October 2016

CAMmuniqué

CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

cadiz

ASSET MANAGEMENT

Our investment philosophy and process

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

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

We apply our investment process with patience, diligence and focus

We identify opportunities through bottom-up fundamental analysis

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

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

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

We consider and combine opportunities both within and across asset classes

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

We only invest if there is a margin of safety

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

In this edition

Introduction

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

The past year proved to be an extremely difficult market for investors, both domestically and internationally. There was plenty of excitement to satisfy drama-hungry investment markets.

Regardless of the success of the elections there are still many local political stressors

This quarter the successfully run local election was a highlight for South Africa. Despite this, we have unfortunately had a number of own goals over the past year. These include:

1. instability in the Finance Ministry – in December 2015, respected Finance Minister Nhlanhla Nene was replaced with an unknown back-bencher, which negatively affected our investment markets and currency; the decision was subsequently reversed four days later with the appointment of highly esteemed Pravin Gordhan,
2. perceived political attacks on Treasury – this has been a theme at different points during the year, culminating with the Finance Minister's recent plea to be 'allowed to do my job', before being issued with a summons by the Hawks in October,
3. persistent noise around an impending cabinet reshuffle,
4. perceived lack of oversight and governance at some of our state-owned entities,
5. the overhanging threat of an imminent downgrade of South Africa's (currently investment grade) credit rating, and
6. stagnant GDP growth.

There are however, signs of an increase in growth, led by the export and manufacturing sectors

Despite the negativity of the above points, it isn't all bad news. After stagnant growth for some time, positive recent signs in exports and manufacturing may be signaling some green shoots of a potential mild increase in growth into 2017.

Internationally, growth remains sluggish and uncertain

It is likely to be a challenging road ahead as a number of uncertainties continue to cause market volatility:

1. Brexit – after an initial severe negative reaction to the vote to exit the European Union, the market settled down as markets realised that the Brexit negotiations and actual exit could take years.
2. The continuation of the stop/start US Federal Reserve interest rate hiking cycle.
3. The impending US election where the outcome remains highly uncertain as candidates agree on very little, apart from their support for infrastructure spending plans.

A tried and tested investment philosophy helps navigate uncertainty

Amidst drama and market volatility, a well-defined investment process and philosophy that has been proven to deliver results is crucial. The performance across our range of funds for the period is testament to this.

We subscribe to the style of value investing, which has performed well the past year

We believe that the main control you have as an investor is over the price you pay for an asset. So in our research process, we spend a great deal of time in understanding the underlying value of assets. If you over-pay for an investment there is a high chance of losing money in the long term. As we critically evaluate shares relative to their long-term fundamental drivers, our process is designed to look through near-term market noise and headlines. Many of the short-term concerns that affect asset prices, like the points raised above (the heightened risk of rating downgrades, fears of a cabinet reshuffle, governance concerns at state owned entities) are out of our control.

We are careful to invest in well-governed assets that we understand

We continue to focus on applying our disciplined approach of being careful not to over-pay for an asset. Whenever we invest, we ensure that we have a margin of safety, and we construct portfolios to safeguard and grow our clients' wealth over the long term. In other words, we will only invest our clients' hard-earned savings in assets that we understand and that have appropriate governance structures.

We are committed to delivering investment excellence through long-term performance

We do this through a range of accessible and understandable products across the risk spectrum. This commitment is aimed at growing and protecting our client's long-term wealth. Along with this, we aspire to provide a service to you that exceeds your expectations.

What you can expect in this edition

In 'Where to invest', Brian Munro explains to what extent you need to consider the value of the rand in your investment decisions. Mpande Maneli explores the breaking up of Old Mutual into separate companies and explains why this separation creates an opportunity to acquire shares in businesses that have previously been undervalued. Alastair Sellick debates whether it is wise to invest in South African parastatals, and Marco Uliana discusses the merits of investing in property through the Cadiz Property Income Fund. Matt Brenzel gives us an overview of the past quarter's international and local performance and highlights. Lastly, we invite you to find out more about the passions and hidden talents of Equity Analyst Mpandekazi Maneli.

Please enjoy the read. ■

Where to invest

To what extent should you consider the rand in your investment decisions?

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

With ongoing political and economic uncertainty both locally and globally, rand volatility has become the norm rather than the exception. Although the value of the rand is crucial to the local economic outlook, it can have a meaningful impact on a company's earnings. However, buying shares simply because of their rand exposure might not be prudent. Rather, when deciding where to invest you need to understand the underlying business, and apply a disciplined process.

Underlying business value (not currencies) should determine whether you buy a share

Any exporter, importer or tourist knows that the influence of the rand on the local economy has always been profound. The value of the rand can have a meaningful impact on corporate earnings.

However, it is important to know why you are buying a particular share. Are you buying the share simply because you are concerned about the rand and want to load your portfolio with rand hedge shares? Or is it because the underlying business offers value?

A key principle in our decision to own a share is to focus on understanding the underlying fundamentals of the business by assessing:

- the quality of the business and management's ability to execute a well-formulated and articulated strategy,
- the company's ability to grow profits over time and where in the profit cycle the company finds itself, and
- the value of the business and what price we are willing to pay for that asset that provides a sufficient margin of safety in case we are wrong (in other words, we assess whether the discount to the intrinsic value is high enough to compensate us for the risk of investing).

