CI AUSTRALIAN EQUITIES FUND
QUARTERLY REPORT

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

DECEMBER 2008

"There is no means of avoiding the final collapse of a boom brought about by excessive credit expansion. The alternative is only whether the crisis should come sooner as a result of the voluntary abandonment of further credit expansion, or later as a final and total collapse of the currency system involved." Ludwig Von Mises (Austrian Economist 1881 - 1973)

"And I sincerely believe, with you, that banking establishments are more dangerous than standing armies; and that the principle of spending money to be paid by posterity, under the name of funding, is but swindling futurity on a large scale." Thomas Jefferson in a letter to John Taylor (28 May 1816)

"You make money by identifying stocks and industries with real value latency that with focused management can be realised through time" CI belief

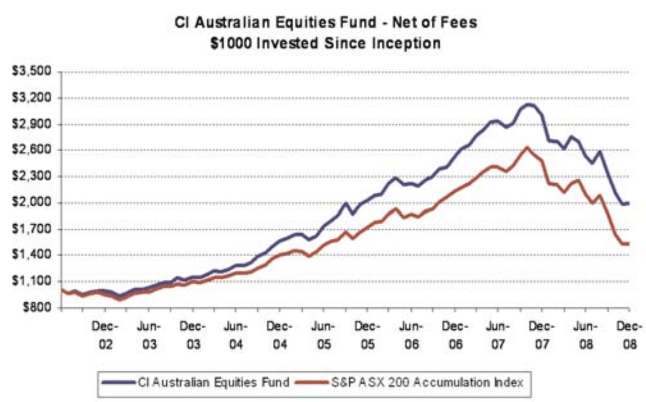
"Modern finance is an antiseptic discipline; it eschews anecdotes and examples, which are messy and possibly misleading – but nonetheless real. It favours abstraction, which is perfect but theoretical. Rather than evaluate financial assets case by case, financial models rely on the notion of randomness, which has huge implications for diversification. It means 2 investments are safer than 1 and 3 safer than 2" Roger Lowenstein

"On financial instruments, our standards are incomprehensible…" International Accounting Standards Board Chairman David Tweedie

PORTFOLIO PERFORMANCE - GROSS

	PORTFOLIO	BENCHMARK	VALUE ADDED
ROLLING 3 MONTHS	-13.82%	-18.25%	4.43%
ROLLING 1 YEAR	-32.80%	-38.44%	5.64%
ROLLING 2 YEAR	-10.18%	-15.46%	5.28%
ROLLING 3 YEAR	0.40%	-3.90%	4.30%
ROLLING 5 YEAR	12.75%	6.89%	5.86%
SINCE INCEPTION*	12.50%	6.77%	5.73%
SINCE INCEPTION^	114.95%	53.01%	61.94%

* Annualised (since 4th July 2002) gross returns
^ Cumulative gross returns (since 4 July 2002)

