

CI AUSTRALIAN EQUITIES FUND QUARTERLY REPORT



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

MARCH 2009

“Owners of capital will stimulate working class to buy more and more of expensive goods, houses and technology, pushing them to take more and more expensive credits, until their debt becomes unbearable. The unpaid debt will lead to bankruptcy of banks which will have to be nationalised and State will have to take the road which will eventually lead to communism” Karl Marx 1867

“Our money will not be spent on dealing with bubbles or clearing up trash like Western countries. Our money will be spent exclusively on promoting economic growth” Li Deshui, China’s former Director of the National Bureau of Statistics

“I place economy among the first and most important virtues, and public debt as the greatest of dangers to be feared. To preserve our independence we must not let our rulers load us with perpetual debt....We must make our choice between economy and liberty or profusion and servitude” Thomas Jefferson

PORTFOLIO PERFORMANCE

	PORTFOLIO	BENCHMARK	VALUE ADDED
ROLLING 3 MONTHS	-5.01%	-1.98%	-3.03%
ROLLING 1 YEAR	-26.61%	-29.52%	2.91%
ROLLING 2 YEAR	-16.38%	-19.04%	2.66%
ROLLING 3 YEAR	-4.12%	-7.25%	3.13%
ROLLING 5 YEAR	10.39%	5.50%	4.89%
SINCE INCEPTION*	11.17%	6.19%	4.98%
SINCE INCEPTION^	104.19%	49.98%	54.21%

* Annualised
^ Cumulative (4 July 2002)

CI Australian Equities Fund - Net of Fees
\$1000 Invested Since Inception



For the quarter ending 31 March 2009 the ASX200 returned -1.98%, after one of its biggest March monthly rises in history (+7.1 %). The fund returned -5.01% for the quarter, underperforming the Index by -3.03%. Fiscal year to date the Index is down -28.24%. The bounce in the month of March came after six consecutive negative quarterly returns so was perhaps unsurprising.

Individual positions which contributed to the Fund’s underperformance included:

- Our underweight position in the banking sector (see below for our rationale for this position) – all the major banks outperformed the Index, Westpac (+12.5 %) and Commonwealth (+24 %) banks by quite a margin.
- Brambles fell 33 % as a slowing US economy impacted earnings, and more worryingly the company committed to a review of the entire CHEP pallet operations and the spending of large sums of capital on pallet quality. Late in the quarter Brambles lost a high profile client in the USA which has focused investors on whether the business model remains sound. We believe that does remain the case albeit that we expect margins to come under a little more pressure in the short term.
- QBE fell as the insurance margin reported for the 2008 year and that forecast for the 2009 year came in under analyst expectations. We

remain of the view that the company is well managed and well positioned to take advantage of a hardening insurance market and any opportunities thrown up by the current global “crisis”.

- AXA share price was down by 29% over the quarter as the market fretted over the likelihood of a capital raising to maintain a sufficient margin above the regulatory capital requirements. Late in the quarter the company did indeed raise equity and not surprisingly the price rose.
- Sonic was sold down on concerns about the Government changing reimbursement levels for pathology in Australia. While that may yet prove to be the course of action adopted by the Government in its efforts to reduce healthcare spending, the likelihood is that the three major providers in the pathology market will then raise co-pay levels to compensate for the lost revenue.

The major positive contributors included Oilsearch (rebound in the oil price), Orica (recovering from having been heavily sold off with the resource stocks earlier in the quarter) and Tattersalls (resilient business in the face of an economic downturn).

The question we are consistently being asked by clients is whether we are witnessing the end of the bear market – we can only answer that we do not know. History is littered with both large negative moves in up-trending markets as well as serious upticks in down markets – the US market bounced 70% over two months (July and August) in 1932 before falling back 30% over the next six months, and the UK went up 115% from November 1974 to May 1975 just a year prior to the IMF being asked for a bail-out in 1976. Therefore there remains the possibility the stock market could rise further while still remaining in a longer term downtrend. What we can say is that economically the globe is struggling and anecdotally (our most recent company visits both in Australia and abroad) conditions are still deteriorating. Eighteen months ago we could not find a lot of value in the market but earnings and industry trends were (apparently!) positive. Today that position is reversed – valuations are, at face value, more attractive as price earnings ratios have fallen and dividend yields have risen, but earnings and industry trends have turned decidedly negative in many areas. We have yet to see the full impact of current global conditions reflected in corporate earnings so today’s “value” may be less than perceived. However the inventory overhang of the last six months which has caused the most recent angst will be cleared and underlying demand will re-assert itself over the next 3-6 months. In the medium term we would expect some reversion of corporate profitability - the last decade has seen the share of profits in the national economy rise in line with rising debt levels – and as deleveraging takes place at both a corporate and consumer level the ability to aggressively grow net profits will reduce.

