Greencape Wholesale High Conviction Fund

Quarterly report - December 2016

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Inception % p.a.
Fund return	3.23	7.84	6.08	11.77	7.19	8.85
Growth return	2.51	2.79	-2.79	4.77	0.91	2.66
Distribution return	0.71	5.04	8.87	7.01	6.27	6.20
S&P/ASX 200 Accumulation Index	5.18	11.80	6.59	11.84	4.53	5.73
Active return^	-1.96	-3.96	-0.52	-0.07	2.66	3.12

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

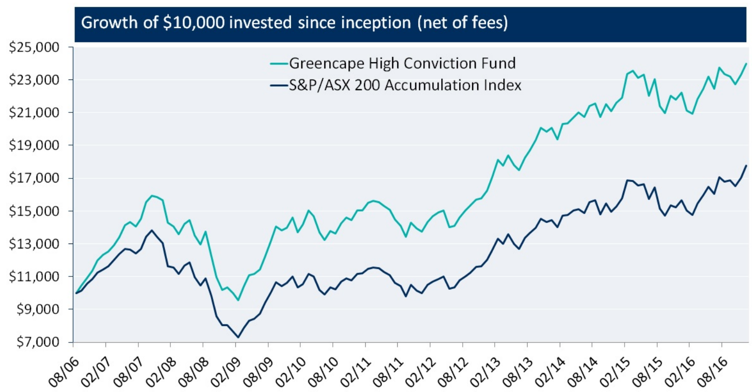
Greencape is an active, 'bottom-up' stock picker. Whilst Greencape does not target any specific investment style and will invest in stocks displaying 'value' and 'growth' characteristics, its focus on a company's qualitative attributes will generally lead to 'growth' oriented portfolios. This is an outcome 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

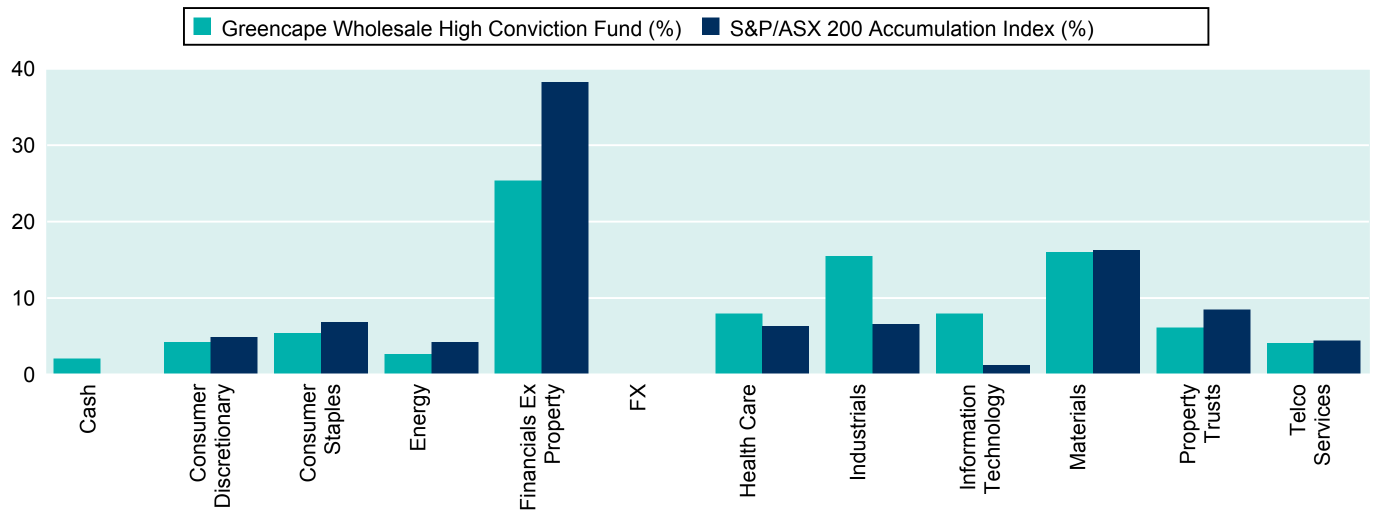


Asset allocation	As at 31 December 2016 (%)	Range (%)
Security	97.92	85-100
Cash	2.08	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0035AU

Fees	
Entry fee	Nil
2015-2016 ICR	0.91%
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 31 December 2016



