

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.

MARCH 2022

“We work in the dark - we do what we can - we give what we have. Our doubt is our passion and our passion is our task. The rest is the madness of art.” **Henry James**

“Medicine is a science of uncertainty and an art of probability.” **William Osler**

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	2.91%	2.24%	0.67%
ROLLING 1 YEAR	18.61%	14.97%	3.64%
ROLLING 3 YEAR	13.89%	10.59%	3.30%
ROLLING 5 YEAR	11.83%	9.22%	2.61%
ROLLING 7 YEAR	9.79%	7.81%	1.98%
ROLLING 10 YEAR	13.61%	10.16%	3.45%
SINCE INCEPTION*	12.52%	8.95%	3.57%
SINCE INCEPTION^	926.87%	443.22%	483.65%

*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

**CI Australian Equities Fund - Net of Fees
\$1000 Invested Since Inception**



Source: NAB Asset Servicing

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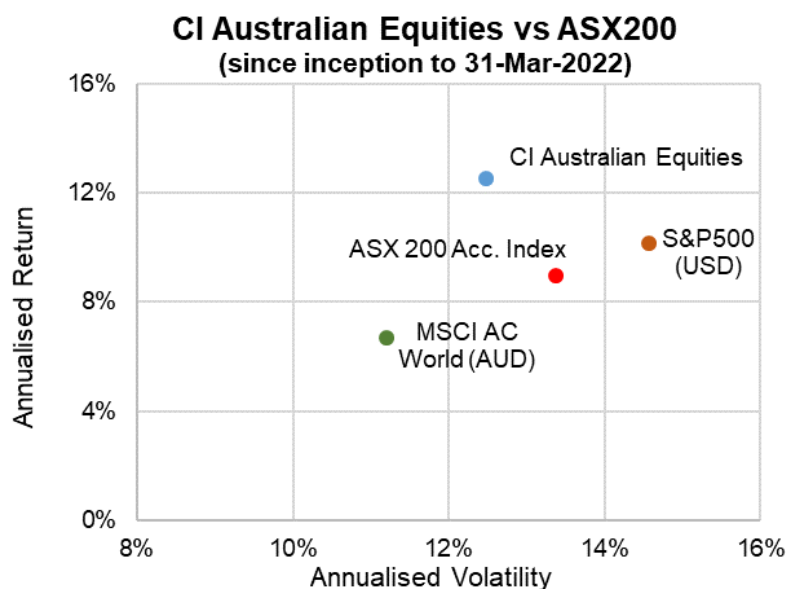
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Market and Portfolio Performance

The ASX200 Accumulation Index rose 2.2% over the quarter, including a remarkable rise of 6.9% during the month of March – remarkable in light of the many seemingly negative factors at play including strong inflation, rising interest rates, high debt levels, ongoing trade wars, the break out of war in Eastern Europe, supply chain interruptions - and the list goes on. Stronger contributors to portfolio performance over the quarter included Computershare (on the view that short term rates are about to rise and this will have a positive medium term effect on earnings), Santos (oil price strength) and Orica (public confirmation by the company that the stabilisation of earnings is on track). The stocks whose performance over the period disappointed included Reece (still pulling back from an overbought position), Aristocrat (perception of slowing growth rate in its digital business, breakdown of the Playtech deal and worries re Ukrainian exposure) and Wesfarmers (a sense that its largest business Bunnings is at a short term peak in earnings and a disappointing first half result for Kmart/Target).

The quarter was also notable for the rise in bond yields. The USA ten-year bond yield rose from 1.5% to 2.33% over the period while the Australian version rose from 1.67% to 2.84%. Overall it was one of the worst quarters for bond investors for some years with the global bond index returning -7.6%. It seems clear we are on the cusp of central banks in both Australia and the USA raising short rates – at a time of rising inflation driven by steep rises in commodity prices of all types (agricultural, chemical and metal), ongoing wages pressure and labour availability issues, highly indebted home borrowers, indebted governments and global supply chain problems. There is a not insignificant risk that central banks misjudge the situation and push economies worldwide into recession. Indeed, the recent (albeit short lived) inversion of the yield curve and falling consumer confidence in the USA would support this assertion.

