CAMmuniqué
CADIZ ASSET MANAGEMENT INVESTMENT UPDATE

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Outlook 2020

Earnings growth to support equity returns, but headwinds and macro risks have increased

IN THE LONG TERM, STOCK PRICES FOLLOW EARNINGS.

Last year, global stocks had an excellent year where the MSCI World index (in dollars) delivered 28%. The US S&P 500 was the top performer, generating 31% in a year where earnings grew only 1%[1]. Focusing on the last 2 years, however, puts the recent performance into context. Earnings grew 20% while the overall market returned 26% (including 4% from dividends). In other words, the share price performance was supported by solid earnings growth over the last 2 years. US tax cuts in 2018 accounted for an 8% once-off boost to earnings growth, which is unlikely to be repeated.

FOR 2020, EXPECT A FUNDAMENTAL TOTAL RETURN OF BETWEEN 7% AND 11% FROM GLOBAL EQUITIES.

Analysts have been revising earnings expectations up to between 5% and 9%[2]. Adding in dividends (2%), one can expect a total return of between 7% and 11%. This is in an investment landscape where the global economy is likely to grow at-trend with below-trend inflation and supported by accommodative central banks that are providing liquidity to the markets. Global bond yields (US Treasury 1.80%) could rise slightly from current low levels but should continue to provide cheap funding for businesses.

RISKS TO EARNINGS AND STOCK PRICES HAVE INCREASED.

The equity bull market that started in 2009 is aging, headwinds are developing and there are macro risks that need to be monitored. These include:

- Operating profit margins have been falling for the last 2 years from historically high levels which has largely been a function of rising oil prices and wage inflation. With most developed countries experiencing close to full employment, workers are demanding wage increases greater than consumer inflation. This is a key risk to operating profits.
- Debt levels on corporate balance sheets have increased meaningfully as businesses have made the most of low interest rates. At present, this is not a concern as debt servicing costs are still manageable, well below long-term averages. Credit markets are well behaved and corporate defaults are low. However, this could become a major concern if interest rates were to rise substantially.
- The manufacturing sector has been severely affected by the US-China trade war. Prices of imports to the US have risen between 15% and 20% on tariff-earmarked goods increasing input costs. This policy uncertainty has also created significant disruptions to the global supply chain and has caused manufacturers to hold back on capital investments, impacting other businesses. We don't believe the tensions between the US and China are likely to go away anytime soon.

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1 Bloomberg – estimated using change in forward earnings
2 FactSet Analyst consensus earnings expectations for the S&P 500 index in 2020

- Investor positioning in equity markets has risen. Equity exposure in pension funds, hedge funds and other alternative funds have all increased. Market participants might be complacent by ignoring possible risks as indicated by the VIX (Volatility index) which is well below its long-term average.
- Equity markets are not cheap. US Equities are trading above their long-term price multiples. If earnings growth disappoints analyst expectations or there is a change in sentiment, equity prices could fall significantly.
- Political and geopolitical risks could affect equity markets, especially if it affects policy.

EXPECT SOUTH AFRICAN EQUITIES TO GENERATE A FUNDAMENTAL RETURN OF BETWEEN 8% TO 12% WITH SIGNIFICANT UPSIDE/DOWNSIDE RISKS TO THIS RETURN.

Last year, South African equities (ALSI) generated a total return of 12% made up of earnings growth of 8% and dividends of 3.5%. Looking forward we expect earnings growth and dividends to be similar, generating a fundamental return of between 8% and 12%.

However, the upside/downside risks to this outcome are significant. The major macro risks are:

- South Africa's fiscal position. Government needs to cut expenditure, especially the wage bill.
- Moody's downgrading South Africa's credit rating to sub-investment grade.
- South Africa's economic growth continues to be subpar with electricity shortages a major concern. Subdued investment from government and business as well as low productivity are also limiting South Africa's growth potential.
- Company operating profits continue to decline as a function of:
  - Below-inflation revenue growth as consumer demand for products remains weak.
  - Cost inflation exceeds consumer price inflation. This includes electricity costs, municipal rates, labour costs and raw material costs.

DOES GOVERNMENT HAVE THE POLITICAL WILL TO REFORM?