The Fund is positioned away from the Index in three major ways:

1. We are underweight in the banking sector, and have been for the past twelve months and more. We remain firmly of the belief that the drivers of the earnings growth for the banks over the 5-10 years to 2008 are

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diminishing and will continue to hold back earnings growth for a while yet. Asset growth is still slowing (note the stock of credit in Australia - housing owner occupier 36%, housing investor 16%, other personal 8% and business 40% - contracted in December 2008 by 0.3%). Overall credit growth has slowed from +15% p.a. last year to be running in low single digits today. Average loans/deposits ratio for the major banks is amongst the highest in the world at 160% and with funding more difficult and expensive to obtain today than has historically been the case at the wholesale and international level, in order for this ratio to fall, loan growth must slow. Provisioning was benign for many years and has started to rise, and looks set to rise further. Commercial property exposures are reasonably well documented and known, the big unknown for the banks is the extent of further housing price falls and unemployment, deterioration in either of which would lead to bad debts on the SME and consumer front.

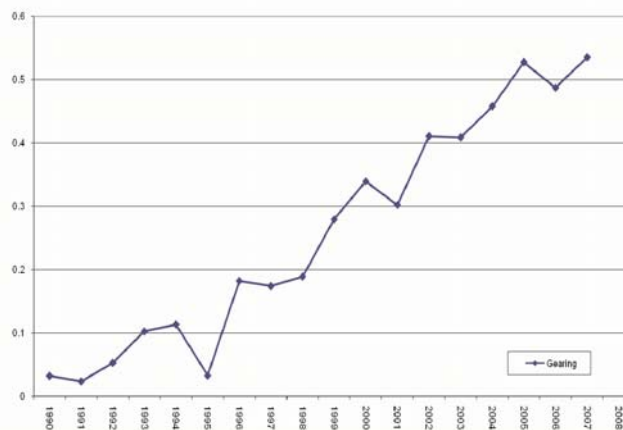
The banks have very few levers to pull to take further costs out of their businesses after the restructuring of the last 10 years. And last but by no means least is the implicit "social contract" – the recently provided support of the Government will come at a price which we believe will be to constrain return on equity to mid teens rather than the 20-25% witnessed up until 18 months ago.

Offsetting these negative factors are some very real positives – most of the non bank competition has now vanished and foreign banks are reducing their presence in Australia, leaving the larger domestic banks in a far stronger competitive position. Interest margins have stopped falling and are in fact starting to rise. The banks maintain that their housing books are running on conservative loan to valuation ratios and the higher LVR pieces are mortgage insured in any event. Banks have increased their Tier 1 capital ratios to around 8.5%. And it is quite possible that with dividend reinvestment plans and small capital raisings, the banks can manage the fall in commercial property values over a 2-3 year period. The demands of Government are likely to be some time in coming given that to emerge from the "crisis" in the best possible shape the Government needs a healthy banking sector. Finally, having already cut their dividend pay outs, fully franked yields of 6-7% remain attractive in a low interest rate environment.

2. We hold positions in 6 different healthcare stocks which gives the portfolio a greater exposure to this broad industry than the Index. Despite being in very different parts of the healthcare arena (pathology, sleep apnoea, respiratory and acute care, plasma products, cochlear implants, private hospitals), each of the companies benefits from the long term ageing demographic providing volume growth, most of them benefit from surety of receivables (payers are for the most part the Government or an insurance fund) and all operate in consolidated industries where they are each among the market leaders. However each is also exposed to Government reimbursement which, in the current global fiscal environment, is at some risk of being impacted adversely by policy decisions taken to constrain expenditure. There can be no doubt, given the levels of Government expenditure on healthcare today, that the future healthcare system must involve more user pay. This will have both benefits (pricing power) and more adverse consequences (potential one off volume rebasing, bad debt profile shifts) but over the medium and long term these companies all have solid growth prospects. To categorise these stocks as "defensives" and sell them merely to add so called "risk" or "beta" to the portfolio is both misguided and very short term.

3. We do not hold any listed property trusts in the portfolio. Our concerns around LPTs have principally been that there has been too much debt in the sector. Almost every LPT has massively increased its gearing over the last 10 years. More recently, the fall in interest rates has led to market losses for those LPTs which had hedged their interest rate exposures, and the currency has also had an impact on FX hedges. However the prices of LPTs have fallen a long way and are now trading at, and in some cases quite substantial, discounts to NTA - we are therefore becoming more interested in the sector. The main problem remains the debt and it is not altogether clear how some of the more leveraged structures will get around this issue. What we would be most interested in is participating in a large recapitalisation.

