Greencape Wholesale High Conviction Fund

Quarterly report - September 2013

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Inception % p.a.
Fund return	10.37	25.92	10.67	9.52	9.79
Growth return	9.25	21.34	6.84	6.17	4.72
Distribution return	1.12	4.58	3.82	3.34	5.08
S&P/ASX 200 Accumulation Index	10.20	24.29	9.28	7.30	5.08
Active return^	0.17	1.63	1.39	2.21	4.72

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

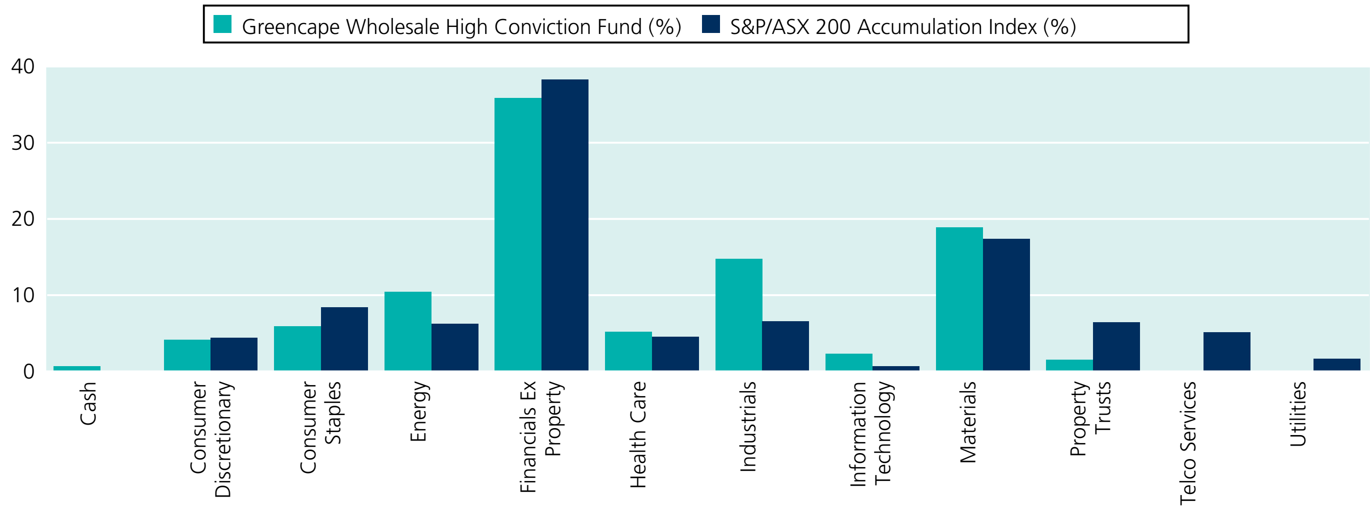
At least five years

Asset allocation	As at 30 September 2013 (%)	Range (%)
Security	99.31	85-100
Cash	0.69	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0035AU

Fees	
Entry fee	Nil
2011-2012 ICR	1.16%
Management fee	0.90% p.a.
Performance fee	15% of the Fund's gross performance above the Fund's benchmark.
Buy/sell spread	+0.30% / -0.30%

Sector exposure as at 30 September 2013



Fund performance summary

The S&P/ASX 200 Accumulation Index returned +10.20% for the quarter. The fund outperformed the market and delivered a +10.37% return over the quarter.

During the quarter Greencape passed its 7 year anniversary. We are pleased to report that over this period, Greencape has outperformed the market in each of those 7 years*. Importantly, this consistency has been achieved whilst navigating extreme bull and bear markets and heightened levels of macroeconomic volatility. We take this opportunity to thank our clients for their trust and ongoing support. Greencape considers it a privilege to invest on our clients' behalf.

*This refers to the Greencape Wholesale High Conviction Fund as at 30 September 2013. Performance figures are calculated after fees have been deducted and assume distributions have been reinvested. No allowance has been made for tax when calculating these figures. Past performance is not a reliable indicator of future performance. The Greencape Wholesale High Conviction Fund inception date is 11 September 2006.

Market overview

The S&P/ASX200 Accumulation Index rose 10.20% for the quarter. The Greencape High Conviction Fund outperformed its benchmark and rose 10.37%.

