CI Australian Equities Fund

COOPER INVESTORS

QUARTERLY COMMENTARY | JUNE 2023

AFS LICENCE NUMBER 221794 ABN 26 100 409 890

"A man who has committed a mistake and doesn't correct it, is committing another mistake." – **Confucious**

"It is impossible for a man to learn what he thinks he already knows." – **Epictetus**

"A great many people think they are thinking when they are merely rearranging their prejudices." – **William James**

"You will never reach your destination if you stop and throw stones at every dog that barks." – **Winston Churchill**

MARKET AND PORTFOLIO PERFORMANCE

If we described FY23 in sporting terms, we bounced back strongly from a halftime deficit but were behind on the scoreboard when the siren sounded. Ultimately, outperformance in three quarters (1Q23 by 0.4%, 3Q23 by 0.9% and 4Q23 by 0.7%) was not enough to offset a poor 2Q23 (3.3% under). The outcome was below our benchmark (13.6% vs. 14.8%) and we are deeply frustrated by this.

The best contributors over the year were QBE, Brambles, WiseTech, Aurizon, Oz Minerals and Qantas.

The underperformance was driven by three stocks: Star Entertainment, Orica and Lendlease.

Star was particularly disappointing. We overestimated organisational capability and underestimated the mounting threat to operating trends and industry structure from regulatory and exogenous risks.

For Lendlease, we were not sufficiently responsive to adverse changes in operating trends.

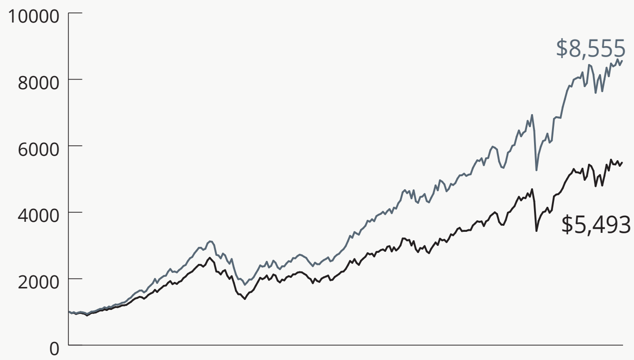
What did we learn from this?

These experiences were the catalyst for deep reflection, particularly on the habits and behaviours that promote outperformance in noisy and complex decision-making environments like investment markets. While analytical tasks, such as financial forecasting, often capture a lot of public

	**Portfolio	#Benchmark	Relative
3 months	1.67%	1.01%	0.66%
1 year	13.56%	14.78%	-1.22%
3 year*	12.61%	11.13%	1.48%
5 year*	8.71%	7.16%	1.55%
7 year*	9.96%	8.95%	1.01%
10 year*	10.96%	8.56%	2.40%
Since inception*	11.87%	8.45%	3.42%
Since inception^	953.52%	449.29%	504.23%

* 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 June 2023

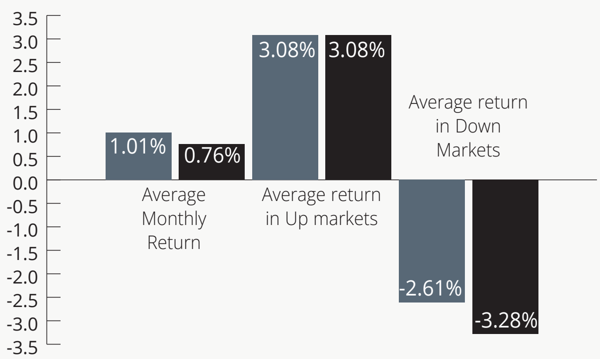
CI Australian Equities Fund – Net of Fees $1000 Invested Since Inception



CI Australian Equities Fund
S&P/ASX 200 Accumulation Index

Past performance is not a reliable indicator of future performance
Source: Internal CI data reports, 30 June 2023

Since Inception Gross Returns In Up And Down Markets



CI Australian Equities Fund
S&P/ASX 200 Accumulation Index

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attention, the key to effective decision-making in the face of uncertainty are the behavioural elements that drive learning, pattern recognition and mitigating unwanted behavioural biases. This reinforces the importance of living our core values when executing the investment process, namely:

- **Gratitude & humility:** humility cultivates self-awareness and intellectual honesty, which are prerequisites to the open-mindedness needed to be a good long-term investor. The absence of humility can lead to overconfidence, which creates a fertile ground for confirmation bias and blindness to emerging risks.
- **Intentionality:** executing our process with purpose, clarity and discipline.
- **Curiosity & passion:** openness, imagination, intuitive thinking and a commitment to continuous improvement. Enthusiasm for understanding how businesses and markets work. Systematic repetitive observations to identify patterns that drive value creation (and destruction).
- **In the moment & present:** attentiveness to what matters through a philosophy of observation, not prediction. Ruthless focus on signals and ignoring the noise. Concentrating on the things that make a difference and being detached from what we don't know or can't change.
- **Authenticity:** openness and honesty. Recognising mistakes quickly and responding accordingly.

