# CI GLOBAL EQUITIES FUND (HEDGED)
# 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

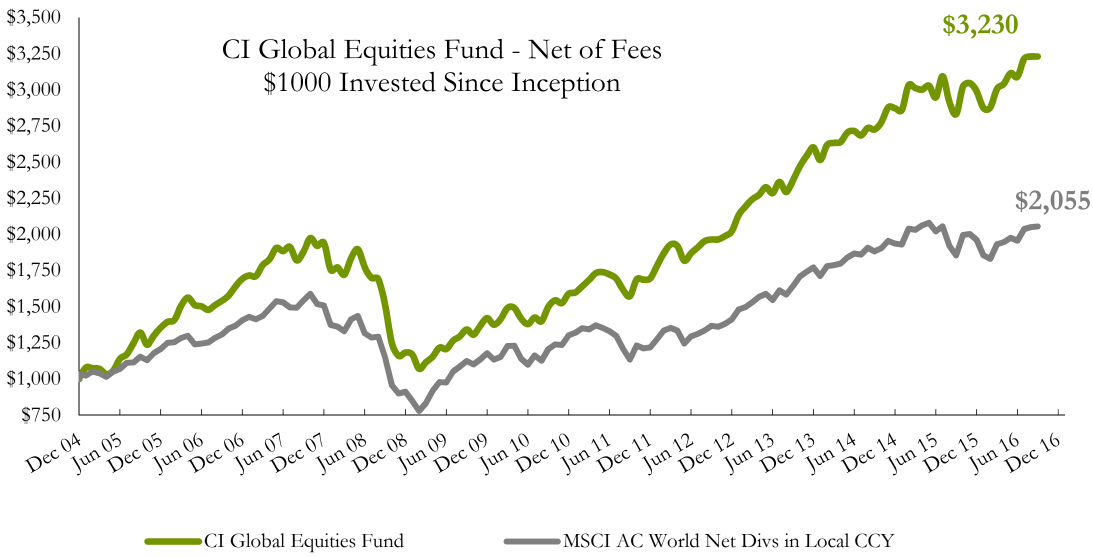
*"A just society is a society that if you knew everything about it you'd be willing to enter it in a random position." **John Rawls***

*"When fascism comes to America it will be wrapped in the flag and carrying the cross". **Sinclair Lewis** (attributed to)*

*"There will be thousands of robots working in our warehouse, if one breaks down another from the swarm simply takes over." **Paul Clarke, Ocado CTO***

| | **PORTFOLIO | #BENCHMARK | VALUE ADDED |
|---|---|---|---|
| ROLLING 3 MONTHS | 4.82% | 5.06% | -0.24% |
| ROLLING 1 YEAR | 16.08% | 10.79% | 5.29% |
| ROLLING 3 YEAR | 12.56% | 7.73% | 4.83% |
| ROLLING 5 YEAR | 16.74% | 12.61% | 4.13% |
| ROLLING 7 YEAR | 14.47% | 9.00% | 5.47% |
| ROLLING 10 YEAR | 9.02% | 4.62% | 4.40% |
| SINCE INCEPTION* | 11.57% | 6.27% | 5.30% |
| SINCE INCEPTION^ | 265.23% | 105.49% | 159.74% |

*Annualised
^Cumulative (1 December 2004). Initially, the Fund invested predominately in Australian equities. However since May 2006, the Fund has been invested in a broad range of global equities.
**Before fees and expenses
# MSCI AC World Net Divs in Local Currency



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## Market and Portfolio Performance

After the initial shock of Brexit in late June stock markets rallied sharply during the first week of July and then spent much of the remainder of the quarter stuck in a holding pattern. In the end the MSCI AC World gained 5% for the quarter, with much of that coming in the first two weeks.

For two months (July 8th to September 9th) the S&P500 posted daily moves of less than 1% in either direction, an unusually long period of low volatility that saw US market volumes decline to their lowest for several years.

We see the market currently caught between a triumvirate of macro uncertainties, namely the timing of US interest rate rises, the impact of Brexit and the outcome of the U.S. Presidential election. While the outcome of the election will be known in just a few weeks, the implications of the first two are likely to take years to play out and will remain high on the investment community's 'worry list'.

