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Nedgroup Investments Global Behavioural Fund

Quarter Two, 2021

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Commentary produced in conjunction with sub-investment manager, Ardevora Asset Management

Indicator	3 months	1 year	3 years p.a.	5 years p.a.	Since Inception# p.a.
Portfolio*	5.3%	38.7%	15.6%	16.3%	12.5%
Performance indicator+	7.4%	39.3%	14.6%	14.6%	10.1%
Difference	-2.1%	-0.6%	1.0%	1.7%	2.4%

* Net USD return for the Ardevora Global Long-only Equity Fund, C class. Source: Morningstar
\# 29 November 2013
\+ MSCI All Country World Index (in USD Net Ret)

Market and portfolio commentary

Two buckets of water

The path of aggregate demand, inflation and interest rates matters to every business. But so does the weather, and all are, in our view, hard to predict. As students of the psychology of error, we stick to the bottom-up approach (where it is slightly easier to get it right). We rely on the interplay between CEO behaviour and market perceptions. Most of the time, if a CEO behaves "well" the business does what it should, and the stock price responds as it should. But in periods when most investors prefer to speculate on the big moving parts of the economy, stocks can be used like macro betting chips. The "bottom up" influence of individual business performance can become crowded out by the "top-down" noise from what-if views on aggregate demand, inflation, and interest rates.

2020 was uncomfortable for us. There was a lot of top down, macro noise. Fortunately, the top-down shenanigans had a degree of familiarity: the behavioural cycles of shock, anxiety, and release. While investors used most stocks as proxies for their view on COVID and the economy, we were still able to stay on the right side of CEO behaviour. And CEO behaviour did matter. We were helped by our willingness to embrace newfound CEO humility. As COVID rolled through, an unusually large number of CEOs dropped previously unrealistic plans and concentrated on reducing risk. They don't usually behave this well, but 2020 was an unusual time. At the same time, an unusually large number of CEOs with growth plans found life got easier. This doesn't usually happen in a macro shock. Staying with good growth companies worked just as well as embracing recovering value.

2021 has been more challenging. We tried to build our portfolios to avoid too much tilt to shifting views on top-down debates. From experience we know this is hard. Stocks often behave differently in different macro cycles. A lack of Energy, Financials, an equal weighting approach (leaving us underweight the big tech heavyweights in the index) and a preference for lower risk CEO behaviour have all worked against us.

In Q1 recovery value did well, but it was heavily concentrated in two sectors: Financials and Energy. We have cautious views on both, so we were left behind in this episode of the value rally. We have a jaundiced view on financials, based on our experience of the last major macro shock. Banks gamed the accounting and other reporting rules to hide risk, so they could behave in an irresponsibly risky way. We have avoided them ever since. Three years ago, we opened our minds to the possibility of change and hired a specialist banking analyst. We are slow and deliberate in our research. We decided (for reasons explained in other commentaries) to begin considering banks as acceptably risky investments this year. But not in time to catch the Q1 rush in bank stocks. In Q2 we concluded a few banks looked interesting. They were the unusual ones: most banks still have risky looking CEO behaviour, as they struggle to navigate a structurally difficult operating environment (that has nothing to do with macro).

Over the last few years, we have thought long and hard about what it means to be a responsible business. In our stock picking approach, we try to avoid irresponsible CEOs. They are generally risky. In our view, they can appear anywhere, in any business activity. But there are some entire business activities where, despite the best intentions of a CEO, the business activity itself is irresponsible. We decided to apply some simple economic tools to the ethical problem of what corporate irresponsibility looks like. Markets have long struggled with externalities – effects from a transaction extending far beyond the participants in that transaction (either by scope or through time). We decided to focus on two high impact externalities: damage to the environment and damage to the fabric of a fair society. In our view, any business activity that sells stuff, knowing its use causes widespread damage to the environment (possibly irreparably) cannot be thought of as behaving responsibly. Oil companies, no matter what they say about running their businesses in a carbon neutral way, still peddle product they know is used in an environmentally damaging way.

In Q2 factors flip-flopped. Energy kept running, but investors flipped back into mega-cap tech and became nervous about most other recovery plays. The lack of Energy was particularly hurtful for us. Energy still makes up a significant part of the current value factor (stocks sharing characteristics associated with investor anxiety, such as low valuations, or weak price momentum). As we have explained before, we have built our portfolios to keep an even balance between value and growth since the middle of last year. But value ex-Energy has behaved very differently to value cum-Energy this year. The combination of "transition anxiety" and the COVID Delta variant stalled the anxiety release. (We go into the details in the market commentary below).

