Greencape Wholesale Broadcap Fund

Fund report and commentary – December quarter 2012

Performance	Quarter (%)	1 year (%)	2 years (%) p.a.	3 years (%) p.a.	5 years (%) p.a	Inception (%) p.a.
Greencape Wholesale Broadcap Fund	**6.24**	**20.77**	**4.46**	**4.77**	**1.09**	**7.52**
Growth return	4.78	16.95	–2.49	–0.77	–3.51	2.15
Distribution return	1.46	3.83	6.95	5.54	4.60	5.37
S&P/ASX 300 Accumulation Index	6.77	19.74	3.25	2.80	–1.81	3.09
Outperformance (net)	**–0.53**	**1.03**	**1.21**	**1.98**	**2.89**	**4.44**

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 outperform its benchmark over rolling three-year periods.

Responsible entity

Fidante Partners Limited

Investment manager

Greencape Capital Pty Ltd

Investment strategy

Greencape is an active, ‘bottom-up’ stock picker. Whilst Greencape does not target any specific investment style and will invest in stocks displaying ‘value’ and ‘growth’ characteristics, its focus on a company’s qualitative attributes will generally lead to ‘growth’ oriented portfolios. This is an outcome of its bottom-up process. As such, Greencape’s investment style may be classified as ‘growth at a reasonable price’.

Distribution frequency

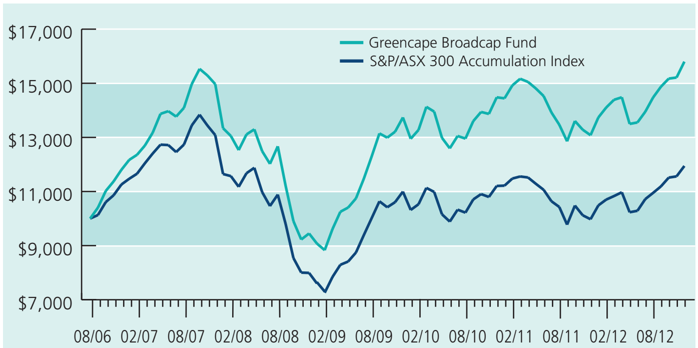
Quarterly

Suggested minimum investment timeframe

At least five years

Greencape Broadcap Fund

Growth of $10,000 invested since inception (net of fees)

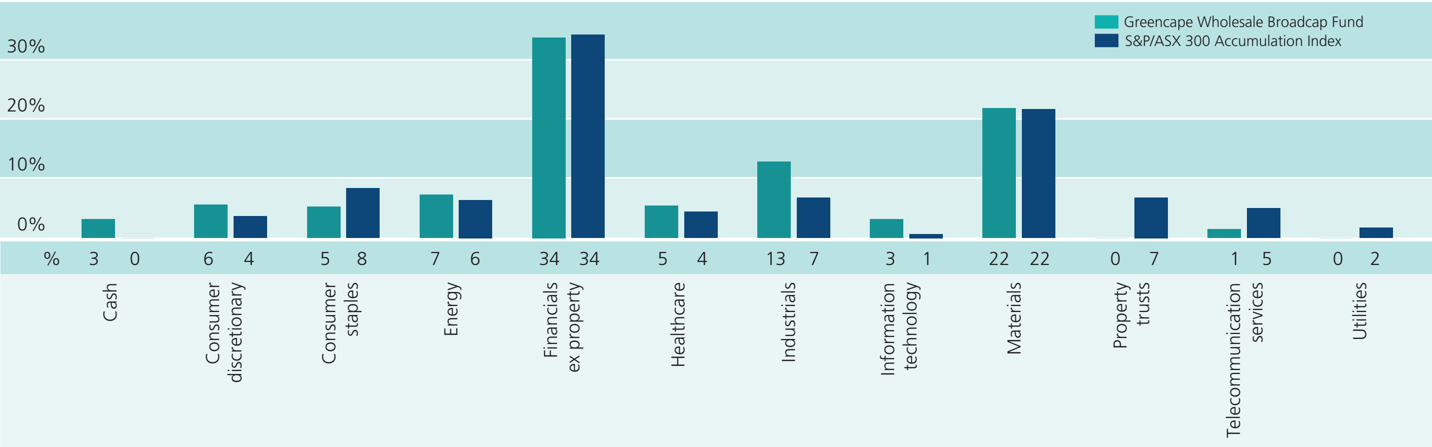


Asset allocation	Current (%)	Range (%)
Securities	96.84%	85–100
Cash	3.16%	0–15

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

Fees	Greencape Wholesale Broadcap Fund
Entry fee	Nil
2011/12 ICR	1.18%
Management fee	0.95%p.a.
Performance fee	15% of the Fund’s gross performance above the Fund’s benchmark.
Buy/sell spread	+0.30%/-0.30%

