

WHY INVEST IN THE CADIZ INFLATION PLUS FUND: AN UPDATE (2011 FM MORNINGSTAR FUND AWARD WINNER IN THE FLEXIBLE ALLOCATION CATEGORY)

31 March 2011

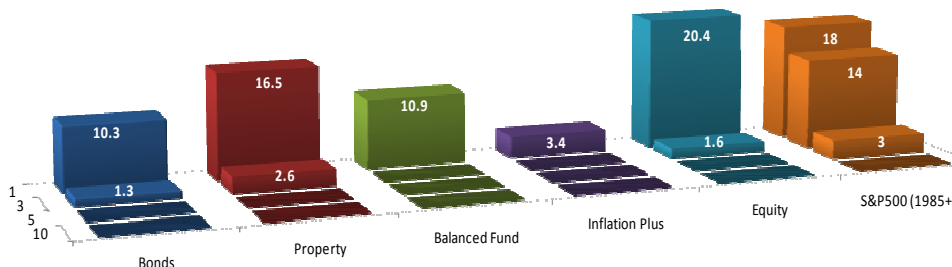
Financial studies show that investing in equities is the best way to beat inflation over the long term. One such study, undertaken by Firer & Staunton (*'102 Years of South African Financial Market History'*, 2002) showed that, over the (very) long term, equities outperformed inflation by 9.2%, whereas bonds delivered a real return of 1.9% and cash only 0.9%. Therefore, in the long run, if you can:

- remain invested;
- are not concerned with a good correlation to inflation;
- are not unduly concerned with the volatility of returns; and
- can afford negative returns (sometimes significant – in the past 30 years, the FTSE/JSE All Share Index has experienced falls in excess of 30% seven times) in certain years;

Then your best investment strategy is to be fully invested in equities.

Unfortunately, however, as illustrated in the following chart, in any given year there is a significant (greater than 20%) probability of South African equities, and to a slightly lesser degree the other asset classes (property, bonds and US equities), delivering a negative return.

Probability (%) of Negative Return



Source: Merrill Lynch, Cadiz; 2009

If the above is of concern to you, specifically negative returns in certain years and volatility of returns, then you have to consider an alternative investment solution – an **'inflation plus' solution**, which, as illustrated in the chart above, at 3.4% for an inflation plus 5% mandate, is extremely unlikely to deliver a negative return over a rolling 12 month period.

Cadiz Inflation Plus Fund as a viable solution

The Cadiz Inflation Plus Fund aims to outperform inflation by 5% over a rolling 36 month period, **while targeting capital preservation (i.e. no negative returns) over rolling 12 months**. Therefore the fund is clearly targeting investors who do not have an appetite for negative returns, and is differentiated from traditional balanced funds (including the Cadiz Managed Flexible Fund) in that it actively focuses on the management of downside risk, which is not necessarily a focus of balanced fund mandates.

It does so by utilising an actively managed multi-asset class investment strategy (both strategic and tactical asset allocation decisions are implemented, more later) with carefully managed equity stock selection. The fund will take positions in asset classes

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other than equities – domestic cash, bonds, inflation linked bonds, preference shares and property – as and when the appropriate opportunities arise.

This strategy is grounded in our belief that markets are driven by interest rates, earnings growth and investor sentiment, and in order to be successful you need to:

- understand investment environments and the likely behaviour of markets;
- have skill in asset allocation and fund structuring - Cadiz Asset Management (CAM) has strong building blocks across all the asset classes, largely due to the fact that CAM has one of the most stable and experienced investment teams in South Africa;
- above all have stock picking capability; and
- understand how to mitigate risks and ensure downside portfolio protection - given that Cadiz has been the top rated derivatives house for the past fourteen consecutive years (source: annual Financial Mail surveys: 1997 – 2010), Cadiz is uniquely placed to protect inflation linked portfolios through the efficient and effective use of derivatives.

