QUARTER 4 INSIGHTS 2017

SEE MONEY **DIFFERENTLY**

NEDGROUP INVESTMENTS

FEATURES

OUR INVESTMENT APPROACH

We help you find Best of Breed™ fund managers and the right investment solution
When you invest, you want the most appropriate fund manager to look after your savings.
We assist you in this process by actively researching and appointing fund managers to manage our fund range.

Our independence is our strength
Our fund manager research process helps us to identify managers with specific traits that we believe will enable them to deliver superior results over the long term.

We focus on monitoring fund managers so that you don't have to
Things do change. To help you manage this, and to ensure that our range remains Best of BreedTM, we actively monitor and review the appointed fund managers. If we think it is necessary, we will replace specific fund managers that are no longer deemed appropriate.

DO YOU TALK TO YOUR CHILDREN ABOUT MONEY?

NIC ANDREW
EXECUTIVE HEAD OF
NEDGROUP INVESTMENTS

As a dad of three wonderful children (dads are allowed to be biased) and an investment professional, a regular conundrum I face is how best to teach them about money and investing.

Much research has shown how our attitude and approach to money are shaped by our parent's attitude to money. Just think of your own experience. Whether or not your parents spoke freely about money; whether they were part of the war generation hoarders (where all discretionary spending is considered excessive); whether they were entrepreneurial or if they were constantly over-spending and running into financial problems, would have had a significant effect on you.

Advances in technology and the ease of moving money or airtime digitally, coupled with society's increasing wealth and instant gratification mentality as opposed to the previous generation's weekly cash, piggy bank and savings deposit book regime, has made our job as parents even less tangible and more challenging.

With this enormous responsibility, how do we best teach our children good money management skills? What can we do to begin to help lay down the knowledge and create habits that foster future financial success? Here are three practical suggestions:

Make it real
Money issues should be discussed and made real. It is really important for children to understand the value of things and that trade-offs are required. Starting an allowance is a useful tool - be sure to set clear rules for what it is expected to cover and what behaviour is required to "earn" the allowance.

Money issues should be discussed and made real. It is really important for children to understand the value of things and that trade-offs are required.

Then comes what is probably the most difficult part. Both parents then need to have the discipline to stick to the agreement - including when the child runs out of money. As hard as this lesson can be, realising that money is finite and that one needs to budget and make choices is an extremely valuable lesson to learn early in life when the stakes are low.

Exercise delayed gratification and learn the benefits of compounding

Just as households need to budget and save for large capital expenditure such as cars and holidays, children should be encouraged to start saving for larger items rather than waste their money on impulse spending (how many fidget-spinners or World Cup stickers do you really need?).

Research at Stanford University in the US, the much referenced "marshmallow test", showed that the ability to display patience and delay gratification at a young age correlated strongly with better life outcomes.

Of course, delayed gratification, self-control and patience are essential components to deliver compounding – and developing a true understanding of the benefits of compounding is one of the most powerful financial insights you can provide for your children.

Be a good example

Our children consciously and unconsciously mimic our behaviour – whether we want them to or not! So, from a financial behaviour point of view, living within our means, saving regularly and making sure we are educated about financial matters is imperative. As children get older, introducing key investment concepts such as asset classes, inflation, risk and reward, time horizons, compounding, diversification and the importance of costs add additional layers to their understanding.

Encourage them to ask how businesses and the economy work, to start small ventures and be inquisitive and confident about money.

A sensible, practical way is to open an investment in a tax-free unit trust and contribute a regular debit order (from as little as R500 per month) on their behalf. Children love to see their investment growing, especially when they start realising that in the future they may have a meaningful lump sum for their university education or deposit for a house or car... ignoring the fact that by then we will all probably just hail a self-driving uber!

As with all investing, teaching children about being responsible with money sounds simple but is not always easy to implement. But it is no doubt worth the effort as giving your children solid financial skills and nurturing good habits are amongst the most valuable gifts a parent can offer.

Good luck!

Nic Andrew

THE EMPIRE STRIKES BACK

ANDREW PARSONS

FUND MANAGER OF THE NEDGROUP INVESTMENTS GLOBAL PROPERTY FUND

The Empire State Building, almost 90 years old, seems to be getting better with age. We explain how going public as a REIT had a lot to do with this revitalisation.

While people would generally be able to rattle off the names of global listed equity companies quite easily, they might struggle to come up with more than 1 or 2 global listed property companies – it's just not an area that people are overly familiar with.

At the annual Nedgroup Investments' summit earlier this year, we shared our thoughts on a company that is held in our global property funds – Empire State Realty Trust. As the name suggests, the company owns an asset that has an iconic brand name: the Empire State Building.

The Empire State Building – a remarkable story

Located in mid-town Manhattan and standing approximately 440 metres tall with 102 levels crowned by an observation deck, the Empire State Building was the world's tallest building for 40 years after its completion in 1931[1]. To put it in perspective it is twice the height of South Africa's tallest building – the Carlton Centre.

Its history is littered with fascinating stories: the fact that it (remarkably) took less than 14 months to build – today buildings of this size would take around 2 years to build; how it was hit by a US B-25 Bomber in 1945 and how it was once again New York's tallest building for a decade after the events of 9-11[1].

The building has been around for almost 90 years but it seems to be getting better with age and going public, as a REIT, has had a lot to do with this revitalisation.

While its history is fascinating, until relatively recently its financial performance wasn't fantastic. You see it was a victim of its birth and dysfunctional ownership structure.

Finished in the depths of the Great Depression, it struggled to lease and sat with a considerable amount of vacant space, so much so that it was nicknamed the Empty State Building.

For many years, the owners simply filled space with whomever would take it, to the point where most of its floors became a rabbit warren of small tenants including lawyers, jewellers, accountants and other small businesses. Some floors had over 40 tenants, which made it very hard to manage the building in an efficient fashion. Consequently, over time the tenant fit-outs, buildings services and infrastructure gradually deteriorated.

[1] http://www.esbnyc.com/explore

For a long period ownership of the building was split among three parties who did not have the capital nor shared vision on how to reposition the building. Consequently, it suffered from chronic under-investment and hence was unable to attract tenants except by effectively giving away the space in return for keeping the lights on and paying city taxes.

A second lease on life

All of that changed around 10 to 15 years ago when the ownership was consolidated and ultimately the property listed on the New York Stock Exchange (NYSE) in 2013 as the key asset of Empire State Realty Trust (ESRT). This dedicated structure provided access to capital to accelerate the refurbishment and repositioning of the building.

Under an extensive modernisation program, the new management team added amenities such as a gym, restaurants and conference facilities while lobby and lifts were upgraded, lighting, and power replaced[2].

They did such a good job that, in spite of its vintage, the Empire State Building is now in the top 15% of the most energy efficient buildings in the US. The Empire was moving from an Empty State to a 'Tower of Power' - and is only getting better with age. The Empire was striking back!

And tenants get it. Occupancy has increased from 78% in 2013 to 92.5% today – that's better than the average premium grade New York office building. At the same time rents have grown from around US$40 in 2013 to on average over US$52 per sq ft today with most recent deals at over US$60 a sq ft. Tenants now include high profile larger names such as LinkedIn, JC Decaux and Shutterstock. It is a phenomenal turnaround in perception and reality in terms of commercial outcomes.

