January 2018

CAMmuniqué

CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

cadiz

ASSET MANAGEMENT

Our investment philosophy

We take advantage of short-term mispricings to unlock long-term value

Our investment philosophy is rooted in the belief that every asset has two values – its current market price, and what the asset is worth to a knowledgeable investor, referred to as intrinsic value.

We believe that, in the long term, asset prices tend to reflect the underlying intrinsic value of a business or bond. In the short term, however, asset prices can differ materially from the underlying value of the investment. This is because prices tend to be driven by investor sentiment (behavioural psychology) and the supply and demand of capital (liquidity/the interest rate cycle).

Our investment approach seeks to take advantage of these short-term mispricings by buying quality assets when they are typically out of favour and are selling at deep discounts to their intrinsic value.

Our investment process

We run an opportunities-driven screening process on a globally integrated basis, designed to find compelling investment prospects.

1. **We generate ideas through a global screening process**

   Our screening process is designed to find compelling investment opportunities in a variety of industries and geographically diverse markets.

2. **We conduct detailed research and analysis of the potential opportunities we identify**

   From our screening process, we create a shortlist of potential investment opportunities that we investigate further based on a range of qualitative and quantitative investment criteria. Price risk, which we define as the permanent loss of capital, is lowest when we can buy a quality investment cheaply, preferably when it is out of favour. This is because quality investments can grow their intrinsic value over time, while cheap assets have a margin of safety as a buffer against incorrect analysis or unforeseen events.

3. **We determine the intrinsic value of an asset**

   We use different valuation methodologies depending on the type of asset we are valuing. We focus on sustainable metrics and do not use any explicit forecasts. To avoid potential valuation errors, we also derive both a bear and bull case valuation in addition to the intrinsic valuation and explicitly focus on the bear case to limit risk if our analysis proves to be incorrect.

4. **We construct our portfolios based on our conviction in an investment**

   Our portfolios are constructed from a bottom-up perspective and are reflective of our level of conviction. We are benchmark agnostic, which means we build portfolios without reference to each asset's weight in an index. As a result, our portfolios tend to look different from the market and our peers. We typically hold a concentrated portfolio that is diversified across sectors, geographies and economic sensitivity. We also run a proprietary quantitative, risk-diagnostic analysis to understand the 'bets' we are taking from a sector, geographic and macro- or microeconomic-sensitivity perspective.

5. **We are disciplined about when to sell an investment to protect investors' interests**

   We will consider selling when:

   - the price exceeds our estimate of fair value,
   - there is a structural deterioration in the fundamentals of the investment,
   - we find more compelling investment opportunities for capital allocation, or
   - it becomes evident that we have overestimated the investment merits of the investment.

6. **We regularly review our portfolios**

   We regularly review our decisions and original investment thesis to ensure they are still relevant so that we can rebalance our portfolios when necessary.

In this edition

Introduction

Reflecting on 2017 and the ethics of index funds

Shawn Stockigt
CEO and Joint Chief Investment Officer

Despite the turmoil of 2017, our business was stable

It's hard to believe that 2017 is behind us, junk status and all, and that we can now look forward to 2018. Reflecting on 2017, our business was stable and focused relative to 2015 and 2016. On the back of this stability, the sound performance of some of our funds (despite a challenging investment environment) and excellent client service have enabled us to curb the challenges that had such a big impact on our business in the previous two years. This provides a strong base going into the new year.

The 'Gupta leaks' revealed an interesting ethical dilemma for index fund managers

The 'Gupta leaks' emails about allegations of corruption against Naspers' 80%-owned MultiChoice and their relationship with TV channel ANN7 got me thinking about ethical investing and index funds. Although not unique to South Africa, it is a problem in the local investment universe, where one company (Naspers) makes up a whopping 23% of the index.

Taking a stand against individual companies within an index is a challenge

Index fund managers are mandated to purchase shares in every company that makes up an index. If managers wanted to take a stand against MultiChoice's alleged wrongdoing, they could publicly state that they have cancelled their DStv subscription and fire the auditors of Oakbay (the former owners of ANN7). They could also be vocal about encouraging others to do the same. However, what about the 23% capital invested in Naspers shares?

The only real option available for an index manager is to engage with the company. But putting pressure on the company's chairman may not yield the required result. This proved to be the case with Naspers, where queries from fund managers and shareholders were stifled, with no opportunity for debate or discussion.

Naspers' complicated shareholder structure makes matters even worse. Even if an investor wanted to vote against any perceived ethical or governance issues, this could well come to naught as the A shares (which are very tightly held) control 68% of the voting rights.

This ethical dilemma blurs the line between passive and active investing

A recent article in The Economist ('Thin edge of a wedge: Ethical investors set their sights on index funds') reports on a Vanguard shareholders meeting. The shareholder 'Investors against Genocide' asked Vanguard to avoid investing in companies that, 'in management's judgement, substantially contribute to genocide or crimes against humanity'.

The article stated that Vanguard's management argued against 'any prescriptive constraints on a fund's investible universe' – which would make the asset manager an active manager. The article reported that the company's outgoing chief executive said that, 'if individuals did not like this, they need not buy a global index that included the controversial companies'.

But what happens if an investor with a passive management strategy invests in an index fund before the tainted company forms part of the index? According to Vanguard's chief executive, the passive investor's option would then be to sell their holding in the fund, making the investor an active investor. An interesting dilemma for passive investors indeed!