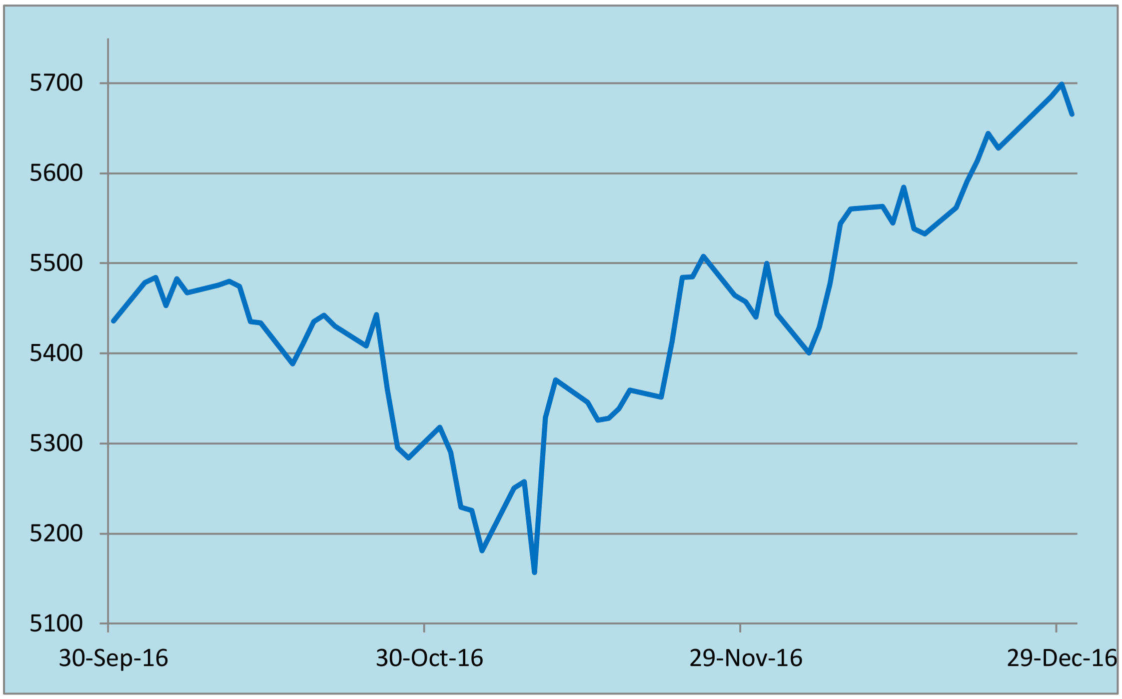
Fund performance summary

The S&P/ASX 200 Accumulation Index returned +5.18% for the quarter. The fund underperformed the market and delivered a +3.23% return over the quarter.

Market overview

Global political events again commanded the market's focus this quarter, with a surprising US election result catching most off-guard. Bonds yields continued their rise from historic lows which saw a rotation out of bond-like equities. November brought with it the annual Annual General Meeting (AGM) season, in which a number of companies disappointed the market with their trading updates. The index finished the calendar year strongly, buoyed by yet another Santa rally in December.

