Greencape Wholesale Broadcap Fund

Fund report and commentary – September quarter 2011

Performance	Quarter (%)	1 year (%)	2 years (%) p.a.	3 years (%) p.a.	5 years (%) p.a	Inception (%) p.a.
Greencape Wholesale Broadcap Fund	**–11.51**	**–5.49**	**–1.11**	**4.66**	**4.32**	**5.10**
Growth return	–12.69	–14.57	–6.83	–0.49	–1.28	–0.49
Distribution return	1.18	9.08	5.72	5.15	5.60	5.58
S&P/ASX 300 Accumulation Index	–11.65	–8.71	–4.14	–0.10	–0.71	–0.17
Outperformance (net)	**0.13**	**3.22**	**3.03**	**4.76**	**5.04**	**5.27**

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

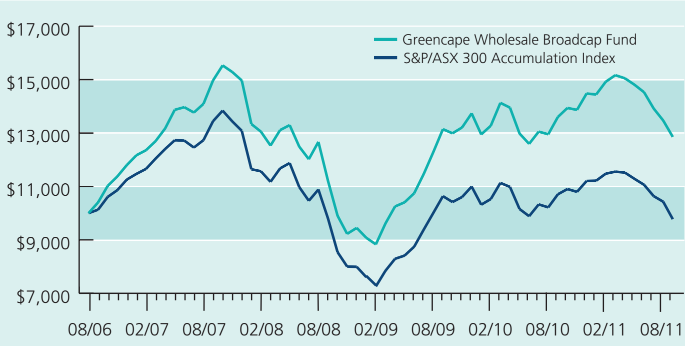
Quarterly

Suggested minimum investment timeframe

At least five years

Greencape Broadcap Fund

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

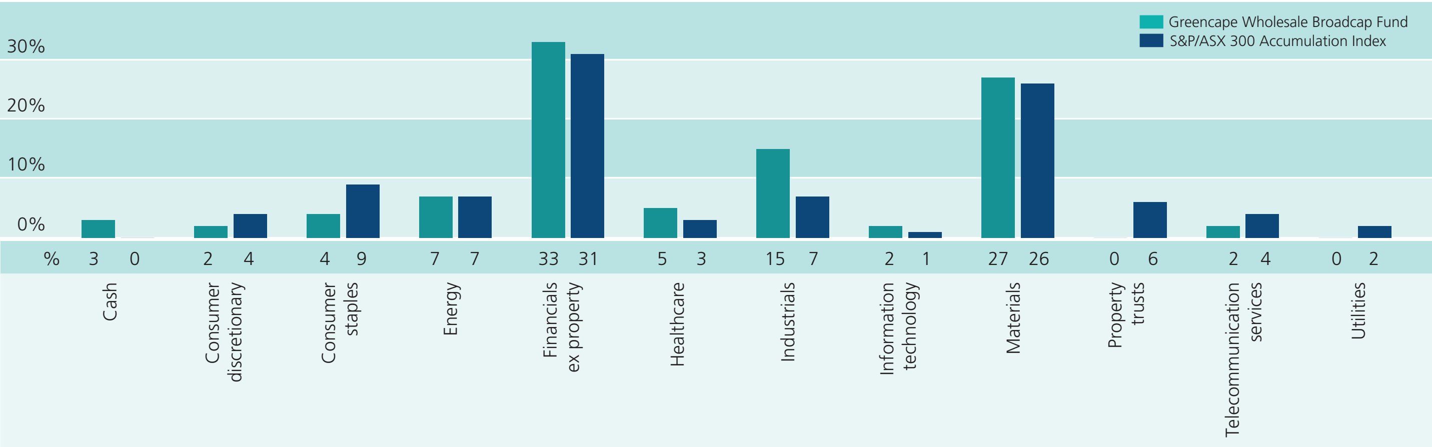


Asset allocation	Current (%)	Range (%)
Securities	96.96%	85–100
Cash	3.04%	0–15

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%

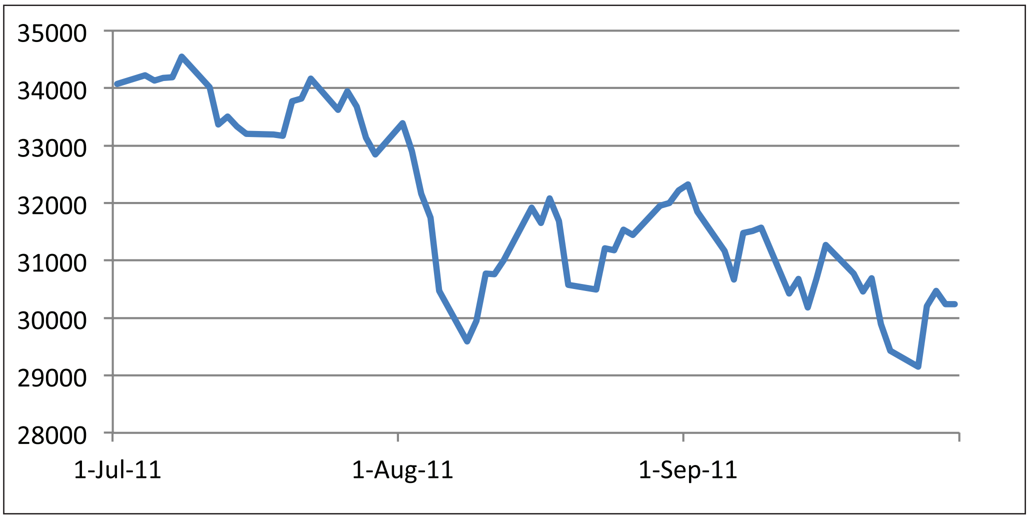
Sector exposures as at 30 September 2011



Market review

The S&P/ASX 200 Accumulation Index fell 11.6% for the quarter. The Greencape Broadcap Fund outperformed the market by 0.1% over the quarter.

S&P/ASX 200



	September quarter	1 year
Market (S&P/ASX 200 AI)	– 11.6%	– 8.5%
Best performing sectors:		
Telecommunication services	12.0%	28.8%
Utilities	– 1.3%	1.7%
Consumer staples	– 1.8%	– 2.1%
Worst performing sectors:		
Materials	– 18.4%	– 10.9%
Energy	– 16.2%	– 14.9%
Consumer discretionary	– 12.2%	– 19.3%

