COOPER INVESTORS ENDOWMENT FUND
QUARTERLY COMMENTARY REPORT

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

SEPTEMBER 2019

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	2.77%	2.85%	-0.08%
ROLLING 1 YEAR	11.95%	14.31%	-2.36%
ROLLING 2 YEAR	15.35%	14.97%	0.38%
ROLLING 3 YEAR	12.49%	13.58%	-1.09%
ROLLING 5 YEAR	12.34%	11.16%	1.18%
SINCE INCEPTION*	11.57%	10.26%	1.31%
SINCE INCEPTION^	84.24%	72.48%	11.76%

*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. 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.

We note that the name of the CI Pensions Fund was changed to the Cooper Investors Endowment Fund to be consistent with the international version of this strategy that was opened up to external investors on the 1st of July. In addition, we think the name Endowment better encompasses the range of investors (retirees, foundations and charities) for whom this strategy might be suitable for. There has been no change to the strategy of the Fund.

Market and Portfolio Performance

The ASX 200 Accumulation Index (adjusted for franking credits) rose by 2.85% over the September quarter and over the past year returned 14.31%. The model Endowment portfolio returned 2.77% and 11.95% 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.

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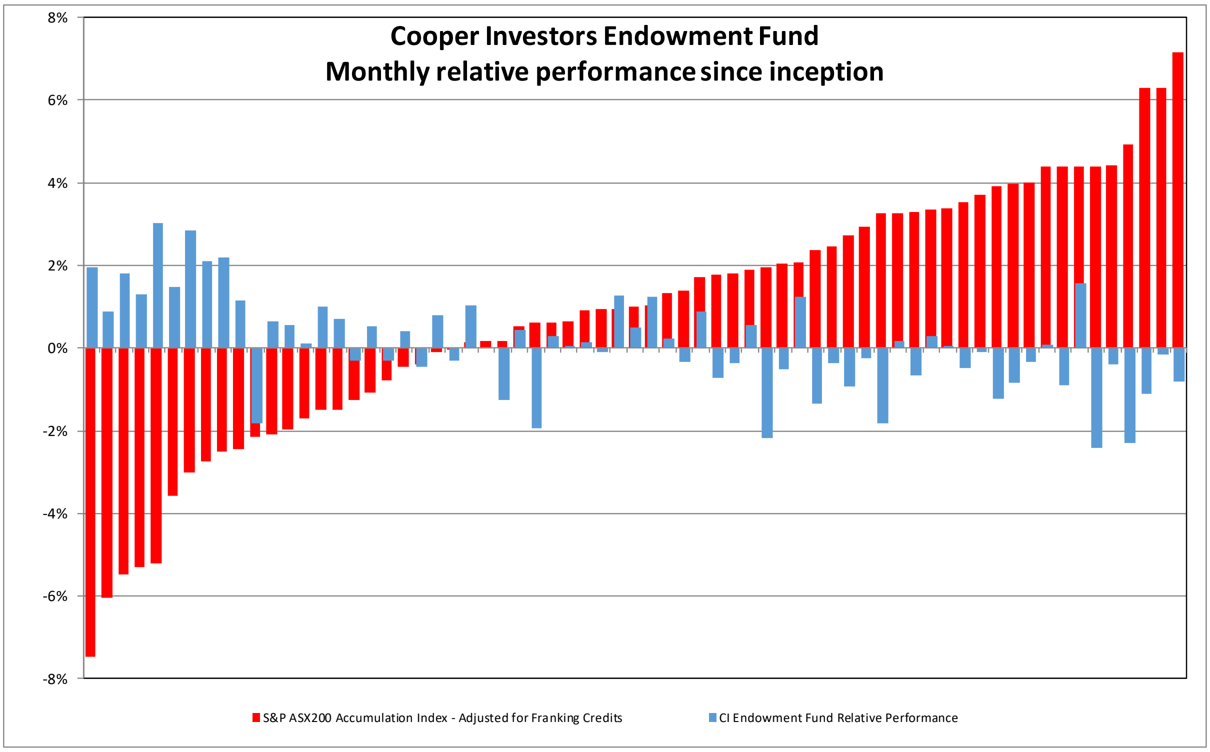
The ASX200 Accumulation Index rose 2.4% over the quarter, again pushing past numerous global areas of concern, and following the lead of the Dow Jones and S&P500 indices which both rose by a similar amount. Bond yields fell in Australia and the USA as markets anticipated further rate cuts which duly occurred. The Federal Reserve cut rates by 25bps, its second cut in the space of three months, while the RBA cut rates in both July and on 1st October by 25bps on each occasion to leave rate at historic low of 0.75%. Inflation is seemingly not a risk and there are growing worries about the global economy in light of a litany of uncertainties.

