CI AUSTRALIAN EQUITIES FUND
QUARTERLY COMMENTARY REPORT

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

For current performance information please refer to the Monthly Performance Report.

DECEMBER 2018

"Bad times coupled with good reflections provide some of the best lessons" Ray Dalio

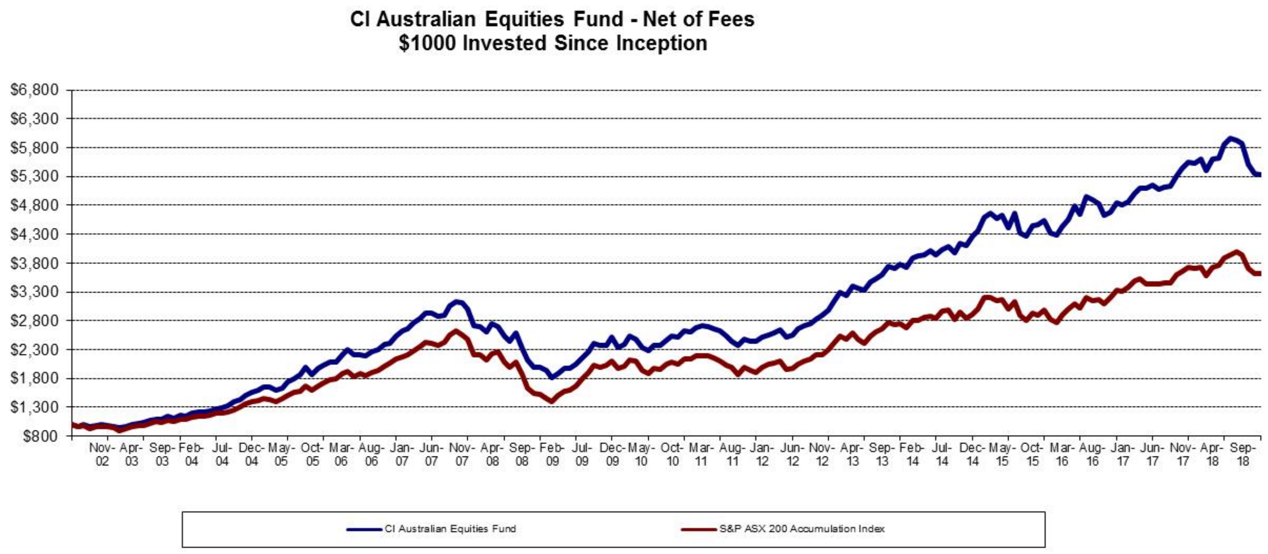
"It is a mistake to try to look too far ahead. The chain of destiny can only be grasped one link at a time." Winston Churchill

"Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it." Warren Buffet

	****PORTFOLIO**	**#BENCHMARK**	**VALUE ADDED**
ROLLING 3 MONTH	-9.16%	-8.24%	-0.92%
ROLLING 1 YEAR	-3.31%	-2.84%	-0.47%
ROLLING 3 YEAR	6.39%	6.69%	-0.30%
ROLLING 5 YEAR	8.28%	5.64%	2.64%
ROLLING 7 YEAR	13.03%	9.61%	3.42%
ROLLING 10 YEAR	11.42%	9.00%	2.42%
SINCE INCEPTION*	11.85%	8.11%	3.74%
SINCE INCEPTION^	533.86%	262.21%	271.65%

*Annualised
^Cumulative (4 July 2002)
**Before fees and expenses
#S&P ASX 200 Accumulation Index

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



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Market and Portfolio Performance

Equities markets have now experienced a major correction with the S&P/ASX 200 returning -8.2% for the December quarter, and the accumulation index having fallen 12.9% from its peak near the end of August to its lows in December. The 2018 total return for the S&P/ASX 200 was -2.8%, the first negative calendar year return since 2011. Despite this, the Australian equities market is one of the better performing equities market for the year. Asia and Europe experienced the greatest falls, with MSCI Asia ex-Japan returning -14.4% and Euro Stoxx -12.0%.

The portfolio has not held up as well as we would have expected in this market downturn, returning -9.2% for the quarter. The major detractors from performance were Clydesdale Bank (CYB), Lendlease (LLC) and Boral (BLD). We address the stock specific issues surrounding CYB and LLC in more detail below. Boral, along with its building and construction materials peers in Australia and the US, underperformed the broader market driven by concerns around slowing building activity.

