cadiz
ASSET MANAGEMENT

Navigating uncharted waters requires a steady hand at the tiller

Benjamin Franklin once said, *"By failing to prepare, you are preparing to fail."*

In these times of uncertainty, one needs a guiding set of principles to steer the course through the unknown. This requires a disciplined and well-practiced process that keeps a focus on what is important and relevant, through the good times and the tough times.

During this global COVID-19 pandemic, we remain focused on protecting our clients from permanent capital loss, while investing in good businesses that should compound your wealth over time.

AT CADIZ ASSET MANAGEMENT, OUR FIRST RULE IS, 'DON'T LOSE CAPITAL'

This focuses our attention on where to start when analyzing any business. Understanding a business's balance sheet, its debt levels and when debt repayment is due is vital to understanding if a business will survive the tough times. During this global COVID-19 pandemic, as countries remain in lockdown and economic activity has largely ground to a halt, corporate balance sheets and liquidity needs are being tested like never before.

A case in point is Sasol. Entering 2020, we had no Sasol exposure as we deemed the financial risk too high as the Company failed to meet our investment criteria. During the COVID-19 pandemic and the subsequent collapse in the oil price, it became apparent that Sasol was going to struggle to pay its debt and interest costs due in the next one to two years. During March this year Sasol lost 70% of its value, announcing that it needed to raise capital, by a combination of selling assets, restructuring costs and holding a rights issue, in order to pay down its debt.

At Cadiz, we have re-interrogated the company's balance sheet for each of our investments, stress-testing their ability to manage their debt obligations and cash requirements under extreme operating scenarios. We are pleased to report that we are comfortable with the balance sheets for all the investments we hold.

INVEST IN QUALITY BUSINESSES, THAT HAVE PROVEN TRACK-RECORDS AND COMPOUND RETURNS OVER TIME

When equity markets fall as hard as they did during March, there is initially indiscriminate selling. As time goes on, investors start to distinguish between the quality stocks that are likely to survive these turbulent times and the poorer quality stocks that are often highly leveraged with weak business models. At Cadiz, we focus much of our attention on understanding the qualitative characteristics of a business, in order to assess the risks of whether a business will endure. We focus on understanding:

- How does the business make its money and what are its competitive advantages? Are these competitive advantages likely to persist, or could they be eroded over time?
- Does it have too much debt and can it repay the debt?
- Does it have a competent management team aligned to shareholders' interests?
- Does it have a proven track-record of generating superior returns on capital, and are these returns likely to persist?
- Where is the company in its business cycle - capital cycle and earnings cycle?

Good quality businesses usually trade at a premium. As equity prices have fallen during the COVID-19 crisis, however, we have used this opportunity to increase our exposure to these good quality businesses by either adding to existing positions or adding one or two quality counters to the portfolio. This will strengthen the portfolio's ability to weather the storm and compound returns over time when the world economy recovers.

MAINTAIN A DIVERSIFIED PORTFOLIO

With the sudden drop in economic activity, the demand for cash for companies to pay their staff, supply chains, rent, interest costs and taxes has been unprecedented. This has led to excessive disinvestments by companies and individuals from money market funds, income funds, bonds and equity funds globally. Foreigners have also repatriated their money out of South Africa. Consequently, this has caused the dollar-rand, credit, bonds and equity prices to fall, forcing correlations to rise towards one.

This is temporary, however and not all is bad news. For example, year-to-date, MSCI World USD has fallen -20%, while the rand has depreciated 27%. For a South African investor, the rand has more than cushioned the blow to foreign investments.

Our portfolios have also enjoyed the benefits of diversification in global businesses listed on the South African stock exchange and other rand hedge stocks. For example, Naspers and Prosus are predominantly exposed to Tencent, British American Tobacco, and AngloGold Ashanti. Besides these stocks, the portfolios are also exposed to defensive businesses, including Shoprite and Mediclinic, along with other US pharmaceutical and healthcare stocks (CVS Health, Gilead Sciences and Walgreen Boots Alliance). All these stocks have different growth drivers and have held up well during this crisis, providing good diversification for the funds.

When the world finally overcomes the COVID-19 pandemic and global economies recover, some industries will recover faster than others. While it is difficult to tell which industries or stocks will be winners in the short term, we believe that the portfolio of diverse businesses our clients are invested in have solid long-term growth prospects. This combined with highly attractive valuations, sets up our portfolios for good long-term returns. Markets can be very volatile over the short-term, but history has shown that those that are willing to be patient and invest for the long-term will be handsomely rewarded.