CI PENSIONS FUND

QUARTERLY COMMENTARY REPORT

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

DECEMBER 2018

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	-6.77%	-7.99%	1.22%
ROLLING 1 YEAR	2.39%	-1.43%	3.82%
ROLLING 2 YEAR	8.65%	5.73%	2.92%
ROLLING 3 YEAR	8.02%	8.23%	-0.21%
SINCE INCEPTION*	9.26%	7.03%	2.23%
SINCE INCEPTION^	53.44%	38.83%	14.61%

*Annualised
^Cumulative (3 March 2014)
**Before fees and expenses and adjusted for franking credits
#S&P ASX200 Accumulation Index – adjusted for franking credits

The purpose of the CI Pensions Fund is to provide a conservative equities portfolio that may be suitable for investors who are in the pensions/decumulation phase. The portfolio may also be suitable for charities, foundations and others who are looking for a conservative equities exposure.

Whilst return is important the portfolio also aims to perform much better in down markets and to exhibit lower than market volatility.

Market and Portfolio Performance

The ASX 200 Accumulation Index (adjusted for franking credits) fell by 7.99% over the December quarter and over the past year returned -1.43%. The model pensions portfolio returned -6.77% and +2.39% for the quarter and year respectively.

The Australian market suffered its worst quarterly return for seven years with the market following trends originating in the US.

Economic data in late September suggesting a decelerating US housing market seemed to trigger panic selling of front-end cyclicals over the month of October, with many stocks linked to the housing or construction industry seeing 30% share price declines.

Selling then spread into other cyclicals as further data-points supported a ‘late cycle ending’ narrative, and combined with a nearly inverted yield curve in the US led to panic that a recession might be peeking over the horizon.

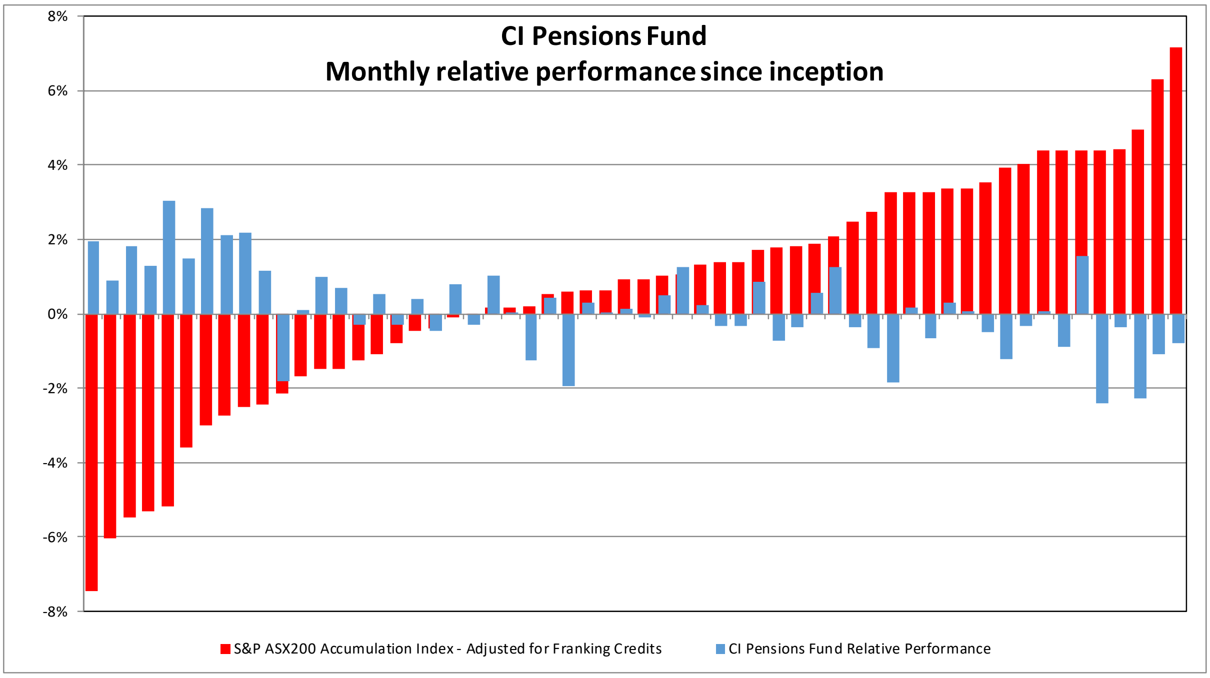
The best performing stocks over the quarter included Transurban, Viva Energy REIT, Ramsay Healthcare and Chorus. The poor performers included Lend Lease, Adelaide Brighton, Bega and Oil Search.

