



NEDGROUP
INVESTMENTS

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NEDGROUP INVESTMENTS GLOBAL DIVERSIFIED EQUITY FUND

Quarter Four, 2019

For the period ended 31 December 2019

NEDGROUP INVESTMENTS GLOBAL DIVERSIFIED EQUITY FUND

Period to 31 December 2019 ¹	Nedgroup Investments Global Diversified Equity Fund A	MSCI ACWI NR USD
3 months	+9.2%	+9.1%
6 months	+8.5%	+8.8%

If you don't like the ending re-write the story

Hindsight Bias is, like most biases, insidious. It creeps in and subtly clouds judgment. At the start of every year I have got into the habit of reviewing my notes from the prior year. All of us at Ardevora try to record our assertions throughout the year; the information which affects us, our views at a specific time about what we think could happen, before it happens. We also try to keep track of the views of others. January is an especially interesting time to do a review exercise, as smart strategists and high-profile CEOs like to reflect on the year themselves, publicly providing predictions. The process starts, like this one, with an attempt to explain the prior year, to build a narrative around what often feels, at the time, like unpredictable chaos. Explaining is not the same as predicting and I have come to appreciate how easy it is to slip into lazy extrapolation of a narrative on what has happened into an assertion of what will happen.

So, our review will take a slightly different form. We will try to keep the “explaining last year” to a minimum. We will focus on a review of what others thought would happen in 2019, in January of 2019 (along with our views). We will highlight the themes and events which appeared to attract and divert attention through the year. Then we will review what others predict for 2020. We won't commit to a view ourselves, since such high-level views do not really impact how we invest.

January 2019 was generally a time of gloom and anxiety. Economic growth was expected to slow, inflationary pressures to build. Most expected the Fed to continue to raise interest rates and a recession to unfold in the US, but not until 2020. Stock market strategists had been wrong-footed by 2018 and believed stocks to be “cheap” within a context of low growth, no recession. They preferred stock markets in emerging countries and Europe (cheaper and better growth) than the US, which was almost universally regarded with suspicion. Almost everyone disliked bonds. Anxiety was generally focused on the Trade War (unlikely to end quickly), but there was a belief that a positive economic policy response in China would confine any damage to the tech sector (which was generally viewed as expensive and vulnerable).

So, in sum, the Trade War would persist, but only hit the tech sector; recession risk was confined to the US, and that wouldn't happen until 2020. Interest rates would rise in the US and Europe as inflationary pressures built; China would chug along, helped by government spending. Stocks would do okay, led by Europe and Emerging markets; bonds would not.

We thought Trump would strive for a win in the Trade War; the biggest risk of recession was in Europe; the US looked like the safest place to be invested given considerable room for the Fed to cut rates (if needed); deflation was the biggest threat; corporate profitability would generally be under pressure; and growth would remain scarce outside technology and healthcare.

I was told when I began to learn about stock markets over 30 years ago, that investing in stocks often feels like “climbing a wall of worry”. This is how we would sum up 2019. The first half was dominated by news the global economy was getting worse, fueling anxiety over an imminent recession. But stocks persistently rose, triggering an early onset of anxiety over why valuations and fundamentals were diverging. This combination – the

¹ Net, USD

fundamentals are getting worse, but stocks are going up – created persistent anxiety throughout the rest of the year. Bonds, stocks sensitive to bonds and US technology led performance, causing more anxiety. This drew louder claims that “cheap” stocks were the best place to invest. In hindsight, three significant events unfolded, and one new impactful trend gathered pace. The Trade War reached a conclusion of sorts by the year end; the Fed paused and then cut interest rates; Brexit moved from paralysis to action; and investors woke up to ESG.

Economic news remained poor and most companies delivered disappointing growth, but stock markets performed exceptionally, unexpectedly well. The simplicity of 2019 - fundamentals got worse, financial assets went up - appears to create a conundrum. But fundamentals got worse in an uneven way. By the end of 2019 fundamentals were improving for most technology stocks. By the end of 2019 US interest rates were falling. By the end of 2019 most economies had stopped getting worse. And inflation remains dead.

Reading others’ current reflections on 2019 it seems most are more relaxed than a year ago. We would summarise the consensus views as follows:

- Global economic growth will slowly recover, prompted by more monetary easing, led by China and Emerging Markets. Fiscal policy will remain constrained due to worries over debt levels.
- There will not be a recession anywhere. Any (mild) negative impact from lingering impacts of the Trade War will easily be offset by supportive economic policies from governments and central banks.
- The Trade War will not escalate and is on a path to resolution.
- Inflation will stay low as a global savings glut and tech innovation offsets some building labour cost pressures.
- Risky assets will win as risk premiums narrow everywhere.

