Greencape Wholesale Broadcap Fund

Fund report and commentary – 31 December 2007

Overview: The Greencape Wholesale Broadcap Fund (Fund) posted a return of -0.01% (after fees)* compared with the S&P/ASX 300 Accumulation Index (benchmark), which returned -2.67%.

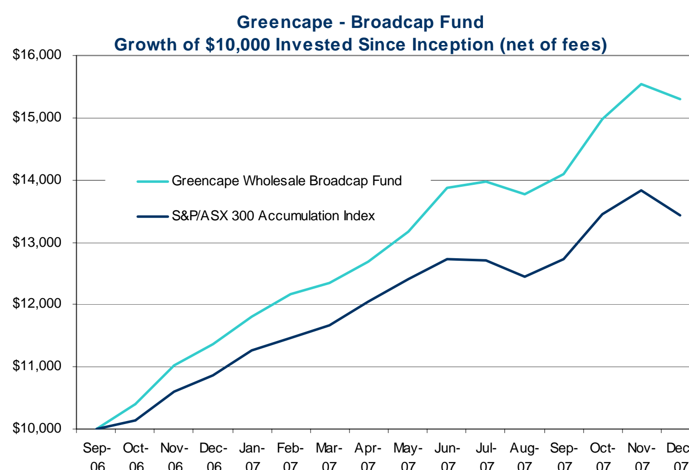
Performance

	Quarter (%)	1 year (%)	3 years (%) p.a.	5 years (%) p.a.	Inception (%) p.a.
Greencape Wholesale Broadcap Fund	**-0.01**	**26.83**	**-**	**-**	**36.28**
Growth return	-0.74	15.86	-	-	27.14
Distribution return	0.72	10.97	-	-	9.14
S&P/ASX 300 Accumulation Index	-2.67	16.22	-	-	24.25
Active return (net)	**2.66**	**10.61**	**-**	**-**	**12.03**

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

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Asset allocation

	Current (%)	Range (%)
Securities	99	85 - 100
Cash	1	0-15

Fund facts

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

Fees

	Greencape Wholesale Broadcap Fund
Entry fee	Nil
2007/08 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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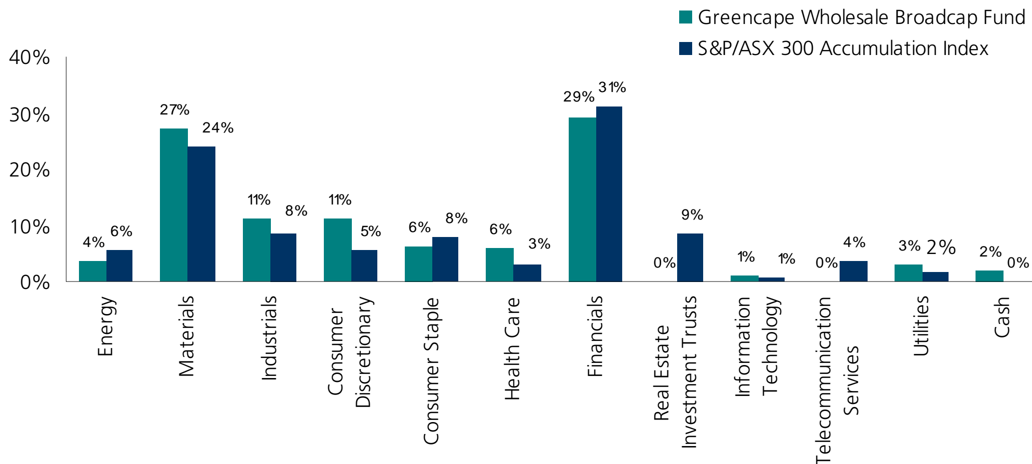
Sector exposures as at 30 November 2007



Market Review

The December quarter was once again a relatively volatile quarter for equity markets. October delivered positive benchmark equity returns however November and December were consecutive down months. This quarter was the first negative one since the June quarter of 2006. The ASX200 fell 2.72% over the quarter.

As the quarter progressed it became increasingly evident credit markets had yet to fully comprehend, let alone over come issues stemming from the sub-prime mortgage “crisis”. We observed numerous attempts by central banks to bring confidence back to credit markets via talking positively. When this didn’t work, central banks injected billions of dollars of liquidity into credit markets in order to maintain basic inter-bank lending. This was combined with further interest rate cuts in the US, UK and even Canada (which like Australia has been a huge beneficiary of the resources boom). Furthermore, the US government announced a grand plan to assist targeted sub-prime borrowers facing imminent significant increases in mortgage rates as their rates are scheduled to reset. The plan appears to involve getting the lenders to agree to freeze mortgage rates for targeted borrowers for around 5 years. The argument put forward by the US Government has been that the cost to lenders of forgone interest payments will be less than the cost of borrowers failing on their mortgage repayments and lenders then being forced to take significant write-downs as houses are sold into an already weak housing market at prices significantly lower than the total mortgage debt (recall in last quarter’s commentary we highlighted the significant risk of “negative housing equity” given falling house prices). Such actions by central banks and governments highlight the significance of the current situation.

