CI AUSTRALIAN EQUITIES FUND
QUARTERLY REPORT

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

MARCH 2006

"Believe nothing, no matter where you read it, or who said it, even if I have said it, unless it agrees with your own reason and your own common sense". Guatama Buddha

"The real message of the Weather Makers is not that global warming is real… the point that he (Tim Flannery) drives home is that it is an issue that we must address today if we are going to avert cataclysmic changes that could affect us all by 2050. He points out that 70% of all people alive today will still be alive in 2050. "Paul Anderson, CEO and Chairman Duke Energy, former MD BHP Billiton Ltd

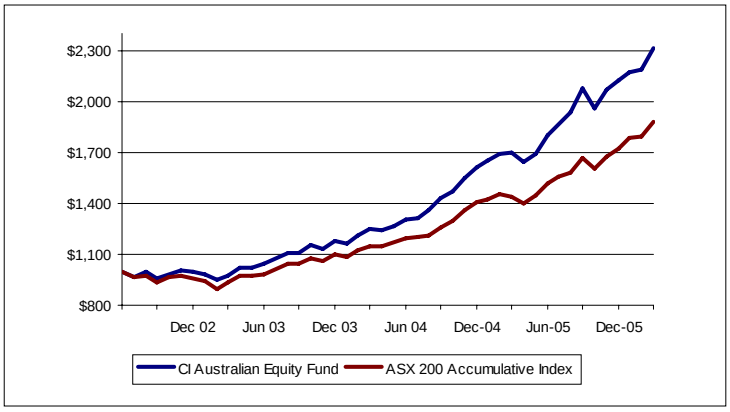
"A principle cannot be compromised but only adhered to or surrendered. Honesty is abandoned as much by theft of a dime as of a dollar." Leonard E. Read (1898-1983)

"Pessimists about China have been wrong for 25 years" Ambassador Roy, Former US Ambassador to China

PORTFOLIO PERFORMANCE

	PORTFOLIO	BENCHMARK	VALUE ADDED
ROLLING 3 MONTHS	9.09%	9.03%	0.06%
ROLLING 6 MONTHS	11.50%	12.91%	-1.41%
ROLLING 1 YEAR	36.32%	30.35%	5.97%
ROLLING 2 YEARS	36.42%	27.99%	8.43%
ROLLING 3 YEARS	33.39%	26.42%	6.97%
SINCE INCEPTION*	25.19%	18.38%	6.81%
SINCE INCEPTION^	131.70%	87.97%	43.73%

* Annualised
^ Cumulative (4 July 2002)



The portfolio retuned 9.09% out performing the benchmark in the March '06 quarter. Strong contributors to the portfolio included BHP, RIO, CSL, Futuris, Promina, AXA and ANZ. Poor contributors include Healthscope, Toll and Macquarie Bank.

Healthscope have experienced acquisition indigestion with the Gribbles Pathology business. We believe that the hospital division remains the key value driver as it represents over 70% of the earnings of Healthscope and is performing well. The “for profit” private hospital industry has an excellent structure as it is dominated by 2 players (Ramsay and Healthsope).