LPT Gearing Ratio: Total Debt/Equity

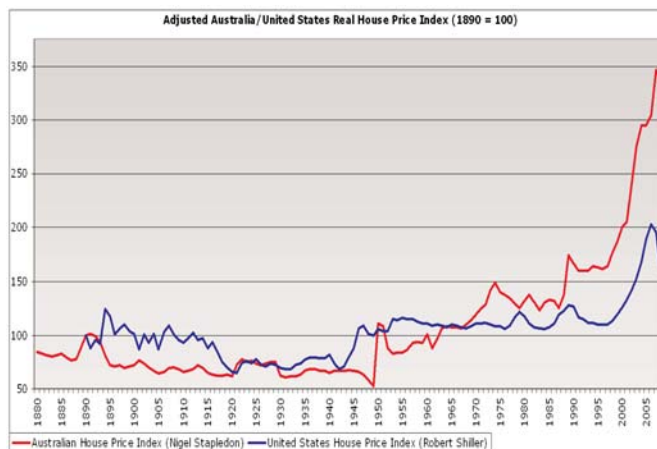


Source: Endeavour Equity

VoF OBSERVATIONS ~ INDUSTRY TRENDS & BEHAVIOUR

Probably the biggest unknown which will have a major impact on the Australian economy, bank balance sheets and the stock market is house prices. House prices in Australia, the UK and the USA have risen sharply over twenty years. In Australia prices have risen further over the last twenty years than in either the UK or the USA. And taken over 100 years the bubble can be put into its true perspective.

USA and Australian Housing Bubbles Compared



Source: Endeavour Equity

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MARCH 2009

Prices in the UK and USA have fallen substantially of late – both down 18% yoy in Q4 2008¹. Various real estate articles published while we were there in March contend that the drop in the UK has continued into the first quarter of 2009. And while some parts of the USA have suffered larger falls (Las Vegas -32%, Phoenix -35%) in adjusted terms there remains an argument that there may yet be further to go - in relation to average earnings, house prices are still 40% above the long term average² albeit that there may be the first tentative signs of stabilisation now appearing.

In Australia the ratio of house prices to household income has risen from 3X to 6X since 1981 and over the same time frame the ratio of household interest payments to household disposable income has risen from 5% to 13%. And in contrast to the more vicious price declines in UK and USA, the same report shows house prices down by only 3% in Australia. The RBA in its March 2009 Financial Stability Review shows a slightly higher decline in the most expensive 20 per cent of suburbs. The arguments against a collapse in house prices in Australia centre around:

- low interest rates and increasing affordability,
- the fact that Australia did not see the decline in mortgage lending standards that occurred elsewhere and resultant negative impact on prices from large foreclosures bringing stock onto the market,
- the current trend that our unemployment rate is not rising as fast as elsewhere, and
- the possibility that demand for new housing has outstripped new builds indicates excess underlying demand.

We cannot predict what will happen in Australia - but we remain cautious because of what we can observe - what has happened elsewhere, high prices relative to earnings and assets, and steadily rising unemployment.

In Australia we have to date been spared the rises in unemployment seen in USA and the UK and other parts of Europe. Unemployment is running at 8% in the UK and 8.5% in the USA compared with 5.7% here. And in China 20 million rural migrant workers have lost their jobs and returned to their villages. In Spain unemployment has reached almost 15%. The Rudd government seems to have conceded that unemployment will rise to 7% in Australia - if that does prove to be the full extent of this issue then we will be able to consider ourselves lucky and it may be sufficient to forestall any major falls in house prices.

We can observe that governments around the world are intent on spending their way out of the "crisis". As we write this report the G20 has just committed \$5TR to rescuing us all. Unquestionably this amount of spending will have a positive impact as it works its way through the system. In Australia we have had the spectre of the Government guaranteeing retail bank deposits, guaranteeing bank borrowing, proposing to bolster the property developers via the Rudd bank, pushing money to first home buyers, supporting the auto sector and twice giving handouts to a large swathe of the population. In doing so, it is running the very serious risk of turning a very healthy surplus into a major, long term structural deficit. One might well ask why the tax payer should be responsible for such a wide array of beneficiaries.

The "crisis", when all is said and done, was caused by too much debt. Yes – fraud, greed, lack of regulation, complexity and a myriad of other factors

contributed – but the root cause of the problems we are facing stem from the indebtedness assumed over the last ten years by consumers and some corporates. Changing accounting rules will not make banks any more solvent. It would appear that governments (particularly here in Australia and the USA) are intent on solving the problem by incurring even more debt, (encouraging people to spend more in Australia, leveraging public funds in the USA to buy "toxic" assets), and leaving our children and grandchildren with a major adverse legacy. How will this money be repaid? Given average wages in this country, tax hikes, although now inevitable in time, will not be nearly sufficient. Given the fact that a lot of major Federal assets have already been privatised (Qantas, Commonwealth Bank, CSL, Telstra) one wonders what there is left to sell. Investors have not yet thought about these long term issues in any depth but it is interesting to note that in the UK, the government failed for the first time in seven years to fully sell a \$3.7B gilt auction and last week the Governor of the Bank of England warned against increasing debt by spending more on stimulus packages. In the long term the potential of the Australian economy is being hamstrung by current short-sighted government actions designed for short term re-election purposes.

