



## Quarterly review

### Nedgroup Investments Prime Money Market Fund

As at 30 September 2020

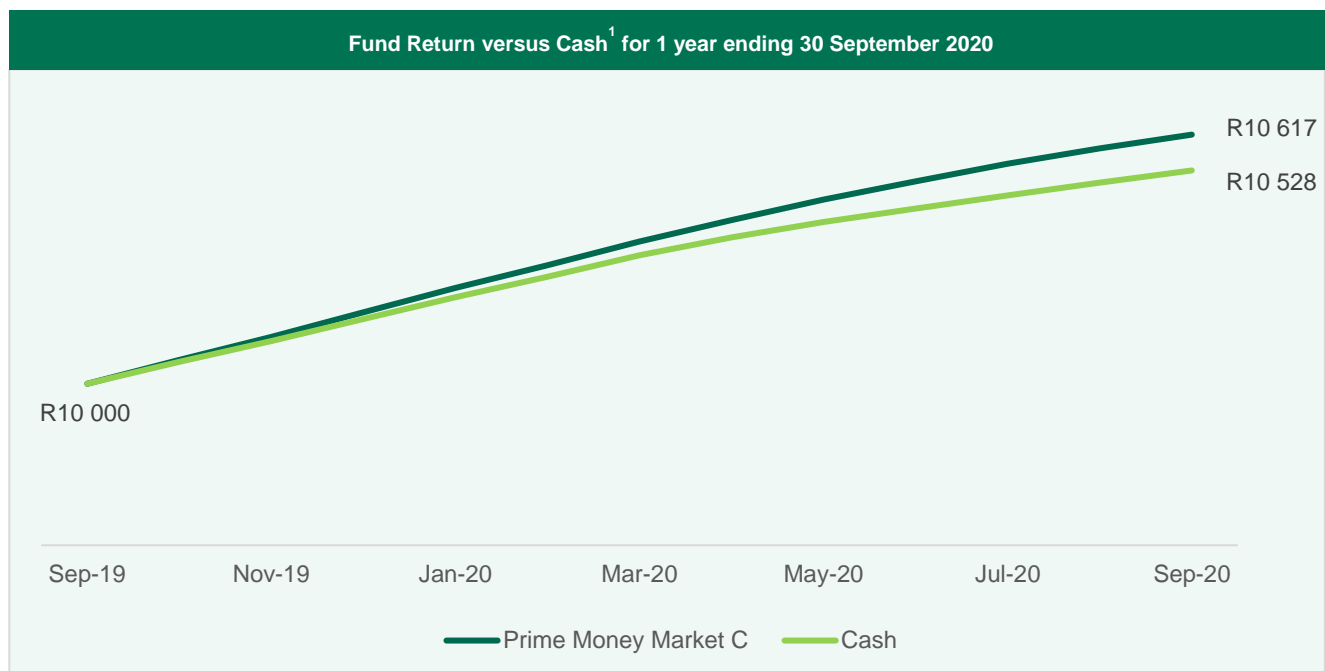


## A quarter of modest returns

The third quarter emphasised the benefits of geographic diversification. The global economy is recovering, with activity indicators improving month on month, from a low base as people return to work and more businesses reopen. Having rallied over the last couple of months, global stock markets flipped in September. Defensive sectors held up well whilst those more sensitive to the economy led the declines. There is no doubt that uncertainty is rising again as a second wave of coronavirus cases gathers pace. During the equity sell-off, investors had a stark reminder of the key role bonds and cash can play as a diversifier in a portfolio. Over the quarter, for every R10 000 invested, the fund value was up by R110 (1.1%).

The table below compares an investment in the Nedgroup Investment Prime Money Market Fund to bank deposits (cash) over various time periods. This illustrates that over longer periods, investors have been rewarded for taking on interest rate risk. For every R10 000 invested in the Nedgroup Investments Prime Money Market Fund a year ago, you would have R10 617 at the 30th of September 2020. This is greater than the R10 528 you would have achieved had you invested your money in bank deposits (cash) over the same period.