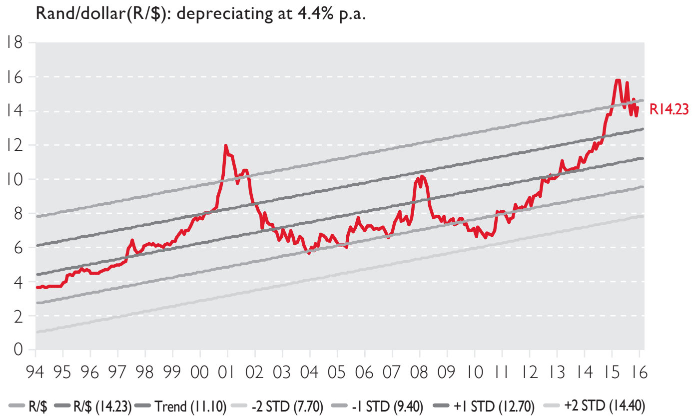
The best approach to a fluctuating rand is to maintain a long-term perspective

There are times however, when the rand can have a disproportionately large impact on the fundamentals of a business. This is particularly true if the rand depreciates or appreciates to extreme levels that are subsequently sustained. Predicting the absolute level of the rand is notoriously difficult and we believe it is a futile exercise. In line with our philosophy, we believe a better approach is to have a long-term perspective and act only when the rand is at extremes, in other words when it is significantly above or below its intrinsic value.

The depreciation of the rand/dollar exchange rate suggests that the rand is oversold

Chart 1 shows the rand/dollar exchange rate since 1994. The trend rate of depreciation has been 4.4% per annum (p.a.) This is in line with standard economic thinking that the rand should depreciate by roughly the difference between South Africa's inflation rate of 6% p.a. and the global inflation rate of 2% p.a. (based on the US inflation rate). Had the rand depreciated according to this trend rate of 4.4% p.a. from 1995, it should now be at R11/$. The starting point to the analysis can significantly influence the result. However, whether fair value is R11.00/$ or R12.50/$, at the current price of R14.23/$ (as at 12 October 2016), the rand still appears to be oversold.

Chart 1: The rand/dollar exchange rate (1994-2016)



Sources: I-NET, Cadiz Asset Management

Table 1 shows the composition of the local equity market categorised according to the following 'rand types':

- rand defensives – large multinationals where the majority of their business operations are outside South Africa
- rand cyclicals – commodity companies that have mining operations in and outside South Africa; the commodities are usually priced in dollars, but could have a large rand cost base
- rand plays – banks, local property and retailers based in South Africa where the majority of their revenue and cost base are in rands; these assets are also affected by South African bond yields
- rand neutral – domestic industrial companies where most of their revenue and cost base are in rands and that are not significantly affected by the rand

Table 1: Composition of the local equity market categorised according to 'rand types'

Rand types	Examples	Weight (%)
Rand defensives (multinationals)	Naspers, Anheuser-Busch InBev, British American Tobacco, Richemont, Mondi	40%
Rand cyclicals (commodities)	Sasol, general miners, gold, platinum	15%
Rand plays	Local property, banks, retailers	30%
Rand neutral	South African domestic industrials	15%

When the rand plummeted last year it created buying opportunities

At the end of last year the rand depreciated significantly to over R16/$. This was an overreaction to the increased political risk coupled with the real risk of South Africa's sovereign credit rating being downgraded to sub-investment grade or 'junk' status. This caused other local assets such as sovereign bonds, banks and a number of domestic industrial stocks to be oversold as well. As prices moved away from their intrinsic value, buying opportunities were created. Consequently, we were able to reposition the portfolios we manage by:

- increasing exposure to banks,
- increasing exposure to various domestic industrial shares,
- reducing exposure to multinationals, and
- protecting a portion of the offshore assets from a strengthening rand.

There are still risks but we will assess them as they occur and respond appropriately

The risk to this positioning is that the rand could sell off significantly if fears increase because of either domestic or global factors. Looking towards the end of the year, various risk events lie ahead, including:

- the US presidential elections in November,
- an Italian referendum in December,
- the risk of a US interest rate hike in December, and
- the possibility of South Africa's sovereign credit rating being downgraded to junk status.

These events – and other unexpected events – could trigger a negative reaction from the rand. As each incident occurs we will assess whether the risk event is temporary or structural, in other words whether it could cause the fundamentals of the companies we're invested in to deteriorate or improve. It is important to remember that the trend is for the rand to depreciate over the long term. It is only because the rand depreciated so quickly and to such extreme levels that we were in a position to restructure the portfolios.

An improved trade balance and the search for yield support the recent rand strength

1. Commodity prices for our export commodities (gold and platinum) have improved in comparison to the commodity price of our major import (oil). This has improved South Africa's trade balance.
2. The search for yield is still a major investment theme globally, which supports foreign investments in our bond market – global investors can earn 7.3% p.a. from a South African three-month cash instrument, compared to losing money in Europe or Japan due to negative interest rates. According to the South African Reserve Bank price inflation is expected to fall in 2017. This is bond bullish and gives global investors a higher yield/return for holding longer duration bonds.

Stay objective when considering the impact of the rand on your investment decisions

The rand can have a major bearing on company fundamentals and movement in asset prices, which could be either temporary or structural in nature. However, the rand is extremely volatile in the short term and notoriously difficult to forecast, so this should be avoided. When considering the impact of the rand on investment decisions, we believe that having a long-term perspective, a sound investment philosophy and disciplined process is vital. ■

Old Mutual:
better apart than together?

by **Mpandekazi Maneli**, *Equity Analyst*

Old Mutual recently announced that, after nearly two decades of steady and strategic expansion, the group will break up into standalone businesses. This will enable more accurate valuation of the underlying businesses and should enhance the growth achieved by the individual entities. From an investment point of view this separation, as well as the current weak share price, creates an opportunity to acquire shares in businesses that have previously been undervalued under the current group structure. Separation will be no mean feat; however, we believe it will be worthwhile over the long term – for both the business and investors.

Old Mutual's demutualisation in 1999 marked the beginning of a new era for the then 155-year old organisation

Since becoming a listed company 17 years ago, Old Mutual has taken significant steps to reshape the business in the pursuit of growth across multiple markets. It first embarked on diversifying the business through the acquisition of several companies, including United Asset Management in 2000, Fidelity and Guarantee Life (US Life) in 2001, and Skandia in 2006. Big was assumed to be better, until now.

Why break up?