The combination of lots of macro noise, flip-flopping factors, strongly performing "risky" sectors, and a big influence from a small number of very large stocks is a bit of a nightmare for us. Disentangling why we have lagged this year comes mainly down to our stubborn avoidance of stocks we either thought were too risky or were too big (equally weighting everything means we didn't own enough of them).

The macro noise will abate. In our experience the persistency of effective CEO behaviour in robust businesses matters through economic cycles. We believe the cacophony of recovery vs inflation is slowly returning to normal. We believe the world is adjusting to the idea COVID will never truly disappear.

Market Commentary

It is over a year since the market hit peak COVID anxiety. A year ago, a recovery barely seemed possible; now it seems inevitable. The last time there was a deep macro shock (2008) recovery stocks ran for three years. The path was rarely smooth. After an initial, steep release from deep anxiety, scepticism intermittently seeped in. Doubts about the pace and durability of the recovery ebbed and flowed. 2010 was an uncomfortable year for the post-GFC recovery trade. So far 2021 has the same feel to it.

2010 was dominated by macro debates: would the recovery stall, or would it roar? The same debate rages in 2021. The differences? In 2008 the banking system and real estate crashed, twitched and ultimately revived; what emerged post-2008 was very different. In 2020 the shock has been deeper, wider and from an entirely unfamiliar source. While the overall shape of recovery looks similar (stock market indices tumbling, then bouncing) the path for sectors, industries and individual stocks has been messier. Factors have flip-flopped; what went up in Q1 has often gone down in Q2.

The economy is still recovering; it has not recovered. COVID still exerts a significant influence. Yet it feels like we are in transition: out of COVID and into something new. We do not know what the "new" will be. Hence, this recovery is confusing: it is not a recovery back to what we had before. As the quarterly reporting season kicked off, surprises were big and widespread. From the bottom-up, businesses were telling us the recovery was faster and steeper than expected. But stock price reactions were strangely muted. CEOs were becoming more hopeful, but investors can be a perverse bunch. The receding fear of 2020 left a vacuum for new anxiety: was the recovery over, was the news as-good-as-it gets?

As the quarter trundled on investors' worries returned to more familiar territory: inflation. Since the trauma of the 1970s, investors have been raised on the fairy-tale monster of catastrophic inflation. We all fear it dreadfully. For as long as I can remember, as soon as anxiety shifts from "will a recovery happen", it is replaced by the inflation-monster. Recently, supply chains and labour markets have struggled to keep pace as the global economy has kicked back into gear.

By the end of the quarter, stock market investing resembled the strange sensation of having one foot in a bucket of cold water, the other foot in a bucket of hot. The recovery still feels hot. For those whose job it is to predict inflation, a worrying pattern of error is emerging. Forecasts are persistently behind the evidence, commentary dismisses error as transitory. We have often seen this type of error pattern play out for those who forecast companies. Errors often have "momentum". We suspect inflation will continue to run hot through the rest of the year. But there is also a bucket of cold water: COVID.

COVID has mutated again. The latest version is more virulent. Despite considerable progress on vaccination programs, infection rates are accelerating. The re-opening part of the recovery path is at risk again. Consistently through the pandemic Governments have struggled to tread the fine line between control and freedom. People respond best to clarity: if it is clearly dangerous, they will behave responsibly (because it's in their interests to do so). If it is clearly safe, they will behave normally. If it is somewhere in between, most people will think they know best, will distrust government messages on collective responsibility, and do their own thing. With hospital admissions still low and a significant proportion of the population feeling safe, having been vaccinated, collective responsibility is hard to enforce. Re-opening is slowing again.

The cold water of COVID derailed large parts of the recovery trade last quarter. The hot water of inflation spooked investors. Yet the overall stock market continues to go up and bond yields fell. If one bucket of water is cold and the other is hot, the mix is lukewarm. Inflation is surging because the economy is trying to recover too fast. Re-opening is a key part of the recovery. A longer, slower recovery looks the most likely. While value and growth factors may flip and twitch, it still feels like an environment where both recovery and growth plans can prosper together.

Portfolio performance

Key contributors	PF weight (%)	BM weight (%)	Base return (%)	Excess return contribution (bps)
BYD Company Limited	0.73	0.04	41.18	22
ALS Ltd.	0.67	0.00	34.15	19
NIO Inc.	0.73	0.10	36.50	18
Elastic NV	0.59	0.00	31.39	15
Sea Ltd. (Singapore)	0.59	0.01	23.01	14
MSCI Inc.	0.56	0.07	27.08	12
IQVIA Holdings, Inc.	0.58	0.07	25.27	11
Edwards Lifesciences Corporation	0.59	0.10	23.69	10
NIBE IndustrierAB	0.34	0.02	35.74	10
Bed Bath & Beyond Inc.	0.65	0.00	16.96	10

