

# CI BRUNSWICK FUND QUARTERLY REPORT



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

JUNE 2008

*"Not everything that can be counted counts, not everything that counts can be counted" Einstein*

*"To every human problem there is an easy solution that is neat, plausible and wrong" HL Menchen*

*"As I grow older, I pay less attention to what men say. I just watch what they do". Andrew Carnegie*

## PORTFOLIO & MARKET PERFORMANCE

	BRUNSWICK FUND**	S&P ASX 200	MSCI HEDGED#
3 MONTHS	-3.29%	-1.79%	-1.09%
2008*	-13.95%	-13.40%	-14.04%
2007*	36.6%	28.7%	22.9%
2006*	26.6%	23.9%	16.3%
2005*	36.1%	26.3%	10.9%
SINCE INCEPTION <sup>0</sup>	19.29%	14.93%	8.04%
SINCE INCEPTION <sup>^</sup>	102.49%	74.46%	36.24%

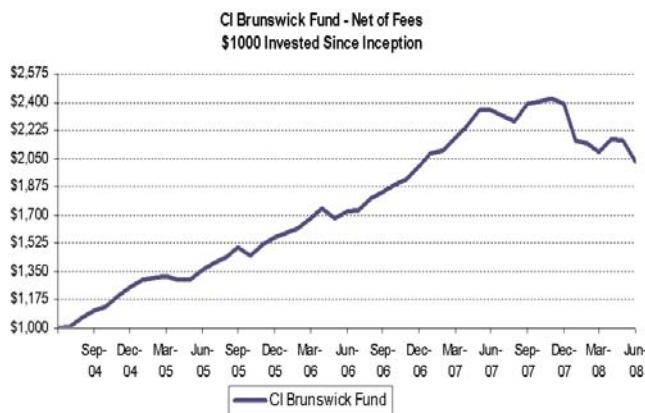
\* Financial year to 30 June

\*\* Net performance - after management and performance fees and expenses

<sup>0</sup> Annualised

<sup>^</sup> Cumulative since the CI Brunswick Fund was launched on 1st July 2004

# MSCI hedged to AS (representing returns on international equity markets)



Stock market indexes weakened a little over the quarter but this masked the fact that they rose in April and May and then fell sharply in June. The weakness in June has continued into July. Stock markets around the world have all been moving in lockstep during 2008.

Over both the last quarter and the full financial year the best returning sectors were energy (+34% and +35% respectively) and materials (+11.9% and +18.1) while the bottom ranked sectors were consumer discretionary (-22.5% and -43.2%), property trusts (-17.2% and -40.3%) and financials (-10.1% and -33.5%).

Bond yields rose a little in Australia over the quarter, 10 year bond yields increased by 0.4% to 6.5% at the end of June however since the end of the quarter yields have dropped to 6.3%. The cash rate was unchanged at 7.25% during the quarter however banks continued to increase their lending and deposit rates. The corporate fixed interest market stabilized over the quarter

after the large price declines in the March quarter.

The Australian dollar has risen substantially since the end of March, in particular the dollar has risen from 91c to 97c against the US\$.

The portfolios return was only a little better than the general stock market which was disappointing given we identified the general investment background quite accurately. A couple of smaller stocks detracted from performance in the past year.

The portfolio is currently structured as follows:

- 8% is invested in cash
- 12% is invested in Australian bank bills in maturities out to December 2008
- 80% of the portfolio is invested in equities
- Of the 80% Australian shares represent 59% and overseas shares represent 21%
- Short positions have been reduced to around 2% of the portfolio.
- The foreign currency exposures are around 70% hedged back to the Australian Dollar.
- Around 10% of the portfolio is invested in energy related stocks

We believe the following are the most important issues that need to be considered in structuring an equities based portfolio.

The first point is that the level of debt has reached unsustainably high levels in many Western countries and in particular in Australia. Of course no one knows in advance what level of debt is too high but the sub prime crisis has been the catalyst to prove definitively that current levels are too high and must come down. Australia in particular has been on a debt binge for the past decade and it has been mainly in the housing market and has been mainly funded by the banks.

The second point is that house prices in Australia are very high and must fall. There have been various studies that show that Australian housing relative to income is the most expensive in the world, consequently there has been much debate about housing affordability in Australia. We think the main way that the affordability issue will be solved is that house prices fall. It seems the market view is that because there is not an oversupply of houses in Australia prices will not fall, to us that is like saying because there are mandated inflows of money into superannuation then share prices will not fall, clearly this argument has not held up in the past year.

The third point is that consumer demand has been running at levels that are too high (or savings levels are too low). As the economy has been growing

Applying Cooper Investor's VoF investment philosophy without reference to indices, benchmarks, institutional style descriptors or portfolio construction rules that apply to institutional equity funds.

