CI AUSTRALIAN EQUITIES FUND
QUARTERLY REPORT

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

JUNE 2015

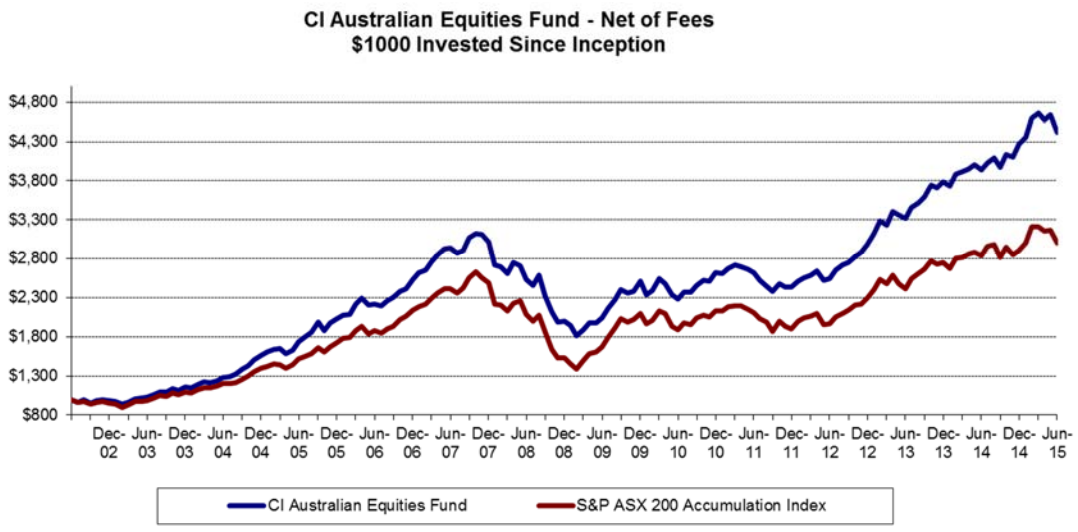
"We've arrived at a situation where a trillion dollars can vanish in a matter of minutes, even though the real world hasn't changed at all". The New Yorker's James Surowiecki.

"When debts are not paid because they cannot be paid, the best thing to do is not talk about them and shuffle cards again." Camilo Jose Sela.

"Across much of the world, too much weight is being put on monetary policy to try and achieve what it can't; a durable and sustainable increase in growth, in an environment where private leverage is already rather high or even too high." Glenn Stevens, Governor RBA.

	****PORTFOLIO**	**#BENCHMARK**	**VALUE ADDED**
ROLLING 3 MONTH	-5.06%	-6.55%	1.49%
ROLLING 1 YEAR	13.67%	5.68%	7.99%
ROLLING 3 YEAR	21.56%	15.07%	6.49%
ROLLING 5 YEAR	15.21%	9.69%	5.52%
ROLLING 7 YEAR	9.36%	5.29%	4.07%
ROLLING 10 YEAR	10.92%	7.08%	3.84%
SINCE INCEPTION*	13.31%	8.82%	4.49%
SINCE INCEPTION^	406.91%	199.85%	207.06%

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



Market and Portfolio Performance

After a very strong three years to March this year, the stock market suffered a fairly severe drop during the June quarter. The benchmark was down 6.55% for the quarter and the annual return fell back to 5.68%. The June 2015 quarter posted the worst quarterly return since the September quarter in 2011.

The Australian stock market was down significantly more than many other major world markets. The MSCI world index was only down by 0.3% over the quarter which suggests that, despite concerns around rising interest rates and Euro problems, the drop in Australia was more about stock specific issues.

The banking sector led the market down with the major banks dropping by around 10%, mainly in response to concerns about how much equity they would have to raise to meet expected higher regulatory capital targets. The other main drag on the market was the retail sector, led by Woolworths and Wesfarmers, whose prices fell by 8.5% and 10.3% respectively as operational problems (for Woolworths) and increasing competition emerged.

