CI PENSIONS FUND
QUARTERLY REPORT

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

SEPTEMBER 2014

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING MONTH	-2.17%	-5.19%	3.02%
ROLING 3 MONTH	0.63%	-0.09%	0.72%
ROLLING 6 MONTH	1.99%	1.10%	0.89%
SINCE INCEPTION^	2.96%	1.63%	1.33%

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

Portfolio and Market Returns

The CI Pensions Fund is an equities portfolio that could form part of an overall portfolio for people and funds that have converted to pension status. The purpose of the Fund is to provide an equities portfolio suitable for those seeking a more conservative exposure to equities than a portfolio that is designed for the accumulation stage of their investment life.

The returns of the portfolio are reported against the S & P/ ASX 200 Accumulation Index (adjusted to include franking credits), the portfolio will also aim to exhibit lower volatility than the market and to perform relatively well in down markets.

The portfolio returned 0.63% over the September quarter and 2.96% since inception, the market returned -0.09% and 1.63% over the same periods.

The September quarter was a particularly volatile period with the market rising 4.4% in July and then falling 5.4% in September. The heavyweight bank and resource sectors led the market declines in September. In addition to troubling global concerns the Australian bank sector was hit because of expectations the banks will need to raise further equity. The large resource companies fell as the iron ore price fell.

Over the quarter the best portfolio stocks were Caltex, TPG Telecom, Recall, CSL and Insurance Australia Group. Poorer performers included Oil Search, Equity Trustees, BHP and the banks.

The monthly performance of the portfolio and the market is set out below. The portfolio has performed better than the market in the two months where market returns have been negative and lagged the market when it has risen strongly.

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%	0.14%
Jun-14	-0.79%	-1.49%	0.70%
Jul-14	2.00%	4.40%	-2.40%
Aug-14	0.85%	0.94%	-0.09%
Sep-14	-2.17%	-5.19%	3.02%

Note: Before fees and expenses adjusted for franking credits

We have analysed the portfolio returns on a daily basis and so far the portfolio has out-performed on 85% of the days when the market has declined.

When analysing the volatility of the portfolio we have calculated the daily standard deviation of the portfolio and market returns since inception. To date the volatility of the portfolio has been around two thirds of the market volatility.

The Portfolio

The portfolio contains thirty seven securities and has a cash weighting of around 7%. Three new stocks were added to the portfolio over the quarter.

Carindale Property Trust's sole investment is a 50% interest in Westfield Carindale, a shopping centre in the South East of Brisbane. Carindale is the second most productive centre (measured by specialty sales per square metre) in the Westfield portfolio and the third largest centre in Australia in terms of sales after Chadstone and Bondi Junction. We purchased Carindale at a 14% discount to NTA and a yield of 5.5%. We expect steady but modest increases in income over the coming years. Carindale is one of the very few property trusts trading at a discount to NTA, this is surprising given it is very high quality, but probably explained by the lack of liquidity of the stock.

We included **Caltex** in the portfolio during July. The primary reason we bought Caltex is that the company is reducing its exposure to the volatile refining business and concentrating on its marketing business. The marketing business has a national infrastructure footprint that is impossible to replicate and it operates in a consolidated industry where margins have increased substantially. Once the Kurnell refinery is closed Caltex will be able to substantially reduce inventories, concentrate on a large efficiency program and lower its interest expense. As we have seen in the past couple of months, a less complex and more predictable business has been re-rated by the market. Caltex also has over $1bn of franking credits, clearly Caltex will be working out how it will be able to distribute these (until now) trapped franking credits to shareholders. At a minimum we expect the dividend to increase substantially over the next two years.

We participated in the initial public offering of **Regis Healthcare**. Regis is the third largest residential aged care operator in Australia with 45 centres spread across Australia. We believe Regis has a high quality portfolio with strong operational capabilities and that it should be able to continue to develop its portfolio through brownfield and greenfield opportunities. While Regis is a large scale operator it still only has a 2.5% share of the residential aged care sector, providing it with a significant opportunity to grow market share in a growing market. The business had no debt on listing and it should be able to generate reasonable fully franked dividends.

One of our rules is that we will invest in businesses that have a long and solid track record. Normally we would be reluctant to invest in initial public offerings because they often do not have a long track record. The Regis track record dates back to 1993 when it commenced with 60 places, this has grown steadily to 4719 places today. The original founders are still heavily involved with the company and retain large shareholdings. The current Chief Executive was appointed in 2008 and we believe that the company is run very efficiently with good management systems. We concluded that Regis does have an observable track record and therefore the fact it is a new listing should not stop us investing.

We sold **Ozforex** during the quarter. On reflection we concluded that the company, whilst having great potential, did not actually have a sufficient track record to be included in a conservative portfolio. This is a good example of a stock that would be more suitable for a portfolio designed for people in the earlier stage of their investment lifecycle but not so suitable for a pension portfolio. Put another way, the range of future outcomes for Ozforex is very wide and this does not fit one of our objectives of low volatility.

Two hybrid securities matured and were repaid in September.

The portfolio owned **Australand** preference shares. When Australand was purchased by Fraser Centrepoint it immediately announced it would redeem the preference shares and this occurred on 12 September. The return from this security was over 4.7% in six months and, as it was a very low risk position, this was a very strong result.

