

CI AUSTRALIAN EQUITIES FUND QUARTERLY REPORT



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

JUNE 2007

"Question every premise, challenge conventional wisdom and never accept the truth of something merely because everyone else views it as obvious. Resist being credulous." Albert Einstein

"The softest things in the world overcome the hardest things in the world. Through this I know the advantage of taking no action." Lao-Tzu

"Thus it is that in war the victorious strategist only seeks battle after the victory has been won, whereas he who is destined to defeat first fights and afterwards looks for victory." The Art of War, Sun-Tzu

"When the people of the world all know beauty as beauty, there arises the recognition of ugliness. When they all know the good as good, there arises the recognition of evil." Lao Tzu

PORTFOLIO PERFORMANCE

	PORTFOLIO	BENCHMARK	VALUE ADDED
3 MONTHS	6.29%	5.43%	0.86%
2007*	33.51%	28.66%	4.85%
2006*	29.29%	23.93%	5.36%
2005*	38.12%	26.35%	11.77%
2004*	24.92%	21.61%	3.31%
2003*	4.23%	-1.49%	5.72%
SINCE INCEPTION#	25.49%	19.32%	6.17%
SINCE INCEPTION^	210.44%	141.35%	69.09%

* 12 months to June except 2003 which is 3 days short of a year as it commenced on the 4th July 2002
Annualised (since 4th July 2002) gross returns
^ Cumulative gross returns (since 4th July 2002)

CI Australian Equities Fund - Gross
\$1000 Invested Since Inception



The Australian share market put in its 4th successive year of above average performance returning 28% in the last 12 months. The portfolio returned 6.29% over the quarter compared to 5.43% for the market.

The small resources were up 17% in the quarter (Queensland Gas +83% Fortescue +67% and Mt Gibson iron +68%). Interestingly the gold price in USD is up only 5% over the past 12 months, it is down in AUD terms as the Australian dollar is up 14% against the USD over that period. (Gold doesn't pay dividends, you can't eat it, and you can't build with it). Other strong sectors over the quarter were retailers +16% and energy +14%. Media, insurance and healthcare had negative returns for the quarter.

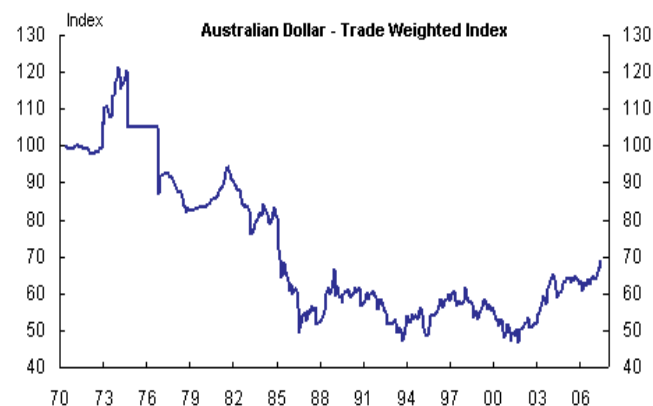
The portfolio outperformed over the quarter due to BHP, Rio Tinto, Macquarie Bank, St George Bank and Toll. Despite its strong cashflow features, the resources sector is still not an area where banks will lend as aggressively as other parts of the economy and consequently PE firms are not active in this sector. However we see governments becoming more active in taking direct strategic positions in resource companies as surety of supply becomes a more important consideration for growth economies. We also like the

resource service sector which is more volume than commodity price sensitive. As commodity prices fall miners will respond by trying to grow volume.

Underperformers over the quarter included Brambles, Coles, Lend Lease, Healthscope and Seven. Healthscope suffered a share price fall post the Symbion takeover announcement. The takeover, if successful, further consolidates the private healthcare market with industry growth rates of 5-6%. Seven trades at a 30% discount to NAV despite a successful track record of astute investing, yet listed investment funds/companies trade at p/nav premiums despite the profit leakage due to external management structures. It is also notable that Seven has reduced its exposure to the Australia's number 1 broadcast TV network thru the sale of 50% to KKR.