After falling in the March quarter, the market staged a remarkable turnaround to post three months of successive gains, which culminated in the largest quarterly gain in four years. The market burst out of the gates in July, surging 5.2% as strong gains in the materials sector led the market higher. August saw reporting season come again, with the vast majority of results coming in line with expectations. The market took the news of the US Federal Reserve (Fed) not tapering asset purchases as positive for stock prices. Australia outperformed the region and US market indices during the period. Risk aversion decreased as cyclical sectors outperformed defensives.

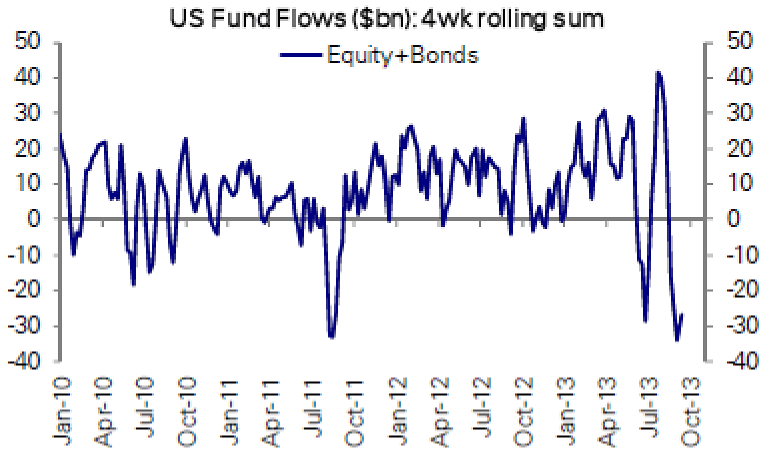
S&P/ASX 200 Price Index

The Reserve Bank of Australia (RBA) cut its cash rate by 25 basis points to a record low 2.50% in their August meeting. In its minutes, the RBA expect domestic growth to remain below trend and unemployment to trend higher. Importantly, the RBA also continue to foresee a low inflationary environment, suggesting they may cut rates again soon, with many economists predicting that will occur in November. For the second consecutive quarter we had a change in Prime Minister, with the Coalition comfortably winning the election as expected. Local data was generally negative, with the unemployment rate rising to 5.8%, its highest level in 4 years. The participation rate also dropped to 65%, its lowest level in 7 years. Interestingly, post the election, the business confidence component of the NAB business conditions survey rose to +5.7 from -3.4, a two year high.

In the US, markets rallied in September after the Fed decided it would not yet taper its $85bn a month bond-buying stimulus program. This came as a surprise as the central bank had seemingly conditioned markets to expect a slow-down in its purchase program in the preceding months. A Fed statement noted that growth had failed to live up to expectations, the bounce back in long-term borrowing rates was stifling growth and with inflation running below expectations it was allowing the bond buying to continue. Chairman of the Fed, Ben Bernanke said the initial move to taper could come "at some point, possibly later this year." After being pummelled in the March quarter due to tapering concerns, gold rallied, as did gold equities. Larry Summers, who was the front runner to replace Ben Bernanke, surprisingly pulled out of the race to become the next Fed chairman, leaving Janet Yellen as the likely candidate, considered to be one of the most 'philosophically dovish' members of the Fed.

As shown below, after the rise in markets, US investors have begun to make redemptions from managed funds at a fast pace.

''One faction of one party in one house of Congress in one branch of government doesn't get to shut down the entire government just to refight the results of an election." – Barack Obama, 30/09/2013



Source: Deutsche Bank

The S&P/ASX 200 Accumulation Index fell 1.6% on the final day of the quarter as the market became spooked by the possible US government shutdown, which eventuated at midnight at the end of the quarter. We discuss the shutdown in more detail later in the quarterly.

In contrast to its recent destabilising effects, Europe actually proved a highlight for global markets during the quarter as the Euro Stoxx Index gained 11.3%. Manufacturing purchasing managers index (PMI) for the region showed expansion for the first time in two years as the index rose above the 50 level in July. The UK in particular was strong, its own PMI index recording a better than expected 57.2 in September. Eurozone unemployment remained stable at 12.1%. German Chancellor Angela Merkel again captured victory in the country's Federal elections. Her conservative Christian Democrats party fell short of winning a majority, and will instead form a coalition with rival party, the Social Democrats. The Italian parliament was plunged into turmoil yet again as five ministers in the former Prime Minister's Silvio Berlusconi's centre-right party resigned, leaving the centre-right and centre-left coalition alliance in limbo.

