CI PENSIONS FUND
QUARTERLY COMMENTARY REPORT

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

DECEMBER 2016

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	0.40%	5.47%	-5.07%
ROLLING 1 YEAR	6.80%	13.41%	-6.61%
ROLLING 2 YEAR	8.45%	8.71%	-0.26%
SINCE INCEPTION*	9.70%	7.95%	1.75%
SINCE INCEPTION^	30.00%	24.20%	5.80%

*Annualised
^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 investors who are in the pensions/ decumulation phase. The portfolio may also be suitable for charities, foundations and others who are looking for a conservative equities exposure.

Whilst return is important the portfolio also aims to perform much better in down markets and to exhibit lower than market volatility.

Market and Portfolio Performance

The ASX 200 Accumulation index (adjusted for franking credits) rose by 5.47% over the December quarter, finishing the 2016 calendar year returning 13.41%. The model pensions portfolio return was 0.40% for the quarter and 6.80% for the year.

Stronger stocks held by the portfolio over the quarter included **Tatts Group (TTS), Lifestyle Communities (LIC)** and **Rio Tinto (RIO)**. Portfolio stocks that performed poorly were **Ramsay Healthcare (RHC), Sydney Airport (SYD),** and **Caltex (CTX)**. A number of our New Zealand stocks also struggled including **Ryman Healthcare (RYM), Summerset (SUM)** and **Auckland International Airport (AIA)**, with the New Zealand equity market significantly lagging the Australian market during the quarter with the NZ20 falling 8%.

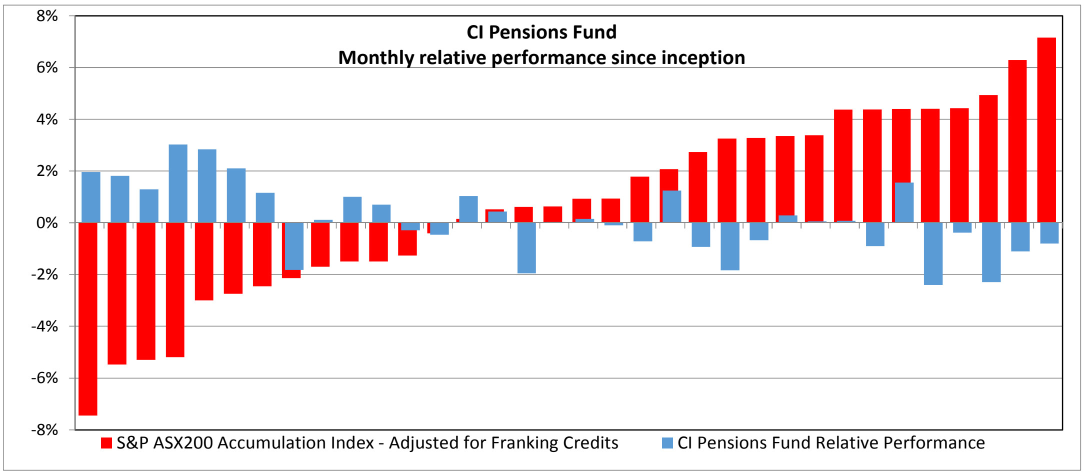
Portfolio performance is discussed in more detail further on in this report.

Over the quarter the A$ fell 6% against the US$ and 1% against the Pound and NZ$. The direct foreign currency adds to portfolio diversification and provided a partial offset this quarter for below-market returns.

The volatility of the model portfolio over the quarter was around 72% of the volatility of the market, this is consistent with the portfolio volatility since inception.

Since inception the market has shown a negative monthly return 14 times and the portfolio has performed better than the market in 11 of these 14 months.

The chart below shows the CI Pensions Fund's monthly relative returns. The red bars show each month's market return sorted from worst to best month and the blue bars show the portfolio's return relative to the market for each month.



Since inception the index has shown a negative monthly return 14 times and the model portfolio has captured 65% of this downside. The index has shown a positive monthly return 19 times and the model portfolio has captured 84% of this upside.

