January 2017

CAMmuniqué

CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

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.

In this edition

Introduction
A year of consolidation and focus

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

2016 was a year of economic and political uncertainty

It's hard to believe 2016 is behind us and we now look forward to 2017. This year has been an extremely difficult one in the market. Investors have had to navigate political and economic uncertainty on an unprecedented level, both domestically and internationally. The charges of fraud levelled against Finance Minister Pravin Gordhan, Brexit in the UK and a surprise Trump victory in the US have made for interesting, if trying, economic times.

For Cadiz, it was a year of consolidation, focus and better performance

We will never pay more for an asset than our calculated true value of that asset. Despite a tough economic environment this strategy is paying off. This is evident in the improved performance across our investment offerings, especially in our flagship Cadiz Managed Flexible Fund. For Cadiz, 2016 was one of consolidation and focus after 2015, which proved challenging.

Why our investment performance improved in 2016

2016 gave us the opportunity to demonstrate our investment skill and 150 combined years of experience. Quantitative easing pumped liquidity into investment markets over the last few years, which created opportunities to benefit from careful stock selection. A large percentage of the domestic market capitalisation has been concentrated in a limited number of stocks, such as Naspers and SABMiller. Investors seemingly ignored fundamentals and merely invested in the larger stocks or the index, so this trend increased the price they were prepared to pay regardless of actual value of the underlying investment. Ultimately, any investment strategy that invests regardless of value will experience a lower future expected return. We strongly believe that the price paid for an asset is paramount, and because we avoid overpaying for investments, we experience underperformance when the diversity of the market is low. The opposite happens when diversity of the market increases, as we are seeing now, and our funds are consequently benefiting from this.

In this edition

In 'Where to invest' Brian Munro provides an overview of the different ways that we help to mitigate the uncertainty that lies ahead in markets. He reminds us to maintain a longer-term perspective and stay the course to take advantage of volatility and grow wealth. Razeen Dinath and Graeme Ronne share their insights about two stocks, Swatch and Franklin Resources. These pieces explain how we think about investing when we apply our disciplined investment process to buying and selling shares. Craig Thompson updates us on local bond market valuations and pricing, with specific reference to the December ratings agency announcements on South Africa's investment grade status. Matt Brenzel provides us with an overview of the previous quarter, with a local and international perspective. Lastly, we invite you to find out about Michele van der Berg, our new Portfolio Manager of the Money Market Fund.

Wishing you well for 2017

I am excited about 2017. We have a strong and committed shareholder, quality, passionate people, a recognised brand and the structures needed to ensure a stable platform for wealth creation. We therefore look ahead to 2017 with renewed energy. Our focus remains on generating superior long-term performance and servicing our clients' needs better, by way of a simplified operating model. Thank you for the trust you have shown in us. We wish you all a successful, happy and healthy 2017! ■

Where to invest

Making sound investment decisions when navigating uncertain times

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

Last year was a difficult year for investors. Local and international uncertainty created a tough environment in which to make wise investment decisions. This year is unlikely to be any different. But prudent long-term investors can still make good decisions. Basic investment principles need to be kept in mind. These include assessing the quality of a company and investing with an appropriate margin of safety, and managing the portfolio and the risks associated with position size and sector exposures. Applying these investment principles will help in navigating the year ahead.

Local and global investors had a tough 2016

For the equity, bond and currency markets, 2016 has been a tough year for investors. Last year the markets experienced considerably more political risk in addition to the usual market uncertainties. We had Brexit in the UK, Trump's surprise victory in the US elections, and the instability of our local politics, particularly surrounding the Ministry of Finance.

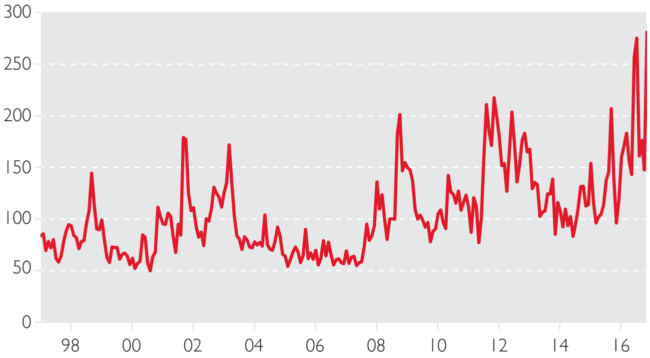
Considering the upcoming risk events, this year is likely to be unpredictable

The level of uncertainty (as shown in Chart 1, the Economic Policy Uncertainty Index) is likely to remain elevated in the immediate future. This is especially true in the context of the wide range of macroeconomic and political risks ahead:

- The US Federal Reserve (the Fed) is expected to continue to normalise interest rates, tightening monetary policy.
- Donald Trump will be inaugurated as the new US president and will likely introduce new policies, even though the details of these policies are not yet known. These could range from tax cuts, increased infrastructure spending and new trade agreements.
- Germany, France and the Netherlands will hold elections in 2017.
- Italy will need to establish a new government after the resignation of Prime Minister Matteo Renzi.

These factors increase the risk to investors in the short term, and could cause a temporary loss of capital. But if investors are able to maintain a longer-term perspective and stay the course, they will be able to take advantage of the volatility and grow their wealth.

Chart 1: Economic Policy Uncertainty Index (1998-2016)



Source: www.PolicyUncertainty.com

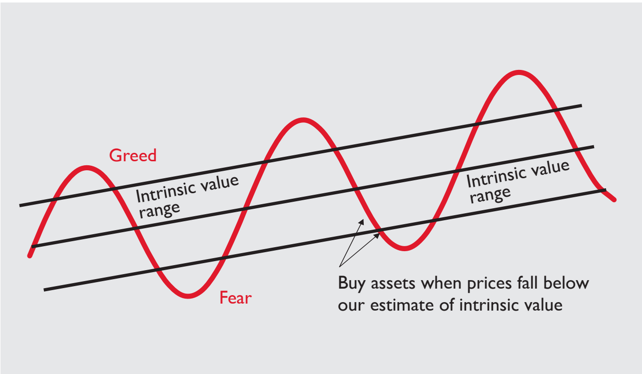
Globally, equity and bond markets are expensive

Equity markets are either fully valued or slightly expensive. Developed market bonds are also expensive even after the recent sell-off.

With all of this in mind, the key to investing in 2017 is to apply a sound philosophy and a disciplined process:

- selecting stocks that have a margin of safety (as Chart 2 shows), and
- managing position size and the overall portfolio risk. It is important to apply prudent risk management measures and, where possible, ensure that any portfolio is not exposed to unintended sector/macroeconomic risks.

Chart 2: Buying shares with a margin of safety



Source: Cadiz Asset Management

It is crucial to select shares that have an appropriate margin of safety

In the long run, the return of a share follows the growth in company profits or earnings. This means that before selecting a share, it is important to understand each share's earnings cycle and where it is in that cycle. The best time to buy a share is when it is at the bottom of its earnings cycle and the price has fallen significantly below the company's intrinsic value. This reduces the risk of capital loss.

