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Quarterly review

Nedgroup Investments Core Bond Fund

As at 31 December 2021

A historic year for markets despite the prospect of tighter central bank policy

The last quarter of the year proved to be a good one as global equity indices made new highs, despite a market that remains alive to inflationary pressures and the upcoming withdrawal of liquidity. Risk taking did not quite extend to emerging markets, with the MSCI Emerging Markets Index gaining a modest +1.9% for December and loosing -2.2% for the 2021 year. Local equity markets mirrored positive momentum from global equity markets with the FTSE/JSE All Share SWIX Index gaining +8.3% for the quarter. Additionally, we have also seen most markets retained a sharp focus on commentary from global central banks that could signal earlier interest rate hikes than anticipated. In the fourth quarter, the Nedgroup Investments Core Bond Fund was up by 3.0%.

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 085 at the 31st of December 2021. This is greater than the R11 539 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 298 *3.0%*	R10 871 *8.7%*	R13 085 *9.4% p.a.*	R15 584 *9.3% p.a.*	R17 360 *8.2% p.a.*	R22 036 *8.2% p.a.*
Growth of cash ***(Growth in %)***	R10 089 *0.9%*	R10 353 *3.5%*	R11 539 *4.9% p.a.*	R13 144 *5.6% p.a.*	R14 856 *5.8% p.a.*	R17 250 *5.6% p.a.*
Growth target (Beassa ALBI) ***(Growth in %)***	R10 287 *2.9%*	R10 840 *8.4%*	R12 994 *9.1% p.a.*	R15 426 *9.1% p.a.*	R17 105 *8.0% p.a.*	R21 985 *8.2% p.a.*

Fund Return versus Cash[1] and the Long-term growth target for 3 years ending 31 December 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

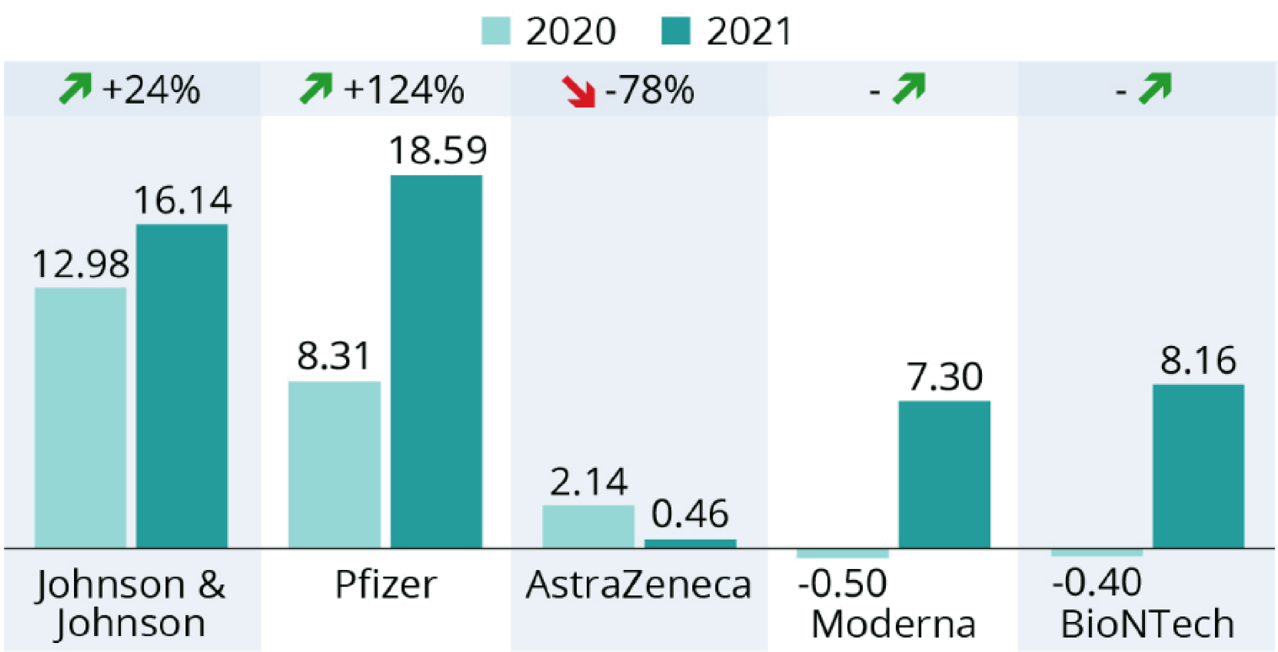
Market and economic commentary: The year 2021 in review

