

CI AUSTRALIAN EQUITIES FUND QUARTERLY REPORT



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

SEPTEMBER 2007

"The increase in China's demand for metals over this period (2000-2020) may be comparable to the total demand of the industrial world today."
Charlie Lenegan MD Rio Tinto Australia

"Short of a few ambiguous incidents, I can think of no circumstances where the expanded rule of law and enhanced property rights failed to increase material prosperity" Alan Greenspan, *The Age of Turbulence*

"You can breed a thoroughbred racehorse to the point it dies of a common cold"

"There is an assumption that more information is better. We believe that enough information is appropriate...but too much information can be unhelpful in building clarity and confidence..."

"Queensland Rail was taking a more commercial approach to investment decision" QR CIO Dallas Stower

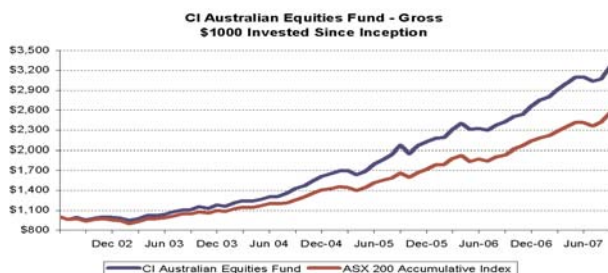
PORTFOLIO PERFORMANCE

	PORTFOLIO	BENCHMARK	VALUE ADDED
3 MONTHS	4.74%	5.89%	-1.15%
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#	25.22%	19.60%	5.62%
SINCE INCEPTION^	225.15%	155.57%	69.58%

* 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

^ Cumulative gross returns (since 4 July 2002)



The Australian share market performed well compared to global markets. The MSCI hedged world returned 0.96% vs. the ASX200 5.89%. The Australian market continues to outperform historical norms returning 32.40% in the past 12 months and 22% p.a. for the past 5 years.

For the quarter, the portfolio returned 4.74%. Major positive contributors included QBE which has a well executed global strategy backed by an investment portfolio skewed toward low risk high quality fixed interest. In addition, the resource sector benefited from stocks such as Worley Parson and BHP. Worley are continuing to grow their business strongly and have found new opportunities in leveraging their knowledge and capability with regard to environmental and energy efficiency services. BHP's decision to recruit from within for its new CEO was well received. The highly regarded Marius Kloppers will oversee a large capital expenditure program that will require commercial savvy, technical skills and the utmost focus on delivering "on time on budget" projects.

Negative contributors were Energy Developments, Transpacific and Bendigo Bank. Energy Developments has been hit by cost overruns on their West Kimberley power project due for commissioning this quarter. Assuming the

commissioning has no further delays or overruns the stock looks cheap. Transpacific is currently refinancing their debt which is expected to raise their borrowing costs. Following the rejection of the Bank of Queensland bid, the board of Bendigo Bank has proposed a merger with the Adelaide Bank (at a premium for Adelaide Bank shareholders). The merger increases the effective exposure to wholesale funding sources and lowers the exposure to hard core retail deposits, the effect of which is the likely raising of their average cost of funds. The bank's entry into the 3rd party mortgage channel is also seen as less valuable than their direct channel. The merger is expected to deliver considerable back office and compliance savings as well as cross sell opportunities.

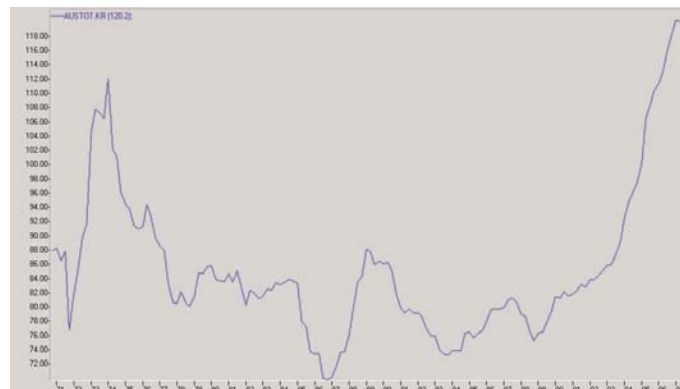
Despite the credit crunch in the US housing finance sector, the Australian economy continues (see the terms of trade and unemployment charts below) to perform well.

