CI PENSIONS FUND
QUARTERLY COMMENTARY REPORT

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

SEPTEMBER 2018

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	3.10%	2.02%	1.08%
ROLLING 1 YEAR	18.83%	15.60%	3.23%
ROLLING 2 YEAR	12.75%	13.21%	-0.46%
ROLLING 3 YEAR	12.53%	13.74%	-1.21%
SINCE INCEPTION*	11.49%	9.40%	2.09%
SINCE INCEPTION^	64.58%	50.89%	13.69%

*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 2.02% over the September quarter and over the past year returned 15.60%. The model pensions portfolio returned 3.10% and 18.83% for the quarter and year respectively.

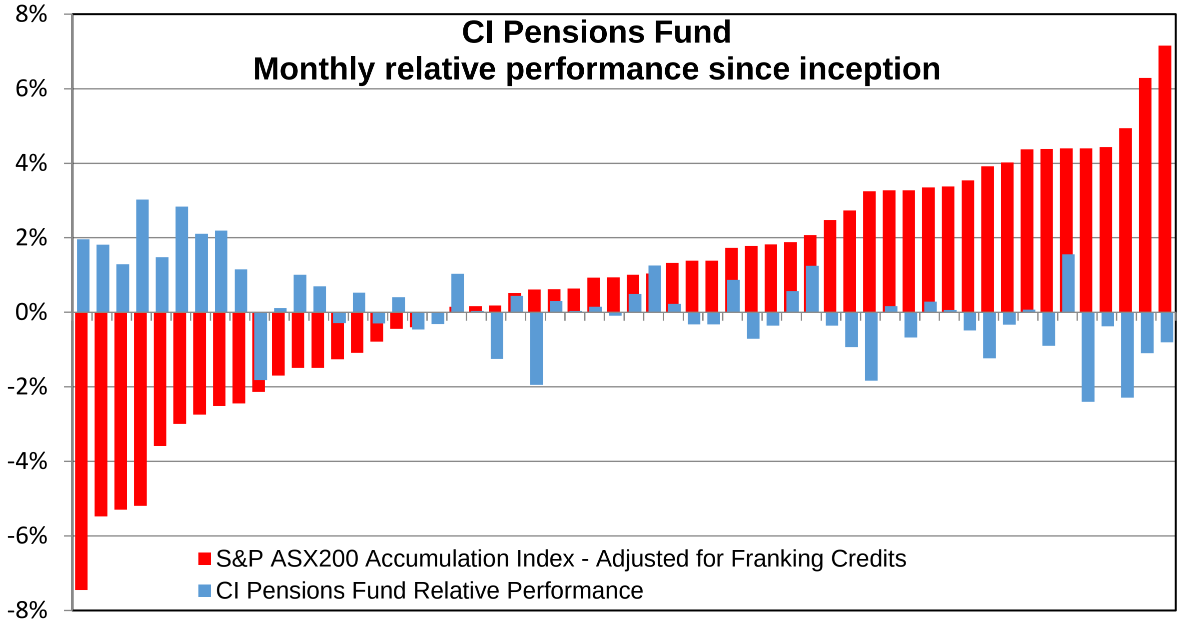
Whilst the Australian market returned a moderate 1.5% over the quarter, there was a high level of volatility of returns on a stock by stock basis. Within the portfolio there were nine stocks that delivered over 10% return and six stocks that fell by more than 5%.

The best performing stocks over the quarter included Soul Pattinson, Brambles, Chorus, Ryman Healthcare and Qube Holdings. The poor performers included Regis Healthcare, Adelaide Brighton, Saputo and Bega Cheese. Whilst we would prefer that there were few poor performers, each of these stocks reacted to specific issues rather than reacting to one overall macro factor. We are aiming to have a very diversified portfolio so it is good that the portfolio is reacting to idiosyncratic issues more so than macro or factor risks.

The international stocks added to the performance over the quarter, in particular Costco, Danaher and Kao rose strongly. The international portion comprises around 15% of the portfolio. The Australian dollar was weaker against most currencies and this helped returns.

The volatility of the portfolio over the quarter was 73% 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 21 times and in these months the portfolio has performed better than the market 16 times. When assessed using monthly data the portfolio has captured 63.6% of the market's downside and 89.6% of the market's upside.

For the 12 months to September 2018 the average annual turnover for the portfolio was 6%, a bit below the four year average of 11%. 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 added **Computershare** to the portfolio, increased the weight of **Chorus** a little, took up a placement in **Bega Cheese** and participated in the **Transurban** rights issue.

