CI PENSIONS FUND
QUARTERLY COMMENTARY REPORT

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

SEPTEMBER 2017

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	1.45%	1.17%	0.28%
ROLLING 1 YEAR	6.97%	10.84%	-3.87%
ROLLING 2 YEAR	9.51%	12.81%	-3.30%
ROLLING 3 YEAR	10.39%	8.70%	1.69%
SINCE INCEPTION*	9.52%	7.72%	1.80%
SINCE INCEPTION^	38.50%	30.52%	7.98%

*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) was up moderately in the September quarter 1.17%, with ongoing uncertainty in macroeconomic trends and a mixed set of results in the August reporting season. The pensions portfolio returned 1.45% for the quarter.

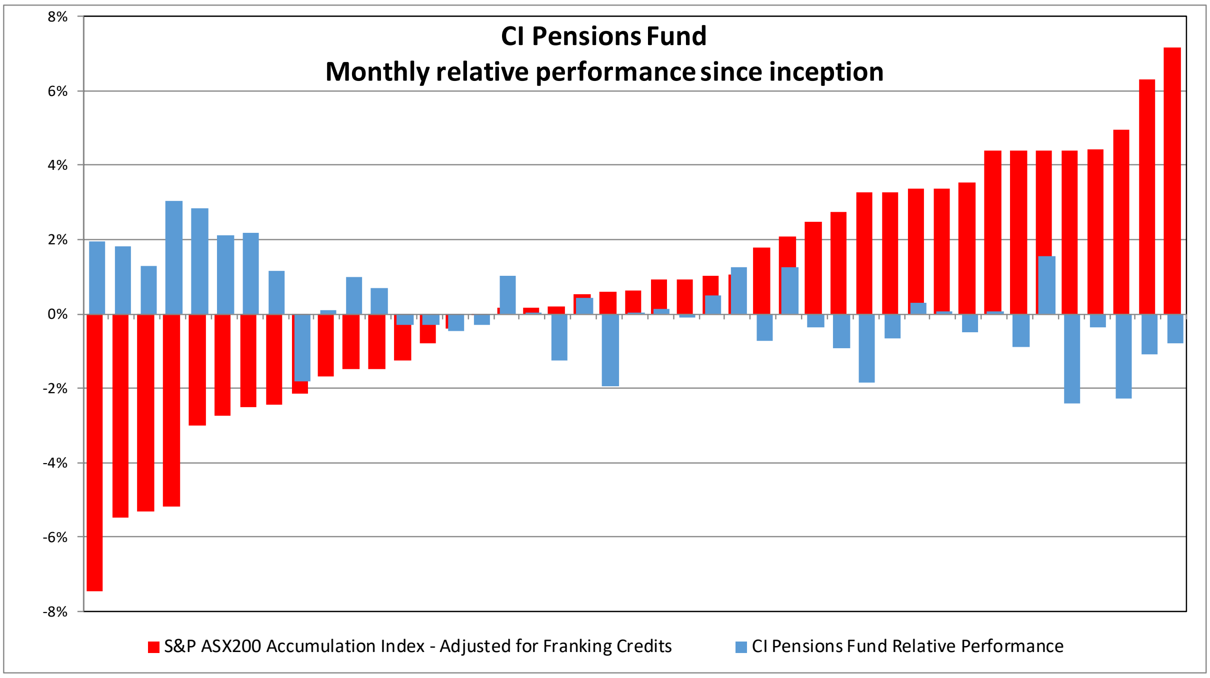
There are various signals that are broadly supportive of equity markets. In particular, growth appears to be returning to both US and European markets and with early signs of inflation, central banks have taken the first steps to normalising the extremely supportive policies (lower interest rates and quantitative easing) that were put in place following the GFC.

On the other hand, from its absolute low point, the recovery in stock markets since the GFC, our last major correction, has been very strong. The S&P500 has increased 310% (15% CAGR) and the ASX200 150% (10% CAGR). At the same time, market volatility (a measure of investor's risk appetite) remains at near record lows.

Stocks that performed well over the quarter included **Alumina**, **Ryman Healthcare** and **Oil Search**, poorer performing stocks included **Telstra**, **Auckland International Airport**, and **Ramsay Healthcare**. The international stocks in the portfolio also made a positive contribution with **Brinks** and **Novo Nordisk** being particularly strong. The contribution to portfolio returns and diversification from international stocks is discussed in more detail below.

