



see money differently

A photograph of an open book with white pages, tied with a white string around the spine. The book is open to a blank page, and the string is tied in a knot.

Nedgroup Investments Contrarian Value Equity Fund

Quarter Two, 2020

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



Indicator	3 months	1 year	Since Inception [#] p.a.
Portfolio*	20.87%	-2.39%	0.01%
MSCI ACWI Index	19.22%	2.11%	3.48%

* Net USD return for the Nedgroup Investments Contrarian Value Equity Fund, D class. Source: Morningstar

[#] 01 June 2018

Portfolio Commentary

The first quarter letter was closed with the observation that economies were worse than stock indices might suggest. What we thought true then is only more true today, yet in the second quarter, the market made one of its larger quarterly moves.

The global MSCI ACWI Index advanced 19.2% in the second quarter, while the domestic S&P 500 Index increased 20.5%, erasing the majority of the year-to-date decline to March's trough. The Nedgroup Contrarian Value Equity Fund ("Fund" or "NCVE") increased 21.1% over the same period, besting both indices.

We would have thought that a global pandemic, social disturbances, extreme political polarity, and all that has accompanied those trends would have created more fear, or at least caution, in global markets. Yet stock and debt markets are up around the world, and in many cases, way up. Koyantsqatsi, a word used by the Hopi Native American tribe to describe a life out of balance, is as apt a description for this disconnect as any.

At the beginning of the year, the global economy was expected to grow 2.5% this year, but thanks to COVID-19, that outlook has darkened significantly and the consensus view now looks for a -5.2% contraction¹. Although you wouldn't know it from the popular indexes, this darkened outlook has pushed the average stock down 10.92%². Economic data suggests we won't return to normal in the near future (see Exhibit A).

¹ Source: The World Bank, Global Economic Prospects, June 2020.

² As of June 30, 2020. This reflects the average year-to-date performance of the S&P 500 Index constituents.



Exhibit A: Select Economic Data/Indicators

	12/31/2019 unless indicated	6/30/2020 unless indicated
GDP estimated growth 2020/2019		
U.S.	1.8%	-6.1%
Global	2.5%	-5.2%
U.S. unemployment (%)	3.6%	11.1% ³
Oil (WTI \$/barrel)	\$61	\$39
Hotel occupancy⁴		
Asia Pacific	66.6%	35.8%
Europe	66.9%	31.9%
Americas	80.7%	30.6%
Middle East and Africa	64.4%	13.3%
Residential mortgages in forbearance	0.25% ⁵	8.5% ⁶
US deficit – 2020 estimated⁷	\$1.0tn	\$3.7tn
US national debt – 2020 estimated⁸	\$24.2tn	\$26.9tn

In March, we were particularly concerned with the high COVID-19 transmission and fatality rates and what a “closed” global economy might look like. Rightly or wrongly, that influenced our judgment. Securities were on sale and we went shopping, but we could have bought even more. There is no lesson here; as presented with the same facts, we would do the same thing again. This coronavirus has delivered less death than initially anticipated, but we are far from done with it, hitting new highs in daily infections almost every day.

We never believed COVID-19 posed existential risk to the global economy, confident that we will eventually reach the other side as we always do, but we still do not know how bad things might get along the way. The world remains, as always, uncertain, though uncertainty has narrowed for now. The left tail of the probability distribution has flattened from what we expected.

Although stocks are still expensive, the portfolio was cheaper to assemble, and we believe the companies in it have more growth and better balance sheets than the stock market overall. In an uncertain world, this gives us some margin of safety, particularly since governments seem willing to do anything to resolve the crisis, including keeping interest rates low or even negative, printing money, giving money away, and making loans that can be forgiven.

In the last letter, the FPA portfolio management team commented on the six headwinds faced over the last market cycle and their belief that those could become tailwinds in the near future. They are worth repeating here, though the details can be found in the first quarter’s commentary.

³ Source: The Bureau of Labor Statistics, as of June 1, 2020.

⁴ Source: Statista.com. Data as of September 2019 (pre-COVID) and May 2020. <https://www.statista.com/statistics/206825/hotel-occupancy-rate-by-region/>.

⁵ Source: MBA.org. Data as of March 2, 2020. <https://www.mba.org/2020-press-releases/april/mba-survey-shows-spike-in-loans-in-forbearance-service-call-volume>.

⁶ Source: MBA.org. Data as of June 29, 2020. <https://www.mba.org/2020-press-releases/june/share-of-mortgage-loans-in-forbearance-decreases-slightly-to-847>.