Sector exposures as at 31 December 2012

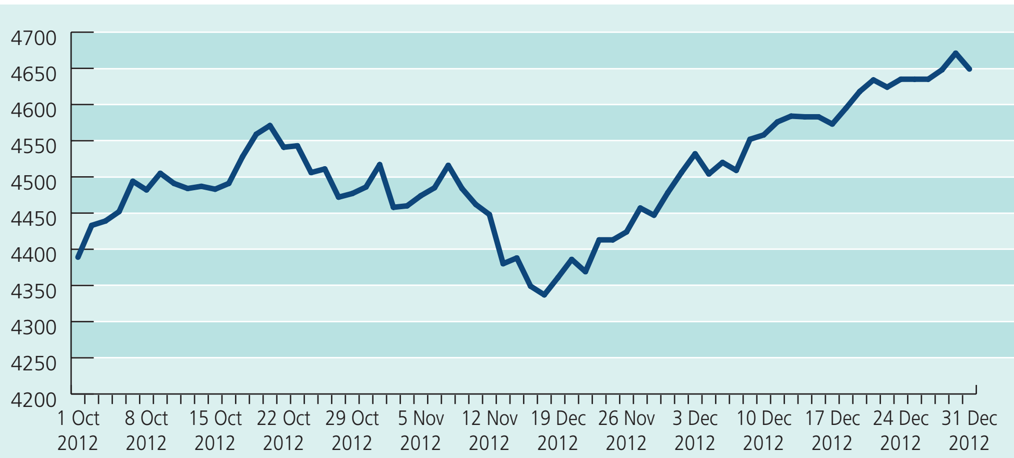


Market review

The S&P/ASX300 Accumulation index rose 6.8% for the quarter. The Greencape Broadcap Fund underperformed the benchmark and gained 6.24%.

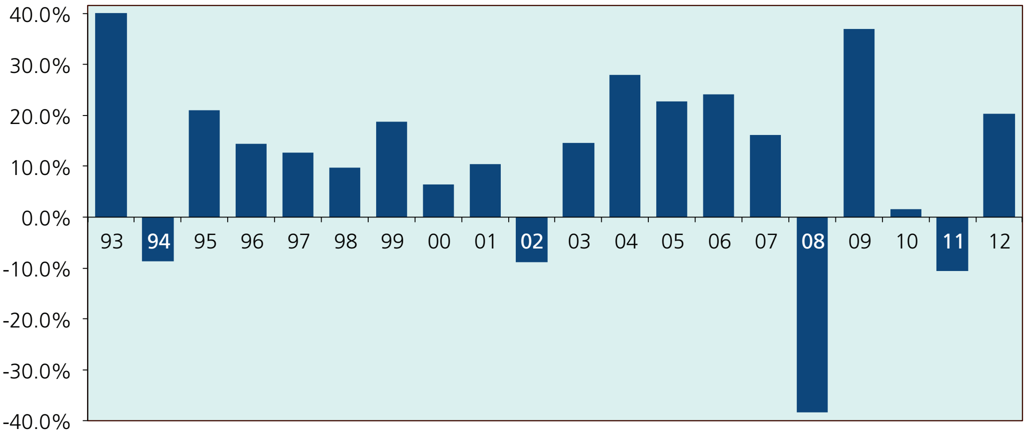
The local market continued on its strong run from the September quarter, which has seen the market deliver a 16% return in the final six months of the year. Following the re-election of President Obama in November, investors began to worry about the implications of the US Congress failing to reach a deal over the 'Fiscal Cliff'. Concern appeared to dissipate as the deadline drew nearer and the consenus view emerged that inaction would simply be too costly for the US economy and therefore a deal would ultimately be reached. December has historically been a seasonally strong month for markets and this time around it didn't dissapoint with the index bouncing 7% off it's mid-November low as global markets rallied into Christmas, albeit on low holiday volumes.

S&P/ASX 300 Price Index

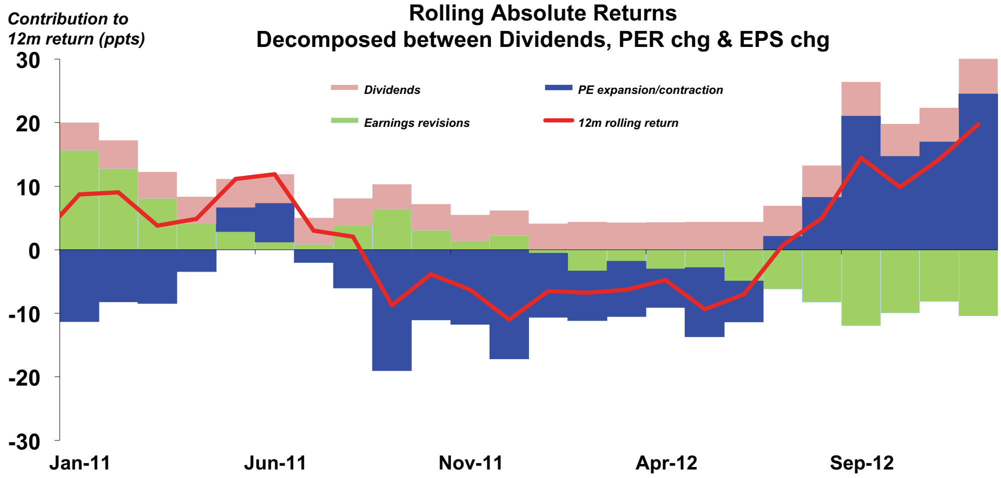


The chart below shows that the ASX200 delivered its 7th best return in 2012 since the accumulation index begun in 1993, delivering 20.3% versus the average of 11.6% over the last two decades.