It was a very challenging start to the year with hospitals around the world struggling to cope with the influx of COVID 19 patients infected with the Delta variant. As the year progressed, we witnessed renewed hope as the global scientific community came together to development COVID vaccines. Unfortunately, despite the introduction of vaccines, the global death toll from COVID 19 was higher in 2021 than 2020, in part due to the unequal access of vaccinations around the world. Growing inequality was observed in many critical areas (income, education, healthcare) and economies around the world took strain.

The economic and market landscape was also dominated by COVID. Consumers and businesses alike struggled with a shortage of items worldwide due to supply chain back logs. The situation was further aggravated by a ship getting stuck in the Suez Canal in March, blocking it for about a week and once again reminding us of our global connectedness. In fact, shipping costs nearly tripled[2] over the year (in US Dollars) as measured by the Global container freight index.

Nowhere was the theme of global connectedness more evident than in pharmaceutical companies, which generally witnessed a rise in profits, most notably Pfizer's whopping 124% increase in profit due to its hugely popular vaccine.

Net profit of pharmaceutical companies for Q1 to Q3 in 2020 vs. 2021 in US Dollars



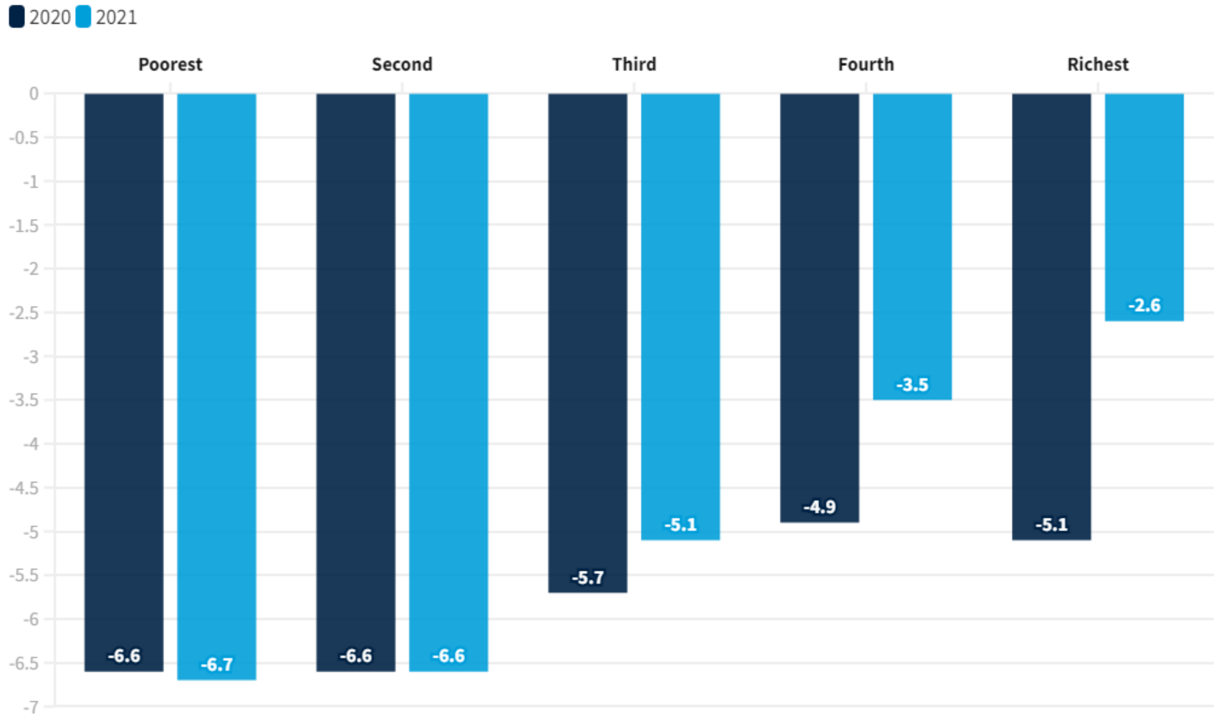
Source: Statistica

Globally, there has been a significant increase in food prices with the FOA Food Price Index averaging almost 30% higher in 2021 compared to 2020. This index represents commonly traded food commodities. Extreme weather events, a significant rise in energy costs (almost 60% in the year[3]) and the global supply chain disruptions have all exacerbated the rise in food prices.

This has compounded the problems of the poorest of the poor who have not yet seen a recovery in their income losses post pandemic. According to the World Bank, the average income of the bottom 40% of the global population by income distribution, are still earning 6.7% lower than before the pandemic. As a result, the World

[2] Source: Statistica
[3] S&P Goldman Sachs Commodity Index

Bank estimates that nearly 100 million more people are living on under $1.90 a day due to the pandemic and resulting policy decisions. In contrast, the rest of the population that have seen some recovery in their income in 2021, as illustrated by the chart below.



