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# NEDGROUP INVESTMENTS RAINMAKER FUND

Quarter One, 2020

| Performance to 31 March 2020 | Nedgroup Investments Rainmaker Fund[1] | ASISA category average | Small Cap Index |
|---|---|---|---|
| 3 months | -26.3 | -23.0 | -21.4 |
| 12 months | -27.4 | -21.4 | -18.4 |

**Market Commentary**

The positive start to 2020 with global markets buoyed by constructive US-China trade news has collapsed sharply under the weight of the COVID-19 pandemic. Countries across the globe have taken unprecedented responses to curb the spread of the virus, with billions of people now subject to some form of lockdown. The steps taken will lead to a severe fall in economic activity in the first half of 2020. Governments and central banks have responded swiftly with significant liquidity and fiscal packages.

South Africa has suffered additional setbacks with ratings downgrades by Moody's and Fitch. The lack of a clear strategy to ensure government debt stabilisation is the key reason for the downgrade.

Against this backdrop, we have seen some extreme moves in equity markets in a very short period. The JSE All Share fell -12.1% for March 2020 and -21.4% for the quarter. At a sector level, Industrials declined -8.4% for the quarter, while Resources and Financials posted losses of -25.3% and -39.5% respectively.

Almost all emerging market currencies depreciated against the US dollar in the first quarter of the year, the Brazilian real (-22.4%) and the SA rand (-21.7%) are the weakest of the major global currencies.

The extent of the economic impact and disruption caused by human and goods movement restrictions, and quarantines imposed on parts of the world to limit its spread, remain hard to predict. Faced with the inevitability of a deep recession, many companies are having to react very quickly to preserve cash flow. Understandably, investor focus has been on the financial resilience of companies.

The shape of a recovery remains uncertain. We are conscious of the fact that it will take some time for the full impact of this global shock to the human healthcare and economic system to be felt and analysed, but we have seen some extreme moves in equity markets in a very short period. The markets appear to be blinded by uncertainty and panic.

**Portfolio Commentary**

The fund's top five performing positions for the quarter added +2.6% to return, while the bottom five detracted -11.2%. The fund's large positions in Naspers as well as British American Tobacco aided performance. Whereas our Sasol position and banking exposure has hurt performance in the short term.

We remain extremely cautious on domestic discretionary spend and have limited exposure, with Mr Price as our preferred holding. The virus and the subsequent government response have resulted in a reduction in consumer demand and forced store closures. While earnings and cashflows will suffer during this period, we take comfort that Mr Price has the strongest balance sheet in the sector. For some time, we have avoided companies with uncomfortably high leverage, such as Foschini.

| Top contributors | Average weight | Performance contribution | Top detractors | Average weight | Performance contribution |
|---|---|---|---|---|---|
| Naspers Ltd | 12.0% | 1.5% | Sasol Ltd | 3.0% | -3.8% |
| Prosus NV | 4.5% | 0.9% | Std Bank Ltd | 4.9% | -2.2% |
| British American Tobacco | 7.5% | 0.1% | FirstRand Ltd | 5.1% | -2.1% |
| Vodacom | 2.0% | 0.1% | Absa Group Ltd | 2.4% | -1.9% |
| Reinet | 1.2% | 0.0% | Sanlam | 3.3% | -1.2% |
| | | **+2.6%** | | | **-11.2%** |

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

It is worth noting the defensive nature of our domestic consumer exposure, we prefer non-discretionary local consumer stocks and have substantial positions in AVI and more recently, Spar. Our avoidance of property stocks, given the numerous headwinds the sector faces, has aided relative performance. The REIT sector declined -51% in the first quarter of the year.

### Sasol and SA banks

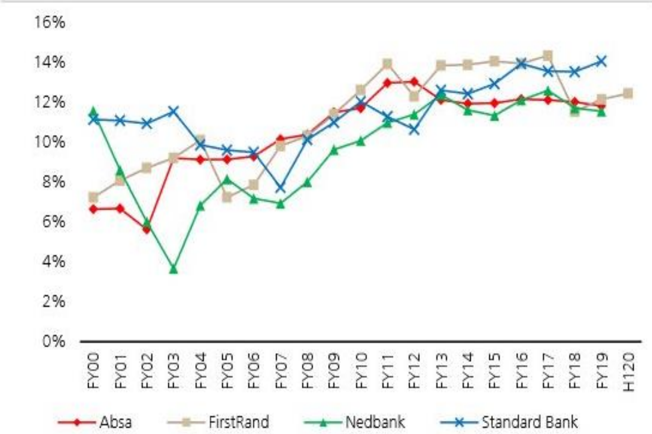
Sasol's share price performance has been a major source of disappointment for us, but we continue to hold the course. Over the past 18 months, Sasol has fallen out of favour with investors for three primary reasons: the abysmal execution of the Lake Charles Chemicals Project (LCCP), downward earnings revisions, and a steadily worsening and increasingly fragile balance sheet. More recently, further events have driven the share price lower, such as Moody's downgrade on their debt which will raise financing costs, and the very unexpected breakdown of talks between OPEC and its Russian counterparts, leading Saudi Arabia to announce significant price discounts on its oil for May delivery. Meanwhile, the spread of Coronavirus will reduce oil demand to multi-decade lows. This has placed Sasol in a precarious position.