Computershare is a global leader in high-integrity data management, high-volume transaction processing and reconciliations, payments and stakeholder engagement. It employs over 18,000 staff around the world, with close to 50% of revenue generated in the US (Australia and NZ contributed 11% in FY18).

We believe that the quality of the business is underappreciated, with key segments typically positioned in attractive industry structures (often as the dominant player in an oligopoly). Circa 70% of revenue is recurring and significant revenue synergies are leveraged across business units (e.g. a registry customer will frequently also use Computershare for corporate actions, stakeholder relationship management or communication services). Low capital intensity supports high ROEs (27% in FY18) and strong free cash flow generation, which feeds growth and capital return optionality. From a portfolio perspective, Computershare also provides a hedge against higher global inflation given the substantial leverage to interest rates.

Computershare appears set to embark on multi-year double-digit EPS growth given: i) growth momentum in the target segments of mortgage services and employee share plans; ii) improving profitability in the world-leading registry maintenance business; iii) cost-out programs that should remove another 5% of the expense base; iv) substantial leverage to rising short-term interest rates in the US, UK and Canada (every 100bp increase is ~15% accretive); and v) a more disciplined approach to capital management, which is manifesting via debt reduction, higher dividends, share buybacks and higher ROICs.

CEO, Stuart Irving, and CFO, Mark Davis, both have ~20 years' experience across the group and have articulated a clear, sensible strategy. While co-founder, Chris Morris, is now a non-executive director, we take comfort from the experience he brings to the Board and his "skin-in-the-game" from retaining 6% ownership.

The portfolio owns 40 securities including seven global stocks (15%) and three New Zealand stocks (6%). The cash weighting is 5%.

Stock News

In late August **Transurban** (TCL) announced that it had been part of the consortium that was the successful bidder for a 51% stake in WestConnex from the NSW Government. The price paid for the 51% stake is $9.3b.

TCL then went on to raise $4.2b through a 10 for 57 rights issue and a further $600m through a placement to fund its share of the acquisition price.

The roads comprising WestConnex will come on line progressively until 2028, the first full year of operation of the integrated three stage network. The price paid by the consortium seems by no means cheap (circa EV/EBITDA of mid 20x) but the asset has long dated concessions (to 2060) and the asset is significant for TCL in light of its ownership of the other toll roads in Sydney and its ability to derive whole of network benefits over time. We subscribed to the rights issue in full.

Given the equity raising was the third biggest rights issue ever in Australia it is not surprising the share price has been weak since the issue.

Bega Cheese (BGA) also conducted an equity raising during the quarter. Having recently bought the Koroit processing plant from Saputo, the funds raised were used to pay down debt incurred in the acquisition. We subscribed to the issue with the belief that the acquisition should be highly synergistic (being in the company's core area of expertise) and value accretive. Opportunities arising from the purchase include:

- Optimisation of production base
- Grow milk supply
- Product development (mozzarella, milk powder sachets)

In addition industry structure improves as this transaction is the consolidation of the industry from 4 to 3 major players. BGA have a lot on their plate (given the recent acquisition from Mondelez) but we think management and company structure are readily capable of absorbing the new facility.

Rio Tinto announced that following the sale of coal assets in Australia they will conduct an off market buyback of shares totalling A$2.7billion. The buyback will be completed in November through a tender process.

The buyback price will comprise a small capital component and a larger deemed dividend component. The dividend component will be fully franked. The benefit to zero or low tax paying owners is that the very large fully franked dividend component plus the capital component grosses up to be well above

the current share price despite shares being tendered in to the buyback at a discount to the Rio share price.
Taxpayers with zero or 15% tax rates will find the tender offer very attractive therefore we expect that most super funds will tender in their shares and there will be a scale back of shares tendered. Zero tax payers will benefit more in an after tax sense than 15% taxpayers. The after tax benefit for zero percent taxpayers could be greater than 15% for shares bought back and around 7% for 15% taxpayers.

Rio conducted a similarly structured off market buyback in November 2017 for A$750 million and the scale back was 89.33%. As the current off market buyback is much larger we expect the scale back to be smaller than in the previous buyback.

The Federal Government has announced that it will establish a Royal Commission into Aged Care Quality and Safety. The immediate share market reaction was to push down the share prices of Australian aged care stocks including **Regis Healthcare** which is a portfolio stock. This reaction seems reasonable given the impact the banking Royal Commission is having on the financial sector.

