

CI AUSTRALIAN EQUITIES FUND QUARTERLY REPORT



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

SEPTEMBER 2010

Market and Fund Performance

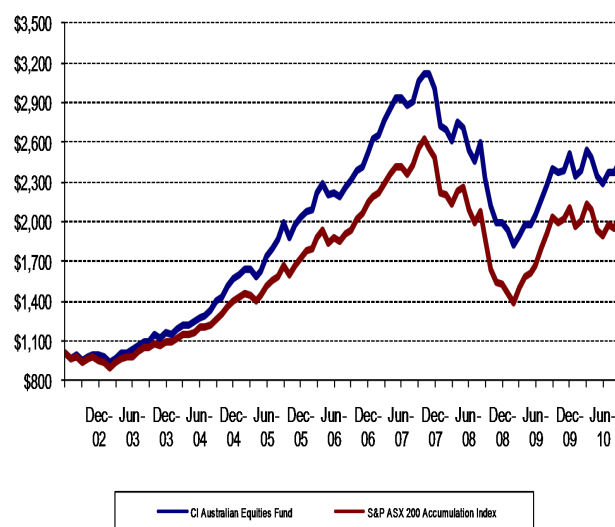
| | **FUND | BENCHMARK | VALUE ADDED |
|------------------|---------|-----------|-------------|
| ROLLING 3 MONTH | 7.76% | 8.04% | -0.28% |
| ROLLING 1 YEAR | 3.31% | 0.61% | 2.70% |
| ROLLING 2 YEAR | 3.87% | 4.41% | -0.54% |
| ROLLING 3 YEAR | -6.11% | -7.23% | 1.12% |
| ROLLING 5 YEAR | 5.31% | 4.15% | 1.16% |
| ROLLING 7 YEAR | 13.51% | 10.05% | 3.46% |
| SINCE INCEPTION* | 12.76% | 9.03% | 3.73% |
| SINCE INCEPTION^ | 169.09% | 104.03% | 65.06% |

*Annualised

^Cumulative (4 July 2002)

**Before fees and expenses

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



In a more buoyant third quarter of the calendar year, the ASX 200 Accumulation Index rose 8.04%. This was supported by global stock markets staging a major recovery in the month of September. Recent economic data continues to support China remaining the major driver of global growth. The stabilization of Chinese growth at relatively high levels has underpinned the recent improvement in global equity markets. In addition, while the back-drop of US economic data remains at best mixed, it does appear that the US has avoided a double dip recession, while concerns of a European Sovereign debt crisis have currently abated.

Over the quarter the Fund rose 7.76%, marginally under-performing the benchmark by 0.28%. The stocks in the portfolio which made a strong positive contribution to performance included Alumina, Transurban, Rio Tinto, Oil Search, Tatts Group and ANZ Bank. On the negative side, the stocks in the portfolio which under-performed were Cochlear, QBE Insurance, Macquarie Bank, Amcor and CSL.

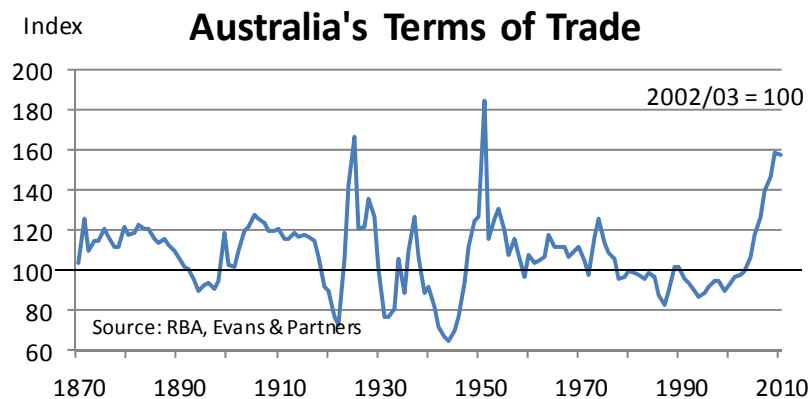
The impact of the global financial crisis has been relatively benign for Australia. Australia has benefited from buoyancy in the resource sector under-pinning a large rise in our terms of trade. The strengthening of commodity prices and the likelihood of Australian interest rate rises has under-pinned the rise in the AUD. Indeed the AUD appreciated 15% over the September quarter. The implication of an AUD approaching parity has quite dramatic implications for Australian companies. On the one hand, Australian domestically focused companies such as retailers continue to enjoy the benefits of cheaper imports. Conversely, a number of high quality healthcare and industrial companies who have resolutely grown their offshore earnings are now finding the rising AUD a significant headwind. It is interesting to note that the majority of our stocks which under-performed over the quarter derive much of their earnings from the US and Europe.

