CI AUSTRALIAN EQUITIES FUND

QUARTERLY COMMENTARY REPORT

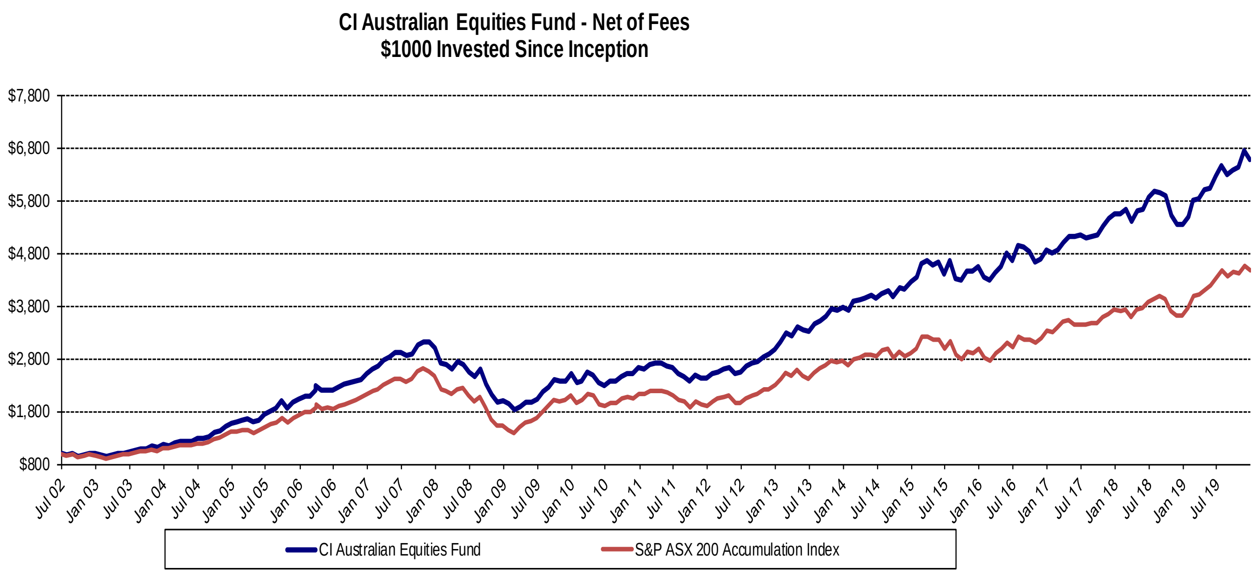
Cooper Investors Pty Limited AFS Licence Number 221794 ABN 26 100 409 890

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

DECEMBER 2019

	****PORTFOLIO**	**#BENCHMARK**	**VALUE ADDED**
ROLLING 3 MONTH	3.24%	0.68%	2.56%
ROLLING 1 YEAR	24.38%	23.40%	0.98%
ROLLING 3 YEAR	11.61%	10.26%	1.35%
ROLLING 5 YEAR	10.08%	8.98%	1.10%
ROLLING 7 YEAR	13.18%	10.02%	3.16%
ROLLING 10 YEAR	11.20%	7.86%	3.34%
SINCE INCEPTION*	12.53%	8.94%	3.59%
SINCE INCEPTION^	688.37%	346.95%	341.42%

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



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"The key is to fail, learn, and improve quickly. If you're constantly learning and improving, your evolutionary process will be ascending." Ray Dalio

"Wisdom is not a product of schooling but of the lifelong attempt to acquire it" Albert Einstein

"People calculate too much and think too little" Charlie Munger

Market and Portfolio Performance

The S&P/ASX 200 returned 0.7% for the December quarter, a relatively modest end to what was a strong year for the market, with the S&P/ASX 200 returning 23.4% for the 2019 calendar year.

The rise in the Australian equities market over the last year has not been supported by earnings. Earnings expectations have been falling for much of 2019, particularly since the August reporting season. The continued pressure on the earnings and balance sheets of the banking sector, weaker domestic demand, particularly associated with the residential building cycle, and generally weaker global growth have all contributed to the downward earnings revision cycle. Consequently, the rise in equities prices that we have seen this year has been largely a result of rising market valuations. This has resulted in the PE ratio for the S&P/ASX 200 expanding to 17.3x as at the end of 2019, just surpassing its previous peak level seen in 2002.

Source: CLSA, Thomson Reuters

The Australian market strength was reflective of equities markets globally. The MSCI World (ex. Australia) was up 25.4% for the year, driven by strong returns in the US, Germany and France. Despite muted earnings, anaemic economic growth and a range of geopolitical risks, equities markets continue their seemingly inexorable rise higher. A key factor in supporting the performance of equities markets has been the continuation of expansionary Central Bank monetary policy, resulting in low, and in many cases negative, interest rates. Despite this global growth has deteriorated into the second half of 2019 as the trade dispute between the US and China had a noticeable effect on global trade, industrial production and business confidence. There is evidence that we may be near the nadir of global growth sentiment, with some leading economic indicators showing early signs of stabilisation and our recent trip to China left us with the sense that China had effectively weathered the trade storm and is set up for solid growth into the second half of 2020 (see below for more from our research trip). This may be aided by what at least appears to be a hiatus in the trade dispute, with a Phase 1 agreement reportedly reached between the US and China (although given the experience of the last year it is difficult to have a lot of confidence in the sustainability of this situation).

