Greencape High Conviction Fund

Quarterly report - March 2018

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Inception % p.a.
Fund return	-2.24	9.80	6.07	9.61	7.54	9.36
Growth return	-3.00	3.81	-1.97	2.13	1.88	3.24
Distribution return	0.76	5.99	8.04	7.48	5.66	6.12
S&P/ASX 200 Accumulation Index	-3.86	2.54	3.76	7.66	5.35	5.76
Active return^	1.62	7.26	2.31	1.96	2.19	3.60

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'.

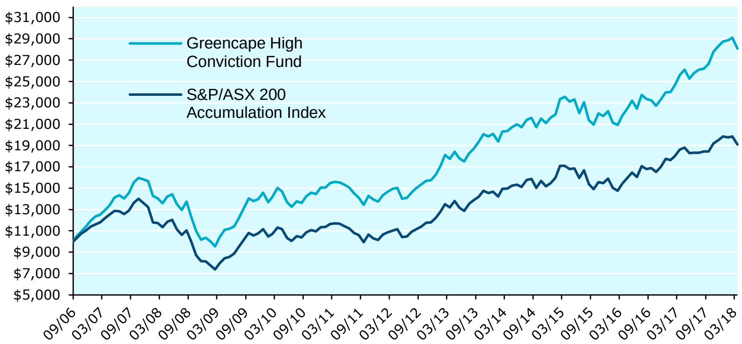
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

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

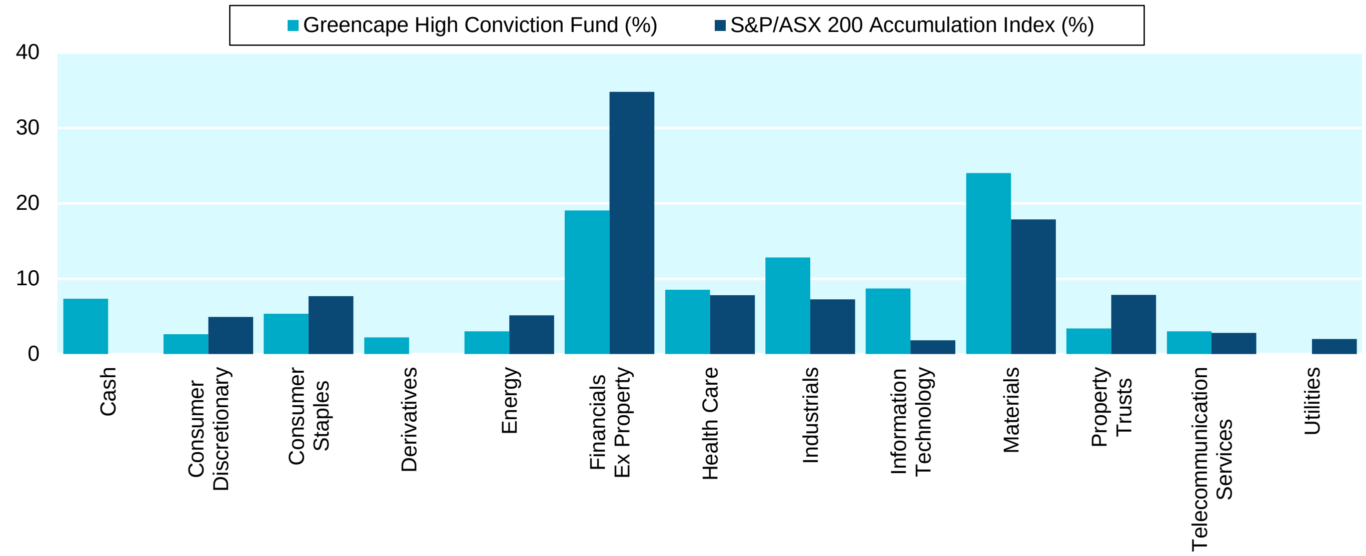


Asset allocation	Actual %	Range %
Security	92.65	85-100
Cash	7.35	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0035AU

