Greencape Wholesale High Conviction Fund

Fund report and commentary – March 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	**8.70**	**–4.33**	**–0.30**	**12.69**	**2.91**	**7.49**
Growth return	8.38	–8.19	–3.39	9.21	–2.61	2.14
Distribution return	0.32	3.86	3.09	3.48	5.52	5.35
S&P/ASX 200 Accumulation Index	8.40	–6.06	–1.43	11.25	–2.04	1.73
Outperformance (net)	**0.30**	**1.73**	**1.13**	**1.44**	**4.95**	**5.76**

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 200 Accumulation Index, over rolling three-year periods.

Responsible entity

Challenger Managed Investments Ltd

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

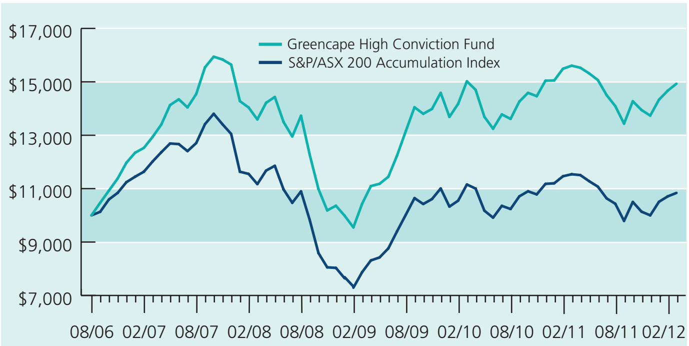
Quarterly

Suggested minimum investment timeframe

At least five years

Greencape High Conviction Fund

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

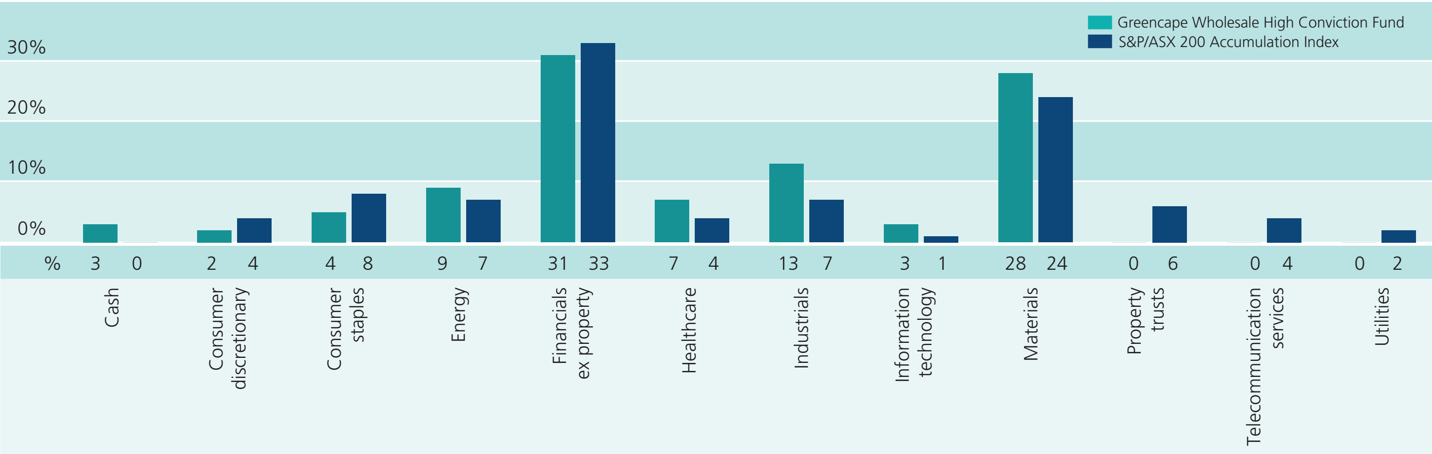


Asset allocation	Current (%)	Range (%)
Securities	97.20%	85–100
Cash	2.80%	0–15

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

Fees	Greencape Wholesale Broadcap 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 31 March 2012



