July 2015

CAMmuniqué

CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

EXCELLENCE
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OF PREPARATION

cadiz
ASSET MANAGEMENT

Our investment philosophy and process

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

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

We apply our investment process with patience, diligence and focus

We identify opportunities through bottom-up fundamental analysis

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

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

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

We consider and combine opportunities both within and across asset classes

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

We only invest if there is a margin of safety

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

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ON THE FRONT COVER

SOCCER CITY - When South Africa hosted the continent's first Soccer World Cup in 2010, it needed a focal point. That point was Soccer City - the gargantuan 94 736 person capacity stadium in Soweto. Built on the site of Chris Hani's funeral and Mandela's post-prison speech, seldom before have architectural beauty and cultural relevance combined so significantly. And it is this combination of artistry and science that makes a few truly excellent.

Introduction

The seasons of the markets are hard to predict

Just like the seasons, investment markets also follow cycles. They typically shift between periods of extreme optimism and extreme pessimism. Coupled with this, not all asset classes move in the same direction at the same time and to the same degree. In theory, this knowledge of the cyclicality of asset class prices should make it easier to make smart asset allocation decisions to improve an investment outcome. The trouble is that while we know when to expect winter, spring, summer and autumn to start, the cycles or seasons of the markets are a little harder to predict.

As investors, we are often so consumed with the current markets, the latest news and 'predictions' that we can lose sight of the fact that a new season or start of a new cycle could be just around the corner. Most of the time, irrespective of the opinions of so-called investment experts, it is only in hindsight that the change in markets becomes apparent.

To make smart investment choices when interest rates rise we need to focus on valuations

Value investing tries to capitalise on the very investor sentiment and emotions that cause prices of securities to increase (or fall) wildly beyond their intrinsic values. The difference of under or over valuation becomes the margin of safety that we, as value investors, aim to benefit from.

Remaining objective and focusing on key drivers of asset prices rather than the hype in the financial press is vital to wealth creation. Interest rates are one such driver and are expected to increase in the second half of the year in the US and South Africa. Interest rates have a significant impact on the future value of an asset. Assessing the opportunities beforehand and being prepared can improve long-term returns by reducing the risk of capital loss.

One glance at current market valuations shows that all asset classes are currently expensive

Risky asset returns have been nothing short of superb over the past few years. Over the last five-year period, the FTSE/JSE ALSI has returned 18% per annum, compounded. Listed property has yielded 21% and South African bonds have returned 9% over the same period. Even cash has outperformed inflation. This is unlikely to continue.

Change in the market cycle may be overdue, but just like the seasons, winter in markets will arrive

Nothing remains positive forever, and the fact that winter may arrive late, doesn't mean it won't arrive. With this as context, our advice to investors is that:

1. You should remain cautious as volatility is bound to increase.
2. Cash may provide a safe but temporary 'parking bay' if you cannot sit out the volatility.
3. Diversify your investments as the age-old wisdom applies: don't put all your eggs in one basket – ever.

Our multi-asset class portfolios are positioned for uncertainty

Our multi-asset class portfolios are overweight cash and maximum overweight foreign equities, especially developed market equities. This foreign exposure gives us currency protection. We are underweight local equities. South African shares that offer offshore exposure and trade at attractive prices are also included in the portfolios to add more diversification. We are underweight the property sector after its stellar performance up to the end of the first quarter. This sector had simply become too expensive, to the extent that the dividend yield had fallen below the yield on cash.

Francois van Wyk
Chief Investment Officer

Where to invest
Benefiting from rising interest rates

by **Brian Munro**,
Investment Strategist

The uncertainty and volatility of the current economic environment combined with imminent interest rate hikes in South Africa and the US provide a challenge for achieving good investment outcomes. However, investors can protect their portfolio from interest rate risk by investing in floating rate instruments. Two examples are floating rate bonds, on which the interest paid increases as rates increase, and preference shares, where dividend payments are linked to the prime overdraft rate. To make an informed decision about floating rate instruments, it is essential to consider the market's expectations about interest rate increases as well as the complete risk/return profile of the instrument. We believe our portfolios' carefully considered exposure to corporate bonds should give investors higher income growth as rates rise.

Investors should remain cautious

In last quarter's article we argued that now is not the time to be greedy and cautioned investors to focus on capital protection instead of chasing performance. With the recent volatility experienced in both the local equity and bond markets, this has proved a worthwhile strategy. However, we still have some time to go and would recommend that investors remain cautious.

The current economic environment holds various challenges

The main concerns facing South African investors are:

- When will the US Federal Reserve start normalising interest rates?
- When will the South African Reserve Bank (SARB) hike interest rates?
- How will financial markets react to the eventual hike in rates?

In both cases, markets are expecting interest rates to have increased by 0.25% by year-end. However, it's questionable whether this is already priced in by the market.

Floating rate instruments can provide protection against rising rates

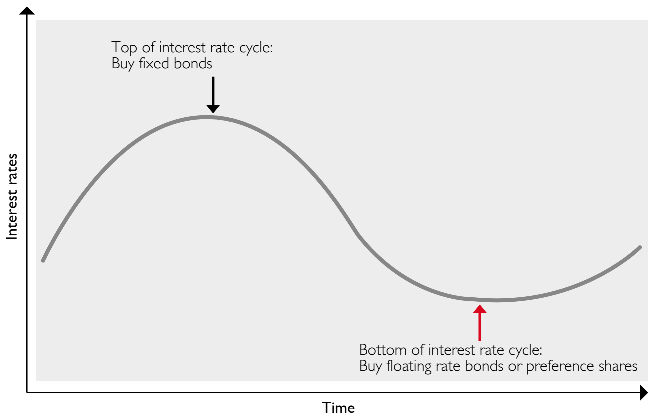
In a rising interest rate environment, investors are often more risk averse towards bonds as an asset class. However, there are low risk bonds that can protect investors from the risk of rising interest rates. Floating rate bonds pay a variable monetary sum (coupon) that is linked to interest rates. As interest rates rise, the coupon increases. Preference shares behave in a similar fashion, where their dividend payments are linked to the prime overdraft rate. As Figure 1 highlights, it is better to buy a floating rate bond or preference share at the bottom of the interest rate cycle.

