Greencape Wholesale Broadcap Fund

Fund report and commentary – March quarter 2011

Performance	Quarter (%)	1 year (%)	2 years (%) p.a.	3 years (%) p.a.	Inception (%) p.a.
Greencape Wholesale Broadcap Fund	**4.74**	**7.33**	**25.60**	**6.57**	**9.59**
Growth return	4.62	5.11	22.28	3.42	5.18
Distribution return	0.12	2.23	3.31	3.15	4.40
S&P/ASX 300 Accumulation Index	3.12	3.79	21.37	1.13	3.55
Outperformance (net)	**1.62**	**3.54**	**4.23**	**5.44**	**6.04**

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 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

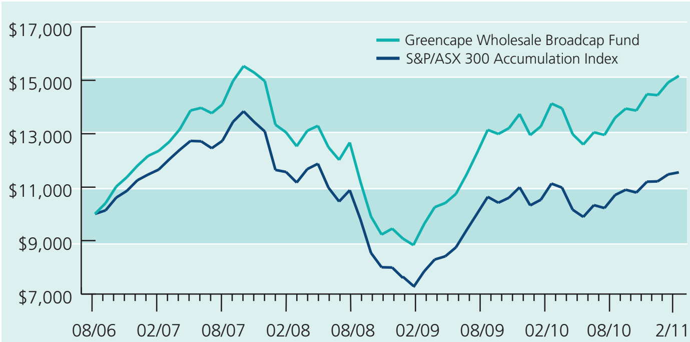
Quarterly

Suggested minimum investment timeframe

At least five years

Greencape Broadcap Fund

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

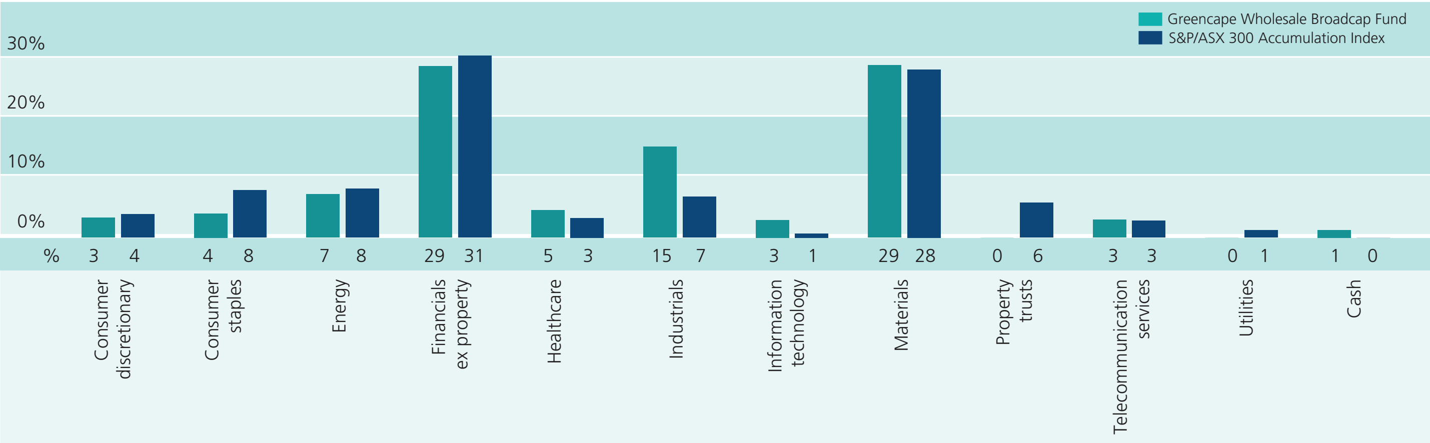


Asset allocation	Current (%)	Range (%)
Securities	98.72	85–100
Cash	1.28	0–15

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

Fees	Greencape Wholesale Broadcap Fund
Entry fee	Nil
2009/10 ICR	1.25%
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%

