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Quarterly review

Nedgroup Investments Core Diversified Fund

As at 31 March 2022

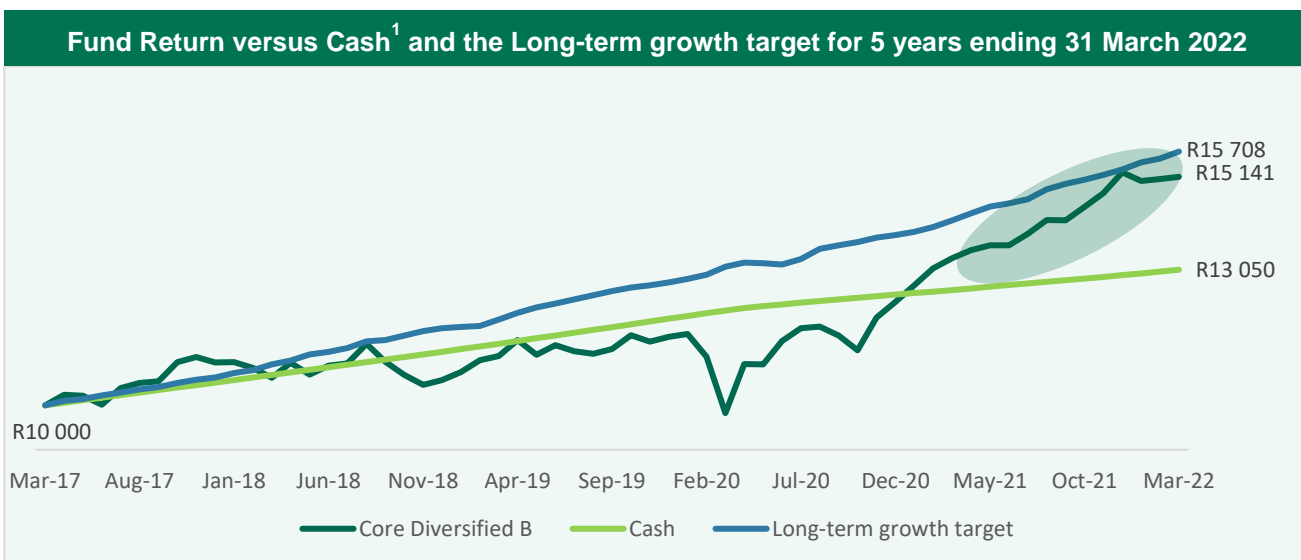


The Russia-Ukraine war dominated headlines over the month

The raging conflict between Russia and Ukraine and the imposition of unprecedented levels of sanctions on Russia by the western nations have cast fresh uncertainty on global growth which was steadily recovering from the scars of the pandemic. The amplified hostilities between the two nations have resulted in a sharp rise in price of certain commodities such as crude oil, gas, wheat, fertilizers, coal etc. amid the creation of global supply-chain shock. What it means for a portfolio is that we likely to see further pricing pressure across the commodity chain and the risks to growth. The Nedgroup Investments Core Diversified Fund mildly declined by -0.6% over the quarter.

The table below compares an investment in Nedgroup Investments Core Diversified Fund to a bank deposit (cash) investment and its growth target over various time periods. For every R10 000 invested in the Nedgroup Investments Core Diversified Fund five years ago, you would have R15 141 at 31 March 2022. This slightly higher than the R13 050 you would have achieved had you invested your money in bank deposits (cash) over the same period. The green circle in the chart below, highlights the recent market recovery, which helps to contextualise the returns experienced over the past few years.

Value of R10,000 investment in Nedgroup Investment Core Diversified Fund versus Cash ¹ and the Growth target						
	3 Months	1 Year	3 Years	5 Years	7 Years	Inception 31 August 2009
Growth of fund (after fees) (Growth in %)	R9 936 -0.6%	R11 374 13.7%	R13 633 10.9% p.a.	R15 141 8.7% p.a.	R16 308 7.2% p.a.	R36 694 10.9% p.a.
Growth of cash (Growth in %)	R10 095 0.9%	R10 362 3.6%	R11 463 4.7% p.a.	R13 050 5.5% p.a.	R14 795 5.8% p.a.	R19 914 5.6% p.a.
Growth target (inflation+5%) (Growth in %)	R10 263 2.6%	R11 094 10.9%	R13 171 9.6% p.a.	R15 708 9.5% p.a.	R19 700 10.2% p.a.	R33 797 10.2% p.a.