National Treasury (NT) has stated expenditure cuts *exceeding* R150bn are required over the next 3 years to bring South Africa's budget deficit down to more acceptable levels and stabilise the debt-to-GDP ratio of around 70%-72%. To achieve these goals, NT plans to tackle the public sector wage bill, which accounts for 46% of tax revenue and reform SOEs, where non-core assets could be sold. Negotiating with the unions will be tough, but Finance Minister Tito Mboweni will need to communicate clearly how government plans to reign in the cost of the public sector wage bill.

- If government can present a credible reform plan; bonds, equities and possibly the rand could rally in expectation that the SA economy will be on the road to recovery in the next 2 to 3 years.
- However, if government fails to reign in its expenditure and present a credible reform plan the risk is that South Africa could enter a debt trap as debt levels increase meaningfully. Moody's (and other rating agencies) will most likely downgrade South Africa's creditworthiness. The rand could depreciate materially, bonds could sell off as they expect increased issuance and domestic equity prices could fall further on poor economic growth prospects. Rand hedges and non-South African stocks could outperform.
- The most likely option is that government does just enough to satisfy market expectations such that South Africa muddles along and the current weak fundamentals continue.

The best way to invest in these economic conditions is to hold a diversified portfolio of both global and local stocks. Our approach is to invest in predominantly good quality businesses with strong balance sheets and capable management that can compound their earnings over time. We like to buy these businesses at attractive prices that should generate handsome long-term returns for our clients. Buying these businesses with a sufficient margin-of-safety helps preserve capital in case we overestimate the merits of the business, or negative macro risks affect the share price.

Asset Class Preference	--	-	N	+	++
Cash				●	
ILB			●		
Bonds		●			
Property	●				
Equity		●			
Resources			●		
Financials		●			
Industrials				●	
Foreign				●	
Cash		●			
Bonds	●				
DM Equities				●	

Our positioning across the funds is to have maximum offshore exposure providing diversification for South African investors. We are overweight global equities, local cash and high yielding corporate bonds. We are underweight South African equities, property and government bonds. Within SA equities, we are defensively positioned, overweight multi-nationals, platinum and gold stocks. We are underweight financials but have been selectively adding to domestic stocks where we believe stocks are attractively priced given the quality of the businesses.

At Cadiz, we remain disciplined in allocating capital to both local and offshore opportunities to achieve the fund's investment objective of compounding your wealth while limiting any permanent loss to your capital.

By Brian Munro

Truworths – Priced well below true worth

Cadiz Asset Management seeks to find above-average quality businesses that are well managed, with low financial risk trading at an attractive price, which increases the likelihood of good long-term returns and low risk of permanent capital loss. Truworths can be classified as such a business.

THE POOR RETAIL ENVIRONMENT HAS IMPACTED TRUWORTHS' PROFITS CAUSING INVESTORS TO SELL THE SHARE

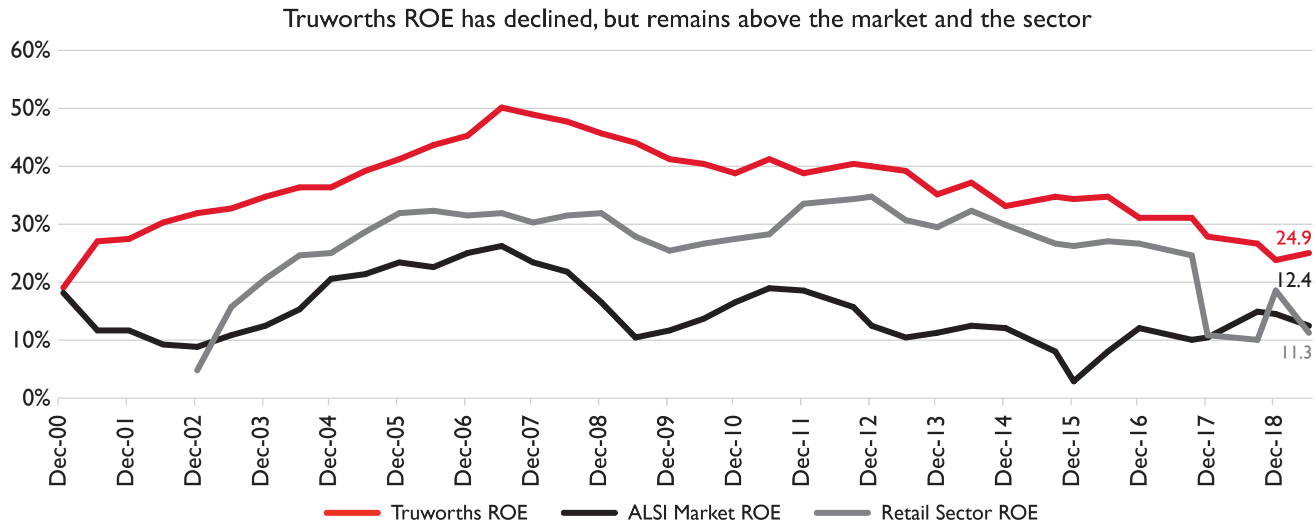
Truworths Africa (97% of sales come from South Africa and makes up 73% of Group revenue)

