NEDGROUP INVESTMENTS

UNIT TRUSTS | INTERNATIONAL | RETIREMENT FUNDS

see money differently

Quarterly review

Nedgroup Investments Core Accelerated Fund

As at 30 September 2022

An all-out war to slay inflation

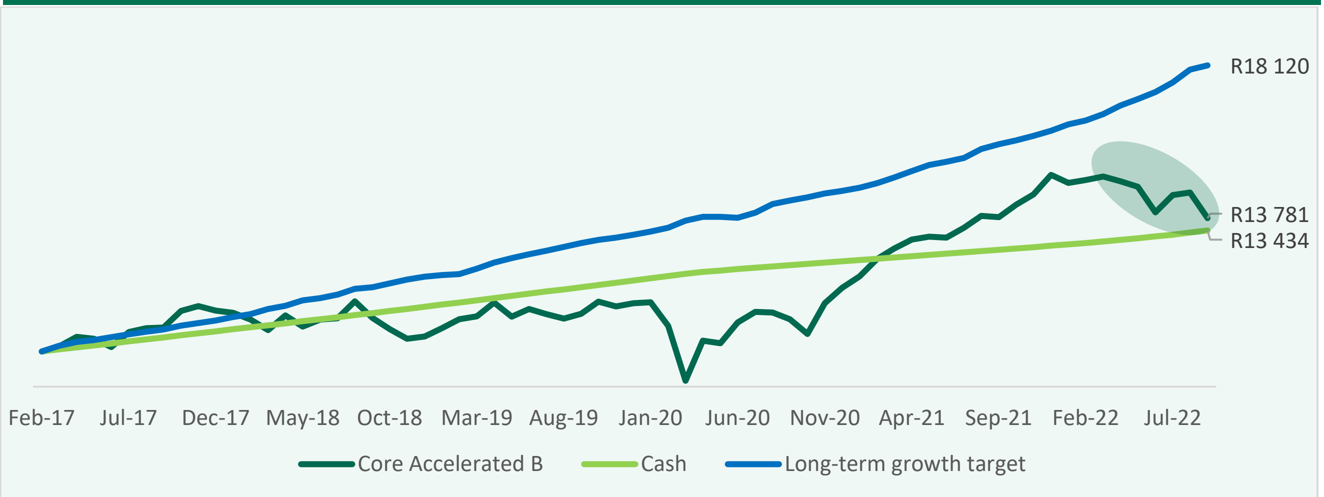
The global economy is rapidly slowing as a momentous monetary tightening cycle is unfolding at top speed, particularly in developed markets. Natural gas prices remain at record highs. Inflation continues to send shivers down the spines of global markets. Central banks have been withdrawing liquidity to arrest inflation's rampant resurgence. It is still important to focus on the long-term and not be overly destructed by short term volatility but yet be mindful that there are shifts happening in the overall landscape. In the second quarter, the Nedgroup Investments Core Accelerated Fund declined by -1.2%.

The table below compares an investment in Nedgroup Investments Core Accelerated Fund to a bank deposit (cash) investment and its growth target over various time periods. For every R10 000 invested in the Nedgroup Investments Core Accelerated Fund at inception (28 February 2017), you would have R13 781 at the 30th of September 2022. This is higher than the R13 434 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 decline, which helps to contextualise the returns experienced in the past few years.

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

	3 Months	1 Year	3 Years	5 Years	7 Years	Inception 28 February 2017
Growth of fund (after fees) ***(Growth in %)***	R9 9877 *-1.2%*	R9 979 *-0.2%*	R12 444 *7.6% p.a.*	R12 909 *5.2% p.a.*	-	R13 781 *5.9% p.a.*
Growth of cash ***(Growth in %)***	R10 128 *1.3%*	R10 425 *4.2%*	R11 360 *4.3% p.a.*	R12 917 *5.3% p.a.*	R14 725 *5.7% p.a.*	R13 434 *5.4% p.a.*
Growth target (inflation+6%) ***(Growth in %)***	R10 433 *4.3%*	R11 407 *14.1%*	R13 859 *11.5% p.a.*	R17 049 *11.3% p.a.*	R21 252 *11.4% p.a.*	R18 120 *11.2% p.a.*

Fund Return versus Cash[1] from inception ending 30 September 2022



The Nedgroup Investment Core Accelerated Fund is designed for investment periods of 7 years and longer as it has a high exposure to shares (90%). This means that it can experience significant fluctuations over shorter periods but in the long-term has a growth target of 6% above inflation (around 12% per year), as demonstrated in the chart above.

