NEDGROUP INVESTMENTS

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NEDGROUP INVESTMENTS GLOBAL PROPERTY FUND

Quarter Four, 2018

For the period ended 31 December 2018

NEDGROUP INVESTMENTS GLOBAL PROPERTY FUND

Commentary produced in conjunction with sub-investment manager, Resolution Capital

PERFORMANCE

The Nedgroup Investments Global Property Fund underperformed the FTSE EPRA/NAREIT Developed Index (USD Net TRI) by 1% for the quarter ending 31 December 2018, as the index produced a total return of -5.69% in US dollar terms. The longer term performance remains strong, ahead of the index by 1.1% annualised since inception.

Indicator	3 months	1 year	2 years p.a.	Since Inception# p.a.
Portfolio*	-6.69%	-7.63%	2.29%	-0.03%
Benchmark+	-5.69%	-5.63%	2.05%	-1.10%
Difference	-1.00%	-1.99%	0.23%	1.07%
Fund Size	US$150,968,378			

* Net USD return for the Nedgroup Investments Global Property Fund, A class. Source: Morningstar
\# 13 July 2016.
\+ FTSE EPRA/NAREIT Developed Index (in USD Net Ret)

MARKET COMMENTARY

Global real estate generated returns superior to general equities, which produced total returns of -13.1% for the quarter, and with substantially less volatility over the course of the year. To be fair, whilst REITs were spared the extent of the recent sell-off, they did not enjoy the extent of the post Trump election equities rally.

Unfortunately, we could not provide a silver lining to the market's negative quarter performance. Our strategy underperformed the benchmark for a variety of reasons, mostly related to our more "pro-growth" positioning, principally through an overweight exposure to the office real estate sector.

Generally, more "defensive" segments and those least vulnerable to tech disruption fared best. This included residential rental apartments, healthcare, "triple-nets", as well as the Japanese and Singaporean REITs more broadly. Self-storage REITs also performed relatively well, albeit rebounding after a sharp sell-off in the third quarter of 2018.

Our portfolio was underweight the broad defensive category as collectively we could not see sufficient long-term value to warrant significantly turning over the existing holdings in light of mixed economic news. Even so, the portfolio did not ignore "defensives" entirely as careful readers will note our long-standing positions in NYSE listed Equity Lifestyles (ELS) and U.K.'s Assura (AGR) among others. Additionally, through its IPO, we initiated a position in Shurgard Europe (SHUR), the largest owner of self-storage properties in Europe.

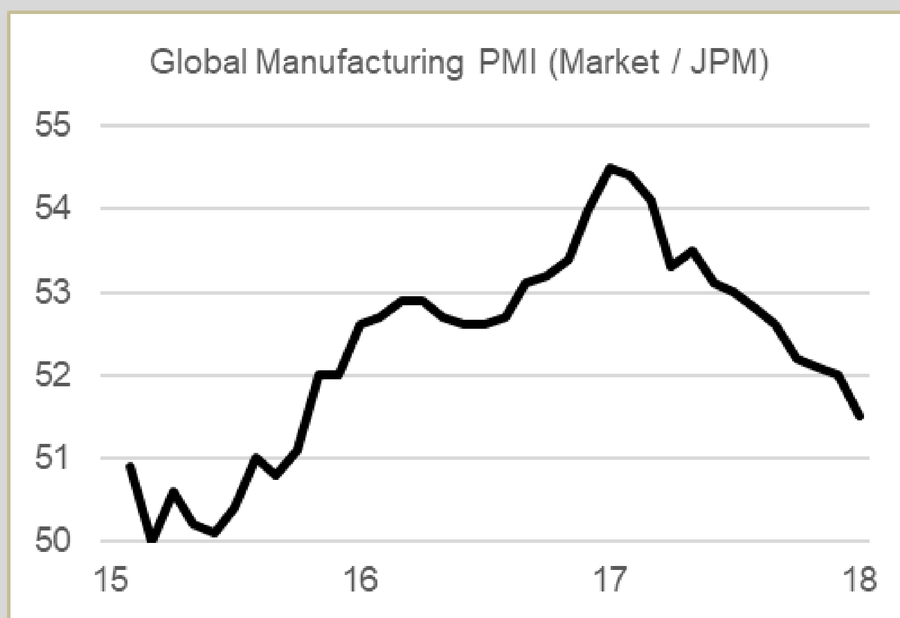
"IT'S THE ECONOMY, STUPID"

