## cor)sp)ondent

The Coronation Fund Managers Personal Investments Quarterly

### Summer 2016

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**January 2016**

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**Coronation Fund Managers**

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Notes from my inbox

The pitfalls of short-termism and pro-cyclical behaviour.

by PIETER KOEKEMOER

Doubt is not a pleasant condition, but certainty is absurd.
– Voltaire

As to methods, there may be a million and then some, but principles are few. The man who grasps principles can successfully select his own methods. The man who tries methods, ignoring principles, is sure to have trouble.
– Emerson

The headline index performance for South African assets shows a somewhat disappointing but relatively benign range of outcomes, with rand returns for 2015 ranging between -4% from bonds, around 5% from shares, 6% for cash and 8% for listed property. But this tight range of single-digit numbers hides a lot. Arguably, the most significant trends of the year were the incredibly shrinking rand (losing another quarter of its value against the dollar) and the very narrow group of large, globally diversified companies (think SABMiller, British American Tobacco, Naspers, Steinhoff and Mondi) that were nearly solely responsible for a positive rand return from the local equity market. The market sectors with a local focus were almost universally decimated, with negative returns from banks (-13%), telecommunication (-28%), general mining (-36%), platinum (-62%) and industrial metals (-77%). In dollar terms, most global markets also ended the year on the wrong side of zero. Tony Gibson provides detailed insight into global market developments on page 33, and confirms that the source of positive returns in the US equity market has been similarly narrow in 2015.

This backdrop explains the results produced by most of our funds, with Coronation Equity (+5%), Balanced Plus and Balanced Defensive (both +8%) as well as Strategic Income (+7%) delivering returns that should not be outside the margins of expectation given how the underlying asset classes performed. Calendar year returns from funds with relatively more assertive risk budgets such as Coronation Top 20 (-10%) and Capital Plus (+5%) were disappointing, and reflect a difficult part of the investment cycle for long-term valuation-oriented investors. You can read more about individual fund performance in the respective fund fact sheets available at www.coronation.com, or for a general overview, Duane Cable’s and Nishan Maharaj’s commentaries included in this issue.

Whilst it is our duty as custodian of your capital to report back on short-term performance, whether good or bad, we also think it is important to remind you of the pitfalls of short-termism and pro-cyclical behaviour. On page 17, Charles de Kock provides some perspective on where we currently find ourselves in the investment and economic cycles, while Karl Leinberger (page 5) sets out the rationale underpinning our long-term investment philosophy, which promises with a
high degree of probability to deliver superior rewards over a meaningful timeframe, but at the unfortunate cost of regular short-term periods of underperformance.

Finally, I also provide a personal financial management checklist on page 10. With a high probability of tax increases in the 2016/17 fiscal year, it is a good idea to restructure portfolios appropriately for the coming decades before the end of February this year. It may be time to overcome the administrative inertia that we are all prone to and externalise those rands, open that tax-free investment account or make that switch to the multi-asset fund best suited to your needs.

While we expect that the environment will remain tough in 2016, we will continue to set our sails for the prevailing winds, with the sole objective of maximising long-term outcomes for our clients. Please do not hesitate to contact us if we have not managed to live up to your expectations.

Best wishes for navigating the choppy waters out there.

MARKET MOVEMENTS

<table>
<thead>
<tr>
<th>Index</th>
<th>4th quarter 2015</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Share Index R</td>
<td>1.7</td>
<td>5.1</td>
</tr>
<tr>
<td>All Share Index $</td>
<td>(9.3)</td>
<td>(21.5)</td>
</tr>
<tr>
<td>All Bond R</td>
<td>(6.4)</td>
<td>(3.9)</td>
</tr>
<tr>
<td>All Bond $</td>
<td>(16.5)</td>
<td>(28.3)</td>
</tr>
<tr>
<td>Cash R</td>
<td>1.1</td>
<td>5.9</td>
</tr>
<tr>
<td>Resources Index R</td>
<td>(19.2)</td>
<td>(37.0)</td>
</tr>
<tr>
<td>Financial Index R</td>
<td>(3.3)</td>
<td>3.9</td>
</tr>
<tr>
<td>Industrial Index R</td>
<td>6.6</td>
<td>15.3</td>
</tr>
<tr>
<td>MSCI World $</td>
<td>5.6</td>
<td>(0.3)</td>
</tr>
<tr>
<td>MSCI EM $</td>
<td>0.7</td>
<td>(14.6)</td>
</tr>
<tr>
<td>S&amp;P 500 $</td>
<td>7.0</td>
<td>1.4</td>
</tr>
<tr>
<td>Nasdaq $</td>
<td>10.2</td>
<td>9.7</td>
</tr>
<tr>
<td>MSCI Pacific $</td>
<td>9.0</td>
<td>3.2</td>
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<tr>
<td>Dow Jones EURO Stoxx 50 $</td>
<td>2.8</td>
<td>(4.5)</td>
</tr>
</tbody>
</table>
Long-term investing
Mirage on the horizon or pot of gold at the end of the rainbow?

by KARL LEINBERGER

The defining feature of Coronation’s investment philosophy is its commitment to long-term investing. We have consistently emphasised this point over the years, regardless of whether recent performance has been good or bad. Why do we make such a big deal about it? Is it nothing more than a weak attempt to defer accountability and ‘buy time’ in periods of poor investment performance?

We all know that patience and discipline are essential if one is to succeed in investments. The point has been made so often, and by so many, that I think it’s fair to say it’s become trite. Perversely, this almost does the practice of long-term investing a disservice – many readers understandably feel they’ve heard it all and just skip the preamble on long-term investing to get to the interesting stuff …

But the case for long-term investing is, in fact, anything but trite. I believe that the supporting arguments are profound and that long-term investing presents the only enduring competitive advantage that exists in financial markets. In what follows, I will explore the reasoning and attempt to build the case from the bottom up:

1. A high percentage of long-term returns comes from a surprisingly few months

The graphs on the right show the compelling results that are available to those investors who are prepared to put money in the equity market for very long periods of time (regardless of the sentiment of the day) and then let the power of compounding work for them. Graph 1 shows the performance, in real terms, of SA equities, bonds and cash over the very long term. Graph 2 shows the performance (before fees) of the Coronation Houseview Equity portfolio versus the return of the equity market over the full period of Coronation’s history.
The conclusion is as simple as it is compelling. Invest in the equity markets for long periods of time, stick with winning fund managers for the long haul, and the power of compounding will do extraordinary things for you. As the market adage goes: ‘It’s time in the markets that counts, not timing the markets.’

And yet the evidence is overwhelming that most investors capture only a small fraction of the market return over time. For some reason, very few investors are prepared to put their money in equities, and with the fund managers they back, for the long haul. Why would that be?

a) A large part of it is due to momentum investing. Many believe they ‘can ride the wave’ and successfully avoid equities (or fund managers) while they are performing poorly and then buy when the tide turns and they start performing well. It’s a seductive notion that many fall for. In practice, however, the vast majority end up buying and selling at precisely the wrong times. They sell when the newsflow is bad (and prices are inevitably low) and buy when newsflow is good (and prices are inevitably high). And so they end up buying high and selling low – when the primary objective of investing is to do the converse.

b) Momentum investing is made all the more hazardous by the fact that the inflection points in cycles typically come when they are least expected. This is the case with both financial markets and the alpha cycle of a fund manager. Typically, the moves are large and, for that reason, a high percentage of the returns that patient investors earn over the long term are made in a surprisingly few trading sessions:

- Since 1960, investors who were not invested in the SA equity market for 13% of those trading months got zero return over the 55-year period.
- Over Coronation’s entire history as an investment house, investors who missed out on only 9% of our trading months received zero alpha over that 22-year period.

2. Financial returns accrue in a geometric manner

At some point in first-year university statistics, the difference between a series of arithmetic (linear) and geometric (non-linear) numbers is explained. Interestingly, the human brain is wired to think in a linear way. While this serves us well in most endeavours, it can be a hindrance in investing, given the fact that financial returns accrue in a non-linear manner. My favourite illustration of the power inherent in a non-linear sequence of numbers is the story of what happens when a piece of paper is repeatedly folded in half. At the first fold, the paper doubles in depth. At the second fold it doubles again, to be four times as thick as it was at the starting point. The astonishing point is how few folds it would take for that imaginary tower to get halfway to the moon. The answer is a mere 41 folds. And from there, it would take for that tower to reach the moon is one more fold. Not easy to get your mind around!

Many of the first principles in long-term investing stem from the fact that financial returns are path-dependent and accrue in a geometric (or non-linear) manner. Two of these investing principles are relevant here:

a) The power of compounding – why small numbers get big on you over long periods of time.

South African equities have delivered a real return of 8.7% per annum since 1925. This may not sound like a big number but, as shown in Graph 1, this annual return would have grown any capital invested at that time by a breathtaking 1 343 times (in inflation-adjusted terms). It is often said that diversification is the only free lunch you get in investments. I would rate the power of compounding (over long periods of time) even higher …

The power of compounding is just as relevant for market returns as it is for the alpha that successful fund managers deliver over long periods of time. History clearly shows that over multiple decades only a handful of managers can do as much as 3% alpha per annum (before fees). Over Coronation’s 22 years as a fund manager, our Houseview Equity portfolio has outperformed the market by 2.8% per annum. Once again, this does not sound like a big number. And yet, outperforming the market by 2.8% per annum over that period delivered a 41-bagger, compared to the (already remarkable) 24-bagger that the SA equity market returned. Meaningful by anyone’s standards …

We are all in the business of creating wealth over the multi-decade timeframe that is implicit in managing retirement

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1 Our Houseview Equity portfolio represents our longest institutional track record. Our longest-running unit trust, the Coronation Equity Fund, was launched in April 1996, meaning it has a track record of almost 20 years. Over this period, it turned a market return of 12x original capital into a return of nearly 42x original capital, after taking into account all management fees and other portfolio costs.
capital. Financial markets can be intimidating and the world is an uncertain place. In this context it seems crazy to me that so few investors use the one advantage they have: the power of compounding over long periods of time. The answer is to keep it simple: allocate capital to equity markets and to the fund managers that you back to deliver over the long term, and let the magical powers of compounding work for you.

b) The importance of avoiding negative returns and focusing on long-term cumulative performance.

The following table shows a hypothetical case study in which the market delivers a cumulative return of only 6% over five years. In the first scenario, ‘steady fund manager’ delivers the holy grail: consistent outperformance of 4% every single year.

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>Average alpha</th>
<th>Arithmetic average</th>
<th>Cumulative return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market return</td>
<td>(50%)</td>
<td>40%</td>
<td>15%</td>
<td>15%</td>
<td>15%</td>
<td>-</td>
<td>7%</td>
<td>6%</td>
</tr>
<tr>
<td>Steady manager</td>
<td>(46%)</td>
<td>44%</td>
<td>19%</td>
<td>19%</td>
<td>19%</td>
<td>4%</td>
<td>11%</td>
<td>21%</td>
</tr>
<tr>
<td>Lumpy manager</td>
<td>(40%)</td>
<td>35%</td>
<td>25%</td>
<td>10%</td>
<td>25%</td>
<td>4%</td>
<td>11%</td>
<td>39%</td>
</tr>
<tr>
<td>Bear market manager</td>
<td>(30%)</td>
<td>40%</td>
<td>15%</td>
<td>15%</td>
<td>15%</td>
<td>4%</td>
<td>11%</td>
<td>49%</td>
</tr>
</tbody>
</table>

Source: Coronation

In the second scenario, ‘lumpy fund manager’ delivers the same aggregate alpha over the five years (20%), but its performance is lumpier. In the third scenario, ‘bear market manager’ delivers the same aggregate alpha, but does it all in the first year (which happens to be the only down year in the period).

In the performance assessment process our brains are wired to:

- weigh recent performance more heavily than earlier performance;
- penalise losses more heavily than gains; and
- appreciate alpha that is more steady than lumpy.

The entire field of behavioural finance is devoted to analysing these flaws in our reasoning process. Suffice to say that the evolutionary process did not equip Homo sapiens to manage capital over multi-decade periods! We are just too guilty of instant gratification and loss aversion (we put two to two-and-a-half times the weight on a rand loss as on the same rand gain!).

Over the full period, the steady manager delivered a compelling return of 31%, the lumpy manager did even better with 39% and the bear market manager did best with 49%. These outcomes are fascinating. All three managers delivered the same aggregate outperformance over the period (20%) and yet the final outcomes for their clients are so very different. Not only are the outcomes materially different from one another, but they are also at odds with what we intuitively would have expected (because our brains don’t easily compute compound returns).

They demonstrate that as much as we desire consistent alpha year in and year out, it was the steady manager that ultimately delivered the lowest value-add. The steady manager was beaten by the ‘inconsistent’ manager whose alpha was lumpier. And the manager who did best was the one that delivered in a down year and then delivered no alpha for the next four years.

This case study talks to some of the pitfalls in assessing investment performance. We instinctively place too much emphasis on recent performance as well as the consistency of alpha, and we don’t give enough credit to managers who can preserve value in downmarkets.

As observers, our expectations of cumulative performance are often very different from reality. This is why Coronation so consistently argues that it is the cumulative, long-term performance of an investment house that matters. Assessment periods of less than five years have little value. They usually reflect only one part of a market cycle and don’t capture what really matters: the actual capital accumulated by clients over the full period of their investment with that fund manager.

3. Markets are becoming less efficient, not more

The efficiency of markets has been the topic of countless academic papers over many decades. I could write pages on the issue, but will simply make the point here that the more years I spend in financial markets the less efficient I believe them to be. A good example would be the performance of a commodity stock like Anglo American, which was pushed to absurd extremes (the share went from $10 to almost $70) in
the commodity up-cycle before collapsing to even greater extremes (currently $3.50) in the current down-cycle. I would be surprised to hear anyone make the argument that these extremes reflected the underlying, long-term value of a share in Anglo over that relatively short period of time.

The dissemination of information in markets is becoming fairer and more efficient all the time. As a result, I think that markets are extremely efficient at pricing in the short-term prospects of financial assets. But, in doing so, (by implication) they cannot price in their long-term prospects. One can argue that they do one or the other, but not both.

In addition, passive investment vehicles have gained significant market share across the globe and, as forced sellers of assets whose prices have declined and forced buyers of assets whose prices have increased, they tend to render markets less efficient. To add fuel to the fire, the investment industry seems to be increasingly geared to rewarding good short-term performance over time (regardless of that manager’s cumulative long-term performance). The incentive structures in the industry (be they remuneration, performance surveys, media surveys or quarterly client report-backs) all drive home the same message: what matters is how you perform this year!

This is the great opportunity that financial markets offer the patient investor. Markets are atrocious at pricing the long-term prospects of financial assets because short-termism is on the increase. In an industry full of smart people, a surprisingly small percentage of money is genuinely managed for the long term.

