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.

MARCH 2016

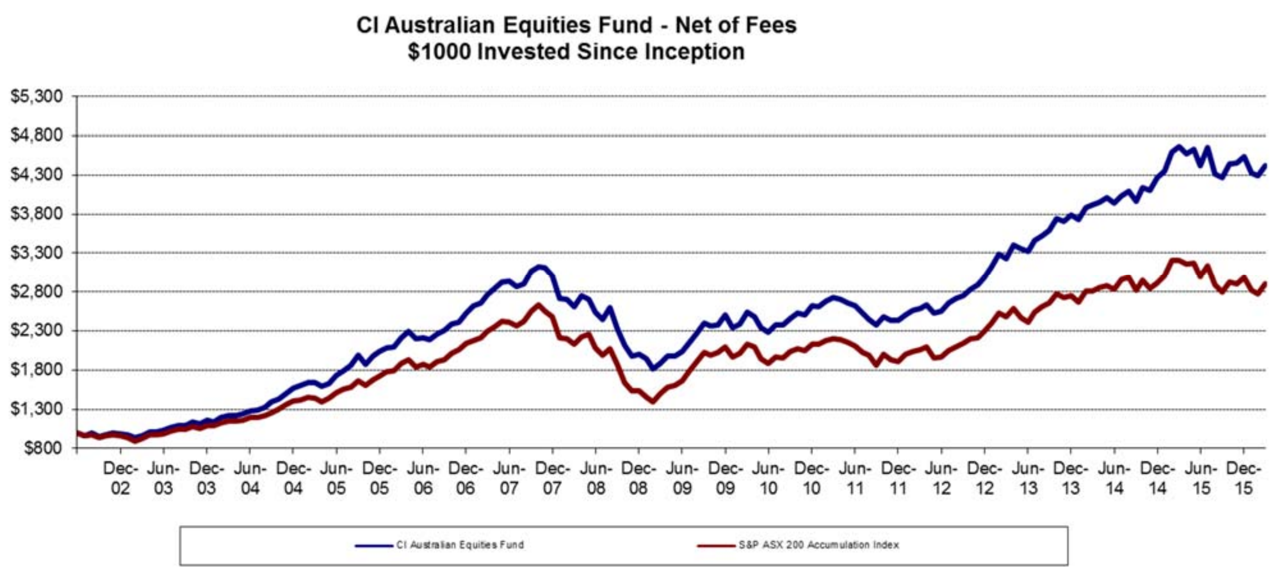
"If you do not change direction, you may end up where you are heading." Lao Tzu

"Technology….is a queer thing. It brings you great gifts with one hand, and it stabs you in the back with the other." Carrie Snow

"We are kept keen on the grindstone of pain and necessity." HG Wells, The Time Machine

	****PORTFOLIO**	**#BENCHMARK**	**VALUE ADDED**
ROLLING 3 MONTH	-2.21%	-2.75%	0.54%
ROLLING 1 YEAR	-3.60%	-9.59%	5.99%
ROLLING 3 YEAR	12.65%	5.39%	7.26%
ROLLING 5 YEAR	11.48%	5.70%	5.78%
ROLLING 7 YEAR	14.12%	9.88%	4.24%
ROLLING 10 YEAR	8.31%	4.43%	3.88%
SINCE INCEPTION*	12.66%	8.06%	4.60%
SINCE INCEPTION^	414.73%	190.08%	224.65%

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



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Market and Portfolio Performance

The last quarter was volatile to say the least. The ASX200 Accum Index fell 5.5% in January, and then again fell 1.7% in February, only to recover 4.7% in March to leave the market down 2.7% for the quarter. However the main constituents of the index showed even greater variability, the Resources Index falling 9.5% in January but rose in February and March by 6.37% and 5.87% respectively. The Financials Index, of which the banks comprise a major part, was equally volatile, falling 7.4% and 6.2% and then recovering 5.6%.

Commodities had a strong quarter, the oil price rising 3.5%, albeit up 46% from its low in February. Similarly the iron ore price rose 23%, up 40% from its low seen in February. The AUD rose against the USD from 72.9c to 76.5c, bottoming out at 69c mid way through the period.

