Greencape Wholesale High Conviction Fund

Quarterly report - March 2016

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Inception % p.a.
Fund return	-1.85	-7.38	7.09	6.93	11.11	8.51
Growth return	-2.57	-19.06	-1.52	0.27	5.33	2.29
Distribution return	0.72	11.68	8.61	6.66	5.78	6.22
S&P/ASX 200 Accumulation Index	-2.75	-9.59	5.38	5.70	9.88	4.66
Active return^	0.90	2.22	1.70	1.23	1.23	3.85

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'.

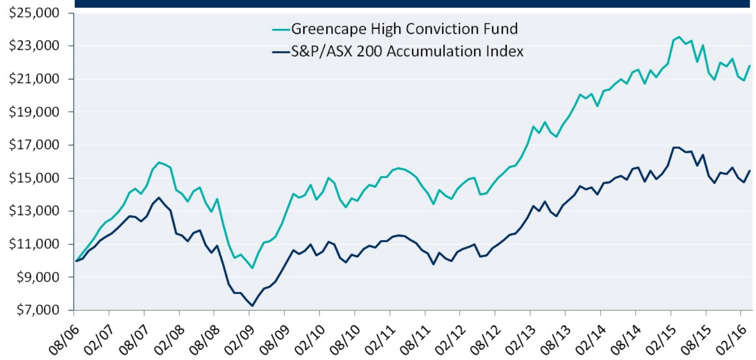
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

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

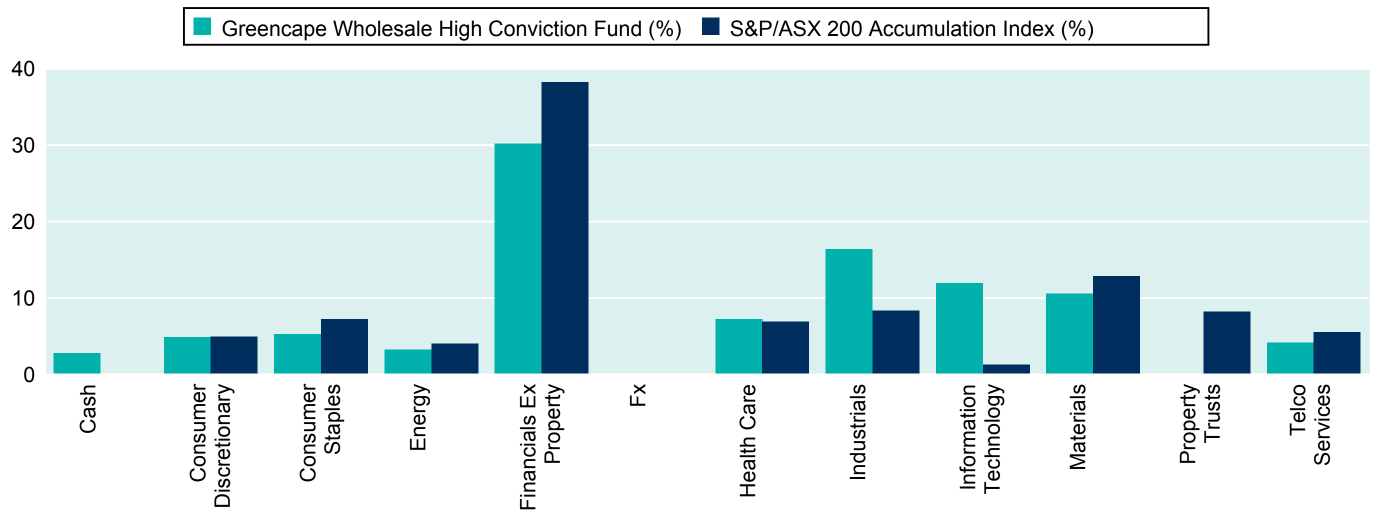


Asset allocation	As at 31 March 2016 (%)	Range (%)
Security	97.21	85-100
Cash	2.79	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0035AU

Fees	
Entry fee	Nil
2014-2015 ICR	1.14%
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 2016



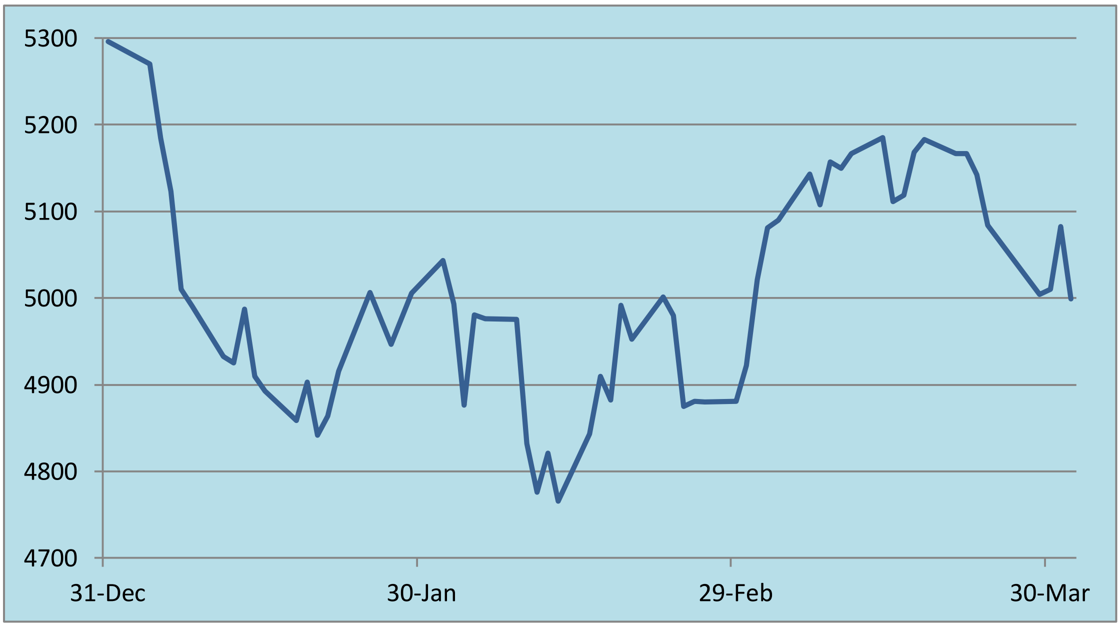
Fund performance summary

The S&P/ASX 200 Accumulation Index returned -2.75% for the quarter. The fund outperformed the market and delivered a -1.85% return over the quarter.