The main macro issues were the quite substantial increase in bond yields around the world and problems in the Greek economy. Fixed interest markets have been in a twenty year bull market that may have peaked earlier this year. Falling bond yields have been a strong support for rising stock prices generally, and if yields are indeed heading up that would have large implications for all sectors of the stock market. We wrote in the last quarterly about the unreality of interest rates around the globe as negative yields became widespread. Ultimately such rates are unsustainable, but it is difficult to predict when this will change.

Positive contributors to performance over the quarter included Macquarie Group (strong result) and Aurizon (apparent resolution of industrial issues paves the way for efficiency gains). On the negative side Sims Metal underperformed the market (industry scrap volumes continue to be poor) as did Fletcher Building.

The Portfolio

We participated in the $5.5b capital raising by National Australia Bank (NAB) in May. The capital raising was conducted through a 2 for 25 rights issue at $28.50. The raising was not a major surprise and it was generally well received by the market as it indicated that NAB is aggressively executing on its plan to exit low returning businesses and increase the emphasis on the core Australian and New Zealand banking businesses.

The portfolio now includes South 32 which was demerged from BHP in May. BHP shareholders received one South 32 share for each BHP share. Whilst South 32 will be a substantial company, its assets are really the ones that did not fit with BHP's focus on its core assets including petroleum, copper, iron ore, coal and potash. Since listing the share price of South 32 has drifted lower but has been roughly in line with other resource stocks.

We initiated a position in Wesfarmers (WES) during the quarter. We comment on the retail sector and its participants later in this report but reasons for buying WES in the portfolio include:

- Coles is the best positioned, and has the clearest strategy, of the three major supermarket chains to continue to prosper in a tough and competitive environment.
- Bunnings continues to dominate its landscape and can grow further.
- Liquor and Target are in the midst of turnarounds which we believe will bear fruit over time.
- The balance sheet remains in good shape.
- The stock is trading around what we perceive to be fair value with upside from ongoing profit growth and use of its balance sheet.

Risks come in the main from the potential entrant of a second discounter into the Australian grocery market (there are rumours the German discounter Lidl may enter), and we are mindful of succession issues at Bunnings in particular.

We sold the balance of our WOW position. We also sold Fletcher Building during the quarter. After a lot of debate we concluded that the company was unlikely to deliver the results we had expected.

Stock News

We remain comfortable with the operational initiatives Galdino Claro and his team at **Sims Metal Management (SGM)** are undertaking as they transform the business from what we viewed as a volatile scrap metal trader, to a metal and electronic recycling distribution business with an asset network that is highly valuable and difficult to replicate. However, macro conditions are currently against the company with scrap prices and volumes significantly weaker than prior years.

In this context we continue to meet with various industry participants to observe conditions and measure these against commentary from the company. While all our observations suggest the market remains weak by historical standards, we also view SGM as adhering to the adage “never waste a crisis”. With a robust balance sheet, excellent management and an asset network that offers significant competitive advantages, our analysis has strengthened our VoF proposition and we continue to see latent value which will be further enhanced if and when the cycle turns in the company’s favour.

Following a successful ruling from the Full Bench of the Fair Work Commission to terminate various existing Enterprise Agreements (EAs) in Queensland, **Aurizon (AZJ)** has struck updated EAs with its respective Queensland unions. This presents a significant opportunity for the company to improve its operating margins through initiatives such as rostering, head count, train time table management and better maximising returns from its current capital spend. As we analyse the challenges and opportunities ahead for the company, we have met with numerous industry participants ranging from Australian competitors to Australian regulators to Canadian comparative players. This has strengthened our investment proposition that AZJ is currently underperforming relative to its potential, with companies such as Canadian Pacific highlighting the margin and returns optionality for AZJ management now the prior restrictive EAs have been terminated.

We are further encouraged by the recent appointment of Mr. Tim Poole as Chairman. We believe that he will bring a fresh set of eyes in looking at how to maximise stakeholder returns through reviewing areas such as capital allocation, network value and existing corporate culture.

