

# CI AUSTRALIAN EQUITIES FUND QUARTERLY COMMENTARY REPORT



Cooper Investors Pty Limited

AFS Licence Number 221794

ABN 26 100 409 890

For current performance information please refer to the Monthly Performance Report.

## DECEMBER 2021

***“It’s frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what’s going on.” – Amos Tversky***

***“For every complex problem, there is an answer that is clear, simple and wrong” – H. L. Mencken***

***“It may be hard to admit – to yourself or to others – that you don’t know what the macro future holds, but in areas entailing great uncertainty, agnosticism is probably wiser than self-delusion” – Howard Marks***

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	2.50%	2.09%	0.41%
ROLLING 1 YEAR	20.57%	17.23%	3.34%
ROLLING 3 YEAR	16.33%	13.62%	2.71%
ROLLING 5 YEAR	11.96%	9.77%	2.19%
ROLLING 7 YEAR	10.77%	8.99%	1.78%
ROLLING 10 YEAR	14.01%	10.80%	3.21%
SINCE INCEPTION*	12.52%	8.94%	3.58%
SINCE INCEPTION^	897.88%	431.31%	466.57%

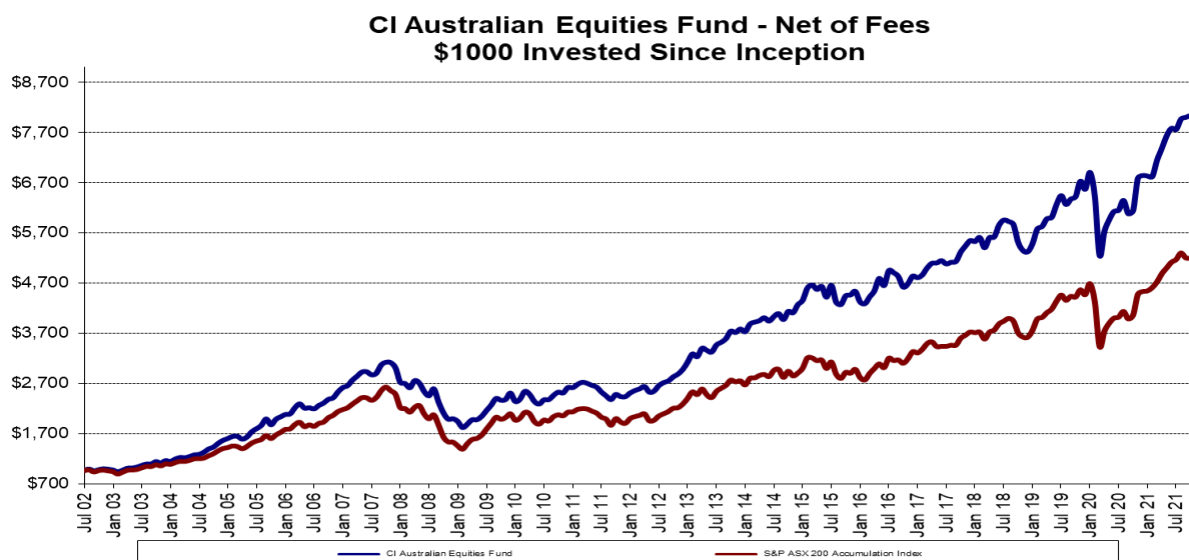
\*Annualised

^Cumulative (4 July 2002)

