NEDGROUP
INVESTMENTS

see money differently

Nedgroup Investments Global Diversified Equity Fund

Quarter Two, 2020

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Performance to 30 June 2020	Nedgroup Investments Global Diversified Equity Fund[1]	MSCI ACWI[2]	EAA Global Fund Large-Cap Blend Equity[3]
3 months	22.92%	18.35%	17.68%
6 months	-2.28%	-4.91%	-7.03%
12 months	5.98%	3.89%	-0.02%

Seeing clouds in the fog

We believe, from reading about numerous experiments in behavioural psychology, that it is surprisingly easy to over-react to recent information; recent information has a tendency to crowd out older, perhaps more relevant, information. This seems particularly true for judgments relying on assessing probabilities for difficult-to-predict events. Humans are notoriously poor at forming subjective probabilities. The human mind prefers dealing with absolutes: definitely "yes", or definitely "no". We are also very susceptible to anchoring when forming our views. Our judgment relies heavily on representation: "does what I see now look like anything I have seen in the past"? The most similar thing we can remember acts as a powerful anchor for our views of the future. Over-emphasis of recent information, poor subjective probability estimation and anchoring can make bad judgments really easy when a brand new source of unpredictability arrives with a violent shock.

New sources of unpredictability do not lend themselves to the way we like to make judgments. Assessing a new source of unpredictability requires us to imagine a range of possible outcomes and to assign probabilities to each. As more information emerges we need to adjust our subjective probabilities accordingly. Ultimately, as uncertainty diminishes with time, we finally might be able to see a single, highly probable outcome (which is what we prefer). But this is often a painful path of learning, peppered with error.

The path of learning about a new thing should feel like a gradual sifting and adjusting of probabilities for a wide range of outcomes; a sort of continuous error-correct flow through time. In reality it tends to be more like an exercise in extreme views. Either a series of gut-wrenching lurches from one extreme to another, or a violent lurch to one extreme view early on (based on anchoring to something in our past experience) where we remain marooned because we dislike the feeling of admitting we are wrong.

The events of the last six months have all of the ingredients for an environment made for bad judgment. We have a new source of uncertainty which lacks easily available precedents. The range of plausible outcomes is extremely wide, and the path towards each of them is shifting rapidly as new information emerges and as people react and change their behaviour in unpredictable ways. It is extremely easy to be wrong. It is also extremely easy to be tempted to anchor one's view to something inappropriate and then to stubbornly stick to this anchored view. Being wrong doesn't necessarily lead to bad judgment. What makes for bad judgment is an inability to learn, to make an error, recognise the error and then form another, better view. It sounds easy, but for the reasons outlined above, it's surprisingly hard to do.

We are interested in how people make judgments and then deal with evidence that these judgments might be wrong. We frame investment as an exercise in recognising the symptoms of poor judgment in others, while attempting to limit the damage of poor judgment when it inevitably occurs in us. As we have set out already, new sources of unpredictability are "great" environments for creating poor judgment. That ought to be good for our type of approach. However, when things get unusually unpredictable, we are also more likely to get derailed by poor judgment.

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[1] USD Net return for the Nedgroup Investments Global Diversified Fund, A class. Source: Morningstar (monthly data series).
[2] USD net return
[3] USD net return

The purpose of this quarterly review is to take you through our take on the shifting judgments of the three groups of people who interest us the most in financial markets – CEOs, financial analysts and investors. It is also a chance for us to talk about how our views have changed and how we are dealing with the learning process.

So, let's start with a quick recap: we started the year flushed with our own success. We weren't alone. 2019 had been a surprisingly good year. Stock prices had generally gone up for pleasant feeling reasons-to-be-wrong. Our three groups of interest had all generally been nervous about 2019 when it began. Trump had unsettled the status quo in many ways, introducing new uncertainty. In particular he had started a trade war. But as 2019 progressed the global economy chugged along and the environment for CEOs remained fairly benign; they had mainly struck conservative, quite humble (for them) plans and found they could either achieve those plans or, if they didn't, it wasn't too painful. By the end of the year anxiety had been released. Investors viewed 2020 with considerably more optimism (we inferred this from what analysts were writing at the start of the year). CEOs were similarly, cautiously optimistic. We were a little more nervous. It is easier to make money in stocks when anxiety and scepticism about prospects is high; it's a bit tougher if investors are already quite hopeful. Our nervousness made us nudge the mix of our portfolio more towards stocks where surprisingly long, easy growth had the potential to catch analysts and investors out and away from stocks which relied more on existing anxiety unwinding for them to "work".

