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NEDGROUP INVESTMENTS MANAGED FUND

Quarter One, 2019

For the period ended 31 March 2019

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Performance to 31 March 2019	Nedgroup Investments Managed Fund	ASISA category average	SA Inflation + 6% Geometric
3 months	+5.3%	+5.8%	+1.9%
12 months	+7.8%	+5.8%	+10.3%

Overview

Global financial markets bounced strongly this quarter, recovering from the weak close to 2018. Global equities made impressive gains, with the MSCI World Equity Index delivering a +12.6% USD return, compared with a decline of -8.2% in the previous quarter.

Emerging market equities were not far behind, producing +10% USD return for the quarter, having fallen by -14.2% during the fourth quarter of 2018. In USD terms, global government bonds returned +1.9% for first quarter of 2019.

South African equity returns for the quarter were strong, but lagged other emerging markets, producing an 8% return for the quarter in rand terms (+7.7% in USD). South African bonds were up 3.8% in the quarter.

Global market commentary

Since late 2018, global developed market bond yields have fallen significantly, signaling the market's expectation of the first synchronised slowdown since the 2008 economic crisis. Already weak numbers have emerged from Germany with the rest of the Eurozone likely to follow. More and more company profit updates are warning of slowing sales across many industries. Brexit is also not helping and remains a source of major uncertainty.

In the US, economic growth remains strong with consumer confidence at high levels and unemployment at record lows. However, business confidence is deteriorating, and earnings downgrades have not yet troughed. However, a more dovish Fed will help maintain expansionary financial conditions which will aid in extending one of the longest US economic expansion in history.

China's slowdown, which started in the last quarter of 2018, might be nearing its end as fiscal stimulus and a positive credit impulse bring its economy back on the boil. A turnaround in Chinese growth would help lift other Asian economies, as well as Europe, which benefits via its export industries.

Despite the possibility of a global turnaround, we remain concerned by the record low unemployment rate and elevated profit margins in the US. Furthermore, the exceptionally low real yields in developed bond markets do not bode well for future financial market returns.

South African market commentary

SARB monetary policy will likely remain accommodative

With the South African repo rate set at over 2.5% above the inflation rate, South African real yields screen as globally attractive. While there is some scope for the SARB to cut interest rates in the quarters ahead, the need to protect the currency, and prevent the knock-on inflation effect, remains.

The South African economy is facing major challenges

South African economic growth has been anaemic for some time now. This has been driven by numerous structural issues. Whilst government spending has remained strong, our lack of employment growth, very high and increasing levels of indebtedness, and a high tax burden are now putting a huge strain on the consumer. Official growth forecasts are all pointing to a lacklustre economic performance in 2019 that will make the worryingly high inequality gap difficult to address. In addition, the parlous state of many of the country's parastatals, notably Eskom, is making efforts to stimulate growth more challenging.

On the positive side, if President Ramaphosa is returned to power with a strong mandate after the May elections, the country could see a major initiative to tackle corruption and service delivery, issues that have been plaguing the country for some time. If combined with increased policy certainty and fiscal discipline, South Africa could start to meaningfully address the structural issues which have been holding us back. This would no doubt be good for overall business and consumer confidence and could attract higher levels of investment that would raise growth rates and living standards over the medium term.

Domestic equity values continue to improve

In previous commentaries we have observed that domestic equities are not cheap, although value has steadily been improving. Given that the global monetary environment is likely to remain benign and that domestic inflation is under control, domestic interest rates are currently poised for either a cut or at worst, remaining steady. The poor economic outlook points to earnings growth remaining weak, suggesting that equity returns will, at least in the quarters ahead, continue along the path of subdued returns similar to the last few years. Earnings growth needs to accelerate if equities are to enter a new bull market.

Property returns are expected to be subdued

In line with equities, property returns are also expected to be subdued as the growth in distributions is likely to remain weak for the foreseeable future. Although the running yield appears attractive, this needs to be balanced against the poorer quality earnings we are seeing from the property counters.

