EXCELLENCE
TAKES A LIFETIME
OF PREPARATION

cadiz
ASSET MANAGEMENT

Our investment philosophy and process

As a long-term investment manager, our valuation-based investment philosophy underpins all of our investment decisions and processes.

- We believe that the market is inefficient over the short term due to investor sentiment.
- Investor sentiment can fluctuate asset prices above or below the long-term underlying true intrinsic value of the asset. These fluctuations are temporary and will 'normalise' or revert to their long-term intrinsic value.
- By applying our valuation-based investment philosophy and process consistently over time we find these opportunities both within and across asset classes to deliver long-term investment returns for our clients.

We apply our investment process with patience, diligence and focus

We identify opportunities through bottom-up fundamental analysis

The team analyses the value of an investment using bottom-up fundamental analysis. We compare current prices and valuations (based on an in-depth analysis of the investment) with long-term historical trends, rather than trying to forecast the future.

Long-term macroeconomic themes also play a key role in our process

We combine our bottom-up analysis with a top-down view on the economy. We specifically focus on normalised interest rates and inflation. Interest rates directly influence sustainable economic growth rates and inform the risk-free rate of return. Inflation affects real returns.

We consider and combine opportunities both within and across asset classes

We recognise the need to be expert at identifying and assessing opportunities both within asset classes and at an asset class level. This includes comparing different asset class behaviours and returns and, most importantly, relative to the returns that investors would receive from investing in cash.

We only invest if there is a margin of safety

All investments carry some degree of risk but, even within our high equity products, we only invest if there is an adequate margin of safety built into our valuations. We calculate a current fair market value based on the long-term historical relationships between economic and market variables, and we carefully measure the extent to which investors may be compensated for any inherent risks.

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ON THE FRONT COVER

THE MEERKAT TELESCOPE - The array of telescopes known as the MeerKAT can be found in the Northern Cape and is the largest radio telescope in the Southern Hemisphere. Each of the 64 dishes measures 13.5m in diameter and is used to research the structure of the cosmos as well as galactic evolution, making it one of South Africa's premier scientific endeavours in astronomy. It's this pioneering and forward-thinking ideology that is needed to achieve excellence.

Introduction

A warm welcome to Shawn Stockigt, our new CEO

Shawn Stockigt was appointed Chief Executive Officer of Cadiz Asset Management with effect from 1 October 2015.

With a wealth of experience, he will focus on sourcing talent to strengthen our team

Shawn has worked at a number of different institutions including Stanlib, Sanlam, Abvest Asset Management and Momentum Asset Management. His short-term focus will be to work with the existing investment team and focus on appointing new talent to further strengthen the team. This bodes well for our investment capability, which lies at the heart of what we do for investors.

We are therefore pleased to welcome some fresh talent to our fixed interest team

We have a successful track record in fixed interest investing and have added to our experienced fixed interest team. Alastair Sellick, Ruen Naidu and Candice Moses have joined Carron Howard and Michele van der Berg. Alastair has been appointed head of fixed interest and his responsibilities will include portfolio management of the Cadiz Bond and Flexible Income Funds specifically. He has over 15 years' experience at various institutions. The team of five professionals will be responsible for all fixed interest mandates across various disciplines and will also feed into our multi-asset class capability. We are counting on their combined talent and experience to maintain our track record and grow an already strong fixed interest capability.

Lastly, nothing happens without our stable and well-regarded infrastructure, administrative and operational support, so Shawn will be working closely with members of this team too. We all wish Shawn and other new members of the Cadiz team a very warm welcome and look forward to the long-term benefits of your leadership and experience.

Markets are increasingly volatile, but there are still opportunities

This edition focusses on why markets appear to be increasingly volatile and what one should consider in an environment like this. Brian Munro explains that capital protection is key in his article: Where to invest. He also highlights some exciting prospects for developed market equities. Also of particular interest, given the low oil price and sub-par economic growth, is the Sasol review by Matt Brenzel.

Enjoy the read.

Francois van Wyk
Chief Investment Officer

Investing: lessons from art and science

by ***Shawn Stockigt****,*
Chief Executive Officer

The Mona Lisa by Leonardo da Vinci wasn't highly regarded until 1911

Although Leonardo da Vinci painted the Mona Lisa in 1507, it wasn't very popular at the Louvre until 1911. Very few serious art critics regarded it as a fine example of renaissance art at the time but today over eight million tourists queue to view the painting each year!

What changed the public's perception?

In August 1911, three Italians stole the painting from the Louvre. Ironically, the painting was so unpopular that it took over 24 hours for staff to notice that it had even gone missing. A few days later there was a media frenzy of Kardashian proportions (a song and a cabaret literally followed the theft) and 28 months later when the thief was arrested trying to offload the piece, there was some fanfare to accompany the paintings return. This marked the start of its soaring popularity and it has since become a tourist 'must see'.

How is this story relevant to investing?

Asset prices always reflect a set of probabilities. The golden rule is that the more you pay for those probabilities, the lower your eventual returns will be. It is therefore important to understand what makes up the probabilities. In other words, which part of the probability of return is made up of knowledge of a company's fundamentals and which part is made up of a subjective expectation (noise)? Just like the sudden popularity of the Mona Lisa, a share price can rise (or fall) because of an event that may not have much to do with the actual underlying value of the asset.

Perceptions can lead to inflated prices in the short term

Human beings often make decisions by observing others. These decisions are not always rational and often lead to asset mispricing. This mispricing creates opportunities that a sound and disciplined long-term investment process and philosophy aims to capture. The success of a good investment process may not always be evident in the short term, as the short term does not necessarily distinguish between good and bad processes. Quality processes are by definition focused on the long term and usually pay off if you stay the course. As investors that focus on the underlying value of an asset, we spend our time and energy focusing on the quality and fair price of the investment itself, as opposed to the short-term momentum of the share price (which tends to be market noise).

Please let me know if we can deploy our Cadiz 'can do' attitude to serve you better

Since arriving at Cadiz, I have spent some time with the people who are entrusted with managing your money and the team whose support enables this management to take place. This includes compliance, relationship and sales support, client service and all the other operational functions that free our investment professionals' time to focus on generating returns for you. I am pleased to report that we have the correct people with the right 'can do' attitude in place to ensure you have a great investment experience with us. Having said that, I am very aware that beauty is in the eye of the beholder, so if we don't live up to your expectations, please let me know.

