Greencape Wholesale High Conviction Fund

Quarterly report - March 2015

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Inception % p.a.
Fund return	8.99	15.70	16.41	9.41	8.17	10.54
Growth return	8.99	6.46	10.90	4.95	3.57	5.13
Distribution return	-	9.24	5.51	4.47	4.60	5.41
S&P/ASX 200 Accumulation Index	10.33	14.13	15.82	8.59	6.04	6.47
Active return^	-1.34	1.57	0.59	0.83	2.13	4.07

Past performance is not a reliable indicator of future performance.

Performance figures are calculated after fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures.

^ Numbers may not add due to rounding

Investment objective

The Fund aims to outperform its benchmark over rolling three-year periods.

Responsible entity

Fidante Partners Limited

Investment manager

Greencape Capital Pty Ltd

Investment strategy

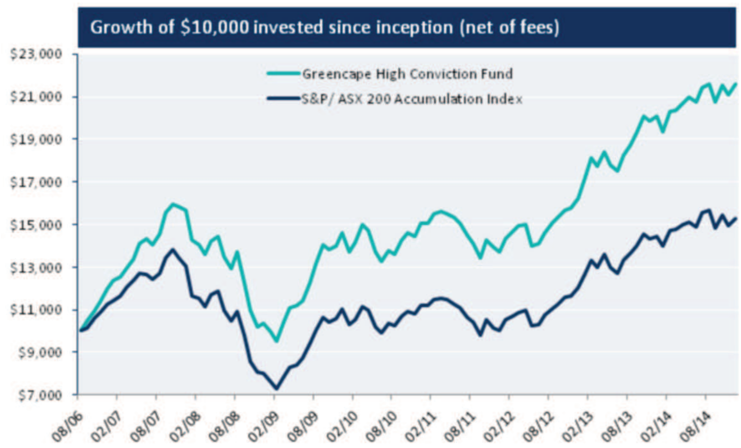
Greencape is an active, 'bottom-up' stock picker. Whilst Greencape does not target any specific investment style and will invest in stocks displaying 'value' and 'growth' characteristics, its focus on a company's qualitative attributes will generally lead to 'growth' oriented portfolios. This is an outcome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

Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

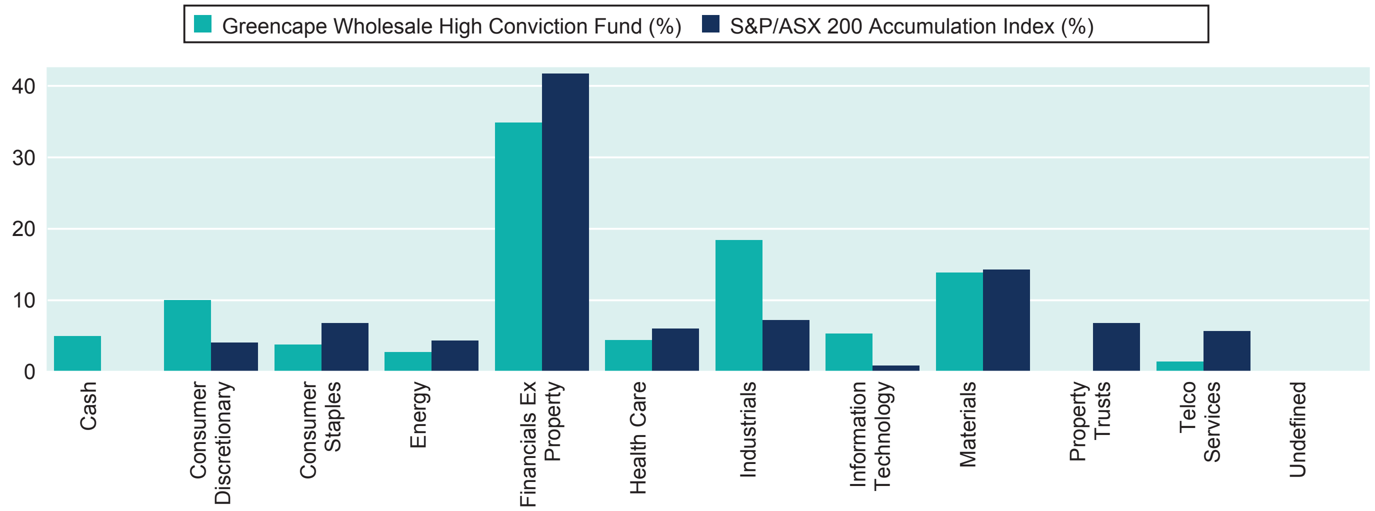


Asset allocation	As at 31 March 2015 (%)	Range (%)
Security	95.00	85-100
Cash	5.00	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0035AU

Fees	
Entry fee	Nil
2013-2014 ICR	1.16%
Management fee	0.90% p.a.
Performance fee	15% of the Fund's daily return (after fees and expenses and after adding back any distributions paid) above the Fund's Performance Benchmark (the daily return of S&P/ASX 200 Accumulation Index).
Buy/sell spread	+0.20% / -0.20%

Sector exposure as at 31 March 2015



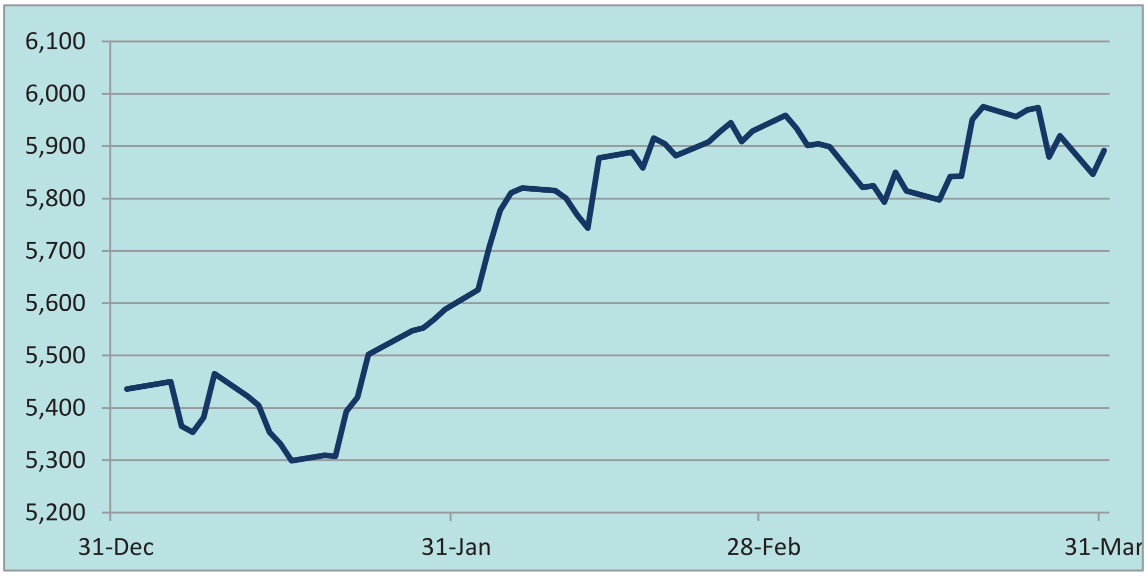
Fund performance summary

The S&P/ASX 200 Accumulation Index returned +10.33% for the quarter. The fund underperformed the market and delivered a +8.99% return over the quarter.