Fees	
Entry fee	Nil
2016-2017 ICR	1.03%
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 March 2018



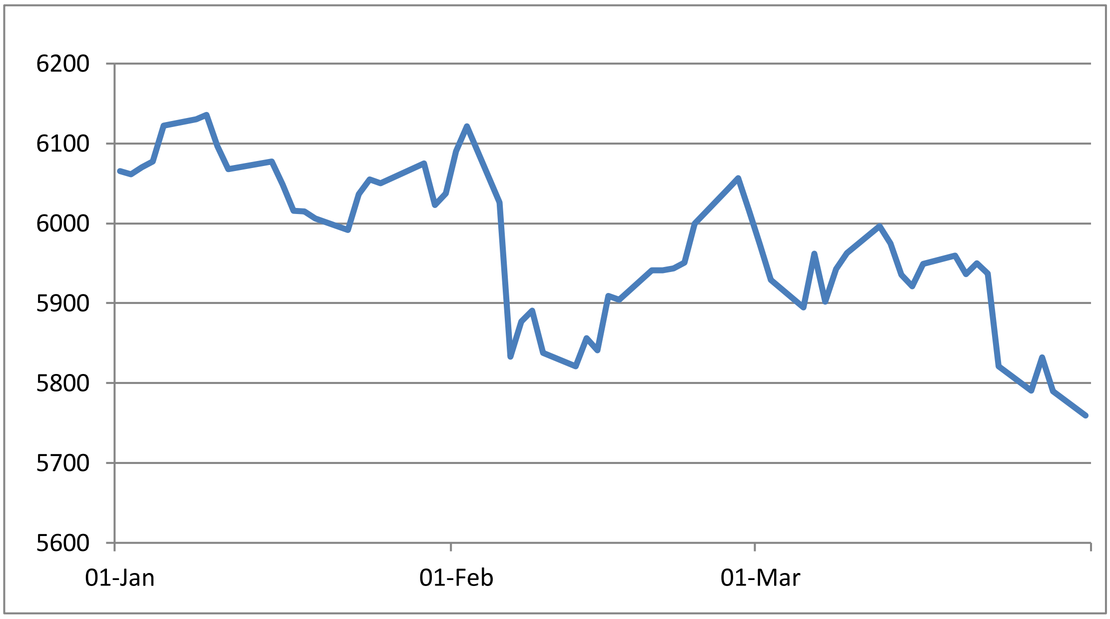
Fund performance summary

The S&P/ASX 200 Accumulation Index returned -3.86% for the quarter. The fund outperformed the market and delivered a -2.24% return over the quarter.

Market overview

Following a subdued 2017, volatility struck global markets with a vengeance at the start of 2018, after a strong wage print in the US spiked inflation expectations. Locally, investor attention was focused on the February reporting season, which was relatively uneventful compared to the August 2017 season. Big price swings weren't confined to traditional markets during the period, with the price of Cryptocurrencies coming back to earth following their huge run late last year. The quarter was rounded out with an extra bout of volatility in equity markets, this time triggered by news flow related to global tech names.

