October 2017

CAMmuniqué

CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

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.

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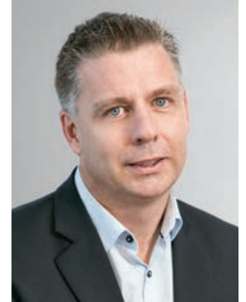
Introduction

Know what you are buying and buy what you know



*by **Shawn Stockigt**, CEO and Joint Chief Investment Officer*

'Don't ever think that the [stock]market knows more than you do about the underlying business. That's the biggest mistake you can make.'

Prem Watsa, CEO of Fairfax Financial Holdings

Investing in an index doesn't necessarily protect you from company-specific risk

If you think the goal of investing in an index is to achieve performance that avoids company-specific risk, think again. Many investors believe that the failure of one business will not affect the overall performance of the index (the ultimate goal of diversification), but this is not necessarily the case.

The increase in passive index investing is pushing up share prices

There are currently more indices to invest in than individually listed companies in the US. The role of an index manager is to avoid having a view on the fundamentals of a business, or the impact that an individual company's weighting can have on the performance of the index. As a result, share prices are often not a true reflection of the intrinsic value of the business. As more money is directed into these increasingly popular passive products, more expensive companies must be added to mimic the index. This pushes share prices even further from their true valuations.

As a share price goes up, the index's exposure to that company increases

The FTSE/JSE Top 40 Index (the Index) consists of the 40 largest companies (in terms of market capitalisation). Naspers currently makes up over 20% of the Index – a clear indication of company-specific risk. As Naspers' share price has risen, its weighting in the Index has increased from around 3.0% in 2011 to a blistering 21.4% currently. BHP Billiton, on the other hand, has dropped from around 21.0% of the Index to 8.6% over the same period, since its share price has fallen. (In other words, the company has become cheaper, moving closer to its intrinsic value.)
So, as long as a company's share price goes up, regardless of valuation, more of that company will be added to the index, and the opposite will happen if the share price drops.

Fewer companies in an index increase company-specific risk

As an index becomes more concentrated, with fewer companies making up the bulk of the weighting, its performance starts to become more dependent on those individual companies. This means company-specific risk cannot be diversified away, since this would involve active management.

For active managers, regulation can limit the weighting of one company in a portfolio

The question is whether a portfolio should have a 21.4% weighting in one specific company. This is a difficult question for active managers to answer. Even if active managers wanted to own a significant weighting of one share in their portfolio, regulation might prevent this. A local unit trust, governed by the Collective Investment Schemes Control Act (Act 45 of 2002), or a Regulation 28-compliant pension fund, has restrictions on the maximum exposure to an individual share in a portfolio. Within these limitations, the next question is how much or little to own of a specific share – which is something passive managers don't have to be concerned about.

As active managers, we carefully consider how much to own of a share

When we decide on a weighting of a specific share in a portfolio, we start with a clean slate and weigh up several factors:

1. The valuation of the business relative to the share price.
2. The risk of losing money. (Does the potential gain outweigh the potential risk?)
3. Corporate governance issues.
4. Voting rights of shareholders.

Voting rights and corporate governance can be controversial, as proven by Naspers

Buying a share is buying part ownership of a company. This raises the question as to why one shareholder should have voting rights that supersede those of other shareholders. Would Warren Buffett agree to this? Naspers' complicated shareholder structure means that the A-class shareholders control 68% of the voting rights, although A-class shares are not available to ordinary investors. As a result, low-voting shareholders (N-class shareholders) have very little say. Despite 74% of N-class shareholders voting against giving directors' control over un-issued shares, and 66% voting against the company's executive remuneration (according to Business Day, 30 August 2017), their strong dissatisfaction came to naught. Where a company has such a skewed ownership structure, ordinary shareholders' voices are stifled. (Incidentally, such an ownership structure is no longer allowed on the JSE; Naspers however received an exemption.) This is not good corporate governance. Very few people worry about governance issues when they are making money, but good corporate governance needs attention regardless of what the share price is doing.

We expect the last quarter of 2017 to be full of uncertainty

The most significant event for the quarter is the ANC elective conference, to be held in Gauteng from the 16th to the 20th of December. At the time of writing, the frontrunners in the presidential race are Nkosazana Dlamini-Zuma and Cyril Ramaphosa, but Home Affairs Minister Lindiwe Sisulu, Minister in the Presidency Jeff Radebe, ANC National Treasurer Zweli Mkhize, and National Assembly Speaker Baleka Mbete have also been tipped as willing presidential candidates. Expectations around the new incumbent's ability (or lack thereof) to grow the economy and deal with the plague of state capture will be a key driver of markets in the short term.

