Greencape High Conviction Fund

Quarterly report - March 2019

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Inception % p.a.
Fund return	10.62	8.27	11.75	8.38	11.30	9.27
Growth return	10.00	-3.34	4.02	-0.62	4.93	2.70
Distribution return	0.62	11.60	7.74	9.00	6.37	6.57
S&P/ASX 200 Accumulation Index	10.89	12.06	11.49	7.40	10.36	6.25
Active return^	-0.27	-3.80	0.27	0.97	0.94	3.03

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'.

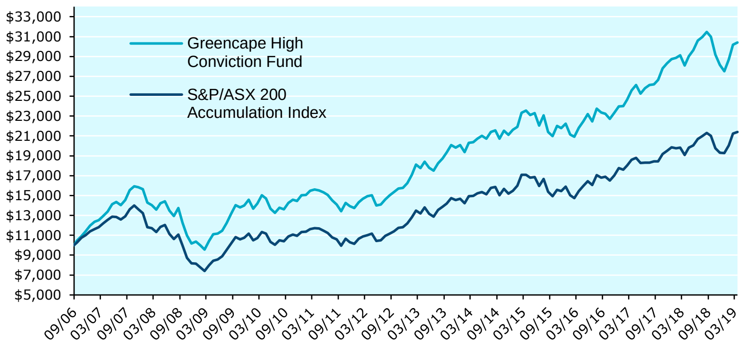
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

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

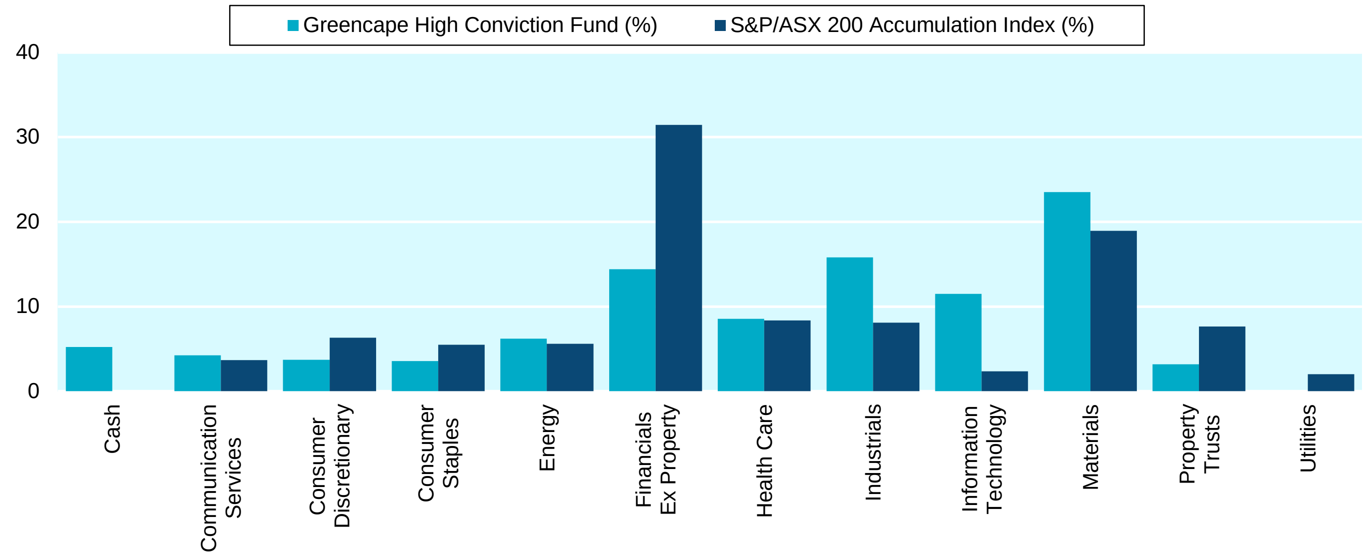


Asset allocation	Actual %	Range %
Security	94.76	85-100
Cash	5.24	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0035AU

Fees	
Entry fee	Nil
2017-2018 ICR	1.59%
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 2019