Old Mutual's management believes that the current conglomerate structure is too restrictive since it inhibits the effective valuation of the underlying entities. In addition, it hinders efficient funding of the future growth plans of the underlying entities, preventing them from realising their full potential.

The managed breakup will create four standalone businesses by the end of 2018:

1. Nedbank,
2. Old Mutual Wealth (the group's UK-focused wealth unit),
3. Old Mutual Emerging Markets (based in South Africa), and
4. Old Mutual Asset Management (the institutional asset management business).

These businesses are competitively positioned to take advantage of the strong growth prospects in their markets.

The weak share price has created a unique buying opportunity

Old Mutual's share price recently weakened due to the latest disappointing results from the Old Mutual Wealth business and the Property and Casualty insurance business, as well as the outflows from Old Mutual Asset Management.

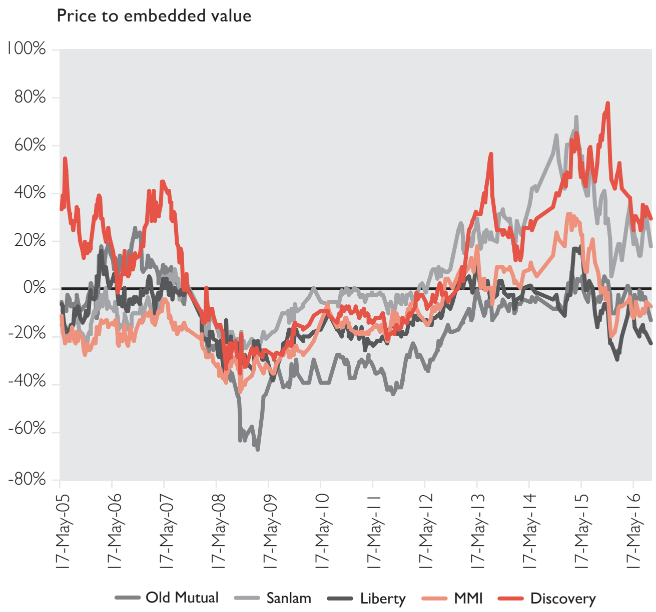
The disappointment associated with these entities seems to have overwhelmed the resilient performance of the rest of the group. This is particularly true of Old Mutual Emerging Markets and Nedbank.

Most of the drag on Old Mutual Wealth was caused by once-off regulatory changes, and while Old Mutual Asset Management suffered outflows, this is inherent to the industry and can reverse. In the long term, we believe that both businesses are well positioned to recover.

Old Mutual's price to embedded value (EV) is trading at a discount of nearly 15%

The EV of a life insurance company is the present value of future profits plus adjusted net asset value. It is a discounted cash flow of all written business at a reporting period (assuming that no more policies are written and the existing book is allowed to run off.) The market's disappointment with the latest results is best expressed by the fact that Old Mutual trades at 15% to its EV. As Chart 1 shows, Old Mutual is trading at the second largest discount to its EV relative to its peers.

Chart 1: Old Mutual's discount to its embedded value (2005-2016)



Sources: Bloomberg, company financial statements

The low hanging fruit…

So why has the relative discount been so elevated for so long? Old Mutual in its current form is a very large and complex financial services provider, operating in both developing and developed markets. It has two listed subsidiaries, Nedbank and Old Mutual Asset Management. It transacts across many financial disciplines, including wealth management, life insurance and non-life insurance, asset management, retail and commercial banking. This group structure has meant Old Mutual attracts a conglomerate discount that currently constrains shareholder value – value that will be released by splitting up the companies.

The hidden gems…

We believe that the separation will unveil the franchises that have been successfully developed over the years, but that have not been appropriately valued by the market. Old Mutual shareholders stand to inherit good quality franchises that currently trade well below their fair value. The reduction of group debt, to be settled by recent asset sales together with internally generated cash flow and the costs of managing the central office falling away, will help unleash these franchises.

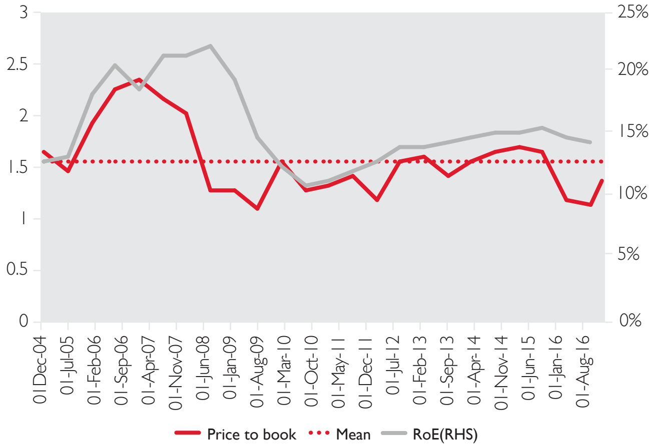
The crown jewel – Old Mutual Emerging Markets, a leader in the South African low-income insurance market

Old Mutual Emerging Markets is a leader in the South African low-income insurance market. Based in South Africa, with a large reach into sub-Saharan Africa, Old Mutual Emerging Markets has positioned itself as being its customers' most trusted partner. This division has a head-start in servicing the low-income insurance market, and has successfully developed a moat in this industry. This is thanks to high barriers to entry, high margins, fast growing demographics in Africa and low penetration rates relative to other income segments. Having established themselves in this segment, Old Mutual Emerging Markets stands to benefit from long-term growth in the industry. With an extensive presence in South Africa and the widest regional/socio-economic reach in the country, Old Mutual is one of the more resilient insurers. This is encouraging, especially ahead of the expected regulatory changes such as the Retail Distribution Review (RDR).

Old Mutual will reduce its shares in Nedbank

Old Mutual intends to reduce its shareholding of 54% in Nedbank to a 'strategic minority position' by unbundling shares to shareholders. We rate Nedbank as a sound operation. With a 20% market share in advances in South Africa and benign impairment losses, it is defensively provisioned for weakness in the economic environment. Currently trading well below its long-term price to book ratio with a 5% dividend yield underpinned by a strong capital position, it remains an attractive asset to own (as shown in Chart 2).

