NEDGROUP INVESTMENTS

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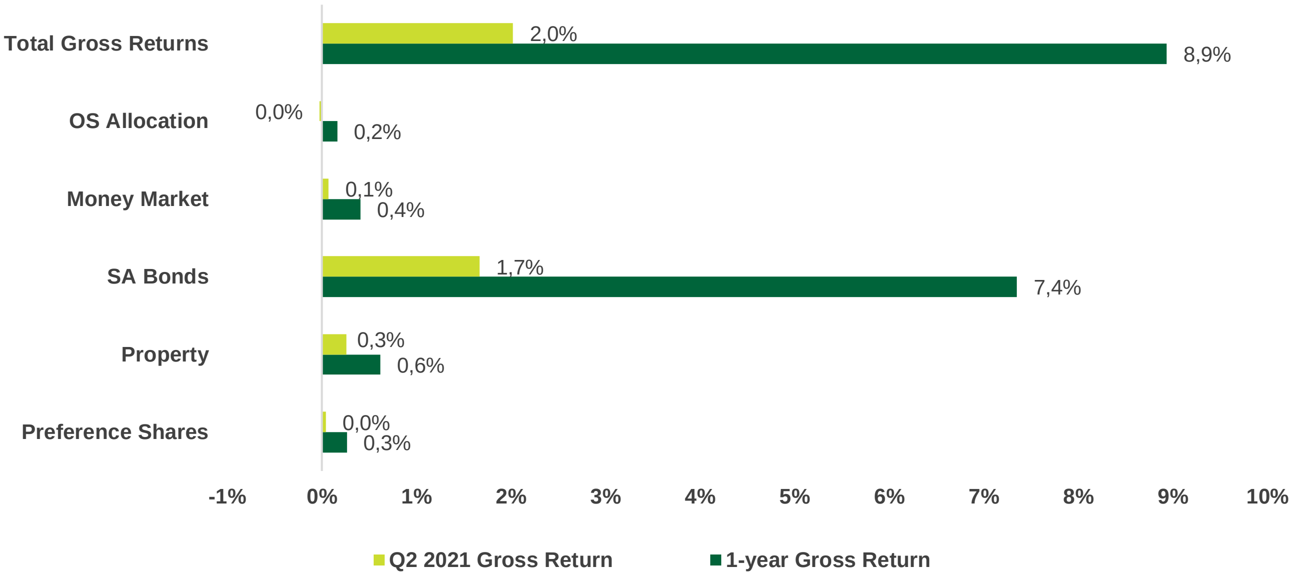
NEDGROUP INVESTMENTS FLEXIBLE INCOME

Quarter Two, 2021

Nedgroup Investments Flexible Income Fund

Performance to 30 September 2020	Fund Performance[1]	Stefi*110%
3 months	1.8%	0.9%
12 months	8.0%	3.9%

The fund had a good Q2, outperforming its benchmark. Nominal bonds, inflation linked bonds, floating rate notes, preference shares and property all contributed positively for the quarter. Our allocation to USD and local convertible bonds unfortunately detracted from performance.



***Source**: Abax Investments, approximate gross return contribution per asset class up to 30th June 2021*

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

Global risk assets experienced another strong quarter, as global economic growth continues to recover at an incredible pace. The continued monetary and fiscal stimulus, as well as the deployment of vaccines, has meant that economic activity is returning quicker (and greater) than expected, with some estimates showing that global GDP will exceed pre-pandemic levels as early as Q3 2021. The quarter saw the S&P 500 return 8.5%, the MSCI World index 7.9% and the MSCI EM index 5.1%, with equity market volatility falling to pre-pandemic levels. Bond markets saw a similar rally, with the US 10 Year appreciating to 1.47% at quarter end, and US high yield spreads reaching all-time lows. On the local front, equities experienced a slower quarter with the ALSI returning -0.8%, largely attributed to the retracement in the resources sector of the market, and the NPN/PRX heavyweight losing around just over 15% for the quarter. Local bonds however participated in the rally and experienced a strong quarter, with nominal bonds returning 6.9%, while inflation linked bonds returned 3.2%. Local property also saw a strong quarter, returning a phenomenal 12.1%.

The rapid pace of the global recovery saw the FOMC revise their growth projections upwards in their June meeting, bringing forward their expectation for tapering and interest rate hikes. This growth remains positive for corporate profits, but an overheating economy will cause havoc in financial markets (as it causes inflation)

