CI AUSTRALIAN EQUITIES FUND
QUARTERLY REPORT

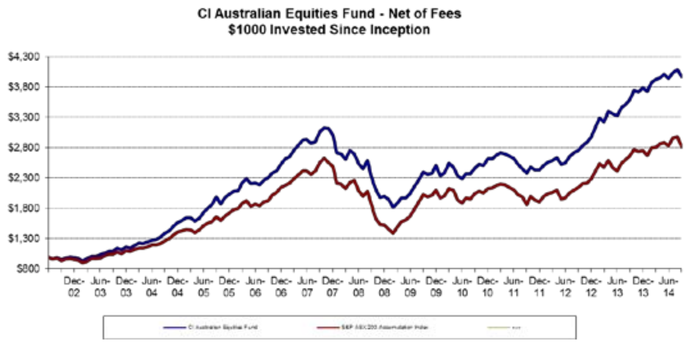
Cooper Investors Pty Limited AFS Licence Number 221794 ABN 26 100 409 890

SEPTEMBER 2014

"That men do not learn very much from the lessons of history is the most important of all the lessons that history has to teach." Aldous Huxley.

"We can't solve problems by using the same kind of thinking we used when we created them." Albert Einstein

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	1.05%	-0.60%	1.65%
ROLLING 1 YEAR	11.82%	5.93%	5.89%
ROLLING 3 YEAR	19.82%	14.77%	5.05%
ROLLING 5 YEAR	11.59%	6.82%	4.77%
ROLLING 7 YEAR	4.77%	1.42%	3.35%
ROLLING 10 YEAR	12.17%	8.40%	3.77%
SINCE INCEPTION*	13.08%	8.84%	4.24%
SINCE INCEPTION^	350.60%	182.05%	168.55%



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

Market and Portfolio Performance

The Benchmark Index fell 0.60% over the quarter and rose 5.93% over the last twelve months. The portfolio returned 1.05% and 11.82% over the three and twelve months respectively. The September quarter was a particularly volatile period with the market rising 4.4% in July and then falling 5.4% in September. The heavyweight bank and resource sectors led the market declines in September. In addition to troubling global concerns, the Australian bank sector was hit because of expectations that the banks will need to raise further equity. The large resource companies fell as the iron ore price fell. In our last quarterly we referred to the AUD as not having cracked – we spoke too soon. Over the quarter it fell from USD94c to 87c.

The positive contributors to performance included:

1. Caltex – outlined an efficiency program designed to secure material cost savings in coming years;
2. TPG – strong result with the first synergies from their acquisition of AAPT starting to appear;
3. Recall – rumours of a potential bid for the company in the offing; and
4. Sims Metal – the new CEO presented to the market on internal opportunities to improve profitability.

The worst performers over the quarter included:

1. Transpacific – a slightly weak result compounded by issues relating to the cost of landfill remediation;
2. Sky TV – lost rights to broadcast USA and European PGA golf; and
3. Oil Search – falling oil price.

The Portfolio

The last quarter was the quietest quarter we have had for some time – no material changes to the portfolio were undertaken over the period in question.

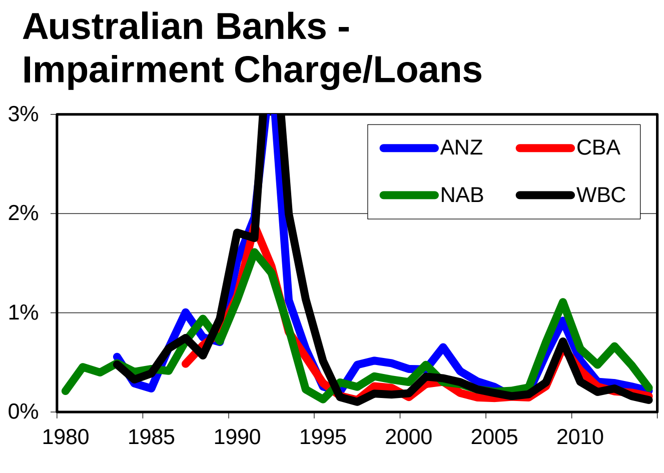
Stock News

Telstra announced a buy-back of $1bn of stock and this occurred during early October. The buy-back was structured in a way that included roughly half the buy-back price being a fully franked dividend and the remainder capital. The scale back of shares tendered into the buy-back was 70% so the benefit was not as large as hoped by many. In addition to this buy back, Telstra also increased the annual dividend from 28cps to 29.5cps.

For the banks the implication of the **Murray Banking Inquiry** signals another milestone that further ends the cycle of leveraging that started in the mid-1980s and was accelerated in the early 1990s when risk weighting was introduced by the RBA. In preliminary comments David Murray has challenged the big four banks' dependence on housing, suggesting that they need to hold more capital against mortgage lending in order to reduce the risks to the stability of Australia's financial system.

