cadiz
ASSET MANAGEMENT

The search for real yield
Have money markets lost their sparkle?

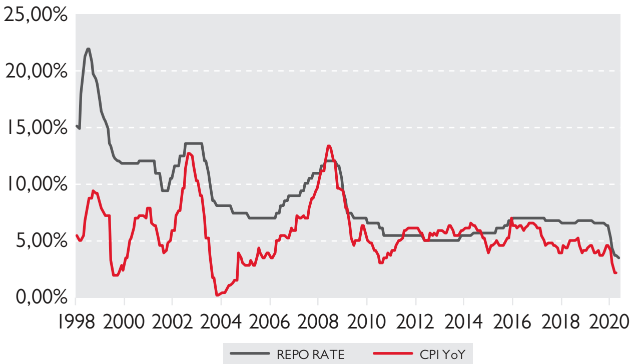
CAN INVESTORS STILL ACHIEVE REAL RETURNS BY INVESTING IN LOCAL MONEY MARKET FUNDS?

Over the past 20 years we have seen interest rates (represented by the Repo Rate) in South Africa reduce from nearly 22% in August 1998 to 3.5% currently. What makes this reduction so significant is that interest rates have declined by 300bpts year to date with the potential for a further cut later this year.

The reduction in interest rates was partially caused by the moderation of Consumer Price Inflation (CPI) from over 12% in 2008 to 2.2% in July 2020.

In the line graph below we highlight the reduction in both the South African Repo Rate (Grey line) and CPI Year on Year change (Red line).

SA REPO RATE AND INFLATION: 1998 TO PRESENT

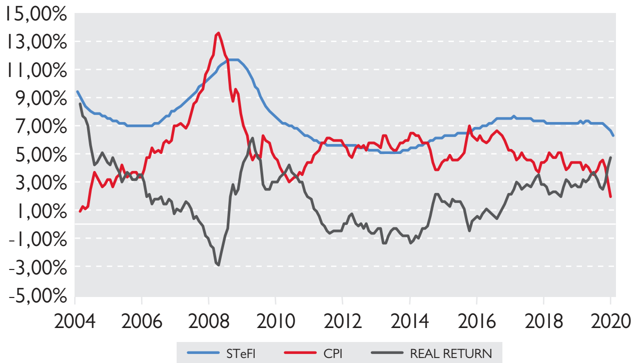


Even with the reduction to both the CPI rate and the Repo rate clients have seen an increase in their real returns, the return an investor receives after deducting inflation, by investing in a money market fund.

In the line graph below we show how investors in money market funds have been able to grow their wealth without taking equity risk.

We have used the returns of the STeFI Composite (Blue line) as a proxy for money market returns, the upwardly slopping real return (Grey line) is the difference between STeFI and CPI (Red line).

STEFI COMPOSITE VS CPI



At Cadiz we believe we could be nearing an inflection point as investors start to slowly experience a decline in real returns as inflation starts to creep back towards the mid-point of the South African Reserve Banks target range of 3% to 6%, over the next 12 to 18 months while interest rates remain lower for longer. Therefore, investors requiring an increased return would need to add measured credit and duration risk to enhance their yield and increase real returns. »

CADIZ MONEY MARKET FUND – A top quartile performing money market fund over 1, 2, 3, 5, 7 and 10 years and the number one ranked money market fund over 7 years and 10 years, with an annualised return of 7.21% and 6.79% respectively.

Source: Morningstar report for the period ending 31 July 2020, Peer Group: (ASISA) SA IB Money Market

WHAT IS CREDIT RISK?

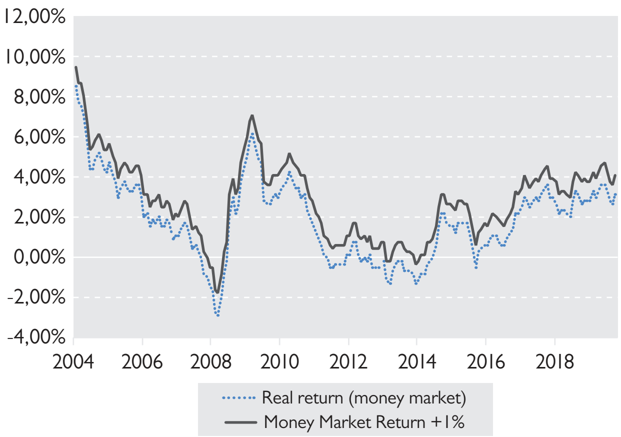
The credit market refers to the marketplace through which companies issue debt to investors in exchange for regular interest payments. Credit risk is the possibility of a loss resulting from a company's failure to repay a loan or meet contractual obligations.

Interest payments from the issuer of a debt are the rewards a lender or an investor receives for assuming the credit risk. Higher credit spreads are mitigated via a higher interest rate, which provides for greater cash flows, and are offered by a lower quality issuer to provide additional cover for taking the elevated credit risk.

Although it is impossible to know who may default on obligations, by properly assessing and diversifying the spread of credit risk in a fund, the manager can lessen the severity should a loss occur.

In the line graph below we have used STeFi +1% (Grey line) to indicate how adding measured credit risk could improve your real returns (Blue dotted line).

WHAT DOES CREDIT MEAN FOR REAL RETURNS?



WHAT IS DURATION RISK?

Duration risk, also known as interest rate risk, is the possibility that changes in interest rates may reduce or increase the market value of a fixed-income investment.

