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NEDGROUP INVESTMENTS BALANCED FUND

Quarter Three, 2022

Nedgroup Investments Balanced Fund

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

Performance to 30 September 2022	Fund[1]	ASISA Category[2]
3 months	2.33%	-0.11%
12 months	6.43%	0.19%

Market Overview

Rates have risen, but inflation is still too high

It's been a tough few months for Central Banks around the world. Not only is inflation proving more resilient than anticipated, but currency weakness and fiscal stimulus have added further complications. With inflation still running hot in most advanced economies, the immediate focus will be on continuing to deliver meaningful rate hikes. Any imminent rate hike pause looks increasingly remote. As Fed Chair Jerome Powell acknowledged, "We have got to get inflation behind us. I wish there were a painless way to do that. There isn't."

As expected, after the strong August inflation numbers, the Fed unanimously decided to raise rates by 75bps in September to 3.00-3.25%. Rates are now expected to reach 4.4% by the end of 2022, and expectations are for one more 25bps rate hike early next year. As things stand today, it looks like the Fed will need to raise rates a little further and see economic growth weaken by more than it previously thought to tame inflation.

Furthermore, US labour markets remain resilient which will force the Fed's hand. The September unemployment rate dropped back to 3.5%, matching the 50-year pre-Covid low. Worker shortages are thus unlikely to be solved by stronger supply; the adjustment will need to come from weaker labour demand. This reinforces the Feds view that the labour market is "out of balance".

Global risk-off sentiment and the Fed's hawkish stance continued to buoy the dollar. The strong dollar coupled with rising interest rates tightened financial conditions and blunted economic activity. The latest manufacturing numbers suggest that the global industry has already weakened significantly and will probably deteriorate further in the months to come.
With world markets down approximately 25% year-to-date, some of this bad news is starting to reflect in valuations. However, earnings forecasts probably require further downgrades to reflect the double-edged sword of high inflation and slowing growth, which must inevitably result in margin pressure. Hence, we expect markets to remain under pressure.

The energy crisis turns into a cost-of living crisis

The outlook for European gas markets remains one of the most important drivers of European inflation and economic expectations. The sharp increases in gas and electricity prices in Europe mean that households will see a steep rise in their costs of energy consumption. Accordingly, governments have announced emergency support packages worth 1.5% to 7% of GDP.

Emergency measures include a cut to electricity demand (10% overall voluntary cut and 5% peak demand mandatory cut), a cap on revenues for non-gas power generators, a "solidarity contribution" from fossil fuel companies, and measures to support small enterprises. As is the case with oil, markets remain tight with little new gas supply expected to come onstream before the end of 2025, which skews price risk to the upside and could lead to further downgrades of European GDP growth in 2023/2024.

Unfortunately, greater fiscal support and stimulus means that monetary policy will need to be tightened even more aggressively, as painfully illustrated recently in the UK. The new UK government unveiled a massive debt-financed package to fund tax-cuts and energy support in the hope of growing the economy and providing relief for the consumer. This debt-funded spending is occurring as the Bank of England (BoE) is raising interest rates to tame inflation. The "mini-budget" heightened concerns about inflation, already near a 40-year high, and a spiralling government debt burden, which triggered a market selloff of the pound and bonds. This new fiscal support implies that the BoE will now need to tighten policy more aggressively than it otherwise would have to counteract the additional price pressures stemming from the fiscal stimulus.

[1] Nedgroup Investments Balanced Fund, A-Class.
[2] ASISA South Africa Multi Asset High Equity

This backdrop of stimulative fiscal policy resulting in growing budget deficits combined with tight monetary policy is an adverse mix for financial markets.

Geopolitical tensions increasingly take centre-stage

Geopolitical tensions continue unabated and provide additional inflationary headwinds. As Ukraine appears to be gaining momentum in the seven-month-old war, Russia continues to up the ante. Elsewhere, US-China tensions are escalating, and the tech cold war is intensifying, while North Korea is also attempting to flex their muscles again. Whilst we continue to monitor all these situations, it is fair to say that geopolitical risks are currently high, and we require a greater margin of safety in our portfolios.

