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.

JUNE 2019

"Life is really simple, but we insist on making it complicated." Confucius

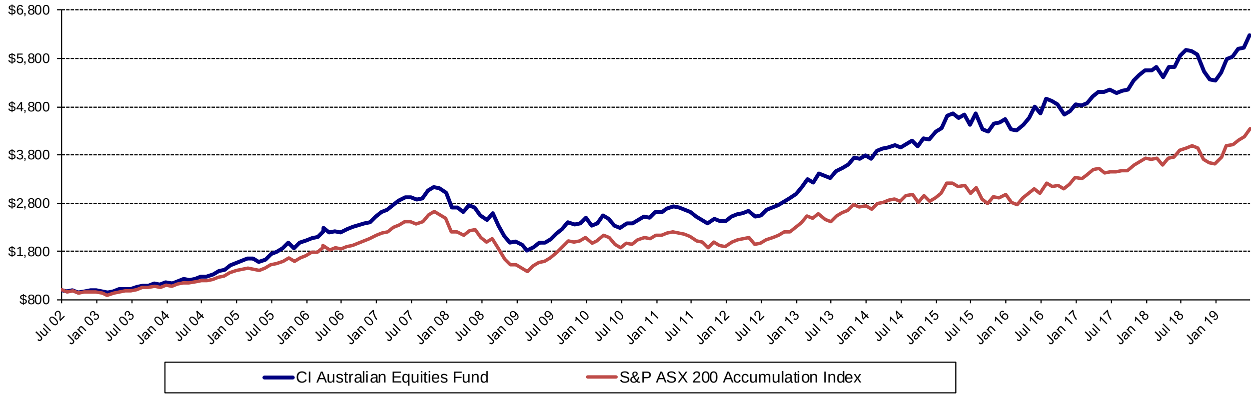
"Sometimes the questions are complicated and the answers are simple." Dr. Seuss

"See: it's a never-ending upward spiral. And if you think at any point you're allowed to stop climbing, I'm afraid you're missing the point. Because the joy is in the climb itself." Mark Manson

	****PORTFOLIO**	**#BENCHMARK**	**VALUE ADDED**
ROLLING 3 MONTH	7.63%	7.97%	-0.34%
ROLLING 1 YEAR	7.80%	11.55%	-3.75%
ROLLING 3 YEAR	11.35%	12.89%	-1.54%
ROLLING 5 YEAR	10.91%	8.86%	2.05%
ROLLING 7 YEAR	14.94%	11.95%	2.99%
ROLLING 10 YEAR	12.94%	10.02%	2.92%
SINCE INCEPTION*	12.57%	9.02%	3.55%
SINCE INCEPTION^	648.22%	333.67%	314.55%

*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

The June 2019 quarter saw a continuation of CY2019's positive equities market performance following the surprise re-election of the Coalition government and the more recent moves by the RBA to lower interest rates to record lows.

The stock market has been climbing the "wall of worry" given the great uncertainties facing the world today (trade war, slowing economic growth, Iran and Middle East geopolitical tensions, populism and popular demonstrations becoming more apparent viz France and Hong Kong most recently).

The ASX200 Accumulation Index increased 7.97% in the June quarter and returned 11.55% for the FY2019. The portfolio increased 7.63% in the quarter and returned 7.80% for the FY2019. The performance of the Fund for FY2019 was below our expectations both in absolute and relative terms. The main reasons for the underperformance were:

1. Poor operating trends in three stocks held in the portfolio (Link, Boral, Clydesdale Bank) all of which have subsequently been sold;
2. Not owning Telstra which rose 52% over the year impacted the portfolio by circa [80]bps; and
3. Higher cash levels than we have held on average at circa 8% in a rising market cost us approximately [70]bps relative to the market.

During the June quarter stocks which performed well included Aurizon (see comment below). ASX (ongoing growth in market trading activity) and Commonwealth Bank.

Portfolio holdings which did not do so well included Link (earnings downgrade due to the bringing forward of accounts losses due to government regulation, and low levels of activity in the UK as a result of Brexit concerns), Computershare (falling interest rate expectations) and Caltex (earnings downgrade due to lower refiner margins and competitive retail market).