The precarious state of large (though not so large anymore) Eurozone banks continue to dominate financial headlines with enormous losses in the Italian banking system yet to be fully realized, and in recent weeks the solvency of once-mighty Deutsche Bank has started to come under scrutiny. The share price of Deutsche is now below the level of the trough during the GFC and on our recent visit to Europe growing concern was noted from bankers regarding the potential for Deutsche Bank to be the 'European Lehman'.

While 2016 has so far been an average year for developed markets it is proving a decent vintage for emerging markets, particularly the 'BRICs' whose markets had (with the exception of India) been all but written off by global investors after consecutive years of losses. The MSCI BRIC has underperformed MSCI World in U.S dollar terms every year since 2009 and has been down four years out of the last five. This year is looking better however, MSCI BRIC is +16% so far in 2016 in USD terms with the Brazilian Bovespa (+39%) and Russian MICEX (+34%) benefitting from political regime change and a 35% rally in crude oil prices respectively.

The portfolio has a number of investments in Emerging Markets stocks and these have had a good year so far in 2016 too, with OHL Mexico up 41%, Shoprite up 39%, and Jardine Strategic up 21% by total shareholder return in local currency.

In terms of overall performance the portfolio was slightly behind the benchmark this quarter as a result of 1) the underweight in Emerging Markets during a strong quarter for those markets, 2) a drag from holding cash of 4-5% in an up market and 3) a few stock specific moves that we elaborate on below.

The Aussie dollar was strong this quarter, gaining 3% against the USD, 2% against the EUR, 6% against the GBP and 1% against the JPY.

The biggest contributors to performance in terms of total shareholder return in local currency included:

1. **S&P Global –** Q2 earnings demonstrated continued strong operating momentum, particularly in the ratings business which outperformed peers.
2. **Constellation Software** – Rose on the back of a strong Q2 result.
3. **Svenska Handelsbanken –** H2 earnings showed the bank's resilience and ability to keep growing profitably even in a negative interest rate environment. Please see further comment below in Stock News.

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

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The biggest detractors to performance in terms of total shareholder return in local currency included:

1. **Novo Nordisk** – Declined after reducing full year guidance due to ongoing competition in the US diabetes market for legacy insulin products
2. **Remgro** – Sold off at the end of the quarter on the announcement of a discounted rights issue to fund investment opportunities
3. **General Mills** – Pulled back off its highs in the quarter as higher dividend paying stocks sold off

## The Portfolio

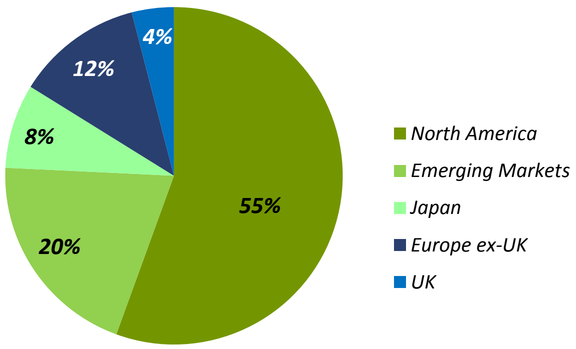
The portfolio is positioned around subsets of value:

- **Stalwarts** (44% of the portfolio) – sturdy, strong and generally larger companies with world class privileged market and competitive positions (AON).
- **Growth companies** (31%) – growing companies with identifiable value propositions using traditional value metrics and run by focused, prudent and experienced management (Heico).
- **Bond like equities** (5%) – stocks with secure, low-volatile dividends that can be grown and recapture inflationary effects over time (Unibail-Rodamco).
- **Asset plays** (6%) – stocks with strong or improving balance sheets trading at discounts to net asset value or replacement value (Remgro).
- **Low risk turnarounds** (6%) – sound businesses with good management and balance sheets. (Willis Towers Watson).

