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# Nedgroup Investments Global Behavioural Fund

Quarter Four, 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] | 10,53 | 4,61 | 14,54 | -1,97 |
| Performance Indicator* | 11,03 | 7,26 | 22,20 | 5,75 |

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

*"Our dilemma is that we hate change and love it at the same time; what we really want is for things to remain the same but get better." — Sydney J. Harris (Thanks to Edu's BBQ by Billy Carpenter).*

### 2023 year in review

**Introduction**

Our investment theory believes mistakes move stock prices. Mistakes can have five fathers:

1. **Top-down shocks:** wars, pandemics, natural disasters. Their timing, extent, and implications are all but impossible to predict (even with correct theories on climate change, geopolitics, and biohazards). Their impact can cause surprising and disappointing outcomes for large groups of stocks.
2. **Top-down policy errors.** Policy makers (Governments, Central Banks) make mistakes when trying to manage the economy, sometimes in response to shocks. Mistakes are usually rooted in the flawed economic, political, or social theories of overconfident, persuasive, deluded policymakers, or their ideologically driven advisors. Their impact can also affect the fortunes of large groups of stocks.
3. **Bottom-up management errors.** CEOs can be delusionally overconfident in their beliefs and forecasts for their businesses. Unrealistic plans by charismatic, self-serving CEOs, particularly for companies having outgrown their purpose, can be a common source of disappointment.
4. **Bottom-up investor and analyst errors.** Analysts (and investors) predict outcomes for stocks. Sometimes they are confronted with uncharacteristically effective CEOs in companies with unusual clarity of purpose (even if this is just the urgent need to change). In such cases it can be easy to underestimate their tendency to deliver unusually good outcomes.
5. **Luck:** the random nature of life.

A lot of mistakes are luck. The world is a complex, adaptive system of numerous and varied semi-autonomous, living, and reactive elements. Forecasting complex systems is very hard and frequently, unpredictably wrong. Amidst excusable mistakes, however, bias can lurk - relying on the wrong kinds of information; assuming the wrong periods of history are representative and normal; clinging to false theories despite overwhelming contrary evidence; deluding ourselves that success teaches us more than failure.

If mistakes move stock prices, to unpick 2023 we must analyse what went wrong with last year's consensus predictions.

**Top-Down Shocks**

Sadly, wars rage every year. What changes is where. There is a bias to expect wars to end quickly and to start rarely. Conflicts already started, yet to end - Russia-Ukraine, Sunni-Shia, and US-China - tugged on some stock prices in 2023.

The most insidious was the US-China trade war. Supply chains have not returned to pre-COVID smoothness. Three years after the pandemic companies are still bull-whipped by inventory surges and collapses in different parts of their supply chains. Something in the structure of the global economy appears to have changed. There has been an erosion of trust in global free trade.

A few 2023 investment forecasters mentioned re-shoring in their outlooks for 2023, but not one mentioned the consequential pain of the lengthy transition - unpredictable inventory swings, cost pressures, sticky inflation.

**Top-Down Policy Errors**

The biggest and most persistent policy errors have their origins in responses to previous shocks: the GFC and COVID. Fourteen years after the GFC, policy makers still fail to recognise how blunt the interest rates tool is when used to control the intentions of companies and, especially, consumers. Nor had the vast majority of the 2023 forecasters. 2022 saw the sharpest rise in interest rate in post-war history, but the widely expected recession of 2023 never came.

The US consumer had locked in low mortgage rates and bolstered savings from the monetary and fiscal largesse of 2020-21. Companies repaired balance sheets with low, fixed rate borrowing. Only banks felt the strain, but from an entirely unexpected source. Credit quality remained superb. They were undone by government bonds and online innovation.

Awash with depositors' cash in 2020, banks pumped money into hideously low yielding Treasuries. As the low yields unwound and depositors shopped around for better returns (or just shopped), numerous US regional banks got into trouble in 2023. They felt the downside of "ease-of-use" online banking - the virtual bank run. Three had to be rescued by the Fed. No one saw that coming.

While COVID was an unexpected shock, the policy response looks flawed and misunderstood; the effects of COVID continue to linger far longer than expected. Sticky inflation, unexpectedly tight labour markets, no post-COVID recovery in China and a VC driven boom-bust investment cycle in tech and healthcare. We all thought the world would be back to "normal" in 2023. It was far from that.