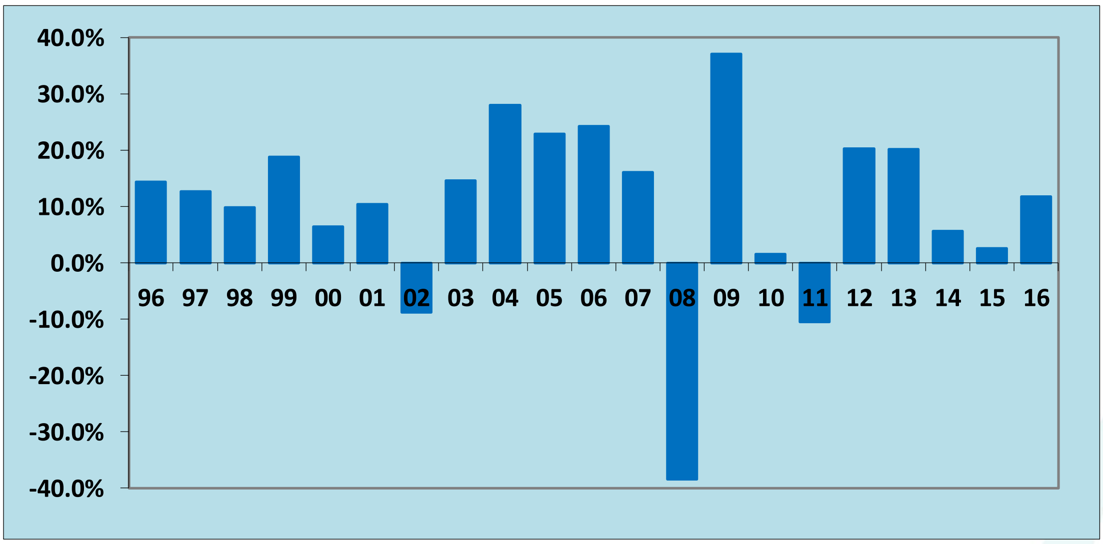
S&P/ASX 200 Index



As expected, the Reserve Bank of Australia (RBA) left rates unchanged for all three meetings during the quarter. The futures market now implies expectations are for the RBA to keep rates on hold for the duration of 2017. The major banks however decided to raise the variable rates on selected home loans independent of the RBA, citing higher funding costs due to increased deposit rates. Australian third quarter Gross Domestic Product (GDP) growth disappointed, registering at -0.5% against expectations of a 0.1% fall.

News flow out of the Federal Government was relatively quiet during the period, the highlight being the Mid-Year Economic and Fiscal Outlook (MYEFO) in which the government forecasted a return to surplus in 2020/21. A number of market commentators predicted the MYEFO would be the catalyst for Australia to lose its fabled AAA credit rating; however the budget update ultimately proved sufficient for the rating agencies to leave the rating unchanged, albeit with a negative outlook.

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



"We risk becoming victims of a complacency that fails to recognise the hard work that enabled our economic success, and the need for it to continue if that success is to be enduring." Malcolm Turnbull, Prime Minister of Australia, 18/11/2016

Global markets reacted to polls, tweets and other headlines in the unconventional lead up to the US Presidential election, which we discuss in more detail later. The US Federal Reserve (Fed) raised the federal funds rate for the first time in 12 months by 25 basis points to 0.50%-0.75%, an outcome which was fully priced in by the market, which now expects at least another 2 rate hikes in 2017. US GDP for the third quarter was higher than initially announced, with the re-stated measure up 3.5% against initial expectations of 2.9% growth. In Europe, the Italian referendum on constitutional reforms was comprehensively voted down, causing the immediate resignation of Prime Minister Matteo Renzi.

Chinese capital outflows continued during the quarter, as the country's FX reserves fell to USD $3 trillion, which is the lowest level since 2011, and USD $1 trillion lower than the peak in 2014. The capital outflows are in part due to the ongoing gradual currency devaluation being conducted by the People's Bank of China spooking some locals to expatriate their funds ahead of the risk of further currency falls. The USDCNY spot rate rose 7% for the calendar year, the biggest yearly gain since 1994.

The Chinese Producer Price Index (PPI) climbed to its highest level in 5 years in December, pointing to higher future inflation for countries that are heavily reliant on imported manufactured goods from China.

"The nation of China is responsible for almost half of America's trade deficit. They haven't played by the rules and I know it's time they're going to start." Donald Trump, President Elect of the United States, 08/12/2016

China PPI Since 2012

Source: Trading Economics

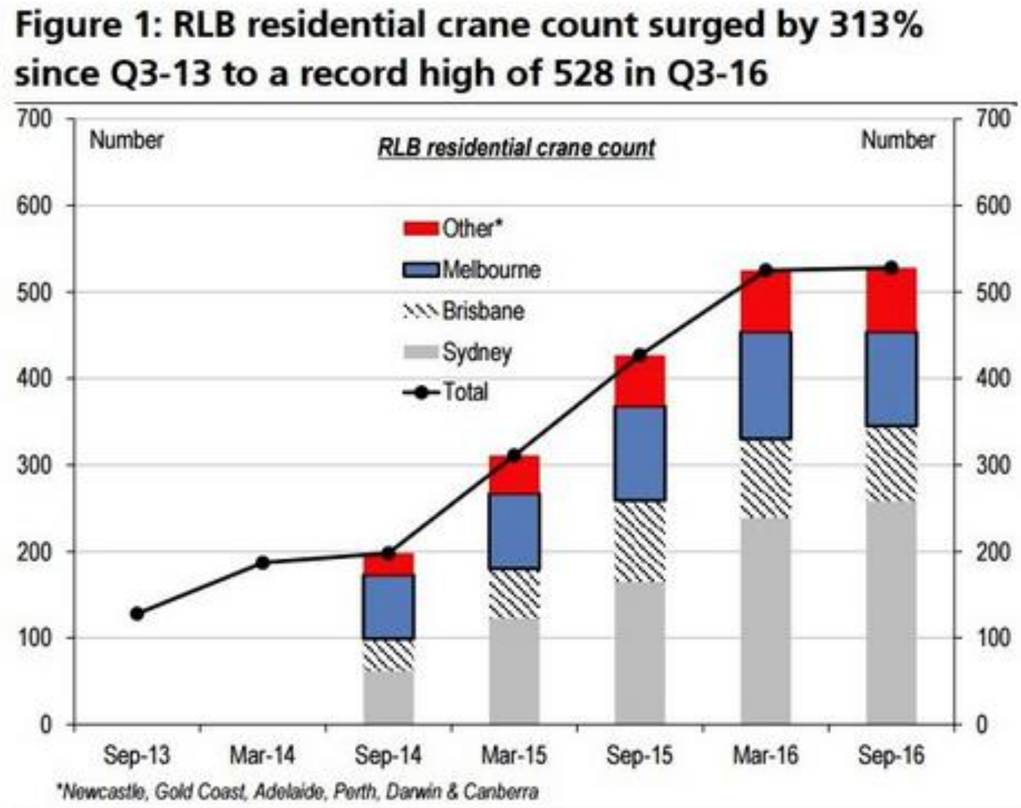
Locally, Resource stocks continued their extended period of outperformance, as Materials ended the calendar year as the best performing sector, up more than 20% over the second best performer (Utilities).The rally in underlying commodity prices has continued longer than most thought possible, triggering a number of earnings upgrades during the quarter.

