Greencape High Conviction Fund

Quarterly report - September 2021

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	15 years % p.a.	Inception % p.a.
Fund return	1.71	30.01	11.11	12.86	12.21	9.79	10.09
Growth return	0.77	19.06	5.03	5.52	4.98	3.16	3.47
Distribution return	0.94	10.95	6.08	7.34	7.23	6.62	6.62
S&P/ASX 200 Accumulation Index	1.71	30.56	9.63	10.42	10.80	6.83	7.01
Active return^	0.00	-0.55	1.48	2.44	1.41	2.95	3.08

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'.

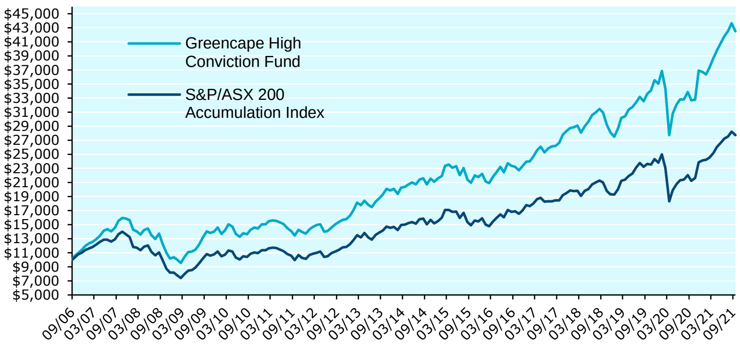
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

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



Asset allocation	Actual %	Range %
Security	96.64	85-100
Cash	3.36	0-15

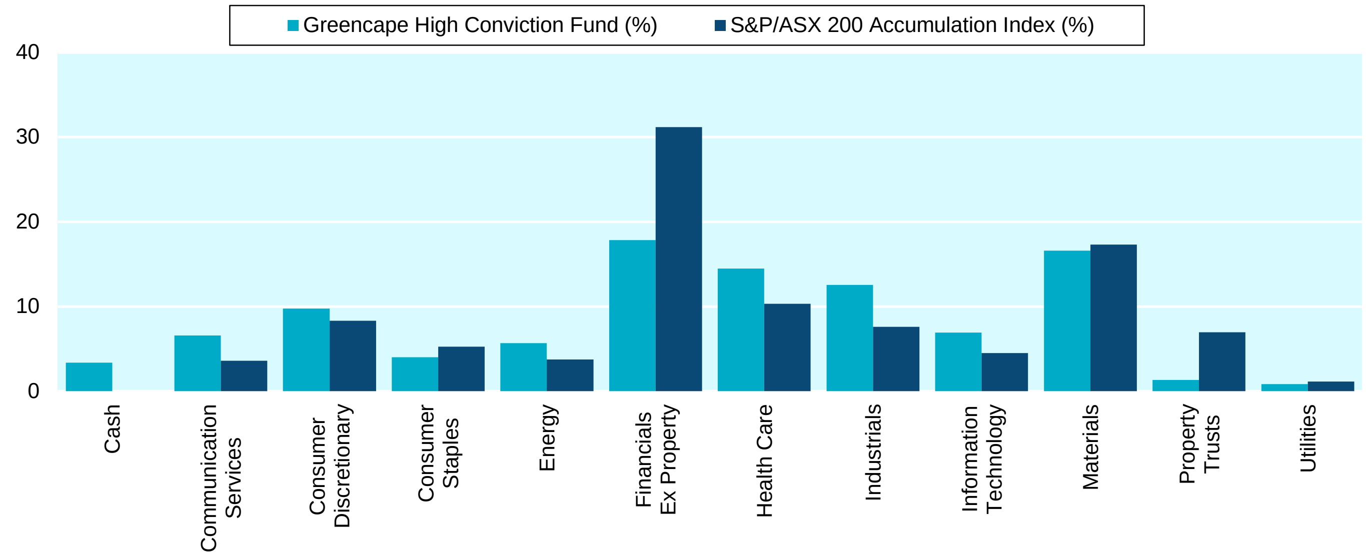
Fund facts	
Inception date	11 September 2006
APIR code	HOW0035AU

Fees	
Entry fee	Nil
2020-2021 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%

Data Source: Fidante Partners Limited, 30 September 2021.

Greencape High Conviction Fund - September 2021 - *continued*

Sector exposure as at 30 September 2021



Data Source: Fidante Partners Limited, 30 September 2021.