\*\*Before fees and expenses

#S&P ASX 200 Accumulation Index

Past performance is not necessarily a reliable indicator of future performance



Source: NAB Asset Servicing

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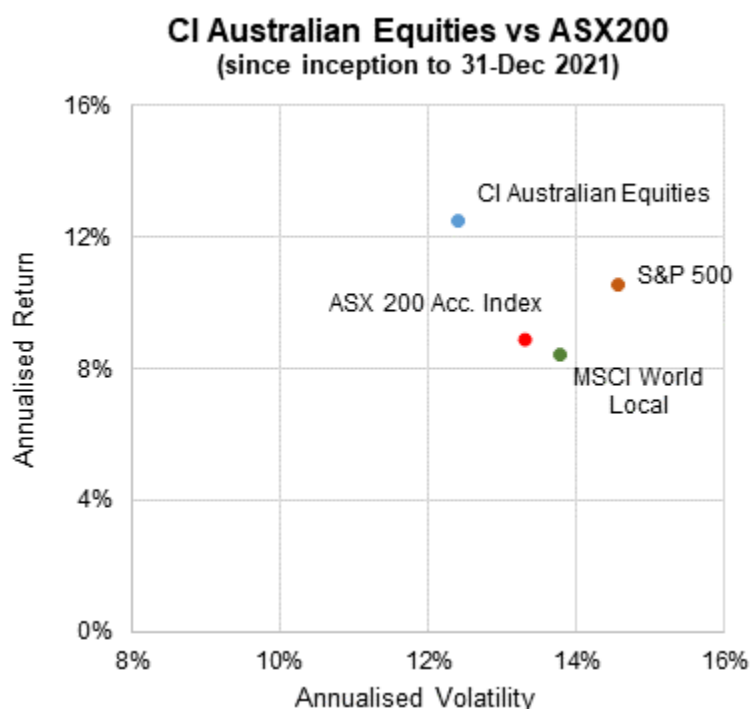
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## Market and Portfolio Performance

The ASX200 Accumulation Index rose 2.09% during the quarter, with the fund outperforming by a further 0.41%.

Our positioning in banks was a key driver of the outperformance. The biggest contributor was not owning **Westpac**, which slumped 17% after delivering a very poor 2H21 result. Of the stocks held in the portfolio, the large active position in **Macquarie** was again a significant contributor after it delivered yet another strong earnings result. **Reece** (positive AGM commentary), **Oz Minerals** (resilient copper price) and **Computershare** (leverage to rising interest rate expectations) were also additive. Additionally, the portfolio's shift from overweight to underweight **Commonwealth Bank** proved timely, allowing it to capture the upside from both its early outperformance and then later underperformance.

On the flipside, **Santos** (oil price volatility, uncertainty around OSH merger), **Aristocrat** (fears of a competing bid for Playtech), **Star Entertainment** (media allegations of inadequate anti-money laundering processes) and **Qantas** (Omicron fears) detracted from performance. Not owning **Goodman Group** (positive momentum in industrial property, cap rate compression) and **Fortescue** (iron ore leverage) also hurt given their strong performances.

Spurred by robust base metal prices and a late rebound in iron ore, materials were the best performing sector (+10.6% vs. market). Utilities were next best (+9.3%), receiving some much-needed respite following years of torrid underperformance (-50% over five years). Energy was clearly the weakest sector, underperforming by 10.9%. Information Technology (-8.2%) was also down, with **Afterpay's** 33% underperformance a major factor.

