

Greencape Wholesale High Conviction Fund

Fund report and commentary – 30 September 2009

Overview: The Greencape Wholesale High Conviction Fund (Fund), posted a return of 22.75% (after fees)* compared with the S&P/ASX 200 Accumulation Index (benchmark), which returned 21.5%.

Performance					
	Quarter (%)	1 year (%)	2 years (%) p.a.	3 years (%) p.a.	Inception (%)
Greencape Wholesale High Conviction Fund	22.75	14.53	-4.93	10.29	11.78
Growth return	21.83	10.78	-9.61	2.76	4.28
Distribution return	0.93	3.75	4.68	7.53	7.50
S&P/ASX 200 Accumulation Index	21.50	8.34	-10.92	1.66	2.55
Active return (net)	1.25	6.19	5.99	8.63	9.23

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

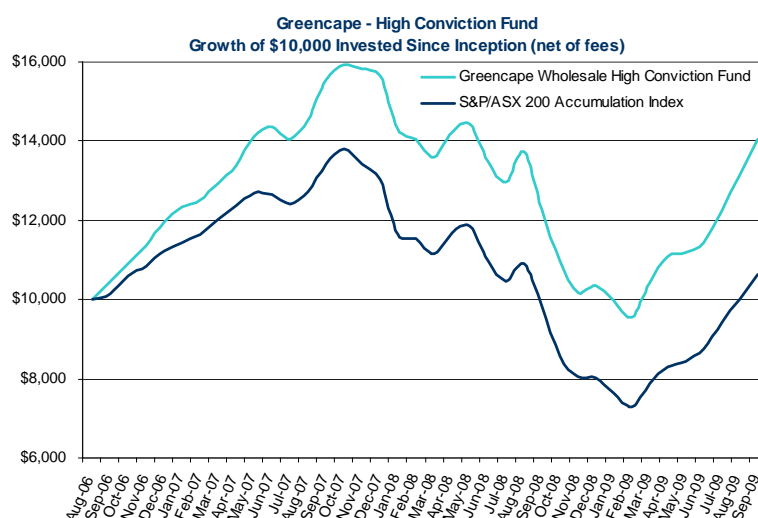
Greencape is an active, bottom-up stock picker. Whilst not targeting a specific investment style and investing in stocks displaying 'value' and 'growth' characteristics, Greencape's focus is on a company's qualitative attributes, which will generally lead to 'growth' oriented portfolios. This is an outcome 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	94	85 - 100
Cash	6	0 - 15

Fund facts

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

Fees

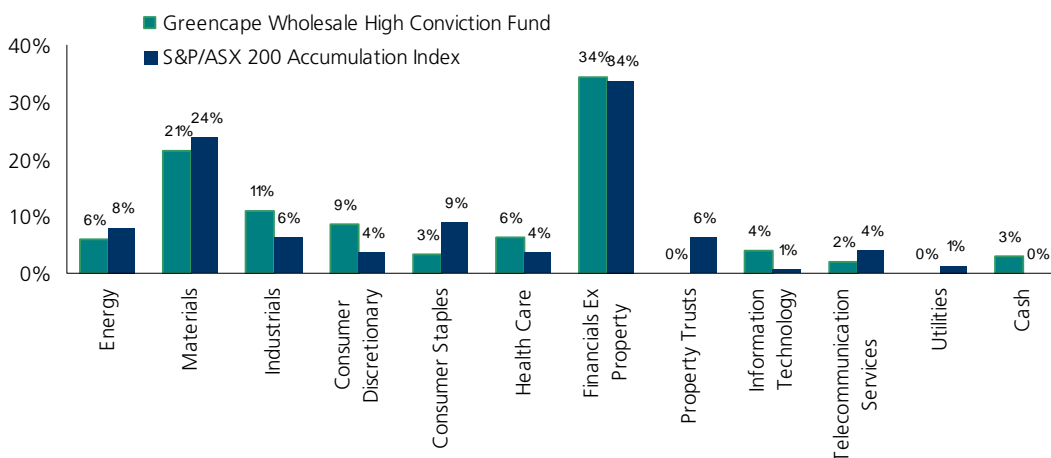
Greencape Wholesale High Conviction Fund	
Entry fee	Nil
2008/09 ICR	1.71%
Management fee	0.90% p.a.
Performance fee	15% of the Fund's after management fee return above the Fund's benchmark.
Buy/sell spread	+0.30%/-0.30%

