

# CI AUSTRALIAN EQUITIES FUND QUARTERLY REPORT



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

JUNE 2006

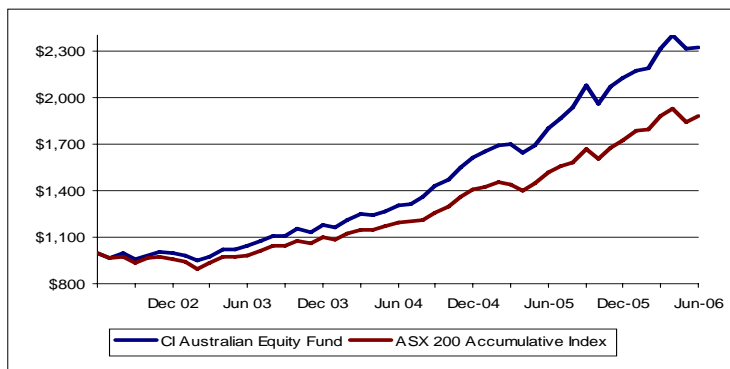
*"Complexity kills...It sucks the life out of developers. It makes products difficult to plan, build and test, it introduces security challenges, and it causes end users and administrator frustration...we got a lot done with a small number of people in a relatively short amount of time. Bringing technology together on time is fundamentally a leadership issue... I start from the outside in; what will define success when you ship [the final product]? If you don't have crisp ideas, you end up with something that is way, way too long or didn't achieve what you wanted." New Chief Geek at Microsoft, Ray Ozzie*

*"China, after the swift, catastrophic failure of the Great Leap, has thrashed about, trying first this strategy to overcome poverty and backwardness, then that, each new departure hailed as revolutionary and each petering out in confusion and recriminations..." Jane Jacobs, Cities and the Wealth of Nations, 1984.*

*"But observation of realities has never been one of the strengths of economic development theorists." Jane Jacobs*

*"Be wary...of trusting too much. Men change and times change, but wars and revolutions are always with us." Louis L'Amour, To the Far Blue Mountains*

*"The buyer needs a hundred eyes the seller not one..." George Herbet*



class, has performed better than the market during the last few months. Market volatility has increased due to rising global short interest rates, and falling base and precious metal prices. In addition, after a long period of good stock price returns and good profit growth the market is questioning the sustainability of high return industries. The high return on equity is being generated in many sectors and the broader market as a result of high prices (e.g. commodities, insurance premiums); lower costs (e.g. domestic bad debt charges in the banking sector); more disciplined industry behavior (e.g. building industry, private hospitals, resources); and good demand growth.

## PORTFOLIO PERFORMANCE

	PORTFOLIO	BENCHMARK	VALUE ADDED
ROLLING 3 MONTHS	0.35%	-0.20%	0.55%
ROLLING 6 MONTHS	9.47%	8.81%	0.66%
ROLLING 1 YEAR	29.29%	23.93%	5.36%
ROLLING 2 YEAR	33.66%	25.16%	8.50%
ROLLING 3 YEAR	30.66%	23.94%	6.72%
SINCE INCEPTION*	23.56%	17.08%	6.48%
SINCE INCEPTION^	132.51%	87.59%	44.92%

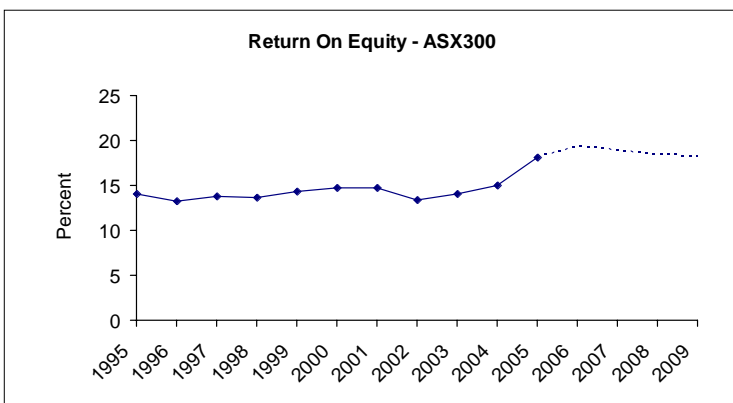
\* Annualised  
^ Cumulative (4 July 2002)

The Fund over the last 3 months returned 0.35% compared to the benchmark, which returned -0.20%. Negative contributors over the last quarter included Toll, CSL, AGL, ABC Learning, St George Bank, Qbe and Boral.

