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Nedgroup Investments Global Diversified Equity Fund

Quarter Four, 2020

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Performance to 31 December 2020	Nedgroup Investments Global Diversified Equity Fund[1]	MSCI ACWI[2]	EAA Global Fund Large-Cap Blend Equity[3]
3 months	18.4%	14.7%	13.5%
6 months	29.0%	24.0%	22.4%
12 months	26.1%	16.3%	14.4%

Key performance contributors for Q4'20	PF weight (%)	BM weight (%)	Base return (%)	Excess return contribution (bps)
Pinduoduo, Inc.	0.86	0.11	126.31	55
Snap, Inc.	0.55	0.08	80.03	41
Trade Desk, Inc.	0.45	0.06	47.05	33
CAE Inc.	0.60	0.01	79.36	25
KIA Motors Corporation	0.69	0.03	37.08	25

Key performance detractors for Q4'20	PF weight (%)	BM weight (%)	Base return (%)	Excess return contribution (bps)
Alphabet Inc.	0.51	1.78	13.10	-18
Teladoc Health, Inc.	0.51	0.04	-12.84	-15
Tandem Diabetes Care	0.47	--	-19.90	-11
Fortive Corporation	0.52	0.04	-12.06	-7
Akamai Technologies, Inc.	--	0.03	-13.30	-7

Why did some markets move more than others?
The year ended with some remarkable variations in stock market performance across the globe, due mainly to how stock markets recovered, not how they suffered in the shock of Q1. Broadly, localised variations in four factors seemed to have been at play during the recovery.

First, pandemic containment policies: variations in government policies to contain the pandemic. Those countries quick and effective at containing the virus generally suffered less subsequent economic impact; this helped their stock markets recover. The South East Asian economies stand out here, perhaps due to their prior experience with SARS.

Second, the service mix: variations in the importance of high-touch service industries vs. low-touch service and manufacturing as sources of economic activity and employment. Containing the pandemic triggered lockdowns and social distancing everywhere. The most disrupted economic activities were in high-touch services. Economies like the UK, and New York State, suffered the most from their high mix of these activities. High-touch services continue to operate well below pre-pandemic levels, having a considerable impact on those economies, while other activities have generally rebounded to at, or above, pre-pandemic levels.

Third, the stock market mix: the behavioural changes necessary to cope with, and contain, the pandemic allowed many areas of economic activity to flourish. Anything which facilitated working or shopping from home saw strong demand. Also, as governments responded swiftly to the disruption to economic activity with higher spending, some areas got an additional boost from prioritising spending on de-carbonisation. Stock markets

[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

where such winning businesses are based, like the US, recovered strongly. Stock markets reflect how investors believe economies will look, not how they look now. The stock price performance of pandemic-boosted businesses on market cap weighted stock market indices was significantly larger than their current economic impact.

Fourth, effective government help: this looks to have been the least impactful on relative performance, partly because nearly all governments quickly recognised the risk of a deep recession. However, some countries threw more money at the problem, and did it faster and more effectively, than others. Arguably, the EU looks to have been the least effective here.

While the initial market reaction to the pandemic was broadly similar, the subsequent rally varied considerably by region. Stock markets in EM and the US rallied by more than 50% from the end March, while those in Europe rose 23%, and Japan rose 30%.

EM stock markets benefitted from a quicker return to normal economic activity plus a boost from pandemic-winning tech sectors in China in e-commerce and electric vehicles. Generally South East Asian governments were more effective at controlling the pandemic and their economies returned to normal sooner. China was the most effective at returning economic activity to pre-pandemic levels.

The US appears to have benefited the most from its stock market skew to pandemic-winning tech sectors and from a proportionally large policy response, both fiscally and monetarily; this was more important than its less effective control of the pandemic, which led to resurgent outbreaks.

The EU market recovery was hindered by repeated outbreaks of infection (like the US), a less impactful fiscal and monetary stimulus package (partly from a weaker starting point) and stock markets which lacked exposure to pandemic-winners. The UK had the most vulnerable economic mix and like the EU, its stock market lacked exposure to pandemic-winners; Brexit anxiety did not help.

Japan appears to have benefitted from a quicker return to normal economic activity but lacked exposure to pandemic-winning tech sectors.

The Great Debates – what we think investors obsessed about last year and why?

With so much news and noise we find it helpful to distil things down to a hierarchy of key, related debates. Answers to the debates drive your beliefs, but without a map it is easy to find yourself holding views which are inconsistent, rendering your thinking non-sensical.

