# CI BRUNSWICK FUND
# QUARTERLY REPORT

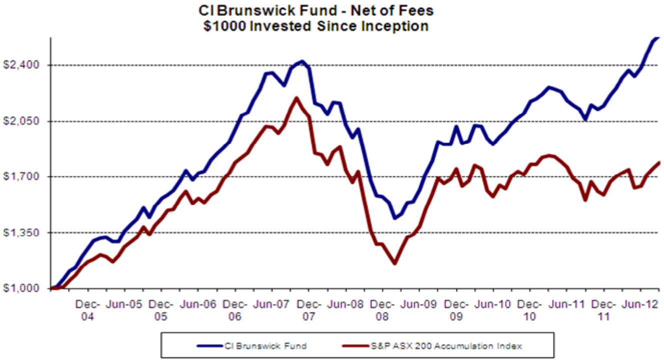
Cooper Investors Pty Limited AFS Licence Number 221794 ABN 26 100 409 890

## SEPTEMBER 2012

***"Prediction is very difficult, especially if it's about the future." Niels Bohr (Danish physicist; Nobel Prize in Physics, 1922).***

***"Nothing in this world can take the place of persistence. Talent will not; nothing is more common than unsuccessful people with talent. Genius will not; unrewarded genius is almost a proverb. Education will not; the world is full of educated failures. Persistence and determination alone are omnipotent." Calvin Coolidge (30th President of the United States 1923–1929).***

| | ****PORTFOLIO** | **BENCHMARK** | **VALUE ADDED** |
|---|---|---|---|
| ROLLING 3 MONTH | 8.83% | 8.84% | -0.01% |
| ROLLING 1 YEAR | 27.42% | 14.83% | 12.59% |
| ROLLING 2 YEAR | 15.12% | 2.47% | 12.65% |
| ROLLING 3 YEAR | 12.38% | 1.84% | 10.54% |
| ROLLING 5 YEAR | 3.09% | -3.47% | 6.56% |
| ROLLING 7 YEAR | 10.86% | 3.67% | 7.19% |
| SINCE INCEPTION* | 16.16% | 7.30% | 8.86% |
| SINCE INCEPTION^ | 244.27% | 78.83% | 165.44% |



* Annualised
^ Cumulative (1 July 2004)
** Before fees and expenses

## Market and Portfolio Performance

The S&P ASX200 Accumulation Index rose over the quarter and the year to 30th September 2012 by 8.84% and by 14.83% respectively. The portfolio returned 8.83% and 27.42% respectively. Out-performers included Hastings Diversified, Australia Infrastructure and Westpac, whilst under-performers included QR National, Rio & Navitas. Utility stocks (including Telco's) under-performed the market, along with resource companies and the energy sectors within the economy. The banks were yet again an out-performing sector but the portfolio has 9% in Australian Banks compared with the index of 28%.

Over the past 10 years the Australian market has returned a modest 8.63% p.a. and has generally under-performed global stock markets in the last 3 years. The modest performance over the last decade stands in the face of the huge benefit afforded by a 150 year commodity boom which has benefited the country but not all sectors. Australian equity investors are now facing their own "Dutch Disease" otherwise known as the 'The Resource Curse' (Paradox of Plenty). Our small educated privileged population, with an enviable resource and agriculture sector, sitting on the door step of Asia faces the following challenges:

- High household debt levels;
- Deterioration in industrial relations;
- High capital and labour costs;

- Increasingly interventionist governments;
- Disappearing manufacturing base;
- Rising energy costs; and
- Rising taxes, royalties and government charges.

Global stock markets continue to perform well despite the general slowing in both the OECD and developing world. Asia continues to be the growth engine for the world where economic growth in non-developed Asia is growing at around 6.8% p.a. (albeit lower than last year) whilst OECD countries are growing at 1.6% p.a. with Australia at around 3%.

