# CI PENSIONS FUND
# QUARTERLY COMMENTARY REPORT

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

JUNE 2018

| | **PORTFOLIO | #BENCHMARK | VALUE ADDED |
|---|---|---|---|
| ROLLING 3 MONTH | 7.86% | 8.74% | -0.88% |
| ROLLING 1 YEAR | 16.93% | 14.64% | 2.29% |
| ROLLING 2 YEAR | 12.24% | 15.17% | -2.93% |
| ROLLING 3 YEAR | 11.21% | 10.67% | 0.54% |
| SINCE INCEPTION* | 11.41% | 9.46% | 1.95% |
| SINCE INCEPTION^ | 59.63% | 47.90% | 11.73% |

*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) performed strongly up 8.7% over the June quarter and finished the financial year returning 14.6%. The model pensions portfolio returned 7.9% and 16.9% for the quarter and year respectively.

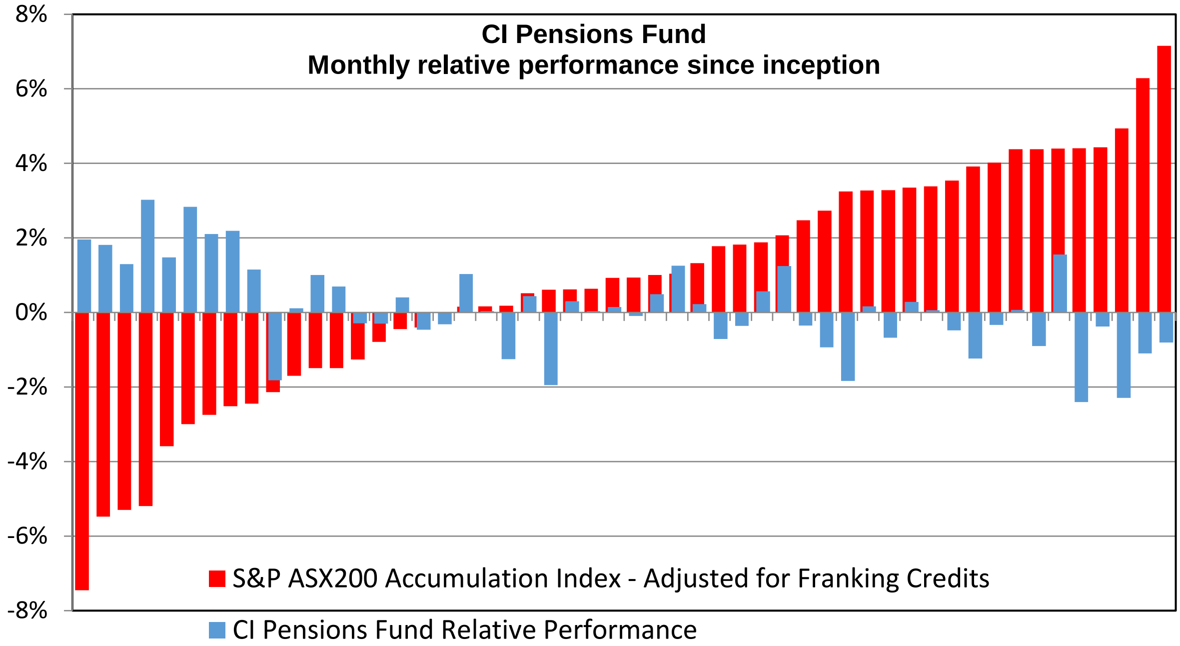
Australia was one of the top performing markets globally, significantly outperforming Asia (Shanghai Composite -11.4%), and other emerging markets in Europe and South America. Contribution across sectors in the ASX200 was broad-based with Energy, Mining and Health sectors among the best performers. The poor performance in Asia appears to reflect concerns of an escalating trade war between China and the US, with China perceived to be most impacted.

Portfolio stocks that performed well over the quarter included **CSL** (earnings upgrade midway through the quarter), **Oil Search** (stronger Brent oil prices), **Macquarie Group** (strong full year result and outlook) and **Wesfarmers** (exit from UK on better terms than anticipated). Poorer performing stocks included **Ramsay Healthcare** (earnings downgrade and ongoing industry pressure), **Link Group** (May budget announcement) and **TE Connectivity** (USD strength, US trade war concerns).

