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 2018

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of light, it was the season of darkness, it was the spring of hope, it was the winter of despair."   Charles Dickens,   A Tale of Two Cities

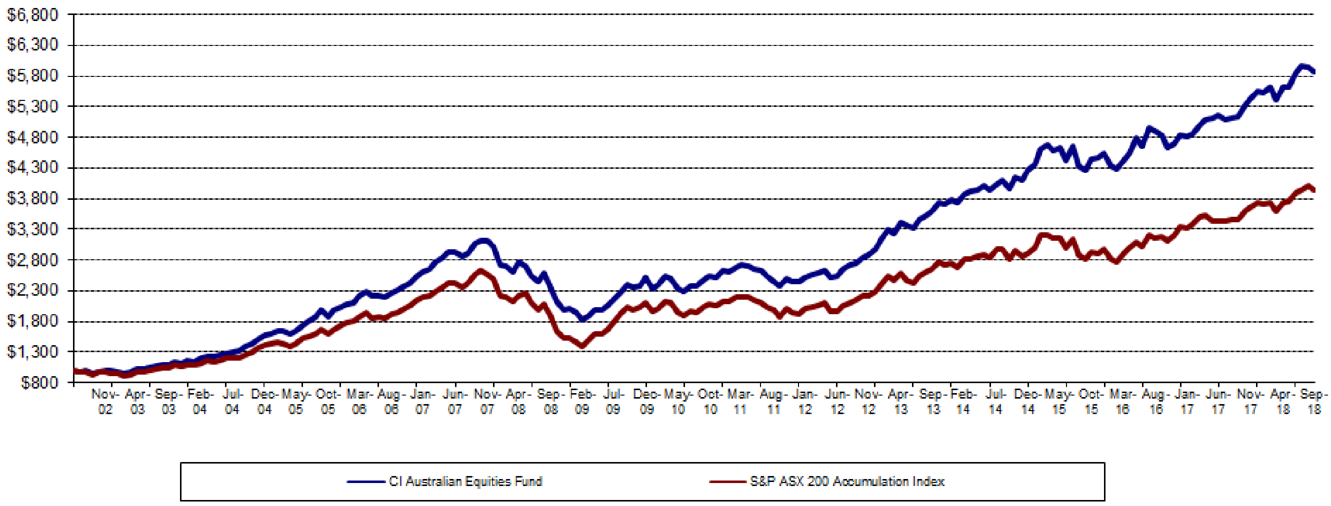
"Do what is right, not what is easy nor what is popular."   Roy T. Bennett,   The Light in the Heart

"Sometimes I wonder whether the world is being run by smart people who are putting us on or by imbeciles who really mean it."   Laurence J. Peter,   The Peter Principle

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	0.53%	1.53%	-1.00%
ROLLING 1 YEAR	15.39%	13.97%	1.42%
ROLLING 3 YEAR	12.19%	12.11%	0.08%
ROLLING 5 YEAR	11.61%	8.19%	3.42%
ROLLING 7 YEAR	15.02%	11.30%	3.72%
ROLLING 10 YEAR	10.84%	7.75%	3.09%
SINCE INCEPTION*	12.70%	8.82%	3.88%
SINCE INCEPTION^	597.77%	294.72%	303.05%

*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



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Market and Portfolio Performance

The ASX 200 index was flat (+.21%) over the quarter, but up 1.53% when dividends declared are included. The AUD continued its downward drift, falling further to 72c, while the oil price remained resilient rising from USD$77 to USD$82.

Within the portfolio the better performers included Brambles (FY18 result was not the car crash some had feared), Qube (similar to Brambles) and Cleanaway (solid result with growth to come). On the other hand the share prices of Sims Group (result met expectations but impacted by fears for future earnings given potential effect of China's National Sword policy, Turkey issues and Trump trade war), Origin Energy (decision to take $160mpa of hedging cost above the line rather than below and fears of regulatory intervention) and Newscorp (Foxtel earnings to be weaker than anticipated) all suffered.

During the quarter **Transurban (TCL)** announced that it had been part of the consortium as the successful bidder for a 51% stake in WestConnex from the NSW Government for $9.3B. TCL then went on to raise $4.8B in equity to fund is share of the acquisition price. TCL maintained its distribution growth guidance of circa 5% pa for the next couple of years. The roads comprising WestConnex will come on line progressively until 2028, the first full year of operation of the integrated three stage network. The price paid by the consortium seems by no means cheap (circa EV/EBITDA of mid 20x) but the asset has long dated concessions (to 2060) and the asset is significant for TCL in light of its ownership of the other toll roads in Sydney and its ability to derive whole of network benefits over time. We subscribed to the rights issue in full. TCL remains our only bond like equity in the portfolio. We believe it will be able to grow its distribution in the mid single digit range for a number of years and its network of roads in Australia, as history has consistently shown, should lead to further accretive opportunities in time.