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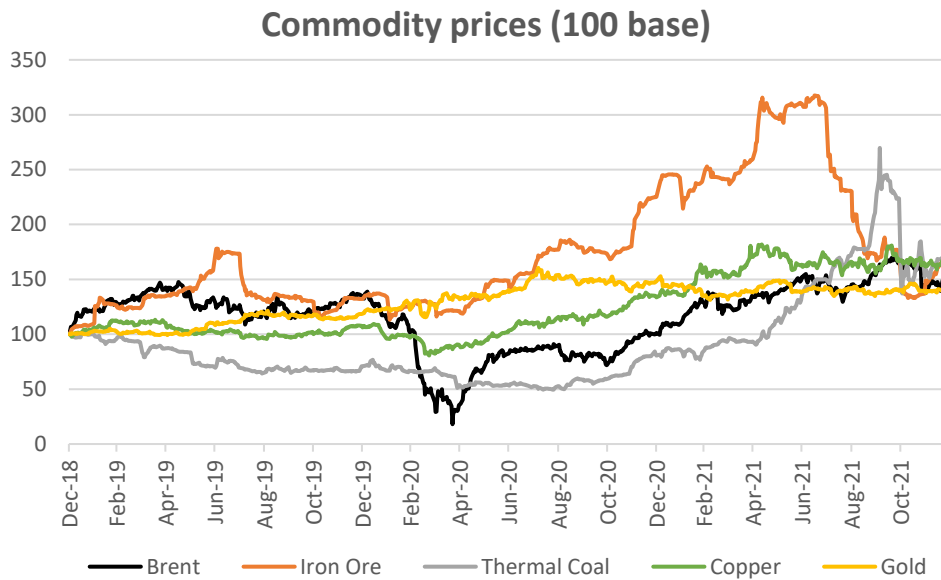
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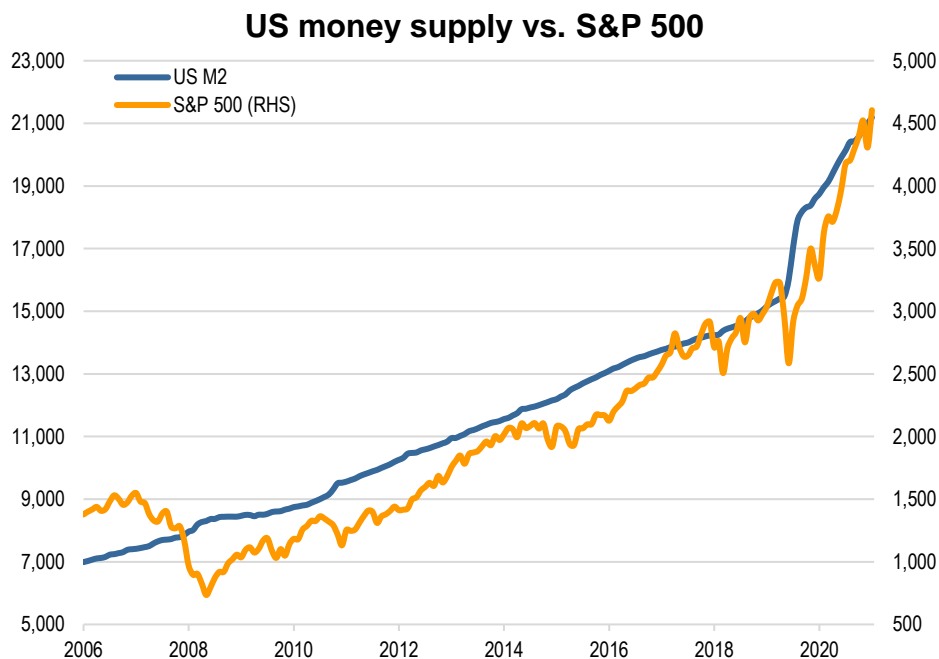
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Source: Factset

The topic du jour is inflation, with markets obsessing over each CPI print and dissecting central bankers' comments in agonising detail in the hope of clues to the future. Given high inflation's insidious impact on purchasing power, it is unsurprising that most major central banks have price stability as a core mandate. Investors also fear inflation because it can erode profit margins and typically leads to higher interest rates, which compress asset valuations. Given the relationship between money supply and markets, many fear a hawkish turn from central banks.



