NEDGROUP INVESTMENTS

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Quarterly review

Nedgroup Investments Core Bond Fund

As at 30 September 2021

A volatile quarter for risk assets and large cap companies

Over the quarter, global vaccination efforts were provided a boost when the Phizer/BioNTech vaccine became the first vaccine to gain full approval from the US Food and Drug Administration (FDA). It was a turbulent quarter for risk assets which saw volatile periods of recovery and retracement. Commodity prices increased and in turn the concerns spilled over to the emerging markets in what proved to be one of the worst quarters for emerging markets since the start of the pandemic. Global financial markets were weighed down during September as investors become more wary of rising inflation and interest rates. In the third quarter, the Nedgroup Investments Core Bond Fund was slightly up by 0.5%.

The table below compares an investment in the Nedgroup Investments Core Bond 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 Core Bond Fund three years ago, you would have R13 053 at the 30th of September 2021. This is greater than the R11 621 you would have achieved had you invested your money in bank deposits (cash) over the same period. The green circle in the chart below, highlights the recent market recovery, which helps to contextualise the returns experienced in the past few years.

Value of R10,000 investment in Nedgroup Investments Core Bond Fund versus Cash[1] and the Growth target

	3 Months	1 Year	3 Years	5 Years	7 Years	10 Years
Growth of fund (after fees) *(Growth in %)*	R10 047 *0.5%*	R11 219 *12.2%*	R13 053 *9.3% p.a.*	R15 261 *8.8% p.a.*	R17 497 *8.3% p.a.*	R22 044 *8.2% p.a.*
Growth of cash *(Growth in %)*	R10 087 *0.9%*	R10 350 *3.5%*	R11 621 *5.1% p.a.*	R13 251 *5.8% p.a.*	R14 931 *5.9% p.a.*	R17 322 *5.6% p.a.*
Growth target (Beassa ALBI) *(Growth in %)*	R10 037 *0.4%*	R11 246 *12.5%*	R12 979 *9.1% p.a.*	R15 045 *8.5% p.a.*	R17 335 *8.2% p.a.*	R22 131 *8.3% p.a.*

Fund Return versus Cash[1] and the Long-term growth target for 3 years ending 30 September 2021

Over most periods, the Nedgroup Investments Core Bond Fund has done significantly better than bank deposits (cash) as the Fund benefited from the yield enhancement from investing in longer dated bond instruments. Over the past ten years it has delivered more than 2.6% of additional return per annum, or R4 722 for every R10 000 invested.

[1] We used the STeFI call deposit rate for cash returns

Market and economic commentary

The most notable event in the third quarter was the Chinese crackdown on tech. In July, Chinese government officials announced that they intend to closely police antitrust and consumer protection practices over the next 6 months. The crackdown has been widespread and far reaching, sending a clear message that the Chinese government is taking cybersecurity very seriously.

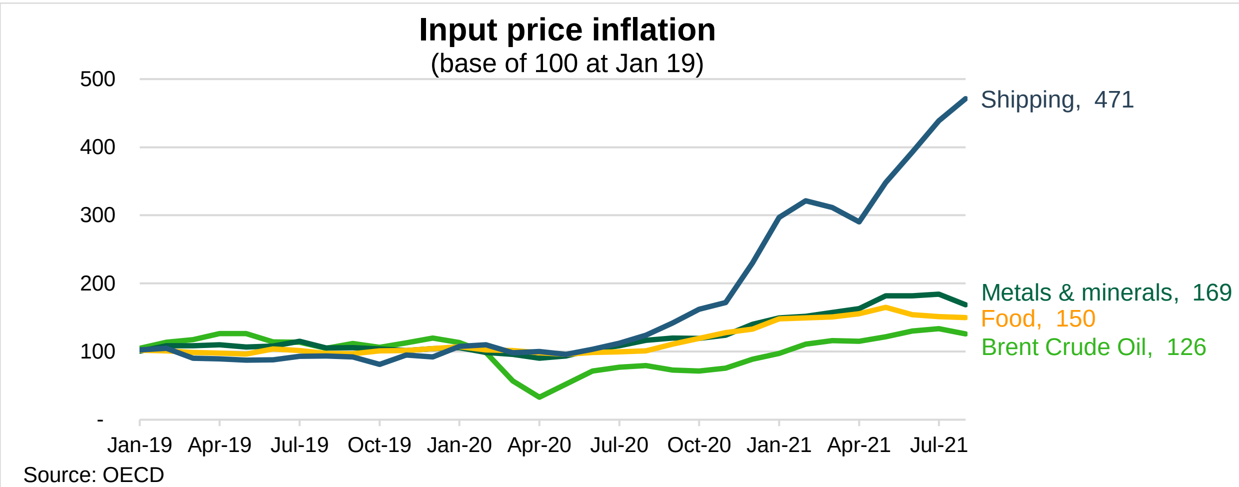
In the past, prior to the internet being commonplace in most households, China relied on the measures in the Golden Shield Project to provide 'digital protection'; essentially blocking many foreign players from entering the Chinese tech market, thereby boosting the growth of home-grown tech companies.