Investors should consider market expectations about rate hikes

It is also important to consider the market's expectation of how quickly and to what level interest rates will rise.

Currently, the market is expecting a gradual interest rate hiking cycle in South Africa and in the US. If, for example, interest rates were to rise more quickly than expected, then the demand for floating rate bonds would increase as they hedge against this increased risk. At the same time, the risk of fixed coupon bonds incurring a capital loss would increase.

Figure 1: When to buy different interest-bearing assets according to the interest rate cycle



Source: Cadiz Asset Management

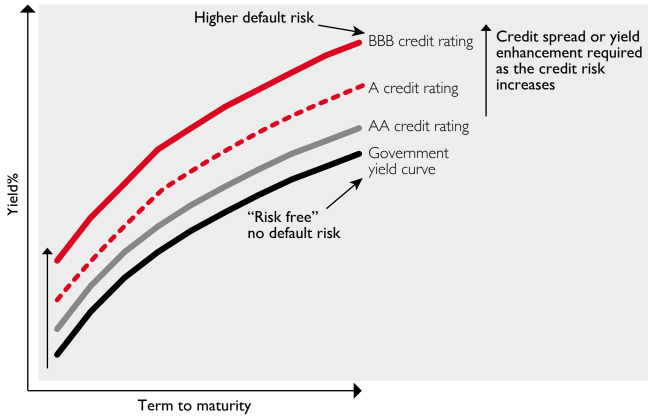
Understanding the instruments' risk/return profile is crucial

Within the asset class of floating rate instruments the main two asset classes are:

1. Floating rate corporate bonds, which is linked to the Johannesburg Interbank Agreed Rate (JIBAR). As JIBAR increases, the interest paid on the bond increases.
2. Preference shares, which pay dividends every six months. The dividend paid is linked to the prime overdraft interest rate, so as prime increases, the dividend will also increase.

A key consideration when buying floating rate instruments is the risk that the issuer (or borrower) will default on their obligations. This risk, also called the credit risk of the bond, ranges from risk free (government instruments), to moderate risk (parastatals and bank instruments) to high risk (typically corporates and preference shares). Investors buying these instruments want to be compensated for the additional risk and, as a result, demand a higher return (or credit spread) for holding these riskier instruments. Figure 2 illustrates the additional yield required to compensate investors for the additional risk of corporate bonds for different maturities.

Figure 2: Credit spread (yield enhancement) for different credit rating bonds



Source: Cadiz Asset Management

We see value in corporate bonds

We have been monitoring the performance of these floating rate instruments and their attractiveness, especially after the collapse of African Bank in August 2014 where corporate bond yield spreads rose significantly. Markets often overreact to an event like this, which can provide a great opportunity to invest. In this case, the opportunity enabled us to increase our exposure to floating rating corporate bonds and preference shares, which should add value to our portfolios' performance going forward.

On a relative basis we believe that corporate bonds offer better value than preference shares. This is after adjusting for the credit risk of the underlying instrument and its position in the capital structure.

For the retail investor who wants to invest directly, preference shares are offering value relative to cash, especially on an after-tax basis. These shares currently have an expected dividend yield of 8.9% over the next year. This translates into an after-tax return of 7.6% compared to the after-tax return of 4.5%[1] for cash.

Our investors should enjoy higher income growth amidst rate hikes

To protect your portfolio from interest rate risk as rates rise, we recommend holding cash and floating rate instruments such as preference shares and corporate bonds. Clients invested in our Money Market Fund, Absolute Yield Fund and multi-asset funds, from the conservative risk Cadiz Stable Fund to the moderate risk Cadiz Inflation Plus Fund, should all benefit from our exposure to these floating rate assets by enjoying higher income growth as interest rates rise. ■

Why invest longer out on the yield curve?

by *Jonathan Myerson*,
Head: Fixed Interest

In addition to finding value in floating rate bonds, Jonathan Myerson explains in this article the value that is currently available in long-dated bonds. The Cadiz Unconstrained Fixed Income Fund and the Cadiz Absolute Yield Fund are positioned to take advantage of these attractive opportunities.

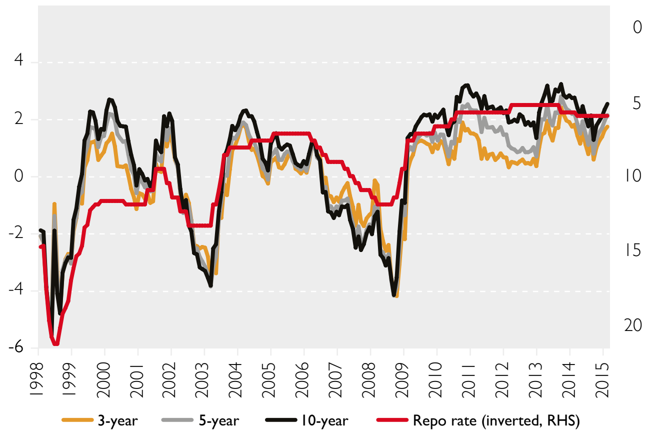
Interest rate hikes are typically negative for long-dated bonds and investors should try to minimise their interest rate risk during an interest rate hiking cycle. However, if (as is currently the case) these instruments fully price in the most likely hiking cycle, they can provide investors with a margin of safety. In fact, we see value in the three- and five-year bonds as their current valuations provide a significant 'cushion' against the risk that the repo rate might rise more than expected.

Despite expected rate hikes there is value in the longer dated end of the yield curve

Conventional wisdom tells us that an interest rate hiking cycle is negative for long-dated bonds. However, we are currently seeing value in the longer dated part of the yield curve.

The longer dated end of the South African yield curve has sold off significantly since its January 2015 rally, as both domestic and international factors have turned negative. The yield on the long-dated R2048 government bond has moved from 7.77% to 9.05%, which translates into a 13.2% decline in capital value. The significant sell-off in the longer end of the yield curve has taken place over a time that the repo rate – the base rate set by the South African Reserve Bank (SARB) – has remained unchanged. While the repo rate and the yield on long-dated bonds do not move in lockstep, the yield of the long-dated bond should equal the average future repo rate, plus a fair risk premium (also called the term premium). The longer the term to maturity of a bond, the higher the term premium. Chart 1 shows the historic term premium for 3-, 5- and 10-year bonds in the South African market.