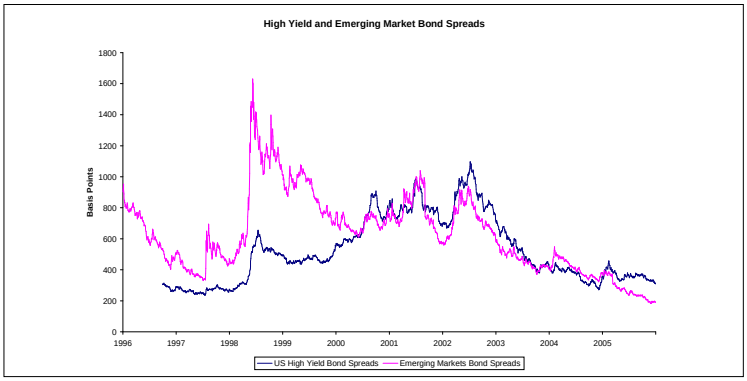
In the case of Toll, the hostile takeover offer for Patrick's has caused an impatient market to be concerned with the potential for increased competition in the integrated logistics industry should Patrick join up with Linfox to compete with Toll. In addition, the Patrick proposal to break up the Pacific National asset jointly owned with Toll is a terrible development for all shareholders as it would fragment the private rail industry at a time when they should be focusing on taking market share from road based transporters. Putting Toll and Patricks together would create a world class business. We share and support Toll's vision for a truly integrated logistics model. We also believe that Toll have the management capability to execute the strategy and it is difficult to identify any other companies in Australia that have Toll's credentials in delivering integrated transport solutions. Using our criteria of return on equity; net profit, growth, cash flow growth, eps growth, management focus and long term share price appreciation, Toll has outperformed the stock market, the transport sector and Patricks.

The Macquarie Bank share price suffered with rising US and global interest rates and talk of discontent amongst the Macquarie Infrastructure Fund unitholders over the share price performance and fees. Macquarie has allayed some fears recently with their proposal to spin off mature assets in the fund.

Over the quarter the gold price continued to rise approaching US$600/oz; US bond yields moved up (4.3% to 4.8%); small resources were the best stock performers; and M&A activity accelerated. The CI risk meter reads "good times are here". In the last quarter, 7 of the top 10 performing stocks in the ASX 200 were small resource stocks. The best performer, Paladin Resources, returned 154% in the 3 months to 31st March 06. With uranium projects across Australia, Namibia, Malawi and a market cap of $2.4b we could be mistaken calling Paladin Resources a small cap.

The fund has been a beneficiary of M&A activity with our investment in AGL but we missed out on "Magnificent Monday" (20th March '06), which saw a trifecta of mergers in one day - Unitab/Tatts; Transpacific/Waste Management NZ; and ASX/SFE.

Leveraged listed property trusts and infrastructure stocks continue to struggle against stronger equity returns and rising bond rates. Listed property has returned 19% p.a. over the last 3 years compared to the Australian Equity market which has returned 26%. The interest rate sensitivity of infrastructure remains an issue in rising bond environments which could see the borrowing spreads increase on top of the rising risk free rates. We don't believe that high yield means low risk. A 1% change in real interest rates typically leads to 10%-15% decline in net present value and that is before a likely rise in equity risk premiums that typically accompany rising interest rate environments.



Source: Factset

The impact of rising interest rates needs to be watched carefully because historically a US inverted yield curve leads to a profit slowdown or recession with a 2-8 quarter lag time.

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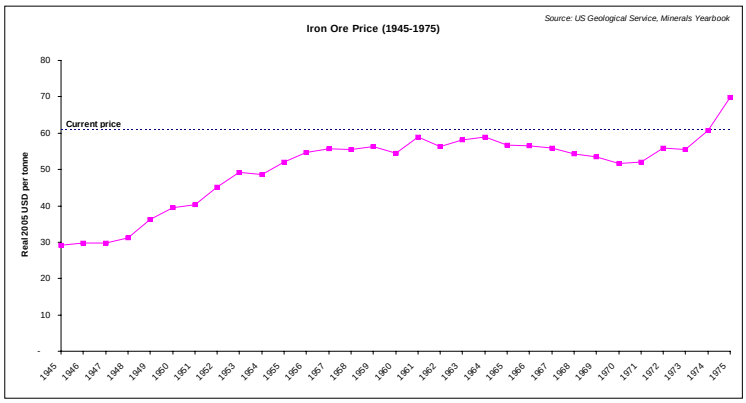
OBSERVATIONS AND INSIGHTS

"Enron stands on the foundation of its vision and values. Every employee is educated about the Company's vision and values and is expected to conduct business with other employees, partners, contractors, suppliers, vendors and customers keeping in mind respect, integrity, communication and excellence. Everything we do evolves from Enron's vision and values statement." Extract from Enron's Code of Ethics Guide

