Greencape Wholesale High Conviction Fund

Fund report and commentary – June quarter 2011

Performance	Quarter (%)	1 year (%)	2 years (%) p.a.	3 years (%) p.a.	Inception (%) p.a.
Greencape Wholesale High Conviction Fund	**–3.45**	**13.76**	**14.74**	**3.74**	**8.92**
Growth return	–4.86	10.09	11.78	0.53	3.24
Distribution return	1.41	3.67	2.96	3.20	5.67
S&P/ASX 200 Accumulation Index	–4.02	11.73	12.44	0.32	2.46
Outperformance (Net)	**0.57**	**2.03**	**2.30**	**3.42**	**6.46**

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 medium to long term through a diversified portfolio of large, mid and small capitalisation Australian shares and provide returns above the benchmark, the S&P/ASX 300 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

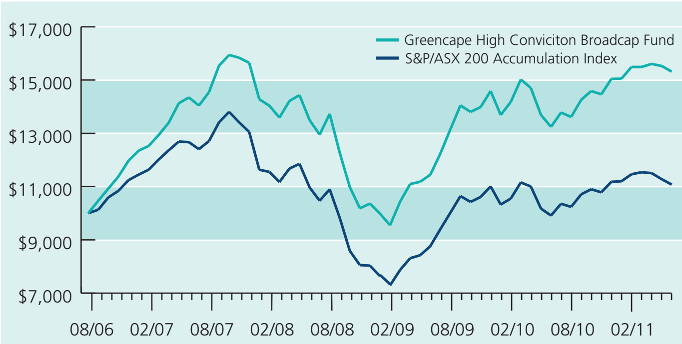
Quarterly

Suggested minimum investment timeframe

At least five years

Greencape High Conviction Fund

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

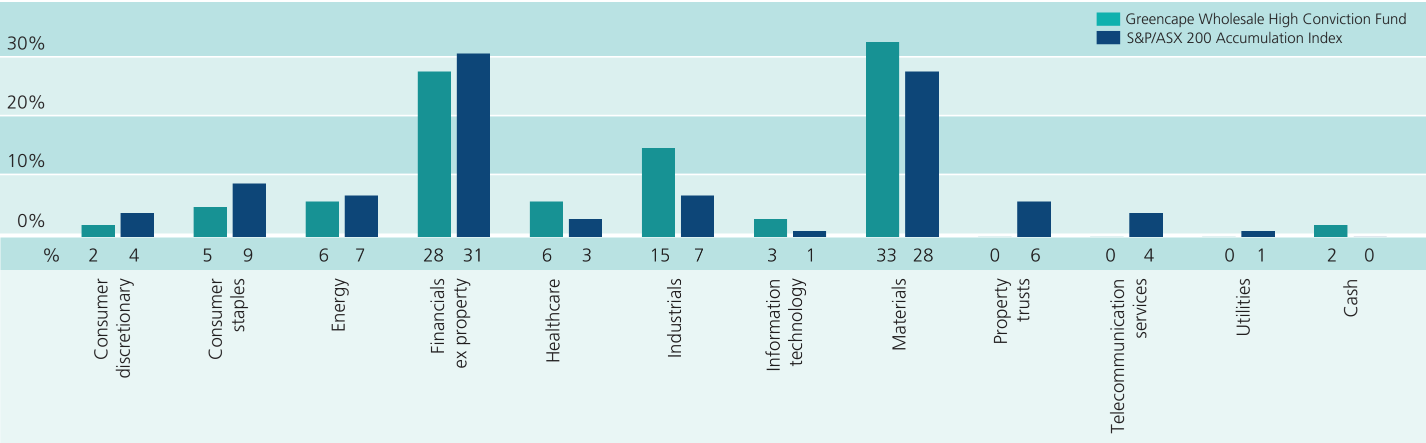


Asset allocation	Current (%)	Range (%)
Securities	97.71	85–100
Cash	2.29	0–15

Fund facts	Greencape Wholesale High Conviction Fund
Inception date	11/09/2006
APIR code	HOW0034AU

Fees	Greencape Wholesale High Conviction Fund
Entry fee	Nil
2009/10 ICR	1.25%
Management fee	0.95%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%

Sector exposures as at 30 June 2011



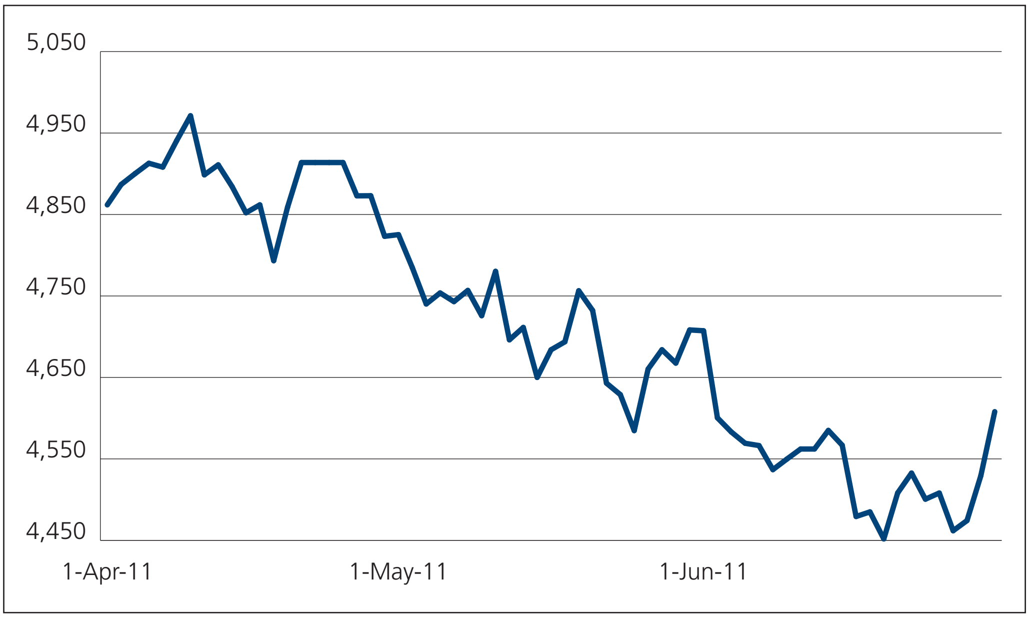
Market review

The S&P/ASX 200 Accumulation Index fell 4.02% for the quarter. The Greencape High Conviction Fund outperformed the market and delivered a –3.45% return over the quarter.