The Nedgroup Investments Core Diversified Fund has a long-term growth target of 5% above inflation (around 10% per year) over 5-year periods. The fund has provided returns closer to cash over the past 5 years. However, history² demonstrates that two thirds of the time a fund such as this would have achieved or surpassed its long-term target. This confirms the importance of being invested for the long term. In fact, if you increase your investment horizon, the risk of underperforming this target decreases.

¹ We used the STeFI call deposit rate for cash returns

² Based on SA market returns from 1960 to 2018 (source Firer 2006) using the same long-term equity allocation and fees.





Market and economic commentary: Inflation remains uglier for a little bit longer



Just when the world was expecting some much-needed relief from living with the COVID-19 pandemic for the last two years, Russia invaded Ukraine in late February sending shockwaves through the world and markets alike. Markets around the globe declined and volatility returned after a relatively calm 2021. Although some of the market fall may in part be attributed to valuations normalising off a base of high historical valuations of developed countries, other significant contributors include the geopolitical uncertainty and changes in the economic environment.

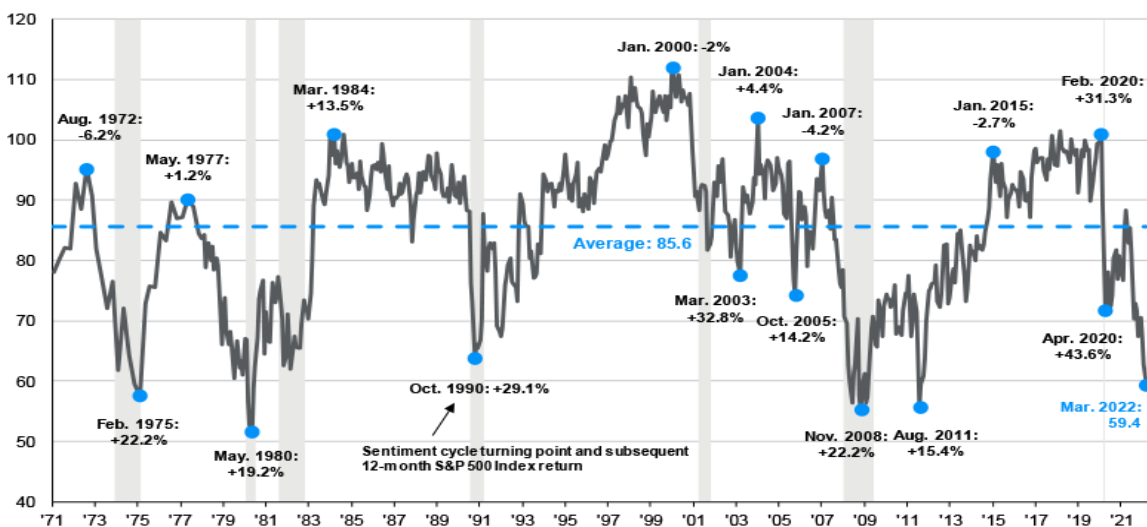
One of the notable changes in the economic environment was the rapid rise in inflation and the fear that this may persist for longer than initially anticipated. Energy prices soared with sanctions being imposed on Russia; one of the world's top energy producers. Furthermore, other essential commodity prices also increased sharply with fears of further supply chain disruptions. The upside of this is that commodities have been one of the few sectors in the market that have performed well in the first quarter.

Add to this, labour shortages in many countries, price hikes to recoup losses during the pandemic and the high demand for goods that are in short supply, and you have the perfect storm for inflation. In the US, inflation reached 40-year highs with their annual inflation rate reaching 7.9% in February, well above its 2% target. The UK was not far behind with inflation of 6.2% per annum to the end of February and the Eurozone at 5.9% at the end of February and with an expectation³ that inflation will tick up to 7.5% in March.

In an attempt to reign in rapidly rising inflation, central banks have begun hiking interest rates. The Federal Reserve has increased interest rates by 0.25% and signalled their intent to increase rates at each of the six meetings this year. The Bank of England has announced two consecutive interest rate hikes with a combined increase of 0.5%, the European Central Bank has not yet increased interest rates but plans to end bond purchases by the end of September and South Africa has had two interest rate hikes this year with a combined increase of 0.5%.

