

Greencape Wholesale High Conviction Fund

Fund report and commentary – 30 June 2009

Overview: The Greencape Wholesale High Conviction Fund (Fund), posted a return of 9.68% (after fees)* compared with the S&P/ASX 200 Accumulation Index (benchmark), which returned 11.29%.

Performance					
	Quarter (%)	1 year (%)	2 years (%) p.a.	3 years (%) p.a.	Inception (%)
Greencape Wholesale High Conviction Fund	9.68	-15.21	-10.69	-	4.93
Growth return	8.01	-18.68	-15.08	-	-2.46
Distribution return	1.67	3.47	4.39	-	7.39
S&P/ASX 200 Accumulation Index	11.29	-20.14	-16.84	-	-4.12
Active return (net)	-1.61	4.93	6.15	-	9.05

Returns are calculated after fees have been deducted, assuming reinvestment of distributions. No allowance is made for tax. Past performance is not a reliable indicator of future performance.

Investment objective

The Fund aims to provide capital growth over the long term through a highly concentrated portfolio of Australian shares, and provide returns above the benchmark, the S&P/ASX 200 Accumulation Index, over rolling three-year periods.

Investment manager

Greencape Capital Pty Ltd

Investment strategy

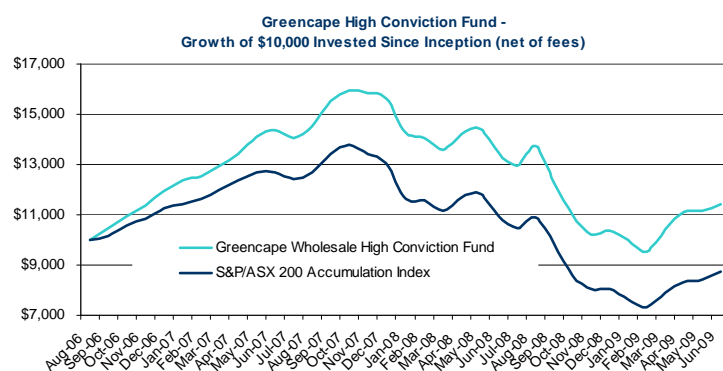
Greencape is an active, bottom-up stock picker. Whilst not targeting a specific investment style and investing in stocks displaying 'value' and 'growth' characteristics, Greencape's focus is on a company's qualitative attributes, which will generally lead to 'growth' oriented portfolios. This is an outcome of Greencape's bottom up process. As such, Greencape's investment style may be classified as 'growth at a reasonable price' (GARP).

Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years



Asset allocation

	Current (%)	Range (%)
Securities	96	85 - 100
Cash	4	0 - 15

Fund facts

Greencape Wholesale High Conviction Fund	
Inception date	11/09/2006
APIR code	HOW0035AU

Fees

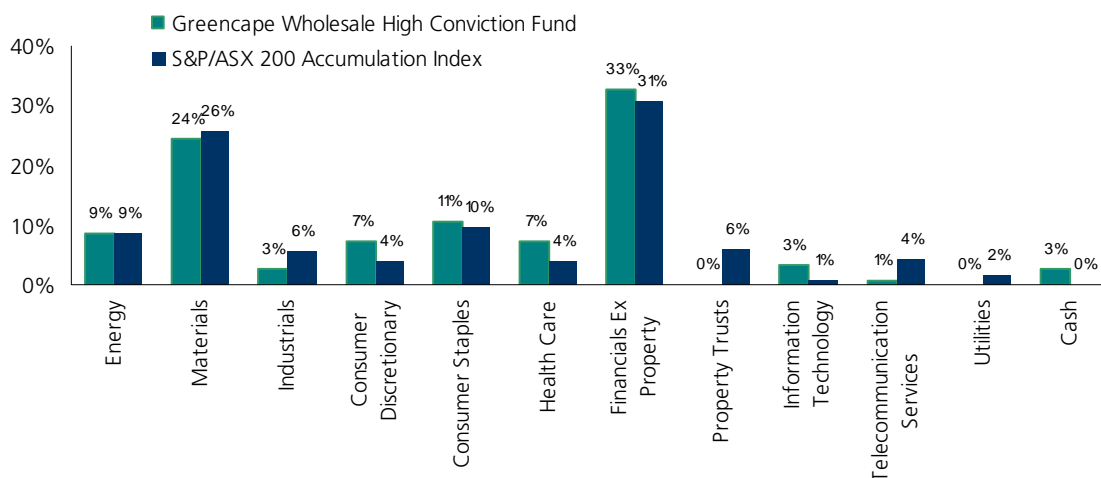
Greencape Wholesale High Conviction Fund	
Entry fee	Nil
2007/08 ICR	0.90%
Management fee	0.90% p.a.
Performance fee	15% of the Fund's after management fee return above the Fund's benchmark.
Buy/sell spread	+0.30%/-0.30%