To us, it appears that the overall equities market correction over the quarter resulted from a post QE party hangover: The winding back of QE, which had culminated in elevated earnings multiples for equities and asset values in general, together with rising U.S. official interest rates made the market susceptible to anything other than good news for the economy and corporate profitably.

In addition, during the quarter there was no shortage of headline news to fill the front pages with concerns about a myriad of geo-political factors including trade tensions, signs of a slowing Chinese economy, Brexit bedlam, civil unrest in France in response to increased taxes as well as an unorthodox U.S. President facing a split Congress and effecting a Federal government shutdown.

The fears of slowing global economic growth and possibly dipping into negative territory in some areas were supported by corporate profit margins contracting, the bond yield curve flattening, and corporate credit spreads widening, particularly in the high yield market.

GLOBAL PMI FALLING



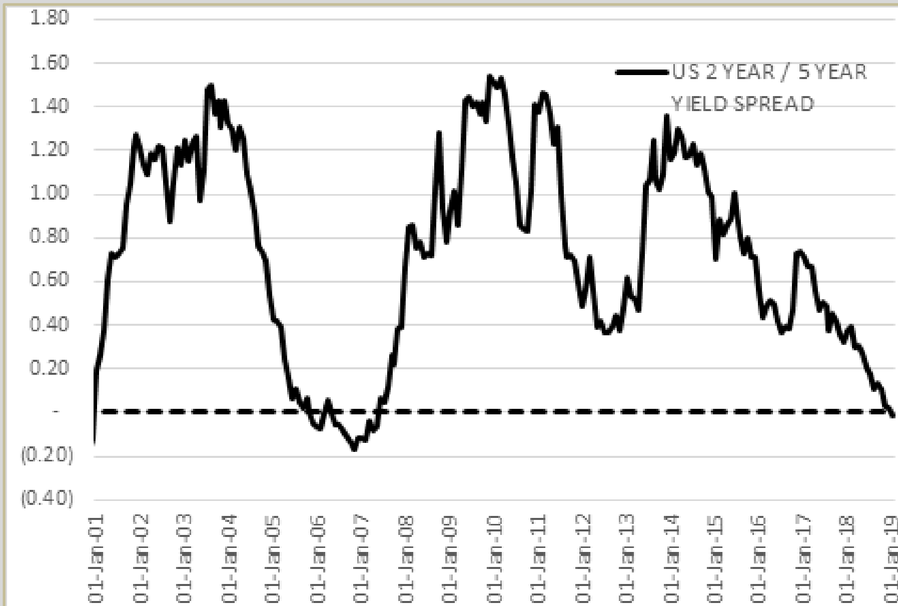
Source: Bloomberg
PMI: Purchasing Managers Index

Furthermore, that the sell-off happened in a period of broadly firmer bond yields reinforces our long-held view: interest rates matter to all asset classes, specific supply and demand dictates relative sector performance.

The U.S. Federal Reserve's tightening strategy is sensible in order to restore interest rates to a level consistent with current low unemployment and relatively strong economic growth. The Fed's commentary that inflation remains relatively benign means that there is limited threat, in the short to medium term, that rates should move considerably higher.

In short, the market had cause to pause after a strong run which elevated earnings multiples. Whilst unsettling, if not inconvenient, at this point it appears to be the very definition of a healthy correction rather than a systemic breakdown, albeit the shape of the yield curve and trade tensions remain concerns.

