Greencape High Conviction Fund

Quarterly report - March 2021

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Inception % p.a.
Fund return	5.23	39.52	11.21	12.13	9.50	9.74
Growth return	4.63	37.83	4.48	5.83	3.01	3.49
Distribution return	0.60	1.69	6.73	6.30	6.48	6.25
S&P/ASX 200 Accumulation Index	4.26	37.47	9.64	10.25	7.95	6.55
Active return^	0.98	2.05	1.57	1.88	1.55	3.19

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'.

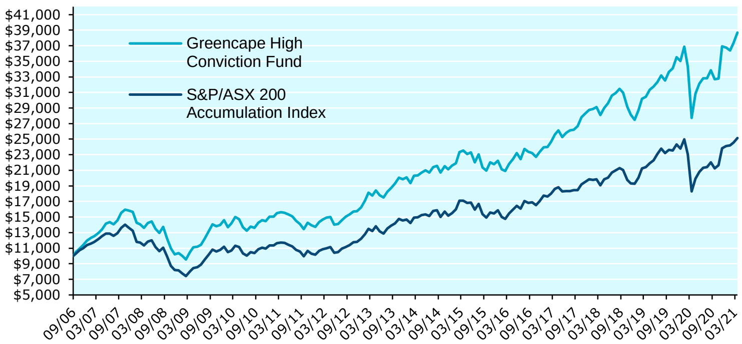
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

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



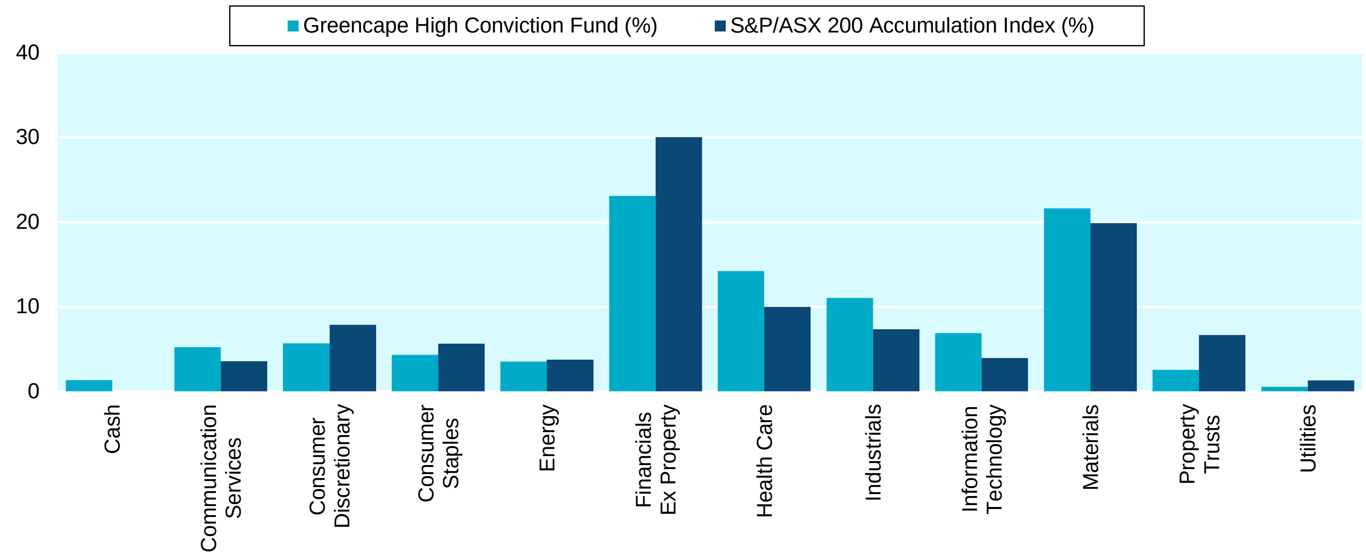
Asset allocation	Actual %	Range %
Security	98.66	85-100
Cash	1.34	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0035AU

Fees	
Entry fee	Nil
2019-2020 ICR	1.52%
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%

Data Source: Fidante Partners Limited, 31 March 2021.

