

# CI AUSTRALIAN EQUITIES FUND QUARTERLY REPORT



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

MARCH 2008

*“Success is not final, failure is not fatal; it is the courage to continue that counts” Winston Churchill*

*“Truly, the most powerful thing in the world is the right decision, made at the right time” Sheikh Mohammed bin Rashid Al Maktoum, Ruler of Dubai*

*“Truth alone will endure; all the rest will be swept away before the tide of time” Mahatma Ghandi*

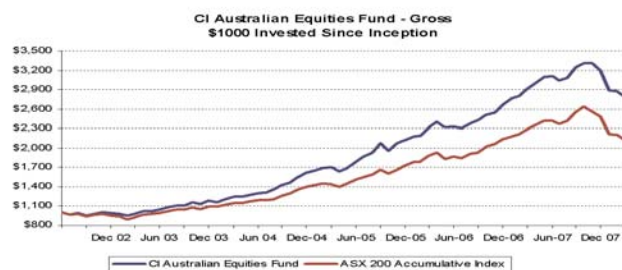
## PORTFOLIO PERFORMANCE

	PORTFOLIO	BENCHMARK	VALUE ADDED
ROLLING 3 MONTHS	-13.02%	-14.39%	1.37%
FYTD	-10.38%	-11.83%	1.45%
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 <sup>#</sup>	19.50%	14.05%	5.45%
SINCE INCEPTION <sup>^</sup>	178.22%	112.80%	65.42%

\* 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

<sup>^</sup> Cumulative gross returns (since 4 July 2002)



Finally the Australian stock market took a breather, the ASX 200 falling almost 15% over the quarter. Worst performers in the market were listed entities which were highly geared, opaque (structurally or operationally), finance or property related or retail focused. A mix of two or three of these characteristics (Allco, Rubicon, ABC Learning, Challenger) was explosive. The occasional negative earnings surprise (United Group, Suncorp) was harshly dealt with.

Within the portfolio, CI managed to avoid all the headline problem stocks (Allco, listed property trusts, Babcock & Brown, ABC Learning, MFS). Better performers for us included the companies with agricultural focus (Nufarm, Incitec Pivot) and healthcare oriented exposures (CSL, Ramsay, Healthscope). On the negative side, our modest performance was due in the main to underperformance from Worley (earnings holding up but overvalued), Energy Developments (continued disappointments operationally), QBE (earnings while strong did not meet market expectations) and AXA.

Needless to say the media, politicians and numerous others have been out in force, somewhat hysterically looking to ascribe a doomsday scenario to the “rout” we have seen in the market. We do not subscribe to this view. At the time of writing the market has bounced back some 5% in short order. And we need to put the fall into perspective. Over the twenty years to 31 December 2007 the All Ordinaries rose in sixteen years, and over the twenty years averaged a gain of 12%, and rose nine fold. This is against a supposed long run expectation held by most market participants of closer to 10% pa. True, we have seen falling interest rates and inflation over this period, both of which help the equities market. Nevertheless the fall in the index over the quarter

does seem a lot less significant in this light.

Arguably the index retreat is doing no more than bringing a dose of reality to the greed, over leverage, and unsustainable valuations witnessed in the preceding periods. The AFR on 1 April, in an article on the market performance and that of certain stocks in particular, commented that “Leverage offered appeal.....complex financial engineering was the feature – not always fully understood by investors, but grudgingly accepted given that it delivered equity outperformance.....in retrospect a better understanding would have helped avoid some costly mistakes.” For CI the equity market is not a game – we try to manage clients’ accumulated wealth with capital consciousness. Where we cannot understand companies or structures, or we are uncertain of management motives, we prefer not to participate – this can make us look foolish in the short and medium term but we believe will be in our clients’ best interests over a longer time frame.

The Reserve Bank has been trying to slow demand in Australia for some time now, as a result of which interest rates have risen consistently over the last two years. Finally there appears to be some light on the horizon. Glenn Stevens’ latest statement sees “tentative evidence that growth in domestic demand is moderating”. Credit demand has slowed and both business and consumer confidence have softened. This points to official interest rates being close to their peak. Our economy however, remains in good shape with high levels of employment and the resources strength ongoing. It would appear that our banks have escaped the worst of the US sub prime issues, although some of their domestic exposures may yet prove troublesome. Thus, although a slowing in growth is likely, we do not currently envisage serious problems of the nature being experienced in the USA. In this environment companies can still prosper if positioned, managed and structured correctly.

Given the problems around availability and pricing of debt, balance sheets which allow for flexibility should attract a premium. In this regard, the outcome of Wesfarmers \$4B debt refinancing will be interesting, and the balance sheets of Asciano, ABC Learning and Primary Healthcare are clearly stretched and in need of some repair. The extent of the issue in our market pales into insignificance compared to global investment bank balance sheet restructuring. To date banks globally have raised close to USD\$90B, led by UBS (\$25B), Citigroup (\$14B), Bank of America (\$13B), Merrill Lynch (\$12B) and the list goes on. Staggering amounts of money. And that does not include the bail out of Bear Stearns which, while according to the US Federal Reserve necessary to prevent financial market implosion, does nothing to deter future behavior of a similar risky nature and somewhat abhorrently asks the tax payer to fund the risk taking activities of a relatively few irresponsible individuals.

