CI AUSTRALIAN EQUITIES FUND
QUARTERLY REPORT

Cooper Investors Pty Limited AFS Licence Number 221794 ABN 26 100 409 890

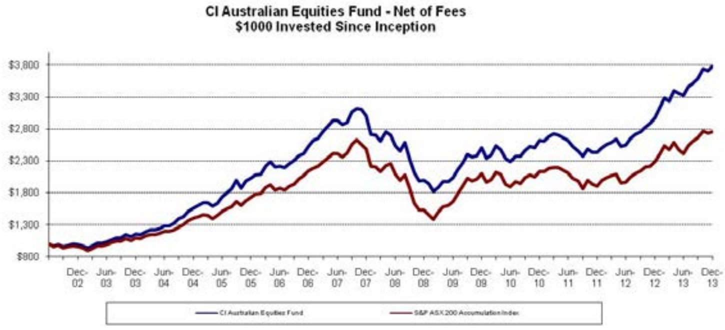
DECEMBER 2013

"Everything we hear is an opinion, not a fact. Everything we see is a perspective, not the truth." Marcus Aurelius.

"Without deviation from the norm, progress is not possible." Frank Zappa.

	**PORTFOLIO	BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	5.69%	3.42%	2.27%
ROLLING 1 YEAR	28.51%	20.20%	8.31%
ROLLING 3 YEAR	14.04%	8.94%	5.10%
ROLLING 5 YEAR	14.66%	12.47%	2.19%
ROLLING 7 YEAR	6.93%	3.66%	3.27%
ROLLING 10 YEAR	13.70%	9.64%	4.06%
SINCE INCEPTION*	13.43%	9.21%	4.22%
SINCE INCEPTION^	325.89%	175.38%	150.51%

*Annualised
^Cumulative (4 July 2002)
**Before fees and expenses



Market and Portfolio Performance

After large increases in the September quarter, the market consolidated gains in the December quarter edging up a further 3.42%. The portfolio out-performed by 2.27% returning 5.69%. Key contributors to performance included Brambles, Amcor, Ramsay, TPG Telecom, Transpacific Industries, Fox, Auckland Airport & Macquarie Bank. Key detractors were QBE, Oil Search and Fletcher Building. There were several notable earnings downgrades during the quarter including QBE, Worley Parsons, SkyCity, ALS, Qantas, Wotif and Coca-Cola Amatil. These downgrades across a variety of sectors indicate that the domestic economy is somewhat fragile. We believe that the market will continue to discriminate between those companies producing durable cashflows and real growth as opposed to flimsy cash flows and overly optimistic growth forecasts.

The financial headlines continued to be dominated by "Quantitative Easing", "Ben Bernanke", "Debt Ceiling" and "Tapering". When the man on the street is concerning himself with the Chairman of the US Federal Reserve, it is obvious that we are living in unprecedented times. To the best of our ability we try to ignore the headlines and focus on buying companies with strong VoF propositions – a tried and tested formula over many market cycles.

While all portfolio decisions are driven by our bottom-up VoF investment philosophy, it would be extremely ignorant to ignore current central bank policies and their distorting impact on asset prices. Central banks have been depressing interest rates globally which has caused a significant re-rate of risk assets. With a limited ability for further rate compression across the yield curve, we believe the re-rate of any security with a relatively attractive headline yield has likely largely played out. We do believe, however, that dividends will continue to play an extremely important part of investors' total return going forward – there just needs to be more to the story.

Domestically we believe that most risks are skewed to the downside – many commodity prices (and thus our terms of trade) still remain above long term averages, we are on the edge of a mining capex cliff, cost structures across most industries have become very uncompetitive, energy prices continue to rise, both State and Federal Governments' fiscal positions are under significant pressure, household balance sheets are amongst the most leveraged in the world, labour costs are high/productivity is poor and unemployment is in the nascent stages of rising.

We think it is somewhat hopeful to expect that non-mining investment, particularly housing construction, can fill the significant demand gap against this backdrop. The housing industry is not a self-supporting industry in and of itself – it requires people with jobs and income security to make this significant personal capital expenditure commitment. We are wary, however, about getting too bearish on Australia as it still has many favourable attributes and remains a very attractive place to live and raise a family – we just feel it needs a "reset".

The Portfolio

In December, ***Brambles (BXB)*** demerged its information management business, ***Recall Holdings (REC)***. Recall traded below our view of its intrinsic value through December so we purchased additional shares and at the end of the quarter Cooper Investors' portfolios together held approximately 5.6% of its issued capital. Recall is one of the two largest information management solutions providers globally. Recall's core business is storing physical documents and digital information for its customers across 308 secure facilities in 23 countries. It also offers ancillary services including secure destruction of documents and business process automation.

