



see money differently

A photograph of an open book with white pages, tied with a white ribbon bookmark. The book is positioned on the left side of the page, with the pages fanning out towards the right.

Nedgroup Investments Global Property Fund

Quarter Two, 2020

Nedgroup Investments Global Property Fund

Commentary produced in conjunction with Sub-Investment Manager, Resolution Capital

Indicator	3 months	1 year	3 years p.a.	Since Inception [#] p.a.
Portfolio*	9.35%	-6.28%	2.47%	1.96%
Performance indicator ⁺	10.07%	-16.22%	-1.60%	-2.14%
Difference	-0.72%	9.94%	4.08%	4.10%

* Net USD return for the Nedgroup Investments Global Property Fund, C class. Source: Morningstar

[#] 12 August 2016

⁺ FTSE EPRA/NAREIT Developed Index (in USD Net Ret)

Summary points

- Will the virus temporarily or permanently change the way the economy utilises real estate and/or simply reinforce pre-existing secular trends?
- Secular trends witnessed before COVID-19 are unlikely to be altered/broken and in many respects have simply been reinforced.
- Limited portfolio changes and cautious stance remains, with a focus on more resilient cash flows.
- Focus on areas of the real estate market which are best placed to thrive, if not survive, the eventual passing of the challenge.
- Overall tenant demand in the Global REIT universe has been negatively impacted.
- Reduced or suspended dividends were not the case across the board. Several residential, office, industrial, healthcare and data centre REITs maintained or increased dividends.
- Majority of holdings have strong balance sheets and are expected to pay distributions at least in line with 2019 levels.
- This has been an exceptional year of opportunity for many stocks in the portfolio, underpinned by high quality real estate that is relevant to the secular trends in the economy.

Market and portfolio commentary

The rapid injection of copious amounts of financial stimulus, both fiscal and monetary, as well as reassurances about continued low interest rates appeared to underpin economies and financial markets as the COVID-19-19 pandemic unfolded. As the consequences of the virus became better understood and social restrictions were eased, financial markets generally became more constructive that the economy had troughed and was moving rapidly into a recovery phase, the downturn appearing to be one of the shortest and sharpest in multiple generations.

Nevertheless, unemployment looks set to be substantially higher for some time and the effects and dynamics of the virus may not be fully understood. Some major pockets remain challenged, such as immigration and tourism, as well as segments of retail trade. Broader questions include how future generations will pay for the bail out and what moral hazards have been created.

While we shouldn't downplay the fact that the economy contracted sharply, one of the key takeaways to emerge from the hibernation period was that the economy was able to function at a reasonable level through the use of IT and ecommerce distribution channels and the short-term benefit of a social wage.

The question most relevant to Global REITs: will the virus temporarily or permanently change the way the economy utilises real estate, and/or simply reinforce pre-existing secular trends? While complex, overall we feel it's more the latter. Through necessity, many of us have rapidly incorporated existing technologies to communicate and complete tasks, accelerating what otherwise would have taken several years to adopt. Whether this is desirable for society is another matter.



With few reference points of underlying asset values provided by direct property market transaction activity, and with interest rates remaining low, listed real estate recovered some of the previous quarter's price declines, allied broadly with the overall stock market.

We have not substantially changed the Portfolio in recent months, most notably we continue to have limited exposure to hotels and retail property. Not drastically changing portfolio holdings in the recent volatility was a considered decision, time will tell if we were too cautious or appropriately disciplined. We do not view ourselves as outstanding traders and we actively debated the opportunities, but to move more aggressively would have required us to close our eyes and buy a dog's breakfast of "down-a-lots". Many of which we judge to remain compromised and do not provide low-risk, long-term value.

We have however been trying to find value in some previously avoided areas and we succeeded in pockets, such as student housing, but there remain too many fundamental challenges facing key segments of the real estate market to compromise our approach which has served us well over the long term.

Indeed, we committed more capital to many of our existing positions, in some cases supporting equity raisings designed to fund the REITs' existing investment activities as well as allowing them to respond opportunistically if/when distress appears.

While the market bounced off its late March lows caused by the initial panic, REIT indices are still well below the peaks that many markets recorded in February 2020. The economy has contracted, unemployment has increased, and business and household cashflows have been disrupted, consequently pushing some close to insolvency. Clearly businesses and consumers have at least temporarily altered their behaviour and in some cases business has been significantly curtailed or prohibited: e.g. tourism, services involving close contact and non-essential bricks and mortar focused retail. Hence overall tenant demand has been negatively impacted.