Sector exposure as at 31 March 2021



Data Source: Fidante Partners Limited, 31 March 2021.

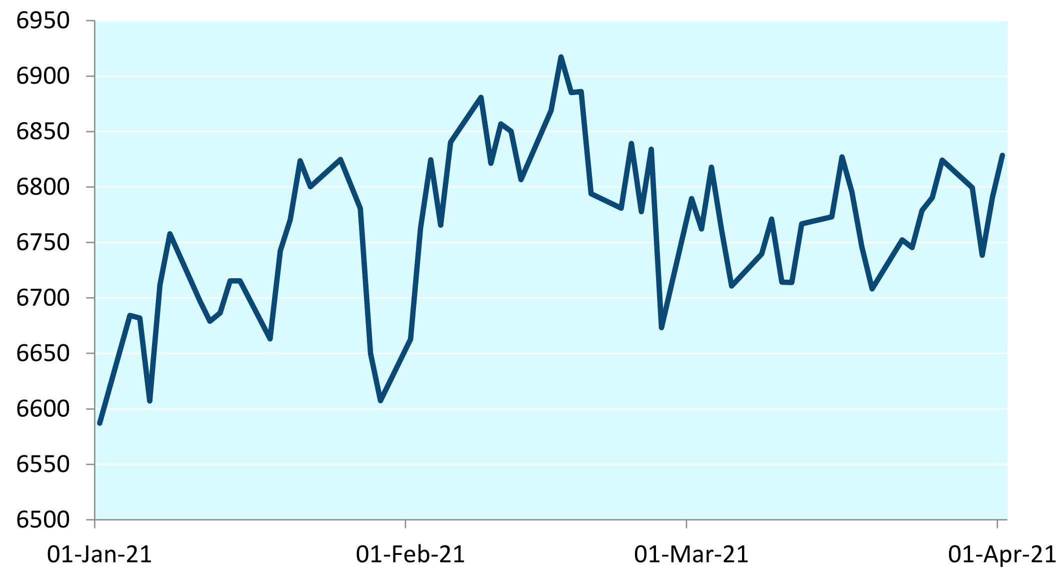
Fund performance summary

The S&P/ASX 200 Accumulation Index returned +4.26% for the quarter. The fund outperformed the market and delivered a +5.23% return over the quarter.

Market overview

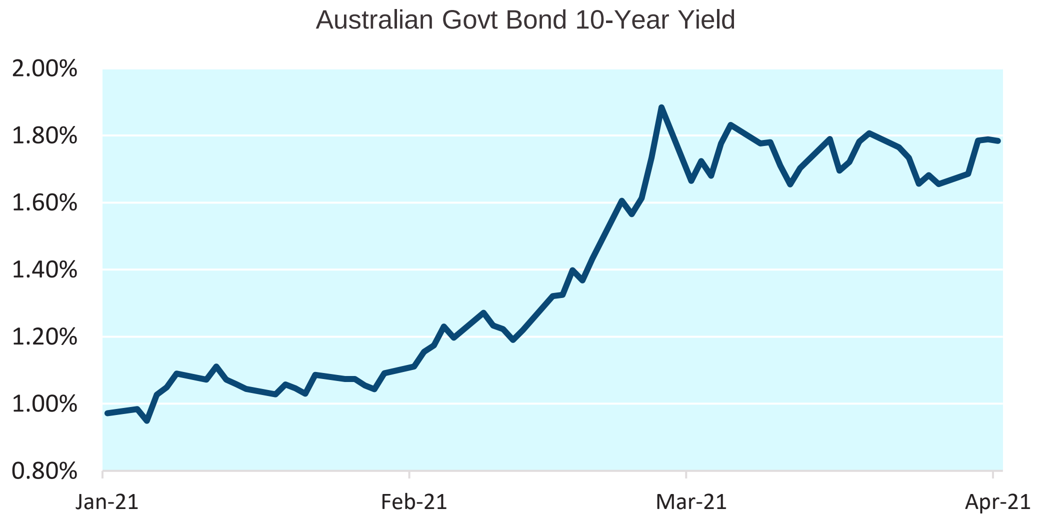
Despite ongoing volatility during the period, the index managed to string together three consecutive months of positive performance which culminated in a strong gain for the quarter. Early January proved to be the peak of global COVID-19 infections, with promising early signs the vaccine rollout is proving successful in suppressing cases. The rotation out of Growth into Value continued with renewed vigor, however the catalyst on this occasion was not due to positive vaccine developments like we saw in November. This time it was an unexpected spike in bond yields which caused investors to reevaluate company valuation and portfolio positioning in the face of higher real interest rates and potential inflation.

