COOPER INVESTORS ENDOWMENT FUND
QUARTERLY COMMENTARY REPORT

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

DECEMBER 2020

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	9.98%	13.80%	-3.82%
ROLLING 1 YEAR	1.85%	2.42%	-0.57%
ROLLING 2 YEAR	12.41%	13.28%	-0.87%
ROLLING 3 YEAR	8.97%	8.15%	0.82%
ROLLING 5 YEAR	9.76%	10.22%	-0.46%
SINCE INCEPTION*	10.18%	8.82%	1.36%
SINCE INCEPTION^	93.91%	78.19%	15.72%

*Annualised
^Cumulative (3 March 2014)
**Before fees and expenses and adjusted for franking credits
#S&P ASX200 Accumulation Index – adjusted for franking credits
Past performance is not necessarily a reliable indicator of future performance

The purpose of the Cooper Investors Endowment Fund (the “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 six 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 S&P/ASX 200 Accumulation Index (adjusted for franking credits) returned 13.8% over the December quarter and for the 12 month period to December 2020 returned 2.4%. The model Endowment Fund portfolio returned 10.0% and 1.9% for the quarter and year respectively.

Global markets reached a turning point in November due to promising developments in a number of COVID-19 vaccine trials as well as the benign outcome of the U.S. presidential election. Equities markets also continued to benefit from the extraordinary monetary and fiscal stimulus being poured into the system by governments trying to combat the economic damage caused by the pandemic.

The December quarter delivered a very strong 13.7% return for the S&P/ASX 200 Accumulation Index, including 10% in November which was the best month since June 2000. This helped the Australian benchmark to eke out a positive 1.4% return for 2020 calendar year, quite a remarkable result given the virus-induced bear market in March.

Other markets were even more buoyant, recovering from their March nadir to reach new highs by year’s end. The U.S. market (S&P500) posted an impressive gain of 18.4% over the year, driven by a surge in the technology sector. The New Zealand market (S&P/NZ50 Gross) rose 13.9%, recording its ninth consecutive year of positive returns. The New Zealand benchmark has now more than doubled since 2015, and more than quadrupled since 2011.

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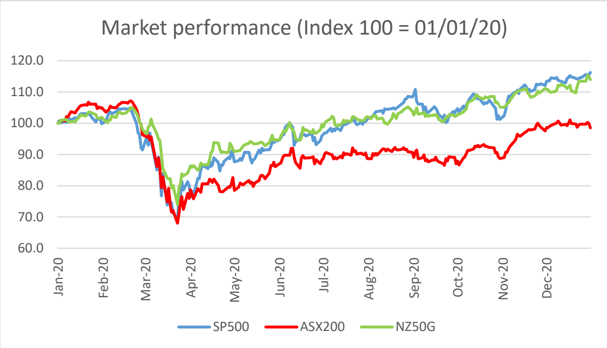


Source: IRESS

Over the last year the best performing sector was Information Technology which rose 57.8% year on year, including a staggering 24.8% over the last quarter. This was more than triple the next best sector, Materials, which added 18.2% for the year after surging 9.5% in December.

The Energy sector was the laggard for the year, falling 27.6%, reflecting the heavy impact of the pandemic on oil prices. However, the December quarter saw a reversal of fortune for beaten down sectors such as Banks and Energy, rising 26.8% and 26.3% respectively. This reflected the rotation into value and cyclical stocks as confidence in the economic recovery gained pace.

Stocks that performed well over the quarter **Mainfreight (MFT)** (solid 1H21 result), **Lifestyle Communities (LIC)** (improving outlook in Victoria, acquired additional sites), and **Seek (SEK)** (recovery in employment demand post the lock-downs in Victoria).

The poor performers for the December quarter included **Chorus (CNU)**, **Franco Nevada (FNV)** (weaker gold price), and **ASX (ASX)** (technology related issues saw the equities market closed for a period of time).