Why the Cadiz Inflation Plus Fund

We believe that the fund manager, Francois van Wyk (who is also CAM’s Chief Investment Officer and Head of the Asset Allocation Committee) and CAM have a clear competitive advantage in the management of Inflation Plus funds. Francois has been a pioneer of inflation linked portfolio management in South Africa and has developed a successful track record of delivering on Inflation Plus mandates.

To better implement our Inflation Plus investment strategy, Cadiz has undertaken proprietary research to establish the optimal asset allocation to attain the required level of outperformance in different economic and inflationary environments. Unique to Cadiz, this asset allocation roadmap allows us to be pragmatic about the environment in which we invest. We have performed a significant amount of empirical back testing to ensure that this approach and our techniques are reliable.

In conducting this research study we defined the economic environment into one of four stages as illustrated below based on our view on inflation and Gross Domestic Product (GDP) growth.

ECONOMIC ENVIRONMENTS		INFLATION	
		Accelerating (Higher Long Rates)	Decelerating (Declining Long Rates)
GDP GROWTH	Rising (Positive sloping yield curve)	Expansion	Correction
	Declining (Inverted yield curve)	Stagflation	Contraction

Source: Cadiz, 2009

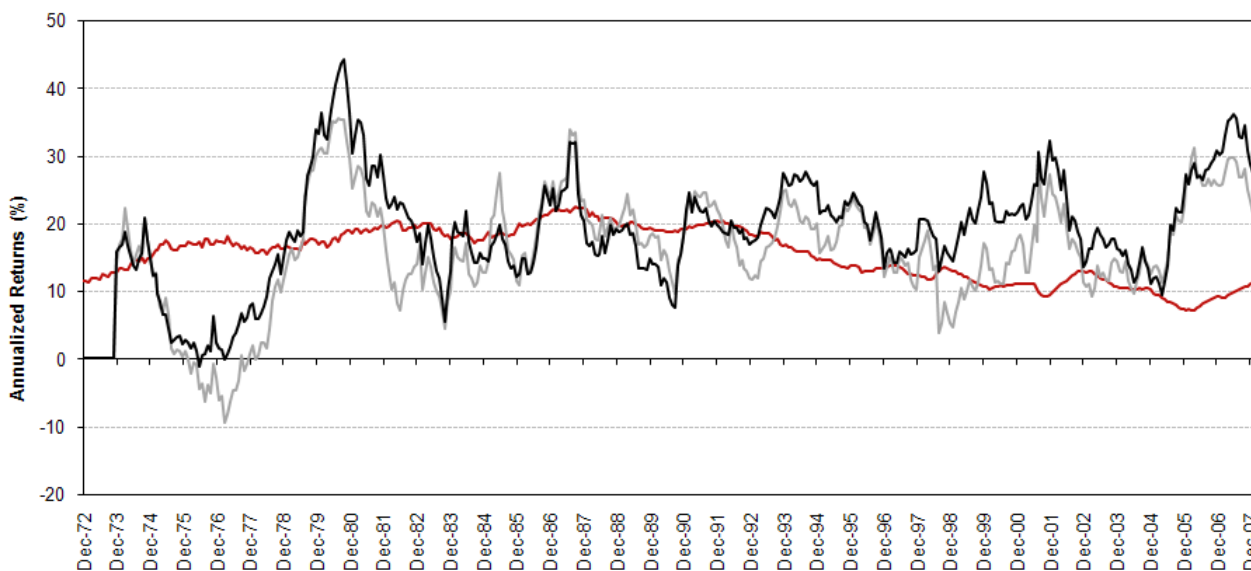


Briefly, the results of this study indicate the following (for more detail please see the article 'Inflation, the Economy and Inflation Plus Benchmarks'):

- The optimal asset allocation is 59% equities, 31% bonds and 10% cash.
- Importantly, however, the probability of this optimal portfolio outperforming CPI+5% over rolling three years was only 56%!

