Greencape Wholesale High Conviction Fund

Quarterly report - June 2016

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Inception % p.a.
Fund return	2.90	1.90	8.62	8.30	10.10	8.60
Growth return	0.68	-2.40	-0.44	1.41	4.27	2.30
Distribution return	2.22	4.30	9.06	6.89	5.83	6.30
S&P/ASX 200 Accumulation Index	3.94	0.56	7.65	7.40	8.81	4.95
Active return^	-1.04	1.34	0.97	0.90	1.29	3.65

Past performance is not a reliable indicator of future performance.

Performance figures are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures.
^ Numbers may not add due to rounding

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

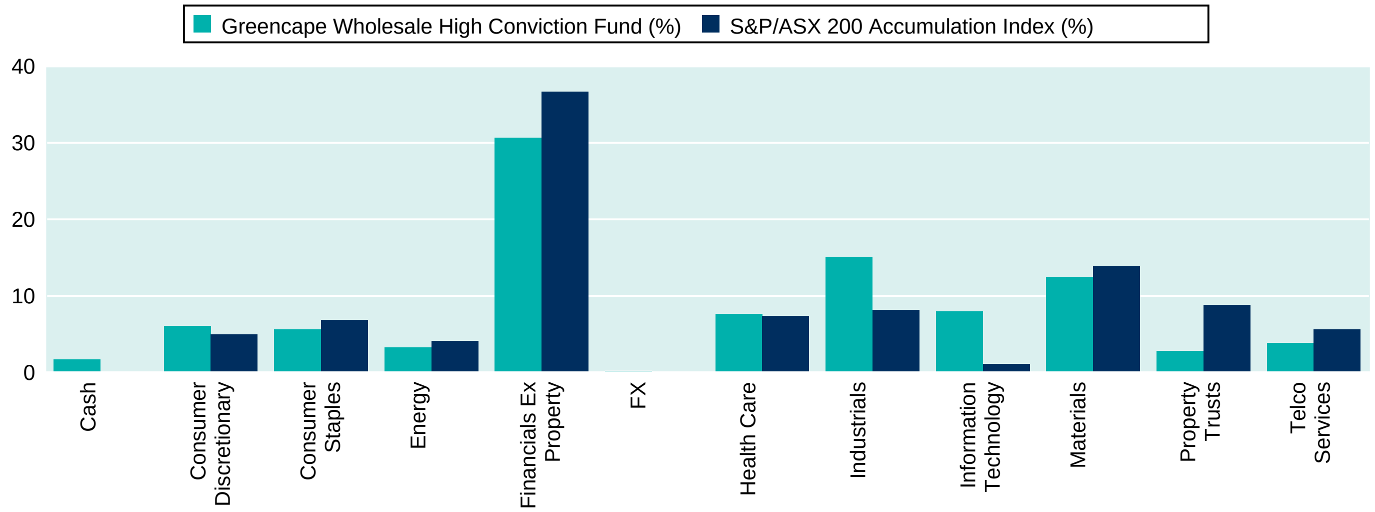
At least five years

Asset allocation	As at 30 June 2016 (%)	Range (%)
Security	98.32	85-100
Cash	1.68	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0035AU

Fees	
Entry fee	Nil
2014-2015 ICR	1.14%
Management fee	0.90% p.a.
Performance fee	15% of the Fund's daily return (after fees and expenses and after adding back any distributions paid) above the Fund's Performance Benchmark (the daily return of S&P/ASX 200 Accumulation Index).
Buy/sell spread	+0.20% / -0.20%

Sector exposure as at 30 June 2016



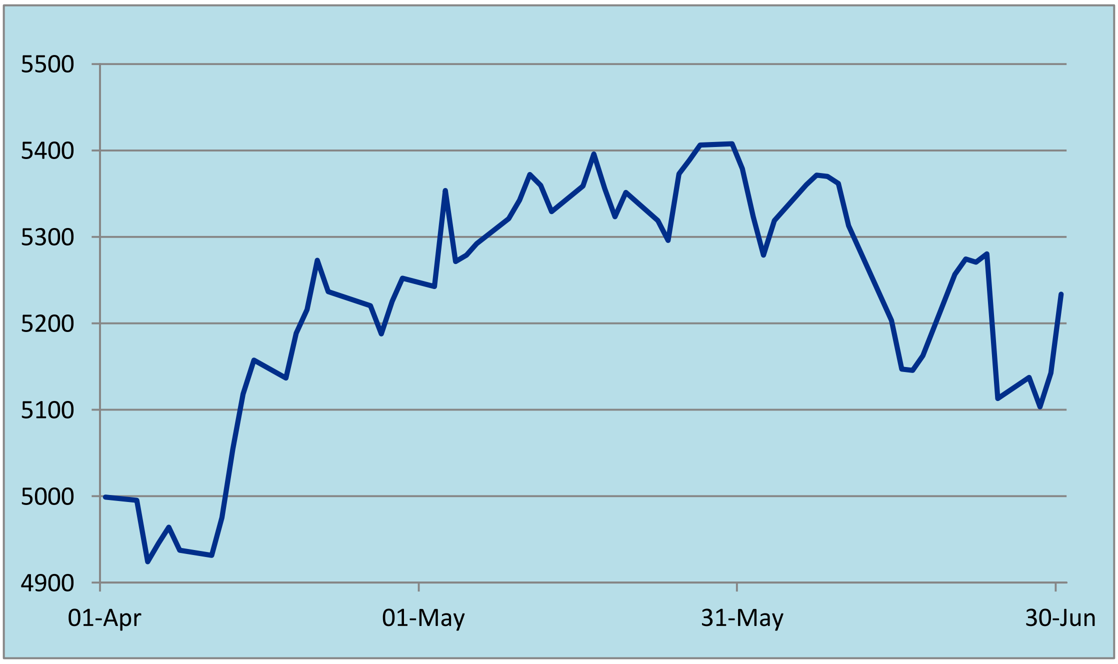
Fund performance summary

The S&P/ASX 200 Accumulation Index returned +3.94% for the quarter. The fund underperformed the market and delivered a +2.90% return over the quarter.