The Murray inquiry is focusing on capital and "too big to fail". It's hard to be certain about the final outcomes, but one thing is certain, and that's capital (ordinary equity) is going up at a time when bad debts are at a cycle low point. The Murray recommendations are likely to:

- Constrain dividend growth;
- Lower ROE %;
- Dilute EPS growth;
- Make banks less leveraged and therefore safer; and
- Increase scrip available if DRP discounts are activated.



Source: Diogenes

BHP announced plans to create an independent metals and mining company based on a selection of its aluminium, coal, manganese, nickel and silver assets. This company will be demerged from BHP and listed on the ASX. This action, along with others, signals a significant change in philosophy at BHP, i.e. to make simplicity a key objective. BHP believes that simplification and focus lead to better outcomes. Following the demerger BHP will have a much reduced suite of assets and it can concentrate on its large, world class iron ore, copper, coal and petroleum assets and possibly increase exposure to potash. BHP has committed to a progressive dividend policy, a limit on capital expenditure and a solid "A" credit rating. It will now shift focus to costs and margin and away from volume and capital expenditure. As most commodity prices have fallen towards costs of production for many producers, we should have more confidence that in the medium term prices will not slip too much further. This new set of circumstances make BHP a more attractive and stable investment proposition.

The price of **Recall** rose sharply based on media speculation that Iron Mountain (the big US document storage company) is considering making a bid to buy Recall, although Recall has said that it has not had discussions with Iron Mountain. Analysts have estimated that Iron Mountain could pay well above the current Recall price and still make a deal stack up, so in a way the speculation has focussed the market's attention on the quality of the Recall business.

Aurizon announced a result broadly in line with expectations. However the market was taken by surprise by the company announcing it would have to spend more in capital expenditure in coming years in order to meet its operating margin expectations. This factor, in addition to lowered expectations of the likely allowed rate of return for its below rail operations at the upcoming regulatory reset, and ongoing weak coal markets, led to the stock's under-performance. The cost out and broader efficiency opportunities, as well as the rolling over of old coal contracts to new form contracts with higher prices for 30% of coal volumes over the coming years should enable profits and cash flow to grow. We remain very cautious over the deal with Baosteel to develop the iron mine in WA, and we will monitor progress in this venture very carefully over the coming months

Summerset (and the New Zealand retirement sector) has had a poor period of share price performance with concerns about the weak NZ$, housing prices, oversupply and a number of listings coming to the market in both New Zealand and Australia. Recent visits to New Zealand did not provide any evidence of oversupply, indeed the companies and sales representative we talked to confirmed strong presales and, for some villages, development had been brought forward to meet client demand.

Summerset has been impacted by increasing costs as it scales up its business for the next phase of growth. The cost burden arises from choosing to bring forward the building of the communal and aged care facilities in the development process, as well as start-up costs associated with new care facilities that typically take 12-18 months to reach full occupancy. This appears consistent with management's strategy to create a scalable platform before demand accelerates over the next few years as we are hit by the grey tsunami.

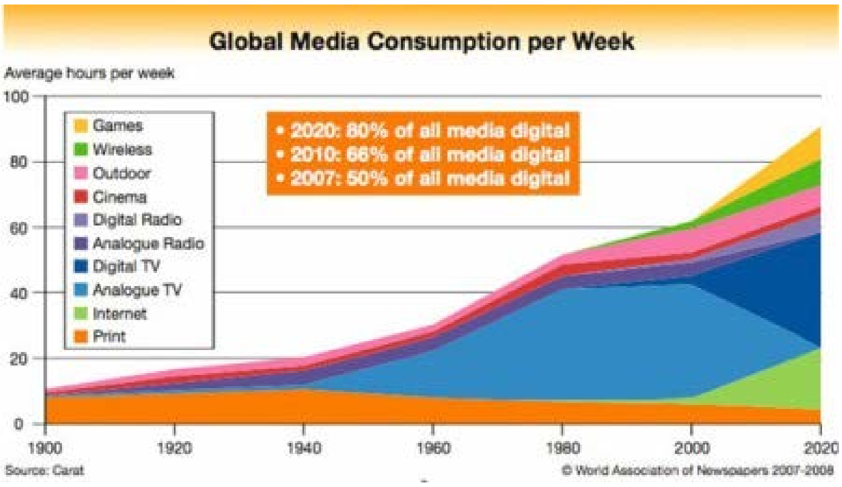
International Trips

We recently visited the US where we met with a wide range of global media companies whose operations spanned the entire media spectrum from content providers to distributors to marketing groups. The clear message remains that "content is king" and we are in a "golden age" for content providers. This is being driven by the proliferation of media distribution with "Over The Top (OTT)" opening up new ways for viewers to consume media. With developed economies consuming more content and emerging economies seeing an explosion in demand for media, globally positioned content providers such as 21st Century Fox (FOX) are very well positioned.