In this quarter's CAMmuniqué

Brian Munro, our Head of Multi Assets, kicks off this edition by providing an overview of the broad investment themes that have influenced equity markets over the last few years. He also looks through the lens of the Cadiz investment philosophy at these themes to explore what we may expect in 2018. Graeme Ronne discusses the investment case for Woolworths Holdings Limited. He explains how the share meets all our key investment criteria despite it currently being out of favour in the market. In his regular 'Quarterly review', Matt Brenzel provides a detailed commentary on the past quarter's international and local developments, and what this may mean for 2018. He cautions that despite strong global growth and the positive sentiment in local markets (from the outcome of the ANC Elective Conference), there are still many uncertainties – so diversification remains key. Lastly, Equity Analyst Craig Thompson shares some personal insights about what drives him.

Looking to 2018 – we're excited about exploring new opportunities

After a focused and stable 2017 and some good investment performance, 2018 will be a year where we explore and launch new and exciting products and distribution opportunities. You can however rest assured that, whatever we do, honesty and integrity will always remain the foundation of every decision we make.

Wishing you all a successful, happy and healthy 2018! ■

Where to invest

The investment landscape and its implications for 2018

Brian Munro
Head of Multi Assets

In this article, Head of Multi Assets Brian Munro, takes stock of the broad investment themes that have influenced equity markets over the last few years. He also explores the implications of these for investors this year. Will 2018 be a continuation of 2017, or can we expect a change to secular, long-term drivers? Brian explains that Cadiz looks at the investment landscape through the lens of our investment philosophy (as summarised on the first page of CAMmuniqué). This philosophy explains that two fundamental drivers of markets are earnings (profits) and interest rates. Brian provides an analysis of these drivers, and what may lie ahead.

Reflationary monetary policy has been the main supporter of equity markets

In 2016, the Bank of England (BoE), the European Central Bank (ECB) and the Bank of Japan (BoJ) lowered their interest rates to their lowest levels in modern history. The BoE decreased its interest rate from 0.50% to 0.25%, and the ECB and BoJ reduced their interest rates to 0% and -0.10% respectively. They joined the US Federal Reserve (US Fed), which had already dropped its interest rate to 0.25% in December 2008. At the same time, the BoE, ECB and BoJ added further stimulus by increasing the size of their asset purchase programmes, which substantially grew their balance sheets in 2016 and 2017. The US Fed, which had started its asset purchase programme much earlier than the others, has at last passed the baton of ultra-supportive monetary policy to other major central banks. This global reflationary monetary response to the 2008 financial crisis did much to support 'risk' assets. Equity and commodity markets have therefore outperformed bonds, credit and property stocks over the last two years.

While monetary support will continue in 2018, shifts in policy are evident

The major central banks have however begun to reduce their monetary policy support from these highly accommodative levels. They are likely to continue this trend in 2018 and even accelerate their reduced support in 2019/2020. The risk is that they remove this support too aggressively. Once again, the US Fed has led the way. It has raised its benchmark interest rate by 1.25% to 1.50% in increments of 0.25% over the last two years, and plans to raise the rate by a further 0.75% in 2018. At the same time, it has begun to normalise its balance sheet by reducing its size. This has the effect of gradually removing the life support it has provided to the US economy since the global financial crisis.

Major central banks are changing their stance on policy support

As explained below, the other major central banks have also been subtly shifting their monetary policy support. Our view is that they will continue to move gradually and successfully give guidance to markets.

1. The ECB has indicated that it will continue with its asset purchase programme until September 2018. However, from January 2018, the bank plans to reduce the amount of monthly purchases from the current €60 billion to €30 billion.
2. The BoE is concerned about the weakening pound, a deteriorating current account deficit, and a slowing economy. Brexit concerns are currently reducing confidence in the UK economy. The BoE therefore chose to increase its interest rate to 0.50% in November 2017.
3. The Chinese central bank, the People's Bank of China (PBoC), raised its interest rate by 0.05% in December 2017, following an earlier hike in March. This signalled the government's intention to implement policies to stop the excessive use of corporate and other debt.
4. The BoJ continues to provide stimulus to the economy, but has altered its strategy to target the shape of the yield curve. It has set the short-term interest rate at -0.10% and will buy or sell government bonds to ensure the 10-year bond yield is close to 0%.

Rising interest rates affect the values of all financial assets

Although central banks focus on the wellbeing of the economy and influence this through interest rate policy, interest rates also affect bond yields and stock valuations. Global bond yields are expected to rise moderately as interest rates rise. Rising interest rates (and rising bond yields) affect the discount rate investors use to value the future profit stream companies expect, thereby placing downward pressure on company share prices. Typically, value stocks are less affected by a rising discount rate.

> ***'…the tiniest change in [interest] rates changes the value of every financial asset.'***
>
> *Warren Buffett*

The change in interest rates may cause a rotation towards value stocks

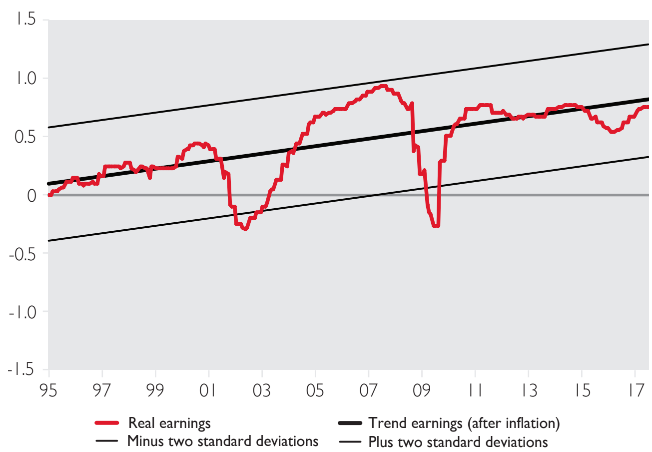
At Cadiz, we focus on buying good quality businesses that have a sound management team and a strong balance sheet without excessive debt or liquidity risk, in line with our value investment philosophy. We focus on buying businesses at attractive valuations that are out of favour and are less likely to be affected by a rising discount rate.