Australian National Unemployment Rate (1980 - current)



Source: Austock Securities

Australian Terms of Trade Index (1970 - current)



Source: Austock Securities

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However specialty finance companies underperformed e.g. Babcock & Brown (down 25%) and MFS (down 28%). The first round affect of the current credit repricing on the banking sector can be summarized as follows:

1. Repricing of credit and access to funding clearly favours the big traditional bank models over new entrants and securitization model.
2. Big AA rated banks will fund and provide liquidity to each other at the expense of lesser institutions.
3. Banks are returning to funding "on balance".
4. Business market going super well.
5. They continue to believe they have better cost out opportunities.
6. House mortgages will be repriced by dropping the discounts and honeymoon rates, not by lifting rates.
7. UK will see further contraction in spreads. They will see another big contraction in 08 but thereafter will be inline with system margins.
8. Corporate rates will rise and availability will be rationed to the best quality credit.
9. More margin pressure in the home mortgage book than the business book.
10. May see better institutional/corporate margins.
11. Banks running a lot of liquidity which means they are issuing bank bills and buying government bonds or depositing with other banks. This hurts the P & L.
12. No real signs of corporate or SME bad debts.
13. No signs of a slow down in infrastructure funding requirements.

The portfolio benefited from the merger interest shown by Asciano and Toll with Brambles (a long term portfolio stock). Further, the Coles board has recommended the Wesfarmers merger proposal which is expected to be completed in November. The merger should bring a more stable and focused environment for management to execute their business improvement plans.

Rio Tinto's US\$44b cash acquisition of Alcan increases their exposure to the fast growing demand profile of aluminum. The deal is based on: 1) Alcan is a big long reserve life integrated aluminum producer with access to cheap hydro energy and is complimentary and synergistic with Rio's aluminum businesses 2) aluminum current spot is close to the marginal cost of production relative to other commodities e.g. copper has risen 5X compared to aluminum which has risen around 2x from cycle lows 3) the Chinese cost of capital will increase as they become a greater part of the global community and the aluminum industry will be forced to meet the fully accounted cost of energy usage. China will scale back on energy intensive industries and will become an importer of aluminum 4) the company is backing a "stronger for longer" strategy.

The biggest risk markets face is a reversal of trends seen over the last 25 years i.e. rising rather than falling borrowing costs, declining profit share & margins from high historically high levels, PE contraction rather than expansion driven by rising inflation, increasing volatility and declining liquidity.

The other is competitive intensity observable in a number of industries. An example of potential margin risk can be seen in Coca Cola Amatil and SA Brewing targeting of the Australian beer market. Beer margins (30%+) in Australia are the highest in the world and with a \$1.2b profit pool it is an attractive target for global competitors and the supermarket chains. The NZX is targeting ASX business (70% + margins) by setting up a crossings

business with Macquarie, Citigroup, Commsec, Merrill Lynch and Goldman Sachs.

On the inflation front there are a number of pressures 1) China's inflation rate in Aug 07 was 6.5%. It is also becoming harder to get workers to migrate due to shortages of skilled labour in Asia. China's unit labour and input costs are not decreasing 2) cost of energy continues to rise. In many cases the drive to reduce fuel emissions is making fuel efficiency worse 3) agricultural costs are rising due to shortages of arable land and water; and the fuel for food substitution is exacerbated by the US desire to diversify its dependency on Middle East oil 4) long term underinvestment in training & skills e.g. engineers 5) central bank intervention in capital markets 6) real interest rate increases 7) government pressures to fund infrastructure budgets 8) USD depreciation is repricing commodities. Everyone selling in USD should be concerned with their relative cost position to the Rmb.

There are 3 broad themes that remain intact: 1) Continuation of growth and development of the Indian, Chinese and Asian economies 2) Demand for global Infrastructure/construction renewal including social infrastructure (hospital and schools) and essential services (power & water) 3) Demand for energy and alternatives to coal and oil. Beliefs which underlie our thinking include:

- Emerging and Asian market consumers are underleveraged compared to developed market consumers.
- The Chinese consumer market is hitting critical mass.
- Urbanization of the BRIC economies has a long way to go.
- Health budgets and State government requirements will require private sector involvement. The health sector is one of the least sensitive sectors to a tightening consumer credit cycle.
- Listed public markets have a big future as they satisfy the capital markets need for liquidity and transparency, and are more easily regulated due to transparent reporting.
- Some listed property assets are being mispriced (due to there property development dependency) whereas the property construction companies are experiencing rising margins for project and risk management expertise i.e. able to deliver on time on budget quality projects.
- Gas prices moving to world parity prices.
- Opportunities should increase for owner operator models that have conservative financial and operating models e.g. Woolworths, Rio, Wesfarmers, Fletcher Building and Orica.

