) needs no introduction. It is arguably the world's most iconic motorcycle brand and symbolises the very ideal of freedom for its riders. The company has been in existence for more than a century and during this time has grown to become one of the most dominant motorcycle manufacturers in the world, with a singular focus on the customer.

The investment case for Harley revolves around a few key pillars: its brand power, industry-leading financial metrics, future growth prospects and a strong shareholder focus.

### BRAND POWER

When you purchase a Harley, you are not simply buying a mode of transport. Rather, you are buying into the Harley lifestyle, which includes branded clothing and accessories. Most importantly, it means joining the local riding chapter (which is analogous to a club). These chapters provide a sense of community and allow riders to socialise while building phenomenal brand loyalty. Harley has approximately 1 400 riding chapters worldwide and the Harley Owners Group (H.O.G.) has over one million members.

In 2015 Harley was the only motorcycle manufacturer to feature in Interbrand's ranking of the world's most valuable brands. Not only does this reflect the legacy that Harley has crafted over many decades, but it also showcases existing management's stewardship of the brand. Customers come first, even if this hurts near-term financial results, as illustrated in the following example.

From late 2014 the Japanese motorcycle manufacturers (Honda, Suzuki, Yamaha and Kawasaki) heavily discounted their motorcycles in response to a weakening yen. This was an attempt to gain increased market share in the US. The discounting by the Japanese manufacturers encouraged other motorcycle manufacturers to do the same, and a vicious downward spiral of promotions ensued. Harley,

however, remained an outlier, with a steadfast refusal to discount. To Harley, this would impair the value proposition of its new motorcycles and negatively affect the residual values of its existing bikes. As a result, Harley's revenue declined and it lost market share in 2015. Most importantly, however, the integrity of the Harley brand remained intact, and it is not surprising to us that its market share has already started to recover. Customer loyalty, combined with Harley's brand power, creates a very high barrier to entry and thus a significant moat around the company.

### INDUSTRY-LEADING FINANCIAL METRICS

Harley's margins are industry leading due to premium pricing on its premier product line-up and excellent operational efficiency. It has been said that a good crisis should never be wasted, and so Harley used the global financial crisis to completely restructure their manufacturing facilities and staffing levels. The company embraced 'surge manufacturing' – a leaner, more cost-effective and less labour-intensive process (labour intensity has been halved in some of its facilities). Surge manufacturing enables Harley to quickly adjust supply levels to meet market demand (and thus not risk oversupplying their dealer network). It also allows the business to cope with the traditional seasonality in motorcycle sales (purchases peak prior to the summer riding season). The adoption of this manufacturing approach has reduced time to market for new products by up to 30%.

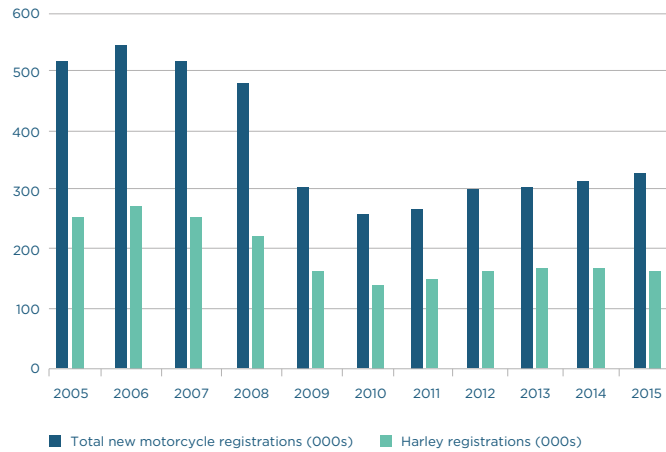
Over the last five years the operating margin within Harley's motorcycle segment has averaged 16%, significantly higher than that of its peer group. One of the benefits of a slow growth market is that Harley does not need to invest large amounts of capex in new facilities. This is one of the key reasons behind Harley's exceptional free cash flow (FCF) generation, with FCF conversion over the last five years of 110%. This compares very favourably to the average business globally, which typically generates 70 cents to 80 cents of FCF for every one dollar of reported earnings.



## FUTURE GROWTH PROSPECTS

Harley dominates the US heavyweight motorcycle market<sup>1</sup> with a market share of approximately 50%, more than double its nearest competitor. The US is a slow growing market and with motorcycle sales for 2015 40% below peak levels, it is clear that any pre-crisis froth has evaporated. We expect steady, but slow, growth from these levels.

### US MOTORCYCLE REGISTRATIONS (601CC AND ABOVE)



Source: Motorcycle Industry Council, 601cc and above data only

Harley's business remains domestically focused, with 64% of sales realised in the US. International expansion is, however, an underappreciated growth opportunity. In the last five years international sales have grown 1.4 times faster than those achieved in the US, and as Harley builds out distribution and expands into new territories, management aims for this to continue. By 2020, Harley envisages to add 150 to 200 new international dealerships – an increase of 20% to 30% on the current international base. In many countries, motorcycle riding is a key form of transport and leisure, and as the most iconic motorcycle brand in the world, Harley is well placed to capture an increasing share in these markets.

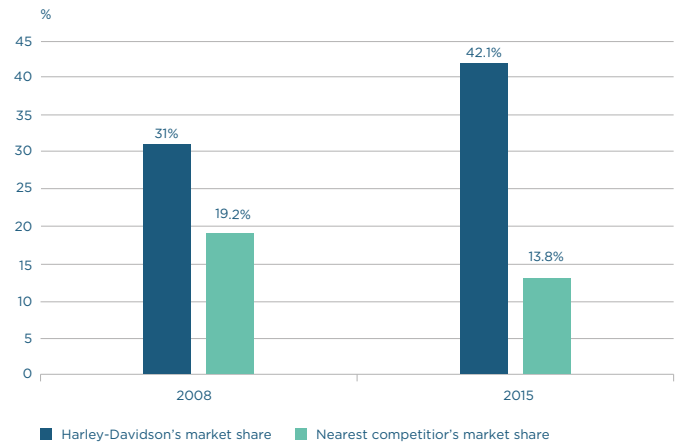
A key concern for Harley has been its ageing rider demographic, specifically the male baby boomer generation. This year the oldest baby boomers will turn 70, which means they are reaching a stage where riding a heavyweight motorcycle may no longer be feasible. Harley will need to supplement falling sales in this demographic with increased sales to a younger audience and other demographics. Management noted this issue some time ago and has since focused on broadening the appeal of motorcycling to other demographics where the company was underexposed. These strategies are beginning to show success, as indicated

<sup>1</sup> The heavyweight motorcycle segment (601cc and above) accounts for 85% of US motorcycle sales.

in the following graph which shows the gains in the key young adult demographic since 2008. In 2015, one-third of new Harley purchasers did not own a motorcycle before. In addition, 2015 was the eighth consecutive year in which Harley was the number one seller of motorcycles to young adults (aged 18 to 34). In a recent earnings call, Harley management stated that the company was now selling more motorcycles to young adults than they had sold to baby boomers at the same stage in their lives, setting Harley up for continued success in the future.

### HARLEY-DAVIDSON US MARKET SHARE: YOUNG ADULTS

Young adult men and women, 18-34 (motorcycles 601cc+)



Sources: Based on IHS Automotive, US new motorcycle data for calendar year 2008 vs 2015

## STRONG SHAREHOLDER FOCUS

For any investment, how management decides to allocate the cash generated by the business can have a meaningful impact on the company's future prospects and returns to equity holders. In our view, management has acted astutely. Harley has a reasonable dividend yield of 3% (higher than the market), which has increased at a compound annual growth rate of 20% since the global financial crisis.

But it is the opportunistic share buybacks during the last 18 months that we view very favourably. The bulk occurred in 2015 when the business used its strong balance sheet<sup>2</sup> and the favourable financing environment to borrow \$750 million at 4% for the purpose of buying back shares (at the time shares were trading at an approximate 9% FCF yield). This debt issuance, combined with cash generated by the business during the year, allowed Harley to repurchase \$1.5 billion worth of shares (13% of the shares outstanding at the time) at prices well below our estimate of fair value.

<sup>2</sup> Technical note: The face value of debt on Harley's balance sheet exceeds the \$750 million borrowed in 2015; however, this includes the financial services segment. The motorcycle company only has \$750 million in debt, resulting in a net debt/EBITDA ratio of 0.7 times in 2015.



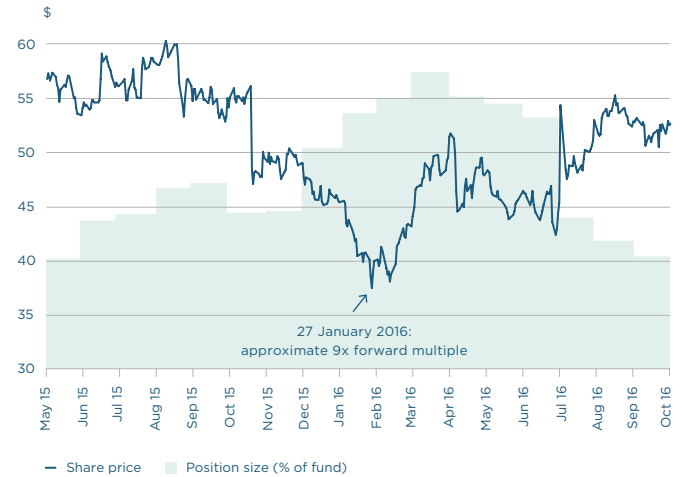
This management action is best described by Warren Buffett in his 1984 letter to shareholders: “By making repurchases when a company’s market value is well below its business value, management clearly demonstrates that it is given to actions that enhance the wealth of shareholders, rather than to actions that expand management’s domain but that do nothing for (or even harm) shareholders. Seeing this, shareholders and potential shareholders increase their estimates of future returns from the business. This upward revision, in turn, produces market prices more in line with intrinsic business value.”

### CONCLUSION

The market has recognised the value of Harley’s brand for many years. In fact, since 1990, Harley has typically traded at an approximate 15% premium to the forward earnings multiple of the Standard and Poor’s (S&P) 500 Index. There has only been one meaningful length of time in the past (2.5 years spanning the global financial crisis) when Harley traded at a discount to the market’s forward earnings multiple. But in mid-2015, when we first purchased Harley, this discount had widened to more than 20%. We naturally spent a significant amount of time researching the company’s fundamentals and determining our own view of what the business was worth. We concluded that there was significant upside to the share price at the time. This in-depth analysis gave us the conviction to add to the position as Harley continued

to underperform (see graph below). At one point, Harley’s forward earnings multiple approached nine times – a 40% discount to that of the S&P 500 Index – while our view of what the business was worth remained largely unchanged.