Thank you for your support. I hope you will enjoy reading this edition of CAMmunique.

Where to invest

Taking stock of global equities

by ***Brian Munro****,*
Investment Strategist

In the current volatile environment, investors have adapted to focusing on capital protection instead of chasing returns. But when it comes to equities, should investors be cautious of stalling growth or can we look forward to improved earnings? To answer this we need to consider various factors. The first factor is where global earnings are in the cycle. With global earnings currently being mid-cycle, it's clear that it can move in either direction. Secondly, we should consider interest rates and liquidity conditions, as well as how key macro drivers are affecting different regional equity markets. Lastly, equity valuations give insight into how attractive the asset class currently is as an investment. Considering all these factors, we still believe there is a good case for investing in developed market equities over the next one to two years.

The current volatility of the global economy is placing a question mark over equity prospects

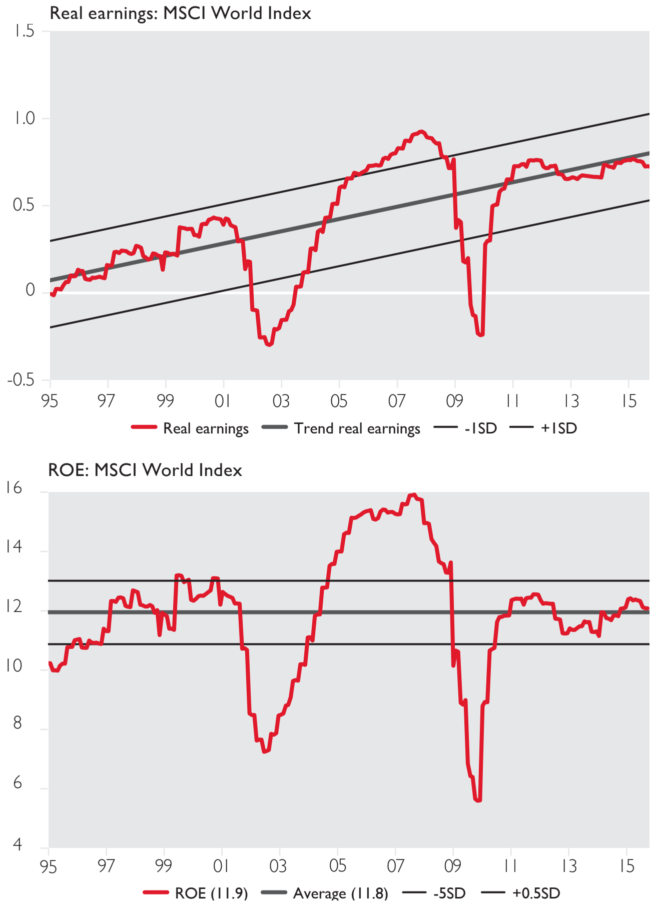
Since the beginning of the year, we have been advising clients to remain cautious, expect volatility and protect capital rather than chase returns. We continue to advocate this message in the context of a global economy that is characterised by high debt, below-trend growth, inflation growth that is barely above zero with persistent deflationary pressures; and a likely change in the direction of interest rates. For equities as an asset class, the key question is whether earnings will grow or stall.

To answer this question we will consider the following:

1. Where global earnings are in the cycle, and what the market is expecting over the next one to two years.
2. Risks to the earnings outlook:
    a. Interest rates and liquidity conditions (where are we in the cycle?).
    b. The economic environment: the growth and inflation outlook as well as key macro drivers that affect earnings growth in the medium to long term.
3. Current equity valuations, including what's been discounted by the current market levels.

Global earnings are currently mid-cycle

Chart 1: Global earnings growth and return on equity (ROE) are mid-cycle



Sources: MSCI, Bloomberg, Cadiz Asset Management

Chart 1 shows global return on equity (ROE) along with global earnings growth, in dollars. Although both measures are around their long-term averages, both have fallen recently. A contributing factor to the recent slowdown in earnings growth has been a strong US dollar, which strengthened by 12% over the last year. Nevertheless, earnings growth is mid-cycle and the question is whether earnings growth will likely re-accelerate, decelerate further or remain largely unchanged.

Assessing the risks to the potential earnings outlook

To assess the risks we have to take stock of a number of factors, including interest rates, current liquidity conditions and potential growth drivers.

a. Interest rates and liquidity: monetary policy should continue to support earnings growth

Since 2010, central banks have adopted an ultra-accommodative monetary policy led by the US Federal Reserve (US Fed). Subsequently, the European Central Bank (ECB) and the Bank of Japan (BoJ) have taken over the baton and continue to expand their balance sheets by adopting their own quantitative easing programmes. This sequence of events has led to developed market (DM) bond yields falling to historically low levels. The decline in DM bond yields, in turn, drove down emerging market (EM) bond yields as investors were forced to seek higher returns from riskier assets. This broad-based decline in interest rates created an environment conducive for equity markets to flourish.

However, this highly accommodative monetary policy is about to change as the world waits for the US Fed to begin raising interest rates and gradually normalise their monetary policy. Liquidity conditions amongst EM countries are also tightening as a result of money flowing back to DMs. This could cause EM central banks to raise rates to defend their currencies to prevent domestic inflation from rising via their depreciating currencies (as has been the case in South Africa) – worsening the liquidity conditions further.

All of this is creating volatility in financial markets. However, it is important to remember that monetary policy has been ultra-accommodative. Although there has been a shift to start normalising monetary policy, the process will likely be a very gradual one that can take several years. It is our view that monetary policy will likely remain supportive of earnings growth over the next one to two years.

b. The economic environment and key macro drivers

Emerging markets – concerns about the knock-on effect of slow growth on commodity exports

Over the last quarter, a possible economic growth slowdown coupled with deflationary fears have become a key concern for investors all over the globe. Even though their concerns centred primarily on the slowdown in the Chinese economy, it also included concerns about the knock-on effect on commodity exporters like South Africa. With EM countries contributing 50% of global GDP, this is weighing heavily on the outlook for global growth.

