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 2017

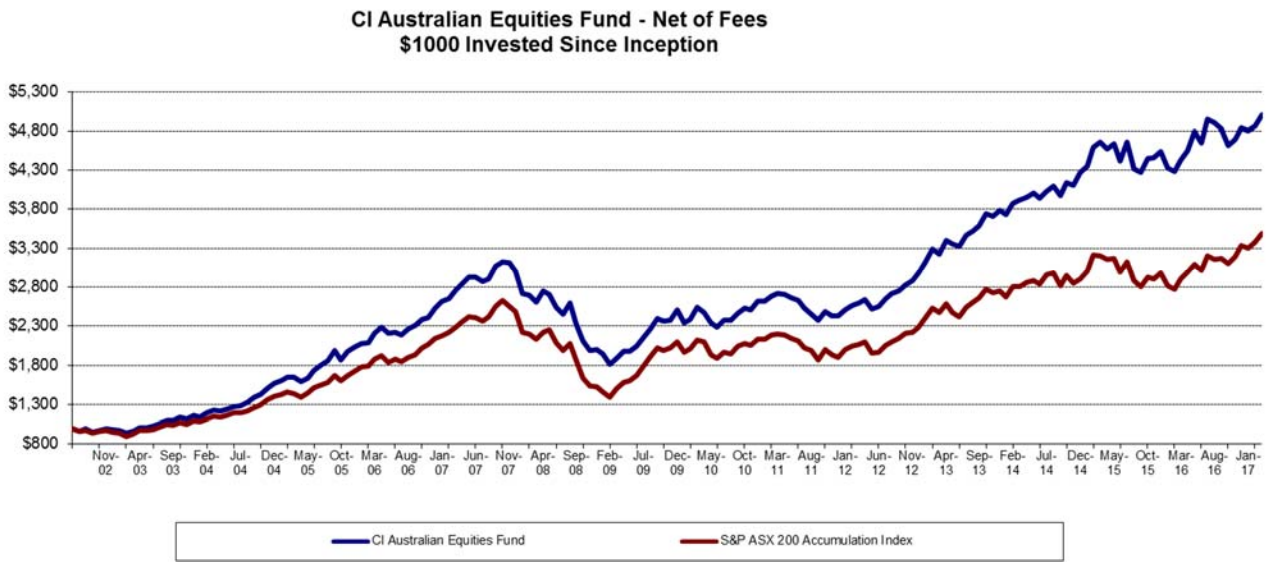
"I do the same thing over and over, improving bit by bit. There is always a yearning to achieve more. I'll continue to climb, trying to reach the top, but no one knows where the top is." Jiro Ono, Sushi Chef

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." Mark Twain

"Tis against some men's principle to pay interest, and seems against other's interest to pay the principle." Benjamin Franklin

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	3.54%	4.82%	-1.28%
ROLLING 1 YEAR	14.10%	20.49%	-6.39%
ROLLING 3 YEAR	9.87%	7.53%	2.34%
ROLLING 5 YEAR	15.42%	11.10%	4.32%
ROLLING 7 YEAR	11.33%	7.36%	3.97%
ROLLING 10 YEAR	7.23%	4.32%	2.91%
SINCE INCEPTION*	12.76%	8.86%	3.90%
SINCE INCEPTION^	487.29%	249.52%	237.77%

*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 (the Index) rose 4.8% over the quarter, adding to the Trump rally of the immediately preceding quarter. The Index is now up 12% since Trump's election victory, while the S&P 500 is up circa 10.5%. Investors are still anticipating market friendly and stimulatory moves from the new government in the USA in the areas of tax, financial regulation wind back, pro growth energy policy, infrastructure and trade policy. Trump's success in implementing these reforms, and their impact in the face of high debt levels, rising interest rates, and weak personal income/wages growth, will be a significant factor in determining the course of markets over the balance of the year.

For the quarter the major positive contributors to the portfolio included Bluescope (upgrade at result time), CSL (upgrade at result time), Transurban and Sydney Airport (both rebounding from having been sold off in the face of rising bond yields) and Boral (share price recovery post completion of rights issue).

