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NEDGROUP INVESTMENTS RAINMAKER FUND

Quarter Three, 2023

Market Commentary

The first nine months of 2023 saw material divergence in performance between regions, currencies and asset classes. Against a backdrop of much uncertainty over central bank interest rate decisions, sticky inflation, growing geopolitical tensions and extreme weather events, investors valiantly attempted to pre-empt central bank moves. The consensus view at the beginning of the year was that inflation would rapidly decline, mostly on account of base effects, that central banks would start cutting interest rates in H2 and that Chinese growth would bounce back after their gruelling zero-Covid policy. This was not to be. South Africa got caught in the cross-fire, also scoring predictable own goals (ongoing loadshedding, global non-alignment, Lady R, Phala-Phala, Grey Listing, Transnet implosion etc.).

The Rand devalued 11% against the USD during the first 9 months, materially impacting our already poor economic prognosis. The FTSE JSE Capped Shareholder Weighted Index declined 3.8% in Q3, erasing earlier gains to now be -0.3% for the year to date. To demonstrate the divergence, the S&P500 index also declined 3.2% in Q3, but is still up 23.8% for the year (as measured in ZAR). NVidia, Microsoft, Google, Meta (Facebook) and Apple alone delivered 10% of the 13% USD gain for the S&P500 this year (these stocks make up 20% of the S&P500 benchmark), a very thin market and not healthy. Europe is somewhere in the middle recording +16% year to date, whereas the Hang Seng Index (Hong Kong listed Chinese shares) matched the SA performance, declining 0.5% for the year after a -5.3% Q3. The SA performance is particularly disappointing, considering that about 2/3 of the profits of SA listed equities come from outside SA (almost all the mining houses, Naspers, Richemont, British America Tobacco and Anheuser Busch are almost 100% offshore earners, with a range of other companies also earning significantly outside our borders).

Having the capability to also invest directly offshore materially benefitted the Nedgroup Investments Rainmaker Fund. This outperformance is not just because of the weakening Rand, but also on account of good stock selection offshore and in SA. The allocation to Chinese stocks mostly detracted (as can be seen in the Hang Seng index performance mentioned above) as the Chinese re-opening remained underwhelming – more on this later.

Looking ahead, we should not confuse the narrow market rally with the health of the global economy. Core inflation measures in developed markets are resurfacing and remain stubbornly high, with US rate cuts now 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, which are surging again with the outbreak of conflict in the Middle East, and will add to unpredictable economic outcomes. Investors should be prepared for further market volatility.

Portfolio Commentary

In Q3 2023, the JSE All Share Index (ALSI) posted a total return of -3.5%. Within equities, SA Financials returned +0.5%, Consumer Staples +0.16% and Energy +0.15%. Consumer Discretionary (mostly Richemont, Naspers and Prosus) declined 2.2%, the Materials sector -1.1% and Communications Services -0.95%. Although volatile, the Rand only lost another 0.4% against the USD (11.6% for the first nine months of 2023), ending the quarter at 18.92 to the US$.

Year-to-date, local cash has been the top performer at +5.8%. In comparison the JSE All Share is +2.2%, while SA bonds have gained +1.5%. SA property has lost -5.4%.

In comparison, the Nedgroup Investments Rainmaker Fund returned -3.4% for the quarter, but still up 5.7% year-to-date, outperforming both the ALSI and peer-group (ASISA category average). The top contributors over the quarter included Sanlam, Google, ABSA, Bidvest, Samsonite, Shoprite and Shell. These contributors clearly demonstrate the advantage of being able to add direct offshore holdings; there are no South African equivalents to Google, Samsonite or Shell. Not only do these then diversify the risk in the portfolio, they also provide unique exposure to investors. Sanlam delivered more than double the earnings of a year ago, not just from strong new business flows, but also from a strong recovery in their life and short-term insurance businesses (which can be volatile). Likewise, Bidvest and Shoprite delivered very good results, demonstrating why they are considered best in class. ABSA is more of a value investment; the underlying conditions for SA banks are not favourable in a weak economy and consumers battling higher interest rates (with higher credit losses a common feature). Alphabet (Google) continued its strong performance (+53% year to date) as it finds itself in the sweet spot of several new technology trends. Samsonite delivered strong results, benefitting from the resurgence of travel, especially in Asia. Shell continues to perform well as the oil price stays stronger than expected. Shell has a better portfolio of assets than most of their peers and generates very strong cash flows from these – we expect that they will return 1/3 of their market cap to investors over the next 3 years from their free cashflow.

The main detractors to the fund's performance in Q3 were Richemont, MTN, Naspers, L'Oreal and Moncler. The common thread here is the decline in luxury stocks. The simplistic reasoning here is that the "revenge shopping" post Covid has come to an end as consumers' excess savings are depleted, higher inflation and interest rates start to bite and that the Chinese consumer is too conservative to spend and has still not returned to pre 2019 travel behaviour. We think that the reality is far more nuanced (and positive).

