

WHY INVEST IN THE CADIZ ABSOLUTE YIELD FUND: AN UPDATE OCTOBER 2011

24 October 2011



The award winning Cadiz Absolute Yield Fund continues to attract significant investor interest and flows. And a review of the Association of Savings and Investments South Africa (ASISA) quarterly statistics for the period 1 January 2007 to 30 June 2011 shows that the unit trust sector with consistently the second greatest investor appeal (after money market funds) was the Domestic – Fixed Interest – Varied Specialist sector.

So, why are investors attracted to Fixed Interest Varied Specialist funds in general and the Cadiz Absolute Yield Fund specifically?

Some background

The Domestic – Fixed Interest – Varied Specialist sector is something of a ‘catch-all’ sector for fixed interest funds that cannot be categorised as either money market, income or bond unit trust funds because of their specific investment philosophies. The ASISA Code of Practice Relating to Fund Classification states that; *‘These portfolios invest in bonds, fixed deposits, structured money market instruments, listed debentures and other high yielding securities. They seek to maximise income with preservation and stability of capital, or an offer of potential growth of capital. The underlying risk and return objectives of individual portfolios may vary as dictated by each portfolio’s mandate and stated investment objective and strategy. However, in terms of the investment mandates of these portfolios, they fall outside the existing subcategories of the Fixed Interest sector.’*

Not surprisingly, given growing investor interest in this sector, there has been a significant increase in the number of Fixed Interest Varied Specialist funds, now totalling 78. By comparison there are only 33 Money Market funds, 13 Income funds and 27 Bond funds.

Why Fixed Interest Varied Specialist funds

Given the product / instrument innovation in the fixed interest area, the broad flexibility of the investment mandates of Fixed Interest Varied Specialist funds is perhaps their primary attraction. While many investors are (relatively) happy to make an asset allocation decision between equities, bonds, property and the money market, they are a lot less so in deciding whether to be invested in long or short dated government and corporate bonds, inflation linked bonds, property loan stock, debentures, fixed deposits, preference shares and listed property. And this before considering more recent innovations, which include securitised assets, Credit Linked Notes, Equity Default Notes, synthetic credit, interest rate swaps, etc.

The ability, therefore, to make use of this myriad of investment opportunities to diversify risk and enhance the yield of a portfolio has proven extremely attractive and beneficial to investors (particularly given the increased volatility evident in the equity market).

Why the Cadiz Absolute Yield Fund

Many funds categorised in the Fixed Interest Varied Specialist sector have either the All Bond Index 1–3 years (ALBI 1-3) as their benchmark or 110% of the Short Term Fixed Interest Index (STeFI). The Cadiz Absolute Yield Fund, however, is benchmarked against CPI+3% – the fund specifically aims to provide investors with a return of 3% in excess of inflation (as defined by CPI) over rolling 3 years, and a positive return over any rolling twelve months. We specifically selected CPI+3% as the fund’s benchmark in recognition of lower risk investors’ need to still generate a real return over time, something not necessarily achieved by outperforming the ALBI 1–3 index or 110% of STeFI.

Bronwyn Blood, the investment manager of the Cadiz Absolute Yield Fund, applies an active asset allocation investment philosophy in the management of the fund, and the fund’s strategy has a combined focus on capital preservation and maximisation of total returns over the long term. Risk diversification and yield enhancement are achieved by investing in the range of fixed interest instruments and property stock outlined above, with downside market risk actively managed through derivative hedging strategies.

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Fund Strategy

An efficient frontier analysis was done to determine the optimal asset allocation to the above asset classes. In doing this analysis, we were cognisant of the benchmark (CPI+3%) risk and return, and solved for optimal weighting of the asset classes based on these constant parameters. Over time the optimal weighting of the fund in the different asset classes according to this analysis is:

- Bonds: 0 – 30%
- Inflation Linked Bonds: 0 – 50%
- Property and Preference Shares: 0 – 20%
- Money Market and Cash: 0 – 100%

This asset allocation leans very much to being short duration in the fund, when excluding inflation linkers. Since the Johannesburg Interbank Rate (JIBAR) should always follow CPI with a lag, one would expect this to be correct. However, we are also cognisant of our peers in the Fixed Interest Varied Specialist sector who may be benchmarked against the ALBI 1-3 and may therefore be taking more aggressive duration bets. We recognise that we need to get the balance right between outperforming the fund's benchmark as well as outperforming our peers.