Early in the crisis, REITs and landlords responded to tenant needs financially and practically through more amenities and safeguards. While not universal, these measures included:


- Increasing building sanitisation programs and promoting social distancing measures in common areas
- Suspending tenant evictions
- Deferring rents, with some simply extending the pre-existing lease expiry date
- Rent reductions for varying periods, sometimes as part of government codes to assist small businesses
- Foregoing rent increases
- Abating rents altogether

Governments encouraged pragmatic discussions between landlords and tenants and in some jurisdictions oversaw industry codes to provide relief primarily to small and medium enterprises (SMEs). Legally, however, tenants are obligated to pay rents detailed in lease contracts which typically do not contain pandemic waivers.

Consequently, the market focused on rent collections as a measurable data point in a time of crisis. While many physical space occupying industries were able to migrate to a home-based workplace, hotels and bricks & mortar retailers suffered very substantial declines in business volumes. Large sections of malls were shuttered and many US fashion-oriented malls closed altogether. With their business coming to a virtual halt, rent collections from retail and hotels were the lowest of any category. Retail rent collections were typically less than 60% of billings with most payments coming from supermarkets and basic needs formats.

Other than retail and hotels, landlords in most other categories reported rent collections of over 90%, although there was some ambiguity about concessions. Furthermore, some landlords were reluctant to publicly disclose concessions for fear of financially capable tenants unnecessarily taking advantage of the situation to avoid their legal obligations.





Sector	Avg May rent received^
German residential	100%
Data centre*	100%
Healthcare (Life Science)	97%
US residential	96%
Storage	95%
Industrial	87%
Office	93%
Retail (Strip centres)	60%
Retail (Malls)**	18%
Hotels***	N/A

Source: RCL, Company data

* RCL estimate. Companies did not disclose May numbers but expect to be close to 100%.

** Minimal disclosure from mall REITs; Macerich disclosed 18% rent collections for May.

*** Hotels have not disclosed May rent collection numbers.

This has come at a cost to REIT cashflows. Many retail and hotel REITs, including several Australian REITs (A-REITs) and the large diversified UK REITs, were among the first to show the practical financial impacts by reducing or suspending dividends until rent collections become clearer. Landsec (LAND) and British Land (BLND) did not pay distributions relating to the March quarter. Meanwhile most A-REITs traditionally declare quarterly and half year dividends in the weeks leading up to 30 June. On average A-REIT distributions were approximately 30% below the previous corresponding period including large mall owners, Scentre Group (SCG) and Vicinity Centres (VCX) which announced they would not pay dividends at all for the period. The extent to which distributions have been deferred or permanently reset to a lower level reflects a combination of factors, including permanently lost rent and the need to retain capital to assist tenants.

Reduced or suspended dividends were not the case across the board. Importantly, several residential, office, industrial, healthcare and data centre REITs maintained or increased dividends. Reflecting greater visibility in near-term cash flow and confidence in asset level performance during the pandemic.

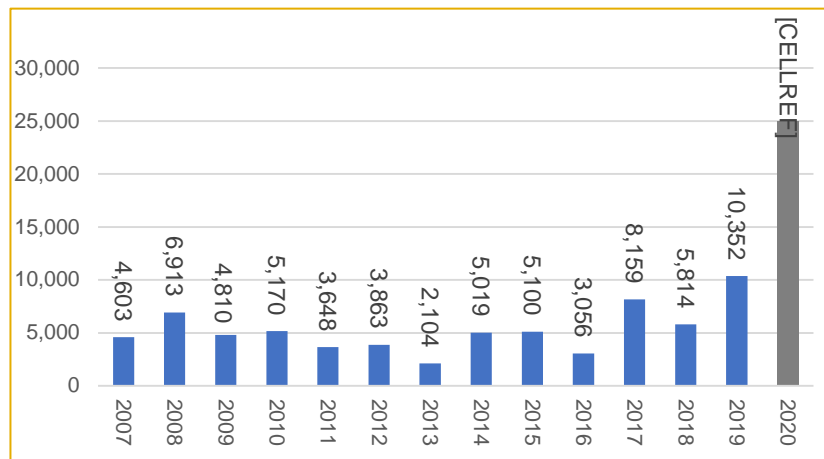
Given the dispersion of conditions, let us delve into each sector in a bit more detail. It's an extraordinary amount to digest in largely unfamiliar waters.

Retail property – buy in gloom?

