July 2016

CAMmuniqué

CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

cadiz
ASSET MANAGEMENT

Our investment philosophy and process

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

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

We apply our investment process with patience, diligence and focus

We identify opportunities through bottom-up fundamental analysis

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

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

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

We consider and combine opportunities both within and across asset classes

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

We only invest if there is a margin of safety

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

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Introduction

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

'If the trend of rising dispersion in market returns continues to revive the battered stockpickers, the real nightmare for the growing number of investors in passive funds will be that they have entered the wrong market at just the wrong time.'
Luke Templeman, Deutsche Bank

Passive funds have been growing in popularity across the globe

In the US the influx of money into passive strategies, particularly since the global financial crisis, has distorted the fair value of the market and of the individual companies that make up the market. Currently one fifth of the market value of the S&P 500 is in passive funds, up from only one tenth in 2000. This is a dramatic change in investor preference over a relatively short period of time. South Africa has been experiencing a similar interest in passive funds.

Distorted dispersion in the market indicates that investors have been ignoring fundamentals

According to a research article by Luke Templeman from Deutsche Bank entitled 'The return of stockpickers', a feature that has received little attention is the curious state of dispersion in the market. Dispersion refers to the gap between the best and the worst stocks in the equity market. Although the market has been lacking appropriate levels of dispersion since the financial crisis, it appears to be returning.

Interestingly, return dispersion (which is the difference in returns between companies in different sectors) has narrowed significantly over the last few years. However, fundamental performance (which is measured by financial drivers such as returns on equity and profitability) shows that companies are not similar enough to warrant comparable returns, regardless of the sector in which they operate. This widening dispersion between fundamentals and stockmarket returns suggests that investors have been ignoring quality (for example, earnings or relatively stronger balance sheets) and allocating their cash based on other factors, such as the relative size of a share in a market index. (There are exceptions, for example, the resources sector. Until recently, all companies in the sector were trading at distressed valuations given the systemic risk of extremely low commodity prices).

Low levels of diversity within an index lead to underperformance from active managers

This skewed dispersion has led to a large percentage of the market capitalisation being in a handful of stocks, which lowers the diversity of an index. For example, in South Africa, a staggering 25% of the market capitalisation-weighted returns of the FTSE/JSE Shareholder Weighted Index (SWIX) consists of only two companies, Naspers and SABMiller. Studies have shown that when diversity in an index is low, active managers underperform.

However, passive strategies based on past performance can lead to disappointing results

Equity markets have done well since March 2009, benefitting from the large increase in liquidity provided by central banks globally through quantitative easing. The risk of buying a strategy that has performed impressively in the recent past, for example via a passive fund, is that you may have unrealistic return expectations if this recent performance was driven by non-fundamental factors. We refer to this as 'steroid-induced performance'. As market distortions fall away over time and valuations revert back to their mean, returns could be very disappointing. The problem with companies receiving a premium that they don't necessarily deserve is that when the liquidity that has been sustaining them in the first place is removed, the value of the company should quickly (and painfully) revert to its fair value. The opposite is true for quality companies trading below their intrinsic value.

Passive strategies favouring expensive, popular stocks expose investors to unnecessary risk

The problem with most popular passive strategies on offer in South Africa is that they are linked to market capitalisations. This forces passive investors to favour expensive and popular stocks over stocks that offer better value but that are unloved. Another way of looking at this is that investors' money is being diverted away from companies with a margin of safety in their valuation and flowing into shares that are overpriced relative to fundamentals. This increases the investment risk of a portfolio substantially, which is contrary to the general aim of investing – to increase and grow wealth. It's important to highlight that an index by itself does not imply a low-risk investment. Investors exposed to the S&P 500 in 2000 would have learnt this lesson the hard way when the technology sector's weighting in the index halved within two years.

This may not be the best time to consider passive investing

With global central banks facing the reality of diminishing returns from their policies, the irony is that investors may well be flooding into passive strategies at precisely the wrong time. If history has taught us one thing it's that markets are not kind to those who rely upon prices going up regardless of fundamentals for future performance. Trees do not grow to the sky.

Are markets efficient or inefficient? That is the question

The 2013 Noble Prize in Economic Sciences was awarded to three men: Lars Hansen, Robert Shiller and Eugene Fama. Robert Shiller, a professor from Yale, is well known for his studies showing that the market is inefficient. On the other hand, Eugene Fama, a professor at the University of Chicago, is well known for the opposite thinking to Shiller, namely that the market is efficient.

So who is right? Some active managers believe that only Shiller is right, in other words, that the market must be inefficient to generate opportunities. Passive investors mostly believe only Fama is right, in other words, that the market has already considered all relevant information (which means it is efficient) and is always priced correctly. A good active manager believes both are right, just not at the same time. The market must be inefficient to create opportunities and then reach a state of efficiency so that price and value can merge.

Comparing returns is not a straightforward exercise

When comparing active managers' performance relative to a benchmark, it's important to take into account the manager's investment process and philosophy, as not all active managers are created equal. It's also important to note that passive managers will underperform the index 100% of the time (adjusted for fees and trading costs). When choosing a passive manager, it's therefore vital to ensure you are paying the lowest fees possible), otherwise you may be disappointed with the results.