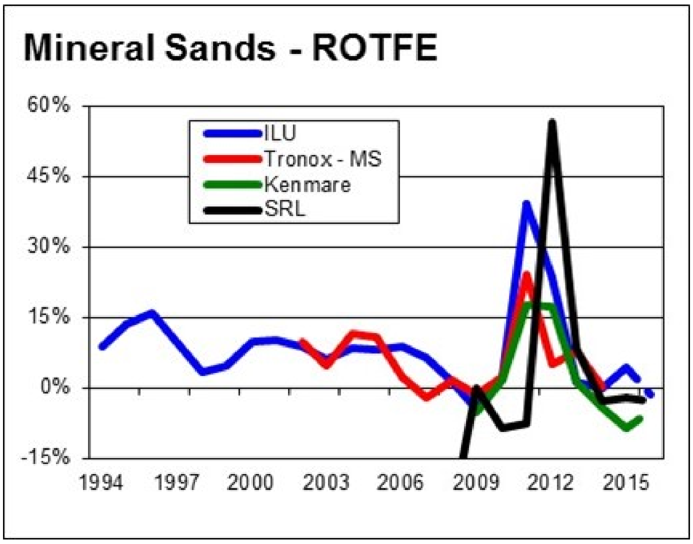
The main detractors from performance included Fletcher Building (poor result in the face of two underperforming contracts in the construction division), Brambles (poorly managed CEO and CFO transition coupled with winding back earnings growth expectations), Telstra (core business under more pressure) and Clydesdale Bank.

The Portfolio

We exited our position in **Ramsay Healthcare** (RHC) after another healthy semi-annual result which culminated in group EPS growth of 13% on prior corresponding period. However, at the same time the company announced that long time, highly respected Chris Rex would be resigning as CEO after 9 years in the top job (following his 13 years as RHC's COO). Given his long tenure and what we observe to be a strong culture within the company we were surprised that the board did not have a replacement to announce in conjunction with this departure. Often such a situation sounds alarm bells. However, pleasingly in March of this year the board appointed 22 year RHC veteran Craig McNally to take over from Chris Rex as of July 3, 2017. Rex subsequently sold a sizeable portion of his share in RHC. Although we believe the transition to Craig will be seamless internally, we do also see rising headwinds for the healthcare industry and think double digit earnings growth for RHC over the medium term will be a lot harder to achieve in the face of better managed health insurance companies in Australia, government pressure on issues such as prosthetics, high and still rising health insurance rates forcing fund members to reconsider the affordability of the product, and pressure on rates in both France and the UK. With the stock trading at 25X forward earnings everything must continue to go right for the company.

Iluka (ILU) was added to the portfolio. Iluka has a high quality, focussed management team. Value latency is also evident with the stock price reflecting current, cyclically low, commodity prices. Additionally, operating trends in the industry have stabilised and there are even signs of life, principally in titanium dioxide markets.

The mineral sands industry in which ILU operates has been through an extended downtrend since prices peaked in 2012 and at current commodity prices few producers are making money, let alone a reasonable return (as can be seen in the chart below). This would indicate that we are near the bottom of the cycle. The extended period of low prices has led to minimal new investment in the industry. Without significant new capital investment existing supply is likely to decline post 2018 for chloride feedstocks (predominantly used for pigment in paint) and post 2019 for zircon (raw material used in the manufacture of ceramics). Higher industry pricing is required to encourage investment in new supply.



Source: Company accounts, Diogenes Research

It is anticipated that the recent succession to a new CEO in Tom O'Leary will see the company's focus and capital discipline continue with Tom coming from a similar background to the outgoing CEO David Robb (both ex Wesfarmers). ILU's management have a focus on shareholder value and a view that this is achieved through acting counter cyclically, a rare thing in resource companies. This counter cyclical investment mentality can be seen in action with Iluka's recent acquisition of Sierra Rutile.

Stock News

Brambles (BXB) recent share price performance highlighted the old adages that where there is smoke (CEO and CFO both resigning) there is fire (earnings downgrades), and that bad things come in threes. The start of a series of negative events began back in February 2016 when the then CFO Zlatko Todorcevski informed the board of his intention to resign in February 2017. We took this at face value and the company subsequently went on to deliver a strong FY16 result which beat our expectations. Unfortunately, this result was overshadowed by announcement that CEO Tom Gorman, would also be resigning in March 2017 - effectively the same time as Zlatko's slated departure date. Graham Chipchase was at that time named as the new CEO commencing as CEO designate on January 1st 2017.

