NEDGROUP INVESTMENTS

see money differently

NEDGROUP INVESTMENTS FLEXIBLE INCOME FUND

Quarter Four, 2019

For the period ended 31 December 2019

NEDGROUP INVESTMENTS FLEXIBLE INCOME FUND

Performance to 31 December 2019	Nedgroup Investments Flexible Income[1]	STeFI*110%
3 months	1.7%	1.8%
12 months	8.7%	7.5%

Performance Summary

The fund had a good quarter with investors benefitting from our tactical positioning in government bonds, yield pickup on our floating rate assets, as well as another strong quarter of performance from our Royal Bafokeng convertible bonds. The fund was tactical with duration but remains conservatively positioned with a modest duration of 0.6 up from 0.5 in the prior quarter.

We added to our exposure of government bonds over the quarter, as yields continued to rise in October, but trimmed the position again as bonds rallied aggressively into year end. Offshore assets were neutral to performance, as firm asset prices were offset by the effect of a strengthening rand. We switched some of our US dollar position into British pounds as we expect an improvement in financial and economic conditions in the UK now that the uncertainty around Brexit is reduced.

During 2019, 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 Summary

The fourth quarter of 2019 was characterised by waning risk aversion and rising asset prices with plenty of positive headlines to stoke animal spirits.

De-escalation of the US-China trade war, with a phase one agreement in sight, and significant progress made in the Brexit saga including a landslide victory by the Conservative Party in their General Election were the main headlines grabbing investor attention. Global core rates drifted higher consistent with a flight from safety into risk assets. Global equities ripped higher.

Locally, South African government bonds in particular benefitted from this trend attracting significant foreign demand. It is remarkable that this was achieved in spite of the weak South African fiscal outlook and looming credit downgrades. This dynamic has pushed the rand to significantly overvalued levels and we have used the opportunity to increase our effective offshore currency exposure.

We are tentatively engaging with South African government bonds at current valuations but remain vigilant given the risks. Post year-end a major escalation in the US-Iran conflict came out of left field, and although the rand and government bonds were somewhat weaker they remained relatively resilient.

It appears for now that there is a temporary US-Iran ceasefire, but one should expect the Middle East conflict to flare up again in 2020 with potentially significant impact on global markets.

---
[1] Net return for the Nedgroup Investments flexible Income Fund, A class. Source: Morningstar (monthly data series).

Market Commentary

The fourth quarter of 2019 saw an environment that was generally supportive of local assets. The FTSE/JSE All Share Index delivered a return of +4.6% (+12.0% full year). The property sector (JSAPY) returns were lacklustre at +0.59% (+1.92% full year). South African government bonds returned 1.7% (10.3% for the year), as the global fall in yields more than offset domestic negativity. The rand traded in a wide range during the course of 2019, appreciating by 6.0% over the quarter (3.5% stronger for the year) on a trade weighted basis.

Developed market equities had a roaring quarter and year, with the S&P500 up 9.1% for the quarter and 31.5% for the year (aided in part by base effects as a result of a flash correction in December 2018). Developed market bond yields took a breather in the quarter with US 10-year Treasury Yield +25bps on declining risk aversion, but still -77bps for the year on the back of aggressive rate cuts by the Fed over the course of 2019.