**HARLEY SHARE PRICE VS CORONATION GLOBAL EQUITY SELECT POSITION SIZE**



Sources: Bloomberg, Coronation analysis

Although the share price has since recovered (up a third from its lows), we continue to see upside and believe that Harley remains an attractive holding in our global funds. ■



## ODONTOPREV A LONG-TERM WINNER

By Marc Talpert

Marc joined Coronation in 2014 as an equity analyst within the emerging markets team. He is a qualified chartered accountant and completed his articles with Ernst & Young.



With 6.3 million members, OdontoPrev is the largest private dental insurance provider in Brazil, founded in 1987 by five dentists. From humble beginnings, it has grown exceptionally over the past 29 years, generating great shareholder returns since its listing in 2006 (a total return of 18.47% in US dollars per annum to date). This is a company that has delivered time and time again. We do not feel the story is finished, and expect compelling shareholder returns in future.

Some 11% of Brazilians have dental insurance, compared to 60% in the US. Brazil has the highest absolute number of dentists globally (277 000, or 12% of all dentists in the

world), with the US in the second position (160 000). This is an important dynamic: the abundant supply of dentists ensures that OdontoPrev has access to an extensive network of dentists as the company continues to grow membership going forward. A testament to this reality is that its current network of 28 000 affiliated dentists is backed up by a waiting list of 25 000 additional dentists wanting to join the network. This allows OdontoPrev to grow its member base while maintaining high service levels, without the commensurate investment in capital expenditure.

Brazil’s public sector has traditionally not invested in the dental segment, contributing to one of the worst ratios of



public to private dental spending globally. For the private sector, this has provided an attractive opportunity.

The dental insurance market has some favourable characteristics when compared to the medical insurance industry. Preventive dental measures are far more effective, even in elderly populations. Also, unlike other medical care, dental costs do not rise significantly with age. Dental issues are far more predictable, given that there are far fewer dental diseases than other medical illnesses, thereby reducing the range of outcomes and the risk of mistakes when developing actuarial models. The dental care business is also not so complex, or as influenced by exogenous events, as dental claims are not severe or random in general, and can be controlled through interventions. Accordingly, management quality becomes a decisive factor for the success of the business.

The dental insurance market in Brazil is split into three categories, namely corporate, small and medium enterprises (SMEs) and individual. Corporate members represent 76% of OdontoPrev's current member base, followed by SMEs (14%) and individuals (10%). The large proportion of corporate members is a function of the dynamics of the Brazilian market, and also part of the company's historic legacy. In the corporate space, you are dealing with a consolidated customer base who are pushed to take up insurance as an employee benefit. The result is a lot of competition, but with less risk of adverse selection (high-risk insurance clients), and a market whereby scale can be achieved quite quickly. This part of the market was where OdontoPrev has historically (until 2014) focused most of its attention, achieving massive success and becoming a market leader. It now has 29% of the dental insurance market share and receives 43% of the revenue (three times more than number two).

This remarkable success is testament to an excellent management team which has out-executed its peers. This was achieved through an unwavering commitment to providing value to its members, as well as nurturing relationships with dentists, ensuring both sides of the value chain were looked after.

OdontoPrev's commitment and value offering to customers are underpinned by its proprietary IT system which has been built up over the last 29 years. It acts as a monitoring system, which links to all their dentists, thereby giving OdontoPrev oversight into each and every dental procedure carried out by its affiliated dentists. These procedures are then audited by a team of 80 dentists, who ensure consumers are not over-treated, significantly reducing waste and effectively bringing down prices for all members. OdontoPrev's management contends that it is cheaper to have a dental plan than pay out of pocket. This is a powerful selling point that will attract future members from the estimated 78 million Brazilians currently paying out of pocket for dental care. In testament to this value offering, the company has

enjoyed the highest renewal rate in the market, despite its above-average premiums.

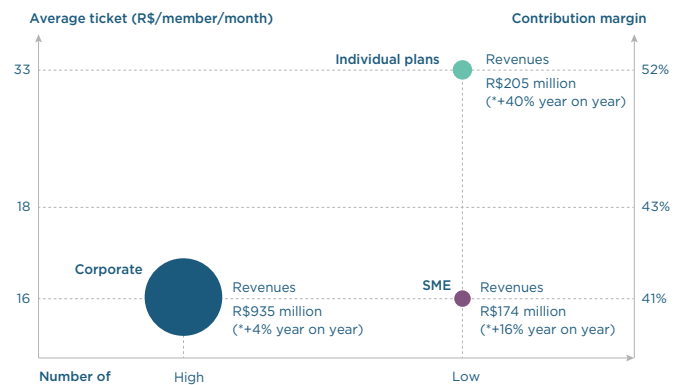
OdontoPrev views dentists in its network as business partners rather than resources, thereby fostering long-term relationships. The specialty area of each dentist is recognised, and patients are matched with suitable dentists, thus providing great customer service and ensuring their affiliated dentists get the experience they desire. The company provides continuous education about new dentistry procedures and technologies to their affiliated dentists, providing great value to their dental network by improving their skills.

The success achieved in the corporate space has set the company up for its next wave of growth in the SME and individual market, of which only 5% has dental plans. This is a far more fragmented market with less competition owing to distribution challenges. However, this market has superior economics due to higher premiums, resulting in higher contribution margins and (notwithstanding the higher distribution costs) higher operating margins.

The distribution challenges in the individual and SME market have been identified by management and addressed through the signing of two exclusive distribution agreements with two of the largest banks in Brazil. OdontoPrev has an agreement with Bradesco (also the controlling shareholder of OdontoPrev) as well as a joint venture with Banco do Brasil (formed in 2015). Together, the agreements give OdontoPrev access to 52% of all Brazilian banking clients.

The other major sales channel is through retailers. Historically the majority of SME and individual plans were sold through retailers, which incurs commissions of 25% to 40% (while banks charge 10% to 15%), but this mix is changing. Currently 40% of all plans are sold via banks, compared to 34% a year ago, with management working actively with its banking partners to improve selling by ensuring incentives at branch

**COMPETITIVE DYNAMIC AND CONTRIBUTION MARGIN DIFFERENTIAL**



\*July 2015 to June 2016 Δ %

Source: OdontoPrev corporate presentation, September 2016



level are aligned correctly. Owing to the low ticket item nature of dental plans, banks are a superior channel due to the existing sales infrastructure. This is also an attractive business for banks: no capital is required, which means it enhances its return on equity (ROE).

Within the individual and SME segment, the company offers a portfolio of more than a hundred different contracts. OdontoPrev believes greater product differentiation helps reveal preferences based on client choices and reduces the guesswork in predicting how members will access dentists. This allows the company to price according to customer needs, reducing the risk of adverse selection.

On top of all the aforementioned characteristics, the business has really delivered phenomenal accounting metrics and should continue to do so. The company generates a very healthy operating margin of 25%, which we believe is sustainable and should in fact rise owing to the increasing contribution of individual and SME plans, which have superior economics. The sustainability of an operating margin is often determined by the competitive environment, pricing power and the barriers to entry in an industry.

The pricing of dental insurance is inherently attractive: the consumer's main goal is not achieving the cheapest dental treatment, but rather the most effective treatment administered by a trusted practitioner. This allows OdontoPrev to consistently charge more expensive rates than its competitors, and still gain market share. So while its competitors, who largely suffered from confused strategies and a lack of focus, have priced aggressively in the past, it did little to entice OdontoPrev members to move across. Moreover, an important development took place in 2009, with the merger of OdontoPrev and Bradesco Dental, which consolidated the market and added 1.3 million lives to OdontoPrev's 2.6 million at the time.

Finally, the barriers to entry for other players are immense, especially in the individual and SME space, which represents the biggest long-term opportunity for the company. These barriers are a function of the proprietary IT system the company has built, along with the exclusive distribution agreements they have formed with major Brazilian banks.

The cash flows a business will generate in future determines its intrinsic value. The challenge is forecasting these cash flows, as the future is unknown. Accordingly, a business with a clearer outlook of its future prospects, with fewer different potential outcomes, is inherently worth more. Thanks to its annuity-type revenue from existing members, along with powerful industry tailwinds owing to the low penetration and superior distribution abilities, there is good visibility of OdontoPrev's future revenue. Moreover, the company has put in place incentives to encourage members to pay their monthly subscriptions upfront, further enhancing visibility.

OdontoPrev's operating margins, its limited capex requirements (less than 1% of sales) and low working capital requirements (working capital to sales of 5% on average over the last ten years), result in free cash flow generation, which is in excess of accounting earnings. Also, the reinvestment requirements of the business are limited, enabling it to pay out close to 100% of earnings each year in dividends. These qualities have resulted in the business generating an ROE of 34% in 2015, up from 18% in 2011. This should continue to rise as its incremental growth and cash generation do not require the equivalent reinvestment in the business.

The biggest risk for the business is changing regulations, but we feel this risk is mitigated by OdontoPrev's plans to provide real value to the consumer and deliver cost-effective dental care. OdontoPrev has been a holding in the Global Emerging Markets strategy for the past one-and-a-half years and we believe it will remain a long-term winner, providing our clients with good returns going forward. ■





# CORONATION GLOBAL FRONTIERS

**INCEPTION DATE**

1 December 2014

**PORTFOLIO MANAGER**

Peter Leger is the head of Coronation's Global Frontiers unit and has been managing the Global Frontiers portfolios since inception. Peter has 18 years' investment experience of which the last nine were spent analysing and managing assets in frontier markets.

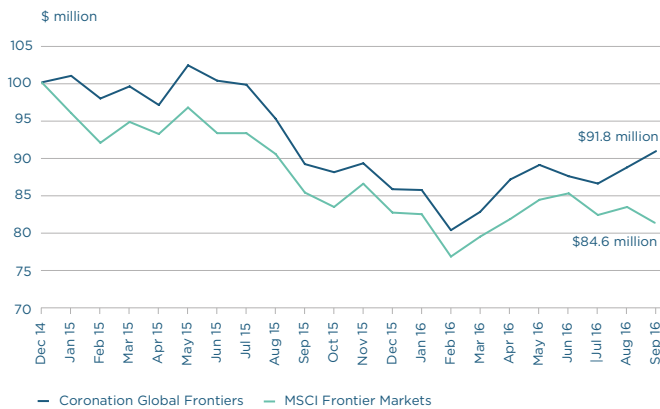


## OVERVIEW

The Coronation Global Frontiers strategy seeks to invest in listed companies that are attractively priced and can best benefit from rapid growth in emergent economies. The strategy has outperformed the MSCI Frontier Markets Index (US\$) by 5.1% per annum since inception.