You can flush out muddled thinking by exploring the consequences of holding a belief in one debate on all the other related debates. Hence, we see the purpose of this section as one of defining, mapping, and clarifying the key debates you should be having, to reveal how a view on any one of them can have a knock-on impact to the rest. We will try to keep our views to a minimum.

Trawling through 2020's news headlines and analysts' research reports the following issues dominated attention in the time before vaccine (BV):

- Does the stock market make sense vs. the rally won't last?
- V-shaped recovery: government interference works vs. we need a vaccine
- Government interference: will it work vs. is it worth it?
- Enforced behavioural change: controlling the virus vs. hurting the economy
- Easy access to capital: is it good or bad?
- Life-after the pandemic: the cost of interference and the jobless recovery
- Would a vaccine change everything (or not)?

Really, it is the first debate we all care about, but to get an answer to whether the stock market "makes sense" or not you need to know where you stand on the other debates. And we believe you need to do this before moving onto the final key debate for 2021, at the bottom of the list: will life return to normal with a vaccine (and how quickly)?

Let us briefly characterise each of the above key debates…

The V-shaped recovery:
Whenever stock markets collapse, debate usually polarises to one involving the end-of-capitalism vs. the shape of a recovery. In Q1, the possibility of another Great Depression seemed to loom large. By the end of March, it became universally accepted that a recovery, following the shock from a global pandemic, would be impossible without government intervention.

Before governments intervened stock markets were tanking, economic activity was collapsing. Enterprise and economic activity rely on trust and stability. At first people were crippled by fear and then they were faced by the evolving moral conundrum of selfish behaviour vs collective responsibility. Solving this conflict is arguably what governments are for.

As soon as governments began to interfere, the debate raged on two fronts. First, will government interference be effective? Second, will it be worth it? The first has implications for the shape of a recovery, the second has implications for life after the pandemic.

Let's take the main forms of government interference and try to clarify the debates within each.

Will government interference be effective?
Government interference took three main forms in the pandemic: rules to enforce behavioural changes, monetary policy and fiscal policy responses to offset the impact of those behavioural changes (enforced or not). The rules-based debate raged the most during the early phase of the pandemic: *lockdown vs. re-opening*. Tighter lockdowns cut the spread of the virus, which reduces its health impact – hospital admissions and deaths. No health system in the world can cope with the unchecked spread of the virus – the peak demand on health services would quickly swamp capacity. Either people must voluntarily take necessary precautions or governments must force them to.

The issue with pandemics is generally the same throughout history – selfish, irresponsible individual behaviour can quickly lead to a terrible collective outcome. This is not the place to speculate on the conditions which encourage voluntary responsible behaviour. What we know from the early stage of the pandemic is that fear is a powerful constraint but fear easily fades. Almost every country decided new rules were needed, to limited social contact and slow the virus's spread. There was an almost immediate and severe impact on economic activity, prompting the debate, which still continues, on economic vs. health care damage.

The UK was probably the most severely impacted of the world's major economies by lockdowns. Our experience is revealing on the balancing act involved. The health care system gets swamped if daily hospital admissions are too high (somewhere between 1,000 and 3,000 depending on the existing utilisation rate); the death rate shoots up to unacceptably high levels and we run out of beds and staff. The UK has implemented three bursts of lockdown rules: a full lockdown in March 2020, a series of escalating restrictions during the Autumn and another full lockdown now. Each was triggered by an unacceptable surge of stress on hospital capacity. While the first lockdown was due to the unexpected arrival of COVID-19, the next two have been entirely from the repercussions of allowing more individual responsibility (to allow more economic activity). Twice, economic activity has staged a recovery, twice this has led to a surge in infections and hospital admissions. This flip-flop is inescapable until the virus has either been wiped out or the population has achieved herd immunity (from either having already had the virus, from vaccinations, or a combination of the two).

