CI PENSIONS FUND
QUARTERLY COMMENTARY REPORT

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

DECEMBER 2017

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	8.20%	7.90%	0.30%
ROLLING 1 YEAR	15.28%	13.40%	1.88%
ROLLING 2 YEAR	10.95%	13.40%	-2.45%
ROLLING 3 YEAR	10.68%	10.25%	0.43%
SINCE INCEPTION*	11.13%	9.35%	1.78%
SINCE INCEPTION^	49.86%	40.84%	9.02%

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

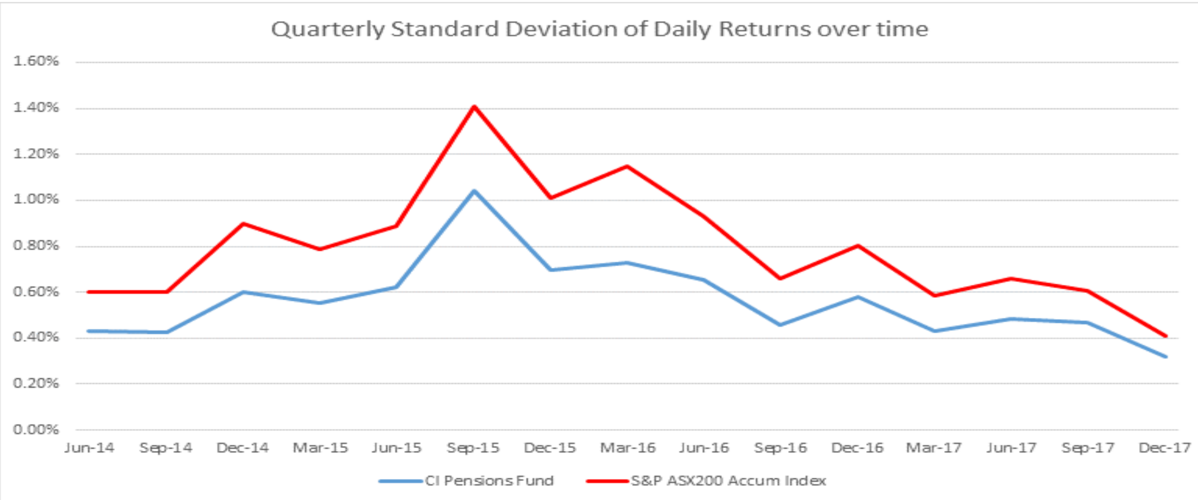
The purpose of the CI Pensions Fund is to provide a conservative equities portfolio that may be suitable for investors who are in the pensions/ decumulation phase. The portfolio may also be suitable for charities, foundations and others who are looking for a conservative equities exposure.

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

Global equity markets performed strongly over the quarter and the year, whilst the Australian market lagged international markets over the year, the ASX 200 accumulation index return (adjusted for franking credits) for the December quarter was a very strong 7.9%.The pensions portfolio returned 8.2% for the quarter and 15.28% for the year.

One notable feature of markets in 2017 was the steady decline in volatility of returns (measured by standard deviation). The chart below shows the portfolio and market's volatility since inception. The portfolio's volatility has run at about 70% of the market's volatility since inception however, as the market's volatility has declined this year that ratio has increased a little.

