Greencape High Conviction Fund

Quarterly report - December 2017

Performance #	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	10 years % p.a.	Inception % p.a.
Fund return	7.85	19.93	9.99	12.09	6.27	9.79
Growth return	7.83	13.74	1.92	4.51	0.72	3.59
Distribution return	0.03	6.19	8.07	7.58	5.56	6.20
S&P/ASX 200 Accumulation Index	7.64	11.80	8.64	10.24	4.14	6.26
Active return^	0.22	8.13	1.35	1.85	2.14	3.54

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'.

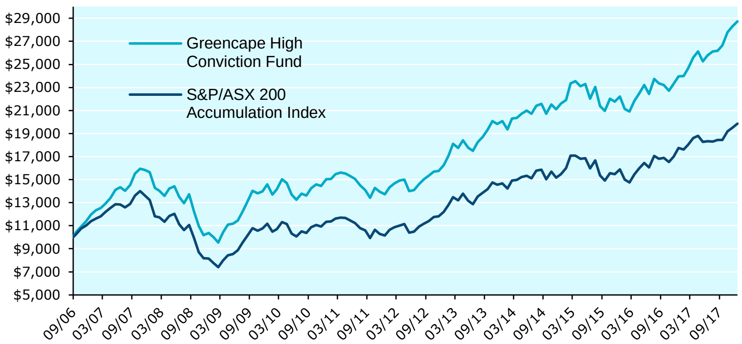
Distribution frequency

Quarterly

Suggested minimum investment timeframe

At least five years

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

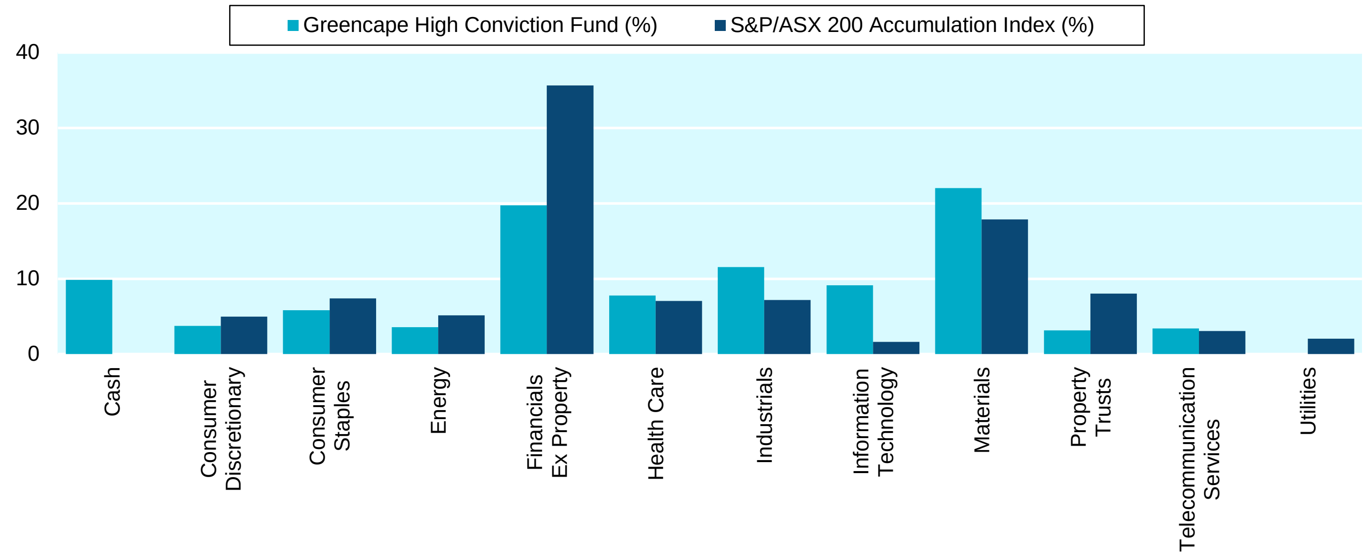


Asset allocation	Actual %	Range %
Security	90.14	85-100
Cash	9.86	0-15

Fund facts	
Inception date	11 September 2006
APIR code	HOW0035AU

Fees	
Entry fee	Nil
2016-2017 ICR	1.03%
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 31 December 2017