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The Portfolio

The biggest stock change over the September quarter was the completion of the bid for Healthscope (HSP). In the June Quarterly Report we briefly mentioned that HSP had received bids from several interested parties at \$5.80 per share. By July, HSP had entered into a Scheme Implementation Agreement with the Carlyle Group and TPG Capital under which they would acquire 100% of the company for \$6.26 in cash per share. On the 24th September the scheme of arrangement received Court approval with HSP share holders set to receive \$6.05 in cash per share plus a 21c fully franked dividend. HSP was delisted on the 27th September 2010. We believe that this has been a good outcome for HSP shareholders.

We made several changes to the portfolio during the quarter. We sold out of our position in Austar after recent results indicated that growth in new subscribers is becoming more challenging. An increase in advertising and marketing expenses to reinvigorate subscriber growth has had only a limited impact. It is evident that competition from new free-to-air digital channels, combined with the introduction of an array of set top box alternatives, is making it more difficult for Austar to attract new subscribers.

We modestly added to our position in QBE, principally because the valuation metrics have become the most attractive they have been for a number of years. We believe the market has placed a sufficient discount in QBE which more than adequately reflects the current level of global insurance premiums and the historically low interest rates in Europe and the US.

Observations from CI visit to the U.S.A.

"Although financial markets are for the most part functioning normally now, a concerted policy effort has so far not produced an economic recovery of sufficient vigour to significantly reduce the high level of unemployment". Ben Bernanke Federal Reserve Chairman, 2010.

"We are getting back to an old fashioned basis of lending, providing credit only to people who have the ability to repay". An Analyst at Moody's Credit Agency.

According to the National Bureau of Economic Research's Business Cycle Committee, the US recession ended in June 2009. In response to the deepest and longest slump in economic activity since the Great Depression, the US Government initiated an unprecedented level of intervention.

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Since the commencement of the Global Financial Crisis, the US Government has spent nearly \$3 trillion in stimulus programs such as cash for clunkers, a home buyer tax credit, mortgage repayment relief measures and increasing the level of unemployment benefits. In the short term such programs have stimulated new demand however, once the programs expired, demand once again has fallen. Moreover, the average rate for a 30 year mortgage of just over 4% is near the lowest level ever recorded since Freddie Mac began tracking the data in 1971. Despite this, demand for new housing remains anemic with the economy growing well below its long term trend rate and unemployment remains stubbornly high at just under 10%.

The combination of US house prices falling by 25% to 30% between 2007 and 2009 and record levels of leverage has resulted in almost one in four Americans with mortgages owing more than their houses are worth. It is not surprising, therefore, that the outlook for consumer spending remains constrained. Recent US Census data compounds the limitations placed on the US household as it highlighted that wage growth has stalled over the last decade. Specifically, inflation adjusted income of the median household fell 4.8% between 2000 and 2009.

In marked contrast, recent commentary by the Reserve Bank of Australia clearly indicates that economic growth continues to be well supported by high commodity prices and the growth in resource export volumes. Although a number of Australian companies have been beneficiaries of this trend it is also apparent that a significant number of Australian companies have operations and generate a meaningful portion of their revenue from the US. With this in mind we thought it was timely that we visited the US to analyse first hand how a number of these companies are fairing.

Sims Metal

Sims Metal Management ("SGM") is one of the companies in the portfolio that derives a substantial part of its revenue from its US operations. It is the world's largest listed recycler with 230 operations globally. Since 2005 SGM has acquired and integrated 24 businesses. Following the acquisition of Metal Management in 2008, a majority of its revenue is generated in North America. Historically consumer spending has made up more than two thirds of gross domestic product, laying the foundation for the US having the highest density of scrap in the world. Today, volumes for scrap remain 25% to 30% below the peak levels of 2008. Consumers are not replacing cars, refrigerators, ovens, washing machines or demolishing buildings at the rate they once did. By way of example, new car sales in the US peaked around 16m prior to the GFC, today new car sales are averaging around 10m to 11m per annum.