In somewhat of an understatement, it was a particularly challenging operational period for retail property. In reality, it was chaos manifested by:

- Retailers refusing to pay rent and/or demanding changes to lease terms, including rents based on the tenant sales turnover.
- Landlords suing tenants – including Simon Property Group (SPG), the largest US mall owner, suing its biggest tenant GAP.
- Busted M&A deals – SPG reneged on its pre-COVID-19-agreed deal to buy listed rival Taubman (TCO), the matter now heading to court.
- Intu, once the largest UK retail REIT, the troubles of which we have chronicled over a long period, finally appointed an administrator to deal with its debt plagued balance sheet.
- Australian mall owner Vicinity Centres (VCX-AU), launching a \$1.4bn deeply discounted equity raising to preserve its credit rating and future access to capital.
- The bankruptcy of two high-profile department stores in the US, J.C. Penney and Neiman Marcus.
- Suggestions that Australian department convenience-based retail property values slipped generally by 5-10%. Less severe than malls, thanks to the relatively high proportion of income derived from supermarkets and other necessity retail.

USA Annual Retail Store Closures – 2020 est. to double 2019 Peak



Source: ICSC General Merchandise, Apparel, Furniture & Other Merchandise Announced Store Closures

As bad as the news was during the quarter, it would seem retail REIT prices had largely anticipated the situation in the prior quarter. Relieved to see evidence of pent-up consumer spending demand being funnelled into re-opened stores, retail REIT unit prices bounced in the June quarter suggesting the market had previously over-reacted, and the worst may be behind us.

While there will be a rebound from the lock-down lows, it is clear that bricks & mortar retail is continuing to lose market share to ecommerce in key segments of consumer goods. We acknowledge there is a strong case that an omni-channel offering, i.e., both physical and virtual stores, is vital to retailers maximising sales. However, this set-up is expensive and complicated, which further stresses retailer profitability and capital needs.

Furthermore, in a battle to retain existing, and to attract new tenants, landlords will be under pressure to provide greater lease incentives in the form of store fit-out contributions, marketing and advertising and in some cases, moving to rents based on turnover while business is in a rebuilding phase.

Compounding this challenge, many shopping centre landlords do not have balance sheets capable of withstanding the challenges of significant upheaval and the need to help provide capital to tenants trying to optimise stores and re-engineer their distribution channels. We nevertheless tried to identify mispriced retail property platforms possessing reasonable balance sheets and which are likely to be the winners of industry rationalisation.

Office – the all-day pyjama cult

With large numbers of white-collar workers staying home during the pandemic, the future of office and central business districts, has become a major talking point in the investment community. Perhaps top of mind for those of us in the finance industry, as if it's the only place where the world works. Nevertheless, it does represent a significant amount of commercial real estate capital, infrastructure and services which supports it.

Office has not produced the best long-term risk adjusted returns, the likely outcome of its commodity characteristics. This is typified by significant price volatility usually caused by excess supply and major tenants able to extort favourable long-term lease deals by threatening current landlords to move to the latest tower offering more amenities, cleaner air, lower emissions, faster lifts, new foyers and the ability to cram more workers into less space.

Hence, COVID-19-triggered Work From Home (WFH) practices have become a hot topic as commercial space users grapple with the issue of how much space they actually need if a sizeable portion of their team seem capable of working remotely. Saving commute time, more family time and a greater sense of being trusted by their manager has been a common theme in employee surveys, while being home to receive Amazon deliveries or for the tradesman to arrive has been an added benefit for many, with limited evidence of lost productivity thus far.



The case against swathes of workers abandoning the office focuses on the inability to build team culture, lack of personal or team connection, peer pressure/mental health, the benefits of collaboration, learning and overseeing quality consistency. Separating work from home seems a reasonable concern and often it is a difficult challenge for smaller living quarters, shared renting or families who don't welcome some members of the household spending too much time at home.

If nothing else, the COVID-19 WFH/Work From Anywhere (WFA) experiment underscores the increased mobility of the white collar workforce facilitated by shifting to a paperless world, co-working and the flexibility of laptops/tablets, wi-fi and the cloud. Once again, the COVID-19 experience accelerates secular trends that have subtly been taking place for decades.

Perhaps the recent positive experience will be enough to convince entrenched cynics that widespread WFH is sustainable. However, we think it would be naïve to be hasty. We recall the dramatic predictions of workplace changes following September 11 and SARS which were eventually discarded and the early adopters of WFH (including IBM) who eventually reversed course.