News flow out of China was relatively quiet for the quarter, which in and of itself was positive for market sentiment! Q2 GDP growth came in line with expectations at 7.5% and the HSBC Flash PMI number strongly beat expectations in August, printing at 50.1 (market at 48.2), which was the first time it has been in expansion territory for four months. Both sets of data helped alleviate market concerns of a China slowdown that were widespread earlier in the year.

	Sept 2013 quarter	Year
ASX200 Accumulation index	10.3%	23.6%
Best performing sectors		
Materials	16.3%	0.9%
Consumer Discretionary	14.7%	48.2%
Energy	14.0%	16.3%
Worst performing sectors		
Property Trusts	0.0%	16.2%
Consumer Staples	5.2%	22.5%
Utilities	5.3%	16.4%

Locally, Materials were the best performing sector over the quarter (although it should be noted that the sector was down 10.3% in June alone). Companies with iron ore exposure rallied particularly hard as prices rose from US$116/t to $131 by the end of the quarter, having reached a high of $143. Fortescue was up 56% on the back of this, as well as reporting a solid result which highlighted that they are now past their peak capital investment spend, and that in the current high iron ore price environment (which has held up higher/longer than the market expected), they will produce a large amount of free cash flow. As mentioned previously, gold stocks bounced back somewhat during the period, after the S&P/ASX Gold Index halved in the March quarter.

Consumer discretionary stocks continued their turnaround with the sector posting strong gains. G8 Education centres again rose strongly after it announced the acquisition of 5 and then another 29 childcare and education centres for a purchase price of 4x EBIT. Crown Casino had a standout quarter after releasing a result in August which beat expectations, due to a better than expected progress on the company's cost-out program and resilient performance from its Perth operations. Crown also benefited from its 33% holding in MPEL (Macau casinos), the US listed company itself gaining 42% for the quarter.

"Why do we need exploration spending when we already have 100 year mine lives?" Andrew McKenzie, CEO of BHP Billiton, 24/09/2013

Energy stocks provided a spark for the market, with the sector being the third best performing for the quarter as oil prices rose close to 6%. Santos outperformed after management reaffirmed that GLNG remained on time and on budget, allaying market fears of a cost blowout. The market also reacted favourably to a gas discovery at Winchester-1 in the Carnavorn Basin announced in July. Oilsearch also performed strongly after the company announced that PNG LNG was 90% complete in August, with costs in line with the US$19bn budget.

No sector was in the red for the quarter, however property trusts lagged the market rally given their defensive nature and rising bond yields for the first half of the quarter. Westfield Group underperformed as the company announced the divestment of 7 non-core shopping centres in the US at a discount to book value. Stockland was the best performing stock in the REIT index, after it announced it will undertake a $222m expansion and redevelopment of its Wetherill Park Shopping Centre in Western Sydney. The company also sold 78 Waterloo Road, Macquarie park for $72m, in line with book value.

Consumer staples underperformed for the quarter, despite posting a gain of over 5%. Coca-Cola Amatil fell after posting an in-line result, but lowering guidance for underlying EBIT to decline by 0 to 4%, with management citing continued challenging trading conditions in the grocery channel. Treasury Wine fell for the quarter after the company announced a $160m write down on its US assets. Late in the period, the board announced the departure of CEO David Drearie, with the company's recent impairment charges taken on US wine inventories mooted as the reason behind the change.

"If we do nothing more than execute in our current markets we are going to have happy shareholders." - Andrew Basset, CEO of Seek, 21/08/2013

As a sector with low beta, utilities underperformed in the rising market. SP Ausnet lagged as its appeal to the Australian Competition Tribunal in relation to the regulator's charges determination for Advanced Metering Infrastructure was dismissed. AGL Energy outperformed the sector after it delivered a 24% increase in NPAT, driven by the successful integration of Loy Yang A.

US Government shutdown

The US government shutdown occurred at midnight October 1 when the two chambers of Congress failed to reach a resolution on the budget. The Senate (dominated by the Democrats) and the House of Representatives (dominated by the Republicans) could not reach a budget agreement due to the Republican opposition to healthcare reforms (Obamacare). Late in September with the midnight October 1 deadline looming, Ted Cruz, a Republican Senator from Texas gave a 21-hour speech with the aim of delaying the spending bill which would fund Obamacare. The Texan can seemingly hold liquid like a Camel, as he did not have a single break during his marathon speech! As the deadline came without spending resolution being met, the government was forced to shut down.