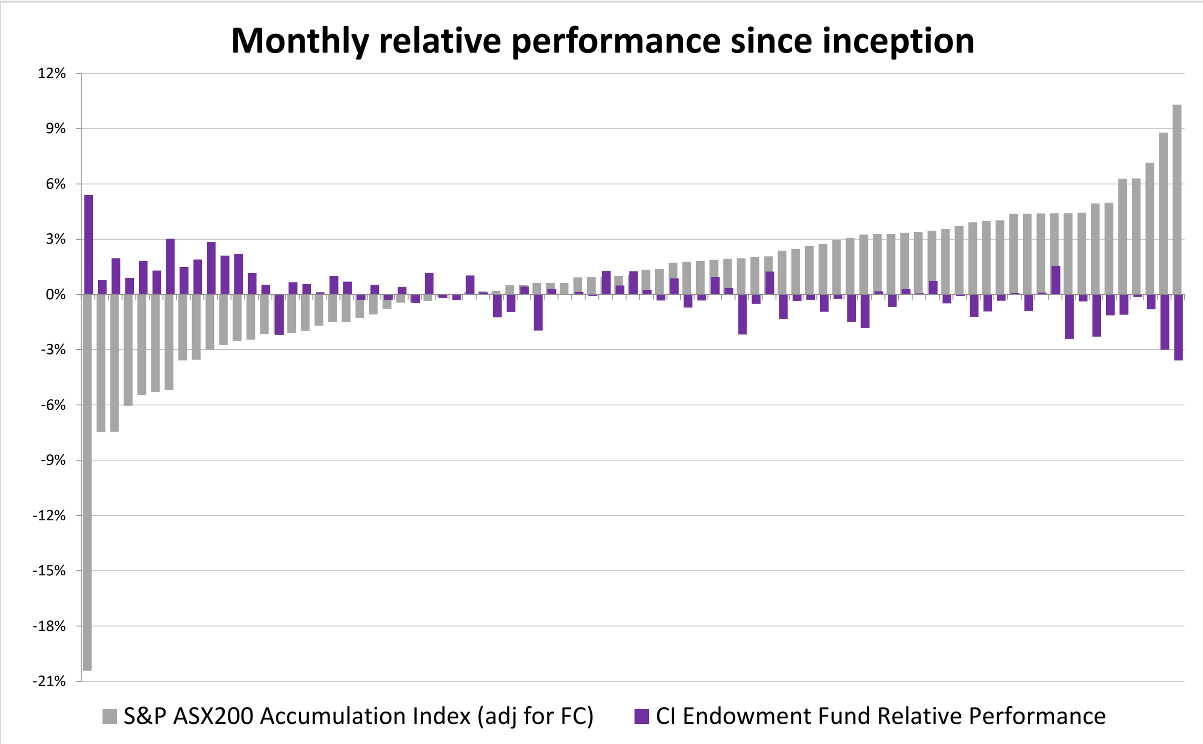
The international stocks in the portfolio (8 stocks, 15% of the portfolio) had mixed performance over the quarter, including a 7.4% headwind from an appreciating A$/US$. Nonetheless, these stocks have provided pleasing returns over the last year, which we think is a more appropriate basis for assessing performance rather than just the last month or quarter.

The portfolio struggled to keep up with the rapidly rising market in the quarter, particularly given our underweight positions in the Energy, Banks and Materials sectors. While the portfolio is underweight Cyclicals it still had a number of stocks that increased substantially over the quarter such as Mainfreight +52%, Seek +34%, Lifestyle Communities +30%, Alumina +33% and Synopsys +21%.

Many of the portfolio stocks that lagged over the last quarter are also the ones that provided strong downside protection in early 2020 (e.g. Chorus, Waypoint REIT, Unicharm). While we want to keep up as much as possible in strongly rising markets, the underperformance in a quarter where there is such a strong rotation to cyclical and value stocks is not to be unexpected.

Given the significant upheavals in 2020 we were satisfied that the portfolio met its key objective of outperforming in down markets as well as delivering lower volatility than the market.

The chart below shows the Fund’s monthly relative returns. The grey bars show each month’s market return sorted from the worst to best month and the purple 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 30 times and in these months the portfolio has performed better than the market 24 times (80%). The portfolio also outperformed on 94% of 'meaningful' down days where the market fell 50bps or more.

When assessed using monthly data the portfolio has captured 69% of the market's downside and 85% of the market's upside. The volatility of the portfolio over the quarter was 73% of the market's volatility.

