Greencape High Conviction Fund

Quarterly report - June 2018

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Inception % p.a.
Fund return	8.95	18.64	11.60	11.82	8.54	9.95
Growth return	-0.81	6.05	3.82	2.50	2.25	3.10
Distribution return	9.77	12.59	7.78	9.32	6.29	6.85
S&P/ASX 200 Accumulation Index	8.47	13.01	9.05	9.98	6.41	6.36
Active return^	0.48	5.62	2.55	1.84	2.13	3.59

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'.

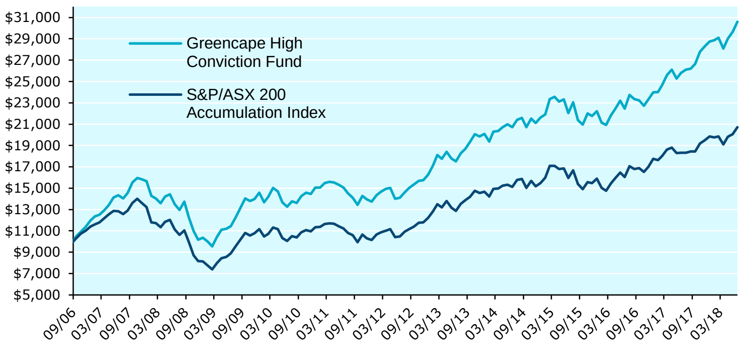
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