Although the collapse in commodity prices, especially the oil price, is hurting the respective commodity-exporting economies, these falling prices are also keeping inflation at bay. In fact, the collapse in the oil price is a huge boost to the consumer globally, as fuel prices and food prices have fallen. This should support global growth, especially developed economies who are large consumers of oil and oil-related products.

US economy

The US economy is clearly gaining momentum – the US Fed is finally at a point where they want to raise interest rates to a more normal, sustainable level.

The US consumer is in good shape and is expected to drive continued economic growth. Not only have consumers reduced their debt burdens to acceptable levels, but their net wealth has increased on the back of increased house prices and the stock market. At the same time, the labour market continues to strengthen and is currently at full employment. However, this should increase wage cost inflation (currently at 2.2%) over time, which in turn should adversely affect profit margins that are at historically high levels. The strong dollar is likely to affect exporters while interest rates and taxes will probably increase, affecting the broader corporate landscape. All of this may impact future earnings growth, causing earnings growth to decelerate to more sustainable levels.

Europe

Whereas the US economy is more than six years into its current upcycle, Europe is only at the beginning of its upcycle. We believe that the European economy will continue to recover and that earnings will continue to accelerate off a low base, supported by low interest funding costs, a weaker euro, a lower oil price and a labour market that has finally bottomed and is slowly recovering. However, there are a number of concerns:

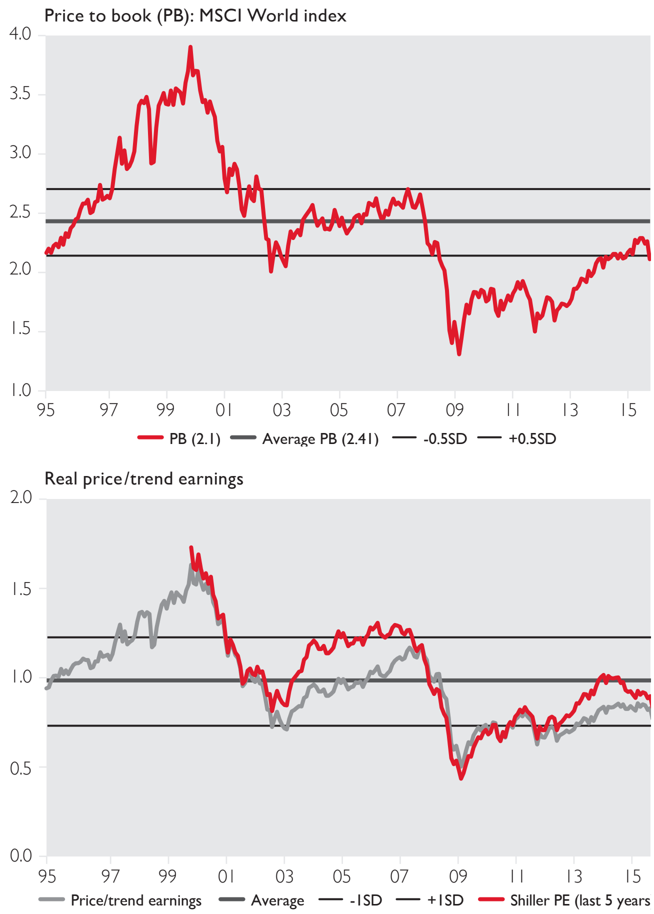
- Europe exports a lot of its products to EMs.
- Structural reforms (a number of EU countries have been slow to implement).
- There is very little inflation in the system – on aggregate, prices remain static.

Having weighed up the risks, we believe European earnings will accelerate off their low base. As a result, we prefer European equities over US equities and dislike EM equities in the near term. We believe earnings growth in EMs will likely decelerate in dollar terms.

Global equity valuations are slightly below fair value

Having assessed the potential pitfalls and growth drivers for the earnings outlook, the final question is: what is in the price?

Chart 2: Global equity price to book and price to trend earnings



Sources: MSCI, Bloomberg, Cadiz Asset Management

Chart 2 shows the price to trend earnings and the price paid per book value. It is evident that valuations are not stretched and equity markets are trading below their long-term averages. These are just some of the valuation metrics we assess to determine the attractiveness of equities. Given the current weakness in equity markets, this could be a suitable entry point. If we add the rand to the mix, which in the long run offers additional returns and diversification and acts as a hedge against South African inflation, the investment case to add exposure to global equities (especially DM equity in a multi-asset portfolio) becomes even stronger. ■

Interest rates: where to from here?

by *Adenaan Hardien*, *Economist*

We assess South Africa's interest rate cycle and the path the South African Reserve Bank (SARB) is likely to take. Some of the contributing factors that we review are the state of the current global economy, US interest rates (that act as a global benchmark) and South Africa's growth and inflation outlook.

The global recovery is fragile with a heightened deflation risk

The International Monetary Fund's (IMF) latest assessment of global conditions confirmed a more fragile global recovery than they expected earlier in the year, with a weaker world growth performance expected for 2015 compared to what was achieved in 2014. Advanced economies are expected to continue leading the recovery, with developing economies struggling with lower commodity prices, tighter external financing conditions, structural bottlenecks, rebalancing in China, and economic distress related to geopolitical factors. Recent market corrections cast even more of a shadow on emerging economies' growth prospects. Weaker activity in China and the recent devaluation of the renminbi raises the risk of another bout of deflationary pressure in the global economy.

With that global perspective, the US Federal Reserve blinked and kept rates unchanged

The Federal Reserve System (Fed) Federal Open Market Committee's (FOMC) rate decision on 17 September was probably the most keenly anticipated economic event over the last quarter. Early in the quarter, the prevailing market consensus was for the Fed to hike its benchmark Fed Funds Target Rate from 0.25%. A hike would have been significant especially for savings-scarce countries like South Africa. The lift-off would have heralded the beginning of global policy rate normalisation and a consequent tightening of global liquidity.

A spate of dismal economic news concentrated in emerging economies. Massive selling across major commodities, currencies and various asset classes caused the FOMC to leave the Fed Funds Target Rate unchanged despite their relatively bullish assessment of US economic conditions. They cited concerns about the potential impact of recent global events on the US economy.