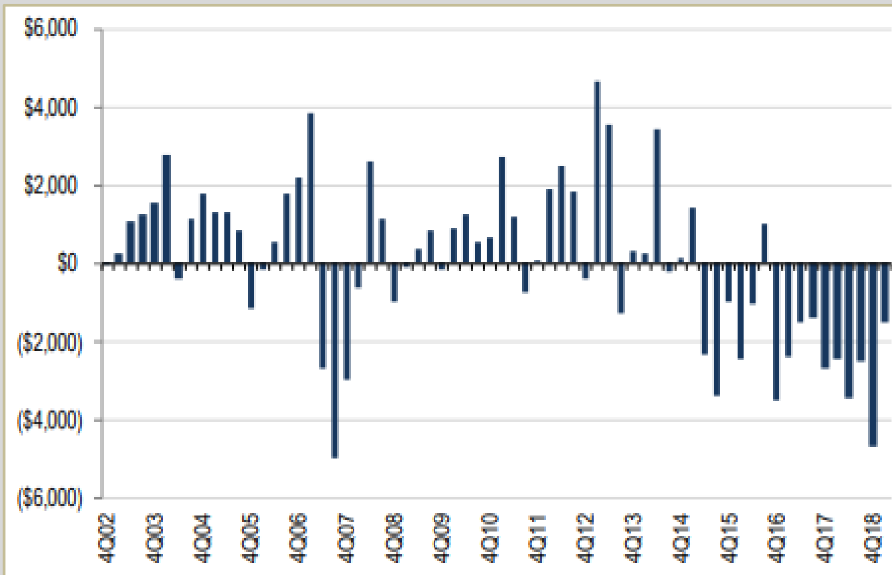
INVERTING U.S. YIELD CURVE



Source: Bloomberg

Furthermore, REIT Fund flows in 2018 didn't help the sector, particularly in the U.S. as the next chart illustrates.

U.S. REIT MUTUAL FUNDS IN OUTFLOW



Source: Lipper (formerly AMG Data); Please note Cohen and Steers reports flows on a quarterly basis.

Whilst disappointing that REITs were caught up in the sell-off, given there was limited news which had direct adverse impact on sector cashflows, one could take the view that the market is rationally and relatively calmly de-rating what were close-to-peak multiples on elevated earnings, thus creating an environment for more sustainable and less volatile future returns. Regardless, generally our stocks are in excellent financial shape and well positioned to weather unexpected storms.

We see little evidence of excessive debt within the listed REIT industry or real estate more broadly. Exceptions can be found in relatively isolated pockets such as Australian residential, U.K. retail and Continental European property, to which we have measured exposure.

Furthermore, there are limited signs of a flood of property development supply hanging over commercial real estate. Indeed, with more disciplined debt markets, skilled construction labour scarcity bottlenecks and the emphasis on infrastructure spending, the building supply capacity picture is somewhat constrained.

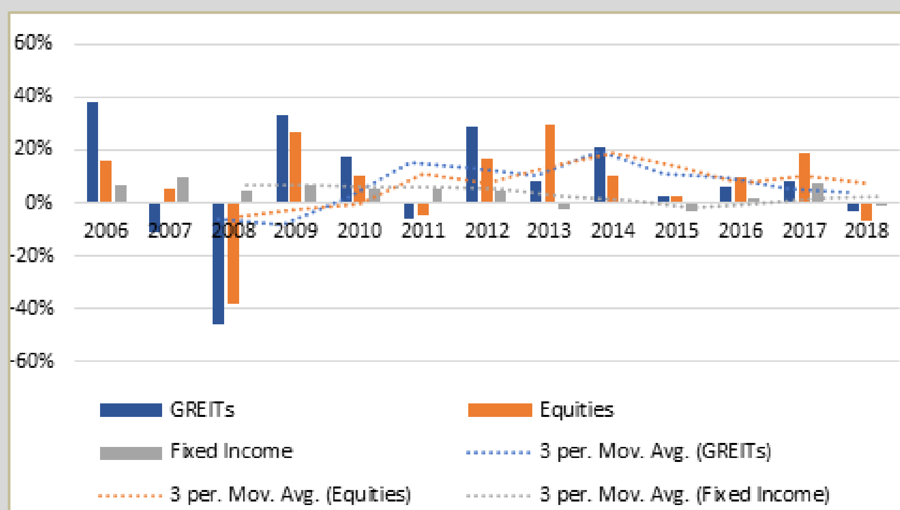
Significant pressure on building contractors continues with Lend Lease Corp (LLC) becoming the latest publicly listed company to report major project cost blow-outs in its construction and engineering division. Furthermore, in our travels, we heard anecdotes of poaching of development teams and issues in retaining reliable staff in a range of building related activities. For example, incentives for modular home building workers who turned up to work on 5 consecutive days.