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

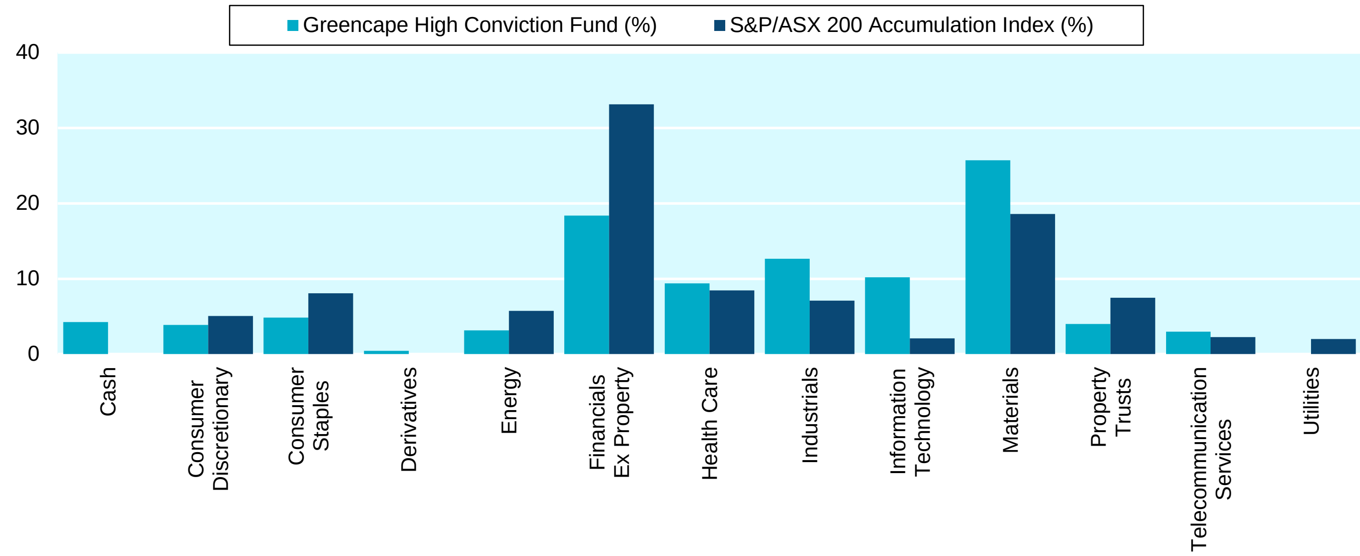


Asset allocation	Actual %	Range %
Security	95.73	85-100
Cash	4.27	0-15

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 30 June 2018



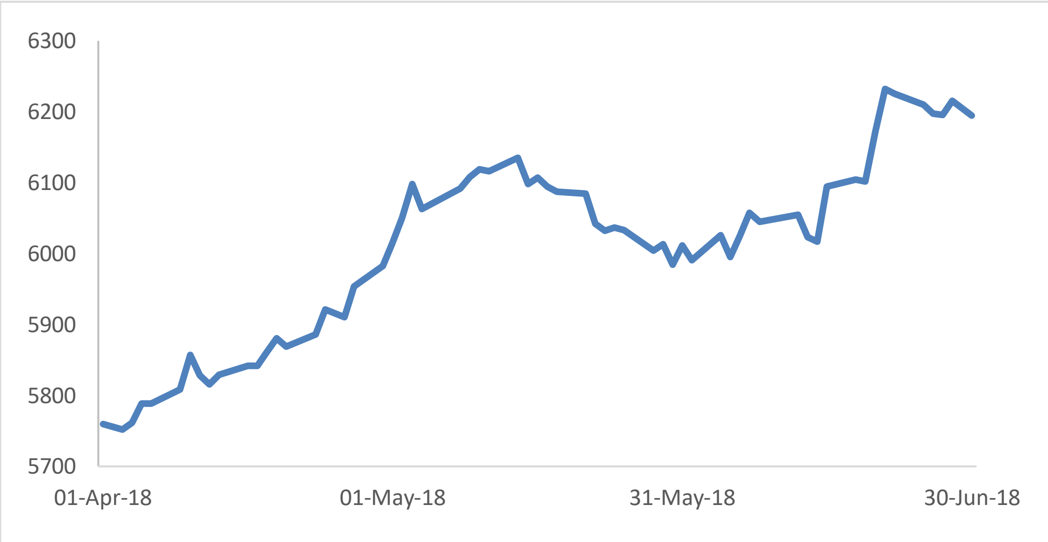
Fund performance summary

The S&P/ASX 200 Accumulation Index returned +8.47% for the quarter. The fund outperformed the market and delivered a +8.95% return over the quarter.

Market overview

The market seemingly brushed off any concerns of a global trade war during the period, as the index posted its strongest quarterly gain for three years to round out the financial year. Geopolitical tensions continued to simmer in the background, as investors watched the historic meeting between President Trump and Kim Jong Un with bated breath. Locally, investors continued to be shocked by the revelations from the Royal Commission into Financial Services, with the fallout claiming the scalps of a number of high-profile executives.

S&P/ASX 200 Index



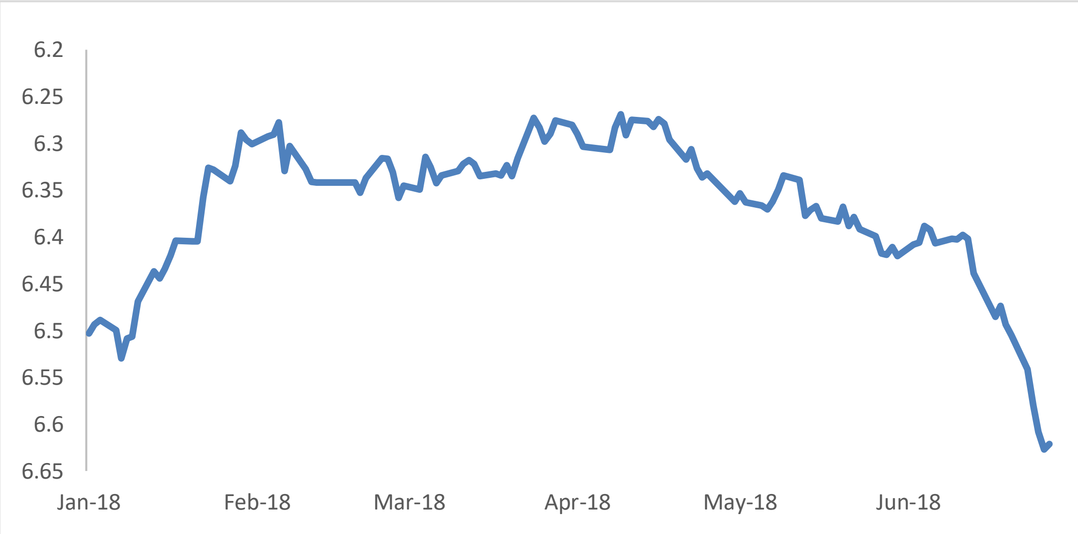
S&P/ASX 200 Accumulation Index Financial Year Returns Since 1999

Uncertainty around the first Tuesday of the month feels like a distant memory for investors, with the Reserve Bank of Australia (RBA) interest rate decision having now been a foregone conclusion for several years. As expected, the RBA kept the cash rate target at a record low of 1.50% at all three meetings during the quarter (the rate at which it has been since August 2016). According to the futures market, the first hike is not expected to occur until July 2019. Local economic data was mixed during the quarter. First Quarter (Q1) Gross Domestic Product (GDP) was +1%, marginally beating the consensus of +0.9%. Building approvals however continued to miss market expectations, as May showed a 3% increase year on year, versus the market at 10% growth. The Federal Budget had a relatively benign impact on listed companies compared to previous years, with impacts more confined to a small number of individual stocks rather than to whole sectors. In April, Prime Minister Turnbull's government lost a 30th consecutive Newspoll in April, which awkwardly was one of the triggers of his leadership challenge to Tony Abbott in 2015.

