Greencape Wholesale Broadcap Fund

Fund report and commentary – June quarter 2013

Performance	Quarter (%)	1 year (%)	2 years (%) p.a.	3 years (%) p.a.	5 years (%) p.a	Inception (%) p.a.
Greencape Wholesale Broadcap Fund	**–0.93**	**26.72**	**8.72**	**10.89**	**6.57**	**8.28**
Growth return	–3.13	20.49	4.11	4.43	1.64	2.86
Distribution return	2.20	6.23	4.61	6.46	4.93	5.42
S&P/ASX 300 Accumulation Index	–2.83	21.90	6.47	8.25	2.70	3.60
Active return (net)	**1.90**	**4.82**	**2.26**	**2.64**	**3.88**	**4.68**

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

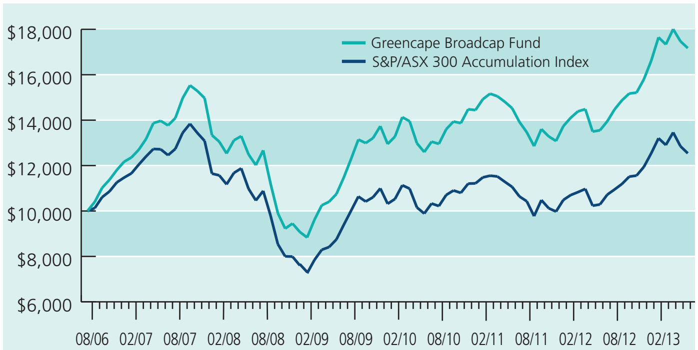
Quarterly

Suggested minimum investment timeframe

At least five years

Greencape Broadcap Fund

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

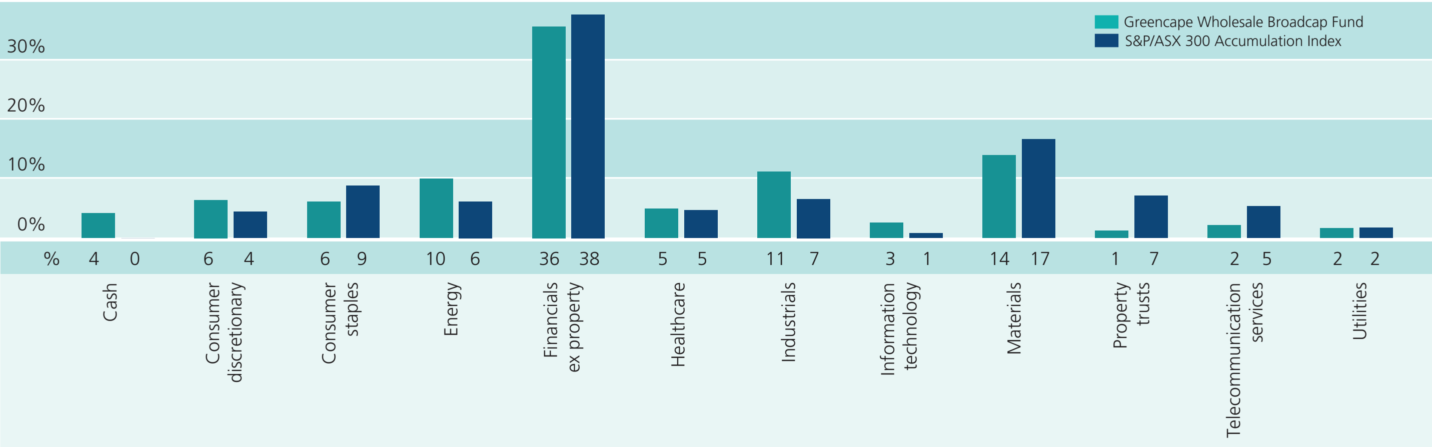


Asset allocation	Current (%)	Range (%)
Securities	95.83%	85–100
Cash	4.17%	0–15

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 30 June 2013



Market review

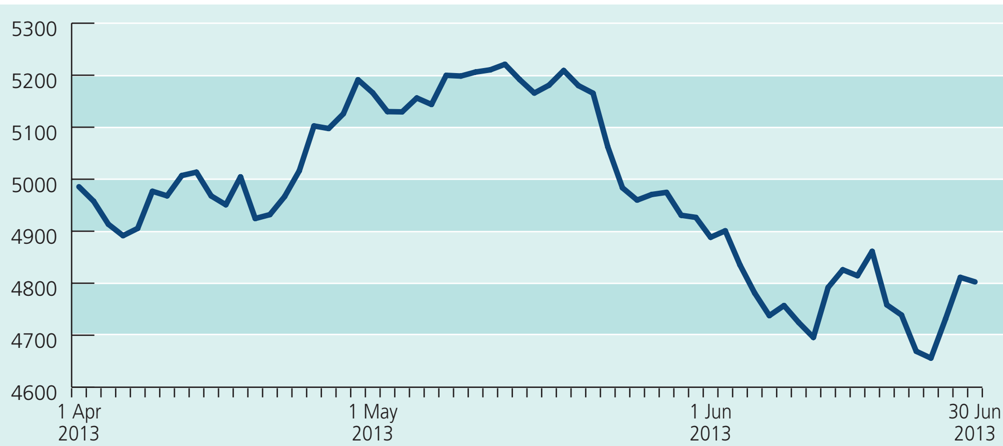
The S&P/ASX300 Accumulation index fell 2.83% for the quarter. The Greencape Broadcap Fund outperformed the benchmark and fell 0.33%.

The momentum from the strong March quarter failed to carry on into this quarter as the local market index fell out of favour with global investors. The period started robustly with the index posting a gain of over 4% in April as global investors continued to satisfy their seemingly insatiable desire for yield. However, this trade came to a grinding halt as the Australian dollar fell away and financial risks in China spooked the market. Higher beta sectors underperformed defensives.

'It was possible that the exchange rate would depreciate further over time as the terms of trade declined, which would help to foster a rebalancing of growth in the economy.'

