Greencape Wholesale High Conviction Fund

Fund report and commentary – 30 September 2008

Overview: The Greencape Wholesale High Conviction Fund (Fund), posted a return of -9.12% (after fees)* for the quarter compared with the S&P/ASX 200 Accumulation Index (benchmark), which returned -10.44%.

Performance

	3 months (%)	1 year (%)	2 years (%) p.a.	3 years (%) p.a.	Inception (%)
Greencape Wholesale High Conviction Fund	-9.12	-21.08	8.23	-	10.46
Growth return	-10.57	-26.24	-1.03	-	1.25
Distribution return	1.45	5.16	9.26	-	9.210
S&P/ASX 200 Accumulation Index	-10.44	-26.76	-1.53	-	-0.16
Active return (net)	**1.32**	**5.68**	**9.76**	**-**	**10.62**

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

Investment objective

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

Investment manager

Greencape Capital Pty Ltd

Investment strategy

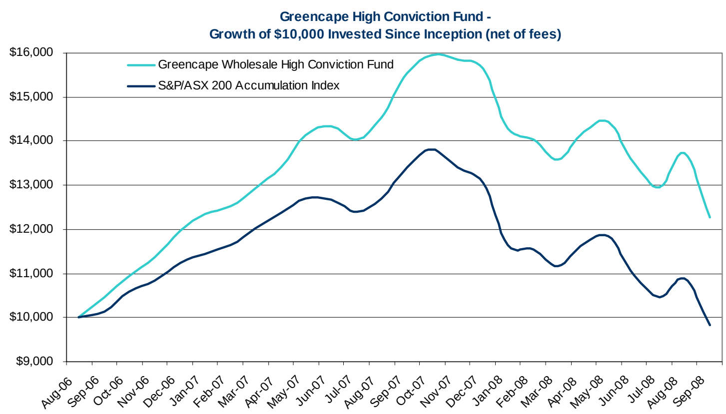
Greencape is an active, bottom-up stock picker. Whilst not targeting a specific investment style and investing in stocks displaying 'value' and 'growth' characteristics, Greencape's focus is on a company's qualitative attributes, which will generally lead to 'growth' oriented portfolios. This is an outcome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

Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years



Asset allocation

	Current (%)	Range (%)
Securities	97	85 - 100
Cash	3	0 -15

Fund facts

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

Fees

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

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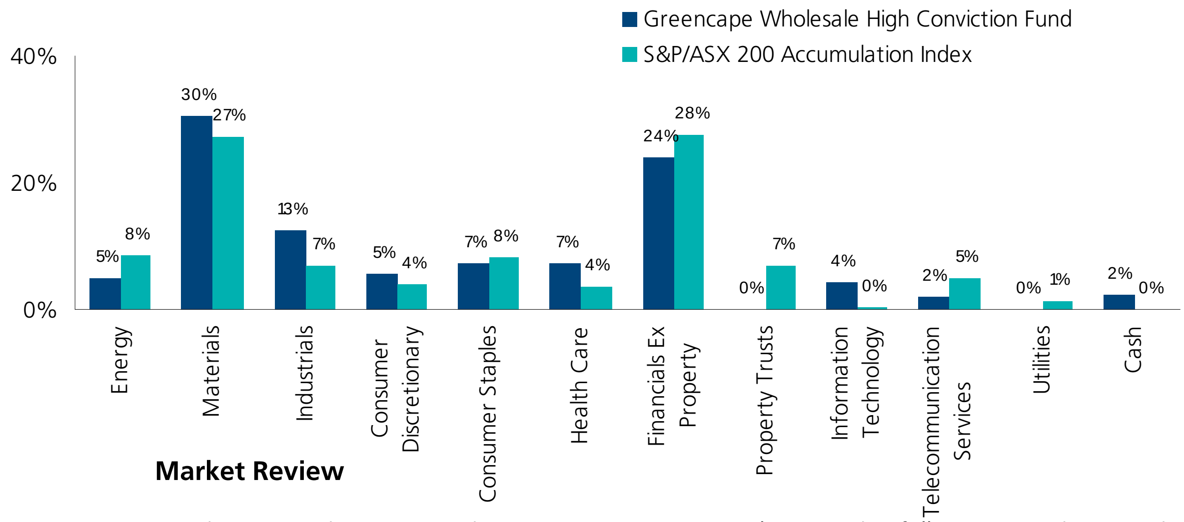
Sector exposures as at 31 May 2008



Market Review

For the September quarter the S&P/ASX 200 Accumulation Index fell 10.44%. This was the 4th quarter in a row of falling returns, and brings the share market's fall over the last 12 months to -26.76%. This is the 4th time since 1970 that the Australian share market has experienced falls in 4 consecutive quarters. The last instance of this was the 1989/1990 "recession we had to have" when the market fell 29.4% with 5 negative quarters in a row. The time before that was December 1972 to December 1973, when the market fell 29.9% due to the oil shock and stagflation period, and before that was in 1970/71 when the market fell 28.6%. Interestingly, on each occasion the market rebounded in the following quarter by 12.8%, 15.4% and 16.3% respectively.