Globally, focus again was on the Twitter feed of the US President, as investors sought any indication of Trump's next move on trade. The President currently has a full plate, flexing his muscles across three trade fronts; China, Europe and Canada/Mexico (NAFTA). Most relevant to Australian investors is the China situation, which after having appeared to have settled down has now again escalated. Late in the quarter, Trump ordered trade officials to draw up a list of $200bn worth of Chinese goods that would be hit with an additional 10% tariff. The Chinese Commerce Ministry labelled Trump's latest move as 'extreme pressure and blackmail', whilst also pledging to retaliate. Worryingly, Trump has indicated his willingness to pursue tariffs on an additional $200bn worth of goods, which by then (along with previously announced tariffs) would encompass 90% of Chinese goods exported to the US.

Interestingly the Chinese government have let the Yuan weaken in June, making their exports more attractive in USD. There is a distinct possibility that Trump will call out this trend if it continues to persist

USDCNY (Inverted)

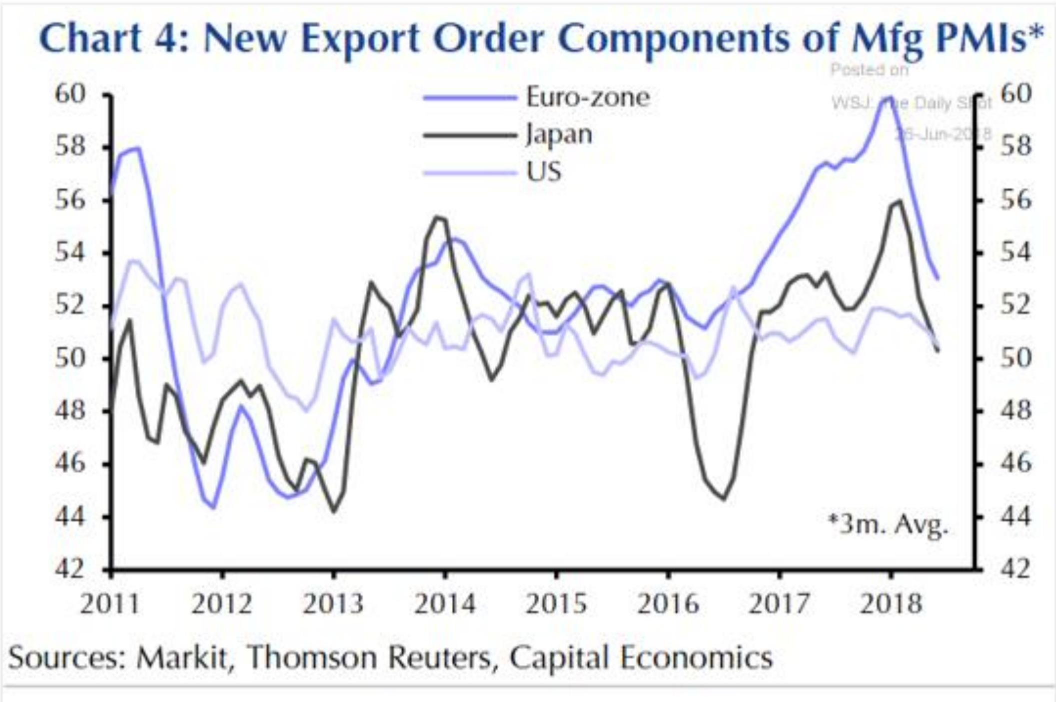


Source: Bloomberg

"This latest action by China clearly indicates its determination to keep the United States at a permanent and unfair disadvantage, which is reflected in our massive $376 billion trade imbalance in goods," Donald Trump, President of the United States of America, 19/06/2018

USD denominated debt issued by developing countries continued to balloon during the period. Below we can see the acceleration of debt issuance over recent years, with countries taking advantage of record low interest rates combined with low spreads. In the event we see rising global rates, coupled with a strengthening USD versus the developing country's currency, there could be potential for an emerging market currency crisis to play out.

‘Synchronised global growth’ was a popular phrase in Financial Year 2018 (FY18). There are some signs however pointing to momentum slowing, and even turning negative for global trade



Local market performance was buoyant during the period, with all sectors posting strong gains except for Telecommunications. The Australian market managed to be one of the best performing indexes globally over the quarter, seemingly benefitting from a weaker AUD and rotation out of Emerging Markets.

“Uncertainty surrounding the outlook had increased and caution was seen as warranted in interpreting recent developments, also because the moderation in growth appeared to be broad-based across countries and sectors." Mario Draghi, President of the ECB, 24/05/2018

	June 2018 Quarter	Year ended June 2018
ASX200 Accumulation Index	8.5%	13.0%
Best Performing Sectors		
Energy	19.7%	41.6%
Healthcare	16.5%	27.7%
Consumer Staples	11.9%	29.1%
Worst Performing Sectors		
Telecom	-13.7%	30.9%
Financials ex Property	4.1%	1.6%
Industrials	5.3%	7.1%

Energy was the best performing sector for both the quarter and the year, as the Organisation of the Petroleum Exporting Countries (OPEC) agreed to increase production quotas by less than market expectations. The oil market is not immune from President Trump's influence however, with the President revealing in a tweet he asked the King of Saudi Arabia to increase production to keep oil prices down.

