# CI PENSIONS FUND
# QUARTERLY COMMENTARY REPORT

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

## JUNE 2019

| | **PORTFOLIO | #BENCHMARK | VALUE ADDED |
|---|---|---|---|
| ROLLING 3 MONTH | 4.47% | 8.26% | -3.79% |
| ROLLING 1 YEAR | 12.30% | 13.39% | -1.09% |
| ROLLING 2 YEAR | 14.60% | 14.02% | 0.58% |
| ROLLING 3 YEAR | 12.26% | 14.58% | -2.32% |
| ROLLING 5 YEAR | 11.87% | 10.52% | 1.35% |
| SINCE INCEPTION* | 11.58% | 10.19% | 1.39% |
| SINCE INCEPTION^ | 79.27% | 67.71% | 11.56% |

*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.

The Fund commenced in March 2014. Over the ensuing five years 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 8.26% over the June quarter and over the past year returned 13.39%. The model pensions portfolio returned 4.47% and 12.30% for the quarter and year respectively.

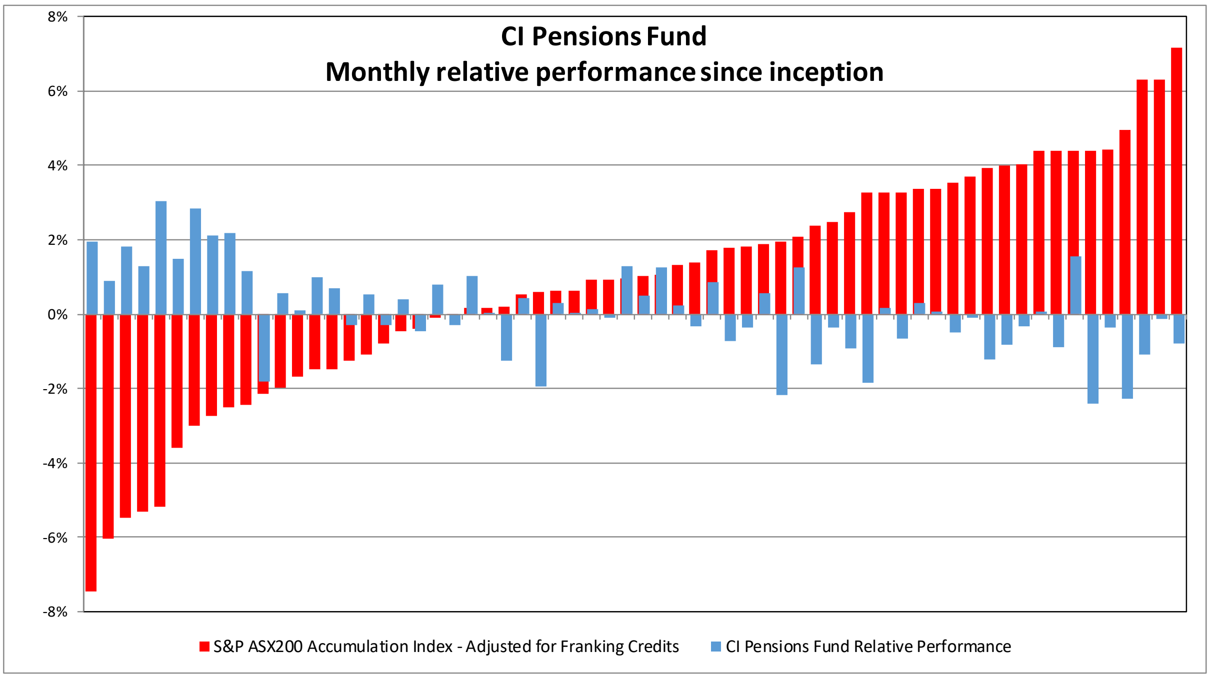
The June 2019 quarter saw a continuation of the positive equities market performance in 2019 following the surprise re-election of the Coalition government and the more recent move by the RBA to lower interest rates to record lows.