This is why we so consistently argue that a long time horizon is the only enduring competitive advantage in financial markets and why it is a cornerstone of Coronation’s investment philosophy. If I go back to all the defining calls in our portfolios over our history, I would credit all of them to the insights and conviction that a long time horizon provides.

The graphs on the right show the alpha of the Coronation Houseview portfolio over its full history. They clearly show how misleading short-term alpha is. Notwithstanding consistent and compelling delivery on a long-term, cumulative basis, our portfolios have underperformed the market in one out of every three years.
However, in every one of those periods, the portfolio actions that caused short-term pain (buying dramatically undervalued assets that were falling, while selling overvalued assets that were rising) were the very same actions that delivered compelling results when the cycle turned.

The investment industry never ceases to amaze me. We all understand that we are managing long-term retirement capital. We all understand that it is the long term that matters. And yet the collective temptation to focus myopically on the short term seems irresistible. If one believes that financial markets misprice assets, then one should expect, not just tolerate, periods of underperformance (as long as the fund manager has a demonstrable track record of delivering over the long term).

Perversely, this groundswell of short-termism is ultimately helpful to our cause. More short-termism means there will be more mispriced assets out there for the patient, long-term investor to profit from.

Whatever the sentiment of the day, our clients can get comfort from the knowledge that we will stay the course. Long-term investing has delivered compelling results for us over long periods and we believe that it will continue to do so in the future.
Taking stock of your portfolio
The 2016 edition.
by PIETER KOEKEMOER

The inevitable period of introspection brought by the change in calendar years is a cue for many purveyors of pop culture to promote reform and fresh starts. At a lifestyle level, the cliché that is the New Year’s resolution may often result in some short-term hardship with doubtful long-term benefits – think of that gym membership that will hardly be used. However, a little bit of occasional effort to better manage your financial affairs can make a significant difference to your long-run outcomes. This article offers some ideas that may prod you into action.

Invest in funds that will allow you to benefit from your future inertia

There is a very good reason why most of our flagship funds are mandated to invest across asset classes. The vast majority of investors are better served by investing in funds that aim to deliver specific outcomes aligned to their specific needs, rather than funds with narrower objectives that limit investments to specific asset classes or market sectors. If the investor has a clear understanding of her needs and invests appropriately, it is a lot easier to remain committed for the long term, especially in more turbulent times. This in turn aligns the investor’s time horizon more closely to our investment philosophy, increasing the likelihood that our investment approach will add value to the returns offered by the financial markets.

The adjacent table contains a reminder of the specific investor needs our multi-asset funds aim to meet:

<table>
<thead>
<tr>
<th>Fund</th>
<th>Investor need</th>
<th>Recommended time horizon</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategic Income</td>
<td>Immediate income (alternative to fixed deposits)</td>
<td>1 to 3 years</td>
</tr>
<tr>
<td>Balanced Defensive</td>
<td>Income drawdown with some protection against inflation (ideal for the second half of retirement)</td>
<td>3 years plus, suitable for funding a long-term income of 4% to 5%</td>
</tr>
<tr>
<td>Capital Plus</td>
<td>Income drawdown with more protection against inflation (ideal early in retirement and for longer-term drawdown programmes)</td>
<td>5 years plus; suitable for funding a long-term income of 4% to 5%</td>
</tr>
<tr>
<td>Balanced Plus</td>
<td>Long-term growth, optimised for retirement savers (subject to Pension Funds Act investment restrictions)</td>
<td>Minimum 5 years</td>
</tr>
<tr>
<td>Market Plus</td>
<td>Long-term growth optimised for discretionary savers measuring outcomes in rands (not subject to Pension Funds Act investment restrictions)</td>
<td>Minimum 5 years; preferably 10 years or more</td>
</tr>
<tr>
<td>Optimum Growth</td>
<td>Long-term growth for investors looking for a balance between local and offshore investments can hold more offshore assets than Market Plus, and more local assets than Global Managed)</td>
<td>Minimum 5 years; preferably 10 years or more</td>
</tr>
<tr>
<td>Global Strategic USD Income</td>
<td>Immediate income in dollars (alternative to dollar fixed deposits)</td>
<td>1 to 3 years</td>
</tr>
<tr>
<td>Global Capital Plus</td>
<td>A balance between long-term growth and shorter term capital preservation for investors measuring outcomes in dollars</td>
<td>Minimum 3 years; preferably 5 years or more</td>
</tr>
<tr>
<td>Global Managed</td>
<td>Long-term growth optimised for discretionary savers measuring outcomes in dollars</td>
<td>Minimum 5 years; preferably 10 years or more</td>
</tr>
</tbody>
</table>
Don’t be fooled by the cycle

We are all prone to emphasise immediate examples when we need to frame choices that will influence future outcomes. Unless we actively guard against this mental shortcut, the so-called availability heuristic, we are likely to make trend-following rather than forward-looking investment decisions. This is a significant risk given current market conditions. In equity markets driven by strong momentum, investors are still happy to own quality defensive global businesses at any price, and are not interested in buying cyclical commodity businesses, energy-intensive producers and many emerging-market companies, no matter how low prices have fallen. For South Africans, the allocation decision is even more extreme given a four-year period of extraordinary rand weakness. This backdrop significantly increases the risk of selling portfolios containing cheap assets to buy portfolios filled with more expensive assets. Times of great dislocation demand a more cautious approach when making changes between asset classes and fund managers.

Understand the interplay between optimising for tax and optimising for investment outcome

While investors should aim to optimise their portfolios for tax outcomes, they should avoid the temptation to remain invested in suboptimal assets merely to avoid paying tax. Tax will always only be a percentage of the rate of return earned. This means that over the longer term, it is typically better to pay some capital gains tax today if this decision enables investment in a portfolio with a higher expected rate or return in the long run.

Understand the taxes applicable to individual investors

SA’s tax system has historically been quite friendly to investors. While capital gains are not indexed for inflation, it is taxed at a significantly lower rate than income. Dividends are also taxed at a reduced rate that is designed to avoid arbitrage on income distributed by companies (already subject to a 28% income tax rate on profits). In addition, unit trust investors can defer tax on their capital gains to the end of the holding period for each fund they hold. As an aside, this deferment is another argument in favour of buy-and-hold investing in needs-based multi-asset funds. Investors also qualify for general exemptions in the case of capital gains (the first R30 000 realised every year is tax free) and interest earned (if you are younger than 65, the first R23 800 is tax free, increased to R34 500 for those older than 65).

Government offers additional tax benefits for retirement savings and through tax-free investment accounts (discussed later in the article). Higher-rate tax payers can also benefit by holding their investments through an endowment structure, currently taxed at a flat rate of 30% on income and 10% on capital gains.

Given the current state of the economy and government’s finances, an increase in all tax rates can be expected over the next few years. However, a fundamental change in the basic approach to tax, outlined above, is unlikely.

<table>
<thead>
<tr>
<th>Tax type</th>
<th>Effective marginal rate for individuals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax (interest earned, rental income)</td>
<td>41%</td>
</tr>
<tr>
<td>Dividend tax</td>
<td>15%</td>
</tr>
<tr>
<td>Capital gains tax</td>
<td>13.65%</td>
</tr>
</tbody>
</table>

Make a once-off contribution to a retirement annuity

The current tax year, ending on 29 February 2016, is the last opportunity for high-income earners to make a tax-incentivised contribution to their retirement savings that is only capped as a percentage of their income. From 1 March 2016, the tax incentive will be capped at a maximum of R350 000 per year, or 27.5% of taxable income, whichever is the lowest. The change in tax incentives for retirement can be interpreted as a redistribution of benefits in favour of those earning less than R2.3 million per year, at the expense of the few earning more. This is the case as the percentage contribution limit has been increased significantly from the 20% or 15% limits.
that historically applied to workplace and personal pensions respectively.

The best way to understand government’s tax deal for retirement savings is to view it as a deferment of tax in exchange for certain liquidity and investment restrictions. While you get to contribute pre-tax money and pay no tax on any investment gains during your investment holding period, you will pay tax when you eventually start drawing benefits. This is referred to as an ‘exempt, exempt, taxed’ (EET) incentive system.

Currently, the first R500,000 of any lump sum taken at retirement is tax free, with tax charged at the average rate (up to 36%) on the balance. All retirement income drawdowns are taxed at the prevailing rates in the year of payment.

The obvious risk of this model is that your future tax payments are uncertain and depend on the tax policy adopted by the government of the day, often decades into the future. In addition, government gets to make the rules with regards to what you can invest in and when you can access your capital.

Investors in a retirement annuity can only access their capital at age 55 (or at the point of emigration), and must use two-thirds of their accumulated pension pot to buy an income in the form of a living or underwritten annuity. Current investment restrictions allow a maximum of 25% offshore exposure, 75% equity exposure and 25% property exposure.

Open a tax-free investment

The recently introduced tax-free investment accounts provide arguably the best investment vehicle for the first R30,000 invested annually, especially for long-term investors. This vehicle operates on a ‘TEE’ basis (contribution is made from money already taxed, no tax is accrued during the investment period and all proceeds taken from the investment are tax free). It therefore gives you complete tax certainty, as your investment will not be subject to future changes to tax rates.

Unlike retirement savings, there are also no investment restrictions on asset classes (although you are currently not allowed to invest in any funds with exposure to manager fees that are performance related). These accounts can also be opened for minors, who are best placed to benefit from ultra-long compounding periods.

Its major downside is that your investments are subject to annual and lifetime limits of R30,000 and R500,000 respectively. Once you have withdrawn money from your tax-free accounts, it cannot be replaced with new contributions beyond these limits without incurring very punitive tax penalties.

Externalising assets: still a good idea?

If you decide to sell local assets and buy foreign assets in early 2016, you should only do it because you still believe that global assets offer more value than local assets over the next several years, not in response to the rand’s already significant devaluation.

With the rand trading at around R16.50 to the dollar and R24 to the pound at the time of writing, this decision may cause some short-term regret if the currency recovers from current oversold levels. We do, however, remain of the view that over the longer term, foreign assets will continue to be likely to outperform local assets.

Also note that the decision between SA and global assets is different from deciding whether you want to hold your foreign assets in a rand-denominated fund or externalise your investment by using your individual foreign investment allowance.

The key benefit of externalising rands is that you are better protected against sovereign risk, meaning that it is less likely that you may fall victim to capital controls during a balance of payments crisis, which is typically when you would most require the protection of holding foreign assets.
Summary

You may be able to enhance your investment outcomes by applying the following checklist to your portfolio:

- Ensure you are invested in the multi-asset funds with objectives aligned to your needs, then make inertia work for you.
- Don’t be fooled by the cycle. Only make changes to your portfolio if your needs have changed, not in response to recent market movements or performance experience.
- Don’t hold on to inferior investments just to avoid paying capital gains tax. Paying some tax now and rather owning assets with higher expected rates of return will optimise long-term outcomes.
- Make use of your general tax allowances. You can invest R360 000 (or R530 000 if you are over 65) in the Coronation Strategic Income Fund without paying tax on the interest earned, assuming an interest rate of 6.6% and no other holdings. This tax benefit provides good cover for a conservative emergency fund investment allocation.
- Commit the first R30 000 of your annual long-term investment programme to a tax-free investment into a suitably long-term orientated fund such as Coronation Global Managed.
- Consider opening tax-free investments for your minor children and grandchildren and give them the gift of compound growth.
- If you are a high-income earner without a workplace pension fund, consider a once-off contribution to a retirement annuity fund invested in the Coronation Balanced Plus Fund.
- If you have more than R250 000 invested in a rand-denominated offshore fund, consider using your investment allowance and externalise your rands.

If you are unsure about the appropriate course of action, we suggest that you consult with your financial advisor. If you do not have one, you can find an independent and qualified advisor via the Financial Planning Institute’s website at www.fpi.co.za.
One of the greatest changes in investor behaviour in the 21st century has been the rise in responsible investment, and the increasing demands on boards of directors and management to be held accountable for their actions. A number of factors have contributed to the immense investor focus on ensuring that all Environmental, Social and Governance (ESG) matters are appropriately dealt with by the companies they are invested in. These contributing factors include the challenges (including climate change and pollution) facing the world economy, the fallout of the global financial crisis (and the behaviour that precipitated it) as well as the debate around income inequality and the rising popularity of social commentators like Thomas Piketty.

The greater the length of the investment horizon, the far greater the impact ESG will have on the value of the business. Short-term investors who regularly buy and sell have little or no interest in ESG as it will not impact the value of the business during their investment horizon. They will in fact often chase harmful policies which may ‘unlock’ a quick profit in the short term. These policies and the failure to make correct but difficult decisions (that might impact short-term profits, but enhance long-term value) will destroy meaningful value for all stakeholders in the long run.

With the increased focus on ESG, there is the increasing risk that this becomes a mere box-ticking exercise that easily meets the stated requirements of responsible investing, but fails to truly deal with the spirit of responsible investing. Particularly troubling is the diverting of ESG responsibility away from investors towards ‘specialist’ ESG management companies, which may have an inappropriate focus on metrics and fail to understand the nature of a business, or even the key issues of the country. Many foreign investors will outsource their ESG to international firms who may not be sensitive to the demands of local stakeholders. For example, the concept of black economic empowerment (BEE) in South Africa, which is often quite alien to foreign investors, needs to be handled in an appropriate manner so that it is genuine, targets the appropriate communities and stakeholders, and is set up in a manner that is sustainable and spans a timeframe that is long enough to ensure benefits to all stakeholders. None of this is easy, and certainly won’t be obvious to third-party ESG managers who have had little or no exposure to the actual business or have not been exposed to South African policies over the past 20 years.

At Coronation, we believe the valuation and handling of ESG should be managed by the fund manager, who has a better understanding of the complex issues that underpin each individual company. As long-term investors, it has always been an important part of our investment process to fully factor in the impact of environmental and social issues, and to ensure that the companies we are invested in maintain high standards of corporate governance. These are issues that may not have a short-term impact, but become clearly evident over longer time periods, which is why it has always been a focus area for us. As the emphasis on responsible investing has increased, we have responded through greater engagement with companies and ensuring that all of these interactions are fully documented. Our voting record is now publicly available online for all stakeholders to see, as we comply with the requests for not just greater involvement in ESG but also greater transparency.
In order to understand our process, one has to start with our inherent investment principles and how ESG issues form part of an investment case, as well as examine the ongoing responsibilities of a responsible investor.

In line with our investment philosophy of investing on long-term fundamentals, we will forecast the long-term earnings potential of a business in order to assess its implicit valuation. Each business will face its own unique set of environmental and social circumstances which may have an impact on future cash flows. These need to be examined carefully, especially as hard numbers and details may not be available. Painstaking consideration is given to understanding how these should be appropriately factored into forecasts.