At the end of the day, always remember that the market does not reflect the whole truth

We often place a lot of emphasis on what the market is telling us but it is important to remember that the market merely reflects the average insight of participants in that market. In the words of Howard Marks, Founder and Co-Chairman of international investment company Oaktree Capital Management: 'It's not that it's always wrong; it's that there is no reason to presume its right.'

What you can expect in this edition

In Where to invest, Brian Munro explains why banks offer better value than bonds. Razeen Dinath explores the underlying business qualities of Michael Kors, a luxury global business that retails and wholesales handbags, accessories and clothing under the Michael Kors brand. He explains why we believe in its potential for creating long-term value. In our fixed income piece, Ruen Naidu shares his views on the relevance of bonds as a diversification tool in a multi-asset portfolio and Matt Brenzel gives us an overview of the past quarter's international and local performance and highlights. Lastly, we invite you to read about what makes our Head of Equities, Graeme Ronne, tick!

Please enjoy the read. ■

Where to invest

Banks offer more value than bonds

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

Since the beginning of the year, the South African 10-year bond yield has fallen from 9.67% to 9.20% with a lot of volatility in between. At these levels, the question we need to ask is – are South African bonds attractively priced? In addition, are there other assets that offer a better risk-adjusted return? It is our view that, over a three-year time horizon, banks offer potentially better returns with limited chance of capital loss compared to bonds.

We assess the attractiveness of local bonds on an absolute and relative basis

To determine how attractive the current bond yield is, we compare it to our assessment of 'fair value' for the South African 10-year bond. We aggregate the yield required to compensate bond investors for the different risks they are exposed to when holding South African government paper. These calculations are shown in Table 1.

Table 1: Bond yield required to compensate local bond investors for their risk exposure

Bond yield (fair value)	9.0%-10.0%
Inflation	6.0%
Inflation risk premium	0.5%-1.0%
Sovereign risk premium	2.5%-3.0% (increased from 2.0%)

Source: Cadiz Asset Management

Table 1 indicates that a bond yield of between 9.0% and 10.0% (which matches the current bond yield) should offer investors sufficient compensation for the different risks related to giving money to the South African government – that the government will honour the interest due and return the required lump sum at the end of the 10-year period.

This calculation is based on the following assumptions:

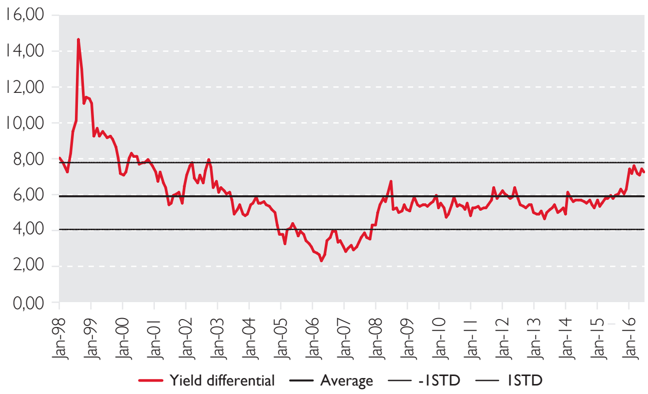
- We expect inflation to be between 5.5% and 6.0% over the next 10 years, towards the upper end of the South African Reserve Bank's (SARB) inflation target. The average inflation rate over the last 16 years, since the SARB introduced inflation targeting, has been just below 6.0%.
- We expect an additional 0.5% to 1.0% premium in case inflation exceeds the 6.0% upper end of the target. In the short term, we expect inflation to increase, peaking in the fourth quarter of 2016 and to remain outside the target for the first half of 2017. However, there is always a possibility that inflation remains outside the target for longer than expected due to some unforeseen risk. That is why we require an additional risk premium.

- The sovereign risk premium demanded by investors from the South African government recently increased from 2.0% to above 3.0%. Although South Africa has avoided being downgraded to sub-investment grade ('junk status') by ratings agencies in June, it remains a concern. As bond investors we demand a higher premium and believe 2.5% to 3.0% should be sufficient compensation.

How attractive are South African bonds to foreign investors?

We also assess the relative attractiveness of South African bonds to global bonds. Using the US 10-year bond as a proxy, Chart 1 shows that the additional yield a foreign investor can gain above the benchmark US bond has increased to 7.3% over the current US 10-year bond yield of 1.7%. This is at the upper band of the trading range over the past 18 years. The question is whether this yield differential is sufficient compensation for a foreign investor.

Chart 1: Yield differential between the South African and US 10-year bond (1998-2016)



Source: Cadiz Asset Management

For foreign investors to find South African bonds attractive, they require a yield that exceeds the US bond yield. To compensate foreign investors for the additional risks associated with holding a South African bond, we add the sovereign risk premium and the inflation differential, which is the difference is inflation between the US and South Africa. The outcome can be seen in Table 2.