### GLOBAL FRONTIERS VS MARKET INDEX

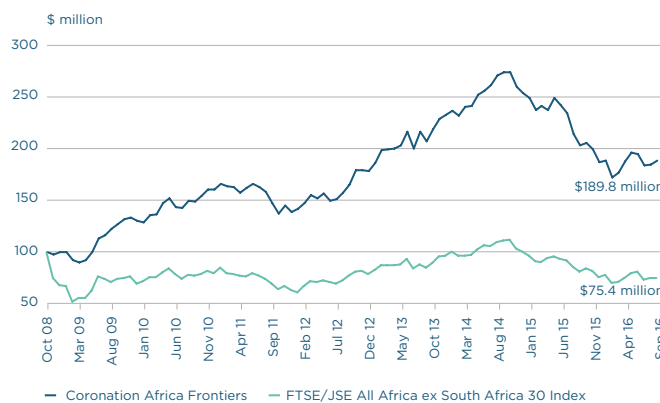
An investment of \$100 million since inception



Source: Coronation

### AFRICA FRONTIERS VS MARKET INDEX

An investment of \$100 million since inception



Source: Coronation

An illustration of our longer-term investment track record in frontier markets is the annualised alpha of 7.8% (gross of fees) delivered by the Coronation Africa Frontiers strategy since its inception in October 2008 (see previous graph).

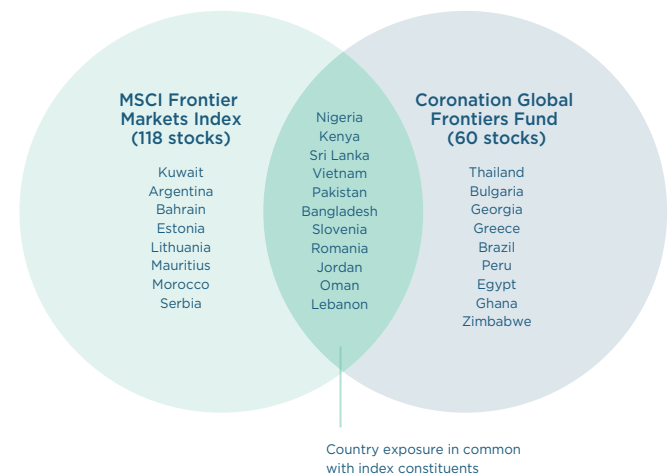
## STRATEGY

Coronation Global Frontiers follows a long-term, valuation-driven investment philosophy. We emphasise bottom-up stock selection rather than top-down geographic allocation or macro themes, an approach that has been applied across all our strategies for more than two decades.

The portfolio holds shares which we believe offer the most attractive risk-adjusted fair value relative to current market prices. Given the lack of reliable information in many frontier markets, calculating what we believe to be the fair value of a business requires intensive on-the-ground research, constant contact with management teams and detailed financial modelling that focuses on through-the-cycle normalised earnings and free cash flows over the long term.

## BENCHMARK AGNOSTIC PORTFOLIO

Coronation Global Frontiers vs MSCI Frontier Markets Index



Source: Coronation analysis



To take advantage of the long-term structural growth in emerging economies, particularly for frontiers, buying the market is generally a bad idea in our view. The Global Frontiers portfolio is therefore constructed without reference to a benchmark. Currently, Kuwait (17%) and Argentina (15%) are the biggest constituents of the MSCI Frontier Markets Index. In our view, this is not a fair reflection of the grouping's investment potential. In fact, our Global Frontiers strategy does not have any exposure to these countries at this point.

The strategy's mandate also allows it to invest in small-cap emerging market stocks. The frontier team works closely with Coronation's emerging market analysts to identify attractive holdings. Since its inception in 2008, the Global Emerging Markets (GEM) team has acquired extensive expertise in different emerging markets and sectors. For example, with 17% of the Coronation GEM Equity strategy invested in Brazil, the team's analysts visit that country at least twice a year to meet with management teams and industry experts.

Recently, based on the GEM team's extensive research of the Brazilian clothing sector, a local group named Guararapes Confecções was suggested as a Global Frontiers holding. The company, which owns the third-largest domestic clothing retailer and operates in an attractive market, is currently trading far below our assessment of its fair value. Liquidity in its shares is restricted due to management owning 76% of the company, disqualifying it as an investment for larger funds.

A somewhat higher risk tolerance and a more clean-slate mindset are required when investing in the frontier asset class, given the volatility in these markets and their currencies, as well as the lack of liquidity in shares.

Risk management is integrated into our investment process and portfolio construction. We define risk as a permanent loss of capital and as such the process of managing risk begins with the universe of shares we are prepared to invest (at the right price), the long-term approach to determining fair value, the required rate of return for the different markets and securities to compensate us for the risk taken, and finally the position size of a stock in the portfolio. We reassess our long-term earnings forecasts and levels of conviction in all our investments continuously. In the frontier space we would typically require a higher margin of safety between our assessment of fair value and the share price before

taking a position. Similarly, we are disciplined about selling shares as a share price approaches fair value.

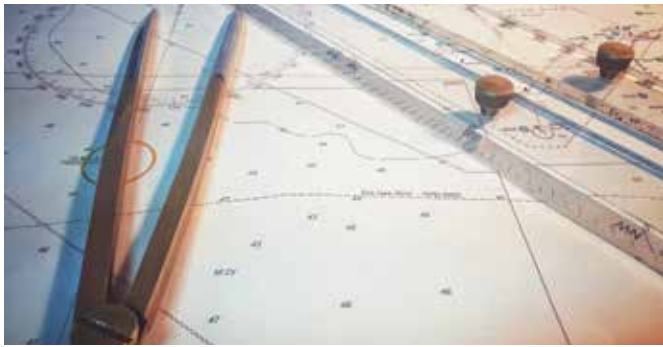
## OUTLOOK

We expect exciting returns from select frontier markets in coming years, reflecting the long runway of economic growth in many of these markets. The per capita consumption of consumer and capital goods continues to be a fraction of that in other markets. Many companies stand to benefit from the formalising of their developing economies, and have large scope to build additional scale quickly, which will have a large impact on profits. We are excited by these developments and believe valuations are still compelling.

Currently, the Global Frontiers strategy's largest exposure is to Egypt, where valuations are extremely depressed following two revolutions and the Arab Spring. We believe the country has some of the highest quality companies and management teams in the world today. However, despite the return of political stability and recent economic reforms, share prices remain deeply discounted. We have a number of attractive holdings in Egypt, including a sizeable exposure to the cigarette manufacturer Eastern Tobacco. Since 1920, the company has enjoyed the status of monopoly manufacturer in one of the only tobacco markets worldwide that is still growing. Despite this, Eastern Tobacco is trading at a large discount to its global peers and offers significant upside to our estimate of its fair value. Following several years of poor capital allocation, new management has been appointed and initial interventions have been encouraging. We expect shareholders will be rewarded with increased dividends and strong returns on their investments.

Another sizeable exposure in the strategy is that of Hemas, a Sri Lankan family-run conglomerate with exposure to the fast-moving consumer goods (FMCG), leisure and transport sectors. Hemas is run with a focus on shareholder return and currently in the midst of restructuring into a professional outfit. While the value unlock has already begun, management's renewed focus on its core FMCG and healthcare businesses, coupled with further potential disposals, make for a compelling investment case in our view.

Currently, the overall weighted-average upside to fair value of the stocks in the Global Frontiers portfolio is around 57%, with the average one-year forward price earnings ratio only 11 times. We believe the strategy is well-placed to deliver meaningful investment returns over the long term. ■



# INTERNATIONAL PORTFOLIO UPDATE

## CORONATION GLOBAL EQUITY FUND OF FUNDS

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Jul 00	14.30%	5.20%	12.07%	5.04%
Benchmark		11.96%	6.42%	12.25%	3.86%

*Annualised, quoted in USD*

The fund advanced 7.8% in the third quarter of 2016, ahead of the benchmark increase of 5.3%. This brings the rolling 12-month performance to 14.3%, compared to the 12% returned by the benchmark.

Equity markets enjoyed a strong third quarter, with the MSCI All Country World Index (ACWI) advancing 5.3% over the period. Investors started to shrug off the shock Brexit referendum result late in the previous quarter, as key central banks continued with their stimulative monetary policies. As widely anticipated after the Brexit vote, the US Federal Reserve (Fed) postponed a further increase in interest rates and the Bank of England cut rates by 0.25%. In addition, the Bank of Japan (BoJ) announced changes to its monetary policy to further boost the Japanese economy. The European Central Bank was the only such institution that did not announce any further changes, but as at the time of writing there is talk about ending the negative interest rate strategy it is currently following. This buoyed the markets, and especially those in emerging countries.

Over the past quarter, Japan was the best performing region within the fund, returning 8.8% (in US dollar terms). It was closely followed by Asia ex-Japan, which returned 8.2% (in US dollar terms). North America was the laggard, returning only 4.1%, while Europe managed to deliver positive growth of 5.5% (in US dollar terms). Emerging markets rebounded by 8.3% (in US dollar terms).

Among the global sectors, IT (+12.7%) and materials (+9.2%) generated the highest quarterly returns. There were also good returns from the financial (+6.3%) and consumer discretionary (+5.8%) sectors. The worst performing

sectors were utilities (-4.1%), telecommunications (-3.2%) and healthcare (-0.2%). On a look-through basis, the fund was positively impacted by overweight positions in IT and consumer discretionary, and an underweight position in utilities. Low exposure to financials and industrials had a negative impact.

The fund's strong performance over the quarter was primarily due to four managers: Contrarius, Viking Global Investors, Egerton Capital and Eminence Capital.

The Contrarius Global Equity Fund returned 15.2%, a significant outperformance driven by a number of the fund's top holdings. Its exposure to resources via Teck Resources (+36.9%), Fortescue Metals Group (+45%) and Stillwater Mining Company (+12.6%) was a key contributor. Exposure to Twitter (+36.3%), JD.com (+22.9%) and Apple (+18.9%) also contributed. Marginal detractors were the fund's exposures to gold mining companies.

Viking Global Investors benefited from exposure to large-cap tech companies such as Facebook (12.2%), Alphabet (+12.3%), Amazon (+17%) and Microsoft (+13.3%). Other key contributors included Biogen (+29.4%), Encana (+34.6%) and MasterCard (+15.8%).

Large-cap tech names such as Facebook, Alphabet, Tencent (+21%) and Priceline (+17.9%) also made a solid contribution to the outperformance of the Egerton Capital Equity Fund over the quarter. In addition, the fund benefited from exposure to Charter Communications (+18.1%), S&P Global (+18.3%), Visa (+11.7%) and the London Stock Exchange Group (+11.1%).

Eminence Capital, whose portfolio differs materially from the other managers in the fund, enjoyed a strong quarter. The fund's holdings in Autodesk (+33.6%), Zynga (+16.9%), ARRIS (+35.2%) and Housing Development Finance Corporation (+12.3%) drove its strong returns over the quarter.

Conatus Capital and Coronation Global Emerging Markets both made positive contributions to performance, but



Lansdowne Developed Markets and Maverick Capital both detracted over the quarter.

