

Greencape Wholesale High Conviction Fund

Fund report and commentary – December quarter 2011

Performance	Quarter (%)	1 year (%)	2 years (%) p.a.	3 years (%) p.a.	5 years (%) p.a.	Inception (%) p.a.
Greencape Wholesale High Conviction Fund	2.24	-8.70	-2.97	9.86	2.79	6.17
Growth return	0.97	-12.27	-6.08	6.36	-2.80	0.70
Distribution return	1.27	3.58	3.11	3.50	5.59	5.47
S&P/ASX 200 Accumulation Index	2.12	-10.54	-4.68	7.58	-2.31	0.27
Outperformance (net)	0.12	1.84	1.71	2.28	5.10	5.90

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

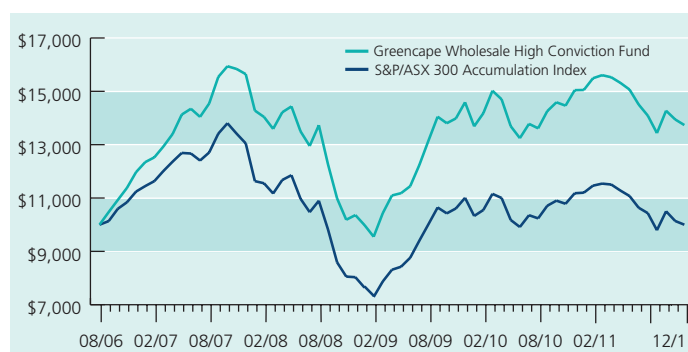
Quarterly

Suggested minimum investment timeframe

At least five years

Greencape High Conviction Fund

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

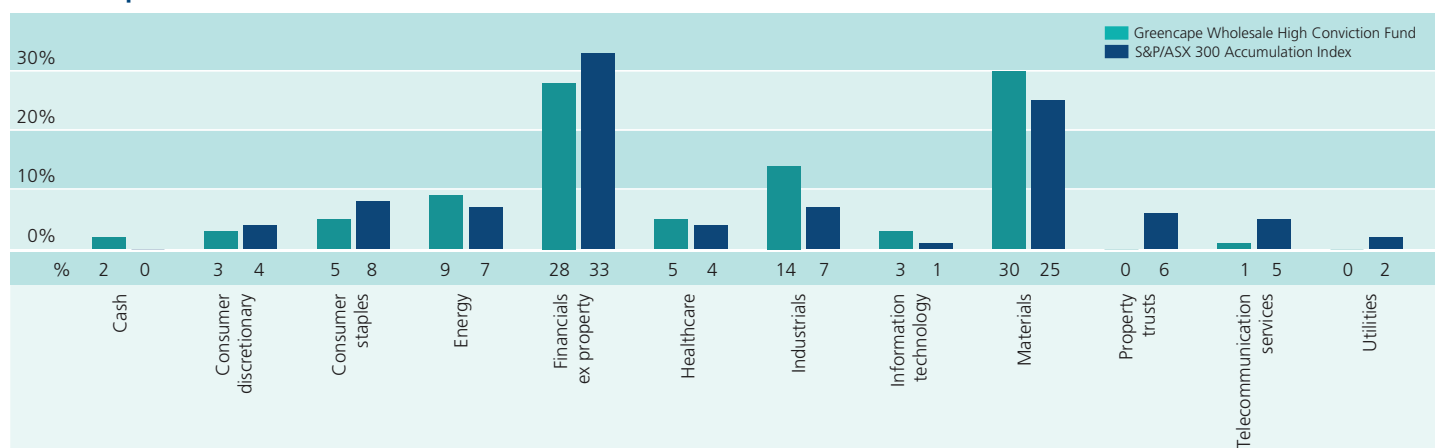


Asset allocation	Current (%)	Range (%)
Securities	97.68%	85–100
Cash	2.32%	0–15

Fund facts	Greencape Wholesale High Conviction Fund
Inception date	11/09/2006
APIR code	HOW0035AU

Fees	Greencape Wholesale High Conviction 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 December 2011