Corporate M&A activity will prove to be more difficult – private equity has, at least temporarily, been dealt out of the game and companies are having to use a large proportion of scrip to finance acquisitions (Premier for Just Group, Incitec Pivot for Dyno, Spotless for Program Maintenance Services, Lihir for Equinox). Where debt has been used asset disposals are being mandated by the banks in order to reduce gearing (Primary Healthcare/Symbion), and funding for new projects is coming in greater measure from equity (Iluka).

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## VoF OBSERVATIONS ~ INDUSTRY TRENDS & BEHAVIOUR

*“China’s scarcity will become the world’s scarcity” Lester Brown*

*“In truth, there is no such thing as a growth industry. There are only companies organized and operated to create and capitalize on growth opportunities. Industries that assume themselves to be riding some automatic growth escalator invariably descend into stagnation” Theodore Levitt*

*“The earth provides enough to satisfy every man’s needs, but not every man’s greed” Mahatma Gandhi*

The most outstanding investments we can make (have made) for our clients are ones where, on both a relative and an absolute basis, we can see the Value latency AND the Operating trends heading in a positive direction AND Focused management. Of late the most difficult part of this equation to fulfil has been valuation – prior to the market correction many stocks had risen to (with the benefit of hindsight!) high levels of valuation. That has in part been rectified post the fall in the market. However the opportunities do not last long as the market is today highly pre-emptive in bidding stocks up “before the event”. In addition the Australian market is small and well picked over by an increasing number of players (private equity, hedge funds, Chinese corporate acquirers and sovereign wealth funds did not exist in any meaningful way ten years ago). These factors add to the ongoing volatility in stock prices.

Inflation has been the great concern of the Reserve Bank. Over the last six years the rising AUD has played its part in keeping inflation at bay, as has a flexible system of industrial relations and the ability to source cheaply from China in particular. Corporate profits have flourished in part due to this phenomenon. It appears to us that momentum has been lost in each of these factors. The currency may yet go higher but for the time being it has stalled and with interest rates on hold for a while reaching parity with the USD (consensus view not so long ago) looks more difficult. The new Rudd government has done away with AWAs, the impact of which will likely only be seen over a period of years but which on balance implies more rather than less wage pressure on corporates. In China inflation (food and energy), tougher product safety regulations, an appreciating currency and higher input costs are beginning to bite:

- We heard from one of our larger retailers that in their view China is now exporting inflation, with price increases of 4-5%.
- Reports of large changes in Chinese cost structures (20-40% rise in labour costs, 8-13% reduction in VAT rebates, 10-50% increase in fuel costs) resulting in manufacturers of textiles/apparel and electronics struggling to break even.
- Rising wholesale price of basic items (toys, coverings, hats, office items) over twelve months of 10-25%.

Inflation in the 1950’s (Korean War) reached 25% and was followed by a recession which saw the CPI return to 0%. In the 1970’s (oil crisis) the CPI reached 18% and took a long time to return to acceptable levels. The RBA believes we will not see a repeat of those levels of inflation due to the floating currency, more flexible industrial labour markets, better fiscal/monetary policy and better management of our financial institutions & corporate sector. Whilst we agree with the governor of the RBA we remain cautious because although the institutional structures are better, financial complexity & consumer indebtedness has increased massively and therefore the risks remain real. Furthermore, given current consumer debt levels, it will take very little

unexpected inflation above the current 4% to cause additional havoc within capital and consumer markets.

Australian retailers are thus going to face more difficult times as the impact of higher interest rates affects demand and the favorable currency and input cost trends of the last few years start to reverse. Both Myer and David Jones have reported sharp slowing in like for like sales growth in March. Stock prices of most of the listed entities have already been marked down substantially in advance of any evidence of this softening. In the USA JC Penney (a large department store) cut its first quarter earnings by 35% - a harbinger of things to come in that sector.

For a while now we have not been favorably disposed towards banks.

Reasons have included:

- Asset (read housing) prices have been bid up dramatically by low interest rates and massive expansion in the availability of credit. We have viewed these trends as unsustainable and house price rises as in need of some moderation.
- Rising interest rates will eventually have an impact on the strength of consumer spending and hence borrowing demand. The consumer is more indebted today than ever before.
- Provisioning has been at historic lows and can only go in one direction. There may yet be further negative surprises of a larger nature.
- More recently funding has become an issue – securitization is no longer available and banks will thus need more capital to support on balance sheet lending.
- The impact of all of the above is likely to be slowing earnings growth which the market is only now coming to terms with.
- Ongoing margin pressure.
- Price earnings ratios have been at historically high levels, and far higher than offshore counterparts.