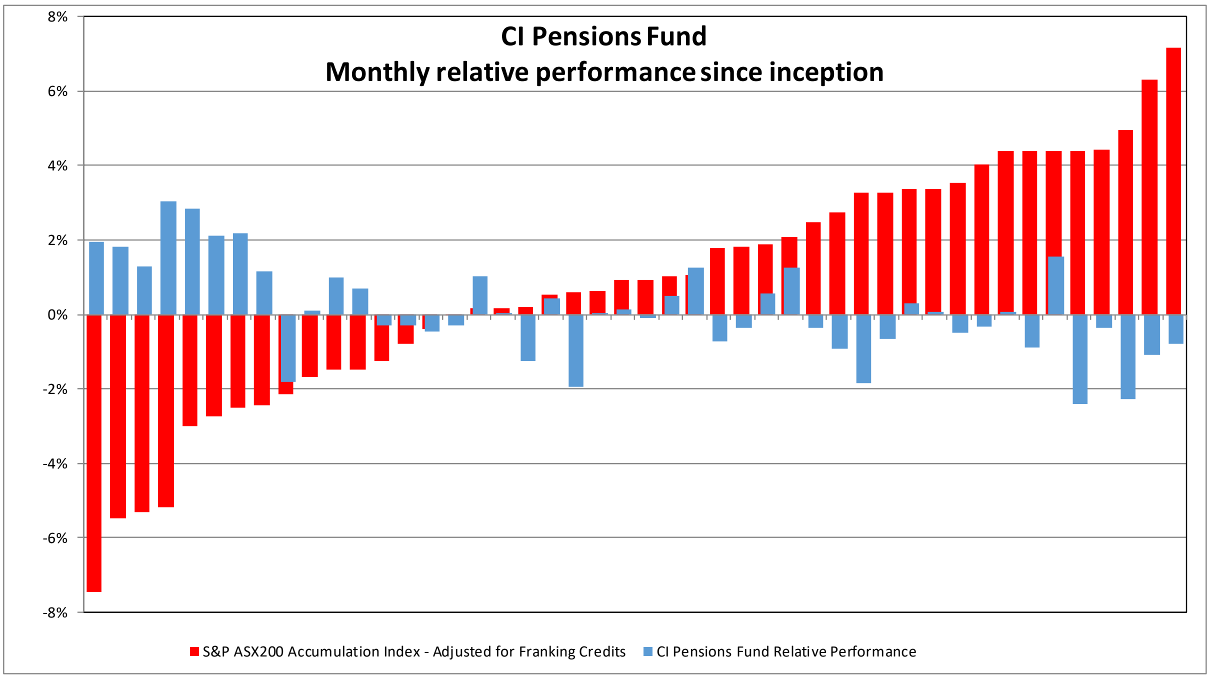


What we are really aiming to achieve is lower than market volatility in down markets, and therefore increasing the likelihood of the portfolio performing relatively well in down periods.

Stocks that performed well over the quarter included **BHP, Ryman, Tatts/ Tabcorp, Costco and Novo**, poorer performing stocks included **the major banks and Regis.**

During the December quarter (using daily data) the portfolio captured 52% of market downside and 79% of market upside.

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



Since inception the market has shown a negative monthly return 16 times and the portfolio has performed better than the market in 11 of these down months. . When assessed using monthly data the portfolio has captured 65.4% of the market's downside and 88.1% of the market's upside.

The Portfolio

During the December quarter we made one switch in the US portion of the portfolio through selling **Brinks** and reinvesting into **TE Connectivity**.

Brinks has been the largest contributor to the portfolio's return in 2017 as it had approximately doubled since it was purchased a year ago. When Brinks was purchased we set out the value latencies we hoped would be realised if management delivered on their plan, they certainly did deliver and the market rerated the stock in a much shorter time than we anticipated, consequently we could not see much upside to the share price from the current level.

TE Connectivity is a US listed global leader in connector systems and sensors with a market capitalisation of US$35b. TE Connectivity products connect and distribute power, data and signals across a large and growing market. We attended the TE investor day in New York in December and comments on TE are included in the trip notes section of this report.

We took up our rights in the **Transurban** 3 for 37 capital raising that funded the equity portion of the project cost for the West Gate Tunnel Project.

The portfolio currently owns 39 securities including four US, two European and one Japanese stock that make up 15% of the portfolio. The cash weighting is around 6%.

Stock News

In December **Transurban (TCL)** announced it had reach contractual close with the Victorian State Government to build, toll and operate the West Gate Tunnel Project (WGTP) until 2045. TCL also announced a $1.9 billion entitlement offer (3 for 37 at $11.40 per share) to help fund their $4 billion share of the WGTP. Construction on the WGTP has commenced and is due to complete in 2022, equating to a concession life of 23 years. We understand that political risk has been addressed by the Government committing to reimburse TCL (including an agreed project return) if the required parliamentary consents are not achieved.

As part of the deal the Citylink concession was extended by 10 years which aligns with expiry of the WGTP. We were surprised by the 4.25% pa fixed toll escalation agreed on Citylink and the WGTP for 10 years and 7 years respectively. This replaces the current CPI toll escalation and in a low inflation environment is a significant value driver for TCL. While this comes with some political risk around cost of living pressures, we suspect this pricing concession in part reflects compensation for the negotiated relinquishment of the Material Adverse Event clause associated with new road developments around Citylink. We took up the entitlement offer because it is a good deal for TCL shareholders and is yet another example of strong capital allocation discipline by management.