GPT announced the resignation of CEO Michael Cameron in April. It is expected he will leave GPT after its full year results in August to take on the role of CEO of Suncorp. Michael had a particularly successful period as CEO of GPT, including winning back the reputation of GPT as one of the country's leading property owners. We feel that there are a number of sound internal CEO candidates within GPT and we do not expect any significant change in strategy at the company.

Banks are having to increase their levels of common equity capital. ANZ, NAB and Westpac reported their half year results in April and they took differing approaches to the capital question.

As discussed above, NAB undertook a $5.5bn rights issue and also announced plans to demerge its Clydesdale Bank to existing shareholders and reduce its exposure to life insurance. Westpac underwrote its dividend reinvestment plan to $2b and also subsequently sold over $400m of its holding in BT Investment Management. ANZ included a 1.5% discount on shares issued under its dividend reinvestment plan that should result in a 20% participation in the plan and therefore build its capital position.

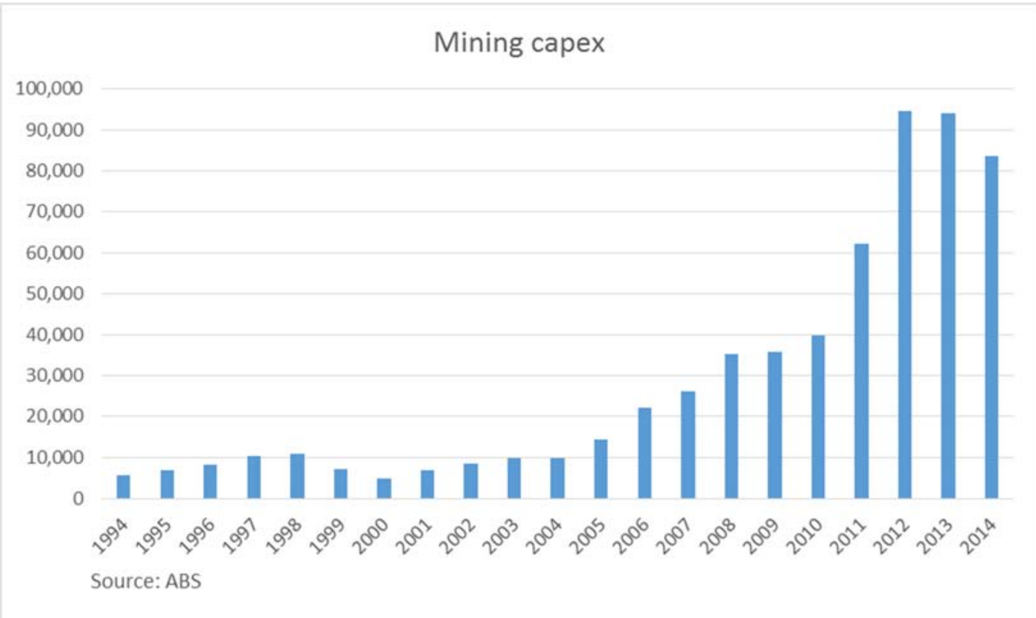
We expect that banks will continue to increase their capital ratios and amounts of common equity held. CBA report their full year results in August and will probably undertake a large capital raising then.

Sydney Airport (SYD) announced it has concluded negotiations with the Board of Airline Representatives Australia over the provisioning and pricing of airport services to member airlines for five years from 1 July 2015. The new agreement includes a price path ahead of many analyst expectations with the proviso that SYD will have stronger service obligations than in the past. The share price of SYD responded positively to this agreement, albeit the share price was particularly weak in June.

Recall (REC) has entered into a Scheme Implementation Deed which will see the company acquired by US listed competitor Iron Mountain (IRM). While the takeover presents significant top and cost line synergies, it is a predominantly scrip based deal (0.1722 IRM shares per REC share plus US$0.50 per share cash) meaning REC investors must be comfortable with the IRM shares they will receive. Our meetings with industry participants and IRM management suggest the issues IRM has of late suffered with regard to its services activities are manageable. Namely, we look to IRMs management not to lose focus on the core business as they grow their global footprint. If this services issue is addressed successfully, the company has latency remaining in its balance sheet and valuable, highly recurring storage cash flow.

