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.

June 2016

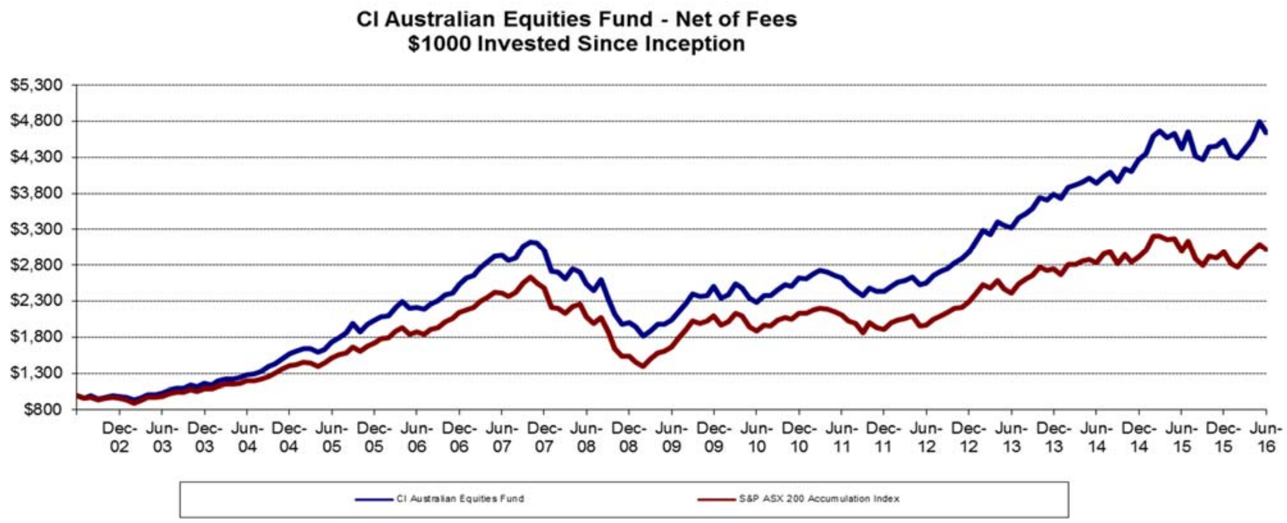
"We are continually faced with a series of great opportunities brilliantly disguised as insoluble problems." John W. Gardner

"The State in particular is turned into a quasi-animate personality from whom everything is expected. In reality it is only a camouflage for those individuals who know how to manipulate it." C.G. Jung

"The distance between what I will call the technocratic elite and the increasingly displaced lower-middle and even middle class is becoming one of the major characteristics of our time." George Friedman

	****PORTFOLIO**	**#BENCHMARK**	**VALUE ADDED**
ROLLING 3 MONTH	5.30%	3.94%	1.36%
ROLLING 1 YEAR	6.93%	0.56%	6.37%
ROLLING 3 YEAR	13.34%	7.66%	5.68%
ROLLING 5 YEAR	13.42%	7.40%	6.02%
ROLLING 7 YEAR	13.63%	8.81%	4.82%
ROLLING 10 YEAR	8.83%	4.86%	3.97%
SINCE INCEPTION*	12.84%	8.21%	4.63%
SINCE INCEPTION^	442.02%	201.52%	240.50%

*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 rose 3.9% for the quarter to get back to roughly break even for the year (+0.6%). In other words, investors have required a dividend return to get into the black this last year. In fact (although clearly dependent on one's starting point) since 30 June 2007 (ie. just before the GFC) now some nine years ago, the market has returned 2.5% per annum – in reality no more than a dividend return. By way of comparison, over the same period, the yield on the Australian 10 year government bond has gone from 6.2% to sub 2% today. One wonders when widely and long held actuarial assumptions of 7-8%+ returns from markets might change, and what the impacts would be on pension funds if such changes were to occur.

Stocks which contributed positively to the portfolio over the quarter included Aurizon (improved coking coal prices), Ramsay Health Care and CSL (both bouncing back after being sold off) and ASX. Stocks which did not perform as well included AMP (resignation of Chairman and announcement of underwhelming cash flows and wealth protection claims result), Sims Metal (ongoing difficult market environment), and Regis Healthcare (falling prey to regulatory risk with the announcement in the Budget of further cuts to aged care funding).