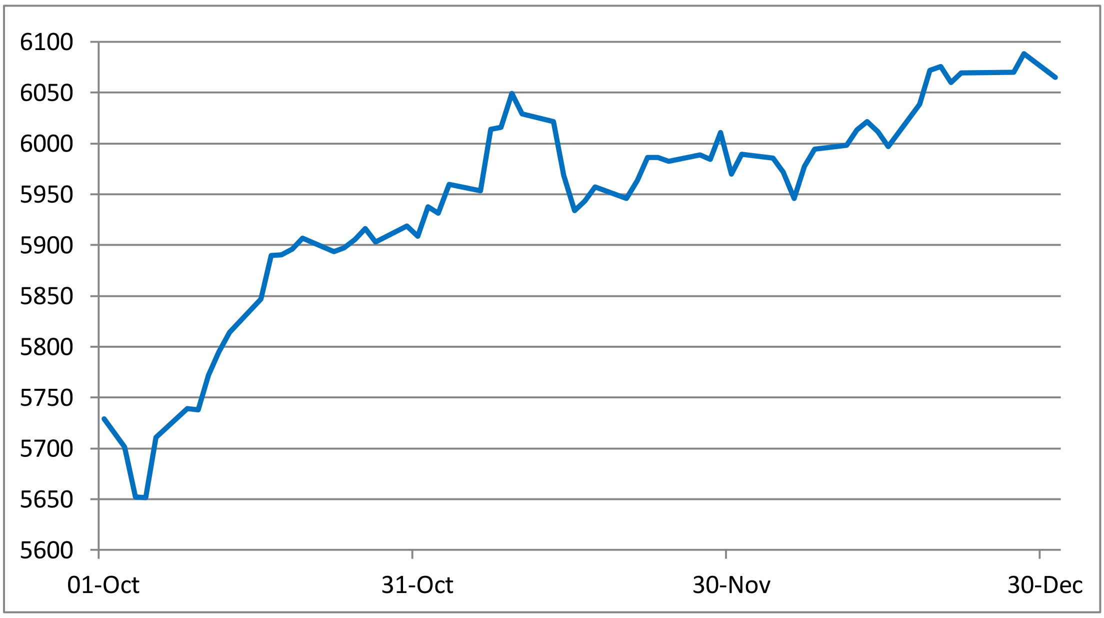
Fund performance summary

The S&P/ASX 200 Accumulation Index returned +7.64% for the quarter. The fund outperformed the market and delivered a +7.85% return over the quarter.

Market overview

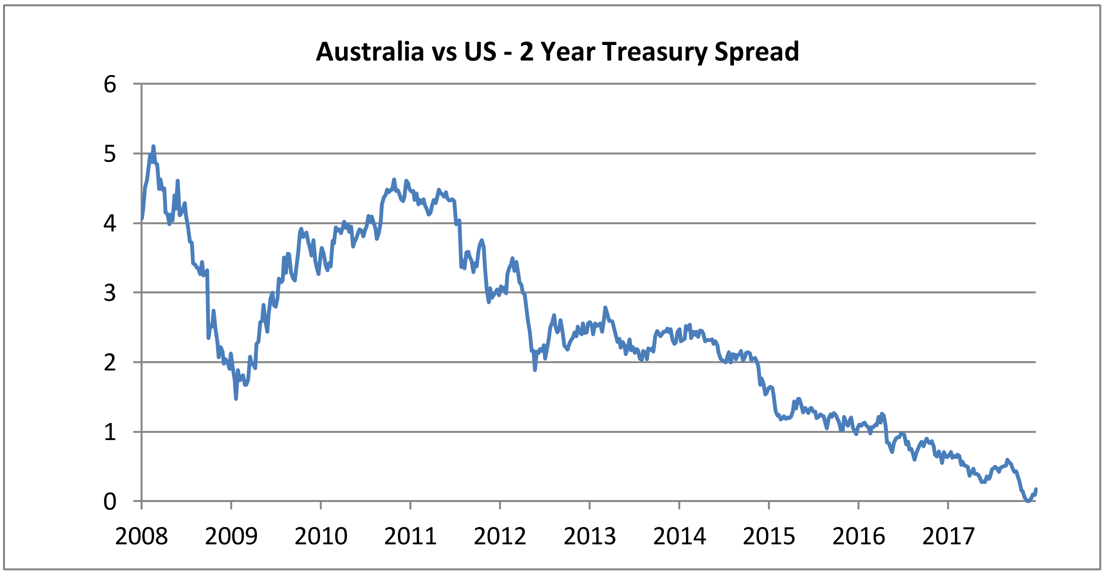
Synchronised global growth, record low volatility across asset classes and major tax reform passed by the US government buoyed global equities and helped the Australian equity market finally break through 6000 points, as the index posted its strongest quarterly gain in almost three years. ‘Crypto Mania’ swept the world during the period, driven by a surge in the price of digital coins and increased media coverage. Locally, the market was focused on trading updates announced in the November Annual General Meeting (AGM) season, before a late flurry of corporate activity closed out the calendar year.