S&P/ASX 200 Index



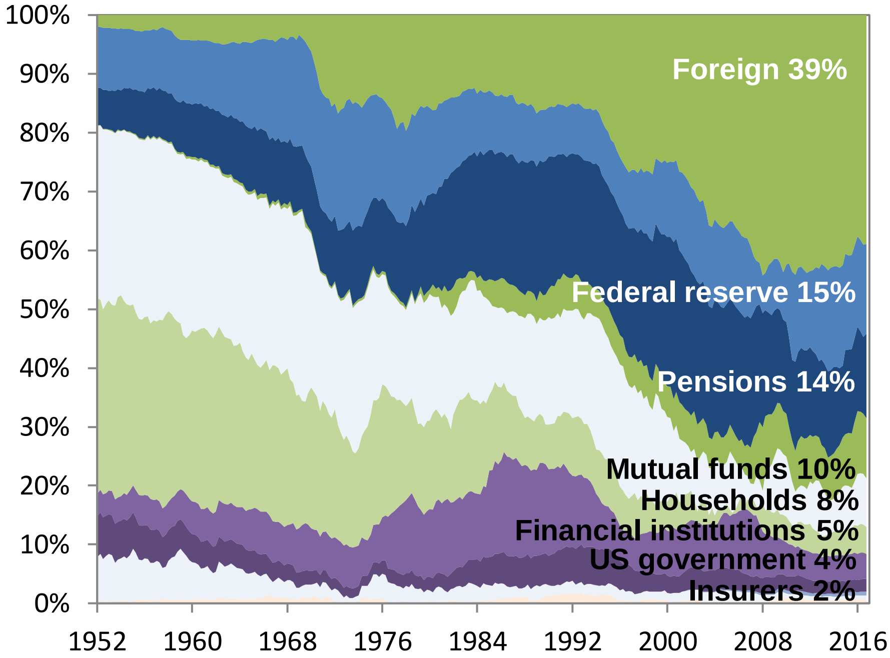
Source: IRESS

As expected the Reserve Bank of Australia kept rates on hold at both meetings held during the quarter, keeping the rate at a record low of 1.5%. Whilst three months ago a rate hike was priced in to occur at the October 2018 meeting, market volatility has tempered expectations, with the rate hike now not being expected at all this calendar year. Data prints were generally disappointing during the quarter. Retail sales for December were -0.5%, missing market expectations of a 0.2% decline. Market commentators suggested the miss was due to retail discounting starting earlier in the season, partially explained by the increasing relevance of online sales events such as Singles Day and Click Frenzy which fall in November.

"In some areas, asset prices are elevated relative to their historical norms." Jerome Powell, Chairman of the Federal Reserve, 21/03/2018

After enjoying a prolonged period of 'Goldilocks' economic growth, whereby data was strong but not strong enough to spike inflation. A post-crisis high reading of the US average hourly earnings of +2.9% (against market expectations of +2.6%), sent bond markets into a tailspin as yields spiked even higher. The ensuing volatility wiped out a number of sizable investment strategies which bet against volatility, and the resultant unwinding of these strategies further compounded the magnitude of the sell-off. To give an indication of the re-emergence of volatility this year; in 2017 there were 8 total 1% or greater moves in the S&P500 index, and in the first three months of 2018 alone there were 23.

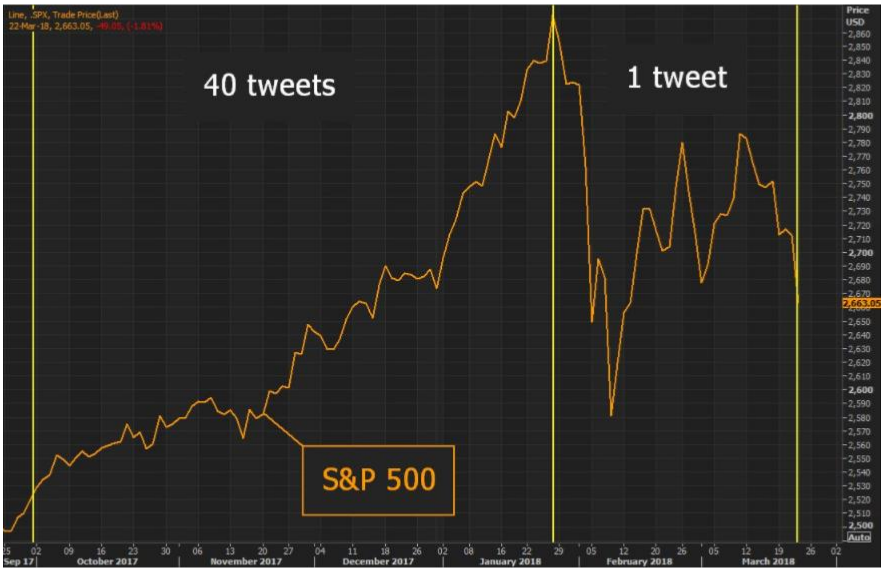
We note that foreigners are the largest holders of US government bonds. This makes for an interesting dynamic in the event the US government announces policy which antagonises these foreign holders.