The second and third forms of intervention involve direct government involvement in the economy, either through *monetary or fiscal policy*. Both have been used in an unprecedented manner during 2020. This intervention fills the void in economic activity created by lockdowns (and/or fear). Without such intervention, economic activity would collapse and unemployment would surge; both would put tremendous stress on society and trust. The use of both have triggered vigorous debates similar to the lockdown vs re-opening debate: 'Is enough being done?' vs. 'Is the long-term cost worth it?' There is an ideological twang to the debate. Quite a few people have a deep-seated core belief it is somehow wrong for governments to interfere with markets at all, ever. For such people, the cost of interference is always too high. They see cost in two ways. First, they think it changes basic human behaviour in a bad way. This is the realm of moral hazard, and its weaker cousin: laziness and inefficiency. Such concerns spark the debate on *easy access to capital*: if companies can raise money easily in a time of crisis, they can keep their businesses going and contribute to economic activity now, but does it mean more inefficiency and a worse economy later? Second, the sceptics over government intervention see all acts as having a cost: it steals wealth and opportunity from the future. Debts must be repaid somehow, sometime. Like the lockdown vs. re-opening debate, a balance is required. The economy will tank and society will probably break down without government intervention; there will be no recovery, of any shape. But too much intervention for too long could create an environment for enterprise, post the pandemic, which is dysfunctional and lacklustre.

Hence the shape of the recovery you believe in depends on your views on how these two great debates will pan out. A V-shaped recovery requires you to believe either: economic activity can return without the need for lockdowns; and/or: fiscal and monetary policy will more than fill the void in economic activity. Equally, your view on *life after the pandemic* revolves around your beliefs over the costs of government intervention: does it steal growth and opportunity from the future or not.

Life after the pandemic

Government interference has been effective so far. Economic activity has rebounded from its terrifying lows in Q2 of 2020. Health care systems have, by-and-large, not been overwhelmed. Economic behaviours have adapted. Work-from-home and shop-from-home have soaked up some of the lost activity dependent on mobility and close contact. The shortfall in activity has been filled by a transfer of money from governments to individuals, so savings rates are high, giving the promise of pent-up demand when the old forms of enterprise and activity are possible. But economic activity in almost every country is stuck at levels significantly below pre-pandemic levels and the status quo requires continued government involvement. As the year has progressed anxiety has grown about the consequences for life after the pandemic: will a prolonged period of government interference prompt any permanent changes in individual behavioural?

There are essentially two parts to the debate. First, the path to "normality": can economies naturally work their way to herd immunity, by balancing government intervention and adaptive behaviour? Second, what will "normal" look like: what are the permanent changes to individual behaviour and the consequences of government interference?

The path back to normality

Current economic activity remains severely impeded by government interference. Governments are interfering for good reason. Health care systems are generally at, or approaching capacity, and in most countries individual behaviour is not careful enough to slow the spread of the virus. Only when we have herd immunity will the need for lockdowns end. The path to herd immunity is key to economic activity returning to normal.

Lockdowns have had a significant impact on economic activity, despite the largely successful adaptation of many activities to the pandemic. Unfortunately, there are many, labour intensive economic activities, which are near impossible without close social contact. Without them, economic activity has remained trapped, well below pre-pandemic levels in most countries. Significant government help has been needed to offset the forced idle labour.

Market commentary has not focused much on the path to herd immunity. In the early stages of recovery, the focus was on the merits and damage of government interference, whether the weight of government support would offset the drag from lockdowns. Real time economic statistics quickly revealed restrictions, combined with support, allowed economic activity to recover substantially from April lows. The rate of recovery quickly flattened in the summer, settling 5-10% below pre-pandemic levels in many countries. The news of a vaccine looks to have diverted attention away from how to get service-related economic activity back to pre-pandemic levels.

There seems to be no debate on how we get back to normal, merely an assumption that with a vaccine it will happen. As we discuss later, the approval of a vaccine does not remove the balancing act required of economic activity vs stability of the health care system.

What will normality look like?

There are two parts to this debate. First, which changes in behaviour during the pandemic will turn out to be permanent. Second, will government interference during the pandemic lead to repercussions for the economy.

Behavioural changes

Most of us have had to change our behaviour during the pandemic. Which of the behavioural changes are here to stay is crucial to your beliefs on which economic activities will recover and which have enjoyed an unsustainable boom. The two key areas of debate revolve around time-spent-at-home and mobility. We have all been forced to spend more time at home. As a result, we have shopped more at home (accelerating the adoption of on-line shopping), consumed more at home (especially eating and leisure) and worked more at home (something very few of us did before). Most of us have been effective at all of them. Why would we change back?

By and large the buying of “stuff” is back to pre-pandemic levels, but the way we have bought stuff has changed. Shopping has seamlessly adapted to more time at home. On the other hand, when lockdowns have lifted, bookings for restaurants and holidays have surged, gym classes and hairdressers have been swamped. There is clearly pent-up demand for these high-touch service areas, impossible to do effectively at home. Meanwhile those who provide the services have seen their jobs go or have been supported by government help.