Market overview

The market endured another turbulent quarter with the index losing ground for the third time in the last four quarters. Reporting season was again overshadowed by macroeconomic developments which caused large scale volatility, particularly in currency markets. Domestically, the surging housing market was again under the microscope as investors questioned the sustainability of the price rally that's been experienced over the past decade.

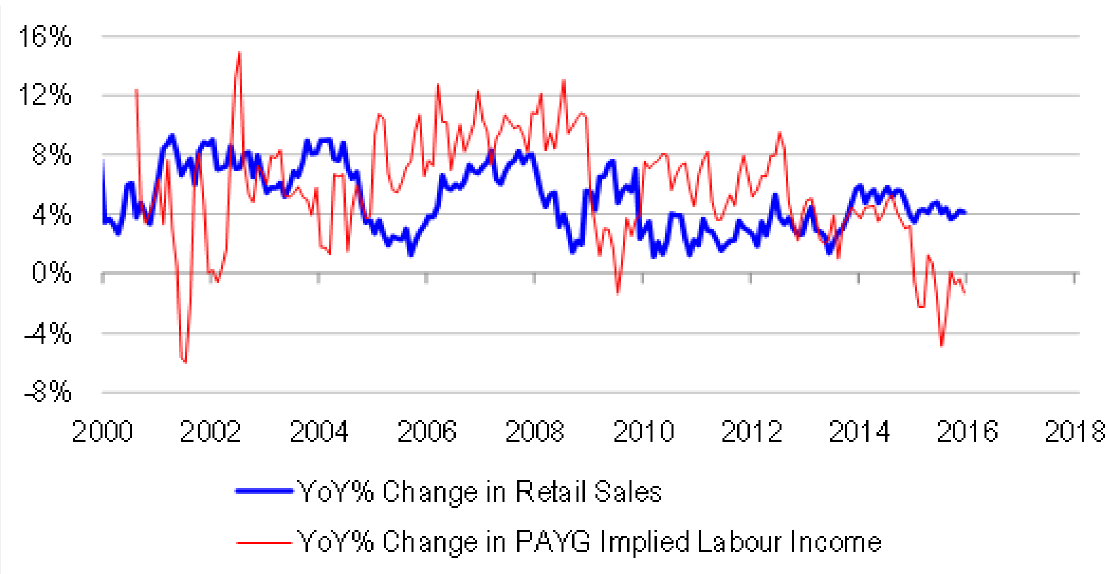
S&P/ASX 200 Index



As expected, the Reserve Bank of Australia (RBA) kept the overnight cash rate at the record low of 2.0% for both meetings during the quarter. Investors do not expect rates to change until August, with the futures market implying a 51% chance of a rate cut by then. After some peculiar employment figures late last year which far exceeded market expectations, the unemployment rate rose to 6.0% in February. Retail sales for December were flat year on year, missing expectations of a 0.4% rise. The AUD/USD cross rate fell to 68c in January, but staged a rally to 77c by the end of March as expectations for further US rate rises were pushed out.

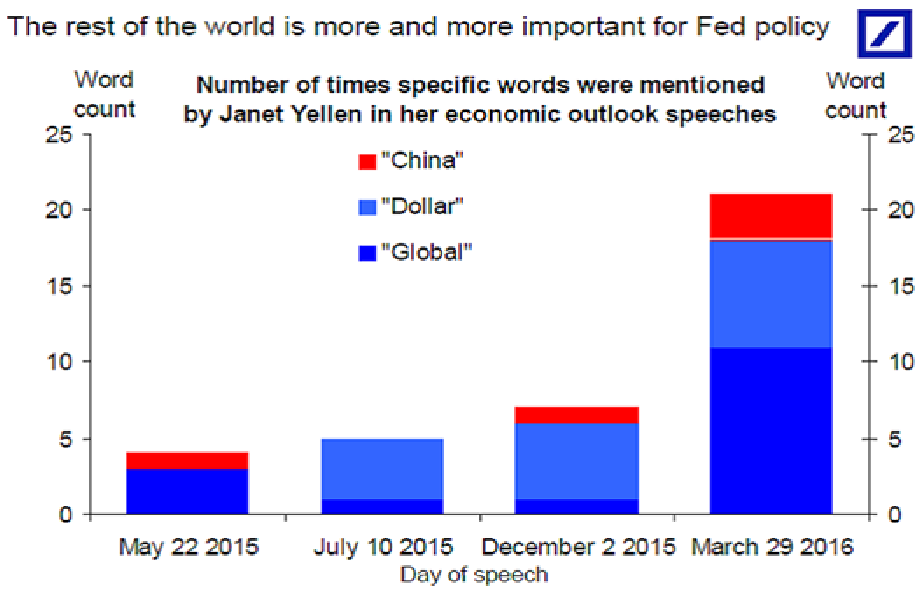
"I think we're sitting on an economic bubble. A financial bubble… we're not at 5 percent unemployment. We're at a number that's probably into the twenties if you look at the real number." Donald Trump, 03/04/2016

Retail sales growth in Australia has been more or less stable for the past few years, however we can see below its relationship with PAYG implied labour income has diverged dramatically. This suggests that consumers are either dipping into savings to fund purchases, or extending themselves by purchasing more good and services on credit. Either way, this trend is not sustainable and we expect retail sales growth to moderate.