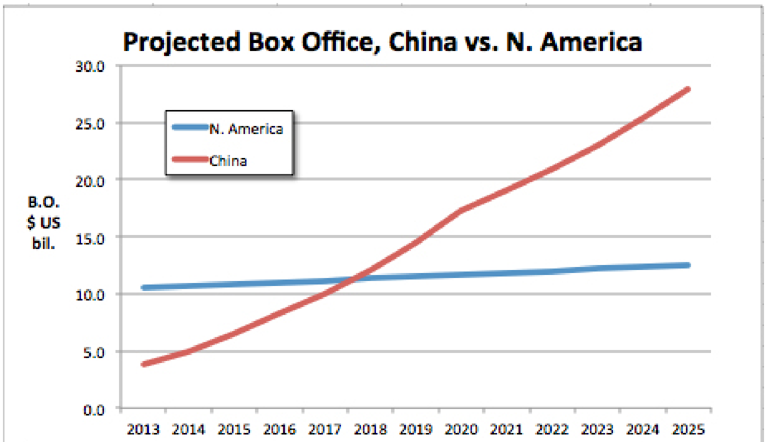
The trip was timely given FOX's recent proposal to acquire Time Warner (which was subsequently rejected). We saw the deal as a long term strategic positive that would have created a global power house – the world's biggest content producer with greater leverage relative to the consolidation currently underway in the cable systems industry. As value for FOX shareholders is dependent on price paid, we applaud the board's decision to discontinue further discussions with Time Warner given the latter's high expectations.

FOX - Overview of industry and company trends:

- FOX has spent recent years building itself into a global media content provider delivering product with global appeal (i.e. The Simpsons, Modern Family, Fox Sports, Star Sports, Fox News and movies such as Avatar and X Men). This has put it in a strong strategic position at a time when content distribution has proliferated (i.e. OTT) increasing demand for quality content. With new technology releases such as larger, improved smart phones, increased internet connectivity across the globe and rising income levels in emerging economies this growth in content demand should continue and underpins what is referred to as a "golden age" for content providers.



- This global reach was a contributor to the +40% increase in Fox's filmed entertainment revenue at a time when the US box office declined. From an industry perspective, international box office now represents 70% of total box office sales (local and Hollywood consumption) with projections for China's box office growth highlighting demand for media content from emerging economies.



Source: China Film Biz

- FOX's cable network programming revenue grew 13% in the 12 months to June 2014. This was despite the early stages of the development of its new cable networks (Fox Sports 1, STAR SPORTS and FXX). As these networks mature, this should provide a strong growth tailwind with all three networks nearing profitability. Although network development takes time, as Fox News has shown, the development of a strong branded channel can create an earnings powerhouse.

- Management believes it should be able to achieve mid-teens percentage growth in group affiliate fees over the medium term. It has good transparency around this with 75% of affiliate fees already booked for FY16 (this implies 33% of group revenues are already committed). With improving ratings within the new networks, management appears confident in achieving at least the same growth for the remaining 25% of affiliate fees not yet booked. This is a result of the quality of their content and their 9 year lock up of sports rights including the NFL, Major League Baseball and NASCAR.

- FOX has a strong balance sheet supported by excellent free cash flow and the recent divestment of Sky Italia and Sky Deutschland (net proceeds of $7.2bn). This provides potential in terms of either further capital management (in addition to the current $6bn buy-back) or acquisitions.

- There is latent value upside in the potential for FOX to add to its current buy back with a further $6B in 2016. This would be highly accretive to earnings per share and valuation if undertaken.

Market Observations

The resource downturn continued its flow of bad news with downgrades to service providers such as ALQ (technical testing services). The negative trends are happening at both the sales and margin level. Whilst there look to be emerging opportunities amongst service companies due to price falls, the sector remains unattractive at the moment due to a shrinking profit pool and the internal competition coming from resource owners in-sourcing. Negotiating power has swung firmly to the producers. ALQ joins the long list of companies caught by aggressive acquisition strategies at the wrong time in the cycle. Generally speaking the resource sector managements and boards have under appreciated the importance of capital decisions and cycle timing on value i.e. cycles move in both directions.

The coal market has been hit by China's import restrictions. China has initiated this policy for 2 reasons:

1. China’s coal industry is undergoing a cycle of closures and consolidation. Whilst the big domestic miners are world class, the smaller village mines (33% of production) produce most of the pollution, poor work practices; and are huge employers. With 70% of domestic suppliers not making a profit and 15% not able to pay wages, it has now become a political issue given the sensitivity of closures on employment. The consequence of this action will be to increase local prices.