RBA Minutes, published June 4, 2013

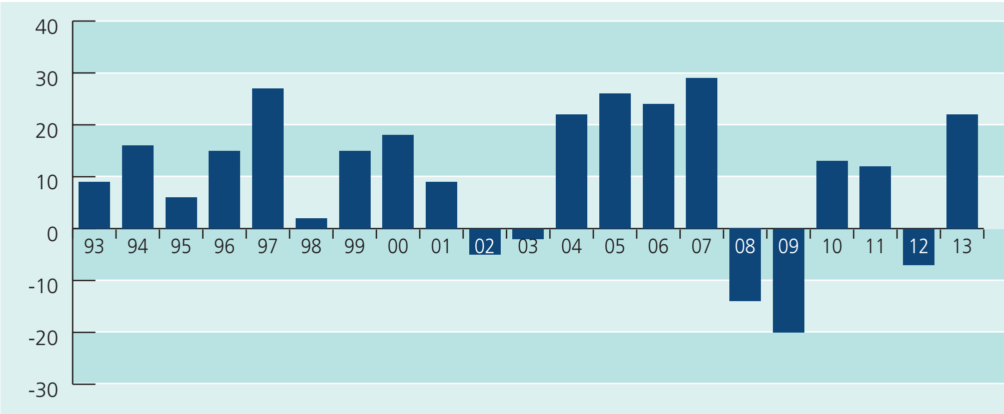
S&P/ASX 300 Price Index



The Reserve Bank of Australia (RBA) cut rates in May for the first time in 2013, lowering the cash rate by 25 basis points to 2.75%. Interestingly, in the minutes from the June meeting which they kept rates on hold, the bank noted that 'the inflation outlook as currently assessed might provide some scope for further easing, should that be required to support demand.' We also had a change in Prime Minister, after backbencher Kevin Rudd won a leadership ballot with 57 votes over the incumbent Julia Gillard who won 45 votes in the caucus meeting. Local data was mixed with unemployment numbers missing badly in April as the economy lost a worse than expected 36k jobs, before then rebounding to add a better than expected 50k and 1k jobs in numbers released in May and June respectively. Australia's current account deficit also narrowed to a better than expected $8.5bn with the terms of trade also improving slightly during the quarter, following its steady decline since late 2011.

[1] ASX200 Accumulation Index.

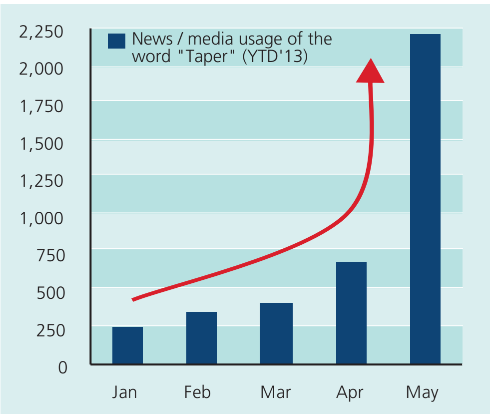
S&P/ASX 300 Accumulation Index Financial Year Returns Since 1993



In the US, the S&P500 index reached fresh all-time highs as economic data improved and the US Federal Reserve (the Fed) continued its quantitative easing program unabated. Non-farm payrolls printed higher in all three months, while the US Manufacturing ISM actually fell all three months, even printing below 50 for the first time since November 2012. However the S&P Case-Shiller index which reflects changes in house prices continued to rise throughout the period, spiking up 12% in March on the prior year.

