COOPER INVESTORS ENDOWMENT FUND
QUARTERLY COMMENTARY REPORT

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

DECEMBER 2019

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	3.34%	0.87%	2.47%
ROLLING 1 YEAR	24.08%	25.32%	-1.24%
ROLLING 2 YEAR	12.52%	11.9%	1.67%
ROLLING 3 YEAR	13.37%	11.15%	1.57%
ROLLING 5 YEAR	11.49%	10.61%	0.88%
SINCE INCEPTION*	11.67%	9.96%	1.71%
SINCE INCEPTION^	90.39%	73.98%	16.41%

*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 Cooper Investors Endowment 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.

The Fund commenced in March 2014. Since commencing, the portfolio has achieved its objectives of delivering a higher return than the market with a lower level of risk. These objectives have been achieved through stock selection and portfolio construction. The strategy is unchanged since the commencement of the Fund.

Market and Portfolio Performance

The ASX 200 Accumulation Index (adjusted for franking credits) rose by 0.9% over the December quarter and over the past year returned 25.3%. The model Endowment portfolio returned 3.3% and 24.1% for the quarter and year respectively.

Equity investors experienced a very strong year with the Australian and most international markets rising by over 20%. In the December quarter the Australian market lagged global markets.

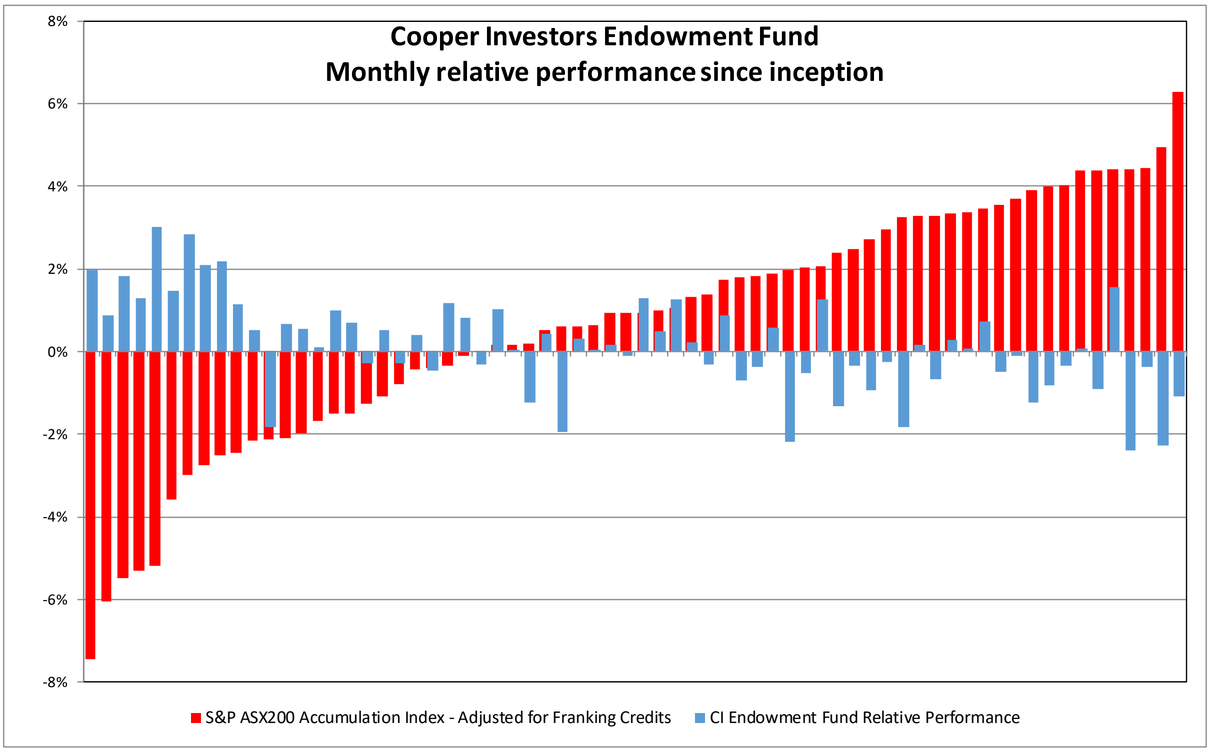
There was a wide dispersion of returns across sectors in Australia, with the financial sector heavily underperforming whilst stocks with more growth rose very strongly. Despite continually negative global geopolitical headlines, economies continued to grind out higher earnings and many high quality companies grew strongly. Continued low (relative to the past few decades) interest rates definitely helped the equity markets, both from an earnings perspective and from earnings multiple expansion.