"Nothing will carry on as swimmingly as it has. It is illogical to assume things could continue as they have been, but from so lofty a level as to be almost unbelievable." Stephen Schwarzman Chairman of Blackstone Private Equity

"Make everything as simple as possible, but no simpler." Albert Einstein

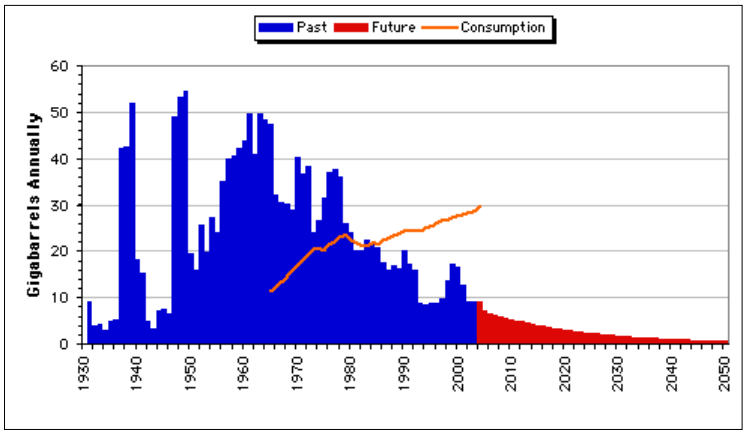
Resource Sector ~ the graph below illustrates that commodities can experience long periods of above normal prices. The period 1945-75 was such a period where prices broadly trended up to higher prices than we are seeing in today's environment. The discounted cash flows of producing resource companies with large in the ground reserves and resources (BHP, RIO and Woodside) appreciate considerably if one assumes a repeat of the post WWII pricing experience. Woodside Petroleum for example, has 1000m bands of oil reserves and 2400m barrels of oil equivalent in contingent resources. At US$65/bbl that is an in situ value of US$221b. Recently Chip Goodyear was quoted as saying that greenfield projects take 8-10 years to bring to market compared to 5 years previously due to environmental concerns and supply chain constraints. However, there are lots of examples of capital expenditure plans that are responding to the better price environment e.g. notwithstanding the greenhouse gas issue, coal is a beneficiary of higher energy prices in a world that will see the use of energy rise by 70% by 2030 and treble over the next 100 years. New coal fired power stations are being commissioned at the rate of 1 a week. 1400 new power plants are on the drawing boards to be built between now and 2030 of which 600 are in China. The International Energy Agency estimates that the Middle East will spend $89b on refining between 2004 and 2030. Environmental regulation and poor returns have constrained the desire of oil companies to build refineries in the US over the past 30 years.



Source: Factset

We remain positive on the energy sector (WPL, AGL, OSH, RIO, BHP). World production from existing oil fields of 85m bbl per day is forecast to decline by around 5% per annum so that by 2020 there is a 71m b/d deficiency between existing production and consumption that needs to be met by new discoveries and alternative fuels. China has an energy problem that needs to be solved through a broad set of options, not just one solution, which augurs well for all non oil based fuels (wind, coal, solar, hydro, nuclear, bio fuels). The difficulty with oil is that new discoveries have been falling for the last 20 years, you have to go back to the 1970's (25 years ago) before you can find a period when discoveries exceeded consumption.

Oil Discovery (3 year average - past and projected) 1930 - 2050



Source: Association for The Study of Peak Oil & Gas (ASPO)

