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NEDGROUP INVESTMENTS STABLE FUND

Quarter One, 2019

For the period ended 31 March 2019

NEDGROUP INVESTMENTS STABLE FUND

Executive summary

Newly-dovish major central bank policy boosted investor sentiment, extending the 2019 market rally into March. US bourses posted their best quarterly return in 20 years while China is the world's best performing market this year, up around 18%. The US Federal Reserve now expects no interest rate increases in 2019 and suggests only one for 2020. The pace of quantitative easing withdrawal will also slow – the Fed has announced that its quantitative tightening will end early, in September 2019. Weak European economic data has also kept the ECB dovish.

While the changed monetary policy response has sparked risk assets, it also implies growing central bank concerns for economic weakness. This supports our base case thesis that we are now late stage in the global economic cycle.

In South Africa, extensive load-shedding suggests that energy constraints will be a bigger drag on growth than initially thought. But sentiment was buoyed at quarter end when Moody's delayed its credit rating review. In April, Moody's maintained South Africa's current investment grade rating and stable outlook.

We concur with Moody's that the post-election government actions will give far greater insight into South Africa's medium-term economic trajectory than is possible now. Economic conditions remain stressed, together with low levels of business and consumer confidence.

Our defensive strategic positioning and high levels of portfolio liquidity seem judicious.

Q1 2019 Performance comments

- The full allocation to foreign assets was the largest contributor to returns whilst South African equities were also positive
- Core portfolio rand hedges British American Tobacco (+29.5%), BHP Group (+21.7%), and CF Richemont (+11.8%) rose sharply despite only moderate rand weakness while Aspen (-31.0%) detracted
- South African bonds were also positive as yields fell on lower SARB inflation and growth forecasts for 2019
- Property also contributed positively driven mostly by Capital and Counties (+8.0%)

Market overview

World

- Despite continuing strength in the US economy, the broader macroeconomic environment deteriorated – a weak European economy and fears of slower Chinese growth due to ongoing uncertainty around a trade agreement with the US compound late cycle growth concerns
- Global equity markets rallied strongly out of the fourth quarter of 2018 sell-off, with the US enjoying its strongest first quarter return in twenty years. China was the strongest performing market (up around 18%) – as most major central banks turned decidedly dovish providing a spark to risk assets, despite the gathering economic storm clouds
- Geopolitical stresses continued to simmer with no resolution of the Brexit crisis in sight and ongoing political tension between Italy and the EU – US/Sino trade tensions eased somewhat as Trump delayed the tariff increase deadline and rumours emerged of positive progress in talks
- The US Federal Reserve did a dramatic policy U-turn becoming surprisingly dovish, indicating concern about global economic strength in the months ahead – despite the strong US economy it announced that no further interest rate hikes are likely in 2019 and it will slow the pace of quantitative easing withdrawal
- US 10-year bond yields declined sharply as investors reacted to the change in central bank monetary policy expectations resulting in an inversion of the US yield curve, albeit for only five days – although in the current environment this is perhaps less of a harbinger of pending recession than historically, it does provide some support to the late stage in the cycle thesis
- The oil price rose on continued involuntary supply disruptions from Venezuela, additional Saudi led OPEC production cuts and a surprise decline in US stockpiles – further upside is likely limited as US inventories showed some recovery towards quarter end while global demand is likely to weaken given slower economic expansion in many parts of the world
- Precious metals gold and silver initially rose sharply in January on dollar weakness but subsequently retraced as investors lightened positions in relatively safe haven assets as markets and the dollar rebounded – iron ore also rose on severe supply disruptions following a Vale tailings dam failure in Brazil, but the rebound in commodity prices might be short-term term in nature, with longer term risk more skewed to the downside

South Africa

- Economic growth was marginally positive, but remains stressed as demonstrated by Mboweni's downbeat budget speech, the return of erratic Eskom load-shedding and falling PMIs – despite the new ANC leadership's high-volume public relations efforts, the looming 2019 national elections make meaningful economic reforms improbable in the near term
- The rand weakened on US dollar strength but recovered a little at quarter end as Moody's delayed their credit rating review, leaving the current investment grade rating and stable outlook unchanged pending the elections outcome – currencies of open economies with large twin deficits and economic growth headwinds remain vulnerable
- The FTSE/JSE Capped All Share Index rose, led higher by resources with industrials and financials both ending in negative territory – several index-heavy non-resource rand-hedge stocks rose meaningfully while SA Incorporated companies were mostly lower given the lack of business investment and consumer demand
- South African government bond yields fell and the All Bond Index posted positive returns as the SARB revised down its 2019 forecast for economic growth and inflation, keeping interest rates steady – whilst high real yields are an attractive investment opportunity they are too restrictive given the SARB's own inflation expectations and a muted economic expansion in the forecast period, opening the possibility of a repo rate reduction in H2 2019, although low probability at this stage
- South African listed property was flat over the quarter following four consecutive quarterly declines but remains under considerable pressure – distribution growth rates are increasingly at risk given negative rent reversions in certain sectors and nodes, high vacancy rates in office and over-leveraged balance sheets
- The rand fuel price was sharply higher as the surging dollar oil price and weaker rand worked their way through the Basic Fuel Price formula – these inflationary pressures should moderate if the dollar oil price stabilises, although food price inflation is starting to emerge following the drought conditions in South Africa's grain growing regions

Investment outlook and portfolio construction

World: US-led global expansion is now undoubtedly late stage. The era of global protectionism is also firmly in place. EU political risks remain elevated whilst there is no resolution in sight regarding Brexit. Increasingly dovish central banks indicate that economic vulnerabilities might be rising. US bond yields are expected to rise moderately. Commodity prices may rise short-term, but longer-term risks are to the downside.

