April 2016

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

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

Welcome to the latest edition of CAMmunique

It's hard to believe we are already three months into the year! Although there were many internal changes at Cadiz Asset Management in 2015, the first few months of 2016 have enabled us to bed down these changes and look to the future. There are many reasons to have positive expectations – we have a strong and committed shareholder in Stellar Capital Partners, high quality and passionate people, a recognised brand, and the necessary structures to ensure a stable platform going forward.

We aim to understand the relationship between price and value

We believe a sound investment process is crucial to sustainable investment success. Understanding the value of an asset relative to its price is critical to our process, because we want to avoid overpaying for the value we receive. In fact, we always try to purchase an asset at a discount to its current underlying value, referred to as a margin of safety. In other words, if the price of an asset is actually lower than the perceived value of the asset, then all the better.

Why we believe it's important to have a margin of safety

We believe that when investing in an asset, the only factor you have complete control over is the price you pay for that investment. You therefore need to ensure that the entry price gives you a margin of safety. This allows for human error and an unpredictable future. Once we have calculated that an asset is trading at a discount to its fundamental value, we always ask why the market is prepared to give us this discount. This helps us distinguish between a cheap company and a quality cheap company. We want to own quality companies that are cheap. By implication, this requires a sound, rigorous, considered process. Unfortunately, emotions such as fear and greed often dictate investors' decisions. At Cadiz, we believe a good portfolio manager is able to take emotion out of investing.

Insisting on a margin of safety is the opposite of the high risk strategy of chasing expensive valuations that has been characteristic of the momentum-driven market over the past few years. As themes shift, market sentiment can change rapidly and out-of-favour sectors can quickly become popular again, resulting in price volatility. One example is the recent turn in the commodity sector. Only last year a market commentator remarked that it was a 'travesty of justice' to have any exposure to the resources market. This commentator must have been dumbfounded about the loss of potential returns from resources over the last quarter. In our experience, trying to time the market seldom has a high hit rate. Instead, an ability to look beyond the noise of the current short-term cycle and a focus on the underlying value of an investment is crucial to building an investment nest egg with a long-term view. There are no short cuts when it comes to market experience.

Sticking to our investment process ensures optimal long-term outcomes

'Any individual decisions can be badly thought through, and yet be successful, or exceedingly well thought through, but be unsuccessful …'

- Robert Rubin

A very effective way to overcome emotional investing is by staying true to a well-defined investment process. The unusual characteristics that have driven the equity markets over the last few years (particularly the role of central bank liquidity distorting traditional valuation drivers) make it hard to detangle good and bad processes over the short term. However, it's important not to confuse outcome and process. In a piece penned by Edward Russo and Paul Schoemaker in 2002 entitled 'Winning Decisions', the authors state that you must accept that a good process may occasionally yield a bad outcome, just as a bad process may occasionally yield a good outcome. A good outcome from a bad process however likely reflects a single event, which may not be repeatable going forward. It is therefore not advisable to base investment decisions on a single result, since future outcomes will most likely not be as positive. Over the long term therefore, a well-defined process will trump a bad process hands down.

Anyone who is in the role of a financial adviser or multi-manager should ensure they can always match outcome with process, irrespective of whether the outcome is positive or negative. In other words, it is more important to understand the drivers and processes behind the returns than purely focusing on the return figure itself.

The role of time in investing

'The best in all probabilistic fields focus on process versus outcome, always try to have the odds in their favour and understand the role of time.'
- Michael J Mauboussin

Generally, the longer the horizon, the better the chance of making money (provided there is a sound process). This is because the differences between a good and poor investing process may not always be clear from the short-term outcomes. Hard work and a robust investment process is the only way to provide outperformance over the longer term.

What you can expect in this edition

In 'Where to invest', Brian Munroe starts with making a case for investing in gold. Following this, Razeen Dinath unpacks all the factors that contribute to the consistently superior performance of Berkshire Hathaway, a significant holding in our funds. On the local front, Mpande Maneli explains why Standard Bank is an attractive opportunity in the banking sector while Alastair Sellick provides an interesting commentary on the prospects for African Bank, which recently resumed trading.

Enjoy the read. ■

Where to invest

An investment case for gold shares

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

The current backdrop and the diversification benefits of gold make it an attractive investment choice. Today's economic scenario is characterised by increased economic and political uncertainty, low growth, and central banks adopting unprecedented expansionary monetary policies (amongst other unorthodox policies). These polices have led to exceptionally low interest rates. This is the ideal backdrop to own gold. Furthermore, gold shares provide excellent diversification properties within a South African portfolio, as they are largely uncorrelated in an investment universe where asset classes have increasingly moved in tandem with each other.

As with most risky assets, gold price action can be volatile

In the 1930s for example, gold diminished in importance as the world's central banks moved away from the gold standard in the period following the Great Depression, in favour of fiat money – the paper money we use today and that governments declare to be legal tender. Well-known economist John Maynard Keynes famously dubbed the gold standard as 'that barbarous relic'. However, there have been periods where gold has shone. In the late 1970s, the gold price rose significantly as the oil price crises of 1973 and 1976 pushed up global inflation, thereby eroding the value of money. As a result, investors bought and held gold to retain their store of wealth.

