NEDGROUP
INVESTMENTS

UNIT TRUSTS | INTERNATIONAL | RETIREMENT FUNDS

see money differently

# NEDGROUP INVESTMENTS BALANCED FUND

Quarter One, 2020

## Nedgroup Investments Balanced Fund

| Performance to 31 March 2020 | Nedgroup Investments Balanced Fund A | ASISA category average |
|---|---|---|
| 3 months | -8.75 | -13.48 |
| 12 months | -1.75 | -10.43 |

## Overview

**The Impact of COVID-19 on the economy**

COVID-19 has introduced an unprecedented demand and supply shock to the global economy. We expect the extent and impact on global growth and corporate profitability to be severe. A global recession now looks like a certainty at this stage. The economic impact is exacerbated by corporate leverage which introduces a potential liquidity and credit crisis. Leverage is high in certain sectors of the global economy, but particularly in corporate America.

The timing of the decision by Russia and the Kingdom of Saudi Arabia to enter into a price war could not have come at a worse time as oil demand plunges on the back of the simultaneous global quarantine lockdowns. Many energy companies are now in financial distress, introducing added contagion to credit markets. The duration of the shock will depend on the length of the quarantine lockdown period and the speed at which infection rates stabilise. Commitments from central banks and governments offering monetary and fiscal stimulus are ongoing and will mitigate some of the damage. The ultimate impact of the virus and the timing of a recovery remains uncertain.

In South Africa, the impact of the virus may be worse given the already precarious state of the economy, and our limited financial resources to stimulate it. This contrasts with many other countries which have much more manageable levels of sovereign debt and can hence engage in various forms of fiscal stimulus. As we expected, on the 27th of March, Moody's downgraded our sovereign debt status to junk and there is already speculation of IMF bailouts circulating in the media.

**Equity markets have sold off aggressively in anticipation of a recession**

The impending recession, high levels of corporate debt, and a US stock market that could have been considered expensive on most metrics prior to the 24% fall from its peak, means a sustained rally from here seems unlikely. The MSCI World equity index declined by 20.9% (in US dollars) over the quarter.

Many South African focused businesses, which would be regarded as higher risk than their developed market peers, underperformed more significantly, especially when measured in dollar terms. The JSE ALSI Index declined by 21.4% in rand terms, and by 38.4% in US dollars. SA financials declined by 39.5% (in rands). In line with falling commodity prices, the basic materials sector underperformed with a return of -25.2% (in rands).

Foreign exposed companies like Naspers and British American Tobacco helped alleviate the overall JSE decline by delivering positive returns. Chinese domestically focused businesses have been unsurprisingly more resilient than global stock indices given that China appears to have more effectively controlled the spread of the virus than many other countries. This, coupled with increased time spent gaming, explains the Naspers and Prosus share price resilience, with respective increases of 11.5% and 17.2% over the quarter.

## Portfolio Positioning

**Defensively positioned with relatively low equity exposure**

As we felt markets were expensive at the start of the year, we reduced our equity exposure in January and February by selling down our physical exposure and using derivatives. The cost of purchasing protection had fallen significantly in January which enabled us to buy put options on the S&P500 index. As mentioned above, the S&P500 is not yet offering value, which coupled with a global recession, will most likely continue to weigh on global markets. We expect news on economic data, potential vaccines and infection rates to be some of the factors that will continue to drive significant volatility going forward.

**Property remains unattractive**

We continue to maintain a low exposure to the property sector. The outbreak of the COVID-19 virus will place significantly more pressure on property companies. Rents will be difficult to collect, and valuation downgrades will result in dangerously higher loan-to-values for many property stocks. However, Growthpoint, which sold off aggressively, provided us with a cheap entry into one of the higher quality property companies. We will continue to be on the lookout for those counters with low gearing that have been substantially oversold.

**Fixed income returns remain attractive**

We have been underweight duration in our fixed income exposure and have been focussed on the floating rate corporate credit market that was yielding a return of around 9% to 9.5%. These floating rate notes will gradually reprice lower over the next 3 months due to the Reserve Bank cutting interest rates by 1%. As a result of the sell-off in global assets, there has been a global lack of liquidity in the bank and corporate bond market that has made price discovery very difficult. We are now slowly seeing limited liquidity returning to the market which suggests spreads will widen by 80 -150bps. It is very difficult to predict where it will settle, but a real return of around 5% on quality assets still looks attractive.