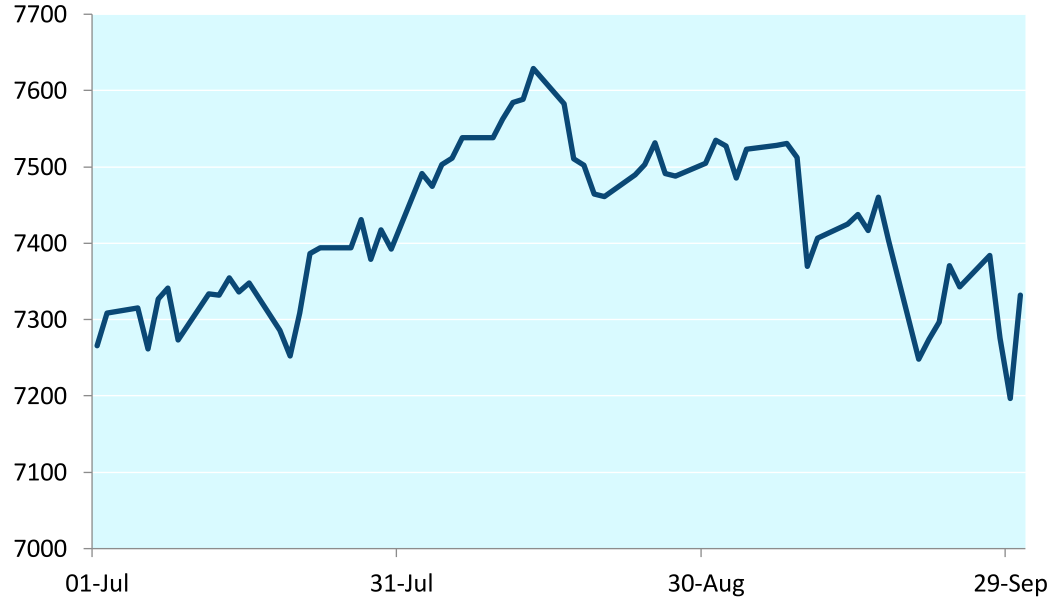
Fund performance summary

The S&P/ASX 200 Accumulation Index returned +1.71% for the quarter. The fund outperformedis in line with the market and delivered a +1.71% return over the quarter.

Market overview

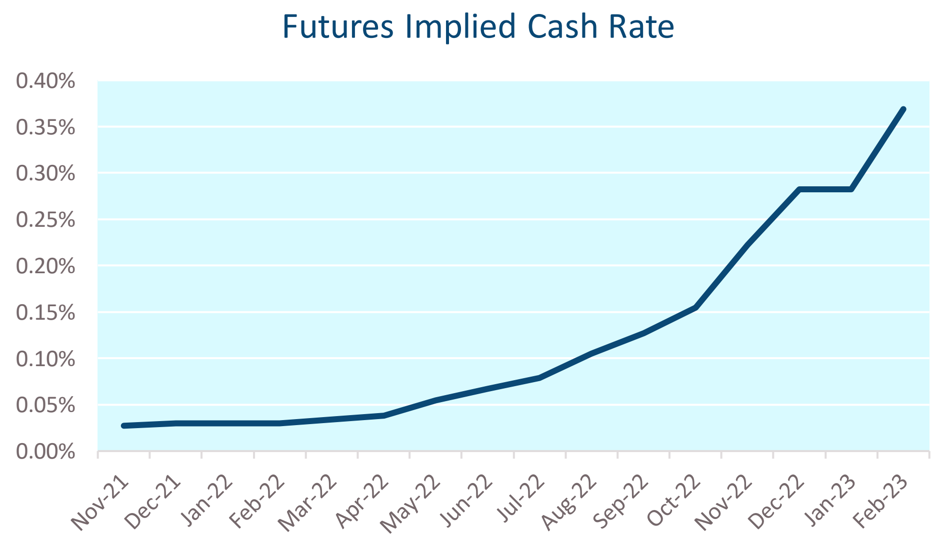
Half the population in lockdown didn't halt the momentum of the Australian market during the period, with the index notching up eleven consecutive months of positive performance in August. Concerns over stimulus tapering (and higher yields) as well as credit worthiness of Chinese property developers took hold late in the quarter to see the run of positive months end in September. Meanwhile, all eyes were on the progress of the vaccination roll out which despite a slow start managed to hit a record pace, with the country well on track to reach the critical 70% and 80% double dose thresholds by the end of the year.

