NEDGROUP INVESTMENTS

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NEDGROUP INVESTMENTS VALUE FUND

Quarter Four, 2020

Market commentary

International

Economic activity improved from the historic second-quarter recession as momentum built on less stringent lockdowns. However, the emergence latterly of more transmissible variants and increasingly onerous winter lockdowns suggests that economic recovery in 2021 may not be as robust as first expected. Positive vaccine trial news flow and the first UK and US inoculations supported expectations for a faster return to normal and propelled equity markets to new highs. But the time required to reach global herd immunity is uncertain given the logistical challenges of vaccinating that many people and developing countries' ability to access sufficient supply. The passage of an additional $900 billion US relief package provided further buoyancy to equity markets.

The US elections did little to settle US political uncertainty given President Trump's non-capitulation and legal challenges to Biden's electoral college and popular vote victories. Longer term, the Democratic clean sweep now makes higher US corporate taxes and increased government spending much more likely. However, the unprecedented peacetime global deficit spending that we saw in 2020 went to personal consumption and not productivity enhancing infrastructure investments, raising the spectre of higher long-term inflation as debt burdens spiral.

The major central banks (excluding China) maintained their extreme monetary policy stance with cash pouring into alternative assets and corporate credits in search of higher yields. Indeed, global corporate debt issuance in 2020 reached a record $5.4 trillion, resulting in much weaker balance sheets and sharply rising risk of corporate credit defaults should solvency ratios not improve meaningfully.

The US dollar was weaker on the sheer scale of US monetary stimulus and as the eleventh-hour Brexit trade deal buoyed the euro and pound. Dollar weakness should persist as the Democrats implement their economic agenda and investors move out of safe havens ahead of economic recovery following the vaccine roll-outs.

Industrial commodity prices surged as market sentiment for economic recovery in 2021 gained momentum. The weaker dollar should provide further support for commodity prices with growing inflation risks in the long-term expected to keep precious metals prices also well bid.

South Africa

The economy continued to recover at pace from the severe second-quarter recession but is still expected to have contracted by at least 5% in 2020. However, a sooner than expected summer second-wave infection caused by a new, more transmissible SARS-CoV-2 variant, the return to Level 3 restrictions and bungled vaccine procurement have elevated the risks to meaningful economic recovery.

The Mid-Term Budget Policy Statement ("mini-budget") in October was disappointingly vague on government's strategy for arresting the rapidly deteriorating public finances. The slim chance of meaningful public wage reductions and incomprehensible support for bankrupt SOEs does not bode well for the trajectory of the country's debt spiral.

SA equities delivered good returns with financials, resources and industrials rallying on buoyant emerging markets sentiment. Despite the weak economic outlook, select 'SA Inc.' companies are attractively valued. Resource companies, however, appear to be near the peak of their earnings and operating margins cycles.

The SA government bond yield curve moved lower and flatter as long bond yields fell on the global risk-on environment amid hopes for a faster return to normal in 2021. South African bond yields remain attractive given the benign inflationary environment. In the long-term however, inflation risks include reserve bank independence, money printing and ever-increasing bond issuances to fund the fiscal deficit.

Listed property was the best performing asset class as investors were bottom feeding the optically attractive yields. But the asset class is still down 34% for the year as property values were marked down amid recession-driven negative rent reversions. Risks to distributions persist, given weakening balance sheets, rising debt ratios and persistently difficult trading conditions.

The rand appreciated on broad-based US dollar weakness, but is at risk longer term from capital outflows despite an improved current account surplus. Notwithstanding, emerging market currencies should stay well bid while market sentiment remains positive for vaccine rollouts, allowing a return to more normal levels of economic activity.

The first, long overdue, high level corruption arrests provided much needed balm to the national psyche. But the country's fortunes remain intricately linked to internal ANC factional frictions, with the time for much needed structural economic reforms starting to run desperately short.

Performance commentary

The contrarian low precious metals and gold miners weight was the largest single contributor to relative performance. Gold miners sold off sharply on a weaker dollar gold price and stronger rand, while platinum miners outperformed on the stronger platinum group metals prices.

The newly upweighted healthcare position was the largest detractor. Pharmaceutical company Aspen contributed positively in absolute terms while holdings in hospital companies Mediclinic and Netcare detracted.

The long-term investments in key mid cap industrials also added value. Hudaco, Invicta, Omnia and Kap were all up sharply in the quarter.

The higher-than-index allocation to financials added value as the sector outperformed. Stock selection also added value with core holding FirstRand outperforming marginally offset by Santam on short-term weakness.

The consumer services investments added value. Stock selection was also strong with The Foschini Group, Italtile and Pepkor all contributing meaningfully.

Listed property stock selection added value with core holding in London property company Capital & Counties outperforming.

Top contributors	Performance Contribution %	Holding Return %	Average Weight %
FirstRand	1.5%	26.9%	6.3%
CF Richemont	1.1%	19.0%	6.0%
Omnia	1.0%	51.1%	2.2%
Hudaco	0.8%	13.6%	5.3%
Capital & Counties Properties	0.8%	20.4%	3.7%

Top detractors	Performance Contribution %	Holding Return %	Average Weight %
RFG Holdings	-0.1%	-9.2%	0.7%
Naspers "N"	-0.1%	-6.4%	0.6%
Mediclinic	-0.2%	-7.5%	1.8%
WBHO	-0.2%	-17.5%	0.9%
British American Tobacco	-0.3%	-4.8%	4.1%

Investment outlook

World:

- Economic recovery to continue to be driven by the speed and efficacy of vaccine roll-outs and extent of continued hard lockdowns.
- Unprecedented monetary and fiscal support is likely to persist for the foreseeable future, raising the risks of an inflation break-out in the longer term.
- Geopolitical risks continue to rise as the US continues to push against the strategic risks of a rising China.
- Market volatility levels are expected to remain elevated.
- Higher US corporate taxes and government spending are expected in time on the back of the Democrat clean-sweep in the US elections.
- Dollar weakness is likely to persist, supporting commodity prices.

