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NEDGROUP INVESTMENTS OPPORTUNITY FUND

Quarter 2, 2018

For the period ended 30 June 2018

Performance to 30 June 2018	Nedgroup Investments Opportunity Fund[1]	ASISA category average	FTSE/JSE ALSI
3 months	3.0%	3.5%	4.5%
12 months	-0.4%	6.9%	15.0%

The Nedgroup Investments Opportunity Fund produced a return of 3.0% (net of fees) for Q2 2018. This was behind the peer group return of 3.5%. Over one year we remain quite far behind the peer group, but have made up some ground since the Steinhoff fallout impacted our performance in December last year. Over longer measurement periods we remain ahead of the peers.

MARKET COMMENTARY

It was a tough quarter for emerging markets, as they bore heavy selling from investors who got spooked by rising rates, the prospect of a trade war and the general increase in geopolitical tensions. The MSCI Emerging Market Index was down 12% over the quarter in US dollars.

The second quarter saw the South African market unwinding some of the initial euphoria experienced after Ramaphosa's victory at the ANC National Elective Conference in December last year. Having said that, Ramaphosa has won some impressive political battles since he won the ANC Presidency. Let's consider a few of the remarkable achievements: replacing Jacob Zuma as the president of South Africa, installing a far more credible cabinet (his close victory implied that some cabinet members from the Zuma camp remained although in less powerful positions), enhancing executive credibility at many SOEs by replacing their boards and instituting a commission of inquiry into the mismanagement of SARS. This led to a period of exuberance regarding what would be achieved under the new administration. The market effectively believed that every possible reform would be achieved, rather than a probability weighted expectation.

As the initial reform momentum has started to fade, the sheer scale of the challenges - those of a structural nature and those resulting directly from the Zuma era - have come into sharper focus. The key social challenges remain high unemployment and income inequality.

The Capped SWIX (our preferred measure of South African market performance) was marginally up over the quarter (+0.9%), but in US dollars was 15% lower (the ZAR had its worst quarter since 2011, with the currency dropping 16% over Q2 alone). The initial strong reaction that domestic counters had to President Ramaphosa's victory at the ANC Elective Conference in December was all but reversed in Q2. We are back where we started.

Developed markets were more resilient, particularly in the US, as evidenced by the S&P 500's quarterly return of 3.5% for the quarter. The evidence suggests that in the context of global developed stock markets, the easy times may well be behind us.

Here are the facts:

- Firstly, the bull market that started in 2009 will turn ten early next year; which is pretty long by historical standards.
- Secondly, the global discount rate – as measured by the yield on the 2-yr US Treasury Bond – has spiked dramatically after a number of years of close to zero interest rates. Over the past two years, the yield has jumped from 0.5% to 2.5%, and over the past year alone it has doubled from 1.25% to 2.5%.

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

This implies two things:

1. Fixed income is again becoming a viable alternative to risky assets; this after years of being unloved and practically unowned by asset allocators.
2. The rate at which people discount the cash flows on their risk assets has moved sharply higher; which should adjust fair values downwards.

- Global liquidity is being sucked out of the system – again a reversal of what has been happening for the last number of years. Quantitative easing and Central Bank asset purchases have slowed, sucking up liquidity in the process. Less liquidity is typically a headwind for asset prices.
- Valuations (particularly in the US) are elevated. Although simplistic 'P/E' measures may appear reasonable, margins are elevated. The risk currently lies more in the 'E' than in the 'P'.
- Greater levels of dissonance in the system: Trump's posturing, the threat of trade wars, Brexit, questions around the European Union, Geopolitical tensions, etc. All things equal, higher levels of uncertainty make investors command higher risk premia.

PORTFOLIO COMMENTARY

The fund's top five performing positions added 5.9% to returns over the second quarter while the bottom five detracted 1.4%.

Winners	Ave.weight	Performance contribution	Losers	Ave.weight	Performance Contribution
Sasol	6.6%	1.8%	Alexander Forbes	1.3%	-0.4%
Naspers	9.9%	1.7%	Steinhoff	0.2%	-0.3%
Abax Global Equity Fund	7.4%	1.3%	Barclays	2.8%	-0.3%
USD/Euro/GBP Cash	5.9%	0.8%	Master Drilling	0.8%	-0.2%
Sappi	1.2%	0.3%	Balwin Properties	0.7%	-0.2%
		5.9%			**-1.4%**

Given the extent of rand weakness, the largest contributors to performance were the offshore assets in the fund. A number of domestic portfolio positions that have rand hedge qualities also contributed meaningfully, most notably: Sasol (+28%), Naspers (+21%) and Sappi (+20%).