Sasol has responded with an ambitious plan to please lenders and calm the market. The share price appears cheap, although they are all earnings and cash flow-based valuations. The real concern is the balance sheet. The situation is likely to remain extremely fluid, and we will endeavor to respond as appropriate.

Turning to our banks position, the sharp fall in bank share prices is unprecedented and appears to be pricing in the need for a recapitalisation. The SA banks would have to incur extreme losses to drive a decline in their capital ratios to regulatory minimums. Their credit losses would have to increase 8x–10x current levels, or >3x that experienced in the global financial crisis (GFC). On our analysis this appears unlikely.

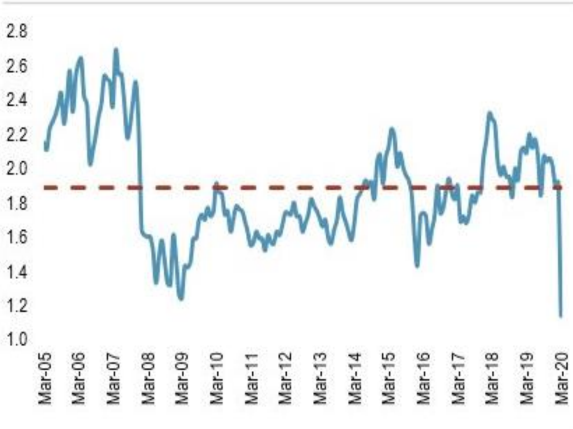
SA banks have seen significant improvements in capital ratios since the GFC. And recent regulatory intervention is also encouraging, as regulators have softened their stance on loan loss accounting, as well as the size of the liquidity and capital buffers banks must hold. The combination of earnings resilience, strong starting capital position and attractive valuation is compelling, as illustrated in the two charts below[2].

**Figure 2: Substantial improvement in CET1 ratios since 2008**




Source: Company data

**Figure 4: SA banks sector P/BV trend**




Source: Datastrream

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[2] Source: UBS

## Current positioning and outlook

We expect the market environment to remain challenging with the fate of equities dependent on the evolution of the COVID-19 outbreak. Fortunately, the pandemic appears to be slowing, although a second wave of infections is a risk. A global recession is inevitable, but decisive intervention by central banks, governments, the IMF and the World Bank, alongside the many humanitarian assistance packages that have been launched will provide support.

There is undoubtedly enormous value in the SA equity market, absolute and relative to both emerging and developed markets, however the full extent of the economic damage we will suffer will only be revealed in the coming months. The best local economists now seem to think our economy will contract by 5% in 2020 and bounce back in 2021, but the bounce only gets us back to the very weak point we found ourselves in at the start of 2020.

Our ability to recover is further hampered by our country's balance sheet, tax collection revenues, and levels of employment. While consumer and business confidence are not nearly as strong as they were in early 2009, after the GFC. Prior to the COVID-19 crisis, SA's debt/GDP was 61% and headed to 70% on a 2-year horizon, assuming a positive outcome on 2020 state wage negotiations. That already pessimistic scenario has been replaced by a looming debt crisis, with a likely 12% budget deficit pushing us to 80% debt to GDP on a 2-year horizon. Add a further 20% SOE debt and we will be close to 100%.

We consequently view any recovery as one that will, post the short-term base effect bounce back, likely to be even slower than our pre-COVID-19 impact expectations. There are still very high levels of uncertainty in the forecast horizon. As such, we will continue to exercise caution. Our investment strategy is focused on owning quality companies which we feel are able to recover, and even flourish.

While we have been hard at work managing the fund, our thoughts are with all our clients and their families at this time. We are experiencing disruption to our daily lives which none of us have ever experienced before. It will require adaptability and perseverance, but in time it will pass and we pray that you and your families will keep safe until that time.

## Responsible Investment Comments

Notable engagements during the first quarter of 2019 include:

1. We engaged BHP Group regarding Scope 3 emissions on iron ore production, and measures to alleviate CO2 emissions in steel smelters. In addition, we discussed the outlook for their coal mining operations.
2. We held discussions with Naspers regarding remuneration and other ESG matters, such as safety of personal information.
3. Engaged Anglo American on adjusting the portfolio to "new world' assets and the purchase of Sirius Minerals as part of this.

## Conclusion

We expect market conditions to remain volatile, but also expect to be through the worst of the lockdowns by the end of the next quarter. Our focus now is on looking to buy or add to high quality businesses that are trading at very low valuations, but most importantly have the balance sheets to be able to weather the storm.

Undoubtedly there will be many tragic casualties of this human health and economic shock, and we expect that many aspects of human interaction, mobility and commercial activity are likely to be permanently altered. For the nimble, appropriately capitalised and astutely managed companies, survival will create fresh opportunity at the expense of those who are not. This is the free market system which must be allowed to work freely while at the same time contributing to the humanitarian crisis our world is facing.

Now is the time to think carefully for the storm will pass, and volatile times such as we are currently experiencing create opportunity for the long-term and patient investor.

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