Chart 2: Nedbank's price to book (PB) and return on equity (RoE) ratios (2004-2016)



Sources: Bloomberg, company financial statements

Old Mutual Wealth should be able to expand its offering in the coming years

Old Mutual Wealth has a vertically integrated business model that is structurally superior to its peers. It will soon be able to start expanding its offering once the migration of its administration platform is completed. Management has successfully shifted the mix of earnings from the heritage business to the asset management and platform businesses, which – like its peers in the UK asset/wealth management space – experienced poor results recently. Yet these peers trade at multiples that are substantially higher than Old Mutual Wealth. We believe the market is overreacting.

This break-up won't be effortless, but it will be worth it

We concede the separation will not be an easy feat for management. But as Einstein said, 'In the middle of difficulty lies opportunity'. We believe opportunity abounds in the Old Mutual separation strategy. ■

Should we invest in South African parastatals?

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

South Africa's largest specialist investor in domestic fixed income (excluding the Public Investment Corporation), Futuregrowth, recently made a public announcement that it would no longer be lending money to South African parastatals. They cited governance concerns, a lack of independent directors, and political threats to the National Treasury (among other reasons) for their decision.

In this article, Alastair Sellick, Head of Fixed Interest, outlines the process that we follow to analyse parastatals and the criteria for lending to them.

The announcement about lending to parastatals led to rand deprecation and a bond sell-off

At the time of their announcement not to lend money to South African parastatals, many applauded Futuregrowth – something had been done to directly link state capture, corruption and, in some cases, deplorable governance, to the funding consequences of these issues. Until enabling financing is less available or more expensive, complaints don't amount to much. The immediate aftermath of Futuregrowth's announcement was a significant depreciation in the rand and a sell-off in government bonds. By extension, there was also a sell-off in the bonds of the parastatals (also known as state-owned companies or SOCs) listed below:

- Eskom
- Transnet
- the South African National Roads Agency (SANRAL)
- Land Bank
- the Industrial Development Corporation
- the Development Bank of Southern Africa (DBSA)

State-owned companies (SOCs) operate within a complex legal environment

The Futuregrowth announcement took place after President Zuma was named as the head of a new council tasked with overseeing SOCs. This appointment appeared to be at odds with the existing council that Deputy President Ramaphosa already chairs, and confuses the already complex legal and operating environment in which SOCs operate. Many already report to two or more ministers, are governed by their own legislation, and of late, are overseen by National Treasury.

There is no shortage of negative news about SOCs, which reduces investor confidence

At the time, Eskom was refusing to provide Treasury with information on an investigation into coal contracts with, amongst others, Tegeta Exploration and Resources, a company that has ties with the Gupta family. A noisy and messy public spat played out in the media which doesn't build investor confidence in our parastatals or South Africa.

The timing of the announcement wasn't good, given our rating review

A day or two after the Futuregrowth announcement, a foreign asset manager, Denmark's Jyske Bank, indicated that it too was suspending all loans to South African parastatals. This was then followed by Moody's Investor Services placing five of South Africa's parastatals (the six parastatals mentioned earlier, excluding Transnet) on review for a potential downgrade on 15 September 2016. They cited concerns about corporate governance and the political climate in Africa's most industrialised economy. The timing of this is ominous because there is a very real risk that the sovereign debt rating (which is already on a negative rating outlook from two ratings agencies) loses its investment grade credit rating in December 2016.

Many of South Africa's parastatals are extremely dependent on Treasury for either guarantees or explicit support. Taking the decision to not support failing or compromised parastatals to its logical conclusion would necessitate a buyers' strike on both the bonds and debt of the parastatals as well as government bonds.

Investment managers should surely hold companies to high standards of governance

As an investment manager charged with being a custodian of investors' retirement fund savings, there is an inherent accountability and duty to lend money to those who are accountable for the use of the money. In other words, should investors be investing in organisations that are plagued by management, governance and operational problems?

From an investment perspective, the key is to pay a price that compensates us for the risk

Every investment has a price and investors will invest when they believe the price they are paying compensates them for the risks associated with the investment. The key determinant of the price one is willing to pay for the debt of a SOC is the credit spread. This is the yield above its equivalent sovereign bond.

A practical example to demonstrate how we think

For example, a Transnet bond maturing in 2030 trades at 2% (or 200 basis points) above the R2030 sovereign bond trading at 9%. So the yield or return of the Transnet bond is 11% if you hold this to maturity. For some investors, buying the Transnet bond at +200 basis points is not sufficient compensation for the risks associated with Transnet and they would rather wait until the credit spread is +300 basis points before buying the Transnet bond.

What are the risks?

To determine the price or overall spread, we consider the following risk factors:

1. The credit spread (risk of default):
   a. What is the risk of the SOC or company not being able to pay its debts? SAA is a case in point. It is bankrupt and requires a bail-out from government.
   b. Is there an explicit government guarantee for the SOC?
2. Other risk factors to consider:
   a. Liquidity risk
   b. Political risk

1. We consider the risk of default for SOCs – do they have explicit government guarantees?

The bulk of the spread or yield that an investor charges over and above the equivalent government bond yield, pertains to the default risk of the issuer. In other words, what is the likelihood of the investor getting their initial capital back? If there is a real risk of default, no price is cheap enough and we will not invest. However, well-run SOCs will be able to borrow money from the capital markets at lower yields than loss-making, poorly run SOCs.

For parastatals, a distinguishing factor is whether or not their bonds are government guaranteed, or whether they are issued on a stand-alone basis, dependent only on the strength of the individual parastatal's balance sheet. A good example is SANRAL, which issues both government guaranteed bonds and un-guaranteed bonds. Investors will be happy to accept a lower credit spread for government guaranteed bonds since there is less risk of default.

