

# CI AUSTRALIAN EQUITIES FUND QUARTERLY REPORT



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

## MARCH 2010

***“New Jerseyans want Mercedes Benz-level services, and they don’t even want to pay Kia prices. The basic reality is, both as a nation and as a state, we have been living a lifestyle we can no longer afford. There are going to be wrenching adjustments that have to take place.” James W. Hughes, a Rutgers University dean and public policy expert.***

***“This means, also, that the government must never try to prop up unsound business situations; it must never bail out or lend money to business firms in trouble. Doing this will simply prolong the agony and convert a sharp and quick depression phase into a lingering and chronic disease.” Ludwig von Mises (1881-1972).***

## Market and Fund Performance

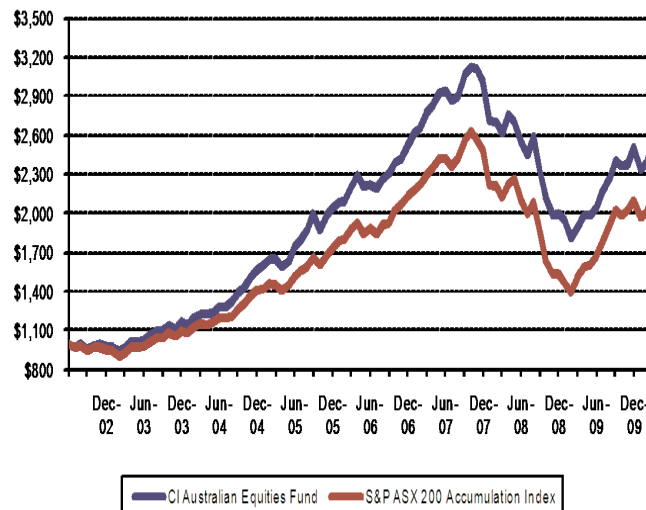
|                  | **FUND  | BENCHMARK | VALUE ADDED |
|------------------|---------|-----------|-------------|
| ROLLING 3 MONTHS | 1.57%   | 1.36%     | 0.21%       |
| ROLLING 1 YEAR   | 35.70%  | 41.70%    | -6.00%      |
| ROLLING 2 YEAR   | -0.21%  | -0.06%    | -0.15%      |
| ROLLING 3 YEAR   | -1.74%  | -2.44%    | 0.70%       |
| ROLLING 5 YEAR   | 10.27%  | 8.07%     | 2.20%       |
| ROLLING 7 YEAR   | 16.07%  | 12.53%    | 3.54%       |
| SINCE INCEPTION* | 14.07%  | 10.23%    | 3.84%       |
| SINCE INCEPTION^ | 177.08% | 112.53%   | 64.55%      |

\*Annualised

^Cumulative (4 July 2002)

\*\* Before fees and expenses

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



The March quarter 2010 saw a return of volatility with the ASX 200 Index falling sharply in January and then more than recovering to show a modest positive return of 1.36% for the quarter. The portfolio performed reasonably well over the quarter rising by 1.57%.

The relative under-performance for the past 12 months is due to our allocation of capital to under-performing sectors such as healthcare and general insurance, and missing the profit normalization and stock market re-rating in bank, mining, discretionary retail and media stocks. The strength of the AUD, driven by Australia’s relatively high interest rates, monetary discipline and recovery in commodity prices has also been a significant headwind for our portfolio stocks with US and European businesses.

The most significant positive contributors to the portfolio return for the quarter included Ramsay Healthcare, CSL, Brambles and AGL. Under-performers included Austar, QBE, and Healthscope. Austar was impacted by a slower pace of market penetration and some competition from the new free to air digital channels. QBE remains Australia’s premier insurance company but profits have had some headwinds due to the currency and low overseas interest rates. QBE have a \$27b investment portfolio backing its insurance business, made up of short duration, high quality fixed interest assets. The yield on these investments is being depressed due to below normal interest rates in Europe and the US caused by events associated with the GFC. The stock trades on 12x PER and a 6% dividend yield.

# CI AUSTRALIAN EQUITIES FUND QUARTERLY REPORT



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

## MARCH 2010

### The Portfolio

The portfolio currently holds thirty two stocks. The cash weighting is 1.8%.

There were a number of changes in the portfolio during the quarter.