Sentiment towards the Australian housing sector also improved markedly driven by a confluence of factors. First, the Coalition re-election meant no changes to negative gearing or capital gains tax treatment. Secondly, borrowing capacity increased with the RBA lowering interest rates and the APRA proposal to remove the 7%+ serviceability floor (in place since 2014) and replace it with a buffer of 2.5% above actual borrowing rates.

The best performing stocks over the quarter included **Lifestyle Communities (LIC)** (improved housing market sentiment), **Seek (SEK)** (market presentation increased confidence in revenue opportunities) and **ASX (ASX)** (ongoing growth in market trading activity). The poor performers included **Link (LNK)** (FY19 earnings downgrade and Woodford fund investigation fallout), **Regis Healthcare (REG)** (ongoing industry and operating headwinds), **Soul Pattinson (SOL)** (New Hope share price impacted by falling coal prices).

The volatility of the portfolio over the quarter was 81% 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 (adjusted for franking credits) has shown a monthly negative return 22 times and in these months the portfolio has performed better than the market 17 times. When assessed using monthly data the portfolio has captured 67% of the market's downside and 88% of the market's upside.

## The Portfolio

During the quarter we added **ARB Corp (ARB)** to the portfolio and sold out of positions in **Adelaide Brighton (ABC)**, **Link (LNK)** and **Lendlease (LLC)**. We added to our positions in **Aurizon (AZJ)**, **Brambles (BXB), GPT Group (GPT)** and **Ramsay Healthcare (RHC)**. We also sold **ANZ** and redeployed part of the proceeds into **CBA** as holding three highly correlated banks doesn't add to diversification, (the portfolio now holds CBA and NAB). For international stocks we sold **Kao Corp (Kao)** and bought **Unicharm**.

**ARB** designs and manufactures automotive accessories for 4WD and light commercial vehicles. ARB was established in 1975 and listed on the ASX in 1987 with a $6m market capitalisation, and today it employs 1,600 people, generates $440m in sales and has a market cap of $1.5b.

ARB has demonstrated resilience through a number of cycles and has an impressive history of dividend growth and periodic special dividends. This is complimented by a net cash balance sheet which we view as a key source of value latency and downside protection.

An excellent track record is underpinned by a founder/owner culture (the Brown family owns 7.5% of shares) and a business that has remained focused on a tight circle of competency since establishment. Medium term prospects for sales growth is encouraging albeit the outlook is tempered by a weakening domestic macro outlook.

ARB is a diversifier for the portfolio and we expect it to continue growing earnings and dividends backed by a highly credible management team and Board. Our purchase was to some degree opportunistic because we participated in a sell down by 3 directors (including the Brown family) at $18.50, which tends to happen every few years as the founders gradually reduce their exposure to ARB.

**Kao** was sold due to deteriorating operating trends and increased competitive intensity across both its core domestic business and its Chinese growth engine. In contrast **Unicharm** represents a more regionally diversified pure play with a simpler growth proposition across premium diapers, feminine sanitary products and adult diapers. Unicharm allows us to retain exposure to Asian growth from Japanese premium consumer products which we view as a strong diversifier for the portfolio.

We sold **ABC**, **LNK** and **LLC** given operating and industry trends were deteriorating and the recent track record has been deteriorating.

The portfolio owns 39 securities including seven global stocks 15% and two New Zealand stocks (4%). The cash weighting is around 8%.

## Stock News

**Aurizon (AZJ)** performed strongly after reaching a commercial agreement with miners for the Queensland network business. This includes an extension of the regulatory term from four to ten years, WACC increase to 6.3% (with a reset in June 2023) and retaining the operating cost benefit for the entire regulatory period if they exceed their targets.

**Chorus (CNU)** had the regulator release their emerging views on the new regulatory regime for the fibre network proposing an indicative WACC in the low 5% range which was much lower than market expectations of 6%-7%. Unsurprisingly this was viewed unfavourably and the share price has been under pressure. We note this is only the start of the process and the regulator is currently accepting submissions before a draft decision is made in November 2019.

