

CI Australian Equities Fund



QUARTERLY COMMENTARY | SEPTEMBER 2023

AFS LICENCE NUMBER 221794 ABN 26 100 409 890

“A Stoic is someone who transforms fear into prudence, pain into transformation, mistakes into initiation, and desire into undertaking.” – **Taleb**

“The key is to not to predict the future but prepare for it.” – **Pericles**

“Forecasts usually tell us more of the forecaster than of the future.” – **Warren Buffett**

MARKET AND PORTFOLIO PERFORMANCE

The portfolio returned -1.33% for the September quarter, underperforming the S&P/ASX 200 by 0.56%.¹

The biggest positive contributors were Worley (as industry trends continue to support strong earnings outlook), Orica (operating conditions are supportive of margin recovery) and Transurban Group (not owned Bond-like Equity coming under pressure as interest rates rise).

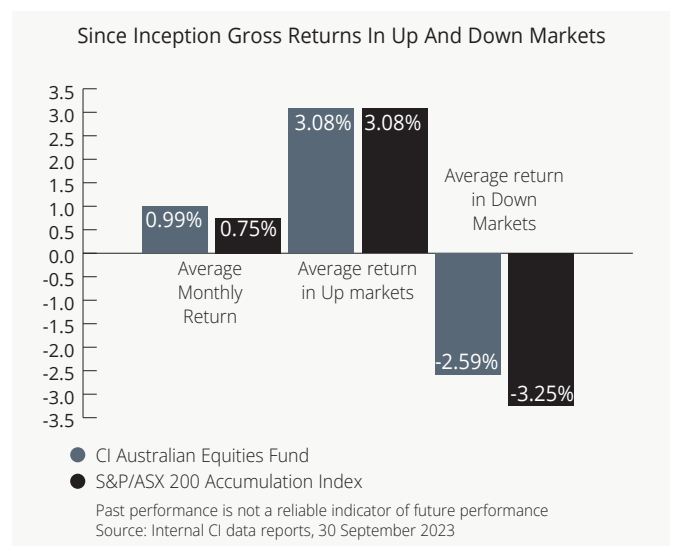
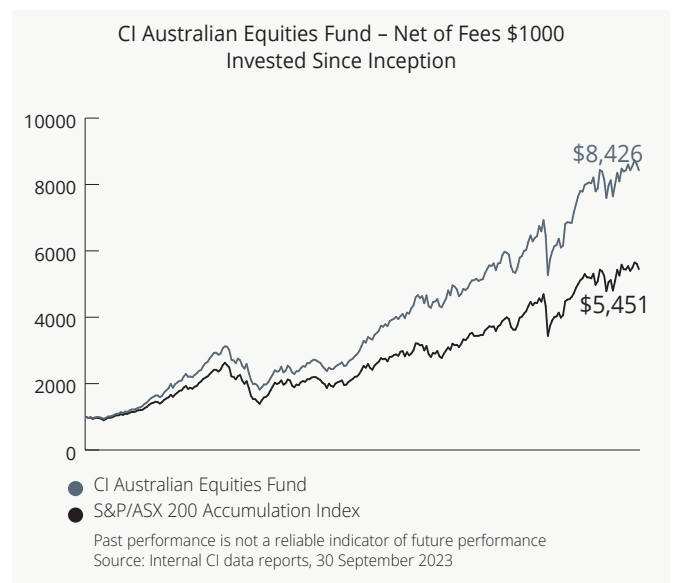
The largest detractors from performance were Woodside Energy (not owned, rose in response to higher oil prices), Aurizon Holdings (unwinding of strong performance in the previous quarter as the market was underwhelmed by the earnings outlook) and Wisetech Global (market earnings forecasts for the next financial year had got ahead of reality and first-time guidance saw these wound back).