Globally, markets were driven downwards by increasing alarm among investors that countries could not continue to keep 'kicking the can' for much longer. In the US, a deal to raise the debt ceiling was not reached until very late in the eleventh hour, whilst in Europe, a long-term solution to the sovereign debt crisis remained elusive. Meanwhile, softer economic data coming from China added to growing concerns that its leaders will be unable to successfully engineer a 'soft landing'.

In Australia, the September quarter featured the key August results season. Results were mixed, with import competing firms (e.g. steel stocks) and contractors (e.g. Leighton and Transfield) delivering weaker than expected results and outlook commentary. The high Australian dollar, wage inflation and delays to resource-related investment programs were the main explanations. Banks continue to show flat credit growth with cost reductions a key focus (and stock differentiator), while retailers delivered generally weaker than expected results, with some suggesting Woolworths had reached the end of an era after revealing a disappointing result. Insurers delivered results impacted by the recent big claims events, and with balance sheets impacted by recent sharemarket weakness. The miners reported solid results and cashflows in line with expectations, however outlook commentary highlighted macro uncertainty and increasing cost pressures. Healthcare results were generally solid although the strong Australian dollar and expectations of government spending cuts weighed on the outlook commentary.

'Estimating is an estimate, NOT a science'

David Robinson, CEO McConnell Dowell, 27/4/11

With little to suggest a broad-based recovery is imminent, defensive sectors outperformed, led by the telecommunications sector. Telstra rose 12.1%, benefiting from investors seeking defensive exposure and robust earnings in its results release.

