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Nedgroup Investments Global Flexible Fund

Quarter One, 2020

Nedgroup Investments Global Flexible Fund

Commentary produced in conjunction with sub-investment manager, First Pacific Advisers LP (FPA)

Indicator	3 months	1 year	3 years p.a.	5 years p.a.	Since Inception# p.a.
Portfolio*	-20.27%	-13.52%	-2.21%	0.48%	2.19%
Performance indicator+	-13.28%	-5.01%	2.53%	2.88%	3.75%
MSCI World Index	-21.05%	-10.37%	1.92%	3.24%	5.54%

* Net USD return for the Nedgroup Investments Global Flexible Fund, A class. Source: Morningstar.
\# Since FPA appointment as sub-adviser on 17/06/2013.
\+ 60% MSCI World, 30% JPM Global Bond, 10% US Cash.

Summary Points

- The portfolio of securities reacted negatively to the instantaneous and simultaneous global destruction of supply and demand wrought by COVID-19
- Three main detractors from performance were: banks, (Citigroup and Wells Fargo); Howmet Aerospace (formerly Arconic); and American International Group (AIG)
- The Fund invested 10% of capital during the first quarter, introducing more than 15 new holdings
- Investing in travel related businesses (2%), such as Booking Holdings, on severe market weakness
- Non-US equity markets have lagged and offer more attractive opportunities
- High Yield and Distressed Credit is still not providing excitement, but this is broadly evolving
- Cash is offering paltry future returns and is likely to be a smaller component of the Fund than recent times

Portfolio Commentary

Stocks around the world declined on the back of the COVID-19 pandemic in the first quarter. Most businesses were ill-prepared for what was a near simultaneous and instantaneous shut-down of the global economy that swiftly destroyed supply and demand.

The stock market extended its long advance well into the beginning of the quarter and then the correction hit like a Category 5 hurricane, entirely erasing (at least temporarily) those historic gains and then some. From peak to trough during the quarter, both the MSCI World Index and the S&P 500 Index declined about 34 percent, while the Nedgroup Global Flexible Fund ("Fund") declined 29 percent.[1] For the S&P 500, this was the steepest decline of 30 percent or more in history, occurring more quickly than what previously were historic declines in 1929, 1931, and 1934.

The FPA portfolio management team wants to express three points they hope investors will take away regarding the Fund and the recent market volatility.

First, the world isn't coming to an end. The impact on the Fund is largely a mark-to-market exercise in the midst of the most unsettling series of events that many of us have ever experienced. The FPA portfolio management team appreciates that it is unpleasant to have your portfolio decline in price – though not necessarily in value – and to share in a downside at the higher end of the Fund's historical performance. With the companies the Fund owned and the cash it held, the FPA portfolio management team believed they were well-positioned for a normal to deep recession. They were certainly unprepared for the near instantaneous and simultaneous global destruction of supply and demand wrought by COVID-19.

[1] For simplicity, market refers to the S&P 500 Index. The peak was February 19, 2020 and the trough was March 23, 2020.

Second, they put over 10 percent of the Fund's cash to work during the quarter. The FPA portfolio management team added nearly a dozen new holdings and are genuinely happy with what they own overall, although they are not yet eager to get fully invested.

Lastly, they believe the Fund's portfolio of securities at the end of this tumultuous quarter is attractive and interesting.

Market Cycle Perspective

The FPA portfolio management team has often expressed the need to judge a manager over full market cycles, and so it is worth noting that we are still in the market cycle that started in 2007 as we can't yet confirm that cycle has ended. As of April 30th, the market had recovered much of its losses and was *only* down about 8.5 percent for the year.[2] In short, we are not in a "bear market" yet, and it is too soon to tell if the cycle, let alone the correction caused by the pandemic, is truly over.

An honest assessment of what your managers have delivered for Fund investors during this extended cycle is mixed.