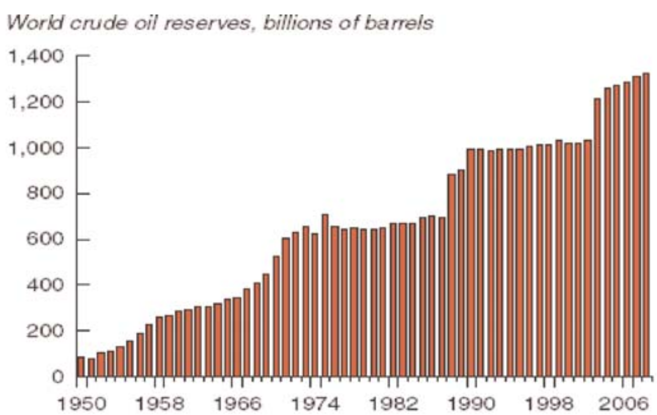


- The fund over the quarter was down -13.82% compared with the index of -18.25%. Outperforming portfolio stocks included Tattersalls, Coca-Cola Amatil and AGL. Underperforming portfolio stocks included Rio Tinto, Worley Parsons & Alumina.
- The Australian stock market over the past 12 months returned -38.44% (ASX 200 Accumulation Index) compared to the MSCI AC World in Local Currency –39.53% and Asia Pac ex Japan – 39.46%. BRIC markets did particularly badly, led by China which was down approximately 70% for calendar 2008. Calendar 2008, with a fall of -38.49%, joins 1931 as the worse year since 1825 for the US S&P 500 index. World bond markets did well returning 13% for the year. The other positive returning asset was the US $ which appreciated 27% against the AUD. The AUD depreciation will pose a challenge for some Australian corporates in 2009 via imported cost inflation and the impact on debt covenants due to the translation effect on overseas debt. The AUD depreciation is a net benefit to exporters, namely the resource and agricultural sectors.
- Over the last 7 years the ASX 200 has returned a modest 5.54%p.a. which is below what we thought likely when we established Cooper Investors in 2001. Whilst market PE's now look attractive, future returns in the Australian market face further reversion to the mean as the profit pool is shared between the competing forces of labour, government, community and shareholders. A number of sectors including banking, telecommunications and gaming are seeing pressures. The banking sector, which accounts for 20% of the ASX 200, has a real challenge to maintain profit levels given:
  - the fact that the Reserve Bank (underwritten by tax payers) has guaranteed their deposit base
  - they are 20/1 leveraged to asset values and economic growth, both of which are contracting. Glenn Stevens recently reminded us "if asset prices continue to decline, the capital of the banks will continue to deteriorate"
  - the non interest income generated by banks, namely fees and commissions, are heavily correlated to real estate and capital markets activity which are also experiencing negative trends.
- With regard to Australia's largest company BHP, if a long run return on equity of 15% were used to impute earnings per share, then this would imply a forward PE of 20x vs consensus of 8.5x.
- Over the last 12 months there were 10 stocks in the ASX 200 that showed positive capital appreciation – Santos, Newcrest, Ansell, Karoon Energy, Felix, Iluka, OM Holdings, Origin, Linc Energy and AGL. There were 14 stocks that declined by more than 90%, led by Babcock and Brown which was down by 99%. We held none of these fourteen stocks. There were no sectors that showed capital appreciation but healthcare was the most defensive declining 12%.
- The Hedge Fund index (HFRX) is down around 23% for the year and has caused problems for some large pension funds that have deployed "portable alpha" strategies involving leveraged structures that have not performed in accordance with predicted behaviour.
- There are a number of companies which we look at as US$ denominated assets e.g. Rio Tinto and Alumina Ltd – these stocks have fallen by up to 90% from peak prices if viewed at in US$ terms. This collapse in share prices may be a pecursor to M&A activity, but in some instances the fall in share prices merely involves a correction from peak price assumptions back to normalised commodity prices.
- The commodity boom (in real prices) we have witnessed in recent years was the largest and longest in a century. This has stimulated significant expansion in supply (e.g. iron ore) which will in turn present a more challenging future price/volume environment for resource companies.

DECEMBER 2008

Source: Grilli and Yang (1988) for 1900 to 1947; World Bank for 1948 to 2008.

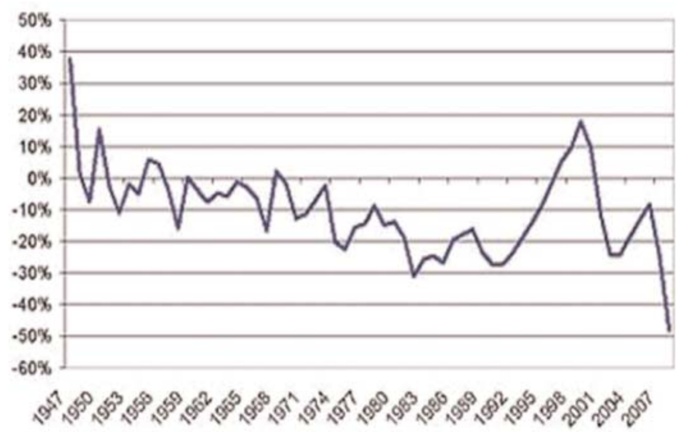
Despite constraints in finding new oil, reserves continue to increase. The role of price as an effective mechanism to stimulate exploration has worked to expand supply (an example of why price controls are generally counter productive).



Source: Oil and Gas Journal.

