Greencape Wholesale High Conviction Fund

Fund report and commentary – June quarter 2012

Performance	Quarter (%)	1 year (%)	2 years (%) p.a.	3 years (%) p.a.	5 years (%) p.a	Inception (%) p.a.
Greencape Wholesale High Conviction Fund	**–5.63**	**–6.49**	**3.14**	**7.18**	**–0.36**	**6.09**
Growth return	–6.04	–9.33	–0.09	4.25	–3.96	0.96
Distribution return	0.41	2.84	3.23	2.93	3.60	5.13
S&P/ASX 200 Accumulation Index	–4.68	–6.71	2.09	5.65	–4.00	0.82
Outperformance (net)	**–0.95**	**0.22**	**1.05**	**1.53**	**3.64**	**5.27**

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 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

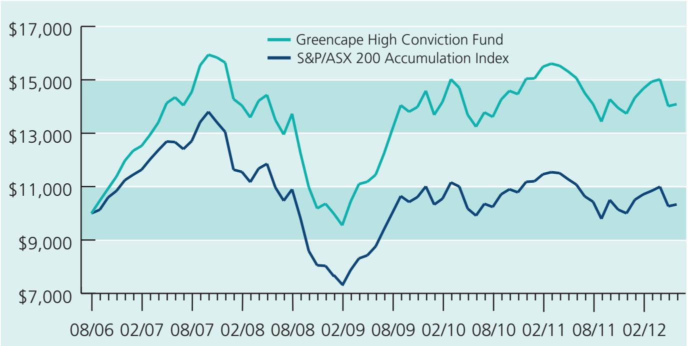
Quarterly

Suggested minimum investment timeframe

At least five years

Greencape High Conviction Fund

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

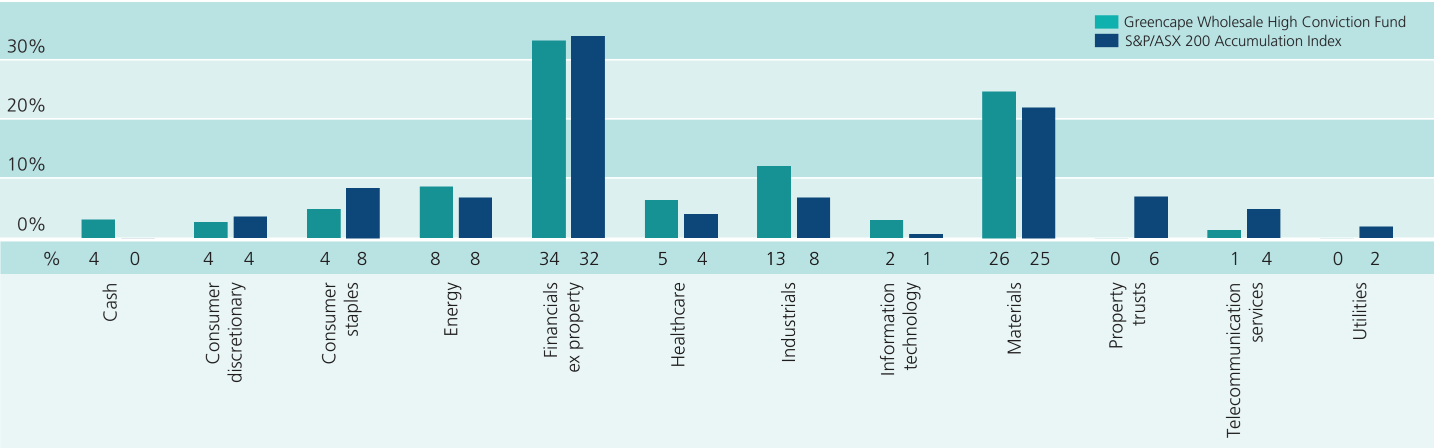


Asset allocation	Current (%)	Range (%)
Securities	96.89%	85–100
Cash	3.11%	0–15

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

Fees	Greencape Wholesale High Conviction Fund
Entry fee	Nil
2010/11 ICR	1.50%
Management fee	0.90%p.a.
Performance fee	15% of the Fund's gross performance above the Fund's benchmark.
Buy/sell spread	+0.30%/–0.30%

Sector exposures as at 30 June 2012



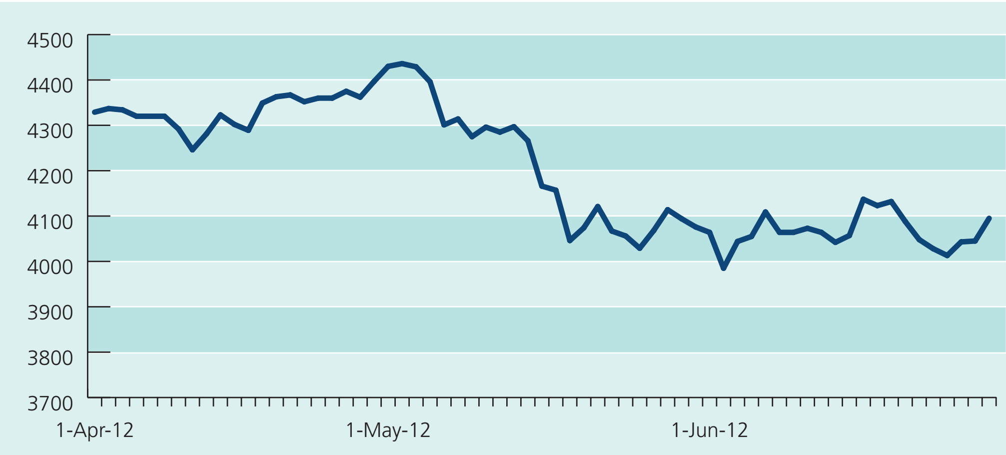
Market review

The S&P/ASX200 Accumulation index fell 4.7% for the quarter. The Greencape High Conviction fund underperformed the market and fell 5.6%.