Value of R10,000 investment in Nedgroup Investments Prime Money Market Fund versus Cash <sup>1</sup>		
	3 Months	1 Year
Growth of fund (after fees) (Growth in %)	R10 110 1.1%	R10 617 6.2%
Growth of cash (Growth in %)	R10 091 0.9%	R10 528 5.3%



Over most periods, the Nedgroup Investments Prime Money Market Fund has done significantly better than bank deposits (cash) as the fund benefited from the yield enhancement from investing in longer dated Prime Money Market instruments.

1. We used the STeFI call deposit rate for cash returns



## Markets – Improving economic data and confidence

Second quarter earnings season delivered some staggering numbers, with earnings coming in better than market expectations. Entering the third quarter, most sectors were looking to leave the worst of Covid-19 behind and look towards recovery. While the consensus outlook was positive, second waves of Covid-19 infections in the US and Europe interrupted what was envisioned to be a smooth recovery. The reopening of economies was bound to lead to a resurgence in new coronavirus cases, but initial indications are that its impact is significantly less than earlier in the year. Amidst the uncertainty, several key asset classes earned positive returns.

Global risk assets roared into the second half of the year fuelled by over \$20 trillion of global stimulus. The MSCI World Index had its best August since 1986, leading to the Index gaining +8.3% (in dollars terms) and +3.9% (in rand terms) for the quarter, while emerging markets edged up +9.5% (in dollars). A lot of investors became too comfortable in the first two months of the quarter, as they observed all the super-charged tech stocks hike higher without much of a thought. US tech giants, which had behaved like defensives during the early year sell-off, and like recovery stocks since, finally suffered a poor month in September leading to a Nasdaq decline of -5.7% for the month.

Moreover, the Barclays global bond index was up roughly +2.7% (in dollar terms) but fell -1.4% (in rand terms) due to the rand appreciation over the quarter. Argentina's freshly-restructured government bonds lost a quarter of their value to score the worst relaunch into markets since Greece in 2012. Meanwhile bonds in Italy were up nearly 8% helped by a super-sized coronavirus rescue plan despite Italy's 160% debt-to-GDP.

Formal talks between the UK and European Union resumed mid-September, meaning the Brexit risks are back on investors' radar. The prospect of the UK and EU reaching a trade agreement by an October deadline is looking less likely, with Prime Minister Boris Johnson stating that the UK would walk away from trade negotiations come October, casting further doubt over a ratified deal by end of the year. That risks the pound falling to a 35-year low, bond yields turning negative for the first time, and stocks that lag international peers.

In the US, election season kicked off with a presidential debate that devolved into a chaotic exchange of insults, interruptions and few hard facts. Considering the uncertainty surrounding the extent of the Covid-19 impact and the upcoming US election, the short-to medium-term outlook remains volatile. Thus far, earnings season has been mostly about banks, however, in Q4 we expect to see a broader range of companies reporting, providing a more comprehensive outlook of how the corporate world is doing and what the future has in store.

Asia's strong performance, delivering a 10% return on equity, has been helped by China's remarkable success in containing the virus. China was first to bear the impact of Covid-19 and first to start recovering economically. As with previous Chinese slowdowns, stimulus measures kickstarted their economy once again. China's 14th Five Year Plan, due to be unveiled in October, should contain further guidance on its future economic trajectory.

From the domestic front, South Africa eased to lockdown level 1 towards the end of the quarter, reinstating tobacco and alcohol sales and providing the tourism industry with a welcome reprieve by permitting inter provincial and international travel. Activity indicators have recovered from a low base, although the pace has slowed since the start of the third quarter. The easing of regulations will aid the recovery already underway, even as continued load shedding weighs on the economy and sentiment.

The third quarter as a whole looked broadly positive for South African Markets, with Bonds still outperforming other asset classes over the quarter, returning +1.5%. The FTSE/JSE Capped SWIX Index delivered a modest return of +1.0% over the quarter, weighed down by financials while resources took a bit of a breather. Small cap counters outperformed large and mid-size companies as regulations were eased and Rand appreciation provided a tailwind. SA REITs continued to trade under duress, with the index losing a further -13.3% over the quarter, bringing 12 month returns to a devastating -50.2%.