**Offshore markets likely to remain depressed**

As mentioned above, we think the valuation of the S&P500 is not cheap. We are maintaining a low equity exposure to offshore markets. We purchased NetEase given its compelling valuation and exposure to gaming which should be resilient in the current environment. We will be looking to increase our equity exposure into a meaningful selloff, or subject to finding compelling investment opportunities.

**We remain cautious on domestically-focused companies and prefer offshore earners**

We expect the profits of our well-managed offshore exposed counters to eventually revert to pre COVID-19 levels. We have held very low exposure to domestically focussed companies given SA's low growth environment and lack of necessary structural reforms. COVID-19 and the global recession will increase the pressure on many of our domestically-focused companies, as well as the ability of the state to repair the fiscus. As a result, our conviction levels in many of our domestic company valuations have reduced. Hence, despite the falling prices of these shares, we maintain our underweight positions.

Notwithstanding the above, valuations have improved given the significant sell-offs in certain sectors and shares, despite the uncertain outlook. As a result, we increased our exposure to the hospital sector which should be better shielded from the economic fallout than many other domestic sectors, which could be shut down or suffer from depressed consumer demand when the quarantine period is over.

We continue to hold more of our domestic exposure in banks, rather than via the retail and domestic industrial sectors. We expect bank earnings to be more defensive, as on balance they are well-managed businesses, and the sector offers high liquidity. Our concerns around higher credit losses and their exposure to property finance has increased, but this is somewhat discounted in their significantly lower prices.

**The outlook for the mining sector will be challenging over the short term**

We have been positive on the PGM sector since the 2nd half of 2018, due to our expectation of growing deficits in palladium and rhodium on the back of a lack of investment in supply, and tighter auto emission standards driving growth in demand. We have steadily reduced the level of our overweight positions in the PGM sector, initially due to the position size becoming overly large from price outperformance and subsequently due to expected pressure on profitability arising from the impending recession. The risk of palladium and rhodium deficits turning to surpluses in an environment of much reduced motor car demand was a key consideration.

Similarly, due to the expected demand contraction in bulk and base metals, we reduced our weighting in the diversified miners. We increased our exposure to the gold sector, as the commodity should be supported by low interest rates and growth in global debt as a result of fiscal stimulus.

**We remain overweight defensive offshore exposed business**

The defensive earnings stream from tobacco and British American Tobacco's cheap valuation have resulted in our maintaining an overweight position. We have held a Naspers position due to its exposure to a resilient online Chinese consumer and investments in a suite of diversified businesses that are yet to monetise profit streams.

Given the high levels of volatility and more attractive valuations, we are looking to increase our equity exposure. We shall look specifically for those higher quality, globally focussed stocks, with strong balance sheets which should be better able to survive the current crisis and recover much faster than many of the domestically focussed business which are likely to see much bigger earnings declines.

## Performance Commentary

Naspers and NetEase outperformed given their dependence on the resilient Chinese online consumer market. An overweight position in tobacco contributed to performance. Our dollar-denominated debt securities contributed positively towards performance due to rand weakness.

The falling PGM basket price negatively impacted PGM miners which detracted from performance from a year to date perspective. Diversified Miners also sold off due to the poor outlook for the global economy. Despite this, we maintain a position in the mining sector, albeit at a reduced weighting due their attractive free cash flow yields and strong balance sheets.

Despite cheap valuations, financial shares sold off and detracted from performance, Absa and FirstRand being the most significant detractors. Sasol also negatively impacted performance. Prior to its collapse in February we took the decision to sell down our position in Sasol given concerns regarding their level of over indebtedness. This decision added significant value as Sasol's share proceeded to collapse by 82% post the announced price war between Russia and Saudi Arabia. Sberbank sold off due to concerns regarding the impact of a low oil price on the Russian economy.

| Top contributors | Average weight | Performance contribution | Top detractors | Average weight | Performance contribution |
|---|---|---|---|---|---|
| Naspers Ltd | 4.7% | 1.1% | Absa group Ltd | 2.2% | -1.8% |
| British American Tobacco | 4.3% | 0.4% | Impala Platinum | 2.5% | -1.6% |
| FirstRand USD Bond | 5.4% | 0.4% | Sibanye Stillwater | 5.1% | -1.2% |
| US Treasury Bills | 1.5% | 0.4% | Sasol Ltd | 0.8% | -0.6% |
| Reinet Investments | 1.3% | 0.3% | Sberbank of Russia | 1.4% | -0.6% |
| | | **+2.6%** | | | **-5.7%** |

