

CHECKING IN WITH THE NEDGROUP INVESTMENTS STABLE FUND



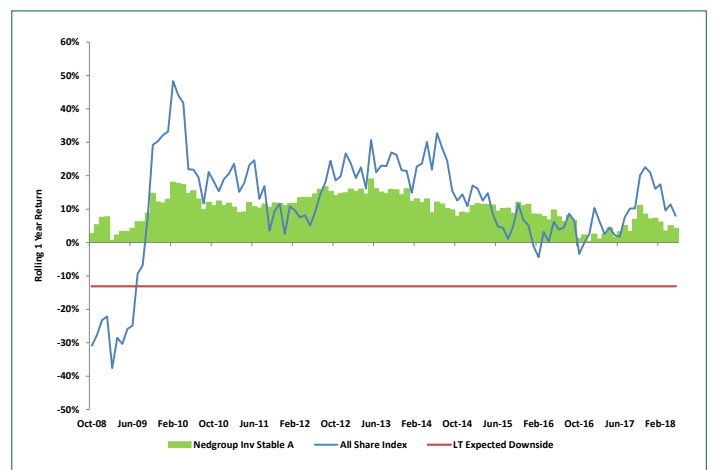
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At Nedgroup Investments, some of the key factors that we look for when selecting an investment manager include the following:

- Managers who own a reasonable stake in the business
- Co-investment alongside clients and alignment of interests
- Valuation driven
- Focus on capital preservation
- Stewardship culture
- Willing to close funds when necessary to protect alpha generation capability

Research shows that these factors tend to characterise managers who have generated strong returns for clients over the long term. A good example of this in practice is demonstrated by our longstanding partnership with Foord Asset Management who have managed the Nedgroup Investments Stable Fund since 2007. While the Fund has gone through a difficult period for performance over the past three years, we remain convinced of Foord's ability to beat inflation + 4% going forward. In fact, despite the relatively poor returns over the recent past, the Fund still remains one of the top performers in its category since launch.

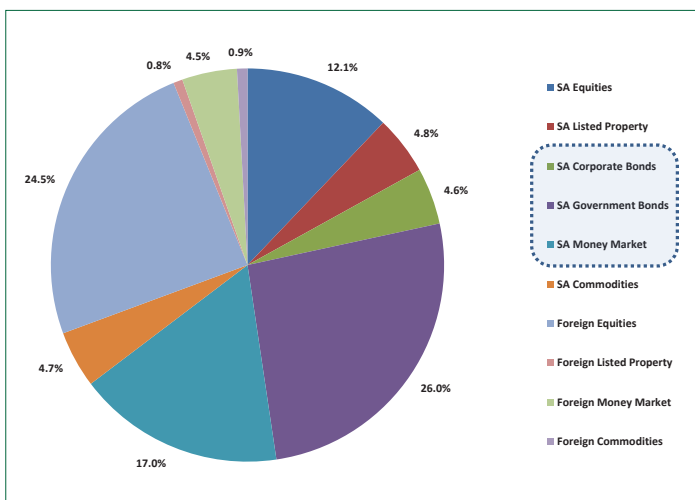
Portfolio construction is prudent, with a focus on capital preservation while also ensuring sufficient exposure to assets which are expected to deliver the necessary returns to meet clients' expectations. The *chart below* demonstrates the



Source: Nedgroup Investments, Morningstar

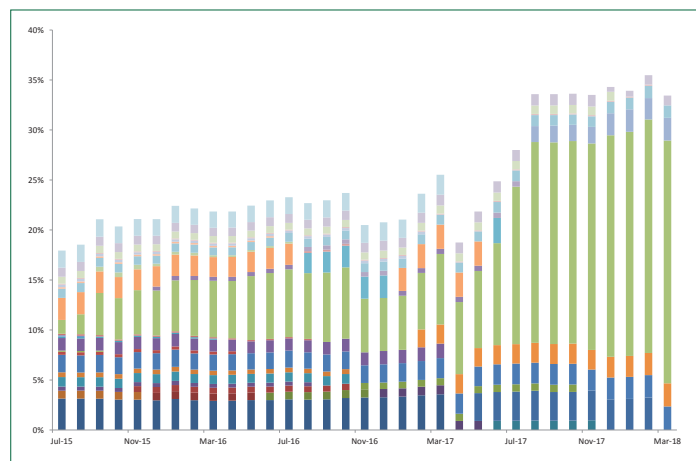
careful risk management philosophy employed within the fund. This chart appropriately demonstrates that the Nedgroup Investments Stable Fund has done well at protecting capital for investors over rolling one year periods in line with the risk objective of the Fund. To explain further, the green shaded area represents the Fund returns and the blue line shows returns of the All Share Index. In addition, the red line shows where we would expect the worst-case one year rolling return of the Fund to be, given this type of mandate and strategic asset allocation. This is based on a comprehensive analysis of historical data going back as far as 1960. As is evident, the Stable Fund's returns are nowhere near the red line, showing that there is significant value-add in being able to protect against capital losses over the short term, a characteristic which can easily be overlooked by investors when times are good. This ability to avoid capital impairment ensures that the fund benefits from the consistent impact of compounding, where gains are made on gains and so forth.

