April 2017

CAMmuniqué

CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

cadiz

ASSET MANAGEMENT

Our investment philosophy

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

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

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

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

Our investment process

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

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

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

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

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

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

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

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

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

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

   We will consider selling when:

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

6. **We regularly review our portfolios**

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

In this edition

Introduction 4
– 2017 is off to a great start for our funds

Where to invest 5
– Value investing is the clear winner in the long term

Brookfield Asset Management: an attractive long-term investment opportunity 8

What is the likely path of interest rates in 2017? 11

Quarterly review 14

Meet our Head of Research: Razeen Dinath 18

Cadiz Unit Trust performance 19

Introduction

2017 is off to a great start for our funds

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

Cadiz Asset Management's funds produced great returns over the past year

After a period of consolidation at Cadiz Asset Management, the table below shows the impressive growth of our funds over the last 12 months. All our funds are top quartile, most of the funds returned over 7%, and all the funds' returns beat inflation last year.

Table 1: Impressive returns over the past year

Cadiz Asset Management fund	Fund sector	One-year returns (to 28 February 2017)	Quartile ranking
Cadiz Money Market A	Money Market	7.95%	1
Cadiz Absolute Yield A	Multi Asset Income	9.58%	1
Cadiz Stable A	Multi Asset Low Equity	6.13%	1
Cadiz Inflation Plus	Multi Asset Flexible	7.76%	2
Cadiz Managed Flexible A	Multi Asset High Equity	8.31%	1
Cadiz Equity Ladder A	Multi Asset Flexible	10.94%	1
Cadiz Mastermind A	General Equity	17.27%	1

Source: Morningstar Performance Report, 28 February 2017

These great returns endorse the strength and depth of our team

We are stronger after the changes we made during 2015. Our team's 150 years of collective investment experience has helped to achieve this superb performance in an extremely challenging investment environment. As one of the few multi-strategy boutique investment managers in the country, our experience and exposure across the different asset classes bodes well for our portfolios in these challenging times.

2017 is off to a great start

While we don't focus on short-term results, growth across the entire range of funds such as this is very encouraging. Looking ahead, we believe we are well positioned, both from a team and investment positioning point of view, to build on the performance we have achieved to date.

In this quarter's CAMmunique….

In 'Where to invest' Brian Munro shares his insights on why value investing is likely to continue to outperform growth investing over time. He also provides an overview of our approach to stockpicking – a key requirement for successful value investing in the South African market – and the qualitative factors that we consider when we analyse companies we're considering investing in. Graeme Ronne shares his insights about Brookfield Asset Management investors, who practise the core principles of value investing with a contrarian point of view, and explains why he believes this business provides an attractive long-term investment opportunity. Alastair Sellick takes a look at the path that interest rates should have followed in 2017. This article was written before the recent cabinet reshuffle by President Zuma and the events that have unfolded since. Although the views in the article are now outdated, we have decided to keep the article as a case study of what an 'alternative scenario' for the South African economy could have been, if it was not for some really poor decision-making. Matt Brenzel provides us with an overview of the first quarter of 2017, providing both a local and international perspective. Lastly, we invite you to find out a little more about Razeen Dinath, our Head of Research.

In conclusion

Although one year is a short term over which to measure performance, we would like to reassure you that our focus remains on generating superior long-term performance and servicing our clients' needs better by way of a simplified operating model, a strong and committed shareholder, quality, passionate people and a recognised brand.

Thank you for the trust you have shown in us and for your continued support. ■

Where to invest

Value investing is the clear winner in the long term

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

In this article Brian Munro shares his insights on why value investing is likely to continue to outperform growth investing over time. He explains the history of value investing relative to growth investing for the past 36 years and gives us an important and lasting reason for this. He also shares an overview of the Cadiz approach to stockpicking (a key requirement for successful value investing in the South African market), and lists the qualitative factors that we consider when we analyse companies in which to invest.

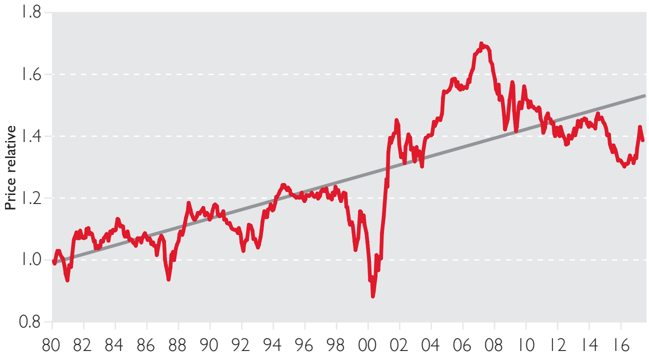
'Markets are inefficient because of human nature – innate, deep rooted, permanent. People don't consciously choose to invest with emotion – they simply can't help it.'

Seth Klarman (Heins, 2013)

Since 1980, value stocks have outperformed growth stocks

Last year saw value stocks outperform growth stocks after 9 years of relative underperformance. It has been one of the longest periods (in the last 36 years) of value underperforming growth since 1980. The relative outperformance of value stocks peaked in December 2006 (as shown in Chart 1). If you owned value stocks you would have earned 1.7 times more return than if you owned growth stocks. However, after the longest period of relative underperformance, this ratio troughed at 1.3 times at the end of December 2015. This means that if you had held value stocks since 1980, you would still be better off than holding growth stocks; the trend is clear, over the long run value outperforms growth.