By the end of March our views had changed a lot. We recognise a new source of unpredictability was emerging and we thought all three of our groups of interest were surprisingly relaxed about it. We were worried a major supply side shock was coming, from the enforced factory shut downs in China from the spread of COVID-19. We worried this could trigger a feedback loop which could impact demand and trigger a more difficult environment in lots of places. This sort of thing worries us because we see risk as, "what happens when CEOs find it difficult to hit their plans". In our experience when the environment changes, CEOs often struggle to meet their plans, and they can "create" risk by being stubborn and unwilling to admit they could be wrong, and analysts and investors don't like it when CEOs are wrong. They start to lose trust in them; this tends to send stock prices down. These signs began emerging in February.

We were wrong. We didn't work out that COVID-19 was already on its way out of China and that its impact would cascade rapidly around the world. We weren't really focused on COVID-19, we were just focused on evidence that Chinese factories were all shut and that most stuff has at least something made in China in it. We were worried that closed factories in China would jam up the whole global supply chain. We had no idea that in a few months everyone would be sitting at home, trembling at the prospects of a premature death from a new, highly infectious virus.

We, like most people, metaphorically reached for the precedent bank as it dawned on us that we were in a pandemic shock. Was it like SARS, was it like MERS, was it like the Spanish Flu? News headlines became swamped with R-numbers, infection curves and mortality stats. Stock markets became incredibly sensitive to the daily release of infection rates. Pretty quickly almost everyone became very anxious. Not just about the health risk of COVID-19, but also its economic impact. We all reached for the precedent bank again. Was this like 2008, was it like 1998, was it like 1929?

The truth is, it's not really much like any of these. The characteristics of the virus are different, the world is different, the way everyone has responded, including governments is different. What we can say is that everything suddenly feels very unpredictable. Our view has changed a lot in the last three months. We have gone from believing that everyone else had under-reacted to now believing pretty much everyone else has over-reacted. In particular three very important things have changed.

First, CEOs' plans and beliefs have changed. In many cases they have changed a lot. No one is dismissing the current situation as a flash in the pan. CEOs in businesses most affected have no time for denial. Optimistic growth plans have evaporated. Most are focused, unusually, on risk and what could go wrong. Second, we are pretty sure most analysts and investors are worried. They have all experienced a really nasty shock, and from a psychological perspective, shocks tend to leave scars which can act as powerful anchors.

Just because some market indices are back where they were before COVID-19 hit doesn't mean anxiety has gone. The scars remain. Third, governments are worried, really worried. They have unleashed an unprecedented package of measures to prop up the economy, at an unprecedented speed. This combination makes us a lot less worried. Yes, we still worry about second waves of infection. Yes, we still worry about going into a packed pub. Yes, we worry about the amount of debt. Worry that from here things won't gradually get better than most other people expect. We hold this view because we think, for the moment, most people have lurched to a new anchor: the first infection wave of COVID-19.

A lot has been learnt in the last 3 months, a lot of new information has been created. While more people are likely to catch COVID-19, the economic impact of this, in our view, is unlikely to be as bad as a few months ago. Just knowing more makes people more relaxed. While the infection rate has started to rise the mortality rates keep falling, and the evidence on most peoples' tolerance for COVID-19 risk is that they are becoming more relaxed. The probability distribution of likely outcomes still remains wide and difficult to judge, but we think most are misjudging the tails. We think the chances of a nasty outcome are diminishing, and are generally less than commonly perceived, while the chances of a surprisingly benign outcome are rising and are generally higher than is commonly perceived.