A recovering global economy is likely to support company profits

The global economy is starting to stand on its own two feet and should require less support from monetary policy. The healing process has finally gained momentum, broadening across sectors and across regions. Economic growth has become more synchronised across developed and emerging markets. Company profits (earnings) grew by more than 10% last year (see Chart 1). We expect the growth in earnings to continue in 2018, supported by the global economy maintaining its above-trend growth and continuing accommodative monetary policy.

> ***'The goal as an investor would simply be to purchase, at a rational price, a part interest in an easily understandable business whose earnings are almost certain to be materially higher five, ten and twenty years from now.'***
>
> *Warren Buffett*

Chart 1: Company profits have grown (as shown by the MSCI World Index earnings growth, adjusted for inflation)



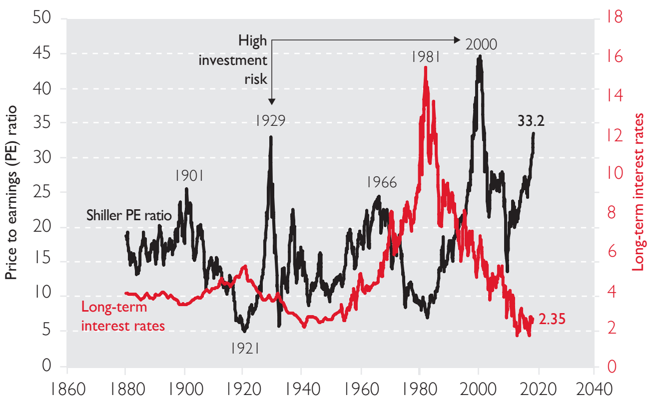
Sources: Cadiz Asset Management, Bloomberg

However, over the long term, sustainable economic growth is a function of population (employment) growth and productivity growth. Because most of the industrial world has an ageing population with slowing employment growth, this leaves productivity growth to drive sustainable economic growth. Since the financial crisis of 2008, productivity growth has been weak. We have only recently seen signs that productivity growth has started to increase. However, additional fiscal and labour reforms are needed, together with innovation, technological change and an investment in human resources to ensure productivity growth is maintained and even accelerated. Otherwise, the current above-trend growth we are enjoying, will not be maintained and there will be a very real risk that the current economic growth rate will fade.

Earnings growth is more likely to drive equity returns but de-rating risks are high

Valuations of stocks in some sectors, especially those that have done well over the last two-to-five years, are expensive. As shown in Chart 2, the Shiller price to earnings (PE) ratio of the market is high by historical standards. It has a reading of 33X, which is the third highest in over 100 years. This is twice the long-term average of 16X. We expect equity returns to be driven by earnings growth rather than a further re-rating.

Chart 2: Equity valuations are elevated



Sources: Yale University, Department of Economics, Robert Shiller

The risk is that if earnings growth does not materialise or disappoints, this would cause equity markets to de-rate significantly as prices fall. As discussed earlier, a further risk is that central banks remove the 'punch bowl from the party' and tighten monetary policy too aggressively. This could also cause prices to sell off significantly. We don't believe that 2018 is the time to be complacent!

At Cadiz we adopt a bottom-up, contrarian, valuation-based approach to investing

In line with our investment philosophy, we assess each company's merits, its potential profit (earnings) stream, and the risks associated with this when we select stocks. We also determine what each business is worth and what we are willing to pay for it. Because the future is unknown, we ensure there is a sufficient margin of safety between the share price and our valuation of the business before we invest. We do our best to avoid buying expensive assets and in so doing, limit potential capital losses for our clients. ■

The investment case for Woolworths

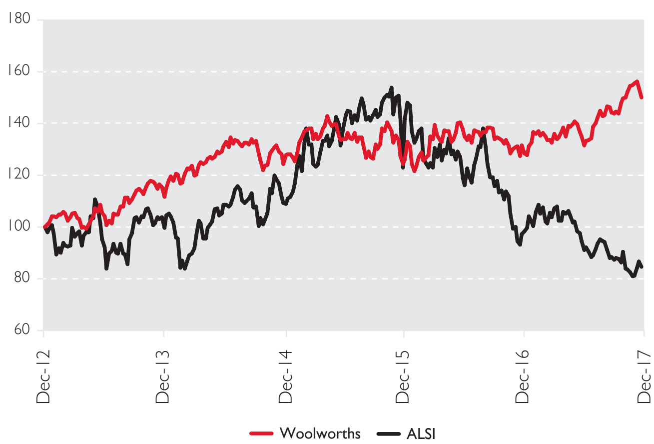
Graeme Ronne
Head of Equities

In this article, Graeme Ronne explains the investment case for Woolworths Holdings Limited using the Cadiz equity investment process. The share meets all our key investment criteria – it's a high-quality business with a proven track record of above-average profitability and low financial risk, it's run by management who are good stewards of capital, and it's attractively priced due to depressed earnings and weak investor sentiment.