After fourteen months of twists and turns the merger between **Tatts (TTS)** and **Tabcorp (TAH)** was finally consummated during December. Tatts shareholders received 0.8 of a TAH share for each Tatts share held plus a 16c fully franked dividend plus a 26.5c cash payment.

We feel that TAH should be a much stronger company than it was prior to the merger and at this stage we will be maintaining the TAH exposure. The share market has greeted the merger with enthusiasm as the TAH share price rose by 30% over the quarter.

In November **Oil Search (OSH)** acquired interests of between 25.5% and 37.5% in three oil assets in the Alaskan North Slope for US$400m. The purchase will be funded from internal sources plus additional financing facilities and will not impact Oil Search commitments to LNG expansions in PNG. It is very impressive that OSH had been able to participate in the development of the PNG LNG project and buy these interests in Alaska without issuing any new equity since 1991. Over the last fifteen years the OSH market capitalisation has risen to $12b from less than $1b.

The attractive aspects of this purchase are it is a well-defined resource in the US, it brings no political risk, the partners are reputable companies with good track records and it provides some diversification from the PNG gas project. The purchase of oil interests are well within the OSH circle of competence.

Caltex (CTX) announced the purchase of a 20% stake in SEAOIL Philippines, an independent fuel company in the Philippines. The purchase price of $115m is relatively small for Caltex. This transaction seems to signal a ramping up of Caltex's strategy of "targeted international expansion".

Caltex was originally purchased whilst it was solely an Australian business and was moving to reduce the volatility of its returns by closing the Kurnell refinery and we were looking forward to the release of most of the franking credits sitting unutilised on its balance sheet. The strategy has now clearly moved to expansion which brings a greater level of uncertainty to the investment case.

Rio Tinto (RIO) completed its off market buyback of shares in November, this was a positive transaction for investors with 15% or 0% tax rates, however because of the very high scale back rate of 89% the benefit was minor for the portfolio.

The **ASX (ASX)** announced that it would be replacing its CHESS clearing and settlement system with distributed ledger technology developed by its partner Digital Asset Holdings. We expect that this decision will be a very good one however it is quite difficult to anticipate the full ramifications of the decision. It is likely that technology of this type will be utilised by many businesses in the future and in particular in the financial services industry and it is good to see an Australian company leading innovation in financial markets.

After a difficult year for banks they received a further challenge when the Federal Government established a Royal Commission into the alleged misconduct of Australian banks and other financial service entities. It is hard to envisage anything positive for bank shareholders from this highly politically motivated announcement.

Costco reported its Q4 and Q1 results in October and December respectively. The business continues to show strong operating momentum generating 8% in comparable store sales growth for Q1. Performance was strong across both North American and International markets. The strength of Costco's eCommerce business is particularly noteworthy. After being slow to fully embrace the online channel recent digital investments are starting to bear fruit with a 40%+ growth number for the eCommerce business in Q1. We see this as further evidence that the Costco customer proposition of delivering exceptional value on a select range of goods and services translates well to online.

Along with other retail peers, Costco's share price came under pressure in the middle of the year on the news of Amazon's acquisition of Wholefoods. Certainly many legacy retailers will struggle to compete in the new omni-channel world, however we saw Costco's results as strong and improving throughout 2017 and did not share the market's subdued view on the company's prospects. The recent share price recovery is a fair reflection of the strong execution by Costco's long-tenured management team.

Trip Notes

Cooper Investors investment teams undertook many trips to overseas markets in the December quarter including Europe, USA, Asia and Japan. Many of the companies visited are either in the portfolio or have relevance to stocks in the portfolio. We set out below some comments on economic conditions and stocks in the portfolio.

A key driver behind the strength of the US equity market was the passing of the tax reform bill in December, one of the most significant changes to the US tax code in 30 years. The tax cuts are likely to be stimulatory for the US economy, with flow-on effects to the currency and interest rate markets. The tax boost is on top of an economy that has been steadily improving. This was evident to us in our recent trips to the US and is resulting in an increased confidence to invest by the companies we have visited.

When meeting companies in continental Europe there was a sense of business as usual at last, with the economic and political instability of recent years giving way to a period of progress. Nordic and Swiss companies have continued to operate unimpeded but for once the German, French, Spanish and Italian companies we met were also broadly positive on their plans for the future.