The volatility of the portfolio over the quarter was around 75% 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 negative monthly return 16 times and the portfolio has performed better than the market 11 times. When assessed using monthly data the portfolio has captured 65.4% of the market's downside and 86.9% of the market's upside.

The Portfolio

The portfolio initiated a position in **Mainfreight (MFT)** which we consider to be another example of a high quality New Zealand company. It has a lot of the attributes we are looking for including a terrific track record, strong management and culture, as well as a significant global growth opportunity.

MFT operates in the freight (LCL, or less than container load), logistics / warehousing and freight forwarding (air, sea) markets globally. It has a particularly dominant share in NZ where it earns high margins, with a growing presence in Australia, Europe and the US.

MFT is a culture led firm, focused on delivering a high quality service to the most profitable customer segments. It maintains a "shop-floor up" approach of having the right people deliver the right service to the right customer. Over time we expect MFT's global growth will help reinforce its position via increased network density, scale and better rates.

We also bought **Kao Corp** which is a Japanese manufacturer of personal hygiene, health and beauty products. It has market leadership in Japan for laundry detergents and baby diapers, and has a strong track record of generating innovation from its vertically integrated chemicals and R&D divisions.

Japanese products are renowned for their quality particularly inside Asia, and in recent years we have seen the benefit of Japanese consumer companies selling their products to aspirational Chinese (among other) consumers. Key to this success has been marketing and distribution, companies like Unicharm, Shiseido and Kose have all seen step-ups in sales and margins from getting these things right.

We think Kao is now poised to join the party, having achieved great success with its premium diaper brand *Merries* which has grown to take the leading position in China. Management are using the lessons learned from this as a beachhead to launch many of their other great products across the region.

As the top line grows, realising margin expansion in the Asian channel from mid-single digits to high teens over the next 5+ years is a key latency for this business.

Culturally Kao exhibits many of the management characteristics we would hope to find in a Western Stalwart, including humility and accountability, long term management tenure and strong capital allocation. Kao have increased their dividend for 27 consecutive years which is almost unheard of in Japan. While they run a net cash balance they're not hoarding cash like many Japanese corporates have a tendency to do, since management are incentivized by return on capital.

During the quarter we sold out of **Auckland International Airport**. We regard this as one of the highest quality assets in the market however recent company announcements have confirmed the significant capex program required over the next decade to support future growth. This will significantly impact free cash flow and put pressure on the balance sheet given capex is typically 100% debt funded. We also think portfolio diversification will be improved by only having exposure to one airport stock, being Sydney Airport.

The portfolio currently owns 39 securities including four US, two European and one Japanese stock that make up 14% of the portfolio. The cash weighting is around 6%.

Stock News

The **Australian Banks** have remained in the headlines this quarter primarily due to the Austrac issues relating to CBA. It appears conduct risk is an increasing problem for the sector in addition to some of the industry headwinds we have discussed previously. Banks remain powerful franchises supported by a positive industry structure however there are two main reasons the portfolio is underweight the sector.

Firstly, macroeconomic headwinds and highly leveraged households mean that loan growth and the general outlook for the banks is not as positive as the last 20 years. Secondly, the four major banks represent around 30% of the Australian stock market and their stock prices are all highly correlated to one another. This increases volatility and is therefore inconsistent with one of our core objectives of having a diversified portfolio.

In September **Sydney Airport** announced the appointment of Geoff Culbert as CEO and he is expected to commence the position before the end of January 2018. Geoff was most recently CEO & President of GE Australia, New Zealand and Papua New Guinea. Sydney Airport has had a great period under the stewardship of Kerrie Mather who has been an exemplary CEO.

In August **Qube Holdings (QUB)** announced that it had secured from Target Australia an initial 10 year lease for a new warehouse at Moorebank. In addition, Target Australia has agreed a new 5 year (plus options) logistics contract with QUB covering freight transport by rail from Port Botany to Moorebank. While it is still very early days we view this is an encouraging endorsement of the Moorebank project, and therefore the long-term investment proposition for QUB.

Rio Tinto (RIO) unveiled a US$2.5 billion share buyback to return the proceeds of the sale of Coal & Allied to shareholders, which will bring total share buybacks announced in 2017 to US$4 billion. RIO has allocated A$700 million (US$560 million) of the US$2.5 billion to an off-market buyback, with the balance of around US$1.9 billion being allocated to RIO's existing on-market purchases of plc shares. The split between on-market and off-market reflects the register composition (22% Ltd, 78% plc).