Market overview

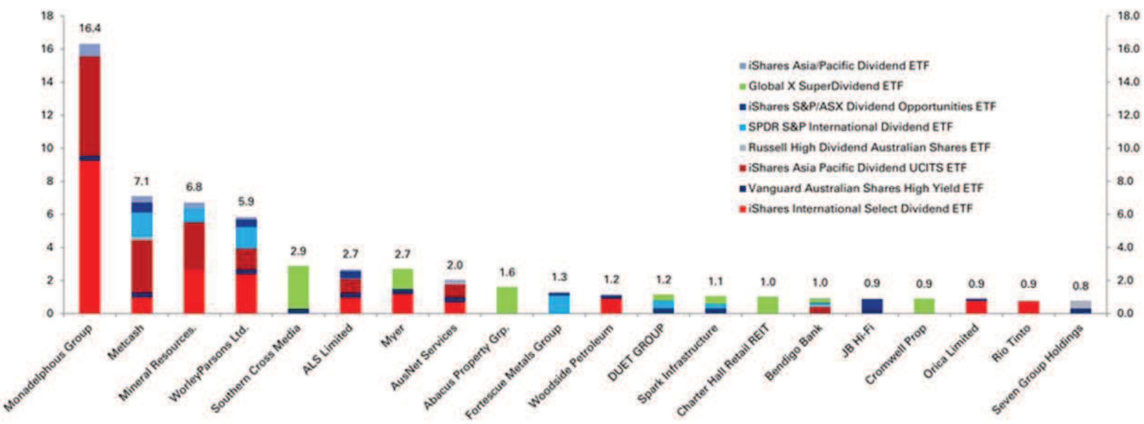
The local index jumped strongly out of the gates this year, posting the best quarterly performance since September 2009. Weak commodity prices saw material stocks continue to underperform, while yield stocks continued to be well supported. The AUDUSD cross rate fell 7% for the third consecutive quarter, aiding local stocks with USD exposure. The US Federal Reserve (Fed) continued to move markets with expectations of rate increases being the main focus of global markets.

S&P/ASX 200 Accumulation Index



In its first move since August 2013, the Reserve Bank of Australia (RBA) in February opted to cut the overnight cash rate to a new record low of 2.25%. After quarter's end, the RBA again decided to keep rates on hold. At the time of writing, the futures implied probability for a cut in May of 81%. The rate cut in February came despite unemployment positively surprising in January at 6.1% against market expectations of 6.3%. House prices continued to strengthen, with Sydney and Melbourne values rising 6% and 4% respectively for the quarter. Based on sales in the December quarter of 2014, there are now 59 suburbs in Melbourne with a median house price over $1m.

Below are the findings of an analysis of the holdings of the 8 largest Dividend ETFs. These 8 ETFs manage a total of $4.4bn in ASX exposure. The graph highlights the largest percentage of free float held by these funds. As yield on higher quality defensive names compressed, the exposures in the more illiquid and higher risk names has been heightened. If these passive ETF positions were to unwind, a catalyst perhaps being earnings downgrades, the market impact could be significant.



Source: Goldman Sachs

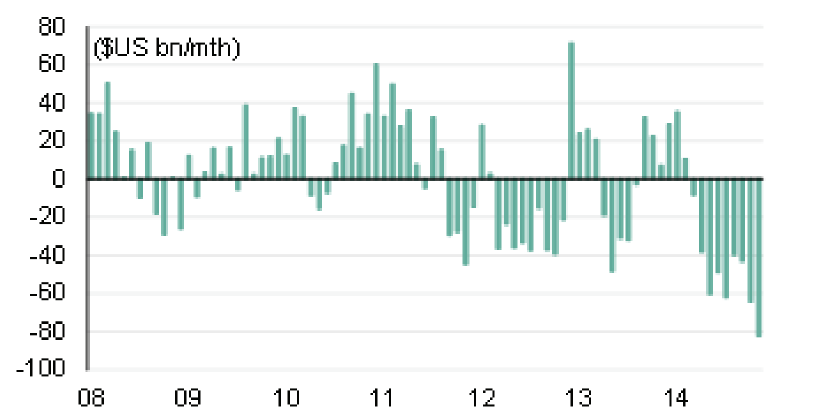
"Despite the headwinds of softer labour markets, very low rental yields, increased oversight on lending conditions and heightened economic uncertainty, historically low mortgage rates appear to be adding further stimulus to the housing market." Tim Lawless Head of Research, CoreLogic RP Data, 01/04/2015

In Greece the 'anti-austerity' party Syriza won its first ever election, forming a majority coalition government with the Independent party. Whilst the change of government caused many to believe a 'Grexit' could be imminent, the negotiation of bailout conditions between Greece and the Troika ultimately concluded with an extension agreement. European Central Bank (ECB) President Mario Drahgi managed to set markets alight yet again, unveiling a €1.1 trillion stimulus package. The quantitative easing program involves monthly purchases of €60bn from March 2015 to September 2016, or longer if deemed necessary. The Swiss National Bank sent foreign exchange markets into a frenzy after unexpectedly abandoning its exchange rate cap of 1.20 Swiss Francs per Euro.

US markets exhibited high volatility during the period but only managed to track sideways as the USD strength and changes in interest rate expectations saw that market underperform global indices. Economic data continued to be strong as February non-farm payrolls rose 295k, much higher than the expected 235k increase. The Fed also slightly changed their wording around monetary policy in its March meeting, which we discuss later in the quarterly.

Chinese economic growth weakened to a 7.4% annualised growth rate for Q4 2014 – the lowest annual rate since 1990. The government also cut the expected GDP growth rate for 2015 to 7%. The People's Bank of China cut the one year benchmark rate by 25bps to 5.35%. The minimum down payment for second home buyers was also reduced from 60% from 40%.

Chinese Capital Flight



Source: CBA

Easing monetary policy attributed to USD $82bn of capital flight out of China in December last year – the biggest month on record.

After a traditionally quiet start to the year, the market became preoccupied with reporting season in February. Record low global interest rates saw M&A continue to be a theme with Toll Holdings agreeing to be acquired by Japan Post at a 49% premium to the last close before the announcement. The thirst for yield saw no signs of abating, with Tabcorp conducting an earnings dilutive capital raising to pay a special dividend and release franking credits.