Woolworths remains out of favour because of weak sentiment, creating an opportunity

Woolworths' share price has fallen by approximately 49% over the past two years, from a high of R106 per share in November 2015, to a low of R54 per share in November, underperforming the FTSE/JSE All Share Index (ALSI) by more than 50% (see Chart 1). In fact, the share price is lower today than it was before the announcement of the David Jones acquisition in Australia in April 2014. Over the past two years, the company has struggled to grow its earnings. A tough consumer environment in South Africa and Australia, local political risk, and some operational missteps are largely to blame. This has driven increased fear and uncertainty in the minds of investors, leading to a significant de-rating of the price to earnings (PE) ratio. When the share price was at its peak, some 70% of stockbrokers rated the share a worthwhile buy, compared to less than 20% today. Investor sentiment is decisively weak, and the share remains firmly out of favour. In our view, this has created an attractive opportunity for disciplined, patient investors.

Chart 1: Total return index for Woolworths and the FTSE/JSE All Share Index (ALSI) (2012-2017)



Source: FactSet

In reality, it's an above-average, highly cash-generative business with low financial risk

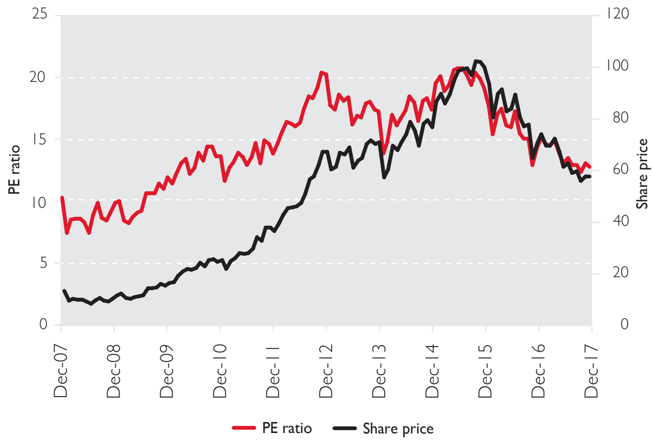
Most local retail investors would be very familiar with the South African food, clothing and general merchandise operations of Woolworths. We regard these as above-average, highly cash-generative businesses because of their attractive profit margins, high asset turnover, and modest capital requirements. The South African operations generate above-average pre-tax returns on capital (25%-30%), with modest levels of financial gearing (1.7X net debt to EBITDA – earnings before interest, taxes, depreciation and amortisation). Strategically, we believe Woolworths is well positioned to continue growing market share and improving efficiency throughout its operations.

Local investors may be less familiar with the Australian operations, consisting of David Jones and the Country Road Group (consisting of Country Road, Witchery, Mimco, and Trenery). Woolworths acquired a controlling interest in the Country Road Group in 1998. David Jones was a struggling department store retailer that Woolworths acquired in 2014 for AU$2.1 billion (R21.4 billion). Management saw an opportunity to generate shareholder value by driving operational improvements and leveraging the group's combined purchasing power. The business has however fallen short of management's expectations, and is the primary reason for the operational underperformance over the past two years. The pre-tax return on invested capital of 6% is extremely depressed and provides significant scope for improvement, if management can execute their strategy effectively.

The business is attractively priced at the bottom of its earnings and valuation cycles

Investors appear to be pricing in very little growth off the existing depressed earnings base, and seem to ascribe little or no value to David Jones at current prices. At the time of writing, the share traded on a PE ratio of 13X and a dividend yield of 5.5%. We take comfort from the fact that profit margins across the clothing and general merchandise businesses are depressed relative to the past several years (as can be seen from Chart 2). This gives us the opportunity to purchase an above-average business at an attractive price on depressed earnings. We believe the margin of safety to our estimate of intrinsic value is more than adequate and shifts the odds in our favour, as the price has already discounted far greater deterioration in the earnings power of the business.

Chart 2: Woolworths' price to earnings (PE) ratio and share price over the past 10 years



Source: FactSet

Woolworths should continue to reward investors over the long term

Good businesses tend to get better when times are tough. The headwinds that Woolworths is currently facing are not insurmountable, and appear to be of a temporary nature. This is not the first time the business has been through such a challenging period, and most likely not the last. Woolworths has demonstrated its resilience in the past, and we believe the current management team can pull through again. Despite challenging market conditions and temporarily depressed earnings, Woolworths continues to generate good returns (more than 20%) and strong cash flows, with low levels of financial risk. In the short term, the share price will most likely be driven by news flow and macroeconomic factors. However, over time, we believe our disciplined approach and patience should yield attractive returns for our clients. ■

Quarterly review

Matt Brenzel
Joint Chief Investment Officer

INTERNATIONAL COMMENTARY

Global economic data appears to support a view that the tide may reverse in 2018

Brian Munro's article in this edition is a timely reminder that the super-accommodative monetary policy, which was one of the tailwinds for risky asset class performances since the global financial crisis, may become a headwind in 2018. This is because economic growth is gaining greater traction worldwide. Here's a brief recap of the latest data that supports this view:

- The US economy grew at the fastest rate in the past three years. Third-quarter GDP figures were revised upwards to 3.3%, annualised. Consumer spending added another 2.3% in the quarter, after registering 3.3% in the previous one. Business equipment sales rose by double-digit figures. Producer price inflation rose by 3.1% year-on-year (YoY), the fastest increase in six years.
- As expected, the US Federal Reserve (US Fed) raised its benchmark rate by 0.25% in December and announced another three rate hikes for 2018. Its growth expectation for 2018 was raised to 2.5% per annum (p.a.). This meeting was Janet Yellen's swansong as Chair, which she will vacate for newly appointed Chair Jerome Powell. Although Powell has been vocal about easing regulatory burdens for businesses and banks, it is generally anticipated that he will maintain the US Fed's current circumspect path of rate tightening.
- The People's Bank of China (PBoC) followed the US Fed rate hike by tightening its own benchmark rates by 0.05%. It was the first hike since March 2017 and signals the PBoC's intention to manage its currency, and its desire to continue reining in debt levels. While the focus in the past has been on the orderly deleveraging of the financial sector, the policy focus in 2018 will be aimed at the highly indebted state-owned enterprises.
- The headline Bank of Japan's (BoJ) Tankan Index for December revealed that the business conditions reading for large businesses improved to +25. This is the fifth improvement on the way to an 11-year high. GDP growth, while positive, remains a tepid 1.4% p.a. This is unlikely to be enough to persuade corporates to accede to Prime Minister Shinzo Abe's call for a general wage increase of 3% in 2018.
- The European Central Bank (ECB) announced its quantitative easing (QE) plans for 2018 as well as its growth expectations for the new year. GDP is forecast to grow at 2.3% p.a., which is broadly in line with expectations. The ECB also appeared more confident of reaching its stated inflation targets, as a significant amount of economic slack had been removed.
- Consumer price inflation in the UK recently rose to 3.1% - its highest level in over five years. How much of that statistic is currency-related (due to Brexit) and how much is reflective of consumer demand, is unclear at this stage.
- We can see further evidence of greater global economic traction in the extended weakness of the US dollar, which started sliding relative to its major trading partners since December 2016. It is currently flirting with its most recent low of September 2017. Conversely, emerging market economies are picking up momentum, as are commodity prices. These are typical signs of a late-cycle rally, which usually ends after an aggressive central bank response to inflationary pressures.

We don't think central banks will be aggressive enough to cause negative surprises

As indicated by Brian in his article, we don't expect central banks to act in a way that results in tears for investors in risky assets. Our view is based on the fact that expectations are for positive but muted growth worldwide. There is still sufficient excess capacity to ensure pricing pressures do not get out of hand, even as the consumer spends more. Central banks have become better at announcing policy well ahead of the event, leading to less potential for negative surprises.

Table 1: International market returns

International (US$)	Quarter	12 Months
MSCI World	5.6%	23.1%
MSCI Emerging	7.5%	37.8%
MSCI SA	21.5%	36.8%
JP Morgan Global Bonds	1.0%	7.0%
US Cash	1.2%	7.0%

Sources: Deutsche Bank, I-NET

Equities continued to outperform, and bonds have been on the back foot

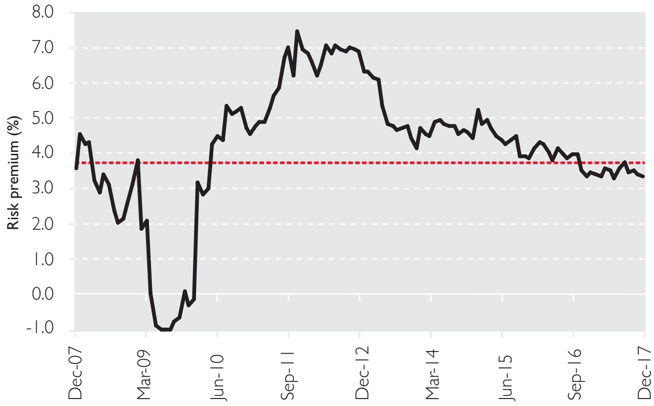
It has been an extraordinary year for equity markets. For the first time on record, global equity markets rallied in all 12 months of the year. The MSCI World Index rose by 23.1% in 2017 (as shown in Table 1) – the strongest performance since 2009. Technology shares took an early lead, which was maintained throughout the year. Software (+41.9%) and tech hardware (+36.1%) were the standouts, while energy (+3.4%) lagged and all defensive sectors underperformed. As is usual during economic upturns, the US lagged the World Index (+19.5%, which is still good), while emerging markets (+34.3%) and Asia-Pacific ex-Japan (+33.5%) led. In the quarter, US tax reform beneficiaries (telecoms, discretionary, staples, financials and industrials) all outperformed, along with energy and materials (amid the rally in commodities). Another standout was the performance of MSCI SA Index (more on this in the Local Commentary section on the next page). Bonds have underperformed due to the scaling back of accommodative QE programmes. Given the extraordinary run in equities, where to for 2018?

We favour global equities over global bonds for 2018

Chart 1 shows the US equity risk premium. It is calculated as the difference between the earnings yield of the S&P 500 Index and the 10-year inflation-linked bond (risk-free rate). It provides an indication of the compensation investors demand to invest in equities as opposed to a risk-free alternative. The red dotted line plots the average of the variable over the past decade. Note how the black line (showing the risk premium) breached zero percent in 2009 as equity earnings evaporated following the global financial crisis. The chart also shows how risk compensation has unwound since the highs of 2011. This was because central banks injected massive doses of QE, aggressively driving interest rates down, rekindling economic and corporate earnings growth, and stimulating the demand for risky assets. The current reading is in line with the average and not overly demanding.