The best performing stocks over the quarter included **Lifestyle Communities (LIC)** (improved housing market sentiment and inclusion in ASX 300 Index), **Viva Energy REIT (VVR)** (attractive yield in a low interest rate environment), and **Regis Healthcare (REG)** (concerns over Royal Commission reducing, otherwise no news of note).

The poor performers included **Chorus (CNU)** (market concerns over the regulatory regime for their fibre network), **Ramsay Healthcare (RHC)** (solid FY19 result but cautious outlook for FY20), and **Brambles (BXB)** (earnings shortfall as a result of issues with the pallet pools in both Canada and Latin America).

The volatility of the portfolio over the quarter was 76% 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 23 times and in these months the portfolio has performed better than the market 16 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 **Telstra (TLS)** to the portfolio. The operating trends in the mobile business are improving as one of Telstra's main competitors have seemingly moved away from aggressive pricing in the pursuit of market share growth. The mobile business remains Telstra's crown jewel and is a key driver of earnings growth over the medium term. However, Telstra still faces headwinds from customers migrating over to the NBN, with 50% of the margin impact absorbed at the end of FY19.

We think Telstra is on the right path with its T22 strategy which involves a significant cost-out programme, simplification of systems and products, investing in their mobile network and setup of InfraCo. In our view InfraCo could be meaningful value latency for Telstra if management are able to execute on the opportunity. Lastly, Telstra's re-based and sustainable dividend of 16cps (~4.6% yield fully franked) is attractive, particularly in the current low interest rate environment.

The portfolio owns 40 securities including seven global stocks (15%) and two New Zealand stocks (3.5%). The cash weighting is around 6%.

Stock News

As we had expected, and part of our investment thesis, **Aurizon (AZJ)** completed the internal restructure of the above rail and network businesses. While deciding to remain an integrated business for the time being, the restructure will essentially allow the network business to be geared more in line with other infrastructure businesses and enable circa $1.2B of further debt capacity. We expect these funds will be deployed into capital returns to shareholders or other value accretive opportunities.

In August **Chorus (CNU)** announced that well regarded CEO Kate McKenzie would step down from the CEO position at the end of 2019, three years after having been appointed CEO in December 2016. Kate is to be replaced by JB Rousselot who has held senior positions at Telstra and NBN Co. Although it is disappointing Kate is stepping down we would be surprised if there are any significant changes to their strategy or our investment proposition and remain comfortable holding CNU in the portfolio.

The **Lifestyle Communities (LIC)** FY19 result was in line with expectations having been well flagged to the market. FY20 settlements (270-310) however are expected to be lower than FY19 (337) due to delays in receiving planning permits for two villages – Wollert North and Kaduna Park – which we view as largely a timing issue. More importantly, management provided settlement guidance for FY21 of 370-420, which points to a medium-term sustainable settlement run-rate of c400 homes pa (or 2 new villages pa). This is higher than what we had assumed in our forecasts and we would not be surprised if there is upside risk to settlement rates over the medium-to-long term.

Demand continues to be supported by LIC's strong affordability proposition, increasing brand recognition, and the long runway of growth in Greater Melbourne. Sentiment in the housing market also appears to be improving, which has been a major concern for the market over the last 12-18 months. Encouragingly, there has been little observable impact from lower house prices in Melbourne for LIC, with average FY19 sales prices for new homes +17% and resold homes +11% (albeit some of this is due to mix). Days from sale to settlement had moved out by around 30 days but industry feedback suggests this has now started to come back in as the housing market improves.

In July Tim Poole announced he would retire as Chairman of LIC in August 2019, having been a Director since 2007 and Chairman since 2013. Tim will be succeeded by Phillippa Kelly who joined the Board in 2013 and is currently Chair of the Audit Committee. We commend Tim for having done a superb job over his time at LIC and look forward to Phillippa taking up the reins. Also worth mentioning is that LIC was included in the ASX 300 Index as part of the September 2019 quarterly rebalance, which is another positive milestone in the company's journey.

During the quarter **National Australia Bank (NAB)** announced that its new CEO would be Ross McEwan, former Group Executive for Retail Banking Services for CBA and more recently CEO of Royal Bank of Scotland (RBS). His experience at RBS post the global financial crisis where he led the organisation through significant change and recovery should serve him well for his role at NAB. For NAB this is a key appointment and we expect McEwan and chairman Phil Chronican to be the best and most experienced management team to have been at NAB for many years. At the time of writing Chronican has cut the dividend to a sustainable level, taken the software and remediation write off we expected, and thus cleared the decks for the incoming CEO.

As discussed in previous quarterly reports we retained an underweight exposure to the banking sector, with the portfolio owning CBA and NAB. With the exception of NAB, we see limited valuation upside: the sector is trading near the top of historical averages, with few identifiable positive latencies. Operating trends remain skewed to the downside: lending volumes are still weak, margins under pressure, remediation charges and investment requirements dragging on costs, and proposed RBNZ changes impact capital. Competition is high as both incumbents and new entrants fight for volume in a low-growth environment.

