see money differently

NEDGROUP INVESTMENTS FINANCIALS FUND

Quarter Three, 2019

For the period ended 30 September 2019

Global markets

Global equity markets experienced a more modest quarter than last. Looking at the indices in US dollars – on a total return basis the S&P 500 Index gained 1.7%, the MSCI World Index was up 0.5% and the MSCI Emerging Markets Index lagged significantly, closing 4.3% lower. The surprising decline in long-dated developed market bond yields that started in the first quarter continued. Yield on US 10-year maturity government bonds declined from 2.4% at the end of the first quarter to 2.0% at the end of the second quarter and down to 1.67% at the end of the third quarter. The yield on 10-year German government bonds declined from -0.1% to -0.3% to -0.57%.

In the US, the Fed cut interest rates, as was widely expected. Chairman of the Fed, Jerome Powell, said in a news conference that more extensive rate cuts could happen if the economy were to turn down. President Trump took to Twitter to share his exasperation with the Fed's slow pace of rate cuts. In September, it was President Trump's turn to be in the spotlight when the Democratic Speaker of the House, Nancy Pelosi, announced a full impeachment inquiry. Unlike with the impeachment inquiries into President Nixon and President Clinton, Pelosi did not put the motion to the House of Representatives for a vote.

Boris Johnson became Prime Minister of the United Kingdom following the resignation of Theresa May. Johnson had campaigned on renegotiating May's rejected withdrawal agreement with the European Union (EU) and getting it through Parliament before the Article 50 expiry date of 31 October 2019. He had also indicated a willingness to exit the EU without a deal - the so-called 'hard Brexit' - for which there is not sufficient support in parliament. Opposition parties have rejected Johnson's call for an election (which requires a two-thirds majority) before the Brexit deadline, but one appears certain to happen shortly afterwards. This might finally unlock the current parliamentary impasse.

South African markets

South African markets underperformed their emerging market peers. The FTSE/JSE Capped Swix delivered a total return of -5.1% in rand. The US dollar investor suffered an additional 7.5% loss as the rand fell from R14.07 at the end of the second quarter to R15.13 at the end of the third quarter. South African bonds closed the quarter without providing any returns to investors.

High frequency data continues to indicate a weak economic backdrop. National Treasury's economic policy document was the subject of some criticism after not having gone through normal policymaking procedures. Proposals include disposing of state owned company assets and changing labour law (to ease regulations on smaller companies). Finance Minister Tito Mboweni presented the main points of the policy to the National Executive Committee of the ANC at a gathering in September.

Fund performance contributors & detractors for the quarter

The fund generated a negative 5.1% return this quarter, which brings the year-to-date performance to -0.6%. The negative return was caused by a sell-off of both emerging markets and their currencies (the one tends to generally cause the other) as part of a broader flight to the perceived safety of the US dollar. Having said that, even the Norwegian krone was down 6.6%. However, the rand (-7.7%) and the JSE have been hardest hit in our opinion. This poor performance reflects the frustration with the continued absence of any signs of growth in the South African economy and government's lack of urgency to generate growth.

In the financial sector banks were sold down 9.7% whilst insurers held up relatively well. Specifically, **Investec** (-13%) and **Absa** were the worst (-12.5%) with **FirstRand** (-9.7%) the relative winner.

The fund had a few gainers: **Zeder** (32.4%), **Transaction Capital** (11.8%) and the investment in the **Denker Global Financial Fund** (2.5%, in rand). Ultimately, the sell-off of the banks outweighed the positives and the portfolio had a negative quarter.

Top five contributors to and detractors from returns

	Return	Weighted return
Denker Global Financial Fund	2.5%	0.4%
Zeder Investments	32.4%	0.2%
Transaction Capital	10.8%	0.2%
Trematon Capital Investments	7.4%	0.1%
Alexander Forbes Group	3.9%	0.0%

	Return	Weighted return
Absa Group	-10.1%	-0.5%
Nedbank Group	-7.5%	-0.6%
PSG Group	-11.7%	-0.6%
FirstRand	-7.2%	-0.7%
Investec (Ltd & plc)	-11.3%	-1.1%

In terms of operational results, the banks reported good results under the circumstances. Loan and revenue growth of around 5% reflected the poor environment, but excellent cost management and continued low bad debts ensured profit growth and continued satisfactory returns on capital. The South African bank sector remains very healthy in terms of capital levels and its ability to continue to pay good dividends.

Zeder (which plans to sell its stake in Pioneer Foods to Pepsi) and **Transaction Capital** (which keeps generating good growth) gained strongly.

Investec was the exception in the sector and reported a disappointing (worse than expected) result, mainly due to a few once-off write-offs (including discontinuation of business in Hong Kong). In addition, asset managers globally are under continued fee pressure - the focus is shifting towards the valuation of Investec Asset Management post its initial public offering and also towards how the market will value the bank after the asset manager's spin-out.