Periodic losses are inevitable, but only rarely did the Fund experience a permanent impairment of capital. Returns can be driven as much by what you own as by what you do *not* own. The Fund's focus on good businesses with a wind at their backs rather than in their faces has protected it from getting caught in value traps, or in businesses that are statistically inexpensive for a reason, typically because they haven't much in the way of prospective growth. Even taking into account Global Flexible's increased downside capture year-to-date, the Fund has since inception delivered on average less than 75 percent of downside capture whenever the equity market corrected more than 10 percent and about 79 percent of the volatility.

Given how unsettling the recent market decline was, the FPA portfolio management team thinks it is important to unpack the Fund's performance. The Fund captured about 85 percent of the stock market's downside during the dip in February and March, exceeding its 62.8% average net risk exposure. This was largely due to two factors: investments made as the market fell and certain holdings more meaningfully affected by the pandemic.

Some of the companies in the portfolio declined significantly more than the market during the sudden recent collapse. Its five worst detractors explain about 33 percent of the Fund's performance relative to its exposure. As of March 31st, the FPA portfolio management team continues to own all the companies referenced in the portfolio section below. The three main industries and/or companies that detracted most from performance, but whose stories have yet to be written, are: banks, particularly Citigroup and Wells Fargo; Howmet Aerospace (formerly Arconic); and, American International Group (AIG). In short, the dents in the Fund were not the result of any permanent impairments of capital but rather because the FPA portfolio management team stuck to its process.

Portfolio Discussion

The world has changed over the last couple of months and with it, stock prices. There is no question that emotion drove much of the share price movement. Businesses owned by the Fund may have seen their *stock value* move 25% day-to-day, or even intra-day, but the FPA portfolio management team can assure you that the companies' *business values* did not similarly change.

Contributors to and detractors from the Fund's most recent quarter and trailing 12-month returns are listed below.

Contributors and Detractors – Q1 2020

[2] For simplicity we reference the S&P 500 as the 'market'. Largest S&P drawdown periods: Since inception and Market Cycle 2 – 10/10/2007-03/09/09; Market Cycle 1 – 09/02/2000-10/09/2002.

Contributors	Performance contribution	Percent of portfolio	Detractors	Performance contribution	Percent of portfolio
JD.com, Inc. Sponsored ADR Class A	0.19%	0.97%	Howmet Aerospace (formerly Arconic)	-1.81%	1.46%
NEXON Co., Ltd.	0.12%	0.98%	American International Group, Inc.	-1.71%	2.28%
Microsoft Corporation	0.04%	1.85%	Jefferies Financial Group Inc.	-1.04%	1.96%
Osx 3 Leasing Bv 13.0% 20-mar-2015	0.03%	0.00%	CIT Group Inc.	-0.99%	0.93%
Uber Technologies, Inc. 8.0% 01-nov-2026	0.01%	0.07%	McDermott International	-0.97%	1.54%
Total:	0.40%	3.87%	Total:	-6.51%	8.16%

Contributors and Detractors – 12 Months to 31 March 2020

Contributors	Performance contribution	Percent of portfolio	Detractors	Performance contribution	Percent of portfolio
Microsoft Corporation	0.50%	1.85%	American International Group, Inc.	-1.13%	2.28%
Charter Communications, Inc. Class A	0.41%	2.21%	CIT Group Inc.	-1.04%	0.93%
JD.com, Inc. Sponsored ADR Class A	0.37%	0.97%	McDermott International	-0.98%	1.54%
NAVER Corp.	0.14%	0.00%	Glencore plc	-0.84%	1.05%
Puerto Rico Municipal Bonds	0.10%	1.45%	Baidu, Inc. Sponsored ADR Class A	-0.67%	1.52%
Total:	1.52%	6.48%	Total:	-4.66%	7.31%