The September Quarter had a significant change in the relative performance of various sectors. The roles of strong and weak performers from the June quarter were reversed, with Materials down 31.4% and Energy down 18.8%. In comparison Financials and Property Trusts were down only 0.1% and 2.9% respectively.

The key sector moves are highlighted below:

	Sept' Quarter 08	June Quarter 08
Worst performing sectors:		
Energy	-18.8%	+ 34.0%
Materials	-31.4%	+ 11.9%
Best performing sectors:		
Property Trusts	- 2.9%	- 17.2%
Consumer Discretionary	- 1.9%	- 22.5%
Industrials	- 3.0%	- 16.0%
Financials (ex Property Trusts)	- 0.1%	- 10.1%

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The September Quarter was an extremely volatile one with the S&PASX 200 Accumulation Index down 4.6% in July. This was led by a fall in energy stocks and profit warnings from a number of companies such as Aristocrat and CSR. Key management changes in Paperlinx, Santos, Aristocrat, Fosters, NAB and Qantas also led to declines.

August was driven by a relatively benign reporting season with the S&P/ASX 200 Accumulation Index up 4% for the period. Most companies delivered on earnings expectations; however outlook commentary was opaque as expected. Property trusts performed strongly as distributions were not cut to the extent that was feared, and valuations have yet to be revised down significantly by valuers. However, many property trusts have December year ends, so numerous property valuations were not fully audited. Another feature during August was a distinct shift towards expectations of a falling interest rate cycle in Australia.

September saw the global credit crises have an increasing negative impact on markets, with the S&P/ASX 200 Accumulation Index falling 10.4%. Numerous events saturated mainstream news headlines, with the level of fear and uncertainty being compared similar only to the 1929 Crash and the corresponding 1930's depression.

Company Visits and Observations

The most disturbing yet common concern facing companies we met during the quarter has been the challenge of accessing debt. We observe that many companies, even with existing debt facilities in place, are experiencing increased scrutiny when drawing down debt. This is direct evidence of the impact the credit crisis is beginning to have on companies globally, and clearly its not only impacting companies wishing to arrange new or expanded debt facilities, but even some companies with existing debt facilities already in place.

We observe that a degree of credit rationing is taking place in corporate Australia, and indeed globally. This involves banks not being able to satisfy demand for credit, and picking and choosing only the best companies and projects they wish to be exposed to. This is clearly driving a growing wedge between those companies with strong balance sheets, credible management and predictable cash-flows and those lesser quality companies that lack these attributes.

"Credit costs are going up, well above underlying earnings growth."

Michael Smith, CEO ANZ 18/02/08.