Ultimately, we are inherently social animals and hence the herd will likely gradually re-form, albeit in different patterns. We believe a hybrid model is the most likely outcome and the need for hot desking, now dubbed "clean desking", is even more critical in a world of greater flexibility. Teams will need to come together periodically but it may not necessarily be five days per week. However, while workers will be afforded a higher level of flexibility, they will need clear parameters.

It is instructive to see the comments of larger space users including technology companies which have been the major demand driver in office markets in recent years.

Company Reactions to WFH



Source: Green Street Advisors

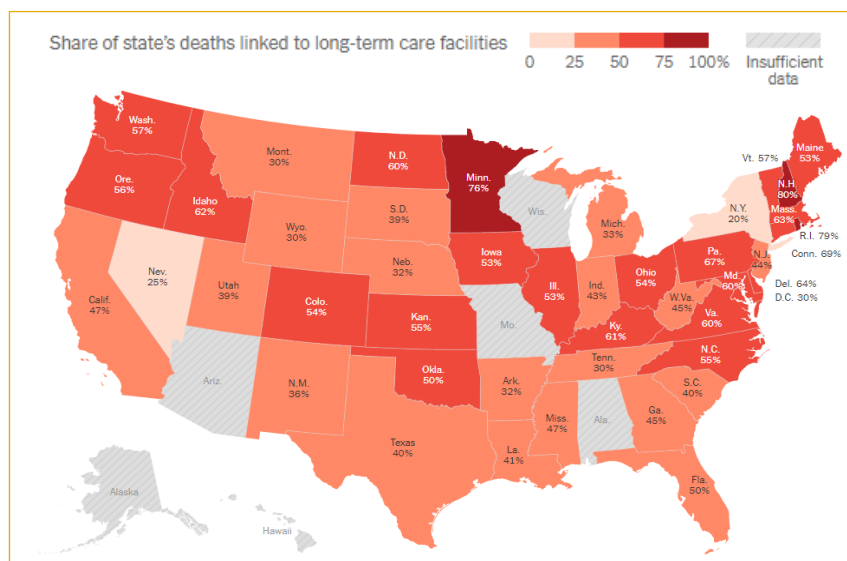
This has significant immediate consequences for CBD retailers in terms of reduced city foot traffic. Combined with the impacts of economic contraction, we expect office demand in CBDs to be more muted in the short term at least.



Healthcare

It's a sad reality that those most vulnerable to the ravages of COVID-19 are those over the age of 70. And that means that nursing homes have become the true epicentre of the Coronavirus crisis.

In at least 23 states, a majority of deaths linked to nursing homes



Source: The NY Times

REITs have limited direct exposure to nursing homes, although a number have meaningful exposure to senior housing which has also been affected by the crisis. In response, operating restrictions of US senior housing facilities include:

- Limited new leasing, significantly curtailed tenant move-ins. Move-ins require a two-week quarantine, and so any discretionary move-ins (e.g., Independent Living) were delayed.
- Move-outs continue, typically 3-5% per month based on a two-year average stay in senior housing.
- No move-ins and continued move-outs put clear and immediate pressure on senior housing occupancy levels and operator margins.
- As a consequence, occupancy rates in US REIT senior housing operating properties fell by an average 500bps during the quarter to 80%.

Data Centres and Cell Towers

There was limited news to report on the sector during the quarter, only confirmation of the surge in data traffic during the shut-down. Of note, the roll-out of 5-G underpinning the outlook for cell tower owner American Tower (AMT-US) which contributed positively to Portfolio performance. During the period, data centre specialist Equinix Inc (EQIX) acquired a portfolio of 13 BCE Inc (Bell) Data centres located in Canada. EQIX raised US\$1.5 billion equity, enabling us to increase our position in the stock.

Logistics

The ongoing robust tenant demand for logistics property continues to be recognised by the market. While logistics real estate fundamentals are broadly buoyant, smaller tenants could be the weak link, with limited credit and less capacity to withstand ongoing business disruption. Those exposed to events, hospitality and bricks and mortar retail are most at risk near term. At the other end of the spectrum, increased tenant demand for larger scale ecommerce facilities – and an expectation that manufacturers will increase inventory levels to ensure critical elements of the supply chain have not been disrupted – continue to support demand.

Time for school

At least since March, our focus has been on trying to identify sectors which are likely to see only temporary dislocation of fundamentally strong long-term demand drivers, such as student housing REITs.

The market appears to be overly discounting the long-term fundamentals and the added pressure on universities to partner with private operators to help solve accommodation needs. We believe demand will recover robustly when lock downs are relaxed.