Cadiz then posed the question; 'Would tactical asset allocation decisions based on each of the defined economic environments (expansionary, stagflationary, correction and contraction) improve the probability of outperforming CPI+5%?' The short answer is 'yes', using tactical asset allocation improved the probability of outperforming CPI+5% to 67%, as evidenced in the graph below.

In the graph, the hurdle rate, CPI+5%, is represented by the red line. The grey line shows the optimal static asset allocation over the research period that had the greatest probability of beating CPI+5%, and the black line indicates the results of strategically altering asset allocation for different economic conditions. From the graph it is evident that using tactical asset allocation improves one's return over most periods.



Source: Cadiz, 2009

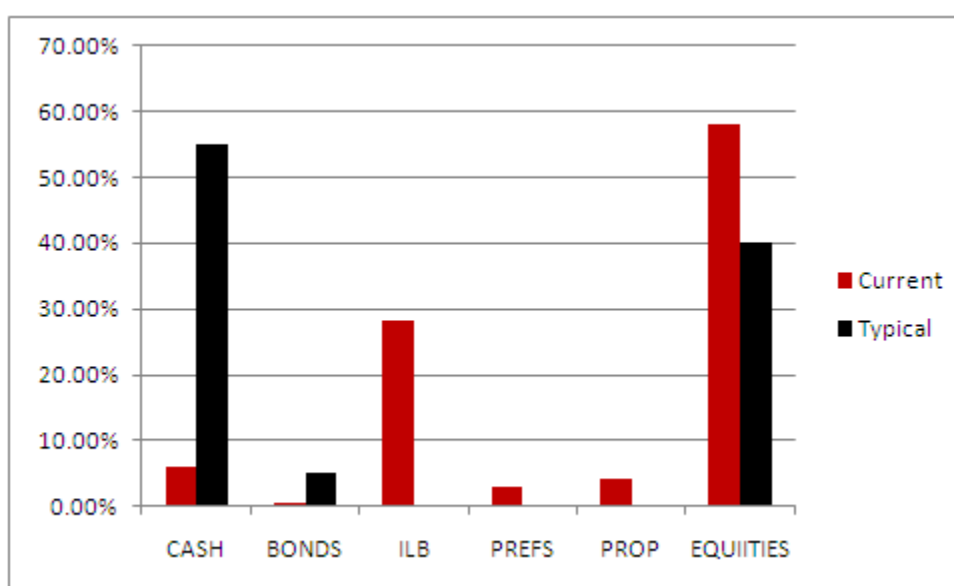
Importantly though, the results of this research study demonstrate the difficulty of outperforming CPI+5% over rolling three years. Even with the benefits of tactical asset allocation based on changing macroeconomic conditions there remains a one in three probability of underperforming this benchmark. As a result, Cadiz expanded this research study even further to include tactical asset allocation decisions using individual clusters of shares (e.g. interest rate sensitive, rand hedge/ commodities) and therefore Francois combines this knowledge with the CAM investment outlook to structure the fund's tactical asset allocation.



Current positioning

Right now (March 2011), we find that GDP is rising and inflation is accelerating and we are therefore in an expansionary economic environment. With this as background, and based on our asset allocation roadmap, we are currently overweight equities, and specifically resource shares as these have the highest probability of outperforming inflation plus 5% in an expansionary economic environment. Interestingly, while cash provides absolute nominal value protection, it has a 0% probability of outperforming inflation plus 5% in an expansionary environment, and bonds only a 21% probability.

