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NEDGROUP INVESTMENTS BALANCED FUND

Quarter One, 2022

Nedgroup Investments Balanced Fund

Performance to 31 March 2022	Fund Performance[1]	ASISA category average[2]
3 months	1.17%	-1.20%
12 months	6.72%	10.67%

Market overview

The War in Ukraine has added further global inflationary pressure which, coupled with a hawkish Fed, has resulted in higher rate hike expectations

Before the war in Ukraine, inflation had remained more elevated than expected by central banks. Although some of this elevation was due to Covid-induced supply chain issues, it was also partly driven by non-transitory factors like wages and their associated impact on shelter costs. The conflict in Ukraine has added further inflationary pressure through the reduced supply of agricultural commodities and energy. Higher food and energy prices are effectively a tax on consumers, with the impact being especially acute in poorer countries.

Fed members have continued to express a hawkish tone in respect of rate hikes and quantitative tightening. This is possible given the low level of unemployment and the strength of the US economy. Both long-term real and fixed interest rates have risen meaningfully over the quarter, reflecting higher inflation and the Fed's pivot to greater hawkishness. The yield on the 10-year fixed-rate bond rose from 1.51% to 2.34% and inflation-linked bonds rose from -1.10% to -0.49%. Most of this move has occurred in the shorter part of the interest rate curve where the market is already pricing in a Fed rate increase from 0.3% to 2.8% by the start of 2023.

Long-term interest rate and inflation expectations for 5-years remain muted. Expected inflation at 2.4% is not out of line with the last 10 years and 5-year fixed rates are at a similar level i.e., the market assumes 0% real rates in 5-years. Long-term real rates are rarely below or close to zero for an extended period unless growth is poor and/or there is an excess level of savings over investment. The latter seems unlikely given the government continues to run deficits, and the capital stock is old and will need replacing. Either growth will disappoint, or real rates need to rise. Both outcomes are negative for the US equity market.

The US market is close to an all-time high with a price/earnings ratio of 19.4X (versus a 10-year median of 16.8X). It seems that rising long-term interest rates (both fixed and real) have not yet had a negative impact on the US equity market.

The US market is facing earnings growth headwinds

In addition to an above average valuation, the high earnings base of the US equity market is of greater concern. Earnings expectations continue to be revised upwards despite headwinds from company cost pressures, a high base in goods consumption that arose from stimulus payments during Covid, and inventory rebuild. Pushing higher wages (wage increases are currently more than 5%), commodity costs, and energy prices onto consumers will prove difficult. Goods consumption has been well above the long-term trend since Covid. Inventory rebuild has been reasonable as some supply bottlenecks have been sorted. This creates a high base for demand going forward. Hence, we are concerned about the impact of earnings downgrades that are yet to feed into market performance. In the case of Europe where energy pressures are far more severe, earnings downgrade risk is also significant.

Global economic growth expectations are being downgraded due to the War in Ukraine

[1] Net return for the Nedgroup Investments Balanced Fund, A class. Source: Morningstar (monthly data series).
[2] ASISA Multi-asset high equity category.

Global manufacturing PMI fell 0.7 points to an 18-month low of 53. The conflict is estimated to shave approximately 1% off global GDP growth. The impact will be more severe in Europe due to the greater impact on their energy costs compared to the US. European gas prices have risen by a significantly higher amount in Europe given their reliance on Russian gas. Certain emerging markets that are net importers of natural resources, especially foodstuffs, will be particularly hard hit. The impact on South Africa should be somewhat mitigated due to the benefit of our net commodity exports, but this is not true for many emerging markets

China PMIs moved into contractionary territory in March (from 51.2 to 48.8) due to their severe Covid lockdowns. According to Bloomberg, April will likely be worse as the survey was closed early due to lockdowns. We are now seeing GDP forecasts for China being revised below 5% for 2022.

Chinese regulatory impacts will result in higher risk premiums

Beijing has stated that they hope to be through the most material changes to tech regulations soon, but the real issue is the effect of the onslaught of tech regulations seen so far… and it is early days. Quantifying these impacts is difficult, and we will only know the full extent a year from now. The policy of 'common prosperity', which may well be positive for consumers, probably implies wealth redistribution which is likely to be negative for tech firms like Tencent. It is still not clear if the delisting of Chinese firms from the US exchange will be averted. However, this is less important than gaining clarity on the structural impact on tech earnings from the new regulatory paradigm.

Commodities will benefit from the Chinese stimulus and a faster pivot to green energy

Bad news is often good news when it comes to Chinese commodity spending. For China to achieve its growth targets, pressure to spend on infrastructure will be even greater given the negative impacts of lockdowns on the economy to date. In fact, Chinese provincial infrastructure bond issuance is at record levels. Hence, the likelihood of stimulus from capital expenditure remains significant.

The War in Ukraine has resulted in a greater urgency for Europe to wean itself off Russian energy. Although this pivot may increase coal usage in the short-term, ultimately investment into clean energy technology will be accelerated. This will add to base metal demand, resulting in greater deficits over the medium term. Risk premiums in energy prices might reduce if some resolution to the war is achieved. However, energy prices are still likely to remain elevated.