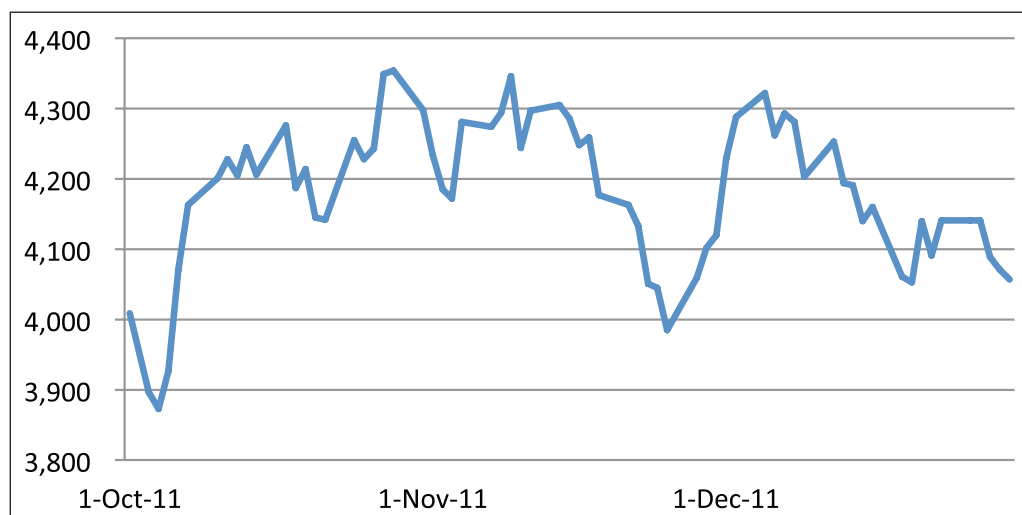
Market review

The S&P/ASX200 Accumulation index gained 2.1% for the quarter. The Greencape High Conviction fund outperformed the market and delivered a 2.2% (net) return over the quarter.

The market endured a volatile quarter, as overseas headlines dictated much of the market movement. Investors were initially buoyed by a deal struck by European leaders to resolve the debt crisis, however problems in the Eurozone periphery and the US debt ceiling crisis spooked the market as volumes thinned out heading into the holidays.

Two consecutive rate cuts from the Reserve Bank of Australia failed to inspire the local market, as downgrades, particularly from retailers, plagued the market before the new year. Soft manufacturing data out of China also raised concerns over a global spill-over from problems in Europe and the US.

S&P/ASX 200



The market started the quarter strongly with the index gaining 7.2% in October. Low domestic inflation figures for the September quarter saw the market price in a November rate cut from the RBA which ultimately eventuated. Globally, the European bailout package and promising initial results out of the reporting season in the US also strengthened the market.

Early gains were all but erased as global problems flared up in the latter half of the quarter. The failure of the US Congress to reach an enduring deal on the debt ceiling, weak bond auctions in Europe and ongoing sovereign debt problems in the periphery kept many investors on the sidelines. Not surprisingly, defensive sectors greatly outperformed cyclicals as investors sought more predictable returns. Bearish outlooks for the AUD also saw some international investors retreat from the local market.

Utilities was the best performing sector for the quarter, as investors favoured defensive stocks in an uncertain market. The takeover bid of the Hastings Diversified Utilities Fund by the APA Group also strengthened the index.

Telecommunications rallied as Telstra gained 7.4% for the quarter as investors sought its high dividend yield and as approvals from the ACCC, necessary for the NBN deal, drew closer.

Industrials also performed well. Brambles and Campbell Brothers both benefitted from a pullback in the AUD and strong operational performance. QR National also performed well, as the relatively dry weather and announcement of new haulage contracts helped boost the stock 8.2% for the quarter.

	December quarter	1 year
Market (S&P/ASX 200 AI)	2.1%	-10.5%
Best performing sectors:		
Utilities	8.1%	9.7%
Telecommunications	6.9%	29.5%
Industrials	6.9%	-7.5%
Worst performing sectors:		
Materials	-3.1%	-23.9%
Consumer Staples	-2.9%	-0.40%
Consumer discretionary	-0.6%	-17.1%

On the back of renewed global optimism, rising commodity prices saw materials surge in October. However weakening global demand stemming from problems in Europe in the US weakened commodity prices in the latter stages of the quarter. BHP and RIO were weaker after sharp falls in iron ore prices, which also weighed on smaller stocks in the sector. Gold suffered a heavy sell off in December, which along with production downgrades, saw Newcrest Mining fall 13% for the quarter. Alumina fell 25% on the back of a 6% fall in the aluminium price during the quarter (20% fall in the last 6 months). Bluescope Steel lost 35% following a heavily discounted capital raising as its export business continued to suffer and profit margins for domestic steel were squeezed by high input costs and a high Australian dollar keeping import parity pricing low. OneSteel fell 44% for the quarter as it was also affected by tight profit margins and having recently overpaid for assets.

The decline in consumer staples was predominately driven by Wesfarmers. The stock fell 6.6% for the quarter due to metallurgical coal price declines, a write down of its Coregas business and market concern about consumer spending following downgrades by several discretionary retailers.