The burgeoning US recovery prompted the Fed to consider slowing down its asset purchases in its forthcoming meetings. Although this action would be taken due to the improvement in the economy, it was taken negatively by the market as the 'tapering' looked to becoming sooner than most had expected. This had a number of flow-on effects. Firstly it strengthened the USD, which helped the AUD/USD cross rate fall 12% for the quarter. Gold, which was a major beneficiary of Quantitative Easing, was hit hard and gold equities fell off a cliff. US long-term bonds yields also climbed, with the 10yr and 30yr rates climbing 64 and 40 basis points respectively as the first signs the Fed's zero interest rate policy was starting to unwind.

As we can see below, 'tapering' became the new buzz word during the quarter.



Source: Merrill Lynch

It was another case of 'sell in May and go away' this year, however unlike last year, problems in the Eurozone were not the cause of concern, as news flow out of the region was relatively benign compared to previous periods. Eurozone GDP fell 0.2% quarter on quarter and the purchasing managers index (PMI) continued to print below 50. While these measures both indicate activity is contracting, the rate of decline appears to be slowing.

'I'm not in favour of going from wild turkey to cold turkey overnight.'

Dallas Federal President Richard Fisher on the reduction of Federal stimulus, 24/06/2013

The stability of the Chinese banking system came into question during June as short term interbank lending rates spiked to record highs. These concerns were somewhat abated when the People's Bank of China (PBoC) announced it would use a range of monetary tools to boost liquidity in the system, including the injection of funds directly into some financial institutions. The Shanghai Composite Equity Index was down 6% on the morning of the announcement, however once the press conference was announced for later that day, the index began to rally and it had completely reversed its losses once the press conference had concluded.

Locally, telecommunications was the best performing sector over the quarter. The index, dominated by Telstra, benefited from the ongoing search for yield as investors sought the assuredness of the company's 28c annual dividend. M2 Telecommunications also performed well after they announced and executed a takeover of Eftel and Dodo Australia.

Healthcare was the second best performing sector, led by Resmed. The company which manufactures products to treat sleep apnea, posted a third quarter result which beat analysts' expectations by 4% at the earnings per share (EPS) line and also beat gross margin expectations. The highlight of the result was the 21% volume growth in the flow generator sales. Resmed also benefited from a falling Australian dollar during the quarter, alongside other offshore earners in the sector, including Ansell, Sonic Healthcare and CSL.

Property trusts also performed well as investors chased yield. Within the sector, GPT Group outperformed as they released a market update in which they reiterated guidance of 5% EPS growth and also announced 5.1c dividend which surprised on the upside. Westfield Group, the largest index component in the sector, outperformed after its first quarter update which showed 97.4% of its portfolio was leased, up by 20 basis points, and sales productivity was up 1.9% to US$704 per square foot.

	June 2013 quarter	Year
ASX300 Accumulation index	–2.8%	21.9%
Best performing sectors		
Telecommunications	6.3%	39.4%
Healthcare	3.6%	42.0%
Property Trusts	3.2%	24.0%
Worst performing sectors		
Materials	–12.4%	–9.2%
Industrials	–7.3%	14.1%
Energy	–5.5%	6.5%

For the second consecutive quarter, the materials sector was the worst performing in the market. While most commodities fell to some degree, the main talking point was the spectacular fall of gold stocks for the period, with the S&P/ASX Gold index down 51% for the quarter. Newcrest Mining, whose price was already being impacted from a falling gold price, fell further following broker production downgrades in June, which was then followed by a $6b write-down on the carrying value of its assets, most of which related to operations at Lihir. The company also cancelled its dividend.

Industrials endured a tough quarter as the market began to factor in a possible recession for the local economy. Mining services in particular were dealt a savage blow, as a number of companies' downgraded guidance, all of them citing a distinct slowdown in mining expenditure and uncertainty in commodity markets. UGL's downgrade was particularly severe, as the company downgraded its full year earnings guidance by nearly 40% as delays in major projects adversely impacted the company's Engineering business, while cost reduction programs from miners impacted the Operations and Maintenance business. Cyclical stocks, whose operations benefit during high periods of economic activity, came under short-selling pressure as some market participants wagered on a domestic downturn. This included but was not limited to transport stocks such as Qantas, Toll and Asciano and other stocks leveraged to the economy, such as Seek.