Source: Credit Suisse

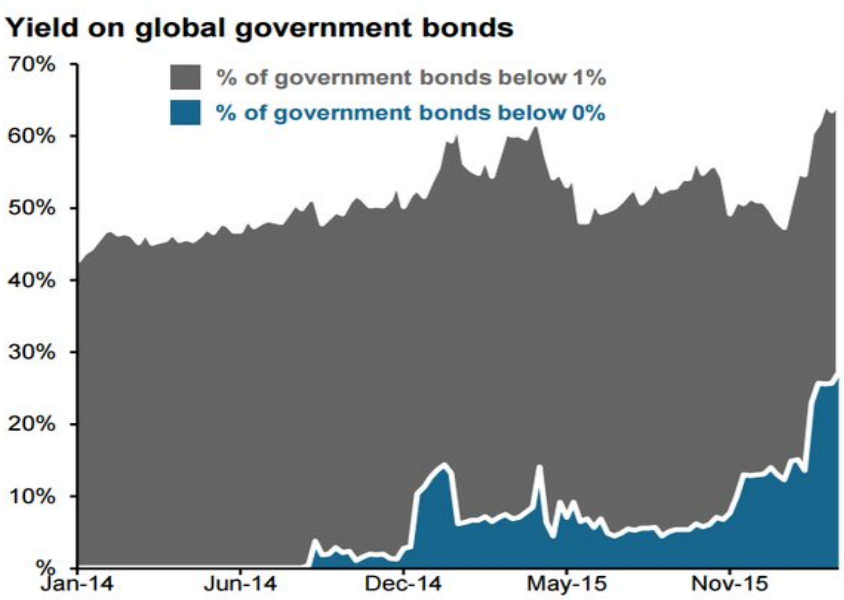
The US Federal Reserve (Fed) kept rates on hold this quarter, as global volatility and opposing interest rate policy in other developed economies saw the Federal Open Market Committee strike a discernibly more dovish tone. We can see from speech analysis below that Fed Chair Janet Yellen has become increasingly concerned with macroeconomic developments, along with the strengthening US dollar.



Source: Deutsche Bank

"Developments abroad imply that meeting our objectives for employment and inflation will likely require a somewhat lower path for the federal funds rate than was anticipated in December." Janet Yellen, Chair of the Federal Reserve Bank, 29/03/2016

Elsewhere, it continued to be a race to the bottom for government bond yields. At the time of writing, over 30% of all developed market government bond yields were negative. Even the Italian government 3 year bond yield (which traded as high at 8% in 2011) turned negative in March. In Japan, the 10-year bond yield turned negative in February; implying that investors are so bearish that they are willing to pay the government to hold onto their money for 10 years.



Source: The Daily Shot/Vconomics

"No one will lend at a negative interest rate; potential creditors will simply choose to hold cash, which pays zero nominal interest." Ben Bernanke, Former Chairman of the Fed, 02/11/2009

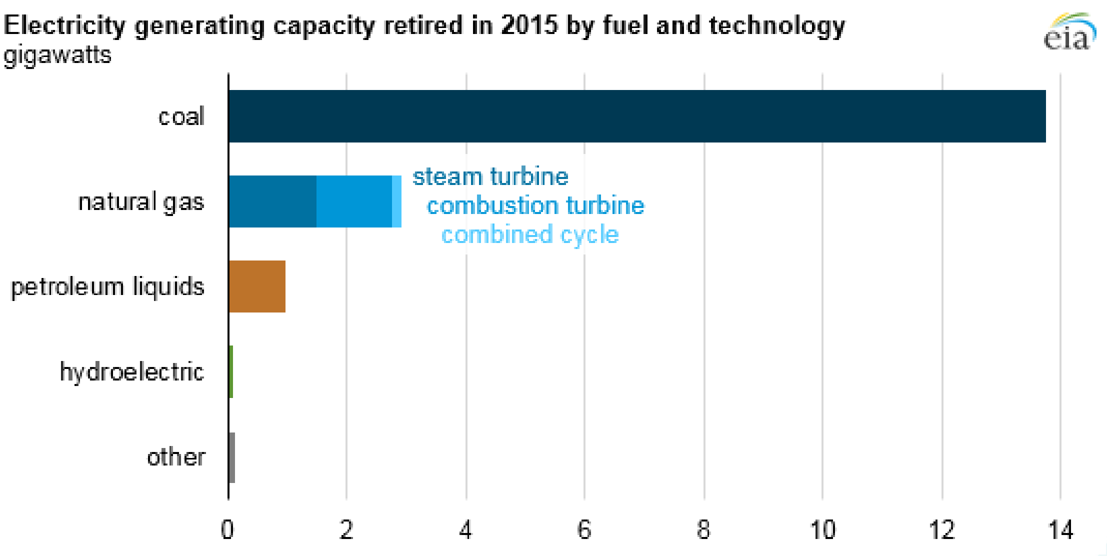
Slowing economic data out of China caused widespread concern in January, with the Shanghai Composite falling 23% for that month alone. Gross Domestic Product (GDP) growth for quarter 4 of 6.8% narrowly missed expectations of 6.9%, while the manufacturing Purchasing Managers Index (PMI) continued to print below 50. Chinese export and imports also continued to decline. Exports in February were particularly bad, falling 25% year on year.

In Europe, the UK Prime Minister announced a June referendum to decide whether the sovereign state should say in the European Union, which as a result saw the British Pound depreciate against other major currencies. Elsewhere in Europe, the European Central bank (ECB) delivered a stronger than expected stimulus package which included monthly asset purchases increasing to €80bn, up from €60bn, whilst also increasing the scope of bonds available for purchase under the program. Initially the package was taken positively by markets, until ECB President Mario Draghi stated that he did not expect there to be further rate cuts (unless the outlook changes), which saw the Euro Stoxx index close 5% off its intraday high post the announcement. The intraday swing was tantamount to a tantrum thrown by global markets, which is a worrying sign for central banks who will be contemplating how to turn off the stimulus tap at some point in the future.

