Greencape Wholesale Broadcap Fund

Fund report and commentary – 31 March 2008

Overview: The Greencape Wholesale Broadcap Fund (Fund) as at 31 March 2008, posted a return of -16.29% (after fees)* compared with the S&P/ASX 300 Accumulation Index (benchmark), which returned -14.61%.

Performance	Quarter (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Inception (%) p.a.
Greencape Wholesale Broadcap Fund	**-16.29**	**-1.31**	-	-	**15.64**
Growth return	-16.79	-9.95	-	-	8.67
Distribution return	0.50	8.64	-	-	6.97
S&P/ASX 300 Accumulation Index	-14.61	-7.21	-	-	8.39
Active return (net)	**-1.68**	**5.90**	-	-	**7.25**

Returns are calculated after fees have been deducted, assuming reinvestment of distributions. No allowance is made for tax. Past performance is not a reliable indicator of future performance.

Investment objective

The Fund aims to provide capital growth over the medium to long term investment horizon through a diversified portfolio of large, mid and small capitalisation Australian shares and provide returns above the benchmark, the S&P/ASX 300 Accumulation Index, over rolling three-year periods.

Investment manager

Greencape Capital Pty Ltd

Investment strategy

Greencape is an active, bottom-up stock picker. Whilst not targeting a specific investment style and investing in stocks displaying 'value' and 'growth' characteristics, Greencape's focus is on a company's qualitative attributes, which will generally lead to 'growth' oriented portfolios. This is an outcome of Greencape's bottom up process. As such, Greencape's investment style may be classified as 'growth at a reasonable price' (GARP).

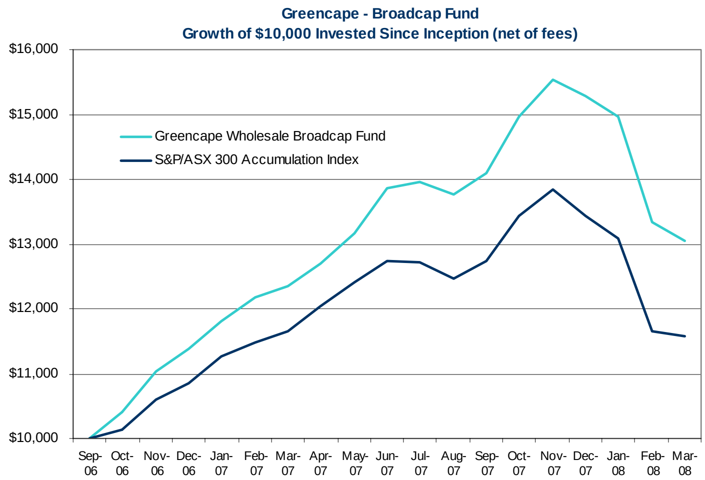
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

Money Management | IMCA
FUND MANAGER OF THE YEAR 2007
WINNER
Rising Star



Asset allocation	Current (%)	Range (%)
Securities	100	85 - 100
Cash	0	0-15

Fund facts	Greencape Wholesale Broadcap Fund
Inception date	11/09/2006
APIR code	HOW0034AU

Fees	Greencape Wholesale Broadcap Fund
Entry fee	Nil
2006/07 ICR	2.58%
Management fee	0.95%p.a.
Performance fee	15% of the Fund's after management fee return above the Fund's benchmark.
Buy/sell spread	+0.30%/-0.30%

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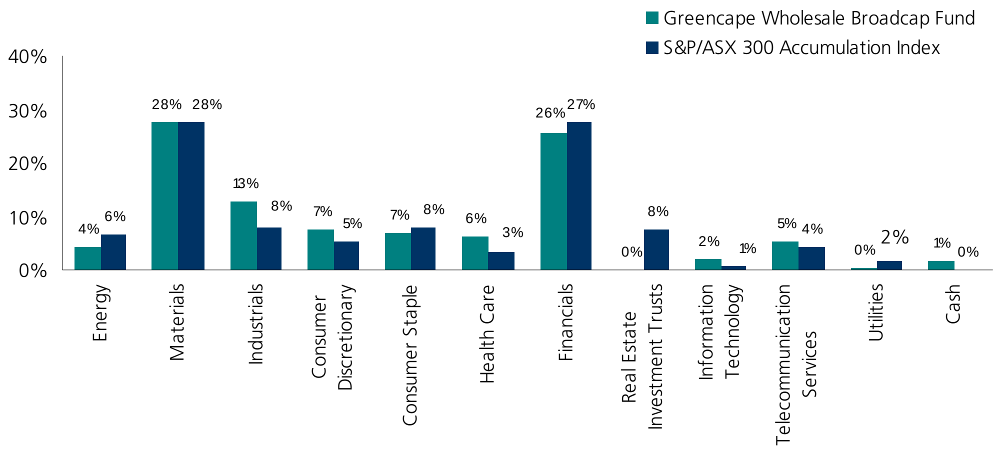
Sector exposures as at 29 February 2008