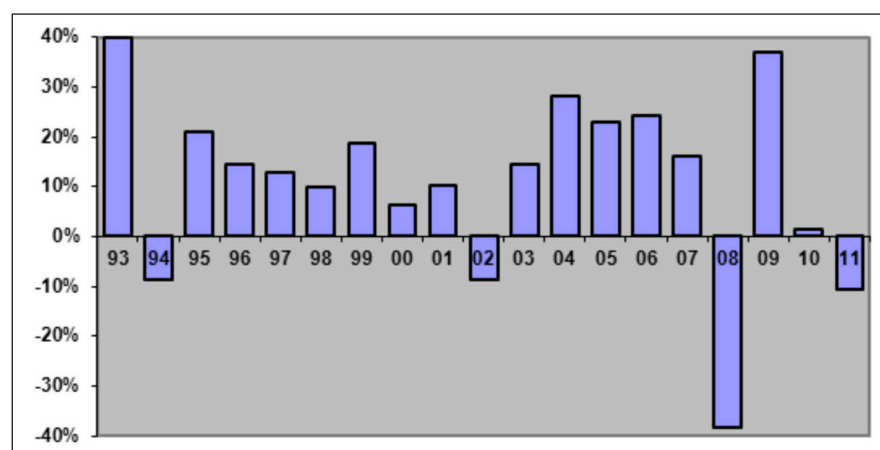
Tough local retail trading conditions triggered some heavy downgrades in the local market late in the quarter. Dire trading updates from Billabong (down 47%) and JB Hi-Fi (down 26%) weighed down other consumer discretionary stocks in the sector but was offset by strong performances from News Corporation, Tatts Group and Seven West Media.

Given the volatility of the market in recent years, we've included some longer term charts below. After the market was devastated by the GFC in 2008, fiscal stimulus, leverage to the recovery in China and rising commodity prices helped the market stage a strong rally in 2009. As the global stimulus came off its peak and the European sovereign debt crisis started to dominate headlines, the market has fallen, as the chart below illustrates.

'Volatility, drawdown, relative performance, client flows all prey on the insecurities lurking deep within, beckoning investors to the comfort of the crowd and the false sanctuary of what everyone else is doing.'

Dylan Grice, Societe Generale, 24/01/11

S&P/ASX 200 Accumulation Index Calendar Years Returns since 1993



The table below shows the average yearly return over the past five years including dividends. In what has been a turbulent period for the market, no sector has been a standout performer.

	5 year p.a.
Market (S&P/ASX 200 AI)	-2.3%
Consumer staples	4.0%
Energy	3.4%
Healthcare	3.1%
Telecommunications	2.9%
Materials	2.1%
Utilities	-1.9%
Financials	-2.9%
Industrials	-7.9%
Consumer discretionary	-12.0%
Property trusts	-14.9%

Company visits and observations

Early in the quarter we travelled to the US to cover off on a number of Australian company-related micro issues, as well as getting a broader feel for the as yet tepid US economic recovery. Some of our observations from the trip were:

- Recession risk? None of the industrial companies we met with were concerned with another recession given how low inventories are in supply chains, with downside risk being more a case of a 'no growth' scenario. As yet, none of the companies had seen much change from low single digit sales growth.
- US banks – still very cautious on home lending given concern of further property value falls. Uncertainty over new regulatory burdens (Dodd-Frank, Consumer credit legislation) is also expected to be a significant overhang for the sector throughout 2012.
- US insurers – signs of premium rates turning positive but most are expecting to only be mildly positive given high levels of capital still in the system.
- US housing – All indications suggest the market has bottomed, but few were confident of a near term recovery in volumes.
- US retail – There has been a consumer trend away from shopping malls in favour of online and cheaper destination stores (e.g. Walmart). However, high end retail strips (e.g. Rodeo Drive) are thriving.
- Emerging markets – many US companies nominate Latin America as their most attractive emerging market.

'In science, progress is cumulative, and in finance, progress is cyclical.'

Jim Grant

Discretionary retailers

The lead up to Christmas saw a number of discretionary retailers issue significant earnings downgrades, despite it generally having been a tough retail environment for the last 12 months. Some of the downgrades included:

- 15 December - JB Hi Fi: Comparative store sales had improved in October from the first quarter (for FY12) decline of negative 3.5%, but appear to have worsened again in the lead up to Christmas. On top of this, aggressive sales campaigns from competitors such as Harvey Norman have seen their gross margin decline. Given the high fixed cost nature of retailers, this has led the market to forecast an earnings decline of 11% for FY12. The share price has fallen 25% post the announcement.
- 19 December – Billabong: At its AGM in October Billabong reported that comparative sales for the first quarter were up 6% and it expected strong underlying earnings growth for FY12. However, sales turned significantly negative in the second quarter, and were down approximately 20% for December. The reason for the sales decline varies by region, but includes unfavourable weather in Australia and poor economic conditions in Europe, with the US holding up relatively better. Billabong now expects their first half profit to be down 23% on the pcp and the market reacted by halving the share price as scepticism remains about management's hope of avoiding a capital raising.
- 21 December – Harvey Norman: After reporting first quarter comparative sales growth of negative 2.8% in Australia, Gerry Harvey was quoted in the media as saying it was the worst lead up to Christmas he'd seen in 20 years, and that sales in some of their stores were down 20%. It's worth noting however that Harvey Norman made no announcement to the ASX about the impact this may have on its earnings. The share price declined 13% from the time of JB Hi Fi's announcement until year end.
- 22 December – Kathmandu: For the 3 months to mid-November, management announced comparative store sales growth of 9%, but this looks to have turned to negative 10% in the month to mid-December. Management only commented that the sales performance was due to weaker consumer spending in both Australia and New Zealand. The share price declined 20% post the announcement.