A good example of this was seen in 2015 when Anglo American Plc's share price fell to R54. This happened because commodity prices had fallen in a heap. This elevated the financial risk as the company's debt was excessive and its ability to service its debt was questionable. However, as the cycle turned, Anglo American recovered, sold assets to pay off some of its debt and is starting to become profitable again. The share price is now over R200 per share, having increased by more than 270%.

Investors must assess the quality of the company

Before investing in a company investors must assess the company's ability to weather the following risks:

Financial risk	The strength of the balance sheet, the company's debt, and its ability to service that debt.
Operational risk	How operationally strong the business is at producing its goods and services and getting them to market. Is there demand for those goods and services?
Industry risk	The type of industry the company operates in as well as changes to that industry. What is the level of competition or are there barriers to enter that industry? Is it operating in a growth industry (such as technology) or a declining industry (like gold)?
Management risk	Are the management team and its policies sound?

Having assessed the quality of the company and the level of sustainable growth in earnings, it is still prudent to buy the share with a margin of safety. This helps build in a buffer against the unknowable future. A good example of this was the unforeseen $5 billion fine that the Nigerian government issued to MTN. Buying with a margin of safety is vital.

Portfolio construction plays a key role in mitigating risk

Portfolios diversify stock selection risk by holding several shares to mitigate the uncertain future of the investments. The more concentrated the portfolio is in either one share or sector, the more risk the portfolio is exposed to, which can lead to either exceptionally good returns or exceptionally poor returns. However, the greater the diversification, the greater the potential to dilute the portfolio's returns.

We carefully assess the quality of each share relative to any position size

To determine an appropriate weight for a share we assess the qualitative aspects of the share, where it is in its earnings cycle and the margin of safety. These factors indicate the chances of capital loss on a share. The lower the risk of capital loss, the greater the weight assigned to that share.

We monitor risk at an individual share, sector, and macroeconomic level

A lack of understanding of the risk associated with concentrated stock positions or being overly exposed to a sector or macroeconomic risk is extremely important. This can lead to excessive risk and has in the past led to the downfall of portfolio managers. History has shown that a lack of in-depth understanding of stock-specific, sector or macroeconomic risks can have dire consequences. This was evident in the last cycle, where several managers were overweight resources far too early in the cycle and experienced significant underperformance and loss of capital. Because the future is so uncertain, applying prudent guidelines, a rigorous ongoing monitoring and evaluation process and focusing on risk is an essential part of our disciplined process.

Diversification is the key advantage of multi-asset class funds for investors

The main advantage of a multi-asset class portfolio is the ability of a portfolio to diversify across different asset classes, including:

- international assets,
- bonds,
- property,
- equity, and
- cash.

Multi-asset class funds enable investors to navigate uncertain times. The best diversification for a South African investor may be found in cash, being risk free and offshore assets, where the rand cushions the blow during a global risk event and all equity markets sell off.

A sound philosophy, disciplined process and prudent risk management are key

When choosing where to invest, invest in a portfolio where the manager applies a sound philosophy, disciplined process, and prudent risk management. This is the most effective way to protect and grow your wealth over the long term. ■

Swatch:
a great time to invest

by **Razeen Dinath**,
Head of Research

Swatch's share price took a knock in the last two years, largely driven by a lack of demand after the Chinese government clamped down on corporate gift-giving. However, this decrease can be attributed to a cyclical decline, rather than being indicative of a fundamental, structural problem within the company. We therefore believe that the share price is likely to recover in future. This presents investors with a compelling opportunity to buy a quality share at an attractive price.

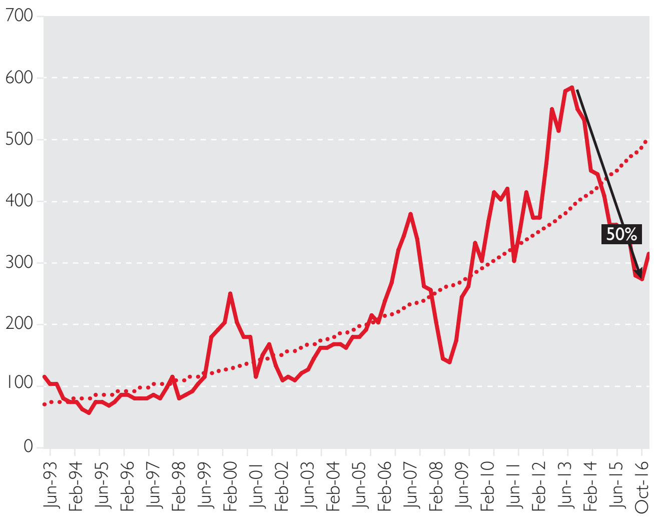
Swatch has a long history of profitability with strong cash flows

The Swatch Group is a Switzerland-based manufacturer of brand name Swiss watches such as Omega, Breguet, Swatch, Jaquet Droz, Longines, Rado and Tissot. They also make watch components, and jewellery that they distribute under the Harry Winston brand. Swatch has had a phenomenal record of generating superior profits, providing a good return on capital and being able to generate strong free cash flows.

Lower Chinese demand, slow global growth and European terrorism

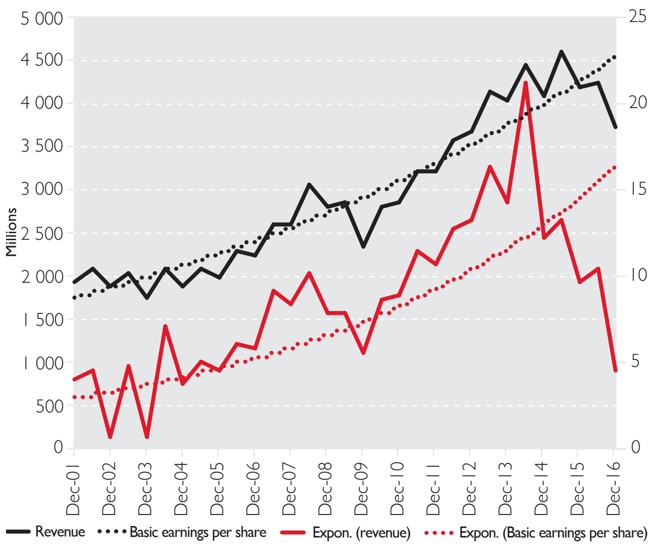
Much of the company's growth can be attributed to the demand from China for gifts, especially from 2010 to 2013. Since then, the business has been under strain. The Chinese authorities clamped down on the giving of gifts that they considered to be associated with corruption. A slow global growth environment and terrorist attacks on European cities have affected international travel, and therefore, the tourist luxury goods market. These factors have all led to a fall in Swatch's share price (shown in Chart 1), and a decline in revenue and earnings (shown in Chart 2). Similar dynamics saw Richemont, a locally listed share, fall by over a third from its November 2015 price to a low point in August this year.