We sold out of Metcash for a number of reasons:

1. Competitive headwinds are increasing – Coles is on an improving trend, Aldi is starting to expand its footprint substantially, Coles and Woolworths are discounting liquor aggressively making life tougher for the Metcash liquor distribution business;
2. Although the margin at Coles is substantially lower, Woolworths' margin is circa 7%. Metcash and their retailers share this margin approximately equally and there will be increasing pressure from the retailers to increase their share of the pie;
3. As Coles and Woolworths spend increasing amounts of capital on refurbishment and new stores so there will be increasing pressure on Metcash to help their retailers in this area; and
4. The entry of Woolworths into the hardware space will make life much tougher for Mitre 10.

We modestly increased our position in Woolworths. The stock trades on a forward PE of 16X and a 4% fully franked yield. In the past year Woolworths has under-performed the broader market by 20% due to its defensive nature and concerns over increased competitive activity emanating from a recovery in the Coles offering and new entrants like Aldi and Costco. Woolworths remains a powerful retail platform with growth options in hardware, financial services, electronics and other specialty markets in a country with a population projected to grow by 50% to 36m over the next 30 years.

We increased our position in Simsmetal as the stock price had dropped significantly and, while the near term economic outlook remains mixed at best, margins and returns will normalize and on a medium term outlook the stock is cheap. It is the leading scrap metal company globally and with \$200m net cash on the balance sheet we would expect it to take advantage of current depressed conditions to consolidate this position.

We also increased our position in ANZ and Westpac. The market increased earnings expectations for the banks following the CBA interim results and the other banks trading updates. The market now seems to be fully factoring in the drop in bad and doubtful debts, however there may still be upside to expectations if the institutional and SME loan books start to grow again as we expect.

### Stock News

Asciano announced a number of new coal haulage contracts in Queensland that give greater credibility to the expected growth of their rail business and they also received investment grade credit ratings. The CFO announced his resignation which was somewhat unsettling however the explanation given appears credible. Of more concern were announcements that the CEO has taken out large margin loans against his Asciano shares. Share holders may well be bemused by these announcements given the company was previously drastically over geared and also lost money on their investment in Brambles. As the share price of Asciano has moved from being very cheap to being closer to our "fair value" we expect the (highly credible and new) Board, as well as management, to make sure the past mistakes are not repeated.

A number of the healthcare companies made acquisition announcements. Healthscope announced it was in acquisition discussions with a private aged care group which drew a negative response from shareholders who were concerned about value dilution and risks associated with the acquisition. To their credit the Board and Management

## MARCH 2010

subsequently withdrew from these discussions. Healthscope management is now focused on delivering higher returns and profits which should flow from the brownfield hospital expansions, the duopoly structure of private hospitals, increased market share in pathology in Australia and the profit contribution from the newly established NZ pathology contract.

Conversely, the announcement by Ramsay Healthcare that it was to take a 57% stake in Groupe Proclif, one the leading hospital operators in greater Paris, was well received by the market. Coincidentally its half year result was buoyed by a strong performance from Ramsay's UK operations acquired two years ago. We believe Ramsay will make further acquisitions in France using this first foray as a beachhead. In addition, Sonic Healthcare announced the acquisition of the Medhold Group in Belgium for approximately \$370m. This is an extension of its European laboratory strategy which to date has been principally focused in Germany. Over time we would expect Sonic to extract synergies as it adds to its position in Belgium.

Tattersalls won the tender for the NSW lotteries licence at what appears to be a sensible price (\$850m) based on management's confident profit forecasts. The earnings per share enhancement will partially offset the loss of earnings from the loss of the Victorian gaming machine licence in 2013 and the acquisition looks to have halted the stock's period of severe under-performance. Tattersalls trades on a 8.9% fully franked yield.

## Market Outlook

### *Regulatory Changes*

On the 31st of March the Federal Government announced that Chi-X had received in principle approval to obtain a licence to operate a trading platform for ASX listed securities. When granted there will be trades in stocks listed on the ASX on both the ASX platform and the Chi-X platform. When investors place an order with a broker they will place the order through an order routing system in an effort to achieve the best price in either market. Chi-X is a global company that operates regional trading platforms, the subsidiaries are usually partly owned by investment banks.

It is probable that other companies such as AXE ECN will seek to obtain similar licences over the next year. AXE ECN is a joint venture between the New Zealand stock exchange and five Australian investment banks. There is also some talk that there may be a new competitor for the ASX clearing system in the future.

The proponents of change (led by Chris Bowen, Minister for Financial Services, Superannuation and Corporate Law) believe that new competition will enhance market efficiency and innovation. They also claim that new competition will lead to better price discovery, tighter bid ask spreads and greater liquidity, all of which will benefit both investors and companies seeking capital. These claimed benefits cannot be proven though and at the moment sit there as conventional wisdom. No doubt the marketing campaign by Chi-X, the Government and others will be large, impressive and convincing.

