NEDGROUP INVESTMENTS

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# Nedgroup Investments Global Cautious Fund

Quarter Two, 2020

## Nedgroup Investments Global Cautious Fund

| Performance to 30 June 2020 (USD) | Fund[1] | Target Return[2] | Peer Group[3] |
|---|---|---|---|
| 3 months | 4.2% | 0.2% | 7.0% |
| 12 months | -0.5% | 1.7% | 1.6% |

**Market overview**

The bounce occurred in risk assets and it had nothing to do with investment fundamentals. Stimulus measures and targeted relief packages alongside an easing of lockdown restrictions, continue to dominate market returns despite the headlines of concentrated spikes in coronavirus cases. The easing of lockdown restrictions is a crucial lifeline to many sectors but optimism around a rebound in earnings is running far ahead of a rebound in sales and earnings.

The scale of the government packages is remarkable. The IMF has calculated that as of mid-May the COVID-19 induced additional monetary deployment amounted to a staggering $9 trillion in the G20 economies. With governments throwing staggering sums of money at the 'problem', fiscal deficits attain dimensions that are without precedent. Some countries have fiscal space because overall government debt levels are relatively modest (Germany and Australia are examples), but most countries are not in this favourable position.

Central banks began their quantitative easing experiment by buying government bonds, but they now view any type of security as ripe for buying. In the US, apart from Treasuries, the Fed has announced that it will be buying corporate bonds. Half of these will be at the lowest investment grade (BBB) - just one step from 'junk' and perilously close to slipping into that category. The other key central banks in the world are also piling on the dollars although the rate and scale of expansion by the Fed dwarfs them.

The impact of the lockdown has varied by industry, but the most adverse impact has been in the areas of accommodation and food services, arts, entertainment, and recreation. The OECD estimates that shutdowns in these industries averaged 70— 80% across most countries. Retail sales statistics have racked up record falls everywhere.

In the Eurozone industrial production has dived by almost 30%, with exports down a similar percentage, outstripping the decline seen over the GFC. In Japan retail sales volumes have dived to a level significantly lower than 30 years ago whilst real household living expenditure has maintained a steady downward trajectory but with a spectacular fall in the latest quarter.

In the US, unemployment has accelerated to 14% from a level that was getting close to equalling a 70-year low. As the various States sporadically and unevenly reopen there will be a bounce back from this shocking number but in common with many other countries there will be some who will choose to accept the variety of government hand-outs in preference to re-entering the workforce.

**Fund performance**

As equities fell sharply in March and value started to emerge, Pyrford began buying equities, finishing the first quarter with a weighting of 30%. In the second quarter, as equities rebounded the Pyrford equity portfolio produced strong returns for our investors with both US (+18.9%) and Non-US overseas equities (+15.6%) contributing. The equity position was trimmed back to 25% later in the second quarter as discussed further below.

The following table highlights the top 5 equity contributors and bottom 5 equity detractors over the quarter:

[1] Net return for the Nedgroup Investments Global Cautious Fund, A class. Source: Morningstar (monthly data series).
[2] US Libor 1 month
[3] Morningstar EAA Fund USD Cautious Allocation

| Top Performers | Country | Performance contribution | Bottom Performers | Country | Performance contribution |
|---|---|---|---|---|---|
| Woodside Petroleum | Australia | 33.0% | VTech Holdings Ltd. | Australia | -16.9% |
| Texas Instruments | USA | 28.1% | China Mobile | USA | -6.7% |
| Rockwell Automation | USA | 41.6% | BP | USA | -8.5% |
| T. Rowe Price Group | USA | 27.2% | Philip Morris Int. | USA | -2.4% |
| Lowe's Cos Inc. | USA | 57.6% | Singapore Telecom | Singapore | -1.1% |

*Note the contribution to portfolio return is weighted by 25%.

In the US, stock markets had one of their best quarters in history rising nearly 20%. Defensively oriented sectors such as consumer staples and utilities lagged the market rebound. On the reverse more cyclical sectors such as technology, energy and materials outperformed the market. Some of the better performing companies in the portfolio during the quarter included Rockwell Automation, Texas Instruments, and T Rowe Price. Rockwell Automation (Industrials) benefited from a more positive view on the US economy and the fact that it is seen as a beneficiary of the reshoring of manufacturing capacity back to the US. Texas Instruments (Technology) performed well as it is levered to industrial production and because it reiterated a commitment to maintaining and growing its dividend. Finally, T Rowe Price (Financials) performed well as it increased its dividend and showed stable assets under management during the previous quarter.

Some of the poorer performing companies in the portfolio during the quarter were in the consumer staples sector. Philip Morris International and Altria (both in the consumer staples sector) lagged the market as investors focused on companies and sectors that were more levered to an improving economy. Both companies currently offer extremely competitive dividend yields in relation to not only global equity markets but also bond markets.

Outside of the US, Pyrford's overseas equities produced strong absolute returns over the period. The largest two overseas contributors came from Australia, with Woodside Petroleum and Computershare both outperforming. The performance of Woodside has been driven by two factors. The partial recovery of the oil price and a more positive outlook for growth at the company. Although Woodside has delayed decision making on two key greenfield projects, it may now have the opportunity to acquire an increased stake in the well-established North-West Shelf project which it operates, as one of its joint venture partners has announced their plans to sell their stake. Computershare has also benefited from a more positive view on the company's earnings outlook. The company performed badly at the start of the Covid-19 crisis as interest rate cuts had a direct impact on the "margin income" earned by the company as services like dividend processing were executed. In the months since, the company has been able to highlight improvements in other, counter-cyclical businesses such as bankruptcy administration and corporate actions which the market has taken well.