Chart 1: Swatch Group share price and trendline (1993-2016)



Source: Bloomberg

Chart 2: Swatch Group revenue and earnings per share (2001-2016)



Source: Bloomberg

Is Swatch going through a cyclical or structural decline?

When investing in a company that has been sold down, a crucial question to ask is whether they are experiencing cyclical or structural factors that are causing the share price weakness. Cyclical declines are a function of the self-correcting nature of the business cycle, and indicate the potential for a share price that has lost ground to recover. Progress is never in a straight line, as businesses experience periods of increasing growth and profits followed by periods of declining growth and profits.

However, a structural decline implies a worsening of the industry economics and is a sign that the future return on capital is likely to be worse than it was in the past. This has been seen in industries where new technology has a negative impact on previous business models. We are very cautious when we believe an industry is experiencing a structural decline. It presents a very real risk of over-valuation and a higher likelihood of a loss of investor capital.

Swatch's prestige and heritage set its brand apart

We believe that Swatch is a cyclical business that has protective barriers to entry that aid the business model. Swatch has strong brands that are associated with prestige and luxury. This enables Swatch to charge a substantial premium for its products over their cost of being made. Their watches are seen to be the equivalent of fine jewellery and are bought because of the beautiful aesthetics rather than a competitive price relative to others. Swatch also has 1 800 existing patent families with more than 10 000 national patents. These patents protect Swatch products from being replicated, while the brand heritage built up over hundreds of years signifies quality and exclusivity. Together with unique and elegant designs, these factors enable Swatch to exercise pricing power relative to their competitors.

Smart watches don't match Swatch watches on luxury

Smart watches are not direct competitors to luxury watches, as they serve a different purpose. They provide fitness, location and connectivity tools. These are very useful features but they do not have the prestige, heritage (and therefore pricing power) associated with a luxury watch. Smart watches are a bigger threat to mid- and lower-tier priced watches and only affect Swatch where its range extends into those mid- to lower-tier price points. To counter this threat, Swatch has already introduced its own range of smart watches. This offers the market a brand name alternative to the lesser known and generic smart watches.

Greater competition in lower-tier watches won't decimate Swatch's profitability

As smart watches compete with Swatch on the lower-tier watches, it is important to gauge whether this increased competition will result in a significant decline in Swatch's profitability. While Swatch doesn't disclose profitability by category of watch, we looked at Richemont (a leading luxury goods business that sells predominantly luxury and prestige watches), to understand which watch category generates the higher profitability.

Richemont discloses its results by Maison. This is a French word meaning 'house', which in this context refers to a house (store) that sells different branded watches. The average long-term operating margin of Richemont's luxury watch Maison is approximately 25%, which is superior to Swatch's average long-term margin of 21%.

Swatch should earn similar margins as Richemont on the luxury and prestige watch brands, which implies that the profitability on the lower-tier brands is mid-to-low teens. We therefore believe that although Swatch is named after one of its lower-tier watch brands, the bulk of its profits are derived from its luxury and prestige watch brands. Based on this, the increased competition from smart watches will not significantly reduce Swatch's overall profitability from the long-term average.

Low risk of permanent capital loss

Swatch was under severe pressure in 2015 when operating margins fell to 15%, which is its lowest level of profitability since 2004. Profits dropped even lower in the first half of 2016, but some once-off events accounted for most of the drop. Management expects to achieve operating margins of 15% for the second half of 2016. Given the lower capacity utilisation and revenue decline, this lower level of profitability is reasonable to use in our bear case valuation. When we invested in Swatch, the share price was slightly above our bear case valuation. This reduces the risk of permanent capital loss. The fair value under more normal conditions is significantly higher.

The current share price offers great potential

This fits the asymmetric pay-off profile (of a greater upside to the share price than the downside) that we seek to exploit. Even if our investment decision were to turn out wrong, we should break even or under a worst-case scenario, lose marginally. But if we are right and there is a normal cyclical recovery, then the investment return will be very good.

Good management and aligned interests add to our investment case

Swatch has the founding family still at the helm with a 40.5% equity ownership. This aligns their interest with minority shareholders and unlike some CEOs, they do not earn excessive remuneration. The business is managed with a long-term focus to pursue innovation and enhance the brand proposition, which strengthens the economic moat and competitive barriers. Good management with aligned interests and a long-term focus is a big positive in our investment case for Swatch.

A quality business at an attractive price with low risk makes Swatch a great investment

Swatch has cash of over a billion Swiss Francs on their balance sheet, which limits financial risk and permanent capital loss. The company has also embarked on a share buyback program at these very attractive prices, which is an excellent use of capital and again demonstrates management skill. Swatch ticks all the boxes on most of our key investment criteria: it is a good quality business at an attractive price with owner-operator management, low financial risk and low risk of permanent capital loss. We therefore conclude that it is a great time to invest in Swatch. ■

Franklin:
a quality business at a great price

by ***Graeme Ronne***, *Head of Equities*

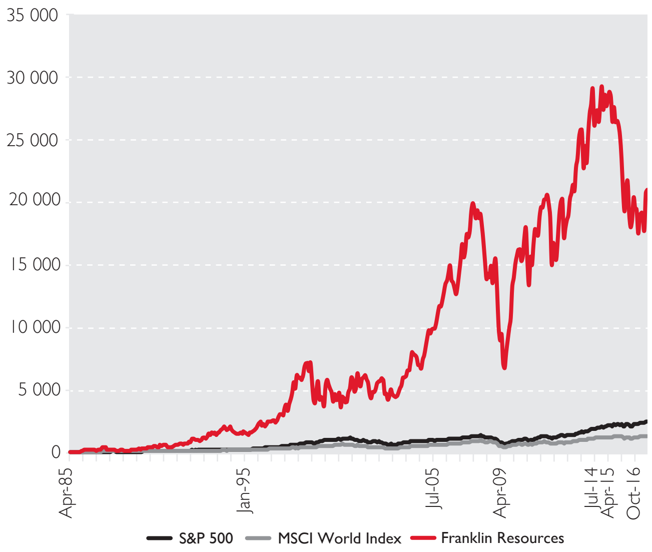
Franklin Resources (Franklin), more commonly known as Franklin Templeton Investments, is one of the world's largest fund managers with US$715 billion in assets under management (AUM) and offices in 35 countries. The company was founded in 1947 by Rupert H. Johnson Sr. and has a proud history and impressive track record. In this article, Graeme Ronne explains why we are invested in Franklin.