Rising interest rates, higher inflation and potentially low growth are all expected to put pressure on households and disposable income. In America, this has led to the lowest consumer sentiment in a decade. However, investors are cautioned not to let their feelings rule their investment decisions. The table below from J.P. Morgan is a good illustration of this. Typically, the best returns (on average 24.5%) are earned on investments made when consumer confidence is at a low, in comparison to investments made when consumer confidence is at a high (with investors only earning subsequent returns of 4.4% on average). This serves as a good reminder not to make emotional investment decisions.

Consumer Sentiment Index and subsequent 12-month S&P 500 returns



Source: JP Morgan Asset Management

³ According to Eurostat





The new offshore limits and resulting changes to the asset allocations

On 23 February 2022 an announcement was made that the offshore limits would be increased from the 30% global plus 10% Africa to a single combined allocation of 45%. Given the home bias research we conducted in 2020 we could apply the new limits across our South African Core range.

We have modelled multi-asset funds with different offshore allocations - ranging from a 30% (old offshore limit) to 100% offshore (Nedgroup Investments Core Global Feeder Fund). This allowed us to study the trade-offs between broader diversification and increased volatility due to the rand exchange rates. We also studied the tax benefits within compulsory and tax-free investment structures for funds with different home biases.

Our research indicated that the offshore allocations of the Nedgroup Investments Core Diversified Fund could be increased to between 40% and 50% while still delivering similar outcomes to investors, but with less concentration risk. We are increasing the offshore allocation to 40% from 30% while keeping the allocation to growth assets consistent.

Asset Class	Current Core Diversified	New Core Diversified
Local Equity	46.0%	39.5%
Local REITs	5.0%	4.3%
Local Bonds	8.0%	6.8%
Local Inflation Linked Bonds	5.0%	4.2%
Local Cash	6.0%	5.2%
Global Equity	21.5%	28.0%
Global REITs	2.5%	3.2%
Global Bonds	2.5%	3.7%
Global Inflation Linked Bonds	2.5%	3.3%
Global Cash	1.0%	1.8%
Limits		
Total Equity and Property	75.0%	75.0%
Total Foreign	30.0%	40.0%



What does the war in Russia mean for investors?

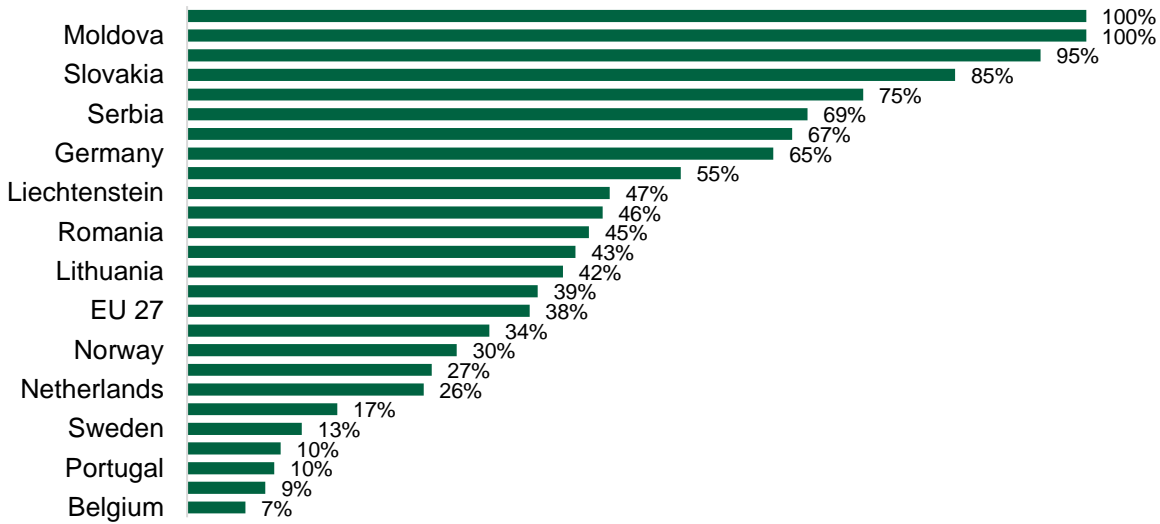


Putin's decision to invade Ukraine has upended assumptions about the sanctity of borders and has the world fearfully questioning whether this may lead to a world war. The humanitarian crisis in Ukraine has been devastating with many civilians affected.

