CI AUSTRALIAN EQUITIES FUND
QUARTERLY REPORT

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

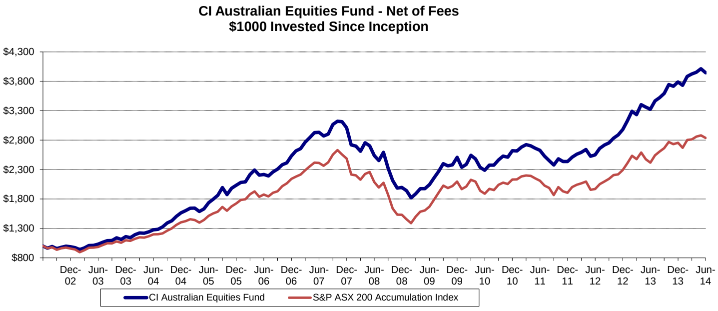
JUNE 2014

"Yesterday is gone. Tomorrow has not yet come. We have only today. Let us begin." Mother Teresa

"The only true wisdom is in knowing you know nothing." Socrates

"I'm not young enough to know everything." J.M. Barrie, The Admirable Crichton

	****PORTFOLIO**	**#BENCHMARK**	**VALUE ADDED**
ROLLING 3 MONTH	0.70%	0.93%	-0.23%
ROLLING 1 YEAR	19.79%	17.43%	2.36%
ROLLING 3 YEAR	15.59%	10.37%	5.22%
ROLLING 5 YEAR	15.01%	11.20%	3.81%
ROLLING 7 YEAR	5.31%	2.34%	2.97%
ROLLING 10 YEAR	13.10%	9.01%	4.09%
SINCE INCEPTION*	13.28%	9.08%	4.20%
SINCE INCEPTION^	345.93%	183.75%	162.18%



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

Market and Portfolio Performance

The Benchmark Index rose by 0.93% over the quarter and by 17.43% over the fiscal year. This makes the second strong annual rise in succession for the market which has now gained 20.08% p.a. since 30 June 2012. The portfolio returned 0.70% over the quarter and 19.79% over the year.

Strong portfolio performers over the quarter included Oilsearch, GPT and Sky TV. In contrast, weaker performers included Magellan, TPG Telecom and QBE.

In our last quarterly we stated that we expect the current "grind it out" economic environment in Australia to continue for a while. Nothing has caused us to change our minds on this view. There appeared to be some weakness in confidence following the first Coalition budget and this was borne out by the rash of earnings downgrades seen through May and June, especially in the retail sector (RCG Group, Reject Shop, Pacific Brands, Super Retail, Kathmandu) and mining exposed companies (Bradken, Tox, Ausdrill).

The spurt of listings continued through the last quarter with another 10 companies coming onto the market, a number of them coming out of private equity hands, making a total of more than 30 for the past twelve months. The amounts raised on listing varied for example, just under $1B (Spotless) down to $90m (Gentrack), and over the year only one listing raised more than $1B. In an environment of low interest rates, a strong equity market, and investors looking for new alternatives, the timing is proving a boon for private equity wishing to exit at a profit. The two largest floats are likely to come over the next six months – Healthscope and Medibank Private – and this will be a stronger test of market appetite.

We note that the most talked about great crashes didn't happen in fiscal 2014; Chinese economy, global bond prices, Australian housing, the AUD.

JUNE 2014

China remains all important to the fortunes of the Australian market. The Chinese premier Li Keqiang recently stated that "we will not take short term and forceful stimulus measures in response to economic fluctuation". We think that the central government wants a modest but stable growth rate in order to buy time for their reform initiatives. This does not imply a stall in fixed asset investment or a reduction in government spending on key infrastructure projects. Between January and May this year the local government of 15 provinces announced infrastructure projects totalling 18trillion RMB (3 trillion AUD).

This round of "micro stimulus" will place greater emphasis on sustainable growth and risk management. We expect to see more "reform compatible investments" in industries such as transport, logistic, energy, water treatment, health care and environmental protection. In June the State Council stressed the importance of "completing target growth rate for the year" and is working closely with local governments on rolling out resource reallocation policies, one being the much anticipated SOE reform. It is clear that growth from China in the next few years will still be investment driven and managed by government, albeit market forces will have a greater influence on how decisions are made. We believe a major hurdle faced by the Chinese economy in transition to a consumption driven model is the dispersion of income and growth rate between regions of the east and west, urban and rural which needs to be addressed. Transitions are never easy and we acknowledge that the dividend of such reform policies could take years to surface.