The market was unnerved by this "coincidence" of timing and was further disappointed when the CEO Tom Gorman sold a very substantial portion of his BXB shares in late August 2016 at prices ranging between $12.79 and $12.97. It is often a red flag when CEO's sell large parcels of shares and this proved the case when in October 2016 the company surprised with a disappointing sales trading update. From the original guidance given in August for FY17 forecasts they shifted down a gear and in February 2017 the company produced a poor 1H17 result, posting constant currency sales growth of 5% and corresponding profit growth of only 3% while also removing its medium term 20% ROIC target. While Pallets America accounts for ~40% of group earnings, we attribute it as the primary cause of the downgraded guidance and in turn, believe it has been the key factor influencing BXB's share price decline.

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Although we are extremely disappointed in how the board and management have handled the CEO and CFO transition, and we are frustrated at the performance of US pallets, we do not believe the issues in this division are structural nor are they indicative of the impact online retail is having on the pallet pooling industry. The arrival of online retail as a force is having an impact on the entire retail supply chain and point of sale and so must be closely monitored by BXB, however we see the current issues behind the US pallets division as poor management of the size and durability of the pallet pool. Management also appear to have misunderstood the supply and pricing dynamic in their US whitewood/recycled product area. To cap it off, their largest competitor has reached a sufficient level of scale where it can more aggressively compete for large contracts. Having said all of the above, we remain believers in the concept of pallet pooling and the network efficiencies it engenders for participants. BXB European business continues to be robust and the Reusable Produce Crates division is growing nicely. It is the US business which needs specific attention - we anticipate the new CEO will install a focussed, disciplined and energetic team in the US to work with online retailers such as Amazon to present a solution which adds value while also ensuring its offering adds more value than its competitors in the traditional retail sector.

Tabcorp (TAH) made two substantive announcements during the quarter. The company has settled proceedings brought against it by Austrac in relation to Anti Money Laundering. TAH agreed to pay a fine of $45m and has instituted internal procedures to avoid a re-occurrence. In light of the amount already spent by the company on this issue, it would appear close to $100m in total of shareholders' funds has been expended – we trust the company has finally fixed the issue. TAH also announced that it would bring to an end its submission to the ACCC for approval for the merger with Tatts Group by applying to the Australian Competition Tribunal (ACT) for authorisation for the merger. We were a little surprised at this move as it had appeared that the issues raised by the ACCC in relation to the merger were far from insurmountable. The reasoning put forward by TAH is that this will bring the consideration of public benefit and detriment into the process (whereas in the ACCC only competition issues could be considered) and that there is now a statutory time limit within which the application must be considered. The Macquarie Bank led consortium which submitted a competing offer to the Tatts board has been silent for some time now, although we would anticipate some action, whether in the form of an increased bid or otherwise, once the ACT has delivered its verdict. We hope that TAH retain their discipline and do not overbid for Tatts in such a scenario.

Fletcher Building (FBU) announced at its half year result in February that it had incurred losses on a large construction project in New Zealand but maintained its earnings guidance for the 2017 fiscal year. However a month later, disappointingly, the company announced an earnings downgrade (for the current fiscal year only) and further contract losses, principally on the initially identified contract and on one other. It appears that the company did not at the time of contracting recognise the complexity and size of the said projects, and has also been caught unaware by the rapid escalation of subcontractor costs (+30% according to industry sources) and labour costs in NZ over the last twelve months. In response the company has changed management in its construction division, installed new systems giving management a quicker and better picture of what is taking place on the ground, and implemented more rigorous processes around contract review and sign off. The company has stated that it has been conservative in estimating the losses in its construction book. The sum of all of this is that we do not expect a repeat of this provisioning. It has come at a bad time for the company which should be benefitting from the current strength in the NZ building cycle. We believe that athough house prices may be at a peak in NZ, at current immigration levels and housing shortages, and with the planned infrastructure spend, there will be sufficient work for FBU to rebuild its profits over the next couple of years.

Trip Notes

During the quarter we visited the UK, and some CSL manufacturing facilities in Continental Europe. The UK economy stopped for a few days immediately post Brexit vote, then resumed its normal course. The wheel is still turning today but more slowly. Uncertainty over Brexit is hanging over the business world and both limiting optimism and delaying investment decisions pending greater clarity on exit arrangements. The currency has been a very valuable shock absorber. London property has peaked albeit not fallen much. No new development projects are getting off the ground – and it appears architects are starting to struggle and lay off people. Regional cities (Manchester, Birmingham, Liverpool) are performing a little better given outsourcing from London to these areas to take advantage of much cheaper people cost.

