CI Australian Equities Fund

QUARTERLY COMMENTARY | JUNE 2024

AFS LICENCE NUMBER 221794 ABN 26 100 409 890

"Superior results have to be based on superior insights" – **Howard Marks**

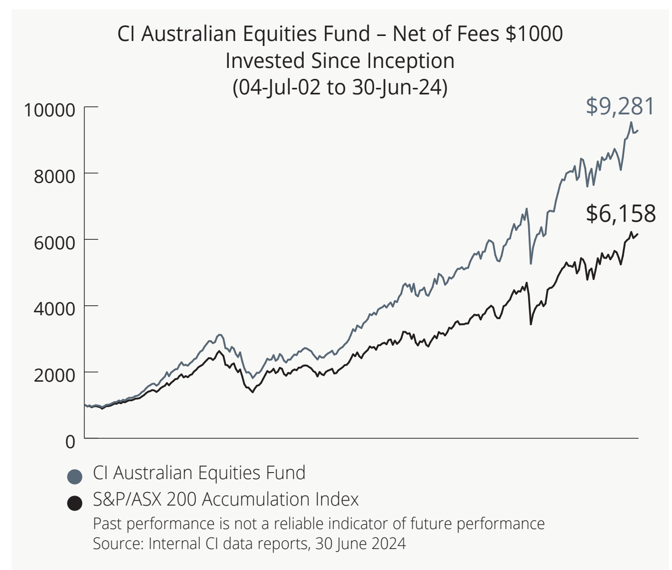
"The person with the edge is always in a position to outguess the person without an edge – who after all will be the last to learn of important change in a given industry" – **Peter Lynch**

"Maturity is the ability to reject good alternatives in order to pursue even better ones" – **Ray Dalio**

"A concentrated mind will pierce a rock" – **Japanese Proverb**

	**Portfolio	#Benchmark	Relative
3 months	-2.47%	-1.05%	-1.42%
1 year	9.29%	12.10%	-2.81%
3 year*	6.81%	6.36%	0.45%
5 year*	8.99%	7.26%	1.73%
7 year*	9.60%	8.67%	0.93%
10 year*	9.94%	8.05%	1.89%
Since inception*	11.74%	8.61%	3.13%
Since inception^	1051.41%	515.77%	535.64%

* 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 2024



Past performance is not a reliable indicator of future performance
Source: Internal CI data reports, 30 June 2024

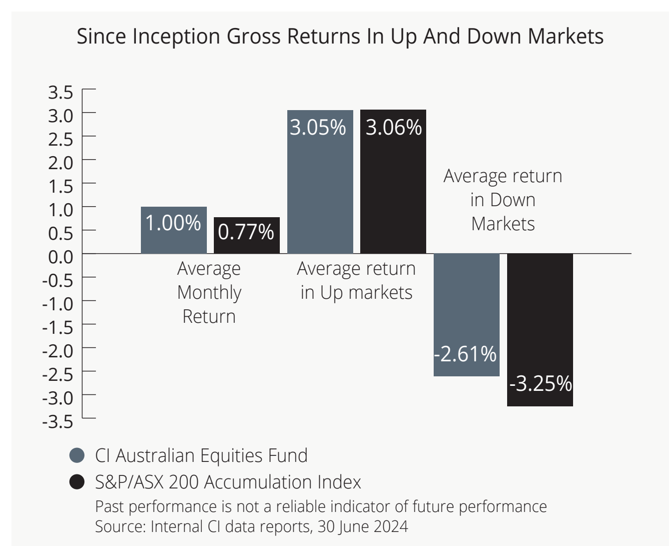
MARKET AND PORTFOLIO PERFORMANCE

The portfolio was down 2.47% this quarter, underperforming the S&P/ASX 200 index by 1.42%.[1]

Half the underperformance came from our underweight position in banks (mid-single digit outperformance, but a large active weight). The remainder came from weakness in portfolio holdings **Ramsay Health Care** (negative sentiment towards private hospital sector), **Seek** (subdued job ad volumes), **Worley** (Dar Group selling most of their 23% stake) and **Mirvac** (rising bond yields). This was only partially offset by the tailwind gained from not owning some large underperformers (**Fortescue, James Hardie** and **Woodside**) and the contribution from our better-performing positions (**Infratil, CSL, Wisetech** and **Macquarie**).

