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NEDGROUP INVESTMENTS BALANCED FUND

Quarter One, 2018

For the period ended 31 March 2018

NEDGROUP INVESTMENTS BALANCED FUND

POSITIVE MOMENTUM CONTINUED TO BUILD THROUGHOUT THE QUARTER

The new ANC leadership that came to power late last year has continued to instil a new sense of optimism that filters through into many walks of life in South Africa. The first quarter has gone far better for the country than 2017, and we are hopeful that further positive news will continue to emerge throughout the year.

- Ramaphosa's cabinet continues to enjoy the benefit of the doubt from the international rating agencies. It was heartening that Moody's maintained South Africa's debt rating at investment grade, despite historic economic data suggesting otherwise.
- Inflation has continued to fall significantly over the last 15 months, reaching 4% by quarter-end. This achievement was undoubtedly helped by the strong rand. However, it laid the foundation for the recent 0.25% cut in the interest rate, going against global pressure to increase rates. Although we do not expect inflation to fall much further, there are also currently no strong upward inflationary pressures.
- The South African Reserve Bank has revised the country's growth expectations for 2018 and 2019 modestly higher to 1.4% and 1.6% respectively. This expected growth rate is far below satisfactory, but at least the numbers are going in the right direction. It would not surprise us to see these numbers increase further during the course of the year.
- Business confidence has improved significantly.
- The deep-rooted problems within the state-owned enterprises (SOEs) are finally being addressed by the Ramaphosa government. New leadership has been appointed at many of the SOEs, most notably Eskom and South African Airways. The government has spoken out against corruption for many years, but now it finally appears like a serious effort is being made to take action. This bodes very well for South Africa's outlook, provided it is carried through.

THE GLOBAL ECONOMIC BACKDROP, THOUGH POSITIVE, HAS PLATEAUED WITH A LOOMING TRADE WAR

Throughout 2017, the global economy appeared to be slowly recovering. US growth was strong, European growth continued to improve, and Asian growth – although slowing – remained at a high level. However, we are now seeing a decline in several countries' Purchasing Managers' Index (PMI) data. A potential slowdown is most notable in Europe, where numerous countries are delivering economic metrics below expectations. The tariffs recently introduced by President Trump against many countries - but most noticeably China - and their inevitable retaliation, has increased the probability of a global trade war. Unfortunately, there are no short-term winners in this scenario, and we can only assume that the US intends to reset its long-term trade relationships with many of its key trading partners. Some form of resolution will be necessary to avoid a negative outcome for the global economy.

CORPORATE SCANDALS REMAIN UNRESOLVED

Unfortunately, the positive developments within the political sphere were not duplicated in the corporate sector. The Steinhoff scandal remains unresolved. We are still waiting for the revised, and hopefully reliable, financial statements, but it is uncertain when these might be available.

Accusations of share price manipulation within the Resilient Property Group had a devastating impact on share prices during the quarter, which also had a negative impact on the Property Index. This matter is also unresolved.

EQUITIES HAD A BAD QUARTER

The MSCI All World Index fell by 2.4% over the quarter. This was against the global backdrop of a potential trade war and falling PMIs in many countries. The FTSE All Share Equity Index contracted by 6.0% over the quarter. The biggest contributors to this severe fall were weakness in the Resilient stable of property companies and the 16.2% fall in the Naspers share price, which together accounted for 75% of the decline. Given the expected improvement in local economic fundamentals, it was not surprising that general retailers (+9.2%) and banks (+4.2%) bucked the negative trend and had a good quarter.

The Property Index contracted by 19.6% over the quarter. However, this was almost solely due to the implosion of the companies within the Resilient stable, where we have no exposure.

BONDS HAD A PARTICULARLY GOOD QUARTER

Moody's decision to raise the outlook for South Africa from negative to stable - and hence keep South Africa in the World Global Bond Index - supported the continued strength in the local bond market. The BEASSA All Bond Index (ALBI) return for the quarter was 8.1%, mainly supported by the 10.0% return from the ALBI 12^{+} Years Index. Over the quarter long-dated bond rates fell from 8.7% to 8.2%.