Fund performance summary

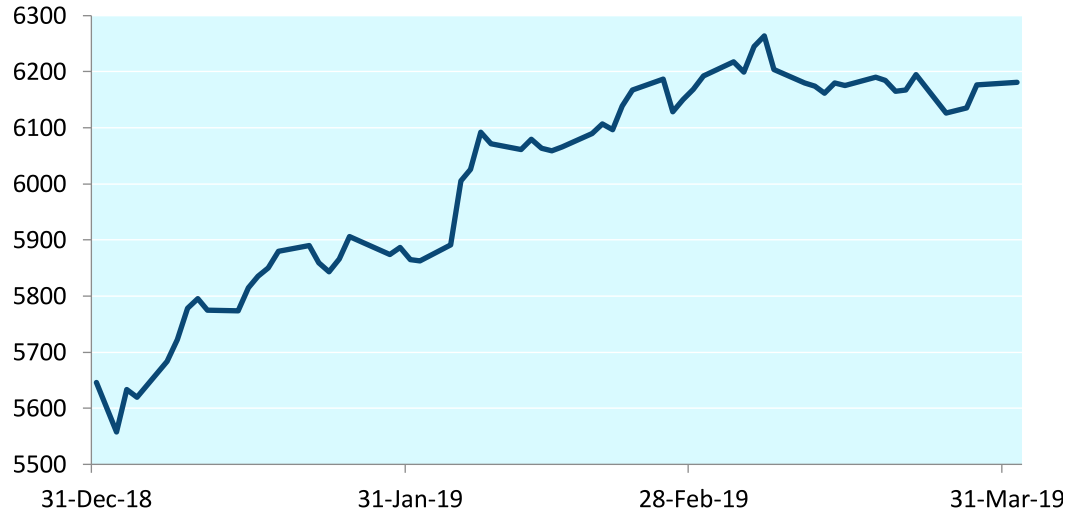
The S&P/ASX 200 Accumulation Index returned +10.89% for the quarter. The fund underperformed the market and delivered a +10.62% return over the quarter.

Market overview

Global equity markets bounced back to start the calendar year, as investor sentiment swung suddenly to a more constructive stance on global geopolitical tensions. Locally, the Australian market enjoyed its best quarterly performance since 2009, at which time the world was exiting the Global Financial Crisis.

The poor performance in the December quarter was fully reversed during the period, with the accumulation index (adjusted for dividends) reclaiming all points lost.

S&P/ASX 200 Index

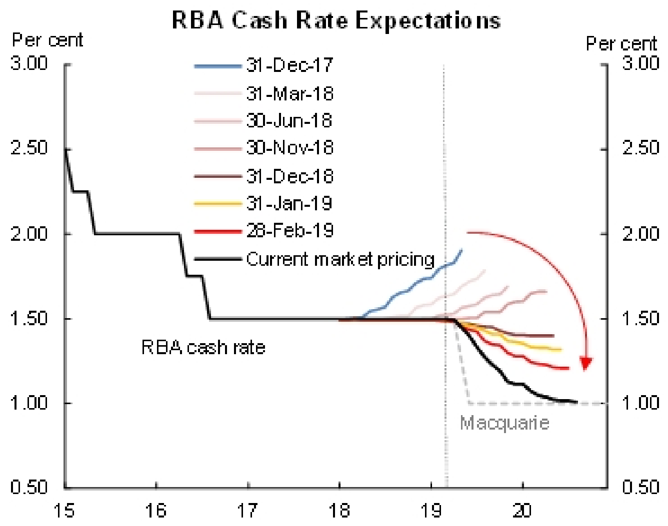


Source: IRESS

As expected the Reserve Bank of Australia (RBA) kept the cash rate target at the record low level of 1.50% at all three meetings during the quarter, the rate at which it has been since August 2016. In March, it was announced that December Real Gross Domestic Product growth (GDP) fell to a 2 year low of 0.2% (consensus 0.7%), which translated to a 'per-capita recession'. Sentiment towards the cash rate soured post the GDP announcement, with a number of economists calling for multiple rate cuts by the end of 2019. Futures markets currently imply a 75% chance of at least one rate cut and a 35% chance of two rate cuts by calendar year end.

