

CI AUSTRALIAN EQUITIES FUND QUARTERLY REPORT



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

JUNE 2008

"Not everything that can be counted counts, not everything that counts can be counted" Einstein

"To every human problem there is an easy solution that is neat, plausible and wrong" HL Menchen

"As I grow older, I pay less attention to what men say. I just watch what they do". Andrew Carnegie

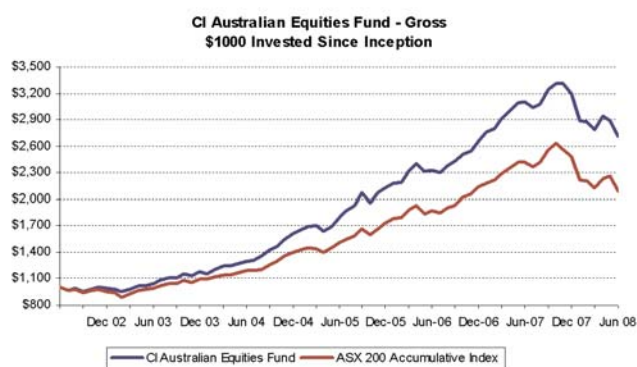
PORTFOLIO PERFORMANCE

	PORTFOLIO	BENCHMARK	VALUE ADDED
ROLLING 3 MONTHS	-2.57%	-1.79%	-0.78%
2008*	-12.68%	-13.40%	0.72%
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#	18.10%	13.09%	5.01%
SINCE INCEPTION^	171.07%	109.00%	62.07%

* 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 4 July 2002)



After a tough first quarter of the calendar year the market continued to give ground in the second quarter, the ASX200 Accumulation Index falling a further 1.8%, to be down by 13.4% over the financial year. This single number however masked a massive disparity in performance between the top and bottom performing sectors. Over both the last quarter and the full financial year the best returning sectors were energy (+34% and +35% respectively) and materials (+11.9% and +18.1%) while the bottom ranked sectors were consumer discretionary (-22.5% and -43.2%), property trusts (-17.2% and -40.3%) and financials (-10.1% and -33.5%). Not surprisingly the top performing stocks over the twelve months comprised in the main small cap coal, iron ore and gas companies while those occupying the other end of the ladder included property and geared financial/infrastructure type companies.

The portfolio's performance in the last quarter was disappointing. While our holdings in materials and energy related companies (Oilsearch, BHP, RIO and Worley) did well, we were less well served by Transurban (cut of dividend pay out), Transfield Services (earnings downgrade due to extra costs unable to be passed on to customers and currency), Tattersalls (gaming license regulatory change) and Lend Lease (property downturn).

Sector performance in Australia over the last twelve months was mirrored in the USA. Of note however is the out-performance of bonds (+13%) over the S&P500 (-13%) as both the 10 year and the 30 year bond yields fell, in contrast to the Australian 10 year bond yield which rose marginally while the cash rate rose by 1%.

Merger and acquisition activity continued across a broad range of sectors throughout the year (Macquarie Media/Southern Cross, Adelaide Bank/Bendigo Bank, Wesfarmers/Coles, Oxiana/Zinifex, Lihir/Equigold, Westpac/St George plus offshore bidders for domestic assets – Xstrata/Jubilee Mines, Brookfield/Multiplex, BG/Origin) but acquisition currency was mostly scrip based rather than cash as availability of the latter tightened up considerably as the year progressed. In light of tougher economic and financial conditions which we believe will endure for a while yet, it is inevitable further such activity will take place and opportunities will finally come to light for those companies which are patient and have the balance sheet to take advantage of the situation.

We have for some time found it difficult to unearth companies which elicit all three of the factors for which we search – value latency, positive industry and operational trends, and strong management focus. Now a large number of stocks in the industrial sectors have been sold down dramatically - but are they cheap on the basis solely of lower price earnings ratios than we have experienced in the recent past? The answer is probably yes if we assume margins remain unchanged. However we are believers in mean reversion for margins/returns, particularly now that a number of sectors are experiencing cost and/or revenue pressures for the first time in many years. Over the last six years earnings for ASX200 firms have risen at 18% p.a. which has driven a rise in return on equity from 13% to 20% in an environment of low and stable inflation and low interest rates. If you do not believe returns of this nature are sustainable now the environment has changed, then stocks are perhaps not as "cheap" as would seem the case at face value.