S&P/ASX 300 Accumulation Index Calendar Year Returns since 1993



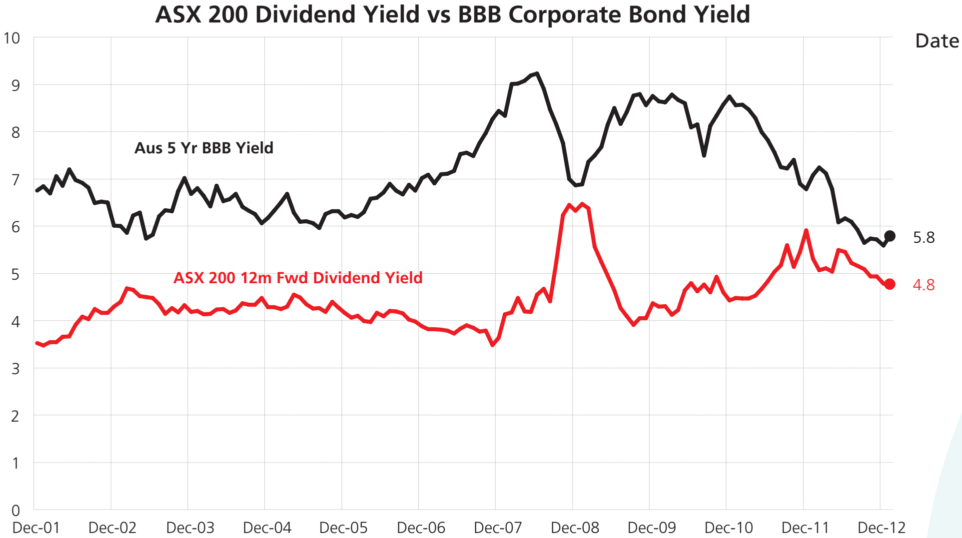
Whilst 2012 was a strong year, it's interesting to note what drove its performance. The chart below highlights that just as earnings downgrades from analysts were gaining momementum, the price-to-earnings (PE) multiple paid for those earnings expanded more significantly, with dividends being a relatively minor contributor to returns.



Source: Macquarie.

The chart below shows that falling bond yields have made equities look 'relatively' cheap, which has driven support for the PE multiple expansion shown in the previous chart.

ASX 200 Dividend Yield vs BBB Corporate Bond Yield



Source: Wilson HTM.

'Comments are often foolishly made that I am a recluse and don't talk a lot. That may be true in some instances because I have found that by talking to idiots you only make a fool of yourself.'

Reg Kermode, Executive Chairman of Cabcharge, 28/11/2012

'The overwhelming empirical evidence thus far from Japan since 1990 and from America since 2008 is that, once a central bank enters a zero-interest-rate regime, it is hard to exit from it.'

Christopher Wood, CLSA, 03/01/13

After inaction in the September quarter, the Reserve Bank of Australia (RBA) cut the official cash rate by 25 basis points at each of their October and December meetings. In an environment of falling interest rates, investors continued to look for alternative means from which to generate income from their portfolios. High yield defensive stocks remained the key beneficary from this trade as investors piled into stocks with perceived safe distributions. Australia strongly outperformed the World Index during the quarter, as global investors began to accept the persistence of the high Australian Dollar.

A close US election which many predicted, ulimately did not eventuate as the Obama administration recorded a strong win in November. Global markets immediately tumbled in the aftermath, with the S&P 500 Accumulation Index posting its largest single day loss since June the day after the election. The 'Fiscal Cliff' became the trending topic in markets, as investors began to worry that a deal between the Democrats and Republicans would not be reached. That meant come midnight on the 31st of December, a myraid of tax increases and spending cuts would automatically be implemented, potentially sending the US economy back into recession. One tax increase mooted was a rise from the current rate of 15% on dividends, which was introduced under the Bush administation. This has seen a flurry of US companies conviently pay special dividends since the election, including Costco, Las Vegas Sands and Dillards.

'Americans can always be counted on to do the right thing… after they have exhausted all other possibilities.'

Sir Winston Churchill, 1944

The ongoing issues in the Eurozone did weigh on the market to some extent during the quarter, however only having a relatively benign effect compared to earlier in the year. There was conjecture over whether Spain would formally request another bailout from the European Central Bank (ECB), which now appears to be more likely than not as the parties are reportedly in negotiatations with a deal to be reached sometime in the new year. Greece received its latest tranche of bailout funds, with the Troika agreeing to release €49bn after the embattled state managed to complete a successful buyback of its own debt.

It was a tough year for China's Shanghai Composite Index, with concerns of activity slowing in the emerging economic powerhouse weighing down the market. However, the index managed to pick itself up off the canvas and make up its lost ground in the December quarter. The leadership transition in November, which saw Xi Jingping succeeding Hu Jintao, brought with it renewed confidence that the new leadership would undertake meaningful policy action to reform the economy. The Shanghai Composite Index managed to rally over 4% in one day in December after the HSBC Flash Purchasing Manager's Index (PMI) printed at 50.9[1], which beat expecations and was a 14 month high.

'Mobile network traffic is doubling every year…. The fixed line network is experiencing more than 50 per cent annual growth in data traffic. In the consumer market this is driven primarily by video.'

Catherine Livingstone, Chairman, Telstra 16/10/12

Locally, the telecommunications sector, lead by Telstra (> 95% of the index), was the best performing sector for the quarter as it continued to benefit from the insatiable investor appetite for yield. The company reaffirmed fiscal 2013 guidance for earnings, free cash flow and the 28c dividend at its Investor Day in October. The New Zealand Commerce Commission also granted Telstra approval for the sale of its wholly owned New Zealand subsidary TelstraClear to Vodafon NZ.

Healthcare was again the a strong performer in the quarter. CSL, which makes up more than half of the Healthcare index, performed strongly as the company upgraded its fiscal 2013 constant currency profit guidance. The company cited a number of reasons behind the upgrade, including better than anticipated sales, improved efficiencies across the supply chain, a better sales mix and higher than anticpated royalty income from sales of Gardasil. The company's share buy-back program is also ongoing.

The Consumer discretionary sector performed strongly, led by Crown Limited which announced its proposal to build a second Sydney casino and resort at Barangaroo, which reduced the market's concern that it may undertake a dilutive equity raising in order to fund a takeover of Echo Entertainment Group. Crown's share price was also buoyed on WA approval to increase its gaming tables and slot machines as part of its Perth development of Crown Towers as well as greater gaming revenues coming out of Macau.

