

CI AUSTRALIAN EQUITIES FUND QUARTERLY REPORT



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

September 2011

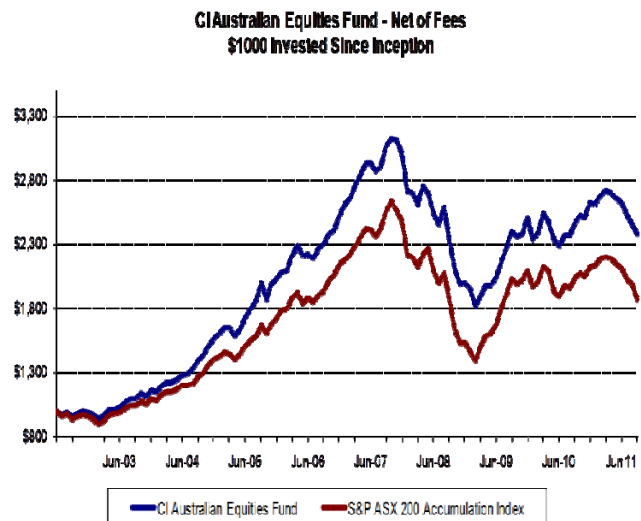
“Not everything that is faced can be changed, but nothing can be changed unless it is faced.” James Baldwin.

“We owe almost all our knowledge not to those who have agreed, but to those who have differed.” C.C. Colton.

“Wisdom consists of the anticipation of consequences.” Norman Cousins.

Market and Portfolio Performance

	**FUND	BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	-9.27%	-11.58%	2.31%
ROLLING 1 YEAR	-2.67	-8.56%	5.89%
ROLLING 2 YEAR	0.28%	-4.09%	4.37%
ROLLING 3 YEAR	1.64%	-0.11%	1.75%
ROLLING 5 YEAR	1.53%	-0.68%	2.21%
ROLLING 7 YEAR	9.04%	5.77%	3.27%
SINCE INCEPTION*	10.98%	6.98%	4.00%
SINCE INCEPTION^	161.92%	86.56%	75.36%



*Annualised

^Cumulative (4 July 2002)

**Before fees and expenses

The ASX200 Accumulation Index fell by 11.58% over the quarter. Commodity prices lurched downwards over the last month of the quarter as investors began to anticipate slower growth in the Western World and further policy tightening in China, particularly around the property market. This was exemplified by the fall in the copper price from \$4.20/lb on 31 August to \$3.24 on 29 September. The AUD/USD followed commodity prices, falling from a peak at the end of July to hit a low of \$0.975 in mid September, and remains under parity.

The best performers in the portfolio over the quarter included Coca Cola, Ramsay Health Care, Transurban and GPT – all viewed by the market as having a relatively low beta to general economic activity. The poorer performers over the quarter included QBE, Alumina and Rio Tinto (the latter two affected by falling commodity prices).

The end of September marked the ten year anniversary of the establishment of Cooper Investors. We started managing our first mandate on 1 October 2001, just a few weeks after the attack on the World Trade Centre in New York. Since that date the portfolio has gained 201.7% while the ASX200 Accumulation Index rose 101.2%. This means we have out-performed that benchmark by 4.4% p.a. over the ten years.

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The Portfolio

We made changes to our positions in ASX, QBE, Cochlear and Brambles during the quarter.

We increased our holding in **ASX**. The 2011 financial year results showed that the ASX continues to operate very efficiently and to maintain a conservative balance sheet with a net cash balance. The ASX strategy is slowly moving away from a dependence on transaction volumes towards service provision and tailored offerings for specific market segments. For instance, the ASX will be opening a new data centre in Sydney later this year to provide co-location and data services for which we expect there will be strong demand from market participants.

We believe the maximum point of pessimism around the introduction of Chi X has passed and brokers and fund managers are now becoming aware of the extra costs to the industry of a new trading platform. The costs of market supervision have increased from around \$5m (when ASX was responsible) to around \$18m now ASIC is responsible and brokers will pay most of the increased cost. The biggest threat to the ASX now is the possible introduction of a second clearing house to compete with the ASX. We believe there is some discount in the ASX share price to account for this possibility. It would seem obvious that the last thing the Australian market needs is the further complexity, risk and cost of a second clearing house, particularly in the volatile times we are currently experiencing. (Note: In the space of four consecutive days during August the Dow gained 635 points, fell 430 points, fell 520 points and rose 424 points!)