This shift has made us more interested in buying stocks where we think we can see unusual investor and analyst anxiety. We are particularly drawn to those where we think we can see evidence CEOs have shifted their behaviour to become much more focused on controlling risk. We think there are generally more stocks with this combination. We think that this combination is also more likely to be rewarding in an environment where, we would argue, it is easier for everyone to over-react and be uncommonly worried about downside risk.

FUND PERFORMANCE

Key sectors for relative contribution were Industrials and Information Technology. Industrials alpha was driven by stock selection, with Cintas (business services) and Techtronic Industries (US power tools) leading the charge. Regarding Information Technology, the fund's overweight acted as a marginal tailwind in the best performing benchmark sector, bolstered by good stock selection, with Square (US mobile payments) and Trade Desk (US digital advertising) performing particularly well. Key sectors for relative detraction were Energy and Financials. The latter was a marginal detractor in the quarter, where stock selection countered the alpha drag from being underweight. Despite positive absolute contribution from Financials, the scale of the fund's structural underweight dragged on alpha.

The following table highlights the top five equity contributors and bottom five equity detractors over the quarter:

Top contributors	Average weight	Performance contribution[4]	Top detractors	Average weight	Performance contribution[5]
Thor Industries	0.5%	0.6%	Microsoft	0.6%	-0.7%
Spotify Technology	0.8%	0.6%	Amazon	0.6%	-0.6%
MercadoLibre	0.7%	0.5%	Alphabet	0.6%	-0.3%
Trade Desk	0.6%	0.5%	Facebook	0.6%	-0.2%
Square	0.6%	0.4%	Carnival	0.4%	-0.1%
		+2.5%			**-1.8%**

The fund equally weights each name and rebalances quarterly. This means that individual stock contribution, even from the "top picks", can be quite modest. However, the fund maintain a strong strike rate (estimate around 60/40) which means it ends up with lots of modestly performing good ideas spread across the portfolio.

[4] Relative to performance indicator
[5] Relative to performance indicator

Key contributors

Among the analyst bias stocks, we identify companies where unusual or changing business models cause analysts to misunderstand them:

Spotify is a US streaming application for music and podcasts; it stands as the one large independent streamer, which does not tie users to particular devices. It has a large user base and is now material to the large record labels as a revenue source. Businesses with large user bases who engage frequently and for long periods of time are often valuable, as they have time to figure out how to make money out of them – either by gathering data from them or by becoming essential to users lives. Investors and analysts see Spotify as controversial however, as it is in an early phase of maturity, where some of its monetisation experiments have fallen flat. For now subscribers are still paying to listen, more subscribers are joining, and negotiations with record labels are not bringing peril Spotify outperformed this quarter due to three factors; subscriber growth and metrics continuing to outpace its peers, increased confidence in its ability to build a differentiated podcast offering and negative news flow regarding a key competitor, Apple.

Among the investor bias contributors, we see companies which have had prior trauma which has shocked management into change:

MercadoLibre is a Latin American e-commerce and online auction company, with a US listing. The company shifted their business model to incorporate payment processing, acting as an online infrastructure provider. As the Latin American version of Amazon/Alibaba, MercadoLibre lacks significant competition and analysts therefore struggle for comparators. The combination of a highly anxiety inducing event (potential retail disruption from COVID- 19) along with persistent worries about an increasingly competitive environment in Brazil resulted in significant valuation compression. We saw this as an overreaction by investors. Share prices have recovered this quarter as investors realise that MercadoLibre is in fact a beneficiary of COVID-19 driven growth in eCommerce and Fintech.

Key Detractors

Analyst bias stocks among our key detractors:

Amazon is a US online retailer. Historically a disrupter of the high-street bookstore, “Amazonization” has now become a ‘thing’ across vast parts of the consumer spectrum. It is neither purely a retailer nor just a website, but a weird hybrid with some unusual features that make it neither. The odd jumble of a retail club (Prime), a third-party portal (Amazon 3P) and its cloud computing offering (AWS) means Amazon has few comparators. Analysts, in our view, therefore have a difficult time trying to find suitable peers for their base desire to categorise things. Mis-categorisation can lead to bias and crucially, surprise. Amazon outperformed this quarter as it has been seen as a beneficiary from COVID-19 driven growth in eCommerce and work-from-home trends. Q2 results provided supporting evidence for this view with strong growth in retail and AWS. Due to our equally weighted portfolio (by region), when a mega-cap like Amazon performs well, our natural relative underweight creates a relative performance headwind.