The best performing stocks over the quarter included **Chorus (CNU)** (positive update from regulator), **Lifestyle Communities (LIC)** (improved outlook for housing market), and **Caltex (CTX)** (Couche-Tard takeover proposal).

The poor performers included **Aurizon (AZJ)** (concern about coal volumes given weak coal price), **Regis Healthcare (REG)** (FY20 earnings downgrade), and **GPT Group (GPT)** (no news).

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

The chart below shows the Cooper Investors Endowment 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 (adjusted for franking credits) has shown a monthly negative return 25 times and in these months the portfolio has performed better than the market 18 times. When assessed using monthly data the portfolio has captured 66% of the market's downside and 89% of the market's upside.

The Portfolio

There we no major changes to the portfolio during the quarter. We made small increases to our weightings in Chorus and Computershare, and reduced our position in TE Connectivity following strong share price performance.

The portfolio owns 40 securities including seven global stocks (13%) and two New Zealand stocks (4%). The cash weighting is around 6%.

Stock News

Chorus (CNU) benefited from the release of the draft input methodologies report by the New Zealand regulator in November, which was an improvement from the emerging views paper published in May. Key benefits included higher discount rate inputs (asset beta and market risk premium), allowance of tax losses to be carried forward, and more favourable treatment of Crown financing. Despite the improvement we still think the allowable return is too low for this asset and should be revised higher.

The input methodologies final decision is due in June 2020 which will largely determine the inputs for the draft decision due in 4Q2020. As we move closer to the implementation of the regulated asset base (RAB) model and capex continues to decline, the dividend policy will become clearer and we expect a material uplift in free cash flow and dividends over the next few years.

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 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. However, 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.

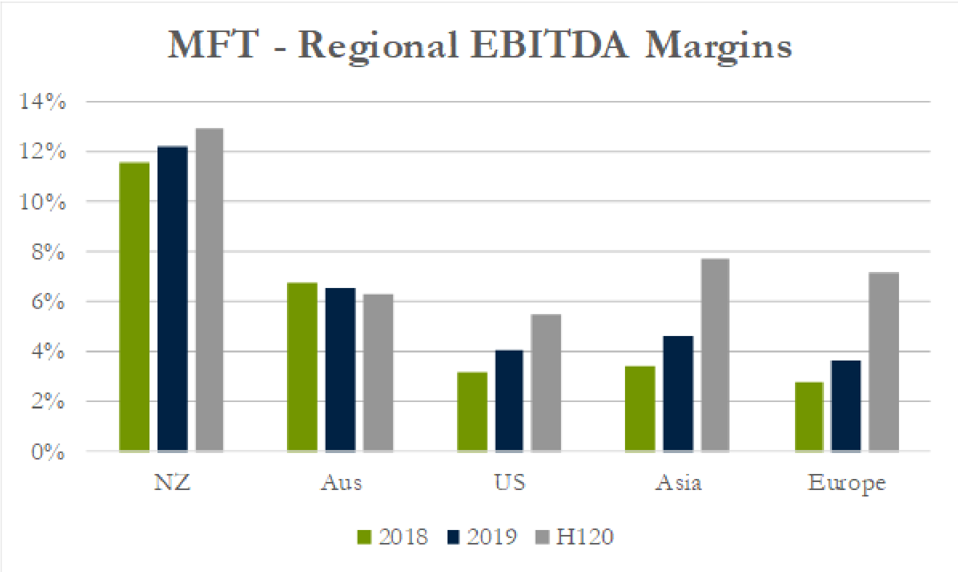
After starting in 2005, it has grown into one of the world's largest investors in renewable energy. It now operates or manages over 13GW of renewable generation capacity and has over 250 projects under development or construction. In 2017 Macquarie acquired the Green Investment Bank, which added £4bn 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.