Source: FRB, Haver Analytics, Goldman Sachs Global Investment Research

Late in the quarter it was revealed that data firm Cambridge Analytica harvested information on 50 million Facebook users, which were used to identify user personalities and influence their voting behaviour with customised political advertisements. These revelations not only impacted Facebook (which lost USD$75 billion in market cap in the two weeks following the story), but the mega cap tech sector which had strongly outperformed market indexes over the past year. These issues were compounded further when President Donald Trump expressed his displeasure with Amazon in late March. He claimed the company used the US Postal Service as its “Delivery Boy (causing tremendous loss to the U.S.)”, while putting traditional tax paying retailers out of business.

Whilst the President was quick to tweet his joy of seeing the stock market climb, it appears he is less keen to mention market movements when it goes the other way



Source: Twitter (@ReutersJamie)

“In the “old days,” when good news was reported, the Stock Market would go up. Today, when good news is reported, the Stock Market goes down. Big mistake, and we have so much good (great) news about the economy!” Donald Trump, President of the United States of America, 07/02/2018

Cryptocurrencies (Crypto) sold off harshly during the quarter, as supernormal gains achieved late last year were quickly erased. Despite the selloff, the eyebrow raising Cryptocurrency news flow did not subside. An Initial Coin Offering (ICO) which caught our eye was 'LivenCoin', a dining rewards based payment system. As far as we can tell, investors in the ICO (of which the minimum buy in was $10,000 worth of Ethereum) purchase LivenCoins which can be redeemed at fast food partner restaurants who offer discounts between 15% of 25% off a patron's bill. We are unsure why an investor would wish to effectively prepay $10,000 worth of fast food to score a discount, but then again, we do not profess to understand the intricacies of the Crypto market and what motivates investors in the asset class.

	Mar 2018 Quarter	Year ended Mar 2018
ASX200 Accumulation Index	-3.90%	2.50%
Best Performing Sectors		
Healthcare	6.90%	17.50%
Info Tech	1.60%	24.70%
Consumer Staples	0.40%	8.90%
Worst Performing Sectors		
Telecom	-11.00%	-26.60%
Utilities	-6.90%	-8.30%
Energy	6.60%	11.60%

Locally, investors were focused on the February reporting season which was largely seen as positive, as earnings 'beats' exceeded 'misses' approximately 2 to 1. Result highlights included A2 Milk, whose result demonstrated accelerating growth in infant formula sales. The company also announced a wide-ranging agreement with Fonterra, which includes manufacturing, supply and geographic expansion to South East Asia. Conversely, a result which missed market expectations was retailer Harvey Norman. Despite strong comparable sales of 4.1% in the second half, investors were concerned with Franchise Operating Margins declining 44 basis points to 5.57% due to increased costs, including tactical support payments to franchisees.

Healthcare stocks performed well on the back of CSL (which constitutes the majority of the index) posting a better than expected result on the back of stronger sales in Seqirus and speciality products. Telecoms and Utilities both underperformed, as investors rotated out of bond like equities as interest rates rose.