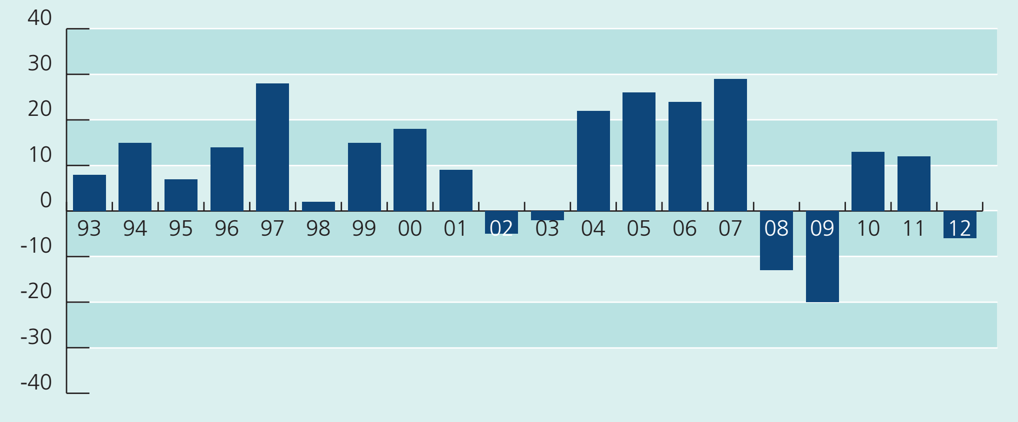
After starting the calendar year on a strong note, the market took a turn for the worse this quarter as problems in the Eurozone again flared up. Greece was the word as the legislative election in May failed to produce a victor, sparking widespread fear that a Greek exit from the Euro was imminent. Markets recovered late in the quarter as European leaders formulated another solution for the region's woes.

After remaining idle during the March quarter, the Reserve Bank of Australia (RBA) cut rates twice – including a larger than expected 50 basis points in May. This however failed to inspire the local bourse as negative leads from global markets dictated much of the market movement. Local investors continue to sit on the sidelines with trading value averaging $A4.3bn per day, well below the 5-year average of $A5.2bn per day.

S&P/ASX 200 Price Index



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



The global rally in equities slowed to a whimper in April as investors ran out of excuses to buy the market. Global risk aversion then took hold in May as a deadlock in the Greek legislative election indicated that the Greek population were more willing than first thought to entertain the idea of leaving the Euro. The pro–bailout New Democracy party did however manage to form a majority Government after the new election in June. Late in the quarter, European leaders unveiled a myriad of measures to boost the ailing economy, an action which the market appreciated, triggering a late risky rally in June.

The run of strong economic data out of the US came to a grinding halt as non–farm payrolls for May were much weaker than expected, while the unemployment rate ticked higher. The US Federal Reserve extended their 'Operation Twist' program, which came as a disappointment to those in the market expecting a third phase of quantitative easing, which now seems unlikely to occur until after the forthcoming US presidential elections. Facebook also debuted on the NASDAQ stock exchange in the US. In a sign of the tough market, despite having 30 advisors for the social network's IPO, the stock initially failed to find any friends, falling as low as 32% below its $38 IPO price before staging a slight recovery. In China, the PBOC cut lending and deposit rates and also the reserve requirement ratio after the official purchasing manager index (PMI) surprised to the downside in June.

Locally there was a distinct flight to the relative safety of high dividend yielding equities as the RBA began to cut rates. The telecommunications sector was a clear beneficiary as investors sought the stability of Telstra's dividend and the company's defensive earnings profile (up 12%).

Property Trusts rose over the period as investors chased yield. Westfield Group (up 10%) performed well as the company announced a divestiture of 8 non–core US shopping centres for $1.8bn. The company also continued to buy-back shares on the market which helped to support the share price.

Solid gains in the Healthcare sector were driven by CSL (up 10%) as the company benefitted from the US Food and Drug Administration delaying the launch of Baxter's (a major competitor) HyQ product, extending CSL's dominant position in the subcutaneous immunoglobulin market.

	June quarter	1 year
Market (S&P/ASX 200 Accumulation Index)	–4.7%	–6.7%
Best performing sectors:		
Telecom. Services	11.7%	38.6%
Property Trusts	8.8%	11.0%
Healthcare	5.7%	11.4%
Worst performing sectors:		
Energy	–15.8%	–19.2%
Materials	–13.9%	–27.8%
Industrials	–13.8%	–4.8%

'Real prices of all telco services in Australia declined 6% in 2010–11 – and are now 17.9% lower than they were in 2006–07, according to a new Australian Competition and Consumer Commission report.'

CommsDay 22/06/12

A fall of 18% in the oil price during the quarter drove a similar decline in Energy sector stocks. A $2.5bn Gladstone LNG Project Capital Expenditure acceleration announcement from Santos (down 25%) also detracted from returns in the sector.

The Materials sector was hit hard as commodity prices tumbled during the quarter and investors sought to decrease their exposure to riskier equities. A number of companies downgraded guidance during the period as tough economic conditions globally continued to weigh on the market. Newcrest Mining (down 24%) announced yet another production downgrade due to ongoing mechanical and weather related issues at Lihir. Iluka (down 36%) fell after downgrading its zircon production forecasts, citing global economic conditions and various unfavourable government policy measures globally. Boral (down 33%) downgraded guidance twice during the quarter, as weak domestic residential housing activity and wet weather delays on major projects, continue to drag the company's earnings lower.