The brewing industry on the continent is an example of where there are many issues to be considered, not all of which may be obvious at first glance. Clearly, alcohol abuse and underage drinking are some of the key concerns expressed by civil society when it comes to making investments into the brewing industry. How this is addressed through spending on awareness programmes and counselling about the dangers of alcohol abuse, is easy to measure. What is more difficult to factor in, is the impact across the broader society. Establishing a brewery requires access to crucial resources like clean water. This can be a drain on a country’s scarce resources. But if properly managed, it can be a huge positive as the brewery puts in place facilities to ensure clean water supply that service not just the brewery but surrounding communities, resulting in reduced infant mortality, etc. Similarly, the strategy followed by most brewers is to localise production of agricultural inputs, often through extensive farming projects that provide skills to local farmers as well as start-up capital and funding, with clear positive spin-offs for the surrounding communities.

Once all the factors relating to environmental and social issues have been considered, these are documented and factored into our models, and the valuation is calculated. Based on this outcome, the investment decision is made. Very importantly, it is not our role to exclude investments based on personal views on ESG issues. Each investor may have certain criteria informed by their religious or cultural beliefs, or by their background. These are specified upfront in their investment mandate, which will then define the universe of companies we can invest in. It would be inappropriate and wrong to use our own biases to exclude investments that could deliver a meaningful return for investors and to other stakeholders. An example of this would be making an investment in a South African coal mine. While coal is clearly a concern in a world where carbon dioxide growth is a major issue, SA is still heavily reliant on coal for its power generation. The impact of power outages on the local economy is well known. Power shortages also have major socioeconomic effects, which raises a host of other ESG issues. Then consider that a local mine will employ thousands of local workers and procure from local businesses, with positive spin-offs for these communities. The investors whose funds you are managing may be mineworkers or employees of the power utility who stand to directly benefit from the investment. The ESG process is clearly not straightforward and needs to handled sensitively. A simple standardised approach will not do.

The golden thread that links all of this, however, is governance – probably the most crucial area of focus. Boards and management are in an agency position, managing assets on investors’ behalf. They should be held accountable to high standards. Since strategy and accountability start at the top, governance is crucial in managing a business, which includes the proper management of environmental and social issues. Governance is the cornerstone upon which the foundation of a company is built. Any weakness in this area, and all parts of the investment case, whether pure valuation or the handling of environmental and social issues, are at risk.

Coronation engages regularly with the boards and management of the companies it is invested in. All these engagements are documented to ensure detailed record-keeping and accountability for boards, as well as for investors to be fully informed as to how their investment is being exercised in the interests of good corporate governance.

When there are specific concerns, our first approach is to engage with management to deal with the respective issues. If this fails to deliver the appropriate action, we then escalate the issue to the board. When governance issues emerge, we do not believe selling out of a company is an appropriate first response. This runs the risk of incurring losses on the investment, and fails to live up to the demands of being a good corporate citizen, who should strive to ensure that companies are applying the correct standards of governance for the protection of all investors.
If we are not satisfied by the board’s response, we will then exercise our rights as shareholders in a general meeting to vote in a way that ensures the board will listen to our governance concerns. Clients often ask why we typically are not seen to lodge opposing votes at AGMs – the reality is that we often engage extensively with boards and management well ahead of any votes. We want to ensure that our concerns are dealt with before the vote. It is only in those cases where the company refuses to take our suggestions on board, that we do end up voting against resolutions.

By far the most common governance issues are the use of capital and its allocation (including share issuances and buybacks), remuneration and BEE deals. In all of these cases, the specifics of each individual company are relevant and a simple template approach does not suffice. Early engagement around remuneration plans and potential BEE deals ensures alignment of all stakeholder interests. Very importantly, we will not interfere in the running of a business. We are cognisant of where our skill set lies, and what the responsibilities of management and the board are, against our role as investors. Where necessary, we will look to appoint an independent director to a company’s board where we recognise there is a particular gap in that board’s capabilities. These directors are typically retired but experienced business people who we believe have the appropriate skills to add value to the company for all shareholders.

In the event that all these interventions fail, we will look to remove board members who we believe are not exercising their fiduciary responsibilities in shareholders’ interests. This is always the last resort and, given the reputational impact, not something that we do lightly. We will always approach the board and the individuals upfront and deal with this process in a professional manner. Ambushing directors at an AGM with a surprise vote is not in our opinion acting in investors’ or the company’s best interests.

All elements of ESG are critical in forming an opinion on the long-term value of a business, and managing the ongoing relationship between the business and all its stakeholders. At Coronation, we believe it is crucial to involve all elements of ESG into our valuation and monitoring a company’s ongoing compliance. However, it is not something that should be approached via a simplistic ‘one size fits all’ approach, but with the careful consideration of each business and how that business fits into the fabric of South African society.
A vicious cycle

Why SA markets were crushed.

by CHARLES DE KOCK

2015 was a brutally tough year for South African investors.

To understand why conditions have been so harsh, a historical perspective spanning the past 15 years is required. This will also help inform some observations (not predictions) of what one may expect going forward.

The boom years

The early 2000s were marked by a strong global economic growth cycle. In the developed world, growth was fuelled by easy credit. The reputable Bank Credit Analyst (BCA), a Canadian-based research house, dubbed it the debt supercycle. This period was marked by rapid expansion, and in several countries such as the US, Spain, Ireland and Portugal to name only a few, it eventually led to property bubbles. All cycles eventually turn (more about this later) and this one was no different. The debt supercycle started to falter with the sub-prime crisis and finally ended abruptly with the collapse of Lehman Brothers in September 2008. This heralded the start of the global financial crisis that effectively ended the strong global growth cycle.

Up to that point, the emerging world also experienced rapid economic growth, led by the juggernaut Chinese economy. Rapid urbanisation in China demanded massive infrastructure spending, creating a huge demand for cement, steel, iron ore, copper, coal and virtually all other commodities. The world was thus experiencing a strong synchronised growth phase. In the developed world it was driven by a large build-up of debt, while the emerging world was powered by a Chinese-fuelled commodity boom.

The zero interest rate world

The reaction from monetary authorities in the developed world to the financial crisis was to cut interest rates to zero. And when that failed to deliver the required growth, the US Federal Reserve (Fed) under chairman Ben Bernanke embarked on an aggressive programme of quantitative easing by buying billions of dollars in government debt, adding massively to US money supply. The EU was slower than the US in its response to the crisis but in the end, under the leadership of Mario Draghi, followed. Eventually the entire developed world had a zero interest rate policy.

Meanwhile the Chinese, reeling under a sharp decline in demand for their manufactured export products, tried to stimulate their economy by embarking on an accelerated infrastructure spending programme. The result was another leg-up for commodity producers, most of which are in the emerging world.

For the next few years, the emerging world grew at a far quicker pace than developed countries. Unsurprisingly, investors found superior opportunities in emerging markets and shunned investment in the developed world where growth was very weak and interest rates extraordinarily low. The result was massive portfolio flows to emerging markets. Emerging currencies strengthened; to such an extent that in the case of Brazil, a tax on foreign investments was even imposed to curb the strength of the real.
The party ends

Cycles are not permanent and the perfect conditions for the emerging world were not going to last forever. The first sign of what could be expected when the cycle would eventually turn was the so-called taper tantrum that followed Bernanke’s indication that the policy of quantitative easing would not continue at the same pace indefinitely. He said it would taper off and end when the Fed felt it was appropriate to do so. Emerging market investors were spooked by his remarks, resulting in a major correction in currencies, bond yields and stock prices. Bernanke made his ‘taper speech’ in May 2013. The tantrum that followed was short-lived and emerging markets recovered, but it was the perfect preview of what was to come. The party (of capital inflows into emerging markets) was drawing to a close.

The US recovery was slow, but the Fed did eventually taper and finally stopped quantitative easing altogether. They also hiked interest rates for the first time in December 2015, thereby signalling a slow start to the long-awaited process of gradually normalising interest rates. This move was widely anticipated and did not cause a ripple in financial markets. The damage to emerging markets was already done in the lead-up to the hike.

China also experienced far-reaching change, with its economic growth slowing from around 10% per annum to the current level of more or less 6%. The nature of its growth is also shifting from being massively orientated to infrastructure spending towards being more consumer-driven. The slower growth in infrastructure spending has had a severe negative impact on the demand for steel and other commodities. The commodity cycle has swung from boom to bust and commodity producers such as South Africa have been hard hit.

In assessing these developments, a few observations on cycles need to be kept in mind:

- All cycles end, but predicting the timing of a cycle's demise is near impossible.
- The current economic cycle is marked by a strong US dollar, generally weak global economic growth, very low inflation and extremely low commodity prices.
- Emerging markets and their currencies, as well as commodity producers, are currently despised in the financial markets while high-quality defensive stocks have become investor darlings.
- Investing with the momentum cycle (rather than value investing) has been the winning style.
- This cycle will end.

The South African perspective

As a small and open economy, South Africa cannot avoid the global economic trends. We also experienced strong economic growth in the early 2000s. Soaring platinum and other commodity prices led to high profits for miners and tax windfalls for the government. Then, in the aftermath of the global financial crisis and the zero interest rate world as described above, South Africa benefited from the favourable commodity and emerging market cycle. The rand, like many other emerging currencies, was strong as portfolio inflows were steady and financed a wide current account deficit. Then, as China slowed, commodity prices declined and emerging countries experienced a reversal of capital flows. As a consequence, the rand tumbled, the trade balance worsened and the government’s finances took a turn for the worse.

What made matters far worse for South Africa was that despite the significant deterioration in the global macroeconomic climate, government did not adjust its spending pattern at all. Salaries of civil servants kept rising year after year at levels way ahead of inflation, leaving very little for spending on infrastructure and thereby limiting future potential growth. The years of inadequate spending on maintaining and improving the country’s infrastructure started to show, with problems emerging in generating sufficient electricity. The current drought is unfortunately also going to confirm the inadequacies of our water infrastructure. The combination of lower growth
and deteriorating fiscal deficits, as well as a weak balance of payments, prompted ratings agencies to downgrade our credit rating.

Then, on top of a very difficult macroeconomic environment, the axing of finance minister Nhlanhla Nene and what followed over the next few days, had a severe impact on investor confidence. Yields on government bonds soared, the rand plummeted and domestic stocks crashed.

**What to expect going forward**

The strong dollar and weak commodity cycle will turn at some point. Cycles are after all not permanent, but looking at the world today I am not hopeful that faster global growth is around the corner. South Africa desperately needs stronger growth and in the absence of an export-led recovery it is imperative that government changes course in its spending patterns. The fiscal deficit has to be shrunk and domestic growth has to improve for us to avoid being downgraded to junk status. Government will have to hike taxes and curb its current expenditure. It will have to stop the bleeding at state-owned enterprises, which are appallingly managed at a massive cost to taxpayers. The drought has also come at a particularly bad time.

There is no dispute that 2015 has been tough for all emerging economies and for commodity producers in particular. In the case of South Africa, this has been exacerbated by excessive current expenditure by government and compounded by the failure of Eskom and other state-owned enterprises, which impacts confidence and limits growth. It is not too late for government to show it can take corrective actions to prevent the country slipping to junk status, but time is running out fast.
Omnia

Growing leading businesses.

by Alistair Lea

Established as a small distributor of lime in 1953, Omnia has emerged as the dominant supplier of fertiliser to the South African agricultural industry, and the most profitable manufacturer of explosives in the country. We believe the share is attractively priced and largely shielded from some of the biggest problems facing South African businesses, as will be explained.

Omnia’s two biggest divisions, Omnia Fertilizer and the explosives group BME, make up 93% of group earnings and are best in class in their respective industries. This certainly wasn’t the case 20 years ago. These divisions have been superbly managed and positioned by an astute management team with a view to building long-term winning businesses.

Omnia’s fertiliser business

Historically, the fertiliser industry in SA was dominated by Kynoch (owned by JSE-listed AECI) and Sasol, which both manufactured fertiliser locally. Ammonium nitrate is a component used in both fertiliser and explosives, which explains why AECI, the owner of African Explosives (AEL), became involved in fertiliser. Sasol produced ammonia as a by-product of its chemical processes at Sasolburg, so it made sense to convert it to ammonium nitrate. Omnia became the third entrant to the market in 1967 when it built a granulation plant in Sasolburg, and then a first nitric acid plant in 1982.

AECI exited the fertiliser industry in 2000, selling to Yara, the largest fertiliser company in the world. Today, Yara is a negligible player in the market, and does not manufacture locally.

In 2010, the Competition Commission fined Sasol’s fertiliser business for anticompetitive behaviour, and barred Sasol from having retail operations. Going forward, Sasol will continue to be a manufacturer and wholesaler only. This disruption to Sasol’s business benefited Omnia, especially considering both companies manufacture the same product: limestone ammonium nitrate.

As a result, Omnia has progressed from a distant third player in the market to the undisputed leader, with a market share of approximately 50%, according to our estimation (market share data for the industry are not published). This expansion in market share is evidenced by the phenomenal growth Omnia has achieved in its sales volumes, in what is essentially a flat market. In the past seven years, Omnia has grown its fertiliser volumes by 75% (or 8.3% per annum), while the overall market has expanded by 7.4% (or 1% per annum). If one assumes Omnia had a market share of 30% in 2008 (our estimate based on discussions with industry players), its market share today would be 49%.
Why has this business been so successful?

Good management. Omnia has a very competent management team, led by CEO Rod Humphris. The team has made some astute and well-timed investment decisions that have contributed significantly to the success of the fertiliser division. In 2011, they raised R1.4 billion in debt and equity funding for an investment in a second nitric acid complex. At the time, management estimated that the cost of the nitric acid plant was roughly half of what similar plants had cost in other geographies a few years earlier. This was due to the fact that the pricing on the imported equipment for the plant was negotiated in the aftermath of the global financial crisis, when demand for such equipment was weak, and when the rand traded at between R6 and R7 to the dollar. The plant was delivered on budget and on time, rare for a project of this size.

The nitric acid plant provides Omnia with a source of ammonium nitrate, an essential input for both the fertiliser and explosives divisions. The investment would not have been feasible based on the ammonium nitrate demand from the fertiliser business alone, demonstrating the benefit of owning an explosives division as well. None of Omnia’s competitors – except perhaps Sasol – has the same advantage.

Superior product. Omnia manufactures a nitrate-based fertiliser called limestone ammonium nitrate (LAN). Phosphates (chemical symbol P) and potash (K) are then added to the LAN to produce an NPK compound, resulting in each granule of fertiliser having the correct ratio between nitrogen (N), phosphates and potash.