Chart 1: Historical spread between bond yields and the repo rate (1998-2015)



Source: Bloomberg

Chart 1 also shows that the term premium is close to its highest level since 1998 – all three maturities (3-year, 5-year, and 10-year) are around 1.25 standard deviations above their long-term average.

The interesting point to observe from the chart is that the yield curve has previously inverted when the repo rate rises (in other words, the long end of the curve does not rise as much as the repo rate). This phenomenon is not surprising. Investors are aware that the SARB will increase the repo rate (which is a short-term rate) to insure that the inflation rate does not exceed the 6% upper end of the inflation target on a permanent basis.

Longer-dated bonds have priced in the repo rate hikes

Since 1998, the yield curve has inverted on three occasions – each time as a result of a hiking cycle that was triggered predominantly by a currency shock. Table 1 shows the details of each of the hiking cycles.

Table 1: South African repo rate up cycle

Start and end date	Term of cycle	Repo rate		Repo rate change
		At start	At end	
April 1998 - August 1998	5	14.93%	21.86%	6.93%
January 2002 - September 2002	9	9.50%	13.50%	4.00%
June 2006 - June 2008	25	7.00%	12.00%	5.00%

Source: South African Reserve Bank

No interest rate cycle is identical to the previous one. The last three cycles varied in term (from 5 months to 25 months) and in magnitude (from 4.00% to 6.93%). The current hiking cycle is already 18 months old, and will likely continue for at least another 21 months. The total magnitude of the hiking cycle is priced to be 2.5% (from 5.0% to 7.5% priced in the Forward Rate Agreements - FRAs).

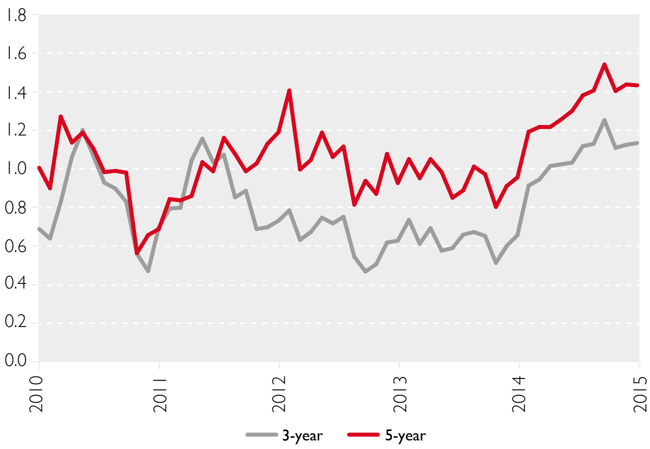
As we discussed in some detail in previous issues of CAMmuniqué, investors should minimise their interest rate risk during a hiking cycle. The rationale for this is that as yields rise, the value of a fixed rate bond declines. This means that fixed rate bonds should currently be out of favour. However, there are times that longer-dated bonds have fully priced the hiking cycle and therefore provide a sufficient risk premium to entice investors. The current implied path of the repo rate (from FRAs) is pricing in the full extent of the Bloomberg consensus forecast repo rate; as well as a healthy risk premium in case the repo rate continues to rise by more than the current forecast.

It is probably not surprising that longer-dated bonds have priced in the future path of the repo rate as the market has had a very long time to digest the SARB's intentions. Both the current Governor of the SARB and his predecessor have communicated very clearly that we are in a tightening monetary policy cycle. While there is obviously some uncertainty around how high the repo rate might ultimately go and how fast, the fact that we have been in a tightening cycle for the past 18 months suggests that investors would have priced in the likely future path. The extent to which the market prices the hiking cycle has varied significantly in the past. For example, the month before the first rate hikes in 1998 and 2002, the market was still pricing in a repo rate cut. In 2006, the market was still not pricing in any rate hikes only six weeks before the beginning of the repo hiking cycle. Currently, as mentioned above. FRAs have been pricing further rate hikes to varying degrees since the beginning of the hiking cycle in January 2014.

Should you invest in call deposits or longer-term investments?

The analysis above (comparing the repo rate to government bonds) demonstrates that the risk of further repo rate hikes resulting in a significant rise in longer-dated bond yields is small. However, for the purpose of deciding on whether to invest in call deposits or longer-term investments, it is useful to use Negotiable Certificates of Deposits (NCDs) for comparison. This helps ensure that there is no credit risk difference between the two alternatives. Banks issue NCDs with maturities from one month to five years. Chart 2 shows that the yield differences (spread) between the yield on three- and five-year NCDs and the three- and five-year government bonds are at extremely high levels.

Chart 2: Yield spread between three- and five-year NCDs and government bonds (2010-2015)



Source: Bloomberg

At yields of 8.52% and 9.24% respectively for the three- and five-year NCDs, there is a significant 'cushion' for the risk that the repo rate might rise above the current expected future rate. Furthermore, at these yields investors should be able to receive a real return of at least 3%.

Which funds would benefit from these attractive valuations?

Flexible fixed income funds such as the Cadiz Unconstrained Fixed Income Fund and the Cadiz Absolute Yield Fund aim to take advantage of the type of opportunities discussed above. The Unconstrained Fixed Income Fund's objective is to maximise both income and capital return, which means the Fund tolerates a higher level of volatility by definition. The Cadiz Absolute Yield Fund focusses more on providing high and consistent income returns, while being more conservative and less volatile. ■

The (dis)comfort of certainty and safety when investing in equities

by ***Graeme Ronne****,*
Equity Analyst

The local equity market is currently more divergent in performance than it has been over the past 50 years. Investors appear to feel 'safe' and comfortable that the popular stocks driving the market will continue to provide favourable risk-adjusted returns. They are willing to pay more for assets whose outcomes are perceived to be predictable and certain. There is however a danger to overpaying for perceived certainty and growth. What matters is the price paid for an asset, not the illusion of certainty and the allure of growth. The best investments are often those that feel most uncomfortable as the risks are typically well publicised and already discounted in the share price.