There is a strong case that can be made that these changes may not be beneficial and indeed may be counter productive.

The first point to be made is that the Australian equity market performs very well in its current structure.

During 2008 and 2009 the ASX market experienced the greatest stress test since the 1987 stock market crash. What happened was that the ASX:

- enabled the Australian corporate sector to recapitalize in a orderly and smooth manner and more efficiently than most other Western markets;
- kept operating as normal with high levels of liquidity;
- the clearing system worked faultlessly;

## MARCH 2010

- the settlement system operated smoothly; and
- did not suffer from any technical or computer glitches.

Secondly, it can be convincingly argued that the splitting of the current ASX liquidity pool will lower liquidity and lead to less efficient pricing, an outcome exactly opposite to the desired result.

Thirdly, conflicts between investment bankers and investors will increase from their already high levels. At present institutional investors only grudgingly accept that the large brokers should take large trading positions. Imagine the increased suspicions if broker sponsored trading platforms are used by broker funded trading desks with even larger principal positions. It is very hard to argue that this does not increase potential conflicts of interest.

Additional trading platforms require new investment in systems, settlements etc that will add to complexity, compliance and cost and may well increase system risk.

As a reasonably significant institutional investor we are unsure that the changes will lead to any improvements for our clients or for the retail investor and we are concerned that there will actually be negative outcomes. Our feeling is that the winners will be the investment banks and the firms that operate in the rapid trading arbitrage business. It could be argued that these types of companies contributed their fair share to the problems that led to the global financial crisis.

### **Healthcare Reform**

This quarter has seen a very major reform of US healthcare. What Hilary Clinton could not manage, Barack Obama has enacted into law. In short, the reforms will extend insurance coverage to an extra 32m people, and will be funded by a number of measures, including tax increases on wealthier individuals, and levies on healthcare companies. While the likes of CSL, Cochlear and Resmed will face a reduction in earnings of an estimated 3-7% as a result of the levies, this will not occur until 2014 giving the companies plenty of time to make adjustments. And this does not take into account any price increases put in place or the additional volumes coming from a greater number of insured. Some analysts are in fact forecasting that in the medium term the reforms will actually work to the benefit of these companies. And perhaps these reforms are also indicative of a deeper psyche entering the American culture – a bigger role for government, greater regulation (as opposed to continuous de-regulation and privatisation) and the obligation of the better off to help the not so well off principally via tax hikes<sup>1</sup>. The financial sector will be watching with interest!

In Australia, what we have seen to date is not so much fundamental reform in the nature or delivery of healthcare, but rather a cost cutting exercise by the government. Pathology funding has been cut by a net \$100m p.a. (approximately 5%) and issues such as deregulation of collection centre licences will spur further competition and so help to keep a lid on prices. PBS reductions are being helped by the growth in generic pharmaceuticals and government mandated price reductions. The Government's wish to change the funding methodology for public hospitals, at face value, is no more than moving the deckchairs and faces opposition from a number of States. The shift from a 60/40 State/Federal funding share to 40/60 will do little to enhance our hospital system in the absence of more meaningful and fundamental efficiency reforms. The creation of Local Hospital Networks for the delivery of health management runs the very real risk of only adding another layer on what is already a bloated bureaucracy. Given some States are more efficient than others in the delivery of hospital services, and that the private sector would seem to have the edge on the public sector in this area, gains will likely come but, given the varied nature of entrenched sector interests, over an extended period of time. It is interesting to note the actions by Medibank Private in acquiring firstly Australian Health Management and more latterly the Australian arm of US healthcare service provider Mckesson. These deals, together with the recently announced diabetes spend, would indicate increasing government emphasis on out of hospital care to prevent and manage disease. A lot more will need to be done across the entire healthcare spectrum (including primary physicians, aged care and mental health) to avoid the cost implications of the demographic shift coming over the next twenty years.