Stock News

Amcor (AMC) made two contemporaneous announcements which saw the stock price drop by over 10% :

- The write off of its assets in Venezuela due to very difficult market conditions as the economy has collapsed; and
- The restructuring of its flexibles plants in Europe to better align them to ongoing operations and customers' operational requirements.

The net earnings impact of the above two initiatives was stated by the company to be positive in two years time. The market clearly does not believe this to be the case, and remains nervous that the Venezuelan problems may also emerge in other Latin American economies. Although growth has slowed in LatAm as it has elsewhere, we remain of the view that AMC will be able to navigate through any issues.

Telstra (TLS) has now had to confess to seven network outages, the latest of which came on the final day of the fiscal year. Having built its reputation, and commanding a price differential (albeit in mobile predominantly) based on a superior network, these problems do not reflect well on the company. As yet they have not cost the company from a cash perspective but, if continued, it appears inevitable that they will, and will certainly tarnish a hard won improving reputation. The ongoing nature of the outages leads us to suspect management issues internally.

Murray Goulburn (MGC) announced a large earnings downgrade during the quarter, due to low commodity prices, lower dairy product sales than anticipated and a higher AUD than anticipated. As a result of the above, the milk price payable to the company's farmers was reduced and a milk supply support package introduced, and the CEO resigned immediately.

After many years spent researching, trialling and gaining approval for the products, **CSL (CSL)** launched both its recombinant Factor 9 and recombinant Factor 8 products for hemophilia this quarter, and received approval for its quadrivalent flu vaccine. These are all positive announcements for the company showing the ongoing momentum in the business and the strength of its research and development pipeline, albeit the products are launching into competitive markets.

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Having found irregular supplier arrangements leading to overstatement of earnings at Target early in the quarter, **Wesfarmers (WES)** recently announced a write down and impairments at Target and Curragh coal mine, and a major restructuring program at Target. We are confident the new MD of Target (Guy Russo) will be able to improve its operating performance over coming years, as he has done successfully with K Mart. The bigger picture for WES is the ongoing competitive environment for Coles and the growth of Bunnings both in Australia and the UK.

Clydesdale Bank (CYB) has fallen 25%, in line with other UK banks, post the Brexit vote, and is now back to a little above the price at which it listed on demerger six months ago. The thesis for buying the stock has not changed but the external environment may be different to that which we anticipated when acquiring the stock. The company has a large cost out opportunity (running at a 75% cost/income ratio compared to peers at 55% or less), opportunity to utilize excess capital over time, and with only circa 2% market share in the UK the opportunity to grow at the expense of the major banks. Any slowing of the economy as a result of the Brexit vote may impact on the latter point but would likely lead to an acceleration of the first two.

Market Observations

The Brexit vote in the UK late in the quarter has engendered plenty of differing views, both as to why the vote went the way it did, and what the ultimate outcome might be. We find it difficult to add much to the reams already written but would observe Central Banks have unwittingly or uncaringly contributed greatly. The amount of so called quantitative easing, bond buying and lowering of interest rates undertaken over the last few years to push liquidity into the system in an effort to generate economic growth has ultimately had the exact opposite impact to that intended. The effect of these actions has been to:

- Increase asset prices (equities, bonds, property)
- Reduce the amount savers and retirees have to spend
- Sadly not increase economic growth; and thus
- Exacerbate the perceived (and real) level of inequality in global society

If one then adds in globalisation, unemployment, lack of wages growth and immigration trends, it is no wonder there is a protest vote by those who have been affected – as seen in the Brexit vote, the rise of the far right party in France, the spectacular success of Donald Trump in the USA, and even the relative lack of popularity of the major parties in the Australian election. While the Western world is not in a recession, economic growth rates are very low. Government balance sheets are stretched and most are running budget deficits. There is little latency to deal with a left field event leading to recession.

