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NEDGROUP INVESTMENTS FLEXIBLE INCOME FUND

Quarter Three, 2019

For the period ended 30 September 2019

NEDGROUP INVESTMENTS FLEXIBLE INCOME FUND

30 September 2019	YTD	1 year	3 year	5 year	7 year	10 year	Since Inception
Nedgroup Inv Flexible Inc A	6.9%	9.2%	8.3%	8.4%	8.3%	8.3%	8.9%
(ASISA) South African IB Short Term	6.4%	8.5%	8.5%	8.0%	7.3%	7.2%	7.8%
110% STeFI	5.5%	7.3%	7.4%	7.1%	6.6%	6.5%	7.5%

The fund had a positive quarter with investors benefitting from a depreciating rand, yield pickup on our floating rate assets, as well as a strong performance from preference shares and our Royal Bafokeng convertible bonds.

The fund is tactical with duration but remains conservatively positioned with a low duration of 0.5 years (0.4 years South African duration). A small exposure to government bonds was added over the quarter, when yields looked particularly attractive.

However, given concerns around the fiscus and major events such as the MTBPS, Eskom white paper, Moody's review and investment conference playing out over the last quarter, we would only look to add further risk at cheaper levels than currently seen.

The fund performed well over the quarter, and the longer-term performance of the fund continues to demonstrate significant outperformance of the benchmark.

The Nedgroup Investments Flexible Income Fund has delivered on its mandate to outperform cash with a predictable and low risk return profile. Its performance is attributable to its philosophy of investing in a diversified range of fixed income asset classes, avoiding expensive asset classes and focusing on high credit quality.

Market Commentary

The third quarter of 2019 saw a depreciation in local risk assets as the market experienced continued trade tensions, concerns around slowing global growth and weakening local investment fundamentals. The FTSE/JSE All Share Index delivered a return of -4.6%, and the property sector continued its negative trend delivering -4.4%. The SA 10-year bond yield moved higher over the quarter, by about 18 basis points, and has generally traded on the weaker side of fair value over recent months. The rand has moved more markedly around these concerns, depreciating by about 7.5% over the quarter. The rand is also trading slightly cheap on our valuation, but similarly to bonds, should a non-credible MTBPS and lackluster growth continue to be presented, can trade substantially weaker.

Developed market equities on the other hand experienced marginal gains, as central banks remained supportive, with the S&P appreciating 1.7%. Developed market bond yields continued their exceptional rally, as US data continues to moderate. Despite this moderation, the data is still signaling a reasonably healthy US economy, but the market continues to bet on additional support from the Fed, with another cut priced for the next meeting, and a 50% chance of yet another by the end of January 2020.

In SA Q3 saw Preference Shares (+2.7%) generate the best return, outperforming Cash (1.8%), Bonds (+0.7%), Inflation-Linked Bonds (+0.1%), Equities (SWIX -4.3%) and Listed Property (SAPY -4.4%).

South African Fiscus

The final quarter of 2019 is proving to be a significant quarter for South Africa. It is a period we will enter with caution, as the challenges to the fiscus and plans for economic revival we believe are skewed to the downside.

The MTBPS is scheduled for 30 October, and the data so far is signalling a poor result. From a revenue collection point of view, most economists in recent months have indicated a shortfall in the region of about R50bn to be likely, with weakness in collection being seen across the board from personal income tax, corporate tax, fuel levies, to VAT. The latest budget data released in September, further surprised the market to the downside, signalling revenue collection may be even weaker than this if a pick-up is not seen in the second half of the year.

On the expenditure side, we have heard Treasury ordering a 5% reduction in spending across all ministries in 2020. This is to be escalated to 6% the next year, and 7% the year thereafter. Should this be implemented it would be a good signal to the market that government is taking seriously the initiative to stabilise the debt to GDP ratio, however one does question how realistic this target is. The wage bill (35%) and social grants (12%) make up almost 50% of our expenditure and we question whether Treasury will be able to adjust these significantly. Both are politically delicate areas of expenditure and historically Treasury has had little success being able to revise these. Another 11% of our budget goes to servicing our significant (and growing) burden of debt. Given the difficulty in adjusting almost 60% of our expenditure, we don't believe these levels of cuts is a realistic outcome.