The FOMC sees the US economy expanding at a moderate pace and noted that the labour market has continued to strengthen. Inflation remains below the FOMC's long-term objective of 2%, but it remains confident that it would achieve this objective over the medium term. The FOMC would clearly have hiked rates if its decision was based solely on their assessment of US domestic economic conditions. However, recent global events have been substantial and the FOMC is not clear about its ultimate impact. Even though the majority of voting members on the FOMC still favoured hiking in 2015, they will allow themselves the benefit of more data before they initiate lift-off.

The South African economy faces stagnant growth and the risk of rising inflation

Recent figures confirmed that growth stalled over the second quarter, with the economy contracting by an annualised 1.3%. Load shedding was the major culprit with sectors that are heavily dependent on stable electricity supply suffering the most. This has caused the SARB to revise their growth forecasts substantially lower to 1.5% and 1.6% for 2015 and 2016 respectively. At the same time they have also revised South Africa's potential growth lower to 1.8% in 2015 and 1.6% in 2016, which is concerning.

Consumer inflation eased to 4.6% in August, following five straight gains that saw it rise from a low point of 3.9% in February to 5.0% in July. Food and oil were major disinflationary forces since mid-2014, driving inflation to its February low before rebounding. But recent declines in the prices of oil and other commodity prices mean that the anticipated peak in the first quarter of 2016 is likely to be notably lower than was previously expected. We expect consumer inflation to still peak above 6%, but we are mindful of the risk that the peak fails to breach the upper bound of the SARB's inflation target of 6%.

The South African Reserve Bank resumes the interest rate hiking cycle, although gradually

With these factors in mind we assess the SARB's recent interest rate hike, their motivation for the hike and what they are likely to do going forward. The SARB Monetary Policy Committee (MPC) resumed its gradual rate hiking cycle in July, increasing the repo rate by 0.25% to 6%, having signalled its intent at its March and May MPC meetings. The latest hike was motivated by a worsening inflation prognosis and a desire for positive real rates ahead of the US Fed FOMC initiating their policy rate lift-off and consequent tighter global liquidity. But things have changed. Domestic growth has collapsed, inflation prospects are improving, risks are more nuanced, and major central banks like the Fed have delayed their normalisation. The potential cost of continuing to hike in the present environment may be too great.

We therefore think that, although there is still a good chance of a November hike, probabilities are shifting towards a resumption of hikes in 2016. ■

The impact of global interest rate changes on the South African bond market

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

In this article, Alastair Sellick explains how the potential changes to global and local interest rates could affect South African bond investors. He shares his insights on the:

1. Current interest rate environment (which builds on Adenaan Hardien's economic themed article: Interest rates - where to from here?); and
2. Understanding the Fed's dilemma – to hike or not to hike this year.

But most critically, he explains how this affects our bond market and what this means for us as fixed interest investors.

The impact of pre-Fed rate hike panic this year

We have seen two concentrated bouts of pre-Fed rate hike panic this year. The first happened in March, and was evidenced by the R186 bond yield selling off from February lows of 7% to hit 8% a few days before the Federal Open Market Committee (FOMC) meeting in March. At that time, the prevailing concern was that the Fed would hike interest rates in June. As it turns out, they didn't. Expectations reset to September and as the world lurched towards the dreaded September hike, R186s sold off from a mid-July low of 8.01% to a pre-FOMC peak of 8.61%.

Why would the Fed scale back the rate hiking cycle before it has even begun?

The US Fed's dual mandate focuses on controlling inflation and delivering growth with low unemployment. We focus on each aspect to understand the Fed's dilemma and possible next move by examining:

1. The absence of US inflation (aided partially by the strength of the US dollar), and
2. A stronger labour market that has:
   a. a declining unemployment rate, but
   b. with a declining labour participation rate,
3. The use of Forward Guidance (telling the public and markets what to expect) as a policy tool.

1. US inflation has been remarkably absent, allowing the Fed to hold fire

Many critics of the massive Quantitative Easing programmes (QE1, 2 and 3) cited the risk of high US inflation as one of the main reasons why the Fed's rapid expansion of its balance sheet through various government and agency bond buying programmes was a policy error. However, in spite of the massive size of the balance sheet and the ongoing re-investment of principal from maturing securities, inflation is simply not evident. One reason for that is the plunge in oil prices. This benefit will be transitory, but has provided a massive deflationary surge to the US economy. The other significant factor has been the strengthening dollar (12% year-on-year) which has contributed to the deflationary pressures. Currently the Personal Consumption Expenditure price index (PCE, the Fed's preferred measure of inflation growth) is 0.3% year-on-year. Forecasts have this at 0.4% by the end of 2015, rising to 1.7% in 2016 and only reaching 2.0%, the Fed's target, in 2017.

2. **(a) Unemployment is low and declining, supporting the Fed's desire to raise rates**

A key indicator of the health of the economy and its growth prospects is the labour market. The unemployment rate has fallen far below the initial threshold at which Janet Yellen initially suggested rate hikes would begin. The Evans Rule, floated in December 2012, suggested that unemployment falling through 6.5% or inflation rising through 2.5% would necessitate hikes. In March 2014, the 6.5% unemployment threshold language was removed, and PCE inflation target was lowered to 2.0%. We now have US unemployment at an impressive 5.1%, near full employment. As the labour market strengthens further, this would increase the likelihood of the Fed raising rates.

(b) The low labour participation rate is a concern for the Fed

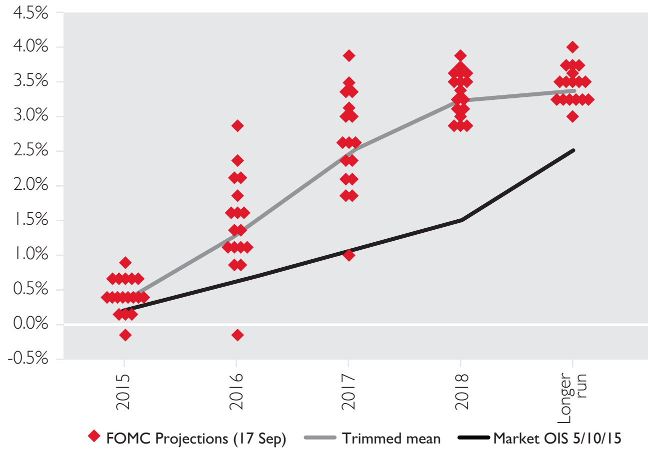
However, a major concern for Janet Yellen has been the low labour participation rate. For the greater part of the first decade in the 21st century, the labour participation rate oscillated between 66% and 67%. But in the aftermath of the financial crisis of 2008 it has fallen to 62.6%. Studies have shown a large part of this decline is structural (e.g. retiring work force). However, there is a cyclical component that the Fed hopes will reverse if rates are kept lower for longer.