Macquarie Group reported a strong full year 2015 result in May with income up by 14%, profit up 27%, earnings per share up 31% and dividends up 27% on the previous year. Positive momentum was evident across all of Macquarie's operating groups and this momentum is continuing into the 2016 financial year. Macquarie is loosely indicating that 2016 results should be slightly up on the 2015 result, whilst it is early in the year (and there are many moving parts), metrics we follow to try to get a feel for how Macquarie is tracking indicate a better year ahead. Macquarie has a very distinctive culture that has clearly led to long term success. This can be seen in many ways including how they report their results. Unlike most Australian companies, Macquarie does not put unwelcome negative outcomes into the non-recurring, below the line basket when it presents its numbers. It also tends to under promise and over deliver, another trait common to successful companies.

During the quarter we visited Perth, seeing a range of companies across the resources arena. Our discussions with the miners centred on cost outs, productivity and capex. This was expected given the significant fall in commodity prices over the past twelve months. As shown in the chart below, mining capex has only just started to step down. This pro-cyclical investment during a period of record high commodity prices is now deflating returns across the sector. The production from this investment is still to come over the next few years, especially in the case of iron ore which is likely to keep prices low for a prolonged period. Iron ore producers have reacted quickly and have taken out costs which has put pressure on employment and contractor rates which have fallen 10-20%. Unfortunately the mining contractors have felt the brunt of this cost out. We heard that mining companies are now extending their contract payment terms, which is putting more pressure on already weak balance sheets. We came away feeling that the worst is probably still to come and there is a little bit more on the cost out story from the big miners.



Market Observations

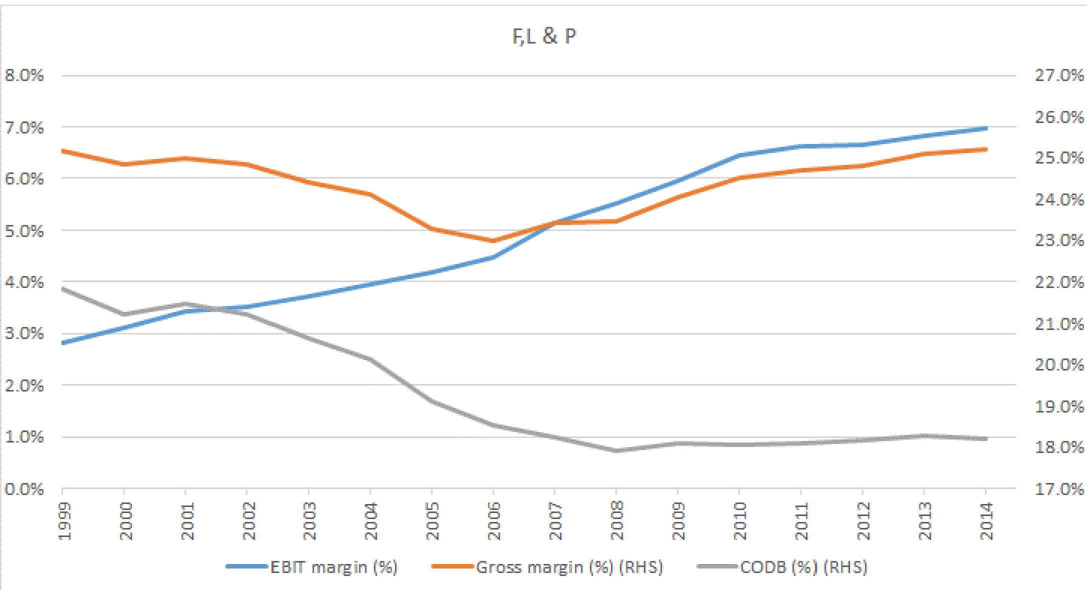
The rise of discount supermarket retailer Aldi in the Australian market has exposed weaknesses within the incumbent operators of the supermarket industry. Aldi's first store opened in 2001 and it has grown to a position where it is now around 10% of the grocery market in Australia, all on the East Coast (Aldi is currently in the process of opening stores in WA and SA for the first time). Apart from this growth, one of the great changes wrought by Aldi in the domestic market is to shift the consumer's perception of value. This is due to Aldi's ability to deliver quality product at a discounted price through its own branded offering.