Table 2: Bond yield required to compensate foreign investors in South African bonds for their risk exposure

	Current yields	Risk scenario
SA 10-year bond yield	9.2%	
Bond yield – relative fair value	8.2%-8.7%	9.0%-10.0%
Inflation differential	4.0% (6.0%-2.0%)	4.0%
Sovereign risk premium	2.5%-3.0%	2.5%-3.0%
US 10-year bond yield	1.7%	2.5%-3.0%

Source: Cadiz Asset Management

Although South African bonds offer value, the risk lies in the US bond market

On a relative basis, given the current yields in the US and South Africa, one could argue that South African bonds offer value. However, the risk lies in the US bond market, where we believe current yields are too low. At a yield of 1.7% and with core inflation above 2.0%, it suggests that the US economy is expecting zero economic growth over the next 10 years. There are of course other factors at play that are creating distortions in the bond market as the global economy continues to grapple with life after the great financial crisis (GFC) of 2008 and the unprecedented monetary policy response from global central banks. Nevertheless, there is a real risk that US bond yields rise as the US Federal Reserve normalises monetary policy.

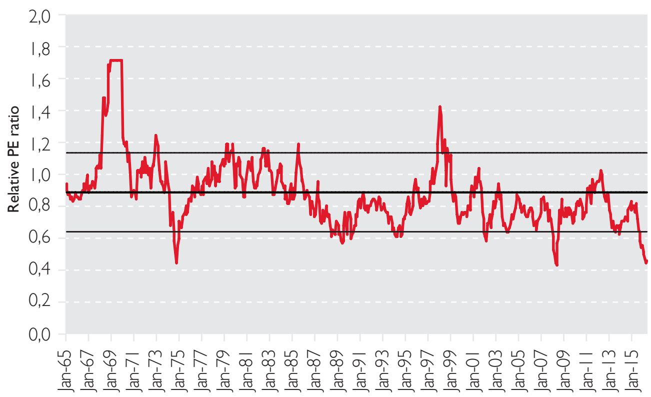
The risk of rising US yields and inflation makes cash more attractive than bonds

On an absolute as well as a relative basis, the current bond yield is therefore trading at fair value of between 9.0% and 10.0%, with the risk that yields can go higher. Compared to a cash return of 8.5%, the risk/reward trade-off is not favourable for bonds, making cash more attractive than bonds.

However, prospective returns from banks exceed cash as well as risk-adjusted bond returns

In searching for other assets that look attractive, the banking sector offers favourable prospects on a relative basis, as shown in Chart 2.

Chart 2: Banks are trading at a substantial discount to the FTSE/JSE All Share Index



Sources: I-NET, Cadiz Asset Management

In particular, Standard Bank and Barclays are looking attractive, trading on a 6% dividend yield with dividends expected to grow by at least 6% over the next three years. This is well below their long-term dividend growth rate of 9% and translates into an 8% expected return from dividends alone, almost equivalent to the cash return of 8.5%.

Assuming that bank earnings grow by a conservative 6% over the next three years, the expected return increases to 14% per annum (p.a.). Current consensus forecasts predict that earnings will fall in the short term. Historically, earnings and dividends have seldom fallen for more than one year. When they do, they typically rebound and grow at a faster rate. A 6% growth rate is therefore in line with the 10-year average, which includes the GFC, when bank earnings were significantly negative. (Since the GFC, earnings have grown by more than 10% p.a.)

Table 3: Expected dividend yield, dividend and earnings growth over the next three years for Barclays and Standard Bank

3-year time horizon	Barclays and Standard Bank	10-year historical growth rates
Expected dividend yield	6% p.a.	
Expected dividend growth	6% p.a.	(9%)
Expected compound return	8% p.a.	
+		
Expected capital growth	6% p.a.	(6%)
	14% p.a.	
+		
Re-rating potential	6% p.a.	
Expected total return	20% p.a.	

Sources: I-NET, Cadiz Asset Management

In addition, both Barclays and Standard Bank are trading below their long-run price to book ratios, offering investors a margin of safety and a potential re-rating of between 20% and 30% (6%-9% p.a.). As a result, the total expected compounded return over the next three years for these bank shares is between 14% and 20% p.a. (as shown in Table 3), with a very limited chance of capital loss. These return levels equate to an expected excess return of between 5% and 12% over cash and a better risk-adjusted return than bonds.

Assessing assets relative to cash, each other and on a risk-adjusted basis is central to our approach

The exercise above is an example of our investment approach in that we assess each asset's attractiveness relative to cash and to each other on a risk-adjusted basis. In doing so we grow our client's wealth while minimising any chance of a capital loss, and ensure that our funds meet their investment objectives. ■

Michael Kors:
not in fashion but on sale

by *Razeen Dinath*, *Equity Analyst*

Michael Kors Holdings Limited (Kors) is a global luxury lifestyle brand that retails and wholesales handbags, accessories and clothing under the Michael Kors brand. Kors is a relatively new investment in our portfolios. The opportunity arose from a significant decline in Kors' share price caused by the current short-term cyclical pressure on the business and the industry. This short-term focus and extrapolation of recent results is a characteristic of the stockmarket that we at Cadiz Asset Management aim to exploit by taking a long-term view and investing in superior businesses at favourable prices. In this article, we explore the underlying business qualities of Kors that indicate its potential for creating long-term value.

