NEDGROUP INVESTMENTS

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NEDGROUP INVESTMENTS FLEXIBLE INCOME

Quarter Three, 2020

Performance to 30 September 2020	Fund Performance[1]	Stefi*110%
3 months	1.9%	1.0%
12 months	5.5%	5.8%

The fund had a good Q3 2020 outperforming the benchmark. Convertible bonds were the biggest contributor, followed by currency hedges that protected our foreign holdings as the rand strengthened against the US dollar. Floating rate notes and inflation-linked bonds also contributed to performance. Listed property and preference shares both detracted from performance as they continued to come into significant selling pressure.

Over the longer term the Nedgroup Investments Flexible Income Fund has delivered on its mandate to outperform cash with a predictable and low risk return profile. Its long-term performance is attributable to its philosophy of investing in a diversified range of fixed income asset classes, avoiding expensive asset classes and focusing on high credit quality.

Market Commentary

While some volatility persisted in Q3 2020, the market was generally far calmer over the quarter compared to the historically extreme moves we saw earlier in the year. The reality of second waves of Covid-19 and the uncertainty around the US election failed to derail global markets The US 10-year was 2bps weaker at 0.68%. The SA 10-year bond weakened 16bps to 9.41%. The rand was 3.47% stronger against the US Dollar and 0.54% stronger on a trade weighted basis. Inflation Linked Bonds, Cash and Preference Shares returned 1.00%, 0.91% and -4.83% respectively. Listed Property returned -14.13% as concerns around solvency and declining physical property valuations continued to plague the sector. Work-from-home and declining disposable income hit office demand and retail sales respectively. The JSE All Share Index returned 0.67% while the S&P 500 returned 8.93%, 2.90% below the all-time-high set during the quarter. The US dollar was 3.49% weaker on a trade-weighted basis. The VIX, also known as the fear index, averaged 25.8 in the quarter down from an average of 34.5 in Q2 2020.

Monetary and Fiscal Policy

In an attempt to support the SA economy, SARB Governor Lesetje Kganyago cut rates another 25bps to 3.5% in July for a total of 300bps since the start of the pandemic, bringing the repo rate to multi-decade lows. In the September MPC meeting the SARB decided to keep rates on hold despite worsening growth expectations since their modeling showed a reduction in potential economic growth (leading to a falling output gap), which diminishes the usefulness of further rate cuts. SARB's bond purchases continued to fall and they are now no longer material. Fortuitously the SA bond market continues to function relatively well with significantly improved liquidity. The fact that the SARB has pledged as much support as is necessary to keep the banking system functioning and has continued to provide calm to the market.

The US Federal Reserve adjusted its forward guidance to further ease financial conditions having already cut rates to effectively 0% and embarked on enormous asset purchases, leaving little room for them to do anything else. The adjusted forward guidance was two-fold. Firstly, they will now target average inflation, implying that they will allow inflation to run above the 2% target for a time to compensate for periods where inflation fell below the target. Secondly, they will seek to reduce the jobs shortfall as opposed to maximizing the level of employment on aggregate. This means they will not only look at the aggregate unemployment rate, but also at unemployment within various demographics and sectors of the economy. As far as actual forward guidance of the federal funds rate goes, the FOMC expects rates to remain near 0% for the entire 3-year forecast horizon.

[1] Net return for the Nedgroup Investments Flexible Income Fund, A class. Source: Morningstar (monthly data series).

Given that the Fed has essentially run out of tools, the market is increasingly looking to US Congress to pass unprecedented stimulus packages. So far, the Federal Government has passed an eye-watering $3tn of stimulus. At the time of this writing Trump is negotiating with the Democrats in the House to pass a follow-up bill opening up roughly an additional $2tn of support. He has threatened that he will only allow a bill to pass after the 3rd of November election which injects a significant amount of uncertainty as his willingness to sign off on a comprehensive bill will likely be affected by the outcome of the election. If Trump loses, Americans may have to wait until after he steps down in January for a bill to pass. Without this stimulus the US economy would be in very deep trouble. The cheques to households have aided consumer health and without the enormous stimulus one would have expected a far deeper recession. As a result of the fiscal and monetary stimulus, the US dollar has weakened 10.1% from its recent highs in March, but only 1.6% year-to-date. This has been crucial in keeping the economy going as a stronger dollar in this environment would've acted as a handbrake on the economy both in the US and globally. Despite all of these actions, and much like most other countries, the US economy has plunged into a deep recession.

A Biden win (he is currently well ahead in the polls – but acknowledging that polls are often wrong) would likely mean even more fiscal spending as well as an unwinding of trade barriers put in place by Trump. Biden would also be inclined to raise company tax closer to the pre-Trump levels, but this may be delayed until after the pandemic has run its course, which will likely take quite some time. It is therefore unclear what this would mean for global markets, although it is fair to say that reduced barriers to trade would be a positive especially for Emerging Markets that are particularly subject to the vagaries of global conditions.

