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NEDGROUP INVESTMENTS RAINMAKER FUND

Quarter Two, 2023

Nedgroup Investments Rainmaker Fund

Performance to 30 June 2023	Nedgroup Investments Rainmaker Fund[1]	ASISA category average	FTSE/JSE ALSI
3 months	+3.9%	+0.8%	+0.7%
12 months	+16.5%	+12.3%	+19.6%

It has been a gruelling first half of the year with domestic economic activity negatively impacted by higher levels of loadshedding, political uncertainty, sticky inflation and a steeper rise in interest rates than forecast at the beginning of the year. As a result of these factors, GDP growth expectations continue to be revised lower (no growth expected for the 2023 calendar year). In addition, the market remains concerned with the South African government's stance on the Russia/Ukraine conflict, which has added to SA's country risk premium, with bond yields rising and the rand vulnerable.

South Africa has adopted what it says is a non-aligned stance toward the war in Ukraine and it has abstained from several United Nations votes condemning Russia's actions. Its neutrality was called into question in May, when US Ambassador Reuben Brigety accused South Africa of supplying weapons to Russia. While President Cyril Ramaphosa denied the allegation, this event triggered a substantial sell-off in South African assets and the rand fell to a record low against the US$ given the risk of potential sanctions by the USA or other Western Allies. Although sanctions are unlikely at this stage, this could exert a devastating effect on an economy that is already fragile because of long-standing political mismanagement.

As a consequence of the abovementioned issues, investor perceptions and business confidence remain constrained with several business leaders warning that South Africa risks becoming a failed state unless its myriad of problems are addressed. These worries are also evident amongst SA consumers, with the latest FNB/BER Consumer Confidence Index for Q2 measuring -25, the second-lowest reading since 1994.

Toward the end of Q2 there has been some relief from these issues - the severity of load shedding has diminished, Operation Vulindlela continues to spur structural change in key areas, President Cyril Ramaphosa was cleared in the final Phala Phala investigation and the ANC have been jolted into emphasising the country's professed non-alignment in the Russia/Ukraine conflict. These developments have reduced underlying anxiety to some of the most pressing investor concerns that have characterised sentiment towards SA for much of this year. As welcome as this is, it is uncertain how durable this reprieve will prove to be.

Despite the above-mentioned issues, SA equities have outperformed other domestic asset classes year-to-date with a total return of +5.9%.

In contrast, it has been a strong first half of the year for global markets (notably in the US and Europe) despite slowing economic conditions, hawkish central bank rhetoric and ongoing geopolitical tensions. Year-to-date, MSCI All World Index has returned +13.9% in US$, the S&P500 is only 8% off its all-time high, and the European region gained +14.2%. The MSCI Emerging Market Index has posted a more modest return of +5.1% (+10.1% excluding China). Chinese equities have sold off as investors question the pace and sustainability of the post Covid rebound.

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

The US market was driven by the return of 'Growth' outperformance and a generative artificial intelligence (AI) fuelled boom which helped the Nasdaq rally +39% in the first half – this is the strongest first six months of the year on record. Nvidia soared to a $1 trillion valuation on the frenzied AI narrative and Apple made Wall Street history by becoming the first company to exceed a $3 trillion valuation. Of concern, the concentration of returns has been very narrow; mostly driven by a handful of technology stocks with only 32% of US stocks outperforming the market year-to-date, the lowest first half breadth on record for US equities.

Looking ahead, we should not confuse the narrow market rally with the health of the global economy. Core inflation measures in developed markets remain stubbornly high, with US rate cuts only expected in 2024 (much later than what was expected at the beginning of the year). Higher borrowing costs will continue to test economic resilience and geopolitics will add to unpredictable economic outcomes. Investors should be prepared for further market volatility.

Portfolio Commentary

In Q2 2023, the JSE All Share Index (ALSI) posted a total return of +0.7%. Within equities, SA Financials returned +5.3% and SA Industrials returned +3.4%. SA Resources lost -6.1%, with the largest losses coming from Industrial Materials (-14.8%), Oil, Gas & Coal (-7.5%) and Precious Metals (-7.0%). The Rand lost another 5.9% against the USD (10.6% for the first half of 2023), ending the quarter at 18.84 to the US$.

Year-to-date, SA equities have outperformed other domestic asset classes with a total return of +5.9%. Cash has returned +3.7% and bonds have gained +1.8%, while property has lost -4.4%.

