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NEDGROUP INVESTMENTS MANAGED FUND

Quarter Two, 2020

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Performance to 30 June 2020	Nedgroup Investments Managed Fund A[1]	ASISA category average	SA CPI plus 4%
Q2 2020	13.6%	13.4%	0.8%
Year-to-date	-4.2%	-1.9%	5.5%
12 months	3.7%	0.5%	6.1%

Source: Morningstar

Overview

Global markets are pricing in a V-shaped recovery

Despite a continued rise in US infections and the uncertain impact of global economies reopening, markets have continued to rise. The MSCI World Index advanced by 2.7% in US dollars in June, following positive returns in both April and May. The S&P500 is now only 9% away from its all-time high reached at the beginning of the year.

Various factors have contributed to this recovery. Unprecedented levels of fiscal stimulus and aggressive monetary policy have been key drivers. On balance, economic indices seem to be exceeding expectations. The US ISM index has now risen above 50, a level indicating economic expansion. It appears markets are either discounting a V-shaped recovery or at least looking through to a period post-Covid where economic fundamentals are expected to normalise back to trend growth.

The risks remain that as economies reopen, a second wave of infections may result in further lockdowns, or a consumer retreat if infections spike aggressively. With markets approaching previous highs, and the reality that the stimulus will need to be repaid at least in part from higher tax rates, the US market is not cheap. However, as real bond yields have fallen as a result of aggressive monetary policy and low inflation rates, higher market multiples can now be justified than was previously the case. At some stage, we would expect these yields to rise which will be a headwind for equity markets. We anticipate that markets may well rally further if a vaccine is found. This would most likely benefit emerging markets that have been harder hit by the pandemic and have not performed as well as developed markets.

SA financial markets also recovered over the quarter

Domestic equities enjoyed a strong quarter with the ALSI advancing by 23.2%, wiping out most of the year's prior losses and leaving the ALSI down a mere 3.2% year to date. The advance was led by resource stocks (up 41.3%) followed by industrials (up 16.6%), with financials lagging with a still respectable return of 12.4%. This divergence of returns is not unexpected given the buoyancy of resource prices and the underperformance of the domestic economy. Resource shares are in positive territory year-to-date with a return of 5.7%, while most offshore exposed industrials have also moved into positive ground, with tobacco up 14.4% and the Technology sector advancing 39.3%. Domestically-focused sectors like financials and retailers are still down by 31.7% and 36.2% respectively for the year. The property sector, which returned 20.4% over the quarter, is still down a meaningful 37.6% thus far in 2020. The All Bond Index was up 9.9% over the quarter and up 0.4% since the beginning of the year.

Rising debt and a lack of growth will continue to weigh on the outlook for South Africa

The trajectory of the COVID-19 pandemic in South Africa suggests that the country will be in some form of lock-down for some time to come. This, unfortunately, means that a return to normal economic conditions is not

[1] A-Class

expected this year. This is exacerbated by the fact that SA was in a state of economic crisis before the pandemic. The additional debt incurred from the required stimulus package, coupled with a severe decline in economic activity which places further pressure on government revenue, has worsened the outlook for an already precarious debt-to-GDP trajectory. South Africa, currently one of the most indebted countries in the emerging market universe, could have a debt-to-GDP over 100% by 2025 unless significant cuts are made to government expenditure and economic growth initiatives are undertaken. We hope that the necessary government spending cuts proposed in the budget are implemented in the next year, but this is far from certain. We would also hope to see an uptick in fixed investment, which often seems to be held back by bureaucracy and not only by limited access to financial resources. Value-adding infrastructure projects would help drive economic growth and reduce record unemployment levels.

Domestically exposed sectors such as financials, discretionary retail and property are trading on low valuation multiples assuming a return to earnings to approximating pre-COVID-19 levels. This may well be a generous assumption. Many of these companies were already on downward earnings trajectories before the onset of the pandemic. Their sustainable earnings will now likely be lower, and wider confidence bands will be required for valuation purposes. Although we remain underexposed to these domestic sectors, given the significant underperformance of some counters we have started to purchase select securities where the companies have sufficiently strong balance sheets and their valuations are adequately pricing in the expected tough environment.

A continued recovery offshore will help resource shares listed on the JSE. An on-going recovery in auto demand should help restore deficits in rhodium and palladium, which would be positive for the platinum group metals miners. Chinese stimulus should continue to drive bulk and base metal demand which would help the earnings of diversified miners. An extended delay in the resumption of global travel may well weigh on Richemont’s medium-term prospects, and valuations in the luxury sector remain stretched. Tencent’s resilient earnings growth continues to underpin Prosus, and a potential increase in Prosus’s weight in European stock market indices should provide further support.