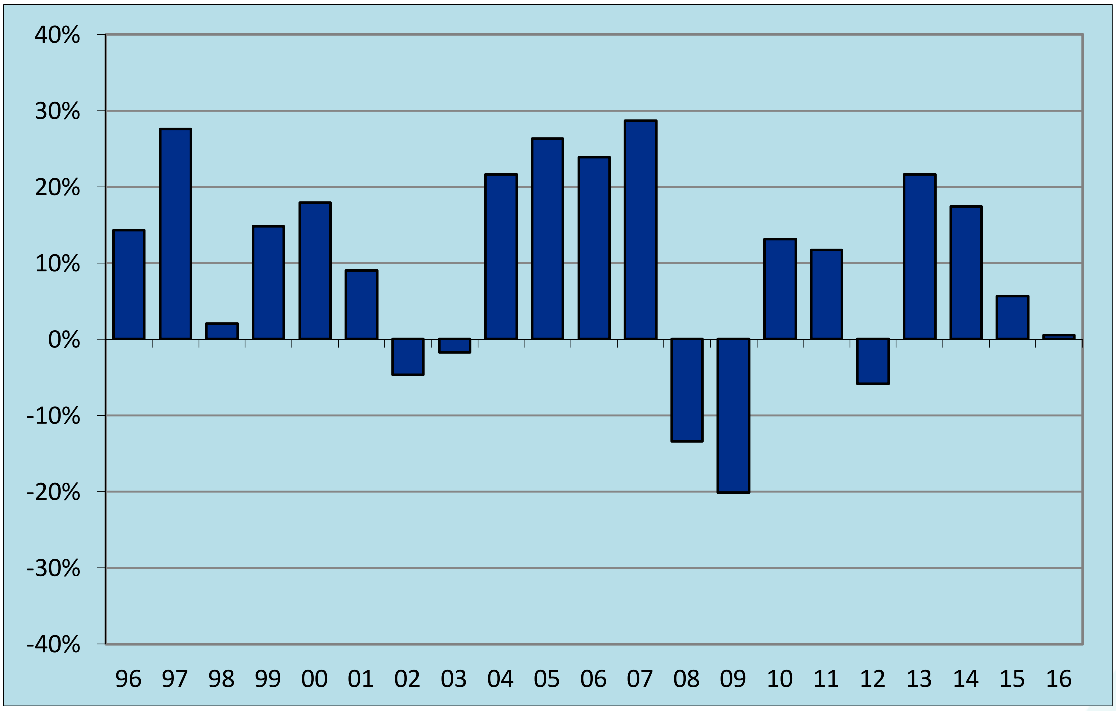
Market overview

A commodity price fuelled rally saw the local index start strongly during the period, as the Materials index rose 14% in April alone. Central Bank actions continued to influence markets, as expectations around another US Federal Reserve (Fed) interest rate hike were pushed out. A surprising referendum result in the UK late in the quarter caught global markets off guard, which resulted in a marked increase in volatility to round out the financial year. The Accumulation index still managed to post a small gain for the year, albeit the lowest in four years.

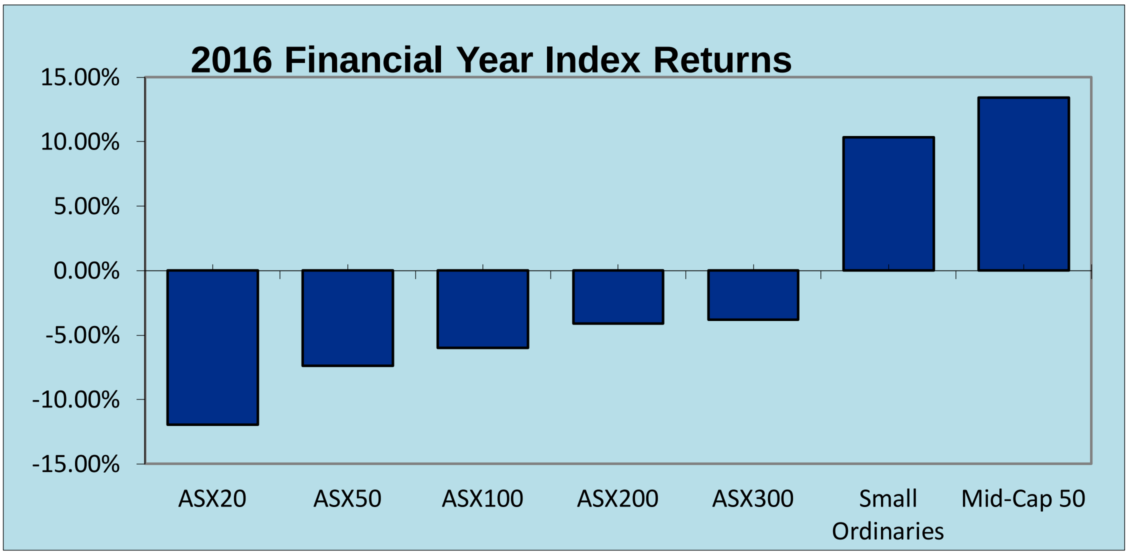
S&P/ASX 200 Accumulation Index



S&P/ASX 200 Accumulation Index Financial Year Returns Since 1996

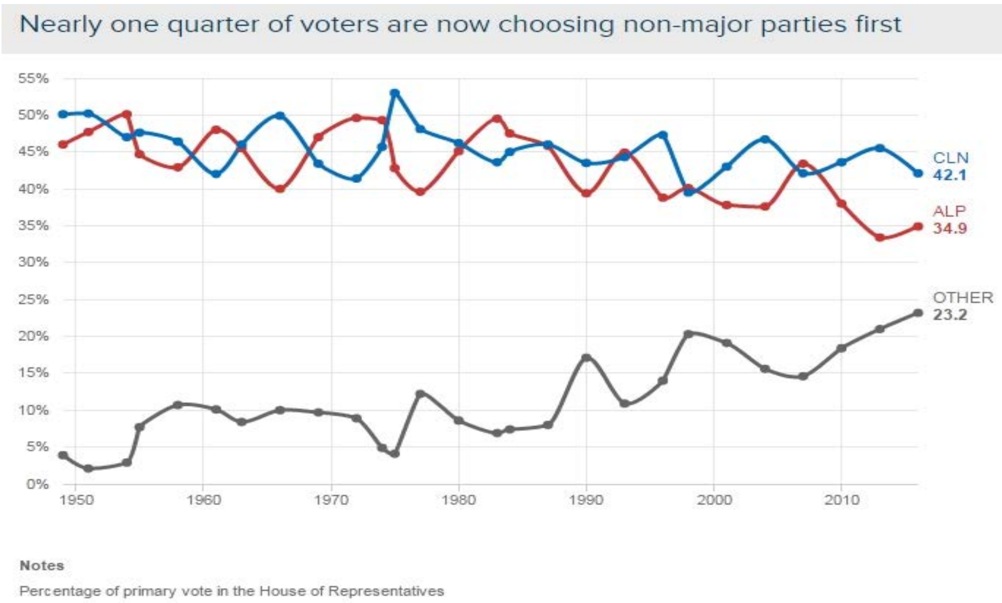


The divergence in performance between the mega-cap stocks and the smaller capitalised stocks was stark over the financial year.



The RBA surprised the market in May by cutting the overnight cash rate to a new record low of 1.75%. After the Brexit result, the market is now attributing an approximate 60% chance of another 25 basis point rate cut at the August meeting. A Federal election was held post-quarter end, the result of which was still undecided at the time of writing, as neither party could obtain a majority in the House of Representatives to form government.

As we see below, the share of non-traditional parties reached a record high as voters continue to desert the major parties.