In sum, with interest rates an unexpectedly blunt tool and lingering COVID-policy repercussions, the world's economies bumbled along in 2023 without a recession, inflation remained sticky and interest rates continued to rise. Government long bonds were by far the most popular investment pick of 2023. They disappointed. Many stocks weren't much better. Big Tech stocks did unexpectedly well, failing to descend into a post-TMT bust (although many smaller tech firms did). The overwhelming consensus for 2023 was for an early recession, a quick peak in interest rates (and inflation) and a second half recovery. Everyone preferred Government long bonds over stocks, value over growth, non-US (especially EM) over US, Financials and Energy over Big Tech. They were mostly wrong.

**Bottom-Up Management Errors (Damaging Disappointments)**

In the US, the biggest, most damaging mistakes by CEOs were clustered in three areas: Life Sciences, Ag Chemicals, and the Energy Transition. Healthcare was littered with the disappointing plans of overconfident company management, who underestimated the depth of the post-COVID biotech bust in biopharma R&D budgets (and bio-processing volumes) and overestimated the pace of recovery in elective surgical procedures from COVID disrupted healthcare facilities.

From Thermo-Fisher to Baxter, Illumina to Pfizer, 2023 was a year of dashed plans for growth. To exacerbate matters, new anti-obesity drugs, from Novo Nordisk and Eli Lilly arrived in 2023. With a potential miracle cure and a wide array of expensive and pervasive medical conditions linked to obesity, investors were unusually intolerant of small disappointments in healthcare (and processed food) company results.

In Ag Chemicals, CEOs believed the Russia-Ukraine war ushered in a new era of high demand, and prices, for crops and fertilizers. The reality was very different. Mosaic, CF Industries and FMC experienced an unexpected collapse in both pricing and volumes. They were (and remain) in disbelief. Ag Chemicals experience was a symptom of a more general exaggeration of the commercially positive impacts of war on commodity prices.

CEOs can be prone to mistaking risk for opportunity. In 2023, they were most likely to fall into the risk/opportunity trap in the Energy Utilities sector. Coping with aging infrastructure, increasingly volatile climate variations, and an outdated regulatory system caused a lot of disappointment for CEOs expecting the energy transition to bring an era of profitable growth. Dominion Energy, Sempra, and Algonquin are three of the many utilities who found the financial strain of meeting the conflicting demands of renewable investment and difficult regulators painfully disappointing.

In the Rest of The World, damaging disappointment had a strong geographical skew. China's promise of a late cycle COVID recovery caught a lot of CEOs out. The Chinese consumer wasn't a source of opportunity. Businesses reliant on a vigorous Chinese consumer were numerous and big disappointers. Failing to recognise China's transition from a source of opportunity to risk was behind much delusionally damaging CEO behaviour in Europe and Japan too.

China-exposed factory automation companies in Japan (like Fanuc) had a difficult 2023. Bureau Veritas and SGS, winners from the rising tide of globalisation before 2020, found the new reality hard to cope with. As did Kone, whose lifts and escalators trundle in many Chinese cities. China's lacklustre performance hurt commodity businesses such as Anglo-American, Norsk-Hydro and Stora. Despite the misplaced top-down fears of a global recession, metal and pulp prices were disappointing.

Away from China, the two disappointing US themes of Life-Sciences and Energy Transition were a clear source of trauma in Europe too. Lonza, Sartorious, Spirax-Sarco and Croda all continued to misjudge biopharma R&D and bio-processing demand post-COVID. Nibe (heat pumps) Siemens Energy (wind turbines), Umicore (battery materials) and Orstead (wind farms) found the energy transition an unexpected source of risk.

The energy transition looks capable of fooling many more CEOs for many more years. So too China. Life-science CEOs have a tendency to be dazzled by the promise of curing the currently incurable, but the last four years have been hard, and some uncharacteristic conservativism may have been beaten into them.

**Bottom-Up Investor and Analyst Errors (Surprisingly Rewarding)**

Most investor and analyst surprise look to have come from indirect impacts of top-down error. Company results weren't as bad as feared in the more cyclical areas of the stock market, especially Consumer Discretionary (Housing, Leisure, Autos) and Industrials (electrification, re-shoring).