Despite several brief bounces the overall trend of the market was a steady drift downwards, with a number of global macro concerns continuing to dominate market sentiment.

Throughout the quarter investors contended with softer economic data out of China and the US, hawkish statements from several central banks due to increasing inflationary pressures, the anticipated end of QE2, and continued sovereign default concerns in the European periphery.

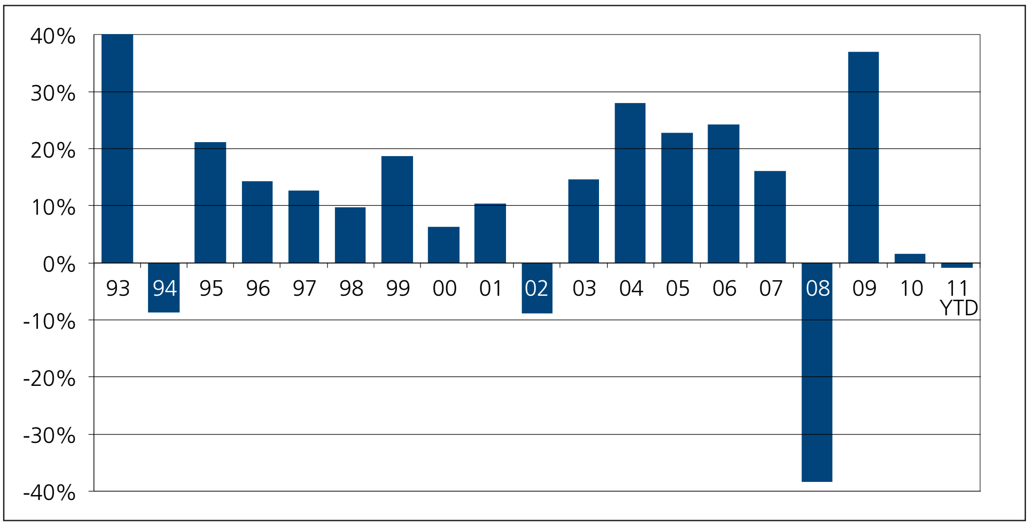
S&P/ASX 200 Accumulation Index



'People do not react symmetrically to loss and gain.'

Charlie Munger, 1995

S&P/ASX 200 Accumulation Index calendar year returns since 1993



Source: Iress

'The market is not a very accommodating machine; it won't provide high returns just because you need them.'

Peter Bernstein

Domestically, the continued strength of the Australian dollar led to profit downgrades for numerous companies, namely those with offshore earnings (e.g. Aristocrat, Billabong). Furthermore, several weak data releases combined with the apparent hawkish stance of the Reserve Bank of Australia, drew attention to the subdued outlook for consumer sentiment.

'Our export customers are doing it really really tough.'

Ken MacKenzie, MD, Amcor, 06/05/11

Partially offsetting these concerns was the potential for merger and acquisition activity. In April, there was speculation of a takeover bid for Woodside Petroleum by BHP, followed in June by SABMiller making an all-cash offer of $4.90 per share for Foster's Group, after it spun off its wine business into a separate listing (Treasury Wine Estates).

Against this backdrop, defensive sectors outperformed with a notable shift out of cyclicals and consumer-related stocks into defensives. Markets did, however, manage to stage a late quarter rally. On 23 June, the International Energy Agency announced a surprise release of strategic oil reserves, intended to help fill the gap left by the disruption to Libya's output. A further positive development was news that the Greek parliament had approved austerity measures necessary to receive a second bailout package.

The Australian dollar continued its advance into unchartered territory over the quarter, finishing up 3.8% to $1.07 by quarter end. On a purchasing power parity (PPP) basis, the Australian dollar is now the most overvalued currency in the world (by 36% vs the US dollar)[1]; however this is against the backdrop of significant valuation headwinds facing the world's major currencies (US dollar, euro, Japanese yen).

Utilities was the top performing sector, driven by a combination of positive stock-specific events, and investor confidence in the sector's dividend yields in an uncertain environment.

Spark Infrastructure rallied 15% following its successful ETSA appeal to the Competition Tribunal, and the internalisation of its management team.

The Telecommunications sector gained 3.1% on the back of Telstra, which benefited from investors seeking defensive exposure, and the signing of an $11 billion NBN agreement with the Government.

Consumer staples rose by 2.2%, with Wesfarmers and Woolworths holding relatively steady in a falling market, whilst Foster's benefited from the SABMiller takeover offer.

[1] According to Bloomberg's calculation of PPP.

	June quarter	1 year
Market (S&P/ASX 200 Accumulation Index)	–4.0%	11.7%
Best performing sectors:		
Utilities	4.9%	15.4%
Telecommunications serv.	3.1%	–0.5%
Consumer staples	2.2%	11.6%
Worst performing sectors:		
Energy	–11.1%	9.4%
Consumer discretionary	–7.9%	–0.8%
Industrials	–5.5%	19.1%

Energy was the worst performing sector, falling by 11.1%. Woodside Petroleum fell by 12% after its new Chief Executive Officer announced the company's first liquified natural gas (LNG) train from Pluto will be delayed from September 2011 to March 2012, and that the capital cost would rise by $900 million. Santos was also hit (down 13%) over similar fears of cost overruns and project delays. Paladin Energy fell markedly (down 30%) as the fallout from the Japanese earthquake disaster continued and sovereign risk concerns emerged over its mine in Namibia.