South Africa:

- The pace of economic recovery is likely to remain slow and volatile given the structural economic challenges and vaccine procurement bungles.
- Unsustainable fiscal deficits are expected to continue, increasing the risk of a full-blown debt spiral.
- Recovery in employment levels likely to be slow in the absence of meaningful reform and accelerating economic growth.
- The outlook for inflation is benign given the weak consumer demand and stronger rand.
- The rand is vulnerable to continued depreciation over time.

Conclusion

The managers added Anglo American to the portfolio to diversify commodity and counter specific risk in the fund's principal sector investment, the highest quality diversified miner BHP Group. Anglo's increases the exposure to consumer metals like copper which should remain elevated given the scarcity of supply against increased demand from electric cars.

The managers also purchased hospital counters on share price weakness associated with near-term earnings uncertainty. The fund's largest healthcare sector holding, Aspen Pharmacare, entered a COVID-19 vaccine manufacturing partnership with Johnson & Johnson which should improve shareholder returns.

The allocation to JSE-listed global businesses was reduced. Although well capitalised with pricing power in hard currencies, valuations have started to become stretched.

We initiated a small position in Naspers and Prosus. Even though underlying holding Tencent's valuation remains high, Naspers is trading at a large discount to underlying value which combined with their directly owned operations nearing breakeven, presents a value investment opportunity.

South African retail holdings were adjusted at the margin. The Pepkor holding was trimmed, and value plays Foschini and Massmart entered the fund.

Cash levels were reduced to take advantage of attractive entry prices to build long-term positions in select quality 'SA Inc.' companies. The portfolio remains well diversified across economic drivers with sufficient liquidity.

Responsible Investment Summary

Voting resolutions for Q4 2020	Total count	For	Against	Abstain
Adopt Financials	5	100%	0%	0%
Auditor/Risk/Social/Ethics related	57	100%	0%	0%
Buy Back Shares	12	100%	0%	0%
Director Remuneration	54	98%	2%	0%
Dividend Related	5	100%	0%	0%
Issue Shares	12	0%	100%	0%
Loan / Financial Assistance	12	25%	75%	0%
Other	19	63%	37%	0%
Re/Elect Director	74	100%	0%	0%
Remuneration Policy	24	8%	92%	0%
Shares under Director Control	5	0%	100%	0%
Signature of Documents	1	100%	0%	0%

General comments:

- There are few abstentions. We apply our minds to every single resolution put to shareholders. When there is an abstention it would typically be intentional or for strategic reasons.
- We typically vote against any resolution that could dilute the interests of existing shareholders. Examples include placing shares under the blanket control of directors, providing loans and financial assistance to associate companies or subsidiaries and blanket authority to issue shares. On the rare occasion, we have voted in favour of such resolutions, we were able to gain the required conviction in the specifics of the strategic rationale for such activities and could gain comfort that such activities are indeed to be used to the reasons stated.
- The firm also has a strong philosophy regarding management remuneration models. We believe in rewarding good managers with appropriate cash remuneration on achievement of relevant performance metrics that enhance long-term shareholder value. We are generally not in favour of share option schemes given the inherent asymmetry between risk and reward typical of such schemes. In addition, we do not believe that existing shareholders should be diluted by the issuing of new shares to management as is the case with most option schemes. We are in favour of the alignment created between management and shareholders when management has acquired its stake in the company through open market share trading and paid for out of management's own cash earnings.

Notable company engagements

Libstar

Concerns around metrics used (operating earnings vs. reported earnings), weightings attached to the metrics and share dilution as result of new share issuances.

Spurcorp

Several engagements with the Chairman and Board Remuneration Committee non-executive members regarding remuneration and corporate governance, as well as capital allocation.

Invicta

Engagement with non-executive director on exco remuneration and general strategy for new management regarding capital allocation going forward.

Bidvest

Management wanted feedback on why we voted against remuneration policy. Our issues were primarily the share based settlement. It should be noted that the group bases returns on ROFE (excludes intangibles and goodwill). We do not believe that ROFE is an appropriate metric for a company of this nature.

Bidcorp

AGM voting and remuneration discussions. Had a discussion with the CFO on the structuring of their debt and the fact that we voted against the convertible (resolution 8.0: creation of convertible debentures). We are not in favour of obscure funding sources and the group's balance sheet is sound with ample liquidity (22% of market cap) and does not require alternative sources of debt. Essentially we voted against due to unnecessary shareholder dilution.

Richemont

AMG voting – feedback to IR on our management meeting. Remuneration policy – in our opinion the policy must be a function of earnings growth, returns and free cash flow measures to ensure that capital allocation drives both short term and long term returns. Regarding the Board of Directors, we feel that both the size of the board and total compensation is high.

MediClinic

AMG voting & rem discussions. We queried 50% of Short Term Incentive (STI) to be delivered in shares. Management confirmed that delivery is in shares and they buy back in the market, hence no existing shareholder dilution.

Disclaimer

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