Market Review

The March Quarter of 2008 was the worst since the "crash' of 1987. The S&P/ASX 200 Accumulation Index fell 15.5%. All months in the quarter delivered negative returns, with March being the fifth straight monthly decline. The last time the market delivered 5 consecutive down months was back in 1992. All sectors posted negative returns over the quarter with the worst sectors being Financials (-24.1%), Consumer Discretionary (-22.6%) and Property Trusts (-19.3%), whilst the best sectors were Energy (-4.6%), Healthcare (-6.4%) and Materials (-6.7%).

The quarter began with all eyes on the US retail sector, with investors looking for signs that that the key Christmas retailing season was impacted by a slowing economy driven by belt tightening associated with sub-prime mortgage borrowers. The market found what it was looking for, and all of a sudden in early January, the market concluded that that the broader economy was in fact being impacted by what is now termed 'the credit crises". This realisation resulted in an aggressive across the board equity market sell off in January – essentially the market was pricing in expected downgrades in corporate earnings expectations. Importantly this occurred despite the US Federal Reserve Bank reacting with a surprise 75 basis point cash rate cut in a hastily convened extra-ordinary meeting of the board, followed by a further 50 basis point cut at the regular January meeting. Despite the concerns towards a slowing economy being largely US centric – after all Australian retailers enjoyed very buoyant Christmas sales - the Australian market was impacted by the negative US sentiment and actually fell further than the US market. This is best explained by the fact that a significant

"Our philosophy is we're in the business of making money and not in the business of writing as much top line revenue as we can."

Frank O'Halloran, CEO QBE 26/02/08.

percentage of the Australian equity market consists of financial stocks (perceived to be directly impacted by the credit crisis), highly geared property trusts and infrastructure stocks (concerns around higher funding costs) and resource companies (concerns that a slowing US economy would reduce demand for commodities).

With the aggressive January sell off behind it, and the traditional mix of "fear and greed" heavily weighted towards fear, the market's attention turned towards the February reporting season. The actual results were generally in line with expectations but outlook commentary was very cautious. The Australian banks suffered further aggressive selling as specific provisions were being flagged for potential bad debts arising from companies impacted by the credit crises. This coupled with further rises in funding costs resulted in expectations for banking earnings downgrades. The sell-off in Australian banks was amplified by their premium price to earnings ratios relative to global peers and the fact that the RBA maintained a very hawkish stance during the quarter. The March quarter saw the Australian RBA hike rates twice by 25 basis points. This then lead to expectations that the Australian domestic economy will rapidly decelerate resulting in further bad debt experiences from Australian domestic borrowers who have over extended themselves.

March was a very volatile month, with financial stocks leading the market lower during the first couple of weeks. Continuous bad news emerged from European and US Investment banks with large write-downs of bad positions. This culminated in Bear Stearns being taken over by JP Morgan and other large investment banks announcing further write-downs and large recapitalisations. With the bad news confessions emerging, and capital being raised, an aggressive rally began in the last two weeks of March which was driven by hedge funds buying back their short positions and some glimmer of confidence returning to the market as finally some of the banking bad debt "skeletons" had began to come out of the closet.

"Wealth is not created by financial engineering. Financial engineering tends to be a transfer of wealth."

Stephen Barrow, Chief Investment Officer HOLT Value Associates, quoted in the Barrons Report, 20 Aug 07.

Company Visits and Observations

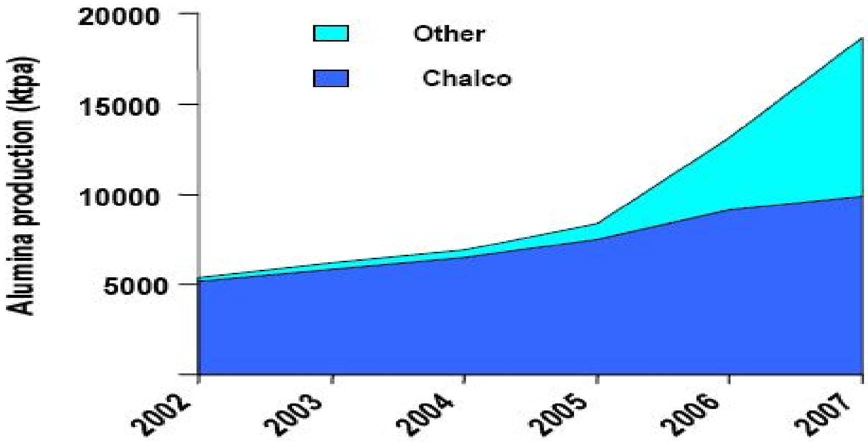
The Greencape research effort largely involved collecting and verifying the information disclosed by stocks during the results reporting season which started in February. Following are examples of observations made:-