Sector exposures as at 31 March 2011



Market review

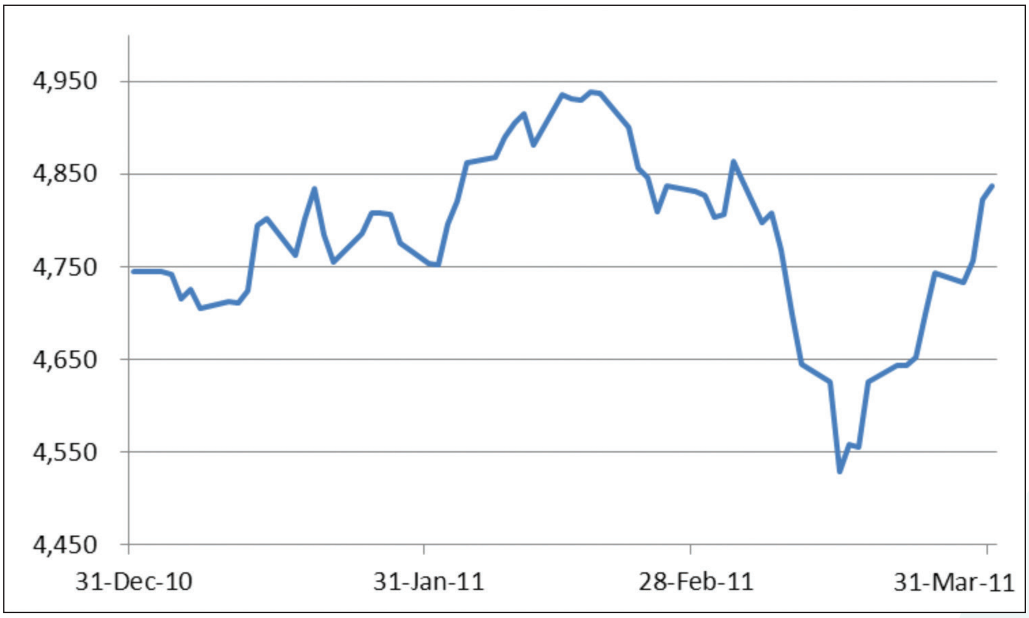
The S&P/ASX 300 Accumulation Index gained 3.1% for the quarter. The Greencape Broadcap Fund outperformed the market and delivered a 4.7% return over the quarter.

The market ended flat for the month of January as more positive economic data emerged from the US, offset by the Queensland floods and political unrest in Egypt.

February saw a mixed half-year reporting season domestically, with strong results generally from the resource and banking sectors, anchored by weaker numbers from industrials and consumer discretionary companies. The market was up 1.6% in February after pulling back late in the month as China tightened monetary policy and the oil price spiked to close to US$100 per barrel on the back of increasing conflict in Libya.

The market was down in early March as concerns mounted about the ramifications of higher oil prices, the re-emergence of European sovereign debt concerns, and the tragic earthquake and tsunami that struck Japan. However, the market rebounded from an intra-month low of 4,529 (S&P/ASX 200) as initial fears of a total meltdown at one of Japan's nuclear reactor sites began to subside.

S&P/ASX 200 Index



'Japan currently maintains central government debt approaching one quadrillion (one thousand trillion) Yen and central government revenues are roughly ¥48 trillion. Their ratio of central government debt to revenue is a fatal 20x… if Japan had to borrow at France's rates (an AAA-rated member of the UN Security Council), the interest burden alone would bankrupt the government. Their debt service alone could easily exceed their entire central government revenue – checkmate.'

Kyle Bass, Hayman Capital Management, 14/02/11

The Australian dollar held up strongly during the quarter, hovering around parity with the US dollar before rising strongly to 1.03 in late March. At the time of writing it is above 1.05, which is an all-time post-float record!

Energy was the best performing sector. The West Texas Intermediate (WTI) (Oil Price) rose approximately 20% which saw strong gains by Woodside (up 11%), and Santos (up 19%). Worley Parsons rose 17% following a positive first-half result and strong guidance for the second half of the year that was driven by recent contract wins and a recovery in its key Middle East and Canadian markets. Uranium stocks fell heavily on the news of the Japanese earthquake and Fukishima nuclear power plant disaster, with Paladin Energy falling 33%.