In tech-heavy US, the absence of a TMT-like bust also caught investors out, especially in big tech. eCommerce (Amazon, Shopify, Meta, Google, Pinterest), Enterprise Software (Microsoft, Oracle, Workday, Salesforce) and the secure infrastructure to support it (Palo Alto Networks, Crowdstrike, Arista Networks) failed to descend into a depression, settling at growth rates not dissimilar to pre-COVID. This was a rare part of the economy where pre-COVID demand did return to "normal".

The semiconductor industry also flourished. CEOs were cautious, having learnt from past experience of wild swings in demand. Semiconductor intensive AI applications arrived in scale. Nvidia's exceptional position in AI compute surprised everybody, but the whole industry coped well with the 2023 inventory correction.

The alternative asset juggernaut continued, at the expense of the increasingly commodified public asset management industry. Apollo, KKR, Blackstone, Brookfield and Carlyle beat nervous expectations. As did Coinbase.

While banking was difficult in the US, it was surprisingly rewarding in the rest of the world, especially in areas of prior investor discomfort – Spain, Italy, Greece. And the slow rumbling of corporate restructuring in Japan continued to be a source of surprise, exemplified by the surprisingly strong performance of Japanese Trading Houses such as Mitsui and Mitsubishi.

The 2023 Top-down consensus was for a recession and a cold Tech winter. But conservative CEOs in the Tech, Industrials and Consumer businesses were surprisingly effective in 2023. Investors and analysts were surprised by no TMT bust and the return to the "normal" process of digitalising the economy, and no consumer or industrial recession.

**The 2024 Consensus**

The investment industry writes annual reviews full of predictions at the start of the year. Reading them is a great opportunity to gauge where the consensus lies. For 2023 the consensus was for a peak in interest rates and inflation in the first quarter of 2023, a recession and a second half recovery. Forecaster anxiety was on a deeper recession, an undershoot in inflation. Most believed Government long bonds were the best bet (great opportunity to lock in an attractive yield) and stocks looked too expensive and risky (apart from value areas like Energy and Financials). China was expected to recover strongly (being the last out of COVID).

Predictions for 2024 are slightly less gloomy, but remarkably like those for 2023. Forecasters waver between a soft landing and a mild recession, with inflation sticky and interest rates elevated during the first half of 2024. Then there is an almost uniform belief in falling inflation and interest rates in the second half. Inflation is not expected to be below the 2% target by year end, but consensus believes it has been tamed. There is variation in what this will mean for winning and losing assets, except for Government long bonds - the strong consensus (as it was in 2023) is they have the best risk-reward.

Inherent in the consensus view is an assumption nothing has really changed since 2009-19 (when the predominant risk was deflation). This, despite numerous areas of contrary evidence: stubbornly high inflation for over two years; malfunctioning supply chains; an extreme burst of fiscal stimulus and monetary easing; unprecedented direct government intervention in people's civil freedoms globally; an unexpectedly sharp drop in labour-force participation; a consumer with low sensitivity to interest rate rises; five years of trade-war, and the gathering momentum of an investment boom in infrastructure for decarbonisation.

**Themes to watch in 2024:**

We think forecasters' obsession with timing of the next recession runs the risk of missing some deeper unfolding changes in behaviour. Forecasters are almost entirely quiet on how the structure of the world economy might change, topics such as:

- What does AI mean for the tech industry?
- What does the continuing global crisis of trust mean for long-term interest rates and inflation?
- Has labour force participation and consumer-worker choice permanently changed post-COVID?
- What does decarbonisation mean for long-term interest rates and inflation (and who will pay for it)?

Each topic deserves an essay, but we will keep it to a few paragraphs.

**What does AI mean for the tech industry?**

Probabilistic, trainable, pattern-recognition, predictive software, or AI, arrived in 2023. In our view it is a big deal, the third stage of the digital economy wave. eCommerce was the first stage, the smartphone the second.

The digital economy thrives on data, collecting, analysing, and transforming it. Semiconductors are the crucial eyes, ears, and engines; software protocols are the crucial tools for automation and scale. There have been three crucial recent innovations in software. First, modularisation: writing code in collections of composable containers rather than monolithic single blocks. Second, open-source research and development: source code is readable, giving rise to developer communities who share and iterate it. Third, machine learning and Large Language Models (LLM): probabilistic, data fed systems capable of developing their own rules.