Almost every strategy piece we read argues for favouring “cheaper” (which in our understanding, essentially means riskier) markets/assets with early cycle upside over defensive, expensive markets/assets; believing improving global growth will drive a rotation out of “safe” into “risky”.

As for what could go wrong, a few strategists worry about the emerging trend of de-globalization but fail to see the inconsistencies with their positive view on risky assets and Emerging Markets. A few still linger on residual Trade War risk but think economic policy will offset. A few worry about the US election cycle causing uncertainty in US markets, but our simple conclusion is that anxiety is considerably less than a year ago. This lifting in anxiety is all you really need to know to explain market performance last year.

PORTFOLIO REVIEW

Does this change anything for us, as an investor? No. We like to speculate about the future like everyone else, but we do it to frame worthwhile debates, to put our stock views into a wider context. As far as our portfolios go, we stick to what we think we are good at: looking for unusual stocks in unusual situations where usually risky CEOs can be trusted (for a while) to potentially deliver reasonable outcomes. We pursue this aim acutely aware of our own failings and how depressingly easy it is to misjudge.

Last year was a pretty good year for us. At a basic level we achieved what we hoped for – to get modestly more right than wrong, to get well rewarded when we are right and to limit the damage when we are wrong. If you can gain modest advantage in each of these three simple drivers of investment performance you can do well without having to be heroic about holding large positions, making bold predictions over the path of economies or markets or trying to micro-manage the short-term timing of when to get in or out of a position.

At the risk of being boring, we will run through a quick refresher of what we look for in a stock. Firstly, because we distrust CEOs, in all of our stocks we look for the symptoms of CEOs behaving unusually well. We are cynical and believe the type of business model and the environment it sits in are far more important than the talent of an individual CEO. This is partly revealed by understanding a bit about what a company does. It helps to focus on how a company does what it does – the business model – more than what it does. We think we are quite good at working out the kinds of business models which CEOs find harder to mess up. They have a certain look to them, which is difficult to pin down in a set of simple quantifiable metrics. Efficient use of capital, reluctance to use external financing, and a clear sense of purpose all play a part.

We also think we are quite good at recognising the kinds of industry environments which make it easier for CEOs to frame and then deliver realistic plans. There is no single simple quantifiable factor that marks them out. We look for two quite different historical paths. One we associate with easy to deliver growth; here we are looking for consistent, efficient use of capital through time, consistency of plan setting and delivery from CEOs, and something a bit unusual about both the company and what it does. The other is more about change. We look for a history which can catalyze change, often where a company and its peers have not behaved how we would like, but the consequences of poor behaviour have come home to roost and coerced previously reluctant CEOs to radically change their priorities and their views. Signs of contrition by CEOs and willingness to accept and then undo past errors is crucial. Sometimes this is revealed through improving capital efficiency or shifts in balance sheets and more often than not it is revealed in how management describe their new plans verbally.

The other part of our approach is to strive to recognise the symptoms of either excessive scepticism or anxiety among others. For stocks which have performed well this usually takes the form of valuation anxiety and a naïve belief in the power of mean reversion to bring high flying companies crashing to earth. For stocks which have performed badly it is usually about trust, or lack of it. Companies which have repeatedly failed to deliver on plans cause pain and trauma for those who own them or follow them. Sometimes a sustained period of trauma can scar and act as an anchor for excessive anxiety.

Our approach to CEOs throws up two types of opportunities. Stocks which are growing pretty fast and where we believe they can stay away from the herd for far longer than other investors may want to believe. They are often “expensive”, have often seen their stock prices already rise, and this usually makes them a bit uncomfortable to own. These types of stocks did very well for us last year. Comfortably more than half of them outperformed, and the outperformance was large. The underperforming minority were painful, but not disastrously so. Many of these were in areas which have performed well for some time, like technology and healthcare, but we were able to hold stocks within nearly all of the sector groupings which performed well.

We struggled much more with the stocks we bought on the basis of trauma and change. Once again (we have found this for many years now), it was difficult for even contrite CEOs to deliver effective plans for change and recovery. They often sat in industries struggling with low demand and peers who either continue to behave badly, or in areas where plans to improve a company struggled to keep up with the pace of competitive change all around them. Stocks which were relying on improving previously disappointing profitability struggled to turn things around.

We have been in an extended period where corporate recovery plans have struggled. We are starting to believe surplus capital and low interest rates since 2009 may be to blame. Our successful investments tended to be concentrated in particular types of stocks where opportunities arose more from interrupted growth plans than long persistent periods of difficulty.

At the start of 2019 it was easier to find stocks where CEOs were trying to deliver credible recovery plans. This, we believed was partly due to an unusual convergence of factors outside of the control of most companies (like the Trade War and economic cycles) which encouraged CEOs to be a little more realistic. However, by the end of the year we have found credible recovery plans harder to come by again and we are drifting back to unusual companies where growth still looks easy.