⁷ Source: Congressional Budget Office April 2020. <https://www.cbo.gov/publication/56020>; <https://www.cbo.gov/publication/56335>. Most recent 2020 estimate as of April 2020.

⁸ Federal Reserve Bank of St. Louis, U.S. Office of Management and Budget. 2019 year-end total debt including estimated deficit.

1. Value vs growth
2. Low volatility vs high volatility (or business quality perception differential)
3. United States vs international
4. High-yield window of opportunity
5. Cash
6. Interest rates

Whether the stock market buying spree is driven by need, given the lack of an alternative, or greed, the result is the same. Investors are showing a willingness to look across a deep chasm and accept a sanguine view of the future for many businesses, particularly those in the tech space. However, prices for high quality businesses have not fallen to levels we might have hoped. This story, however, is far from written.

Portfolio Discussion

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

Contributors and Detractors – Q2 2020

Contributors	Performance contribution	Percent of portfolio	Detractors	Performance contribution	Percent of portfolio
Alphabet	1.93%	8.7%	Wells Fargo & Co	-0.24%	2.4%
Analog Devices	1.67%	4.6%	Swire Pacific Limited	-0.16%	1.0%
Broadcom	1.51%	4.5%	Raytheon Technologies	-0.11%	0.8%
Facebook, Class A	1.37%	4.0%	Royal Bank of Scotland	-0.04%	0.4%
TE Connectivity	1.17%	3.7%	Jardine Strategic	-0.03%	0.8%
Total:	7.66%	25.6%	Total:	-0.58%	5.4%

Contributors and Detractors – 12 Months to 30 June 2020

Contributors	Performance contribution	Percent of portfolio	Detractors	Performance contribution	Percent of portfolio
Alphabet	2.05%	7.9%	Howmet Aerospace	-2.51%	4.7%
Microsoft Corp	1.58%	3.2%	AIG	-2.44%	4.8%
Charter Communications	1.13%	3.7%	Ally Financial Inc	-1.38%	1.4%
JD.com	1.01%	1.7%	Wells Fargo	-1.29%	2.8%
Analog Devices	0.96%	4.4%	Citigroup Inc.	-1.08%	3.8%
Total:	6.73%	21.0%	Total:	-8.70%	17.5%

As is clear from the above, the Fund's investments in the tech sector have continued to outperform its more traditional value investments. While the Fund owns a number of high-quality growing businesses that trade at reasonable valuations, it seems no price is too high for some "quality" stocks, and no price is too low for lower quality ones. Similarly, growth can't be expensive enough, nor value cheap enough.

The portfolio management team has come across a number of references made to work done by Empirical Research that identified 75 large-cap stocks with great growth characteristics. Looking back to the 1950s, that firm has not seen a period as expensive as the current – at 66 times forward price-to-earnings (“P/E”) estimates, and the highest relative P/E multiple for these 75 names when compared to the rest of the large cap market. This is not to suggest that these companies are bad (although, approximately 30 percent of them do lose money).⁹

A lot must go right in the future for such companies to justify their current valuation. Conversely, a lot would have to go incredibly wrong for many of the value stocks that have been left behind in this bull run to prove to be unreasonable investments in the future.

Investors have found comfort in those businesses that have a less volatile earnings stream, for instance, consumer products companies selling staple goods, and have recent and seemingly great future prospects, such as a Netflix or Tesla. The investment team believes there is better opportunity in the uncomfortable, where the short-term is more challenged, but with respectable long-term prospects, like industrial, travel and leisure, hospitality, and foreign-based companies. Given the Fund’s avoidance of more richly priced companies, the team believes this dichotomy should position the Fund well for the future.

It is not the first time that the portfolio manager’s style of investing has been so out of favour. As shown in Exhibit C below and based on consensus earnings projections at that time, the Fund’s equity portfolio has remained attractive relative to the market over the past year.¹⁰

Nedgroup Investments Contrarian Value Equity’s equity portfolio had better earnings-per-share (“EPS”) and book value than the indices, while achieving higher historic and forecasted EPS growth. Over time the portfolio management team would expect the relationship between valuation and growth to support improved performance, but, of course, they can make no guarantees and the disconnect may continue to try their patience. Relative to the indices, the Fund’s equity holdings continue to trade at a significant discount on forward P/E and Price/Book. One might suggest that the growth rate of the companies held by the Fund is lower, but as you can see in Exhibit C, both the trailing and forecasted consensus 3-year EPS growth is higher than the market. There are a number of puts and takes that make these Wall Street consensus numbers far from precise, but directionally, suggests that the Fund’s equity portfolio is (and has been) less expensive than the market and the earnings growth potential of its underlying companies is at least as good if not better than the market as one looks through the economic cycle.