PORTFOLIO POSITIONING

Following the Ramaphosa victory and the consequent outperformance of domestically-focussed companies over foreign and rand-hedge shares, we have started to switch out of domestically-focussed companies into more reasonably valued rand-hedge shares. Furthermore, the strength in the rand has meant that the currency risk associated with owning rand-hedge shares has significantly diminished.

We increased our holding in British American Tobacco (BAT), which is currently trading on a compelling 5% dividend yield. We think there is a reasonable amount of negative news regarding regulatory risks and potentially rising bond yields being discounted into the current price. We still see good value in Sasol, where negligible value is being placed on their ethane cracker project. We have increased exposure to Naspers, given its significant discount of over 40% to its underlying constituents and due to Tencent now trading at a more reasonable valuation.

Within the domestically-focussed space we continue to see significant value in Old Mutual, which is trading on a price to earnings (PE) multiple of less than 11X in an expensive domestic universe. We expect to see an unbundling of its UK wealth business in the next few months. This should create interest from a new class of investors who will only invest in a cleaner structure, with exposure only to emerging markets. We have been steadily reducing our exposure to banks and retailers as prices have rallied. We purchased some Woolworths shares, since it is one of the few retailers still reflecting value.

We increased our exposure to Growthpoint given its higher prospective returns relative to other domestic equity and offshore property opportunities. We reduced our exposure to Sirius Real Estate, which has reached fair value.

We invested 2% of the multi asset portfolios in long-duration bonds in December and sold out at the end of February. We continue to invest the bulk of the fixed income portion of the portfolios in high-yielding floating rate bank sub-debt.

From an offshore perspective, we maintain significant exposure to the oil sector, mainly through Royal Dutch Shell, given its compelling valuation and consistently strong operating metrics. We continue to avoid US-based stocks because of valuation concerns and are focussing more on emerging markets and Europe where we see better value.

INVESTMENT PERFORMANCE

The outperformance of domestically-focussed companies over offshore and rand-hedge shares had a positive impact on investment performance. Financials, including Old Mutual and FirstRand contributed positively to performance, as did retailers, including Shoprite and The Foschini Group. Our investment in local property companies Growthpoint and Redefine also benefitted from a more optimistic domestic outlook and lower interest rates.

Howden contributed positively on the back of a very strong set of results and compelling valuation. Excluding the cash on its balance sheet, the stock trades on a 6.4 PE ratio, which is still cheap, notwithstanding the strong share price performance.

Naspers underperformed against a backdrop of weaker global tech markets. While Tencent's financial results for the fourth quarter of 2017 were in line with expectations, the company is indicating a further investment in strategic areas to solidify their market position and drive long-term growth. This will probably result in short-term margin pressure, but greater sustainability of future growth. Shortly after Tencent released its results, Naspers announced the sale of 2% of its Tencent holding. The proceeds will be used to fund the development of their unlisted internet companies, instead of being applied to share buybacks. This disappointed the market as investors want to see Naspers management proactively closing the significant discount of approximately 40% that the share trades on, relative to its underlying holdings.

BAT's underperformance, in addition to being affected by the stronger rand and higher US long bond rates, was also affected by a disappointing update on their progress in the new generation heat-not-burn sector. We think the share price has overreacted, especially given the continued momentum in BAT's constant currency profit growth.

Hulamin, despite producing improved operational results, underperformed due to the negative impact of the strong rand on their operating profits. We maintain our exposure to this share, which trades at a 60% discount to its net asset value.

RESPONDING TO ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) ISSUES

Our engagement and shareholder activism around Steinhoff is ongoing, and we will be attending the Annual General Meeting in April. We have recently engaged with Naspers, BAT and Howden to address specific governance issues. We have had almost zero exposure to the Resilient group (apart from a small holding in Fortress A, which we exited), and therefore no shareholder activism was required on our part.

WE WILL CONTINUE TO FIND SHARES WITH ATTRACTIVE RETURN PROSPECTS

The new ANC leadership has injected a much-needed sense of optimism into consumer and business confidence. The leadership is already making significant changes, which will help turn the fortunes of South Africa for the better. There is unfortunately no shortage of global risks that we need to consider in building our portfolios, from overvalued global financial markets to trade wars. However, despite these concerns, we have identified shares and financial instruments that we believe will deliver inflation-beating returns over the medium term, irrespective of the global economic environment.

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.

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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
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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
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