The recent de-rating of Kors offers an attractive investment opportunity

Kors shares have recently been de-rated by the market because of near-term concerns about luxury goods sales in general and about Kors' ability to maintain superior profitability and growth in the current environment in particular. This has created an attractive risk/reward investment proposition as the current share price allows the business to weather quite a hefty storm while still producing a decent investment outcome, and any outperformance of the market's low expectations will produce a very good investment result. Kors is therefore perfectly tailored to our investment criteria.

The investment holds a low risk of permanent capital loss

Kors has no debt. In fact, it has $700 million of cash and operates a highly cash-generative business model that has allowed the business to grow very quickly and to buy back shares using little financial leverage. This gives us confidence that Kors has enough financial strength to survive a tough luxury goods environment for an extended period of time with the ability to pick up distressed assets at attractive prices.

Future growth prospects are looking favourable

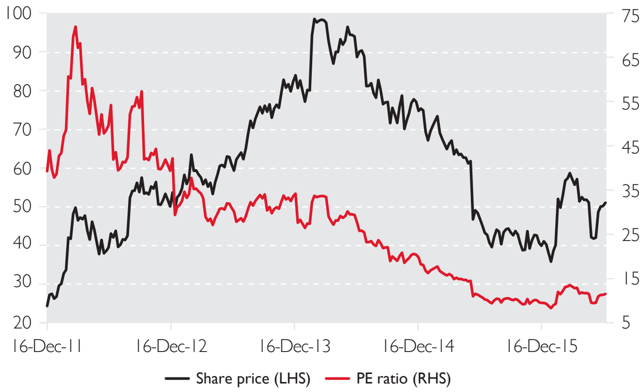
Kors' business quality resides in the brand, since Michael Kors is highly regarded as a world-renowned, award-winning designer. The business focuses on designing high-quality luxury accessories and clothing with stringent quality control over outsourced manufacturing. Kors initially distributed its products via department stores. However, it has shifted its focus to Kors-branded, stand-alone stores on prominent streets in the most prestigious cities as well as the Michael Kors online store.

These factors enable Kors to operate a business model that is not as capital-intensive, with superior free cash flow generation and a high return on capital. Kors has also been growing quickly following the opening of a number of retail stores to expand its geographic presence. The company is well represented in the US, but there is still significant opportunity to grow its presence in Europe and Asia. This gives us reason to be more optimistic about Kors' overall growth prospects, since any headwind from the US could be offset by growth in Europe and Asia.

Effective brand management is an ongoing task

Although a strong brand is an asset and offers a competitive advantage, it must be nurtured. It requires continuous improvement in fashion and quality as well as significant marketing spend to reinforce the brand image and perception in the consumer mind. As a result, brand power as a competitive advantage is prone to poor management and could be competed away or become unattractive to the next generation of consumers. This risk is very real and one that we will continuously monitor over time to ensure that Kors' investment case still holds.

Chart 1: Kors share price and price to earnings (PE) ratio (2014-2016)



Sources: Bloomberg, Cadiz Asset Management

Attractive return prospects bode well for future performance

Kors was first listed in December 2011 and was very well received, with the share price rising from $20 to almost $100 in early 2014, as can been seen in Chart 1. Since then, luxury goods sales have struggled and so too have the share prices of luxury goods companies. We waited for an opportune moment and finally invested at the beginning of this year when the price to earnings (PE) ratio was only 8, while luxury businesses usually sell for PE ratios close to 20.

When we evaluated our investment based on the implied market expectation for Kors (given the PE ratio of 8), we found that the price implied a significant decline in revenue with a large drop in profit margins. In our opinion however, the implied revenue decline was too severe, taking into account the fact that the penetration of stores in Europe and Asia could offset declines in US sales. The margin decline was also too severe as Kors has good pricing power and, as long as the brand retains its brand power, should be able to achieve superior profitability. As a result, our worst-case valuation was close to the share price at which we invested, while our base case of normal operating conditions in the future indicated significantly positive prospects. Low risk of loss with significant potential of future gain and attractive total return prospects is what we look for when we invest and Kors is definitely such an opportunity.

Management's growth strategy and long-term focus is reassuring

Kors's top management consists of Michael Kors as the Creative Director and John Idol as CEO. Michael focuses on ensuring that high-quality, fashionable products are produced while John focuses on running the business. Insider shareholding is quite low at 3.7%. While Kors's capital allocation history is short, it is positive that management has not gone on an acquisition spree. Instead, they concentrated on growing Kors' retail presence and buying back shares when the share price declined significantly. Management has also stated that it manages the business for the long term and is not overly focused on quarterly results. We therefore have confidence that management is on the right track.