This should be viewed as unambiguously positive for commercial building owners, as supply bottlenecks typically results in higher economic rents to justify development and constrain overall new supply volumes to levels well below previous peaks.

OUTLOOK – GET SOME PERSPECTIVE

We have not had expectations for high nominal returns for some time: interest rates would increase, and QE would be retracted, normalised levels of commercial building supply would also moderate landlord pricing power. By and large this has played out, with REIT sector returns moderating in recent years.

ASSET CLASS ANNUAL AND 3-YEAR ROLLING RETURNS

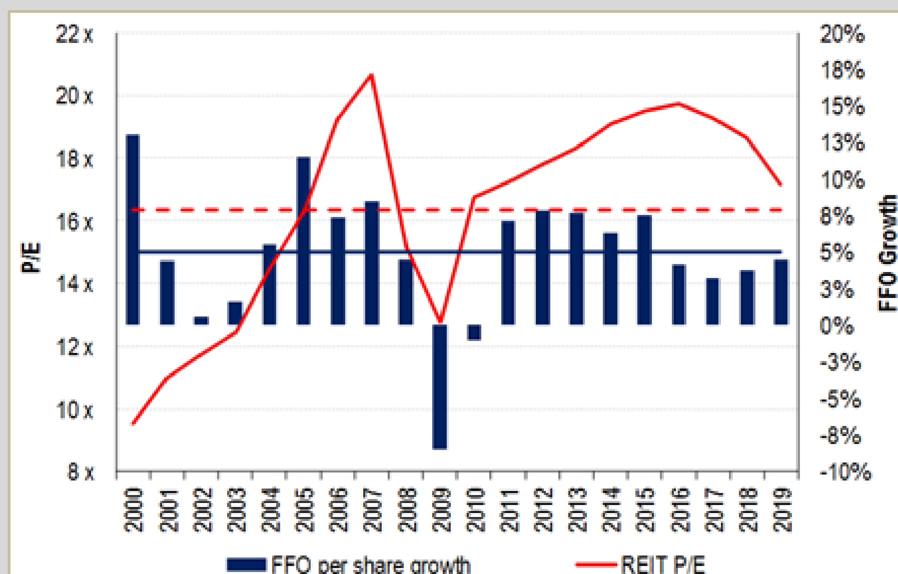


Source: Bloomberg. All returns quoted in local currency.
GREITS: FTSE EPRA NAREIT Developed Index
Equities: MSCI World Index
Fixed Income: Barclays Global Aggregate Index

This does not mean we have a negative view, simply more modest return expectations generally. With long term contractual cash flows from a broad cross-section of the economy and backed by tangible assets, we maintain that REITs represent an effective means of diversification within a broad investment portfolio.

The sectors earnings multiple has moderated and is now within sight of its long-term average, albeit it rarely settles there. Whilst weaker stock prices have contributed, pleasingly stable earnings growth and natural deleveraging by REITs has contributed significantly to a relatively orderly restoration of value.

RCL Select Global REIT FFO Growth Rates and Multiples



Source: Resolution Capital

The Global REIT sector now is trading at a slight discount to NAV and has a reasonably strong balance sheet in light of limited development exposure, a shift to unsecured debt and a historically low dividend payout ratio. Coupled with a moderate commercial property supply picture, further uncertainty around the underlying economic conditions, REITs should benefit in a relative if not absolute sense. The sector is increasingly attractive to private equity raiders.