US Corporate bond market

In November, Newcrest Mining announced it had issued debt in the US bond market, borrowing \$750 million at a 4.5% interest rate for 10 years and a further \$250 million at 5.8%, locked in for 30 years. These low rates at such long durations highlight the low funding costs available to companies that are large enough to borrow direct from the US corporate bond market. However, we've heard from a number of management teams that it's a different story for medium sized listed companies who are solely reliant on the Australian banks for their funding.

Woolworths

Woolworths commented at their investor update in November that they were happy that their product pricing was competitive relative to Coles, but they had to improve their communication of such. We thought the following advert was unlikely to help their cause however.



'10% of the economy is growing at 15% and 90% of the economy is growing at 2%.'

Ric Battellino, RBA Deputy Governor,
20/07/11

'Data traffic on our networks doubled in 2011, and is projected to increase 30-fold within 5 years and 1,000-fold within 10 years.'

David Thodey, CEO Telstra, 18/10/11

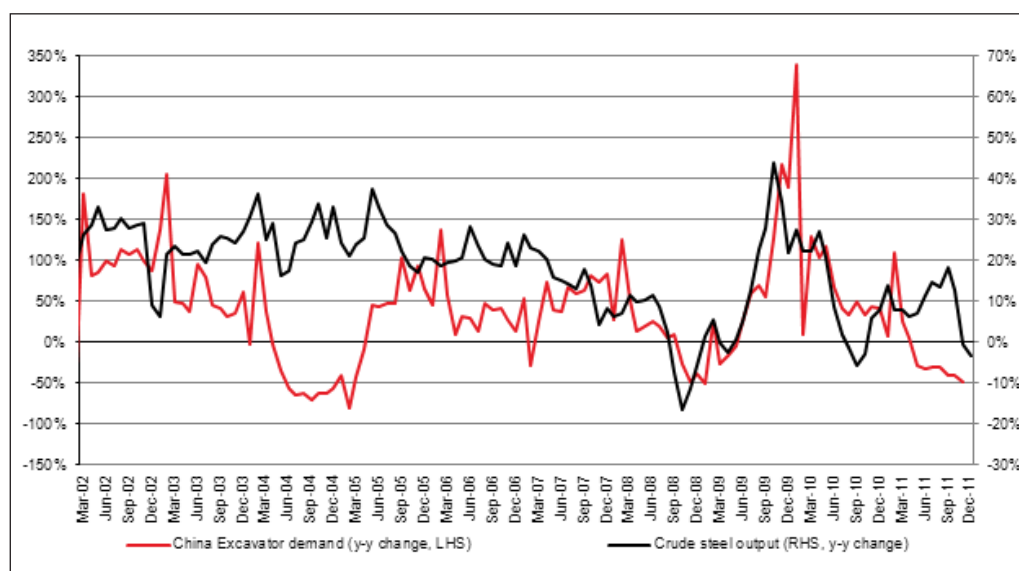
Macro observations

Chinese steel production

A lot of commentary has been made in respect to Australia's reliance on China's continued economic growth, predominantly due to China's demand for iron ore and metallurgical coal (two of Australia's biggest exports) used in its steel production. China's current level of fixed asset investment (FAI) makes up 49% of its GDP¹ (a level higher than any other country achieved during their industrialisation). Of China's total steel consumption, approximately half is consumed in construction, with the other half in manufacturing, the mix of which is as follows:

	Where steel used	Greencape comment
Construction (long steel)		
Residential property	20%	Property prices declined significantly, private construction down, how much can social housing build offset?
Non-res property	16%	
Infrastructure	14%	2009 fiscal stimulus rolling off ²
Manufacturing (flat steel)		
Machinery	19%	Weaker excavator sales, refer to chart below
Appliances	6%	Weaker export demand from Europe, US looks ok
Auto	5%	Car sales slowed and inventories up, truck sales declined ³
Other	20%	

China Excavator sales v steel production



Source: Nomura

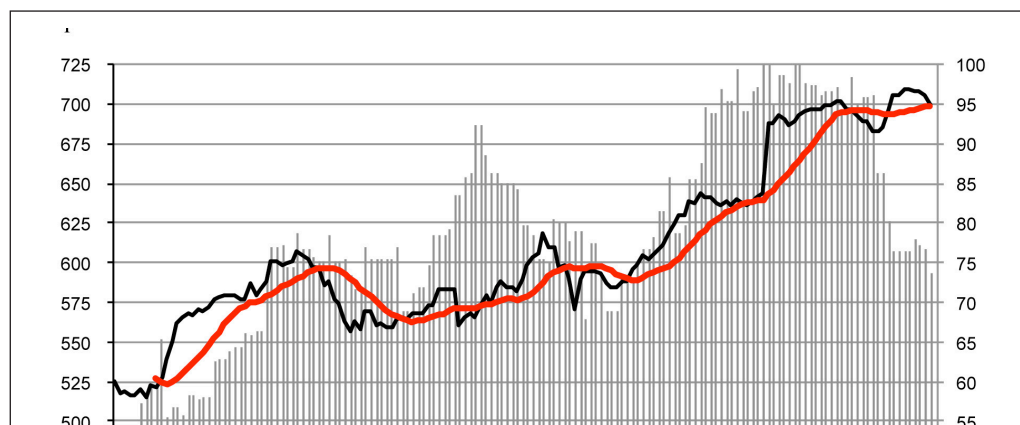
In 2011 China produced approximately 682 million tonnes of steel (with Japan at 127mt and the USA at 97mt) with market consensus being for 5 to 7% growth off this level into 2012. We note the latest data actually shows that November and December steel production actually declined 0.6 and 0.4% on pc, therefore a more rapid bounce back to growth is required in later months in order for consensus forecasts to be met.