We must now be very close to a point where Central banks will need to reassess their policies – keep on pushing on a piece of string or reverse course and start to normalise interest rates (the Swiss **50 year** bond yield went negative this week). Either course is fraught with risk. Very low, falling and negative interest rates, if a harbinger of deflation, would not be positive for highly geared structures, pension funds and insurance companies, and not good for banks' profitability. Equity valuations have typically been based on bond rates – using current interest rates is close to meaningless in this regard. And any rise, or perceived rise in interest rates will, given the levels of debt involved, also likely be negative for asset prices.

There are many possible, and indeed likely, reasons for the UK having voted as it did. One of them is exemplified the world over – that of increasing regulatory and tax imposts in many parts of the economy. The latest Economist shows that of 43 of the larger economies of the world, only five run a budget surplus. Sadly Australia is not one of them, and in all likelihood our budget and government debt position will get worse (perhaps substantially so) before it improves. It is perhaps why tax imposts continue to rise and government funding to industry remains tight. In Australia we have recently seen:

- The funding to aged care cut in the latest Budget;
- The South Australian government propose a point of consumption tax on wagering in the state, potentially paving the way for other states to follow;
- Ongoing tobacco tax increases;
- Both parties in the pre election battle backing away from committing funding to healthcare.

The point of the above is that it is getting more difficult for business to operate – at a time when global growth remains stubbornly low and episodes like Brexit only serve to exacerbate this issue. This will continue to put a premium on companies who can continue to grow earnings, cashflow and dividends without risking the farm to do so.

The residential aged care sector is set to go through a period of significant change over the next few years as the Government introduces policy reforms aimed at providing a more consumer-driven, market-based and financially sustainable industry. The Aged Care Roadmap, released in 2016, provides the blueprint for how this will be achieved over the next 5-7 years and while there appears to be broad support for these reforms within the sector, they will result in major changes to business operating models and the full impact will not be known for some time.

Recently sentiment towards the listed residential aged care sector has been impacted by measures in the recent 2016-17 budget looking to reign-in aged care funding growth back to within the 5.1% per annum envelope the Government is committed to. The sector's image has also been tarnished by claims of over-servicing residents and incorrectly claiming Government funding. These issues highlight that the future financial sustainability of aged care funding is likely to be an increasingly significant issue for the Government, particularly given current budgetary pressures and the significant increase in demand for aged care services expected over the next 20 years.

While residential aged care still has long-term exposure to the ageing demographic, it comes with a high degree of regulatory risk given around 70% of an operator's income is currently funded by the Government. We expect over time there will be a trend towards greater user-pays and means-testing, so that those residents who can contribute more to their aged care will have to do so. These dynamics reinforce our preference for the integrated retirement living operators, such as Ryman or Summerset, which gives us exposure to the ageing demographic but with less of the regulatory risk found in the residential aged care sector.

Trip Notes

We met with numerous health care industry players in France and the UK as we revisited our investment thesis on Ramsay Health Care (RHC). While tariffs to private hospitals remain under pressure in France we see some potential for modest reprieve if there is a change of government in 2017. Notwithstanding this, RHC's France expansion offers value for shareholders not only through management's ability to improve in-country operating efficiencies, but also their ability to leverage off the increased scale of RHC group in negotiating with product/consumables suppliers. Over time we think sizeable savings could come through purchasing these products on a global rather than local basis, with procurement being done out of a central Singapore office.

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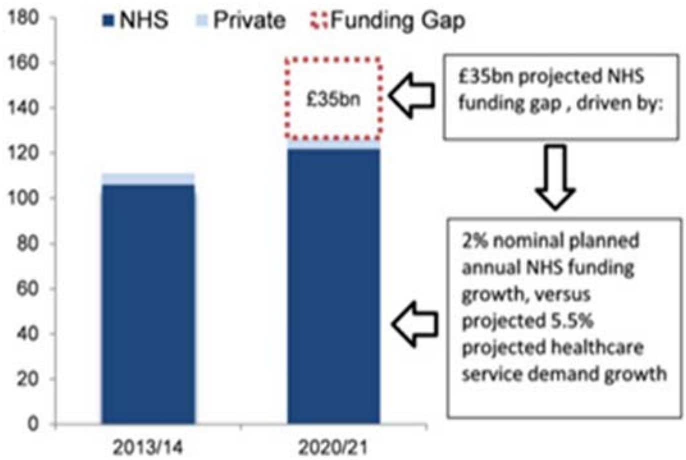
In what is a worldwide trend, the UK public healthcare system is facing ongoing funding challenges.



