CI PENSIONS FUND
QUARTERLY REPORT

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

JUNE 2014

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING MONTH	-0.79%	-1.49%	0.70%
ROLLING 3 MONTH	1.35%	1.19%	0.16%
SINCE INCEPTION^	2.31%	1.72%	0.59%

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

This is the second quarterly report for the CI Pensions Fund. The Fund was launched on 3 March 2014. It is a wholesale unit trust managed by Cooper Investors Pty Limited.

The CI Pensions Fund is an equities portfolio and we would expect it to normally form part of an overall portfolio for people / entities that are in the pension phase. The portfolio may also be appropriate for charities.

The purpose of the fund is to provide an equity portfolio suitable for those seeking a more conservative approach than an average equities portfolio which is usually designed for those in the accumulation stage of their investment life.

The returns of the portfolio will be reported against the S&P/ ASX 200 Accumulation Index (adjusted for franking credits) and will also be measured against two other explicit objectives; that the portfolio will exhibit lower volatility than the market and perform relatively well in down markets.

Portfolio Returns and Attributions

The portfolio returned 1.35% over the quarter and 2.31% since inception (including franking credits). The market returned 1.19% and 1.72% respectively over these two periods.

Normally a statistical analysis of a portfolio's volatility and down market performance would encompass monthly data however as the portfolio has a short history we have instead analysed portfolio attributes on a daily basis since its inception. Clearly whilst four months is too short a period to draw conclusions we feel the analysis to date is of interest.

With regard to performance in down markets we have looked at the portfolio's performance relative to the market on a daily basis. Of the 81 days of activity, there have been 36 down days in that period; the portfolio has performed better than the market on 31 of those 36 days (86%). On each of the 18 days when the market has been down more than 0.5% the portfolio has performed better than the market.

The table below sorts the daily market returns from worst to best (the red bars) and for each day shows the difference between the portfolio return and the market return (the blue bars).

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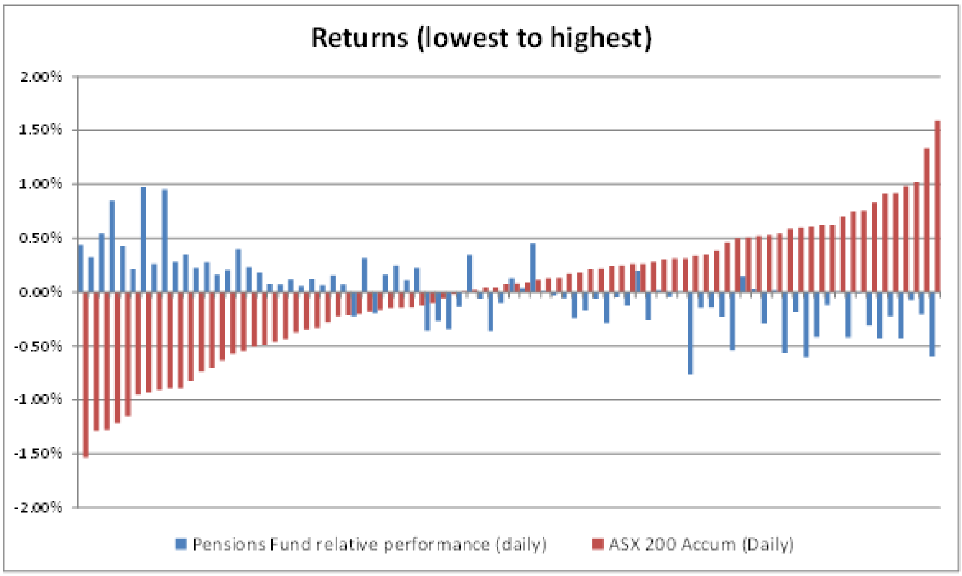

We have also set out the monthly performance of the portfolio and the market in the table below.

The portfolio had its best outperformance in the biggest down month for the index which is consistent with our objectives.