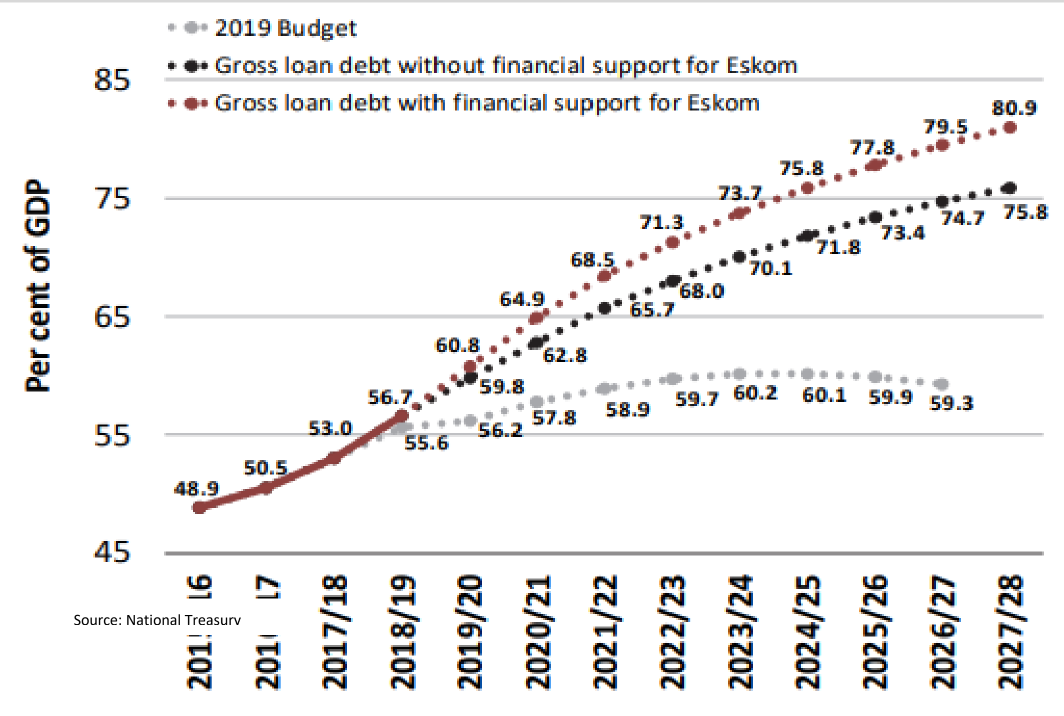
Preference Shares were the stand-out local asset class generating 3.0% for the quarter and 18.6% for the full year. Cash generated 1.6% for the quarter (6.64% full year) and inflation-linked bonds -1.0% (+2.3% full year).

South African Fiscus Update – Medium Term Budget Policy Statement (MTBPS)

The 2019 MTBPS delivered by Finance Minister Tito Mboweni presented a worrying path for South Africa's fiscus over the next few years. The market was expecting a poor outcome, yet the budget managed to surprise even the more pessimistic participants. It wasn't the main budget deficit that disappointed, but rather the medium-term projections being far worse than expectations, showing no debt consolidation over the next few years. Treasury communicated that the MTBPS was more of an illustration of where the fiscus is headed in the absence of reforms, and that come the budget in February 2020, restorative steps will be announced. Despite these however, it appears that fiscal metrics will remain weaker than what we had all expected.

South African Debt Trajectory

Treasury forecasts a budget deficit of 5.9% of GDP for the current fiscal year, and disappointingly shows this widen to 6.5% of GDP in 2020/21, 6.2% of GDP in 2021/22 and back to 5.9% in 2022/23. Wider fiscal balances take the sovereigns debt ratio to new highs, with debt to GDP shown to reach 71.3% in 2022/23, and should the trajectory continue, 81% by 2027/28.



Source: National Treasury

NEDGROUP INVESTMENTS

Government Expenditure

Government managed to remove R21bn from the cost base, but unfortunately this wasn't enough to compensate for greater than expected debt service costs and SOE bailouts, leading to an upward expenditure adjustment of R44bn for the 2019/20 fiscal year. Contrary to market expectations, Eskom debt was not moved onto the sovereign's balance sheet. In our opinion this is a positive development, as it keeps Eskom accountable for interest payments, and limits their ability to take on more debt before the business is fully reformed.

Government Revenue

Collections continue to disappoint, with poor economic growth the driver. Real growth has been revised down going forward by Treasury (and look more in line with market forecasts), with 0.5% penciled in for the current fiscal year, reaching a mere 1.6% in 2021. Many economists continue to believe that the risks to these estimates are still largely on the downside. Not only has real growth disappointed, but the lack of inflationary pressure experienced by the economy, means that nominal growth is disappointing as well. These productivity disappointments have meant that the tax income expected by treasury have fallen significantly short, to the tune of R52bn in FY2019/20, R84bn in FY2020/21 and R114bn in FY 2021/22.