S&P/ASX 200 Index



As expected, the Reserve Bank of Australia kept the cash rate on hold during all three meetings held during the quarter. The rate has been at a record low of 1.5% since August 2016, with market expectations indicating a hike is not expected until October 2018.

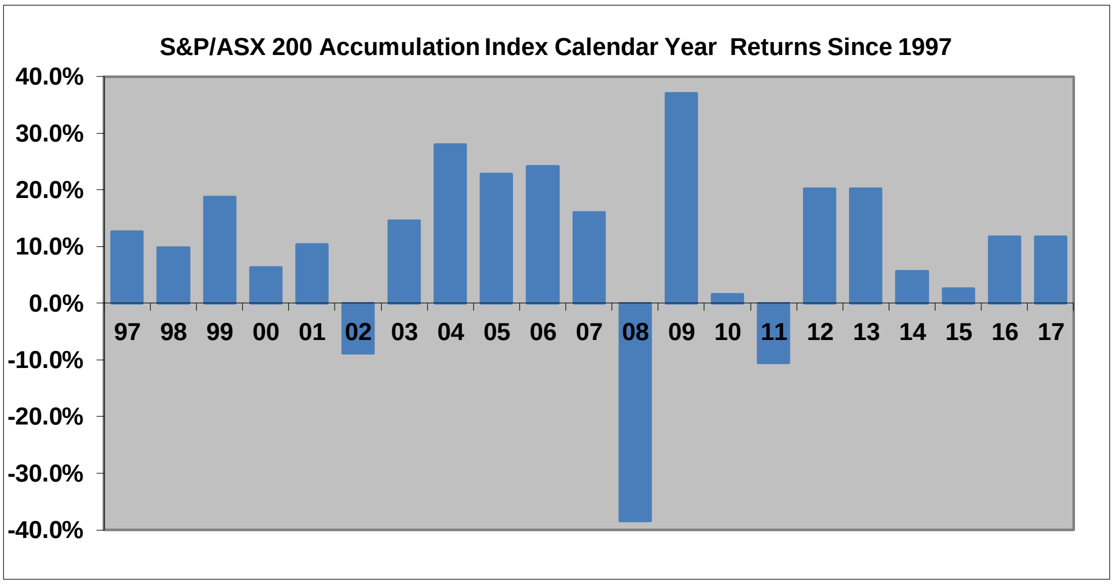
Interestingly, we have now seen Australian and US government bond yields converge. This will provide a degree of margin pressure to Australian banks which partly fund their operations through international borrowing.



Source: Bloomberg

“Houses are for living, not for speculating.” Xi Jingping, President of the People's Republic of China, 18/10/2017

The Turnbull government briefly lost its slim majority during the period as the High Court ruled Barnaby Joyce was ineligible to sit in Parliament given he held New Zealand citizenship at the time of the 2016 Election. The government's majority was later restored after the National party prevailed in the New England by-election. After much speculation, the Federal Government also announced the establishment of a royal commission into misconduct in Australia's banking and financial services sector.



