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Two Decades of Winning by Not Losing

By Steven Romick, sub-investment manager of the Nedgroup Investments Global Flexible Fund

To some of you, all Americans are exactly alike. I may as well be President Trump. Like him, you have no idea what I'm about to say.   Well, check that: it often seems he has no idea what he's about to say, and that's a major source of uncertainty in all of our lives, both personally and professionally, that can create an insecurity on which much of the business media preys.

The business media, like President Trump, looks for winners and losers. They'll highlight the stocks du jour that are either performing really well, and in the next breath, show a graphic of those that tanked. Stocks go up, stocks go down, sectors do well, sectors do poorly. It's entertainment. Ultimately, I don't find it very valuable. It's no more than tabloid reporting. It's their version of who is sleeping with whom and who has fallen off the wagon. Short-term market price movement does not tell us anything about long-term value.

Running with the bulls...

At any given moment, the media highlights whichever few stocks are driving the stock market. In the U.S. in 2015, it was the FANG stocks – Facebook, Apple, Netflix, and Google.   In the UK in 2016, it was just three rebounding commodity companies and one financial that accounted for more than three-quarters of the FTSE's 14.4% return[1].

For as long as I've been investing, it has generally been the case that just a few stocks drive these indices, and that these few stocks pull the lesser performing stocks along with them. The investing community has come to define this law of financial physics as "positive skew." "Positive skew" now joins "active share" in that lexicon.   Passive management advocates don't use this phrase to praise the active manager, but rather to poke at us.

What the passive manager would have you believe is that, thanks to exorbitant fees, to transaction costs, and to not picking winners, it's always better to index. I've read that maybe just 10% of the managers can outperform the market over time, and the odds that you will find that manager are even lower still. Armed with some selective data, some critics of our approach say that it is unlikely an active manager will consistently own those few stocks that drive stock returns in any given year, let alone year in and year out.

Fundamentally, passive investment is always going to look great during a long-lasting bull market. If an investor wants market rates of return and can withstand some volatility, then passive investing can serve as an efficient, low-cost tool. The further you get away from a bear market, the greater the number of people who have convinced themselves they can handle the downside – until the next time, of course. In the interim, if the indices are performing well, then you can bet that many investors – individuals and professionals, alike – are going to feel pressure to do whatever they can to ride the bull. They fear being different. Tracking error is bad. Owning too many securities in every sector is a sure way to avoid being fired for being different.

I'd rather spend my time surfing than to have to invest like that.

[1]Royal Dutch Shell A; Royal Dutch Shell B, BP, HSBC Holdings, and Glencore contributed 11.1% to the FTSE Index 2016 return.

It's not just what you own that matters, it's also what you don't own

Thanks to the accelerated increase of passive investing – now around 40% of the U.S. market – I'm confident that there will be a period when it will look really easy to beat a benchmark – followed by another time when, again, it won't. I believe this academic ar gument against active investment is fundamentally flawed because it's built on a false premise, which holds that only the best performing stocks will drive returns. The argument doesn't consider the other side - if you avoid the worst performing stocks, you can still put up good numbers. This is a maxim I have taken to heart.

Further, these critics place too much weight on performance in each year and ignore performance over a full-market cycle[2]. This leads to short-termism and short-termism is a breeding ground for all sorts of cognitive dissonance to which smart people fall prey when trying to adapt and join the crowd.

People viewed the internet as a fast-growing disruptive game changer in the late 1990s. And so it was, but internet stocks of that era were largely priced at wholly illogical levels. Yet, many smart people couldn't handle not participating. Maybe they were worried about not making as much as their friends. Or maybe they were worried about being fired. Whatever the reason, if they participated they generally lost badly.

In 2008, we sat on the precipice of a depression and many investors quickly liquidated their stocks and bonds, believing the economy would get worse, and stocks would continue to decline. It appeared correct to do so… for a time. Some of those who exited the market realized their mistakes and came back to the market down the road, after the economy found firmer footing, but also after prices had already rebounded.

Patience, a long-term focus, and avoiding the fads are crucial to successful investing. Some of the most successful stock investors of the last few decades in the United States aren't known for finding the latest and greatest. I give you as just a few examples: Warren Buffett, Seth Klarman, Jean-Marie Eveillard, and my former partner of two decades, Bob Rodriguez. Each compiled a long track record respected by investors of all types. Each had their share of winners, but none created their enviable performance by owning those few golden stocks of a given year. They won by not striking out rather than by hitting grand-slams. In other words, they won by not losing – emblematic of our approach at FPA.