	Dec 2016 Quarter	Year ended Dec 2016
ASX200 Accumulation Index	5.2%	11.8%
Best performing sectors		
Financials ex-Property Trusts	12.7%	7.3%
Utilities	9.2%	19.4%
Materials	7.9%	42.9%
Worst performing sectors		
Healthcare	-8.8%	1.9%
Telecommunications	-4.3%	-7.1%
Consumer Discretionary	-2.0%	11.9%

Financials (dominated by the major banks) led the market during the period, as investors took the view that interest rates have bottomed, pointing to higher Net Interest Margins (NIM) being earned in the future. Utilities gained on the back of Cheung Kong Infrastructure's bid for Duet Group at a 27% premium to the last close before the bid was announced.

This quarter we observed a large scale transition out of high multiple industrial 'growth' stocks into the 'barbells' of the market, being Banks and Resources. Following an extended period of significant outperformance, Healthcare was one sector which was on the wrong side of that market transition, with stocks such as CSL, Cochlear and Ramsay all falling victim to profit taking.

We thought this was an interesting snippet. RLB, a property consultancy firm, estimates that in quarter three 2016 there were more cranes in use for apartment construction in Sydney, Melbourne and Brisbane (454) than there were in New York, Boston, Chicago, San Francisco, Los Angeles, Toronto and Calgary combined (419).



Source: UBS

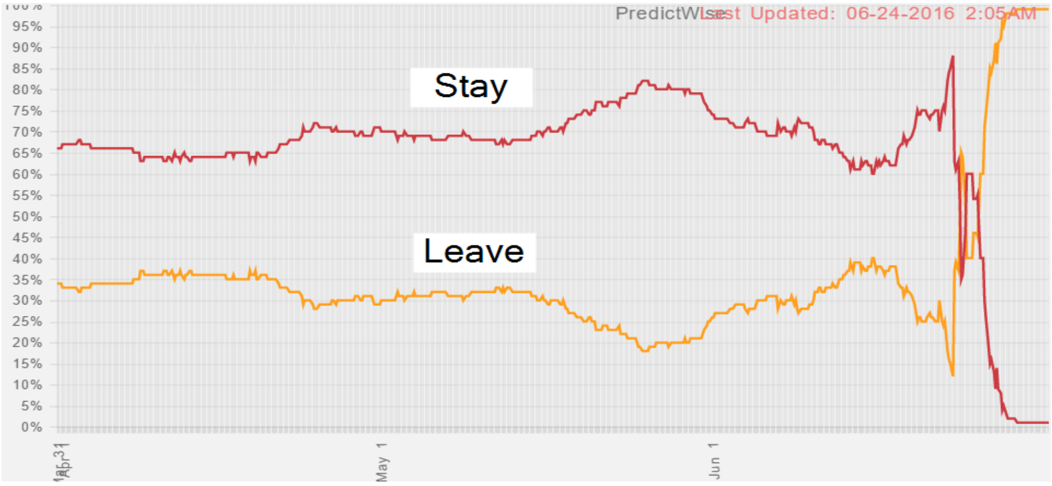
US Election

Similar to Brexit, the US Presidential election was a contest between keeping the status-quo, or an isolationist/non-establishment option, the implications of which were not entirely clear at the time of voting. The two votes were also similar for Australian investors, insofar that the votes would be counted during the ASX trading hours, potentially creating significant volatility which needed to be carefully navigated through.

