



NEDGROUP
INVESTMENTS

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NEDGROUP INVESTMENTS VALUE FUND

Quarter Two, 2019

For the period ended 30 June 2019

NEDGROUP INVESTMENTS VALUE FUND

EXECUTIVE SUMMARY

The quarter to June saw the US economy recording its longest period of expansion since 1854 according to the US National Bureau of Economic Research. At 121 months and counting, it is now longer than the 1991–2001 golden era. Despite June's US–China trade détente at the G20 summit in Japan, concern persists that the next downturn still looms. The US Federal Reserve's abrupt January U-turn and decidedly dovish statements during the quarter under review lend support to this thesis, sending US yields sharply lower and the dollar weaker in expectations that the US interest rate hiking cycle may be over.

Safe haven bond investments gained, with more than \$12 trillion in sovereign debt trading at negative yields by quarter end. Investors cheered the advent of lower rates and global developed and emerging market bourses rallied through June to recoup May's declines. Meanwhile precious and industrial metals prices gained as geopolitical tensions rose as the US faced-off against Iran. But the US yield curve has been inverted for a full month, a traditional bellwether of approaching economic weakness. The portfolio thus remains conservatively positioned.

The rand was buoyed by broad-based dollar weakness. But negative terms of trade from rising crude oil prices and South Africa's policy vacuum, growing fiscal deficit and looming debt trap are currency negative. We maintain the bias towards international businesses, balanced an allocation to high quality domestically focussed businesses on attractive valuations.

Q2 2019 PERFORMANCE COMMENTS

- Underweight allocation to resources added value as the sector underperformed.
- RMB Holdings (+14.0%) and EOH (+89.0%) rose sharply whilst British American Tobacco (-15.3%) and Sasol (-22.0%) detracted
- The overweight allocation to financials contributed positively to relative returns as the sector led the market higher.
- Property detracted at the margin with Capital and Counties (-15.4%) falling on negative sentiment to UK property companies

MARKET OVERVIEW

WORLD

- Growth in the world's two largest economies slowed after a surprisingly buoyant first quarter as the US–China trade war escalated – culminating in the US branding Huawei, HIKVision and other Chinese technology businesses national security risks
- President Trump's more conciliatory tone at the G20 meeting renewed hopes of a less confrontational second half with improved growth dynamics forecast – but expectations of a speedy trade resolution should be tempered given the shift in Trump's ire towards European manufacturers
- Global equity markets rose 3.8%, led higher by developed market cyclicals after dovish ECB and Fed commentary ignited expectations of a half-point US interest rate cut this year – but falling earnings expectations amid growing uncertainty over fixed investment, slower employment gains and pedestrian wage growth may scupper appetite for equities
- Geopolitical risks rose after UK Prime Minister Theresa May resigned and Brexit hardliner Boris Johnson emerged as Tory leadership front runner – while Iran's downing of a US surveillance drone, suspected attacks on oil tankers in the Strait of Hormuz and announcement of uranium enrichment exceeding previously agreed limits tested Trump's appetite for conflict
- The Fed kept rates unchanged but signalled its propensity to lower the federal funds target rate amid growing macro risks and slower growth, with outgoing ECB President Draghi promising further policy easing if Eurozone growth falters – fed fund futures indicate a high probability of at least two quarter-point reductions this year, unless employment gains continue, and global sentiment improves
- Demand for sovereign debt soared, with Austria successfully placing a 100-year bond at a 1.1% yield and an astounding \$12 trillion (that's 12 followed by 12 zeros) of government debt now negative yielding – the US yield curve inverted, with 10-year yields lower than 3-month yields, which suggests a weaker growth outlook and commensurately lower policy rates
- Iron ore prices rose sharply on supply concerns given low inventory levels and new incremental ore volumes slow to respond with Brazilian mines out of commission, but oil retreated on rising inventory levels despite supply responses from US shale producers – the longer-term outlook for commodity prices is skewed to the downside given expectations for weaker global growth, although US dollar weakness may support commodities in the short term

- The gold price rose sharply, responding to lower interest rate expectations and major central bank balance sheet support of developed economies— near-term inflation risks are skewed to the downside, but any central bank policy missteps this late in the cycle may trigger rapidly rising inflation which should continue to support bullion prices