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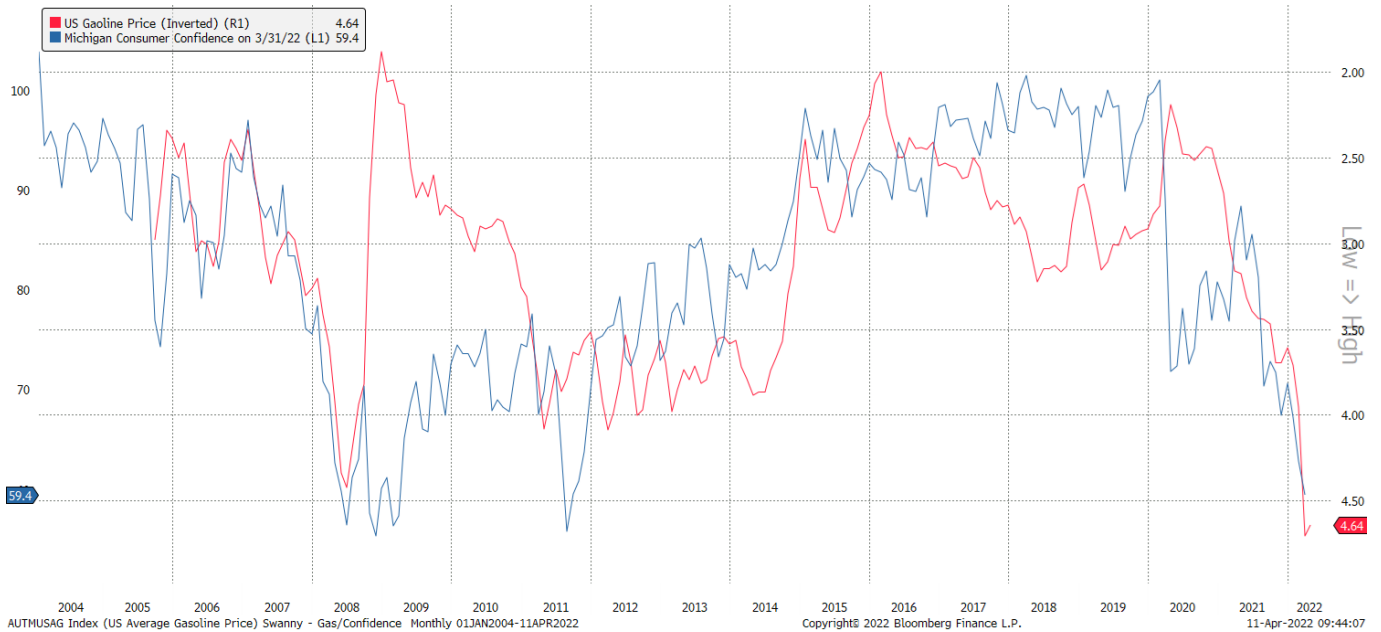
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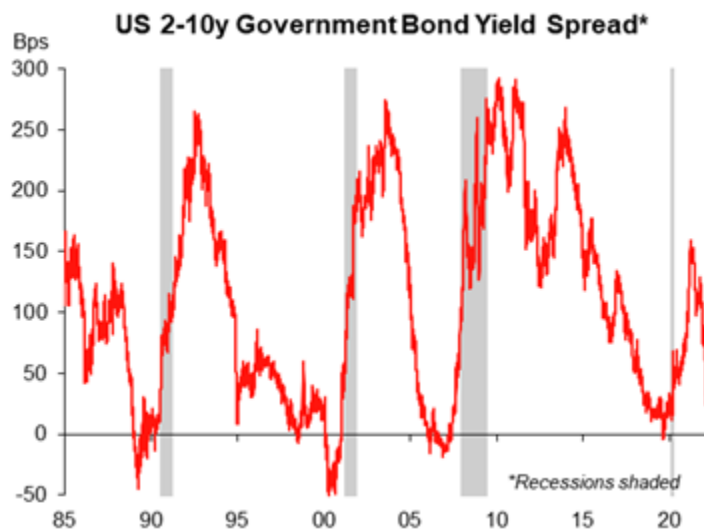
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Source: Bloomberg



