Greencape Wholesale High Conviction Fund

Quarterly report - September 2014

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Inception % p.a.
Fund return	-0.02	7.24	15.55	8.09	4.20	9.47
Growth return	-0.98	-1.68	9.81	3.67	-0.31	3.90
Distribution return	0.97	8.92	5.74	4.42	4.51	5.57
S&P/ASX 200 Accumulation Index	-0.60	5.93	14.77	6.82	1.42	5.18
Active return^	0.58	1.31	0.78	1.27	2.78	4.29

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

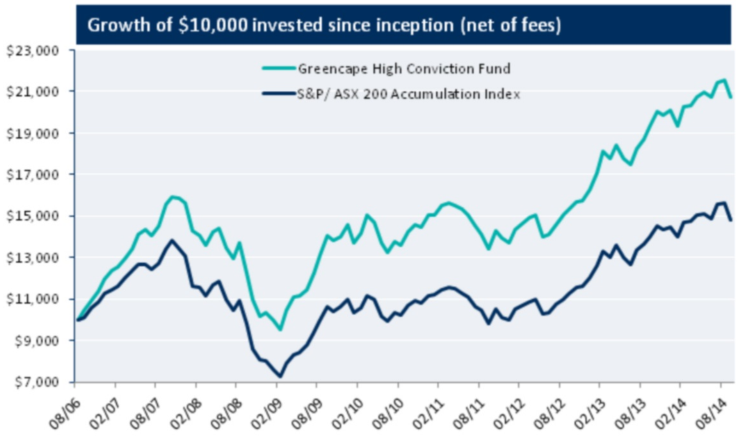
Greencape is an active, 'bottom-up' stock picker. Whilst Greencape does not target any specific investment style and will invest in stocks displaying 'value' and 'growth' characteristics, its focus on a company's qualitative attributes will generally lead to 'growth' oriented portfolios. This is an outcome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

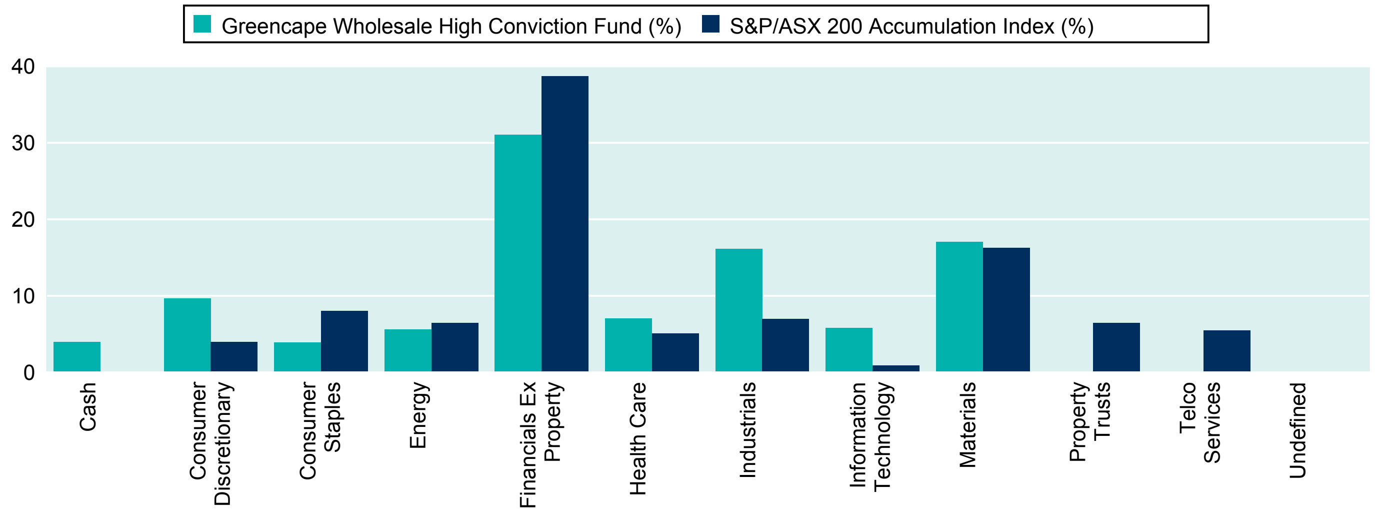


Asset allocation	As at 30 September 2014 (%)	Range (%)
Security	96.07	85-100
Cash	3.93	0-15