The outcome of the Brexit vote showed that opinion polls and betting odds should not be relied upon to accurately predict the outcome of an election. However with no alternative to gauge voter sentiment, markets relied on the polls and the outcome caught many investors wrong footed. As we can see below, the probability trajectories of both votes show a remarkably similar pattern.

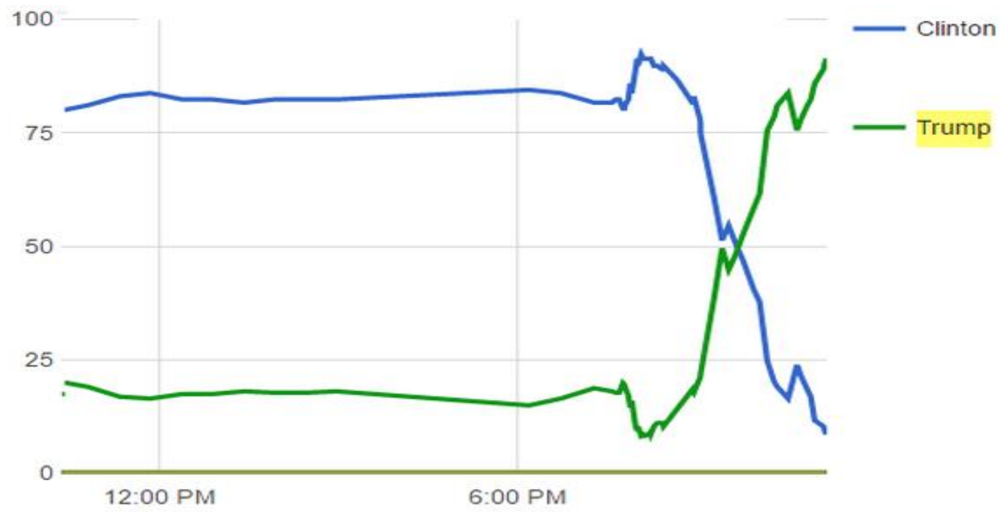
"It is unlikely to be in the public interest, given current projections for the economy, to encourage a noticeable rise in household indebtedness, even if doing so might encourage slightly faster consumption growth in the short term." Philip Lowe, Governor of the RBA, 15/11/2016

Brexit Vote Probabilities



Source: PredictWise

US Presidential Vote Probabilities



Source: Wall Street Journal

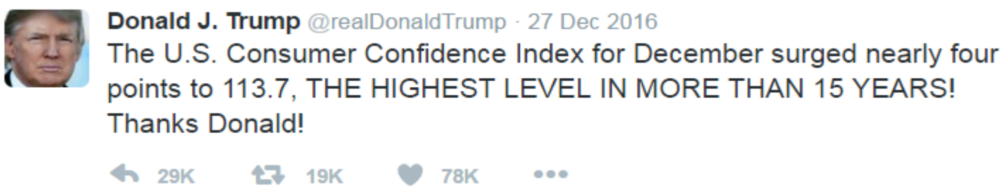
The ASX and U.S. futures markets traded progressively lower during the day as the Trump election victory became increasingly likely, with 'beta' names (cyclical stocks with more market exposure) selling off sharply as the market took a 'risk-off' stance. The market sentiment however took a 180 degree turn following Donald Trump's victory speech, which was seen as much more moderate (and even Presidential) than many predicted he would give (and indeed was capable of). Instead of being seen as a dangerous and protectionist leader, markets suddenly lauded Trump as a pro-business Republican, capable of restoring robust economic growth. Commodities rallied particularly hard on the back of Trump's $500bn infrastructure plan to 'rebuild' America (with the exception of gold, which is seen as a safe-haven asset).

Since the election, we have found that monitoring Donald Trump's twitter feed (@realDonaldTrump) has become necessary given his ability to move markets 140 characters at a time. Some of the tweets sent out by Trump could be seen as amusing, if only they weren't being sent out by someone who was about to become the leader of the free world.

An interesting trend we have observed since the election outcome has been the return of 'animal spirits' in the US economy. Consumer confidence for example is at its highest level since 2001. According to President Elect Trump, this was due to his influence.

