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NEDGROUP INVESTMENTS RAINMAKER FUND

Quarter Three, 2022

Nedgroup Investments Rainmaker Fund

Commentary produced in conjunction with the sub-investment manager, Abax Investments

Performance to 30 September 2022	Fund[1]	ASISA Category Average	FTSE/JSE ALSI
3 months	-2.8%	-1.7%	-3.8%
12 months	-1.8%	1.9%	-0.8%

Market Overview

Relentlessly rising inflation, central bank tightening of monetary policy through raising interest rates, antagonistic geopolitics and extreme weather events continue to wreak havoc on global markets.

The dominant issue remains the break-out in developed market inflation to 40-year highs and the increased signalling from the US Federal Reserve that it will determinedly raise rates into restrictive territory to tame inflation. This process runs the risk of triggering a global recession, especially when growth in the Eurozone and China is already weak.

Markets remain rivetted on the outlook for US interest rates and the next actions of the Federal Reserve and the smallest change in inflation linked data points are causing wild swings in sentiment and asset valuations. The overall trend seems to be for central banks to continue to hike aggressively to try and restrain inflation – so far their efforts do not seem to be bearing fruit, and we have experienced consequential negative impacts on equity market valuations.

As a result of these suppressing interest rates, global growth expectations have been revised down with a recession in the US now likely. Both the World Bank and International Monetary Fund (IMF) revised their forecasts for global economic growth in 2022 down to +2.9% (from +4.1%) and +3.2% (from +3.6%) respectively. The IMF chief economist Pierre-Olivier Gourinchas said, "risks to the outlook are overwhelmingly tilted to the downside".

Despite the sizeable downgrades to GDP growth forecasts for most countries, earnings forecasts have yet to be materially revised and we expect this will prove a further headwind for equity markets as it inevitably materialises in the months ahead. Thus, despite the substantial market pullback, we still think that certain markets (the US) and companies screen as expensive.

The conflict in the Ukraine continues, with Vladimir Putin recently announcing a partial military mobilization that will conscript as many as 300 000 troops, together with a "referendum" to annex the four regions of Luhansk, Donetsk, Kherson and Zaporizhzhia, which represent about 15% of Ukrainian territory. Consequently, European Union member states are deliberating further sanctions against Moscow. The penalties include removing more Russian banks from the SWIFT international payment system, as well as targeting Russia's tech, cybersecurity and software industries. The most hard-hitting and controversial sanction would be to impose a price cap on Russian oil and the possibility of banning the trade in globally important commodities where Russia is a material source of supply such as nickel, palladium and copper.

As the war in the Ukraine lingers, the ramifications for those involved are having profound impacts on their economies. Europe is on the frontlines as energy is weaponized, with Russia turning off the taps of the Nord Stream 1 pipeline to Germany and beyond. Gas is widely used for residential heating and power generation for industry. Europe imported 155 billion cubic metres of gas from Russia in 2021 (40% of their total consumption),

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

whereas the biggest LNG carriers “only” carry 266,000 cubic meters – this shows the scale of piped gas / energy that needs to be sourced from elsewhere in the worst-case scenario.

Chinese economic activity continues to slow, as the state sticks dogmatically to its zero-Covid policy which has been a drag on every aspect of economic activity and a heavy restriction on the everyday life of its citizens. However, the recent end of Hong Kong’s Covid quarantine fuels hope of looser China rules with the market broadly anticipating a relaxation to be announced at the Communist Party Congress starting on October 16th, and which will support a recovery in 2023 – if relaxation materialises.

In South Africa, electricity supply deteriorated significantly over the quarter, especially during September 2022 where the country was subjected to Stage 6 power outages. While many companies have found ways to cope with load shedding, the near-term growth outlook remains at ransom to volatile and unpredictable electricity supply conditions.

With the above unpredictable and unfavourable macro backdrop, it is not surprising that equity markets behaved erratically, although the SA Rand acted as somewhat of a shock absorber. The MSCI All World Index rose as much as 10.4% in the quarter, only to drop 16% again to end the quarter down 6.8% (in USD). The Rand depreciated 11.2% against the mighty US Dollar, but substantially less so against other developed market currencies as it was more a factor of a strong US$ than necessarily a weak ZAR. As a result, the Rand returns of global markets seem less severe, but this of little help to SA investors that are losing global purchasing power. SA cash retuned 1.3% for the quarter, SA Bonds 0.6% and SA Equities -3.8% (as measured by the FTSE/JSE All Share Index).

With slowing growth and higher inflation, global risk appetite is likely to remain subdued and markets volatile.

Portfolio Commentary

We experienced significant volatility during the quarter, as macroeconomic headlines continue to weigh heavily on investor sentiment. Amongst this backdrop, we are pleased to have delivered a better outcome than the benchmark. In the quarter ended 30 September 2022, the Rainmaker fund delivered a net return of -2.8% versus the JSE All Share’s -3.8%.