¹ Macquarie's estimate for 2011. In 2010 it was 46% of GDP

² Nomura estimates that the post GFC government stimulus accounted for 14.5% of 2011 steel consumption

³ Refer to Greencape Sep 2011 Quarterly report

Chinese Steel Production & Iron Ore Inventories



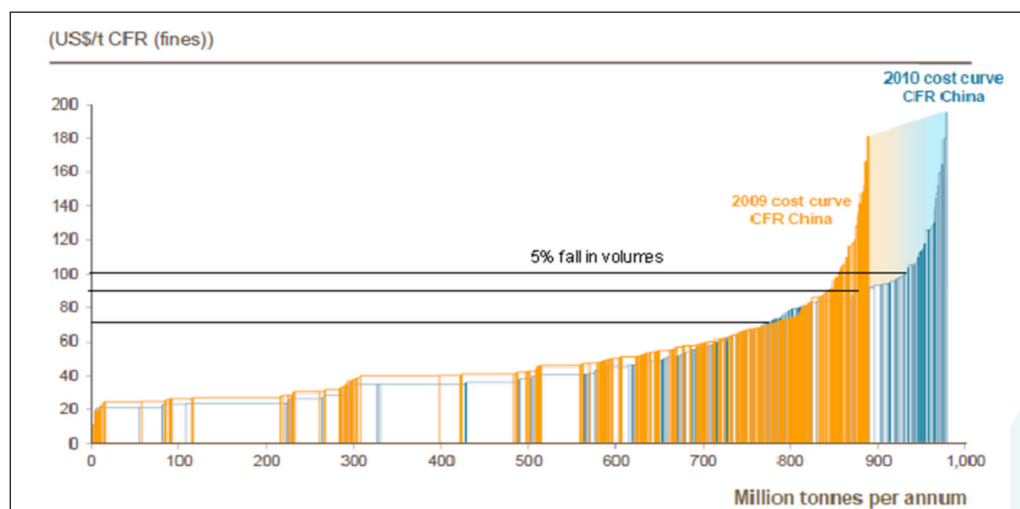
Source: Nomura

Whilst the above chart highlights the challenge for China to grow its steel production, given it is already producing such a high amount, it's worth noting that continual growth in steel production is not in itself required to ensure a country maintains GDP growth. The US steel consumption peaked in 1973 for instance. However, at a base level of 49% of GDP coming from FAI, it does highlight the over-reliance China has had to date on constructing buildings/infrastructure in order to meet its GDP growth targets. The Chinese bulls are banking on a continuation of this economic imbalance in the near term, yet everyone concedes at some point FAI needs to at least slow to allow consumption growth to become a bigger part of the economy.

Iron ore

Following on from our look at Chinese steel production, the implications for iron ore pricing are unclear. Whilst steel production growth for December was modestly negative, iron ore imports into China were up 10%, suggesting some displacement of high cost local Chinese iron ore production and/or a build-up in iron inventories. Whilst the above chart does show iron ore inventories at record levels, this only reflects inventories held at port, which anecdotally are offsetting lower inventories held at steel mills, although no data is available on the latter.

The consensus view is that a floor for iron ore pricing exists somewhere between US\$120 and \$140 a tonne, given that's where the marginal cost of low grade, high cost Chinese supply sits. It's worth noting however, that the marginal cost curve is quite a steep one, and if Chinese/global steel production growth was to turn negative, the floor price could be lower than thought by many.