While the re-opening might take longer than expected, we view the impacts on student housing as temporary. We do not believe demand for higher education and the delivery through centralised institutions will change in the foreseeable future. Hence, share price weakness was an opportunity for us to establish positions in two of the leading listed student accommodation platforms.

Self-storage

Self-storage was not surprisingly a steady performer during the quarter. Occupancy in European and US storage has held up well with move-out levels down considerably from the prior year. To be fair, it would have been near-impossible for move-outs to occur while entire markets were in lock-down during stay-at-home directives. Pleasingly, even after these stay-at-home orders have been lifted, move-out levels have not yet surged. It is also noteworthy that local zoning incentives in New York changed earlier this year which should effectively disincentivise further storage construction in New York City.

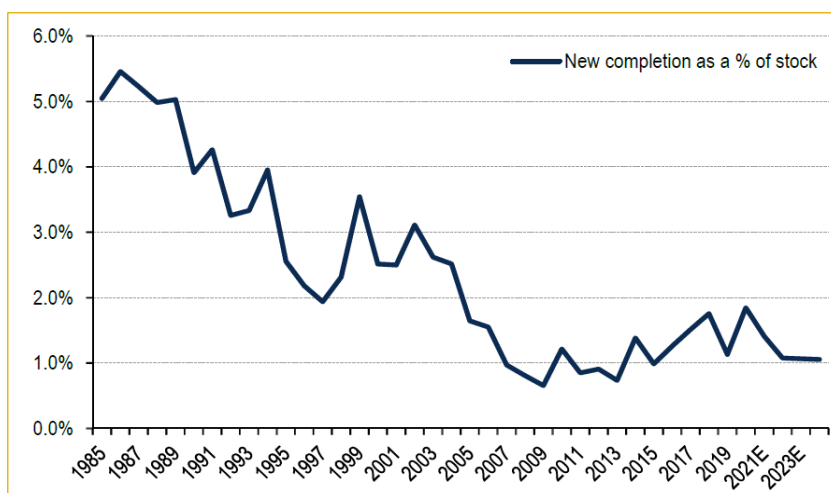
Hong Kong/China: one country - one security law

We had increased our exposure to Hong Kong in the prior quarter as the stocks had already been battered by social unrest, have strong balance sheets and the region had recent experience dealing with pandemics. However, Hong Kong stocks lagged other regions over this quarter after China announced its intention to impose national security laws, which many fear will erode freedom of expression and judicial independence.

Hong Kong's position as a financial hub appears to be threatened, with the risk of capital flight and a wave of emigration similar to that which Hong Kong experienced in the lead up to the 1997 handover when approximately 60,000 people emigrated each year between 1990 and 1994 (compared to approximately 10,000 people per annum over the past 20 years).

Nevertheless, the supply of residential homes as a percentage of inventory (per the following chart) remains low, while demand from the mainland buyers could potentially more than offset emigrant losses.

Hong Kong new home completions as % of stock

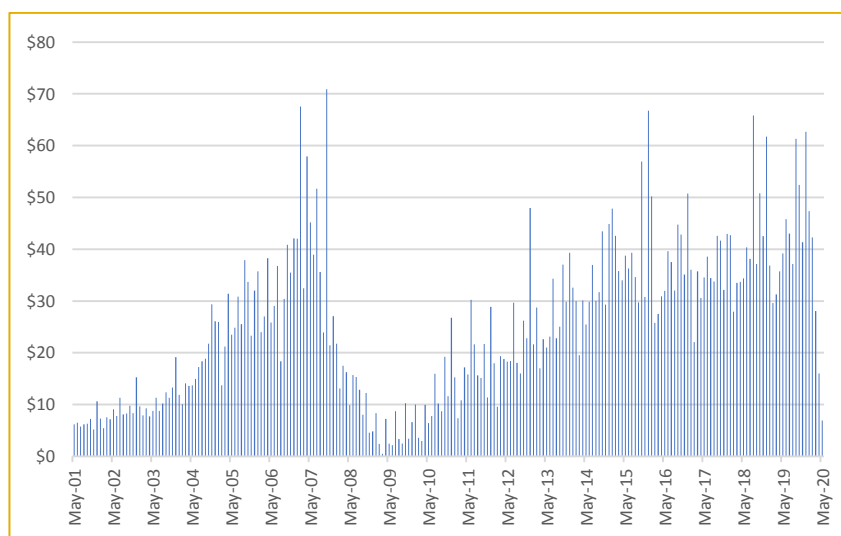


Source: BofA Global Research

Capital Markets

Direct property market investment activity slowed considerably in the quarter as both buyers and sellers paused and the cost of capital changed for investors and lenders alike. Secured finance became prohibitive for weaker rated buyers, and several transactions did not complete when planned mortgage finance fell apart.

