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Nedgroup Investments Opportunity Fund
Seizing opportunities while mitigating risk

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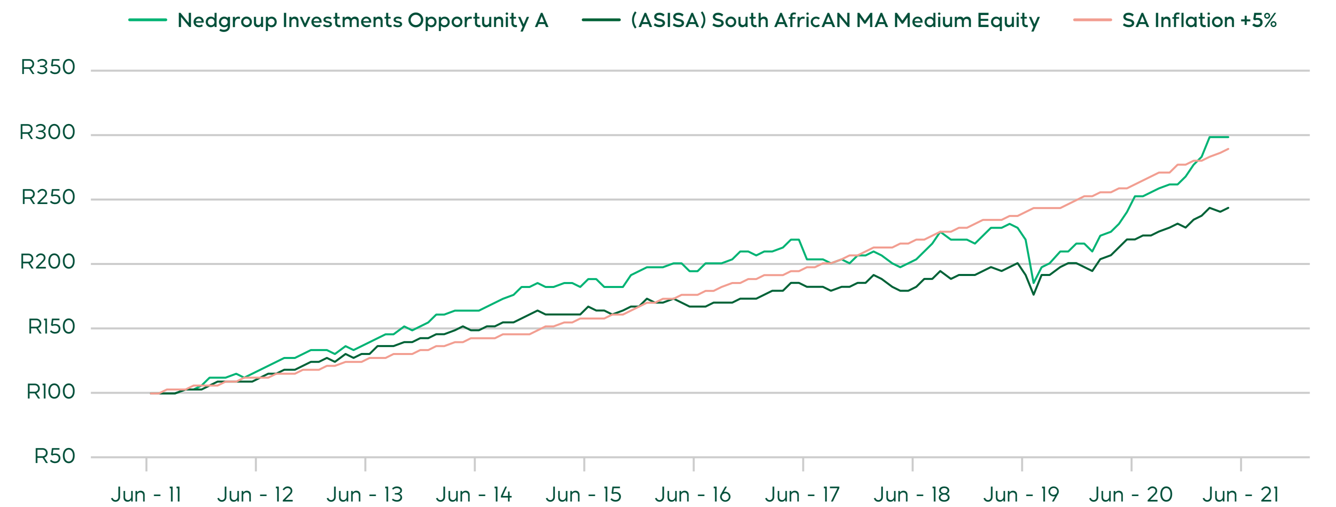
NEDGROUP INVESTMENTS

The Nedgroup Investments Opportunity Fund is managed to achieve two primary objectives: we aim to deliver returns of CPI + 5% (the return objective) but at the same time endeavour not to produce negative returns over rolling 2-year periods. For the most part, these objectives have been achieved. As at the end of February 2022, the annualised return of the Fund since inception (July 2011) has been 10.6% p.a. net of fees vs. CPI + 5% of 10.3% p.a. And for the vast majority of rolling 2-year periods (with the exception of a 3-month period in 2020 at the height of the Covid crisis) the Fund has produced positive outcomes.

1. Growth of R100 since inception



Our investment approach of sensible asset allocation and stock selection combined with searching beyond the traditional to try and add value via a broader range of assets and strategies has been consistently applied since the Fund's inception. This approach enables us to construct portfolios from a more diversified set of risk premia (sourced from areas of the market where fewer people are looking) in the attempt to improve risk-adjusted returns for investors. These strategies include the ability to analyse businesses across the capital structure and invest in hybrid securities with a more favourable risk-reward payoff (our convertible bond exposure, for example, has made a material contribution to returns over the years); the inclusion of quality smaller and mid-sized businesses in the portfolio that can add value over a full market cycle; the bespoke structuring of investment notes to produce pay-off profiles that align with the Fund's objectives; and the inclusion of cost-effective hedging strategies (at an individual security or asset class level) to help manage risk.

More recently, the most notable change in the portfolio is one of a large asset allocation shift into SA Government Bonds which we believe are attractively valued. Our weighting within the Fund has increased from 6.5% as at end May 2021 to the current weighting of 22.3% (end Feb 2022). At a high level, we believe local nominal bonds are attractively valued. With medium-term inflation expectations at around 5%, 10-yr bonds trading at 10% infer a risk premium of about 5% - a level typically more associated with equities and well aligned with the Fund's objective of CPI + 5%, while presenting materially lower risk than equities.