Utility stocks overall remained steady, down slightly by 1.7%. Similarly, consumer staples fell by 1.8%, with Fosters rising 5.1% after management approved a higher offer from SABMiller of $5.40 per share. Goodman Fielder was a notable underperformer, falling 49.0% over the quarter, as it announced a 5 for 12 pro rata entitlement offer to raise $259 million from investors at 45 cents per share.

The materials sector led the market downwards, falling by 18.4%. Most of the selling was macro related rather than due to stock-specific factors, with many of the mid-small cap companies falling by over 30%. MacArthur Coal however, increased by 46.9% after Peabody & Arcelor Mittal made an off-market takeover bid of $15.50 cash per share.

Energy stocks were also down significantly, dropping by 16.2%. Among the underperformers, Paladin Energy plummeted by 51.8% after announcing a surprise US$82.3 million net loss.

Consumer discretionary stocks suffered another weak quarter, dropping by 12.2%. Of the retailers, Billabong fell the furthest, falling by 42.6% after reporting annual profits at the bottom end of guidance, and conceding it faces a tough outlook for 2012.

'When talking about department stores Myer and DJs… Get out is my advice'

Mark McInnes CEO Premier investments , ex CEO David Jones, 30/7/2011

India

As we highlighted in the June quarterly report, over the next five years, China is depending on a significant transition from fixed asset investment driven GDP growth (currently 60% of GDP) to a more sustainable consumer demand led GDP growth (currently 25% of GDP). It has been pointed out to us (for example during our meeting with the US Treasury's Beijing representative last May) that the expected 'transition' in such a tight time horizon would be remarkable and 'not without substantial risk'. With this in mind, we thought it would be useful to observe India - another emerging economy which actually has over 60% of its GDP growth driven by consumption.

Our research in India focused on a number of retailers, packaging and logistics firms that serve the middle class consumer (and provide insight for the likes of Amcor, Brambles, Toll and Woolworths). We also met with steel, cement, aluminium, construction and power-generating companies (who are competitors and in some cases customers of many Australian resource and steel stocks). Other meetings included the single largest buyer of fertiliser in the world (relevant for Incitec), a large buyer of LNG, some banks (local and foreign) and a large EPC contractor that would compete against Worley and Leightons.

Overall conclusions:

- Although growth is moderating at present, conditions should improve in 2012 as:
  - rates pressure should ease as inflation moderates
  - a good monsoon season should lead to healthy rural demand
  - the Government will need to kick start growth projects ahead of elections in 2013 and 2014.
- Longer-term growth prospects look sound, with India's balanced nature of consumption and investment driven growth helping sustainability.

Investment insights:

- Infrastructure has improved a lot over last five years. For example, a new airport has been completed in Delhi and Mumbai has a new domestic terminal with a new international one under construction. However, there is still a massive infrastructure deficit nationally.
- Iron ore exports are to be restricted, and export tax likely to be lifted to 30% from 20%.
- Coal supply is unable to keep pace with demand. Indonesian ban on low rank coal exports would be hugely damaging as they lack the infrastructure to import and blend higher rank coal.
- There is a high level of gas power demand but an inability to afford current Asian prices.
- Considerable opportunities for investment exist in packaging and logistics, AMC and BXB both likely to pursue growth options in India.
- Australian banks are unlikely to get far unless they buy subsidiaries of other foreigners. The political framework is not supportive.

Above: The $1b residential house built by the CEO of Reliance Power in Mumbai…it's the skyscraper in the middle….

'Doing business in India is not easy. Anyone who says so is lying through their teeth.'

Planning Commission

'It is – we appreciate and welcome your concluding that the United States is such a safe haven because we appreciate your investment in U.S. treasuries. And very sincerely, I want to make clear that you have nothing to worry about in terms of their – their viability.'

Vice President Joe Biden to Premier Wen Jiabao, 19/8/2011

Mumbai from the plane window…

Iron ore

- There is wide expectation that the Government will increase export duty to 30% from 20%.
- Orissa (an Indian state), which has high quality iron ore resources (63% Fe), will not grant iron ore mines to exporters.