The mix of the upside and downside capture has resulted in the model portfolio return since inception being 9.70% p.a. compared to the markets return of 7.95% p.a.

The intention is that the portfolio captures a greater percentage of the upside than the downside. In reasonably flat periods as we have seen over the past few years if a portfolio captures more of the upside than the downside the result should be lower than market volatility, better performance in down markets and a return that at least keeps up with the market's return.

The Portfolio

During the quarter we added Tatts Group (TTS), Qube Holdings (QUB) and Washington H. Soul Pattinson (SOL) to the portfolio.

The investment proposition for **Tatts Group (TTS)** is centred around the effective Australia-wide monopolies in lotteries (excluding W.A.) which generate strong cash flow with margin upside through internet expansion. In our view lotteries are a high quality business with a relatively low risk earnings profile. In addition, TTS should also provide a 4% dividend yield (fully franked) growing at low-to-mid single digit levels.

Qube Holdings (QUB) is building out one of Australia's largest integrated logistics and infrastructure businesses, with a network covering road, rail and intermodal with stevedoring operations at all major ports. The recent acquisition of 50% of the Patrick's Stevedoring business in combination with development of the Moorebank intermodal facility will enable QUB to run services with one touch point for customers. We think this will make for a very strong customer value proposition as this plays out over the next three to five years. The CEO and Chairman have deep industry experience and think like owners rather than corporate managers, importantly they also have a lot of 'skin in the game'.

Washington H. Soul Pattinson (SOL) has a long corporate history having been incorporated in 1902 and listed on the Sydney stock exchange in 1903. SOL also has a long track record of shareholder value creation, underpinned by the history, family connection and long-term thinking of management. Importantly for a portfolio focused on downside protection, on multiple occasions SOL has significantly outperformed in down markets. We also like that SOL trades at a significant discount to its underlying asset value, has a net cash balance sheet, and 15 years of uninterrupted dividend growth.

We sold **Bunnings Warehouse Property Trust (BWP), Vicinity Centres (VCX), Iron Mountain (INM) and TPG (TPB)**, the first three mainly to reduce the interest rate sensitivity of the portfolio and TPG following its weak 2017 profit guidance.

We have also made some changes to our international stocks including purchasing **Priceline Group (PCLN)**, and selling **Johnson & Johnson (JNJ)**.

Priceline Group is the largest global Online Travel Agency (OTA). Priceline's main platform is Booking.com which has over one million properties providing unrivalled breadth of customer choice whilst connecting independent hotels with travellers from across the globe. The company's scale allows it to invest significantly more than peers helping to drive increased traffic and improve conversion, creating a virtuous cycle.

In the ~US$1.5trn global travel industry, the OTAs account for ~15% of total bookings and there remains a strong secular tailwind to growth as bookings continue to migrate online. We think Priceline will grow its bookings at ~20% this year. On a Free Cash Flow basis Priceline trades broadly in line with the market. We think the stock presents compelling investment in a growth company with a net cash balance sheet and high returning business model.

At the end of the quarter the portfolio held 38 securities. 11% of the portfolio was held across six US and European stocks and the cash weighting was 8%.

Stock News

In December the Commonwealth Government issued **Sydney Airport (SYD)** with a Notice of Intention (NOI) setting out the main terms for the development and operation of the Western Sydney Airport (WSA). A key surprise in the announcement was the requirement for SYD to fund all of the construction of WSA without any Commonwealth Government funding or cost protection. We understand this is a significant departure from what SYD were expecting, noting in their release that this change of approach makes WSA a "challenging investment proposition". Preliminary estimates are that the first stage would cost up to $5 billion so this will be a real test of management discipline.

During the quarter **Tatts Group (TTS)** received two proposals, a merger proposal from Tabcorp and a subsequent takeover offer from Pacific Consortium (comprising Macquarie, Kohlberg Kravis Robert, Morgan Stanley Infrastructure Inc, and First State Superannuation Scheme). The TTS Board has determined that the Pacific Consortium bid is not superior to the Tabcorp merger proposal, which the TTS Board believes is in the best interests of shareholders absent a superior proposal. TTS is clearly in play as a takeover target and highlights the value of the attractive lotteries business.