S&P/ASX 200 Index



Source: IRESS

As expected, the Reserve Bank of Australia (RBA) didn't move on rates in any of its three meetings during the period. Despite the futures market implying a rate hike as early as 2022, RBA Governor Phillip Lowe remained resolute in his forecast of no rate hikes until 2024. Ordinarily such dovish comments would provide a bid for residential property prices, however the property market softened during the period due to east coast lockdowns and the looming threat of intervention of the home loan market by the Australian Prudential Regulation Authority (APRA).

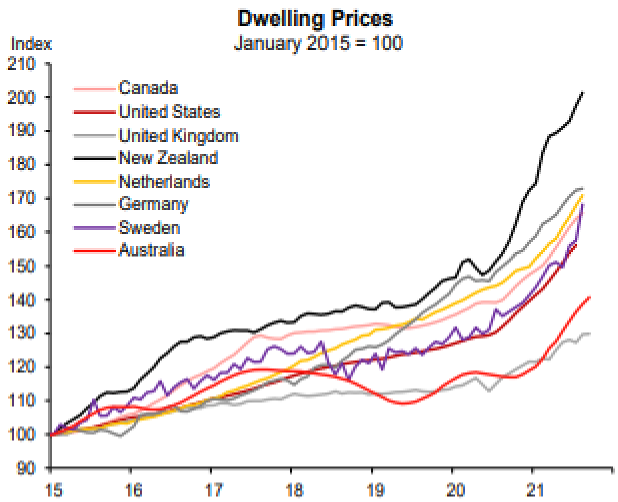


Source: Bloomberg

" Our judgment is it will take some time for wage increases to lift to a rate that is consistent with achieving the inflation target ... this judgment stands in contrast to the expected path of the cash rate implied by market pricing." Philip Lowe, RBA Governor, 14/09/2021

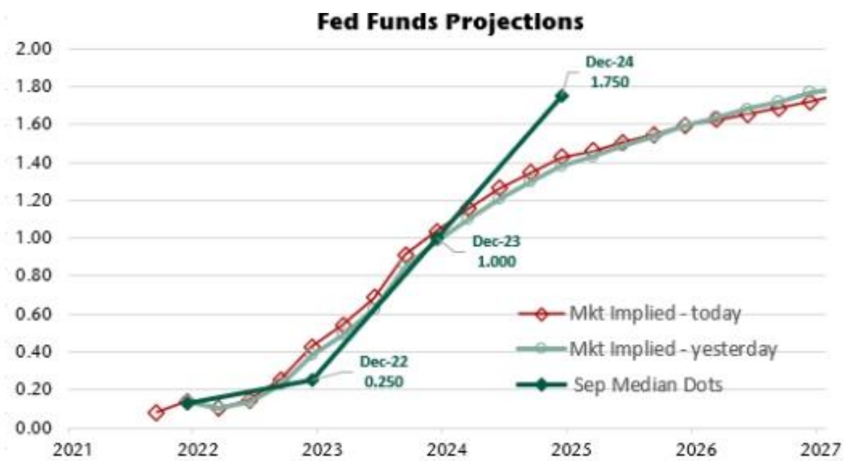
"We must be mindful of the balance between credit and income growth to prevent the build-up of future risks in the financial system. Carefully targeted and timely adjustments are sometimes necessary. There are a range of tools available to APRA to deliver this outcome." Josh Frydenberg, Federal Treasurer, 28/09/2021

Media reports in September alluded to a potential crackdown on mortgages to new borrowers with high debt to income ratios. Whilst the government is not explicitly targeting housing affordability, they are understandably hoping to avoid a situation like New Zealand where property prices have doubled since 2015. After quarter end, it was announced that APRA would be increasing the minimum interest rate buffer on home loan applications from 2.5 to 3 percentage points.



Source: Macquarie

In the US, debate continued to rage over whether the recent uptick in inflation is transitory or persistent. The Personal Consumption Expenditures (PCE) index increased 4.2% in August, the highest rate for over 30 years. The core PCE (the Fed's preferred inflation measure) which excludes food and energy rose 3.6%. In the much-anticipated September Federal Open Market Committee (FOMC) meeting, US Federal Reserve Chair Jerome Powell took a discernibly more hawkish tone, saying that tapering "may soon be warranted". Market expectations are now for a quantitative easing tapering announcement to be made in November. However, this change of tone from the Fed Chair may be driven somewhat by self-interest, with important figures in the Biden administration calling him out publicly for destabilising the economy with ultra-loose monetary policy settings.