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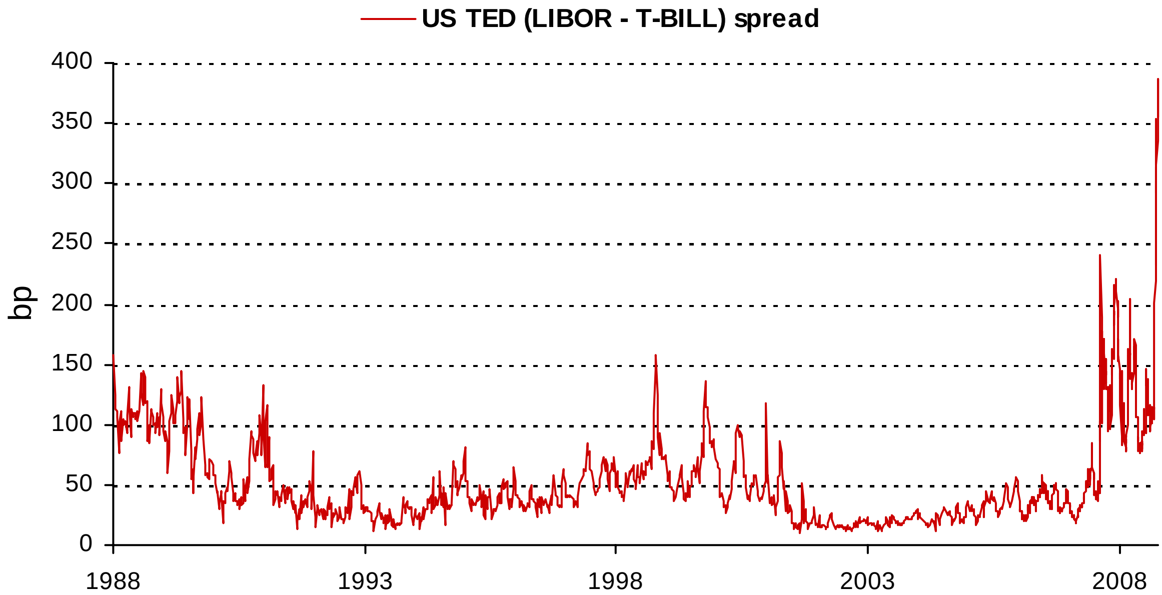
Credit spreads are the best means to demonstrate the fact that banks are too scared to lend to each other. For example the spread between the London Interbank Offered Rate (LIBOR) vs US Treasury Bill rates has spiked. The chart below puts the degree of mistrust between banks in perspective over the last two decades:



It is clear that expectations for global economic growth have taken a rapid decline. Many economists are now forecasting recessions in the US, Europe, and Japan. Such forecasts have recently been supported by weakening economic data such as employment payrolls, retail sales and consumer sentiment. Many economists previously assumed China and other key emerging economies would be able to maintain their rapid growth rates and effectively offset the developed economy slow down – the associated term "decoupled economy" is no longer in their vocabulary, and consensus economic thinking is that, in the short term at least, China and India won't grow fast enough to offset the slowing US, EU and Japanese economies.

The recent rapid change in consensus outlook has added an additional challenge to fundamental "bottom up" research techniques. Investor's due diligence and research efforts must be very wary of sources of information that reflect history and are lagging indicators. For example, Greencape observes that many companies that service the exploration activities of junior miners still report very buoyant conditions. Such firms remain extremely bullish on the resources boom and certainly the term "decoupled economy" remains in their vocabulary. However, when questioning the customers of such services (the junior mining exploration companies) it is evident that much of the exploration spending is funded by equity raisings (placements and IPOs).

Thus, given nervous equity markets and investors with increased risk aversion, exploration budgets are being reduced or are being run with less urgency, hence leading to slower spending rates. Greencape considers such observations to be relevant forward indicators suggesting demand for mining services from this important cohort of customers is about to slow. Furthermore, Greencape is very aware of service providers that utilise distributors as these providers are one step removed from the ultimate customer, and hence can be the last to be aware of changing demand patterns.

Greencape observes that logistics companies continue to deal with large volumes. The concern is that pre-Christmas ordering from retailers has already largely occurred. Importantly, Christmas forward orders were done when consumer sentiment was significantly higher. Greencape has received feedback from companies that suggest concern is growing regarding retailer inventory levels going into the Christmas season. A Chief Financial Officer from a major logistics company commented "the January sales may occur in December this year"

"In any supply chain, there's invariably one part of the chain where most of the money is made."

Jonathan Ling, CEO Fletcher Building, 18/09/07

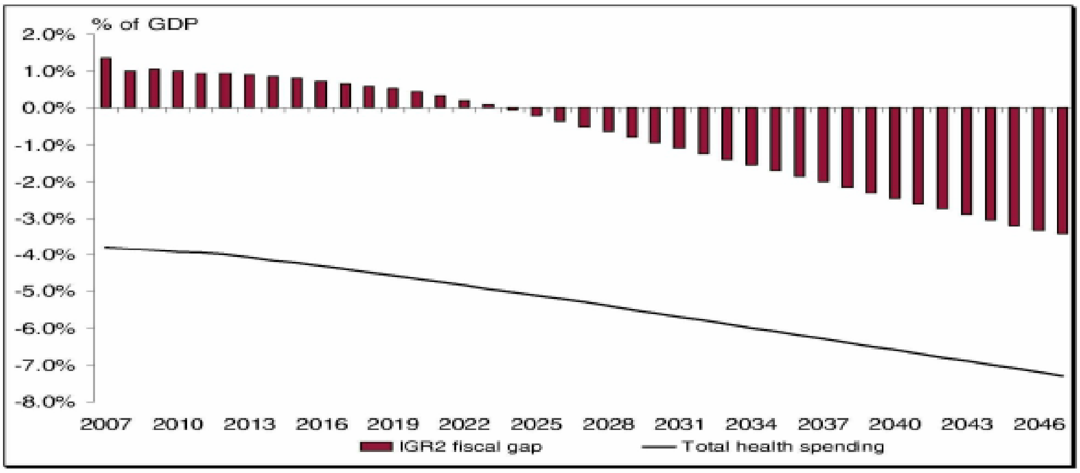
Stocks with hidden dependency on debt have been identified by Greencape, and avoided. Such companies have customers or clients which require access to debt in order to maintain high activity levels. With current credit rationing conditions evident, a large amount of activity will be delayed or reduced until credit becomes available once more.