Stocks which contributed positively to the portfolio included **Sims (SGM)** (steel price uplift and general perception China is dealing with overcapacity in its steel industry), **TPG Telecom (TPM)** (strong result principally driven by higher than expected iiNet synergies and growth in its corporate business) and **Transurban (TCL)**. Stocks which did not perform as well included **Macquarie Group (MQG)** (fear of bad debt write offs, especially in the resource exposures), the four major banks (recognition finally that we are at the bottom of the bad debt cycle which will hamper earnings and dividend growth from here), and **Caltex (CTX)** (falling refiner margin).

The Portfolio

The portfolio has done well in recent periods from its exposure to bond like equities – especially companies whose dividends have grown – and niche growth companies, where falling interest rates and an uncertain economic environment has supported interest in these types of companies. Over the same timeframe falling commodity prices have meant that resource companies have not performed well, and regulatory and capital issues have made life tough for the bank sector. Although the first two months of the quarter extended this phenomenon regarding share prices the last month saw a reversal of the trend.

In thinking about changing the structure of the portfolio we are looking to observe changes, or signs of change, in company operating and industry trends. For banks we see little sign of change – although ANZ and Westpac have made recent comment about corporate bad debt exposures, the banks remain at historically low levels of provisioning, and both APRA and the Basel Committee have made it clear that we are not yet at the end of the regulatory and capital imposts on banks. Although capital may not be as big a requirement/issue as we have seen in the last two years, when combined with rising levels of bad debt and likely lower growth in residential lending, it will be difficult for banks to grow earnings and dividends from here.

Commodities and resource companies benefited from a ten year golden period of rapidly rising Chinese growth driven by high fixed capital investment which drove increased demand and thus higher prices for commodities in general. The heat has now come out of the Chinese economy and its growth rate will likely be lower, different in composition and skewed to different parts of the economy as overcapacity in a number of industries is dealt with by the authorities. Add to this anaemic growth in Europe and consistent but lower than historical growth rates in the USA and it is no wonder commodity prices have fallen. From a company perspective both RIO and BHP have been cutting costs and capex rapidly, and no doubt ruing large acquisitions made at the wrong time of the cycle. Their respective share prices have fallen dramatically. However if one assumes long run iron ore prices of circa $45 and oil at $50, AUD/USD of 75c and factoring in some recovery in other commodity prices (at which RIO and BHP generate a high single digit return on equity) their share prices today are trading around fair value. Given the deep cuts in capital expenditure one wonders where their growth will come from (in the absence of commodity price rises).

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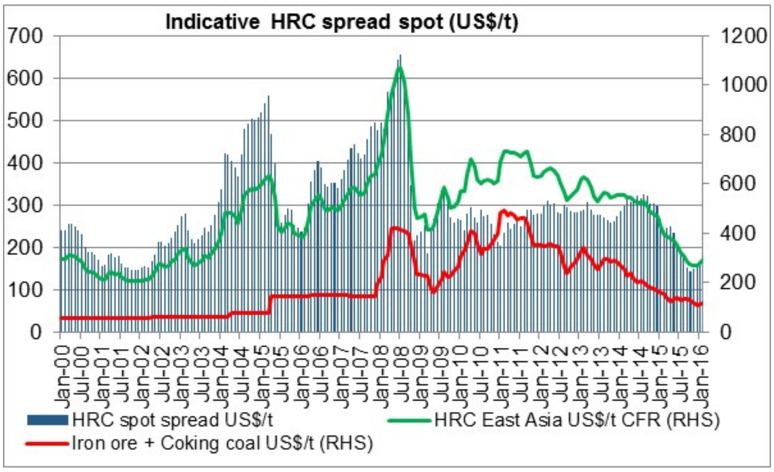
At a macro level, global economic growth remains low and there is not too much on the horizon which offers hope that this state of affairs will change in the near future. Inflation is generally dormant, and although commodity prices may have fallen far enough, given company emphasis on cost out, and wages pressure, the ongoing impact of technology, and the fact that few companies are able to put through price increases, inflation does not appear likely to rise in the near term. We note interest rate movements and especially the negative interest rates imposed in Japan and Europe. We do not know the ultimate outcome of these efforts but would also note that interest rates have fallen a very long way over the last twenty years and the fall in yields (especially in bond like equities) this has supported. Although this trend may not yet have fully played out, we do believe it is time to move the portfolio towards companies who have the opportunity and management team capable of creating value in the current environment.

