CI PENSIONS FUND
QUARTERLY REPORT

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

DECEMBER 2014

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING MONTH	3.32%	2.07%	1.25%
ROLING 3 MONTH	7.33%	3.40%	3.93%
ROLLING 6 MONTH	8.01%	3.31%	4.70%
SINCE INCEPTION^	10.51%	5.09%	5.42%

^Cumulative (3 March 2014)
**Before fees and expenses and adjusted for franking credits
#S&P ASX200 Accumulation Index – adjusted for franking credits

The purpose of the CI Pensions Fund is to provide a conservative equities portfolio that may be suitable for people and funds that have converted to pension status.

Whilst the portfolio return is important, we are aiming to invest in companies who provide sustainable and growing income and for the portfolio to have lower than market volatility, and particularly, to perform much better in down markets.

Market and Portfolio Performance

Monthly returns for the Australian stock market were volatile over the December quarter, however they hide even greater intra-month volatility. For instance, in the first half of December the market was down by 3% and in the last half of December it rose by over 5%.

If we delve into sector returns there has been a huge dispersion of outcomes. At the two extremes, any stock that has exposure to commodity prices has fallen sharply whilst predictable, high quality companies that provide yield have generally risen consistently. For example, Transurban has risen in each of the past eleven quarters, whilst BHP has fallen in seven of the past eleven quarters. These trends will change at some point, but for the time being falling commodity prices and falling fixed interest yields point to more of the same.

The portfolio returned 7.33% for the quarter and 10.51% since inception whilst the market returned 3.40% and 5.09%respectively.

The portfolio has benefitted from owning many predictable, high quality companies that provide yield. Stocks that did particularly well include Recall, Caltex, Amcom and Telstra. Poor performers include BHP and Oil Search.

The volatility of the portfolio's returns has been much lower than the market. When measured on a daily basis the portfolio's volatility continued to be around two thirds of the market's volatility.

The portfolio has fallen by less than the market on over 80% of down days.

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The monthly fund returns and market returns are set out below. The portfolio has done much better than the market in down months.

Month	Pensions Fund	ASX 200 Accum	Relative Performance
Mar-14	0.96%	0.52%	0.44%
Apr-14	1.07%	1.78%	-0.71%
May-14	1.07%	0.93%	0.14%
Jun-14	-0.79%	-1.49%	0.70%
Jul-14	2.00%	4.40%	-2.40%
Aug-14	0.85%	0.94%	-0.09%
Sep-14	-2.17%	-5.19%	3.02%
Oct-14	4.05%	4.43%	-0.38%
Nov-14	-0.16%	-3.00%	2.84%
Dec-14	3.32%	2.07%	1.25%

Note: Before fees and expenses adjusted for franking credits

The Portfolio

There were no significant changes to stocks held during the quarter.

Stock News

On 27 October Vocus announced that it had acquired a 10% interest in **Amcom (AMM)** with the intention of reaching an agreement to merge with Amcom. On 17 December, after due diligence and successful negotiations, Amcom and Vocus entered into a scheme implementation agreement whereby Vocus will acquire the outstanding 90% of shares in Amcom it doesn't own. Under the agreement Amcom shareholders will receive a fixed exchange ratio of 0.4614 Vocus shares for each Amcom share. The Board of Amcom may also declare an interim or special dividend not exceeding $0.05 per share. The scheme is subject to shareholder and Court approval and is expected to be completed in April 2015.

We believe that the businesses are highly complementary because the merger will combine Amcom's major fibre networks and data centres in Perth, Adelaide and Darwin with Vocus's fibre network and data centres in Eastern Australia and New Zealand. Beyond the outlined cost synergies of $13-15m, the combined entity will be able to offer a national fibre footprint that should lead to further revenues. We feel that the merger makes a lot of sense and it is most likely a better outcome for Amcom shareholders than the previous plan for Amcom to purchase East Coast fibre and data businesses.