Recall is a quality cash-generative business that in our view presents an exciting turnaround opportunity. Under Brambles ownership, Recall had lacked focus and was deprived of capital to grow. In addition, the failed sales process undertaken during 2011 and 2012 was a major distraction for the business and resulted in questionable management actions that increased short-term profitability at the expense of customer relationships and the long-term health of the business. We are becoming increasingly confident that the current management team is rectifying these issues.

Our research to date has focused on the US (25% of earnings) and Australian (40% of earnings) operations. On our trip to the US during the quarter (discussed below) we met with many contacts, including competitors, ex-employees, customers and industry consultants, and we have spoken with similar contacts from an Australian perspective to understand these markets in more detail. Recall is the clear market leader in Australia but has lost market share in recent years due to poor customer service, although there appears to be an opportunity to halt this market share loss under the right management team. In the US, Recall is relatively smaller and has many opportunities to grow its market share through acquisitions and improved customer service levels.

Aspects of the Recall business and industry that we find attractive include:

- The business produces stable recurring earnings with high cash flow conversion and mid-teen returns on capital;
- Mature industry but experiencing GDP-type growth as net storage volumes are still growing (despite digital threat);
- Ample opportunities to boost organic growth through acquisitions (e.g. US is fragmented with Recall the 2nd largest with a ~7% market share), emerging market expansion and penetrating un-vended markets;
- Balance sheet at 2.4x ND/EBITDA has some headroom given the ability of the business to carry debt;
- Many small customers – largest customer is <2% of group revenue;
- High switching costs – document storage is a small part of a customer's cost base (storage costs ~$2-3/box per year), "customer inertia" is a very strong force in the industry; and
- A new management team that is driving change, reinvesting back into the sales force and improving customer service levels.

In addition to the risks involved in implementing a turnaround and growing via acquisition, probably the largest risk to Recall is the impact that digitisation of information will have on its business model. Since the 1975 prediction of the "paperless office", commentators have incorrectly been calling the death of paper. Physical storage volumes in mature markets continue to grow (albeit at a much slower pace than digital volumes) due to regulatory requirements, the lack of sophistication across the records management industry and the relatively low cost 'insurance' from storing physical records in a rapidly evolving digital world. In the medium-term we see digitisation as a low risk to Recall but we continue to monitor the situation as it is not yet clear how Recall will compete in the digital world longer term.

We also increased our position in ***Transpacific Industries (TPI)*** via a private equity sell down (discussed below).

During the quarter we commenced selling our long held position in ***Tatts Group (TTS)***. Although we remain attracted to the lotteries business, the stock price has appreciated so that it captures most of the synergies yet to emerge from prior year State lotteries acquisitions. There are few obvious further substantial acquisitions in this area in Australia for the company, and to go offshore (e.g. the Irish lottery was recently sold) increases the risk profile of the company not insubstantially. Today 30% of profits come from the wagering business which has a few headwinds such as:

- It is a low growth business;
- Competition for the tote business run by Tattersalls has increased as corporate bookmakers have stepped up their activity. In addition we have seen the entry into Australia of large offshore players (Paddy Power, William Hill) who bring with them on-line experience and expertise which threatens the totes;
- In June next year Tatts exclusivity for its retail wagering licence in Queensland expires. Although we can attempt to impute a likely payment required to extend the licence from the amount paid by Tabcorp to the NSW government, there remains uncertainty; and
- Separately, in June next year Tattersalls' agreement with Qld racing expires and will need to be renegotiated. This too creates uncertainty around the amount Tattersalls will need to pay to continue to access racing content.

We continue to look for highly focused and passionate management teams who understand how to create shareholder value. The portfolio is currently positioned around the following themes:

- Offshore earnings ~ We have a cautious view of the domestic environment and we continue to seek out well managed companies with exposure to developing markets that should continue to grow and other developed markets that have reset and are now showing positive trends. (e.g. Brambles, Amcor, Fisher & Paykel)

- Structural growth ~ Companies with a strong position in an industry that has structural growth characteristics (e.g. air travel, healthcare, content) or has a small market share in a large industry with a differentiated value proposition that allows them to increase market share. (e.g. Fox, TPG, Auckland Airport)

- Turnarounds ~ We believe that companies and industries go through hubris to humility cycles, i.e. they go from periods of excess confidence that generally lead to value destructive behaviour (e.g. over-priced "big bang" acquisitions, large pro-cyclical capex plans, entering new non-core business segments or geographies, excess leverage) to periods of inner reflection and more modest ambitions. This transition is typically accompanied by a "reset" event (e.g. new management team, new capital structure, industry rationalisation/consolidation, efficiency savings/reset of cost base). Such periods can be extremely painful for pre-existing shareholders but can provide an attractive opportunity for new shareholders. We also like Government to private turnarounds and demergers. (e.g. Fletcher Building, Aurizon, Macquarie Bank)

- Stalwarts ~ Companies with a long corporate track record, focused business model, very conservative balance sheet, attractive growing dividends and growth options. (e.g. Telstra, Woolworths, Sky TV)

We maintain significant under-weight positions in resources (~10% underweight) and banks (~10% underweight).