Of our investor bias stocks, declining share prices signal high anxiety:

Biogen is a US based biotech company with a focus on diseases such as Multiple Sclerosis and Spinal Atrophy. It has a large, sticky customer base, but in our view a reasonably limited core product base. Analysts are worried about the lack of portfolio diversification, and with concerns over increased competition coming into this space investors are cautious. The underperformance this quarter has largely been driven by two factors; their new Alzheimer's drug failing the latest trial, and the patent for one of their core Multiple Sclerosis drugs being invalidated.

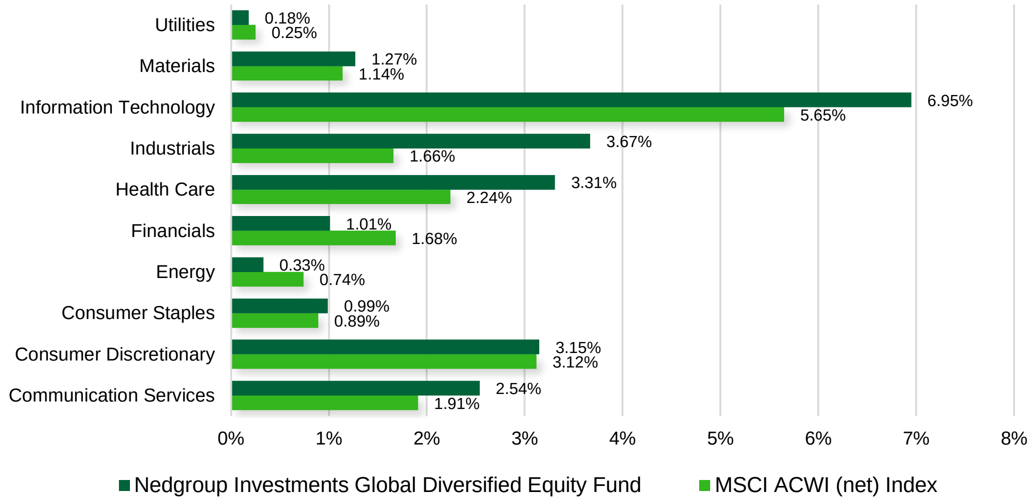
Sector analysis

Overweight Industrials: we can find an unusually large number of conservatively run businesses, with apparent analyst bias or investor bias, as macro worries cloud perceptions. We view many of them as much lower risk than they are given credit for. We have, however, culled a few names: the industrial recession "scar" of 2015-16 no longer seemed to be acting as a biased anchor point for some stocks (scepticism has dissipated), and compounding this, there are creeping signs of inflation, with some areas struggling to pass this through.

Overweight Information Technology: an inappropriate sector classification in our view as its scope is so broad, and the companies so eclectic. Within the plethora of tech sub-industries however, we have been able to find many opportunities which we view as low-risk (hard to break, sticky customers etc.), but tarnished with the "risky" traditional label for the technology sector.

Underweight Energy: Our energy weighting has varied since 2015. 2016 saw a brief moment of respite (and share price anxiety unwind) in a long cycle of trapped capital, and we saw an investor bias opportunity window open up. And again, more recently when there was a run up in oil prices as inflation briefly promised to flicker into life in 2017 (our underweight served as an implicit, unintended macro bet, which we do not like to make). However, despite pockets of capital discipline emerging - particularly amongst large integrated oil companies with long investment cycles and a desire to pay dividends – the industry's fragile peace collapsed and market share maximising tactics broke out once again. Hence, we sold the rest of our oil related stocks, in the aftermath of OPECs collapse.

Sector attribution: 2Q20



Regional analysis

Europe and our Rest of World bucket detracted from a relative point of view this quarter, whilst North America and to a lesser extent Japan outperformed the benchmark.