After reaching a peak of more than $700/oz in 1980, the next 20 years was a largely indifferent period for gold as central bankers stood up to inflation. However, from a low of $256/oz in 1999, the gold price rose to a peak of nearly $2 000/oz in 2011, staying solid through the chaos of the great financial crisis of 2008 (as shown in Chart 1).

Chart 1: Movements in the gold price ($/oz) (1970-2015)

Source: IGraph

Various current economic developments are supportive of gold

Focusing on our expectations for the macroeconomic environment over the next few years, we see three developments in particular that have previously been supportive of gold and gold shares:

1. Increased uncertainty about global growth causes investors to seek 'safe haven' assets.
2. As a result of exceptionally low interest rates set by central banks, traditional safe haven assets are yielding negative real yields, making then unappealing.
3. Valuations of gold shares in South Africa are attractive.

1. Increased uncertainty about global growth causes investors to seek 'safe haven' assets

The global economy continues to limp along, heavily burdened by high debt levels, weak demand and insufficient investment. The International Monetary Fund, central banks and other authorities continue to downgrade their growth forecasts for the next couple of years, with the risk of growth disappointing even more. In particular, the global manufacturing sector is in recession, which has caused corporate earnings growth to stall and even fall in some regions. Corporate balance sheets have also deteriorated to a certain extent, which has caused concern amongst investors in the corporate debt market. All this uncertainty and the fear of a potential global economic recession have led to a greater demand for safe haven assets.

2. Negative real yields from exceptionally low interest rates are making traditional safe haven assets unappealing

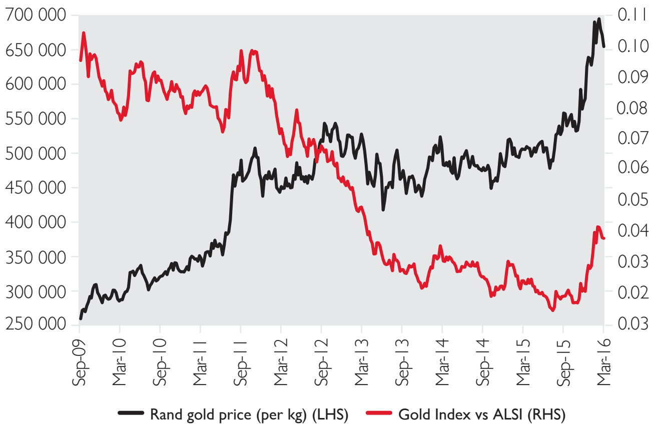
The monetary policy adopted by major central banks after 2008 has been unprecedented in scale. The European Central Bank has reduced its interbank deposit rate to -0.40% and the Bank of Japan has also set a negative interest rate policy. While the US Federal Reserve has made an attempt at normalisation by raising rates, levels are still exceptionally low. With unusually low rates and low inflation, cash is giving investors either negative real returns or close to a zero return. Under this scenario, gold becomes an attractive alternative asset.

Over the longer term, we are more optimistic of a positive resynchronisation of global growth. Central banks will, however, be prone to be reactive to the upturn in the cycle (and inflationary pressures) as opposed to being proactive. In other words, they will be slow to raise rates, even in the face of increasing inflation. This is supportive for gold.

3. Valuations of gold shares in South Africa are attractive

With the increased demand for gold as a safe haven asset, the price of gold has stabilised around $1 200/oz. Coupled with the rand depreciating over 25% in the past 12 months, the rand gold price (currently at over R650 000/kg as shown in Chart 2) has led to an increase in revenue for South African gold companies. At the same time, these companies have been restructuring over the last two to three years to reduce their unit cost of producing an ounce of gold. Some companies have been able to reduce their all-in cost to below $1 000, which implies that these companies are very profitable. The implication of this can be seen in Chart 2, with gold stocks starting to outperform the market since August last year, driven by the higher rand gold price and lower all-in costs. While this outperformance has been remarkable, forward valuations are undemanding.

Chart 2: Gold miners' performance relative to the market and the rand gold price (2009-2016)



Source: IGraph

Our increased exposure to gold offers the benefits of protection and market-beating returns

We added exposure to gold stocks across all our equity and multi asset funds at the beginning of the year. They effectively act as insurance, helping to protect against capital loss when markets are in 'risk-off' mode while offering returns that have so far outperformed the market, compounding capital growth. ■

Berkshire Hathaway:
excellent quality at a bargain price

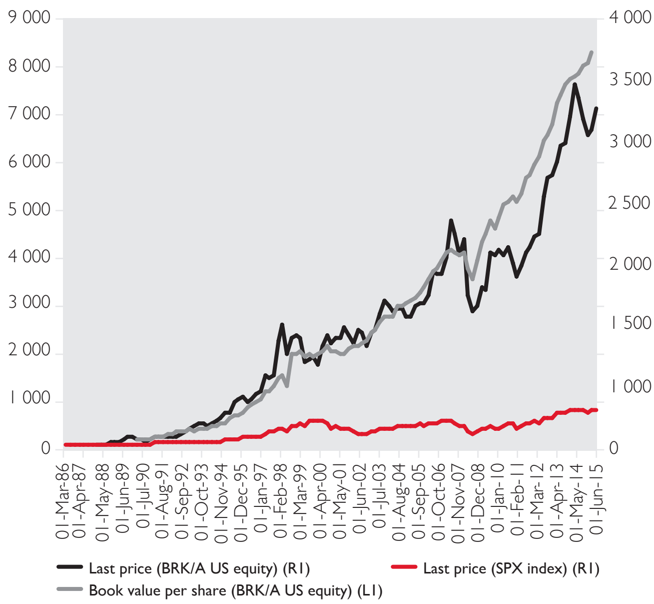
by ***Razeen Dinath****,*
Equity Analyst