I still haven't got to the jewel in the crown, the observation deck. Today it attracts more than 4 million visitors per annum[2] and generates US$100m of income per annum. In the past 20 years other decks have been launched including, Rockefeller's Top of the Rock and the One World Observatory but, almost everyone wants to go to the Empire State Building. Since 2001 (the worst year in terms of income from the observation deck) and through the Global Financial Crisis (GFC), the observation deck saw a drop in income of less than 1%. It's been an incredibly resilient cash cow for this property.

Why Resolution Capital invested in it

Resolution Capital is a global real estate securities manager, with over a 10-year track record in analysing and investing in global listed property markets. We believe that listed property provides an excellent means of gaining an efficient exposure, to the returns of some of the world's highest quality real estate assets.

In 2013, when the IPO for the Empire State Building was launched, the general perception was that it was a novelty, if not a tired old building and not a serious investment. It is fair to say that there was reasonable but not overwhelming demand for the stock. Nevertheless, for us, it had the bones of a good building, an improving location and the character was consistent with what an increasing number of tech and media tenants were drawn to. We saw the enormous potential of a well-run building, with a better balance sheet to be able to extract returns. It reminds us of The Tea Building in London's Shoreditch – a century old tea warehouse that retains a number of its raw features and has a waiting list of tenants.

The Empire State Realty Trust listed at US$ 13 per share and the stock now trades at US$ 20 per share. Along the way, it has paid a good and increasing dividend, with earnings expected to grow at 7% pa in the decade after its IPO. Better still, last year the company did a placement of 10% of its issued capital at US$ 21 per share and using the proceeds to significantly deliver what was already a solid balance sheet. Now the loan to value (LTV) across the consolidated portfolio is less than 15%.

So this is why we get excited about selective listed global real estate opportunities. They give you the ability to gain access to great real estate, with management that is focused and strong balance sheets, which allow this value to be unlocked.

Access to an exceptional strategy through Nedgroup

The interesting investment case study provided in the narrative above is just one example of the real estate companies held within the Nedgroup Investments Global Property Fund. The Resolution Capital team invests in a select and diverse group (no more than 55 stocks) of real estate companies capable of generating superior risk adjusted returns for investors.

The stringent filtering process focuses on identifying and exploiting three key attributes:

1. High barrier property markets where landlords have pricing power; and
2. Strong balance sheets, which can successfully withstand and exploit market cycles; and
3. Management teams with skill, discipline and alignment.

The Nedgroup Global Property Fund is a mirror of the Resolution Capital flagship Global Property Securities Strategy, which boasts a stellar 10-year track record of out -performance.

Nedgroup Investments provides access to this strategy via two FSB approved access points:

- Nedgroup Investments Global Property Fund (USD - domiciled in Ireland)
- Nedgroup Investments Global Property Feeder Fund (ZAR - domiciled in South Africa). ■

[2] https://www.esbnyc.com/sites/default/files/esb_fact_sheet_4_9_14_4.pdf

THE ROLE OF HEDGING IN PORTFOLIO CONSTRUCTION

OMRI THOMAS
FUND MANAGER OF THE NEDGROUP INVESTMENTS OPPORTUNITY FUND

We examine the aspects of our process that give us confidence in our ability to meet the risk target of no negative 2-year periods.

The objective of the Nedgroup Investments Opportunity Fund is two-fold:

- CPI + 5% p.a. over rolling 3 years periods (return target)
- No negative rolling 24-month periods (risk target)

The pay-off profile described above is asymmetrical, implying we need to focus on upside as well as downside in equal measure. This is how we naturally think about things at Abax, and our multi-asset process is built around meeting both of these objectives.

By actively allocating between the asset classes and harnessing our bottom-up security selection capabilities, we try to capture the risk premiums (and alpha, hopefully) on offer and combine them as efficiently as possible into a portfolio whose expected return aligns with that of the funds objective. The focus of this article however is not so much the return aspect of the fund's objective, but rather, the differentiated aspects of our process that give us confidence in our ability to meet the risk target of no negative 2-year periods.

Broadly speaking, we actively seek out individual assets that have known downside or asymmetric pay-off profiles. Cash, credit, nominal and inflation linked bonds are natural candidates, but unfortunately do not usually provide sufficient upside to enable us to deploy all of our capital into these assets. Listed property has both equity and fixed income attributes, so can be a useful asset class in constructing absolute portfolios. Equity clearly has the highest return potential, but also the highest downside volatility, which can impact on our ability to protect capital if things do not turn out as expected.

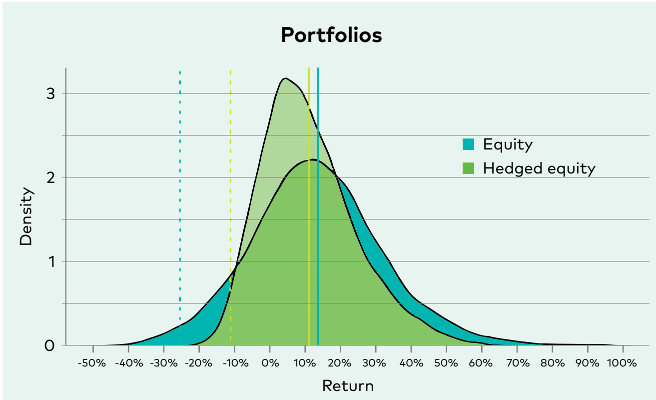
We can also search for opportunities outside of the more traditional, easy to define asset classes and instruments: 'hybrids' serves as a good description of these assets as they provide exposure to the risk premia from a mix of different asset classes. The added benefit of analysing hybrids is that fewer people seem to be looking here - potentially making it less competitive and a richer source of alpha - as some of these instruments do not fit the traditional classifications and require a skillset that can simultaneously deal with equity, credit, duration and derivative valuation.

Convertible bonds (essentially a credit bond with built in equity optionality) would be a useful example – they resemble equity on the way up, but a bond with its fixed coupon on the way down. The Zambezi Platinum preference share is another flavour of hybrid: essentially this instrument pays a floating rate coupon of prime + 3.5%, and is backed by shares in Northam (converted at a 10% discount) in the event of default.

Another way to produce an asymmetrical pay-off profile is to create one by adding derivative overlays to an existing position. For example, in the Opportunity Fund, we protected some of our Naspers exposure (the biggest position in the fund) against a 10% fall in price, so as to limit the downside impact should the counter's strong momentum reverse. We have structured this trade on a 'zero premium' basis by effectively financing the protection though selling away some of our upside. In other words, the return distribution for our Naspers allocation has been 'narrowed' and is now more closely aligned with the fund's dual objectives.

It is also possible to protect equity exposure at an asset class level. By adding protection structures to an overall asset class, you can effectively create new asset classes with more fit-for-purpose pay-off profiles. Incorporating asset classes with different characteristics can have portfolio construction benefits, even if the expected returns on the newly hedged asset class is lower than the unhedged return.

To illustrate this, consider the output in the following charts from one of our proprietary tools. In this instance we are modelling the impact of purchasing a simple '2% out-the-money put' over our equity exposure. By doing this we protect our equity exposure from any fall in price over and above the first 2% drop. We pay for this protection by paying away premium rather than financing it through giving away some of our upside. In other words, there is an explicit cost paid for the hedge. No assumption of skill is made in terms of the timing of the implementation of the protection strategy, or in our ability to seek out more 'favourably priced' structures. It simply assumes we blindly implement the structure by purchasing 6-month puts - rolled every 3-months - regardless of the market's valuation.