Industrials struggled during the quarter as investors rotated out of cyclical equities. Brambles (down 13%) fell after launching a $448m capital raising, following the decision not divest its Recall business. Qantas (down 40%) was heavily sold off after announcing a sizable downgrade to earnings as structural issues continue to hurt the business, particularly the company's international operations which are loss making. Toll Holdings (down 32%) also downgraded earnings in which the company wrote down the carrying value of Footwork Express, its logistics arm in Japan. The company also stated it continues to feel the pressure from the soft local retail sector.

Company visits and observations

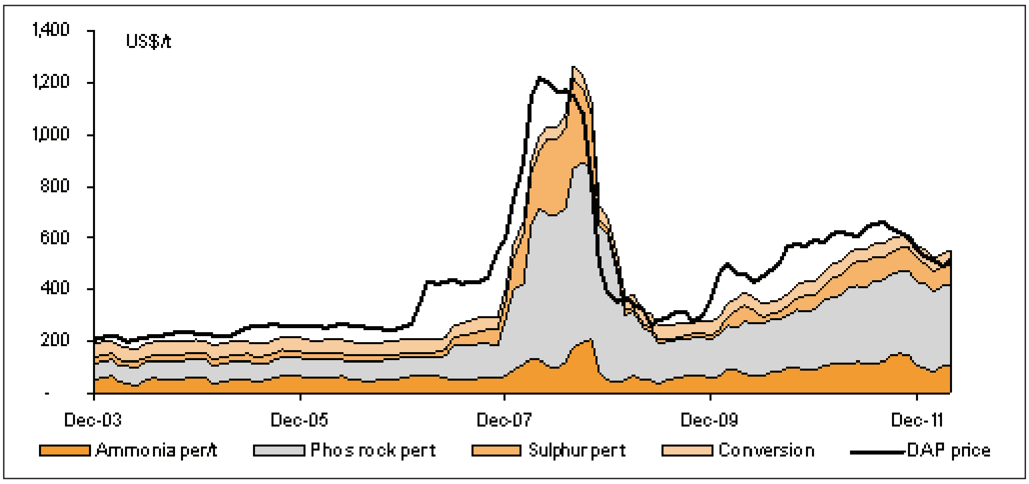
US healthcare trip

During the quarter we again travelled to the US, this time focusing on the healthcare sector which listed Australian companies such as CSL, Sonic Healthcare and Resmed are exposed to. Some of our take-outs were:

- More than ever, physicians are asking for specific sleep apnoea devices which we put down to successful marketing by large manufacturers;
- Distributors of medical equipment have seen their gross margins on sleep apnoea devices shrink from 65% to 50% as physicians are requesting higher end products for which the distributors receive the same dollar margin as when selling cheaper products;
- The Obama healthcare bill is attempting to align regulations to achieve better patient outcomes for a lower cost. One example is that if a hospital has a patient re-admitted within 30 days of discharge, they won't be reimbursed for the cost. This aims to prevent hospitals sending patients home early to improve their waiting time statistics; and
- The Obama healthcare bill is incentivising consolidation across the industry to increase efficiencies. One example is some hospitals have purchased GP clinics to tie up the referral of patients from those doctors.

Fertiliser prices

Diammonium Phosphate (DAP) fertiliser prices appear to be stabilising, having now found support from input costs which have recently risen. This favours integrated supply producers such as Incitec Pivot and puts margin pressure on marginal non–integrated producers.

