

# CI BRUNSWICK FUND QUARTERLY REPORT



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

## SEPTEMBER 2011

*"If you have an apple and I have an apple and we exchange these apples then you and I will still each have one apple. But if you have an idea and I have an idea and we exchange these ideas, then each of us will have two ideas." George Bernard Shaw.*

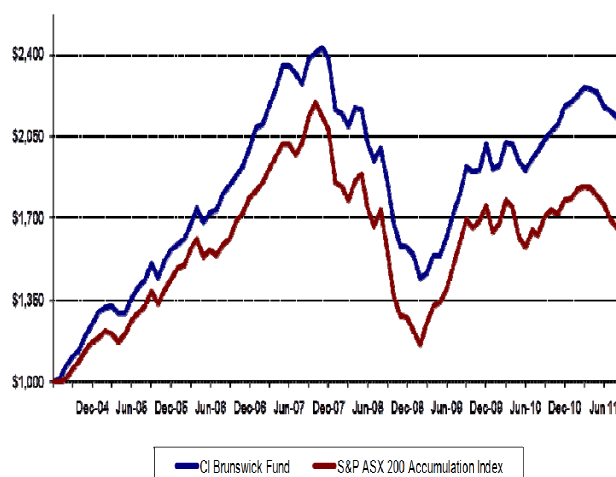
*"A committee is a cul-de-sac down which ideas are lured and then quietly strangled." Sir Barnett Cocks (in New Scientist, 1973.)*

*"The basis of effective government is public confidence". John F. Kennedy.*

### Market and Fund Performance

	**FUND	BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	-4.02%	-11.58%	7.56%
ROLLING 1 YEAR	4.02%	-8.56%	12.58%
ROLLING 2 YEAR	5.55%	-4.09%	9.64%
ROLLING 3 YEAR	5.07%	-0.11%	5.18%
ROLLING 5 YEAR	4.60%	-0.68%	5.28%
ROLLING 7 YEAR	13.15%	5.77%	7.38%
SINCE INCEPTION*	14.69%	6.30%	8.39%
SINCE INCEPTION^	170.18%	55.74%	114.44%

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



\*Annualised

^Cumulative (1 July 2004)

\*\*Before fees and expenses

The ASX200 Accumulation Index fell by 11.58% over the quarter and by 8.56% over the 12 months to 30 September 2011. The best performers in the portfolio over the quarter included Connect East, Coal and Allied, Transurban and QRN. The poorer performers over the quarter were most of the major resource and energy exposures (Oil Search, Alumina and Rio Tinto Plc). All of these stocks under-performed due to falling commodity prices. Coal and Allied was the exception due to the takeover bid from its majority shareholder for a \$125 per share, including a fully franked dividend, which clears the surplus franking account. We intend accepting the offer and reinvesting the proceeds into the market where we see a number of attractive opportunities.

### The Portfolio

Over the quarter there were no new stock positions and one sale, being Cochlear. Cochlear was sold fortuitously from the portfolio prior to the recent voluntary product recall. The reason for the sale was valuation based. The stock was trading 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 and we took the view that there was better value elsewhere. The recall is a useful reminder of the inherent risks in a high tech, single product, high PE stock, with the stock currently trading at \$48.

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The portfolio consists of high quality, low beta stocks that on average tend to out-perform in falling markets, as has been the case in the last quarter and year. The Fund has been positioned to invest in three types of stocks:

- 1) Asset plays with good balance sheets such as Alumina Limited and Soul Pattinson, both of which sell below replacement value;
- 2) Yield plays, such as Transurban, which can grow their already high dividend yields and recoup inflation under the terms of their long life tolling concessions; and
- 3) Growth stocks with high sales and profit growth profiles such as Navitas and some of our Asian stocks, which are operating in high growth markets.

Importantly, for all stocks, we are looking for quality businesses, good value, strong balance sheets and focused management.

The portfolio has around 2% cash. In addition, we have 8% of the portfolio in stocks that are subject to cash takeover offers so we expect to be able to reinvest some of these proceeds into the market where we see emerging opportunities, thanks to the current global pessimism amongst equity investors.

The Fund has around 16% of assets invested in overseas markets. NZ represents half of our overseas positions with the balance spread amongst the UK, Singapore and Hong Kong listed stocks.

Portfolio attributes as at 30 September 2011 are summarized below.

PE	13.5x
Beta	0.77
Yield	5.0%
P/Book	1.5x
Roe	11.2%
Debt/equity	42%
Tracking error vs ASX 200	6.80
Stock Numbers	28

Major sector exposures are:

Sector	Portfolio Weight
Energy	7%
Materials	10%
Industrials	19%
Health & Aged Care	8%
Banks	11%
Utility & Infrastructure	11%
Telecommunications	4%
Foreign Equities	16%
Cash & Equivalents	2%

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### Stock News

Commonwealth Bank reported an excellent result for the year ended June 30th. The final dividend increased by 11% along with a strengthening balance sheet. Tier 1 capital increased 86 basis points over the year due to a strong lift in cash after tax net profit which was up 12% for the year. Whilst the financial metrics were very good some of the trends were indicative of a much more challenging banking environment. For example, the on- off lowering of bad and doubtful debt charges which fell 38% and are now at cycle lows. In its annual report CBA makes mention of the many new challenges facing the banking sector. They include lower asset growth, higher funding cost, higher regulatory capital requirements under Basel III and more balance sheet liquidity. Community pressure continues with calls by the Greens for more bank regulation and taxes.

