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.

September 2016

"The Great Depression, like most other periods of severe unemployment, was produced by government mismanagement rather than by any inherent instability of the private economy." Milton Friedman

"The saddest aspect of life right now is that science gathers knowledge faster than society gathers wisdom." Isaac Asimov

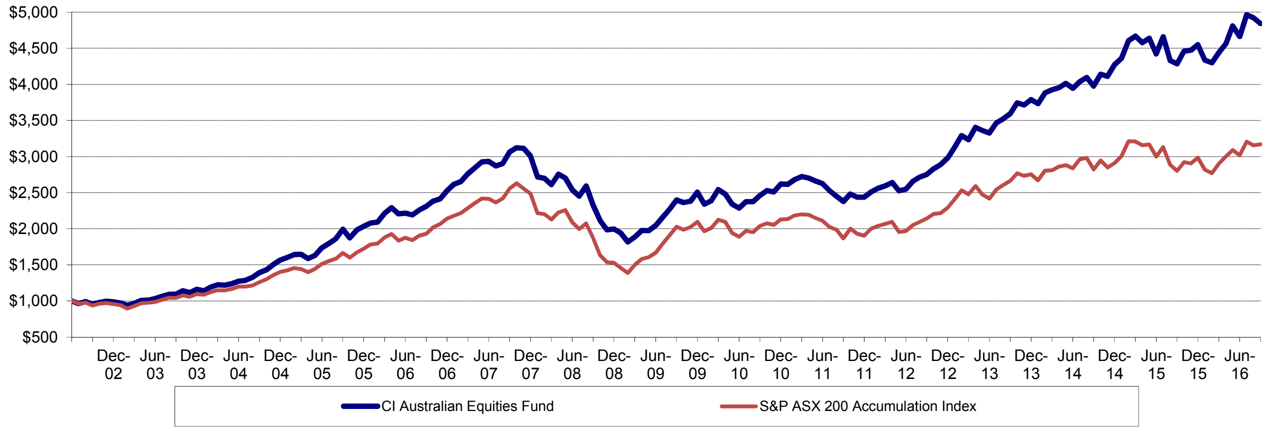
"Christmas is a time when kids tell Santa what they want and adults pay for it. Deficits are when adults tell the government what they want and their kids pay for it." Richard Lamm

"When a government spends the public pays for it. There is no such thing as an uncovered deficit." John Maynard Keynes

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	4.14%	5.14%	-1.00%
ROLLING 1 YEAR	14.23%	13.17%	1.06%
ROLLING 3 YEAR	11.89%	5.99%	5.90%
ROLLING 5 YEAR	16.59%	11.18%	5.41%
ROLLING 7 YEAR	11.68%	6.59%	5.09%
ROLLING 10 YEAR	8.80%	5.09%	3.71%
SINCE INCEPTION*	12.92%	8.44%	4.48%
SINCE INCEPTION^	464.48%	217.03%	247.45%

