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NEDGROUP INVESTMENTS FINANCIALS FUND

Quarter Two, 2019

For the period ended 30 June 2019

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Market overview

The ongoing battle between Trump and China over tariffs continued to dominate sentiment. In the background, Prime Minister Theresa May stepped down as leader of the ruling Conservative Party in the United Kingdom (UK) after successive failures to deliver an acceptable Brexit deal whilst the Federal Reserve signalled that it might cut interest rates sooner than it previously thought.

Despite the ongoing uncertainty around these issues, global equity markets continued their rebound from their 2018 sell-off. Looking at the indices in US dollars – on a total return basis the S&P 500 Index gained 4.3%, the MSCI World Index gained 4.2% and the MSCI Emerging Markets Index, lagged again, closing 0.7% higher this quarter.

South Africans went to the polling booth in May where the ANC secured 57.5% of the vote (the worst performance for the ANC in any national election). At the same time, published estimates of South Africa's gross domestic product (GDP) showed that the economy contracted by 3.2% in the first quarter – recording the largest quarterly drop in output since the financial crisis.

The market seemed to have anticipated something worse and the FTSE/JSE Capped Swix gained 2.9% in rand outperforming its emerging market peers with the rand gaining from R14.48 at the end of the first quarter to R14.07 at the end of June. South African bonds also delivered another strong performance, closing 3.8% higher over the quarter.

Fund performance contributors and detractors for the quarter

The fund's R class generated a net return of 4.6% this quarter - which is quite satisfactory in light of current circumstances but, as can be seen from the detractors below, could have been even better. However, one seldom gets a score of 10 out of 10, and the detractors are often the strongest gainers in the next quarter.

Top five contributors to and detractors from returns

	Return	Weighted return
FirstRand	11.2%	1.1%
Sanlam	10.2%	1.0%
Absa	20.2%	0.9%
Investec	8.9%	0.8%
Standard Bank	9.1%	0.4%

	Return	Weighted return
Sasfin	-14.3%	-0.5%
PSG	-7.5%	-0.5%
Zeder	-11.6%	-0.1%
Trematon	-6.9%	-0.1%
Old Mutual	-3.1%	-0.1%

The detractors

- **Sasfin**'s results have disappointed two years in a row, so its price has been under pressure for almost three years. In addition, the immediate outlook for SMEs is bleak in terms of growth and risk of bad debts. However, after the severe price decline, its valuation is now exceptionally cheap. In the short term the share is very volatile due to the combination of uncertainty and illiquidity.
- **PSG** (and Capitec) became too expensive earlier in the year so the share prices needed to correct. At the same time, Curro's and **Zeder**'s share prices have been under pressure. We did lighten PSG slightly but feel the quality and growth prospects of this group are such that we don't want to reduce our holding further. This is a company where the probability is high that it will continue to outperform over the long term so we don't mind some underperformance in the short term.
- **Trematon** is a great little company, focused on property and education, but its results did slightly disappoint (which company's didn't?) and it got sold down on very light volumes.
- **Old Mutual** has been under pressure (it underperformed Sanlam by 14% this quarter). We give further insight in the responsible investments section.

The contributors

Absa, FirstRand, Sanlam, Standard Bank and **Investec** performed well - with Absa simply re-rating from very oversold levels, helped by the fact that it is taking market share (which might not be a good thing in a struggling economy). Quarterly price moves are fairly meaningless, and indeed when one looks at six-month price moves (or more importantly longer periods like three or five years) one often gets a totally different picture. For interest's sake, over the past six months the two largest contributors were the Denker Global Financial Fund and Transaction Capital.

Portfolio changes/current positioning and outlook

We made only three changes to the portfolio.

1. Reduced the PSG holding slightly (as per above),
2. Sold down the Old Mutual holding from an already low 3% to 0.5% and
3. Increased the Sanlam holding to the allowed maximum.

Old Mutual has consistently allocated capital poorly over many years (which, in our opinion, is the most important decision a CEO/executive team must make) whilst Sanlam has allocated capital wisely. This can be seen in the respective growth in shareholder values over the past 10 years and the current returns on capital. Recent events (refer to section on responsible investment) place a question mark in our mind on the ability of the Old Mutual board to turn this situation around.

One could make a case for Old Mutual being very undervalued (especially relative to Sanlam). At the moment we continue to prefer the certainty of the higher rate of shareholder growth that an investment in Sanlam provides.

The management teams of the large banks and insurers have generally been exemplary in being conservative and have tempered their loan growth and underwriting. However, the continued low growth of the economy (and worse, the absence of any signs that government grasp what is required to turn this around) means that the South African public sector is increasingly crowding out the private sector- dooming the country to continued low growth and higher debt levels.

Continued deterioration is putting pressure on property valuations and the risk for potential bad debts must be increasing.

The fund's five largest positions remain, as per the table below.

Denker Global Financial Fund	20.1%
FirstRand/RMBH	12.0%
Sanlam	10.7%
Investec	9.9%
Nedbank	8.3%

- **FirstRand** and **Sanlam** would be deemed as being expensive in terms of the P/NAV (price/net asset value per share) they trade at in relationship to our forecast return on capital. However, both companies (along with Capitec/PSG) have arguably the best management teams in South Africa. Looking at our back testing, our experience has shown that businesses with quality managements come through crises/recessions best and generate the highest rate of shareholder value growth.
- **Investec** and **Nedbank** on the other hand are cheap. Investec has cleaned up its balance sheet and the new CEOs are very focused on unlocking value for shareholders, whilst Nedbank has a hands-on team that is on top of the problems they face. We think the valuations are incorrect and both shares should re-rate.
- Finally, we keep the investment in the **Denker Global Financial Fund** at the maximum level allowed for the following reasons:
    - Except for Europe/UK, each country the fund is invested in has a higher GDP growth than South Africa (considerably so in the case of India, Indonesia, Thailand, Georgia, Peru and the United States).
    - The fund is invested in a group of high quality businesses that are growing shareholder value at 10-15% in US dollars and are priced at lower valuations than their peers in South Africa.
    - The top 10 investments in this fund have an excellent track record of growing shareholder value. In addition, they are world leaders in digitalisation strategies.
    - Investors benefit from diversification amongst more than 15 countries and between banks, insurers, exchanges, debt collectors and so forth – whose revenues are all driven by different economic factors.
    - The rand is currently being pushed higher by short-term "hot money" prepared to take some currency risk for a higher yield, but these investors could sell very quickly if South Africa doesn't resolve Eskom or its other debt problems soon.

Conclusions and outlook

The South African banks and insurers we own are well reserved and have increased capital levels. In light of this, share valuations of those companies with good management teams in place are expensive but the lack of better alternatives for pension funds means that this is unlikely to change.

Responsible investment comments

Although it is a separate section in this commentary, considering responsible investing is part and parcel of our decision making (even more evident in this quarter's commentary where we reflect on the actions of the Old Mutual board).

Investors are forced to draw conclusions from board decisions and management actions. In the case of Old Mutual, its long track record of poor capital allocation and the decision a few years ago to appoint Peter Moyo as CEO are of concern. From the start of his appointment until after his dismissal, questions were raised about Moyo's true allegiance to his executive team and whether he put his own interests or those of Old Mutual first – even though the board did try to address concerns. Adding to this, he was (in our opinion) excessively rewarded in his position as CEO.

The directors' most important task is to appoint and oversee the CEO and how he and his executive committee allocate capital and manage the business. As said above, Old Mutual does now seem undervalued, but in the light of their recent track record we'd like to first get certainty about the new CEO and future allocation of capital.

DISCLAIMER

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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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FEES

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