[1] A PMI reading above 50 indicates expansion.

	December quarter	1 year
Market (S&P/ASX 300 Accumulation Index)	6.8%	19.7%
Best performing sectors:		
Telecommunications	11.4%	42.1%
Healthcare	10.6%	47.5%
Industrials	8.9%	22.1%
Worst performing sectors:		
Energy	–0.3%	–0.5%
Consumer Staples	5.2%	26.7%
Materials	6.4%	2.7%

Energy was the worst peforming sector for the quarter, which capped off a very weak 2012. The sector was dragged down by WorleyParsons. Although they did not quantitatviely downgrade their guidance, their cautious AGM commentary of 'good growth' for fiscal 2013 spooked investors. Weakness in the oil price also hampered the sector during the period.

A trading update from Coca-Cola Amatil weighed on the performance of the Consumer Staples sector during the quarter. The company guided to 4 - 5% net profit after tax (NPAT) growth in 2012, which was below consensus of 7%. Treasury Wine Estates also dowgraded their earnings for fiscal 2013, citing weather impacts on the company's 2011 vintages in Australia and California and higher corporate costs driven by the need to build a standalone IT system following the company's demeger from Fosters Group.

Mega-cap miners BHP and Rio Tinto performed well during the quarter, however the materials sector still slightly lagged the market. Newcrest Mining again weighed heavily on the index as the miner posted a weak September quartely production report while also being impacted by weakness in the gold price and high Australian Dollar. Iluka Resources again downgraded sales production volumes, guiding that Zircon and Synthetic Rutile volumes would be at the lower end of previously issued guidance. Rutile sales would be 40% lower than previous guidance. The company citied low pigment plant utilisation levels as the driver behind the weaker than expected Rutile sales.

Micro observations

Queensland property trip

The property market in Southeast Queensland has taken a much publicised battering since 2008, and even now prices are still somewhat deflated. We undertook a Queensland property trip during the quarter, visiting a number of listed and unlisted property developers, shopping centre managers and office managers on the Sunshine Coast and in and around Brisbane. Our key take outs are below.

The residential market appears to have bottomed. We noted:

- The first home buyers grant has been taken off for established houses, however a $15k incentive remains for new homes which is a positive for builders;
- Sales volumes have picked up in the last few months in almost all markets but developers are still offering discounts, so the true demand picture will emerge as they roll off;
- Buyer default rates have recently fallen below 20% for one developer from a higher level (which wasn't quantified);
- The sales process is long as upgraders want to sell their own house first before buying a new house/apartment whereas in the past many were comfortable buying before they sold;
- There is a new hospital being built on the Sunshine Coast (construction well underway, 2016 opening), which will bring more stable employment opportunities (versus the construction/ tourism bias to date);

'Tough people last, tough times don't.'

Nathan Tinkler, 01/11/12

'Costs, once in, are hard to remove.'

Australian Coal Mining Executive, 101/12

'The short term equilibrium price [for iron ore] should stay around US$90, but it's not impossible for it to go to US$80 by the end of year. Iron ore will stay in a downward trend until the end of the year, there's no possibility of it increasing by the end of year.'

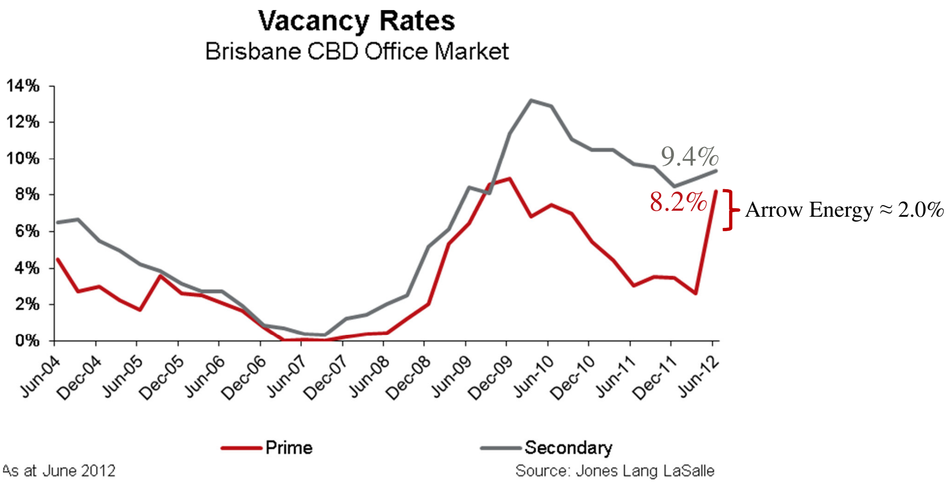
Iron Ore trader, Tangshan 21/09/12. The iron ore price closed at US$140 on 31/12/12

- Developers are very focused on affordable housing which is selling the most. Costs for builders are at record lows, so developers can offer house & land packages for as low as $200k on the Sunshine Coast; and
- The upper end of the market is still struggling, which makes it harder for developers like Mirvac who have a larger exposure to that segment.

Brisbane office market

On the supply side in the prime segment of the market, the recent completion of 111 Eagle St has recently pushed up the wider office vacancy rate. However there will be very little new supply coming into the market between now and 2016 and the prime market fundamentals remain solid. The secondary/B-grade segment (43% of stock) take outs were not so positive. The state government downsizing will see an exiting of 40,000 sqm on top of a vacancy rate which is starting at 9.4%.

Demand from the resource sector (combined LNG/Coal) remains positive, however one contact we met with said 'for the first time in years large companies are focused on headcount and costs.' For example Peabody Energy were originally looking for 12,000 square metres but have now revised their requirement down to 7,000 square metres.