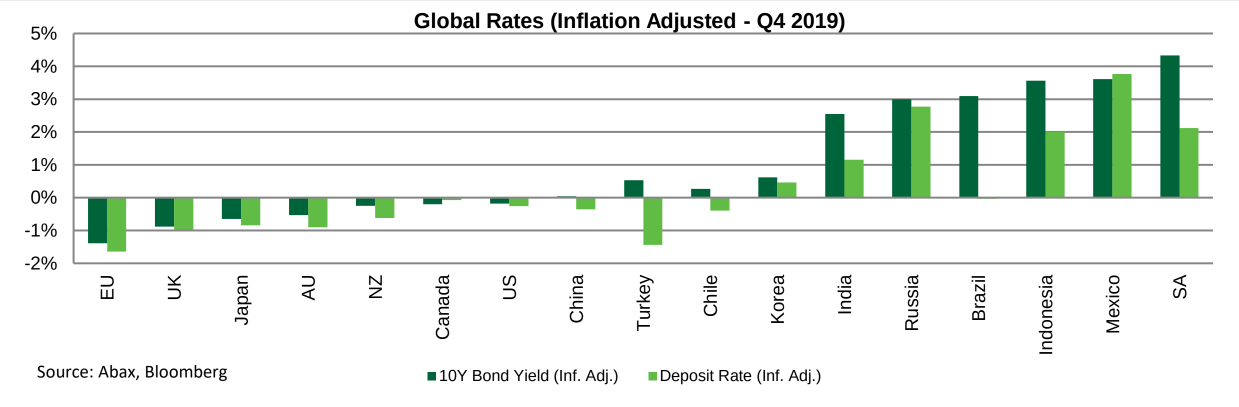
Fiscus Outlook and Moody's Ratings

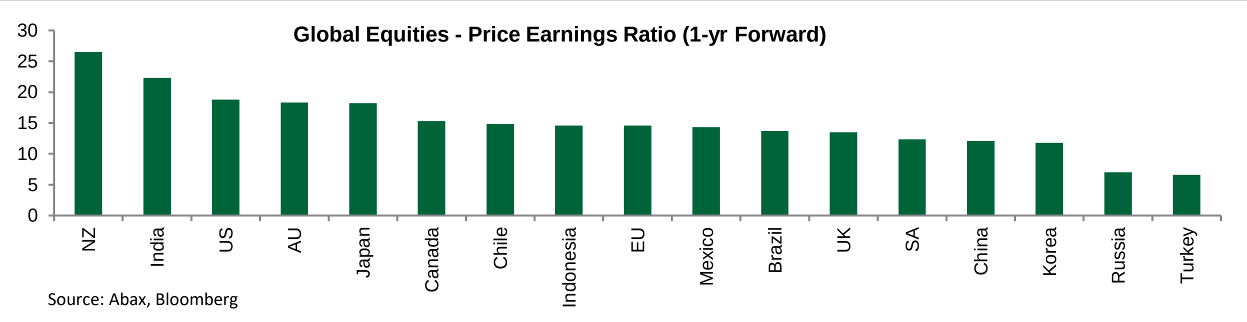
On the positive side, Treasury announced they are looking to adopt a fiscal rule which delivers a balanced main budget primary balance by FY2022/23 (excluding Eskom), thereby ensuring debt stabilisation sooner than that projected in the MTBPS. The proposed interventions, although still vague, looking to raise R150bn over three years, and it appears this is largely intended to be done by addressing the government wage bill. For serious expenditure adjustments to be made, government will need to address this, as it makes up a massive 35% of our current expenditure. However, we remain skeptical around the implementation of this, as it could mean bringing government into conflict with the unions, especially since our public sector is in the middle of a multi-year pay deal.

Following the MTBPS Moody's changed the outlook on the South Africa's sovereign credit rating to negative, leaving us on the cusp of non-investment grade. They are waiting on the budget in February to ascertain whether government will succeed in stabilising its debt ratios over the medium term by reigning in expenditure, improving tax compliance and exercising measures to lift potential growth. We remain skeptical that given the slow progress of reform seen so far, that these major steps are possible in just three to four short months. It is our view that the downgrade to sub investment grade will likely occur on the 27th March, Moody's next scheduled review date.