Bega Cheese (BGA) also conducted an equity raising during the quarter. Having recently bought the Koroit processing plant from Saputo, the funds raised were used to pay down debt incurred in the acquisition. We subscribed to the issue with the belief that the acquisition should be highly synergistic (being in the company's core area of expertise) and value accretive. Opportunities arising from the purchase include:

- Optimisation of production base
- Grow milk supply
- Product development (mozzarella, milk powder sachets)

In addition industry structure improves as this transaction is the consolidation of the industry from 4 to 3 major players. BGA have a lot on their plate (given the recent acquisition from Mondelez) but we think management and company structure are readily capable of absorbing the new facility.

Sims Group (SGM) reported a strong FY18 result during the quarter with volumes +13%, revenue +27%, EBIT +53% and dividends per share +33%. Sims collects scrap metal, shreds it into a more useable form and sells the ferrous component to blast furnaces for making steel. A key end market for Sims scrap is Turkey (~20% of volumes) with the end steel product sold both in domestic markets, which has been strong recently due to a strong domestic economy, and to export markets.

However, in the last few months Turkey has experienced a large fall in the lira, high inflation, and a significant increase in interest rates. Combined, this is expected to result in much slower domestic growth, lower steel consumption and the risk that some businesses (including steel mills) are exposed to USD denominated debt. In addition to Turkey, sales of SGM's non-ferrous product has been impacted by changes to China's import regulations. On the back of these concerns SGM's share price has performed poorly.

Despite these near-term headwinds, SGM has a number of potential offsets. Firstly, SGM is mostly exposed to the four largest steel mills in Turkey, who are more export orientated and are therefore less impacted by weakening domestic demand for steel. Secondly, even mills that are exposed domestically, have the option to change product mix from rebar (domestic) to billet (export). Finally, SGM has in recent years been managing down its exposure to

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Turkey by increasing sales to other end markets, which we expect will continue. From SGM's perspective, it retains a strong balance sheet and a number of ongoing operational improvement opportunities.

Portfolio characteristics are as follows:

PE	16.3
Yield	3.9%
P/Book	2.0
ROE	12.3%
Debt/Equity	27%
Beta	0.96
Tracking Error	3.57

The portfolio remains underweight banks (approximately 50% of the index weight) for reasons we have enunciated in previous quarterlies – and those reasons have not changed sufficiently as yet to change our thinking. One aspect that has changed is that bank share prices have come down and now trade at a slightly larger discount to the market than long term historical averages – thus starting to price in the effects of the Royal Commission and a housing slow down. However a severe disruption to the housing market is by no means taken into account in current pricing. We also remain overweight materials/resources albeit that we have reduced our position where stocks have hit values reflecting a lack of latency (RIO, Bluescope). As mentioned above, we have only one bond like equity holding. Characterised by high levels of gearing, these stocks are sensitive to movements in interest rates which have been trending up for the last twelve months now.

Portfolio Changes

OZ Minerals was added to the portfolio. OZL is a copper miner focussed on IOCG (Iron Oxide, Copper, Gold) style copper/gold mineralisations, targeting relatively higher grade and higher margin operations. The company has been refreshed under Andrew Cole's leadership. Since taking over as CEO in 2014 Andrew and his team have done an excellent job of stabilizing Prominent Hill, progressing the development of Carrapateena in a measured way and setting the business on a clear strategic path. OZL have also been building a portfolio of tangible growth options, which has been further increased with the takeover of Avanco and its portfolio of assets in Brazil.

OZL have adopted a decentralised management structure, with independent teams focussed on and accountable for outcomes at the asset level. This enables the executive team to focus on oversight of asset outcomes and executing on the value latencies that exist. A strong balance sheet (net cash) and a disciplined approach to capital allocation sees OZL well positioned to take advantage of opportunities within their existing portfolio of assets as well as those that may present themselves externally.

Industry Observations

Over recent years there has been increasing enthusiasm from investors for all things technology and internet related. The Internet of Things (IoT) has been a catch cry and used to justify ever higher valuations for companies associated with the advancement of technology, with the FANG group of companies leading the charge. Here in Australia, particularly in large cap land, we have often heard investors bemoaning the somewhat limited opportunities we have to participate in these world changing technologies. In fact these technologies are more frequently viewed as threats to the existing franchises of the top Australian companies. Although we need to be cognisant of the threat that new technologies pose for incumbent operators, we are becoming increasingly interested in some of the opportunities that these technologies present for some of our "old world" companies. It is in the adoption of technology that we are seeing increasing opportunity for industrial companies to differentiate themselves and open up opportunity.

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Automation, data analytics and the connected world are driving real change at an accelerating pace. Although many of these technologies have been around for some time, the continued advancement of technology has driven improved ease of implementation and cost reduction. When it comes to companies adopting technology we need to clearly differentiate between on the one hand technology investment that is effectively business as usual and necessary to effectively compete, and on the other hand technology that companies can use to differentiate themselves and gain a competitive advantage. A good example of the former is the banking sector where technology investment undertaken by any particular bank to reduce costs is followed by each bank in turn undertaking a similar investment. In these situations any competitive advantage is at best short lived.