Stock News

Transpacific Industries (TPI) once again made the headlines during the quarter with its major private equity shareholder Warburg Pincus selling down its entire ~34% shareholding in the company. TPI also announced that it is looking to divest its NZ business. While being somewhat cautious about buying stock off a very savvy insider, our significant work on the company and industry over the past 2 years gave us confidence to participate in the sell down. We believe that the decision to sell its mature NZ business is a very positive development – it is likely that TPI will achieve a good price which will provide good read-through value for its Australian business and its balance sheet will move to an under-leveraged position allowing TPI to invest for growth and reinstate ordinary dividends for the first time in many years.

After downgrading profit expectations at the end of June, ***Caltex (CTX)*** confirmed our faith in its marketing business late in December by providing full year profit guidance that implies the marketing operations will achieve 8% year on year EBIT growth in the second half. This is a very solid outcome given the step-up in competitive intensity in the industry and soft domestic economic conditions which speaks to the durability of earnings of this business. The journey from a volatile refining business to a "boring" fuel marketing business remains on-track.

Telstra (TLS) continues to produce incrementally positive shareholder news – during the quarter it announced the sale of its non-core Hong Kong mobile business CSL for US$2.4bn (trailing EBITDA multiple of >9x; TLS proceeds A$2bn) and the IPO of its Chinese on-line automobile business Autohome (TLS retains a ~A$2bn shareholding which was not fully captured in most sell side valuations). The sale price for CSL, in what is a far more competitive market than Australia, helps to confirm our positive view of TLS's domestic mobile business. Additionally, the transaction further strengthens Telstra's balance sheet – it now has one of the strongest balance sheets in corporate Australia with significant latency. Market consensus believes that TLS is "fully valued" – we continue to take an opposing view.

TPG Telecom (TPM) announced the acquisition of AAPT from Telecom NZ for $450m. AAPT has a significant complimentary infrastructure network including 11,000km of fibre and 15 data centres across the country. AAPT was the last remaining opportunity for consolidation of significant telecommunications infrastructure in Australia. The price paid was undemanding at 6.4x EBITDA (will increase net debt/EBITDA to a manageable 1.2x and given the highly cash generative nature of the business the debt should be fully extinguished within 2-3 years) and the opportunities for synergies will be significant given the similar nature of the businesses and TPG's relentless focus on costs (TPG's labour/overheads represent 14% of revenue vs 40% for AAPT). The enhanced infrastructure footprint will further increase TPG's ability to be highly disruptive to the incumbents in fixed line broadband.

In October ***Dexus Property Group (DXS)*** and the ***Canadian Pension Plan Investment Board (CPPIB)*** announced a bid to purchase ***Commonwealth Office Fund (CPA)*** using cash and DXS scrip. A month later the DXS consortium increased their bid and received a recommendation (assuming no other higher offer) from the Responsible Entity of CPA that shareholders accept the bid. On 19th November GPT announced a competing bid for CPA, also using cash and scrip. Subsequently the DXS consortium again raised their bid, with the market waiting to see whether GPT would also increase its bid. On 6th January GPT announced that its wholesale funds had entered into binding memoranda of understanding with the consortium and CPPIB to acquire either whole or part interests in four office assets and one retail asset, for a combined value of approximately $1.2 billion.

As a result of these actions CPA has been the best performing property trust over the calendar year increasing in price (plus distributions) by 29%, while the bidders returns have been very weak. Over the year GPT's return was -0.7% and DXS's return was 5.1%, both well below the property sector return of 7.1% and the overall market return of around 21%.

We believed that GPT was making a strategic error in pursuing CPA and that it would be exacerbating this error if it continued in a bidding war with the DXS consortium. So we are very pleased that on 14th January GPT announced that it will not increase its bid, effectively walking away from the CPA transaction having secured $1.2 billion of assets for their funds management platform.

GPT has spent a number of years regaining its pre-eminent position and it has now established a fortress balance sheet. We believed that it would have been inappropriate to give up this position over such a large but marginally earnings accretive transaction. We were encouraged by some of the commentary in the announcement around the focus on total returns for shareholders, in particular; "it also means issuing or buying back equity when value can be created for security holders, and not relying on increasing debt in a low interest rate environment to enhance short term earnings at the expense of long term total return."

