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 2017

"It is a mistake to try to look too far ahead. The chain of destiny can only be grasped one link at a time." Winston Churchill

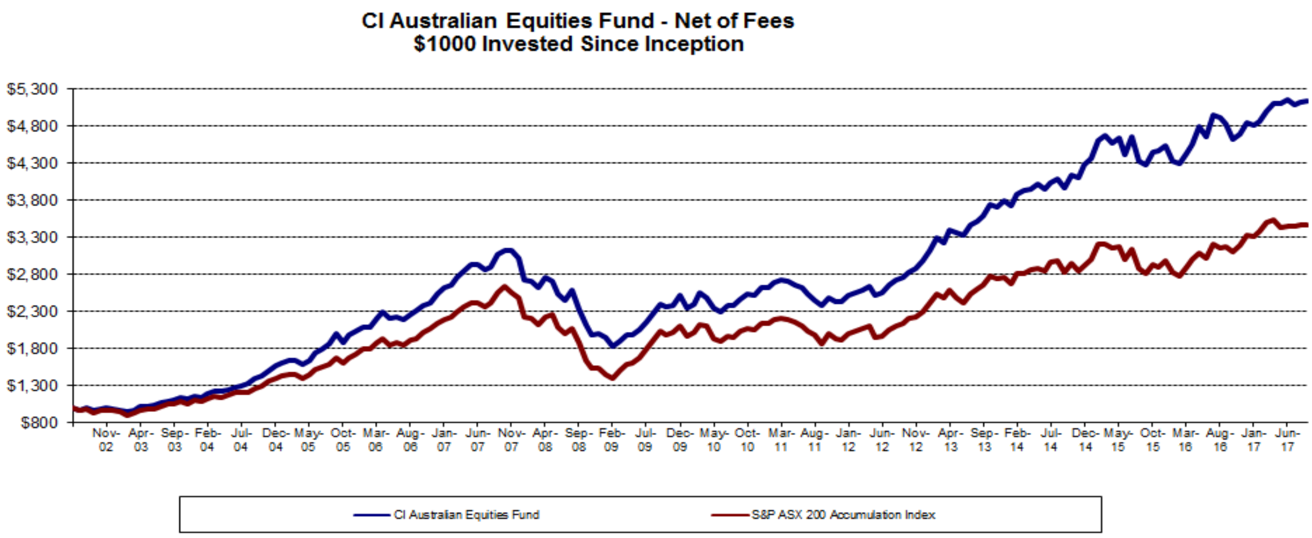
"The world as we have created it is a process of our thinking. It cannot be changed without changing our thinking." Albert Einstein

"The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails." William Arthur Ward

"Politics is war without bloodshed while war is politics with bloodshed."   Mao Zedong

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	-0.17%	0.68%	-0.85%
ROLLING 1 YEAR	7.13%	9.25%	-2.12%
ROLLING 3 YEAR	10.30%	7.08%	3.22%
ROLLING 5 YEAR	14.64%	10.09%	4.55%
ROLLING 7 YEAR	12.26%	7.85%	4.41%
ROLLING 10 YEAR	6.40%	3.09%	3.31%
SINCE INCEPTION*	12.53%	8.49%	4.04%
SINCE INCEPTION^	504.72%	246.35%	258.37%

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



For current performance information please refer to the Monthly Performance Report.

SEPTEMBER 2017

Market and Portfolio Performance

The ASX200 Accumulation Index was up moderately in the September quarter +0.68%, with ongoing uncertainty in macroeconomic trends and a mixed set of results in the August reporting season.

On the one hand, there are various signals that are broadly supportive of equity markets. In particular, growth appears to be (slowly) returning to both US and European markets and with early signs of inflation, central banks have taken the first steps to normalising the extremely supportive policies (lower interest rates and quantitative easing) that were put in place following the GFC.

On the other hand, from its absolute low point, the recovery in stock markets since the GFC, our last major correction, has been in many ways remarkable. The S&P500 has increased 310% (15% CAGR) and the ASX200 150% (10% CAGR). At the same time, market volatility (a measure of investor's risk appetite) remains at near record lows, despite what appears to be a myriad of geopolitical and economic risks, including high levels of debt in many countries (particularly Australia) and the still significant intervention of central governments.

During the September quarter, the Fund's performance slightly lagged the index (-0.17% absolute or -0.85% relative).

Key contributions to portfolio performance during the 3 month period included **Iluka** (strong commodity prices), **Clydesdale Bank (**positive Q3 trading update), **Origin Energy** (completion of lenders production test on APLNG gas production, sale of Lattice Energy helping to degear the balance sheet) and **Fisher and Paykel Healthcare** (ongoing strong operating performance)

Portfolio stocks that performed poorly during the quarter include **Bluescope** (announcement of CEO retirement and disappointing guidance as higher electricity prices and non repeating one off cost benefits to impact in FY18), **Sims Metal Management** (abrupt departure of CEO, deteriorating outlook for scrap metal prices), and **Aurizon (AZJ)** (ongoing turnaround challenge).

