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NEDGROUP INVESTMENTS GLOBAL CAUTIOUS FUND

Quarter Three, 2019

For the period ended 30 September 2019

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1. PERFORMANCE SUMMARY

The Fund produced a negative net return of -0.8% in the third quarter of 2019 against the benchmark, USD LIBOR 1 month of +0.6%. The aim of the strategy is to provide a stable stream of real total returns over the long term with low absolute volatility and significant downside protection.

The quarter witnessed a slowdown in global economic data, offset by further monetary easing from central banks. Political drama was at the forefront of news over the third quarter. There were no major changes to the portfolio after the new portfolio was implemented at the end of the second quarter due to the change of manager.

2. MARKET OVERVIEW

The OECD has updated its May economic forecasts and, predictably, has moved growth expectations down a notch or two. It summarises its latest forecasts thus: “The global outlook has become increasingly fragile and uncertain. Global growth is projected to slow to 2.9% in 2019 and 3% in 2020. These would be the weakest annual growth rates since the financial crisis, with downside risks continuing to mount…escalating trade policy tensions are taking an increasing toll on confidence and investment, adding to policy uncertainty, weighing on risk assessment in financial markets, and endangering future growth prospects.”

Trade features heavily in the OECD release. It comments: “Global trade remains exceptionally weak. Trade volumes (goods and services) stalled at the end of 2018 and are now declining. High-frequency indicators suggest that near-term trade prospects are weak.” The OECD calculates that as at mid-September the market value of negative yielding debt (corporate and government bonds) amounted to US$14 trillion or around 24% of total issuance. In August it was even higher: US$17 trillion and 30%. This is an indictment of economic policies. Confidence has evaporated, long-term investment decisions are not being made and investors are seeking safety by snapping up long-term bonds - even if it means accepting a negative yield.

It is difficult to see what is going to change this situation in the near-term as quantitative easing is back on the table in the US and eurozone (it never left the table in Japan) and central banks the world over are steadily reducing their key interest rates. The European Central Bank recently moved to a negative 0.5% from a negative 0.4% whilst the outgoing ECB President, Mario Draghi, announced that that the bank would commence buying 20 billion euros of assets per month “indefinitely.” QE and lower key interest rates send a message that the patient is not well. It is difficult to encourage positivity and a robust consumer in these circumstances.

Central bank key interest rates continue to fall. During the quarter we saw rate reductions by the US, Eurozone, New Zealand, Australia, Russia, Chile, South Korea, Brazil, South Africa, Mexico, Saudi Arabia, India, China and Turkey. In addition, many emerging markets also cut their rates. The tightening trend, such as it was, ended at the beginning of 2019. On current expectations rates are likely to be cut further

Despite the disappointing economic news and the various stoushes in the political arena most developed global stock markets were generally in positive territory over the quarter. Global government bonds, at the benchmark 10-year level, all experienced further falling yields over the quarter, which also benefited corporate and high yield debt.

3. CONTRIBUTORS & DETRACTORS

Leading into the quarter, the portfolio was conservatively positioned (see Market Outlook) with short dated sovereign bonds, high quality equity (high RoE, low leverage & high dividend yield) and maximum exposure to foreign currency (GBP, EUR, CAD etc.).

Within the portfolio, both equities and bonds were in negative territory, hampered by US dollar strength over the third quarter.

Currency

Based on Purchasing Power Parity (PPP) analysis we consider the dollar to be extremely overvalued against other major currency in the portfolio (GBP, EUR and CAD) and expect it to fall over the medium-long term, which will be to the advantage of the portfolio. Whilst it’s difficult to judge currency movements over the short term, we maintain our maximum level of unhedged foreign currency exposure at 45% of the total portfolio and continue to fully hedge the Australian dollar exposure.

Fixed Income

As a result, the biggest detractor over the period was the overseas bond portfolio with the UK Treasuries (15% of portfolio) in particular detracting. Sterling fell by nearly 3% against the dollar over the period as the risk of a “no-deal” Brexit scenario remains on the table. The portfolio’s US Treasuries were up just +0.2% over the period compared to the wider market (JPM US - All Maturities TL) which rose +2.8% as yields continued to fall and benefitted longer dated bonds. Pyrford continues to adopt a very defensive stance by only owning short duration securities in order to protect the capital value of the portfolio from expected rises in yields. – as witnessed for most of 2018.