After tracking below the SARB's target range of 3 to 6% in the midst of the pandemic, local inflation increased to 3.1% y-o-y in August. The jump was largely driven by an increase in fuel costs due to a higher oil price and annual increases in municipal and utility costs, including water and electricity tariffs. After falling from 18 to an all-time low of five in the second quarter, the RMB/BER Business Confidence Index rebounded to 24 in the third quarter. These survey results foreshadow an improvement in the third quarter relative to the second quarter. Nonetheless, bouts of volatility are likely to keep markets on their toes in the coming last few months of the year. Vaccine trials have been progressing, hence, positive news on this front in the coming months could be a game changer for markets.



## Is all bank debt equal - and why does this matter?

*Income type fund fact sheets prominently publish the funds' exposures to banks. Most investors have a tendency to treat debt issued by a bank as uniform – which begs the question: “Is all bank debt issued by a single banking entity equal?”*

It's a simple question but understanding the nuances of the answer has become crucial for investors in the current environment and due to pending regulation. To answer, we must begin by looking at the concept of leverage.

### Bank leverage

The concept of leverage is essential to banks. In contrast to industrial companies, banks need to be highly leveraged in order to generate an acceptable rate of return. The downside to leverage is that it increases the risk of a bank. The market recognizes this risk, and investors will require a premium over their invested capital if a bank is too highly leveraged. Therefore, it might benefit a bank to hold a higher than required amount of capital, signaling confidence to the market and in turn potentially lowering its funding costs.

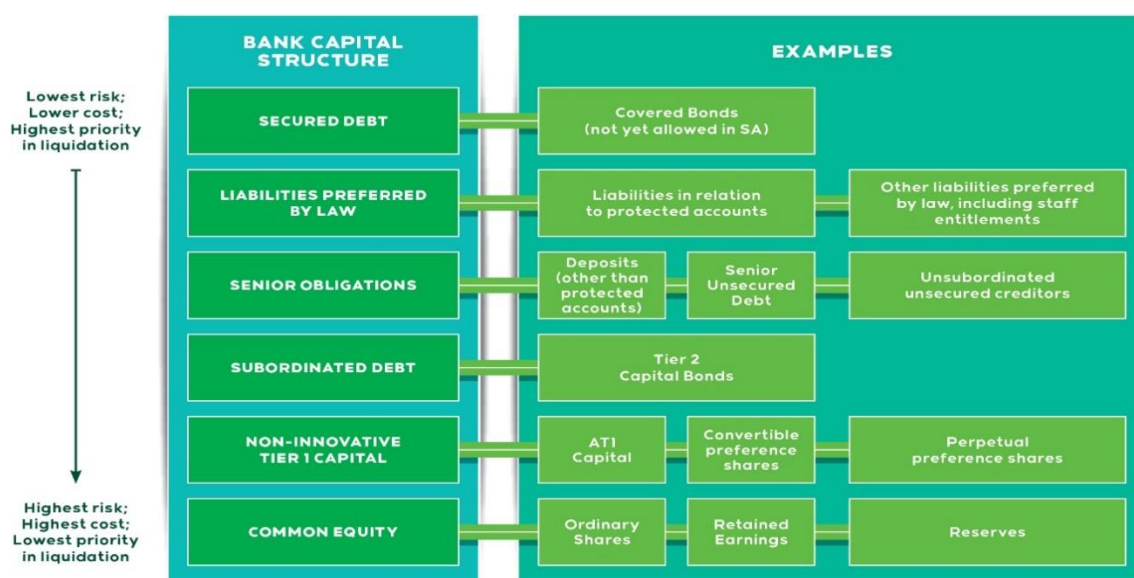
### Understanding bank capital

From an accounting point of view bank equity is simply the bank's assets less its liabilities. Bank assets are cash, government securities and various types of loans offered by the bank that earn interest (e.g. home loans, personal loans, vehicle financing). Bank liabilities are any loans or debt obtained by the bank, including deposits by customers. Bank capital consists of equity and it includes some loss-absorbing liabilities such as Tier 2 and Tier 1 paper. Bank capital is considered from a regulatory point of view as the “equity” in the bank and therefore it is important to investors because it acts as a reserve against unexpected losses. It also protects creditors if the bank were to go into liquidation.