In December 2013 **Brambles (BXB)** divested **Recall (REC)** via a listing on the ASX. Recall is a Document Management Solutions, Data Protection Services and Secure Destruction Services business which assists companies with their information storage needs.

On December 15th, Recall announced that Iron Mountain, the world's largest Document Storage Company, had launched a non-binding, indicative proposal to acquire Recall. The bid values Recall at A$7 per share with consideration being a combination of Iron Mountain shares (82%) and cash (18%). We believe that the deal makes a lot of strategic sense with large business overlap and significant cost and revenue synergies potentially available. However, we were disappointed in both the price of the bid and the composition of the consideration.

On our estimates, we believe that $150m+ in cost benefits can be comfortably realised upon integrating the two businesses with the opportunity for this to increase to north of $200m. These synergies relate to labour, overhead and real estate cost savings. Revenue upside is also likely. These factors combined with the higher Iron Mountain earnings multiple relative to Recall creates significant value for Iron Mountain shareholders under the current proposal.

As a Recall shareholder with a positive view on the company's stand-alone growth prospects we believe that any takeover warrants Recall shareholders getting both a fair price for the company's existing growth prospects while also receiving an appropriate share of the significant synergy benefits that could be realised. We do not believe that this is reflected in either the current takeover price or as an Australian domiciled shareholder, by the consideration mix. We see a fairer outcome being achieved at a takeover price north of $8 and with a 100% cash consideration option being available.

Telstra (TLS) acquired an Asian telecommunications and services provider Pacnet Limited for US$697m. Pacnet is a provider of connectivity, managed services and data centre services to carriers, corporations and governments in Asia. Pacnet will provide Telstra with ownership of submarine cable systems and data centres. The acquisition is aligned to Telstra's strategy of growing in Asia and allows Telstra to better serve its enterprise and wholesale customers who connect with Asia. Pacnet generated revenues of US$472m and EBITDA of US$111m for the year ended December 2013. This represents an EV/EBITDA multiple of 6.3x, which does not include Telstra's targeted capex and opex synergies of A$65m and revenue synergies. The multiple paid appears to be reasonable. Pacnet is currently privately owned and is heavily geared with gross debt of US$400m.

Telstra also signed revised definitive agreements with NBN Co and the Commonwealth to enable the rollout of the multi-technology mix national broadband network. The estimated net present value in the revised agreements is expected to be equivalent to the original agreements (i.e. approx. $11bn post tax NPV as at 30 June 2010). There is also potential for Telstra to provide planning, design, construction and maintenance services to NBN Co which would be in addition to the revised agreements and generate additional profits for Telstra.

We view these developments to be in line with Telstra's strategy and they will not impinge on the expected future growth in dividends.

There has been a burst of activity from **National Australia Bank** (NAB) following the appointment of Andrew Thorburn as the CEO.

NAB started the process of selling out of its US business through the sale via initial public offering of a minority interest in Great Western Bank. We expect NAB will complete the sale of Great Western Bank over the next year.

During December NAB announced the sale of the majority of its remaining UK commercial real estate loans at a price above book value. This sale effectively brings to an end NAB's costly involvement in troubled UK commercial real estate loans and it is a further step along the path of NAB closing or selling legacy positions and refocussing on its core Australian and New Zealand businesses. We expect a number of further announcements over the next year that should strengthen NAB and improve its return on equity and capital position.

The Financial System Inquiry (FSI) released its final report during December. The market was expecting a firm recommendation on how much extra capital the **banks** would need to hold. There was no such definitive recommendation from the FSI.

The key finding was that the major Australian banks should hold capital ratios such that they are unquestionably strong and in the top quartile of internationally active banks. The ball has now been handed back to APRA to determine what it concludes on the required bank capital ratios; and Treasury has sought another round of public submissions on the topic. Additionally the question of possible changes to the risk weighting for mortgages was not concluded.