The Portfolio

"It was never my thinking that made the big money for me, it always was sitting." Jesse Livermore

We had a quiet quarter in terms of portfolio movements. During the quarter we participated in the float of **Spotless Group (SPO)**, the only addition to the portfolio. Spotless had been taken over by private equity (PEP) in 2012, so it has been a relatively quick turnaround. On listing PEP retained 35% of the company.

- Spotless provides largely essential services under long term contracts with a wide diversity of customers.
- A large proportion of the revenue is government backed. Large scale government contracts require scale, expertise and expense to win at tender – thus there are not insignificant barriers to entry to this part of the business.
- Although we do not believe there is much scope to improve margins, there are a number of revenue growth opportunities of which we expect the company to win a proportion.
- Management and private equity have retained a large number of escrowed shares (40%) and are thus incentivized to do well. CEO Bruce Dixon took Healthscope from a small company to a market cap of over $1.5B. Prior to becoming CEO at Healthscope he was at Spotless so knows the business very well.
- The stock is trading at a sub-market multiple and at a discount to our assessed value. New contract wins should narrow these discounts.

Stock News

A number of stocks in the portfolio made significant announcements during the quarter. One of these was **Ramsay Healthcare (RHC)**. On 2nd May the company announced that founder, Chairman and major shareholder Paul Ramsay had passed away. His shareholding was passed to a charitable foundation. A new Chairman (Michael Siddle) was put in place. Michael has been on the board for many years (and Deputy Chairman for the last 17 years) so there is no loss of continuity of knowledge or strategy. Shortly thereafter the company announced the acquisition by Ramsay and its French partner (Credit Agricole Assurances) of 83% of the issued capital of the listed hospital company Generale de Sante (GdS), with a tender offer to be made for the balance of the shares. The acquisition will make Ramsay the largest private hospital operator in France. Ramsay is paying an EV/EBITDA multiple of less than 8X, and the acquisition will be earnings per share accretive immediately. However given the amount of depreciation incurred by GdS, the initial return on acquisition price is approximately 7%. Ramsay have been very successful in achieving returns of 15% or above on its Australian brownfield expansion program so this appears low by comparison. Ramsay are confident of achieving a return of 15% on the acquisition of GdS, but over a number of years. This will require the achievement of significant synergies, procurement benefits, operational improvements and potentially further consolidation of the sector.

Having implemented management changes last year, **National Australia Bank (NAB)** went further this quarter and announced that CEO Cameron Clyne would be departing in August 2014, to be replaced by Andrew Thorburn. Andrew has been running the Bank of New Zealand since 2008. Prior to then he was Executive GM NAB Retail and Chairman of Great Western Bank, and was with St George Bank and CBA prior to joining NAB. Andrew has clearly had a lot of banking experience – we hope he has the courage and tenacity to make the decisions and execute on the initiatives required to take the bank forward. In addition NAB announced the appointment of Peeyush Gupta to the board recently. Mr Gupta has had a long career in the funds management industry in Australia, primarily with IPAC, an AXA business. We view this appointment as a positive as it adds to the Board's capability on wealth management. The NAB wealth business has been a long term underperformer, as such the addition of a well credentialed Board member and a new business manager may increase the possibility of better returns from this important NAB division.

Recall (REC) has continued to demonstrate renewed focus and energy post its demerger from Brambles. The company announced its largest acquisition since the demerger being the $47m acquisition of CitiStorage in New York, adding 3% to group profits and continuing the consolidation of the fragmented US document storage industry. Later in the quarter Recall announced a facility optimization program whereby the company will consolidate its facilities in the USA over the next twelve months, improving utilization by 3% and lifting margins.

Fisher & Paykel Healthcare (FPH) announced a very strong full year result, growing by 26%. This included 15% revenue growth and margin expansion as the benefits of its manufacturing facility in Mexico, and reinvigorated research and development program began to take visible effect. The company is growing its market share in the sleep apnea space, and continuing to open new markets in its respiratory business.