Source: Abax

In isolation, the return characteristics of the equity overlaid with the puts looks inferior (expected return of 10.9% p.a.) compared to naked equity (13.5% p.a); the difference is attributable to the cost of purchasing the protection. However, the risk-adjusted returns are similar, as the volatility decreases pretty much commensurately with return. But - and this is the important take-out - the altered pay-off profile may be more suitable for funds with an 'absolute' objective that are attempting to avoid large drawdowns. What is interesting is that in the event of large market drawdowns (we consider here the worst 10% of drawdowns), the equity market drops by an average of 25%, and hedged equity by only 11%; a far more palatable and recoverable outcome for absolute-minded investors.

	Equity	Equity + 2% OTM puts
Return p.a.	13.5%	10.9%
Volatility	19.8%	13.9%
Sharpe	0.35	0.32
Average 10% worst drawdowns	25.1%	11.2%

Source: Abax

The over-riding principle is that the addition of hedges can improve the likelihood of meeting both the risk and return objectives of an absolute mandate, and make the funds return signature more aligned to the expectations of investors. ■

WEIGHING IN WITH THE NEDGROUP INVESTMENTS GLOBAL EQUITY FUND

ANIL JUGMOHAN
INVESTMENT ANALYST

In the gloomy economic outlook, how does our Global Equity Fund aim to produce outstanding performance?

South Africa's domestic economic outlook is not particularly impressive. In fact, despite posting relatively good GDP growth figures last quarter to emerge from a technical recession the reality remains that we're in for a tough time. South Africa is fortunate that Emerging Markets in general are being favoured by global investors for now – certainly not because of our political environment, and despite risks from Trump, Brexit as well as continuing threats from North Korea (who just launched another missile over Japanese airspace).

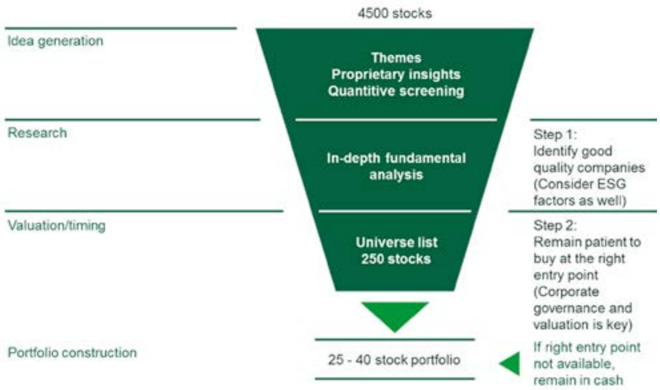
We're also fortunate that inflation is relatively low against our bond yields when compared to the rest of the world. This means that global investors are piling cash into our bond markets resulting in rand strength, creating desirable conditions for SA-based investors to allocate capital to global assets.

The Nedgroup Investments Global Equity Fund managed by sub-investment manager Veritas Asset Management (UK) has a concentrated global equity mandate typically comprising 25 – 40 carefully chosen shares of high quality businesses from around the world. Given the thousands of listed global shares to choose from, this affords the fund managers the opportunity to be extremely selective about which companies to actually include in the portfolio. With a significant emphasis placed on capital preservation, Veritas are able to appropriately diversify and manage risk to produce outstanding long term outperformance.

How do they do it?

All of this would not be possible without the deep fundamental research process that is employed to identify quality and cheapness. The majority of companies that are initially identified as potential candidates are eventually discarded in favour of only the very best ideas for inclusion in the portfolio, which is then constructed in a benchmark agnostic manner. Typically, Veritas closely monitor approximately 250 stocks as part of their universe list.

These are companies that have passed multiple filters and have also made it through their disciplined fundamental process while waiting for the right opportunity to present itself before they can buy in while paying close attention to key factors such as valuation and corporate governance:



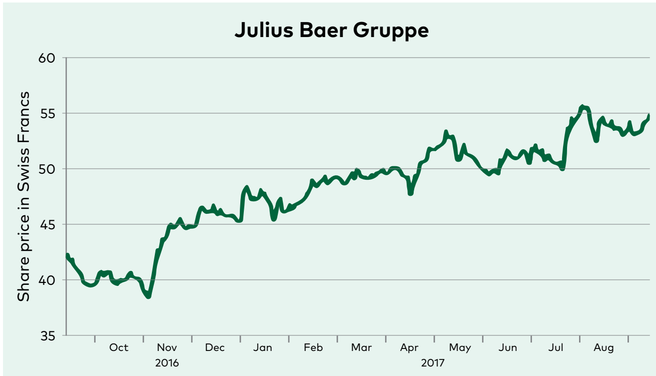
Source: Veritas Asset Management

In fact, the Veritas process is so strictly disciplined that they are willing to allow cash levels to rise in the portfolio rather than invest in companies where they are not fully comfortable with the investment thesis and/or share price valuations. The fund managers would rather be patient to wait for the right opportunities to arise. An example of a recent purchase for the portfolio is Qualcomm, a US-based technology company that holds the key IP to the wireless semiconductor market. The company is also a global leader in semiconductor design. Qualcomm has undertaken a transformational deal to acquire NXP, a leading automotive and industrial semiconductor company. Given the increased usage of smart technology in cars such as self-driving algorithms and other driver assist systems, the deal is seen as a game-changer for the combined business.

Disciplined selling

Another important pillar of alpha generation is their sell discipline. Typically, Veritas look to achieve an absolute return of 15% p.a. over the next 3 – 5 years for a given stock at the time of purchase. This return requirement is increased to 20% p.a. for stocks that are more risky, and decreased to 12% p.a. for stocks that are of the best quality with the most predictable returns, as long as the valuations remain attractive. Stocks are sold when they reach their target intrinsic value, where there is a thesis breach or perhaps even when there is a significantly better opportunity that arises which will enhance the portfolio's characteristics such as expected return and/or diversification.

A recent example of a company that was sold out of the portfolio due to reaching its target price was Julius Baer, the Swiss private banking group. Although Veritas still likes the business itself, the share price has increased significantly and, they believe, now discounts far too optimistic future outcomes based on their assessment of the company's prospects:



Source: Thomson Reuters Datastream

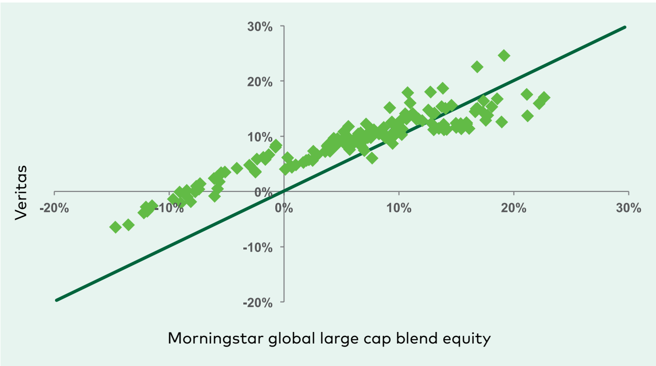
Since November last year the share price has risen from a low of CHF 38 to CHF 55 today. The company remains on their universe list and will continue to be monitored closely for any potential purchasing opportunities that may arise in the future.