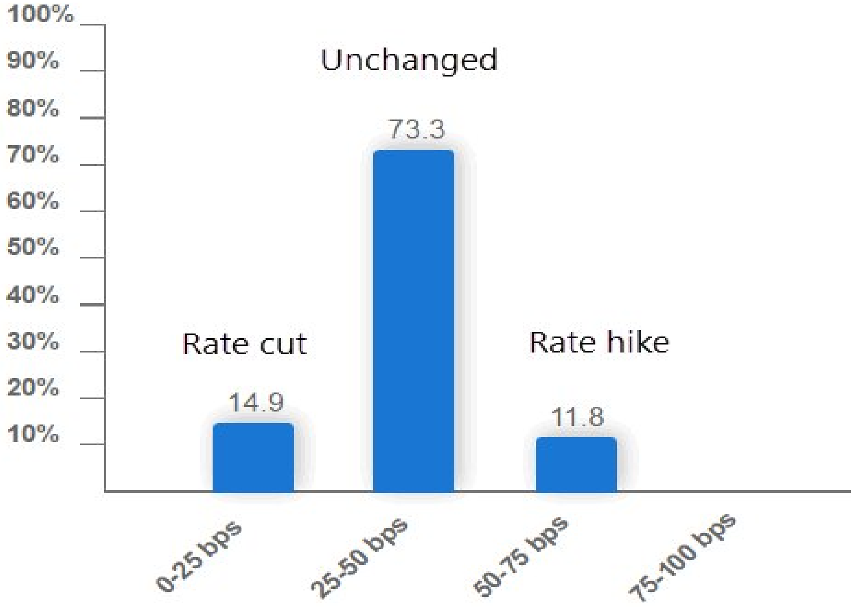


Source: ABC

The Federal Budget was also unveiled in May, which included the introduction of a $1.6m cap on individual superannuation balances and a $500k cap on life-time non-concessional contributions.

"Political gridlock that leads to a sustained widening of the deficit would put downward pressure on the (AAA) rating, particularly if the economic environment deteriorates." Mervyn Tang, Director of Asia-Pacific Sovereigns at Fitch, 04/07/2016

In the US, a much weaker than expected non-farm payrolls report (+38k jobs compared to market expectations of +160k) kept the Fed from hiking rates further in June. Despite the Fed's best efforts in communicating a hawkish tone and insisting the July meetings was still 'in-play' for another rate hike, the market has completely dismissed this view post the Brexit result. As shown below, the futures market is now pricing in a higher probability of a rate cut than a rate hike this year.



Source: CME

After the incredible rise and fall of the Shanghai stock exchange last year, Chinese investors turned their attention to commodity futures in April. The trading frenzy saw the prices of a range of commodity futures from soy beans to steel rebar soar, with the latter rising 65% from its December low.

Market turnover at the height of the frenzy in April was over USD$260bn on the futures exchanges, which dwarfs the S&P500 average daily trading value of $35bn. On a single day, there was enough cotton traded to make a pair of jeans for every person on the planet, and enough soybeans traded for over 50 billion servings of tofu. Similar to the Shanghai Composite index activity last year, this activity was driven predominantly by retail investors, with over 40% of the trading volume occurring during the night session.

Figure 1
China commodity futures total daily turnover

Note: Include futures on the Dalian Commodity Exchange, Zhengzhou Commodity Exchange and Shanghai Futures Exchange.
Source: CEIC Data

Source: CLSA

"Trump has written a lot of books about business—but they all seem to end at Chapter 11." Hillary Clinton, Presumptive nominee of the Democratic Party for President of the United States, 22/06/2016

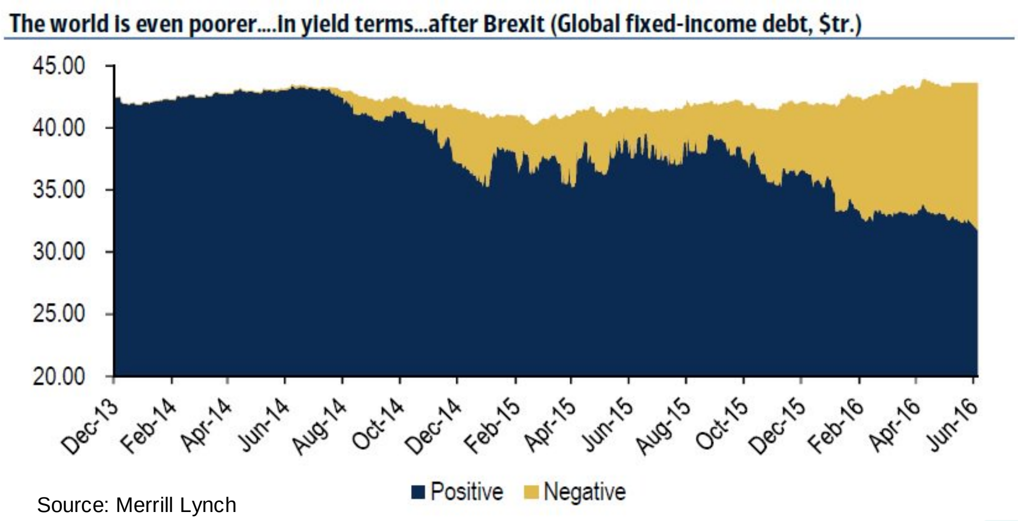
The surge in activity came with exceptionally short holding periods, as investors sought to profit from heightened intraday volatility.

Source: Bloomberg

The rally in commodity futures translated into significant outperformance for the Materials sector during the quarter, as the sector found itself at the unfamiliar position at the top of the performance table for the quarter.

	June 2016 Quarter	Year ended June 2016
ASX200 Accumulation Index	3.9%	0.6%
Best performing sectors		
Materials	10.8%	-4.2%
Healthcare	10.3%	21.5%
Property Trusts	9.2%	24.6%
Worst performing sectors		
Consumer Staples	-3.6%	1.6%
Financials ex Property Trusts	0.3%	-8.7%
Information Technology	1.1%	1.7%

Property trusts continued to outperform as investors sought alternative sources of yield to bonds, whose spreads continue to tighten. Following the Brexit referendum, the Australian 10 year government bond yield traded at a new record low of less than 2%. The yield is of course still positive however, unlike an increasing number of global bonds as evidenced below.



Source: Merrill Lynch

"You have far too much credit, money sloshing about, money looking for higher returns… Even in commodities where you could have argued there is some reason for prices to rise, that gets quickly swamped by a nascent bull market and becomes an uncontrollable bubble." Fraser Howie, Author, 10/05/2016

Consumer Staples was the only sector to retreat during the period. Price deflation continued to impact the major supermarket chains, as Woolworths posted negative comparable third quarter sales growth. On the conference call following the sales update, management called out two issues in particular, customer service improvement on weekends (especially Sundays) along with stock availability problems due to problems with the inventory management system, particularly in fresh food. We took a tour of a local Woolworths on a Sunday evening to see how these initiatives were tracking first hand.