To some degree, collectively the market remains scarred by the events of the GFC on the sector, when asset prices fell precipitously as a consequence of too much debt and widespread poor allocation of capital to fundamentally flawed products which caused a seizure of the debt capital market and banking in general.

The current challenge is understanding how the economy and asset prices will adjust to the withdrawal of the QE largesse and a normalisation of interest rates. Clearly the trade policies pursued by the U.S., China and to some degree the U.K. adds to the uncertainty. Consequently, from a real estate perspective, tenant credit remains our greatest concern at this point. Even so, we believe REITs, which have actively managed their portfolio composition and capital structures are in relatively good shape to weather this uncertainty.

INDUSTRIAL TAKES A BREATHER (REALITY CHECK?)

Given the high multiples applied to industrial REIT earnings, we have been careful not to have too much exposure to this segment and indeed during the quarter we reduced our exposure to U.K./Europe platform SEGRO (SGRO). Nevertheless, our other major industrial property exposure, NYSE listed ProLogis (PLD) did not fare well, declining -12.7% in local currency terms during the quarter. We believe the long-term drivers of logistics warehouse demand remain intact, particularly for infill locations close to large population centres and would likely see any further meaningful pull-back as a buying opportunity.

OFFICE REITs

Overall however, enthusiasm for office REITs over the quarter was drained by the weakening economic outlook and a number of our positions suffered. Our U.S. office names Empire State Realty (ESRT), Brandywine Realty (BDN) and Kilroy Realty (KRC) weighed on performance. The stocks represent attractive value and are importantly in good financial shape. To this effect, subsequent to year end, in January Brandywine announced a US$150m share buy-back program, coinciding with the sale of one of its properties for US$107m, thereby having limited impact on the leverage of the company.

Our exposure to Gecina (GFC), a Paris focused office landlord, was hit hard by the concerns for the French economy, seen vividly in the riots associated with President Macron's tax policies. Gecina's relatively high financial leverage amplified the downdraft in the share price during the quarter.

Of some comfort, several of our other office holdings were among the sector's best performers: cash rich U.S. based Equity Commonwealth (EQC); Canadian focused Allied Properties (AP); and Australian office REIT Dexus (DXS). Dexus has done an outstanding job of recycling its capital and maintaining a strong balance sheet. Its disposal during the quarter of a significant part of its legacy industrial property assets to Singapore's GIC was achieved at attractive pricing and provides the platform with financial strength and flexibility for some time.

But back to one of our higher profile names in the portfolio: Empire State Realty Trust. The market did not take kindly to ESRT during the quarter, the stock produced a return of -13.7% in local currency terms. Higher levels of tenant move-outs announced during the year point to weaker earnings growth in the short term. This did not unsettle us, generally the vacating tenants are being replaced within a reasonable time frame at significantly higher rents. More concerning is the potential impact on the Empire State observation deck from two new observation deck competitors expected to open in the next two years: at 30 Hudson Yards and at One Vanderbilt near Grand Central Station.

Whilst we expect they will have an impact by virtue of their locations being in the mid-town south part of New York, the Empire State building continues to be an iconic asset which has a strong brand and where management is investing to maintain the competitiveness of the platform. We believe the market has overly discounted this income stream. With a low implied value per square foot for its property portfolio, its strong capital structure, and the improving location of its key office assets in the transforming Mid-Town South district, we believe Empire State Realty Trust is one of the world's most attractively valued REITs, but acknowledge patience is needed from a short-term earnings growth perspective. The mounted sale of another iconic New York trophy tower, The Chrysler Building, will provide an interesting benchmark.