- Faced with the backdrop of continuing global slow down in industrial production and GDP, rising unemployment and relatively high profit margins, the Australian market remains challenged. The portfolio presently holds around 6% cash (max 10%) and is characterized by large company exposures that are industry leaders with strong balance sheets across a wide range of industries including hospital operators, diagnostic services, utilities, energy producers, logistics & retail services, consumer goods manufacturing and packaging. The portfolio does not hold investment banks, small resource stocks or property companies and has only a relatively small exposure to small companies.
- Since 1925 to November 2008 there have been 876 rolling 10 year periods. The 10 years to Nov 2008 for the US S&P 500 returned -8%, and is the first negative 10 year return period since 1941. The worst returns since 1925 range from -0.3% (Sept 1940) to -39.8% (Aug 1939). The good news is that in **every subsequent 10 year period** following a 10 year decline returns were positive, ranging from +7% p.a to +15% p.a.
- The challenge for the US and many developed markets will be the rebuilding of savings and the re-establishment of a sustainable fiscal position. The following table shows the extent that the US budget deficit has deteriorated in recent years.

Federal Budget Deficit as % of Gross Savings



Source: St Louis Federal Reserve

VoF OBSERVATIONS ~ INDUSTRY TRENDS & BEHAVIOUR

"One thing we all have to do to help with confidence is learn to relax, don't ask too many questions. There is no special psyche, nor set formula for reaching our potential. Confidence is all between the ears – good and bad. Either you believe in yourself or you don't" Wayne Bennett, Don't die with the music in you

"They thought that it would be a disgrace to go forth as a group. Each entered the forest at a point that he himself had chosen where it was darkest and there was no path. If there is a path it is someone else's path and you are not on the adventure." Joseph Campbell.

"The biggest cost pressures are coming from the significant decline in the Australian dollar" Bernie Brooke, Myer CEO

"We foresaw that the fallout from the US sub prime mortgage market would contribute to a slowing economy in Australia and adjusted our strategy accordingly early this year...." John Mulcahy, Suncorp CEO

- Australian credit growth has been higher than that in the USA and UK in last 10 years, and housing debt has increased from $234b to $969b (i.e. 4x) fuelling widespread asset price increases. House prices are now falling in most countries around the world. Australia is vulnerable to this factor given the importance of house prices to Australian household wealth.
- This back drop has supercharged a number of business models (mortgage broking, investment banking, margin lending) which will no longer have the wind at their back.
- The trend in employment is a key indicator for the banking and retail sectors. We observe that employment trends are negative in most economies around the world and that consumers are trading down in many categories.
- The commodity boom was driven by infrastructure and fixed capital spend in the developing economies and is now going through a correction phase.
- Rural customers are a better credit risk than city borrowers
- If the government sticks to the 20% renewable target by 2020 there will be a resultant energy infrastructure boom. (The 20% target would require 10,000 mwhr of generation from wind @ $3m/mwhr which would imply

$30b of required capital expenditure.