The Nedgroup Investments Core Accelerated Fund has fallen short of this target since inception. However, history demonstrates that two-thirds of a fund such as the Nedgroup Investments Core Accelerated Fund would have achieved its long-term growth target of 6% above inflation (around 12% per year) over any 7-year period. In fact, as the time horizon extends, so the risk of underperforming this target decreases.

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

Market and economic commentary

Market declines in the third quarter were an extension of market movements seen year to date. Reprieve from market volatility has not been seen yet. The war between Russia and Ukraine and the ramifications of global rate hikes continued to be dominating the market. Weaker economic prints around the world point to the crystallization of the global economic slowdown. The standout macro data came from the strength in the US labour market as non-farm payrolls improved to the point where US unemployment reached levels last seen in 1969. However, there are indications of a US labour market strength slow down as unemployment reached 3.7% in August from 3.5%.

To add to injury, the Nordstream pipelines increased the intensity of energy insecurity in the Eurozone winter approaches. This has not necessarily changed the trajectory of the easing of energy inflation which is positive. However, the full impact of the caused capacity constrained will be gauged during winter.

On the inflation reaction front, central banks remain hawkish notwithstanding the slight moderation in the increase in price levels - surprises on the upside are the main cause. EU inflation reached 9.1%, while the US reached 8.3%. The US Federal's rate hikes have contributed significantly to the strength of the currency relative to the rest of the world and on a relative basis, the Sterling saw notable volatility as the market corrected for the relative real returns between the two countries. The new UK prime minister, Liz Truss, started her term on the back foot as the market responded unfavourably to the announcement to implement an expansionary strategy during a high inflation era.

On the South African front – the Q2 GDP contraction of -0.7% showed the impact of the KZN floods, loadshedding and the mining strikes. Loadshedding should be the damper in Q3 data, although optimism is noted in the PMI numbers. Consumers in SA also face higher than normal inflation rates (7.6% in August), combined with unemployment levels well above pre-pandemic levels. When taking Producer inflation into account, which came in at 16.6% for the same month, it provides a more complete perspective. South Africa's central bank has followed the rest of the world with reliably aggressive hikes. The ZAR however, like most currencies, has lost ground to the USD with a 11.5% depreciation in the third quarter. In sympathy with global markets, the local equity market declined by c.4.1% in September and 1.9% over the quarter.

Outside of the usual macro concerns – South Africa's review by the Financial Action Task Force (FATF) for potential grey listing is a potential landmine of some sorts faced by SA businesses. Slowdown in business due diligences, transactions, and the increased cost of doing business that come with being grey listed are some of the perils business owners hope to avoid. The market will be looking to the government and business to land this one together.

Asset Allocation in Turbulent Times: What goes up must come down

The increase in volatility around the world's asset classes, that followed the pandemic, is likely here to stay if inflation expectations are informed by today's multitude of weak macroeconomic conditions. Off the back of the wave of inflation, the mantra of 'Trust the Fed' no longer exists - unless we see a change in the mindset of Central Banks about arresting inflation.

On the other side of the coin of high inflation are:

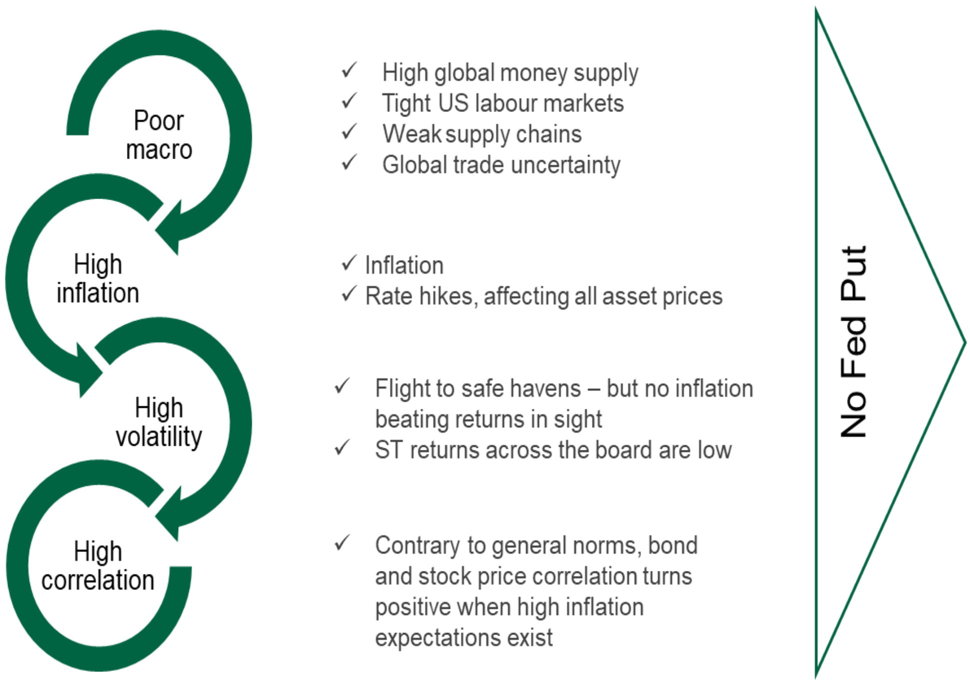
- the high US and DM money supply that is still circulating,
- the tight US labour market,
- and uncertain global trade conditions

With all the existing data on hand, it is not hard to assume that inflation remains high in the short to medium term. We tend to steer clear of macroeconomic predictions, so we aim to highlight that a combination of these types of factors have historically resulted in different asset classes behaving in a more uniform manner than we are used to.

Additionally, we note that correlations between different type of companies in the US have increased since 2017 and the correlation between developed and emerging market assets increased substantially since their lowest correlation of c.0.14 in 2017. [2]When macroeconomic conditions are strong, asset class correlations tend to be low. However, as noted above, this is not the type of environment we are in. At present, the environment is characterised by macroeconomic conditions are broadly weak. Therefore, return expectations across the board in real terms are weak. Earnings or income from assets are informed by the health of economies.

With no Fed Put in sight – in the short-term, we see how there's nowhere to hide anymore. Volatility is likely to remain high and correlation between assets will likely be a dominant risk for navigating short to medium term market conditions. However, in the long run, diversifying, staying the course and keeping costs low will play a key role in capturing long term returns from different asset classes. As the markets ebb and flow – what goes up must come down, we envisage this is true for volatility and asset class correlation too.

Conditions are ripe for volatile asset price environment



Source: Jenna Ross (2021), Nedgroup Investments

Who owns our market and what is driving the shift to passive funds?

Over the past decades we seen a shift from traditional actively managed funds to rules-based or passive funds. The four drivers behind this shift: regulation, the market environment, technology and the balance of informed versus uninformed investors. The diagram below unpacks each of these four drivers.

[2] Jenna Ross, 2021, Visualizing Asset Class Correlation Over 25 Years (1996-2020)

Drivers behind the shift from active to rules-based investing

Source: Mauboussin (Credit Suisse), Looking for Easy Games: How Passive Investing Shapes Active Management, January 2017.

The increased competition between informed investors over the past 50 years has led to continuously declining "alpha" making it more and more difficult to outperform equivalent market portfolios after fees and taxes. The research on the drivers behind passive also showed that the majority of market inefficiencies are extracted by the largest decile of fund managers which does not bode well for the large tail of smaller investment houses.

To illustrate how balance of informed versus uninformed investors have changed we have look at the largest non-corporate owners in our South African equity market.