Omnia’s main competitors sell fertiliser based on urea, an organic compound containing nitrogen. This is either added to the soil on its own, or mixed with phosphates and potash to create a blend. The latter results in a bag of fertiliser that contains separate granules of N, P and K. Even distribution of each chemical across the land is therefore not guaranteed.

Nitrates are considered to be a more effective product than urea, for the following reasons:

- Due to the higher concentration of nitrogen in urea, it can burn the plant seed on contact.
- Urea needs to be converted to ammonium nitrate before it can be absorbed by plants. This process is performed by bacteria in the soil, but it takes time. As such, the nitrogen from urea is not immediately available to the plant.
- Urea is more unstable than nitrates. If left exposed to the sun on a hot day, it can break down and lose 40% of its nitrogen content.

Independent research shows that nitrate-based fertilisers can result in a 20% better crop yield than urea-based fertilisers.

Strong service model. About 90% of Omnia’s fertiliser sales are direct to farmers, and high levels of service are offered.
Omnia employs a team of agronomists who work with farmers in devising solutions for their fertiliser needs. In contrast, importers tend to adopt a pure wholesaler model and do not have the agronomy skills to advise and service their clients in the same way. This has become a significant advantage for Omnia.

**Omnia’s explosives business**

The growth in Omnia’s explosives business has been equally impressive. In 1987, it acquired an explosives manufacturing business, Bulk Mining Explosives (BME). As with the fertiliser business, BME was a distant third player in the market ten years ago, behind Sasol and AEL (owned by JSE-listed AECI). Today, while not the biggest explosives business in the country, it is certainly the most profitable. If we take the combined profits of the two largest players in the market, and express Omnia’s profits as a percentage of this profit pool, Omnia has grown its share of profits from around 20% in 2001 to 70% today.

How has this been achieved?

A focus on the only expanding sector of SA’s resources industry: open-cast mining. BME’s main line of business is the manufacture of emulsion explosives (or bulk explosives), as opposed to packaged explosives (or shock tubes). Emulsion explosives are essentially delivered to a site in liquid form and poured into a hole before being ignited by a detonator chord. These explosives are used in open-cast mines, whereas packaged explosives are used in underground mining applications.

Open-cast mining has grown significantly in South Africa, whereas underground mining has contracted. This is due to the high cost involved with underground mining relative to open-cast. BME has therefore been positioned in the growing part of the market.

Access to ammonium nitrate. The core ingredient in explosives is ammonium nitrate, which is produced by the chemical reaction between ammonium and nitric acid. Building a nitric acid plant is, however, very expensive. Omnia spent R1.4 billion in 2011 and 2012 to establish their second nitric acid plant. This quantum of capital expenditure could partly be justified by the ammonium nitrate demand from two separate businesses, which meant that the new plant could operate at sufficient capacity to cover overheads and generate profits from day one. According to management, the new nitric acid plant operated at 60% capacity in its first year, which means that Omnia will have many years of growth before full capacity is reached.

Many of Omnia’s competitors do not have complementary businesses in explosives and fertilisers, and are therefore not able to achieve the same economies of scale. This is one of the reasons why BME generates far superior operating margins than its closest competitor, as shown in the following graph.
Less cyclical than assumed

Omnia is often regarded as a highly cyclical company due to its exposure to both mining and agriculture. While it is cyclical, we argue that it is significantly less so than, for example, a mining company or a sugar producer, for the following reasons.

Omnia’s fertiliser business is impacted far less by drought than a farmer or grower of crops. This is because the farmer typically plants his crop at the start of the season, making use of fertiliser, and then waits for the rains to fall. If drought conditions follow, the farmer suffers significantly, whereas the fertiliser company has already sold the bulk of its product. Yes, a drought is not good for the fertiliser company because of the negative impact on its customer base, but it is not nearly as damaging as it is for the farmer. This is borne out by the statistics for South African industry-wide fertiliser sales, which show a remarkably stable level of sales around the 2 million ton level for the past 32 years.

Similarly, an explosives business is far less cyclical than a mining company. An explosives business is not directly impacted by cyclical commodity prices unless the prices fall too low for a mining company to operate. What is important to an explosive company is the volume of ore being mined, which is essentially a function of the demand for the particular commodity. This demand, while still cyclical, is far less so than the commodity price.

According to Omnia’s latest interim results, BME’s volumes did decline significantly (by 21%) due mainly to the loss of two large contracts. However, the business remains very profitable, whereas the same cannot be said for many of its mining customers.
Conclusion

We are not bullish about the prospects for many South African-based manufacturing companies at the moment. Rising electricity prices and an unstable labour market are just two reasons why local manufacturers have struggled so much. Omnia, however, is largely shielded from these two issues. The company produces a significant amount of its own electricity from its nitric acid plants, and many of its facilities are automated and require limited human intervention.

Omnia is a business that has been carefully and strategically built over many decades, such that it now has a few significant competitive advantages over its competitors:

- Having both a fertiliser and an explosives business gives it both scale and flexibility in the manufacture of ammonium nitrate, an important input in the products of both divisions.
- Omnia timed the construction of its second nitric acid plant to perfection, and it was established at a fraction of what the plant would cost today. This gives the company a significant cost advantage relative to its competitors.
- Omnia management has always built their business with a long-term vision in mind, and as shareholders in the business themselves, are well aligned with institutional investors such as ourselves.
- Omnia has a well-capitalised and healthy balance sheet. The company has low levels of debt, and should be in a net cash position by the end of its March 2016 financial year.

These factors set Omnia apart from its competitors and should result in continuing market share gains for the company.

Lastly (but not least), all of its businesses price off US dollar commodity prices, and therefore benefit from a weak rand. Its customers will also benefit significantly from a depreciating currency.

The share is attractively priced at less than a 10 times forward price earnings ratio (by our estimates) amid the current drought conditions in SA and the huge uncertainties in commodity markets. We believe that the current valuation offers an opportunity for long-term investors to become shareholders in this quality company. It is one of the few shares exposed to the SA economy that we are comfortable holding.
SA economy

Poor prospects and tough choices.

by MARIE ANTELME

For a long time, South Africa has managed to attract sufficient foreign investment to meet the shortfall between domestic saving and the investment needed to fund growth. Investments in South African equities accounted for most of these foreign flows, although fixed income has also grown materially in the period following the global financial crisis. During this time, low global growth and policy rates drove investors to search for higher yield, often in increasingly challenging markets. However, very little foreign money found its way into fixed assets, such as new or existing infrastructure, on a consistent basis. There have been short periods when foreign investors withdrew capital and the currency came under pressure; however, the outflows have not generally been sustained and investors have returned.

The type of foreign investments that South Africa attracts is instructive. Foreign investors have put money into financial market instruments such as bonds and equities, taking advantage of superior returns, or high yields. But they are unwilling to commit capital to greenfield investment – either because the anticipated future return does not warrant the investment, or because there is not a big enough incentive to offset some of the risk. Equities and bonds are also more liquid and much easier to buy and sell.

An important influence on these investment flows has of course been South Africa’s own financial market, which is large relative to GDP, even among developed economies. There are obviously many other things that influence performance, including the standard of management, and the regulatory
environment in which the economy operates. The quality of the economic institutional infrastructure, regulation, financial monitoring and reporting, taken together, provide an important underpin to investment appeal.

Unfortunately, the financial market performance has not always been a reflection of strong underlying economic performance. The South African economy has persistently underperformed its peers, even in the pre-crisis boom periods, earning a reputation as ‘an emerging market with a developed economy growth rate’. This has only worsened in the post-crisis world. The problem is that the country still has significant economic and social challenges and its ability to address these challenges is increasingly restrained by its low growth rate that fails to generate sufficient employment and productivity. Even with (or without) the best intentions and well-constructed policies, interventions to help stimulate growth require funding and effective implementation.

Of the 189 countries surveyed in 2016, 122 economies improved their rankings. However, South Africa’s overall rank fell four places in one year, from 69 to 73. Not all subcomponents deteriorated; some other countries simply did better. A closer look at South Africa’s score shows ‘macro’ indicators remain weak – the weakest being ‘getting electricity’, with an overall rank of 168; registering a property fell to 101 from 97; starting a business fell from 113 to 120; enforcing contracts declined to 119 from 117; and trading across borders was unchanged at 130. Disappointingly, South Africa’s best-scoring indicator, a ‘micro’ indicator that measures the protection of minority investors, remains very high, but fell to 14 from 12 as other countries outpaced South Africa.
Comparing South Africa to its emerging market peers, as well as the direction in which South Africa’s scores have moved, is very discouraging. It is clear from the survey that each economy has its challenges and is positioned at a different level of development, but South Africa needs to compete with all of them to attract the capital flows it needs to fund growth. And if South Africa’s policymakers are serious about stronger, more inclusive growth, the World Bank data show very clearly which indicators need to improve in absolute terms, and where the relative performance has deteriorated because other economies and policymakers are formulating and implementing policies to improve the business platform.

South Africa competes with other countries for investment flows, and even local investors who cannot freely invest in other countries can still choose how to invest their money. This has become even more important when globally economic uncertainty is very high. At the start of 2016, the growth prospects for South Africa in the year ahead are poor. Not only did the economy narrowly avoid a technical recession in 2015 with mining and agricultural sectors contracting, but the global environment remains challenging, with modest growth expected from the US and Europe, while weakness in China is keeping pressure on commodity prices. Domestic household spending cannot grow without an acceleration in employment or salary increases. Public sector wages will rise again this year, but at a slower real rate than in 2015. The private sector remains constrained; companies are not hiring and rising pressure on profitability will constrain their ability to raise salaries. Capital investment is under pressure as commodity prices continue to fall, capacity utilisation is low and business confidence is at its weakest level since 2010 and, on the public side, implementation remains relatively poor. Electricity capacity keeps being rolled back, and the proposed nuclear programme raises more concerns than confidence at this stage.

The net effect of the aforementioned is a slumping currency, which also reflects not only falling commodity prices, but a reassessment of investors’ faith in the underlying institutional fabric which has to date largely been taken for granted. Inflation is likely to be higher as a result, with some risk that the central bank sees a further deterioration in the inflation outlook and raises the repo rate more than it might have if the currency had not weakened so much. Bond yields have risen, raising the cost of funding in the economy, and importantly, the government’s debt service cost. This in turn means that the government may have to try to raise more money at more expensive rates, or have to cut back on spending to finance its existing, growing stock of debt at current levels. The weaker currency should help reduce the external deficit, but global growth continues to weigh. These changes also are not likely to encourage investment.

What might help? Unfortunately turning this situation around will not be easy or comfortable. The biggest immediate challenge is to restore some confidence that the economic management of the country is in steady, safe hands. Much of the burden now lies with the National Treasury to address the economy’s biggest vulnerability: the deteriorating fiscal position and the political dynamics driving fiscal policy. For people to really believe that government is serious about its commitment to sustainable and responsible fiscal policy, the reappointed minister of finance will have to stick to a tough path of consolidation amid a much more challenging investment climate.
The All Bond Index (ALBI) suffered a torrid end to 2015 as it lost 6.67% in December, which dragged down returns for the fourth quarter and the year to -6.43% and -3.93%, respectively. There was no safe place to hide on the bond curve as yields widened across the curve by approximately 125 basis points (bps) during the quarter (and some 175 bps over the year). Bonds with maturities of longer than 12 years were worst hit, losing 7.04% in 2015, while the one-to-three year area of the curve outperformed and delivered 4.1%. The index itself experienced significant changes during the course of the year as its weighting of bonds with maturities of longer than 12 years increased from 36% to 51%. As one would expect, the riskiness (as measured by the modified duration) of the index increased from 6.54 (at the start of the year) to a peak of 7.17. However, following the sell-off in the final months of the year, this has settled at 6.52. Still, the fortunes of the index will continue to remain largely a function of longer-maturity (more than 12 years) bond performance.

2015 was a difficult year for emerging markets (EM), and specifically for South Africa. The global environment was plagued by concerns of a more pronounced slowdown in China, a European economy still struggling to lift itself out of recession and the effects of the first interest rate hike in the US following the financial crisis in 2008. The commodity slump that followed continues to cloud the outlook for many EM countries. These factors, combined with high levels of uncertainty (as reflected by the increase in asset price volatility), left EM currencies battered. South Africa, unfortunately, did very little to differentiate itself in a positive way from its peer group. Its deteriorating growth outlook, along with concerns around government finances and an increase in both socioeconomic unease and political uncertainty, contributed to a slump in the rand over the course of 2015. This weighed on local government bonds, and intensified negative sentiment during the last quarter of 2015, resulting in a significant widening of these yields.

The outlook for local bonds during the course of 2016 will be dictated by three major factors: the outlook for global bond yields; the outlook for local inflation (which could see further deterioration given the persistent drought in most of the country and the significant rand decline); and the risk premium that needs to be priced into local assets given the political landscape.

To assess the current investment case for local bonds, the end of the third quarter of 2015 is a useful point of reference. In our assessment of the fair value of bonds, we use the ten-year US bond yield as a proxy for global bond yields, the difference between inflation expectations in the US and SA as measure for the inflation premium and the SA sovereign spread as proxy for SA’s risk measure. At the end of September 2015, these were 2.04% (ten-year US bond yield), 287 bps (SA sovereign spread) and 4% (expected one-year inflation differential between the US and SA), which together indicated that the fair value for the ten-year SA government bond was around 8.9%, compared to its actual level at the time of 8.6%. This suggested that local government bonds, although not cheap, were relatively close to fair value. Consequently, as we stated in the previous Bond Outlook, any widening in yields would warrant an increased allocation to local bonds. However, given the events of the last quarter of 2015, some of the valuation metrics have seen such significant change that an adjustment to our expectations of fair value, and hence our view on SA government bonds, is warranted.
The first major factor to take into account is the US rate-hiking cycle, where the focus has shifted to the breadth of the cycle following the first increase. The Fed has indicated that rates will only increase by some 75 bps during the course of 2016, which is in line with current market pricing. The recent further decline in energy prices, a strong dollar and new indications of a further economic slowdown in China are bound to keep the Fed relatively cautious during the year. Inflation remains well below the Fed’s 2% target; however, the economy is very close to full employment with growth expectations close to 2.5% for 2016. This implies that the current ten-year US bond yield of 2.3% may be a bit optimistic. Clearly, a level of conservatism should be incorporated into expectations. Also, a slightly higher risk premium should be priced in since much of the lower commodity prices are already baked into baseline readings and expectations. Consequently, a fair value range for the US ten-year bond yields of between 2.5% and 3% seems more appropriate.

