

Greencape Wholesale High Conviction Fund

Fund report and commentary – September quarter 2010

Performance	Quarter (%)	1 year (%)	2 years (%) p.a.	3 years (%) p.a.	Inception (%) p.a.
Greencape Wholesale High Conviction Fund	7.66	1.50	7.82	-2.83	9.15
Growth return	7.19	-0.14	5.18	-6.56	3.17
Distribution return	0.47	1.64	2.64	3.72	5.98
S&P/ASX 200 Accumulation Index	8.04	0.61	4.40	-7.23	2.07
Active return (net)	-0.38	0.89	3.42	4.40	7.08

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

Greencape High Conviction Fund

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

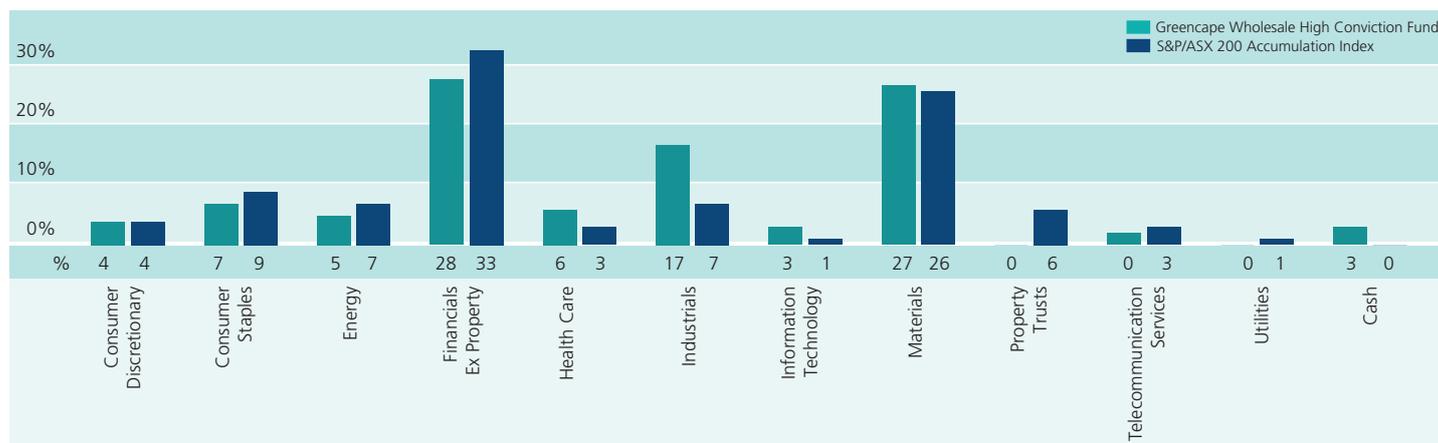


Asset allocation	Current (%)	Range (%)
Securities	97.30	85–100
Cash	2.70	0–15

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%

Sector exposures as at 30 September 2010



Market review

The S&P/ASX 200 Accumulation Index gained 8.04% for the quarter but was only up 0.61% for the 12 months. The Greencape Wholesale High Conviction Fund underperformed the market and delivered a 7.66% return over the quarter.

S&P/ASX 200 Index



Industrials were the best performing sector in the September quarter (after being the worst for the June quarter) driven by strong performances from Brambles which bounced off its lows from the previous quarter. Incitec Pivot also performed strongly driven by rising soft commodity and fertilizer prices. Qantas was also up on the back of the strong Australian dollar driving lower fuel costs and increased outbound international travel. Consumer Staples also performed strongly, driven by Wesfarmers (following a strong Cole's result) and agriculture consumer staples, with a takeover bid for AWB Ltd.

'The Fourth Law of Motion: For investors as a whole, returns decrease as motion increases.'

Warren Buffett, Chairman Berkshire Hathaway Annual Report, 2005

After being the worst performing sector in the March quarter, then the best in the June quarter, telecommunications was again the worst performing sector for the September quarter, driven by Telstra's guidance for negative earnings growth in 2011. Healthcare and Property Trusts were positive for the month; however their defensive characteristics were less of a focus for the market.