Largest 10 non-corporate owners in the Top 40 index by free float weightings

Investor	Weight in Top 40	Investor type	Country
Public Investment Corporation	8.4%	Sovereign Wealth Fund	South Africa
BlackRock	8.3%	Investment Manager	Global
Vanguard	5.2%	Investment Manager	Global
Capital International Group	3.7%	Investment Manager	United States
State Street Global Advisors	2.0%	Investment Manager	Global
Allan Gray	1.9%	Investment Manager	South Africa
Norges Bank	1.4%	Sovereign Wealth Fund	Norway
Ivan Glasenberg	1.4%	Individual	Australia
Coronation Fund Managers	1.3%	Investment Manager	South Africa
Ninety One	1.3%	Investment Manager	Global including South Africa

Source: Refinitiv as at the 23rd of September 2022

One can clearly see that the majority of assets invested in our market are managed by professional fund managers and therefore highly competitive. One can also see that some of the largest asset managers in the world are near the top of this list and own a greater share than our South African based fund managers. Finally, one can also see the impact of the shift to rules-based funds by the presence of the PIC, BlackRock, Vanguard and State Street among the largest 5 holders. Each of these have a significant portion of their AUM in rules-based funds.

What is the risk of retiring just before a market dip?

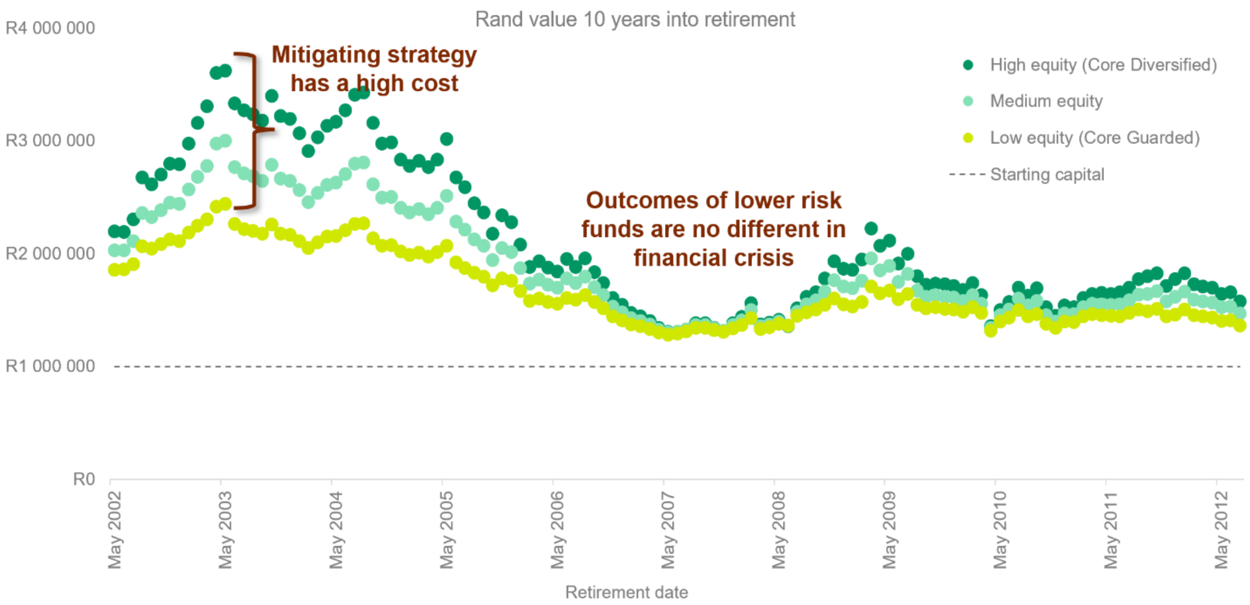
We have spent the last year investigating various investment strategies for retirees; specifically focusing on different investment portfolios and the impact on outcomes when returns are volatile. One of the methods typically employed to mitigate volatility and protect retirees from the risk of experiencing a market dip early in their retirement, is reducing exposure to growth assets. We explore this below.

Does reducing the proportion in growth assets help?

We tested this strategy for a range of different retirement dates going as far back as we have data for our funds (i.e., May 2002). Each person retires with R1 million and withdraws an income of R50 000 (i.e. 5%) in the first year, escalating this with inflation each year. For each retirement date, we tested how much money someone had left 10 years into their retirement. The first person retires on 1 May 2002, second person retires on 1 June 2002, and so forth, with the last person (number 123), retiring on 1 July 2012. The last retirement date is 1 July 2012 because 10 years into retirement take us to 'today' (30 June 2022).