Chart 1: MSCI Value relative to MSCI Growth (1980-2016)



Sources: Bloomberg, Cadiz Asset Management

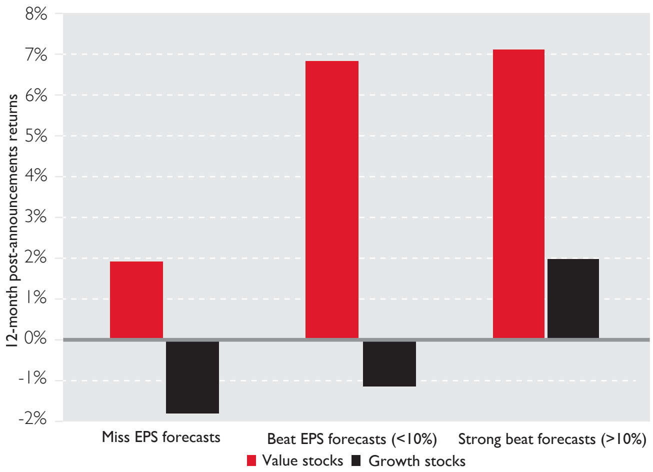
Why value stocks outperform growth stocks

Value investing does not rely on forecasts of the future nor on trying to predict what the earnings growth of the company is likely to be. The future is just too uncertain! Instead, value investors rely on the assumption that the current below-trend earnings growth of a company is likely to recover back to its normal long-term growth rate.

As earnings recover, so the price re-rates as well, moving from a heavily oversold position back to what is a more appropriate price level. The combined return from the change in earnings plus the change in price (re-rate) from oversold levels is why value stocks outperform growth stocks overall.

How value and growth stocks re-rate is highlighted in Chart 2. Value stocks tend to re-rate significantly if they beat earnings expectations. Growth stocks however tend to de-rate, unless the company beats forecasts substantially. After 9 years of growth stocks outperforming, it was inevitable that they were likely to disappoint.

Chart 2: Value and growth stocks behave differently around earnings announcements



Source: Barclays Equity Valuation Academy (May 2013)

Investor behaviour is predictable and repeatable

There have been numerous academic and industry studies showing that value outperforms growth over the long term. A strong argument why this phenomenon exists is because humans tend to 'overreact'. The impact of this is compounded by the 'herd effect' as people overreact in response to others overreacting, which often happens at the same time.

When a company is going through a tough time, investors' perception is that the rough patch is likely to continue indefinitely and they overreact by selling the share down to heavily discounted levels. This is also true of investor behaviour when the flipside occurs – share prices are pushed higher beyond what is a 'fair' price as shares beat the market's expectation, making it expensive. These human traits are ingrained and are unlikely to disappear anytime soon, making this behaviour predictable and repeatable.

With patience, you can take advantage of investor behaviour

Value investors can take advantage of this human phenomenon by remaining objective and buying stocks when they are heavily discounted. Patience is therefore an important ingredient of value investing as you wait for the herd's overreaction to drive the share price down to bargain prices. The price you pay is so important in determining the potential return from an investment.

It is important to have a solid understanding of the stock

Of course, to determine how discounted the stock is compared to what you believe the stock is worth, you need to follow a disciplined process of understanding what the key investment criteria are to owning the stock. We prefer to invest in a company that:

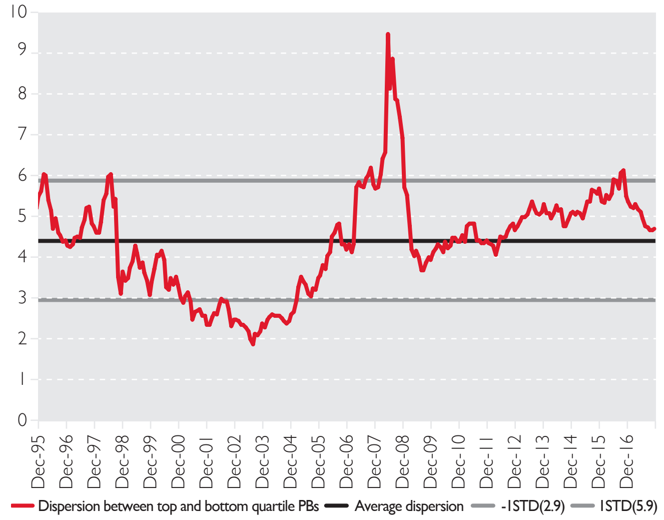
1. has a simple and understandable business model,
2. preferably has a barrier to entry to protect profitability against competition,
3. is part of a stable, structurally attractive industry,
4. is a financially sound business that can meet its debt obligations when they are due,
5. has a proven track record of above-average profitability over an entire business cycle, and
6. has a management team with interests aligned to those of its shareholders.

We also tend to buy a share when market sentiment towards the company is weak. This is typically when the company is at the bottom of its earnings, capital and valuation cycles. This is when asset prices are cheap and the margin of safety large.

In the South African market, value stocks are likely to outperform in 2017

In South Africa, value stocks outperformed growth stocks last year. Value shares that dominated bottom quartile performance at the beginning of 2016 started to show signs of their earnings recovering. As the market began to believe this recovery was sustainable, the market re-rated these shares, driving their prices up significantly. At the same time the shares that were expensive were sold. This has caused the valuation differential between the very cheap and very expensive shares to narrow considerably, as seen in Chart 3 on the next page.

Chart 3: The valuation gap between value and growth stocks in South Africa (1995-2016)



Sources: I-NET, Cadiz Asset Management

This chart highlights the valuation gap between the shares with the most expensive price to book ratios (a proxy for growth stocks) and the shares with the lowest price to book ratios (a proxy for value stocks). We believe this valuation gap can narrow further, but the extent of the convergence is likely to be smaller than last year. This is where stockpicking becomes critical. It is about understanding where each company is in its business cycle and assessing the staying quality of the company to deliver on its long-term objectives. We believe value stocks have further to go and are likely to outperform in 2017.