2. **We assess a range of other risk factors, including liquidity and political risk**

   An additional spread required by investors, over and above credit risk, is the liquidity risk premium. Some SOCs issue bonds and then employ the services of a bank to act as a market maker to make prices to the secondary market so investors can buy and sell their bonds. A good example of an SOC that has a market maker is Transnet, where the market maker quotes prices daily for up to R25 million worth of bonds. For Transnet bonds, an investor would therefore charge a lower liquidity risk premium (in the region of 10 basis points) than an SOC, where there is no market maker.

   An example of an illiquid bond is that of the Development Bank of Southern Africa (DBSA), where one could argue the liquidity premium should be higher ranging from 50 to 100 basis points. The reason for this is that during the financial crisis in 2008, the credit spreads on DBSA bonds significantly increased by 100 basis points, purely due to the lack of a market maker. The creditworthiness of DBSA didn't deteriorate, but its bonds were simply illiquid at the time. The only price that a desperate seller could find was a price 100 basis points higher than the market.

When it comes to SOCs, we only invest at a price that compensates us for all risks

The Cadiz Asset Management approach to credit follows our overall investment philosophy of minimising the potential for losses by ensuring that an appropriate margin of safety is built into the price of any asset we buy. This philosophy is embedded in a process that focuses on an asset's credit spread and how that spread compensates for the risk of loss. The degree of risk compensation is informed by a combined qualitative and quantitative process that considers a wide set of factors including (but not limited to):

- macroeconomic drivers,
- company and industry analysis,
- financial ratios,
- debt maturity profiles,
- credit ratings,
- quality of management, and
- corporate governance.

Once we are satisfied these risks are priced in, we will be happy to invest in the bond. ■

The Cadiz Property Income Fund:

offering a steady income and capital growth

by ***Marco Uliana****,*
Director: Camstone Asset Managers

Investing in direct property is an attractive investment option – it offers consistent returns and the capital value of property tends to grow over time. However, because of the high cost of property and the administrative burdens of being a property owner, many individual investors aren't in the position to benefit fully from a direct property investment. That is where a property investment vehicle that allows investors to pool their money, such as the Cadiz Property Income fund, becomes very appealing. By providing access to quality property investments, the Fund offers low to moderate capital growth and a predictable and steadily increasing income.

The main attraction of investing directly in property is the consistent returns

Investing in direct property offers relatively predictable returns with a low level of variability compared to investing in the shares of listed property companies. The total return from property is made up of two components: income return and capital growth.

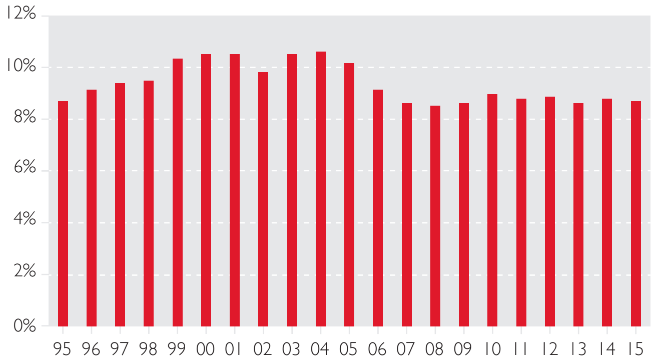
Income return is the net income received from the property – that is, the total rent received from tenants, less all the management and operating/maintenance costs.

Capital growth is achieved in two ways.

1. As the income return generated from properties held in a portfolio increases over time, so the capital value of that income rises.
2. Demand for property assets can change the yield investors are prepared to receive to purchase the property. As demand and competition for property assets increase, the price of those assets also increases and this generates capital growth (or vice versa, as the case may be).

Income return from property tends to be quite stable, as Chart 1 illustrates. Over the 21-year period from 1995 to 2015, the income return from direct property in South Africa was remarkably predictable, averaging at 9.4% with volatility (or standard deviation) of only 0.8%.

Chart 1: The stability of direct property income return (1995-2015)



Source: IPD

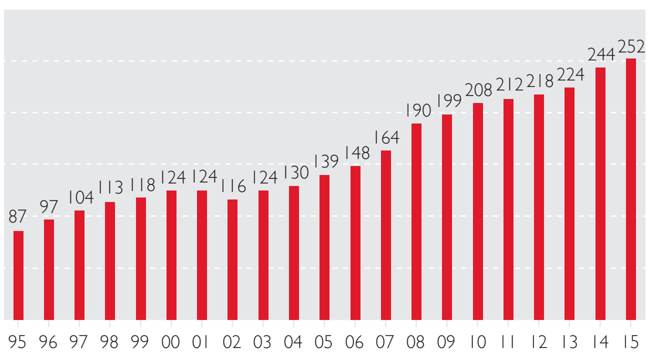
Escalating rental income provides income stability

Income earned from property rentals typically escalates annually at the rate specified in the lease agreement. This assures investors of a stable income on their asset. Sometimes escalations are linked to an index such as the Consumer Price Index. In South Africa it is more common to stipulate a fixed escalation rate in the lease agreement. However, owning property incurs operating/maintenance expenses, and in recent years these have increased by more than inflation. Examples of these expenses include:

- municipal rates and taxes,
- electricity and water usage costs,
- security,
- cleaning costs, and
- repairs and maintenance.

After these costs are taken into consideration, income return from property has tended to grow by less than inflation. Although this does not make for particularly exciting prospects, the important thing is that this growth has been consistent. Chart 2 illustrates the income return you would have earned each year if you invested R1 000 in direct property in 1995.