In this quarter's CAMmuniqué

Brian Munro, who co-manages the Cadiz Balanced Fund, explains how the Fund enables investors to benefit from diversification across equities, bonds and property. Alastair Sellick looks at why our strategy to play the waiting game has paid off for our clients invested in African Bank. He emphasises that Cadiz ABIL retention fund investors should continue to be patient and focus on the long term to benefit. Michele van der Berg explains why, at a time when having some degree of protection is more relevant than ever, the Cadiz Money Market Fund is a good investment option. In his regular 'Quarterly review', Matt Brenzel updates us on international and local performance over the last quarter and concludes that, in these uncertain times, it is wise to diversify investments into less risky assets. Lastly, you have the opportunity to learn more about Gerald Mafunda, our Head of Institutional Business Development. ■

Where to invest

The Cadiz Balanced Fund: a fund for all seasons

by ***Brian Munro****,*
Head of Multi Assets

In this article, Head of Multi Assets Brian Munro, who co-manages the Cadiz Balanced Fund, explains how the Fund enables investors to benefit from diversification across equities, bonds and property. He explains how we aim to meet the Fund's objectives and provides a snapshot of how well the Fund has performed. This provides ample evidence of how the Fund has helped compound clients' wealth.

What does the Cadiz Balanced Fund offer investors?

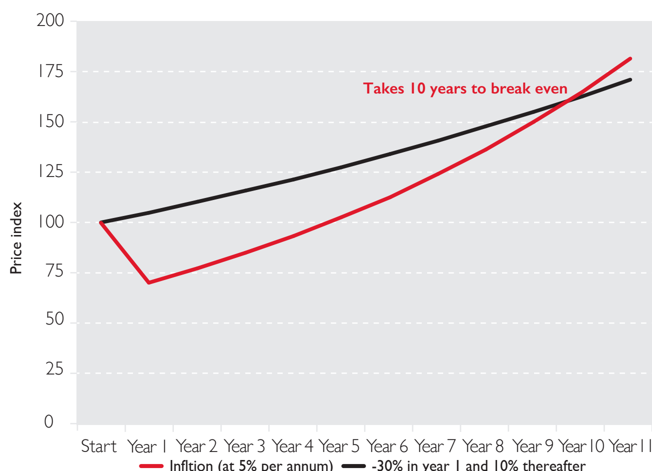
The Cadiz Balanced Fund is a Multi Asset Class unit trust fund. This means it can invest in a range of asset classes and therefore offers investors diversified exposure to equities, bonds and real estate assets, both locally and internationally. It is suitable for investors who are saving for retirement or have retired and need to manage their retirement savings. (It complies with Regulation 28 of the Pension Funds Act.) The Fund is designed for investors who have a moderate risk profile and are comfortable with a degree of short-term market fluctuation (volatility) to achieve long-term capital growth.

What is the Fund's objective?

The Fund's objective is to compound wealth over the medium to long term. To achieve this, we focus on protecting investors from capital loss and at the same time, investing in assets that increase the odds of substantially outperforming cash.

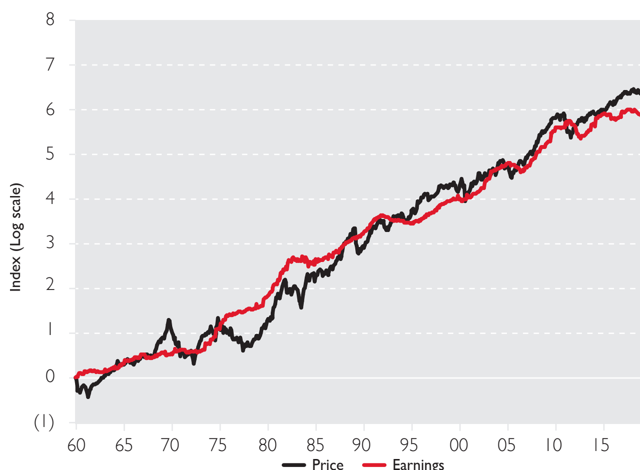
Chart 1 illustrates the importance of protection against capital loss. If an asset's price falls by 30% in year 1 and compounds by 10% thereafter, it will take 10 years to match inflation (or another asset) that grows by 5% per year. Avoiding large losses (drawdowns) is critical to grow and compound wealth.

Chart 1: The importance of avoiding capital loss



Source: Cadiz Asset Management

Chart 2: How compound earnings drive share prices over the long term



Sources: Cadiz Asset Management, I-NET

What are the key pillars of our investment approach?

Our investment philosophy informs how we select shares and fixed income investments like bonds and property, it determines our cash weighting, and it informs our portfolio construction process. We explain these below.

Our investment philosophy − what drives financial markets?