S&P/ASX 200 Index



Source: IRESS

As expected, the Reserve Bank of Australia (RBA) kept the overnight cash rate at the record low of 0.1% at both meetings during the quarter. During the global bond sell off in late February, the RBA took the proactive step of doubling the size of its daily bond purchases to $4 billion. The move caused ructions globally, as bonds rallied with the realization that central banks would not hesitate to step in if yields rose too quickly. The added intervention has so far proven effective, with the Australian 10-Year Bond rate not yet surpassing the levels seen in February.

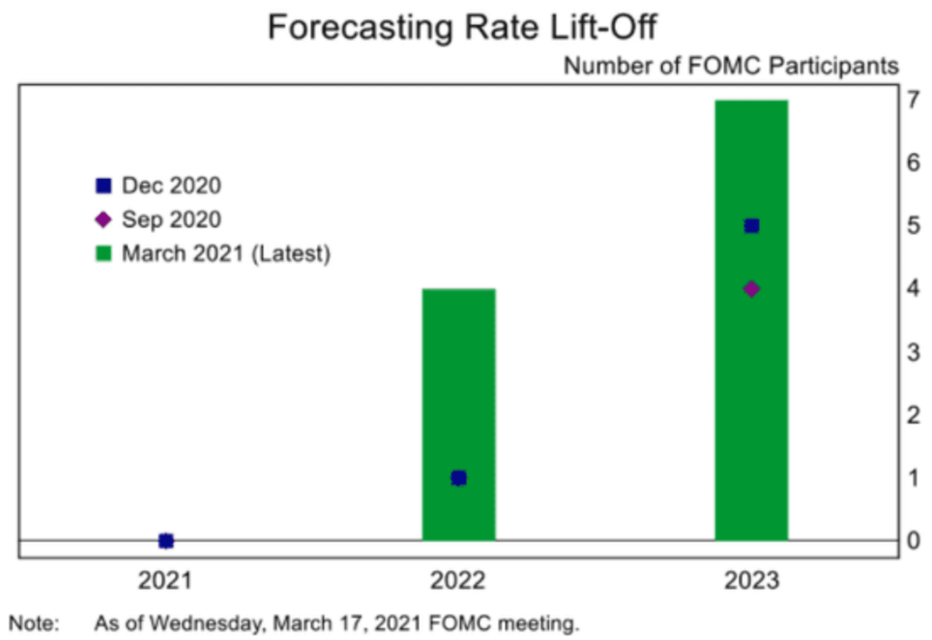


Source: IRESS

"For inflation to be sustainably within the Bank's target range of 2–3 per cent, a period of labour market tightness that leads to faster wages growth is needed." RBA Statement of Monetary Policy, February 2021

In the US, strong economic data and increased inflation expectations have seen yields continue to rise throughout March. As a result, the market is now pricing in a near 90% chance of The Federal Reserve (Fed) raising rates in 2022. This contrasts with the survey of Fed members, of which the majority do not expect to increase rates until 2023. This suggests that either the Fed members need to reevaluate their expectations in the face of improved data, or the market needs to readjust.