'The huge outstanding economic challenge for us is the end of the China resources boom… This will have a dramatic effect on our terms of trade, a dramatic effect on living standards in the country, a dramatic effect also potentially on unemployment unless we have an effective counter-strategy.'

Kevin Rudd, Prime Minister, 28/06/2013

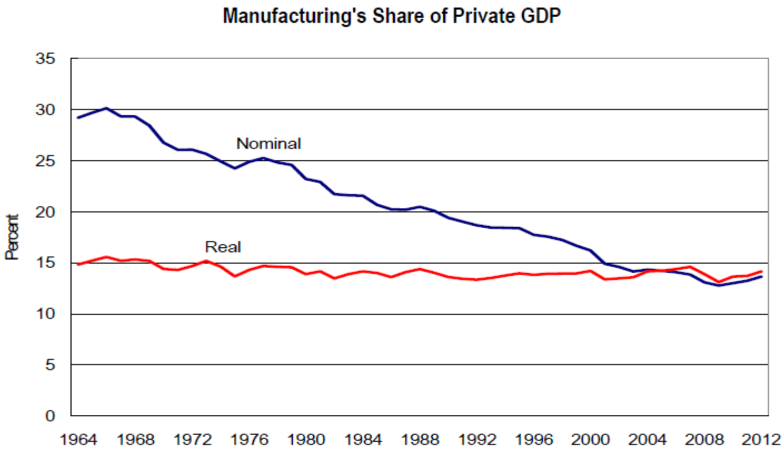
Energy stocks were dim as oil and natural gas prices floundered during the period. However there were also a number of company specific downgrades. WorleyParsons guided to financial year 2013 earnings between 2-7% lower than financial year 2012, instead of previous guidance of 'growth'. The company cited softening of demand for resource infrastructure in Western Australia as clients delayed major projects and implemented cost saving initiatives. Caltex also guided to a lower than expected result, as the company stated it expected first half replacement cost operating profit (RCOP) of between $160-$175m, compared to the previous corresponding period of $197m. The company advised in May that the unaudited RCOP in Q1 was $146m, which implies the company is having a difficult second quarter.

Macro observations

US manufacturing

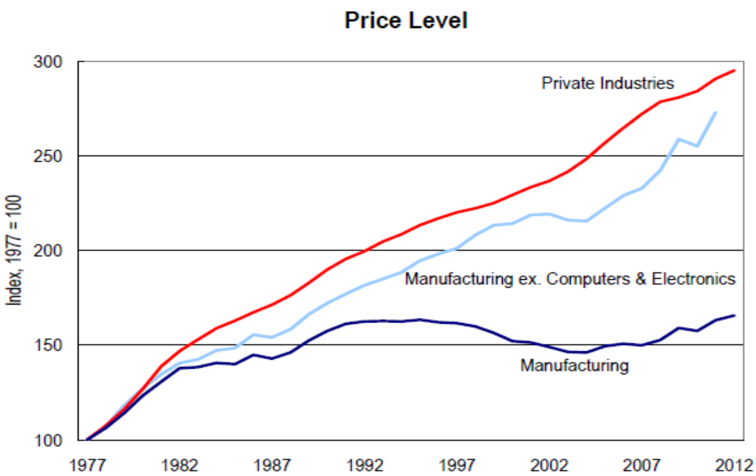
During the latter half of the 20th century, the share of total economic output created in the US by the manufacturing sector diminished greatly. In 1970 it stood at around 24% and has since dropped to 13% as of 2012. The decline has been steady and not isolated to any particular period as the US has gradually moved towards becoming a 'services' based economy, where more money is paid for intangible items such as specialised advice.

If we look at manufacturing's share of private GDP, we can see the nominal share was at one stage over 30% in the 1960's, however manufacturing's real share has remained steady. This shows the deflation in manufacturing products has masked the value of production.



Source: Citi Group

We can see below that excluding computers and electronics (the prices of which have declined due to technological advancement); the price index of manufacturing was more closely correlated to that of the private economy.



