NEDGROUP INVESTMENTS

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NEDGROUP INVESTMENTS FINANCIALS FUND

Quarter Two, 2023

Nedgroup Investments Financials Fund

Performance to 30 June 2023	Nedgroup Investments Financials Fund (R class)	Benchmark: FTSE/JSE SA Financials Index
3 Months	5.9%	5.3%
12 Months	16.6%	13.6%

Market Commentary

The rand weakened by 5.9% against the US dollar and more against the Euro and pound during the quarter. This was due to the uncertainty created by the government's handling of its stance on the Russian invasion of Ukraine and continued evidence of its inability to govern and provide electricity, water, transport and policing. Hence, despite the evidence of a stronger than anticipated global economy, the JSE (FTSE/JSE All Share Index) ended the quarter a mere 0.7% up.

Central banks globally maintained their rate hiking stance - including the Fed, Bank of England, European Central Bank and the central banks of New Zealand, Canada and South Africa (to name a few).

Not surprisingly, market sentiment on the financial sector remained negative, causing US regional banks shares to be sold down 10-25%. The narrative was that the persistence of high inflation would necessitate much higher interest rates, eventually causing a sharp recession leading to high bad debts (specifically in the commercial real estate sector).

Fund performance

Against the backdrop sketched above, the Fund has performed remarkably well. It outperformed its benchmark, as well as the JSE, over the quarter and 12 months to 30 June 2023.

The largest contributor to performance this quarter was the Fund's investment in the Denker Global Financial Fund, which had a strong rebound (+7.9%) in US dollar. Taking into account the 5.9% fall in the rand, this fund generated a 14% return in rand.

But both locally and globally, banks' share prices were resilient (with the exception of US regional banks) due to the conservativeness of their loan books (or in other words quality of underwriting standards) and the benefit from higher interest rates.

Regarding the concerns about the effects of a possible recession, recent stress test results released by the Fed highlighted that US banks have sufficient capital to withstand a 40% fall in commercial real estate (CRE) values. In addition, JP Morgan reported that their bad debt provisions will be sufficient for a 5.8% US unemployment rate (current rate of 3.6%). March 2023 results released by South African banks also showed +/- 50% increases in bad debt provisions, providing for potential bad debts in the event of a downturn. This highlights how conservative management teams are and overtly negative markets are.

Top contributors	Ave. weight	Performance attribution	Top detractors	Ave. weight	Performance attribution
Denker Global Financial Fund[1]	23.7%	2.0%	Reinet Investments	-	-0.3%
Capitec Bank	5.5%	0.3%	Trematon Capital	1.1%	-0.2%
Growthpoint Property	-	0.3%	Remgro	-	-0.2%
Sanlam	1.0%	0.2%	FirstRand	16.1%	-0.2%
Equites Property Fund	-	0.2%	Absa Group	9.6%	-0.2%

Source: StatPro

1. Incl. the Denker SCI Global Financial Feeder Fund.

Top 5 contributors

- **Denker Global Financial Fund (+14.0%):** The fund bounced back strongly from the March 2023 regional bank deposit flight sell-off. However, uncertainty regarding US regional banks remained and the regional banks themselves continued to sell-off in April/May. But the fund's European and emerging market banks performed well, more than making up for the weakness in US regional bank share prices. The rand fall further benefitted the investment, generating a return in rand of 14%.

- **Capitec (-5.6%):** When an expensive share disappoints, investors get a double negative whammy from both the earnings downgrade and the de-rating. In Capitec's case, it disappointed two quarters in a row (once with disappointing fee income and second with higher-than-expected **provision** for bad debts). In both cases this should have been expected but caught the market, which had too high (and unreasonable) expectations, by surprise. Due to the expensive rating the Fund has been under-weight but, post the de-rating, we have slowly started adding. However, even after the de-rating seen in Q2 it could still de-rate further and we'll be very patient in increasing our investment.

- **Sanlam (+10.5%):** Sanlam (as well as the other insurers) has under-performed since Covid in 2020 due to large mortality and business interruption pay-outs as well as the effect of negative markets on investment returns. Sanlam, in particular, suffered due to its previously high rating. However, these headwinds have turned into tailwinds, and we have gradually increased our investment in Sanlam and also MMI. Sanlam remains very undervalued, especially in the light of its dominance and earnings power potential in both South Africa, Africa and India.

- **Growthpoint (-6.3%) and Equites (-19.7%):** The headwinds faced from the weak economic backdrop and higher interest rates keep us from investing in property related shares**.**

- **Investec (+8%):** Investec was the 3rd best performer in the Fund, gaining 8% in the quarter and 206% over the three years since 1 April 2020. However, Investec is only 6th in terms of contribution to outperformance relative to the benchmark. It did come off a VERY low valuation in March 2020 but management have really performed and the changes initiated keep adding value. It is perhaps the opposite of Capitec: A bank where both the rating and expectations were too low. The new team, under Fani Titi keeps delivering both in SA and the UK (stronger than expected growth and profitability in the UK bank). The team has also managed to do a very good transaction, selling the wealth management division to Rathbones but keeping a 41.3% stake (but 29.9% voting rights) in the combined entity. At the same time, it has been using excess capital to buy back its own shares at the current low levels - further enhancing ROE (return on capital). Hence, it remains the 4th largest investment in the Fund.