One reason the FPA portfolio management team is excited about the portfolio right now is the compelling valuation of the banks the Fund owns, equal to 6.5% of the Fund, even after accounting for a potentially prolonged recession. Banks in the S&P 500 Index trade at some of the lowest valuations since either the financial crisis from 2008 into 2009 or the savings-and-loan crisis in the early 1990s. In general, banks not only have better loan portfolios today than they did in those crises, they also have capital ratios, or tangible equity-to-assets, two to three times greater than before the last recession.[3] The banks held by the Fund trade at an average 40 percent discount to book value. Assuming no growth and permanently reduced returns on tangible equity due to lower interest rates and/or upcoming loan write-downs, the FPA portfolio management team believes these banks should still be able to generate in the neighbourhood of a 10 percent return on tangible equity in a downside case. At just 0.6 times book value, that would equate to an owner earnings yield of 16.7%. The investment team finds this valuation math to be undemanding and therefore appealing.

During the initial market decline, AIG sank more than 60 percent, dramatically underperforming its peers in what the team believes will prove to be an overreaction. Life insurance companies were down 40 percent to 50 percent while their property and casualty, or P&C, peers were down 20 percent to 30 percent.[4] The conviction in AIG stems from several factors:

a. The investment team does not think their life insurance business, which accounts for 40 percent of premiums, will be overly affected as we are seeing a flattening of the COVID-19 infection curve.

[3] Source: Bloomberg, as of March 31, 2020.

[4] Source: Bloomberg, as of March 31, 2020.

b. Its P&C business, generating about 60 percent of premiums, does not cover pandemics. Some U.S. states have said they may try to force coverage of pandemics, but we are confident the U.S. Constitution does not allow such a retroactive revision. There also is a case to be made that reduced activity around the country will lower P&C claims.
c. AIG has earnings power in the next few years of around $6 per share.

Panicked selling caused the AIG stock price to trade as low as an unchallenging 0.3 times tangible equity. The Fund added to the position on this weakness.

It's important to remember that chaos creates opportunity and the portfolio management team does not shy from market sectors that others avoid, too paralyzed by uncertainty to act. In late March, they put roughly 2 percent of the portfolio into the travel space, specifically into well-financed companies that have a long enough runway to get through a temporary shutdown or even longer delay in travel-and-leisure spending. They purchased Booking Holdings ("Booking") at what they believe are low double-digit multiples of enterprise-value-to-trailing-earnings. They did not take this position, however, simply because it was trading at a low multiple of estimated trailing or normalized earnings. Instead, the attraction of Booking is the long-term strength of its business and a strong balance sheet with net cash, further complemented by several billion dollars of investments in various securities. They also expect Booking to pare its expense structure, albeit with some lag, to protect profitability. The team believes that those attributes should more than sufficiently ensure that Booking emerges from the other side of this pandemic in a stronger position than its poorly financed peers. Regardless of what the new normal looks like, we are highly confident that Booking, with excellent stewards of its business and capital at the helm, will emerge as a profitable company generating excellent free cash flow.

They also took advantage of market weakness to add roughly a dozen new positions in companies that have sat for years on their wish list and whose stock price declines finally afforded the team appealing opportunities to buy.

The Long View

The portfolio management team enumerates below some significant drivers of performance relative to the indices over the last decade or so.

1. FPA are value managers, making investments that have an appropriate margin of safety.

Traditional value investors have sought such protection in a company's balance sheet. The FPA team prefers a margin of safety more predicated on the quality of the business – its returns on capital; the defensibility of its market position; pricing power; good management, and future top- and bottom-line growth potential; among other attributes. Since value received for a price paid does matter to them, they have all too frequently found themselves not owning businesses priced to perfection during this unprecedented market cycle.

Growth stocks have reigned supreme for a long time, and the Fund has held positions in growth businesses like Alphabet and Facebook (that were initially purchased when the market thought less of their investment merits). More traditional value names that are more cyclical on average have not performed as well, however, including the aforementioned banking and aerospace investments.

Growth's outperformance of Value has left Value appearing relatively inexpensive (Exhibit A). This cannot continue unabated unless Value fails to deliver even a modicum of growth. The Fund should benefit from some reversion to the mean to the extent that it holds positions that are clearly value names.