Source: The Daily Shot



Source: Mizuho Securities

Whilst stocks favoured by retail investors have performed well since the onset of the pandemic, it was taken to a new level in January. The frenzy was initiated by the popular r/wallstreetbets forum on Reddit, where members identified structurally challenged companies with large short interests which were vulnerable to a short squeeze. The results were remarkable, with the Game Stop's (owner of EB Games in Australia) share price up 2800% for the month in January at one stage. The forums also introduced new phrases into the market such as 'diamond hands' (strong holder of stock), 'paper hands' (weak holder of

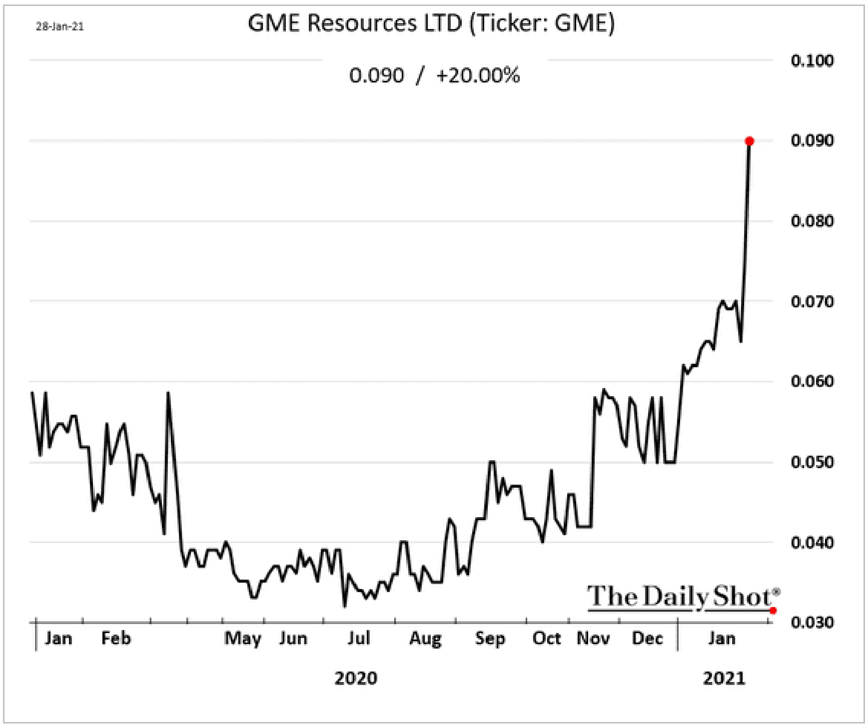
"I would be concerned by disorderly conditions in markets or by a persistent tightening of financial conditions that threaten the achievement of our goals. We think the stance of monetary policy remains appropriate." Jerome Powell, Chairman of the Federal Reserve, 17/03/2021

stock) and ‘tendies’ (market gains). Although stocks such as Game Stop, Blackberry and AMC Entertainment have retraced somewhat from the highs, retail activity is still elevated in the broader market. It remains to be seen whether retail participation will hold up when restrictions are eased and more spending channels (e.g. travel) open up.

“A few things I am not. I am not a cat. I am not an institutional investor. Nor am I a hedge fund.” Keith Gill aka Reddit user ‘Roaring Kitty’, 22/02/2021

Source: The Daily Shot

GME Resources on the ASX also enjoyed a rally at the time, presumably because it shares the same code as Game Stop. It’s difficult to argue markets are efficient when this type of behaviour is observed!

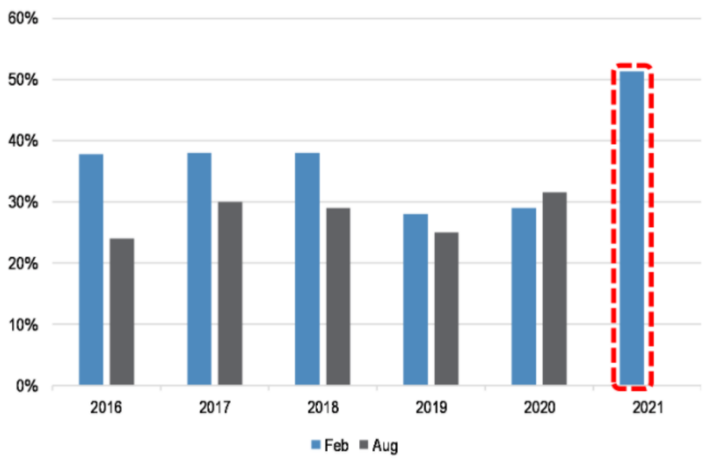


Source: The Daily Shot

Whilst offshore market events captured the imagination of the market, local investors also had the bi-annual reporting season to contend with in February. As opposed to the August reporting season where investors were largely flying blind following the onset of the pandemic, results were generally well flagged to the market.