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

CI Australian Equities Fund - Net of Fees
$1000 Invested Since Inception



September 2016

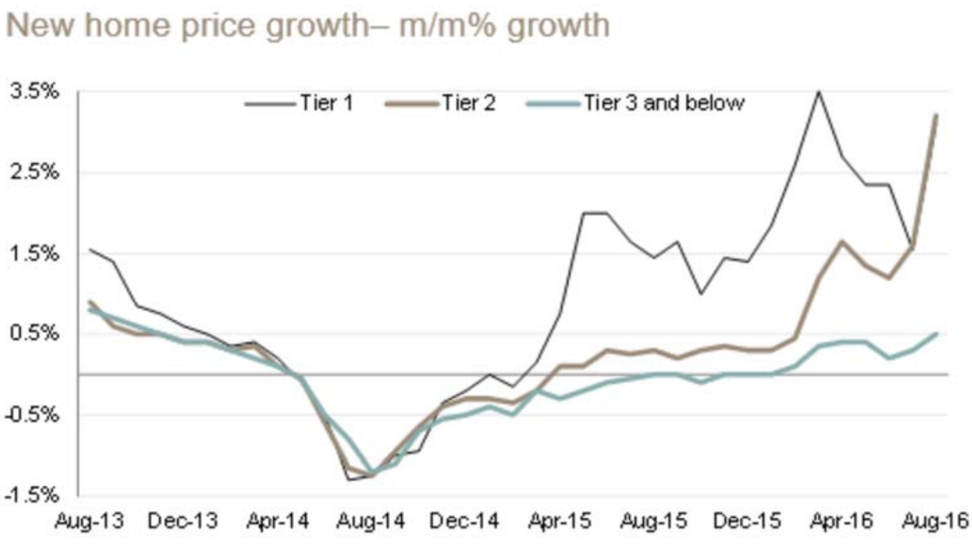
Market and Portfolio Performance

The ASX200 Accumulation Index performed strongly in the September quarter (+5%). This included a post Brexit recovery during the month of July followed by a small downward drift during August as investors digested a mixed set of company results.

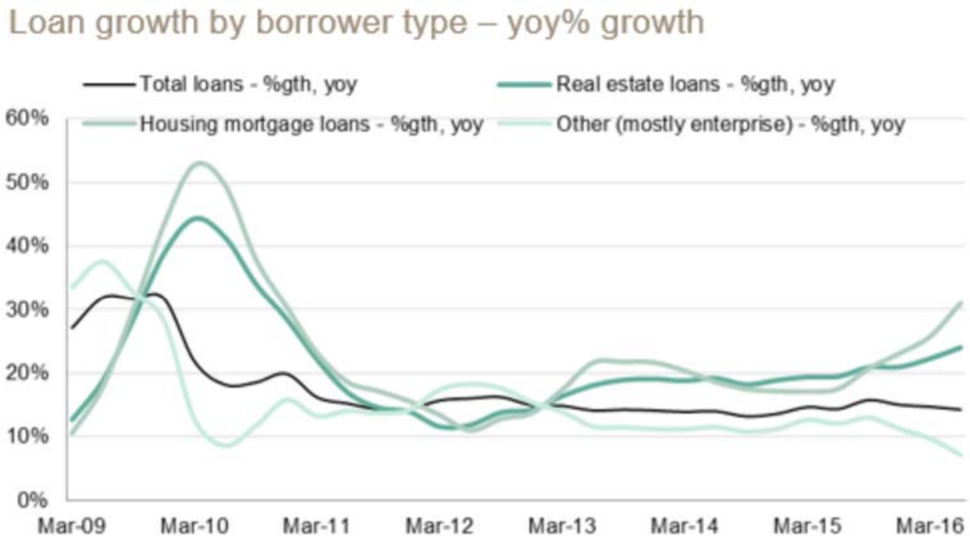
Key contributions to portfolio performance during the quarter included **Cleanaway (CWY)** (solid 2H 16 result showing that management actions to improve company performance are on track), **Macquarie Group (MQG)**, **Bluescope Steel (BSL)** (solid FY16 result), **Sims Metal (SGM)** (management actions to reduce costs taking hold) and **National Australia Bank (NAB)** (moving up with the banking sector generally).

Portfolio stocks that performed poorly were **TPG Telecom (TPM)** (weaker than expected FY17 guidance driven by slower organic growth, increasing margin pressure from the NBN, and delays in realising IIN synergies), **Regis Healthcare (REG)** (further regulatory issues arising for the sector), **CSL (CSL)** (flu vaccine losses worse than anticipated in FY16 result), **Brambles (BXB)** (good result but the fact that CEO and CFO going at the same time proved disconcerting for the market), and both **Transurban (TCL)** and **Iron Mountain (INM)** were affected by concerns that US bond rates will rise.

The resources sector continued its strong performance calendar year to date, outperforming the broader market by 8.2% in the quarter. In China, the stimulus from the government and easing in monetary policy has provided strong support to infrastructure, property and consumer goods (automobiles and appliances). House price growth has been very strong this calendar year in tier 1 & 2 cities, but more surprisingly tier 3 and lower cities have sustained some price increases despite the high inventory levels (see chart below). We are wary as the growth has been supported by an acceleration of credit growth. This has led to a recovery in property construction, and along with the increase in infrastructure investment, steel production has held up better than most had anticipated earlier in the year. As a result, prices across the commodity complex have rallied.