Edenred on the other hand is a business that was owned for quite a long period of time within the fund and was sold recently due to a thesis breach. The company previously held significant cash reserves as a function of their operational business, where there would often be a lengthy time lag between the point at which they received upfront payment for their services and when they would actually need to provide these services to their customers.

Due to the low interest rate environment globally, Edenred's management team has been determined to increase ROE by now using these cash reserves for M&A activity. While the strategy could end up being quite profitable for the business, it does hugely increase earnings uncertainty going forward. As a result, Veritas chose to close out the position and remove the company from their universe list going forward.

The end goal: outperformance

Over the long term, this disciplined process has resulted in Veritas being able to outperform their peers by 4% p.a. since inception of the strategy in 2001. Interestingly, an analysis of their return profile over rolling three year periods does indeed show that they tend to lag their peers in upward trending markets, while strongly outperforming when market returns are more tempered:



Source: Morningstar, using rolling three year data since 2001.

On a three year rolling basis they have outperformed their peer group 80% of the time overall. Through their primary focus on downside protection, Veritas have again proved that the long term benefit of capital preservation when markets are falling far outweighs the strategy of trying to produce better performance than peers when markets are sharply rising.

Ultimately, the team at Veritas spend their time looking for companies that have these key characteristics:

- Distinct growth drivers that are independent of economic growth
- A moat to protect future cash generation such as a network that is extremely difficult to replicate despite large capital investments
- High levels of recurring revenues (at least 60% or more)

With their real return mind set and foremost focus on capital preservation, it makes the Nedgroup Investments Global Equity Fund a compelling proposition for investors seeking exposure to global stock markets. This is indeed an important differentiator to its peers.

By following a proven fundamental research process and maintaining their strict valuation discipline to be highly selective before investing in a company ensures that prospects for future outperformance remain very attractive. ■

THE CASE FOR RULES-BASED INVESTING IN A WORLD OF EVER SHRINKING ALPHA

JANNIE LEACH
HEAD OF CORE INVESTMENTS

The increased scrutiny of costs in the financial services industry has seen a big global move towards passive investing.

The increased scrutiny of costs in the financial services industry has seen a big global move towards passive investing. In 2016, over 85% of new net flows into mutual funds (including ETFs) went to passive or rules-based funds. Net flows into rules-based fund at the end of June 2017 were already sitting at over $500bn, close to 60% of the total new flows into mutual funds and ETFs.

Many market commentators have expressed fears that the growth of passive may have a negative impact on price discovery in the future. Currently, passive only makes up 22% of the world's mutual fund industry which is still a drop in the ocean of the total assets invested globally. In the US, which is leading the passive trend, assets managed by investment companies accounted for 31% of US-issued equities outstanding as at the end of 2016 up from 29% in 2013[1]. This means than less than 8% of the US equity market was invested in passive funds.

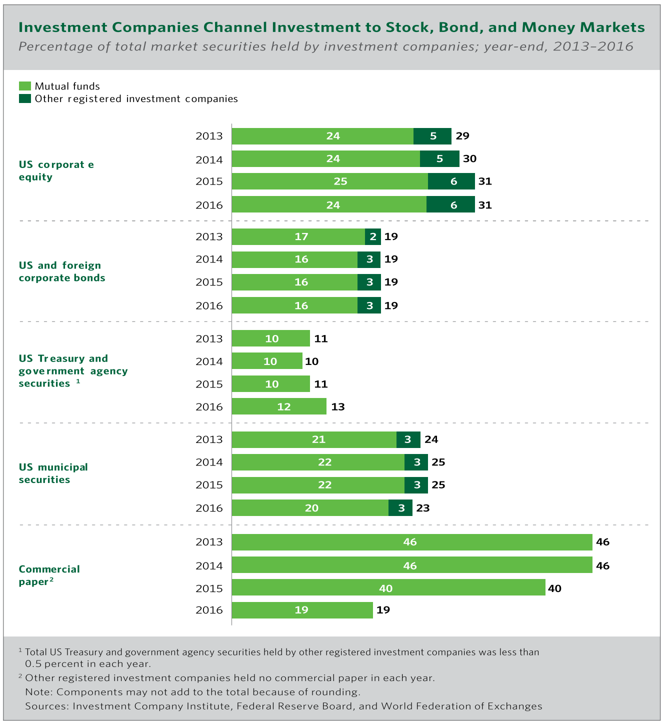
Explaining the shift to passive - A long-term consequence of the move from Defined Benefit to Defined Contribution pension schemes

There are two important trends that have emerged in global markets over the past few decades as a consequence of the move from Defined Benefit (DB) to Defined Contribution (DC) pension schemes.

The first trend, illustrated by the US market figures shown is the steady increase of assets managed by professional asset management firms. For example, the share of household financial assets managed by asset management firms in the US has risen from 8% in 1980 to 22% in 2016, with most of these assets coming from retirement savings via IRAs and 401k plans[1].

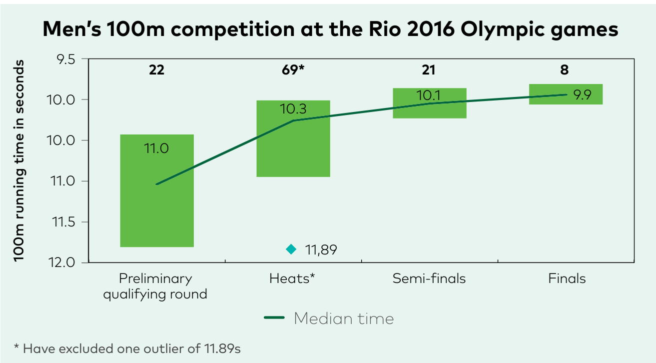
The second trend is that, under the DC world, a big focus was placed on delivering superior returns which provided a competitive environment for asset management firms. This saw the rise of very successful independent asset management firms who have performed well against their peers. The rise of passive investing is a consequence of this continuously evolving competition between active management firms. To

[1] ICI Factbook 2017



understand why this is the case, we need to understand how competition improves absolute skills but ultimately leads to smaller relative difference in skills between the competitors.

Example: Olympic 100m competition
Consider the results of the 100m Men's competition at the 2016 Rio Olympics throughout the difference stages of qualification- summarised in the chart below.

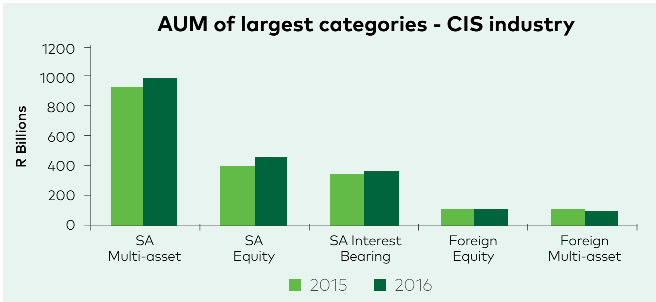


We can clearly see that the times improved as the athletes progressed through the qualifying stages and the competition got tougher. The fastest, slowest and median times improved at each stage until the final result - where the difference between the fastest and slowest times was only 0.25s. The toughness of the competition is illustrated by the steady decrease the time difference between the fastest and slowest times during each stage of the competition, starting at 1.38s and ending at only 0.25%.

There is therefore an improvement of absolute skill levels, measured by the median time, at each stage of the competition. However, there is a commensurate decrease in the relative skill levels of the remaining contestants as measured by the time difference, i.e. the competition gets tougher.