Having initially dismissed Aldi as a serious threat, the incumbent operators now recognise this changing dynamic in consumer behaviour and see Aldi as a serious competitor; albeit the degree of this recognition varies. The strategic responses to date have also varied. Coles has enunciated a clear strategy of delivering value to the consumer to drive volume, and use efficiencies driven by the increased volume and cost reductions to offer more value to the consumer. In this instance value is not just price, although that is a key component, but also includes emphasising what differentiates it from the discounters, including fresh produce, in store bakery, range, etc.

The independent supermarket sector, which includes the Metcash banner IGA, has to date borne a large proportion of the impact of Aldi entering the market. With higher cost structures, a lack of scale and fragmented store ownership, they have struggled to provide a coordinated response to the more value focused consumer. Over the last year Metcash has been working closely with the IGA network to implement a number of strategies to stem the loss of sales that they have been experiencing. These include price matching across a core basket of items, store refurbishments and refreshing their private label offer "Black & Gold", as well as emphasising the local differentiated nature of the IGA supermarkets as a key competitive advantage.

Woolworths has been the least responsive to the changing market dynamic. This is a function of lack of management focus and strategic direction in the supermarket business. It is only in the last six months that Woolworths' management has recognised that its prices and value proposition are not matching that offered by competitors and that this was resulting in slowing sales momentum across the business. The key strategic response announced has been to invest in lower prices and in store service, funded through a renewed cost savings program. However, sales have continued to come under pressure, culminating in the retirement of the CEO, Grant O'Brien.

The issue facing Woolworths is how to respond to the increased competitive market place and protect the current earnings level. The chart below illustrates the issue. Since 2006 the EBIT margin for Woolworths' food, liquor and petrol operation has risen 250bps to 7.0%, and this has been driven predominantly by an increasing gross profit margin. WOW current EBIT margin is also 250bps above the 4.50% achieved by Coles. Reinvigorating sales growth and sustaining the current margin would appear to be a difficult, if not impossible, task.