We recently attended the ABARE commodities conference in Canberra. Australia's pre-eminent commodity forecasters are expecting commodity exports to rise by 7% to A$134b in 2006/7. Total winter crop in Australia for 2005/6 is estimated at 40.1m tones, the second highest on record. Exports of minerals and energy products account for 80% of the increase. There remains export opportunities to India given that India represents 5% of Australia's merchandise exports compared to China at 10%. China consumes 27% of the world steel and 34% of thermal coal but 4% of dairy products; 9% of sugar; 1% of wine and 7% of gold. In 2005 world sugar price doubled from US10c a pound to a high of 22c at the beginning of February. Commodity prices have been appreciating rapidly for the past two years, but until recently price appreciation has been restricted to oil, gas and base metals. Sugar though, can be refined into ethanol, and in sugar-rich Brazil, 70% of new small cars, and a significant portion of the existing fleet, are 'flex-fuel', able to run on either ethanol or gasoline, or any mix of the two. As a result, the sugar price has become linked to the oil price. What is most interesting to us though, is the effect of price movement in one commodity on other commodities. Delicate equilibriums exist in world markets for our most basic goods and sustained high prices in energy markets are breaking down long-held norms elsewhere. Oilseeds like canola may be used to produce bio diesel and EU production of bio diesel has increased twofold from 1.9 million tonnes in 2002 to 3.8 million tonnes last year. Like sugar, corn can also be refined into ethanol, and forms a large part of US agricultural output. The twin forces of renewable energy and energy security are driving US investment into corn-based ethanol production, for use as a fuel extender and octane enhancer. Eight new ethanol plants were built in 2005, and thirty more are planned or proposed for 2006. Moreover, ethanol production from corn removes starch from the grain, making the residual corn a more attractive feed for US livestock than unprocessed corn.

In Australia, where wheat is used in growing quantities for cattle feedlots, beef is currently enjoying a Japanese moratorium on US imports. High oil prices, by way of ethanol and corn to corn-fed beef, may eventually drive the cost-competitiveness of Australian beef in Japan, and with it a large component of local demand for wheat. Incidentally, cotton and wool become more cost-competitive relative to oil dependent synthetic fabrics.

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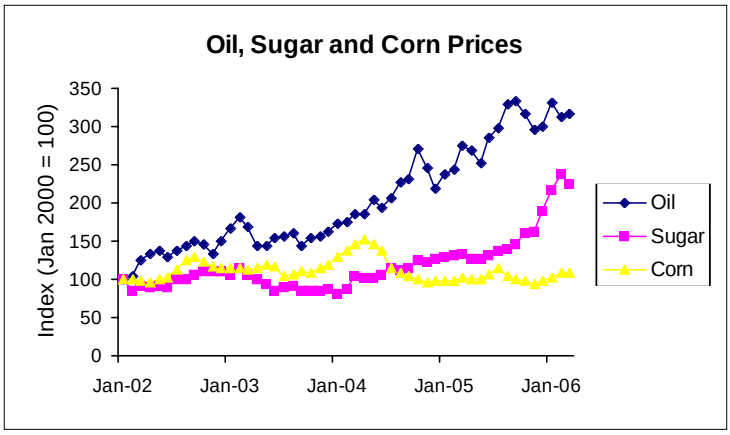

Source: Factset

The more general question of whether soft commodity prices (grains, meat, dairy etc) will follow metals and energy prices is exercising our minds also. Key drivers for base metals were historical underinvestment in productive capacity and rapid demand growth from Chinese industrialization, in particular the Chinese switch from net exporter to net importer. It is not obvious that these drivers apply to wheat, cotton, or sugar. Agricultural commodity supply is influenced by seasons rather than long term investment decisions, and decisions are dispersed amongst a large number of individual growers, rather than within large resource companies. On the demand side, emerging growth driven by the new Chinese and Indian middle classes is made harder to foresee because of differing diets. Beef may present opportunities, particularly if bird flu effects chicken meat sales the way mad-cow disease affected beef sales. There is evidence that there is some switching from rice to wheat based diets (and protein) in India and China. AWB recently has made new sales to both these countries.

With constraints on land and water availability in developing countries like China and India, science & technology will play a big part in improving crop yields. GM foods are already significantly improving yields and reducing the affect of pestilence. The production of artificial sweeteners through advanced chemistry as an alternative to natural sugars is another example of science impacting food production. One note of caution for those expecting a big increase in food demand in China - there are few hungry people in China. Composition changes will be the big driver of change rather than overall quantum increases.