- Debt encumbered companies will be more willing sellers of assets and will look to recapitalise their balance sheets e.g. Rio (packaging assets) Wesfarmers (Coal or Target, Office Works) Asciano (ports/rail infrastructure).
- NZ retail investors have shown a large appetite for quality corporate bond issues reflecting demand for lower risk investments and the falling yields on bank bills and bonds.
- The next up cycle is unlikely to be driven by increasing leverage by western consumers and a continuous expansion of current account surpluses in the developing countries i.e. China. In other words, consumers in the developing economies will need to start spending.
- The “savvy” deal of the year goes to Origin which sold 50% of their coal seam assets to Conoco Phillips for AUD$7b (and up to $9b if four trains of LNG proceed).
- Telsta’s attempt to control the national broadband network with underwritten high rates of return has been rejected as a non-complying bid by the government tender panel ~ we assume that the Telstra option was deemed to be anti-competitive. Telstra has attracted investors seeking defensive & yield characteristics. However Telstra’s future profits are partially dependent upon government policy which appears to be hardening as the government resolves to get a more competitive landscape in Australia. For the government to select someone else to build the broadband network will require highly targetted and onerous (to Telstra) legislation to ensure fair interconnection rules and to stop Telstra from selectively overbuilding a competing network in high yield regions. In light of the high importance attached to this project by all concerned, and the fact that Telstra is widely acknowledged to be the logical builder of the network, it reflects poorly on both the government and Telstra that the tender process has proceeded in the manner we have seen to date.
- Commodity prices have fallen because global economic growth is falling. In China, for example, electricity consumption is down by 3.7% in Oct 08 yoy - the first such fall since 1999 - and Chinese steel production is down 12 % in November on the previous corresponding period.
- Fixed asset investment in China is up 44% year to Oct 08 vs pcp.
- China remains a very competitive economy e.g. labour rates are around US$2.51/hr (all up costs) compared to Poland $16/hr, Germany $38, UK $21, Indonesia $1.29, Japan $42.
- Maintenance of assets has become more important given the massive capex cycle we have seen recently and the additional risks and liabilities companies are facing around OH&S, the environment and pollution controls. Further, there is increasing acknowledgement of the value created by optimising asset life via more intensive maintenance and management.
- Margin destruction is everywhere:
  - ASX 80% margins have attracted the attention of regulators and customers
  - Coca Cola can build a beer business on 20% margins rather than Fosters’ 30%
  - the Australian government has provided $4b in mortgage loans to the competitors of the large banks on competition arguments; Banking executives are indicating returns look likely to decline; asset managers, financial advisers and mortgage brokers are under pressure without the back drop of rising asset prices which hide the true cost of fees.
- Development property doesn't work at the current cost of capital and low cap rates. Australian super regional shopping centres are a true monopoly business.
- The demand for public transport is exploding and current systems are already struggling to cope.
- Infrastructure does have price and economic elasticity e.g. traffic Macquarie Infrastructure’s M6 road is down 11% after a 20% price increase.
- Local cost of capital is cheapest ~ banks are returning to local funding models and property assets will be purchased by locals first, “Americans know the value of real estate in USA better than Australians”.
- Petrol and gasoline tax receipts in the USA are 1/3 today compared to the 1960’s on a miles driven basis (TCL). The US is not going to build its way out of congestion, they need more conservation and efficient public transport.
- Demographics is favouring volume growth in diagnostic businesses.
- BRIC economy consumerism - Cochlear has reported a strongly growing demand profile from the BRIC economies for their product (circa $20K per unit) due to rising income levels in these economies.
- This is the longest downturn in NSW (60 months) since WW2, and now Queensland and WA are starting to turn down.
- Freddie Mac and Fannie Mae were leveraged 110/1 assets to equity. Including off balance sheet assets the equity /assets was 0.45% (ie. over 200/1 gearing) which was justified on the basis that housing had lower write-offs and therefore was a lower risk asset class.
- Downstream refining activities are more cyclical because investment generates supply more easily i.e. prefer upstream operations to downstream
- Bottom of the market signals ~ listed property trust sector revalues assets to reflect market clearing yields; pension funds forced to liquidate unlisted assets; auditors/ASIC pressure more disclosure and rigour around unlisted asset valuation; a major Aussie bank cuts its dividend; resource project losses and write-offs; corporate spin-offs at cheap prices; foreign M&A activity; large balance sheet restructuring and recapitalisation (to date companies have been playing at the margin hoping the financial markets will return to “normal” in the next twelve months)

<u>Hong Kong and China Trip Notes (October 08):</u>

- A summary of comments: "hit the wall…customers trading down...challenging...prices down 50% in the upper end HK apartments...20,000 factories closed in Pearl River Delta".
- Big hits to the SME book are expected after Chinese New Year Lehman’s went bust with 13% Tier 1 capital. The quality of assets and the funding mix matters more than the absolute Tier 1 ratio.
- Amcor is sitting on a really good opportunity with Amvig (40% owned by Amcor). Amvig are the premium leading cigarette packaging company with further consolidation options and opportunities.
- The banks in HK are well prepared for the downturn in terms of capital and management capability. Standard Chartered have a loan to deposit ratio of 85% whereas the banks in Australia are close to 150%.
- 2/3rds of the worlds foreign reserves are held by Asian countries.
- 1/3rd of China's imports come from Asia and exceeds USA, Japan, UK.
- China is full of dynamic hard working industrious people who are very goal focused. There will be many opportunities to emerge from the downturn in the longer term. Cheap land and cheap labour is still a powerful formula.
- Looks like China has surplus capacity and overbuild in many sectors, particularly the export sector and property.
- Lots of comments that the tier one cities (provincial capitals) and Tier two cities (1-5m population) have been saturated for the time being e.g. Gome

