CI AUSTRALIAN EQUITIES FUND
QUARTERLY COMMENTARY REPORT

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

For current performance information please refer to the Monthly Performance Report.

December 2016

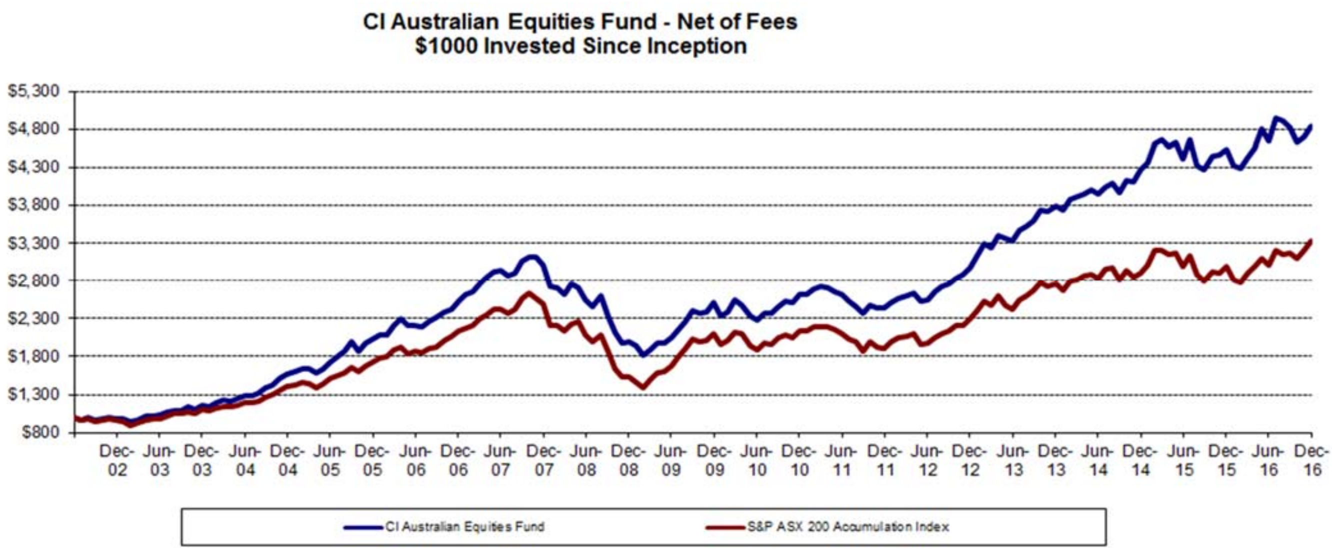
"The measure of intelligence is the ability to change." Albert Einstein

"The more we learn about the world, and the deeper our learning, the more conscious, specific, and articulate will be our knowledge of what we do not know" Karl Popper

"… we'll be jumping from eight billion Internet-connected devices today to fifty billion by 2025, and to a trillion a mere decade later. We like to think that thirty or forty years into the Information Revolution we are well along in terms of its development. But according to this metric, we're just 1 percent of the way down the road. Not only is most of that growth still ahead of us, all of it is." Ismail, Malone and van Geest, Exponential Organizations

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	0.48%	5.18%	-4.70%
ROLLING 1 YEAR	7.76%	11.80%	-4.04%
ROLLING 3 YEAR	10.02%	6.59%	3.43%
ROLLING 5 YEAR	16.09%	11.84%	4.25%
ROLLING 7 YEAR	11.02%	6.85%	4.17%
ROLLING 10 YEAR	7.85%	4.53%	3.32%
SINCE INCEPTION*	12.72%	8.66%	4.06%
SINCE INCEPTION^	467.21%	233.46%	233.75%

*Annualised
^Cumulative (4 July 2002)
**Before fees and expenses
#S&P ASX 200 Accumulation Index



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Market and Portfolio Performance

The ASX200 Accumulation Index performed solidly in the December quarter (+5%) finishing the 2016 calendar year returning 12%.