The telecommunications sector gained 4.9% driven by Telstra, which paid a 14c half dividend and reaffirmed its full year dividend guidance of 28c for 2011 and 2012.

Financials were up 4.9% led by Westpac (up 10%) and NAB (up 9%). Both banks reported better than expected quarterly results in February which helped drive a re-rating by investors.

	March quarter	1 year
Market (S&P/ASX 200 Accumulation Index)	3.2%	3.4%
Best performing sectors:		
Energy	6.4%	9.0%
Telecommunications	4.9%	3.4%
Financials (excl. property trusts)	4.9%	–3.0%
Worst performing sectors:		
Utilities	–2.0%	3.8%
Healthcare	0.6%	1.0%
Consumer discretionary	1.8%	–5.5%

Utilities were the worst performing sector falling 2%. AGL Energy underperformed by 10% following a disappointing first half result. CSL drove the underperformance of the healthcare sector, driven by the uncertainty as to when its main competitor Octapharma (Octa) may be granted approval by regulators to re-enter the market.

Consumer discretionary stocks continued to lag the market. David Jones and Myer both reported weaker quarterly sales results than expected, which were heavily impacted by the Queensland floods and heavy rain on the east coast. Retailers also generally provided a subdued outlook for consumer sentiment and spending for the second half of the year. JB Hi Fi was the standout in the sector, outperforming by 15% following the announcement of a $170 million off-market buyback.

Company visits and observations

Europe and US healthcare trip:

In March we travelled throughout the US and Europe, conducting 25 meetings across the healthcare sector, in order to follow up specific company issues raised during reporting season and to gain a better understanding of how austerity measures in Europe are impacting healthcare budgets. Some of our observations are listed below:

- The UK is the most likely healthcare system in Europe to feel the biggest impact from austerity measures.
- The UK public health system (NHS) is looking for savings of £15 – 20 billion via:
  - Incentivising general practitioners (GPs) to shift patients to private hospitals where private health insurance cover is in place.
  - Reducing retirement pensions to healthcare workers.
  - Fixing tariffs for certain medical procedures.
  - Removing funding for some elective procedures that may have arisen due to controllable lifestyle factors, like lap band and some forms of dental surgery.

'Cultures self-propagate.'

Warren Buffett, 2011 letter to shareholders

- In other parts of Europe:
  - Austerity is manifesting itself through flat healthcare budgets in absolute terms despite rising system costs – so austerity by stealth!
  - There is a noticeable shift from public to private care and away from universal healthcare, with the basket of funded services reducing and increasing hurdles for funded procedures at the patient level.
  - Healthcare industries offering scale economies (e.g. pathology) are likely to be subject to fee cuts such that scale benefits are essentially shared with 'the system'.
- One of CSL's large direct competitors, Octa, had its intravenous immune globulin (IVIG) product pulled by US and European regulators in late 2010. We met with several industry players, including Octa employees, GPs and regulators to assess what the likelihood, timing and implications of Octa's return to the market might be. However, given we believe this information is not well understood in the market, we won't disclose our findings in this report.
- Sonic Healthcare is benefiting from driving scale procurement benefits across Europe.
- In the US there has been an increase in discounting of sleep apnea devices by manufacturers in order to generate sales growth, which recently impacted Resmed's reported results.
- Home sleep apnea testing continues to grow, with the reimbursement costs for insurers (c $250) being significantly lower than traditional sleep lab testing (c $900).
- Ramsay Healthcare is a respected hospital operator in the UK and will have opportunities to take over the running of NHS hospitals, although bureaucratic delays in such transitions have taken years in the past.