The bull market continues

The South African equity market continued to grind higher over the first half of 2015, returning 5.6% year-to-date. The key themes driving the current bull market remain largely unchanged: search for yield, earnings certainty and rand hedge exposure. Industrials continued to edge higher while resources fell back further. At no point in the past 50 years has the local equity market been this divergent in terms of performance. The phrase 'we live in interesting times' springs to mind, often used to describe somewhat uncertain and murky conditions. Yet, market participants appear quite comfortable and 'safe' in the certainty that the popular stocks fitting these themes (large cap industrial multinational stocks) will continue to provide adequate risk-adjusted returns.

What makes people feel safe when investing?

Humans are by nature social creatures. We find comfort in the crowd and in consensus opinion. After all, if everyone else thinks it's a good idea, they surely can't all be wrong? We also have a tendency to extrapolate the present into the future. When things are going well we expect them to continue and vice versa. In investing, these behavioural biases often provide us with an illusion of certainty and a false sense of comfort. However, it rarely pays for investors to do what feels comfortable, because it is at these times that investment risk is highest.

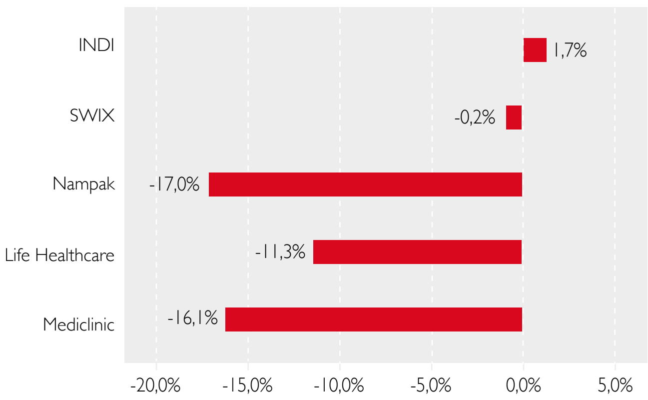
The dangers of overpaying for certainty and growth

As investors we deal with imperfect information and uncertainty. We are never going to have all the facts and we don't know with certainty what the future holds. To make provision for these realities, we invest with a margin of safety and hold a diversified portfolio.

The healthcare sector has been the poster child of the current bull market, ticking all the boxes in terms of the popular market themes. The sector includes high quality businesses with earnings that tend to be relatively stable, run by very competent people. As a result, investors have been prepared to pay more for assets whose outcomes are perceived to be predictable and certain. The same holds true for 'growth' assets, especially in a low-yield environment.

Recently, the share prices of companies like Mediclinic, Life Healthcare and Nampak have come under pressure for missing market earnings expectations, with negative consequences for investors (as shown in Chart 1).

Chart 1: Returns for the three months ending 30 June 2015



Source: I-NET Bridge

While some of these companies will continue to perform well operationally, the scenario highlights the dangers of overpaying for certainty and growth. In reality, there is always uncertainty and many known as well as unknown risks. What matters is the price paid, not the illusion of certainty and the allure of growth.

The market is increasingly short-term focused

The search for yield in a low-yield environment has forced many investors up the risk spectrum into equities and, as prices continue to rise, complacency appears to be taking centre stage. However, the case for buying something with the expectation that someone will bid the price higher remains extremely uncomfortable. This is being aggravated by an increasing short-term focus. For example, net inflows by retail investors in local equity funds since October 2014 have exceeded cumulative inflows since 2008. Investors drive prices and prices drive investors. With the local equity market trading at elevated price to earnings (PE) ratios compared to history and the prospect of rising interest rates on the horizon, now is the time for caution.

The best investments are often those that feel most uncomfortable

When we do something new for the first time, we often have mixed feelings of excitement and the fear of an unknown outcome. This is similar to buying unloved, cheap shares. There is typically lots of bad news, a string of poor financial results and a falling share price. The more the share price falls, the more negatively it affects investors' views of the underlying fundamentals (and vice versa) and the perceived risk level of the investment. People are hard-wired to think in narratives, framing the investment into a story that weaves together reason and emotion in order to feel comfortable with their decision. However, our objective as investors is to identify gaps between the underlying fundamentals of the business and the expectations implied by the share price. What matters is reconciling the story with the fundamentals and the valuation.

We focus on finding opportunities with asymmetric payoffs

The impact of central bank activity on the current investment landscape has made it extremely difficult to make sensible investment decisions. Our response has been to revisit the underlying principles of our philosophy, because they keep us on track and provide a clear understanding of what we aim to achieve. In short, we take a long-term view and look for opportunities where the downside is largely reflected in the share price but with significantly more upside, providing an asymmetric payoff.

For example, Barclays Africa is one of the largest holdings in client portfolios. The stock sells for 10.5X 2015 earnings, which are expected to grow around 13%, and a prospective dividend yield of 5.7%. The company has until recently struggled operationally for a number of years. However, we believe this is fully reflected in the PE ratio, which is at a significant discount to the peer group (10%) and the market (38%). Contrast this with the industrial index, which sells for 20X 2015 earnings, with similar earnings growth as Barclays Africa, and a prospective dividend yield of 2.5%. In our view, Barclays Africa is an example of an opportunity with an asymmetric payoff profile, as both the PE ratio and earnings are well below trend, compared to the market where both are well above trend.