Concluding remarks

Risks to global markets remain elevated. We have mentioned the higher taxes to reduce record debt levels and uncertainty regarding the ultimate impact of the Covid pandemic, but geopolitical tensions between the major powers and within countries are also ever-present. Markets are being buoyed by current record low real bond yields but this could turn into a headwind if inflationary pressure returns and higher rates are required. These risks, coupled with a fragile domestic economy, inform our moderate exposure to risk assets in the portfolio. However, despite these risks, there are still sectors which have reasonable economic prospects and shares that offer value. As a result, we expect our portfolio to generate inflation-beating returns going forward.

Portfolio positioning

The significant fall in many shares prices over the first quarter of 2020 provided us with cheap entry points into a number of well-capitalised companies whose earnings should revert to their pre-COVID-19 levels. Some of these domestically exposed businesses include Woolworths, Liberty, Telkom, Cashbuild and Astral. Sasol Ltd fell aggressively with the oil price collapse. The share was pricing in the continuation of an unsustainably low oil price, and this provided a cheap entry point despite its balance sheet concerns. The portfolio reduced its exposure to tobacco to fund many of the above purchases, as well as switching out of Goldfields into Harmony, given the latter’s cheaper valuation. There was also a switch from Absa into FirstRand and Standard Bank which should prove more defensive.

Performance commentary

The fund’s position in Sasol contributed to performance as the oil price recovered from extremely depressed levels and the extent of a required rights issue was reduced. The position in the PGM and gold miners was a net contributor to performance. Naspers contributed to performance on the back of strong earnings from internet gaming and related businesses during the pandemic.

British American Tobacco and African Rainbow Minerals also contributed to performance. RECM and Calibre prove the main detractor, as the effect of lockdown negatively impacted the limited pay-out machine industry.

Top contributors	Ave. weight	Performance contribution	Top detractors	Ave. weight	Performance contribution
Naspers Ltd	6.4%	1.9%	RECM & Calibre Ltd	1.3%	-0.8%
Sibanye Stillwater Ltd	2.7%	1.8%	FirstRand Ltd	1.8%	-0.2%
Sasol Ltd	0.9%	1.7%	Netcare Ltd	2.3%	-0.2%
British American Tobacco plc	7.7%	1.5%	FirstRand 2024 bond	4.2%	-0.1%
African Rainbow Minerals Ltd	2.1%	1.2%	Absa 2025 bond	1.1%	-0.1%

Responsible investing

Truffle Asset Management met with Sasol on 29 Jan 2020 and the purpose of the meeting was primarily of a technical nature to establish the chemical processes that contribute the most to CO_2 emissions and what processes could be introduced to mitigate these emissions.

The meeting was essentially a discussion around the Sasol Limited 2019 Climate Change Report. In this report Sasol has committed to a 10% reduction in CO_2 emissions off the 2017 base by 2030. Clearly, given the magnitude of Sasol's total CO_2 emissions, this is not enough and will require a significantly greater reduction to satisfy investors and society at large. The meeting was therefore to discuss the next available steps and the technology required.

The GTL (gas-to-liquids) Fischer Tropsch process, Natref, and the chemicals production operations are not inherently the major polluters. The main culprit with regard to CO_2 emission is the hydrogen plant. This plant produces gaseous hydrogen from coal in a process that combines coal with oxygen to produce hydrogen and CO_2 via an intermediate CO production process. The carbon content of coal is captured by oxygen to produce CO_2 that is released to the atmosphere. The problem is that the mass of the carbon content in the coal is about 10-times the mass of hydrogen and therefore the CO_2 by-product production is huge relative to the hydrogen produced. The remaining hydrogen is used as a feedstock in the GTL plant producing liquid fuels. The hydrogen plant produces the bulk of Sasol's 65 mtCO2e per annum emissions.

The company has two options with regard to lowering their CO2 emission over the long term:

The first option is to capture the carbon, preventing the gas from being released into the atmosphere. This option is not economically feasible as the CO_2 molecule is very stable and would require a huge amount of energy to separate out the carbon. This option therefore remains only a remote possibility at present.

The second option is to produce hydrogen via the electrolysis process. This process would use electricity instead of burning coal. The feedstock would be water and would produce oxygen as a by-product producing zero emissions. The technology is proven and available but the decision rests on the financial viability of the project. It is likely that Sasol will be forced down this route at some point.

Sasol has committed to producing a comprehensive report on their climate change mitigation strategy by November 2020. This report will ventilate all Sasol's options giving guidance regarding future strategy and the environmental and financial implications thereof. Clearly this report will be critical in assessing Sasol's long-term potential to reduce emissions in compliance with the 2016 Paris Climate Agreement.

Disclaimer

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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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