3. **The Fed would like to move away from Forward Guidance**

Many central banks use this tool (it is a policy of telling the market what to expect) to influence market expectations of future levels of interest rates. It differs markedly from the traditional Taylor Rule approach, which is a data dependent approach to setting monetary policy.

One Forward Guidance tool the Fed adopts is the 'dot plot' (shown in Chart 1) that indicates where each member of the FOMC believes interest rates will be in the next one to two years. Currently, the projected path of interest rates (as captured by the mean value) is significantly higher than what the market is expecting. This divergence in views (between the FOMC and the market) is creating uncertainty and volatility amongst investors. The credibility of the Fed is at stake.

Chart 1. FOMC 'dot plot' highlighting the committee's future target rate compared to the market's expectation



Source: Credit Suisse

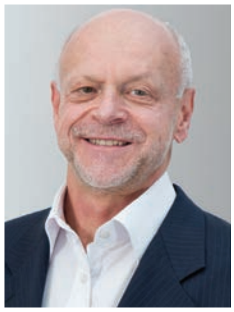
Even though US inflation is currently absent and there are global deflationary pressures, the Fed is eager to raise rates off the near-zero bound. They wish to ensure that inflation doesn't materialise in the future. They would also like to have some form of policy tool available if future easing is required. They have communicated their eagerness to raise rates before the end of the year, although they also stress they are data dependent. Will Forward Guidance prevail or will the economic data continue to disappoint, keeping the Fed from hiking rates? At Cadiz, we will continue to monitor what the Fed says and how the market responds as this has a direct bearing on the South African bond market.

What does this mean for South African fixed interest investors?

If the Fed hikes rates and we see capital flight from emerging markets in general and South Africa in particular, then the rand could weaken further. The extent of any rand weakness could cause the SARB to raise interest rates. In such an environment, short-end bonds would sell off causing the yield curve to flatten. Once any selloff had taken place, long-dated government bonds would start to offer value. Especially if any rate hikes anchored inflation expectations.

We will continue to monitor the risks associated with any change (or expected change) in global or local interest rates which will inform us on how best to position the fixed income funds to achieve their investment objectives. ■

Sasol: potential for a high octane return?



by ***Matt Brenzel****,*
Portfolio Manager

Investing in Sasol is not for the faint hearted. In the last decade, the company was one of the calendar year winners (in 2005 and then again in 2013), but also one of the losers (in 2006, 2009, 2012 and 2014). So far this year it is competing for the position of bottom performer amongst its commodity peers.

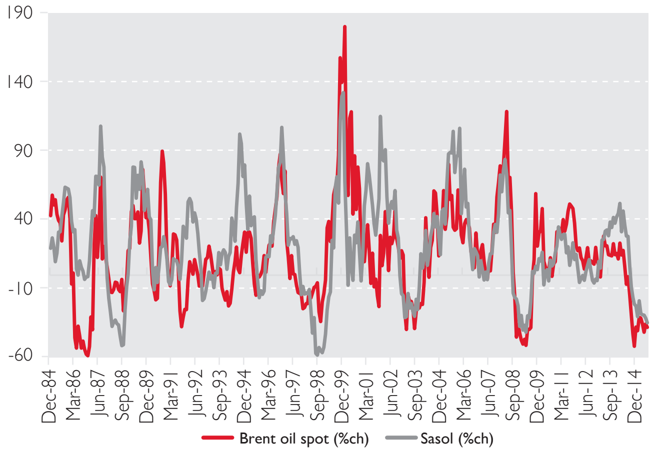
That said, Sasol remains one of the preferred ways to invest within the notoriously volatile commodities universe. The reason: its earnings and dividend profiles are substantially less cyclically extreme than those of its commodity peers, because the oil price has been less volatile relative to commodities over time.

We are of the opinion however, that Sasol's current price does not offer an attractive entry point, and we discuss the reasons for this conviction in the article.

Understanding the key revenue drivers for Sasol

At the most basic level, Sasol's earnings and share price drivers are the oil price and the rand/dollar exchange rate. This is neatly illustrated in Graph 1.

Graph 1: Percentage change in Sasol's share price versus the percentage change in the rand oil price



Sources: I-NET, Cadiz Asset Management

Given the high degree of correlation, some might argue that getting the call on Sasol right would hinge on the successful forecast of the oil price and the rand. However in reality, understanding Sasol is a bit more complex than that.

Since its establishment in the early 1950s, Sasol has evolved into a vertically integrated miner, oil and chemical producer. Today, Sasol is the world's leading applicator of the Fischer-Tropsch process used in the conversion of coal to synthetic fuel (CTL) or gas to synthetic fuels (GTL). The process is particularly useful in the case of stranded assets: large coal or gas reserves that are great distances from their final markets. Importantly, the process is very expensive and complex, which offers effective barriers to entry.

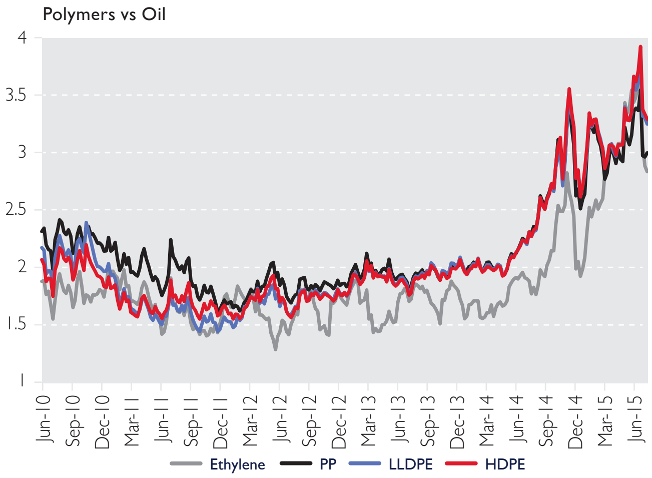
Sasol's drivers are therefore a mix of the prices of coal, oil, ethane and other gases and a range of chemical compounds.