Global markets were strong, led by the US where the equity market continued to break through fresh all-time highs (the occurrence of which was usually promoted via the President's Twitter account). Despite a healthy level of scepticism following the Trump administration's inability to repeal Obamacare, the Tax Cuts and Job Acts was signed into law by the President in December. Whilst the plan elements are wide ranging, of most direct relevance to market participants was the cut to the corporate tax rate from 35% to 21%. As expected the Federal Open Market Committee raised the target range for the federal funds rate for a third time in 2017 in December, with the futures market implying two more rate hikes are expected in 2018.

Global synchronised economic growth has been a key driver of the equities upswing. As we see below, late in the year there were no countries reporting a monthly Purchasing Managers' Index below 50.

Source: Haver Analytics

"The reason our stock market is so successful is because of me. I've always been great with money… And I've done it well, I've done it really well, much better than people understand and they understand I've done well." Donald Trump, President of the United States of America, 06/11/17

Locally, AGM season was largely uneventful, with the vast majority of companies reporting trading updates in line with market expectations. There were some highlights however, including Computershare which upgraded its FY18 guidance due to stronger contributions in its Corporate Actions and Mortgage Services businesses. A2 Milk also released another strong sales update, with sales for the first four months of the financial year amounting to NZD$262m, an increase of 69% on prior year.

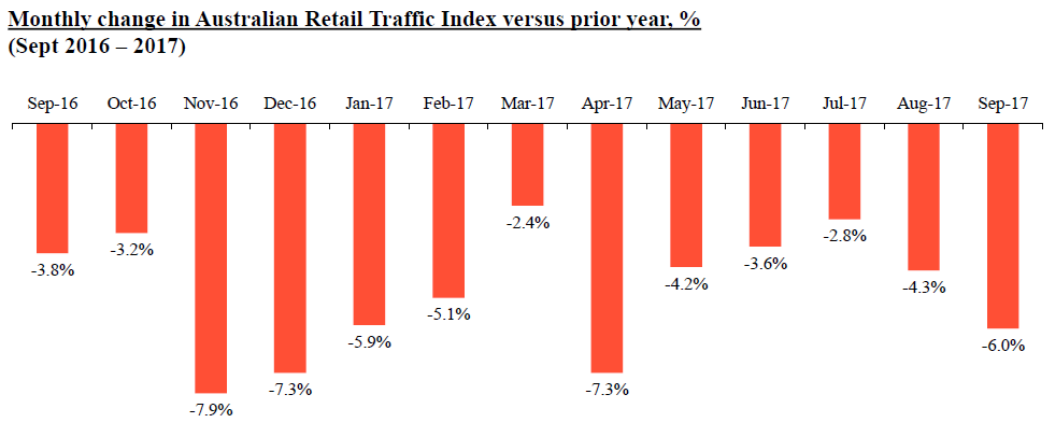
	Dec 2017 Quarter	Year ended Dec 2017
ASX200 Accumulation Index	7.6%	11.8%
Best performing sectors		
Energy	18.0%	23.3%
Info Tech	15.7%	26.0%
Materials	13.0%	22.9%
Worst performing sectors		
Utilities	3.2%	9.0%
Financial Excluding Property	3.6%	5.0%
Industrials	5.2%	18.2%

Energy stocks were the best performing for a second consecutive quarter, aided by a 17% gain in the Crude oil price, whilst Utilities underperformed as global bond yields rallied. There was also a surge in corporate activity late in the year. Deals announced included the acquisitions of Westfield, Tox Free Solutions, Aconex and AWE. The theme was not exclusively local, with a number of deals announced offshore, including Walt Disney acquiring film, television and international businesses from 21st Century Fox for USD $52bn.

*"But the most simple thing is they (Amazon) don't give a s*** about whether they make a profit in Australia for five years, whereas Gerry Harvey cares a lot about the profit he makes next quarter. That's an unfair battle; who do you think is going to win that?" Andrew Bassat, CEO of Seek, 30/11/2017*

In December, Amazon finally launched its Marketplace offering in Australia as media speculation reached fever pitch. The initial offering was received as underwhelming, which saw potentially exposed stocks including JB Hi-Fi and Harvey Norman rally on the day of the launch.

However Amazon is not the only concern of brick and mortar retailers in Australia, as evidenced by the bearish Retail Traffic Index statistics provided by Myer at their Strategy Day in November.



