NEDGROUP INVESTMENTS

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NEDGROUP INVESTMENTS OPPORTUNITY FUND

Quarter Three, 2019

For the period ended 30 September 2019

Performance to 30 September 2019	Nedgroup Investments Opportunity Fund[1]	ASISA multi-asset medium equity category average	FTSE/JSE ALSI
3 months	1.1%	0.5%	-4.6%
12 months	8.0%	3.3%	1.9%

Market Commentary

The third quarter of 2019 saw a depreciation in local risk assets as the market experienced continued trade tensions, concerns around slowing global growth and weakening local investment fundamentals. The FTSE/JSE All Share Index delivered a return of -4.6%. The property sector continued its negative trend delivering -4.4%. The rand depreciated by 7% over the quarter. Developed market equities posted marginal gains, as central banks remained supportive. The S&P appreciated 1.7%.

Portfolio Commentary

The Nedgroup Investments Opportunity Fund was 1.1% higher over the quarter, which was ahead of the peer-group return of 0.5%. Year-to-date, the fund is up 11.5% versus 7.3% for the peers and CPI inflation of 3.2%.

The fund's top five performing positions for the quarter added +3.3% to our return while the bottom five detracted -2.9%.

Winners	Ave.weight	Total Return	Performance contribution	Losers	Ave.weight	Total Return	Performance Contribution
Impala Convert	6.5%	31%	1.7%	Sasol	2.1%	-28%	-1.5%
Naspers	6.8%	10%	0.7%	Sappi	1.1%	-32%	-0.6%
RBP Convert	3.3%	11%	0.4%	Standard Bank	3.3%	-9%	-0.3%
Zambezi Pref	3.5%	5%	0.3%	Exxaro	0.9%	-24%	-0.3%
DRD Gold	0.4%	63%	0.2%	Merafe	1.0%	-20%	-0.2%
			3.3%				**-2.9%**

Contributors

The largest contributors to returns over the quarter included the two platinum convertible bonds (Impala and Royal Bafokeng), which collectively account for 10% of the portfolio, and together added 2.0% to performance. Even though the share prices of the platinum companies have moved up strongly of late, at current spot prices they are generating immense amounts of cash and appear cheap. However, should there be any reversal in the PGM prices (or a materially stronger ZAR), it is likely that the strong momentum will reverse. But for now, we remain comfortable with our holdings in the convertible bonds, especially the Royal Bafokeng Bond which is just into the money and therefore has limited downside. The Impala convert, in contrast, is now deep in the money and we will be exposed to downside should the company's share price re-trace. The bond does, however, provide us some additional margin of safety over the underlying share, as it is currently conservatively valued relative to the share price and has a 3% higher yield than the shares.

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

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We have been rebalancing the portfolio by locking in some of our gains in the Impala convertible bond to prevent our exposure growing as the price has risen.

One of the most significant events in the quarter was the spin-off of Prosus from Naspers. The transaction, which follows the unbundling of MultiChoice, had been widely anticipated for some time as Naspers has looked to realise value for the assets in the group. Prosus comprises the international internet assets of Naspers and is listed on Euronext Amsterdam with a secondary inward listing on the Main Board of the JSE. With assets valued in excess of US$100bn, Prosus ranks among the top 10 consumer internet companies globally. The Prosus transaction removes a technical overhang, lowers friction costs for investors and the inclusion of Prosus into major developed market indices should create incremental demand from active and passive funds. Over time, it is anticipated to partially address the Naspers/Tencent discount thereby creating more value for shareholders, although the extent of this unlock is in our view, unlikely to be nearly as significant as management expects.

Another, albeit smaller contributor to returns over the quarter was our holding in British American Tobacco (0.6% of the portfolio, up 13.9% over the quarter). Of interest is that the U.S. Food and Drug Administration (FDA) has strengthened its warning to consumers to stop using vaping products containing THC (which is derived from cannabis) amid more than 1,000 reports of lung injuries (including some resulting in deaths) following the use of vaping products. It seems to be that this black-market cannabis oil (often imported from the Far East) has been contaminated with ‘other’ additives. This oil is then introduced into the vaping devices themselves which may also be illegal. Although none of these factors apply to British American Tobacco or Philip Morris devices (which are legal, do not offer THC options, and use an internal system were the quality of the vaping liquid is carefully controlled) it is likely that the assumption that vaping is ‘less harmful’ than combustible tobacco will be vigorously tested by the FDA. This emphasizes the importance of the May 2020 deadline for the application for vaping products to be considered for formal approval by the FDA. This process is likely to be to the benefit of big tobacco as they have the product and resources to pass that hurdle.