Growth v Value Relative Value

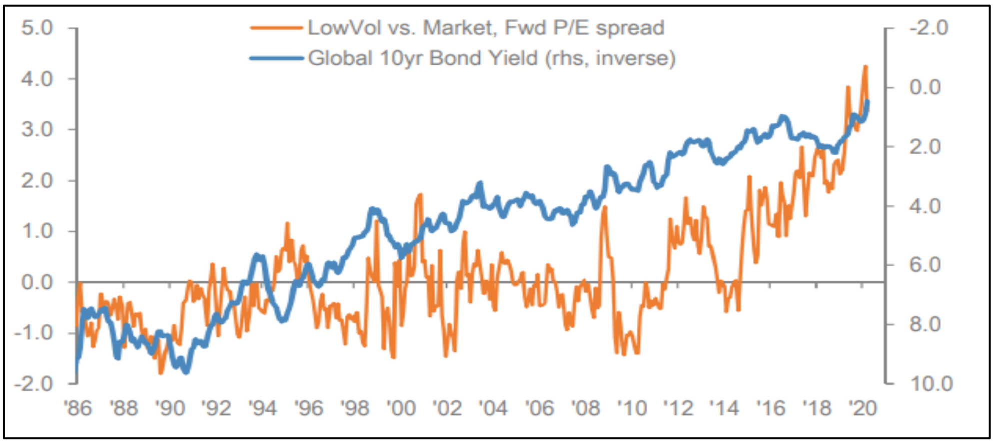
Source: Bloomberg, as of March 31, 2020. Chart data covers period March 31, 1995 to March 31, 2020. Uses the z-score of the ratio of the Russell 1000 Growth Index divided by the Russell 1000 Value Index.

2. Quality and low-volatility indices have outperformed for much of the last decade.

This has pushed prices to valuation levels too high to give us comfort that there are reasonable margins of safety (Exhibit B). Such indices have historically been populated by less cyclical businesses. The investment team is quite comfortable with *growing* cyclical businesses as long as they are paying an appropriate price for them. Just because some of these prices are lower today than when the Fund made its purchases does not mean it overpaid, although they are certainly more "appropriate" today than they were. As Warren Buffet has said, "I would much rather earn a lumpy 15 percent over time than a smooth 12 percent." [5]

Many businesses of historically high quality but very low earnings growth now trade at price-to-earnings ratios exceeding 20 times, including many consumer product companies. Investors are currently more comfortable paying for the perceived stability of an earnings stream regardless of price. Paying a rich multiple for such a business, however, might prove no different than buying a long-dated bond at a yield that approaches zero.

Relative Valuation of Low Volatility Stocks vs Broader Market



Source: J.P. Morgan U.S. Equity Strategy: Style Positioning, Value Squeeze, Winner Takes All, p4, as of April 3, 2020. "LowVol" is represented by JPM's quantitative group metrics. Market is represented by the S&P 500 Index. Chart data covers period December 31, 1986 to March 31, 2020.

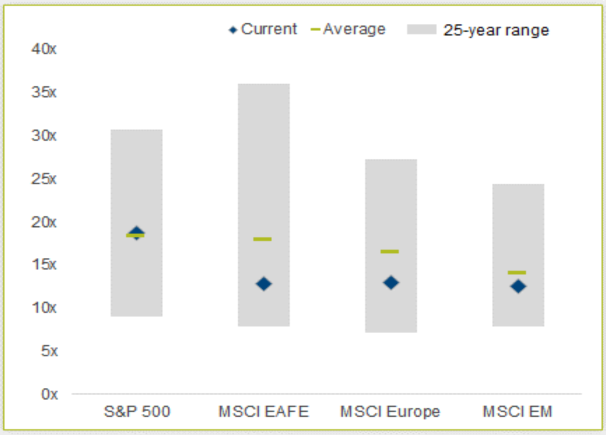
[5] *Warren Buffet on Business: Principles from the Sage of Omaha*, p72, Richard J. Connors, ©2010.