Transpacific repaid their step up preference shares on 30 September. The return on these securities was around 4% over the seven month holding period. This was much higher than the return from holding cash and, as it turned out, was also higher than the market's return over the period. The return included the franking from the two dividends received.

Opportunities in the hybrid market are re-emerging at the present time because yields to maturity of these securities have been rising. Good quality hybrids do offer higher yields than cash and generally exhibit very low volatility, thus providing the portfolio with a shock absorber in down markets.

The international stocks are about six percent of the portfolio, even with this modest weighting they assisted the portfolio return as they appreciated by around 7% in September against the Australian market that fell by 5.4% over the same period. The prices of the US stocks did not change much, however the A$ fell by nearly 7% in September and lifted their price in A$. The fact the international group helped the portfolio in a strongly down market is pleasing because one of the reasons for including international stocks is the diversification they provide to an Australian equities portfolio.

Stock News

Full year results were announced by most of the stocks in the portfolio in August. We felt the best results were produced by **CSL** and **TPG** and generally speaking there were no shocks to portfolio stocks. As usual there was plenty of news flow over the quarter.

Telstra announced a buy-back of $1bn of stock and this occurred during early October. The buy-back was structured in a way that included roughly half the buy-back price being a fully franked dividend and the remainder capital. Because the Pension Fund assumes a zero tax rate and also receives franking credits, the structure of the buy-back was beneficial. The scale back of shares tendered into the buy-back was 70% so the benefit was not as large as hoped however the after tax benefit of the shares sold back to Telstra was around 4%.

The **Financial System Inquiry** released its interim report in July and it certainly had plenty of observations that may affect the major Australian banks. The main points raised in the interim report and in subsequent briefings are that Australian banks' capital ratios are only around the middle of the range of international banks, that the current risk weighting methodology favours lending to housing rather than small business and that the banks' concentrated exposure to mortgages has become a significant source of systemic risk. Subsequently the RBA and APRA have raised questions around the level of capital held by banks and around the modelling behind the major banks' risk weighting methodology.

Bank regulatory capital is a complex issue and no one has a strong feel for where the minimum capital ratio will end up, what the impact of changes to the risk weighting methodology will be, or how long banks will have to meet higher requirements. We believe that it is likely that banks will have to raise a lot of extra capital and that will reduce their return on equity and lower the growth in earnings per share and dividends per share. Three of the major banks report full year results at the end of October and capital ratios will be the most important topic at the results briefings.

The banks do have options to mitigate the effects of higher capital requirements, these include trying to increase their net interest margins, lowering lending growth, cutting costs further and divesting businesses. The bank with the most options is **NAB** and the most challenged will probably be **CBA** and **WBC**.

BHP announced plans to create an independent metals and mining company based on a selection of its aluminium, coal, manganese, nickel and silver assets. This company will be demerged from BHP and listed on the ASX. This action along with others signals a significant change in philosophy at BHP, i.e. to make simplicity a key objective. BHP believes that simplification and focus lead to better outcomes. Following the demerger BHP will have a much reduced suite of assets and it can concentrate on its large, world class iron ore, copper, coal and petroleum assets and possibly increase exposure to potash. BHP has committed to a progressive dividend policy, a limit on capital expenditure and a solid A credit rating. It will now shift focus to costs and margin and away from volume and capital expenditure. As most commodity prices have fallen towards costs of production for many producers, we should have more confidence that in the medium term prices will not slip too much further. This new set of circumstances mean that BHP is a more attractive and stable investment proposition.

The price of **Recall** rose sharply based on media speculation that Iron Mountain (the big US document storage company) is considering making a bid to buy Recall, although Recall has said that it has not had discussions with Iron Mountain. Analysts have estimated that Iron Mountain could pay well above the current Recall price and still make a deal stack up, so in a way the speculation has focussed the market's attention on the quality of the Recall business.

GPT has created a new listed property REIT, the Metropolitan Office Fund. Whilst not a big REIT at the moment, it is a further step towards GPT's target to manage $10bn of property funds for external investors.

Our key takeaway from the **Lifestyle Communities'** FY14 result was that the business model has been confirmed by the success of the Chelsea Heights and Hastings communities. Net profit, operating cash flow and net sales commitments highlighted improving operating trends. The balance sheet is in good shape with gearing (ND / D +E) of 23% and interest cover of 5.4 times.

We are attracted to the future annuity cash flow streams the business will produce, primarily from rental income which is predictable, low risk and inflation hedged. Lifestyle Communities only operates in five out of 10 core growth corridors in Victoria and, with the potential for two to four villages in each corridor, we think the opportunity set in front of the company is promising.

Summerset (and the New Zealand retirement sector) has had a poor period of share price performance with concerns about the weak NZ$, housing prices, oversupply and a number of listings coming to the market in both New Zealand and Australia. Recent visits to New Zealand did not provide any evidence of oversupply, indeed the companies and sales representative we talked to confirmed strong presales and for some villages' development had been brought forward to meet client demand.

Summerset has been impacted by increasing costs as it scales up its business for the next phase of growth. The cost burden arises from choosing to bring forward the building of the communal and aged care facilities in the development process, as well as start-up costs associated with new care facilities that typically take 12-18 months to reach full occupancy. This appears consistent with management's strategy to create a scalable platform before demand accelerates over the next few years as we are hit by the grey tsunami.

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