Steel

- Construction is heavily biased towards cement rather than steel. Cement costs $3 for a 50 kg bag! – reportedly one of the cheapest man-made products on the planet.

Example of concrete intensive building construction in India

'There's no chance all of these LNG projects can be built at the same time, none, not unless there's significant change to our immigration policy.'

Richard Leupen, MD UGL Ltd, 17/08/10

Coal

- Coking coal prices may moderate. Plenty of appetite to secure resources in Indonesia, Australia and Mozambique.
- Very poor quality coal. Coal India coal is 3500kcal, imports are about 4500kcal quality from Indonesia, compared to 6300kcal standard of Newcastle coal.
- Coal India is notorious for under-delivering on quality and quantity (it gets stolen from open rail wagons!)

Power

- There is an overall energy deficit of 9-10% and a peaking deficit of 13% driven by a shortage of infrastructure.
- Many provinces face six to seven hour blackouts, forcing use of expensive diesel generators.

Base metals

- Only 30% of India has been explored for minerals.
- Middle East governments are reconsidering aluminium capacity. Their capital expenditure costs of $6,800/t compare to $3,200/t in India.
- Aluminium demand is growing at 14% p.a. Consumption per capita is 5kg, relative to 11kg in China and 32kg in Germany. Half the growth is expected to come from the rollout of electrical transmission and distribution.

'In China it's build it and they will come, in India it's hurry up and build it! They're here!'

Anon

Cement

- Demand growth has typically been 8-10%, but only 5% last year and about 3.5% this year as infrastructure spend slows due to government indecision.
- Supply growth has remained at double digit rates. Expected to reach 500mt+ in 2020, 1500mt+ in 2030.

Fertilisers

- India lacks the resources for fertiliser manufacturing – no rock, not enough gas.
- Demand for DAP is increasing as there is too much urea used due to excessive subsidies. The Govt is now reducing urea subsidies to reduce price differentials and encourage greater use of P (DAP – which Incitec produces) and K (Potash, which Rio and BHP produce) to offset the excess of N (urea).
- Underlying fertiliser demand is c.50mt, but the logistics infrastructure can only handle 45mt.

The consumer opportunity

- India is the reverse of China, in that the Chinese have built malls and endless opportunities to consume but are yet to be in a position to really embrace them, whereas the Indians have the will and wherewithal to consume but lack the modern consumer infrastructure to so do.
- Organised, modern retail represents only c.6% of sales today but this is expected to expand towards 20% by the end of the decade.
- Very hard to get suitable retail space given high urban land values and lack of logistics infrastructure.
- Basic aspiration consumption remains strong, e.g. 20% growth in motorcycle market versus 10% drop in more corporate driven car market.
- 60% of the population lives day by day, so branded goods are being marketed in small packages (eg: Rp1 shampoo sachets) to encourage trial.
- The level of competition is enormous. In the last five years, there have been over 1,000 new skincare brands launched and nearly 300 new tea companies.

Indian maccas – serving the growing middle class…

The Desk of the Head of Indian Department of Environment…big inbox

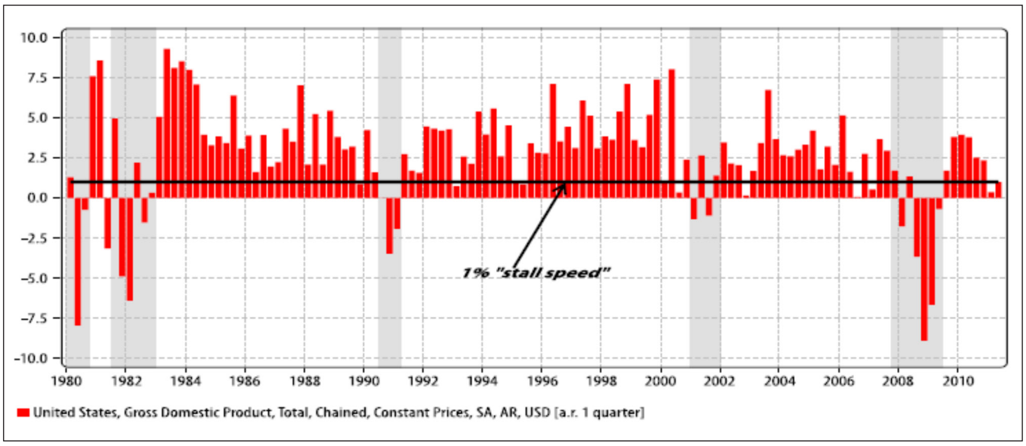
Macro observations:

United States – Michigan sentiment

Source: GaveKal Research

- US consumer sentiment has fallen back to GFC lows.

US GDP Growth



Source: GaveKal Research

'Temporary factors, including the effects of the run-up in commodity prices on consumer and business budgets and the effect of the Japanese disaster on global supply chains and production, were part of the reason for the weak performance of the economy in the first half of 2011, accordingly, growth in the second half looks likely to improve as their influence recedes. However, the incoming data suggest that other, more persistent factors have also been at work.'

Bernanke Jackson Hole Speech, 26/8/2011

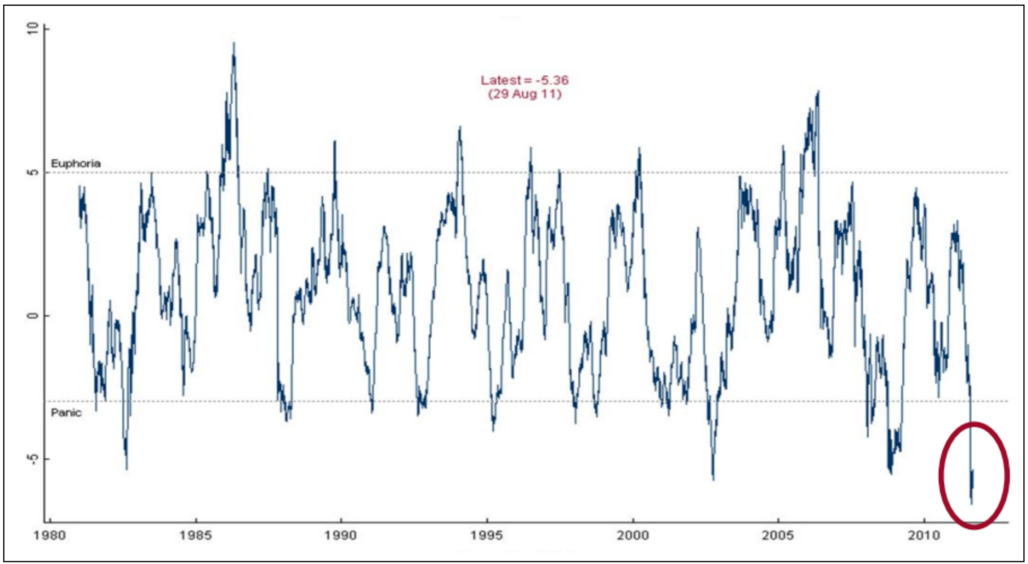
'If the U.S. Government was a family, they would be making US$58,000 a year, while spending US$75,000 a year, with US$327,000 in credit card debt. They are currently proposing big spending cuts to reduce their spending to US$72,000 a year. These are the actual proportions of the federal budget and debt, reduced to a level that we can understand.'

Wesley Legrand, a fund manager at Grand Private Equities

[2] ABS

- Whilst the economy continues to stall.

Global risk appetite since 1981



Source: Credit Suisse

- With a lack of positive macro data, global risk appetite for equities has dipped into panic territory.
- Domestically, the banks face both structural headwinds and contagion risk from offshore.

Five year credit default swap for CBA

Source: Bloomberg

'I know what I believe. I will continue to articulate what I believe and what I believe – I believe what I believe is right.'