A renewed focus on these values helped underpin a significant improvement in performance during the second half of the year. Nevertheless, the second quarter's experience highlights the need to remain ever vigilant.

FOURTH QUARTER PERFORMANCE

The portfolio rose 1.7% during the quarter (vs. benchmark up 1.0%).

The biggest positive contributors were Aurizon (improving earnings outlook), QBE (progress on turnaround, improving operating & industry trends in insurance), Brambles (operating trends remain favourable), WiseTech (tech sector outperformance), Aristocrat (industry resilience, outperforming peers) and James Hardie (improving sentiment towards US housing).

The key detractor was EBOS, which lost the contract to supply Chemist Warehouse. Other drags included ANZ (not owning the quarter's best performing bank), Xero (not owned at a time when it delivered a solid result) and Seek (moderating job ad trends).

MACRO OBSERVATIONS

The current environment is proving unusual in many respects. Despite sharp rate hikes, central banks are struggling to meaningfully contain inflation (particularly in the UK). Some of this can potentially be explained by the typical lags between actions and reactions. However, we suspect that aggressive fiscal stimulus (which is working in the opposite direction to monetary policy) and growing inequality (an increasing number of people are unaffected by interest rates) are also playing an important role in this cycle too. A "K-shaped" recovery might be unfolding.

This is creating high uncertainty and there are several possible paths that the global economy and financial markets could follow. Observable evidence supports the view that the global economy is slowing in response to tighter monetary conditions in much of the developed world, albeit at a slower pace than many anticipated. The depth and duration of any slowdown is uncertain.

More recently, sentiment towards the trajectory of China's post-COVID recovery has swung from excessive optimism to pessimism. Given leadership's focus on better balancing growth and stability, stimulus on the scale seen post-GFC and in the mid-2010s seems unlikely. There is also growing evidence that households are behaving with greater conservatism (e.g. managing cash flows, deleveraging, reducing spending). This creates a more challenging backdrop, albeit the government will likely step in to support parts of the economy that come under sustained pressure in order to avoid instability.

Given the divergent range of outcomes, we are endeavouring to maintain a balanced portfolio with substantial value latency, that will be resilient in many different scenarios.

CHINA TRIP INSIGHTS

We recently travelled through China. This was our first trip to the country since December 2019. Three and a half years is a long time and this trip reminded us why we travel to get insights on the ground. The clarity that is provided from first-hand observations and discussions with industry participants cannot be replicated from sitting at a desk and reading the numerous interpretations of what is going on.

Although China's economic recovery is happening following the removal of COVID-related restrictions, and this will continue, it is lagging expectations in several key areas. The revival so far has largely been services-led, which is to be expected given travel (which, as in the west, is booming), dining out and other activities largely shut down during the restrictions. The key point from an Australian investor's perspective is that this is not commodity-intensive demand. Additionally, despite the recovery, there are numerous areas that remain subdued. Confidence in the household sector is low, job uncertainty is high, and households are focussed on managing cash flows and deleveraging. This muted consumer sector is mirrored in the private business sector, which is an important source of employment, investment and general entrepreneurial vibrancy in the Chinese economy.

Another important sector for the Australian resources industry is residential housing, which is a key source of steel (and, hence, iron ore) demand. Residential property remains subdued and, although it will continue to recover over the course of the year, will remain muted as the government seek to manage the sector and pursue a "houses are for living" mantra. On a more positive note, infrastructure investment continues to grow robustly and is supported by policy settings.

Despite the above issues, the GDP growth target for this year of greater than 5% is readily achievable based on current policy settings and does not require additional stimulus. It is important to differentiate the policy response we are seeing now (and continue to expect) to what most people consider "stimulus". We do not expect to see traditional stimulus in the form witnessed post the GFC and in the 2015-2016 period. The government now sees this for what it was: excessive investment into non-productive assets that added excessive leverage into the system and increased the instability of the economy. We expect continued use of what we would term stabilisation measures that are targeted at areas of perceived instability in the economy, rather than broad-based stimulus. For example, ongoing stabilisation measures in the property sector that target specific pockets of weakness as it continues to deleverage and previous excesses are worked through. Similar stabilisation measures are likely in the private and household sector, albeit given the lack of confidence it will be more challenging to have the desired impact in these areas.