Our investment philosophy, explained in every edition, is our set of guiding principles that informs our decision-making process. It includes our beliefs about what drives financial markets, what causes financial assets to become mispriced, and how we can take advantage of mispriced assets. We believe that there are three factors that drive financial markets over time – earnings, interest rates and sentiment:

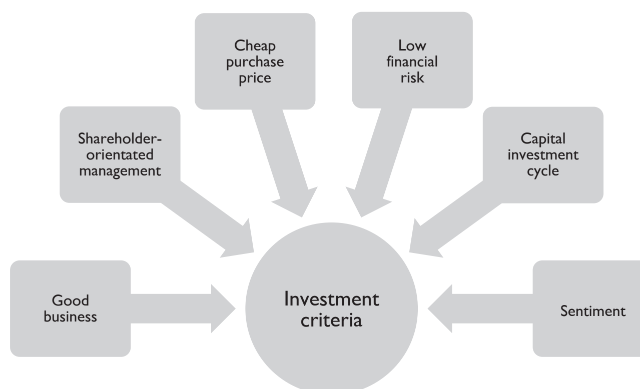
1. Over the long term, the single most powerful driver of share prices is the compounding of earnings or cash flows, as shown in Chart 2.
2. Interest rates are also important because they affect the value of every financial asset since all investments compete for yield.
3. Sentiment is the psychological factor that drives the 'fear and greed' cycle of financial markets over the short term. It is this psychological factor that is the cause of most mispriced assets in the market, and the one we try to exploit.

Our objective is therefore to buy above-average companies that can compound earnings over time when sentiment is weak, and valuations are attractive.

Share selection − how do we pick shares for the Fund?

Our investment team looks for high-quality companies with low financial risk, shareholder-oriented management, and the shares of which trade at a sufficient discount to our assessment of their worth (to provide a margin of safety). We prefer to invest in these companies when market sentiment is weak (when they are out of favour or disliked) and have reached the bottom of the earnings and industry capital investment cycles. Chart 3 shows our investment criteria for owning a share.

Chart 3: Our investment criteria for owning a share



Source: Cadiz Asset Management

We focus on increasing the odds of successfully buying above-average companies at attractive prices. We aim to buy:

1. Above-average companies that can do the 'heavy lifting' for us by compounding their earnings and business value over time. This minimises the risk of a poor result.
2. Companies at attractive prices to ensure we have a margin of safety to buffer against unforeseen events that could impair the sustainable earnings of the company, and therefore our assessment of its worth.

How do we select bonds and property assets for the Fund?

We follow a similar approach and use similar investment criteria for fixed income assets as for equities. Whether we are evaluating government bonds, corporate bonds or property shares, we first assess the odds of losing capital by understanding the business (or government) and their financial risks. We then assess what we believe the asset is worth, whether sentiment is depressed, and if there is a sufficient margin of safety to limit the risk of capital loss while generating a yield higher than inflation or cash.

What role does cash play in the portfolio?

Our cash holding at any time is an outcome of our investment process. When assets are expensive, or the odds of capital loss are high, we will simply hold cash as we wait patiently for the right investment opportunity. Besides the excellent diversification properties of cash, its real value is in its deferred purchasing power. This means it enables us to buy assets when their prices correct and represent value.

How do we construct multi-asset portfolios?

Our bottom-up approach to investing means that we start with cash and invest in assets that we believe have a small chance of losing capital in the medium to long term, but a high probability of beating the return on cash.

Based on this mindset, we allocate capital to our best high-conviction ideas. However, we are keenly aware of the dangers of overexposing the portfolio to potential macroeconomic and sector risks. So, we try to strike a balance between having high-conviction positions in assets that meet our investment criteria and maintaining sufficient diversification across the portfolio.

How has the Fund performed?

In Table 1 we compare the Fund's performance to the median return of similar funds in the ASISA Multi Asset – High Equity unit trust category. It is encouraging to see that our investment approach is bearing fruit. The Fund has managed to outperform the median return of our peers over the last two years and is ranked in the top quartile. Obviously, it is our intention to extend the shorter-term positive performance into the longer term.

Table 1: Performance of the Cadiz Balanced Fund to the end of September 2017

Time period	Peer group median	Cadiz Balanced Fund
1 year	6.2	9.8
2 years	6.6	8.6
3 years	6.7	6.2
5 years	10.7	7.9
7 years	10.5	9.2

Source: Morningstar

Over the last two years, we have refined our process and focused even more on protecting investors against capital loss. At the same time, we continue to focus on buying above-average companies that can compound earnings over time when sentiment is weak and valuations are attractive. In this way we have been able to compound our clients' wealth. ■

Why consider the Cadiz Balanced Fund?

Our aim is to seek capital and income appreciation over the medium to long term.

- We have an experienced investment team that follows the disciplined and rigorous process that drives our investment decision-making.
- We exercise patience as we wait for opportunities that meet our investment criteria.
- We allocate capital to our best high-conviction ideas while following sound risk management principles that limit the risk of capital loss.
- We believe these are the right ingredients to deliver on our objective of compounding wealth for our clients.