Source: Jefferies

"Your record gives me grave concerns. Over and over, you have acted to make our banking system less safe, and that makes you a dangerous man to head up the Fed, and it's why I will oppose your renomination." Elizabeth Warren, US Senator, 28/09/2021

"So what could have changed his mind? What was so different between Jackson Hole and last week's FOMC? And then it dawned on me over this past weekend. Jay is really in trouble. He now realises that his odds of renomination are starting to crater." David Zervos, Chief Market Strategist at Jefferies, 28/09/2021

Another interesting dynamic playing out in the US is the 'catch up' in housing construction due to a period of chronic underbuilding since the GFC. During the pandemic many millennials moved back into the family home. Given the recent surge in prices for established homes it's expected that more people in this cohort will look to build instead of buy. This thematic should provide a tailwind for companies like James Hardie who service the US Homebuilder market.

Figure 3: Surplus (Shortfall) of New Home Completions, Relative to Historical Average

(thousands of units, rolling 10-year sum)

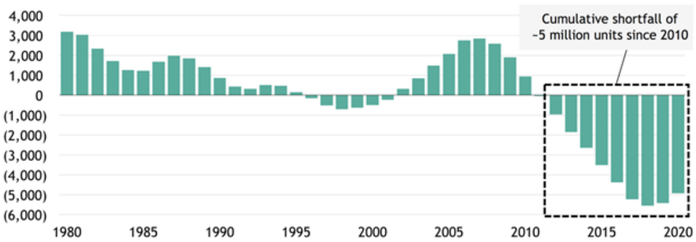
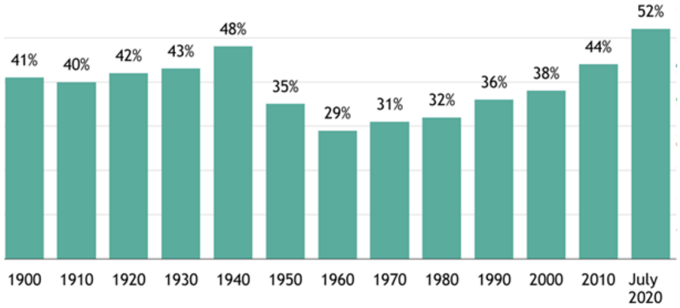


Figure 2: U.S. Young Adults Living with a Parent

(share of total population aged 18-29)



Source: Blackstone

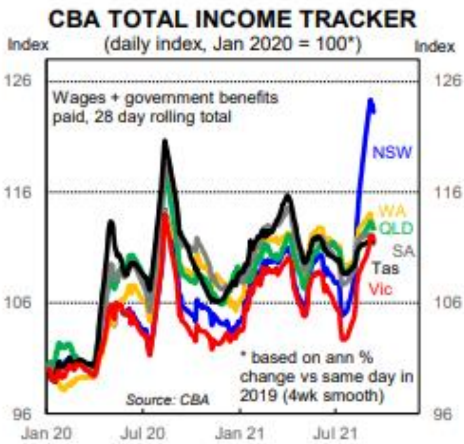
Locally the energy sector found itself in the unfamiliar position at the top of the performance tables as increasing global demand combined with low inventories saw spot prices rally. Conversely, Materials were the only sector in the red as Resource stocks sold off due to issues in China which we will discuss later in this report.

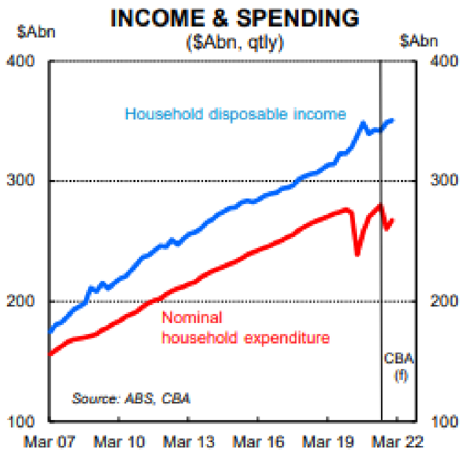
	QUARTER	YEAR
ASX200 Accumulation Index	1.7%	30.6%
Best Performing Sectors		
Energy	9.3%	39.1%
Industrials	6.6%	17.7%
Telecommunications	5.1%	-6.8%
Worst Performing Sectors		
Materials	-9.9%	16.6%
Consumer Discretionary	2.6%	37.9%
Healthcare	2.7%	8.2%