The portfolio underperformed the index both in the December quarter and the 2016 calendar year. This underperformance was as a result of some stock specific issues set out below, while a significant portion of the portfolio's underperformance relative to benchmark for the quarter can be attributed to the underweight positions in both resources and banks, both of which performed strongly during the quarter and which we discuss in more detail further on in this report.

In many ways the equity markets performance during the quarter was a tale of two periods, marked by the election of Donald Trump as the next President of the US. Similar to "Brexit", President Elect Trump's election had not been widely anticipated, particularly by mainstream media. In many ways the election spoke to issues consistent with "Brexit", resonating with individuals impacted by globalisation and international trade.

Prior to Mr Trump's win, the S&P/ASX 200 had fallen -5% since the 1st of October. It subsequently rallied +10%, with many global markets also rallying strongly. This reflects expectations that the new US Administration will be pro-business, result in stronger economic growth and, if not outright inflationary, will at least result in higher inflation outcomes than were previously anticipated.

In addition to the election, the other significant event was the well flagged increase in US rates made by the US Federal Reserve. The Fed also outlined a series of anticipated rate rises for 2017. While this suggests the US is now in a rate hardening cycle, it is not yet evident that Australia is as well. It is unclear what a decoupling of US/Australian rate cycles would mean.

This combination of events supported an improved outlook for Australian banks that could stand to benefit from a rising rate cycle, at least in the near term (improved outlook for margins). These events also supported the ongoing recovery in commodity prices and the resources sector more broadly, from now what appears to be trough levels in early 2016.

Key contributions to portfolio performance during the quarter included **Sims Metal Management (SGM)** (improving industry backdrop combined with management execution of cost reductions), **BlueScope Steel (BSL)** (rising steel prices and supportive earnings update provided at AGM), and **Macquarie Group (MQG)** (strong first half result).

Portfolio stocks that performed poorly were **TPG Telecom (TPM)** (continued weakness after delivering weaker than expected FY17 guidance and a potentially heavy capital investment program for mobiles in Singapore and Australia), **Ramsay Healthcare (RHC)** (concerns regarding industry growth rates sparked by a Healthscope guidance downgrade in October), and a number of our New Zealand holdings, including **Ryman Healthcare (RYM), Fisher & Paykel Healthcare (FPH,) Z Energy (ZEL) and Summerset (SUM)**. The New Zealand equity market significantly lagged the Australian market during the quarter, with the S&P/NZX 20 index falling 8%.

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The Portfolio

During the quarter we made some changes to the portfolio.

In November **Boral (BLD)** entered into an agreement to acquire Headwaters Incorporated for A$3.5b (US$2.6b). Headwaters is a US-based business that manufactures building products and is the leading marketer of fly ash (one of the most widely used construction materials in the US, mainly as a replacement for Portland cement). Headwaters appears to be a highly complementary US business for Boral given product and geographic overlap, as well as providing greater exposure to an improving US residential and infrastructure cycle that is still in recovery phase.

While we were expecting Boral to make an acquisition in the US, the size of the deal was substantially larger than we had anticipated. The acquisition price looks full at 10.6x EV/EBITDA but will be more reasonable at 7.5x EV/EBITDA if the targeted US$100m of synergies are delivered. It is clear that for this deal to stack up Boral needs the US recovery to continue as well as full synergy capture. The acquisition is expected to complete mid-2017 pending Headwaters' shareholder approval and US antitrust review. The portfolio participated in the capital raising that was undertaken to fund the acquisition, increasing the portfolio's exposure by around 1%.

We sold our position in **AMP (AMP)**. Although we continue to view AMP as having a significant opportunity to leverage its brand and inherent latency in the business, we have been disappointed by management's ability to get their arms around the issues facing the company and provide a clearly articulated plan for the longer term strategic direction of the business. The recent change in the Chair adds a further disruption to the company that is facing a number of headwinds, particularly in the protection operations.