The larger positive contributors for the quarter included Transurban (TCL), Woolworths (WOW) and Orica (ORI). Although both WOW and TCL are performing well operationally, the primary driver of relative performance during the quarter was their stalwart and bond-like-equity characteristics, respectively, in an environment where concerns regarding economic growth were rising and bond yields falling. Despite the TCL holding, the portfolio is 8% underweight Bond-Like-Equities (BLEs). BLEs outperformed by an average of 8% for the quarter, providing a substantial headwind to portfolio performance. As a whole, we struggle to find attractive risk adjusted value latency in the BLE segment; balance sheets are full, valuations stretched and management lacking in meaningful opportunities to add value.

The resource sector has performed better than expected given the deteriorating cyclical backdrop and the 35% fall in the oil price, with the S&P/ASX 200 Resources sector performing in line with the market. Notably, BHP and Rio Tinto were down just 1.2% and 0.4%, respectively. This resilient performance can be explained by both the relatively stable bulk commodity prices (coal and iron ore) and both companies undertaking substantive capital returns during the quarter. Additionally, most of the commodity companies' balance sheets are in better shape today than previously and continue to generate strong cash flows. That said, the deteriorating demand environment we observed in China (see the Trip Notes section below), and reduced value latency, led us to modestly reduce the portfolio's commodity exposure.

With the weak performance of equities markets for the 2018 calendar year, it is worth highlighting one of the major changes that has occurred over the course of the year. This time last year we were writing with cautious optimism about the global economy, whilst highlighting some of the excessive valuations that had been building in equities markets. As we come to the end of the year, we find equities markets' valuations substantively lower and sentiment turning increasingly bearish, far more than we would have anticipated 3-4 months ago.

The significant swing in sentiment towards the global economy can be best evidenced by the near inversion of the yield curve today. The reasons behind this change are, as always, multifaceted. The gradual monetary tightening by the US Federal Reserve, and to some extent the ECB, to normalise extreme monetary policy settings can wear part of the blame. However, equities markets would normally deal with this comfortably in an environment of solid underlying economic activity. China had been slowing for much of this year, in response to reforms and tightening measures designed to move economic growth to a more balanced footing, away from the traditional heavy industry and fixed asset sectors and towards consumption and services. This appeared to be progressing in an orderly manner up until the second half of the year.

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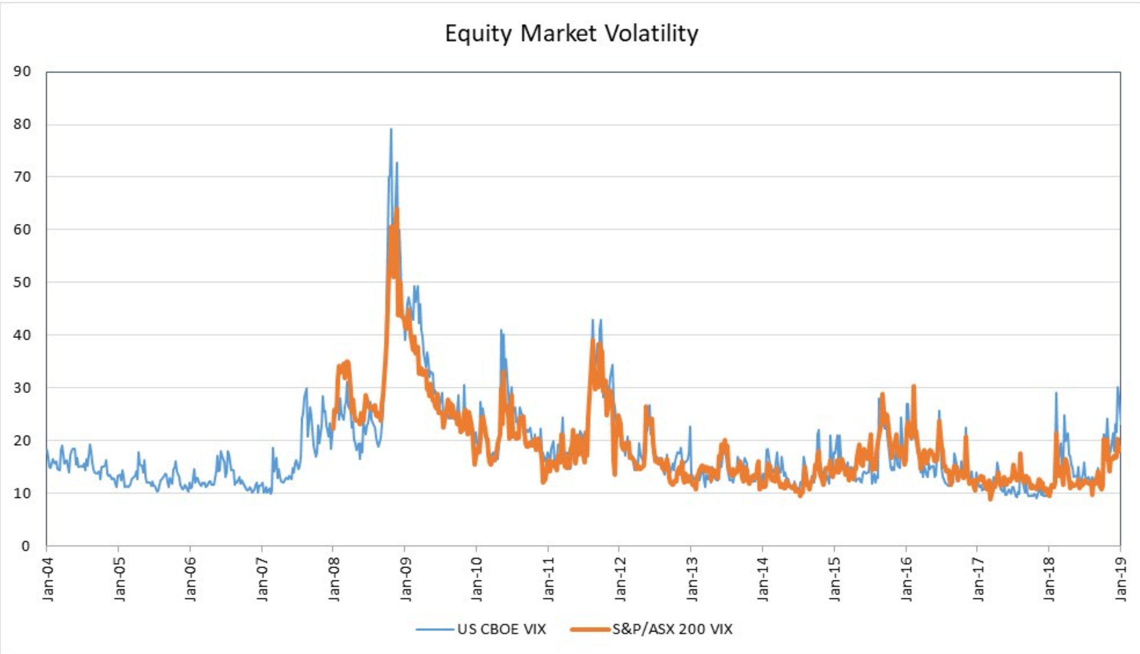
A key change to the scenarios described above took place with the US political agenda being increasingly focussed on trade and Chinese trade in particular. Although recognising the risks associated with this agenda, our view was centred on the key protagonists recognising that a trade war would be a bad outcome for both the US and China, as well as the world economy more generally. The extent of the escalation in the trade dispute has not only been a key factor in the severity of the sentiment swing in financial markets, but the uncertainty it has created is beginning to affect real world activity. Adding to this uncertainty is Brexit and the current political malaise in Australia.