Source: US Federal Reserve, S&P, J.P. Morgan

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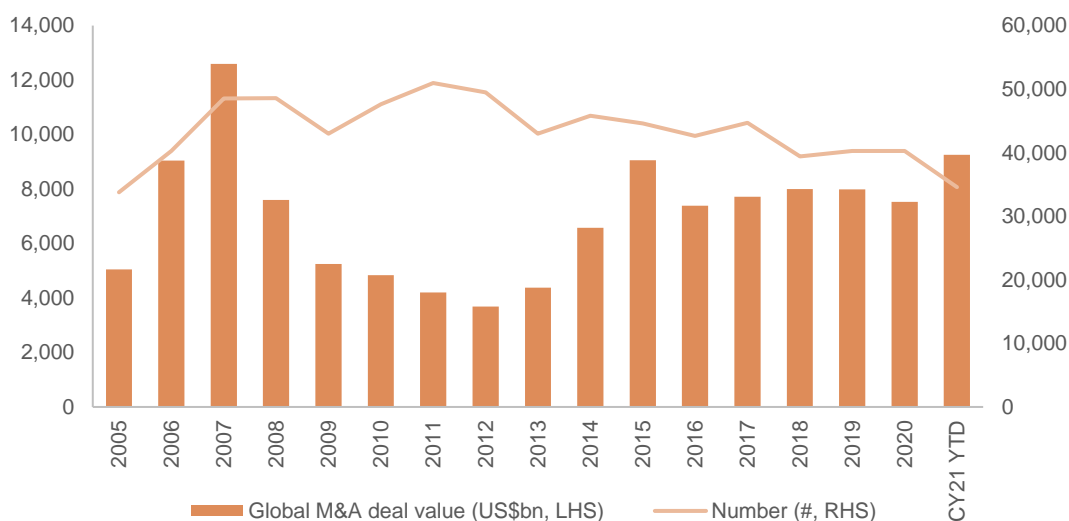
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While it is easy to articulate why inflation matters, predicting its future path is not so simple. The economy is a complex organism, which is shaped by countless variables and reflexive feedback loops. This is why we view macro forecasts with scepticism. Such predictions rarely prove correct. When they do, we suspect this is more a function of good luck than a consistently repeatable process.

Rather than masquerading as futurists, we focus our efforts on pattern recognition and the observable facts, information, behaviours and actions that are precursors to long-term value creation. This includes assessment of how such observations compare to normalised expectations, their directional trend, likely endurance and any necessary quality and risk adjustments.

From a global top-down perspective, what we can observe is:

- Ongoing monetary and fiscal stimulus (albeit, growth rates are moderating);
- Evidence that inflation is both rising and beating expectations;
- Elevated prices across many asset classes;
- Low interest rates stimulating significant deal activity, with M&A at its highest level since 2007; and
- The US central bank seemingly increasingly fixated on supporting financial markets.



Source: Dealogic, Barrenjoey Research

Similar observations have been made by central bankers, with recent actions including:

- The US Federal Reserve acknowledging that inflation might be less “transitory” than it previously thought;
- The Bank of England responding to inflationary pressures by lifting its policy rate by 15bp to 0.25%; and
- The Bank of Canada hinting at an accelerated time-line for increasing rates.

We are also increasingly hearing anecdotes from companies that signal inflation is on the march, at least for the time being. Common themes include rising raw material input costs, supply chain dislocations and labour shortages. Some examples include:

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- **Amcor (AMC)** recently increasing prices by up to 15% globally in response to supply constraints and higher raw material, transport and energy costs;
- **Computershare (CPU)** noting broad-based wage pressure in the US;
- **Reece (REH)**, Australia's largest distributor of plumbing and bathroom materials indicating inflationary pressures are starting to emerge across key inputs (e.g. copper, lumber & freight);
- **Domestic insurers** facing double-digit price increases for car parts and escalating building costs; and
- Stubbornly elevated commodity prices.