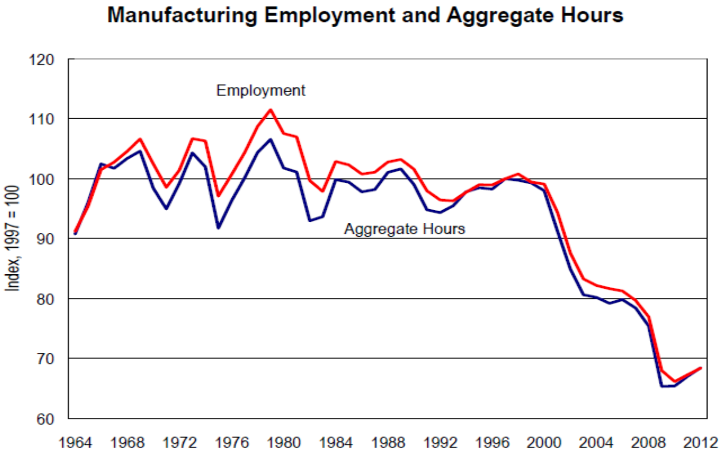
Source: Citi Group

'The best companies have an element of capital scarcity in their culture.'

Aled Amith, Portfolio Manager at M&G, June 2013

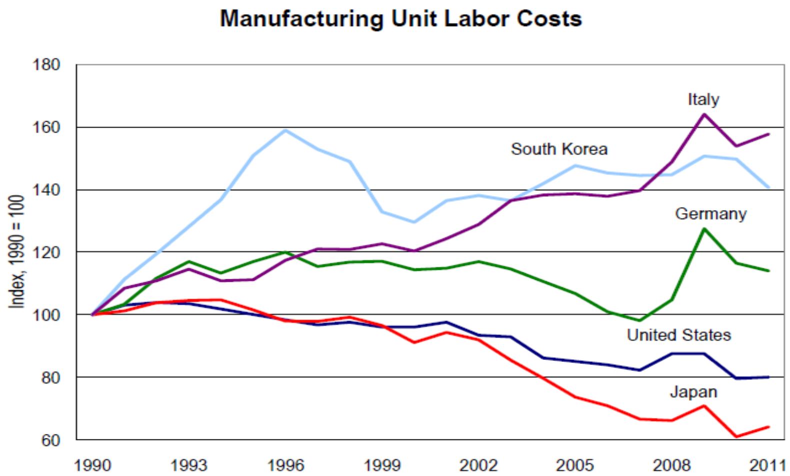
Is US manufacturing making a comeback?

During the late 1990's and early 2000's, the manufacturing sector shed an average of 380,000 jobs per year. During the GFC the pace was closer to 700,000 per year. The sector has now begun to add jobs, but only at a run rate of 150,000 per year. The sector is still net down 1.8 million workers since 2007 and 5.6 million workers since 1997.

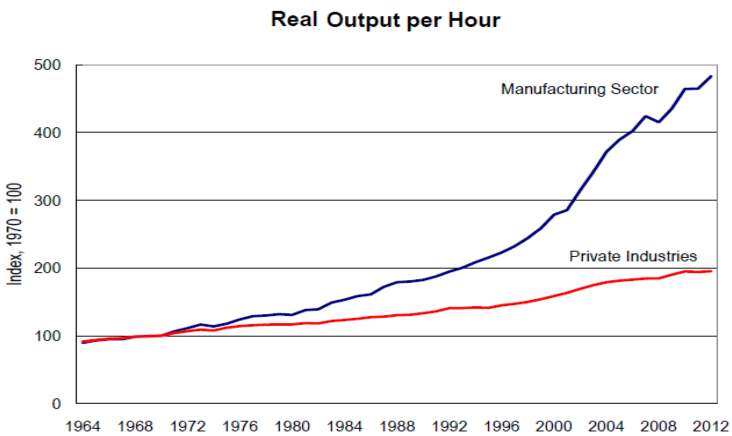


Source: Citi Group

There are a number of factors working in the sector's favour. Firstly, unit labour costs have trended lower than nearly all major trading partners in the past 20 years. Only Japan which has experienced deflation during the period has become more competitive. This has gone some way to increasing productivity in real terms as shown below.



