

CI AUSTRALIAN EQUITIES FUND QUARTERLY REPORT



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

MARCH 2011

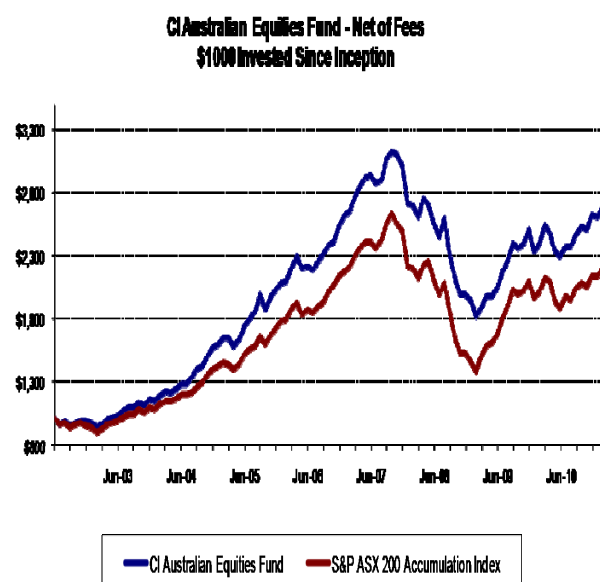
“The two worst strategic mistakes to make are acting prematurely and letting an opportunity slip; to avoid this, the warrior treats each situation as if it was unique and never resorts to formulae, recipes or other people's opinions.” Paulo Coelho

“A politician is a fellow who will lay down your life for his country.” Texas Guinan

“What mortals see are delusions. True vision is detached from seeing.” Bodhidharma

Market and Portfolio Performance

	**FUND	BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	4.08%	3.23%	0.85%
ROLLING 1 YEAR	7.85%	3.44%	4.41%
ROLLING 2 YEAR	20.99%	21.08%	-0.09%
ROLLING 3 YEAR	2.41%	1.09%	1.32%
ROLLING 5 YEAR	5.22%	3.18%	2.04%
ROLLING 7 YEAR	13.32%	9.73%	3.59%
SINCE INCEPTION*	13.34%	9.43%	3.91%
SINCE INCEPTION^	198.83%	119.83%	79.00%



*Annualised

^Cumulative (04 July 2002)

**Before fees and expenses

The ASX200 Accumulation Index rose by 3.2% over the quarter, making the third consecutive positive quarter for the stock market. The AUD dipped down from above \$1.00 to 97c but then resumed its upward climb to finish at \$1.03, its highest level since 1981.

Oil was the stand out commodity rising 16% over the quarter, with copper easing slightly. The best performers in the portfolio over the period included QR National (earnings exceeding expectations as efficiency improvements are coming more quickly than anticipated), Worley (partly in line with the rise in the oil price and partly due to a number of new contract announcements), News Corporation and Westpac. The poorer performers over the quarter included QBE and IAG (the impact of mother nature in Australia and Japan and, in addition, in the case of IAG further negative news from their UK business), ASX (souring of sentiment on the merger with the Singapore stock exchange) and Tatts Group.

The Portfolio

We made two important changes to the portfolio during the quarter – the up-weighting of QR National and the purchase of a holding in GPT.

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In our last quarterly report we set out the basis of our positive view on QRN and there is nothing we have seen to date which has caused us to change this perspective. To the contrary in fact, the first half result gave us confidence that management is doing the right thing in a timely manner.

The investment case for GPT is that the share price is trading at a substantial discount to NTA and the management and the Board of GPT have outlined a series of actions that should lead to the share price discount to NTA narrowing. These actions include lowering the cost of debt, selling off non core properties, lowering corporate overheads and reducing the GPT ownership of the wholesale shopping centre and office funds they manage. If they can make significant progress on these actions we would expect the (previous) management discount the market applies to GPT to narrow. Over the quarter GPT did reduce the cost of debt, it sold the non core US Seniors portfolio and reduced its ownership of the shopping centre fund. While the price of GPT rose by about 7% over the quarter, the NTA also rose and GPT is still trading at a discount to NTA of 12.5%. It is also possible the market may ascribe some value for the property development pipeline, although GPT will have to demonstrate the profitable delivery of some projects before this occurs.

Stock news

Cochlear is the world leader in cochlear ear implants with a circa 65% market share. The number two player, Advanced Bionics, was acquired early in 2010 by Swiss listed company Sonova, the global leader in hearing aids. On top of the recall of AB's product we mentioned in our last quarterly, the Chairman, CEO and CFO of Sonova all resigned late in this quarter as a result of insider trading issues. Although not directly related to the cochlear implant business, this does bear on the management and focus of Sonova and may assist Cochlear in the short term.