In the case of oil, both downstream and upstream stock levels are extremely low, and OPEC still seems reluctant to increase supply despite a tight market. Although many Russian commodities can be redirected to other markets like India and China, coal cannot be due to logistical factors. This, coupled with under-investment in coal due to ESG, and additional European demand, will likely keep coal prices at elevated levels. Europe's efforts to reduce dependence on Russian gas will keep European gas prices elevated.

The key concern regarding commodities is one of demand destruction due to excessively high prices and a potential recession. Mining shares are priced at substantially lower commodity prices given that their P/E ratios on spot commodity prices are below 6-times earnings and are on high double-digit free cash flow yields. We have still found value in the resource sector using lower assumed commodity prices than reflected by the spot market. However, should miners' share prices continue to rise we shall reduce our exposure.

South Africa's economic outlook remains subdued

Although the SA balance of payments and the budget deficit are benefiting from elevated commodity export revenues, we are concerned about the impact of inflationary pressure on the SA consumer. Although SA's inflation figure is within the SARB's band (CPI 5.7% in Feb), household affordability compiled by Pietermaritzburg Economic Justice and Dignity reflects a 10.2% increase in the average SA food basket.

Consumers, especially in the lower LSM groups, are likely to face significant pressure from their consumption basket rising meaningfully above their wage growth.

Domestically focused shares have benefited from SA's net commodity export status as well as from emerging market funds that are being diverted away from Russia, Turkey, and possibly China. We have reduced our exposure to this price strength, especially in financials. There is still good value to be found in certain counters like Absa which is trading on a dividend yield of 8%. However, some of its competitors are now trading on expensive valuations. We remain focused on finding value in domestic shares that are not overly reliant on domestic economic growth or are at least pricing in a lackluster outlook. This would include companies that benefit from self-help or that generate defensive earnings.

Performance Commentary

The war in Ukraine resulted in a pivot to a risk-off investment environment. This coupled with sanctions against Russia benefited commodity prices and miners. Higher food and energy prices increased the probability of a recession, especially in Europe, which contributed to the risk-off environment. British American Tobacco, being defensive, benefited from this environment.

EM flows moved away from Russia towards EMs that benefit from higher commodity prices such as South Africa. This especially benefited the financial sector. Continued Chinese regulatory pressure on the tech sector resulted in underperformance from the likes of Tencent. This resulted in an underperformance from Naspers and Prosus. Telkom's poor results and cashflow generation negatively impacted the share price which detracted from performance.

The risk-off environment and concerns regarding a possible European recession negatively impacted European banks and Stellantis, which detracted from performance.

Top contributors	Average weight	Performance contribution	Top detractors	Average weight	Performance contribution
Absa Group Ltd	3.74%	0.74%	Prosus Nv	2.49%	-1.02%
Sasol Ltd	2.47%	0.70%	Stellantis Nv	2.17%	-0.53%
Glencore Plc	4.54%	0.57%	Telkom Ltd	1.96%	-0.45%
British American Tobacco	4.31%	0.56%	RSA Jan'24 $ bond	3.47%	-0.37%
Investec Ltd	2.92%	0.47%	Naspers Ltd	1.14%	-0.34%

Portfolio positioning

We increased our mining exposure, as we expect the sector to benefit from an increased need for stimulus from China given their struggling economy. In addition, we expect a more dramatic pivot to clean energy generation as Europe tries to wean itself off Russian energy. This will result in greater base metal demand. Coal prices will also likely remain elevated for longer due to Russian sanctions.

We reduced our holdings in financials which are offering less value than at the start of the quarter. We purchased Pick 'n Pay which has sold off aggressively and is offering compelling value. We reduced our holding in Anheuser Busch due to concerns regarding input cost pressures and a less compelling valuation. We further reduced our exposure to Prosus due to the likelihood of a higher risk premium for Tencent. This is due to regulatory changes and the associated negative impact on the earnings outlook for the company.

We sold Hyprop which reached our valuation target. We sold our Russian exposure due to concerns regarding the impact of sanctions. We sold Vivendi post the realization of value from the unbundling of the Universal Music Group.

Responsible Investing

Mining companies' environmental impact
We are engaging with the mining companies, especially those in the platinum and gold sectors, on the risks of tailings dams, with specific reference to safety issues, additional capex spend that might be needed and environmental impact studies.

Environmental risk in property companies
One upcoming environmental risk for South African property companies is the Energy Performance Certificate (EPC) Ratings. To better understand how companies are dealing with this risk, we engaged with a few property companies. Our engagement with Vukile in August 2021 gave us some comfort that even though shopping malls are exempt from the certification deadline of December 2022, they were still considering this risk.

Governance at Naspers
General concerns – control structure, lack of independence of certain directors, and a remuneration policy that we did not think incentivised the right behaviour

Over many years we have engaged with management and industry specialists on many of the issues around the control structure of Naspers and its low voting N shares. This means that shareholders have little sway over effecting the necessary changes within the business. We also raised concern around the re-election of BJ van der Ross, MF Phaswana and RCC Jafta as their years of service have now rendered them non-independent.

We have consistently voted against endorsing the Naspers remuneration policy, as well as amendments to any of the share incentive schemes. Many of these concerns raised are not new and have been part of the broader Naspers governance debate for quite some time. Other issues raised were around the MultiChoice matter and ANN7 probe. We engaged extensively with management around the MultiChoice corruption charges.

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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