NEDGROUP INVESTMENTS

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NEDGROUP INVESTMENTS FINANCIALS FUND

Quarter Two, 2022

Market Commentary

Central banks keeping interest rates low/negative have always led to considerable misallocations of capital. The eventual collapse in the crypto and profitless tech and growth asset classes was likely to happen at some point - and that point came with the signal that the period of low interest rates was over. This, the ongoing Russia/Ukraine conflict and continued inflationary pressures increased the uncertainty about how high the US Fed would have to hike rates, increasing fears of a pending severe recession.

Not surprisingly, the rand and SA markets have not been spared the subsequent global sell-off although our market did initially hold up better due the positive effect of higher commodity prices. Nevertheless, in $ terms the JSE fell 24% (the JSE 12% and the rand 12%).

Whilst both US banks and SA banks will benefit from the impact of higher interest rates, the recession risk in the US and EU increased the fear of bad debts. In South Africa that risk is potentially lower and hence they sold off a bit less than their global peers (measured in local currency)

Our view has been that the end of low interest rates would be a positive for the bank sector but, for the moment, the market disagrees with us and is focused on the risk of higher bad debts.

Fund performance, contributors & detractors for past quarter

Fund performance was broadly in line with the FTSE/JSE All Share Index and better than peers. However, literally everything was sold down heavily. Investec seemingly held up the best but that was because of its offshore business. Over the quarter, the investment in the Denker Global Financial Fund outperformed (also thanks to the weak rand). Measured over 12 months, the better performing SA banks meant that this investment had a negative impact on the fund.

Top 5 contributors:

Measuring the fund via contributors relative to its index is the best way, but this sometimes has disadvantages. For example, in this quarter both positive contributors and detractors included a large number of shares the fund doesn't own. But that is because of our bottom-up philosophy which ignores the index and its constituents. We find it more valuable to write about the companies we have selected and why, rather than focus on the companies we have decided not to be invested in. Nevertheless, it is useful to comment on the top 5 contributors to performance:

- **Denker Global Financial Fund**: The fund was hit hard in the 'risk-off' environment. Although the global financial sector was sold off, it was generally sold off less than the main indices. This is because the sector benefits from higher interest rates. On the negative side, the market fears the potential impact of bad debts from a deep recession. So, whilst the fund fell 14.8% in US dollars, the 12.1% fall of the rand cushioned most of this blow.
- **Discovery**: The fund has not owned Discovery for many years mainly due to its high valuation (we think the market put too high a valuation on possible future earnings from its potentially attractive growth initiatives).
- **Sasfin**: The fund has for many years held a 3%+ investment in Sasfin, initially because of its strong growth prospects. However, the economic growth slowdown hit Sasfin's client base hard and its illiquidity made it difficult to sell. Hence, when we received an offer to sell our holding at a very attractive price we accepted. We continue to rate management and the prospects, and because of its very attractive valuation we retained a third of our original holding.
- **Ninety-One:** We regard the business and management highly but sold the shares that we received via the unbundling a while ago, fearing a bond market collapse and recession. This proved to be prescient, but we would look at buying the shares back when global markets stabilise.

An additional top contributor is RMI Investments. RMI unbundled its holdings in Discovery (sold by the fund on receipt) during the quarter and MMI (held) and cash from the sale of Hastings PLC generated a return (per our calculations) of 8.5%. The remaining holding is Outsurance, a business we rate highly and have held.

Investments that detracted with negative or below index price performance this quarter:

- **Resilient Property Income Fund and Hosken:** The property sector has never been part of our core area of competence, so the fund has only by exception held shares in the sector. This worked against us in the years that leverage enabled the sector to be a 'go-go' sector, and it worked for us when it subsequently collapsed. Covid-19 was a big negative for the sector, which pushed valuations down considerably. We believe the industry remains under pressure but accept that there will occasionally be individual counters that will outperform. During the quarter, Resilient and Hosken were detractors as they re-rated in a very negative market.
- **Transaction Capital**: A phenomenal company led by a very entrepreneurial team. It is one of those holdings that we rarely sell and accept that we will occasionally have periods when it becomes too expensive and it will underperform. Like Capitec, it still has considerable growth opportunities and the recent acquisition and subsequent financial performance of We Buy Cars proved that. It remains marginally expensive, but we have decided to maintain our holding and add to it should the price fall further.
- **Standard Bank:** Standard Bank does screen as undervalued. However, the multiple challenges it faces in integrating Liberty into the group, continuous overspending on IT and delivering a strong retail presence in Africa classifies it as an "underperform" in the sector (in our opinion).
- **Sanlam**: Earnings were hit by a few factors in the quarter - most importantly, the required high Covid-19 reserves in its life business and Santam. Besides, its rating (judged on a price/embedded value basis) was too high. We were at fault to not reduce the holding but preferred (and still do) its quality and high return on capital.