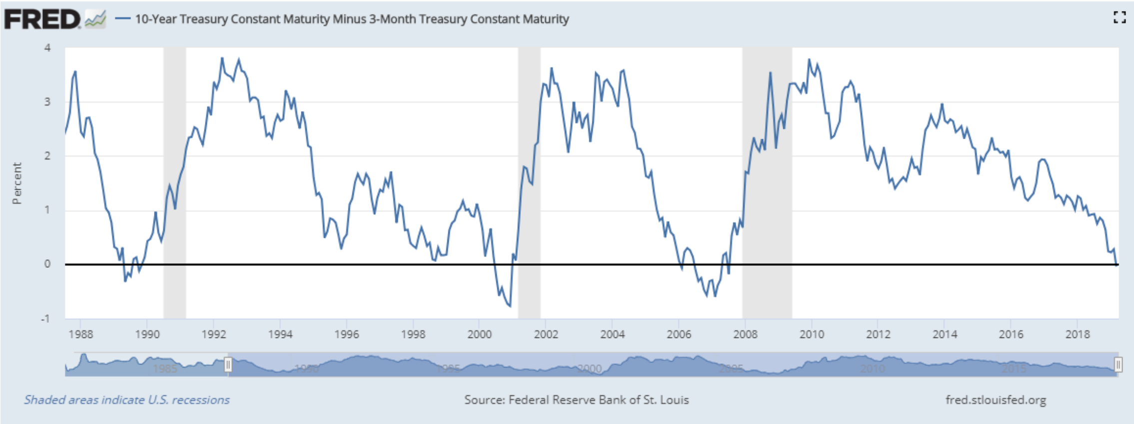
"Looking forward, there are scenarios where the next move in the cash rate is up and other scenarios where it is down." Philip Lowe, RBA Governor, 06/02/2019

We can see below how rate expectations have evolved from a gradual increase to a decline over the past year. The market is now almost fully pricing in 50 basis points worth of rate cuts by mid-2020.



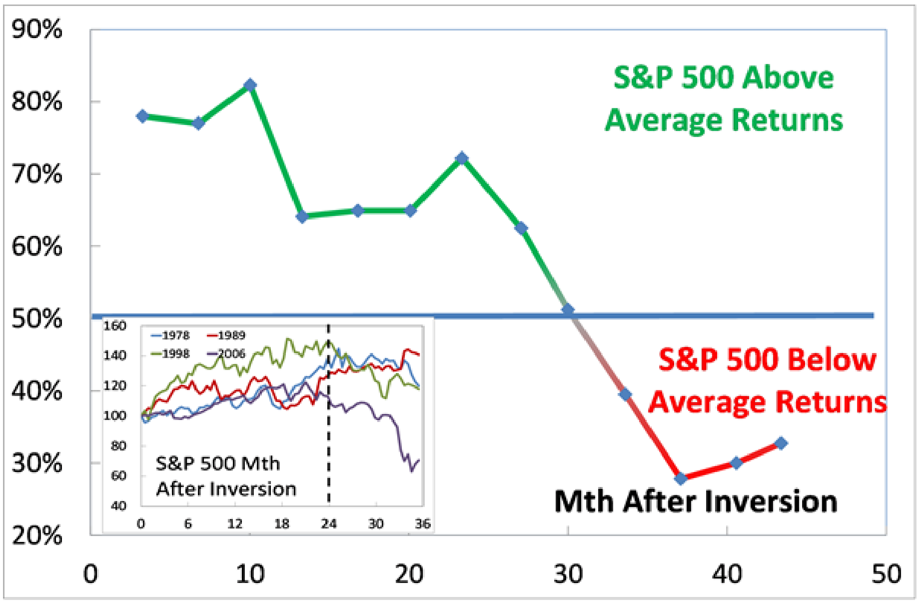
Source: Macquarie

Globally, investors were also focused on interest rate movements as the US Federal Reserve became distinctively more dovish. Contrary to the experience in late 2018 where markets were concerned around an increase in global rates on the long end of the curve impacting growth, attention in March turned to the shape of the US yield curve, as the 10-year minus 3-month yield curve inverted. As per below, an inversion of these two rate has preceded a recession in the US three times since 2010.