We noted the following:

No baskets

No Bananas

No berries

"There's nothing more frustrating than a customer coming to the store and the product is not there. So, I think it's had a material impact on our customers and that's the thing we need to focus on most." Brad Banducci, CEO of Woolworths, 02/05/2016

Along with a number of empty fruit shelves

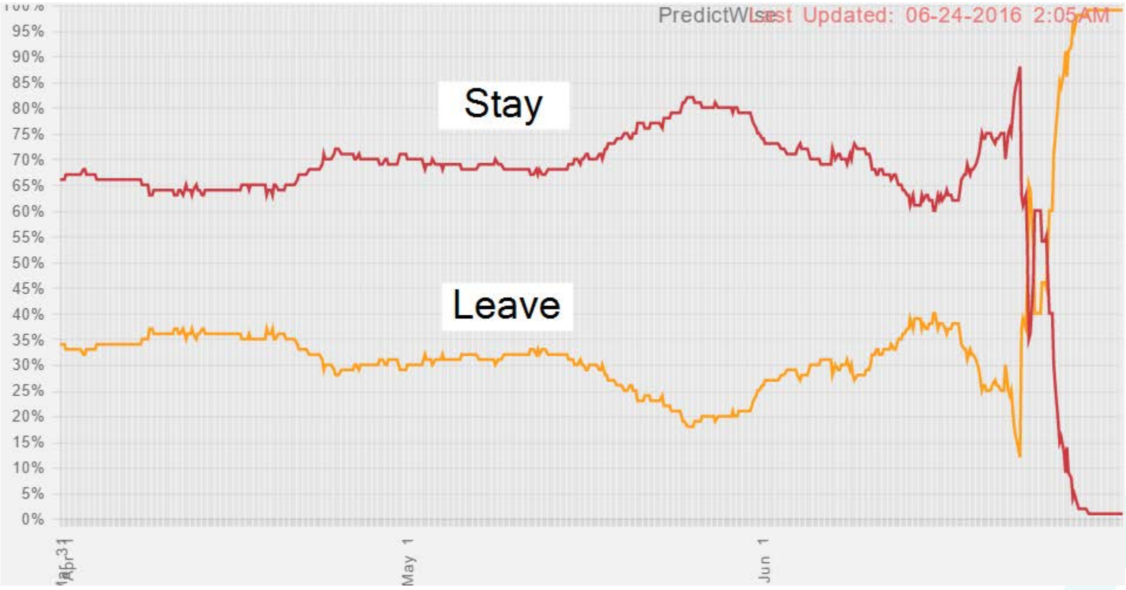
We will continue to monitor this situation, both as investors and consumers!

Brexit

Given the challenges the European Union (EU) has faced over recent years, there has been a growing discontent within the UK of its place within the bloc. In an effort to appease certain factions within the Conservative party, British PM David Cameron in 2013 promised to renegotiate the UK's relationship with Europe along with the intention to put the UK's membership in the EU to a vote. On June 23, a referendum was held whereby the United Kingdom was given the simple choice on whether to remain or leave the EU. Since the date of the vote was confirmed in February, betting markets had prescribed an approximate probability of 30% of the Leave vote succeeding. Opinion polls in the lead up saw the result as much closer, however it was assumed that the undecided voters would opt to remain with the status quo, much like the Scottish referendum on whether to leave the UK in 2014.

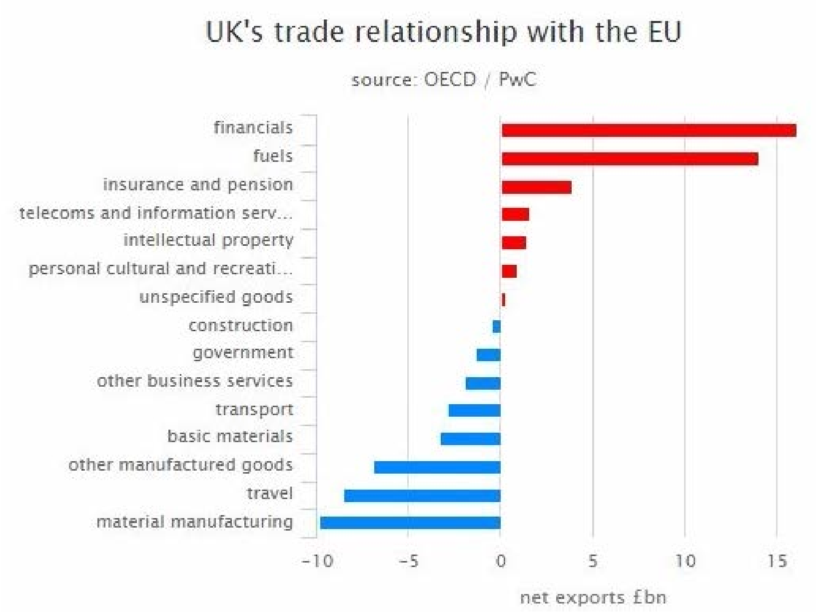
The betting markets were wrong.

Probability of Stay vs Leave



Source: PredictWise

The financial markets were also caught off guard, with the FTSE 100 up over 1% the day before the vote as the probability of a Leave outcome was given as low as 10%. The Australian market opened up nearly 1% on the 24th of June, however once the voting results started filtering through and the Leave outcome became increasingly likely, the ASX200 fell 5% from its intraday highs. Australian listed financial services companies with UK exposure were sold off harshly, as the Pound Sterling lost more than 10%. Globally, financial services companies with exposure to the UK were sold off harshly. Many of these companies have set up offices in the UK as their EU hub, which may have to change in the future.



Source: OECD/PwC

In the aftermath of the vote, the UK had its credit rating downgraded from AAA to AA. Below is a selection of economist predictions of the impact of the Brexit on UK GDP.