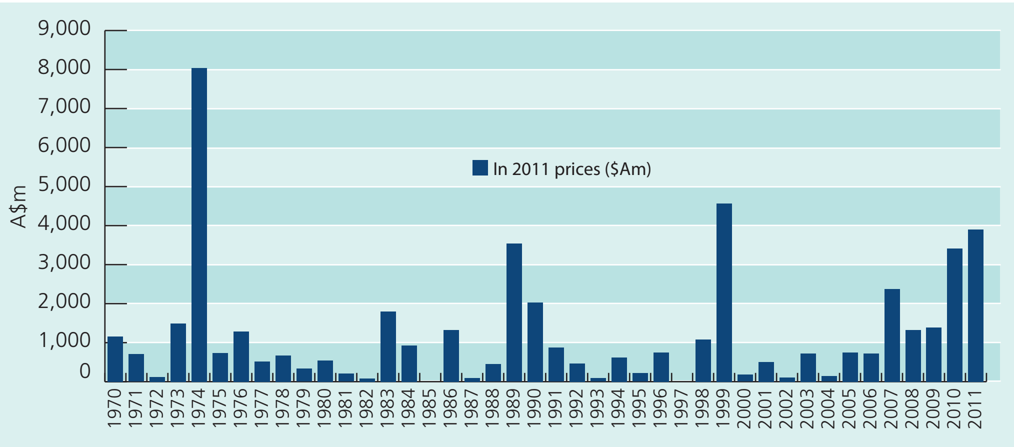


Source: Merrill Lynch

Insurance sector

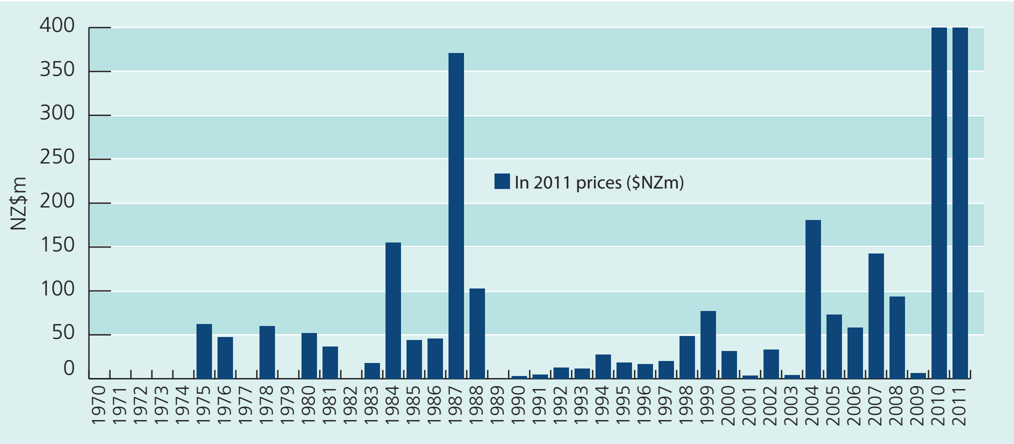
Listed insurers in recent years have been hit hard by a long string of large catastrophes. The domestically focused insurers IAG and Suncorp, were particularly hard hit in 2010 and 2011, the magnitude of which relative to history is shown in the chart below. Note in the New Zealand chart, both 2010 and 2011 numbers are off the chart… we would need to extend the chart scale by a multiple of 30 in order to fit 2011, which is when the major earthquakes struck in Christchurch.

Australia – Catastrophe costs



Source: Insurance Council of Australia, JP Morgan

NZ – Catastrophe costs



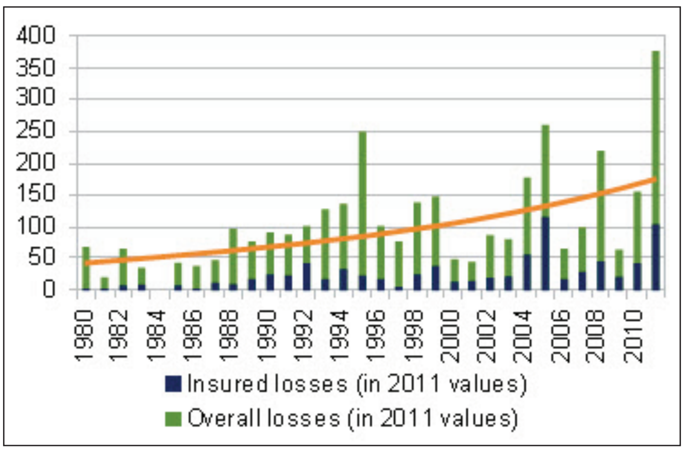
Source: Insurance Council of NZ, JP Morgan

The last two years of the Australian chart above have corresponded with a strong La Nina weather system, causing 2010–11 to have the second–highest rainfall over a two year period on record. During this time, IAG and Suncorp's earnings have been battered as they have had to pay out claim costs well in excess of what was allowed for in their pricing, as well as incurring higher reinsurance costs themselves. As we look forward however, we note that the insurers have been lifting insurance prices significantly over the last 2 years (excluding some classes such as liability insurance) to cover a higher and higher level of catastrophes given recent experience. Should we move into a more benign/average weather period, which the Bureau of Meteorology is currently forecasting with an El Nino period this coming summer, the insurers could move from a period of below–forecast profits to a period of above–forecast profitability. We remind ourselves that one should always be cautious when relying on a weather forecast!

QBE Insurance, whilst a much more globally diversified insurer than IAG and Suncorp, also suffered a similar impact from multiple large global catastrophes in 2011. The chart below gives an indication of how bad 2011 was for catastrophe events, with QBE's international exposure being disproportionately exposed to:

- January – Qld flooding (US $30bn event[1])
- February – Christchurch (NZ) earthquake (insured losses original estimate US $13.5bn)
- March – Japan earthquake & tsunami (US $210bn event)
- July to October – Thailand floods (US $45bn event)
- December – Melbourne Christmas Day hailstorm (US $256m event)

Overall and insured losses, with trend (bn US$)



Source: Munich Re

'There is a big part of me that continues to believe that QBE is a quality insurer that made a few strategic mistakes at a critical juncture in macro economic trends and has gone through the painful transition from a growth to a cyclical orientation.'

Andrew Kearnan, Merrill Lynch Insurance analyst, 13/01/12

[1] Aon/Benfield Annual Global Climate and Catastrophe Report 2011

In 2011 catastrophe claims cost QBE 15.3% of its premium revenue, compared to its historical average of 9%. In the first half of 2012 catastrophe claims have been much more benign for QBE which, unless the second half is extraordinarily bad, should allow QBE to report a solid 2012 earnings result. However, like weather, we are always cognisant of playing mean reversion when the underlying thematic is inherently 'lumpy'. But like IAG and Suncorp, QBE has been able to raise its pricing to reflect the recent catastrophes, and so even a return to a moderately above average catastrophe year should be positive for the share price.

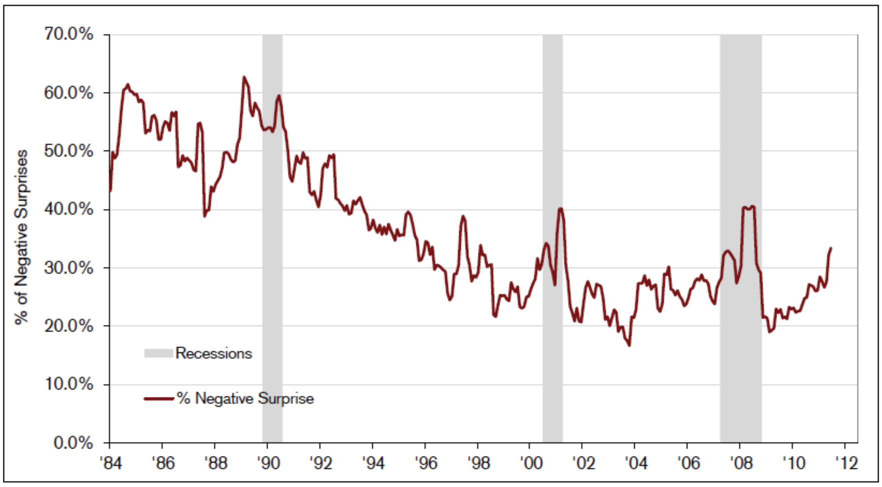
'You can outperform if you specialise… the moment you try to be all things to all people you drag yourself down to the same profitability as everyone else.'