We continuously monitor key risks to ensure our investment case is still valid

History is littered with up-and-coming brands that initially shoot the lights out but end up disappointing. Kors is higher up the value chain in the luxury goods category rather than a 'fast fashion' business, but this is a key risk that we will monitor to ensure our investment thesis holds.

Kors should offer favourable investment outcomes over the long term

Kors is a very good investment proposition with a low risk of permanent capital loss and significant upside potential with the ability to grow intrinsic value. The market is pricing Kors as if the current low to no growth environment will continue indefinitely. We, however, believe that the lack of revenue growth can be attributed to the poor economic cycle, which means revenue growth will improve when the cycle turns. Once growth returns, the market will re-rate Kors, leading to a very good investment outcome. ■

Misperceptions about bonds in a rising interest rate environment

by **Ruen Naidu**, *Portfolio Manager*

As an inflation-targeting central bank, the South African Reserve Bank (SARB) has increased the repurchase (repo) rate by 200 basis points in the current interest rate cycle to combat the threat of runaway inflation. A common misperception from investors is that rising interest rates are bad news for bonds. In this article, Ruen Naidu explains why this perception about the relationship between interest rates and bond returns is inaccurate. He considers both local and global monetary policy tightening cycles for a comprehensive analysis. Ruen also assesses the relevance of bonds as a diversification tool in a multi-asset portfolio.

There is evidence that local bond yields do not increase during monetary tightening

The SARB has imposed three tightening cycles since the inception of inflation targeting. For each of these cycles, we examined the change in the generic South African 10-year government bond yield over the following two overlapping periods:

1. Period 1 – from the start of the tightening cycle until the last hike
2. Period 2 – from the start of the tightening cycle until the end of the pause cycle (the month before the first rate cut after the hiking cycle)

Table 1: Changes in the South African 10-year bond yield during monetary tightening cycles

		Changes in the 10-year bond yield	
Start of cycle	Increase in the interest rate	Period 1	Period 2
Jan-02	400 bps	-23 bps	-248 bps
Jun-06	500 bps	+205 bps	-30 bps
Jan-14	200 bps*	+27 bps	+27 bps

**Cycle potentially incomplete*
Source: Cadiz Asset Management

It is clear from Table 1 that the generic 10-year yield is lower at the end of Period 2 than at the beginning of the tightening cycle. The results for bond yield changes over Period 1 are mixed, with the largest yield change at 205 basis points.

Similar results are evident on an international scale since the great financial crisis (GFC)

To better understand the implications of rising policy rates on bond yields in a post-GFC world, we conducted a multi-country, cross-sectional analysis of monetary policy tightening cycles, shown in Table 2.

Table 2: Analysis of the impact of monetary policy tightening on global bond yields

			Changes in bond yields	
Country	Start of cycle	Increase in the interest rate	Period 1	Period 2
Australia	Oct-09	175 bps	-13 bps	-103 bps
India	Mar-10	375 bps	+104 bps	+71 bps
India	Sep-13	75 bps	+2 bps	-91 bps
Poland	Jan-11	125 bps	-88 bps	-176 bps
Mexico	Dec-15	75 bps*	-17 bps	n/a
Malaysia	Mar-10	125 bps*	-27 bps	n/a
Average		158 bps	-6.5 bps	-74.75 bps

**Cycle potentially incomplete*
Source: Cadiz Asset Management

Table 2 confirms the results from our local analysis in Table 1, namely that rising policy rates do not necessarily result in rising bond yields. Australia, Mexico, Poland and Malaysia have all witnessed falling bond yields over the period of their tightening cycles.

Even in a rising yield environment, bond returns are satisfactory

The next step is to explore the expected return profile of a bond in an environment where yields rise. We used the South African benchmark R186 government bond in our calculations, shown in Table 3, as it is the most liquid bond and matures in 10 years. The horizon of the expected returns is three years and returns are annualised.

Table 3: Expected bond returns in a rising yield environment

Yield change	Expected return
Unchanged at 9.2%	10.21%
+50 bps	9.44%
+100 bps	8.70%
+150 bps	7.99%
+200 bps	7.30%

Source: Cadiz Asset Management

Table 3 shows that if the R186 bond experiences a massive 200 basis points rise in its yield over the next three years, it would still deliver an annualised return of 7.3% over the period. This exceeds the long-run average of South African inflation of 6%. Should the R186 return to pre-tightening levels over the next three years, the annualised return would be a handsome 10.7%.

Taking the scenario where the R186 yield rises by 100 basis points over the next three years, the expected return of 8.7% compares favourably to the 8% return from one-year treasury bills. While this return may be less attractive relative to long-run equity returns, it is important to assess the diversification benefits of bonds relative to both equities and cash.

Bonds offer superior returns to cash when equities are down

To evaluate the diversification qualities of bonds, we considered periods of equity market drawdowns and evaluated the annualised returns delivered by both bonds and cash over those periods. We used the FTSE/JSE All Share Total Return Index (ALSI TR), BEASSA All Bond Total Return Index (ALBI TR) and the Short-Term Fixed Interest Composite Index (STeFI) as proxies for the equity market, bond market and cash respectively. The results, shown in Table 4, indicate that bonds offer superior returns to cash in periods of equity market weakness.