Stock News

Early in the quarter **Caltex (CTX)** announced that they were bidding for the Woolworths' (WOW) fuels business as well as disclosing that their 10 year contract to supply Woolworths' service stations was dependent on their continued ownership by Woolworths. This potential loss of the Woolworths volumes was not previously known to the market and, as it subsequently became clear that Caltex were not the preferred bidder for the Woolworths business, the Caltex shares were sold down heavily. Woolworths has since announced the sale of the fuels business to BP for $1.785 billion.

The loss of the Woolworths' contract and strategic alliance will result in a substantial drop in Caltex's earnings in 2018. Our analysis shows that the loss of these earnings is more than reflected in the current share price, with the market discounting the stock due to the uncertainty associated with the loss of these volumes. We anticipate that the company will be able to replace a significant portion of these earnings through both acquisitions (albeit having to deploy capital to do so) and cost reductions. We would also strongly encourage management and the Board to pursue options to return to shareholders the franking credits that currently languish on the Caltex balance sheet.

In December the Commonwealth Government issued **Sydney Airport (SYD)** with a Notice of Intention (NOI) setting out the main terms for the development and operation of the Western Sydney Airport (WSA). Sydney Airport has a first right of refusal but not an obligation to accept the NOI. The project timetable outlines that earth moving works will commence by late 2018 with airport operations to start by 2026. Estimates are that the first stage would cost up to $5 billion, which would include a 3,700 metre runway and a terminal with capacity for 10 million passengers per annum.

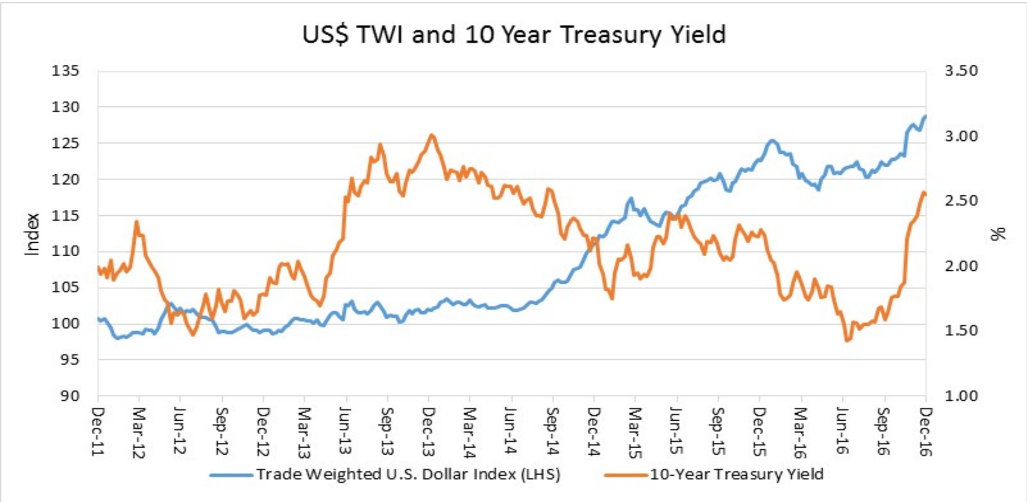
Sydney Airport will be required to fund all of the construction of WSA without any Commonwealth Government funding or cost protection. We understand this is a significant departure from what management were expecting based on their consultation with the Commonwealth Government over the past two years. Sydney Airport stated that this change of approach makes WSA a "challenging investment proposition". We see it as a key risk that Sydney Airport proceeds with the project in order to keep a competitor out of its catchment rather than because it is a value accretive opportunity and we will continue to monitor this.