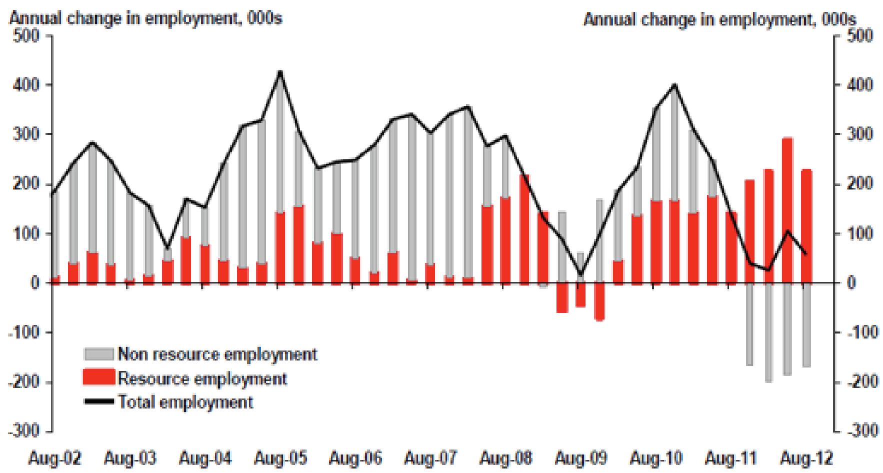


Macro observations

Unemployment in Australia

To the surpise of many, the unemployment rate in Australia has continued to decline. Evidence of the disconnect between the resource sector and other sectors in the economy is illustrated in the chart below which shows employment growth in the resource sector has effectively masked the decline of employment in the rest of the economy. Resource employment has only declined in 3 of the past 41 quarters, all of those three quarters occuring consecutively during the global financial crisis.

Fig 2 Employment growth in resources has hidden losses in non resources ... will weakening resource employment growth in 2013 turn invisible unemployment to visible?



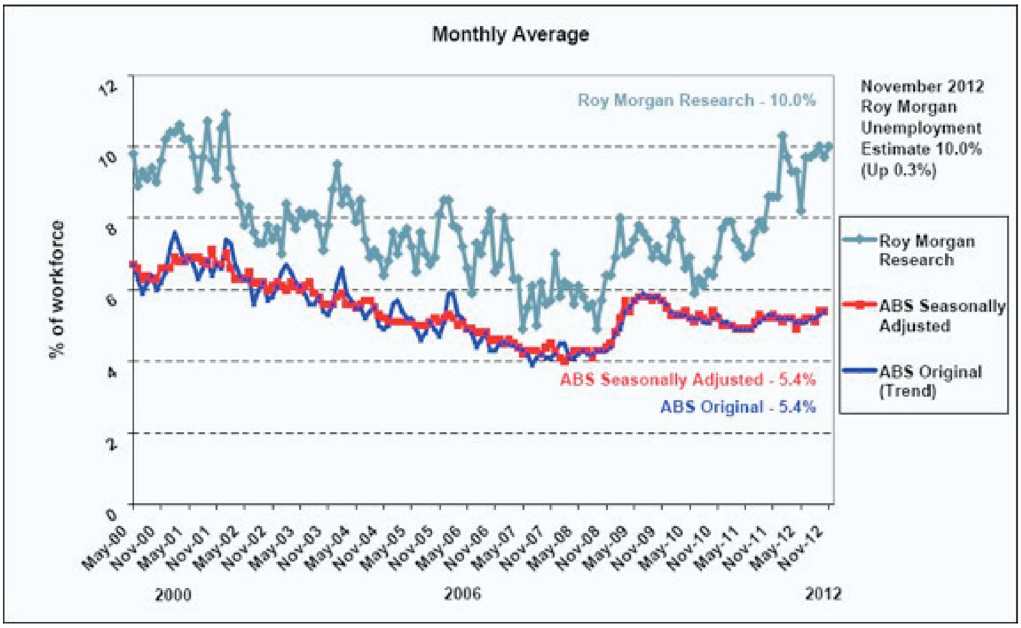
Source: ABS, Macquarie Research, December 2012

'A Toyota Tarago has more seats than Labor in QLD.'

Charlie Aitken, Bell Potter, 20/4/2012

Roy Morgan Research (RMR) publishes their own estimate of the unemployment rate, which printed at 10% in November. This is almost double the Australian Bureau of Statistics (ABS) estimate of 5.2% for the same period. The large differential is mainly attributed to their definitions of an unemployed person. According to RMR, an unemployed person is classified as part of the labour force if they are 'looking for work, no matter when', meaning they include those who have become disenchanted in the search for work. However according to the ABS, an unemployed person is classified as part of the labour force only if they have been 'actively looking for work in the four weeks up to the end of the reference week, and if they were available to work in the reference week'. The ABS also counts those employed for a small amount of part time work but would like to work additional or more permanent hours as employed within their definition, which consequently hides underemployment. Furthermore, the ABS disregards certain people on welfare, including those on youth allowance which understates youth unemployment.

Below we see both measures plotted against each other since 2000. As expected the RMR estimate is always higher than the official ABS figure. Intriguingly however, the movements of both sets of data mirrored each under until approximately November 2010, when the RMR figure began to break to the upside. We understand no change in methodology occurred at this juncture.



