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Nedgroup Investments Global Behavioural Fund

Quarter Three, 2023

Marketing Communication

Nedgroup Investments Global Behavioural Fund

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

Past performance is not indicative of future performance and does not predict future returns.

Performance (USD net return)	3 months	6 months	1year	3 years (annualised)
Nedgroup Investments Global Behavioural Fund[1]	-5,35	-2,66	12,10	0,17
Performance Indicator*	-3,40	2,56	20,80	6,90

Source: Morningstar, [1]A-Class, *MSCI All Country World Index

Performance and market overview

The Ardevora process tends to struggle during shocks – when large and unpredictable things happen that affect lots of businesses in many of different ways. The strategy tends to do well in the periods after those shocks have played out, or the "aftershock" period.

In our experience, most of these big shocks tend to impact markets in a short sharp burst, such as the 1991-1992 double dip recession, the TMT boom/bust between 2001 and 2023, and the Global Financial Crisis from 2007 to 2009. As those shocks flow through, lots of forecast error for companies is created from the outside-in. We're more focused on forecast error created from the inside-out; by the choices that management make at individual companies. Forecast error created from the outside-in is much harder to predict, and our process can often struggle.

Often after these periods of unpredictability, there are very long periods where the consequences of those shocks ripple through the economy and separate out the businesses that can do well or badly from it. That ripple effect and Darwinian selection process can often act as a persistent source of bias in forecast error, especially when management behaviour before and after a particular shock is very different. This is where our process often works well.

In summary, our investment process struggles when forecast error is driven by these unpredictable, top-down sources. During those times, we have to be mindful of the risk controls in the portfolio. It tends to do well as the consequences of those transition periods flow through which can often lead to 5 or even 10-year periods where quite interesting things can happen.

The portfolio lagged the benchmark again this quarter, in what has now been a frustrating 2.5 years where we have struggled. Since COVID, we've been in this period of lots of shocks and unpredictability. Prior experience suggests these periods should last only twelve to eighteen months, but we've just had a series of these events stuck together. The normal timeframe for an "aftershock" where we would regain ground is being eaten up by these subsequent shocks.

We've spent a lot of time dissecting the last 3 years to get to the bottom of why there is a disconnect between what we're good at (finding stocks that surprise) and actually being rewarded for it. During the third quarter, like most of 2023, most of the underperformance has not been the result of poor stock selection, but how we assemble a portfolio that is compared against a market-cap weighted index. The interplay of what you get from a broadly equally weighted portfolio, and the resulting sensitivity to what's going on in the long-bond market and some of these shocks more broadly, has been especially impactful – forecast error is being driven by things that don't have a lot to do with individual management behaviour.

Mega-caps continue to do very well, with benchmark performance increasingly driven by just a handful of companies. A structural underweight to these "Magnificent Seven" stocks has acted as a material headwind for portfolio performance year-to-date.

Key performance contributors

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Key contributors	PF weight (%)*	MSCI ACWI weight (%)*	Base return (%)	Excess return contribution (bps)**
Apple	1.87	4.41	-8.01	23
BJ's Wholesale Club	0.00	0.00	21.53	12
DBS Group	1.04	0.07	11.89	12
Alphabet	2.55	2.42	13.51	10
Kajima	0.42	0.01	15.17	8
Novo Nordisk	0.76	0.49	18.53	7
Airbnb	0.65	0.09	11.26	7
Cheniere Energy.	0.65	0.07	13.53	7
WSP Global	0.63	0.03	11.82	7
Microsoft	1.91	3.65	-3.20	6

Key performance detractors

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Key detractors	PF weight (%)*	MSCI ACWI weight (%)*	Base return (%)	Excess return contribution (bps)**
ResMed	0.65	0.04	-29.43	-17
Block	0.00	0.04	-29.84	-15
Enphase Energy.	0.00	0.03	-25.82	-13
IPG Photonics	0.65	0.00	-22.15	-13
Fortinet	0.32	0.06	-21.82	-12
Exxon Mobil	0.95	0.78	-1.51	-11
Liberty Media	0.63	0.03	-10.61	-10
Edwards Lifesciences	0.62	0.07	-20.70	-10
Daikin Industries	0.42	0.07	-18.72	-10
Bombardier	0.33	0.00	-25.88	-9

Period end weights are shown.
**Excess return is the out / underperformance of the portfolio (NAV basis) relative to the benchmark for the identified period
Source: Ardevora, FactSet.