Source: Federal Reserve Bank of St. Louis

However there may be some cause for some short term optimism, with research showing that US equity returns have historically been above average for the 30 months following yield curve inversion.



Source: JP Morgan

Geopolitical tensions between the US and China continued to simmer during the period. Whilst no official updates on negotiation were provided by either country, market sentiment turned decidedly positive around the expectation of a deal being done. In the US, the outcome of the long awaited Special Counsel report into interference in the 2016 President Election was somewhat benign, removing a ‘black swan’ risk for global markets. Meanwhile in the UK, the Brexit situation remains an ungodly mess with Prime Minister Teresa May’s multiple attempts to pass an acceptable version of Brexit through parliament all failing. The Brexit deadline of March 29 was extended by two weeks, with the outcome from here being a complete unknown given the lack of precedent. The chances of a ‘hard Brexit’ have increased however, with Teresa May likely to resign her post in the near future to be potentially replaced by a ‘Brexiteer’.

“In light of global economic and financial developments and muted inflation pressures, the Federal Open Market Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes.” Jerome Powell, Chairman of the Federal Reserve, 30/01/2019

“The implications of the house’s decision are grave. The legal default now is that the United Kingdom is due to leave the European Union on 12 April. In just 14 days’ time.” Teresa May, UK Prime Minister, 29/03/2019

	QTR	YR
ASX200 Accumulation Index	10.9%	12.1%
Best Performing Sectors		
Information Technology	20.7%	27.4%
Materials	17.8%	24.1%
Telecom Services	16.9%	7.9%
Worst Performing Sectors		
Consumer Staples	5.2%	9.7%
Financials ex Property Trusts	6.0%	1.7%
Healthcare	6.3%	18.6%

Source: IRESS

Locally, investors were focused on the February results season where capital management was a common theme as companies sought to beat proposed changes by the Labour government to the treatment of franking credit refunds. In terms of positioning, investors rotated into high beta sectors and out of defensives during the period as appetite for risk increased. Also in February, Commissioner Hayne submitted the final report of the Banking Royal Commission. The report included 76 recommendations for reform and 24 referrals for prosecutions to the regulators. From an equity market perspective, the major banks rallied strongly the day following the release of the final report as the final recommendations were less draconian than feared.

House prices – are we there yet?

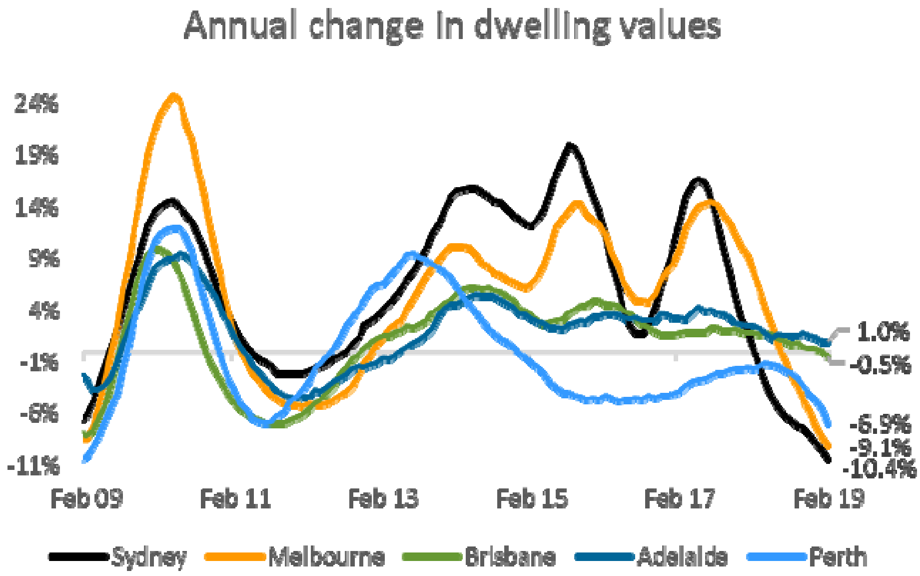
We are confronted daily with differing views on the house market, which range from vested interests unashamedly dismissing any weakness as short term, all the way to bearish economists forecasting Armageddon. As many market commentators tend to forget, capital city property gyrations can be discrete, so we have had a look at the recent history of Perth price movements to try and garner some insight to what we can expect in the east coast markets.