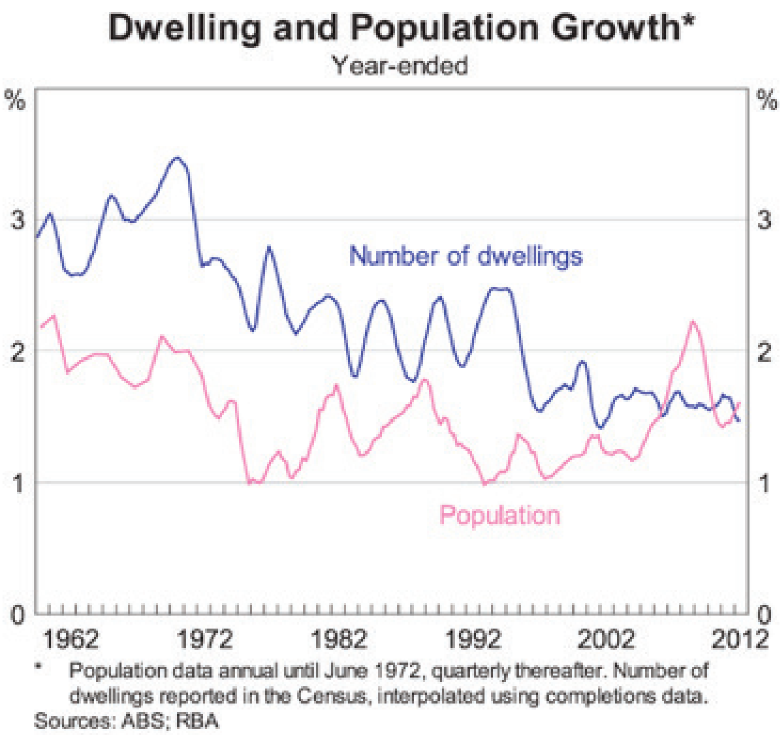
Source: Roy Morgan Research, ABS.

Australian housing

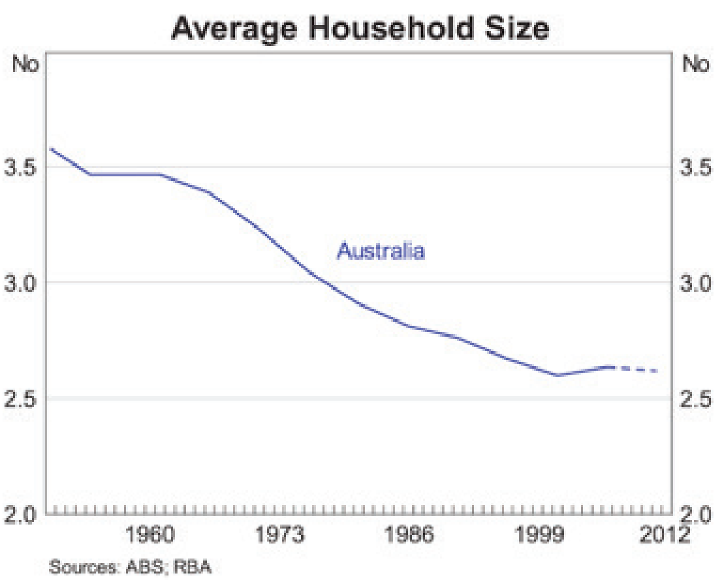
A number of market commentators have publicly predicted that the current interest rate easing cycle will lead to an eventual official cash rate of 2.0%, down from its current level of 3.0%. With interest rates to possibly fall another 100 basis points, the potential increase in seemingly already elevated house prices is the big unknown. An undersupply of housing could be the factor that would give house prices the next leg up. As we can see from the chart below, Australian population growth has lagged behind dwelling growth for much of the past 50 years, however recent data shows that this may be turning.

'For most of the past 20 years we were benefiting from either the credit boom or the terms of trade boom.'

Philip Lowe, RBA Deputy Governor, 05/12/2012



As birth rates lowered and quality of life has improved in Australia over the past 60 years, the average household size has fallen. The structure of households has also changed, as the number of single adult households with or without children has increased as a share of the market. Easier access to credit has also helped more Australians purchase their own home.

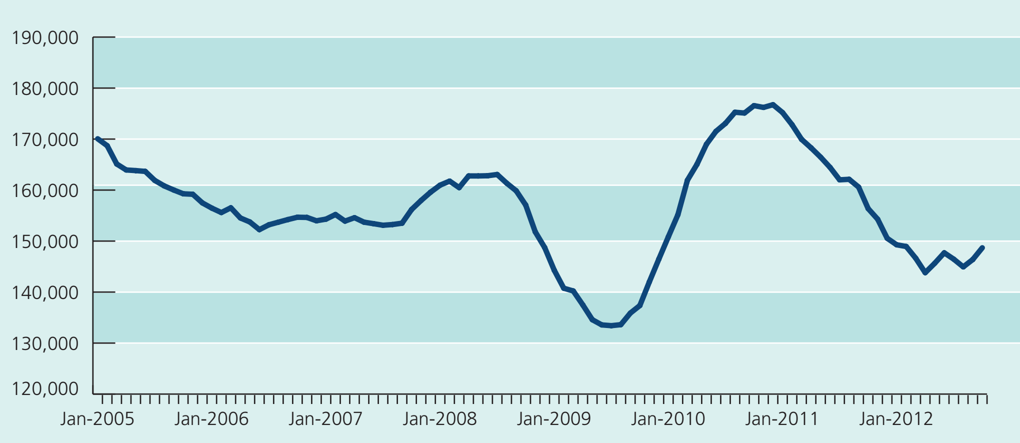


Nomura research estimates that the 'normal' level of dwelling commencements, which is the level of new housing required to account for population growth and replacement of run-down buildings, is currently 140,000 p.a. But if the average household was to increase from 2.55 to 2.65 people per household, it would equate to 300,000 houses which are no longer required, pushing the normal rate of dwelling commencements well below the perceived 'normal' level. This highlights just how sensitive annual building approvals are to changes in household formation.

