



see money differently

A photograph of an open book with white pages, tied with a white string bookmark. The book is open to a blank page, and the pages are slightly curved, suggesting it is being turned or held open.

## Nedgroup Investments Global Flexible Fund

Quarter Two, 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 <sup>#</sup><br>p.a. |
|------------------------------------|----------|--------|--------------|--------------|--------------------------------------|
| Portfolio <sup>*</sup>             | 13.93%   | -4.28% | 1.45%        | 3.22%        | 4.02%                                |
| Performance indicator <sup>+</sup> | 12.83%   | 3.46%  | 5.53%        | 5.48%        | 5.48%                                |
| MSCI World Index                   | 19.36%   | 2.84%  | 6.70%        | 6.90%        | 8.02%                                |

\* Net USD return for the Nedgroup Investments Global Flexible Fund, A class. Source: Morningstar

<sup>#</sup> Since FPA appointment as sub-adviser on 17 June 2013

<sup>+</sup> 60% MSCI World, 30% JPM Global Bond, 10% US Cash.

### Summary points

- The significant global equity market rebound was driven by US equities and reflected proportionately in the fund's quarter two return.
- Equities are expensive, but the companies in the portfolio have more growth and better balance sheets than the stock market overall.
- Six headwinds faced over the last market cycle could become tailwinds in the near future.
- The fund's equity holdings continue to trade at a significant discount on forward P/E and Price/Book relative to the broader market.
- The optionality of cash is attractive but given the increase of global money supply and interest rates near zero, the portfolio managers are reluctant to hold too much dry powder.
- When money costs zero or less, it perverts price discovery. If there is no cost of capital, then one theoretically can pay an infinite price for assets.
- Owning higher quality businesses gives the team the comfort to invest more over this next decade.
- Lack of attractively priced high yield bonds due to yield seekers and government buying.

### 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 even truer today, yet in the second quarter, the market made one of its larger quarterly moves.

The global MSCI World Index advanced 19.4% in the second quarter, while the US market represented by the S&P 500 Index increased 20.5%, erasing the majority of the year-to-date decline to March's trough. The Nedgroup Investments Global Flexible Fund increased 14.1% over the same period.

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% contraction<sup>1</sup>.

<sup>1</sup> Source: The World Bank, Global Economic Prospects, June 2020.

Although you wouldn't know it from the popular indexes, this darkened outlook has pushed the average stock down 10.92%<sup>2</sup>. Economic data suggests we won't return to normal in the near future (see Exhibit A).

#### Exhibit A: Select Economic Data/Indicators

|  | 12/31/2019<br>unless indicated | 6/30/2020<br>unless indicated |
|--|--------------------------------|-------------------------------|
| <b>GDP estimated growth 2020/2019</b>                |                                |                               |
| US   | 1.8%                           | -6.1%                         |
| Global   | 2.5%                           | -5.2%                         |
| <b>U.S. unemployment (%)</b>                         | 3.6%                           | 11.1% <sup>3</sup>            |
| <b>Oil (WTI \$/barrel)</b>                           | \$61                           | \$39                          |
| <b>Hotel occupancy<sup>4</sup></b>                   |                                |                               |
| Asia Pacific   | 66.6%                          | 35.8%                         |
| Europe   | 66.9%                          | 31.9%                         |
| Americas   | 80.7%                          | 30.6%                         |
| Middle East and Africa                               | 64.4%                          | 13.3%                         |
| <b>Residential mortgages in forbearance</b>          | 0.25% <sup>5</sup>             | 8.5% <sup>6</sup>             |
| <b>US deficit – 2020 estimated<sup>7</sup></b>       | \$1.0tn                        | \$3.7tn                       |
| <b>US national debt – 2020 estimated<sup>8</sup></b> | \$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.

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

<sup>3</sup> Source: The Bureau of Labor Statistics, as of June 1, 2020.

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

<sup>5</sup> 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>.

<sup>6</sup> 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>.

<sup>7</sup> 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.

<sup>8</sup> 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. And thanks to unprecedented US government involvement in the country's corporate debt markets, high-yield bonds also have not presented the opportunity that one might have expected. 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                     | 1.11%                    | 5.20%                | Wells Fargo & Co      | -0.15%                   | 1.44%                |
| Analog Devices               | 0.95%                    | 2.69%                | Swire Pacific Limited | -0.10%                   | 0.59%                |
| Broadcom                     | 0.89%                    | 2.75%                | Raytheon Technologies | -0.07%                   | 0.48%                |
| Facebook, Class A            | 0.78%                    | 2.38%                | O-I Glass             | -0.04%                   | 0.02%                |
| American International Group | 0.72%                    | 2.62%                | Jardine Strategic     | -0.02%                   | 0.51%                |
| <b>Total:</b>                | <b>4.44%</b>             | <b>15.64%</b>        | <b>Total:</b>         | <b>-0.38%</b>            | <b>3.04%</b>         |