For each retirement date there are three different colour dots representing the three different funds. Across all retirement dates, a high equity fund gave retirees the same or more money 10 years into their retirement than a medium or low equity fund (i.e., dark green dots are above the light green and yellow dots).

Value 10 years into retirement of R1 million invested with an initial withdrawal of 5% with aim of income growing with inflation [3]



Reducing the proportion in growth assets did not improve outcomes in poor markets or in the 2008/9 financial crisis and was in fact very detrimental in good markets with retirees having up to R1 million less in a low equity fund than a high equity fund.

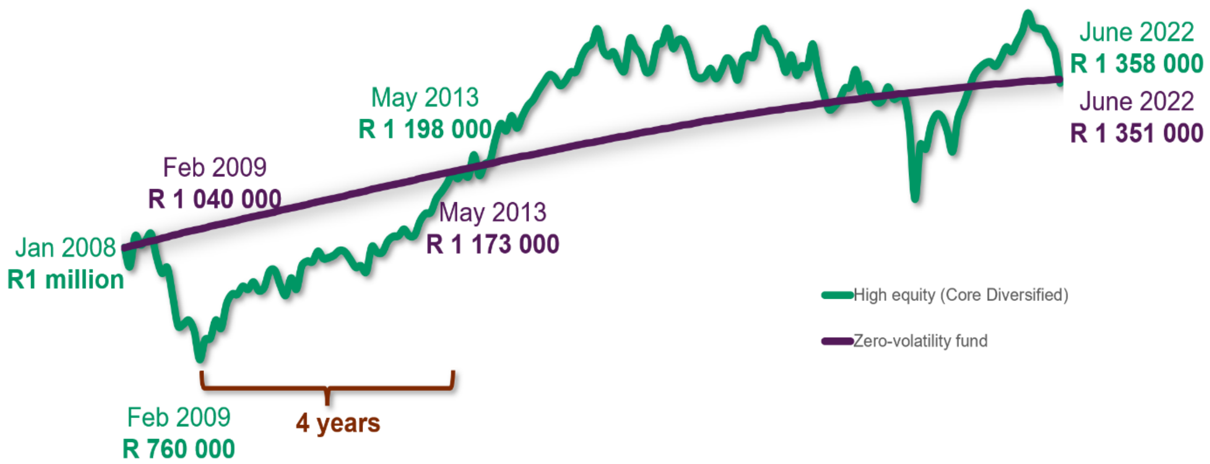
Acknowledging the emotions experienced by investors

Although the outcomes of retirees who retired in 2007 and 2008 was very similar in all the funds, the journey in the high equity fund was volatile. To illustrate the journey, we plotted the Rand value over time of a retiree who retired with R1million on 1 January 2008, invested in a high equity fund and withdraws an income of R50 000 (i.e. 5%) in the first year, escalating this with inflation each year. We compare this to a zero-volatility fund (where we assume we had the magical ability to remove all ups and downs so that the retiree had absolutely no volatility but still earned the same average returns over the period).

[3] Low equity is Nedgroup Investments Core Guarded Fund C. High equity is Nedgroup Investments Core Diversified Fund C. Medium equity is a 50:50 blend of the Low and High equity portfolios.

Imagine how you would feel, if just over a year into your retirement you had lost R240 000 of the R1 million you retired with. Naturally, it would be very difficult to stay the course and not switch investments.

Rand value of R1 million invested on 1 January 2008 with an initial withdrawal of 5% with aim of income growing with inflation[4]



Therefore, we tested a second approach, where a small portion of money is held in a lower risk fund. This helps retirees stay the course, this is a good option in practice as it helped a bit in bad times, didn't cost too much in good times and psychologically provided reassurance of having a cash reserve in the early years of retirement.

For more information on this strategy, watch our Core Perspectives webinar on sequence of returns.

Disclaimer

[4] Tested using Nedgroup Investments Core Diversified Fund Class C