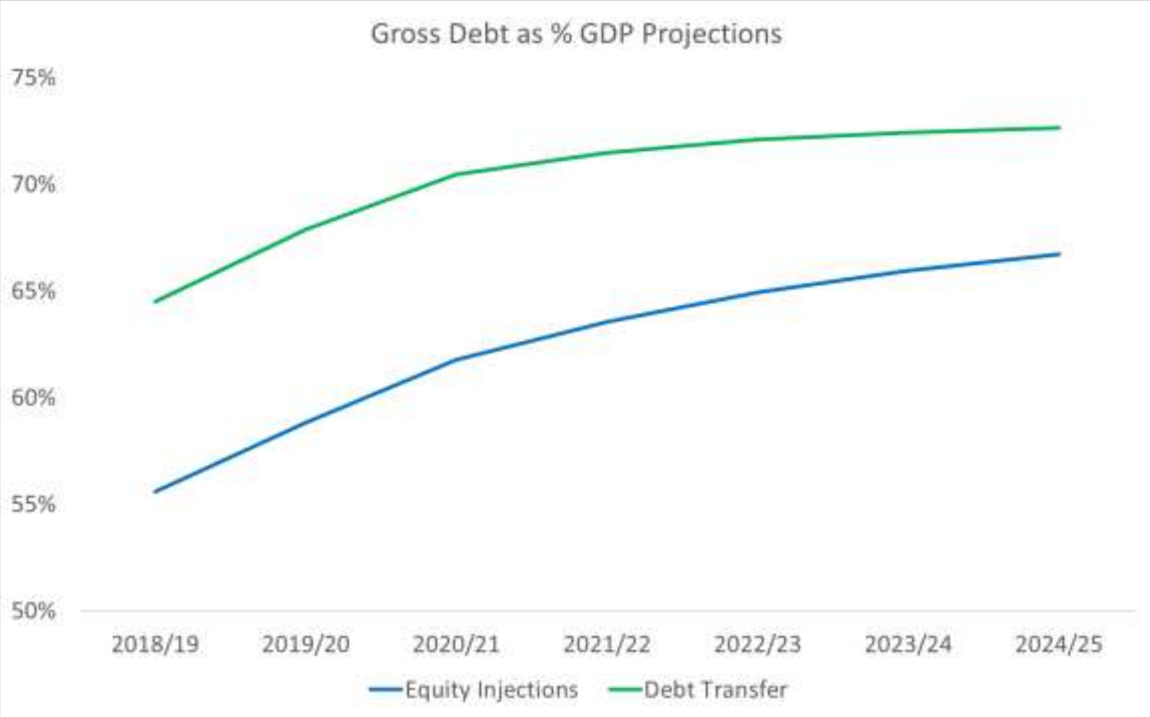
The budget deficit is estimated to come out at around 6%, a staggering miss from treasury's targeted 4.5%. This implies a debt to GDP ratio of approximately 60% in FY 2019/2020. South Africa has experienced a 30% increase in debt to GDP over the past 10 years – second only to Argentina amongst EM peers when monitoring the pace of debt accumulation. The direction of this debt trajectory depends predominantly on two key variables, firstly growth, and secondly further reform commitments to SOEs.

For our debt to GDP ratio to stabilise, we need real growth to be greater than our real cost of funding (i.e. around 2.5%). Our growth over the past five years has averaged a mere 1.25%. At this level of growth our debt trajectory will continue to drift upwards. Growth is paramount to the health of our fiscus and the initiatives presented by government need to be practical and implementable.

The amount of support Treasury has had to provide SOE's has put severe pressure on the Fiscus and we fear the end is not yet in sight. The commitment made by Treasury over the next 10 years has been significant and in the form of continued equity injections. An additional proposal by Eskom is for the sovereign to move a significant portion of the debt onto its balance sheet and avoid any future increase in equity support. For the fiscus, continued (even increasing) equity injections would be preferable, but from Eskom's point of view they would naturally prefer the debt transfer. The debt transfer, in our opinion, would be risky. The turnaround seen at Eskom so far has been very limited, and the restructuring plans so far discussed have been vague. Freeing up their balance sheet at this stage, would remove all accountability and allow for destructive behaviour to continue. The market is waiting for the restructuring paper to gauge how the separation would improve the sustainability of the business. We would look to see whether they are making headway on reducing primary energy costs, and how coal contract negotiations are going. We are sceptical around the focus and practicalities around Independent Power Producers (IPPs) and believe these need to be readdressed; it is concerning that IPPs comprise 25% of the Primary Energy budget but contribute a mere 4.7% to energy production.

The below chart demonstrates the debt trajectory of South Africa under two different scenarios for Eskom. Growth is assumed to be 0.9% for 2019, moving up gradually toward 2% in 2024, the approximate growth trajectory envisaged by economists going forward. Other realistic assumptions are implemented alongside this regarding revenue collection, expenditure cuts, FX depreciation etc.