Progress at African Bank

What this means for the Cadiz ABIL retention funds

by *Alastair Sellick*, *Head of Fixed Interest*

For more context on our thinking and analysis of African Bank since it was placed under curatorship in 2014, we recommend reading this article in conjunction with the article titled 'The return of African Bank' in the April 2016 edition of CAMmuniqué, which we refer to here.

Those who were invested in African Bank Investments Ltd (ABIL) debt instruments when the infamous default happened in 2014 have been waiting to know if they will receive their capital back. In April 2016, all old ABIL debt instruments were re-floated in new instruments with longer terms to maturity, guaranteed by African Bank Ltd. In this article, we explain how we prioritised the long-term interests of all Cadiz investors who were exposed to African Bank by not immediately repaying investors' capital. Despite investor discomfort, Alastair Sellick, Head of Fixed Interest, clarifies why this was the right thing to do. He also explains why Cadiz ABIL retention fund investors should continue to be patient and focus on the long term to benefit.

Short-term demands have a price

As custodians of the Cadiz ABIL Absolute Yield Retention Fund (one of many similar industry funds), we have faced many requests and demands from investors for their capital. We understand that our decisions to retain investors' capital were very frustrating for these investors at the time, but we have always committed to taking a long-term view and considering investors' long-term interests. It was uncomfortable at the time for us too, especially because many of our competitors took a range of actions to return money to investors to meet investor demand. But at what prices and valuations?

The valuations of some instruments have more than recovered

We are particularly intrigued to know what other investment managers chose to do with the stub instruments. These instruments were claims that senior and subordinated ABIL bondholders have on the residual assets and liabilities of the 'Bad Book' – the pool of dubious and uncreditworthy loans that were guaranteed by the South African Reserve Bank at the time of the default. It is now possible to sell the senior stub instruments at close to 75c per R1 nominal, but in 2016 the senior stubs were trading at amounts varying between 5c and 10c per R1 nominal. The Cadiz ABIL retention fund portfolios still conservatively reflect these stubs at zero, which is the listed market price despite the bids that are in the market.

We continue to watch African Bank's ability to repay debt

In the April 2016 edition of CAMmuniqué I wrote an article titled 'The return of African Bank' about possible scenarios. The article explained how we viewed the market's likely response to the re-flotation, and valuations of the African

Bank bonds ('Good Bank' debt). By making use of the retention fund framework that the industry body ASISA established after permission was granted by the Financial Services Board around the time of the default, we could take a long-term view on:

1. The likely liquidity conditions surrounding new African Bank debt instruments after the re-flotation of African Bank Ltd in April 2016.
2. The financial statements and regular updates by both African Bank Ltd and the Curator of the ABIL Residual Debt Services, and ultimately, the ability of African Bank to repay interest and capital on its debt.

We were correct to expect a return of our clients' capital

After the default, we prioritised the long-term interests of all our investors who were exposed to African Bank. This was frustrating for those wanting and needing their capital, and those who felt they could earn a better return elsewhere. The guiding principle behind our decision was that there was a strong investment case and recovery story behind the new African Bank. Given the 'bail-in' that was engineered around the time of the default, almost all the large South African banks had an equity and/or vested interest in African Bank. Therefore, the odds of success were also higher for African Bank. Standard & Poor's Global Ratings (S&P), in their rating of African Bank on the 22nd of August, confirmed this by re-instating its 'BBB' rating. In addition, we have seen steady and consistent improvements in the trading updates and financial statements from African Bank.

It is best not to sell an investment when it is unpopular

Straight after the re-flotation of the African Bank bonds, bond spreads on the various instruments widened. Some widened immediately, for example, spreads on the subordinated bonds widened from JIBAR plus 6% at re-flotation, to current mark-to-market of JIBAR plus 12.8%. JIBAR is the Johannesburg Interbank Agreed Rate and is often used as a benchmark by money market funds. Without going into too much detail, most of the bonds have spent the last two years priced at significant discounts to what, in our opinion, was fair value, and definitely discounts to the re-floated price.

A conservative, lower-risk operating model is working

African Bank still has a long and difficult road ahead. South Africa's sovereign credit rating downgrades in the first half of 2017, and the technical recession in the first and second quarters of 2017 have not helped. Neither are the rising unemployment statistics and weak disposable incomes in our low-growth economy conducive to strong performance in African Bank's market segment. Despite these tough environmental factors, the strategic decisions and conscious choice of a far more conservative, lower-risk operating model seem to be bearing fruit.

