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NEDGROUP INVESTMENTS GLOBAL DIVERSIFIED EQUITY FUND

Quarter Three, 2019

For the period ended 30 September 2019

Period	Nedgroup Investments Global Diversified Equity Fund A	MSCI ACWI NR USD
3 months	-0.64%	-0.03%

OVERVIEW

The slowly tightening tourniquet of trade war

On the face of it, last quarter was rewarding and dull. Most global stock markets eked out gains. There is an old adage in stock market investing: the less frequently you check stock prices the more relaxing it is. We come to work every day and can watch stock prices unfold on a second-by-second basis, reading the deluge of news in real-time. This can be stressful. It felt particularly stressful last quarter. Within the quarter, stocks swung wildly as two nascent themes played out: firstly, the trade war and secondly, disruptors winning and the disrupted losing.

The trade war between America and China is well underway. What was originally seen as a short-term phenomenon, driven by populist politicking has now become entrenched and persistent. To us, two significant factors changed last quarter: first, the impact of the trade war has become clearer; second, the perception of the trade war has changed.

First, the impact of tit-for-tat tariffs and corporate blacklisting has started to emerge and it has not been good for economic growth, something we noticed from both a top-down and bottom-up perspective. From the top-down, macro-economic statistics, especially from Europe and China, have been poor. In the case of the former, alarmingly poor, suggesting Europe is teetering into a recession; in the case of the latter, rapidly deteriorating, suggesting a sharp deceleration in growth well below historical norms. In America, the news has been more mixed with Trump's tax stimuli from 2018 confusing the picture. Nonetheless, it seems safe to say economic growth is slowing pretty fast everywhere and since not much has changed from last year, apart from the duration and scope of the trade war, this is the most likely cause.

From the bottom up, which is our natural habitat, incremental news has been disappointing in focused areas of the stock market. We scurry around looking at lots of stocks in an attempt to infer which businesses are winning, and finding life easier, and which are losing, and finding life harder. As we find interesting stocks we attempt to see whether any of them have enough in common to allow us to draw "top-down" conclusions. So, in the context of the impact of the trade war we have taken particular interest in businesses which have reported a more difficult time. Our sense is almost every company dependent on growth from China, both overseas and Chinese, have reported incrementally worse news. It is also our sense that businesses reliant on customers whose intentions waver with the economy have also reported incrementally worse news. A lot of the trails of disappointment lead to trade, and especially trade between China and America.

When such a wide variety of businesses reliant on healthy economic growth start to disappoint, it is easy to think of them as "cyclical" – subject to the transient vicissitudes of unpredictable economies which occasionally slump into recessions. But the trade war is not, it now appears, a transient phenomenon. Investors, analysts and central bankers appear to have worked this out last quarter, with interesting consequences.

Second, in our view, other people's views about the trade war have shifted markedly in the last three months. We believe most people used to view the trade war as transient and of low impact, but now believe the opposite. Buried within last quarter's trajectory was a violent stock market correction in August, during which anxiety over the trade war built rapidly. We think the consensus has shifted a long way, especially over the last year. News on the waxing and waning of trade negotiations is treated very differently now. A year ago, aggressive tweets on tough negotiating tactics were dismissed as transient reasons to be nervous, now they are treated as confirmation we are in for a long period of trade warfare. Likewise tweets on negotiation progress, once leapt on as signs of a speedy resolution, are now generally dismissed as ephemeral. We still believe most people are too relaxed about the degree of negative impact a prolonged trade war will have, but they have, at least come around to the idea that a trade war is here to stay. This is good for stock markets since, as the cliché goes, more is now in the price.

In addition, and of greater impact, central bankers appear to have changed their view on the trade war. There has been a remarkable flip, especially in America, on the likely path of interest rates. The Federal Reserve has moved from strongly signaling an intention to raise interest rates earlier in the year, to a position of clearly signaling multiple rate cuts. This, in our view, reflects a clear acceptance the trade war is here to stay, will have a dampening impact on growth and requires a policy response. The abrupt policy reversal was the most likely cause of the rapid unwind of August's anxiety in September, giving us such a benign looking quarter. The stock market is a complex beast because of this reflective, adaptive nature of the players involved. Gloom triggers response, which triggers relief. So once again stock markets are interestingly poised. News is getting worse, but anxiety is receding because governments think they can see the mounting risks and are responding with economic stimulus.