There continues to be underfunding in healthcare and social care. Public hospitals are clogging up and waiting times deteriorating due to there being little available social care for elderly patients to decamp to (care homes struggling due to living wage uplift and no corresponding ability to raise revenue), and increased GP waiting times are forcing people to attend the A&E at their local hospital regarding problems which should be seen by a GP. The NHS employs many European doctors and nurses which will make the negotiation of Britain's exit from the EU harder.

We visited the Bank of England (BOE), the Prudential Regulatory Authority (PRA), and Clydesdale Bank (CYB). It appears that there is no significant capital uplift to come for banks. However, risk weights (used to calculate capital held against different types of loans) will change to equalise the playing field between large and small banks. The BOE has set up a small bank unit to help small banks in this regard. Challenger banks/banks on standardised risk weights will be able to convert to internal ratings based calculated risk weights - requirements to make this change will be legal (amount of data required, experience as an organisation), risk management systems, governance (board, people). The PRA did question how many people with sufficient experience there are in the market.

The timing on such changes will be 1.5 – 2 years from the submission of a formal application to the PRA. Approximately half the smaller banks are going down this route today. Capital released from this process can be used however the relevant bank wishes, subject to meeting regulatory standards and requirements. We believe CYB will be able to complete this process given their new, experienced management team. This will release potentially up to GBP 550m of capital. We do not believe that all this capital will be returned to shareholders – although we have no doubt some will, we suspect some of the capital will be used to grow the business.

We gleaned some further insights on our travels regarding UK banks:

- The mid-tier in UK banking needs consolidation. Given that Santander has a much larger balance sheet, and that Williams and Glynn has been taken off the market by RBS, and the start-ups (the likes of Shawbrook, Aldermore, One Savings) run completely different business models, this would seem to leave CYB, Virgin and TSB as potential candidates for merger activity.

- It finally appears that the conduct issues besetting the sector (PPI) are drawing to an end (likely final date mid 2019). Most sense that while there are not large numbers of new cases yet to come there will be a final push.

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While in the UK we took the opportunity to visit one of the new Bunnings stores. Last year Wesfarmers acquired Homebase, a home and hardware retailer, with the aim of building a business in a market worth GBP 38BN. Homebase has a network of 255 stores in a fragmented market and historically has not been the cheapest player in the market. Although generally similar, there are some differences between the markets in Australia and the UK eg. in the UK gardens are a much bigger focus, houses are generally smaller, there is a high level of wear & tear due to size & climate meaning a greater emphasis on kitchens, bathrooms and flooring is important. Bunnings will first focus on better operational performance at Homebase, trial the Bunnings Warehouse brand & format in pilot stores, and then roll out the format on a wider basis. The Bunnings store we saw did indeed look and feel like an Australian store, albeit with some subtle differences to cater for market nuances. It is estimated the total investment by Bunnings into its UK venture will be up to $1B over a five year period.

During the quarter we travelled to the U.S. to look at building products and construction materials in light of Boral's (BLD) intended acquisition of Headwaters Inc. While we perceived there to be uncertainty around political risks in the U.S. under Trump, the outlook for housing related companies over the next few years remains very positive. Housing starts are expected to continue the gradual recovery towards the long term average of 1.5m starts per annum, with very strong activity levels down South, particularly in Texas, which is a key market for BLD. The outlook for construction materials (i.e. cement, concrete, fly ash) was also very buoyant given the recovering U.S. economy, the mooted infrastructure spending programs, and the inability to expand cement supply given stringent regulatory requirements. Overall we came away thinking that there are strong industry tailwinds for BLD in the U.S.

We also looked to gain a better understanding of the U.S. fly ash industry, which will be one of the key businesses for BLD once the Headwaters Inc transaction completes. Fly ash is used as a replacement material for cement in ready-mix concrete, with the current replacement rate of cement by fly ash estimated to be around 18%. Fly ash is sought after because it delivers superior concrete performance, has environmental advantages, and is (on average) priced at a 30%-35% discount to cement prices. Our meetings highlighted that while the demand for fly ash is expected to be very strong, the key issue going forward will be securing enough supply of high quality fly ash to meet demand. The industry is looking to address this by investing in storage, better infrastructure as well as developing technologies to reclaim the large amounts of fly ash stranded in landfill. In summary, we think fly ash is a high quality business that is relatively capex light with low fixed costs, and should deliver high margins, returns and cash flow in coming years.