Several consumer discretionary stocks fell significantly, hit by both ongoing cyclical weakness in consumer spending and structural concerns over the shift in spending to online. Media stocks dropped on the weak outlook for advertising spending, with Fairfax sold down aggressively (down 24%) as it reported that the decline in its newspaper circulation was accelerating. Weaker than expected sales figures from Myer and David Jones helped fuel pessimism surrounding any recovery in consumer spending, with the major retail stocks down between 15-20% and JB Hi-Fi becoming the most shorted stock in the market. Crown however rallied by 9% on positive operating performance coming out of its Macau operations.

Industrials fell by 5.5%, although there were several stocks that managed to hold steady (e.g. Brambles, ConnectEast, Transfield). Leightons Holdings fell by 28%, hurt by the announcement of writedowns, profit downgrades, and cancelling its dividend. Qantas fell by 16%, with the industry hit by flight cancellations and delays due to ash clouds from Chile, and investor concerns over a potential pilot strike. Macquarie Airports increased by 13% helped by speculation, followed by an official announcement, that it would simplify its structure by selling offshore airport stakes in Brussels and Copenhagen to increase its stake in Sydney airport and reduce debt.

Company visits and observations

In May we again travelled to China and neighbouring countries to gain insights into China's political process around social housing, monetary policy, foreign investment policies, environmental issues regarding energy development and how trends in the financial and transport sectors may impact Australian listed companies. Some of our observations are listed below:

- The Chinese consumer is very aspirational and luxury brands are already highly penetrated in tier 1 cities.
- Intra-Asia shipping container volumes are still growing circa 10% p.a.
- Export volumes from China to the US are mildly up on last year.
- Shipyards are running at full capacity with 6% growth in fleet size forecast.
- Chinese housing:
  - 72% of the population live in apartments
  - the home ownership rate is 84% (up from 80% in 2002) versus 67% in the US
  - high home ownership implies the Government's social housing initiative is more about upgrades and refurbishments than actual new net housing stock
  - 90% of houses are priced at four or more times the median annual salary (in the US the comparison is 26%)
  - our view is that there is clear evidence of a property bubble.

'Department stores are dying globally except in China and emerging markets where they provide an efficient way for eager consumers to discover brands.'

US apparel wholesaler, May 2011

- There are signs that China is becoming more environmentally conscious (off a low base perhaps) with talk of 'carbon per unit of GDP' and the fact they have halted approvals of new hydroelectric developments for the moment.
- China's infrastructure development is pushing further west, however it's worth noting that the south west of China is environmentally sensitive, being home to 20% of the country's biodiversity (including pandas!) and half of the minority ethnic groups.
- China has surpassed the World Bank as the biggest lender to Africa.
- ANZ is doing a good job operationally in Asia, Macquarie is struggling.
- Having a pan-Asia banking presence is advantageous given many corporate customers have their supply chain spread over many different countries.
- Signs that Chinese banks are growing their lending intra-Asia with aggressive pricing.
- The Hong Kong Stock Exchange (HKSE):
  - was the number one destination globally for initial public offerings (IPOs) in 2009 and 2010
  - is not interested in mergers with other exchanges
  - is targeting the 100 million mainland Chinese investors (versus 2 million in Hong Kong) by planning to allow future IPOs in RMB (China's currency, Renminbi), and
  - wants to grow its resource company listings, where African miners may be the key opportunity.
- Hong Kong had 38 million mainland Chinese tourists in 2010, in comparison to their 7 million population.
- Hutchison is on track for becoming the third port operator in Brisbane and Sydney in 2013.

In June we travelled to the US on two occasions and met with a wide range of companies to assess the extent of weaker US macro data, how multinationals are viewing growth in US/Europe/emerging markets, the implications structural trends may have on Australian listed companies, and how Australian listed companies' US operations are performing relative to their competitors. Some of our observations are listed below:

- A slowdown in business activity was observed in both consumer and intra-corporate segments.
- Corporates are generally positioning themselves for a long slow economic recovery.
- US population growth rate remains strong.
- The average consumption of Coca Cola in the US is 394 serves per person per annum. In Australia it is 324 and in China it is only 11. But in cities like Shanghai, the consumption pattern is similar to the West.
- Best Buy (a mature consumer electronics retailer) believes in a combined online and bricks and mortar model, but it is facing the following headwinds:
  - product price deflation
  - general merchandisers such as Walmart and Target pushing low-end electronic products
  - growth categories (tablets/smartphones/games) only need a small retail footprint and can be purchased online just as easily. Below is a Best Buy vending machine we saw at the airport, which dispenses smart phones and tablets!

'We think that now days the consumer is virtually prescribed their consumer sentiment thru the mass media. The political cycle and environment is therefore not a positive for sentiment, as every Republican from now until November 2012 will be talking down the economy. Fox news and CNN will be depressing.'

US Corporate manager, June 2011

'We are seeing consumer behaviour consistent with the last downturn. That is, less high price point discretionary buys and the consumer trading down to smaller size products.'

Coca Cola, June 2011

'The recovery must involve the consumer.'

John Farrel, VP Strategic Planning, Coca Cola, June 2011

- Lowes (who will launch the Masters JV with Woolworths in Australia in October) claims its key competitive advantages are:
  - it can deliver superior customer service whilst still having an 'Every Day Low Price' model
  - its online infrastructure allows more product choice for consumers and assists in project planning e.g. having a digital kitchen where you can copy in appliances to see how they appear together
  - buying power advantages for private label products.
- Lowes' former head of Canada will be running the Australian Masters business.
- JC Penny, a US department store recently lured Ron Johnson, the head of Apple's retail stores, to be their next Chief Executive Officer. Watch out for a radical change in department store marketing!
- Private equity is back in the market given cheap debt on offer.

'Who dares wins… if you want to win, you have to have a crack.'