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Fund report and commentary – 30 September 2009



Sector exposures as at 31 August 2009



Market Review

In the September quarter the S&P/ASX 200 Accumulation Index returned 21.5%, the largest quarterly return since 1987. For the last two quarters the market has returned 35.2% and the ASX200 is now up 51% from its March low. The Greencape Wholesale High Conviction Fund outperformed the market and delivered a 22.75% return over the quarter.

The market initially declined 5.5% to 13 July (ASX200 3,737), then rebounded and continued its climb all the way through the remainder of the quarter to be up over 1,000 points (27%) from its low point, closing at 4,744 points. The market rallied on improving economic data from the US and the increasing consensus view that Australia has escaped the financial crisis relatively unscathed. The table below shows that the more leveraged and macroeconomic sensitive sectors outperformed the market versus defensive sectors. The big four banks outperformed the market by between 11 and 28%, led by ANZ. Within the industrials sector, building materials stocks were strong on greater optimism that an economic recovery would see increases in housing starts whilst mining contractors were significantly re-rated upwards due to excitement about the magnitude of work on offer from the Gorgon LNG project off Western Australian and coal seam methane gas projects in Queensland. The telecommunications sector was the worst performing sector, holding flat, as a result of the Federal Government's regulatory announcement to 'encourage' structural separation of Telstra's fixed line wholesale and retail businesses.



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Fund report and commentary – 30 September 2009



	September Quarter	Year to September
Market (S&P/ASX 200 AI)	21.5%	8.3%
<u>Best performing sectors:</u>		
Financials (ex-property trusts)	34.5%	24.5%
Property Trusts	30.5%	- 23.7%
Industrials	30.2%	- 9.7%
<u>Worst performing sectors:</u>		
Telecommunications	0.8%	- 13.0%
Utilities	7.0%	- 2.1%
Healthcare	8.9%	- 3.1%

Company Visits and Observations

- On 28 September the Chinese Government began its sale program of 6 billion in Yuan-denominated bonds (US\$900m) in Hong Kong for the first time. This is an important step in creating an offshore market for China's currency and is the first time in a significant period that such an issue has not been made in US Dollars, something which may see the US Dollar's use as a global currency decline over time.
- The US official unemployment rate reached 9.8% at the end of September, up marginally from 9.7% in August. On a state basis, in August (the latest figures available at the time of writing) 42 states reported rising unemployment compared to 29 in July¹. In California (the world's 6th largest economy accounting for 13% of US economic growth) the jobless rate is now 12.2%. In Michigan (home of the US car industry and a hub for heavy manufacturing) the unemployment rate is the nation's highest at 15.2% and is predicted to average just under 16% for 2010². The unemployment figures in both California and Michigan represent 40-year highs while in other states the figures are the highest since records began. Importantly it is worth noting that the Labor Department figures reveal that where unemployment rates have declined more modestly a significant portion of the fall has been due to an increase in government-sponsored jobs. Whilst the official unemployment rate is 9.8%, the chart below shows that the level of under-employment in the US is significantly higher, now at 17%.

"China holds 13% of the US government's bonds and notes in public hands; at the 2007 peak it was absorbing 75% of the new issuance. But in H1 2009 this is down to 10%."

Niall Ferguson, author,
21/09/09

"We have operated in an environment, which in my 33 years in the media industry, is the worst I've ever seen."