Two other shares in the sector that were sold down aggressively were **Discovery** (in which the fund doesn't have a holding) and **PSG Konsult (**which to date had held up well whilst the performance of their funds deteriorated).

Portfolio changes/current positioning and outlook

We switched a small percentage of **Investec** and **FirstRand** into **Standard Bank, Absa** and **Nedbank** whilst reducing **PSG** and **PSG Konsult** a bit more.

Although **Investec** looks cheap in terms of its P/NAV (price/net asset value per share) or PE ratio, compared to other UK banks it is not. On top of that, markets have been under pressure and Investec Asset Management's rating post its spin-out should be lower than previously anticipated by the market.

FirstRand has held up remarkably well, reflecting its quality, whilst its peers have sold off.

One can understand the recent sell-off of banks as the outlook for financials in South Africa remains poor, in line with that of the general economy. However, valuations are becoming more attractive – just as they are in the rest of the world, due to the uncertainty of the future profitability of banks in a lower growth and low (negative) interest rate environment.

Our meetings with managements throughout the world show that the leading banks have made significant progress in digitalisation. They are evolving into providing eco systems for their clients' lifestyle needs, using their technology and size to simplify their lives. This includes activities like booking flights and tickets to events and even buying/selling property (the bank website enables the search for properties and completes all legal documentation).

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

Denker Global Financial Fund	20.5%
Sanlam	11.2%
FirstRand	9.8%
Investec	9.0%
Nedbank	8.7%

- **FirstRand** and **Sanlam.** These two would be deemed as being expensive in terms of the P/NAV they trade at in relation to our forecasted return on capital. However, both companies (along with **Capitec/PSG)** have arguably the best management teams in South Africa (and rank very high by global standards). Our experience, proven by back testing, has shown that businesses with quality managements come through crises and recessions best and generate the highest rate of shareholder value growth.
- **Nedbank,** as opposed to **FirstRand** and **Sanlam,** has a very attractive P/NAV for the return on capital it is generating. In contrast to **Investec,** whose future earnings could be under pressure due to its UK banking operations and reduced earnings prospects of the asset manager, **Nedbank's** prospects have a greater degree of certainty. Hence, as the risk of a hard Brexit increased we decreased our holding in **Investec** and continued to do so after the end of the quarter.
- We kept the investment in the **Denker Global Financial Fund** at the maximum level allowed due to 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 US).
    - The fund is invested in a group of high quality businesses that are growing shareholder value at around 10-15% in US dollars and are, on average, 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, and they are world leaders in digitalisation strategies.
    - Investors benefit from diversification across more than 15 countries and also diversification between banks, insurers, exchanges and debt collectors.
    - The emerging market and European banks have been sold down and now reflect excessive negativity.

Conclusions and Outlook

As said above, the South African banks and insurers are well-reserved and have increased their capital levels. In addition, they have now been sold off to levels where they represent good value and pay good dividends. The financial sector is geared to the economy and should re-rate sharply when the first signs of a turn in the economy becomes apparent.

Until that happens, investors in this fund can find comfort in valuations and the quality of management, plus the additional benefit of having 20% of the fund invested outside South Africa in the Denker Global Financial Fund.

Responsible Investment Comments

Our recent visits to Scandinavia in particular highlighted how investors are changing the investment world and behaviour of managements. The banks have all launched ESG funds and have done a lot of work on their own behaviour and footprint but are increasingly reviewing their lending and investment policies: A classic example in Sweden and the Netherlands is "green mortgage bonds". **AIG** (one of the largest insurers in the world and a top 5 holding in the Denker Global Financial Fund) has created a senior position responsible for advising internal teams on sustainability and climate issues.

In South Africa **Standard Bank,** followed by **Nedbank,** says it will only fund coal-fired power projects if they meet certain emissions and size criteria. The bank has adopted a group-wide policy on lending to coal-fired power projects and is in the process of developing a policy on lending to coal-mining operations though out all of its African operations.

At Denker Capital, we are thinking a lot about the positives and negatives of ESG scores and the factors that drive these scores. Both Capitec and PSG have made considerable contributions to South African society. We feel that the ESG score does not reflect this and would not reduce our holding in these companies simply because of a low score.

The general trend is very positive but, as usual, it is dangerous to simply apply it blindly.

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.

For the Nedgroup Investments Bravata World Wide Flexible Fund it is calculated monthly as a percentage (the sharing rate) of outperformance relative to the fund's benchmark, with the high watermark principle applying. All performance fees are capped per fund over a rolling 12-month period. A schedule of fees and charges and maximum commissions is available on request from Nedgroup Investments.

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