The fund had a good, diverse range of companies making positive contributions to performance, with Glencore, Amazon, Mediclinic, Martin Marietta Materials, Shoprite and Autozone leading the charge. At the other end, it was mostly large SA companies that struggled in the volatile and interest rate driven market that detracted; Capitec (short term miss on the markets earnings expectations), Prosus, MTN, Alibaba and British American Tobacco were the primary detractors.

Top contributors	Average weight	Performance contribution	Top detractors	Average weight	Performance contribution
Glencore	3.0%	0.4%	Capitec	2.9%	-0.6%
Amazon	2.1%	0.3%	Prosus	4.6%	-0.4%
Mediclinic	0.9%	0.2%	MTN	3.9%	-0.4%
Martin Marietta	1.1%	0.2%	Alibaba	1.3%	-0.4%
Shoprite	1.6%	0.2%	British American Tobacco	7.6%	-0.4%
Total		**1.3%**	**Total**		**-2.2%**

While Glencore, Mediclinic and Shoprite all appreciated by about 10% in the quarter, the flattish performance in USD for several of the offshore investments translated into good Rand returns with the 11.3% depreciation of the Rand against the USD. A flat performance in USD in the quarter was good, given the 5.4% decline in the S&P500 Index.

The strong Glencore returns and contribution to the fund's return is welcome after several years where poor governance and mine safety performance kept us away from this company. In recent years it has recorded much improved governance and mining safety. They retain a well-diversified portfolio of resources, with a balance of future looking cleaner energy materials, while at the same time still offering exposure to fossil fuels like thermal coal (although on a diminishing basis as these run down) which is currently perversely benefitting from the adverse impact on energy markets caused by the war in Ukraine.

Mediclinic rose 10% as a take-out offer by shareholder Remgro and a private company (MSC) became more of a certainty as they lifted their offer price. Contrary to other corporate actions where the target company's share price remains well below the offer price, indicating shareholder scepticism that the deal will be concluded, Mediclinic traded at or about the offer price immediately following the announcement. As we concurred with the Mediclinic Board that the offered price represented a fair and reasonable valuation of the company we sold our entire holding.

The fund exited positions in Reunert (a small position), Sasol, Sibanye Stillwater, adidas and Garmin. We hold Shell in preference to Sasol for energy exposure. Sasol is effectively locked into extremely high CO_2 emission operations in South Africa and an American chemicals operation that is seeing high inflation on their feedstock, limiting their potential. Shell, on the other hand, has a much better long-term life of supply (compared to other oil companies) and is therefore much better placed for a world that has decarbonised energy supply much quicker than energy demand has diminished (i.e. the supply of carbon energy sources have been curtailed much faster than the addition of alternative/renewable energy, whilst the need for traditional energy remains high). In the short term, volatile refining margins will impact profitability, but this does not deter us from the positive long-term outlook.

Having made a good return in Richemont since the onset of the Covid pandemic, the fund reduced its holding. Although Covid curtailed international travel (where/when most luxury items are purchased), the lack of alternative spending options and significant growth in personal savings during the pandemic materially boosted luxury goods purchases. It has now reached a much higher base, just as global consumer budgets are being squeezed by rapidly rising inflation (specifically energy costs in Europe), so we expect some return to "normality" could be detrimental to their sales.

Amongst the offshore holdings, the Chinese exposed stocks were particularly hard hit as the general global economic malaise and specific Chinese impact of strict zero-Covid policy lockdowns of large cities negatively impacted consumer stocks. In addition, the unravelling of the Chinese housing property boom of recent years is causing much angst. Alibaba (China's Amazon) declined 32%, whilst Puma (-24%), Li Ning (-18%) and adidas (-12%) all declined on concerns about consumer spending in China. Adidas (with about 35% of sales in China and it being their fastest growing region to date) spooked the market in September with a trading update highlighting much elevated stock levels (that then usually translates into more discounting to clear stock and hence lower profit margins) and ongoing resistance for Western athletic brands in China in general. As a relatively small position, the fund hence exited adidas in preference for Li Ning and Puma. In the US, Trex – manufacturer of composite decking material – also declined a further 20% on US housing market concerns. These are all quality companies with solid financials and balance sheets, and they will survive this downturn. The question remains how much further they might derate. We also sold Garmin, a quality business, but too reliant on discretionary spending on outdoors activity which is now of lesser importance to an ever more stretched US consumer.

Current positioning and outlook

Domestic SA Equity

With the new Regulation 28 limits announced in February, compliant funds may take up to 45% of the fund offshore (compared to the previous 30% limit). With the recent depreciation of the Rand/USD combined with the multi-year attractive valuation of the SA equity market we consider further increasing offshore exposure as likely to be poorly timed. Despite this we note with some despair that foreign investors continue to disinvest from the JSE and expect further selling pressure to come from SA institutions taking advantage of further relaxation in exchange control limits. While we reconcile ourselves with the view that our patience will be rewarded and that we have already seen several corporate M&A events unlock value (with more expected) we are frustrated with the lack of supportive factors. We acknowledge that South Africa has huge challenges with an energy deficit, state sanctioned criminality and corruption, high unemployment, practically absent business and consumer confidence and now higher inflation. But despite these realities, equity valuations are at multi-year lows and we have high quality investment options such as the banking sector; well regulated, well managed, well capitalised, and yet valued much lower than international peers. Likewise, we have a range of medium sized businesses that offer attractive investment prospects. As a result, we have not taken any further capital offshore since the relaxation of the limits. We believe in a reasoned, calculated decision as opposed to a simplistic "taka as much as you can" approach.