Telecommunications was the worst performing sector for both the quarter and the year, driven by Telstra (which constitutes over 80% of the Telco index). In May at an offshore conference, management guided FY18 Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA) to the bottom of the previously guided range of $10.1-$10.6bn and also flagged challenging conditions to persist into FY19. Later in the quarter, the company held its 'Telstra 2022' Strategy Day where management laid out the long term plans of the business. Among the various announcements, Telstra announced guidance for FY19 which was 14% below market expectations. Of relevance to the company's large base of retail shareholders, there were no changes announced to the dividend policy. Despite the underperformance of Telstra's share price and optically cheap FY19 multiple of 12x, it should be noted that once the NBN payments cease, the Price to Earnings (P/E) 'resets' to 19x in FY21.

Banking

The Royal Commission into financial services continued during the quarter, with the ensuing fallout claiming several senior executives and Board members at AMP. Whilst the AMP situation was certainly headline grabbing, perhaps a more relevant implication of the Royal Commission was the impact to credit availability, as banks now need to undertake a more stringent analysis of buyer expenses. Many home buyers use their maximum borrowing capacity as their home price target; therefore, a reduction in borrowing capacity should lead to softer demand for housing.

UBS have attempted to quantify the impact of a reduction in borrowing capacity. The resultant percentage reductions in credit availability are by no means trivial.

Figure 5: Borrowing capacity scenarios (A$)

Gross Income	Prior HEM *	Prior Borrowing Limit	Prior Loan-to-Income	Scenario Living Expenses **	New Borrowing Limit	New Loan-to-Income	Reduction in credit availability
80,000	32,400	337,985	4.2x	50,000	195,912	2.4x	-42%
100,000	32,400	484,315	4.8x	58,320	327,000	3.3x	-32%
125,000	32,400	643,892	5.2x	68,320	465,615	3.7x	-28%
150,000	32,400	817,340	5.4x	78,320	538,622	3.6x	-34%
200,000	32,400	1,144,225	5.7x	88,320	792,804	4.0x	-31%
500,000	32,400	3,141,171	6.3x	108,320	2,472,763	4.9x	-21%

Source: Major Banks, UBS estimates. Note: the borrowing limits are based on a simple average of the four Major Banks' home loan calculators based on the inputs above. * Note: The prior HEM was not regularly adjusted by the banks for income until 6-12 months ago. ** Note: Scenario living expenses are based on UBS estimates of more realistic consumption levels.

Source: UBS

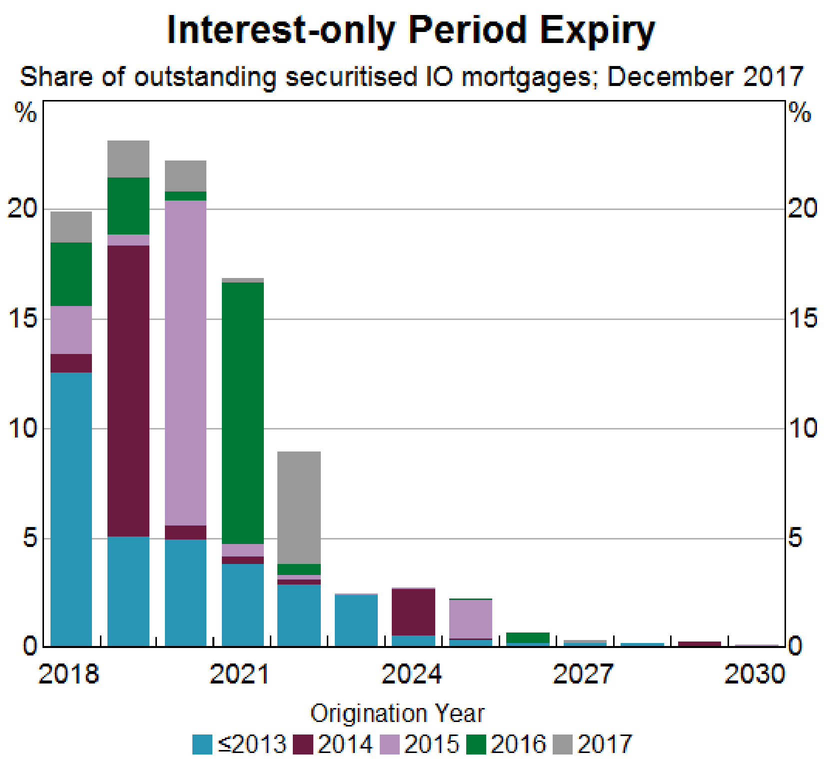
Furthermore, there are a number of sell side analysts with mid-single digit credit growth and minimal credit impairment charges in their forecasts. If credit growth is crimped by increased buyer scrutiny and credit charge increases from current low levels, the potential for profit downgrades by the major banks is high. The following table quantifies earnings sensitivities from lower loan growth and higher credit impairment charges.