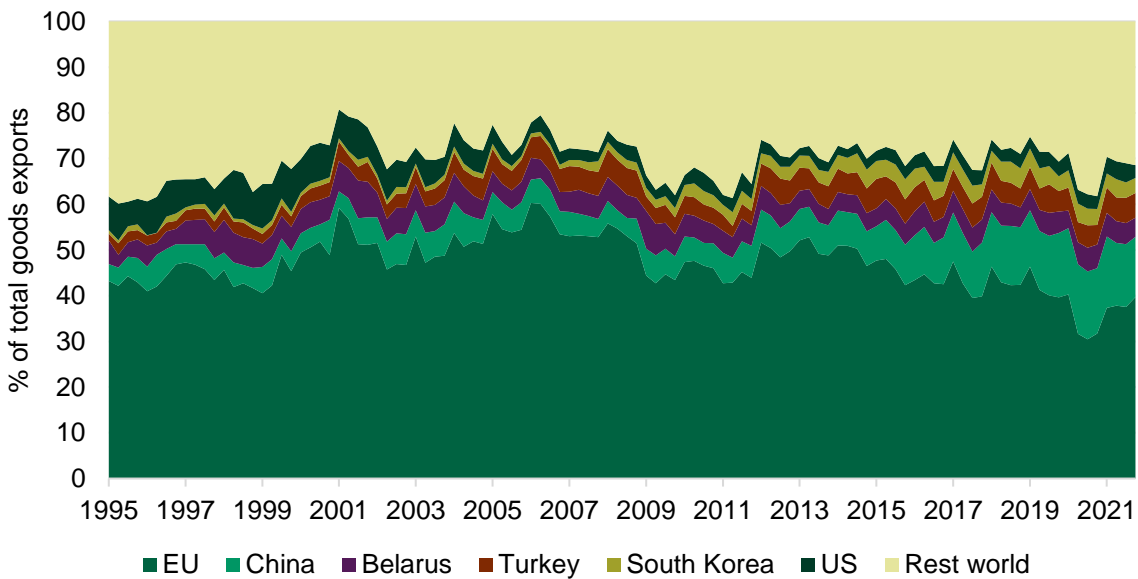
The world chose to fight back with economic rather than military sanctions. In fact, the response was surprisingly unified, solidifying the West with even Sweden and Switzerland abandoning neutrality. Unfortunately, economic sanctions are a blunt instrument and have had a significant impact on Europe, which was heavily reliant on energy and other imports from Russia, as depicted in the charts below. The impact on the US has been a lot smaller as they are essentially self-sufficient in oil due to the growth in their shale oil industry. Moreover, the rise in energy prices has been beneficial for US producers.

Europe natural gas imports from Russia

% of total natural gas imports (2020)



Russia goods exports by destination





Russia has spent many years positioning themselves to be self-reliant. They are among the top energy producers in the world and have been described as an energy superpower with natural gas, coal, oil and oil shale reserves. Furthermore, they are the world's largest exporter of wheat, largest producer of barley, buckwheat, oats and rye and second largest producer of sunflower seeds. Besides having ample energy and food, Russia has also amassed significant foreign reserves. However, they have lost access to some of these reserves under the sanctions imposed. These are just a few examples of the self-sufficiency of Russia. Unfortunately, this reduces the delays the effectiveness of the economic sanctions and means that it will take longer for these measures to hurt.

The ripple effect on the world has been further supply chain disruptions, a spike in commodity prices, higher inflation, and the potential for slower economic growth. The longer the war and sanctions persist the greater the chances are of a global economic slowdown.

So, what does this all mean for markets and your investors? The implications are broader than just direct exposure to Russian investments. There has been a widening in the equity risk premium, meaning that investors are demanding higher expected returns from shares to compensate them for the perceived additional risk, leading to a decline in markets. Another reason for the decline is that many central banks have begun hiking interest rates in response to rapidly rising inflation and in some regions, markets were overvalued. Additionally, investors may also have indirect exposure to Russia via companies that earn some of their revenue from Russia. For example, Mastercard, used to earn from Russian transactions prior to the sanctions imposed.

The best response is to remain calm and avoid making emotional investment decisions. It is also a good reminder of why it is so important to hold a well-diversified portfolio which helps reduce risks that are predominantly concentrated to a region.



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