Brookfield Asset Management:

an attractive long-term investment opportunity

by *Graeme Ronne*, *Head of Equities*

With more than a century of experience, Brookfield Asset Management is a leading global alternative asset management company. They invest in high-quality, real assets with a long lifespan, creating significant wealth for long-term investors. With predictable earnings and low risk exposure, Brookfield offers investors an under-appreciated, above-average business at a discount. In this article, Head of Equities, Graeme Ronne, explains why this business provides an attractive long-term investment opportunity.

Over a century of experience

Brookfield Asset Management (Brookfield) is a leading global alternative asset management company that uses internal capital and funds raised from investors to invest in real assets that have a long lifespan. These typically include high-quality infrastructure, renewable power, real estate, and private equity assets. Brookfield has over 100 years' experience, with more than 700 investment professionals and 70 000 employees in 30 countries. Assets under management total $250 billion, of which $110 billion is fee-bearing capital. Their investments include one of the largest portfolios of office properties and renewable power businesses in the world.

Brookfield are long-term, contrarian value investors

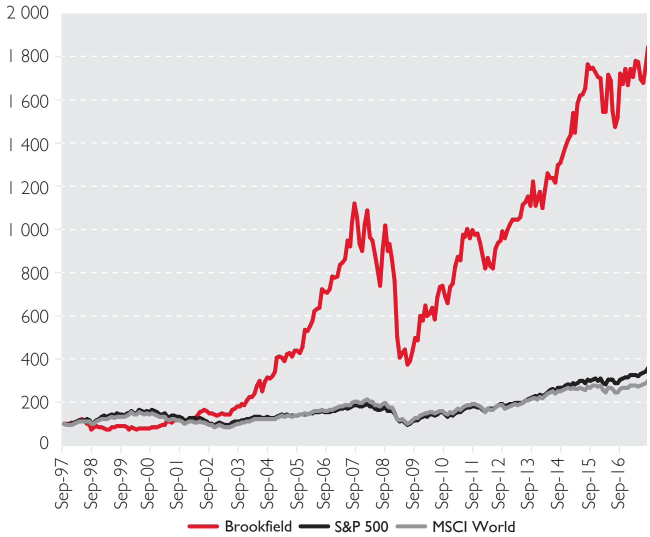
Brookfield has a simple and repeatable business model. They source capital from investors seeking exposure to real assets by leveraging their global expertise, strong long-term track record and size. Their global reach and partnerships give them a strategic advantage in identifying and acquiring high-quality real assets that are financed on a long-term, low-risk basis. They use their global business platforms to enhance the cash flow and value of the acquired assets.
In our view, Brookfield are truly long-term investors who practise the core principles of value investing with a contrarian point of view – buy with a margin of safety and act like owners of the business when making decisions. They typically create value by being contrarian. They invest large amounts of capital when markets are stressed and assets are cheap, and realise mature assets during robust markets when assets are expensive.

Brookfield has created significant wealth for long-term investors

Brookfield has been a very rewarding investment for shareholders. If you had invested $1 000 in Brookfield in 1997, you would have earned $18 415 by 2016, or 17% per annum (p.a.).

This compares very favourably to a total return of $3 585 from the S&P 500 and $2 991 from the MSCI World Indices (7% and 6% p.a. respectively), over the same period. This return is an outperformance of 11% p.a. over world markets (as shown in Chart 1). The company remains well positioned to continue generating returns like these.

Chart 1: Total returns for Brookfield, S&P 500 and MSCI World (indexed to 100 at start) (1997-2016)



Sources: Bloomberg, Cadiz Asset Management

Shareholder-oriented investors that 'eat their own cooking'

In Warren Buffett's *Owner's Manual* issued to Berkshire Hathaway's shareholders in 1996, he stated that most of their directors have a major portion of their net worth invested in the company: 'We eat our own cooking.' In other words, there is an alignment of interests between the managers and shareholders of the company. This is a core principle of Brookfield's business philosophy. They ensure their people think and act like business owners in all their decisions and treat their clients' and shareholders' money like it is their own. Brookfield have demonstrated that they 'eat their own cooking' by co-investing alongside their clients (85% of invested capital) while corporate insiders have a significant ownership stake (roughly 12%) in the company. Bruce Flatt, Group CEO since 2002, has been instrumental in driving this owner-manager culture, and with a 3.7% shareholding in the company, he has a significant portion of his own money invested alongside other shareholders and investors.

Brookfield has predictable earnings with low business and financial risk

Brookfield generates relatively predictable and stable revenues and has a well-capitalised balance sheet. Most of Brookfield's revenue consists of investment management and service fees. These revenues are generated from a fee-bearing capital base that tends to be either perpetual or long term in nature. This is because 90% of Brookfield's fee-bearing capital, about $110 billion, is invested in listed partnerships (perpetual instruments) or private funds with an average life of 10 years, along with their own invested capital. In addition, they have a diversified client base of 455 global private fund investors and a high client retention rate, with 45% invested in multiple funds. This means there is relatively low business risk. Brookfield has $31 billion of its own capital invested alongside client funds that yields 4.2%, an annualised dividend income stream of $1.3 billion. Equity largely funds this capital, with only $4.5 billion in corporate debt and $4.0 billion in perpetual preference share funding. The average duration of the corporate debt is eight years and there are no significant near-term maturities. In our view, Brookfield has relatively predictable earnings with low business and financial risk.