Top 5 Contributors	Weight Mean	Return in Rand	Contribution
Denker Global Financial fund	20.07%	-4.49%	2.15%
Discovery Holdings	-	-29.68%	1.18%
Investec Ltd	9.87%	-5.75%	0.55%
Sasfin Holdings	1.30%	12.50%	0.37%
Ninety-One Ltd	-	-21.36%	0.18%

Top 5 Detractors	Weight Mean	Return in Rand	Contribution
Resilient Property Income Fund		-2.34%	-0.12%
Hosken Consolidated Investment		30.79%	-0.14%
Transaction Capital Ltd	2.88%	-25.17%	-0.15%
Standard Bank Group Ltd	4.81%	-12.38%	-0.23%
Sanlam	9.42%	-23.16%	-0.26%

Portfolio Changes, current positioning and outlook

We made very few changes to the portfolio and the top five holdings remain the investment in the Denker Global Financial Fund, FirstRand, Investec, Absa and then Sanlam. Due to the current strong US dollar environment and with the poor growth prospects of South Africa, the fund has a very high allocation to offshore earnings (above 35% of total).

The holdings in the Denker Global Financial Fund have been significantly sold off - back to very attractive valuation levels. There is a risk of a global recession, but global banks and insurers have come through previous recessions very well and bounced back 90%+ before the end of these recessions were in sight. Based on our research, we feel the market is wrong in its assessment of the severity of a possible recession and the extent of bad debts. Both US and EU banks have been very cautious and low loan growth rates reflect this, and both consumer and corporate balance sheets are generally still strong.

Conclusions

We feel strongly that the market has overreacted (good quality insurers like Legal and General and banks like ING and Swedbank have been sold down more than 30% and are yielding 6%+ dividend yields). The results being reported to date have shown that our research is proving to be correct. As in 2020, banks and insurers will provide macro-prudential reserves - but very little will need to be used.

Therefore, investors in the financial sector get the benefit of being invested in quality franchises that are well positioned and will bounce back strongly when the environment improves.

Responsible Investment Comments

I was able to attend a recent session hosted by Investec. The discussion, led by the chairman on ‘corporate governance, remuneration and climate’, was excellent and gave us new insights on many of the current issues.

On selecting and onboarding new independent directors: I was really impressed with the amount of effort they have been putting into this and with the focus on the substance and not the numbers. The effort that is required to attract the right directors and then train them to understand the culture and values of the business runs into hundreds of hours. That is over and above the training needed to ensure they understand the industry and risks. In the financial sector that is a sizable task. However, a problem here is that (as a legacy of King II) non-executive directors may only serve nine years (the fear is that they lose their independence after that). However, economic and market cycles often last longer than nine years. The previous severe economic recession and bear market was in 2008 (12 years before 2020).

It is also a pity that all the efforts in the end are measured by a number or a percentage. This can lead to ‘box ticking’. However, I was impressed that the effort being put in is not to be able to tick boxes but rather to achieve the main goal: Ensuring the business is so managed that it can sustainably and responsibly create value growth for its shareholders, employees and the broad environment it operates in. Investec’s slogan captures it very well I thought: “Living for society and not off society”.

Disclaimer

WHO WE ARE
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OUR TRUSTEE
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HOW ARE OUR FUNDS PRICED
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
A schedule of fees and charges is available on request from Nedgroup Investments. One can also obtain additional information on Nedgroup Investments products on our website.

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Some funds may hold foreign securities including foreign CIS funds. As a result, the fund may face material risks, which could include foreign exchange risks, market conditions and macro-economic and political conditions.

A fund of funds may only invest in other funds, and a feeder fund may only invest in another single fund, both will have funds that levy their own charges, which could result in a higher fee structure.

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