NEDGROUP INVESTMENTS OPPORTUNITY FUND

Quarter Two, 2019

For the period ended 30 June 2019

NEDGROUP INVESTMENTS OPPORTUNITY FUND

Performance to 30 June 2019	Nedgroup Investments Opportunity Fund[1]	ASISA category average	FTSE/JSE ALSI
3 months	1.9%	1.5%	3.9%
12 months	7.3%	4.4%	4.4%

Market Commentary

The US Fed made a monumental shift in tone on the back of the sharp market correction toward the back end of 2018 (which the market attributed in the main to increasing rates and escalating trade tensions). The market moved in short course from pricing multiple hikes for 2019 to pricing a 100% chance of a cut in July, and an additional two or three cuts by the end of the year. It seems that the policy makers - egged on by a strident Donald Trump who abhors high rates - are willing to come to the rescue every time the market hiccups. The rest of the developed world seems happy to tow the party line, with the European Central Bank likely to start easing soon; while others, such as India, Australia and New Zealand have already started cutting rates.

Markets duly obliged, with the S&P 500 finishing the quarter 4.3% higher, and the MSCI ACWI +3.6%. Emerging Markets couldn’t keep up, posting a gain of 0.6% for the quarter. The SA market outperformed EM in general, with the FTSE/JSE ALSI posting a gain of 3.9% for the quarter.

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.

Local bonds (+3.7%) and the rand (+2.9%) also posted good gains over the quarter, as plummeting global base rates and the search for yield supported prices. It should be noted, however, that South Africa’s government finances are looking increasingly bleak. Ballooning budget deficits combined with weak economic growth means that stabilising the public debt burden is looking increasingly unlikely in the medium term. Eskom remains a key investor concern, from the perspective of both its fiscal impact and the impact on the broader economy. A bail out of Eskom will add significantly to the government debt burden (up to 10% of GDP) and to a further deterioration of our credit rating. Addressing Eskom’s balance sheet and operational challenges is the most critical test for the new president.

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

Portfolio Commentary

The fund's top five performing positions added 2% to returns over the second quarter while the bottom five detracted 1.7%.

Winners Q2 2019	Ave.weight	Performance contribution	Losers Q2 2019	Ave.weight	Performance Contribution
Impala Conv.bond	5.9%	0.58%	Sasol	1.2%	-0.68%
Naspers	8.1%	0.50%	Sappi	1.6%	-0.34%
Absa	1.4%	0.38%	KAP	1.4%	-0.29%
Abax Global Equity	8.9%	0.28%	BAT	0.9%	-0.20%
Standard Bank	1.8%	0.26%	Redefine Property	0.4%	-0.15%
		2.00%			**-1.66%**

The Nedgroup Investments Opportunity Fund produced a return of 1.9% for the quarter, above the category average (peer-group) return of 1.5%. For the year-to-date, the fund is up 10.2% relative to the peer-group return of 6.8%. Over five years the fund has delivered a return of 6.2% relative to the category average of 5.2%. It is encouraging that despite the Steinhoff impact on performance, that the fund managed to outperform the category average by 1% per annum over the past five years.

The largest contributor to performance over the quarter was the Impala convertible bond, to which we currently have a 6.2% allocation. The bond was up 8% over the quarter (contributing 0.6% to performance) on the back of a continued strong run-up in the rand platinum price. We have maintained our holding of c. 9% of the fund in a combination of the Impala and Royal Bafokeng convertibles. These instruments have less than three years to maturity and the pay-off profile remains attractive: should the underlying share prices fall materially, we incur manageable (and known) losses; should the share prices move higher, we will participate in almost all the upside.

The largest detractor from performance was Sasol, which fell 22% over the quarter. After standing by the Lake Charles Ethane Cracker project (LCCP) capex forecasts in December 2018, February 2019 and again in April, management increased its capital spend estimate for the project by over $1bn in May (when the project was already 96% complete!). The abysmal communication from the company and the clear lack of oversight on the part of top management resulted in a steep price drop. Opinions and valuations for the LCCP vary widely, but at current prices, a lot of value is being ignored. Lake Charles should generate almost $1.3bn of EBITDA p.a. through the cycle, but if one more conservatively assumes $850m p.a. and we apply an undemanding 5x multiple to that, we derive it's value to be about R100/share. Subtracting that from the current share price of R350 per share, leaves R250 for the core business which is expected to earn in the region of R35/share in the next reporting period (implying a forward multiple of 7x earnings, in-line with historic lows). We have used the opportunity to add to our position.

Current positioning and outlook

When analysing the prospects for the different asset classes in our universe, we marry our top-down perspective and our bottom-up view of individual securities. In other words, our ultimate allocation to the different asset classes is a function of our fundamentally based asset class return expectations and our bottom-up assessment of underlying security values. The more heterogenous the asset class we are analysing (for example equity and property), the greater the emphasis on bottom-up versus top-down analysis.

This is the reason that although from a top-down perspective SA property may appear optically cheap given the apparently high dividends yields on offer, for the time being we remain conservatively positioned with our 4% allocation. The fundamental reasons for this are that SA REITs have been distributing in the region of 110% of their operating cashflows, which is clearly not sustainable. This is achieved through capitalising costs which would more appropriately be expensed and distributing other one-off items.

In contrast, the global REIT peer-group typically distributes only 80-90% of operating cashflows, leaving enough to maintain their buildings without having to raise equity or increase debt. Adjusting for this over-distribution would require the reduction of the dividend yield of SA property stocks by c.1-1.5% to make like-for-like comparisons meaningful. Furthermore, SA listed property companies have high levels of debt, and have been synthetically increasing their yields by disproportionately gearing their offshore properties and under-gearing their local properties. This allows them to pass on the lower cost of funding in the form of apparently higher dividends, but this will ultimately be at the expense of lower growth and higher balance sheet risk. In order to ‘equalise’ for this, we estimate one again needs to reduce current dividend yields by c.1-1.5%. Therefore, if one adjusts for both these items, the sustainable dividend yield of SA property stocks may well be 2-3% lower than what they appear to be. These stocks are therefore not nearly as attractively valued as they initially appear to be, and we remain highly selective in this space.

We have slightly lowered our equity allocation over the course of the quarter on the back of strong markets. One of our focus areas is searching beyond traditional asset classes to try and add value via a broader range of assets and strategies. This approach enables us to construct portfolios from a more diversified set of risk premia which should help improve risk-adjusted returns. These strategies include cost-effective hedging strategies (at an individual security or asset class level); the ability to analyse a business across the capital structure and invest where the best risk-reward payoff exists; and the inclusion of quality smaller and mid-sized businesses in the portfolio.

Presently, we have several hedges in place, both at a market level and on a few of our larger individual stock positions. We also have holdings in a number of hybrid instruments that we believe can deliver equity-like returns but with less risk. These include a 9% allocation to convertible bonds discussed earlier, a 5% allocation to a combination of preference shares, bank sub-debt and property A-units which currently yields 11%, and our 10% allocation to EuroStoxx notes that have the potential to deliver geared upside for relatively small market movements, but with limited downside. We also retain to exposure to several higher quality mid-cap stocks that we believe will out-perform the general market over a full cycle.

We view the rand as slightly over-valued. That said, the currency has been volatile which provided us with an opportunity to hedge some of our exposure at levels closer to R15 to the dollar. Currently we have a full 30% allocated to offshore assets (including the EuroStoxx notes), although our hard currency exposure is slightly lower at 25% due to these hedges.

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