



## DAUDS ADVISORY

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### Corporate Governance

#### *“When Fund Managers Neglect Their Duty of Care to Clients”*

Cornwell Dauds

#### Introduction

1. Clients (as individuals, via pension funds, retirement annuities and other channels) hand their hard-earned money to fund managers in the expectation that the managers will grow their money. Naturally, clients do not expect the impossible, only a fund manager’s best efforts, more so since the fund managers charge their clients a not insignificant fee for those efforts.

#### A display of gross neglect of duty of care

2. Coronation Fund Managers is South Africa’s third largest investment

manager. It is a fund manager with supposedly highly skilled investment professionals. As at 09 March 2023, it had a total of ZAR602 billion of its clients' money under management — many of them pensioners — and does business under the motto “trust is earned”. It used this money to make large investments in African Bank, a South African bank, which spectacularly collapsed in August 2014. An African Bank share was considered a quality stock and included in Coronation's Top 20 Fund. By February 2014, a mere 5 months before the bank's collapse, the money manager had such faith in the bank that it had bought 22.7% of its issued equity shares. During the bank's meltdown in August 2014, Coronation was saying to anybody ready to listen that equity holders, preference shareholders and subordinated debtholders stand to lose all their capital. The fund manager's own accumulated loss from its investment in African Bank shares totalled ZAR3.52 billion – there was a further accumulated loss totalling ZAR31.6 million from its investment in the bank's debt securities. That's how much money Coronation lost its clients.

3. US hedge funds had predicted African Bank's meltdown as early as 15 months before the bank's actual collapse. At the Ira Sohn Investment Conference in New York in May 2013, David Stemerman, founder of the US-based hedge fund, Conatus Capital Management, was telling his fellow US hedge fund managers to bet against African Bank by shorting its stock. In fact, a SA-based hedge fund ended up shorting

the stock, making its clients a ZAR100 million profit. Conatus Capital Management could tell that African Bank was headed for a crash for a number of reasons–

- the bank had become vulnerable due to the aggressive growth of its unsecured consumer lending, followed by a growth in bad debts;
  - unlike South Africa’s largest banks that rely on branch deposits, African Bank was relying almost entirely on debt financing from the bond market;
  - the reserves set aside on the bank’s balance sheet to cover future losses on non-performing loans were 10% lower than the reserves set aside by the big four South African banks.
4. Curiously, Coronation – African Bank’s biggest shareholder – either failed to see these warning signs or chose to ignore them.
5. It was well-known that African Bank had accounting issues which related to the impairment of consumer loans and the ZAR1.4 billion loan extended to Ellerines, the non-profit making furniture retailer the bank had purchased at an inflated price of ZAR9.1 billion. While the loan was extended to Ellerine Group’s retailer, Ellerines (a subsidiary), to keep it afloat, no security was provided for it and there was no reasonable prospect of its repayment. And while the bank sought to

justify the purchase of the retailer, doubts remained over the wisdom of the acquisition. Corporate governance failures at both executive and board levels at the bank were also well-known. Added to all these problems, almost ZAR20 billion worth of consumer loans of the bank's ZAR60 billion loan book were non-performing. While Coronation was aware of these red flags, or should have been aware, the money manager nevertheless chose to expose its clients' capital to those risks by investing their money in African Bank.

6. At the height of African Bank's meltdown in August 2014, when more than 90% of its market capitalisation was wiped out in just three days and trading in its shares on the Johannesburg Share Exchange was suspended, Coronation embarrassingly admitted its mistakes and apologised to its clients for losing them money. The fund manager claimed it had learned a "sobering lesson" from the African Bank debacle. But given the fact that Coronation is an apparently astute fund manager with highly skilled investment professionals, and does business under the motto "trust is earned", its so-called mistake and conduct in losing its clients money was inexcusable. Coronation was expected to do its work, but it failed its clients dismally. It breached the fiduciary duty it owed its clients.
7. A mere 3 years later, and it was *deja vu* for Coronation's clients. This time it was Steinhoff, a South African-based multinational retail group,

in which Coronation was one of the biggest shareholders, and to which the money manager had significant exposure. As at 01 December 2017, 10 funds managed by Coronation on behalf of its clients had the following exposures to Steinhoff – Coronation Industrial Fund 6.6%, Coronation Top 20 Fund 5.5%, Coronation SA Equity Fund 4.5%, Coronation Equity Fund 3.4%, Coronation Market Plus Fund 2.1%, Coronation Balanced Plus Fund 2.1%, Coronation Global Emerging Markets Flexible Fund 1.8%, Coronation Optimum Growth Fund 1.5%, Coronation Capital Plus Fund 1.2% and Coronation Balanced Defensive Fund 0.6%. Coronation subsequently confirmed that the total losses from these exposures amount to ZAR14 billion. That’s how much money the apparently astute money manager lost its clients – again, and a mere three years after admitting its “mistake” in losing its clients significant amounts of money through investments in African Bank.

8. Steinhoff went into meltdown in December 2017. In the process, more than 80% of the group’s market capitalisation was wiped out in just 2 days, with the bleeding continuing. The group admitted to some serious accounting irregularities. It dabbled in creative accounting practices which included the improper booking of revenues, the improper capitalisation of losses and expenses, and the creation of off-balance sheet structures to conceal losses, out of control debt and risk. The group brazenly went on a global acquisition spree purchasing

retailer after retailer, almost all loss-making, and for which it needlessly overpaid. Steinhoff was a retailer popular with investors, becoming the fifth most popular share for fund managers to invest in. It ranked among the 10 biggest companies in the Johannesburg Share Exchange Top 100, and its share was considered a quality stock by fund managers.

9. Year after year, Steinhoff published audited financial statements reporting on its financial performance and financial position. Ultimately, Steinhoff itself acknowledged that its audited financial statements – and vouched for by one of the 4 big accounting firms, Deloitte – could not be relied on and required restatement. Yet Coronation and its peers in the fund management industry – during their fascination with Steinhoff – did rely on those financial statements. Supposedly highly skilled investment professionals are not expected to behave like Sally Jane, the lay investor. The test and expectations are different. Coronation’s investment professionals were expected to conduct a fundamental analysis and proper research on Steinhoff. The purpose of such analysis and research was to pierce any appearance Steinhoff might have put up in its financials. Had Coronation’s investment professionals done this, it would have revealed the true risks embedded in the Steinhoff group. The information was there, the investment professionals simply had to do their work.

10. When it lost its clients money in the African Bank debacle, Coronation said it was a “sobering lesson”. When the money manager lost its clients money in the Steinhoff debacle, the fund manager says it was a “learning curve”. The question is, does the fund manager with its supposedly highly skilled investment professionals ever learn?
  
11. Through what may be considered a gross neglect of duty a care – a second time – Coronation lost its clients money. The money manager owed its clients a fiduciary duty which it had breached. In the absence of serious consequences for such breaches, it may not be long before the fund manager’s clients see a repeat of the neglect.