John Gillam, CEO, Bunnings, 02/06/11

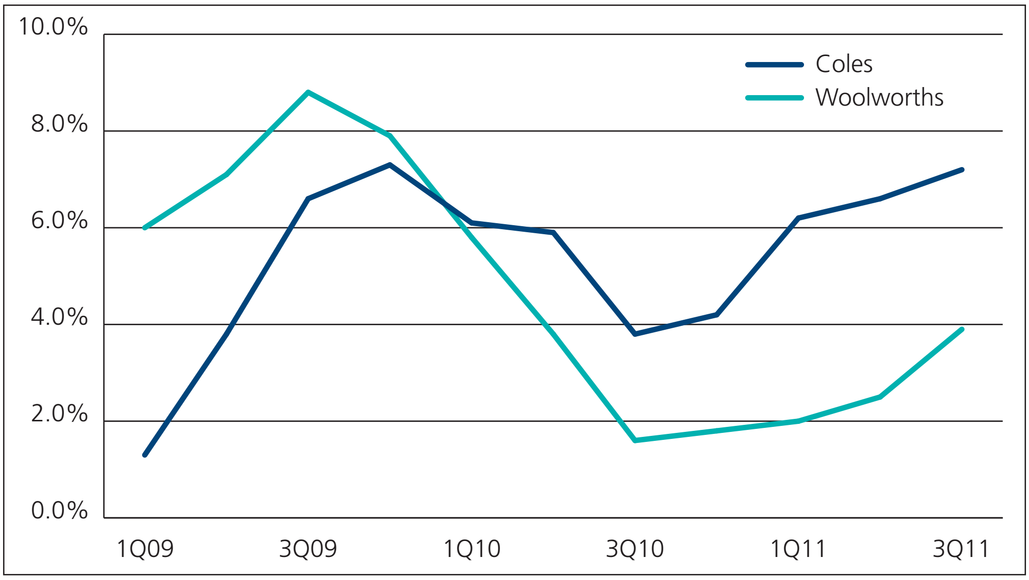
Coles v Woolworths

The chart below shows the comparison between Coles and Woolworths comparative stores sales since the current Coles Managing Director joined in May 2008. Coles attributes the success in its sales turnaround from a range of initiatives that include improving the fresh offer, empowering store managers, better marketing, reducing the amount of 'out-of-stocks' and from refurbishment of some stores.

'You don't need to do much spin when you've got 7% comps.'

Richard Goyder, Wesfarmers CEO re Coles sales growth, 20/04/11

Coles v Woolworths Food and Liquor same store sales growth



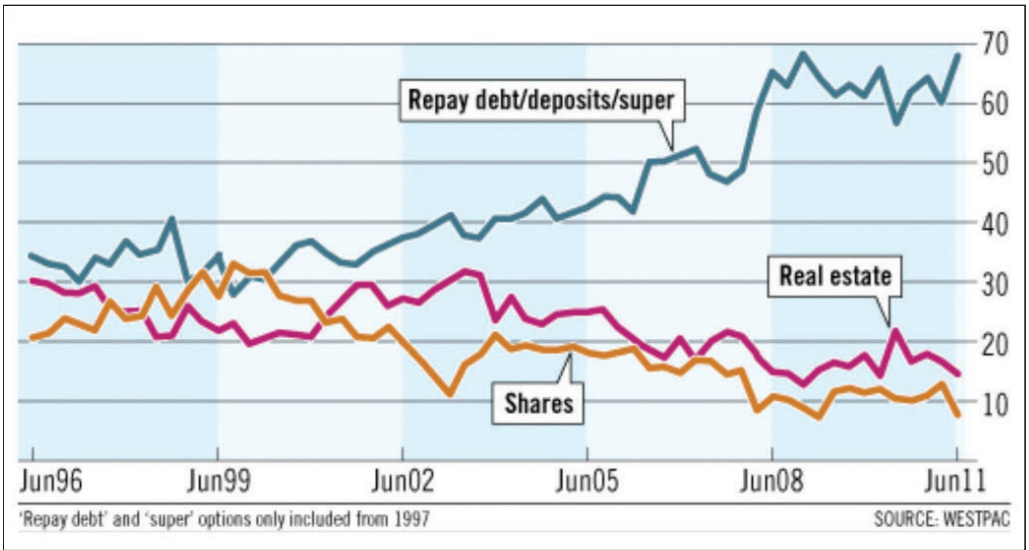
Source: RBS

Macro observations

Australian savings rate and impact on the property market

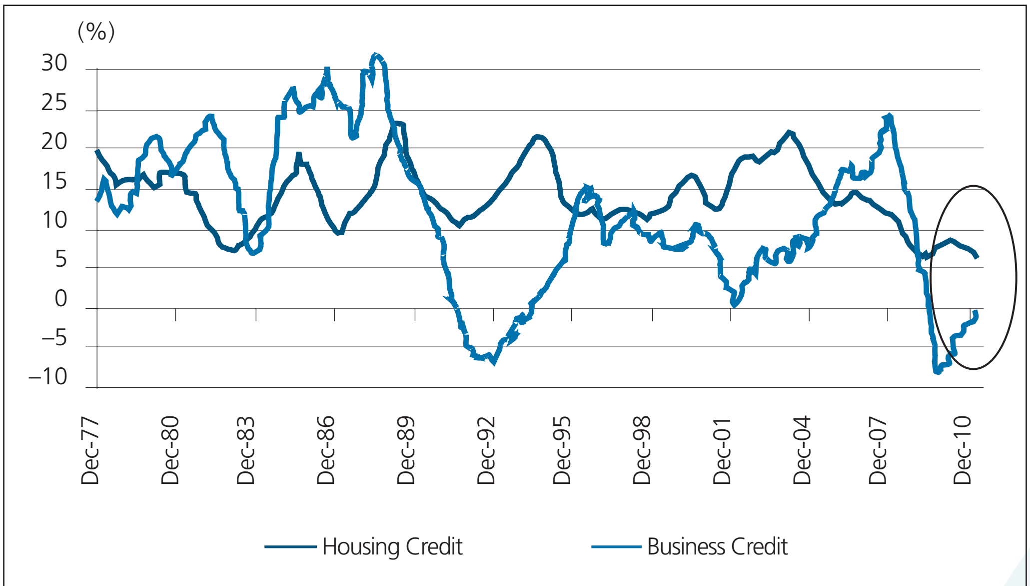
Retail sales have been weak in Australia for over 12 months now. Post the Government stimulus payments rolling off, they've stayed weak given the headwinds from rising interest rates, higher utility costs, consumer take-up of online shopping and a higher propensity for consumers to save in a post-GFC world. The chart below gives an insight into the change in savings patterns, which spiked two years ago, moderated a little from that level, and now look to have picked up again in the last six months.