We have added **Bluescope Steel (BSL)** to the portfolio during the March quarter. BSL has a management team with an impressive track record in a difficult industry. The stock offers value latency even without factoring in an improvement in steel prices and spreads. BSL also has niche growth businesses in their coated products operations, namely Colourbond in Australia and the joint venture with Nippon in SE Asia. Both of these provide BSL with growth options which we believe are not fully valued by the market. While current industry conditions are challenged, they would not appear to be sustainable longer term and BSL are positioning themselves well to both manage through this down cycle and benefit significantly when spreads eventually recover.

Global steel prices have been driven down by the significant amount of excess production that is being exported out of China, as Chinese domestic demand weakened. Over the past year steel spreads have reached levels not seen since early last decade (see chart below). At these levels 70-80% of steel makers do not cover their costs of conversion. With the majority of the industry losing money the necessary capital investment to keep blast furnaces operational will not be spent, indicating that spreads at these levels are not sustainable longer term. That said, as has been seen in a number of markets affected by excess Chinese capacity, the rationalisation of capacity can take a long time and often involves non-Chinese production being curtailed.



Source: Credit Suisse

BSL has used this period of industry weakness to significantly improve the cost structure of both its Port Kembla steel manufacturing operations as well as the New Zealand business. This process has demonstrated the strong execution capability of management. The improved efficiencies delivered from this restructure will enable BSL to ride out the current difficult industry conditions while continuing to invest in their value added product lines.

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We have sold **Resmed (RMD)**. The US sleep medicine industry, a key market for RMD, continues to come under funding pressure. As of January 1 this year the remaining regional areas, collectively known as Competitive Bidding Round 3, saw a 22% reduction in Medicare reimbursement rates, with a further 22% reduction occurring from 1 July, to bring the rates into line with other regions. Additionally, the CMS recently released the outcomes for the rebid of CB2 (Competitive Bidding Round 2) which will result in a further reduction in reimbursement rates for sleep therapy in the order of 14% as of 1 July 2016.

During our travels through the USA in March we took the opportunity to meet with a number of Durable Medical Equipment (DME) suppliers, the customers of RMD in the home therapy market. This highlighted not only the extent to which this industry's profitability is coming under pressure from the Medicare reimbursement cuts but also that private health insurance companies are, in general, following the downward trend in reimbursement rates. In addition, the threat of the bundling of sleep products into a single reimbursement rate per patient for the provision of sleep therapy remains on the horizon, which would likely further reduce the margins available to the industry. At this stage no details on the timing or processes for bundling have been released.

RMD management have done a good job of managing through the difficult funding environment, but pressures remain and it is difficult for us to get comfortable with the longer term profitability of the sleep therapy manufacturers given the challenges being faced by their key distribution channel.

RMD has also recently made a significant move into the software services market with the acquisition of Brightree for US$800m. Brightree provides cloud based software to assist in the business management of the post-acute healthcare industry. Brightree's primary market is the same DME suppliers to which RMD sell. The software provides a range of services including inventory, billing, patient, and reimbursement management. Although considered a high quality platform and the best product in the market by the DME providers we have spoken to, it is also the most expensive. We are concerned by the high price RMD paid for Brightree, the fact that it is outside RMD's core capability, as well as the significant risks that sit within the primary customer base of Brightree. The challenged profitability of the industry mentioned above has led to, and we expect to continue to see, consolidation in the DME supplier industry with the larger more efficient suppliers getting bigger and the small and mid-sized operators being consolidated or leaving the industry. It is this latter shrinking segment that are the key customers of Brightree.

