see money differently

NEDGROUP INVESTMENTS ENTREPRENEUR FUND

Quarter Two, 2019

For the period ended 30 June 2019

NEDGROUP INVESTMENTS ENTREPRENEUR FUND

Performance to 30 June 2019	Nedgroup Investments Entrepreneur Fund[1]	ASISA category average	Small Cap Index	Mid Cap Index
3 months	-2.7%	0.3%	1.8%	1.5%
12 months	-8.9%	-5.1%	-10.9%	5.2%

Market Commentary

The second quarter of 2019 proved to be volatile. Markets fell sharply in May (JSE ALSI -4.8%) as the US-China trade war escalated. However, SA equities staged a recovery in June (JSE ALSI +4.8%) given the US-China trade 'ceasefire' as well as the prospect of further stimulus by the world's primary central banks.

For the quarter, the JSE Mid Cap Index achieved a total return of +1.5% while the Small Cap Index returned 1.8%. Financials (+5.4%) was the leading sector, followed by Industrials (+4.0%) and Resources (+2.4%). Gold shares performed particularly well for the quarter (+29.6%), benefiting from a higher gold price that is being buoyed by lower global interest rates and rising geopolitical tensions (US and Iran).

The rand traded in a broad range versus the US dollar, but closed 2.5% stronger over the quarter, appreciating to R14.08 at the end of June.

Domestically, the May 8th national election was a much anticipated market event and the ANC victory with 57% of the vote is considered a market-friendly outcome, and broadly in line with analyst expectations. Much of the focus leading up to the elections was whether the result would provide Mr. Ramaphosa with a strong mandate to address corruption, state capture, and introduce structural reforms that can lift economic growth. And whether South Africans could look forward to seeing harder evidence of delivery. While we recognise that the wheels of politics move frustratingly slowly, we are underwhelmed by the lack of progress on several fronts. Recent developments including statements regarding the ownership and mandate of the SARB, questionable appointments to head portfolio committees in parliament (such as Mosebenzi Zwane and Faith Muthambi) and the Public Protector, Busisiwe Mkhwebane's priorities in relation to her investigations into the President and Minister of Public Enterprises, Pravin Gordhan. While we see no progress regarding prosecution of many other crimes that have been publicly exposed by demonstrably more corrupt members of the ANC, these are undermining any confidence in the ANC's promised turnaround.

Investors are looking for signs of policy coordination, joint purpose and a willingness to execute structural reforms. At a recent investor presentation, I listed the ideal conditions required for small cap businesses to prosper. These include the following:

1. Political stability and Economic Policy certainty;
2. Accelerating and broad-based economic growth;
3. A rising capital investment cycle and improving business confidence;
4. Employment growth and improving consumer sentiment.

Unfortunately, for the time being, these remain either entirely absent or worse, moving in the opposite direction.

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

NEDGROUP INVESTMENTS

Portfolio Commentary

The fund's top five performing positions added 1.27% to returns over the second quarter while the bottom five detracted -2.83%.

Winners	Ave. weight	Performance contribution	Losers	Ave. weight	Performance Contribution
Italtile	3.79%	0.35%	KAP Industrial	5.60%	-1.18%
Alexander Forbes	1.94%	0.27%	Netcare	2.30%	-0.58%
Impala Con Debs	1.65%	0.24%	Sappi	2.06%	-0.40%
Transaction Capital	0.76%	0.23%	British American Tobacco	2.01%	-0.34%
JSE Ltd	3.19%	0.18%	Merafe Resources	2.35%	-0.33%
		1.27%			**-2.83%**

Current positioning and outlook

In the context of the above comments and our view over the past four years that South Africa faced a very weak macro-economic growth outlook, our portfolio management approach has been focused on identifying and investing in larger / mid-cap businesses, where those businesses despite not being large caps were still reasonably dominant in their area of operation. We have preferred companies with appropriately geared balance sheets and where the board and executive management followed a shareholder centric approach to governance with a strong focus on capital management and the delivery of returns. Good examples of where we have had success in this regard and which are all material positions in the fund include AVI, Italtile, the JSE, and Santam.