Although the RBA's recent interest rate cuts make their dividend yields more appealing, low interest rates are fundamentally negative for banks. As rates approach zero, it becomes increasingly difficult to re-price deposits to offset the pressure on mortgage rates, and returns on replicating portfolios and equity hedges decline. We also question how effective monetary policy will be in stimulating credit growth given high household indebtedness and a more cautious approach from the banks following the Royal Commission.

On October 1, **Oil Search (OSH)** announced that Peter Botten will retire as MD in February 2020 before leaving the company in August. One of the longest serving CEOs in the ASX200 (appointed CEO in 1994), Botten has done an exceptional job transforming the company from a dozen employees and a market capitalisation of ~A$200m to a company with 1,700 employees and a market capitalisation of ~A$11bn. His successor Dr Keiran Wulff has nearly 20 years' experience at OSH across senior technical, operational and executive positions in both PNG and Alaska that hold him in good stead to lead the business through the current growth period and beyond.

Following the change in PNG leadership on 30 May 2019, the Marape led government asserted that the Papua gas agreement (signed by the prior Government in April 2019) was disadvantageous to the State and resolved to seek a renegotiation. A period of uncertainty followed where the PNG Minister for Petroleum first announced the Cabinet had agreed in principal to stand behind the initial agreement but only 2 weeks later authorized a team to conduct "negotiations that could work out well or even disastrously". On 3 September the initial Agreement was validated, a positive step towards FEED (front end engineering and design) for the PNG LNG expansion developments.

A weak global demand outlook weighed on oil prices throughout the quarter with Brent reaching US$55/bbl before an attack on Saudi oil infrastructure temporarily shut-in ~5% of global supply and saw prices spike to US$68/bbl. A quick resumption saw prices end the quarter at ~US$60/bbl.

Qube Holdings (QUB) delivered very solid FY19 results despite some challenging industry and macroeconomic trends, reflecting management's commercial acumen and QUB's diversified portfolio of highly strategic assets. QUB reported FY19 revenue +4.7%, EBITDA +7.5% and NPATA +13.4% demonstrating good top line leverage through the P&L. Pleasingly, cash conversion of EBITDA was very strong and net operating cash flows were up 25%. The balance sheet is also in reasonable shape with a leverage ratio of 32.5%, which is at the bottom of the long term target range of 30%-40%.

In late September QUB hosted a tour of the Moorebank Logistics Park (MLP), which is the key value latency for our investment proposition. To give a sense of size MLP is 243Ha including 850,000 sqm of warehousing, which is roughly equivalent to the Sydney CBD. Significant progress has been made over the last 12 months as infrastructure is being delivered, trains have started running, and management remain upbeat around tenant inquiry levels for warehousing. MLP continues to de-risk as milestones are delivered and we came away from the site trip incrementally positive that QUB continues to progress in line with our investment proposition.

On September 16, **Ramsay Health Care (RHC)** announced that its largest shareholder, the Paul Ramsay Foundation, would be selling part of its stake in RHC (approximately 10.9% of Securities on issue to the value of A$1.36 billion). We took this opportunity to increase our position in RHC at what was a 5.2% discount to the last closing price of A$65.20.

In RHC's offshore markets, we continue to see signs of improvement in both France (tariff increases effective March 2019) and the United Kingdom (recovery in NHS volumes and tariff increases effective 1 April 2019). Domestically, RHC faces some near term headwinds including private health insurance uptake and affordability, but long-term growth is underpinned by favourable ageing population demographics.

In September **Regis Healthcare (REG)** CEO Ross Johnston stepped down after 11 years in the role having done an admirable job against the backdrop of incredibly difficult industry conditions. Ross had strong operational expertise and deep industry experience, and transitioned the business from a privately-owned aged care operator to become a leading listed residential aged care provider. Ross will be replaced by Linda Mellors who was previously Chief Operating Officer of Mercy Health, with responsibilities covering both health and aged services (aged care, home care and retirement living).

Viva Energy REIT (VVR) had another very strong quarter with the share price rising 9.6%. The share price rose because the 5.5% yield VVR offered at the start of the quarter was very attractive compared to yields offered by bank term deposits and other secure fixed interest securities. Term deposit rates dropped to well under 2%, the cash rate and bond yields dropped below 1% and the Reserve Bank has virtually underwritten further drops in the cash rate that look to be sustained for some years.

VVR offers a predictable income stream that will grow by at least 3% per annum, a strong business and a robust balance sheet and a clear business strategy. These attributes are scarce among listed stocks and are particularly attractive for retirees and charities that need current income that will grow.

SEPTEMBER 2019