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 30 September 2014



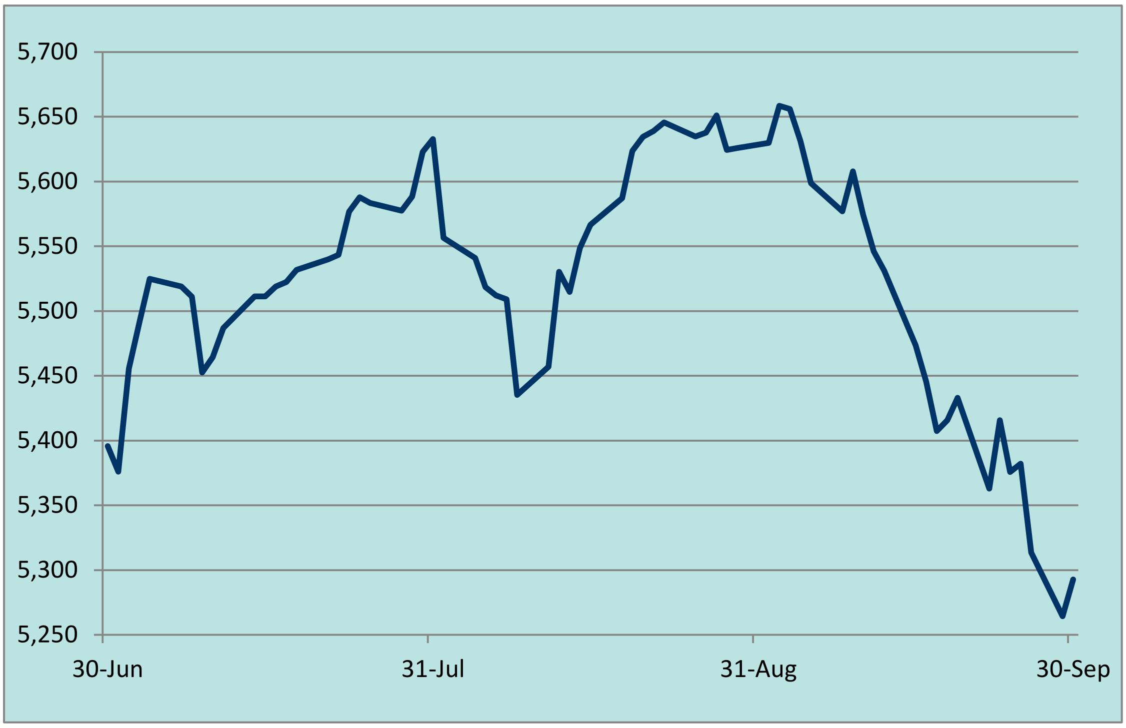
Fund performance summary

The S&P/ASX 200 Accumulation Index returned -0.60% for the quarter. The fund outperformed the market and delivered a -0.02% return over the quarter.

Market overview

The market charged strongly out of the gates in July; however a poor finish saw the Accumulation Index post its second quarterly negative return in the last two years. Australia underperformed the region and the world in USD, as the AUD/USD cross rate fell by over 7%. Reporting season came in August, and companies who announced better than expected capital management were rewarded. Commodity prices came under pressure which saw the Materials sector underperform the index. Volatility also started to creep back into global markets.

S&P/ASX 200 Index

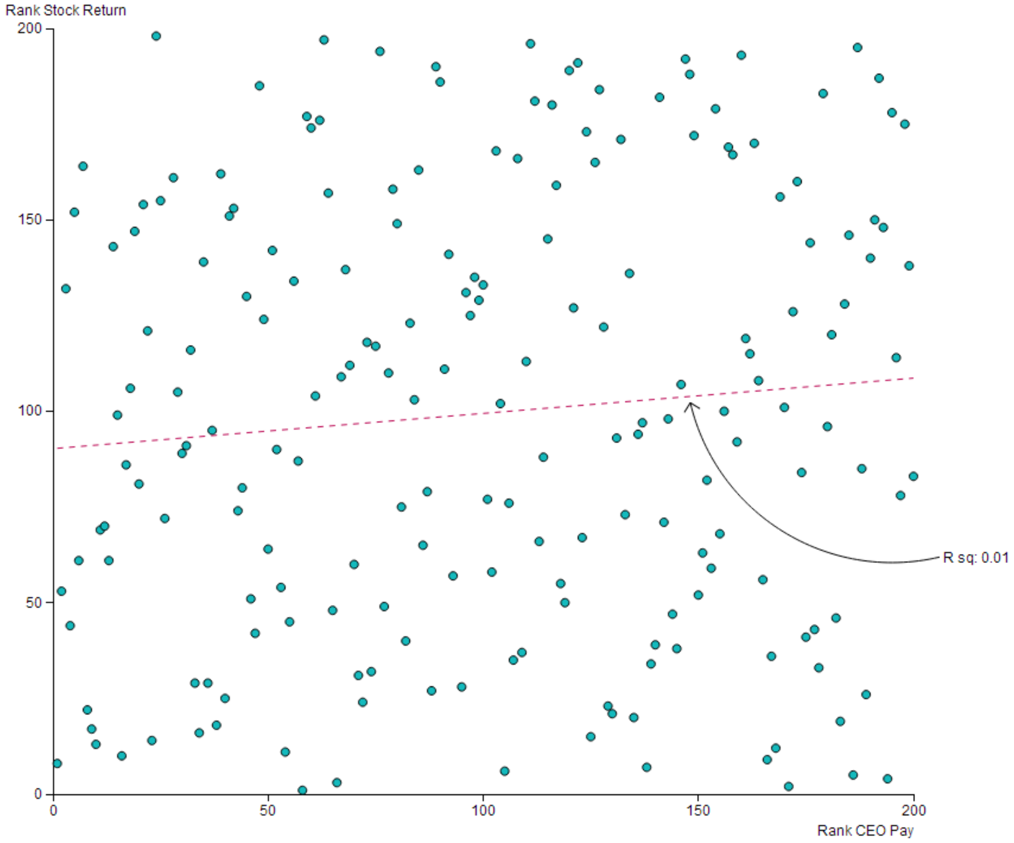


The Reserve Bank of Australia (RBA) again chose to stay on the sidelines during the quarter, having now left the cash rate at the record low level of 2.5% for over a year. The jobs figure for August took the market by surprise, with 121,000 jobs added compared to market estimates of only 15,000. The composition however was less positive with 107,000 of the jobs added being part-time positions. The CPI printed at an annualised rate of 3% for the June quarter, at the very upper end of the RBA's 2-3% targeted range. The AUD/USD cross rate fell by over 7% for the quarter, however this was more a function of strength in the USD as the broad USD index gained nearly 8% for the period.

As always, the market waited on the US Federal Reserve's (Fed) statement on monetary policy with bated breath. As expected, the Fed retained its guidance that short term interest rates will remain near zero for a "considerable time" after QE3 ends in October. We touch on the timing of US rate increases later in this report. Data out of the US remained solid, with Q2 GDP revised up to an annualised rate of 4.6% compared to market expectations of 3% growth. Housing starts however were not so spectacular, with the number falling 14.4% month on month in August to an annual run rate of 956,000.