3. On average, foreign stocks have underperformed domestic U.S. stocks.

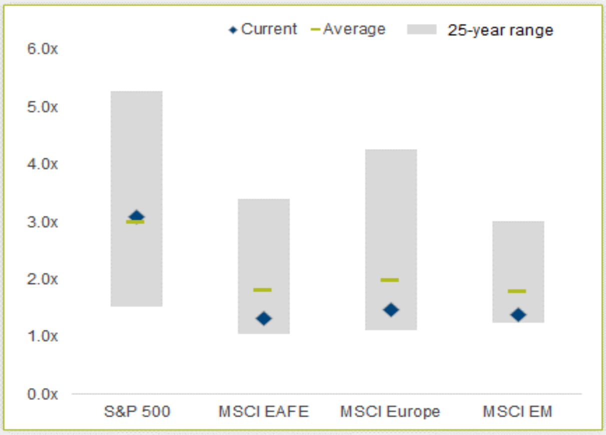
Both in local currency and, thanks to U.S. dollar strength, even more so in dollars. This has caused the Fund to look suspect when compared to a U.S. benchmark only. On the other hand, it appears more than competent in comparison to international benchmarks. How the Fund has done in recent years has become a matter of geographic perspective.

Global Valuations

Price to Earnings Ratio: Trailing 12M



Price to Book Ratio: Trailing 12M



Source: Factset, as of March 31, 2020. Data is represented by the respective indices in the charts.

There are many wonderful businesses domiciled outside the United States with characteristics similar to their U.S. counterparts yet trading at discounted prices. The Fund's exposure to these companies has therefore increased from roughly 24% at year-end 2017 to roughly 37% today. Should investors once again become willing to pay similar valuations for similar businesses regardless of geography, then the Fund's exposure to international stocks should deliver nice returns.

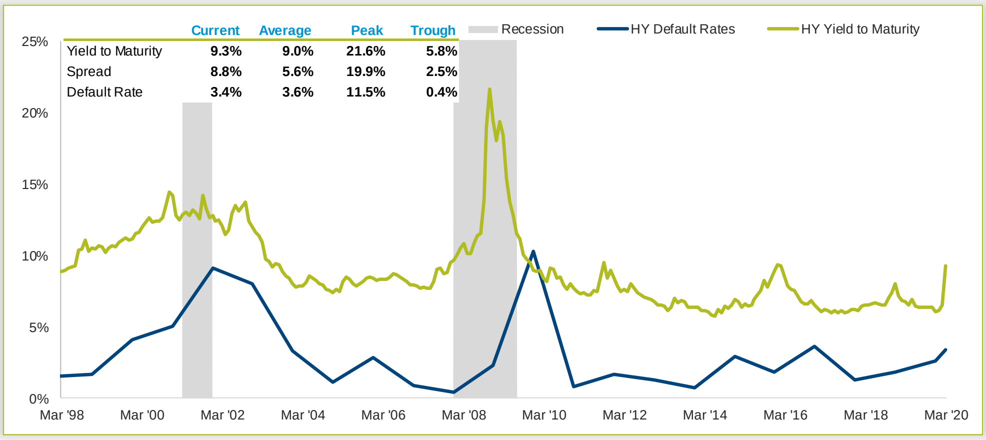
U.S. dollar strength also has proven a headwind for the investor in foreign securities. In dollar terms, the MSCI World's return is 0.61% lower than the return in its local currency during the current market cycle. Should the dollar weaken, the Fund's foreign exposure should look better still in dollar terms.[6]

4. High-yield bonds have offered very poor yields in recent years.

There has also been no distressed cycle since the 2008-2009 downturn. The paltry yields of the sector have kept us away. Simply because the Fund can invest in an asset class doesn't mean it should. Nevertheless, not owning much in high yield has hurt performance as interest rates kept going down and risk spreads narrowed, despite increasing corporate leverage, declining average credit quality and weaker covenants for borrowers. That has finally started to reverse.

