

CI AUSTRALIAN EQUITIES FUND QUARTERLY REPORT



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

MARCH 2007

"Commitment is what transforms a promise into reality" Abraham Lincoln

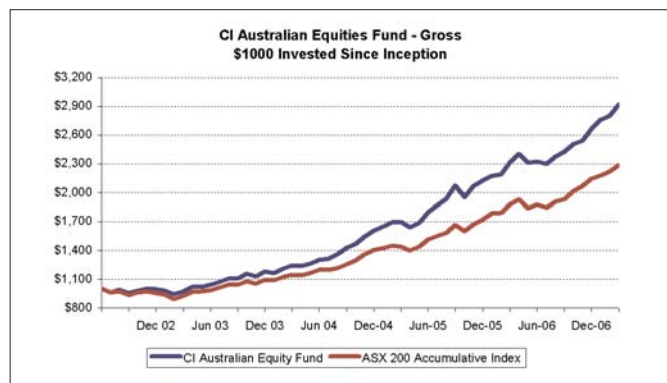
"There is genius in persistence. It conquers all opposers. It gives confidence. It annihilates obstacles. Everyone believes in a determined man. People know that when he undertakes a thing the battle is half won, for his rule is to accomplish whatever he sets out to do" Orison Swett Marden

"Those who have knowledge, don't predict. Those who predict, don't have knowledge" Lao Tzu, sixth century Chinese poet

PORTFOLIO PERFORMANCE

	PORTFOLIO	BENCHMARK	VALUE ADDED
1 MONTH	4.33%	3.29%	1.03%
ROLLING 3 MONTHS	9.61%	6.89%	2.72%
ROLLING 6 MONTHS	20.31%	18.59%	1.73%
ROLLING 1 YEAR	26.05%	21.78%	4.27%
ROLLING 2 YEAR	31.11%	26.02%	5.10%
ROLLING 3 YEAR	32.88%	25.89%	6.99%
SINCE INCEPTION*	25.38%	19.09%	6.29%
SINCE INCEPTION^	192.06%	128.91%	63.15%

* Annualised
^ Cumulative (4 July 2002)



Since the end of December 2004 the ASX 200 has risen 63%. This last quarter was the ninth consecutive quarterly rise in the index, and the last six months has seen the market rise a stunning 18.5%. While the direction of the market may yet continue, we would be surprised to see ongoing moves of similar magnitude.

The portfolio returned 9.61% over the quarter. Amongst the better contributors to this performance were Tattersalls (re-rating of the company as new CEO Dick McLwain produced a better than expected result and the market becomes more comfortable that it will retain its Victorian gaming licence), Worley (a very strong first half result and the announcement of the acquisition of Colt, a design and project services company operating predominantly in the hydrocarbons area with exposure to the growing Canadian oil sands industry), and Bendigo Bank (received a takeover offer from Bank of Queensland at a 25% premium late in the quarter).

Underperformers included CSR, Energy Developments (delay and 10% cost overrun in its West Kimberley development led to an earnings downgrade) and AXA (cooling off post a period of strong share price performance). In

addition, Telstra continued its stellar run since the listing of T3. Investors are starting to believe that the 28 cent dividend may not be cut next year. Furthermore, the Labor Party's announcement of a fibre roll out plan in conjunction with a group of second tier telcos looks increasingly likely to drive the Government back to Telstra as a means of gaining the political upper hand on this issue pre the election due in 5 months time.

The takeover fervour surrounding Coles Myer post the company's announcement that it would not reach its profit targets set only six months ago, meant that the share price rose 16% over the quarter, and 51% over the last twelve months. This despite increasingly poor operational performance. Of interest is that the sector leader Woolworths rose 13.8% and 44% over the respective periods – evidence that well managed companies can provide equivalent returns to those subject to takeover without the potential heartache!

Also of note during the quarter was the large differential in performance between RIO (+6%) and BHP (+18%). The major contributor to this difference was most likely to have been the announcement by BHP that it would undertake a further USD\$10B of capital management initiatives over the course of the next 18 months. The first \$3B was completed during the quarter. We remain believers in the "stronger for longer" scenario and thus have retained our BHP holding in the portfolio post the buy back, and have taken the opportunity to add to our position in RIO. In the short term, global economic growth is expected to remain solid led by China, Japan and Europe. As demand for commodities in this environment continues to be robust, and inventories remain relatively low, commodity prices are expected to stay above long term trend. Whilst we acknowledge that in the medium to long term, prices must revert to their economically justified level as capacity is expanded to meet demand (global exploration expenditure has risen from USD\$2B in 2002 to USD\$7B in 2006), we also believe that it will take some time for this adjustment to occur. It is inevitable that trend prices have been set at structurally higher levels due to recent industry cost inflation.