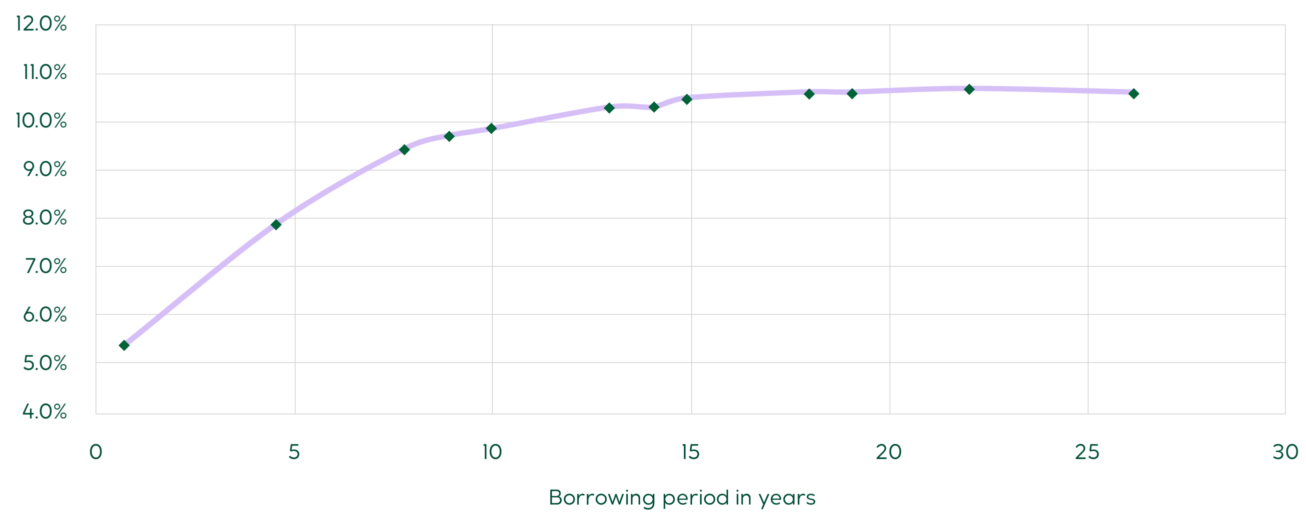
The increase in SA bond exposure has largely been funded through a reduction in equity exposure. Over the last year, quite a few holdings were subject to corporate action which prompted us to realise the value of those holdings. These include Royal Bafokeng, Imperial, and Vivo. We have also trimmed some of the holdings that have performed exceptionally well over the period in order to reduce their weightings and lock-in gains.

In this note we look at the reasons why we have added to bonds and explain our current view.

Background

A paradigm shift occurred from February 2021 onwards when global bond volatility increased significantly. This caused big changes across the SA yield curve, causing large non-parallel shifts. The R186 area of the curve weakened 64 bps in February (down 2.2% in performance), while the 12+ year area strengthened by 11 bps (up 1.7% in performance). In March 2021 the US 10-year bond yield rose by more than 30bps, continuing the global sell-off in bonds. The US Treasury inflation-protected securities (TIPS) real yield took the lead to weaken from -1.1% to -0.6%, which resembles the 2013 "taper tantrum" when tapering of QE was announced. The SARB Monetary policy committee (MPC) also indicated in March that the end of the Covid-19 induced cutting cycle was reached and the South African bond yield curve subsequently started to price in hikes, with the yield curve flattening.