Source: Bloomberg, CEIC, China NBS, CBA estimates



Source: Bloomberg, CEIC, China NBS, CBA estimates

The Chinese government has also stepped up its reform agenda with the reduction of coal output (-9.5% year to date) and steel capacity (targeting 45mt this year out of total capacity of 1.1bnt). With consumption of coal falling by a lower amount, coal prices have rallied significantly from their lows in the first quarter, especially metallurgical coal which is now trading above US$200/t on the spot market (and has also been impacted by supply disruption from South32 and a train derailment in Queensland's Bowen basin).

Most of the recent data-points coming out of China do not suggest that the economy will come to a halt, but the longer term issues around high debt levels, NPLs and reliance on heavy industries remain. It does seem that the government is willing to provide support to the economy in the near term, particularly given that the 19th National Congress is being held next year.

Our underweight position in the large diversified miners has detracted from our performance as our resource and cyclical related plays have not been able to fully offset this. The increase in the bulk commodity prices and the sustainability of the price rises to date has surprised us. Given the supply outlook and our view of long-term commodity prices, we continue to take a cautious view on the sector.

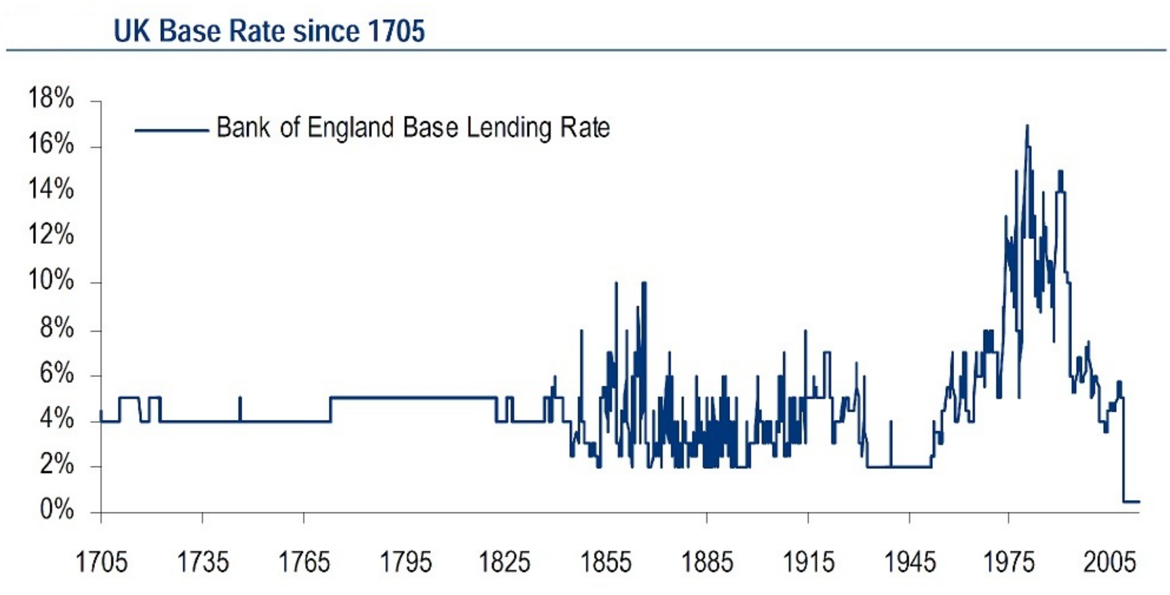
During the quarter the Reserve Bank of Australia lowered rates (again) by 25bps, bringing the cash rate down to 1.5%. The key reasons cited were:

- conditions have become more difficult for a number of emerging market economies and the underlying pace of China's growth appears to be moderating;
- Australia's terms of trade remain much lower than it has been in recent years;
- recent data suggests that overall growth is continuing at a moderate pace, despite a very large decline in business investment;
- other areas of domestic demand, as well as exports, have been expanding at a pace at or above trend;
- labour market indicators continue to be somewhat mixed, but are consistent with a modest pace of expansion in employment in the near term;
- inflation remains quite low;

- the most recent information suggests that dwelling prices have been rising only moderately over the course of this year, with considerable supply of apartments scheduled to come on stream over the next couple of years, particularly in the eastern capital cities;
- growth in lending for housing purposes has slowed a little this year. This suggests that the likelihood of lower interest rates exacerbating risks in the housing market has diminished.