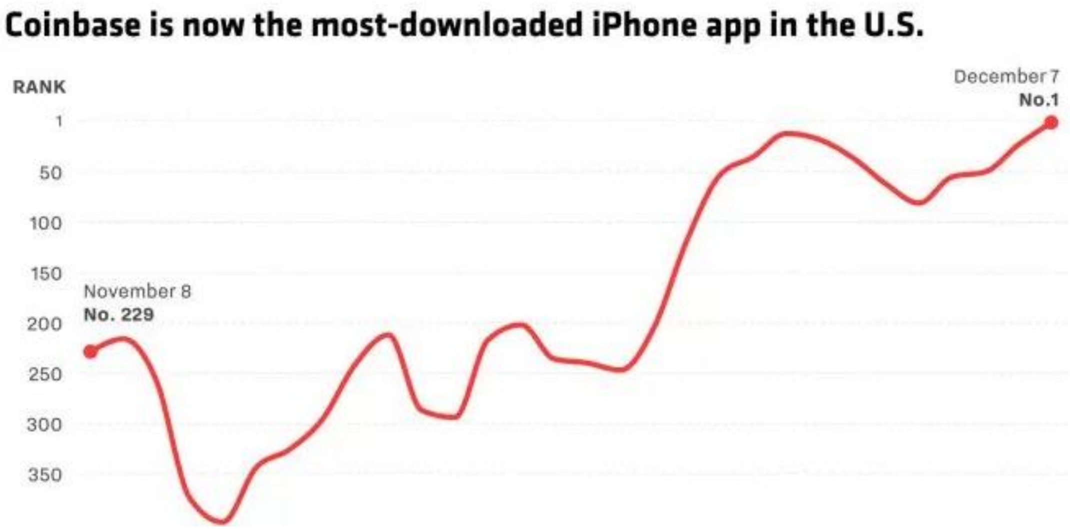
Source: Myer

Bitcoin

Despite not being part of an investable asset class at Greencape, we have nonetheless been fascinated by the meteoric rise in Bitcoin. Whilst we do not dispute the revolutionary nature of the Blockchain technology which underlies Bitcoin and its' potential to change the fabric of future commerce, we cannot help but harbour some reservations in regards to the current speculative nature of trading in cryptocurrencies.

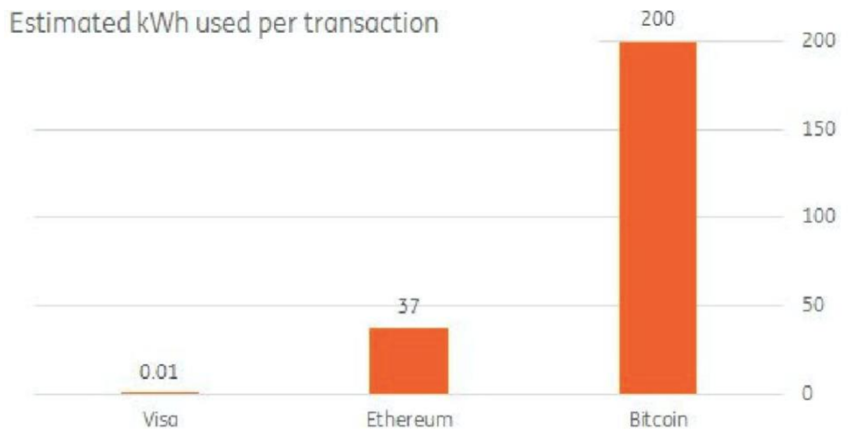
Media interest in Bitcoin has catapulted it to now being the most talked about asset in the financial world. Each day seemingly without fail there is an article in the press about an investor who bought early and has made a huge profit (on paper at least). An example of the tremendous amount of paper wealth created is 'Ripple', which at the time of writing had coins (called XRP) in circulation valued at USD$143bn, second only to Bitcoin. However only 38% of XRP are in circulation, the rest are held by Ripple Labs who created the cryptocurrency. Therefore the company on paper is worth USD$225bn and the founder himself worth USD $55bn, making him one of the top 10 richest people in the world. Naturally, stories like these have led to a widespread 'FOMO' (Fear of Missing Out) affect, where less sophisticated investors then enter the market hoping to get a piece of the action and become the next crypto millionaires. This phenomenon is similar to what occurred in the Chinese stock market in 2015, where one study showed the highest level of education attained by 60% of new investors in the Chinese stock market at the peak of the hype was Junior High School. As shown below, a digital currency exchange app became the most downloaded iPhone app in the US in December.