	September Quarter	1 year
Market (S&P/ASX 200 AI)	8.0%	0.6%
Best performing sectors:		
Industrials	17.8%	-0.7%
Utilities	12.0%	14.2%
Consumer Staples	12.0%	13.1%
Worst performing sectors:		
Telecommunications	-13.5%	-12.6%
Healthcare	3.3%	-2.9%
Property Trusts	3.8%	-4.1%

Company visits and observations

United States trip

- September is a timely month for US company visits. Retailers begin to focus on Christmas sales inventories, logistics companies start moving the product and corporate America returns to work from summer holidays with a lot of planning for next year underway.
- In September we visited numerous companies in Las Vegas, Los Angeles, New York, Arkansas and Texas. Below are some of our observations.
 - US macro observations
 - The US economy is experiencing widely varying demand profiles for end product segments. This is resulting in contrasting capacity utilisation of different industries and industry segments. In other words, the economy is best described as 'patchy'.
 - Labour and housing markets are perhaps the most extreme examples of where excess capacity prevails. Labour is illustrated through the unemployment and underemployment rates. Housing through the inventory levels of housing and the pipeline of foreclosures.
 - The transport and logistics industry has undergone significant supply side adjustments in respect of both labour and in freight carrying capital equipment. There are now early signs of shortages. This is currently being reflected in strengthening freight rates. As a result, in capacity constrained segments of the economy such as freight, splutterings of economic growth is sufficient to generate pricing power and improved levels of confidence. We caution this and note it should not be misread as a broad demand driven recovery.
 - Industrial-focused company balance sheets appear to be in reasonable shape, with some companies exploring ways to lever this to drive productivity through means such as automation. This seems to support the notion of 'the jobless recovery'.
 - It is difficult to see a sustained 'V-shaped' recovery in the US without the consumer eventually finding its feet – the question remains whether a capex led recovery has the legs and impetus to turn the employment picture around.
 - In Las Vegas there is a noticeable improvement in the forward orders book for Las Vegas conventions which may be a sign that corporate USA is feeling better about their prospects. That said Vegas is currently a very cheap place to do business with more than one strip operator 'fessing' up to effectively 'giving away' up to 30% of hotel capacity.

'A superior man is modest in his speech, but exceeds in his actions.'

Confucius

'The way to win is to work, work, work and to hope that you have a few insights along the way.'

Charlie Munger, Vice Chairman
Berkshire Hathaway

– Thematic observations

- ‘The greenhouse or the green back’ – an interesting thematic in the US is the continual focus on greenhouse emissions. From December 2010, new efficiency standards will prohibit the sale of less efficient motors. New motors sell for a 25% premium and at improved gross profit margins. This is good news for the environment. Approximately 25% of all US electricity consumed is done so through electric motors. The impact should be material on emissions.
- JIT (Just in Time) inventory management is here to stay – opportunities exist for those involved in the re-engineering of supply chains towards JIT. Walmart has recently gone from requiring suppliers to deliver goods within 14 days before, and within three days after, the specified date, to up to three days prior and not beyond the specified date – i.e. from a 17 day window to a three day window!
- Market power – Walmart requires each of its suppliers to have a corporate presence within a 25 mile radius of its head office. Head Office is located in Bentonville Arkansas which has a population of only 33,000. With stockkeeping units of 125,000 one could be forgiven for concluding that Walmart has underwritten Bentonville’s existence, however its remoteness combined with the corporate representation makes it fertile ground for company visitation.
- Private equity – an example of the difficulties still being experienced by ill-timed private equity deals: we noted one large private equity owned casino operator has \$20b of net debt and is generating \$2b of earnings before interest, taxes, depreciation and amortisation (EBITDA). With private equity having a reasonable presence in this gaming space, it reinforces that casino operators will remain very conservative with capital expenditure.
- In an example of what is a growing dilemma for policy makers and transport companies, many truck drivers are choosing to stay at home and ‘earn’ \$25,000 in unemployment benefits rather than go to work on six day rolling shifts for \$35,000.

Brambles

- We attended a Brambles company presentation covering both the CHEP pallet pooling business and Recall document solutions business. We also visited iGPS (CHEP’s largest US competitor) and a transport company who have been collecting pallets on CHEP’s behalf for 10 years. Key observation include:
 - The new senior management team now in place was noted as being a large improvement on the previous team, with a renewed focus on customer facing activities.
 - CHEP holds a tangible opportunity to penetrate the SME (small medium enterprise) space, via leveraging its ability to deliver a low cost service.
 - As a competitor iGPS has a very competitive offering, with adequate funding for at least the next 12 months.

Car insurance

- Price comparison websites now dominate the UK motor insurance distribution landscape and now account for around 40% of sales compared with just 7% in 2005. This has contributed heavily to the commoditisation of the market, an extremely price sensitive consumer and low margins for insurers. As a result, UK insurance renewals have fallen by approximately 40%, as consumers opt to compare offerings and shop around.
- To date, price comparison websites have failed to penetrate the Australian private motor insurance market as it is dominated by IAG and SUN. Together the two companies own and/or control the major trusted retail brands including NRMA, Suncorp, GIO, AAMI, RACV, SGIO, SGIC, APIA, for which the premium ratings engines are not made available to price comparison websites.

‘Our biggest competitor is ignorance.’