As an indicator of European "stress", we recently received a notice from a custodian that reads: "The current interest rate environment is experiencing unprecedented low levels in several markets. Driven by central bank policies, some markets have experienced negative interest rates. As a result, we will be **applying negative interest** to your cash deposit balances for the Danish Krone of -0.75% and for Swiss Francs -0.25%" (i.e. we pay for cash deposits!)

Over the quarter there were a number of stocks purchased including Brambles, News Corporation and Vodafone. Stocks sold included ARB and Trust Power as well as high yielding hybrids Macquarie and Colonial Subordinated Notes.

## The Portfolio

The portfolio is positioned around five types of stock clusters:

- **Bond like equities** (19% of the portfolio) - such as Hastings Diversified, which can grow their above market dividend yields and recoup inflation under the terms of their long life contracts.

- **Asset plays** (26%) - with good balance sheets such as Jardine Strategic and Soul Pattinson, both of which sell below net replacement value.

- **Niche growth** (13%) - stocks with focussed, prudent and experienced management teams operating in industries and product segments that can generate high sales and profit growth. Importantly, though the growth stocks must display growth, value, quality management and sound business models. Examples include Ryman (demographic and aged care play) and some of our Asian stocks such as Vitasoy.

- **Turnarounds** (10%) - sound businesses with good management in place and good balance sheets essential (QR National). We especially like government to private turnarounds.

- **Stalwarts** (33%) - sturdy, strong and generally larger companies with world class privileged market and competitive positions (News Corp, Woolworths).

Currently the portfolio has around 4% cash and another 14.5% in bond like equities (high yielding securities such as Australand Notes, Transpacific Preference shares and APA Group (Australia's largest natural gas infrastructure business).

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The portfolio has around 14% of assets invested in overseas markets (excluding Australia and NZ). These are spread across UK stocks (7%) and the balance across Singapore & Hong Kong listed companies.

Portfolio attributes as at September 2012 are summarized below.

| | |
|---|---|
| PE | 13.3 x |
| Beta | 0.66 |
| Yield | 4.7 % |
| Price Book | 1.8x |
| Roe | 13.6 % |
| Debt/equity | 37% |
| Tracking error vs. ASX 200 | 6.5% |
| Stock Numbers | 36 |

Major sector exposures are:

| **Sector** | **Portfolio Weight** |
|---|---|
| **Energy** | **3.6%** |
| **Materials** | **4.6%** |
| **Industrials** | **18%** |
| **Health & Aged Care** | **6.1%** |
| **Banks** | **11.3%** |
| **Utility & Infrastructure** | **12%** |
| **Telecommunications** | **6%** |
| **Foreign Equities *** | **14%** |
| **Cash & Equivalents** | **2.8%** |

*Excludes NZ stocks which are considered domestic along with Australian listed securities

## Stock News

**Nib Holdings (nib)** has had a busy twelve months. Despite some emerging headwinds, nib produced a solid headline result in FY12. The result was muddied by a change in accounting policy regarding capitalisation of broker commissions, and the pre-payment of premiums ahead of implementation of means-testing the private health insurance (PHI) rebate. The change in accounting policy had a positive impact on earnings (+11.5% to Group underwriting profit), and the pre-payment of premiums has meant the impact of means testing the PHI rebate has effectively been pushed out another year. The industry regulator, PHIAC, is also in the process of developing new capital standards for the industry.

Pleasingly, nib continued to return excess capital to shareholders, paying a $75.4m (16.2cps) special dividend in 1H12, and conducting a share buy back in 2H12 of $41m (6% of outstanding shares). We note this was in addition to paying out $61m (9.25cps) in dividends for the year. Management considered returning the remaining $13.3m of surplus capital to shareholders however they believe that there are near-term opportunities to deploy the capital for acquisitions. nib expects surplus capital to increase by approximately $22m in 1Q13 as the unearned premium liability from the increase in pre-paid premiums reduces. The surplus capital position is also clouded by the new capital standards proposed by PHIAC, which are currently in the consultation stage and have a planned implementation date of 30 June 2013. Management do not anticipate this will have a material impact on nib's capital requirements.