In the first scenario (blue), Treasury continues to make equity injections of R50bn a year into Eskom until FY2024 (this is the level of equity injections promised over the next two years). In the second scenario (green) all the Eskom debt (R450bn) is moved onto the sovereign's balance sheet, and further equity injections are no longer needed.



Source: Abax Investments, RMB Morgan Stanley

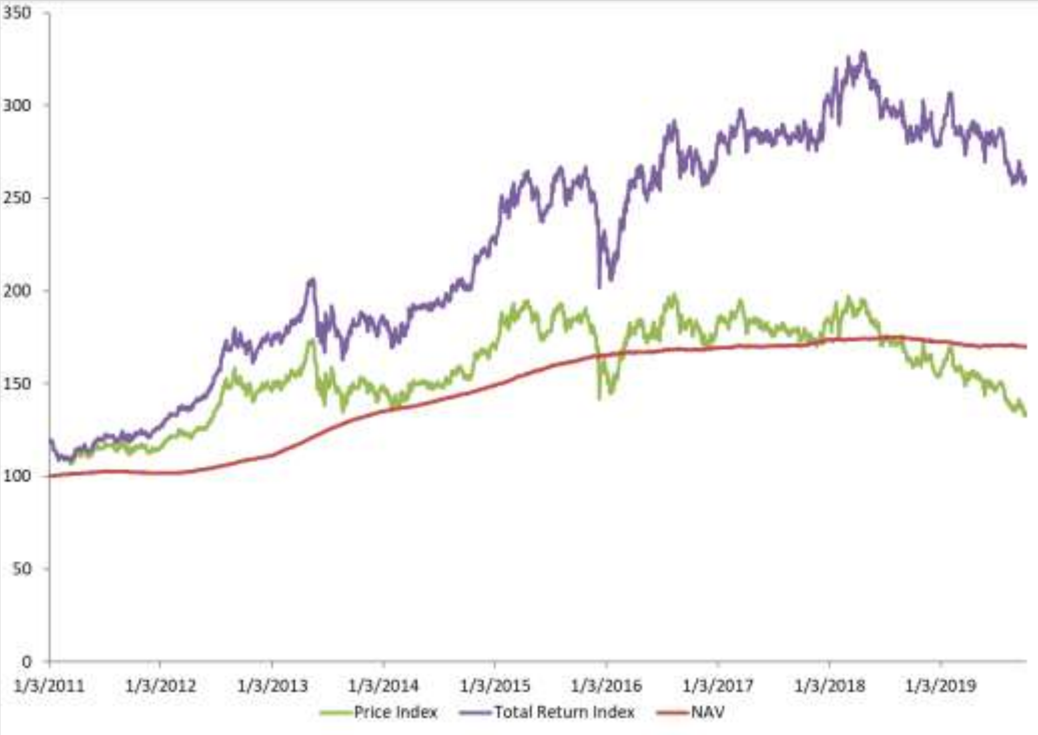
Should things continue as they are, we can likely expect South Africa to move in line with one of the two scenarios outlined (or somewhere in between depending on the Eskom resolution). The IMF marks a debt to GDP ratio of more than 70% for emerging markets as breaching the critical debt threshold, beyond which debt sustainability is put at high risk. This illustrates how imperative it is for a credible budget to be presented, and reforms for growth and expenditure management to be implemented with resolve, as it is not unfathomable that as things stand, we can get there in just a few short years.

Property

Property has been a consistent high performing asset class for the last two decades, with returns only briefly interrupted by the financial crisis of 2008. However, since the start of 2018 the sector has de-rated significantly. Shareholder returns of property stocks can be decomposed into three sources: Growth in Net Asset Value (NAV), dividends and the change in the share price discount or premium to NAV per share (the rating). Rarely have South African listed property companies failed to print growth in dividends and up until recently, contributed to deliver attractive returns to investors. In the last couple of years however, total shareholder returns in the sector have been lacklustre. Dividend growth has slowed dramatically, and expectations are for a continued slow down, but this only explains part of the picture.