We allow ourselves the opportunity to participate on the upside while protecting ourselves on the downside. Our focus is on fundamental research to identify companies that can create value over time. Some of the best investment decisions in my career have been acts of omission – avoiding those securities, industry sectors, and asset classes that we believed offered a poor risk versus reward opportunity. FPA's Contrarian Value Strategy (CV strategy) – in line with which the Nedgroup Investments Global Flexible Fund is managed - operates with a global, go-anywhere mandate and invests across the capital structure, using mostly stocks and corporate bonds to seek equity rates of return, while at the same time seeking to avoid a permanent impairment of capital.

[2] Steven Romick and Ryan Leggio, "The Importance of Full Market Cycle Returns." See: http://fpafunds.com/docs/special- commentaries/2015-04-29-market-cycle-performance-final.pdf?s-fvrsn=2

Active security selection drives differentiated returns

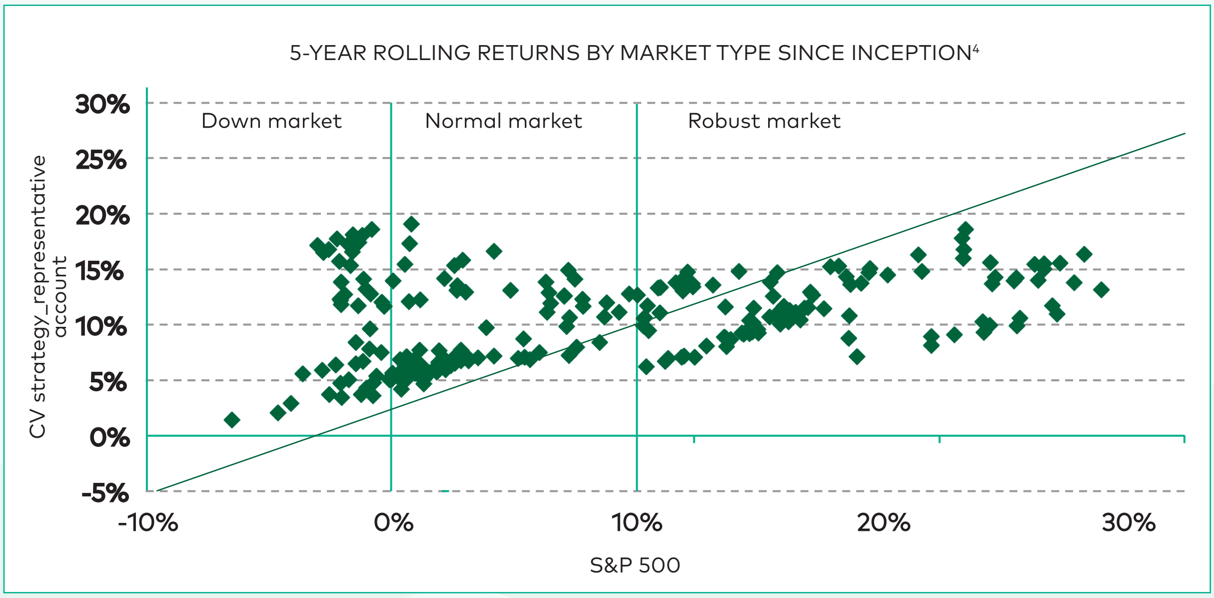
The table below depicts the returns of the CV strategy representative account over the past decade (gross of fees). You can see there were times we underperformed (in red). When compared to the MSCI ACWI, we underperformed in just one year of the past ten. When compared to the U.S. market (as represented by the S&P 500), we underperformed in three of the last 10 calendar years. Our worst relative showing was just -2.4% vs the S&P 500 in 2015. Our average underperformance of these four years was just -1%.

	Q1 2017	2016	2015	2014	2013	2012	2011	2010	2009	2008	2007
FPA CV Strategy long equity	7.35%	15.19%	-1.04%	13.67%	39.62%	17.69%	6.25%	22.30%	38.39%	-38.27%	11.47%
MSCI ACWI	6.91%	7.86%	-2.36%	4.16%	22.80%	16.13%	-7.35%	12.67%	34.63%	-42.19%	11.66%
Alpha vs. MSCI ACWI	0.44%	7.33%	1.32%	9.51%	16.82%	1.56%	13.60%	9.63%	3.76%	3.92%	-0.19%
S&P 500	6.07%	11.96%	1.38%	13.69%	32.39%	16.00%	2.11%	15.06%	26.46%	-37.00%	5.49%
Alpha vs. S&P 500	1.28%	3.23%	-2.42%	-0.02%	7.23%	1.69%	4.14%	7.24%	11.93%	-1.27%	5.98%

There were five instances where our equity holdings outperformed the MSCI ACWI by more than 5% and four instances where we outperformed the U.S. market by the same margin. The average alpha delivered in the years when we bettered our benchmarks was 6-7%.