In 2023 LLMs broke into the vaults of language-based information. These models need huge amounts of data and processing power (semiconductors) to work effectively. Their success opens up vast areas of information-based human activity for automation and improvement. But the big will win. They have access to the huge quantities of useful data needed to train systems and the scale to cope with the huge compute costs involved.

Whatever you think of the 2023 performance and valuation of the "Mag-7", they have the data and the scale to take full advantage of AI. We are now of the view big tech companies will get bigger and a semiconductor investment boom will help this happen.

**What does the continuing global crisis of trust mean for long term interest rates and inflation?**
Commerce requires trust. Trust is hard to earn, easy to lose, expensive to protect. When trust in the integrity and governance of your trading partners has been built, and your trade routes are reliable and robust, supply chains can weave their way across the globe, searching for the lowest cost means of production. If you cannot trust your trading partners - to validate the integrity of their product and the conditions under which it was made - your supply chain breaks down.

Decades of outsourcing to low cost “emerging” economies reached its apogee in 2018. China opened the last great frontier of cheap production. Supply chains were geopolitically blind. This is over. We are now in the era of trade-wars, supply chain security and the polarisation into trusted and non-trusted partners.

Russia is no longer seen as friendly. Democracy will not insidiously conquer China. COVID has revealed the fragile consequences of supply chains optimised for low cost and low working capital alone. Securing supply chains will be more capital intensive, more expensive and will shift demand for workers back closer to the countries where products are consumed. Deglobalisation of supply chains will be expensive and capital intensive, putting upward pressure on inflation and interest rates.

**Has labour force participation and consumer-worker choice permanently changed post-COVID?**
One of the post-COVID conundrums was the debunking of the jobless recovery and the persistent underestimation of inflation (after decades of overestimation bias). COVID was used to justify the most intrusive burst of government policy since the second world war. Everyone had to break their normal routines for a prolonged period. The experience has been extremely disruptive to general attitudes to work and consumption.

We are creatures of habit, mainly sleepwalking though routine to create the illusion of control. We only consider the purpose of routines when forced to abandon them. Why work until 65 when you have won from the institutionalisation of retirement savings and the improbable inflation of residential property? Why be a two person, full-time, working household when your children’s development has been (irreparably?) damaged by the COVID lockdown and your generation is suffering a mental health crisis? Many of us have been forced to ponder such questions.

Economists have consistently underestimated inflation since COVID. Initially it was the persistently “transient” supply-chain disruptions, then the mystery of missing workers. Labour force participation has fundamentally changed. The Philips Curve has shifted. Wage inflation is notoriously sticky after it gets entrenched. The genie is out of the bottle. Inflation will not sustainably return to pre-COVID “norms”.

**What does decarbonisation mean for long term interest rates and inflation (and who will pay for it)?**
One of the bottom-up features of stocks in 2023 was the carnage in the Energy Utility sector. Rebuilding the energy infrastructure for decarbonisation is expensive and capital intensive. For too long we have been tolerating aging, under-invested infrastructure which increasingly looks unfit for our new demands.

The infrastructure mainly sits within regulated regimes persistently gamed by businesses to extract maximum profit with the minimum investment, policed by politically driven regulators keen to “protect” consumers from a cost-of-living crisis. The world wants a carbon-free future, but it is unclear who is going to pay for it. Such a toxic cocktail is already causing trauma in the once safe utility sector.

Renewable energy sources may end up being cheaper than fossil fuels, but the rebuilding of the infrastructure to enable the transition is going to be very expensive, capital and resource intensive, and judging by 2023, no one has properly worked out how to pay for it. Hence the decarbonisation process seems likely to put more upward pressure on interest rates and inflation.

**Conclusion**
Financial markets have a timeless ability to make fools of us. Perhaps the most pervasive bias is overconfidence. When one is paid to invest money for others, you are expected to be right more often than wrong. But you will

still be wrong. The key is to never lose sight of the purpose – invest wisely, balancing risk and reward, and never stop learning.

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**Issue Date:**
**Dec 2023**