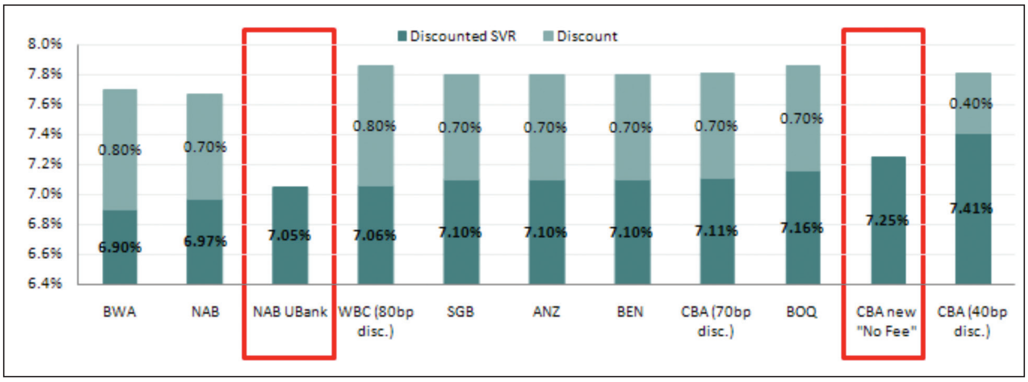
Increasing competition amongst Australian banks:

Readers may have recently noticed aggressive advertising campaigns by National Australia Bank (NAB), followed by Commonwealth Bank (CBA), particularly with regard to lower mortgage rates and the removal of mortgage exit fees. Competitive pressure in mortgages has clearly been on the rise; however the latest offerings from CBA and NAB are not actually that much more competitive than existing offers by the other majors once discounts are taken into account. The chart below shows recent available standard variable rates both prior to and post applying discounts often given to customers.

'Whilst it is preferable to cannibalise your own business rather than have someone else do it for you, in reality it's very hard to do.'

Paul Bassat, Joint CEO, Seek Ltd, 02/05/07

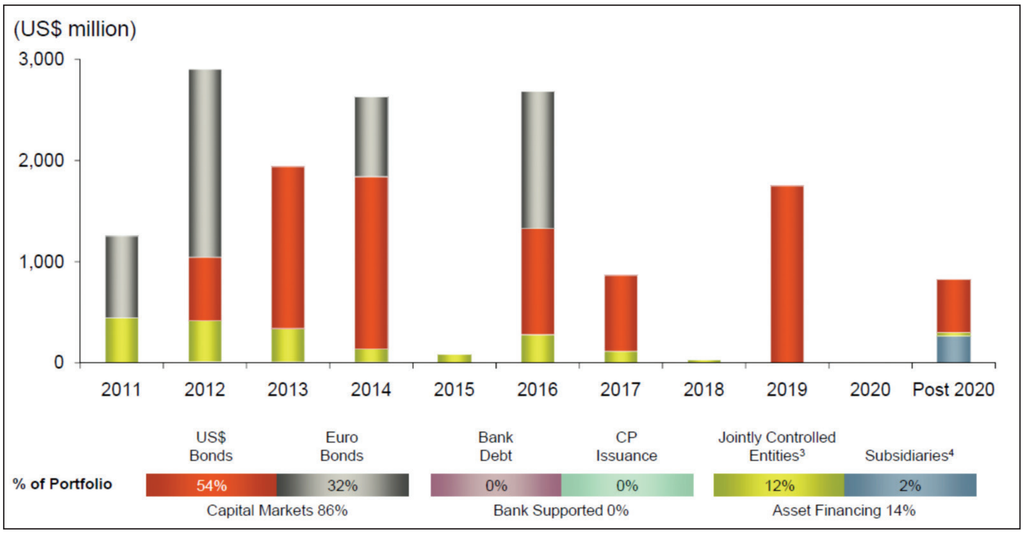
Standard variable rates before and after discounts



Source: Citigroup

Competition for corporate lending is also heating up. It's not just local bank peers that the Australian big four banks need to compete against. In the mid to high end corporate market they are also up against the foreign majors as well as other forms of lending, such as corporate bonds. A stark reminder of this is BHP's balance sheet, which despite having plenty of debt, currently has zero bank debt (see below).

Debt balances



Source: BHP

Telstra

Telstra's half-year result highlighted that it is at an interesting juncture in its history. On the positive side:

- Telstra reaffirmed its willingness to maintain the current 28% fully franked dividend for FY11 and FY12, representing a 10.0% yield (14% pre-tax!) at the current share price. Although we question the sustainability of such a high dividend payout from FY13 and beyond.
- Telstra is trading on 10.4x FY12 consensus earnings (about in line with offshore incumbent telcos).
- Telstra has regained sales momentum in mobiles and broadband, albeit after substantially increasing its subscriber acquisition costs and lowering its price points.
- Telstra looks likely to sign a deal with NBN Co. in the near future which would give investors some much sought after certainty about how the company will look in an NBN world.