Where consumers are putting their savings (%)



Less money flowing into residential property is also evidenced by the chart below which shows that housing credit growth is the lowest in 33 years.

Australian housing v business credit growth



Source: RBA data, UBS

'There's no question we are in a two-speed economy. In fact, it has all the feeling of a major down-turn.'

Kerry Stokes, Chairman, Seven West Media, 16/05/11

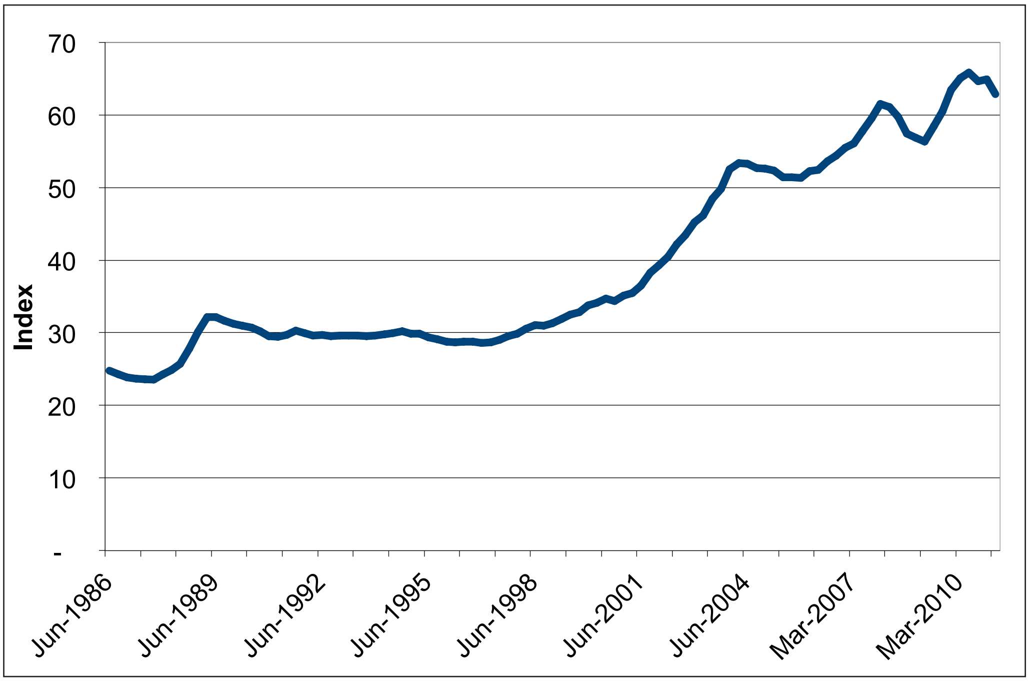
'Household debt servicing loads are at near-record levels, and interest rates are on the rise. Growth in housing credit is at 30-year lows – we have to go back to the pre-deregulation recession of 1982, with unemployment more than 10%, to find such low growth.'

Mike Codling, Partner, PwC 01/06/11

[2] *ABS*

Lower credit growth has also corresponded with lower nominal house prices in the last six months or so. In real terms, the housing market peaked (national average) in the June 2010 quarter[2] as shown in the chart below which is up until March 2011.

Australian Capital City Median Real House Price Index



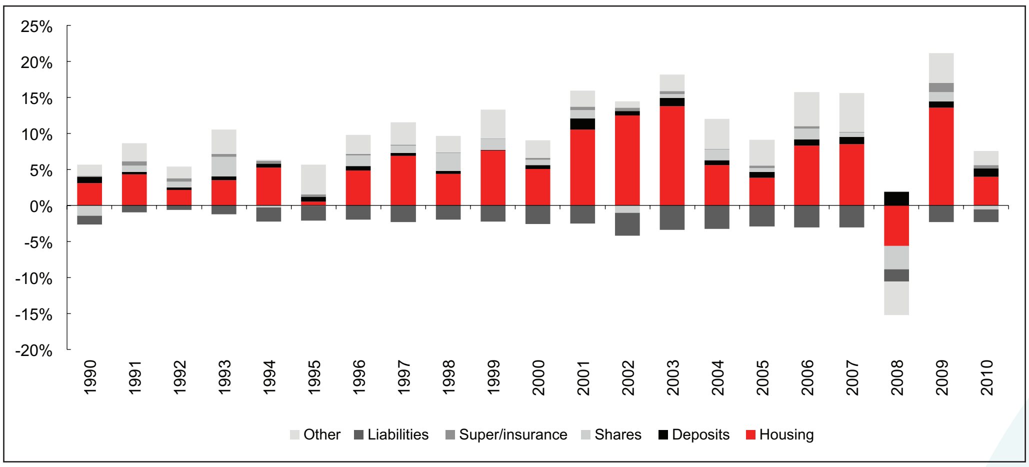
Source: ABS and RBA

'The dearth of credit which marks the crisis is caused not be contraction, but by the abstention of further credit expansion.'

Ludwig von Misies

Whilst there has been much debate about whether Australia's housing market is in bubble territory, a weakening or even flat-ish market may well temper any hoped for rapid bounce back in consumer spending given the negative (or at least absence of a positive) wealth effect. The chart below shows the strong growth in household wealth from 1996 to 2007, which corresponded to a period of strong discretionary retail sales growth. What stands out is just how much of the wealth effect has come from housing, with 2008 being the only negative year in the last 20 years, which was quickly offset by a rebound in 2009.