## Responsible Investing: Sasol Ltd

We met with Sasol on 29 Jan 2020, with the purpose of understanding the chemical processes that contribute the most to $CO_2e$ emissions, and what could be done to mitigate these emissions. The meeting revolved around the Sasol Limited 2019 Climate Change Report, where the company committed to a 10% reduction in $CO_2e$ emissions, off the 2017 base by 2030. Clearly, given the magnitude of Sasol's total $CO_2e$ emissions, this is not enough and will require a significantly greater reduction to satisfy investors and society at large. The meeting was therefore to discuss the next available steps and the technology required.

The gas-to-liquids (Fischer Tropsch) process, and chemicals production operation at Natref, are not inherently the major polluters. The main culprit regarding $CO_2e$ emissions is Sasol's hydrogen plant. This plant produces gaseous hydrogen from coal in a process that combines coal with oxygen to produce hydrogen and $CO_2$ via an intermediate CO production process.

The carbon content of coal is captured by oxygen to produce the $CO_2$ that is released into the atmosphere. The problem is that the mass of the carbon content in the coal is about 10 times the mass of hydrogen, and therefore the $CO_2$ by-product is huge relative to the hydrogen produced. The remaining hydrogen is used as feedstock in the gas-to-liquids plant, producing liquid fuels. The hydrogen plant produces the bulk of Sasol's atmospheric emissions, of 65 $mtCO_2e$ per annum.

The company has two options to lowering their $CO_2$ emissions over the long term. The first is to capture the carbon, preventing the gas from being released into the atmosphere. This option is not economically feasible as the $CO_2$ molecule is very stable and would require a huge amount of energy to separate out the carbon. This option therefore remains a remote one.

The second option is to produce hydrogen via the electrolysis process. This process would use electricity instead of burning coal. The feedstock would be water and would produce oxygen as a by-product producing zero emissions. The technology is proven and available but the decision rests on the financial viability of the project. It is likely that Sasol will be forced down this route at some point.

Sasol has committed to producing a comprehensive report on their climate change mitigation strategy by November 2020. This report will express all Sasol's options, giving guidance regarding future strategy and the environmental and financial implications thereof. Clearly this report will be critical in assessing Sasol's long-term potential to reduce emissions in compliance with the 2016 Paris Climate Agreement.

# Disclaimer

**WHO WE ARE**
Nedgroup Collective Investments (RF) Proprietary Limited is an authorised Collective Investment Scheme and the representative of Nedgroup Investments Funds PLC in terms of the Collective Investment Schemes Control Act. 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.

**HOW ARE OUR FUNDS PRICED**
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**
A schedule of fees and charges is available on request from Nedgroup Investments. One can also obtain additional information on Nedgroup Investments products on our website.

**DISCLAIMER**

Unit trusts are generally medium to long-term investments. The value of your investment may go down as well as up. 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. Our funds are traded at ruling prices and can engage in borrowing and scrip lending.

Some funds may hold foreign securities including foreign CIS funds. As a result, the fund may face material risks, which could include foreign exchange risks, market conditions and macro-economic and political conditions.

A fund of funds may only invest in other funds, and a feeder fund may only invest in another single fund, both will have funds that levy their own charges, which could result in a higher fee structure.

The Nedgroup Investments Money Market Fund offering aims to maintain a constant price of 100 cents per unit. A money market fund is not a bank deposit. The total return to the investor is made up of interest received and any gain or loss made on any particular instrument held. In most cases the return will merely have the effect of increasing or decreasing the daily yield, but in an extreme case it can have the effect of a capital loss. Excessive withdrawals from the fund may place the fund under liquidity pressures and that in such circumstances a process of ring-fencing of withdrawal instructions and managed pay-outs over time may be followed. The yield is calculated using an annualised seven day rolling average as at the relevant dates provided for in the fund fact sheet. Nedgroup Investments has the right to close its funds to new investors in order to manage it more efficiently.

**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