This capital protection ability over time has been partly driven through dynamic asset allocation. The Fund's latest asset allocation is shown in the chart below as at 31 May 2018:



Source: Nedgroup Investments, Foord Asset Management

As can be seen, the portfolio is highly diversified, tapping into various sources of return to generate alpha. For purposes of this article, we will focus on the SA fixed-income component of the portfolio, which currently makes up almost half of the fund. This portion of the fund in isolation is multifaceted, with underlying instruments in use which have maturity from 3 months all the way up to 2036! We have floating rate notes linked to JIBAR, fixed coupon bonds, corporate issuers listed in SA and some listed on international exchanges. Furthermore, we have inflation-linked bonds and of course we have bonds issued by the South African government. Importantly, the fixed-income holdings are dynamically adjusted on an ongoing basis as shown in the following chart.



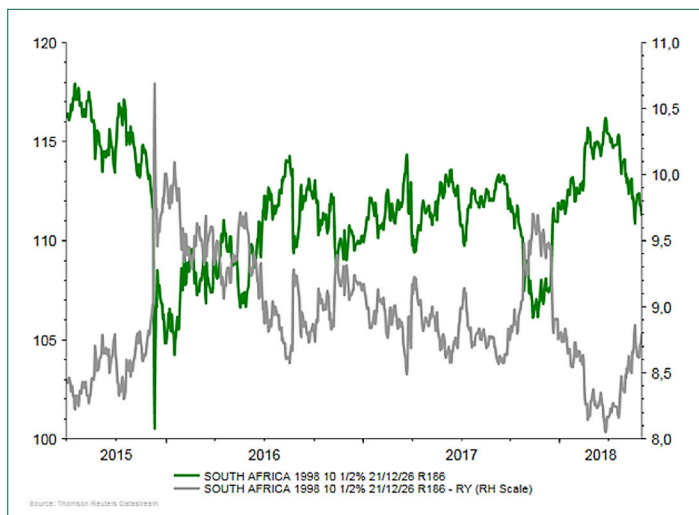
Source: Nedgroup Investments, data to Q1 2018

Each block in the chart above represents the holding of a particular bond within the fund, and is colour coded through time. It is evident that the allocation to bonds has almost doubled within the fund over the past three years, with the top holding being the R186 SA Government Bond making up just over half of the Fund's bond holdings as at 31 May 2018. Currently, there is a high running yield of 9.3% per year which makes the real return on these bonds quite attractive. Overall, the fixed-income part of the portfolio gives you almost a 2% real return regardless of equity risk. Within the equity segment of the portfolio, the Nedgroup Investments Stable Fund is currently biased to rand hedge stocks due to better valuations and prospects for earnings growth, which is counterbalanced by the large SA Government Bond exposure. In addition, this holding has shifted the duration positioning of the Fund as can be seen in the chart below:



Source: Nedgroup Investments, Foord Asset Management

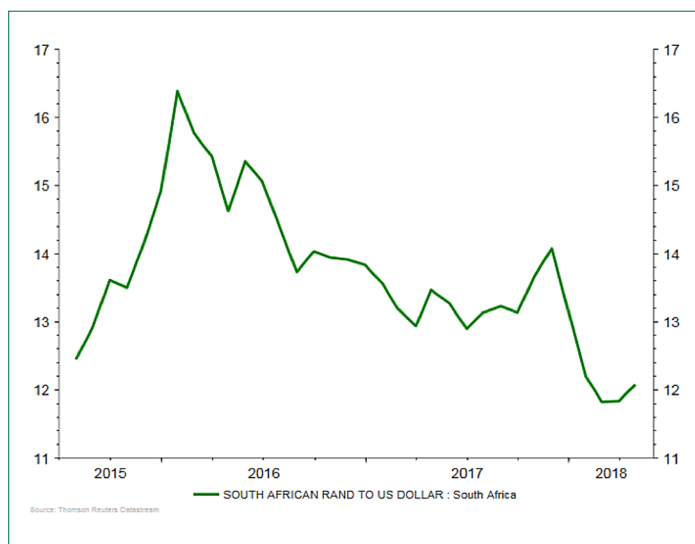
Since the middle of 2015, Foord have increased duration from less than one year to almost four years currently. This has had the effect of increasing interest rate sensitivity of the fixed-income component and was a huge benefit to the fund by producing large capital gains as yields fell and bond prices increased following political developments early this year. This is good evidence of how the portfolio is constructed: to ensure robustness and acceptable outcomes regardless of which market environments eventually transpire. It is worth bearing in mind that this decision was taken after much careful research, as there has been lots of uncertainty to contend with over the past three years. For example, the R186 bond price and yield has been particularly volatile due to global macro factors and SA-specific risk:



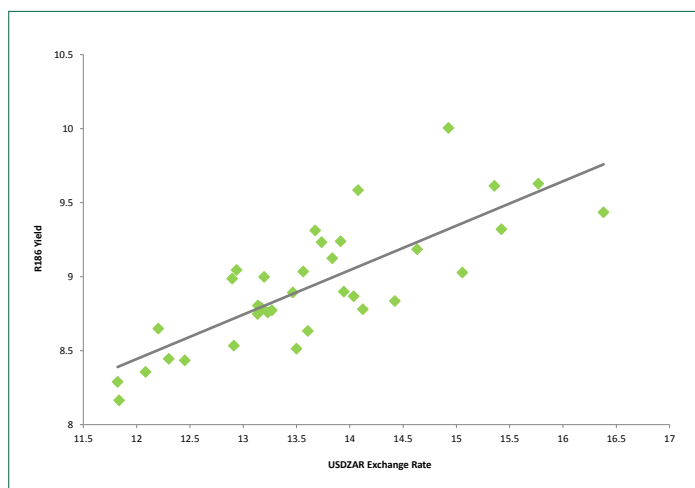
Which has had further knock-on effects on the yield spread between the R186 and 3 month JIBAR:



Let's not forget about the drastic movement in the USDZAR exchange rate over the period:



And finally it's worth noting that there's been a high correlation between the level of the rand and the R186 yield over this time:



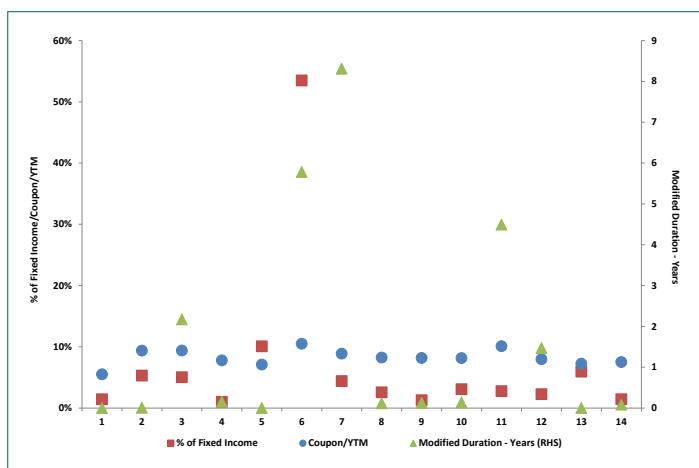
Source: Nedgroup Investments, Thomson Reuters Datastream, data since June 2015 to current

So it certainly has been quite a rollercoaster ride in markets recently and there's no sign of things abating – which is why Foord have utilised a wide spectrum of fixed-income assets to add value for the Fund. Importantly, their holdings are diversified and are not solely reliant on a single theme playing out.

As an example, the Fund holds bonds from a wide range of issuers such as:

- SA Government
- Strong SA banks (ABSA, Firststrand, Nedbank, Standard Bank)
- Top rated global banks (Bank of China)
- High quality SA corporates (Aspen)
- Global corporates issuing in SA (Mercedes Benz)
- Listed property (Growthpoint)

More characteristics of the individual bonds (with names removed) such as coupon, yield to maturity and modified duration are included in the chart below, reflecting the diverse nature of the bond portfolio as at 31 May 2018:



Source: Nedgroup Investments, Foord Asset Management

Over the past three years, the world has changed dramatically. Sentiment towards Emerging Markets has improved drastically, SA political risk is now perceived to be far lower (despite all the noise around land redistribution), the rand has strengthened significantly, global bond yields are rising rapidly and the extremely long bull market that we've enjoyed since the 2008 Financial Crisis looks to be getting increasingly out of breath.

It's worth noting that rand strength has tended to coincide with capital gains from bonds and locally focused counters, such as banks and retailers, doing well along with domestically focused property companies. These positions are a counterbalance to the Fund's offshore holdings and rand hedge stocks – another example of how Foord has constructed a robust portfolio that can withstand market shocks.

In this environment, we are confident about the prospects of the Nedgroup Investments Stable Fund. We are convinced that the Fund is invested in a diversified mix of fixed-income assets to help smoothen out returns, while enabling the Fund to achieve its return objective going forward through an appropriately selected range of quality companies that have a high likelihood of consistently growing their earnings. ■

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