Target Return

Since the Cadiz Absolute Yield Fund is focussed on yield enhancement as a primary alpha generator, we thought it prudent to estimate a minimum target spread above JIBAR that would outperform CPI+3% over the long term. This yield spread may vary over time according to where real policy rates are, and where they are forecast to go given certain repo rate and inflation assumptions. To make this point clearer, the minimum target yield spread has been increasing over the recent past as real policy rates are at an all time low and the Reserve Bank has a much clearer growth focus. The result of this has been a move to increase the fund's inflation protection, as the potential for real rates to go even lower becomes a reality in our economy. We also looked at how the ALBI 1-3 has performed versus JIBAR and determined that the ALBI 1-3 has outperformed JIBAR over the long term. This proved that in order to achieve a competitive return in the Fixed Interest Varied Specialist sector, we would need to take more active duration positions around the short end of the yield curve.

We therefore target a minimum yield enhancement which should be enough to outperform the benchmark over the long term, but we will actively change the fund's duration depending on our view on the interest rate cycle and the valuation of fixed rate bonds. We use derivatives in the form of swaps and futures to manage this need to switch between fixed and floating rate exposure.

Risk of Capital Loss

A further objective of the Cadiz Absolute Yield Fund is to minimise the potentially long negative drawdown periods associated with the bond and equity markets. The fund has successfully done so to date, with only 4 negative months in the five and a half years since the fund's inception on 1 March 2006. We do though recommend that the investor's horizon be longer than one year as there may be periods where the fund underperforms the money market. This is due to the fact that the fund is also invested in longer dated assets, and in a rising interest rate environment the fund may experience some negative performance. Over the longer term, however, our ability to switch between fixed and floating rate exposure should benefit the fund to the extent that it outperforms cash and its benchmark on a rolling three year basis.

The other area of risk in the fund is credit or default risk. We mitigate this risk by ensuring that all credit assets that we invest in have gone through a thorough due diligence process internally and have been rated by a reputable rating agency (as required by Cisca). We are thus comfortable that the risk of default in the fund is minimal. We further mitigate this risk by diversifying sufficiently across the various rating categories according to internal Cadiz Asset Management credit committee guidelines so that we are not overexposed to any individual counterparty.

Cadiz Asset Management (CAM) Fixed Interest Team

Importantly, in managing this flexible fixed interest fund, Bronwyn is able to call on the strengths of one of the most highly qualified and experienced fixed interest teams in the country, as demonstrated in the following table.



Name	Role	Qualifications	Years in industry / company
Jonathan Myerson	Head: Fixed Income / Strategist	MSocSci (Econ), MIFM	16 / 5 years
Adenaan Hardien	Economist	MA (Econ), MA (Dev Econ)	15 / 11 years
Gus Louw	Portfolio Manager / Derivative Specialist	BSc(Hons)(Maths)	14 / 6 years
Adre Smit	Portfolio Manager: Money Market	FIFM	31 / 13 years
Bronwyn Blood	Portfolio Manager	BCom (Hons)(Econ)	12 / 5 years
Kefilwe Moadira	Credit Analyst	BBusSci (Fin.), CFA	5 / 2 years
Vaneshen Naidoo	Credit Analyst	MSc (Eng)	4 / 4 years

This team has leadership skills across all areas from which returns can be generated – fundamental asset management, credit and quantitative asset management.