Telstra's share price fell over the quarter after a strong T3 launch. With Optus's successful tender for the subsidized rural broadband rollout, the focus is now on the government's commitment to a competitive telecommunications model. Broadband regulation in the cities becomes the critical test for determining how competitive the telecommunication industry will be in Australia.

Whilst Australia's current economic performance is good (CPI 2.4%, unemployment 4.2%, bonds 6.25% and credit growth running at 14.6% p.a.) stock market upside from economic latency appears limited due to high corporate profit share, rising interest rates, a high and rising AUD, state government budget pressures, high consumer leverage ratios, and environmental issues (including carbon cost pressures). We would look at the 10 year global equity returns of 8% p.a. as being indicative of normal return expectations. In this context we remain positive on Australia's participation in the Asian region with its 3.1b people and a GDP of \$9 trillion (9x Australia's GDP). A good indicator of our performance is the trade weighted index (see below) as it reflects the difference between export and import prices. Furthermore, Australia's population growth exceeds most in the region e.g. South Korea, Japan and China.



Source: Deutsche Bank

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The Wesfarmers proposal to buy the Coles Group appears attractive for WES shareholders and uninspiring for Coles shareholders because effectively WES are paying \$13.95 per Coles share, not \$17.25. This assumes the underlying value of WES is \$35 per share, and the cash and merger ratio are applied to this value. WES were trading around \$35 pre bid and are valued by a number of broking analysts at around this price.

Coles has revenue of \$35b and earns \$1.1b ebit (earnings before interest and tax) whereas Woolworths has revenue of \$41b and ebit of \$2b. If Coles could achieve Woolworths margins at current ev/ebitda multiples then Coles would trade at \$19.58. If Coles could achieve Woolworth's margins and Woolworths ev/ebitda multiple Cole's price would be \$26 a share. At current prices WES is trading at over 20x pe and is overpriced because a portion of profits come from commodity cyclical businesses (insurance and coal) which are rarely priced at this multiple. Comparable global equivalents (QBE and Rio) today trade on less than 14x pe. Conclusion: Wesfarmers have done well for their shareholders if Cole's shareholders accept the offer as it stands.

Corporate activity in the property sector has been frenetic e.g. Morgan Stanley announced a bid for Investa at a 53% premium to the latest net tangible assets of \$1.97; Brookfield announced a full cash bid for Multiplex and the Roberts family have agreed to accept the offer and will effectively sell out of the family company; Westfield raised \$3b cash; Valad acquired Scarborough Holdings, an integrated pan European real estate company, for \$2b funded by a \$1.2b equity raising.

VoF OBSERVATIONS & IDEAS ~ TRENDS & BEHAVIOUR

"The stocks you can't see are more important than the stocks you can see." Vivek Tulpule RIO Tinto Economist

"We are not the new James Packer. We are institutional investors. We sit around a board table not the executive table". Adrian McKenzie, Head of CVC Asia Pacific - Private Equity firm

"The ultimate goal of marketing is to match a company's products and related services to the customers who need and value them the most. This maximizes the value of the company's products. It's not just about extracting tonnes. It's about being canny enough to sell tonnes at the most advantageous price so that we make the most of the products' intrinsic value". Gordon Hamilton, Head of marketing, Rio Tinto

"It's liquidity that is driving the world. It will continue to be strong as long as real long term interest rates stay low. This is not a permanent feature. It's an intermediate term period in world economic history that has never occurred before." Alan Greenspan

"One World One Dream ~ I participate, I contribute and I enjoy." Beijing Olympics Games official message

"Boards are no longer willing to go the knuckle; no guts no glory." Anonymous

UK Visit ~ In May 07 we visited the UK and saw a number of company's including HBOS, Lloyds TSB, HSBC, Netcare, General Healthcare, Bupa, RIO, Xtrata, Anglo American, Olympic Development Authority, BSKyB, Wolsley, BP, Diageo. Some observations:

- Beer margins in Australia are the best in the world and now have attracted competition from one of the world's biggest brewers, SA Brewing, who is in a joint venture with Coke Cola Amatil. Initially they will target the premium end of the \$1.2b beer profit pool. Fosters also find themselves competing against companies like Diageo, a world class brand focused company. Global brands are tending to cannibalize local brands in the premium alcoholic beverage space.
- The NHS has grown from £35b to £95b over the last 10 years. Only 5% is outsourced. NHS seems highly political, capital intensive and it is premature to be called a low risk opportunity for Australian healthcare operators.
- BSKyB are using telephony as a commodity to be bundled with pay TV. By bundling they reduce churn. BSB price below British Telecom margins (which are high due to their incumbent & historical position).
- Iron ore and uranium are secular growth industries.
- Resource supply side still looks very constrained.
- Xtrata has a tax advantage that allows them to squeeze 3%-5% more income out of each deal due to their Swiss resident tax status.
- "Predator" and "prey" behavior is a primary driver in the resource sector now i.e. get big or get out. Size in the resource industry is critical because it provides project risk mitigation, technology, market access to scarce resource such as technology, people and suppliers. Large projects also provide better long term optionality.
- There is huge upside for big resource companies in infrastructure, services, knowledge sharing and co-operation between the big players.
- From now on new project decisions have become more risky because the first 4 years of cashflow determine project economics. Given high costs any price declines would really hurt project returns.
- The last time we had high energy prices, diversification strategies were a disaster so oil company managements (who lived thru the 70's experience), especially BP and Exxon, are very conscious of not repeating that mistake.
- It is virtually impossible for the US to wean themselves off Middle East oil as conservation and alternative fuels are too small a part of the total pie in the short term (next 20 years).
- Big resource companies vs. Big Oil ~ generally the large resource companies have longer resource lives; higher returns on capital; better control on costs because large oil is more susceptible to being captive to outside contractors; the oil industry has more regressive tax regimes; the energy supply chain is more difficult to manage.
- In the last 12 months there have been 22 PE bids in Europe and only 6 were successful.
- HSBC will make more out of China than Hong Kong in 12-15 years time.
- Corporate lending couldn't be better, it can only get worse. Incumbent banks are doing comparatively well in UK with little inroad being made by new entrants. ING entered with an aggressive pricing strategy but have now pulled back from discounting. They are now more focused on making money. In addition the regulator has cemented the incumbent's position and made it more difficult for new entrants; there has been quite a big change in consumer attitudes with regard to social responsibility to repaying loans. Younger Brits are less concerned with the stigma of being a bankrupt.
- Large consumer good companies are saying that the TV medium is less effective at the margin as teenagers don't watch as much TV. They will gradually redeploy advertising toward non media like in store, direct mail and internet advertising.

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Asian Visit ~ highlighted 3 key points

- 1) Australia's banking sector continues to grow faster than most e.g. Hong Kong's banking growing at 6% p.a. vs. 14% in Australia
- 2) Asian household borrowers and regulators are more cautious than Australians which is reflected in their lower gearing levels
- 3) Wealth management is the key growth market in Asia. Furthermore, foreign wealth management companies (AIG, AXA and ManuLife) have been much more successful entering savings markets in Asia compared with foreign banks entering banking markets. The banks have needed to enter the market by taking minority interest positions in local banks e.g. ANZ and GE Money. Local customer loyalty makes greenfield operations difficult for foreign banks in consumer and SME banking.

BP statistical summary ([www.bp.com/statistical review](http://www.bp.com/statistical_review)) ~

- Over the past 12 months energy has experienced above average growth in world consumption despite higher prices. Oil and gas reserves were unchanged and remain above 40 years for oil and 60 years for gas.
- Energy consumption continues to move away from the OECD countries and becoming more carbon intensive.
- China is now 15% of world energy consumption. China accounted for 70% of global growth in coal demand. China's coal consumption growth was 8.7% in 2006 down from double digit growth rates.
- The USA reduced energy consumption by 1% (mainly coal and oil).
- Russian gas grew by 7% and represents about the same as the Asia Pac region in terms of demand.
- OECD accounted for most of the increase in nuclear.
- Renewables grew at 25% but is still heavily government subsidized and represents less than 1% of world electricity production.
- Over the last 25 years US refineries have fallen by 50% in number. Due to upgrades in capacity the overall capacity has only fallen 10%. Over same period gasoline consumption is up 45%. The increased attention on promoting alternative fuels e.g. ethanol is a disincentive for refiners to build more capacity.