- The aluminium industry is behaving irrationally. Unlike other resource-based commodities the aluminium price has not appreciated enough to offset the rapidly rising input costs. Key inputs to aluminium production are energy and freight. Cost per tonne of production is up 25% so far this financial year. This coupled with the strength of the Australian dollar has resulted in an extreme margin squeeze for Australian producers in particular. It appears the industry structure continues to favour buyers rather than producers, with many producers generating returns which do not justify the capital costs. Given the ability to substitute towards Aluminium, and the Aluminium price remaining relatively depressed, demand for Aluminium is very strong with global consumption running at around 12% growth with the industry expecting consumption to double from current levels by 2020. Producers question how long marginal suppliers will continue to supply demand at prices that are not economically rational, they do however point out that such suppliers are effectively Chinese government owned producers with financial objectives very different to other Aluminium producers. This highlights potential threats to other commodities where sovereign funds and governments seek industry influencing stakes which can lead to vertical integration between supply and demand. The following charts highlight the significant increase in Chinese production and the relatively flat Aluminium prices over the last 3 years.

"Profit margins are probably the most mean-reverting series in finance, and if profit margins do not mean-revert, then something has gone badly wrong with capitalism. If high profits do not attract competition, there is something wrong with the system and it is not functioning properly."

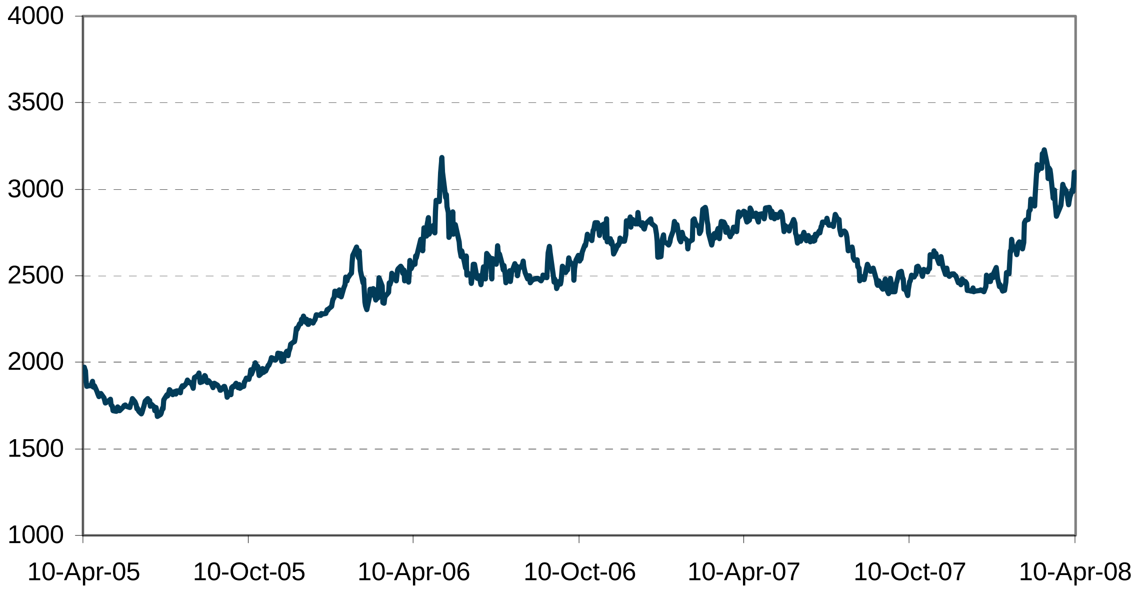
Jeremy Grantham, Chairman GMO, quoted in JP Morgan report 19/03/08.

China's Alumina Production



Source: Brook Hunt

LME Aluminium Prices (USD)