The final quarter of 2016 brings with it a number of key events that could provide some market volatility. These include the US presidential election, a constitutional reform referendum in Italy and a widely anticipated second interest rate rise by the Fed. There will also be further clarity on the Brexit process, which so far has had a much smaller impact than originally feared. However, that may still change as the way forward emerges.

Also of concern is the fact that Deutsche Bank is under severe pressure and at risk of needing a bailout, something the German government has so far ruled out. Equity and bond markets are in the later stages of a multi-year bull market, and investors are rightfully cautious on the near-term future. However, if the US economy proves resilient – and we believe it may, as discussed on page 22-23 – then, combined with modest cyclical growth improvement in Europe and Japan as well as investment-led momentum in China, the global growth outlook may be more favourable than anticipated.

### CORONATION GLOBAL CAPITAL PLUS

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Sep 09	9.43%	2.89%	6.79%	6.12%
Benchmark		0.64%	(2.67%)	(1.28%)	(1.13%)

*Annualised, quoted in USD*

The fund performed well over the quarter, returning 3.73% and outperforming its benchmark by a significant margin of 3.53%. Year-to-date the fund has returned 7.15%, again comfortably ahead of its benchmark. Over five years, the fund has delivered 6.79% per annum, a very credible performance in a low-return environment and a handsome outperformance of its benchmark's very anaemic returns.

Our equity holdings outperformed the ACWI handsomely over the last quarter, as well as over the last 12 months, and have contributed strongly to the fund's good performance. Over the last quarter or two, our property holdings detracted in relative terms, but returns were still positive in absolute terms. In addition, over all longer time periods, property has been a very strong contributor.

Our credit holdings did well over the shorter and longer term. As we keep emphasising, we hedge out the interest rate risk in these credit positions, as we continue to be very negative about potential returns from government bonds in a more normalised interest rate scenario. Our position in physical gold added positively over the last year, but our exposure to pound sterling detracted significantly.

Within our equity holdings over the last quarter, our holdings in alternative asset managers finally contributed positively, with some other long-term holdings such as Charter and Qualcomm also fulfilling some of their anticipated potential. Our other IT stocks such as Amazon, Alphabet and Priceline also performed well. Measured since the beginning of the year, the biggest contributors have been Estácio and Kroton, our holdings in the Brazilian educational sector, which announced a merger after an agreed takeover by Kroton (covered in an earlier commentary). Other winners included Apollo Global Management, Tata Motors, Amazon and Urban Outfitters.

The biggest detractors were TripAdvisor (after disappointing results), Pershing Square (due to ongoing disappointment around the Valeant Pharmaceuticals holding), and LPL Financial. Apart from LPL Financial, where we sold because we lost faith in management's ability to tackle their cost base in light of disappointing revenues, we continue to believe in these holdings.

We reduced our equity allocation over the last few months, and ended the quarter with an effective 30% exposure to equity. This is significantly below the 36% exposure we had after the sell-off in February. The bulk of this reduction was due to the purchase of put options on the US market. While we are mindful of the cost of these instruments, we felt that they offered an attractive risk/reward trade-off for the first time in a long time. We have also reduced our position in listed property, as we perceive stock prices around the world to be quite fully valued. The one exception is in the UK, where we continue to hold significant positions in light of the price weaknesses in the sector after the Brexit vote. We have been alarmed by some of the more recent political utterances, and are monitoring the situation closely.

We have also reduced our exposure to credit, as these markets have bounced back strongly after the February 2016 correction. We have increased the fund's exposure to physical gold, and intend to build this position as a portfolio risk diversification tool. In a world where the competitive devaluation of currencies seems to be viewed by politicians as a panacea to solving competitive pressures in their economies we believe gold holds additional attractive qualities.

A relatively new stock in the portfolio, Tempur Sealy International, provided a lot of price action since its inclusion less than a year ago. The company is one of the two leading mattress manufacturers in the US – and, for that matter, the world. It owns strong brands covering the whole spectrum of price points, but is particularly strongly positioned at the top end of the range with the Tempur brand. What attracted us to the stock was that an activist investor took control of the board through a hostile proxy vote, and immediately replaced the incumbent top management. The new CEO, Scott Thompson, has an impressive track record. He had particular success at Dollar Thrifty, where he



managed to increase operating margins significantly before the business was sold to one of its larger competitors. We think his appointment is appropriate, because we believe that there is a big opportunity to boost margins at Tempur Sealy. When Tempur bought Sealy, its biggest listed competitor, in 2012, poor execution led to a series of manufacturing hiccups at Sealy. This has resulted in current operating margins at Sealy being just over half of what they were at the time of the deal. We are confident that this situation can be rectified through better operational management. Scott has bought equity in the business using his own balance sheet, and has displayed sound balance sheet management.

The company's more recent set of results (June 2016) looked promising. The share price reacted positively by jumping over 20% in a few days. Unfortunately, just before this quarter-end, the company guided profit growth down again due to a very slow September. As a result of typical short-term investor orientation, the company's share price dropped by 25% in two days. We managed our position size down after the initial positive price reaction, and could thus take advantage of the price decline. While we acknowledge that pure online players pose a threat to traditional incumbents, we think that the strength of Tempur Sealy's brands and its innovation will endure. In our view, the company is offering a promising investment opportunity and it currently makes up about 2% of the fund.

## CORONATION GLOBAL EMERGING MARKETS EQUITY

	Launch date	1 year	3 years	5 years	Since inception
Fund	14 Jul 08	32.14%	(1.67%)	7.48%	6.22%
Benchmark		16.78%	(0.33%)	3.32%	0.99%

*Annualised, quoted in USD*

The Coronation Global Emerging Markets Equity Strategy returned 9.04% during the third quarter of 2016, which was in line with the index's return. Year-to-date the fund has now appreciated by 21.6%, which is 5.6% ahead of the index's return of 16%, and over the past one-year period the fund has returned 32.1%, which is 15.4% ahead of the 16.8% return from the index.

Over the past year, five of the top ten contributors were Brazilian stocks, collectively contributing 9.2% of the fund's 15.4% outperformance. All five (Kroton, Estácio, Itaúsa, Hering and BB Seguridade) are up by over 50% in US dollar over the past year, with the education company Kroton being the standout, having appreciated by 143% in US dollar and contributing 4.8% to outperformance. Other notable contributors over the past year have been the owner of Jaguar Land Rover, Tata Motors (+78%; 2.2% contribution), the Indian private bank Yes Bank (+70%; 1.8% contribution) and the

Russian food retailer X5 Retail (+66%; 1.2% contribution). Not owning Tencent and Samsung Electronics detracted by around 1.4% each, although a positive contribution from Naspers (whose biggest asset is its stake in Tencent) partly offset the negative Tencent attribution. The only other negative detractor of more than 1% was the Indian IT services company Cognizant (-24%; 1.1% negative contribution).

We would make the point, as we always do, that a one- or two-year period is a short time period, and not too much should be read into performance over these timeframes in our view. In this regard, while the fund has now outperformed the market by 15% over the past one year, this time last year the fund was in fact 12% behind the market.

Given our long-term focus and the fact that we therefore often own stocks that are disliked by the market because of a poor short-term outlook (Brazilian stocks being the most recent case in point), it is often necessary to go through periods of short-term underperformance in order to achieve the fund's objective of significant long-term outperformance of the market. In our view, only periods of five years or longer are meaningful, and ideally, performance should be assessed on this basis. In this regard, since the fund launched just over eight years ago, it has outperformed the index by 5.2% per annum. Over the past five years it has outperformed the index by 4.2% per annum.

There were a few notable developments on the political front during the quarter, however none had a material impact on the fund's performance. The final impeachment and removal of former president Dilma Rousseff in Brazil was highly anticipated and therefore did not really have an impact when it happened, as the big upward moves in Brazilian equities and currency had already happened in the first half of the year. We did continue to reduce the fund's Brazilian exposure by slowly decreasing a few of the bigger positions, with the result that the total Brazilian exposure is now 16.6% of fund compared to 20.3% at the end of June.

The fund's biggest Brazilian exposure is still in the education companies. In this regard Kroton and Estácio's shareholders approved the proposed merger at an increased offer price to that initially proposed by Kroton, and the deal is now awaiting regulatory approval by the country's anti-trust authorities.

We remain very positive on the long-term prospects for the Brazilian education industry, and in particular the prospects of a combined Kroton/Estácio (who are respectively the number one and two tertiary private education companies in Brazil). We think both assets are actually still very attractive on a stand-alone basis, and even more attractive as a combined entity due to the scale, nationwide footprint, synergies and the fact that the best management team in the industry will be running the combined entity. As such, 7.8% of the fund is still invested in Brazilian education, made up of 4.6% in Kroton and 3.2% in Estácio.







The attempted coup in Turkey in early July and its aftermath has severely dented investor confidence in the country. The fund held only two Turkish stocks prior to the coup attempt – small positions in Garanti Bank and in BIM, a hard-discount food retailer. We sold out of the position in Garanti Bank – as a bank it was simply too exposed to a big downturn in the Turkish economy and therefore the risk/reward trade-off did not, in our view, warrant retaining the position, despite what appeared to be reasonable upside in the share. In contrast, we believe BIM is one of the best food retail operators in emerging markets and should not be materially impacted by post-coup developments, so we have marginally increased the fund's exposure to BIM as it has declined (along with the Turkish lira). It still remains a sub-1% position and we would require more upside before increasing the position size materially further.

In terms of portfolio activity over the quarter, on the sales side a notable reduction in position size was that of the Indian banks. In our view, India remains one of the most attractive emerging markets on a ten-year view. Its banks offer a significantly cheaper way to get access to the Indian consumer – through very low financial services penetration that is gradually increasing, as well as through market share gains from the State banks – than the country's more obvious names in the household and personal care space, which trade on eye-watering multiples.

We had been adding to the positions in the two banks that the fund owned (Axis Bank and Yes Bank) from the fourth quarter of 2015 while their share prices declined (along with the broader market) as investors lost faith in the pace of regulatory reform in India under the Modi government. We also bought a third (HDFC, a mortgage provider that also has a stake in HDFC Bank, as well as insurance and asset management interests) for the first time in early March. From their bottom at the end of February, all three banks are up sharply – Axis Bank, the largest position, is up close to 50%; Yes Bank, the second largest position, has almost doubled; and HDFC, the smallest position, is up 35% (all returns in US dollar).

Naturally we have trimmed position sizes in response to such large moves in share prices. Although all three are still reasonably attractive, their reduced upside warrants a smaller exposure. At the end of June the combined holding in the three amounted to 8.3% and by 30 September their collective exposure was down to 4.8% of fund. This, in turn, meant the fund's Indian exposure decreased from 16.4% to 12.2% over the quarter.