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In Australia, the two best performing sectors for 2019 were both growth sectors, namely Healthcare and Information Technology, which returned 43.5% and 33.5% respectively. Both of these sectors also saw their PE ratios rerate by just over 9 PE points over the year, the largest PE ratio increase of all the sectors and subsequently they also have the highest PE ratios. Illustrating that in a world where growth is scarce the market is willing to pay more for growth where it is available. Although we are cautious regarding the level of value latency that exists in many of these companies, we continue to see well positioned companies with capable management teams in growth industries able to deliver value through continually adding to their opportunity set. The portfolio has exposure to these sectors through CSL (CSL), Ramsay Health Care (RHC), Xero (XRO) and Computershare (CPU).

Led by a sharp fall in Westpac (WBC) (down 15.6%), the banks underperformed the market by 10% during the quarter. Banks were the worst performing sector for both the quarter and the calendar year, returning 9.4% in 2019. It was a tough year for bank management teams as they dealt with the fallout from the Hayne Royal Commission, increased political and regulatory scrutiny, and a weaker economic backdrop.

Only CBA escaped the December quarter rout, holding relatively flat. Given the portfolio's 6% sector underweight, including a zero weight in both WBC and ANZ (down 10.8% for the quarter), this was a significant tailwind to the portfolio's performance.

We exited our position in WBC earlier in the year given concerns around its capital adequacy. These concerns came to fruition at the full year result, with the group raising $2.0bn from institutional investors at a 6.5% discount (and subsequently $770mn from retail investors at an even lower price) and cutting the dividend from $0.94 to $0.80. Shortly thereafter, AUSTRAC also commenced civil proceedings against WBC for alleged contraventions of its obligations under the Anti-Money Laundering and Counter-Terrorism Financing Act. This included a failure to report a large number of international funds transfer instructions (IFTIs), concerns around appropriate customer due diligence on transaction to the Philippines and South East Asia, and a number of other areas relating to WBC's processes, procedures and oversight.

NAB (-14.3% for the quarter) was dragged down with it given its contingent liability disclosures also reference to AML/CTF compliance issues. There was also growing concern that new CEO, Ross McEwen, might also raise capital to re-set the business.

The sector remains unappealing to us. Despite the underperformance, we see minimal value latency. Operating trends are negative, with management consistently guiding to next year being even tougher and falling interest rates a growing headwind. While the oligopoly remains strong, competition among existing players, disruptors targeting high ROE segments, a heavy investment burden, political/community pressure, higher capital intensity and structurally lower interest rates are continually eroding returns.

Our preference remains for CBA, which is the highest-quality franchise and has the strongest track record.

During the December quarter portfolio stocks which performed well included Caltex (takeover proposal), Xero (strong result) and BlueScope Steel (improved steel making spreads).

Portfolio holdings which did not do so well included National Australia Bank (concerns surrounding the potential for AUSTRAC issues à la Westpac), Aurizon (low coal prices and modestly slower growth in export coal volumes) and ASX (no significant news).

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The Portfolio

No major portfolio changes were made during the December quarter. Our focus remains on identifying those companies and management teams that have the capability and the opportunity to realise identifiable value latencies and add value even in these more difficult and uncertain times. With the increased financialisation of the world, driven by ever lower interest rates, we have a preference for businesses with hard assets, strong and resilient cash flows, low gearing, and companies that recognise the need to add value to all stakeholders to deliver sustainable returns.

Our singular goal is to identify 'risk-adjusted value latency' by focusing on businesses that have:

1. Identifiable value latencies.
2. Good operating trends and strong industry/strategic positions.
3. Focused management behaviour (proprietorial management cultures).

Key areas of opportunity that we are currently focussed on include:

- Cyclical stocks with strong balance sheets. Due to deteriorating economic conditions this is an area where we are seeing more potential for risk adjusted value latency on a through the cycle basis.
- Traditional businesses, with strong industry positions, that are utilising technology to reinvent their business model. Combining the advantages of incumbency with an innovation mindset.
- Underappreciated infrastructure-like assets.
- New economy (software, online economy, technology enablers).

We have undertaken some preliminary analysis on the portfolio's exposure to greenhouse gas emissions. This work has shown that the portfolio's emissions (measured on a scope 1 & 2 basis) are significantly below the benchmark emissions on both an absolute emissions and emissions intensity measure (calculated on a portfolio weighted basis). This is despite the portfolio being significantly underweight the low emissions Financials sector. The main drivers of the lower emissions intensity of the portfolio relative to the benchmark is not having any exposure to the Utilities sector (a high emissions sector) and lower than benchmark emissions in the Materials sector (despite a 2% overweight positon) due to stock selection.

