NEDGROUP INVESTMENTS

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Nedgroup Investments Global Emerging Markets Equity Fund

Quarter One, 2020

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Portfolio strategy

Global emerging markets fell dramatically in Q1 2020 as the impact on economic activity and corporate profits of the restrictions put in place by many governments to fight the COVID-19 virus was discounted by markets. The MSCI emerging markets index fell 19.02% in local currency terms and 23.57% in US dollars as emerging market currencies came under pressure from the rapid shift to a risk off environment. Perhaps surprisingly, as it was the first country to go into lockdown, China was the best performing market, falling 10.22%, while Brazil, where President Bolsonaro tried to ignore the crisis, was the worst declining 50.2%. Healthcare was the best performing sector falling 8.49% while energy was the worst, down 39.8%.

Current portfolio strategy is based on the belief within the team that the policy action by the monetary authorities will be sufficient to tide the global economy over until the COVID-19 virus is suppressed sufficiently to allow a normalisation of people's lives. The example of China suggests an end to lockdown around two months after its first implementation but equity markets will discount ahead of a return to normality. Given the huge injections of liquidity in the financial systems there is the possibility of a dramatic recovery in equity prices as the newsflow on the virus gradually improves. There will be bad economic data and massive downgrades to earnings with companies already in a weak financial or operating position experiencing distress but businesses that entered the crisis strong should emerge potentially even stronger. Our analysis has been focused on assessing every holding's financial and operational gearing and, where sales have fallen significantly, the cash burn of the business and its ability to survive without government aid that may lead to equity dilution.

Consensus profit growth expectations have been revised down significantly as a result of the impact of COVID-19 on global economic activity. Analysts' adjustments are ongoing and further negative revisions are likely next quarter. We have moved further underweight energy where stocks have been hit by a collapse in demand for crude combined with the breakdown of the OPEC plus Russia talks in Vienna in early March, which was followed by Saudi Arabia's announcement that it would abandon attempts to limit supply and instead aim to increase market share. This has led to a historic 65% decline for crude measured as by Brent in Q1. The Saudis want to bring Russia back to the negotiating table and, with the oil price at levels close to US$20 per barrel, President Trump intervened in the dispute as the entire Texas shale industry is under financial strain, which puts stress on banks and the corporate bond market. Companies have slashed capex but oil is an 'old world' industry that is being superseded by alternative forms of power and energy and OPEC appears to have lost control of the market for crude post the advent of shale. We currently own just Lukoil which we see as a long-term winner/survivor within a low-cost Russian industry that can weather the current storm in the oil market.

Estimates for cyclical sectors such as materials, banks, consumer discretionary and industrials have suffered most, notably any groups connected to the travel and leisure industries which have been effectively closed by social distancing in most countries. In materials, the steel industry in China continued to produce through Q1 and is now overstocked at a time when European demand has collapsed with the US close behind. We like construction related name Conch Cement in China which is well-positioned to leverage tighter markets and higher utilisation levels in the Eastern and Southern regions where it dominates. Government policy measures to support the infrastructure sector set the stage for improved utilization rates for the group.

In industrials, airlines have been grounded and some will need government support if they are to survive. We like names such as Airtac in Taiwan where market share gains in the pneumatic space and expansion in linear motion guides and electric actuators are driving higher ROIC. Automation will remain a key theme: productivity enhancement is the main reason for increasing the number of robots on a production line but following the COVID-19 lockdowns there is the added driver of being able to keep factories open should similar disruption occur in the future. Commercial and professional services such as recruitment and human resources have been hard hit as have capital goods, but logistics have benefitted from the resilience of home delivery in transport.

In consumer areas discretionary has suffered from cuts in autos as new car sales have collapsed and plants have been closed across the emerging world. General retail has had to close stores in some countries surrendering more market share to online sales. In hotels occupancy has collapsed across regions but there are encouraging signs of a rapid recovery in China where rates are back up over 50%.