Building approvals

Building approvals have steadily risen since the beginning of the year, much to do the delight of the government and industry.

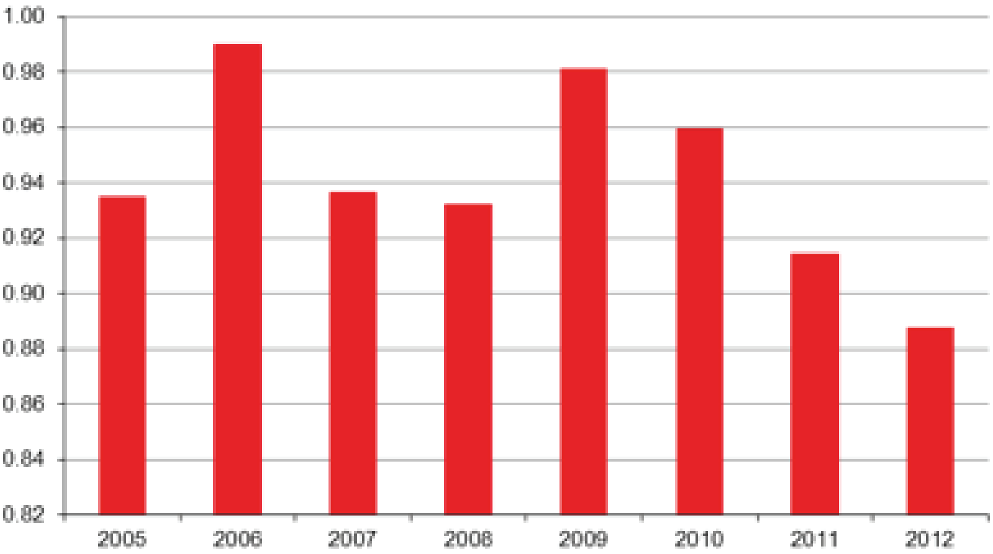
Australian Housing Approvals – Rolling p.a.



Source: ABS

However, what is hidden in this data is the breakdown of the type of dwelling that is approved. Common practice in recent times is for developers to gain approval for large scale apartment projects, with the ability to not execute on the project if the demand does not meet. Below we can see that since 2009, the conversion of approvals into commencements for apartments has fallen more than 10%, perhaps masking the bullish building approvals statistics we have seen this year.

Conversion of approvals into commencements for Apartments



Source: Nomura Research

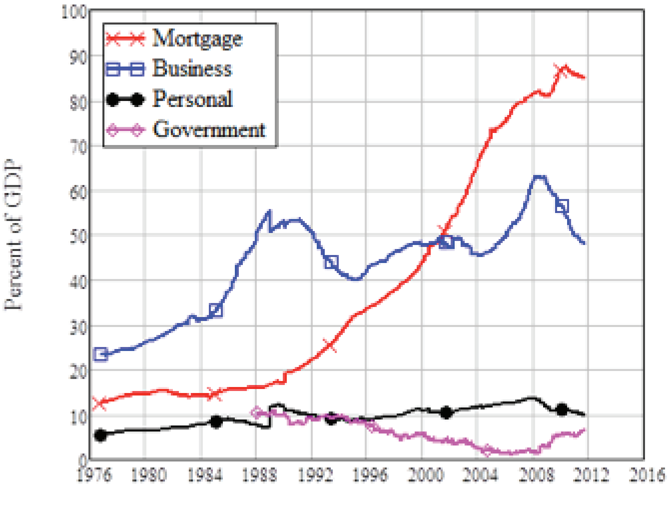
'The fact is that when commodity prices come down that will have some impact on our budget.'

Wayne Swan, Treasurer of Australia, 24/08/2012

Deleveraging and the current easing cycle

Australian household debt has plateaued since rising markedly during the credit boom which began in the early 1980's. Businesses have been deleveraging their balance sheets since the global financial crisis, however this deleveraging process can take much longer for the household sector due to the longer time frame of a mortgage.

Australian Debt by Sector



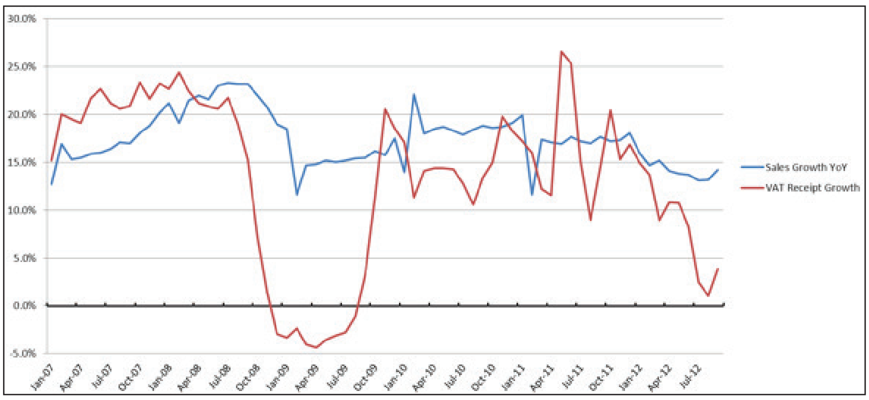
The effect on house prices has so far been relatively benign during this rate cut cycle compared to those of the past, with house prices marginally falling on average since the first rate cut in November 2011. Although rates still have some room to fall, because household debt is starting from a relatively high base, unless the economy starts to leverage up again, it is difficult to see a large uptick in house prices in the short term.