The SA market is one standard deviation below its long-term rating relative to Emerging Markets (and now trades at a discount to EM peers) and just less than 1 standard deviation relative to Developed Markets (SA long-term average PE trades at a 25% discount to Developed Markets, currently sitting at close to 40%). The forward PE of SA stocks that operate internationally (i.e. the likes of Richemont, British American Tobacco, Naspers, etc.) trade at just over 10X 1 year forward PE, with domestically focussed stocks trading at a mere 5X – combined this is the lowest rating since the 2009 global financial crisis.

We continue to believe that the Tobacco and Food sectors are well placed to navigate a deteriorating consumer environment, thus we hold meaningful positions in both British American Tobacco and Shoprite. Together with general retailers, these are the only sectors to receive earnings upgrades in the last quarter.

Commodities markets may also provide a valuable inflation hedge. Recently, commodity shares and many commodity prices have pulled back meaningfully as concerns around the outlook for global growth have mounted. However, we believe that there is still long-term structural support for select commodity prices stemming from elevated demand due to the global energy transition. The energy transition is going to be very metal-intensive, and we believe that our resource holdings in Anglos and Glencore will be beneficiaries of this transition.

Global Equity

As argued above, we have not taken the maximum allowable allowance offshore as we believe there is good value in SA assets on a relative basis. That does not mean that we do not see value or attractive assets offshore. To the contrary, the global allowance enables true diversification of the portfolio holdings. This is rather limited in the 130 odd companies that one can reasonably invest in in the SA market. In addition to the best that SA can offer, we diversify and augment the portfolio with companies that, amongst others, offer access to the best health care diagnostics (Thermo Fisher Scientific), global semiconductor manufacturing (Samsung Electronics), global financial solutions (Visa), US auto parts distribution for the DIY enthusiast (Autozone), US semi-urban small holding essentials (Tractor Supply), US infrastructure cement and aggregate suppliers (Martin Marietta Materials and Eagle Materials), global beauty and skin care (L'Oreal), soft luxury goods (Moncler) and the best of global search engine, data centre and corporate productivity software (Google, Amazon and Microsoft). Not only are these well capitalised and managed long-term compounders, but they are also global leaders, and we have no local companies that can offer similar exposure. We augment this list with smaller holdings that offer value at a given time.

We remain vigilant of risks and remain committed to seeking out investment opportunities during these uncertain times, based on detailed fundamental analysis. We remain confident that over the medium term the earnings growth of our shares will translate into attractive returns for investors.

Responsible Investment

The global covid pandemic revealed and magnified a range of social issues (inequality, unemployment), while the threat of climate change is escalating. These have profound implications for investors. Investors need to consider how well their portfolios are prepared to navigate climate-related risks (including regulatory changes, supply chain disruptions, as well as political and social backlash). Investors should also prepare for opportunities that arise.

Our approach to the integration of sustainability and ESG is pragmatic and is constantly evolving. We aim to invest in companies that are well positioned to provide sustainable returns into the future and that consider their impact on all stakeholders.

Abax actively and consistently engages with companies and other stakeholders to address ESG issues. Notable engagements during the third quarter of 2022 include:

- Mr Price: Engagement with the Board ahead of their AGM. The main topics addressed included remuneration, audit committee independence and initiatives to improve transparency of their supply chain.
- FirstRand: Engagement with several board members covering a range of aspects across ESG, with a specific focus on executive remuneration.
- Woolworths: Participated in qualitative research conducted by the company assessing Woolworths' governance, environmental and social standards.
- JSE: Engagement on a variety of ESG initiatives including enhancements to ESG indices and data, as well as encouraging JSE listed companies to improve their ESG disclosure.

Conclusion

The global economic growth environment is expected to deteriorate further. The slowdown is likely to intensify as persistent inflationary pressures and rising interest rates hurt household incomes, while sluggish growth and rising costs (energy, wages) will erode company profit margins.

Furthermore, when the next recession arrives, we expect the monetary and fiscal responses to be more reserved than in the past when inflation was not a concern and when government debt levels and central bank balance sheets were less bloated.

Investors will have to navigate a volatile and challenging path over the next year as disruption and uncertainty are likely to persist. This reinforces the case for active management with a thoughtful long-term focus. For our part, we will look to build resilience into the portfolio and seek to benefit during periods of market volatility. Identifying beneficiaries and relative winners in this new environment will be integral to generating alpha in a world with less rewarding beta.

In summary, we will continue to perform bottom up, fundamental research, and invest rationally where market prices deviate from fundamental value. Now is the time to own strong businesses, with quality characteristics that are attractively valued, and we are confident with our selection.

SA equities are very cheap on both an absolute and relative basis, and we remain confident that over the medium term the companies we own will deliver attractive returns for investors.

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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