Tension also exists inside stock markets, bringing us to our second theme. Nerdy investment professionals often talk about "factors" when investing. Factors are general characteristics of stocks which can appear more or less attractive depending on your view of the world. Two factors which have polarized debate since 2009 are "value" and "growth". Most investors have a tendency to believe "value" is good. The argument, is complex, but essentially leans on a belief in mean reversion and intrinsic value, both concepts which are (in our view) intellectually comforting but quite possibly flawed. Many investors also like "growth" but frequently worry it can get "too expensive". The outcomes from preferring, for whatever reason, one factor over another in the last 5 years have been wildly different. There are many theories as to why this has been the case, but perhaps the most credible one is based on "disrupters" and "disrupted". To simplify and summarise: sometimes "growth" stocks have their growth characteristics because they are businesses which steal growth from other companies by disrupting them; essentially they win by others losing. In a sort of zero sum game this creates pools of stocks (disrupters) which grow faster, for longer, by causing trauma for another pool of stocks (the disrupted) which slowly die. We have noticed it has become unusually easy to characterise a lot of growth stocks as disrupters and an unusually large number of value stocks as disrupted. The trouble with disrupted stocks is they are unlikely to mean revert. All this may make perfect sense, but we have the added complexity of perceptions to deal with.

Two types of stocks have done especially well so far this year: disruptive growth stocks and safe, defensive stocks. One type of stock has done especially badly: disrupted value. But last quarter this clear delineation of winners and losers, from a stock market sense, got a lot more volatile. In particular, both disruptors and disrupted stocks experienced a much bumpier ride.

The spread in performance between growth and value has been cumulatively wide since 2011, but the divergence has accelerated at an unusual pace this year. Perceptions over the relative merits of both types of stocks have shifted sharply. We believe stock markets can become over-confident about the speed at which slower structural trends move. In a day-to-day environment where speed and immediacy feels like everything, it is easy to forget how long things usually take to fully unfold. Stock prices move fast, however, and sometimes perceptions can get ahead of reality. We think this is what happened last quarter. We have not discovered an objective, easy way of gauging when others' views get extremely over-excited or gloomy about particular themes. But, having lived through the flash crash of 1987, the double-dip recession of the early 1990s, the LTCM blow-up of 1998, the TMT boom and bust and the GFC, we think we can tentatively recognise some of the signs of possible extreme perception shifts. One of them could be an unusually wide divergence of performance between factors like growth and value, another may be an unusual pickup in the volatility of performance between such factors. Whatever the answer, we took the prompt from an unusually violent few days in September to conclude it was prudent to have a more agnostic view over the relative merits of value and growth.

Hence, we indulged in a flurry of activity during the early part of September. We sold a number of positions which had (even after the shenanigans of September) performed really very well for us. We also bought a few new positions in stocks with more value characteristics; stocks we have been watching for some time and we believe fit the other aspects of what we look for (particularly, sensible management behaviour within sensible, robust businesses). The net result was a modestly disappointing quarter of performance for us, but largely due to our structural bias away from mega-caps (we equally weight).

So, what next? We remain fairly sanguine about the overall prospects for stock markets. We do believe news will continue to have a negative slant and for many stocks facing structural pressure from being disrupted, life is likely to remain tough and probably get tougher. On the other side, there are quite a few stocks which we like from a management behaviour perspective and where we believe, because they are disrupting other businesses, they have unusually easy growth. But we don't actually own them all at the moment. We still fret about the faster moving waxing and waning of others' perceptions on them (investors and analysts). A bit of general gloom might take more of the zeal out of their stock prices and present an opportunity to buy over the next year. We have tried to assemble a portfolio which can do reasonably well whatever, but as ever, who knows what lurks around the corner.

REGIONAL ATTRIBUTION ANALYSIS

Japan

This bucket of the portfolio contributed from a relative point of view this quarter, whilst North America and Europe detracted. Japan was an outperformer with names like Tokyo Electron (electronics and semiconductors) and Kakaku (price comparison website) leading the winners whilst OBIC (infrastructure software) and SMC Corporation (control systems) dragged slightly on performance.

Rest of World

As ever with our Rest of World bucket, there was a real mix of winners and losers spread across countries and sectors. B3 SA Bolsa (Brazilian exchange) which we closed out of in September, and ANTA Sports (Chinese branded sportswear) led the outperformers. The main detractors were largely China based stocks, like iQIYI (video entertainment) and Lenovo (computers).

North America

This region was the largest relative detractor this quarter, with a mix of themes. Edwards Lifesciences Corporation (medical equipment company) and Dollar General (chain of variety stores) outperformed whereas names like GrubHub (online food delivery) and Spotify Technology (US music streaming service) led the detractors.

Europe

An underperformer, with idiosyncratic losers driving negative alpha. London Stock Exchange (UK stock exchange) which we closed out of in early September, and Scout24 (German internet-based services) led the contributors. Jungheinrich (German manufacturer of merchandise stackers and forklifts) and Spectris (UK manufacturer of measurement instruments) led the detractors.

SECTOR ATTRIBUTION ANALYSIS

Key sectors for relative contribution were Financials and Consumer Discretionary. Our structural underweight in **Financials** combined with stock selection drove alpha in an underperforming sector. Again, exchanges did well this quarter, with London Stock Exchange (UK) and B3 (Brazil) driving alpha with Amundi (France) slightly dragging on performance.