Source: Citi Group

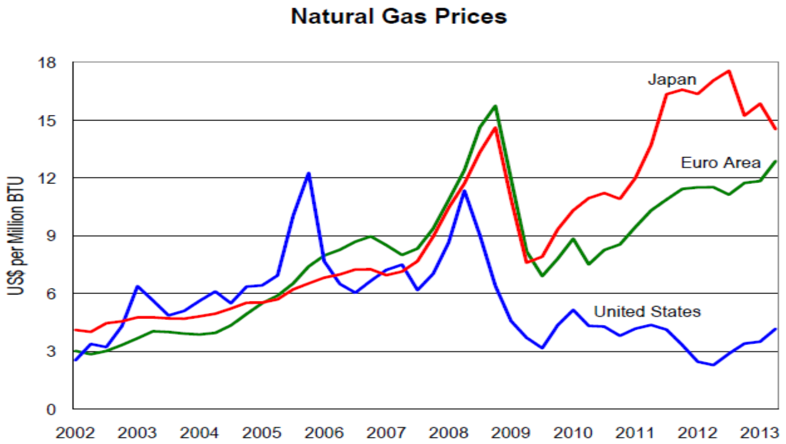


Source: Citi Group

'The beneficial effect of State intervention, especially in the form of legislation is direct, immediate, and so to speak visible, whilst its evil effects are gradual and indirect, and lie out of sight.'

Albert Venn Dicey, 1905

Natural gas prices have also decreased in the US relative to its major trading partners since 2008. This is due to drilling technology improvements which have significantly increased the level of recoverable gas from shale reserves.



Source: Citi Group

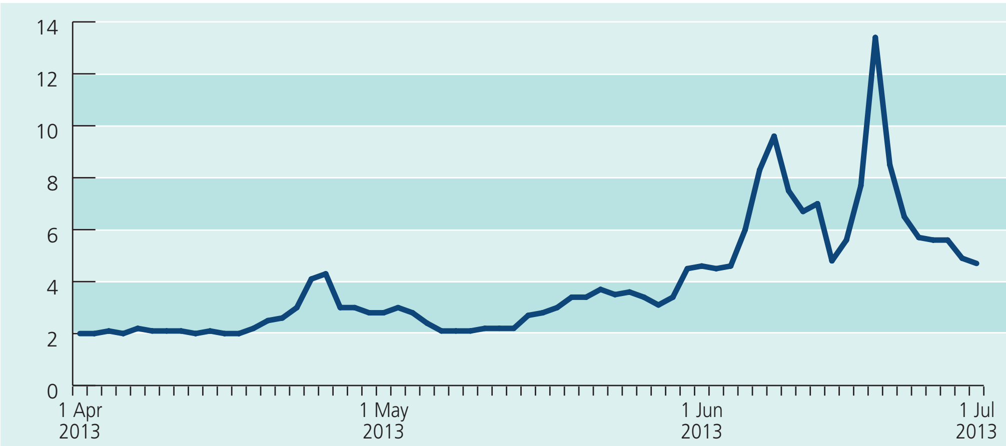
The Chinese credit crunch

A credit crunch among Chinese banks unfolded in June as interbank liquidity dried up. The chart below shows the spike in the overnight SHIBOR (Shanghai Interbank Offered Rate) to 13.4% at one stage. The SHIBOR is the annualised rate banks charge each other for overnight lending between each other. As the rate increases, so do the cost of funding for a bank, which likely increases the cost of the lending they provide to corporates as they pass this on.

'China will have replicated the entire US banking system in 5 years…$14 Trillion in lending. You do not see credit expansions of that magnitude going smoothly over the longer term.'

Charlene Chu, head of China financial institutions for Fitch Ratings, 18/06/2013

Shanghai Interbank Offered Rate (SHIBOR)



Source: Bloomberg

The leading theory behind the sudden rise in SHIBOR is that is it driven by the PBoC's concern regarding the rapid credit growth in financial system, especially the growth in lending by the shadow banking system, which includes wealth management products and trust lending.

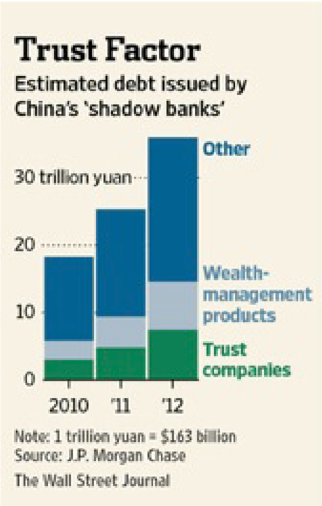
The credit crunch resulting from the sudden increase in SHIBOR will hurt banks that have behaved aggressively. Smaller banks that could not compete with larger banks for deposits, used the short-term interbank market to fund longer term loans, thereby creating a large asset-liability duration mismatch. These smaller banks who have gained market share from the previously stable SHIBOR will now have to deleverage and/or find alternate sources of funding. Longer term this will help to reduce risks in the financial system, but the risk is it could a spark a near term credit crunch at a time when the Chinese economy is already slowing. Therefore it was no surprise on June 25 when the PBoC held a press conference announcing they will use tools to safeguard stability in money markets and that tight liquidity will ease.