Toll, after a protracted takeover battle with Patrick, needs to demonstrate to the market their ability to deliver synergies from the acquisition to justify the acquisition price. Toll appears to be the only company in Australia that has the capability of delivering a truly integrated international logistics solution under the one ownership banner. That is why there were no objections from Coles or Woolworth over the Toll offer. The big retailers see the transport consolidation as an opportunity to get more services managed under the same roof, which can deliver better coordination and efficiencies for all. Presently, \$10b is spent on shipping & transport services for Asian sourced imports ~ \$2b on shipping costs and \$8b on ports services (of which \$4-4.5b is through Patrick's). Toll presently handles \$1.5b of the arising transportation revenue. Toll's big opportunity is to capture a larger portion of the rest of Patrick's throughput through its network. Incremental revenue of \$1.5B from this source could add \$90m in profit.

Stocks that out performed but we do not own include Telstra, AMP, and Westfield.

Positive contributors to performance included Brambles, AXA and Transurban. We have a nil exposure to property trusts, which returned 4.54% over the past quarter. The LPT sector as a low return, low volatility asset



Source: Goldman Sachs JB Were

Our market observations are:

- Return on equity is high versus history in most markets and profit growth is robust.
- Company managements are doing a good job for shareholders.
- Many Australian companies have taken their Australian business models overseas and are doing well e.g. Brambles, James Hardie, Westfield, Macquarie, Babcock and Brown.
- The growth in China and India is driven by sound social, economic and political desires.
- Big positive thematics (China, basic industry consolidation, low interest rates) are now incorporated into share prices.
- Volatility in asset prices has been falling sharply until the last month. Rising rates, inverted yield curves, and a slowing profit cycle would favour high quality securities, cash, and large caps.
- The share market in Australia seems awash with cash to spend
- Governments' aversion to debt is loosening (e.g. NSW budget) but policies are generally friendly to equity investors.
- Global growth is running at 5% in the 1Q06, which is above the historical average of 3%. Global inflation is around 3.1%.
- Debt levels are high in some sectors of the economy (especially households and utilities/ infrastructure) and corporate interest spreads are very low without many credit default surprises (domestically and globally).

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## Stock & Industry VoF Trends & Observations

*"Product is a ticket to play, brands channels to market and client services are the things that distinguish the ability to gain profitable market share." Craig Winkler CEO of MYOB*

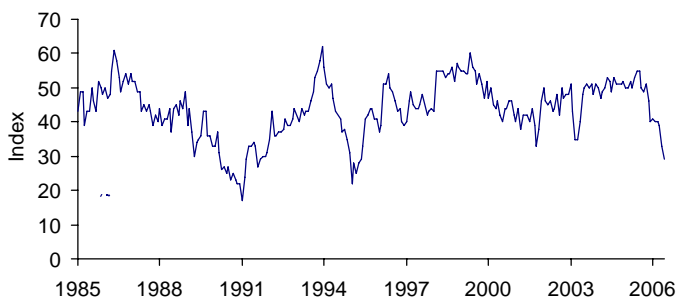
*"What probably distorts everything in life is that one is convinced that one is speaking the truth because one says what one thinks..." Sacha Guitry*

*"The proper office of a friend is to side with you when you are wrong. Nearly anybody will side with you when you are right." Mark Twain*

*"Humans need organization and a system because they are behaviorally volatile, distracted judgmental & emotional creatures. Successful communities require leadership setting the ground rules for performance incentives & risk boundaries. Without strong leadership a lack of clarity will result from an accumulation of decisions that will increase complexity to the point that behavior is no longer focused on the few things make the difference."*