However, this time things are different. The new regulations and tech crackdown have been applied to both foreign and local players. The new regulations include the Data Security Law which came into effect in September and the Personal Information Protection Law, which was passed in August 2021, which together insure the necessary protection of data.

The crackdown has had a notable effect on tech giants and their market prices. For example, under 18s are only permitted to play games for a maximum of three hours a week at dedicated times, with the media equating gaming to "electronic drugs" and "spiritual opium". Tencent Holdings, a significant player in the Chinese gaming market, has experienced the brunt of the clampdown with its share price dropping almost 30% since the end of June. Other measures 'to protect' its youth include banning profits on educational subjects that are covered in primary and middle school, not allowing new registrations of private tutoring companies and banning raising capital. Other examples include forcing Didi (akin to the Uber of China), to remove it's app form the Chinese app store and blocking new users from signing up, earlier in the year Alibaba was fined $2.75 for antitrust violations and Tencent experienced yet another knock with it being banned from engaging in exclusive music streaming agreements.

For now, it looks like cybersecurity and Chinese protectionism trumps the need for the fast growth that tech companies have been inclined to deliver.

Looking beyond China, the global economic recovery has remained strong, underpinned by good progress in vaccinations and central bank support. In fact, in many countries, GDP has risen to pre-COVID levels. However, there are large deviations from country to country driven by marked differences in vaccinations rates forcing some countries to revert to lock down restrictions. This stop-start of economies has created all sort of demand and supply pressures creating bottlenecks in supply chains and ultimately leading to inflation. This is evident in the chart below, with shipping in particular increasing by almost 5 times over the last three years!

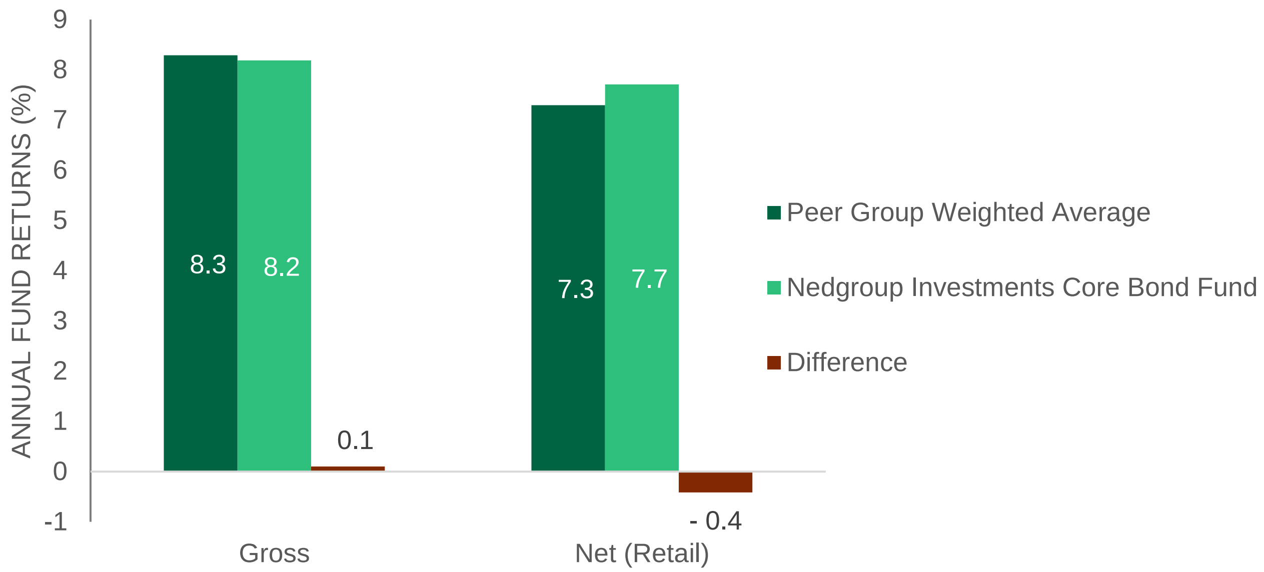


Central banks will have to balance rising inflation with their accommodative monetary policy. Given that a fair portion of inflation has been driven by supply chain disruptions, inflation rates could normalise once the pandemic related disruptions are no longer present.