At Cadiz, we still favour equities over bonds for the moment. The reduction of QE and rising inflation will affect bonds first. Equities should still experience meaningful earnings growth (especially in the US, courtesy of lower corporate taxes and share buy-backs by forced offshore fund repatriation), which should be supportive of equity prices. That said, returns will most likely be generated by earnings growth and dividend payouts, and not an upward move in ratings.

Chart 1: US equity risk premium (2007-2017)



Sources: Cadiz Asset Management, I-NET

The potential risks to our view include the following:

- The US dollar strengthens due to a host of reasons, including weak growth elsewhere, geopolitical instability (North Korea and the Middle East), or the US Fed having to tighten policy more rapidly and by a greater quantum than expected
- Corporate earnings growth underwhelms
- More defections from the European Union
- No agreement on Brexit
- A credit crisis in China
- A strong outflow from emerging markets

LOCAL COMMENTARY

A mixed macro picture during the quarter

The economy continued the rebound that started in the previous quarter.

- Manufacturing output rose by 2.2% YoY in October, after having fallen by 1.7% in the previous month.
- South Africa's retail sales increased 3.2% YoY in October, after an upward revision to 5.7% in September.
- Inflation was marginally higher at 5.1% in September, but then reversed course in the following two months, coming in at 4.8% in October and 4.6% in November. Prices for food, non-alcoholic beverages and transport rose at a slower pace and a stronger rand helped.

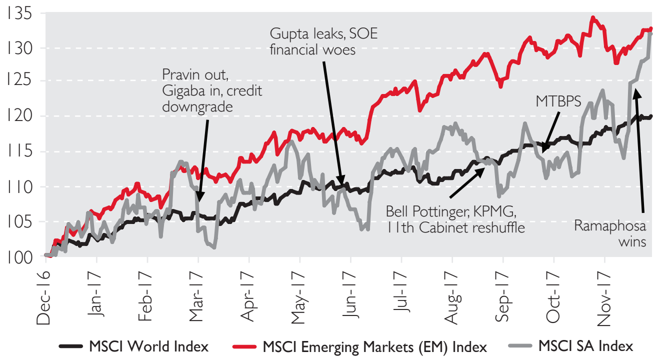
A bleak medium-term budget offset the good news

Offsetting the more positive data was Finance Minister Gigaba's maiden delivery of the Medium Term Budget Policy Speech. This painted a bleak picture of the fiscus. The numbers indicated a budget deficit of 4.3% of GDP and a revenue miss of R50 billion for 2017/18. Bonds sold off aggressively. The RSA 2040 long bond rose from 9.8% to 10.2% and the yield curve spread added 30 basis points to 268 basis points. The rand weakened from R14.10/$ to R14.50/$. As expected, the ratings agencies did their bit too. Fitch maintained South Africa's foreign and local ratings at one notch below investment grade with a stable outlook; Standard & Poor's Global Ratings cut South Africa's long-term local rating to below investment grade; Moody's rating remained unchanged, but on review for a downgrade – most likely after the Budget in February 2018.

The election of a new ANC president has had a positive effect on markets

Cyril Ramaphosa won the race to be elected as the ANC's new president. The impact was quite remarkable. This is shown in Chart 2.

Chart 2: MSCI SA vs MSCI EM vs MSCI World indices – all in US dollars, indexed to 100 (2016-2017)



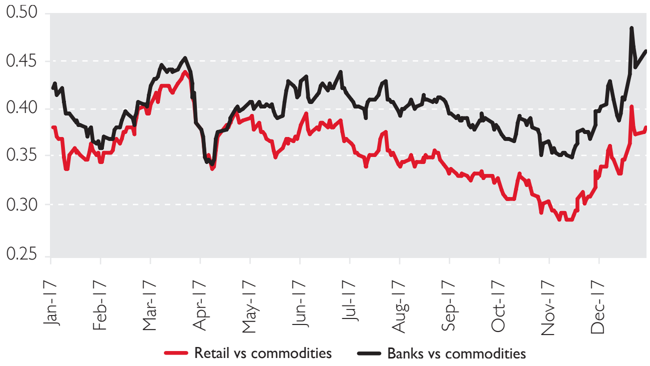
Sources: Cadiz Asset Management, FactSet

Chart 2 plots the course of three equity markets since the end of 2016. It also reflects some of the major political events that influenced our markets in that time. As will be seen later, the 2017 equity market return has been quite good in local currency terms. However, the weakness of the rand for most of the year meant that our market missed the emerging markets rally – at one stage by some 19.5%! However, expectations (then confirmation) of Ramaphosa's victory led to a broad hope for change that saw the rand recover from R14.50/$ to R12.40/$, the RSA 2040 bond yield retrace from 10.51% to 9.68%, and the performance gap between the MSCI SA Index and the MSCI Emerging Markets Index close to zero. All this took place in 30 trading days.

There was significant rotation within the local equity market

The reversal in fortunes in the currency and bond markets was also evident in the equity market. Chart 3 shows the performance of the rand hedges (simplistically represented by the commodity shares) and the non-rand hedges (represented by the banks and retailers). In line with the move in the rand over the year, commodity shares were on the front foot until mid-November, but this trend reversed shortly thereafter, more than eliminating the relative performance advantage that they had enjoyed for most of the year.