Peter Farrell CEO, Resmed, 1/11/07

- A recently launched comparison website in Australia is Just-Ezi, which uses an algorithm to estimate the premium rates of the major motor insurers and then attempts to rank the insurers from cheapest to dearest. This is potentially a new threat to the large insurers in IAG and SUN.

Cloud computing

- A big paradigm shift in the IT space is cloud computing (CP). CP is essentially a delivery model for IT services, where the internet replaces a company's server.
- Michael Ossipoff, Telstra's director of capability and innovation, noted the potential for significant cost savings in call centres with cloud computing, which is expected to dwarf the impact of other new technologies. 'As a futurist and as a technologist... I say this with a fair degree of measured consideration – I think this [cloud computing] will be the biggest play of the last ten years. This is as big a deal as mobile devices,' he pronounced. One of the things Telstra will introduce is a calculator that can help clients understand the true cost of operating help desk and contact centre environments. And he suggested that the numbers would be compelling: 'In our experience operational costs go down about 40%, capex cost on service can go down about 70%, that's what we're seeing across the market – big numbers.'

Macro observations

- China has now overtaken the U.S. as the world's largest energy consumer, representing a major turning point for the world, according to The Guardian's Data Blog. During the past decade, China's energy use more than doubled, while US energy consumption only modestly increased between 2000 and 2008, according to preliminary data from the International Energy Agency.
- On another note, we read that UK doctors have been asked by the Government to refer to obese patients as simply 'fat'. It was thought too many obese people interpreted the term 'obese' to mean a medical condition rather than simply admit that they are fat and need to lose weight! Post the announcement of the initiative there was plenty of controversy.
- The UK Office for National Statistics published a report highlighting the UK faces a financial crisis that will force the retirement age to be increased. Government officials noted they are seriously considering raising the retirement age to 66 within five years and to 68 by 2038, if not sooner. The French have been protesting moves to raise their retirement age from 60 years to 62 years.

Cash is King

- Referring to the graph below, it is apparent that the some of the many billions of cash raised in markets through 2009 is now being deployed towards acquisitions. It is also interesting to observe the patterns of private equity, which made up a greater share of merger and acquisition activity at the end of the last up-cycle in 2006 and 2007. This dried up through the GFC as access to debt tightened. Private equity backed acquisitions appears to be picking up in 2010, with the buy-out of Healthscope a recent example.



'I think there is a world market for maybe five computers.'

Thomas Watson, Chairman of IBM, 1943

'While a calculator on the ENIAC is equipped with 10,000 vacuum tubes and weighs 30 tons, computers of the future may have only 1,000 vacuum tubes and weigh only 1.5 tons.'

Popular mechanics, 1949

'Our business is about transactions.'

Simon Pillar, Pacific Equity Partners

Company snippets

- At its full year results briefing in August, Telstra talked up its focus on customer service, together with its extensive customer satisfaction surveys, which it believes indicated an improvement in satisfaction levels. That same day, one of our team members who had recently purchased a new iPhone with Telstra received a phone call from a ‘computer generated voice’ wanting to ask him questions about his experience with Telstra!...how ironic....
- Tox Free Solutions noted they had recently purchased a four bedroom ‘nothing special’ house in Karratha, Pilbara, Western Australia, for \$1.3M. It’s to house their head of waste management in the region. Prior to this they were paying \$2,500 per week without any certainty of being able to extend the lease beyond the initial period.

Analyst valuations

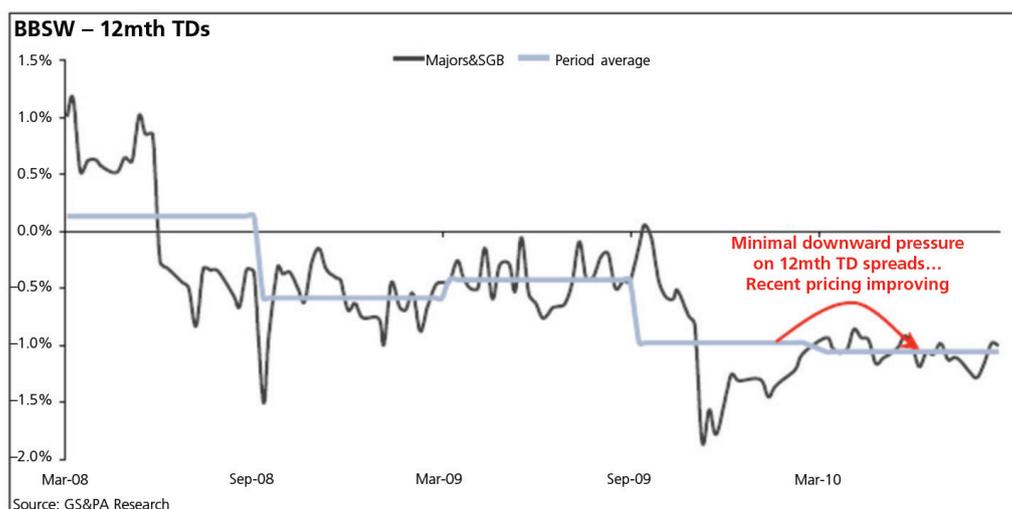
- At times we observe how arbitrary a valuation of company can be when we observe sell-side analyst valuations. In some cases it appears that changes to an analyst’s valuation and recommendation appears to be more about being aligned to the direction of a company’s share price. A recent example noted:
 - ‘As the local comparables for Newcrest have rapidly disappeared we have decided to align our NPV (net present value) calculation method with that of our Canadian peers. We have lowered our discount rate to 5% (from 8.3%) and now apply a long term gold price (beginning in 2015) of US\$1,300/oz, up from our previous house assumption of US\$850/oz. Together these have seen our NPV increase from A\$16.99/share to A\$35.27/share. However, this has been offset by a reduction in the assumed gold ‘premium’. Applied to the operational Discounted Cash Flow, from 2.7x previously to now 1.3x the NPV. The net result is a change in our DCF-based valuation from A\$49.13/sh previously to now A\$46.42/sh.’ What the ??