Businessweek ran a regression analysis to identify whether there was any link between CEO remuneration and a company's stock return. The measures are graphed against each other below. Interestingly, the study showed that there was only a 1% correlation between the two.

Stock Return Rank vs CEO Pay Rank for 200 Executives



Source: Bloomberg Businessweek

Eurozone economic growth paused as real GDP for Q2 came in at 0.0%, missing market expectations of 0.1% growth. The European Central Bank (ECB) unveiled yet another easing measure, this time an Asset Backed Securities and covered bonds purchase program. These are due to begin in Q4 2014, starting with covered bonds in the second-half of October. The market seemingly expected more however, and European Indexes were sold off after the announcement, with the region's bank index down 3.1% in the session following. The ECB also cut the deposit rate to -0.2% from -0.1% and therefore increasing the cost to banks of parking capital with the central bank.

The main point out of China was the fall in the iron ore price, which fell over 19% for the quarter. Iron ore has been impacted by weaker Chinese steel demand and at the same time, iron ore production has stepped up. Real GDP for Q2 grew at the expected rate of 7.4%, while industrial production for August only grew at 6.5%. This was well below market expectations of 8.8% growth and the growth for July of 9%. Pro-democracy demonstrations in Hong Kong also weighed on exchanges across the region late in September. Despite these setbacks, the Shanghai Composite managed to post a massive 15% gain for the quarter.

"More money has been lost trying to anticipate and protect from corrections than actually in them." – Peter Lynch, Fidelity Investments

Since 2000, weekly earnings for low- and middle-income workers in the US are nearly unchanged, after adjusting for inflation. Earnings for workers at the 90th percentile have risen.

Cumulative percent change since 2000.

Usual weekly earnings, full-time wage and salary workers

Source: US Bureau of Labour Statistics

The local market was pre-occupied with reporting season in August, with capital management continuing to be a common theme amongst index stalwarts with Telstra announcing an off-market buy-back; Suncorp paying another special dividend, and Wesfarmers paying a special dividend alongside a capital return. Well received results during reporting season were those from Commonwealth Bank, Oil Search, Caltex, Amcor and Iress. Companies that disappointed included Coca-Cola Amatil, Leighton Holdings, Treasury Wine Estates and James Hardie.

	Sep 2014 Quarter	Year
ASX200 Accumulation Index	-0.6%	5.9%
Best performing sectors		
Healthcare	9.4%	15.0%
Telecommunications	5.5%	14.3%
Property Trusts	1.1%	12.2%
Worst performing sectors		
Materials	-2.8%	-1.3%
Financials ex Property Trusts	-2.5%	7.6%
Consumer Discretionary	-0.1%	1.9%

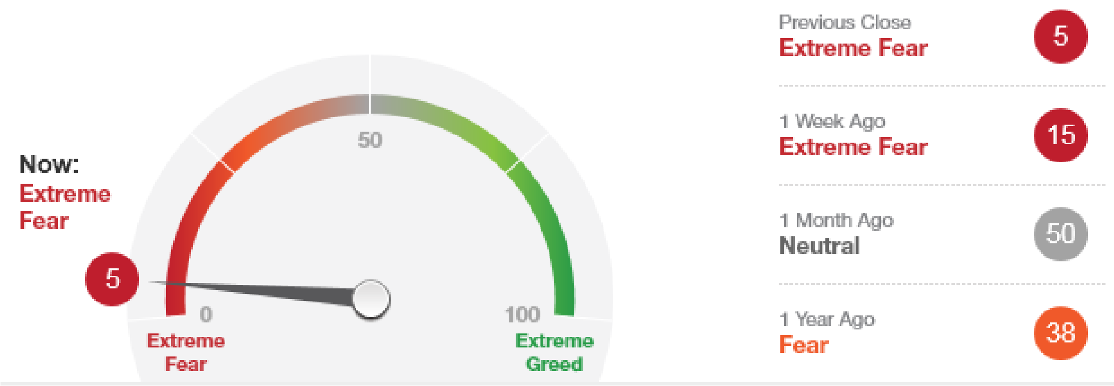
CSL (which comprises over half of the Healthcare Index) outperformed after posting a strong full year result in August in which it grew NPAT by 11%. Highlights from the result included 13% growth in Immunoglobulin (IG) products (with 17% growth in the second half of the financial year) with the group EBIT margin up 200 basis points to 31.9%. Resmed also managed to outperform, despite a disappointing full year result with mask sales in the US missing expectations by 7%.

The telecommunications sector performed well after Telstra announced a dividend uplift and a $1bn off-market buyback at its full year result in August. The tender had a discount range of 6% to 14%, with a capital component of $2.33 and fully franked dividend for the remainder.

"If you're not getting reasonable cash-conversion, then you've got issues on your jobs, you're not getting paid, it's as simple as that." Grant Fenn, CEO of Downer, 05/08/14

Property trusts also fared well during the quarter. Federation Centres outperformed after a strong result where the company beat market EPS expectations due to cost control measures implemented by management. The company's development pipeline also grew to $1.3bn.

Fear & Greed Index – October 2014



Source: CNN Money

CNN Money publish a 'Fear & Greed' Index based on market volatility, market momentum, safe haven demand, junk bond demand, stock price breadth, stock price strength and put & call options. According to the Index, market sentiment has become markedly dourer over the past month.

