

CI AUSTRALIAN EQUITIES FUND QUARTERLY REPORT



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

SEPTEMBER 2008

"Charlie Munger and I are of one mind in how we feel about derivatives and the trading activities that go with them: we view them as time bombs, both for the parties that deal in them and the economic system." Warren Buffett in the 2002 Berkshire Hathaway Annual Report

"There's no doubt that things feel better today, by a lot, than they did in March...the worst is likely to be behind us" 6th May 2008, Treasury Secretary Henry Paulson

"It's a safe banking system, a sound banking system. Our regulators are on top of it. This is a very manageable situation." 20th July 2008, Treasury Secretary Henry Paulson

Uncertainty is the only certainty there is, and knowing how to live with insecurity is the only security." John Allen Paulos

PORTFOLIO PERFORMANCE

| | PORTFOLIO | BENCHMARK | VALUE ADDED |
|------------------|-----------|-----------|-------------|
| ROLLING 3 MONTHS | -7.99% | -10.44% | 2.45% |
| 2008* | -12.68% | -13.40% | 0.72% |
| 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# | 15.76% | 10.56% | 5.20% |
| SINCE INCEPTION^ | 149.42% | 87.18% | 62.24% |

* 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)

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



- The deterioration of the ASX200 Accumulation Index gathered momentum over the September quarter, falling 10.4% for the period. Over the quarter there continued to be significant disparity in performance between the top and bottom performing sectors.
- With tangible evidence of a global slowdown there has been a meaningful reversal in commodity prices over the quarter. Both BHP and RIO (-29% and -38%) were notable underperformers. The unambiguous trend in their prices was not helped by China recording its slowest growth in industrial

output for five years in the month of August. While the portfolio was buffeted by the falling Materials Index, a broad spectrum of healthcare stocks (+8.3%) namely Cochlear, CSL, Healthscope and Ramsey provided the foundation for a more acceptable portfolio return.

- In the midst of dire economic conditions and global financial disfiguration it was most surprising to see David Jones (+53%) as the best performing stock. It has been apparent that David Jones had prepared well in anticipating a downturn in discretionary spending by actively reducing its cost and inventory base.
- We would note, however, that a great many retailers have been beneficiaries of the rising \$AUD over the last several years. A most noticeable trend over the September quarter has been the rapid depreciation of the \$AUD (-17.4%). It will be interesting to see how resilient operating margins are for the retailers if the new lower levels of the \$AUD are maintained.

VoF OBSERVATIONS ~ INDUSTRY TRENDS & BEHAVIOUR

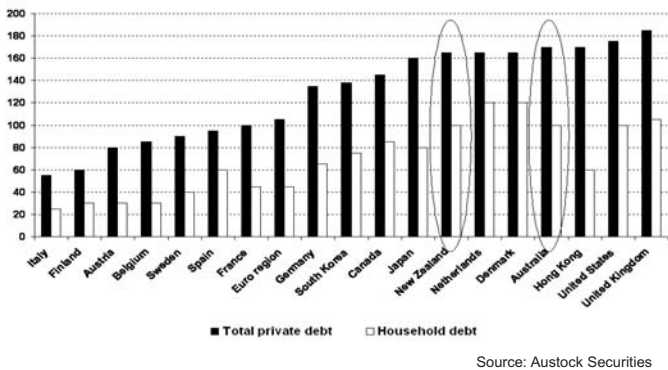
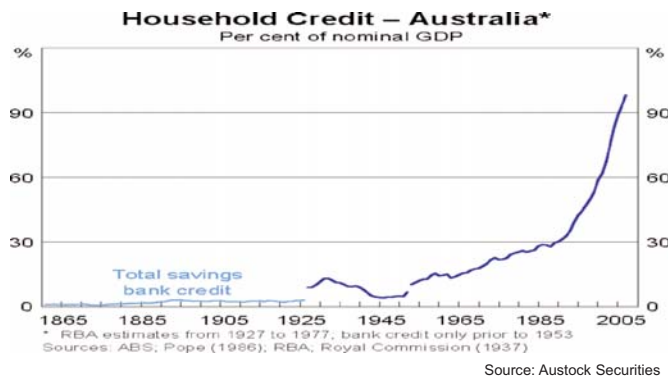
- A recent tour of the assets of a listed property developer highlighted the problems emerging in their residential development book. Sales of land and house packages had fallen 50% year to date. With their balance sheet at the upper echelons of its debt capacity, it was noted by one of its senior executives that no longer did "strategy drive liquidity but that now liquidity drives strategy". This is a problem that has beset the great majority of companies operating in the property sector. Hence at this point our preference is to be careful observers rather than investors in the listed property sector.
- The basic message from a recent tour of Coles and Safeway has been the growing penetration of the private label category. While Australia is still under represented in its Private Label offerings compared with UK supermarkets its category share is rising markedly. More noticeable, has been the improvement in packaging of the premium private label products. The result has been an effective dilution of branded products across most categories.
- As indebted consumers become more cost conscious this trend should become more deeply entrenched. The beneficiaries may also be the large discount Supermarkets such as Aldi and to a lesser extent Costco.
- As we start to receive a myriad of Annual Reports, one further indicator may warrant closer attention, namely the composition of receivables. Already there have been a handful of companies which have reported deterioration in the ageing of their receivables. This trend may gain further traction in a more challenging economic environment as distressed customers try to defer payments.
- The charts below of Private Sector debt to GDP ratios by country and Household credit vividly highlight the unenviable position Australia is currently in. Undoubtedly many Australian corporations and consumers will be required to rebuild their depleted balance sheets. The substantial deleveraging required by the private sector and households will require return expectations to moderate noticeably.