George W. Bush

'We are still in a deleveraging period," he said. "We will be in a deleveraging period for ten years or more.'

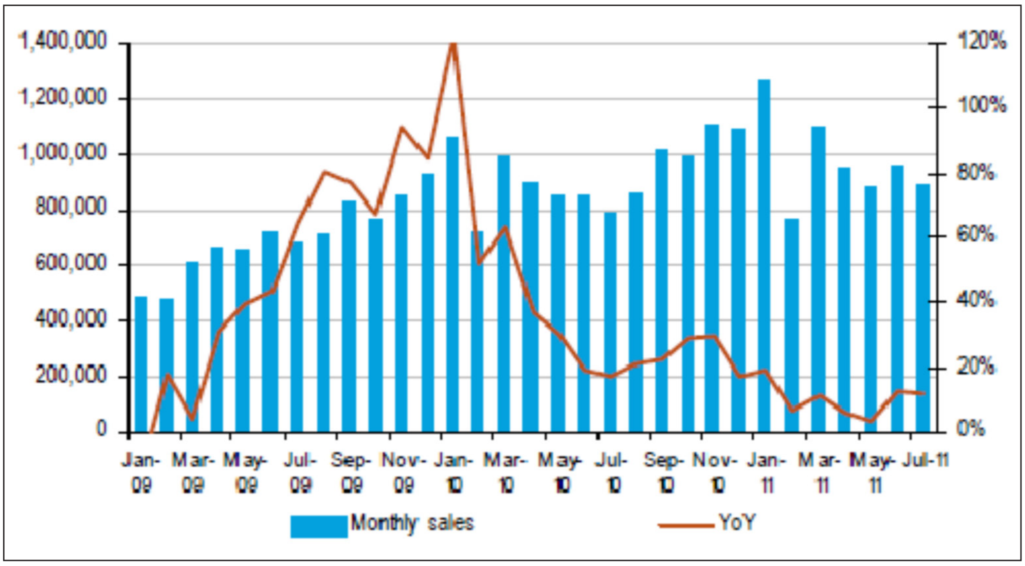
Ray Dalio

'Markets are constantly in a state of uncertainty and flux, and money is made by discounting the obvious and betting on the unexpected.'

George Soros

Chinese auto sales… worth monitoring

Auto Sales are a useful indicator to monitor as it's a key discretionary item sought after by China's growing middle class.



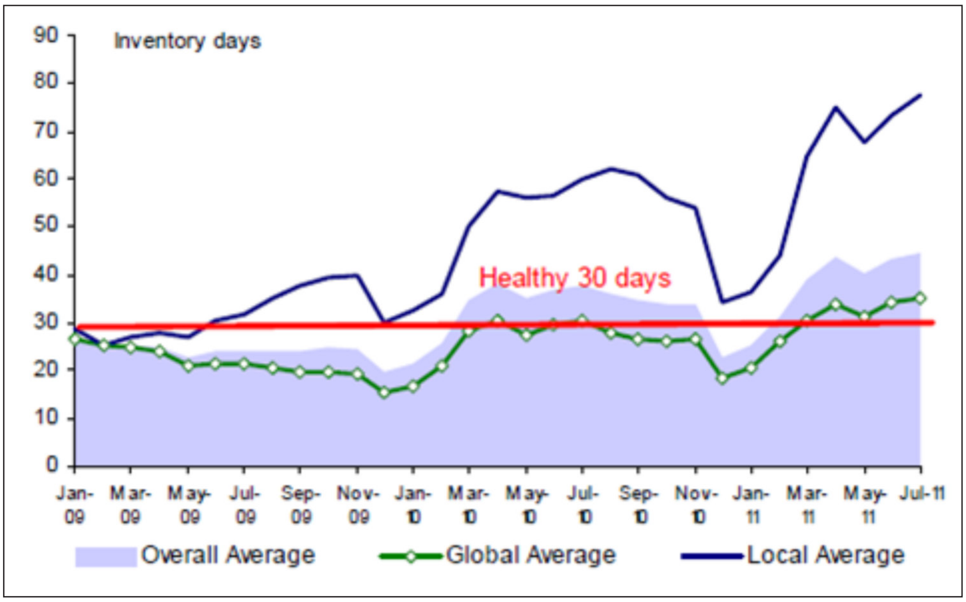
Source: BofA ML

The above chart indicates that Auto Sales growth has faded substantially since the start of the year. At these rates, auto sales as a percentage of overall consumption has been falling.

