NEDGROUP INVESTMENTS

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NEDGROUP INVESTMENTS FINANCIALS FUND

Quarter Two, 2020

Nedgroup Investments Financials Fund

Performance to 30 June 2020	Nedgroup Investments Financials Fund	ASISA SA Equity Financials
Q2 2020	11.8%	12.7%
12 Month	-29.5%	-33.3%

Source: Morningstar

Market commentary

While economies worldwide have taken a knock, global equity markets had one of the best quarters in stock market history. Markets jumped as governments and central banks announced unprecedented spending and liquidity support for the economy. On a total US dollar return basis - the S&P 500 Index gained 20.4% (it's third highest quarterly return in over 40 years), the MSCI World Index 19.4% and the MSCI Emerging Markets Index 18.1%. Despite some volatility during the quarter, yields on US 10-year maturity government bonds closed the quarter at similar levels as prevailed at the beginning of the quarter. The yield on 10-year German bonds, which are amongst the lowest risk bonds in Europe, ended the quarter at -0.4% (similar to the rate that prevailed at the start of the quarter).

In the second quarter headlines have focussed on the daily tally of Covid-19 deaths, vaccine trials, lock downs and, finally, on the scale, frequency and consequences of unprecedented interventions by monetary authorities and lawmakers to support economies shuttered by lockdowns.

The US again proved to be the most flexible labour market in the world. Before the pandemic drove the US into recession, the unemployment rate was at a 50-year low of 3.5%. In April over 20 million Americans were laid off and unemployment reached 14.7%. By June, 8 million jobs had been created and unemployment in the US fell to 11.1%.

Fund performance, contributors & detractors for past quarter

Whilst global markets (and the JSE) rebounded strongly in Q2, South African financials lagged, the FTSE/JSE Financial 15 Index gaining only 7% (compared to the MSCI World Financials' +12.9%). The main reason being the country's pre-Covid-19 high budget deficit and debt/GDP ratio. This means the South African government simply hasn't got the firepower available, compared to most other countries, to financially help companies (especially SMEs) and individuals badly affected by the lockdown. At the same time, despite the SARB lowering interest rates (which helps consumers and corporates), the government's cost of borrowing hasn't really come down.

The biggest contributors to performance were Sanlam (30% of earnings generated outside South Africa) and the investment in the Denker Global Financial Fund whilst Nedbank rebounded from an extremely oversold valuation. Shares like the JSE, Coronation and Sanlam benefitted from the market rebound.

Top 5 Contributors	Weight Mean (%)	Return in Rand	Contribution in Rand
Sanlam Ltd	12.94	22.74	2.90
Denker Global Financial Fund	20.87	11.90	2.48
JSE Ltd	7.54	20.49	1.60
PSG Group Ltd	6.30	23.00	1.41
Nedbank Group Ltd	3.96	33.13	1.08

Top 5 Detractors	Weight Mean (%)	Return in Rand	Contribution in Rand
Santam Ltd	4.53	0.70	0.04
Investec	5.50	0.50	0.03
Cash	2.20	0.40	0.02
Trematon Capital Investments Ltd	1.27	-22.22	-0.46
Sasfin Holdings Ltd	3.17	-14.80	-0.74

Sasfin and Trematon were negatively affected by the effect of lockdown on SMEs and the property sector and despite being exceptionally undervalued, they won't re-rate until the market sees proof of an economic turnaround.

Portfolio changes, current positioning and outlook

Sadly, the outlook for the South African consumer remains bleak with unemployment expected to continue to rise which will undoubtedly have an effect on banks' bad debts charges. At the same time lower interest rates will negatively affect net interest margins, although they will counter the cost of bad debts somewhat. We continue to believe that this is an environment which favours financially and operationally strong companies. Hence, we made only minor changes to the portfolio during the quarter, reducing the fund's investment in Sasfin and selling PSG Konsult and using the proceeds to buy PSG. The cash we held at the beginning of the quarter was used to increase our Nedbank, Standard Bank and Investec positions.