Competition is increasing in the core Health Insurance Business (HIB) as evidenced by the increased marketing spend of key competitors. Growth is also being impacted by rising lapse rates, which appear to be driven by increased competition and the ability and willingness of customers to shop around (which may be exacerbated given nib's skew to younger members). It is also possible that while the increased use of i-Select as a distribution channel helps to drive new policyholder sales, it also increases policyholder churn, although this is unclear at present. Management has implemented a number of initiatives to offset these impacts including targeting the over -55's and corporate health insurance markets, increasing the focus on Western Australia as a growth market, the use of aggregator sites to drive new policyholder sales, and management is exploring the potential around medical tourism. In summary, nib is still targeting 10% premium revenue growth and underwriting margins of 5.0%-5.5% for its health insurance business, which we think is respectable in the current environment.

The International Workers Business (IWB) represents 2.2% of Group premiums but 10.6% of Group underwriting profit. In FY12 IWB premiums grew by 18.6% and earned an underwriting margin of 30%. Management sees a lot of potential for this business given that circa 100,000 workers leave Australia each year for work purposes, a trend that is increasing with globalisation and, additionally, Australia is also seeing a lot of migration of skilled workers. The International Students Business (ISB) continues to operate at a loss and is considered to be sub-scale, management will give the business until the end of CY13 before a decision will be made as to whether it is discontinued.

Management has continued to demonstrate that they run the business from a shareholder-friendly perspective, with a focus on return on equity (FY12 19.0%) and returning excess funds to shareholders. Whilst there are headwinds for nib, we note they are still targeting 10% top line growth albeit likely at lower margins. The management team is full of energy and it appears that there are a plethora of business opportunities for them to pursue. The balance sheet is net cash and surplus capital provides some value latency in the business, particularly if management can execute on an accretive acquisition or new business investment. The interesting 'wildcards' are whether Medibank Private lists in the next 12-18 months and what this would mean for industry dynamics (i.e. would it spur further industry consolidation?) and whether a change in Government would prove more favourable for the PHI industry.

**Australian Infrastructure Fund (AIX)** has been a long standing position in the portfolio and we continue to like the stock because:

- AIX has simplified its business by divesting non-core assets (Port of Portland, Port of Geelong and Metro Transport Sydney) and outlined a proposal to internalise the Hastings Funds Management Limited ('HFML') external management agreement. These measures essentially resulted in AIX becoming a pure-play Australian airport fund (Australian airports account for well over 90% of the valuation).

- AIX's core assets have shown consistent strong growth in earnings over a long period and we believe that they will continue to achieve solid growth going forwards (people love to fly!). From 2003 -2011 the following growth was achieved:
  - ∗ Perth airport (30% owned) EBITDA increased from $59m to $196m (CAGR 16%).
  - ∗ Melbourne airport (12.4% owned) EBITDA increased from $169m to $422m (CAGR 12%).
  - ∗ NT airports EBITDA increased from $11m to $48m (CAGR 21%).
  - ∗ Queensland airports EBITDA increased from $13m to $67m (CAGR 23%).

- Very supportive 'light-handed' regulatory regime for the Australian airports that is locked in until 2020 – the Government is very happy with the outcomes of privatisation and the light handed regulatory regime as it has delivered significant capacity expansions that were unlikely to have occurred if they were publicly owned and aeronautical charges have remained relatively cheap compared to global peers.

- Second derivative exposure to the Asian consumer through the international airports (particularly Melbourne and Perth) – this strong thematic is difficult to get exposure to as an Australian focused investor.

- Good opportunities for the re-investment of significant capital back into the airports at attractive rates of return. While there is currently a hunger for yield in the market, we still believe that the best businesses continue to be those that can reinvest significant amounts of capital back into their business at attractive rates of return.