ASX shares are trading below our estimate of value and at a historically low PE of around 14 and a fully franked yield of 6.5%. Of interest in this regard is the recent London Stock Exchange (LSE) offer for 51% of LCH Clearent which values the latter at over 20x pre-tax profits. The rationale for the bid is to help re-position the LSE away from traditional areas of business (cash equities) towards post trade services (e.g. derivatives).

Having held **QBE** in the portfolio for many years, we decided to sell the holding. We continue to have a great deal of respect for the management and board of QBE and we believe that they continue to be excellent insurance underwriters.

However external factors, largely out of management's control, have contributed heavily to the continued half-on-half declines in the insurance margin. These include the extremely low cash and fixed interest yields in the U.S. and Europe, the very high number of severe weather events and the seemingly limitless capital available to the industry. The low yields and abundant capital appear likely to continue to impact margins for the foreseeable future. The number and size of catastrophes is a bit of a two edged sword for insurers. If there is a period of low insurance claims it is unlikely that insurance pricing will improve and, conversely, if there are a number of large catastrophes there will be concern about the level of capital held by many insurance companies.

While the QBE capital position appears to be fine, we find the complexity of the capital calculations in the Insurance industry high, and the market continues to be regularly surprised at results time. The interaction of discount rates, actuarial assumptions, claims development, reinsurance programs, possible regulatory changes and surprises at results have lowered our confidence in our estimation of the true value of QBE and insurance companies generally.

We commenced selling **Cochlear** during the June quarter and we completed the process in July. The recent negative news relating to the failure of the new Nucleus 5 implants and consequent recall has made our selling look very prescient – occasionally one needs some luck! Although clearly not the main reason for our sale, the recall does illustrate the risks inherent in a high tech, single product, high PE stock (albeit one of very high quality) – if something comes off the rails even slightly there is no room for error!! We sold out of Cochlear due more to valuation concerns, the stock having traded at the top end of our valuation (post the successful launch of the Nucleus 5 and the competitor Advance Bionics being out of the market), and reached a PE of greater than 30x when adjusted for currency. The long term growth rate required to sustain a stock price of \$75+ is demanding,

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particularly in light of the ever growing installed base, the move towards adult recipients whose decisions to have an implant are more impacted by economic circumstances than those relating to an infant, and ongoing reimbursement constraints globally as governments look to rein in spending. The stock is now trading around \$48.

We also increased our holding in **Brambles**. We wrote in detail on the reasons for taking our position in Brambles in the June 2011 quarterly report, and when the stock fell back during market weakness we took the opportunity to add to our position.

Stock News

After having fallen in the wake of the hacking scandal, News Corp shares performed well over the quarter as the company reported a solid earnings result, gave encouraging guidance for the FY12 year, walked away from the acquisition of BSKyB and put in place a \$5bn buy back which, to date, has been pursued aggressively. The balance sheet latency of the company is such that, in the absence of acquisitions, it could over the next 3-5 years buy back close to 40% of its shares on issue from cash flow. The cable business is robust and, together with growth in retransmission fees, will drive earnings growth despite the cyclically difficult environment and its challenged print business.

Worley continued to show the benefits of its global depth of network and breadth of service by winning a number of new contracts including:

- a contract for construction services for Suncor in Canada;
- a contract for the provision of consultancy services relating to a proposed 4000 megawatt nuclear power plant in Turkey;
- a contract for construction services with MEG Energy in Canada; and
- an agreement to provide services to support an iron ore expansion in Brazil.

Worley is seeing increased levels of activity in most of its divisions, including the hydrocarbons division, has indicated good growth this year and continues to recruit aggressively.

Amcor reported a strong result despite difficult economic conditions in Western world economies. The benefits of the Alcan acquisition are flowing to the bottom line, the upgraded quantum of acquisition benefits serving to offset the adverse effect of the rise in the currency and rising resin prices. In addition, Amcor announced, and has now started to enact, a share buy-back of \$150m to utilize the proceeds of the sale of its glass tubing business.