Source: Bloomberg

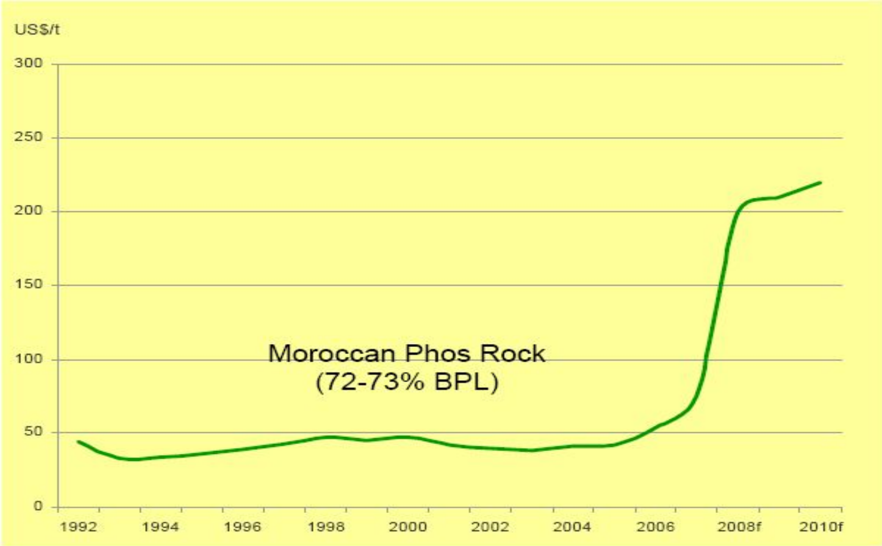
- Stocks which have been actively consolidating their sectors are excited to report that they are no longer competing against private equity buyers when attempting to make acquisitions. However, this is not immediately translating into better priced acquisitions as many acquisition targets have maintained, what appears to, be unrealistic price expectations. It appears it will take some time for the unlisted market to price in the "new lower valuations" now implied by the listed market. This highlights the lagged impact of marking-to-market valuations for assets which do not trade regularly. The ramifications of lagged "mark-to-market" actions on unlisted securities and assets can be expected to be experienced in the unlisted property and infrastructure sectors in coming months. It is important to note that many unlisted property and infrastructure assets are valued once or twice a year. This suggests many quoted unit prices of property and infrastructure funds are yet to reflect the realities of lower asset valuations.
- We continue to observe that the NZ economy supports industries which more often than not generate margins which are significantly higher than the same sectors in Australia.

- The total listed share margin lending book in Australia is $38 billion. A 20% fall in equity markets implies a $7.6 billion fall in the aggregated wealth of margin lending borrowers, this is equal to a quarter of the much talked about $31billion tax cuts promised by the government.

- The mortgage broking industry is undergoing significant change. The value proposition of mortgage broking is better service (faster approvals) and attractive rates (driven by increased choice of lenders). The credit crises has resulted in the non-bank financial lenders disappearing and foreign banks readily giving up market share to the major Australian banks as a means to preserve capital. This means significantly less choice and minimal bargaining strength from brokers resulting in less attractive lending rates. Furthermore the banks are once again paranoid about lending standards hence approval speed has slowed across the industry further reducing the value proposition of brokers. To top this off, the acquisition of Rams Homeloans by Westpac has allowed Rams to undercut the broking market. The end effect is broker commissions are significantly threatened. The once typical 70 basis point upfront and 25 basis point trailing fee paid to a broker is threatened. The analogy is what would you expect a travel agent to earn if the choice in airlines was reduced from over 25 down to 5, whilst all 5 remaining suppliers have branch networks which are competitive distribution platforms? The apparent weakening in the industry structure of mortgage brokers provides a rare opportunity for the domestic banks to re-establish their advantage over brokers. The opportunity is large as at its peak almost 50% of new mortgage loans were sold through the broking channel. The value of a loan to a bank which was originated through a broker is around 20% less than a loan sold directly from a bank's own branch.

- Vertical integration in basic industries is proving to be very important. Onesteel is benefiting with its iron ore assets, as iron ore price increases actually assist margins, despite the rising input costs for steel manufacture and the timing lag in passing prices through to steel prices. In contrast rising pulp prices driving paper price increases are resulting in Paperlinx being squeezed as it doesn't own enough pulp assets.

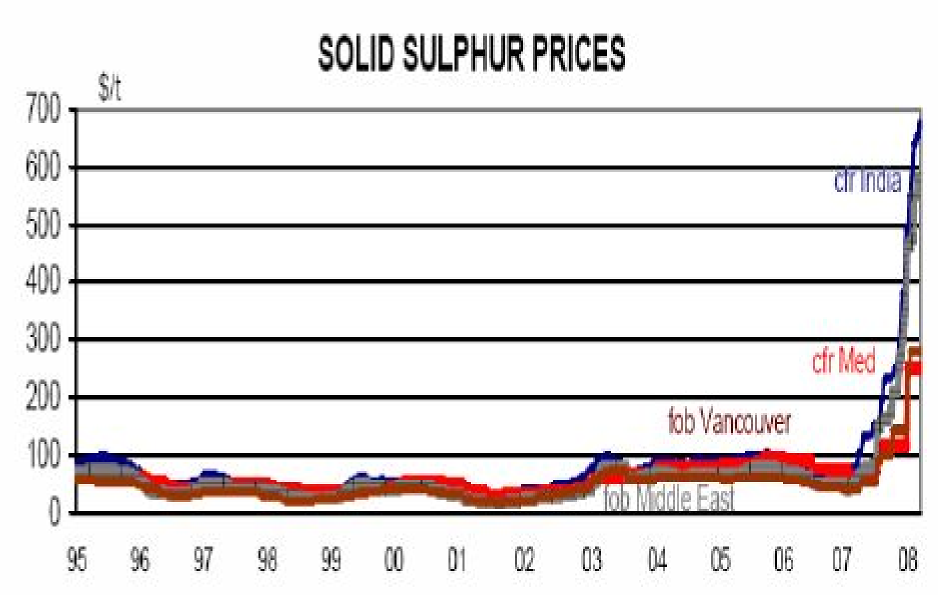
- Vertical integration is playing a significant role in the agricultural input sector. In the case of Incitec Pivot, Australia's largest fertilizer producer, its vertically integrated business model is very well placed to capture material profits from rapidly rising fertilizer prices. The key fertilizer is Ammonium Phosphate which has key inputs of phosphate, sulphur and ammonia. The price of phosphate rock has spiked as new production capacity has been delayed due to increased capital costs and existing production yields have fallen as lower quality deposits are exploited.