SA inflation has been relatively well-behaved over the last year. Falling oil prices and limited pass-through from the weakening rand have helped keep both actual and expected inflation fairly contained. The SA Reserve Bank (SARB) expects inflation to breach the target band in the first quarter of 2016, averaging just over 6% for the year. These expectations were based on assumptions of an electricity price increase of 12%, an oil price of $56, slightly lower world food prices and a weakening in the real effective exchange rate of 4% (as at the November meeting of the monetary policy committee). Since then, the rand price of oil has moved lower by 5%, the rand is 11% weaker, white maize prices have increased by a whopping 50% and the outlook for the second-round effects of higher food prices has deteriorated. The food component of the consumer price index (CPI) represents just under 15% of the basket, implying that the risks to current inflation expectations are firmly to the upside and that the expected inflation average of 6% for 2016 is too benign. A more prudent and realistic expectation would be an inflation average of 6.3% to 6.5% for 2016. Growth and its underlying components have and will continue to remain weak, hampering the ability to pass on price increases to the consumer. Furthermore, the lower growth prospects will continue to restrict the SARB from acting as aggressively as it would like to limit the second-round effects of a persistent breach of the inflation-targeting band.

Current market levels suggest that the repo rate will rise close to 200 bps (bringing the repo rate to 8.25%) during the course of 2016 as the SARB will be forced to act on its hawkish rhetoric. While this would seem like a fair expectation in any other cycle, it is very difficult to see such rate hikes over the next year given the poor growth backdrop. We expect that a repo rate of between 7.25% and 7.5% (hikes of between 100 bps and 125 bps) will be more palatable for the ailing local economy.

Lastly, SA’s risk profile has been significantly elevated relative to its peers following the replacement of finance minister Nhlanhla Nene. Although the reappointment of Pravin Gordhan, a former finance minister, did bring some calm to the markets, it is highly unlikely to expect the risk premium to decrease in the run-up to the February budget. All eyes will be on the new finance minister, and how willing and able he is to take on fiscal consolidation.

A very dark cloud is hanging over SA’s fiscal future. In the following graph, it is clear how SA’s sovereign spread jumped higher during the December period, highlighting the market’s increased scepticism over the political will to get the economy on a better footing. Going forward, a reduction in the country’s risk premium is highly unlikely and a level of 325 bps to 350 bps seems appropriate given the current political and socioeconomic climate.

**CREDIT-DEFAULT SPREADS VS MOODY’S LONG-TERM FOREIGN RATING**

*Source: Bloomberg*
When the drivers of the various valuation metrics are adjusted to reflect the new realities – resulting in a 2.5% to 3% ten-year US bond yield, a 6.3% to 6.5% SA inflation average for 2016 (against an unchanged 2% inflation outlook for the US) and a 325 bps to 350 bps SA sovereign risk premium – the fair value range for the SA ten-year bond benchmark shifts to the 10.25% to 10.5% range. This compares unfavourably to the current market levels of around 9.75% and suggests a definite degree of caution is warranted when it comes to local government bonds. In addition, with government issuing bonds that are focused on the longer end of the curve, and with growth continuing to deteriorate, it is very likely that a further risk premium will have to be priced in for longer-end bonds, relative to the short-end and belly of the curve.

Unfortunately, given the current local backdrop, SA is setting itself apart from its peers in all the wrong ways. Until we see a strong shift towards sustainable economic growth and a definite political commitment to making the necessary hard decisions, the appeal of the asset class will only be enhanced if yields widen more to reflect the necessary risk premium.
Market review

The shorter-term outlook is challenging.

by DUANE CABLE

The final quarter of 2015 certainly provided little respite in what ended up being a much more difficult year for global markets relative to their robust performance over the last decade.

In US dollars, the MSCI World index returned 5.6% for the quarter and -0.3% for the calendar year, while the MSCI Emerging Market index returned 0.7% for the quarter and -14.6% for the calendar year.

Locally, the JSE All Share lost 9.3% for the quarter and 21.5% for the calendar year in US dollars. Given the significant depreciation of the rand, its performance in the local currency was widely divergent: 1.7% for the quarter and 5.1% for the calendar year. Commodity prices continued to slide: oil fell 23.6%, palladium lost 15.8% and copper was down 7.9% in US dollars for the quarter. The decline in commodity prices weighed heavily on resource shares with the local resources index declining 19.2%, underperforming industrials and financials that returned 6.6% and -3.3% for the quarter respectively. The longer-term divergence in the performance of resources relative to industrials and financials remains stark. The resources index has declined over one, three and five years and has underperformed cash over a ten-year period.

On the global front, the economic and geopolitical outlook remains uncertain, with the US being the only bright spot. As expected, the US Federal Reserve raised interest rates by 25 basis points in December, the first hike in almost a decade. Our base case remains that the pace of interest rate normalisation will be gradual and that interest rates will remain at historically low levels for longer. The growth outlook for Europe and Japan can at best be described as sluggish. China remains the most important economy for resource demand, but economic data continue to deteriorate.

The South African economic growth outlook remains anaemic. Although one can blame the impact of falling commodity prices and sluggish global economic growth, these challenges have been further exacerbated by a number of policy errors. The shock replacement of Nhlanhla Nene as minister of finance incited a dramatic reaction among both market participants and ordinary South Africans. The well-respected former finance minister Pravin Gordhan was appointed four days later. However, the damage had already largely been done.

South Africa’s deteriorating growth outlook, along with concerns around government finances and an increase in both socioeconomic and political uncertainty, contributed to the rand losing 25.2% in the calendar year. The impact of the weaker currency and significant drought that has hit the country poses upside risk to inflation expectations for 2016.

As mentioned on previous occasions, China remains the key call for resource shares given its role as a significant consumer of commodities. It is an opaque, command-driven economy that is in the process of rebalancing from being traditionally investment-led to becoming more consumer-driven. As a result, one can never have complete conviction as to how the Chinese economy will unfold. We believe a lot of this uncertainty is
reflected in the significant underperformance of resource shares. This presents a good opportunity for the valuation-driven, patient investor who is prepared to take a long-term view. Based on our assessment of fair value, resources are attractive enough to warrant a reasonable weighting in our equity and balanced portfolios. However, given that China remains an imponderable, this is not a portfolio-defining position. Our preferred holdings remain Anglo American, Mondi, Exxaro and the platinum producers. We continue to favour platinum over gold producers and our preference remains the low-cost platinum producers Impala Platinum and Northam.

We continue to prefer the quality global businesses that happen to be domiciled here, such as Naspers, British American Tobacco, Steinhoff, MTN and Richemont. These companies have robust business models, are diversified across numerous geographies and currencies, and remain attractive based on our assessment of their intrinsic value.

We also continue to hold reasonable positions in the food retailers and producers as well as selected consumer-facing businesses (Woolworths and Foschini). These businesses are exceptionally well managed and trade below our assessment of fair value.

Banks returned -12.9% for the quarter, underperforming the broader financial index. Valuations remain reasonable on both a price-to-earnings and price-to-book basis. Our preferred holdings are Nedbank, Standard Bank and FirstRand. Life insurers returned 1.5% for the quarter. We prefer Old Mutual and MMI Holdings, both of which trade on attractive dividend yields and below our assessment of their intrinsic value.

In terms of asset allocation, 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.

The bond market returned -6.4% for the quarter, underperforming cash, which yielded 1.1%. We believe yields on global bonds are too low and do not offer value. Despite the sell-off in local government bonds, we do not believe that yields fully reflect the deteriorating risk profile. In our view, the real returns from cash and government bonds are likely to be relatively poor over the long term, both from a local and global perspective.

Listed property returned -4.7% for the quarter. We expect domestic properties to grow distributions in line with inflation over the medium term, which, combined with a fair initial yield, offers an attractive return over the holding period. We continue to hold the higher-quality property names which we believe will produce better returns than bonds and cash over the long term.

As we start a new year, we are bombarded with predictions from numerous financial experts about what lies ahead in 2016. Although we would agree with the market consensus that the shorter-term outlook is challenging, history has taught us that our ability to forecast the immediate future is limited.

In an incredibly uncertain world, we continue to strive to build anti-fragile portfolios that could absorb a dramatic change in the strong momentum markets experienced over the last few years. We will remain focused on long-term valuations and will seek to take advantage of whatever attractive opportunities the market presents to generate long-term returns for our investors.
A review of the performance of asset classes during 2015 shows it was clearly a year during which negative asset class returns dominated; those finishing in positive territory were few and far between. In fact, of the 40-odd different assets monitored by broker surveys, just nine finished with a positive return (in US dollar-adjusted terms) over the full year. Of these, the big winner was the Nikkei index (+10.4%) – boosted by the accommodative Bank of Japan and relatively stable yen. Additionally, both Portuguese (+6.5%) and Italian (+3.9%) equity markets closed higher, while in China the Shanghai Composite index (+6.2%) finished up for the year, but not without some huge volatility over the 12 months and, of course, ending well off the highs posted back in June. In the US, the Standard & Poor’s (S&P) 500 index (+1.4%) also closed just about in positive territory for the year on a total return basis, although that performance was the worst for the index since 2008. It was largely weighed down by negative returns from energy stocks. As with US equity markets, there was a small positive return from US Treasuries (+0.8%) in 2015.

At the other end of the scale, there were some notable falls that need highlighting. Oil, in particular, stole the limelight, with huge declines in both Brent (-44.1%) and West Texas Intermediate (-30.5%). Copper (-24.4%), wheat (-20.3%), silver (-11.7%) and gold (-10.4%) were also hard hit.

2015 was a particularly tough year for both emerging and frontier markets. Overall, the MSCI Emerging Markets (EM) index lost 14.6% in US dollar terms (following -1.8% in 2014), suffering the third consecutive year of losses. Latin America (-30.8%) was the worst performing region, dragged down by the 41.2% loss from heavyweight Brazil. The Europe, Middle East and Africa (EMEA) region fell by 19.7%, with the largest losses coming from Greece (-61.3%), Turkey (-31.6%) and South Africa (-25.1%). Asian markets lost 9.5% in 2015. Thailand (-23.3%), Malaysia (-20.1%) and Indonesia (-19.1%) were the worst performing Asian countries. Hungary (+36.3%) and Russia (+5.0%) were the only EM countries to post positive dollar returns in 2015. In local currency terms, Russian equities (+32.3%) came out on top, followed by some of the peripheral markets. Not surprisingly, all EM sectors posted negative total returns in US dollar. Materials, utilities and telecommunication recorded the largest losses. Within the overall MSCI Word index, the consumer staples, healthcare and consumer discretionary sectors recorded the best performance in 2015. The worst performers were energy, materials and utilities.

US dollar strength was a big theme for 2015, as evidenced by the dire returns from commodities. The US dollar index rose by a significant 9.3% for the full year. All global currencies weakened against the US dollar in 2015; with material falls for, amongst others, the euro (-10.3%), the Australian dollar (-10.7%) and the Canadian dollar (-16.1%).

In credit markets, it was the divergence between European and US credit which was most notable. This reflects the higher US exposure to credit in the energy sector. In the US, high-yield credit closed with a loss of 5.0% for the full year, while US investment-grade credit was down a more modest 0.4%. By comparison, European high-yield credit returned 0.5% for the...
year, although European investment-grade credit was down slightly (-0.7%). Again, converting these returns into US dollar terms wiped out any gains for European credit which, as a result, underperformed US credit for the full year.

Within the US equity market, the most noteworthy development was that a very small group of companies – essentially nine of them – kept the market afloat in 2015. This small grouping of stocks rose by close to 60%, while the S&P 500 index closed only marginally up. None of the main ten S&P 500 sectors rose by as much as 10% – the first time this has ever happened outside a bear market. Predictably, value investing fared poorly, as most of the narrow market leaders looked like bad value at the start of the year.

Analysed another way, were the S&P returns stated on an equal-weighted basis (around a 0.2% weight for each share), the index would have fallen slightly for the 12-month period – the implication being that the average US stock fell in 2015, despite massive gains from fewer than ten stocks. Looking back at 2014, we recall that this was an extremely difficult year for active equity fund managers to add alpha. This was due to the very low dispersion of returns among shares, as they all tended to move by the same amount in the same direction. Whereas in 2015, investors experienced much greater equity return dispersion, and successful investors would have needed to invest in an extremely small group of equity names. This narrowing of equity sector performance reflected concerns that the US economic recovery may falter in 2016 due to a combination of economic weakness in Europe and commodity-sensitive emerging markets, as well as a cyclical downturn in the Chinese economy.

During the opening weeks of 2016, headlines have been dominated by the sharp falls in global stock markets, largely driven by extreme turbulence in China and ongoing declines in industrial commodity prices. The overriding cause of investors’ concern is the belief that the end of the commodity boom, especially the collapse in the price of oil, has created complex risks. The fall in commodity prices is bound to trigger increasing debt defaults among commodity-producing companies. It has also lowered government revenue, thereby increasing fiscal deficits in commodity-dependent economies. Key to this is that many EM companies filled up on cheap foreign currency debt during years of ultra-loose monetary policies in the US, which have now gone into reverse. EM companies’ foreign currency debt rose from $900 billion to $4.4 trillion in the decade to mid-2015, according to the Institute of International Finance (IIF), an industry association, using data from the Bank for International Settlements. Additionally, there is potentially a much greater problem. That is the even bigger build-up of local currency debt in emerging markets over the past decade; total foreign and local currency debt rose from the equivalent of $5.4 trillion to $24.4 trillion, or 90% of EM gross domestic product, according to the IIF.

The mobility of capital, combined with investor impatience with the slow pace of post-2008 economic growth, has led to exaggerated swings in sentiment and capital flows over recent years. Capital has rotated between bonds and economically sensitive equities as growth expectations grew, only to be later judged as premature. The massive level of liquidity in the system has resulted in higher anxiety as investors are confused between equal bouts of optimism and scepticism. That said, a slow but inexorable turn in global capital flows began in 2015, thereby ending a near decade-long liquidity push by the US Fed. This liquidity had lifted most asset classes, generally regardless of risk profiles. As we move into 2016, these concerns are again being reflected in declining equity and commodity markets.

Looking at the US economy, it has been (and remains) our view that the US economy will show good growth in 2016 and 2017. Sustained job growth and accelerating wage growth – against a monetary backdrop that is still generally accommodative – are likely to provide strong tailwinds for the US consumer and, by implication, the overall economy. The December 2015 jobs report (292,000 jobs were added) was significantly better than expected. This, coupled with an increase of 2.5% in average hourly earnings, should add to the purchasing power of Middle Americans. It must be remembered that consumption accounts for over 70% of the US economy. It is therefore hard to envisage a recession without a slowdown in consumer spending. Linked to this is US housing and car sales, which remain buoyant and at post-2008 recovery highs. In 2016, sales and production of
traditional cars, trucks, buses and heavy vehicles will continue to serve as valuable barometers of consumer demand and economic activity. Vehicles sales in the US are expected to rise modestly to a record 18 million units in 2016.