Table 4: Annualised returns from cash and bonds during periods of weak equity performance

Period	Length (weeks)	ALSI TR	ALBI TR	STeFI
30-May-08 to 06-Mar-09	40	-48.44%	25.33%	11.98%
08-Jan-10 to 27-Aug-10	33	-6.33%	24.79%	7.17%
04-Feb-11 to 26-Aug-11	29	-15.86%	18.75%	5.74%
04-Jul-14 to 16-Jan-15	28	-9.09%	21.73%	6.19%

Source: Cadiz Asset Management

In the current environment of fully priced equity markets, growing risks of an impending economic slowdown in the US, and a substantial global shortage of safe-haven assets, it makes sense to seek the protection that bonds have historically provided.

Bonds provide valuable diversification benefits in a multi-asset portfolio

We have shown that fears of bond markets performing poorly as a result of rising interest rates are unwarranted. Since equity market returns deliver negative returns under certain market conditions, bonds are an important element of a multi-asset portfolio due to their diversification benefit and 'insurance' value. ■

Quarterly review

by *Matt Brenzel*,
Joint Chief Investment Officer

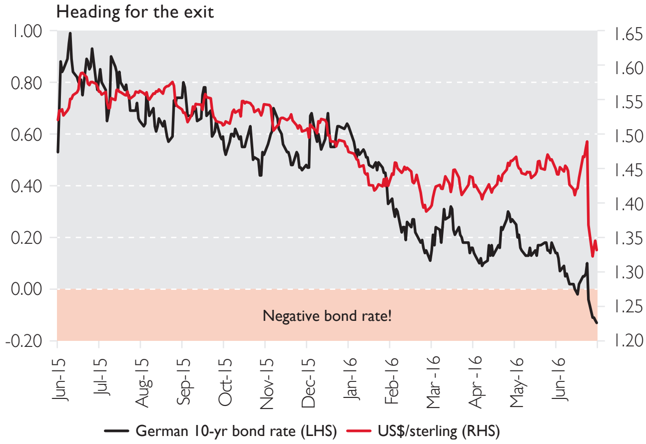
INTERNATIONAL PERFORMANCE

The club of nations that is described as having 'geopolitical risk', has a new member

'Schadenfreude' is a German word that means to take pleasure in someone else's misfortune. So for some, there is a wonderful irony that the opening scene of the recently released film 'Independence Day: Resurgence' shows London being crushed by an alien invasion. Shortly thereafter and once the Brexit referendum results were in, some of the lead campaigners for the 'Leave' campaign declared that the UK could 'finally celebrate its independence from Europe'. A few days later, the English team was eliminated from a different Euro; Iceland beat England 2:1 in a leading soccer tournament.

The surprise Brexit decision was bad for markets. The initial reaction shaved $3 trillion off global equity market capitalisation and sent another flood of money into the negative-yielding bond market. This raised the total value of the latter to over $11 trillion. Ratings agencies immediately lowered the rating of UK debt. Sterling was another casualty in the aftermath as can be seen in Chart 1.

Chart 1: German 10-year bond rates and the US dollar/ sterling currency



Sources: I-NET, Cadiz Asset Management

Is the US on hold?

Last quarter, we argued that the US dollar had run out of steam after posting a remarkable run against most other currencies since mid-2014. We said that the reason for the weakening of the dollar was that the US Federal Reserve had been hamstrung in its attempts to normalise the level of US interest rates by virtue of the inability of the rest of the world's economies to reach a positive growth path. The Brexit vote has done nothing to change this view. In fact, political events in the US – with Donald Trump as the lead candidate of the Republican Party – has contributed to the view that US rates will remain on hold, possibly into 2017.

The proliferation of negative rates

Meanwhile, in economies that are battling to restart (such as peripheral European countries and Japan), central bankers have moved monetary policy into a new area of the unknown: pushing interest rates into negative territory. As background to this thinking, it must be remembered that the massive quantitative easing policies implemented in the US, Europe and Japan, were an attempt to enable banks and individual lenders to repair their debt-strained balance sheets. To some extent this has happened, but the consumer remains fearful of spending, especially by using debt. So the thinking is that negative interest rates will encourage savers to spend. The consequences of negative rates are not yet known, but are bound to prove distortionary. As an example, the typical banking model of paying depositors a rate that is lower than the one it lends at, must be compromised.

Table 1: International market returns

International (US$)	Quarter	12 Months
MSCI World	1.2%	-2.2%
MSCI Emerging	0.8%	-11.7%
MSCI SA	1.7%	-15.5%
J.P. Morgan Global Bonds	3.6%	11.9%
US Cash	0.3%	0.2%

Source: Bank of America Merrill Lynch

It was a quarter of raised volatility and uncertainty. True to form, investors fled back into gold and bonds. That said, the top-performing regional equity play was Brazil (+13% in US dollar terms). All of its sectors produced world-beating returns. One of the worst equity performers was Italy (-13%), with its banks (-34%) being pummeled. Given the big jump in oil prices, energy shares were the place to be from a global perspective, whereas consumer discretionary shares led the falls.