The numerous bail-out packages, liquidity injections and bank recapitalising programs enacted by governments and central banks are clearly aimed at reducing stress and increasing trust in the banking system as soon as possible. It is clear that previous concerns regarding inflation and fiscal imbalances are being ignored due to present conditions. Greencape observes that Australia's very strong fiscal position, proactive central bank, and well capitalised trading banks have positioned Australia relatively well to weather the financial crisis although some concern remains regarding consumer indebtedness. Greencape expects an increased willingness for the Federal Government to begin spending the fiscal surplus and assist in stimulating the economy. It is hoped that such spending is targeted towards productive capital rather than pure consumption. With the federal government surplus likely to be reduced, it is worth highlighting that, over time, in sectors such as healthcare; Australia must become increasingly dependent on the private sector. Below is a chart that shows the forecast impact on the federal government's surplus if current healthcare policy settings are maintained. It highlights the need for increased service delivery by the private healthcare

"Liquidity is just confidence."

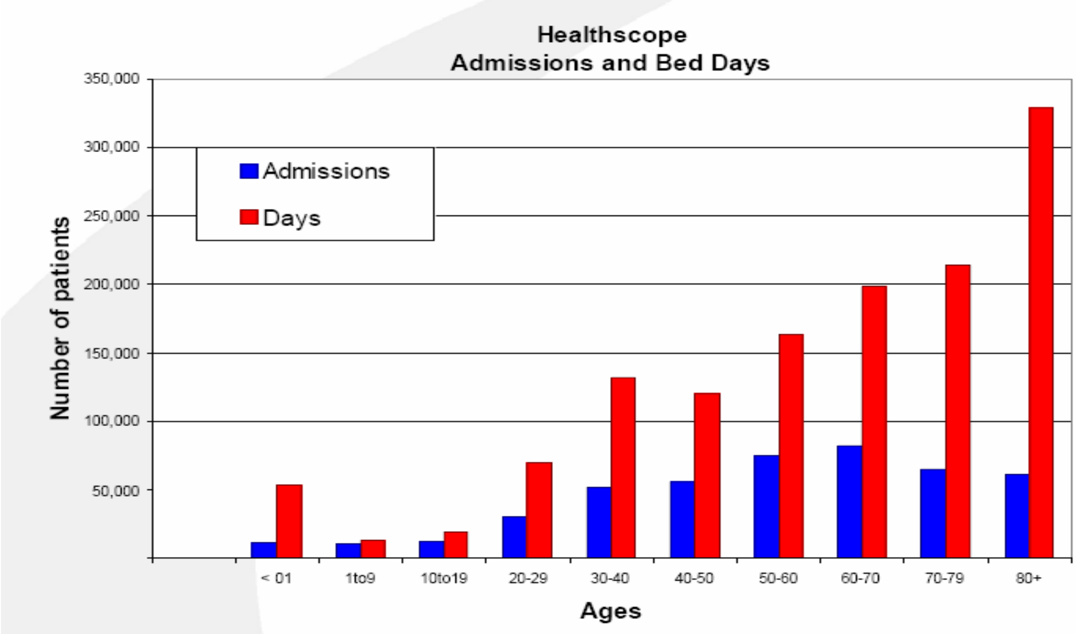
Nicholas Moore, CEO MQG 30/09/08

sector relative to the public sector, given the projected swing into underlying fiscal deficit as the population ages. This bodes well for domestic healthcare providers.



Source: Australian Government (2007)

An aging population has been often sighted as a key thematic behind investing in healthcare companies. Below is a chart that highlights the relationship between age and hospital admission trends. Unfortunately, aging will occur with or without a financial crisis!