In comparison, the Nedgroup Investments Rainmaker Fund returned +3.9% for the quarter and +9.4% year-to-date, outperforming both the ALSI and peer-group (ASISA category average). Pleasingly, the fund's diversification into global equities made a meaningful contribution, not just because the Rand weakened against the USD, but also in the nominal price performance of the respective holdings.

The top contributors over the quarter included Firstrand, Amazon, Microsoft, Samsung and Google. Despite deteriorating macro factors, Firstrand continues to deliver commendable results as evidenced by their recent trading update (June 2023) with no change to the group's expectations for double-digit earnings growth and their ROE to be at the top-end of their 18-22% range. Amazon (+26% in USD), Microsoft (+18% in USD) and Google (+15% in USD), were buoyed by market beating results, the supportive US equity market and their association with generative AI which is fast becoming the buzzword of the year. A recovering US housing market and the benefit of being able to pass on inflationary pricing also greatly helped Trex (composite decking) and Eagle Materials (aggregate and cement producer) to make a meaningful contribution to performance as their share prices increased 35% and 27% in USD respectively.

The positive sentiment of China's re-opening from earlier this year has faded in recent months given softer than expected Q2 GDP growth, which is weighing on the outlook for miners as well as our China exposed holdings. It is thus unsurprising that the top relative detractors in the second quarter included our resource holdings (Anglos, Implats and Amplats) as well as our Chinese equities (Li Ning, Alibaba and Tencent). We remain confident in the Chinese businesses we hold with our largest exposures being to the technology and consumer discretionary sectors. The Chinese consumer's "reawakening" post their very restrictive Covid lockdowns have been slower than initially expected, but still on track; we believe our patience will be rewarded, also with the travel exposed holding in Samsonite.

Q2 Top contributors	Average weight	Performance contribution	Q2 Top detractors	Average weight	Performance contribution
Firstrand	6.4%	+0.83%	Anglo American	5.3%	-0.48%
Amazon	2.0%	0.60%	Impala Platinum	1.9%	-0.41%
Microsoft	2.5%	+0.57%	Li Ning	1.0%	-0.33%
Samsung	2.8%	+0.55%	Amplats	1.7%	-0.24%
Alphabet	2.5%	+0.49%	Alibaba	1.3%	-0.20%
Total		**+3.04%**	Total		**-1.66%**

Current positioning and outlook

Domestic SA Equity

Mounting risks have decimated confidence in SA's ability for a durable economic recovery. There are numerous areas in which government's interventions remain persistently deficient – crime, local government, and education the most prominent. Notwithstanding a slight easing of investor anxiety towards SA in some areas, deeper concerns remain which will contain enthusiasm around the country's longer-term course. As a result of these lingering issues, SA's equity multiple discount to other emerging markets has widened in recent months with MSCI SA trading on a 9x 12-month forward PE versus MSCI EM on 12x. Despite numerous country challenges, we are encouraged by the compelling value on offer within our domestic equity market.

We continue to see value in our SA Banks (principally Firstrand and Absa), with fundamentals holding up better than expected as revealed by several detailed trading updates in June. Although retail credit losses are rising, the banks are conservatively provisioned and corporate credit quality remains good. Our detailed sensitivity analysis on possible credit-loss outcomes highlights the earnings resilience of the SA banks notwithstanding the expectation of far higher credit-loss-ratios. We remain attracted to the relative conservatism and strong client franchises of FSR, as well as the value on offer with Absa that offers an 8.5% dividend yield and trades on a 6x forward PE multiple.

We retain a relatively defensive stance on the SA consumer, with an ongoing preference for food retail (Shoprite) ahead of apparel retail. We anticipate another rate hike at the next SA MPC meeting on 20th July placing added financial pressure on SA consumers. An anticipated reprieve from severe loadshedding in 2024 will support a recovery in the earnings outlook for the food retailers given the significant increase in associated costs during 2023.

Fears of a global economic slowdown continue to weigh on commodity prices, earnings momentum (downgrades) and in turn resource equity prices. The fund has a relatively low resources weight (c10%) which has aided relative performance this year. The good news potential lies in further expected stimulus measures from China that have historically boosted commodity prices. Our preference is the diversified miners, principally Anglo American, that will benefit from an uptick in demand, yet their diversified product mix should also prove more defensive should that not occur.