Whilst we are aiming to take idiosyncratic stock specific risk and trying to avoid as far as possible correlated macro cross-winds, the December quarter was dominated by the macro picture. Nearly all the stocks that had positive returns were in the bond like equity grouping and most of the large decliners were in the cyclicals category.

The international stocks detracted from the performance over the quarter reflecting the much steeper decline in overseas markets than the Australian market. The Australian dollar was weaker against most currencies and this cushioned the decline in stock prices.

The volatility of the portfolio over the quarter was 80% of the market's volatility.

The chart below shows the CI Pensions Fund's monthly relative returns. The red bars show each month's market return sorted from the worst to best month and the blue bars show the portfolio's return relative to the market for each month.



Since inception the market has shown a monthly negative return 21 times and in these months the portfolio has performed better than the market 15 times. When assessed using monthly data the portfolio has captured 66.8% of the market's downside and 89.6% of the market's upside.

The Portfolio

During the quarter we added **Aurizon, Coles** and **CBA** to the portfolio and exited Lend Lease, Westpac and reduced Soul Pattinson.

Aurizon was to some degree an opportunistic buy because a major shareholder was selling down their final 9% holding in Aurizon at a discount to market ($4.11) just prior to Christmas.

The AZJ share price had been under pressure since the Queensland Competition Authority set a low regulatory return in its draft announcement on revenues for the Central Queensland Coal Network. 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. The final decision announced by QCA in December saw an uplift in the maximum allowable return of $232m over the four year period from the draft decision base of $3,888m, albeit 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.

Coles was a spin out from Wesfarmers and we took the opportunity of the listing to create a holding in this focussed supermarket group.

Coles has a number of attributes 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.

We sold our Westpac position and reinvested into CBA.

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.

The portfolio owns 41 securities including six global stocks (12.7%) and three New Zealand stocks (6%). The cash weighting is around 6%.

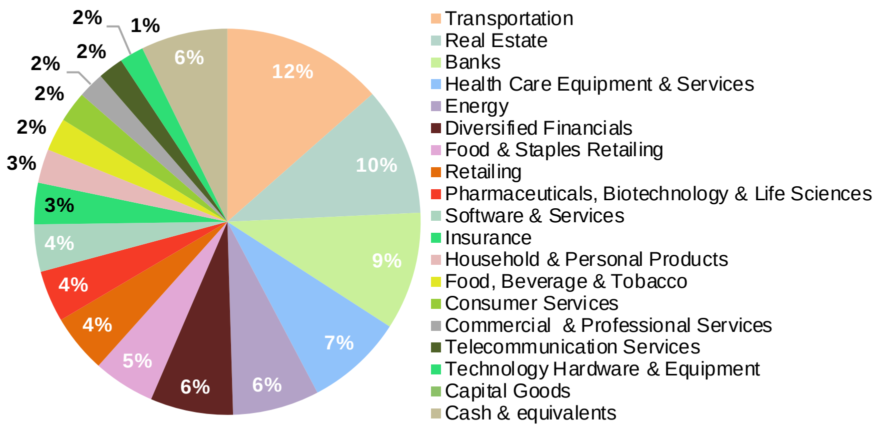
Portfolio Construction

The portfolio's objectives are to perform relatively well in down markets, exhibit lower than market volatility and at least keep up with rising markets. The end result should be a strong risk adjusted return compared to the market as well as a better than market return over the medium term if we can execute the strategy well.