This has aggregated into some poor periods when the bulls were a runnin'. Over the full history of the strategy (since 1993), the fund has underperformed about 87% of the time in periods where the S&P 500 has delivered a trailing five-year return in excess of 10%. However, we beat the market in 100% of the trailing five-year periods when the market declined; and almost 98% of the time when the trailing five-year returns fell in the 0-10% range. In addition, unlike the S&P 500, our strategy has delivered positive performance in every rolling five-year period. We exceeded our goal of doing as well as the market mostly by avoiding permanent impairments of capital. This is in line with how we expect the Nedgroup Investments Global Flexible Fund to perform over time.

[2]The performance data for the CV strategy's representative account is based upon the long equity segment of the fund, and is provided as supplemental information. Returns for the strategy are presented gross of investment management fees, transactions costs, and operating expenses, which if included, would reduce the returns presented. Performance for 2017 is through March 31, 2017. Past performance is no guarantee of future results.



	Down Market – 5yr average return below 0%	Normal Market – 5yr average return 0-10%	Robust Market – 5yr average return above 10%
CV Strategy aver age	9.5%	8.7%	11.4%
S&P 500 average	-1.8%	3.3%	17.4%
CV Strategy out-performed in	100% of periods	97.5% of periods	13.3% of periods
	(49 of 49)	(77 of 79)	(13 of 98)

[4]Source: Morningstar Direct, FPA. The chart illustrates the five-year rolling average returns for the Representative account of the CV strategy using monthly data from July 1, 1993 (the first full month of performance since inception) through March 31, 2017 compared to the S&P 500 Index. The horizontal axis represents the five-year rolling average returns for the Index, and the vertical axis represents the Fund's five-year rolling average returns. The diagonal line illustrates the relative performance of the Fund vs. the Index. Points above the diagonal line indicate the Fund out-performed in that period, while points below the line indicate the Fund under-performed in that period. The table categorizes returns for three distinct market environments: a "down market" is defined as any period where the five-year rolling average return for the Index was less than 0%; a "normal market" is defined as any period where the five-year rolling average return for the Index was between 0-10%; and a "robust market" is defined as any period where the five-year rolling average return for the Index was greater than 10%. There were 226 five-year rolling average periods between July 1, 1993 and March 31, 2017. Past performance is no guarantee of future results.

We cannot offer any certainty other than that we put investors first

There are very few asset managers in the public arena who practice value investing without arbitrary capital structure, asset class, or geographic borders. In this age of Instagram and Snapchat when immediate gratification seems to rule our lives, few portfolio managers have the patience to remain disciplined through their inevitable difficult periods, and even fewer clients are willing to stay with their under-performing managers. Thanks to poor relative performance in the late 1990s (and lacking Berkshire Hathaway's permanent capital!), FPA saw assets under management drop by more than 80% during the 1997-2000 period as clients exited the strategy. Although we received a lot of flak at the time, we argued that we were taking the prudent approach in protecting investors' capital.

This cautious stance can bruise a business in the near-term, but in the long-term, it benefited those clients who stuck around. As I wrote when Bob Rodriquez retired from FPA this past December, "He taught all of us what it's like to put investors first, whether they like it or not."

I'm not going to lie - I'd love to be loved all the time! But you can't be a value investor and expect that. If I want to win over time, I'll just have to settle for periodic appreciation.

There's risk to operating in our unconstrained idiosyncratic fashion. We won't be fully invested at all times regardless of valuation. And although we may be avoiding losers, there will be times when our winners aren't keeping up with the market. This will periodically lead to relatively poor performance and we will invariably lose clients as a result.

We will avoid whole sectors of the market for years, if not decades. We benefited by not owning technology stocks when they declined 78% from 2000 to 2003.[5] It also helped that we didn't own much by way of financials in the 2007 to 2009 time frame, as they collectively declined 76%.[6] Since we aren't closet indexers, our returns will therefore usually look vastly different than our benchmarks – for better and worse. As an unconstrained manager, we don't have to do anything…and we certainly don't have to do everything.