US direct property market transactions (US\$b)



Source: Bloomberg, Real Capital Analytics

By way of contrast, REIT markets remained open and highly liquid.

Thankfully, with a few exceptions, the listed REIT sector entered the crisis with solid capital structures, with minimal short-term debt maturities and limited need for additional capital. To the last point, most REITs have postponed speculative new development.

Nevertheless, there were some that were pushed over the edge such as the aforementioned UK mall owner Intu, which was finally forced to admit defeat, calling in administrators on 26 June when it was unable to secure a standstill from creditors on its significant debt load.

Several hotel REITs were also required to seek covenant relief from lenders as rental cashflows evaporated. Given fairly tame leverage levels, most lenders generally agreed in exchange for some compensation such as higher interest rates or cash flow priority.

Importantly, capital markets remained open and many REITs refinanced debt and some (in particular Australian and UK REITs) tapped the equities market. In general, the capital raisings were for offence, VCX the clear exception.

Meanwhile in Singapore, regulators relaxed the statutory maximum loan-to-value (LTV) ratio for REIT qualification from 45% to 50%. While the initiative is intended to avert the need for deeply discounted equity issues in order to retain REIT status in the event that asset values fall during this period of pandemic induced distress, the change has no sunset date and we fear that REITs will move towards the upper limit and inevitably find themselves in trouble in the next downturn.

Admittedly early in the downturn, and with transaction markets restricted, private equity has thus far largely been absent, although a few funds acquired relatively small positions in a basket of listed REITs. However, there were two notable transactions:

1. No doubt encouraged by the success of on-line entertainment during the pandemic, Blackstone (BX) acquired a 49% interest in a US\$1.65 billion portfolio of studio and studio-adjacent properties in Hollywood from Hudson Pacific Properties (HPP) who will retain a 51% stake in the newly formed JV.
2. BX and Starwood Capital acquired a stake in Extended Stay America, a US budget hotel owner currently bucking weak industry occupancy trends.

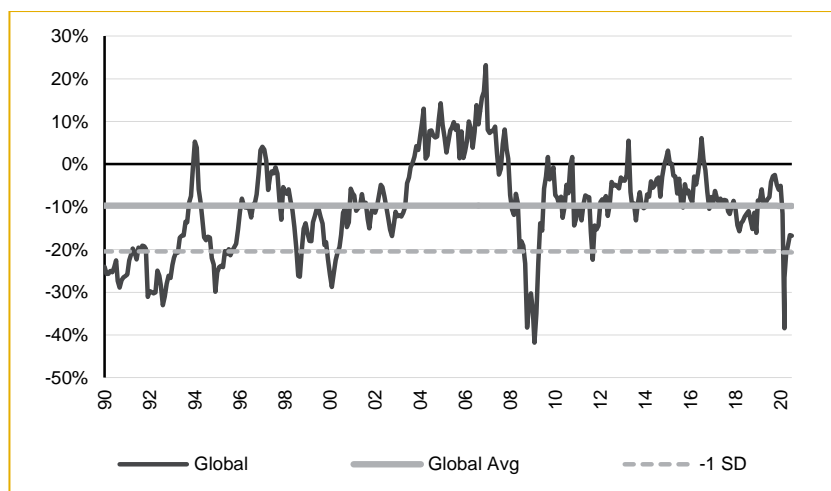
With REITs in relatively strong financial shape and capital markets operating at near normal levels, it seems private equity isn't needed at this point. It is however still early days, with enterprises living off government accommodation. As this is removed, we expect PE activity to ramp up.

Valuations

In this environment there is uncertainty as to the true clearing price of many segments of the direct property market which presents a challenge for custodians of private market assets – particularly when investors in pooled vehicles are buying or selling. This is of particular interest for Australian superannuants given temporary early access to their pension accounts during the pandemic.

Notably, REITs are trading at a discount to private market values, a signal that often proves to be a leading indicator of where real estate values are heading. Moreover, this is before the immeasurable value of liquidity and price discovery that REITs also provide.