	Mar 2015 Quarter	Year ended Mar 2015
ASX200 Accumulation Index	10.3%	14.1%
Best performing sectors		
Consumer Discretionary	14.3%	12.2%
Financials ex Property Trusts	14.1%	20.7%
Utilities	13.7%	26.4%
Worst performing sectors		
Energy	-3.7%	-16.7%
Consumer Staples	4.0%	0.1%
Information Technology	7.1%	9.0%

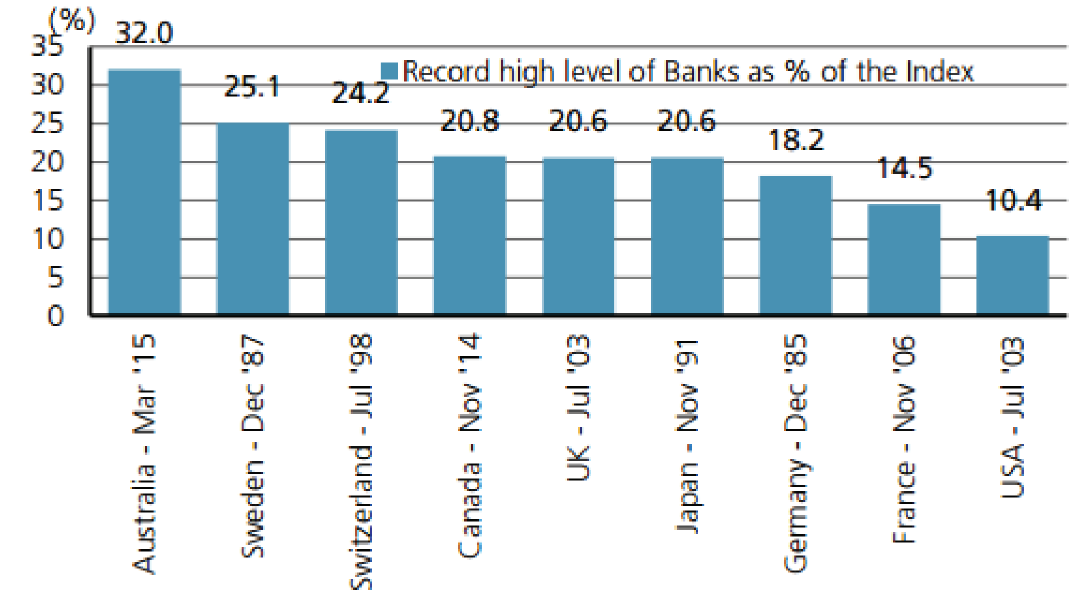
"I think we are in such a dynamic period but also a period where there is just so much volatility... It layers risk on risk on risk. Predicting the future is always fraught but is now very, very difficult." Richard Goyder, CEO of Wesfarmers, 01/04/2015

Despite retails sales for the key month of December rising 0.2%, missing market expectations of 0.3% growth, Consumer Discretionary was the best performing sector over the quarter. Domino's Pizza rallied strongly after posting another strong result and trading update, both well ahead of market expectations. Flight Centre Travel also fared well after posting an in-line result, with the market expecting an earnings miss due to bearish trading commentary from travel insurance group Cover-More around levels of outbound leisure departures in Australia.

Financials outperformed during the quarter, with rising equity markets aiding the performance of listed fund managers Henderson Group, Perpetual and Magellan. Macquarie Group also rallied after it announced the earnings accretive acquisition of an operating lease portfolio of 90 modern commercial passenger aircraft from AWAS Aviation Capital for US$4bn.

In Australia, we are at the highest percentage level of bank market capiltalisation of any developed share market globally.

Maximum Banks Market Cap as % of Index



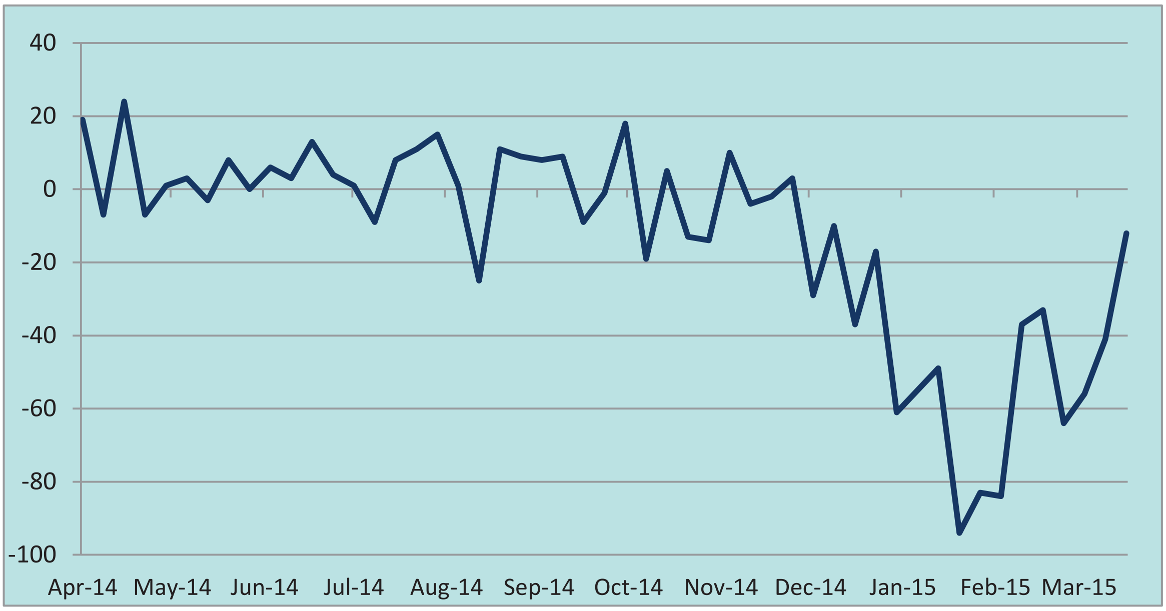
Source: DataStream, UBS estimates

Utilities stock were a beneficiary of the ongoing yield trade during the quarter. AGL performed well as the stock posted a solid half year result, in which management reiterated full year's earning guidance of $575-$635m. The highlight of the result came from the Merchant energy business, with Wholesale Gas gross margin of $205m against $81m in the prior corresponding period.

Oil continues its slide, with WTI Crude falling 11% over the quarter. Energy was again the worst performing sector with traders left disappointed having expected a short term bounce in the underlying commodity. Despite equity raisings being a common theme with their US peers, local oil producers are yet to tap the equity market for capital. Iron ore also continued its downward trajectory, falling a further 29% during the quarter, falling below $50 at the time of writing.

The closely watched weekly change in oil rig counts in the US remains negative, but the rate has slowed due to the most inefficient rigs having been shut down.

Baker Hughes Weekly Change in US Rotary Oil Rig Count



Source: Bloomberg

Consumer Staples struggled as Woolworths posted disappointing half year earnings. Whilst the supermarket giant achieved expected EBIT, Management outlined the need for reinvestment into the core franchise and guided towards the lower end of analyst expectations for FY15. A $150m provision was taken against Big W which continues to underperform, whilst Masters EBIT loss for the half ballooned out to $103m from $61m in the prior corresponding period. Interestingly, annualised sales per store for Masters have decreased every quarter since March 2013.

Despite the sector rising over 7% for the period, Information Technology stocks still underperformed during the period. Carsales struggled after it posted a disappointing first half result, due to a combination of weaker display revenues and the market failing to appreciate both the margin mix and sales mix that is occurring within the group as they grow businesses such as Stratton Finance and their Tyresales.com.au venture.