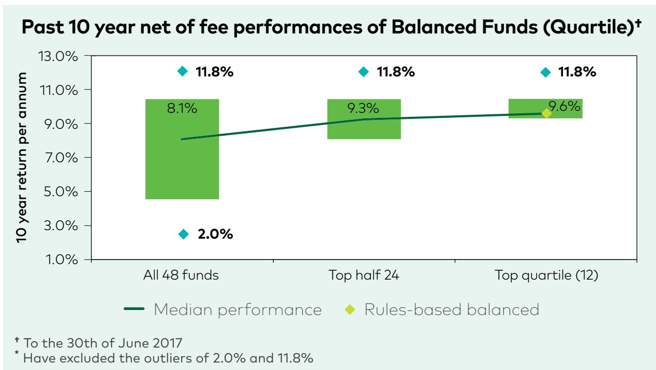
How does this relate to the South African investment industry?
The South African investment industry has evolved similar to the Olympic 100m example. We can identify the winners over the past few decades. We can measure the success of the winners by growth in 3rd party Assets Under Management (AUM) which is usually as a result of investor needs and consistent fund performance over time.

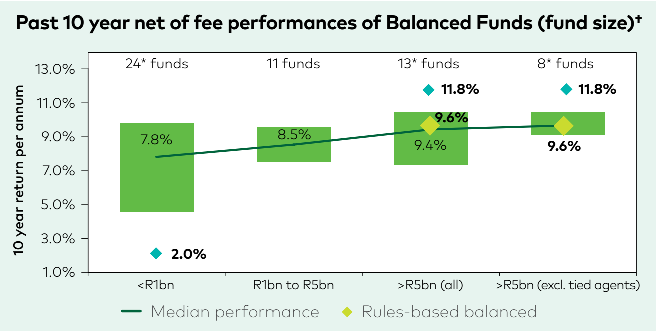
Investor needs over the past decade or so have driven growth in the SA Multi-Asset categories to nearly R1tn in AUM as at the end of 2016. These funds comply with Regulation 28 of the Pension Fund Act and are therefore used for retirement and discretionary savings. More than half of these assets were in traditional balanced funds (SA Multi-Asset High Equity Category).



Source: Nedgroup Investments

Similar to our analysis of the Olympic competition, we can compare the performance results for different performance quartiles and for the different fund sizes over the past decade in the SA Multi-Asset High Equity category. We have summarised the results below.





† To the 30th of June 2017
* Have excluded the outliers of 2.0% and 11.8%

We can see that, similar to our Olympic 100m example, there is an improvement in absolute skills levels as we go from all funds to the top quartile performance. The median annualised performance over 10 years steadily increases from 8.1% to 9.6%. The relative returns across the quartiles also decrease from 2.8% in the bottom quartile to 1.1% in the top quartile (excluding the two outliers).

We see a similar result if we categorise the funds according to their sizes where the median performance steadily increase from 7.8% to 9.4%. Furthermore, if we strip out the funds that draw flows predominantly from in-house tied agents, then the median performance increases to 9.6%. There is a marked decrease in relative performance as we move from funds smaller than R1bn to those greater than R1bn (7.7% versus 4.5%).

There are also a few other interesting observations:

- The two largest funds account for R220bn in AUM and have both outperformed the >R5bn median (9.6%) by 0.6% and 0.8% respectively. Only one more fund, the top performing fund, has meaningfully outperformed the median - while four funds delivered performance close the median. The worst performing fund in this segment underperforming the median by 0.6%.
- The largest eight funds with 10 year track records and not linked to tied agent forces are standalone funds, i.e. non-Fund of Funds (FoFs). Among the smaller funds (<R5bn) there are a further eight funds (all FoFs) which also lie within this performance range (9.1% - 9.8%). That is, a third of the 48 funds have delivered returns above 9.1% pa over ten years.

One of the drivers behind the massive growth in SA Multi–Asset funds was the steady shift from private client segregated portfolio management into holistic financial planning where Independent Financial Advisors (IFAs) selected unit trusts rather than managed portfolios on behalf of clients. This steady move of assets to professionally managed unit trusts has led to tougher competition and therefore partly explains the narrowing of relative returns among the successful managers.

Rules-based investing and the ever shrinking alpha

One of the main reasons for passive investing becoming so attractive for investors is the "shrinking alpha"[2] as a result of tougher competition among active managers. As the absolute outcomes for investors have improved, the relative differences between fund managers have narrowed. This has occurred to such extent that fees play an important role on who generates the highest net of fee return for investors.

In South Africa, where the greatest growth has been in the SA Multi-Asset categories, we are likely to see rules-based[3] funds benefiting from the tough competition between active balanced funds. For example, we can broadly calculate the return for the Nedgroup Investments Core Diversified Fund over the 10 year period used in the analysis above. Our calculations indicate that the fund would have delivered a similar return to the median performance for >5bn group (excluding tied agents) which is in line with the research on South African and Global Equity funds[4]. In other words, only the funds in the top decile would have meaningfully outperformed over this period, ie by more than 0.5% per annum.

The technological tailwinds for rules-based investing

The rise of rules-based investing in South Africa comes at a time when the active management industry has matured. This means that rules-based investments will likely benefit proportionally more than active investing from the long term structural trend towards greater use of retail funds managed by professional asset managers. This will not only include retirement assets but will also include private client share portfolios, which is likely to come under pressure from the implementation of the Retail Distribution Reforms (RDR).

The digital revolution that we are currently experiencing will also be a major tailwind for rules-based investing. The rise of digital or robo-advisors will be ideally suited to rules-based strategies which offer low cost and a greater degree of certainty in achieving return objectives. The investment market is also likely to become even more efficient with the focus on big data analytics, machine learning and artificial intelligence.

These trends do not mean that it is all doom and gloom for active management - but there is little doubt that it will become harder for them to compete. Active managers will have to pick "attractive games"[5] where they can add value. Similarly, competition between rules-based managers will be fierce and managers will have to differentiate themselves by understanding their clients' needs and running focussed business that can deliver on those needs. ■

[2] Matthew De Wet, The incredible shrinking 'alpha', Newsletter Q4 2014
[3] Rules-based investing is the umbrella term we use to describe traditional market cap passive investments, quantitative strategies such as smart beta and multi-asset passive balanced funds.
[4] We have used a back tested return series prior to the funds launch in September 2009 based on the fund's composite benchmark. This series includes fees and frictional costs assumptions from our experience in implementing the Nedgroup Investments Core Diversified fund.
[5] Mauboussin and Callahan, Alpha and the paradox of skill, Credit Suisse 2013.

HOW TECH IS CHANGING THE BUSINESS OF INVESTING

DONNA BARNES
HEAD OF INVESTOR CHANNEL

Technology has a profound impact on our lives. What impact will the emergence of 'fintech' - and even more so, 'invest-tech' have?

Technology has a profound impact on almost every aspect of our lives – and there is no doubt that it will continue to do so. We have become increasingly reliant on technology in our daily lives, particularly when it comes to some of the most challenging and complex decisions. Whether we're using an app or website to source information, conduct daily transactions or for some, even find a partner, it's become increasingly common that we rely on technology for several of the most challenging and uncertain and complex decisions in our lives.