For the second consecutive quarter, materials was the worst performing sector. Falling iron ore prices were the main talking point, however it was not the only commodity to take a hit. Gold fell 9%, natural gas fell 8%, and WTI crude oil retreated 14% over the period. Iron ore miners such as Fortescue Metals, Atlas Iron and BC Iron all retreated. Amcor however performed strongly after posting a solid full year result. Flexibles margins grew 50bps to 12.1% and EBIT from Emerging Markets grew 8% in constant currency terms.

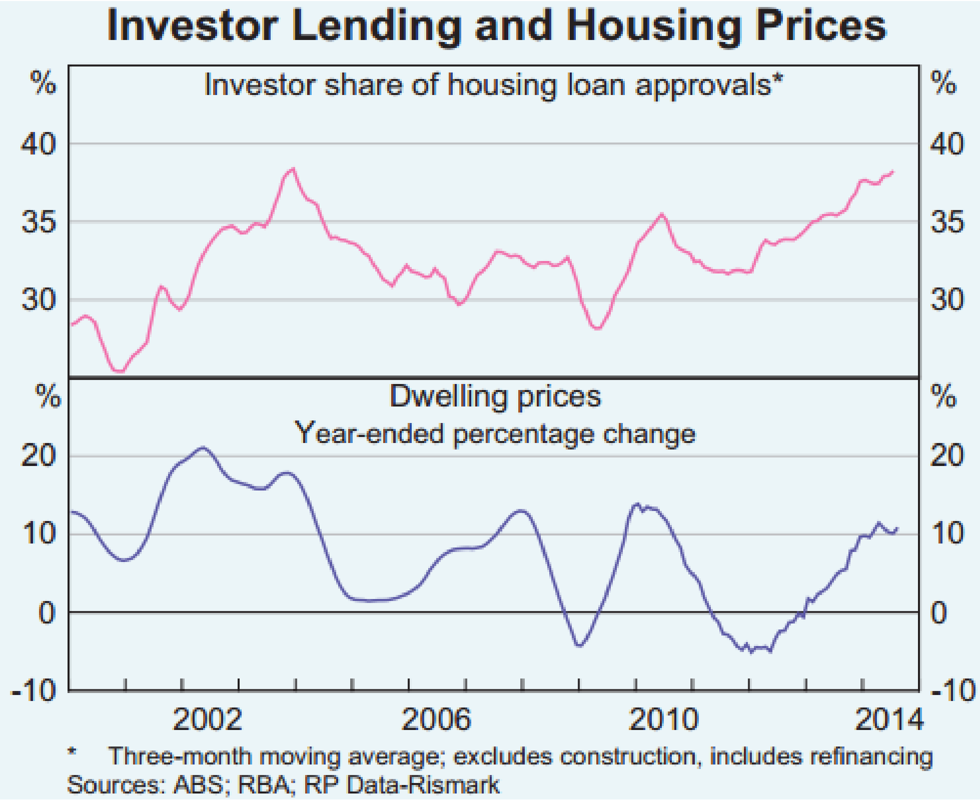
Financials also struggled during the period. The big four banks suffered the effects of profit taking this quarter after an extended period of outperformance. Online international payments service provider Ozforex fell after the company reiterated prospectus forecasts, with the market expecting an upgrade to guidance. Lend Lease however outperformed as the company entered into a Public Private Partnership with the Victorian State Government to build the controversial East West Link in Melbourne, as part of a consortium.

Consumer discretionary stocks outperformed the market as a sector, but were still the third worst performer. Myer underperformed after it posted an uninspiring result which saw EBIT miss market expectations due to lower Gross Profit margins. Education pathway provider Navitas sold off after it announced the loss of its largest and most profitable contract with Macquarie University. Aristocrat however outperformed after it announced the acquisition of US-based Video Gaming Technologies for $US1.3bn.

Household Finance

In late September the RBA released its Financial Stability Review, in which it took the opportunity to outline some of the trends which have developed during the recent period of record low interest rates. Below are some of our key take outs from the report.

Household risk has picked up markedly in the past year, with the composition of new debt causing the mortgage market to become 'unbalanced'. Investor housing approvals (as opposed to owner-occupied) now sit around 40 per cent of total housing approvals, similar to the early 2000's housing boom.



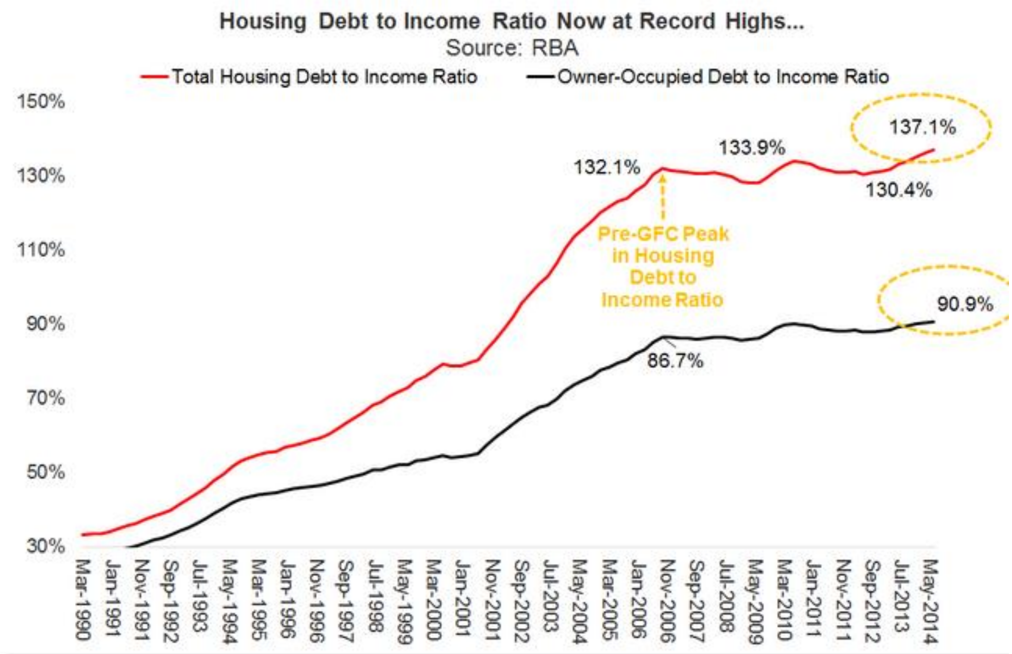
Currently the RBA is worried that investors may be extrapolating the gains since 2011, which is very much an unrealistic expectation given where we currently sit in the interest rate cycle. The Financial Stability report follows on from the research paper released by the RBA in July which suggested that the "average home buyer would be financially better off renting" if the rate of house price growth slowed to below the historical average.