"It's only in bullish times that investors accept financial inventions. When the market's in an up-swing, people tend to say, "Sure, I'll give it a chance" or "good, I've been looking for new ways to make money", but when the market has been moving down and people are tallying their losses, they tend to be much less open to new ideas. Inventions originate in up markets, but they're tested in down markets. Rarely do they work as entirely hoped." Howard Marks, Chairman of Oaktree Capital, 2007



Source: 9to5Mac.com

Bitcoins are earned by verifying pending transactions (blocks) by solving mathematical puzzles, the solutions of which are then verified by other miners, which are then added to the ledger (or 'Blockchain'). This process is deliberately energy intensive as to deter any potential fraudulent transactions. Bitcoin mining energy use is growing at 25% per month and currently consumes more electricity than Ireland in a year. If current growth rates persist, Bitcoin will consume the same amount of electricity as the US in 2019 and the whole world by 2020 according to the World Economic Forum. This trajectory of energy usage is clearly not sustainable.



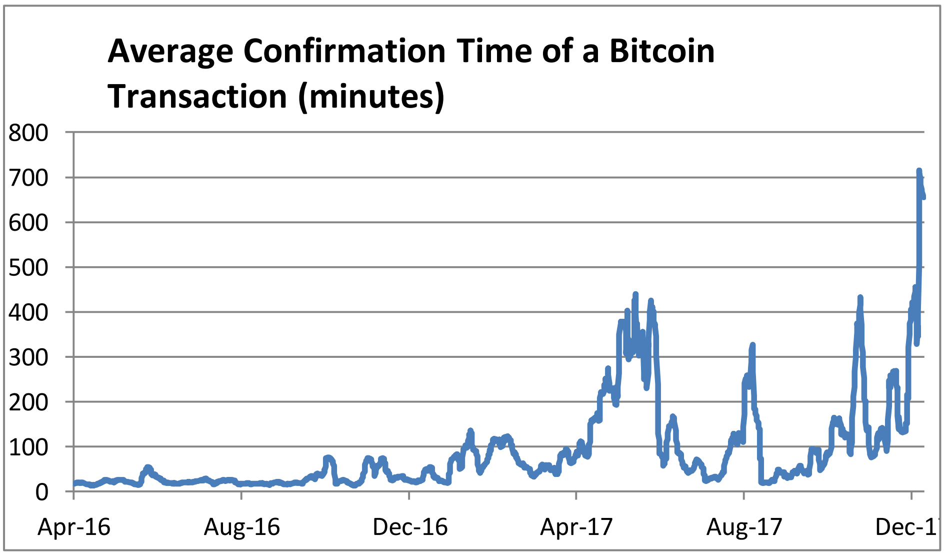
Source: ING

Whilst current regulation on cryptocurrency markets is largely non-existent, we see the potential for this to change which could risk the practical usefulness of digital coins. Given Bitcoin can be used as a means to transfer money internationally tax free, it is unlikely governments and financial institutions will sit idly as the opportunity cost of revenue could be substantial. Here in Australia, Bitcoin investors have claimed accounts with each of the big four banks have been frozen following transfers to coin exchanges as the transactions pose a 'security risk'.

Coin exchanges are also vulnerable to cyber-attacks. Youbit, a South Korean exchange was forced to shut down in December after large amounts of Bitcoin were stolen. The Wall Street Journal has pointed to North Korea as the possible perpetrator. If hypothetically these Bitcoins were found to be used to fund a nuclear program, the regulatory response could be significantly more oppressive.