That said, we do see “industrial” companies doing some interesting things that could enable a more enduring advantage to be gained. Brambles is currently pursuing increased automation of their repair centres along with working with technologies that can help them track the flow of their pallets through the system. Both of these initiatives, at different levels, will enhance Bramble’s competitive position through lower operating or capital costs. Pallet tracking with sensors could further enhance the offering to customers to enable shock, temperature and humidity sensing for more effective management of supply chains.

Woolworths is a company that we see as being at the forefront of technology adoption in retailing in Australia. They have been deep into data analytics for some time with their Quantium joint venture and loyalty programs and have recently pushed hard into the online/offline integration with the rollout of click and collect style operations across their supermarket footprint. Additionally, their new in-store operating systems, combined with the move to an automated distribution centre later this year, is the first step in what will be a multi-year optimisation of the supply chain using data analytics and automation. Although we do anticipate some competitors also moving down this path, many will not be able to match this from an integrated perspective.

Additionally, we highlight the drive of Orica to bring technology to the drill and blast environment, through real-time data analytics, automation and monitoring equipment, and ASX’s move to adopt a blockchain style system as a technology replacement for the current CHESS platform, as further examples of companies doing some interesting things with technology that have the potential to provide additional value latencies.

All that being said, it is easy to talk about technological innovation but far more difficult to deliver it. It is in the execution and delivery of meaningful solutions that can be monetised, either through improved efficiencies or a meaningful offer to customers, that tangible value will be realised. We will continue to observe these developments with interest as we are encouraged by some of the opportunities being pursued.

Trip Notes

We travelled to the USA during the quarter to attend the investor day hosted by Boral, one of the portfolio holdings. At a macro level we have some concerns about the US economy generally – in the midst of rising interest rates and the Federal Reserve running down its balance sheet the bull run in equities will get more difficult and housing markets are losing some momentum.

Nevertheless we came away from the event believing that Boral has opportunity to grow its business, potentially substantially, by way of:

- Growth in fly ash volumes and margins;
- Growth in its fledgling composite trim business;
- Synergies arising from the Headwaters acquisition;
- Playing its cards well in the takeover of USG by Knauf

More generally we would make the following observations about the US home building market:

- US housing fundamentals appear to be shifting from ‘great’ to ‘good’. While still positive in absolute terms it is negative from a trend perspective (the second derivative), as evidenced by the recent de-rating of US home builders.

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- After 7 years of recovery housing starts are still not back to the 50 year average of 1.5m per annum. The slow recovery has stopped the industry from overbuilding and suggests a more sustainable cycle (i.e. no "sharp up, sharp down" cycle).
- Housing starts will continue to grind upwards as long as the underlying US economy continues its current path. The consensus view is that starts will grow at c3%-5% pa rather than in the mid-to-high single digit range of the past few years.
- Affordability, labour availability, increasing input costs and rising land values were common themes. These constraints are not easily fixed given the current political and economic settings.
- Affordability is the number one issue at the moment, driven by higher home prices and rising interest rates. Demand at the top-end has really come off but it remains strong at lower price points (<US$350k). Those with a strong entry level / affordable offering are best placed. Affordability is also driving a trend towards smaller houses and land lot sizes, having said that most buyers still want the biggest house they can afford.
- Labour availability is the second biggest issue given many of the framers and labourers were immigrants, and millennials are not interested in manual labour. Truck drivers are also an issue with an ageing workforce and limited entry into the profession, which is a key reason freight costs are going up.
- Access to land is another handbrake on housing starts given the inventory of developed land lots is tight. Land prices are going up with the cycle and tend to be quite sticky. Builders are trying to 'option' more inventory to manage capital outlays and cyclical risk (i.e. getting caught out with excess inventory at the wrong time).
- Cost inflation is around the low-to-mid single digit range. Wage inflation is c3%-4% and building materials are increasing more like 5%+. Despite this margins are holding up well although we would not expect them to increase significantly from here absent cost-out programs.
- Access to credit has improved and banks are being more flexible around lending criteria. The equation of buy vs rent is still in favour of owning, particularly as rents have grown significantly in recent years.
- The South and the 'Smile States' of the bottom third of the US remain very strong – think of a curve from areas in the northeast, down to the Sun Belt states like Florida, Texas, and Arizona, and then back up to the northwest in areas like Seattle and Portland.

Team Update

Frank Podrug has joined the Australian Equity team as an analyst. Frank has more than a decade of equities and corporate strategy experience, with a focus on financials. He has covered retail and investment banking, wealth/asset management, exchanges and other diversified financials. He was previously with Merrill Lynch for eight years, including as Head of Australian Banks Research and Head of Diversified Financials Research. He previously spent three years at AMP, including as Strategy Manager – Mergers & Acquisitions.

Frank completed both a Bachelor of Commerce and Bachelor of Arts (Psychology) and is a CFA charterholder.

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