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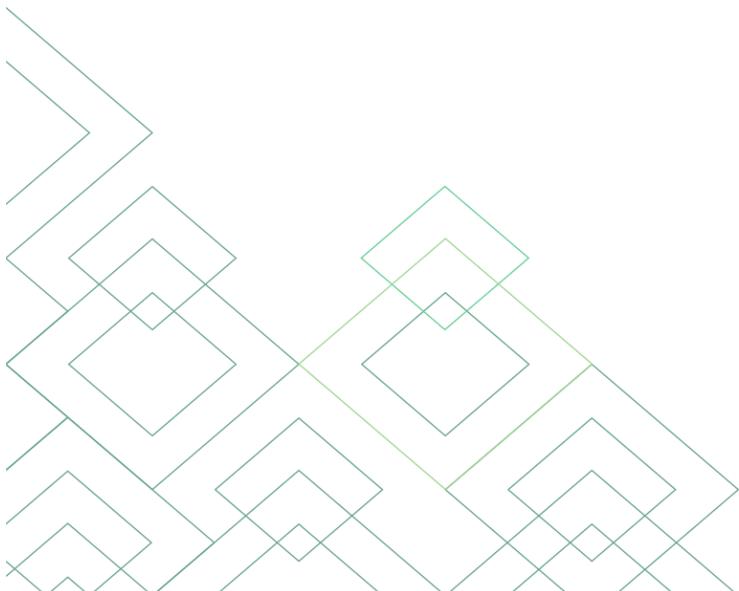
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# Quarterly review

Nedgroup Investments Core Diversified Fund



As at 31 March 2023



## Traditional 60/40 stocks and bonds portfolio have its best start in 10 years



In 2022 investors were dealt with very disappointing results in both stocks and bonds. What we have seen in 2023 so far is a complete reversal of that. When one looks at 60% stocks and 40% bonds portfolio, it is off to its best start in 10 years. Investors are looking beyond what we have seen as very weak economic growth, likely recession this year, even the banking crises that occurred in the first quarter of 2023 and focusing on the fact that the federal reserve may be close to being done on the aggressive tightening cycle. This easing inflationary pressure helped lift markets in the first quarter. Therefore, the Nedgroup Investments Core Diversified Fund increased by 4.6% 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 R14 883 on the 31<sup>st</sup> of March 2023. This is slightly higher than the R12 913 you would have received had you invested your money in bank deposits (cash) over the same period. The green circle in the chart below, highlights the recent market decline, 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 <sup>1</sup> and the Growth target						
	3 Months	1 Year	3 Years	5 Years	7 Years	Inception 31 August 2009
<b>Growth of fund (after fees) (Growth in %)</b>	R10 462 4.6%	R10 435 4.4%	R16 083 17.2% p.a.	R14 883 8.3% p.a.	R16 152 7.1% p.a.	R39 469 10.6% p.a.
<b>Growth of cash (Growth in %)</b>	R10 170 1.7%	R10 571 5.7%	R11 370 4.4% p.a.	R12 913 5.2% p.a.	R14 753 5.7% p.a.	R21 051 5.6% p.a.
<b>Growth target (inflation+5%) (Growth in %)</b>	R10 225 2.3%	R11 239 12.4%	R13 459 10.4% p.a.	R16 163 10.1% p.a.	R19 716 10.2% p.a.	R37 985 10.3% 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, history<sup>2</sup> 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.

<sup>1</sup> We used the STeFI call deposit rate for cash returns

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





## Economic and market review



South African markets started off the year on a good recovery in 2023 as the tailwind from China's re-opening benefited the local market. However, for the remainder of the quarter, loadshedding and the grey listing outcome decreased the appeal of investing capital in South Africa. In addition, the fears of contagion from the SVB fallout weighed on SA markets due to market volatility increasing. Even though the FTSE/JSE lost ground in the last two months of the quarter, it managed to return 5.2% over the quarter.

On the economic front, South Africa's inflation remained slight elevated and above market expectations, leading the Monetary Policy Committee (MPC) to hike the key lending rate by 50bps. This was higher than the market's 25bps expected hike. The risk of higher-than-expected inflation is expected to continue to be a pain point in addition to the mentioned headwinds. The MPC however showed much higher inflation forecasts than outlined in previous meetings, fueled by higher food prices, core goods inflation and a weaker ZAR. Their concern around higher inflation, higher expected inflation and (we suspect) a vulnerable ZAR, prompted greater action. This certainly signals the intention from the SARB to bring inflation back down to the midpoint of the target band, but it remains a further constraint on growth. Bonds returned a reasonable 3.4% for the quarter (with the back-end outperforming as global rates lower), and outperformed inflation linkers which returned only 0.8% despite increased inflation expectations.

After a strong January, robust jobs data, high retail sales growth and sticky core inflation in the US saw bond markets again having to revise their rates views. Treasuries sold off through February and early March, with the 10Y moving from its low of 3.36% to over 4%. Despite the headline US CPI print looking within expectations (and behaving as expected, as energy prices fall), core CPI continues to surprise to the upside with services inflation being particularly problematic.