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Over the quarter, due to the nervousness in credit markets, the equity market punished stocks which require large refinancing of debts on their balance sheet. With numerous examples over recent years of companies being able to take advantage of low interest rates and strong competition between banks to lend money, many companies have been enjoying very low costs of debt funding. Some companies (and private equity funds) took the opportunity to borrow more than they otherwise would have at such attractive rates and therefore they could afford to borrow more.

"We believe the organisation is solvent and will continue to be, at least until February 15 [2008]"

Andrew Scott, CEO Centro Properties Group 18/12/07 (AFR) in response to the question *"Is the company still solvent".*

What we are observing now is that as these attractive rates roll off, such companies are not only struggling with an impending negative impact on profits due to a step up in borrowing costs, but are struggling to find an institution to even lend to them. The most high profile example to date is Centro Property Group which lost over 80% of its value in recent months.

A feature of every December quarter is that most of the banking stocks report their results. Generally speaking the sector reported in line with market expectations however outlook commentary was generally regarded as weaker than expected. This was due to the banks flagging rising funding costs (thanks to the credit market turmoil) will further reduce net interest margins whilst underlying costs such as wages growth will generally remain higher than was previously expected. The Australian banks are generally domestically focused. They remain confident in the strength of the Australian economy and don't expect any major increase in bad debts for the year ahead.

Corporate merger and acquisition activity was evident in the soft (agricultural) and hard (materials) commodity sectors. Incitec Pivot (Australia's largest fertilizer company) acquired around 13% of Dyno Nobel shares on market whilst a consortium of private equity and a Chinese government backed chemical company made a non-binding approach to Nufarm (world's 2nd largest generic Ag-chem player). The highest profile M&A event of the quarter was undoubtedly the informal approach by BHP to acquire Rio Tinto with a proposed 3 for 1 scrip bid. All 3 deals are far from being concluded for different reasons; however they highlight the accelerating consolidation phase of the strongly performing soft and hard commodity sectors.

"trust has to be earned; reputation is often the most valuable asset a business has."

Alan Greenspans' 2007 book The Age of Turbulance:

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Federal Election

The Australian federal election came and went with a change in government. As expected, this had little impact on market sentiment. In the lead up to the federal election Greencape conducted a number of meetings with politicians, advisers, party power brokers and lobbyists. Importantly this involved meeting with both sides of politics. A highlight was meeting with a key ALP figure (who wishes to remain anonymous), who, in the week before the election, with access to private party polling, called the outcome of the election to within 2 seats. At the time, we were told confidently that private polling is rarely wrong. Our meetings with ALP figures told us not to expect material policy change other than that outlined during the election campaign. Key points to note are the following:

- Climate change policy will only become more clear post the release of the Garnaut report on the economic impact of climate change. This is expected in June 2008.
- The ALP will incorporate in policy the opinions and recommendations of Treasury more readily than the previous government.
- The ALP people we met with recognise the importance of maintaining a fiscal surplus as a means to keep a downward influence on inflation and hence interest rates. This has two important consequences:-

    1) There is a real chance that a portion of the promised $31B in tax cuts will be given in the form of superannuation savings.
    2) Government spending cost cutting will be a key feature of the first budget.

The fact that a change in government had little noticeable impact on market expectations and sentiment is a meaningful reminder to foreign investors that the risk premium related to Australian sovereign risk is deservedly low.

Sovereign Funds

The prominence of sovereign funds became evident during the quarter. A number of Wall Street investment banks received timely capital injections from various sovereign funds as capital was urgently required following significant write-downs associated with the credit crunch. For example, we observed the Chinese investing in Morgan Stanley, the Singaporeans investing in Merrill Lynch and the Middle Eastern state of Abu Dhabi invested in Citigroup. Sovereign funds and government owned corporations have also been active investors in both hard and soft commodity stocks. As mentioned a Chinese government owned entity is currently “interested” in Nufarm. Speculation mounts that the Chinese government may consider investing in Rio Tinto as a means to block BHP.

Simon Johnson, an International Monetary Fund Economic Counsel said sovereign funds currently manage around US$3 trillion. To put this into context, this compares to US GDP of around US$12 trillion and the estimated total global value of traded securities of US$165 trillion. Importantly, sovereign funds are growing their coffers rapidly. The International Monetary Fund estimates such funds may manage US$10 trillion by 2012.

To date sovereign funds have invested primarily in low risk fixed interest assets such as government bonds. It is becoming evident that exposure to other asset classes such as equities, real estate and strategic assets such as infrastructure and resource reserves is increasing.