VoF OBSERVATIONS ~ INDUSTRY TRENDS & BEHAVIOUR

"It is dangerous to be right when the government is wrong" Voltaire

"The average age of power transformers in service is 40 years, which also happens to be the average lifespan of this equipment. Combine the crying need for maintenance with a shrinking workforce, and we may find that the 2005 blackout that affected parts of Canada and Northeastern United States might have been a dress rehearsal for what's to come. Deregulation and restructuring of the industry created downward pressure on recruitment, training and maintenance and the bill is now coming due". Edwin Hill, President of the International Brotherhood of Electric Workers.

Inflation is now centre stage again globally, for the first time in twenty years. In the face of rising oil and commodity prices, the ongoing attention on inflation fighting from mandated Central Banks in the Western world has not been sufficient to avoid the risk of the first serious bout of inflation in two decades or more. Global inflation is running at 5.5%, the highest figure since 1999. Lower but rising in developed economies, the numbers in some of the developing economies are truly scary – Indonesia 7.6%, China and India 8-

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10%, Russia 14%, Argentina 20%. "Two thirds of the world's population will probably suffer double digit inflation this year"¹. Negative real interest rates prevail as emerging markets have used price controls and subsidies to control prices of essential items and the Federal Reserve has reduced interest rates to avoid a financial implosion. Wages are starting to reflect the trend established in prices – in Russia they are rising at 20%+ p.a., in Indonesia the government has just allowed a 17.5% salary increase to public servants to reflect a cost of living allowance. Governments are bowing to the inevitable – in Indonesia the price of petrol was raised by a third in May, in India and China the same is happening. The cost of food and fuel subsidies in these economies is now too high for governments to bear despite the obvious political ramifications of reduced subsidies.

The engines of emerging Asia which helped drive down inflation for twenty years – cheap labour, cheap energy, cheap currencies, cheap money – now face more difficult times. Winners in the new environment will be businesses which can pass on price, those operating in essential services, every day needs businesses and essential input industries. Losers will be those sectors which are dependent on lower cost of money – retail/discretionary expenditure and finance dependent industries.

In Australia consumers are facing their most troublesome environment for many a year. Stock prices have dropped, house price increases have stabilized and prices have in fact dropped in many areas, rental rates have risen, interest rates have risen dramatically and bank terms have become tougher. Petrol prices are up and food prices are trending in the same direction. Consumer confidence is very poor. In the short term these trends look unlikely to change direction. Thus companies are facing top line pressure. In addition costs are rising. Wages, while still in control, are under pressure. Input costs (fuel, materials) are rising. Profit margins, which are at record highs, are coming under pressure.

There is another more insidious trend we have observed in the last six months – one which unfortunately is more distasteful and risks Australia, from a governance perspective, looking like a third world entity, namely government intervention/regulation which is unnecessary, ill thought out with no rational economic basis or merely the revocation of prior promises or imposition of new taxes. The lengthy list to date is as follows:

- Termination of the agreement with the OPEL telco consortium
- Medicare rebate changes in the 2008 budget
- WA mandating of gas for domestic use
- Queensland coal royalty tax increase
- Victorian gaming license regime change
- Fuel Watch scheme
- Supermarket review
- Maintenance of the Four Pillars banking policy
- WA decision re Pilbara rail access
- Revocation of North West Shelf rebate
- Alcohol tax on alcopops

The regulatory risk inherent in investing in companies in any sector would seem to have risen substantially in recent times. Further areas of risk include Telstra and the fibre to the node project, changes to the funding regime for

pathology and radiology, and futile industry assistance (e.g. auto).