Chart 3: Local is lekker as rand hedges are suddenly on the back foot



Sources: Cadiz Asset Management, I-NET

What is next for the rand?

If Ramaphosa is able to follow up on his election ticket and institute the sound economic, social and fiscal governance policies that carried him to victory, South Africa could be a vastly different country. This could lead to further strengthening of the rand. At R12.40/$, the rand is trading at a level that places it in line with its normalised, real, long-run depreciation rate of 4% to the US dollar. However, we think that investors will need more tangible proof of reform before the rand will strengthen much more.

Table 2: South African financial market returns

Asset class (ZAR)	Quarter	12 Months
All Share	7.4%	21.0%
All Bond	2.2%	10.2%
Listed Property	8.3%	17.2%
Cash	1.8%	7.5%
Tier-1 (ZAR)	**Quarter**	**12 Months**
Resources	4.9%	17.9%
Financials	16.0%	20.6%
Industrials	4.7%	22.6%
Size (ZAR)	**Quarter**	**12 Months**
Large Cap	6.7%	23.2%
Mid Cap	11.6%	7.4%
Small Cap	3.6%	3.1%
Bond market (ZAR)	**Quarter**	**12 Months**
All Bond	2.2%	10.2%
1-3 years	2.0%	9.6%
3-7 years	2.0%	11.2%
7-12 years	2.0%	11.0%
12+ years	2.3%	9.7%
Rand	**Quarter**	**12 Months**
vs US$	9.1%	10.6%
vs Euro	8.3%	-2.3%
vs Sterling	8.7%	1.4%

Source: Deutsche Bank

A strong rand and rotation dominate the local market

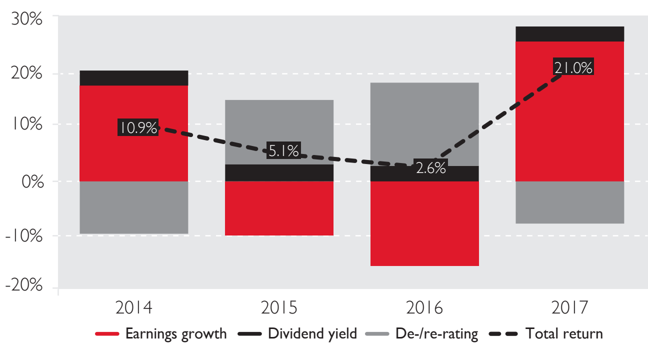
As Table 2 shows, the local market produced a mixed bag of returns for the quarter and inflation-beating returns across the board for the year:

- Cash lagged the other asset classes in both periods covered.
- Listed property shares had a much better quarter and year than the consensus expectation at the beginning of 2017. The strong showing is especially stark given the performance of local bonds, which are similarly long-duration assets.
- Bonds performed well for the year, but poorly in the quarter. The first two months of the quarter yielded returns of -2.3% and -1.0%% for the BEASSA All Bond Index. December returned 5.7%, courtesy of the strong rand. The long end of the yield curve provided the best return for the quarter, whereas the belly of the curve was the place to be for the year.
- The FTSE/JSE All Share Index (ALSI) produced a return of 21% in 2017. This considerably exceeded the consensus forecast of 9% at the beginning of 2017. The breakdown of that return is shown in Chart 4. Most of the heavy lifting was done by a turn in earnings growth from -16% in 2016 to +26% in 2017. The bulk of the 26% increase in 2017 came from a reversal in the profitability of the resource sector and strong earnings uplift by Naspers.

The local equity market remains high, and returns will be driven by earnings growth

The ALSI ended the year on a price to earnings (PE) ratio of 21X (16X excluding Naspers). This is still high by any standards, which is why we believe that any positive performance by equities in 2018 will have to be driven by earnings growth. Consensus has pegged 2018 earnings to lift by 13%, hardly sufficient to see a repeat of the market's return in 2017.

Chart 4: Deconstructed returns of the FTSE/JSE All Share Index (2014-2017)



Sources: Cadiz Asset Management, I-NET

The ALSI produced a third of its annual return in the last quarter

That said, momentum slowed from a strong October (+6.3%), a middling November (+1.5%) to a weak December (-0.3%). No Santa rally then. Investors were whiplashed by the performance of the rand, which was strong against all the majors. Banks (+28% in the quarter, +31% in the year) were the prime beneficiaries, followed by retail (+23% in the quarter, +19% in the year), highlighting that it only happened for these two sectors in the last three months. Almost counter-intuitively, industrial metals (+63% in the quarter, +90% in the year) ran in a period during which the rand was so strong. Kumba Iron Ore performed exceptionally well as the iron ore price approached $70/tonne again and the company reported improved operational performance. Although Naspers did come off the boil towards the end of the year, it still showed a return of 18% for the quarter and 71% for the year.

The misfortunes of Steinhoff have been well documented. Its performance resulted in the Household Goods Index (-92% in the quarter, -93% in the year) being the largest loser in 2017. Steinhoff was also the weakest constituent of the European STOXX 600 Index. Another notable underachiever in 2017 was EOH (-30% in the quarter, -58% in the year), which was beset by governance issues. Although the mid caps lifted in the quarter, courtesy of The Foschini Group (+45%) and Exxaro (+32%), the annual performance of both the mid and small caps remains concerning. These two sectors are more reflective of the performance of the local economy, which is weak.

Where to from here?

