NEDGROUP INVESTMENTS

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NEDGROUP INVESTMENTS FLEXIBLE INCOME

Quarter One, 2022

Nedgroup Investments Flexible Income Fund

Performance to 31 March 2022	Fund Performance[1]	Stefi*110%
3 months	0.1%	1.0%
12 months	6.2%	4.0%

The fund had a below par Q1 performance, underperforming its benchmark (preceded by the strong Q4 2021). The stronger currency, a re-rating in offshore bonds and poor listed property performance detracted from performance for the quarter.

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

Rising global interest rates and the sudden invasion of Ukraine by Russia in late February, saw the first quarter of 2022 experience significant market volatility. Notwithstanding the humanitarian crisis, the broad sanctions applied to Russia by most of the developed world saw significant market impacts. Russia is not only of one of the biggest oil and gas exporters in the world, but also one of the biggest exporters of wheat, nickel, platinum group metals, coal, uranium and aluminum. Despite the risk-off sentiment, this led to a significant rally in both energy and commodity prices.

The FTSE/JSE All Share Index ended the quarter up 3.8%, despite a more difficult month in March. Returns across sectors were however very diverse, with the Industrial sector delivering -13.9% for the quarter, but rising interest rates and strong commodity prices meant that the financial and resource sectors returned 20.2% and 18.2% respectively. The local bond market returned 1.9% for the quarter, but experienced incredible intra-quarter swings, with the ALBI showing a negative YTD return mid-March before recovering. Local inflation-linked bonds delivered a marginally positive return for the quarter (+0.4%), while property had a poor quarter, delivering -1.3%, despite a strong March.

On the global front, equity markets struggled, with the S&P and NASDAQ delivering -4.6% and -8.9% respectively, not experiencing the benefit of a high resource weighting as we do in our local equity indices. US rates were very topical, as not only did we see extreme upward moves in yields (particularly in the short end of the curve), but we experienced a yield curve inversion, where the 2Y point of the curve was actually slightly higher than the 10Y point of the curve. This rise in rates naturally saw offshore USD/EUR bonds rerate over the quarter.

The fed started their interest rate hiking cycle in the March meeting, raising rates by 0.25%. Against an inflation backdrop of 7.9%, it is fair to say the Fed is behind the curve. Unfortunately, the only way for monetary policy to bring down inflation that is broadly supply driven, is to dampen demand, and naturally that is a recessionary by nature. Unfortunately, this is happening as signs of US growth deceleration are already starting to show, making the avoidance of a stagflationary environment extremely difficult for the Federal Reserve to navigate. Our view remains that, despite increases in interest rates, negative real rates will prevail for an extended period of time, as it remains the only tool to deleverage a highly geared economy. Should the economic pressure mount, we will likely hear a reversion to a more dovish tone.

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

On the local front, the SARB increased the repo rate by 25bps. The increase in energy and commodity prices means inflation forecasts have had to be revised, and we foresee inflation peaking over 6% in the first half of this year, moving down thereafter, but not easily reaching the midpoint of the target band in the foreseeable future. This was noted by the more hawkish tone of the Reserve Bank at the MPC, with 2 members actually voting for a 50bp increase. Despite this, the market is still pricing in multiple 50bp hikes over the course of the year, which although possible, we believe to be unlikely. As a result, we would still favor being received fixed rates.

The ZAR has continued to defy all expectations, and despite the risk-off sentiment experienced over the quarter, still managed to appreciate. The correlation between the bond market and ZAR has practically disappeared over the short term, as ZAR purchases continue on the back of strong commodity exports. The ZAR has also been the beneficiary of other emerging markets currencies (e.g. Turkey and Russia) facing substantial headwinds. The strengthening of the ZAR was a detractor of performance, but we continue to view the currency to be on the expensive side at month-end levels.