Despite the slowdown in demand, China's auto factories have maintained levels of production, resulting in a large inventory build.

We would caution that the sustainability of continuing high levels of production GDP growth, steel demand and job creation, is questionable.

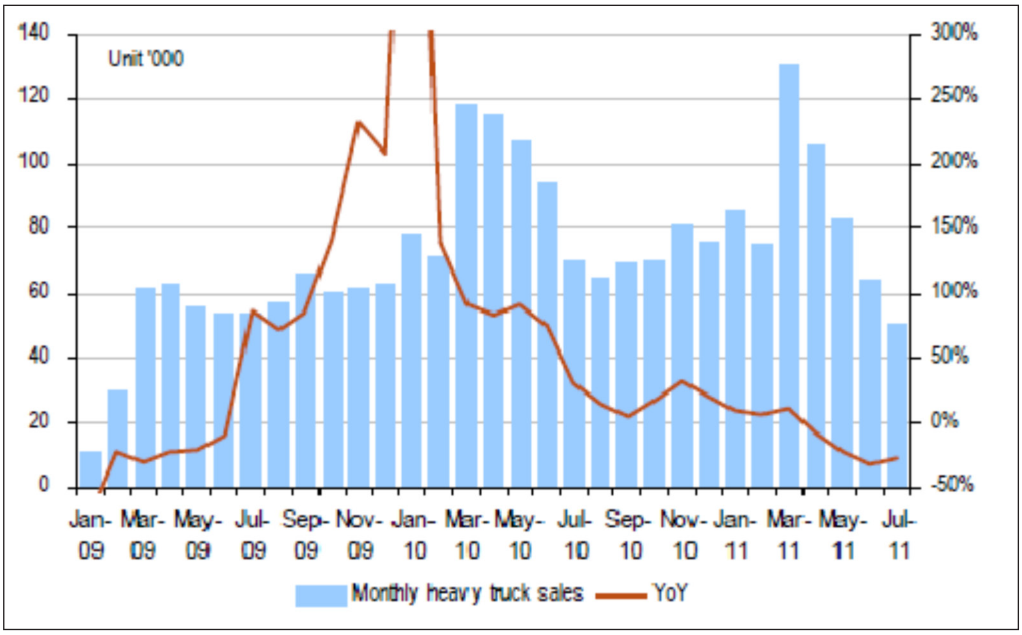
Chinese auto inventories (days)



Source: BofA ML

It is also worth highlighting the recent fall in demand for heavy vehicle sales growth, which perhaps reflects a slowdown in construction activity and commodity intensive fixed asset investment growth.