Berkshire Hathaway, which is run by well-known investors Warren Buffett and Charlie Munger, has consistently outperformed the S&P 500 Index for three decades. In this article, Razeen Dinath explains why we are optimistic about our significant holding in Berkshire Hathaway by measuring the company against our investment criteria. He finds that Berkshire Hathaway ticks all the boxes: it is a high quality business selling at an attractive price with excellent management and a low risk of permanent capital loss. Each of Berkshire Hathaway's underlying businesses contributes to the investment case and our strong conviction in the superior return this investment will likely generate for our clients.

Berkshire Hathaway has consistently outperformed the S&P 500 Index since the late 1980s

Berkshire Hathaway has grown its net asset value (NAV) by 19.0% per annum (p.a.) since 1965, matched by share price appreciation of 20.8% p.a. This is a significant outperformance of the S&P 500 Index, which delivered 10% p.a. over this period, as shown in Chart 1.

Chart 1: Berkshire Hathaway's net asset value and share price versus the S&P 500 Index (1986-2015)



Source: Bloomberg

Berkshire Hathaway is a quality business and meets all of our investment criteria

Cadiz Asset Management (CAM) defines a good investment as a business that delivers a superior real return at a very low risk of loss. Ideally, we prefer a low probability worst-case scenario where the investment suffers no or low capital loss. To achieve this, we predominantly invest in high quality businesses with good management that are selling at an attractive price with low financial and operational risk.

Berkshire Hathaway's underlying businesses consist of insurance operations, energy operations, railroads, and a whole host of manufacturing, retail and service businesses as well as financial services businesses (secured lending and fleet leasing). The company also has a large investment portfolio of high quality businesses. We've included a brief discussion of the key businesses:

The insurance business provides insurance only when it is profitable

The nature of the insurance industry is that these businesses receive money today with a promise to pay in the future when the risk event occurs. The official term for this is 'float'. Insurance businesses can invest this float and keep the return on investment, which causes the industry as a whole to write business at a loss. Berkshire Hathaway's insurance business is cautious about writing profitable policies and has earned an average underwriting profit of $1 434 per share over the last 10 years, with no underwriting losses. In addition, the fact that two of the best capital allocators – Buffett and Munger are in charge of the float has resulted in a very good investment return.

The energy business benefits from Berkshire Hathaway's credit rating and economies of scale

Berkshire Hathaway's excellent credit rating enables the highly regulated energy business to have a low cost of capital. The business has also shown the ability to operate efficiently and lower the cost of energy for consumers, which regulators appreciate and encourage. In addition, the large fixed cost of power plants limits competitors, allowing the business to benefit from economies of scale. These factors all contribute to a fairly stable operating environment with consistent returns.

The railroad business benefits from a lack of competition

Berkshire Hathaway's railroad business also benefits from economies of scale since there are usually only two rail operators in any region in North America. In addition, rail is the low-cost option for transporting goods, and cannot be replicated by other forms of transport. The only exception is transport by barge, but this is only viable where the transport route follows a major waterway.

The manufacturing, retail and service businesses generate high return on tangible capital

These businesses either operate in niche markets or have brand and other intangible assets. They use their brand power to charge a higher price for better quality products or operate a very low-cost business model to generate superior profitability. Together these businesses have sufficient barriers to entry with diverse operations that are considered sustainable.

The financial service businesses operate in niche markets and have very good reputations

In addition, they have the back-up of Berkshire Hathaway's balance sheet. These businesses therefore use a low-cost model to maintain and improve their market share at similar or better profitability than their competitors. Berkshire Hathaway also instils a culture of only making loans to clients who will be able to pay back the loan in full, which limits bad debt write-offs.

Berkshire Hathaway is not exposed to any single risk

The diverse, well-managed underlying businesses reduce the potential of permanent capital loss significantly. In fact, there is no single risk that could significantly impair the underlying businesses' profitability in the near future. According to Buffett, only a major global catastrophe or horrific terror attack could cause a material loss. This risk, however, applies to the global economy and is not specific to the company or its underlying businesses.