"The world was gloomy before I won – there was no hope. Now the market is up nearly 10% and Christmas spending is over a trillion dollars!" Donald Trump (via Twitter), President Elect of the United States, 26/12/2016

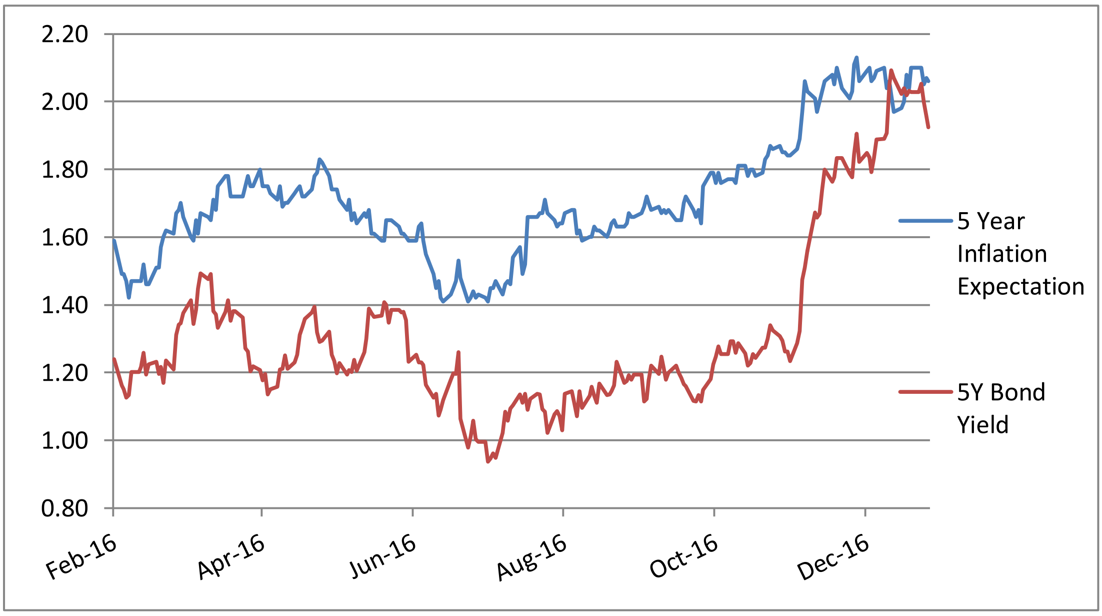
Source: Investing.com



Source: Twitter

Related to consumer confidence increasing, inflation expectations and Treasury yields have also shot up post the election outcome. We suspect a Trump administration will be required to issue a significant amount of Treasuries to fund its planned infrastructure spend.

US 5 Year Bond Yield and Inflation Expectation

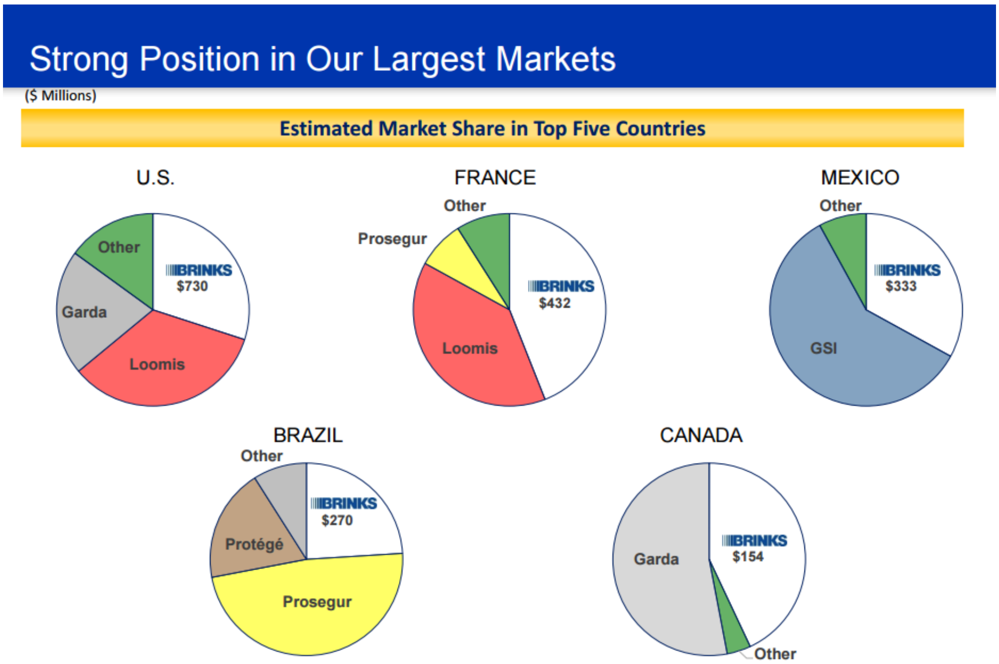


Source: Bloomberg

"The message from history is so blatantly obvious – that free trade causes mutual prosperity while protectionism causes poverty – that it seems incredible that anybody ever thinks otherwise." Matt Ridley, The Rational Optimist, 2010