Key detractors	PF weight (%)	BM weight (%)	Base return (%)	Excess return contribution (bps)
Microsoft Corporation	0.54	2.92	14.89	-33
Alphabet Inc.	0.56	2.22	18.26	-31
Amazon.com, Inc.	0.52	2.21	10.95	-18
Lenovo Group Limited	0.59	0.01	-19.09	-13
Facebook, Inc.	0.60	1.26	17.89	-11
Alaska Air Group, Inc.	0.46	0.00	-17.65	-10
Delta Air Lines, Inc.	0.48	0.01	-15.75	-9
1Life Healthcare, Inc.	0.49	0.00	-15.62	-9
Guardant Health, Inc.	0.55	0.00	-18.98	-9
SK hynixInc.	0.55	0.09	-14.91	-9

Unlike our regional exposure, we do take significant positions between industries. These typically fall into two camps. Firstly, we are underweight financials because we do not currently invest in insurance companies. Secondly, our sector exposure can vary due to the degree of opportunity we find at a particular time.

Europe and our Rest of World bucket of stocks added alpha this quarter while Japan and North America detracted relative to the benchmark.

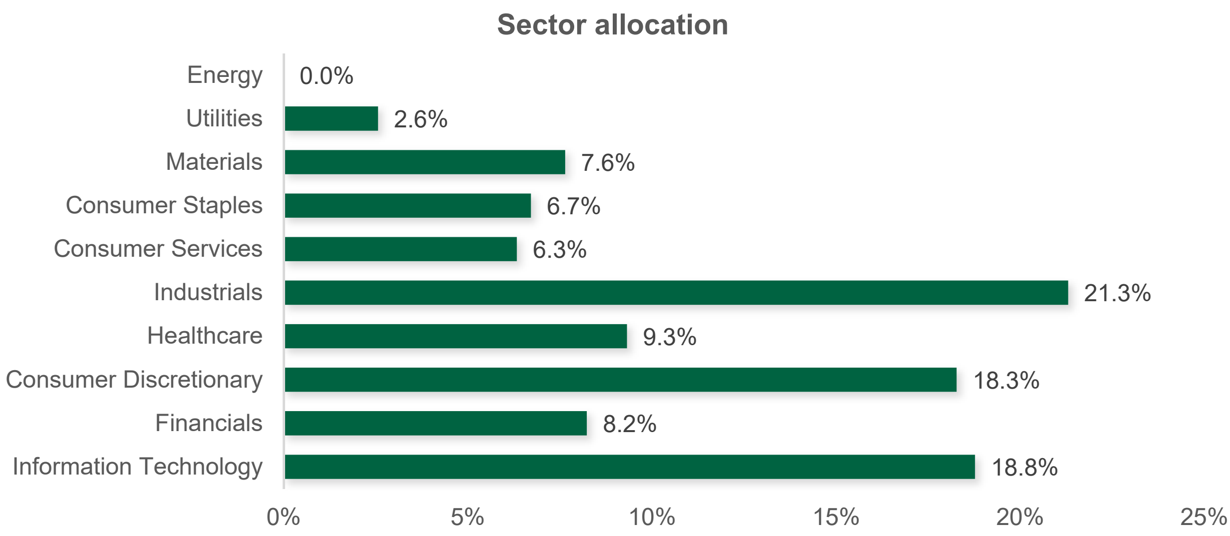
Sector analysis

Overweight Industrials: we can find an unusually large number of conservatively run businesses, with apparent analyst bias or investor bias, as macro worries cloud perceptions. We view many of them as much lower risk than they are given credit for. We have, however, culled a few names: the industrial recession “scar” of 2015-

16 no longer seemed to be acting as a biased anchor point for some stocks (scepticism has dissipated), and compounding this, there are creeping signs of inflation, with some areas struggling to pass this through.

Underweight Information Technology: an inappropriate sector classification in our view as its scope is so broad, and the companies so eclectic. Within the plethora of tech sub-industries however, we have been able to find many opportunities which we view as low risk (hard to break, sticky customers etc.), but tarnished with the “risky” traditional label for the technology sector.

Underweight Energy: Our energy weighting has varied since 2015. 2016 saw a brief moment of respite (and share price anxiety unwind) in a long cycle of trapped capital, and we saw an investor bias opportunity window open up. And again more recently when there was a run up in oil prices as inflation briefly promised to flicker into life in 2017 (our underweight served as an implicit, unintended macro bet, which we do not like to make). However, despite pockets of capital discipline emerging - particularly amongst large integrated oil companies with long investment cycles and a desire to pay dividends – the industry’s fragile peace collapsed, and market share maximising tactics broke out once again. Hence, we sold the rest of our oil related stocks, in the aftermath of OPECs collapse.



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