Frank O'Halloran, outgoing CEO of QBE Insurance, 01/03/12

Earnings revisions

There has been a lot of research done by neuroscientists, social scientists and behavioural economists on our human tendency to be biased towards optimism. It turns out investment analysts are no different, with Credit Suisse finding that approximately one third of reporting companies miss earnings targets set by analysts[2], as shown in the chart below:

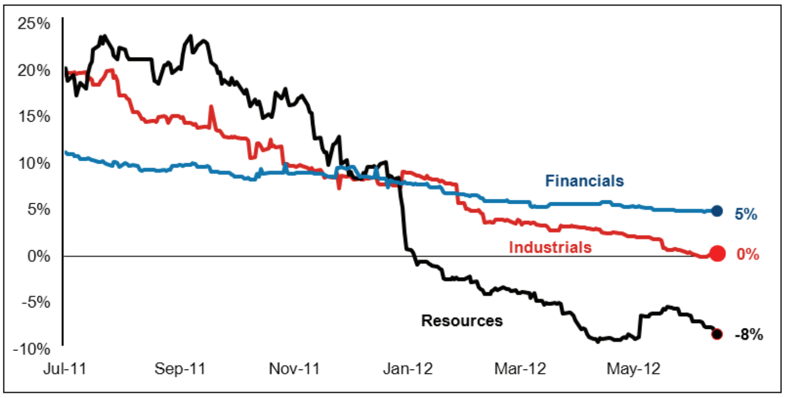
% of companies with negative earnings surprises through time



Source: Credit Suisse HOLT analysis
Universe: Russell 1000

The charts below show the earnings per share (EPS) growth revisions by analysts in FY12 and FY13, and how they've changed over time. The first chart shows that at the beginning of FY12, analysts were forecasting 25% and 20% EPS growth for the Resources and Industrials sectors respectively for the year ahead. But at the end of the financial year their estimates had dropped to minus 7% and 0% growth!

FY12 consensus EPS growth forecasts



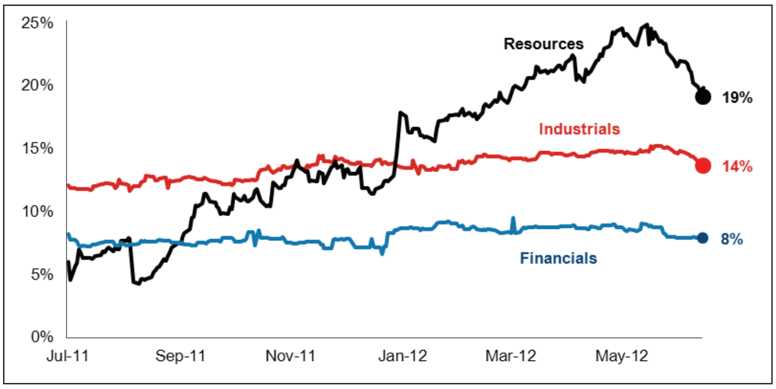
[2] Credit Suisse HOLT

Over that same period FY13 EPS growth estimates have actually drifted upwards. This tends to be the result of analysts downgrading their FY12 number, but not moving their FY13 number as much on the expectation (or hope?) that things will be better further into the future. With a lower FY12 earnings base, the growth rate required to get to their FY13 number increases. Looking at the Industrials sector, in the face of rising costs (electricity, labour rates) and weaker revenue expectations (think discretionary retail and weaker export markets), we think 14% EPS growth in FY13 is unrealistic and will be revised down as the year progresses.

'Our average labour cost in our US business is between $15 and $17 an hour. My son earns $22 an hour working part–time at Myer!'

CFO of an Australian Top 100 listed company, 2 July 2012.

FY13 consensus EPS growth forecasts



In an environment of earnings downgrades, companies with even modest earnings growth will continue to standout from their peers and should outperform.

Barclays LIBOR Fixing Scandal

We couldn't help ourselves to include this photo. Sometimes a picture says it all…

Macro observations

Australian interest rates

The RBA Governor, Glenn Stevens, gave a speech on 8 June which we think gives some insight into the RBA's reluctance to use interest rate policy to reignite a credit growth led recovery. We have included some of the excerpts of the speech below:

> 'One thing we should not do, in my judgement, is to try to engineer a return to the boom. Many people say that we need more 'confidence' in the economy among both households and businesses. We do, but it has to be the right sort of confidence. The kind of confidence based on nothing more than expectations of ever–increasing housing prices, with the associated willingness to continue increasing leverage, on the assumption that this is a sure way to wealth, would not be the right kind. Unfortunately, we have been rather too prone to that misplaced optimism on occasion. You don't have to be a believer in bubbles to think that

a return to sizeable price increases and higher household gearing from still reasonably high current levels would be a risky approach. It would surely be a false basis for confidence. The intended effect of recent policy actions is certainly not to pump up speculative demand for assets. As it happens, our judgement is that the risk of re–igniting a boom in borrowing and prices is not very high, and this was a key consideration in decisions to lower interest rates over the past eight months.

… I do not think **we should set monetary policy to foster a renewed gearing up by households**.

The reduction in interest rates over the past eight months or so – 125 basis points on the cash rate and something less than that, but still quite a significant fall, in the structure of intermediaries' lending rates – will speed up, at the margin, the process of deleveraging for those who need or want to undertake it.

… **we cannot neglect the interests of those who live off the return from their savings** and who rightly expect us to preserve the real value of those savings.