SOUTH AFRICA

- First-quarter GDP growth (-3.2%) contracted the most in a decade as severe electricity load-shedding constrained mining and manufacturing output – second-quarter growth should improve but will remain well below levels required to improve revenue collection and government’s balance sheet, despite optimistic Treasury forecasts to the contrary
- The rand breached R15/\$ on ANC infighting regarding the South African Reserve Bank’s independence and the rogue proposal for “quantity easing” (sic) to alleviate government’s debt burden, but rallied latterly on broad-based US dollar weakness – poor SA economic growth prospects, rising debt burden and fiscal deficit exceeding 5% for the foreseeable future bodes ill for the rand
- The FTSE/JSE Capped All Share Index rose 4.0%, led higher by financials and industrials, while resources lagged following Sasol’s stunning 22% price fall, despite stellar returns from gold and platinum miners and Kumba – interest rate sensitive shares benefitted from falling bond yields, but UK-focused property companies continued to slide amid falling property valuations and high gearing
- The All Bond Index advanced 6.1% (and 9.8% year to date) as government bond yields fell across all maturities, with the R186 gaining most – yet prospects of bond prices rising more is increasingly assured given expectations that SARB will lower the repo rate as soon as July, although MPC hawks will likely veto a deep rate reduction cycle
- Inflation should rise at the margin in the coming months as petrol, water and electricity prices accelerate – however, poor consumption expenditure by households and increasing competition by retailers for consumers’ wallets should constrain inflation to the midpoint of the 3-6% inflation target, leaving further scope for future rate cuts

INVESTMENT OUTLOOK

World: Global economic expansion is now late stage with the US economy reaching its longest expansion since 1854. Low interest rates as a result of dovish central banks should be supportive of risk assets. However, geopolitical risks continue to rise, and gold could move higher on safe-haven demand. Industrial commodity prices are likely to drift lower in time as the expansion cycle continues to age.

South Africa: Despite a solid election result, the new ANC government’s reform momentum appears to be waning. The highly strained public finances keep the rand vulnerable in the medium term. Recessionary economic conditions are likely to continue near term. The inflation outlook is favourable given low domestic demand conditions. Bond yields should move lower as the market anticipates near term repo rate reductions.

CONCLUSION

Resource counter holding remains defensive. Growing concerns of a global slowdown give credence to the thesis of the record global expansion cycle’s late stage. We invest in the highest quality diversified miner, BHP Group and petrol price hedge, Sasol. Both companies should benefit from the recent movements in the iron ore and oil prices. We increased consumer sector weight at the margin by adding selectively after the sector sold off but remain cautious given ongoing electricity supply problems and the generally deteriorating economic outlook. The full financial sector allocation was reduced given challenges flowing from the sluggish SA economy. We favour banks and short-term insurance over the life insurance companies as they should provide utility-type returns even in tough times compared with long-term insurers that are more geared to discretionary spend and equity markets.

We retain the allocation to JSE global businesses despite the growing global growth headwinds and the pull-back in these share prices last year. We are confident that the companies will deliver good earnings growth in hard currencies aided by expected further rand weakness. We increased our weighting to Life Healthcare, Mediclinic and Aspen – the latter sold off on market concerns mostly around its high gearing, but the balance sheet is acceptably structured with cash generation now reaching a positive inflection point.

The low listed property weight is focused on niche counter Capital & Counties; we continue to avoid companies with office and retail exposure given the significant structural challenges. The cash position is relatively high – providing much needed liquidity to take advantage of opportunities.

RESPONSIBLE INVESTMENT SUMMARY

Proxy Voting Summary Q2 2019

Resolution Type Name	Total Count	For %	Against %	Abstain %
Adopt Financials	6	100%	0%	0%
Auditor/Risk/Social/Ethics related	33	100%	0%	0%
Buy Back Shares	8	100%	0%	0%
Director Remuneration	10	80%	20%	0%
Dividend Related	1	100%	0%	0%
Issue Shares	3	0%	100%	0%
Loan / Financial Assistance	12	58%	42%	0%
Other	10	90%	10%	0%
Political Expenditure/Donation	1	0%	100%	0%
Re/Elect Director	61	98%	2%	0%
Remuneration Policy	23	70%	30%	0%
Share Option Scheme	3	33%	67%	0%
Shares under Director Control	5	0%	100%	0%

General Comments:

- There are very few abstentions. We apply our minds to every single resolution put to shareholders. When there is an abstention it would typically be intentional or strategic reasons.
- We typically vote against any resolution that could dilute the interests of existing shareholders. Examples include placing shares under the blanket control of Directors, providing loans and financial assistance to associate companies or subsidiaries and blanket authority to issue shares. On the rare occasion, we have voted in favour of such resolutions, we have been able to gain the required conviction in the specifics of the strategic rationale for such activities and have been able to gain comfort that such activities are indeed to be used to the reasons stated.
- The firm also has a strong philosophy regarding management remuneration models. We believe in rewarding good managers with appropriate cash remuneration on achievement of relevant performance metrics that enhance long-term shareholder value. We are generally not in favour of share option schemes given the inherent asymmetry between risk and reward typical of such schemes. In addition, we do not believe that existing shareholders should be diluted by the issuing of new shares to management as is the case with most option schemes. We are in favour of the alignment created between management and shareholders when management has acquired its stake in the company through open market share trading and paid for out of management's own cash earnings.

Standard Bank Climate Change related resolutions:

During Q2 2019, there were two climate change related resolutions put to shareholders for voting at the Standard Bank AGM, which was a first in South Africa. The resolutions were as follows:

1. To report to shareholders on the company's assessment of greenhouse gas emissions resulting from its financing portfolio, and
2. To adopt and publicly disclose a policy on lending to coal-fired power projects and coal mining operations.

A summary of our positioning on this as follows:

- Climate change is a material long-term risk factor that must be considered in a long-term investment management context
- Whilst climate change risk is not explicitly mentioned in the current Regulation 28, PF130 or other directives, the existing broad ambit regarding ESG considerations, provides ample space (indeed compulsion) for asset owners and investment managers to be appropriately seized with the matter.
- Over time, there are likely to be continued regulatory interventions (already emerging globally) as the climate change risk issue specifically continues to become more politically relevant and broadly accepted in the mainstream. As such, the proactive and relatively advanced ESG ecosystem in the South African retirement funding system is well placed and we are fully supportive of its further development.
- We also note however that the issue of investment choice is salient. Pension funds in the developed economies with their much larger investment opportunity sets can afford to be more resolute on applying ESG factors than South African investors, given the country's historic reliance on commodity exports. Exchange control constraints also mean that we must make do with a tiny subset of viable long-term investments.
- We therefore have a pragmatic approach whereby we can still invest in companies that score poorly in terms of environmental impact, but as owners will exert influence over these investee companies' ESG policies and look to see ongoing incremental improvements.
- Regarding the recent Standard Bank climate change related resolutions, we voted in favour of both. Quite simply, from an investor perspective more information enables better investment decision making. Therefore, whilst we might not necessarily proactively propose such a resolution, we will in most instances, vote in favour of one that does. In Standard Bank's case, meaningful lending exposure to companies facing ethical headwinds and potential liabilities and additional regulation does pose incremental business risk, which albeit relatively small, needs to be understood and quantified to the extent possible. Lastly, from an ethical perspective it is positive for investors to demand greater transparency regarding all market players involved in areas which raise environmental concerns.

Notable engagements – Q2 2019

- Mediclinic – The analyst met with the Chair of the Board Remuneration committee to explain the rationale we apply when voting on remuneration schemes in general. In their particular case, the remuneration model relies on EBITDA measures, which we feel is not appropriate in a capital-intensive business.
- Omnia – Met with management regarding the pending capital raising requirement as well as the bank's bridging finance facility. Ongoing discussions are taking place until finalisation of the rights issue.

DISCLAIMER

WHO WE ARE

Nedgroup Collective Investments (RF) Proprietary Limited, is the company that is authorised in terms of the Collective Investment Schemes Control Act to administer the Nedgroup Investments unit trust funds. It is a member of the Association of Savings & Investment South Africa (ASISA).

OUR TRUSTEE

The Standard Bank of South Africa Limited is the registered trustee.
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PERFORMANCE

Unit trusts are generally medium to long-term investments. The value of your investment may go down as well as up. Certain unit trust funds may be subject to currency fluctuations due to its international exposure. 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.

PRICING

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

Certain Nedgroup Investments unit trust funds apply a performance fee. For the Nedgroup Investments Flexible Income Fund and Nedgroup Investments Stable Fund, it is calculated daily as a percentage (the sharing rate) of total positive performance, with the high watermark principle applying.

DISCLAIMER

Unit trusts are traded at ruling prices and can engage in borrowing and scrip lending. Nedgroup Investments has the right to close unit trust funds to new investors in order to manage it more efficiently. For further additional information on the fund, including but not limited to, brochures, application forms and the annual report please contact Nedgroup Investments.

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