The fall in bank share prices has certainly fixed the level of absolute valuation (now trading on PE ratios of 9-11X 2009 earnings and dividend yields of circa 6.5-7.5%), but these statistics are predicated on earnings growth of +8-10% - it remains to be seen whether growth at this level is attainable. And on a relative basis overseas banks are still cheaper, trading on PE ratios of closer to 7-8X. However the Australian banks operate in oligopolistic environment in which their competition has just been dismantled by the sub prime crisis and subsequent liquidity and confidence issues and, in the absence of any further major dislocation, our banks will survive in an even stronger position albeit the short term future looks tough.

The agricultural boom continues – record prices being seen for both farm inputs (fertilizer) and produce (rice in particular but also corn, soybean and wheat) which is putting immense strain on governments and systems around the world. A very recent holiday in Cambodia confirms that the retail price of rice has gone from US\$0.50/kg to US\$1.25/kg in the last twelve months. Leading rice producers Vietnam, India and Egypt have imposed export restrictions in order to feed local mouths and to try to keep control over prices. China has imposed controls over pork and egg prices. Russia has done likewise with respect to bread and milk. It is quite possible that these moves will be counterproductive – keeping demand up while disincentivising farmers from increasing production. And this is in addition to food riots which have already occurred in parts of the developing world. Demand continues to grow as supply struggles to keep up for reasons we have addressed in past reports. World grain stocks, for instance, are at record lows. According to the OECD in their recent report “Environmental Outlook to 2030” global agriculture will

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need to increase output by more than 48% in order to feed a population going from 6.5B today to 8.2B. This cannot be done by increasing arable land by this amount and so will need more intensive farming practices and higher yields, thereby underpinning long term demand for fertilizer and pre/post emergent crop chemicals, areas in which Incitec Pivot and Nufarm respectively operate.

We note that despite the high price of farm inputs, the incentive exists for farmers to use more fertilizer. In a recent presentation Potash Corp stated that fertilizer remains a very small part of a farmer's total input costs – a \$100/t increase in the price of potash adds only \$0.03 to the production cost of a bushel of corn. In addition, a survey by the International Plant Nutrition

Institute found that farmers globally in a wide range of produce generate a \$3+ return for every \$1 spent on fertilization. And to date the price for the raw produce has represented a very small proportion of the end retail price paid by the customer in the supermarket. In the USA total farm cost represents 5% of the price of a pound of chicken, 15% for beef, and 6% for bread. Processing, packaging, transport and logistics are the main drivers of cost – the increases here coming from the rising oil price. As with base metals and bulk commodities, we believe long term demand will continue (albeit that we will experience volatility around the trend) in an upward trajectory.

Continuing our selection of company discussions:

### Fletcher Building (FB)

FB holds strong positions in its home market (New Zealand) across the building construction and infrastructure sectors, having exposure to both residential and commercial activity via a wide range of products. In addition the company has over the last five years built positions in Australia and overseas markets via its acquisitions of Laminex, Tasman, Amatek and most recently Formica. Synergies from these acquisitions, as well as strong non residential markets, have helped drive profit growth.

Today the external environment faced by FB looks far less certain. The interest rate regime in New Zealand is starting to bite and although residential building has been in decline for some years (rising interest rates where the New Zealand Central bank has done its best to kill off its economy, and falling immigration) the rate of decline may steepen in the short term. In addition commercial building now also looks to be weakening. Combined with a slowing in the USA (where Formica has exposure) profit growth looks set to become more difficult. However, on a price earnings ratio of 9X (compared to Boral on 13X++) the price of FB now reflects these difficulties. We have confidence that management can steer a path through the malaise and once macro conditions ease the stock will perform strongly.

### QBE Insurance Group

QBE is one of the worlds leading general insurance companies both in terms of size and return on equity. In 2007 the weighted average return on equity of the worlds 60 largest insurers was less than 16%, QBE's return on equity was 26%. QBE operates in 45 countries and has an outstanding long term record. Over the last ten years premium growth has been 18% pa, earnings per share growth has been 20% pa and dividends have grown at 16% pa. The total return from QBE shares has comfortably exceeded the return from the overall stock market over the longer term.

Since QBE released their results on the 26th February the share price has fallen quite sharply, at one point during March the shares had fallen by 27% and are currently down by 11%. The reasons for the very sharp falls seem to be that the 2007 headline results were lower than market expectations, QBE's PE was higher than most global insurance companies and that falling interest rates and the rising Australian Dollar would damage future profits. Our assessment is far more positive than that of the general market.

Most importantly QBE has demonstrated a strong culture with clear business targets, accountability and business acumen. The QBE model has a small head office team and strong level of accountability at the regional and country level.

This QBE way of doing business has allowed many acquisition opportunities to be quickly assessed, and if purchased to be incorporated into the overall business. In short, QBE has a culture that delivers higher than industry average results.

In our view the current share price assumes that their long term return on equity will be less than 15%. Clearly the past few years have delivered returns on equity that are higher than should be assumed into the share valuation however based on history, a 15% return on equity assumption seems reasonable. We think that insurance companies absorb similar levels of risk, to banks and therefore should earn similar long run returns on equity. Banks returns have been over 20% for many years, albeit they are currently falling.

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<sup>1</sup> Potash Corp