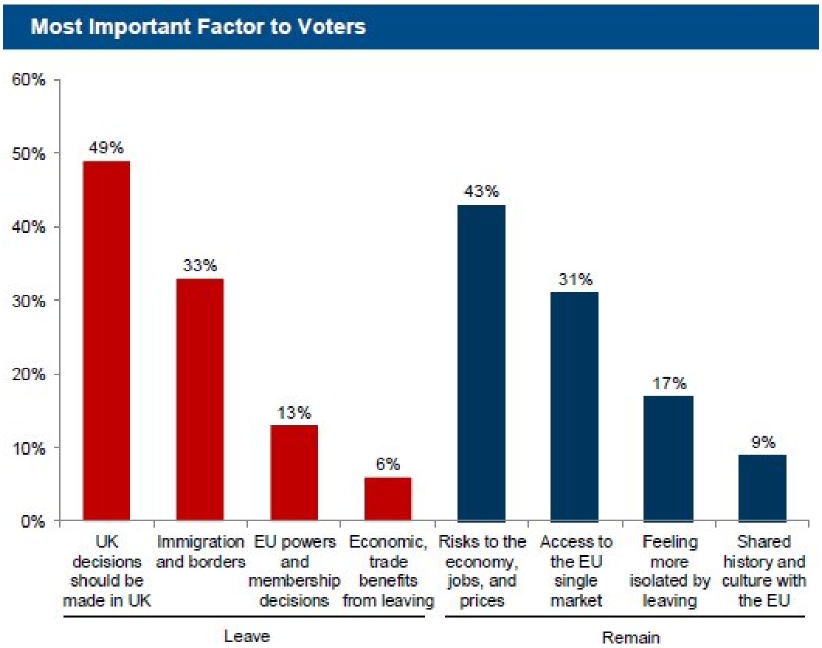
	Effect on GDP Level (%)
PwC	-3.1 to -5.5 (over 5 years)
Citi	-4 (over 3 years)
Credit Suisse	-1 to -2 (over 2 years)
Deutsche Bank	-3 (over 3 years)
HSBC	-1 to -1.5 (over 1 year)
JP Morgan	-1 (over 1 year)
Morgan Stanley	-1.5 to -2.5 (over 2 years)
Nomura	-4 (over 1 Year)
Société Générale	-4 to -8 (over 5 years)

Source: Bank of England

This data however was irrelevant to the Leave campaign, which told voters that they needed to stop listening to experts and bureaucrats. The campaign's main policies were to limit EU regulation and decision making in the UK, to 'take back' the £350m a week the UK sends to the EU, and to tighten border control. The latter policy it claimed was increasingly vital given EU membership was going to be granted to a number of new countries in the periphery of Europe, whose citizens could then enter the UK unabated. The Leave campaign also launched a large scale social media effort, in addition to a targeted door-knocking campaign which was aided through sophisticated data analytics of the voter base.

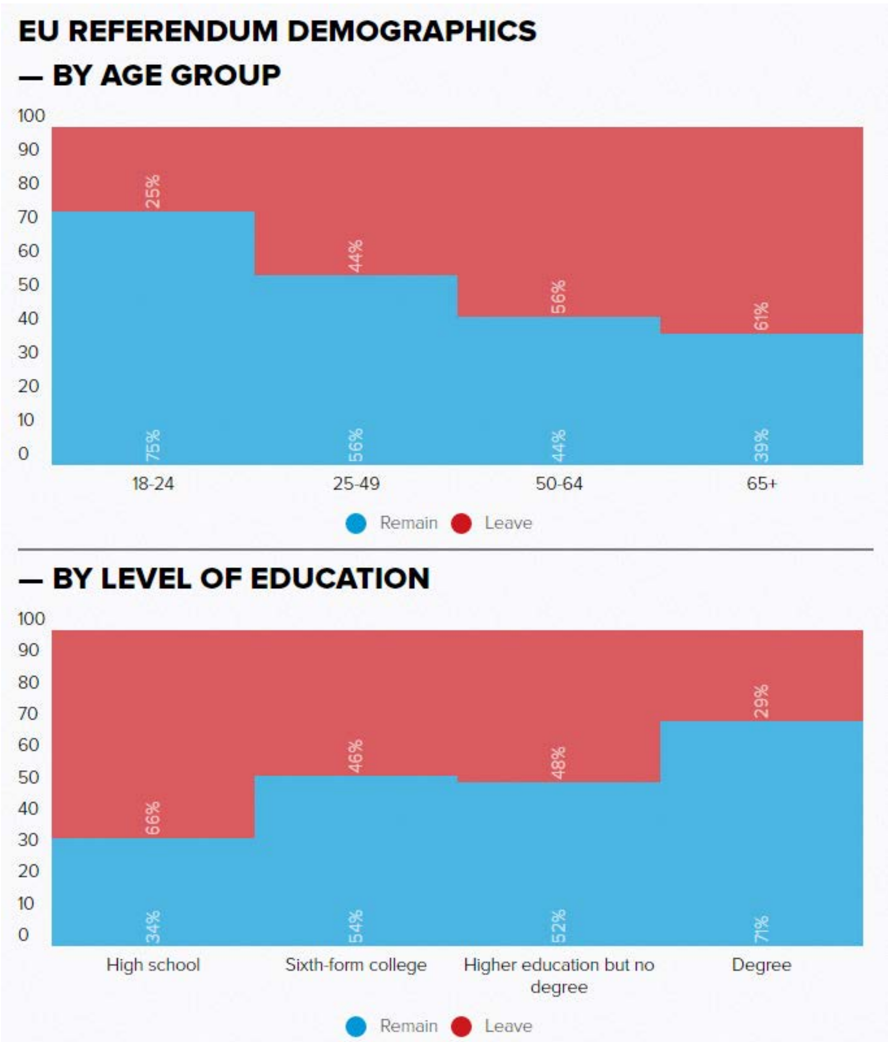
"China hopes to see a prosperous Europe and a united EU, and hopes Britain, as an important member of the EU, can play an even more positive role in promoting the deepening development of China-EU ties." Chinese Foreign Ministry, 23/10/2015

The Leave campaign clearly struck a chord, as voter polls showed their main arguments influenced voter behaviour.



Source: Goldman Sachs/Ashcroft Polls

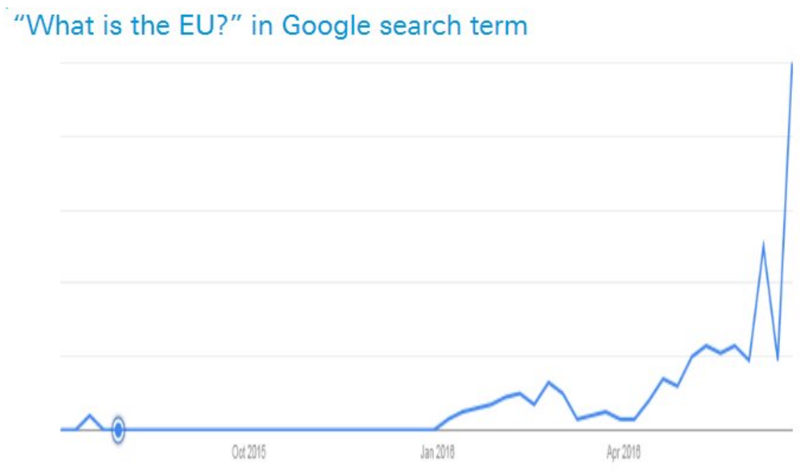
The breakdown of the vote also showed older and less educated citizens were more inclined to vote to Leave.