Management has a 50-year track record of superior capital allocation

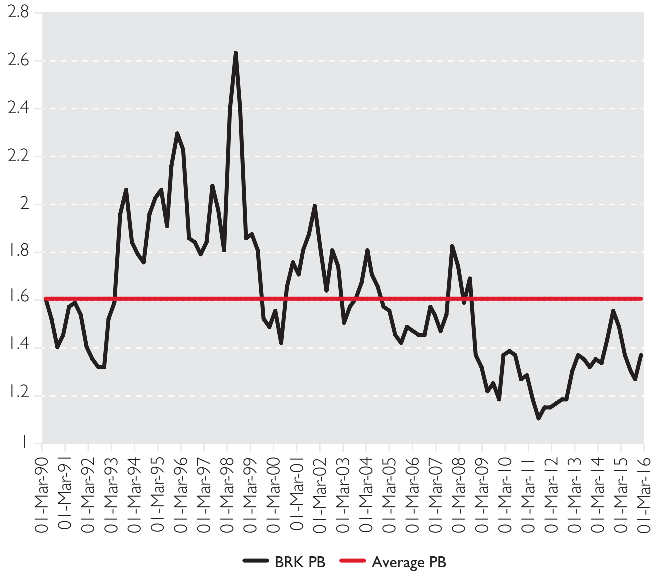
Buffett and Munger have an excellent track record of over 50 years of superior capital allocation and are thought leaders on investing and business management. Berkshire Hathaway does not have a share option scheme and Buffett earns only $100 000 a year. Management has almost all of their wealth invested in Berkshire Hathaway shares, and their interests are aligned with minority shareholders. They run the business in a frugal manner, with only 25 people employed at the head office. In addition, Buffett doesn't interfere with the CEOs and management of the underlying businesses. In fact, he rarely speaks to them unless they call him with a question.

Due to the age of the management team (Buffett is 85 years old and Munger is 92), succession planning has long been cited as a key risk. However, Buffett has implemented a well-defined succession plan with two co-investment managers who have excellent track records. Two of Berkshire Hathaway's current subsidiary CEOs have been identified as potential candidates to take over as CEO, and Buffett's son will take over the role of chairman.

The attractive price offers a large margin of safety

The last piece of the puzzle is the price, and Berkshire Hathaway is currently very attractively priced at a price to book ratio (PB) ratio of 1.3X, as shown in Chart 2. There is also the backstop of the company's ability to buy back shares at or below a PB ratio of 1.2X, which is too cheap according to Buffett.

Chart 2: Berkshire Hathaway's price to book (PB) ratio (1990-2016)



Source: Bloomberg

We are confident that our significant holding in Berkshire Hathaway will benefit our clients

Berkshire Hathaway is a good quality business with high sustainable return on tangible capital, an excellent track record and fantastic management. It is very attractively priced, with low risk of permanent capital loss. Berkshire Hathaway is therefore an ideal candidate for a large investment position, and we are optimistic that, as our single largest offshore investment, it will benefit our clients. ■

Standard Bank:
defensively positioned to withstand the short-term headwinds

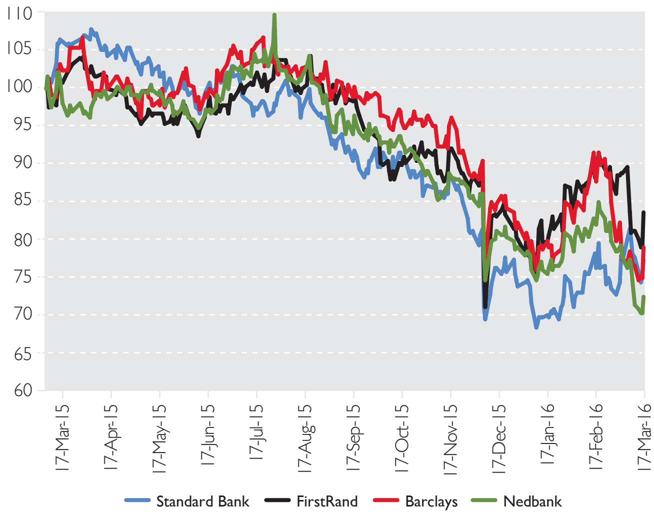
by *Mpandekazi Maneli*, *Equity Analyst*

2015 was a rollercoaster year for the local banking sector. While the banks benefited slightly from rising interest rates, regulatory changes and the finance minister reshuffle in December weighed on the sector, already navigating nascent macroeconomic challenges. The recent de-rating across the banking sector has presented some compelling investment opportunities. Standard Bank is particularly attractive, trading at valuation levels last seen in 2009 during the height of the global financial crisis. Importantly, it is more defensively positioned today than before the crisis due to its surplus capital position and better quality asset portfolio. It offers a large margin of safety (15-year low price to book ratio) and an attractive 5.5% dividend yield. While the future remains unknown, we believe that at these prices, there is limited downside but significantly more upside potential – an asymmetric pay-off.

Macroeconomic challenges in 2015 created an opportunity to invest in Standard Bank

Towards the end of 2015, the banking sector was confronted with macroeconomic challenges. The commodity and oil price bear market deepened, weaker emerging market currencies persisted against US dollar strength, and South Africa's potential credit rating downgrade weighed on the sector. The 'Nenegate' incident was the tipping point and we witnessed a collapse in domestic shares. This created an opportunity to invest in a quality banking franchise such as Standard Bank, as seen in Chart 1.