This mix of tightening credit conditions, global trade fears and general political uncertainty has proved to be an unpalatable mix for financial markets. But it also highlights the opportunity and risks for 2019. Recent commentary from Federal Reserve officials suggests that the job of normalising monetary policy is nearing completion. While the outcome of current trade discussions are anyone's guess, our sense is that although a hard bargain is being driven, neither party wants a no-deal situation.

Political and economic uncertainty are not new. The higher level of volatility seen in 2018 is not outside the bounds of historical norms (see chart below), but is higher than the unusually low levels of 2017. However, the longer elevated levels of uncertainty persists, particularly surrounding the trade negotiations, the greater the potential for it to have meaningful real world effects.



Source: IRESS

Despite the more challenging markets, and a disappointing period of performance for the portfolio, the current environment is providing a number of opportunities. Stocks are moving to valuation levels where risk-adjusted value latency is looking increasingly attractive through the VoF process. Many of these opportunities, perhaps unsurprisingly, are coming from the more cyclical components of the market. Robust balance sheets, tight capital management and focussed management teams are providing a terrific base, as stock prices retrace to more interesting levels. PE ratios approaching recent historical lows (see chart below) are indicative of some intrinsic value opportunities that we are starting to see emerge. We continue to be cautious of companies that have been beneficiaries of the "financialisation" of the global economy, which has underpinned growth in recent decades, and have high levels of debt. On the other side, we have a preference for real or hard assets and companies backed by high levels of cash.

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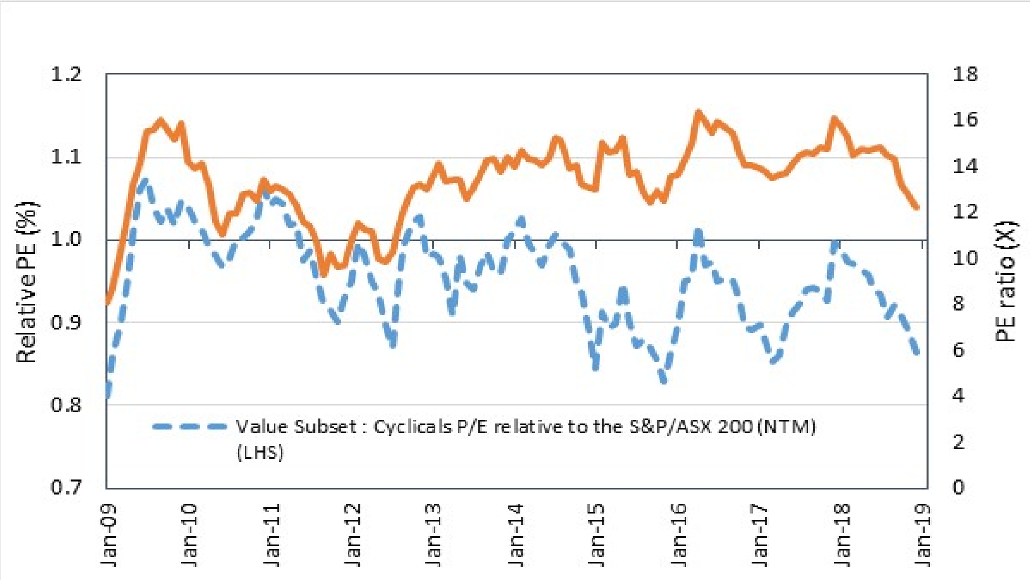