	March 2016 Quarter	Year ended March 2016
ASX200 Accumulation Index	-2.8%	-9.6%
Best performing sectors		
Property Trusts	6.4%	11.3%
Industrials	5.7%	12.9%
Materials	4.6%	-18.1%
Worst performing sectors		
Financials ex Property Trusts	-9.7%	-17.2%
Information Technology	-5.1%	-5.5%
Consumer Staples	-1.8%	-5.3%

Domestically, investors were preoccupied with the February reporting season. The Materials sector found itself in an unusual position of being on the best performers list as commodity prices rebounded during the period. Iron ore gained 23% over the quarter, at one stage reaching a high of USD$64 following a one day gain of 18% in March. Oil prices were topical once again, as crude traded at USD$26, its lowest level since 2003 before surging 46% to close the quarter at USD$38.

We can see which form of electricity generation is out of favour in the US. Coal made up more than 80% of retired electricity generating capacity in 2015 according to the U.S. Energy Information Administration (EIA) after new environmental legislation was introduced.



Source: EIA

Financials were the worst performing sector as the sustainability of the housing boom again came into focus for the big four banks. An article entitled 'Uncovering the big Aussie short' (which we talk about in more detail later), which discussed the possibility of a housing crash in Australia, gained widespread attention in February, along with reports that apartments in Melbourne were being re-sold at a 30% discount to their off-the-plan prices. Bad debts were also topical, as investors questioned the exposure of each bank to troubled mining loans and other high profile bankruptcies. ANZ were the first to reveal the extent of the losses, announcing that its bad debt charge would be $100m higher than anticipated.

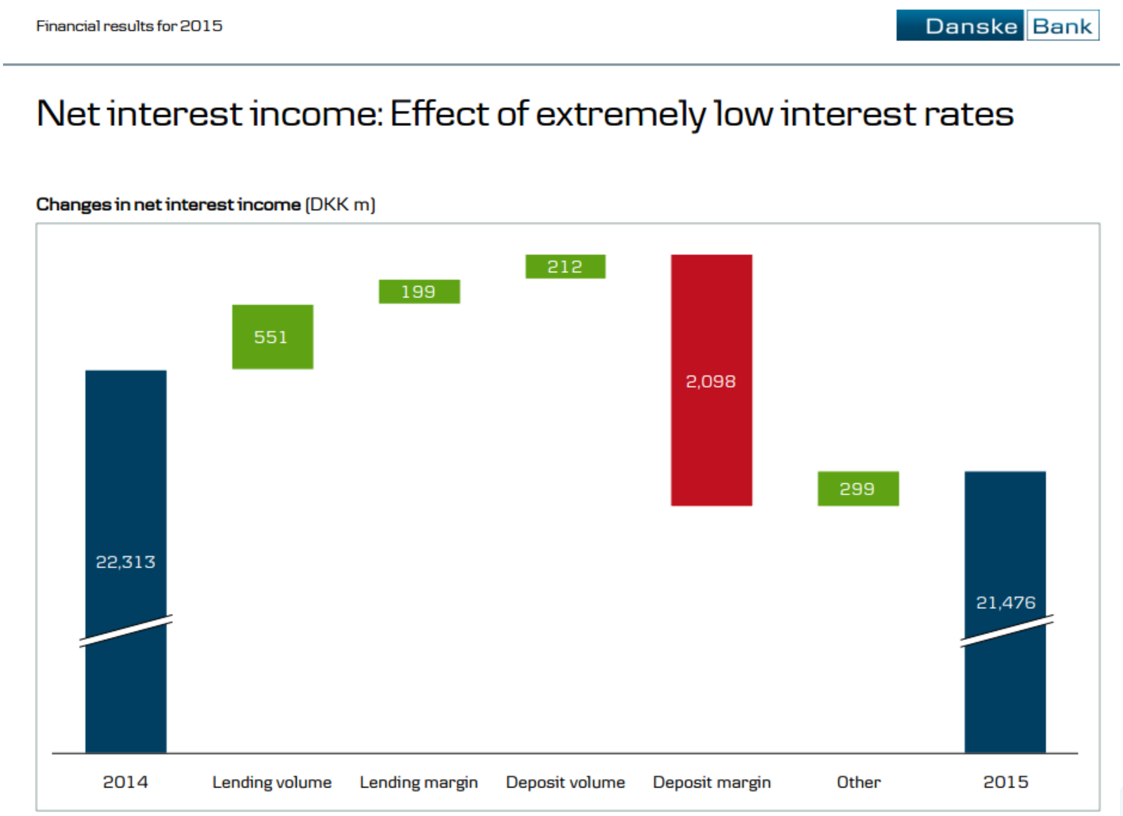
This table from UBS summarises the exposures of each of the major banks to the largest known problem loans in the market.

Figure 1: Single Name credit exposures (aka Bad Boys)

	ANZ	CommBank	NAB	Westpac	Macquarie
Arrium	✓	✓	✓	✓	-
Slater & Gordon	-	-	✓	✓	✓
Dick Smith	-	-	✓	-	✓
Peabody	✓	✓	✓	✓	-
McAleese	✓	-	-	✓	✓

Source: Company data, LoanConnector, Media report, UBS estimates

Australian banks were not alone however, as international bank profitability came into question given the current environment of record low (and even negative) interest rates. Traditional operating models have been made redundant as banks must now pay to park cash overnight at central banks, while also considering whether to pass on negative deposit rates to their customers. We thought this slide from Danske Bank was interesting, which showed the effect of low rates on the firm's deposit margin and net interest income.