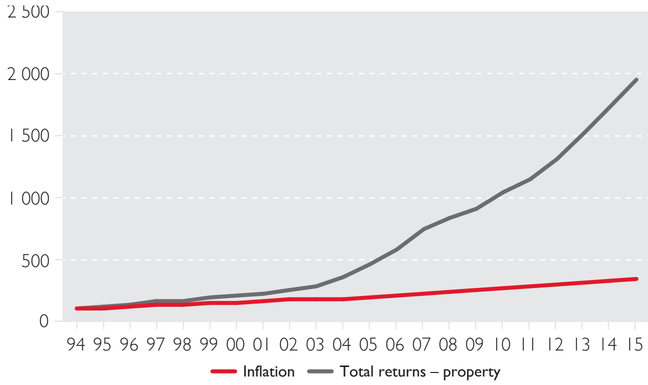
Chart 2: The income return on R1 000 invested in direct property (1995-2015)



Sources: IPD, Cadiz Asset Management

The total return on property of course includes capital growth as well. When we take into account this component it is clear that direct property far outstrips inflation, as shown in Chart 3.

Chart 3: Total returns on direct property compared to inflation (1994-2015)



Sources: IPD, Statistics South Africa

Buying property via an investment vehicle makes economic and practical sense

Buying property as an individual holds various challenges. These include sourcing and negotiating deals, managing the property and all its tenancies, administering the rent collection, and managing service providers. In addition, very few individuals have the cash to buy quality properties – especially when you consider how many properties you need to buy to achieve sufficient diversification. These and other realities can turn what sounds very attractive in theory into an administrative headache in reality. The attraction of an investment vehicle that enables investors to pool their cash to access quality property investments is therefore obvious.

Investing in listed property exposes you to the volatility of the stock market

When investing in property via an investment vehicle you have two options: listed or unlisted property.

Listed property shares certainly have their benefits. Some of the listed property companies on the JSE hold quality property assets and are very well managed. Unfortunately, their merits do not shield them from the volatility associated with listed companies. In contrast, the Cadiz Property Income Fund is not listed – the value of the units is determined only by the value of the actual properties in the portfolio. Comparing the listed sector as a whole to the Cadiz Property Income Fund since the inception of the Fund offers a valuable perspective. Chart 4 shows the average premium or discount to net asset value (NAV) – that is, the underlying value of the actual property portfolio less any debt – for all listed property shares on the JSE for the period January 2012 to June 2016.

Chart 4: Average premium or discount to net asset value of JSE-listed property shares (2012-2016)

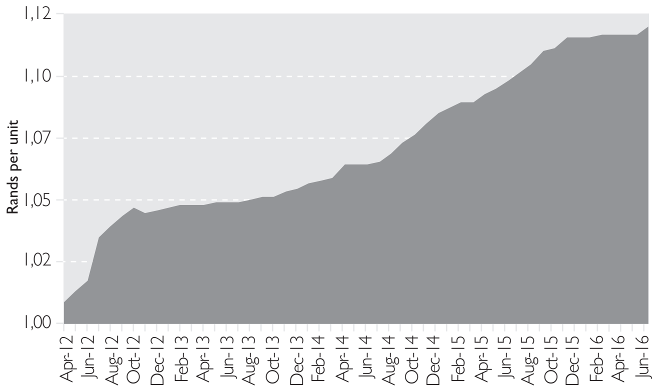
Sources: Catalyst Fund Managers, Cadiz Asset Management

This chart indicates that, on average, listed property shares have traded at a premium of 30.4% to NAV over the period. What it doesn't show is that the premium or discount applied to individual shares during that period ranged from 816.8% to -82.9%. In addition, almost every month there were some shares that moved from a premium position to a discount, or the other way around. That is simply the nature of the stockmarket and listed property shares certainly have a place in a well-balanced investment portfolio.

Unlisted property investments provide investors with moderate but predictable returns

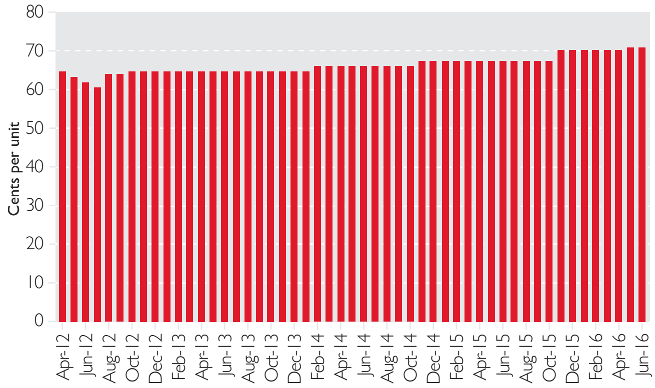
Chart 5 shows the steady growth in the unit prices of the Cadiz Property Income Fund over roughly the same period as Chart 4. It is clear that the unit prices have increased slowly but steadily since the Fund's launch four and a half years ago. Likewise, monthly income distributions have increased steadily, as shown in Chart 6.

Chart 5: Cadiz Property Income Fund unit price growth since inception (2012-2016)



Source: Cadiz Asset Management

Chart 6: Cadiz Property Income Fund monthly income distributions (2012-2016)



Source: Cadiz Asset Management

With the Cadiz Property Income Fund you know what you get and what you can expect

In the mid-1990s a British wood stain manufacturer became famous for its slogan 'It does exactly what it says on the tin'. The phrase has become idiomatic in British culture and is used to describe something that delivers according to expectations. When we created the Cadiz Property Income Fund our intention was to provide investors with a solution that delivers low to moderate capital growth and a predictable and steadily increasing income return. The Cadiz Property Income Fund does just that – it delivers what it promises. ■

Quarterly review

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

INTERNATIONAL PERFORMANCE

It's as though Brexit never happened

Although the initial response to the Brexit vote was to shave $3 trillion off global equity market capitalisation and send a *tsunami* of money into the bond market, the performance of risky assets in the third quarter was almost exactly the same as in the second quarter. To a large extent, this can be attributed to the US Federal Reserve (US Fed) once again delaying a rate hike at its September meeting. Despite pronouncements by the European Central Bank (ECB) that it had run out of quantitative easing ammunition, and the 'new-improved-guaranteed-not-to-fail-as-it-has-in-the-past-three-years' plan by the Japanese authorities (which now targets the shape of the yield curve), investors' spirits were not dampened.