Mainfreight (MFT) reported their first half FY20 results during the quarter. Revenue increased 5% (a slower rate of growth than in recent periods), EBITDA was up 10% and EPS up 12%. Margin expansion was mostly offshore with EBITDA growth in US and Europe both very strong (+22% and +34%), which reflected improved utilisation particularly in Europe.

MFT is optimistic that the opportunity for growth in US/Europe, particularly with existing clients, remains significant. Over its roughly 25 years as a listed company, MFT has grown sales at a 14% CAGR. Our VoF proposition for MFT is based on a continuation of growth in both ANZ and US/Europe driven by MFT's strong service culture, premium positioning and its focused execution.

In addition, we expect there is further room for margin expansion across MFT's business as it continues to grow its network and reinforces its advantage with customers.



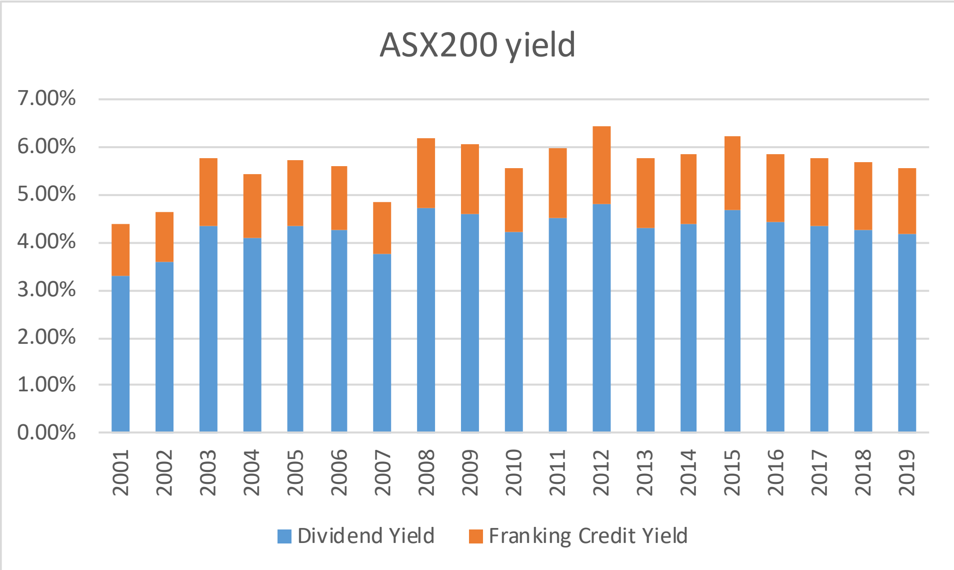
Oil Search (OSH) announced they have approved entry into the Front End Engineering Design (FEED) phase of the Pikka Unit Development on the North Slope of Alaska subject to joint venture approval and finalisation of several third-party agreements, expected in early 2020. Following an independent assessment completed during the quarter, OSH also increased the 2C resources held for the unit by 46% to 728 million barrels. Whilst in line with our expectations, the announcements are a positive reinforcement of both the size of the project and the development timeline. Attention will now turn to official FEED entry and the divestment of up to 15% of OSH's existing 51% in the Pikka unit and adjacent leases, expected to be completed around mid-2020.

In December **Regis Healthcare (REG)** announced a downgrade to FY20 guidance citing continued industry-wide pressure on occupancy. Occupancy had fallen from 92.4% as at 30 June 2019 to 91.5% as at 17 December 2019 reflecting the ongoing challenging industry conditions. The downgrade to FY20 EBITDA and NPAT guidance was 12% and 26% respectively, and assumes no further deterioration in occupancy which may be optimistic given current operating trends.