We recently returned capital in our ABIL Absolute Yield Retention Fund to investors

In 2016, African Bank took an encouraging decision to buy back expensive foreign currency debt, both in the open market, and via a tender offer to investors. On the 14th of July 2016, African Bank announced that they had bought back foreign debt equivalent to $325 million. After the 22nd of August 2017 ratings upgrade to BBB by S&P, African Bank made a similar tender offer to investors to buy back some of the shorter-dated local currency bonds at lower yields than the re-flotation yields of April 2016 – in other words, at higher prices than they had traded in the entire year-and-a-half since re-flotation. Cadiz participated (in small sizes) in this tender offer and managed to sell some other African Bank bonds. This enabled us to repay more than 20% of the capital in the Cadiz ABIL Absolute Yield Retention Fund to investors.

We will continue with our attempts to sell African Bank bonds

We will continue with our attempts to sell the existing African Bank bonds in the ABIL retention funds. The Cadiz Asset Management Credit Committee evaluates our credit exposure across the firm, and provides high-level management oversight to ensure that we adhere to credit mandate limits and restrictions.

Investors should remain patient to benefit

We encourage investors who remain invested in the various ABIL retention funds to stay patient – not an easy task, we know. But we are working hard to realise the value that still exists in the remaining African Bank bonds, by selling them at even higher prices/lower yields. We aim to participate in further African Bank buy-back tenders, or in the secondary market when opportunities arise and if prices are attractive. We will continue to earn very high, competitive yields on these bonds, commensurate with a BBB issuer. By doing this, we are earning the liquidity premium that is associated with an illiquid, lower-quality debt instrument like African Bank. ■

Why invest in the Cadiz Money Market Fund?

by **Michele van der Berg**,
Portfolio Manager

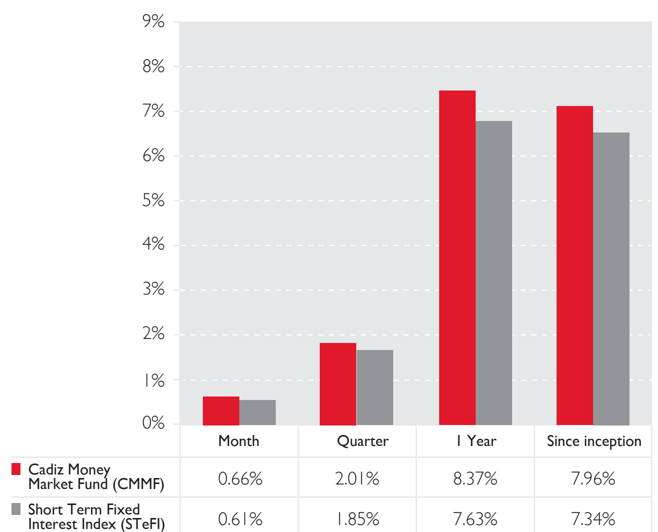
The Cadiz Money Market Fund has outperformed its benchmark since inception and has consistently ranked in the first quartile against its peers. In this article, Portfolio Manager Michele van der Berg explains why the money market is a good investment option in uncertain times, providing capital protection when other riskier asset classes are more volatile. In the current South African context, with reviews from the credit ratings agencies and the ANC elective conference coming up, having some degree of protection is more relevant than ever. In addition, cash enables investors to take advantage of promising investment opportunities when they arise, since it is easily accessible.

The Fund has outperformed its benchmark since inception and continues to do so

The Cadiz Money Market Fund was established in 2006 and has managed to outperform its benchmark, the Short Term Fixed Interest Index (STeFI), since inception (see Chart 1). During this 11-year period, the Fund has also consistently ranked in the first quartile against its peers.

Looking at the most recent short-term performance figures, the positive performance can largely be attributed to extending the duration of the Fund during the first quarter of 2017. We made this decision based on our expectation that the Monetary Policy Committee (MPC) would cut the repo rate, and invested in fixed long-term assets as opposed to floating-rate instruments. Because we made this move before the first rate cut of the current rate-cutting cycle (in July 2017), the Fund outperformed the STeFI in August and was ranked second amongst 32 peers according to Morningstar.

Chart 1: Performance of the Cadiz Money Market Fund versus its benchmark



	Month	Quarter	1 Year	Since inception
Cadiz Money Market Fund (CMMF)	0.66%	2.01%	8.37%	7.96%
Short Term Fixed Interest Index (STeFI)	0.61%	1.85%	7.63%	7.34%

Source: Cadiz Asset Management

In addition to the performance figures, the benefits of investing in the Cadiz Money Market Fund include:

- Diversification
- Liquidity
- Quality rated assets
- Yield

Local consumers remain under pressure, affecting consumer-related equities

Expectations are that South Africa's economic conditions will remain pressured into 2018. The South African Reserve Bank (SARB) is forecasting GDP growth of only 0.6% for 2017 and 1.2% for 2018. Our economy is largely consumer-driven. However, given the rising unemployment and high debt levels, consumers are not in a healthy state financially. Even though the repo rate cut in July resulted in a cut in the cost of debt, this was insufficient to provide much relief to the over-indebted consumer. Any 'savings' from lower repayments will most likely be used to pay off debt, rather than being used for frivolous spending or greater consumption. If tax rates are increased at the Medium Term Budget Policy Statement on the 25th of October, it will have a further negative impact on the consumer and related equities.