Brambles (BXB) acquired Transpac International during the quarter. Having withdrawn from negotiations to acquire Goodpack, a Singaporean container company, the company has now enhanced its containers capabilities in Europe and North America with this acquisition. Although not a large purchase (max Euro42m), Transpac will fit nicely into Brambles' existing operations.

Transurban (TCL) announced the acquisition of Queensland Motorways (QM) for $6.7B, and a $2.7B equity raising to fund the acquisition. The acquiring consortium comprises Transurban (62.5% interest), Australian Super and an arm of the Abu Dhabi Investment Authority. Although the consortium paid a high multiple (EV/EBITDA 20+X), the company believes there is substantial upside from:

- Increasing tolls;
- Tolling parts of motorways not currently tolled; and
- Improved operational efficiencies (QM earning an EBITDA margin of 69% compared to Transurban's other operations running at 80%).

Management continues to believe that its asset base of major roads will drive distribution growth of 10% p.a. in the medium and long term.

Aurizon (AZJ) and Baosteel joined forces to launch a $1.4B takeover bid for Aquila Resources, the owner of an undeveloped 40mt iron ore resource in WA. After a little noise thrown into the ring by Mineral Resources Ltd, it now appears that the Baosteel bid will be successful. If so, then Aurizon will end up having paid circa $210m for 15% of the acquired entity, effectively a fee to access work done on Aquila's WA iron project to date, and to secure an exclusivity period to develop an integrated multi user rail and port plan for the project. It is Baosteel's current intention to develop the mine and to use Aurizon's newly built rail and port infrastructure. The rail and port project is estimated to cost $5-6B. Aurizon has stated that it does not intend to be a long term holder of its stake in Aquila.

We remain suspicious of Baosteel's real motives in acquiring Aquila. We believe the low quality of its iron ore resource is such that at today's iron ore prices the project returns are likely to be sub optimal and we wonder if Baosteel has ulterior motives in this regard. We remain attracted to the ongoing operational improvements in Aurizon and step up in free cash flow from 2015 onwards – however the announcement makes us suspicious that shareholders may not see the real benefits from these effects.

International Trips and Market Observations

It was another solid reporting season for the banks with all players reporting higher earnings and dividends, driven by moderate revenue growth and declining loan impairment charges.

Revenue growth in the mid-to-high single digits was primarily due to improving credit growth offset somewhat by falling net interest margins. Whilst falling wholesale funding costs and lower competition for deposits are a positive for net interest margins, the aggressive competition on front book lending and customer preference for lower spread fixed rate mortgages has seen net interest margins continue to decline. The banks demonstrated good cost control with modest improvement in cost ratios.

Asset quality trends continue to improve with low interest rates and rising asset prices driving reduced rates of new impairments as well as write-back gains on previously provisioned exposures. This culminated in another period of significant declines in bad and doubtful debt expenses, highlighted by lower net write-offs and lower collective provision coverage. We think that in the current environment these positive asset quality trends are likely to continue.

Banks will need to keep building capital to meet the new APRA Domestic Systematically Important Bank (D-SIB) capital buffer and the requirement to remove double-gearing from within their wealth management subsidiaries. We think these new capital requirements are very manageable given the banks generate a lot of organic capital and their dividend reinvestment programs are another ready source of capital.

The recent May 2014 APRA banking statistics and RBA credit aggregates showed that credit growth in May 2014 was 4.7% on an annualised basis. Housing lending grew at 6.2%, driven again by investor lending growth of 8.5% and more subdued owner-occupier growth of 5.2%. Business lending growth remains low at 2.8%, but improved slightly from April. Credit growth seems to be making a slow and steady recovery, consistent with our company and industry feedback.

Over the last 6 months NAB has seen the largest increase in housing lending market share followed by ANZ, with CBA and WBC both losing ground. NAB lost the most market share in business lending over the last 6 months, which underpins the revenue pressure they are seeing in their core business banking franchise, with the other major banks gaining share over this period led by WBC and ANZ. While deposit market share continues to be dominated by CBA and WBC, NAB has gained the most market share over the last 6 months in an effort to improve their funding composition and be ready to meet APRA's LCR requirements.

Macquarie Group (MQG) presented their FY14 result in May and delivered a significant increase in profits (EPS +53%) and dividends (DPS +30%). Eligible shareholders also received a Sydney Airports distribution in January 2014 comprising a special dividend of A$1.16 (40% franked) and a return of capital of A$2.57 per share.