Overall, we returned from China more cautious on both the short-to-medium term outlook for commodities in general, and the iron ore market in particular. We do not consider the current iron ore price as being supported by the supply and demand structure we see today. That said, we are not overly bearish in the short term as we see cost curve support in the $70-90 range based on current supply and demand dynamics. Longer-term, it is difficult to see how we are not past peak steel demand in China as the economy moves to be a more service and higher-value manufacturing-led economy, moving away from its traditional capital-intensive industries. This, combined with potential new sources of supply, will eventually push the iron ore market through the current curve support. The portfolio is modestly underweight the mining sector, with our primary exposure being through a holding in BHP.

US TRIP INSIGHTS

Multiple team members toured the US this quarter. All noted the sense of optimism surrounding opportunities that the Inflation Reduction Act (IRA) will create. The IRA aims to expedite investment in US manufacturing capacity, secure procurement of critical supplies domestically or from free trade partners, and support R&D and commercialisation of technologies such as carbon capture and clean hydrogen. The key challenge for the US is balancing social and economic priorities, namely ensuring effective transition to net zero while also reducing the dependence on Chinese imports to achieve it. It seeks to do so by accelerating US innovation and manufacturing.

The IRA is broad-reaching, and some details are yet to be finalised. However, examples of projects could include lithium production, battery manufacturing, carbon capture technology and clean hydrogen investments. Clean electricity and clean transportation (electric vehicles) are a major focus.

Over the next two months more information about the specifics of the IRA will emerge. Businesses are now trying to understand how they can align their projects to meet the criteria for IRA funding. Key items outstanding that need clarification include the types of projects eligible for funding, criteria for funding and foreign entity of concern. Foreign entity of concern is critical for Australian businesses given it outlines which countries are not to supply into the US market. Obvious frontrunners include China, North Korea and Russia. Australia can supply critical minerals to the US, but Australian companies with an element of Chinese ownership might not be eligible. The specific percentage of ownership is not yet defined.

Permitting and bureaucracy are significant risks to IRA funding distribution. A key negotiating point in the debt ceiling discussion was overhauling permitting in the US to allow funding to reach business. The US Department of Energy's (DOE) Loan Program Office (LPO) is a key body in distributing funds. Industry conversations suggest they have received more funding to facilitate permitting.

Lithium production, battery manufacturing, carbon capture technology and clean hydrogen investments are all likely to benefit. Clean electricity and transportation (electric vehicles) are a major focus.

The portfolio is leveraged to these developments through our positions in **Macquarie (MQG)**, which is a significant global manager, investor and advisor in the renewables space, and **Worley (WOR)**.

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QUARTERLY STOCK NEWS

We established a position in **Worley (WOR)** during the quarter. We believe that operating trends in engineering and construction will benefit from the significant investment required to shift the world's energy system from fossil fuels to clean energy. The energy transition has gained significant momentum over the last few years with countries and companies increasingly adopting net zero targets. Russia's invasion of Ukraine in February 2022 has increased focus on the energy transition, with decarbonisation seen as a pathway to energy security.

The sector has traditionally been volatile given the cyclical nature of oil and gas investment, but returns will improve over the next decade given the structural tailwind as the world continues to decarbonise. Worley pivoted early towards the energy transition and is positioned well to benefit from clean energy investment, much of which is expected to be made by their existing customer base.

The International Energy Agency (IEA) estimates that global energy investment needs to increase from US$2.4tn to US$5.1tn (current dollars) p.a. by 2030 to achieve net zero by 2050; a CAGR of 10%. Policy settings are increasingly accommodative, with the US Inflation Reduction Act accelerating investment in clean energy and similar policy settings emerging in other countries. This suggests energy investment might somewhat decouple from the oil price, which reduces the risk that weak global economic activity impacts demand in Worley's end markets. Growth looks increasingly structural, in contrast to what has historically been a highly cyclical sector.

Industry structure is also becoming more supportive given: i) increased pricing power (consolidation, capacity constraints); ii) higher margin sustainability-related work (new technology); and iii) productivity gains (some of the benefit should be retained by contractors). Worley should also benefit from operating leverage as volumes increase and having taken out A$360mn of costs since the onset of COVID. Guidance is for FY24 EBITA margins of approx. 7.5% (ex-procurement revenue); a return to double-digit margins appears to be a reasonable ambition.