Our large holdings in Naspers / Prosus should benefit from developments in China. China is in a different phase of its economic cycle compared to developed market economies, and it is encouraging to note that many of the headwinds that have been present in China over the past couple of years are now dissipating. The country has fully reopened post Covid, with consumers and businesses taking advantage of this. After a series of regulatory actions, especially for the large e-commerce and internet companies, it appears the required adjustments in business strategy and operations are now largely complete. With the economy now in a steadier state, we anticipate activity levels will once again pick up aiding our Chinese exposed holdings. Moreover, we are encouraged that Naspers / Prosus management have recently obtained regulatory approval to collapse the overly complicated cross-holding structure which, in combination with the material share repurchase programme, should drive a further narrowing of the discount to NAV.

Global Equity

The buzzword of the year must be Generative AI (and related Large Language Models). Whereas the term “Artificial Intelligence” has been used for some time, the generative nature of the latest tools, popularized by ChatGPT, which launched late last year, has opened this pandora’s box. Nvidia (who designs the chips that power these models) explains it very simply: generative AI models use neural networks to identify the patterns and structures within an existing data set to generate new and original content. Inputs and outputs to these models can include text, images, sounds, animation, 3D models, or other types of data. Whereas there are many competing models (from OpenAI – developers of ChatGPT, to Google’s BARD, Microsoft’s Copilot and many others), the quality and diversity of the underlying data being “learned” from, and the computational complexity of the generative part all play a role in the quality of the answers being generated. As the learning approaches range from semi-supervised to un-supervised, the nature of the unlabelled data sets may have profound implications for the answers generated. A significant risk is bias and how to avoid this in the model. One approach to overcome these challenges is to use adversarial models that continuously try to distinguish between real (original data) and fake (generated data). Another approach uses diffusion models that actively adds “random noise to the data” (think of an increasingly grainy photo) when training on the data, whilst the second step is then to take a very noisy data set and attempt to diffuse it. By continuously learning from these forward and backward steps, the model improves its learning ability and hence will deliver even more intelligent outcomes. It may sound complicated, but it is not too dissimilar to how humans progress from rote learning at lower grades to applied/original thinking later on. All else being equal, a child with a better data set (diverse books, toys, flash cards, music, etc.) and a better learning model (teachers, parents, schooling, etc.) has a better chance of developing original, critical thinking.

The applications are wide reaching and the consequences profound. Popular belief has always been that computers will one day replace mundane, manual tasks, but will not be able to compete with humans’ more artistic and creative abilities. Generative AI has flipped this around and has caused much angst from the creative quarters; it is far more than a mere tool for students to prompt ChatGPT to generate a written assignment, it can generate original, photo-realistic pictures and/or art from text-based prompts.

The evolving regulatory environment for generative AI is not to be underestimated. The source of the datasets being used to learn from is a critical issue; where do companies draw the line on privacy? What about intellectual property rights or copyright? At the other end, how to manage the use of these tools; the potential for societal manipulation with deepfake generated content is not to be under-estimated.

The investment world reacted very quickly and Nvidia rose 200% this year, Microsoft and Amazon rose 50%, Google 40%, whilst TSMC (the only manufacturer in the world capable of producing the chipsets required for these learning models) only rose 30% and still trades on a more modest 15X PE. “Crypto” has unceremoniously been relegated to the second league of buzzwords.

What to do as a portfolio manager about generative AI? We certainly believe that generative AI is here to stay and that it will evolve further and faster than expected. We also expect that the winners and losers are not as obvious as you'd think. Least of all because the regulatory environment and oversight is still in its infancy. We remain fundamental, bottom-up stock pickers – this means that we will always be mindful of valuation – we will not chase a trend at any price. For example, whereas we've known that Nvidia has always made the better Graphic Processing Units (GPU's), popular with computationally demanding applications, we were not comfortable with the greater than 60X PE it traded on (currently ~200X).

The fund is exposed to generative AI in several ways; Microsoft, Google and Amazon (large databases, own generative AI models and significant user bases to deploy to), but also Samsung (not the processors, but the memory chips). The fund therefore has material exposure, but in a hedged way; generative AI makes up a relatively small percentage of these companies' revenue; but should it grow exponentially, these companies will benefit. Conversely, should generative AI be restricted through regulations or fade away for some other reason, these companies still have the bulk of their existing business.

As for the rest of the global portion of the portfolio, we remain well invested for the (gradual) reopening of China with luxury exposure through Moncler, Richemont and Kering, but also for the resumption of travel in Samsonite. L'Oreal remains one of the larger holdings with their aspirational, luxury, pharmaceutical and everyday brands of skincare and make-up finding global appeal and driving consistent growth. We continue to hold Shell in preference to Sasol (getting much bad publicity again with their significant pollution at the Secunda plant and prohibitive cost of abatement).