Source: Cooper Investors, Factset

The Portfolio

In November **Lendlease (LLC)** announced a $350m post-tax provision (c$500m pre-tax) for its Australian Engineering division. This comes on top of the $153m post-tax provision (c$218m pre-tax) raised in 1H18. While the $350m post-tax provision represents around $0.61 per share, the LLC share price has lost almost $6 per share (1/3rd of its market capitalisation). The share price reaction suggests the market expects further material engineering provisions, in addition to concerns it has about LLC's exposure to Brexit and softening housing and commercial property markets.

In our view, the core issue with the Australian Engineering business is that the balance of risks are skewed against the engineering firms given the open-ended risk to the downside and no upside risk (specifically for fixed-price, fixed-term contracts). This is compounded by the fact there appears to be little evidence engineering is a decisive swing factor in LLC winning urbanisation projects (e.g. the European division won $20b of urbanisation work in FY18 without an engineering division). This suggests there is little strategic merit in retaining exposure to the Australian Engineering business, particularly if the relevant intellectual property could be retained in a small team.

This has been a big hit for management and Board credibility, particularly as it relates to their ability to price risk and allocate capital. LLC are now conducting a 'strategic review' of the engineering business and we expect a substantive update at the February results. We struggle to see how the outcome cannot be to exit such a problematic business, which should lead to a re-rating of the stock and allow the market to refocus on the positive long-term story around LLC's global urbanisation pipeline and funds management platform.

Clydesdale Bank (CYB) shares have been under significant pressure due to Brexit uncertainty, weak FY19 net interest margin (NIM) guidance, and an additional £150m of provisions for Payment Protection Insurance (PPI) claims. The lack of a refreshed medium-term roadmap at the FY18 result was also disappointing, effectively providing the market with an information vacuum in a highly volatile environment.

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Guidance that synergies from the Virgin Money (VM) acquisition will be largely back-ended in FY20 and FY21 was disappointing. We had assumed benefits would start flowing from FY19, which caused us to overestimate the earnings trajectory of the combined entity. Unsurprisingly, the market has discounted CYB's original guidance for material earnings accretion from the VM acquisition, which would represent substantial upside to market expectations should investors get confidence they can be delivered. We expect management to provide greater clarity on the roadmap forward at the 1Q19 result and then again at their Capital Markets Day in June 2019.

The risk of a negative Brexit outcome cannot be dismissed (or a Corbyn government), but we still think there is a good story for the patient investor. Trading at <7x PER, with a strong balance sheet, value latencies around ongoing cost-out, capital optimisation, VM acquisition synergies and the RBS remedies package (aka Williams & Glynn), we think the share price has been too heavily discounted for what is still an attractive medium term story.

We added **Aurizon (AZJ)** to the portfolio. Despite selling our holding earlier in the calendar year, we continued to visit industry contacts in Brisbane and meet regularly with management. We originally sold our holding mainly on the premise that the regulatory return set by the QCA was too low and the final decision was unlikely to materially deviate from the draft decision. Since the draft announcement, AZJ have been working with the industry and its customers on reaching a commercial outcome that would be favourable to both the industry and the company. Whilst the final decision announced earlier in the month saw an uplift in the maximum allowable return of $232m over the four year period from the draft decision base of $3,888m, it is still well below AZJ's submission. Although we think it is unlikely AZJ will achieve the outcome it submitted, a commercially negotiated outcome with the industry could result in an improved result above the QCA's final decision. The coal price has sustained at a level higher than most would have anticipated earlier in the year, and it would be in the interest of all stakeholders to have an efficient below rail operator.

Beyond the regulatory front, the high coal price has provided the industry increased confidence to start investing in expansions. As one of two above rail operators in Queensland (excluding BMA which is an owner operator), AZJ should benefit from this over the medium term. Combined with the continued focus on cost outs, the earnings outlook is starting to improve.

We also added **Computershare (CPU)** to the portfolio. Computershare is a global leader in high-integrity data management, high-volume transaction processing and reconciliations, payments and stakeholder engagement. It employs over 18,000 staff around the world, with close to 50% of revenue generated in the US (Australia and NZ contributed 11% in FY18).

