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NEDGROUP INVESTMENTS FLEXIBLE INCOME FUND

Quarter One, 2018

For the period ended 31 March 2018

Performance

Performance to 31 March 2018	Nedgroup Investments Flexible Income Fund[1]	STeFI * 110%
3 months	3.0%	1.8%

The fund had a positive start to the year as investors benefited from yield pickup on our floating rate assets and the performance of nominal and inflation linked bonds. The recovery in domestic and offshore Steinhoff bonds also added to performance and helped to reverse the underperformance from December 2017.

The Rand continued to strengthen during the quarter so the currency exposure and offshore property was a slight detractor. We see value in maintaining an offshore exposure with the Rand at overvalued levels.

After a disappointing 2017, the fund has performance is now back above cash on a 1 year basis and the longer term performance demonstrates significant outperformance of the benchmark.

Market Commentary

The first quarter of 2018 saw continued positive political developments in South Africa. Jacob Zuma was forced to resign as president after weeks of intense pressure and Cyril Ramaphosa was appointed State President. After a closely contested ANC elective conference in December, Ramaphosa has cemented his power quickly. He announced a cabinet reshuffle and made immediate changes especially to key economic positions of political power and within some State Owned Enterprises. These are the most positive political developments in the country for more than a decade. Despite this, our analysis shows that it will require skill, continuity, conviction and many years of investment before the severe economic damage done during the Zuma years can be recovered. As a consequence, despite the low base, we do not anticipate a very fast acceleration in economic growth in the short term. This is exacerbated by policy uncertainty in many sectors of the economy (Mining Charter, Land Expropriation without compensation, BEE Charter requirements). Considering the diverse opinions on these matters among stakeholders these are unlikely to be resolved in the short-term.

The February budget was delivered by Malusi Gigaba. The budget was an improvement compared to the MTBPS delivered in September 2017, but still shows a massive deterioration in the fiscal position compared to a year ago. Tax hikes of R36bn were announced with the 1% increase in the VAT rate being the biggest contributor. For ratings agencies, the key change is that Debt to GDP ratio is forecast to stabilize at 56% of GDP in 2022. This is a far more optimistic forecast compared to the MTBPS which showed no debt stabilization. Despite the revenue measures, the deficit will remain wide in the coming years as South Africa's social and economic challenges imply constant pressure on expenditure. South Africa needs economic growth to ensure fiscal sustainability.

South Africa avoided a ratings downgrade in March when Moody's announced the conclusion of its review. The rating was maintained one notch above sub-investment grade at Baa3. A positive surprise was that the outlook was changed from negative to stable.

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[1] Net return for the Nedgroup Investments Flexible Income Fund, A class. Source: Morningstar (monthly data series).

Moody's identified three main drivers behind the rating confirmation: a halt to the erosion of South Africa's strong institutional framework following President Cyril Ramaphosa's victory at the ANC elective conference, improving economic prospects and a credible fiscal plan as represented by the 2018 Budget. S&P and Fitch continue to rate South Africa as sub-investment grade, and we will need to see significant political and economic improvement before these downgrades can be reversed.

The Outlook for Interest Rates

The Monetary Policy Committee of the South African Reserve Bank (MPC) reduced the repo rate by 25 basis points on the 28th of March 2018. The MPC forecast inflation to remain well within the target band of 3-6% over the entire forecast horizon. This provided sufficient comfort to the MPC to narrowly vote in favour of the action. The split was 4 in favour and 3 against. The strong Rand, further supported by Moody's decision to keep its rating for South Africa's sovereign debt unchanged and move the outlook to stable, is expected to keep CPI subdued. The impact of the VAT hike on CPI will be limited and the MPC will only react to any second-round effects of the VAT hike. Economic activity is expected to increase due to the higher confidence levels observed since Mr Ramaphosa became president but consumption is still far too low to meaningfully push prices higher.

The MPC has also experienced a change in orientation over the last few years, whereby they are far more eager to see inflation expectations closer to the middle of the target band. Accomplishing this will require CPI inflation to stabilise closer to the middle of the band. This results in a relatively tighter policy response function when compared to the previous paradigm where the MPC was happy with inflation very close to the top end of the band. Benign CPI expectations reduce the need for near term rate hikes and a desire to reset inflation expectations lower reduces the scope for rate cuts.

We thus expect the repo rate to stay roughly where it is and are confident that it should not deviate by more than 50bps (in either direction) from the current level over the next 2 years.