During the quarter there were also a few new buys. The largest of these was LiLAC (Liberty Latin America and Caribbean), which is now a 1.5% position. LiLAC was initially created as a tracking stock by Liberty Global to spin out their Latin American broadband, mobile and pay-TV assets. During the spin-out process, LiLAC bought Cable & Wireless

Communications (mobile telecoms in the Caribbean and Central America), which itself had just purchased Columbus (broadband and pay-TV in the same region).

The single biggest market for LiLAC is Chile (25% of total operating profit), followed by Panama (19%) and Puerto Rico (12%), with various Caribbean islands making up the bulk of the rest. The share price is down by a third since late-May after poor results and from an overhang of shares, with the latter having had the bigger impact in our view. Many of the shareholders in Liberty Global (who were the recipients of LiLAC shares due to the unbundling) may have little interest in holding onto their LiLAC shares given how small the business is/was in the context of the overall Liberty Global business (5%).

Aside from revenue opportunities from rolling out services in countries where there is low penetration and also from market share gains, there are big cost saving opportunities due to the new-found scale of the business, as well as the ability to realise synergies. For these reasons we believe margins have scope to increase from current levels. In addition, capital expenditure is currently high and will reduce to a more normal level over the next few years. As a result of these factors, we believe the company will generate significant free cash flow looking a few years out, and LiLAC trades on only a high single-digit multiple of this free cash flow. In addition, we have high regard for the capital allocation skills (running an efficient balance sheet, undertaking significant share buybacks, etc.) of John Malone (the chairman and controlling shareholder of both Liberty Global and LiLAC) and his senior managers, and we believe that over time these same capital allocation skills will be applied to LiLAC to the benefit of shareholders.

Over the past few years we have spent a lot of time researching and understanding online classified businesses due to the fact that these businesses make up a large part of the valuation of the fund's largest holding, Naspers.

We like dominant online classifieds businesses – the largest player in each vertical benefits from the virtuous circle of most sellers/service providers and most buyers/users being attracted to the biggest site, and as such it is very hard to disrupt once established as the network effect creates a high barrier to entry. They are also inherently very cash generative (converting over 100% of earnings into free cash flow) and generate very high returns on capital. In this regard, the fund's second largest buy during the quarter was a 1.2% position in 58.com, the leading classifieds website operator in China. The company is very strong in a number of key classified verticals, with dominant positions in job listings (70% market share of the blue-collar job market), online classifieds (85% market share) and property (in which they have three of the leading property sites). The company is investing significantly in these three verticals as well as others, in order to achieve dominance and the economic



benefits that come with this. It is also investing heavily in its home services arm, which will allow plumbers, electricians and other service providers to offer their services online and be booked directly by the customer. Customers will be able to rate the quality of the service provider, creating a feedback mechanism and loop that will entrench customer loyalty and trust for good service providers, much like (as an example) the review system works for hotels on TripAdvisor.

This investment in the business means that current profitability is low (single-digit EBIT margins) and is well below normal in our view. The leading (those with > 50% market share) online classifieds businesses in the world (both in emerging markets and developed markets) are extremely profitable and typically generate EBIT margins in the 40% to 60% range (Avito in Russia, for example, generates 45% EBIT margins). In this context one must bear in mind that 58.com already has dominant positions in a number of verticals, and in fact currently generates gross margins of 90%. We would not expect 58.com to generate EBIT margins of 40% to 60% (its business model requires higher cost because of a large direct sales force), but we do believe that normal EBIT margins will ultimately be much higher than the current single-digit level.

The online classified industry in China is still in its infancy and 58.com has many leading positions in this market. In our view, it is well placed to retain these leading positions. As a result, we believe that its revenue, profits and free cash flow will grow at a high rate over the next five years and beyond. We also like the fact that Tencent owns over 20% of the business. Tencent is dominant in social media in China and captures a very high percentage of all online traffic; it also has management that we have high regard for. In addition, we like the fact that the founder and CEO of 58.com still retains a big stake (11%) in the company, resulting in an alignment with minority shareholders.

While the weighted average upside to the portfolio has come down (now just below 50%), this is still very attractive upside. At the same time a useful positive backdrop is provided by the fact that political environments appear to be getting slightly better in many emerging markets (Brazil, SA and India stand out in this regard) and arguably worse in a number of the main developed markets as populism takes hold (US, UK and Europe would fall into this category). This arguably increases the relative attractiveness of emerging markets.

We are continuing to find a number of potentially interesting ideas – either stocks that we cover already but that are becoming more attractive due to share price declines or as a result of additional work we are doing on them, or stocks on which we are doing the detailed work for the first time.

Over the past quarter, we went on research trips to South Korea and China and also met with management from

a number of portfolio holdings and other companies in London and New York. During October we will be going to Asia and will be returning to Brazil in January, followed by India in February.

### CORONATION GLOBAL BOND

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Oct 09	11.13%	2.32%	3.33%	3.66%
Benchmark		8.83%	1.51%	0.61%	1.79%

*Annualised, quoted in USD*

Global bonds, as measured by the Barclays Aggregate Bond Index, were up 0.82% during the third quarter, driven principally by continued strong returns from credit markets. Core developed government bond markets saw yields bottom in early July and rise modestly thereafter. Better returns were to be found in peripheral and emerging market government bonds as investors continued to seek out yield. Central bank comments continued to be agonised over by investors who have become increasingly accustomed to the backstop they have provided. There appears to be a subtle shift in policymakers' language, highlighting the limitations of further monetary policy actions and once again raising the prospect of a return to fiscally driven support. The fund enjoyed a strong quarter, returning 2.7%.

In the US, investors spent the majority of the quarter speculating as to whether the Federal Open Market Committee would increase the federal funds rate at its meeting on 21 September. In the event they left rates unchanged, but three voting members dissented and voted for a hike.

The read-through was a hawkish one, and investors now view the likelihood of a hike in December to be 60%. However, the Fed's expectation for future rates (its dot plot) once again fell: the median expectation for 2017 is now 1.1%, while it is 1.9% for 2018 – a full 0.5% lower than before. The long-term neutral rate also came down to 2.9% from 3%. US yields rose modestly during the quarter (the 10-year yield rose by 0.15% to 1.6%), which was partly a reflection of the continued strength in the labour market but was also an acknowledgement that the weakness in inflation has moderated. Breakeven inflation rates widened (the 10-year rate is up 0.2% to 1.63%) and the breakeven curve steepened as the extremely low levels of implied long-term inflation unwound slightly. The fund captured the upwards move in breakeven rates, having switched some of its fixed rate exposure into US inflation-linked bonds during August.

US Treasuries have seen net outflows from central banks and sovereign wealth funds, as these participants have required the funds to support their economies and currencies. In the



last six months, however, these offshore flows have been replaced by buying from portfolio managers whose local yields have fallen to extremely low levels due to quantitative easing (QE).

At the beginning of 2016, a Japanese investor buying 10-year US Treasuries could earn an extra 1% yield over local Japanese 10-year yields by hedging US Treasuries back into yen. However, because of the recent rise in hedging costs, this extra yield has now completely evaporated. This is also the case for European-based investors. The removal of this valuation support should begin to weigh on the market and is another factor that makes us cautious of valuations at these levels.

The US election also injects plenty of uncertainty into the mix. It seems likely that fiscal policy will be more expansive going forward (especially under a Trump administration), which is another reason to be cautious of valuations.

Changes to US money market regulations that come into effect in mid-October have certainly added to the rising costs of hedging for non-US-based investors. The cumulative move out of money market funds (whose principal holdings tend to be more bank and corporate orientated) and into funds (whose principal holdings will be government based) is likely to be close to a trillion dollars. This has had the impact of boosting interbank funding costs, which has been most acute for non-US banks such as the Japanese who do not have US depositors they can access. This appears, however, to be a only contributory factor to what is a wider US dollar shortage. It is thus a little perplexing that the US dollar itself has not been stronger on the back of this, but that may be the end result. In the past, some of the dislocations in the currency markets would have been addressed by investment banks arbitraging away opportunities but, as the Bank for International Settlements observes, the new regulatory capital regimes for banks mean arbitrage is no longer a costless activity.

Japan has been at the forefront of unconventional monetary policy in recent years. The BoJ's September meeting elicited a lot of interest, as previous policies have to date failed to achieve their aim of boosting inflation. The BoJ has now given itself more flexibility by choosing to target the yield curve (specifically, a 10-year yield of 0%). This opens up the possibility of cutting short rates deeper into negative territory and enacting reverse twist operations (selling long bonds to buy shorter ones). The effect has been to steepen the longer end of the yield curve (20 bps steeper during the last three months), something that should help the banking sector and a theme that is attracting attention in other core markets. Japanese bonds were the weakest within developed markets during the third quarter.

Meanwhile in Europe, the European Central Bank (ECB) made no changes to its policies when it met in September,

adding that it believed the monetary policy transmission mechanism was working. In the near term, the two biggest challenges facing Europe are the Italian referendum to be held on 4 December and the potential for renewed problems in the banking sector. With core European yields extremely low and the differential to US yields close to its widest (1.7% less for 10-year yields), we see little value in unhedged positions.

UK bonds were the best performing bonds (both government and corporate) among developed markets during the third quarter, as yields fell sharply post the Brexit decision. The long duration of the UK market also boosted returns. The Bank of England (BoE) cut its base rate by 0.25% to 0.25% in early August and signalled that it would be prepared to do more if required. In addition, the BoE also indicated that it would expand its balance sheet by as much as £170 billion via gilts (£60 billion over six months) and corporate bonds (£10 billion over 18 months), as well as via a bank lending programme (up to £100 billion).

In recent months, economic activity has held up better than feared. In the last few weeks, however, it has become clear that the UK will follow a harsher Brexit line rather than trying to compromise on key EU policies, and will also be less sympathetic to the concerns of the City of London. This harsher stance has coincided with renewed weakness in sterling.

Emerging markets were well supported both in local currency and in hard currency terms by investors seeking out the higher yields they offer. The stimulus unleashed by China in late-2015 is still working its way through the system and credit creations have been very strong this year, as have property prices. Commodity prices would have certainly derived some support from China, and more stable prices have supported emerging market sentiment more widely. Higher-yielding markets such as Brazil, Indonesia and India all performed well, as did SA.

Mexico proved to be an outlier, as the Mexican peso proved to be a vehicle for those speculating against a Trump victory in the US election. Turkey also struggled on the back of political concerns and Moody's downgrading the country to sub-investment grade. The strong run by emerging market corporate bonds now means that they are trading very close to similar-rated entities from developed markets.

There were numerous new issues from emerging markets in the dollar market, among them developments in SA, Ghana, Ecuador and Russia. Asian issuers were also very active, with total emerging market issuance in the third quarter of \$84 billion – the second highest on record. The build-up of debt within emerging markets is a concern for the long term, and the most concerning of these is China. The fund reduced some of its exposure to Brazil during early August, and then sold out completely after the Brazilian government



moved to impose withholding taxes on investors. The fund switched some of its Brazilian exposure into Mexico, where we see the Trump-induced weakness as overdone. The fund also bought some SA government bonds in late-August after the political tension once again re-emerged, and sold them after yields recovered.