After a number of false starts an agreed merger between **Tabcorp (TAH)** and Tatts Group (TTS) was announced. Tabcorp is paying a premium to Tatts shareholders to secure the transaction. As we wrote last time this merger was mooted, we believe the merger to be beneficial for both companies and will yield potentially large value enhancing synergies both with regard to costs and also national branding and pricing. The combined group will be an attractive investment proposition with a strong franchise, strategically well positioned to face the competitive threats in the industry, and have high cash conversion. That said, Tabcorp are paying a relatively full price and will need to execute the merger well to justify the price they are paying, let alone see value accretion.

The transaction requires approval from a number of regulatory bodies, of which the ACCC is likely the most onerous. Additionally, later in the quarter Tatts received a competing takeover offer from a Macquarie led consortium which was later rejected by the Tatts' Board due to it not being superior to the Tabcorp proposal. We may not have heard the end of this one, but would urge the Tabcorp Board to remain focussed on shareholder value through this process.

Market Observations

The surprise election of Mr Trump in the US has been assessed by markets, at least at this stage, as being an inflection point, with investment markets reflecting a more positive outlook towards economic growth and more inflationary environment through higher interest rates and a stronger US$ post the election (see chart below).



Source: Federal Reserve Bank of St. Louis

In part this appears to reflect expectations that the new President will:

1. Lower taxes
2. Increase spend on infrastructure
3. Remove red tape/ regulation.

While still too early to draw conclusions, we would observe that there are already signs (based on appointments to the incoming Administration) that Mr Trump's presidency will be more favourable to Corporate America, although what this would mean for others is less than clear. It may be an instance of what is good for America is not good for the rest of the world. In particular, a key issue for both China and therefore Australia is the potential impact of any changes made to US trade relations.

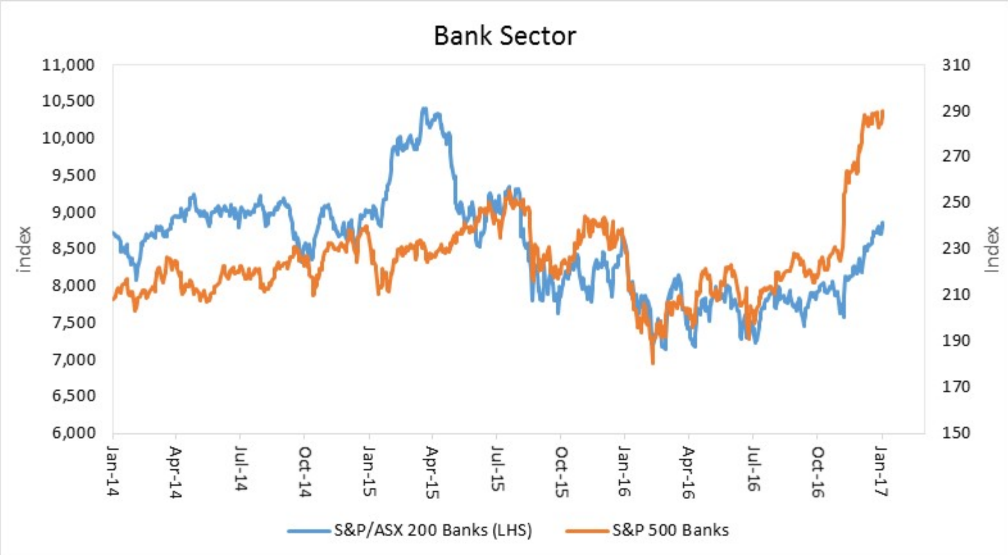
Whether or not a Trump presidency will prove to be reflationary for the US economy will be as much about psychology as economics. Can enough be done to unleash the animal spirits of American business, which in recent times has been more focused on capital preservation and returning capital to investors than on capital investment? A sustained increase in optimism and investment across both small and large firms will require at least some of the rhetoric becoming reality, a meaningful reduction in regulation and taxes would be a good start. With a Republican Congress and President it is a reasonable expectation that America is in a better position to actually implement policy changes and that these are likely to be more pro-business relative to the recent past. Whether this will be sufficient to satisfy both Mr. Trump's electoral base and already elevated market expectations remains to be seen.