"I have certain scepticism about macro-prudential tools as a panacea, but I remain open to using them if it seems sensible to do so and that's the kind of thing we have in mind right now." Glenn Stevens, RBA Governor, 25/09/14

Loan Characteristics

Investor loans tend to be lower loan to value ratios (LVR), due to the investor preference to avoid paying lenders mortgage insurance (usually required when the LVR is above 80%). Currently, around 38% of owner-occupier loans have an LVR above 80 compared to around 29% for investor loans. Around 64% of mortgages taken out by investors are interest-only compared to 31% for owner-occupiers. This is due to the tax-deductibility of interest payments for investors. Negative gearing, which allows investors to deduct interest payments from other person income, has been a contentious point of discussion recently. Most recent figures show that the top income quintile has a 60% share of the investor housing debt and therefore claims the lion's share of tax deduction on mortgage repayments.

Overall, the Total Housing Debt to Income Ratio is back at all-time highs, along with the Owner-occupied Debt to Income Ratio. Is this the new normal, or will we see a retracement when rates eventually start rising again?



The RBA is said to be considering using Macro-prudential tools to cool the housing market with the central bank saying it is in discussions with the Australian Prudential Regulation Authority in regards to “additional steps that might be taken to reinforce sound lending practices, particularly for lending to investors”. The RBA has been asked to explain this consideration to the Senate economics committee, who have expressed their concern with any potential changes to regulation. The RBA interfering in the lending policies has the potential to cause some issue for the major banks, who derive the vast majority of their income from mortgage lending.

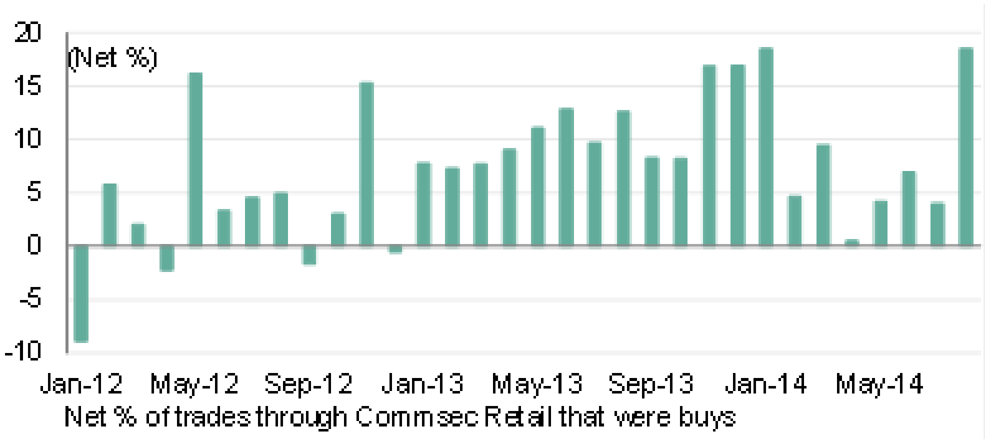
“Macroprudential tools have the potential (for) macro-sized errors,” Nationals Senator Matthew Canavan, 29/09/2014

In the UK and Ireland, such macros prudential have been recommended and have been mandated for implementation in the coming months. In the UK, no more than 15% of mortgages written by any given lender can be at a Loan to Income ratio of greater than 4.5x. In Ireland, most homebuyers will soon have to have a 20% deposit when applying for a home loan.

Retail Investor Movements

Data from Commsec, the largest retail stockbroker in Australia, showed that retail investors stepped back into the market in August. As shown below, the net buying percentage was the highest it has been for three years. August was also the 20th consecutive month of net buying from Commsec retail investors.