Although dividends return cash to shareholders in the short term, sustainable NAV growth is crucial to delivering long term returns. The problem is that a number of factors have in general depressed NAVs in the sector (and in some instances slashed considerably – particularly among the smaller highly indebted stocks). Cyclical factors such as an oversupply of office buildings have led to rising vacancies. A weak consumer environment has resulted in flagging sales in most malls and shopping centres. These have put downward pressure on asset valuations and rentals. Rising debt levels have made it difficult for companies to conduct value accretive acquisitions. Over distributing cash has also put pressure on the balance sheet as well as leading to underspending on refurbishments that are critical to the long-term value preservation of property assets, all of which lead to NAV erosion. Financial engineering through derivatives have worked to boost dividends in the immediate term (by accessing cheap euro and US dollar debt), but in our opinion at the cost of severely constraining their ability to grow NAV.

The chart below depicts the sources of shareholder return for six of the largest SA Property Stocks. With the market believing that future NAV growth was likely for much of the period, these stocks traded at substantial premiums to NAV (Price Index trading above NAV). This also enabled acquisition lead growth as these stocks were able to easily access funding from capital markets. Over these periods generally sell-offs have coincided with rising government bond yields as the market anticipates the impact on property valuations – something outside of the control of management of these companies. In recent years however the average NAV premium has disappeared, and a sustained widening of the NAV discount has emerged, but this is not explained by rising bond yields. Instead it is the factors mentioned above that we believe have driven this correction as the market moves to price in future NAV erosion, which is already beginning to show up in the chart below.



Source: Company Data, Bloomberg

Our investment philosophy is to avoid expensive asset classes. Clearly property stocks are trading cheap (a yawning 20% discount to NAV based on the chart above). Where there are stocks that possess a robust NAV underpin due to prudent management decisions surrounding capital allocation, debt assumption and conservative use of derivatives we will use this opportunity to gradually add to our position in these counters.

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Portfolio Commentary

Current positioning and outlook

- Low Duration

The fund continued to remain cautious over the quarter, with South African duration at 0.39. South African yields have been fluctuating around fair value, perhaps on the slightly cheap side, but have not moved to sufficiently attractive levels for the fund to materially increase duration. We anticipate that the deterioration in South Africa's investment fundamentals will be brought to focus over the next quarter. Should yields move significantly off the back of these events, we would look at add more duration.

- High Credit Quality

The portfolio has a high degree of credit quality. Our credit process has historically shielded from credit events in South Africa and we are confident in our ability to protect investor's capital in the fixed income space.

Corporate credit spreads continue to trade tight, and we remain unwilling to lock in long dated names at these compressed levels or to purchase poor quality names for the sake of yield. We are happy to maintain a higher allocation to cash and allocate to shorter dated instruments until we find assets offering value in this regard.

- Convertible Bonds

We have 3.5% exposure to convertible bonds issued by Royal Bafokeng Platinum, Remgro, and Redefine. We sold out of our Intu Convertible bond position, as the latest company results signalled a shift to the risk of the position, that we were not willing to assume. We have historically added value through this asset class as it provides a mix of yield and capital appreciation. We will look to increase the exposure if we see value.

- Property

The fund currently has 1.7% exposure to a diversified pool of domestic property assets. We slightly increased this exposure during the quarter, buying opportunistically into share price dips. Given the diminished growth prospect of this sector, we are cautious to buy only stronger quality and more liquid names.

- Preference Shares

Our exposure to Preference Shares is slightly reduced to 3.5% (Q2 2019: 4.2%) over the quarter.

- Offshore Cash & Money Market

The fund maintains an exposure to Offshore Cash & Money Market instruments at 6.9% (effective offshore exposure of 3.8% after hedging) where a very attractive yield pickup over domestic assets is available while maintaining a high degree of credit quality.

Summary and Conclusion

The third quarter saw a decline in local risk assets, as the global growth concerns, trade tensions and deteriorating local investment fundamentals concerned the market. We remain cautiously positioned into the last quarter of the year, given the amount of news flow on local investment considerations scheduled. Should asset prices cheapen significantly over these events, we would look to tactically increase risk. However, over the longer term we believe structural reforms and more urgent action is required by government to move asset prices significantly stronger from current levels (unless global forces allow for a risk-on environment, in which case we will benefit).

Our exposure to property remains underweight and will largely remain so for the time being. We are however open to tactically adding exposure to specific, higher quality stocks when the market moves to cheaper levels. Although yields look optically cheap it's important to note how low growth is, and strip any false yield enhancing mechanisms, when assessing the fair value of these assets.

Portfolio summary	
Domestic Duration	0.23
Domestic Inflation Linked Duration	0.16
Total Domestic Duration	0.39
Offshore Duration	0.09
Total Fund Duration	*0.48*
Effective Offshore Exposure	3.8%
Fund Yield	8.0%

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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
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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.

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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.

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