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The quotes above remind us somewhat of what we do as investors – we do what we do in the face of uncertainty for the vast majority of time. Today the level of uncertainty is as high as we can remember it being for quite some time. Hence our desire to observe history, and current patterns, trends and behaviours, and to think about value latencies in an effort to ground our decisions in as much common sense as possible. Hence too our search for companies with the opportunity to add value, combined with management teams with both the capability and the intentionality to do just this. Only in this way can we try to give our decisions the maximum opportunity to succeed while painting on a canvas of uncertainty. We have found on numerous occasions that it is in times like the current that good management teams can make a real difference.

In addition, the ability to look at the market through the lens of our subsets of value (SoV) allows us to invest in whichever parts of the market appear the most prospective at any given point in time. If we look back to when the pandemic hit in early 2020, we saw significant opportunity for risk adjusted value latency develop in the Cyclical SoV. These industries came under significant operational pressure as the disruptive impacts of the pandemic became evident. We took this opportunity to increase the portfolio's exposure to the Cyclical SoV through stocks such as BlueScope Steel (BSL), Oz Minerals (OZL) and Santos (STO). More recently we are seeing increasing opportunity in the Growth SoV. This is due to a combination of factors, including both pandemic related disruptions effecting the operational performance of some Growth companies and the rising interest rate environment resulting in the higher valuation multiples this SoV typically attracts coming under pressure. As such, the portfolio's exposure to the Growth SoV has risen from being circa 6% underweight two years ago, to being slightly under benchmark weight now. We anticipate more opportunities in this SoV to develop over the coming year.

The Portfolio

Towards the end of the quarter we visited both the USA and the UK. General observations on the USA include the following:

- For the most part, things felt pretty normal. Airports were busy, planes were full, there was plenty of traffic on the roads, cafes and restaurants were full (a sad exception to this was San Francisco where the city was lifeless with homeless dominating the streets – and this effect was a talking point wherever we went). The only area where things were noticeably not back to normal was in office workers – without exception the companies visited indicated that April was now the month to try to get people back in in a more meaningful way. However even this is likely to involve a mandate that all staff are in the office for only 3 days a week (Tue, Wed, Thur);
- People were very receptive of meeting with us, in multiple cases visibly excited to be meeting with people in person again either in their offices or at a local café / restaurant where the administrative burden to have guests in the office still exists. While effective, virtual meetings have lost their allure;
- The detached housing market remains, for the time being, strong and this is flowing through into the apartment market. We had two separate people (one talking about detached, the other apartments) describe activity levels as the highest they have seen in their careers. Apartment rents (even in the San Fran Bay area pre any real return to the office) are broadly back to pre COVID levels where in other parts of the country they are 10-20% above (i.e Brooklyn in NY). The recent rise in mortgage rates to over 4.5% poses a risk to this strength;
- Inflation is real and being seen by working class Americans in their everyday essentials – petrol, gas, rent, milk, eggs, the price of household repairs etc. The sense is inflation will get worse (more widespread) before it improves;

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- There has been a noticeable shift in power from the employer to the employee. Wage pressure is persistent and employers spoke to the importance of attracting quality talent as one of their key challenges. The competition for talent is high and employers are finding more extreme ways to attract the best people. This was most obvious on our visit to Silicon Valley. The growth of the world's largest tech companies is driving a relentless need for talent (Google added close to 8,000 staff in Silicon Valley just last year). To attract and retain the best talent Google is investing heavily in the employee experience in a number of ways (office space, employee accommodation, amenities).