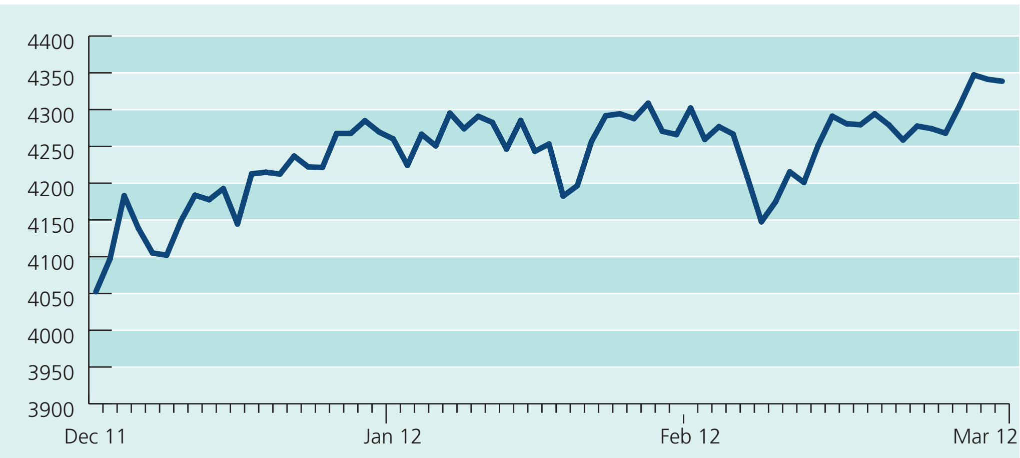
Market review

The S&P/ASX200 Accumulation Index gained 8.40% for the quarter. The Greencape High Conviction Fund outperformed the market and delivered a 8.70% return after fees for the quarter.

The market posted three consecutive months of gains, culminating in the best performance for a March quarter since 2006. The risk aversion that plagued global markets during 2011 dissipated somewhat, as a loosening in monetary policy from global central banks and better than expected macro data eased market concerns.

The local market was taken aback in February when the Reserve Bank of Australia chose to hold rates, against the unanimous view that a rate cut was to be announced. Softer than expected domestic economic data throughout the quarter and a mixed reporting season in February highlighted the void between sectors in the domestic two-speed economy.

S&P/ASX 200 Price Index



The market started the quarter strongly with the index gaining 5.1% in January, mainly on the back of leads from overseas markets. The strong AUD continued to hamper the market as the local index underperformed the region and other major global indexes. Local economic data disappointed with employment figures, building approvals and retail sales all surprising to the downside during the quarter. Trading volumes also continue to suffer, with the All Ordinaries turnover for the period being 16% lower than the March quarter in 2011.

Globally, markets were buoyed by strong employment and manufacturing data coming out the US, along with the Federal Open Market Committee promising to continue their policy of ultra-low interest rates 'at least through late 2014.' Better than expected economic data out of China continued to point towards a 'hard landing' being less likely, and in February the People's Bank of China cut the Reserve Ratio Requirement by 50 basis points. The European Central Bank's second Long Term Refinancing Operation (LTRO) lent out €530 billion in February, exceeding the €490 billion initially lent out in December. This move, along with the eleventh hour bailout of Greece seemed to allay investor fears that a disorderly Greek default was imminent.

	March quarter	1 year
Market (S&P/ASX 200 AI)	8.4%	–6.1%
Best performing sectors:		
Industrials	13.6%	0.8%
Information Technology	12.5%	–4.6%
Consumer Discretionary	11.0%	–16.7%
Worst performing sectors:		
Telecommunications	–0.4%	17.4%
Consumer Staples	4.3%	–1.1%
Materials	4.7%	–22.7%

Cyclical sectors outperformed the defensive sectors during quarter as renewed optimism saw investors increase their exposure to riskier equities. Industrials was the best performing sector for quarter, helped by a strong half year result from Campbell Brothers (up 37%) and the market's positive reaction to Toll's more disciplined strategy for M&A going forward (up 39%). Logicamms (up 63%) performed well after a strong half year result and the announcement of some key contract wins from Rio Tinto and Chevron projects.

Computershare's outperformance (up 12%) for the quarter drove the I.T. sector higher as investors chose the stock as a conduit to expose themselves to a steepening U.S. bond yield curve.

Gains in the Energy sector were predominantly driven by strong gains in the oil space. Woodside Petroleum (up 14%), Santos (up 16%) and Oil Search (up 12%) all benefitted from a surge in the spot price for Brent Crude oil, which gained 11% for the period.

Financials performed well for the period, led by ANZ (up 13%) which benefited from the LTRO which acted to reduce funding costs. Westpac (up 9%) also outperformed as the market appeared to be pricing in a higher dividend payout ratio and some news on further cost initiatives.