*"We make assumptions we don't make forecasts" Brian Fisher Head of ABARE*

US Housing Market  
Traffic of Prospective Buyers



Source: National Association of Home Builders

- US housing ~ the US housing market is looking a bit sick - starts have dropped off this year, and survey-based "buyer traffic" and sales expectations are falling. The yield curve is essentially flat, noting that an inverted yield curve has always meant a slowing in USA profit cycle. USA consumption has been driven by people releveraging their wealth gains from stock and housing price appreciation.
- As an asset class USA long/short equity hedge funds, have materially increased their correlation with S&P 500 over the past 5 years. This means that the market neutral claim that some of the managers make is unlikely to be true due to the fact that alpha is being derived from beta, the very thing many claim to be hedged against.
- Infrastructure requirements continue to be a high profile theme running through both developed and undeveloped countries e.g. Panama is seeking international support to build a £5.25b third lane for the Panama Canal. The canal carries 5% of the world's trade. The widening would allow the new super sized ships to sail directly from Asia to the east coast of USA. The alternative route is to ship to the west coast and truck. The canal opened in 1914.
- The USA has 25% of the world's coal reserves and coal accounts for 50% of the country's electricity. The first coal to diesel facility is being built (1.4m tons will produce 5000 barrels a day of diesel). The initial cost of the fuel is about \$54 a bbl equivalent. Other coal technologies require

\$40/bbl to justify their costs. Oil sands break even at \$35/bbl but are experiencing cost pressures. The real challenge remains how to develop methods to sequester the CO2 gases generated by coal fired plants.

- Bad business models ~ community rated health insurance is a difficult business due to the product offer which makes insurance cheaper for old people and expensive for young people. Travel insurance has some quality issues as well given that 65% of premiums go to the intermediary in commissions and the underwriters need to knock back 50% of claims to make the business profitable.
- Demographic change - ageing is not the only change happening. Asian females are replacing Anglo Saxon males in the health care industry.
- Media convergence with new media and telecommunications ~ one key driver is customer acquisition and retention costs e.g. pay TV customers who have three products from the same provider churn 50% less than those with two products, and two product customers churn 50% less than 1 product customers. A further driver to consolidation is highlighted by a recent statement by a media agent: "we are telling clients whatever you are spending on broadcast TV it's too much".
- Commodity prices ~ A volatile quarter for base metals lead by copper which started at US\$2.50 per pound, rose to nearly \$4 by mid-May, and then fell back to \$3.15 in late June. Indications are that the Asian market will pay a premium for Australia's LNG gas, and that Japan and China would like to limit Middle Eastern sourced gas to 20% of their gas requirements. The Asian market has the capacity to take 100% of the gas from the Browse and Pluto basins. The long-term commodity story is driven by the urbanization of China and remains intact.
- Resources ~ Resource companies are increasingly challenged by the question of what to do with their excess cash? BHP produced US\$8.4b in operating cash flow last financial year, and RIO US\$6.9b. Companies have four choices for excess cash: 1) Accelerate new projects, but chronic heavy equipment and skills shortages make this difficult or impossible 2) acquire other companies 3) Reduce net debt 4) Return the money to shareholders through buybacks and special dividends. BHP and RIO are well positioned, world class companies with long duration assets. Examples of BHP long-life assets include the Pilbara iron ore, Olympic Dam copper and uranium mine, and the Gulf of Mexico & North West Shelf oil assets. Upside options, exist in copper, oil and uranium. Also worth noting is that the mineral companies generally have longer life assets than the oil companies. BHP and RIO offer quality exposures to the "to get rich is glorious" theme. 20m per year rural Chinese are moving to cities, demanding housing, infrastructure, manufacturing jobs and all of the raw materials to build them....it feels backable. One issue of caution is the rapid ramp up of the Chinese alumina industry. China has brought online alumina production much more quickly than many industry participants anticipated; they have handled complex commissioning and technological issues better than expected; sourced bauxite more readily than expected; produced better quality than expected. Implications: 1) do not invest in things with which China can compete e.g. steel. In addition, scrap steel is presently imported into the Chinese market because they are relatively immature in steel recovery. As the Chinese market develops its capacity to recycle scrap global steel prices will be pushed down. 2) Do not rely on infrastructure bottlenecks in China to constrain and product supply because they are building infrastructure quickly.