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The State of the Global Economy

- The American financial system remains in acrid condition. In September the financial crisis intensified to a level whereby the whole global economy was endangered. In order to alleviate this devastation US authorities abandoned its strategy of dealing with one problem at a time to adopting a more comprehensive plan (Emergency Economic Stabilization Act) of the Government acquiring billions of dollars of illiquid assets from financial institutions so those institutions could raise capital and resume lending. What is clear is the uncertainty of predicting the course of this crisis. Nonetheless, the impact of this crisis will be the deleveraging of the banks, corporations and households. Each of these entities balance sheets have become so badly dislocated with cheap and easy credit. We would contend that this will lead to a prolonged period of credit contraction; lower returns on funds employed and forced asset sales. As such we remain resolute in our view of favouring financial institutions with strong and expanding deposit bases and prudent capital ratios.
- Six months ago the United States heralded five large investment banks. Over this short period Bear Sterns and Lehman Brothers have collapsed, Merrill Lynch has been forced to merge with Bank of America and Goldman Sachs and Morgan Stanley are becoming commercial banks.
- Goldman Sachs and Morgan Stanley will now have to conform to the capital requirements that govern commercial banks. In essence, this will mean significant less leverage for each organisation, with assets representing 10 times their capital bases instead of 20 to 30 times. Undoubtedly more prudent use of leverage will translate into lower returns and compensation.
- The regulatory moves to convert Morgan Stanley and Goldman Sachs into bank holding companies and Treasury's plan to buy distressed

securities from errant financial institutions have provided some short term relief. However, the real problem is that the financial sector and the broader economy remains vastly over leveraged.

- The nationalization (conservatorship) of Fannie Mae and Freddie Mac coupled with the collapse of Lehman Brothers and the near failure of AIG Insurance lead to the credit and debt markets almost stop functioning.
- While the risks of a global recession are arguably increasing some positive trends have emerged. In the first instance there has been the reduction in inflationary pressures through the easing of energy and food prices. Over the quarter, the price of oil in particular, has fallen around 31% from a peak of \$147 a barrel. This may have also contributed to the first noticeable reduction in the Chinese inflation rate.
- Over the quarter we visited both the United States and Singapore. Our visits, it could be said, have shown two vastly contrasting regions. – the USA where debt levels have spiraled out of control across financial institutions, the Federal Government and the consumer compared with Singapore and much of Asia where debt levels remain at subdued levels across the spectrum of their economies. Undoubtedly, Singapore and much of Asia are being affected by the headwinds of a global slowdown but with unleveraged balance sheets at both a corporate and government levels this should place them in a more resilient position. We visited two of Singapore's largest banks, namely DBS and OCBC, both of these banks have deposits that exceed loans. Moreover, deposits continue to grow at double digit levels despite the consumer receiving on average a .35% interest rate.
- During our Singapore visit we also had the chance to re-visit Toll Holdings Asian operations. Since our last visit to their operations nearly a year ago, it was clear that management had further deepened their understanding of the opportunities and challenges Toll faces in Asia. Over the last couple of years Toll has acquired 3 large Asian logistic businesses (Sembcorp, Kimtrans & Baltrans). It is interesting to note that in Asia, Toll have acquired quality businesses not the distressed assets which characterized Toll's acquisition strategy in Australia throughout the 1990's. The rationale for this change is that in building a presence in an entirely new market it was a safer approach acquiring well established businesses with some security of long duration contracts.
- It is evident as multinationals and large local corporations move from a country specific to a regional focus a more complex logistic solution is required. The multinational corporations are now requiring a multi capability/model approach using road, rail, air and sea services across the Asian region. Despite a number of leading global logistic companies building a base in Asia, to capture the evolving opportunities in the region, the logistic and transport markets remain highly fragmented. Toll estimate that their markets share in Asian Logistics is around 2%, this compares with a 12% market share in Australia.

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