Source: Company Reports

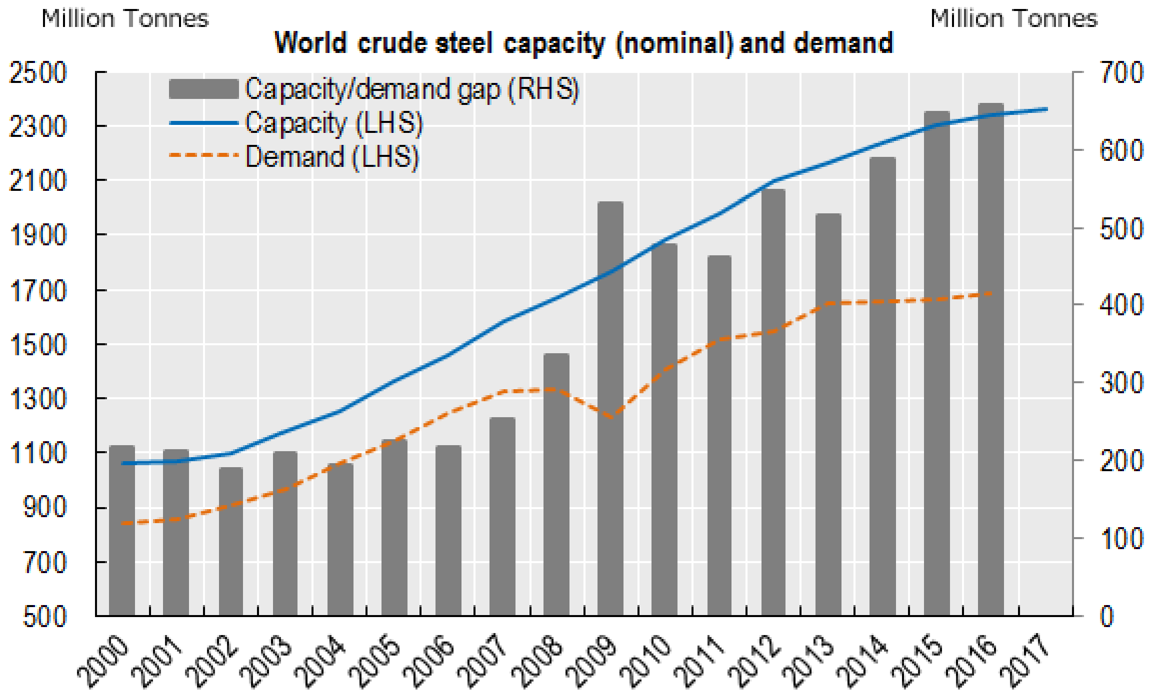
The disruption caused by low cost entrants is not unique to Australia or food retailing. It has been seen in industries as diverse as stock broking to airlines. The experience in the UK grocery market, which has been disrupted by the growth of discount operators Aldi and Lidl, is often pointed to as a lead for where Australia is heading. Although the specific circumstances of each situation is unique, there are some overriding similarities and lessons to be learned from them. In his article "Strategies to fight low-cost rivals", published in the Harvard Business Review, Nirmalya Kumar highlights that incumbents must first recognise the threat and when they do, the response generally follows two paths, differentiate or imitate through the launch of their own low cost operation. Responding solely on price does not work for incumbents and generally leads to price wars and the rapid loss of earnings and market position for the incumbents.

The failure of the Australian incumbents to recognise earlier the threat that Aldi represented has effectively seen Aldi achieve a position in the market from which they are unlikely to be removed. The focus of the incumbents is now on limiting the market share that Aldi can achieve over the longer term. No incumbent is currently pursuing an aggressive price discounting strategy. As already mentioned, both Coles and IGA are pursuing a strategy of being close enough on price for it not to be a major factor in the consumer's decision making, and are attempting to differentiate the value proposition in ways that the discounter will struggle to match. The challenge is to differentiate in a way that the customer values and is willing to pay for. Woolworths, on the other hand, seems yet to settle on a coherent strategy. Even now, Woolworths' management appears primarily focused on Coles as a competitor rather than developing a strategy to combat Aldi. Given Woolworths is the industry leader, with industry leading margins, both it and the industry have a lot to lose from any strategic miss-steps on their part. Although there is a risk that Woolworths unwittingly sparks a price war in attempting to reset the business under new management, it is likely that management will be careful to avoid this outcome. It is recognised by industry participants that a price war would be detrimental to industry profitability and would not be successful in unseating Aldi's positon in the market.

There appears to be excess capacity wherever we look in the world today. Leading into the GFC capital was abundant and poured into mining and other projects around the globe. Since the GFC central banks have flooded the world with liquidity in an attempt to stave off deflation and recession. These efforts have only partially succeeded – economic growth is for the most part anaemic and inflation is not an issue for the time being. The main impact of central bank actions has been to pump up asset prices (most notably share markets and property prices) and to keep interest rates at historically low levels. Very little of the liquidity has ended up in the "real" economy. This is likely due to a number of factors including nervousness on the part of companies in investing and making an adequate return (companies have been slow to drop return hurdle rates for new investments in the face of lower interest rates), partly it may be due to the ease with which buying back shares has enhanced shareholder and thus management returns, and partly it may be due to over-capacity and thus lack of necessity to invest. Increasingly the corporate balance sheet has gone into merger and acquisition activity.