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Sector exposures as at 31 May 2009



Market Review

In the June quarter the S&P/ASX 200 Accumulation Index returned 11.3%, marking the first positive quarter in the last 21 months. The Greencape Wholesale High Conviction Fund underperformed the market and delivered a 9.68% return over the quarter.

The market continued its advance through April and May off its low of 3,145 (S&P/ASX 200) on 6 March, albeit at a more modest pace, to close up 26% at 3,955 on 30 June. The market rose on improving economic data and lead indicators which were collectively described by Ben Bernanke as signs of 'green shoots', a phrase that has since become the latest catch phrase of market commentators keen to latch on to any sign that the worst may be behind us. The improving data led to the outperformance of higher beta sectors, which had suffered the most in downturn versus defensives as shown in the table overleaf:

"So-called green shoots in the global economy are mostly due to inventory cycles."

Andy Xie, former Morgan Stanley economist
08/06/09



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	June quarter	Year to June
Market (S&P/ASX 200 AI)	11.3%	- 20.1%
<u>Best performing sectors:</u>		
Consumer Discretionary	17.9%	- 15.4%
Property Trusts	15.2%	- 42.3%
Industrials	14.6%	- 29.5%
<u>Worst performing sectors:</u>		
Utilities	- 0.3%	- 17.6%
Healthcare	3.9%	- 0.8%
Telecommunications	6.5%	- 13.7%

Company visits and observations

- Government stimulus packages are making an impact:
 - Australia – Retail sales were up 7% in May versus the prior corresponding period, following the government cash handouts over March and April.
 - US – The 2009 US tax refund “season” delivered the strongest year on year growth since 2002. Approximately US\$209bn (just under \$700 for every man, woman and child) was returned to US citizens in 2009, up 15% versus 2008. This has been a cushioning factor to weak US retail sales.

“Stocks are simply much more sensitive to stimulus than the economy.”

- Stimulus packages come with a cost, governments are now looking at ways to fund their burgeoning expenditure programs. In the UK, high income earners have been singled out with the announcement that the top marginal tax rate (>£150k) will rise from 40% to 50% from April 2010. As a comparison, the graph below shows how the US top marginal tax rate rose during the depression and World War II along with the current projection of the US government budget.

“... if over-consumption and excessive debt have caused our problems in the US, then pushing rates so low that they practically beg us to borrow and consume some more seems an odd cure.”

