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NEDGROUP INVESTMENTS GLOBAL FLEXIBLE FUND

Quarter 1, 2019

For the period ended 31 March 2019

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Commentary produced in conjunction with sub-investment manager, First Pacific Advisors

USD performance to 31 March 2019	Nedgroup Investments Global Flexible[1]	S&P 500	MSCI World
3 months	10.2%	13.6%	12.5%
12 months	2.3%	9.5%	4.0%

In the first quarter of 2019, the stock market delivered the best quarterly return in a decade, and the best quarterly start to a year since 1998.[2] It's almost as if the drawdown in the preceding fourth quarter didn't happen. The S&P 500 and MSCI World index increased 13.6% and 12.5% in the first quarter, respectively. The Nedgroup Investments Global Flexible Fund ("the Fund") returned 10.2% (net of fees). In each case, the Q4 2018 decline was largely recovered in Q1 2019.

Individual security performance in the first quarter was generally quite strong. The top five securities among the Fund's holdings provided fairly similar contributions to the overall quarterly return. All but Broadcom declined in value in the fourth quarter of last year and on little news, only to rebound, similarly without any discernible newsworthy event, in the most recent quarter.

Q1 2019 winners and losers[3]

Winners	Performance contribution (%)	Ave.weight (%)	Losers*	Performance contribution (%)	Ave.weight (%)
Altaba Inc	0.56	2.2	OSX Leasing Group	-0.01	0.0
Analog Devices	0.50	2.3	Cabot Corp.	-0.01	0.1
Broadcom	0.50	2.6	-	-	-
CIT Group	0.49	2.1	-	-	-
Alphabet	0.48	3.7	-	-	-
	2.53			**-0.02**	

* There were only two positions with at least a basis point of negative contribution in the first quarter.

The Contrarian Value[4] investment team ("CV Team") has the ability to invest broadly. The fund's investment universe includes global equities (typically the greatest exposure in the portfolio) of various market capitalisations, with high-yield bonds and distressed debt making up the next 'risk' asset class, and cash and cash-equivalents as a residual of the portfolio. Just because the fund can invest in a vast variety of vehicles however, does not mean it always should. Quite the opposite is true.

We only invest where we believe there is an excellent prospect for return combined with a margin of safety. A well-constructed new home does not need someone to come in and re-model the kitchen. Particularly following such a robust first quarter, we found little opportunity to use the tools at our disposal. Having little risk exposure to any asset class other than stocks makes the fund look more homogenous in terms of exposure - for a period of time anyway – although the equities the fund holds and the sectors in which it is invested look nothing like any index with significant sector overweight and underweight differentials.

We continue to exercise restraint, using only those tools that we believe will increase the value of the "home." We have no intention of pulling a hammer from its tool belt to bang holes in a perfectly good wall.

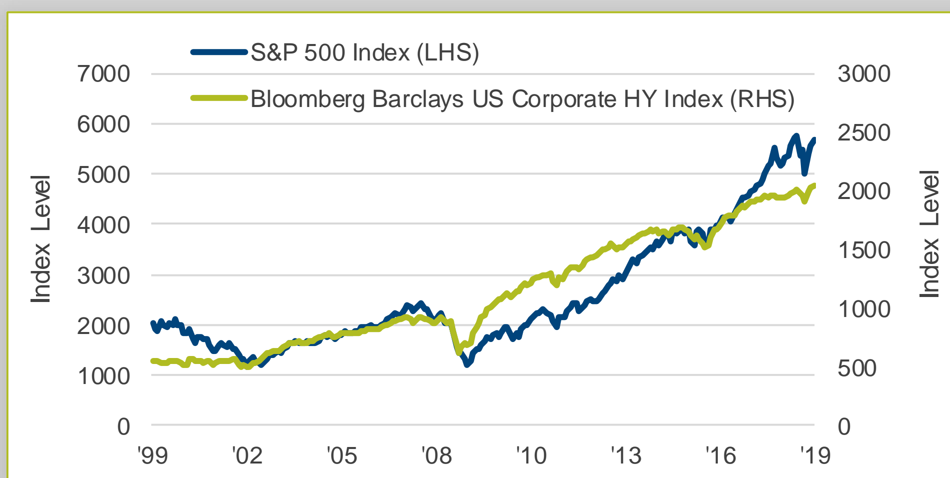
[1] Net USD return for the Nedgroup Investments Global Flexible Fund, A class. Source: Morningstar (monthly data series).
[2] Third quarter 2009 S&P 500 return was 15.61%. First quarter 1998 return was 13.95%.
[3] Reflects the top contributors and top detractors to the Fund's performance based on contribution to return for the quarter. Contribution is presented gross of investment management fees, transactions costs and Fund operating expenses, which if included, would reduce the returns presented. The information provided does not reflect all positions purchased, sold or recommended by FPA during the quarter.
[4] The FPA Contrarian Value strategy, on which the Nedgroup Investments Global Flexible Fund is modelled.

Stock market valuations can be a bit fuzzy. A commonly used but not always appropriate tool to value equities is the price-to-earnings ratio, or P/E. Determining an appropriate P/E requires consideration of a multitude of variables, including growth rate, interest rate, financial leverage, earnings (whether they are "normal" or accurately represent free cash flow), and so forth. The only certainty in the equation is price. For the purposes of this discussion, it is left to you to decide the appropriateness of the current trailing P/Es of the S&P 500 and MSCI World indices at 19.7 times and 17.7 times, respectively.

Now consider the current 6.7% yield-to-maturity of US high-yield bonds. That's a gross yield, which ignores whatever average annual net defaults may be over the years remaining until maturity. If the future is equal to the four-decade-plus past, then the gross yield would drop by 2.1% to an expected net yield-to-maturity of 4.6%.[5] A similar analysis of European high-yield bonds is even more depressing, currently offering a paltry 1.2% yield-to-maturity. We believe one can objectively state that such low yields are not enough to justify investment in higher yielding corporate credits in either the US or Europe, given that the next economic contraction (depending on its depth) could have higher than average defaults and lower than average recoveries.

If one accepts this argument that high-yield debt is currently expensive, then we think it is difficult to argue that the stock market offers great value, either. High-yield bonds and stocks tend to move up and down together, as shown in the following chart, and historically, there has been a 91.7% correlation between the S&P 500 and the Bloomberg Barclays US Corporate High Yield Total Return Index. So, should the fears we discussed in our special January commentary "Risk is where you're not looking" [6] become manifest, then high yield will perform poorly. Stocks would have to buck long-standing convention, then, to perform well from current levels.

S&P 500 and Bloomberg Barclays US Corporate HY Indices since 2000[7]



The seemingly effortless outperformance of the S&P 500 over the past decade – compared to foreign stocks, any kind of bond, and almost all other asset classes -- has fostered a new caste that worships at the altar of complacency. The more people do the same thing because it seems the "right thing to do," the more likely it is that, one day, it will become the wrong thing.

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[5] US gross yield as of March 31, 2019: BofA Merrill Lynch High Yield Master Index II (H0A0);
US historical high yield default and recovery rates: J.P. Morgan, Moody's Investors Service, S&P LCD using year-end data from 1982-2017. Net Default Rate = (1 - recovery rate) x default rate. Net Yield = Gross Yield minus Net Default Rate.
[6] For additional detail on the subject of the risks in corporate credit, please refer to our "Risk is Where You're Not Looking" special commentary. https://fpa.com/docs/default-source/funds/fpa-crescent-fund/literature/risk-is-where-you're-not-looking.pdf?sfvrsn=10
[7] As of March 31, 2019. Source Bloomberg

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