Source: Yonzan et al. (2021) • Compared to pre-pandemic projections.

However, not all developments last year were doom and gloom. The pandemic has also seen some positive repercussions, drastically accelerating digital adoption and fostering a new way of working with many businesses, adopting a hybrid approach in working from home and the office. This is still relatively new for businesses and much experimentation is required, but the hope is that the approach will lead to increased productivity, happier staff and a reduction in carbon footprint due to a reduction in travel. Furthermore, markets provided great returns, in part fuelled by monetary stimulus.

In conclusion, the year 2021 was a very challenging year for many. Although nobody knows what the year ahead holds, many are hoping for a better 2022.

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South African fixed-income market overview[4]

The relatively mild symptoms of the omnicron coronavirus variant gave global financial markets some cheer in December. Investors are cautiously optimistic that the economic hit will not be as severe this time around. Globally, bond yields are being driven up by the expected winding down of quantitative easing as well as the US Fed signalling its expectation of three quarter-percentage-point interest rate hikes by the end of 2022. At the latest policy meeting, US Fed Chair Jerome Powell noted that the pace of inflation is uncomfortably high.

On the local front, South Africa ended the year on a better footing which should bode well for economic growth going forward. However, it should be noted that South Africa's economic activity remains constrained with benign investment spending, a narrowing current account surplus, as well as stubbornly elevated levels of unemployment. Fitch Ratings removed its negative outlook on South Africa in mid-December post the Medium-Term Budget Policy Statement (MTBPS) and noted that "low growth reflects deep-rooted labour market problems including skill mismatches and the fractious relationship between social partners, but also very weak investment exacerbated by electricity shortages". Despite the improvement in South Africa's cyclical fiscal position (and some token reforms) announced at the MTBPS, S&P and Moody's kept their outlook on the SA sovereign unchanged.