Emergent themes and portfolio positioning

The strongest theme, which is possibly the most controversial, is related to the energy transition and the role fossil fuels have in that transition. An interestingly uncomfortable place to be as a portfolio manager at the moment.

Within industries like fossil fuels, but more broadly across the commodity complex, management behaviour appears to be unusually conservative. A lot of those businesses have had a pretty rough five years, and owing in part to the ongoing environmental debate they are being particularly conservative in their outlook – displaying uncharacteristic caution about their medium and long-term plans. They're worried about the existential threat of the ESG discussion, but equally recognise that they will need to play a part (for a longer period than most people expect) to aid in that transition. This cautious management behaviour, combined with prior share price trauma, has led to upward pressure on forecast error. This time as a result of management choices and behaviour, rather than any top-down shock.

Outside some of those 'old fashioned' industries, some of the software/IT/digital economy names are also interesting us. In this instance, it's more of a shuffling-the-pack situation rather than finding a fantastic thematic opportunity. There appears to be a shift in the winners and losers, whilst the overall envelope of that area seems mixed.

Looking ahead

After an uncomfortably long period of underperformance, the answer on how we return to alpha is partly backward looking. The key question is what needs to change that's outside of our control, and what needs to change that's within our control. Within our control, not much needs to change. We are finding stocks that surprise and beat estimates. The issue at the moment is the reward function.

In general, the process does badly when there are unpredictable shocks that come along. We adjust and adapt, but as bottom-up stock pickers, we don't try and predict those shocks. Thinking about the last few years, and the impact that has had on our outlook, it's helpful to break down our performance.

- **COVID:** We coped reasonably well because of the way that shock unfolded. Whilst the nature of the shock was obviously very unusual, the impact was more like a classic recession. We've had lots of experience of recessions and could identify the early signals of that shock, how they permeate through the economy and separate the winners and losers.

- **2021:** We struggled because of structural decisions we have made around portfolio construction:
    - Broadly equally weighted – mega caps exerted a cumulatively greater impact on the benchmark performance and our structural underweight hurt.
    - No Financials – in a period where suddenly what was going on with interest rates and long bonds really started to matter, particularly as a driver of surprise and disappointment.
    - No Energy – our wrestles with ESG meant we held an exclusion to almost the entire Energy sector.
    - We picked good stocks, and they performed well, but we were damaged overall because we weren't invested in areas of the market that were better rewarded.

- **2022:** In late 2021 and early 2022, we opened positions in a group of stocks: rapidly growing tech and healthcare. We were severely damaged by them given the sudden unusual behaviour in the long bond market and interest rates. Whilst we identified this quickly and unravelled those positions through the 1st quarter, this explains most of 2022's poor relative performance.

- **2023:** The process has worked. We've found stocks that have surprised, but we've just not got the relative reward. 2023 has been a year where our skill in stock selection has been drowned out by a handful of benchmark mega caps.

We can see the seeds already in this year of a shift to the "aftershock" period where we have historically performed reasonably well. We're not through the shock (or multiple shocks we've experienced in sequence) yet though. Long bonds and inflation are still behaving in an unpredictable way. But we see the overall shape and drivers of the portfolio broadly in the right place. We need to stick to what we do well (find stocks that surprise) but be slightly cuter about portfolio construction (which we've done).

Outside of our control, what needs to change? Our process struggles in periods of shock – something big happens and changes the status quo. We must understand the new "normal" though. Emerging out of this post-COVID transition, we are in a world where inflation is going to be much higher than pre-COVID (which it is), interest rates are going to be much higher than pre-COVID (which they are) and that we'll be in a world with perpetual geopolitical shocks that create broad supply chain disruption. We just need the market impacts from the unprecedented series of shocks that have emerged over the last few years to keep playing out in the same way. It will be a brand-new shock (one we're not yet experiencing), that isn't easy to predict, that would make the environment difficult for us. Status quo, even in a disrupted, shocked, post-COVID world, is where our investment process can do well.

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NEDGROUP INVESTMENTS CONTACT DETAILS
Tel: toll free from South Africa only 0800 999 160
Email: helpdesk@nedgroupinvestments.com
For further information on the fund please visit: www.nedgroupinvestments.com

OUR OFFICES ARE LOCATED AT
First Floor, St Mary's Court
20 Hill Street, Douglas
Isle of Man
IM1 1EU

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