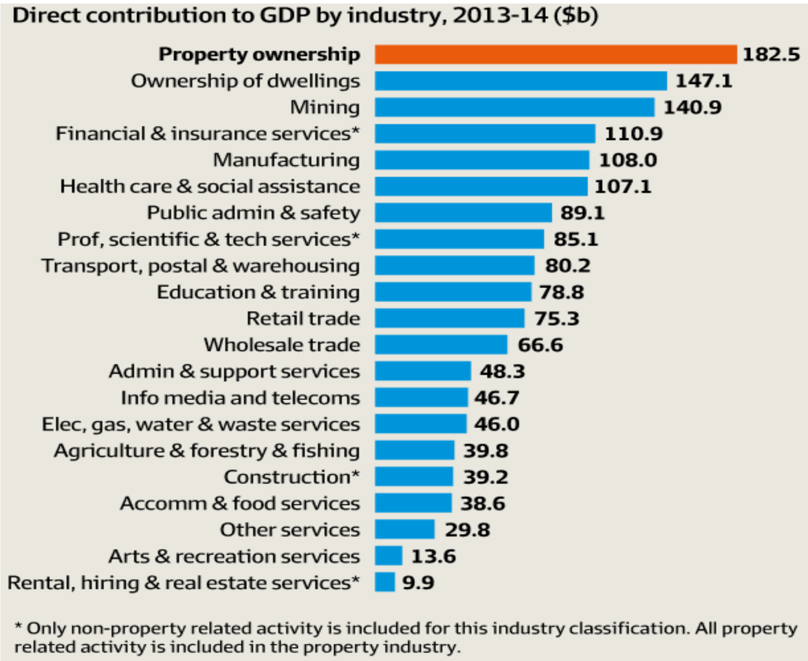


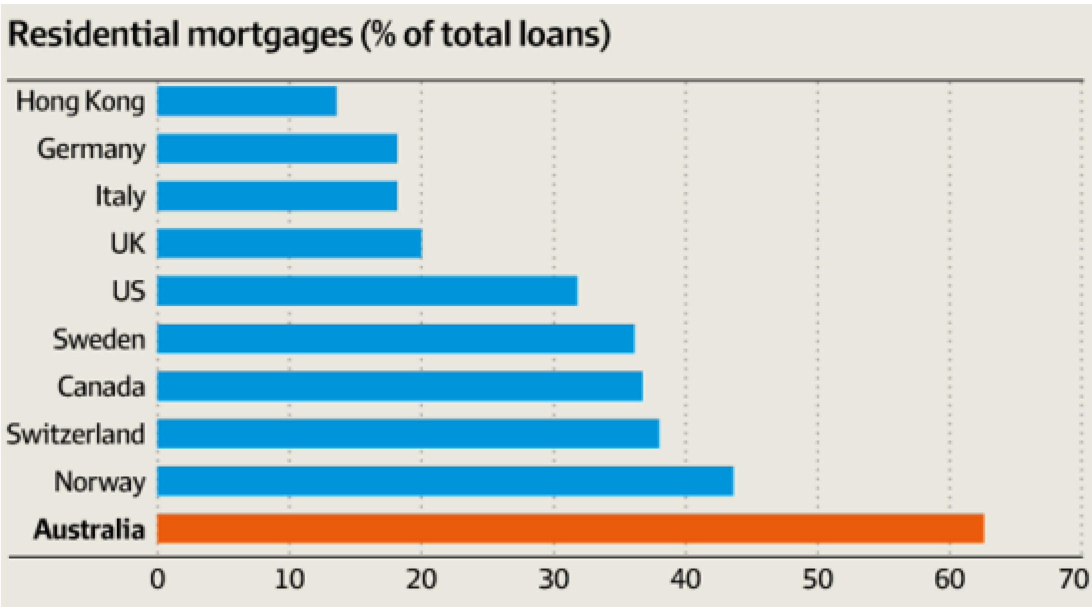
Source: Danske Bank

Housing

Australians have always had an obsession with the housing market. Property ownership in Australia has long been fabled as the 'Great Australian Dream' while renting is seen as sub-optimal; so much so that the saying 'rent money is dead money' has been ingrained into the local psyche. An interesting point which came out of the 'Uncovering the big Aussie short' article was that Australia was the only country in which "middle-class houses are auctioned like paintings." Going to a local auction to see what price the vendor would fetch is a favourite past-time for Australians, and the clearance rate for capital cities is often the first headline we see on a Monday morning.

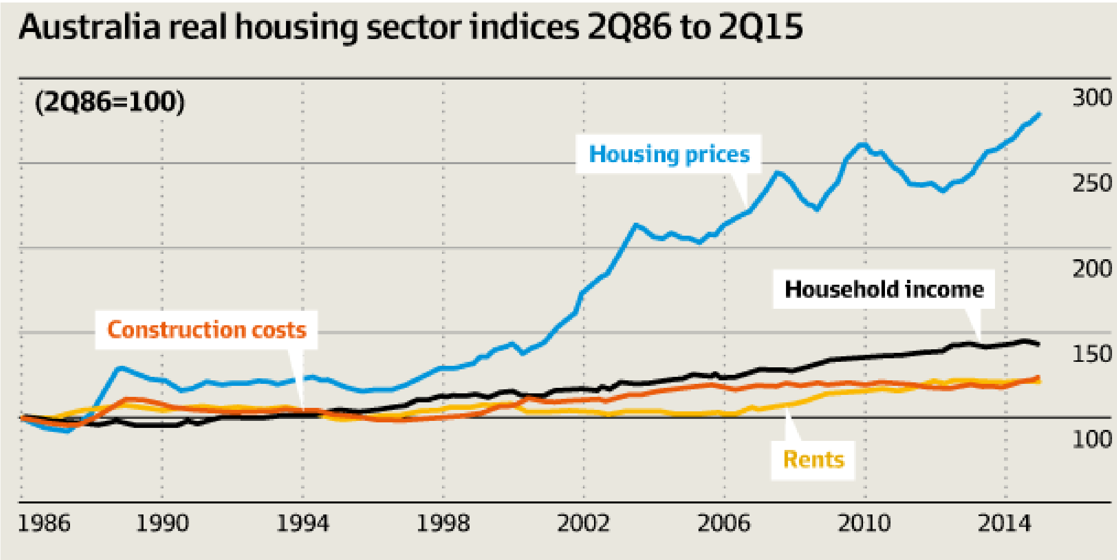
We can see below that property ownership is by far the biggest contributor to our GDP, while our mortgage debt compared to total debt is almost double the proportion of the US.