In the US SGM processes around 7m-8m tonnes of scrap a year, which equates to a market share of around 12%. Over 50% of the scrap industry is controlled by small regionalised operators. As the cost of business is rising, as more onerous regulatory requirements are being placed on the scrap industry and volumes remain subdued, SGM expects that there will be opportunities for industry consolidation. A \$400m capital raising last year by SGM has bolstered its balance sheet to a net cash position and provided the foundation to participate in the consolidation of the scrap industry.

CI visited SGM's largest US recycling facility in New Jersey. The facility is in an impressive position, situated adjacent to a deep water port and a rail network, both of which make the transportation of scrap economically attractive. The latency of the site is also enhanced by its close proximity to one of US's largest population catchment areas.

SGM has also been able to fund the introduction of new scrap shredder technology which it will progressively roll-out to its largest scrap facilities. The new shredders provide greater automation and allow a broader range of materials to be recycled. Improving recycling technology has provided SGM with the ability to effectively compete for rubbish traditionally processed by landfill sites.

In its first major contract, SGM won a 20 year with a 20 year extension with the New York City Municipality to collect and process all recycled waste. SGM is currently building the largest curbside recycled processing plant in the

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US. Under the contract SGM will separate paper, plastic, aluminum, glass & steel for the 9 million people in the NYC region. Interestingly, in NYC only 50% of recyclable rubbish is processed for recycling, the balance is still thrown away as general rubbish in landfill. Therefore, it is not surprising that the NYC municipality is trying to more effectively encourage businesses and consumers to dispose of their waste in a more environmentally friendly way, which over time should be beneficial to the volumes received by SGM.

Undoubtedly SGM is well positioned in an industry which is a beneficiary of communities encouraging greater use of recycling. Nonetheless, in an ironic twist SGM is wholly dependent on the consumer replacing the old with the new. Hence, any sustainable recovery for SGM, as with many other corporations, is largely dependent on more normalised levels of consumption by the US consumer. Due to our concerns about the embedded challenges facing the US economy, we will continue to monitor our position in SGM closely.

Brambles

A primary component of our US trip was attending Brambles' annual investor briefing. The focus of the briefing was principally on its US pallet business (CHEP) which contributes over a third of Group revenue. In recent years, a central disappointment with Brambles operational performance has stemmed directly from CHEP US.

CHEP US enjoyed remarkable growth both in revenue and in its operating margin through the earlier part of this decade. A financially focused management team enabled significant operational leverage but with a sharp contraction in the US economy many problems surfaced in the US CHEP franchise. With undiluted gumption US CHEP strived for higher and higher returns. Alas while these returns improved dramatically they were achieved through insufficient investment and attention to customer needs.

In essence, a progressive deterioration in its pallet offering led to CHEP not meeting the expectations of its customer base. The manifestation of this disenchantment provided a springboard for other pallet providers to enter the market, such as IGPS, which has built its presence from winning contracts from CHEP US. The meaningful deterioration of its franchise has thankfully galvanized Brambles into implementing significant change.

The changes have been twofold. In the first instance, investment in a new management team both at Brambles Head Office and in the US has added much needed operational experience into the Group. Moreover, in late 2009, CHEP implemented a capital investment program requiring over US\$250m of investment in lifting and maintaining the pallet quality over the next 3 years.

From our visit, it is evident that CHEP has made solid progress in improving the quality of its pallet pool. In addition, greater management concentration on the US business has led to a more refined and sustainable growth platform. A central focus on its existing customer base coupled with opportunities to extend its presence into the SME market provides encouragement of the appeal of its franchise. Notwithstanding this, we remain concerned the US economy continues to place large constraints on the consumer. For CHEP US, this will arguably continue to dampen both organic growth and hinder its ability to raise prices in a meaningful way over the foreseeable future. Due to this ongoing concern, we have sold out of the portfolio's position in Brambles.

Costco

In the US we spoke to Costco, the 3rd largest retailer in the US and the 8th largest retailer in the world. We were keen to visit Costco for a number of reasons: first, we are interested in retail trends which may be relevant to the Australian market and our investment in Woolworths; secondly, to provide an insight into how the US consumer is tracking; and, thirdly, to hear how Costco's first store in Australia has performed in its first year of operation.

While Costco remains a North American centric retailer with 80% of revenue generated in this region, the company has gradually extended its footprint into Asia and the UK over the last decade. Indeed, a central strategic goal for Costco is to ultimately have 50:50 split in revenue between North America and the rest of the world.