The portfolio is also diversified by country and sector:

| | |
|---|---|
| **No. of Stocks** | **41** |
| **Region Weights** | **North America 54%**<br>**Europe 30%**<br>**Asia inc. Japan 5%** |
| **Most OW Sectors** | **Industrials, Staples** |
| **Most UW Sectors** | **Energy, Materials** |
| **Cash** | **4%** |

***Geographical Exposure by Source of Revenues#***




*#Derived on a look-through basis using underlying revenue exposure of individual portfolio stocks*

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**Buys**

- After following UK-based wealth manager **St James's Place** ("STJ") for several years we took advantage of the stock market fallout from Brexit to initiate a position. STJ is a major beneficiary of recent UK pension reform in addition to the increasing degree of UK retirement wealth that is concentrated in the hands of the over 50's. The investment proposition fits into our '1950's Banking' cluster given STJ is a high-service, focused financial services company run by a team of long serving executives who act like stewards for key stakeholders (clients, employees and shareholders). We are attracted to the structural growth in the UK market and the unique positioning of STJ's business model, being advice-led with an outsourced investment function.

  STJ's strong customer proposition has resulted in them growing funds under management by around 14% p.a. over the past decade to around £65 billion. We believe STJ continues to have significant growth prospects in both the UK market and in the expat markets where they are developing businesses in Dubai, Hong Kong, Shanghai and Singapore.

**Sells**

- The portfolio exited its small position in **Close Brothers** during the quarter. As a domestic UK SME focussed lender Close faces a challenging period over the next few years as the minutiae of Brexit is thrashed out and the impact on clients crystallises. It will be difficult for small businesses to make investment decisions while Brexit uncertainty persists while at the same time competition from challenger banks and large banks is growing, many of whom are prepared to lend at irrational rates.

## Stock News

**Svenska Handelsbanken** rose a third from early July lows and is one of the few large European banks (the others are incidentally all Nordic) to have posted a positive total shareholder return this year.

In August the Board announced the dismissal of CEO Frank Vang-Jensen, to be replaced by Anders Bouvin, head of the UK bank. This is one of the few banks we can think of where the CEO getting fired is almost a non-event due to the decentralised nature of the operational model, neatly summarised in one of their favourite idioms: '*the bank is the branch*'.

In the recent past we have met various members of senior management and continue to marvel at the consistency of language, vision and culture displayed irrespective of which country you're in. Meeting management in London during this quarter's trip was no exception. The discussion refreshed our conviction about the large opportunity Handelsbanken has in the UK with currently less than 1% market share, yet already the highest level of customer satisfaction scores amongst all UK banks. While competitors are closing branches and firing staff, Handelsbanken are opening branches and hiring more bankers.

Beyond management change, the real headwind for the stock over the last year has been the change in corporate risk weights by the local regulator. This heralded rising capital requirements and prompted concerns about the dividend. After a one-year suspension of contributions to the staff share scheme (the 'Oktogonen') combined with some minority stake sales Handelsbanken has now cleaned up its balance sheet and materially boosted capital levels. Stress results by the Swedish FSA in early October revealed a Common Equity Tier 1 two hundred basis points under the bank's H2 reported CET1 ratio of 23% and thus a very comfortable position. With a sustainable dividend yield of 5% (compared to a negative local bond rate) and a proven ability to continue growing profitably irrespective of the interest rate environment, we still see the shares as attractive.

~

During the quarter we attended the **Willis Towers Watson** (WLTW) Analyst Day in Washington DC.

A core tenet of our investment proposition regarding WLTW is the long term track record of the legacy Towers Watson management team, led by CEO John Haley, who have created significant value for shareholders over time. However the Analyst Day was an excellent opportunity to meet and hear from some newer members of the organisation post the merger of equals between Towers Watson and Willis.

We came away with increased conviction that WLTW can realise the majority of merger synergies and thus drive significant earnings growth through to 2018. John and the team acknowledged some near term softness in pockets of the insurance broking and benefits consulting end markets, however the company's focus is now firmly on profitable revenue growth and free cash flow generation, requiring only modest top line momentum to achieve management's long term objectives.

## Trip News

This quarter the Global team visited Europe, the U.S. and Hong Kong.

In Europe we visited corporates in Munich, Amsterdam and Helsinki before spending a week in London.

In Germany it is clear that the nationally strategic auto industry is desperately playing catch-up to Silicon Valley regarding the future of the automobile. While the Germans have endured a period of distraction and soul-searching due to VW 'Emissions-gate', Elon Musk has stolen a handy lead particularly in the mind of the consumer. Bright red displays of gleaming Teslas seem to greet us in pretty much all airports and high end shopping malls these days and we are seeing more and more of them on the road in major Western cities.