Chart 1: Twelve-month performance of the 'big four' South African banks relative to the ALSI (2015 - 2016)



Source: : Bloomberg

Standard Bank offers an excellent investment opportunity

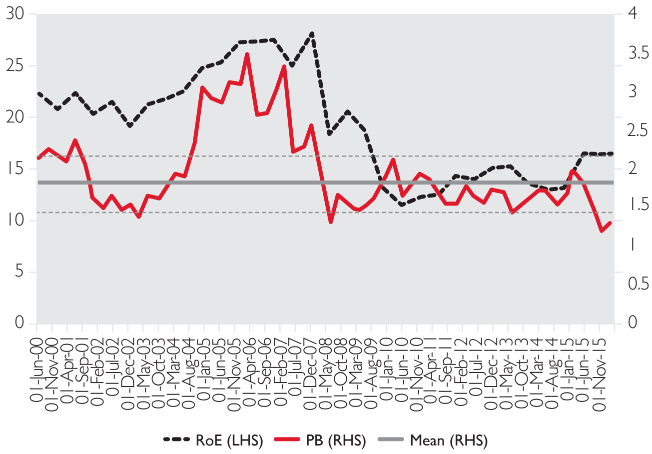
1. **It has a strong balance sheet and an attractive dividend yield**

The company is in a robust capital position with surplus capital. Tier 1 capital is currently at 13.3%. It is therefore able to support its dividend cover policy of 2X (pay-out ratio of 50%). The dividend yield is currently 5.5%, which is the highest it has been since 1999.

2. Valuations are attractive and the bank is trading at very low price to book (PB) multiples

Management has a targeted return on equity (RoE) range of 15%-18%. It reached the target (15.6%) for the first time in the 2015 financial year, despite substantial spending on IT systems that dragged down earnings. Chart 2 shows that Standard Bank's PB ratio continues to trade lower than it has in the last 15 years.

Chart 2: Standard Bank's price to book (PB) and return on equity (RoE) ratios (2000 - 2015)



Source: : Bloomberg

Standard Bank is defensively positioned for short-term risks

While the banking sector will likely experience a rising credit impairment cycle, we believe Standard Bank is defensively positioned to withstand such headwinds, for the following reasons:

1. It has a better quality and more diversified portfolio today compared to 2009

Standard Bank has a market-leading franchise across personal business banking (PBB) and corporate and investment banking (CIB) in South Africa. The bank enjoys the highest market share in retail deposits and is also dominant in home loan advances. Standard Bank's CIB business, with its leading product and service capability as a foreign exchange and derivatives provider, has a superior Pan-African franchise with an excellent footprint on the continent, covering 20 countries. This makes Standard Bank the biggest bank in Africa measured by assets.

2. Its Non-Interest Revenue (NIR) provides a good buffer against credit impairment risk

NIR (including fees and commission earned on cards as well as insurance income on personal loans) has grown almost two-fold to R42 billion from before the financial crisis. This currently covers 80% of the bank's operating expenses. NIR income will act as a shock absorber against the risk of higher credit impairment charges and slowing Net Interest Income (NII) growth. Overall, NIR is a more stable income stream (4% of advances) and is unaffected by interest rate movements.

3. The bank has made adequate provision against bad debts

Standard Bank has built a considerable layer of protection over the years by way of portfolio provisions, thanks to the lower-for-longer interest rate environment. Provisions for doubtful debts as a percentage of advances have grown by 40% (from only 1.30% before 2009 to 2.37%), despite non-performing loans as a percentage of advances declining from the 2009 peak of more than 6.0% to 3.2%.

4. It has reduced exposure to underperforming assets

The partial exit of Standard Bank's Global Markets Plc business that was draining the bank with material losses, is slowly moving in the right direction. Standard Bank has sold 60% of the business to the Industrial and Commercial Bank of China (ICBC). The remaining 40% is expected to continue generating losses until 2017. However, these losses are now down 70% from R4 billion to R1.2 billion.

Standard Bank is better positioned and more resilient than it has been in the past

It has surplus capital, a diverse earnings stream, and is well provisioned against an impending credit impairment cycle. A company of Standard Bank's quality and long-term track record seldom trades at such cheap prices. The share offers a large enough margin of safety with limited downside and significantly more upside – an attractive asymmetric pay-off. ■

The return of African Bank

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

In 2014, the South African Reserve Bank (SARB) placed African Bank under curatorship following the largest bank and corporate default in South Africa's financial market history. After two years of uncertainty, African Bank resumed trading on 4 April 2016. This time around, the bank seems to be moving away from only targeting the unsecured lending segment of the market. It is offering a range of additional financial products and services, including a range of new bonds. In light of the ongoing political and economic tension triggered by the 'Nenegate' fiasco that started in December 2015, we believe the sales of these bonds should initially exceed demand. However, once the bond spreads have widened to enable the market to clear, we believe these bonds might offer value.

Two years after Abil was placed under curatorship, African Bank is trading again

On 10 August 2014, Abil was placed under curatorship by the SARB, a surprise move that stunned local credit markets. The SARB then committed approximately R17 billion worth of capital to guarantee and support Abil, and split the entity into a 'Good Bank' and a 'Bad Book', which still resides at the SARB.

After two years of uncertainty, legal wrangles and bad press, the Good Bank was granted a new banking licence by the South African Banking Regulator in March 2016, and resumed trading on 4 April. The Good Bank will be offering additional financial products and services and will expand to retail deposits in 2017. The dual objective is to offer transactional banking products to clients as well as to facilitate the direct deposit of wages into customer accounts.