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In the US Costco has increased its retail market share through the global financial crisis as consumers have become more value conscious. Costco has observed that its customer base has changed the way in which they shop. At the peak of the economic downturn there was a marked slowdown in the purchase of non food items and consumers tended to purchase only what they immediately needed to consume. The consumer, therefore, shopped more frequently but purchased less. Costco, like other US retailers, has seen their demand for private label increase as shoppers seek greater value. In recent months there has been some evidence of an improvement in non food purchases but everyday value has become the new norm for the US consumer.

In Melbourne, Costco's warehouse has performed remarkably well in its first year of operation, exceeding the company's average revenue per store of US\$140m to US\$150m. In FY11 Costco is opening its second warehouse store in Sydney. Over the next decade, Costco wants to build its Australian presence to generate over \$1bn in annual revenue. Interestingly, Costco's greatest challenge to date has not been attracting a customer base to its unique membership model but in its ability to secure appropriate land sites for its warehouses. The ambitions of Wesfarmers and Woolworths to expand their hardware presence and Costco's enthusiasm to grow in Australia suggest that demand for big box retail sites will be at a premium. Nonetheless, we remain confident that Woolworths will retain its premier position in both supermarkets and general merchandise given its unmatched scale and efficiency in its supply chain.

Market Observations and Outlook

While history will show that Australia sailed through the global financial crisis almost unscathed, the crisis did expose a weakness in Australia's structural position. We have run a large current account deficit and we are also investing heavily in mining and infrastructure. Consequently there is a large shortage of domestic savings which is financed overseas. The major banks dominate the lending market and they in turn have a shortage of domestic deposits to fund their loan growth so they are large borrowers overseas. So really the four major banks are doing the foreign borrowing for the whole country. The potential problem is that there are only four large banks and if one of them made a major mistake it would have very negative ramifications for the economy. The other potential problem is that foreign lenders may one day decide they no longer want to fund Australia.

The Australian banks are subject to the same regulatory changes that the Basel Committee is imposing on the large overseas banks that caused and suffered from the global financial crisis, that is higher levels of capital and liquidity.

We set out below our observations of the current conditions for the banks' operations and some expectations of developments we may see in the future.

- While the banks have a challenging foreign borrowing program, they are having no problem in borrowing and the margins they are paying are declining. Foreign investors see Australian banks as sound and they see Australia as having strong economic prospects. More and more foreign investors are viewing Australia as an extension to the China and Asian growth story. The banks are diversifying their overseas lending and significantly lengthening the duration of their borrowings, thus improving the quality of their balance sheet.
- Deposit rates have risen as the major banks want to increase their level of deposits to meet stable funding requirements. In general, deposits are viewed more favourably than borrowings by bank regulators. Term deposit rates are around 6% which is well above the bank bill rate and it is expected that term deposits will continue to be attractively priced.
- It is most likely that bank loan growth will be much lower than it has been in the past because of overseas funding pressures and because the capital and liquidity requirements of the banks are so much higher. Mortgage growth, in particular, is likely to slow and business lending is likely to start increasing again. Under this outcome house prices are unlikely to increase because easily available mortgages have been a major stimulus to house prices.

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- Alternate funding sources to deposits and overseas borrowings will increase. These include domestic bank bond issues, securitisations of home loans, greater overseas syndication of bank loans and possibly the commencement of a covered bond market in Australia.
- Large companies are very keen to diversify their funding requirements away from the four major banks and some will seek to raise money through the domestic fixed interest markets. The domestic fixed interest market is very small but it will grow because companies want to use it and retail investors want to have some exposure to fixed interest markets.
- There is a likelihood that superannuation funds will increase their allocation to cash and fixed interest markets, first, as there are more attractive issues to invest in and, secondly, in response to the disappointing performance of equities.
- Finally, if banks lending grows slowly, they will be even more certain to pass on increases in their own funding costs to borrowers and to increase their efforts to reduce costs.

Banks are likely to show lower earnings growth than they have for the past couple of decades but they will have stronger balance sheets and be reasonably attractive investments. Good quality companies will be able to refinance loans reasonably easily and attractive investment propositions will be easily funded. We have seen many maturing loans in the infrastructure sector (airports, pipelines, roads, utilities) being refinanced in the past six months. We have also seen banks wanting to grow their loans to strong property companies and they expect the strong property companies to buy property from the more stressed property companies and help solve any lingering problems the banks have in their property loan books. Overall funding has become much more stable this year and should not be a negative for the stock market in the next year or two.

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