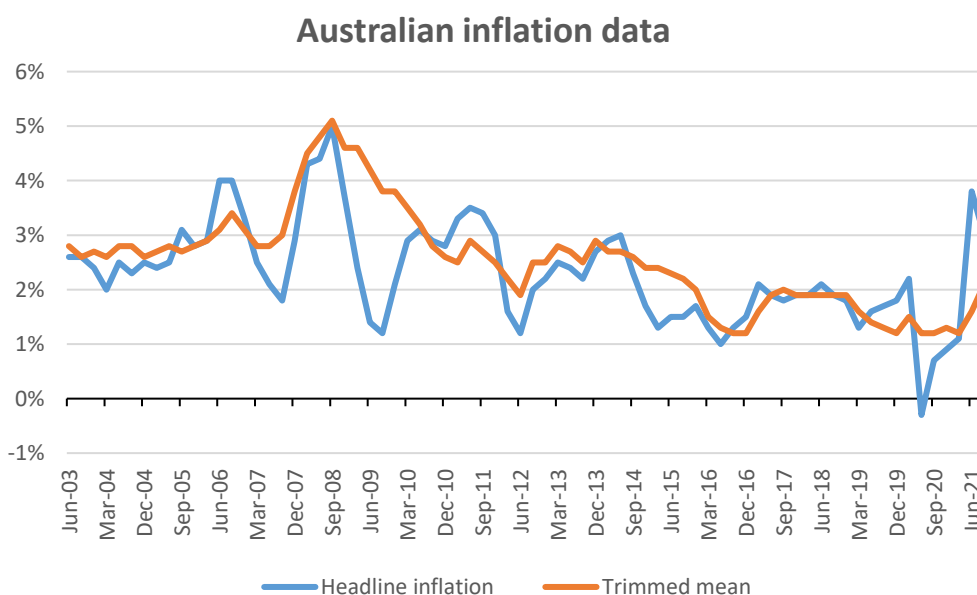
All of the above point to a period of elevated, and potential significantly higher inflation. This would present an unfamiliar paradigm for most investors and favour pro-inflation assets like commodities and gold. In contrast, asset classes that have been major beneficiaries of the low growth/low rate regime (e.g. long-duration equities) would face secular headwinds.

But is it really such a *fait accompli*?

We can also observe a consistent four decade-long trend of falling inflation. Numerous explanations have been provided for this, including persistent deflationary pressure from globalisation, financialisation, ageing demographics and platform power. All are observable, logical and seem unlikely to simply disappear overnight.

Further, while CPI inflation in the US has hit a four-decade high of nearly 7%, the official data is more subdued in Australia (3% headline, 2% underlying inflation). The gap is largely attributable to lower energy prices and less wage pressure here. In a recent speech at the CPA Australia Riverina Forum, Governor Lowe stated that the RBA will not increase the cash rate until inflation is sustainably in the 2-3% target range. He added that we are "still a fair way from that point" and that the RBA's base case is that "the condition for an increase in the cash rate will not be met next year".

Lowe has previously indicated that the first cash rate increase will not be before 2024. While we have no insight into what the rate will be by then, we do question the merits of making such long-dated predictions. Will higher inflation force his hand earlier? If so, will that undermine confidence in future central bank guidance?



Source: ABS

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Given the enormous debt accumulation in recent decades, it is also right to question the system's ability to handle even moderately higher interest rates without significant disruption. One could also plausibly argue that central banks might allow inflation to run for a period of time without increasing rates in order to inflate away the debt; albeit, such a path could further exacerbate socially-disruptive inequalities (given that asset owners would disproportionately benefit).

Given this divergent range of plausible outcomes, it seems more prudent to heed Howard Marks' advice ("agnosticism is probably wiser than self-delusion") rather than stake our fate on a bold proclamation on what the future holds. Our philosophy is to pursue a delicate balance between presence and detachment, concentrating our focus on unbiased observations of emerging patterns, seeking risk-adjusted value latency and building a robust portfolio that can withstand most scenarios.

### The Portfolio

The banks have been weak in the second half of the year, underperforming by 5%. This number is flattered by NAB, which has beaten the market by 7%. WBC has been an extreme underperformer, shedding 17% in the quarter alone. To put this into context, the ~\$17bn of market capitalisation that has evaporated in three short months would almost qualify as an ASX top 30 company in its own right.

We retain an underweight sector positioning. Simply put, risk-adjusted value latency is unappealing. Operating trends are weak, with margins under pressure (competition, low rates, higher liquids), non-interest income struggling (non-core exits, competition, social license considerations) and the ambitious cost-outs that banks have promised for years remain just that: ambitions. A lack of observable value latencies remains a chronic issue for the sector. After a brief valuation-driven rally, we're back to where we were pre-COVID: no growth, no latency and lacking in imagination.