They are well positioned to capitalise on the strong demand for real assets

Investor demand for listed real assets has been steadily growing over the past 15 years. Characteristics that make them attractive to investors, especially in a low-interest-rate environment, include:

1. Portfolio diversification that goes beyond traditional stocks and bonds.
2. Tangible assets with a long life that form the backbone of the global economy.
3. Stable and predictable cash flows supported by contracted or regulated revenues.
4. An ability to price these essential products or services off inflation.
5. Diversification across geographies, industries and business models.

These trends are evident in Brookfield's operating performance, where assets under management have grown by about 250% over the past 10 years, driving strong value creation.

An under-appreciated, above-average business at a discount

Brookfield's excellent long-term performance track record and astute capital management have driven growth in intrinsic value and share price outperformance over time. However, current valuations remain at a discount to our assessment of underlying value and world stockmarkets. A buyer of Brookfield is paying a 15X price to earnings ratio for the historic fee-related earnings of the asset management business and a 0.8X price to book ratio for the invested capital. Roughly 75% of Brookfield's capital is invested in listed entities, namely:

- Brookfield Property Partners
- Brookfield Renewable Partners
- Brookfield Business Partners
- Brookfield Infrastructure Partners

These investments generate an annualised dividend yield of 5.2% at current market prices. In addition, the accumulated deferred carried interest and future growth in fee-bearing capital is free, as the market is not attaching any value to this at current prices. We purchased Brookfield for client funds at 20% below the current spot price, building in a large margin of safety and a potentially attractive asymmetric payoff profile.

Brookfield meets our key investment criteria

Our purchase of shares in Brookfield represents an attractive investment opportunity that meets our key investment criteria – a good business with shareholder-oriented managers, low financial risk, and a cheap purchase price. We took advantage of weak investor sentiment to invest in Brookfield at a low point in its earnings and valuation cycle. This coincided with a low point in its capital cycle as Brookfield capitalised on stressed market conditions to acquire high-quality assets from financially distressed sellers toward the end of 2015. We believe these attractively-priced assets have positioned Brookfield to generate significant value for shareholders over the next investment cycle. ■

What is the likely path of interest rates in 2017?

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

IMPORTANT NOTE ABOUT THIS ARTICLE

The local bond market was shaping up to have its best month in March – the following article was written in the context of the drivers of that performance. Alastair's view was a non-consensus call at the time of writing. However, the recall of Pravin Gordhan from his overseas meeting with ratings agencies and foreign investors four days before month-end and the events that followed have effectively changed the outcome of the article. It's the basis of an editorial nightmare. Should we pull the article? We have decided to retain it because it sets out the 'alternative scenario' that the South African economy could have followed. It therefore serves as an example of what good management, effective decision-making and social governance should have achieved.

Last year, the Cadiz Fixed Interest team's view of the likely future path of the repo rate for 2017 was that it would be maintained at 7% for the whole year. There was also a risk of a possible hike early in 2017, predicated on inflation possibly being higher than expected, and a weaker rand based on the widely-expected ratings downgrade of South Africa's sovereign debt. In this article, Alastair Sellick, Head of Fixed Interest, shares the Cadiz Fixed Interest team's views on the repo rate for the year ahead, and the risks to that view.

Much has changed since the volatile, uncertain times of 2016

Financial markets were plagued with the uncertainty and concern related to the fiasco around the removal of Nhlanhla Nene as Finance Minister, and the ultimate replacement of Des van Rooyen with incumbent Finance Minister Pravin Gordhan. The world also had to wrestle with the uncertainty and surprise from the Brexit decision, whereby the citizens of the UK decided to leave the European Union, and then the surprise victory of Donald Trump over Hillary Clinton in the November 2016 US presidential election. These environments are usually not conducive to strong economic growth and central bank rate cuts.

South Africa survived the potential ratings downgrade

The Finance Minister delivered a credible Medium Term Budget Policy Statement (MTBPS) in late 2016, the key pillar of which was that taxes would be raised to plug the gaps in the Budget left by a much lower GDP outcome than had been forecast. There must have been a great deal of work behind the scenes with the ratings agencies to allay their fears and address their concerns.

The rand has maintained its strength

In January, the rand was about 25% stronger than it had been a year ago, on a trade-weighted basis. Just as a weakening rand provides a source of monetary stimulus by increasing the revenues that exporters earn for their exports, a strong rand has the opposite effect of tightening monetary policy.

It effectively acts as a rate hike, as exporters' revenues are reduced in rand terms.

The other key consequence of rand strength is that it will act as a major deflationary force, which will positively influence consumer price inflation (CPI) outcomes for the entire year. The South African Reserve Bank (SARB) has forecast that CPI will average 6.2% for 2017, but we struggle to arrive at the same conclusion, especially in light of the massive rand tailwinds.

1. **Food inflation is expected to be lower as the country recovers from the drought**

   The drought that plagued us in 2016 and had a large, negative effect on growth has been broken everywhere except in the Western Cape, where there is every likelihood that the drought will be broken in the winter of 2017. The Vaal Dam is full, and many of the other key dams in the country are rapidly filling up as the rains fall. Maize, wheat and other agricultural commodity prices have come down from their previous highs.

2. **Electricity prices will only increase by 2% in 2017/2018**

   There was additional good news on the inflation front when the National Energy Regulator of South Africa (NERSA), the entity responsible for approving Eskom's price increase requests, delivered a consumer-friendly electricity price increase to Eskom – allowing a mere 2% increase in 2017/2018. This will put further downward pressure on the South African CPI outcomes.