- Attractive valuations metrics – on a 'look-through' EV/EBIDTA multiple AIX was trading at a significant discount to peers and our conservative DCF valuation was broadly in-line with the independent experts valuation (and well above the share price).

- Given its reinvestment opportunities, we believe that the AIX portfolio of assets could continue to increase in value by > 10% p.a. for the foreseeable future – a highly attractive proposition.

Unfortunately the Future Fund formed a similar view of the high quality nature of AIX's portfolio of airport assets and compelling valuation and made a bid for the assets when AIX released their results on the 24th of August for $3.22/share. The bid is complex as it is for the individual assets rather than the entire fund and it will take some time for the deal to close.

By the time the deal closes, we believe that the bid will not represent much of a premium to the underlying value and that we will miss out on the very strong likelihood that the value of these assets will continue to increase strongly over coming years.

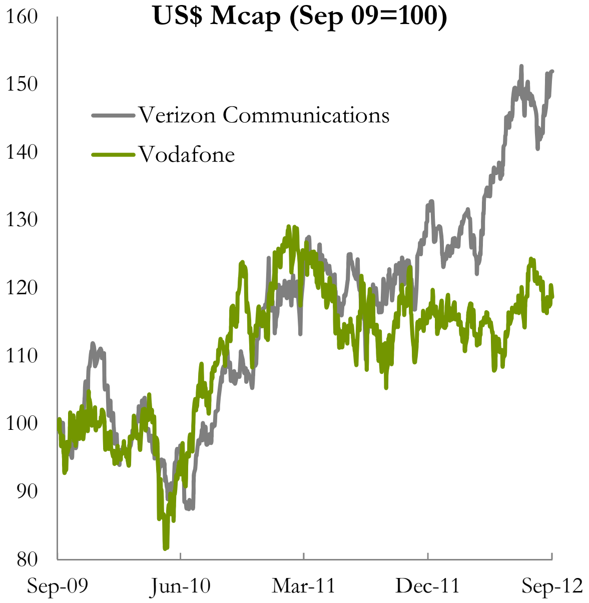
**Vodafone** is best known as a leading European telecommunications company. Yet the real story is the company's 45% stake in Verizon Wireless ("VZW"), one of the best mobile businesses in the world. A joint venture with Verizon Communications ("VZCOM") in the U.S., VZW will contribute more than half of Vodafone's profits this year.

The U.S. is a concentrated mobile market with two players controlling the majority of industry profits, which results in VZW having almost 100mn subscribers, US$75bn of revenues and 40% EBITDA margins. There is a large discrepancy in how this asset is valued within NYSE-listed VZCOM compared with the other JV partner, London-listed Vodafone. VZCOM (the value of which is almost entirely driven by VZW) trades on a PE of 18x, EV/ EBITDA 8x and 4.5% dividend yield. Yet Vodafone trades on a PE of 11x, EV/EBITDA 5x and 6% dividend yield.

We see two reasons driving this discrepancy, both of which will dissipate over time. First, with zero rates in the U.S., investors have bought up anything that constitutes a "bond like equity". VZCOM has doubled since mid-2010 as the dividend yield has fallen from over 7% to 4.5%. European investors now face the same scenario of prolonged low rates, and with a yield almost 500 basis points higher than 10 year Gilts, Vodafone makes an attractive prospect for income investors. Secondly, the market perceives that because VZCOM consolidates VZW it has access to the cash flow while Vodafone does not. This is incorrect. They both have the same rights to cash flow and only receive cash when VZW pays a dividend up to its two parents. Historically VZW has been in a growth phase and the parents have received minimal dividends from the operating company, but that changed in 2011 with the first meaningful distribution to Vodafone of a healthy US$10bn.

We believe that over the coming years Vodafone will begin to receive more regular dividends from VZW because, on our numbers, VZCOM is in dire need of the cash. The U.S. parent's barely profitable fixed line business simply cannot support an annual dividend of US$5.5bn whilst servicing a $40bn debt balance.