Having walked away from its bid for Potash Corp, BHP announced an off market buy back of about 3% of its shares. We believe this to be a better use of its balance sheet. The buy back will be tax effective for superannuation funds and low tax rate investors, as well as helping to drive earnings per share.

Origin announced the signing of a heads of agreement with Sinopec whereby Sinopec will take 4.3mt of LNG from its coal seam LNG development (effectively comprising the first train in a two train initial project), as well as take a 15% equity stake in the project. Origin then undertook a one for five rights issue to right size the balance sheet post the acquisition of NSW energy assets in December 2010. We anticipate further LNG off-take announcements during the course of 2011, and the final sanctioning of the project later this year. The market is speculating on a further equity raising from Origin at that stage, however it is entirely possible that the necessary funds can be raised via a convertible instrument rather than straight equity.

The acquisition of the Alcan packaging assets by Amcor has the potential to effect a step change to Amcor's earnings. Amcor gave the market its first view of the combined businesses at its half year result release. As part of its release, Amcor upgraded the underlying synergies to be realised from the acquisition by 20%. Although this will do no more than offset the appreciation in the AUD, it is a positive sign that the integration of the two companies is going according to plan.

Worley announced three new contracts during the quarter:

- A contract with BP and Petro China to perform services in the Rumaila oilfield in Iraq;
- A contract to perform work for MEG Energy Corp in Canada; and
- A contract with a joint venture between Saudi Aramco and Kuwait Gulf Oil to work in the Middle East.

These announcements point to the ongoing improvement in global energy capital expenditure and to Worley's ability to continue to win work for large oil companies in all parts of the world.

Part of our reason for holding Alumina is that the pricing of alumina is changing from long term contracts linked to

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the aluminium price to a spot market price. At its results presentation Alumina stated that all long term contracts which matured during 2010 had been replaced with spot contracts—so we are more confident that the new spot pricing will flow through all alumina production over the next four years. This will be a good outcome because spot alumina prices are likely to be higher than linked prices.

Market Observations

The dynamics of the insurance markets have, over the last two years, proven to be difficult for general insurance companies in Australia, albeit for different reasons.

We feel that some of the negative trends that have impacted QBE over the past few years are starting to turn and are likely to become positives. Very low interest rates in most developed economies have badly affected QBE's insurance margin and earnings. QBE has an investment portfolio of over \$25b which is mostly invested in cash and short term fixed interest securities. As economies are recovering from the global financial crisis it is likely that cash rates will increase this year. The European Central Bank has increased interest rates in early April and it is likely the Federal Reserve will commence increasing rates later this year. A 1% increase in interest rates would add about \$180m to QBE's revenues and increase earnings per share by around 8%.

The second major negative for QBE has been the weak commercial insurance market where rates have been on average falling. QBE has managed to achieve rate increases in some of its markets but overall it has been a difficult period. The insurance losses from the Japanese earthquake and tsunami and other catastrophes (particularly in Australia and New Zealand) should lead to better pricing for insurers. While insurance underwriters are cautious about making predictions about whether we are entering a "hard" market, the recent losses are definitely changing the psychology of the market and now a large hurricane loss in the US this year would certainly lead to higher insurance prices.

Despite these issues the QBE underwriting performance has continued to be sound. Underwriting is the most important skill insurance management need to exhibit and this gives us confidence that when market conditions improve, QBE will benefit. The QBE share price implies a low multiple of around 8 times on its insurance earnings, if its insurance margin increases it is likely the insurance multiple will also increase, leading to a much higher share price.

The domestic insurers have been facing a different set of issues to QBE. There have been numerous large weather events in Australia in the past few years (floods, fire, wind, hail) and this has led to very large claims and in turn led to a consistent down grading of profit expectations. Whilst insurers buy reinsurance to cover extreme losses from these large events, they still have to pay the deductible amount which is typically \$25m to \$50m and more recently they have had to pay a further premium to reinstate the reinsurance. In addition to lower than expected insurance margins, both IAG and Suncorp have non essential businesses that are performing badly. IAG has a UK motor insurer which has reported very large losses in the past six months and Suncorp has a very poorly performing bank. It appears that insurance prices are rising in Australia and that if there are fewer large negative events the companies will post strong insurance results. It is less certain that the non core businesses will return to reasonable profitability in the next couple of years. The domestic insurers have recorded strong investment returns as Australian cash rates have already increased.