**NAB** is now our only bank sector overweight. With business credit growth recovering and SME margins being more defensible (less price-sensitive, higher barriers to switching), it looks uniquely well-positioned in this part of the cycle. Chairman, Phil Chronican, and CEO, Ross McEwan, are highly experienced bankers with a strong pedigree. They have a clear mandate for change and have introduced much greater focus and accountability into the business. The green shoots are emerging: NAB delivered the best result this earnings season.

As a consequence of participating in **CBA's** off-market buyback, our long-standing overweight position turned into a mild underweight. The timing was fortuitous given that this occurred prior to the weak 1Q22 margin commentary that took a large toll on the stock. From a longer-term perspective, we remain attracted to CBA's best-in-class retail franchise and the investments being made to consolidate those competitive advantages.

Our sector underweight is primarily driven by not owning ANZ and WBC. While **ANZ** is leveraged to rising global interest rates and is a powerhouse in institutional banking, this remains the lowest-returning part of the banking value chain. **WBC** is suffering from a litany of operational, strategic and risk management mishaps that have caused significant damage to the franchise. We also question both the wisdom and practicality of such an aggressive cost out program.

The key risk to our underweight positioning is the potential for higher interest rates, which would support both sentiment and earnings. A less appreciated scenario is if inflation is allowed to run well above interest rates; a characteristic of financial repression. This is not a good outcome for retail banks. As net monetary creditors, rising prices decrease the value of their nominal assets (e.g. loans denominated in fixed dollar amounts) more than the value of their nominal liabilities (e.g. deposits, wholesale funding). As such, bank equity suffers a loss. Again, neither scenario is hard to imagine and both sides can mount persuasive arguments. Indeed, one could put forward the



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case that we are already in the early innings of the latter. From a longer-term perspective, however, both still lie in the realm of “prediction”. Hence, we would prefer to observe for a bit longer.

**Macquarie (MQG)** remains one of our largest overweights and longest-standing holdings. Our investment proposition is centred on backing expert value creators with an outstanding track-record, leadership in attractive structural growth segments and a deep proprietorial culture. The quarter’s outperformance was driven by yet another record half-yearly profit. While this partly reflects very favourable operating conditions (e.g. buoyant activity, high volatility), it is also an outcome of being exposed to attractive industries with structural growth tailwinds. Examples include infrastructure, renewables, energy trading and digital banking. This is more than just good luck. For decades, Macquarie has proven highly adept at identifying attractive opportunities early and then strategically positioning themselves to benefit from them. Macquarie’s high-performance, proprietorial culture is a key enabler. It encourages both entrepreneurialism and risk management. There are very few companies with Macquarie’s combination of opportunity, capability and intentionality.

While **Aristocrat (ALL)** has been the single biggest contributor to our fund’s outperformance in the past year, this was a trickier quarter with the stock underperforming by 5%. Frustratingly, an outstanding 2H21 result was overshadowed by concerns that their bid for Playtech might be trumped by a competing offer. The fear is that this escalates into a drawn-out and value-destructive bidding war. While we consider the prospect of an alternative bid succeeding to be low, this will not necessarily stop them from trying. Attention has centred on potential bidders that have either materially higher completion risk (given lack of licenses and regulatory approvals) or much lower scope for synergies. Under UK takeover law, any competing bid must be submitted by 26 January 2022. Regardless of the outcome, what we can clearly observe is evidence of favourable operating trends, an outstanding (and improving) franchise and top-notch management team.

Over the past 20 years, **CSL (CSL)** has rarely embarked on material acquisitions (i.e. Swiss Red Cross ZLB, Aventis Behring, NABI, Novartis flu vaccine business). All of these purchases took time to mature, but were ultimately successful and significantly contributed to making CSL the global leader it is today. In December, the company announced a bid for Vifor Pharma for US\$12.3bn, together with an equity raising to part fund the acquisition. Unsurprisingly, the deal (if completed) will be double-digit EPS accretive (low interest rates, issue of higher-rated equity, cost synergies we believe conservatively stated at \$75mn). Whether it is value accretive remains to be seen over the next three to five years. Management’s track record is excellent so we believe, until evidence emerges to the contrary, that they deserve the benefit of the doubt in this endeavour.