We also reduced our position in **Telstra (TLS)** during the quarter:

- The main growth engine for the company over the last few years, its mobiles division, has come under more competitive pressure as Optus and Vodafone have improved their respective networks. While mobile data consumption continues to grow, the mobile operators continue to provide better value to customers by providing more data on lower tier plans which makes it difficult for the industry to grow ARPU. We are cautious that the behavior of the participants is becoming more market share driven. Another slight concern is that competitive intensity has also stepped up in the wholesale mobile resellers/reseller market.
- The last half saw the company add an extra $1B in costs – some of this is explainable (e.g. variable costs supporting growth and acquisitions) but there is scant evidence of ongoing efficiency gains which we believe to be achievable
- TLS has invested over one billion dollars (excluding its investment in Pacnet of circa $900m) in technology ventures (e.g. health, video and cloud software). We recognize that the company needs to find avenues for growth for the time when NBN payments are expected to peak in 2019 (depending on the pace of roll out) and returns may take some time, but to date the investments seem to have been piecemeal and it is difficult to grasp the value add to the TLS business.

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Stock News

Wesfarmers (WES) announced the acquisition of Homebase in the UK for $700m. The company's intention is to take the Bunnings concept to the UK. WES looks likely to spend in the order of $2B to refurbish and restock the acquired store network. Unlike the Woolworths strategy with Masters (rolling out a large number of stores early on), WES are going to trial a small number of stores to get the concept right before rolling out the entire network. We believe this is sensible and if done well will provide WES with a useful growth opportunity.

NAB finally achieved separation from its UK subsidiary **Clydesdale Bank (CYB)** by way of a demerger. We have subsequently bought more CYB shares on the basis of the opportunity presented by:

- The release of energy and greater focus in the bank as a result of moving away from NAB and having new management involved in the business.
- A de-risked balance sheet, a strong regulatory capital position, and scalable IT systems.
- Valuation of approximately 0.55X NTA.
- Cost out opportunity – we believe the cost/income ratio should fall from 75% to closer to 55% over the next four years.
- The ability to utilise excess capital if the bank gains approval from the regulators for the transition from standardised to advanced accreditation for mortgage risk weightings.

Tabcorp (TAH) was in the news a number of times during the quarter:

- The company renewed its Keno licence in NSW to 2050 for a payment of $25m and ongoing annual fees. Although not a large contributor to profits, Keno is nevertheless a valuable asset for TAH.
- TAH lost the final court decision concerning a refund from the Victorian government for the lapse of its gaming licence. Neither we nor the market expected a different result. We do however believe it sets a very poor precedent and, when combined with the Victorian government's decision to tear up contracts on the East/West link, shows that sovereign risk in Victoria is alive and kicking.
- Late in the quarter TAH announced that one of its directors would take leave of absence from the board during an investigation by the Australian Federal Police into TAH's activities in relation to a business opportunity in Cambodia in 2009/10.

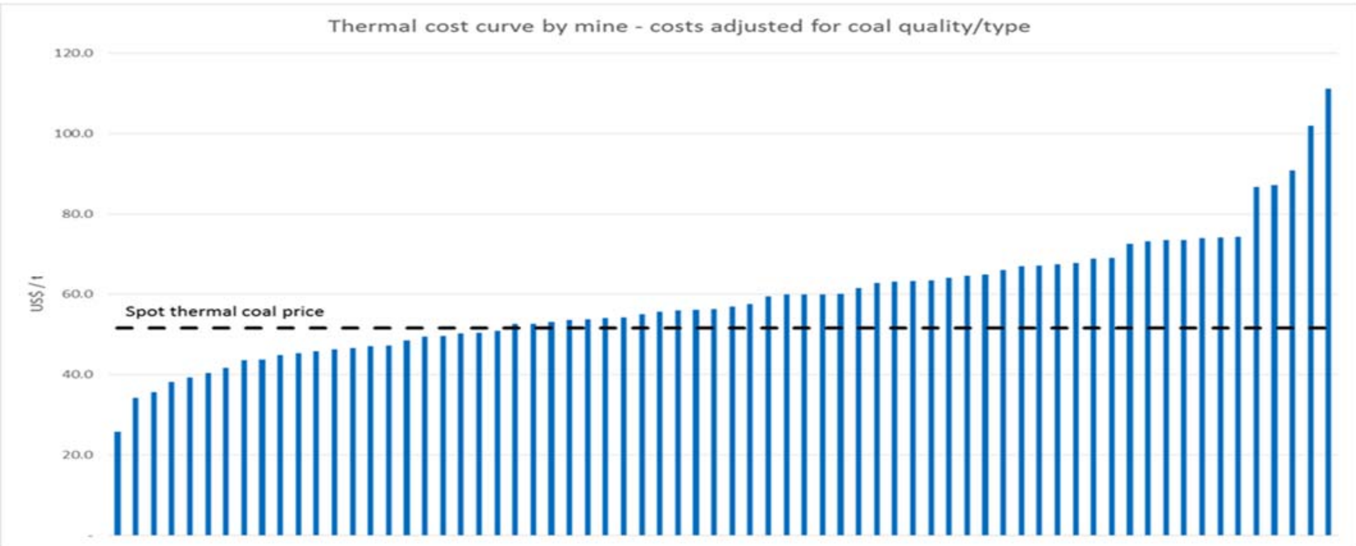
Caltex (CTX) finally announced a share buy back of $270m via an off market buy back. Although we welcome this capital initiative, we do believe further such initiatives are possible and CTX management and board should be able to continue to undertake these over the next two years.