The proposed takeover of the ASX by the Singapore Exchange has taken an unexpected turn with the Treasurer announcing on 8 April that he rejected the proposal. We had expected the process to take a number of months. The details of the reasons for this decision have not been released at the time of writing, however the Treasurer's media release does say that he had strong concerns that the proposal would be contrary to the objective to build Australia's standing as a global financial centre in Asia. The Treasurer also said he does not oppose in principle commercial arrangements involving the ASX and a global exchange that would build Australia's standing as a significant financial services centre in Asia. We find this media release confusing as it is difficult to see an alternative exchange to Singapore that could help build Australia's standing as a financial centre in Asia and meet the Treasurer's regulatory sovereignty concerns. We felt the proposal would have been in the national interest.

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As the Chairman of the ASX said, the umpire has ruled and we move on and evaluate the investment in the ASX in the light of these developments.

Inflation is becoming a bigger issue in financial markets. We can see that reported inflation has risen in Asia, and in the UK the latest reading was 4.6%. Expectations of inflation are rising as well. The European Central Bank has responded by increasing interest rates. Low interest rates overseas have allowed some Australian companies with offshore revenue streams to lock in very attractive borrowing rates for the medium term – by way of example Amcor has recently raised 550m euros for eight years at 4.625%. The window for such advantageous funding may be closing but with such anemic rates of economic growth it is difficult to see rates rising too far.

In Australia inflation has not risen as yet. However there are a number of signs that, at least in some sectors, inflation is likely to increase. The most obvious is in the resources sector where many companies are reporting that there are labour shortages and costs are rising. There are more reports of aggressive wage bargaining claims in many parts of the economy including the State and Federal public services. Over the last twenty years the wages share of the economy has been declining and the private profits share has been rising. While an equity investor could have worried that this trend had run too far for a number of years, it now seems that a heightened level of anxiety is warranted because the Federal Government has, by its actions across numerous sectors since coming to power, clearly shown it is interested in reducing private sector returns.

As the Australian consumer continues to deleverage, more of Australia's economic growth is expected to come from capital investment. Higher inflation can be very bad for the returns from capital expenditure and for companies in the construction industry. Many of the large companies in Australia have extensive capital expenditure plans and we are becoming wary that the stated investment returns on this expenditure will be achieved. On average, stocks perform better when they are delivering strong free cash flow than when they are building large new projects. As such, we are trying to sort through what we view as good capital expenditure and what is higher risk capital expenditure. An example of a company with good capital expenditure is Transurban where most of the capital expenditure is on existing roads with fairly predictable returns. An example of riskier capital outlays could be where a number of companies are planning to build LNG trains in one area, with an advantage going to the company who completes the project first. Issues come and go in importance but we feel that scrutiny of capital expenditure plans is increasing in importance.

For the last twelve months or more the pundits have been predicting a recovery in the US housing market. In fact it is getting worse!! Sales of homes fell in February, home resales falling 9.6% to be almost 3% lower than a year ago. Prices were down 5% over the year.

Sales of repossessed homes rose to 39% of all sales (perhaps not surprising considering that today over a quarter of mortgaged single family homes have negative equity) and the inventory of unsold homes continued to rise. In addition, housing starts are running at less than 600,000 per annum, a long way below the 1.8m-2m pa of a few years ago. There is still a long way to go to get to the 900,000 starts pa that Boral needs just to break even on its USA business!

There is no single reason for the prolonged weakness, rather we believe there are a number of contributors including:

- deleveraging of the US consumer from record levels of indebtedness;
- tighter credit standards being imposed by the banks;
- lower levels of household formation, down to 400,000pa currently from the peak of 1.3mpa;
- unemployment remaining stubbornly high at circa 10%

In Australia one can add rising petrol prices, rising energy prices and rising health spend into the mix

The situation is so bad in the USA that federal banking regulators have proposed paying non performing home owners cash (up to \$21,000) to move out on the basis that it takes time and money to remove such occupants in

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any event, and it may prevent the stripping of all valuable elements (copper wire etc) from the house prior to repossession. Although at face value this may seem an interesting proposal, in practice it faces a couple of obvious issues – owners who have negative equity but are not in default may be tempted to leave, and why is there a need for an incentive not to break the law? It remains difficult to see a fully fledged economic recovery in the USA without a reasonable recovery in the housing market.

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