For FY24 the portfolio was up 9.29% but underperformed the index by 2.81% (up 12.1%).[1]

This disappointing outcome was largely driven by the rally in banks, combined with some poor stock selection outside of the banks. Notable underperformers included **Iluka Resources**, **Worley**, **Ramsay Health Care**, **Aurizon** and **Seek**. While **Wisetech**, **Orica** and **Reece** performed well, and we also benefited from not owning a couple of large laggards (**Woodside** and **Transurban**), we simply did not have enough winners.



Past performance is not a reliable indicator of future performance
Source: Internal CI data reports, 30 June 2024

1 Past performance is not a reliable indicator of future performance.

CI Australian Equities Fund

AFS LICENCE NUMBER 221794 ABN 26 100 409 890

BANK SECTOR OBSERVATIONS

The rally in the banks was a key drag this year. Our underweight position was initially based on our assessment that long-term Risk-Adjusted Value Latency was unattractive relative to the rest of our investment universe. This view was predicated on the dearth of value latencies, operating headwinds (e.g. margin pressure, low credit growth and persistent cost pressures), elevated competitive intensity crimping returns, and little evidence of management teams creating opportunities over time (with a few notable exceptions).

The banks ultimately outperformed by just over 20% for the year; this was one of the largest contributors to the portfolio's underperformance. There has been much speculation as to the drivers of this outcome given that fundamentals did not improve noticeably. We believe it is attributable to a combination of:

1) Relative appeal versus other major sectors, including the allure of highly franked dividends, support from buyback activity and more stable earnings drivers than cyclical sectors like commodities,

2) At the margin, some moderation in operating headwinds (albeit, still well short of tailwinds), and

3) Non-fundamental factors, such as passive fund flows, adjustments to regional benchmarks and tactical asset allocation decisions by superannuation funds.

Our view remains unchanged. Indeed, the rally in the banks has reduced our assessment of long-term Risk-Adjusted Value Latency even further. Hence, we remain underweight. Meaningful value latencies are hard to find, operating trends are lacklustre (i.e. minimal pre-provision profit growth) and competition remains intense.

Within this, we retain overweight positions in ANZ Group Holdings Limited (ANZ), which shows underappreciated value latency from the steps taken to reshape the institutional business, upside from ANZ Plus and SUN integration, and National Australia Bank Ltd (NAB) where continued disciplined execution should support further recognition of latent value, which should narrow the gap to Commonwealth Bank of Australia (CBA).

We still consider CBA to be the strongest and best-managed franchise, but believe this is more than offset by the current valuation. We also do not own Westpac Banking Corp (WBC) given significant execution risks around the turnaround plan, particularly considering the track record.

THE PORTFOLIO

The portfolio's performance has been disappointing for the year and clearly below our expectations. The largest contributor to this underperformance from a Subset of Value (SoV) perspective has been Stalwarts. As discussed above, a significant portion of this is due to our underweight position in banks. Outside of the banks, the portfolio has significantly reduced its exposure to Stalwart companies over the course of the year by selling Telstra, Brambles and Woolworths. The portfolio is now ~10% underweight Stalwarts, having begun the financial year overweight. Although these sales were the correct decision, a portion of this capital was reallocated to new Stalwarts (mainly Aurizon and Ramsay Healthcare) which have lagged the market since being added. The setup for these companies is not dissimilar to when we originally added Telstra and Brambles to the portfolio. Both stocks were discounted at the time due to short-term industry-specific issues, despite, at their core, being sturdy businesses that will endure the short-term challenges. These are one type of Stalwart opportunity that we find attractive, as they offer value latency over the medium term with manageable risk profiles, due to the Stalwart nature of their businesses, and each having an element of self-help available to drive improved performance.

The other noticeable change we have made to the portfolio over the course of the last year was increasing the exposure to Cyclicals from underweight to ~5.5% overweight. With the portfolio's exposure to mining and resources being broadly neutral, this active exposure is coming from industrial cyclicals such as Orica, Worley and Incitec Pivot.

While we remain cautious on short-term operating trends for Cyclicals given the challenging conditions we are observing for a range of these industries, we expect to see more opportunity for attractive Risk-Adjusted Value Latency to emerge over the coming year as these cycles develop further.