In Britain the tone was markedly more cautious. The political impasse (partly of Theresa May's own making) means corporates are now taking matters into their own hands and preparing for 'Hard Brexit'. Suddenly March 2019 is not far away and the uncertainty around what rules look like post-Brexit is becoming acute in certain regulated sectors such as airlines and financial services. A number of companies we spoke to are setting up European licenses, delaying investment decisions and spending time and money on increased regulatory compliance and 'Brexit committees'.

Whilst in the UK we conducted visits around **Link Group (LNK),** specifically relating to their recent acquisition of Capita Asset Services (CAS). By way of background, Link acquired CAS from Capital plc in the UK, whose strategy has been a roll-up of various outsourcing businesses over the last 20 years. As can happen, numerous acquisitions were not properly integrated and significant debt was taken on, which combined with two recent profit downgrades resulted in Capita plc having to sell assets to reduce debt. CAS was considered non-core by Capital plc and that it could better fulfil its potential under more focused ownership.

The acquisition strikes us as a classic corporate carve-out where CAS management had been frustrated by a lack of support and capital from the head office. New ownership, together with investment in the business, could lead to a release of management focus and energy. There is also a significant opportunity for CAS to lift efficiency after years of underinvestment, although this will take time to realise. Our meetings highlighted that CAS was considered the best business within Capital plc – high quality, solid growth, cash generative, with well-regarded and long-tenured management. While LNK paid a full price for CAS the acquisition is consistent with strategy, although a couple of new business lines and geographies does increase complexity and risk. In summary, we back management to execute on this transaction noting their track record of acquisition integration.

In the US we attended the investor days of two of our holdings, **Danaher** and **TE Connectivity**. It was a good opportunity, not only to hear updates but also to meet the next layers of management and view product demonstrations.

Danaher has been in the portfolio since inception and has been a consistent performer. Founded in the 1980s by two brothers Mitch and Steve Rales, Danaher went about copying the Toyota lean production system for their brakes and tools business. Over the next 30 years, they have used that lean mindset in all facets of business and in particular M&A. Today Danaher is a US$18bn revenue business in healthcare and technology. They are leaders in diagnostics equipment, dental supplies and water treatment - businesses with strong brands, large recurring revenues and a global footprint.

The investor day was a good showcase of where the opportunities exist today. The good news is that future plans look very familiar to the past, being in growth areas of technology and healthcare, and having a large presence in emerging markets, Danaher has a strong growth outlook combined with margin and M&A opportunities, just as they have had over the past 30 years.

TE Connectivity is a more recent buy. Previously we saw TE as a Low Risk Turnaround as performance had been good, but not much more, post its spin from the disgraced conglomerate Tyco over 10 years ago. In 2016 a new CFO arrived who was known to us from a prior investment. We had also previously invested in Amphenol, the number 2 player in the connector industry. We have found that investing in people and industries we know well makes for good Low Risk Turnaround candidates.

2017 showed TE is well out of its turnaround phase with revenues up 9% and margins expanding over 1%. The investor day was a good opportunity for the new CEO and CFO to lay out their thinking around the business and positioning. Rather than specific short-term EPS goals they provided a framework for shareholders, running through the levers on growth, margins and capital allocation. This felt very familiar given the background of the CFO and we like this long-term outlook that favours sustainable shareholder value creation.

TE has the benefit of some powerful tailwinds at its back given its leadership position in the connector and sensor markets. The electrification of all things in particular cars, planes, factories and consumer appliances is clear for all to see - a typical car now has US$62 of connector content up from US$50 five years ago. With an electric vehicle containing US$120 of content you can see where TE is headed. After 10 years of transformation as a standalone company TE now has the product set, customer relationships, margin structure and management team to capitalise on the opportunity set.

We also visited China in October, spending time in Beijing, Tangshan, Jinan, Wuxi and Shanghai. Policy decisions have always been key in China, but we came away with the sense that it is becoming even more important, especially in the sectors that we are exposed to in our portfolio.

Reforms in heavy industries are likely to continue to take place with the intent to reduce the excess capacity in the market, reduce pollution levels, improve profitability and reduce the high debt levels in SOEs. The supply side reform implemented over the last few years, in industries including coal, steel, aluminium, cement and chemicals, has in general resulted in a significant increase in prices and margins. While we expect the prices of some of these commodities to fall from current elevated levels, the profitability of these industries is likely to be higher on average going forward than in the past and this background is encouraging for our resources stocks, **BHP, RIO** and **Alumina**.