see money differently

NEDGROUP INVESTMENTS BALANCED FUND

Quarter Two, 2019

For the period ended 30 June 2019

NEDGROUP INVESTMENTS BALANCED FUND

Performance to 31 March 2019	Nedgroup Investments Balanced Fund[1]	ASISA category average	SA Inflation + 6% Geometric
3 months	-0.6%	+1.1%	+3.2%
12 months	+5.7%	+3.2%	+10.7%

Financial markets bounced back from May's retreat

Global markets bounced back strongly from May's contraction despite many of the market's pressing issues remaining unresolved. Firstly, while the trade negotiations between the US and China are back on track it will take compromise from both sides to reach an agreement. Brexit is firmly on hold as the UK Government's Tory party is still struggling to find a new leader to replace Theresa May even before a revised strategy can be contemplated.

The global economy is currently going through a synchronised slowdown that has seen developed central banks pivot towards more accommodative monetary policy. This more dovish stance by developed central banks has opened up room for emerging markets to also cut rates. Given the limited room for conventional monetary policy, we may yet see central banks turn more aggressively toward fiscal policy, in an attempt to avoid a recession in the years ahead.

The S&P 500 Index advanced 6.9% in June, representing one of the strongest moves seen in recent times, driven, in the main, by the pivot on interest rate policy from the US Fed.

Much has been said about the demise of the current global equity bull market that, by many measures, is very mature. Having been in place for over a decade, it will rank as one of the longest in history. However, the excesses that normally signal the end of the cycle are not that apparent. But earnings have already enjoyed a very strong advance over the last half-decade and are looking like they are in top-of-cycle range. It is unlikely that earnings growth on its own can sustain further equity gains.

The key risk to the current equity bull market would be earnings disappointments into 2020, or an unexpected rise in interest rates resulting in an upward spike in equity yields. As this does not appear to be on the very short-term horizon, the global equity backdrop is likely to remain a benign influence with regard to domestic financial markets.

South African markets followed suit

In June the JSE All Share Index produced a total return of 4.8%, having fallen by 4.8% in May. This brings the year-to-date return of the ALSI to 12.2%. All sectors contributed to the performance in June, although the Financial sector and the Resource sector outperformed the Industrial sector by 3% and 2% respectively. The more broadly-based SWIX experienced a more modest advance but was still up 3.1% in the month and by 9.0% year-to-date.

[1] Net return for the Nedgroup Investments Balanced Fund, A class. Source: Morningstar (monthly data series).

Bonds also enjoyed a good month with yields at the long end softening by about 20bp. Real yields remain high by historical standards. However, the Property index continues to lag, being barely in positive territory year-to-date. As the sector generally lags the economy, distribution growth is likely to disappoint for several years to come.

Precious metals also enjoyed a strong advance

Both gold and PGM's had a strong June and no doubt was a significant factor behind the good performance from the Resource sector. Equity returns could have been even better were it not for the currency strengthening by 3.5% against the US dollar. The gold price breached the 1400 $/oz mark for the first time in six years and the prices of the entire PGM basket rose, possibly indicating a change in sentiment with regard to precious metals that could signal a more sustained move.

SA's economic performance is cause for concern

The SA economy is currently trapped in a cycle of low economic growth and high unemployment that if not arrested soon, could result in a major crisis. The current trajectory is leading to greater levels of poverty and inequality that increase the probability of economic instability.

Recent statistics on credit growth and retail sales suggest that the currently employed SA consumers are at their limits and are unable to meaningfully take on more debt. Spending on badly needed infrastructure is also declining as seen in the demise of the local construction industry. Barring an export-led windfall the only sustainable path to higher economic prosperity is to increase employment, thus bringing in more people into the consumer economy. Despite President Ramaphosa's positive message at the State of the Nation Address, we have yet to see decisive action taken on critical structural reforms that are necessary to move us out of the low growth environment.

The currency has been surprisingly strong

Given the country's disappointing growth outlook it might have been expected that the rand would remain weak, however this has not been the case. A consequence of our low growth environment has seen imports decline, and with rising commodity exports the country has experienced an improvement in the external trade balance over recent months. Inflation has also been stable, surprising most economists on the downside. These metrics have underpinned the strong rand, and are likely to lend stability to the currency in the short term, in spite of the weak fundamentals.

Financial markets should produce modest positive returns

Low economic growth prospects for the year mean that SA-focused corporates will struggle to grow earnings and dividends in real terms over the next twelve months. Despite this, a large proportion of the SA market is dominated by resource and rand hedge stocks which are still enjoying the benefits of a growing global economy and should still produce modestly positive returns.

Over the shorter term, the outlook for fixed income assets is encouraging. The weak economy and the stable currency are taking the pressure off the inflation rate and are providing the SARB with the data to cut short term interest rates. Given that yields across the yield curve are positive, real returns can be expected from fixed-income investments over the next few months.

PORTFOLIO POSITIONING

We maintain a large weighting in the resources sector not as a function of any top-down view, but rather the result of our bottom-up assessment of value on a stock by stock basis. Our position in the gold sector is a function of our positive view on AngloGold which continues to trade at a large discount to its global peers. We also like the diversification it brings to the portfolio in a world of increasing geopolitical tensions. We like the platinum sector as certain stocks are still trading at a significant discount to their intrinsic value, despite the recent exceptional performance. Our largest position in the diversified miners remains Anglo American where the valuation on its rump assets remains on an undemanding three times EV/EBITDA.