At the time of writing, the US government was still in shutdown. While a 'shutdown' sounds daunting, only around a third of the government shuts down. The following still occurs:

- 85% of all government activities are still being funded during the shutdown.
- 1,350,000 'essential' federal employees will continue to work.
- US Postal Service will continue to deliver mail.
- Social Security/Medicare/Medicaid/Food Stamp recipients will still receive their benefits
- The Fed, IRS & TSA will still function as per usual (however the IRS will suspend punitive audits.)

Source: ZeroHedge

Key dates for the shutdown are as follows:

- October 17: exhaustion of Treasury accounting manoeuvres which allow government to avoid breaking $16.7 trillion debt ceiling.
- October 30: $6bn coupon on outstanding Treasury bills due.

- November 1: lack of funds to pay for scheduled non-debt expenses. $56bn outlay for Social Security, Defence & Medicare due.
- November 15: debt default, with a lack of funds to pay interest on Treasury coupon bonds

Source: Merril Lynch

If the US government defaults, it could wreak havoc in financial markets throughout the world, the extent of which makes it seem unlikely the Republicans will allow this to happen. Although the last few weeks have shown the conservative party can be quite stubborn, some sort of concession will likely be necessary from the Democrats in order to increase the debt ceiling and avoid default.

"The fact that we are here today to debate America's debt limit is a sign of leadership failure. It is a sign that the US government cannot pay its own bills." (Then) Senator Barack Obama, March 2006

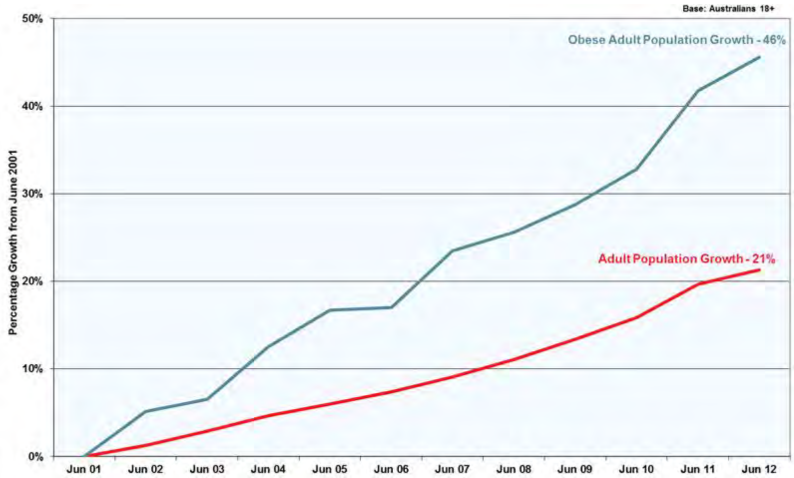
Globesity.... A "growing" thematic

We have highlighted in past Greencape Quarterly reports that one of the apparently structural thematic demographic drivers has been the obesity "epidemic". Indeed it's been widely reported that the human population recently past a milestone whereby there are now more people on the planet dying of obesity related diseases than of hunger[1]. As investors who value observations, it's difficult to ignore such powerful trends.

We have in past quarterlies highlighted how carbonated soft drink (CSD) companies have targeted and benefited from such trends. For example, Coca Cola Company has deliberately targeted sales in Latin America, and the rapidly growing Latino population in the US. This is because the Latino population have been consuming soft drinks at rates many times higher than the average American. Recent consumption data illustrated Mexicans on average consumed 163L of soft drink a year per person, or around a 500mL bottle every day! The corollary is an extremely high percentage of obese people, over 33% and sadly (and costly to the public purse) 10.8% of people with diabetes, the highest in the OECD.

Australia hasn't escaped the trend either:

Australian obese population growth v adult population growth since 2001



Source: Roy Morgan

"Childhood obesity isn't some simple, discrete issue. There is no one cause we can pinpoint. There's no one program we can fund to make it go away. Rather, it's an issue that touches on every aspect of how we live and how we work." Michelle Obama, First Lady of the US, 9/15/2010

As with such trends, and the law of large numbers, eventually the impacts cannot be ignored. It was recently proposed by Mexican president, Enrique Pena Nieto that a tax against sugary soft drinks be introduced. Although at this stage a proposal, the symbolism of the action has been a 'game changer' for the beverages industry. We have observed the messaging from Coca Cola has changed significantly, with a switched emphasis towards its non-sugar drinks. Below is a napkin we observed on a recent trip to the US.