VoF OBSERVATIONS ~ INDUSTRY TRENDS & BEHAVIOUR

"We rarely look closely at that principal operating unit of economic activity: the human being. What are we? What is in our nature and not subject to change and how much discretion and free will do we have to act and learn? I have been struggling with this question since I first knew to ask it...All people appear motivated by an inbred striving for self-esteem that is in large part fostered by the approval of others. That striving determines much of what households spend their money on...Economist cannot avoid being students of human nature, particularly of exuberance and fear. Exuberance is a celebration of life. We have to perceive life as enjoyable to seek to sustain it. Regrettably a surge of exuberance sometimes also causes people to reach beyond the possible; when reality strikes home, exuberance turns to fear. Fear is an automatic response in all of us to threats to our deepest of all inbred propensities, our will to live. It is also the basis of many of our

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economic responses, the risk aversion that limits our willingness to invest and to trade, especially far from home, and that, in the extreme, induces us to disengage from markets, precipitating a severe falloff of economic activity.” Alan Greenspan, The Age of Turbulence

Upon reading The Alan Greenspan biography, The Age of Turbulence we found the following points interesting:

1. He relies heavily upon observation not prediction.
2. His sources of information are heavily skewed toward government agencies such as bureau of statistics, dept of labour; other central banks and industry leaders and associations.
3. He is an optimist.
4. The financial system is more flexible and adaptable than 25 years ago to handle exogenous shocks because of globalization, deregulation and information technology.
5. There are good reasons why interest rates and inflation have fallen in the last 25 years but not necessarily permanently. Nor is the excess of savings over capital investment demand a permanent.
6. “We rarely look at the principle operating unit in economic activity: the human being” That is behind every sales and profit number lies a behavioural choice made by a customer.
7. History shows that despite advancement in technology and knowledge that productivity rarely advances more than 3% per year on a sustainable basis.
8. Of concern is his reference to Beijing as Peking.
9. He admits to putting on a show of “confidence” even though he harboured deep concern and fear during the S11 and LTCM crisis.

Europe & Asian Trip

“Investors are like reef fish, they all turn together”

During September we travelled to Europe and Asia and visited over 50 companies operating in a wide range of industries. Some of the general thoughts/themes we identified are listed below:

- Asian and Middle East savings switching from US treasuries and bonds into equities and hard assets e.g. Qatar is bidding for Sainsbury, diversifying from US\$; Temasek acquired 10% of Standard Chartered Bank
- Retail deposits are king.
- Strength is shifting from the financiers to corporates.
- Forget manufactured yield.
- Inflation is coming through more strongly and the liquidity provision from central banks will add to the pressure. For example Tesco, after decades of food deflation have recently encountered mild food inflation.
- Central banks talk now about a slowing of economic growth putting downward pressure on future inflation, i.e. moving into prediction.
- Spending on power generation, transmission and distribution will be high for many years.
- The use of materials in developing countries is skewed to housing whereas in developed countries the skew is to infrastructure and communications.
- China is the swing factor in the supply and demand for cement globally. Currently cement is sold out.
- Interest rates are rising regardless of the movement in cash rates now.
- Grain prices have gone up significantly, currently the world is very close to facing a shortage of food, the up cycle in agriculture is strong and long.
- Ageing, diabetes, obesity, depression, Alzheimer’s etc lead to a great future demand for drugs. Interestingly, the obesity phenomenon

is associated with economic growth so obesity disease in the developing world is now also increasing E.g. Mexico and India

- Flu doses are going up sharply.
- People running REIT’s are investment banking types rather than property types.
- The cycle is moving in favour of constructors, away from developers and owners.
- In the UK food experienced deflation for at least the past few years. This has now turned to modest inflation. For retailers modest inflation is ok, high inflation is not good.
- Compared to recent crisis the current crisis is centered on the consumer and residential housing.
- Bank funding is not a problem for strong corporates, it is a problem for financially driven entities such as infrastructure funds.
- There is a real refinancing risk in most infrastructure vehicles.
- There is not much difference between a good and bad retailer. Retailing is all about looking after the consumer and the detail, this is much more important than the big bang advantage in supply chain or other areas the consumer does not see.
- There is a new retailing model based on providing convenience shopping at a premium price of only 2% over the hypermarket price.
- The environment is becoming a much bigger focus for companies and regulators.
- Some portion of the total reinsurance risk has been on sold by insurance companies to fund managers, this should lead to a less volatile insurance market.
- There are many plausible reasons why the insurance market will not revert to the bad old days.
- The price of discovered gas is significantly cheaper than the price of discovered oil.
- Gas will fill the energy gap for the next decade at least but gas producers need to keep an eye on clean coal as the next major new energy source.
- UK regulator (gas & electricity) the arbitrage between debt and reset rates is over.
- Attracting, keeping and optimizing talent (people) is a growing issue for companies. The value of human capital is becoming more measured.

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