Chinese shadow banking

Shadow banking is a more informal and less regulated banking system that provides credit for businesses, local governments and property developers. It is the fastest growing segment of China's financial sector.

There are two main methods of shadow banking in China, the first being the issuance of wealth management products (WMPs) and using the funds to invest in loans via a trust company or to buy bonds, the second being borrowing short-term funds in the interbank market and subsequently investing in bonds and other longer-term assets that offer a higher yield.

According to the Wall Street Journal, in the last two years shadow lenders doubled their outstanding loans to 36 trillion Yuan, roughly 70% of China's GDP. Assets under management in the trust sector almost tripled between 2010 and 2012, making it the second largest segment in the China financial services industry. Our own research indicates that equity of the trust companies involved is leveraged 40x. In Q3 2013, half of the trust products will be maturing so in Q4 there is a risk of a liquidity crunch as these roll over. Interconnections between financial parties have increased, so trust company failures would impact banks, and other financial intermediaries given counterparty exposures. Our understanding is that regulators are now reviewing large WMP projects and requiring bank/trust companies to hold more equity against them.



In recent years, Chinese banks have been expanding credit by taking greater risks, however in the future they will need to reign in credit growth and rely more on fee income and/or raise equity.

Non-performing loans (NPLs) make up 4% of total loans or RMB 3.8 trillion which includes off-balance sheet WMPs[1]. This compares to RMB 2 trillion of bank provisions. In the event that this was all hit at once then it would be a 20% hit to bank equity, and to cover this the banking system would need RMB 400 trillion additional capital. This could theoretically be managed if the government set up asset management companies (AMCs) to take the NPLs off bank's balance sheet and progressively worked them out. This would be similar to 1998 where local governments stood behind the AMCs and the AMC provided a bond back to the bank. In effect the leverage was transferred from the financial sector to the government, and the problem gradually became a relatively smaller and smaller one as China's economy grew rapidly year after year in the decade that followed. Of course the government is dealing with a much larger challenge today considering the numbers involved, economic growth is slowing, and many local governments are already highly indebted themselves.

'Steel production is much larger than demand in China.'

Xu Lejiang, Chairman of Baosteel, 28/05/2013

[1] Tao Wang, UBS Head of China Economics Research, 17/06/13

The issue of huge amounts of non-performing loans highlights numerous examples capital miss-allocation under the Chinese growth model, where local governments have pushed construction projects simply to meet GDP growth targets, but where the asset provides little or no economic return. There have been many stories of ghost cities, and we have witnessed huge numbers of newly constructed empty buildings ourselves in 3rd tier cities such as Tangshan and Taiyuan. The unknown is whether these are isolated examples in a huge country, or whether they are widespread.

'Nine times the commercial space sold last year (in China) is under construction now.'

Jonathan R. Laing, Barons, June 2013

We wonder if financing for the below building, currently under construction in the city of Changsha, will be the latest addition to someone's non-performing loan book.

Artist's impression of the Sky City project, at 220 floors it will be the tallest building in the world.

Micro observations

We undertook a number of research trips during the quarter. We travelled to the US (on three separate occasions), New Zealand, Macau/Singapore and Europe. Presented below our some of our observations:

Macau gaming

- Macau is for serious gamblers, minimum table bets are rarely less than US$100 and the non-gaming amenities (pools, cinemas, golf courses) were almost empty compared to Las Vegas;
- Very high returns (>50%) are being earned on properties only launched a few years ago. The market is tight with strong demand and limited supply as the market is short of hotel rooms;
- Raising minimum bet levels attracts higher quality gamblers. Slot machines numbers are uncapped under gaming licences but they make up a relatively smaller share of gaming revenue compared to western casinos;
- Infrastructure investment will bring more people to Macau with a number of new casinos to be opened between 2014 and 2017. In 2016/2017 a bridge from Hong Kong will be opened which will make the trip from Hong Kong airport to Macau a 20-30 minute drive;

- Macau is slowly becoming a broader-based tourist destination, which should help capture more casual gamblers in future;
- 50% of Macau gamblers are day tripper currently. Or they just gamble all night and don't use a hotel!
- Mass market gamblers are much higher margin for casinos;
- Risks remain – China slowdown flow on effect, gaming licences expire in 2022, risk of further anti-corruption crackdown by the government (hurts VIP revenue), and construction cost inflation given the huge amount of activity there.

No floors in the 40's at Wynn casino, 4's are unlucky!