The Good Bank has a different approach to funding and its target market

These changes represent a distinct shift in both the funding strategy and target market mindset of African Bank. It suggests that the Good Bank may move away from purely targeting the unsecured lending segment of the market. The bank resumed operations with R10 billion worth of equity and R24 billion worth of cash, as well as a reasonably diversified basket of debt instruments, spread out across the shorter sections of the nominal and real yield curves. This basket was determined by the terms of the restructure. Importantly, the first of the Good Bank's bonds will mature in May 2018, which provides a bit of breathing room before the onerous task of returning principal (capital) payments to bondholders.

The Good Bank has successfully listed a range of new bonds

For the sake of simplicity, we list two fixed-rate senior bonds and two floating-rate senior bonds below. There are several other bonds, including inflation-linked senior bonds and subordinated unsecure floating-rate Tier 2 notes, which we can discuss in future.

- ABK1 is an 11.50% senior unsecured fixed-rate note maturing on 7 November 2018, with R360 million in issue.
- ABK2 is a 9.50% senior unsecured fixed-rate note maturing on 24 May 2018, with R420 million in issue.
- ABK3 is a floating-rate note maturing in November 2018, with R400 million in issue – it will pay a set coupon of 10.38% (the Johannesburg Interbank Agreed Rate (JIBAR) + 315 basis points = 7.23% + 3.15%) for its first quarterly coupon.
- ABK4 is a floating-rate note maturing in May 2018, with R304 million in issue – it will pay a coupon of 9.73% (JIBAR + 250 basis points).

Comparing these yields to a cash return of 8.7% and a two-year sovereign bond yield of 8.3%, these higher yielding bonds offer an attractive return to investors.

The biggest risk is that existing bondholders sell all their debt

The biggest risk facing the curator is that the existing Abil bondholders, who are now new bondholders in the Good Bank, may collectively decide to sell all their debt. This would effectively show that they have no faith in the long-term sustainability of the refloated business. While we think it's unlikely that this will happen, it is possible, considering that the South African government's sovereign credit rating is at risk of a downgrade.

In such an environment, sub-investment grade and (marginal) low-quality investment grade issuers are generally spurned by investors seeking certainty, safety and liquidity from their fixed-income investments. Even supposedly AAA rated South African government bonds faced a zero liquidity environment at the height of the now notorious Nenegate crisis. This crisis was triggered by President Jacob Zuma's finance minister reshuffle in December 2015 and culminated in the reappointment of Pravin Gordhan. In the days surrounding Nenegate, also known as South Africa's 15-12 event, the R186 yield recorded its largest ever one-day sell-off, with yields rising by an eye-watering 147 basis points in one trading session. The R186 government bond is the most liquid South African bond, with R153.9 billion nominal in issue. Yet, under these circumstances, it was simply not possible to find a 'decent' bid in the R186. It goes without saying that if one can't trade in the R186, it is impossible to trade in the debt instruments of a credit like Good Bank, which is rated zaBB- by Standard & Poor's and that defaulted so recently.

We currently demand higher-than-usual credit risk premiums on all corporate and bank credits

A return to Nenegate is unlikely, especially in light of the groundbreaking judgement from the Constitutional Court of South Africa against President Jacob Zuma and in favour of Public Protector Thuli Madonsela on 31 March 2016. However, it is possible that the South African credit rating could be downgraded further, and that sovereign credit spreads could either widen gradually or rise sharply. As a result, we currently demand higher credit risk premiums on all corporate and bank credits than we ordinarily would.

The sales of the Good Bank's bonds may initially overwhelm demand for the bonds

Our analysis suggests that the spreads on the Good Bank's bonds will widen in the period immediately following the resumption of trading. How much they will widen depends on many factors, but the forces of demand and supply will dominate. We expect that the market will establish a clearing spread within the first month or two of trading, with a wave of selling initially overwhelming the demand for the bonds. The factors that contribute to this scenario include:

- the drawn-out delays in establishing the Abil resolution regime,
- the significant legislative changes that had to be enacted by Parliament,
- the size of the so-called 'Bad Book' (which still resides on the SARB's balance sheet), and
- the estimated and actual calls for cash from the thousands of small- and medium-sized investors whose capital was reduced due to mandatory haircuts (reductions in the market value of their assets), and then had their reduced capital stuck in retention funds at almost every large asset manager in the country.

We believe the Good Bank's bonds can potentially offer value and we'll consider these for our holdings

However, once the salient details of the flotation become more widely known and a clearing spread is established, we suspect that value might emerge in some of the bonds. At this point, we may consider increasing our holdings in the Good Bank's senior debt, subordinated Tier 2 debt and/or equity. Any such decisions will be subject to detailed analysis by our analysts and in-house approval from our Credit Committee.

Regardless, the flotation of the Good Bank should prove to be an interesting and groundbreaking chapter in the history of the South African corporate bond market. In fact, it will undoubtedly be taught to university students at commerce faculties around the country for many years to come. ■

Quarterly review

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

INTERNATIONAL PERFORMANCE

A quarter of two halves

Global markets started off the year in 'risk-off' mode as fears of a global recession mounted. As a result, global equities fell by 6% in January. However, sentiment changed mid-February, leading to a recovery in risk assets. The major asset returns for the quarter are shown in Table 1.