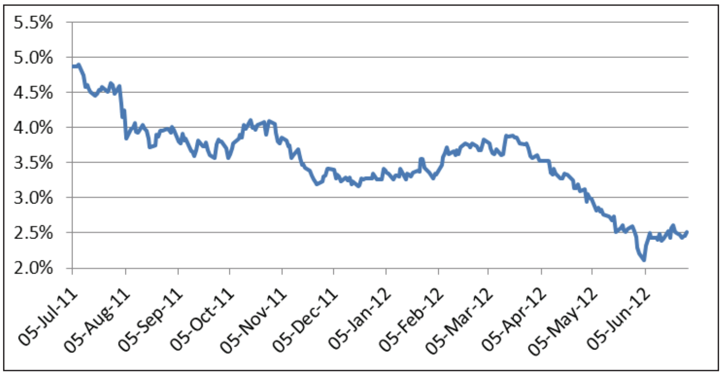
And to repeat, it is not our intention either to engineer a return to a housing price boom, or to overturn the current prudent habits of households.

'Money and credit growth can never make a nation prosperous. It may bring about a shift in income and wealth from some groups to other groups, but it inevitably tends to impair the prosperity of the whole nation'

Ludwig von Mises 1949.

We think the above indicates that the RBA is unlikely to cut interest rates as aggressively as the bond market is implying, with the 5 year government bond yield now at around 2.5% (official RBA cash rate 3.5%). In our view, the RBA would only cut so aggressively if the global economic outlook worsened materially, particularly in China.

Aus 5 yr government bond yield



Whilst we've pointed out above that we think Australian bonds are expensive, the phenomenon is even more pronounced overseas. For example, Dutch government bond yields touched 1.53% in June – their lowest yield in 500 years! Similar records were set in the US (220 year low), Germany (200 year low), and France (260 year low).

This of course has made the dividend yields on utilities, property trusts and other high yielding stocks like Telstra, even more attractive than the return on cash compared to just three months ago, which explains the majority of the relative sector performance discussed above.

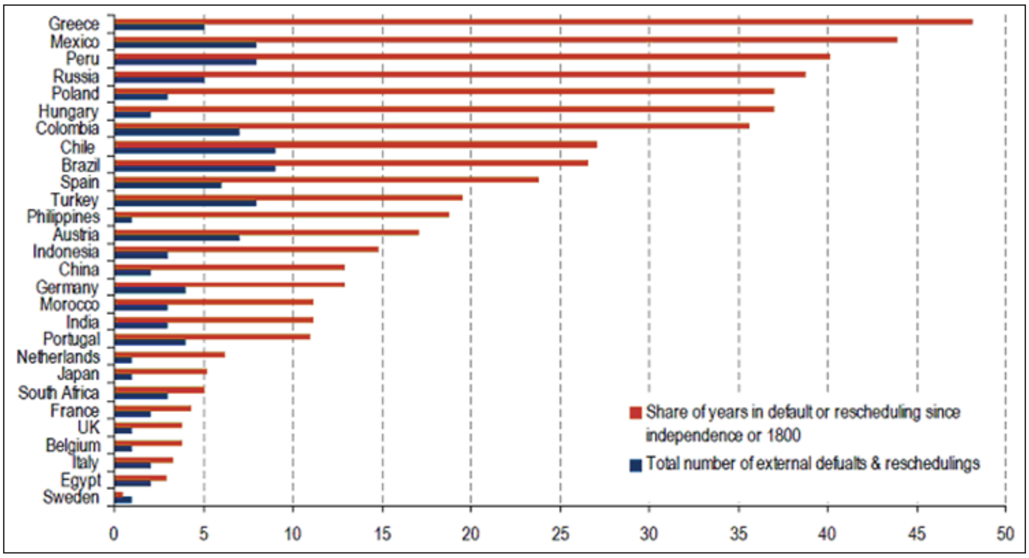
Europe and sovereign default

It seems almost every month there is talk of a new acronym that will be the solution to Europe's problems. We've listed these below:

- EFSF May 2010 – European Financial Stability Facility ;
- ESFM Jan 2011 – European Financial Stabilisation Mechanism;
- LTRO Dec 2011 – Long Term Refinancing Operation;
- ERF May 2012 – European Redemption Fund; and
- ESM Jul 2012 – European Stability Mechanism (to replace EFSF and ESFM).

The issue facing some of the peripheral European countries in our view is one of solvency, rather than simply a liquidity crisis. And to that end ultimately there has to be a substantial write–off of debts owed by sovereigns, or significant inflation over a long period to reduce the debt in real terms. Both will be costly and on the latter, the European Central Bank and Germany appear vehemently opposed to, leaving some form of debt default to be taken at some stage. Whilst there is a lot of fear in global markets on the ramifications of a default, it's worth keeping in mind just how prevalent sovereign defaults have actually been. The chart below shows that Greece has spent almost half of the past 210 years in default or rescheduling its debt. Mexico, Peru, Russia and Poland are not far behind.

External sovereign debt defaults and reschedulings, 1800–2012



Source: BofA Merrill Lynch Global Equity Strategy, Reinhart and Rogoff, *This Time is Different*

US federal government debt

Market commentators seem to have been very quiet in the last nine months or so about the US federal government debt position and the next looming debt ceiling approach, but as we expected, as the November elections draw nearer, attention is once again focusing on the issue. On 31 July 2011, Congress finally agreed on a deal to increase the then debt ceiling from US $14.3 trillion to $16.4 trillion. Obama managed to get the 'can kicking' extended until after the US elections in July 2012, in return for an Automatic Sequester being put in place. The Sequester means that if no deficit reduction plan is put in place prior to 1 January 2013, government spending cuts of US $1 trillion over 9 years will automatically come into place. We note that this is also the date when the Bush tax cuts, that were extended by Obama, also expire. The US Bipartisan Policy Center predicts that if the Sequester comes into effect it will cost the US economy 1 million jobs by 2014.