Source: IRESS

An interesting situation to play out on the other side of the east coast lockdowns will be the size and composition of consumer spending. Given constrained spending channels over the past 18 months, the household savings ratio increased from low-single digit pre COVID to a peak of over 20% of income in 2020. Whilst it has eased off somewhat, it has settled meaningfully higher relative to pre pandemic levels. CBA estimates accumulated savings will total $230bn or over 11% of GDP, which works out to be an average of $11,200 per household. Notably this has not been on a lower income base, with total income (incorporating government payments) increasing over 2021 despite the drop in wages and salaries. This suggests that whilst we may see a channel shift to services in the new year, the drop off in the consumption of goods may not be as severe as feared given the sheer extent of consumer 'dry powder'.

"The household income surge, which has generated an almighty war-chest of savings, is an upside risk to consumption over the next two years." Gareth Aird, Head of Australia Economics at CBA, 16/09/2021

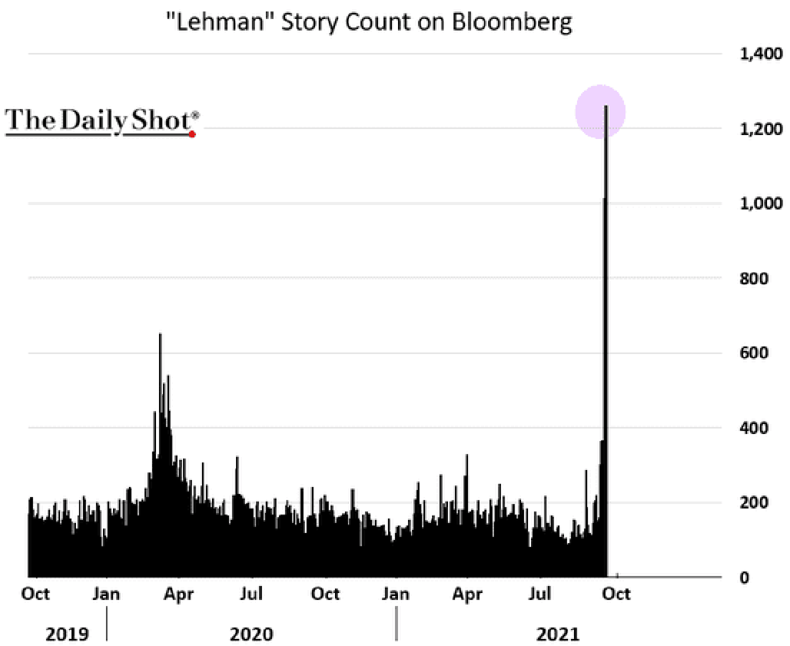




Source: CBA

Evergrande – China's 'Lehman' moment?

The likely default of Chinese property developer Evergrande caused ructions across global markets in September, with many pundits questioning whether this was another 'Lehman' moment leading to a broader collapse of the financial system.



Source: The Daily Shot

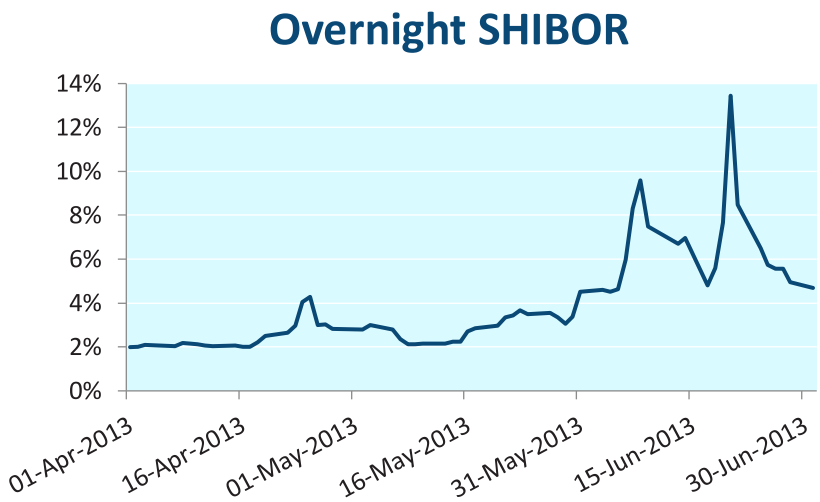
By way of background, in August last year the Chinese government introduced the 'three red lines' policy framework for property developers, stipulating acceptable net gearing, liabilities to assets, and cash to short term debt ratios. These were brought in with the specific purpose to minimise systemic risk in the finance system from an individual player going down – i.e. a Lehman moment. The property (and adjacent) sectors contribute around 15% of China's GDP, and this policy was not introduced from a position of strength in the sector with all sub investment grade (and some investment grade) issuers failing the three tests at time of implementation.