We think it's instructive to look at house prices in two phases. The first phase of a housing downturn occurs due to a combination of extreme prices, with excess demand abating but supply not diminishing. This phase can be accelerated with a tightening of credit, which we observed at the height of the recent property boom. This is where prices first start falling. Generally, this is a healthy correction as it represents 'heat' coming out of the market.

The second phase is where things get more interesting. Given a large percentage of mortgage borrowing from 2014-2017 was to investors (of which the vast majority are negatively geared), we are now seeing the situation where a large amount of investors are experiencing negative cash flows while also seeing their house prices fall. When this stress become too much, investors tend to bite the bullet and sell before the falls become worse (not dissimilar to equity market behaviour!). Our understanding is that this dynamic is playing out in Perth, where prices have taken another turn for the worse as per CoreLogic data below. The question we are therefore pondering is; does this second phase play out on the east coast? And if so, when?

"Members noted that the cumulative falls in housing prices in Sydney and Melbourne were relatively large by historical standards, and that it was unusual for housing prices to fall significantly in an environment of low mortgage interest rates and a declining unemployment rate," RBA Minutes, February 2019

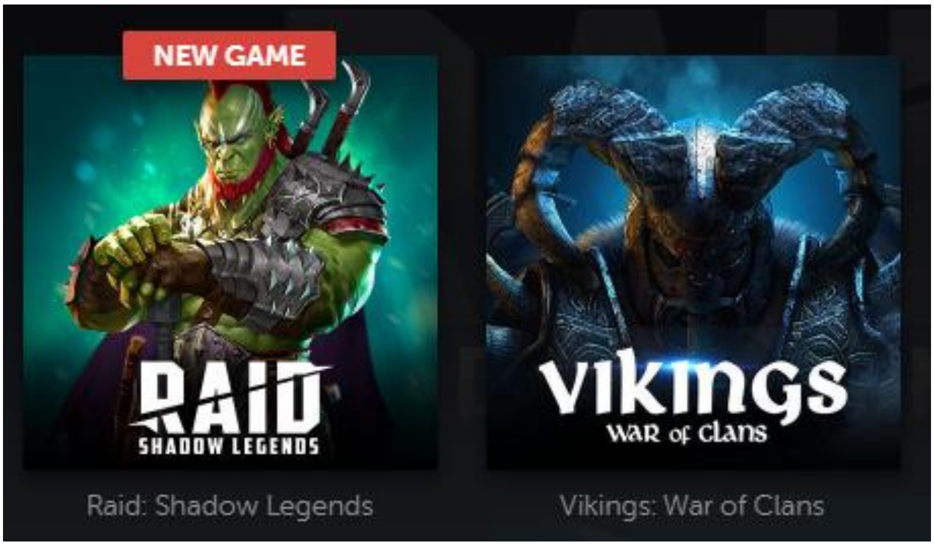
Source: CoreLogic



Aristocrat Leisure

Aristocrat Leisure Ltd (ALL) is a company we are attracted to that appears miss-priced currently. The company earned a 43% Return on equity in FY18 but the result and outlook commentary came in below some investor's high expectations. In addition, concerns on the merits and growth outlook of two Digital gaming acquisitions ALL made in 2017 (Plarium US$500m + earn out and Big Fish US$990m) have been raised which has seen ALL's share price decline from ~ $33 in July 2018 to ~$21 in December, before recovering to ~$25 at the time of writing.