An impressive long-term track record

Franklin has been a very attractive investment over the long term: since 1985, $1 000 invested in Franklin would have generated a total return of $209 805 (209 times your money) compared to $25 955 for the S&P 500 and $14 323 for the MSCI World Index, an outperformance of over 9.6% per annum (p.a) over world markets. Chart 1 shows that over the past three years Franklin's share price has fallen 50% from the peak as they lost a significant portion of their AUM to passive funds, due to underperformance. This is understandable, as up until recently, world markets have been trending – expensive shares kept outperforming while cheap shares kept underperforming. This resulted in passive funds outperforming active funds. As the market value weight of the expensive shares increased in an index and money flows shifted to passive funds, there was a natural tailwind driving these shares even higher.

As an active manager, Franklin avoided these expensive shares. This led to their flagship Franklin Income Fund ($79 billion) and Templeton Global Bond Fund ($41 billion) underperforming the market, placing pressure on their asset base. However, the recent sharp rise in US bond rates and the recovery of 'value' shares has driven a significant turnaround in both absolute and relative performances. This bodes well for a turn in the recent trend of net fund outflows.

Chart 1: Total return for Franklin Resources, the MSCI World Index and the S&P 500 (based to 100 at start) (1985-2016)

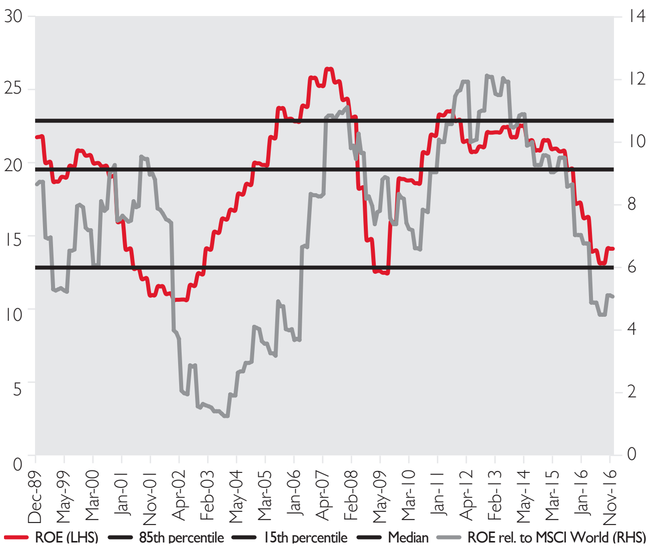


Source: Bloomberg

A quality business with a proven track record of above-average profitability

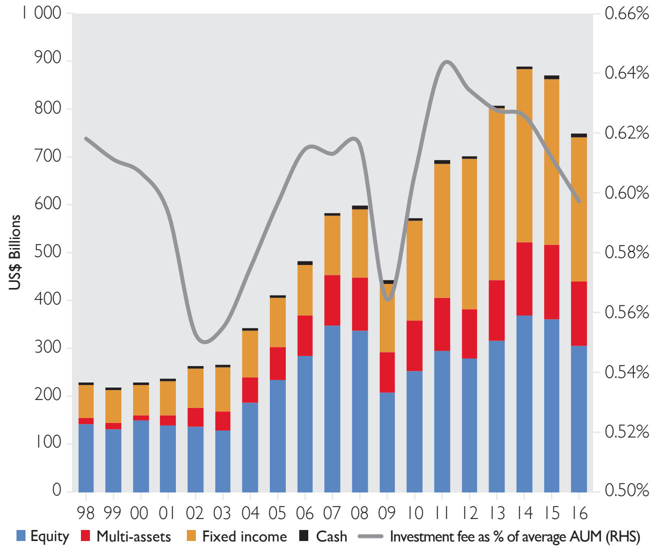
Franklin has a proven track record of above-average profitability through an entire market cycle (as shown in Chart 2), outperforming the average global business by more than 7% p.a. over the past 18 years. This has been driven by good long-term investment performance, stable investment management base fees (as shown in Chart 3), operational cost discipline and excellent capital management. The high return on equity, low capital requirements and strong cash generation are signs of a quality business.

Chart 2: Franklin's return on equity (LHS) relative to the MSCI World Index (RHS) (1989-2016)



Sources: Bloomberg, Cadiz Asset Management

Chart 3: Average AUM (US$ billions) and investment management fee % (1998-2016)



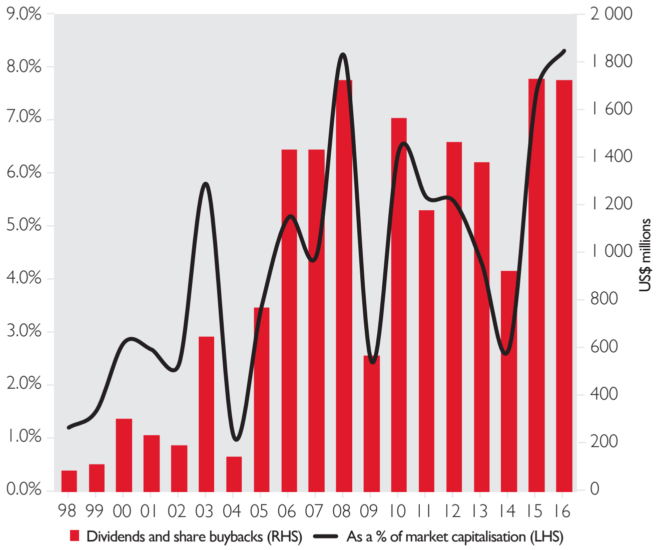
Source: Bloomberg

Shareholder-oriented managers with 'skin in the game'

Investors familiar with our philosophy and process understand that the quality of management is a key investment criteria. We prefer to invest in companies with management that have 'skin in the game', a demonstrated history of good capital allocation and operational efficiency. In our view, the Johnson family meets all three criteria.

The Johnson family collectively hold 38% of the company and remain well entrenched, with CEO Gregory Johnson having taken over in 2005 from his father, Charles B Johnson. In addition, various family members hold management and directorship positions. The Johnson family have built the company through organic and acquisitive growth, displaying very astute capital allocation and foresight to remain at the forefront of the evolution of the global asset management industry. This is clearly demonstrated in the above-average returns generated over the long term (Chart 3) and the vast amount of cash returned to shareholders through dividends and share buybacks (Chart 4). This has been a key contributor to the total shareholder return earned by investors over time.