From a Subsets of Value Latency perspective, Stalwarts were the largest detractor from performance for the quarter. This is despite the portfolio having significantly reduced exposure to Stalwarts over the last year. Stalwarts are strong and sturdy companies with privileged market positions. These companies typically have high resiliency and defensive characteristics, and have performed well over the last few years in the face of rising interest rates and volatile economic conditions. This has seen a number of the portfolio's Stalwart holdings perform well and being priced at levels where Risk-Adjusted Value Latency is less compelling. As such we have been progressively reducing the portfolio's Stalwart exposures and this continued through the September Quarter, with the sale of Brambles and Telstra.

During this period of redeployment of capital away from some of our Stalwart holdings, we have also identified new investment opportunities that offer more attractive Risk-Adjusted Value Latency. This has resulted in some rotation of capital within the Stalwart Subset of Value itself. Examples here include Aurizon and, more recently, Ramsay Health Care and Australia and New Zealand Banking Group.

	**Portfolio	#Benchmark	Relative
3 months	-1.33%	-0.77%	-0.56%
1 year	11.08%	13.46%	-2.38%
3 year*	12.31%	11.00%	1.31%
5 year*	8.30%	6.67%	1.63%
7 year*	9.12%	8.05%	1.07%
10 year*	9.94%	7.43%	2.51%
Since inception*	11.65%	8.31%	3.34%
Since inception^	939.56%	445.08%	494.48%

* Annualised
 ^ Cumulative (since the inception date of 4 July 2002)
 ** Gross of fees and expenses
 # S&P/ASX 200 Accumulation Index
 Past performance is not a reliable indicator of future performance
 Source: Internal CI data reports, 30 September 2023



¹ Past performance is not a reliable indicator of future performance

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All of this has resulted in a heightened level of turnover in the portfolio over the last quarter. This happens from time to time as opportunities arise and the investment propositions of current portfolio holdings play out. We remain resolutely focussed on investing in companies where value creation over the next three to five years is a focus, and where management teams have the capability and intentionality to execute on these opportunities. We take a longer-term investment perspective and the recent higher than normal levels of turnover remain focussed on positioning the portfolio to capture these opportunities.

GENERAL OBSERVATIONS

A notable feature of the financial markets in the last quarter has been the relentless rise of bond yields, with the US 10-year yield rising 76 basis points to 4.57%, as the market continued to grapple with the trajectory of inflation and central bank monetary policy. This has seen renewed pressure on stocks in the Growth and Bond-like Equity Subsets of Value. We remain underweight in Bond-like Equities, but have continued to use these opportunities to increase our exposure to Growth stocks, where we are identifying more opportunity for value than we have for some time. We are now overweight in the Growth Subset.

Cooper Investors' investment philosophy incorporates both top-down and bottom-up thinking, however we "observe" rather than "predict". The current environment highlights why this is the case. We have been writing for some time on the heightened level of opacity in the trajectory of key top-down factors such as inflation, interest rates and economic activity, both domestically and globally. Mindful of this, we aim to structure the portfolio to maximise performance that is not dependent on a particular macro scenario. We believe this increases the probability of generating meaningful outperformance over the long term, and leaning into our intentional observational process to identify and understand changing industry dynamics and monitoring potential risks in the portfolio.

The August reporting season also evidenced the uncertainty of the operating environment for companies. Despite reported earnings broadly delivering in line with market expectations, outlook for future periods evidenced an increased level of uncertainty and the subdued, or slowing, nature of current conditions. This resulted in net downgrades for the forecast period, which was exacerbated by adjustments due to rising interest costs. So far industrial companies appear to be effectively managing inflationary pressures, through both pass through pricing and internal cost control, but these pressures continue. The question is how long, particularly in a weakening demand environment, companies can continue to offset this pressure.

THE PORTFOLIO

During the quarter the portfolio initiated a position in **Ramsay Health Care (RHC)**. RHC sits within our Stalwarts investments and has experienced a range of challenges in recent years. In 2020, the private hospital sector was impacted by the Federal Government restrictions on elective surgery in response to the COVID-19 pandemic. The private sector, including RHC, partnered with the Government in meeting challenges posed by the pandemic.