Retail sales in China

Many companies listed in Australia are making substantial investments to take advantage of the rise in consumption in China. Determining the strength of the consumer is unfortunately not a straight-forward exercise. The official data for retail sales released by the National Bureau of Statistic has shown strong growth for the past five years, with the growth rate never falling below 10%.

There are a number of crosschecks that can be performed on this data, the most popular being to monitor the growth of Value Added Tax (VAT) receipts. In theory, assuming constant tax rates, the growth of VAT receipts should effectively mirror sales growth in an economy. However as you can see in the table below, the growth in VAT receipts does not exactly reconcile to the nominal retail sales growth. Given the current environment of low single digit inflation, if we take the VAT receipt growth as the more accurate reading, sales growth in real terms would be very modest, even flat.

Sales Growth vs VAT Receipt Growth



Source: Bloomberg, Nomura Research

'Financial leverage is the weapon of companies with weak strategies.'

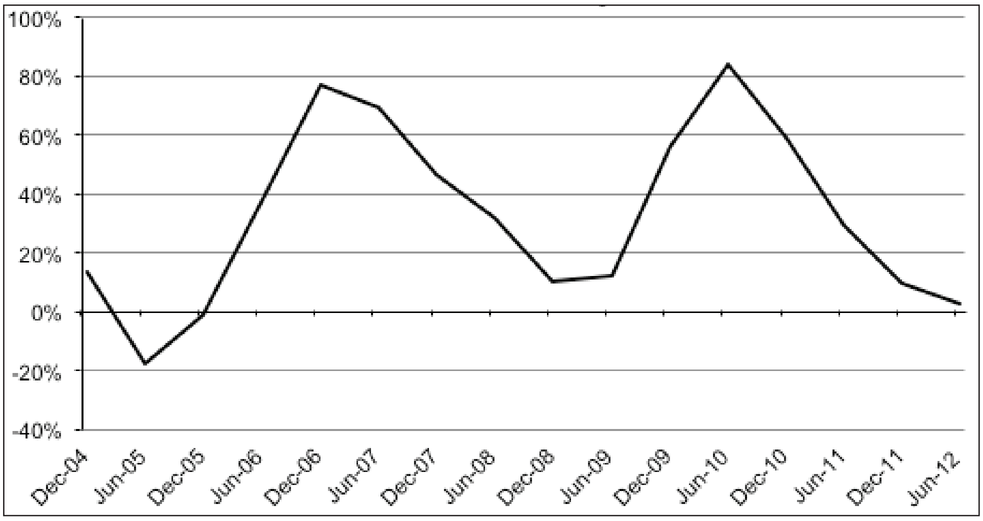
Anonymous CEO, Nov 2010

'The strongest indication about whether or not the current Chinese growth model is no longer providing sustainable growth is whether debt is rising faster than debt servicing capacity.'

Michael Pettis, Finance professor at Peking University's Guanghua School of Management, 7/10/2012

Another crosscheck for retail sales is the reported sales from companies listed in China. As we can see below, this data does not exactly reconcile to the double digit retail sales growth reported by the National Bureau of Statistics either. We can see that the large stimulus program launched by the Chinese government went some way to boosting sales after the financial crisis; however the effect of this appears to have petered out with the sales growth up until June 2012 being only 2.5%.

Sales for Chinese Discretionary Consumer



Source: Nomura Research

Market outlook

In a continuation of what we wrote in our previous quarterly report, December saw 'no new [material] negatives' from an exogenous macroeconomic perspective. In fact some early signs that China may be stabilising ahead of the Chinese new year [and perhaps more importantly ahead of the beginning of a new political term], and the US averting the Fiscal Cliff (albeit at the 11th hour) helped buoy markets further with a 6.8% return. Whilst outcomes like this continue to highlight the inferior returns from alternate asset classes such as cash and bonds, the fact that the Australian equity market rally has come from valuation expansion rather than earnings upgrades, highlights just how important some flow through of economic growth is to sustain these elevated levels.

The first phase of this dichotomy in asset class returns (throughout 2012) has been borne out in a material thematic rally in high dividend yielding stocks, with stock picking taking an effective back seat. As the market gets more comfortable (or perhaps less uncomfortable!) with the outlook for (still troubled) developed economies we would expect the next phase to see outperformance of more economically leveraged parts of the market. We continue to play this thematic through well managed companies that deliver growth over and above broad economic outcomes – effectively providing us with an earnings cushion should economic growth disappoint.

With respect to the US we remain mindful that, at least to date, they have only postponed their fiscal woes rather than solved them. It remains inevitable that 'the [fiscal imbalance] can' continues to get kicked down the road – albeit it this is well entrenched in the market's expectation.

As we approach reporting season, the market will again focus on earnings delivery and associated outlook commentary. The improved market sentiment continues to lengthen the investment horizon of the market, so medium term and even longer term earnings drivers can be expected to form a larger part of the market's thinking. This is expected to assist bottom up stock picking as diverging stock performance is an outcome of the market discovering the 'haves and have nots'. Whilst yield delivery is expected to remain a focus, we expect increased discretion between dividend grower's and those that offer a stagnant dividend stream. Our strong sense is that the preoccupation with yield during 2012 has led to a number of valuation anomalies which we expect to see unwind over time.

'There is no such thing as 'good" or 'bad' information; information is only true or false. But because of our hardwiring, we only want certain information to be true. In particular, we want the information that confirms our prior beliefs and validates our belief systems to be true... Thus, de-biasing ourselves must involve an honest assessment of what we want: do we want to be 'right' about everything, or do we want to know what's true?.'

Dylan Grice, Societe Generale, 23/01/12

'It's not always easy to do, what's not popular, but that's where you make your money.'

John Neff

More information

To find out more about investing with Greencape, please contact:

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