According to Vivek Tulpule, RIO chief economist, it has historically taken five years for iron ore prices, and less than three years for copper and aluminium prices, to return to trend once a peak has been reached. However in the current cycle, "production and capacity growth is being hindered by the availability of inputs, engineering resources are being stretched, suppliers' production lines are also being tested, leading to quality issues and the cost of construction materials have increased.....since 2003 the price of structural steel has risen by 60%, the price of piping has nearly doubled and electrical equipment has risen by about 25%....".

Private Equity (PE) has continued to make waves in our market, driven by low interest rates and low spreads. Deals have been done or proposed in a wide ranging number of sectors – media (Channel 7 and PBL), transport (Qantas), retail (Coles Myer, Flight Centre, Colorado, Rebel Sport) and waste (Cleanaway). We see the main risk to ongoing activity as being precisely these factors – the levels of gearing in PE deals required to produce a

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satisfactory return on equity means that a rise in either the level of rates or the spread will pose difficulties. We note the following points about PE:

- High levels of debt funding – we have heard of one large recent deal where the ebitda/interest coverage is 1.2-1.3X. Ideally the first 18-24 months of cash flow would go towards paying down debt thus making some breathing space. Clearly an upward move in interest rates or spreads of even 50 basis points would threaten this scenario.
- Does PE do more than work out what an asset could be worth in three years time after some surgery (eg. Myer, Coles), discount that value back to today and give current equity holders a slice of the upside? In other words, does this initiative amount to any more than pulling forward value?
- Should investors sell to PE? If we make the (admittedly bold) assumption that the majority of investors are industry /superannuation funds, and that the main exit mechanism for PE is ultimately refloating the asset on the market, then it is arguable that all the investor is doing is selling an asset to themselves (as they are also funders of PE acquirers) only to buy it back (from themselves) later at a higher price. In some cases the asset will be performing better (eg. Myer) but in a large number of cases better management is likely to have been able to produce a similar outcome without change of asset ownership. In other cases the recycled asset does not perform any better even with a change in management (eg. Repco) and so becomes a target for PE for a second time!
- PE activity in our market may yet continue for some time despite what seems to be a large number of deals being done, Australia is three to five years behind Europe and the USA. PE is involved in 18% of Australian merger and acquisition activity, compared to 37% in Europe (Deborah Tarrant, In The Black, Feb 2007)
- Buoyed by the success of the float of Fortress (the first US manager of PE and hedge funds to go public) in February, Blackstone looks like it will become the first PE group to list. Although PE is not the only profit generator for the firm (real estate, investment banking, and alternative asset management also contributed substantially to profit in 2006) it is intriguing that the principals are prepared to expose the PE operations and their own personal rewards to higher levels of scrutiny and public company regulation in an environment where there is increasing public angst towards wealth generation/remuneration practices at the upper management levels in corporates.

We have in previous reports made mention of the ongoing “westernization” of the Chinese population and its resulting impact on demand for commodities. But will it have a similar long term impact on the Chinese stock market? The Shanghai Composite Index trades at lofty multiples (some 30X forward earnings) but its composition has a bearing in that the top 3 companies account for 40% of the index – namely Bank of China, ICBC, Sinopec. No doubt Chinese exchanges will be deepened over coming years (note the plans of China Telecom and China Netcom to list, and the planned introduction of Chinese stock index futures by Shanghai’s new derivatives exchange). In addition, according to Huang Yiping (Citigroup chief Asian economist) the levels of Chinese savings (\$4TR) exceeds the market capitalizations of the Shanghai and Shenzhen exchanges combined (\$1.2TR). Add to this the ageing demographic (China will supposedly have 200m retirees in 2015, climbing to 400m in 2050) and the need for an investment return greater than the 2.5% available from cash is obvious.