One cautionary note that is worth adding to the more optimistic view is the risk that the higher economic growth expectations of the market undermine the potential for this to become a reality, at least in the short term. The higher US interest rates and US$ that we have seen since the election will put an increased burden on both US households and exporters. Given the high level of indebtedness and consistent below trend growth seen in the US since the last recession, these moves have the potential to have more pronounced consequences than seen in previous cycles.

On top of this, it is difficult to see how more protectionist policies, such as raising import tariffs, will be a positive outcome for American economic growth in the longer term, particularly when taking into account the likely reactions from key trading partners.

What this all means for Australia is even more uncertain, although it is likely that we will see a stark contrast between the political and policy paralysis in Canberra and a more dynamic, pro-growth and pro-business America. This is perhaps highlighted by the latest GDP data for Australia that showed real GDP falling (-0.5%) in the September quarter for the first time since the March quarter 2011, with year-on-year growth slowing to the slowest pace since the financial crisis (+1.8%).

The above is mentioned to make the point that the rally in the Australian bank sector seen in the last quarter was a global phenomenon led by US banks which rallied 31% (see chart below) and not a result of a pronounced change in the outlook for the earnings of the sector.



Source: Factset

The rally in US banks is in part due to more pro-growth positioning by market participants and the view that banks will benefit from a steepening yield curve, as well as the anticipation of a reversal of the increased regulatory burden seen in the US. Although this may be the case in the US, Australian banks will see limited direct benefit from much of this and we remain cautious on the outlook for lending growth, and thus earnings growth, for the sector here in Australia. That, combined with full valuations and a bad debt cycle that remains near historical lows, means we remain sceptical of sustained outperformance by the Bank sector from here, with risks on a longer term basis skewed to the downside.

The resources sector finished the year with a solid performance, returning 9% in the December quarter, which saw the sector outperform the S&P/ASX 200 by 31% for the 2016 calendar year. Having discussed the performance of resources in some detail in our last quarterly, we will just make two points here.

First; though the proposed US$1 trillion of infrastructure investment over 10 years, proposed by Mr. Trump, is a meaningful amount in a US centric context, it pales somewhat relative to the near US$2 trillion (Rmb13.6 trillion) spent in China in the 11 months to November 2016, itself an increase of 17% or US$287bn (Rmb2 trillion) over 2015. China will continue to be the critical demand source for key mined commodities for some time and the impact on China of an increase in US based trade protectionist policies will need to be monitored closely.

Secondly; although we continue to look for opportunities within resources and commodity exposed industries, we remain focused on implementing our investment philosophy. A critical part of this is finding and backing the best management teams. These are “best in breed” managers when it comes to focused management behaviour (the “F” in our “VoF” investment process), which is particularly important to sustaining a company’s performance over the longer term. Unfortunately, it is this criterion that most resource companies have historically failed to meet.

However, it is also fair to say that the current set of management teams in the resources sector still have the excesses of the recent past firmly embedded in their corporate memories (at least for now) and are both espousing and exhibiting more capital discipline than has been evident in the past. This in itself is not unusual behaviour for this stage of the cycle, but with a newfound focus on returns and cash generation, the sector is likely to be heading into an extended period of more focused management behaviour, which may produce more investment opportunities.

Trip Notes

We spent time in the US revisiting our investment thesis on **News Corporation (NWS)**. With a backdrop of traditional media formats such as newspapers and magazine inserts remaining under significant pressure, it is hard to see News Corporation's News & Information division growing revenue over the medium term. However, we do not believe this segment is worthless which is demonstrated by its current (albeit falling) free cash generating capability and growth in digital subscriber numbers in its key mastheads. Although the earnings outlook is tough for this segment we believe it will reach an inflection point over the medium/longer term where growth in digital revenue will offset the fall in print revenue. In the meantime our analysis suggests that very little value is being ascribed to the segment.