CBA's cost to income ratio has fallen from 56% to 45% over the past decade, driven by strong revenues and tight cost control, delivering a strong return on equity capital (currently at 19.5%). With costs rising and domestic revenues constrained due to the rebuilding of consumer savings, the outlook for earnings per share growth is expected to be mid-to-low single digit. To achieve growth CBA has a stated strategy to grow its Asian business. CBA currently has businesses in Indonesia, China and Vietnam, which delivered an 18% increase in after tax net profit to \$53m.

The recent fall in the CBA share price sees its gross yield (including franking) exceeding 11%. The sustainability of the 20% return on equity that underpins earnings and dividends is the question.

A portfolio stock, Carindale Property Trust, reported a retail sales decline of 2% and a net profit increase of 2.7% for the 12 months ending June 2011. The subdued results were impacted by the lack of consumer confidence and disruption caused by the centre's redevelopment. Carindale is one of Brisbane's largest shopping centres and is undergoing a \$300m redevelopment and expansion that will increase the floor area by 20% to 127,000 M2. The Brisbane floods had no material impact on the development program and the first stage is on track for completion by June 2012. The trust represents excellent value with a stated asset backing of \$5.54 compared with a \$3.90 share price and debt to assets of 16%. The stock yields 7% per annum on current distributions with 26% of distributions tax deferred.

### Observations from CI company visits world wide -

#### CHINA TRIP

"China has never grown in a straight line". Ambassador to China, Frances Adamson.

During the September quarter we visited companies in four Chinese cities - Beijing, Qing Dao, Weigoa and Shanghai. Beijing and Shanghai have populations of 20m and 23m, close to and just above Australia's population of 22 million. Qing Dao and Weigoa have similar populations to Sydney and Melbourne. Companies we saw operate in a range of industries including education and training, baby pram and accessory manufacturing, medical devices, supermarket retailing, textile and shoe retailing, shopping centre development and operation, and agricultural product traders/wholesalers. We also visited the Australian Ambassador to China as well as directors of Australian listed companies operating in China. Following our visits, we make the following observations

- China has 1.3b people that are smart, hard working, ambitious and committed to social, economic and political success. Other attributes include a high propensity to save and an innate commercial acumen. In the long term the economy shows every sign of continuing its growth trajectory, albeit with slower short term growth in a number of sectors which are overheating. Examples include property development, steel, aluminium and a number of commodity manufacturers.

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- It is important to note the stock market is different to the economy. China has many issues which are weighing on stock prices. These include poor governance practices, transparency issues, property rights, central government directed banking, changing laws, regulatory issues, highly competitive markets, non trade barriers and a growth imperative that needs heavy capex re-investment into industry in order to satisfy the growth and progress expectations. We hasten to add that a number of these matters are also issues for investors in developed markets.
- China is complex and thus difficult to understand. We are dubious of the value and accuracy (especially by stock market commentators) of their "bull and bear" predictions concerning Chinese economic, political and social developments. Experts are limited by their narrow perspectives and captive to current events which do not account for the flexibility within China to respond to changing conditions. History says that growth markets rarely grow in a straight line and, as investors, the question is how to turn the inevitable road bumps and risks into opportunities.
- China and the rest of the emerging market world have large populations that by and large have not experienced the benefits of economic development enjoyed by the West. In Australia, for example, the generation born before 1946 and who experienced the life-shaping events of the Great Depression, WWII and the post-war economic boom, today represent a mere 4% of Australia's workforce.
- There are many industries in China that can look forward to growth rates well above average (7-15%) for the next 10 years, including education, medical devices, and a broad range of consumer goods such as electronics and motor vehicles. Conversely in some industries, China are already large and growth rates are expected to slow relative to the last decade. Examples include mobile phones and steel production, where China is already the dominant player in world markets.
- From bitter experience we are highly sensitive to the inherent risks in organisational change. We view the transition to new leadership as an uncertainty to the continued successful economic management of China. The Party changeover next year is a "transition of power" and therefore carries risk.
- The 12th five year plan is all about growing the internal economy and lowering China's reliance on the West over time. The reliance of China and Asia on the OECD is diminishing, so a good outcome for them is a 1% p.a. growth in the West. On the other hand, the Chinese authorities spent 10 trillion RMB post the GFC to keep the economy growing. They are now in a less flexible fiscal position than the lead up to the GFC, suggesting a severe recession in the West could be more problematic for China than the GFC.
- Social housing has been a big focus for government in spreading wealth. In 2010 China built 5m social housing units, 10m in 2011 and 35m are planned over the next 5 years. This compares with 500k housing starts in the USA this year and 140k starts in Australia.
- China is Australia's biggest export market, accounting for 23% of total exports. Japan, South Korea and, recently, India rank in front of the USA and the UK making Asia by far Australia's most important trading region.
- Going up the value chain - we saw many examples of companies that were redirecting resources by investing in their own distribution channels, brands, and research and development. With growth coming from China and emerging markets, Chinese companies are moving into building their brands where margins are better compared with original equipment or contract manufacturing for the west.