Source: British Sulphur Consultants
A Division of CRU

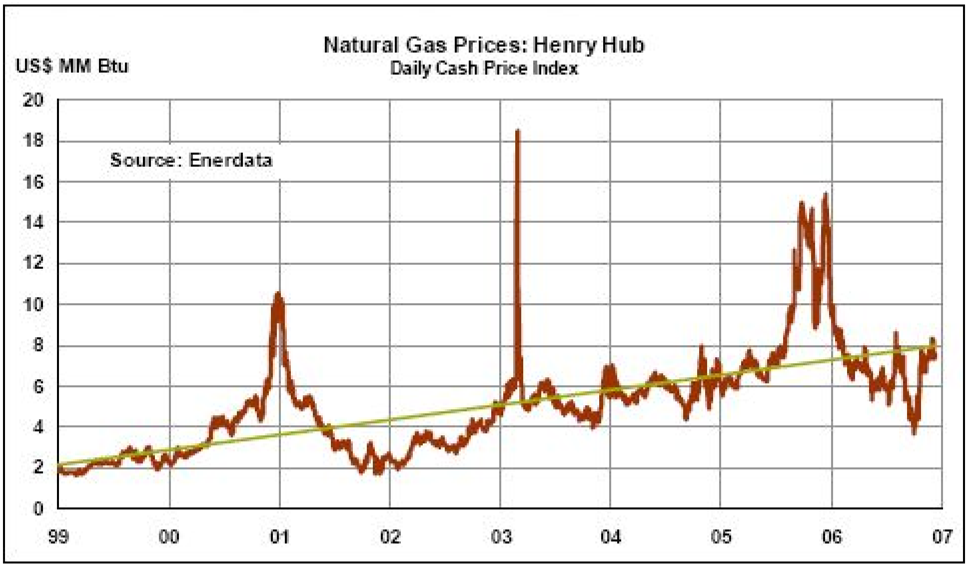
Fortunately, for Incitec, they own Phosphate Hill in Australia, a large high quality phosphate deposit located near cheap gas.

Sulphur prices have also spiked with supply interruptions in Canada and the Middle East. Sulphur prices can however be expected to fall once supply resumes, albeit, new capacity in Kazakhstan and Qatar is being delayed due to rising capital costs.