Source: Fairfax / Variant Perception

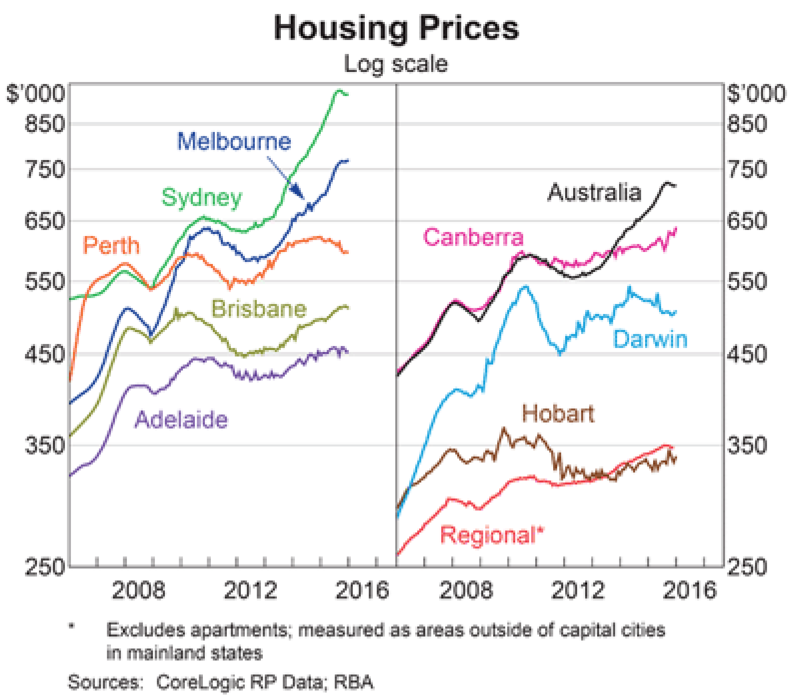
In February the Australian Financial Review published an article titled 'Uncovering the big Aussie short', which detailed the fact finding mission of an Economist who along with a Sydney hedge fund manager posed as a same sex couple looking to enter the Sydney property market. During their tour, they were advised by mortgage brokers to lie on loan applications about their income and to get their properties revalued multiple times in the same year, allowing them to speculate further with additional leverage. The report noted that 40% of all new housing loans were interest-only, which relies on houses to appreciate and be re-valued in order to be repaid. This was labelled as 'Ponzi-financing'. Unsurprisingly, the report concluded that house prices in Melbourne and Sydney would fall up to 50%, and that share prices in the big four banks could fall up to 80%. The day the article was published, shares in the major banks were sold down aggressively.



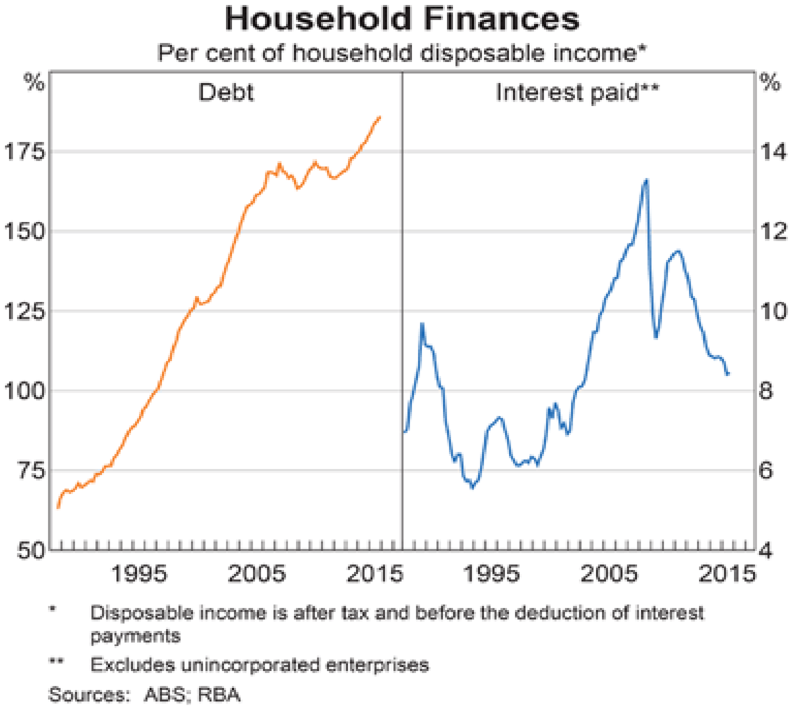
Source: Fairfax / Variant Perception

The strategy of purchasing property with leverage, then subsequently revaluing and using equity in the house to purchase further properties has been successful in the past decade as house prices have undergone a period of impressive growth in a low interest rate environment.

The median house price for Sydney is now over $1m.

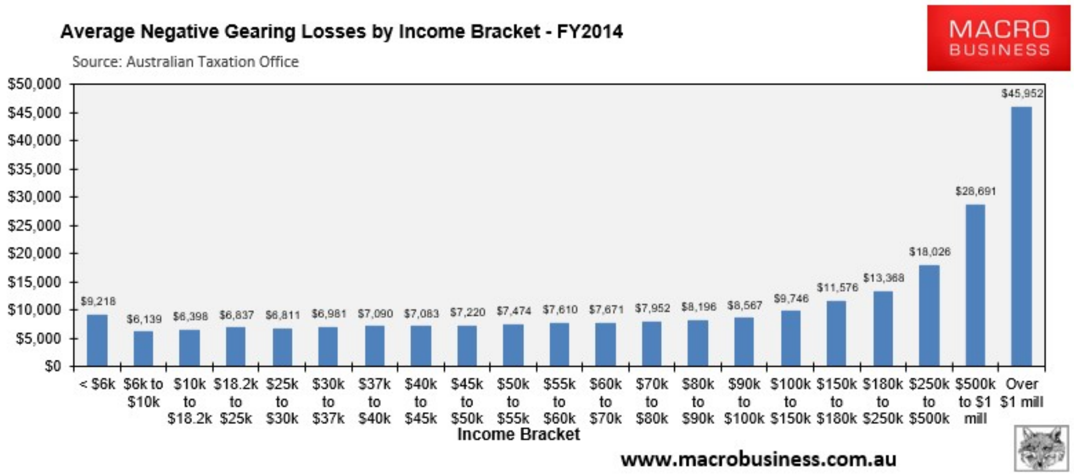


Worryingly, this has caused a large surge in the amount of debt relative to disposable income as shown below. Due to record low interest rates however, interest payments have decreased from their peak. As the 'Uncovering the Big Aussie Short' article explained, interest only loans have become increasingly popular in Australia. The most recent Australian Securities and Investments Commission data shows that for owner-occupier loans, 1 in 4 are interest-only; however 2 in 3 investor loans are interest-only. The total aggregate amount of interest-only mortgages was $143bn in 2014 compared to $89bn in 2012.