Events over the next few months could have a negative impact on the bond market

One of the key events that could affect the bond market is the reviews of South Africa's sovereign credit rating in late November or the first quarter of 2018 by Moody's and Standard & Poor's Global Ratings. Any negative outcome has the potential to weaken the rand and lead to government bond outflows. The ANC elective conference in December may affect bonds further if the outcome of the conference is not what the market had anticipated or wanted. We are also waiting on confirmation about whether the US Federal Reserve will increase US interest rates in December.

The money market however offers capital protection in uncertain times

Considering the hazards to risky assets described above, the money market offers a safe place to park or invest cash. With the MPC forecasting inflation to average 5.30% in 2017 and the current money market yield at 7.97%, investors can earn inflation plus 2.67% off current levels in the money market. And with interest rates expected to fall, while the SARB is forecasting inflation of 4.90% for 2018, the Cadiz Money Market Fund should continue to offer returns above inflation. That is why we believe the Fund offers a highly competitive return over the other major asset classes, protecting investors' capital despite the ongoing uncertainty.

Cash also offers the opportunity to take up better investment opportunities when they arise. Investors can withdraw their cash with ease as the Fund offers liquidity on a daily basis, with no impact on capital.

We will retain the Fund's current positioning as we search for quality assets

The Cadiz Money Market Fund is currently positioned with a large exposure to low-risk, bank-issued assets (65% of the Fund). Also, 92% of the Fund is rated F1+, which is the highest credit rating for a short-term asset. We will maintain this positioning as we search for quality assets.

We also have various risk control measures in place to further maintain the Fund's low-risk profile and protect investors' capital. The Fund is governed by the Collective Investment Scheme Control Act (CISCA) and all rules are adhered to daily. In addition, our Credit Committee meets every month to review exposures and issuer concentration to ensure we maintain the Fund's low-risk profile. ■

Quarterly review

by *Matt Brenzel*,
Joint Chief Investment Officer

INTERNATIONAL PERFORMANCE

The macro backdrop is supportive

The Organisation for Economic Co-operation and Development (OECD) mentioned in a recent publication that it expected the global economy to grow at its fastest pace since 2011 this year and maintain momentum into 2018. All the major economies are expected to contribute to this positive outcome. The OECD projects a global growth rate of 3.5% in this calendar year and 3.7% in 2018. Increased investments, employment and trade are the main drivers of this growth. A gradual unwinding of monetary stimulus while employing greater fiscal impetus is likely to sustain this. However, headline statistics like retail sales, industrial production and fixed asset investments – while still in high single- or low double-digit numbers – are starting to undershoot expectations.

US interest rates didn't change, but in Europe there was a change in tone

The hype around the US Federal Reserve's September meeting proved to be mainly hot air, as Chair Janet Yellen maintained interest rates at current levels. Core goods prices continue to be a drag on inflation, stalling the rate normalisation process. The next 0.25% hike is now expected in December 2017 and projected rate hikes for 2018 have fallen from three to only two. Yellen did however announce that the balance sheet normalisation would commence in October.

Possibly the biggest surprise in the quarter was the tone of a speech delivered by European Central Bank President Mario Draghi. It was in strong contrast to his more dovish approach during the previous quarter.

Emerging markets outperformed developed markets

With monetary policy still in 'easy' mode, investors have a revived interest in emerging markets. The significant flows (of about $50 billion for the year to date) into emerging markets have been driven by:

1. **Developed market monetary policy reticence**

   There has been a continued soft stance on monetary tightening, predominantly in the US, which placed the US dollar onto a weaker trajectory (as shown in Chart 1).

2. **Synchronised growth in emerging markets**

   We have seen a revitalisation of economic conditions in many emerging market countries, including better growth prospects, sensible economic reforms, low inflation and relatively attractive valuations.

Please refer to Table 1 on the next page for more detail about the relative performance of developed markets and emerging markets.