We tend to think the prospect of contagion to the broader Chinese financial sector is overblown. Whilst granted Evergrande's RMB 2 trillion (USD 300 billion) debt appears large, it is only 1% of the total loan portfolio of Chinese banks. Further to the point, development loans in aggregate across all issuers only represents around 7% of total bank loan balances. Lehman Brothers was a large scale investment bank and primary dealer of Treasury bonds with a complex network of counterparties. Their speculative derivatives book also carried significant contagion risk given the inherent leverage and counterparty risk which spread across international financial markets. In comparison, Evergrande's counterparty exposures are relatively contained and clearly defined. The company also has land reserves, developments in progress and finished products as assets to be called upon in event of a default.

The unique nature of the Chinese financial system also grants it an implicit level of protection. State involvement (ownership) of players in the system ensures that any market participant crucial to the operation of the whole system will always have access to credit, a luxury which Lehman Brothers did not have in 2008. An example of Chinese government intervention was the 'credit crunch' in 2013 when the People's Bank of China (PBoC) stepped in to constrict the growth of potentially destabilising shadow banking activity in the financial system. At the time, smaller banks who could not compete for deposits with larger banks were utilising the usually stable interbank market (Shibor) to fund longer term loans and therefore creating a risky asset-liability duration mismatch. The central bank intervention in the Shibor market saw the rate spike 900 basis points in a matter of days.

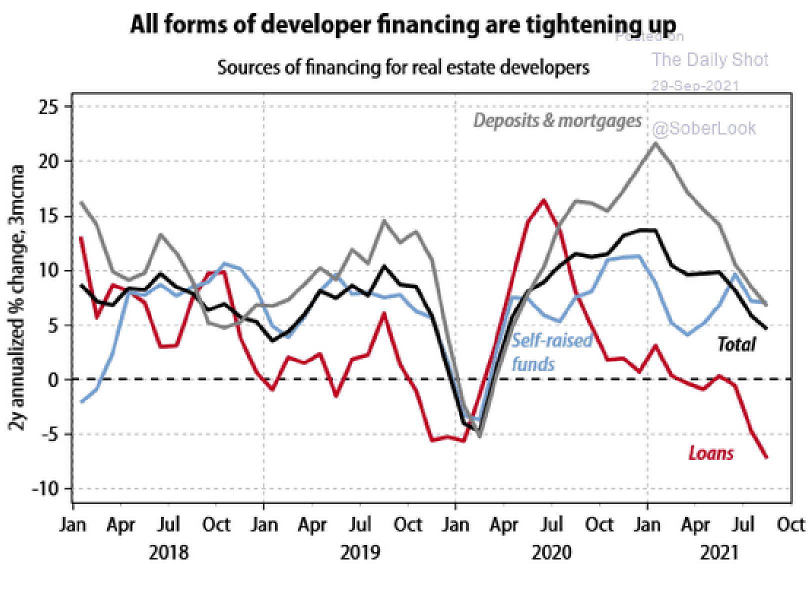
"We see a risk that spillovers from the property sector would keep 4Q21 growth below 5% on a 2Y CAGR basis. This is a low starting point relative to next year's growth target of 5.5%. Moreover, a sharper growth slowdown could increase the risk of a material impact on the labour market." Chetan Ahya, Chief Economist at Morgan Stanley, 26/09/2021

Ordinarily, a credit crunch of that magnitude would lead to bank failures and contagion, however the PBoC quickly stepped in to contain the situation by injecting much needed liquidity into the system. As it pertains to Evergrande, there have already been some media articles suggesting the government may nationalise the company to resolve the issue.