As an example, should you have invested into a bond at an interest rate of 5% and the interest rates increase by 1%, any additional investors into the same bond will now demand a 6% rate of return and the market price (capital value) of the bond will decrease to allow for the increase in the rate of return from 5% to 6%.

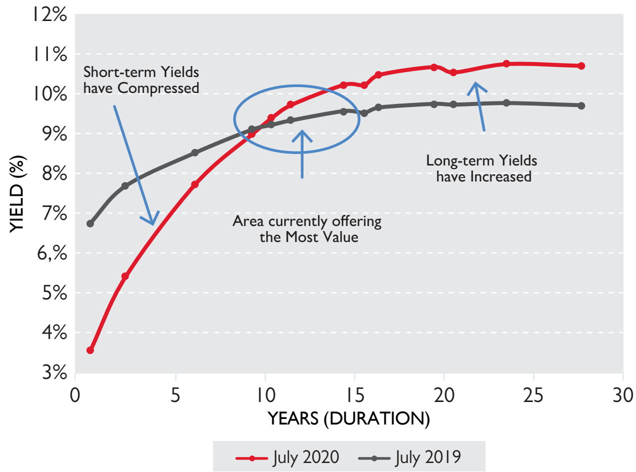
The longer the duration, the period for which you lend to the issuer, the greater the interest rate default risk you take, therefore an investor would want to be adequately compensated for taking the extra duration risk.

The image below is the yield curve as of July 2020 (Red line) which indicates the yield percentage and duration, in years, for the bonds you can purchase. The grey line is the yield curve from July 2019 and shows how the short end has compressed, due in part to falling interest rates, while yields at the back end have increased.

Cadiz are cognisant of the risks to the local bond market and believe that investors are not being adequately compensated (flattening of the yield curve towards the back end) for taking extra duration risk.

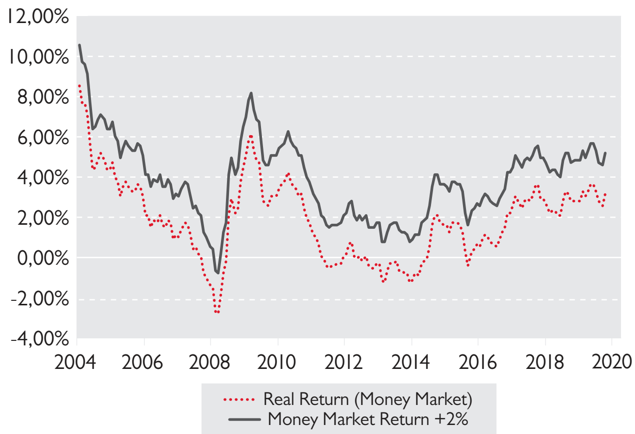
The highlighted area is where we believe the most value can be found, the yield relative to duration risk is best positioned, and have been buying into this area for our clients.

THE YIELD AND DURATION RELATIONSHIP



The line graph below assumes an investor could achieve money market returns plus 2% per annum (Grey line) by buying into bonds and highlights the additional real returns (Dotted Red line) that may be achieved for taking this extra duration risk.

IS RISK NEEDED TO ENHANCE REAL RETURNS

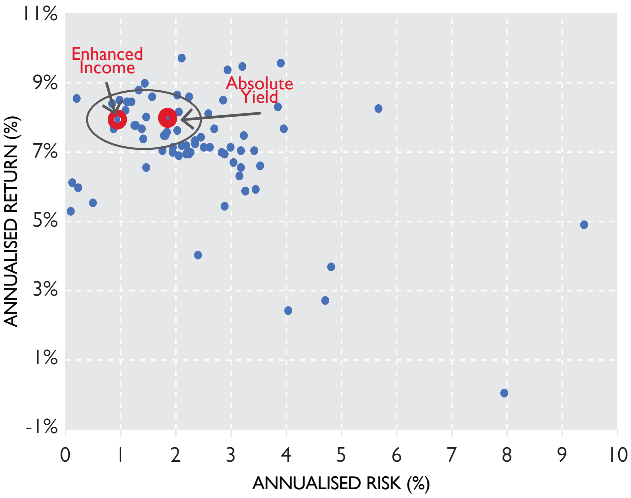


An important question an investor should ask is, what level of risk am I prepared to take to enhance my returns, and how consistent is the manager at outperforming its peers.

A way to depict this is to look at the 3-year annualised returns relative to annualised risk (standard deviation) scatterplot of the funds in the ASISA SA Multi Asset Income category.

Funds that are in the top left-hand quadrant indicate a lower level of risk while still providing above average returns.

3 YEAR ANNUALISED RISK VS RETURN - ASISA SA MULTI ASSET INCOME CATEGORY



CONCLUSION

Investors are still able to achieve real yields in money markets even during the current low interest rate environment. However, real yields could decline if inflation picks up over the next 12 to 18 months while interest rates stay lower for longer.

We believe that by adding measured duration and credit risk into your portfolio an investor is able to enhance their yield and increase real returns.

We also believe that blending well chosen funds that have a low correlation to each other will reduce manager risk while still providing real returns.

Our two fixed income solutions, the Cadiz BCI Enhanced Income Fund and the Cadiz Absolute Yield Fund, are an ideal way to enhance yields while adding measured risk to a client's portfolio.

Why include the Enhanced Income Fund or the Absolute Yield Fund in your client solutions?

- Low variability of returns
- Long term outperformance with lower levels of risk during adverse market periods
- Increased real yields to maintain purchasing power
- Competitive asset management fees •