MTN declined on the back of the materially weaker Nigerian Naira after the currency was moved to a "free-floating" system, although in reality it seems to remain under some control with limits on liquidity. Naspers underperformed as Tencent, which makes up more than 100% of the market value of Naspers/Prosus, drifted lower on generally weak Chinese consumer sentiment. There is mixed news from China, but in general, the consumer's re-awakening post their harsh zero-Covid lockdowns has been muted. Regulatory interference seems to be waning and there are some green shoots of positive consumer trends emerging (as evidenced in travel bookings), although the tough residential housing market remains an overhang.

Q3 Top contributors	Average weight	Performance contribution	Q3 Top detractors	Average weight	Performance contribution
Sanlam	2.4%	+0.26%	Richemont	2.8%	-0.77%
Google	3.0%	+0.24%	MTN	3.9%	-0.76%
ABSA	3.0%	+0.22%	Naspers	6.5%	-0.74%
Bidvest	3.7%	+0.22%	L'Oreal	3.2%	-0.38%
Samsonite	1.1%	+0.21%	Moncler	2.2%	-0.36%
Total		**+1.15%**	Total		**-3.0%**

Current positioning and outlook

Domestic SA Equity

The SA economy and political landscape seem to lurch from one crisis to the next. As if global growth and geopolitics are not enough to make life challenging, loadshedding and now also water-shedding adds significantly to the cost base for SA corporates and hinders investment. Business confidence remains in a 14 year uninterrupted period of decline, and consumer confidence is at a post 1994 low. However, despite this reality, there are some silver linings and corporate SA in its typically adaptable and entrepreneurial way is taking the initiative to help government solve problems where possible. Importantly despite remaining ideologically incapable of embracing the private sector, the failure of every state controlled commercial entity is forcing the government to engage the private sector to rescue the situation. Visible examples here include private provision of power and recent changes appearing at Transnet.

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 and results. Their interest margins have risen during a period of rising interest rates which cushioned the impact of rising bad debt costs. The balance sheets are conservatively provisioned and corporate credit quality remains reasonably good. Our detailed sensitivity analysis on possible credit-loss outcomes, even under significantly worse conditions, highlights the earnings resilience of the SA banks. We remain attracted to the relative lending 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 repeat the view we expressed on Resource stocks last quarter where fears of a global economic slowdown continue to weigh on most commodity prices, while earnings and dividend declines that we have seen already will continue to be driven by lower commodity prices and rampant uncontrollable cost growth. The fund retains a relatively low resources weight (c10%) which has aided relative performance this year. We remain very wary of further expected stimulus measures from China that have historically boosted commodity prices. But we note with interest that all stimulatory measures implemented by the Chinese state in 2023 have so far proven ineffectual. 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. In addition, we own Shell which has been discussed previously.

The SA equity market is far more exposed to China than just through Naspers/Prosus where their Tencent investment is more than 100% of the share price. The Chinese consumer is the largest single group of customers for Richemont and a fair portion of AB Inbev. Our mining companies are exposed to Chinese infrastructure and residential construction, not just iron ore, but also copper and other commodities. Given that China is our largest trading partner, the indirect impact to the rest of our economy takes this percentage even higher.

The slower than expected re-awakening of the Chinese consumer post their stringent zero-Covid policies therefore has a direct impact on the SA economy and also the listed SA equities. This can be partly blamed on the housing crisis (residential construction companies that overextended themselves to current distressed levels – not only harming their own ratings, but directly consumers whose significant deposits are at risk). It is unclear how this will be resolved, but there have been a number of stimulatory moves from government and relaxation of restrictive property ownership rules to help resolve the issue. Travel numbers (internal and international travel) suggest a resurgence and points to a consumer that is willing to spend, but we acknowledge that the pick-up will be more gradual than we had hoped. Despite several well publicised and hyped stimulatory interventions the state have made so far this year these have not met with the success they have been able to achieve in driving cyclical economic recovery previously.

We still feel the growth prospects for Tencent are attractive versus the current valuation, and the resurgence of luxury consumption by Chinese consumers will continue albeit on a slower trajectory. Demand for base metals for construction is likely to remain subdued as the property sector battles to emerge from its over-leveraged position. This will benefit Naspers/Prosus, Richemont and the diversified mining houses in the portfolio.

The sudden, and unexpected, resignation of the Naspers/Prosus CEO surprised the market and introduced a level of concern; as the market fretted that the replacement may present an ambitious new strategy to use the cash pile to expand the portfolio. This will be a terrible outcome for shareholders who have only recently managed to convince the Board to take a more pragmatic approach of using cash to buy back shares at the wide NAV discount and reduce the number of now demonstrably failed venture capital investments that have been made. We continue to advocate a preference to crystalise value from existing investments and to show strong capital allocation discipline whilst also maintaining the share repurchase programme (which makes mathematical sense).