Growing income

One of the objectives of the Endowment Fund is to grow distributions over time. This objective is important because people in the pension phase require a regular income to meet living expenses which ideally grows at least in line with inflation. Growing distributions is also important for charities and foundations whom require income to fund their spending commitments.

The Endowment portfolios have a dividend yield of around 3.5%, franked to around 56%, which is below the ASX200 market yield of 4% franked to approximately 75%. There are some reasons for having a lower yield than the market that are worth explaining as they tie back to our portfolio strategy and objectives.



Two of our key portfolio construction guidelines are to be very diversified without concentrated exposure to one industry, and to have low correlation between stocks in the portfolio. These guidelines are critical to reducing portfolio volatility and providing downside protection.

To lift yield a portfolio would conceptually have higher weightings in Bond-like equities (BLEs), Cyclicals and the banks as they generally provide the highest yield. However these sectors, particularly the banks and the big miners, tend to be highly correlated as well as representing large weights in the index.

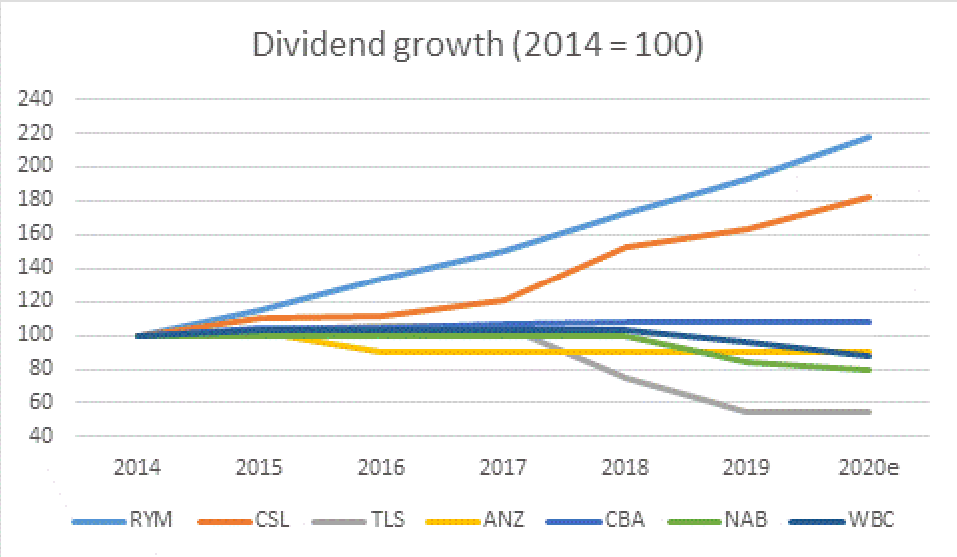
By way of example, the four major banks represent around 20% of the index, and BHP and Rio Tinto together make up another 8%. If these stocks were held in a portfolio at or above market weight the portfolio becomes very concentrated in these sectors which crowds out diversification. In addition, the banks are highly positively correlated and the big miners even more so, which in simple terms means most of the time they move in the same direction at the same time.

Therefore a portfolio with a significant weighting in banks, the big miners and BLEs has a higher risk of underperformance in down markets or when these sectors underperform. As such a portfolio focused on diversification and low correlation between stocks is likely to be underweight these sectors which, all other things being equal, will lower the yield of the portfolio.

A higher yielding portfolio is also likely to have less exposure to Growth and Stalwart type stocks which we think is likely to lead to lower growth in dividends over time. This is important because while BLEs in particular have predictable earnings and dividends, quality Growth and Stalwart companies have the ability to reinvest retained earnings at high rates of return which over time grows income and dividends.

CSL and Ryman Healthcare (RYM) are good examples of the magic of compounding returns. Both companies payout 50% of earnings in dividends and reinvest retained earnings into growing their businesses. In contrast the banks and Telstra (TLS) have had payout ratios that were too high and declining returns on equity which has flowed through to earnings and dividends.