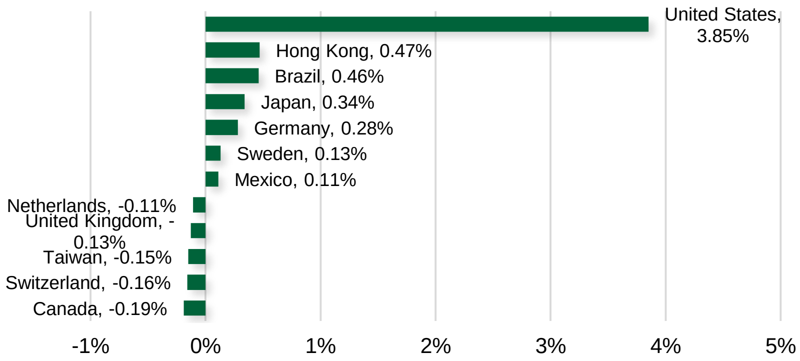
North America: the portfolio's top relative performers for the quarter were Thor Industries (US RVs), Spotify (US online music streaming) and Trade Desk (software), which also performed well. Relative detractors were dominated by Microsoft, Amazon and Alphabet where our structural underweights dragged on alpha.

Japan: a mix of stocks, as always contributing to the region's outperformance. GMO Payment Gateway (payment platform) the leader and Nihon Kohden (medical equipment) picking up the rear.

Europe: winners were clustered in Germany, with Jungheinrich (forklift trucks) and Nemetschek (software) taking the top regional spots. Detractors were more spread out and less quantitatively impactful, with International Consolidated Airlines and Rolls-Royce (engines) near the bottom.

Rest of World: winners included Techtronic Industries (power tools) and B3 Bolsa (exchange) doing well. The major detractors were Clicks Group (South African pharmacy) and to a lesser extent Copa Holdings (airline).

Country attribution: 2Q20



OUTLOOK AND POSITIONING

We think the worst of the economic impact of the pandemic is over. We think infections are likely to accelerate again (as they are already doing in the US) and so statistics on the pandemic's spread will get worse. But we don't think this will drive markets like it did in the early part of the year. We believe people's behaviour will be different. Crucially we know what to expect now. We think a lot has been learnt about how to cope with COVID-19: how to control its spread without imposing draconian lockdowns; how to limit its impact on the vulnerable; how to control its more life-threatening instances. We believe the recent anchor of the first wave of infection is misplaced and is creating too much anticipatory anxiety. Markets are rallying as fear and anxiety gradually recedes.

Global stock markets continued to rally in June, with most major indices up. Below the surface there were hints of a leadership change. Most of the rally, since the lows of March, has been driven by large, growth orientated stocks, leaving many of the more distressed, cyclical parts of the stock market lagging. In June, the 'left-behind' stocks sparked into life violently. Many spiked sharply in the first week of June and then faded through the end of the month.

In the midst of this highly volatile rally we decided we had seen enough to warrant a shift in the mix of our portfolios. We have carried a more defensive, growth mix for over 5 years, but with lots of evidence of both extreme anxiety and CEO response to pressure, we felt it was time to even the mix and buy some investor anxiety stocks.

We know the pandemic is bad. We know the disruption is deep and widespread. But we think the worst of the impact is passed, even if a second wave of infection builds. We also believe that, despite some market indices (like the US) having recouped much, or all, of their losses, there remains plenty of anxiety below the surface. There are many stocks which are still well below pre-pandemic levels, with plenty of evidence of investor anxiety and stress. And the shock delivered to these businesses has, in many cases, been enough to pressure previously lazy or complacent management out of denial and into action. This is the evidence we look for in a deep Investor Anxiety opportunity: reasons for anxiety which have at least some component which is transitory, combined with CEO behaviour which is orientated around reducing risk and improving robustness. We see it the most in the cyclical sectors of Europe.

One of the symptoms of these types of stock is their highly volatile stock prices. This makes short term timing tough, with a few days making quite a difference to monthly returns. The precise timing of pour mix shift wasn't great during June, resulting in a bit of dropped relative performance. But we think the portfolios have a good balance now and should be able to do well under most conditions.

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FEES

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