Brink's

During the quarter we increased our position in The Brink's Company (Brink's), having initiated the position in the September 2016 quarter. Headquartered in the US, Brink's is the largest global provider of secure transportation of valuables and cash management services, generating revenue of US$3bn and operating in 41 countries. Approximately half of Brink's revenue is generated from 'core' services including the secure transportation of cash in armoured trucks and from servicing automatic teller machines. The other half of Brink's revenue is generated from 'high-value' services including global transportation of valuables, outsourced cash management for banks and providing secure 'smart' vaults to retail customers. Brink's holds an approximate 20% market share globally with a top 2 share in each of its five largest markets being the US, Canada, Brazil, Mexico and France (see picture below). Approximately 75% of Brink's revenue is generated outside the US.



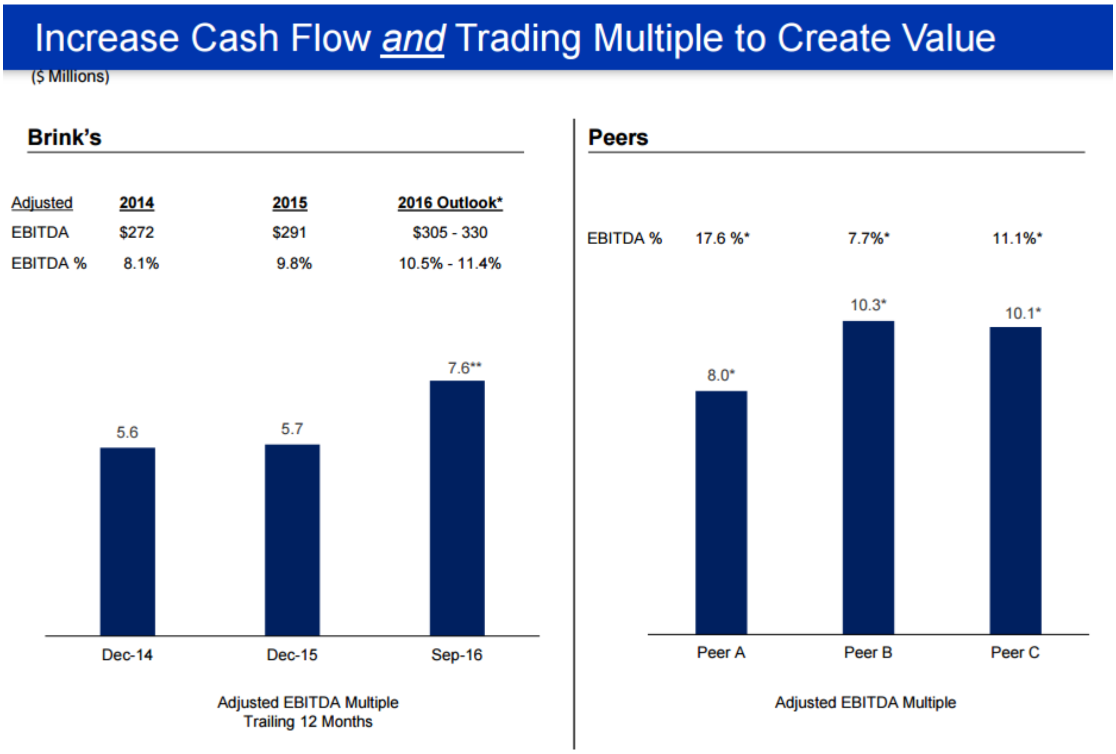
Source: Brink's

Brink's is listed on the New York Stock Exchange (ticker BCO). We were alerted to the opportunity in Brink's when they appointed Doug Pertz as their new CEO in June 2016. Doug was previously the CEO of Recall Holdings (Recall) which we had a large holding in and have written about in previous quarterlies. Having been a large shareholder in Recall until it was acquired by Iron Mountain Inc. in early 2016, we have gotten to know Doug well and view him as a passionate and energetic CEO who is focused on increasing shareholder value. He has a strong history of executing on turnarounds and driving shareholder value through industry consolidation.