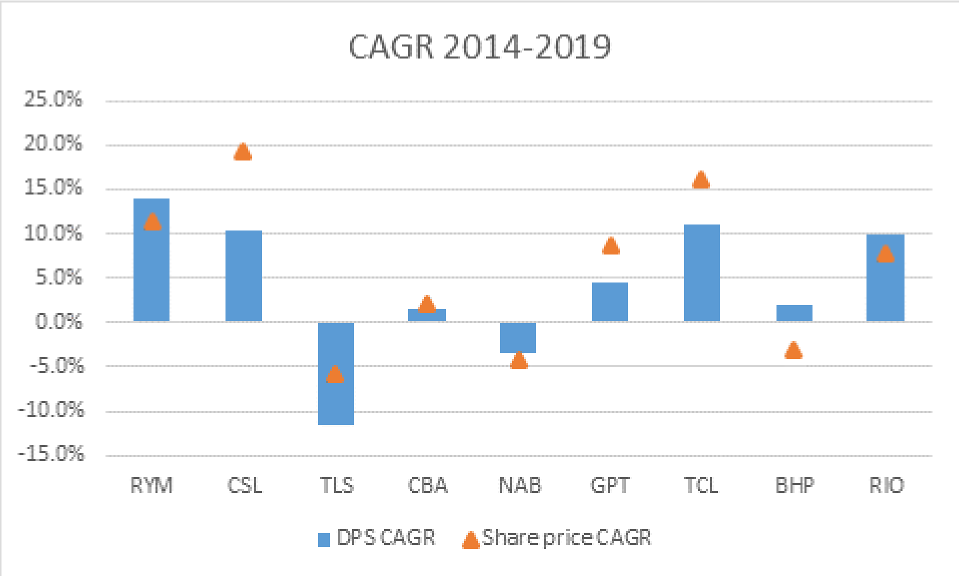
If we compare CSL and RYM to TLS or the banks over the last 5 years we can make some observations (Note: we have selected 2014 as a starting point as the Endowment Fund commenced on 3 March 2014).



Firstly, CSL and RYM have significantly grown their dividends over this period whereas bank dividends are flat-to-down and the TLS dividend is significantly lower. So while investors may have received a higher yield from TLS and the banks, today they would be receiving less income from these stocks than five years ago.

CSL and RYM typically trade on dividend yields of 1%-2% which is far lower than many BLEs or Cyclical stocks. However we would expect the yield on the entry cost of Growth and Stalwart (ex Banks) companies to steadily increase over time and exceed the current yield on many BLEs and Cyclicals. For example, the current yield of CSL on original cost ($94 in March 2014) is 8%

This also highlights one of the issues with fixed interest for investors seeking income. Coupons are at a fixed interest rate and therefore do not grow nor do they keep up with inflation to protect purchasing power. In addition the corpus does not grow as the original face value is repaid upon maturity.
The chart below illustrates the link between growth in dividends and share price performance for some of the stocks we have in the portfolio. We recognise that share price performance can be affected by a range of factors other than dividends but nonetheless we find it instructive.



It is a salient reminder that stocks with poor dividend performance are unlikely to perform well and present investors with the risk of both declining income and capital loss. Conversely companies with strong dividend performance usually also have robust operating trends and earnings which is rewarded by the market, particularly in a low interest rate environment.

In summary, we think the portfolio delivers a reasonable yield albeit one that is below the market yield. This is consistent with a strategy focused on performing better in down markets, having lower volatility than the market, and being very diversified. Portfolios should be diversified across all of the subsets of value – BLEs, Cyclicals, Growth and Stalwarts – not just the higher yielding sectors. While this delivers a more modest yield it is more likely to deliver better long term income and returns with less volatility.

Given the strong performance of markets in 2019 it would be hard to have a high yielding portfolio that balances the desire for higher income with the risk of an expensive market in a low interest rate environment. We are cognisant that income is important to our investors and we will endeavour to modestly increase the yield of the portfolio through our stock selection and portfolio construction processes.

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