Truworths Africa has been experiencing below-inflation revenue growth. This is due to the combination of a low economic growth environment, high unemployment, increased competition, rising living costs, and higher VAT that has constrained local consumers' disposable income and decreased their spending power.

Truworths UK ("The Office" makes up 27% of Group revenue)

The UK retail environment is not much better. It has been impacted by continued uncertainty in the wake of Britain's decision to withdraw from the European Union which has resulted in a weak economy, low consumer confidence and a slowdown in consumer spending. This has resulted in decreased footfall into malls. At the same time, the growth of online shopping has also reduced physical store sales.

TRUWORTHS INTERNATIONAL LONG-TERM RETURN ON EQUITY (ROE)



Source: Bloomberg, Cadiz Asset Management

The poor retail environment and fashion missteps has forced Truworths to discount products which has caused profits to decline. Despite this, returns on capital within Truworths Africa remain above the market and the sector. This is because management have managed costs well throughout the economic downturn.

TRUWORTHS HAS AN OUTSTANDING LONG-TERM TRACK RECORD OF SUPERIOR RETURNS

Truworths has consistently generated return on capital greater than its cost of capital which indicates value creation for its shareholders. Additionally, Truworths has shown the ability to compound its revenue and net profit at impressive rates over the longer term. This has been achieved by sustaining higher margins relative to competitors.

We believe Truworths can maintain this premium margin due to their ability to source products at a lower price and astutely manage their operating costs. Historically, consumers have been willing to pay a higher price for Truworths products because of their perceived superior quality. Although there is increased competition, Truworths continues to invest in its Brand to maintain its market position.

EXPERIENCED MANAGEMENT TEAM THAT HAS EXPERTLY GUIDED THE BUSINESS

The management team has been involved in Truworths for decades, so they have been through many business cycles and have a wealth of experience. They have a good track record in terms of capital allocation and have grown the business organically without engaging in value destructive merger and acquisition activity. Furthermore, they have shown time and again their incredible ability to contain and cut costs, which has protected the company's margins over time.

- **Investing in the company's online platform:** The management team has invested over R300 million in upgrading and improving Truworths Omni-channel capabilities, which positions the company favorably for the coming years as consumers increasingly shop online. Last year, online sales accounted for 10% of total sales for the Group, which continues to grow strongly and offsets muted physical store sales growth.
- **Improving trading densities:** Management are also rationalizing their UK store estate with store closures amounting to 6% last year and a further 7% of store closures expected this year. This shows how management are actively looking for ways to improve the profitability of The Office. They are cutting costs whilst simultaneously driving their online retail presence to take advantage of the shift to online shopping.

FINANCIAL RISK IS LOW

Truworths has a strong balance sheet with little debt and is unlikely to go bankrupt. Truworths has the capability to trade through this difficult period, while continuing to invest in the business. This should put the business in a strong position to take advantage when the cycle turns and the retail environment improves.

DIVIDEND YIELD OF 8% PROVIDES A 'CASH-LIKE RETURN', WHILE WE WAIT FOR THE CYCLE TO TURN

We believe that the current share price is low enough such that the probability of losing money is low, while any improvement in the business prospects could lead to excellent returns for investors. There is no certainty in investing, hence we seek opportunities where we are unlikely to lose money if a reasonable worst case scenario occurs but there is tremendous upside if the business is able to return to a reasonable level of growth. The current share price of R47 implies that Truworths earnings will only grow at 1% p.a. forever, which is well below inflation and is too pessimistic. While we wait patiently for the SA and UK retail environment to improve, the business should be able to pay a dividend (dividend yield of 8%), given its strong balance sheet and good free cash flow. When the environment does turn, we should be handsomely rewarded.

By Sahil Gyanda