Quality luxury has held up well despite the industry's sensitivity to travel. Sportswear stocks such as Li Ning have been impacted by the slowdown in Chinese demand throughout the quarter although some have fared better because of superior online channels. Staples have held up well with the food retail industry rising to the challenge of maintaining food supplies and taking significant market share from restaurants. Spirits companies have typically fared better than beer which is more reliant on premises consumption. How the recovery in consumption in China evolves will be key to the outlook for many consumer companies. The restart is in its infancy, but estimates will reflect the shape of the recovery, whether a second phase of the virus emerges as populations resume movement and how the slowdown outside China develops. We have maintained our positions in favoured names such as hotel operator Lemon Tree in India and Chinese sportswear maker Li Ning. We have raised Alibaba to a large active position and kept Brazillian clothes retailer Lojas Renner which has been hit hard by the crisis but should emerge in a stronger competitive position.

In healthcare, the race is on to find a vaccine for COVID-19 with significant global demand expected as governments try to immunise key workers and the vulnerable. Pharmaceutical companies have performed better than medical device makers, which have been affected by procedures and operations being postponed or cancelled as hospitals switch capacity to the care of victims of the virus. Companies that manufacture ventilators, protective clothing and intensive care equipment have fared better than others. The relative success of health systems in different countries will be a source of debate in the future with spending likely to rise as governments improve and expand safety net programs. In financials, banks are much better positioned to manage the current situation given stronger capital positions, vastly improved liquidity and a greater range of funding options. Clearly, there are substantial headwinds with low interest rates, a higher level of corporate indebtedness and heightened uncertainty in the non-bank lending sector. Net interest margin pressures and postponed or cut dividends have weighed on the sector. The asset side of insurance companies' balance sheet is likely to cause most concern for investors but there are potential liability side risks.

Some areas of IT have benefited from the boom in working from home and we have added to direct plays on this such as Quanta and Tencent in China, but the cyclical semiconductors have faced elevated inventory and limited demand visibility outside of data centres. Memory pricing is holding up well and channel checks indicate very little change in demand for equipment. Memory should be well positioned if a 2021 recovery ensues. In communications media has been hit hard by significant cuts in advertising spend although gaming related names performed well.

Regionally we are overweight Taiwan where we like the IT exposure and China where we favour some of the online technology giants. We are underweight India, which is behind others in the lockdown cycle, and South Africa, which will suffer again from the weakness in commodity prices and falls in tourism. We are also underweight in Latin America which could come under further financial stress from the crisis.

Attribution commentary

The impact of the COVID-19 pandemic related global shutdown was felt across markets but particularly in traditional higher risk assets such as emerging market equities and high yield credit. The fund added value in sector and country selection but the positive contribution of both was partially offset by negative security selection over the period.

The worst performing sector over the quarter was energy (-39.8%) as Saudi Arabia and Russia failed to agree to an extension of production cuts even as global demand for crude collapsed (WTI -66.46%) in the face of the pandemic. The fund's underweight in energy was positive as was the underweight in materials (-30.7%) and industrials (-28%). The underweight in financials (-31%) was too modest to be of significant benefit and was more than offset by market positioning within the sector, more on this later. The best performing sector was healthcare (-8.5%) and the underweight here was negative. The underweight in communications (-9.6%) was negative but the industry level split of overweight media & entertainment (-4.3%) and underweight telecoms (-18.7%) was positive overall. The overweight in consumer discretionary (-18.1%) ought to have been positive but industry positioning with an overweight in hotels & leisure more than offset the sector contribution. The fund's overweight in IT (-17.9%) was positive and further helped by our Chinese software positions.

3 Months to March 31, 2020	Allocation (%)	Stock Selection (%)	Net Impact (%)
Total	**0.86**	**0.49**	**1.35**
Emerging Market Asia	-0.50	-0.47	**-0.97**
China	-0.39	1.10	**0.70**
Korea, Republic of	0.03	0.32	**0.35**
Taiwan	0.06	-0.07	**-0.00**
India	0.00	-1.08	**-1.08**
Malaysia	-0.03	-0.06	**-0.09**
Thailand	-0.03	-0.58	**-0.62**
Emerging Markets Europe, Middle East and Africa	-0.07	0.90	**0.83**
South Africa	0.55	0.24	**0.78**
Russian Federation	-0.13	-0.06	**-0.19**
GCC (Saudi Arabia, Qatar, UAE)	-0.08	0.03	**-0.05**
Emerging Market Latin America	0.70	0.06	**0.77**
Brazil	0.61	0.14	**0.75**
Mexico	0.09	-0.12	**-0.03**
Frontier Markets	-0.10	0.00	**-0.10**
Cash	0.82	0.00	**0.82**