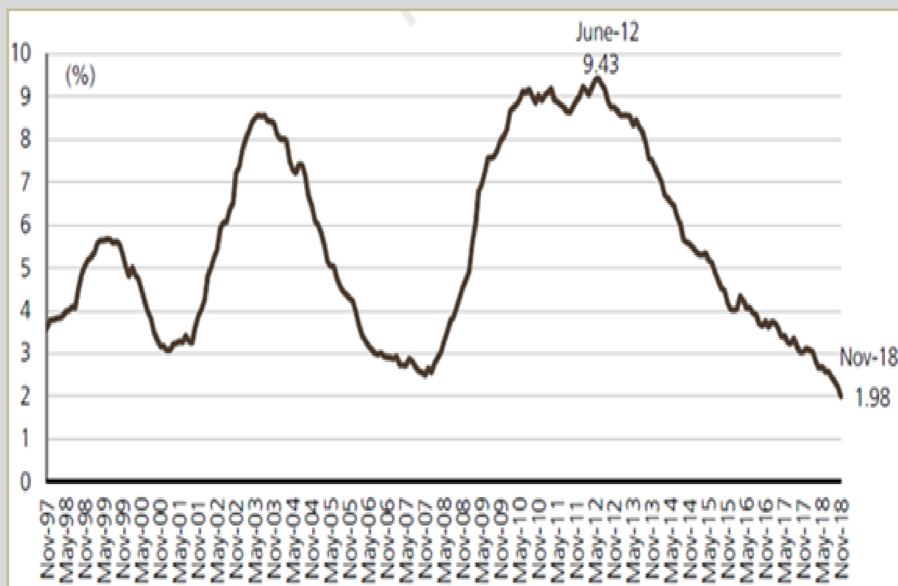
The Manhattan office market has absorbed a great deal of challenges over the past decade including the impacts of the Global Financial Crisis on the finance industry, construction of new buildings which, in addition to adding space, have enabled tenants to reduce their overall space requirements through greater workplace staff densification. These factors have combined to keep the market vacancy rate elevated and rent growth modest.

JAPAN: J-REIT vs J-DEVs

Our avoidance of J-REITs detracted from performance. We remain bemused if not frustrated by the relative out-performance of the J-REITs (+0.91% for the quarter, in local currency terms) which defy traditional investment value metrics and have been a major drain on our relative to benchmark performance. J-REITs, of which we have no exposure, now represent circa 8% of the benchmark so it is a meaningful bet. As a value investor, we remain committed to not following the herd when we do not believe it is grazing in fertile pastures.

We continue to believe Japanese property investment and development companies (JDevs) are now trading at increasingly attractive prices and see little reason to change our stance. For all the negative sentiment toward the JDevs, their medium to long term history of earnings and Net Asset Values (NAV) growth has at least been reasonable. They are now trading at historically low earnings multiples and wide discounts to NAVs. The property market is stable with extremely low vacancy rates in the Tokyo office market, as highlighted in the chart below, and the Japanese economy is starting to look relatively attractive compared with the uncertainties in the U.S. and Europe.

OFFICE VACANCY RATES IN TOKYO'S 5 MAIN WARDS



Source: Miki Shoji

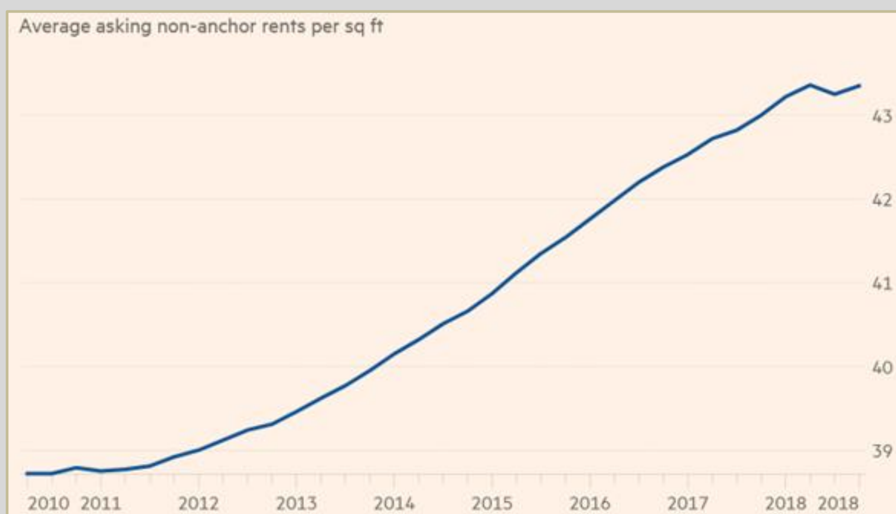
However, less than ideal transparency and corporate governance, higher financial leverage than we would like (although not excessive and lower than J-REITS) keeps us from taking a more substantial position.