We accept volatility as being the cost of participating in investment markets that we expect to deliver long run returns.

## JUNE 2008

above capacity (aided by increased debt) this has led to inflationary pressures and a very high trade deficit in Australia.

Right around the world inflation is rising, in almost all cases to levels well above the inflation range that Central banks target. While some of the inflation has been due to oil and food prices a significant cause of inflation has also been driven by excess demand. We think there is a real risk that the level of inflation will not drop sharply if oil prices fall because it is feeding through second round effects, in particular into wages. We also think that Central Bank objectives of targeting low inflation and also stable banking systems and employment levels will prove to be incompatible and that the targeting of inflation may be the objective that is not achieved in many countries.

In Australia the Reserve Bank has clearly achieved its objective of slowing demand and we feel that the domestic economy will feel like it is in recession for the rest of the year even though the GDP will still be positive due to the resources sector growth in income.

These negative factors have led to the sharp fall in share prices we have seen in Australia and right around the world.

On the more positive front Australia is in better shape than most other developed countries.

The Reserve Banks actions represent good "hard money" policy and it is leading to short term pain for long term gain. At least we have scope for interest rates to fall in the next year because the starting point of 7.25% is high.

The A\$ at nearly parity to the US\$ could also provide a buffer if domestic conditions deteriorate more than expected, there is at least scope for a fall in the A\$ to cushion the effects of lower commodity prices.

Australian governments also have budget surpluses in many cases and again these provide a buffer if domestic conditions deteriorate more than expected.

So overall we are likely to see a return to conservatism in terms of allocation to equities, government intervention, gearing levels, home ownership and consumption levels that will run for many years.

The areas to be very cautious about continue to be stocks relying on consumer demand, housing and banking. Unfortunately in Australia these sectors represent very large segments of the listed markets.

With this background it is appropriate to hold higher than normal levels of cash, to diversify into international stocks where the fundamentals are better than Australian equivalents, to seek stocks that provide some protection against inflation and to be patient. It is unlikely we will hold significant short positions as much of the negative background we identify above is well recognized now. We have positioned the portfolio based on this background.

We feel that new opportunities are most likely to emerge in the following areas:

- Stocks that recapitalize through the issue of new equity at attractive prices. The key is to make sure that the equity issue is of sufficient size to ensure that whatever the problem was it is definitely fixed.
- Stocks where value becomes compelling and the balance sheet has low or no debt. The challenge in this area is to gain sufficient confidence in the valuation because rising inflation, slowing sales, rising interest costs

and increased risk aversion makes valuations very difficult to pin point.

- Stocks in industries where the operating trends are improving, though at present we are finding it difficult to identify new areas where trends are improving.
- Overseas stocks where the pricing is significantly lower than in Australia.
- Infrastructure and property listed debt issues where returns are higher than the expected equity returns.

### VoF OBSERVATIONS ~ INDUSTRY TRENDS & BEHAVIOUR

#### *"It is dangerous to be right when the government is wrong" Voltaire*

"The average age of power transformers in service is 40 years, which also happens to be the average lifespan of this equipment. Combine the crying need for maintenance with a shrinking workforce, and we may find that the 2005 blackout that affected parts of Canada and Northeastern United States might have been a dress rehearsal for what's to come. Deregulation and restructuring of the industry created downward pressure on recruitment, training and maintenance and the bill is now coming due", Edwin Hill, President of the International Brotherhood of Electric Workers.

Inflation is now centre stage again globally, for the first time in twenty years. In the face of rising oil and commodity prices, the ongoing attention on inflation fighting from mandated Central Banks in the Western world has not been sufficient to avoid the risk of the first serious bout of inflation in two decades or more. Global inflation is running at 5.5%, the highest figure since 1999. Lower but rising in developed economies, the numbers in some of the developing economies are truly scary – Indonesia 7.6%, China and India 8-10%, Russia 14%, Argentina 20%. "Two thirds of the world's population will probably suffer double digit inflation this year"<sup>1</sup>. Negative real interest rates prevail as emerging markets have used price controls and subsidies to control prices of essential items and the Federal Reserve has reduced interest rates to avoid a financial implosion. Wages are starting to reflect the trend established in prices – in Russia they are rising at 20%+ p.a., in Indonesia the government has just allowed a 17.5% salary increase to public servants to reflect a cost of living allowance. Governments are bowing to the inevitable – in Indonesia the price of petrol was raised by a third in May, in India and China the same is happening. The cost of food and fuel subsidies in these economies is now too high for governments to bear despite the obvious political ramifications of reduced subsidies.