All the above-mentioned acquired businesses were pretty much in CSL’s then core areas of expertise. The bid for Vifor is slightly different in this regard, being more in the nature of an adjacency. Vifor operates in the renal area (kidney disease, dialysis) – the market for which is expected to grow from US\$13bn in 2020 to US\$25bn in 2026 (low double-digit compound annual growth) – and iron therapy. In addition, Vifor has a strong R&D pipeline with four drugs in late-stage development. CSL believes it can bring its own R&D and commercialisation process, expertise and global reach to both Vifor’s existing product line up as well as its development portfolio, thereby enhancing and accelerating its growth prospects. One of the other main attractions of the deal appears to be the Vifor joint venture with Fresenius, which offers CSL access to 40,000 dialysis patients via the Fresenius network of centres as well as access to valuable cohort data and analytics. In summary, an opportunity for CSL to extend its global reach and maintain growth rates to which its shareholders have become accustomed.

We initiated a position in **Qantas (QAN)** in the last quarter. The proposition was based on investing into a well-managed and iconic brand that will benefit from both late-cycle reversion and an underappreciated self-help story. While the stock initially performed well, it has pulled back more recently on concerns that the Omicron strain will stifle the recovery in travel. Indeed, this was subsequently confirmed in a trading update on 16 December. While this hiccup is frustrating, it does not alter our investment proposition. Experience has shown that demand rebounds quickly once restrictions are eased, which will support operating trends. While COVID has taken a significant toll on airlines, we believed it has improved the strategic positioning of the industry’s strongest players. The group is run by

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a highly experienced and focussed management team that has responded dynamically to COVID. This includes pursuing an ambitious Recovery Plan, which includes a \$1bn structural cost-out that the market is seemingly not giving it full credit for.

During the quarter we added to our position in **EBOS (EBO)**. EBO's core business exhibits attractive stalwart-like characteristics. In addition, we observe a highly capable management team who continues to pursue opportunities that sit logically within the group's portfolio. EBO is Australia and NZ's leading pharmaceutical distributor, with a retail presence via a 100% ownership stake in Terry White Chemmart. In the Australian market, there are three core distributors of pharmaceuticals to hospitals and pharmacy groups: EBO, Sigma and API (currently under offers from WES and WOW). Industry players are governed by the Pharmaceutical Benefits Scheme (PBS), whereby the government dictates pricing within the industry. While this restricts revenue and margin upside, it also creates significant barriers to entry for new entrants given the strict regulatory requirements around the delivery of prescription drugs. COVID has emphasised the need for a well-functioning domestic distribution network. EBO has emerged as the leading player after ~10 years of continued capital investment and the establishment of highly automated distributions centres across Australia. These investments have allowed EBO to win customers on price and timeliness, as well as delivering operational improvements, industry-leading margins and returns (five-year average ROCE 17%). Endorsement of the investments made came when in 2018 EBO was awarded the Chemist Warehouse pharmaceutical supply contract that was previously held by Sigma (contract value ~\$1bn per annum). Over time, management have diversified the business beyond pharmaceutical distribution, establishing leading positions in animal care (pet food and veterinary wholesale), contract logistics and medical consumables.

In December EBO announced the acquisition of medical devices distributor, LifeHealthcare, for ~\$1.2bn via a combination of debt and equity. EBO have already made some smaller acquisitions in medical devices and we have observed the team build up a deep understanding of the space over the last few years. EBO already supplies hospital groups with pharmaceuticals and medical consumables and we see the supply of medical devices into the channel as a logical next step. The acquisition also gives the group a foothold into the South East Asian market where we see significant opportunity for the group across both devices and consumables over the long term. We participated in the raise viewing this as a great opportunity to back a highly disciplined and authentic management team with a strong track record of delivery to pursue opportunities in a new category.

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