### Bank creditor hierarchy – why all debt isn't the same

It is important to recognize debt heterogeneity in a bank's capital structure. All types of debt issued by a counterparty will be ranked differently according to the risks rooted in these assets - such as how much the debt holders may lose in a credit event, or potentially, even prior to any credit event. The figure below shows hierarchy of bank creditors. The contractual or legal liability structure (seniority) determines how a bank's assets and cash flows will be distributed upon default to its creditors.

Simplified bank creditor hierarchy in event of liquidation



Source: Taquanta Asset Managers

Equity holders bear the most risk in the bank. Equity holders in a bank are entitled to profits and have unlimited growth potential. Debt holders are exposed to limited upside while being exposed to default risk. It is for this reason that debt holders rank above equity holders. That said, banks have a complex capital structure.



This means their capital structures comprises of multiple types of debt with different levels of seniority. It is therefore important for investors to know where their investment lies in the priority of payments.

Because banks are subject to regulation which requires them to hold excess amounts of capital to mitigate operational risks, they issue additional Tier 1 and Tier 2 instruments which are classified as regulatory capital.

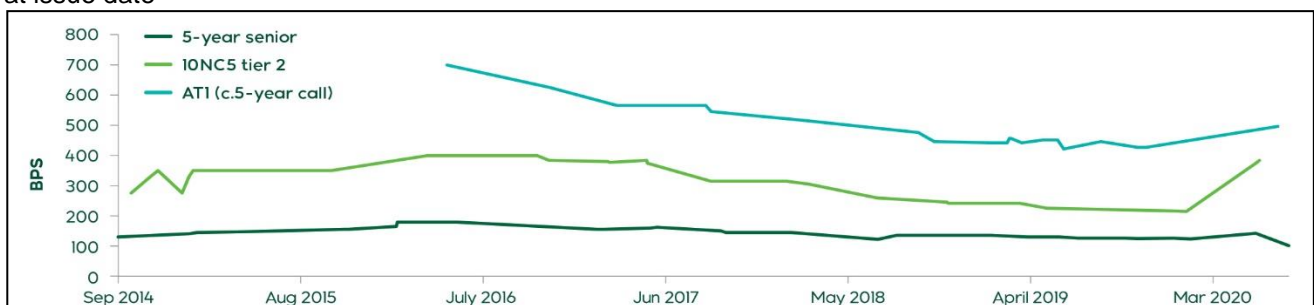
### What should you look for?

Many phrases are used when identifying seniority but the most common and obvious term to look out for is “subordinated”. The term “subordinated” means the debt you are holding ranks below more senior debt and is therefore riskier. As a result of this higher risk, these instruments will pay investors a higher rate of return. It is important for prudent investors to understand a bank’s capital structure to help justify the risk and return inherent in a fixed income investment and price appropriately.

### So, what we’re saying is...

At the end of the day, risk is directly correlated to the return i.e. the holder of a riskier asset wants to be compensated for additional risk. This is illustrated very simply below.

Comparison of bank spreads for senior unsecured floating rate notes versus subordinated floating rate notes at issue date



Source: Standard Bank Research

### Looking forward: what happens if a bank fails?

Currently the Insolvency Act does not provide for a granular enough hierarchy amongst bank creditors. That means there is no legal basis in which certain bank creditors (e.g. junior and senior unsecured creditors) are differentiated in a liquidation scenario. This lack of hierarchy makes it hard to enforce a bail-in sequence, even if the Resolution Authority (RA) is provided with explicit bail-in powers. As a result of this, a Resolution Framework to deal with this issue which will come into effect in the next few years. Refer to Figure 2 for the proposed bail-in sequence being looked at currently by the banking industry in South Africa and abroad.