Restrictions have lifted, however the recovery in elective surgery volumes has been slower than expected. Furthermore, disrupted operating rhythm continues to impact industry profitability. As a result, RHC has experienced a period of share price underperformance. We believe there is enough Risk-Adjusted Value Latency to compensate for uncertainty around the timing of a recovery in elective surgery in the Australian market, as well as a scenario where margins do not return to pre-COVID levels.

Private hospitals provide roughly 60% of all surgical services in Australia and remain a key component of the healthcare landscape. As Australia's largest private hospital operator, RHC will continue to play an important role in delivering surgical services for the foreseeable future. Our investment thesis in RHC centres around eventual recovery of elective surgery volumes, ongoing Brownfield expansion, asset sales to reduce exposure to foreign operations and improving balance sheet quality through asset and/or property sales.

Australia and New Zealand Banking Group (ANZ) was added to the portfolio this quarter. Another Stalwart investment, ANZ is underpinned by underappreciated upside from initiatives taken to reshape its institutional division into a higher-returning, lower-risk business.

Since 2015, ANZ's management has diligently redirected this division's focus from growth to returns. This includes de-risking the customer base, optimising the lending book and allocating more capital to higher-returning businesses such as Payments and Cash Management (PCM). These actions, along with the rise in global interest rates, have supported a vastly improved return and expected loss profile.

While ANZ's underweight position in retail banking has historically dragged on group returns, a combination of intense mortgage competition and recent regulatory capital changes that are incrementally beneficial to institutional businesses, have caused retail and institutional returns to converge.

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Further, the deposit-heavy nature of corporate and institutional banking has reduced the need for ANZ to compete aggressively for funding in the competitive retail deposit market. In a sector where incremental improvements can make a large difference, these factors should be supportive to ANZ's relative performance.

The longer-term opportunity for ANZ's new digital banking service, ANZ Plus, to improve both customer experience and cost efficiency is another reason it has been added to the portfolio.

We funded this purchase by exiting our long-standing position in **Commonwealth Bank of Australia (CBA)**, maintaining the portfolio's underweight position in the Bank sector. We consider CBA to be a fantastic franchise with an exceptional management team – truly one of the world's great banks. However, we believe that these qualities are now largely reflected in the premium valuation and no longer see sufficiently attractive opportunity to justify a continuing position. We would gladly revisit it on a pullback in valuation.

We built a position in **The Lottery Corporation (TLC)** in the September quarter. TLC falls within our Stalwart Subset of Value; the business is highly defensive but will still generate reasonable earnings growth over the medium-term from a combination of moderate top line growth (population growth, product innovation) and some margin expansion (product mix, operating leverage). Earnings can be volatile over short periods, depending on jackpot sequences, but we expect TLC to deliver consistent returns over the long-term.

TLC's market position is a key attraction of the investment. Lotteries have infrastructure-like characteristics and compare favourably to other infrastructure opportunities in its relatively lower capital intensity.

Finally, we see scope for additional value creation from product innovation and new/expanded lottery licences in Australia and potentially New Zealand.

OBSERVATIONS FROM THE ROAD

Towards the end of the quarter, we attended a site visit to the Santos (STO) Pikka project in Alaska. As part of the site visit, we had the opportunity to meet with local management, the Natural Resource Minister of Alaska as well as representatives from Kuukpik, the traditional land-owner group on which the Pikka project is located. The visit increased our confidence in the opportunity set in Alaska with the ~1,500mmboe resource base (gross) offering the potential for additional phases beyond the initial phase 1 development currently in construction. Importantly, this is in a jurisdiction that has a supportive government, regulatory and traditional owner landscape.

The opportunity set in Alaska, together with that in Australia and PNG across carbon capture and storage for both traditional oil and gas, highlights our investment proposition in STO and the Risk Adjusted Value Latency we see despite the increasingly more challenging regulatory landscape in Australia.

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