The sanctions imposed on Russia has had a particularly negative effect on one bond in the portfolio. At the time of the invasion, we had 0.7% exposure to the Mail.Ru/VK 2025 convertible bond, a Russian social media company, whose shareholders include Alibaba, Tencent and Prosus. Despite the continued performance of the business in Russia, this bond was marked down due to uncertainty on whether we can get USD out of Russia. It is important to note that this is not a credit event, but merely the result of sanctions. The business in the meantime continues to service its debt, and we therefore believe there may be potential upside performance from this instrument going forward.

After a difficult quarter, we believe that the fund has a payoff profile that is skewed to the positive. We continue to think South African government bonds present good value and remain comfortable with our duration. We don't foresee any significant increase in US rate expectations from here, and despite a continuous strengthening ZAR, we remain comfortable buying USD into strength, as the ZAR in our opinion remains fundamentally on the strong side. We remain positive on the prospects of the fund for the year, and for the long term, where our investment approach has proved itself over the history of the fund.

Current positioning and outlook

- Moderate Duration

As at the end of Q1 2022, SA duration is 0.9 years in nominal bonds and 0.3 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), but also have exposure to longer term government nominal bonds, as a result of our view of a flattening yield curve in a rising interest rate environment. Yields on nominal bonds remain at attractive levels and are pricing in a SA risk premium that we believe more than compensates for any fiscal risk; we therefore further increased our duration in March, when bonds experienced a significant selloff. Inflation linked bonds generally appear more fairly priced compared to nominal bonds but provide a nice hedge should inflation fears escalate over the coming months, we still prefer the shorter-dated exposure to the inflation-linked bonds.

- 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

Locally, we maintain a 30bp position in the Sappi convertible bond. Additionally, we maintain a 0.5% exposure to some offshore convertible bonds. We continue to look for opportunities in this space, but given the strength of equity markets, it remains on the expensive side.

- Property

The fund currently has 2.9% exposure to domestic property. We have maintained a conservative exposure, as the levels of debt and reduced economic activity maintain an uncertain outlook for the sector. 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 3.1%, with the majority in the Big 4 banks. The pre- and post-tax yield remains attractive in this environment. Institutions buying back their preference shares has allowed this asset class to rally dramatically over the past few months, as this trend is expected to continue.

- Offshore Bonds & Money Market

The fund maintains an exposure to Offshore Bonds & Money Market instruments at 10.6% where a very attractive yield pickup over domestic assets is available when hedged back to ZAR while maintaining a high degree of credit quality and diversification. Our effective offshore exposure is at 5.9%; this was reduced last quarter as the ZAR weakened against the USD to fairer levels. This quarter however saw phenomenal ZAR strength and below R14.50/USD we will be looking to add to our offshore exposure. Our offshore exposure can also be seen as a pseudo hedge to our healthy duration in the portfolio, despite the short-term correlation of this relationship breaking down due to strong commodity prices.

Summary and Conclusion

The first quarter of 2022 presented us with challenges. Rising rates and tensions between Ukraine/Russia, sparked a risk-off event, that saw the sell-off of many global asset classes. The supply dynamics as a result of tensions, however, also saw a rally in energy and commodity prices. As a fiscal beneficiary of strong commodity prices, this is positive for local bonds over the long term and we remain happy to increase duration in local government bonds into weakness, especially as the curve remains steep. Our continued current account surplus, however, has seen the sustained strength of the ZAR into expensive territory, despite the risk-off sentiment. Despite these strong tail winds for the ZAR, we continue to focus on our fundamental valuations, and are happy to add conservatively to our offshore position should the currency move stronger. Strong global interest rate increases are firmly entrenched in the markets expectations for this year, but a slowing global growth environment is evident and could potentially risk the degree of tightening expected, despite inflation still running high. Should such a scenario unfold, we believe ourselves to be well positioned. Despite a difficult quarter, we believe that the fund has a payoff profile that is skewed to the positive and remain confident the fund will deliver ahead of its benchmark over reasonable measurement periods.

Disclaimer

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.

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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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