INDUSTRY AND COMPANY VoF TREND OBSERVATIONS

*“Before the widespread adoption of the internal combustion engine at the beginning of the 20th century, and the subsequent growth of the petrochemical industry, agriculture was the primary source of raw materials for energy, food and a wide range of every day commodities”
Melvyn Askew, Central Science Laboratory, UK*

*“There’s this growing debate over food versus fuel, but we don’t see that as a problem at all. Quite frankly, when the value of the wheat in a loaf of bread is less than the advertising on the bag, then there’s something wrong. It’s not a food versus fuel issue - it’s a value issue. Food has been produced for too little of a profit margin for too long.”
Marty Ross, Director of United Soybean Board*

Infrastructure

According to Booz Allen Hamilton, global urban infrastructure will require spending of \$40TR on refurbishment, modernization and expansion in order to cope with demand. History shows years of neglect and under-spending by governments too concerned with budgets, finance and the politics of staying in power to look for long term, potentially costly solutions to the various infrastructure crises which have been witnessed around the world in both developed as well as third world countries. It is not being too alarmist to characterize a lot of major infrastructure today as “technologically outdated, woefully inadequate, increasingly fragile or all of the above”.¹ Drivers of ongoing demand for bigger and better critical urban infrastructure include a growing global population (projected to increase by 30% to 8 billion people in 2050), an increasingly mobile and global workforce, and competition for human and other forms of capital (which is likely to migrate to areas where there is sufficient supporting infrastructure). Note that in 2006 China expanded its power capacity by 102GW, more than double the existing installed capacity in Australia.

Water, power, transport, and social infrastructure are all on the hit list. The International Energy Agency’s World energy Outlook 2004 estimated that \$4TR in power sector infrastructure improvements will be needed in OECD countries over the next 30 years. In the USA the US Department of Transportation estimated in 2006 that freight bottlenecks and delayed deliveries due to congested highways and inefficient rail and deep water transportation systems cost the US \$200B annually.² It is estimated in Detroit that due to leakages from the system, residents pay \$23m each year for water which never reaches its destination.

In Australia water has assumed a prominent position in the infrastructure debate, predominantly due to the current drought. However the area which has caught our attention is power. Electricity spot prices are rising on the east Coast, including a spike to \$10,000/mwh during the hot spell in January. The forward price is also rising. In addition gas prices are showing a rising trend. The price in the newly created Victorian spot market has risen, and the cost of gas acquired by some resource companies on the West coast has doubled on recent contract expiries. There are a number of reasons why it is likely the price of electricity will rise at rates higher than CPI:

¹ Lights! Water! Motion! Viren Doshi, Gary Schulman, Daniel Gabaldon from Strategy & Business issue 46 Spring 2007

² As per 1 above

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- a) the reserve capacity in the National Electricity Market has reduced over the past few years and this has altered the supply/ demand dynamic in favour of the generators;
- b) the drought (low water levels) has limited the ability of hydro to generate and has also had an impact on the ability of the Tarong coal fired power station in Qld to run;
- c) it will take three years for dams to fill up even with reasonable rainfall;
- d) market participants are maturing and this is improving the market dynamic for generators;
- e) new entrant pricing has risen quite sharply over the past year because of the increase in plant costs (plus 25-30%) and the lack of confidence in being able to finish new projects on time and on budget;
- f) the price of electricity in Australia is the second lowest among OECD countries, only Greece has cheaper power. Electricity in the UK and USA is twice the price of Australia; and
- g) to date there has been virtually no linkage between international oil and gas prices and the price of gas in Australia. By contrast, in overseas markets the rise in oil price has led directly to a rise in gas price and which has in turn led to an increase in the price of electricity in both the wholesale and retail markets. There are early signs that linkages between international oil and gas prices and Australian gas prices are developing. Firstly some gas fired power stations are running at much higher levels than expected and the extra gas they are buying is at rising spot prices. Secondly the PNG gas that was expected to be piped into Australia at low prices is now likely to be developed at LNG at higher international prices.

The other main factor causing uncertainty for generators is the possible introduction of an emissions trading scheme, making it very difficult to commit to a large capex spend on generating plant, as well as implying uncertain outcomes for the electricity price. The price of electricity does not include an allowance for a carbon cost as yet. Therefore when a carbon cost is introduced the electricity price will have to rise to a level where a gas fired plant is economic. Assuming existing coal fired plants have some aspect of grandfathering they will make windfall profits until the point where the level of "free" credits reduces to say 70% of base line production. If credits can be sold internationally Australian producers will arbitrage between the Australian and overseas markets and therefore lift the electricity price closer to prices achieved in international markets.