Figure 14: Earnings sensitivities vs Consensus estimates – FY20E

NPAT % difference from consensus / Credit impairment charge (bp)	Total Credit Growth (%) -3%	-2%	-1%	0%	1%	2%	3%	4%	5%
10	-8.0%	-7.0%	-6.0%	-5.0%	-3.9%	-2.9%	-1.8%	-0.8%	0.3%
15	-10.7%	-9.7%	-8.8%	-7.8%	-6.8%	-5.7%	-4.7%	-3.7%	-2.7%
20	-13.4%	-12.5%	-11.5%	-10.5%	-9.6%	-8.6%	-7.6%	-6.6%	-5.6%
25	-16.1%	-15.2%	-14.3%	-13.3%	-12.4%	-11.4%	-10.5%	-9.5%	-8.6%
30	-18.8%	-17.9%	-17.0%	-16.1%	-15.2%	-14.3%	-13.4%	-12.4%	-11.5%
35	-21.5%	-20.6%	-19.8%	-18.9%	-18.0%	-17.1%	-16.2%	-15.3%	-14.4%
40	-24.2%	-23.3%	-22.5%	-21.7%	-20.8%	-20.0%	-19.1%	-18.3%	-17.4%
45	-26.8%	-26.1%	-25.2%	-24.4%	-23.6%	-22.8%	-22.0%	-21.2%	-20.3%
50	-29.5%	-28.8%	-28.0%	-27.2%	-26.4%	-25.7%	-24.9%	-24.1%	-23.3%

Source: UBS

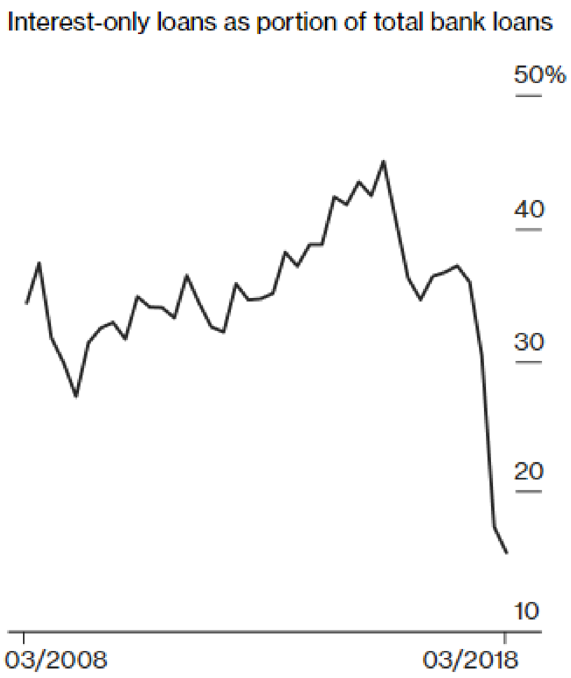
Another issue investors need to consider is the huge amount of interest-only loans which are due to 'reset' to Principle & Interest (P&I) loans in the coming years. Monthly repayment due dates increase substantially; a situation likely not budgeted for by all borrowers, given recent media reports of a substantial amount of borrowers unaware their payments are set to increase. Over time, in order to honour these repayments, discretionary spending is likely to be impacted over time.



Source: RBA

The housing boom was partly fuelled by investors borrowing with interest-only loans, which made up over 60% of investor loans originated between 2010 and 2016. Last year, The Australian Prudential Regulation Authority tightened the rules regarding interest-only loans, requiring banks to limit new interest-only lending to be no more than 30 per cent of new mortgage lending. After these new measures were implemented, the percentage of interest-only loans as total of new mortgages fell dramatically.

"If, however, a borrower spends the extra cash flow available to them during the interest-only period (compared with the alternative of a P&I loan), they will need to make sizeable adjustments when that ends… That will be more difficult and possibly come as a shock to the borrower if they haven't planned for it in advance." Christopher Kent, Assistant Governor of the RBA, 24/04/2018



Source: Bloomberg

Usually when an interest-only loan period ends, an investor is able to simply refinance with another. However given the current situation where credit availability has been tightened, this may not be possible for all borrowers, some of whom may be forced to sell the mortgaged property. Assuming credit availability remains tight, this could be a situation with increased supply but falling demand, a recipe for a softer market.