Also of particular concern is the liquidity of the cryptocurrency markets in the event that you should wish to cash out, a factor which we do not believe is well understood by market participants. We read with amusement a thread on Twitter of a Privacy Engineer at Google (@TedOnPrivacy) who attempted to sell his Bitcoins. The exchanges that were quick to take his money when purchasing Bitcoin had strict withdrawal limits and required various verification steps which took a number of days to complete. Coinbase, one of the most popular coin exchanges does not offer the ability to sell Bitcoin in Australia and in the US withdrawals on Coinbase can take up to 4-6 days to process. Another anecdote we heard was that some exchanges are offering other coins such as Ethereum instead of cash when you sell Bitcoin. It is likely the difficulty in selling Bitcoin is discouraging some potential sellers, and therefore the relative ease to buy versus sell would be supporting the Bitcoin market to a degree.

Adding to the liquidity issues, the average confirmation time of a Bitcoin transaction has increased exponentially to approximately 11 hours as at the end of calendar 2017.



Source: Blockchain.info

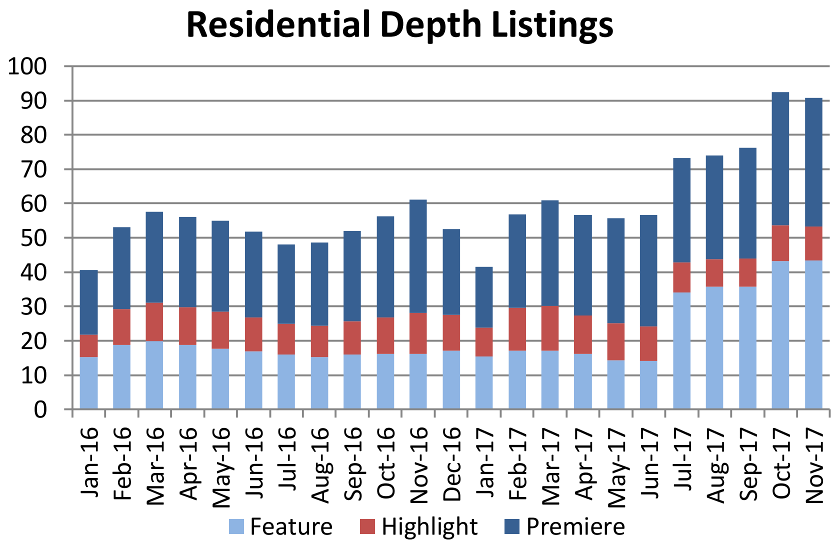
If a ‘Minsky moment’ was to occur and Bitcoin holders all sought to crystallise their paper profits en masse, there is a potential for a sharp selloff in in cryptocurrencies similar to other speculative asset downturns witnessed historically. Given the coin exchanges are also largely unregulated; it is possible they could simply shut down in this situation, potentially exacerbating the problem. Whilst we are not digital coin trading specialists, we would advocate taking some profits in Bitcoin (if you can).

REA Group

We continue to like REA’s position in the Australian real estate market, especially as house prices across the East Coast moderate. In periods of rapid house price growth, listing volumes tend to suffer as prospective sellers hold back for fear of prices running away from them as they search for their new home. On balance, we expect volumes to increase, also helped by auction clearance rates reducing from unsustainably high levels.

Volume listing growth is only part of the REA investment thesis. A theme which we continue to see further runway from is high depth penetration as more listings are either ‘Premiere’ or ‘Feature’ (see chart below). As REA continues to invest into their product across platforms (mobile, desktop and tablet), we expect strong user engagement to continue and further monetisation of theses ‘eyeballs’ via agents using depth to highlight both their listings and standing their respective standing in the markets they operate in. This over time should see depth continue to trend higher, with price rises also contributing to earnings growth. Our channel checks with real estate agents continue to suggest that due to the vendor paid market structure for advertising, the high absolute dollar value of house prices relative to online advertising costs, and the relatively infrequent nature of selling a house means REA remains well placed to increase prices as the value they provide in connecting vendors to prospective buyers is underappreciated.

“We are delivering growth against the backdrop of favourable conditions for residential in Australia, with an increase in listings in the key markets of Sydney and Melbourne.” Tracey Fellows, REA Group CEO, 10/11/2017



Source: Credit Suisse, Greencape estimates

Increasingly, we also see upside from REA’s efforts in providing its users with mortgage options. Although early days, the audience REA attracts lends itself to high quality leads therefore we are watching this space closely.