Chart 4: Capital returned as a percentage of market capitalisation (LHS) and dividends/share buybacks (RHS) (1998-2016)



Sources: Franklin Resources, Cadiz Asset Management

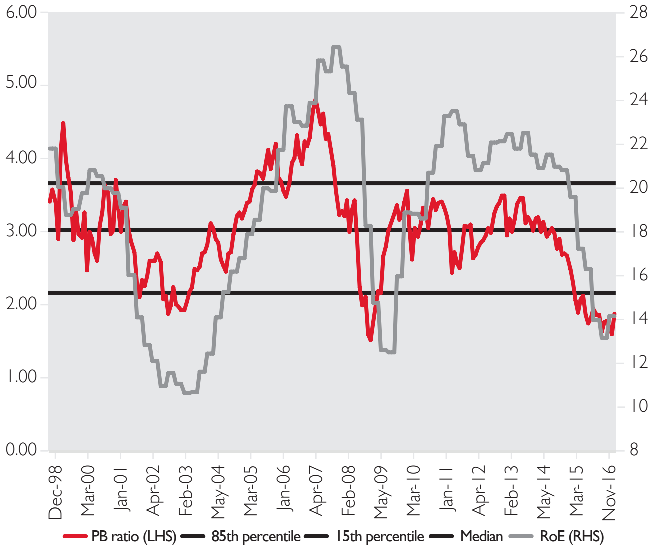
Strong balance sheet provides significant downside protection

Low capital requirements and strong cash generation has resulted in a cash-rich balance sheet despite the vast capital returned via dividends and share buybacks. In fact, the equity market drove the share price so low over the past three years that net cash and investments (US$9.6 billion) reached 45% of the market value of the company. This provides a significant margin of safety to our valuation and allows the company to continue to buy back shares at attractive prices and pay dividends.

Franklin is trading at a low point in its earnings and valuation cycle

We prefer to purchase shares that meet our qualitative criteria – business quality, management and proven track-record of above-average profitability – when they are typically out of favour and trading on depressed earnings and valuation multiples. Firstly, quality businesses with good management have the ability to grow their intrinsic value over time, and secondly, purchasing these shares at a low point in their earnings and valuation cycle provides a margin of safety to buffer against unforeseen negative developments. Franklin is trading well below the 15th percentile of its historic price to book (PB) multiple (as shown in Chart 5) and has only been this cheap on two other occasions, both of which were significant equity market corrections. In addition, Franklin's return on equity is depressed relative its long-term cycle, signalling that it is at a low point in its earnings cycle.

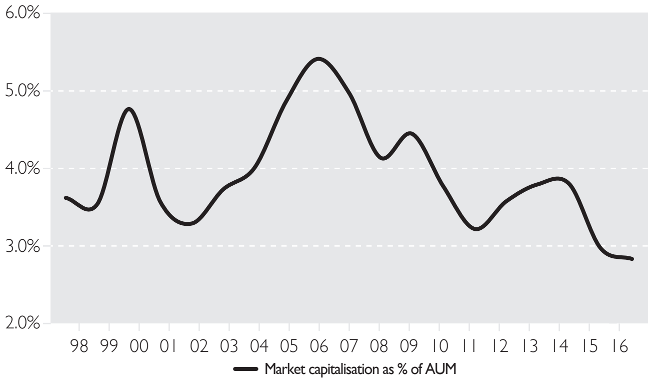
Chart 5: Price to book (PB) ratio (LHS) and return on equity (RoE) (RHS) (1998-2016)



Sources: Bloomberg, Cadiz Asset Management

The asset management industry tends to be cyclical as revenue is driven by underlying changes in assets under management. This is driven by equity market movements, net fund flows and the impact on fees from changes in the competitive landscape and regulation. As we've seen earlier, Franklin's investment management fees have been relatively stable over long periods of time. It is therefore very useful to assess the valuation by comparing the market capitalisation to the average AUM (as shown in Chart 6). Historically, Franklin has traded at 3.8% of AUM over time but we were able to purchase it at only 2.4% of AUM. If we strip out the large net cash and investment balance of US$9.6 billion, then we effectively purchased the operating assets at 1.1% of AUM or a price to earnings (PE) ratio of 5X. Over the long term, Franklin has traded at an average PE ratio and free cash flow multiple of 17X respectively. This highlights that the equity market has historically rewarded the share for its above-average profitability.

Chart 6: Market capitalisation as a percentage of AUM (1998-2016)



Sources: Franklin Resources, Cadiz Asset Management

Attractive asymmetric payoff profile

In our view, Franklin is an example of a mispriced share, driven to cheap levels by an overly pessimistic market that has extrapolated the recent cyclical downturn into perpetuity. The market appears to have forgotten that Franklin has navigated many market and performance cycles in its 69-year history. On each occasion, it has come out the other side stronger and subsequently has significantly outperformed the market. This can be seen in Chart 1 in 1999/2000 and 2008/2009.

In terms of our philosophy and process, Franklin meets all of our investment criteria: a high-quality business with strong management and a proven long-term track record of above-average profitability. The share is currently out of favour, and trading at the bottom of its earnings and valuation cycle, with a significant margin of safety provided by its cash-rich balance sheet. In conclusion, we believe the shares of Franklin represent an attractive asymmetric payoff profile – limited downside with significantly more upside potential. ■

South African bonds remain investment grade… for now

by ***Craig Thompson****, Analyst*

The South African sovereign credit rating is only one notch above non-investment grade. A downgrade to non-investment grade levels may lead to a forced sell-off by investors who are obliged to adhere to strict investment-grade-only mandates. For anyone investing in local debt assets, maintaining our investment grade status is vital. In this article, Craig Thompson explores this issue.

Are bonds currently offering value?

Investors can determine if a bond is fairly priced and offering sufficient risk compensation by calculating its intrinsic value. This is done by looking at the real risk-free rate (proxied by the US 10-year bond yield), relative inflation rates and South Africa's sovereign risk premium. The way this is calculated is shown in Table 1.

Table 1: Nominal bond fair value calculation

	Current	Risk scenario
Risk compensation	1.00%	0.90%-0.40%
Current South African 10-year bond yield	9.05%	9.05%
Fair value	**8.05%**	**8.15%-8.65%**
US 10-year bond yield	2.40%	2.50%-3.00%
Inflation differential	3.25%	3.25%
SA sovereign risk premium	2.40%	2.40%

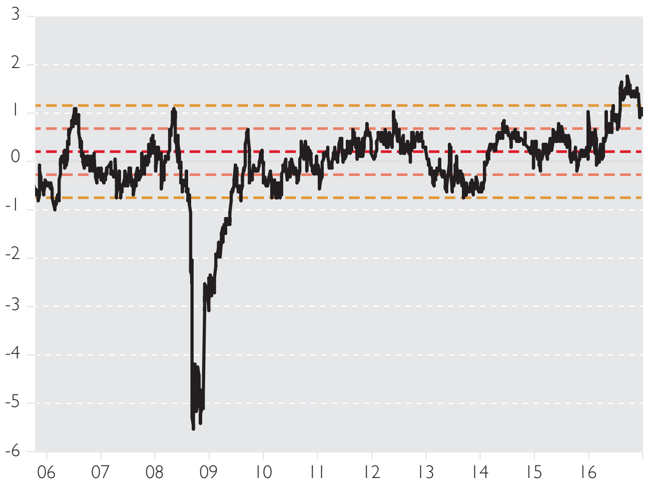
Source: Cadiz Asset Management

The South African 10-year bond is currently trading at a yield of 9.05%, while the fair value yield (pricing off the equivalent US bond (2.40%), the countries' inflation differential (3.25%) and South Africa's sovereign risk premium (2.40%)) is 8.05%. At first glance, the current price of a South African 10-year bond could be considered undervalued. The yield of 9.05% has a risk compensation margin of 1.00% (or 100 basis points) before it reaches 8.05% at which point the price of our 10-year bond is equal to fair value. This could be perceived as a substantial margin of safety by investors. However, the risk scenario incorporates the general view that the US 10-year bond is overpriced and will likely sell off to between 2.50% and 3.00%. This leaves a risk compensation level of between 0.40% (or 40 basis points) and 0.90% (or 90 basis points). Is this a sufficient margin of safety?