Portfolio positioning

The funds underweight positions in many of the highly rated South African-focused stocks paid off handsomely as the poor economic environment translated into difficult trading, and ultimately resulted in very poor earnings updates from many of these companies. As we have been warning in previous commentaries for quite some time, the market was too optimistic in terms of the expected earnings growth from many of these companies given the above difficult economic environment. This combined with ratings that were still expensive resulted in significant share price underperformance as the companies released their earnings updates.

The fund’s overweight positions in many of the cheap industrial and commodity-based rand hedges generated significant outperformance as year-on-year rand weakness and better global growth buoyed their earnings. The fund’s overweight positions in platinum did particularly well after a significant improvement in the basket price of the Platinum Group Metals (PGMs) over the last year manifested in significant earnings beats as these companies released their results to the market.

Our underlying investment thesis for the platinum sector has been that the lack of capital investment over the last decade because of poor economics would eventually manifest in a lack of supply. This would ultimately drive PGM basket prices higher to the point where producers were once again incentivised to invest in new supply. South African platinum mines have grappled with a decade of declining profitability largely because of the excess supply resulting from South African mines historically chasing production at the expense of returns. This realisation, and the current reduction of unprofitable ounces, comes at a time when underlying demand is accelerating and benefitting from tighter global emission standards in both developed and emerging markets.

This has resulted in a substantial rise in the PGM basket price, specifically palladium, which is in a significant deficit position and is expected to remain so for at least the next three years. Even at current PGM basket prices, producers are reluctant to invest more capital to meet the current PGM shortages, as long-term concerns around electric vehicles taking more market share from internal combustion engines dominate discussions about the long-term demand outlook. This means we could well see the PGM basket prices move higher and stay elevated for quite some time.

We turned positive on Naspers in November last year. The share price had been weak because of a sell-off in Tencent due to concerns around a moratorium by the Chinese gaming regulators on new game approvals. We believed the moratorium would be temporary and took the opportunity to increase our exposure to Naspers. As expected, the Chinese gaming regulators restarted approval in earnest this year, initially with domestic game approvals. The first batch of international games has just been announced. We think this should manifest in a better performance from the gaming business in 2019. Naspers also unbundled Multichoice this quarter and announced the intended listing of most of its assets in Amsterdam. All of this bodes well for unlocking a portion of the significant discount on which the share trades.

Over the quarter the fund reduced exposure to Howden, Northam Platinum, Capitec, Vodacom, Spar, and Sappi. Major purchases included Anheuser-Busch, Reinet, and FirstRand. Although a significant portion of the fixed income assets remain invested in floating rate subordinated debt of SA top five banks, we have started to reduce these positions after making significant gains as credit spreads narrowed over the last year. We are looking to increase the liquidity of fixed income holdings at this stage of the cycle as the spread compression seen over the last year is no longer sufficient to justify our current exposure.

Contributors and detractors

There were some very large share price moves this quarter, but the stand-out performance was undoubtedly the platinum sector, up 49.7%! We have been steadily building a position in this sector since the middle of last year, and our positions in Implats and Northam contributed meaningfully to performance this quarter.

We shared with you last quarter our investment thesis on British American Tobacco and why we thought the valuations were now pricing in a significant amount of risk. The share price increased 29.5% this quarter and our holdings in both British American Tobacco and Reinet were positive contributors.

We sold out of all our Vodacom prior to their December quarterly update as we feared that the pressure on data pricing, combined with a weak macro, would produce weak numbers. Other contributors to performance were Quilter and BHP Group plc. Our positions in Pepkor, Sappi, and Woolworths detracted from performance.

DISCLAIMER

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The Standard Bank of South Africa Limited is the registered trustee.
Contact details: Standard Bank, Po Box 54, Cape Town 8000,
Trustee-compliance@standardbank.co.za, Tel 021 401 2002.

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NEDGROUP INVESTMENTS CONTACT DETAILS
Tel: 0860 123 263 (RSA only)
Tel: +27 21 416 6011 (Outside RSA)
Email: info@nedgroupinvestments.co.za
For further information on the fund please visit: www.nedgroupinvestments.co.za

OUR OFFICES ARE LOCATED AT
Nedbank Clocktower, Clocktower Precinct, V&A Waterfront, Cape Town, 8001

WRITE TO US
PO Box 1510, Cape Town, 8000

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