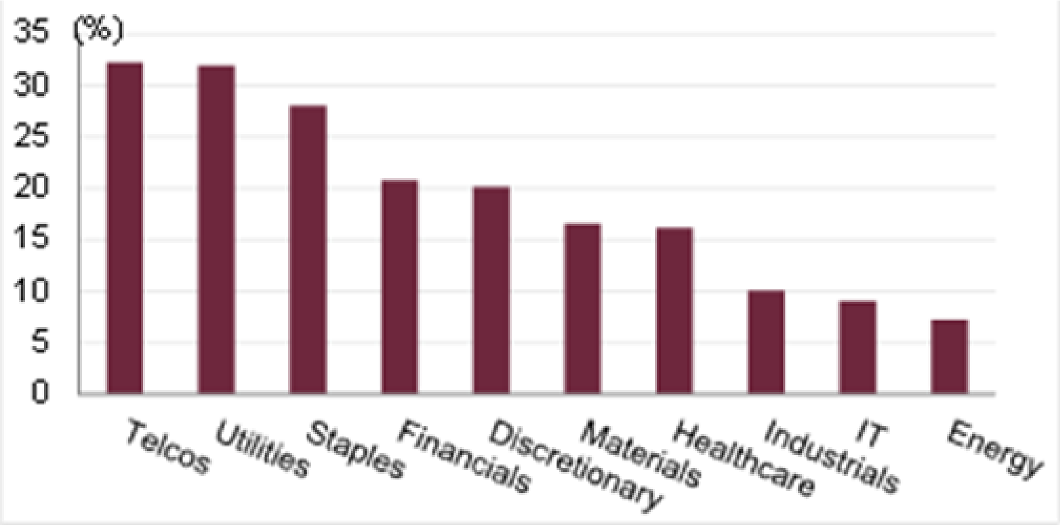
Commsec Net Buying Percentage by Month



Source: Commsec

While 'mum & dad' investors appeared to increase their risk appetite by buying shares, they seem to remain conservative in their sector preferences. As shown below, high yield and defensive sectors still remain in vogue.

Net Buying by Sector – August 2014

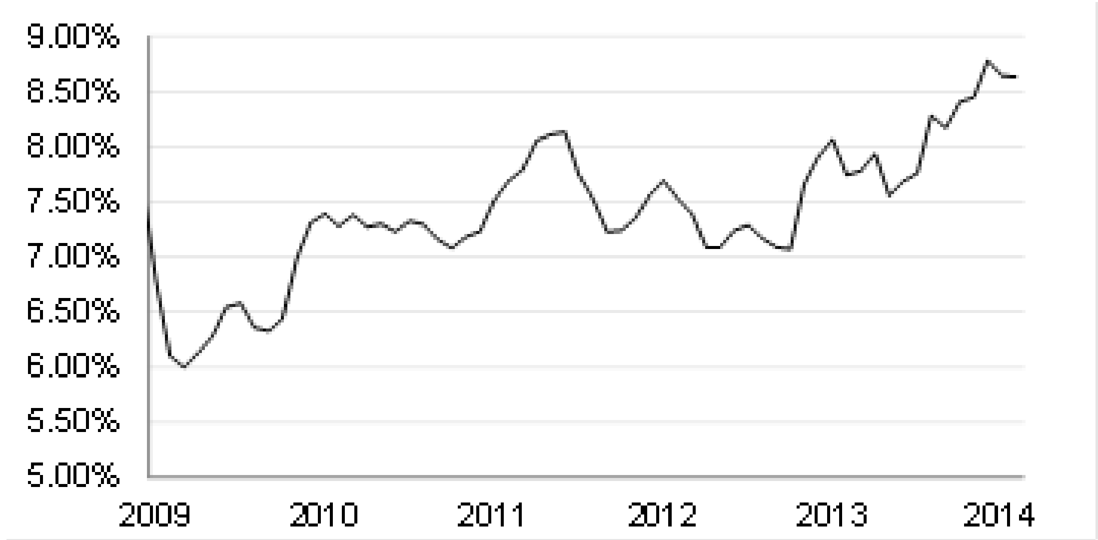


Source: Commsec

The data also showed that retail investors continue to hold large overweight positions in financial stocks (predominantly the big 4 banks). While the banks did take a hit during the quarter in absolute terms, their underperformance compared to the broader index was benign.

"The four most dangerous words in investing are: 'this time it's different.'" - Sir John Templeton

Aggregate Overweight Position in Financials of Commsec Clients



Source: Commsec

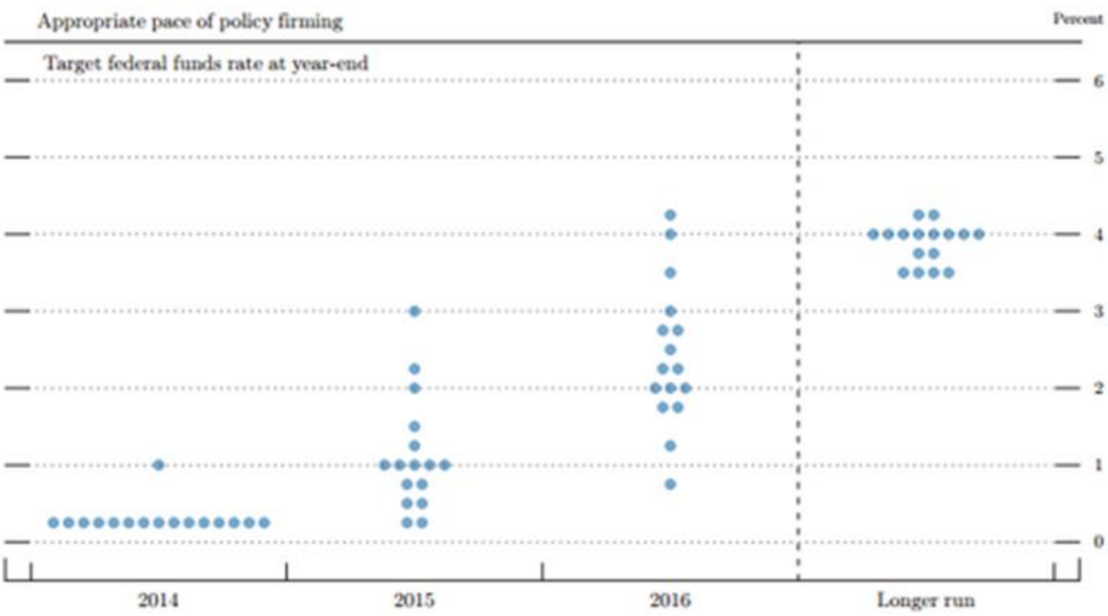
News flow surrounding the banks is key to the retail investor psyche. One item worth keeping track of will be the Financial System Inquiry report which The Murray Committee released its preliminary version of during the quarter. The report considered the lessons from the GFC and how the regulatory framework can ensure banks are better positioned to deal with crises in the future. The report highlighted the regulatory risk surrounding the banks, and the final report when published in November, may push for more onerous capital requirements for the big 4 banks.