CI Pensions Fund monthly performance

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%	0.15%
Jun-14	-0.79%	-1.49%	0.70%

Note: Before fees and expenses, adjusted for franking credits

When analysing the volatility of the portfolio we have again looked at the daily data since inception. So far the portfolio has been less volatile than the market. The figures used are the standard deviation of the portfolio and market returns since inception. The portfolio standard deviation has been 0.45% compared to the market standard deviation of 0.63%.

We are not suggesting that readers should make too much of these short term statistics however it is at least encouraging that the portfolio is operating within expected tolerances.

The real test though will be when the market suffers a severe downturn.

Portfolio Structure

The portfolio contains 37 securities and has a cash weighting of around 6%.

The four major Australian banks make up 20% of the portfolio. The banks had another solid reporting season with all players reporting higher earnings and dividends driven by moderate revenue growth and declining loan impairment charges. The major challenge for the banks will be to grow revenues at a faster pace as we do not expect further significant falls in loan loss impairments. We expect the higher capital requirements will be relatively easily met though that will be partly through continued use of dividend reinvestment plans. We suggest banks now have a lower risk profile because of their high capital base and that their dividends can grow slowly from here.

The three resource stocks in the portfolio (BHP, RIO and Oil Search) were in aggregate ahead of the market over the quarter, mainly driven by a sharp rise in the Oil Search price. Oil Search announced that its LNG project started ahead of schedule and was accompanied by production upgrades. Resource stocks are generally more volatile than the overall market although because they have a different cycle to industrial stocks they add to portfolio diversification. The portfolio has a key portfolio construction objective of being highly diversified. A golden rule for the portfolio is that resource stocks in the portfolio must own world class assets, such as Pilbara iron ore or PNG gas reserves.

The portfolio holds 3 hybrid / convertible securities and these performed in line with the market.

Transpacific Industries (TPI) announced that they will redeem the Step Up Preference Securities (TPAPA) in October for the face value of $100. The redemption will crystallise the 9% internal rate of return that was anticipated when purchased.

The **Australand Preference Shares (AAZPB)** are also likely to be redeemed at their $100 face value if as expected the Frasers Centrepoint Limited bid for Australand is successful. If the redemption occurs the internal rate of return will also have been around 9%.

Both these securities offered an attractive risk/ return profile on purchase, that is they had very limited downside and an upside return not far off expected equity returns. We will search for opportunities to replace these securities however the hybrid market internal rates of return are currently well below 9%.

Infrastructure stocks were mixed; the **Auckland Airport (AIA)** price fell whilst **Transurban (TCL)** had a very strong quarter.

Transurban acquired the Queensland Motorways portfolio of toll roads for $6.7b and partly funded this through an equity raising of $2.7b. The portfolio increased its weighting to Transurban by taking up its rights at $6.75 per security. The company now has many new projects on its plate as well as the integration of the Queensland roads into its portfolio. Transurban now dominates the toll road sector in Australia. We expect the stock's distribution to continue to grow strongly over the next few years.

The portfolio's 3 property stocks performed better than expected with the stock prices rising moderately as well as going ex-distribution on 27 June. The companies will not pay these distributions until August however in accordance with tax rules the distributions will be included in the Pension Fund June quarterly distribution to be paid later in July. We believe there are a couple of further property stocks that could be suitable for the Fund. The features we are looking for are resilient and growing rental income, high quality assets, moderate debt and management committed to a simple model with limited development exposure.

There was a wide divergence in returns across the "industrial" exposure of the portfolio. Better performers included Lifestyle Communities (LIC), Insurance Australia Group (IAG), Macquarie (MQG) and Recall (REC) whilst poorer performers included Amcom (AMM), CSL (CSL), and Fletcher Building (FBU).

There are 3 US stocks in the portfolio representing 6% of the portfolio. As a group these stocks rose more than the Australian market despite the A$ rising against the US$ over the quarter. The stand out stock was **Johnson & Johnson** which has risen by about 15% since purchase. International stocks generally have a lower dividend yield than Australian stocks and do not provide franking credits. The low dividend payout ratio is normally supplemented by regular buy backs of shares which means the overall "return of cash" to shareholders is similar to Australian companies. The total return of international stocks should be similar over time to Australian stocks however the return is expected to be skewed more to capital gain over dividend.