The Core Bond fund has truly delivered "what's on the tin"

Investment theory states that the average asset weighted return of all participants investing in a market should be equal to the market return less fees. Over the years there have been some who have said "South Africa is different" because "Our market is too concentrated" and so they would expect active managers to outperform the markets. Some of the confusion arises from the fact that the average fund manager return is not equal to the average Rand invested in the market. This is because the largest 10 funds in most SA fund categories represents nearly 70% of the total assets within that space.

A recent study we conducted for our Core Chartbook seems to indicate that most fund categories in South Africa do follow investment theory. Each of the categories' peer weighted returns before fees were broadly in line with their passive (rules-based) counterparts. Lower fees for passive funds resulted in better performance after fees as can be seen for the South African Interest-Bearing Variable category over the period 1 November 2012 to 30 September 2021 (approaching 9 years).



Source: Nedgroup Investments Core Chartbook 2021
We have excluded Inflation-linked bond funds and credit funds to remove inconsistencies in benchmarks

The Nedgroup Investments Core Bond fund is 3 out of 13 since its inception (1 November 2012, just illustrating what an important difference fees have made over the period.

Generally, asset weighted average returns in SA categories have been higher than the standard peer average (equally weighted) used as benchmarks for funds in their categories; 8.2% vs 8.0% per annum over the period since the inception of the Core fund. This implies that fund managers who have delivered better relative performance compared to their peers have been able to grow their assets. Generally, the smaller funds also had higher fees due to lack of scale and multiple fee layers.

Inflation outlook and what it means for asset prices

It is no secret that inflation is top of mind for investors right now as prices for housing, used cars, commodities, airfare, and hotels increase at a faster rate. 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. In 2020, the US Federal Reserve confirmed a shift in policy to target average inflation of 2%. Fast forward a year and inflation across the world has risen in the US above the 2% mark. This has backed the Federal Reserve switch to inflation-averaging from inflation-targeting to alleviate potential policy pressures from inflation. Some drivers will no doubt be transitory, while other areas of pricing pressure may prove to be more persistent. For many countries, inflation prints over the quarter exceeded expectations, but a similar result for US inflation gauges and the resultant US Federal Reserve's (Fed) response was the main bellwether for market volatility.

Globally, inflation increased in September. US CPI increased to 5.4% y/y in September from 4.2% y/y in April and UK inflation rose to 3.2% y/y in August from 1.5% y/y in April. In the Eurozone, inflation increased to 2% y/y in September from 1.6% y/y previously. Higher energy prices and ongoing supply constraints has kept input prices elevated for much longer than anticipated, especially for producers. Hence, global financial markets were weighed down during September as investors become more wary of rising inflation and interest rates.

The rapid pace of the global recovery saw the Federal Open Market Committee cut its forecast for 2021 growth in the nation's GDP from the 7% it projected in June to 5.9% in the September meeting, bringing forward their expectation for tapering and interest rate hikes. 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, amplified by 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). This 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. Combined, the idea of peak growth and more persistent inflation has stoked fears of potential stagflation further down the line and a concern that the reluctance of policy makers to acknowledge inflationary pressures as anything but "transitory" will leave them behind the curve.

In Emerging Markets, we have seen some central banks 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 COVID-19.

In conclusion, the US Fed continues to support the premise that inflationary pressures will be transitory but refined their communication at the September meeting to reflect a slightly more hawkish stance. It is important to monitor this to assess how long the stimulatory factors (asset purchases and low rates) will remain in the market and economy. Markets are keenly aware that price increases are again playing a part in Fed policy even if the rhetoric is muted. The Federal Reserve may have thought its switch to inflation-averaging from inflation-targeting would alleviate potential policy pressures from inflation. It has not. Inflation is a very public drag on consumption at a time when the economy needs all the spending families can muster. Looking ahead, the market expectation is for interest rates to 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. Talk of tapering or the withdrawal of liquidity will no doubt become one of the main drivers of potential volatility for markets that have become used to, if not dependent, on easy financial conditions.

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