So the current position is that banks will have to raise additional equity capital but there is no consensus on how much more equity and by what date they will need to do this. It seems the equities markets are now hoping that whatever extra equity is needed will be achieved through dividend reinvestment plans, however the final outcome could be much harsher than this. Not surprisingly, bank share prices have been choppy with this uncertain background.

Retirement Income

"It's a really hard problem – the hardest problem I've ever considered – because – it's multidimensional". Professor William Sharpe (winner of Nobel prize in Economic Sciences) on the issue of retirement income.

It is 22 years since the inception of the Superannuation Guarantee, and during this time super assets have grown more than sixfold reaching around $1.8 trillion dollars in 2014. During this period the majority of these assets have been in what is known as the accumulation phase of the superannuation process, thus naturally, compared with the pension phase, it has been the subject of more focus. However as the industry has matured and the Baby Boomers transition to retirement, the share of pension assets relative to accumulation has increased. According to Rice Warner, the proportion of assets in the pension phase will grow from 30% in 2014 to over 40% by 2033, a year where Deloitte has predicted super assets to total $7.6 trillion.

In recent years, this increasing proportion of pension assets has been accompanied by a growing discussion on the issue of retirement incomes; explicitly, how best to harness from your superannuation, a sustainable and also sufficient income throughout your retirement. In 2009 the topic of retirement incomes was canvassed by the Henry Tax review, in 2010 it was the focus of the Cooper Review, in 2014 the topic of a Treasury review and most recently it was a focal point of David Murray's 2014 Financial System Inquiry (FSI).

The FSI has put forward a general framework of what they feel a retirement income system should look like, and recommends that the details be filled in through future collaboration between industry and government. The FSI's first priority was to reinstate and make clear the original purpose of superannuation; that is, "to provide income in retirement to substitute or supplement the Age Pension". Their view is that there has been an overtly large emphasis on the accumulation of fund balances, and that a reorientation towards sustainable cash flows for retirement is essential for the future.

Reorientation is easier said than done, and the FSI has acknowledged this, highlighting that retirement is a multidimensional issue riddled with uncertainties and challenges, particularly within the sphere of a retiree's financial choices. One of the most prominent themes underpinning the quandary of retirement incomes are the issues of increasing life expectancy and longevity risk; that is the risk of outliving your wealth.

Statistics and forecasts by the Australian Actuaries Institute suggest that life expectancy has been rising and that it will continue to do so. Life expectancy of a 65 year old male in 1901 was 11.3 years, at 2010 it was 21.3 years and in 2050 it is expected to be 27 years. Given that recent statistics from Deloitte Access Economics indicate the average age of retirement is around 63, retirees are increasingly being faced with investment horizons of twenty years or more. The task of ensuring superannuation assets provide sufficient but also sustainable income throughout this very long but indefinite time period is at the heart of the retirement income debate.

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The FSI is clear that within its ideal framework for retirement income, the level of support and guidance currently available within the accumulation phase must, at the very least become available throughout the pension stage. In addressing this, the FSI put forward Recommendation 11 stating that superannuation trustees should be required to pre-select a 'comprehensive income product for retirement' (CIPR) for their members. The CIPR is a term coined by the FSI which describes a default bundled investment product that the retiree is opted into upon the commencement of retirement.

As the product would be purposely designed to accommodate factors such as longevity, investment and inflation risks, as well as the individual circumstances of a retiree; the FSI has suggested that a CIPR's design could follow a portfolio approach containing combinations of products. The FSI provided one possible example of a CIPR that was 77% account based pension and 23% deferred lifetime annuity. As for what goes into the account based pension; the FSI emphasised a point made by Rice Warner that "… any investment period of 20 or more years requires a significant proportion of growth assets". For this reason we feel that equities have an important role in the pension phase, but we believe that the nature of the equities exposure should be more conservative to reflect the changing circumstances of the investor.

As part of recommendation 11, the FSI also called for the removal of legislative impediments that are blocking the development of group self annuitisation schemes and deferred lifetime annuities, products that could form a component of CIPRs.