Telecommunications was the only sector that fell during the period, as investors no longer sought the safety of Telstra's stable dividend policy as they switched into more cyclical sectors.

Consumer staples was another defensive sector that underperformed the market during the quarter, as the deflationary environment in Food & Liquor impacted the half year results for Wesfarmers (up 2%) and Woolworths (up 4%).

Sluggish returns from BHP Billiton (up 0.5%) during the quarter weighed on the Materials sector, as investors began to doubt the company's capital expenditure program. Newcrest Mining started the quarter well (up 22% in February), however the company's second production downgrade in three months and weakness in the gold price saw the stock finish flat for the quarter. Notable outperformers in the sector were OneSteel, soon to be known as Arrium (up 77%), which posted a stronger than expected half year result and Fortescue Metals (up 36%), which like OneSteel, gained on the stabilisation of Iron Ore prices over the period.

Large-cap downgrades were persistent throughout the quarter, starting with QBE which finished the quarter up 9% despite a heavy downgrade in January and a $600m capital raising in February. Leighton Holdings also surprised the market in March with a downgrade in relation to their airport link and Victorian desalination projects. The stock still managed to post a 12% gain after a strong start to the quarter. Other notable companies that downgraded earnings during the period were QR National, Bank of Queensland, Ten Network Holdings, and Stockland.

'Nothing is more permanent than temporary government spending.'

Milton Friedman

'Everything comes back to productivity. It always does.'

Glenn Stevens, RBA Governor, 26/07/11

Company visits and observations

During the quarter we visited Europe, USA and South America to meet with company management from industrial and resources sectors as well as a number of banks, exchanges and insurance companies. We also met with the European Central Bank in Frankfurt. The following themes and points of interest emerged from our travels:

Macro observations

- Global manufacturers with exposure to industry rather than the consumer consistently comment 'North America and Europe doing better than we had originally planned for, yet Asia is softer and Australia is particularly weak';
- US industrial packaging volume growth run rate is 5%. Manufacturing and Automotive sector solid as is the energy sector in US;
- 'We were initially sceptical regarding the strong note that the US finished 2011 on, but it has continued into 2012', 'It's clear China has slowed in all facets of our business.' – Large Global Industrial Conglomerate;
- US and European fast moving consumable goods (FMCG) volumes are flat. This was a consistent message from retailers, to logistics firms and packaging companies;
- Companies appear to be reviving their appetite for mergers and acquisitions. There is an expectation that private equity have assets that they need to sell. It's clear the price expectations between vendors and buyers are slowly converging;
- As highlighted in previous quarterly reports, US quantitative easing (QE 1, 2 and 3) and its European version (LTRO) have resulted in enormous liquidity looking for a high return. This has resulted in companies increasingly being able to bypass banks and access debt funding through corporate bond issuance and private debt placements at rates and durations more attractive than those offered by traditional banks. This has also begun to assist companies' merger and acquisition plans.

Bank observations

- Banks continue to de-lever, whilst corporates are content to plan for flat outlooks and require less capital. This combination is allowing US and European banks to provision for GFC-related bad debts that had been yet to be properly valued whilst improving capital positions and loan to deposit ratios. Some banks have made rapid progress, whilst others have got a long way to go. Unlike the relative homogeny of Australian banks' capital positions, European and North American banks have a wide spectrum of progress;
- Banks are shamelessly raising mortgage rates in the United Kingdom. One of NAB's competitors estimated that 100 basis points of out of cycle rises have been executed. Let it also be said that UK retail bank margins hover around the 2.4% mark, compared to Australian margins which are closer to 2.1% and German margins lower again at 1.8%;
- UK banks are targeting a return on equity ratio of 12-13% compared to Australian banks who aim for 18%-20%. Interestingly the UK regulator is happy with 9%!
- French banks are not prepared to totally withdrawal from Asia as BNP Paribas and SocGen are favoured by French multi-national corporates, many with Asian operations;

'It's always been a mistake to bet against America, since 1776.'

Warren Buffet, Chairman of Berkshire Hathaway, 02/05/2011

- The table below depicts how bank metrics have changed post-GFC. You will note the metrics are much more defensive these days.