Australian energy ~ Australia needs to add 8,000MW to the installed base of 40,000 MW by 2015. Currently 85% of our power is supplied by coal fired power stations, whereas gas and renewables will supply the growth. Recent electricity price volatility has highlighted the benefit of the integrated model. The retailer industry has become a 3 player market with Origin, AGL and TRU being the only big integrated players that can handle the volatility and cost of hedging.

China ~ On current forecasts the absolute working population of China begins to shrink from 2015 when it reaches a peak of 1 billion workers. Will China grow old before it grows rich? China's factories are experiencing high worker turnover as workers look to upgrade their jobs and living conditions. Wage inflation is running 3-5%. Yue Yuen, one of the worlds largest OEM sports wear manufacturers, has experienced falling selling prices of 3% pa (1998 – 2003) but increasing prices in 2004 (+3%), 2005 (+4%) 2006 (+5%). They are expecting a flat outcome in 2007. Yue Yuen are diversifying to Vietnam and Indonesia where manufacturing costs are 30% less with lower staff turnover. The next phase of the Chinese economy is the rise of the domestic consumer which will make the world less reliant on the US consumer. The Chinese consumer will look to buy local brands as well as being attracted to the premium foreign brands (Chanel, Heineken, Kentucky

Fried Chicken and Porsche).

Agriculture ~ 90% of water is consumed by agriculture or industry, not by households. The cost in Australia of a desalination plant needs \$3/kilolitre vs. current prices of 20c to be economic.

Modigliani-Miller Theorem ~ in an efficient market the value of a firm is unaffected by how the firm is financed i.e. the asset value reflects its debt carrying capacity and tax advantages from structuring e.g. Coles and Sydney house land prices. Even with the benefit of leverage and their tax advantaged position as foreign tax payers (which means that they do not have to pay capital gains tax) private equity firms could not make Coles stack up at \$17.

Bank lending practices ~ Some banks are doing leveraged finance lending at 10% p.a. interest rates with light covenants and/or on a non recourse basis. This means the equity investors gets all of the upside and the bank gets 10% p.a. if all goes well. If the project goes badly the bank gets between 0 and their loan amount back. Lending at low interest rates into highly leveraged structures with downside and no upside does not make sense to us. We also believe a lot of banking deals are being driven by short term kpi's and bonus structures to banking executives that don't include enough long term risk kpi's.

Listed equity capital markets ~ We take heart that there is a role for listed equity markets given the decision by large PE firms to list themselves e.g. Blackstone and KKR (indicative intent at this stage). Although this may say more about their exit strategies and the liquidity and value on offer in equity markets.

Environment and Climate Change ~ There are 43 bills going through congress at present; Euro carbon prices are down 70% because they issued or grandfathered too many credits to incumbents; USA sulphur abatement credits have gone from US\$1600/t to US\$450/t due to the switch to natural gas by the power sector. Sugar prices are below the theoretical 12c required to make ethanol fuel economically. Globally coal fired power is still the fastest (volume basis) growing electricity source.

Risks ranks ~ 1) Global diseases not terrorism e.g. malaria is endemic in 106 nations affecting 500m and a million people die p.a. 2) Regulation not debt.

Absolute vs. relative ~ In considering the importance of comparisons consider what is more important (the absolute or the relative answer) in the following questions:

- 1) On grand final day your football teams score vs. the opposition team's score?
- 2) Your pay vs. your peer group?
- 3) In a commodity business your position on the cost curve?
- 4) The height of a plant seeking sunlight in the forest?
- 5) Your insurance company's exposure to a catastrophic event like S11?

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Competitive advantage is derived from the relativity between you and the competitor assuming you survive. CI's VoF investment framework is about understanding the comparative positions, performance and optionality of companies. We look at value compared with other investment opportunities including low risk fixed interest investments like government bonds.

Corporate governance ~ We disagree with the claims by some that the likes of QBE, Macquarie Bank, Westfield and Wesfarmers do not meet best practice because their boards/Chairman don't have sufficient independence. We believe these are excellent boards of world class companies. They are experienced in their respective industries; board members have excellent business acumen; the board understands the management; they have significant invested capital in the companies they are overseeing. We prefer substance over prescriptive formulae.

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