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NEDGROUP INVESTMENTS FINANCIALS FUND

Quarter One, 2020

Performance to 31 March 2020	Nedgroup Financials Fund	ASISA SA Equity Financials
Q1 2020	-34.0%	-37.8%
12 Month	-34.1%	-38.2%

Market Commentary

Global equity markets had one of the worst quarters in stock market history, as the impact and spread of COVID-19 dominated headlines. The first US COVID-19 case was reported in Washington on 20 January and on 31 January President Trump banned foreign nationals from entering the US if they had been in China in the two weeks prior. On 8 March Italy locked down 60 million residents, signalling the start of a rolling global lockdown which already counts the significant drop (>50%) in the oil price as one of its casualties.

South Africa, under president Cyril Ramaphosa, took the wise step of enforcing an early lockdown from midnight on 26 March and shortly thereafter dealt the long expected blow of a downgrade to junk by Moody's and also a further downgrade by Fitch.

The rand took the brunt of the fall, declining 27% to 17.75 against the US dollar whilst the FTSE/JSE All Share Index fell 21% in rand terms and the MSCI World Index fell 21% in US dollar terms.

Fund performance, contributors & detractors for past quarter

The financial sector was sold down aggressively (the FTSE/JSE Financial 15 Index losing 40%), investors fearing the effect of the downgrades and lockdown on economic activity and especially on a severe increase in bad debts. The fund holdings reflected the fears, although one can see how some holdings (e.g. Nedbank) were sold down much more than others.

Top 5 Contributors	Weight Mean	Return in Rand	Contribution in Rand
JSE Ltd	5.50%	-8.10%	0.22%
Santam Ltd	3.50%	-4.60%	0.10%
Alexander Forbes Group Holdings	0.20%	-20.40%	-0.02%
Trematon Capital Investments Ltd	1.30%	-24.50%	-0.12%
PSG Konsult Ltd	1.30%	-26.50%	-0.16%

Top 5 Detractors	Weight Mean	Return in Rand	Contribution in Rand
Investec/Ninety-One	8.20%	-42.00%	-3.47%
Sanlam Ltd	12.10%	-35.40%	-4.25%
FirstRand Ltd / RMB	12.80%	-35.90%	-4.50%
Nedbank Group Ltd	6.30%	-61.40%	-4.73%
Denker Global Financial Fund	20.20%	-16.30%	-5.83%

In terms of contribution, JSE and Santam held up well (chosen in the portfolio for their defensiveness) and the investment in the Denker Global Financial Fund was the 3rd best performer helped by the 27% depreciation of the rand. Hence the -16% belies the extent of the sell-off in global financials (the fund was -43% in US dollars) at the same time indicating the extent of fear in global and local markets regarding the economic effect of the global lockdown.

Portfolio Changes, current positioning and outlook

We entered 2020 expecting a ratings downgrade and a high probability of a recession and continued rand weakness. Hence, we had a portfolio focusing on higher quality (in terms of robustness of balance sheet and business model) and a high percentage of direct and indirect offshore exposure.

However, mutual funds were under pressure due to significant outflows causing forced sellers in an environment where buyers could afford to be patient and hence one saw significant price falls (as the Nedbank price fall indicates).

And so, we (as most mutual fund portfolio managers) had to deal with rapid changes in the environment whilst financing outflows amidst falling prices. Hence changes to portfolio holdings reflect price moves and which holdings we did not sell (or sold less of). However, the initial sizes of holdings played a role as well. For instance, the sizes of our holdings in Sanlam and FirstRand (largest holdings in the portfolio) forced us to sell down these counters and due to regulatory restrictions had to continuously sell down our holding in the Denker Global Financial Fund to keep it at 20% of the fund. But at the end of the quarter the largest increased holdings (measured as percentage change from 1 January to 31 March) were Santam, JSE, Coronation and Trematon whilst the biggest negative changes were Nedbank, Old Mutual and to a lesser extent Absa and Investec.