The largest detractors were domestic counters that gave up much of the gains they enjoyed in late December and Q1 2018 on the back of President Ramaphosa's victory at the ANC Elective Conference. These included some of the smaller, primarily domestic focused businesses (Alexander Forbes, Balwin Properties, Master Drilling) and the banks. We were however, reasonably active over the first half of the quarter and managed to 'rotate' out of the some of the domestic winners and into rand-hedges which had sold off, thereby locking in some of the gains we enjoyed in the first quarter.

Also on the list of detractors was the Royal Bafokeng Convertible Bond which fell 10% over the quarter. We have retained our approximately 4.3% allocation to convertible bonds (Impala and Royal Bafokeng). They have just less than 4 years to maturity and are currently yielding approximately 14% p.a.

Although these bonds have detracted value (they are approximately 10% down since issue one year ago if you adjust for income received), they have thus far proven a far better alternative to the underlying equity, which has halved. Furthermore, the bond will pull-to-par with time, making the current loss transient. That may not be the case for the equity. Although the likelihood of upside from the equity option ending in the money has materially reduced, even with no upside, we will still earn 14% p.a. to maturity provided the credit remains sound.

STEINHOFF

During the quarter we made the decision to sell out of the last Steinhoff shares that we owned. This was not a decision we took lightly, as since December 2017 we have had the view that substantial value still remained within the group. As new news became available it became evident that conditions for the firm had continued to deteriorate to a point where the future of Steinhoff as a going concern became very precarious. Any eventual value was assessed to be uncertain, and should it materialise, it was expected to be limited and to take a long time to realise. In the intervening period, Steinhoff will have to contend with and fund several costly law suits which will further erode much of the possible remaining value.

The incremental negative news points that drove our decision were:

1. Continued asset sales to fund operational working capital requirements. This included the sale or partial sale of STAR, PSG, KAP as well as certain of their key properties and additional peripheral assets. These sales were all done at discounts to fair value for those assets.
2. During a presentation to lenders in May 2018, it became clear that the company was under severe liquidity constraints and unable to convince their creditors to extend lending terms for more than one month at a time. At the same time it was revealed that historic profitability of many of the underlying businesses was much worse than previously reported. This significantly impacted the confidence of our valuation of their European businesses.
3. In addition to all the class action claims against Steinhoff, new claims emerged from Christo Wiese, GT Ferreira and Braam van Huysteen.

Together with the other South African institutions exposed to Steinhoff prior to the December 2017 revelations, we have actively engaged with several Dutch class action law suit service providers and have selected a highly qualified and experienced provider to pursue a claim against the company and its auditors on our clients' behalf. We will be engaging with clients within the next quarter to elaborate on this exercise and to advise on our recommended route of legal action and the alternatives available.

Portfolio positioning

We added Vivo Energy to the fund on listing. Vivo Energy is Africa's largest independent downstream fuel retail operator and an exclusive Shell brand licensee in each of the 15 countries it operates. It currently has nearly 2 000 retail sites and occupies number one or two position in most of the countries in which it operates. The shares currently trade on a P/E of 13.5x and 7x EV/EBITDA, which we deem attractive given the relatively defensive nature of fuel retailing combined with its strong organic and inorganic growth opportunities.

Emerging Markets have been firmly in the cross-hairs of investors, with EM bonds and equities having experienced massive outflows this year. In our view, EM valuations are now reasonable, especially relative to markets like the US, which has been relatively resilient and remains expensive.

This view is reflected in the positioning of the fund, where we have a reasonable allocation to South African equity (many of the securities we hold are 20-30% off their 12-month highs), and only a modest allocation to developed market equity, much of which is hedged in some form. From a portfolio construction perspective, we currently prefer to allocate some of our offshore allowance to gain exposure to 'risk-off' assets – such as US cash, shorter-term treasury bonds and inflation linkers. This should help offset some losses should markets wobble.

Furthermore, we have hedges in place over four of our largest equity positions in the Fund (Naspers, Sasol, British American Tobacco and Firstrand) to help protect against some losses should that eventuality materialise.

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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