I know by reading the financial press that many firms like to offer a degree of certainty, even though they're not allowed to actually promise anything. They use words to offer investors a confidence that their rates of return will be stable, will be solid, maybe offering a visual of a calm sea. Our approach does not offer certainty. Because we're different, we may even breed insecurity. We do what we think is best to deliver a good risk-adjusted return to our clients. We believe we have shown that it is advantageous over time to operate with such a broad charter.

Let me give you some specifics which will give you a sense of our values and how we manage money.

- I started our Contrarian Value go-anywhere strategy in 1990, and introduced its flagship public mutual fund in 1993. Not long after joining FPA in 1996, I found myself in the middle of the biggest valuation bubble in seventy years. Compared to any broad equity benchmark, the CV strategy's performance in 1998/99 was pretty horrible. Market valuations reached levels we'd never seen, or even read about. Yet the capitalization-weighted indices hid something key: that many stocks were very, very inexpensive. Small-cap stocks were trading at the biggest discount to large-caps stocks in history, and were absolutely cheap. High yield bonds were inexpensive as well, trading with double-digit yields.

  Thanks to the pricing disparity between the loved and unloved, we were able to make money in each of the subsequent three years post-1999, even though the broad U.S. market dropped each year. We simply avoided the detritus as it cascaded from peaks that should never have been scaled. That was good enough to place us way ahead of the benchmark for the five years, even though we started deeply in the hole. We didn't own any of the best performing stocks in the Russell 3000 in any of those five years, but we didn't own any of the worst performing stocks either.

[5] Russell 3000 Technology sector declined -78.14% from 3/22/00 to 3/11/03. Source: Morningstar.
[6] Russell 3000 Financials sector declined -76.18% from 10/7/2007 to 3/9/2009. Source: Morningstar.

This was the CV strategy's first big test and we passed it by avoiding losses. Although our patience and discipline allowed us to prevail, that didn't benefit the majority of the strategy's investors who capitulated along the way.

- Amidst scant opportunities, I closed to new capital in 2005. The best way to avoid unnecessary losses is by understanding what you own (or might own) – the business and its industry. I therefore focused on building a best in class research team in order to ensure we could continue to win by not losing.

- Our second big test came in 2007. A few years earlier, we had begun to document the rapid rise of subprime debt and the attendant risks faced by many over-leveraged and over-valued financial institutions. In order to effectively frame the opportunity, we need to understand both risk and reward. Determining what can go wrong enables us to evaluate the downside. Evaluating the potential return is the other part of the equation.

  Stock and corporate bond valuations weren't low enough to justify the risks of excessive leverage in the system, so we positioned ourselves conservatively. By October 2007, we had 45% in cash (close to an all-time high) and just 4% in high yield (which, at the time, was an all-time low). And yet, the CV strategy was still able to best the market that year although we did own one of the top five performing stocks.[7]

  We communicated to our clients why we were maintaining such a cautious posture and this time they trusted our rationale. We were therefore prepared when the markets wilted in 2008 which saw our strategy decline as well but our losses were just 55% of the market's (S&P 500).

- In late 2008 and early 2009 we used our cash hoard to aggressively buy distressed corporate bonds, many of which offered yields-to-maturity in excess of 20%. The high yield market rebounded quickly and our new investments were drivers of our 2009 return, allowing us to outperform the market once again without any of the top five performing stocks. If one were to look at 2008 and 2009 cumulatively, winning by not losing allowed us to be one of the few managers in our space to book positive performance.

Avoiding the pitfalls of market hubris

This brings us to today, with an impending third test due to come before too long – or, maybe too long, but one day. The S&P 500 is in its 99th month of a bull market, the second longest since 1926. The US market hasn't had at least a 20% correction since 2009; while, the US economy is in its ninth year of economic expansion, the third longest since 1900.[8] US stocks currently trade at historically high valuations, supported more by low interest rates than by earnings growth.[9]

On the other hand, stock markets in the UK, the rest of Europe, and Asia ex-Japan have seen their markets suffer 20% drawdowns in the last couple of years – making them relatively cheaper. This leaves global valuations looking a bit better than the US, but the median MSCI ACWI stock still trades at levels higher than the prior two market peaks while, Asian and Emerging Market stocks are trading closer to their median valuation. For the most part, we would argue that the valuation disparity reflects more of a relative value when compared to over-priced markets, rather than absolutely cheap, offering great investment opportunity.[10] I also will offer that like-for-like on a business quality measure, companies in these markets are not as inexpensive as they might at first appear. As a result, we aren't finding many investments where the juice is worth the squeeze. It feels like it's a better time to emphasize avoiding losses rather than seeking gains.