[1] Michael Bloomberg, New York Mayor, 11/03/13

It is clear this issue is not going away any time soon. Investment implications can be negative (in the case of Coca-Cola) and positive in the case of Resmed, with its sleep apnea treating medical devices experiencing growing demand globally. Importantly, in times of slow macroeconomic growth, such trends can have more meaning as a headwind for Coke but a tailwind for a Resmed.

Overseas trips

This quarter we undertook two trips to North America. The first to Canada and then to the US which covered testing & inspecting, mining services and energy companies. The second focused on US homebuilders and media companies.

Macro themes

- Overall the mood was positive, but probably not as strong as some of the headline economic data suggests, with cautiousness remaining ingrained in management teams, particularly evidenced by restricted capital spending budgets.
- Many companies were holding or even lifting margins despite revenue declines.
- Early signs that Europe is reaching a bottom in Automotive and industrial sectors.

Energy

- US future oil production growth from shale reserves may be overstated given rapid well decline rates along with current production rates being flattered by the fact the best locations are being targeted first.
- Canada LNG projects look like they'll go ahead.
- If the Keystone XL pipeline (proposed oil pipeline between Canada and the USA) is ever approved it will provide a large boost to oil sands project development economics, given channels to market are currently constrained.

Media

- Retransmission consent fees driving earnings for Broadcast TV owners with the recent Time Warner Cable and CBS deal a talking point.
- Across cable, content owners continue hold the leverage in negotiations for affiliate fees revenues.
- The ability to invest into original content and platforms as brands is becoming even more critical and to do this you need scale.
- Advertising markets are solid whilst measurement on mobile screens and catch-up TV is getting better.

"The man who reads nothing at all is better educated than the man who reads nothing but newspapers." - Thomas Jefferson

- Additional cable growth is likely to come from overseas geographies, often emerging markets where cable is underpenetrated.
- Broadcast TV, despite the softening ratings remains in demand by a strong US advertising market.

Home builders – James Hardie

- JHX continues to innovate with R&D and ensure that its products remain industry leading. This allows it to invest into the fibre cement market in order to help shape it's development.
- Volumes in the US at the moment necessitate investment into manufacturing capacity, and this is being optimised to ensure operating leverage and returns.
- Trim/accessories sales have renewed focus and upside as JHX rolls out and gains market share.
- Management want market share over pricing and are comfortable with the current trends / balance with respect to achieving its goals of 35/90 (fibre cement at 35% category share with JHX at 90% market share).

Outlook

The September Quarter included the August reporting season and federal election. Results were generally in line with market expectations and outlook commentary, although generally vague, was no more negative than six months ago. Similarly the election result was in line with expectations. Global macro feedback remained the case of Europe being flat, US showing some modest growth and China stabilising from a recent weak patch.

We observed market sentiment towards domestic cyclicals improving somewhat during the quarter. This was driven by increasingly hard to ignore low interest rates (at call deposits now earn negative real returns!) combined with an expectation that post-election, a majority government will provide improved perceptions of stability and assist consumer and business confidence. Greencape have carefully selected exposures to domestic cyclicals. We have a clear quality bias to the names we are prepared to own. They are typically companies with highly regarded management teams combined with relatively strong market positions in their industries. The quality bias is considered important for our domestic cyclical exposure.

As bottom up investors Greencape won't speculate on a cycle and its timing. However, we expect quality names will more likely be 'more forgiven' if this cycle (which is considered inevitable by the market) has a false start or two. With the solid absolute returns in the quarter and the current events in the US (government shutdown and Fed tapering debate), we remain cautious and the portfolio continues to favour 'self-help' names with bottom up growth drivers.

"We have got to turn the page on this kind of bubble-and-bust mentality that helped to create this mess in the first place, we have got to build a housing system that's durable and fair and rewards responsibility for generations to come. That is what we have got to do." - Barack Obama, 06/08/2013

"As something goes in one direction for a while, people conclude increasingly that it always will . . . often just when the likelihood grows that it will reverse instead." Howard Marks, Oaktree, 13/03/13

"You know nothing for sure, except the fact that you know nothing for sure." - John F. Kennedy

More information

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

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