CI PENSIONS FUND
QUARTERLY REPORT

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

SEPTEMBER 2015

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	-0.50%	-6.03%	5.53%
ROLLING 6 MONTH	-5.36%	-11.96%	6.60%
ROLLING 1 YEAR	12.15%	0.90%	11.25%
SINCE INCEPTION*	9.54%	1.60%	7.94%
SINCE INCEPTION^	15.47%	2.54%	12.93%

*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 and foundations 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

Fear dominated global equity markets this quarter, as concerns over the slumping Chinese market and its implications for a slowdown in global economic growth triggered the largest increase in volatility we have seen since the global financial crisis.

The Australian equity market fell by 6.6% over the quarter which was roughly in line with other developed equity markets (in their local currencies). Over the year the Australian market was down by just under 1% which was worse than other developed equity markets.

In Australia cash rates were unchanged, however bond yields fell again. The Australian dollar continued its slide, this quarter it fell 9% versus the USD and the Euro, 5% against the Pound and 10% against the Yen. Again the banking and resource sectors led the falls in the Australian market.

The portfolio returned -0.50% over the quarter and 12.15% over the year whilst the benchmark returned -6.03% and 0.90% respectively. Since the portfolio’s inception date of 3 March 2014 the portfolio return has been 9.54% compared with the benchmark return of 1.60%.

Despite the weak market, around half the stocks in the portfolio rose over the quarter. Sydney Airport, Lifestyle Communities, TPG Telecom and Equity Trustees all rose by more than 10%. All the major banks and BHP fell by 10% or more.

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The quarterly performance of the portfolio and the market is set out below.

Quarter Ended	CI Pensions Funds	ASX 200 Accum	Relative Performance
Mar-14	0.96%	0.52%	0.44%
Jun-14	1.35%	1.19%	0.16%
Sep-14	0.63%	-0.09%	0.72%
Dec-14	7.33%	3.40%	3.93%
Mar-15	10.41%	10.83%	-0.42%
Jun-15	-4.88%	-6.31%	1.43%
Sep-15	-0.50%	-6.03%	5.53%

Note: Before fees and expenses and adjusted for franking credits

The portfolio has continued to perform better than the market on down days and has done better than the market on around 89% of down days. The portfolio's volatility continues to run at around 71% of the market's volatility as measured on a daily basis.

Since our Pensions strategy commenced on 3 March 2014 the market has been up on 53% of days and down on 47% of days. On the days where the portfolio has risen, the portfolio has "captured" 72.3% of this upside. On the days when the market has fallen, on average, the portfolio has captured 63.4% of the downside. The sum of these two occurrences is that the portfolio has outperformed the market since inception and has been much less volatile than the market.

The Portfolio

We added **Federation Centres** to the portfolio in August. Federation Centres owns a large portfolio of Australian shopping centres and was formed through the merger of Novion Property Group and Federation Centres earlier this year. At the time of the merger the CEO of Federation Centres was appointed CEO of the merged group. In August he was replaced by the former CEO of Novion Group. The share price of Federation Centres fell sharply on this news, probably because this was a surprise, rather than because there were any serious problems with the combined portfolio of shopping centres. We purchased Federation following the weakness in the share price.

In August Origin sold its controlling stake in **Contact Energy** through an institutional book build at a steep discount to the prevailing share price. We participated in the book-build for Contact at the clearing price of NZ$4.65, and subsequently sold the position at a gain of around 10%.

Within the international portion of the portfolio we sold **Twenty-First Century Fox** shares in August and added **Reckitt Benckiser** to the portfolio in September. Reckitt is a large British company that sells a small stable of high quality health and home consumer goods such as Nurofen, Strepsils, Finish and Dettol. Reckitt is a stalwart type company with options to grow and a first class track record.

Stock News

In July **Energy Developments** (ENE) announced that it had agreed to be taken over by Duet Group (DUE) for $8.00 per share. This is an attractive price for ENE and it appears that the proposal will pass all the conditions precedent and payment of $8.00 should be received in mid-October. ENE has been held in the portfolio since inception.

Woodside Petroleum (WPL) approached **Oil Search** (OSH) with a proposed takeover offer. The approach was a non-binding indicative proposal that offered 1 WPL share for every 4 OSH shares, effectively valuing OSH at around $11.6 billion or just over $7.60 a share. Prior to the approach OSH was trading at $6.73.

WPL's approach was rejected by the Board of OSH, with the Board concluding that the approach by WPL was "opportunistic and grossly undervalues the Company". OSH has two globally competitive LNG projects in front of it; the train 3 expansion of PNG LNG and the development of the Elk/Antelope fields. These projects have the ability to add significant value to OSH shareholders over the next 5-6 years. WPL on the other hand has limited viable growth projects at current oil prices. Although we do see some strategic merit in the combination of WPL and OSH, as with any stock based transaction it needs to take into account the relative value of both OSH and WPL's asset bases. It remains to be seen if WPL come back with an offer at a level that more fully reflects the value of OSH's assets.

In December 2014 Iron Mountain (IRM.US) proposed to acquire REC in a bid valuing REC at the time at A$7.00 per share (comprised of A$5.73 in IRM shares and A$1.27 cash). This was rejected by the REC board. In June 2015 a revised bid comprising 0.1722 IRM shares and US$0.50 per share cash (currently valuing REC at A$8.31) was agreed to by both boards, subject to shareholder and regulatory approval. Combining the IRM and REC businesses represents an excellent value creating opportunity for both sets of shareholders.