This cash flow to Vodafone will likely result in additional distributions to shareholders over time, and push the annual dividend higher - potentially resulting in a doubling of the dividend. As an indication, if Vodafone received its full proportionate share of VZW's 2012 cash flow and paid all of it out, the stock would be trading on a dividend yield equivalent to nearly 9% today. We believe it is only a matter of time until this asset realises its full worth to Vodafone, and the market values Vodafone appropriately.



## Overseas Trips

U.S. Trip

During the quarter we visited the US to attend a **James Hardie (JHX)** investor tour in Seattle and a media industry tour which included several meetings with mid-level management at **News Corporation (NWS).**

JHX is the world's leading manufacturer of fibre cement building products for external and internal use, with the US accounting for approximately 2/3rds of JHX's global operations. Despite the precipitous decline in the US housing market over the last 5 years, JHX has remained profitable by growing its market share and significantly reducing its cost base. With an improving US housing market outlook, JHX focused on how it will grow the fibre cement market to 35% of external cladding in the US (currently 16%) while maintaining its 90% market share of the fibre cement market over the next 10-12 years. To support this growth profile, JHX will first increase the utilisation of existing plants from 65% to 80%, then re-start two idled plants and then look to build new plants.

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Two important insights as JHX rolls out its 35/90 strategy are that it will not push up operating margins if this limits growth, and that it will invest in capacity ahead of demand as the cost of being short capacity in a growing market is substantial. We expect both capital and operating expenses to be above market expectations over the medium -term.

JHX is a high-quality business with focused and proven management and a wide economic moat driven by its fibre cement intellectual property and its manufacturing and distribution network. As the US housing market continues to recover from its 1H 2009 lows of approximately 500k housing starts towards the 50 year average in the US of 1.5m (currently 750k), JHX will be in a strong trend position of growing market share in a growing market. However, JHX appears to be the default way to play a US housing recovery on the ASX and we feel that the majority of the upside from achieving the 35/90 goal in a 'normal' US housing market is captured in the current share price.

The NWS part of the tour gave us the opportunity to meet with key divisional managers and to gain greater insights into the business. In Los Angeles we met with the CEO of Fox Filmed Entertainment (c.20% of group earnings), the CEO of Fox International Channels (c.10%) and had a tour of 20th Century Fox Studios. In New York, we met with the CEO of FOX Television (c.15%), CFO of Fox News Channel (c. 20%) and the CEO of News America Marketing (<10%).

The tour gave us additional confidence in our investment thesis. We believe that NWS can achieve strong EPS growth over the medium term and cash flows will enable ongoing share buy backs of 5-10% of shares outstanding per year, without material impact on its debt position. Profit growth will be driven by growth in content fees, emerging market pay TV penetration and continued tight cost control, with a declining reliance on more volatile advertising revenue. With the majority of growth coming from high margin content fees, NWS should be able to improve its return on capital.

Aside from earnings growth, the other attractive aspect of NWS is the latent value being unlocked through consolidation and divestment of equity investments, and the planned demerger of its Publishing and Media and Entertainment businesses during 2013. Whilst we are mindful of potential corporate governance issues with an investment in NWS, positives to come out of the News of the World phone hacking scandal include a renewed focus on business discipline, improving disclosure and increasing influence of Deputy Chairman and COO Chase Carey.

NWS is well positioned to participate in and benefit from the following broad trends in the media and entertainment sector:

- value is being transferred from distributors/platforms to content owners driven by digital distribution, more on-demand viewing and consumption across multiple platforms;
- cable and TV channel earnings mix is structurally shifting to be less reliant on advertising and more driven by content fees;
- there remains a large opportunity in emerging markets to increase pay TV penetration, particularly in Latin America; and
- the majority of companies are undertaking substantial buybacks and paying dividends given strong balance sheets and cash flows.