The increased discussion and awareness of retirement incomes is not unique to Australia. In November 2014 we conducted a research trip to the UK, where the issue of retirement income was at the forefront of debate. In March of 2014, the UK government announced incredibly significant changes to the world's second largest pension system, particularly in the sphere of the decumulation phase.

To date the UK pension phase has been dominated by annuities, a financial product wherein a retiree would use their accumulated savings to buy a guaranteed set of cash flows for the rest of their life. For many Australians annuities will be an unfamiliar product; indeed OECD data indicates that the Australian annuity market is the equivalent of 0.3% of its GDP, whereas in the UK it is closer to 40%. The two key features were that for most people buying an annuity was compulsory, and that upon retirement they were making an irrevocable decision to choose an annuity that they would be locked into for life. The compulsion to purchase an annuity before age 75 existed in the UK through until 2011; however the alternative option of freedom and drawing down your account required a minimum balance of £100,000. This meant that even after 2011, the annuity remained the most widely chosen solution for 75% of defined contribution funds.

Despite the size of the annuity market, the annuity has had an unhappy history in the UK. The average size of annuity purchase in the UK is around £40,000, yet the cash flows derived from annuities costing less than £100,000 were insufficient to live off. In addition, many people take the view that you either live long enough to recover your principal, or you don't, in which case the annuity company wins. Indeed, Financial Conduct Authority statistics have indicated that the average UK male retiree will only ever recover 94% of his principal. In addition, as an annuity's cash flows are largely a function of interest rates, the record low rates that have prevailed since the GFC have reduced annuity rates significantly. As a result of the March 2014 announcement that there would be freedom in pensions, sales of annuities have halved and commentators have forecast the UK annuities market to shrink 90%.

With the new changes due to be implemented by April 2015, the industry and Government have been laboriously working out what exactly this new post-annuity retirement world will look like. We felt that one of the prominent suggestions coming out of the UK is for the increased use of equity release; which is a product wherein the owner of house can sell part of the equity in their house for a lump sum or a series of cash flows, but still live there. This product creates liquidity out of the family home, and is a viable source of funds for those in the retirement phase. In 2014, the UK equity release market involved over 15,000 new customers and over £1 billion worth of new lending. Key Retirement, an equity release company, identified that 77% of their demand came from people aged 65-79.

In Australia there are approximately 40,000 existing equity release products with a combined value of $3.5 billion. Given Deloitte's estimate that there is $500 billion of home equity owned by people over 65, we certainly feel that equity release is something that could form a significant aspect of Australia's retirement income framework in the future.

During our trip we heard about many other products that people believe could help solve the retirement income issue. Some of these include variable annuities, sculpted fixed income products, pooling schemes, balanced risk solutions and enhanced equity income solutions. There were people for and against active management and we also heard that the solutions to retirement income actually already exist. At a conference on retirement incomes, there were over twenty different speakers and twenty different views on what to do.

To summarise, in twenty years' time the retirement portion of the total superannuation pool in Australia is likely to be around $3trillion. This huge pool will comprise a number of products and assets; as suggested by the FSI there will be account based pensions, many forms of annuities and some types of insurance products. We think the family home will have to provide a source of retirement income. The retirees will also be backstopped by the Government pension.

We do not think annuities will provide as big a part of the solution as many think because it is unclear whether annuity rates will be attractive to retirees given low interest rates and the large amounts of capital that are needed to support annuities. The experience in the UK is that annuities have a fraught history and as soon as they were not compulsory sales plummeted. So it is hard to see why they will be popular here and they certainly should not be made a compulsory purchase for retirees.

Completely de risking a retirement investment portfolio would not be sensible given that on average people are going to be retired for more than twenty five years. Some growth assets will need to be held in retirement but we think that these growth assets should be more conservatively managed in retirement than in the accumulation phase.

As Professor Sharp's quote infers, there is unlikely to be one silver bullet solution to the retirement income issue, there can be no doubt that the debate is far from finished.