Is there an inflection point ahead for China?

The much-anticipated 20th National Congress of the Chinese Communist Party takes place this October, where President Xi is expected to retain an unprecedented third term. Whilst some stimulus measures have been introduced to-date to help the ailing economy, it is hoped that more meaningful fiscal stimulus will follow post the Conference. If coupled with a relaxation in the Zero-Covid Policy, consumer confidence could also recover. At present, poor sentiment among households and businesses is reducing their willingness to spend, invest, and hire. Additionally, weak private sector credit demand is dampening the effectiveness of stimulus measures. Should a shift in growth materialise, the fortunes of commodities might see a reversal.

Commodity prices and oil

The stronger dollar and deteriorating global demand outlook weighed on commodity demand and prices. The price of Brent oil fell and dipped below the level last seen prior to Russia's invasion of Ukraine. Industrial metals declined based on concerns regarding Chinese demand while gold fell amid rising real interest rates and a strong dollar. Coal was unsurprisingly resilient, underpinned by the energy crisis.

Notwithstanding demand concerns on weak economic growth, oil remains at highly profitable levels for producers. The continued tightness in the market is highlighted by the US attempts to increase supply by lifting sanctions on countries like Iran and potentially Venezuela. The recent announcement from OPEC + to cut quotas by 2mb/day adds further pressure to supply even though most OPEC countries, including Russia, are already producing well below their individual allowances.

What this all means for South Africa

The surge in energy prices will have the greatest impact on Europe and would likely push their economies into recession. An impact on emerging markets is anticipated, but on a much smaller scale due to the less severe energy price shock outside Europe as well as the limited use of gas for electricity.

A strong dollar is typically negative for commodity prices, as is deteriorating global demand. Lower commodity prices weaken our trade account, as well as our budget deficit through reduced tax receipts from mining companies. However, the lower oil price and resilient coal price are providing some buffer for our trade account.

South Africa's relative potential insulation against global headwinds lies in both domestic reforms and compelling domestic equity valuations. As such, the 2022 Medium Term Budget Policy Statement later this month will be keenly watched by investors. Large revenue overruns combined with good cost control have provided a meaningful improvement in the fiscal backdrop relative to the February 2022 Budget. But the most important aspect will be the potential announcement of the deleveraging of Eskom's balance sheet. We hope to see the recent windfall tax gains from the mining companies being used to address Eskom's contingent liabilities and capital adequacy.

The ongoing crisis at Eskom is spurring some overdue reform urgency from the government. A new, and credible, Eskom board has finally been announced and Eskom management appears to be making some progress in tackling the criminal networks throttling its coal power plants.

We believe it might be difficult for SA to avoid a greylisting by the FATF in its upcoming October review. However, authorities are making substantial progress in addressing the deficiencies which should help SA to exit the list reasonably quickly as was the case with Mauritius, which managed to exit within 20 months. Whilst some negative impacts cannot be ruled out, we think that some of SA's shortcomings are already being discounted in our elevated risk premia. Furthermore, we maintain, that over the long term, capital flows will more likely be influenced by factors like SA's growth and fiscal position.

Domestic SA shares are still offering meaningful value with the ALSI trading on a 12-month forward P/E of 8.3 versus a long-term average closer to 12.5. MSCI SA is trading at 8x 12-month forward consensus, a 27% discount to MSCI EM peers. 10-year bond yields have breached 11% and offer a compelling real yield. These valuation metrics should hopefully provide some relative insulation in markets that we expect to remain volatile.

Portfolio Positioning

Resilient coal prices benefited both Glencore and Thungela which rose some 14% and 70% for the quarter. Absa contributed meaningfully on the back of good results and gained 19% over the quarter. There was finally a value unlock in MMI as the share benefitted from their healthcare investment in India reflecting a significant premium to their own valuation post a capital raise from a third-party.