The behaviour of other investors is, sadly, less predictable than the behaviour of CEOs, in our view. One of the perils of public markets is stocks are constantly being repriced. If you invest like us, at a slow pace, holding stocks for months and years rather than days or weeks, there are inevitable periods when stock prices do not do what you want them to do. In May just about everything went down. In September, previously unloved stocks generally went up, while many of our stocks did not. But most of the time, the majority of our stocks behaved pretty well.

We, like just about everyone else, feel more comfortable now than we did a year ago. There's nothing like a period of rising stock prices for boosting the spirits. But we can still find plenty of things to worry about. At the start of last year, we resisted the temptation to overly commit to stocks which felt comfortable and safe. Now the pull is to embrace stocks with higher risk. We shall resist this temptation too. Sensible plans from sensible CEOs in unusual companies in unusual environments; trying to recognise these characteristics has served us well. We will do the same in 2020.

REGIONAL PERFORMANCE REVIEW

Our Rest of World bucket, Europe, and to a lesser extent, Japan contributed from a relative point of view this quarter, whilst North America detracted.

Rest of World: as ever with our Rest of World bucket, there was a real mix of winners and losers spread across countries and sectors. WEG (Brazilian electric motors) and Clicks Group (South African chain of retail stores) led the winners while Autohome (Chinese online platform for car purchase and sales) and Wal-Mart de Mexico (Mexican retail stores) dragged slightly on performance.

Europe: an outperformer with names like Spectris (UK manufacturer of measurement instruments) and Infineon Technologies (German manufacturer of semiconductors) leading the outperformers. Recordati (Italian pharmaceuticals) and Chr. Hansen Holding (Danish bioscience company) lagged near the bottom of the detractors.

Japan: marginal contributor over the quarter with names like DISCO Corporation (precision tools) and Shimadzu Corporation (a precision tools and equipment manufacturer) leading the contributors. Nihon Kohden Corporation (medical equipment and devices) and Nissan Chemical Corporation (manufactures chemical products) led the detractors.

North America: the only detractor this quarter. Bausch Health Companies (Canadian pharmaceutical company) and DexCom (US manufacturer of diabetes monitoring systems) outperformed whereas names like Twitter (US social network service) and our structural underweight in Microsoft (US software company) led the detractors.

STOCK PERFORMANCE REVIEW

Analyst bias stock among our key contributors: Dexcom

Dexcom is a US medical devices company focused on the development of glucose monitoring sensors used by standalone insulin pumps. Dexcom has a technological advantage in glucose monitoring and has recently acquired TypeZero Technologies. This now gives them a strong position in two of the three key areas of the artificial pancreas value chain. Share prices suffered in 2016-2017 from aggressive competition from incumbents Johnson & Johnson (“JNJ”) and Medtronic. Recent regulatory moves have favoured the company’s approach to diabetes care whilst the competitive environment has improved with the exit of JNJ. Despite a more benign environment, investors and analysts remain scarred by the experience and continue to worry about competition. Recent quarterly results beat expectations, and the share price jumped.

Investor bias stock among our key contributors: Bausch Health

Bausch Health is one of Canada’s largest drug makers, producing both specialty and generic products. Between 2015 and 2017, the share price collapsed by over 90% as debt ramped up while management doggedly pursued an aggressive acquisition strategy. In accepting the errors of their ways, management came to focus on three segments: eye care, dermatology and gastrointestinal diseases. What has followed is more cautious management behaviour, consistent paying down of debt and an increased focus on internal R&D. We thought the investor overreaction, and subsequent strategy reset, provided an attractive entry point. A new analyst rating, positive quarterly results and an improving outlook for the sector pushed the share price upwards in Q4.

Analyst bias stock among our key detractors: Microsoft

Microsoft is a US technology giant. Investor anxiety peaked in 2012/13 (evidenced through valuation compression), and company management were forced into submission: the mobile strategy was a relative failure. The submission also drove a model change; to embrace cloud infrastructure and focus on a higher free cash flow generative subscription model for Windows. In our view, these past traumas still weigh on investors and analysts. Within an equally weighted portfolio (by region), when a mega-cap like Microsoft performs well, our natural relative underweight creates a performance headwind.

Investor bias stock among our key detractors: Twitter

Twitter is a US social media company used by seven-year olds on their first smartphone through to prominent politicians. With a historically volatile share price, investors have been through the proverbial wringer, and remain scarred. Company management appear to be focusing on the right things though: restructuring their business model, and ultimately monetising their uniqueness. Weak results driven by a software bug and advertising issues lowered the share price this quarter.

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