Given that these commodities are predominantly priced in US dollars, Sasol displays strong rand hedge characteristics.

The attraction of this spread of commodities lies in the relative pricing dynamics. For example, the oil price (off which many of Sasol's products are priced) is less volatile than some of its industrial commodity peers.

In addition, increased focus on value-added products has bolstered the bottom line. This is evident in Graph 2.

Graph 2: Polymer prices relative to the oil price



Sources: Datastream, Investec Securities

Graph 2 shows how – after a period of relative stability – polymer prices have outperformed the oil price since June 2014. This outperformance was one of the reasons why most analysts underestimated Sasol's recent results. It's important to point out that the increase was more ascribable to the sharp fall in the oil price, rather than a strong rise in polymer prices. Nevertheless, we believe that the price relative ratios displayed in Graph 2 pose a risk to future earnings. The most recent data points already show some weakening taking place.

Fundamental reasons for not investing in Sasol

1. The carbon debate

Sasol's management is keenly aware of the ongoing debates about global warming – the company has the reputation of having the highest disclosed sulphur dioxide and nitrous oxide emissions per unit of sales than any other listed entity.

The move to the gas fields of Qatar, Mozambique, Canada, Uzbekistan and the USA are an obvious attempt to mitigate the company's pollution profile, but one can argue that it might be a case of too little too late.

Although Sasol has been adept at realising value out of stranded assets, these assets could become a detrimental factor. Increased investor militancy against polluters such as Sasol has led to large institutional funds divesting out of any corporates who have similar business profiles. While polluters have access to large coal resources, for example, these assets may never be developed by virtue of investor and legislative pressures. Remember that these are assets that were paid for but are delivering zero return unless developed at some stage in the future.

2. Possible carbon taxes are a threat to Sasol's earnings

Linked to the previous point is the fact that governments are pressured by the public voice to punish polluters. Carbon taxes have therefore been imposed to encourage perpetrators to install technology that reduces or eliminates harmful emissions.

South Africa has joined the club. In May 2013, National Treasury released a carbon tax policy paper for public comment, showing that Sasol and Eskom are the largest emitters of greenhouse gases. The implementation date will likely be in 2016.

The debate around the effectiveness of a carbon tax leading to a change in producer and consumer behaviour is complex. What guarantee does the investor have that the imposition of this tax has more to do with the financing of the fiscus than the reduction of pollution? Whatever the case, the imposition of this tax is a threat to Sasol's earnings.

3. Legal cases can snowball at any time

Sasol has been accused by customers and the Competition Commission of uncompetitive behaviour because:

- it is a dominant producer of certain goods and services, and
- it prices its South African products using an import parity pricing structure.

The company has been involved in cases that have shown or attempted to show collusion in the fertilizer industry (1996-2004), price fixing of diesel (2005-2011), and price manipulation of propylene and polypropylene between Sasol Polymers and plastics manufacturer Safripol (2010).

While the amounts involved and fines imposed have been relatively small, these can escalate quite quickly with dire consequences for investors, as the recent Volkswagen case has shown.

4. Questions have arisen about finding a new, suitable CEO

David Constable was appointed CEO on a five-year contract in June 2011. Under his guidance, Sasol undertook several initiatives:

- In 2011, the company started moving away from CTL towards the monetisation of oil and gas.
- The following year, Project 2050 (the extension of the lifespan of South Africa's assets to 2050) was

approved. In that same year, Sasol launched the Lake Charles Chemical project (conversion of ethane gas to ethylene products).

- In 2013, the company adopted the Business Performance Enhancement Programme, which was aimed at achieving significant operational efficiencies.
- The group structure was changed in 2014. Three entities were created: the Operating Business Units (housing the mining, exploration and production international companies); Regional Operating Hubs (the Southern African, North American and Eurasian operations) and the Strategic Business Units (the energy, base- and performance chemical, customer interface businesses). The reason for the re-structure was to reduce the complexity of the company and to locate the South African operation in one entity.

The refocus that Constable provided led to new GTL projects in the USA, Mozambique, Canada and Uzbekistan. While some investments have proven less successful, the savings generated by the initiatives listed above have been substantial.

Constable's tenure ends June 2016 and he has indicated that he will not renew his contract, but will remain as consultant for another 12 months to guide the Lake Charles project to its completion. Sasol has launched both an internal and external executive search to find a successor. Without pre-empting the result, we believe that an internal appointment will be less favourably viewed by investors.

5. Substantial capex programme planned for the next few years

Linked to the move away from CTL into purer gas projects, is a significant capital expansion programme over the next couple of years. The Lake Charles project will absorb some R45 billion in 2016, R42 billion in 2017, and R16 billion in 2018, at which date it will be commissioned. The project is primarily debt funded and will boost the debt-to-equity ratio to about 40% at its peak in two years' time. Although this ratio is hardly punitive, it is concerning. If oil and polymer prices continue to weaken and remain low for an extended period of time, cash flow generation and Sasol's ability to fund interest, debt repayments and capex requirements becomes the more critical question.

In recognition of the cash flow impact of this programme and weakening fundamentals, Sasol announced a change in its pay-out policy from progressive to a dividend cover range, based on earnings performance.

Sasol does not have a great record in delivering capital projects on time and on budget. We are averse to investing in companies that have a strong capex programme at a time when the business cycle is clearly weakening.

Are all these elements factored into the price?

In absolute terms, Sasol is trading 1 standard deviation (SD) cheap on trailing earnings and dividends and close to 2SD cheap on price to book ratios. Although Sasol has generated earnings, dividend and book growth well in excess of the broader FTSE/JSE All Share Index in the last 20 years, the most recent relative underperformance by those metrics has eroded investor confidence.

Of the 635 oil, gas and consumable fuel companies listed around the world, the following two points are of interest:

1. Sasol ranks 52nd in market capitalisation terms ($19 billion), with first and second spots occupied by Exxon Mobil ($303 billion) and Royal Dutch Shell ($155 billion).
2. As Table 1 shows, Sasol has outperformed its peers on price, but is not particularly attractively valued.