We believe that the quality of the business is underappreciated, with key segments typically positioned in attractive industry structures (often as the dominant player in an oligopoly). Circa 70% of revenue is recurring and significant revenue synergies are leveraged across business units (e.g. a registry customer will frequently also use Computershare for corporate actions, stakeholder relationship management or communication services). Low capital intensity supports high ROEs (27% in FY18) and strong free cash flow generation, which feeds growth and capital return optionality. From a portfolio perspective, Computershare also provides a hedge against higher global inflation given the substantial leverage to interest rates.

Computershare appears set to embark on a multi-year double-digit EPS growth phase. Mortgage services and employee share plans have both structural and cyclical tailwinds, while cost-out initiatives are improving profitability in the world-leading registry maintenance business. A more disciplined approach to capital management underpins further debt reduction, higher dividends, share buybacks and higher ROICs.

CEO, Stuart Irving, and CFO, Mark Davis, both have ~20 years' experience across the group and have articulated a clear, sensible strategy. While co-founder, Chris Morris, is now a non-executive director, we take comfort from the experience he brings to the Board and his "skin-in-the-game" from retaining 6% ownership.

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While we retain an underweight exposure to the banking sector, we have built an overweight position in **Commonwealth Bank of Australia (CBA)** during the quarter. At the same time, we exited our entire position in National Australia Bank (NAB).

We believe that the sell-off in CBA post the AUSTRAC proceedings and APRA's Prudential Inquiry created a rare opportunity to buy Australia's highest quality bank at an attractive valuation. A structurally-advantaged business mix and superior scale underpin sector-leading returns, while an 11.2% pro-forma CET1 ratio (vs. 10.5% target) and strong organic capital generation provide optionality. Ultimately, it is also set to have most leverage to higher interest rates given the lower-beta deposit mix.

The previous management team delivered exceptional financial results, but at the expense of non-financial metrics (e.g. operational risk and compliance). This culminated in a $750mn fine for AML/CTF deficiencies, a Prudential Inquiry and dramatic overhaul of the Board and executive team. New CEO, Matt Comyn, has almost 20 years of banking experience and was previously head of the high-performing retail division. He strikes us as authentic, knowledgeable and aware of the key issues. Resolving the matters identified in the Prudential Inquiry has been made a key priority. A number of senior executives have exited, with their replacements typically having more banking industry experience.

Also of note, the December quarter saw the execution of the demerger of **Coles (COL)** from Wesfarmers (WES). Given the portfolio's existing holding in WES, it now has a position in COL. COL has a number of attributes with which to commend it, including a defensive every-day needs business with a defendable market position. The key attraction though is the potential of what a de-merged business can mean, namely increased focus from management, leading to better execution and improved cost structures. We see a number of meaningful value latencies, including improved supply chain efficiency and cost savings in head office and support services. Delivery of these will require both capital investment and management capability to execute effectively. The benefits ultimately retained will be significantly dependent on industry competitive dynamics. Within Coles' management team, there are a significant number of senior executives who are new to their current roles. CEO Steven Cain's leadership will be critical to focus the team behind a clear strategic direction.

The portfolio is positioned across the six subsets of value as detailed in the table below.

	Market %	Portfolio %	Active %
Asset Plays	0.4%	2.9%	2.4%
Bond-like Equities	11.4%	3.7%	-7.7%
Cyclicals	32.6%	33.5%	1.0%
Growth	15.9%	11.9%	-4.0%
Stalwarts	39.0%	42.2%	3.2%
Turnarounds	0.7%	-	-0.7%

The portfolio remains underweight Banks, as detailed in previous quarterlies. Despite this, the portfolio has a 3% overweight position in Stalwarts, with the underweight to banks offset by holdings in industrial stalwarts such as Woolworths, Brambles and Cleanaway. This has been added to in the last quarter with the addition of Aurizon to the portfolio.