Brian McCarthy CEO
Fairfax Media 24/08/09

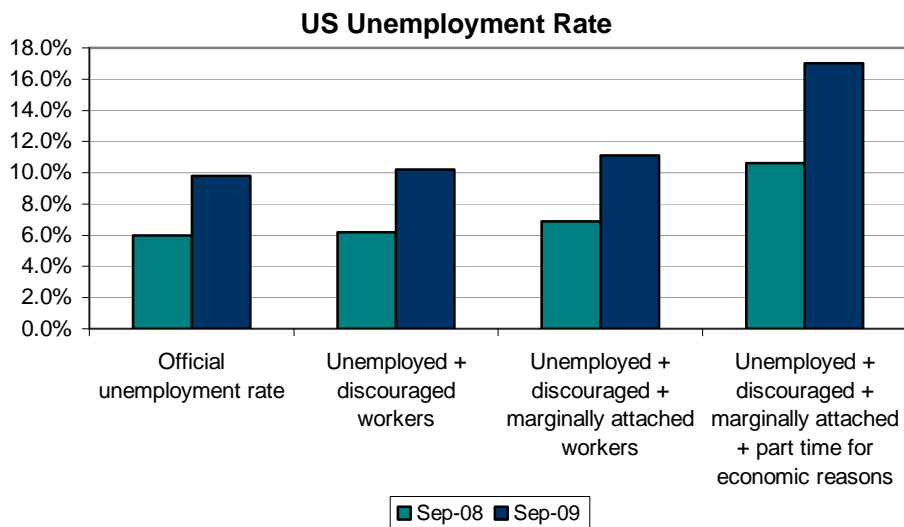
¹ US Department of Labor

² University of Michigan



Greencape Wholesale High Conviction Fund

Fund report and commentary – 30 September 2009



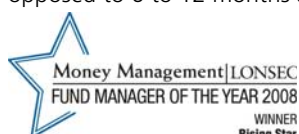
Source: US Government

Since the recession began in December 2007 the US economy has shed 6.9 million jobs and the unemployment rate is expected to peak at around 10.5% in 2010. If this is indeed the case we find it hard to see how the US economy can recover as strongly and as quickly as what's implied by stock prices.

- We recently travelled to the US to visit a number of companies, the majority of which were related to the building materials sector. We make the following observations:
- The government has successfully stemmed the tide in US housing to date with housing starts appearing to have bottomed and signs of stabilisation in pricing.
 - The fortunes of the US economy remain tied to new housing, real estate prices, reducing foreclosures and the employment picture, which in and of themselves are inextricably linked.
 - Ongoing improvement in US housing will require a continuation of existing policies for some time to come (read 2-3 quarters). Given that several of the policy responses with respect to housing are soon to expire (or up against capital constraints) the rolling of such initiatives remains key to stability.
 - Inventory remains scarce across the majority of supply chains; we observed this particularly in the steel and retail sectors. This means that production will continue to be supported over the next few quarters as supply chains are rebuilt (albeit not at the levels previously seen).
 - Labour as a cost lever has been pulled very hard by distressed industries. Many of the home builders we visited are down to 40% of previous full time employees. This suggests that job losses from the housing sector going forward will moderate.
 - Most companies suggested the current environment is one that can be managed as opposed to 6 to 12 months ago where their outlook was less clear.

"It's still too early to call the end of uncertainty"

Chris Skilton, Suncorp
acting CEO 25/08/09



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Fund report and commentary – 30 September 2009

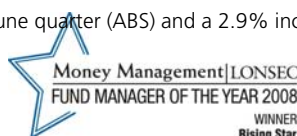
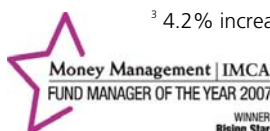