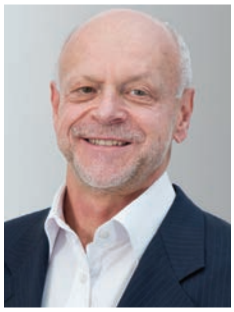
While Sasol's prospective dividend yield of 3.7% as shown in the table might appear competitive when viewed against global peers, it should be borne in mind that the yield backed up to nearly 7% in the previous emerging market crisis of 1998. The current commodity calamity is affecting emerging market exporters, of which Sasol is one. Furthermore, the company is particularly expensive on the PB ratio. We therefore argue that Sasol's current share price does not offer an attractive entry point.

Table 1: Sasol versus world energy companies

World energy companies	Total return - 6 months	Total return - 12 months	Total return - 3 years	PE	Dividend yield	FCF yield	EV/ EBITDA	PB (equity)	EBITDA margin	Gearing: debt/ equity
	Trailing	Trailing	Trailing	FY1	FY1	FY1	FY1	FY1	FY1	FY3
Sasol	7.5	-31.2	20.4	11.4	3.7	-9.9	5.7	1.4	26.8	42.0
Median	-19.3	-39.5	-23.5	10.9	2.7	-2.6	7.0	1.0	31.6	36.0
Sasol premium/ discount	27	8	44	5	-27	281	-19	40	-15	17

Source: Cannacord Quest

Quarterly review



by ***Matt Brenzel**, Portfolio Manager*

INTERNATIONAL

Events in China and the US dominate headlines for the quarter

We have argued over the past few months that the investment climate is more conducive to defensively structured portfolios. At the heart of the factors driving investment markets is a world that lacks both synchronicity in monetary policy and a powerful growth profile. The US is trundling along at a positive, but sub-par pace, in desperate search of the right time to raise rates. Europe is 'economically schizophrenic' as Germany powers ahead, but Greece and other peripheral countries lag. Japan's recovery is spotty and more quantitative easing may be required. China is trying to find a balance between manipulation and letting free market forces dictate, with a resultant poor outcome for emerging markets such as South Africa.

None of this is new – it is a refrain that has been in place for the past few years. We are just a bit further down the road and visibility is still poor.

China attracted the headlines again – for the wrong reasons

The Chinese A-share market continued to weaken in the quarter. The People's Bank of China committed wave upon wave of capital into the market and applied more regulations onto the market in an effort to end the slide. In the end, the Bank pledged to print money and buy A-shares.

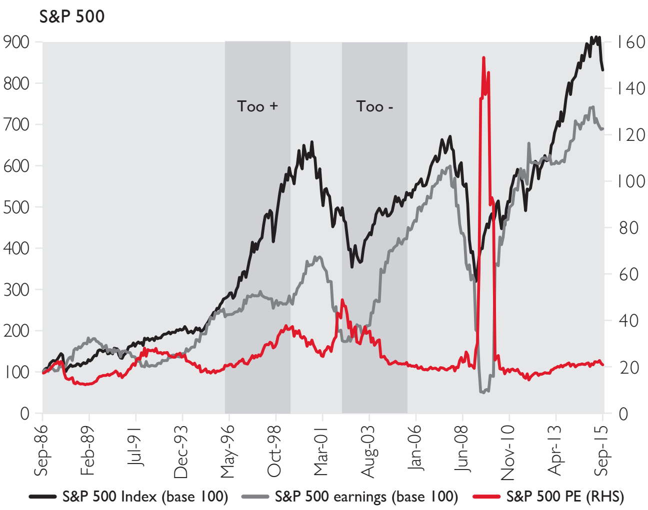
This provided some stability, but then in August, Chinese policymakers shot themselves in the foot again by adjusting the currency float against the US dollar by 2%. This occurred without any warning. Commentators are still debating whether this was done in order to gain IMF approval for the renminbi to achieve reserve currency status or whether it was done to help distressed exporters, but the impact on financial markets was acutely negative. The US dollar powered ahead in the month, pushing commodity prices and emerging markets out of its way. The net impact of the Chinese currency move is that world's powerhouse economy will export more deflation. This goes some way to explain why bonds had a better quarter than equities.

The US does care

The Fed decided to err on the side of caution and delay the rise in interest rates. In essence, the reasoning is as follows: China currency change + emerging market weakness + S&P 500 shakiness = Fed standing pat. Most commentators remain convinced that the Fed will hike this year still. But if the storyline does not change between now and then, there is a good chance that the first hike will only occur in 2016.

But for equities to go higher, corporates need to produce earnings growth

Chart 1: Where are the earnings?



Sources: I-NET, Cadiz Asset Managementt

Investments 101 teaches us that corporate earnings drive share prices. Although the accounting fraternity has done its best through the ages to confuse us about what exactly constitutes earnings; at its simplest: profit growth equals price growth. When profit growth surges, so does the share price and vice versa. There are times on either side of these events when a spot of irrationality sets in and investors become either overconfident and drive prices too far in excess of the underlying profit growth vector or become overly pessimistic. The chart on the previous page shows this interplay by indexing the earnings of the S&P 500 against the Index to 100 in September 1986 (LH axis), superimposed by the S&P 500 PE ratio (RH axis).

The shaded area entitled 'Too +' shows how market exuberance between 1995 and 1998 drove prices to exceed earnings by a factor of 4 on an annualised basis. The price to earnings (PE) ratio doubled to 33 times. The party ended when Russia defaulted on its loan repayments and a couple of south-east Asian nations were compelled to delink their currencies from the US dollar.

The second shaded area ('Too –') shows how despite the fact that earnings growth powered ahead post 9/11 by an annualised 31%, the index only rose by 4% as investors turned their backs on risky assets.

The most recent data points show both a turn in the index and earnings. Importantly though, the gap between the two is still too wide, i.e. ratings are extended. Data from Merrill Lynch Bank of America highlights that the global earnings revisions ratio (a ratio that measures the number of earnings upgrades versus the number of earnings downgrades) fell dramatically in September from 0.85 to 0.62 (in other words, for every 100 downgrades in earnings, there are 62 upgrades). All major regions and most global sectors showed deterioration. Markets do not perform well whilst earnings downgrades are in place.