As part of our US tour we stopped in Dallas, Texas to visit portfolio company **Reece (REH)**. Our long term investment thesis centres in part on REH's US growth strategy which was accelerated by the \$1.9 bn acquisition of US-based Morsco in 2018 (170 stores across the "Sun Belt" region). Our visit confirmed the progress made towards developing a store model that draws on learnings from the highly successful ANZ model, while allowing for the nuances of the US customer base. The trip highlighted the patience the team have demonstrated in scoping out the local market and getting the model right before investment accelerates. Probability of success is further strengthened by the presence of a highly capable and intentional US CEO (a REH long term) who embodies many of the qualities we look for in a management team (focus, passion, humility).

We continued to test our investment proposition in **Lendlease (LLC)** with company and other related meetings during our trips to both the US and Europe during the quarter. The core of our investment proposition revolves around a cyclical reversion in the development business which has seen completions fall from a peak of \$5.6bn pre-pandemic (FY19) to a trough of \$0.2bn in 1HFY22. Given that, it was pleasing to see the strength of residential apartment markets, particularly on the rental side with multiple local real estate agents describing activity levels as the best they have seen. Also evident was both the demand for and rarity of high quality, modern and sustainable office space post pandemic as distinct from older, higher emitting and less technology enabled product that today represents the majority of office stock in markets such as London. Being on the ground, observing these trends and the general "buzz" that is back in global gateway cities such as New York, London and Milan, increases our confidence that LLC's operating trends are now positive and supportive of moving the development pipeline into delivery. In addition, ongoing discussions with LLC as well as industry feedback continues to build confidence in the depth of the placemaking expertise within the business. Combined, this reaffirms our conviction that LLC has the product, the market conditions and the capability to deliver ~\$8bn in development completions from FY24 and represents an investment with compelling risk adjusted value latency.

Post completion of the Oil Search merger, we continue to see multiple sources of value latency for **Santos (STO)** across both the traditional upstream oil and gas activities as well as the emerging mid-stream and clean fuels business. In the upstream business, the opportunity set includes completing the integration of the OSH business unlocking pre-tax synergies of US\$90-115m p.a, rationalisation of the portfolio post-merger providing alignment between JV partners in PNG at the same time as significantly de-leveraging the balance sheet and delivering on the pipeline of growth projects we have discussed in prior quarterlies. In the midstream and clean fuels business there is an opportunity over the long term to leverage infrastructure and expertise into providing customers with clean fuels such as hydrogen and ammonia but the timeline of this will ultimately be market driven. Over the short to medium term we see significant opportunity in Carbon Capture and Storage in the Cooper Basin (a project that is in construction) and offshore Northern Territory (in the engineering phase) to not only materially reduce STO's scope 1 and 2 carbon emissions but to be revenue generating businesses, material sources of value latency in their own right.

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After a more positive performance in 2021, **Aristocrat (ALL)** share price has had a difficult start to this year. This reflects a combination of factors including contagion from compressing peer multiples, breakdown of the Playtech deal and exposure to Ukraine. Albeit watchful of the share price gyrations, we remain of the view that the investment proposition is underpinned by the company's best-in-class competitive position in land-based gaming, its large opportunity set in digital gaming and a focussed, high-calibre management team. We see numerous value latencies which include:

- gaining further market share in land-based adjacencies,
- monetising RAID,
- growing share in digital, increasing adoption of Plarium Play as an alternative payment method to the major platforms,
- the opportunity in real money gaming and
- the latency inherent in a net cash balance sheet.

While the disruption to its Plarium gaming studio in Ukraine is having a short-term impact on revenues, we note that the larger land-based gaming and social casino businesses continue to perform very strongly. This includes continued market share gains, which speak to the capability and commitment to creating the industry's best customer value proposition.

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