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Asian Trip

We visited the Philippines, Hong Kong, China and Korea recently as part of our regular quarterly research visitation program. Our trip provided a timely reminder of the disconnect between the "man on the street" vibe, which was by and large positive across the board (as judged by the numbers of cars on streets, busy restaurants and shopping centres, through general conversations with a broad range of individuals, etc.) and share prices or perhaps more pertinently share market indices, as broader economic proxies.

We remain as convinced as ever about the prospects for the Asian region, although there is no doubt the external environment is having a negative impact at present, particularly on the more export-dependent open economies. We were also frequently reminded that despite all the trappings of capitalism, much of the Chinese economy remains policy driven. This has been in a "holding pattern" (comment from a leading Chinese internet company) for much of 2012 given the upcoming, once in a decade, leadership change at the Chinese Communist Party. The recent announcement of a date for the 18th National Congress suggests that the new makeup of the politburo's standing committee has been agreed. Whilst we would not expect any radical shifts in policy, which remains to transition China from an export led economy to one of more sustainable growth, clarity, particularly to the extent this extends to the provincial and local governments, would be helpful.

We caught up with Standard Chartered, a portfolio holding, in which we modestly increased our exposure over the quarter. We believe that the bank is uniquely positioned to benefit from the following themes:

- A rising Asian middle class - we understand that per capita GDP of USD 3000-5000 represents an "inflexion" point on the banking demand J curve, which bodes well for China and Indonesia, the two most populous countries in the region;
- The gradual opening up of the Chinese financial system, through both RMB internationalization as well as banking industry liberalization; and
- The emergence of new trade corridors (i.e. intra-regional and "south-to-south" as opposed to the traditional "south-to-north") given the bank’s presence in Africa, India and the Middle East.

We continue to be impressed by the bank’s management in both Asia and Europe, from our interactions with them over the years. In our view, we believe that Standard Chartered has a strong risk management and compliance culture. In regards to the recent U.S. Iranian issue, we believe that the bank is working hard to ensure an expeditious settlement with all of the relevant authorities. We believe Standard Chartered’s shares are attractively valued at current levels.

## Investment observations, trends and themes (VOF)

- Consumers deleveraging ~ Kmart has reduced the number of products they sell from 100,000 to 75,000.
- Asian markets have been poor performers in the last five years (in fact negative returns). This has been coincident with strongly rising commodity prices. The mean reversion underway in commodities may provide some beneficial cost and margin relief for some sectors.
- “As the world becomes more complex advice becomes more valuable”, CEO of Equity Trustees.
- Obamacare adds 48m people to the health system in the U.S.
- Gold ~ since 2004 the gold price has risen from US$410 per ounce (oz) to US$1683. Despite this mine production has risen modestly over the same period (2504 tonnes to 2748 tonnes). Consumer demand has been relatively inelastic to price rises as jewelery has fallen from 2616 tonnes to 1914 tonnes. Over the same period central banks have gone from sellers to buyers of gold.

- Commodities ~ many commodities are now operating close to breakeven economics defined as price being 90% on the cost curve (nickel, US gas, alumina, uranium, aluminium, coal). However, at current prices iron ore, oil, copper & gold remain highly profitable.
- Changing property occupancy usages ~ Apple replacing department stores as shopping centres traffic driver; services replacing goods.
- New emerging industries include health tourism, obesity, wellness and aged care, data hosting and storage; data insurance; tribal economics (local communities).
- Weak currencies are a precursor to equity returns which bodes well for continued U.S. recovery and support for Asian currencies (linked to the US$.)
- Recent market returns from China and U.S. are a further reminder that in the short to medium term correlations between GDP growth and equity returns are weak. Over the last 3 years the Shanghai Composite Index has returned -17% p.a. vs. US S&P 0.9% p.a.
- Emerging Market Risk ~ the Macquarie Infrastructure Fund (MIIF) has experienced a 40% devaluation on their road investment in China as a result of unexpected regulatory toll reductions.
- Most Asian direct investment is coming from within Asia and particularly the Japanese and Taiwanese;
- Sydney and Melbourne are becoming service centres for Asia.

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