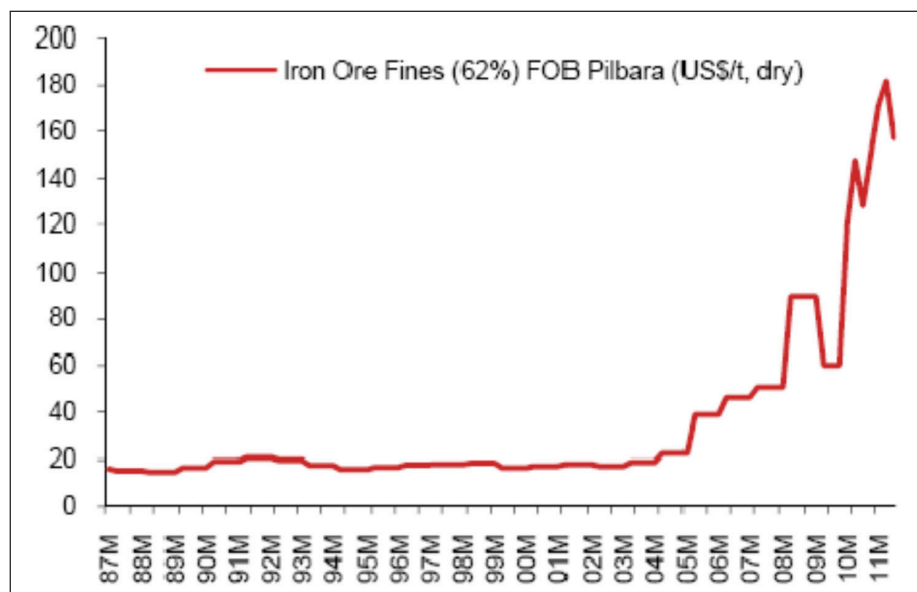


Source: Merrill Lynch, Rio Tinto

'There will not be a painless ending to all these years of unbalanced growth and excessive lending. China could either suffer the punishment through one big blow or take it, punch by punch. Probably will opt for the latter – expect GDP growth of below potential over 2011-15 horizon.... Two potential internal triggers that could force bad debt recognition and then spark an imminent downturn – tough economic policies and/or a sharp correction in the property sector.'

Societe Generale

The other thing to note is that it's really only been in the Chinese post GFC stimulus period that steel production has reached such a level that an iron ore price of greater than \$100 has been required in order to bring on sufficient supply.

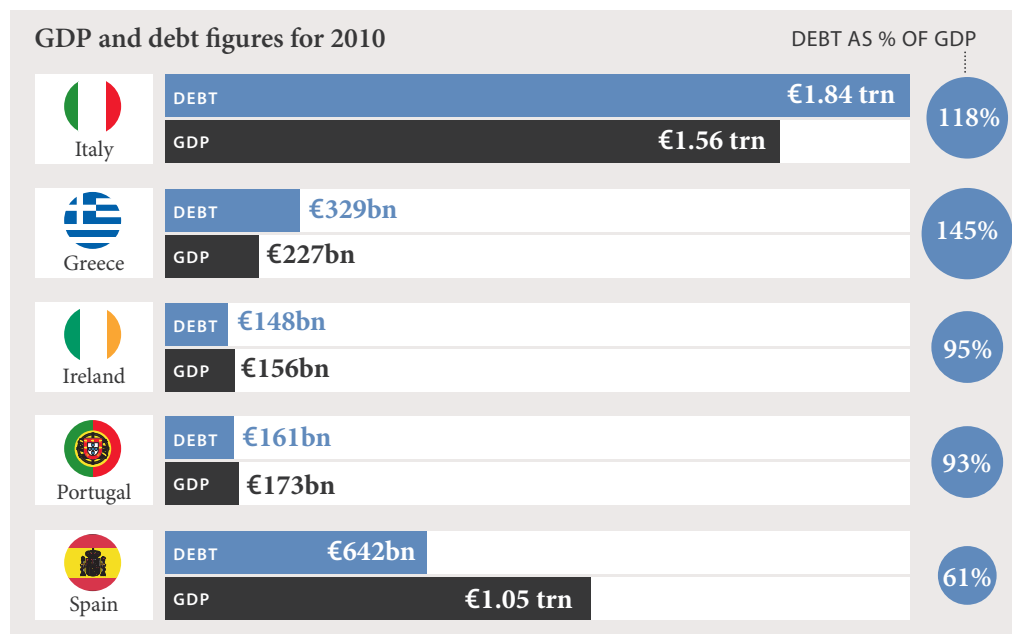


Source: Bloomberg, Nomura estimates

Macquarie estimates that the share price of Rio Tinto is implying an iron ore price of only \$105 per tonne whilst Fortescue's and Atlas Iron Ore's share prices are implying \$125 per tonne⁴.

Europe sovereign debt

The chart below highlights just how big an issue that Europe faces, particularly if the debt markets force Italy and Spain down a similar path to Greece, given how much larger their economies and debt burdens are in absolute terms.



In simple terms, once a country's debt level exceeds its GDP, in order for it to stabilise its debt load (debt as a % of GDP), it either needs nominal GDP growth (real growth + inflation) equal to the interest rate on the debt, or a lower GDP growth rate combined with a budget surplus, in

'The European Stability and Growth Pact of 1995... EU countries agreed to limit their fiscal deficits to 3% of GDP to ensure debt discipline under the Euro so that no country could use the new currency to take its neighbors hostage and force them into bailout operations. In fact, the EU countries exceeded the limit 97 times... The self-imposed debt constraints [By EU governments] were never taken seriously after that because the sinners and the judges were one and the same.'