As a reminder, challenging operating environments typically increase Risk-Adjusted Value Latency for Cyclicals as security prices begin to discount overly pessimistic longer-term scenarios. To this end, the portfolio has begun building positions in real estate-exposed industries (Lendlease , Mirvac and Iluka Resources) as we see this cycle as being very advanced and companies within this area offering attractive Risk-Adjusted Value Latency on a medium-term view. That said, we have been early as the cycle has been extended, and these positions have been a drag on performance in the last year.

The best performing SoV over the past year has been Growth. The portfolio has maintained a modest overweight to Growth stocks for most of the year, with holdings in Wisetech Global, Goodman Group, Seek and CSL. While Wisetech

and Goodman have performed well, Seek and CSL have underperformed, as they continued to face short-term earnings headwinds. Our sense is that CSL is on the other side of these challenges and is in a strong position to create value for shareholders as the industry recovers from the pandemic-related disruptions.

The portfolio has not had enough exposure to Growth stocks more generally given the performance of these over the last year. We do not currently see attractive Risk-Adjusted Value Latency in many of these names, despite our expectation that many will deliver good earnings growth into the medium-term. That said, we continue to monitor this Subset of Value closely and are ready to act, as we did with Goodman Group last year, when we identify the characteristics that we look for in Risk-Adjusted Value Latency.

As mentioned above, the performance of the portfolio over the last year has not been in line what we expect to deliver for our clients. This overview seeks to provide a better understanding of the primary drivers, along with how the portfolio is positioned and the confidence we have in the continued execution of the investment process. Our focus is on long-term value creation, through the lens of Risk-Adjusted Value Latency, to deliver long-term sustainable returns to our clients. History has taught us that continued disciplined execution of the investment process determines long-term success. Our focus remains on pattern recognition and the observable facts, information, behaviours and actions that are precursors to long-term value creation.

OBSERVATIONS FROM THE ROAD

China

During May, we continued our monitoring of lithium supply and demand trends with a trip to China. Observations remain consistent with those made in November; the pace and quantum of raw material development, both in China and through Chinese-controlled African supply, continued to impress, despite the lower commodity price environment.

There is no evidence of supply reductions or mine closures to date. Environmental inspections for lepidolite producers in China do not appear to have materially impacted either the supply or cost of supply, with operations that produce “hazardous waste” of concern, believed to be immaterial in the context of total Chinese supply. On the demand side, domestic demand for New Energy Vehicles (NEVs) remain robust. However, within this, hybrid vehicles (which on average contain just ~25% of the lithium used in a battery electric vehicle) continue to take share and now represent ~40% of total Chinese NEV sales.

Given the persistence of weak supply and demand trends, we continue to remain cautious on the lithium sector.

More generally, since our previous visit to China last year, the economic backdrop is relatively stable, and gradually improving, off what was a fairly poor period. That said, there is more recognition of the challenges being faced by the economy more broadly, which continues to weigh on investor and consumer sentiment. We see it as a small positive step that there appears to be increased recognition by central authorities of the challenges faced by the residential market and economy. We anticipate continued targeted policy responses to manage downside risks, while not anticipating any major policy stimulus along the lines seen post the GFC and 2015/16.

Given the continued subdued demand environment within China, we need to be cautious of those industries that experience excess capacity, with exports being used as a release valve. We are seeing this in steel, with regional Southeast Asian steel-making margins under pressure. This is also resulting in increased anti-dumping measures globally, as countries endeavour to protect their domestic industries.

United States

We also travelled through the industrial base of America, getting a read on the current state of business activity. This included housing, packaging, steel, construction, agriculture and auto-related industries. What was notable on this trip was the more subdued tone than what we experienced when we were there just six months ago. Back in December, the sense of optimism was palpable, and a number of businesses were describing (backwards looking) an environment of robust activity, strong demand for products and high margins. Although not wanting to paint an overly negative picture, the tone this time was more subdued, with a range of industries coming off the boil and demand, although solid, by no means as ebullient. In fact, one broad-based industrial supplier indicated that the only end markets still tracking strongly versus last year were data centres and renewables.