We are also beholden to comment on less positive news relating to portfolio companies – in this case Orica. During the quarter there were three separate environmental incidents affecting Orica operations, all of which were negative. During August some hexavalent chromium was released into the atmosphere from Orica's Kooragang Island ammonia plant, and later in the month there was a discharge of effluent containing arsenic at higher than allowed levels into the Hunter River. During September mercury vapour at higher than allowed levels was released into the atmosphere from Orica's Port Botany plant. While an isolated incident is always possible (indeed almost inevitable over any long period of time) in large scale chemical manufacturing, three such incidents in a short space of time may indicate some systemic or other problem in culture or process. We are surprised at what has occurred as we have long had a positive view of Orica management, and we will be meeting with them shortly to better understand what is going on.

Market Observations

Industrial Relations

We have observed a marked rise in the rate of management-union disputation over the last year or so, across a number of sectors. Most obviously Qantas has been battling with parts of its employee base, but we have

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seen the same situation with; the miners, Cochlear, airports and ports, and in the manufacturing sector. What appears to be a rising level of disputation would point to a government problem in this area. After a long period of relative peace, we are cognisant that companies will remain under pressure to increase wages in a slow economy where revenue increases are not easy to achieve.

Coal

This quarter we have been reviewing the outlook for the coal industry. A number of stocks in the portfolio are leveraged to the future of the domestic and international coal industry and the seaborne coal market including:

- QRN – QR National is the world's largest rail transporter of coal from mine to port. In 2010/11 QR hauled 181.6 million tonnes of coal or 64% of the 283 million tonnes of coal exported from Australia.
- BHP- BHP Billiton, through BMA (BHP Billion Mitsubishi Alliance,) is the largest global supplier of traded seaborne coking coal and a major supplier of thermal coal, mostly from operations in Australia.
- RIO - Rio Tinto is one of the world's largest suppliers of traded seaborne thermal coal and a significant supplier of coking coal.
- ORI - Orica is the world's largest supplier of explosives. The coal mining industry is the largest user of explosives.
- CPB – Campbell Brothers is the largest provider of coal inspection and testing services in Australia and a top three provider globally.
- WOR – Worley Parsons is a major provider of pit to port infrastructure EPCM services (engineering, procurement and construction management) for bulk commodities domestically and internationally.

Generally, the coal industry in Australia has been somewhat of a laggard to the resources boom relative to commodities such as iron ore and copper. Coal production and export volumes have lagged iron ore domestically since the beginning of the resources boom. Coal export growth has averaged 4.1% per annum over the five years to June 2011 compared with 11.3% for iron ore. Coal prices have also not rebounded as strongly as iron ore in relative terms post the GFC. The main reason for the slower growth in seaborne coal exports relative to iron ore is China. To date Chinese domestic coking and thermal coal production has expanded fast enough to help fuel its explosive rate of industrialization, whereas it has had greater difficulty increasing production of its relatively high cost iron ore. Total coal production in China has increased by 1.9 billion tonnes over the last decade from 1.3 billion tonnes in 1990 to 3.2 billion tonnes in 2010.

A number of recent developments provide support for an accelerating growth outlook for the global and domestic seaborne traded market for both thermal and coking coal. China moved from a net exporter of coking coal to a net importer for the first time in 2009. While partly opportunistic in the wake of collapsing world prices post GFC, exports have remained minimal while imports have continued to grow in 2010 and 2011. China observers note the push to close and/or consolidate small and unsafe mines along with rising costs and a rising currency as supporting factors for rising imports, both in total and as a share of total coking coal consumption. The shift to larger blast furnaces by the Chinese domestic steel industry is also favouring imports of high quality hard coking coal.

The growth in thermal coal is assisted by the accelerating expansion of the Indian power sector. Indian coals are low grade and contain high ash. High ash content means high levels of pollution (acid rain) when they are extracted and burned. Social dislocation is a major issue in India and, in a country with such high population density, gaining approvals for new mines is difficult. Over the decade to 2010 thermal coal imports into India increased at an average rate of over 19% per annum, rising from 10mt in 2000 to 60mt in 2010. These growth rates are forecast to be maintained in the short to medium term.

It is the thermal coal space that presents the highest growth opportunities for Australia. The global traded thermal coal market is growing at a much faster rate than coking coal (see chart below) and this is expected to continue.