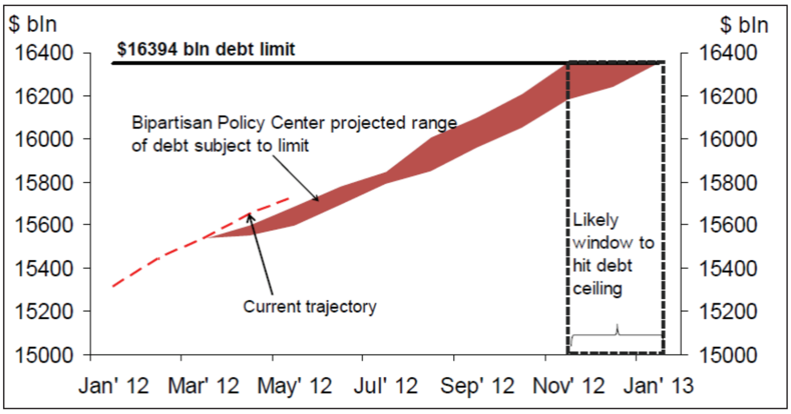
Deutsche Bank are forecasting that the current debt ceiling will be breached earlier than first thought, in November, which should make for an interesting presidential election in that same month.

'Politicians must not abuse the central bank as state financier, otherwise there will be danger ahead for the ECB itself and for the Euro.'

Former Bundesbank board member Edgar Meister – 11/09/2011

Under current projections we will reach the debt ceiling sometime around the elections in November.

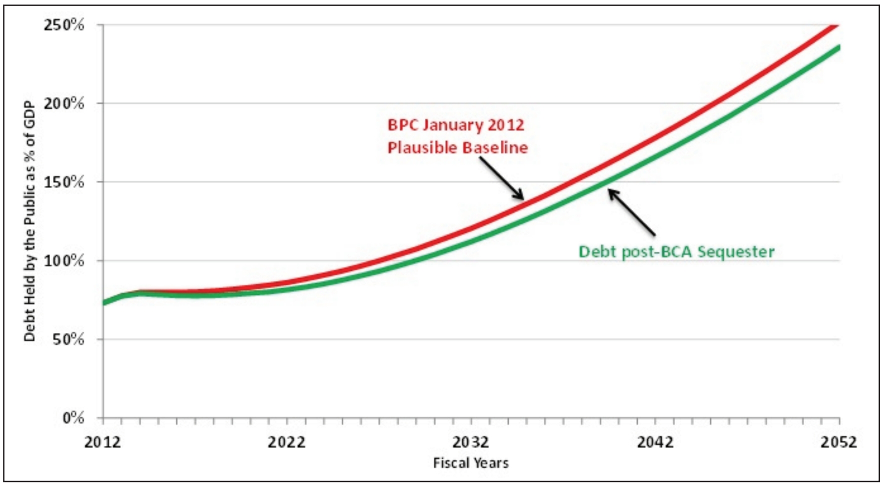
The debt ceiling



Source: Deutsche Bank

To give an indication of just how large the structural debt issues are that are facing US federal government, the chart below highlights that the $1 trillion cuts, seen by many as severe, will only delay by 2 years the time it takes for total US government debt to reach 100% of GDP!

Sequester delays national debt reaching 100% of GDP by only 2 years



Source: US Bipartisan Policy Center

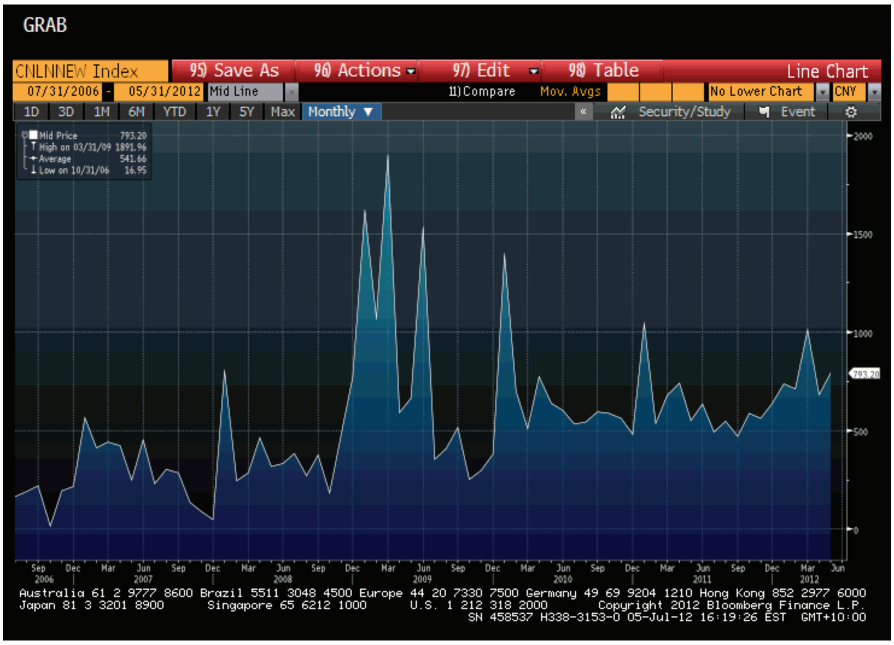
China and the resources sector

China's GDP growth rate has slowed recently[3] as government restrictions on property ownership have deliberately cooled the housing market, seen both in house prices and new property construction. The PBOC (Peoples Bank of China) has since reduced the 1 year bank lending interest rate by 56 basis points over the last month. The upside case for China is that post engineering a slowdown which succeeded in reducing property prices and cooling inflation, the government will use more stimulatory measures to see the economy get back to above 8% GDP growth.