Consumers, particularly middle to low-income consumers, are feeling the pinch with trading down and subdued spending on big ticket items (e.g. auto, renovations, whitegoods, etc). New housing activity, having recovered off its lows, was stabilising, with affordability pressures constraining demand. Construction activity was solid, but muted, with the positive momentum of the Infrastructure Bill only slowly hitting the ground in terms of actual spending and many Inflation Reduction Act (IRA)-related projects waiting for more regulatory clarity before moving forward.

Overall, it seems that the impact of rising interest rates and cost of living pressures are beginning to have a more broad-based impact on economic activity. This could provide an opportunity to build exposure to more cyclically-exposed companies at attractive entry levels, particularly for those companies with robust industry positions and capable management teams, that exhibit attractive Risk-Adjusted Value Latency.

STOCK COMMENTARY

QBE Insurance (QBE) announced that it is closing its North American middle-market business. We view this decision favourably. Despite numerous attempts to remediate this unit over time, it remains loss-making and dilutive to both divisional and group margins. Exiting will improve the group's financial profile, reduce its property catastrophe exposure and eliminate another source of management distraction. Mathematically, it should make hitting the 95% Combined Operating Ratio ambition for the North American business even more likely.

As part of the update, QBE also confirmed guidance but announced that exposure to civil unrest in New Caledonia could cost $175-225mn. This caused some market consternation as it came as a surprise to many. As a global insurer, it is QBE's business to write risk where it assesses the risk-adjusted return profile to be appropriate. Of course, given that this involves assessing potential future outcomes, this will not always play out as intended. We are more encouraged by the fact that QBE was able to absorb this hit, along with other major events like the Baltimore Bridge disaster, within its catastrophe allowance. This points to greater portfolio resilience and more conservatism in their guidance than has historically been the case.

As part of the ongoing work on our QBE investment thesis, we also visited the UK and US during the quarter. Our industry research concluded that:

i) operating and industry trends remain very favourable for global insurers with very few signs of irrational behaviour; and

ii) while some aspects are proving challenging, such as fixing the middle-market business, QBE's North American turnaround is broadly going to plan (NB: these trips were done before the closure of the middle-market business was announced).

We recently added **Lendlease (LLC)** to the portfolio, with the investment proposition centred around a cyclical reversion in the development business as the broader property cycle recovers from the current low.

The COVID-related property cycle of 2020/2021, which was followed almost immediately by the monetary tightening-induced cycle that we are currently experiencing, has seen Lendlease's development business generate a ~4.4% ROIC over the past four years. This is well below the 10-13% through-the-cycle target, a target that has been comfortably achieved historically. With a pathway towards reversion in development returns to more historical levels over the coming years as the cycle recovers, combined with the stock currently trading at ~0.75x last reported net tangible assets (in line with the trough of ~0.8x experienced during the GFC), we believe this opportunity represents compelling Risk-Adjusted Value Latency.

In addition to the reversionary opportunity that underpins our investment proposition, we also see the potential for significant value creation in global real estate funds management given Lendlease's market presence, brand and asset creation capability. Having said that, successfully executing on this long-term opportunity is likely to require a significantly greater focus and intentionality than what Lendlease has displayed historically, along with cultural change (albeit this is not part of our base investment proposition). In this regard, it was pleasing to see a step change in focus, and intentionality from current Lendlease management at their strategy update in May. This included announcing plans to simplify the organisational structure through a managed exit of their international development and construction activities, redeploying capital back into the high-returning Australian development business, and the international investment management platform.

Towards the end of the quarter, we participated in portfolio holding **Infratil's (IFT)** ~NZ$1.2bn equity raising. The proceeds will primarily be used to fund further investment into data centre operator, **CDC Data Centres (CDC)**, of which IFT own 48%. CDC continues to benefit from surging demand for data centre capacity as cloud adoption increases and significant global investment goes into generative AI. The step change in demand has allowed CDC to both expand and accelerate its 1.9GW development pipeline for which this incremental funding will be used.

Goodman Group (GMG) is another portfolio holding that is well-placed to benefit from the step change in demand for data centre capacity, with a development pipeline of 4.3GW across 12 global cities expected to be developed over the medium-term. However, given the hype associated with the AI thematic, we are observing closely with a greater degree of caution.