On the flip side:

- Sensis' underlying revenue fell 8% (Yellow Pages down 13%) as structural headwinds (e.g. SME customers advertising via Google Search for a fraction of the cost) begin to bite.
- The above has added to the ongoing challenge of declining fixed line voice revenues (still 22% of the group) which declined by a further 8% in the half, driven by fixed line call volumes falling 14%.
- Internet service providers such as TPG Telecom are only just beginning to aggressively target Telstra's fixed line voice customers, and may be a precursor to the type of competition Telstra may face more broadly in a more level playing field that the NBN will bring about.

On balance we are less negative of the outlook for the stock as we have been in the past and we are keenly awaiting any outcome on a deal with NBN Co.

'On the one hand, the private sector is now saving more and borrowing less because of tighter lending standards, thereby imposing its own tight monetary conditions.'

Marc Faber, July 2009

'Only three years after Amazon launched its Kindle electronic reading device, it is now selling more Kindle books than paper books.'

Canberra Times, 31/01/11

'…few compensation schemes carry consequence for failure – something that became clear during the financial crisis, when many of the leaders of failed institutions retired as wealthy people.'

Dominic Barton, Harvard Business Review, 23/02/11

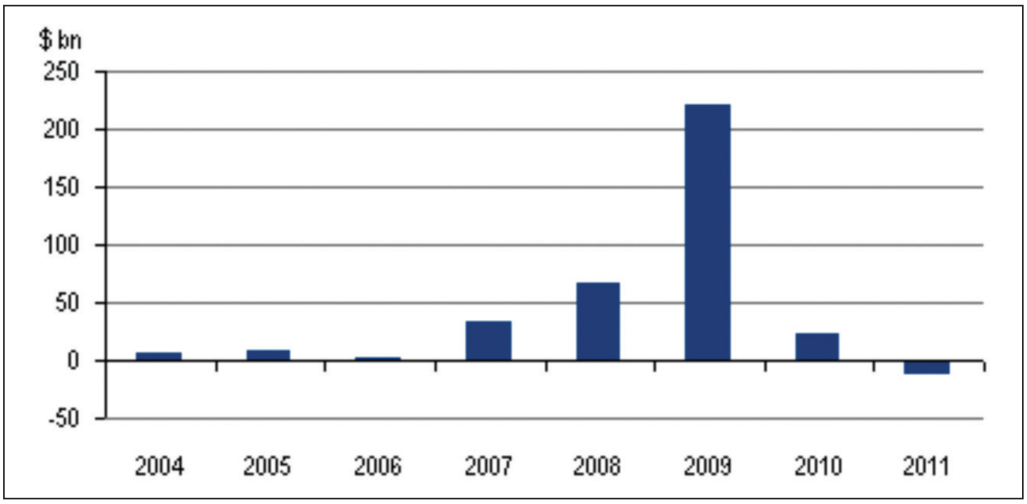
Macro

China

Concerns re-emerged during the quarter as the Chinese Government again tightened monetary policy by lifting the Banking Reserve Requirement Ratio (RRR) by a further 0.5% (to a record 20%) and the one year borrowing rate by 0.25% (to 6.3%). Although it should be remembered that the bank deposit rate is only 3.25%, still below the current inflation rate of 4.9%[1] and nominal GDP growth, hence real deposit interest rates are still negative.

Whilst monetary policy is still highly accommodative, uncertainty remains about what impact this tightening bias will have on GDP growth and fixed asset investment growth, which also needs to cycle the pull forward in government-directed infrastructure spend during the global financial crisis. The following chart highlights the accelerated growth in fixed asset investment in recent years and into 2011.

Change in central government investment program



Source: Merrill Lynch

When considering the impact on bulk steel making commodity prices, such as iron ore and coking coal, key swing factors remain regarding whether private sector steel demand (e.g. commercial buildings, machinery and autos) can offset the above, and how quickly new resource supply can be brought to market. We note that a significant amount of new iron ore supply is due to come onto the market sometime between 2014 and 2016, although BHP noted in a recent presentation that in the last three years, only about half of all new iron ore supply announcements were actually delivered on time.

