CI PENSIONS FUND
QUARTERLY COMMENTARY REPORT

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

JUNE 2017

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	0.88%	-1.31%	2.19%
ROLLING 1 YEAR	7.71%	15.68%	-7.97%
ROLLING 2 YEAR	8.45%	8.73%	-0.28%
ROLLING 3 YEAR	10.09%	8.24%	1.85%
SINCE INCEPTION*	9.80%	7.95%	1.85%
SINCE INCEPTION^	36.52%	29.02%	7.50%

*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) declined by -1.31% over the June quarter and finished the financial year returning 15.68%. The model pensions portfolio returned 0.88% and 7.71% for the quarter and year respectively.

After the Brexit vote in the UK last year and the US elections that followed, global investors started to price a more favourable economic environment globally. More recently, some of this optimism has faded following elections in the UK and challenges the Trump government has faced passing legislation in the US.

Bond yields increased sharply in June following remarks by several central banks that the period of historically low interest rates and unprecedented central bank intervention in bond markets would start to normalise. The Australian 10-year bond rate rose by over 20bps in June to 2.6% taking the annual increase to over 60bps. Australian bond yields appear to be following the US 10-year bond which rose by more than 80bps to 2.3% over the 12 months to June 2017. This has made for a very volatile year for bond-like equities in sectors such as property trusts, infrastructure and utilities.

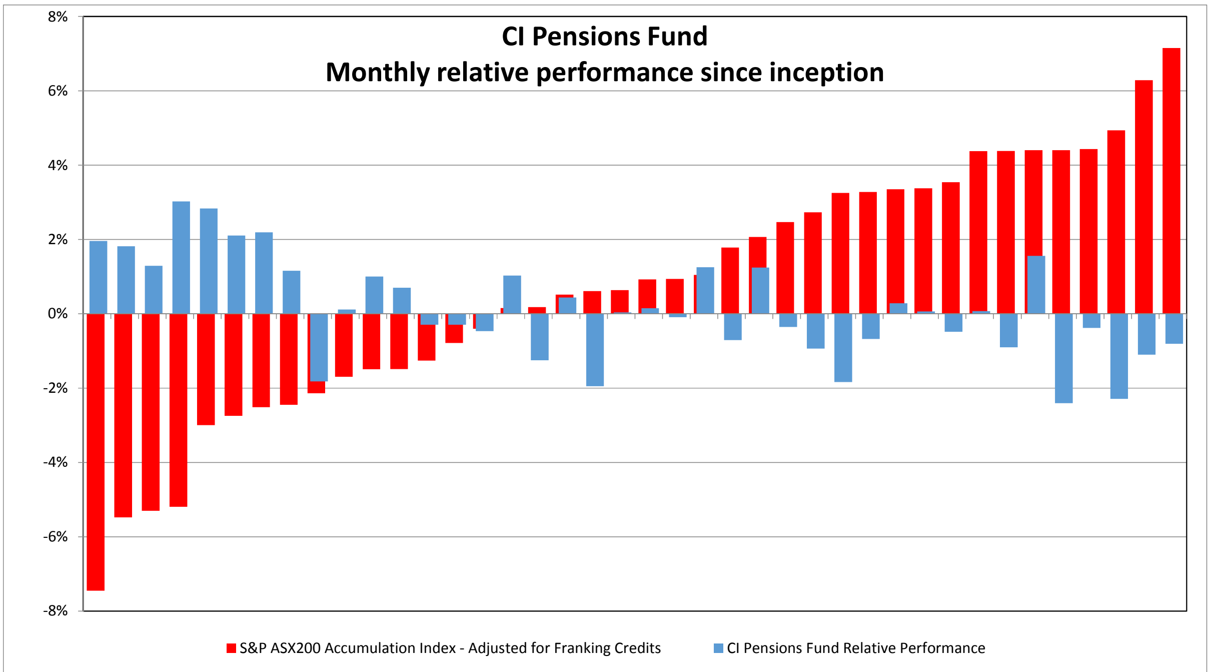
In Australia, weakness in several discretionary retailers points to softness in consumer demand in the face of record levels of household debt and weak wages growth.

Stocks that performed well over the quarter included Auckland International Airport, CSL, IAG, Novo Nordisk, Henkel and Brinks. Poorer performing stocks included Regis Healthcare, Wesfarmers, Soul Pattinson, and the major banks. The resources, banks, and healthcare sectors performed well over the year whilst telecoms and property trusts had particularly tough periods.

The international stocks in the portfolio performed well as a group. International stocks increase diversification within the portfolio by providing access to industries typically not available in the Australian share market as well as creating direct foreign currency exposure. Over the quarter the A$ rose slightly against the USD, but fell against the NZD, EUR and Danish Kronor, which was a net tailwind for the international stocks in the portfolio.

The volatility of the portfolio over the quarter was well below the market's volatility.

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 monthly negative return 15 times and the portfolio has performed better than the market 11 times. When assessed using monthly data the portfolio has captured 64.7% of the market's downside and 85.9% of the market's upside.

The Portfolio

During the quarter we sold out of our Australian Foundation shares post conversion of the convertible notes into ordinary shares given they were trading at around NTA. We also reduced our position in Brinks given the strong run in the share price. The portfolio also participated in the equity raisings for Viva Energy REIT and Link Administration Holdings.

The portfolio currently owns 40 securities including four US and two European stocks that make up 12% of the portfolio. The cash weighting is around 8%.

Stock News

In June **Link Administration Holdings** (LNK) announced the acquisition of Capita Asset Services (CAS) from Capital plc in the UK for A$1.5 billion, which is significant in the context of LNK's A$2.8b market capitalisation. CAS provides a broad range of financial and administrative services in the UK & Europe, which are broadly consistent with LNK's core skillset.