In summary, its rarely pays for investors to do what feels 'safe' and comfortable, as the prices for these popular shares have discounted most of the good news. Investors are reminded that there is no certainty in investing. Overpaying for popular shares increases your risk of a permanent loss of capital as your return is determined by the price you pay for an asset. More often than not, the best opportunities are those that feel most uncomfortable, as the share has discounted most of the well-publicised bad news. We refer to this as an asymmetric payoff – limited downside but significantly more upside. ■

South Africa's low economic growth is structural

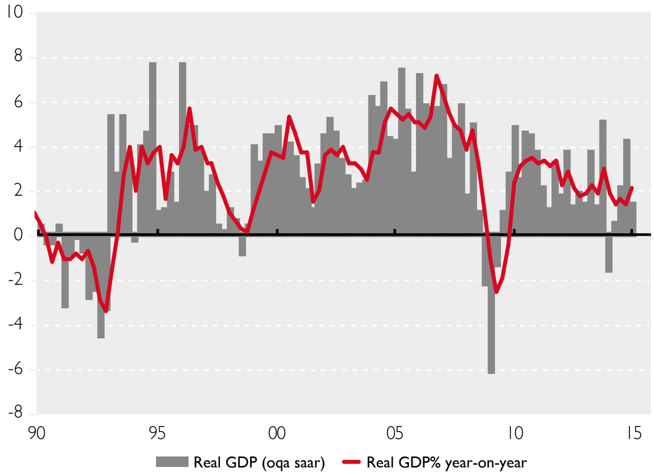
by **Adenaan Hardien**, Economist

Despite South Africa entering its third decade of democracy, economic policy discourse still largely revolves around the need to correct pre-1994 legacy issues. In this article, Adenaan Hardien explains the impact of policy failure on growth prospects. Load shedding is just one case in point, reflecting a failure to respond to the needs of a growing economy through timeous investment. Without appropriate and aggressive policy responses to ease multiple and growing bottlenecks, growth will remain stuck at rates that are inadequate to address major socioeconomic challenges like unemployment. Likewise, calls for easier monetary policy are misplaced, since the lack of growth is more structural than cyclical. In fact, the inflationary cost of overstimulation through low interest rates in this environment is that much greater.

Growth performance and prognosis have been poor

Recent growth figures were disappointing, as shown in Chart 1. After annualised growth of 2.1% and 4.1% over the third and fourth quarters of 2014, the economy grew by only 1.3% over the first quarter of 2015. For 2014 as a whole, the economy grew by 1.5% compared to 2.2% a year earlier and the post-1994 annual peak of 5.4% in 2006.

Chart 1: Real GDP growth has weakened since 2007



Sources: Statistics South Africa and Cadiz Asset Management

Near-term growth prospects are not good. The South African Reserve Bank (SARB) projects growth of 2.1% in 2015 and 2.2% in 2016, with an increase to 2.7% in 2017. The risks to these forecasts are stacked to the downside. Load shedding should continue for a number of years, labour-related disruptions are an ongoing risk, rand prospects remain uncertain, and business and consumer confidence remain weak.

The economy has hit binding constraints

Public Enterprises Minister Lynne Browne warned recently that electricity supply will remain tight until 2018, which means load shedding will likely remain a major headache over the medium term. But more importantly, load shedding is a symptom of a more pervasive problem. Weak growth is not just a function of temporary headwinds; it rather shows that the economy lacks the capacity to sustain higher rates of growth.

Although insufficient electricity infrastructure may be the most prominent binding constraint facing the economy, other network infrastructure is also in urgent need of upgrade and expansion. This includes rail and land transport. ports, water and telecommunications. In addition, South Africa's labour market remains hamstrung by a skills mismatch – a shortage of skilled labour and an abundance of unskilled labour, indicating policy challenges in education, labour and migration. Furthermore, product markets are characterised by limited competition, which penalises small businesses, especially in network industries dominated by state-owned enterprises

The electricity bottleneck was avoidable

South Africa's electricity challenge bears special focus since the country had been here before and the current situation was predicted early enough. An inadequate supply of generation capacity from the mid-1970s to the early-1980s led Eskom to undertake a massive build programme that resulted in big surplus capacity by the mid-1990s. A reserve margin of between 15-20% is required to prevent load shedding – Eskom enjoyed a reserve margin of 40% in 1994, which led it to mothball power stations. By the mid-2000s the utility had however run out of surplus capacity despite ample warning.

Although a government White Paper published in 1998 warned that the country would run out of generation capacity by 2007, the cabinet only gave Eskom the go-ahead to expand its capacity in 2004 and construction on a series of megaprojects only started in 2007. The first episode of load shedding due to capacity constraints happened in 2008.

The three most notable megaprojects are the Medupi power station, the Kusile power station and the Ingula pumped storage scheme. These projects have all been held back by ongoing delays and cost over-runs. The first of six Medupi units was initially scheduled to come on-stream in 2011 and the last was scheduled to be operational by 2015. However, the first of the six Medupi units is still in the process of being synchronised to the grid and the other units look set to be delayed further. Medupi and Kusile were initially budgeted to cost R70 billion, but recent cost estimates are around R105 billion, excluding capitalised borrowing costs.

There are many lessons to be learnt from Eskom's current troubles. Government delayed giving Eskom the go-ahead because it did not recognise the urgency of the problem highlighted by its own experts and it wanted to reduce Eskom's monopoly. Eskom continued to focus on big greenfield projects that are susceptible to unpredictable cost escalations, instead of smaller tested technology. The push for big nuclear power despite serious objections is especially paradoxical.

Cyclical and structural headwinds require different policy measures

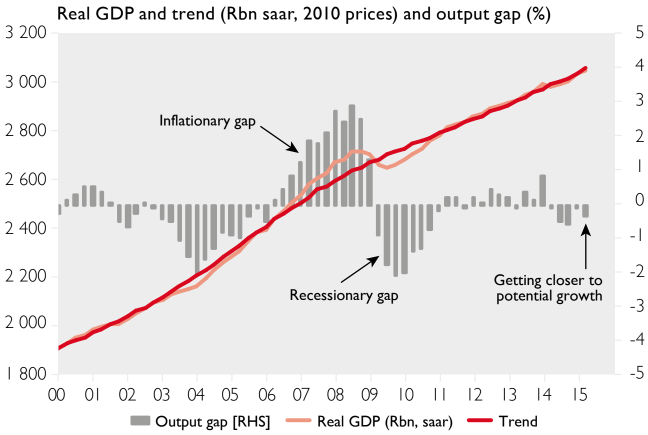
Whether an economy's growth is restrained by structural, (permanent) or cyclical (temporary) headwinds has important implications for policy. Monetary stimulation through lower interest rates and expansionary fiscal policy can be used to speed up a recovery following cyclical headwinds. But these policy measures are ineffective when dealing with structural challenges to growth, which require more far-reaching macroeconomic policy initiatives that target the underlying structural inhibitors to growth.