We have written in previous reports of the necessity for infrastructure spending around the world. This is a theme which will continue for some time yet driven by growth and urbanization in emerging economies (China, India), the need to improve old infrastructure (Eastern Europe), the need to maintain competitiveness in a context of rapid globalization (Panama Canal) and the need to renew/replace old infrastructure in the West (USA bridges, French and UK blackouts).² However the financing of infrastructure projects has been thrown into temporary disarray by the current credit crisis. Banks are unable to lend to the same degree, private equity has gone quiet and the listed sector is de-leveraging rather taking on more debt. Structures put in place by the likes of Macquarie and Babcock & Brown no longer resonate with investors. Government is the final alternative – in Australia there is to be a \$20B fund set up, in the USA government spending on roads continues. But there is a growing gap between projected worldwide infrastructure requirements and public funding capacities.³

The sheer \$ amount required to be spent on infrastructure is mind boggling. The USA today spends 1-2% of GDP on infrastructure, India spends 5% and China 9%. But the world's population is set to increase from 6.5B today to 9B in 40 years – all of whom will require transport, medical and many other facilities. It has been estimated⁴ that, in the period 2000-2030, \$38.5TR will be spent by OECD and BRIC nations on road, rail, electricity and water. Today the World Bank estimates that governments and public utilities account for 70% of global infrastructure spending, the private sector accounts for 22% and official development assistance the balance of 8%. It is inevitable that governments will increasingly utilize the private sector to help with the funding of infrastructure requirements. This will require the involvement of areas where there are large pools of savings – Middle East and Asia – the sources of funds we have seen already in the bail outs to date of US investment banks. In the medium term opportunities will exist for service providers to infrastructure owners, but also for traditional owner operator companies geared correctly and prepared to make a reasonable long term return on investment. Given that a large proportion of the investment will be in emerging economies, this will necessitate reform of their regulatory systems – historically a tortuous process.

How damaging is the current oil price? A study by Deutsche Bank, using the previous historical high in the early 1980s, shows that inflation adjusted the equivalent oil price today is \$118/b. Adjusting further for income growth the price today would be \$134/b, and for energy spend to comprise the same share of disposable income it would be \$145. Perhaps it is not so surprising then that the high oil price on its own was insufficient to cause the consumer too much of a headache in the short term – rather the prolongation of high prices we are seeing now, and additional factors of higher interest rates and falling housing and equity markets, are now having an impact on consumers in Western economies. The question of course is how long will the oil price stay at these levels, or will it continue to go even higher? There is no doubt that it does not suit the Middle East producers to maintain such high oil prices for long periods due to the risk of substitution and the risk to the economies of the main buyers of oil. The unanswerable question is whether they are able to increase, or even maintain, production to ensure that what the world fears is a supply problem does not eventuate. Globally world oil production fell by 0.2% in 2007, the first decline in five years, while demand continued to grow. Coal to liquids (technology), Canadian oil sands (expensive, requires gas, emissions issues) and biofuels (raises food prices) would not seem in the short term to be the answers to the problem. Geo-political issues (Iran) are

¹ Potash Corp

² Pierre Lortie – OECD forum on Climate Change, Growth and Stability June 2008

³ OECD Report – Infrastructure to 2030: Telecom, Land Transport, Water and Electricity

⁴ Ernst & Young report - Infrastructure 2007

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unlikely to recede in the short term. A global recession may be the only immediate solution to the problem!

The emphasis of the manufacturing world over the last twenty years has been to shift capacity from high cost (Western) regions to lower cost areas (China in the main). We query whether that game is now playing itself out. Costs in China have started to rise, as has the Chinese currency. In addition, but much less heralded as a reason for the fading of this trend, is the rise in global shipping costs. The Baltic Dry Index (measure of shipping rates), having plummeted in January 2008, recently hit all time highs driven by record volumes of Chinese imports of iron ore and coal. Exacerbating the problem is the credit crisis, raising borrowing costs and limiting the availability of credit for the financing of new ships. This, and shortage of parts such as engines and generators, raise the risk of delays in new ships coming on line. Already production capacity has moved back to onshore USA in items such as heaters appliance motors and steel pans. The current weak USD and high transport costs make domestic manufacturers competitive for the first time in many years.

We are not yet buyers of the banking sector as the consumer slowdown has further to go, companies face increased cost and revenue pressures and asset prices do not yet fully reflect the second order effects of the credit crisis. Banking sector profits will therefore be under pressure as loan growth stalls and bad debts rise. We believe core banking return on equity will fall from 20%. However in the medium term the competitive position of banks has been strengthened by the current environment – consolidation is occurring (Westpac – RAMS and St George, Adelaide Bank – Bendigo Bank) and non bank players (Challenger, Macquarie) have withdrawn from the game. The model of disintermediation is reverting back towards traditional banking and deposit taking which will favour the traditional banking entities.

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