A final point to note with respect to our global holdings is the volatility of the Rand against the USD and other developed world currencies where the fund is invested; this adds a further investment process step, not just whether the underlying company is worth investing in, but how could the exchange rate impact the investment return for SA based investors. Forecasting a pinpoint Rand USD exchange rate some way into the future is almost impossible, but there are broad trends that help us derive a range of expectations. As the Rand depreciated materially since middle 2022, we have hedged some of the international exposure back into Rand; i.e. we retain the benefit of owning diversified global equities, but we can limit the potential negative impact of the Rand strengthening again after a bout of weakness. In general, we prefer zero premium fence structures, i.e., no explicit fees to be paid upfront. Despite the strong market performance globally and the great uncertainty in markets, volatility levels have remained relatively low. As volatility is an input parameter into the cost of these hedging structures, pricing of these hedges has been relatively attractive. About 1/3 of the global holdings have been hedged back into Rand.

Responsible Investment

We focus on doing the right thing for our clients, community and the environment and we expect the same from the companies in which we invest. We seek to invest in companies that are well positioned to provide sustainable returns into the future and that consider their impact on all stakeholders. In our analysis, we focus on business issues we believe to be material to long-term stakeholder interests. We view financial metrics and factors classified as environmental, social and governance ("ESG") as intertwined, and essential for a comprehensive understanding of the business and its financial strength.

Abax actively and consistently engages with companies and other stakeholders to address ESG issues. Notable ESG engagements during the second quarter of 2023 include:

- AngloGold Ashanti: Engagement with company management on policies and understanding the impact of their plan to redomicile on their 2030 targets.
- Nedbank: Engagement with several board members including the Chairman and Lead Independent Director on environmental, social and governance matters.
- Anglo American: Engagement with company management on sustainability performance.
- MTN: Engagement with the Chairman on environmental, social and governance matters.
- Absa: Participated in an independent stakeholder engagement survey.
- EWT Business of Biodiversity Conference: Participated in various sessions of facilitated debate of business response and incorporation of environmental impact across their activities and engagement thereon.
- Nedgroup Investments Biodiversity Workshop: Participated in an industry workshop providing context to global and local Biodiversity risks and opportunities, and importantly what practical steps can be implemented.

Conclusion

Expectations are now that inflation and interest rates will be higher for longer and that economic growth will come under increasing strain in the second half of the year. The IMF flagged as recently as April that developed economies are likely to see an "especially pronounced growth slowdown".

We expect a risk-off period in the second half of the year, with the US share market expensive by historic standards (S&P 500 forward PE of 19x), even after stripping out the most expensive tech shares. The much-anticipated Fed capitulation has not materialised. Instead, the Fed wants to keep financial conditions tight, and the FOMC minutes have revealed that most policymakers are willing to err on the side of being too tight rather than too easy. History shows that that this usually spells trouble for the economy and markets with the cumulative impact of tightening likely to be felt more keenly in the second half of the year. All this despite US inflation having fallen substantially from the peak earlier this year. We are watching closely to see how this balance may change.

In contrast, Chinese shares offer the opportunity to invest in growth businesses at attractive valuation multiples. Even though China's activity data was weaker than expected in Q2, the fundamentals still reflect an economy that is expanding and one that doesn't have the inflation headache in developed economies providing flexibility for policy makers to stimulate growth. We note with great interest the very recent softening in enforcement rhetoric against business by senior Chinese politicians.

The South African equity market remains very attractively priced, but the outlook fragile given lower commodity prices, a deteriorating fiscal position, ongoing energy uncertainty and falling growth forecasts. The pre 2024 election populist push is also starting to gather momentum (namely the NHI Bill) and could also frustrate economic outcomes and equity market performance.

There are reasons for caution, but this market is well suited to our investment approach, and we will use market uncertainty / volatility to our advantage. As the economic outlook comes under increasing pressure, we believe that our diversified holdings in quality companies should stand investors in good stead - the attributes of earnings resilience and strong balance sheets have enabled quality companies to survive multiple economic cycles with their market position and economics intact, while delivering returns to shareholders.

We are confident in our portfolio holdings' long-term prospects and remain focused on finding companies with competitive advantages that we believe can compound earnings and cash flows over the long term.

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)..

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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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