When Will the Fed Raise Rates?

After the Fed released its September policy statement, every day it seemed like a different member of the Fed would give their (varying) opinion on when the central bank should raise rates. Federal Reserve Bank of Dallas President, Richard Fisher, admitted he was worried that they may be too late to raise rates saying "I worry we're behind the curve at the Fed." Preceding his comments, the Fed President of Atlanta spoke about being able to hold off increasing rates until late 2015. The Fed Presidents of St Louis and New York advocated raising rates early in 2015, while the Chicago President voiced his support for an "exceptionally patient" approach.

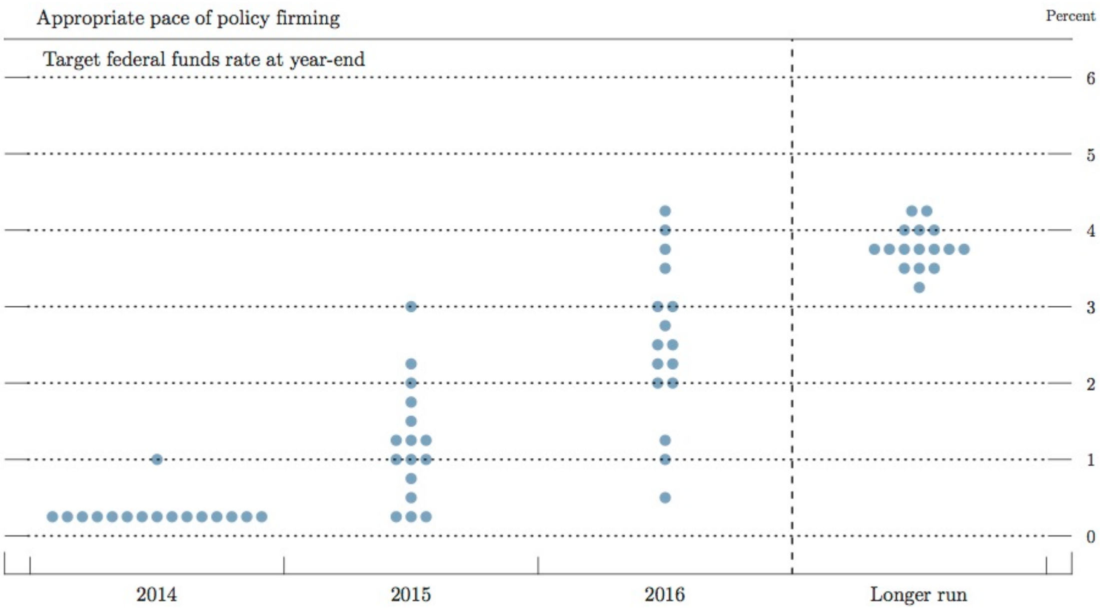
The Fed periodically surveys each member on their preferred pace of interest rate policy. Below is the distribution from the last 3 surveys.

March 2014



Source: Federal Reserve

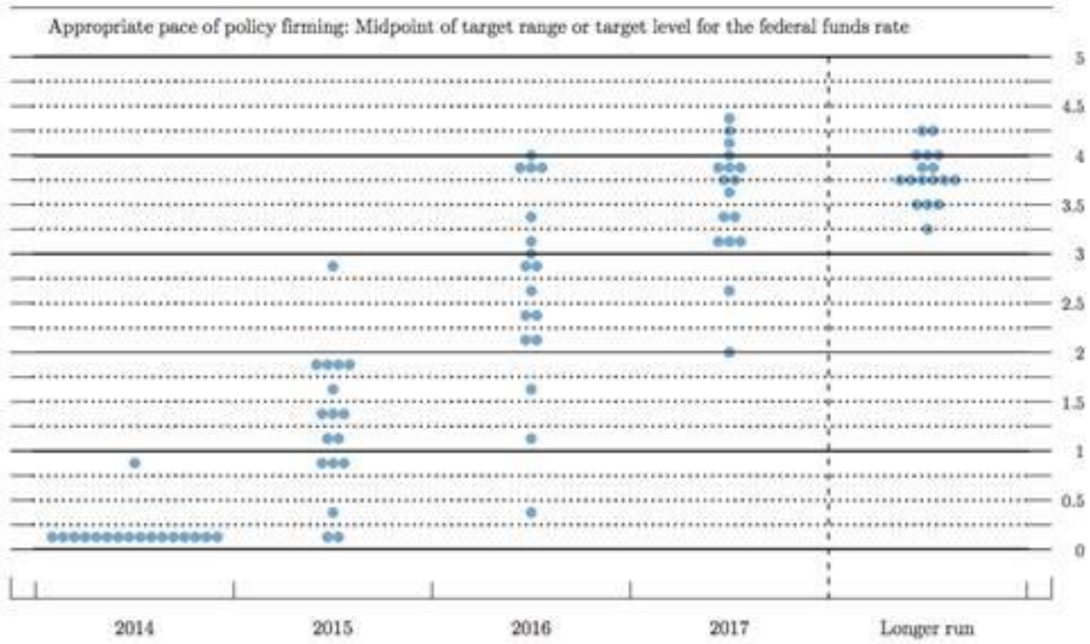
June 2014



Source: Federal Reserve

"In the financial world, if you offer cheap money, they will borrow, buy and build – often without discipline, and with very negative consequences." Howard Marks, Oaktree Capital, 2013

September 2014



Source: Federal Reserve

The USD Index, measured against a basket of other currencies rallied nearly 8% for the quarter as the market brought forward its expectations for interest rate rises. Morgan Stanley captures when market consensus believes the first rate hike will occur. The Index has dropped to just above 9, which suggests the market is positioned for a rate rise in June or July 2015.