The fund follows the CAM fixed interest, money market, credit, property and preference share valuation process in detail to determine a horizon return for each asset class. This horizon return is the main input into determining the allocation to each asset class, within the parameters specified above. Each of the valuation processes are described briefly below:

- **Bonds:** We employ an exhaustive set of quantitative tools and systems. Much effort is spent on establishing fair value for government issued bonds across the yield curve. We have developed three core valuation models to enable us to do this quickly and efficiently. These models entail, inter-alia, the use of global government bond yields, South African government issued foreign currency bond yields, various measures of inflation in various countries, and an inferred bond risk premium. Some of these indicators are forward looking and, for this purpose, we also establish consensus expectations and the range around these. We have also developed robust proprietary quantitative tools for establishing mis-pricing in the shape of the yield curve and in individual bonds. Among these tools are modified duration curves, spot curves, forward curves, swap curves and total return differential calculators. We also have the expertise to maximise convexity of a portfolio, while simultaneously satisfying various constraints.
- **Inflation Linked Bonds (ILBs):** We use a global bond valuation process, which establishes fair value for ILBs and uses US Treasury Inflation Protected Securities (TIPS) with a sovereign spread overlay. We also establish relative values of ILBs versus nominal bonds by comparing breakeven yields with consensus inflation forecasts. Finally, we employ total return differential calculators to calculate the relative return of ILBs versus cash and nominal bonds.
- **Money Market:** The process starts with an analysis of the international environment, which is overlaid on the local economy. The South African Reserve Bank's benchmark policy rate, the repo rate, anchors short-term interest rates. Movements in short-term interest rates thus reflect market perception of the future course of the policy rate. The Reserve Bank adjusts the repo rate to affect a certain inflation outcome over its (two-year) policy horizon, given the Bank's inflation targeting framework. The view on short-term interest rates thus comes down to a view on inflation. CAM has developed a detailed analytical framework for understanding the drivers of inflation, ie the global business cycle, commodity prices, currencies, the local business cycle, local food prices, the labour market, monetary conditions and inflation expectations. CAM has also developed an extensive money market tool set for the purposes of analysing the money market.
- **Credit:** The credit process is a top down process where we initially look at macro drivers that may be affecting credit spreads. The direction that spreads should be moving based on these drivers informs our initial overweight or underweight position in credit. We then drill down further into a particular credit instrument by first looking at the industry a corporate may be operating in and the macro drivers for the divisions within the corporate and the industry. The majority of our analysis is aimed at company specific risk; broken into business risk, financial risk, performance risk and qualitative factors. The rating of a corporate is very important and we subscribe to two rating agencies; Moody's and Fitch. We also use two rating models; the Altman Z Score and S&P Comparison Ratio Model to try and determine our own rating for the corporate. Our valuation process extends to pricing credit, where we try to determine a fair value spread to the curve based on the assumed rating and fundamental risk factors. We use various



tools to analyse and determine fair value spreads, namely breakeven spreads, interpolated benchmark spreads and asset swap spreads.

- **Property:** Our model for property is based on a target exit yield for each property stock in the index. This target yield is derived from a risk premium above the 10-year bond yield, which is then further adjusted for the growth assumptions underlying the stock. The risk premium is based on a stock's medium, high or low risk assumptions. This target yield is then compared to the 1-year forward clean yield on the property stock and the difference between the two is the assumed capital growth of a stock over a 1-year horizon. The forward clean yield of the stock is added to the capital growth to determine the total return for a particular stock. This total return is then market cap-weighted to get an overall total return for the sector. We also use a dividend discount model to determine value among the various stocks.
- **Preference Shares:** The preference share model is a simple forward clean yield model, which is stated as a percentage of prime. We overlay credit ratings on top of these yields for the various banking preference shares to determine relative value.

Expected Asset Class Returns and Current Fund Positioning @ October 2011

The following table summarises our expected horizon asset class returns:

Asset Class	Historic Return (1 year)	Horizon Return (1 year)	Commentary
Nominal Bonds	5.92%	8%	Our key valuation models suggest that South African bonds are above fair value, although the sovereign debt crisis and resulting risk aversion is weighing on this market. The deteriorating fiscal position means that there will be supply pressure going forward and that the long end of the curve could experience further sell-off. Risk – lower returns
Inflation Linked Bonds (ILBs)	9.17%	8.5%	While yields on ILBs remain low compared to history, with inflation on a rising trajectory and growth to remain subdued, we feel it important to increase the inflation protection in the fund. Risk – lower returns
Property	8.3%	11%	Property looks to be offering the most attractive returns of all of the fund's investable asset classes, although on a risk adjusted basis is still not offering enough. We remain concerned about the robustness of growth rates given that property lags the economic cycle. We are sticking mainly to the more defensive stocks and keeping our weighting to this asset class around 5%. Risk – lower returns
Cash	5.91%	5.75%	While Forward Rate Agreements (FRAs) are pricing in a small chance of a rate cut, we believe that rates will be on hold for the foreseeable future. Risk – lower returns