In the current uncertain environment, earnings growth is key. Without sustainably higher earnings growth, it is difficult to see share prices moving sustainably higher.

Table 1: International equity market returns

International (US$)	Quarter	YTD	12 Months
MSCI World	-8.3%	-5.6%	-4.6%
MSCI Emerging	-17.8%	-15.2%	-19.0%
MSCI SA	-18.5%	-16.3%	-13.8%

Source: Bank of America Merrill Lynch

The going got tougher during the quarter

The three months ending September were brutal – the worst quarter for equities in the past four years. Global equity market capitalisation fell by a record $10 trillion and at its current level of $60 trillion, is at the same level as it was in September 2013.

At the heart of the fallout was ongoing angst about Greece, further confirmation of the Chinese economic slowdown and another delay in the much-anticipated rate hike by the Fed.

So where could one have found a safe haven? Only in bonds and cash, with the former delivering the better return at 1%. At the country level, not one equity market succeeded in generating a positive return in the quarter. The best performer, Denmark, managed to yield only -3%; while the worst was Greece at -36%, with the rest of the world in-between the two.

LOCAL

Table 2: South African financial market returns

Asset class (ZAR)	Quarter	YTD	12 Months
All Share	-2.1%	3.4%	4.8%
All Bond	1.1%	2.7%	7.0%
Listed Property	6.2%	13.3%	25.8%
Cash	1.6	4.7	6.4
Tier-1 (ZAR)	**Quarter**	**YTD**	**12 Months**
Resources	-17.9%	-22.0%	-37.1%
Financials	-1.1%	7.5%	19.1%
Industrials	0.8%	8.2%	15.8%
Size (ZAR)	**Quarter**	**YTD**	**12 Months**
Large Cap	-1.5%	4.9%	4.9%
Mid Cap	-5.9%	-5.2%	3.2%
Small Cap	-3.9%	0.6%	7.2%

Source: Deutsche Bank

Property over cash over bonds and equities

The lull that property shares experienced in the previous quarter did not last long. Buoyed by the likes of Redefine, Resilient and Capital – which account for a third of the FTSE/JSE Property Index capitalisation – this long duration asset continues to attract investors and has been supported by stable bond yields.

SABMiller to be swallowed?

Anheuser-Busch InBev, the world's largest brewer approached SABMiller (the second largest) as takeover target with the view to creating a company that will produce one third of the world's beer. The combined group will have a value of over $380 billion. The deal is proposed in an environment that has seen customers swing away from traditional ale to craft beers, wine and other spirits. Power has also moved into the hands of the retailers who increasingly call the shots on pricing. The proposed grouping will combine AB InBev's dominance in Latin America with SABMiller's in Africa.

The deal is no slam-dunk as there are numerous hurdles to cross. Competitive concerns probably top the list, especially in the US, where the two hold more than two-thirds market share. China similarly presents a problem. Furthermore, the management cultures are significantly different, so there is likely to be some clashing. As SABMiller is listed in the UK and given the particular quirks of that market, AB InBev has to put up or shut up by 14th October. Finally, SABMiller is under no compulsion to accept the offer if it is unattractive.

While SABMiller held the market up, resources let it down in the quarter

The resource sector remains under the cosh. With commodity prices falling in the quarter, driven lower by slowing Chinese data, a strong US dollar, and the impact of the VW emissions manipulation scandal on the price of platinum (-16%), share prices crumbled. Table 2 shows just how poor resource share returns have been.

Where to from here?

There is little doubt that the mood in investment markets is universally bearish. Perversely, this could lead to a temporary rebound in those sectors that have been heavily sold. As these are predominantly deeply cyclical shares and there is little to support them, we would caution against following what we see as a short-term bounce at best. ■

Cadiz Unit Trusts' performance

All performance figures in the table below are annualised percentage figures to 30 September 2015.

Unit Trusts	1 Year	3 Years	5 Years	7 Years	Since Inception	Inception Date
No Equity Exposure						
Cadiz Money Market Fund	6.76%	6.05%	5.96%	6.88%	7.65%	01-Mar-06
Alexander Forbes Short Term Fixed Interest (STeFI) Composite Index	6.38%	5.73%	5.74%	6.60%	7.35%	
Quartile Rank	1st	1st	1st	1st	1st	
Very Low Net Equity Exposure (up to 20% in listed property and preference shares only)						
Cadiz Absolute Yield Fund	7.24%	6.33%	7.50%	8.77%	8.92%	01-Mar-06
CPI+3%	7.59%	8.80%	8.54%	8.12%	9.25%	
Quartile Rank	2nd	2nd	2nd	1st	1st	
Low Net Equity Exposure (20 - 40%)						
Cadiz Stable Fund	5.14%	5.63%			5.58%	01-Sep-12
CPI+3%	7.59%	8.80%			8.91%	
Quartile Rank	4th	4th				
Medium Net Equity Exposure (40 - 75%)						
Cadiz Inflation Plus Fund	4.01%	6.00%	8.07%	9.85%	9.24%	13-Jan-06
CPI+5%	9.58%	10.80%	10.54%	10.11%	11.28%	
Quartile Rank	3rd	4th	4th	3rd	2nd	
Cadiz Managed Flexible Fund	1.50%	7.48%	9.46%	11.28%	9.67%	01-Mar-06
Average of the Domestic - Asset Allocation - Prudential High Equity sector	8.54%	13.95%	12.35%	11.10%	11.62%	
Quartile Rank	4th	4th	4th	3rd	3rd	
Flexible Net Equity Exposure (50 - 90%)						
Cadiz Equity Ladder Fund	-3.92%	-1.99%	0.20%	5.26%	6.33%	03-Jun-05
CPI+6%	10.58%	11.81%	11.54%	11.11%	11.61%	
High Net Equity Exposure (100%)						
Cadiz Mastermind Fund	-5.19%	4.87%	7.32%	9.77%	9.09%	01-Mar-06
FTSE/JSE SWIX Index	6.07%	11.87%	16.17%	15.69%	14.41%	
Quartile Rank	4th	4th	4th	4th	4th	

Source: Morningstar and Cadiz Asset Management

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