In contrast, the US Federal Reserve continued to signal that an increase in rates is now more likely. In August, Fed Chair Janet Yellen stated that *"…in light of the continued solid performance of the labor market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months".*

As we have previously spoken about, the collective action of Central Banks across the globe is unprecedented. For example, the Bank of England's cash rate has never been this low in its 300-year history:



The ECB, BoE and BoJ have extended their asset purchase programs (quantitative easing) to include corporate debt and equities, in what can only be described as an ongoing large and unprecedented experiment.

Interestingly the IMF has just published a sombre piece about the amount of debt in the world today. Perhaps not surprisingly, given the level of interest rates and encouragement coming from central banks, the amount stated ($152TR, more than two times the size of the global economy) is eye watering. We have been thinking about what happens if interest rates rise – how will this debt be serviced and repaid, and what impacts will this have on global economies.

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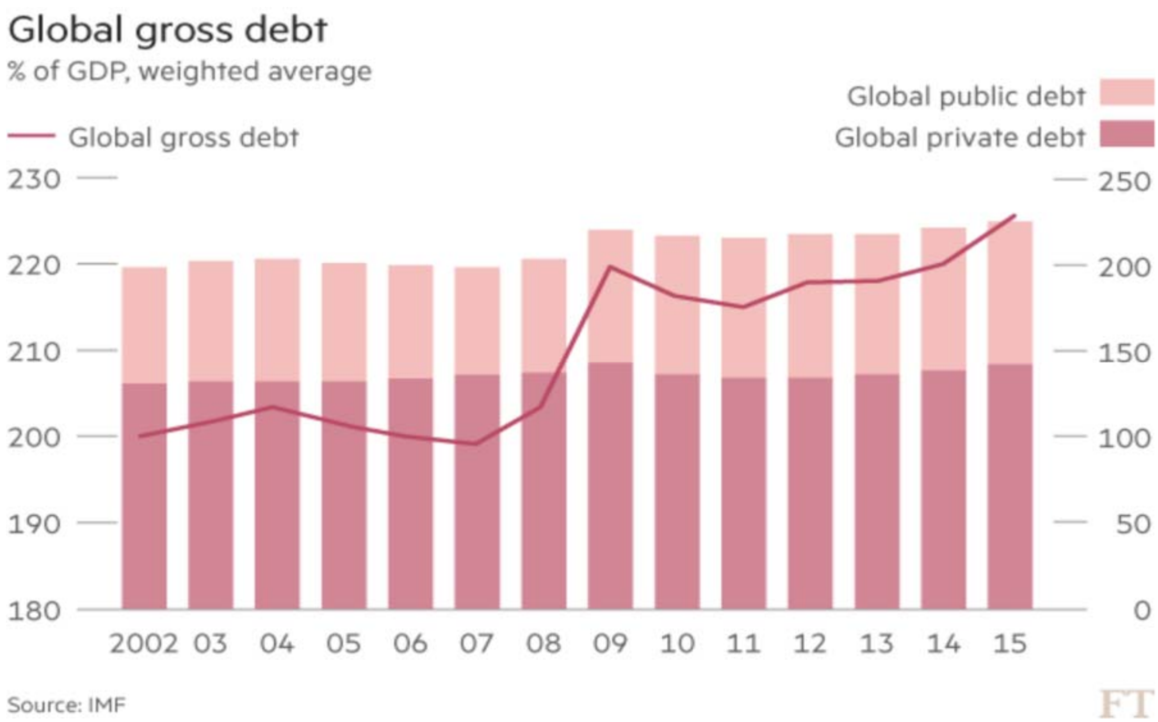

Bank of England

Although we are bottom up investors, the magnitude of this intervention by governments in financial markets is hard to ignore and has undoubtedly influenced asset prices and skewed the allocation of capital across economies. There is little doubt of the potential future risks to asset prices and performance of the portfolio, even though the end game remains uncertain.