Hans-Werner Sinn, Prof of Economics and public finance, University of Munich
04/01/11

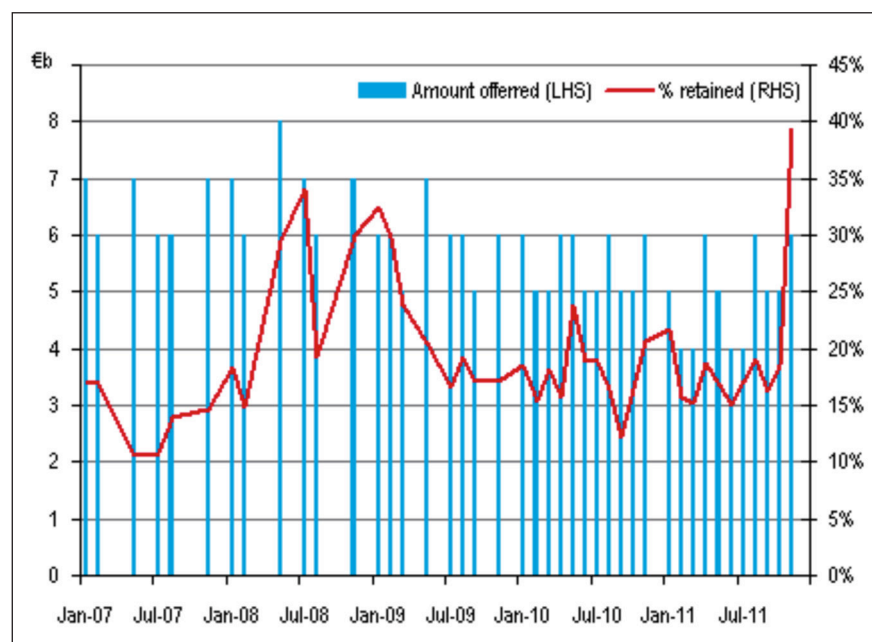
⁴ Assumes those iron ore prices and AUD/USD at parity until 2017, then an iron ore price of \$80/tonne and AUD/USD into perpetuity thereafter.

order to pay down the debt load. The problem exposed by Greece and Ireland in particular is that austerity measures designed to get the government budget back into surplus are combining with recessionary forces to reduce the countries' GDP in a downward spiral that has no clear solution.

All hopes on Germany – In November the German government offered to sell €6 billion of government debt (not large by historical standards), but on this occasion nearly 40% of the issue was retained by the German Finance Agency (double the recent average) because of weak private investor demand.

Such events highlight just how unpredictable the next stage of this crisis could be.

German Bund Auctions



In light of the crisis and myriad of bandaid solutions being bandied about by government officials, we thought the below was a humorous and apt view on what has been proposed to date:

It is a slow day in a little Greek Village. The rain is beating down and the streets are deserted.

Times are tough, everybody is in debt, and everybody lives on credit.

On this particular day a rich German tourist is driving through the village, stops at the local hotel and lays a €100 note on the desk, telling the hotel owner he wants to inspect the rooms upstairs in order to pick one to spend the night.

The owner gives him some keys and, as soon as the visitor has walked upstairs, the hotelier grabs the €100 note and runs next door to pay his debt to the butcher.

The butcher takes the €100 note and runs down the street to repay his debt to the pig farmer.

The pig farmer takes the €100 note and heads off to pay his bill at the supplier of feed and fuel.

The guy at the Farmers' Co-op takes the €100 note and runs to pay his drinks bill at the tavern.

The publican slips the money along to the local lady of the night drinking at the bar

The local lady of the night then rushes to the hotel and pays off her room bill to the hotel owner with the €100 note.

The hotel proprietor then places the €100 note back on the counter so the rich traveller will not suspect anything.

At that moment the traveller comes down the stairs, picks up the €100 note, states that the rooms are not satisfactory, pockets the money, and leaves town.

No one produced anything.

No one earned anything.

However, the whole village is now out of debt and looking to the future with a lot more optimism.

And that, what I'm told, is how the bailout package works

Ken Landon JP Morgan London

'There is an old saying, 'How did you go bankrupt?' And the answer is 'Gradually, and then suddenly.' The impending fiscal crisis in the US will make its appearance in the same way.'