Emerging markets are, however, not the only area where debt is rising, as robust corporates issuance was once again a feature. Investment-grade issuance in the dollar market has reached \$1.2 trillion year-to-date, of which 34% was A-rated and 34% BBB-rated. Investor appetite has remained robust, and excess returns above government securities of 1.7% in the third quarter and 3% year-to-date have only further fuelled demand. US high-yield returns were even stronger, up 5.5% in the third quarter. High-yield spreads now average 5% (from 9% in February), even as defaults have picked up and recovery rates have fallen.

In Europe, credit also performed well as the ECB bond buying programme continued to drain liquidity from the market and squeezed prices higher. Meanwhile in the UK, a similar dynamic has just begun and the net effect is likely to be larger given the smaller market; in the third quarter UK corporate bonds (albeit with a longer duration) outperformed government securities by 3.8%.

After the strong performance of corporate bonds, the fund reduced some of its exposure in Old Mutual and shortened the duration of its exposure to Naspers. The fund added some exposure to a new subordinate bank deal issued by Absa. The fund also increased its exposure to floating-rate instruments in the US via instruments issued by Standard Chartered and Macquarie.

In the foreign exchange markets, the US dollar, euro and yen all traded in tight ranges, as investors focused on the respective central bank meetings. Sterling remained one of the weakest currencies, losing another 3% in value against the dollar. We remain overweight sterling but concede that it may yet fall further if the harsher Brexit line is maintained.

Elsewhere, steadier commodity and rising oil prices combined with investors seeking out higher-yielding assets to support emerging market currencies. Mexico was a noticeable exception to this trend (down 6% against the US dollar), as its proximity to the US and the hostility directed at it by US presidential candidate Donald Trump weighed on it as Trump's poll ratings rose. China, meanwhile, held its currency broadly stable ahead of its admittance to the IMF's Special Drawing Rights basket of currencies on 1 October. The fund remains overweight US dollar and underweight the euro and yen. During the quarter we reduced our exposure to the Brazilian real to zero and increased our exposure to the Mexican peso. The fund continues to run a large underweight duration position, principally via Europe and Japan. The yield on the portfolio remains above that of the benchmark

by virtue of its holdings in emerging markets and corporate bonds. We believe that volatility and risk premiums probably underestimate the event risk that faces markets. We also have sympathy with the view that monetary policy actions are beginning to be less effective, and investors should remain vigilant to potential changes in the policy responses of central banks. While we would be wary of underestimating the impact of QE on corporate bond valuations, we are mindful that credit quality is deteriorating and greater volatility would pose a threat to current valuations. With year-to-date fund returns of over 13%, we would downplay the likelihood of repeating such strong returns in the near term.

## CORONATION AFRICA FRONTIERS

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Oct 08	(7.78%)	(4.81%)	6.74%	8.30%
3 Month USD Libor		0.64%	0.38%	0.38%	0.47%

*Annualised, quoted in USD*

*'The future is never clear and you pay a very high price for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values.'* – Warren Buffett

Over the past three months the performance of markets across Africa was mixed. Egypt, which is still the fund's largest country exposure, was up 10.3%. In contrast, Nigeria was down 14.5% on the back of further naira devaluation, and Kenya was down 5.9%, largely as a result of new banking regulations announced in August 2016. Against this backdrop the fund returned 3.1% over the quarter, compared to its benchmark (3 Month USD Libor + 5%), which was up 1.5%, and the JSE Africa Top 30 ex SA Index, which was up 3.6%.

Policy uncertainty is still one of the key concerns for many investors in African markets. Excise tax changes, pricing caps for mobile operators, one-off super taxes and pegged currencies have all added to this concern over the past few years.

During the past quarter we saw another regulatory intervention when the Banking Amendment Bill was passed in Kenya. This legislation stipulates the maximum interest rate banks are allowed to charge clients, as well as the minimum interest rate they have to pay on deposits. The average interest rate Kenyan banks were charging prior to the new bill was more than 400 basis points higher than the new maximum rate. Therefore, this will no doubt have a material negative impact on their net interest margins and overall profitability.

The bill was introduced by the Kenyan parliament without consultation with the banking sector. Although many



consumers will benefit significantly from lower interest rates on outstanding loans, there will likely be some unintended consequences:

- Small banks that are mainly focused on higher-risk lending at high interest rates will not be able to run profitable businesses. We spoke to bankers in Kenya who estimate that at least half of the banks in the country will be making losses under the new legislation, and are at risk of failing.
- We might well see a significant slowdown in lending, which would impact the economy as a whole.

Prior to the new legislation, Kenyan banks' high profits provided investors with a sense of certainty, which led to a very cheery consensus on that country. None of these risks were priced into Kenyan multiples, particularly in the banking space. We have said in the past that we believe most of the larger Kenyan banks are just too profitable, with net interest margins above 10% and returns on equity north of 30%. The fund therefore had no exposure to the largest banks in Kenya. Admittedly, our base case was that competition, rather than regulation, would drive down the net interest margins of the industry over time. However, we have seen many times that very profitable businesses that are charging high fees are more likely to be a target for governments.

The only bank in Kenya owned by the fund is CFC Stanbic, which has a lower – but in our view, a much more sustainable – profitability level. CFC Stanbic will be impacted by the new regulations, but we expect the impact to be more pronounced for its competitors that have higher net interest margins. In the week following the announcement, CFC Stanbic was down 4.4%, compared to Equity Bank, which lost 23.6%, and KCB Bank, which fell by 15.3%.

We typically put a lower rating on businesses that are more exposed to regulatory risks, and therefore normally view banks as discount businesses. We also put a lower rating on earnings streams that we view as unsustainably high. However, we are willing to pay up for high-quality businesses with strong moats. These businesses are typically better positioned to withstand regulatory changes and, when these changes occur, they often come out stronger on the other side.

While many investors might perceive a company that is simply too profitable as a low-risk investment, our view is the opposite – these businesses actually present larger risks as profits do eventually normalise, whether this happens through competition or as a result of government intervention. We rather try to identify quality businesses where current earnings are below our assessment of normal. We believe there are a number of these businesses across the African universe that offer excellent opportunities for investors who are willing to take a longer-term view.

## CORONATION GLOBAL FRONTIERS

	Launch date	1 year	3 years	5 years	Since inception
Fund	1 Dec 14	4.06%	-	-	(4.59%)
3 Month USD Libor		0.64%	-	-	0.48%

*Annualised, quoted in USD*

Over the past quarter, the performance of frontier markets was mixed, as detailed in the Africa Frontiers commentary on page 37. Egypt, which is still the fund's largest country exposure, was up 10.3% and Sri Lanka, the fund's second largest country exposure, was up 3.9%. In contrast, Nigeria was down 14.5% and Kenya was down 5.9%. Against this backdrop the fund returned 5.9% over the quarter, compared to the 3 Month USD Libor, which was up 0.2%, and the MSCI Frontier Markets Index, which was up 2.7%.

We continue to have sizeable holdings in the telecommunications sector. These businesses are generally good cash generators with attractive dividend yields. In addition, we find the growth prospects of mobile money in the frontier universe particularly attractive.

Mobile telecommunication companies across the globe have grown spectacularly over the past two decades. In many countries the mobile penetration rates are now well above 100% – which means that there are more mobile phones than people. In many frontier markets the mobile industry is still in an early stage of its life cycle.

A case in point is Pakistan, where mobile penetration is estimated to be below 80% and 3G or 4G subscribers make up only 24% of the population (July 2016 data).

Despite the strong growth outlook in Pakistan, there has been intense price competition among the five mobile operators over the past few years. Large promotions and price cuts led to call rates in Pakistan falling to levels among the lowest in the world. It is our understanding that none of the mobile operators in Pakistan were profitable in 2015 – a situation that is clearly not sustainable.

In the past we saw a similar phenomenon play out in Kenya, and we believe this seemingly dire situation presents some interesting investment opportunities. During 2011 and 2012, intense competition in Kenya drove voice tariffs down significantly and today Kenya ranks as one of the countries with the lowest voice tariffs in Africa. As a result, the earnings and share price of Safaricom, Kenya's largest mobile operator, came under pressure in 2012.

However, in 2013 the competitive environment improved when competitor behaviour became more rational. In the years following this price war we saw very strong profit growth. In the most recent financial year the profit of





Safaricom was three times higher than it was in 2012, while its share price increased fivefold over this period.

In 2016 we have seen a definite change in the competitive environment in Pakistan, with the merger of Mobilink (largest operator) and Warid (smallest operator) in July 2016. Mobile tariffs have stabilised and the aggressive promotions of particularly the smaller operators have reduced significantly.

Two companies owned by the fund which should benefit from a more rational competitive environment are Global Telecom Holding (GTH) and Pakistan Telecommunications Company Limited (PTCL). GTH owns the largest mobile operator in Pakistan, while PTCL is the monopoly fixed-line operator which also owns one of the smaller mobile operators called Ufone.

The industry consolidation, coupled with the fact that voice tariffs are already among the lowest in the world, leads us to believe that the risk of further tariff cuts is limited. In addition, capital expenditure is on a downward trend following the large investments in spectrum and mobile networks. In our view, this should lead to a large improvement in the profitability and cash generation of these mobile operators going forward.