Just as the market was pricing in some of its most hawkish sentiment, the story of Silicon Valley and Signature Banks broke (followed by further news of Credit Suisse). Following the banking sector induced turmoil, the Fed hiked rates by 25bps in the March FOMC. This was largely anticipated by the market, and although their tone was slightly more dovish, there was no sign of a 'pivot', as many market participants may have hoped. The dots for 2023 were left unchanged and suggest that there may be one hike left in the cycle. Importantly, unlike the market, they still do not foresee any policy easing this year.

The year started off with a bang, reminding us just how precarious a position global markets and economies are in. An early rally in markets was halted by strong economic data and sticky core inflation in the US, and markets quickly reacted with more hawkish pricing, even pricing a 50bp hike for the March FOMC at a stage. This again had to be revised after the second largest banking failure in history, occurring off the back of high interest rates and limited liquidity, had the market then questioning whether the Fed could hike at all. Ultimately the FOMC hiked a largely expected and more neutral 25bps, failing to 'pivot' but certainly sounding more dovish than previous meetings.

The market continues to grapple with how policy makers will react to sticky inflation, while serious economic failures and stresses are starting to show because of tight monetary policy.

As at the end of Q1 2023, domestic duration is 0.9 years in nominal bonds and 0.2 years in inflation linked bonds. Bond valuations moderated in the last quarter of 2022, moving from cheap, into a cheaper value territory. Overall the market seems to have reacted by moving to shorter term money market instruments although longer term duration bonds are offering attractive real yields and are in most cases favorable instruments to hold at the top of a hiking cycle. High credit quality instruments have received a higher level of attention as investors seek low risk, high grade debt instruments to park their money. On the other hand, opportunities to pick up yield are diminishing, even in the convertible bond space given the low yields relative to nominal bond and the stretched balance sheets of issuers.





## The banking system issues and its impact on Core Funds



Although markets appear to have regained some composure, it has been an unsettling period for investors. The spectre of a systemic banking crisis has created significant volatility in equity and bond markets in the wake of the collapse of Silicon Valley Bank in the US and the fears over Credit Suisse in Europe.

The current situation partly has its roots in the significant interest rate hikes seen in 2022. Bond markets have moved to reflect expectations that the turmoil would force a significant change in interest rate policy from the Federal Reserve (Fed) and other central banks. This may be premature. An observation is that the key data continues to show that the inflation print remains on hold and not on track to settle at Fed's target. The February CPI report and tight US labour market show inflationary pressures remain. The Fed's decision to raise interest rates by 0.25% on the 22 March balanced the need to tackle elevated inflation while also maintaining financial stability. This was lower than the 0.5% increase expected by markets at the start of the month, signalling that the Fed intends to tread carefully as it navigates volatility in the banking sector.

The speedy and decisive response from policymakers supports a more optimistic outcome. Which is that;

*'These events prove isolated. The problems are brought under control, confidence returns to markets and the economy remains resilient. In this situation, the Fed would continue with its original plan to keep rates tight throughout 2023'*

The US Federal Deposit Insurance Corporation, an independent agency which focuses on maintaining financial stability, has moved in to protect deposits. Meanwhile the Fed enacted the Bank Term Funding Programme, which increases lending to banks. The Swiss central bank acted swiftly to get the UBS/Credit Suisse deal over the line. It's been a robust response, which should help settle investors' nerves. However, there are arguments against this being an isolated event. There remain significant unrealised losses at smaller US commercial banks. It is not yet clear whether they have hedged these risks and whether they will be forced to divest assets (and crystallise losses). Equally, there may be other sources of stress in the system that have not yet been uncovered.

### Exposure to Credit Suisse, SVB and Signature bank

Nedgroup Investments Funds	Core Diversified
Effective Credit Suisse exposure	0.008%
Effective SVB exposure	0.002%
Effective Signature bank exposure	0.001%
<b>Total</b>	<b>0.011%</b>

It is important to note that Core Funds are diversified portfolios, hence, the exposures to some of the regional banks are generally small as shown in the table above. However, there is potential impact on real estate side. This is because the regional banks are large players in commercial lending. Constraints of availability of capital might impact upcoming construction activities. Hence, further regulation changes on the availability of capital could intensify this risk cycle in real estate.

Finally, it does appear that sentiment is stabilising. There has been an increase in investment grade issuance, which is an important signal to markets from moving from this period of crises/paralysis to one where we see the resumption of capital formation process, which might be a catalyst to further calm markets and sentiment. There was clearly a failure in a duration mismatch and regulators might be focused in understanding how to prevent the replication of this mistake in the future, so new regulation may have to be factored in.

There are a lot of moving parts when it comes to judging the investment implications. The global banking system remains well-capitalised. Tier 1 capital is significantly higher than during the last crisis, allowing banks to withstand negative shocks. It will be important to monitor the situation as it evolves. We remain cautious and continue to assess the fallout from these events.