Chart 1: The US dollar is on a weaker trajectory

Sources: FactSet, Cadiz Asset Management

Table 1: International market returns

International (US$)	Quarter	YTD	12 Months
MSCI World	5.0%	16.5%	18.8%
MSCI Emerging	8.0%	28.1%	22.9%
MSCI SA	4.0%	12.7%	8.2%
JP Morgan Global Bonds	1.7%	5.7%	-0.5%
US Cash	0.2%	0.3%	0.5%

Sources: Deutsche Bank, Bloomberg Finance LP

Equities continue to outperform

Equity markets continued to outperform other asset classes over the quarter. Technology sector darlings Netflix, Facebook, Microsoft and Apple continued to deliver stellar performance, while Amazon lagged (-1.5%) for the quarter. The tobacco sector fell due to concerns around the US Federal Drug Administration proposal to limit the nicotine content in cigarettes. The consumer goods sector also had a poor quarter (-5%). Financials continued their good run from June, with Berkshire Hathaway up 8%, Mastercard up 17%, and Visa up 12%. The energy industry appears to be picking up some steam due to the higher oil price. Healthcare also continued to outperform the market.

LOCAL PERFORMANCE

The recession has ended

A feature of the third quarter was the firming of the rand to R12.90/$. This was due to news of better-than-expected second quarter GDP growth of 2.5%, after negative GDP growth of -0.6% in the first quarter. The market expected the recovery in GDP after two particularly weak quarters, but the extent of the recovery was a surprise. The consensus view is that the local economy should record a positive GDP number of between 0.6% and 0.8% for the 2017 calendar year.

Despite supportive data, interest rates remain the same

August's headline inflation rate of 4.8% was a decent result and better than consensus expectations. Food price inflation finally moderated from 6.8% in July to 5.7% as the effect of the drought on perishables continued to reverse. Prices of the staples like bread, cereals, oils and fats, and fruit and vegetables were all lower than the same month in 2016. Despite the supportive data, the Monetary Policy Committee (MPC) didn't cut rates as expected, which led to a strong sell-off in interest-sensitive equities and a flattening of the yield curve.

The local equity market gained 8.9% for the quarter

Resources bounced back quickly from last quarter's poor performance, thanks to strong earnings from good commodity prices. Within the resource sector, Assore, Anglo American, Exxaro and Kumba Iron Ore were the standout performers, returning more than 30% for the quarter. Only Royal Bafokeng Platinum (-6%) and Impala Platinum (-11%) suffered a decline. The healthcare sector was the only sector with a negative return (-1%) for the quarter, with Mediclinic, Netcare and Life Healthcare under pressure. Naspers was again a strong driver of index performance, gaining 24% for the quarter. Richemont continued its good performance (+15%). Rhodes Food Group and Pioneer Food Group were down (-15%) because South African consumers are under pressure. These businesses have a limited ability to pass on inflationary price increases.

Brait SE has also seen a large share price decline due to the Newlook business in the UK underperforming expectations. Steinhoff International successfully unbundled their African retail operation. As the poor economic environment affected their financial results, mid and small caps continued their underperformance relative to their large, multinational peers.

In the bond market, the middle of the yield curve provided the best returns

The rand weakened sharply against the pound and euro towards the end of the quarter, with a more moderate decline against the US dollar.

Table 2: South African financial market returns

Asset class (ZAR)	Quarter	YTD	12 Months
All Share	8.9%	12.6%	10.2%
All Bond	3.7%	7.8%	8.2%
Listed Property	5.7%	8.2%	9.6%
Cash	1.8%	5.6%	7.6%
Tier-1 (ZAR)	**Quarter**	**YTD**	**12 Months**
Resources	17.7%	12.7%	11.5%
Financials	6.1%	4.4%	7.7%
Industrials	8.3%	19.9%	13.5%
Size (ZAR)	**Quarter**	**YTD**	**12 Months**
Large Cap	10.1%	15.4%	12.0%
Mid Cap	3.8%	-3.8%	-2.7%
Small Cap	3.0%	-0.5%	0.1%
Bond Market (ZAR)	**Quarter**	**YTD**	**12 Months**
All Bond	3.7%	7.8%	8.2%
1-3 years	2.7%	7.4%	9.0%
3-7 years	3.1%	9.1%	10.3%
7-12 years	3.6%	8.9%	9.6%
12+ years	4.0%	7.2%	7.2%
Rand	**Quarter**	**YTD**	**12 Months**
vs US$	-3.4%	1.3%	1.2%
vs Euro	-6.7%	-9.8%	-3.7%
vs Sterling	-6.3%	-6.8%	-2.0%

Sources: Deutsche Bank, Bloomberg Finance LP

Where to from here?

The S&P 500 rose above the 2 500 level for the first time in September. From trough-to-peak, the current eight-and-a-half-year run is the third longest of all bull markets. The S&P 500's performance has been very concentrated, with stocks like Amazon, Apple, Facebook, Microsoft and Google accounting for a third of the performance. Other equity markets have also reached new highs in the past few months. (The FTSE/JSE All Share Index set a new peak above 56 000 in August.)