The international stocks in the portfolio detracted from performance over the quarter but have been strong contributors over the year. During the quarter the AUD fell against the USD, rose against the NZD and EUR, and was flat against the Japanese Yen, which in the end meant currency had little impact on portfolio returns. Australian 10-year bond yields rose slightly over the quarter to 2.6%, which is broadly flat year-on-year, and continues to be quite volatile as the market frets about the potential for rising interest rates.

The volatility of the portfolio over the quarter was 76% of 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 20 times and in these months the portfolio has performed better than the market 15 times. When assessed using monthly data the portfolio has captured 63% of the market's downside and 89% of the market's upside.

For the 12 months to June 2018 the average annual turnover for the portfolio was 10%, a bit below the four year average of 13.5%. A low turnover portfolio gives well-selected stocks time to compound which is consistent with the conservative nature of the fund. However having said this we don't want turnover to be too low to ensure we don't end up with yesterday's portfolio.

## The Portfolio

During the quarter we made a change in the international portion of the portfolio through selling **Novo-Nordisk** and replacing it with **Saputo**. We also sold **AMP** and reduced our position in **Link Group**.

The portfolio initiated a position in **Saputo**, a Canadian-listed, global dairy processor, specifically focusing on cheese. The company was founded over 60 years ago and today is run by a third generation Saputo, CEO Lino Saputo Jnr. The family still own >40% of the company, fostering a unique owner-operator culture for a US$13b market cap company. They have proven to be excellent stewards of capital generating a mid-teens ROE for over 20 years.

Saputo has leading market positions in the American and Canadian dairy markets which provide a stable stream of cash flows. Since listing in 1997 the company has returned around one third of this cash flow to shareholders and deployed the other two thirds into acquiring undermanaged or underfunded dairy processors. More recently the acquisitions have been focused in international markets like Argentina and Australia (Warnambool Cheese and Butter, Murray Goulburn) as Saputo builds a platform to service faster growing emerging markets.

Recent consternations between the US and Canadian administrations around trade have highlighted the heavy tariffs in place to protect the regulated Canadian dairy industry. Whilst the current arrangement is attractive for farmers, consumers in Canada pay a lot more for milk than their US counterparts. For scale processors like Saputo, whilst the current Canadian dairy system provides stability around price and volumes, there is little opportunity to grow organically. Our discussions with industry experts indicate that opening North American trade should be net-positive as Saputo could purchase milk from the cheapest sources and process milk in the most efficient plants across the entire North American continent.

One of our core objectives is to have a diversified portfolio and Saputo helps to increases our diversification by industry, geography and currency.

We fully exited **Novo Nordisk** during the quarter because in a world of bio-similars and pressure on universal healthcare budgets we do see value latencies becoming more limited, particularly linked to the success of one or two drugs whose outcomes tend to be binary in nature (i.e. success or failure). The stock has been quite volatile over the time we have owned it, in particular around the 2016 profit warnings and CEO transition which worked out after the stock rallied over 60% from its low through to January this year. So with the shares trading back at handsome premiums to its peer group and a lack of observable value latency we decided to sell.

We also sold out of **AMP** as findings emanating from the Royal Commission were unexpected and did not reflect well on the company. The financial advice business is a significant part of the AMP valuation and is now much more uncertain given the ongoing industry headwinds. Combined with the significant upheaval in management and the Board we no longer consider that AMP fits the investment guidelines we have set out for the Pensions Fund.

We reduced our position in **Link Group** due to the uncertainty engendered by the budget as per comments below.

The portfolio currently owns 39 securities including seven global stocks (14%) and three New Zealand stocks (5%). The cash weighting is 7.5%.

## Stock News

In the last quarterly report we wrote about **Wesfarmers' (WES)** new CEO Rob Scott and his decision to demerge the Coles business. During this last quarter WES revealed its decision to exit the UK, and shortly thereafter the completion of the divestment to restructuring specialist Hilco Capital, recording a loss on disposal but importantly avoiding ongoing lease liabilities.

Rob Scott is showing himself to be a man of considered action and we would anticipate further announcements from him over the next months. We continue to believe that post the de-merger of Coles (and the sale of their coal assets), Wesfarmers will be in a position of financial strength, with a strong balance sheet, good cash flow and a reinvigorated management team. This serves to reinforce our view that WES is a core portfolio holding.

**Link Group (LNK)** were buffeted by surprise changes announced in the May Budget release. The government released proposed changes relating to the treatment of inactive superannuation accounts from 1 July 2019, proposing that for member balances less than $6,000 and where there has been no contribution for 13 months, the account balance will be transferred to the Australian Taxation Office (ATO) and the account closed.