A trend over the past five years and arguably the real big game changer is financial technology or 'fintech' – the use of technology in the financial services sector. More and more, fintech has come to represent small and agile start-up businesses using technologies to disrupt traditional business. We have already seen big disruptions in areas such as mobile payments, money transfers, loans, fundraising and asset management – most notably across three broad areas - increased access to services, reduction in barriers to open and downward pressure on fees.

Take for instance the evolution in share trading over the past decade. While previously reserved for only experienced stock exchange traders, today investors can search the web to see which brokerage company has the lowest transaction fees and buy and sell shares themselves at the click of a button.

Not only is this information easily accessible but it is also available at a fraction of the cost thanks to the advances in online investing which has pushed a dramatic decline in broker commissions and trade fees.

Digging deeper into the tech realm of investing, we are seeing the emergence of 'invest-tech', a sub-set of fintech as we know it. Ashby Monk* describes invest-tech as the technologies that help investors raise their expected risk-adjusted net return, get their risks and costs in order, and ultimately provide investors with a better opportunity set.

* ASHBY MONK, Executive and Research Director, Stanford Global Projects Center -2016 CFA Institute Annual Conference 10 May 2016 Montréal http://mmd.cfainstitute.org/pdf/transcripts/2016/how_technology_will_change_the_business_of_investing.pdf

The rise of the robo-advisor

One of the biggest innovations of the past ten years in this space has been the advent of the robo- advisor. First to market in the US and more recently in South Africa, these companies employ artificial intelligence (AI) techniques to create automated investment portfolios based on the characteristics of investors. In other words, bringing the advice of an advisor and the full expertise of an investment manager online. Most robo-advisors invest in low-cost ETFs or passive funds, removing or augmenting the online experience with human interaction and drastically lowering the cost of investing.

More and more investors are choosing the DIY route to invest and seeking other avenues of financial advice. According to an iQuantifi survey done in April 2015, only 29% of young workers have looked to professionals for advice, while 71% asked family members and 45% turned to friends.

So these products have been aimed at providing investment services to those that potentially know very little, or nothing, about the market. They do not have the time or expertise to pick stocks or funds by themselves and only want to invest their money in a diversified portfolio that meets their long term goals. This requires low effort on the part of the investor who is benefitting from high automation built into the robo-advisor.

Still room for human advice and guidance

While robo-advisors can provide real benefits for the investor such as ease of use, convenience, lower fees and the transparency that investing directly offers, the value of an advisor should never be underestimated. Robo-advisors only see a snapshot of the investors' circumstances. There are still some concerns about a robo's ability to accurately determine risk tolerance, other assets, residency status, emigration plans, tax planning and estate planning that already may be in place, and the impact of the investor's marital status and dependants. If the benefit of paying no advice fees outweighs the risk of not getting totally holistic advice then a robo-advisor could work to the investor's benefit. However, the deep understanding of an investor's complete financial situation that the very good financial advisors have should never be overlooked by investors.

What does the future look like?

The next emerging stage for technology in investments is responsive artificial intelligence (AI). This is where the computer understands an investor's situation and starts to offer concrete short-term and long-term advice to improve an investor's financial planning. This is already underway in the investment industry where technology is currently being developed to apply all the data available about an investor to their financial plan.

Responsive AI gleans information from Facebook posts, tweets, pins on Pinterest, spending habits or investment choices and finds patterns to customise a financial plan and investment strategy for a specific investor. The intention is to produce smarter technologies that can actually "think", analyse data and make suggestions, predictions and decisions based on all the available knowledge. And the implementation of these advancements is already here.

For example, global asset manager, BlackRock is already directing its quantitative research toward machine learning and exploiting social media and web search information to develop passive strategies that give investors exposure to specific return factors.

AI and the investor

AI can also help improve efficiency for the investor. Investment chatbots enable investors to communicate and transact on investments in much the same way that they would on other messaging apps such as Facebook and Whatsapp - offering complete familiarity and convenience. This helps to break down some of the traditional barriers (like having to meet someone face to face or call someone) to access investment information.

As it should, technology will continue to improve and is going to help us collect and manage data and information in new ways, mobilise it and turn it into actionable knowledge. Investing will be no different. How much understanding and insight can we get from these technology advancements and data and convert it into investment actions and decisions will change dramatically over the next decade.

While the possibilities for improvement in investments is exciting, for now, these technologies should be seen primarily as an assistant to investment and advisory professionals, helping them to deliver better solutions to investors. Although AI can help process and gather a lot more data, when it comes to making judgement decisions, the human touch remains superior. Although improvement in AI processing and learning will accelerate in the next few years, AI still has a long way to go to replace human understanding in the investment world. ■

LEGISLATION CHANGES AND RETIREMENT FUNDS

DENVER KESWELL
SENIOR LEGAL ADVISOR

A look at some of the recent changes as well as some of the proposed changes that will have an impact on the retirement fund industry.

1. **Final Default Fund Regulations released:**
   On the 25 August 2017 the Minister of Finance issued the final Default Fund Regulations. The regulation aims to provide retirement fund members with appropriate pre and post retirement solutions that are more cost effective than current solutions. The regulations require every retirement fund in South Africa, where membership is determined by a condition of employment, to have a default investment portfolio and preservation fund. If a member is unable to elect an investment portfolio then the retirement fund must default the member into a regulated default fund. When a member leaves a participating employer, the member's benefits are preserved by the fund and the member becomes a "paid-up" member. In both scenarios the member is entitled to "opt-out" and either select their own investment portfolio after becoming a member or transfer their benefit after leaving the participating employer. The third provision that the regulations require is for all retirement funds (including retail funds) to provide their retiring members with a default annuity strategy. The strategy can be made up of a living annuity, traditional (guaranteed) annuity or a combination of the two.

   The effective date for the regulations was 1 September 2017. Retirement funds that already have (unregulated) default funds in place were given a grace period of up until 1 March 2019 to comply with the regulations. Retirement Funds without default funds were not however given the same grace period. On the 30 August this year, the FSB issued Practice Note 3 of 17 which exempted all funds registered before 1 March 2018 from complying with the regulations before 1 March 2019.

   Another interesting amendment from the second draft of the regulations, is that Section 39(3)(a) of the Pension Funds Act has changed its requirement that a living annuity's drawdown levels must be compliant with an *accepted industry standard* to a *prescribed standard*. This means that a standard needs to be provided to retirement funds in order for trustees to monitor and inform members invested in a default living annuity if their income drawn is deemed to be unsustainable.

2. **Transfer into a Retirement Fund after you retire from employment.**
In 2014, legislation changes allowed a retirement fund member to retire from employment but postpone retirement from the retirement fund itself. This allowed retirement fund members to keep their retirement fund benefits with the retirement fund after their normal retirement date, thereby only accessing their benefits when they needed them. In order for the member to have this option however funds would need to amend their rules to make provision for this. It is understood that some funds were reluctant to amend their rules to accommodate this as they did not want to deal with the administration of "inactive" members. This reluctance eradicates the benefit for members who want to "preserve" their benefits after they retire from employment.

   In the **2017 Taxation Laws Amendment Bill**, National Treasury has therefore proposed allowing members to transfer their retirement fund benefits to an RA even after they retire from employment. It was noted that transfers to preservation funds were not accommodated and the assumption was that this was because a preservation fund allows one withdrawal which would simply bypass the annuitisation rule. On the **14 September 2017** Treasury issued the "**Draft Response Document on Taxation Laws Amendment Bill, 2017**" in which they proposed allowing transfers to preservation funds subject to the amendment of the Income Tax Act, to ensure that transfers made to these funds after the normal retirement date cannot be withdrawn in the same manner as other transfers to preservations funds. This has the added benefit of allowing a member to consolidate their retirement benefits with their other investments. The proposed date for this change is the 21 March 2018.