The Portfolio

During the quarter portfolio stock **Aurizon (AZJ)** reached an agreement with customers on the regulated pricing of its Network business (its monopoly track assets**)**, that effectively bypasses the regulator's (QCA) decision of more than 12 months ago. This direct agreement provides incentive for AZJ and its customers to work together to find ways to optimise operations and improve outcomes for both parties.

AZJ is Australia's largest rail freight operator, moving coal, iron ore and agricultural products usually from near point of production (eg mine or farm) to port. Our VoF proposition for AZJ includes:

- A flow through of benefit to the coal business via increased volumes (brownfield mine expansions and small greenfields).
- Ongoing near-term cost savings which should help offset any pricing pressure in recontracting.
- Over the longer-term, reducing train drivers from 2 to 1 in the Queensland network.
    - A 30-40% reduction of the current 1,000 train drivers equates to $0.20-$0.30 /share gross of any implementation costs.

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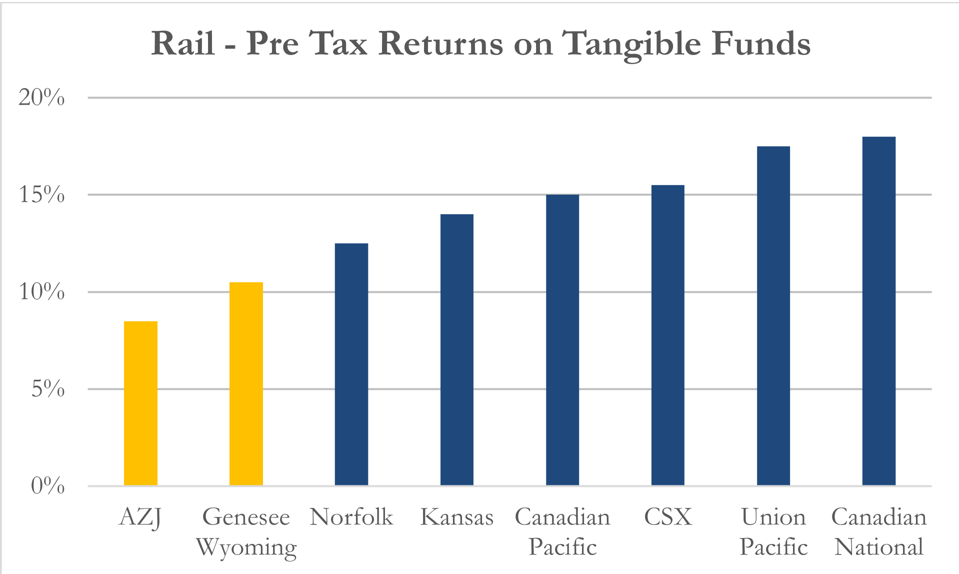
Of interest to the Fund's investments in Aurizon, was the very recent announcement of Brookfield's (infrastructure group) bid to acquire US based Genesee Wyoming (railroad and rail freight operator) for ~US$8.4bn, alongside Singapore's GIC. The acquisition fits Brookfield's typical playbook of applying operating and capital allocation focus to below average earning assets (which for Genesee Wyoming has been partly driven by poor M&A outside the US). Genesee Wyoming's returns remain well below North American peers (see chart below). From our perspective the acquisition, which is at a premium multiple to where Aurizon currently trades, also highlights the potential value latency that we think still exists within Aurizon. Latest reports would indicate interest by Macquarie in the Australian part of the business at a multiple above that at which Aurizon currently trades.



During the quarter, **Xero (XRO)** reported a strong result for FY19, highlighting the group's ongoing operating momentum. FY19 subscribers grew 31%, revenue increased 36%, and EBITDA was up 52%. The UK was particularly strong in H2, with 48% growth in subscribers to 463k, a clear acceleration on recent periods. CEO Steve Vamos stated, the UK was *"an overnight success that was 10 years in the making"*.

One tailwind assisting Xero in the UK is regulatory change known as "making tax digital (MTD)". This requires small businesses to increasingly interact with HMRC (equivalent to Australia's ATO) digitally, initially for VAT (equivalent to GST), and eventually also for income tax. This is very easily done in XRO but not so easily done if you don't have access to cloud accounting software. In addition, Xero's acquisition of Instafile in the UK (which files statutory accounts and taxes) has helped cement XRO's product positioning, particularly in the accounting channel (XRO's primary channel to market). Over the short to medium term we expect momentum remains solid in the UK, with a target of reaching 1m subscribers and leading indicators remaining positive – 'Xerocon' UK had 3,000 attendees vs 2,000 the year prior; Net Promotor Scores from partners (accountants) remains high.