As a result of widespread cost cutting during the pandemic and a faster than expected (stimulus aided) recovery in demand, earnings beats were well ahead of recent averages.

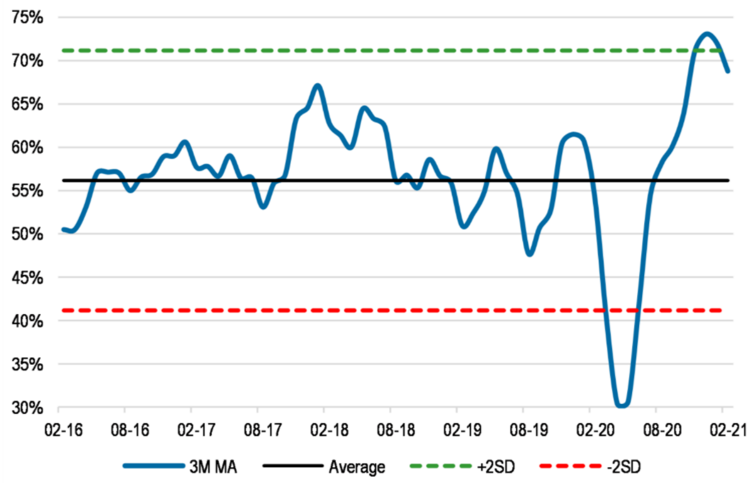
Figure 46: Rate of beats



Source: JP Morgan

And the breadth of earnings upgrades across the market reached record levels.

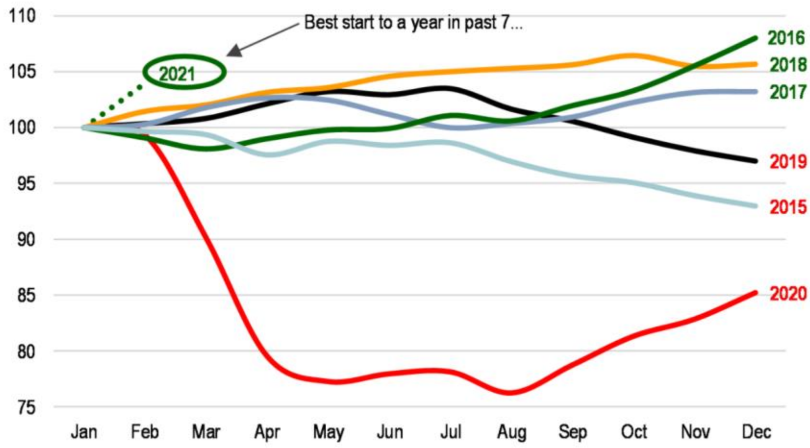
Figure 12: EPS Revision Breadth | Proportion of stocks 'upgrading'



Source: JP Morgan

This has seen the market earnings estimate trajectory have its best start to the year in recent history.

Figure 15: EPS Trajectory – 2015-21



Source: JP Morgan

In terms of sector performance, Financials ex-REITS led the charge during the quarter, buoyed by a hot property market which saw house prices rise by 2.8% in March; the highest growth rate in 32 years. Telecom stocks also fared well, with the market seemingly taking a more favorable perspective on the ability for Telstra to unlock value from its ‘T22’ company restructure whereby the company plans to separate its Tower, Retail, and Infrastructure divisions.