Pricing of bank term deposits and out-of-cycle rate rises

- Out of cycle rate rises for banks = Earnings upgrades

Irrational pricing of TDs for banks

- The chart below illustrates how term deposits (TDs) used to be profitable for banks. These days the trend has been for them to be loss making.



- With deposits less profitable (TD’s loss making), and funding costs rising, banks are expected to be forced to raise mortgage rates, even if the Reserve Bank of Australia (RBA) doesn’t lift cash rates.
- The following chart illustrates the earnings leverage sensitivity to banks raising mortgage rates beyond the RBA rate changes.

‘We’re now a marketing company.’

Sol Trujillo, CEO Telstra, 26/02/08

‘There is always free cheese in a mouse trap.’

Arnold S Wood, CEO Martingale Asset Management, on The Anatomy of a Bubble May, 2006

‘Consumers in Melbourne and Sydney will say I enjoyed the recession more than I enjoyed the recovery.’

Gerard Minack, Economist, Morgan Stanley, 8/12/09

‘... as a result of both availability and price constraints on credit, it is likely that Australians in the post-crisis economy will need to be encouraged to save more and borrow less.’

Gail Kelly, Westpac CEO, 12/01/10

FY11 Sensitivity to cash earnings

	Variable mortgage spread increase (Aust. Only)				
	0.05%	0.10%	0.25%	0.50%	0.75%
ANZ	1.0%	2.0%	5.0%	10.1%	15.1%
CBA	1.5%	2.9%	7.4%	14.7%	22.1%
NAB	1.3%	2.7%	6.7%	13.3%	20.0%
WBC	1.5%	3.1%	7.7%	15.4%	23.1%
Majors	1.4%	2.7%	6.8%	13.6%	20.5%
SUN	1.1%	2.2%	5.6%	11.2%	16.9%
BEN	3.0%	6.0%	15.0%	30.1%	45.1%
BOQ	3.0%	6.0%	14.9%	29.8%	44.6%

Source: GS&PA Research estimates

Outlook

Having navigated reporting season, and the predominately stock specific drivers, the market has reverted back to being more influenced by macro drivers. The macro driver taking the spotlight is the obvious growth differential between higher growth developing economies (eg China, South East Asia, South America and their key suppliers such as Australia) and low growth developed economies (USA and Western Europe). These economic growth differentials combined with the US central bank acting to keep interest rates low through quantitative easing (QE), is observed to be driving vast capital flows out of US dollars and into other assets such as commodities and high growth currencies (eg Australia) – a phenomenon labelled ‘the carry trade’. The degree of sustainability of this observed market driver is dependent largely on the following combination:

1. The willingness and ability of the US central bank to execute quantitative easing.
2. The continued positive outlook for emerging economy growth rates.

Greencape considers the first driver (QE) to remain intact in the short term, whilst the second driver (emerging growth expectations) is less clear in the very short term. What detracts from visibility is regulatory risk (eg Chinese acting to slow down growth, or emergence of a trade war with the US) and inventory cycles (eg Asian iron ore stock piles). Greencape is conscious that even limited moves by Chinese regulators to slow economic growth, have amplified impacts on short term movements in carry trade inspired capital flows and thus commodity prices, currencies and the Australian equity market.

Given the very strong September quarter market, and the ‘carry trade’ clearly driving capital flows at present, the next leg in the market is governed by the sustainability of carry trade dynamics, or a return to bottom up fundamental driven stock performance. Greencape portfolios attempt to balance both drivers while maintaining a clear bias to quality management teams and business franchises.

‘There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.’

Lord John Maynard Keynes (1883-1946)



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