Months Until First Rate Hike (Consensus)

Source: Bloomberg

"The labor market has yet to fully recover. There are still too many people who want jobs but cannot find them. Too many who are working part time but would prefer full time work. And too many who are not searching for a job but would be if the labor market was stronger." Janet Yellen, Chair of the Federal Reserve Bank, 18/09/2014

Overseas Trips

This quarter we visited the US on four separate occasions in addition to research trips to Europe, the UK, Canada and China.

China Take-outs

- Companies leveraged to consumer wealth, as opposed to firm or asset investment growth are likely to outperform as China continues to transition its economy. For decades, a mixture of fixed asset investments, emerging industries and importantly, cheap labour meant that excess returns and hence significant capital accrued to a wealthy few. This equation has now flipped as labour constraints mean that the middle class now has pricing power, and hence wage inflation should continue to outpace GDP growth. Deficit tax of 2% on incomes over $180,000, costing taxpayers $600m in 2014/15;
- Shadow banking has its concerns however there is evidence that systemic risks are being addressed. The pace of growth in Wealth Management products is slowing, and Trusts are being more closely regulated. Whilst there will be some failures going forward (which is accepted as a good thing), continued financial reforms, including enforcement regulation, are likely to help reduce the systemic risks as China develops its banking sector;
- People we spoke to expect GDP growth this year of 7.4-7.5%, however this may not be sustainable. A managed glide path towards 6.5% over the next few years is a likely outcome. Policy makers believe this can be achieved with an unemployment rate held around current levels;
- Reduction in Fixed Asset Investment is likely to detract from future growth. Steel production should lag behind consumption growth (and wage inflation) which continue to materially out-pace GDP.

"If you compare [now] to 20 years ago, credit growth had been the same and the Chinese authorities owned up to about 30 per cent of non-performing loans in the banking system. They currently claim its one per cent." Gabriel Stein, Oxford Economics, 02/09/14

Print assets are doing it tough globally. We saw this large print factory for sale in Calgary, Canada.

US Observations

- Interest rates are very much a secondary issue relative to the lack of credit availability for mortgages, which although improving at the margin over the last 6 months is still very restrictive and is increasingly inconsistent with (the improvement in) broad macroeconomic indicators with direct implications for the US housing recovery;
- Given the qualification criteria, the mortgages that are being written are of higher quality;
- Lots of discussion around the 'Millennial' generation and their lack of household formation. Most point to the burden of student debt - where there once was a positive correlation with getting a mortgage (due to better paid employment prospects) that has now reversed due to a fall in the confidence around actually finding a job and servicing student debt burdens;

- Some Multi-Home developments are being sold at < 4% yields!
- In the dynamic Pay TV world, value continues to shift to must-have/premium branded content producers from lower valued content producers and distributors who are increasingly becoming commoditised. The "golden age of TV" looks set to continue over the medium-term;
- Corporates continue to buy back stock at high rates despite the stock market being at 6 year highs - increasingly being funded through debt (the old 'EPS accretion' argument);
- Healthcare expenditure is a massive issue for the country - 17% of GDP, $7.5k per person p.a. spent on healthcare in the US is the highest in world with no relative outcome benefits, cost of healthcare for the uninsured is the largest reason for personal bankruptcy in the US;
- San Francisco was buzzing given the strength of the Tech sector, lots of new start-ups, as evidenced by traffic complaints;
- The average daily commute for people in Los Angeles is three hours!
- More generally, the US economy continues to bumble along the bottom with the low end consumer and the capital expenditure cycles notable headwinds.

"Mobility and cloud present an enormous opportunity" Microsoft, 22/07/14

Outlook

Despite a relatively solid reporting season, our caution highlighted in June was justified given the September retreat in the Australian market. This quarter has seen a further pull back in the iron ore price, oil price, the Australian dollar and the Australian Equity market (with both Resources and Banking sectors participating).

We observe however that the US equity market remains within a few percent of its all-time highs. Geo-political uncertainty has risen, we observe trust between USA and its allies with Russia and China is at a low point and the tension in the Middle East continues to rise. To us this means the risk of disruptive capital flows are heightened, and sudden changes in cross border capital flows can have amplified impacts on pricing, given the prolonged low interest rate environment. In other words volatility has risen. We remain cautious with raised levels of cash in our portfolios.

We remain attracted to the ‘self-help’ medium term growth stories, which can maintain an attractive growth trajectory despite the macro noise. With cheap debt, strong balance sheets and some added volatility, shareholder stewardship and optionality within companies has rarely been more valuable.

“In all my work on the evolution of cooperation it is always the same story, cooperation is never here to stay. Cooperation prevails for some time. Then the system breaks down and you have to rebuild it. This is far away from the typical economist notion of equilibrium. There is no equilibrium.” Martin Nowak, Harvard Biologist and Author, January 2014

More information

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

Fidante Partners Investor Services team on: **13 51 53**

Visit the Greencape website: **www.greencapecapital.com.au**

Email Greencape at: **bdm@greencapecapital.com.au**

Financial advisers

For more information, please contact:

Cathryn Franks
National Sales Manager
Fidante Partners

Phone: **+61 2 9994 7606**

Email: **cfranks@fidante.com.au**

Institutional investors and asset consultants

For more information, please contact:

Roger Prezens
Institutional Business Development Manager
Fidante Partners

Phone: **+61 3 9947 9419**

Email: **rprezens@fidante.com.au**