### Proposed Resolution Framework - Protection of depositors in the event of a bail-in



Source: Standard Bank Research



The resolution procedure is triggered when a bank is failing or is likely to fail. It will make specific proposals on a minimum creditor hierarchy, which should serve as a guide to the bail-in sequence. “The bail-in tool will therefore give shareholders and creditors of institutions a stronger incentive to monitor the health of an institution during normal circumstance”. The too-big-to-fail burden will no longer fall on taxpayers as it did in the 2008-2009 Financial Crisis!

### The take out

Understanding the difference between a bank issued instrument’s capital ranking to price the risk and assess the relative liquidity of each instrument under various market scenarios, is going to become increasingly important to investors. And not all paper issued by any particular bank is equal.

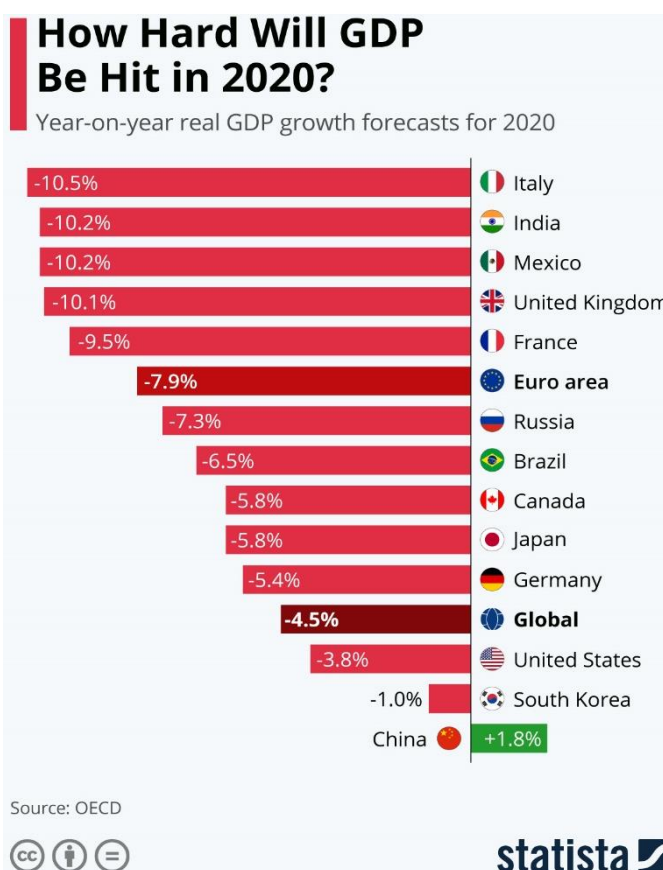


## The political landscape

COVID-19 and the resulting policy responses continue to dominate the global political landscape, especially in light of the resurgence of COVID-19 in many countries. Most governments have responded by re-introducing some of the lock down measures that were in place earlier that year in the affected areas. The challenge for policy makers in dealing with the resurgence, is how best to balance controlling the pandemic against stimulating growth in a flailing global economy.

Almost all countries are expected to see a decline in real GDP this year, with the exception of China. This has led to stimulus packages and significant reductions in interest rates, leaving investors that rely on interest income high and dry. A critical implication of the stimulus measures is the burgeoning debt to GDP ratios that are forecast, driven by the double whammy of falling GDP and rising debt. One such example is South Africa’s debt to GDP, which is expected to rise from 63% at the end of Q1 to over 80% by the end of the year (according to Trading Economics). This puts South Africa in a precarious situation and the political will to make the necessary tough decisions for economic reform is nowhere to be seen.

Moreover, the depressing state of the economy has caused a shift in voters’ sentiments. Nowhere is this more evident than in the US, where Trump is losing support predominantly amongst white working-class voters driven by their loss of faith in the way he handled the pandemic and the resulting economic fallout.



Across the Atlantic, the saga of Brexit continues. The UK put forward the Internal Market Bill, which removes the requirement for a new customs arrangement with Northern Ireland and ignores key aspects that were previously agreed. The draft bill has been criticised for undermining international law.