JP Morgan, Laing & Buisson, PESA 2013, NHS England

However, unlike the French the UK government appears to look more favourably on the role of private hospital operators in assisting the healthcare challenges. In fact, the Torys surprised everyone when they recently announced an average 1% increase in hospital tariffs. We see this as an attempt to relieve pressure on public hospitals both in terms of their profitability (or lack thereof) and better incentivising private hospital operators such as RHC to take excess cases from the NHS, thereby improving national patient waiting times. We are far from convinced that there will be further tariff increases but nevertheless, think RHC UK still has sufficient growth optionality through ongoing e-referral (Choose & Book) NHS work within its existing capacity while undertaking brownfield work to add extra capacity.

We also visited with a number of industry participants related to the pallets and Reusable Plastic Container (RPC) industries across the United States with reference to the outlook for Brambles (BXB). In particular, we wanted to test our views on the potential size and longevity of the US pooled pallet and RPC markets and how the company is managing growth in these areas – areas we see as critical in BXB achieving its FY19 20% ROIC target. This was particularly important after periods where BXB incurred cost challenges within its US pallets business while also recently losing a sizeable RPC customer.

A key takeout was that BXB is the clear market leader in pooled pallets but has not dramatically lifted prices. While such price hikes would be aesthetically pleasing to BXB's short term results, we believe it would be very detrimental to the value of BXB's network and therefore long term earnings. Rather than pricing, BXB is using its expertise to attempt to move into new client segments such as auto after care or pet care products while also increasing the product lines it services within its retailer client networks. We also came away with a sense that the initiatives around rolling out clinch nails and nail plates across their pool should support product durability which over time, assists margins in a growing revenue environment.

In terms of the US RPC offering, despite the loss of a key client in 1H16, BXB appears to be gaining significant momentum as growers and retailers gravitate to its offering versus traditional cardboard. As it continues to grow scale we believe management are creating significant long term shareholder value which over time could be as large as its current European RPC business.

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We visited China, Singapore, Thailand and Malaysia late in the quarter. We spent the bulk of our time in China visiting a number of tier 1 & 2 cities. While we spent some time on the trip focusing on the heavy industry sectors (steel, property, infrastructure, equipment manufacturers), we also met with companies in the agricultural, consumer services and technology sectors. We came away quite enthused about the outlook for these consumer related sectors.

It is clear the stimulatory efforts from the central Chinese government earlier in the year are flowing through to the economy. The "old economy" sectors have been the main beneficiaries with the approval of new infrastructure projects and investment in the property sector picking up again. Not surprisingly our meetings with the steel mills and traders were more positive today than previously as in the short term margins have recovered – a contrast to last year when most were loss making. The closure of steel capacity late last year in combination with a pickup in demand post the Chinese New Year saw steel margins increase significantly in the first quarter but have since fallen to a more normal level. The central government still has the intent to shut excess capacity but it looks like it will be a slow process given the social implications of doing so.

The anti-corruption drive and weak local government balance sheets had a material impact on the economy last year. Credit is flowing again and local governments are commencing infrastructure projects with increased private market participation through PPPs. Similar to other central banks around the world, the PBOC has been lowering interest rates which has provided a boost to property prices and sales. A lot of hot money has flowed into tier 1 cities with one of the property consultants we met describing the market as "crazy". With limited land supply, there has been a sharp appreciation in prices at public auctions. One of the listed developers recently acquired land at full development cost that materially exceeds the current apartment selling price – this speculative behaviour is not healthy. Property developers are hesitant to acquire land and develop in tier 3-4 cities given the overhang of inventory and a fundamental lack of demand. The government has a difficult task fine tuning policy to encourage migration to these cities. From a resources perspective, our concern is that these cities represent a large share of property construction, circa 50-60%.

Another headwind the heavy industry sectors face is the government's strong intent to reduce pollution, and the fact it is pushing the rollout of renewable and nuclear energy, coined "new energy". The government is also forcing manufacturers to install anti-emission devices, an impost producers will need to deal with on their own. However, there are beneficiaries from this new policy such as electric vehicles, a thematic that a few large Chinese car manufacturers are looking to take advantage of.