There is another more insidious trend we have observed in the last six months – one which unfortunately is more distasteful and risks Australia, from a governance perspective, looking like a third world entity, namely government intervention/regulation which is unnecessary, ill thought out with no rational economic basis or merely the revocation of prior promises or imposition of new taxes. The lengthy list to date is as follows:

- Termination of the agreement with the OPEL telco consortium
- Medicare rebate changes in the 2008 budget
- WA mandating of gas for domestic use
- Queensland coal royalty tax increase
- Victorian gaming license regime change
- Fuel Watch scheme
- Supermarket review
- Maintenance of the Four Pillars banking policy
- WA decision re Pilbara rail access
- Revocation of North West Shelf rebate
- Alcohol tax on alcopops

## JUNE 2008

The regulatory risk inherent in investing in companies in any sector would seem to have risen substantially in recent times. Further areas of risk include Telstra and the fibre to the node project, changes to the funding regime for pathology and radiology, and futile industry assistance (e.g. auto).

We have written in previous reports of the necessity for infrastructure spending around the world. This is a theme which will continue for some time yet driven by growth and urbanization in emerging economies (China, India), the need to improve old infrastructure (Eastern Europe), the need to maintain competitiveness in a context of rapid globalization (Panama Canal) and the need to renew/replace old infrastructure in the West (USA bridges, French and UK blackouts).<sup>2</sup> However the financing of infrastructure projects has been thrown into temporary disarray by the current credit crisis. Banks are unable to lend to the same degree, private equity has gone quiet and the listed sector is de-leveraging rather taking on more debt. Structures put in place by the likes of Macquarie and Babcock & Brown no longer resonate with investors. Government is the final alternative – in Australia there is to be a \$20B fund set up, in the USA government spending on roads continues. But there is a growing gap between projected worldwide infrastructure requirements and public funding capacities.<sup>3</sup>

The sheer amount required to be spent on infrastructure is mind boggling. The USA today spends 1-2% of GDP on infrastructure, India spends 5% and China 9%. But the world's population is set to increase from 6.5B today to 9B in 40 years – all of whom will require transport, medical and many other facilities. It has been estimated<sup>4</sup> that, in the period 2000-2030, \$38.5TR will be spent by OECD and BRIC nations on road, rail, electricity and water. Today the World Bank estimates that governments and public utilities account for 70% of global infrastructure spending, the private sector accounts for 22% and official development assistance the balance of 8%. It is inevitable that governments will increasingly utilize the private sector to help with the funding of infrastructure requirements. This will require the involvement of areas where there are large pools of savings – Middle East and Asia – the sources of funds we have seen already in the bail outs to date of US investment banks. In the medium term opportunities will exist for service providers to infrastructure owners, but also for traditional owner operator companies geared correctly and prepared to make a reasonable long term return on investment. Given that a large proportion of the investment will be in emerging economies, this will necessitate reform of their regulatory systems – historically a tortuous process.

## TERMS AND CONDITIONS

### Information contained in this publication

The opinions, advice, recommendations and other information contained in this publication, whether express or implied, are published or made by Cooper Investors Pty Limited (ABN 26 100 409 890), Australian Financial Services Licence (221794), and by its officers and employees (collectively "Cooper Investors") in good faith in relation to the facts known to it at the time of preparation.

Cooper Investors has prepared this publication without consideration of the investment objectives, financial situation or particular needs of any individual investor, and you should not rely on the opinions, advice, recommendations and other information contained in this publication alone.

This publication contains general financial product advice only.

### To whom this information is provided

This publication is only made available to persons who are wholesale clients within the meaning of section 761G of the Corporations Act 2001. This publication is supplied on the condition that it is not passed on to any person who is a retail client within the meaning of section 761G of the Corporations Act 2001.

### Disclaimer and limitation of liability

To the maximum extent permitted by law, Cooper Investors will not be liable in any way for any loss or damage suffered by you through use or reliance on this information. Cooper Investors' liability for negligence, breach of contract or contravention of any law, which cannot be lawfully excluded, is limited, at Cooper Investors' option and to the maximum extent permitted by law, to resupplying this information or any part of it to you, or to paying for the resupply of this information or any part of it to you.

### Copyright

Copyright in this publication is owned by Cooper Investors. You may use the information in this publication for your own personal use, but you must not (without Cooper Investors' consent) alter, reproduce or distribute any part of this publication, transmit it to any other person or incorporate the information into any other document.

<sup>2</sup> Pierre Lortie – OECD forum on Climate Change, Growth and Stability June 2008

<sup>3</sup> OECD Report – Infrastructure to 2030: Telecom, Land Transport, Water and Electricity

<sup>4</sup> Ernst & Young report - Infrastructure 2007