Global Valuations versus Domestic Fundamentals: Rand caught in the crossfire

In a global context, South African assets currently appear to be offering attractive prospective returns. Short term deposit rates are among the most attractive on offer at about 2% above expected inflation. Twenty-year South African government bonds currently yield about 5% above inflation making it the most attractive of the major bond markets from a yield perspective. South African equities, having delivered lackluster returns over the past five years, are among the cheapest as measured by the Forward Price Earnings Ratio.





Support for the rand?

These valuation arguments should be supportive for the rand as foreign investors buy the currency to allocate capital to South African markets. Foreign flows into the bond market in Q4 2019 amounting to R40bn (per National Treasury numbers) indicates that even with the major issues plaguing the South African economy, investors see value at current bond levels. Add to this the fact that the major central banks have pledged to remain highly accommodative for the foreseeable future and it goes a long way to explain the rand's strong Q4 2019 performance (+10.4%) relative to the US dollar.

South Africa's remoteness from the Middle East conflict and that it is not subject to the risk of sanctions may also make South Africa look better as an investment destination in 2020 than peers such as Turkey or Russia. It should also be noted that SA inflation (4.7% expected for 2020 according to a Bloomberg survey) will likely remain contained, preserving the purchasing power of the rand, while the Reserve Bank will want to keep the repo rate high relative to inflation. Both of these are positive for the rand exchange rate.

Amid a positive backdrop for risk-assets the rand performance was the second-best return in the quarter out of the major Emerging Market currencies, but a range of factors signal that there is reason to be cautious. South African business confidence is deteriorating to depths not seen since the Global Financial Crisis - the Q4 2019 BER Composite Business Confidence registered 26.0 (midway between absolute pessimism and neutral).

Eskom is likely to be in constant load shedding mode for many months to come – inflicting relentless damage to the economy (a staggering 12GW or roughly 30% of total generation capacity went offline in December). Further, a Moody's downgrade is now more likely than not this year given the shock MTBPS in October. In light of all these factors it is easy to envisage rand weakness even though valuation and global factors are supportive.

Turning to our currency fair value model, which incorporates key economic indicators such as budget and current account balances, indicates that the rand is significantly overvalued (about 15%) against a basket of major currencies. The rand does not appear to be pricing in the fact that GDP growth will remain extremely low relative to peers (1.1% expected for 2020 according to a Bloomberg survey compared to 2.2% for Emerging Markets as a whole according to World Bank estimates) and as a result government finances will come under increasing pressure.

What does this mean for South African Asset Prices and Investors?

Although South African equities are cheap it remains to be seen whether that is enough to start attracting major flows from foreign investors given lingering pessimism for SA Inc. Bonds are probably the biggest draw-card which should lead to a reduction in yields as South African bond prices revert to more normal levels. Once this occurs the rand will become more vulnerable but given that global liquidity conditions will most likely remain supportive, sell-offs should be contained. This should provide opportunity to be tactical when hedging currency risk.

Current positioning of the und

Low Duration

As of end of Q4 2019 South African duration is 0.4 years from 0.2 at the end of the prior quarter. This is a notch higher as a result of a significant rise in South African bond yields which was used as an opportunity to trade tactically over the quarter. We still remain cautious given the weak South African outlook, but acknowledge that much of the bad news is now in the price.

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.

Overall 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.

Convertible Bonds

We have 3.5% exposure to convertible bonds issued by Royal Bafokeng Platinum, Remgro, and Redefine. 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 1.8% exposure to a diversified pool of domestic property assets. 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 3.2% (Q3 2019: 3.5%) over the quarter.

Offshore Cash & Money Market

The fund maintains an exposure to Offshore Cash & Money Market instruments at 7.8% where a very attractive yield pickup over domestic assets is available while maintaining a high degree of credit quality. We increased our effective offshore exposure from 3.8% to 5.2% as the rand moved to overvalued territory. In addition, we added GBP exposure as we believe that reduced uncertainty around Brexit bodes well for the UK outlook.

Portfolio Summary

Portfolio summary	
Domestic Duration	0.37
Domestic Inflation Linked Duration	0.15
Total Domestic Duration	**0.52**
Offshore Duration	0.07
Total Fund Duration	**0.59**

Effective Offshore Exposure	**5.2%**
Fund Yield	**7.8%**

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