A long-term view indicates enough risk compensation to invest

When the current price of the bond versus its intrinsic value is compared over time, 40 basis points to 90 basis points under the risk scenario does offer sufficient compensation. This is because the average risk compensation for the South African 10-year bond has been 22.7 basis points since 2006 (as shown by the dotted red line in Chart 1). This spread has widened to above one standard deviation over the past six months, offering investors a large safety margin. At the current 100 basis points spread, the bond is trading between +0.5 (upper dotted orange line) and +1 standard deviation (upper dotted yellow line) above the average spread.

Chart 1: Risk compensation: 10-year bonds (2006-2016)



Sources: Cadiz Asset Management, J.P. Morgan, I-NET, Bloomberg

Ratings agencies have kept South Africa at investment grade… for now

Most South African debt is denominated in South African rand and issued within our borders. Therefore, although rating agencies rate both local and foreign currency debt, in South Africa the local rating is more relevant. South Africa's current ratings are shown highlighted in white in Table 2.

A downgrade to non-investment grade may result in a significant sell-off

The distinction between investment grade and non-investment grade is important within the debt market space. Most investment mandates require portfolios to be invested in debt products that maintain an investment grade rating. A drop from an investment credit rating to non-investment credit rating may lead to the widening in the sovereign risk premium. This would result in a significant sell-off, an excess supply of South African debt in the market, and inflated yields. The cost of South African debt would rise materially.

The South African risk premium indicates that a downgrade is already priced in

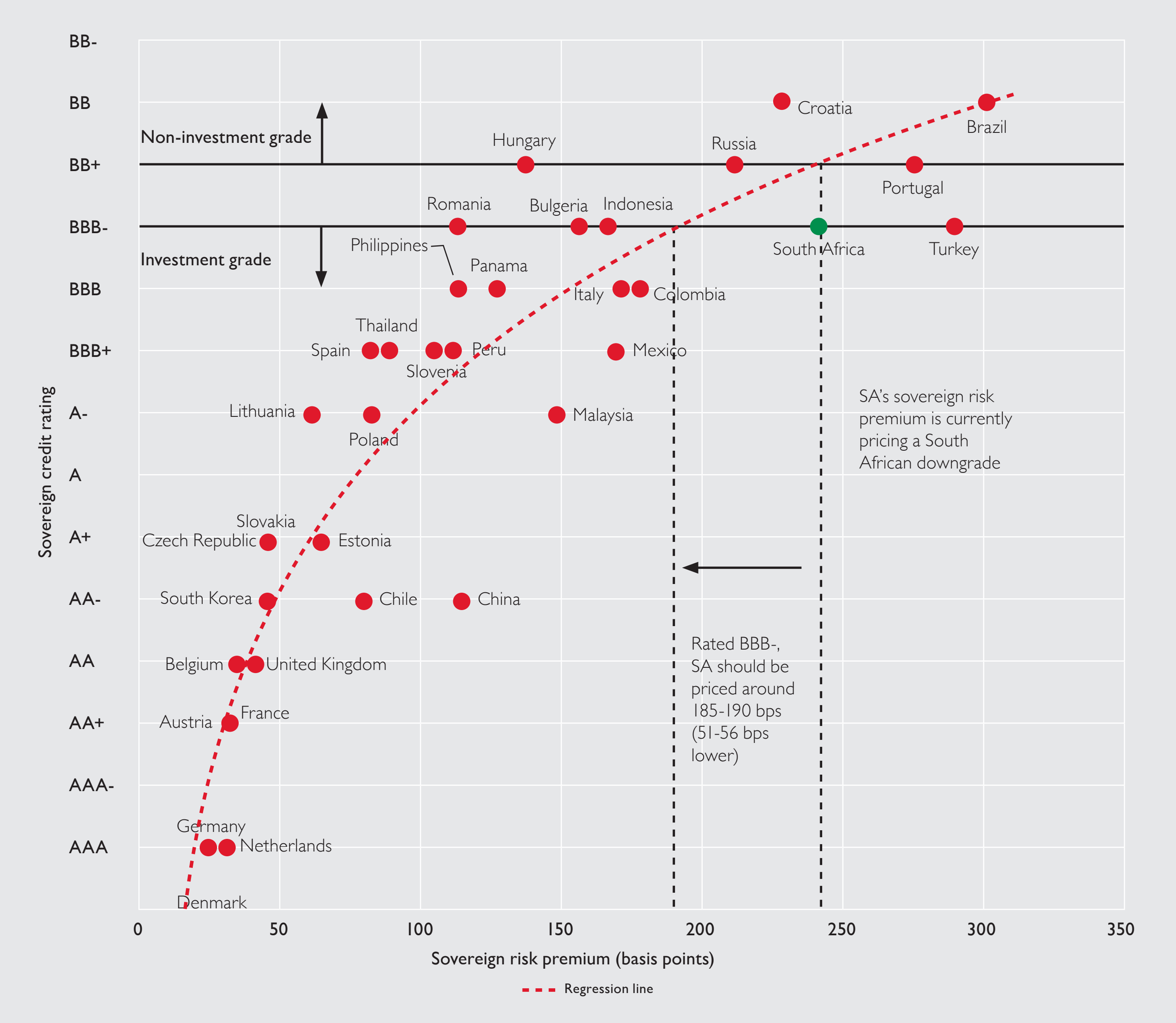
The sovereign risk premium is the additional compensation required by foreign investors when investing in riskier bonds. Investors that are attracted to lower quality bonds require compensation in the form of higher yields. The sovereign risk premium of a country and its respective credit ratings are inversely related. The higher the credit rating, the lower the premium required to entice investors to invest (as shown by Chart 2).