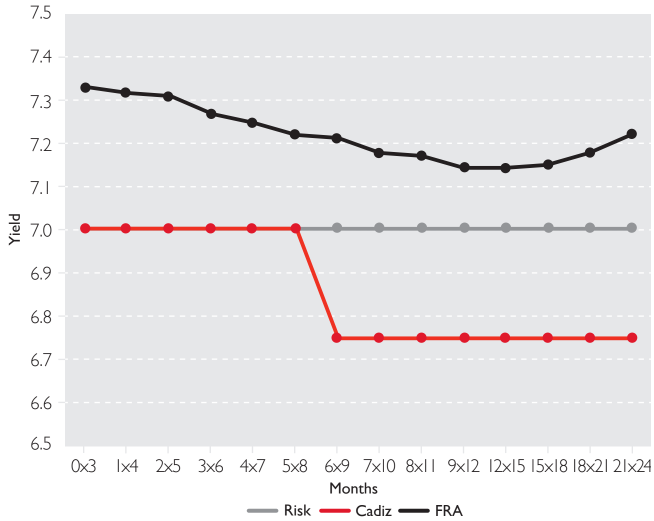
3. **The fuel levy increase was lower than expected**

   Although Minister Gordhan was forced to raise a variety of taxes in the recent Budget to generate the revenue required, the fuel levy was lower than expected. That too, will provide a deflationary impulse for the course of 2017/2018, which should lead to lower inflation outcomes.

We are therefore expecting a rate cut in the second half of 2017

The Cadiz Fixed Interest team has changed their interest rate view based on the survival of the Finance Minister, his excellent Budget and the range of positive forces acting to lower CPI in 2017. We are now expecting a rate cut in the second half of 2017. This is shown in Chart 1, where the red line denotes our view of the progression of the repo rate. The risk view (highlighted in grey) is that there is no change to the repo rate. The market's Forward Rate Agreement (FRA) curve is in black and was also pricing in a rate cut towards the end of 2017. An interest rate cut is unlikely to have a major impact initially. However, over the medium term it would help South Africa achieve a higher economic growth outcome. Admittedly, a cutting cycle is unlikely to only include one cut of 25 basis points, so the question then becomes one of when could or would the SARB cut again? This can only be answered once the inflation trough of 2017 or early 2018 becomes known, and there are many variables that may affect this.

Chart 1: Forward rate Agreement ('FRA') curve versus our repo view



Sources: Bloomberg, Cadiz Asset Management

Three key risk factors that will affect local inflation this year

1. **The extent of the US Federal Reserve's tightening**

   Admittedly, America is in a very different phase of recovery after the financial crisis caused massive rate cuts, former US Fed Chairman Ben Bernanke's quantitative easing policies, and now Donald Trump's presidency. The most recent US rate hike occurred in the context of US unemployment data being very favourable. The US is close to 'full employment'. This is commensurate with a growing economy where US fiscal policy is expected to drive economic growth. This type of environment will necessarily require higher US rates.

2. **The behavior of the other major G7 central banks**

   The European Central Bank (ECB) and Bank of Japan (BoJ)'s continued use of unconventional monetary policies provides a massive source of global stimulus. This is beneficial for global bond markets in general, and emerging bond markets in particular. In fact, the ECB and BoJ are largely replacing the US Fed's removal of accommodative monetary conditions. However, there are signs that European growth is on the rebound (figures in the region of 1%+ are being forecast for 2017) and CPI might be starting to rise, at long last. No one knows how much longer the BoJ can continue with its approach, but it clearly has the resolve to pursue its current experiment further. When ECB tapering occurs and the BoJ allows market forces to return to its bond market, this will definitely put upward pressure on global bond yields, and this too, will make it harder for small, open economies like

South Africa to move against the global interest rate tide. However, this is more 2018's or 2019's problem, hence our view that the SARB still has a window of opportunity to cut rates in 2017.

3. The SARB's hawkish intent

The final factor that will determine whether the SARB will cut rates or not is the SARB's Monetary Policy Committee's hawkish intent. Governor Lesetja Kganyago is a known hawk. As inflation subsides towards 5%, maintenance of the repo rate at 7% implies the real repo rate rising towards 2%. The CPI target that the SARB follows is intended to keep CPI within a range of 3% to 6% over the medium term. Under the previous dovish leadership of Gill Marcus, there was a clear drive to target growth over inflation. The market interpreted this as a CPI target of just below 6.0%, rather than a more balanced 4.5%. The issue for Kganyago will be whether to enforce a CPI mid-point of 4.5% by keeping the repo rate at 7.0%, or to cut the repo rate. This would support economic growth that will help the valiant efforts of the National Treasury, under Gordhan's leadership, to stave off a dreaded potential ratings agency downgrade. If ever there was a time for the SARB to prioritise growth, this is it. ■

Quarterly review

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

INTERNATIONAL PERFORMANCE

The macro background continues to improve

There are signs that the previously uncorrelated regional growth profiles are starting to assume a greater positive relationship and momentum.

- In the US, manufacturing activity lifted to a two-and-a-half year high, with the ISM Purchasing Managers' Index (PMI) for February rising to 57.7 from January's 56.0.
- German industrial production beat expectations in January and rose by 2.8%, which was ahead of the 2.5% expected growth.
- UK GDP growth was 0.6% in the last quarter of 2016, defying those who were looking for slower growth after the Brexit announcement.
- For the first time in four years, annual inflation in the Eurozone breached the European Central Bank's target, reaching 2% in January on a 'headline' basis.
- Chinese manufacturing and services activity gathered pace in March. The official manufacturing PMI climbed to almost a 5-year high of 51.8 from February's 51.6.