Jeremy Grantham, GMO, 05/05/09

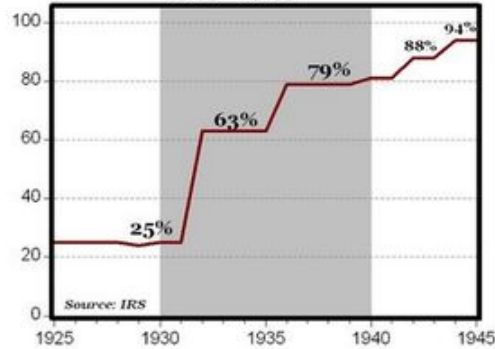


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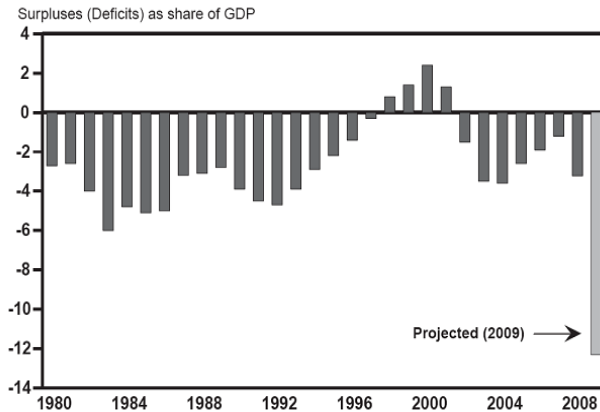
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**Highest Marginal Individual Income Tax Rate
1925 - 1945**

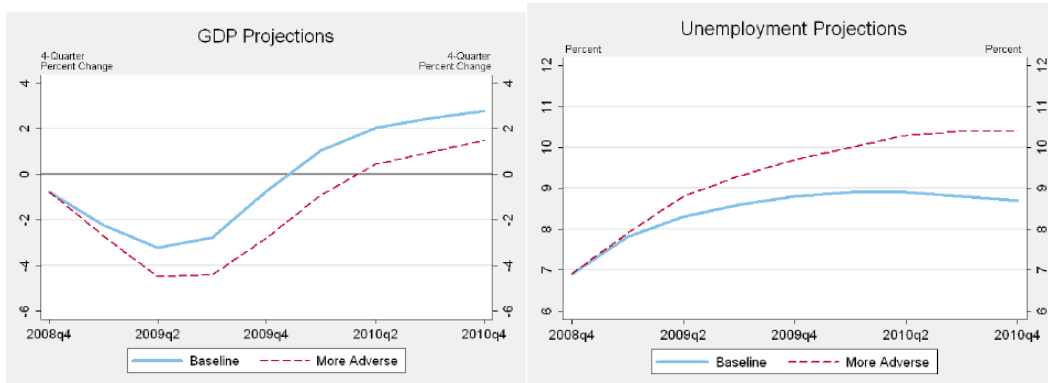


Federal Budget Balance



“The fiscal deficit could top US\$2 trillion (15 percent of GDP) in 2009. That would increase by one-third the total stock of Federal Government debt outstanding. Such a massive amount of Federal debt paper needs a buoyant Treasury to absorb. If the Treasury market is a bear market, absorption becomes a huge problem.”
Andy Xie, former Morgan Stanley economist 08/06/09

- On 24 April the US Federal Reserve released the economic assumptions they used as the basis for the ‘stress test’ they performed on the US banking system, which was ultimately awarded a clean bill of health. Below are the GDP and unemployment assumptions they used, which we believe are optimistic, particularly when the purpose of the test is to apply ‘stress’ to the financial system! In fact, the unemployment rate reached 9.5% in June which is not only higher than the peak in the ‘Baseline’ scenario but is worse than the ‘More Adverse’ scenario at this point in time which had assumed only 9.0%.



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- SRB (a Chinese government offshoot) has been buying commodities in the form of both the physical commodity and through synthetic derivatives. To give you a sense of the significance of this, the estimated surplus in copper this calendar year is around 600mt to 1,000mt whilst the Chinese have apparently bought 300mt of copper in addition to synthetic contracts in the last three months. The point here is that the Chinese could potentially account for the entire 2009 copper surplus!

"When one can't trust anything else – banks, money market funds, or politicians – that leaves only gold – the only asset that is no one's liability."
Don Coxe, Coxe Advisors
19/03/09

Although drawing any firm conclusions from the above is problematic given that the SRB has a history of trading its holdings and may not even take delivery of copper from their synthetic derivative contracts. However, the magnitude of this activity has undoubtedly had a significant impact on the copper price recently. It may be that the Chinese are diversifying their reserve holdings away from the US dollar (something which they have been or record as saying is their intention) in part via a basket of commodities, including soft commodities.