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During the quarter two portfolio stocks completed large transactions:

1. **Brambles** sold IFCO (its returnable plastic crate business) for USD$2.5B, of which $300m is to be returned directly to shareholders and $1.65B will be spent on an on market share buyback. The buy back is large and will no doubt offer some support to the share price. However, given the share price rose 48% over the year, management now needs to deliver on its promise of improving margins and returns in the core US pallets business.

2. **Amcor** completed its acquisition of Bemis, the US based global packaging company. Although we understand the strategic rationale behind the acquisition, and believe the stated $180m of synergies very likely to be attained or exceeded, we note the return on capital on the acquisition of Bemis will be circa 11% - well below current returns but above cost of capital. One wonders if investors will have to adjust return expectations downwards in light of current interest rate levels which look to be here for the foreseeable future.

In London recently we attended investor days put on by **Computershare (CPU), Link (LNK)** and **Clydesdale Bank (CYB)**. What we gleaned from these days, and other associated meetings, was confirmatory of our decisions to hold Computershare, and to sell the latter two names.

The underlying businesses in **CPU** are performing in line with our expectations and operating trends are positive. Issuer Services is targeting $2.6bn in adjacent opportunities, which could push growth to mid-to-high single digits in a couple of years; well ahead of expectations. Growth opportunities are being driven by clients' increasing compliance and tax obligations – a good structural demand driver. In UK Mortgage Services, we gained comfort that the cost savings from platform consolidation, while delayed, will materialise in FY21. In the Employee Share Plans business, it appears the recent Equatex acquisition is exceeding expectations, including potential revenue synergies.

One of the drivers for recent underperformance has been interest rate expectations. Given the size of "float" balances held by CPU and interest income earnt on these balances, US interest rates are a driver of profitability. The long term trend has not helped profitability, and despite attempts by the US Federal Reserve to raise rates, the most recent expectations are for interest rate cuts to resume. Although clearly not helpful to CPU, we are happy to look through this dynamic while the underlying businesses are doing well.

At their strategy day, **CYB** put out some reasonably aggressive and (given recent history and current industry trends) ambitious targets. Mortgage competition is intense, deposit competition looks set to increase as TFS loans (low cost government funding) are refinanced across the industry, and a 'bad Brexit' scenario remains a possibility.

Lending mix targets (75% mortgages/15% SME/10% unsecured personal) imply a significant step up in the non-mortgage growth trajectory at a time when system growth is anaemic. The mix will also increase in risk profile.

Relationship deposit growth of "high single digit CAGR" - this has recently been more like mid-single digits - also likely to be difficult to achieve given significant current account deposit inertia (system churn is 1-2% p.a.) and strong competition for deposits as challenger banks seek to replace maturing TFS funding. This will likely drag further on the net interest margin.

Cost targets look more achievable given their strong track record and synergy opportunities. However, they will also incur £360mn in costs to achieve cost synergies, which will drag on free cash flow and capital. This is confirmed by a CET1 target of circa 13%, which implies a significant drop from the current 14.5%

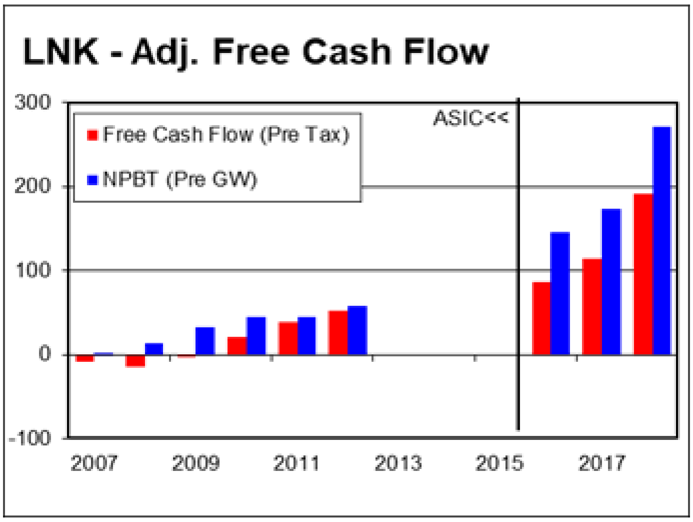
While the Virgin Money acquisition provides a new brand and fills capability gaps, both the asset and liability sides of the balance sheet have deteriorated as a result of the acquisition. This raises questions around capital allocation. In light of the abovementioned trends, we decided to sell the stock out of the portfolio.