Current positioning and outlook

- Low Duration

As at the end of Q3 2020, SA duration is 0.53 years in nominal bonds (Q2: 0.41) and 0.48 years in inflation linked bonds (Q2: 0.44). This is primarily due to our 7.8% weighing in the SA 10-year nominal bond and 8.7% weighting in 5-Year SA inflation-linked bonds. We added to our positions in the R2030 and I2025 bonds in the quarter. Yields at current levels offer significant value, but the risk to the SA fiscus has shifted fundamentally higher due to the crisis. We will therefore look to maintain a relatively conservative position to bonds and increase our preference for inflation linked bonds.

- High Credit Quality

The portfolio has a high degree of credit quality. Our credit process has historically shielded from capital loss due to credit events in SA and we are confident in our ability to protect investor's capital in the fixed income space.

Overall corporate credit spreads have widened from expensive levels since the onset of the Covid-19 crisis, but we believe further weakness can be seen should economic activity continue to lag. We retain our preference for senior bank debt.

- Convertible Bonds

The position in Royal Bafokeng convertible bonds has been a top contributor to the fund's performance. We believe that convertible bonds can provide an inflation hedge, so in this new environment we will look for opportunities to add to this asset class, although the local convertible market remains small.

The position in Remgro convertible bonds offers a very high degree of credit quality at a significant yield pickup over similar bonds.

- Property

The fund currently has 2.12% (Q2: 1.62%) exposure to domestic property assets, adding to a basket of higher quality names such as Nepi Rockcastle and Stor-age. We have maintained a conservative exposure and have chosen to add only modestly despite the weakness. The levels of debt and reduced economic activity make the yield outlook highly uncertain, and for the time being would rather selectively allocate to names who are not highly leveraged.

- Preference Shares

Preference Shares exposure is conservative at 2.17% (Q2: 2.44%), with the majority in the Big 4 banks. Given the systemic importance of the banks, we believe that the SARB will do everything possible to help them navigate the crisis. We are comfortable with the capital value and the post-tax yield of 8.1% is very attractive in this environment.

- Offshore Bonds & Money Market

The fund maintains an exposure to Offshore Bonds & Money Market instruments at 18.7% where a very attractive yield pickup over domestic assets is available while maintaining a high degree of credit quality. Our FX exposure is around 6.4%, an increase owing to the expiration of a R/$ option structure, resulting in the purchase of FX at very compelling levels. The exposure allows us to participate in rand weakness, should further weakness occur.

Nedgroup Investments Flexible Income Fund	
Gross estimated 12-month forward yield	**6.13%**
Modified Duration:	**2.41**
Local modified duration	1.01
Offshore modified duration	0.37

Summary and Conclusion

Many nations have found themselves in a second wave and have had to reintroduce new lockdown measures to contain the Covid-19 pandemic. The silver lining is that in most regions the second wave is proving to be less deadly than the first. However, the global economy is in a protracted recession as the virus has hit activity and confidence. Nevertheless, most markets remain reasonably strong. The S&P 500 set an all-time high during the quarter thanks to extraordinary monetary and fiscal stimulus unleashed in the United States despite the US being among the worst affected countries by the virus. While it appears that there is no limit to the stimulus, incremental stimulus becomes less effective and we are sceptical about the sustainability of the market levels and believe prospective returns are constrained. As far as South Africa is concerned, the jury is still out on the potential for a second wave. One thing is clear however, the economic prospects for the local economy are among the worst they have ever been. Given this backdrop, we have positioned the fund defensively which we believe will generate steady returns while protecting from capital loss and avoiding chasing a frothy market.

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.
Contact details: Standard Bank, Po Box 54, Cape Town 8000,
Trustee-compliance@standardbank.co.za, Tel 021 401 2002.

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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Unit trusts are generally medium to long-term investments. The value of your investment may go down as well as up. Past performance is not necessarily a guide to future performance. Nedgroup Investments does not guarantee the performance of your investment and even if forecasts about the expected future performance are included you will carry the investment and market risk, which includes the possibility of losing capital. Our funds are traded at ruling prices and can engage in borrowing and scrip lending.

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.

NEDGROUP INVESTMENTS CONTACT DETAILS
Tel: 0860 123 263 (RSA only)
Tel: +27 21 416 6011 (Outside RSA)
Email: info@nedgroupinvestments.co.za
For further information on the fund please visit: www.nedgroupinvestments.co.za

OUR OFFICES ARE LOCATED AT
Nedbank Clocktower, Clocktower Precinct, V&A Waterfront, Cape Town, 8001
WRITE TO US
PO Box 1510, Cape Town, 8000
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