The fund's largest investments are in managements that have proven track records of growing shareholder value. In that regard, we kept the FirstRand shares that were unbundled from the RMBH unbundling making FirstRand a 14% position, followed by Sanlam (13%).

The four predominant South African banks have been sold down from an average P/NAV of 1.86x on 31 December 2019 to the current 1.07x. Yet, our forecast shareholder value growth has only come down from 19% for the year ended December 2019 to 14% for the year ended December 2020, and potentially 16% for December 2021.

We think the market is missing the fact that lockdown actually increased the demand for credit, which will increase the banks' revenue streams. The question is, how much of this growth will be taken away by provisions for bad debts? Our banks are all well capitalised and this recession didn't follow after a lending bubble (as recessions normally do). So, whilst banks' bad debts will increase substantially, we don't think it will be as bad as the market expects

The valuation drop signals the uncertainty regarding the SA economic environment for the next few years. Based on the quality of the SA banking sector and management teams we think the rating is unjustified, but the uncertainty about future growth justifies it.

Conclusions

We do believe banks will continue to grow shareholder value in both 2020 and 2021 but a re-rating is dependent on a number of factors, most important being factors that would simultaneously reduce South Africa's unemployment rate and government debt levels.

The months ahead will test South Africans and the business models of the banks, as well as highlight which banks and insurers are really 'best-in-class'.

Responsible investment comments

Standard Bank has been in the news recently for its continued fossil fuel project financing while other banks have started extracting themselves from this type of financing. This resulted in Standard Bank coming under pressure due to the supposed lack of independence of directors who also serve as directors on companies involved in the fossil fuel industry. This has caused Standard Bank's ESG score to plummet from 84 to 27. Similarly, the ESG scores for a large number of banks in the global space have come down significantly during 2020.

While we watch the scores of each individual counter and test them against what managements and the investment community tell us, the large quarterly swings in the scores do highlight the industry's difficulty in rating banks and insurers. The philosophy and practices of a board and management team don't deteriorate or improve so much over short periods. Our interactions with managements show that their ESG policies are consistent and the focus is on continuous incremental (positive) changes. The COVID-19 lockdown and recession will highlight the strength and weaknesses of the business models and policies, including governance.

In this regard we prefer managements who apply their minds to problems rather than simply wanting to be able to achieve short-term positive ticks on a checklist. In the case of Standard Bank, we know the management team and board are grappling with their involvement in the fossil fuel industry and trying to make decisions that are responsible in terms of the environment and shareholders.

Experienced and wise directors are difficult to find, especially ones with the experience of someone like Jacko Maree (Standard Bank's deputy chairman and non-executive director, whom I believe is someone of the highest integrity). We would see it as a negative if he were to terminate his directorship.

Disclaimer

WHO WE ARE
Nedgroup Collective Investments (RF) Proprietary Limited is an authorised Collective Investment Scheme and the representative of Nedgroup Investments Funds PLC in terms of the Collective Investment Schemes Control Act. It is a member of the Association of Savings & Investment South Africa (ASISA)..

OUR TRUSTEE
The Standard Bank of South Africa Limited is the registered 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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Some funds may hold foreign securities including foreign CIS funds. As a result, the fund may face material risks, which could include foreign exchange risks, market conditions and macro-economic and political conditions.

A fund of funds may only invest in other funds, and a feeder fund may only invest in another single fund, both will have funds that levy their own charges, which could result in a higher fee structure.

The Nedgroup Investments Money Market Fund offering aims to maintain a constant price of 100 cents per unit. A money market fund is not a bank deposit. The total return to the investor is made up of interest received and any gain or loss made on any particular instrument held. In most cases the return will merely have the effect of increasing or decreasing the daily yield, but in an extreme case it can have the effect of a capital loss. Excessive withdrawals from the fund may place the fund under liquidity pressures and that in such circumstances a process of ring-fencing of withdrawal instructions and managed pay-outs over time may be followed. The yield is calculated using an annualised seven day rolling average as at the relevant dates provided for in the fund fact sheet. Nedgroup Investments has the right to close its funds to new investors in order to manage it more efficiently.

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