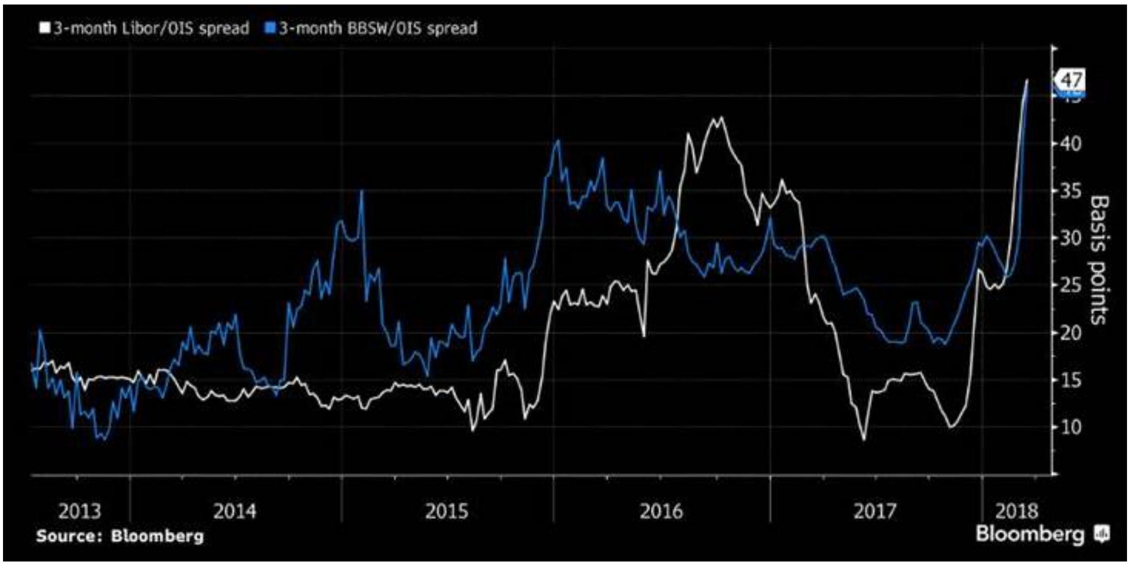
Banks

Banks were firmly under the spotlight during the period as the first round of public hearings kicked off in the Banking Royal Commission, which was primarily focused on misconduct by the banks in their consumer lending practices. We found some of the revelations which came to light during the first round, were particularly intriguing. ANZ admitted the bank didn't cross check expense information, even when the customer had an ANZ credit card/bank account. Meanwhile NAB, via its 'Introducer Program', incentivises small businesses to refer their customers to the bank, with the ability to earn commission for the referral based on the size of the loan. It was revealed a fraud ring operating within a Western Sydney NAB branch concocted a scheme to use the Introducer program to organise mortgages unsuitable for the loan applicants. The scheme allegedly involved 40 staff members who initiated over 2000 loans.

"The use of loan size linked with upfront and trailing commissions for third parties can lead to poor customer outcomes." Ian Narev, CEO of CBA, February 2017

Mortgage brokers were a particular focus, with representatives from CBA quizzed over the practices of Aussie (its fully owned mortgage broker subsidiary). The bank admitted there was a conflict of interest in the commission structure paid to brokers, given they are incentivised to recommend the largest (and longest) loan possible in order to maximise their commission. The bank reasoned that despite acknowledging the conflict, it couldn't move away from the volume based commission model as the first mover would likely lose substantial market share. Given the Royal Commission's focus on the broking industry, we believe the current incentive structure of commissions will change. The market seems to agree, as shares in Mortgage Choice (a listed mortgage broker) fell 25% during March, with no company specific news being released.

The Royal Commission wasn't the only headache for the major banks during the period. Funding costs also came into focus, with the BBSW spiking during March as shown below.



"If money is more expensive, asset prices must fall." Peter Cosetllo, Chairman of the Future Fund, 20/03/2018

No single event was attributable for the jump in rates; instead it is believed a confluence of factors in combination pushed the rate higher. Firstly, as shown above, the BBSW is somewhat correlated to the US Libor, as Australian banks borrow in Libor and then convert into AUD. The two main factors affecting the US rate were the US Treasury issuing increasing amounts of short term debt, and also the repatriation of offshore cash held in short term instruments. In Australia, market feedback has suggested foreign investors are lending out Aussie bonds acquired in the repo market, which is also working to push up rates.