The Portfolio

During the quarter we added EBOS Group to the portfolio and increased our position in Franco Nevada following the sell-off in the gold sector. We also exited our small remaining position in Aurizon.

EBOS Group (EBO) is Australia and NZ's largest wholesaler and distributor of health and animal care products, both of which are proven defensive end markets, as well as a retail presence via the Terry White Chemist brand.

EBO has strong market positions with most of its businesses being #1 or #2 in their respective markets, in particular in the core pharmacy / hospital wholesale businesses where EBO has built a significant scale advantage over its peers.

Pharmacy distribution is a regulated industry which effectively caps revenue and margin potential, but also limits the number of competitors given the regulatory requirements around the distribution of prescription drugs create significant barriers to entry.

EBO has a track record of executing on strategy which has driven growth in underlying EPS, free cash flow generation, improving returns (average 15% return on capital employed over the last 5 years, and 17.1% in FY20) and the efficient integration of acquisitions.

EBO is relatively clean from an earnings quality perspective and free cash flow is expected to remain strong given moderating net working capital requirements and the capex cycle has peaked after having recently completed 3 new distribution facilities.

The balance sheet has been improving and FY20 saw $40m debt reduction despite paying $112m in dividends. Gearing is now 1.1x ND/EBITDA (target 1.7x-2.3x) and should continue to reduce absent acquisitions or other significant growth capex. This provides the business with optionality.

EBO has averaged more than one acquisition a year since 2000, and has completed ~NZ$320m in acquisitions over the last four years. While we normally don't want companies that do too much M&A, EBO is more like Danaher (also owned by the Fund) where we can observe a proven and consistent approach to acquisitions that has added value to the business.

We take comfort that the track record on acquisitions is very good given EBO has maintained a ROCE above their target of 15%, and management has a reputation for disciplined capital management. M&A will remain part of the group's expansion strategy going forward.

The management team is well regarded and has deep industry expertise, with the CEO having been with the business for 10 years. Responsible Investing credentials are improving and there have not been any significant controversies.

The Zeullig Group (via Symbos Holdings) owns 18.7% of EBO and although they are not involved operationally they do hold a Board seat. The Zeullig family sold Symbion to EBO in FY13 for NZ$865m so there remains a connection of sorts to the underlying business.

At the time of purchase EBO had a 3.5% dividend yield (or 4.5% grossed-up for franking credits) which is attractive in a low yield environment, particularly given expectations of mid-to-high single digits DPS growth over the forecast period. EBO's dividend history is very good having a compound annual growth rate of +9.4% since FY11.

From a portfolio construction perspective EBO fits into the Fund nicely as a growing Stalwart, and correlation data shows it has one of the lowest pairs correlation in the portfolio. Therefore in our view EBO adds to both the quality and diversification of the portfolio.

The portfolio owns 37 securities including eight global stocks (15%) and three New Zealand stocks (7%). The cash weighting is around 4%.

Stock News

During the quarter, **Ampol (ALD)** hosted their 2020 investor day at which it was pleasing to see the intentionality of management around cost efficiency, capital effectiveness and extracting value from the underutilised asset base reinforced.

ALD announced a $300m off-market buy-back expected to complete in 1Q21 and subsequently issued a $500m hybrid positioning the balance sheet for ongoing capital management and the release of the significant franking credit balance to shareholders (worth around $3 per share).

Together with a recovery in fuel volumes as domestic and international travel restrictions ease, this intentionality to drive value both from operational (i.e. latent land at Kurnell) and financial assets (i.e. franking credits) forms the basis of our investment proposition..

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In December **The a2 Milk Company (A2M)** delivered a ~30% downgrade to FY21 EBITDA guidance, following on from a 20% downgrade in September. The quantum and timing were both surprising given FY21 guidance was confirmed a little over one month prior at their AGM.

A2M think these earnings downgrades will be temporary as COVID flow-on impacts normalise and they implement initiatives to rectify ongoing distribution channel issues. Management also contend brand metrics remain very healthy across all geographies. Post this disappointing announcement A2M will be in the sin-bin until some credibility is restored, although we don't think it has suddenly become a bad business and it still has a good brand and very strong balance sheet.