This would potentially have a significant adverse impact on the number of member accounts administered by LNK. The company was unable to quickly disclose the number of such accounts on its books and only a week later revealed that in its current form, with no offsets, the new legislation would cost LNK $55m in revenue.

Perhaps as disappointingly, along with its initial post budget announcement, LNK also revealed it had lost a contract for the provision of fund administration services worth 1% of group revenue – our concern arises from whether the company with a lot on its plate (delivery of not insignificant cost synergies promised on listing, integrating a large acquisition in the UK) may have taken its eye off the ball in its core business.

**Adelaide Brighton (ABC)** announced in May that CEO Martin Brydon would be retiring after over 30 years of service with the company. This comes on top of Les Hosking stepping down as Chairman after 15 years as a Director and seven years as Chairman. This is significant change for the company in terms of the loss of corporate memory, industry knowledge and commercial acumen. We regarded both Martin and Les very highly and little more is required to acknowledge their achievements than the fact that the share price has more than doubled over the last four years under their stewardship. We are confident in ABC's ability to manage these two key successions and continue to like their exposure to infrastructure spending.

During the quarter **Lifestyle Communities (LIC)** upgraded its expected settlement by 25 homes (or 9%) and said it continues to see strong demand for its product. This was pleasing given another listed peer had announced earlier that settlements would be impacted due to the more difficult housing market, effectively downgrading their guidance. There has also been M&A activity in the sector with GIC (and local JV partner Tasman Capital) acquiring National Lifestyle Villages in WA. In addition, Gateway Lifetsyle Group (GTY) has received takeover offers from both Brookfield and Hometown Australia. This suggests that interest in the residential land lease sector is increasing, which is still in its infancy when compared to offshore markets like the US. This is positive for LIC.

In June **IAG** announced it reached an agreement to sell its Asian operations in Thailand, Indonesia and Vietnam subject to regulatory approval. IAG will realise an after-tax profit of at least $200m and the sales are not expected to have a material impact on earnings. Importantly this increases IAG's regulatory capital position which provides value latency for potential capital management initiatives. IAG has remaining exposures in Asia to India, Malaysia and China which are still under review and may be sold at a later date. We think it is a positive that management is reducing exposure to Asia and increasing focus on its home markets. For the Pensions strategy we look for companies that operate in a tight circle of competency.

**Ramsay Health Care (RHC)** released an earnings downgrade due to challenging operating conditions in both Australia and the UK, as well as delays in the rollout of the Pharmacy franchise network. RHC now expects FY18 EPS growth of 7% compared to 8%-10% previously. High single digit growth would normally be perfectly acceptable except for the fact RHC trades on a premium multiple, in which case the stock gets marked down twice – once for earnings and then again on the multiple. Given the industry issues in Australia around private health insurance and affordability these trends are expected to continue into FY19. While RHC is facing some near-term headwinds our view remains that it is still a high quality, focused business with the right long-term strategy and therefore remains appropriate for the portfolio.

## Industry observations

In our experience New Zealand (NZ) produces a lot of high quality companies and management teams, and the NZ retirement sector is no exception. We have invested 'across the ditch' in the NZ retirement sector for many years and the portfolio currently holds Ryman Healthcare (RYM-NZ). We have had relatively little exposure to their listed peers in the Australian market despite them being exposed to the same demographic tailwinds. We thought it might be informative to outline some of the reasons why we have preferred the NZ listed operators to-date.

**Focus:** RYM only does one thing – build, own and operate integrated retirement villages. In Australia there are few dedicated listed operators with most being part of a larger diversified group (e.g. Lendlease, Stockland). We think the likelihood of success is better for companies that maintain a tight circle of competency.

**Owner-operator mindset:** The origins of many Australian retirement village operators are as property developers primarily focused on development profits compared to the owner-operator mentality in NZ. This is an important distinction for businesses that are long-term in nature and deal with residents (and their families) in the final years of their lives. It's hard to convey this nuance on paper but when you have been to as many retirement villages as we have, you know it when you see it.

**Continuum of care:** RYM operates integrated retirement villages which combine independent living and residential aged care at the same facility. This is referred to as offering a 'continuum of care' because residents can stay in the same village as their aged care needs change, allowing them to 'age-in-place'.