The Portfolio

Although perhaps no more than an odd coincidence in terms of dates, various economic commentators (for example Ann Rutledge of Forbes) have highlighted the significant share market corrections that occurred during or close to the month of October in each of 1987 (black Monday), 1997 (Asian Financial crisis) and 2007 (GFC), and of course 1929. The key point being it has been 10 years since the last big correction began. We therefore remain ever vigilant of companies:

- exposed to high levels debt
- that have been beneficiaries of the "financialisation" of the global economy, which has underpinned growth in recent decades

It also suggests more broadly, a need to consider opportunities with:

- real or hard assets with low correlation to other asset classes:
  - gold, and other commodities
  - property, with latent options and long-term leases
  - agricultural products and related goods
- core household goods and services
- businesses backed by high levels of cash
- companies that are proponents or beneficiaries of disruptive technologies (as post GFC many flourished when incumbent models came under both cyclical and structural pressure)

In line with the above, over the course of the last year, simplistically, we have been looking to reduce our exposure to bond like/interest rate sensitive/highly geared equities and in so doing have sold down our positions in stocks like **GPT, Iron Mountain** and **Sydney Airport** which had performed very well. At the same time we have looked to increase our exposures to hard assets (e.g. **RIO, BHP, Iluka**) and household goods (e.g. **Woolworths, Wesfarmers**). Of course the picture is clouded by many other factors – amongst them commodity price movements in the case of the first mentioned, and the twin threats of Aldi and Amazon with respect to the retailers.

Following our purchase of Rio Tinto in the prior quarter, we increased our position in **BHP Billiton (BHP)** during the quarter. The improvement in RIO's balance sheet and disposal of non-core assets provides investors an exposure to a high quality commodity business with latency/optionality which has not been present for some years. We view BHP through a similar lens but BHP still has more to do on the balance sheet front. We view the appointment of the new Chairman, Ken MacKenzie, and recent board appointments positively – Ken has made it clear the focus will be on creating shareholder wealth through capital allocation and balance sheet strength. The near term focus is on the review of the US Onshore assets with a sale of the assets expected but likely to take some time given the oil & gas environment remains relatively weak. A portfolio of globally leading "hard" commodity assets, a rapidly improving balance sheet and more prudent management and governance is an attractive proposition to us as an offset to the "financialised" global economy. We believe the stock is undervalued based on our assumptions of long term commodity prices at or below current market prices, and the improving balance sheet should allow the return to shareholders of some of the excess franking credits on the balance sheet.

We are however cognisant that commodity prices broadly have rallied strongly and are elevated compared to recent years which, if history repeats, will start to induce new supply into the market. Demand has been relatively strong driven by improvement in global economic growth and China's infrastructure investment. More interesting is the supply side reform that is currently being implemented in China. The capacity cuts in coal and steel have led to a strong increase in commodity and end product (steel) prices, margins and profits. Despite the strong iron ore price, the supply response out of China has been less than expected, which suggests that environmental reforms are also impacting iron ore. The next phase of reforms are the temporary cuts in steel and aluminium in areas around Beijing that will take place over the coming winter months.

Woolworths (WOW) has seen a significant improvement in the operational performance of its core supermarket business over the last twelve months. CEO Brad Banducci has undertaken a disciplined approach to moving the business into a more competitive position, although it has required a substantial reduction in price and margins to achieve this outcome. The company has also begun using the strength and breadth of their store footprint more proactively for its online offer, with the rollout of pick-up in-store for online orders across their supermarket network. This is the first step in what is likely to be a more aggressive approach to enhancing their online offer including the establishment of “dark” stores and the use of technology in the home e.g. Google Assist. The sale of the fuel division (pending ACCC approval) will leave the balance sheet in a strong position, even after considering lease liabilities.

The most significant negative issue outstanding remains the Big W franchise. This business has undergone a number of management changes in recent years, which has left an already struggling business in a very difficult position, losing circa $150m per annum. Management are now applying the same systematic and disciplined approach that they used in supermarkets to address this issue. However, the challenge in turning around Big W is greater than that that was faced by supermarkets, and they are only in the very early days of executing on their plan.

It is also worth noting that the success of WOW’s supermarket turnaround has come, at least to some extent, at the expense of Wesfarmers’ Coles supermarket operations. This was always going to be the case, as once Woolworths improved their customer offer there would be a natural flow of once disgruntled Woolworths’ customers returning. However, our sense is that the impact on Coles has been somewhat exacerbated by Coles not executing operationally as well as they have in the past. This is unlikely to be a prolonged issue, and once market shares stabilise we would anticipate that both business can hold their own in what is a competitive market.