In response, German auto original equipment manufacturers (OEMs) and component suppliers are now rapidly re-tooling and re-strategizing for the era of electric and autonomous vehicles, the biggest transition in the industry since the invention of the combustion engine. Not that the locals aren't benefitting from Musk's success - indeed a Mittelstand champion that makes paint robots discussed with us their biggest ever order to supply the Tesla production lines in California.

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With the car of the future being more or less a computer on wheels we were struck by how keen industrial companies are to talk about their capacity for software innovation. Indeed this was an underlying theme across the trip – five years ago it was all about "the percentage of sales from China" but today the badge of honour is how many software engineers you employ (the benchmark figure seems to be "over a thousand").

The technology theme continued in London where we met many companies particularly in the sub-sectors of Fintech, online classifieds and e-commerce.

One of the major concerns post the Brexit vote has been around what the long term impact on London will be. The City is heavily dependent on the financial sector (it represents one in three jobs today), and the ongoing ability to 'passport' financial services into Europe will undoubtedly be a key point of negotiation in the coming months. However, not only did we see no evidence of a Brexit induced slow-down on the ground, we actually came away feeling more excited about the future of the city's technology sector.

Over a very long history London has faced many potentially terminal threats - revolutions, plagues, wars and fires, but through her culture, laws, institutions and people the city has overcome each of these challenges and rebuilt stronger each time. Rather than worry overly about the implications for the investment banks and fund managers of the Square Mile and Canary Wharf (who have their own unique set of problems) this trip has drawn our eyes North and East to upcoming suburbs like Clerkenwell, Shoreditch and Old Street.

Here, known as East London Tech City (or more colloquially 'Silicon Roundabout') we experienced the growing buzz of one of the most innovative regions in London and indeed the world. Today London employs 47% of European technology workers and this area alone is the third largest technology cluster globally after San Francisco and New York.

While recent visits to Berlin, Stockholm and Helsinki revealed thriving innovation hubs, we don't see how they can compete with London for the incremental 'creative worker' when taking into account the vibrancy of culture, diversity (40% of London's population are foreign born), education, entertainment and lifestyle.

Our meetings will be followed up by further work on a number of names and new additions to the Watchlist.

We also spent two weeks in the US travelling up and down the North East Coast. Spending some time in New York we have been observing two major regulatory trends passed down on the financial industry. These are affecting both the banks involved whilst also having greater follow on implications for broader industry.

Firstly, the concern and reigning in of loan book concentration at small and mid-sized banks. In New York a group of local specialist banks have emerged in taking deposits and lending on NY real estate. These are very simple business models where the banks know the assets and borrowers intimately. However, over the last 5 years the property and banking industry has seen a refinance boom driven by ultra-low interest rates. The banking regulators see the expanding balance sheets and concentration of these banks as cause for concern and are limiting additional lending in New York real estate. This has led to a slowdown in high end commercial and residential real estate.

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Regarding residential real estate over half the rental properties in New York have some form of rent stabilisation or rent control which means the rents can be up to half their market value. This unique market structure means spikes in vacancies and defaults are unlikely – you're not going to give up your apartment if you're paying half the market rent. It is feasible therefore that any softness would be contained to the high end markets. The portfolio owns one US based bank being First Republic Bank which has some exposure to the New York market but small relative to their total portfolio.

Secondly, the regulators are limiting the amount of leverage lent to private equity buyers at 6x equity. We think this will be positive for our "capital allocator champions", a group of companies that have and continue to show success in deploying their free cash flow into M&A opportunities. The amount deployed into M&A over the last 12 months has been a bit slower as competition and valuations have been heating up. This should be positive for the likes of Roper, Constellation Software and Halma who with strong balance sheets have stayed patient and therefore have large amounts of dry powder. This capping of borrowing capacity for private equity buyers should free up more opportunities for these long term purchasers.

On leaving New York and entering the more industrial cities in New Jersey and Pennsylvania you get a much more sombre feel. Consensus was largely that industrial and commodity markets have finally stabilised even though comparisons mean that the last two quarters of revenues will still be declining year on year. While no one has official guidance out yet the sentiment for 2017 is that it's looking a lot like 2016, as opposed to a rebound.