Source: Bloomberg

Whilst we are comfortable around the risk of contagion from Evergrande, we do see the potential for some level of shorter term dislocation to the current status quo. Property demand in the months leading up to the default was already weakening, given the propensity for mortgage originations to be front loaded in the first half of the year to meet quotas. If the government continues down the path of deleveraging the system, the potential for a sustained slowdown in activity is high. We saw this in the wake of the GFC as American households deleveraged their balance sheets and a resultant 'underbuild' of housing occurred, a situation which is only now starting to be resolved. Given the importance of the property sector to the Chinese economy, a slowdown could create a noticeable spill over given the negative wealth affects associated with slowing (or negative) growth in house prices and weaker activity across the property value chain. Potentially exacerbating the issue is the fact some industries adjacent to the property sector are also facing stringent restrictions on energy usage.



Source: Gavekal Research

Whilst these issues do not solely dictate our positioning, they have been factored into our portfolio exposures, in particular Resources which we will delve into in more detail.

Resources

Resources account for approximately 17% of the ASX200 index. Within this, Mining (non-Gold) accounts for approximately 12%, Gold Mining approximately 2.5% and Oil & Gas approximately 2.5%. Given the large weighting in the index, Resources stocks invariably account for a meaningful proportion of the portfolio.

Our approach to investing in Resources stocks is to apply the same investment process as we do for all other stocks. That is, we score Resources stocks using our 4 criteria (Shareholder Stewardship, Business Evaluation, Valuation and Market Milestone) to come up with a Stock Rating (1 being the lowest, 5 the highest) that we assess against all other stocks. 4 and 5 rated stocks make up the core of the portfolio and account for the majority of the active share in the portfolio. Given the nature of commodities and the cyclicality of earnings, Resources stocks generally rate lower on our assessment of Business Evaluation and hence have to score higher on the other 3 criteria to force their way into the core of the portfolio.

Resources stocks that we have held in the core of the portfolios over the past few years have tended to share similar qualities. They all have strong operationally focussed management teams that act like owners and deploy capital well, own assets that are unique or highly valuable and/or generate material free cash flow through a cycle, and have offered attractive valuations without a need for commodity prices to lift above long-term consensus expectations (i.e. genuine bottom-up value).

We also view these stocks favourably from an ESG perspective compared to their peers. Examples of these stocks are below, some of which we have written about more comprehensively in previous quarterly reports.

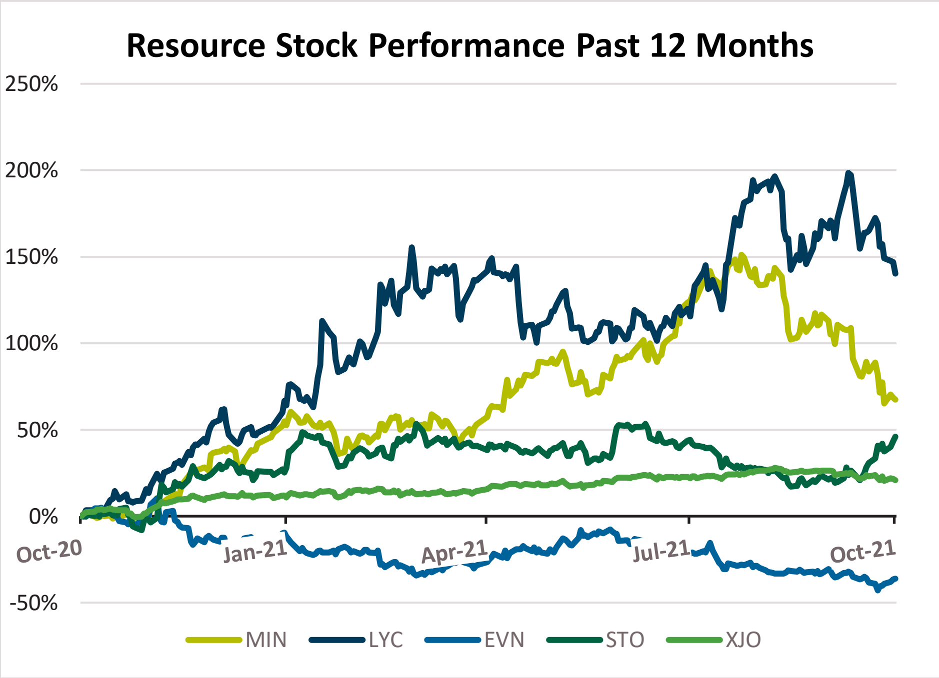
- Lynas Rare Earths (LYC) – Globally strategic asset as the largest (and only one of significance) separated rare earth producer outside of China that has transformed operationally and strategically under the leadership of CEO Amanda Lacaze since 2014. Fully funded to lift production by 50% by 2025 to benefit from the ongoing growth in demand for rare earths, predominantly from electric vehicles and wind turbines.