Global REIT Premium/Discount to NAV



Source: UBS as at 16 July 2020

Outlook

Answering how “we” pay for the government’s COVID-19 induced largesse is above our pay-grade, but it seems that it must weigh on long term real economic growth. We will be fascinated to see the outcome of moral hazards, understand the true extent of non-performing loans, learn about the veracity of Modern Monetary Theory, the social wage (also termed negative income taxes), and the merits of a 4-day work week. But we will be equally intrigued about the management and outcome of the forthcoming US election, the terms of Brexit and how China’s increasingly bellicose attitude is manifested. The market loves something to worry about and being outwardly nervous has served it well, complacency is a greater threat to constructive investment markets.

Clearly it would be irresponsible to be dismissive of the impacts and ongoing risks of COVID-19, or hopefully the chances of a vaccine. With a seemingly overwhelming amount of information to digest, we think it is important to simply recognise that certain areas of the economy have contracted and that the recovery is likely to be stunted and irregular. Hence real estate markets face a challenging period.

Ultimately, we think our investors will be best served by focusing on those areas of the real estate market which are best placed to thrive, if not survive, the eventual passing of the challenge. We see little to alter the approach we’ve taken – secular trends we witnessed before COVID-19 are unlikely to be altered/broken and in many respects have simply been reinforced. Strong balance sheets provide extra protection and durability.

To some extent the market is writing off 2020 as an unrepresentative, exceptional “lost” year, and that we must look to 2021 or perhaps 2022 when things return to normal. While we have some appreciation of this approach, for many of the stocks in our Portfolio, we see this as being an exceptional year of opportunity and confirmation of the power of these platforms in the new normal.

We continue to believe our portfolio is invested in high quality real estate that is relevant to the secular trends in the economy. The Global real estate sector commands its place as a valid part of a diversified portfolio, due to a resilient income stream and tangible underlying assets, and the through-cycle liquidity has once again been proven.

Pleasingly, the overwhelming majority of our investments have relatively strong balance sheets and are expected to pay distributions at least in line with 2019 levels. However, for this to be sustained beyond the current period we have to assume that the economy will not deteriorate further – a prolonged period of economic contraction will weigh on the tenant demand outlook in a broader range of sectors.

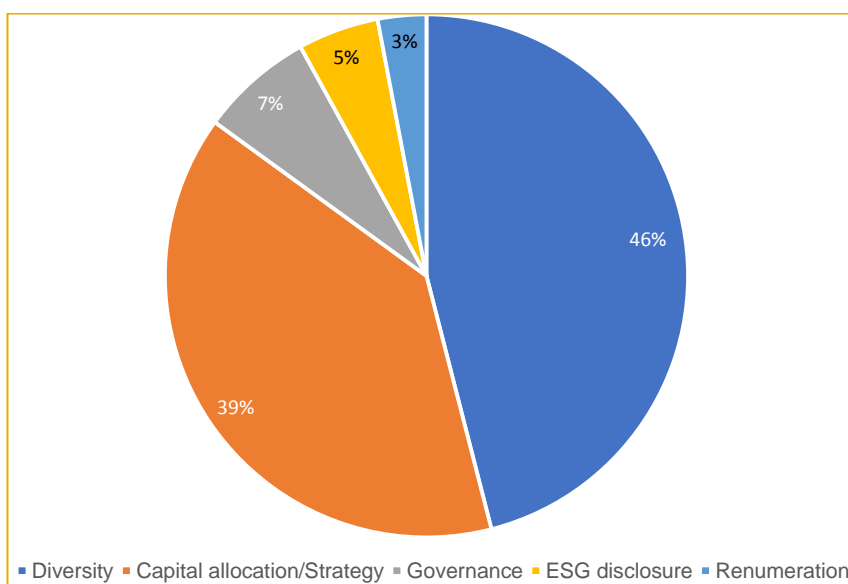
ESG: Active ownership overview

Active ownership is an important part of our investment process. We believe this can have a beneficial impact on society as well as the risk and return outcomes for our investors.

Over the past 12 months we have engaged with 31 companies specifically with regard to ESG related matters. We can divide the categories of engagement into three broad groups:

- Targeted company-specific issues including strategy, capital allocation, governance and remuneration
- Board diversity
- ESG disclosure

Reasons for engagement



Source: Resolution Capital. 12 months to June 2020

Holding management to account on strategy, capital management and governance has been a focus of our engagement activities with investees since inception. Pleasingly, the broad opportunity set within Global REITs provides us with ample capacity to gravitate to best-in-class companies. Nevertheless, we still find overly generous remuneration practices and relatively low bonus hurdles an ongoing issue, particularly in the US