Nvidia

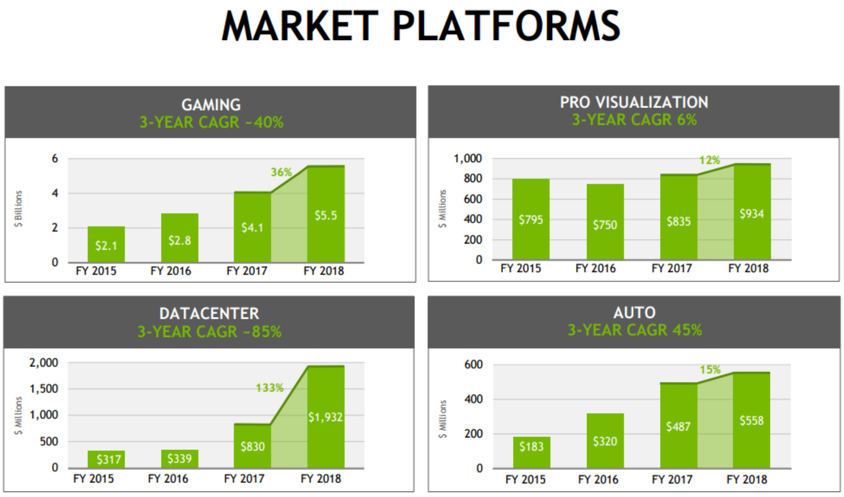
Founded more than 25 years ago in California, Nvidia now generates revenues of close to USD$10bn and continues to be managed by one of its co-founders, Jensen Huang. Our view is that the company is uniquely placed to benefit from a generational shift in compute technology over the coming years. Our fundamental research of NextDC, a portfolio owned stock helped develop our understanding of Nvidia. We believe that by investigating the future roadmap of various chip designers, game developers and cloud providers, in addition to engaging with the usual datacentre peers, we would better gauge the data demand environment. These participants are at the forefront of rapid data processing growth globally and Nvidia was a company which continually stood out during our research.

In gaming, Nvidia's brand is synonymous with performance graphics processing units (GPUs). More recently, it has been recognised that the parallel processing nature of GPU's can extend more broadly into other compute intensive use cases. This includes the training and inference (i.e. the application of already trained models) aspects of machine learning (ML) which is a necessary precursor to a range of Artificial intelligence (A.I.) applications such as self-driving cars and various cloud computing applications.

Nvidia's key competitive advantage is that the industry has adopted its 'CUDA' programming language as the de-facto standard. This ties its users to their ecosystem and means rather than selling just fast GPU's, Nvidia is seen as a fully integrated platform solution. Developers can leverage the wide array of CUDA software libraries to efficiently optimise the training and inference programs that are running on the GPUs which is critical given the A.I. developer space is competitive and speed to market is crucial. The demand for CUDA is also growing at a rapid rate. Over the last five years, CUDA downloads have increased fivefold to over 8 million, whilst GPU developers have increased ten-fold over the same period to over 800,000 as of earlier this year. To highlight how strongly entrenched the CUDA programming language is, it is now taught in the world's leading universities including Stanford and Oxford as part of ML and A.I. courses.

Our key takeaway here is that there is a vibrant and fast-growing ecosystem of CUDA trained developers, who should logically go on to develop their own software on the Nvidia platform in relation to ML and A.I applications.

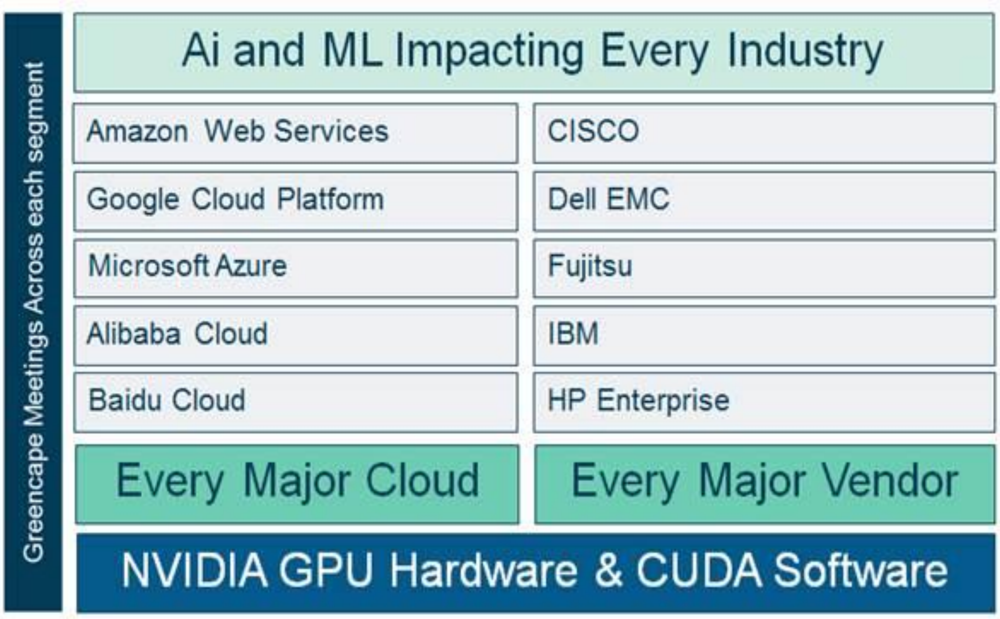
Going forward, we believe Nvidia's earnings growth is likely to come from three sources; its gaming, datacentre and automotive segments. Each of these segments has a different time frame or wave of growth. To give some context, we set out the relative size and historical pace of growth for each source below.