A few examples of areas where there is excess (ample capacity) include:

1. Steel capacity. The graph below tracks world steel capacity and demand since 2000. It shows excess capacity has been expanding since the global financial crisis in 2009.



Notes: The Secretariat assumes demand growth of 0.5% in 2015 and 1.4% in 2016. These are the most recent rates of growth forecast by the World Steel Association of world apparent steel use (April 2015 Short Range Outlook).

Sources: OECD for nominal capacity and the World Steel Association for demand.

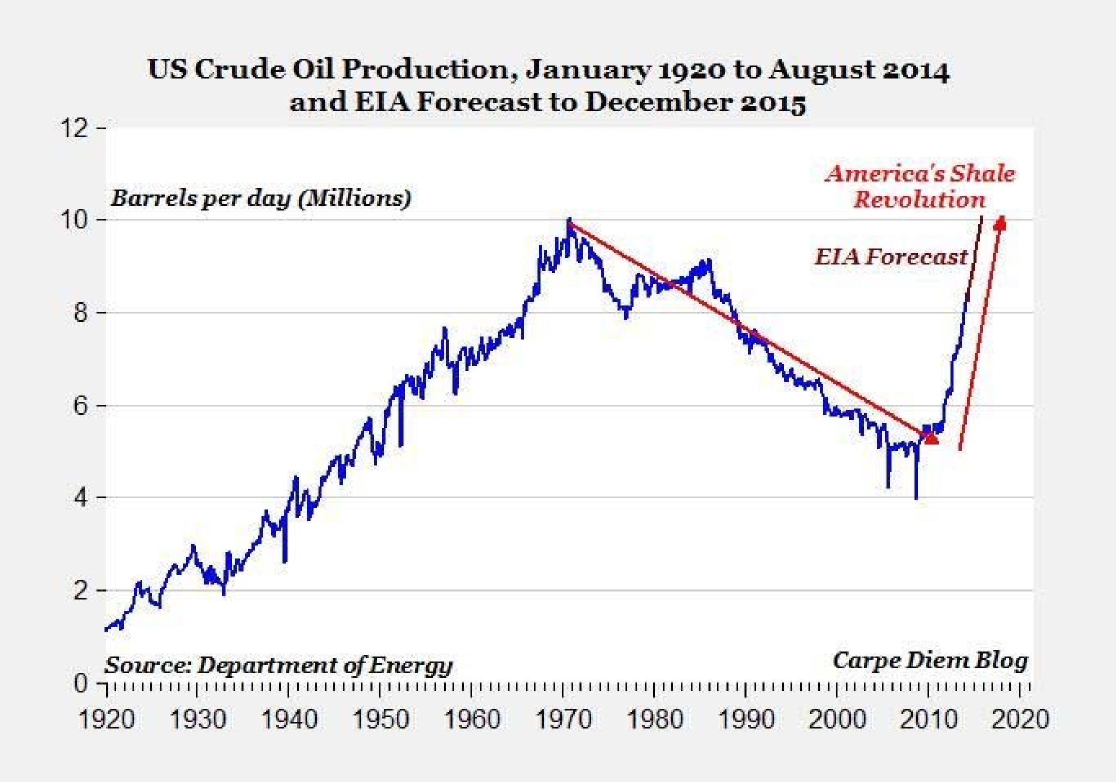
China accounts for approximately half of global steel capacity (having grown its capacity substantially since 2000) but it is producing at 800mtpa – a rate which has been rising for some years but this year is flat on last as GDP slows and steel makers are barely profitable.

It is interesting to look at the Japanese experience in the 1970 and 1980s in this regard when economic growth rates ratcheted down and steel capacity of 160mtpa ultimately had to be cut to cope with demand of only circa 90mtpa. It is likely to be difficult to quickly or easily dismantle capacity, which with tepid demand for the time being, is likely to keep a lid on steel prices.