On the 9th of December ***QBE*** announced a large earnings downgrade for the 2013 financial year which was centred on increases on prior year claims reserves in the US. It also announced an increase in risk margins, goodwill and intangible asset write downs and further restructuring charges relating to parts of the US business. Given the downgrades QBE had made over the past couple of years and the assurances that it had properly addressed the claims reserves issue, the latest downgrade was a body blow to confidence and the share price fell by 21% over the December quarter.

There have been a number of changes to the Board and senior management of QBE and a complete change of management in the US business. The capital ratios are satisfactory and the regulatory capital ratios should quickly improve as some business is in run off and QBE will be retaining nearly all its profits over the next year.

There is a strong value proposition for QBE at the current share price if the business operates within the broad metrics QBE has set, however, given the inherent opacity of insurance company's balance sheets and income statements it is hard to have high levels of confidence especially given QBE's poor track record in the past few years. Without putting too much weight on the macro situation, it would be good for QBE's share price if the A$ continued to fall and if shorter term interest rates started to rise; of course currency and interest rates will not help much if management cannot execute the current plan.

The results of the three major banks who reported during the quarter were in line with expectations. The quality of the banks' loan books continue to improve and it would be surprising if bad debts jumped during 2014. Tier 1 capital ratios have increased to the point where all the banks are reporting that capital is not a constraint on lending. Whilst lending growth continues to be low (3.8% system credit growth for the 12 months to November 2013) the banks will be able to continue current dividend payout ratios in the 70 to 75% range and keep providing the majority of franking credits to the market.

On the 23rd of December, APRA released its framework for dealing with systemically important banks in Australia (D-SIB). The four major banks are included as systemically important whilst Macquarie and the regional banks will not be treated as systemically important. APRA has determined that there will be an additional 1% capital requirement for these banks however it also noted that these banks are currently holding significant management buffers of capital and that they will be able to utilise a portion of these buffers to meet the increased capital ratios. APRA also noted that the banks have strong capital generation capability. In short the new D-SIB requirements will not be a significant drag on banks' return on equity.

International Trips and Market Observations

During the quarter we visited the US to meet with portfolio companies and to further research two industries – the document storage industry (see section above on Recall) and the scrap steel industry. In an environment where it is difficult to uncover value across the market, Sims Metal Management (SGM), the world's largest scrap steel recycler, is trading near all-time lows compared with its tangible asset value and therefore warranted a closer investigation.

In short, the US scrap steel industry (60-65% of Sim Metal's revenue and asset base) is super-cyclical, super-competitive, has very few barriers to entry and is facing structural oversupply issues that don't appear to be abating. The industry is reliant on a strong rebound in consumer confidence and employment growth to generate more post-consumer scrap, neither of which is rebounding quickly. With this industry backdrop, and given that there is no clear advantage in being the largest player in the industry, it is likely to be a tough road ahead for Sims Metal. However, with a new CEO who is more operationally focused, opportunities for more cost-out and a modest valuation, Sims Metal is a stock that we continue to monitor closely.

Although we are principally bottom-up fundamental investors, we think it is important to also understand the macro factors at play as they relate to the earnings power and competitive position of our portfolio companies. As such, the macro insights we gained from the trip include:

- Limited/no evidence of the financial market recovery hitting the "real world" – life remains extremely tough in middle America with the overhang of the debt fuelled consumption binge over the past 20 years likely to persist for the foreseeable future.
- Expect to continue to see low growth, high unemployment and a lack of consumer confidence for a while yet – the “non-recovery recovery” was the best description of the current environment that we heard.
- Huge efficiency drive by corporate America – looking to increase the productivity of existing workers rather than hiring new workers leading to the so-called "jobless recovery".
- Housing "recovery” has been a relative bright spot but has come from very depressed levels – it will be interesting to see if starts can recover back to the long-term average of 1.5m (from ~1m today) in the medium-term given the points above and the impact of rising mortgage rates as the Federal Reserve begins to taper its quantitative easing program.

We also visited New Zealand for the third time in 2013. We met with a variety of industry, government and regulator contacts in Wellington and Auckland, focused on our positions in Z Energy (ZNZ), SkyTV (SKT) and Fletcher Building (FBU). Key insights included:

- Housing affordability is shaping up to be the #1 election issue in 2014.
- Fletcher Building is ultimately part of the solution for lower cost housing in NZ via larger scale developments such as its recently completed Stonefields site.
- The risk of any severe adverse policy or regulatory outcomes against both SkyTV and Fletcher Building appears to be low.
- There are likely to be some policy measures to try to increase competition in certain building materials; specifically plasterboard.
- The Government does not have concerns with Fletcher Building’s vertical integration.
- Z Energy continues to be highly focused on building out its leadership position in the fuels marketing sector via strong price signalling and building out new sites – there is limited competition from its major competitors for new sites.
- The NZ economy is in a very strong position and is likely to be one of the fastest growing developed economies in the world in 2014.