In our view continuum of care is critical to the customer value proposition as it drives the 'needs-based' nature of their business, that is, residents are moving in because they need aged care (or soon will) rather than as a lifestyle choice. We think this underpins demand for these villages and makes the business model more resilient in a downturn. By way of example, in FY18 NZ real estate volumes were down 14% but RYM resales volumes (i.e. existing units) were up 15%.

Importantly, the ability to provide 'continuum of care' impacts unit pricing, age of entry, turnover rates, elasticity of demand, resales values and waiting lists. All of which drive the economic engine of the business.

In contrast many Australian retirement village operators have a lifestyle focus and offer little to no aged care services. So when residents require aged care they typically have to leave their village and enter a residential aged care facility at another site. This is a complicated and stressful process at what is often a very emotive time for the resident and their family.

**Simplicity and certainty:** Resident contracts in Australia are complicated, legalistic and typically loaded with a litany of different types of fees. In comparison NZ resident contracts are simple with only 3 main charges for residents being entry price, the deferred management fee (DMF) and the weekly fee. Together with the continuum of care the simple NZ contract structure provides residents with certainty and security which really resonates with prospective residents.

**Greenfield development:** The key reason RYM and SUM have been able to grow their retirement village portfolios significantly over many years without the need to raise additional equity is because of their greenfield development capability. This allows them to efficiently recycle capital from a completed village into building the next one, and so on. This has a powerful compounding effect over time and doesn't expose them to the risk of overpaying for acquisitions and loading the balance sheet with 'core' debt, which turned out to be a significant issue for some operators during the GFC.

**Management and culture:** We think the management teams at RYM and SUM are best in class. Their owner-operator culture is reinforced by long-tenured management with deep industry expertise. As a case in point, RYM has only had 3 CEOs since the business started in 1984, and has a culture guided by the principle of '*It's got to be good enough for mum*'.

**Track record:** RYM has built a strong track record of operating performance and generated significant value for shareholders over the past 3 years, whereas their Australian counterparts have been poorer performers in both a relative and absolute sense.

The banking **Royal Commission (RC)** continued during the quarter with the main focus on financial advice, and loans to small and medium enterprises. There have been forests worth of paper written on the proceedings to date so we will not dwell on the issue other than to note likely impacts of the RC on the banking sector will include:

- Tighter lending criteria and thus potentially slower growth in lending volumes
- Higher risk aversion on the part of management and Boards in light of statements made by the RC and the Treasurer
- Higher regulatory and compliance cost.

We remain comfortable with our underweight position in the bank sector given the ongoing industry headwinds and the opportunity this gives us to invest in other stocks to add more diversification to the portfolio.

## Trip notes

During the quarter we visited the **Midwest of the USA** and **Canada**. It was a timely visit to the Midwest being an industrial heavy area in the middle of trade talks and concerns over an impending downturn. The tone from many executives was outwardly positive. We heard a number of times "It's only 18 months out of the industrial recession". Giving us further confidence is that the bad behaviour seen in previous cycles such as over ordering and paying anything for supply is not occurring. However there is also a natural caution with trade talks, a stronger USD and inflation rearing its head.

The gentrification of an old city like Milwaukee is a further example of the revitalisation of downtowns across the US. Milwaukee's population is down over the last 50 years. It was only over 10 years ago when we first started visiting the city that you wouldn't want to be walking the streets after dark. Today it's a very different scenario where the city is occupied with cafes, art stores and boutique clothes shops while restaurants and craft breweries dominate the nightlife. This is a powerful trend occurring across much of the US as the downtown is providing an attractive and affordable lifestyle for young and old. Reflecting on the gentrification of Milwaukee reminded us of the significant urban renewal opportunities that exist for another of our portfolio holdings, Lendlease.

For the international stocks in the portfolio we rely on the expert research of our Global Equities team. In June the team visited **Japan** for two weeks meeting around 35 corporates across Tokyo, Osaka and Kobe. The benefits of a focused repeat visitation program are really starting to be felt as the team have now met some of these companies 5 or 6 times over the last few years. The meetings are going beyond the 'get to know you' phase and drilling into the nitty gritty of execution across different parts of management's opportunity set. It is apparent that Japanese management will only take you seriously if you keep showing up consistently over many years, having been jaded by Western investors that dip in and out of Japan whenever it is in vogue.

Importantly for the Pensions Fund we have been able to leverage this research and in the September quarter last year we added our first Japanese stock to the portfolio, **Kao Corp**. This provides the portfolio with exposure to industries and economies not represented in the Australian or New Zealand markets and direct exposure to another foreign currency (the Japanese Yen) which is an additional diversification benefit.

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