We continue to hold a meaningful position in British American Tobacco. Despite the significant de-rating seen in the stock, it continues to deliver earnings growth in line with our expectations. Additionally, the stock trades on an attractive forward dividend yield of 7.5%.

On the 22nd of May 2019, Sasol issued an update on the progress of the construction of their Lake Charles Chemical Project (LCCP). The update was disappointing as they guided for an additional US$1bn cost overrun on the project when it is almost 96% complete. This was particularly shocking given that Sasol management had issued an update on the LCCP project only four months earlier on the 8th of February 2019, where they assured the market the project would be completed within a range of US$11.6bn - US$11.8bn. Given the above disappointing update, we believe that management may not have had a sufficiently clear line of sight around what was happening on the ground at the project. As a result of the additional cost overruns, the expected project return has declined from 7.5% to between 6% and 6.5%. As a shareholder, this is extremely disappointing but the cost of the LCCP project is largely sunk capital, which we still think should generate US$1.0bn of EBITDA by 2022. At the current share price, the market is not putting any value on the capital spent on the LCCP. Once production at LCCP is ramped up over the next three years we expect the market to put a value on the cash flow produced by these assets. As a result, we maintain our current holding.

SA-focused stocks continue to struggle in the current low growth environment. SA corporate margins are being squeezed by increasing costs which they are unable to pass through to consumers given the poor economic backdrop. If the broader SA economic backdrop does not improve, we expect that SA-focused stocks will continue to struggle to deliver real returns, increasing the probability of a value trap.

Our exposure to the local economy remains largely through the financial shares, being banks and insurers, which are reasonable value, and offer forward dividend yields of over 5% and mid-single-digit earnings growth. These shares are liquid and more defensive than many of the direct consumer-facing shares, which have more exposure to the challenging economic environment.

We have very little retail and SA industrial exposure as P/E multiples are not cheap enough given the difficult economic backdrop. We remain cautious about the property sector where fundamentals continue to look poor. We think the risk of distribution resets remains high as rent negotiations still favour the tenants. While distribution yields in some cases remain optically attractive the quality of distributions is low.

Over the quarter the fund continued to reduce its exposure to the Ping An Insurance Group, which has rallied 35% since the fund built a position in the last quarter of 2018. We continued to reduce exposure to the US markets, which we think are expensive, by reducing our weighting in the Vanguard Value ETF. The fund also reduced its positions in Naspers, Richemont, and Anheuser-Busch Inbev which have all done well over the last two quarters. Major purchases included iShares EuroStoxx ETF, British American Tobacco, Sberbank of Russia, and BHP Billiton.

Unchanged from the previous quarter, our fixed income assets remain predominantly invested in the floating rate subordinated debt of SA's top five banks, where we are earning approximately 120bps above government bonds with no equivalent duration risk. Investment opportunities in the corporate debt market outside of the banks are few and far between, with huge oversubscription because of the lack of issuance driving the yields down to unattractive levels. While real yields on longer duration bonds look superficially attractive, the deteriorating fiscal position of the country means the probability of a ratings downgrade into 2020 remains high. As a result, we continue to prefer shorter duration assets.

The fund remains close to its maximum allowable offshore exposure.

CONTRIBUTORS AND DETRACTORS

Top contributors for the quarter included Anglo American, AngloGold and Impala Platinum all of which enjoyed the benefits of higher commodity prices and an improving earnings outlook. Our positions in FirstRand, Investec Australia Property Fund, Equites Property Fund, and Sberbank made a meaningful contribution to overall performance.

Detractors included Sasol, as discussed above, and British American Tobacco plc which was a detractor on the back of continued negative market sentiment around the deteriorating US tobacco regulatory environment. Despite the poor performance from a share price perspective, the company guided for a better than expected second-quarter earnings performance, which should see full-year earnings grow at high single digits. KAP Industrial Holdings and Hulamin, two smaller industrial companies, also detracted from performance post disappointing earnings updates.

RESPONSIBLE INVESTMENT

Over the quarter we had several engagements with companies on environmental, social and governance issues:

Sasol: Truffle engaged with the Sasol board expressing our dissatisfaction on behalf of clients with the implementation of the Lake Charles Chemical Project, with specific reference to overruns on both timelines and budgets. We requested details of the senior management responsible for oversight and decision-making on the project and suggested a claw-back of historic bonuses that were paid based on the progress of the project.

South African retailers: We collaborated with a group of other asset managers to engage all the South African retailers to do away with single-use plastic carrier bags.

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

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.

PERFORMANCE

Unit trusts are generally medium to long-term investments. The value of your investment may go down as well as up. Certain unit trust funds may be subject to currency fluctuations due to its international exposure. Past performance is not necessarily a guide to future performance. Nedgroup Investments does not guarantee the performance of your investment and even if forecasts about the expected future performance are included you will carry the investment and market risk, which includes the possibility of losing capital.

PRICING

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.

FEES

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.

DISCLAIMER

Unit trusts are traded at ruling prices and can engage in borrowing and scrip lending. Nedgroup Investments has the right to close unit trust funds to new investors in order to manage it more efficiently. For further additional information on the fund, including but not limited to, brochures, application forms and the annual report please contact Nedgroup Investments.

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