The primary reasons to own international stocks are to diversify the portfolio further by industry, country and currency and to get access to stocks that are higher quality than the average stock on the Australian market. The portfolio's exposure to international stocks is limited to 20%.

Portfolio Changes

We participated in the **Equity Trustees (EQT)** capital raising that accompanied their purchase of the ANZ Trustees business in April.

Equity Trustees is a niche financial services provider that categorises itself as providing Private Wealth Services and Corporate Fiduciary and Financial Services. In plainer English this means they offer a multitude of services relating to estates, trusts, asset management, aged care and responsible entity services for fund managers.

Equity Trustees was established in 1888 by an Act of Victorian Parliament and has a rich history. An attractive trait is the company has a conservative, risk conscious culture that has withstood a multitude of investment and regulatory cycles.

The ANZ Trustees offer many of the same services as EQT and as such increases scale in a consolidating industry and in particular has a very large "will bank". ANZ Trustees is even older than Equity Trustees having been established in 1878.

From a numbers perspective the transaction is very attractive with expected scale benefits, synergy benefits and a reasonable price. In the longer term the businesses look to have good prospects with an ageing population requiring trusted advice in an ever more complicated regulatory regime. We feel the management team are experienced and have an energy that should enable the company to participate in a growing market opportunity.

Portfolio Strategy

The strategy is derived from the proposition that as people grow older their investment portfolios should become more conservative and should provide dependable and growing income.

The reasons for this straight forward proposition are that once people stop full time employment they would find it hard to recover a permanent loss of capital, and they rely on portfolio income to pay for necessary goods and services.

There are plenty of ways that investments in securities can suffer a permanent loss of capital, these include:

- paying way too much for investments,
- investing in companies or industries that have fundamental underlying problems,
- investing in companies that have too much debt, and
- investing in companies whose Board and management allocate capital poorly.

Investment portfolios can also suffer a permanent loss of capital because of taxes and inflation.

Fortunately in Australia for superannuation funds in the pension phase (and charities) the most important tax rules are that income and capital gains are tax free and franking credits can still be claimed and refunded. So under the current rules taxes are a benefit and not a detriment to capital and income.

There are limits to the degree that investment portfolios can be protected against the damage of high inflation but what can be said is that most companies have some degree of pricing power and they are a much better defence against inflation than fixed interest and cash. As such an equity portfolio has a sensible role in most people's portfolios throughout their life.

Diversification of an equity portfolio is a key consideration in protecting against the permanent loss of capital. Diversification in our view involves spreading investments across industries, countries, currencies, size and characteristics. We are developing our thinking on how we can present the portfolio to demonstrate that it is diversified. Ultimately diversification can be measured by looking at the degree of correlation between securities in a portfolio and how the portfolio performs in down markets. We are aiming to have few securities in the portfolio whose prices have a very strong relationship with other securities in the portfolio.

The guidelines for the portfolio provide some scope to use asset allocation to protect the portfolio; these are the ability to hold both cash and international securities at up to 20% of the portfolio. As discussed earlier cash is not an attractive investment in the long term.

The next step in the portfolio strategy is considering how we select individual securities for inclusion in the portfolio.

The first point to be made is that we are using the whole research effort of Cooper Investors and the Cooper Investors' VOF framework. At its simplest we are looking to invest in companies that have a value proposition, have some sort of positive operating trends and are managed by competent and passionate Boards and management teams. We want to avoid companies that are too expensive, have underlying fundamental problems and have too much debt.

When we are considering whether to include a stock in the portfolio (having passed through the process discussed in the previous paragraph) we would consider issues such as whether it would add to the diversification of the portfolio, whether it would increase the income or future growth of income from the portfolio, whether it would add to the overall quality of the portfolio and whether it would add to the margin of safety inherent in the portfolio. In terms of future outcomes we examine whether the potential stocks would lower the volatility of the portfolio and increase the possibility of the portfolio outperforming in a significant down equity market.

Hopefully this discussion gives some guidance as to why and how this portfolio will be different to portfolios that are prepared to take on more risk.

In future reports we will discuss changes within the portfolio in the context of this portfolio strategy.

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