There would seem little doubt that the Australian consumer will over time pay more for the electricity and gas consumed.

Global Opportunities

Fast growing companies in Australia rapidly run out of options in their home market and need to look offshore to continue their growth aspirations. But the opportunities available in overseas markets are huge. Very often these markets are fragmented, have had underinvestment or have legacy issues arising due to size and potential for disruption in the event of change, and thus Australian companies can bring to bear expertise in systems flexibility and innovation learnt at home.

In the USA road expenditure amounts to \$45B annually, of which 95% is done in the public sector. A number of States in the USA with large budget deficits are looking at selling off roads (toll roads). In the UK the NHS has the aim of moving the amount of surgery done in the private sector from

15% to 50% by 2009 – almost certainly unachievable but nevertheless indicative of the ongoing trend. Each of these offers opportunities for Australian companies operating the relevant sectors.

Food or Fuel

"Faced withshortages of basic foods like beef, chicken and milk Venezuela's president Hugo Chavez has threatened to jail grocery store owners.....if they violate the country's expanding price controls" (the New York Times, February 2007). India, the world's second largest producer of wheat and rice, last month banned trading in the two commodities to curb inflation – wheat prices in India have risen 20% since September. The prices of red beans, green peas and yellow lentils have soared. According to the BBC the price of onions has gone up five fold. China too must maintain a careful vigil on its food supplies in order to ensure social stability. According to the US Department of Agriculture, the area sown to wheat in China dropped 27% with a consequent decline of similar proportions in production. The same has occurred in rice production. In the USA the 5B gallons of ethanol produced in 2006 used nearly 20% of the corn crop. If all the ethanol plants under construction and planned go into operation, by 2008/9 this will increase to half the corn crop.

Climate change and shorter-term water shortages are one issue for Agricultural commodity prices have historically been affected in the main by climactic factors and shorter term water shortages. More latterly, with the rise in the oil price and the US requirement for energy security, the use of land for biofuel has become a major driver of increasing commodity prices. In Brazil, 77% of new cars now run on ethanol. In the USA President Bush has determined that 35 billion gallons of transport fuel must come from bio fuel, seven times more than is currently the case. Brazil can produce ethanol for 22c/l using sugar cane as the main input, compared to 30c/l using corn as the main input in USA. The USA raises a 54c/l tariff on imported ethanol yet does not have sufficient spare land to grow the necessary feedstock to meet the 35BI requirement.

Thus there is now for the first time real competition for crops – feeding a growing global population and expanding bio/alternative fuels in the face of a higher expected long term oil price. The supply of arable land will not change (if anything it may decrease as soil quality deteriorates, global warming takes effect and the developing world sees increased urbanisation and industrialization – right now the supply of arable land in China is falling at 1-2% pa) but how it is used will be different. Thus better yields and productivity will be essential, requiring increased use of technology and inputs. The nature of what is grown in different parts of the world will change. In the USA, close to 10m additional acres of corn are being planted for ethanol production. This is coming predominantly from the conversion of land previously used for soy, to the benefit of Brazil and Argentina, both major producers of soy. China, a big food importer, is attempting to change to become more of a processed food producer and may therefore use land for these types of foods (tomatoes, carrots) at the expense of soy/corn/broad acre. Thus other parts of the world will need to take up the slack in these products, most likely Eastern Europe.

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One effect of this global dynamic is the rise in price of agricultural land. According to Bloomberg news, the value of crop land in Indiana has increased 16% and in Idaho 35% in 2006, and similar appreciation has been seen in corn land in Argentina. In Australia we have witnessed a similar if not more marked phenomenon over the last 3-5 years. Agriculture funds such as Hancock AIG in Boston have been purchasing agricultural land in the last twelve months.

We may well be witnessing a once off change in farm economics as the price of corn takes a structural lurch higher. This in turn will lift prices for other crops and their resultant base products, and thereafter meat and poultry as the impact of increased input prices rolls through our system. Or this may be a temporary change as the use of corn for bio fuel is inefficient, and more environmentally friendly and higher yielding sources will become available - such as agricultural waste or cellulose from trees or switchgrass. Or the oil price may drop sharply bringing the trend towards biofuels to a halt. Perhaps the oil will become the pricing mechanism for farm products, forming a linkage between different commodities that has not been evident to date. One thing is for certain - in the near term, the world agricultural community will find it increasingly difficult to cope with feeding the world's 6.5B inhabitants.

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