South Africa: Tangible economic reform is unlikely before the 2019 elections. Generally, twin-deficit emerging market nations remain vulnerable to setbacks. Erratic energy supply in South Africa also remains a drag on economic growth. Business investment and consumer spending continue to languish.

Fund construction: The portfolio remains conservatively positioned in domestic assets given the weak domestic economy and struggling consumer. Disposable income is being held back by low real income growth, rising administered cost inflation and low savings rates, while government policy uncertainty and stubbornly high and persistent budget deficits impedes private and public sector fixed capital investment. The historically-low JSE equity allocation favours global businesses but is balanced by a small holding in select domestically focused financial and consumer services counters, often in niche sectors with greater earnings certainty given the low growth outlook. Foreign assets remain at the prudential maximum with a preference for equities over bonds or cash. Specific global companies' earnings prospects offer greater certainty given the long-term structural tailwinds supporting them. We continue to avoid retail and commercial property counters in the main given the structural challenges facing the sector. The small listed property position is mostly in Capital & Counties and niche counters less correlated to major economic drivers. Physical gold (ETF) is an attractive, uncorrelated investment providing some portfolio insurance by preserving real capital value during times of increased financial or geopolitical risk. The relatively short-duration R186 government bond investment is preferred over cash, but at a slightly decreased weight due to some profit taking during the quarter. The high real yield still offers enough margin of safety if inflation rises more than anticipated and hedges the possibility that we have overstated the South African-specific economic risks. The cash allocation is higher following the relatively small disposal in bonds. Real cash yields remain stubbornly high in South Africa and offers a decent real return in an uncertain world.

Conclusion

The portfolio has been cautiously positioned for at least two years. We are often criticised for being early but long experience has shown that it's better to be early than late when the bears are at the door. Caution remains the watchword for 2019, but the portfolio managers are vigilant for quality opportunities that will sustain long-term performance when the bears retreat. We maintain high conviction that the current portfolio positioning will deliver the returns investors expect over time.

Responsible investment summary

Proxy Voting Summary Q1 2019

Resolution Type Name	Total Count	For %	Against %	Abstain %
Auditor/Risk/Social/Ethics related	9	100%	0%	0%
Buy Back Shares	1	100%	0%	0%
Director Remuneration	2	100%	0%	0%
Issue Shares	5	40%	60%	0%
Loan / Financial Assistance	4	25%	75%	0%
Other	1	0%	100%	0%
Re/Elect Director	5	100%	0%	0%
Remuneration Policy	4	50%	50%	0%
Share Option Scheme	2	0%	100%	0%
Shares under Director Control	1	0%	100%	0%
Signature of Documents	1	100%	0%	0%

Notable engagements

SASOL
Met with remuneration committee:

- Discussed proposed LTIP scheme and re-iterated our opposition to any incentive scheme that dilutes existing shareholders.
- Informed the committee that we feel there should be remuneration consequences for management given the unexpected delays in the LCCP cracker project.
- Once the LCCP project is complete, the company's cashflow will improve materially. As a result, we think the committee needs to start thinking now about appropriate long-term targets/guidelines for management's application of this cash-flow in the coming year

BHP Billiton

- Have raised with management our concern regarding the lack of direct mining experience at board level, especially for a company so dependent on mining.

DISCLAIMER

WHO WE ARE
Nedgroup Collective Investments (RF) Proprietary Limited, is the company that is authorised in terms of the Collective Investment Schemes Control Act to administer the Nedgroup Investments unit trust funds. It is a member of the Association of Savings & Investment South Africa (ASISA).

OUR TRUSTEE
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Funds are valued daily at 15:00. Instructions must reach us before 14:00 (12:00 for Nedgroup Money Market Fund) to ensure same day value. Prices are published daily on our website and in selected major newspapers.

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Certain Nedgroup Investments unit trust funds apply a performance fee. For the Nedgroup Investments Flexible Income Fund and Nedgroup Investments Stable Fund, it is calculated daily as a percentage (the sharing rate) of total positive performance, with the high watermark principle applying.

For the Nedgroup Investments Bravata World Wide Flexible Fund it is calculated monthly as a percentage (the sharing rate) of outperformance relative to the fund's benchmark, with the high watermark principle applying. All performance fees are capped per fund over a rolling 12-month period. A schedule of fees and charges and maximum commissions is available on request from Nedgroup Investments.

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