2. Iron Ore. In order to cope with the expanding requirements of China (as illustrated above), Australia (predominantly BHP, RIO and Fortescue) have poured billions of dollars into growing their iron ore businesses. And more is to come with both BHP and RIO still talking expansion, as is Vale in Brazil, and Gina Rinehart is poised to bring on another 55mtpa with her new mine over the next two years. It is difficult to see a lot of strength in the iron ore price as this supply comes on, particularly if steel makers are already struggling.

3. Oil and gas. The chart below shows the highly significant ramp up in domestic US production of oil since 2010 when technology (horizontal drilling and fracking) allowed the long term decline in production to be reversed. The Saudis, unwilling to give up share, have continued to keep the pumps wide open through

through this period, resulting in over supply of oil and the resultant fall in the oil price from $100 back to $60. Given the US security concerns, they are unlikely to wind back production any time soon so a period of full supply and lower oil prices looks likely in the absence of a shock to the system. As oil production has risen, so has the amount of gas which has been produced. The Henry Hub (US price of gas) price has fallen to sub $3 from averaging higher levels over the last few years. As US LNG, priced off this gas price, becomes a reality, new LNG projects using an oil price link in this lower oil price environment may find it difficult to get off the ground.



4. As liquidity has been pushed into the global monetary system, and this has gone into asset pricing rather than the real economy, so we have witnessed the rise of the huge asset managers. According to the RBA, asset managers are estimated to have had $76TR in assets under management at the end of 2013, equivalent to more than half of global banking assets at the time. This number is up from $35TR in 2001/2, and $50TR immediately post the GFC. The likes of Blackrock ($4.5TR+), Vanguard, State Street and Fidelity (each $2TR+) have come to dominate this world. In our own small part of the world, when CI first started managing client's money fourteen years ago, there were (from memory!!) roughly 50 equity managers in the published performance surveys. Today that number is over 100 and there are a number of managers who do not go into the surveys. Likewise the "sell side" of our market continues to evolve as brokers and bankers are laid off but appear again in another guise elsewhere in the industry.

5. People. Unemployment, and the more difficult to measure underemployment, are a major issue around the globe. In Australia the end of the mining boom has seen thousands laid off while in Spain it has been documented that unemployment overall is above 20% and youth unemployment there (and in Greece, Croatia and Italy) is closer to 50%. In the US, although the unemployment rate has fallen of late, the country is struggling to get back to same employment numbers as 2007/8, despite the population having risen from 301m people in 2007 to close to 320m today. As for Europe, unemployment is slowly improving today but the rate of unemployment rose from 7.5% in 2008 to 12% in late 2013.

6. In addition to the phenomenon described in 4 above, as liquidity has been promulgated, so too have global debt levels risen. Greece is clearly the most topical example of the result of too much debt, but this trend has been witnessed elsewhere. Towards the bottom end of the scale is Australia, where thanks predominantly to the Rudd and Gillard governments, our balance sheet has moved from sub 10% in 2010 to a level where our public debt is now circa 30% of GDP. According to a study by McKinsey global debt has grown by $57TR since 2007 (from $142TR to $199TR), of which government debt accounts for $25TR of the growth. The most spectacular rise is China whose total debt has risen from $7Tr in 2007 to $28Tr in 2014, representing 280% of GDP (having been 120% of GDP as recently as 2001). Clearly deleveraging has not been on the agenda, and in today’s low growth environment, it would appear countries will not be able to grow out of their debts (in fact heavy debts stifle the ability to grow in any event). (Viz what is going on in Greece.) It seems logical that somewhere along the line there will need to be defaults and/or debt forgiveness and write offs. The repercussions of such events are very difficult to forecast, as second, third and fourth derivative events and exposures take place – we need only to look back six or seven years to see that the unexpected most often can and does happen.

In conclusion we believe we are in an era where, as has been the case for the last few years, for the time being at least, inflation will be low as will rates of economic growth. Pricing power will remain difficult for companies and thus new capital expenditure will be difficult to justify if traditional return metrics are used as hurdle rates. Merger and acquisition activity, especially for those perceived to have a lower cost of capital, is likely to continue apace.