Additionally, it is in the area of fixed investment that we expect the US economy to receive a boost over the next few years. US fixed investment expenditure (as a percentage of GDP) has declined to a multi-decade low following the 2007–2009 recession. As would be expected, the US capital stock, in particular public infrastructure, is ageing and will require renewal in coming years. Failing this, productivity will increasingly lag, thereby creating potential upside to the medium-term inflation outlook. The funding of this expenditure should not present a problem as the federal fiscal deficit is expected to shrink due to economic expansion as well as reduced military spending.

Obviously, we recognise that there are always tail risks to the US economic outlook that should not be ignored. However, the bottom line on the US economy is that, for the past seven years, none of these tail risks have pushed the economy into a new recession. In fact, despite wider credit spreads, a rising dollar, falling commodity prices, a slowdown in China and emerging markets, the stock market correction in September 2015, the euro crisis, the Fed raising rates and rising geopolitical risks, the US economy continues to do well.

A further point to bear in mind is the gradual return to growth in the eurozone. If its economic growth in the fourth quarter matches forecasts, output expansion in 2015 will be around 1.7%. (Interestingly, a very similar number is forecasted for the US economy.) That would be the eurozone’s strongest relative performance over any four-quarter period in over four years. This compares to consensus expectations at the beginning of 2015 of eurozone growth of 1%. The outperformance is not entirely surprising as Europe is growing from a low base, while a weaker euro is boosting its competitiveness and its central bank is still actively trying to stimulate its economy.

While we well know that the expectation of continued strength in the US dollar has become the consensual opinion, we do believe that this upward trend will continue into 2016. The primary reason relates to our positive prognosis for US economic growth in 2016. Currently, forward markets (in our opinion) remain locked in a view that is too sanguine on rate hikes. The Fed itself expects to raise rates four times in 2016, whereas the Fed Fund futures market believes that the chance of even three hikes in 2016 is as low as 20%! We believe that rate normalisation will be an ongoing medium-term trend, rather than a one-off event. Continued growth, along with reduced global dollar liquidity and a smaller US current account deficit, will underpin these rate hikes. This will attract a growing flow of capital back to the US, thereby supporting a sustained US dollar bull market.

On the US bond market, we believe that too many investors remain stuck in a ‘crisis mindset’. One reason why this bearish approach has persisted for so long is most likely the fact that long rates in the US have remained so low, and because of low rates, some investors have mistakenly concluded that the US economy must also be in bad shape. However, we should not forget that the Fed and foreigners own 60% of US Treasuries, so the level of US rates has not been a true reflection of the health of that economy. This is particularly true in recent years, where the accelerating US economic data have been offset by a slowdown in Europe and EM, resulting in significant foreign private demand for US Treasuries. It is true that market pricing of US interest rates is distorted by central banks, but to say that ten-year rates (2.2%) are a pure reflection of the health of the US economy is, in our view, misleading. In fact, the Fed raising short-term rates and an improving outlook for Europe and EM economies could put upward pressure on US bond rates, and hence 2016 could be the year when we finally leave the crisis mindset behind.

Turning to China, its economy is currently digesting the fallout from a 15-year investment-led boom distorted by a misallocation of capital. This cyclical cleansing process is made all the more difficult by the fact that China’s demographic window has closed (with the working-age population now contracting). In addition, public sector corruption is endemic, capital flight is accelerating and the economy must transition from property development and manufactured exports toward domestic consumption of goods and services. Despite these...
daunting challenges, China still has considerable economic momentum and government resources to stimulate near-term growth. While gross overcapacity in many sectors (such as steel production) is being slowly consolidated, domestic motor vehicle sales (a valuable barometer of economic activity) remain firm. So too does electricity consumption and the volume of crude oil imports. Hence, while China’s growth is slowing, it is not stalling. Investors appear too pessimistic about China over the next two to three years, but probably remain too complacent about China’s secular dilemma that lies in wait from around 2025 onwards.

Making an investment prognosis at the start of a new year is always a hazardous exercise – especially against the backdrop of a complex geopolitical environment and significant pressure on emerging markets. In addition, active and value-driven equity managers are finding it extremely difficult to outperform the broad market indices. In the US, the poor results from mutual funds have led to an acceleration of investors redeeming investments from their actively managed funds and reinvesting in index funds. 2016 will undoubtedly be a year that will test investors’ resolve, both in withstanding confusing and conflicting data, and also in terms of knowing when to add risk to their portfolios. At present (early-January 2016), investors are doing their best to avoid risk. It is, however, our belief that at some point during 2016, the global economic outlook will improve sufficiently to trigger a broad capital rotation back towards economically sensitive equity risk.
Angst and volatility were felt across global markets in 2015, but it is clear that South African-focused investors encountered a singular world of pain. A slumping currency and intensifying sovereign risks underscored the importance of diversifying abroad. We have long argued that global equities offer compelling value to South African investors, who should not restrict themselves to a domestic market that offers a narrow range of industries and growth opportunities.

The Coronation Global Equity Select fund, which was launched last year, is aimed at providing investors with a new avenue to access these opportunities. The fund is biased towards developed market companies and targets attractively valued shares to maximise long-term growth for investors.

Since launch, this global equity fund has certainly lived through interesting times, encountering some of the worst market volatility in recent years. This has naturally had a marked impact on its early performance. Still, we have also experienced our share of excitement, including a phenomenal performance in two of our key holdings, Amazon and Google. After pedestrian performances in the previous two to three years, these companies exploded in 2015. The fund saw its investment in Amazon more than double and Google gaining almost 40%. 2015 was also the year that the online payments company PayPal completed its spin-off from parent group eBay, which created significant value for its shareholders, including ourselves. The fund continues to invest in companies that can benefit from disruptive technology and is invested in a wide range of e-commerce companies, which have huge cost advantages over bricks-and-mortar incumbents.

JD.com, the second largest online retailer in China, holds particular interest. Unlike Alibaba, the largest player, it has invested in building its own fulfilment capacity, aligning it closer to the successful Amazon model. Other holdings in the online environment, including TripAdvisor and Priceline, performed well.

One bricks-and-mortar retailer, Dollar General, delivered gains for the fund in 2015. We have long seen value in the so-called dollar stores, which are essentially limited-range convenience stores serving a lower income consumer (at lowish price points) in the US. We held a large position in the US’ second largest discount retailer at the fund’s inception, but sold out when the share grew too expensive and posed transaction risk. Dollar General entered into a bidding war with the largest discount retailer (Dollar Tree) for the number three player, Family Dollar. We believe the latter is a poor asset, and that there was a risk that Dollar General could overpay. After we sold out, the company lost the bidding war, but still saw a significant decline on the back of concerns around the health of the US consumer. It offered value in our estimation and we started buying again.

Another strong theme in the fund, since the start, was our investment in alternative asset managers. These are broadly defined as fund managers who invest in unlisted assets such as private equity, real estate, credit as well as hedge fund strategies. The alternative asset managers were punished in 2015 as investors worried about lower shorter-term earnings; weaker investment markets will have an impact on the unrealised gains on their income statements. In addition, the sector has been penalised for its exposure to the energy
sector. In recent years, many of these asset managers have raised capital to invest in the sector. However, while some of it has already been invested (before the latest sharp decline in energy prices), we believe a large part of the investments has not yet been made.

We continue to find value in the top-quality alternative asset managers, particularly Blackstone, KKR, Carlyle, Apollo and Fortress. They offer high returns on equity, and growth that requires very little capital investment. The industry has very high barriers to entry, including tough regulatory requirements, and we like the fact that management and employees often own more than 50% of these businesses, creating a strong alignment with shareholder interests. We believe the underlying fundamentals of the industry are still strong, and that the leading franchises will benefit from increased investment allocations in coming years.

Porsche, the holding company of Volkswagen, was a key holding that detracted in the fund. In the previous edition of Correspondent, we discussed the developments at Volkswagen in detail. Porsche’s share price has started to recover and we have been reducing our position into strength. The perceived lack of introspection among Volkswagen’s senior management following such a serious infraction, is concerning.

While our portfolio is biased towards developed markets, and currently has almost 80% of its assets invested in companies that are listed in these countries, the fund also has the flexibility to invest in emerging markets (EM). These have had a torrid time of late, and our positions in EM companies have lagged their developed market counterparts by almost 20% in the past calendar year.

The Russian retailer X5 delivered a positive performance thanks to a strong improvement in earnings. But our other emerging market holdings – particularly in the Brazilian education and retail sectors – were decimated. The Indian car manufacturer Tata also suffered losses, despite strong fundamentals and delivering an operational performance that trumped our expectations. We continue to believe in the underlying value offered by our emerging market holdings.

However, given the extreme volatility in emerging markets, as well as the instability in their underlying economies and the accompanying political uncertainty, we are taking a more circumspect approach to EM holdings. In order to qualify for inclusion in our global portfolio, we are expecting a slightly higher upside from these holdings, which should lead to stronger long-term returns. We are also limiting the size of potential positions. Currently, our typical EM holding is equivalent to half or two-thirds the size of a developed market holding.

The fund’s investment universe is immense, and we have the luxury of focusing primarily on good quality or above-average businesses. In developed markets alone, our research currently covers around 110 superior companies. On the whole, we continue to prefer US companies, which we believe are managed exceptionally well and remain strongly aligned with shareholder interests. This is, however, tempered by the fact that US companies are generally trading on more demanding ratings, and that growth will have to be achieved from higher earnings bases (relative to history).

Our long-term focus on valuation results in us evaluating companies over periods of at least four to five years. This provides the great opportunity to ignore short-term noise and invest in assets that are trading at a discount to our assessment of their real long-term value. We believe that the focus on the longer term is one of the last competitive advantages left in markets today – especially in a world where quarterly US earnings reports fuel material short-term investor reactions.
**ABI and Heineken**

The case for beer.

by PIETER HUNDERSMARCK

---

I was looking at Latin America and who was the richest guy in Venezuela? A brewer. The richest guy in Colombia? A brewer. The richest in Argentina? A brewer.  
– Jorge Paulo Lemann, principal at 3G Capital

The Global Emerging Markets fund holds meaningful positions in Anheuser-Busch InBev (ABI) and Heineken, the world’s largest and third largest brewer respectively. Both have substantial emerging market businesses that contribute over 50% to their respective revenues. Together, ABI and Heineken comprise 5.3% of the fund.

Both brewers enjoy high barriers to entry, what investors call ‘moats’, consisting of powerful brands (with the associated pricing power this affords); distribution muscle and established routes to markets; access to cheap capital and top talent; and most importantly, a high level of free cash-flow generation. The latter is often higher than their accounting earnings, the result of negative working capital dynamics and low reinvestment needs.

For the long-term investor in ABI and Heineken, two barriers in particular deserve consideration: pricing power and scale. Pricing power is a prized characteristic of a high-quality business, allowing it to offset cost increases associated in the making of its product. Pricing power is maintained through advertising and promotion (‘brand building’) that consistently identify the product to its target audience and communicate its value proposition (whether that be reliability, quality, affordability, health, etc.).

In addition to pricing power, increasing scale is an important driver of higher returns as fixed costs are diluted by higher volumes of beer sold, meaning each beer sold comes at a lower incremental cost. These scale benefits are not confined to national borders: they accrue on a regional level (e.g. when fragmented markets become oligopolies or duopolies, which lower supply chain and shared services costs) and global level (e.g. the procurement of raw materials, personnel deployment, marketing efficiencies). The clear benefits of size has spurred consolidation among brewers. Today, after 15 years of intense consolidation, four global brewers (ABI, SABMiller, Heineken and Carlsberg) together control c. 47% of global beer volumes (up from 35% in 2004) as the following charts illustrate.

![Global Market Volume Controlled by Top 10 Brewers](chart)

---

**GLOBAL MARKET VOLUME CONTROLLED BY TOP 10 BREWERS**

<table>
<thead>
<tr>
<th>Brewer</th>
<th>2004</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>InBev</td>
<td>11%</td>
<td>21%</td>
</tr>
<tr>
<td>Anheuser Busch</td>
<td>9%</td>
<td>10%</td>
</tr>
<tr>
<td>SABMiller</td>
<td>9%</td>
<td>9%</td>
</tr>
<tr>
<td>Heineken</td>
<td>6%</td>
<td>6%</td>
</tr>
<tr>
<td>China Resources Enterprise</td>
<td>3%</td>
<td>6%</td>
</tr>
<tr>
<td>Grupo Modelo</td>
<td>3%</td>
<td>5%</td>
</tr>
<tr>
<td>Tsingtao Brewery</td>
<td>2%</td>
<td>5%</td>
</tr>
<tr>
<td>Carlsberg</td>
<td>3%</td>
<td>6%</td>
</tr>
<tr>
<td>Molson Coors</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>Baltic Beverages</td>
<td>2%</td>
<td>2%</td>
</tr>
<tr>
<td>Others</td>
<td>49%</td>
<td>34%</td>
</tr>
</tbody>
</table>

Source: Euromonitor
This consolidation has been a boon for investors, as seen in the following chart. The global brewers have outperformed the MSCI Global index by c. 300% in the past 10 years, driven in no small part by the large amount of revenue and cost synergies (from consolidation) that have accrued to shareholders over time.

Heineken: Mature Europe, but an emerging market powerhouse

Our investment in India … is for my successor’s successor.
– Jean-François van Boxmeer, Heineken CEO

Heineken is the world’s third largest brewer. It earns roughly a quarter of its profits from leading market positions in Western Europe, with the balance evenly distributed between Africa (mainly Nigeria, the DRC and Egypt), Mexico and South-East Asia (mainly Vietnam). Its namesake Heineken brand (the no. 1 global premium brand by volume) represents 18% of company volume, complemented by strong regional brands such as Tiger (South-East Asia), Dos Equis (Mexico and the US), Multi Bintang (Indonesia), Sol (Mexico) and Kingfisher (India).

The investment case for Heineken is premised on the continued growth in emerging markets; premiumisation (consumers trading up as they become wealthier); continued profit-pool management in mature geographies; a continued expansion in the group’s operating margin and a flexible balance sheet.

Let’s look at each of these in turn.

The growth opportunities in Heineken’s emerging markets are enormous. Heineken holds leading market positions in emerging markets like Nigeria, India and Vietnam where per capita consumption of beer is low. These strong market positions are the result of investment decisions made many years ago, where Heineken patiently built brand equity over many decades. As these economies mature, we expect rising wealth levels to contribute to increased consumption of leisure activities and associated products, of which beer will remain a large constituent.