Oil prices

The oil price has risen substantially during the quarter, as discussed earlier, starting 2011 at US$91[2] a barrel, climbing to US$107 by quarter end, and at the time of writing is hovering around US$110.

The following chart shows that the rise in oil prices is expected to only have a minor impact on the Australian consumer. Remarkably the share of wallet going to operating vehicles (which includes petrol) barely rose at all during the 2000s as oil prices jumped. Even during the spike in 2008, the increase was equivalent to only 0.5% of total consumer spending.

'Without democracy, there can be no socialist modernisation.'

Hu Jintao President of China, 17/01/11

'China now consumes 55% of world cement production, and consumes domestically more than the rest of the world has ever consumed in one year. China now consumes more than the entire world, including China, consumed as recently as 2003. The Chinese Cement Association forecasts a further 12% growth in 2011 following the 15% growth in 2010… Per capita consumption in China is now about the highest in the world.'

UBS 08/03/11

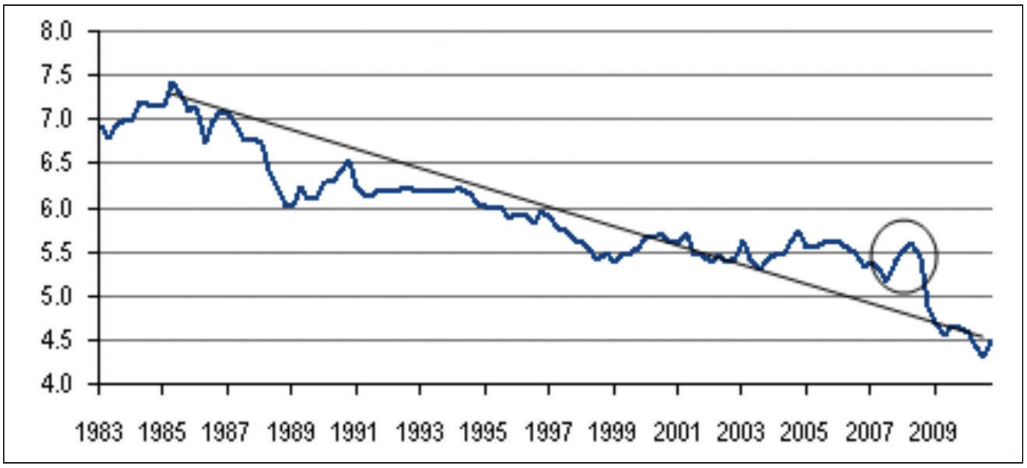
'Our results suggest that an important part of the effect of oil price shocks on the economy results not from a change in oil prices per se, but from the resulting tightening of monetary policy.'

Taken from a Ben Bernanke paper from 1997: Systematic Monetary Policy and the Effects of Oil Price Shocks

[1] *Annualised rate for February 2011*

[2] *West Texas Intermediate*

Operation of vehicle (incl petrol) as % total spending



Source: Merrill Lynch

The reasons that the effect was so small during the 2008 oil price spike was due to offsets from:

- A rising Australian dollar (the impact for US consumers tends to be amplified due to currency changes).
- Refining margins were going down.
- Fuel efficiency was rising and people were switching to smaller cars.

Whilst some of these offsets are not present this time around, our conclusion is that it is important not to exaggerate the impact of oil prices on consumer spending.

At a recent meeting with Woolworths management, we were told that petrol at $1.60 per litre is considered a key threshold beyond which the consumer will noticeably change spending behaviour.

The direction of the savings rate will be much more important for total consumer spending. Spiking oil prices might cost consumers another $1 billion this year, but a decline in the savings rate by 2% would add $4 billion to spending.

As an aside, in February the UK's Guardian newspaper reported that Wikileaks had uncovered cables between the US Embassy in Riyadh from November 2007 where senior officials in Saudi Aramco (Saudi's state oil company) confessed that they had overstated their oil reserves by 40%. If true, this may mean that Saudi Arabia's ability to ramp up oil production at times of high prices (the historical safety cap to high oil prices) is less than many have assumed. We thought this was interesting, since it supports claims made by Matthew Simmons in his 2006 book, 'Twilight in the Desert, The Coming Saudi Oil Shock and the World Economy'.