Unfortunately many of the agri-stocks in Australia have poor organizational and governance structures. AWB is potentially an interesting stock that has fallen from $6.30 to $3.90 due to the Cole inquiry into whether AWB has broken the law and talk of single desk reviews. The Australian Wheat Board was created during World War 1 in 1915. Today AWB is a company with $9b revenue, 2700 employees, 100,000 customers, shareholder funds of $1b and net profit in 2005 of $157m. We ask ourselves the following questions:

- Has AWB broken the law? Who's law?
- What are the positives and opportunities that can come out of the Cole inquiry? What are the costs of an adverse finding?
- Does the AWB management have the talent, clarity, vision and passion to go after the opportunity?
- How can directors operating under the A and B class share structure deliver benefits to all shareholders?

Telecommunications sectors ~ Telstra and incumbent telecoms face a threat to their broadband strategies from WiMax. WiMax is an acronym that stands for Worldwide Interoperability for Microwave Access. Wimax is a standards-based technology that enables the delivery of last mile wireless broadband access as an alternative to cable and DSL. WiMax will provide fixed, nomadic, portable, and eventually, mobile wireless broadband connectivity without the need for direct line-of-sight to a base station, at equivalent data speeds to DSL. The benefits of WiMax are its mobility; its relatively cheap network cost. For example, Unwired has rolled out pre-WiMax technology in Sydney for just A$32m, Austar is to rollout WiMax to 500,000 regional homes for A$50m. In contrast, the cost of Telstra rolling out Cable to the bush has been recently estimated at A$7b by the National Party (and that it is a globally certified standard). The global certification should not only create global economies of scale, which it is hoped will mean a fast take-up of the technology, it has also allowed Intel and other manufacturers to design WiMAX compatibility into their products, which will make WiMAX an easy to use network for consumers. The WiMax standard is based around two different sections of radio spectrum. In Australia these two sections are owned by Austar (regionally), and Unwired (in the cities). It is possible to run WiMAX on unlicensed higher bandwidth; however the potential lack of exclusivity makes commercialising this spectrum risky for potential competitors.

Mckinsey recently released a study on the return on invested capital (ROIC) performance of 7000 listed US entities from 1963 to 2004. The findings were a good reminder of the fact that DCF valuation models are dependent upon margin assumptions that are volatile due to changes in economic conditions and/or business performance. Paying for a cash flow stream based on cyclically high margins is completely different to paying for cyclically low profit streams. Key points of the Mckinsey study:

- There is significant variance between industry performance e.g. from 1963 to 2004 pharmaceuticals averaged 23% ROIC whereas utilities averaged 10%
- There are big differences between the top & bottom quartiles within an industry e.g. the top quartile in media delivered 30% ROIC vs. 7% for the bottom quartile
- Through time performance varied substantially e.g. the top quartile of companies for all industry participants ROIC varied from 20% to 10% with an average ROIC of 15.7%.

New Listings ~ with the listing of Dyno the majority of the worlds listed explosives players will be Australian domiciled. The global commercial explosives industry is around US$6-8b of which North America is around US$1.6-$2b and Australia is around US$600m. Strong end user demand in metals and coal mining indicate 6%-8% growth in Australia, Asia, and Latin America for the medium term and 2%-4% for North America. The combined market share of Orica and Dyno in the Australian market is over 95% and around 70% in North America. Increasing technological and regulatory demands such as low maximum quantities to travel in a single shipment are driving consolidation in the industry and increasing benefits to integrated players such as Orica and Dyno. The reason we like both Orica and Dyno is that the listing of Dyno will give the industry real market disciplines and transparency; a two player industry has no need for unhealthy price competition; both have strong management; the first response of a miner to a down turn is to produce more volume; margin expansion in these companies has not been as steep as some of the miners and therefore margin contraction risk should be smaller; the cost of ammonia nitrate is 5 % of the cost of mining but influences 40% of total mine cost.

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