The following chart of global beer consumption illustrates where Heineken strongholds are: Mexico (where Heineken holds the no. 2 position), Vietnam (no. 2 position), Nigeria (no. 1 position) and India (no. 1 position).
The growth in per capita consumption will be complemented by increasing penetration of ‘premium’ beer offerings and other underpenetrated categories like ciders and non-alcoholic beers. Heineken has a powerful premium portfolio (led by the Heineken brand) that it can roll out globally, and we believe that opportunities in cider and non-alcoholic beers have not been fully realised. The charts below illustrate these opportunities in India and Vietnam.
Although beer sales in Heineken’s large Western European segment have been slowing for over a decade, margin decline has been kept to a minimum (margins have, in fact, increased in the latest set of results) largely due to excellent revenue and cost management.

We believe management effectively right-sized their Western European business to the new reality of zero to low negative volume growth and will continue to incrementally grow profitability in this environment.

Going forward, we believe that in the majority of its markets Heineken can continue to price above cost inflation over the long term, leading to margin expansion.

Specifically, in the next 18 months, subdued raw material costs, especially for natural inputs such as barley, as well as packaging costs, should allow for gross margin expansion.

Looking at the operating profit level, Heineken has made great strides in lowering its fixed costs via various cost-savings programmes over the past five years, and this should allow modest gross margin expansion to flow through to the earnings before interest and taxes (EBIT) level.

Finally, we expect Heineken to have a net debt to EBITDA (earnings before interest, tax, depreciation and amortisation) ratio of 2.0 times in 2015 versus 2.6 times at the end of 2014. Further de-gearing this year will create substantial capacity for bolt-on M&A and share buybacks, should management feel the price is right.

Heineken (alongside the other global brewers) generates cash in excess of its accounting earnings, largely due to good working capital management.

Due to these strong cash flows, Heineken’s debt holders are willing to accept low interest rates for their loans to Heineken, allowing the company to fund itself at rates close to 4% over the long term.

**ABI: Crafty competition at home, but formidable execution and M&A optionality**

Costs are like fingernails: you have to cut them constantly.
– Carlos Alberto Sicupira, Principal at 3G Capital

ABI, the world’s largest brewer, has market-leading positions in the two largest profit pools worldwide: the US and Brazil. Together with Mexico, where it is also the market leader, these three countries account for 75% of profits. ABI has more than 200 brands, but concentrates on its ‘focus brands’, which receive most of its marketing spend. These include three global brands (Budweiser, Corona and Stella Artois) and a long list of local champions (including Bud Light, Skol, Antarctica and Brahma).

The investment case for ABI echoes Heineken in some ways (increasing consumption in emerging markets, the rise of the emerging market consumer and premiumisation, operating margin expansion). However, there are two key differences: ABI has a larger percentage of profit from mature geographies (46% of its revenue comes from the US, Canada and Europe, where competition is more intense) and per capita beer consumption in its main emerging market (Brazil) is approaching developed-world levels (68 litres per capita in Brazil vs 76 litres in the US).

The investment case for ABI is based upon management excellence, a return to volume growth after years of heavy competition, and value-adding acquisitions.

Since inception, InBev and its successor AB InBev (ABI), together with their founders 3G Capital, have been excellent managers of industry profitability in their core markets of the US and Brazil. This was achieved by focusing on value share, not volume share, and by managing price gaps (the difference in the prices of low-end, mainstream, and premium-priced beer) in major markets, typically leading to above local CPI inflation pricing power. In the case of the US, for example, the price gap between premium and subpremium beers has been narrowed to approximately 22% versus 29% at the time of the Anheuser-Busch acquisition.
3G Capital is the original family office of three Brazilians, Jorge Paulo Lemann, Marcel Hermann Telles and Carlos Alberto Sicupira, and has been in business in New York since the mid-1990s. 3G has a track record spanning two decades of creating value through running and combining beer assets. More recently, it has optimised the cost structures and helped drive revenue growth of consumer businesses like Kraft, Burger King and Heinz. In 1999, 3G created AmBev, the leading Brazilian brewer, by amalgamating two brewers (Brahma and Antarctica) purchased previously. Five years later, AmBev merged with Belgian brewer InterBrew in an $11 billion transaction, and in 2007 the combined company (called InBev) led a hostile takeover of Anheuser-Busch for $52 billion to create ABI.

On top of this, ABI has famously been able to reduce operating costs and drive efficiencies thanks to a frugal company culture and their ferocious commitment to ‘zero-base budgeting’. Every year, every single expense must be justified anew, with the goal to reducing expenses from the previous year.

Logistics and distribution costs have also been cut, most notably with ABI taking control of distribution where it can (there are limitations under the three-tier system of alcohol distribution in the US), allowing them greater control over costs.

Naturally, the combination of revenue and cost control has boded well for operating margins: AB InBev’s group operating margins are the highest in the industry at 32.5% in 2014, up from 23.3% in 2008 when AB was bought.

Over the last few years ABI has seen stiff competition from craft breweries and spirits. Alcohol consumption moves in long cycles, and we believe that with greater commitment to brand building, ABI volumes can once again see more meaningful top-line growth.

The following chart shows how ABI is steadily increasing its advertising and promotion (A&P) budget to meet this challenge.

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The following chart shows how ABI is steadily increasing its advertising and promotion (A&P) budget to meet this challenge.
An often-discussed threat in its home market (the US), where over a third of profits are generated, is the rise of craft breweries. Craft beer presents both opportunities and challenges.

As craft maintains popularity, and spreads through Europe and other regions, the brewers will either have to defend their own brands aggressively or become increasingly involved in craft themselves. ABI is doing both – focusing advertising on defending the quality and heritage of its brands, while buying craft brands or growing its own.

There is reason to believe that A&P efforts will be successful. Research from UBS, a Swiss bank, indicates that while there is continued strong demand for experimentation in the beer category, big brands remain favoured on quality, heritage and affordability metrics. As one would expect, brand scores are lower with ‘millennials’, yet still strong. We expect A&P efforts will improve this.

According to UBS, while craft brands are highly recommended, rather surprisingly the most recommended brands across all consumers remain Budweiser, Guinness and Heineken. We attribute this to the aforementioned association with quality and heritage, as well as material investments in marketing.

Naturally, the more trend-conscious millennial consumers prefer import and craft brands, but their most preferred brands – Heineken, Dos Equis (Heineken’s Mexican import), Corona and Goose Island (ABI’s largest craft brand, purchased in 2011) – remain owned by major brewers.

ABI has also been aggressive in capturing some of the superior growth that craft brewers offer through selective M&A.

Acquired brands, such as ABI’s Goose Island, have tended to continue performing well, suggesting less of a consumer backlash against acquired craft brands than some in the industry had speculated. Even after its takeover, Chicago-based Goose Island (now distributed nationally) continues to be the brand most associated with being a ‘craft/micro brewer’, according to UBS.

ABI has also been a successful acquirer of larger targets, such as AB in 2008 and Modelo (no. 1 in Mexico and owner of the Corona brand) in 2011. Most recently management has targeted SABMiller.
Management has a strong track record on cost saving from these acquisitions: ABI’s core M&A competency is cost management and we expect margin expansion, driven by cost savings, to remain its main focus.

As a benchmark, at Budweiser and Modelo, ABI extracted cost savings equivalent to 15% of acquired sales, well above the beverage industry average of 6%.

Regarding the potential merger between ABI and SABMiller, we feel a credible base case must be that the transaction goes through. Should this happen, the new company will be one of the most powerful businesses in this industry, controlling over 50% of the global profit pool, as well as strong positions in three of some of the most attractive emerging market growth regions (Africa, China and Latin America). But even if the merger fails, we remain comfortable holders of the stock.

**DEAL SYNERGIES**

The deal synergies that the acquiring company was able to extract as percentage of the takeover target’s net sales

![Chart showing deal synergies](source: Bernstein)
Frontier markets

The new Silk Road is on the right track.

by PETER LEGER

Few things can make the eyes glaze over quite as effectively as yet another government announcement of a bilateral comprehensive regional cooperation zone, promising to weave a mist of tax breaks and special dispensations. For the most part, this effectively translates to: ‘Yes! We went on a travel jolly at the taxpayer’s expense, and this is the smokescreen that we have to show for it!’

The political landscape is littered with trade policy tombstones of good intentions. An impressive array of developmental acronyms – the Common Market for Eastern and Southern Africa (COMESA), Economic Community of West African States (ECOWAS), the Regional Comprehensive Economic Partnership (RCEP) – has been created, but little else. At best, these initiatives muddle along in their own atmosphere of complexity and die a slow death in obscurity.

So it has been with interest, and some surprise, that a truly transformative policy initiative has emerged. Central to its success has been China, who does seem somewhat better than other countries at making policy work, maybe because it is good at setting workable policy.

Faced with a slowing economy at home, China is fortunate to have a number of developing neighbours who are experiencing rapidly rising demand. And with this, the Chinese model of domestic investment, with the goal of being ‘the world’s Walmart’, is morphing. China is pushing to redirect the country’s overcapacity and capital to develop regional infrastructure, which in turn will stimulate regional trade and growth. This is a repeat of history, as the Silk Road trade routes did exactly the same over 2 000 years ago. The new phenomenon has a less romantic name, though: One Belt, One Road (OBOR).

The regional economy is massive and still holds significant opportunity. The Asia-Pacific universe is forecast to generate $8.8 trillion in revenues, $872 billion in net profit and $574 billion in free cash flow in 2016, according to the global brokerage CLSA.

To harness this enormous opportunity, China plans to negotiate free-trade agreements with 65 countries along the OBOR. Twelve agreements have already been signed and eight more are under negotiation. While the initiative was kicked off almost three years ago, 2016 is the year when it will start to come into its own: all of the main financial institutions set up to fund OBOR projects will be fully operational this year. Combined, these institutions have $240 billion in capital, implying that with good old banking leverage magic, they can fund $800 billion in infrastructure projects.

And this is where it starts to get interesting. Deals are already underway. One of the countries where tax-free agreements are already in place, Pakistan, provides an interesting window. A poetical local acronym was chosen – CPEC (China Pakistan Economic Corridor) – and electricity has been highlighted as a focus area. The results are concrete: 2016 witnessed the start of construction of the Karot hydropower plant. It will cost $1.65 billion and should be completed by 2020. Five other energy projects officially broke ground last year as part of CPEC. Included in this has been the completion of the first stage of the world’s largest solar plant in the Punjab province, with the
The final stage is due end of 2016. In total, 14 Chinese-constructed energy projects in Pakistan will provide an additional 10,400 MW of electricity by 2018, equivalent to a quarter of South Africa’s current capacity, and a 50% increase in Pakistan’s current capacity.

The consequences for the average Pakistani, and the overall economy, are vast. Rolling blackouts have been the order of the day in Pakistan for some time, and generators are standard home appliances. Having had a taste of this in South Africa, it is easy to imagine the benefit to business should this power shortfall be reversed. Already some of the impact is quite visible. For example, domestic cement sales – despite growing off a very solid base – were up another 16% in 2015.

The strategic Gwadar port project will also unlock significant growth. A massive free-trade area will be constructed, linked to an international airport, an expressway and rail link, opening up access into Pakistan.

The bulk of these projects are in infrastructure, and the current softness in commodity prices has cut capital expenditure costs, further supporting project approvals. Every month, more goodies can be bought for the same money.

We believe that a number of economies will benefit significantly from Chinese foreign economic policy. The sphere of influence reaches far across the globe, and includes the likes of Turkey, India, Kenya and Sri Lanka.

It is clear that Pakistan, in particular, will see significant benefit. Investors should take note. Equity valuations in Pakistan are reasonable, and there are many investment opportunities that look very interesting. The banking sector is shaking off a chequered past, and also offers value, with valuations trading a little over book value and earnings multiples in single digits. This proves that in an emerging market world which is currently running a misery surplus, there are still opportunities that promise to be rewarding.
Coronation offers a range of domestic and international funds to cater for the majority of investor needs. These funds share the common Coronation DNA of a disciplined, long-term focused and valuation-based investment philosophy and our commitment to provide investment excellence.

### Table: Domestic Flagship Fund Range

<table>
<thead>
<tr>
<th>INVESTOR NEED</th>
<th>INCOME ONLY</th>
<th>INCOME AND GROWTH</th>
<th>LONG-TERM CAPITAL GROWTH</th>
</tr>
</thead>
<tbody>
<tr>
<td>FUND DESCRIPTION</td>
<td>Strategic Income Cash&lt;sup&gt;1&lt;/sup&gt;</td>
<td>Balanced Defensive Inflation&lt;sup&gt;1&lt;/sup&gt;</td>
<td>Capital Plus Inflation&lt;sup&gt;1&lt;/sup&gt;</td>
</tr>
<tr>
<td>FUND DESCRIPTION</td>
<td>Conservative asset allocation across the yielding asset classes. Ideal for investors looking for an intelligent alternative to cash or bank deposits over periods from 12 to 36 months.</td>
<td>A lower risk alternative to Capital Plus for investors requiring a growing regular income. The fund holds fewer growth assets and more income assets than Capital Plus and has a risk budget that is in line with the typical income-and-growth portfolio.</td>
<td>Focused on providing a growing regular income. The fund has a higher risk budget than the typical income-and-growth fund, making it ideal for investors in retirement seeking to draw an income from their capital over an extended period of time.</td>
</tr>
<tr>
<td>INCOME VS GROWTH ASSETS&lt;sup&gt;1&lt;/sup&gt;</td>
<td>92.5% / 7.5%</td>
<td>61.7% / 38.3%</td>
<td>45.6% / 54.4%</td>
</tr>
<tr>
<td>ANNUAL RETURN (Since launch)</td>
<td>10.6%</td>
<td>11.0%</td>
<td>13.6%</td>
</tr>
<tr>
<td>QUARTILE RANK (Since launch)</td>
<td>1st</td>
<td>1st</td>
<td>1st</td>
</tr>
<tr>
<td>ANNUAL RETURN (Last 10 years)</td>
<td>9.1%</td>
<td>–</td>
<td>11.3%</td>
</tr>
<tr>
<td>QUARTILE RANK (Last 10 years)</td>
<td>1st</td>
<td>–</td>
<td>1st</td>
</tr>
<tr>
<td>ANNUAL RETURN (Last 5 years)</td>
<td>8.7%</td>
<td>11.8%</td>
<td>10.6%</td>
</tr>
<tr>
<td>QUARTILE RANK (Last 5 years)</td>
<td>1st</td>
<td>1st</td>
<td>3rd</td>
</tr>
<tr>
<td>STANDARD DEVIATION (Last 5 years)</td>
<td>1.6%</td>
<td>3.7%</td>
<td>5.2%</td>
</tr>
<tr>
<td>FUND HIGHLIGHTS</td>
<td>Outperformed cash by on average 5.5% p.a. over the past 5 years and 2.7% p.a. since launch (after fees). Note that outperformance is expected to be less in periods of stable or rising interest rates.</td>
<td>Outperformed inflation by 5.0% p.a. (after fees) since launch, while producing positive returns over 12 months 100% of the time. A top performing conservative fund in South Africa over 5 years.</td>
<td>Outperformed inflation by 7.6% p.a. (after fees) since launch, while producing positive returns over 12 months more than 90% of the time.</td>
</tr>
</tbody>
</table>

1. Income versus growth assets as at 31 December 2015. Growth assets defined as equities, listed property and commodities.