Equity
The equity portfolio returned -0.3% in the third quarter. Half of the portfolio's equities are invested in the US and outperformed the domestic market over the period (+1.1% v +0.8%, MSCI USA Index). Key drivers in the US portfolio included Texas Instruments (+9.0%), Lowe's (+7.6%) and S&P Global (+6.2%). Texas Instruments performed well as the company benefitted from an improving investor outlook for the global semiconductor sector and a positive earnings announcement. Lowe's posted a strong set of results and gave an optimistic view on the performance improvement plan the corporation has initiated. This should see the company improve profitability and increase returns to shareholders. Outside of the US, the Canadian company Metro (consumer staples) rose nearly 17% following a strong set of results and confident outlook for its pharmacy chain, Jean Coutu which it recently acquired.

The biggest detractor within the US equity portfolio came from the Tobacco company Altria (consumer staples). The company lagged the market as investors digested the potential acquisition by Philip Morris International. What disappointed shareholders most was the lack of take-over premium that Philip Morris was prepared to pay. Bowing to pressure by Altria shareholders the deal was called off at the end of September.

Outside of the US, Notable detractors over the period included Brambles, Woodside Petroleum (both Australia) and Axiata Group (Malaysia). Brambles fell 11% over the quarter following FY19 results. The company has performed well over the past year and whilst results were solid the market was concerned by the company's cautious outlook for the year ahead. Woodside Petroleum reported a fall in second-quarter revenue on Thursday, the first decline in six quarters, as it was hit by an extension of planned maintenance at its Pluto liquefied natural gas facility. Finally, Axiata Group fell sharply in September following news that Axiata and Telenor's planned merger was called off. The companies had been in discussions about merging their telecom and infrastructure assets in Asia, a move which had been well received by investors in the second quarter. The companies have not ruled out that a future transaction could be possible. In the meantime the company is focusing on continuing operational improvements in its core Malaysian business.

4. PORTFOLIO POSITIONING / MARKET OUTLOOK

There were no asset allocation changes in the quarter. The current model allocation remains 25% equities, 72% bonds and 3% cash. This reflects our continued view that there is little fundamental value in either equities or longer duration quality sovereign bonds and that capital market valuations do not discount the significant structural economic problems and material risks that exist.

The equity portfolio remains positioned in traditionally defensive sectors which offer predictable revenue streams and attractive valuations. The focus of the portfolio is on balance sheet strength, profitability, earnings visibility and value. In Asia, we have a preference for the Southeast Asian markets over Japan as the economies in Southeast Asia offer sustainable economic growth supported by increased labour output or productivity growth and trade at more reasonable valuations.

Within the equity portfolio there were no new stocks purchased or sold outright over the quarter.

Our positioning in bonds remains the same. Pyrford continues to adopt a very defensive stance by owning short duration securities in order to protect the capital value of the portfolio from expected rises in yields. At the end of the quarter the modified duration of the fixed income portfolio stood at just 1.3 years. Whilst these very short duration bonds are unlikely to yield high returns they will provide significant capital protection for the portfolio and importantly they are highly liquid. The portfolio management team will have sufficient liquidity to efficiently sell these positions and switch into equities (or higher duration bonds) if value emerges. In the quarter there were no further changes to the overseas bond portfolio. 42% of the portfolio is invested in overseas bonds, with 15% in the UK, 16% in Canada and 11% in Australia. The remaining bond portfolio is invested in US Treasuries.

Finally, there was no change to the unhedged non-USD exposure in the portfolio over the quarter. 45% (the maximum level) of the portfolio remains exposed to unhedged foreign currencies, representing the view that the US dollar is an expensive currency.

5. CONCLUSIONS

At Pyrford we believe that a long-only, fundamental, quality and value-based approach utilising a long-term outlook with the ability to move allocations flexibly and appropriately between the key asset classes – global equities, cash and sovereign debt - will provide a rewarding and stable real return stream for our clients.

It is worth noting that Pyrford do not just think equities and bonds are overvalued, which gives rise to defensive positioning of the portfolio. In our view the unprecedented and unorthodox central bank actions of recent years have resulted in extraordinary rises in just about all asset prices – equities, fixed income, property and "alternatives" – you name it.

6. RESPONSIBLE INVESTMENTS COMMENTS

As long-term shareholders of companies, we have the ability, and in our view the responsibility, to try and influence the business practices of companies.

In the quarter Pyrford voted 212 ballots in 10 company meetings. We voted against management in 70% of meetings. All voting records and rationale is available to view on our website (www.pyrford.co.uk), contained within our responsible investment section.

Finally, in the quarter, Pyrford's 13 member Investment team engaged with nearly 79 companies worldwide and ESG issues are a standing agenda item in every meeting we conduct. For a detailed overview of ESG activity, please visit our website for our latest annual ESG report.

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