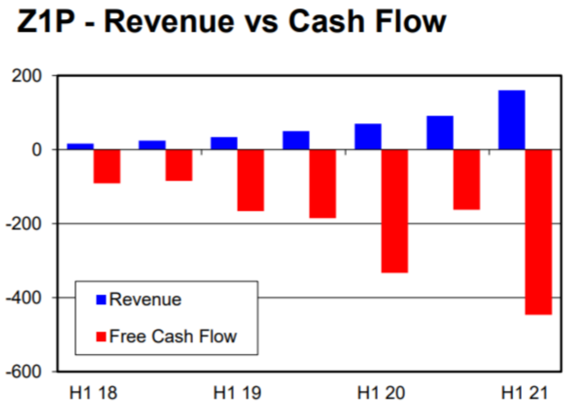
	QUARTER	YEAR
ASX200 Accumulation Index	4.3%	37.5%
Best Performing Sectors		
Financials Ex-Property Trusts	12.2%	45.9%
Telecommunications	8.8%	35.0%
Consumer Discretionary	8.8%	70.9%
Worst Performing Sectors		
Information Technology	-11.3%	85.4%
Healthcare	-2.3%	-0.4%
Utilities	-1.8%	-10.0%

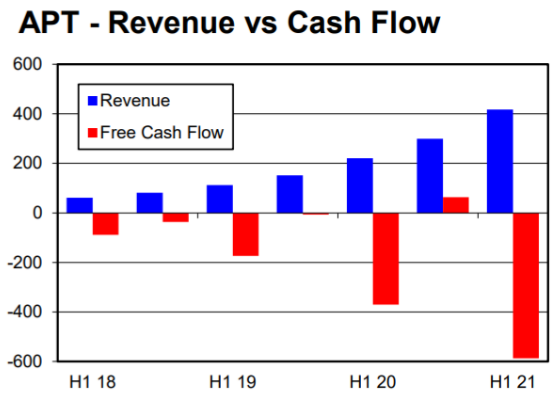
Source: IRESS

The Tech sector found itself in the unfamiliar position of being the worst performing sector during the quarter. Given the vast share of the sector is considered ‘Growth’, whereby a significant portion of the company value is attributed to expected cash flows in the distant future, Tech valuations are more sensitive to higher interest rates as these expected cash flows are worth less discounted to present day.

Within the space, Buy Now Pay Later (BNPL) stocks came under notable pressure, as expected profits are very long dated (the sector is free cash flow negative today) and hence their valuations are particularly sensitive to rising interest rates.

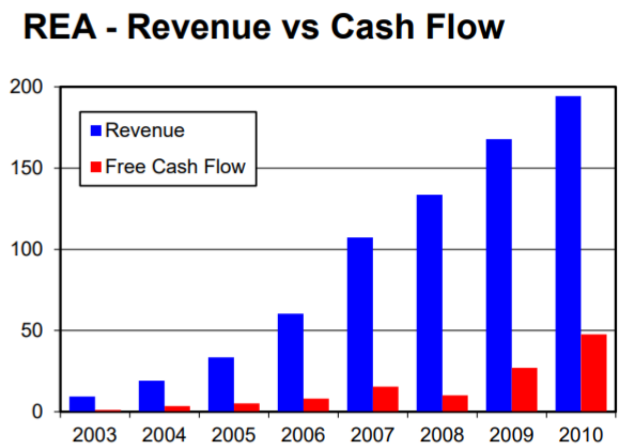
"We've got to make sure that holistically, customers are in a position where the product is appropriate. We're going to treat it like it's credit." Angus Sullivan, Group Executive of Retail Banking, CBA (on the launch of CBA's BNPL product), 17/03/2021