ALL's core business is designing and manufacturing electronic gaming machines for casinos, pubs and clubs (land-based business) which represents 70% of group earnings, with Digital Gaming making up the remaining 30%. Within Digital gaming, two thirds of this is 'Social Casino' games which has a direct crossover of game content with their land-based business, and the remaining one third is 'Casual' games which are electronic games unrelated to gambling and came with the acquisitions of Plarium and Big Fish.



Source: ALL

The land-based business has been hugely successful for ALL over recent years. In what has been a competitive market with large competitors, ALL has taken approximately 65% market share of games sold in Australia and one third of the Class III video leased market install base in the US. Whilst the land-based industry has traditionally been cyclical in the sense that the prevalence of hit games comes and goes for each of the industry players, we think ALL is likely to maintain and even continue to expand its strong market share position for the following reasons:

- Our customer channel checks continue to suggest that ALL's two most successful game franchises in its land-based business, Lightening Link and Dragon Link, have very high player loyalty, suggesting these games should remain successful for several more years. In addition ALL is continually releasing new games and features within these two games, which helps maintain player interest.

- ALL continues to invest around 11% of its revenue into future games development. With double digit revenue growth continuing in its land-based business, maintaining the 11% ratio affords the company a large step up in the absolute level of investment to come up with games that will be potential future hits.

- ALL has demonstrated a strong track record of creating a culture that attracts and retains talent in game design, and we think there is a strong chance they can replicate this success within their Digital business.

- ALL's two largest competitors, IGT and Scientific Games, are both heavily indebted and part of broader gaming groups, both limiting their ability to reinvest into new gaming content as well as being less focused on the core gaming machine market relative to ALL.

Source: Broncos League Club

In summary, we think that the market has overreacted to question marks over 10% of ALL business when the outlook for the remaining 90% remains strong. ALL is a global company significantly outperforming its larger competitors. It throws off a high amount of free cash flow and its balance sheet will begin to look under-geared again in 12-18 months time, affording it a position to potentially add further earnings accretive acquisitions. Despite this the business trades on a 1 year forward earnings multiple in-line with the ASX Industrials average.

With a strong earnings growth outlook persisting for ALL we expect the market is likely to re-rate the stock higher and therefore the stock presents attractive risk-reward equation at current levels.

Trip notes

During the period we travelled to the US 4 times, Europe and the UK.

US notes

- The high level demand story for data remains very much intact. Outward visibility around what's required in the future from participants suggests that cloud computing growth has a long runway remaining, with one Datacentre owner saying that talks with overseas clients suggests "we're only at the bottom of the hockey stick".

- Use cases for Graphic Processing Units (GPU's) are increasing at a rapid rate. For example, US hospitals are now actively exploring wider deployment of GPU use cases given Machine Learning has provided overwhelming evidence of better analysis and more accurate detection rates for echocardiograms vs the specialists themselves.

- Transport cost inflation is moderating. 2018 was an abnormal cost inflation year driven by driver hour regulations being implemented at the same time as a general economic uplift and unemployment tightening. We heard multiple anecdotes that driver supply is starting to increase and transport inflation rates are slowing, albeit there is no decline in inflation, just a moderation in growth.

- Underlying US economic growth remains solid and broad-based. Despite all the political rhetoric, contacts we spoke to said that they are seeing solid underlying growth driven by a consumer who is doing OK.

Outlook

Following a better than expected results season (both here and abroad), we believe fears of a deep global slowdown have been overdone. We observe the trade war has impacted US domestic growth somewhat, thus a resolution of this issue is likely to see improved momentum returning to the US, which will in turn support market sentiment.

Australia however remains patchy. The housing downturn is clearly beginning to weigh on consumer demand and general sentiment in our view. The market has also now fully priced in a change of federal government and an election outcome of a clear majority should add to certainty, which the business community is craving. We don't expect many surprises with respect to policy changes post a Labour victory.

Greencape used the recent sell off to selectively increase weights into favoured companies which were indiscriminately sold down. We have not rotated towards yield despite the bond market pushing bond yields lower. We remain comfortable backing good management teams deploying capital to generate attractive returns.

"Everyone has a plan until they get punched in the mouth." Mike Tyson

More information

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

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