# CI PENSIONS FUND
# QUARTERLY COMMENTARY REPORT

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

## SEPTEMBER 2016

| | **PORTFOLIO | #BENCHMARK | VALUE ADDED |
|---|---|---|---|
| ROLLING 3 MONTH | 2.16% | 5.59% | -3.43% |
| ROLLING 1 YEAR | 12.13% | 14.84% | -2.71% |
| ROLLING 2 YEAR | 12.13% | 7.64% | 4.49% |
| SINCE INCEPTION* | 10.52% | 6.53% | 3.99% |
| SINCE INCEPTION^ | 29.48% | 17.76% | 11.72% |

*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) rose by 5.59% over the September quarter and 14.84% for the year. The portfolio rose by 2.16% for the quarter and 12.13% for the year.

The dispersion of individual stock returns was extreme over the quarter. Some of the dispersion was due to individual stock news but the majority was due to a movement away from defensive stocks and into more cyclical stocks. Strong performers included BHP, RIO, Macquarie Group, Summerset, Wesfarmers and Ramsay Healthcare. The poorer performers included all real estate stocks, Regis, Transurban and TPG.

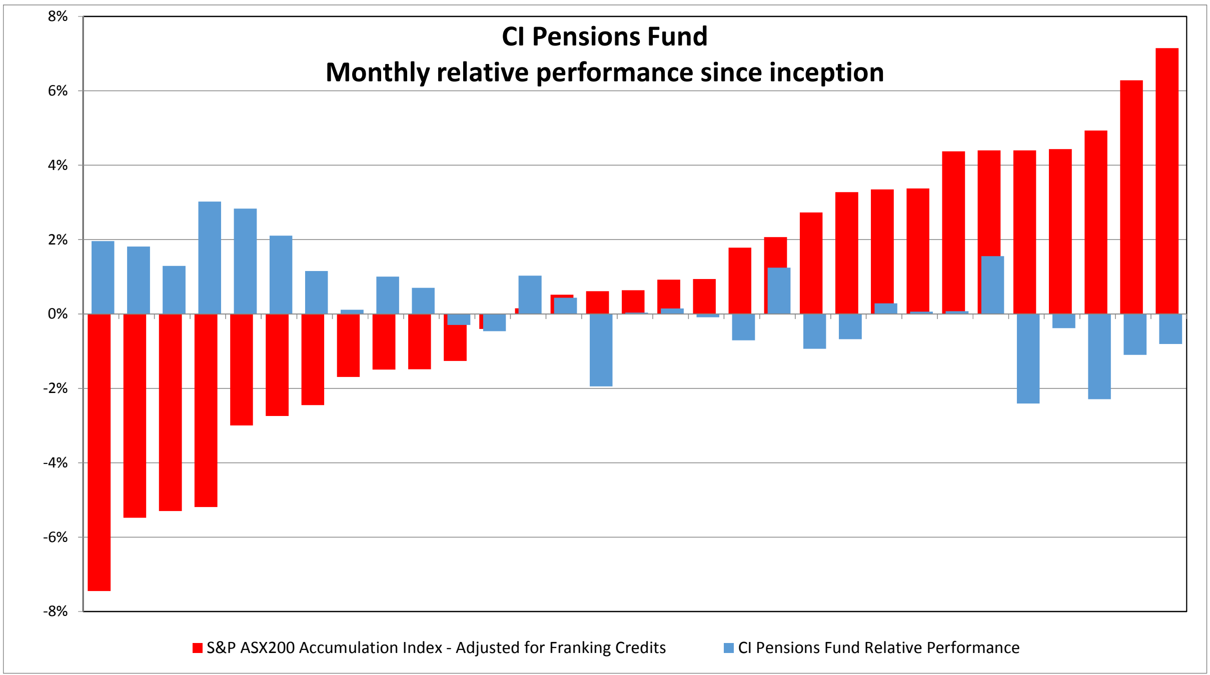
The international stocks detracted from return due to some individual stock news and the A$ which rose over the quarter.

The portfolio has a higher weighting to property and infrastructure stocks and less weighting to resource and cyclical stocks than the ASX 200 index, this was the major reason the return lagged the benchmark for the quarter.

The volatility of the portfolio over the quarter was around 69% of the volatility of the market, this is consistent with the portfolio volatility since inception.

During August the market return was negative and the portfolio marginally underperformed, since inception the market has shown a negative monthly return 13 times and the portfolio has performed better than the market in 11 of these 13 months.

The chart below shows the portfolio's monthly relative returns. The red bars show each month's market return sorted from worst to best month and the blue bars show the portfolio's return relative to the market for each month.