Global growth is not as bad as you might think

Cutting through all the noise, we are generally positive about global economic growth. As we have stated in the past, the US is ahead of the pack and while we have been concerned about Europe, there are signs of recovery. The major European economies – Germany, France, Italy and Spain – have a positive GDP track and employment is also picking up at about 1.5% per annum (p.a.). It is therefore probably a good thing that the ECB is switching off the morphine pump. China recently pump primed its economy (by increasing government spending and cutting down interest rates and tax), which boosted property demand, and subsequently property prices. Although it's introducing curbing measures once again, one has to admire the number of levers available to the managers of the Chinese economy to keep the momentum going.

Table 1: International market returns

International (US$)	Quarter	YTD	12 Months
MSCI World	5.0%	6.1%	12.0%
MSCI Emerging	9.2%	16.4%	17.2%
MSCI SA	6.4%	23.3%	10.3%
J.P. Morgan Global Bonds	3.0%	11.0%	9.2%
US Cash	0.1%	0.2%	0.3%

Sources: Deutsche Bank, Bloomberg Finance LP

The quarterly performances reflected above were supported to some extent by the weakness of the US dollar, which was lowered by the fact that the US Fed once again kept interest rates unchanged. The second feature of the quarter was that it was a 'risk-on' period – investors were prepared to back higher-risk assets such as equities over bonds and cash, and preferred emerging over developed markets. Support in the equity market was mainly targeted at cyclical industries and shares, with gold and defensive assets being sold.

The MSCI China Index (+13%) registered the best equity market performance in the quarter. Most sectors in the equity market did well, but software (+23%), auto and durable services (both +19%) dominated. Mexico (-3%) was a major underperformer in the quarter, which is unsurprising, given the threat of being walled off from the US if one of its presidential candidates has his way.

LOCAL PERFORMANCE

Politics dominated the quarter

As has been the case worldwide, political developments dominated the local economy in the third quarter. Some aspects were positive, such as the largely peaceful local municipal elections. Others less so, such as the constant attack on the person and institution of the Minister of Finance, which created massive unease. With politics front and centre of newscasts, it would have been easy to miss some of the more positive developments in the local economic and financial markets:

- The South African Reserve Bank's second quarter release showed that there was a significant narrowing of the current account deficit from a revised -5.3% of GDP in the first quarter to -3.1%. This was driven mainly by the fact that the seasonally adjusted trade balance improved from a deficit of -R47.7 billion to a surplus of R33.3 billion.
- Private consumption expenditure rose by 1% in the second quarter from -1.7% in the first quarter, with most of the improvement in semi-durable and non-durable goods and services. Consumption of durables remained weak on the back of rising interest rates. This was because prices of durable goods, which are highly import-intensive, have increased on the rand's earlier depreciation. This is evidenced by the recent poor new car sales figures.
- Household debt as a percentage of disposable income fell to the lowest level recorded since the beginning of 2006.
- Inflation statistics at both producer and consumer levels appear to have peaked. Together with the recent strengthening of the rand, there is therefore little reason to raise local rates.

Bonds and resources remain strong, whereas financials delivered mixed results

Whereas the international bond markets lagged in the quarter, this was not the case locally. As is evident from Table 2, local bonds have been the asset class of choice over all the periods measured, although it still lags equities over three, five and ten years. The carry trade, where investors borrow funds in low-yield countries and redeploy in high-yield economies, was back on in South Africa, Brazil, India and Russia, indicating a broader emerging market strategy. In a world of zero or negative interest rates this makes sense. The lower section of Table 2 reflects that most of the bond returns were concentrated in the long end (12+ years) of the market. Foreign purchases of South African bonds total US$4.7 billion year-to-date, as opposed to US$7 billion of net selling of local equities, confirming this renewed interest in yield.

Property had another weak quarter. We have argued for some time that a large portion of the last two years of outperformance has been driven by substantial deal flows and the conversion to a real estate investment trust (REIT) structure, which holds certain tax and other benefits. Valuations became too stretched and are still not at levels that are appealing to us.

Resources had another strong quarter on the back of price surges in:

- palladium (+22%, leading to Impala recording a return of +47% - the best return in the quarter),
- premium hard coking coal (+139%, helping Exxaro to a +25% gain), and
- tin (+18%).

The +0.8% quarterly return by the financial sector hides a divergent set of performances. For example, the banks (which we are positive on) produced a gain of 10%, with Nedbank yielding +19%, Standard +10% and FirstRand +6%. On the other hand, the general financials (mainly Investec) were down by 6%.

Industrial shares, which have long been the backbone of the positive return league, crumbled in the quarter with the likes of MTN down by 18%, as Nigerian concerns continue to drain investor support. Other previous luminaries such as Mr Price (down 26% on the back of a poor trading update), MediClinic (down 24% on the back of overvaluation) and Brait (down 21% because of its UK exposure) caved in.

Table 2: South African financial market returns

Asset class (ZAR)	Quarter	YTD	12 Months
All Share	0.6%	5.0%	6.8%
All Bond	3.4%	15.1%	7.7%
Listed Property	-0.7%	8.8%	3.8%
Cash	1.9%	5.4%	7.1%
Tier-1 (ZAR)	**Quarter**	**YTD**	**12 Months**
Resources	8.1%	35.9%	24.1%
Financials	0.8%	2.5%	-0.9%
Industrials	-1.9%	-1.8%	4.7%
Size (ZAR)	**Quarter**	**YTD**	**12 Months**
Large Cap	-0.1%	1.5%	4.1%
Mid Cap	4.0%	26.1%	23.3%
Small Cap	5.5%	20.3%	15.0%
Bond Market (ZAR)	**Quarter**	**YTD**	**12 Months**
All Bond	3.4%	15.1%	7.7%
1-3 years	2.2%	8.5%	8.0%
3-7 years	2.9%	12.2%	9.2%
7-12 years	3.2%	14.6%	7.9%
12+ years	4.0%	17.5%	7.2%
Preference shares	2.2%	16.5%	13.4%

Sources: Deutsche Bank, Bloomberg Finance LP

Where to from here?