- Many commented that commercial real estate remains a key area of concern and a large remaining risk.
- We also met with Royal Dutch Shell PLC. Some comments of note:
 - Since 2001 every internal capital allocation decision has included a charge for carbon to reflect the climate change regulatory risk. They wouldn't disclose their estimated cost of carbon but did say it is assumed to increase 'significantly' over the next decade.
 - Shell are actively lobbying for a global cap and trade framework. They support climate change legislation but want a level playing field.
 - Shell expect climate change legislation globally will highlight that gas (which burns cleaner than oil and coal) is a critical long term energy source.
 - Shell operate over 45,000 retail outlets globally – more than McDonalds!
 - Shell are believers in floating LNG terminals. This development is expected to have 2 impacts:
 1. Reduce localised labour constraints for building conventional LNG plants (avoiding potential bottlenecks like Western Australia) since floating platforms are manufactured in Asia.
 2. The economics and flexibility regarding location can allow previously offshore "stranded gas" to be commercialised.
 - Shell's short term outlook for the oil price is negative due to soft demand and healthy production profiles.
 - Shell are cautious about the outlook for natural gas prices whilst positive on volume demand. They highlight demand growth from China, India, Korea and Western Europe (as they diversify supply away from Russia) yet highlight significant supply growth from Qatar, Australia's North West Shelf, Indonesia and Russia (as gas is diverted to Asia and even the US!). Shell didn't even mention the coal seam methane gas in Eastern Australia or PNG – reflecting the relative insignificance of the volumes in a global context.
 - Shell hope to further divest oil refining assets but when asked about their Geelong plant the comment was "we only want competitive assets".
- Australian property – We have watched the Australian property market closely for sometime given its correlation with consumer sentiment and the resilience of house prices to date has surprised many. House prices peaked nationally in March 2008, and in the year to March 2009 they declined 6.2% according to the ABS. Since then prices have rebounded up 7.1% in the five months to August³ following the RBA dropping the cash rate to its 49-year low of 3.00% on 8 April.

"For a bubble, you need liquidity, greed and a good story."

Ben Inker, GMO
strategist, AFR
23/09/09

³ 4.2% increase in June quarter (ABS) and a 2.9% increase in July and August (RP Data)

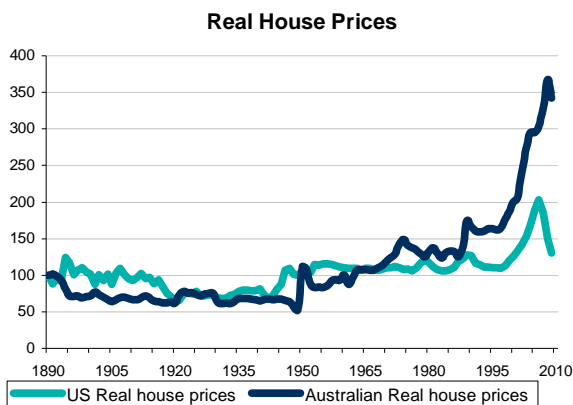


Greencape Wholesale High Conviction Fund

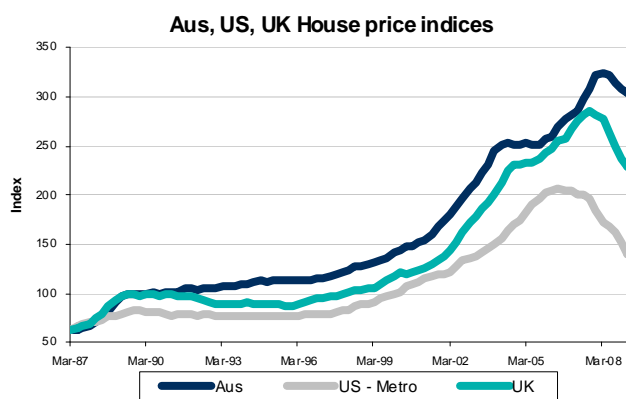
Fund report and commentary – 30 September 2009



The pace of growth in real Australian house prices, particularly since 1999 has been extraordinary. This has been a global phenomenon yet Australia's price appreciation has been ahead of the pack as the following charts show