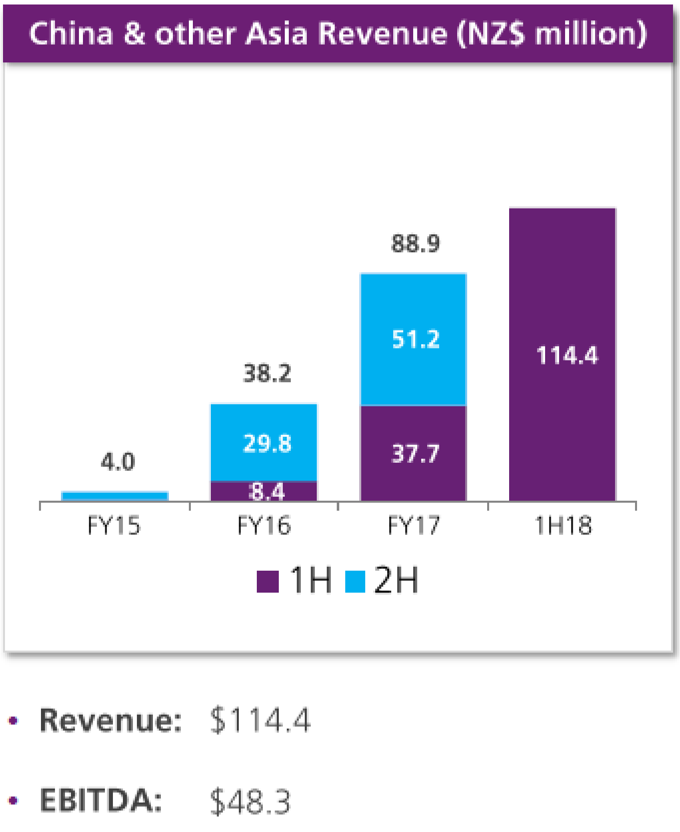
As Australian banks are partly funded from offshore, an increase in borrowing costs would put pressure on Net Interest Margins (NIM), a metric which is heavily scrutinised by investors. Suncorp (who has not yet been under the Royal Commission spotlight) raised variable interest rates on home loans by 5-12 basis points, citing the increase in the BBSW as a factor in their decision. Given the current focus on banks from the Royal Commission, we believe an out of cycle mortgage rate increase by the major banks would be a brave move.

A2 Milk

We last wrote about the a2 Milk Company (A2M) in our December 2015 quarterly report. Since then, the company under the leadership of CEO Geoff Babidge has continued to perform exceptionally well and has exceeded all (including our own lofty) expectations. This has seen its share price lift from $1.70 at the end of 2015 to $12 at the time of writing, with a market capitalisation of ~$9bn and recent inclusion into the ASX100 index. Such is the company's earnings power and still early stage in its growth trajectory, it generated $143m in earnings before interest, tax, depreciation and amortisation (EBITDA) in the first half of financial year 2018 (FY18) which was larger than the $141m in EBITDA that it generated in the entire FY17.

"The single most important decision in evaluating a business is pricing power. If you've got the power to raise prices without losing business to a competitor, you've got a very good business." Warren Buffet, Chairman of Berkshire Hathaway, 26/05/2010

The major factor driving this performance has been A2M's success in gaining market share in the Chinese infant formula (IF) market. From a starting point of zero in 2014, A2M now has a market share of approximately 5.4% in Chinese Tier 1 cities for the quarter ending December 2017. Whilst the majority of this market share is from English-labelled product sourced indirectly out of Australia, A2M has been successful in developing a direct Chinese-labelled business into over 7,000 mother and baby stores throughout China, which now accounts for 12% of their IF sales. A2M's management of the Chinese regulatory landscape and the numerous sales channels into China over the past few years has been best-in-class. Our confidence in A2M ultimately achieving a ~10% market share in IF in China, continues to increase which helps underwrite a valuation over time in excess of the current share price.