The IRM bid at current prices is worth A$8.31 to **Recall** shareholders. We believe the bid will fail because the current offer does not represent our view of fair value of A$11.32 to A$12.24 per Recall share.

Recall as a stand-alone entity has an excellent asset network, management team and operating initiatives underway which present a clear roadmap to delivering long term value. We continue to believe in the underlying recurring nature of the document storage business which is complemented by current management's track record in generating solid synergies as it acquires assets across the globe. Therefore, we view the current offer price as far too low as it doesn't fairly share the synergy benefits. Given the existing services and cost challenges within IRM we believe there is better optionality in remaining with the REC stand-alone entity.

The banks continued to increase their equity capital bases with both **ANZ and CBA** raising further equity during the quarter.

ANZ raised $2.5bn at a price of $30.95 in a share placement to institutions in August and a further $0.720bn in a share purchase plan for retail shareholders at a price of $26.50. The portfolio did not participate in the ANZ capital raising.

In conjunction with its 2015 results CBA raised approximately $5.1bn through a 1:23 rights issue at a price of $71.50. The portfolio did take up its rights in the CBA issue.

It is expected that **Westpac** will raise further capital when it releases its full year results in November.

These capital raisings increase the bank's common equity Tier 1 ratios however we expect the banks will have to continue to raise further equity over the next year or two as more stringent capital requirements are placed on banks around the world. There has been a lot of discussion on whether the banks' payout ratios and current dividends are sustainable. Clearly there are many factors that banks will have to consider regarding dividends, our view is banks may be able to hold their dividends at current levels but it will be very unlikely they can grow at rates we have seen in the past.

In the August profit announcement **Caltex** management made their desire to grow the business clear. Although we encourage companies to invest where they see value adding opportunities within their core capabilities, we would be concerned to see CTX utilising its strong balance sheet to invest outside of their core transport fuel related competencies, an area where we continue to see ample opportunity for growth.

CTX is currently sitting on just over $1 billion of franking credits. We are pleased by management's comments regarding the preferred form of returning additional capital to shareholders via an off-market buyback, as this is an effective mechanism to get these franking credits into the hands of shareholders. However we would add that there is no value for CTX shareholders in these franking credits remaining on CTX's balance sheet and we strongly encourage CTX's board and management to move to return these to shareholders in a timely manner.

Portfolio Strategy

The portfolio objectives are to provide a more conservative equity exposure that performs better than the Australian equity market in down markets and is less volatile than the Australian equity market.

The key planks of the strategy are that:

- The portfolio is more diversified than the Australian equity market benchmark, and
- individual stocks selected have on average less downside than the market under stress

Diversification in our view involves spreading investments across industries, countries, currencies, and company size and characteristics.

The Australian equity market is not well diversified with the four major banks making up around 30% of the total market capitalisation and when we add in BHP, RIO and Telstra these seven biggest stocks make up 40% of the total market capitalisation. This concentration contrasts with the US S&P 500 Index where the seven largest companies make up 13.5% of the total market capitalisation. The seven largest stocks in the S&P 500 operate in different industries whereas four of the largest stocks in Australia are banks.

The portfolio has a relatively low exposure to banks and is below index weight in BHP and Telstra, this frees the portfolio to have higher exposures to industries not represented by these six largest stocks.

The ability to invest in international stocks provides opportunities to diversify further into industries that are not represented in the Australian market and also to gain some limited foreign currency exposure that is a further diversifier. At present around 7.5% of the portfolio is invested in international stocks (not including NZ which is a further 5% of the portfolio) that operate in industries that are not represented in a meaningful way in the Australian market.

The international stocks add direct foreign currency exposure to the portfolio, this exposure is in addition to foreign currency exposure that is inherent in some Australian listed stocks such as CSL and Brambles. Of course currency exposure can work for and against a portfolio's return however as it seems that the A$ tends to be weak when the Australian market is under pressure, limited currency exposure often also works to smooth returns.

We aim to have a good representation of non-leader stocks in the portfolio as correlations amongst the largest stocks in the Australian market are much higher than correlations amongst non-leader stocks. Lower correlations between stocks means more diversification which should mean a less volatile portfolio. Correlations are especially important in down markets. Under stress, correlations increase, this could be taken to mean that on bad days all stocks fall by a similar amount. We have established in poor markets that correlations are much higher amongst the largest stocks than mid and smaller stocks so the inclusion of non-leader stocks has helped the portfolio outperform in poor markets and has lowered the portfolio's volatility.

Stock characteristics can be assessed in a multitude of ways; what we are aiming for is to make sure that no one factor can have an unexpectedly large impact on the portfolio. These factors could include exposure to interest rates, gearing, yields, commodity prices, inflation and a myriad of other things. Whilst risk systems can provide some help in assessing whether a portfolio is over-exposed to any characteristic their main weakness is the use of historical data to extrapolate into the future. We rely heavily on our experiences and intuition in assessing risk.

As far as individual stocks are concerned we have a set of guidelines that help us decide on which stocks should and should not be included in the portfolio.

These guidelines include assessments of aspects such as gearing, track record, sustainability, ability to grow, focus and valuation. By sticking to our guidelines we have avoided many companies that have suffered from problems such as over-gearing, paying unsustainably high dividends and poor track records.

The portfolio can also hold up to 20% in cash and can invest in listed fixed interest/ hybrid securities. The cash holding of 5-7% has provided some protection in weak markets, as have the three listed fixed interest/ hybrid securities we own.