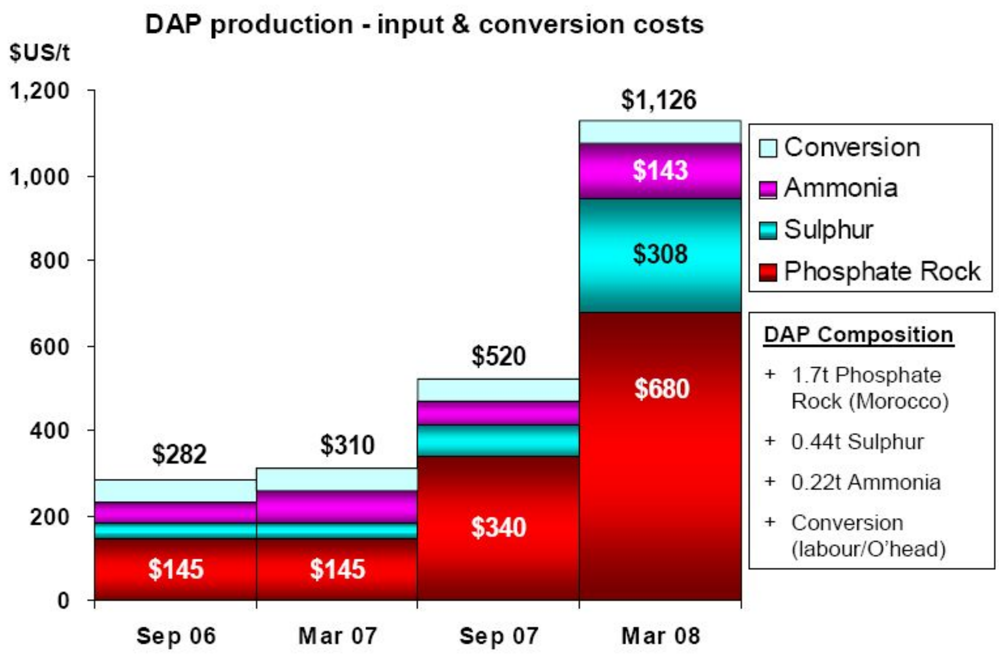


source: Incitec Pivot

Global natural gas prices have trended higher as oil price hikes have lead to some substitution towards gas and environmental concerns are also supporting demand.



The result of input cost increases is significantly increased fertilizer prices from US$282 per tonne in 2006 to US$1,126 per tonne and rising. Incitec's ownership of phosphate rock results in significant value leverage to high prices. Interestingly we note market expectations imply pricing of around US$850 per tonne in 2008 and 2009 before falling back to only US$450 per tonne in 2010.



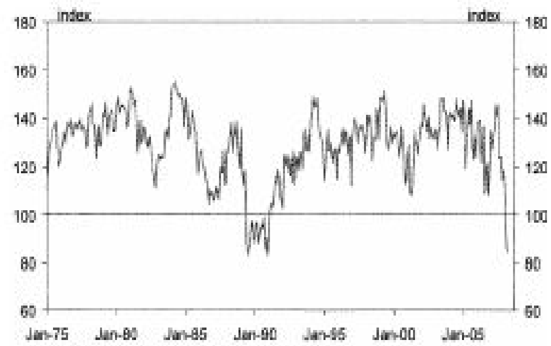
Source: Incitec Pivot

- The recent RBA interest rate increases and additional mortgage rate increases announced by the banks coupled with the equities market sell-off has rapidly dampened consumer sentiment in Australia. Many corporates are using adjectives such as "cautious" or "nervous" or "tentative" to describe customer demand. Given the prolonged strength in the domestic economy, many management teams and business models have not been tested in a slower economic environment. Below are some charts highlighting rapid negative changes in consumer sentiment in Australia.

Figure 11. Westpac-MI Consumer Sentiment Index

Source: Westpac Economics, Melbourne Institute

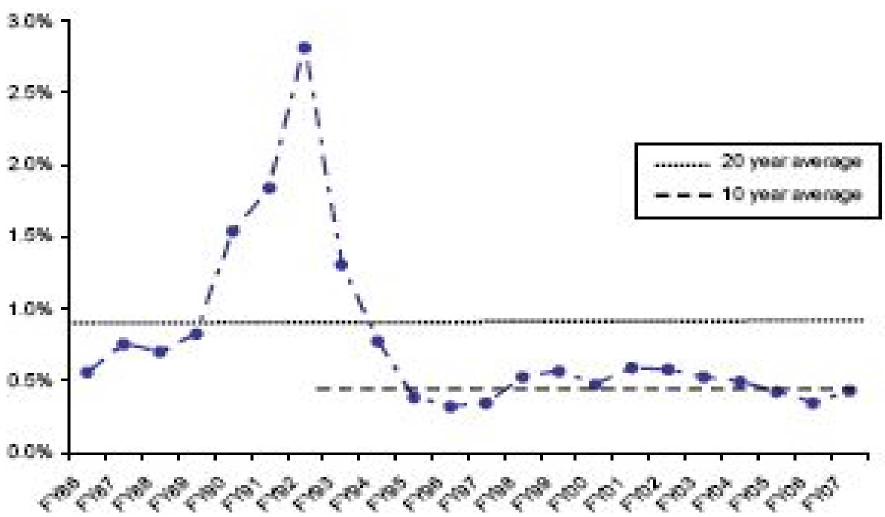
Figure 12. Westpac-MI Survey – Time to Buy a Major Household Item



Source: Westpac Economics, Melbourne Institute

The Australian banks have enjoyed a prolonged period of historically low bad debts.