Source: Company reports

Although IF at 80% of A2M's revenue is the main earnings driver, the company is progressing well across its other products and geographies. In Australia, fresh milk continues to grow market share and the company recently reached a favourable settlement with Lion Dairy which restricts Lion's use of the words 'A2 Protein' on their labelling, which serves to protect A2M's differentiated brand proposition. In the US, fresh milk sales continue to build momentum with a recent expansion of distribution into the important North-East market a positive sign. To further advance its geographical reach into South-East Asia and the Middle East, A2M recently signed a comprehensive supply agreement with Fonterra to supply IF (along with other non-IF products) sourced from Australia and NZ. Importantly, this agreement also locks up the majority of A2 protein milk supply in Australia and NZ (controlled by Synlait and Fonterra) which serves to protect A2M's business as new entrants look to enter the A2 Protein space.

Of course, success attracts detractors and recently we have seen an increase in negative opinions and commentary on A2M. Most of this has been either factually incorrect (e.g. one commentator completely ignoring that A2M sell IF to China and instead claiming that A2M needs to earn twice the entire profit pool of Australia to justifying its valuation) or biased (e.g. using PE ratios based on prior earnings to claim the stock is expensive rather than using forward earnings which are more applicable for fast growing companies). However, we believe that some commentary around the recent entry of Nestle into the A2 Protein space in China is on point. The entry of the largest dairy products company globally into the A2 Protein space can be viewed either negatively (will take market share from A2M) or positively (will grow the entire A2 Protein market size). As yet we don't have a definitive view on this market development but combined with the strong share price reaction in February post the 1H FY18 result and the CEO change set for mid-2018, we have reduced the size of our A2M position in the portfolio. Whilst we are still confident in the long-term story and an ultimate valuation above the current price, market expectations now more closely reflect reality, and long-term value optionality from geographic and product expansions are also better reflected in the current share price.

"The biggest lesson learnt... was that a sense of urgency needs to be an ever-present thing and we must always strive, challenge and remain productively paranoid.'' Andrew Basset, CEO of Seek, 11/11/2017

Offshore Trips

This quarter we travelled to the US on four separate occasions, the UK, Singapore and Malaysia.

US Observations

- The last 12 months has seen a huge step change in Datacentre computing power demand, with growth accelerating (albeit off a low base). People we spoke to believe we are still in the infancy of this trend, with likely winners in the space to be those with already dominant market positions.
- Data remains critical in the effort to leverage greater advertising dollars. Computing power and AI are hugely important in these efforts. Despite the recent controversy, Facebook and Google are still the best placed to succeed here.
- The FOX/Disney deal could reshape the entertainment landscape, as the deal will enable the combined company to compete more effectively with Netflix.
- Large talent agencies now have specialist social media units to help manage talent and 'influencers'. There is an increasing trend to structure endorsement deals in reference to social media engagement metrics.
- We continue to be convicted in an elongated US housing cycles based on the notion that first home buyers are still in the relative infancy of their own cycle.

Outlook

US interest rates, global trade policy uncertainty and the Australian banking Royal Commission were considered the key market drivers this quarter. The noise was so loud, the relatively solid reporting season and its theme of building inflation was largely drowned out.

Greencape remain focussed on shareholder stewardship as a key value driver for our portfolios. The speed of the February sell-off (especially in the tech names) highlights the elevated positive sentiment and complacency that has been building in equity markets. Good shareholder stewardship involves the effective management of market expectations, in our view. This attribute only grows in importance as the bull market matures.

Currently, we are seeing the cross currents of encouraging bottom up macro drivers, combined with heightened geopolitical risk and macro policy risk. Therefore, we remain generally cautious with higher than usual cash levels, whilst selectively topping and tailing long duration quality stocks with value adding shareholder stewardship.

"This market reset is vulnerable to technical amplification, particularly because of "crowded trades" in tech and credit, along with the overpromising of liquidity associated with the recent proliferation of certain exchange-traded funds and the extent to which some investors have overstretched in pursuit of returns." Mohamed Aly El-Erian, Chief Economic Officer, Allianz, 20/03/2018

More information

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