One of the areas the Royal Commission will cover are the future challenges and opportunities for delivering aged care services in the context of changing demographics. What this means is there will be a large increase in demand for aged care facilities and that the private sector will need to play a significant role in building and running the required facilities.

The **Chorus** share price rose substantially following the release of their full year results in August. The results were not that different to expectations, but the market seemed to take a lot of comfort that the capital expenditure is proceeding as planned, the take up of fibre cable is proceeding as expected and the use of data is continuing to grow unabated. We view this a part of the derisking of Chorus as its plans proceed smoothly.

Industry observations

Over recent years there has been increasing enthusiasm from investors for all things technology and internet related. The Internet of Things (IoT) has been a catch cry and used to justify ever higher valuations for companies associated with the advancement of technology, with the FANG group of companies leading the charge.

In Australia, particularly in large cap land, we have often heard investors bemoaning the somewhat limited opportunities we have to participate in these world changing technologies. In fact these technologies are more frequently viewed as threats to the existing franchises of the top Australian companies.

Although we need to be cognisant of the threat that new technologies pose for incumbent operators, we are becoming increasingly interested in some of the opportunities that these technologies present for some of our “old world” companies. It is in the adoption of technology that we are seeing increasing opportunity for industrial companies to differentiate themselves and open up opportunity.

Automation, data analytics and the connected world are driving real change at an accelerating pace. Although many of these technologies have been around for some time, the continued advancement of technology has driven improved ease of implementation and cost reduction.

When it comes to companies adopting technology we need to clearly differentiate between on the one hand technology investment that is effectively business as usual and necessary to effectively compete, and on the other hand technology that companies can use to differentiate themselves and gain a competitive advantage. A good example of the former is the banking sector where technology investment undertaken by any particular bank to reduce costs is followed by each bank in turn undertaking a similar investment. In these situations any competitive advantage is at best short lived.

That said, we do see Australian companies doing some interesting things that could enable more enduring advantage to be gained.

Brambles is currently pursuing increased automation of their repair centres along with working with technologies that can help them track the flow of their pallets through the system. Both of these initiatives, at different levels, will enhance Bramble's competitive position through lower operating or capital costs.

Pallet tracking with sensors could further enhance the offering to customers to enable shock, temperature and humidity sensing for more effective management of supply chains.

Transurban has been steadily increasing its technology capability and now about 40% of its workforce is in technology and in particular working on data, network performance and security. The use of technology and data will enable more traffic on the existing road network and less likelihood of accidents and other hold ups.

The data that Transurban has on traffic and behaviours on Melbourne, Sydney and Brisbane roads is a competitive advantage that is hard to see other companies matching. The knowledge that Transurban has from operating variable pricing (HOT lanes) on their Virginia roads will probably be used on some of their Australian assets in the future.

The benefits of Transurban's intellectual property has been demonstrated by their success in approaching State Governments with unsolicited proposals to improve traffic movement on major toll roads and seeing these proposals move through to agreement to proceed with new projects. The Western Distributor project in Melbourne and the Logan Enhancement Project in Brisbane are examples of Transurban initiating projects that have resulted in billions of dollars of road projects.

The **ASX** is another company that is heavily involved in utilising technology, creating and using data and operating a physical data centre.

Financial regulators are aiming to lower risks in the world's financial systems in part by using trusted and independent intermediaries to absorb clearing and settlement risks. The ASX has committed to replace the domestic clearing and settlement system CHESS with new distributed ledger technology developed by Digital Asset Holdings. This replacement system should increase security and resilience of a key piece of Australian financial infrastructure as well as lowering costs and reducing reconciliation issues.

Once the new system is introduced for equities markets the ASX can move it into other areas such as Austraclear, the system currently used by the fixed interest markets. Ultimately the ASX is hoping this new technology can be used across large parts of the Australian financial system to increase efficiency, lower risk and take out costs. The costs of running the investment markets in Australia are huge and if the ASX systems and technologies can reduce costs significantly they should be paid some portion of the saved costs.

The ASX is also collating source data on most of the financial markets in Australia and this data is very valuable for market participants and regulators. Already, data, analytics and technical services provides around 20% of ASX revenue and this is expected to grow in the future.

Many other companies in the portfolio such as **Qube**, **Link** and **Sydney Airport** have an opportunity to improve their business through investment in technology.

All that being said, it is easy to talk about technological innovation but far more difficult to deliver it. It is in the execution and delivery of meaningful solutions that can be monetised, either through improved efficiencies or a meaningful offer to customers, that tangible value will be realised.

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