Growth in net worth – Contribution from housing is stunning – Not too many highlights over last four years

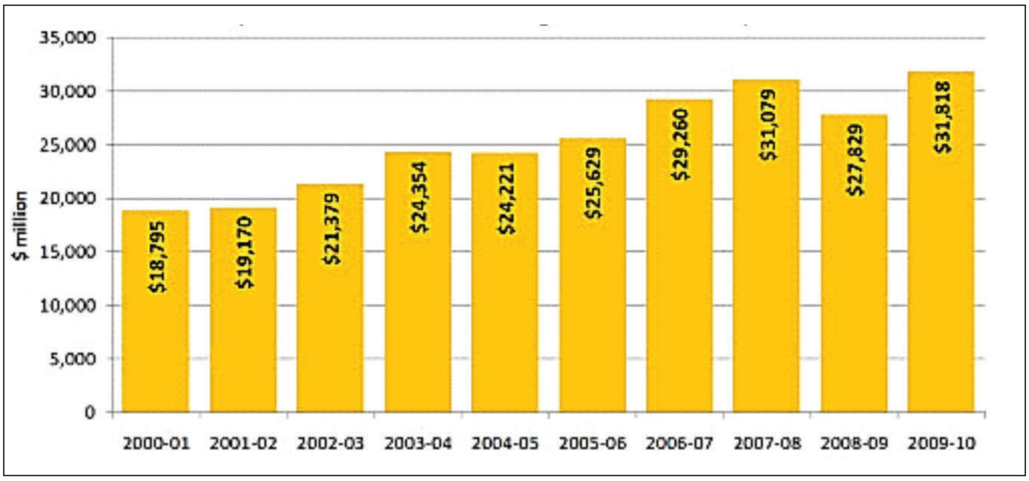


Source: Macquarie Research

[2] ABS

The other flow-on effect from a weaker housing market (both in price and sales volumes) is in reduced revenues to the State Government in the form of lower stamp duty takings. The chart below shows that the 2010 financial year tax take by state governments grew by 14%, following a 10% drop in 2009.

Total property related tax revenue (all state and local governments)



Source: rpdata.com, ABS

Sovereign debt

On 18 April Standard & Poor's (S&P) put the US' debt rating, which it still rates as AAA, on 'negative watch'. Below are some excerpts from its press release highlighting what S&P sees as some of the key risks and underlying drivers to its US credit rating.

> 'We expect the general government deficit to decline gradually but remain slightly higher than 6% of GDP in 2013. As a result, net general government debt would reach 84% of GDP by 2013.'
>
> 'Even in our optimistic scenario, we believe the US' fiscal profile would be less robust than those of other 'AAA' rated sovereigns by 2013.'
>
> '… it could cost the US Government as much as 3.5% of GDP to appropriately capitalize and relaunch Fannie Mae and Freddie Mac.'
>
> '… we now estimate the maximum aggregate, up-front fiscal cost to the US Government of resolving potential financial sector asset impairment in a stress scenario at 34% of GDP compared with our estimate of 26% in 2007.'
>
> '… the US' unfunded entitlement programs (such as Social Security, Medicare, and Medicaid) to be the main source of long-term fiscal pressure. These entitlements already account for almost half of federal spending (an estimated 42% in fiscal-year 2011), and we project that percentage to continue increasing as long as these entitlement programs remain as they currently exist.'
>
> '… the US' net external debt level (as we narrowly define it), approaching 300% of current account receipts in 2011, demonstrates a high reliance on foreign financing. The US' external indebtedness by this measure is one of the highest of all the sovereigns we rate.'
>
> 'While thus far US policymakers have been unable to agree on a fiscal consolidation strategy, the US' closest 'AAA' rated peers have already begun implementing theirs.'
>
> '… there is **at least a one-in-three likelihood that we could lower our long-term rating on the US within two years**.'

'The bond market is the only language policymakers will listen to. Once the bond markets impose austerity on the country, that's when they follow through … when things are going better, that's when they lapse.'

Axel Merk, CIO Merk Investments, 23/05/11

On 1 June Moody's downgraded Greece's credit rating (again) three notches, from B1 to Caa1, and retained its 'negative outlook' on the country. Since then the Greek Parliament has passed an austerity package which has allowed it to receive the next tranche of European funds which should see it avoid defaulting on its debt obligations in the near term. However, on our reading, it appears unlikely that Greece's financial situation is on a sustainable footing, with much of the success of the austerity package hinging on strong economic growth over the next few years, in order to reign in its budget deficit.

At the time of writing Moody's also downgraded Portugal's credit rating from Baa1 to Ba2 with a negative outlook.

'One moment I veer toward a 'no', the other toward a 'yes'. I will make a last-minute-decision.'

Thomas Robopoulos, Greek MP, re whether he would back the proposed austerity package, 26/06/11

China's demographics

In April China released headline data from its sixth census, which was conducted in November 2010. Some of the key results are shown below:

Population – 1.34 billion, up from 1.31 billion in 2005 with population growth averaging 0.6% over the past decade (this still added 74 million people in 10 years, three times Australia's population)!

Urbanisation – 50% of the Chinese population live in urban areas, up from 36% in 2000. In the last decade, the average net increase in the urban population was 20.7 million p.a., up from 15.7 million p.a. during the 1990-2000 period.

Education – The ratio of Chinese with a college degree or higher rose to 8.9%, up from 3.6% in 2000, providing a more educated workforce. The illiteracy ratio fell to 4.1% from 6.7% in 2000.