Whilst some Japanese property companies have launched share buy-back programs, they are generally tokenistic. Management could help the situation by cutting expenses as well as selling more property, using the proceeds to de-lever and make the share buy-backs more meaningful. Offshore investment programs could be curtailed with excess capital going toward increased dividend pay-out ratios. We stress, the earnings and NAV situation is reasonable, but given the current market dynamics they could be so much better.

RETAIL – THE CLOSING DOWN SALE SALE?

Retail property has recently floundered, the sector generating among the weakest market returns for the quarter. The sector was bombarded with more bad news surrounding the impacts of changing consumer spending patterns much associated with ecommerce technology disruption. Administrators called in to U.K. music doyen HMV, weaker retail sales for one of Australia's major department store operators Myer, U.S. department store owner Sears and its Kmart stores seemingly in its final death throes, all weighed heavily on shopping centre and mall landlords in many developed regions. U.S. retail rents are showing signs of wilting.

U.S. SHOPPING MALL RENTS FLATLINE



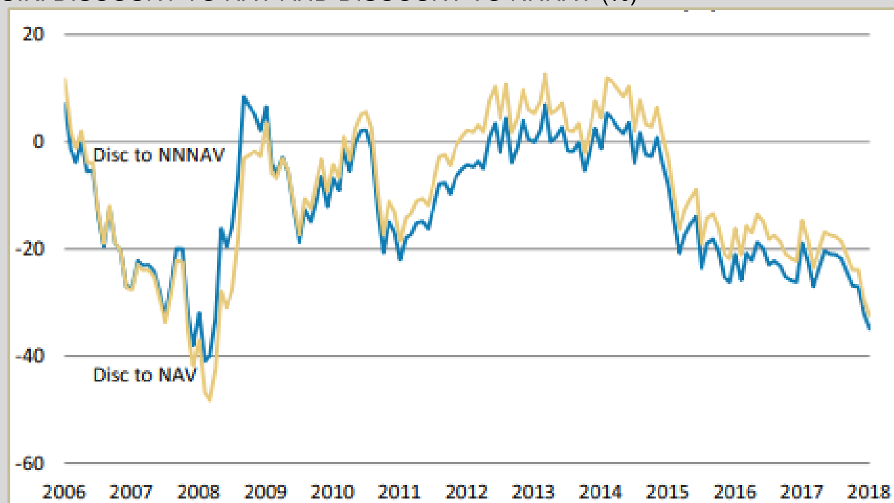
Source: Reis

Nonetheless our exposure to Simon Property Group (SPG), the sector's largest REIT and owner of various retail property formats (malls, lifestyle centres and outlets) seems to be weathering the changes better than most. The stock produced a return of -3.9% in local currency terms for the quarter. Its strong balance sheet provides it with capacity to help its tenants adapt, combined with U.S. consumers in the mood to spend. Its overall portfolio is enjoying elevated occupancy levels as retailers focus on the most productive locations. In contrast, those retail related REITs with weak balance sheets are ill-placed to provide the capital for tenants to refurbish stores and remix the properties with retailers relevant to today's shopping trends.

DOES BREXIT MEAN BREXIT?