From an investment perspective, our thinking around the resources sector has not changed materially. We remain relatively cautious on the outlook given long-term structural issues still remain. However, there doesn't seem to be any urgency from the government to deal with these issues. If commodity prices stay at current levels, especially iron ore, the balance sheet of the large resource companies will de-lever given the cost and capex cuts, making the investment proposition less risky.

Boral

One focus on our research tour of Asia was Boral's plasterboard joint venture in the region, namely USG Boral. The business has tangible long term growth potential as plasterboard adoption rates increase across the region. Current plasterboard consumption rates are low at 1-2 sqm per capita versus developed economies at 6-8 sqm per capita. The potential for an increase in consumption rates can be illustrated by Singapore, where consumption has increased from around 1 sqm to 4 sqm per capita over the last 5 years.

Plasterboard has significant advantages in terms of weight, ease of construction, thinner profile and environmental footprint, relative to bricks, the key competing material. The main impediments to penetration appear to be the total installed cost differential between plasterboard and bricks and mortar, and the, largely unjustified, perception of the relative build quality of plasterboard in terms of solidity, acoustic properties and finish. As well as working to increase the penetration of plasterboard in the region, management are also aggressively pursuing growth in adjacencies such as metal fixtures & fittings, adhesives, acoustic tiles and water resistant products.

Although in recent years we have seen economic growth slow in a number of countries in which USG Boral operate, they continue to grow revenue at double digit rates, and increase margins and returns. Management are very focused on driving adoption rates and staying ahead of the competition, leveraging off the innovation and R&D capabilities of their partner USG.

BlueScope

While in Asia we also took the opportunity to investigate further the opportunity available to BlueScope's building products joint venture NS BlueScope (a joint venture with Nippon Steel Sumitomo Metal Corporation, (NSSMC)). NS BlueScope manufactures and distributes coated and painted steel products across the ASEAN region, with manufacturing facilities in Malaysia, Thailand, Indonesia and Vietnam.

Their metallic coating and painting operation in Thailand is now producing SuperDyma, a product targeted at the large home appliance manufacturing base in Thailand. SuperDyma has been successfully trialled by a number of appliance manufacturers and NS BlueScope have begun to ramp up production to meet demand. The first stage is the replacement of the current NSSMC imported SuperDyma product, which is around 30% of the 250kt market, and then to target the rest of the market. Although this will take time, the product quality and local sourcing capability is likely to be a credible value proposition for customers.

The broader coated steel market is intensely competitive within the ASEAN region, with significant import competition from China and Vietnam. NS BlueScope focuses on being the local in-market supplier of quality product, they are building out a local distribution network of owned or aligned roll-formers, and are investing in training distributors, installers and customers to entrench their market position. They also offer a product range in each market that is fit for purpose, i.e. in Thailand they have the JingJoe brand targeted at the mass market (albeit still at a quality and price premium), Zacs in the mid-market and Colourbond at the high end. This further helps them differentiate themselves from the generic competition. BlueScope's aim is to sell a premium product in all segments of the market.

Although the countries NS BlueScope operate in are different in many ways, the opportunity for the business across the region is underpinned by an overarching dynamic of increased demand being driven by rising middle class wealth and aspirational trends. Supported by these underlying growth trends and their expansion into the appliance market in Thailand, there remains significant long-term growth for NS BlueScope. We see the coated product business of BlueScope as a segment of BlueScope where observable value latency exists, although it is one that will require excellent execution to maximise the potential value.

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Amendment to Constitution

The Australian Government has enacted legislation which establishes a new tax regime for managed investment trusts that qualify as attribution managed investment trusts (“AMIT”). Cooper Investors intends to elect to apply the new AMIT regime from 1 July 2016. Under this new regime, taxable income will flow through to unit holders on an attribution basis, rather than a distribution basis and it will also facilitate Cooper Investors allocating realised capital gains arising from the sale of assets in order to fund a significant redemption to the redeeming unit holder. This is instead of a pro rata distribution of realised capital gains based on unitholdings.

In order for the Fund to be operated in a manner permitted by the AMIT regime, Cooper Investors has amended the Constitution of the Fund.