While many investors focus only on the short-term earnings of a company, we continue to spend our time trying to identify quality businesses where current earnings are below our assessment of normal. We believe there are a number of these businesses across the frontier universe which offer excellent opportunities for investors who are willing to take a longer-term view. ■





## INSTITUTIONAL FUND PERFORMANCE

PORTFOLIOS <sup>A</sup>	FEES <sup>B</sup>	LAUNCH DATE	1 YEAR	3 YEARS	5 YEARS	10 YEARS	15 YEARS	CUM SINCE LAUNCH <sup>†</sup>	ANN SINCE LAUNCH <sup>†</sup>
<b>GLOBAL BALANCED</b>									
Global Houseview	G	Oct-93	10.42%	10.87%	16.30%	14.23%	16.83%	3,470.94%	16.82%
Peer Median*			8.82%	10.04%	15.03%	12.17%	15.23%	2,585.36%	15.38%
<b>Alpha</b>			<b>1.60%</b>	<b>0.83%</b>	<b>1.27%</b>	<b>2.06%</b>	<b>1.60%</b>	<b>885.58%</b>	<b>1.44%</b>
Managed	G	May-96	13.07%	10.56%	16.92%	14.99%	17.04%	2,475.91%	17.25%
Peer Median*			8.82%	10.04%	15.03%	12.17%	15.23%	1,412.44%	14.23%
<b>Alpha</b>			<b>4.25%</b>	<b>0.52%</b>	<b>1.89%</b>	<b>2.82%</b>	<b>1.81%</b>	<b>1,063.47%</b>	<b>3.02%</b>
<b>DOMESTIC BALANCED</b>									
Domestic Houseview	G	Jan-98	8.97%	9.14%	14.50%	14.10%	17.64%	1,650.18%	16.49%
Domestic Balanced Benchmark			8.69%	9.53%	13.54%	11.76%	14.44%	1,018.92%	13.75%
<b>Alpha</b>			<b>0.28%</b>	<b>(0.39%)</b>	<b>0.96%</b>	<b>2.34%</b>	<b>3.20%</b>	<b>631.25%</b>	<b>2.75%</b>
<b>SPECIALIST EQUITY</b>									
Houseview Equity	G	Oct-93	9.91%	8.90%	17.55%	15.67%	19.96%	4,443.17%	18.05%
Houseview Equity Benchmark			7.17%	9.09%	15.48%	12.45%	16.73%	2,421.69%	15.06%
<b>Alpha</b>			<b>2.74%</b>	<b>(0.19%)</b>	<b>2.07%</b>	<b>3.22%</b>	<b>3.24%</b>	<b>2,021.48%</b>	<b>2.98%</b>
Aggressive Equity	G	Jan-04	14.26%	6.87%	15.72%	15.34%	-	860.74%	19.42%
Aggressive Equity Benchmark			9.04%	10.92%	16.77%	13.35%	-	719.47%	17.94%
<b>Alpha</b>			<b>5.22%</b>	<b>(4.04%)</b>	<b>(1.05%)</b>	<b>1.99%</b>	<b>-</b>	<b>141.27%</b>	<b>1.48%</b>
Core Equity	G	Mar-04	8.98%	8.97%	17.12%	15.87%	-	882.37%	19.91%
FTSE/JSE Shareholder Weighted Index			9.04%	10.92%	16.77%	13.34%	-	687.22%	17.82%
<b>Alpha</b>			<b>(0.06%)</b>	<b>(1.94%)</b>	<b>0.35%</b>	<b>2.53%</b>	<b>-</b>	<b>195.15%</b>	<b>2.09%</b>
<b>SPECIALIST FIXED INTEREST</b>									
Strategic Cash	G	Sep-06	8.18%	7.34%	6.99%	8.16%	-	120.32%	8.15%
Short Term Fixed Interest 3 month Index			6.79%	6.07%	5.74%	7.10%	-	99.87%	7.11%
<b>Alpha</b>			<b>1.39%</b>	<b>1.27%</b>	<b>1.25%</b>	<b>1.05%</b>	<b>-</b>	<b>20.45%</b>	<b>1.04%</b>
Active Bond	G	Jul-00	9.39%	8.00%	9.33%	9.64%	10.49%	509.19%	11.76%
BEASSA All Bond Index			7.65%	6.82%	8.02%	8.52%	9.50%	431.61%	10.83%
<b>Alpha</b>			<b>1.74%</b>	<b>1.18%</b>	<b>1.31%</b>	<b>1.12%</b>	<b>0.98%</b>	<b>77.58%</b>	<b>0.93%</b>
Strategic Bond	G	Jan-08	9.03%	8.14%	9.60%	-	-	133.77%	10.19%
BEASSA All Bond Index			7.65%	6.82%	8.02%	-	-	105.91%	8.60%
<b>Alpha</b>			<b>1.38%</b>	<b>1.31%</b>	<b>1.58%</b>	<b>-</b>	<b>-</b>	<b>27.86%</b>	<b>1.59%</b>
Absolute Bond	G	Mar-03	9.18%	8.12%	8.87%	10.62%	-	294.40%	10.63%
CPI			6.26%	5.59%	5.64%	6.20%	-	114.10%	5.76%
<b>Alpha</b>			<b>2.92%</b>	<b>2.53%</b>	<b>3.23%</b>	<b>4.42%</b>	<b>-</b>	<b>180.30%</b>	<b>4.87%</b>
Flexible Fixed Income	G	Jul-10	9.45%	8.63%	10.01%	-	-	84.75%	10.32%
BEASSA All Bond Index			7.65%	6.82%	8.02%	-	-	68.34%	8.69%
<b>Alpha</b>			<b>1.80%</b>	<b>1.81%</b>	<b>1.99%</b>	<b>-</b>	<b>-</b>	<b>16.41%</b>	<b>1.63%</b>
Short Term Fixed Interest 3 month Index			6.79%	6.07%	5.74%	-	-	41.81%	5.75%
<b>Alpha</b>			<b>2.66%</b>	<b>2.56%</b>	<b>4.27%</b>	<b>-</b>	<b>-</b>	<b>42.93%</b>	<b>4.57%</b>
Medical Aid Cash	G	Dec-05	8.19%	7.22%	6.79%	8.10%	-	130.37%	8.01%
Short Term Fixed Interest 3 month Index			6.79%	6.07%	5.74%	7.10%	-	110.37%	7.11%
<b>Alpha</b>			<b>1.40%</b>	<b>1.15%</b>	<b>1.05%</b>	<b>0.99%</b>	<b>-</b>	<b>20.00%</b>	<b>0.90%</b>
<b>INFLATION-LINKED BENCHMARK</b>									
Global Absolute	G	Aug-99	10.07%	9.39%	13.10%	12.86%	15.84%	1,255.12%	16.40%
CPI			6.26%	5.59%	5.64%	6.20%	6.08%	181.39%	6.21%
<b>Alpha</b>			<b>3.81%</b>	<b>3.80%</b>	<b>7.46%</b>	<b>6.65%</b>	<b>9.76%</b>	<b>1,073.73%</b>	<b>10.18%</b>
Domestic Absolute	G	Apr-02	7.23%	7.27%	10.20%	11.96%	-	733.73%	15.75%
CPI			6.26%	5.59%	5.64%	6.20%	-	130.73%	5.94%
<b>Alpha</b>			<b>0.97%</b>	<b>1.68%</b>	<b>4.56%</b>	<b>5.75%</b>	<b>-</b>	<b>603.00%</b>	<b>9.81%</b>
Inflation Plus	G	Oct-09	8.39%	9.22%	11.06%	-	-	114.56%	11.52%
CPI			6.26%	5.59%	5.64%	-	-	43.53%	5.30%
<b>Alpha</b>			<b>2.13%</b>	<b>3.63%</b>	<b>5.42%</b>	<b>-</b>	<b>-</b>	<b>71.02%</b>	<b>6.22%</b>
Medical Absolute	G	May-04	7.21%	6.95%	9.90%	11.17%	-	387.79%	13.61%
CPI			6.26%	5.59%	5.64%	6.20%	-	102.34%	5.84%
<b>Alpha</b>			<b>0.95%</b>	<b>1.36%</b>	<b>4.25%</b>	<b>4.97%</b>	<b>-</b>	<b>285.45%</b>	<b>7.77%</b>



PORTFOLIOS <sup>Δ</sup>	FEES <sup>°</sup>	LAUNCH DATE	1 YEAR	3 YEARS	5 YEARS	10 YEARS	15 YEARS	CUM SINCE LAUNCH <sup>†</sup>	ANN SINCE LAUNCH <sup>†</sup>
<b>HEDGE FUNDS</b>									
Coronation Presidio Fund	N	Oct-05	3.52%	11.27%	19.14%	17.87%	-	489.59%	17.50%
Cash			6.46%	5.73%	5.42%	6.75%	-	105.54%	6.77%
<b>Alpha</b>			<b>(2.93%)</b>	<b>5.54%</b>	<b>13.72%</b>	<b>11.12%</b>	-	<b>384.04%</b>	<b>10.73%</b>
Coronation Multi-Strategy Arbitrage Fund	N	Jul-03	16.97%	8.47%	9.16%	11.61%	-	375.40%	12.49%
Cash			6.46%	5.73%	5.42%	6.75%	-	143.09%	6.93%
<b>Alpha</b>			<b>10.52%</b>	<b>2.73%</b>	<b>3.73%</b>	<b>4.86%</b>	-	<b>232.31%</b>	<b>5.55%</b>
Coronation Granite Fixed Income Fund	N	Oct-02	8.06%	7.48%	7.51%	9.32%	-	285.08%	10.11%
Cash			6.46%	5.73%	5.42%	6.75%	-	165.87%	7.23%
<b>Alpha</b>			<b>1.60%</b>	<b>1.74%</b>	<b>2.09%</b>	<b>2.57%</b>	-	<b>119.21%</b>	<b>2.88%</b>
<b>OFFSHORE FUNDS<sup>Δ</sup></b>									
Coronation Global Equity FoF (US\$)	N	Jul-00	14.30%	5.20%	12.07%	6.17%	8.19%	122.29%	5.04%
Coronation Global Equity FoFs Benchmark			11.96%	6.42%	12.25%	5.05%	6.85%	85.14%	3.86%
<b>Alpha</b>			<b>2.34%</b>	<b>(1.22%)</b>	<b>(0.19%)</b>	<b>1.12%</b>	<b>1.34%</b>	<b>37.15%</b>	<b>1.18%</b>
Coronation Global Managed (US\$)	G	Mar-10	15.02%	4.05%	11.01%	-	-	69.04%	8.30%
Coronation Global Managed Benchmark			10.92%	4.59%	7.63%	-	-	53.42%	6.72%
<b>Alpha</b>			<b>4.10%</b>	<b>(0.54%)</b>	<b>3.38%</b>	-	-	<b>15.62%</b>	<b>1.58%</b>
Global Capital Plus (US\$)	G	Sep-09	9.43%	2.89%	6.79%	-	-	52.27%	6.12%
Global Capital Plus Custom Benchmark			0.64%	(2.67%)	(1.28%)	-	-	(7.73%)	(1.13%)
<b>Alpha</b>			<b>8.79%</b>	<b>5.56%</b>	<b>8.07%</b>	-	-	<b>60.00%</b>	<b>7.25%</b>
Global Bond (US\$)	G	Oct-09	11.13%	2.32%	3.33%	-	-	28.63%	3.66%
Global Bond Custom Benchmark in US\$			8.83%	1.51%	0.61%	-	-	13.19%	1.79%
<b>Alpha</b>			<b>2.30%</b>	<b>0.81%</b>	<b>2.72%</b>	-	-	<b>15.45%</b>	<b>1.88%</b>
Global Emerging Markets Equity Strategy	G	Jul-08	32.14%	(1.67%)	7.48%	-	-	64.25%	6.22%
Coronation Global Emerging Markets Equity Benchmark			16.78%	(0.33%)	3.32%	-	-	8.49%	0.99%
<b>Alpha</b>			<b>15.35%</b>	<b>(1.35%)</b>	<b>4.16%</b>	-	-	<b>55.76%</b>	<b>5.23%</b>
Coronation All Africa Strategy	G	Aug-08	(2.82%)	(5.13%)	6.03%	-	-	76.09%	7.17%
3 Month USD Libor			0.64%	0.38%	0.38%	-	-	4.42%	0.53%
<b>Alpha</b>			<b>(3.47%)</b>	<b>(5.51%)</b>	<b>5.65%</b>	-	-	<b>71.67%</b>	<b>6.64%</b>
Coronation Africa Frontiers Strategy	G	Oct-08	(7.78%)	(4.81%)	6.74%	-	-	89.29%	8.30%
3 Month USD Libor			0.64%	0.38%	0.38%	-	-	3.82%	0.47%
<b>Alpha</b>			<b>(8.42%)</b>	<b>(5.20%)</b>	<b>6.36%</b>	-	-	<b>85.47%</b>	<b>7.83%</b>
Coronation Global Frontiers Strategy	G	Dec-14	4.06%	-	-	-	-	(8.25%)	(4.59%)
3 Month USD Libor			0.64%	-	-	-	-	0.88%	0.48%
<b>Alpha</b>			<b>3.42%</b>	-	-	-	-	<b>(9.13%)</b>	<b>(5.07%)</b>
Coronation Global Equity Strategy	G	Nov-14	19.34%	-	-	-	-	0.19%	0.10%
MSCI All Country World Net US\$			11.96%	-	-	-	-	3.78%	1.95%
<b>Alpha</b>			<b>7.39%</b>	-	-	-	-	<b>(3.59%)</b>	<b>(1.86%)</b>

<sup>1</sup> Figures quoted in US\$ as at 30 September 2016.