Local investors have a few hurdles to cross in the next few months that should cause some volatility in the markets, namely:

- the Medium Term Budget Policy Statement,
- ratings agency assessments in South Africa,
- an election and potential rate rise in the US, and
- an Italian referendum.

In the second quarter of this year we raised our equity allocation marginally and introduced a slightly more cyclical bias to the overall structure, both in our local as well as international exposures. In the third quarter, we increased our multi-asset class funds' exposure to local bonds, given the improved inflation and trade account outlooks. We remain overweight cash, but will deploy these reserves when opportunities become available. ■

Meet Equity Analyst:
Mpandekazi Maneli

by ***Mpandekazi Maneli****,*
Equity Analyst

Driven by a passion to change ordinary people's financial outcomes through knowledge

Mpandekazi is a qualified chartered accountant. She discovered her passion for the investment industry while completing her articles with Deloitte & Touché, when she audited asset managers. At the same time, one of her family members retired with an insufficient pension – largely because of poor advice and a lack of access to information. This inspired her to play a role in empowering people through sharing knowledge. Following her articles, Mpandekazi worked at Cadiz Asset Management before joining the unconstrained investment team at Momentum Asset Management as an Analyst and Head of Research. She then returned to the Cadiz team. Mpandekazi has nine years' investment experience.

What are three things that few people know about you?

1. I paint to unwind
2. I love travelling – I am fascinated by people, places and cultures
3. I am a great (but not so keen) cook

Who or what was the biggest influence in your life?

1. My walk with God
2. My mother – she is the most intelligent, down to earth, strongest person I know with a fantastic sense of humour

Tell us a bit about your family life.

I'm an only child but I have a cousin I consider a sibling, so I have had the best of both worlds.

What do you do to relax?

I listen to a lot of jazz music. I also run, pray, paint, host, and spend time with family and friends.

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

This largely depends on the day and time of day, but it's a mixture of Metro FM, SAFM, and my playlist on iTunes.

What are your pet peeves?

Anyone that knowingly wastes my time. It is usually because they are not being honest with me, so dishonesty is also a pet peeve.

What would you have liked to become if you hadn't become an equity analyst?

A lawyer or an artist. I initially enrolled to be a lawyer. In my first week of lectures I accompanied a friend to an accounting lecture. The lecturer's passion for accounting inspired me to change my course right there and then.

What's important to you at work?

Challenge, and growth. I think we are fortunate in this industry because we get to interact with captains of industries. Investment teams typically have many intelligent people who think and interpret things differently. I like a good healthy debate and being challenged because it leads to growth.

Cadiz Unit Trusts' performance

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

Unit Trusts	1 Year	3 Years	5 Years	7 Years	Since Inception	Inception Date
No Equity Exposure						
Cadiz Money Market Fund	7.53%	6.72%	6.28%	6.42%	7.64%	01-Mar-06
Alexander Forbes Short Term Fixed Interest (STeFI) Composite Index	7.12%	6.38%	5.99%	6.15%	7.32%	
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	6.58%	6.16%	7.29%	7.77%	8.69%	01-Mar-06
CPI+3%	8.98%	8.65%	8.66%	8.31%	9.17%	
Quartile Rank	3rd	4th	2nd	2nd	1st	
Low Net Equity Exposure (20 - 40%)						
Cadiz Stable Fund	7.45%	4.97%			6.04%	01-Sep-12
CPI+3%	8.98%	8.65%			8.79%	
Quartile Rank	2nd	4th			3rd	
Medium Net Equity Exposure (40 - 75%)						
Cadiz Inflation Plus Fund	6.22%	3.86%	8.73%	8.58%	8.90%	13-Jan-06
CPI+5%	11.03%	10.67%	10.67%	10.31%	11.20%	
Quartile Rank	2nd	4th	3rd	3rd	1st	
Cadiz Managed Flexible Fund	7.33%	3.89%	10.30%	9.95%	9.44%	01-Mar-06
Average of the Domestic - Asset Allocation - Prudential High Equity sector	7.02%	8.52%	11.87%	10.73%	10.80%	
Quartile Rank	2nd	4th	4th	4th	1st	
Flexible Net Equity Exposure (50 - 90%)						
Cadiz Equity Ladder Fund	2.79%	-1.30%	0.89%	1.58%	5.94%	03-Jun-05
CPI+6%	12.05%	11.67%	11.67%	11.31%	11.65%	
Quartile Rank	3rd	4th	4th	4th	3rd	
High Net Equity Exposure (100%)						
Cadiz Mastermind Fund	4.02%	-0.12%	8.04%	8.09%	8.60%	01-Mar-06
FTSE/JSE SWIX Index	9.04%	10.91%	16.75%	15.55%	13.89%	
Quartile Rank	3rd	4th	4th	4th	2nd	

Source: Morningstar and Cadiz Asset Management

Contact details

For more information kindly contact:

Gerald Mafunda
Head: Institutional Business Development

Institutional Investments:
Direct: 021 657 8656
cam@cadiz.co.za

Natalie Smith
Head: Retail Business Development

Personal Investments:
Direct: 0800 022 349
investorservices@cadiz.co.za

Cadiz Asset Management (Pty) Ltd (Reg. No.1953/001254/07) is an authorised financial services provider (FSP 636).

Cadiz Collective Investments Ltd (Reg. No 2004/032263/06) is a member of the Association for Savings & Investments SA (ASISA).

Cadiz Life Ltd (Reg. No. 2005/006996/06) is a registered long-term insurer.

4th Floor, The Terraces, 25 Protea Road, Claremont 7708, Cape Town • T 08000 22349

www.cadiz.co.za

cadiz
ASSET MANAGEMENT