[6] For the period 10/10//07 to 3/31/20, the MSCI World (USD) returned 2.93% annualized; while the MSCI World (Local) returned 3.54% annualized.

High Yield



Source: Federal Reserve Bank of St. Louis, Bloomberg, as of March 31, 2020. Chart data covers period March 31, 1998 to March 31, 2020. High Yield bond market data is represented by ICE BofA US High Yield Index.

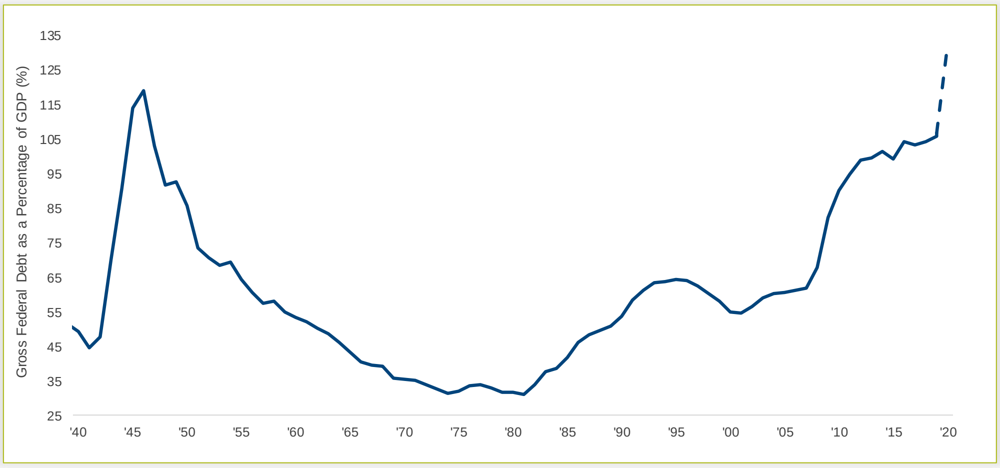
The investment team believes that now is the time to begin to seek ideas in the universe comprised of the overleveraged and economically challenged. Never mind that the U.S. Federal Reserve is buying corporate debt for the first time and even some recently downgraded, less-than-investment-grade debt, we strongly expect a spate of restructurings to bring opportunities.

5. Cash had accumulated in the Fund as a result of finding few attractive risk/reward propositions.

This mattered more in this market cycle than the previous cycles for two reasons: First, the current market cycle is the longest in history, so standing on the side-lines caused the team to look more foolish than they believe they are. Secondly, when cash in the FPA Contrarian Value Strategy did build prior to 2008, it had the benefit of receiving attractive returns on cash, something that has not existed during an era of low and lower short rates.

There are two reasons that you can expect the Fund to run with less cash going forward. For one, cash offers an even lower yield than at the beginning of the last market cycle. Governments cannot afford to let rates rise, particularly in the wake of the deficits being created by the massive support packages to mitigate the economic impact of COVID-19. Central banks and sovereign treasuries will do everything in their power to keep rates low. U.S. government debt will shortly exceed $25 trillion and is increasing at such a rate that the debt-to-GDP ratio will hit a level not seen since World War II. Even excluding $6 trillion of intragovernmental holdings, the country still has $19 trillion of debt. At that level, even a 1% increase in rates would increase the U.S. deficit by $190 billion for that year and that doesn't consider continued growth of the U.S. national debt, which most certainly and dramatically will happen in the coming months, if not years.

Federal Debt (accumulated deficits)



Source: Federal Reserve Bank of St. Louis, as of Sept 30, 2019. 2020 year-end projection is calculated by adding at least $4 trillion to the Gross Federal Debt levels and estimating that GDP will be 5% lower than at September 30, 2019 levels.