We agree that the government is likely to continue to at least ease it's more restrictive policy stance held recently, but think any stimulatory measures will be much more subdued that the huge fixed asset investment stimulatory package that was launched in 2009. This is due to an awareness from the government that local governments have a much higher debt load than they did back then and that any more investment led growth above GDP growth will make the ultimate transition to a more consumption driven economy, an even harder and more painful one ultimately.

[3] GDP growth was 8.2% for the March 2012 quarter, but is forecast to drop below 8% in the June quarter. Source: Bloomberg

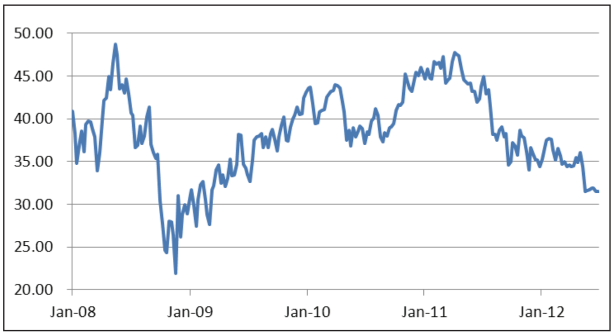
One thing we are watching in China is bank loan growth. Bank lending dominates lending growth in China, and one thing we know from the US, Japan and European experience is that just because interest rates are reduced, it doesn't necessarily mean that the demand for new credit will appear. The chart below shows monthly new bank lending growth, which highlights that after showing negative growth on prior corresponding period in January and February, growth has turned positive with 11% growth for the year to date (until end of May).



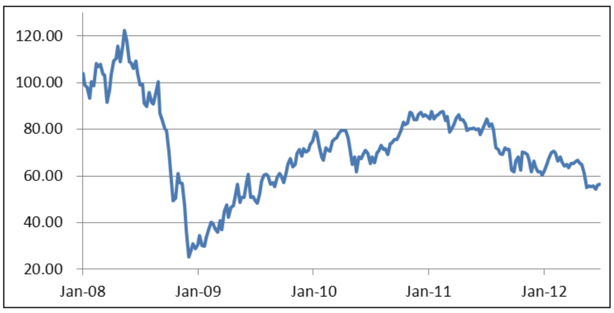
Source: Bloomberg

As discussed earlier, the resources sector was a significant underperformer for the quarter. BHP and Rio Tinto are now trading at prices last seen back in March and September 2009 respectively, which was when commodity prices were significantly lower than they are today. The market is clearly pricing in a fairly bleak outcome for Chinese and world growth over the next few years.

BHP share price



RIO share price



'In China, the banks are the financial system; nearly all financial risk is concentrated on their balance sheets.'

Red Capitalism, Carl Walter & Fraser Howie, 2011

Outlook

As we look around at the global macro environment we see a number of headwinds. Markets continue to swing from positive rallies (risk–on) as hope builds of a European deal, to sudden drops in sentiment on any signs of weak data out of the US or China (risk–off). We expect continued uncertainty in Europe until both sides (Germany and the peripheral countries) agree to a balance of debt write–off and structural reforms, which still appears to be some way off. In China, our concerns over slowing growth have played out with the case for improving economic growth from here looking reasonable. However, we are still cautious on companies directly leveraged to China's growth given the still very lop–sided nature of their fixed asset investment led economy. In the US, recent data is pointing to slower economic activity just at the time looming federal government debt issues are coming again into focus. Our assessment 'on the ground' is more constructive, with most corporates we've spoken to seeing fairly resilient end–user demand. Further, whilst off a low base, the housing construction sector finally appears to be turning positive.

In Australia the business environment appears to be becoming more challenging, with many corporates talking about the second–order impacts of a high Australian dollar, and bemoaning the high and increasing cost of doing business in Australia versus almost all other developed countries. With weak top line growth in all sectors and rising costs, we think margin pressure will be highlighted at this coming results reporting season in August, and will be an ongoing thematic in FY13.

In an environment of earnings downgrades, our continued focus on quality business franchises and management teams should outperform through the cycle. We are cognisant of using the market gyrations to our advantage, trimming some defensive positions when we think the market is seeking safety at any price, and picking up some cyclical stocks when strong value is present. Whilst the market has been bidding up a number of high yield but low growth stocks, we can see a number of stocks offering a circa 5% yield that still offer decent and reliable earnings growth, as providing the best prospect for outperformance in the future.

'We're hardwired to think we're right more often than we are right'

Dylan Grice, Societe Generale, 23/01/12

'There are two types of forecasters; those who don't know and those who don't know they don't know.'

JK Galbraith

'The global monetary system which has evolved and morphed over the past century but always in the direction of easier, cheaper and more abundant credit, may have reached a point at which it can no longer operate efficiently and equitably to promote economic growth and the fair distribution of its benefits.'

Bill Gross, MD PIMCO, June 2012

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

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

This page has been left intentionally blank.

This page has been left intentionally blank.

More information

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

Fidante Partners Investor Services team on: **13 51 53**

Visit the Greencape website: **www.greencapecapital.com.au**

Email Greencape at: **bdm@greencapecapital.com.au**

Financial advisers

For more information please contact:

Cathryn Franks
National Sales Manager
Fidante Partners

Phone: **+61 2 9994 7606**

Email: **cfranks@fidante.com.au**

Institutional investors and asset consultants

For more information please contact:

Marsha Beck
Institutional Business Development Manager
Fidante Partners

Phone: **+61 3 9947 9419**

Email: **mbeck@fidante.com.au**

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

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

15175/0413