LOCAL PERFORMANCE

Local growth is poor

Other than the anxiously awaited pronouncements by the various ratings agencies (all unchanged, but with warnings about the political situation and growth prospects), local macro news in the quarter continued to reflect an economy on the skids.

- The quarterly Labour Force Survey showed that 355 000 jobs were lost in the first quarter of 2016. Even adjusting for the seasonal factor (businesses ramping up employment ahead of the festive season and then laying off thereafter), this was a poor number.
- The Reserve Bank's leading indicator fell sharply in April, to 90.9 from 91.7 in March, reaching a level last seen in October 2009.
- Similarly, the Reserve Bank's quarterly bulletin for the first quarter of 2016 was bleak: the quarter-on-quarter seasonally adjusted and annualised rate of growth in GDP of -1.2% was well down on the 0.3% and 0.4% growth rates recorded in the third and fourth quarters of last year, respectively. Household consumption expenditure slumped to -1.3% in the first quarter of 2016, from 2.4% and 2.1%, respectively in the final two quarters of 2015.
- While the extraordinary trade surplus of R18.7 billion in May surprised forecasters, we believe that this statistic, like others such as money supply and inflationary pressures, are more indicative of a constrained consumer than anything else.

Table 2: South African financial market returns

Asset class (ZAR)	Quarter	12 Months
All Share	0.5%	4.1%
All Bond	4.4%	5.2%
Listed Property	-0.4%	11.1%
Cash	1.8%	6.9%
Tier-1 (ZAR)	**Quarter**	**12 Months**
Resources	6.4%	-1.5%
Financials	-4.3%	-2.7%
Industrials	0.5%	7.8%
Size (ZAR)	**Quarter**	**12 Months**
Large Cap	0.1%	2.8%
Mid Cap	1.9%	11.7%
Small Cap	2.3%	4.8%

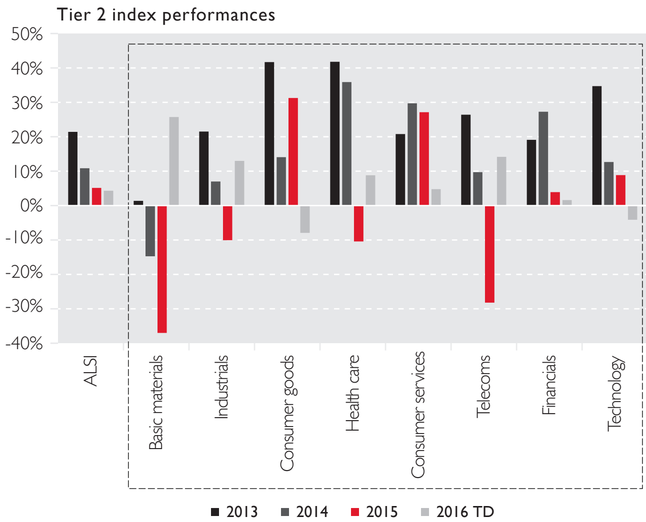
Source: Deutsche Bank

As in the case of the international markets, it was bonds over cash over shares. Surprisingly, property had a really weak quarter (it's normally positively correlated to bonds). Property stocks such as Intu (-14%) and Capital & Counties (-16%) were battered by virtue of their exposure to the UK. Resources had another strong quarter on the back of price surges in oil (+25%), gold (+7%) and platinum (+4%). Financials were punished in line with their world peers as the potential for interest rates to increase was pushed back further. Those with a UK exposure (Investec, -18%) were particularly hard-hit. Within industrials, the major laggards were Richemont (-13%), SABMiller (-6%) and Steinhoff (-13%).

Meaningful rotation within equities

Chart 2 shows the performance of the FTSE/JSE All Share Index (ALSI) and its sub-components (marked by the dotted line) for the calendar years of 2013, 2014 and 2015 as well as the last six months of 2016.

Chart 2: Performance of the FTSE/JSE All Share Index and its sub-components (percentage change)



Sources: I-NET, Cadiz Asset Management

There are some interesting highlights:

- The year-to-date return of the ALSI of 4.3%, is only marginally less than 5.1%, the return for the whole of 2015.
- The outperformers of 2013-2015 are generally the under-performers of 2016. The 'bulletproof' consumer goods sector has finally turned (-8%), after three superb years: +42% in 2015, +14% in 2014 and +31% in 2013, all courtesy of British American Tobacco, SABMiller and Steinhoff.

- Similarly, the underperformers of yesteryear have become the outperformers. The most notable example is basic materials, which has returned 26% year-to-date, after falling by 37% in 2015 and 15% in 2014. The second best performer year-to-date is Telecoms (+14%). This sector bounced after falling by 28% in 2015 as the investment case for MTN unravelled.

Where to from here?

