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NEDGROUP INVESTMENTS FINANCIALS FUND

Quarter Four, 2017

For the period ended 31 December 2017

THE FUND'S PERFORMANCE

The fund generated a return for investors of 14.3% over 2017. It delivered this remarkably good performance despite slow GDP growth, rating agency downgrades, considerable uncertainty about the future of South Africa and the strength of the rand (10% gain in December against the dollar). There are two main reasons why the fund performed well in the face of these conditions:

- Despite poor circumstances, well managed companies in good industries continue to generate returns on their shareholder capital and grow shareholder value. So net asset values (or shareholder capital) at the end of 2017 (after dividends paid) was about 9% higher than at the beginning of the year. This is something that investors often tend to forget.
- Financial shares were undervalued (based on both five and 10 year history) and re-rated strongly from their low valuations post 18th December when Cyril Ramaphosa was elected as ANC leader.

The top 10 performing holdings in the fund (representing about 65% of the fund) generated an average return of 30% over the 12 months. The top five contributors were Sanlam (44.2%), Standard Bank (36.0%), FirstRand (33.0%), Barclays Africa (16.1%) and the Sanlam Global Financial Fund (22%, or 29.7% measured in US dollars).

Despite the volatility, we maintained most of our positions at the same levels during the year and in fact made only three changes worthwhile mentioning:

- We like Sanlam's high ROE plus the high degree of certainty we have of Sanlam's ability to keep generating these high returns and used price weakness during the year to increase the funds' investment from 7% to 10% during the year.
- Nedbank was sold down earlier in the year due to uncertainty about its investment in Ecobank from 6% at the beginning of the year to 2% but then later built up again to 5% toward year-end when the price had fallen too and it became significantly undervalued in our opinion.
- We built up a 2% position in Brait after it fell more than 40% early in the year, but sold it again when further research highlighted that the underlying businesses were in worse shape than thought.

Sasfin, JSE and Investec were the main detractors from what would have been an exceptionally good year (but JSE has bounced back strongly from its lows) and, as we do each year, we've spent considerable time analysing why the underperformers did underperform and where our thinking was wrong when we made the investment.

The 14.3% gain keeps the fund's long-term track record of outperformance intact. Although not the fund's benchmark, we found it noteworthy to compare its returns to the FTSE/JSE All Share Index. The fund outperformed the FTSE/JSE All Share Index by 4.1% p.a. over five years and 3.4% p.a. over 10 years. This highlights how specialisation in a circle of competence allows consistent good performance.

TRENDS THAT SUPPORTED GLOBAL FINANCIALS IN 2017

Last year ended up being a very good year for global financials, with the MSCI Financials Index ending the year up about 23%. We are excited about the prospects for financials in 2018, because the same trends that started in 2017 should continue in 2018. So what are these trends?

- There has been a pick-up in global growth. For the first time in almost 10 years we are seeing synchronised global growth. This means it is not any single country that is driving growth – there are growth engines almost everywhere we look.

- In our company visits everywhere we go, we find that economies are becoming stronger and banks are reporting stronger demand. We see this in the US (aided by Donald Trump's tax reform), Europe, Germany, Holland, Belgium, France, Portugal and Ireland – to name a few.
- Commodity prices have also been strengthening, which is very good for emerging market countries like Brazil, Russia, Turkey, Indonesia and Mexico.

HOW DO WE EXPECT LAST YEAR’S TRENDS TO CONTINUE SUPPORTING FINANCIALS IN 2018?

The main benefit will come from higher interest rates, which are pushed by higher inflation. Central banks will have no option but to gradually increase interest rates due to rising inflationary pressures. Since we've had a very long period of unnaturally low interest rates, increases will immediately flow through to financials’ bottom line. With higher interest rates, banks can immediately charge more interest on loans. At the same time, because banks are operationally clean – having disposed of all non-profit businesses and having cut costs – the benefit of higher interest rates will have a direct impact on their bottom line.

A second important point is bad debts – as usually is the case, credit committees tighten up a lot after a crisis resulting in very clean loan books, in turn resulting in low bad debt charges for an extended period.

A final point important for stock picking funds is that an environment like this helps new and upcoming smaller companies, since these companies can use a growth period to take market share from the larger incumbents.

Overall, we think this will be a very good year for global financials. Emerging market financials in particular should benefit (because of the commodity price cycle) as well as smaller financials, which should take market share and be more aggressive in this period of strong growth.

Hence we have maintained the investment in the Sanlam Global Financial Fund at 20%. This should prove beneficial in terms of expected returns, but also as good diversification away from the rand should it weaken after its strong rally.

FINANCIALS IN SOUTH AFRICA

After 18th December 2017 South Africa will be changing for the better, we just don’t know the extent and the pace of change. Although short-term expectations might be too high, the possibilities of a more capital friendly economy with a higher growth rate is real.

In the first few weeks of his election, Ramaphosa has already indicated an anti-corruption stance and the importance of attracting international capital to create jobs and reduce unemployment - so we can look forward to a few years of gradual but consistent improvement. The country comes off a very low base and the markets should experience regular positive surprises. This is very good for financial shares as they provide the oil that drives an economy. Surprisingly, to date very few analysts have upgraded their earnings forecasts, everybody is waiting to see if (or how) Ramaphosa’s talk translates into action and how he resolves the debt problems at Eskom and other SOE’s.

THE RAND

The rand wouldn't have strengthened had Ramaphosa not won, but it's important to bear in mind that the recent strength has simply been a catch-up to other emerging market currencies that (along with the Euro) strengthened against the dollar during 2017. Other emerging markets have strengthened on the back of stronger commodity prices as well as the weaker dollar, so for the rand to maintain its strength Ramaphosa has to deliver, commodity prices have to stay strong and the dollar has to remain weak.

We have repositioned the fund slightly, increasing our investment in South African banks. The table below shows how the South African banking sector has re-rated during 2017, the question now is: Should it re-rate further? This will depend on the new cabinet but bear in mind that 2018 is likely to be emerging market friendly with stronger global growth and higher commodity prices.

	2012	2013	2014	2015	2016	2017
Price-to-net-asset-value (P/NAV)						
Three banks (Standard Bank, Barclays Africa and Nedbank)	1.9	1.8	2.0	1.4	1.6	1.8
Firstrand	2.3	2.2	2.9	3.2	2.9	2.9
Return on equity						
Average four banks	17%	18%	19%	20%	18%	17%

Our research based on past trends shows that banks should grow shareholder value by at least 15% in 2018, which means that bank results should surpass expectations and that some gradual further re-rating is possible. This considered, we expect good returns for the fund for 2018.

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
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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.

For the Nedgroup Investments Bravata World Wide Flexible Fund it is calculated monthly as a percentage (the sharing rate) of outperformance relative to the fund's benchmark, with the high watermark principle applying. All performance fees are capped per fund over a rolling 12-month period. A schedule of fees and charges and maximum commissions is available on request from Nedgroup Investments.

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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