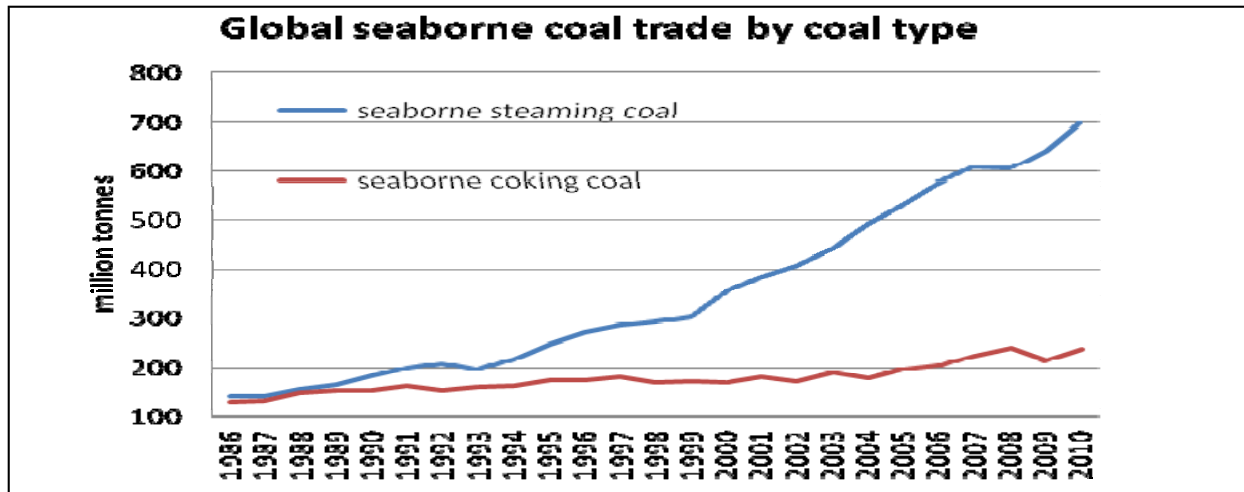
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Australia accounts for 20% of the seaborne thermal market compared with a trend of 65% of the seaborne coking coal market, providing much more upside from market share gains in the thermal coal space.



Source – BREE and IEA

A number of announcements during the quarter provided further confidence in the long term commitment of Chinese and Indian interests in developing new coal basins and, in particular, the Galilee basin in Queensland. Earlier this month Indian power and infrastructure group GVK agreed to pay \$1.26 billion to acquire a majority stake in Gina Rinehart Hancock's coal assets in the Galilee basin. This was followed by an 'expression of interest for rail haulage' by Hancock Coal Infrastructure in the AFR the following week. The project will require the construction of a new rail line to the Abbot Point export terminal.

On the 16th of September it was announced that an agreement had been reached on the \$4 billion funding package for the Wiggins Island coal export terminal. The Wiggins Island coal export terminal is the first industry funded delivery model in Queensland with the terminal owned directly by the industry (8 coal companies) rather than third party investors. The terminal will be completed in three phases with a final capacity of 84 million tonnes per annum by 2018.

These announcements and associated increases in capital commitments to the industry provide further confidence that the Australian coal industry is at the foothills of a major expansion phase.

Shale and Coal Seam Gas

BHP Billiton has made a substantial investment in the U.S. shale gas industry through its recent \$15bn cash acquisition of Petrohawk Energy (its largest acquisition since Western Mining) and \$5bn cash acquisition of Chesapeake Energy's Fayetteville shale assets in early 2011. Given the large ongoing capital expenditure requirements of these assets, BHP's total investment into U.S. shale gas could potentially exceed \$50bn over the next 5 years. In light of this, on our recent research trip to the U.S. and U.K., we visited three significant U.S. shale gas producers to further understand the industry, the implications for BHP and obtain insights relevant for Australia's unconventional gas industry (in particular for Origin's coal seam gas (CSG) to LNG project).