The acquisition aligns with the company's growth strategy, although we are mindful some new businesses and geographies increase complexity and risk. The transaction was part funded by an A$883m 4 for 11 rights issue, with the residual funded by debt costed at around 3% (pre-tax). The deal is expected to complete at the end of calendar 2017 following regulatory approvals across a number of jurisdictions.

Auckland International Airport (AIA) released the aeronautical pricing schedule for July 2017 to June 2022 (PSE3). The aeronautical pricing was in line with expectation but the aeronautical capex of NZ$1.87 billion was much higher than expected, particularly when compared to the NZ$500 million spent in the current period (July 2012 to June 2017).

The higher capex is required to support expected future growth. In August AIA will release a full 10 year pricing disclosure including passenger and capex forecasts. This will give us a better picture on pricing decision rationale as well as more information on long term funding and capital management requirements.

The Australian Competition Tribunal (ACT) granted authorisation for Tabcorp (TAH) to proceed with the proposed merger with **Tatts Group** (TTS), subject only to the condition that TAH divest its Odyssey gaming services business in Queensland. Subsequently the Australian Competition and Consumer Commission (ACCC) appealed the ACT's decision claiming it made errors in its deliberations and has applied to the Federal Court for a judicial review of the ACT's approval. The ACCC is seeking an expedited timetable however there is still the potential for delays in completing the merger which may increase the likelihood of a competing offer for TTS.

In June **Viva Energy REIT** (VVR) conducted an equity raising to help fund the acquisition of 8 service station properties for a purchase price of $89.1 million (excluding transaction costs). The announcement also noted there are another 10 properties under due diligence with an estimated value of approximately $45 million. These acquisitions are consistent with the growth strategy outlined at the time of the IPO and will add to the quality of the existing portfolio and cash flow profile. The portfolio participated in the equity raising.

During the quarter **Australian banks** faced increased scrutiny from regulators trying to slow growth in investor lending, interest only mortgages, and high loan-to-value mortgages. These are now considered to be high risk areas given very high house prices and levels of household debt.

In addition, the 2017 Federal Budget announced the introduction of a 'levy' (read tax) on the four major Australian banks and Macquarie Bank. The levy will be 6bps of liabilities which preliminary estimates from the banks suggest will cost them collectively around one billion dollars after tax on an annual basis, well short of the $1.6 billion revenue per annum the federal government was seeking to raise.

The SA government has also announced plans to implement a state levy on the four major Australian banks and Macquarie Bank of 6% of the total value of liabilities subject to the federal levy. The bank levy's are a disappointing policy development but the banks have a number of levers to manage the impact on earnings.

IAG announced an upgrade to its reported insurance margin for FY17 from 10.5%-12.5% to 13.5%-15.5%. This was driven by higher than expected prior year reserve releases in Australian long-tail classes (e.g. CTP, workers' compensation, professional risks), reflecting favourable experience for claim size and inflation against underlying assumptions. We consider large reserve releases to be a non-recurring item (a positive one) and do not capitalise them into our valuation.

CSL has acquired 80% of Chinese plasma fractionator Wuhan Zhong Yuan Rui De Biologics ("Ruide") for US$352m, with the final 20% dependent on milestones. This provides CSL with a strategic entry into the Chinese domestic plasma fractionation market, complementing their leadership position as an exporter of albumin into China. The acquisition will not be material to CSL in the near-term but does provide a long-term growth platform given the Chinese plasma market is growing at 15% per annum and is structurally undersupplied.

In April **Regis Healthcare** (REG) received a sanction on their Darwin facility, following a review by the Aged Care Quality Agency, relating to two specific items: skin care and human resources management. This is the first sanction in REG's 25 year history, and while it has an immaterial impact on earnings it highlights the high level of operational risk in these businesses.

REG also applied to the Federal Court for a declaration in relation to the Department of Health's position regarding the Asset Replacement Charge (ARC) currently charged to some residents. The ARC is an initiative to mitigate the impact of the government funding cuts on earnings yet it is not clear this is permitted under the Aged Care Act 1997. This is another example of the pressure the residential aged care industry is under to maintain and grow earnings.

Trip notes

As usual, we undertook a number of trips both domestic and offshore.

We travelled throughout **China** in April. The focus of our trip was on the iron ore, steel, aluminium, mineral sands and gas markets and specifically assessing industry dynamics, the demand environment and policy initiatives. The most notable change to when we visited China last year was the significantly increased focus on environmental policy. This was pervasive across almost all industries we encountered and it became clear that the central government has taken control of the process and put some teeth behind their environmental policy. Additionally, the environmental standards that are required to be met are also gradually rising.

The effect this more rigorous enforcement of environmental policies is having on industry is meaningful; increasing capital requirements and operating costs, squeezing out smaller or weaker players and resulting in consolidating industries. This could prove positive for longer term profitability in a number of industries and companies that our portfolio has exposure to. For example, Alumina would potentially benefit from reduced incremental supply of both aluminium and alumina in China.

We also visited **Perth** during the quarter to see a number of mining contractors and engineers, miners and property consultants. The general mood is becoming more upbeat and activity levels are picking up from a low base. The main driver of activity thus far has been predominantly from the gold sector where gold companies are highly profitable given weak currencies and the relatively stable gold price. Capital markets have also been accommodative for junior to mid-tier gold companies, which has seen exploration spend pick up for the first time in five years.

Although activity levels are picking up, most companies we visited still have spare capacity and are yet to see pricing pressure. The next big wave of work is coming from the iron ore tonne replacements from BHP, Rio Tinto and Fortescue Metals. We are doing a bit more work on a few names in the sector but in most cases we think the share price has run ahead of fundamentals.

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