We sold out the small remnants of our holding in **Telstra (TLS)** very early in the quarter. TLS was a significant holding in the fund a couple of years ago, a position which we have progressively trimmed over time. The company faces headwinds on a number of fronts including declining margin in its fixed business (which it is being partly compensated for by payments received from the NBN) and increasing competitive intensity in both its fixed and mobile businesses. At its full year result, management indicated that the negative recurring NBN impact to its earnings base is expected to be at the higher end of its previous guidance of $2-3bn. To offset this impact, management will need to reduce its cost base significantly and grow the core earnings base. In the past few years the mobile division has been the main driver of earnings growth as it took advantage of its superior network. This will not repeat over the next few years given the improved network position of both Optus and Vodafone, and TPG Telecom entering the market in the next 2-3 years as the low cost, low price player. We think it is prudent that the dividend has been reduced to reflect the change in the competitive environment.

For current performance information please refer to the Monthly Performance Report.

SEPTEMBER 2017

General Industry Observations

One of the most impacting, and generally business adverse, trends we have seen occurring over the last few years is that of government (and regulatory) involvement in almost every sector of the market. Very few parts of the market have escaped the attention of the politicians:

- Electricity prices and potential re-regulation in Victoria
- Gas volumes and prices in the domestic market
- WA government intention to increase gold royalties to impact on miners, let alone the proposal to tax the iron ore miners
- Aged care funding and regulatory changes have impacted greatly on the listed providers
- General healthcare and proposed prosthetics pricing changes will impact on hospital companies, and of course the ongoing setting of premium rates sets the tone for insurance providers
- Banks – the list of areas in which government has tried to get involved is long and well known
- Asset management and insurance
- Enquiries into supermarkets and petrol retailing
- Toll roads – viz the ripping up of a valid contract in Victoria in favour of a different project
- Airports – the decision to build the Western Sydney airport

The result of interference of this scope and magnitude is greater risk for equity holders and therefore an implicit increase in the discount rate with which we value stocks. The difficulty can lie in quantifying the extent of the increased risk. In the case of some stocks we can make a well informed summary of the downside (e.g. re-regulation of electricity retailing in Victoria – assuming the form of regulation is in line with that in other areas, and the impact of any increase in royalties is clearly assessable), in other areas the risk is clear but the quantitative impact less so (e.g. bank enquiries). One thing is for sure – the list of things to think about when assessing stocks and industries has gotten longer.

Australia for many years has been a country where oligopolies have ruled the roost in a number of industries (banking, supermarkets, utilities, telco, healthcare). The advent and progression in the use of the internet, and the likes of Amazon, Google and Uber et al are rapidly changing historical structures and margin profiles for these industries. In Australia, and globally, there has been a lot of noise about, but to date the major banks have not been visibly impacted by, "fintech". Although the fintech opportunity appears massive, traction so far has been underwhelming relative to how quickly Uber, Airbnb, Amazon and other disruptive models have spread. Australian banks are under pressure on a number of fronts at the moment – in the longer term this will likely prove to be another.

In essence there are really two key components to banking: payments, and savings and loans. So far disruption has been more evident in payments via players like Paypal and more recently the opportunity presented by the blockchain technologies. In contrast, savings and loans remains highly concentrated in large global banks. Given this opportunity, many are targeting investment in the sector. As an example, Goldman Sachs recently developed their own personal lending platform called "Marcus" (https://www.marcus.com/). In addition there are a proliferation of peer to peer and crowdfunding platforms (eg. Society One, Ratesetter, Zopa). A lot of them have grown rapidly in their early days but find the going tougher as they get bigger. There are some big uncertainties around these new platforms – such as can they scale up successfully, and what happens to bad debts in an economic/banking downturn (i.e. how good is their credit assessment and risk management).

Trip Notes

Late in the quarter we visited New Zealand to attend the **Z Energy (ZEL)** investor day. The presentation from management highlighted the focussed approach to strategy and operational improvement that is one of the key attributes in the "Focussed management behaviour" that we look for in our investment process. Additionally, management are now concentrating on maximising value from the strategic footprint afforded to them from the recent integration of Chevron's New Zealand fuel business. The combined business gives ZEL an unmatched strategic position in the New Zealand transport fuel industry and management are utilising this network and infrastructure advantage to realise productivity benefits and growth with lower capital requirements. The initial benefits of which are forecast are an additional $30-35m of earnings through to 2020 and a significant reduction in net capital expenditure. This will also see cash returns to shareholders grow strongly over the coming years.

ZEL management also discussed at length the real longer term strategic issue of electric vehicles, what this means for fuel demand and the strategic options that exist for the business. A range of potential scenarios and outcomes were presented. We do not often see this clear and honest assessment of a future challenge by management teams and this is a credit to ZEL. The strategic path currently being pursued by management is to maximise the returns from the core fuel business while exploring extensions beyond this that are aligned with their capabilities or brand, but keeping open their choices for alternative strategic paths pending industry developments.