- We recently travelled through China where we met with numerous banks, logistic companies and government planning officials. Some observations from our trip:
 - Bank lending attitude is the key to the effectiveness of the government stimulus package, since banks fund 65% of all project spending. The recent jump in Chinese M2 money supply is the government loosening bank covenants for specific sectors, however there has been local concern that bank lending is flowing more to risky property developers and infrastructure construction companies.
 - China is planning to build 100 airports in the next 20 years, increasing domestic connectivity and the mobility of labour.
 - 80% of logistics companies have less than five trucks. Local players can bid 30% below market and then without warning raise prices. "Toll will find it very tough!"
 - Manufactured goods buyers finally have the upper hand with factories, now getting better service, quality improvements and sharper pricing.
 - Quote from a logistics company despite the government crackdown on safety: "We don't run a truck unless it's overloaded!"
 - Wage inflation is rising. The biggest employer is the government and public service employees have been getting wage rises as part of the stimulus package.
 - China's focus is going back to growth and away from environmental protection, "China Environmental Protection Authority officers are seen less often inspecting factories these days."



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- There is a significant over-supply of container ships which is a key risk for shipping lines and banks (particularly European banks). Over 10% of the global container fleet is idle today whilst the order book for new ships is 50% of the existing fleet! A third of new orders have come from speculative financiers. Historically, these players have been less than 7% of the market.
 - ANZ has hired over 150 people in Hong Kong over the last six months, many of whom are from HSBC and Standard Chartered.
 - Most large Asian companies are keen to diversify their banking relationships, particularly away from US and European banks. Australian banks are viewed favourably due to their AA ratings and ANZ has been actively pushing this advantage.
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- Copper production utilisation rates are currently running at greater than 90%, implying that all producers are profitable, with the current copper price running at \$2.20.

 - High cost aluminium producers have been protected by favourable long-term hedge contracts to date, hence there has been a minimal supply response to falling prices.

 - Globally there is around 400mt to 500mt of steel production capacity that is sitting idle and ready to respond to any increase in demand. In such an environment, it is hard to see a sustainable spike in steel prices for some time.

 - Chinese imports of Australian and Brazilian iron ore were up 45% in the first quarter of 2009. This is due to over 100mts of high cost Chinese production recently being closed.

 - Companies are cutting costs across the board, some examples include:
 - Worldwide ad spending is predicted to fall 7% in 2009 versus 1% growth in 2008 (Financial Times 14 April).
 - Marriott Hotel Chain will no longer provide complimentary copies of the Newspaper USA Today (Financial Times 14 April).
 - David Jones changed its key Melbourne fashion week show from evening to daytime and complimentary drinks from champagne to mineral water.

 - Salmon fish farming disease issues in Chile are worsening which should be favourable to international prices. Refer to the following extracts from a recent report by Goldman Sachs overleaf:



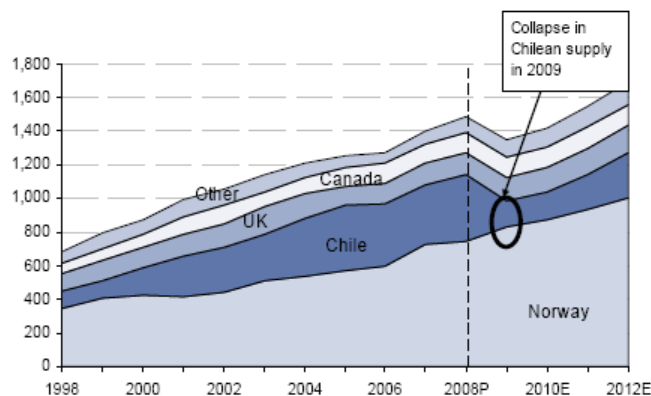
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- We expect the salmon farming industry to benefit from a sustained increase in salmon prices, in the context of our forecast of a 60% decline in Chilean salmon production this year (following the ISA biological crisis). We believe the three remaining major farming regions will be unable to significantly increase capacity to make up for this shortfall, until at least 2011, leading to a supply/demand imbalance that should lead to a sustained peak in the salmon price.
- Marine Harvest (the world's largest producer) is planning to mothball its Chilean operations until it is comfortable that the ISA crisis has passed.
- After a year and a half of deteriorating biological conditions in Chile, global harvest volumes are finally set to decline. The salmon farming industry has not experienced a decline in harvest volumes since its emergence in the 1990s; though the average annual salmon price has increased in every year in which production has grown by less than 6.75%. We now forecast a 9.4% production decline in 2009.
- Through 2008 however, the deterioration was been reflected in production volumes in Chile – 2008 was a record year, with 400k tonnes of harvested salmon. Much of this increase was due to farms being harvested out earlier than scheduled, a trend that continued through the first quarter of 2009. This trend is now ending.