A2M also announced just prior to Christmas they had entered into a binding agreement for the acquisition of 75% of Mataura Valley Milk, a dairy nutrition business located in Southland, New Zealand. A 25% interest will remain held by China Animal Husbandry Group, a subsidiary of China State Farm, which is A2M's logistics and distribution partner in China.

During the quarter **Costco (COST)** paid a US$10/share special dividend (US$377 share price as at 31 December 2020). As well as regular quarterly dividends, Costco pays a special dividend every three years or so. Management's conservatism means they will be funding the special dividend from existing cash balances. 2020 (August year-end) was another strong year for Costco, with some pandemic related tailwinds the business grew comparable stores sales 8%, which was the fastest pace in almost 10 years.

In November **Insurance Australia Group (IAG)** announced it has taken a $1.24bn provision after insurers lost a test case on Quarantine Act wording issues relating to business interruption insurance.

IAG also announced another $70-90mn in downgrades from additional customer provisions and reserve strengthening (higher long-tail large claim incidence, adverse development trends and revised economic considerations).

Given the above IAG raised $750m ($650m placement, $100m SPP) at $5.05 (7.5% discount) to support their regulatory capital position. While it appears IAG has taken a conservative approach to provisioning it is hard to be sure.

The Fund did not participate in the raising as the dilution was minimal and the offer price was not compelling.

Mainfreight (MFT) reported a strong 1H21 result during the quarter, despite the challenges of Covid-19 which included a significant lockdown across New Zealand. During the half sales grew 7% (vs 1H20), EBITDA 16%, EBIT 20%, NPAT and EPS 23% and dividends per share 36%.

Mainfreight has an outstanding history of compounding shareholder returns at over 20% p.a. underpinned by reliably growing earnings. Although its home country of New Zealand has been the biggest contributor to earnings, more recently growth in Australia has accelerated (14% sales growth in the half, EBITDA +39%) driven by market share gains. In addition, MFT's Australian and New Zealand customers proved highly resilient and in many cases were positively impacted by Covid-19 (food and beverage, DIY).

Mainfreight has a very strong balance sheet (net debt/EBITDA 0.3x), which was further strengthened in the period by a strong focus on cash collection and reduced capex spend which means it is well placed to ramp-up investment in its network assets, particularly in Australia, US and Europe, and build out its cross-docking capability at some of its existing sites.

Although the stock has performed strongly we continue to see a long-term opportunity across its various geographical markets with a highly focused management team and strong culture which supports Mainfreight's quality service offering and long-term positive operating trends.

Telstra (TLS) also held an investor day in November. The focus of the investor day was on InfraCo where management provided more information on a new simplified corporate structure, greater financial transparency and a timeline for monetisation of its mobile towers.

The other key takeaways from the investor day included the expectation of further productivity benefits from FY22 onwards, i.e. above its current $2.5bn target by FY22, a mid-teen margin target from reselling NBN by FY23 and commentary that was supportive of growing profitability in the mobile business. We think the focus on further productivity is important given the enterprise market has become more competitive in recent periods and NBN access prices in the retail market are likely to remain elevated.

The new corporate structure is sound and we are of the view that the board and management should move quickly on its implementation, along with the monetisation of its mobile tower assets. There is significant value latency to be realised from its infrastructure assets and the sale of part of the mobile tower assets is a good starting point.

The stock has substantially underperformed both on an absolute and relative basis over the past 5 years, we expect the value creation opportunity within its infrastructure assets will play a key part in improving performance.

In mid-December, **Transurban (TCL)** agreed to sell a 50% interest in its 95 and 495 Express Lanes in the Greater Washington Area for gross proceeds of US$2.1bn, or US$1.9bn post-tax. In addition, there is a potential earn-out between FY24-26 of up to US$70m. Financial close is expected by June 2021, subject to regulatory consents.

The buyers of the 50% stake are AustralianSuper (25%), CPPIB (15%), and UniSuper (10%),which are part-owners in other TCL assets. Importantly, this partnering strategy is designed to allow TCL to pursue potential growth opportunities both in the USA and domestically (e.g. the NSW Govt's sell-down of its remaining 49% stake in WestConnex).