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Infrastructure delays are much more of an issue in western countries where approval and labour shortages are more acute.

- Explosives businesses run by Orica and Dyno have attractive business models due to the now concentrated global industry. In addition, these mining service providers are less likely to follow directly a down turn in commodity prices because the miners' first response to lower prices is to produce more. Furthermore, ammonia nitrate prices are roughly 5% of mine costs but influence 40% of mine costs.
- China ~ In 5 key commodities (grain, meat, steel, coal, oil) China now consumes more than the USA. China consumes 380mtpa of grain vs. USA 260 mtpa. China consumes 250mtpa of steel vs. 119mtpa in the USA. China now leads in many consumer goods with China consuming more TVs, cell phones and refrigerators. The USA leads in auto and personal computers but not for long. Increasingly there will be competitive tension between the "better-life" aspirants and wealthy countries with a desire for cheap goods. The emergence of developing countries from economic poverty will have all sorts of investment implications for global savings, interest rates, currency re-alignments, price, relative labour and capital costs and consumption patterns. One anecdote that caught the eye shows that Americans do not have a monopoly on conspicuous consumption. In petro-tourist driven Dubai they recently opened a shopping mall, with a ski village attached. The kids can enjoy a winter ski resort with real snow and a pretend log fire in -5c temperatures inside and 44c outside - could this threaten Swiss ski resorts?
- India can produce injectibles at 30% of the cost of the western world because 1) they have cheaper educated labour at 1/10th of the cost of western labour 2) factory costs are 50% less than the capital costs of a western factory.
- Road financing requirements present Transurban with global opportunities. As a road operator you are in a fundamentally better position when working with the RTA's (such as Vic Roads), rather than merely being structured to rely heavily on tax/financing advantages and being the smartest guy in the room. Governments around the world seem keen to balance their budgets using PPP's and toll roads are an excellent alternative (certainly better than say, public transport and even utilities). So the pipeline of new projects, and extensions to existing roads through "HOT lanes" (High Occupancy Toll lanes), should be strong. Once the road is developed, there may also be an ongoing stream of \$50-100m projects on surrounding roads, which have the double benefit of extending the concession and increasing the traffic and improving customer experience on the toll road. On top of that, traffic growth flows disproportionately to the road with capacity, so growth exceeds economic growth. These assets are very low risk. TCL is currently priced at a 7.5% dividend yield, which gives it downside protection, and the cash flows are based on entrenched consumer habits. The danger is that the company is beaten out of deals by more aggressive financiers with lower cost funds. However, the recently acquired Pocahontas Parkway in the Virginia USA is small but is evidence Transurban has something to offer the state government.
- Oil refining industry - Caltex and Shell have created a near duopoly in petrol retailing based on their deals with Woolworths and Coles. This was a very smart deal to swap price sensitivity on petrol for (relative) insensitivity on groceries. However, petrol prices have been volatile due to

oil price movements. One potential opportunity is to lift the marketing margin to higher levels. Regional supply-demand balance is positive for refining margins. Yet we have not seen a large response from China. A new refinery has not been built in the USA for 20 years although volume capacity has increased by 20% due to brownfield expansion and technological improvements. Low profitability has been a disincentive for the expansion of new refineries. Therefore, today's higher margins will encourage refiners to build capacity. Timing though is uncertain, as is the impact of higher capital costs as well as labour and material constraints. China currently has 33m cars in its fleet, which is expected to rise to 130m by 2020. In the USA, there are three cars for every four people, which would put the Chinese car fleet at close to 1B cars, more than the current global car fleet of 800m today. Therefore, notwithstanding that with higher fuel prices consumers are buying fewer large cars (e.g. the failure of the new Mitsubishi 380) the outlook for transportation fuel looks positive.

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