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Fund Outlook

Readers of past Greencape Quarterlies would recall our caution towards equity markets since September 2007, when we highlighted an expectation for "US consumer belt tightening" and outlining that positive sentiment towards resource stocks and Chinese demand will eventually "be influenced by US economic growth expectations".

Twelve months later we can highlight that the average bear market over the last 50 years has declined by 32% over 52 weeks, compared to the current bear market which has declined around 40% over 48 weeks thus far. It appears this bear market is rivalled only by the crash of 1929.

In positioning the portfolio it is important to maintain a medium term perspective and target mispriced opportunities that have been sold in what appears to be an irrational panic.

Greencape's intensive company visitation program has identified a number of companies which we expect will be somewhat resilient to an expected economic slow down. Indeed, combining well placed companies with effective management and strong balance sheets highlights that some companies will take advantage of current conditions and prosper. Such relatively defensive stocks, when discovered by the market, have typically been bid up to relatively expensive prices, eg. Woolworths. Greencape considers numerous defensive stocks have yet to be fully appreciated by the market, and as they deliver earnings and cash-flows, will become positively re-rated by the market. Such stocks include healthcare service providers.

"In the short-run the stock market is a voting machine, in the long-run it's a weighing machine. As a voting machine, it responds to people's emotions. There's no literacy test for voting. You vote according to how much money you have, not according to how smart you (are.)"

Warren Buffett CNN interview 24/09/08

We consider current market levels are either at or nearing the bottom. This statement is made with respect to the psychology of the market as reflected in indicators such as the VIX volatility index, peaking at over 60. This index is a proxy for fear (it measures volatility) and history has demonstrated that when VIX peaks above 48.5, a market bottom is reached.

How the S&P traded AFTER the VIX traded over 48.5

S&P 500 low when VIX peaked	Why ??	Over 48.5	1 week later	1 mth later	3mths after	6mths after
12th March 2003	last capitulation world looked terrible	yes	9%	12%	27%	29%
24th July 2002	last capitulation in long decline	yes	15%	22%	14%	11%
10th Oct 2002	mkts sold off to 5 yr lows	yes	13%	16%	21%	13%
21st Sept 2001	Sept 11 Attacks	yes	10%	15%	21%	22%
1st Sept 1998	LTCM collapse	yes	7%	5%	25%	32%
28th Oct 1997	Asian crisis	yes	10%	12%	14%	27%
	Average gains later on		+10.50%	+13.80%	+20.30%	+22.30%

Source: Goldman Sachs JB Were

We expect financial stocks will lead real economy related stocks in any market recovery. This is because many financial names whose earnings are related to market levels (e.g. fund managers such as AXA, AMP) are somewhat more transparent and hence earnings are revised in real time relative to real economy stocks which have earnings dependent on margins and volume demand. Thus we expect real economy stock's earnings are yet to be sufficiently downgraded to reflect the expected slower economic growth. Many financial stocks in comparison have already had earnings expectations slashed. Furthermore, for real economy stocks to experience stabilising demand, credit markets have to begin to operate effectively once more – this implies confidence returning to banks and insurers as a first round impact. Therefore we expect real economy stocks will only begin to rally/recover if financial companies recover first.

Greencape is careful to differentiate between soft commodity stocks and hard commodity stocks. We acknowledge both sets of stocks have been sold on the back of expected slower economic growth amplified by hedge fund redemptions (12 months ago Hong Kong had around 2800 registered hedge funds, today that number is 900!). Greencape considers the sell-off in soft commodity input stocks such as Incitec and Nufarm as valuable opportunities to buy quality stocks at very attractive prices. Unlike hard commodities, demand is not discretionary with grain inventories remaining at 30 year lows. In addition, bankers have highlighted to us that lending to agricultural producers is considered very favourable. Our observations are thus at odds with the "speculation" that farmers can't get finance to plant crops. Furthermore, our investigations suggest that over 25% of fertilizer manufacturing is done by non-vertically integrated producers. Hence the marginal cost of production remains supportive of strong fertilizer prices (unlike many hard commodities).

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Greencape has an absolute focus on maintaining frequent contact with company management and industry sources of information. Indeed, many sources are more candid than usual given the uncertainty of the market and economy. Observations made from such contacts provide us with confidence and conviction in our stock selection, and we remain vigilant with respect to focussing on the medium term rather than short term market noise. We fully intend to take advantage of the many opportunities which are now presenting themselves at prices more attractive than we had previously imagined possible.