"People generally do not exert the effort to accumulate the capital necessary for economic growth unless they can own it."

Alan Greenspans' 2007 book The Age of Turbulance:

In October the US treasury secretary Henry Paulson hosted a meeting between G7 Finance Ministers and representatives from 20 of the world's largest sovereign funds to *"discuss their role in the global financial market"*. Paulson was quoted as saying *"it was an important initial step"* in developing consensus and collaboration on best practice for sovereign funds. This highlights the emerging significance of such funds. We also however note the following:-

- Beyond direct regulation, there is not a lot investee countries can do to prevent such foreign investment. For example the US government had to step in directly to prevent China from acquiring US oil refining assets, and Dubai from acquiring strategic US port assets. Currently Germany and France are planning legislation to make it difficult for sovereign funds to acquire European assets.
- We expect key challenges for governments will be defining "national interest" when faced with large foreign investment decisions. A very well connected Australian political figure we met with recently mused that the government's single biggest market related decision will be how to deal with China and the Middle Eastern sovereign funds making take over offers for significant and strategic Australian resource, energy and agricultural assets. He also raised the interesting question of - *'would the US Government allow China to take over weak US icon companies such as General Motors and Ford?'*
- Sovereign funds are typically quite secretive. It's difficult to obtain precise information on asset allocation and fund size.

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Below is a list of the largest sovereign funds according to Wikipedia.

Countries with the largest sovereign wealth funds

Country / State	Fund	Assets $Billion	Inception	Origin	Approx wealth per citizen
Abu Dhabi	ADIA Abu Dhabi Investment Authority	$1,300	1976	Oil	$1,529,000
Singapore	GIC Gov't of Singapore Investment Corp	$330	1981	Non-commodity	$100,000
Norway	GPF The Gov't Pension Fund of Norway	$315	1990	Oil	$71,000
Saudi Arabia	Various	$300	N/A	Oil	$15,000
Kuwait	KIA Kuwait Investment Authority	$250	1953	Oil	$250,000
China	CIC China Investment Corporation	$200	2007	Non-commodity	$151
Russia	SFRF Stabilization Fund of the Russian Federation	$158	2004	Oil	$1,180
Singapore	Temasek Holdings	$115	1974	Non-commodity	$30,300
Australia	FFMA Australian Gov't Future Fund	$61	2004	Non-commodity	$2,900
Qatar	QIA Qatar Investment Authority	$50	2000	Oil	$250,000
US (Alaska)	APFC Alaska Permanent Fund	$40.10	1976	Oil	$61,000
Libya	-	$40	2007	Oil	$7,200
Brunei	BIA Brunei Investment Agency	$30	1983	Oil	$90,100
South Korea	KIC Korea Investment Corporation	$20	2005	Non-commodity	$417
Malaysia	KN Khazanah Nasional	$18.30	1993	Non-commodity	$658
Kazakhstan	KNF Kazakhstan National Fund	$17.80	2000	Oil	$1,170
Canada	AIM Alberta Heritage Fund	$16.60	1976	Oil	$4,800
Taiwan	NSF National Stabilisation Fund	$15	2000	Non-commodity	$652
Iran	OSF Oil Stabilisation Fund	$12.90	1999	Oil	$174

Company Visits

During the quarter the Greencape team conducted numerous meetings with company management and industry participants. A number of these meetings involved foreign companies and contacts. With continued market debate regarding the extent of the impact on the broader US economy caused by the sub prime mortgage fall out, Greencape conducted another extensive research trip to the US.

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Following is a sample of some observations we have noted during the quarter;

- One prominent US housing company we met with suggested we would make money shorting their stock.
- US Home builders continue to build at a rate more rapid than actual unit sales. This stems from a desire to liberate capital tied up in land banks. This suggests new home sales data (already weak) is temporarily inflated as builders run down inventory. Such actions will further weigh on house prices in coming months.
- A large lumber player we met with in Atlanta saw sales down 20% in first 6 months of 2007, 33% over the year and off 50% in the last 120 days to December.
- US building industry players we met with estimate there is currently 1 year's worth of housing inventory on the market. It's noted that this doesn't include land banks on which houses are yet to be built, this is estimated to add over 6 months worth of sales at current rates.
- All US home builders are currently cutting staff levels materially (many have halved) – this has to feed into broader economy.
- We met with one high profile Florida based realtor who, whilst not being able to say the "C" word (property Crash), did say he had just listed a property for $309,000 that he would look to buy personally for "low $200's" at some point.

Greencape conducted a number of meetings with listed and unlisted companies in South Australia during the quarter. It is noticeable that business confidence is continuing to improve in SA on the back of expected mining investment growth in the north of the state. It is possible that SA may be the next WA in terms of economic growth acceleration given the implied infrastructure spend required to service the mining capital investment.