We remain entirely focused on implementing the philosophy of the Fund. Perhaps the most important part of this is finding and backing the best management teams, who will ultimately find a way to navigate whatever is ahead of us. These "best in breed" managers are often owner operators with a proprietorship culture, deep (nuanced) industry/ business knowledge, are passionate and above all honest.

We also believe that a number of secular growth opportunities will remain robust in almost any future scenarios and so we continue to focus our efforts around "clusters" of companies exposed to these trends. For example, the ongoing dynamic of our ageing population.

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Portfolio

During the quarter we made some changes to the portfolio.

We sold our position in **GPT (GPT)**. Our original investment proposition was based on buying high quality property assets at a significant discount to net tangible assets (NTA) with a clear roadmap for how this gap would be closed. Management executed well on their plan and this, together with a supportive low interest rate environment, means the stock now trades on a significant premium to NTA. While the underlying business is performing well we do not see much upside to the current share price and given that our investment proposition has played out we decided to exit.

We also sold out of **Oilsearch (OSH)**. The PNG LNG project is now up and running well, and despite many rumblings, the political situation on the ground in PNG would seem no more risky than usual. However, despite the fact that the project is one of the lowest cost most efficient of LNG projects globally, we believe the stock is fully valued at current oil prices. We do acknowledge the opportunity to add two further projects with Exxon and Total but these projects need to go through the sanctioning process, and find customers, and are unlikely to come on line for another five years. In the meantime the vagaries of the oil price are the most likely impacts on the share price.

We participated in the **Viva Energy REIT IPO (VVR)**. The stock has very simple and secure cash flows underpinned by a 15.3 year weighted average lease expiry, fixed 3% per annum rental increases, and a triple net lease structure. The petrol station property portfolio has been established over a period of more than 100 years and would be very hard to replicate given the scale and strategic locations of properties. Viva Energy has an acquisition pipeline of 100 sites over the next five years, some of which may be added to the property portfolio and therefore increase the distribution profile. We think from listing price the Viva Energy REIT can deliver a 10% p.a. total return comprising a 6% dividend yield and 4% earnings growth. There is upside to this if the dividend yield compresses towards the level of peers such as ALE Property Group and BWP Trust which trade on dividend yields of 4.5% to 5.5%.

We also bought **Newscorp (NWS)**. The company owns a number of leading media assets (traditional as well as digital, encompassing newspapers, on-line real estate and book publishing) and we believe the stock is undervalued – closing the valuation gap is hampered by the transition all such companies are making from “old” to “new” media. Note though that even the old media assets (print newspapers in the main) are generating substantial cash for reinvestment.

We expect the industry wide declining trend in print to continue. However NWS has some very strong digital media brands with very wide reach. For example, some of its key mastheads including The Wall Street Journal, New York Post and The Sun (UK) have 143m, 43m and 45m unique visitors to their sites respectively per month. We believe this offers significant optionality if management can capture the power of this reach through better data management and more targeted advertising. In addition to capturing a greater share of digital advertising spend NWS is also looking to leverage its brands into new verticals, such as its recent JV with Tabcorp in the UK where it has effectively licensed its “The Sun” media brand in establishing the online bookmaking firm Sunbets.