## Introducing the new Nedgroup Investments Core SA Equity Fund

The Nedgroup Investments Core Range were designed to fulfil the need for low-cost multi-asset unit trusts portfolios which can be used as standalone solutions or combined with traditional active portfolios. Extensive research went into designing the portfolios to provide sensible exposure to five different local and global asset classes (equities, listed property, bonds, inflation linked bonds and cash).

Over time clients expressed interest in various components of these multi-asset funds which led to new additions to the Core range:

- Nedgroup Investments Core Bond Fund in 2012.
- Nedgroup Investments Core Global Fund (UCITS) and Feeder in 2015 and 2016, respectively

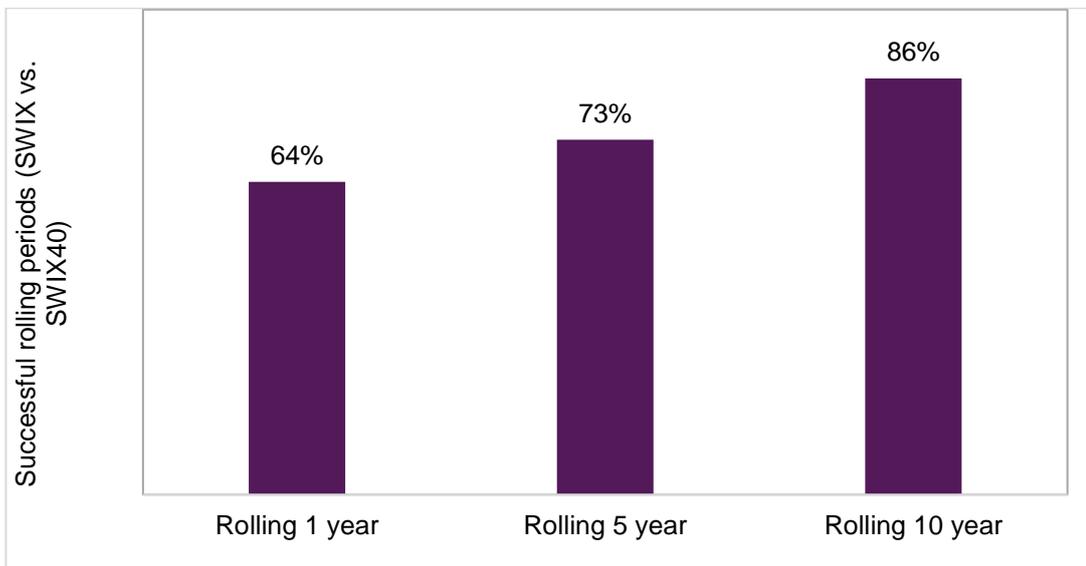
The Nedgroup Investments Core SA Equity Fund is the latest addition to the range.

### **Sensible exposure to South African equities**

Obtaining sensible exposure to South African equities at low costs is not as simple as picking an off-the-shelf index. It requires careful design so that it fits into an investment strategy and incorporates the appropriate implementation approach to execute successfully. The Johannesburg Stock Exchange (JSE) has recently embarked on a harmonisation project to align the current All Share (ALSI) indices with the All Share Shareholder Weighted (SWIX) Indices. This process will simplify the number of benchmarks available which is a positive for South African equity investors. However, all these indices still require tailoring to obtain sensible market exposure, especially within the context of portfolios that invest across multiple asset classes.

*Nedgroup Investments Core SA Equity Fund* aims to provide sensible, broad market exposure to South African equities in a cost-effective manner. Here are some of the important considerations that went into its design:

- **Double counting on listed property shares when using the fund with other asset classes**  
Listed property shares fall within the Real Estate sector and are therefore included in all the major SA equity benchmarks. In a multi-asset portfolio which has a separate allocation to listed property one therefore runs the risk of having the same shares in both the SA equity and listed property allocations. To avoid double counting on the listed property shares, especially the five largest shares, we exclude all Listed property shares from the fund.
- **Single security risk**  
Events such as the Steinhoff debacle illustrates the importance of managing the risk to any single security within a portfolio. Within the fund we manage this risk by capping the maximum weighting to any one share to 10%.
- **Broad market coverage**  
The 40 largest shares on the JSE make up nearly 80% of the market capitalisation of the JSE while the remaining 20% is distributed across around 100 mid- and small- cap shares. To date most equity index funds only covered the large caps and therefore do not provide broad market coverage which includes mid- and small- cap shares. There is, however, extensive academic research that shows that broad market coverage offers better risk-adjusted returns over time. From the perspective of the Nedgroup Investments Core Range, the broader diversification leads to an increase in the reliability of outcomes.



Source: Morningstar Direct. Period from February 2002 to February 2023.

The Nedgroup Investments Core SA Equity fund is competitively priced at 0.25% (excluding VAT) for retail investors and 0.175% (excluding VAT) on LISP platforms.

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