A very big disappointment in the last quarter was a weak trading update from one of our core portfolio positions, KAP Industrial. KAP is a diversified industrial holding company, with the underlying operations all having substantial scale in their niches of Logistics (e.g. Unitrans tankers), Chemicals (Hosaf PET), and Integrated Timber (e.g. PG Bison forest to finished product timber). In the prior financial year, profit growth was impeded by a delayed and problematic 50% capacity expansion at their Hosaf plant. The expectation of this not re-occurring, as well as the further pay down of their debt and reduced interest charge to the income statement, was expected to easily generate reasonable profit growth.

These factors, coupled with our participation at an attractive pricing discount in the successful placing of the last remaining shares previously owned by their controlling shareholder, Steinhoff (which marked the final severance of their association with that doomed enterprise and the removal from the market of the perceived overhang of scrip), led us to have some confidence in the prospects for this position.

It appears not to be the case. The confidence we have previously had in this management team has been severely dented by these events and the manner in which it was 'communicated' to the market. We will need to spend a considerable amount of time re-evaluating the company and its financial statements once the June 2019 results have been published at the end of August.

On the subject of quality, long term investors will be aware that a cornerstone to the Abax investment philosophy and portfolio construction process is the focus on a core of high quality businesses. We define high quality as being businesses that are very cash generative, have stable to high degrees of profitability, and where these levels of profitability are defendable and preferably expandable. They have conservative degrees of gearing on their balance sheets and are governed by a shareholder centric, accountable board with experienced management who are appropriately incentivised and remunerated. We do not sit passively on these positions, but rather seek to manage them as dynamically as market conditions allow by adding when, for whatever reason, they become cheaper. While not hesitating to lighten (and even sell out completely) when they become more expensive.

In this context, the gold and platinum mining sectors, which at times combined make up material components of the JSE's Mid and Small market cap indices, present a challenge to us, because they fail on many of our quality criteria, including, but not limited to the following factors:

1. A primary driver of their revenue are commodity prices (gold, platinum, palladium, and few others) and currency exchange rates all of which are highly unpredictable and often volatile.
2. These businesses are constantly required to invest a significant proportion of their income in capital and exploration expenditure, simply to maintain the volumes of material available to sell. Think of it as a manufacturer constantly having to rebuild a piece of their factory EVERY year to at best produce the same volume of saleable goods.
3. Their ability to produce is conducted in inhospitable locations (deep underground), and reliant on a relatively uneducated (safety, training and negotiation problems) and unwell (HIV and occupational health) manual labour force. Labour is usually unionised with representation by militant, self-serving and politically motivated leaders.
4. The regulatory environment is private sector business unfriendly – South Africa has finally signed our 3rd mining charter in 15 years (the goalposts always move and always in the wrong direction) which inhibits exploration activity or the ability to make long term capital commitments.
5. Local communities, informed by ambitious politically motivated representatives have, and make, unreasonable demands of mining operators.

All the above factors result in the profit streams of these companies being highly volatile and unpredictable. That does not however eliminate them from our research efforts, but does mean that it is unlikely that they will ever form a material proportion of our client portfolios. Currently our exposure to them is only 4.3% of the Nedgroup Investments Entrepreneur Fund, while they form substantially more than that of the JSE Mid Cap Index. Typically, these shares either do very well or very badly, and the first half of 2019 has been a period where they have done very well, and thus a primary reason behind the fund's underperformance versus that index over this short-term period.

Current positioning and outlook

The second half of the year promises to be very eventful, with monetary policy a key focus area in the coming months.

In South Africa, Eskom remains a key investor concern, from the perspective of both its fiscal impact and the effect on the broader economy. Addressing Eskom's balance sheet and operational challenges is the most critical test for the new president, and the whole country is watching closely to learn if, or how, it will be addressed.

Conclusion

Despite some concerns, the portfolio continues to be dynamically managed and continues to reflect strong investment preferences where our conviction is high, within appropriate degrees of risk management.

The portfolio currently trades on a historic Price/Earnings (P/E) ratio of 12.5x and a dividend yield of 4.1%.

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

NEDGROUP INVESTMENTS