Top 5 detractors

- **Absa (-4.2%):** Absa reported an unfortunate loss in its Ghanian subsidiary, due to a significant fall in Ghanian government bonds as it became apparent that government would default on interest payments. It is a classic case of how quickly a country's fortunes can change due to mismanagement of fiscal policy. This caused a once-off write-down in Absa's bond portfolio in the country. The BEE issue announced, whilst being positive for the bank's longer-term transformation goals, caused a short-term dilution to shareholder value. Operationally, however, Absa is performing well and now represents very good value and remains the Funds' 5th largest investment.

- **FirstRand (+13.5%):** FirstRand's solid operational update highlighted the quality of the franchise. The subsequent re-rating from a fairly 'full' valuation made it the 2nd best performer over the quarter. However, the investment detracted from the relative performance due to the Fund being marginally under-weight the index.

- **Trematon (-10.0%):** Trematon is a good example of the risk of investing in illiquid shares, but it now trades at a deep discount to its value. In the meantime, the share price fluctuates wildly on very small trades. The management team is working hard to unlock both operational value and the discount at which it trades.

- It looks as if **Reinet (14.2%)** and **Remgro (10.0%)** were 'detractors' from relative performance, due to us having no exposure to these two shares over a period in which they had positive performance. We have favoured an investment in the Denker Global Financial Fund which we believe is a better investment in terms of valuation upside and diversification.

Current positioning and outlook

We added marginally to our Sanlam and Capitec holdings during the quarter, funding these purchases by reducing our holding in JSE. The additional shares purchased and its price movement have pushed Sanlam to the 3rd largest investment of the Fund. As a result, the top 5 investments in the Fund are now the Denker Global Financial Fund, FirstRand, Sanlam, Investec and Absa.

Conclusions

Despite very attractive valuations and solid operational results, investors remain scared to invest in the sector, not only in the US, but globally including SA. Investors must guard against 'taking instructions from the market', as Warren Buffett calls it.

This emotional irrationality creates an investment opportunity for investors who understand that one's best investments are made when a market is this negative, especially when a positive surprise could bring about a significant re-rating.

In SA, the ongoing privatisation of energy could mean reduced or very low levels of loadshedding by end 2024. A stronger rand (both from both being oversold and from a weaker US dollar) will put downward pressure on inflation and see a move towards lower interest rates, which would be very good for the financial sector (as it reduces the perceived risk of bad debt stresses).

The 20-year track record of the Fund and current very attractive valuations give us the confidence to expect continued good returns from the sector and the Fund for 2023.

Responsible Investment Comments

Investec Group announced in July that it will continue to fund coal projects for another seven years in South Africa, while its UK subsidiary will end all coal financing exposure in 2027. Similarly, Standard Bank has decided to fund the oil pipeline across East Africa.

Listening to and interacting with the management teams, we know that these decisions are not taken lightly. The lenders say they have to balance the continent's developmental goals with the effects of fossil fuels on the environment.

To quote one CEO: *"The more I read and ponder about it, the more I feel that many of the loudest voices in these debates refuse to think seriously about the inevitable trade-offs involved, they take an apocalyptic view of climate change that is not warranted by the best science; and refuse to accept that Africa has a right to self-determination and economic development; and that besides that by far the largest - and most rapidly accelerating - emitter is China.*

We need to tread a balanced middle path that seeks to do the best we feasibly can both for Africa now and over the generations to come. "

Similarly, we are invested in companies that are penalised in their ESG score for not being diverse enough or when the board is not independent enough based on their definitions. Yet, they are committed to having a knowledgeable and experienced and critical board that play an active role in guiding and ensuring executive management strategy - that it is sustainable and in the best interest of all stakeholders.

So not all the companies the Fund is invested in score AAA on the official ESG tables but I can report that the Fund's ESG score is 7.3 (improved from 6.9 in March 2023).

Disclaimer

WHO WE ARE

Nedgroup Collective Investments (RF) Proprietary Limited is an authorised Collective Investment Scheme and the representative of Nedgroup Investments Funds PLC in terms of the Collective Investment Schemes Control Act. It is a member of the Association of Savings & Investment South Africa (ASISA)..

OUR TRUSTEE

The Standard Bank of South Africa Limited is the registered 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.

DISCLAIMER

Unit trusts are generally medium to long-term investments. The value of your investment may go down as well as up. 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. Our funds are traded at ruling prices and can engage in borrowing and scrip lending.

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.

The Nedgroup Investments Money Market Fund offering aims to maintain a constant price of 100 cents per unit. A money market fund is not a bank deposit. The total return to the investor is made up of interest received and any gain or loss made on any particular instrument held. In most cases the return will merely have the effect of increasing or decreasing the daily yield, but in an extreme case it can have the effect of a capital loss. Excessive withdrawals from the fund may place the fund under liquidity pressures and that in such circumstances a process of ring-fencing of withdrawal instructions and managed pay-outs over time may be followed. The yield is calculated using an annualised seven day rolling average as at the relevant dates provided for in the fund fact sheet. Nedgroup Investments has the right to close its funds to new investors in order to manage it more efficiently.

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