LNK is a company which in our view has not met potential. As we sit today, weak organic growth and regulatory pressures now create downside skews to sales, margins and returns. Overall, it appears reliant on acquisitions, cost-outs or financial engineering for growth.

In Fund Solutions, an apparently appealing growth opportunity (growing regulatory burden will increase the propensity to outsource, entering Luxembourg should roughly double their addressable market), UK regulators are scrutinising the sector more rigorously and Luxembourg is already penetrated by competitors so it will be difficult to execute in practice.

In addition, downside risk exists from the Woodford saga in the UK, which has only just begun to play out. In its Corporate Markets business it appears to be losing market share and our feedback in the UK indicated LNK's technology platforms to be inferior to those of its peers.

In Retirement & Superannuation Solutions LNK is Australia's largest third-party fund administrator (>$450bn FUM). Regulatory initiatives (e.g. fund consolidation) are an immediate $50mn revenue headwind (9% of divisional revenue) and there is doubt as to whether we have seen the end of reform initiatives. And since its float three years ago cash flow has been weak with little outward sign of improvement. We had sold a large portion of our stake some time ago, and during the quarter sold the balance.



Following on from the commentary on **Boral** in our last quarterly around poor operating results and the concerning announcement that CEO Mike Kane would be going onto the Sims Metal (SGM) board, we exited our position. When a complex multinational business is not performing well, integration and adequate returns on the significant Headwaters acquisition have not been achieved, and Knauf plasterboard joint venture negotiations are ongoing, there is a major risk in the CEO taking on the significant additional responsibility of being a director on another listed company's board. This is not consistent with the focus or management behaviour we look for in the companies we invest in.

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Trip Notes

During the quarter we visited China again. There is little doubt the Chinese economy is going through a managed slow down. There is clear concern around the trade conflict with the US. If the trade conflict worsens the government will respond with further stimulus to stabilise the economy but there now needs to be a finer balancing act between stimulating for growth and increasing leverage/risk. The government is more tolerant of a lower growth rate (5.5-6% in 2020). We believe demand for the key commodities will remain relatively stable.

- The two most important and quickest ways to stimulate growth are to loosen the screws on infrastructure and property. On infrastructure, we have started to see some loosening of policy with the recently announced decision to allow local governments to issue special purpose bonds. This will increase funding but it is unlike the previous policy stimulus in 2015/16 where the China Development Bank provided direct funding to local governments.

- The state grid spend, which is relevant for copper and aluminium demand, is down in the first 4 months compared to prior corresponding period. The annual target is to increase spend by 5% for the full year, which would imply a significant pick up in 2H. It was interesting to note a comment we heard for the first time that the new norm for copper demand growth is likely to be ~2% compared to ~4% in previous years. Copper demand from electrical vehicles is still in its infancy.

- Copper scrap imports have become more restrictive this year with the ban of category 7 scrap (average copper content of 24%). Beginning 2H19, there will be quotas on imports of category 6 scrap (average copper content of 76%). For 3Q19, the quota has been set at a similar level to 3Q18 so no impact. The government is expected to issue a draft document on the re-classification of category 6. The major issue is that the government may ban lower grade category 6 scrap, with brass scrap (content of 65%) being banned which would reduce copper equivalent content of 400kt. The expectation is that quotas will remain in place for 2020 with potential bans to come in 2021, which would create tightness on copper supply.

China looks to be a stable, rather than growing, influence on commodities in the near future. While the iron ore price has been very strong (in the main due to supply issues in Brazil and Australia), most other commodity prices have failed to rally in the same vein. At current prices the large miners are generating strong cash flows and the resultant balance sheets are likely to allow further special dividends post the current round of results. We retain positions in BHP (diversified high class asset base, ongoing efficiency opportunities, likely capital returns) and Oz Minerals (start up of the Carrapateena mine due in the latter part of this year, value latency in both the Brazilian assets and West Musgrave deposit, disciplined management).