The solution is a multi-faceted development programme with multiple macro and micro interventions, which exists in the form of the National Development Plan. However, although it has been accepted as official policy by the ruling party and supported by major opposition parties, implementation remains a challenge, especially because the ruling party still needs to secure buy-in from its supporter base and its alliance partners.

Growth potential and the output gap

Structural constraints reduce a country's growth potential. But boosting growth through interest rate cuts can fuel inflation. This is why the SARB has been making more frequent reference to South Africa's growth potential and output gap (illustrated in Chart 2) when deflecting criticism to its tightening monetary policy bias.

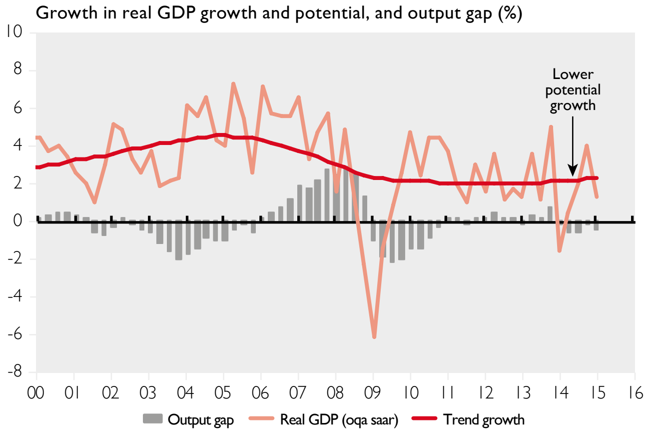
Chart 2: South African GDP is close to its potential output, with a small recessionary gap



Sources: South African Reserve Bank and Cadiz Asset Management

Estimates of South Africa's potential growth varies, but all estimates show that it has declined sharply in recent years, as shown in Chart 3. Our research suggests that South Africa's potential growth has declined from around 4.0% in 2006 to 2.0% in 2014. A recent study by the SARB estimates that South Africa's potential growth rate has declined from 4.0% in 2007 to 2.5% in 2013* which is also the current IMF estimate**.

Chart 3: Growth potential has been in decline since 2007



Sources: South African Reserve Bank and Cadiz Asset Management

The implications of a low growth potential are severe

There is no quick fix. South Africa's current low growth rates are structural rather than cyclical. Boosting growth beyond its potential through low interest rates is likely to be inflationary, and therefore self-defeating. The real challenge is to boost South Africa's growth potential by removing the current bottlenecks to growth. This requires multipronged macroeconomic policy initiatives, and implementing the National Development Plan is a start. However, as load shedding has shown, each day's delay means slipping further into the void. ■

*Anvari, et, al.. 2014
** IMF Article IV: SA 2014

Quarterly review

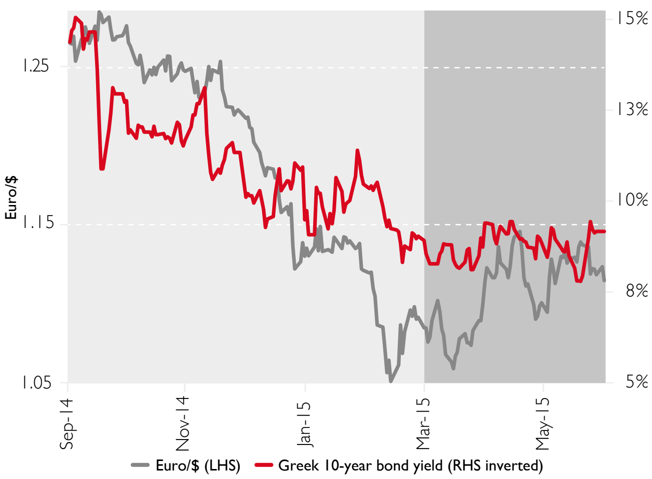
*by **Matt Brenzel**, Portfolio Manager*

INTERNATIONAL

Greece, China and Germany – the main role players of the past quarter

Equity markets started strongly in April, but then subsided in May and June. The following three charts summarise the factors that switched the mood from 'risk on' to 'risk off'.

Chart 1: Greece continued to be problematic

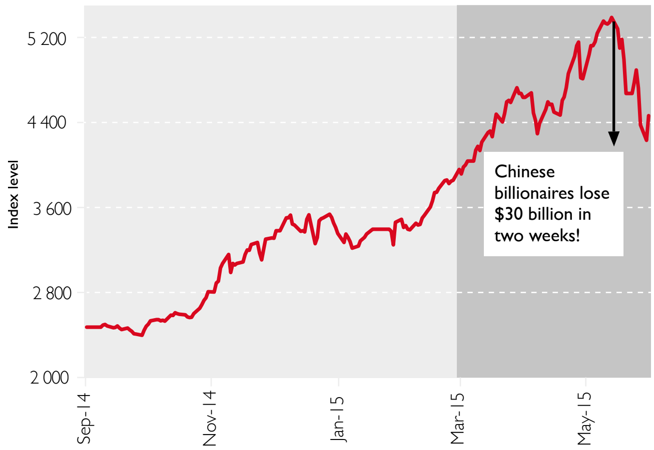


Sources: I-NET, Cadiz Asset Management

The first Greek default was apparently recorded in 4 BC after borrowers walked away from their obligations to pay off the building costs of a new temple in Delos. Neither the fear of godly retribution then nor the prospect of having to face German Chancellor Angela Merkel now has turned the Greek nation from its history of overspending and under-collecting. According to recent calculations, Greece owes its official lenders €250 billion. The repayment schedule obviously extends over a long period of time. However, investors have been spooked by the missed payment of €1.6 billion to the IMF at the end of June and the prospect of skipping the July and August payments of €6.7 billion due to the European Central Bank (ECB). On the back of this uncertainty, the Greek bond market and the euro continued to perform poorly, as shown in Chart 1.

Given the inflexibility of both debtor and creditor nations, the Greek leadership surprised by passing the decision on whether to accept the demands of the IMF, the ECB and the Eurozone to the Greek populace via a referendum to be held in early July.