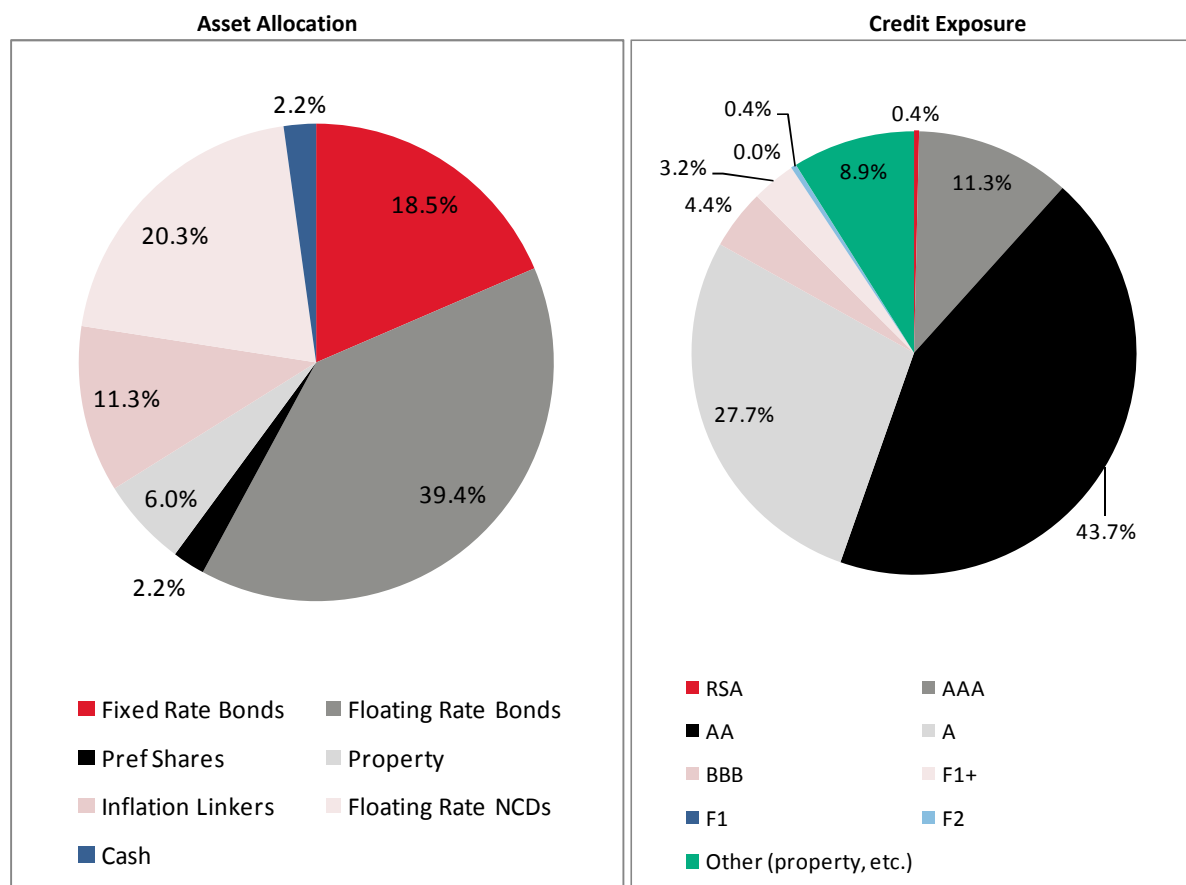
In summary:

- Although the market is pricing in the risk of a rate cut, we believe that rates will be on hold for the foreseeable future, and with real yields so low, the Reserve Bank will see little benefit from cutting rates at this point in the cycle
- The yield curve has steepened considerably, and with the continued Eurozone turmoil we believe that volatility and risk aversion will remain in the market place in the near term
- We are well positioned from a duration perspective to weather the storm of any further interest rate volatility
- We continue to find opportunities to get exposure to floating rate assets with 'safe' spread to keep the yield in the fund high
- Due to real yields likely being lower for longer and a worse growth outlook, we are still finding better value in inflation linked bonds with real yields of 3% and above



- We continue to find value in offshore credit and we are looking to sell some of our local exposure and replace it with offshore exposure (now at 15% of the fund) as far as capacity will allow, while hedging out any currency risk
- We actively invest in derivatives as a means to change our duration position in the fund
- As property has been underperforming we have slightly up weighted our exposure to the more defensive property stocks

Given the above, the Cadiz Absolute Yield Fund is currently positioned as follows:

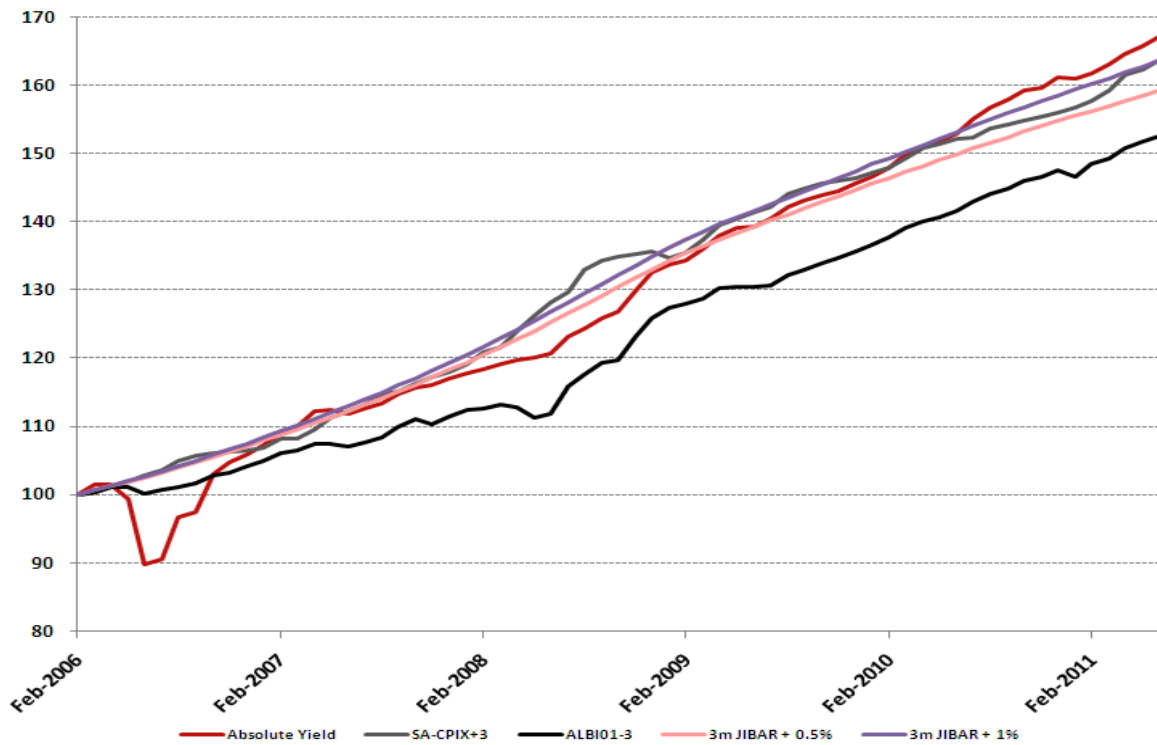


The fund's weighted average duration is 0.79 excluding inflation linkers and 1.55 with inflation linkers included, as compared to the weighted average duration of the ALBI 1-3 of 2.14. The fund's yield is 7.8%, as compared to the yield on the ALBI 1-3 of 6.06%.