In the U.S, we visited the largest shale gas producer ExxonMobil (in which our Global Equities Fund is an investor) and a large rapidly growing low-cost independent, Range Resources. We also visited BP in London, who has substantial U.S. shale gas assets. The rapid technological advancements in horizontal drilling and hydraulic fracturing (fracking) from the early 2000's has resulted in an industry which now accounts for

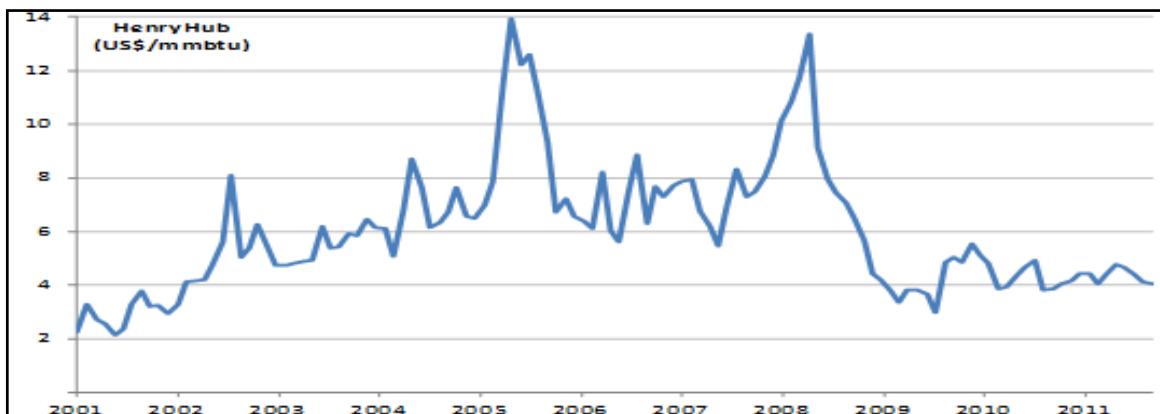
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approximately 25% of U.S. gas supply (up from practically nothing in 2000) and has pushed U.S. gas prices below \$4/mmbtu today from a six year average of above \$6/mmbtu prior to 2009 (see chart below). Increasing environmental regulation affecting coal fired power, and doubts around the future of nuclear energy, is resulting in new power generation being mostly gas-fired and record levels of switching of existing coal-fired power generation to gas-fired. There is no shortage of shale gas reserves in the U.S. – indeed we have seen estimates by the U.S. Energy Information Administration of shale gas reserves of 862TCF, which equates to 35 years of U.S. gas supply at today's rate of consumption.



Source - Factset

BHP's shale assets are well positioned in their respective basins and we view the retention of key Petrohawk employees for 2 years as a positive. Whilst the acquisitions appear to fit BHP's 'Tier 1' criteria, with capital continuing to pour into the industry and a benign U.S. economic outlook, we struggle to see how U.S. gas prices will recover sufficiently in the near-term to offer returns on this investment comparable with BHP's other investment opportunities (including returning capital to shareholders). Over the long-term, if BHP is able to capture the arbitrage between U.S. gas prices and Asia-Pacific LNG prices (which are approximately three times higher) the assets may offer more attractive returns. This will likely require the U.S. to export LNG to achieve global pricing parity, an event which in all probability is some years away.

An interesting parallel is the current situation in the Australian gas market. The major CSG to LNG projects under construction in Queensland are attempting to capture the arbitrage that exists between east coast domestic gas prices (approximately \$3-4/GJ (*Note: 1mmbtu is approximately equal to 1.06GJ*)) and the higher Asia-Pacific LNG prices (approximately \$6-10/GJ on an equivalent LNG netback price). In Western Australia domestic gas prices are approximately \$7-8/GJ as they are subject to LNG export pricing parity. LNG parity pricing, combined with the possible carbon tax and the increasing cost of electricity transmission and distribution, will likely lead to an increase in east coast domestic gas prices which in turn will significantly impact the cost of electricity on the east coast of Australia in the middle of this decade.

Despite the benefits from technological advancement seen in the U.S. shale gas industry which are relevant for CSG production in Australia, we remain cautious on the major CSG to LNG projects as:

- there are three projects competing for resources which are in relatively scarce supply, all looking to commence production in as quick a time as possible;
- rising capital and labour costs may squeeze anticipated returns;
- ongoing costs of the large quantities of drilling required to access and produce the gas (compared with the much simpler projects in conventional gas) remain a cost risk; and
- although stated to be a non issue by each of the project participants, environmental issues remain a concern – particularly (but not limited to) the disposal of enormous quantities of brine arising as a by product of the production process.

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