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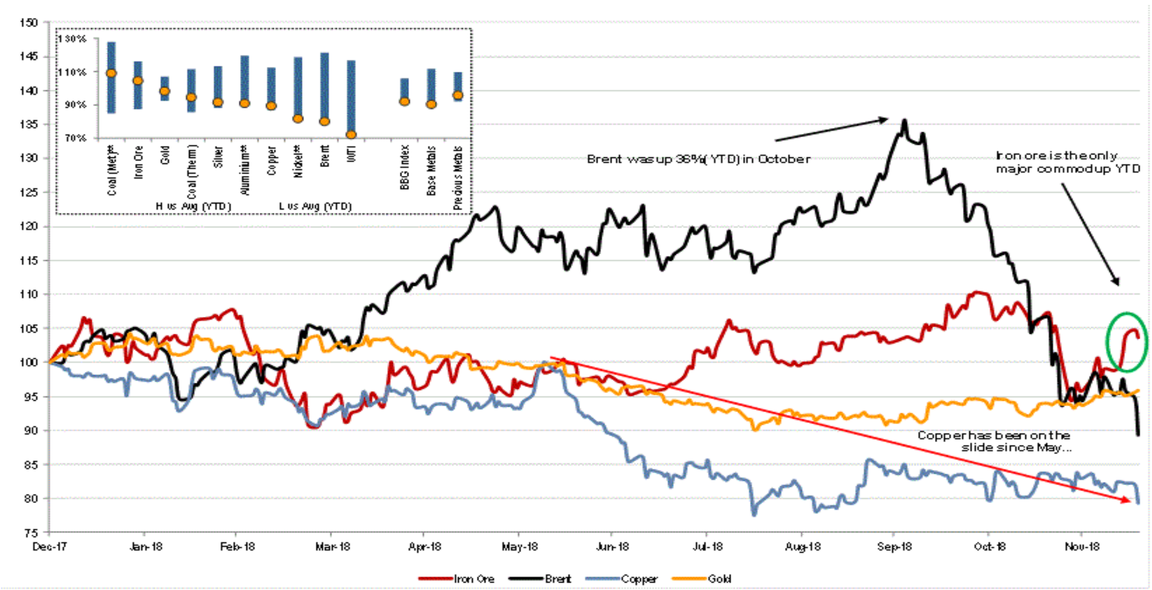
As mentioned earlier, the portfolio is underweight Bond-like Equities, predominantly due the portfolio not holding any property securities. The markets' willingness to pay ever higher multiples for growth has significantly reduced the risk-adjusted value latency in these stocks. This has been the principal driver behind the portfolio's reduced exposure to Growth over the last year, to be now underweight this subset of value. Despite the underperformance many growth stocks experienced in the second half of 2018, we have not yet seen any compelling investment opportunities emerge.

The reduced exposure to resources stocks discussed above has seen the portfolio's Cyclicals exposure reduce. The portfolio remains slightly overweight Cyclicals, with an underweight positon in resources (predominantly energy sector related) offset by industrial and financial cyclical holdings, such as Orica, Macquarie Group, and Boral.

Trip Notes

We visited China for the third time this year with the primary focus this time on industries linked to consumption of raw materials. Compared to earlier trips in the year, the sentiment was clearly weaker on the ground, driven by the ongoing trade concerns and effects of the tighter policy that has been progressively implemented. The slowdown in domestic demand became more pronounced in the third quarter across a number of industries (home appliances, automobiles, tiles/sanitary), and there is an expectation that exports of consumer goods will be impacted by the trade dispute. This has been reflected in the decline in flat steel margins from October onwards.

The property market is slowing, with property sales growth declining in recent months. The property sector has been well supported this year by government policy through the shanty house redevelopment program, which has driven an increase in demand for properties in tier 3 and 4 cities and reduced housing inventory levels. Residential building starts have also been strong. We think this is one of the key reasons why steel production has been strong and rebar steel margins have been high for much of the past year. This is also perhaps why the iron ore price has been stable this year and performed better relative to other commodities (see chart below). However, we came away a bit more cautious on the property market outlook as the shanty house redevelopment policy is expected to be less supportive in 2019.



Source: JP Morgan, Bloomberg

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Given the slowdown we observed, it is widely expected that the Government will respond through easing measures and outright stimulus. This is already underway, with the government moving to reduce taxes to support the consumer and services sectors, while also continuing to support new infrastructure investment and attempting to improve credit availability to the private sector. However, the sense we get from our discussions, is that any stimulus will be measured, with the desire to act as stabilisers rather than outright growth drivers. An outright stimulus package, similar to that seen post-GFC, would go against the reform agenda that the government has put in place. That said, the government is likely ready to respond more aggressively in the event of a more pronounced deterioration in economic conditions.

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