Timing of US rate rises

Each day financial markets seem to gyrate based on changes in expectations around when the Fed will finally raise interest rates. As expected during the March FOMC meeting, Chairwoman Janet Yellen dropped the phrase “can be patient in beginning to normalise (rates)”. However markets were caught off-guard when Yellen added that “export growth has weakened”, indicating the Fed is not entirely comfortable with how the USD has strengthened (before the meeting the USD index DXY had increased 10% in two months). Unsurprisingly, global equity markets took this dovish statement well, with the Dow Jones and ASX200 gaining 1.3% and 1.8% respectively after the FOMC meeting.

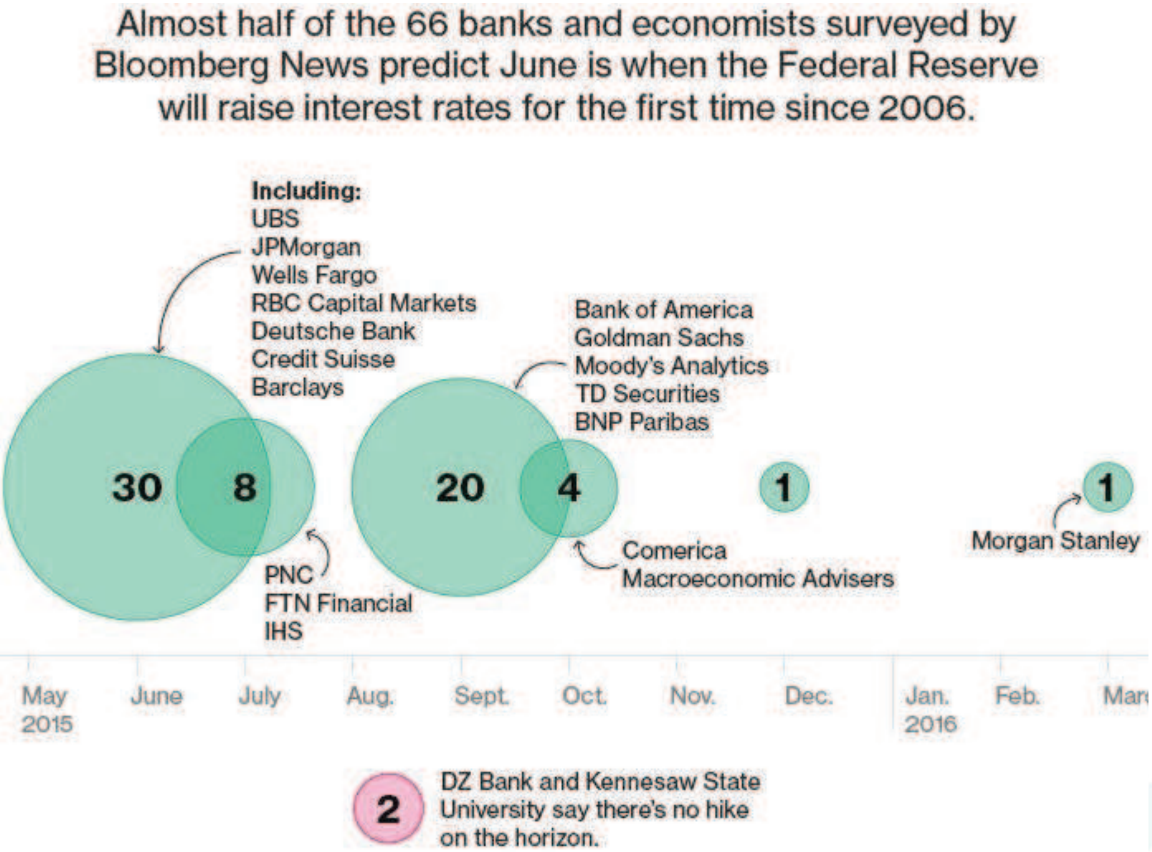
Adding to the dovish sentiment of the meeting was that inflation expectations had tempered, with Fed projections not expecting inflation to hit the long run 2% target until 2017.

Variable	Central tendency[1]			
	2015	2016	2017	Longer run
Change in real GDP	2.3 to 2.7	2.3 to 2.7	2.0 to 2.4	2.0 to 2.3
December projection	2.6 to 3.0	2.5 to 3.0	2.3 to 2.5	2.0 to 2.3
Unemployment rate...........	5.0 to 5.2	4.9 to 5.1	4.8 to 5.1	5.0 to 5.2
December projection	5.2 to 5.3	5.0 to 5.2	4.9 to 5.3	5.2 to 5.5
PCE inflation.................	0.6 to 0.8	1.7 to 1.9	1.9 to 2.0	2.0
December projection	1.0 to 1.6	1.7 to 2.0	1.8 to 2.0	2.0
Core PCE inflation[3]	1.3 to 1.4	1.5 to 1.9	1.8 to 2.0	
December projection	1.5 to 1.8	1.7 to 2.0	1.8 to 2.0	

Source: Federal Reserve

Interestingly, economists are still predicting a rate rise in mid-2015.

When Will Rates Rise?

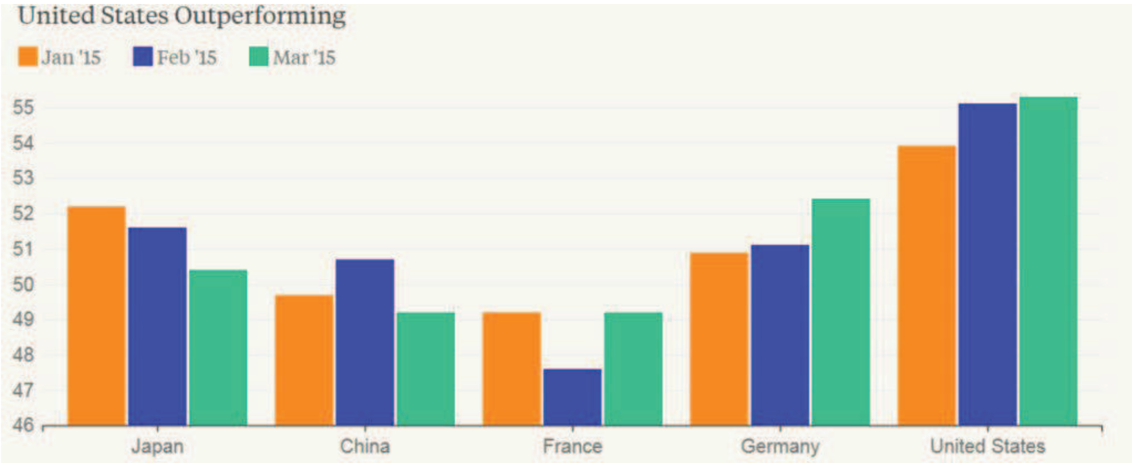


Source: Bloomberg News Surveys

“Market forecasters will fill your ear but will never fill your wallet.” Warren Buffet, Chairman & CEO of Berkshire Hathaway, 27/02/2015

The hawkishness of the economists is due to the underlying strength in the US economy. The Purchasing Managers Index (PMI) measures growth of new orders, inventory levels, production, supplier deliveries and employment environment, and a reading of above 50 indicates growth compared to the previous month. As we can see below, the US has outperformed other developed countries in 2015 thus far.