The proposed merger between **Tatts Group (TTS)** and **Tabcorp (TAH)** has hit a potential regulatory roadblock with the Federal Court upholding the ACCC's appeal against the Australian Competition Tribunal's (ACT) approval of the merger, which is to be referred back to the ACT for further consideration. While we think the merger will still proceed the timeframe is likely to be extended, perhaps significantly, and there is increased risk that the merger is blocked upon the ACT rehearing the proposal. Interestingly, while TTS remains committed to the TAH merger process, TAH's implied offer for TTS is at a small discount to both the TTS spot share price and the Pacific Consortium's last all-cash bid of $4.21.

International stocks

A key way we aim to achieve the objectives of delivering strong relative performance in down markets and lower volatility is to incorporate international stocks in the portfolio.

The portfolio guidelines allow up to 20% of the portfolio to be invested in stocks listed in markets outside Australia and New Zealand.

The proposition is that international stocks add to diversification of the portfolio by providing exposure to industries and economies that are not represented in the Australian and New Zealand listed equity markets. International stocks also give the portfolio direct exposure to foreign currencies that also provide a diversification benefit.

The portfolio currently owns seven international stocks, four are listed in the US, and the others are listed in Denmark, Germany and Japan. The portfolio weighting in these international stocks is around 14%.

The international stocks that are included in the pension portfolios are selected from stocks held in Cooper Investors global and Asian portfolios. The pensions fund team works closely with the global and Asian portfolio managers including travelling overseas to visit stocks that may be suitable for the pensions portfolio.

Industries that are represented in the international section of the portfolio include on-line travel, global consumer staple brands, diabetes treatments, healthcare, warehouse club retailing and cash handling and security. The Australian market provides virtually no listed exposure to these industries.

The majority of these stocks have net cash balance sheets which we would expect to result in a degree of resilience in down markets.

All but one of the stocks have solid dividend histories with expectations of growing dividends in the future. Priceline does not pay a dividend however 2017 will be the eighth year in a row of buying back shares. The US tax system leads many companies in the US to conduct buy backs rather or in addition to paying dividends. This feature is particularly evident in the technology focussed companies in the US.

The portfolio gives up some yield by including international stocks as yields in international markets are generally lower than the yield on the Australian market, however we feel that the diversification benefits, quality uplift and higher expected earnings growth more than compensates for the lower yield.

The pensions strategy has been running for around three and a half years and based on our practical experiences to date there is a reasonably low correlation of returns between the Australian market returns and the international markets returns. This low correlation of returns supports our proposition that adding an international component to the portfolio increases portfolio diversification, which lowers total portfolio volatility and increases the probability that the portfolio will perform relatively well if the Australian market suffers a downturn.

The inclusion of international stocks has also increased the portfolio returns compared to a portfolio solely invested in Australian and New Zealand stocks. As an aside the New Zealand exposures have also benefited the portfolio’s returns and volatility.

As far as how we are seeing the prospects for international equities markets, we have included some comments from our international teams following their travels over the past year.

Global equities markets have continued their remarkable run with seemingly nothing able to halt what has become a slow but inexorable grind higher, this is despite the apparent threat of nuclear war on the Korean Peninsula, Russian interference in US politics and increasing fractious headlines out of Europe.

From our meetings with companies a general observation is that management teams seem relatively bullish about business prospects, are investing and doing deals and believe they can continue to grow earnings. With the exception of Brexit most of the big political uncertainties and now out of the way and an environment of easy (albeit very slowly tightening) monetary policy and low taxes is still supportive for corporate profits.

The takeaways from Europe are that the backdrop feels probably the most benign it has since the GFC in terms of broad based steady growth. No countries or sectors are "shooting the lights out" yet most are growing. Unemployment rates are at close to record lows across most of Northern Europe and are finally improving in the South.

There continues to be a vibrancy to the US economy. We are seeing more cranes and large towers being built and plenty of home construction and renovations, this started in New York and San Francisco and has now spread into many other areas such as Philadelphia and Los Angeles.

We are encouraged that the overall environment of "no new regulations" and the release of a new tax framework by the Administration which should increase the free cash flow power across many companies.

Overall the international markets look quite attractive compared to the Australian market which have large market segments such as banks, telcos and retailers subject to significant pressures.