Caltex (CTX) shares have been sold down heavily over the quarter as it became clear that CTX was not the preferred bidder for the Woolworths (WOW) fuels business and would lose their 10 year contract to supply WOW service stations. WOW has since announced the sale of the fuels business to BP for $1.8 billion. The loss of the Woolworths' contract and strategic alliance will result in a substantial drop in Caltex's earnings in 2018, although we think this is already reflected in the share price. We anticipate that the company will be able to replace a significant portion of these earnings through both acquisitions and cost reductions.

Market Observations

The surprise election of Mr Trump in the US has been assessed by markets, at least at this stage, as being an inflection point, with investment markets reflecting a more positive outlook towards economic growth and more inflationary environment through higher interest rates and a stronger US$ post the election.

In part this appears to reflect expectations that the new President will:

1. Lower taxes
2. Increase spend on infrastructure
3. Remove red tape/ regulation.

While still too early to draw conclusions, we would observe that there are already signs (based on appointments to the incoming Administration) that Mr Trump's presidency will be more favourable to Corporate America, although what this would mean for others is less than clear. It may be an instance of what is good for America is not good for the rest of the world. In particular, a key issue for both China and therefore Australia is the potential impact of any changes made to US trade relations.

Whether or not a Trump presidency will prove to be reflationary for the US economy will be as much about psychology as economics. Can enough be done to unleash the animal spirits of American business, which in recent times has been more focused on capital preservation and returning capital to investors than on capital investment? A sustained increase in optimism and investment across both small and large firms will require at least some of the rhetoric becoming reality, a meaningful reduction in regulation and taxes would be a good start. With a Republican Congress and President it is a reasonable expectation that America is in a better position to actually implement policy changes and that these are likely to be more pro-business relative to the recent past. Whether this will be sufficient to satisfy both Mr. Trump's electoral base and already elevated market expectations remains to be seen.

One cautionary note that is worth adding to the more optimistic view is the risk that the higher economic growth expectations of the market undermine the potential for this to become a reality, at least in the short term. The higher US interest rates and US$ that we have seen since the election will put an increased burden on both US households and exporters. Given the high level of indebtedness and consistent below trend growth seen in the US since the last recession, these moves have the potential to have more pronounced consequences than seen in previous cycles.

On top of this, it is difficult to see how more protectionist policies, such as raising import tariffs, will be a positive outcome for American economic growth in the longer term, particularly when taking into account the likely reactions from key trading partners.

What this all means for Australia is even more uncertain although it is likely that we will see a stark contrast between the political and policy paralysis in Canberra and a more dynamic, pro-growth and pro-business America. This is perhaps highlighted by the latest GDP data for Australia that showed real GDP falling (-0.5%) in the September quarter for the first time since the March quarter 2011, with year-on-year growth slowing to the slowest pace since the financial crisis (+1.8%).

The other significant event was the well flagged increase in US rates made by the US Federal Reserve, as well as outlining a series of anticipated rate rises for 2017. While this suggests the US is now in a rate hardening cycle, it is not yet evident that Australia is as well. It is also unclear what a decoupling of US/Australian rate cycles would mean.

This is consistent with our comments in the last quarterly report around an inflection point for US cash rates and rising bond yields, which has proven to be a challenging backdrop for relative portfolio performance in the second half of 2016.

Discussion of the December quarter return

The December quarter portfolio performance was disappointing, the model portfolio return was 0.1% compared to the overall market return of 5.2%.

The main problem occurred in October where the model portfolio return was -4.3% compared to the market return of -2.1%. Whilst the model portfolio underperformed the market in November and December, the market rose strongly in both of these months, a circumstance in which we acknowledge this strategy may not keep up with the market.

This was the first month when the portfolio has been significantly worse than the market in a month when the market was down by a reasonable amount.