While we saw numerous newspaper executives, a key reason for the trip was to better uncover the optionality within News Corporation's United States digital real estate business, Move. Move is the number two player to the dominant Zillow Group, in terms of users, in what remains an early stage market for online offerings. Following our meetings we came away seeing Move as a strong and credible number two which has created value for shareholders (and should continue to do so) since News Corporation acquired it. With further top and bottom line growth and News Corporation providing more transparency around Move's key operating metrics over time, we believe the business offers upside to the valuation of the wider group.

We have high regard for News Corporation's book publishing business which currently owns Harper Collins and Harlequin. Although earnings will swing with hit releases, we do not believe this industry is in structural decline. To the contrary, we view it as a steady growth business over time, run by a management team that impressed. It is also a potential source for deployment of the $1bn+ net cash that News Corporation has on its balance sheet.

Our recent visit to Perth highlighted that the recovery in commodity prices is yet to have a material impact on the WA economy. CBD office space continues to run at very high vacancy levels (25%), with a number of major office buildings still yet to be completed. West Perth is also problematic with some businesses using the downturn as an opportunity to move from West Perth to the CBD.

Detached housing approvals continue to fall (to 13k based on the October run rate) to levels below mid-cycle (probably closer to 15-16k). Meanwhile some large miners are still making redundancies. That said, the improvement in commodity prices seen in the last year has assisted many of the marginal producers to stay in business and a number of players with stronger balance sheets have managed to make some investments at what appears to be the bottom of the cycle.

One contractor described the current environment as being akin to that seen in the pre-boom years, i.e. back to normal. This can be seen in the ABS data (see chart below), where mining investment has more than halved from the capital expenditure binge seen earlier this decade. The base going forward will be higher than that seen in the early 2000's due to the higher production base that needs to be maintained. We are likely to be approaching a new normalised level, with the remaining expansion projects initiated during the boom years winding down over the next year.

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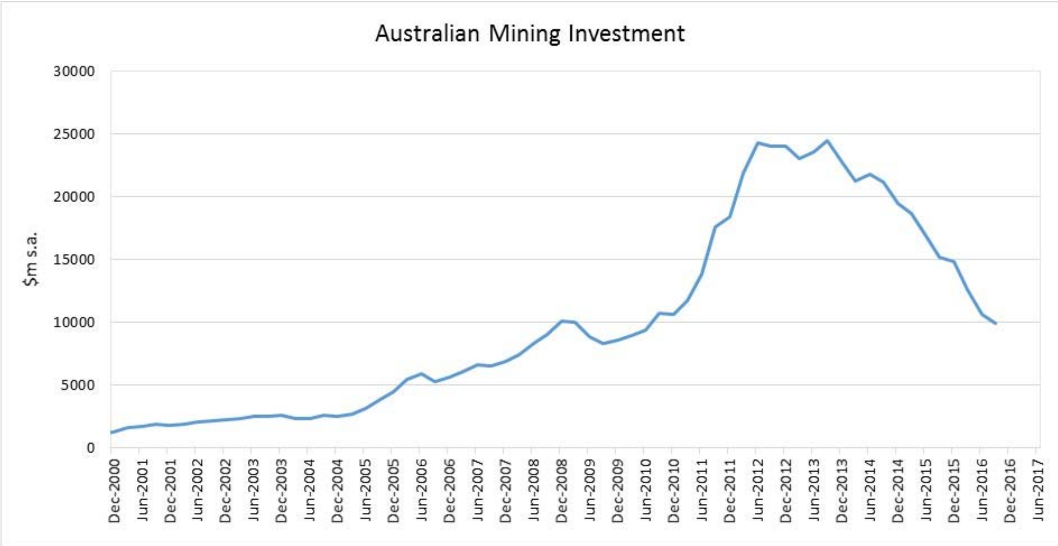

Source: Australian Bureau of Statistics