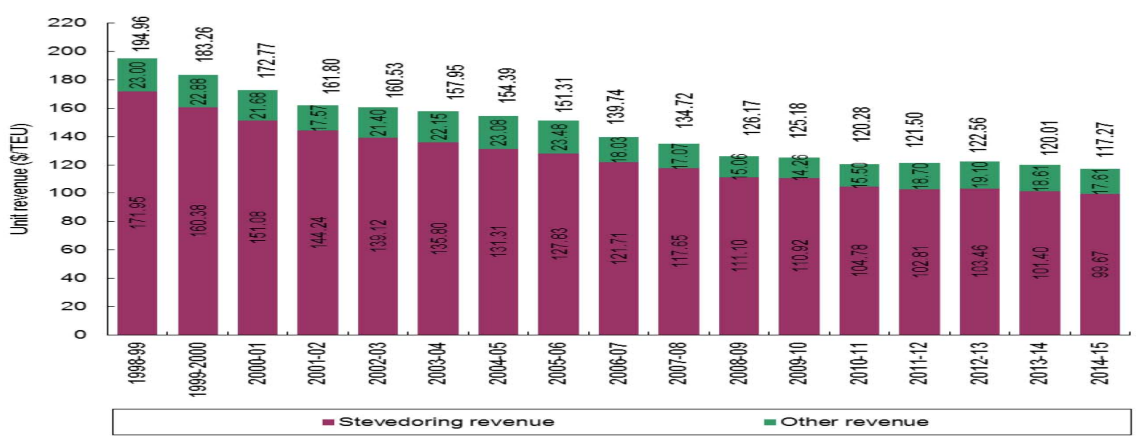
When NWS acquired Move in the US in November 2014 it took control of realtor.com which is the number two online real estate site in the US behind Zillow Group (based on Comscore data). Pleasingly, since acquisition Unique Browsers (UBs) have increased 50%, revenue has increased 50% and the company is EBITDA positive. While we do not expect Move to overtake Zillow in the medium term, we do believe that with a potential addressable market of $12-14bn there is room for more than one player. We are already seeing evidence of NWS utilising its existing media brands to promote realtor.com while Move should also be benefiting from the experiences NWS have learned through their involvement with REA Group (REA).

In summary, while NWS faces clear challenges in its “traditional” media segments as well as an ever changing digital environment, we see latent value in the company’s very strong brands and wide reach. We do not believe this is reflected in the current share price and are looking for management to create value through continuing to develop their data management capabilities and their capacity to monetise the audiences they touch every day. There is also US$1.5bn in cash on the balance sheet!

We acquired a stake in **Qube (QUB)**. QUB recently acquired 50% of the Patrick’s Stevedoring business which we see as a key piece in the puzzle for QUB in building out one of Australia’s largest integrated logistics and infrastructure businesses. The deal comes at a very interesting time for the company which has encountered a contraction in earnings within both its existing Ports & Bulk and Logistics divisions. Management maintained at its FY16 result that this decline was macro driven and given there were no material contract losses to competitors, conditions are beginning to stabilise.

The Patrick’s acquisition may yet be a transformational investment for QUB. As a standalone stevedoring business it offers investment optionality around improvement in operating metrics which can lower costs and help hasten ship turnaround times – both of which act to boost Patrick’s value proposition to its ship line customers. This is not to say we underestimate the challenges evident across the Australian Stevedoring industry. To the contrary, with Hutchison in Sydney improving its offering and VICT in Melbourne opening up as the third operator in the near term, the competitive dynamic will remain high. This will inevitably see continued pressure on revenue per container (TEU). However, as the chart below shows, this is not a new phenomenon:

Figure 3.3: Components of total revenue per TEU in real terms, 1998–99 to 2014–15



Source: nominal data provided by the stevedoring companies, converted to real terms using ABS GDP deflator series
Base year for ACCC deflator series: 2000–01.

Over the medium term QUB management should be able to integrate the wider logistics operations into the stevedoring activities which could generate material cost advantages for the company and enable a more integrated end to end solution for QUB’s import/export (IMEX) customers. This would (in combination with development of the Moorebank intermodal facility) enable the creation of market leading infrastructure and logistics assets in Australia.