Market Observations

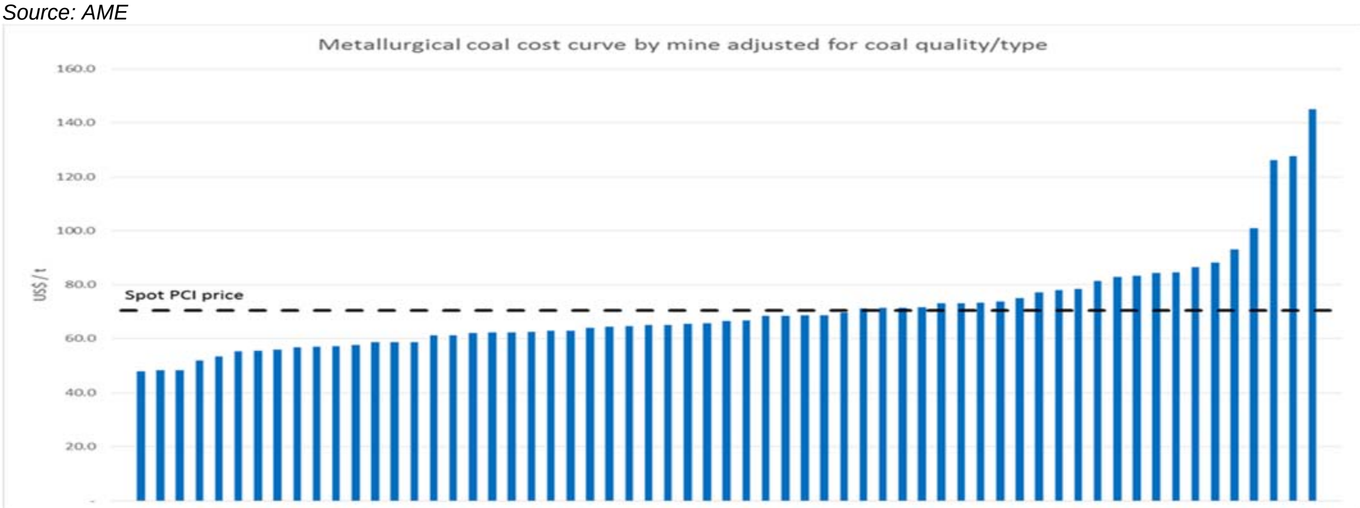
During the quarter we visited a range of mining and mining related companies in both Western Australia and Queensland. While conditions are undoubtedly tough for most players in the space, the mood in Queensland was somewhat bleaker than what we observed in WA. While much of this related to some relief from the recent improvement in the pricing of commodities such as iron ore and gold, there was also a sense that mining operations in WA were benefiting from the focus over the last few years on lowering costs of production.