- Mineral Resources (MIN) – A dynamic, innovative, and market-leading mining services company at its core (predominantly iron ore crushing and processing) that has also generated substantial value through developing and monetising iron ore and lithium mining assets under the leadership of Managing Director Chris Ellison. As an indicator of the value that MIN has generated for shareholders since its IPO in 2006 at $0.90 per share, in FY21 the company paid a dividend of $2.75 per share.

- Santos (STO) – 65 year old oil and gas company that has been transformed operationally and strategically under the leadership of CEO Kevin Gallagher since 2016 to become a focused and reliable free cash flow generator with multiple self-funded growth options across 5 key asset hubs. We think the current merger proposal with Oil Search will be transformational for STO.

- Evolution Mining (EVN) – Low-cost gold mining company with a market capitalisation today of $7bn having grown through multiple corporate and asset transactions under the leadership of Executive Chairman Jake Klein from a market capitalisation of <$300m in 2010. Today the company operates a portfolio of 5 gold mines across Australia and Canada with a lowest quartile cost position and fully-funded organic production growth of >30% over the next 3 years.

“The bounce back in 2021 from the effects in 2020 has been quite extraordinary. As we look at global vehicle sales demand, for electric vehicle sales, all of these are very much feeding demand, which, in turn, is feeding into price. And even in our catalysts segment, we're back to pre-COVID demand levels.” Amanda Lacaze, CEO of Lynas Rare Earths, 27/08/2021



Source: Iress

Most often, the core of the portfolio is 'underweight' Resources stocks relative to the index which results in unintended factor risks relative to the index at a portfolio level. We manage these risks by holding stocks with a rating of 3 in the 'tails' of the portfolio.

These are generally large and liquid stocks that we can trade actively to manage these risks. Examples of these stocks include BHP Billiton (BHP), Fortescue Metals (FMG) and Oil Search (OSH).

Over the past 18 months we have held a larger aggregate position in these 'tails' stocks than in the previous few years beforehand as we have viewed the landscape for Resources to be largely favourable as the world emerged from the depths of COVID in mid-2020. Specifically, after years of underinvestment in supply across most commodities (both deliberate and unintended), the rebound in demand in China and the rest of the world has pushed commodity prices above long-term averages. Resources stocks have also played an important role in offsetting the USD bias that tends to run through the core of the portfolio (i.e. 'overweight' offshore earners) and providing somewhat of a hedge to increasing inflation expectations (commodity prices generally have a solid correlation with inflation).

In the September quarter we meaningfully reduced the overall weighting of Resources stocks in the portfolio primarily through reducing these 'tails' positions but also taking some profits in some of our 'core' holdings which had pushed through sensible valuation markers. This was done exclusively in Mining. After a solid 12-18 months of relative outperformance, the data points on both supply and demand of most mined commodities (specifically iron ore) became incrementally negative (or at best, less positive). The exception is in mined commodities in which demand is driven by electric vehicles and decarbonisation for which we continue to retain exposure through LYC and MIN. In contrast, we lifted our exposure to Oil & Gas stocks through the quarter as the incremental data points on both supply and demand for oil and gas have been mostly positive, and we feel that Oil & Gas stocks are still yet to fully reflect this improving macro environment.

Outlook

Greencape observe the IPO pipeline is incredibly strong, with bankers seemingly having a stronger sense of urgency in bringing companies to market. We also note most developed economies have limited COVID related restrictions remaining as vaccine supply has ramped up. Market expectations are that remaining restrictions will continue to ease.

Inflation commentary is everywhere and consuming much of the market's attention at the present time. From the companies we speak with, we note most are planning for a more protracted inflation wave rather than a transitory pulse. This suggests risks are growing that federal banks are behind the curve. We do note Canada, South Korea, Norway and New Zealand's central banks have begun to act. Thus far, equity markets have taken this shift in their stride. Greencape's focus on effective management teams gives us conviction our portfolio companies are appropriately planning for extended cost pressures. We expect some businesses will manage the change appropriately, whilst others will struggle. Active stock picking is expected to become increasingly valuable in this environment.

"We are beginning to see an increased number of suppliers approaching us for cost price increases in the grocery space.. [That] is very aligned to increased shipping costs, or to raw ingredients." Steven Cain, CEO of Coles Group, 18/08/2021

Source: Marketcartoonist

More information

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

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