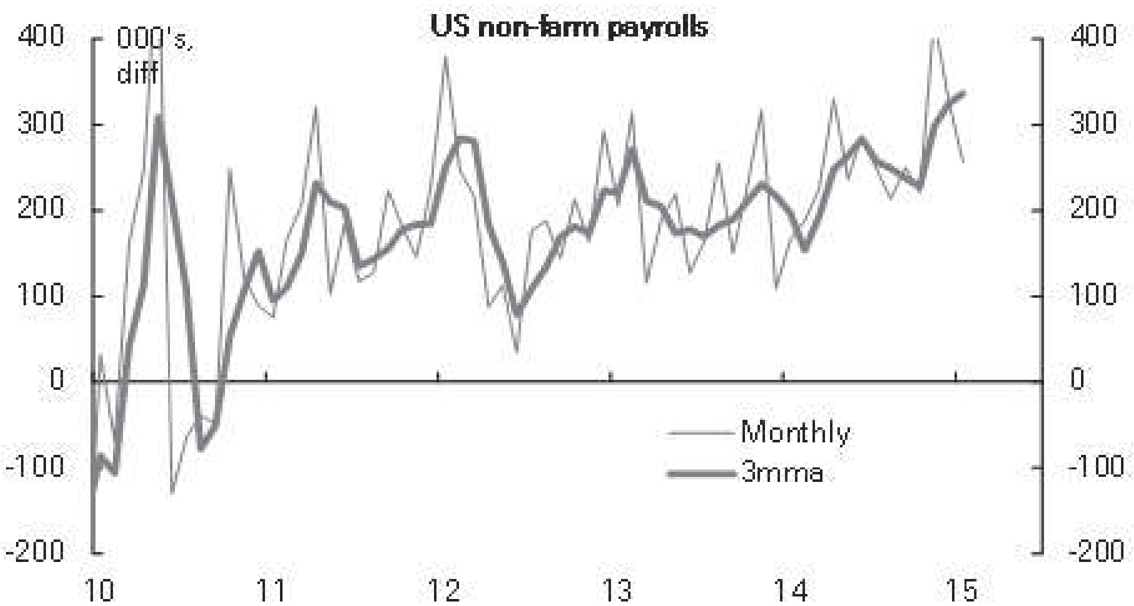
Manufacturing PMI



Source: Bloomberg

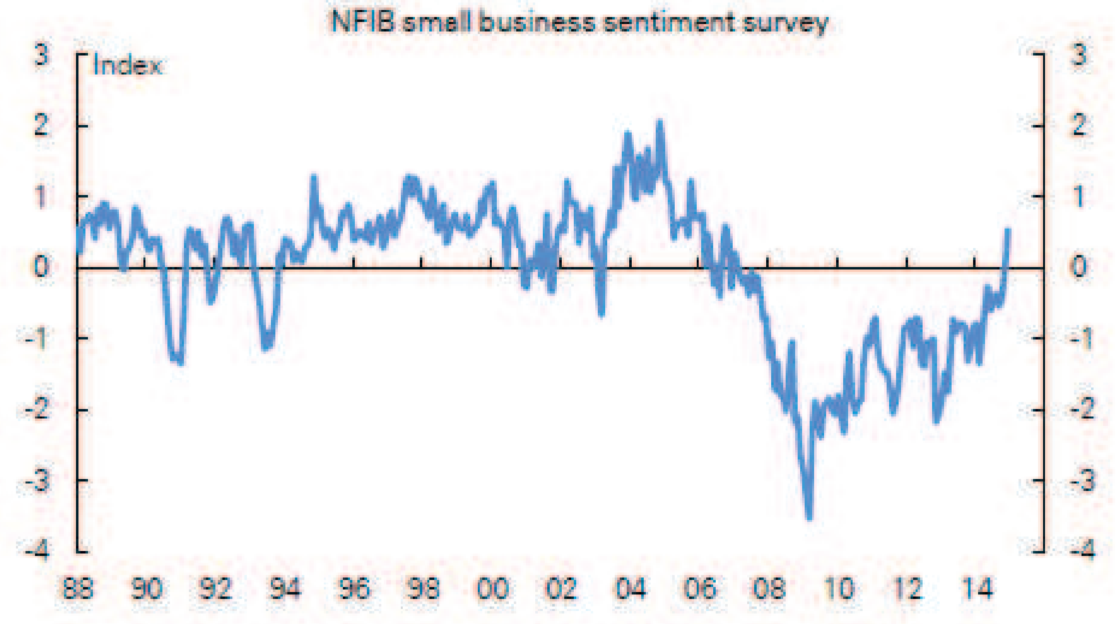
The growth of jobs being created as measured by US non-farm payrolls has also been strong, with the 3-month moving average showing an increasingly positive trend.

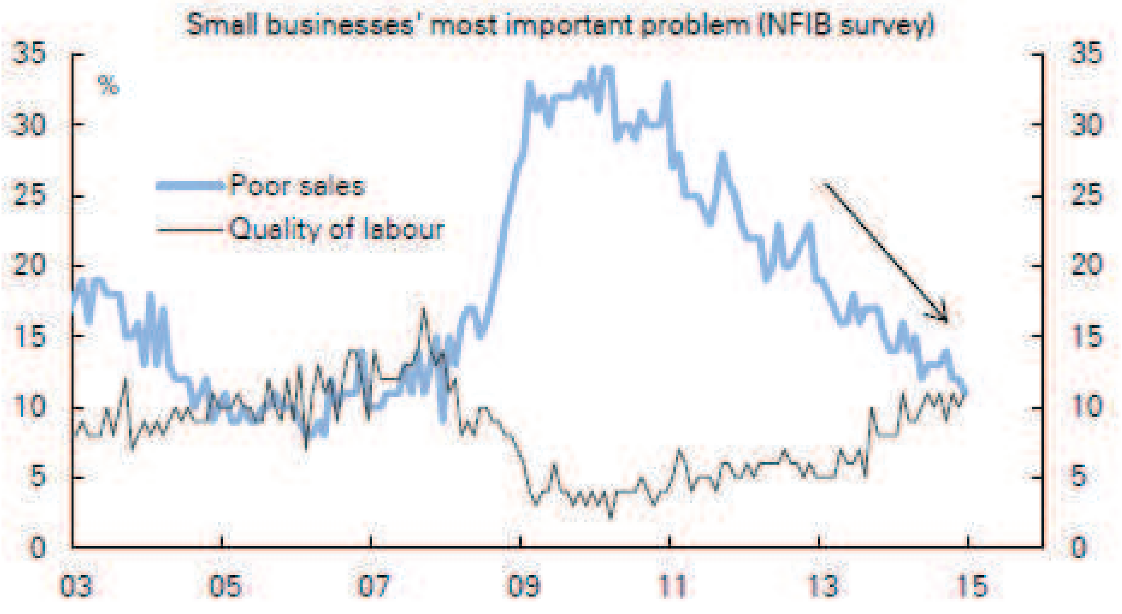
"Over the past five years, our businesses have created more than 11 million new jobs." Barack Obama, President of the United States, 20/01/2015



Source: Deutsche Bank, US BLS

Small businesses are now no longer seeing sales as the clear key issue, but quality of labour for the first time since 2008. Sentiment has also ticked positive for the first time since 2007. Taken in conjunction with the non-farm payroll growth, this bodes well for future wage growth and hence the likelihood of the fed raising rates.