Pre-GFC	ANZ	CBA	NAB	WBC
NIM	2.01%	2.02%	2.19%	2.02%
Credit growth expectations	17%	7%	11%	10%
Balance sheet leverage (x)	20.1	21.0	23.0	25.0
Loan-to-deposit ratio (x)	1.41	1.51	1.41	1.37
Tier 1	7.7%	8.2%	7.3%	7.8%
Payout	77%	73%	74%	53%
BDD/RWA (T+1)	1.21%	1.17%	1.11%	1.14%
Provisions/RWA	1.29%	0.85%	0.86%	1.21%
2007 PE (x)	13.3	15.9	14.7	15.2
2007 yield	4.6%	4.6%	4.6%	4.6%

2011	ANZ	CBA	NAB	WBC
NIM	2.46%	2.19%	2.24%	2.22%
Credit growth expectations	5%	3%	5%	3%
Balance sheet leverage (x)	15.7	17.9	17.9	15.3
Loan-to-deposit ratio (x)	1.14	1.28	1.13	1.35
Tier 1	10.9%	10.0%	9.7%	9.7%
Payout	64%	73%	69%	75%
BDD/RWA	0.43%	0.45%	0.53%	0.35%
Provisions/RWA	1.84%	1.83%	1.43%	1.60%
2013 PE (x)	8.9	10.7	8.6	9.7
2013 yield	7.3%	7.0%	8.2%	7.9%

Source: Bell Potter.

- Corporate bond issuance and the numerous related securities (many are derivate in nature) are increasingly being seen as the next important market to be facilitated through exchanges. This has been a clear focus when meeting with the ASX's peers in Asia, Europe and North America. Regulators and investors seek increased transparency, and the GFC has highlighted the increased risk associated with opaque over the counter (OTC) securities and often questionable mispricing (e.g. credit default swaps with NAB!). Deutsche Bourse estimate there is $700 trillion of OTC traded securities, many of which to could trade over an exchange. They estimate banks have a profit pool of circa $50 billion from constructing markets in OTCs. The regulatory push is expected to result from European and Frank Dodd (in the US) reforms.

European costs, emission reductions and retailer influence

The flat European environment has been another catalyst to focus on costs for Pan-European companies. Although Pan-European manufacturing and logistics networks have been evolving over the last 10 years, it appears the pace of change is accelerating. We observe an increased closure of high-cost western European plants to be replaced with new large-scale Eastern European plants which are designed to service the entire European market. These trends evidently favour the large established market leaders (e.g. Amcor, Brambles, and Campbell Brothers) who are willing to invest in Eastern Europe and service Pan-European markets.

'I would have thought what's happening in Europe would be one of the most timely wake-up calls in Australia's history and it is being completely ignored because we've had 20 years of growth and the size of complacency here is outrightly dangerous.'

David Murray, Former Chairman of the Future Fund, 24/11/11

European Retailers continue to drive private label. An implication is that retailers are further increasing their influence over their supplier's supply chain (e.g. logistics and packaging). This influence is at the expense of the large FMCG players (think Procter & Gamble, Unilever, Kraft, DANONE etc.). An example of that influence in action is with CHEP's key competitor in Germany, Switzerland, Austria and Italy, EPAL. Dominant retailers such as Aldi and Migros have significant private label offerings in the mentioned countries. As the pictures below illustrate, EPAL have provided new pallets to the big retailers, and the old, more damaged pallets to everyone else.

Stack of new pallets for the big retailers

Stack of old pallets for the rest

European companies continue to highlight carbon emission reductions. Carbon pricing schemes in Europe have established frameworks such that emission reduction targets are disclosed and progress measured. This has further raised the profile of logistics suppliers and packaging suppliers as its these parts of the value chain that are observed to have a material influence on emission reductions for retailers and FMCG companies. In particular, pooling companies such as Brambles' CHEP are very well placed to reduce emissions through network optimisation (a fancy way of saying reduced haulage distances) and recycling of pallets, plastic crates and containers. For example CHEP's crate business, IFCO Systems, provides an imbedded carbon intensity calculator as well as cost calculator that is provided to all retail customers. It's web based and totally transparent. They claim they are typically 23% cheaper than cardboard carton alternatives and have 49% less emissions.

Tesco advertises their intent to reduce co2 emissions at their distribution centre in Rugby, UK. See picture below.