There is no doubt that company balance sheets will need to be stronger than has been the case during the last ten years. More regulatory capital will need to be held by financial companies, banks will demand far more stringent lending terms of their "customers", and working capital demands will rise – we have heard from at least two retailers indicating that they will need to support their suppliers and indeed their customers through tough times. The plain implication is that the strong will get stronger – well capitalised incumbents will do relatively better than their competitors. Consolidated industries in Australia will benefit - the banks in Australia, private hospitals, supermarkets and BHP are prime candidates to be long term winners on this score.

China is very clearly becoming more voracious in acquiring long term strategic commodity assets and positions. Four years ago they failed with an attempt to acquire Unocal in 2005, and Minmetals has recently been rebuffed, on spurious grounds, in buying Oz Minerals. In the meantime the China Development Bank has lent \$39B to two Russian oil and gas companies OAO Rosneft and OAO Transneft in return for 15mt of crude a year, Anshan Iron and Steel has acquired a stake in Gindalbie Mines, China Petrochemical Corporation has acquired a stake in the Puffin oil field, CITIC has acquired a stake in McCarthur Coal, and Sinosteel has acquired Midwest Corporation just to name a few transactions in Australia. The big prize remains the proposed deal with RIO. The "crisis" has played into the hands of China as they are able to play lender/saviour of last resort on a grand scale. The longer commodity prices stay down the more such actions we are likely to see.

TRIP FILE

We have just returned from two weeks spent in Continental Europe and the UK. The overriding impression is one of still deteriorating economies and much more pessimism than exists in Australia. In the UK unemployment sits at 8% and rising, interest rates have fallen to their lowest point in 300 years and can go no lower. House prices have fallen and show no signs of arresting the decline, while the banking sector is now half owned by the government. Not surprisingly retail sales are in the doldrums and the building industry is in sharp contraction. The light at the end of the tunnel there is not yet evident.

We attended a global agriculture conference while in London at which all the major ag participants (fertiliser, ag chemicals, seeds, trasers and

¹ The Economist 21/3/09

² S&P Case Shiller Index

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biotechnology) presented. The overwhelming view was that 2008 was a freak year in terms of commodity and farm input prices and thus there was great uncertainty about the short term moves in demand (curtailed in late 2008 by high prices in the USA and by lack of credit in Brazil) and price. Equally however there was unanimity in the belief that the long term fundamentals of the agricultural sector remain strong – increasing per capita income and a large emerging middle class in India and China will drive improving diets, global population growth and ongoing demand for biofuels will underpin demand, and a lack of arable land will mean strong requirements for fertiliser, herbicides, and biotech in order to maintain and increase yields. The farmer in the USA remains reasonably well off having had a couple of good seasons and still seeing profitable commodity prices – by way of example the corn price of \$4+ available for the next two years compares very favourably with the average of the last twelve years. We have sympathy for this view – our exposure to this sector is via our holding in Nufarm, a global manufacturer and distributor of branded generic ag chemicals.

Ramsay Healthcare has become the fourth largest private hospital operator in the UK over the last twelve months so we were interested to learn more about that sector. It is very different to Australia, but we came away with the belief that although it will not be an easy path, the opportunity does exist for Ramsay to continue to grow profitably in that market. Only 13% of the population have private health cover in the UK, compared with 44% in Australia, and the majority of private insurance comes from the corporate sector. In addition there is a private pay segment, most of which is cosmetic surgery. Two private insurers hold 75% market share. Hospitals (average 40-50 beds) are generally much smaller than in Australia (80-100 beds plus), insurers pay higher fees than in Australia and so private hospitals are able to run at lower occupancy rates (50% compared to 80% in Australia) and hospitals do a large amount of diagnostic work. The growth in the sector is being driven by a government push to reduce waiting times by driving public patients into private hospitals. This is now being done predominantly by the “choose and book” system whereby the patient can choose which hospital to go to (private or public) when booking on line. There is not surprisingly a difference between what the government pays the hospital for a public patient and what the insurer will pay for a private patient, so the hospital must be able to differentiate between the service offering to the two types of patient (eg. single or multiple occupancy room, choice of doctor), as well as run efficiently enough to make a profit from both revenue streams. In this regard we would expect Ramsay to put to good effect the lessons learned in the lower price environment in Australia, and to benefit from economies of scale as volumes grow and capacity utilisation increases.

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