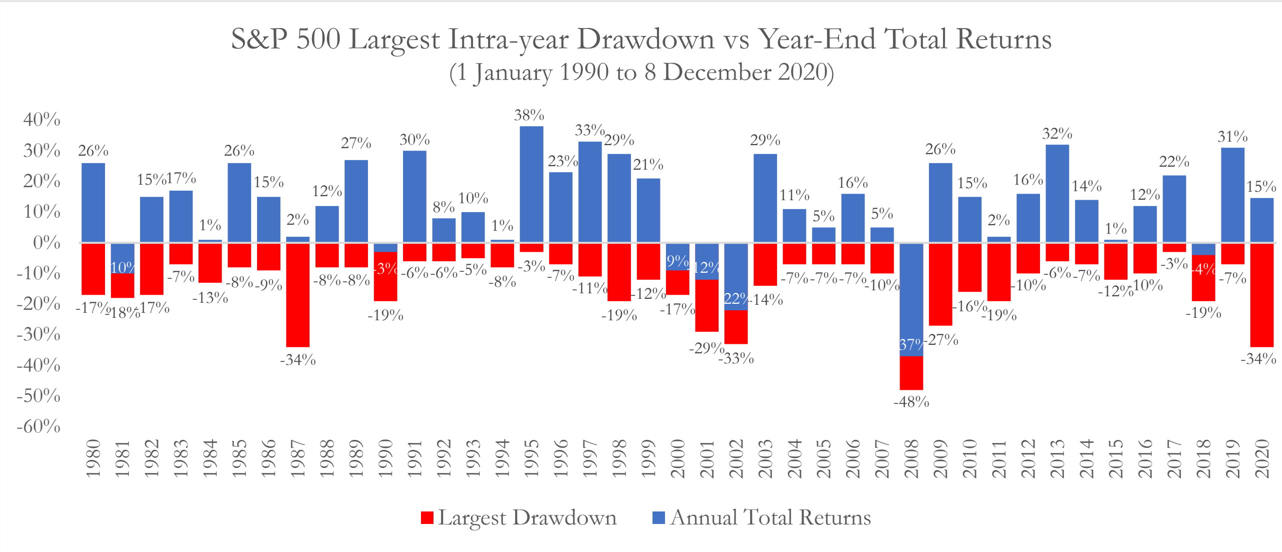
The Case for Lower-than-Market Volatility

One of the Funds core objectives is to exhibit lower volatility than the market. Put simply, this means that our portfolio should be less volatile than the benchmark as measured by the standard deviation of returns. We would also expect that when the market falls the portfolio should fall less than the market.

Volatility is a normal part of investing but nonetheless periods of severe volatility can be highly disconcerting for investors. After all, when equities markets fall, as they often do, the timing of this fall can have a major impact on both financial and psychological wellbeing.

In recent year's periods of heightened daily volatility have become increasingly common in an environment marked by rapid market swings. Volatility is also becoming more asymmetric whereby markets go down much faster than they tend to recover.

The chart below shows the regularity of market drawdowns. The red bars represent the largest declines from a peak (high) to a trough (low) that occurred each year. The blue bars represent the calendar year total returns for the S&P 500. Despite average intra-year declines of 14%, the S&P 500 Index had positive year-end total returns in 34 out of the last 41 years (or 83% of the time).



Source: Morningstar, FactSet, J.P. Morgan Asset Management, Cooper Investors. Returns are based on price index only and do not include dividends. Data are as of 20 November 2020. Drawdown refers to refers to the largest market drops from a peak to trough during the year.

So what we don't want is investors panicking amidst volatility, tempting them to pull out of the stock market after a large drawdown to avoid further losses. No one wants to be forced to sell when markets are low. History says this only serves to lock in losses and investors may also miss out on participating in the subsequent market recovery.

