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NEDGROUP INVESTMENTS FINANCIALS FUND

Quarter One, 2023





Nedgroup Investments Financials Fund

Performance to 31 March 2023	Nedgroup Investments Financials Fund (R class)	Benchmark: FTSE/JSE SA Financials Index
3 Months	-1.7%	-0.3%
12 Months	-3.5%	-8.6%

Market Commentary

The period post Russia's invasion of Ukraine unleashed strong inflationary pressures which subsequently forced central banks in the developed world to hike interest rates much more than anybody forecast or anticipated in 2022. The effect of the tightening led to the US regional deposit panic in March 2023, when Silicon Valley Bank and Signature Bank had to be taken over by the Federal Deposit Insurance Corporation (FDIC). This represented the second and third largest bank failures in the history of the US.

In 2008, Washington Mutual, the largest bank failure, experienced \$17 bn deposit outflows over nine days. Silicon Valley Bank experienced more than \$40 bn deposit withdrawals in a day.

This unexpected deposit flight quickly spread to other banks with similar concentrated and uninsured deposit bases and shook the system. The Fed's quick action has since stabilised the system but the underlying causes (reversal of excess liquidity created post Covid and large unrealised bond portfolio losses on bank and other balance sheets) are worrying and could still play a role during 2023.

In South Africa, the Reserve Bank surprised the market by hiking interest rates by 50bp in March - instead of 25bp as was widely expected. The market now expects further rate increases, where previously it was thought that the expected 25bp would be the last hike in this cycle. The bank worries that, despite very weak growth, the output gap may in fact be negative.

Over the quarter, the FTSE/JSE Capped Swix was up 4.3% and the Financial index was down marginally for the quarter (-0.3%).

Fund performance

March's 11% fall in the Denker Global Financial Fund unit price (in USD) had a relatively small impact on the Nedgroup Investments Financials Fund's performance. The main reason for the small underperformance over the quarter (-1.7% vs. the benchmark's -0.3%) had more to do with large swings in stock prices unrelated to the US deposit panic.

Over the 12 months to March the Fund's investment in the Denker Global Financial Fund and the poor share price performance of Capitec (the Fund is underweight) and Discovery (the Fund is not invested) were the main contributors to the outperformance of the Fund (-3.5%) vs. its benchmark (-8.6%).

Top contributors	Ave. weight	Performance attribution	Top detractors	Ave. weight	Performance attribution
Sanlam Ltd	8.1%	0.4%	Transaction Capital	1.7%	-0.5%
Capitec Bank	5.6%	0.3%	Discovery Holdings	-	-0.5%
Growthpoint	-	0.3%	Old Mutual Limited	-	-0.4%
Redefine	-	0.2%	Trematon Capital	1.3%	-0.3%
Momentum Metropolitan	4.9%	0.2%	Investec Ltd	5.1%	-0.3%





Top 5 contributors

- **Sanlam:** Sanlam (as well as the other insurers) has underperformed 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 again and we have gradually increased the Fund's investment in Sanlam (and also MMI). Early in the second quarter we have further increased the investment as Sanlam remains undervalued relative to its dominance and earnings power potential in South Africa, Africa and India.
- **Capitec:** Capitec's more client focused franchise, aided by its much younger technological platform, is allowing it to continue to grow its market share. However, as it grows larger it will become increasingly difficult to maintain its past level of outperformance. Hence the very high rating (which was >6.0 price/net asset value) has been declining, leading to its share price underperformance. It is this very high rating that has kept us holding a smaller investment in Capitec (underweight) than we otherwise would have, which is contributing to it being a source of outperformance.
- **Momentum (MMI):** As with Sanlam, MMI was sold down post Covid due to the headwinds caused by Covid but also because it was still in turnaround mode. However, the fruits of three years' hard labour is becoming visible. This and its very attractive valuation (quite far below its intrinsic value) has made us increase our investment in MMI over the 12 months.
- **Growthpoint and Redefine:** We remain negative on the property sector due to the low economic growth and headwinds caused by work-from-home. Besides, there are enough other attractively valued opportunities in the sector. Hence, we remain very underweight. In fact, besides a small investment in Trematon the Fund has no investment in REITs (both locally and globally).

Top 5 detractors

- **Transaction Capital:** Transaction Capital was one of those rare high growth companies that was highly rated. Per management, the environment in which taxis operate has deteriorated significantly. Higher fuel and parts costs and other inflationary pressures, plus the unavailability of parts and deterioration of the employment situation in South Africa had a material impact on both the profitability of Transaction Capital's taxi business and its balance sheet. The announcement of the restructuring had a dramatic impact on market confidence and led to a big de-rating of the share. The Fund's investment in Transaction Capital was gradually brought down (due to its expensive rating) from 3% in March 2022 to 2% in December 2022. After the price fall it is now 0.8%.
- **Old Mutual and Discovery:** As with Sanlam, Old Mutual and Discovery are also benefitting from the better environment and have re-rated. We continue to prefer Sanlam and MMI to Old Mutual and Discovery for very different reasons: Old Mutual is very undervalued but is not attractive enough for us due to its low return on capital, whereas Discovery is just too expensive (especially as it follows an aggressive growth strategy on a number of fronts).
- **Trematon:** Trematon highlights the risks of investing in illiquid shares, despite them showing good value. Given the illiquidity, the share price fluctuates wildly on very small trades, but we believe management are working hard to unlock both operational value and the discount at which it trades.
- **Investec:** After being a strong performer in 2022, Investec management continue to surprise positively despite a tough operational environment both in SA and the UK. The decision to sell the UK Wealth business to the Rathbones group results in a simpler business structure and should unlock value over time. We are more than happy with the investment in the company and think it will continue to grow shareholder value at above 10% per annum and as such it remains a good investment opportunity due to its still 'too-low' investment rating.





Current positioning and outlook

Besides increasing the investment in Sanlam (and MMI) we made very little change to the portfolio over the quarter. The purchases were financed by using cash and reducing the holdings in JSE and Standard Bank.

The top five holdings remain unchanged:

The weight of Sanlam has increased but in terms of ranking, the top investments in the Fund remain the Denker Global Financial Fund, FirstRand, Investec, Absa and then Sanlam. The US dollar will most probably continue to weaken which implies a stronger rand. However, the inability of the ANC led government to resolve the electricity problem and its continued ideology that the state must create jobs rather than create an environment that facilitates growth that creates jobs, means that SA's growth rate is likely to remain sub-par - particularly when compared to other attractive investment destinations.

Despite that, South Africa regularly produces outstanding companies like Investec, Capitec, Transaction Capital and now Outsurance. In fact, the history of the Fund (outperforming both the JSE and MSCI World over the past 20 years for a compound return of 15.5%) shows that we have world class management teams and banks and insurers like FirstRand, Absa, Standard Bank, Santam and Sanlam have been world class at capital allocation and growing shareholder value.

Conclusions

The global and local outlook seem more uncertain. But markets have been selling off since late 2021 and the financial sector especially is very attractive in terms of its valuation. It is important that investors bear in mind that the structural problems the market now sees have been there since 2021... they have only now become evident. Hence, investors must guard against 'taking instructions from the market', as Warren Buffett calls it. The fact that the market has now woken up and is possibly over-reacting is creating good investment opportunities.

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 and into the future.

Responsible Investment Comments

In the current tumult, ESG scores have taken a backseat (but not forgotten). Of note this quarter was the fact that SA banks have all introduced various packages helping both businesses and the public to invest in solar capacity to reduce dependence on Eskom. This might be of greater ESG significance for SA than we realise if our new minister continues with his plans to propose increased investment in old coal-fired plants.





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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