## The Portfolio

We added **Adelaide Brighton (ABC)** to the portfolio. ABC provides a high quality exposure to the building materials sector which will help to further diversify the portfolio. We think there are good prospect for earnings growth given the construction materials industry appears likely to increase prices and South Australia is recovering, which is ABC's most profitable market. ABC has a solid management team with a track record of being good custodians of capital as evidenced by a return on funds employed of almost 20%, which is much higher than peers. A strong balance sheet and reliable cash generation support ongoing capital management in the absence of acquisitions or significant growth capex. In the mean time we receive a 4% dividend yield (fully franked) that should continue to grow.

We participated in the **Viva Energy REIT IPO**. The stock has very simple and secure cash flows underpinned by a 15.3 year weighted average lease expiry, fixed 3% per annum rental increases, a triple net lease structure, and internalised management. The property portfolio has been established over a period of more than 100 years and would be very hard to replicate given the scale and strategic locations of properties. Viva Energy has an acquisition pipeline of 100 sites over the next five years, some of which may be added to the property portfolio and therefore increase the distribution profile. We think the Viva Energy REIT can deliver a 10% p.a. total return comprising a 6% dividend yield and 4% earnings growth.

We sold our holding in **CBA**. One of our objectives is to have a diversified portfolio where ideally stocks are not highly correlated to each other which reduces volatility. Holding the four major Australian banks, which are highly correlated, therefore seems inconsistent with this objective. CBA trades on a significant premium to the other Australian banks yet faces the same trends and as such we find it hard to justify the current valuation premium.

At the end of the quarter the portfolio held 39 securities. 8.5% of the portfolio is held in five US and European stocks and the cash weighting was 8%.

## Stock News

There were two pieces of negative stock specific news during the quarter.

**TPG Telecom** reported a full year profit slightly above expectations however they also forecast much weaker than expected 2017 profit guidance driven mainly by expected margin pressure as customers migrate to the NBN for broadband. When broadband customers are moved onto the NBN the charge to TPG and other internet providers increases a lot and in a competitive market it is unlikely that prices can rise to compensate for increased costs. As the share price fell by nearly 30% clearly we and the market had not anticipated correctly the magnitude of the NBN migration on margins.

**Bunnings Warehouse Property Trust (BWP)** was informed by Bunnings Group that it intends to vacate up to seven of BWP's properties to move into ex Masters sites, subject to negotiations with the landlords. Bunnings is required to pay rent until lease expiry and BWP has time to find alternate tenants which means that there is little near term impact on income. These vacancies do create some challenges for the BWP management. This stock specific news resulted in BWP being the worst performer amongst the property and infrastructure stocks in the portfolio.

**Telstra** and **IAG** announced off-market buybacks during the quarter which were finalised in early October. The buy backs provide a high level of franking credits which are particularly attractive for pensioners, charities and foundations that have a zero tax rate. The portfolio participated in both these buy backs.

## Portfolio Positioning

The portfolio is designed to be a conservative, lower risk equity portfolio.

The intended outcomes are that the portfolio should deliver a reasonable return compared to the overall market (the ASX 200 Index) but with lower than market volatility and better than market returns in down markets.

We aim to meet the risk and return objectives through a combination of both higher than market diversification and stock selection guidelines that try to screen out higher risk companies.

In July there was an inflection point where the focus turned very strongly to the prospect of higher cash rates in the US and the actuality of bond yields increasing. This macro shift has proven to be challenging for the relative performance of the portfolio whilst the volatility has been largely unchanged. As the market has been strong in this period there has not been a test of the portfolio's resilience in a severe down market.

Quantitative analysts break the markets into many subsets such as risk, quality, value and growth. This analysis estimates how the different subsets have performed over different periods.

During the September quarter stocks that fell into the risk category (typified by high variability of earnings and high beta) performed very well whilst stocks that fell into the quality category (typified by higher return on equity) performed adequately but below market.

Stocks that are highly correlated to bond yields had a very poor quarter. These type of stocks normally have predictable cash flows that should not be volatile. Higher bond yields flow into higher discount rates that when applied to a set of predictable cash flows leads to a lower price.

We are at multi century low interest rates in many countries and many sovereign bond yields are negative. We also have some acknowledgement that the dropping of interest rates in the past year or two has not had the desired economic effects. There is a possibility we are at a major inflection point for markets.

Given the uncertainties we face our response is to try to increase further the diversification of the portfolio.

As part of our investment process we will continue investigating new opportunities with the objective of finding quality companies that over the long term should increase earnings and dividends and therefore their share price. While we don’t want turnover to be too high, new ideas should help to further diversify the portfolio and ensure we don’t get stuck with ‘yesterday’s portfolio’. This will also help us to retest the investment propositions of our stocks to make sure we don’t have any major fault lines that get exposed under stress.

One thing we will not knowingly do is decrease the quality of the stocks in the portfolio in response to a change in macro conditions. We do note that nothing is stationary in the investment world and that includes an assessment of quality. Our view on quality goes well beyond quantitative factors and places great emphasis on quality of management and Board, quality of assets and quality of balance sheets.