Source: Politico

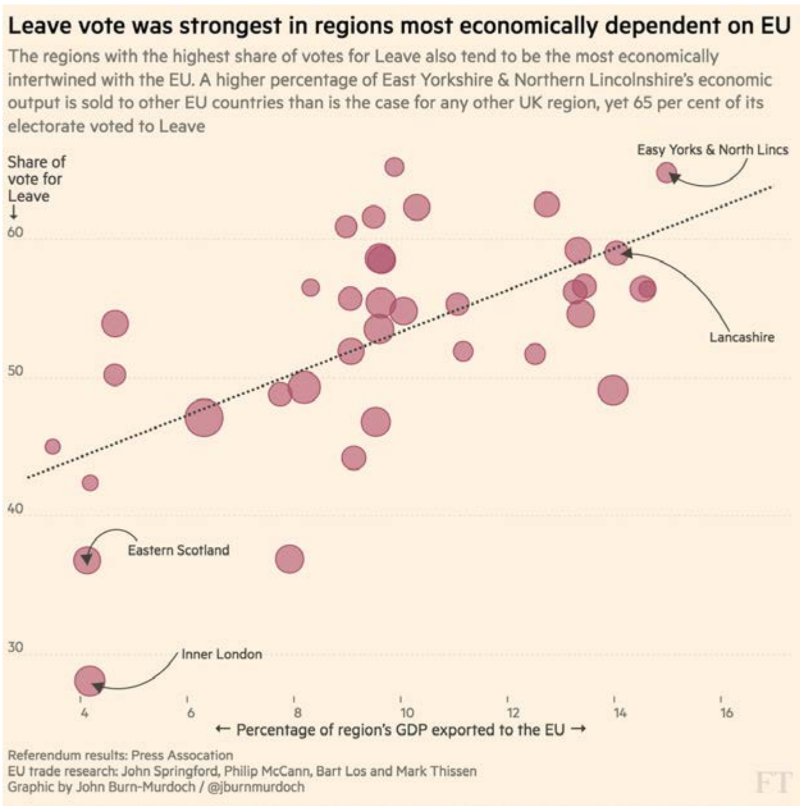
"Married or divorced, but nothing something in between… We are not on Facebook, with 'It's complicated' as a status." Xavier Better, Prime Minister of Luxembourg, 29/06/2016

In the following days, it became clear the U.K. population were not entirely clear on what they were voting for, as evidenced by this worrying Google search trend.



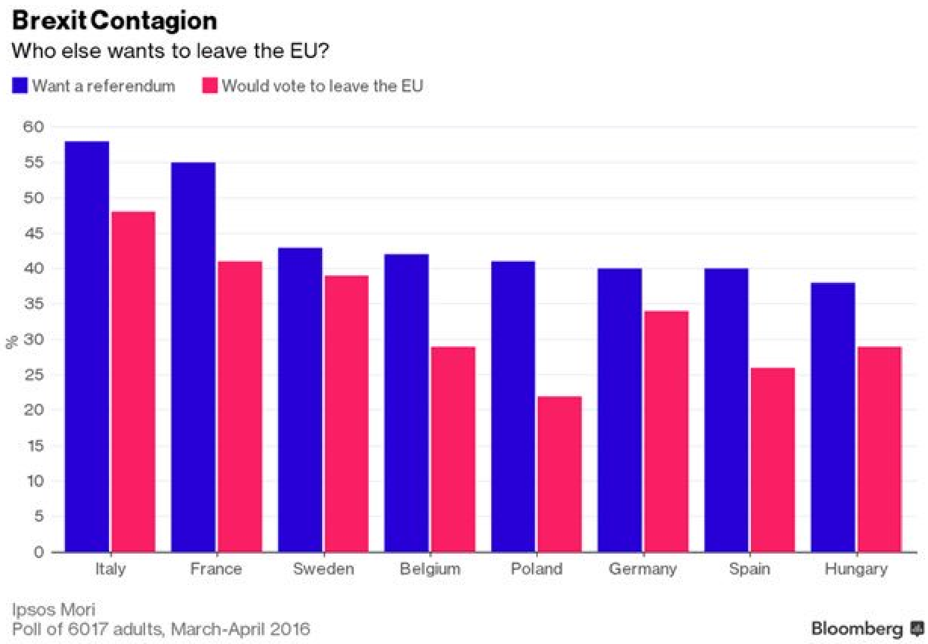
Source: Google and Deutsche Bank

Many voters, particularly in the more working class areas of the UK, are perhaps more economically dependent on the EU than they were aware of when casting their vote. Sunderland for example, which voted 61% to Leave, has a Nissan plant which employs nearly 7,000 people and exports 55% of its production to the EU.



Source: FT

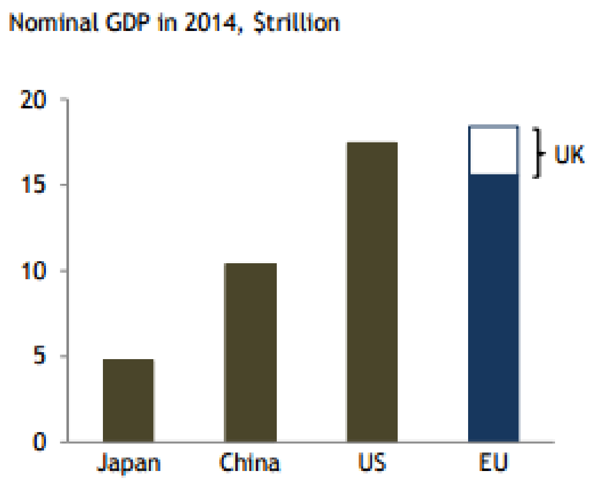
The position of Northern Ireland and Scotland in the UK has also been brought into the debate, as the majority in both countries voted to Remain. In Scotland, one of the main arguments in the vote to remain in the UK in the 2014 referendum was the benefits of EU membership. Some Scottish politicians have gone so far as seeking a way that they could somehow block the UK from leaving the EU, although that remains unlikely. Meanwhile, anti-EU parties within other countries such as France and the Netherlands have also called for their countries to hold referendums on their membership. Further countries voting to leave the EU would no doubt be problematic.



Source: Bloomberg

The focus has since shifted to the mechanics of how the UK, the second biggest net contributor to the bloc, can actually leave union. In order to leave, the UK must invoke article 50 of the Lisbon Treaty, after which time they have two years to finalise their exit. Within that two years however, the UK needs to organise individual trade and immigration deals with each of the 27 countries. It is unlikely these deals will be struck at terms favourable to the UK, given the EU will want to discourage further nations from leaving. German Chancellor Angela Merkel has taken a firm stance, saying the UK cannot 'cherry-pick' certain aspects of the EU which they want to access. She noted that Norway, which is not a member of the EU but has access to the market, only has access because it accepts open migration. Clearly this arrangement is in disagreement with Leave party polices. Furthermore, the UK will be in a distinct position of disadvantage given they must negotiate these agreements within the two year window.