Since the low of February 2009, the MSCI World Index has crested new highs and added a non-annualised return of 181%. Much of this has been courtesy of the performance of the tech giants. As highlighted elsewhere, the unwinding of QE does change the environment for risky assets.

Changes in interest rates will influence returns

At some stage, even well-known and incremental adjustments to interest rates will remove a pillar of support. When that will happen is anyone's guess, but we do anticipate price momentum to at least slow in 2018.

We advocate diversification across asset classes

Locally, maintenance of a stronger rand is undoubtedly a plus for consumers. Imported inflationary pressure will subside and present the Monetary Policy Committee with an opportunity to provide some interest rate relief. Its meeting in January will provide further detail. Thereafter, the next major event is the Budget Speech in February, as well as a decision about our credit rating by Moody's. A downgrade by the latter would see South Africa fall out of the World Government Bond Index and trigger an outflow from index funds. This mix of potentially positive and negative outcomes enforces our view that diversification across asset classes and the risk spectrum is warranted. ■

Meet Equity Analyst:
Craig Thompson

Craig Thompson
Equity Analyst

An equity analyst who loves the dynamics of football and financial markets

As Equity Analyst, Craig is responsible for researching, analysing and presenting potential investment opportunities to our portfolio managers. In addition, he monitors and maintains various financial models, news flows and company results. He is passionate about learning from the industry professionals and market specialists with whom he interacts regularly. When not in the office, Craig enjoys keeping in touch with current affairs, socialising with his mates, and travelling.

What are three things that few people know about you?

1. I am ambidextrous – I throw left, bowl right, kick left, write right. The list goes on…
2. I was cast as Issachar, Joseph's half-brother, in my high school's production of 'Joseph and the Amazing Technicoloured Dream Coat'.
3. I play and watch football – I am an avid Manchester United supporter.

Who or what was the biggest influence in your life?

My parents. To this day they continue to support me and to encourage me to achieve to the best of my abilities.

Tell us a bit about your family life.

I have a small, close-knit family. I am the only immediate Thompson of my generation who can keep the family name going. I also have a younger sister.

What do you do to relax?

Grab a beer and socialise with mates, kick a ball and watch comedy series.

What's the best holiday you've ever had?

A trip to Courchevel in the French Alps – a family skiing holiday during my high school years.

What would you have liked to become if you hadn't become an equity analyst?

An architect. I enjoy geometry, technical drawings and problem solving.

Why did you become an equity analyst?

I have always been intrigued by what drives asset prices and the dynamics of financial markets. I was exposed to a long-short hedge fund during high school and this reinforced my fascination.

What's important to you at work?

A challenge. I refuse to plateau. I strive to learn something new each day from the various industry professionals and market specialists with whom I constantly engage.

Cadiz Unit Trusts' performance

All performance figures in the table below are annualised percentage figures to 31 December 2017.

Unit Trusts	1 Year	3 Years	5 Years	7 Years	Since Inception	Inception Date
No Equity Exposure						
Cadiz Money Market Fund	7.96%	7.54%	6.86%	6.53%	7.67%	01-Mar-06
Alexander Forbes Short Term Fixed Interest (STeFI) Composite Index	7.54%	7.12%	6.49%	6.24%	7.35%	
Quartile Rank	1st	1st	1st	1st		
Very Low Net Equity Exposure (up to 20% in listed property and preference shares only)						
Cadiz Absolute Yield Fund	8.64%	7.68%	6.92%	7.62%	8.73%	01-Mar-06
CPI+3% up to 30-Jun-17 STeFI+2% from 01-Jul-17	9.52%	8.96%	8.81%	8.82%	9.15%	
Quartile Rank	2nd	2nd	3rd	2nd		
Low Net Equity Exposure (20 - 40%)						
Cadiz Stable Fund	8.35%	7.01%	6.04%		6.50%	01-Sep-12
CPI+3%	7.64%	8.34%	8.43%		8.48%	
Quartile Rank	3rd	2nd	4th			
High Net Equity Exposure (60 - 75%)						
Cadiz Balanced Fund	10.43%	6.22%	6.92%	8.38%	9.42%	01-Mar-06
SA Multi Asset High Equity Median	10.06%	6.44%	9.41%	9.71%	10.35%	
Quartile Rank	2nd	3rd	4th	4th		
Flexible Net Equity Exposure (50 - 90%)						
Cadiz Worldwide Flexible Fund	7.16%	2.42%	0.28%	0.85%	5.99%	03-Jun-05
CPI+6%	10.70%	11.38%	11.46%	11.57%	11.54%	
Quartile Rank	3rd	4th	4th	4th		
High Net Equity Exposure (100%)						
Cadiz Equity Fund	16.46%	6.28%	5.67%	7.15%	9.42%	01-Mar-06
FTSE/JSE SWIX Index	21.21%	9.35%	12.74%	13.66%	13.86%	
Quartile Rank	2nd	2nd	4th	4th		

Sources: Morningstar, Cadiz Asset Management

Notes

Contact details

For more information kindly contact:

Gerald Mafunda
Head: Institutional Business Development

Institutional Investments:
Direct: 021 657 8656
cam@cadiz.co.za

Natalie Smith
Head: Retail Business Development

Personal Investments:
Direct: 0800 022 349
investorservices@cadiz.co.za

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4th Floor, The Terraces, 25 Protea Road, Claremont 7708, Cape Town • T 08000 22349

www.cadiz.co.za

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