Portfolio commentary

The position of Steinhoff remains uncertain and clarity on the true financial position of the firm is only expected toward the end of 2018. The information released to date has been mixed. Some of the underlying companies are doing very well and the value of the SA listed components of the business has been affirmed. However, there has been no further information regarding the key issues of off balance sheet entities, cash positions and the extent to which profits have been overstated. The changes in the value with respect to the listed property portfolio demonstrate the uncertainties. On 20 February 2018, Steinhoff disclosed a value of EUR2.2bn for the property portfolio post the sale of a building in Vienna. On the 3rd of April 2018 they then announced that the property portfolio was valued independently at EUR1.1bn. The property values are therefore substantially lower than our previous expectations.

Despite the uncertainty, our position in Steinhoff experienced a recovery during the quarter as the bonds we held enjoyed substantial claims on the assets of the firm in the form of guarantees.

The majority of our holding in the Flexible Income Fund were in the domestic bonds which are best placed in the capital structure and are covered many times over by solid operating assets as well as liquid underlying listed holdings. These bonds were redeemed at par on 20 February 2018 and investors did not suffer any capital losses.

We also held 1% in the offshore convertible bonds. These also have guarantees in place in the form of the property portfolio and inter-company loans from the local business. While these bonds lost half their value in the December panic, we held on to the bonds as they were pricing in a very negative scenario and were fundamentally undervalued as they did not consider the guarantees in place. The convertible bonds have since recovered to around 10% below the level at which we purchased the bonds. Post quarter end we fully disposed of our Steinhoff convertible bonds.

Current positioning

- Low Duration

We have decreased duration from 0.5 years back to 0 over the last quarter. We bought bonds and fixed rate NCD's prior to the ANC elective conference where yields were pricing in an attractive risk premium. The rally since December has compressed risk premia and priced in an optimistic rate cut cycle. We have hedged all local interest rate exposure and are now fully floating.

- High Credit Quality

The portfolio has a high degree of credit quality, with no unlisted issuers. We have managed to exit the Steinhoff position with minimal performance impact on the fund. Our credit process has historically shielded investors from credit events in SA and we are confident in our ability to protect investor's capital in the fixed income space.

Corporate credit spreads remain very compressed. This is largely a function of the global liquidity dynamic and lack of corporate bond issuance in South Africa. We have focused our asset purchases on senior bank debt and will wait for value to emerge before taking corporate bond exposure.

- Addition of Short Term Inflation Linked Bonds

Inflation Linked bond yields have moved up significantly over the last 2 years and we have been correct in avoiding this asset class as it performed poorly. We increased the inflation linked bond exposure to 4.4% during February as yields moved higher. We purchased assets with real yields of 3.5%, which have now rallied down to 3%. While we remain in a cyclical downturn in inflation in the near term, we expect inflation to average 5.3% over time for a total return of over 8%.

- Maintain offshore exposure with ZAR over-valued

Offshore bonds have added significant value in recent years as we have been able to take advantage of risk-off events which caused them to be undervalued. Global yield spreads have narrowed across the Investment grade, high yield and emerging market space. Spreads are less attractive and last year our average exposure was 10% compared to 15% in 2016. We will wait for better value before increasing our risk in this area.

The currency exposure is 7.6% at present. The Rand is pricing in a very significant recovery in SA fundamentals and is overvalued at current levels. We believe it makes sense to maintain a foreign exposure at these levels.

- Convertible Bonds

We have 3.2% exposure to convertible bonds issued by Royal Bafokeng Platinum and Remgro (via an offshore issue). We have historically added value through this asset class as it provides a mix of yield and capital appreciation. We will look to increase the exposure if we see value.

Summary

After a positive first quarter we have used the opportunity of the market rally to lock in the gains on our bond and swap positions. Last year saw a strong bull market in risk assets as asset prices and spreads moved to very expensive levels while volatility was extremely low. This year has started with a lot more uncertainty and volatility has increased. US rates have moved sharply higher in recent months and the Fed is set to continue its hiking cycle. Foreign flows rather than domestic developments have been the key driver of markets over the last year, and despite the current positive sentiment in SA, we expect global flows to continue to be the key market driver. Our aim is to generate a reasonable return with a low level of downside risk, and take advantage of opportunities provided by any shocks to add risk exposure when the market offers value. A more volatile environment and wider credit spreads will create opportunities for the Flexible Income Fund.

Portfolio summary	
Domestic duration	0.00
Domestic Inflation linked	0.19
Total domestic duration	0.19
Offshore duration	0.10
Total fund duration	0.29
Effective offshore exposure	7.7%
Fund yield	8.5%

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.

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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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