USA

- Anything related to online facilitation is seeing great growth – VISY are now doing 40m boxes per annum for Amazon alone!
- The affluent consumer is in great form whilst the mid-tier consumer is trading down;
- In discretionary retail, 'Omni Channel' is the new buzz term – i.e. physical stores and online as an integrated offering. There is a real focus on leveraging the store base as a powerful distribution network for online facilitation;
- The major US discretionary retailers such as Macy's and Nordstrom are now getting 11% of their sales online;
- Most companies commented that the economy feels better compared to a few months ago, with housing and online retailers being the most positive;
- US housing continues to grow strongly and multi housing appears to have peaked in terms of the percentage of the growth it represents, which bodes well for the intensity of most materials. If anything labour seems to be the key constraint to growth;
- A mid-tier regional bank expressed little interest in taking on balance sheet 30 year residential mortgages at prevailing rates. Most of the business they are writing sits on the Federal Housing Administration's (FHA's) balance sheets;

'When people forget that corporate profits are unlikely to grow faster than 6% per year, they tend to get into trouble.'

Warren Buffett

- The apparent trend of softening carbonated soft drink consumption is being exaggerated by the manufacturers not doing enough to recruit younger generations of consumers as the older ones natural diversify into healthier substitutes;
- Note to Woolworths and Wesfarmers - beware Costco! From here, they will move pretty quickly from 3 Australian stores to 8-10;
- Home entertainment has stabilised, and it seems we have reached the cross over point where digital, whilst small (and growing quickly) is contributing enough to offset DVD declines.

Outlook

Through the June quarter Greencape travelled through Europe, Asia and the US on several occasions. We observed a clear, yet small lift in US economic activity, albeit it was very sector and geographic specific. The evident strength of the US property market and share market is beginning to generate a wealth effect that is resulting in improved consumer and corporate confidence. Many corporates told us that having got through last year's election, then the fiscal cliff then the sequester and more recently a late spring, things are starting to look better. This comment on the US is in contrast to the flat observations of previous trips.

Given the improved economic observations in the US, the debate about the timing of the US Fed's quantitative easing 'tapering' is based on fundamentally positive developments. The tapering theme is evidently having an impact on capital flows. Carry trade assets such as commodities and emerging markets, bond funds and the Australian Dollar are seeing capital outflows, whilst US equities, despite also falling initially, are expected to relatively outperform these asset classes going forward.

With Europe still delivering flat-at-best activity, and China demonstrating opaque signs of tight credit and slower growth, and the RBA demonstrating a clear easing bias, this is acting to further magnify the capital flow velocity. We consider the fundamental economic improvement in the US reduces the necessity of self-help growth drivers at the margin, as the cycle can be expected to finally assist corporate profit growth from US exposed businesses.

Domestically, signs of a weakening economy are evident. Falling commodity prices have again caught out large miners carrying more debt than they should have for this stage of the cycle, particularly Newcrest and Rio Tinto. This has led to a dramatic shift in strategy, from maximising economic value on projects through raising production growth as fast as possible to a one of rationing capital spending, divesting non-core assets, and severely cutting operating costs and in Newcrest's case, cancelling dividend payments. This change is having dire consequences for the contractor services sector, engineering firms and general confidence in effected regions where workers are being made redundant. The RBA is hopeful that the slack in economic growth felt from the removal of the mining construction boom can be filled by a stronger domestic economy, particularly housing construction. We are more cautious on that front, noting that after a 22 year recession-free period on the back of a once-in-a-generation mining boom, such transitions are unlikely to be entirely smooth. Furthermore, on the back of the mining boom consumers have become highly indebted due to an expensive housing market, which to date has been evident in their unwillingness to spark a housing construction led recovery despite already very low interest rates. As the RBA Governor pointed out recently, a lot depends on collective confidence, which we expect may get a boost following the federal election, however we expect the forces of the mining boom unwind to ultimately outweigh this.

For the above reasons the current portfolio positioning reflects our more cautious view on domestic cyclicals, high yield stocks which were 'over-bid' in the chase for yield earlier in the year, and our more positive view on an improving US economy.

'If your purpose contemplates still being here in five to 10 years' time, then the choice seems clear: it is better to sacrifice reach and preserve sustainable profitability.'

Mike Darcey, CEO of News International at News Corp, 02/07/2013

'Being too far ahead of your time is indistinguishable from being wrong.'

Howard Marks, Chairman and Co-founder of Oaktree Capital, 2011

'You gain more by not being stupid, than you do by being smart. Smart gets neutralised by other smart people. Stupid does not.'

Phil Birnbaum, 13/06/13

More information

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

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