Figure 17. Bad debts as a % of average non-housing credit



Source: Citigroup Research

Small increases in bad debts as a percentage of what are very large loan books result in very large increases in the dollar value of bad debts to the banks. Below is a table from Citigroup which highlights that if bad debts as a percentage of loans reverts back to the

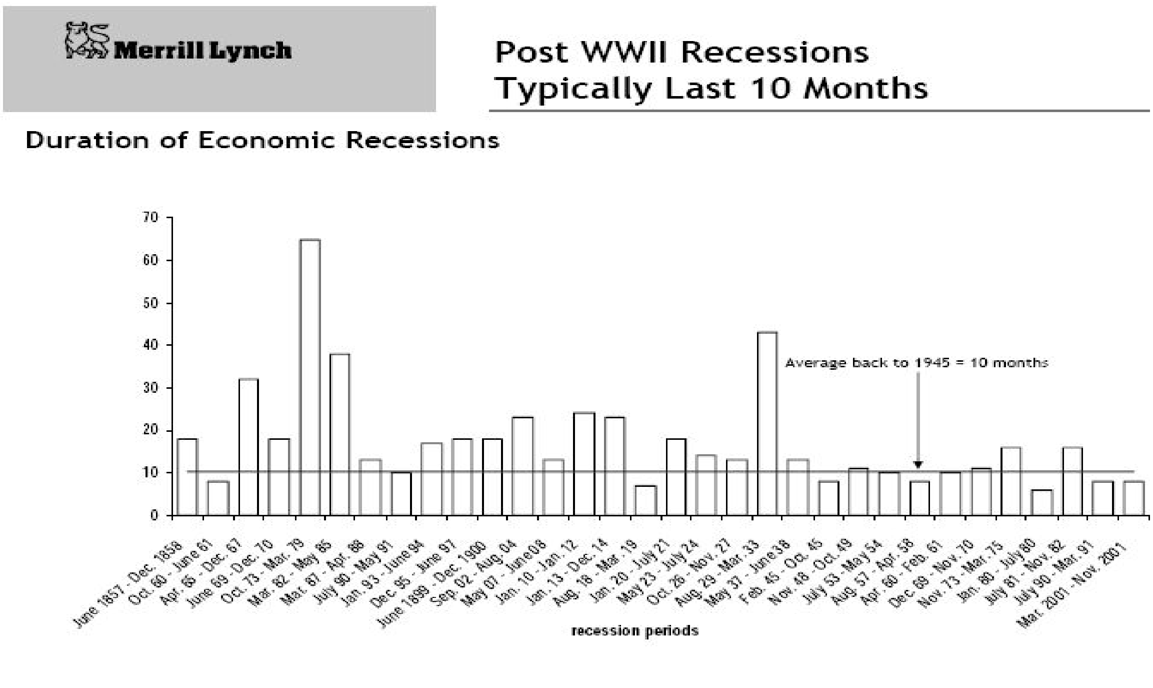
20 year average, then the banking sector bad debt expense rises from $2.5B in 2007 to $8.2B in 2010. The $5.7B impact to sector profits compares to the sector's aggregated profit in 2007 of approximately $17.6 B, in other words an impact of over 30%!

	FY07	1H08E	2H08E	FY08E	FY09E	FY10E
BDD charges						
ANZ	567	975	500	1,475	1,683	2,067
CBA	434	333	426	759	1,251	1,713
NAB	790	575	612	1,187	1,741	2,196
WBC	462	345	342	687	1,040	1,336
SGB	178	106	131	237	457	677
BEN	8	4	18	22	90	156
BOQ	21	11	17	27	41	47
Total	2,460	2,348	2,045	4,393	6,302	8,193