China heavy truck sales

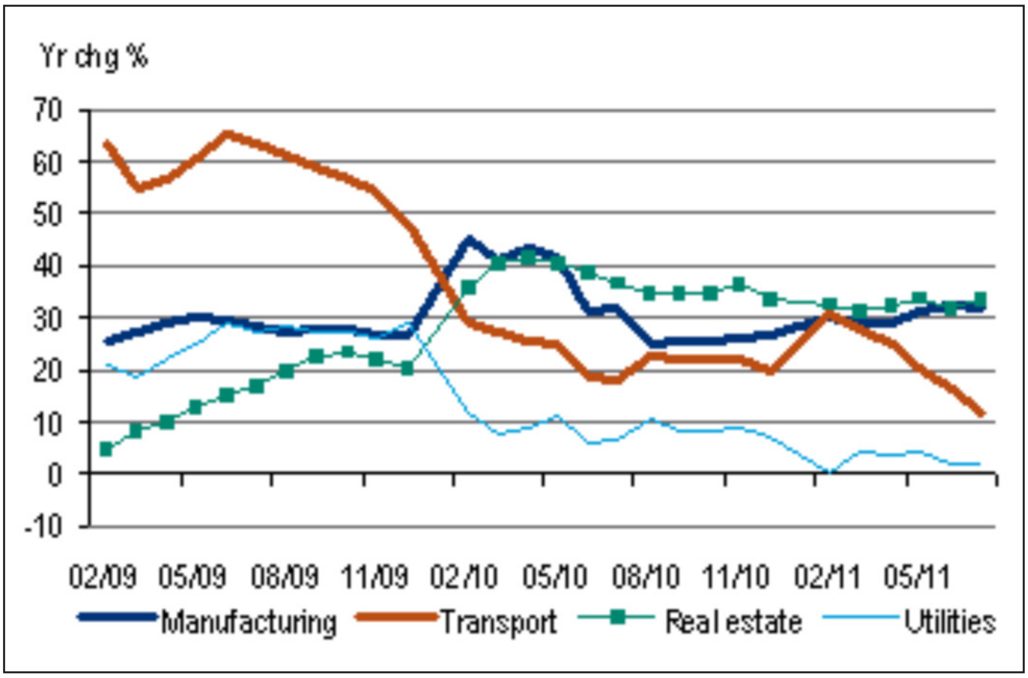


Source: BofA ML

Narrowness of China's economy a concern

As mentioned, Chinese fixed asset investment is at an unsustainable level of around 60% of GDP. It's worth considering the components of Chinese investment below.

Components of Chinese investment



It shows the historically high investment growth is increasingly been driven by real estate and manufacturing investment, both of which have seen investment growth (production) exceed sales growth over recent months.

Chinese exports - impacted by US and Europe demand?

During the GFC the sudden drop in Chinese exports was offset by China's fixed asset investment focussed stimulus. On some measures China's stimulus was a greater % of GDP than US's 'infamous' TARP bailouts. This time around (some are calling it GFC 2), once again there are early signs of weakness in China's exports as illustrated by basic export container port volume data:-

Container growth for top eight Chinese ports

Source BofA ML

Outlook

In last quarter's outlook we contended that 'earnings expectations for FY12 and CY11 in the Australian and US markets respectively remain inflated beyond the likely reality'. We cited several earnings headwinds – a strong Australian dollar, labour cost inflation, pressure on household spending and a back drop of political inertia and sovereign risk globally. What has changed this quarter is that the sharemarket sell off has seen further value emerge, earnings expectations look more realistic (following downgrades during reporting season) and the Australian dollar has weakened somewhat. On balance this is positive. The ongoing negative however is the lack of a long-term solution for Europe's sovereign debt problem. Markets have increasingly become impatient with the current stalemate, with credit default swap pricing having doubled in the last two weeks of September. This indicates a growing mistrust of banks lending to each other. Furthermore, as highlighted above, we observe China has some concerning real economy trends emerging.

Given the above, our portfolio continues to be heavily biased towards companies which have earnings growth driven by a program of 'self help' rather than macro-economic dependence. Examples of 'self help' include harvesting synergies from recent acquisitions, market share growth through product or service differentiation, or return on capital improvements through reduced capital intensity. On the margin we have begun to increase our portfolio beta and deploy some cash but our feeling is we should remain patient and continue to seek observable opportunities rather than predict a market bottom.

'In markets you can actually be too smart for your own good'

Peter Morgan, when Head of Equities at Perpetual, 1997

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

Money Management | LONSEC
FUND MANAGER OF THE YEAR 2008
WINNER
Rising Star

Money Management | LONSEC
FUND MANAGER OF THE YEAR 2011
AUSTRALIAN EQUITIES (BROAD CAP)
FINALIST

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