Secondly, the investment team has posited over the last decade that we would eventually find ourselves on a deflationary path to inflation. Up to this point, governments have kept the economic party going, thanks in part to expansive fiscal and monetary policy. We expected more of the same when the next downturn hit. Given the suddenness and magnitude of this recent economic decline, however, the U.S. government felt obliged to act in an unprecedented (and unproven) fashion. The economy is the lab, apparently, and we the people its rats. The worse the economy, the greater the stimulus; and the longer the downturn, the longer the presses print money, which will eventually lead to inflation. That inflation may not be broad-based and may yet occur even amid general economic malaise – remember stagflation? – but stocks may nonetheless perform well nominally as there may be little alternative.

The Fund's investors should be keenly aware that the Fund will likely operate with less cash in the future, which will likely increase unit price volatility. The Fund's lower volatility has always been a by-product of its strategy, not a goal. The strategy will continually aspire to avoid any permanent impairment of capital and not be bothered with the ephemeral, and usually visceral, mark-to-market that the investments they own might have during their life-cycle in the Fund.

6. The Fund often is compared with balanced funds.

This peer group typically run 60 percent stocks and 40 percent bonds or lower risk assets. Balanced funds generally hold growth stocks, and in addition, these funds have enjoyed a major tailwind boosting performance as bond prices have risen in lockstep with declining interest rates. The rate on a U.S. government 10-year bond declined from 5.3% to 0.5% since 2007, helping the Bloomberg Barclays U.S. Aggregate bond index return 4.8% over that time. [7]

Balanced Funds, with their large dedication to investment grade bonds, will likely find the future more challenging. Yes, the tailwind of declining rates is unlikely turn into a headwind of rising rates, but for the bond portion of a balanced fund's portfolio to have as bright a future, the 10-year bond would have to fall to a negative 3 percent return. That is an uncomfortable bet to make. Additionally, we expect that some corporate bonds currently considered investment grade will end up as junk bonds.

[7] Source: Morningstar. The US Government 10-year bond yield peak and trough dates were June 12, 2007 and March 9, 2020, respectively. Return for the Bloomberg Barclays US Aggregate Bond Index is annualized between those dates.

Summary

It's a bit surprising that from where we are today, the market is only off 13% from its February peak.[8] The world today is more than 13% worse than it was then, but the more pertinent question is what the future will look like. As emotion is wrung from the stock market, it tends to look forward to what the economy looks like on the other side.

Eventually we will have a COVID-19 vaccine that will also boost our ailing economy. Additionally, central banks are unlikely to raise interest rates for years to come – how many countries can afford to pay a higher rate for their burgeoning national debt? With those two things in mind, it is difficult to act as your fiduciary and not become more invested over time, largely in equities with some high-yield and distressed debt. Cash just won't produce the return to which we collectively aspire. For better or for worse, we believe central banks have set the state for inflation in risky assets, and since the investment team can't tell you when the show starts, they have to be in their seats in advance. If they successfully find a sufficient number of investments with attractive risk-to-reward, this may mean greater volatility – but they see little alternative as they look out five to 10 years.

The investment philosophy hasn't changed, and the strategy although evolved remains largely unaltered. Sometimes you don't appear as smart as you are, and other times you look much smarter than you actually are. As we continue to focus on delivering good risk-adjusted returns, we suspect the clock will be right more than just twice a day.

The FPA portfolio management team appreciates your trust and patience. While unsettling, we hope for continued volatility in the equity and credit markets as we would love nothing more than to become even more fully invested. The team is excited about the opportunities that are destined to come. Let us consider how the six points mentioned above were relative headwinds in the last market cycle and could become tailwinds in the near future.

[8] Source: Bloomberg, as of April 30, 2020. Market refers to the S&P 500 Index. The S&P 500 Index peak was on February 19, 2020.

Disclaimer

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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

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FEES

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NEDGROUP INVESTMENTS CONTACT DETAILS

Tel: toll free from South Africa only 0800 999 160
Email: helpdesk@nedgroupinvestments.com
For further information on the fund please visit: www.nedgroupinvestments.com

OUR OFFICES ARE LOCATED AT

First Floor, St Mary's Court
20 Hill Street, Douglas
Isle of Man
IM1 1EU