Table 1: International equity market returns

International (US$)	Quarter	12 Months
MSCI World	-0.3%	-6.2%
MSCI Emerging	5.4%	-14.1%
MSCI SA	13.0%	-19.8%
J.P. Morgan Global Bonds	6.7%	5.3
US Cash	0.3%	0.1%

Source: Bank of America Merrill Lynch

Some more interesting moves in the quarter include the following:

- US high yield debt delivered 12% after being priced for recession.
- Commodity prices rose 4% in the quarter. Precious metals, however, were particularly strong, rising by an average of 14% in US dollar terms.
- Interestingly, bonds (+7%) managed to outperform equities despite increased risk appetite.
- Emerging markets were viewed with greater sympathy and outperformed their developed peers in the quarter by 6% in US dollar terms. The Brazilian Bovespa Index delivered remarkable returns, rising by 29%. However, we are not sure whether this was due to the demand for commodity-based investment destinations or the potential impeachment of Brazil's head of state. Probably a bit of both.

A major reason for the turnaround was the weakness in the US dollar

The dollar fell by 5% against its trade weighted peers. This follows its remarkable run since mid-2014, during which time it outperformed the currencies of its trading partners by an annualised 12%.

Has the US dollar peaked?

An interesting debate has emerged in the international arena about whether the US dollar has indeed peaked. The main argument of those in favour of this view is that the US Federal Reserve (US Fed) has been restricted in its attempts to normalise the level of US interest rates. They argue that the Fed has been forced to retreat on both the pace at which it wishes to raise rates and also on the level it had targeted. On the one hand, the macroeconomic environment within the US supports higher rates – employment is strong, the latest readings from the Institute of Supply Management and the regional US Fed surveys are favourable, housing sales have been broadly flat (despite some volatility), and credit extension figures are reasonable. On the other hand, however, factors largely outside of the US Fed's control have forced it to back-pedal.

The US dollar should drift higher over the next 12 months

The rest of the world's central bankers are pulling in the opposite direction to the US Fed. The hugely aggressive monetary policy moves by the European and Japanese central banks have eroded their respective currencies. In addition, the Chinese authorities' (often inept) attempts at weakening the renminbi late last year, coupled with other countries moving to negative interest rates, have all conspired to strengthen the US dollar. The impact of this is the equivalent of monetary tightening in the US economy, which will be compounded further by higher US rates should the US Fed indeed decide to raise rates.

With the US dollar expected to drift higher overtime, the $50 question is – is this the start of a renewed cycle for commodities? We would argue it is not, and expect commodities to be range bound. Our reasoning is as follows:

1. The US Fed will eventually hike rates in 2016 and no other major central bank is in a position to act correspondingly. This should see the US dollar move higher.
2. Despite China showing tentative signs of having moved through its downturn, we doubt that the world's largest buyer of the incremental tonne of commodities will buy as aggressively as it did in the past decade. The recent restocking of commodities is a cyclical event ahead of the Northern hemisphere winter. Furthermore, China's main focus is on empowering the consumer rather than spending on large capital projects.
3. The major commodity-producing nations have received a substantial currency boost as a result of the strong dollar, leading to supply still outweighing demand for most commodities.
4. The rebound in commodities and commodity shares was helped by the unwinding of hedge books.

LOCAL PERFORMANCE

The South African market dragged higher in the quarter

The South African equity market also benefited from the commodity price rebound. The MSCI South Africa Index rose by 14% in the quarter, handsomely outperforming the MSCI World Index return of -0.2%. It was as if the wreckage of December had never happened. Even the rand appreciated by 5% against the US dollar and by 8% against the pound sterling. Interestingly, the market response to this was almost bipolar in nature as the commodity stocks, whose bottom line was previously protected by a weak rand, performed strongly – Harmony rose by 240%, Assore by 159% and Sibanye by 150%. The more expensive and defensive rand hedges were hit hard – Richemont was down by 13%, SABMiller sank 5% and Naspers was lower by 3%. Given our view on the progression of the US dollar, we believe that this relative performance is unsustainable.

Table 2: South African financial market returns

Asset class (ZAR)	Quarter	12 Months
All Share	3.9%	3.2%
All Bond	6.1%	-1.0%
Listed Property	10.1%	4.6%
Cash	5.3%	9.2%
Tier-1 (ZAR)	**Quarter**	**12 Months**
Resources	18.1%	-25.5%
Financials	6.2%	-0.7%
Industrials	-0.4%	8.7%
Size (ZAR)	**Quarter**	**12 Months**
Large Cap	1.5%	3.3%
Mid Cap	18.8%	2.1%
Small Cap	11.4%	3.8%

Source: Deutsche Bank

Despite some remarkable individual performances by certain equities, the first three months of 2016 produced a refrain we have seen countless times before – property over bonds over cash over equities (as can be seen in Table 2). Interestingly, most of the positive equity returns were centered in the mid cap resource area, driven by the likes of Harmony and Sibanye, but perversely also the fallen angels (Assore, Exxaro and Impala) which had recently dropped out of the large cap index by virtue of poor performance.

Welcome back to our Finance Minister

In the quarter, newly appointed Finance Minister Pravin Gordhan delivered the annual South African Budget. While he did well in the delivery and content of his speech, we still doubt some of the figures he produced. The most crucial figure was Gordhan's growth assumption, which is at the core of his projections. While we certainly don't expect a local recession, things will get tighter.