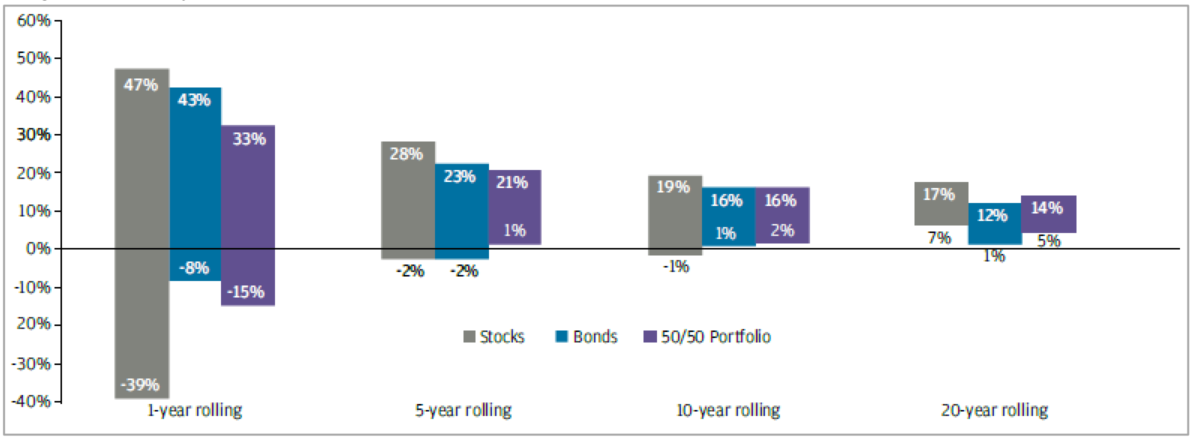
Research shows that the volatile and asymmetric returns experienced on a short-term basis tend to be smoothed out over a longer time horizon, which helps to explain why over-reacting to short-term volatility is likely to work against investors.

Having a long-term perspective also helps to manage an investor's sensitivity to market volatility given equities markets have typically rewarded those who have stayed invested over the long term. Expanding the investment holding period has historically improved the risk/return profile of a portfolio.

As illustrated in the chart below, the S&P 500 has experienced calendar year gains as high as 47% (in 1954) and losses as low as -39% (in 2008). Clearly an undiversified equities portfolio is highly risky for investors with a short term horizon.

The risk/return profile for stocks improves markedly as the holding period expands. For example, the worst 5 year rolling period for equities only experienced a 2%pa decline and no 20-year rolling period in the post-war era delivered a negative return. This reinforces that having a longer term time horizon helps to minimise portfolio risk.

Range of calendar-year annual returns for the S&P 500 – 1950 to 2015



Source: FactSet, Barclays Capital, Robert Shiller, Strategas/Ibbotson, Federal Reserve, J.P. Morgan Asset Management.

There is a large body of evidence demonstrating that less volatile stocks have outperformed on both an absolute and risk-adjusted basis over the long term, challenging traditional finance theory that contends higher returns come with higher risk. The returns profile for less volatile stocks was characterised by strong downside protection, particularly during significant drawdowns, outweighing underperformance in up markets.

The power of lower volatility has historically come from its low return dispersion. Smaller drawdowns mean there are less losses to recover than if a portfolio had experienced larger drawdowns. Lower volatility portfolios therefore reduced downside risk without compromising much on long-term returns.

While risk is potentially mitigated in low volatility strategies it is not eliminated as it is still an equities portfolio. Nonetheless a lower volatility strategy can provide the comforting psychological benefits of losing less in a downturn as well as having fewer and less violent swings in a portfolio value.

Well established research by Kahneman and Tversky shows that people prefer avoiding losses more than twice as much as realising equivalent gains. Some consider that for retirees this two-for-one relationship between losses and gains increases to over 5 times. In short, volatility becomes a more important consideration in retirement as the stakes – both financially and emotionally – are higher.

Many retirees are therefore likely to have a lower tolerance for volatility, which is challenging given equities can be a significant portion of assets in retirement. While we want equities for both growth and income stock markets are inherently volatile, at least in the short-term, and drawdowns occur regularly.

Hence we think a portfolio that is less volatile than the market, and also provides a degree of downside protection, may be a highly desirable attribute for those looking for a more conservative equities exposure. These characteristics can help to deliver greater stability of returns, thereby providing a smoother investment journey with less financial and emotional stress. Ultimately, who doesn't want greater peace of mind in their retirement?

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