The largest detractors both came from Hong Kong listed companies, Vtech and China Mobile. Vtech reported strong numbers for their FY2020 which ended on 31st March. However, owing to a lack of visibility on earnings for this year, and reflecting the company's innate conservatism they elected to cut the dividend pay-out ratio to 75%. The reduced dividend leaves the company with a yield still over 8% and with no debt and the equivalent of 1 year's profit in cash on the balance sheet, the current environment may give the company the opportunity to grow through acquisition. With China Mobile there has been no significant news from the company during the quarter. The increasingly belligerent relationship between the US and China however, including the US suggestion that the company was controlled by the Chinese military, has caused some share price weakness.

Outside of equities, government bond yields were flat over the quarter. Within this environment, the US bond portfolio returned +0.1% over the quarter. The overseas bond portfolio (UK, Canadian and Australian) returned 5.0% as the US dollar weakened by 4.3% against the Canadian dollar and 11.1% against the Australian dollar. The Australian dollar exposure is hedged however so this returned is largely cancelled out within our currency hedging programme. The US dollar was flat against the UK pound.

## PORTFOLIO CHANGES / OUTLOOK

The current model allocation is 25% equities, 72% bonds and 3% cash. Following an increase in the portfolio's exposure to equities in the first quarter, the Investment Strategy Committee (ISC) took the decision in June to reduce equities again back to 25%. The ISC noted that in the time since the exposure to non-US equities was increased on 12th March, the MSCI EAFE index had risen over 20%. Over the same period dividends have been cut by more than 25%. As a result, the dividend yield on the index is now 2.9%, much lower than when the equity weighting was increased and lower than prior to the COVID-19 crisis. As a result, the committee agreed to reduce the equity weighting by 5ppts to 25% but to keep the US equity weighting flat through the change.

Our positioning in bonds remains the same. Pyrford continues to adopt a very defensive stance by owning short duration securities in order to protect the capital value of the portfolio from expected rises in yields. At the end of the quarter the modified duration of the fixed income portfolio stood at just 1.0 years. While these very short duration bonds are unlikely to yield high returns they will provide significant capital protection for the portfolio and importantly they are highly liquid. In the quarter there were no further changes to the overseas bond portfolio. 42% of the portfolio is invested in overseas bonds, with 15% in the UK, 16% in Canada and 11% in Australia. The remaining bond portfolio is invested in US Treasuries.

The equity portfolio is positioned in traditionally defensive sectors which offer predictable revenue streams and attractive valuations. The focus of the portfolio is on balance sheet strength, profitability, earnings visibility and value. In the quarter one stock was added, Power Assets Holdings (Hong Kong) and one stock was sold Total (France).

Power Assets Holdings, formerly Hongkong Electric Holdings Limited, is a vertically integrated utility company based in Hong Kong. Through its subsidiaries, the company invests in regulated infrastructure assets with a focus on gas and electricity utilities. In addition to its operations in Hong Kong the company owns assets in Australia, Canada, New Zealand, Thailand and UK. The company's earnings are driven by the need to maintain reliable performance from critical national infrastructure. The strength of its balance sheet presents the opportunity to grow these earnings by acquisition.

Total was sold as massive and unprecedented demand and supply shocks, and political pressure, has put the dividend at risk. In addition, the breakdown of OPEC+ and a prolonged period of marginal cost pricing is a possibility plus there is a global political consensus away from polluting fuels and towards renewables. Total is onboard with this and is spending significant capex on areas where its competitive advantages are questionable and returns are structurally lower.

Finally, there was no change to the unhedged non-USD exposure in the portfolio over the quarter. Forty-five percent (the maximum level) of the portfolio remains exposed to unhedged foreign currencies, representing the view that the US dollar is a very expensive currency and we expect it to fall based on our Purchasing Power Analysis. If the currency does fall, the portfolio will benefit.

### Conclusion

The investment world continues to digest the threat that coronavirus (COVID-19) poses to the world economy. Global supply chains remain fragile and global demand has been decimated whilst governments scramble to understand and contain the virus. The length of national lockdowns is uncertain and whilst some lockdown measures are easing, close attention will be paid to a second wave of cases.

What is undeniable is that a big slice will be taken off world growth. The consensus view among investors was for a sharp economic rebound but this view seems increasingly questionable. It is impossible to time the bottom as each crisis is different, this one certainly is unprecedented. It is no surprise that governments and central banks around the world are responding to try to offset this negative shock.

Central banks have moved to ease monetary policy but have little room to cut rates further hence the raft of large-scale fiscal spending plans that continue to be announced.

The private sector in most advanced economies is heavily leveraged as is the government sector. Central banks are effectively acting as the buyer-of-last resort and adding staggering sums to their already bloated balance sheets. Many government bond markets will end up being largely owned by their central banks.

Valuations reflect the view that earnings growth will recover over 2021 despite continued uncertainty on the duration of a recovery and the impact of unprecedented government borrowing. As we've discussed before, such swift and sizeable rescue packages were a necessity, but they come at a price. A legacy of greater debt and challenging demographics suggests global growth will remain subdued for many years.

Investors are looking through the pandemic and disappointing earnings announcements to 2021 to justify pushing equity valuations higher despite the reduction in corporate profits and dividend payments. We admire the optimism, but it is premature. The economy and the stock market have totally disconnected and, with familiar geo-political issues returning to the fore, opportunities for continued volatility through the end of the year remain.

**RESPONSIBLE INVESTMENTS COMMENTS**

As long-term shareholders of companies, we have the ability, and in our view the responsibility, to try and influence the business practices of companies.

In the quarter Pyrford voted 1576 ballots in 65 company meetings. We voted against management in 52% of meetings. All voting records and rationale are available to view on our website (www.pyrford.co.uk), contained within our responsible investment section.

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