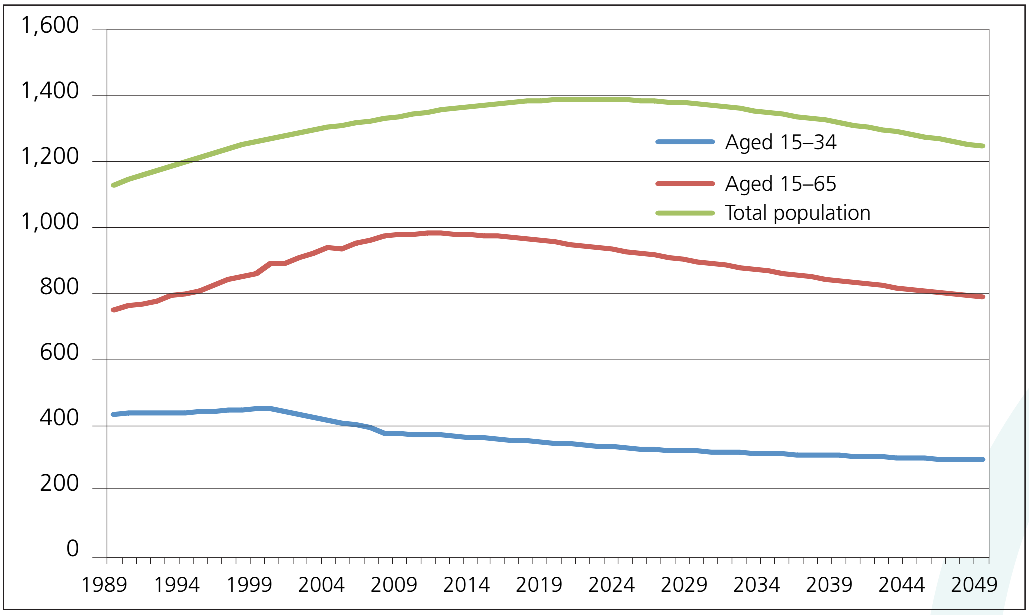
Family size – The average family size dropped to 3.1 persons, down from 3.4 in 2000, the outcome of China's one child policy.

Aging society – China continues to age, with the 60-and-older share of the population now 13%, up from 10% in 2000. The coastal population is aging at a faster rate than the rest of the country.

Population mix – The population remains very homogenous, with the ethnic Han share making up 92% of the total.

A recent report from Deutsche Bank predicted that in the next five decades, China's working age population will decline by 200 million people, which is the equivalent to 100 times the size of the entire Singaporean labor force!

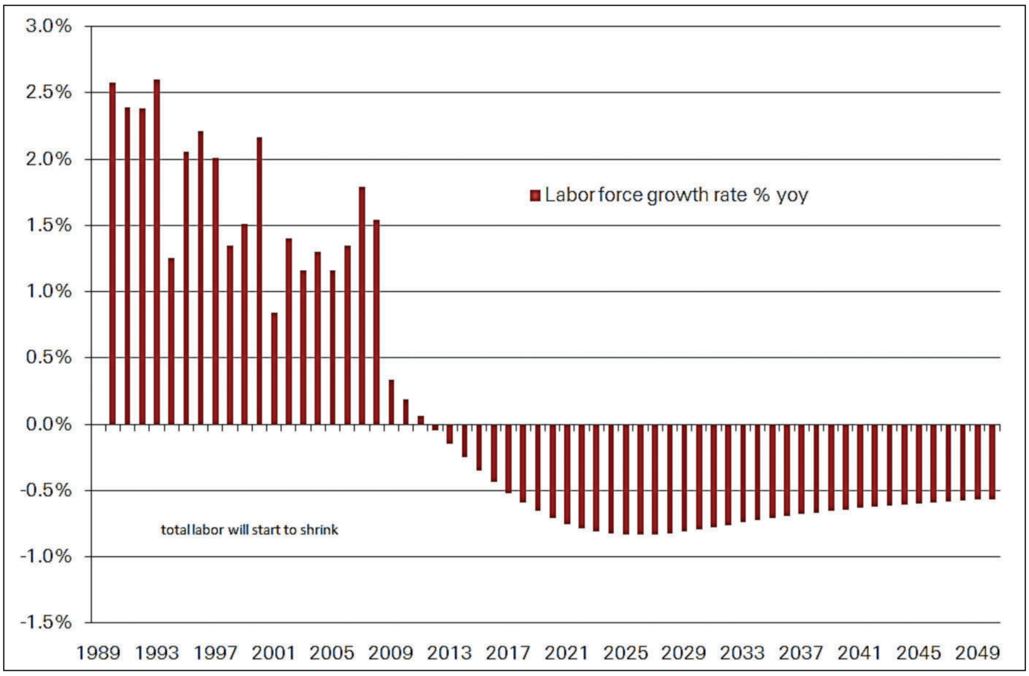
China projection of population and labor force, 1989-2050 (in millions of people)



Source: Deutsche Bank population model, CEIC

The chart below shows that the growth in labor force has stalled, and is just about to turn negative. The urbanisation rate, which is taking relatively unproductive rural labor and putting it to more productive use in cities, will offset the labor force decline to some degree. But the passing of the peak of China's workforce will act as a constraint on gross domestic product (GDP) growth versus the decade we've just had where the working age population was growing strongly. Hence a lower GDP growth rate is likely going forward.