The US reacted by raising rates

Given the more supportive global and local variables, the US Federal Reserve (US Fed) raised the Federal funds target rate to 0.75%-1.0% from 0.50%-0.75%. The accompanying statement reiterated that the labour market has continued to strengthen, economic activity has continued to expand, and inflation has moved closer to the US Fed's 2% target. Consensus expectations are that there will be three rate hikes in 2017 and another three in 2018.

The swing to the conservative right might have stalled

The Dutch election was widely seen as a barometer of the level of populist support in Europe. However, the incumbent Prime Minister, Mark Rutte, retained power. As expected, the UK Prime Minister, Theresa May, set the Brexit process in motion by signing a letter that triggered Article 50.

Table 1: International market returns

International (US$)	Quarter	12 Months
MSCI World	6.5%	15.4%
MSCI Emerging	11.5%	17.7%
MSCI SA	4.6%	8.7%
J.P. Morgan Global Bonds	-3.5%	1.6%
US Cash	0.1%	0.4%

Sources: Deutsche Bank, Bloomberg Finance LP

Equity markets had a particularly strong quarter, with emerging markets the major beneficiary of improved investor sentiment, backed by investor flows.

LOCAL PERFORMANCE

Recent political events have dwarfed the relevance of the last quarter

The local market's quarterly performance is a distant memory. Table 2 shows the past quarter's performance:

- Equities outperformed bonds over cash and property.
- Industrials outperformed resources, which outperformed financials.
- Small caps trumped the large caps and mid caps.
- In the bond market, it was the middle of the yield curve that outperformed.

Table 2: South African financial market returns

Asset class (ZAR)	Quarter	12 Months
All Share	3.8%	2.5%
All Bond	2.5%	11.0%
Listed Property	1.4%	1.5%
Cash	1.9%	7.6%
Tier-1 (ZAR)	**Quarter**	**12 Months**
Resources	2.7%	16.7%
Financials	-1.1%	-1.8%
Industrials	6.6%	0.2%
Size (ZAR)	**Quarter**	**12 Months**
Large Cap	3.9%	0.8%
Mid Cap	1.1%	8.4%
Small Cap	4.6%	13.7%
Bond Market (ZAR)	**Quarter**	**12 Months**
All Bond	2.5%	11.0%
1-3 years	2.6%	9.4%
3-7 years	3.3%	11.6%
7-12 years	2.6%	11.0%
12+ years	2.2%	11.5%

Sources: Deutsche Bank, Bloomberg Finance LP

Within the equity market, the three best performers in absolute terms were Trencor (+40%), Murray & Roberts (+34%) and Exxaro (+32%). The worst three were Lonmin (-38%), JSE (-22%) and Netcare (-20%).

In terms of the weighted impact on the JSE, the biggest contributors were Naspers (+15%), Richemont (+17%) and British American Tobacco (+13%). The detractors were Billiton (-5%), FirstRand (-13%) and Steinhoff (-10%). The overall theme was risk-on, with a flight to quality multinationals.

Pravin Gordhan's recall and new ministerial appointments triggered a downgrade of South African debt

The long-expected fall of the guillotine has happened at last. While many had expected this to happen, it certainly is not an event to celebrate, as much as it is deserved. Just as we thought we had survived the political attacks on National Treasury at the end of December 2015 and in the third quarter of 2016, the recall of Pravin Gordhan at a critical point in an investor roadshow with international investors, creditors and ratings agencies at the end of March, proved to be the final straw. In an announcement on 3 April 2017, Standard & Poor's Global Ratings (S&P) downgraded South African government debt.

- The country's long-term sovereign foreign currency debt rating was cut a notch to a sub-investment grade ('junk' status) of BB+ from BBB-, outlook negative.
- The long-term local currency debt rating was cut to BBB- from BBB, outlook negative.
- Short-term foreign debt was similarly adjusted to B from A-3 and the short-term local debt to A-3 from A-2.
- The agency raised the concern that the contingent liabilities relating to the poorly-managed state-owned enterprises (SOEs) will further deteriorate, pressurising the fiscal prudency that is so desperately required. S&P expects state guarantee utilisation to reach R500 billion by 2020, which is about R5 billion more than National Treasury expects.

At the core of the decision was the political uncertainty arising out of the most recent cabinet changes