Exhibit C: The Fund’s equity holdings Valuation and Earnings Growth vs Stock Market¹¹

	Price/Earnings 1 Year Forward		Price/Book		3-Year Historic EPS Growth		3-Year Forecasted EPS Growth	
	6/30/2019	6/30/2020	6/30/2019	6/30/2020	6/30/2019	6/30/2020	6/30/2019	6/30/2020
NCVE Fund	15.1	20.7	2.8	3.6	18.0%	13.7%	19.9%	18.6%
S&P 500	18.1	24.9	3.3	3.5	11.8%	6.5%	9.8%	10.6%
MSCI World	15.6	20.4	2.4	2.5	11.6%	4.5%	9.5%	10.7%
MSCI ACWI	16.2	21.9	2.3	2.3	11.2%	3.5%	9.7%	11.1%

⁹ Source: Empirical Research Partners (“ERP”), National Bureau of Economic Research. ERP categorized a group of 75 U.S. large-capitalization (“cap”) stocks that have faster and stronger growth credentials than the rest of the U.S. large-cap universe (830 companies) as ‘Big Growers’. Their analysis covered the period January 1, 1952 through June 8, 2020. Trailing P/E analysis showed the Big Growers, as an equally weighted group, currently trade at a relative (to the universe) trailing P/E ratio higher than anything seen since 1952. Forward P/E is the average of the Forward P/E’s for the 75 firms as of July 22, 2020. Forward P/E’s are estimates and subject to change.

¹⁰ References to Nedgroup Global Flexible Fund “equity portfolio” refers to the Fund’s equity holdings. The equity portfolio statistics noted herein do not represent the results that the Fund or an investor can or should expect to receive.

¹¹ Source: CapIQ, Factset, Bloomberg, FPA calculations. 3-Year Forecasted EPS Growth is based on FPA calculations using consensus data from CapIQ, Factset and Bloomberg. Comparison to the S&P 500 and MSCI ACWI Indices is being used as a representation of the “market” and is for illustrative purposes only.



If we consider the equity portfolio as depicted in Exhibit C, it trades at a 4.8% earnings yield (earnings/price) on depressed COVID numbers. Assuming the consensus earnings growth of 18.6% over the next three years, then the prospective earnings yield will have increased to 8.1%.¹² If we then assume a more pedestrian 4% growth for the rest of the decade, our equity portfolio would trade at 10.6% yield in Year 10, and we will have earned a 2.09% dividend along the way, or approximately 20% of your capital, assuming no increase in dividends. If instead one were to buy a 10-year bond at 0.66% yield, in 10 years you'd have collected 6.6% of your capital pre-tax and have the option to reinvest in whatever the opportunity set might be at the time. Framed over the long-term, the NCVF equity portfolio's earnings and dividend yields appear superior to the bond and cash markets. So we have chosen to accept a bit more volatility in exchange for the opportunity for a better longer-term return on capital. We believe when global economies recover, investors will appreciate the merits of many of these unloved companies with deeply discounted valuations compared to the market. People will again stay in hotels, and Marriott will be there to accommodate them. The cruise industry will not disappear, as vacationers will once again set sail (though the industry could suffer more than the hotel business). During the downturn we therefore established a position in Marriott stock.

For the most part, the Fund's more significant 2020 purchases were in companies hurt in this economic downturn, in many cases quite severely. Expectations have changed, but prices sank much more than those expectations changed. Looking toward an eventual economic recovery, the FPA portfolio management team believes these recent investments – LG Corp, Swire Pacific, Booking Holdings, Marriott International, NXP Semiconductors, Compagnie Financiere Richemont and Wabtec (formerly Westinghouse Brake Technologies), complemented by additions to many of the Fund's existing holdings – will fare quite well and once again return to investor's favour.

Where possible, we have traded lower quality businesses for higher quality ones for which growth, even if cyclical, should hopefully ensure a prosperous future. Owning higher quality businesses gives the team the comfort to invest more over this next decade than previously.

Portfolio Activity:¹³

The Fund had one corporate action, one increases, zero decreases, zero additions and three exits in the portfolio during the quarter. This quarter, the Fund saw a corporate action revolving around United Technologies which merged with Raytheon Technologies and spun off Otis Worldwide. We received shares in the newly formed Raytheon (after United was no longer) and in Otis. Additionally, the Fund increased its exposure to Marriott International as the FPA portfolio management team believes people will travel again in the future. The Fund saw exits from JD.com, Royal Bank of Scotland and Toyota Industries. The main driver behind the exits was to rebalance the portfolio into higher quality businesses.