<sup>1</sup> Macquarie Bank - Unconventional Wisdom 24 March 2010

# CI AUSTRALIAN EQUITIES FUND QUARTERLY REPORT



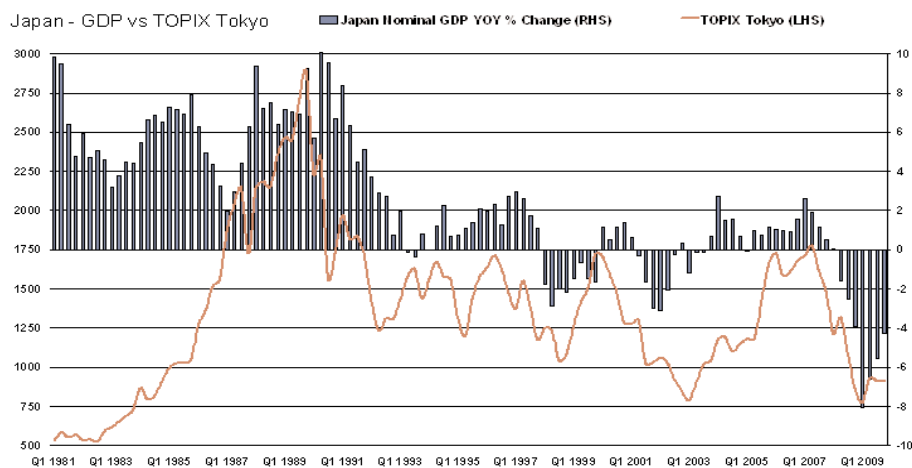
Cooper Investors Pty Limited AFS Licence Number 221794 ABN 26 100 409 890

## MARCH 2010

### Global Markets

Global stock markets have staged a major recovery from the lows of March 2009. Where they will go from here we do not know. However there are a number of general points worth considering in trying to understand the likelihood of further substantial gains:

1. In the long term stock markets will reflect corporate profit growth, in turn largely a function of the world's economic health. Currently economic growth in the Western world is anemic. Most of the visits we have made to industrial companies resulted in the view that, although activity levels are no longer falling, there is no sign of any real upturn. The bounce in stock markets, from an oversold level, has restored price earnings ratios to long term averages of 14-15X. To rise further, in the absence of PE expansion, will need sustainable earnings growth;
2. The theme of deleveraging has, in our view, a way to run yet. In digging the private financial sector out of a hole, and in pump priming to avoid recession, governments have taken on massive amounts of debt and gone into budget deficits. When added to long term pension and health liabilities, it is apparent either spending cuts, or higher taxes, or most likely both, will be required over time to fix public balance sheets. This will clearly hinder economic growth;
3. The consumer has over the last fifteen years had the benefit of falling interest rates, rising asset prices, and generally falling tax rates – a perfect concoction to drive increased spending, particularly when allied to increased leverage. These factors are now behind us, and are in most cases reversing;
4. While things are always a little different in different eras, we do note the example of Japan. There have been four rallies of substance in the Japanese market since its peak in 1989. There rallies have ranged in size dramatically. The fact remains though, that this market is today at less than half its level of twenty years ago. And the primary reason for its continued decline has been the lack of economic growth in Japan, with declining nominal GDP growth causing the end of each rally. The lesson for the Western world, and the USA in particular, may be that if monetary policy (which cannot be loosened more than is currently the case) does not gain traction, the deleveraging phenomenon will drive an extended period of sub par growth and thus lower than average share market returns.



Source: GSJBW Research Estimates

## Terms and Conditions

### Information contained in this publication

The opinions, advice, recommendations and other information contained in this publication, whether express or implied, are published or made by Cooper Investors Pty Limited (ABN 26 100 409 890), Australian Financial Services Licence (221794), and by its officers and employees (collectively "Cooper Investors") in good faith in relation to the facts known to it at the time of preparation. Cooper Investors has prepared this publication without consideration of the investment objectives, financial situation or particular needs of any individual investor, and you should not rely on the opinions, advice, recommendations and other information contained in this publication alone. This publication contains general financial product advice only.

### To whom this information is provided

This publication is only made available to persons who are wholesale clients within the meaning of section 761G of the Corporations Act 2001. This publication is supplied on the condition that it is not passed on to any person who is a retail client within the meaning of section 761G of the Corporations Act 2001.

### Disclaimer and limitation of liability

To the maximum extent permitted by law, Cooper Investors will not be liable in any way for any loss or damage suffered by you through use or reliance on this information. Cooper Investors' liability for negligence, breach of contract or contravention of any law, which cannot be lawfully excluded, is limited, at Cooper Investors' option and to the maximum extent permitted by law, to resupplying this information or any part of it to you, or to paying for the resupply of this information or any part of it to you.

### Copyright

Copyright in this publication is owned by Cooper Investors. You may use the information in this publication for your own personal use, but you must not (without Cooper Investors' consent) alter, reproduce or distribute any part of this publication, transmit it to any other person or incorporate the information into any other document.