The key portfolio structural characteristics we are looking for are individual stock diversification and to avoiding the portfolio being buffeted strongly by correlated macro or factor cross winds.

As far as individual stocks are concerned we are looking for a portfolio of quality stocks that have idiosyncratic characteristics. In simpler English this means we want each stock to have distinctive, individually distinguishing characteristics. These characteristics are wide ranging and include things such as location of operations, type of business, regulation, market structure, size, balance sheet structure and so on.

The easiest way to demonstrate the diversification is the pie chart divided into GICS classifications.



There are many other ways to demonstrate aspects of diversification such as graphs of company size, charts showing where revenues are sourced, ranges of dividend yields and other easily measurable characteristics.

However, it is difficult to demonstrate more subjective characteristics such as track records, quality of management, risk characteristics, business models. These type of characteristics need to be dealt with on a stock by stock basis.

Even if we construct a very well diversified portfolio the reality is that the market does categorise stocks into varying groups and sometimes the correlations between stocks in these groupings are very tight. The simplest example of this is stocks that are strongly affected by changes in expectations for interest rates. In the first nine months of 2018 the expectations were that US interest rates were definitely going to continue to rise, over this period interest sensitive stocks performed poorly relative to the market, almost regardless of what businesses these stocks are in.

Even though we had a range of interest sensitive stocks such as diverse REIT's (GPT and VVR), diverse infrastructure (TCL and SYD) they all underperformed the market over this period. When the expectations around the direction of interest rates changed during the December quarter these stocks outperformed the market by about 15%.

To make sure we have a portfolio that is diversified by these macro type factors we categorise our stocks into the following groupings, or what we call subsets of value.

Bond Like Equities: Transurban, GPT

Companies with a secure, low-volatility income/dividend stream that can be grown to recapture inflationary effects over time. The dividend policy is to pay out almost all earnings as a dividend or distribution, consequently there are little retained earnings to reinvest.

The majority of the return is through dividends/ distributions.

Stalwarts: ASX, Brambles

Strong and sturdy companies with best in class privileged market and competitive positions and a track record to prove it. These companies tend to have a larger market cap bias and their stock prices tend to exhibit lower volatility than the market.

Payout ratios are normally around 50%+, retained earnings are reinvested in the business. Around half the return will be through the dividend, the other half through organic growth and return on reinvested capital.

Growth: CSL, Ramsay Healthcare

These companies are actively pursuing growth opportunities backed by a clearly differentiated customer value proposition or core competency. They are usually run by a focused, passionate, prudent and experienced management and tend to have a product or market focus and given the growth opportunity are unlikely to be mega cap companies.

The payout ratio is low, normally 0-20% so the majority of return is through reinvestment of capital and organic growth.

Cyclicals: Adelaide Brighton, BHP

Companies with earnings that are cyclical – i.e. industry supply/demand balance fluctuates through time. Stocks will show both upside and downside leverage to the cycle. Importance of contrarian management who allocate capital prudently is paramount.

Dividends change through the cycle in line with cyclical earnings, the majority of return is through dividends and astute allocation of capital.

We also have a category called **low risk turnarounds**, these type of companies do not normally form a part of the pension portfolios because they can be too risky.

We keep exposures to these categories through the cycle although the percentage of the portfolio in each category does vary. The discipline in maintaining exposures is important because the stock market regularly throws up outcomes that are different to expectations. For example during the middle of 2018 there was an almost universal expectation that interest rates in the US would continue to rise, as it turned out in the December quarter US bond yields started to fall and at this time the very out of favour bond like equities very quickly became large outperformers, so much so that this group became outperformers for the calendar year.

Our approach depends on categorising stocks correctly and getting the research at least roughly right, but even then there are surprises, firstly from unexpected stock specific news and secondly when stocks do not perform as expected.

A recent example of unexpected news was the second downgrade to Lend Lease earnings from its engineering business.