"The will of the British people is an instruction that must be delivered." David Cameron, Prime Minister of the U.K, 24/06/2016



Source: IMF

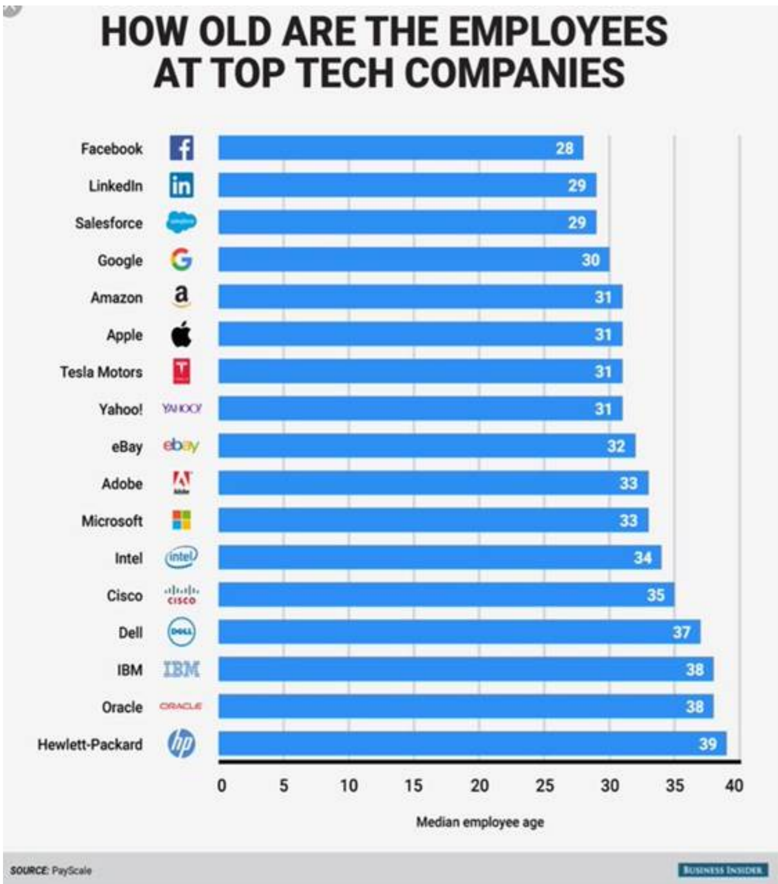
No matter the outcome of the negotiations, the EU (which as a single entity is the largest trading bloc in the world) will look somewhat different after the outcome has been resolved. The Australian market will continue to focus on this issue, given our close trading relationship with the UK and exposure to the EU at large.

Facebook

Facebook (FB) should be well known to many as the world's dominant social networking platform. At the most recent update, their monthly active user base grew to over 1.65bn. Our interest in FB originated from understanding the shift in advertising dollars to online. We noted the increasingly consistent commentary from industry contacts that social media spend is gaining a larger and more co-ordinated share of advertising dollars over multiple trips to the US in particular. We subsequently formed a view is that FB is likely to be the key beneficiary in the years to come given the likelihood of a 'winner take most' market scenario.

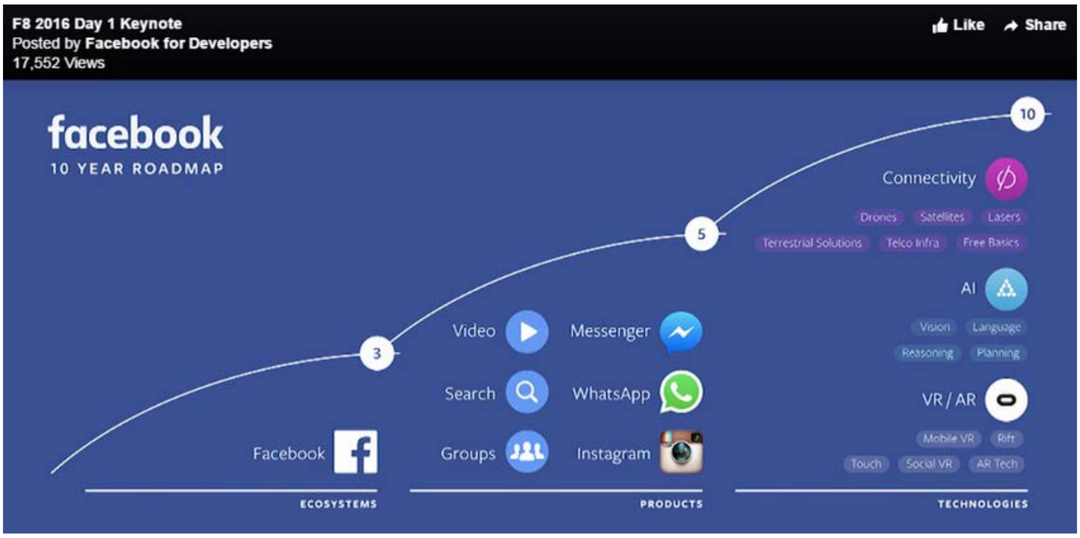
Despite a market capitalisation around USD$330bn, we believe it's still early days with respect to FB's monetisation potential. We see many aspects of the business being difficult to replicate, with the gap between FB and others in many instances widening. FB has a unique position in mobile, owning 4 of the top 6 apps globally (Facebook, Facebook Messenger, Instagram and WhatsApp). This is crucial as it is now widely accepted that accessing the internet via a smartphone will increasingly be conducted through apps, and that on average individuals only use a handful of apps regularly. FB also has industry leading data analytics and unrivalled targeting capabilities (thanks to the information that its user base provides). Small and large businesses alike can leverage this user base in order to reach targeted audiences, often at scale and with strong, measurable return on investment.

A central aspect to FB's strategy is driving user engagement. This is done via a combination of continued investment into product (carousel ads, dynamic products ads, video ads) and innovation (live video, leveraging AI, user interface development etc.) in order to provide a uniquely personalised experience on the platform. Underpinning this is a strong company culture that embraces disruption. It has been reported that some of the values that FB promotes internally includes "This journey is 1 percent finished" and "If we don't create the thing that kills Facebook, someone else will".



Source: Business Insider

Fast paced innovation and ensuring the user experience remains at the core has led to users on average now spending 50 minutes per day on the platform. We think time spend is likely to trend higher, as FB becomes more integrated into the mobile experience, and as FB develops its other products such as Instagram, Facebook Messenger and WhatsApp over time. There is also a strong overarching roadmap, with management clearly focused on deliverables across various time horizons and verticals, best highlighted by the below slide from the 2016 Facebook F8 "Developer Conference".



Source: Facebook

Recently, we spent time both at FB in Menlo Park, California along with a host of social media focused advertising agencies in San Francisco and New York, who work as "advertising partners" to various digital platforms. Getting behind the product and understanding how small businesses and larger enterprises are engaging with FB related advertising provides us with good comfort around the potential growth in revenues.