Source: Deutsche Bank, NFIB

"Small business is the backbone of our economy. I'm for big business, too. But small business is where the jobs are generated." Michele Bachmann, former member of U.S. House of Representatives, 26/06/2011

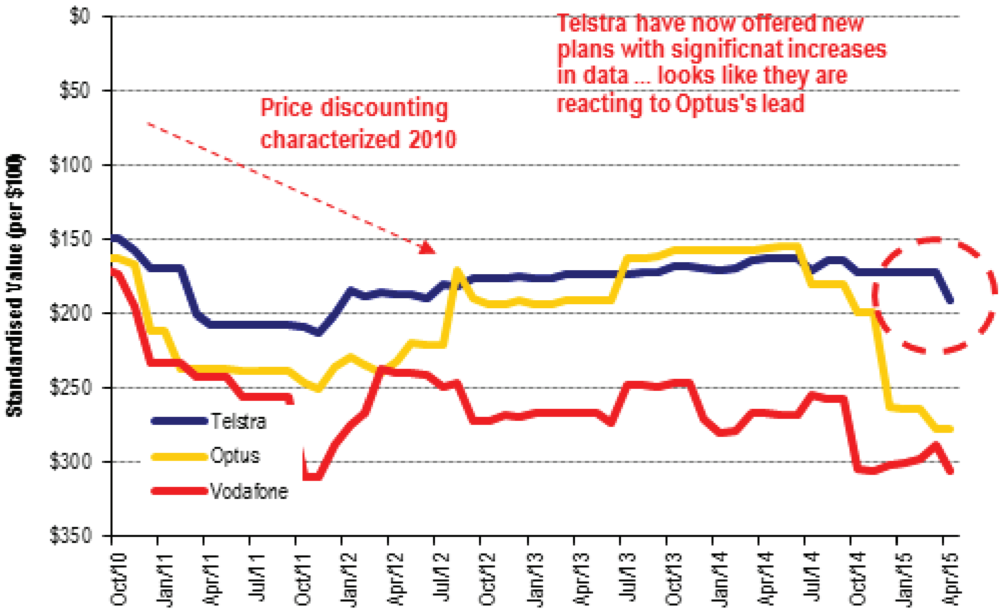
Telstra's shifting competitive landscape

Following the release of the Samsung Galaxy S6, Telstra (TLS) announced updated pricing plans to protect its dominant position in the mobile market in the face of increase competition. The carrier increased data allowances on premium plans, now offering 6GB and 10GB of data on $95 and $135 plans respectively (compared to 3.5GB and 4GB allowances previously).

Excess data costs have also been changed, whereby instead of customers paying excess data charges once they breach their limit, the charge will now be $10 per 1GB (data packs were previously priced at $15 per 1GB). This move follows that of Optus and Vodafone who previously dropped their charges on excess data usage. Telstra will also offer six months of Presto for free, while Optus is providing free Netflix for six months.

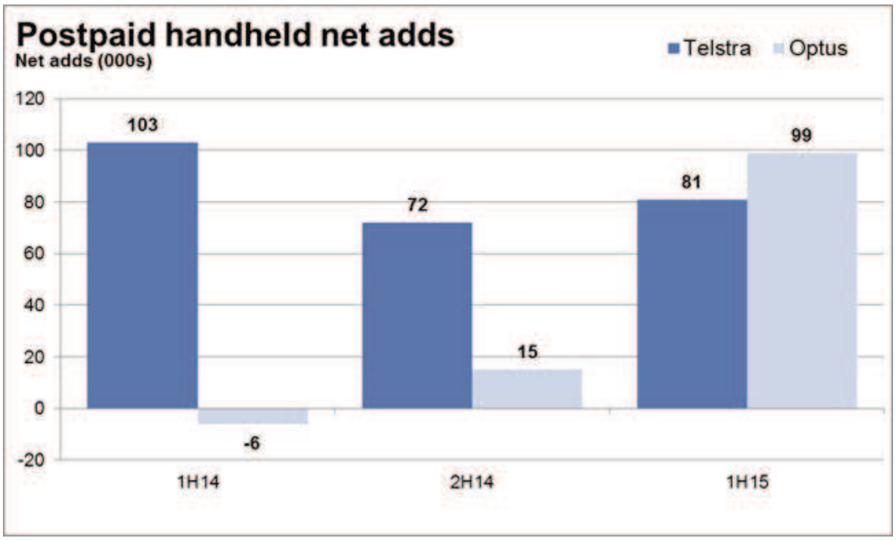
As evidenced below, this is the first meaningful increase in value for Telstra's mobile plans for four years. Meanwhile, Optus have made a concerted effort under new management to dramatically increase their value offering for mobile plans in an attempt to gain share it had previously lost.