An example of a stock which did not perform as expected during 2018 is Tabcorp. Tabcorp is classified as a stalwart and as such we expected it to perform relatively well in the December quarter, whereas it underperformed the market. We discuss Tabcorp in more detail in the stock news section.

An example of a stock that performed better than expected is BHP. BHP is classified as a cyclical stock and cyclicals were the worst performing category of stocks in the December quarter, however BHP performed much better than the market in the December quarter and for the calendar 2018 year. We discuss BHP is more detail in the stock news section.

Stock News

The **Tabcorp** (TAH) share price has performed poorly over the past year which has been surprising seeing that we believe it owns defensive businesses that should have been more resilient in tough market conditions.

This note attempts to reconcile the poor share price performance of TAH against what has happened within the company and against our categorisation of TAH as a stalwart stock.

An analysis of the track record of TAH over the past ten years would lead to the question of whether it is actually deserving of the tag of being a stalwart type company. A short form descriptor of a stalwart is "a strong and sturdy company with best in class privileged market and competitive positions and a track record to prove it. These companies tend to have a larger market cap bias and their stock prices tend to exhibit lower volatility than the market."

A series of events over the past decade has lowered the market's confidence in TAH. These include:

- Very patchy statutory profit record
- Varying dividend payout ratios
- Poor capital allocation most recently demonstrated by the failed Sunbets business in the UK
- Court battles with the Victorian Government
- AUSTRAC civil proceedings and an Australian Federal Police investigation into activities in Cambodia
- Poor transparency of operating businesses
- Volatile share price
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As a result of this history, the market views TAH with a degree of suspicion and is waiting for evidence of improvement before pricing in probable upsides. The market's view on TAH was demonstrated through the 40% vote against the remuneration report and 35% vote against the increase in Directors fees at the 2018 Annual General Meeting.

If we look at the current position we think things look quite a lot better than the history.

The merger with Tatts brings together two strong and relatively stable businesses being the lotteries and the tote, together with a fixed odds business that at least has the opportunity to grow earnings.

TAH has had a couple of regulatory wins that should help its business.

The first is the introduction of a point of consumption tax on fixed odds betting that should improve its competitive position against corporate bookmakers and could lead to market share and yield gains.
The second is the change in legislation that stops the sale of synthetic international lotteries in Australia and therefore removes the threat of Lottoland to the TAH lottery business.

We expect that TAH will deliver on the merger synergies they have targeted in the Tatts merger and we expect that they will see some improvement in the fixed odds results. However, based on the history of the company, the market is not giving them credit for these upsides before seeing some evidence.
Based on the business's strong market positions and the changes to some regulations we think TAH deserves to be categorised as a stalwart, albeit the track record is not good. We will need to see evidence of improvement before the market will move it into the stalwart category.

We would like to see TAH improve their disclosures, lower their debt, avoid acquiring businesses (except perhaps the WA TAB) and progressively demonstrate an improvement in the fixed odds results.

BHP is a categorised as a cyclical stock because of its exposure to commodity prices. BHP performed very well over 2018 which was somewhat surprising given that cyclical stocks bore the brunt of the December quarter downturn.

There were three main reasons we can point to as why BHP did well.

Firstly the iron ore price was the only major commodity that finished up over the year, additionally it did not suffer a large decline through the year such as oil which was up by 36% through to October and ended the year down.

Secondly BHP announced a very large capital return program during the year following the sale of its US onshore assets. The capital return program of US$10.4b is being done through a deeply discounted buyback of US$5.2b which was completed in December and a special dividend payment of US$5.2b to be completed in January 2019.

The buyback predominantly benefitted Australian shareholders who value the franking credits released through the buyback and the special dividend benefitted all shareholders.

The third reason why BHP performed well was that through the sale of assets at good prices and the return of capital to all shareholders, the market gained confidence in BHP's new capital allocation framework. BHP followed up these actions with a 65 page capital allocation briefing to investors and analysts that was presented in a number of cities.

The ability to allocate capital astutely is one of the key skills good companies exhibit and the clarity of the BHP process is impressive.