### Contributors and Detractors – 12 Months to 30 June 2020

| Contributors           | Performance contribution | Percent of portfolio | Detractors                       | Performance contribution | Percent of portfolio |
|------------------------|--------------------------|----------------------|----------------------------------|--------------------------|----------------------|
| Alphabet               | 1.25%                    | 4.6%                 | American International Group     | -1.32%                   | 3.3%                 |
| Microsoft Corp         | 0.84%                    | 1.8%                 | Howmet Aerospace                 | -1.30%                   | 2.8%                 |
| Broadcom               | 0.65%                    | 2.5%                 | CIT Group                        | -1.20%                   | 1.5%                 |
| Charter Communications | 0.64%                    | 2.2%                 | McDermott Intl (multiple issues) | -0.85%                   | 1.0%                 |
| Facebook, Class A      | 0.54%                    | 2.2%                 | Ally Financial                   | -0.71%                   | 0.6%                 |
| <b>Total:</b>          | <b>3.92%</b>             | <b>13.32%</b>        | <b>Total:</b>                    | <b>-5.38%</b>            | <b>9.15%</b>         |

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% of them do lose money).<sup>9</sup>

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.<sup>10</sup>

#### Exhibit C: The Fund’s equity holdings Valuation and Earnings Growth vs Stock Market<sup>11</sup>

|                    | Price/Earnings<br>1 Year Forward |             | Price/Book |            | 3-Year Historic<br>EPS Growth |              | 3-Year Forecasted<br>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    |
| NGFF - Equity Only | 14.5                             | <b>20.6</b> | 2.7        | <b>3.4</b> | 20.7%                         | <b>13.9%</b> | 27.3%                           | <b>18.7%</b> |
| S&P 500            | 18.1                             | <b>24.9</b> | 3.3        | <b>3.5</b> | 11.8%                         | <b>6.5%</b>  | 9.8%                            | <b>10.6%</b> |
| MSCI World         | 15.6                             | <b>20.4</b> | 2.4        | <b>2.5</b> | 11.6%                         | <b>4.5%</b>  | 9.5%                            | <b>10.7%</b> |
| MSCI ACWI          | 16.2                             | <b>21.9</b> | 2.3        | <b>2.3</b> | 11.2%                         | <b>3.5%</b>  | 9.7%                            | <b>11.1%</b> |

The Fund’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, we would expect the relationship between valuation and growth to support improved performance, but of course, there are no guarantees and the disconnect may continue to try investors 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 above, both the trailing and forecasted consensus 3-year EPS growth is higher than the market.

There are several variables that make these Wall Street consensus numbers far from precise, but directionally, they suggest that the fund’s equity portfolio is (and has been) less expensive than the market. In

<sup>9</sup> 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.

<sup>10</sup> 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.

<sup>11</sup> 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.

addition, 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.

The portfolio management team remains intent on preserving capital and purchasing power over time, though they acknowledge that the fund's current risk exposure represents a greater concern for the former. The team can understand why price volatility and increased equity exposure may feel incompatible with this goal, but they think that it makes sense to increase the fund's exposure to an equity portfolio with the characteristics as depicted above. The portfolio management team continues to like the optionality of cash, but given the increase of the global money supply and an expressed commitment by central bankers to hold rates near zero, they are reluctant to hold too much dry powder.

If we consider the equity portfolio as depicted in Exhibit C, it trades at a 4.9% earnings yield (earnings/price) on depressed COVID-19 numbers. Assuming the consensus earnings growth of 18.7% over the next three years, then the prospective earnings yield will have increased to 7.5%<sup>12</sup>. If we then assume a more pedestrian 4% growth for the rest of the decade, our equity portfolio would trade at 9.9% yield in year 10, and we will have earned a 2.15% 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 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, although the industry could suffer more than the hotel business. During the downturn we therefore established a position in Marriott stock, but opted to retain our perch atop the capital structure in the cruise industry, purchasing senior secured loans of Carnival Cruises and Royal Caribbean at close to 12 percent yields.

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 investment team believes these recent investments – LG Corp, Swire Pacific, Booking Holdings, Marriott International, NXP Semiconductors, Compagnie Financière Richemont and Wabtec (formerly Westinghouse Air 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.

### **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

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<sup>12</sup> 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.



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. It’s no wonder we have found so few high yield bonds to put into our portfolio.

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 US Federal Reserve and European Central Bank are doing their best to inhibit what should have been (and might hopefully still be) a historic opportunity to buy high-yield debt. However, investors thirsty for yield, coupled with central bank purchase of high-yielding corporate bonds, has propped prices up at higher levels than they otherwise would be.

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 minimising 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 socialisation 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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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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