Source: S&P Case-Shiller Index, Nigel Stapleton, ABS



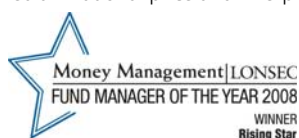
Source: ABS, S&P Case-Shiller, Halifax

Many economists have recently pointed to improving housing affordability however we note that this has been driven by cheaper debt the majority of which is borrowed at a variable rate rather than a commensurate increase in incomes. The price-to-income ratio, which we believe is a more fundamental method of valuation, has expanded 75% from 4x income in 1986 to 7x today⁴ and now sits well ahead of comparable western countries. The chart below shows that people's ability and willingness to take on greater debt levels has been closely correlated with house price increases.

“Over a protracted period of good times, capitalist economies tend to move from a financial structure dominated by hedge finance units to a structure in which there is large weight to units engaged in speculative and Ponzi finance.”

Hyman Minsky 1992

⁴ Based on RP Data median National price and ABS price index, divided by ABS median male gross full-time earnings

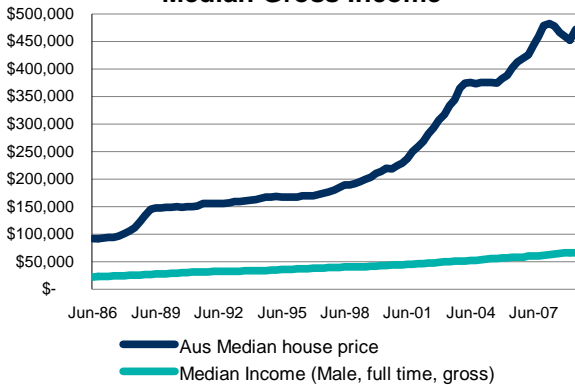


Greencape Wholesale High Conviction Fund

Fund report and commentary – 30 September 2009

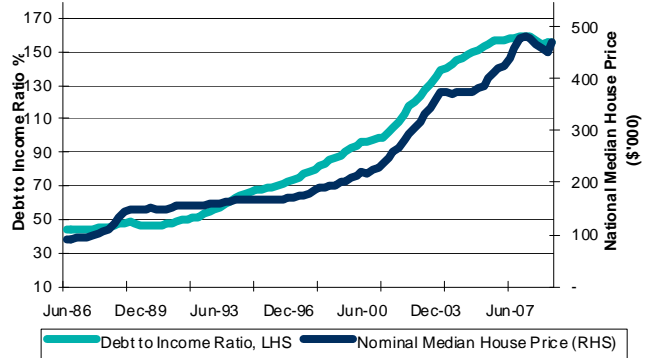


Australian Median House price vs. Median Gross Income



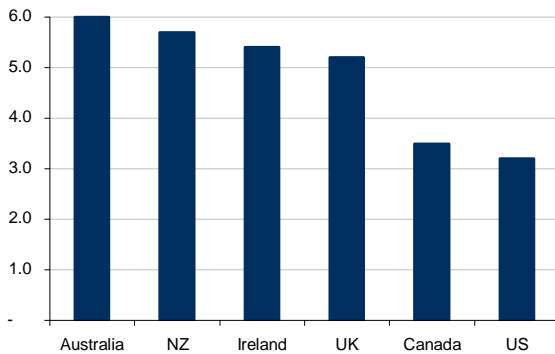
Source: ABS

House prices vs Debt Accumulation



Source: RBA

Median Home Price to Median Gross Household Income



Source: Demographica

"I am deeply concerned that our society has come to the point where this kind of leverage is still encouraged by the government (and the Fed) and is regarded as the norm. That the policy makers couldn't see the danger of such leverage everywhere is beyond my understanding as a simple, commonsense economist."