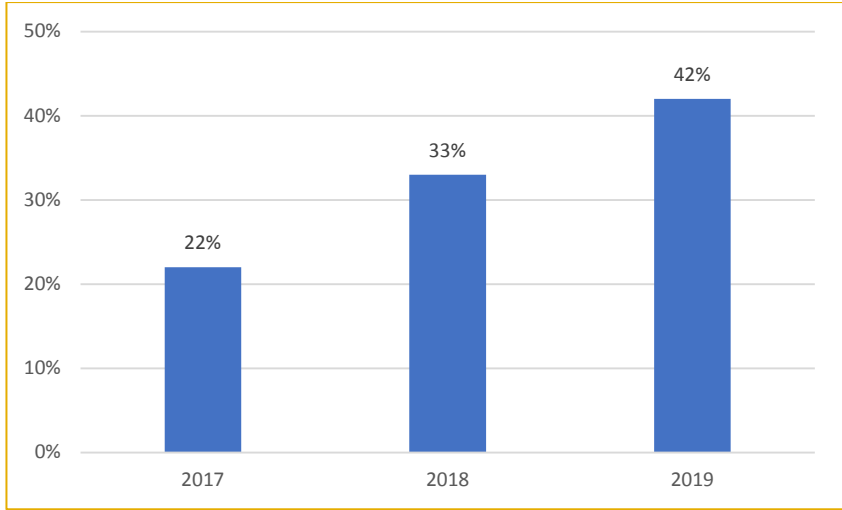
We believe that boards which exhibit cognitive diversity will more than likely outperform over the long run. A diversity in thinking comes through, for example, different skills, gender, race, age and background. In terms of



gender diversity, we note good progress has been made in recent years – almost half of the Portfolio holdings have 30% or more women on the board.

Overall, the portfolio has slightly better gender diversity than the index. Nevertheless, more work needs to be done to create better diversity, whether in terms of gender, race or skills, including for example technological and environmental expertise.

ResCap global holdings with 30% or more women on the board

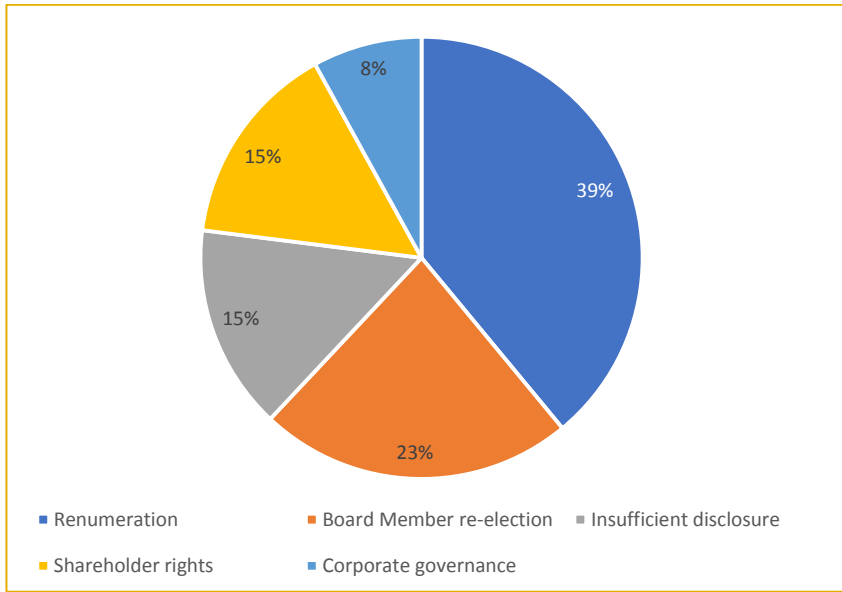


Source: Resolution Capital

While ESG disclosure has improved in recent years, a huge gap still exists between the best and the worst. In some cases, the substance of how they operate is better than what they disclose, i.e. they have good initiatives, but they just don't tell us. In other cases, there is a lot of room for improvement. We urge companies to increase ESG disclosures, including publishing greenhouse gas (GHG) emissions and ambitious energy savings and GHG reduction targets. We also encourage companies to join the GRESB survey, as this is a very comprehensive assessment designed specifically for property companies.

Finally, proxy voting remains an important aspect of active ownership. Calendar year-to-date we voted against management in 4% of the resolutions, slightly more than the year before. Remuneration remains the number one reason we vote against management, followed by corporate governance concerns, including shareholder rights and board composition.

ResCap reasons for voting against management



Source: Resolution Capital. 12 months to June 2020.



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FEES

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