A key variable in managing a pool of crates or pallets is the loss rate. This is the percentage of units sent out to customers that never make it back to the pool to be used again...and again... and again. Some markets have unique risks as to why loss rates may be higher. Below is a common observation in Amsterdam, where bike baskets are often plastic crates! Pleasingly, Brambles confirmed Amsterdam isn't a major target market for its IFCO crate pooling business.

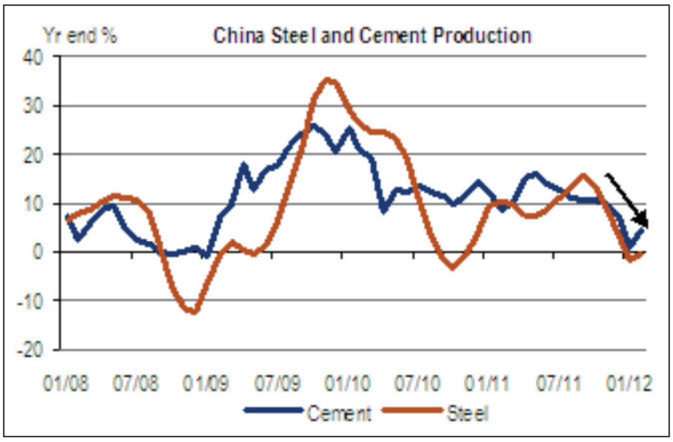
'I strongly agree with Vice President Gore that we cannot drill our way to energy independence, but must fast-track investments in renewable sources of energy like solar power, wind power and advanced biofuels.'

Barack Obama, President of the United States of America

Comments on China

As mentioned in earlier reports, we monitor Remimbi deposit growth as a means to assess the Chinese hot money outflow risk. After meeting with several global banks in recent weeks, it's clear the Remimbi deposit growth has stalled. The policy response from the Chinese authorities is to loosen controls on Chinese domestic banks with regards to lending, thus developers maintain access to capital. We maintain our vigilance on monitoring the situation.

Chinese cement and steel production tell a consistent story of construction activity falling from a growth rate of 10% to around flat over the second half of 2011.

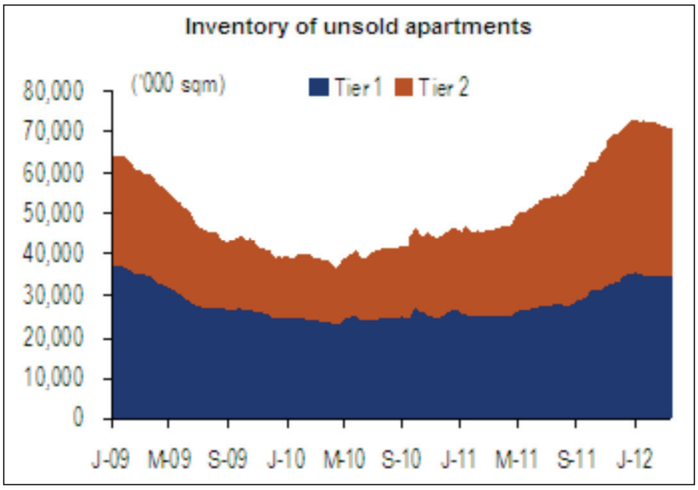


Source: BoA ML Research

Consensus has volume growth in steel reaccelerating to 5-8% but it is extremely hard to see this given:

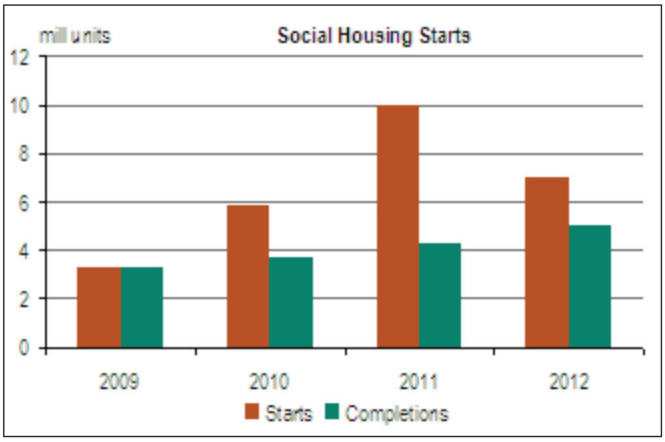
- Public investment in transport and utilities is now contracting;
- Auto sales have been flat for more than a year; and
- Inventory of unsold apartments has surged over the past two years.