[7]The CV strategy owned Chevron in 2007, which was the fifth largest contributor to the S&P 500's return that year.
[8]JPMorgan First Quarter 2017 Guide to the Markets.
[9]US stocks (as measured by the Shiller P/E and Price/Sales) are trading at the second richest valuation since WW II and the median S&P 500 and MSCI ACWI stock (as measured by price to earnings and price to sales) are trading at levels higher than the last two market peaks. US small cap stocks now trade at their highest level ever using Cyclically Adjusted P/Es (CAPE) – 56x earnings.
[10]Asian, European, and Emerging Market stocks are trading at closer to median CAPE ratios. The US high yield market once again is trading near its lowest yield. The European high yield market is at its lowest yield.

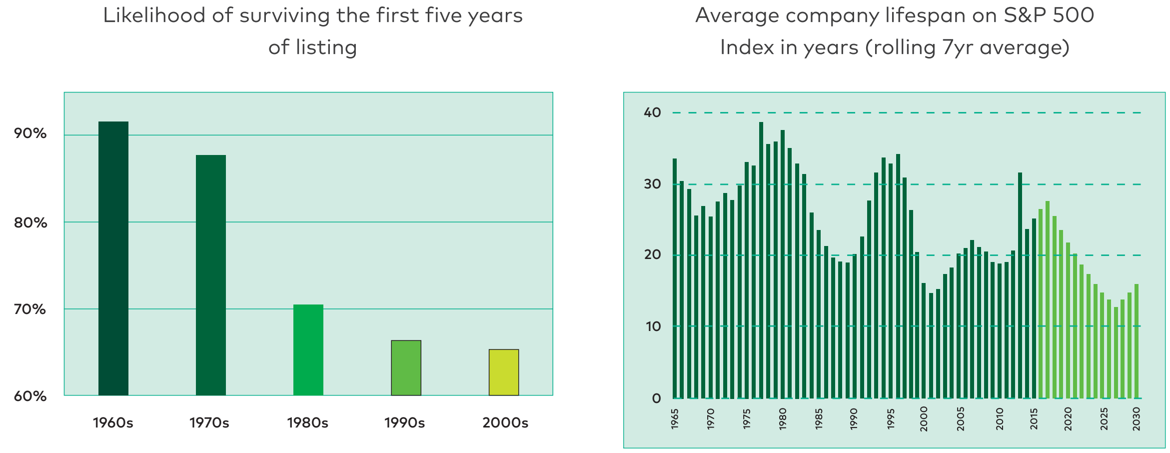
As an example of successful omission, I suggested in a mid-2015 speech that I thought it made sense to avoid Grainger, a US-domiciled industrial distributor that was trading at 19 times its current year's earnings estimate.[11] As well-run as this company was (and is), it's still just a middleman, distributing products made by others, that was collecting a 43%+ gross margin – an unusual margin for a company that exists to move a widget from one warehouse to another! With such a large pricing umbrella, it's no wonder that Amazon has targeted industrial distribution as a sector ripe for the picking. Amazon believes they can dis-intermediate industrial re-sellers just as they have high street retailers.

We concluded that Grainger would face revenue and margin pressure. Since then, Grainger has missed earnings for 3 of the last 8 quarters, revenues have been less than forecast, its gross margin has declined by almost three points, and its earnings have declined almost ~15%.[12]

Amazon is still early in developing this business and it's too hard to know what will happen. Although Grainger's stock has since declined more than 25%, I still wouldn't buy shares on the hope that they figure out a way to beat the Everything Store. We regret not buying Amazon a few years ago – an error of omission. However, avoiding those businesses that Amazon is likely to disrupt is essentially making the same trade - winning by not losing.

Innovative technology is driving business transformation faster than ever before. As a result, the expected tenure of a company in the S&P 500 is expected to drop from 25 years to 14 years.[13] We want to avoid those companies whose businesses are existentially challenged. Many of these will end up being the worst stock performers in the coming years. Since 1995, the worst performing 10% of stocks in the S&P 500 have detracted -3.3% on average annually from the S&P's annual return, or 35% of that index's annual average return. Sidestepping them would have been good for one's financial health.

CORPORATE MORTALITY[14]



The Contrarian Value strategy's overlap with the large index contributors has been minimal since inception, though it has picked up in recent years as market opinion has gradually converged to our 2011 conclusion that large-cap tech companies were inexpensive and unlikely to be dethroned anytime soon. What's been rarer is for us to have held a top 5 loser – occurring only six times since 1995 and with smaller average positions than our winning long positions.