3. **Postponement of Annuitisation.**
The proposed changes - to force members to annuitise two thirds of their fund benefits at retirement – has once again been postponed until 1 March 2019. This proposal would only apply to contributions made to a provident fund after the implementation date. What's interesting though is that provident fund members continue to benefit from the tax deduction allowed for pension and retirement annuity funds which was harmonised in 2016. The reason provided for the postponement is to allow the Minister of Finance to consult with stakeholders such as NEDLAC.

4. **Social Security and Retirement Reform**
In a paper released late last year government indicated that it plans on introducing a National Social Security Fund (NSSF). The funds purpose will be to provide a low cost, equitable vehicle for the provision of basic risk and retirement savings benefits. The NSSF aims to protect income earners through the provision of basic retirement, unemployment, death and disability benefits. Contributions for all workers will be mandatory to the NSSF up to a certain threshold (currently earnings up to around R150 000 per year) at a contribution rate of 12%. Government has indicated that there will be subsidisation for low income earners. Any contributions over and above the threshold can be made to a group or individual retirement fund solution. This tier is pretty much in line with the current employment retirement fund system in South Africa. ■

THE OTHER SET OF NUMBERS

JP LANDMAN
POLITICAL ANALYST

The old saying says, "demography is destiny". Stats SA's fifteen-year population figures review reveals 3 very important drivers to watch - fertility, migration and mortality.

The numbers occupying centre stage at the moment are which candidates are nominated by how many branches in the ANC leadership contest. That can tell us what will happen in December at the ANC's elective conference. But, we will have to be patient and wait until the end of October for those numbers to emerge.

In the meantime, however, we can take a breather from politics and look at a different set of numbers: basic demographic data. That is arguably as important for our future as the nomination numbers. As the old saying goes, "demography is destiny".

Stats SA recently released the annual mid-year population estimates. What makes this year's estimate particularly interesting is that it includes a 15-year review – from 2002 to 2017 – of all available data on fertility rates. Fertility is the most important driver of population growth, so getting that number right is important. The other two drivers are migration and mortality.

Fertility

The number of children per woman in 2017 came to 2.41. Ten years ago in 2007 it was 2.73. Looking back further to the 1970s, it was 5.8. In the 1950s it was 6.4! (Very few women today would have 6 and more children!) So the decline in fertility since the 1950s and even 1970s has been truly significant.

In 2003 the global replacement level at which a population will remain constant was about 2.33 (it varies between developed and developing countries). So at 2.41 SA is not far away from the replacement level of fertility.
(So much then for the argument that social grants encourage more births – fertility has declined despite the introduction and massive expansion of social grants.)

Urbanisation, access to basic education and medical services, access to the labour market and changing perceptions about women, work and their place in society all play a role in determining fertility.

Mortality
The second driver of population growth is mortality.

The infant mortality rate has declined from 48.1 per 1 000 children under the age of one year in 2002 to 32.8 in 2017 – an improvement of more than 30%.

The under-5 mortality rate has declined from 71.3 per 1 000 in 2002 to 42.4 in 2017 – an improvement of 40%. The crude death rate decreased from 13.4 per 1 000 in 2002 to 9 – an improvement of almost 33%. Collectively these are significant decreases in mortality.

These improvements are an indication that despite the public health system creaking under the load of numbers, inefficiency and corruption, significant progress have been achieved.

Life expectancy
As a result of lower mortality, life expectancy has increased from an average of 55 years (53 for males and 57 for females) in 2002 to 64 years now (61 for males and 67 for females).

The corollary of the success of programs to prevent mother-to-child transmission and promote access to antiretroviral treatment, is that the proportion of the population living with Aids increased to 12.6% of the population from 10.9% in 2002. People live longer. The total number of people with HIV is now estimated to be just over 7 million.

Migration
The third driver of demography is migration. Stats SA assumes a net migration into the country of more than two hundred thousand people per year – or about one person every 2.6 minutes. Back in the 1990s there was one immigrant only every 21 minutes. SA is an attractive destination for particularly Black African, but also Indian immigrants. Many skilled and unskilled people from Zimbabwe, Nigeria, East Africa and elsewhere have moved to SA. Emigration, in contrast, is largely by Whites.

Population growth
The upshot of all the above is that in 2017 population growth is estimated to be 1.61%.

This is sharply down on the 2.5% p.a. recorded over the 50 years between the Second World War and the first census of democratic SA in 1996. If we go further back, to the first census of the Union of SA in 1911, population growth over the 106 years since then averaged 2.14% p.a. So the current 1.61% is a substantially lower than we had in the past.

(If the differences seem small and you think I am just splitting hairs: R100 invested in 1911 at 2.14% would now be R946 – invested at 1.61% it would only be R544, a difference of 74%! Ditto population growth. Small differences compound.)

As far as population growth goes, SA has indeed made the transition from a developing to a developed country.

Demographic transition and dividend
The combination of lower fertility and declining mortality is known as the "demographic transition". SA has now clearly experienced that.

Everything else being equal the "transition" should result in a "demographic dividend". The age structure of the population changes and there are more working age people that can "carry" the non-working age people; or in the jargon, there are fewer dependants per income earner. Higher consumption and investment then become possible, leading to higher economic growth.

The working age people can of course only carry the non-working age people if they indeed have some income. That is the trick. There is a misconception amongst some that the mere presence of a large youth cohort in the population automatically constitutes a demographic dividend and higher growth. Common sense tells one that cannot be correct. It is only a dividend if that youth cohort can earn a living. Otherwise it is more a demographic time bomb.

Reaping the dividend
The 1.61% population growth creates a window of opportunity for SA. Growth only needs to be about 2.8% per year to increase incomes by 1.2% a year – the number at which SA has increased per capita income for 70 years. Yet since 2014 economic growth only averaged 1.1% p.a. and per capita income is now 1.1% lower than 3 years ago. So, no dividend.

It should be no surprise then that Stats SA's poverty report reveals that the percentage of citizens living in poverty increased from 53.2% in 2011 to 55.5% in 2015; that is 3.1 million more people now living in poverty. (The 55.5% is still a meaningful improvement on 2006 when 66.6% of the population lived in poverty.) But the deterioration since 2011 confirms that there has been no dividend.

It is all about politics
Economic growth would have to be returned to 3% and more to capitalise on the demographic transition and generate a dividend. That in turn depends very much on

politics and brings us full circle back to how the ANC branches will nominate and who will get elected in December!

So what?

- Demography is driven by fertility, mortality and migration.
- Fertility has declined to 2.43 children per female – not far above the 2.33 replacement level.
- Mortality has improved substantially and so has life expectancy, from 55 to 64 years.
- Population growth is now down to 1.61% p.a.
- Between lower fertility and mortality, SA has undergone a demographic transition.
- However, the much vaunted demographic dividend that should flow from a transition has so far escaped the country because growth is too low and unemployment too high. In fact, poverty has worsened.
- Getting the economy growing sufficiently again will require a substantial change and re-focusing in our politics.