Global salmon production in thousands of tonnes, 1998-2012E



Source: Company data, Goldman Sachs Research estimates.

- On 7 April the Federal Government announced they would set up a company themselves to build a National Broadband Network (NBN) with fibre to the premises (FTTP) instead of awarding the contract to private companies who had tendered. Given that the cost has been estimated to be up to \$43bn and the Government is seeking a commercial rate of return, this is undoubtedly a significant negative for Telstra's long-term outlook, who currently derive one third of their revenue from fixed line telephony and broadband.

"We are in great haste to construct a magnetic telegraph from Maine to Texas; but Maine and Texas, it may be, have nothing important to communicate."
Henry David Thoreau, philosopher 1854

"There is no reason why anyone would want a computer in the home". Ken Olson, Chairman and founder of Digital Equipment Corporation, 1977



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- You may have noticed recently when you use a foreign ATM (any ATM not owned by your bank) that you are informed up front that the transaction will cost you \$2 (usually). On 3 March, the RBA introduced direct charging, whereby the owner of an ATM now charges the cardholder directly rather than the previous complex interchange system. This change is a significant positive for the owner of ATM networks and comes at the expense of banks with small ATM fleets who now miss out on the interchange revenue they used to receive.

"...similarly, it was the development of reliable electric power flows that eventually convinced businesses to reorganise themselves around electric power." Professor Joshua Gans, Melbourne Business School, 20/03/08

Fund outlook

We wrote last quarter that we saw value in the market and that whilst earnings risk was a feature, relative to analyst expectations this gap was narrowing. In the last three months the market rallied 11.3% (S&P/ASX 200) and many stocks, particularly cyclicals which previously looked cheap, are now trading closer to fair value.

On a macro level there appear to be two camps as to where the global economy is headed. Those in the 'green shoots' camp believe government and central bank stimuli are taking effect, and the improvement (or at least less negative result) in lead indicators is evidence of the early stages of a sustained economic recovery. Others point out that the improving data coincides with inventory restocking cycles, which were massively de-stocked late in 2008, as well as temporary government spending programs which cannot be sustained in the long term. Whilst we do not have a strong view either way, we are cautious on the macroeconomic environment, and in particular Australia's relative resilience to date. Given the very nature of significant government intervention in the economy and markets, combined with still fragile credit markets, there persists the potential for significant market volatility to return.

In such an environment we continue to focus on companies with competitive advantages, which should only be extenuated in tougher economic conditions as companies continue cutting back on any non-essential spending and reviewing the value-add proposition of their suppliers more closely.

"Central banks that tried to use stimuli to solve structural problems in the '70s saw their stimuli didn't work. People saw through what they tried again and again, and began behaving accordingly, which translated monetary stimulus straight into inflation without stimulating economic growth.... I expect a second dip for the global economy in 2010."

"Real economies are much more resilient than they are given credit for."

".... the uncertainties of the economy are so great that when the uncertainties of the stock market's anticipation are laid on top of them, you simply must have big ranges of outcomes..."
Jeremy Grantham, GMO, 05/05/09



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As we move into reporting season for full year results, we expect the markets will move from less of a macro focus to more on how individual companies have performed in the last six months. We expect results to be more divergent as companies with strong operating models surprise on the upside whilst weaker companies who have struggled in tough conditions will demonstrate greater negative operating leverage than people expect. As always much attention will be paid on managements' future outlook, however we expect to hear a common theme of caution and less market guidance compared to previous periods.

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