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NEDGROUP INVESTMENTS FINANCIALS FUND

Quarter Four, 2019

For the period ended 31 December 2019

Market overview: 2019

The South African economy remained in a recessionary condition plagued by lack of constructive government policies and Eskom's inability to generate sufficient electricity. The market had however discounted the bad news in 2018 and so the rand actually gained 3% against a slightly stronger US dollar (the dollar gained 2% against the euro) and the FTSE/JSE All Share Index gained 12.1% while underperforming the MSCI World Index's gain of 28.3% (refer Figure 1).

Despite the poor economy and uncertainty, the South African banks maintained good shareholder value and dividend per share value growth of around 15%. The market however focused on the lacklustre loan and poor earnings per share growth and de-rated the sector quite a bit, with the Nedgroup Investments Financials Fund taking the biggest hit (Figure 2).

Figure 1: 2019 total returns

	USD		ZAR
S&P 500	27.8%	FTSE/JSE All Share	12.1%
MSCI World	28.4%	FTSE/JSE Financial 15	3.8%
MSCI World Financials	26.4%	Nedgroup Investments Financial Fund	0.3%
S&P 500 Banks	40.6%	ZAR/USD (- = stronger)	-2.7%

Figure 2: SA banks maintained good shareholder value and dividend per share value growth

	Valuation: P/tNAV			Shareholder value growth	
	Average 2009-2018	*Dec-18*	*Dec-19*	*CAGR 2009-2018*	*Forecast next 3 yrs (p.a.)*
Absa	1.6	1.4	1.1	9.9%	12.6%
Standard Bank	1.9	2.0	1.7	9.6%	16.1%
Nedbank	1.8	1.8	1.3	10.8%	15.6%
FirstRand	2.6	3.1	2.7	15.3%	19.8%
Capitec	4.5	7.1	6.7	29.5%	23.4%
Investec	1.3	1.1	1.0	4.2%	13.8%

Fund performance contributors & detractors for the year

Figure 3: The main contributors and detractors

	Average holding	Total return	Contribution
Top 5 contributors			
Denker Global Financial Fund	20%	17.3%	3.1%
Sanlam Ltd	11%	3.3%	0.5%
Investec (Ltd and plc)	9%	9.5%	0.4%
Transaction Capital Ltd	1%	27.2%	0.4%
FirstRand Ltd	10%	0.1%	0.1%
Top 5 detractors			
Sasfin Holdings Ltd	3%	-7.9%	-0.3%
PSG Konsult Limited	2%	-9.4%	-0.3%
Rand Merchant Investment Holdings	3%	-12.4%	-0.4%
JSE Ltd	5%	-23.7%	-1.2%
Nedbank Group Ltd	8%	-17.6%	-1.5%

The investment in the Denker Global Financial Fund was the biggest contributor, performing well and in line with global markets. In South Africa, Transaction Capital continued to generate good results, but the smaller market cap and liquidity of the share kept us from making this a bigger investment. Investec also performed well (measured relatively to the rest of the sector) as the share price reacted positively to both the certainty around Brexit in December 2019 and the progress on splitting out the asset management business. Other investments in the fund that contributed positively were Coronation, Zeder (thanks to Pepsi's offer for Pioneer Foods) and RMB Holdings (in which we invested when the discount to FirstRand became excessive).

Nedbank and JSE were the biggest detractors. Nedbank was de-rated (most probably due to the perception that it has large exposure to commercial real estate) whilst the JSE was sold down along with the drop in profitability due to a significant fall in trading volumes and a higher cost base.

It is interesting to look at the shares the fund was not invested in:

- We made a good call to stay out of the property sector (both locally and international) as well as Discovery Holdings and Brait.
- Shares that the fund was not invested in and that performed well were Capitec (the fund holds the holding company PSG instead), Remgro and Reinet (the fund is invested in global financials instead) and Quilter (sold too early) and MMI. MMI was re-rated on the back of progress made by the new management team. As a rule however, we prefer to get more certainty about the long-term sustainability of turnarounds and hence stood on the side lines.

Portfolio changes/current positioning and outlook

Figure 2 highlights the significant de-rating the bank sector experienced during 2019. The economic prospects for 2020 and thereafter remain poor but the high interest rates allow banks to sustain wide interest margins while managing the quality of their loan books (which is something they've been good at). The low rate of loan growth means that they generate excess capital which they use to pay higher dividends, resulting in attractive (and sustainable) dividend yields of around 6%.

We made a few changes to the portfolio during the year, selling almost the entire Old Mutual investment (in May) and reducing the Absa position. The troubles with the ex-CEO of Old Mutual reflected negatively on the effectiveness of its board and its ability to make good management decisions. We sold Absa because we're concerned that they're taking market share whilst the economy is weakening. Only time will tell whether they are growing their loan book without negatively affecting their loan book quality and if the strategy is profitable. Our experience in the past (both in South Africa and internationally) has made us cautious on this and hence for the moment we retain only a smaller investment in Absa.

Other actions included selling Zeder after they received a cash offer for Pioneer Foods from Pepsico and a trimming of PSG and PSG Konsult after their price moves pushed them into expensive territory. The cash generated was used to increase our holding in Sanlam, Santam and RMB Holdings (which was trading at a large discount to FirstRand).

Conclusions and outlook

Our forecasts are for the banks (see Figure 2) continue to deliver strong NAV/share growth (shareholder value growth) over the next three years reflecting the health of the South African banking system despite the poor economic environment. Even though we think these forecasts might be a bit optimistic it does show what is possible should South Africa's growth rate normalise.

Figure 2 also shows that valuations are now very attractive.

The fund retains an almost 35% non-SA exposure via the direct investment in the Denker Global Financial Fund as well as indirect investments in the UK, Africa and India via Investec, Sanlam, Standard Bank and Santam.

Responsible Investment Comments

Both globally and in South Africa, investors focus on responsible investment has been noticeable as banks have started terminating their financing activities to ecologically damaging mining and gas and oil extraction. In South Africa all the banks have terminated or given notice (*Standard Bank Group says it will only fund coal-fired power projects if they meet certain emissions and size criteria*).

A noticeable recent case was Goldman Sachs' announcement regarding Alaska: *"We will decline any financing transaction that directly supports new upstream Arctic oil exploration or development."*

The Alaskan government via Governor Dunleavy says the decision will have real costs for Alaskans and the U.S. economy while generating unintended environmental consequences: *"That's because many oil-producing regions of the world have much less stringent environmental regulation than Alaska does. You're going to push jobs and wealth and revenues to overseas areas and "exacerbate" ecological problems elsewhere".*

The bad news is that other (smaller) investment banks are prepared to take over the activities Goldman's in exiting:

We hear many institutions are not investing in traditional energy projects. We think this is short sighted on their part. The US energy business is very dynamic and will offer good returns. It is also extremely important to our country's energy independence. We would welcome the opportunity to help these projects with their capital needs just as we try to help alternative energy projects. (Warren Stephens, Chairman and CEO of Stephens, Inc.)

The above section highlights that this is not an easy debate. We ourselves are making it part of analysts' task to be aware of each investment's ESG score. Whilst we've always steered clear of companies with poor corporate governance this is more difficult to do with environmental impact. Whilst the extreme cases are easy to make decisions on, it is more difficult how to value companies with average ESG scores.

As said, the focus has widened significantly from simply governance to include environmental and social impact, both in the industry and within our financials team and Denker Capital and we think this is good and we are taking it seriously.

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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).

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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
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