Global Equity

The fund has a broad exposure to global luxury stocks; from direct luxury like Richemont, Moncler and Kering (Gucci), to pseudo luxury in L'Oreal. One could possibly stretch the definition to the likes of Puma and Li Ning as these two athletic footwear companies offer athleisure products where the purchase is more discretionary and fashion driven than pure functional sports gear. These companies all have very strong brands (in the case of pure luxury, these brands have material provenance and cannot be replicated), directly appealing to the aspirations of hundreds of millions of upwardly mobile middle classes around the world. They make high gross margins (in the upper 50's to 60's percentages) but spend significantly in their messaging (advertising) to further the aspirational demand. In recent years these companies have generally become better managed, also focussing more on selling through their own stores and on-line where they can connect directly with the customer, as opposed to via traditional wholesale agreements.

In recent years it was not only the newly affluent and aspiring Chinese middle class that drove luxury spending, but also the US and European consumers. Post Covid the US consumers spent even more from pent-up savings, whilst the re-awakening of the Chinese consumer remained elusive. Now, as the Richemont chairman mentioned at their recent AGM, they are seeing a slowdown in European consumer spending on luxury as inflation and higher interest rates impact on consumer wallets. It has been the same in the US.

However, whilst Chinese tourist numbers to Europe are only at 60% of pre-Covid levels, their luxury spending is at 90%. Lower Chinese outbound travel is not just due to a reluctance to spend, it is also the logistical challenge of not being able to fly over Russian airspace since the invasion of Ukraine as well as some other travel impediments that still exist. New routes and airline capacity need to be established. Chinese GDP (and disposable income) is unlikely to grow at the pre-Covid pace, but it is still expected to grow faster than the rest of the World. Travel inside China is also important for luxury sales; 90% of luxury retail shops are in tier 1 cities, yet 50% of luxury consumers live outside these cities. Recent travel statistics (including the Golden Week holiday just past) are encouraging and should translate into better sales.

Solid growth trends are also expected from India and parts of the Middle East (with elevated oil prices). India's urbanisation and middle-class lags that of China yet is very much expected to follow the same trend in years to come. It recently overtook China as the world's most populous nation. This will bring new consumers to luxury spending. The larger, more established luxury companies with established brands and strong balance sheets will benefit from these longer-term trends – these are exactly the stocks the fund is invested in. In addition, luxury stocks are now trading well below their long-term average ratings (ranging from LVMH at 25% lower to Prada at a 50% discount).

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 the middle of 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 which come at no cost to the fund. Despite the strong market performance globally and the great uncertainty in markets, option 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. Abax actively engages with companies and other stakeholders to address ESG issues. Notable ESG engagements during the third quarter of 2023 include:

- Woolworths: Engaged with food and sustainability experts discussing how Woolworths Food business is supporting a healthy and sustainable world.
- Multichoice: Engagement with several board members on various governance matters, with an emphasis on remuneration practices.
- Anglo American: Engagement with company management on water use licenses.
- Anglo American Platinum: Engagement with company management regarding the Mogalakwena expansion options, including burial site relocation and dewatering.
- Naspers / Prosus: Engagement regarding remuneration practices which we regard as excessive and not adequately aligned to shareholders.
- Shoprite: Engaged with the company regarding the impact of the Cape Town taxi strike, how they ensured continuity of operations as well as the treatment of staff.
- Pepkor: Engaged with the company regarding the impact of the Cape Town taxi strike, how they ensured continuity of operations as well as the treatment of staff.
- Mr Price: Participated in an independent stakeholder engagement survey.
- Pick n Pay: Engaged with the company regarding the impact of the Cape Town taxi strike, how they ensured continuity of operations as well as the treatment of staff.
- BHP Billiton: Discussion with management regarding the impact of new pilot projects on the environment.
- EWT Biodiversity Framework: Abax was co-opted to participate in development and monitoring of biodiversity performance ratings of SA companies.

Conclusion

We continue to expect a volatile and possible weak period in the second half of the year, as hawkishly high interest rates and stubbornly high inflation in the US pressurise monetary authorities. The start of the election cycle will be fraught with antagonistic comments and grandstanding to win support and comes at a time when geopolitical tension in many parts of the world is already high and sensitive. The US share market remains expensive by historic standards (S&P 500 forward PE of 19x), even after stripping out the most expensive tech shares. Under these circumstances we remain cautious and vigilant and with low costs we recently hedged the downside for the majority of the fund's US exposure.

The South African equity market continues to be very attractively priced, but with absolutely NO buying interest from foreign or domestic investors – who seem determined to extract every Rand that they can from the country. With a looming election in 2024, a gloomy consumer and business confidence mood, limited progress on the anti-corruption agenda and ongoing loadshedding we see little reason for any kind of re-rating. Consequently our focus remains on global businesses listed here whose fortunes are not dependent on the SA economy, the most attractively valued local stocks where dividend yield is a large part of expected total return, but who also have some angle around the ability to grow despite the headwinds. We were most encouraged by a series of meetings at a recent investment conference to find the mood surprisingly resilient – with the realities of commercial survival in the face of load shedding costs now well in hand for most firms.

Despite our overall caution we look to the final quarter with some optimism.

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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