Source: Diogenes Research

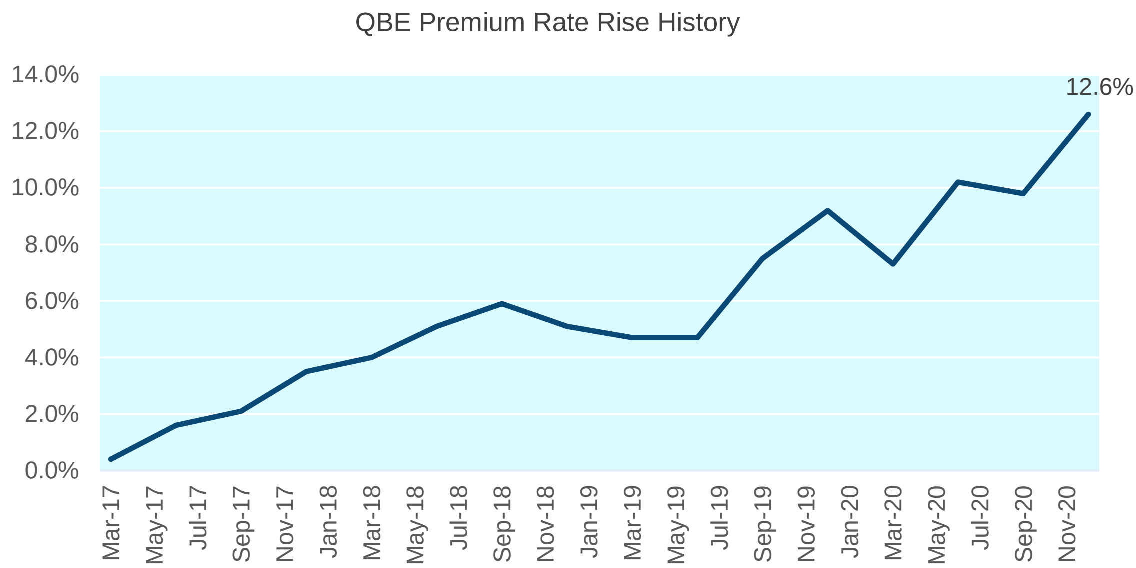
Whilst Greencape currently has no shareholding in any BNPL companies, we do own REA which we wrote about last quarter. It's worth noting that the free cash flow characteristics of REA in its early growth phase was starkly different to the BNPL stocks today.



Source: Diogenes Research

QBE

QBE is an insurer operating predominantly in Europe, Australia, and the US. We generally view insurers as unattractive investments, given they are largely price takers in a cyclical industry which has a history of under-pricing for catastrophic events (e.g. storms, floods, bushfires, etc). In recent years insurers have also faced the headwind of falling bond yields on their investments held against policy liabilities, which has weighed on their earnings. However, we think the earnings prospects in the years ahead have significantly improved with what many people in the industry are describing has the strongest premium rate cycle in 20 years (i.e. since September 11), particularly in Europe and the US. See chart below.



Source: Jarden, QBE

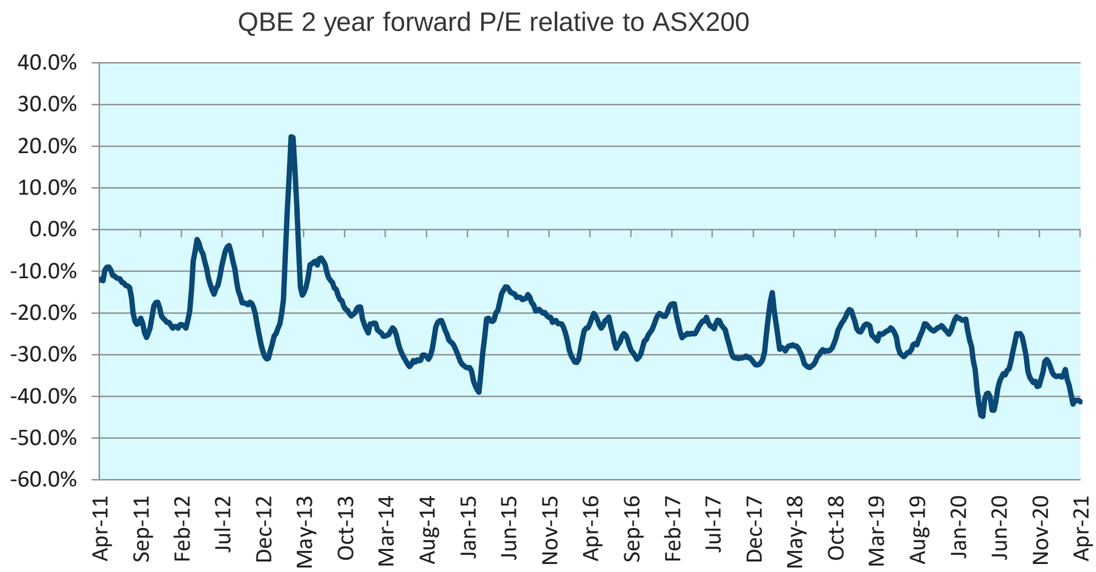
“The level of rate and rate of increase (in Q4) was the strongest since this part of the underwriting cycle began approximately 3 years ago. I expect the favourable underwriting conditions to continue.” Evan Greenberg, Chairman & CEO of Chubb Limited, 03/02/2021