Table 2: South African credit ratings are still investment grade

	Moody's	S&P	Fitch	Moody's	S&P	Fitch
Long-term ratings	Local currency			Foreign currency		
Investment grade	Baa1	BBB+	BBB+	Baa1	BBB+	BBB+
	Baa2	BBB	BBB	Baa2	BBB	BBB
	Baa3	BBB-	BBB-	Baa3	BBB-	BBB-
Non-investment grade	Ba1	BB+	BB+	Ba1	BB+	BB+
	Ba2	BB	BB	Ba2	BB	BB
	Ba3	BB-	BB-	Ba3	BB-	BB-

Sources: Moody's, S&P, Fitch

Chart 2: South Africa's credit risk premium



Sources: Bloomberg, Cadiz Asset Management

South Africa is currently trading at a sovereign risk premium of 240 basis points. According to the regression line, a premium of 240 basis points represents the price of a country trading at a sovereign credit rating of BB+, the highest non-investment grade credit rating. This indicates that South Africa's foreign bond is already pricing in a 2017 downgrade. At a credit rating of BBB-, South Africa's premium should be priced at around 190 basis points. This offers investors in South African debt some margin of safety, unless the threatened downgrades do occur.

South Africa still holds some risk for potential investors, and the low GDP growth environment continues to hinder South Africa's fiscal performance. Despite our low growth, South African policymakers continue to be distracted from implementing growth-enhancing initiatives by ongoing political events.

We only invest in undervalued assets with a margin of safety

Cadiz Asset Management's investment philosophy is to invest in assets that are undervalued that have an attractive margin of safety. Even though it may be argued that a sovereign credit rating downgrade is already priced in, bond yields can be volatile as we approach the announcement of the next credit rating by rating agencies in the middle of 2017.

Minimising potential capital loss is vital during times of increased volatility. Ahead of any ratings announcements, we incorporate extensive risk management tools to mitigate the potential negative effect of a significant bond sell-off. ■

Quarterly review

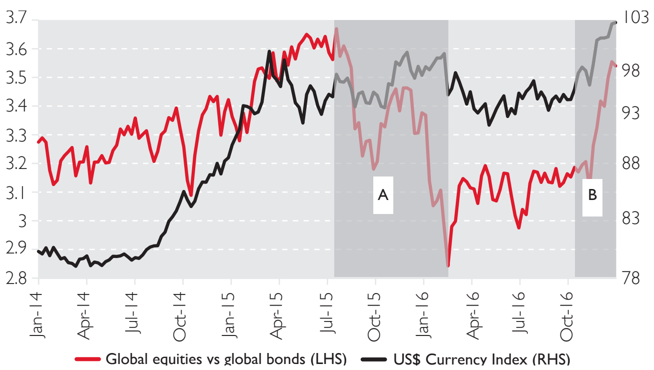
by ***Matt Brenzel****,*
Joint Chief Investment Officer

INTERNATIONAL PERFORMANCE

Once again, expectations and forecasts were way off course

After the disappointment of the Brexit vote, there was a surge in equity markets in the third quarter of 2016. The surge disproved doomsayers who had forecast the 'start of the end'. The fourth quarter did much the same. As implausible as it appeared at the time, Donald Trump snatched victory and will become the 45th American President on 20 January 2017. Although the US (and other) equity markets dipped as it became increasingly evident that Trump would win the election, it was soon back to the races with several regional markets cresting new highs. The expectation of substantial corporate tax reform is driving the US market. This is possible because the President and the two branches of Congress are of the same party. While this alignment will remove previous bureaucratic deadlocks, it also increases the risk of ill-conceived ideas being passed. 2017 is bound to be interesting.

Chart 1: Equities, bonds and the US dollar (2014-2016)



Sources: I-NET, Cadiz Asset Management

Equities gained the upper hand

Chart 1 plots the performance of global equities relative to bonds (in red), as well as the US dollar against the currencies of its major trading partners (in black). The shaded area 'A' shows the period from the third quarter of 2015 to the first quarter of 2016 when it became clear that the US Federal Reserve (the Fed) wasn't going to hike rates as expected. The world was still mired in a deflationary cycle. Equities were sold in favour of bonds and the US dollar essentially marked time. More recently however, the Fed hiked interest rates, emboldened by sound local macro statistics as well as the fact that other regions in the world staged a modest recovery. The shaded area 'B' shows the fourth quarter of 2016. This area illustrates the most recent surge in equities relative to bonds, where bonds saw a 9% collapse in prices. The US dollar also increased as the Fed hiked rates and Mr Trump became President-elect. Despite this, global equities experienced outflows of $93 billion in 2016, the second largest outflows since 2008.

Table 1: International market returns

International (US$)	Quarter	12 Months
MSCI World	2.0%	8.2%
MSCI Emerging	-4.1%	11.6%
MSCI SA	-4.0%	18.4%
J.P. Morgan Global Bonds	-8.6%	1.4%
US Cash	0.4%	0.3%

Sources: Deutsche Bank, Bloomberg Finance LP

The outstanding statistic in Table 1 is the quarterly performance of the bond market. This matched long-run predictions that it was most at risk once policy rates normalised. This happened in the US in the last quarter and has driven a sharp bear-steepening in the yield curve, which had a knock-on impact on other bond markets. Note also that emerging market equities lost some impetus as commodity prices came off the boil during the quarter. For the past 12 months though, emerging markets performed well in dollar terms. A foreign investor holding the MSCI SA Index enjoyed a 18.4% return on the back of the rand strengthening by 13% against the US dollar, 16% against the euro and 34% against sterling.

LOCAL PERFORMANCE

We survived the ratings agencies – for now

After a particularly draining political environment in the third quarter of 2016, the last quarter of the year was comparatively calm. South Africa managed to avoid being allocated junk status by the ratings agencies. This was largely owing to a valiant effort by the Minister of Finance to present a credible 2016 Medium Term Budget Policy Statement (MTBPS). The reality of a weak growth path has meant that the budget deficits have been revised upwards by around R12 billion for each of the next three years. Treasury has also attempted to convey its commitment to reduce government spending by improved management and procurement practices as well as better oversight of municipal and state-owned enterprise (SOE) expenditure. Here's hoping.

We are encouraged by the fact that the Reserve Bank's Composite Business Cycle Indicator rose strongly to 94.4 for the third successive month in October from a recent low point of 91.8 in July. This represents the steepest upturn in the indicator since the recovery from the global financial recession in 2009 and 2010. Inflation statistics appear to be tracking expectations. Together with the recent strengthening of the rand, we see little inducement to raise local rates in 2017.