[13]Innosight. "Corporate Longevity: Turbulence Ahead for Large Organizations." Spring 2016.
[14]Source: Left chart: Govindarajan, Vijay and Srivastava, Anup, Strategy When Creative Destruction Accelerates (September 7, 2016). Tuck School of Business Working Paper No. 2836135. Right chart: Innosight. "Corporate Longevity: Turbulence Ahead for Large Organizations." Spring 2016.

We do what we think is right, recognizing that we will sometimes be wrong

Our approach isn't painless, to which I can sorely attest. I'm not going to tell you it was easy to come into the office from 1999 to early 2000 and get fired every day, as our strategy was losing 80% of its assets. After I lived through such business devastation and ego realignment once, I knew I could do it again, giving validation to Nietzsche's observation, "What does not kill him, makes him stronger."

Watching others do better bruises the ego of the investment professional. It's also hard for clients to watch their neighbors make money when they're not. Such a dynamic can place external pressure on the investment manager who might seek to appease the client in order to protect their business. We frame our investment discussions about where we want to be in ten years. That makes the daily decisions easier. Sometimes, it means that we do nothing. For some, that's hard to do and for others it's impossible. Bull markets breed a certain complacency that leads many to assume more risk in their portfolios. In an effort to maximize returns, people want to see every dollar working for them. Cash sitting around earning negligible returns can be viewed as an abdication of responsibility.

We will be fired at times as a result. We were hired to do what we think is right, which is the best way to protect one's business (and reputation) – recognizing that sometimes we will be wrong. Therefore, we shop when goods are on sale, and when product is marked up, we look for what we might want to buy in the future. More importantly, consider how cash performs when there are historically high valuations, typically the time when we have more cash than usual sitting on the sidelines (as determined by a purely bottom-up analysis, not because of a macro view). Historically, when the CAPE[15] ratio was above 25x, cash outperformed in the subsequent rolling 5-year periods 77% of the time. The CAPE ratio is at 29x today.

Since I started the Contrarian Value strategy, cash has outperformed the market almost half the time over rolling 5-year periods.[16] Having cash when assets are priced to perfection generally has not been a bad idea, although it may not serve one well over the near-term. So, in addition to avoiding the losers, having the ability to not be fully invested has allowed us to win by not losing. I'm not arguing that holding equities for the long-term is a bad idea, but it does assume one actually holds them and doesn't panic sell at inopportune times, an affliction of both professional and personal investors alike.

I'm an optimist. Over time, I expect that there will be global economic growth and that will translate into higher asset values. We expect however, that there will be bumps in the road and we want to make sure our portfolio has decent shocks on its chassis to absorb them. It will be important to stay the course when the going gets rough, but all the better to have some liquidity to put to work when others want, or need to sell.

So after three plus decades of investing, I'm left with the following conclusions:

- Think long-term, in rolling seven to ten year blocks. It's too hard to make good things happen every year, so why bother trying.
- Keep your own counsel. Relying on others just gives you someone else to blame.
- Don't pay up. It's the surest way to lose by not winning.
- Do your homework. Understanding a business will save you from mistakes.

To those of you with the patience and fortitude to resist the temptations of the moment, to those of you who don't want to be the mosquitoes that bang into every bulb that's illuminated … you can not only not lose….

You might just win more than you'd ever expect!

Steven Romick

[15]CAPE stands for Cyclically Adjusted Price to Earnings ratio
[16]On a rolling 5-year basis, since June 1, 1993, cash has outperformed the S&P 500 45% of the time and the MSCI ACWI almost 50% of the time.

CONTACT US

PHONE	0860 123 263 if you call from South Africa +27 21 416 6011 if you call from another country
EMAIL	clientservices@nedgroupinvestments.co.za
FAX	0861 119 733 if you send it from South Africa +27 11 263 6067 if you send it from another country
WRITE TO US	PO Box 1510, Cape Town, 8000

OUR OFFICES ARE LOCATED AT

SOUTH AFRICA	Nedbank Clocktower, Clocktower Precinct, V&A Waterfront, Cape Town, 8001
LONDON	Millenium Bridge House, 2 Lambeth Hill, London, EC4V 4GG
ISLE OF MAN	1st Floor Samuel Harris House, St George's Street, Douglas, Isle of Man, IM1 1AJI, British Isles

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