Source: Nvidia 2018 Investor Day

The first wave is coming from Gaming, which is the oldest and largest segment. We continue to expect solid momentum given a number of structural tailwinds at work. At a high level, population demographics help underwrite a growing worldwide gamer base particularly as emerging markets develop. Within the gaming segment, we recognise the potential application of GPUs in cryptocurrency mining, and whilst individual currencies themselves may remain volatile, it's the number of currencies being developed and mined overall that matters most.

The second wave of growth relates to data centre revenues. This has accelerated strongly, with growth in FY18 growth of over 130% to nearly USD $2bn. Nvidia has established relationships with all the major cloud providers, as well as the equipment manufacturers (refer to the below diagram). So far, Nvidia has identified a total addressable market of around USD $50bn, made up of the high-performance compute, hyper scale and cloud, and various industry uses for GPUs.



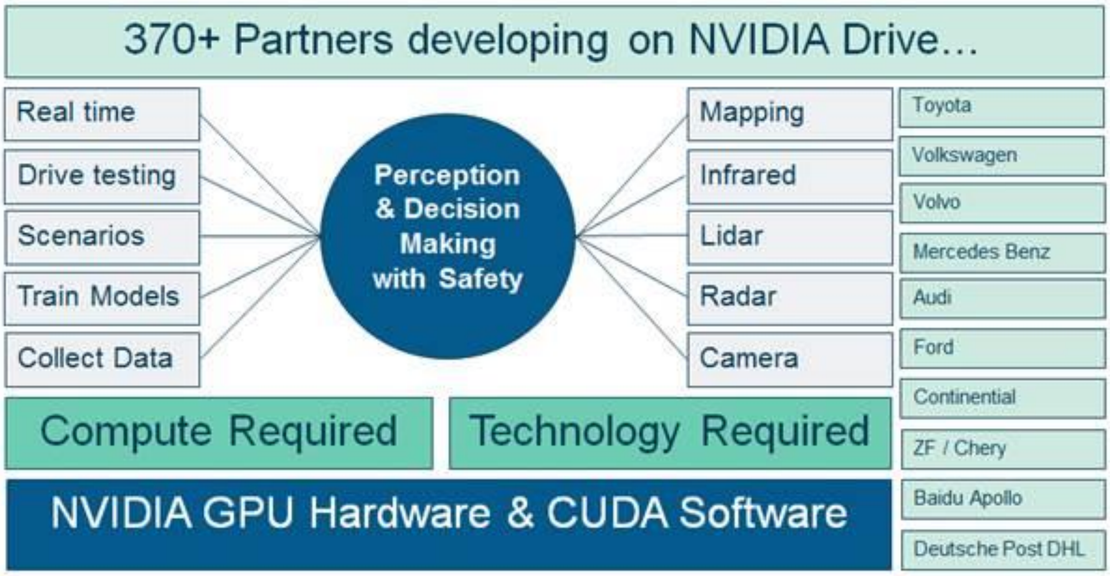
Source: Greencape

The third wave of growth revolves around autonomous vehicles. Over time, everything that moves will likely have some form of automation, but the largest opportunity remains autonomous cars. Major car manufacturers have programs in place which should see autonomous cars become a reality from around

"The number of Esports Enthusiasts worldwide will reach 165 million in 2018, a year on-year growth of +15.2%. The total Esports Audience will reach 380 million this year, a year-on-year growth of +13.5%." Peter Warman, CEO of Newzoo, 21/02/2018

2020 onwards, with Nvdia being a key partner to the majority of the industry's participants. The GPU is the compute engine that enables autonomy as it acts to combine and process various sensor technologies in real time. This is immensely data (and therefore compute) intensive, especially in order to maintain safety which is recognised as the key focus for autonomous cars.

"Driverless vehicles are going to change the playing field and open up so many new opportunities to provide personalised transport services." Andrew Constance, NSW Minister for Transport, 18/06/2018



Source: Greencape

Nvidia, being a US listed company will be subject to the volatility of quarterly reporting. This can lead to timing differences compared to market expectations from quarter to quarter. However, overall we believe that the medium to longer term upside we have discussed is compelling. NVDA's lead in general purpose GPU's and the ecosystem that has been built over it with CUDA, should support its standing as the market leader as innovation in ML / A.I. continues at a rapid rate in the coming years.

Offshore Trips

This quarter we travelled to the UK twice, China twice, Continental Europe and the US.