Pleasingly, operating trends across all divisions were positive, in particular for the Macquarie Funds and Fixed Income Currencies and Commodities (FICC) businesses, which grew their net profit contributions by 39% and 29% respectively.

Two-thirds of the Group's net profit contribution now comes from annuity style businesses, being Macquarie Funds, Corporate and Asset Finance, and Banking and Financial Services. These annuity businesses deliver reliable earnings streams (that grew by 26% in FY14) and collectively earn a 20% ROE, which is pretty good in our book. Macquarie's capital markets facing businesses, being Macquarie Securities, Macquarie Capital, and FICC, grew their combined net profit contribution by 68% in FY14 and delivered an ROE of 11%.

Management expect FY15 profit to be broadly flat on FY14 with upside if market conditions continue to improve. Factoring in the Sydney Airports distribution gain of A$228m in FY14 this equates to underlying profit growth of around 18% which is pretty reasonable. We note that capital markets activity is improving and that there is the potential for a significant lift in performance fees as a number of unlisted infrastructure funds are wound up and performance fees appear over the next few years.

Additionally, Macquarie Group continues to be well positioned from a regulatory capital perspective, which they expect will be an ongoing constraint for competitors, and could potentially throw up some opportunities for them. We think the outlook for Macquarie Group continues to be positive.

We visited the UK and the US (New York and Los Angeles) during late May and early June. One of the primary aims of the trip was to meet firms involved in the property market in the UK to establish whether the NAB's very large commercial real estate problem loans should now be consigned to the past or whether shareholders should contemplate further issues from this book of property loans.

We visited a number of firms involved in the UK property market including agents, accounting firms and investors. It was clear from our meetings that the commercial real estate market has improved significantly over the past six months.

A couple of years ago there was a large increase in demand for prime London trophy properties from mainly foreign capital, including sovereign wealth funds and mega wealthy individuals. Shortly thereafter contrarian funds became interested in London property and began to look for investment properties. These investors clearly initially stabilised prices in London and then pushed prices higher. Until mid 2013 there were very few buyers for properties outside London and very few buyers for non prime properties. However towards the end of 2013 the market outside Central London started to turn sharply as the demand pushed out from London into regional areas and also pushed out from prime properties into secondary properties.

One successful property investor described the change in the market over the past 18 months as follows: “We were able to buy a secondary shopping centre on a yield of 8%, there were virtually no other buyers for this property at the time. The property was purchased at a price 40% below its peak valuation. Financiers (and there were only 2 or 3 possible lenders) limited the gearing on the property to a 68% loan to valuation ratio (58% senior debt and 10% mezzanine debt) at an average interest rate of Libor plus 4.46%. The current market valuation of the property is based on a 7% yield and we have recently refinanced the property on an 80% loan to valuation ratio at an interest rate of Libor plus 2.9% (and there were 15 potential lenders).”

They are now looking to sell at a yield of 6.5% which will include some rental income growth. Taking into account the drop in yield, the drop in interest costs and the increase in leverage the return on their equity will be very high.

This success is being played out across many parts of the UK and is attracting further investors, albeit they will have missed the major move in the market.

The rise in property prices is not just a book entry, during 2013 there was a record transaction amount of £20b, of this amount foreign buyers accounted for 71% of the volume.

The NAB property book is spread across all markets outside London and is certainly not prime in nature, however it is clear that there are buyers of properties in virtually all UK markets and that there are also buyers of property loan books from banks. We therefore feel quite confident that the write downs of the NAB commercial real estate loan book have finished and the negativity around this issue should be consigned to the rear vision mirror by investors. A very good outcome would be write backs by NAB of some of its provisions on the UK property book, however we are not factoring this possibility into earnings estimates yet.

JUNE 2014

The turn in the UK markets is not confined to property, the equity market has now turned its attention to the potential upside from investing in previously distressed and unsaleable bank equity. There has been one or two successful sales of bank equity in the UK, as well as the listing of TSB Banking Group and the large number of capital raisings on the UK equity market suggest buyers may emerge for the entire NAB UK banking business.

We feel that investors should be contemplating the long awaited exit by NAB from the UK, and if this happens in the next year or two there would likely be a rerating of NAB.