QBE’s average premium rate increase accelerated to 12.6% in the December quarter, which compares to their estimate of underlying claims inflation of 4%. The longer premium rate increases can be sustained at current levels, the greater the scope there is for margin expansion. Whilst we expect management to hold back some of the margin gains in the form of provisions until COVID-19 uncertainty has dissipated, the sheer size of the current pricing gains vs claims inflation implies more than 8% points (i.e. 12.6% less 4%) of margin expansion over time vs analyst consensus expectations for ~ 3% points[1] of margin expansion between 2020 and 2022.

Strong premium rate increases also provides management with more ‘fat’ to absorb unexpected earnings hits from insured loss events, which is something that has plagued QBE for years and been exacerbated by a tough premium rate environment from 2014 – 2017. During this time QBE also went through a de-risking strategy of shedding unwanted business. Whilst this should have helped improve underlying margins, it also led to negative operating leverage given largely fixed corporate costs. For context Gross Written Premium (GWP) in 2020 (US$14.6bn) was still below what it was in 2015 (US$15.1bn). 2021 will be the first year since 2015 that QBE will see decent growth in both GWP and Net Earned Premium (NEP), which should provide positive operating leverage.

[1] Combined Operating Ratio (COR)

Despite the forward looking prospects of QBE improving the stock currently trades on a ~40% discount to the market vs its ~20% average over the last 10 years (see chart below). We view this being due to largely backward looking issues and industry uncertainty surrounding COVID-19 related Business Interruption (BI) losses. QBE has quantified the worst case scenario of BI losses and these loss estimates have now been factored into analyst forecasts.



Source: UBS

In summary we think the strongest premium rate environment since September-11 vs modest claims inflation should expand margins and lower earnings volatility. Despite this the stock trades at its largest discount to the market in the last decade and analyst forecasts have been rebased post conservative COVID-19 related provisions. Ultimately the strong operating environment should create upside risk to earnings forecasts and drive a closing of the valuation gap vs market. Whilst the insurance industry is inherently unpredictable, we think it's likely QBE will be trading at a significantly higher share price in 1 – 2 years from now.

"Let me give you a better sense of the rate movement. In major accounts, risk management related primary casualty, up 7%, while general casualty rates were up over 36% and varied by category of casualty. Property rates were up over 30% and financial lines rates were up over 26%." Evan Greenberg, Chairman & CEO of Chubb Limited, 03/02/2021

Outlook

Equities markets continue to be fuelled by enormous liquidity, positive economic data cycling the start of COVID-19 and optimism regarding vaccination roll outs, with the market seemingly looking through short term vaccination rate disappointments in Australia and Europe. We are conscious of not holding too much cash as even low beta and dependable dividend payers look more attractive in a relative sense.

We observe increasing appetite for M&A and remain confident our focus on identifying excellent stewards of shareholder capital will be well placed to add value in this unprecedented time of near free money. We remain grounded through demanding explicable valuations and are not tempted to ignore this key criterion in our stock selection.

"I have little doubt that with excess savings, new stimulus savings, huge deficit spending, more QE, a new potential infrastructure bill, a successful vaccine and euphoria around the end of the pandemic, the US economy will likely boom. This boom could easily run into 2023." Jamie Dimon, Chairman and CEO of JP Morgan Chase, 07/04/2021

More information

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

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