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### UNITED STATES/EUROPE TRIPS-

Some observations from the company visits by our Australian equities team to the U.S. and Europe include the following.

- People and businesses in the U.S. and U.K. are similarly as perplexed/angry/frustrated as Australians are with the inaction and poor leadership of their respective governments.
- 2/3rds of the U.S. population live on the East coast and account for 75% of consumption.
- It will cost the U.S. Government \$7-10tn over the next 20 years just to maintain the country's existing road/highway network.
- Behind the headline unemployment rate of 9%, there is 20% under-employment. The unemployment rate for college-educated people is closer to 5%.
- Regulation and scrutiny of U.S. banks continues to increase - Citi has 100+ regulators/compliance officers based in their offices on a day-to-day basis.
- Rail is 3-4x more fuel-efficient than trucking. In the U.S., Gen X and Y do not want to be truck drivers.
- In order of importance, the key drivers of shareholder returns for rail companies are: (i) price, (ii) productivity (offset non-fuel inflation), and (iii) volumes.
- Conversion to a gas-fired U.S. is real and happening – coal-fired power stations are being shut or switched to gas to meet regulations and new generation capacity is mostly gas-fired. Shale gas production ramp is incredible – accounts for 25% of U.S. gas supply today from nothing 10yrs ago and could be >50% in 20yrs time.
- Unlike the previous two U.S. recessions, the housing market will lag rather than lead this economic recovery. We met with the 7<sup>th</sup> largest US homebuilder who now has a market cap less than its annual cash interest charge.
- Pay TV penetration – U.S. 90%, U.K. 50%, Latin America 25%. Hours of TV watched per day: U.S. 6-8hrs and U.K. 4hrs. There is a Pay TV channel in the US that shows karate 24/7.
- The bafflingly popular 'Two and a Half Men' TV series is in a much better financial (and reputational) situation now without Charlie Sheen, given his enormous pay packet.
- In the U.S. over 50% of the 'stomach share' of food is not prepared at home. The environmental impact of spoiled food/meat is 10x the impact of making and disposing of packaging to keep it fresh.
- The U.K. NHS (National Health Service) is the 3rd largest employer in the world behind the Chinese Army and India State Railways.
- Oil and gas projects are becoming larger, more complex and larger in duration. Major EPCM companies are not seeing delays in project timing from design through to construction.
- According to the CEO of Lend Lease in Europe, the market is bleaker and outlook worse than the last time we visited in March 2009.

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- The Russians are taking over the London high-end property market.
- France is a nation of regulation, especially in the hospital industry which is regulated at a provincial level.
- The glass security gates at Ladbrokes HQ (online gaming) are vicious – recently installed to stop any angry punters taking out their grievances on head office.

### Industry and Observations– The Coal Industry

This quarter we have been reviewing the situation and outlook for the coal industry. The main stock in the portfolio leveraged to the future of the domestic and international coal industry is 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.

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.

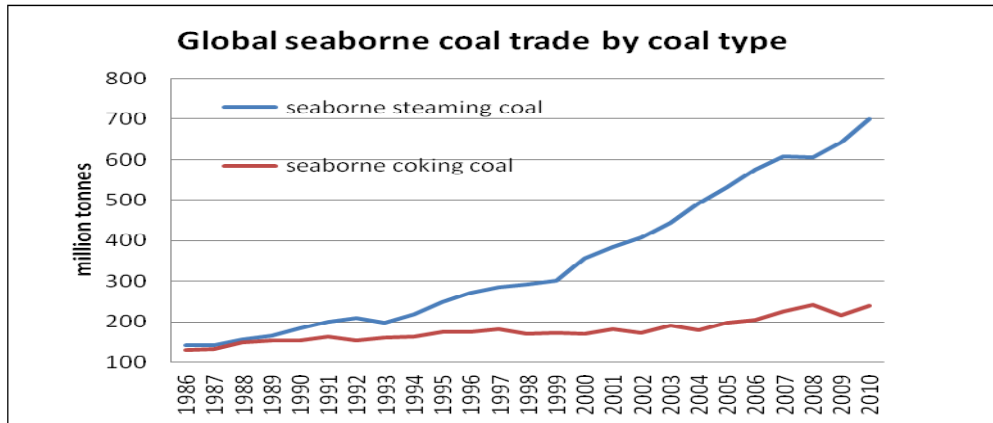
It is the thermal coal space that presents the highest growth opportunities for Australia. The global traded thermal coal market is growing at a much faster rate than coking coal (see chart on next page) and this is expected to continue. Australia accounts for 20% of the seaborne thermal market compared with a trend of 65% of the seaborne coking coal market, providing much more upside from market share gains in the thermal coal space.

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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 16<sup>th</sup> 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.

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