Marc Faber re a homebuyer with only a 5% deposit, 01/09/09

The RBA appears to be becoming increasingly vocal on the issue of high prices, having made the following statements:

"A very real challenge in the near term is the following: how to ensure that the ready availability and low cost of housing finance is translated into more dwellings, not just higher prices.... If we fail to do that – if all we end up with is higher prices and not many more dwellings – then it will be very disappointing, indeed quite disturbing. Not only would it confirm that there are serious supply-side impediments to producing one of the things that previous generations of Australians have taken for granted, namely affordable shelter, it would also pose elevated risks of problems of over-leverage and asset price deflation down the track." Glenn Stevens, Governor, 28 July



Greencape Wholesale High Conviction Fund

Fund report and commentary – 30 September 2009



“My third point is a reminder on the consequences of higher housing prices. It is important to remember that housing is a consumption item. We all need to consume some level of housing services, either rented or purchased. So a higher level of housing prices and rents allows less spending over our lifetimes on other items... As I have noted before, as a nation, we are not really any richer when the price of housing rises, but the more vulnerable tend to be hurt.” Anthony Richards, Head of Economic Analysis Dept, RBA 29 September

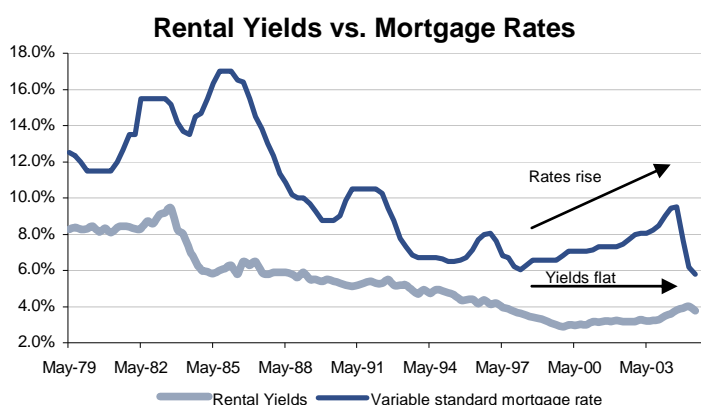
“Nevertheless, the ratio of Australian housing prices to incomes is still high relative to earlier decades, or compared with other countries.” Anthony Richards, 29 September

A likely cause of Australia’s unique willingness to choose to pay more for housing is the obvious tax distortions which rationally encourages capital being allocated to residential housing. Examples of tax distortions include zero capital gains tax on owner occupied houses and the ability to negative gear on investment properties, of which the latter is rare in a global context. Such policy distortions may be targeted (The Henry Tax Review currently underway?) if policy makers wish to address this apparently growing concern. The point on tax rules distorting the market has been made by the RBA before, as quoted below:

“Australian household debt accounted for 155% of household disposable income and 108% of GDP at the end of 1Q09, compared with 13% of GDP in China and 11% of GDP in India.” CLSA 10/09/09

“Another difference between investors in Australia and elsewhere is that in most countries the earning of rental income is seen as the most important reason for investing in rental properties... This seems to stand in contrast to the situation in Australia where properties are commonly marketed on the assumption that they do not earn positive taxable income for a considerable period.” RBA, Nov 2003

The decline in gross yields can be seen in the chart below:



Source: REIA, RBA



Greencape Wholesale High Conviction Fund

Fund report and commentary – 30 September 2009



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- Telstra – On 15 September the Federal Government announced reforms to the telecommunications regulatory framework. The Government has in essence threatened legislating strict functional separation of Telstra along with preventing the company from bidding on future wireless spectrum and requiring it to sell its Foxtel stake unless the company voluntarily structurally separates. The Government suggests one form that structural separation may take is the gradual migration of Telstra's customers to the new National Broadband Network (NBN) as it is rolled out over the estimated eight-year build out. This appears to us to be the most likely outcome that will unfold however there is clearly conflicting interests that are poles apart and that need to reach a compromise for this to play out not to mention the impact that politics may have on the process.

The regulatory changes announced also enhance the power of the Australian Competition and Consumer Commission (ACCC) to prevent anti-competitive behaviour.

If Telstra can sustain its current dividend of 28 cents per share, at its closing price of \$3.27 this represents a fully-franked yield of 8.6% p.a. or a 12.3% pre-tax yield to Australian investors.