We have expectations to perform much better than the market in poor markets and have described this as follows. If the market was down 20% and the portfolio was down 15% we would regard that as a good outcome, and if the portfolio was down 10% that would be a very good outcome.
In light of these expectations the outcome in October deserves some detailed analysis and discussion. There were broadly four contributors to the outcome in October.

The portfolio has a much lower weighting to the four major Australian banks than the ASX 200 benchmark weight of nearly 30%. The banks went up a little in October and the underweighting cost the portfolio around 0.50% compared to the benchmark.

The portfolio's direct exposure to the resources sector includes BHP, RIO and Oil Search. In aggregate the weighting to resources is lower than the benchmark and this cost the portfolio around 0.50% compared to the benchmark.

The portfolio exposure to infrastructure stocks and property stocks was higher than the market, as this grouping of stocks fell by around 10% this cost the portfolio around 0.30% compared to the benchmark. These three contributors to the negative month can be broadly attributed to the big rotation in the market away from interest sensitive, stable and predictable stocks and towards more cyclical and economically sensitive stocks.

The fourth grouping was five stocks that had stock specific negative news during October, that is news that had nothing to do with the macro trend mentioned in the previous paragraph.

- AMP announced further issues with its life insurance business and weak flows into its managed funds.
- The market learnt that Caltex would be likely to lose its successful fuels alliance with Woolworths.
- The ACCC announced that it would have issues with the purchase by Link of the Pillar business.
- Estia (an aged care business) announced a further downgrade to earnings along with a number of other negative developments, this caused all stocks in the sector to fall quite sharply, including Regis Healthcare which is owned by the portfolio.
- The TPG share price continued to fall following their earlier announcement that the roll out of the NBN would have a damaging effect on its margins.

This grouping of stocks cost the portfolio around 0.9% compared to the benchmark.

These four groupings combined cost the portfolio about 2.2% return compared to the return of the benchmark which reconciles with the underperformance in October.

We will discuss each of these groupings with respect to the portfolio strategy and any actions we subsequently took.

With regard to the banks we believe that the four major banks are very similar businesses and their share price moves are highly correlated. A key pillar of the portfolio strategy is to have a highly diversified portfolio where as much as possible stocks move up and down on their own merits. Therefore we believe that it would not be logical to hold a large weight in the banks given they could almost be regarded as one stock from a risk perspective. We have not adjusted the bank position.

We have about 10% direct exposure to the resources sector which we still feel is an appropriate level when one balances the individual merits of the companies, their high share price volatility and the diversification benefits they offer to a portfolio. We did add a little to the BHP position in October and there would be room for another resource based exposure as long as the company held world class assets and had a strong balance sheet.

The grouping of infrastructure and property stocks do have a fairly high share price correlation despite the grouping operating in a diverse range of businesses such as shopping centres, offices, airports, toll roads and petrol stations. We have sold a couple of the property stocks and reduced the weight a little to Sydney and Auckland airports. We have no great concerns about the quality of these businesses but felt that the likely end of very loose monetary policy (for example negative interest rates in many countries) is a turning point for markets and this could provide a head wind for a considerable period. The current weighting of around 13% reflects the quality of the underlying businesses, the predictable growth in earnings and distributions offset by the fact that changes in interest rates do have an effect on these companies' share prices.

The final grouping all had their own stock specific negative news in October. Whilst we would obviously prefer we didn't have a cluster of individual negative news in one month we think that most of these events were within the run of the mill surprises that are going to emerge from a portfolio of stocks. We do think that the NBN issues facing TPM are more long term and have sold the stock.

We did add Tatts, Qube and Washington H Soul Pattinson to the portfolio during the quarter, we feel these changes further increase the diversification of the portfolio.

Even though the portfolio return was poor in October, on the days when the market fell the portfolio fell less than the market. The problem for October and for the quarter was the portfolio only achieved about 60% of the upside on the days when the market rose.

The volatility of the portfolio (when measured on a daily basis) during the quarter was 72% of the market's volatility, which is roughly in line with the portfolios historical volatility.