Finally, REA’s Asian investments have in recent years has been weaker than expected due to macro conditions and tighter investment spending under an inefficient ownerships structure. Conditions appear to have stabilised of late and we expect new management, consolidating ownership and a renewed focus on investment spending should over time see accelerated top line growth (notwithstanding our recognition that Asia remains a market where patience is required). Some of this investment will be evident in Financial Year 2018 numbers as a step up on operating expense is likely however we are encouraged by this given the longer term opportunity across the region.

Offshore Trips

During the quarter we went to the UK & Europe twice, China and the US.

UK/Europe observations

- The Consumer in the UK is subdued as inflation is rising faster than wages. Much of this inflation was imported post the Brexit referendum, but had a delayed impact given hedges put in place by retailers. These are now starting to roll off and prices are increasing meaningfully.
- Brexit is proving difficult to execute in reality. For example, it is not possible to have a border between the Republic of Ireland and Northern Ireland as it would attract terrorists. This is fine now as they are both part of the same customs union; however this will change with Brexit. People would theoretically be able to take goods from the continental EU into the Republic of Ireland, walk them across the border into Northern Ireland and then take them into other parts of the UK. It is uncertain how this issue will be solved without Northern Ireland being treated as separate from the UK.
- Amazon causes prices to spiral downwards in each country they enter as they continually match the marketplace offer lower. Earnings before Interest & Tax (EBIT) margins of incumbent Australian retailers are at risk if historical dynamics play out. Amazon Prime plays a key part in the timing of this impact.

China observations

- President Xi's power has been consolidated post the party conference in October, thus his push to improve air quality will be adhered to. There is a large push from the top to focus on 'quality' over 'quantity' of Gross Domestic Product (GDP) growth).
- A number of provincial leaders now have measurable air quality as their top Key Performance Indicator, and are therefore incentivised to keep the air clean rather than aimlessly grow the GDP of their region. Some leaders face jail if they don't make targets, which should provide plenty of incentive!

Outlook

Writing the outlook at the start of a new year typically falls into 3 common categories: Momentum (continuation of the current trend), Contrarian (mean reversion) or Black Swan (essentially a 'Hail Mary' prediction). Greencape's evidenced based approach can make outlook commentary challenging. Observations worth highlighting include solid US macro data combined with positive sentiment from recent tax reform. Utilisation also keeps improving suggesting the outlook for US consumer demand is encouraging. Europe remains stable, with the potential there for gradual quantitative tightening. China still remains stable also as it enters its important New Year period; however geopolitical risk is high in the region given current tensions between the US and North Korea.

Australia remains patchy with business sentiment improving despite consumers still burdened by large debt loads. With the Australian share market driven largely by Banks (with slowing growth due to mortgage demand flattening) and Resources which have already rallied strongly (given solid free cash flows generation at spot commodity prices), there isn't an obvious market driver either way for the Australian market at large. Amongst the rest of the sectors, outlooks respectively are very stock specific.

It's clear that valuations look stretched, investor sentiment is optimistic and is FOMO fuelling the latest concepts (be it Lithium batteries or cryptocurrencies for example). In this environment we continue to observe that liquidity is undervalued. We also again highlight that (M&A) Mergers & Acquisitions still appears on the agenda for many industries. Greencape considers the outcomes of M&A to be critically dependent on the quality of shareholder stewardship executed by management. We expect the market will be driven by a narrower number of stocks; therefore stock picking will become even more critical. The outcome for the portfolio has been higher than average cash weights. We consider patience a virtue.

"Northern Ireland will not be separated constitutionally, politically, economically or regulatory from the rest of the United Kingdom." Arelene Foster, Leader of the DUP, 08/12/2017

"Taking the driving seat in international cooperation to respond to climate change, China has become an important participant, contributor, and torchbearer in the global endeavour for ecological civilization." Xi Jingping, President of the People's Republic of China, 18/10/2017

"What is clear is that we are not just living in a low volatility environment, we are currently living through the 'Greatest' of the 'Great Moderations' for asset class volatility." Tim Toohey, Ellerston Capital, 27/12/17

More information

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

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