US economy snap shot

The Chicago Fed recently released the results of its latest regional purchasing manager's survey. It showed continuing expansion, though at a slower rate. When compiling the survey the Chicago Fed asks for comments from participants. Here is a sample of responses from people on the ground.

- 'Commodity inflation hurting profits. Issuing first pricing increase in three years to help recover.'
- 'Chemical pricing is through the roof right now. Instability in oil markets as well as high demand and low supply due to crop feedstock are serious concerns. Steel and plastic have risen. Continued inflation will have negative impacts on our ability to pass costs on to our customers in the short term.'
- 'It seems like it's time for everybody to jump on the "price increase" bandwagon, justified or not.'
- 'Disasters in Japan will cause inventory to blip upward as contingency plans are placed into effect.'

- 'Challenges remain for offsetting any price increases incurred during 2011.'
- 'Commercial real estate activity is beginning to slowly show signs of life, especially downtown.'
- 'Skilled labour is beginning to be hard to find, and domestic raw material deliveries are not being met and lead times are increasing beyond reason (32-48 weeks) and our customers are becoming unsatisfied.'
- 'Strong demand for transportation related products, especially aluminum. Filling vacancies in employment slots, including some new positions created in technology arena.'
- 'The orders keep coming as do the requests for quotes.'

US stimulus

Whilst the US economy has been showing some slow/steady signs of recovery from recent data, as we have written about previously, this has been under the guise of huge fiscal and monetary stimulus. What's apparent as we sit here today is that we are likely witnessing the peak of the stimulus, which will begin to unwind as follows:

- Fiscal stimulus
  - The current US budget deficit projection for fiscal 2011 is US$1.48 trillion[3], representing approximately 10% of GDP[4]. Until now the Federal Government has been able, and indeed very willing, to 'spend their way' out of the recession. Without going into the arguments for and against such an approach (versus the UK's austerity program), what occurred on 8 April highlighted the political challenges to continually increasing government spending.
  - On 8 April the Democrats and Republicans impasse about approving the Budget came within hours of breaching the debt ceiling limit before reaching a compromise. Breaching the limit would have meant that in a matter of months the Government would not have been able to pay any of its bills… just consider the ramifications of all government workers across the country suddenly not getting paid, teachers, postal workers, soldiers, and of course congressmen! Whilst the compromise was relatively small, a $38 billion reduction to 2011 spending (a mere 2.6% off the current deficit, or 1.0% of this year's total government expenditure), it does signal a change in political attitude that further stimulus programs (if required) will be harder to come by as concerns about mounting debt levels grow.
- Monetary stimulus
  - The US Federal Reserve's Quantitative Easing programme, 'QE2', is scheduled to complete on 30 June 2011. The implications of ending this program are largely unknown, but it will see the removal of a large buyer of US Treasury securities from the market, and hence it is likely to see yields rise.
  - Rising yields would increase borrowing costs for home borrowers and corporates, and so is likely to put further strain on the US recovery.

'Many critics, though, including yours truly, would wonder whether quantitative easing policies actually heal, as opposed to cover up, symptoms of an unhealthy economy.'