Performance

The Cadiz Absolute Yield Fund is well on its way to achieving its objectives since inception on 1 March 2006 and we believe that it is well placed to continue to meet investor expectations into the future. In fact, the fund's excellent performance has resulted in it twice being the recipient of Morningstar Fund Awards, specifically the 2011 Morningstar Fund Award Winner in the Cautious Allocation category and the 2010 Morningstar Fund Award in the Cautious Balanced category.

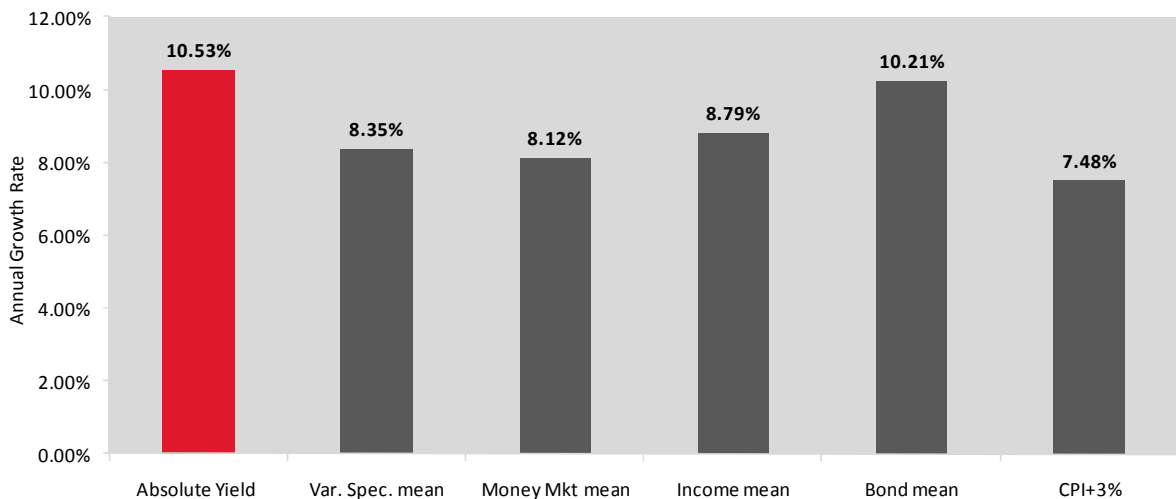
The following graph illustrates the fund's return for the period since inception until 30 September 2011 versus CPI+3%, the ALBI 1-3 and 3 month JIBAR + 1%. It is worth noting that the underperformance for the period April – June 2006 was as a result of an overweight to property. Subsequently, and as a result of the efficient frontier analysis, we decided to cap property exposure to a maximum of 10%, and from the graph you will see the fund's outperformance since June 2006. It is also worth pointing out the relatively high inflation rate over 2008 and into 2009 and the subsequent material reduction in the inflation rate.



The bar chart below further illustrates the benefits of a flexible fixed interest mandate. You will note that because of the Cadiz Absolute Yield Fund's ability to invest across the spectrum of fixed interest instruments it has been able to outperform the mean of the other, more restrictive fixed interest categories ie money market, income and bond funds for the three years to 30 September 2011. The fund has also outperformed all money market, income, bond and flexible fixed interest funds for the 5 years ended 30 September 2011.

Domestic - Fixed Interest - Varied Specialist sector 3 years to 30 September 2011

Source: Morningstar





Who should invest and how

This portfolio is ideally suited for investors who do not want to make the complex asset allocation decision between the growing (in number and complexity) range of fixed interest instruments. As investors continue to de-risk their investment portfolios, lower risk flexible mandated funds, such as the Cadiz Absolute Yield Fund, have become increasingly attractive.

It is also at times of increased market volatility that cash seems like the safer bet, however, it comes at the price of lower longer term returns. The Cadiz Absolute Yield Fund therefore targets those investors seeking to maximise real returns over the long term. These include investors making use of retirement products ie retirement annuities, preservation funds and living annuities. Investors can access the Cadiz Absolute Yield Fund directly or via the following linked investment service providers AIMS (ABSA Wealth Series), Equinox / Intervest / PSG, Glacier, Investec, Odyssey, Old Mutual, Momentum (Core) and Stanlib (Select 50).

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