Our overweight in **Consumer Discretionary** drove alpha as the sector outperformed the benchmark, helped marginally by stock selection. Notable winners included ANTA Sports (Chinese branded sportswear) and Sally Beauty Holdings (US specialist retailer), with key detractors Grand Canyon Education (US online education services) and Melco Resorts & Entertainment (developer, owner and operator of Asian casinos) on the downside.

The key sectors for relative detraction were **Information Technology** and Industrials. Within the tech space, despite attribution from asset allocation being positive, idiosyncratic stock movements drove underperformance. Leading contributors included Tokyo Electron (electronics and semiconductors) and LAM Research (manufacturer of semiconductor processing equipment), with detractors led by our structural underweight in Microsoft (US computer technology).

Allocation effect in a poor performing sector combined with negative stock selection drove underperformance across **Industrials**. Leading contributors included ALS (Australian commercial services company) and WEG (manufacturer and distributor of industrial machinery), with detractors led by Navistar (US truck manufacturer) and Fortive (industrial measurement instruments).

FUND POSITIONING

Unlike our regional exposure, we do take significant positions between industries. These typically fall into two camps. Firstly, we are significantly underweight financials because we view the entire industry as having opaque reports and accounts, meaning we can’t get comfortable with where the risk is. This means we simply don’t invest in most financials. Secondly, our sector exposure can vary due to the degree of opportunity we find at a particular time.

Overweight Industrials

we can find an unusually large number of conservatively run businesses, with apparent analyst bias or investor bias, as macro worries cloud perceptions. We view many of them as much lower risk than they are given credit for. We have, however, culled a few names: the industrial recession “scar” of 2015-16 no longer seemed to be acting as a biased anchor point for some stocks (scepticism has dissipated), and compounding this, there are creeping signs of inflation, with some areas struggling to pass this through.

Overweight Information Technology

An inappropriate sector classification in our view as its scope is so broad, and the companies so eclectic. Within the plethora of tech sub-industries however, we have been able to find many opportunities which we view as low-risk (hard to break, sticky customers etc.), but tarnished with the “risky” traditional label for the technology sector.

Marginal overweight Energy

In 2017 we closed quite a few names in the energy sector. It looks to us as if the combination of the demand for energy shifting (old sources of demand like China, are slowing) and new technology in renewables are making
the demand environment unstable. 2015 now looks like a brief moment in a long cycle of trapped capital; the pattern of high anxiety followed by anxiety release in 2016 kept capital inside the industry. This traps profitability and lowers the propensity for stocks to break out into prolonged anxiety releases, and their ability to string together periods of surprisingly good news. More recently, inflationary concerns have led to a strong run up in Energy, with our underweight acting as an indirect bet against inflation. We're not macro investors, and don't like unintentional bets like this, (we also think that there is emerging evidence of supply side restraint) so we've removed that underweight by finding those names we consider to be the hardest to break.

KEY CONTRIBUTORS

Among the analyst bias stocks, we identify companies where unusual or changing business models cause analysts to misunderstand them:

Anta Sports is to China what Nike is to America: the leading sportswear manufacturer. Historically a wholesaler, Anta Sports has transitioned to become a multi-brand direct retailer, with growth driven by its higher margin, lifestyle sports name, Fila. Analyst scepticism appears to rest largely on two things. Firstly, on expectations of fading growth as Fila's sustained success is questioned based on greater competition with Nike and Adidas. Secondly, a premium valuation. Anta's transition, however, coincided with a favourable demand backdrop (athleisure trends taking hold in China), as well as the government promoting citizens to lead a more physically active lifestyle. Anta is looking to replicate Fila's success through the acquisition of Amer Sports; owner of Salomon and Arc'teryx. Analysts seem to remain sceptical on Fila's growth, and see near-term uncertainties from the Amer deal, but investors seem cautiously positive, boosting the share price this quarter.

Fidelity National Information Services ("FIS") is a US payment processing services company providing the 'plumbing' for financial payments. It recently purchased Worldpay (which was held in the portfolio) in a stock and cash deal. Worldpay shareholders received 0.9287 shares of FIS plus cash, for each Worldpay share held. The FIS position in the portfolio was therefore created on the back of this corporate action, driving the relative contribution up (as the book cost was zero). FIS should be viewed in conjunction with Worldpay in the detractors.

Lam Research is a US provider of equipment and services to the semiconductor industry. Investors and analysts appear to view LAM Research skeptically due to past cyclicality, and fears of consolidation in its end market. We believe that these concerns overlook the fact that consolidation in semiconductor equipment makers has been proportionally higher than their customers, leading to higher and more stable margins, and stronger bargaining power. The share price continued to track up through the quarter following solid fiscal Q4 results, released in July, more positive news in the sector from memory prices stabilising, and an increasing belief amongst investors that memory fabs capex will resume.