The chart below shows apartments released for sale but unsold while many more apartments are sitting, ready to be released.



Source: BoA ML Research

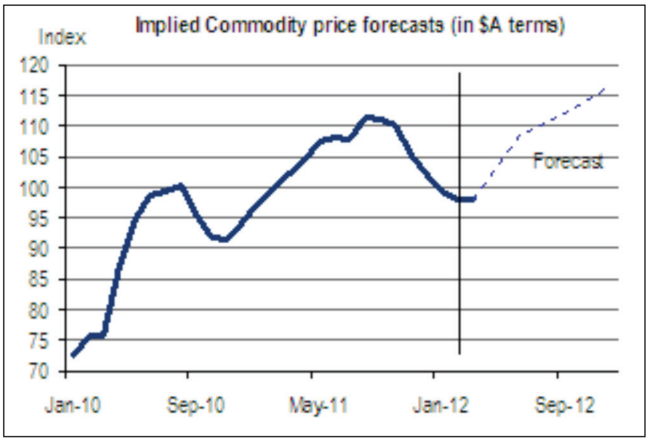
Social housing completions will only grow by around 15%, according to the targets at the recent Chinese National People's Conference. Bank of America Merrill Lynch's China team estimates that this will only use 1.5% of total steel outlook so it will not be a 'game changer'.



Source: BoA ML Research

It is much more likely that steel production will fall by 5-10% and therefore place enormous pressure on feeder sectors, particularly iron ore and coking coal.

Given the data above, it is important to be reminded of market expectations for commodity prices. Consensus forecasts are $160 for iron ore, $230 for metal coal and $115 for thermal coal, and for the $A to be about $US0.96. This means that the assumed path of $A commodity prices is as depicted in the graph below (which should have a high correlation with $A earnings). It shows a rise of about 20% over the rest of the year.



Source: BoA ML Research

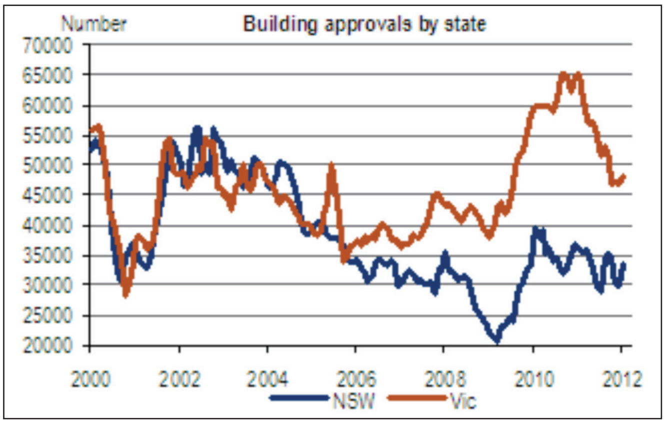
If instead commodity prices are flat in $A terms (a more sensible starting point) then downgrades will occur to the order of:

- 10% more for FY2012; and
- 25% for FY2013 (the current forecast is for 20% earnings per share growth in FY2013).

To obtain an upgrade to earnings forecasts in resources from the current position would require one of the best years in the current commodity boom.

Beware, the domestic building sector

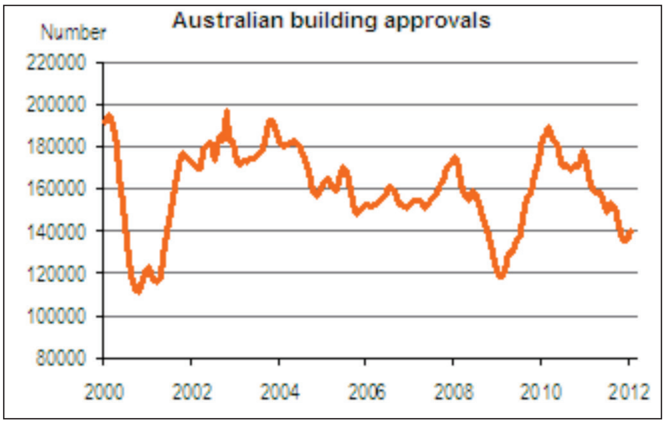
The removal of the First Home Bonus in Victoria on 30 June 2012 is considered a major sentiment risk to domestic builders and building supply companies. This scheme added to the Federal scheme introduced at the time of the GFC but was much larger than that in other states, and lasted longer.