Detractors

The clear detractors to our performance have been our positions in Sappi and Sasol (collectively detracted 2.1% from performance over the quarter). The performance of both shares has been very disappointing, and for contrasting reasons, but we believe both remain oversold at current levels. In Sasol’s case, the mis-steps have been internal, with continual upward revisions to the Lake Charles Chemicals Project (LCCP) capital cost estimates and commissioning delays obfuscating the investment case just as oil prices came under increased pressure. The LCCP remains a major disappointment for the market, and it has raised serious questions about governance and internal control processes within the company, subject to the findings of a board review currently underway. Alongside the completion of this report, the company has twice delayed the release of its 2019 financial results. We expect Sasol to release results by the end of October, concurrently with the LCCP board review, which will hopefully clear the air somewhat, allowing investors to focus once more on fundamentals. We continue to think the LCCP is worth almost half the current value of Sasol, its commissioning is underway, and it will eventually contribute around a quarter of total Sasol profits. In the meantime, at record lows relative to the rand price of oil and long run P/E and P/B multiples, the shares are attracting a substantial credibility discount.

In contrast, Sappi’s performance relates to external, macro factors outside of its control. As a result of US-China tariffs and concerns about trade wars, China has not been buying paper pulp (for graphic paper and packaging) or dissolving wood pulp (for viscose and textile production) at the same rate it did last year. This has impacted trade flows around the world and acted as a real drag on pricing, forcing Sappi to consider taking capacity out temporarily or permanently. As is the case for Sasol, investors have grown increasingly concerned about the company’s balance sheet, although we don’t share these concerns unless prices fall significantly further from spot levels.

While it’s hard to see any real upside to Sappi’s share price over the next six to twelve months as the market adopts a wait-and-see approach, we don’t expect much downside from current levels as we believe valuations

already discount recessionary conditions for the company. On a medium-term view, we think Sappi shares offer material upside.

Current positioning and outlook

We currently have little fixed income duration in the fund, despite the real yields offered on bonds being attractive. We estimate the South African budget deficit to be in the region of 6%, a staggering miss from Treasury's targeted 4.5%. This implies a debt to GDP ratio of approximately 60% in FY 2019/2020. South Africa has experienced a 30% increase in debt to GDP over the past 10 years – second only to Argentina amongst EM peers when monitoring the pace of debt accumulation. The direction of this debt trajectory depends predominantly on two key variables, firstly growth, and secondly further commitments to SOEs. The IMF marks a debt to GDP ratio of more than 70% for emerging markets as breaching the critical debt threshold, beyond which debt sustainability is put at high risk. This illustrates how imperative it is for a credible budget to be presented, the Eskom issue to be dealt with and reforms for growth and expenditure management to be implemented with resolve.

Rather than taking on duration to boost income, we are finding some interesting high yield opportunities within the floating rate credit bond, preference share and property markets. The 30%-odd allocation to fixed income instruments / hybrids is currently yielding close to 9.5% p.a.*, which is higher than that of South African government bonds, is more diversified, and has the potential to grow in time (as opposed to the fixed coupons of government bonds).

There is much talk about the fact that the global equity bull market is long-in-the-tooth. The more sobering reality is that the strong performance of the MSCI has been driven by a few stocks listed in a few sectors (technology, consumer staples and healthcare), mainly in the US. In comparison, emerging markets, European, UK and Japanese markets have been material laggards, and appear attractively valued.

In South Africa, for instance, 60% of stocks are below their levels of 5 years ago. Against this backdrop, equity valuations are compelling - the JSE Top 100 (ex-Naspers) is now trading on a forward P/E of approximately 10x - a massive de-rating since its peak in October 2015 at 14x. There are also a significant number of stocks outside the Top 40 with P/E's of less than 8X and dividend yields greater than 5%. While growth driven by a robust economy is not expected in the next two years, our research is focused on businesses we believe can grow their profits notwithstanding the unsupportive trading environment. The combination of cheap valuations and depressed earnings expectations implies the prospect of better returns ahead, although it is likely that our patience will continue to be tested, as it is difficult to imagine the economy (or sentiment for that matter) improving in the short term. Off this base we feel the upside outweighs the downside and have been adding equity exposure opportunistically.

The fund currently has a low exposure to a diversified pool of domestic property assets. We increased our exposure slightly during the quarter, buying opportunistically into share price dips. Given the diminished growth prospect of this sector, we are being selective. Although yields look optically cheap it's important to note how low growth is and strip any false yield-enhancing mechanisms when assessing the fair value of these assets. Our exposure to property remains on the low side.

**Assumes offshore fixed income hedged into ZAR*

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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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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