Among the investor bias contributors, we see companies which have had prior trauma which has shocked management into change:

Kakaku is a Japanese price comparison site with a restaurant booking business. The company experienced a period of low growth driven by Yahoo and Rakuten moving into the price comparison space, switching from previously being partners, to competitors. Whilst the restaurant booking business is a more stable growth revenue segment, we believe doomsday predictions for the price comparison site are overdone, and that it has longer legs than investors seem to have priced in. The share price picked up steam in August and September as good results combined with news of a potential addition to the Nikkei 225.

There is little negative about **Tokyo Electron** in our view. Tokyo Electron is a Japanese semiconductor capital equipment company which supplies wafer fabrication equipment to semiconductor manufacturers. Semiconductor capital equipment has become more consolidated in recent years with major players carving out dominant positions in separate niches. Tokyo Electron also benefits from a strong growth environment. There is growing demand for semiconductors which are becoming more complex, and capital intensive, to manufacture. Analysts seem sceptical, dismissing growth as just another normal cyclical peak and worrying about sustainability of growth. The share price rallied in July, sparked by a strong set of Q3 results on the back of a much-anticipated recovery in demand as excess inventory fades; more positive news in the sector from memory prices stabilizing, and an increasing belief amongst investors that memory fabs capex will resume.

KEY DETRACTORS

Analyst bias stocks among our key detractors:

Microsoft is a US technology giant. Investor anxiety peaked in 2012/13 (evidenced through valuation compression), and company management were forced into submission: the mobile strategy was a relative failure. The submission also drove a model change; to embrace cloud infrastructure and focus on a higher free cash flow generative subscription model for Windows. In our view, these past traumas still weigh on investors and analysts. Within an equally weighted portfolio (by region), when a mega-cap like Microsoft performs well, our natural relative underweight creates a performance headwind.

Worldpay is an online payment processing company created through a merger between Worldpay and Vantiv in 2018. We like companies which provide infrastructure that underpins financial markets as they tend to be difficult to break utility-like businesses with safe, predictable growth. Worldpay's scale and integrated nature allows it to be a consolidator in a fragmented market, giving it faster growth than its peers. Analysts seem to exhibit fade rate bias and continue to underestimate the duration of growth. The share price spiked in March 2019 on news Fidelity National Information Services ("FIS") would be acquiring Worldpay. In July, that acquisition was completed, with Worldpay shareholders receiving cash and shares in FIS. The contribution for Worldpay this month was therefore negative as the position was closed out at zero, but it should be viewed in combination with FIS in the contributors.

Of our investor bias stocks, declining share prices signal high anxiety:

Grubhub is a US based online platform for food delivery; connecting stay-at-home customers with local restaurants. The business model has shifted; shedding the historically overly ambitious, and subsequently missed, growth plans, and targeting more achievable growth with a stronger connection to both customers and suppliers. Analysts and investors however, remain anchored on the trauma of missed growth targets in the past, giving them an unnecessarily sceptical viewpoint. The share price stumbled this quarter as results highlighted a drop in EPS on the back of higher expansion related costs. The shadows of large competition is causing investors angst: Uber and Doordash are growing fast, and there is a fear that these businesses will dominate. We think this concern overlooks some strong attributes that Grubhub has: a large user base, and the overall growth in the market. Unlike housing or autos advertising applications, the food delivery market can sustain several large players, we believe.

Jungheinrich sits in an industry with good characteristics: a niche product, with barriers to entry. Company management behaviour appears to be conservative, disciplined and consistent. Analysts often struggle when faced with accurately forecasting steady, stable, 'boring' companies; like journalists, they crave an exciting headline story to make their name with. As a result, they exhibit predictable patterns of forecast bias through apathy. The share price dropped in July as the company lowered its 2019 outlook, and it fell further through August as the market sold off European cyclical stocks, and stocks exposed to global trade.

Spotify is a US streaming application for music and podcasts; it stands as the one large independent streamer, which does not tie users to particular devices, like say Apple does. It has a large user base (85m paying subscribers) and is now material to the large record labels as a revenue source. Businesses with large user bases who engage frequently and for long periods of time are often valuable, as they have time to figure out how to make money out of them – either by gathering data from them or by becoming essential to users lives. Investors and analysts see Spotify as controversial however, as it is in an early phase of maturity, where some of its monetisation experiments have fallen flat. For now, subscribers are still paying to listen, more subscribers are joining, and negotiations with record labels are not bringing peril. Analysts and investors only see peril however: Amazon is lurking with its own offering, stalking another industry - but we think this may be representativeness bias firing off. Superficial similarity to other risky situations, crowding out other risk lowering attributes, the user base, the user engagement, the stable supplier relationships, and the monetisation path for podcasts.

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