2. Environment and pollution quality - an attempt to clean up the pollution being generated by coal fired power stations. This is a similar path to that the Japanese took in the 1970's i.e. better enforcement and quality control. On this point Australia should be a beneficiary given its generally lower sulphur coal. Indonesia will be the most affected because of their high sulphur and low energy value coal. The biggest issue for Australia is not the relatively small export quantities (50m tpa) to China but the impact on seaborne prices resulting from China's import restrictions designed to favour domestic producers.

In a world where LNG costs 3 times more than coal for the same unit of energy and emerging populations are seeking higher standards of living, coal is expected to remain an important part of the energy mix. There are reports that Japan is going to restart the new build of coal fired power stations.

The iron ore price continued its decline from the previous two quarters, falling to $US77/t, the lowest level since 2009 and down from its peak of $170/t. The junior iron ore miners’ share prices fared the worst (BC Iron -49.5%, Mount Gibson -21.0%, Atlas Iron -33.3%) while Fortescue Metal was down 20.0%, BHP was down 5.7% and Rio Tinto managed to produce a positive return of 0.5%. This compared with the ASX 200 return of -0.60% in the quarter.

The slowdown in China’s residential sector continued which has led to weakening in steel demand, of which iron ore is a key ingredient. China appears to be focused on long-term reform and it is unlikely there will be major stimulus to provide short-term relief. China’s continued prosperity and urbanisation is very important for the miners, as China represents 50% of global steel production and 67% of seaborne imports. The large miners still hold the view that steel demand in China will exceed 1bntpa over the long-term (~780mt in 2013) and currently have large iron ore expansion projects in place to capture this expected increase in demand. It also appears that they have their eyes on displacing high cost producers and ensuring that there are limited new players over the next few years. The current iron price is helping and should see capital exit this once lucrative market. However, we are yet to witness any significant mine closures which we think is the next stage of the process.

Cash costs are expected to continue declining, and in addition to a lower AUD, will serve to delay mine closures. Both RIO and BHP still make handsome profits at current spot prices as their cash costs are estimated to be $US45/t and falling.

China – My Thoughts by Carol Fang (Analyst, CI Asian Tiger Fund)

I thought I'd share my experience as a Chinese consumer.

As a Chinese consumer who used to buy rice according to amount allocated by the government, the past 30 years have been an incredible ride. After almost 100 years of turmoil, China opened its doors to the world in early 80's. Products like "Milo", "Colgate" or "Maybelline" which were common to westerners were simply not available in China until the 90's and a Chinese consumer had a lot of catch up spending to do. To facilitate today's more frequent and mobile transactions, excellent payment infrastructure has been rolled out in 1st tier cities – for example, in Beijing you can pre-pay your meals or movie tickets using Ali Pay to avoid disputing who should shout dinner.

Motivations of consumption for Chinese mostly come from the desire to conform. China runs on a unique Confucian value system where individual expression is something to be frowned upon. Whilst a westerner might ask: "how can I differentiate myself?" Chinese tend to ask: "why am I different?", yet people crave for positive social acknowledgement as it is the essence of "winning" in Chinese culture. It is therefore important to find a middle ground between "being accepted by the mass" and "display social status".

Across the nation we observed young consumers opting for fashionable but mass market labels; people relentlessly compare price and value of every product before they open their wallet and an ever increasing national saving ratio of more than 50%. However, "living a green life" and "have rich experiences" have become signs of social status among mid-high income earners. Regular visits to beauty salons, reduced car usage, or taking a trip to Australia beat owning more designer goods. Shares of travel, education, personal care and recreational activities as a percentage of household budgets have been increasing faster than basic necessities like food and clothes. Even as the Chinese economy slows down and offline retail becomes muted, online information consumption still grew 20%, there are more than 10 new movie screens being put in place across the nation every day and newspapers are filled with multiple pages of ads from travel agents.

One exception that beats all lifestyle or experiences however, is to own multiple properties. It is hard to ignore Chinese passion for owning, upgrading and decorating their homes. Whilst most people are still working towards buying their first home in urban areas, many 1st tier city dwellers have moved on to buy their second property or overseas holiday house which are newer, bigger and better. Property is not a simple store of wealth to the Chinese but a carrier of family traditions to be passed down for generations.

By comparison with what's been observed in China, the neighbouring ASEAN countries are a few steps behind. Lack of infrastructure and transportation systems still limit consumers' mobility and their desire to spend. No doubt as ASEAN consumers become more sophisticated, we will observe a more vibrant service industry servicing domestic consumers rather than foreign companies.

We believe that Chinese consumers' spending power has not been fully unlocked. As the country slowly establishes a better social security system for its people, more disposable income will be available to drive further development in the service industries such as education, aged care and health care. The mass majority will experience this consumption upgrade as wage level increases across the board, albeit from a lower base. We therefore expect to see more complicated consumer behaviours which will translate to new investment opportunities in the consumer space.

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