2. Yield curve (NACS)*



*nominal annual compounded semi-annually

Motivation

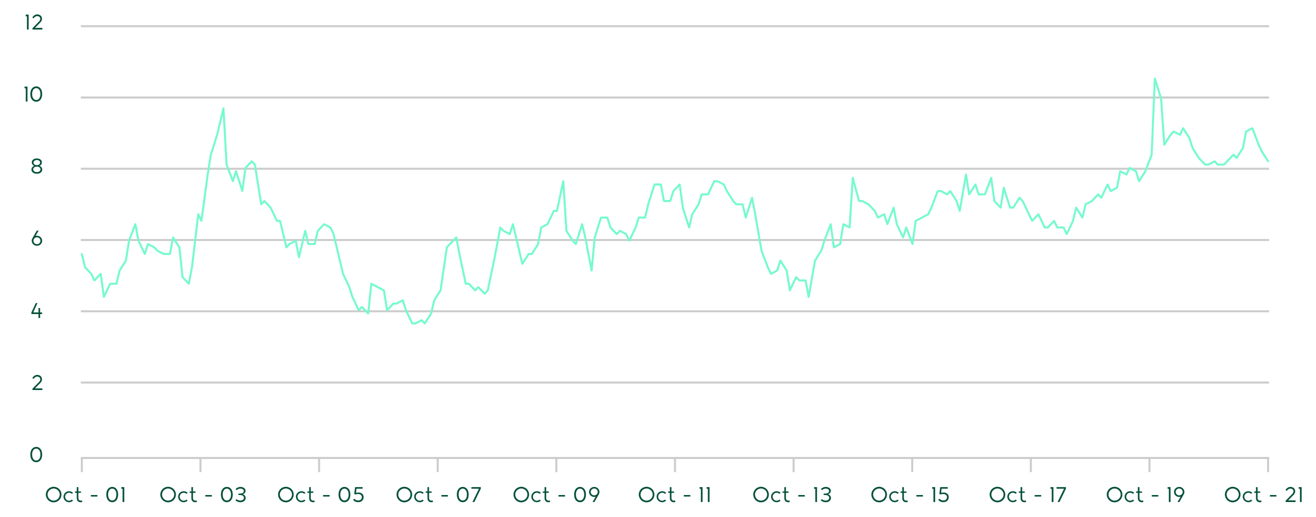
After a bull run in June 2021, the long-term bonds in SA increased again in September and October that year by more than 75bps after Federal Reserve Chair Jerome Powell announced in his Jackson Hole testimony that the bank "could" begin to reduce monthly bond purchases (quantitative easing or "QE") in the second semester of 2021. SA bonds weakened in sentiment with this, and the yield curve steepened to attractive levels. At the time we viewed bonds as an attractive addition to the portfolio.

We cautiously considered the following factors in our analysis:

- that global moves in EM bond yields were sentiment driven,
- high real rates and the attractive carry trade relative to US short-term rates,
- global risk-on sentiment after large lifting of Covid restrictions and more focus on global recovery,
- the view that the long-term inflation outlook in South Africa remains within the target band and well managed by the MPC,

- SA long-term bonds pricing in a large premium for inflation- and country risk,
- the revised and re-benchmarked GDP levels were published in August 2021 and resulted in an 11% bigger economy than previously estimated. The benefit of this is that it produces lower fiscal and debt to GDP ratios. We acknowledge however that the revision does not provide fiscal support and reveals an economy where 82% of the incremental nominal GDP is attributed to household consumption, and not the productive sectors of the economy. A strong fiscal position is needed to reduce pressure on the long-term bonds due to over-supply.
- the over-run in tax collection due to higher commodity prices and earnings.

3. Carry trade



Current situation

The tapering and ending of QE in the US caused a steepening of our curve resulting in a hefty risk premium. We believe the relatively steep yield curve still offers attractive real rates for investors in SA bonds, especially if currency risk is hedged out at these levels. Fiscal risks, however, remain the big concern, since an increased budget deficit would put renewed pressure on bonds. The continued positive support of commodity prices to our trade- and current account balances eases this pressure and reduces the need for excessive bond issuances. We therefore continue to believe that bonds offer attractive nominal and real returns at current levels and will continue to attract foreign interest.

Perhaps counter-intuitively, the situation in Ukraine may in the medium term provide even more support to the fiscus, given the sharp price increase in some of our commodities, and the fact that many global investors may move away from Russian bonds and look to SA for a home for those proceeds. Of course, in the shorter term, the situation does add volatility to prices.

Conclusion

Having started the year fully weighted to risk assets, we have used the opportunity of strong market conditions to rotate to a more balanced portfolio in terms of asset class allocations. We still retain a weighting to equities, but now have decent exposure to SA bonds as well as we believe they can deliver healthy real returns that are aligned to the objectives of the Fund, without having to take on too much risk.