- Recruitment agencies tend to act as good lead indicators on the future direction of employment and we note that Hammilton & James Bruce (HJB) a small listed recruiter recently removed a hiring freeze on its client facing staff and are now looking to hire again. All existing staff are also back to full time work versus the nine-day fortnights they were working previously.
- The market appears to have gone through its recapitalisation phase having raised \$88bn in capital through rights issues and placements in FY09 (vs \$51bn in FY08) and an additional \$28bn has been raised in the three months since. We are seeing a greater number of IPO's being brought to market, Myer being the most prominent, along with the early market soundings of others such as the retailer Kathmandu.

"I do like an investment where I don't need good things to happen... I just need horrible things not to happen." Ben Inker,
GMO strategist, AFR
23/09/09

"Economic forecasting makes weather forecasting look like physics!" Ben Bernake, US
Fed Chairman, 27/07/09



Greencape Wholesale High Conviction Fund

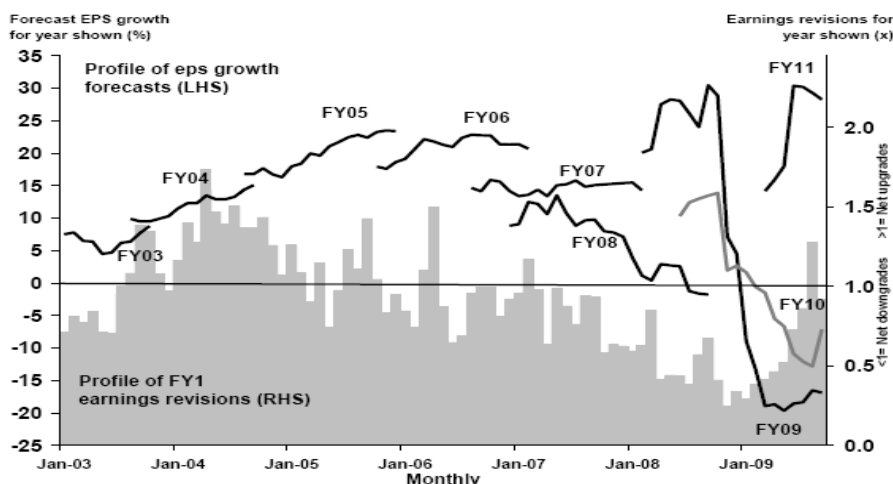
Fund report and commentary – 30 September 2009



Fund Outlook

Last time we wrote of investors being in two camps, those that believed in 'green shoots' and those more bearish given the structural economic weaknesses that still persist in the global economy. Whilst both camps still exist it appears clear that the equity markets are, at least to date, being priced by the optimists.

PE multiples to us look relatively full unless earnings growth is significantly higher, or comes through faster than the market is currently forecasting. The chart below shows consensus EPS growth forecasts for the next few years, in which we note there is modest growth forecast for FY10 followed by significant growth for FY11. We also observe that analyst forecasts are typically revised downwards over time perhaps reflecting the optimism bias present in all of us!



Source: IBES, Macquarie Research, September 2009

The dispersion in price-to-earnings ratios is low currently, with the majority of stocks trading within a relatively narrow band of 15x – 17x PER for FY10. This suggests to us that the market is neither rewarding the higher quality companies, nor discounting the lower quality ones. The portfolio seeks to exploit this situation whilst resisting to be driven by a binary macro view of either a strong or muted economic recovery.

“Actions to stabilise the global economy seem only to have created new bubbles – in government debt and emerging markets. Government actions seem to be primarily designed to ensuring continuation of the ponzi game. The only lesson learned is that no ponzi game can ever be allowed to stop.” Satyajit Das, GFC Cures – Placebo Effects, 29/07/09

It is much harder psychologically to be unsure than to be sure (re investment decision making) – Seth Klarman, Baupost Group, Feb 2009

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