Source: BoA ML Research

The scheme provided as much as $19,500 for the construction of a new home ($19,500 in the regions and $13,000 in Melbourne) which led to a push in new homes within Victoria. It eventually doubled new homes in NSW (despite it having a quarter less population). Victoria has been artificially holding up the national series for a couple of years, and the turnaround in policy could be savage and take approvals well below consensus expectations.

If Victorian starts now drop back to those in NSW, this could drag the run rate in national starts back to the GFC lows of 120,000/year and take sentiment towards building materials and developers with it...



Source: BoA ML Research

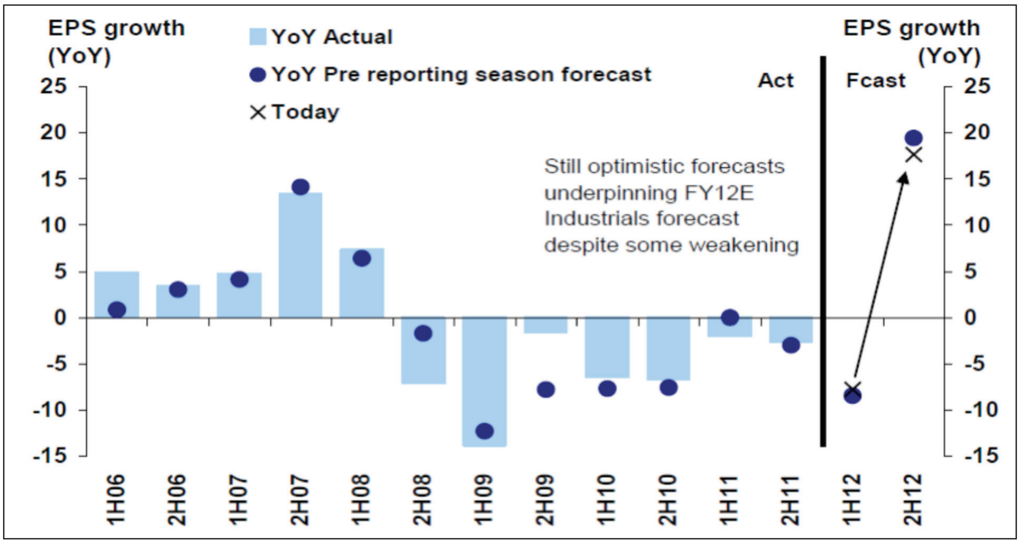
'If you knee cap the sector through a super profits tax on banks, watch what happens to house prices… and good luck getting re-elected.'

Mark Joiner, CFO NAB, 7 Dec 2012

February results season: Second half club

Leading up to the February results season, the market had revised down expectations, so that in general expectations were met. In many cases companies maintained their guidance for the full year (to June end), despite softer than expected first half results. This implies a bigger than expected result is now required for the second half result. Hence the phrase, 'the second half club' was coined.

The chart below shows consensus expectations of implied second half growth for industrial companies to meet full year expectations. A big jump in positive momentum is required, however with less than one quarter to go; time may be running out...



Source: Macquarie Research, February 2012

Outlook

The March quarter had an important take out. Despite downgraded earnings expectations, continued patchy domestic economic data and long list of 'second half club' members, the market rallied. Even post the February reporting season the market added to the strong January gains. It was the second positive quarter in a row.

A rising market despite falling earnings expectations suggests to us the market is beginning to recognise relative attractiveness of the market's earnings growth and dividend combination when compared to alternative asset classes. The combination of balance sheet repair, dividend and earnings stability and falling interest rates is positive for equity markets.

Furthermore, continued stability in the US and Europe, macro-economic data and deleveraging progress of the consumer and banks is providing a base on which confidence is being built.

We have been slowly adding some beta to our portfolios (as mentioned in last quarters' commentary we made of point of insisting on strong balance sheets in such names). We continue to favour 'self-help' stocks as we are not prepared to rely on volume growth or macro outcomes to drive returns. Stock picking appears to have come to the fore once again, so a quality bias remains a feature of our portfolio.

'One lesson about investing during a sharp recession: the best stock market opportunities will arise just as stabilization is on the horizon, and by the time the turn is in the statistics the markets will already have moved.'

Harry Sawikin, 01/08/11

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

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

15174/0413