Furthermore, the UK ignored the deadline set by the EU of the end of September to remove the controversial changes. In response, Brussels has taken legal action, arguing that the UK draft bill is “a breach of the obligation of good faith laid down in the withdrawal agreement”. This is expected to come to a head on the 15 October, when Prime Minister Boris Johnson is meeting with the EU in a crunch summit, which will ultimately determine whether the UK exits the EU without a deal. The EU’s key concern is to ensure a level playing field in order to avoid distortions.



## Smart ways to get more out of your savings

2020 has been a tough year. Economies across the globe have been hit hard and, in an attempt to stimulate growth, interest rates have been cut to the lowest levels in history. However, the subsequent reduction in yields has left many people stranded with a big cut in income at the same time as investments have taken a knock. In such uncertain times, it's important to get the most out of the savings and investments that you do have. Although there is no silver bullet, there are some tips and tricks to make sure that you are optimising your savings during this time.

### Tip 1: Optimise your tax

To encourage South Africans to save, the government has provided some great tax incentives. Here are a few tax incentives you should take advantage of.

- a.) Savings made to a retirement fund reduce your taxable income (up to 27.5% of taxable income subject to a R350 000 annual cap), so SARS is effectively funding your retirement contributions. The money grows tax free and you only pay tax on this in retirement when you draw an income.
- b.) Money invested in a tax-free savings account will grow tax-free i.e. you won't pay dividends tax, interest tax or capital gains tax. You can contribute up to R36 000 a year to a tax-free savings account with a lifetime contribution maximum of R500 000. This is a no-brainer for any investor.
- c.) If you are younger than 65 years, the first R23 800 in interest earned is tax free and this is increased to R34 500 for those 65 years and older. At current yields, this allows you to invest about R500,000 (under age 65) and R750,000 (age 65+) without paying any tax on the interest.

Many people are not aware of the generous tax exemptions available to investors when it comes to earning interest. Some people invest their money in tax efficient vehicles at lower yields, before they have utilised their allowances, which is a mistake. For example, assume a couple over age 75 only earn an income from the interest on their investments. At current interest rates, they would be able to invest approximately R8m in interest earning investments and pay no tax on the interest earned. This tax benefit is a combination of the interest exemption and the annual income tax threshold.

### Tip 2: Maximize your returns by matching your time horizon

#### Short term investments (under 3 years)

In order to get the most out of your savings and investments, you should invest in something that matches the time horizon of when you need the money. For example, if you only need the money in a few years, investing it in a short-term fixed deposit would mean that you lose out on interest. Currently the call rate is around 3.2%, a 12-month fixed deposit would give you about 3.7% a year, but a 3-year fixed deposit would give you about 4.5% in interest per year.

However, there is an even smarter way to earn a higher interest rate without being locked in for a long period. This is via something called a money market fund or enhanced money market fund, where the money is accessible within a day. These popular income bearing funds offer yields similar to fixed deposits, but without having to "lock up" the funds for the term of a fixed deposit. To give you an example, the Nedgroup Money Market Fund currently yields about 4.3% and the Nedgroup Core Income Fund (an enhanced money market fund) yields about 4.6%. The yield on the latter is similar to what you would earn if you locked your money into a 3-year fixed deposit.

#### Longer term investments (3 years or longer)

On the other hand, if you only need to access the money after a number of years (3+ years), then a more suitable investment is a fund that has exposure to some growth investments, such as the Core Guarded, Core Diversified and Core Accelerated Funds. The longer your time horizon the greater the percentage you should have in growth investments. This generally provides the best long-term returns and you have the time to ride out some of the ups and downs of the market.

### Tip 3: Consider the fees you are paying

The higher the fees you pay, the greater the drag on your investments and the more difficult it is to earn higher returns over the long-term. It's important to find out the fees you are paying, determine whether they are reasonable, and if not, consider similar investments with more reasonable fees. A rough guideline is to try keep your fees under 1% of your investment value a year. One way of reducing your fees, is to consider investing your money in an equivalent "rules-based" (passive) fund such as the Nedgroup Investments Core Funds.



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