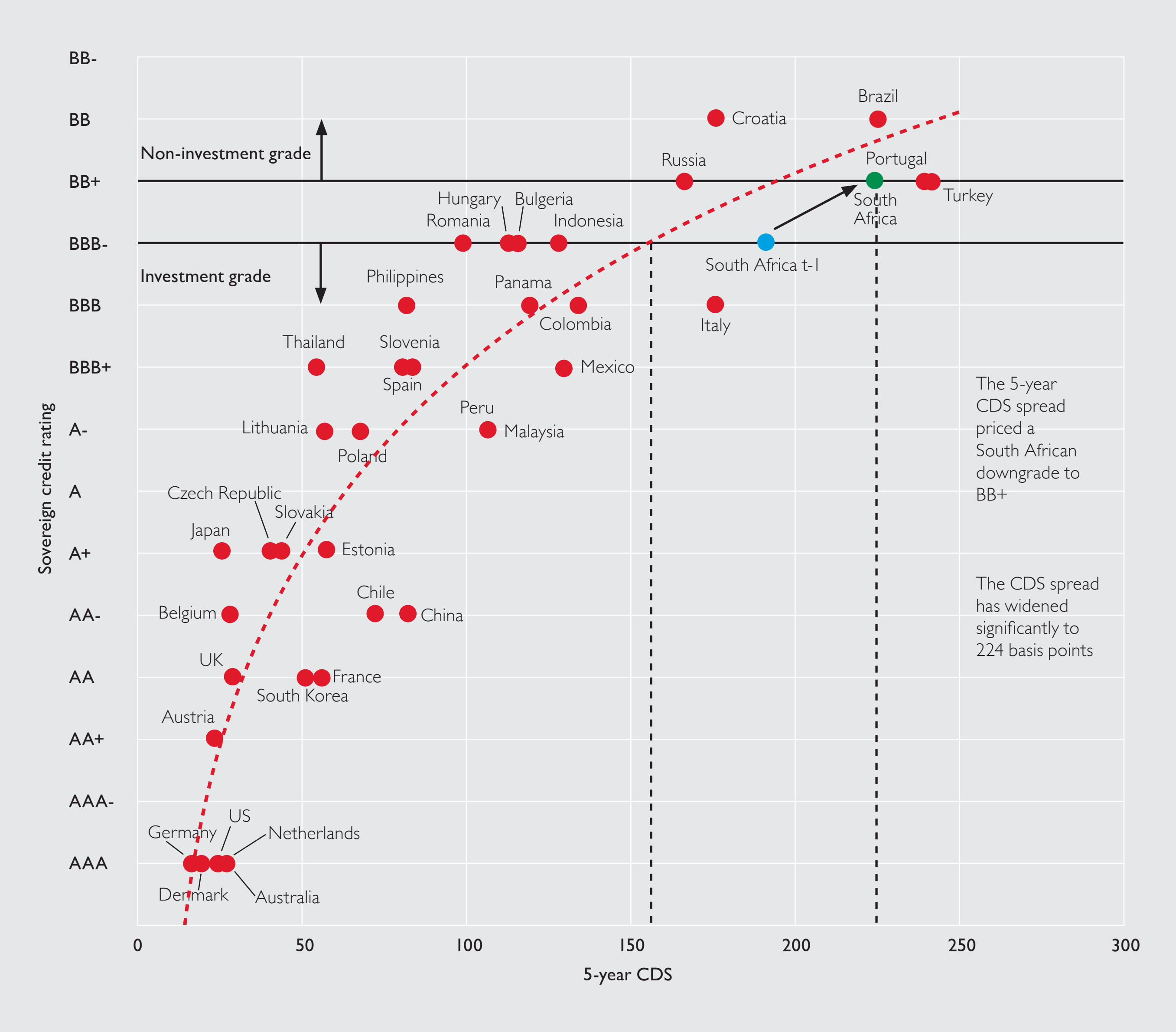
S&P had previously explained that these aspects would lead to a downgrade. The fact that the outlook on both local and foreign long-term debt is negative will keep markets concerned about more downgrades to come. If another ratings agency downgrades our debt to below investment grade, South Africa will be removed from key global bond indices and many institutional investors will be forced to disinvest because of investment mandate exclusions.

The consequences of the downgrade lead to a negative cycle of events

The downgrade-induced negative spiral is listed below and the charts that follow illustrate some of the linkages mentioned. The worst-case outcomes may include hyperinflation, rampant unemployment and a recession, which Brazil experienced and that ultimately led to the impeachment of its president.

1. The cost of financing government's borrowings goes up.
2. Currency weakness on poorer confidence initially.
3. Inflationary feed-through on imported product prices.
4. Uncontrolled fiscal expenditure requiring higher short rates to attract foreign capital as well as dampen inflation increases.
5. Negative impact on the banking sector (via rating downgrades, higher funding costs, rising bad debt) and retailers (via lower discretionary expenditure).
6. Low economic growth.
7. Another downgrade.
8. Repeat the cycle.

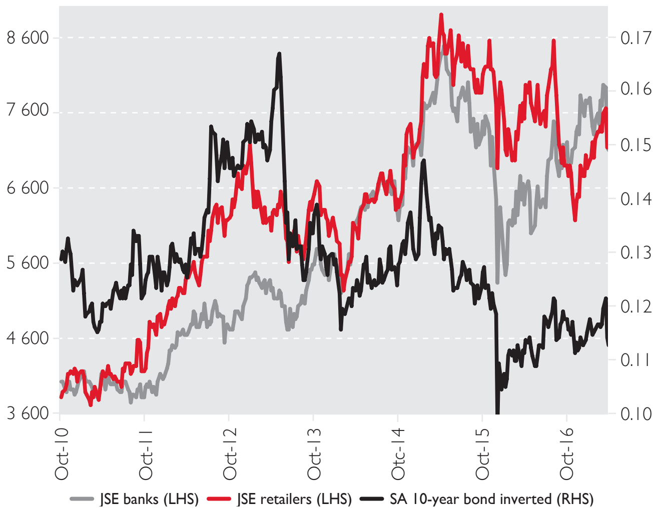
Chart 1: The impact on South Africa's credit risk



Source: Bloomberg Finance LP

Prior to the downgrade, South Africa's five-year credit default swap (CDS) premium (the cost of insuring against potential default) jumped from 191 basis points (blue dot) to 224 basis points (green dot) as the Finance Minister was replaced and the downgrade was announced. Chart 1 is instructive in that South Africa was already poorly rated relative to emerging market countries that had similar sovereign rankings. This means that a downgrade was priced in to some extent. Whereas our risk compensation model previously showed that there was some margin of safety in local bonds, the adjustment to South Africa's credit risk has eliminated this margin.

Chart 2: Banks versus retailers versus bonds



Sources: I-NET, Cadiz Asset Management

As shown in Chart 2, bond price falls are replicated in bank and retail share performance.

