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NEDGROUP INVESTMENTS FINANCIALS FUND

Quarter One, 2021

Performance to 31 March 2021	Nedgroup Financials Fund	ASISA SA Equity Financials
3 Months	6.8%	4.4%
12 Months	40.0%	38.1%

Market Commentary

Global markets (and especially the financial sector) recovered strongly from the Q1 2020 sell-off, continuing the Q1 2021 trend as the vaccination process gathered pace in especially the US (average of 3 million people per day) and the UK.

The FTSE/JSE Capped Swix gained 12.6% in the quarter and delivered a 12 month return of 54.2%. However, South Africa was one of the few countries where the financial sector lagged the country’s all share index as South Africa's high debt levels and inability on various fronts to respond adequately to the pandemic retarded the strength of its recovery.

Fund performance, contributors & detractors for past quarter

The team's hard work and insights paid dividends as the fund performed well compared to its peers (and the index). The outperformance was mainly due to good stock selection with the top five investments (representing 42% of the fund) outperforming the JSE. The four large South African banks and insurers on average showed a positive return for the quarter (average of 3.4% with Nedgroup the best at 8.0%), but this lower share price gain did drag down the fund’s total return. Insurers Sanlam, Santam and Old Mutual's share price returns were also below the FTSE/JSE All Share Index returns.

The fund had four investments that proved to be poor investments (and hence poor decisions) over the past 3 and 12 months.

- Sasfin and Trematon: Both Sasfin and Trematon highlight the risk of investing in illiquid shares. Both came through the crisis fairly well, but there were simply too many sellers and not buyers for these illiquid counters. Both now represent good value (Sasfin trading at 60% discount to net asset value) but unless it is bought out or liquidity of the share is increased it is unlikely to re-rate for some time. Investing in it is a mistake we made a few years ago and we now have to be patient. Trematon is in a similar situation but management have a large shareholding themselves and a strong incentive to unlock the value.
- JSE: We like the JSE for its safety and cash generation, but in the post March 2020 bounce back markets preferred risk to safety and de-rated the JSE. It is now one of the most undervalued exchanges in the world and should generate an ROE of 24% and is on a dividend yield of 6%.
- Santam: Santam ranks amongst the best short-term insurers in the world but along with its global peers faced large business interruption claims. It used the 2020 financial year to fully provide and will start the 2021 financial year on strong footing and we plan to use the weakness to add to our holding.

Despite outperforming the financial index and our peer group, the performance of the top 5 investments relative to the remaining 58% of the fund forces us to ask the question: "Could we have done better?"

- Firstly, a quarter is a short period to measure the correctness of investment decisions and secondly, over the 12 month period the banks and Sanlam (which dragged down the quarter's performance) performed well from the 1 April 2020 oversold levels.

- Secondly, one must bear in mind that banks and insurers make up almost 70% of the financial index so one cannot escape them. We did realize that they would need to make large provisions - hence our investments is PSG, Coronation, Transaction Capital and JSE. Looking back we should have increased this but bank and insurance valuations were attractive and such a strategy would have made our ‘underweight’ even bigger and hence risky.

Within the banks and insurance group we preferred the quality of FirstRand and Sanlam and still prefer them for the certainty they provide, as well as their faster growing earnings streams in the UK (FirstRand’s Aldermore) and India and Africa (Sanlam).

Top 5 Contributors	Weight Mean	Return in Rand	Contribution in Rand
Denker Global Financial fund	24.7%	14.0%	3.6%
PSG Group	6.4%	18.0%	1.1%
Investec	5.2%	18.4%	0.9%
Coronation Fund Managers	3.7%	26.9%	0.9%
Transaction Capital	2.4%	24.9%	0.6%

Top 5 Detractors	Weight Mean	Return in Rand	Contribution in Rand
Capitec	4.7%	-0.9%	-0.1%
Standard Bank	5.0%	-1.3%	-0.1%
Tremation	1.4%	-5.1%	-0.1%
Santam	2.9%	-4.4%	-0.1%
Sasfin	2.6%	-17.0%	-0.6%

Portfolio Changes, current positioning and outlook

We made two small changes to the portfolio during the quarter (most of the changes needed to react to the pandemic were made last year). We made an initial small investment in RMI and increased our investment in Coronation. To fund these, we sold a few Nedbank and Sasfin shares (yes, we were able to sell a few).