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

and the Fed will continuously need to finely balance their policy such that it fosters economic growth while not overstimulating the economy. Inflation is a metric we, and the rest of the market, have followed exceptionally closely over the past few months, as it signals whether and for how long low interest rates and asset purchases can continue. We have seen large inflation prints (5% most recently) for an economy that targets 2% inflation, but this was largely expected due to the low base effects from 2020 and is communicated by policy makers to be short lived given the pent-up demand in the system. The market largely seems to believe this rhetoric, as seen by breakeven inflation expectations, where short term breakevens are higher than long term ones. The fact that CPI has spiked due to specific components such as used cars (where semiconductor shortages are reducing car outputs), airfare and hotels (which are quickly rebounding given the pent-up demand) is playing into the Feds transitory story, and the market thus far has been relatively relaxed about the higher inflation prints. The risk remains that they are wrong, that these pressures last longer than expected, and that other components in the basket also start to contribute to this persistently. Should inflation turn out to be a persistent issue, the Fed will be forced to make the impossible decision: raise interest rates in a leveraged system or suffer the consequences of high inflation. Our view remains that we are in an extended period of financial repression (similar to that seen in the 1940/50s), and interest rates will remain below the inflation rate for the years to come. Should inflation become problematic, it is more likely that methods of yield curve control are employed, as opposed to a return of normal monetary policy.
In Emerging Markets, we have seen some central banks start to hike rates, including Mexico, Russia, Brazil, Hungary and the Czech Republic. Unlike South Africa, these countries have hiked largely as a result of inflationary pressures, but this could exert pressure on the South African Reserve Bank (SARB) to hike rather sooner than later. The SARB has the difficult job of balancing this with the fact that our economic growth might be again affected by current round of lockdown due to COVID19. Currently the market expects two hikes by the end of the year, and four by the March 2022 meeting. We largely agree with this view, but think the risk is for a more dovish SARB.

The local bond market has delivered exceptional returns, and we remain constructive in this space, particularly the belly to longer end of the curve (which will generally benefit from rate hikes). Not only do we think that long term inflation expectations have come down, but we also believe an argument can be made for the country risk premium to come down over the next few years given recent developments. We are slowly starting to see the rebuilding of state institutions (Eskom and SARs in particular), a harder stance on budget expenditure and corruption, positive developments in the energy sector, and our fiscus being in a substantially better condition than expected due to high commodity prices. Our view on bonds however does not extend to the Rand, purely because its extensive rally has meant that it overshot what we deem to be fair value. Our fair value models, which take PPP and fundamental principles into account, suggest a fair value range of the ZAR to be around 14.70 to 15.70. The currency touched levels last seen in 2019 during the quarter, but moved back to 14.28 from its low of 13.43.

Current positioning and outlook

- Moderate Duration

As at the end of Q2 2021, SA duration is 0.74 years in nominal bonds and 0.38 years in inflation linked bonds. We continue to predominantly hold the SA 10 Year nominal bond (R2030) and 5 Year SA inflation linked bond (I2025). Yields at current levels remain attractive for nominal bonds, whereas we view inflation linked bonds to be around fair value. We expect increased volatility around US treasuries as communication around tapering/hikes continues, and this will translate locally. The short end of the curve may also come under pressure as rate hike expectations increase, but this should bode well for the belly to longer end of the curve.

- High Credit Quality

The portfolio has a high degree of credit quality. Our credit process has historically shielded the fund 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. We retain our preference for a diversified portfolio of senior bank debt and low risk / high grade corporates.

- Convertible Bonds

The position in Royal Bafokeng Convertible was closed during the quarter and generated strong returns for the fund. We believe that convertible bonds can provide an inflation hedge, and in an environment of financial repression represent a differentiated way for income funds to hold real assets. We continue to look for opportunities in this space, but given the strength of equity markets, remains on the expensive side.

Property

The fund currently has 2.8% exposure to domestic property. We have maintained a conservative exposure, as the levels of debt and reduced economic activity make the outlook uncertain. We continue to selectively allocate to names who are not highly leveraged and where liquidity is sufficient.

- Preference Shares

Preference Shares exposure is conservative at 2.6%, with the majority in the Big 4 banks. The pre- and post-tax yield remains attractive in this environment. Over the past year preference shares also experienced a recovery in capital values as banks recovered from the initial COVID19 shock.

- Offshore Bonds & Money Market

The fund maintains an exposure to Offshore Bonds & Money Market instruments at 19.3% where a very attractive yield pickup over domestic assets is available while maintaining a high degree of credit quality and diversification. Our FX exposure is at 9.3%; this exposure remains high given the strength of the rand and provides a natural hedge to our higher duration. Subsequent to the end of the quarter, we have reduced this exposure slightly, and will continue to actively manage this position.

Summary and Conclusion

The second quarter of this year saw risk assets continue to rally, as the global economy recovers at an incredible pace. The market continues to monitor US inflation and communication by the Fed to assess how long the stimulatory factors (asset purchases and low rates) will remain in the market and economy. So far, higher inflation prints have successfully been communicated as being transitory. The risk remains that policy makers are wrong, and that inflation runs higher for an extended period of time. Either way, we believe we will remain in a period of financial repression for an extended period of time, where rates will remain below inflation. We maintain this environment will be good for global real assets, but will look to take advantage of increased volatility as the market moves from nervousness to complacency On the local front, we continue to see value in nominal bonds, particularly the belly to longer end of the curve (which will do well if rate hikes start to come through), and we maintain a higher than normal USD position given recent strength of the ZAR and its ability to act as a hedge on duration.

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
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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.

DISCLAIMER

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.

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