<sup>Δ</sup> Figures are quoted from the Independent Retirement Fund Survey as at 30 September 2016.

<sup>\*</sup> Median of Peer Group is the median of the largest fund manager's fully-discretionary retirement fund portfolios as published in performance surveys and calculated by Coronation Fund Managers.

<sup>°</sup> G = Gross, N = Net

<sup>†</sup> CUM SINCE LAUNCH = Cumulative returns since launch, ANN SINCE LAUNCH = Annualised returns since launch. Figures of one year and less indicate percentage change.



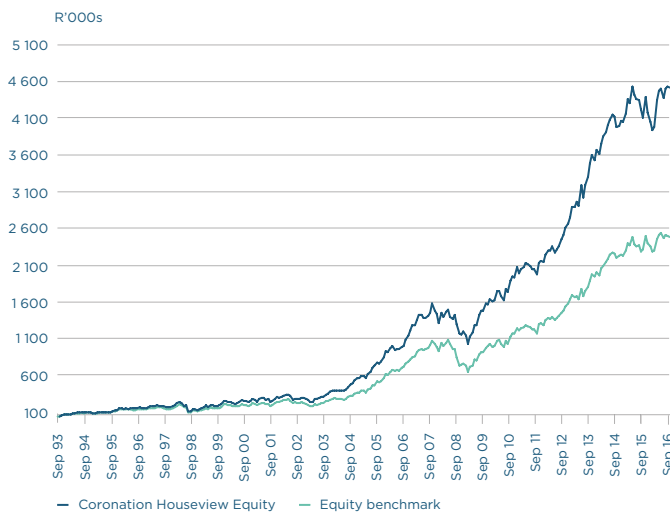
LONG-TERM investment track record



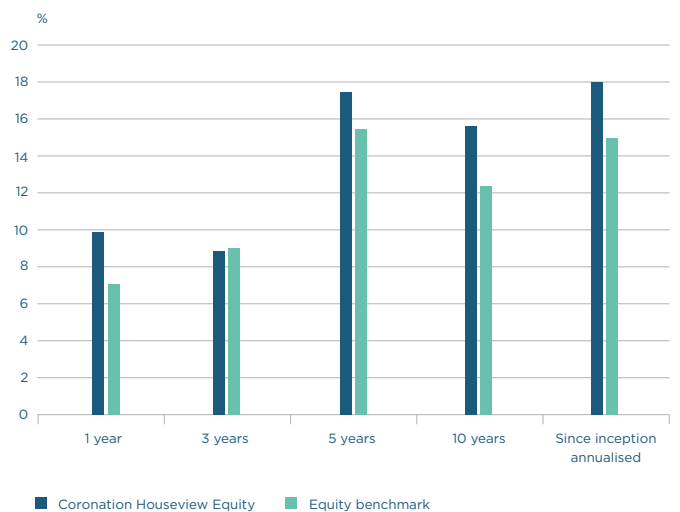
CORONATION HOUSEVIEW EQUITY RETURNS VS EQUITY BENCHMARK

5-YEAR ANNUALISED RETURNS	CORONATION HOUSEVIEW EQUITY	EQUITY BENCHMARK	ALPHA
1998	8.15%	6.49%	1.66%
1999	14.23%	10.91%	3.33%
2000	10.93%	7.52%	3.41%
2001	10.95%	9.38%	1.57%
2002	9.46%	7.80%	1.66%
2003	18.02%	13.78%	4.24%
2004	14.12%	9.63%	4.49%
2005	23.35%	18.94%	4.41%
2006	28.38%	23.66%	4.72%
2007	33.79%	29.55%	4.24%
2008	23.36%	19.73%	3.63%
2009	22.23%	20.67%	1.56%
2010	18.55%	15.73%	2.82%
2011	11.58%	8.73%	2.85%
2012	13.39%	10.10%	3.29%
2013	24.37%	20.21%	4.16%
2014	19.39%	16.08%	3.31%
2015	14.05%	13.14%	0.91%
4 years 9 months to 30 September 2016	16.65%	14.41%	2.24%
<b>ANNUALISED TO 30 SEPTEMBER 2016</b>			
1 year	9.91%	7.17%	2.74%
3 years	8.90%	9.09%	(0.19%)
5 years	17.55%	15.48%	2.07%
10 years	15.67%	12.45%	3.22%
Since inception in October 1993 annualised	18.05%	15.06%	2.98%
Average outperformance per 5-year return			3.08%
Number of 5-year periods outperformed			19.00
Number of 5-year periods underperformed			-

CUMULATIVE PERFORMANCE



ANNUALISED RETURNS TO 30 SEPTEMBER 2016



An investment of R100 000 in Coronation Houseview Equity on 1 October 1993 would have grown to **R4 543 169** by 30 September 2016. By comparison, the returns generated by the Equity Benchmark over the same period would have grown a similar investment to **R2 521 691**.

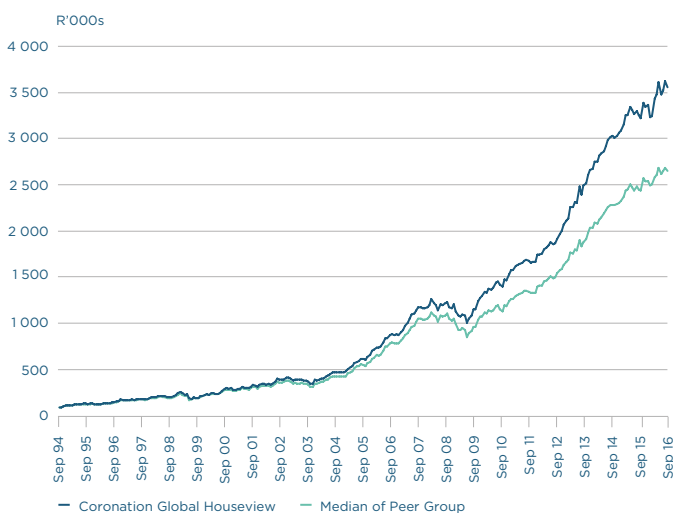


## CORONATION GLOBAL HOUSEVIEW (BALANCED) RETURNS VS MEDIAN OF PEER GROUP\*

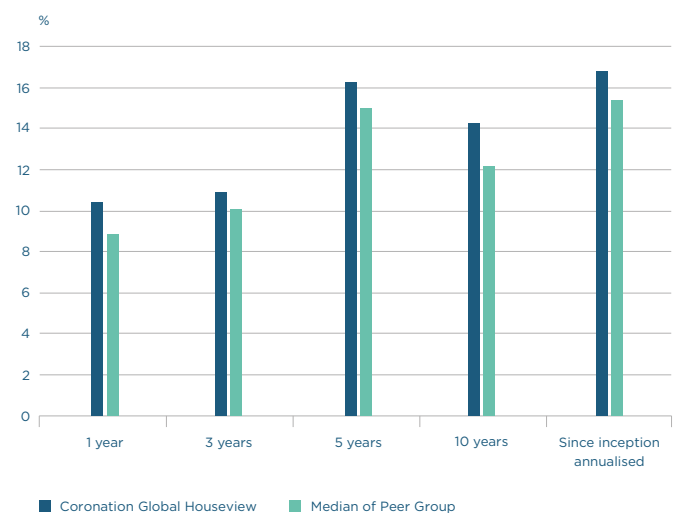


5-YEAR ANNUALISED RETURNS	CORONATION GLOBAL HOUSEVIEW	MEDIAN OF PEER GROUP*	ALPHA
1998	11.21%	11.26%	(0.04%)
1999	16.36%	15.54%	0.82%
2000	13.82%	13.17%	0.65%
2001	16.54%	15.02%	1.52%
2002	12.74%	12.05%	0.69%
2003	17.67%	15.96%	1.71%
2004	14.35%	13.30%	1.05%
2005	19.58%	18.16%	1.42%
2006	20.74%	19.53%	1.22%
2007	24.93%	24.82%	0.10%
2008	18.96%	17.52%	1.44%
2009	18.28%	15.19%	3.09%
2010	15.23%	12.02%	3.21%
2011	10.75%	8.32%	2.43%
2012	12.23%	9.83%	2.40%
2013	20.13%	17.67%	2.46%
2014	17.52%	15.64%	1.88%
2015	15.69%	14.61%	1.08%
4 years 9 months to 30 September 2016	15.96%	14.58%	1.38%
<b>ANNUALISED TO 30 SEPTEMBER 2016</b>			
1 year	10.42%	8.82%	1.60%
3 years	10.87%	10.04%	0.83%
5 years	16.30%	15.03%	1.27%
10 years	14.23%	12.17%	2.06%
Since inception in October 1993 annualised	16.82%	15.38%	1.44%
Average outperformance per 5-year return			1.50%
Number of 5-year periods outperformed			18.00
Number of 5-year periods underperformed			1.00

### CUMULATIVE PERFORMANCE



### ANNUALISED RETURNS TO 30 SEPTEMBER 2016



An investment of R100 000 in Coronation Global Balanced on 1 October 1993 would have grown to **R3 570 942** by 30 September 2016. By comparison, the Median return of Global Large Managers over the same period would have grown a similar investment to **R2 670 761**.

\* Median of Peer Group is the median of the fully-discretionary retirement portfolios of the largest managers as published in performance surveys and calculated by Coronation Fund Managers.





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