While costs of production will remain a key focus for the miners, for the operators servicing WA mines there is an increasing trend toward their ability to improve mining productivity and quality of work, as opposed to the last few years where pricing was the primary criteria. In this context, reputable, well capitalised services companies should begin to see a steadying in work flow and over time growth in earnings. However, in Queensland with the weighting toward coal, conditions still remain tough. Although Queensland operators have pushed hard on mining contractors, it appears that the stronghold of the union is making it difficult to reduce the stickiness of high internal labour rates that have accrued since the mid-2000s. From a volume perspective, it seems that the Australian market will continue to produce at similar levels to current output but there is likely to be a shift in the mix of output. Higher cost producers are likely to exit with their volumes being replaced by the larger lower cost operators.

Our analysis has shown there are numerous mines that are not profitable and at risk of closure. (See charts below). Because of rail and port take-or-pay contract liabilities, those mines that may potentially close are likely to be smaller independent operators that will fall into receivership as opposed to mines operated by large groups such as BHP that will be required to honour their contractual rail and port agreements.



Source: AME



Source: AME

Despite the tough backdrop, crises can create opportunity. In this regard there are likely to be a number of asset divestments by coal miners such as RIO, Peabody and Anglo. Nimble, astute players could benefit from any such sales.

Trip Notes

Given **Wesfarmers (WES)** recent move into hardware retailing in the UK through the acquisition of the Homebase retail chain, we took the time to visit some hardware stores while in the UK. This included a couple of Homebase outlets, Wickes (owned by Travis Perkins), Travis Perkins themselves, B&Q (the leading DIY retailer, owned by Kingfisher), and the more trade orientated franchises Screwfix and Toolstation.

Wesfarmers intention is to roll out a Bunnings branded format across the Homebase store footprint. There is currently a reasonable level of competition in DIY retailing in the UK. However, what was instructive from the store tour is that there appears to be a window of opportunity that sits between the more trade orientated Wickes format, with its significant private label offering, and the retail focussed, but confused, offering from B&Q. Perhaps the most intense competition will come from the likes of Screwfix and Toolstation. Although these are trade orientated operations, their successful integration of extensive range, online ordering, delivery or in-store pickup, and efficient supply chains make them extremely attractive to the trade customer who is looking for a quick and easy way to source goods. Attracting the trade customer is important for a DIY/hardware operation, as trade significantly improves the asset utilisation throughout the week, improving asset turnover and ensuring adequate returns.

Excellent execution will be critical for Bunnings to be successful in the UK. It is going to be a challenging task to both prepare a successful Bunnings format for the UK market while at the same time disentangling Homebase's business infrastructure from the current owners, all in the first 12 months of ownership. Bunnings have put some of their best people on the task and we will be watching with interest as they move forward.

During the quarter we travelled to the U.S. and visited a number of building materials and housing construction companies. Our meetings highlighted that the positive momentum in U.S. housing is continuing with housing starts expected to reach 1.2m in 2016, an increase of 9% on the 1.1m housing starts in 2015. The current recovery is more gradual than previous cycles, which was attributed to the difficulty in obtaining mortgage finance, the delay of 'Millennials' entering the housing market, and the availability of trade labour. The upside to this is that we may see a more sustainable and extended housing recovery. Over the medium-term, U.S. housing starts are expected to get back to the long-term average of 1.5m per annum suggesting there is still a long way to go in this housing cycle, which provides a nice tailwind for companies like Boral and James Hardie.

CSL hosted investor tours of their recently acquired Novartis influenza vaccine business. The acquisition was completed in August 2015 for US$275m, and the business has been renamed Seqirus (which means "securing health for all of us"). The head office is based in Maidenhead, just outside of London, and we visited their two manufacturing facilities which are located in Liverpool in the U.K., and Holly Springs in the U.S. Liverpool is an efficient egg-based manufacturing facility but the cell-based Holly Springs is loss making and appears to be where material improvements in operating performance are required. The Seqirus business is currently loss-making and expects to be break-even in 2018, with medium-term targets of $1b in sales revenue and 20% EBIT margins by 2020. Key to reaching these targets will be launching their new products, optimising the US cell-based business, the material step down in R&D spend in 2018, and ongoing pursuit of cost and efficiency gains with higher volumes.

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