Seth Klarman, Baupost Group, 19/05/10

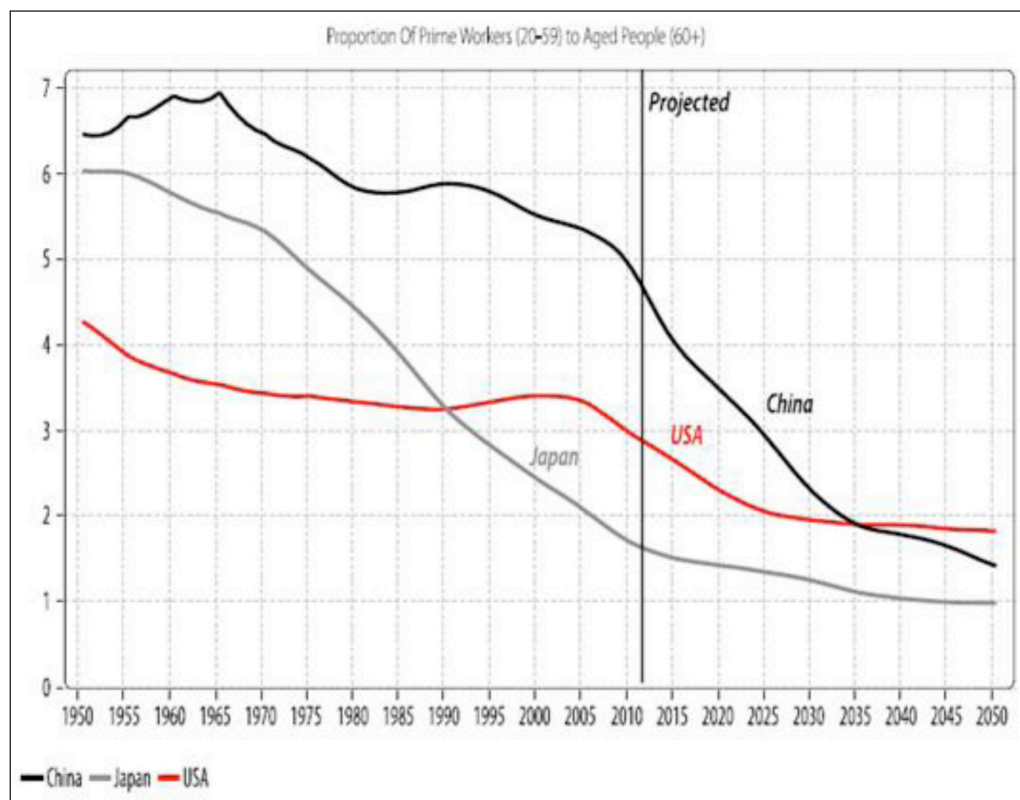
'...investors should recognize that Euroland's problems are global and secular in nature, reflecting worldwide delevering and growth dynamics that began in 2008. It will be years before Euroland, the United States, Japan and developed nations in total can constructively escape from their straitjacket of high debt and low growth. If so, then global growth will remain stunted, interest rates artificially low and the investor class continually disenchanted with returns that fail to match expectations. If you can get long-term returns of 5% from either stocks or bonds, you should consider yourself or your portfolio in the upper echelon of competitors.'

Bill Gross, PIMCO, 01/12/11

Demographics

According to GaveKal Research, over the next 15 years, the US Prime Worker ratio (workers to dependents) will fall as much as Japan's did from 1995 – 2005, and China's ratio is set to fall even further.

A decade of demographic headwind: prime workers ration declines, in the US and elsewhere



Source: GaveKal

Outlook

Despite a stream of downgrades throughout the quarter, commodity prices falling and banks experiencing margin pressure in a slower credit growth environment, the quarter still posted a positive return, suggesting much of the bad news to date was priced in, at least for the market as a whole.

The market's short term focus is now turning to the approaching results season in February. As has been a feature for many results seasons in recent years, company outlook commentary will be critical. In this context, the 'self-help' stocks we are biased to with internally generated growth drivers are expected to provide relatively more confidence in their outlook commentary, and thus we are depending on them to deliver performance for our portfolios.

A feature of the quarter has been emerging divergence of economic growth from key geographies. Europe's outlook is weaker as it looks set to enter a recession, China has slowed (with market consensus expectation that government stimulus policies will be announced soon), and the US has shown some improvement from its mid-year slump. This emerging divergence of economic growth is once again resulting in large currency moves, with a weaker Euro and a volatile Aussie dollar (yet it remains above parity with the US). The currency moves are expected to provide a short term headwind for our global names, many of which are in our key 'self-help' basket of the portfolio.

At the margin, during the quarter we have acquired some over sold stocks which had faced earnings downgrades but are now providing attractive valuations. In particular, with the market focus on short term earnings evident, we observe the market is in some cases ignoring the strong balance sheets of certain stocks. With so much uncertainty, combined with large volatile currency

'What has become obvious in the last few years is that debt-driven growth is a flawed business model when financial markets and society no longer have an appetite for it.'

Bill Gross, PIMCO 01/12/11

'What is often regarded as pessimism by financial market participants could perhaps be more reasonably described as rationality, realism and being aware and protective of the financial circumstances and well-being of others.'

Erik Metanomski, Hood Sweeney, 15/08/11

'Our compensation programs, our annual meeting and even our annual reports are all designed with an eye to reinforcing the Berkshire culture, and making it one that will repel and expel managers of a different bent.'

Warren Buffett, March 2011

moves, we remain cautious, and our portfolio is balanced with a quality bias. Shareholder returns are expected to be driven by a combination of corporate capital management (dividends and buybacks) and modest earnings growth driven largely internally from synergy benefits, cost savings or utilizing pricing power in structurally attractive industries. We are NOT depending on volume growth!

'... there is no such thing as a value company. Price is the essential determinant in every investment equation. At some price, every company is a buy; at some price, every company is a hold; and at a still higher price, every company is a sell.'

Seth Klarman, Baupost Group, 19/05/10



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