On average people have saved more. Most of us would spend less leisure time at home, given the choice. The debate is whether the mix of time spent outside of our home will be different after the pandemic. Will we spend more time eating, drinking, and then exercising (losing the weight from the eating and drinking) and less time shopping? Will we spend more time travelling to, and having, holidays and less time travelling to and from work? Will we want our homes to be in different places, less tethered to workplaces? Will we all work more from home? The varying beliefs on these debates do not really have an impact on economic growth and recovery, but they do have an impact on what the economy will look like, where employment opportunities will be, and where assets and skills might get stranded.

The cost of government interference

We have read a lot of commentary on the cost of government interference through the second half of 2020. It has seemingly fixated investors. The topic encroaches on some deep fundamental beliefs on the appropriate role of governments vs. free-markets. Much of the commentary is built on the core belief that government intervention is bad; whenever it happens a price will be paid, either in the form of inflation, higher taxes, or a less efficient economy. The debate rumbles on during normal times but has been especially acute during the pandemic. Let us try to clarify some of the key arguments and beliefs.

First, lockdowns are a good/bad idea. You think they are a good idea if you believe people cannot be trusted to behave responsibly during a pandemic and some rules designed for the greater good are inevitable to maintain a stable society. You think this is a bad idea if you have faith people can be trusted to behave responsibly but governments cannot be trusted to make rules to look after the common good.

Second, paying people to do nothing during a pandemic is a good/bad idea. Those who think it is a good idea believe high unemployment, with a low safety net, is a threat to a stable society. Those who think it is a bad idea either believe it encourages the unemployed to be endemically lazy (which will lead to a less efficient economy) or the cost providing support will steal growth and prosperity from the future (generally in the form of higher taxes or inflation).

Third, stopping struggling businesses from going bust during a pandemic is a good/bad idea. Keeping businesses going is a good idea if you believe they are struggling for temporary reasons (like a lack of customers) which will change after the pandemic. You also probably believe it is much harder for supply to come back in battered activities if businesses must start from scratch (and is likely to be inflationary). You believe this is a bad idea if you worry about moral hazard (if people don't have to deal with the repercussions of bad risk taking they behave recklessly), zombie companies (businesses will continue doing worthless activities and trap assets and employment, inhibiting good companies from hiring and growing), asset bubbles (low interest rates and "easy money" encourages reckless speculation) and somehow it is unfair (we read quite a few comments from successful investment firms who complained about being denied lucrative opportunities to offer rescue financing).

In sum, government intervention in a pandemic is a bad idea if you believe inflation, higher taxes and systematically poor individual behaviour (either too lazy, too risky, or untrusting in government) will be the inevitable result. It is a good idea if you believe people cannot be trusted to behave responsibly when their behaviour causes external harm (which doesn't immediately or directly impact them), if it helps to keep people motivated (they keep their jobs), keeps society stable (they feel society is fair) and reduces the risk of inflation (by keeping supply ready for recovering demand).

Does the market make sense?
Since the end of March 2020 there have been regular commentaries on whether the stock market rally makes sense. Broadly they have followed the following path:

At first, debates revolved around whether the pandemic would inevitably destroy economic activity or whether government intervention would, or could, make a difference. We would say most of the early consensus was disbelieving of effective government intervention and sceptical the stock market rally made sense.

In the second phase, the debate moved on to the shape of a recovery: would it be V-shaped, could normal economic activity return without causing catastrophic problems in the health care system? Again, we would say the consensus was generally disbelieving of a quick recovery, distrustful government intervention could wholly make up for economic damage from the pandemic and anxious about the prospect of further stress on the health care system. As companies began to report results, it became clear commercial life was not as bad as first feared.

In the third phase, the debate moved on to market valuations (these always rumble on), how and when economic activity could return to normal and the cost of government intervention. Again, we would say the consensus was generally sceptical (on valuations) and anxious about the pace of recovery and the cost of government intervention.

In the fourth stage, bringing us to now, good news on vaccines arrived. There was a rapid shift in debate from how and when a recovery will happen, to what kinds of stocks would lead the re-opening and recovery (small cap, cyclical, value) and how life would look after the recovery. Suddenly the market rally now seemed to make sense and 2021 would be a year of V-shaped recovery, Value and Vaccines.

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FEES

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