Our expectation for risky assets is the same as our views in previous quarters: expect raised volatility for the rest of the year. Where we have changed our thinking however, is on the path of interest rates. Monetary policy will not change course as meaningfully as we had anticipated. As such, we raised our equity allocation marginally in the quarter and introduced a slightly more cyclical bias to the overall structure, both in our local as well as international exposure. Overall, we remain tactically underweight equities. Similarly, we are underweight local and offshore bonds in our multi-asset class funds. By deduction therefore, we are overweight cash, but will deploy these reserves when opportunities become available. ■

Meet our Head of Equities – Graeme Ronne

Graeme Ronne, Head of Equities

Excellent analytical skills and a temperament that removes emotions from investment decisions

With more than 10 years' investment experience, Graeme is as passionate about robust debate and engaging with the team about his work as he is about his family and the outdoors. He began his career at Element Investment Managers as an analyst before he moved on to develop his career at Cadiz Asset Management. As Head of Equities, Graeme takes the lead role within the equity team, but appreciates and values the role of different opinions in the team when it comes to debating the merits of where there may be value within local and global equity markets.

What are three things that few people know about you?

1. I represented South Africa at table tennis up until the age of 21
2. I enjoy reading about world history
3. I enjoy watching wildlife documentaries

Who or what was the biggest influence in your life?

My wife has been a big influence in my life. We have completely opposite personalities. She takes me out of my comfort zone and I admire her passion for life and willingness to explore what the world has to offer.

Tell us a bit about your family life

I've known my wife for 17 years and we've been married for 10 years. I have an 8-year-old daughter and 4-year-old son. My kids love the outdoors and we spend most weekends enjoying the natural beauty of the Western Cape.

What do you do to relax?

Spending time with my kids and enjoying priceless moments while they still want to be with mom and dad. I love cycling, running and reading. The view from the top of Chapman's Peak never gets old no matter how many times we cycle over it.

What do you listen to in your car when you're driving?

KFM and SAFM

What are your pet peeves?

1. Loud people in restaurants and other public places.
2. People who don't respect another person's opinion just because it doesn't match theirs.
3. Drivers that are inconsiderate of cyclists on the road.

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

An aircraft pilot or wildlife photographer.

Why did you become an investment manager?

I entered the investment management industry more by luck than design. However, it quickly became a passion, initially as I learnt about many different companies and industries, but later on as I started to more fully understand how asset prices are set and financial markets work.

What's important to you at work?

In a nutshell, being true to your investment philosophy and process. The difference between success and failure in our industry is often small and has less to do with how much you know (or think you know) and more to do with how you behave emotionally. The psychological aspect of investing – keeping emotions from clouding your better judgement and maintaining your objectivity and humility – is often the defining trait of successful money managers over time. ■

Cadiz Unit Trusts' performance

All performance figures in the table below are annualised percentage figures to 30 June 2016.

Unit Trusts	1 Year	3 Years	5 Years	7 Years	Since Inception	Inception Date
No Equity Exposure						
Cadiz Money Market Fund	7,23%	6,53%	6,16%	6,44%	7,63%	01-Mar-06
Alexander Forbes Short Term Fixed Interest (STeFI) Composite Index	6,85%	6,17%	5,89%	6,17%	7,31%	
Quartile Rank	1st	1st	1st	1st	1st	
Very Low Net Equity Exposure (up to 20% in listed property and preference shares only)						
Cadiz Absolute Yield Fund	6,07%	6,06%	7,25%	7,90%	8,72%	01-Mar-06
CPI+3%	9,16%	8,77%	8,69%	8,38%	9,19%	
Quartile Rank	3rd	3rd	2nd	2nd	2nd	
Low Net Equity Exposure (20 - 40%)						
Cadiz Stable Fund	4,79%	5,46%			5,94%	01-Sep-12
CPI+3%	9,16%	8,77%			8,82%	
Quartile Rank	4th	4th			4th	
Medium Net Equity Exposure (40 - 75%)						
Cadiz Inflation Plus Fund	3,00%	5,31%	7,41%	9,73%	8,95%	13-Jan-06
CPI+5%	11,21%	10,79%	10,70%	10,38%	11,22%	
Quartile Rank	3rd	4th	4th	3rd	2nd	
Cadiz Managed Flexible Fund	2,53%	6,43%	8,85%	11,56%	9,49%	01-Mar-06
Average of the Domestic - Asset Allocation - Prudential High Equity sector	5,60%	10,84%	11,63%	11,89%	11,01%	
Quartile Rank	4th	4th	4th	3rd	3rd	
Flexible Net Equity Exposure (50 - 90%)						
Cadiz Equity Ladder Fund	0,58%	1,62%	-0,56%	3,19%	5,92%	03-Jun-05
CPI+6%	12,22%	11,79%	11,70%	11,38%	11,66%	
High Net Equity Exposure (100%)						
Cadiz Mastermind Fund	-4,19%	2,74%	5,68%	10,47%	8,48%	01-Mar-06
FTSE/JSE SWIX Index	4,12%	14,79%	15,66%	17,67%	14,22%	
Quartile Rank	4th	4th	4th	4th	4th	

Source: Morningstar and Cadiz Asset Management

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