A recent point of contention in the political arena has been negative gearing, a tax subsidy whereby property investors can offset any investment carrying losses against their personal income for tax purposes. The idea is that the capital gain once the property is eventually sold (the tax of which is discounted at 50% if the property is held over a year) will make up for the losses incurred over the life of the loan. Proponents of negative gearing argue that abolishing the subsidy will push up rents as negative gearing positively adds to housing supply available for rent.

The most common argument against negative gearing is that it is used by higher income earners who drive up house prices through speculation, making houses unaffordable for lower income earners and prospective first home buyers. Proponents argue that this is not the case, as ATO data shows investors earning below $80,000 are the primary uses of negative gearing. What is often overlooked however is that the $80,000 figure is taxable income, which is what is reduced by the negative gearing offset. A large number of investors who utilise the subsidy in fact report a negative taxable income, including some taxpayers who earned over $1m but managed to get their taxable income below the $18,000 low income threshold through negative gearing offsets. We can see below from data originally obtained from the ATO, that average negative gearing losses are generated from higher income earners.

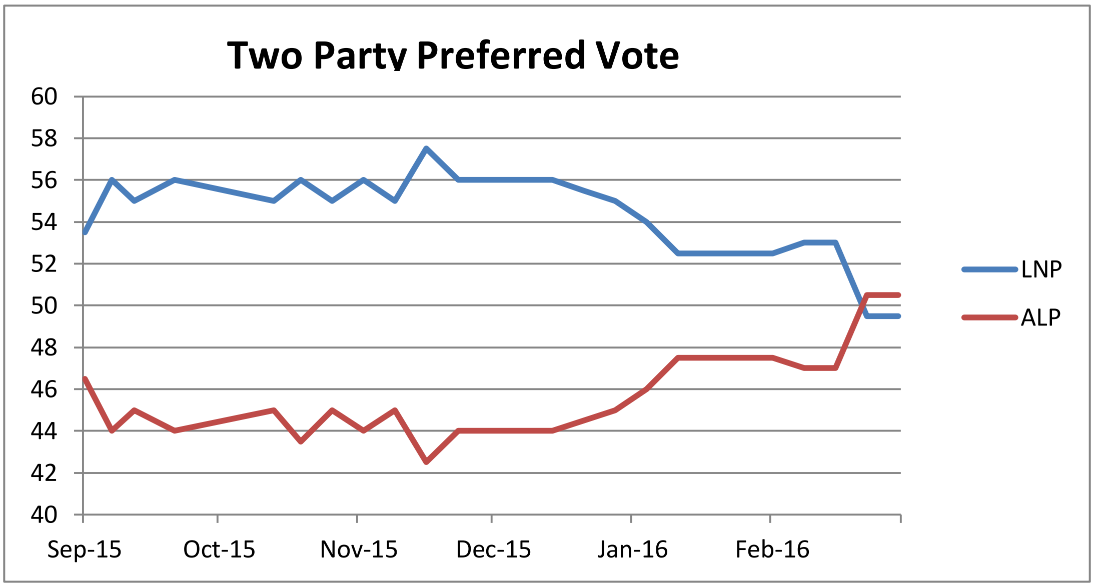


"Property ownership and speculation has been elevated to the status of religion in Australia, compounded by a perverse culture of homeowner entitlement driven by a degenerate taxation system that penalises work and effort while rewarding unearned wealth and income." LF Economics, 20/05/2015

"I can't think of anything that would provide more assistance to the increasing proportion of Australian young people and even middle-aged adults who would like to be homeowners than getting rid of negative gearing." Saul Eslake, Economist, 23/04/2015

The Labor government has proposed that negative gearing would be limited to new homes from July 2017, and then capital gains tax discount would halve from 50% to 25%, which modelling shows will save the government approximately $7bn per year. The Liberal Government did consider potential changes of their own; however these were backed away from after concerns were voiced by the backbench.

Interestingly, the Labor government's two party preferred vote has increased relative to the Liberal National Party since their proposed changes to negative gearing were announced in early February. We expect the negative gearing debate to play a key part in the upcoming election campaign for both parties.



Source: Roy Morgan

Vocus

We have been following both the Vocus and the M2 Group closely now for a number of years. After it was announced that the companies would merge, we felt that this could be a company shaping deal done at the right time given the evolving domestic telecommunications landscape.

Post-merger the group is a $4bn plus market cap company within the ASX100 which operates across the consumer and corporate telecommunications space, and importantly is increasingly vertically integrated. The key issue and focus for us was always culture and management fit, given we have long recognised that these have been two very differently run businesses. Pleasingly, we think the right executives are overseeing the key divisions and that there is good awareness and understanding of their respective skill sets.