Table 2: South African financial market returns

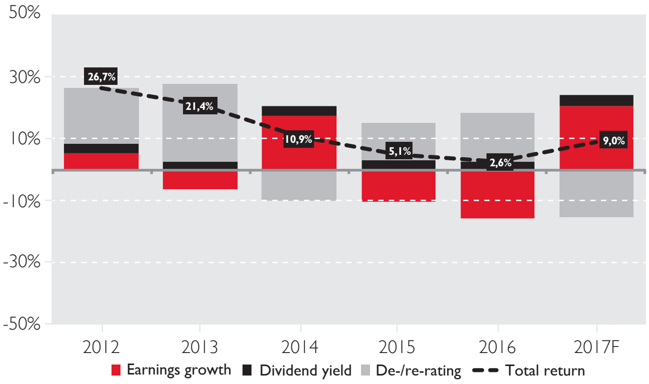
Asset class (ZAR)	Quarter	12 Months
All Share	-2.1%	2.6%
All Bond	0.4%	15.5%
Listed Property	1.3%	10.2%
Cash	1.9%	7.4%
Tier-1 (ZAR)	**Quarter**	**12 Months**
Resources	-1.2%	34.3%
Financials	2.9%	5.5%
Industrials	-4.7%	-6.3%
Size (ZAR)	**Quarter**	**12 Months**
Large Cap	-3.0%	-1.5%
Mid Cap	1.1%	27.6%
Small Cap	0.6%	21.1%
Bond Market (ZAR)	**Quarter**	**12 Months**
All Bond	0.4%	15.5%
1-3 years	1.4%	10.1%
3-7 years	1.1%	13.4%
7-12 years	0.7%	15.4%
12+ years	0.0%	17.5%

Sources: Deutsche Bank, Bloomberg Finance LP

Equities had a difficult quarter and produced the second worst annual return in the past decade. The worst was -28% in 2008. Both the quarter and year were characterised by a strong rotation out of defensive and growth shares into cyclical and value counters.

- For the quarter: The top, weighted performers were: Richemont (+9%), Anglos (+14%) and Billiton (+6%). The losers were dominated by Naspers: (-15%), British-American Tobacco (-11%) and AngloGold (-31%)
- For the year: The top, weighted performances came from: Anglos (+183%), Billiton (+26%) and Standard Bank (+33%). The main losers were: Richemont (-19%), Naspers (-5%) and Old Mutual (-17%).
- Bonds had what can best be described as a cautious quarter. Most of the positive return was centered at the short end of the yield curve. That said, the strong bounce back in the rand and a resurgent carry trade led to the bond market being the clear asset class of choice for the year.

Chart 2: Deconstructing the FTSE/JSE All Share Index (ALSI) return (2012-2017F)



Sources: I-NET, Cadiz Asset Management

Chart 2 shows the composition (earnings growth + dividend yield + de-/re-rating = total return) of the ALSI's performance over the past five years. Notable is the declining trend in total returns over that period. Both 2015 and 2016 produced low, single-digit returns driven solely by the combined effect of a dividend pay-out and re-rating of the index, as earnings were negative in both years. Contrast this with what is expected of earnings in 2017. Consensus has pegged earnings to grow by 21% in the coming year, with the resource sector driving most of the earnings (+28%), followed by the industrials and financials at +18%. We would argue that at current ratings, any disappointment in earnings could be severely punished, placing the forecast ALSI return of 9% at risk.

Where to from here?

Our expectations for 2017 are as follows:

- A subtle shift in policy response from ultra-accommodative monetary policy to still-accommodative monetary policy plus fiscal stimulus. The latter is likely to be muted as debt levels are still at elevated levels.
- A continued uptick in global economic growth. Both global manufacturing and trade are starting to show signs of life.
- Increased cyclical inflation, but levels likely to remain below central bank targets.
- Equities to outperform bonds, value to continue to beat growth, cyclical over growth, active to trump passive. Stockpicking will be of paramount importance as headline indices are not particularly cheap. ■

Meet our Portfolio Manager:
Michele van der Berg

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

A passion for learning and embracing new challenges

Michele is passionate about learning, whether it is about markets or helping to grow young minds, having studied preschool education in her spare time. She began her career in the finance arena at African Harvest in 2001, until taking up a position as a dealing assistant. From 2006 she has traded money market instruments and was recently promoted to Portfolio Manager.

What are three things that few people know about you?

1. I'm a qualified preschool Montessori Teacher for children aged 3-6 years.
2. I ran my first half marathon in October 2016.
3. I love watching ballroom dancing.

Who or what was the biggest influence in your life?

There is no one single influence. I am inspired by family, my faith, colleagues, and the diverse people that I have been privileged to meet.

Tell us a bit about your family life.

I'm one of three siblings and am particularly close to my younger sister.

What do you do to relax?

For the past year, running. I love the way it can clear my mind. I also enjoy watching a good movie and going to the beach in summer.

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

A preschool teacher.

Why did you become an investment manager?

I like the stimulation and intellectual challenge of the markets. Markets evolve and so do asset types. I find it fascinating to understand the different assets and instruments. I am energised by the pressure of the constant news flow and find it rewarding to analyse the possible impact market changes could have over the short and long term.

What's important to you at work?

The opportunity to apply what I have learned in a meaningful way for our clients. I also value the opportunity to share insights and discuss ideas with my colleagues.

Cadiz Unit Trusts' performance

All performance figures in the table below are annualised percentage figures to 31 December 2016.

Unit Trusts	1 Year	3 Years	5 Years	7 Years	Since Inception	Inception Date
No Equity Exposure						
Cadiz Money Market Fund	7.83%	6.92%	6.40%	6.43%	7.65%	01-Mar-06
Alexander Forbes Short Term Fixed Interest (STeFI) Composite Index	7.39%	6.58%	6.09%	6.16%	7.33%	
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	8.97%	6.46%	7.34%	7.90%	8.74%	01-Mar-06
CPI+3%	9.64%	8.73%	8.62%	8.40%	9.11%	
Quartile Rank	2nd	3rd	2nd	2nd	1st	
Low Net Equity Exposure (20 - 40%)						
Cadiz Stable Fund	5.50%	4.91%			6.07%	01-Sep-12
CPI+3%	9.64%	8.73%			8.67%	
Quartile Rank	1st	4th			3rd	
Medium Net Equity Exposure (40 - 75%)						
Cadiz Inflation Plus Fund	4.89%	4.00%	7.60%	8.53%	8.83%	13-Jan-06
CPI+5%	11.70%	10.75%	10.63%	10.40%	11.14%	
Quartile Rank	2nd	3rd	4th	3rd	1st	
Cadiz Managed Flexible Fund	5.37%	3.10%	8.52%	9.36%	9.33%	01-Mar-06
Average of the Domestic - Asset Allocation - Prudential High Equity sector	1.07%	6.30%	10.48%	9.83%	10.37%	
Quartile Rank	1st	4th	4th	4th	1st	
Flexible Net Equity Exposure (50 - 90%)						
Cadiz Equity Ladder Fund	6.94%	-0.88%	0.16%	0.59%	5.86%	03-Jun-05
CPI+6%	12.71%	11.75%	11.63%	11.41%	11.61%	
Quartile Rank	2nd	4th	4th	4th	3rd	
High Net Equity Exposure (100%)						
Cadiz Mastermind Fund	4.65%	0.20%	6.83%	7.13%	8.79%	01-Mar-06
FTSE/JSE SWIX Index	4.13%	7.58%	14.16%	13.61%	13.21%	
Quartile Rank	2nd	4th	4th	4th	2nd	

Sources: Morningstar, Cadiz Asset Management

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