Santam is the financial company that should suffer the least from the lockdown. In fact, it benefits from the lower accident and crime rate as does the JSE which benefits from higher trading volumes. Despite valuations where they are, we reduced the funds exposure to Nedbank due to its relatively high exposure to commercial real estate and Nigeria via its investment in Ecobank. The difference between Sanlam and Old Mutual was reflected in Sanlam's recent results and the top management changes it announced. One can clearly see that the Sanlam team are on the front foot which is very important during a crisis.

We conducted interviews with the top management teams in the 10 days before lockdown and it was reassuring to confirm that the South African financial sector (both banks and insurers) are in excellent shape. At that stage managements were expecting minimal increases in bad debts over the coming six months and were focusing on reducing their cost base and pro-actively reviewing all exposures and funding.

Based on our experience of the 2008/2009 global financial crisis we've modelled significantly worse outcomes, yet the outcome still reflects growth in shareholder value. In other words, we are not forecasting any of the banks or insurers to report a loss for the financial period ending December 2020.

Many central banks have requested that banks do not pay dividends for the next six months. The US Federal Reserve Bank has instructed banks not to buy back shares for this period. The SARB issued similar instructions to South African banks. This does not reflect fears about lack of capital but is simply a precautionary measure.

Conclusions

Globally, bank shares have been sold down to levels seldom seen since 1982. In fact, based on our models the last time South African banks traded at current valuations was post president PW Botha's infamous Rubicon speech (15 August 1985) after which capital fled South Africa and foreign exchange controls were introduced (and Nedbank needed to be rescued by Old Mutual).

The valuations shout "buy" but while the situation is deteriorating and one doesn't know where we are both in terms of COVID-19 and economic cycle, the market is understandably reluctant to invest.

Based on current expectations that the global lockdown is over by end June (China and Korea first, then Norway, Denmark and Austria and thereafter the Netherlands, Italy and Spain) the markets should pick up sharply in H2 2021, but that depends on the extent of the damage done to smaller businesses and travel and tourism related sectors.

Ever since 2008 our team has been continuously stress testing banks and insurers for shock events (the shutdown in Japan post the 2011 Fukushima earthquake, tsunami and nuclear reactor shutdown is one example) and others in Brazil and then obviously the global financial crisis. Based on all our work both central banks and the private sector banks are ahead of the curve at this point, yet markets have (understandably) reacted negatively. Larry Fink (Blackrock CEO) summarised it well recently: 'The world will get through this crisis. The economy will recover. And for those investors who keep their eyes not on the shaky ground at our feet, but on the horizon ahead, there are tremendous opportunities to be had in today's markets.' Once the environment turns negative, buyers for financial shares will increase and there will be very few sellers. Difficult as that may be emotionally, investors have to start making decisions about the post lockdown period now.

Responsible Investment Comments

The lockdown period has highlighted the extent to which western society has been driven by consumption and how 'growth at all costs' has been the mantra overriding other concerns.

Hence the crisis could cause a re-assessment of responsible investing (RI) as initially for many the focus is on survival. For governments this will be a challenge as well when fiscal budgets will be under excessive strain - will the hard yards won in recent years be reversed?

Johann Rupert (FM Investors Monthly 20 April 2020) worries (and warns) that the lockdown period could spur social unrest. 'More people will become unemployed…. people are already angry. People will come out of this far more aware of the gap between rich and poor'.

Our team has been observing the actions of the managements we are invested in. The crisis will reveal to which extent they are committed to ESG investing. So far what we see is encouraging with the managements being pro-active in helping staff and the communities they operate in.

Senior managements of almost all financial firms followed (and some pre-empted) president Ramaphosa's example of donating a third of salaries to funds which will help with food relief as well as setting up packages via which retail, SME- and larger commercial clients can restructure payment schedules to help them through the period of lockdown.

The evidence so far is encouraging. Our opinion is that the post lockdown period will see increased focus on responsible investing (RI) rather than a move away from it.

Disclaimer

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OUR TRUSTEE
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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.

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