US Observations

- Autonomous cars are proving more difficult than anyone envisaged, so the solution is to throw more sensors and hence compute power in order to solve, which works well for Graphic Processing Unit (GPU) manufacturers such as NVDA. More compute power is required as additional sensors are loaded to increase safety and scenario test in real time. The industry is moving towards 'multi-sensor fusion' whereby the car takes information from radar and LIDAR cameras and overlays and processes everything together for real time decisions around depth perception, object identification etc. This helps cover those niche scenarios where individual technologies have limitations.

- There has been minimal practical impact from the recent Cambridge Data issues for Facebook. Contacts we spoke to recognised that it wasn't a Facebook breach, and that Cambridge had violated its terms. Comments from advertising partners ranged from "yet to see a single advertiser pull out" through to "it's only a bleep on the radar, a setback like this won't change such an effective tool and network".

- BMW data scientists have predicted that their own data storage requirements for the BMW Group will increase from 2.5pb of data per year to 100pb of data to be managed in the next 3 years, so a 40x increase. This indicates a huge growth rate of data storage and processing, which reads well for data centre demand growth.

Europe Observations

- Iress' momentum in the UK has improved given large reference sites have now gone live. Clients confirmed that efficiencies gains are occurring and importantly, they're now able to address a wider suite of clients as the wealth model in the UK becomes structurally more integrated. Also, smaller sized Iress implementations are being done at a faster pace with a new pre-customised option gaining traction. Whilst we were away, Intelliflo (Iress's key competitor in the small segment of the market) was purchased by Invesco. We received timely industry feedback that suggests genuine concern around vertically integration of Intelliflo within Invesco. In time this will place Iress in a strong position to take share of existing Intelliflo customers.

- The new GDPR (General Data Protection Regulation) will mainly be an issue for 3rd party data providers. These are companies who collect and aggregated data across a range of sources, often without consumer knowledge around its end use. Facebook gains permissions directly (via its terms of use), therefore they hold what's known as '1st party data'. By accepting, you acknowledge that Facebook will serve you targeted advertisements. Feedback from advertising partners is that the vast majority of Facebook users accept this, and they haven't seen a shift in advertising dollars due to GDPR. In fact, they anticipate that the limitations on 3rd party data will see the likes of FB get stronger in the long term as advertisers will have to rely on those companies with 1st party data.

- We gained further appreciation of what occurred in the French market once a 4th mobile operator was introduced. As one former CEO said, "The disruption in France has been brutal and fast. In less than 2 years they gained 15% market share". The French market had two years to prepare for the launch of Illiad's 'Free' brand, however, everyone still underestimated the impact. This is despite the brand effectively telling the opposition, via its name, one of its key strategies. The average price of French post-paid mobile bills dropped by around 40% in less than 3 months after Illiad's launch, and the total market didn't see growth for around 5 years. Illiad had 2 simple plans, one at €2 and the other at €20, which compared favourably to the average price at the time of around €40. If you were a broadband customer of Illiad already, then you received a €2 discount if you joined their new mobile offer, which meant that the lower priced offer was effectively 'free' as their branding suggested. This feedback suggests Telstra's mobile segment will remain under pressure going forward.

"We are seeing a level of demand that is unprecedented at any other time." Craig Scroggie, CEO of NextDC, 17/04/2018

Outlook

We are closely monitoring global inflationary trends, given their importance in influencing central bank policy and interest rates. An uptick in inflation is evident in the US and even in certain sectors in Australia. In the US, capacity utilisation has areas of constraint such as transport (due to labour) and home building (also due to labour and some materials such as lumber). We note that the Federal Reserve has acknowledged these factors in their recent meetings. We observe however there is less inflationary pressure in Europe. China meanwhile has experienced some inflation, driven in part by the weak currency, and thus rising commodity prices. We are also keeping a close eye on capital outflows from China in light of the recent currency weakness and escalation in trade war rhetoric.

Sentiment towards equities remains mixed. There is growing acknowledgement that the bull market is being driven by fewer stocks, whilst earnings updates below consensus expectations are being punished severely without a second thought being granted by the market. Approaching reporting season, market milestone scores will be increasingly important, whilst valuation and liquidity are also remaining front of mind. Our cash weights remain elevated as we find ourselves increasingly taking profits in selected holdings.

"If I'm happy at home, I come into work full of energy. If I'm happy at work, I go home full of energy. There is no trade off or a balance - it's circular." Jeff Bezos, CEO of Amazon, 07/05/2018

More information

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

Fidante Partners Investor Services team on: **13 51 53**

Visit the Greencape website: **www.greencapecapital.com.au**

Email Greencape at: **bdm@greencapecapital.com.au**

Financial advisers

For more information, please contact:

Fidante Partners Adviser Services

Phone: **+61 1800 195 853**

Email: **bdm@fidante.com.au**

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