It is worth emphasising that Cooper Investors' approach, through the VoF investment philosophy, is to assess the risk of each company's exposure to greenhouse gas emissions, recognising potential policy impacts and the ability and intentionality of management to mitigate these risks. The portfolio based measures described above in no way fully capture the risks (for example service companies to high emission sectors), or the opportunities (see the example of Macquarie below), that companies face in transitioning to lower emissions. Nor do they assess the readiness of these companies to deal with the transition. We seek **risk-adjusted** value latency, this risk based assessment includes both the challenges and opportunities associated with the transition to a low emission world.

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Stock News

Xero (XRO) reported another very strong set of operating results. Growth in the UK (+51% growth in subscriptions) and Australia (+28% growth in subscriptions) were underpinned by regulatory tax reform (making tax digital and single touch payroll). Our VoF proposition for XRO is based on its expected strong top-line growth profile particularly in ANZ and the UK. In addition, the company appears to be on track to deliver EBITDA in the range of $140-150m having recently reached a significant inflexion point in terms of profitability. In FCF terms, XRO continues to invest heavily in R&D and sales and marketing to continue to develop its platform and grow into new markets. With more than 2m subscribers and $764m of annual recurring revenue as at the H1 20 result, XRO's business has reached a level of scale that should help support ongoing growth in new geographical markets, as well as expansion of its revenue base in existing markets through new and expanded products.

Caltex (CTX) received an indicative takeover proposal from Canadian listed company Alimentation Couche-Tard. We have seen value latency in CTX's asset base for some time and have had numerous discussions with both the management team and board of CTX on potential means of realising this value. Recent steps, under the guidance of new CFO Matthew Halliday, to sell non-core retail sites, undertake an IPO of its 49% interest in 250 core retail sites and focussing on reducing costs in the business, are significant steps towards CTX realising its potential.

The approach from Alimentation Couche-Tard has seen a portion of the value latency we saw in CTX realised earlier than it otherwise would have been. From Alimentation Couche-Tard's perspective the approach is well timed. CTX's earnings are coming off cyclical troughs in both the retail fuel and refining businesses and the announcement of the pending retirement of current CEO Julian Segal in August creates a level of leadership uncertainty. CTX's response so far has been reasonable and measured, with the Board looking to engage more directly with Alimentation Couche-Tard to highlight the extent of the value latency within the business.

Macquarie (MQG) has a long history of pioneering attractive investment opportunities. More recently, the group has been at the forefront of supporting the transition to a cleaner world via its asset management, advisory, trading and proprietary investing activities.

After starting in 2005, it has grown into one of the world's largest investors in renewable energy. It now operates or manages over 13GW of renewable generation capacity and has over 250 projects under development or construction. In 2017 Macquarie acquired the Green Investment Bank, which added £4bn in green projects under management and significant operational expertise. The early momentum is very positive, with it on track to exceed the original commitment of £3bn in investments over three years. In addition, Macquarie is the world's top renewables advisor (by deal count), second largest natural gas marketer in the US and has $1.0bn of its own balance sheet committed to 25 separate green energy investments.

Research indicates that to meet the Paris objective of 2°C by 2050 CO_2 emissions would need to fall by 66% from current levels. Industry estimates suggest a $4tn renewable energy investment requirement by 2030. As the world's biggest infrastructure manager and advisor, with significant experience and operational expertise in renewables, Macquarie is both supporting and benefiting from the transition to a cleaner world. This reinforces why we consider it one of the best businesses and management teams in the world.

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Trip Notes

We visited China again in mid-December, having previously been there in June. We met with a more diverse range of contacts this trip, not just relating to commodities but also participants in the online jobs classifieds and consumer industries. It is clear that the ongoing trade tensions have impacted confidence, particularly in the private sector where companies are holding back on hiring and wage growth has slowed. However, there was a clear sense of optimism regarding the outlook that we did not get from our recent trips. The government has attempted to soften the impact of the trade dispute by reducing taxes and interest rates. Property investment surprised to the upside in 2019 with construction activity remaining strong, which has been supportive of commodities, especially concrete and steel. Infrastructure investment has been below expectations, as local governments faced funding constraints.

There was consistency from our meetings that policymakers are prepared for ongoing trade tensions and will support the economy, through accommodative monetary and fiscal policy, to ensure that there is stable GDP growth of 6% in 2020. It seems more likely that there will be a benign slowdown in property construction activity, rather than a material slowdown as we had previously feared. Property completions should improve over the first half of 2020, which supports later stage commodities such as copper. With the trade concerns, there has been a material de-stocking of manufactured goods this year. As demand starts to improve, inventory re-stocking should start to take place early in 2020, which is also supportive of later stage commodities. Lastly, there should be a mild improvement in infrastructure investment as policymakers alleviate some of the funding constraints local governments face by increasing the issuance of special purpose bonds and allowing it to be used as capital.

On the whole we came back from China with the view that the economy was well placed to deliver solid, if not robust, growth in 2020. With the potential for moderately stronger outcomes if a sustainable truce can be reached in the trade dispute with the USA.