Portfolio Profile:

There are currently 34 equity positions in the Fund, with the top five holdings comprising 27.5% and the top 10 comprising 46.8% of the portfolio. The top three sectors, based on GICS sector classification, are Communication Services, Financials, and Information Technology, which comprise over 60% of the Fund. The Fund has been able to find opportunity outside of the U.S. and, as a percentage of equity, currently has 33.3% non-U.S. exposure and 66.7% exposure in the U.S.¹⁴

¹² Source: CapIQ, Factset, Bloomberg, FPA calculations. As of June 30, 2020. The earnings yield refers to the earnings per share for the most recent 12-month period divided by the current market price per share.

Past performance is no guarantee, nor is it indicative, of future results.

¹⁴ The information provided does not reflect all positions purchased, sold or recommended by FPA during the quarter. It should not be assumed that an investment in the securities listed was or will be profitable. Increases and decreases represent securities whose position size changed by at least 25% over the period and represent greater than 0.50% of the portfolio. Any exited position mentioned was fully removed, regardless of its representative portfolio size. Portfolio composition will change due to ongoing management of the Fund.

¹⁴ 'As a Percentage of Equity' excludes cash and cash equivalents. Portfolio composition will change due to ongoing management of the Fund.

30,000' View

We believe that irrational behaviour has once again entered pockets of the market. We also believe that the Fund owns good businesses at good prices, though their stock prices appear dwarfed at the moment by the unnaturally levitating shares of businesses with unproven operating models.

Faith-based investing has a chequered history, whether it be blind faith in a charismatic CEO or in central bankers around the world.

Having set zero-bound interest rates in most parts, central banks have successfully forced the move into riskier assets, but that has failed to translate into real economic growth. Those who started with an investment portfolio are generally wealthier, while those who did not are generally worse off. Central bankers have spiked the Kool-Aid punch bowl, widening by fiat the gap between the Haves and Have Nots.

Negative interest rates take money away from savers and lenders and give it to borrowers and investors, including speculators. In one shocking example, Louis Vuitton SE ("LVMH") acquired Tiffany for \$16 billion, selling \$10 billion of bonds to finance its purchase. Even the longest maturity of the bonds it sold, a tranche with an 11-year maturity, promised a yield of just 0.43%. As if that wasn't stunning enough, the European Central Bank has snapped up about 20 percent of European bond issues that meet certain qualifications, which this new LVMH debt appears to meet. Two of the five LVMH tranches denominated in Euros were even sold with negative yields – in other words, the holders of these bonds are literally paying Bernard Arnault, LVMH's largest shareholder and the richest man in a country with historically left liberal leanings, to buy into a foreign-based luxury brand at a time when Covid-19 has vastly diminished consumer appetites.

When money costs almost nothing, or even less than nothing, it perverts price discovery. If there is no cost of capital, then one theoretically can pay an infinite price for assets, which creates a difficult backdrop for investors such as ourselves who insist on a margin of safety.

The pandemic has brought the global economy to its knees. How long it will take the economy to reopen and what the world might look like when the economy does revive remains in question. We believe there will be no high interest rates in the years to come. Governments have an imperative to keep rates low, if for no other reason than minimizing budget damage. As a result, a portfolio light on risk assets might be disadvantageous.

Crisis foments change, and a new economic order can translate into a new social order. Currently, there is movement in the United States to establish greater equality, racially and financially. The coming U.S. elections are a cipher at this point. It's impossible to know which presidential candidate will win or what the ramifications might be if one were to remain in office or the other were to take over. We think the more significant variable could be the Senate races. If the Senate were to flip to the Democrats, we can expect higher personal and corporate taxes together with more generous and costly social programs, and an attendant increase in Federal deficits and the U.S. national debt. This would likely put an even more significant crimp in our economy, and we don't think the markets yet appreciate that. This, along with more attractive valuations outside the United States, further supports our continuing investment overseas.



Conclusion

The portfolio management team believes what one pays for a business shall guide returns. They will continue to prudently manage your portfolio.

None of us have seen anything like this, with so many businesses closed, people afraid to leave their homes, necessary socialization hijacked, and the loss of life. As Frodo said in J.R.R. Tolkien's *The Fellowship of the Ring*, "I wish it need not have happened in my time."

"So do I," replied Gandalf, "and so do all who live to see such times. But that is not for them to decide. All we have to decide is what to do with the time that is given us."



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FEES

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