Markets are elevated

Equities have been buoyed by low interest rates (at both the short and long end) and improving macroeconomic factors. But despite reasonably robust earnings growth, valuations have become elevated. The US market, for example, generated quarterly earnings growth of 10% and 14% respectively in the first and second quarters of 2017. But at a price to earnings ratio of 19X, the risk of the US market correcting has risen. The potential domino effect on other markets is obvious. We have little skill in calling bear markets, but we anticipate momentum to at least slow down in the coming months.

Diversify and reduce risk

Locally, we believe that the MPC may have missed an opportunity to provide some interest rate relief. We face several potentially disruptive events over the next few months. These include the potential for a poorly constructed Medium Term Budget Policy Statement in October, a ratings downgrade from S&P Global Ratings on the 25th of November, a negative Eskom tariff decision on the 7th of December, and the ANC elective conference from the 16th to the 20th of December. These could all reduce the MPC's ability to ease interest rates at the November meeting. We believe that it is prudent to diversify investments into less risky assets. ■

Meet our Head of Institutional Business Development:
Gerald Mafunda

*by **Gerald Mafunda**, Head of Institutional Business Development*

An actuary with a sense of adventure

As Head of Institutional Business Development and Co-Founder and Managing Director of Cadiz Life, Gerald's responsibilities include ensuring that our products remain relevant to our clients. With over 17 years' experience in investments and insurance, he is well-known for his insights and desire for simplicity. Here Gerald tells us a bit more about what's important to him, both at work and at home.

What are three things that few people know about you?

1. I am a Blue Bulls supporter even though I have never lived in Pretoria!
2. I bake cakes for fun…
3. I was a decent artist at school

Who or what was the biggest influence in your life?

My parents gave me a good grounding. I spent six great years at boarding school; my older cousins Clement, Lovemore and Nisbert made sure I was spoken for at school and were (and still are) 'standard-bearers'. Professionally, it is Sandra Graham and Wilhelm van Zyl from Metropolitan Odyssey for hiring me on the spot for my first job.

Tell us a bit about your family life.

I have a lovely wife, Vimbayi, and two boys, Michael (9) and Joshua (6). I have thus far resisted dogs in married life to avoid being demoted to number five or six in the family.

What do you do to relax?

I am a road trip junkie. I also run, play golf and enjoy mountain biking.

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

We did an epic 3 400km, five-state road trip from California to Texas a year ago. I loved the vast, dramatic landscapes, the architecture and the ordinary people. The food was great!

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

A professional basketball player.

Why did you become an investment professional?

I have always been intrigued by numbers and stock prices.

What's important to you at work?

People matter to me - whether they are colleagues or clients. We are custodians of their hopes and dreams, expressed in currency. Doing our best each day is a privilege.

Cadiz Unit Trusts' performance

All performance figures in the table below are annualised percentage figures to 30 September 2017.

Unit Trusts	1 Year	3 Years	5 Years	7 Years	Since Inception	Inception Date
No Equity Exposure						
Cadiz Money Market Fund	8.01%	7.43%	6.74%	6.48%	7.67%	01-Mar-06
Alexander Forbes Short Term Fixed Interest (STeFI) Composite Index	7.60%	7.03%	6.38%	6.21%	7.34%	
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	10.24%	8.01%	7.15%	7.75%	8.83%	01-Mar-06
CPI+3% up to 30-Jun-17 STeFI+2% from 01-Jul-17	8.81%	8.45%	8.84%	8.64%	9.14%	
Quartile Rank	1st	2nd	2nd	2nd		
Low Net Equity Exposure (20 - 40%)						
Cadiz Stable Fund	10.03%	7.52%	6.86%		6.81%	01-Sep-12
CPI+3%	7.74%	8.09%	8.62%		8.58%	
Quartile Rank	1st	2nd	4th			
High Net Equity Exposure (60 - 75%)						
Cadiz Balanced Fund	9.85%	6.17%	7.92%	9.21%	9.48%	01-Mar-06
Average of the Domestic - Asset Allocation - Prudential High Equity sector	5.90%	6.50%	10.01%	10.04%	10.37%	
Quartile Rank	1st	3rd	4th	4th		
Flexible Net Equity Exposure (50 - 90%)						
Cadiz Worldwide Flexible Fund	7.10%	1.89%	0.72%	1.53%	6.05%	03-Jun-05
CPI+6%	10.79%	11.12%	11.64%	11.50%	11.58%	
Quartile Rank	3rd	4th	4th	4th		
High Net Equity Exposure (100%)						
Cadiz Equity Fund	17.14%	4.92%	7.04%	8.18%	9.31%	01-Mar-06
FTSE/JSE SWIX Index	7.00%	7.36%	12.83%	13.44%	13.28%	
Quartile Rank	1st	3rd	4th	4th		

Sources: Morningstar, Cadiz Asset Management

Notes

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