Addendum

The mid-year population review also gives the population per province. It is interesting to compare that with the ANC provincial membership numbers on which the Policy Conference was constituted in July this year. The divergences are striking. (Cautionary: audits of provincial membership numbers in KZN, the Eastern Cape and Western Cape have not yet been completed.)

Province	Percentage of SA population	Percentage of ANC members
Gauteng	25.3%	10.76%
KwaZulu Natal (KZN)	19.6%	21.35%
Eastern Cape	11.5%	16.22%
Western Cape	11.5%	5.87%
Limpopo	10.2%	11.41%
Mpumalanga	7.9%	12.39%
North West	6.8%	10.23%
Free State	5.1%	7.58%
Northern Cape	2.1%	4.20%
Total	100%	100%

According to the mid-year review, Gauteng and the Western Cape will experience the biggest inward migration flows over five years, 1.0 million and 309 000 people respectively; followed by North West with inward migration of 110 000.

KZN is expected to have a net outward migration of more than 500 000, followed by the Eastern Cape with 324 000 and Limpopo with 139 000, also over five years.

Clearly the balance of power will change over the next five years. ■

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NEDGROUP INVESTMENTS UNIT TRUST PORTFOLIOS

UNIT TRUST PORTFOLIO	INVESTMENT MANAGER	RISK	BENCHMARK	MINIMUM RECOMMENDED TERM
Income unit trust portfolios: aim to provide investors with high levels of income (at low levels of capital volatility), by investing primarily in fixed income asset classes. These portfolios are often appropriate for investors with shorter investment horizons.				
Nedgroup Investments Money Market Fund	Taquanta Asset Managers	1	STeFI Call Rate	None
Nedgroup Investments Core Income Fund*	Taquanta Asset Managers	1	STeFI Composite	6 months
Nedgroup Investments Flexible Income Fund	Abax Investments	1	110% STeFI Call Rate	6 months
Nedgroup Investments Core Bond Fund	Taquanta Asset Managers	2	Beassa All Bond Index (ALBI)	2 years
Nedgroup Investments Property Fund	Bridge Fund Managers	4	South African Real Estate General Unit Trust Mean	5 years
Asset allocation unit trust portfolios: aim to provide investors with moderate levels of income and capital growth (at moderate levels of capital volatility), by investing in a range of different asset classes. These portfolios are often appropriate for clients with medium to longer investment horizons.				
Nedgroup Investments Balanced Fund	Truffle Asset Management	3	ASISA Category Average	3 - 5 years
Nedgroup Investments Stable Fund*	Foord Asset Management	2	Inflation +4% pa over rolling 3-year periods	3 years
Nedgroup Investments Opportunity Fund*	Abax Investments	3	Inflation +5% pa over rolling 3-year periods	3 - 5 years
Nedgroup Investments Managed Fund*	Truffle Asset Management	3	South African Multi Asset High Equity Unit Trust Mean	3 - 5 years
Nedgroup Investments Bravata Worldwide Flexible Fund	Aylett & Co Asset Management	3	Inflation +5% pa over rolling 3-year periods	3 - 5 years
Equity unit trust portfolios: aim to provide investors with high levels of capital growth (at high levels of capital volatility) by investing in listed equities. These portfolios are often appropriate for investors with longer investment horizons.				
Nedgroup Investments Rainmaker Fund	Abax Investments	4	South African Equity General Unit Trust Mean	5 - 7 years
Nedgroup Investments Value Fund	Foord Asset Management	4	South African Equity General Unit Trust Mean	5 - 7 years
Nedgroup Investments Growth Fund	Electus	4	South African Equity General Unit Trust Mean	5 - 7 years
Nedgroup Investments Private Wealth Equity Fund	Nedgroup Investment Advisors	4	FTSE/JSE SWIX40	5 - 7 years
Specialist equity unit trust portfolios: are equity portfolios that are invested according to a specific sector or theme. They tend to display higher levels of price volatility.				
Nedgroup Investments Entrepreneur Fund	Abax Investments	5	South African Equity Mid and Small Cap Unit Trust Mean	5 - 7 years
Nedgroup Investments Mining & Resource Fund	Prudential Portfolio Managers	5	South African Equity Resources Unit Trust Mean	5 - 7 years
Nedgroup Investments Financials Fund	Denker Capital (a division of Sanlam Investment Mngt.)	5	South African Equity Financial Unit Trust Mean	5 - 7 years
International unit trust portfolios: if you wish to have exposure to offshore investment opportunities, you may consider the following range of rand-denominated unit trust portfolios that provide this exposure for lower minimum investments and without the hassle of having to apply for foreign exchange control approval.				
Nedgroup Investments Global Cautious Feeder Fund	Chartwell Investment Partners	3	USD Libor 1 month (rand equivalent)	3 - 5 years
Nedgroup Investments Global Flexible Feeder Fund	First Pacific Advisors	3	Global Multi Asset Flexible Unit Trust Mean	3 - 5 years
Nedgroup Investments Global Property Feeder Fund	Resolution Capital	4	Global Real Estate General Unit Trust Mean	5 - 7 years
Nedgroup Investments Global Equity Feeder Fund	Veritas Asset Management	4	Global Equity General Unit Trust Mean	5 - 7 years
Core unit trust portfolios: aim to provide low-cost exposure to a range of local and global asset classes. You may use these as a low-cost core holding or use them to implement your entire strategy.				
Nedgroup Investments Core Guarded Fund*	Taquanta Asset Managers	2	Inflation +3% pa over rolling 3-year periods	3 years
Nedgroup Investments Core Diversified Fund*	Taquanta Asset Managers	3	Inflation +5% pa over rolling 5-year periods	3 - 5 years
Nedgroup Investments Core Global Feeder Fund	BlackRock Investment Management	4	Global Multi Asset High Equity Trust Mean	3 - 5 years
Nedgroup Investments Core Accelerated Fund*	Taquanta Asset Managers	4	Inflation + 6% pa over rolling 7-year periods	5 - 7 years

1 = Low, 2 = Low to medium, 3 = Medium, 4 = Medium to high, 5 = High | *Comply with Regulation 28 of the Pension Funds Act

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Nedgroup Investment Advisors Proprietary Limited (Company registration number 1998/017581/07) an authorised Financial Services Provider (FSP number 1652)
Sponsor of the Nedgroup Investments Retirement Funds

Nedbank Clocktower Clocktower Precinct V&A Waterfront Cape Town 8001
PO Box 1510 Cape Town 8000 South Africa
www.nedgroupinvestments.co.za
Directors: I Ruggiero, NA Andrew, CE Sevenoaks

Contact us

FUNDS DOMICILED IN SOUTH AFRICA

Phone	0860 123 263 if you call from South Africa +27 21 416 6011 if you call from another country
Fax	0861 119 733 if you send it from South Africa +27 11 263 6067 if you send it from another country
Email	clientservices@nedgroupinvestments.co.za
Write to us	PO Box 1510, Cape Town, 8000

FUNDS DOMICILED IN IRELAND

Phone	0800 999 160 if you call from South Africa (toll free) +44 (0)1624 645150 if you call from another country
Fax	+44 (0) 1624 670630
Email	helpdesk@nedgroupinvestments.com
Write to us	1st Floor, Samuel Harris House, St George's Street, Douglas, Isle of Man, IM1 1AJ, British Isles

nedgroupinvestments.com