"The U.S. is one of our greatest challenges, but it also represents one of our biggest opportunities." Doug Pertz, CEO of Brink's, 08/12/2016

Brink's is a turnaround opportunity. As the large incumbent for many years, Brink's had taken its customers for granted and allowed its competitors to win market share from them. Previous management teams had failed to respond to competitive pressures, lagging competitors in both customer value proposition (e.g. price, innovation) and operational performance. The most prominent example of this is in the US where it is now the 2nd largest player behind competitor Loomis (a Swedish company who competes with Brink's in the US and Europe). Five years ago, Loomis generated only approximately 80% of the revenue that Brink's generated in the US. In addition to growing twice as fast as Brink's over this period, Loomis expanded its margins while Brink's experienced a margin decline. At a group level, Loomis' margins are >50% higher than Brink's.

Given our experience with Doug, we believe that he will be successful in turning around Brink's fortunes by applying a similar strategy to that which he successfully implemented at Recall. Specifically, he will accelerate revenue growth (both organic and acquisitive), close the margin gap to Loomis (which is achievable based on our industry research) and introduce differentiated services to add value for customers and shareholders. Should he be successful with this strategy, we believe that he can increase earnings by at least 50% over the next 2-3 years and attract a higher trading multiple more in line with peers (see picture below) making the stock an attractive investment today. Longer-term we see potential opportunity for Brink's to be involved in industry consolidation which could add more value for shareholders.



Source: Brink's

Offshore Trips

During the quarter we travelled to the US, UK, China and Europe

US media observations

Within the US media industry, there's growing momentum around providing a better "over the top" product offering which recognises that content delivery has changed. This is critical to addressing the 20 million households who don't have a cable subscription, along with providing a product to those who are looking to transition to IP delivery. Direct TV Now launched at aggressive price points (vs cable) with Hulu (partly owned by FOX) confirmed to follow in the first half of CY17. Importantly for content owners such as FOX, the economics are generally as good as a subscriber on traditional cable.

China observations

- Following a sharp economic slowdown in late 2015, China stimulated its economy during 2016 (predominantly targeted at the property sector) resulting in uplift in confidence and economic growth through 2016 that exceeded market expectations. As an example, steel consumption in China in 2016 grew approximately 1-2% vs. consensus expectations at the start of 2016 of negative growth.

- Combined with supply-side discipline (e.g. some miners electing to reduce production, China Government policy restricting coal production) and low levels of physical inventories across commodities supply chains in China, commodity prices rallied strongly through 2016 with a subsequent strong lift in share prices of resources companies.

"The arbitrary growth target of 6.5 percent has become not only an impediment to the necessary structural adjustments but also a culprit for rapidly rising debt risk." Yao Wei, Chief China economist, Societe Generale, 23/12/2016

- On early indications, 2017 appears to be another year of demand and economic growth at-or-above market expectations, as infrastructure stimulus should offset any slowdown in the property industry which saw tightening measures introduced in the fourth quarter of 2016. However, unlike 2016, we expect to see the supply-side responding to the positive commodity price signals and accelerate production growth, which should see supply chains restock and ultimately put downwards pressure on commodity prices in the year ahead.

Outlook

We said last quarter we thought the uncertainty of the US election was being priced in by the market, and now post a Trump victory, the uncertainty discount has unwound. The continued solid US macro data and Trump commentary about tax cuts and large scale infrastructure spending has led to increased inflation expectations, which is driving a large reflation rotation trade towards risk assets. We have been surprised by the degree of animal spirits and bullishness driving the global market rally, but we observe it has been partly fuelled by accelerating Chinese capital outflows and the US dollar carry trade also attracting money from Europe, the UK and emerging markets.

Fundamentally we observe better US economic data and sentiment, flat Europe (still) and China hanging in there (despite relentless capital outflows and credit growth). Australia remains patchy but business sentiment has continued its improvement which we highlighted last quarter.

Looking forward to the next reporting period, we don't expect much in the way of upside risk despite expectations being lowered during the AGM season. Given the strength of the recent equities rally we are again erring on the side of caution as forecast Earnings Per Share growth acceleration doesn't seem likely based on our contact with companies, and Price to Earnings multiple expansion will be difficult with early signs of inflation becoming evident (mainly in the US). The recent sell off of some high quality stocks has created some attractive stock picking opportunities. Greencape remains committed to applying our process and adding to positions when our conviction warrants it.

"It's waiting that helps you as an investor, and a lot of people just can't stand to wait. If you didn't get the deferred-gratification gene, you've got to work very hard to overcome that." Charlie Munger, Vice Chairman of Berkshire Hathaway, 2014

More information

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

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