CI Australian Equities Fund

QUARTERLY COMMENTARY | JUNE 2024

AFS LICENCE NUMBER 221794 ABN 26 100 409 890

We are pleased with the progress that fund holding, Cleanaway (CWY), is making towards its Blueprint 2030 strategy. Cleanaway is Australia's leading waste management and resource recovery provider. The company operates a collection of prized infrastructure assets across Australia, including landfills, waste transfer stations, recycling facilities and a fleet of waste collection vehicles.

Our analysis suggests that the favourable tailwinds for the waste industry remain intact. A combination of state and federal waste policies, and the introduction of landfill levies nationally, will continue to underpin the economics for investment into waste processing assets. A selection of actions identified within the national waste policy that are of relevance to Cleanaway include waste export bans to increase domestic reprocessing, targeting 80% recovery rate from all waste streams, halving the amount of organic waste sent to landfill and increased use of recycled materials by government and industry. As Australia's largest waste operator, Cleanaway is uniquely well-positioned to take advantage of the supportive regulatory environment emerging for circular waste solutions.

In 2022, CEO Mark Schubert announced the company's "Blueprint 2030" strategy. This highlighted how Cleanaway intends to take advantage of this positive industry backdrop. Blueprint 2030 is an extension of Cleanaway's Footprint 2025 strategy under prior CEO, Vik Bansal, which was focused on building out a core network of waste infrastructure assets and becoming Australia's leading waste services provider. Blueprint 2030 is now focused on creating superior shareholder value by integrating this leading network of infrastructure assets to provide high-circularity, low-carbon solutions, seamless customer service and value for money. Key initiatives include:

- Accretive investment across the asset base, including organics processing, energy-from-waste and circular plastics,
- A focus on operational improvements and superior efficiency across the asset base. This includes route optimisation and customer analysis of customer profitability, and
- Market share growth through providing circular recovery solutions for customers looking to dispose of waste more sustainably.

At the FY23 result, Cleanaway provided further clarity around Blueprint 2030's financial potential. This included an increased focus on return on capital and greater clarity surrounding capital investments, particularly as it relates to waste-to-energy. While not without execution risk, we see potential for Blueprint 2030 to deliver value for shareholders over the medium to long-term.

Terms and Conditions

Financial product advice contained in this document

This document has been prepared by Cooper Investors Pty Limited ACN 100 409 890 AFSL 221794, the trustee and investment manager of the CI Australian Equities Fund (Fund). The opinions, advice, recommendations and other information contained in this document, whether express or implied, are made by Cooper Investors Pty Limited and by its officers and employees (Cooper Investors) in good faith in relation to the facts known to it at the time of preparation. Cooper Investors has prepared this document without consideration of the investment objectives, financial situation or particular needs of any individual investor, and you should not rely on the opinions, advice, recommendations and other information contained in this document alone. This document contains general financial product advice only.

This document does not constitute an offer of units in the Fund to investors. Offers of units in the Fund are made in the information memorandum (IM) for the Fund. You should obtain the IM and consider the important information about risks, costs and fees in the relevant IM before investing. Cooper Investors recommends investors seek independent, legal, financial and taxation advice from appropriate professional advisers before making any decision about investing in the Fund.

Past performance warning

Any information in respect of past performance is not a reliable indication as to future performance and any forecasts, prospects or forward-looking statements in this document (if any) are based upon Cooper Investors' current views and assumptions and involve known and unknown risks and uncertainties, many of which are beyond Cooper Investors' control and could cause actual results, performance or events to differ materially from those expressed or implied. These forward-looking statements are not guarantees or representations of future performance and should not be relied upon as such.

To whom this document is provided

This document is only made available to persons who are wholesale clients within the meaning of section 761G of the Corporations Act 2001 (Cth). This document is made available on the condition that it is not passed on to any person who is a retail client within the meaning of section 761G of that Act.

Limitation of liability and copyright

To the maximum extent permitted by law, Cooper Investors disclaims all liability and responsibility for any direct or indirect or consequential loss, damage, cost, expense, outgoing, interest, loss of profits or loss of any kind which may be suffered by any person through relying on anything contained in or omitted from this document. This document may not be reproduced or used for any other purpose without the express permission of Cooper Investors.