Chart 2: The Chinese A-share market has come off the boil

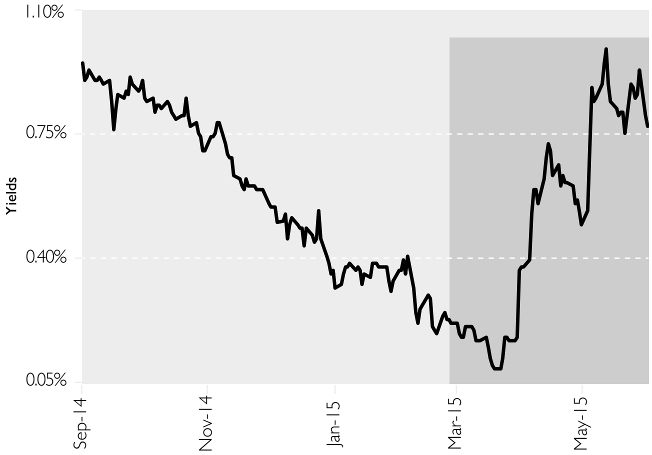


Sources: I-NET, Cadiz Asset Management

Attempts by the Chinese authorities to reform their economy have been like trying to flatten a balloon – it just leads to a bubble elsewhere. Between limiting investments in the now notorious trust funds, aggressively cutting back on infrastructural spending by state-owned entities (SOEs), clamping down on bribery and corruption, lowering reserve requirements for the banks, and dropping official interest rates in the face of a weak property market, the Chinese equity market took off like a rocket.

The average Chinese investor found a new wealth outlet. The 150% rise in the A-share index since the end of June 2014 galvanised the desire for more as investors aggressively opened margin accounts. Corporates were only too keen to take part in the feeding frenzy and over 200 initial public offerings have been conducted year-to-date. The balloon popped in the last two weeks of June, as shown in Chart 2. More on prospects for this market later.

Chart 3: German 10-year bonds blow out



Sources: I-NET, Cadiz Asset Management

Bill Gross, who started and ran one the world's largest bond funds at PIMCO and then left last year following a series of wrong investment calls, redeemed some esteem by calling the German bond market 'the short of a lifetime' in April this year. German bond yields had been driven to excessively low levels by their status as the European bond haven and the expectation that there would not be sufficient bonds available once the ECB launched its quantitative easing-based bond buying programme. Yields rapidly reversed course (as shown in Chart 3) as inflation in Germany as well as the broader Eurozone region rose by more than anticipated. More relevant though is that German bond yields rose in sympathy with rising bond yields around the world, led by the US.

We have often argued that the spectacular bond market returns of the past few years are unsustainable. Although the macroeconomic environment has been supportive of lower bond rates (weak growth, no price pressure), this is changing as the US, UK and German economies achieve a more sustainable growth path. From a macro perspective, a normalising yield curve (long bond rates being higher than short-term rates) is unequivocally good news as it implies an increase in economic activity. From a risky asset perspective however, it also signals a rise in inflation, which is typically controlled via tighter monetary policy. This is not good news for equity markets and represents the 'winter' that Francois van Wyk comments on in his introductory note.

Table 1: International equity market returns

International (US$)	Quarter	YTD	12 Months
MSCI World	0.5%	3.0%	2.0%
MSCI Emerging	0.8%	3.1%	-4.8%
MSCI SA	-0.6%	2.7%	-1.1%

Source: Bank of America Merrill Lynch

Looks can be deceiving

The MSCI global market returns for the second quarter changed little in US dollar terms. Table 1 shows that the MSCI World Index was up 0.5% (+2.5% in the first quarter), emerging markets were up 0.8% (+2.3% in the first quarter) and South African equities were down 0.6 (+2.5% in the first quarter). However, there was a substantial amount of volatility within the quarter. Most of this came through in June on the back of the Greek and Chinese issues. As a result, emerging markets fell 2.5% in the month and world markets lost 2.3%.

So where would you have made the best and worst returns in the past quarter? The top three performing asset classes were Russian government bonds (+9%), Irish equities (+8%) and ironically, Greek equities (+7%). The three worst performing markets were Greek bonds (-15%, which means there was a 22% performance difference between Greek bonds and equities), Indonesian equities (-13%) and German equities (-7%).

LOCAL

Local macro data was generally worse than expected

The following local macro data release stood out the past quarter:

- South Africa's first quarter GDP report showed that economic activity slowed substantially after its fourth quarter 2014 spurt. GDP grew by an annualised 1.3% over the quarter, following growth of 2.1% and 4.1% over the third and fourth quarters of 2014. The fourth quarter rebound was largely driven by manufacturing. Likewise, the weaker outcome during the first quarter of 2015 was mainly due to a reversal of manufacturing's fortunes as the sector continued to grapple with the effects of load shedding.
- On the positive side, the country's current account deficit narrowed to 4.8% of GDP in the first quarter of 2015, from 5.1% in the final quarter of 2014. The improvement was largely due to a sharp increase in dividend inflows, rather than an improvement in South Africa's trade balance. That said, the trade balance did swing from a R1.4 billion deficit in April to a R5.0 billion surplus in May.
- The South African Reserve Bank (SARB) Monetary Policy Committee (MPC) left the repo rate unchanged at 5.75% at its third meeting of the year in June.
- The MPC flagged electricity tariffs, the rand and wages as key upside risks to its inflation forecast. The tone of the statement was hawkish, which fits our expectation that the hiking cycle will start in the third quarter of 2015.
- Ratings agency Fitch affirmed South Africa's BBB rating on foreign currency debt and BBB+ rating on domestic debt and maintained a negative outlook. Standard & Poor's had similar ratings and maintained a stable outlook.