Value vs Price: All Plans



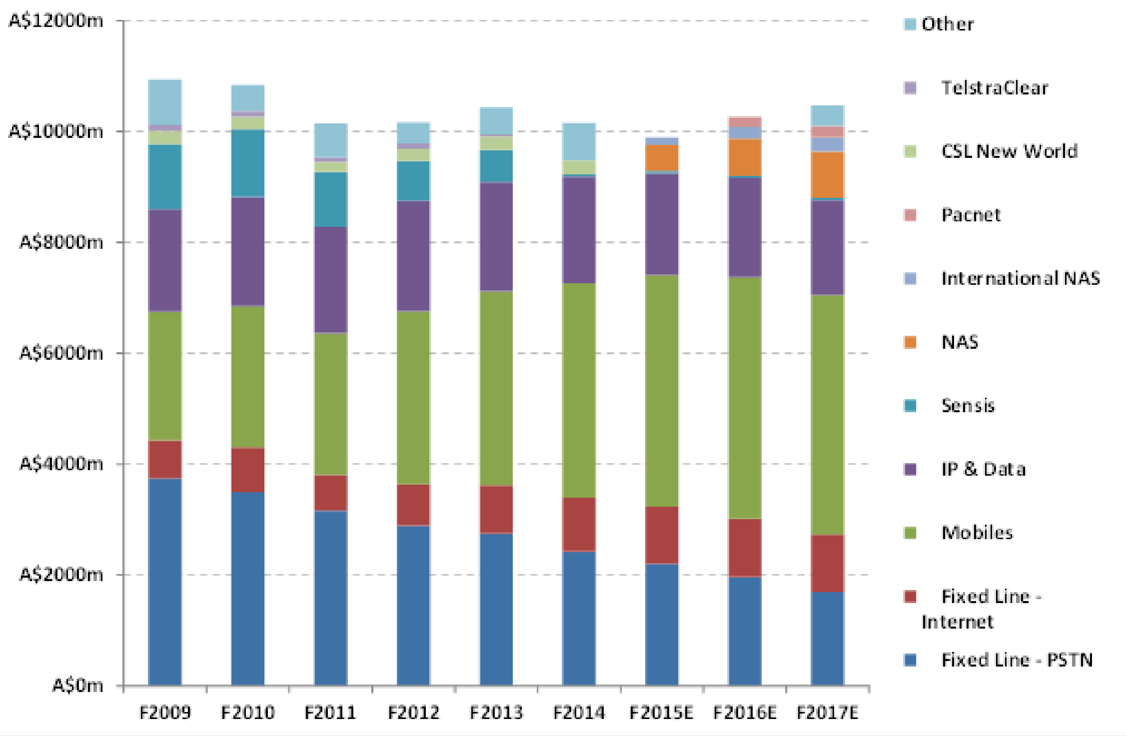
Source: Morgan Stanley

This renewed focus on subscribers and market share appears to be working for Optus, as they added a large net number of customers in the first half of the financial year. Optus has continues to increase value in a material way since this chart, hence further subscriber growth should be expected.



Source: Goldman Sachs

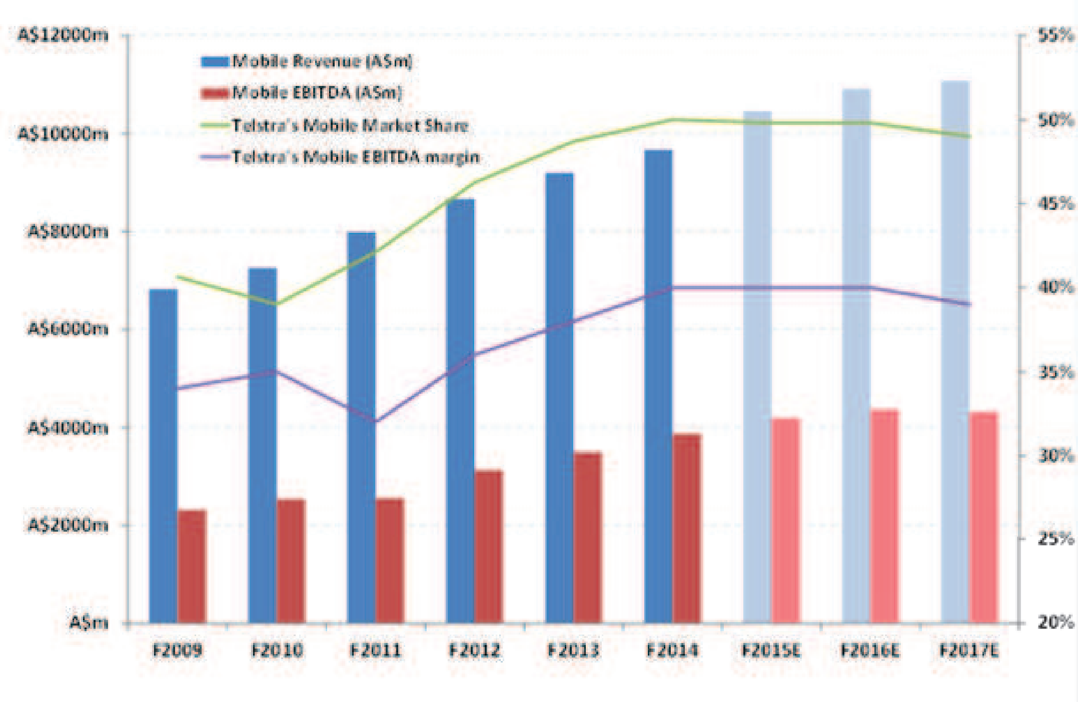
Defending their share could be an issue for Telstra, whose mobile franchise has been the key driver to their underlying earnings. Below, the green bars highlight the EBITDA reliance on mobiles in recent years, in order to keep broadly flat EBITDA at a group level.



Source: Morgan Stanley

This increase in Mobiles EBITDA has come from market share gains which in turn have driven earnings, given relatively fixed costs provides operating leverage. Also, network issues at Vodafone and a previously uncompetitive Optus provided easy gains in a consumer market that started to value the network due to rising data usage.

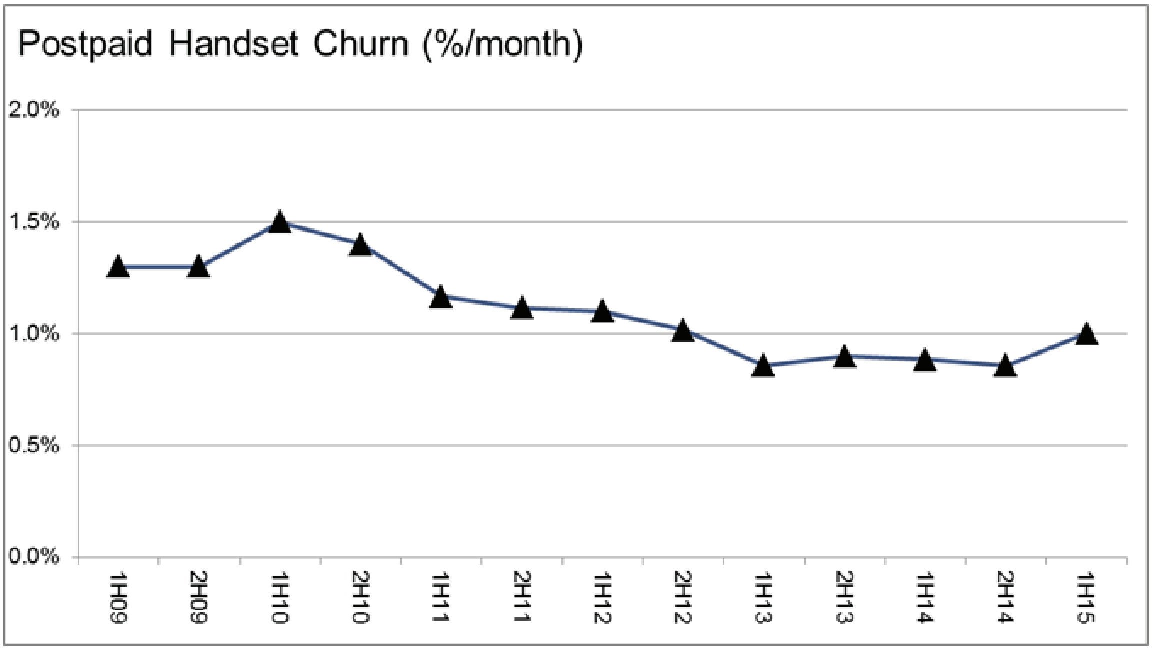
"We want to grow Optus and take back the market share… If we want to win in this marketplace we will have to walk the talk (and) when we give the specific guidance it'll be proof to the market that we are able to execute and deliver on this promise." Allen Lew, CEO of Singtel-Optus, 27/01/2015



Source: Morgan Stanley

By effectively doubling data allowances on mobile plans as detailed earlier, Telstra's ability to drive earnings higher by migrating customers to higher ARPU (Average Revenue Per Unit) products is mitigated. Telstra experienced a recent uplift in earnings by doing this; however the tougher competitive landscape going forward would suggest it would be more difficult to achieve this in the future.