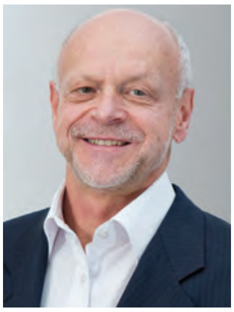
The level of the rand will be critical to the local market in the next year. While the year-to-date progress is encouraging, it remains substantially weaker than the average of last year. The impact of the weak rand will be visible in higher inflation, leading to a justifiable response by the South African Reserve Bank.

Where to from here?

In summary, we anticipate that risky assets will continue to be volatile this year, with higher US and local rates eroding investor risk appetite. As such, we will remain underweight equities overall. However, we are committed to using our full offshore allowance in seeking better opportunities outside of the local stockmarket. Similarly, we are underweight local and offshore bonds in our multi-asset class funds. We have been adding small holdings to the local component in the form of inflation-linked bonds. By deduction, we are therefore overweight cash, which we will not hesitate to deploy if we find opportunities elsewhere. ■

Meet our Joint Chief Investment Officer:

Matt Brenzel



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

A passionate investment guru with an appetite for life

With almost 40 years' experience in the world of finance, there's no doubt that Matt Brenzel is an expert when it comes to investment management. His roles at Standard Bank, Central Merchant Bank, Bankorp Trust, Syfrets Managed Assets, African Harvest Fund Managers and Coronation Asset Management all contributes to the vast knowledge and skills base he employs as Joint Chief Investment Officer. But there's a lot more to Matt than making the most of the markets – his responses to a few simple, personal questions reveal a quirky sense of humour, a diverse range of interests, and a whole-hearted passion for life.

What are three things that few people know about you?

1. I have a need for speed (car, bicycle, jet ski, sevens rugby).
2. I received full colours for dramatics in high school.
3. I did once have a full head of hair.

Who or what was the biggest influence in your life?

My parents, church and school friends in my formative years. Thereafter, my wife, children and business colleagues.

Tell us a bit about your family life.

I have a wife and four children who range in age from 25 to 32.

What do you do to relax?

If my knees are in form, I love road cycling. If my knees are out of sorts, live theatre and stairless restaurants in Franschhoek and Stellenbosch. Otherwise, a good book and a peaty single malt.

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

A Baltic cruise that took in the sights of Stockholm and St Petersburg, or a visit to a game farm in the Eastern Cape.

What was the last book you read?

The Climb', an autobiography of Tour de France winner Chris Froome.

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

A plastic surgeon. Not the nip and tuck kind though. Working for an organisation like the 'Smile Foundation' would have been hugely rewarding.

Why did you become an investment manager?

It was a combination of planning and happenstance. I started out in a well-known bank's money and capital market division. Thereafter, I followed a friend into equity research.

What's important to you at work?

Investing is a bit like golf – just when you think you have it so right, you get it so wrong. That creates interest, raises energy and stimulates the desire to do even better. Oh, and working with people who are smarter than me also helps.

Cadiz Unit Trusts' performance

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

Unit Trusts	1 Year	3 Years	5 Years	7 Years	Since Inception	Inception Date
No Equity Exposure						
Cadiz Money Market Fund	6.95%	6.32%	6.05%	6.51%	7.62%	01-Mar-06
Alexander Forbes Short Term Fixed Interest (STeFI) Composite Index	6.61%	5.99%	5.81%	6.24%	7.31%	
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	4.79%	5.56%	7.23%	7.86%	8.67%	01-Mar-06
CPI+3%	10.05%	8.60%	8.75%	8.44%	9.16%	
Quartile Rank	4th	3rd	1st	1st	1st	
Low Net Equity Exposure (20 - 40%)						
Cadiz Stable Fund	3.00%	4.91%			5.75%	01-Sep-12
CPI+3%	10.05%	8.60%			8.72%	
Quartile Rank	4th	4th			4th	
Medium Net Equity Exposure (40 - 75%)						
Cadiz Inflation Plus Fund	2.08%	4.80%	7.68%	10.65%	9.12%	13-Jan-06
CPI+5%	12.11%	10.62%	10.75%	10.45%	11.20%	
Quartile Rank	3rd	4th	4th	3rd	1st	
Cadiz Managed Flexible Fund	0.15%	5.69%	8.92%	12.70%	9.59%	01-Mar-06
Average of the Domestic - Asset Allocation - Prudential High Equity sector	4.95%	10.88%	11.61%	12.54%	11.23%	
Quartile Rank	4th	4th	4th	3rd	2nd	
Flexible Net Equity Exposure (50 - 90%)						
Cadiz Equity Ladder Fund	-3.53%	-2.62%	-0.95%	5.19%	5.98%	03-Jun-05
CPI+6%	13.13%	11.62%	11.75%	11.45%	11.62%	
High Net Equity Exposure (100%)						
Cadiz Mastermind Fund	-9.07%	0.70%	5.14%	12.55%	8.45%	01-Mar-06
FTSE/JSE SWIX Index	2.65%	14.57%	15.41%	19.02%	14.45%	
Quartile Rank	4th	4th	4th	4th	2nd	

Source: Morningstar and Cadiz Asset Management

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