**Coles (COL)** performed strongly after outlining a new $1bn cost saving program at its strategy day as well as no reset of earnings or blowout in capex which some in the market had been expecting.

**GPT Group (GPT)** In June GPT announced an $800m institutional placement to help fund asset acquisitions and their development pipeline. There have been a raft of equity raisings in the REIT sector as they take advantage of highly priced scrip to fund growth and reduce gearing. This strikes us as sensible capital allocation given we are in the later stages of the commercial property cycle. We did not participate in the equity raising given the offer price of $6.07 does not represent compelling value and GPT is already a reasonable weight in the portfolio.

**Viva Energy REIT (VVR)** announced late in the quarter that well-regarded CEO Margaret Kennedy will step down from her position in first half 2020. Margaret should be commended for building a track record of delivering attractive risk-adjusted returns at VVR since listing on the ASX in 2016. There will be an orderly transition to new CEO Hadyn Stephens who is expected to start in September 2019 and comes with 20 years of property experience. We remain attracted to the low-risk income stream and long lease expiry profile that VVR offers within a very simple and focused business.

**Oil Search (OSH)** was weak on concerns that political instability in Papua New Guinea could delay expansion plans.

## Trip Notes

During the quarter some of the team travelled to the US as part of our ongoing visitation program.

The biggest change in tone from US companies is the attitude towards China. From an investment perspective companies with no China exposure were bragging about the predictability of their businesses while those with big China businesses under pressure were defending their strategies and highlighting the long term opportunities. A big turnaround from only 1 or 2 years ago when China was a key driver of many companies' outsized earnings growth.

From an operating perspective the narrative has also changed. 12 months ago with the soon to be introduction of tariffs executives were analysing and discussing their supply chains and flexibility to protect their costs and margins. So far the majority of companies we invest in and follow have done a great job mitigating any tariff pressures. However today the concerns have moved from cost concerns to revenues. Does China explicitly or implicitly push US companies out of domestic China business. This is top of mind for many CEOs as well as for us as investors.

## Stock Selection and Portfolio Construction

One of the key criteria we assess in stock selection is a company's track record.

Track record is loosely the company's history with respect to a quantifiable financial metrics as well as the qualitative aspects of the companies operation. Or put more simply, all the past achievements or failures of an organisation, considered together.

To assess a track record it should be observable and include a reasonable time period. Some of the qualitative characteristics we use to judge the quality of the track record would include consistency and duration of performance, sticking to a roadmap, management and Board competency, integrity and candidness.

Quantitative measures would cover amongst other things earnings and dividend history, earnings quality, free cash flow conversion, balance sheet strength, ROE and returns on reinvestment, outcomes vs guidance, and achieving targets.

Why do we think a strong track record is likely to deliver good future outcomes? There are a number of reasons, many of which relate to downside protection, and they are:

- Companies with good track records usually have lower drawdowns and quicker share price recovery in market downturns;
- They are less likely to make poor capital allocation decisions or move outside a tight circle of competency;
- They are less likely to deliver negative shocks; and
- There is also research that shows that companies with a history of high returns are likely to continue delivering good returns in the future.

However there are some risks associated with companies with good track records, such as extreme over-valuation as investors can over-pay for quality and reliability. There is also an argument that high factor exposure to quality can lead to underperformance if value and cyclical stocks outperform. We are mindful of these risks when constructing the portfolio.

We expect most portfolio stocks to have good or excellent track records and the portfolio to have limited exposure to companies with average track records. The portfolio could have some exposure to companies with improving track records as long as there is evidence of improvement and not just promises. We should not own companies with poor or worsening track records.

It is challenging in the Australian market to have a diversified portfolio that is solely comprised of companies with excellent (e.g. CSL, MQG), good (e.g. LIC, IAG), or improving (e.g. VVR, CNU) track records, so there are normally some companies in the portfolio with average track records (e.g. banks).

In summary, in assessing a company's track record all the factors discussed above need to be considered *in totality*. Track record is a critical factor in determining a company's suitability from a stock selection and portfolio construction perspective, which are the two ways in which we achieve the portfolio objectives.