Source Citigroup Research

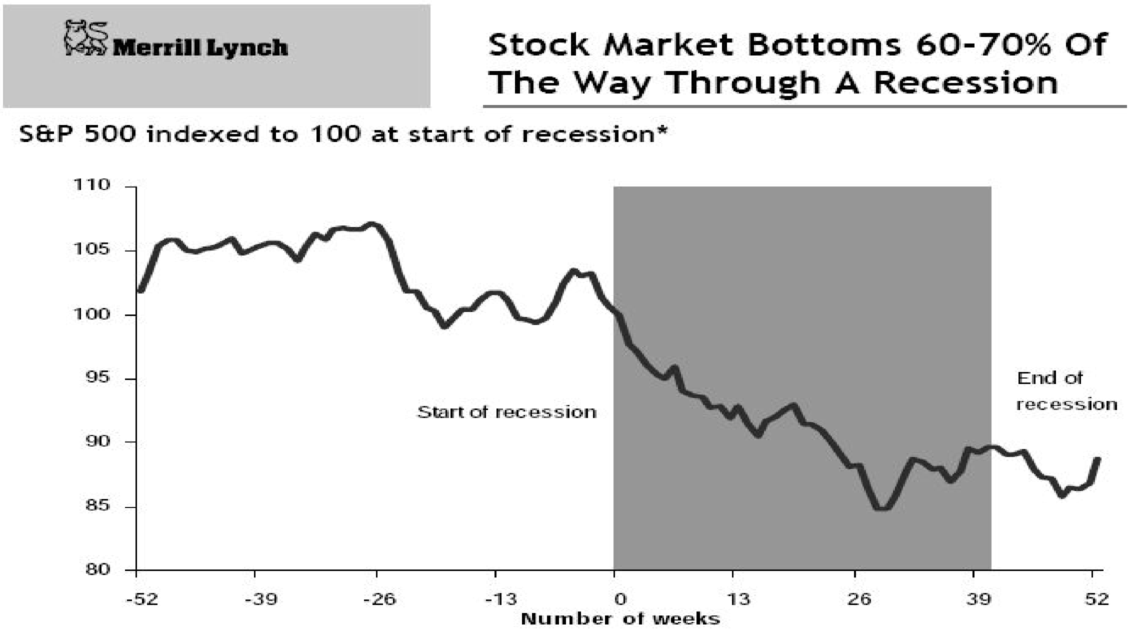
Fund Outlook

We believe it is now market consensus that the US economy is in recession. The debate now is how deep and how long. Post world war two, the average US recession has lasted 10 months.



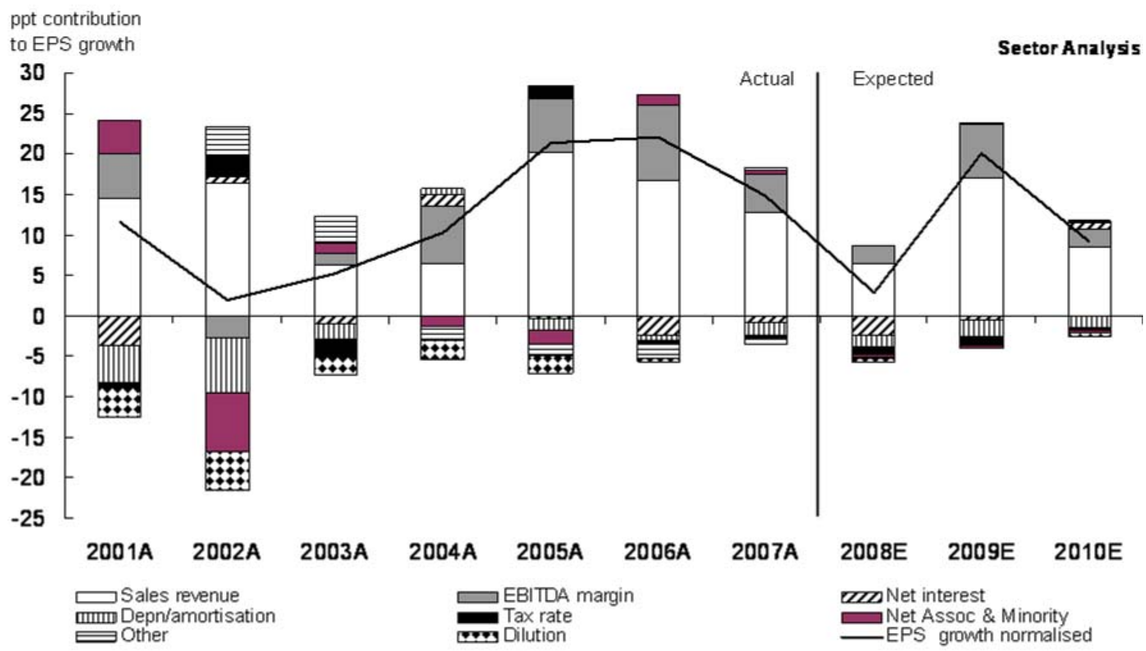
Source: National Bureau of Economic Research, Merrill Lynch

When evaluating US equity performance through the last five recessions, it's worth noting the market bottoms around six months into a recession. This suggests the sell off in March may have been the absolute low in the market.



*average of 1969-70, 1973-75, 1981-82, 1990-91, and 2001 recessions
Shaded area represents recession period
Source: Merrill Lynch

At Greencape we continue to remain cautious. We observe that market earnings forecasts for the Australian equity market continue to forecast margin expansion. We note that in times of economic slowdown, typically margins contract (consider the chart below, where the grey component of earnings per share growth is margin expansion).



Source: Macquarie Research

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This suggests that further earnings downgrades are likely from corporate Australia. As was highlighted in last quarter’s commentary, we don't expect the market to perform strongly with a negative earnings revision headwind. We note that the recent sell off has in many cases thrown out the baby with the bath water with the investment horizon contracting significantly such that market focus centres on short term dividend and earnings delivery. Our research effort has highlighted a number of stocks where we do not consider earnings risk to be negative, yet these same stocks are now trading significantly cheaper than they were only four months ago. We are using this period of market uncertainty to concentrate the portfolio towards these attractively priced stocks. We expect than when the market's confidence begins to return, and investment horizons begin to extend beyond immediate news flow, these names will deliver healthy returns.

"It's only when the markets are perceived to have exhausted themselves on the downside that they turn," he said. "Trying to prevent them from going down just merely prolongs the agony."

Alan Greenspan, quoted in the Age 17/12/07