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Portfolio attributes as at September 2016 are summarized below:

P/E (x)	19.9
Beta	0.86
Yield (%)	3.80
P/Book (x)	2.04
ROE (%)	11.90
Tracking error vs. ASX 200 (%)	3.70
Stock Number	36

Source: Goldman Sachs Risk Model

Market Observations

General Industry Observations

- We are the still in the early stages of companies migrating to the "Cloud". While the economics of the public cloud for startups appears strong, driven by the more efficient utilisation of computing equipment by scale players such as Amazon's cloud business AWS, the debate is more complex for established businesses;
- Microsoft's spend on their cloud product Azure is now 5x Amazon's spend on AWS;
- The cost of the NBN will be borne either by consumers or retail broadband providers, or a combination of the two;
- Companies are increasingly hiring internal teams to develop data smarts or mining. As the amount of stored data grows this will become both increasingly sophisticated and a source of competitive advantage;
- The value of some drilling rigs has doubled in recent months, albeit still at a value well below book value;
- Within the wealth management sector, growth in FUM flow is increasingly being captured by Separately Managed Account platforms.
- There is still a significant gap in installed capacity required to meet the Renewable Energy Target as it stands.
- The pipeline of solar projects suggests that the economics of solar is much improved at the "farm" level, arguably now much closer to wind.
- Regulation has negatively affected Hospitals, Pathology, Radiology and Primary Care at various points over the past 20 years. This proved transitory, either because operators eventually more than offset the changes (eg via increased scale) or, where final impacts of regulation proved less significant than originally anticipated.
- The mortgage broker channel is rapidly approaching 60% of all mortgage sales in Australia up from 30% in recent years. A remarkable change that puts increasing power in the hands of brokers. Note in the UK this number is closer to 85%. One implication is the branch network's primary role is now serving rather than acquiring customers. It also means Banks are increasingly headed towards being primarily product manufacturers.

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Tourism Industry Observations

The tourism market continues to look attractive over the next five years:

- $3 trillion is being invested globally in tourism infrastructure/assets;
- There are currently 100m Chinese outbound tourists. This is expected to grow to 200m by 2025. Australia gets 1% of Chinese tourists, however Australia is no.1 destination in terms of aspiration. Australia expects to get 5m Asian tourists by 2025;
- The Australian tourism industry has a labour shortage of 35k people. This will increase to 125k by 2020;
- In terms of Hotel rates (RevPAR), there has been very good growth in the tourist areas of QLD, Sydney and Hobart. However, Darwin, Perth, Brisbane and Adelaide are all struggling and impacted by mining;
- Hotel Rates in Mooranbah, QLD peaked at $250/night and 80% occupancy, but are now only 10% occupied at $50/ night.

Trip Notes

During the quarter we visited the UK to investigate how the economy and companies are faring post the 'Brexit' vote. While it is still too early to be definitive, the economy appears to be holding up better than expected and reassuringly the consumer has continued to spend. However, there remains a lot of uncertainty around the political and economic outlook, particularly surrounding the UK negotiating its exit from the European Union. While this is providing a more challenging macroeconomic backdrop for companies operating in the UK, we think the economy will be supported by the lower Pound and monetary and fiscal support if needed. At this point we don't see Brexit resulting in a hard landing for the UK economy, indeed it may prove to be a long-term positive although we expect ongoing volatility in the short-to-medium term.

While in the UK we also attended **Clydesdale Bank's (CYB)** capital markets day. Presentations by operational management highlighted a clear and simple strategy, and served to reinforce our confidence in the depth and quality of the management team. Revised medium term (FY19) targets included tempered mid-single digit revenue growth expectations, a cost-to-income ratio of 55%-58%, and a double digit return on tangible equity which encouragingly has been brought forward by one year. We think there is a level of conservatism in management's medium term targets which is prudent given the more challenging operating environment discussed above. Interestingly, management noted now that they have successfully delivered FY16 results they would consider acquisitions, of businesses or loan portfolios, if the right opportunity presented itself. This is a subtle change in messaging and something we will continue to monitor closely.

The final point worthy of note is the potential upside for shareholders should the bank manage to change from standardized credit risk weightings to those calculated by the bank's own internal modelling (or to a lower level than is currently the case as set by the regulator). This will require regulatory approval. Our meeting with the Bank of England indicated this both possible and likely to occur.

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