Figures are quoted from Morningstar as at 31 December 2015 for a lump sum investment and are calculated on a NAV-NAV basis with income distributions reinvested.
**Risk versus return**

5-year annualised return and risk (standard deviation) quoted as at 31 December 2015. Figures quoted in ZAR after all income reinvested and all costs deducted.

<table>
<thead>
<tr>
<th>Source: Morningstar</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Long-term growth (equity only)</strong></td>
</tr>
<tr>
<td>Top 20</td>
</tr>
<tr>
<td><strong>Long-term growth (multi-asset)</strong></td>
</tr>
<tr>
<td>Balanced Plus</td>
</tr>
<tr>
<td><strong>Income and growth (multi-asset)</strong></td>
</tr>
<tr>
<td>Capital Plus</td>
</tr>
<tr>
<td>Balanced Defensive</td>
</tr>
<tr>
<td><strong>Income (multi-asset)</strong></td>
</tr>
<tr>
<td>Strategic Income</td>
</tr>
</tbody>
</table>

**Growth of R100 000 invested in our domestic flagship funds on 1 July 2001**

Value of R100 000 invested in Coronation’s domestic flagship funds since inception of Capital Plus on 1 July 2001 as at 31 December 2015. All income reinvested for funds; FTSE/JSE All Share Index is on a total return basis. Balanced Defensive is excluded as it was only launched on 2 February 2007.

<table>
<thead>
<tr>
<th>Source: Morningstar</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>R100 000</strong></td>
</tr>
<tr>
<td><strong>R1 119 647</strong></td>
</tr>
</tbody>
</table>

**Source:** Morningstar
## INTERNATIONAL FLAGSHIP FUND RANGE

<table>
<thead>
<tr>
<th>FUND DESCRIPTION</th>
<th>INVESTOR NEED</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Managed [ZAR] Feeder</td>
<td>Global Opportunities Equity [ZAR] Feeder</td>
</tr>
<tr>
<td>Global Managed [USD]</td>
<td>MSCI ACWI</td>
</tr>
<tr>
<td>Global Opportunities Equity [USD]</td>
<td>Global Emerging Markets Flexible [ZAR]</td>
</tr>
<tr>
<td>Global Emerging Markets (USD)</td>
<td>MSCI Emerging Markets Index†</td>
</tr>
</tbody>
</table>

### INCOME V/S GROWTH ASSETS†
- **97.9% / 2.1%**
- **59.9% / 40.1%**
- **31.9% / 68.1%**
- **1.8% / 98.2%**
- **1.8% / 98.2%**

### LAUNCH DATE
- **Aug 2013**
- **Sep 2008**
- **Oct 2009**
- **Aug 1997**
- **Dec 2007**

### ANNUAL RETURN† (Since launch)
- **1.4%**
- **5.4%**
- **6.3%**
- **6.6%**
- **1.8%**

### QUARTILE RANK
- **2nd**
- **1st**
- **1st**
- **1st**
- **1st**

### ANNUAL RETURN (Last 5 years)
- **–**
- **1.8%**
- **5.1%**
- **6.8%**
- **–**

### QUARTILE RANK (Last 5 years)
- **2nd**
- **1st**
- **1st**

### FUND HIGHLIGHTS
- Outperformed US dollar cash by 2.6% (after fees) since launch in January 2012.
- The houseview currency class of the fund has outperformed its cash benchmark by 5.2% p.a. since launch.
- No. 1 global multi-asset high equity fund in South Africa since launch in October 2009.
- Both the rand and dollar versions of the fund have outperformed the MSCI Emerging Markets Index by more than 2.0% p.a. since their respective launch dates.

### Collective Investment Schemes in Securities (unit trusts) are generally medium- to long-term investments. The value of participatory interests (units) may go down as well as up and past performance is not necessarily an indication of future performance. Participatory interests are traded at ruling prices and can engage in scrip lending and borrowing. Fluctuations or movements in exchange rates may cause the value of underlying investments to go up or down.

### have you considered externalising rand risks?

### it’s easier than you might think.

The SARB allows each resident South African taxpayer to externalise funds of up to R11 million per calendar year (R10 million foreign capital allowance and a R1 million single discretionary allowance) for direct offshore investment in foreign currency denominated assets. If you want to invest more than R1 million, the process is as easy as:

1. Obtain approval from SARS by completing the appropriate form available via eFiling or your local tax office. Approvals are valid for 12 months and relatively easy to obtain if you are a taxpayer in good standing.

2. Pick the mandate that is appropriate to your needs from the range of funds listed here. You may find that the ‘Choosing a Fund’ section or ‘Compare Funds’ tool on our website helpful, or you may want to consult your financial advisor if you need advice.

3. Complete the relevant application forms and do a swift transfer to our US dollar subscription account. Your banker or a foreign exchange currency provider can assist with the foreign transaction, while you can phone us on 0800 86 96 42, or read the FAQ on our website, at any time if you are uncertain.

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1. Rand and dollar-denominated fund names are included for reference.
2. Income versus growth assets as at 31 December 2015. Growth assets defined as equities, listed property and commodities.
3. Returns quoted in USD for the oldest fund.
4. Available in USD Hedged, GBP Hedged, EUR Hedged or Houseview currency classes.
5. Figures are quoted from Morningstar as at 31 December 2015 for a lump sum investment and are calculated on a NAV-NAV basis with income distributions reinvested.

Collective Investment Schemes in Securities (unit trusts) are generally medium- to long-term investments. The value of participatory interests (units) may go down as well as up and past performance is not necessarily an indication of future performance. Participatory interests are traded at ruling prices and can engage in scrip lending and borrowing. Fluctuations or movements in exchange rates may cause the value of underlying investments to go up or down. A schedule of fees and charges is available on request from the management company. Pricing is calculated on a net asset value basis, less permissible deductions. Forward pricing is used. Commission and incentives may be paid and, if so, are included in the overall costs. Coronation is a member of the Association for Savings and Investment SA (ASSA).
Expected risk versus return

Expected return and risk positioning for both rand- and dollar-denominated funds after all income reinvested and all costs deducted.

![Graph showing expected risk versus return for various funds]

Source: Morningstar

Growth of R100 000 invested in Global Opportunities Equity [ZAR] Feeder on 1 August 1997

Value of R100 000 invested in Global Opportunities Equity [ZAR] Feeder on 1 August 1997 as at 31 December 2015. All income reinvested for funds; MSCI World Index is on a total return basis. Global Capital Plus [ZAR] Feeder, Global Emerging Markets Flexible [ZAR], Global Managed [ZAR] Feeder and Global Strategic USD Income [ZAR] Feeder, which were launched between 2007 and 2012, have not been included.

![Graph showing growth of R100 000 investment]

Source: Morningstar
An investment of R100 000 in Coronation Houseview Equity on 1 October 1993 would have grown to R4 076 334 by 31 December 2015. By comparison, the returns generated by the Equity Benchmark over the same period would have grown a similar investment to R2 412 255.

* Coronation Houseview Equity, which is an institutional portfolio, has been used to illustrate Coronation’s investment track record since inception of the business in 1993.
CORONATION BALANCED PLUS FUND VS INFLATION AND AVERAGE COMPETITOR

<table>
<thead>
<tr>
<th>5-YEAR ANNUALISED RETURNS</th>
<th>CORONATION BALANCED PLUS</th>
<th>INFLATION</th>
<th>REAL RETURN</th>
</tr>
</thead>
<tbody>
<tr>
<td>56 months to 31 December 2000</td>
<td>16.00%</td>
<td>7.90%</td>
<td>8.10%</td>
</tr>
<tr>
<td>2001</td>
<td>14.38%</td>
<td>7.41%</td>
<td>6.97%</td>
</tr>
<tr>
<td>2002</td>
<td>10.73%</td>
<td>8.04%</td>
<td>2.69%</td>
</tr>
<tr>
<td>2003</td>
<td>14.68%</td>
<td>7.33%</td>
<td>7.35%</td>
</tr>
<tr>
<td>2004</td>
<td>13.82%</td>
<td>6.68%</td>
<td>7.14%</td>
</tr>
<tr>
<td>2005</td>
<td>20.53%</td>
<td>5.85%</td>
<td>14.68%</td>
</tr>
<tr>
<td>2006</td>
<td>22.43%</td>
<td>5.54%</td>
<td>16.89%</td>
</tr>
<tr>
<td>2007</td>
<td>25.35%</td>
<td>5.17%</td>
<td>20.18%</td>
</tr>
<tr>
<td>2008</td>
<td>19.28%</td>
<td>6.41%</td>
<td>12.87%</td>
</tr>
<tr>
<td>2009</td>
<td>17.60%</td>
<td>6.82%</td>
<td>10.77%</td>
</tr>
<tr>
<td>2010</td>
<td>13.97%</td>
<td>6.71%</td>
<td>7.26%</td>
</tr>
<tr>
<td>2011</td>
<td>9.49%</td>
<td>6.94%</td>
<td>2.55%</td>
</tr>
<tr>
<td>2012</td>
<td>10.81%</td>
<td>6.36%</td>
<td>4.45%</td>
</tr>
<tr>
<td>2013</td>
<td>17.98%</td>
<td>5.39%</td>
<td>12.58%</td>
</tr>
<tr>
<td>2014</td>
<td>15.57%</td>
<td>5.19%</td>
<td>10.38%</td>
</tr>
<tr>
<td>2015</td>
<td>14.05%</td>
<td>5.59%</td>
<td>8.46%</td>
</tr>
</tbody>
</table>

ANNUALISED TO 31 DECEMBER 2015

<table>
<thead>
<tr>
<th>5-YEAR ANNUALISED RETURNS</th>
<th>CORONATION BALANCED PLUS</th>
<th>AVERAGE COMPETITOR</th>
<th>ALPHA</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 year</td>
<td>8.05%</td>
<td>7.61%</td>
<td>0.45%</td>
</tr>
<tr>
<td>3 years</td>
<td>14.61%</td>
<td>11.63%</td>
<td>2.98%</td>
</tr>
<tr>
<td>5 years</td>
<td>14.05%</td>
<td>11.23%</td>
<td>2.82%</td>
</tr>
<tr>
<td>10 years</td>
<td>14.01%</td>
<td>10.75%</td>
<td>3.26%</td>
</tr>
<tr>
<td>Since inception in April 1996 annualised</td>
<td>16.11%</td>
<td>13.53%</td>
<td>2.58%</td>
</tr>
</tbody>
</table>

Average 5-year real return | 9.58%
Number of 5-year periods where the real return is >10% | 7.00
Number of 5-year periods where the real return is between 5% – 10% | 6.00
Number of 5-year periods where the real return is between 0% – 5% | 3.00

CUMULATIVE PERFORMANCE

ANNUALISED RETURNS TO 31 DECEMBER 2015

An investment of R100 000 in Coronation Balanced Plus fund on 30 April 1996 would have grown to R1 886 951 by 31 December 2015. By comparison, the mean return of the South African Multi Asset High Equity sector over the same period would have grown a similar investment to R1 212 537.

Average competitor return is the mean of the South African Multi-Asset High Equity sector.
All information and opinions provided are of a general nature and are not intended to address the circumstances of any particular individual or entity. As a result thereof, there may be limitations as to the appropriateness of any information given. It is therefore recommended that the reader first obtain the appropriate legal, tax, investment or other professional advice and formulate an appropriate investment strategy that would suit the risk profile of the reader prior to acting upon information. Neither Coronation Fund Managers Limited, Coronation Management Company (RF) (Pty) Ltd nor any other subsidiary of Coronation Fund Managers Limited (collectively “Coronation”) is acting, purporting to act and nor is it authorised to act in any way as an advisor. Coronation endeavours to provide accurate and timely information but we make no representation or warranty, express or implied, with respect to the correctness, accuracy or completeness of the information and opinions. Coronation does not undertake to update, modify or amend the information on a frequent basis or to advise any person if such information subsequently becomes inaccurate. Any representation or opinion is provided for information purposes only. Unit trusts should be considered a medium- to long-term investment. The value of units may go down as well as up, and is therefore not guaranteed. Past performance is not necessarily an indication of future performance. Unit trusts are allowed to engage in scrip lending and borrowing. Performance is calculated by Coronation for a lump sum investment with income distributions reinvested. All underlying price and distribution data is sourced from Morningstar. Performance figures are quoted after the deduction of all costs (including manager fees and trading costs) incurred within the fund. Note that individual investor performance may differ as a result of the actual investment date, the date of reinvestment of distributions and dividend withholding tax, where applicable. Where foreign securities are included in a fund it may be exposed to macroeconomic, settlement, political, tax, reporting or illiquidity risk factors that may be different to similar investments in the South African markets. Fluctuations or movements in exchange rates may cause the value of underlying investments to go up or down. The Coronation Money Market fund is not a bank deposit account. The fund has a constant price, and the total return is made up of interest received and any gain or loss made on any particular instrument, in most cases the return will merely have the effect of increasing or decreasing the daily yield, but in the case of abnormal losses it can have the effect of reducing the capital value of the portfolio. Excessive withdrawals could place the fund under liquidity pressures, in such circumstances a process of ring-fencing of redemption instructions and managed pay-outs over time may be followed. A fund of funds invests in collective investment schemes that levy their own fees and charges, which could result in a higher fee structure for this fund. A feeder fund invests in a single fund of a collective investment scheme, which levies its own charges and could result in a higher fee structure for the feeder fund. Coronation Management Company (RF) (Pty) Ltd is a Collective Investment Schemes Manager approved by the Financial Services Board in terms of the Collective Investment Schemes Control Act. Unit trusts are traded at ruling prices set on every trading day. Fund valuations take place at approximately 15h00 each business day, except at month end when the valuation is performed at approximately 17h00 (JSE market close). Forward pricing is used. Additional information such as fund prices, brochures, application forms and a schedule of fund fees and charges is available on our website, www.coronation.com. Coronation Fund Managers Limited is a Full member of the Association for Savings and Investment SA (ASISA). Coronation Asset Management (Pty) Ltd (FSP 548) and Coronation Investment Management International (Pty) Ltd (FSP 45646) are authorised financial services providers.
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We strive to always put our clients first.

We have an unwavering commitment to the long term.

We focus on producing top performance over all meaningful periods.

We are uncompromising about ethics.
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