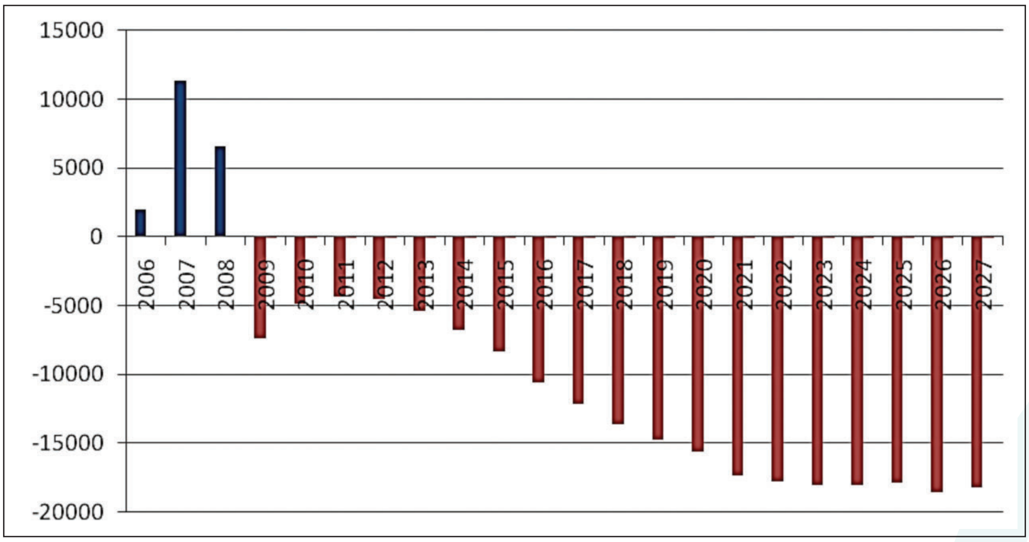
China labor force growth rate



Source: Deutsche Bank

Deutsche Bank estimates that demand for residential properties will fall 10% by 2015 due to the demographic changes highlighted above, and shows the following chart as an estimation of the impact. Whilst this thematic will also be offset by the urbanisation trend to some degree, it points to a lessening in building-related commodity demand from a sector that has had a very large appetite historically.

Impact of demographic change on demand for housing (change in 10,000 sqm)



Source: Deutsche Bank

Chinese government debt and bank lending

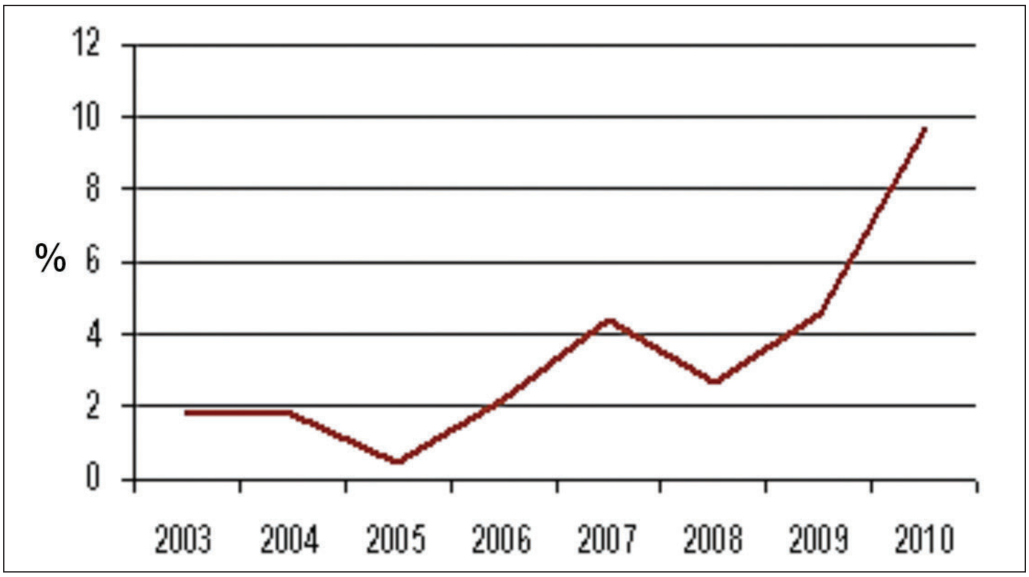
Local government debt – A recent report from Moody's estimates that Chinese local government debt is approximately a third higher than the 10.7 trillion yuan (US$1.7 trillion) than the central government records it as. This report followed an article from Reuters that claimed Chinese regulators are planning to shift 3 trillion yuan (US$460 million) of local government debt off the banks' balance sheets onto the central government. A large portion of these debts arose when local governments hastily commissioned projects as part of the post GFC stimulus package, many of which appear now to have been uneconomic. However, as with a lot of data coming from China, the accuracy and hence the ultimate implications of the above, are not clear cut.

'The Chinese audit agency could be understating banks' exposure to local governments.'

Moody's, 05/07/11

Bank off-balance sheet lending – According to Merrill Lynch, 40% of new bank lending is now occurring 'off-balance sheet' as banks divide corporate loans into smaller parcels and sell them through retail networks as a higher yield alternative to deposits. The chart below shows new off-balance sheet lending as % of GDP.

Bank off balance sheet lending – % GDP



Source: Merrill Lynch

Merrill Lynch reports that securitised schemes have boomed in China since December 2010 despite such lending being officially banned a year ago. The report identifies the following implications:

- China will use administrative measures to tighten monetary policy since banks are finding ways to avoid lending growth limits, and speculative money from offshore is being lent in the black market (at rates greater than 20%).
- Securitised loans are unlikely to be high credit quality, and when they deteriorate, losses to retail customers could become a major issue.

Outlook

Whilst the market sell-off has seen some value re-emerge, a number of earnings headwinds remain: Australian dollar earnings translation impacts, labour cost inflation and pressure on household spending to name but a few. Against a back drop of ongoing sovereign risks and minority governments 'presiding' over most of the world's developed economies (resulting in significant political inertia), we see little impetus for markets to trade convincingly higher over the next quarter or so. In addition, our sense is sell-side earnings expectations for FY12 and CY11 in the Australian and US markets respectively remain inflated beyond the likely reality.

Given ongoing macro uncertainties, our portfolio continues to be heavily biased towards stocks where a substantial portion of earnings growth is micro managed and in the direct control of the management team. This can come in many forms including successfully executing on the integration of a recent acquisition or a compelling market share story based on product differentiation and management excellence.

'... great investing is about arbitraging price versus value - period.'

Jame Roumell, Roumell Asset Management, May 2011

'Price trumps outlook.'

James Roumell, Roumell Asset Management, May 2011

Money Management | IMCA FUND MANAGER OF THE YEAR 2007 WINNER Rising Star

Money Management | LONSEC FUND MANAGER OF THE YEAR 2008 WINNER Rising Star

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