Whilst Brexit is no doubt weighing on the outlook for U.K. real estate, other than in retail, at face value there was limited evidence of material deterioration in rents or values in other segments of the property market. However, anecdotally tenants are taking longer to make new commitments and are extracting more incentives, the terms of which are harder for public markets to assess. In light of the uncertainty, the public market has voted: REITs are currently trading at significant discounts to NAVs, which have changed little since those conducted prior to the Brexit vote. The chartered surveyor (independent valuer) community is either supremely omniscient or just bluffing.

U.K. DISCOUNT TO NAV AND DISCOUNT TO NNNAV (%)



Source: Company data, DataStream, Morgan Stanley Research

The discount to NAV is informative as it is now approaching similar levels to the depths of the GFC when the economy was in a deep recession and the REITs were over levered in an environment where credit had evaporated. Today, the economy does not appear to be contracting, credit remains available and the REITs, with one or two exceptions, are generally in good financial shape having prudently deleveraged in recent years.

We currently have approximately 5% exposure to UK listed stocks, predominantly via Assura which invests in NHS backed doctors clinics with long term-leases, and Segro which invests in logistics across the UK and Europe where solid demand is being driven by ecommerce.

UNIBAIL'S LOWY INDIGESTION

Whilst Intu's plight was noteworthy, from a market capitalisation perspective the biggest casualty was Unibail Rodamco Westfield (URW), its share price fall wiping over A$7.8bn off the value of the company in just the quarter alone, representing over one-fifth of its equity value. The stock is struggling amid concerns about its relatively high leverage and disappointing operating performance numbers, particularly from the Westfield assets. Our concerns about key issues means that at the end of the quarter we have circa 1% exposure to URW, compared with 4.7% combined exposure to Unibail and Westfield at the end of 2017.

LINK PERFORMANCE REWARDS

Bucking the retail trend, and defying weakness in listed Hong Kong landlords associated with an environment of rising rates and slowing economic growth in China, Link REIT (823) produced a solid total return of 4.6% over the quarter. Link, a portfolio holding, continues to print solid operating results and announced the sale of another collection of its assets at a price materially above appraised value. Link sold 12 assets for HK$12 billion, equivalent to approximately 5% of its enterprise value, at a 32% premium to book value. Pricing reflects a net income yield of approximately 2.7%, which is similar to the yield achieved on the HK$23 billion portfolio of higher quality assets sold approximately 12 months ago. Proceeds from the sale will be used to reduce financial leverage, buy back shares and fund potential acquisitions and redevelopment.

Link's loan to value ratio will be approximately 12% on completion of the sale and proforma for the recent acquisition of its fourth asset in mainland China. Link's portfolio continues to deliver sound growth with 6.9% like-for-like net property income growth and 7.2% tenant sales per square foot growth reported for the period ending 30 September 2018.

RESPONSIBLE INVESTMENT

ADDRESSING DIVERSITY (AGAIN)

In our opinion, which is also supported by empirical research, Boards that embrace cognitive diversity, through appropriate gender representation and a broad spectrum of skills and experience, are more likely to achieve superior risk adjusted investment returns.

In a similar exercise undertaken to last year, we analysed the gender diversity of the Boards of the companies we invest in. On average, women make up 22%, an increase from 18%. Whilst we believe this is still too low, it is encouragingly an improvement versus last year.

A third of our holdings have female Board representation at or above 30%. Pleasingly this is a 50% increase compared to last year, which highlights improvements are being made. During the quarter we contacted all companies in our portfolio which have less than 30% of women on the Board. We stated our concern and asked if they have plans to increase gender diversity.

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UK investors should read the Appendix for UK Investors in conjunction with the Fund's Prospectus which are available from the Investment Manager. www.nedgroupinvestments.com

The Fund has been recognised under paragraph 1 of schedule 4 of the Collective Investment Schemes Act 2008 of the Isle of Man

Isle of Man investors are not protected by statutory compensation arrangements in respect of the Fund.

The Prospectus of the Fund, the Supplement of its Sub-Funds and the KIIDS are available from the Investment Manager and the Distributor or from its website www.nedgroupinvestments.com

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