Table 2: South African financial market returns

Asset Class (ZAR)	Quarter	YTD	12 Months
All Share	-0.2%	5.6%	4.8%
All Bond	-1.4%	1.6%	8.2%
Listed Property	-6.2%	6.6%	27.0%
Cash	1.6%	3.1%	6.3%

Tier-1 (ZAR)	Quarter	YTD	12 Months
Resources	-4.9%	-5.0%	-28.8%
Financials	-2.3%	8.6%	20.9%
Industrials	1.7%	7.4%	14.0%

Size (ZAR)	Quarter	YTD	12 Months
Large Cap	0.7%	6.4%	3.4%
Mid Cap	-6.4%	0.7%	11.7%
Small Cap	1.5%	4.7%	13.7%

Source: Deutsche Bank

Cash over shares over bonds and property

After experiencing a great first quarter, listed property shares declined in the last three months. The kick-up in bond yields took some of the shine off these long duration assets. Within bonds, most of the damage was done at the long end of the curve (12+- year bonds).

Resources

- At first glance, basic materials had a fairly muted month. Within this composite though, the gold and platinum shares were down 17% and 12% respectively. The collapse in the palladium and rhodium prices was largely responsible for dragging the platinum basket price down to a level last seen at the end of 2013.

Industrials

- Industrials was the worst performing sector with the hugely volatile construction shares (-8%) on the back foot again.
- In line with international peers, the highly popular and valued health care shares came down hard: MediClinic (-16%), Netcare (-8%) and Life Healthcare (-11%).
- MTN (+12%) was the top performing share on a weighted basis for the quarter and provided most of the upside for telecoms. Telkom fell by 19% following a more muted release recently.

Financials

- Within financials, only Investec (+9%) and offshore property developer Capital & Counties (+15%) showed any inclination to run in the right direction. Banks (-3%) and insurance (-6%) suffered under the whiplash of Greek events.

Table 3: Breaking down the -0.2% return of the FTSE/JSE All Share Index (ALSI) by sector

All Share	Oil & gas	Basic materials	Industrials	Consumer goods	Health care	Consumer services	Telecoms	Financials	Technology
-0.2%	139.7%	-0.9%	-3.8%	0.6%	-8.6%	2.1%	9.3%	-2.3%	2.0%

Source: Deutsche Bank

Where to from here?

The investment markets will likely be dominated by the following in the next quarter:

1. *What will be the outcome of the Greek referendum votes?* As this publication went to press, early polls indicated that views were fairly balanced between 'yes' and 'no' votes
2. *The unwinding of the Chinese local equity market will likely continue*. At its peak, the index traded on a rich price to earnings (PE) ratio of 25x and an enterprise value to EBITDA ratio of 13x. New listings grew at an unprecedented pace and margin debt stood at over ¥300 billion. The run on the market had all the classic symptoms of a mania, so it was always a question of 'when' and not 'if' the fun was going to stop.

   While the fall in the Chinese market will add an additional layer of gloom, we doubt it will have a significant impact on markets. Firstly, the share euphoria has mainly been driven by locals. Secondly, it is a relatively small depository for Chinese wealth (some estimates peg it at 3% of net Chinese savings). Thirdly, given the developmental state characteristics of the Chinese economy, expect some form of support to shares.
3. *The world will be one step closer to a rate hike in the US.* Most commentators expect the first hike to occur in September, depending on data released. Thereafter, the extent and duration of the hikes will determine the path of equity markets. We expect growth to be subpar compared to previous cycles and therefore for the monetary response to be more muted. In our view, bond prices are more at risk than equities under this scenario.
4. *Local markets will largely be affected by global issues*. However, the local problem areas of load shedding and strikes will also play a role. The important question is that, if the US Federal Reserve starts raising rates soon, will the SARB be far behind? We think not.

The ALSI has fallen 6% since its peak in April. In the process, the PE ratio has fallen 10%, from 19.4X to 17.5X. The reason for the larger fall in PE is a rise in the earnings base of the index in the quarter. That said, South Africa is one of the few markets where earnings forecasts are still being wound back, mainly because of the negative impact of a strong US dollar on commodity prices, load shedding, rising rates and a weak consumer. None of these will likely change in the near future. We remain cautious on prospects for the equity market. ■

Cadiz Unit Trusts' performance

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

Unit Trusts	1 Year	3 Years	5 Years	7 Years	Since Inception	Inception Date
No Equity Exposure						
Cadiz Money Market Fund	6.52%	5.96%	5.97%	7.09%	7.67%	01-Mar-06
Alexander Forbes Short Term Fixed Interest (STeFI) Composite Index	6.27%	5.65%	5.76%	6.79%	7.36%	
Quartile Rank	2nd	2nd	1st	1st	1st	
Very Low Net Equity Exposure (up to 20% in listed property and preference shares only)						
Cadiz Absolute Yield Fund	4.87%	6.81%	7.89%	9.21%	9.01%	01-Mar-06
CPI+3%	7.55%	8.57%	8.38%	8.51%	9.19%	
Quartile Rank	3rd	2nd	2nd	1st	1st	
Low Net Equity Exposure (20 - 40%)						
Cadiz Stable Fund	3.74%					01-Sep-12
CPI+3%	7.55%					
Quartile Rank	4th					
Medium Net Equity Exposure (40 - 75%)						
Cadiz Inflation Plus Fund	1.85%	8.49%	10.15%	10.18%	9.73%	13-Jan-06
CPI+5%	9.54%	10.57%	10.38%	10.50%	11.23%	
Quartile Rank	4th	4th	4th	3rd	2nd	
Cadiz Managed Flexible Fund	0.91%	10.64%	12.48%	10.36%	10.27%	01-Mar-06
Average of the Domestic - Asset Allocation - Prudential High Equity sector	7.81%	14.87%	13.46%	10.57%	11.58%	
Quartile Rank	4th	4th	3rd	3rd	3rd	
Flexible Net Equity Exposure (50 - 90%)						
Cadiz Equity Ladder Fund	-7.65%	-1.79%	1.50%	4.50%	6.60%	03-Jun-05
CPI+6%	10.54%	11.57%	11.38%	11.50%	11.61%	
High Net Equity Exposure (100%)						
Cadiz Mastermind Fund	-6.58%	8.48%	10.77%	9.47%	9.93%	01-Mar-06
FTSE/JSE SWIX Index	10.20%	20.64%	19.85%	13.81%	15.36%	
Quartile Rank	4th	4th	4th	4th	4th	

Source: Morningstar and Cadiz Asset Management

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