We are also already seeing higher churn off TLS in the first half, albeit off impressively low levels. However relative to history, where competition was higher (and arguably heading that way now), Telstra could see churn continue to increase. If it were to attempt to avoid this, it will again cost them via a mixture of additional subscriber costs and/or lower ARPU as mentioned previously. Both impact margins and mobile momentum which is has being the key earnings driver for the business.



Source: TLS Reports

Overseas Trips

This quarter we went to the US (on four separate occasions), China and Canada.

US technology observations

- Scale content owners remain well positioned to leverage better economics, with increasing demand across SVOD (Subscription Video On Demand) across both international and domestic markets.
- Advertising demand is firming, with political spend likely to be a strong medium term catalyst to see markets continue to tighten with one contact noting “Last election we saw 3bn, could see 4-5bn spend (this round).” How advertising dollars are spent remains an area of focus, with online continuing to take share.
- The use of data for advertising will change the advertising landscape as we know it. The best players in the market are still only very early in the process of using data analytics. Big data and cloud combined could be a large growth opportunity for new players and a threat for traditional companies.
- San Francisco taxi usage is reportedly down around 60% in 2014 due to Uber.

A slide from PayPal’s presentation which demonstrates them redefining their marketplace to include activities traditionally conducted by financial institutions.

Source: Paypal

North American oil observations

- Canada has lots of onshore (conventional and shale) gas now without a home given US shale revolution has displaced Canadian pipeline imports into US.
- There are currently many proposals to export LNG from Canadian west coast but progress is slow given tough economics at these spot prices, despite strong government support.
- It was ‘Black Tuesday’ in Calgary when we visited as a number of energy companies laid off employees.
- US shale now towards the top end of the cost curve but aggressively taking down costs, high grading production and improving productivity, with US oil inventories at all-time highs and there remains a substantial amount of equity capital on the sidelines awaiting a recapitalisation opportunity. US shale is a good supply source to have at the marginal part of the cost curve as it is very reactive to price signals which should serve to rebalance markets relatively quickly vs other commodities.
- US explorers and producers have raised over $8bn of new equity already this year with an enormous amount of private equity capital on the sidelines waiting for acquisition/recapitalisation opportunities.
- Uniformly, Texas is yet to see any notable economic fallout from lower oil price. Qualitatively, meeting recipients ranged from exhibiting complacency to outright nervousness.

“I worry that we don’t have a culture of innovation; we don’t celebrate science and mathematics, we don’t really applaud great education. Why is it that when you go to Silicon Valley, you’re just overcome by the incredible energy?” David Thodey, CEO of Telstra, 04/03/2014

“In the world of business, bad news often surfaces serially: You see a cockroach in your kitchen; as the days go by, you meet his relatives.” Warren Buffet, Chairman & CEO of Berkshire Hathaway, 27/02/2015

US General Observations

- Confidence from consumers was incrementally better and helped by Walmart and Target both raising minimum wages recently. Comparable store sales trended better through 2014 and made a good start to 2015.
- Yields for quality commercial Manhattan Commercial property in 3-4% range. Lots of foreign money simply seeking a home offshore.
- USD strength is a real focus for US corporates and investors alike. The notion of ‘Constant currency earnings’ does not exist there.
- Throughout the meetings there was consistent feedback regarding wage increases being implemented (excluding oil and gas).
- The fastest growing product (double digit growth) for one of the largest US home builders is their low end home which sells for $170k, which suggests that part of the challenge around getting credit has been the principal borrowing amount rather than credit scores.
- Costco buy (and on-sell) 35% of the world’s cashew production.

A new apartment building under construction in Manhattan which is taller than the Empire State building.

China observations

- The government targeting a ‘new normal’ (a frequently used phrase in the media) – the focus is on stabilising GDP growth at about 7%, which will be the slowest rate of growth in over 20 years (7.4% in 2014).
- The observed trend of slowing demand (particularly in commodity-intensive industries) continues, but it feels this year that the rate of slowdown has moderated.
- No large scale fixed asset investment stimulus on the horizon. Any stimulus will be targeted and won’t drive a sustainable uplift in commodities demand growth.
- Unlike previous trips, companies no longer have expansion plans – heavy industrial companies has finally come the realisation that overcapacity can’t continue in this demand environment.
- Focus from Government on anti-corruption and pollution is impacting growth – removing some of the grease that has kept the Chinese economy lubricated.
- Investment-to-consumption shift continues – e.g. cash grants and incentives for investment by ‘new-tech’ companies in industrial heavy regions.
- 2015 is the last year of the government’s 5-year plan – there is still plenty of catch-up growth/spending to happen this year to meet the 5-year plan targets.

“It is true we have adjusted down somewhat our GDP target, but it will by no means be easy for us to reach this target.” Li Keqiang, President of China, 15/03/2015

Outlook

With broad macro trends remaining consistent in key economies, the February reporting season delivered results and outlook commentary largely in line with expectations. The market continued to climb and given a lack of positive earnings revisions, implied valuations stretched further meaning genuine value appears scarcer than 3 months ago.

Taking a closer look, the relative consistency of the macro environment, combined with cheap money (and hence falling discount rates), is helping fuel confidence in equity markets. As the bull market continues, we observe the breadth of the rally is reducing. First the miners and mining contractors stumbled, then the energy stocks. More recently, it's some of the structurally challenged former market darlings such as key retailers (e.g. Woolworths) and media. The weight of money looking for attractive risk adjusted returns keeps building, and when targeted at a smaller and smaller opportunity set, the risk of bubble-like valuations grows. Indeed we are observing pockets of this already - particularly in slow growth but high yielding names where reinvestment in the long term business is replaced by an increasing propensity to distribute profits back to shareholders.

We expect the combination of highly regarded management and attractive businesses takes on a greater importance in this environment. The ability to wisely allocate capital, and manage market expectations are key skills we value, whilst attractive businesses tend to provide the best opportunity set for management to add to shareholder value. The prize for demonstrating shareholder value creation is great, whilst the cost of disappointing or worrying the market from lofty valuations is large. Greencape is being increasingly discerning in our stock selection. We have been taking profits in the lower quality stocks that have run and are comfortable holding higher levels of cash and liquidity at present. We are comfortable avoiding the chase for short term yield - the pervasive thematic that has come back to life in the recent two quarters.

"The greatest risk doesn't come from low quality or high volatility. It comes from paying prices that are too high… When capital goes where it shouldn't, bad things happen." Howard Marks, Chairman of Oaktree Capital, 2013

More information

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

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