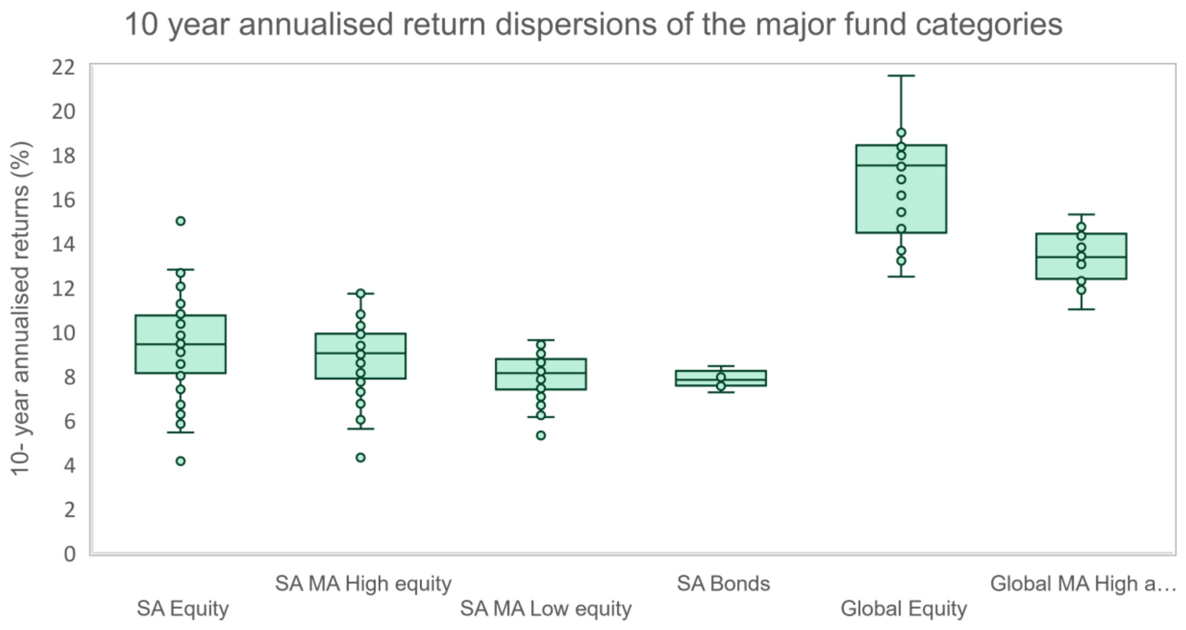
Headline CPI inflation numbers in SA rose to 5.5% y/y in November from 5.0% in October, the highest rate since March 2017. CPI inflation was largely driven by fuel inflation. PPI inflation for final manufactured goods surprised the market on the upside accelerating to 9.6% y/y in November from 8.1% y/y in October, also because of high fuel inflation. This was the highest producer inflation rate since at least 2013. Administered price inflation for November 2021 was 14.1% y/y and non-administered (i.e. market-determined) price inflation was 3.8% y/y. Examples of administered prices include municipal rates, water, electricity, public transport costs, school and tertiary education costs. Aside from administered prices, inflation remains well contained. It is worth noting that non-administered price inflation accounts for 83.8% of CPI and has remained below the mid-point of the CPI target range since the middle of 2017.

The rate path projection of the SARB's Quarterly Projection Model (QPM) currently provides a guidance of eight 0.25% rate hikes over the next 2-years. The SARB has mainly attributed this trajectory on second-round effects, primarily driven by administered prices, fuel costs, and nominal wages rising well above headline inflation. The SARB is now forecasting headline inflation to average 4.5% in 2021 and 4.3% in 2022. On the other hand, muted consumer demand for services is expected to stifle increases in core price inflation, estimated at 3.0% in 2021 and 3.7% in 2022.

Picking attractive games – Is dispersion of returns an indicator?

Michael Mauboussin has written numerous research pieces covering the challenges facing active managers[5]. He highlights that their other fewer "fools" on the other side of trades on the stock market meaning that active managers need to work harder to generate outperformance. Picking attractive games is essential to their future success but the question is how to identify these. Many fund managers believe that they should focus on fund categories where there is the greatest level of dispersion in relative fund returns, ie between fund managers. The chart below shows the dispersion in 10-year annualised returns for the major South African fund categories.

[4] Provided by the Taquanta Fixed Income Team with some adaptations
[5] Mauboussin (Credit Suisse), *Looking for Easy Games: How Passive Investing Shapes Active Management*, January 2017.
Mauboussin (Credit Suisse), *Winning the Easy Game: Skill and the Ability to Extract Value*, June 2017.
Mauboussin (Blue mountain), *Who Is On the Other Side?*, February 2019



A quick glance at the chart and we see that return dispersions between Equity funds (SA and global) are significantly wider than in Bonds. Multi-asset fund lies somewhere in between and generally the higher the equity allocation the higher the return dispersion. But how have passive fund's fared in these categories? In most of the fund categories the Nedgroup Investments Core range rank among the top four best performing funds meaning that dispersions alone doesn't guarantee success – fees also maters.

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