At country level the story was similar with positive country selection offset by security selection. Among the weakest markets over the quarter were Brazil (-50.2%) and Colombia (-49.7%), reflecting their resource sensitivity – the most resilient Latin American market was Chile (-33.3%), which still lagged the Index. The fund's intra-region positioning was helpful for relative performance with underweights in Brazil and Colombia and a small overweight in Chile. Brazil's weakness followed a very strong Q4 in 2019 but also reflected a degree of concern regarding President Bolsanoro's nonchalance towards the impact of the impending virus and a consequent lack of preparation. Mexico (-35.4%) and Colombia are negatively impacted by lower oil prices despite the fact that Mexico hedges its energy exports for budgeting purposes.

In EMEA Greece (-45.1%) was badly hit reflecting the economic dependency on tourism while South Africa (-40.3%) was subject to further credit downgrades and concern about its ability to afford any effective response given an already weakened economy and struggle to reform. Russia (-36.3%) was also hit by oil price weakness though its floating exchange rate does provide some level of stabilisation for the fiscal picture here. The fund's underweight in South Africa offset the modest overweight in Russia and Greece. In Asia, China (-10.2%) was the strongest market in the asset class and the small overweight was helpful. Taiwan (-19%) performed moderately better than the broader MSCI EM Index and Korea (-22.6%) even closer to neutral but India declined a disappointing 31.1% - we reduced exposure over the quarter as the world's second most populous nation implemented a shutdown. The fund's cash levels over the quarter were reflective of our cautionary stance and this was positive for relative performance.

Security selection was negative over the quarter notably in India and Thailand where our exposure to hotels & leisure names as well as some energy exposure hurt relative performance. In India, Lemon Tree Hotels (-67%) was badly hit by the shutdown as was Minor International (-57%) in Thailand. It is difficult to make a positive case for the segment in a pandemic induced shutdown and strong operating models have not saved either business from the carnage. An unwind of lockdown and return to normal travel patterns will undoubtedly see a recovery in both businesses but the timing remains uncertain and the impact over the quarter was negative. In India, the fund's overweight in financials proved a negative contributor particularly when juxtaposed with the underweight in Chinese financials. Banks in India declined 42.3% and our holding of HDFC (-36.1%) and HDFC Bank (-39.3%) hit performance even as lower quality banks (in our view) in China posted more modest declines of 9.9%. Our Indian financials contributed strongly in the previous quarter, but we suspect that selling by foreign institutions this quarter, as investors divested from the asset class, played a part in the relative weakness. We chose HDFC for the portfolio for its high quality, low loan to value mortgage business which we expect will continue to deliver a strong ROE and HDFC Bank for its disruptor and digitally innovative finance model. By contrast we find little to recommend the state-controlled banks in China with low ROE's and high lending exposure to state owned enterprises and old economy businesses.

Despite the underweight in financials, Chinese stock selection added value overall, with software businesses and work from home beneficiaries of the new economy both delivering positive contributions. In software, Yonyou Network Tech (+40%) was positive as was Venustech Group (+7.6%) while the tech platform giants Alibaba (-8.3%) and Tencent (+1.8%) proved resilient over the quarter as belief that e-commerce and online-gaming would be relative winners in a shutdown situation proved correct. Outside the WFH beneficiaries in China, Conch Cement (-4.7%) in materials proved its worth as a dominant regional producer with strong margins while in consumer staples China Feihe (+52.7%) delivered positive results from its resilient infant formula business. China Education Group (+7.3%) was another positive contributor. In South Africa our only remaining exposure is to Tencent's largest shareholder Naspers (-12.8%), which holds 31% of the Chinese business and is therefore somewhat protected from a very weak domestic economy. Polish stock selection was also positive as the gaming company CD Projekt (-5.7%) enjoyed increased sales of its popular Witcher3 title during the lockdowns ahead of the release of its long-anticipated Cyberpunk 2077 title.