How could our experience be the same or different to other sovereign debt downgrades?

It's helpful to compare the impact of similar downgrades to junk status in other emerging market countries and its effect on their investment markets. In an analysis by UBS covering Thailand, Indonesia, Korea, Colombia, Hungary, Russia, Brazil and Turkey, the equity market in each case discounted the downgrade ahead of the event. On average, this universe saw share prices fall by 35% three months ahead of the event and recover by 15% three months thereafter. By comparison, our share market is 3.5% higher than it was three months ago. We would argue that this owing to the sizeable rand-hedge, multinational make-up of South Africa's benchmark index, compared to our emerging market peers.

Where to from here?

There can be little doubt that the events at the end of the quarter have raised investment risk. We are paid to manage risk. Our investment approach is designed to capitalise on the opportunities that increased volatility and irrationality present, and our portfolios are well positioned to weather the current storm.

- Within our local equity exposures, we have a substantial weighting to rand-hedge beneficiaries such as British American Tobacco, Richemont, Naspers, AngloGold, Impala and Sasol.
- We recently trimmed our overweight exposures to the banks.
- While we do have exposure to property shares, the bulk of the exposure is in UK-based real estate companies Capco and Hammerson, which we bought post the Brexit-induced sell-off.
- Our multi-asset offerings are short duration in bonds and we recently trimmed our overall allocation to this asset class. We have generally maintained above-average levels of cash.
- The recent strength in the rand enabled us to rebuild our foreign exposure back to the maximum 25% by taking more investor cash offshore for deployment into attractively-valued equities. ■

Meet our Head of Research: Razeen Dinath

by ***Razeen Dinath****,*
Head of Research

Setting the standard for achieving excellence

With a passion for learning and expanding his knowledge, Razeen is well-suited to being Head of Research at Cadiz Asset Management. He has over 10 years' experience in finance. He started his career at Allan Gray as a risk analyst and then an investment analyst, before moving on to RECM. This was followed by his roles as senior analyst and co-portfolio manager in the unconstrained division at Momentum Asset Management. Razeen has a BCom degree (with majors in accounting and statistics) and a postgraduate diploma in accounting. He sets extremely high standards, particularly for himself, which has helped him pass the first two levels of the CFA® Program on his first attempt.

What are three things that few people know about you?

1. It is very important to me to give back and help people improve their situation.
2. I have very high expectations of myself, and those close to me.
3. I try to always have a positive influence on those around me.

Who or what was the biggest influence in your life?

My mother deserves a special mention for enabling me to attend university. I also read a lot, particularly a book called *Poor Charlie's Almanac*.

Tell us a bit about your family life.

I have been married for 11 years and we recently had a boy who is now 10 months old. Although life is a bit more complicated now, it is more rewarding.

What do you do to relax?

I enjoy playing golf, being outside and in the company of my friends, more than the score I achieve. I also enjoy exercising and spending time with my family.

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

An entrepreneur. I enjoy learning and thinking about business and different business models.

Why did you become an investment manager?

I learnt about the stockmarket during my university studies. I had a hunger to learn about investing. I completed my articles and immediately sought a job within the investment management industry. I was fortunate to be accepted at Allan Gray, which put me on the path to develop my investment skills.

What's important to you at work?

Striving for excellence and continuous improvement, and trying to expand and enhance my knowledge.

Cadiz Unit Trust performance

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

Unit Trusts	1 Year	3 Years	5 Years	7 Years	Since Inception	Inception Date
No Equity Exposure						
Cadiz Money Market Fund	8.00%	7.10%	6.51%	6.43%	7.66%	01-Mar-06
Alexander Forbes Short Term Fixed Interest (STeFI) Composite Index	7.56%	6.76%	6.19%	6.17%	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	9.55%	6.72%	7.26%	7.79%	8.75%	01-Mar-06
CPI+3%	9.32%	8.73%	8.79%	8.54%	9.17%	
Quartile Rank	1st	2nd	2nd	2nd	1st	
Low Net Equity Exposure (20 - 40%)						
Cadiz Stable Fund	8.75%	5.65%			6.40%	01-Sep-12
CPI+3%	9.32%	8.73%			8.85%	
Quartile Rank	1st	4th			3rd	
Medium Net Equity Exposure (40 - 75%)						
Cadiz Inflation Plus Fund	9.15%	4.74%	7.65%	8.61%	9.12%	13-Jan-06
CPI+5%	11.37%	10.76%	10.81%	10.55%	11.21%	
Quartile Rank	1st	3rd	3rd	3rd	1st	
Cadiz Balanced Fund	9.07%	3.98%	8.26%	9.56%	9.54%	01-Mar-06
Average of the Domestic - Asset Allocation - Prudential High Equity sector	2.07%	6.40%	10.17%	9.74%	10.37%	
Quartile Rank	1st	4th	4th	3rd	1st	
Flexible Net Equity Exposure (50 - 90%)						
Cadiz Equity Ladder Fund	8.66%	0.16%	-0.02%	1.25%	6.26%	03-Jun-05
CPI+6%	12.37%	11.76%	11.81%	11.55%	11.69%	
Quartile Rank	2nd	4th	4th	4th	2nd	
High Net Equity Exposure (100%)						
Cadiz Mastermind Fund	19.54%	2.10%	6.95%	8.05%	9.41%	01-Mar-06
FTSE/JSE SWIX Index	1.59%	7.07%	13.27%	13.32%	13.23%	
Quartile Rank	1st	4th	4th	4th	2nd	

Sources: Morningstar, Cadiz Asset Management

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