Operationally both the banks and insurers came through the crisis well, increasing provisions substantially and focussed on cost efficiencies. If our outlook is correct, a large part of these provisions will prove to be unnecessary and can be reversed during 2021, which means year-on-year earnings per share growth in 2021 over 2020 will look very good.

In terms of our outlook, we believe the $1.9 trillion approved by President Biden on top of the aid given during the past 12 months should result in the US economy growing at 6.5%+. This, plus the further $3 trillion infrastructure package proposed will result in the US running above its capacity bringing down unemployment, but at the same time increasing inflationary risks which could push the US 10-year bond yield to above 2% (from 0.6% in 2020).

This is good for global growth and the financial sector. Stronger growth, higher interest rates, ability to pay dividends and resume share buyback programs on top of the cost cutting initiatives started in 2021 should generate very strong earnings growth.

South Africa should benefit from stronger US (and world) growth but our high debt levels, inability to provide electricity and other services will be a brake on the positives of stronger exports and low interest rates.

Conclusions

We do believe that South Africa's growth rate in 2021 and most probably in 2022 will surpass current expectations. The wild card in South Africa is the uncertainty brought about by ANC infighting, besides low growth (one of the lowest post-pandemic-growth-rebounds in the world) places a discount on our valuations. Hence, the South African situation is just not attractive enough to offshore (and South African) investors. But even without being very positive in terms of growth forecasts, due to the long period of price underperformance, valuations are at levels that make South African banks very attractive globally.

Despite the negativity, 2021 will most probably prove to be a good investment for investors in the SA financial sector.

Responsible Investment Comments

The role of the banking sector is often very misunderstood. Even President Ramaphosa showed his ignorance when he criticized banks for not doing enough during the Covid-19 pandemic. For an economy to function well and grow one needs policy making to create the environment that entices entrepreneurs to risk capital. The role of the banking sector is to take deposits and on-lend the funds entrusted to them responsibly. Bad loans put not only the banks themselves but also the country's financial system at risk. South Africa has had its share of such instances which threatened the sector - Nedbank and Absa in the 80s, Saambou and African Bank and currently the Land Bank (VBS was fraud, not injudicious lending).

The Saambou debacle led to the demise of Fedsure, BOE and NBS which shows how important the key tenets of deposit taking and lending are.

In that regard, the SARB and banking sector came through the Covid-19 crisis with flying colours. Banks non-performing loans and bad debt write-offs were far lower than expected whilst at the same time banks played a stellar role in, where possible, keeping clients afloat by rescheduling loans and extending fresh loans. The increase in unemployment and reduced income levels put considerable pressure on the system but, if I may repeat, our banking system (in line with global peers) came though the crisis well.

The insurance sector had to deal with a situation not envisaged when policies and contracts were written and this resulted in a some angst, to say the least. But it is important to bear in mind that again, one cannot expect banks to risk depositors savings and lend to clients who won’t be able to repay, nor insurers to pay out claims that were not covered by the premium paid. In 2020 managements were forced to make decisions about whether to widen the definition of "cover" that could possibly bankrupt the insurer.

This highlighted the experience levels and ability to overcome unforeseen situations of our financial sector. They should get a few extra ESG points for this whilst at the same time delivering good enough (under the circumstances) returns to investors.

At individual company level, Capitec and PSG reflect low ESG scores due to Environmental and Social scoring and lack of (based on the scoring system) management and board level diversification.

This is where the scoring systems used are, in our opinion, too one-sided. But then, I suppose investors can make the decision themselves. We ourselves prefer experienced management teams who make a difference in the societies they serve (think Capitec, Curro and Stadio) but do it efficiently generating a good return for shareholders that keeps shareholders happy and makes an investment in the company attractive enough for them to continue to hold and invest capital in the company.

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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