Greencape research continues to observe rapidly rising inflation in terms of capital costs for production expansion and associated infrastructure. This combined with increasing funding costs associated with the credit crises is making investment projects less and less viable unless the prices of the products to be manufactured are sustained at current cyclically high levels or are in fact increased. This is likely to prolong a number of commodity cycles and constrain supply of certain products and limit productivity growth as measured by volume.

During the quarter the Greencape team keenly read the recently published book by Alan Greenspan titled *"The Age of Turbulence".* It's not every day that the former Governor of the US Federal Reserve who was in office for around 20 years from June 1987 and who started a long economics career in 1945 publishes detailed insights into his experiences, learnings and future expectations of the global economy.

Greenspan's book highlighted the extent of "private lobbying" towards financial market participants that is required by central bankers in times of crises. Greenspan writes in detail of the 1987 stock market crash, the Asian economic crises, the Russian bond crises and the Long Term Capital Management hedge fund crises. In all cases, the single biggest fear appeared to be the fear of counter parties failing to pay an obligation. In such events, Greenspan says the thing to avoid is credit markets seizing up as lenders of funds and market participants stop transacting for fear of counter parties not delivering what is promised. Greenspan outlines the most important element in free market economies is being able to have confidence in property rights. Greenspan emphasises the difficulty in winning back confidence in a market once it stalls, and the rapid transmission such a stalling has on broader economic activity. What was eye opening was the extent of "behind the scenes" activity during a crises. Such activity typically centred on central bankers "encouraging/begging" banks and financial intermediaries to keep on trading and transacting. Reading Greenspan's book and then reading reports of central banks currently "talking up markets" and injecting liquidity into credit markets which appeared to have stalled, underlines the seriousness of the current credit market crises. I suspect significant behind the scenes activity is currently underway, and numerous central bankers are quite nervous presently.

"History has not dealt kindly with the aftermath of protracted periods of low-risk premiums."

Alan Greenspans' 2007 book The Age of Turbulance:

Some selected quotes from the book:

> "Shutting down a market during a crash only compounds investors' pain. As scary as their losses on paper may seem, as long as the market stays open investors always know that they can get out. But take away the exit and you exacerbate the fear. To restore trading afterward is extraordinarily hard – because no one knows what prices should be, no one wants to be the first to bid."

> "… as riskless interest rates rise and risk premiums are purged of the unsustainable optimism they now embody, prices of income-earning assets will surely grow far more slowly than during the past 6 years. As a consequence of the decline in long-term nominal and real interest rates since 1981, asset prices worldwide have risen faster than nominal world GDP in every year, with the exceptions of 1987 and 2001-02."

> "Value is what people perceive it to be."

> "… liquidity can come or go with the appearance of a new idea or fear."

> "… the business cycle. It is not dead, even though it has been muted for the past two decades."

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"Recessions are tricky to forecast because they are driven in part by non-rational behaviour. Sentiment about the economic outlook usually does not shift smoothly from optimism to neutrality to gloom; it's like the bursting of a dam, in which a flood backs up until cracks appear and the dam is breached. The resulting torrent carries with it whatever shreds of confidence there were, and what remains is fear"

"The rate of decline in trade barriers is almost surely going to slow as we reach the point of intractable political resistance to further lowering. This suggests that the growth of export-oriented economies such as those of East Asia, is not likely to be as rapid as that of the last six decades"

Fund Outlook

We believe that it is now market consensus that the US economy is slowing rapidly. And much of this is now priced into stock prices. Thus any observed pick up in US economic activity can be expected to be very positive for equity markets. The market appears to be debating if global growth can continue without any meaningful support (and perhaps even a drag) from the US economy, with positive drive being maintained from emerging economies such as China.

At Greencape we remain cautious. We remain wary that the economic slow down in the US is dual pronged, ie consumer driven via belt tightening from sub prime mortgage resets and house price deflation, but also increasingly corporate investment driven as corporate borrowing slows as companies struggle to find attractively priced funding. It is this second factor that the market appears complacent about as it is potentially a global phenomenon and not US-centric. Also the fact that oil prices and base metals remain high and food prices are continuing to rise limits the degree at which central banks can lower interest rates. We also note Japan and the European economies are slowing too. Such global economic growth deceleration isn't the problem; rather it's the lack of downward revisions in corporate earnings expectations to date. We have seen some revisions in the back half of 2007 and for fiscal 2008 but not a lot beyond that. Despite the strong domestic economy, and expected further tax cuts (even if they are put into superannuation), we don't expect the market to perform strongly with a negative forecast earnings revision headwind acting on key equity markets globally.

"Inbred human propensities to swing from euphoria to fear and back again seem permanent: generations of experience do not appear to have tempered those propensities."

Alan Greenspans' 2007 book The Age of Turbulance:

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