We also built a position in **Aurizon (AZJ)** during the quarter, with risk-adjusted value latency underpinned by improving operating trends and attractive valuation. Regulated earnings (below rail coal) should see strong near-term growth driven by higher interest rates, which drive an increased rate of return on these assets. We also expect unregulated earnings (above rail coal and bulk) to rebound on a combination of higher volumes (cycling severe weather events) and better margins (inflation pass-through on contracts).

Coal was 86% of Aurizon's earnings in 1H23 and offers material near-term growth given: i) the building blocks for the regulated return on the below rail business for the period FY24-27 are largely known; and ii) coal haulage volumes have been impacted by above average rainfall over the past three years, which is expected to improve with the commencement of an El Niño event (as predicted by the Bureau of Meteorology).

Coal will be a headwind in the medium to long-term as the world transitions to clean energy, but Australian coal is expected to take market share given it is higher quality (less emissions) with a lower cost-to-produce. Aurizon's investment in bulk should also partly mitigate the impact. Bulk contract returns are expected to be lower than thermal or met coal contracts but are still above the company's cost of capital (particularly where trains can be repurposed). We also see bulk as a partial hedge for coal as the energy transition proceeds given the quantum of critical minerals that will be required to meet global net zero objectives.

We participated in **Infratil (IFT)** NZ$850mn equity raising to fund the acquisition of the remaining half of New Zealand's second-largest telecom, One NZ. Infratil is an infrastructure investment fund with ownership stakes in a range of assets, including One NZ (100%), CDC Data Centres (48%), Wellington International Airport (66%), and Longroad Energy (37%).

The management team has a strong track record of extracting attractive returns from infrastructure assets. The One NZ holding offers upside given that strong mobile pricing momentum is supporting operating trends and industry participating are behaving more rationally, which is strengthening industry structure and generating better returns on capital. One NZ is also well-placed to take advantage of the expected opportunities from the shift from private to public cloud services. Infratil offers exposure to two attractive long-term themes: i) energy transition/energy security via its investment in Longroad Energy (renewable energy projects); and ii) public cloud/AI, via its investment in CDC (data centres).

EBOS (EBO) underperformed on news they were unsuccessful in renewing their Chemist Warehouse pharmaceutical supply contract, which was instead awarded to Sigma (SIG). EBOS currently generates ~$1.9bn of revenue from the Chemist Warehouse contract annually, which will expire June 2024. In our view, the share price reaction was proportional to the earnings lost from the contract renegotiations.

The renewal of the Chemist Warehouse contract was never guaranteed. EBOS performed its obligations under the contract to a high standard. However, this was overshadowed by Sigma's offer that included issuing Chemist Warehouse with shares equal to 10.7% of SIG issued share capital.

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The board and management of EBOS have always acknowledged the risk that contract renewal presented and have developed strategies to minimise the earnings impact of this outcome. Focus has now turned to replacing lost volumes and cost saving opportunities. Efforts have been made in recent years to further diversify group earnings. EBOS reiterated its confidence in growth strategies across its business, including the continued rollout of Terry White Chemmart pharmacies, animal care, medical devices and contract logistics.

Fund holding, **CSL (CSL)**, provided a market update late in the quarter. New guidance for FY23 constant currency earnings was largely in-line with previous guidance, but unfavourable FX impacts increased from previous outlook. New FY24 guidance, which was ~12% below market estimates, was the catalyst for some subsequent underperformance.

It appears that the market was over-enthusiastic on the rate of the recovery in Behring margins, which had been impacted through COVID by higher donor fees and lower volumes (negative operating leverage), and then FX more recently. While donor fees have declined from their peaks, CSL management does not expect them to return to pre-COVID levels. The recovery is now expected to take 3-5 years (i.e. FY26-28).

Importantly, there was nothing in the update to suggest any structural concerns with the plasma business. Collections continue to improve, demand remains robust and CSL continues to pursue a range of operational efficiencies that should materially improve medium to long-term margins and returns. Some of these do not appear to be factored into the company's outlook. We think margins can comfortably recover within the guided timeframe, possibly faster if new specialty products are a success, and ultimately exceed pre-COVID margins. These operational efficiencies, combined with an attractive late-stage R&D portfolio, give us confidence in our investment thesis.

We exited our positions in **Cleanaway (CWY)** and **TPG Telecom (TPG)**.