Sasol underperformed as fears of a global slowdown impacted the oil price. Our holding in Investec detracted, despite good results. The share was swept up in the UK sell-off towards the end of the quarter on the back of a deficit-increasing fiscal package which was poorly received by markets. Deteriorating metrics in the Chinese economy resulted in weakness in our Chinese equity positions

Performance Commentary

We increased our exposure to domestic financials and industrials which were at compelling valuation levels. We took profits in Bidcorp, Naspers and Mediclinic and further reduced our holding in MTN as Nigerian forex markets look increasingly fragile. We took profits in some of our offshore oil majors.

Top contributors	Average weight	Performance contribution	Top detractors	Average weight	Performance contribution
Thungela Resources Ltd	2.63%	1.32%	Sasol Ltd	2.71%	-0.80%
Absa Group Ltd	5.74%	1.07%	Investec Ltd	3.36%	-0.47%
Glencore plc	3.71%	0.30%	British American Tobacco plc	5.14%	-0.43%
Naspers Ltd	4.56%	0.20%	iShares FTSE/Xinhua China	2.61%	-0.38%
MMI Holdings Ltd	0.97%	0.16%	UBS China Basket	1.51%	-0.21%
Total		**3.05%**	**Total**		**-2.29%**

Responsible Investing

Mining and resources
We are continuing to engage with 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.

In 2020, we engaged with Anglo American Platinum and discussed their specific plans and progress in reducing their carbon footprint. They will switch out of their diesel trucks (one of the biggest emitters of CO_2 on the mines) for hydrogen trucks. These trucks will be rolled out to the rest of their mines. We also engaged with Exxaro on their Scope 1, 2 and 3 emissions and their strategy around reducing these emissions with their Cennergi (Wind power) JV.

Sasol Ltd
We met with various Sasol executives in 2019 to discuss their carbon footprint and how they could reduce this given their specific chemical processes. The meeting also covered how they could improve on their carbon disclosure vs. global peers. Sasol undertook to provide a more comprehensive report on their impact on climate change by 2020. They also undertook to improve their carbon footprint disclosure. We have attended multiple decarbonisation conferences globally which we use to benchmark Sasol and provide feedback to the company in this regard.

Following that meeting in 2019, we went through their 2020 Climate Change report and attended a group ESG meeting in June 2021 to discuss the level of ambition in that report. Sasol stated that they were aware that their commitment of reducing greenhouse gas emissions by 10% to 2030 might fall short of expectations. They were in the process of revising these targets and would give further detail at the Capital Markets Day later in the year.

We noted the increased ambition in Sasol's Capital Markets' Day in 2021 – from 10% emissions reduction by 2030 to 30% reduction. After engaging them on a number of climate-related topics, Sasol were planning to table their own climate change resolution and explained the main driver behind the increase in ambition. We had some concerns around how their more ambitious climate targets would come through in remuneration, and whether the right people were being incentivised in the right way.

Give the ESG concerns facing fossil fuel producers, we have set internal limits as to our maximum active position we would take in Sasol in the portfolios. These limits are set at a much lower levels than we would have been the case historically.

Naspers
Over many years we have engaged with Naspers 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.

In June 2021, Truffle teamed up with 35 other managers to question the complex shareholding structure and lack of management alignment in the new Naspers/Prosus deal. We found several aspects of the proposed transaction problematic. We were of the view that it introduces elements which serve to increase complexity in the overall company structures, thereby reducing the likelihood of further value unlock, whether immediate or longer-term. The collaborative engagement was a way to escalate our commonly held concerns directly with the non-executive directors of Naspers and Prosus.

In addition to those core matters, we also had concerns over the more commercially based aspects of the proposed transaction, including the exchange ratio in respect of the Naspers share offer and the future potential tax liabilities. The engagement was unsuccessful since the transaction went through, but we managed our risk through the portfolio construction process.

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.

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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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