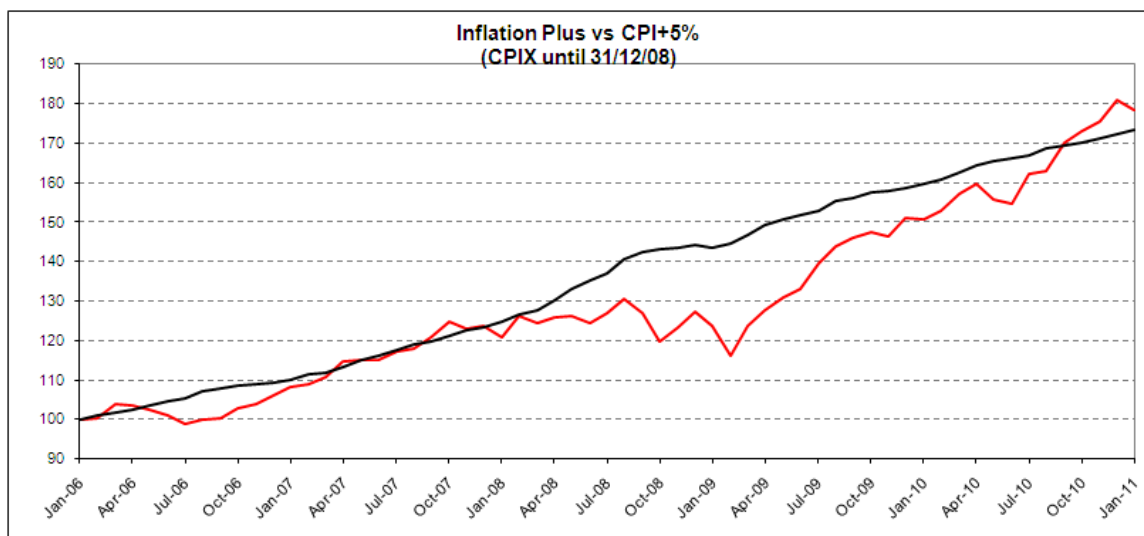
The following bar graph illustrates the current asset allocation of the Cadiz Inflation Plus Fund, with the black bars illustrating the fund's typical, through the cycle, asset allocation. You will note that based on our current view we are significantly underweight cash in favour of inflation linked bonds, whose exposure we have built up as the coupon on inflation linked bonds is positively correlated to inflation, which is attractive in a rising inflation environment. As indicated above we are overweight equities and slightly overweight preference shares and property.



Source: Cadiz

Cadiz Inflation Plus Fund performance

The benefits of Francois' experience and skill are evidenced in the following chart, which illustrates the fund's performance since inception (January 2006) to 31 January 2011 of the Cadiz Inflation Plus Fund compared to CPI+5%. You will note that during what has been an extremely trying period for financial markets and all asset classes bar cash, by comparison, the Cadiz Inflation Plus Fund has performed exceptionally well and is now ahead of its CPI+5% benchmark.



Source: Statpro and Cadiz

Furthermore, there have been 48 rolling one year periods (to month ends) since the Cadiz Inflation Plus Fund's inception on 13 January 2006. During this time the fund has only experienced four negative one year returns – an extraordinary achievement given that the FTSE/JSE All Share Index has experienced 14, with the market's most negative one year return being -37.59%!

Who should invest and how

For the five years prior to May 2008, investors experienced an unprecedented equity bull market. Unfortunately, the strength and duration of this bull market blinded most participants, both investors and fund managers, to the link between risk and return. That reality has once again been cruelly reinforced – risk and return remain two sides of the same coin, and it is the fund manager's duty to ensure that returns are balanced against the risks taken. Historically the primary defence fund managers used to protect portfolios against tumultuous markets was diversification across asset classes. It is this investment strategy that the Cadiz Inflation Plus Fund continues to employ.

The Cadiz Inflation Plus Fund, therefore, targets those investors seeking to maximise real returns over the medium term. These include investors making use of retirement products i.e. retirement annuities, preservation funds and living annuities. Investors can access the Cadiz Inflation Plus Fund directly or via the following linked investment service providers; AIMS, Equinox, Glacier, Investec, Odyssey, Momentum and Stanlib.

In conclusion, the Cadiz Inflation Plus Fund is ideal for lower risk institutional and retail investors with a medium term investment time horizon **who are seeking consistent, real returns.**

Paul Hutchinson
March 2011