Portfolio activity

Transactions over the period raised exposure to Chinese internet names, Taiwan and beneficiaries of working from home. We have reduced India, South Africa, Saudi Arabia and cyclical areas such as energy, industrials and materials. In China, e-commerce is likely to turn around first, with solid general merchandise and small appliances' sales. Advertising and travel companies expect revenue declines to carry into Q2, but to moderate. Most expect normal growth by Q3 while entertainment has been resilient, and gaming has increased significantly due to COVID-19 lockdowns. We have added to e-commerce giant Alibaba where the huge monetisation story in its online mall from insights into the consumer and marketing solutions remains. Penetration of lower tier cities is a priority with user base expansion and wallet share gain. We see online retail growth recovering strongly from the COVID-19 emergency with the basic premise that companies which were strong going into the crisis will emerge even stronger as weaker competition struggles to survive.

We have partly switched into the recently created Hong Kong listing where we expect better Chinese demand for shares only previously listed in US. The current price discount could be eliminated and move to a premium when Chinese investors are approved to buy through the stock connect program. We have also added to Tencent where its cloud business has been growing rapidly and the company has strengthened its position as the second largest public cloud provider in China with a 19% market share in 2019. We believe Tencent Cloud will continue to serve as a strategic focus for Tencent's 2B initiatives with potential in smart industry solutions in various verticals such as retail, finance, education and municipal services. The online gaming and social media exposure is positive and the group benefits from the shift to WFH. On the sell side in China we have exited online direct retailer JD.com, which had held up well, as we looked to increase Chinese platform leaders Alibaba and Tencent. We also sold 58.com which provides jobs and real-estate listings as the company faced outsized risk from the coronavirus outbreak due to an offline focus. We have disposed of miner Jiangxi Copper where the copper price is likely to remain subdued due to weaker demand. We have also sold Hong Kong listed auto body parts manufacturer Minth where volumes have declined, and price cuts have been forced by the big car makers.

In Taiwan we have introduced Quanta Computer which manufactures and sells notebook devices. The company has experienced supply chain issues due to COVID-19 but production should normalise and shipments and revenues in Q2 2020 may partially compensate for the poor Q1. The company's server business should benefit from demand from cloud services driven by the shift to WFH, offsetting declines in smartphone and PC shipments. As the company benefits from data centre capex its return on invested capital should rise as its product mix improves.

We have also bought Largan Precision which is a major supplier of camera lens modules for smartphones, tablet computers and digital cameras. The company has a leading industry position and strong balance sheet, which should help it weather the downturn in demand. Despite a weaker smartphone outlook, the company should sustain its pricing and margins due to its focus on the high-end lens market. We have added to convenience store operator President Chain Store Corp, which has a dominant market position in Taiwan with a strong ROIC in a country that has good COVID-19 controls. We have also topped up Accton Technology which develops and manufactures computer network system products such as adaptors, switches and routers. Accton's white-label switch dominance should help it benefit from a switch market upturn. Also, edge computing applications are accelerating with the launch of 5G and there are upside catalysts from 400G switches driving its earnings momentum. On the sell side in Taiwan we have exited Airtac Intl. reducing cyclical exposure to industrial capex, and Win semiconductors reducing cyclical semiconductor exposure, both in response to the escalating coronavirus crisis. We have also reduced Mediatek, the fabless chip manufacturer, as the mobile handset sales outlook was deteriorating for this year.

Elsewhere we have switched Amorepacific Corp into LG Household & Healthcare, the former being a travel related cosmetics and luxury goods business, the latter being more stable and less dependent on Chinese tourism with a Coca Cola bottling operation and more household products such as shampoo and detergent. In India we have bought high quality financial HDFC Bank which we believe is the best quality play in the current environment, given its stable margins, healthy asset quality, consistent performance and superior management. The bank's expansion in rural areas and leadership in technology should drive growth and improve return on equity. On the sell side in India, we have exited exploration and production group Oil & Natural Gas Corp. In Europe we have introduced Turkish biscuit and confectionary producer Ulker Biskuvi Sanyi which has strong sales and growth throughout the Middle East. We have also added Magnit Pjsc in Russia which operates a chain of discount supermarkets and has relatively low financial leverage and limited foreign exchange exposure.

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UK investors should read the Appendix for UK investors in conjunction with the Fund's Prospectus which are available from the Manager www.nedgroupinvestments.com

The Prospectus of the Fund, the Supplement of its Sub-Funds and the KIIDS are available from the Investment Manager and the Distributor or from its website www.nedgroupinvestments.com

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FEES

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