(China's Harvey Norman) said that they would need to go to Tier 3 cities to get growth. They are experiencing negative same store growth pcp.
- The credit contraction is happening in China. Credit worthiness is a big issue e.g. SMEs are seeing credit and trade terms withdrawn by their suppliers in addition to banks tightening limits.
- GDP for 10 years to 2004 was circa 8% in real terms p.a. 8% is a good representative average number for China's growth expectation. Therefore the average for next few years will be below that number to cleanse the hype years.
- Labour shortages are no longer an issue due to the export downturn and the fact that China put through costly industrial relations reform legislation which increased the cost of labour. Unskilled labour still earning 1200-1500 RmB per month (AUD$3000 p.a.) including food and board.

Social, Political & Economical Observations

" The US is the greatest democracy that money can buy" anonymous

- A move from savings surplus (loose money) to savings deficit is better for stock investors as there is more discipline and you get paid for taking a risk.
- What holds back a recovery is the fact that companies and consumers continue to retract spending plans and return to more conservative positions.
- Asia ex Japan stock markets are back to pre-1994 levels.
- USA now has $US11TR in debt and rising.
- The role of outsourcing has gone too far and hasn't delivered the desired efficiency in some areas e.g. securitization proposes to distribute risk and returns efficiently to the optimal holders of these risks. Sub prime is the result ~ it was about distribution and fee driven asset growth. As it turns out, securitization by separating risk assessment and asset ownership creates the wrong incentives to judge risk over the life of the asset.
- We recently attended a presentation by Madeleine Albright, former US Secretary of State and a former US Ambassador to the United Nations. She has also been appointed to a transition committee for President elect, Barack Obama. Key points:
  - there is an unhealthy disparity between rich and poor around the world;
  - the best way to deal with the global financial crisis is to kill two birds with one stone by pouring money into infrastructure i.e. road, rail, airports & social infrastructure. This way you create jobs and fix the appalling state of America's utilities & infrastructure;
  - Obama's economic team are conservative and "they know how Wall St works";
  - the USA now realizes that foreign policy cannot be shaped with bi-lateral arrangements. They need to more broadly encompass multiple countries;
  - the UN needs considerable reform. When she joined politics there were 50 nations now there are 181 nations;
  - foreign policy is "getting another country to do what you want them to do";
  - for countries to negotiate with the USA "they will need to give up something";
  - the biggest mistake she made as Secretary of State was to have too many priorities;
  - on China "they own us because of their large holdings in US treasuries but they need us because their exports are now falling without US demand";
  - by electing "a black man" the USA has sent a great message to the rest of the world about the virtues of democracy; and
  - there is no obvious replacement to the USA as world leader.

Conclusions

- We are likely to see a period of opportunity for owner operators of infrastructure assets.
- There will be many fiscal and industry policies that narrow the earning capacity of the rich relative to the poor.
- The finance sector will be governed by a much more restrictive, disciplined and accountable regulatory framework.
- GDP composition will trend away from private consumption toward fixed capital investment with a government or infrastructure flavour and government supported economic services i.e. essential services, health, welfare and preferred industries of national importance.
- The USA's credit culture is mean reverting, leading to lower consumption and higher savings rates. This will be a global phenomenon.
- Global unemployment is trending up everywhere and is a problem in both emerging and developed economies.
- The RBA cash rate of 4.25% will encourage investors to supplement their low risk, low yield assets with high quality equities (yield and growth stocks), hybrids, corporate and semi government bonds. A study of Japan shows that following a deleveraging asset deflation period (1990-2009) cash and bonds were the asset class winners as investors systematically reduced their exposure to "risk" assets. However selective equities did relatively well.
- Governments around the world are looking to solve rising unemployment by pumping money into public projects which will be beneficial to reputable companies that can design, build, operate and maintain public assets.
- There are many businesses (domestic travel, discount retailers, internet shopping, home brands, pizza shops, public transport, pay TV, 3 star hotels, video conferencing) that are relative winners from the "trading down" phenomena. We see consumers everywhere returning to frugal value-based behaviour and abandoning wasteful, debt funded, conspicious consumption.