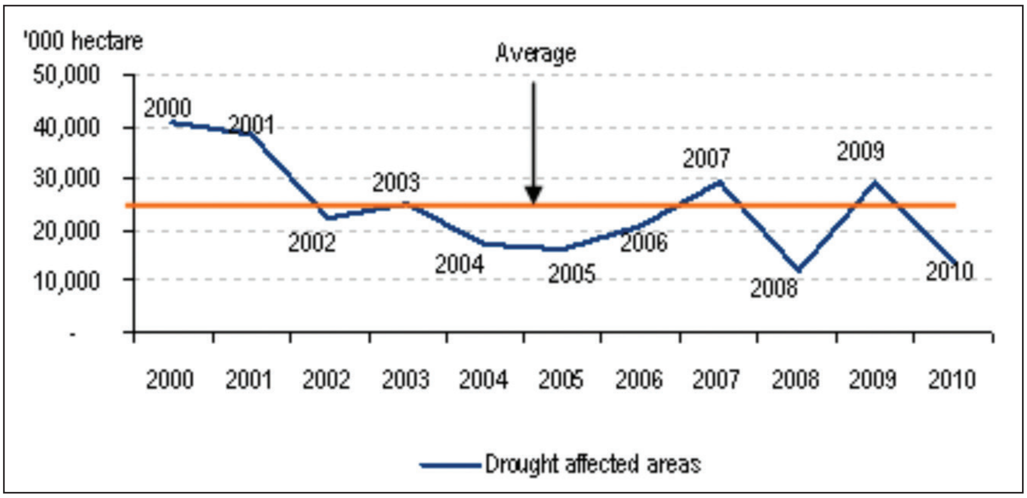
Bill Gross, PIMCO, March 2011

[3] US Congressional Budget Office, January 2011

[4] Note the federal deficit was 9% of GDP in 2010, 10% in 2009 and 3% in 2008

Chinese inflation

Contrary to popular opinion, weather problems did not play a major role in driving food prices higher in China last year. There were droughts in China last year – but the chart below shows that crop land affected by drought was close to the lowest in a decade.



Source: CLSA

Instead the major cause of inflation was hoarding and speculation. With real deposit rates negative (3% versus a 5% inflation rate) depositors went looking for any way to make a real return including speculating on commodities and property.

The inflation problem won't go away until you have removed the excess liquidity, probably by increasing interest rates a lot more. If liquidity and low rates linger there is a risk that the inflation problem gets worse again this year.

Outlook

The March equity market correction highlights the consensus bet that has emerged, namely the carry trade (i.e. long commodities, emerging markets and resource stocks; short US dollar). This consensus bet is illustrated by the fund manager survey chart below which shows investors' net long positions in cyclical stocks (e.g. commodity stocks) is close to a record high. The speed and magnitude of the March correction is indicative of a rapid unwind of the 'carry trade' and a sudden rush for the door, so to speak.

Global investors overweight cyclicals

Source: Merrill Lynch, March 2011

'…the 12th Five-Year Plan is likely to spark the greatest consumption story in modern history.'

Stephen Roach, Morgan Stanley 28/02/11

'Printing money does not create wealth. If it did, Zimbabwe would be the richest country in the world.'

Marc Faber, July 2009

Similarly the speed of the markets' positive recovery in late March and early April reinforces the markets' concern that sustained economic recovery in developed economies, and particularly the US, is not a 'no brainer'. This is because the 'carry trade' is as much a bet against the US as it is a bet in favour of emerging markets.

A current debating point is the continuance or otherwise of US quantitative easing. Will QE2 become QE3? If so, will it be like the Rocky sequels, where each one gets worse and falls further and further short of expectations? To us it feels like the commodity boom (and carry trade) is getting 'toppy'. Taxi drivers all over the world have a small cap mining stock to spruik and can tell you how great the Chinese economy is. That said, we too observe only patchy recoveries in the US and Europe.

Such macro uncertainty underscores the importance of maintaining a balanced portfolio. At the margin, over the last quarter we have taken profits in stocks benefiting from strong commodity prices and reinvested the funds into high quality liquid names where market earnings expectations don't require everything 'going right' for the company. Our research effort is focussed on observing, identifying and verifying relevant information to drive bottom-up stock selection whilst remaining conscious of the macro-economic cross currents which influence our stock selection and risk controls used in our portfolio construction.

'…one of the craziest afflictions I know of is our faith in our ability to see the future.'

Dylan Grice, Societe Generale, 24/01/11

'…think back, for example, to December 6, 1941, October 18, 1987 and September 10, 2001. No matter how serene today may be, tomorrow is always uncertain.'

Warren Buffett, 2011 letter to shareholders

'…The most difficult subjects can be explained to the most slow-witted man if he has not formed any idea of them already; but the simplest thing cannot be made clear to the most intelligent man if he is firmly persuaded that he knows already, without a shadow of a doubt, what is laid before him.'

Leo Tolstoy, 1897

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