FB remains underpenetrated across many segments of the market. Small businesses should provide meaningful upside over time, with FB's location based advertising capability combined with targeting likely to attract new advertising dollars. The ability for larger businesses to reach its audience in a more efficient and targeted way also provides for greater upside. Recently, Air China used FB's 'custom audiences' targeting tool to attract potential customers in the US to fly to China. They were able to specifically target frequent flyers, whilst filtering for other characteristics in order to provide a return many multiples higher compared to without customisation. Similarly, Tourism New Zealand recently used FB to increase traffic to its website by 50% during the key month of its campaign where it wanted to promote New Zealand during off peak periods to qualified people who were actively considering a holiday. They managed to do this with a materially lower cost per arrival to the website compared with expectations and a higher conversion rate. When we consider the flexibility, scalability and targeted nature of what FB provides, we do not think there is another company that can deliver the results that FB can to its client base.

In the most recent quarter, FB's four major regions all grew over 50% whilst mobile advertising revenue grew over 70% and now represents over 80% of total advertising revenues. With cost growth around 30%, its operating margin (inclusive of share based compensation) is a healthy 37%, up from 26% in the prior corresponding period with expectations that this should exceed 40% in the near term (based on market expectations). Given the relatively capital light business model, FB generates good cash flows and there is no debt on the balance sheet. Our view is that its cash generation and growing cash balance provides another layer of optionality that is under appreciated by the market. Whilst we see FB as a long term position in our portfolios, we continue to monitor the space closely given the pace at which the industry is evolving.

"Facebook has been built by a series of bold moves. And when I look out into the future, I see more bold moves ahead of us than behind us." Mark Zuckerberg, Chaiman and CEO of Facebook, 27/04/2016

Offshore Trips

This quarter we travelled to the US on four separate occasions, in addition to trips to South America, China, South Korea, Malaysia and New Zealand.

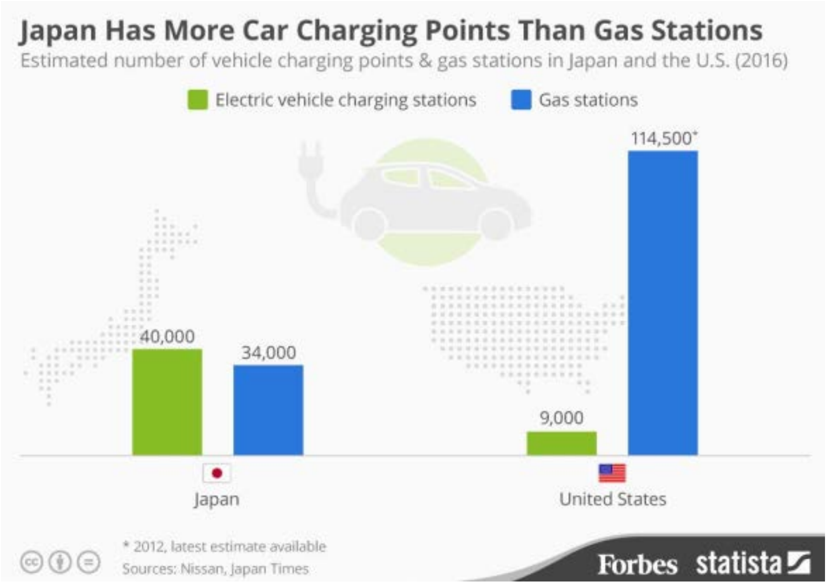
US Observations

- The momentum of growth feels to have slowed somewhat, although some growth still remains. The uncertainty surrounding the November Presidential election was quoted a number of times as the key driver, however confusion surrounding Fed monetary policy was also mentioned frequently.
- The US consumer continues to shift spend away from apparel towards entertainment and when spending on the former, appears to be trading down. Industry fragmentation, particularly due to the proliferation of online offerings has impacted traditional retailers.
- Millennials are delaying forming households, rather than abandoning the concept altogether, suggesting that there is a looming step change in the housing cycle still to come.
- The viability of Blockchain is not in question; however any hard solutions and timelines are still to be determined.
- Online travel companies have noted lower utilisation rates and yield during peak periods due to the impact of AirBnB and the ‘sharing economy’ at large.

Source: Statista

- Across most meetings, the use of data has been forward as an area of focus. 'Data scientists' are commonly being hired to take customer analysis further. There was no mention of this on previous trips.

- Battery/Electric Vehicle adoption is accelerating, with a very long way to go (especially when compared to Japan).



Source: Statista

South America

In June we visited Brazil and Argentina with a fast-moving consumer good (FMCG) focus, relevant for Brambles and Amcor (who recently announced a USD$435m acquisition in the region). In addition, Brazil is home to meaningful operations for Nufarm, Seek and Carsales.com, whilst Argentina is a key New World Wine and Lithium producer (as used in electric car and home storage batteries).

- Both Brazil and Argentina are considered 'mature' emerging markets where a growing middle class and developing modern retail channel is an observed trend.
- Both economies have suffered several years of populist governments taking a route down the slippery slope towards the extreme case of Venezuela. Interestingly, recent political manoeuvres and subsequent elections have resulted in relatively pro-business political blocs taking over government. Importantly, such political change in the past would have only occurred via a military coup; encouragingly this time, democracy to a degree has appeared to work.
- FMCG volumes have been incredibly resilient. Typical key product volumes have continued to experience volume growth of 2-5% p.a. Furthermore, the large global brands are growing slightly faster than this.
- Unlike China where consumers readily trade up, South Americans are typically more value conscious but will select a global brand leader over a local brand at a similar price point.
- The quality of management in Brazil and Argentina is high. Most management we met had US or European MBAs, experience in multinational corporations and high standards when it came to preferring proven tier 1 suppliers.
- The feeling on the ground is that the worst is behind them, and that economic growth, political stability and various other key economic indicators will improve, albeit slowly.

"Car design will change more in the next 15 years than it has in the past 100; electrification will kick-start the biggest change in automotive design in history." Ian Callum, Jaguar Head of Design, 13/04/2016

Outlook

Political uncertainty in UK (Brexit), Europe (response to Brexit), the US Presidential and Australia's inconclusive election are front and centre for global markets at the present time. Simmering in the background remains China's debt fuelled economy among numerous other emerging market growing pains elsewhere across the globe.

We are monitoring developments to observe whether this uncertainty translates into companies delaying investment and hiring, and whether consumers are changing their behaviour. The US still remains the key focal point of global markets, and we reiterate our view that the 'elephant in the room' remains the perception of a risk of a slowdown in the world's largest economy.

At the present time, there is a large degree of uncertainty across global markets, with sentiment regularly switching from risk-on to risk-off. Such volatility (and often increased liquidity) creates opportunity. As we have recently been highlighting, our conviction tends to favour stocks with a combination of management skill and balance sheet optionality, two key ingredients in these times of low interest rates, slow income growth and choppy market sentiment.

"The day to day market isn't a fundamental analyst; it's a barometer of investor sentiment. You just can't take it too seriously." Benjamin Graham, Investor and Author, 1932

More information

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

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