"This is the dream team of telcos…I'm incredibly excited to be gearing up with these guys; preparing to go into battle and win the war with these guys." James Spencely, CEO of Vocus, 28/09/2015

The consumer business (legacy M2 assets) has demonstrated a strong capability around winning gross subscribers. Historically, a poorer than expected broadband experience (but one that was arguably commensurate with the value offer provided) led to industry high churn levels. Management effectively traded the cost of providing bandwidth with quality of service given their reseller status. With the merger, the consumer business can now leverage the fibre backhaul and other infrastructure that Vocus provides, especially where capacity utilisation is lower. Whilst not fully integrated to the extent of TPG, the consumer business within Vocus can now better optimise its higher bandwidth users (a relatively small proportion of total consumers) which in turn release capacity for the bulk of existing users, ultimately reducing issues around quality and speed of service. We expect this to be a meaningful source of earnings benefit to the combined group over time.

The corporate business is at a unique juncture, having spent significant capital expenditure in order to lay around 1,800km of fibre and connect over 3,600 buildings 'on-net'. The focus from here shifts to selling more services into existing buildings. These sales should come at materially higher incremental margins and less capital expenditure, which should see returns step up as operating leverage becomes increasingly apparent. With the incumbent provider charging materially higher prices, the success of this strategy is contingent on an effective sales and marketing effort. Vocus should also be able to better leverage the sale capability of the legacy M2 corporate business which has traditionally focused at the smaller end via the "Commander" brand.

As the National Broadband Network (NBN) footprint expands, more consumers will be forced to make a decision. Traditionally, Telstra has been the only option for broadband in regional areas (hence their dominant market share compared to metro areas), however as all broadband operators transition to an 'access-seeker' model, regional Australia will provide a 1.5 to 2 million subscriber market opportunity. Vocus retail products are up to 30% cheaper than Telstra's, therefore the NBN provides an opportunity for Vocus to win share off a low base which is likely to help underwrite solid growth for a long period of time. Encouragingly, the incremental share gained to date by Vocus in newly enabled NBN areas suggests they are already gaining momentum.

"We want to open [the network] up to provide more value, more downloads and more services to businesses as well as more wholesale competition." James Spencely, CEO of Vocus, 28/09/2015

Overall, we expect Vocus to win share across both the consumer and corporate markets. As this occurs, the operating model should provide for margins to improve meaningfully and return on invested capital to increase, all supportive of a higher share price over time. The key variables around future earnings growth and valuation will be the 'on-net' penetration of the wholesale fibre business, market share across consumer, and general operating synergies of the combined group, all of which could have upside risk if management are able to execute well. As mentioned, we think highly of the executive team and believe the entrepreneurial culture that has provided them with success in the past provides a good base for the company going forward.

Overseas Trips

This quarter we travelled to the US twice and to China.

US takeaways

- US housing continues to be robust, despite oil price induced fears pertaining to the Texas market. Whilst Houston is exhibiting some signs of weakening, most other Texas markets remain very healthy.
- Millennials are increasingly starting to move out of their parent's basements, which is beginning to move the household formation dial.
- A banker we met with (who owns businesses spanning a broad cross section of the US economy), is seeing "zero evidence of a material slow down" in his US businesses.
- There is a sense that the recent bounce in oil prices was more due to derivative positioning, rather than a shift in supply and demand fundamentals.
- We expect the US economy to continue to grow at a low but reasonable rate despite the continuing headwinds provided by the energy and heavy manufacturing industries.

"For 240 years it's been a terrible mistake to bet against America, and now is no time to start. America's golden goose of commerce and innovation will continue to lay more and larger eggs." Warren Buffet, Chairman of Berkshire Hathaway, 27/02/2016

China takeaways

- The structural shift away from heavy industry towards consumer/services is accelerating, with government policy increasingly favouring the latter.
- Official government press agencies are reporting on closures and job losses as e-commerce is providing new job opportunities (e.g. from deliveries and distribution). Banks are now being told to take impairments on bad loans and not lend more to these industries facing over-capacity.
- Trends for industrial/heavy commodities continue to deteriorate with the risk of stimulus to drive a rebound in demand remaining low. Recent supply side consolidation policy announcements are carrying more weight as they are coming from the President and Premier.
- China is 'leap-frogging' commerce trends in Western economies – very internet and social media savvy. There are now 200k e-commerce sites in China with one start-up we met with having funding for 5 years until they are expected to make a profit.
- The Chinese consumer is highly researched, internet savvy, can be fickle and can move aggressively en masse – companies need to be on top of consumer trends (e.g. new viral social media platforms).
- Alibaba is well placed as the scale e-commerce player. It is by far the best route for new foreign brands to access Chinese consumers, very influential with government and provides huge employment opportunities (deliveries, distribution, supports SMEs), supplying 10m direct jobs and 3.5m indirect jobs currently.

Outlook

Greencape observes uncertainty has increased through the March quarter, driven more by geopolitical events than economic data. General elections in the US and Australia are beginning to impact business and consumer confidence, whilst 'Brexit risk' in the UK, Euro debt refinancing, China's National People's Congress, Oil cartel commentary, central bank "currency wars" and tax avoidance and bribery scoops all combine to influence market sentiment.

As we mentioned last quarter, the elephant in the room remains the perception of risk of a US slowdown; which has by far and away the biggest impact on markets. Again, the key word here is 'perception' as the high frequency macroeconomic data and recent observations from reporting season and our proprietary research travel to the US all suggest that the US economy is hanging in there. Indeed the recent reporting season in Australia was marginally better than expected.

Looking forward we continue to see more of the same, as the sentiment drivers remain (with markets ebbing and flowing in the short term in reaction to the news of the day), whilst the fundamentals remain benign. We note with the AUD having bounced (against a weaker USD) and market consensus now sitting at 1-2 US rate rises this year, down from 3-4 at the start of the year, Greencape are more comfortable with our portfolio factor bias risk against the AUD and 'uber' yield. This has resulted in more conviction in our bottom up ideas. As our conviction tends to favour a combination of management skill and balance sheet optionality, we are confident our favoured stocks are well placed to navigate these sentiment driven choppy markets.

"When there's nothing particularly clever to do, the potential pitfall lies in insisting on being clever." Howard Marks, Chairman of Oaktree Capital, 2013

"… it is a matter of time before risk aversion returns to the fundamentally flawed world of credit." Christopher Wood, CLSA, 07/04/16

More information

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

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