CI AUSTRALIAN EQUITIES FUND
QUARTERLY COMMENTARY REPORT

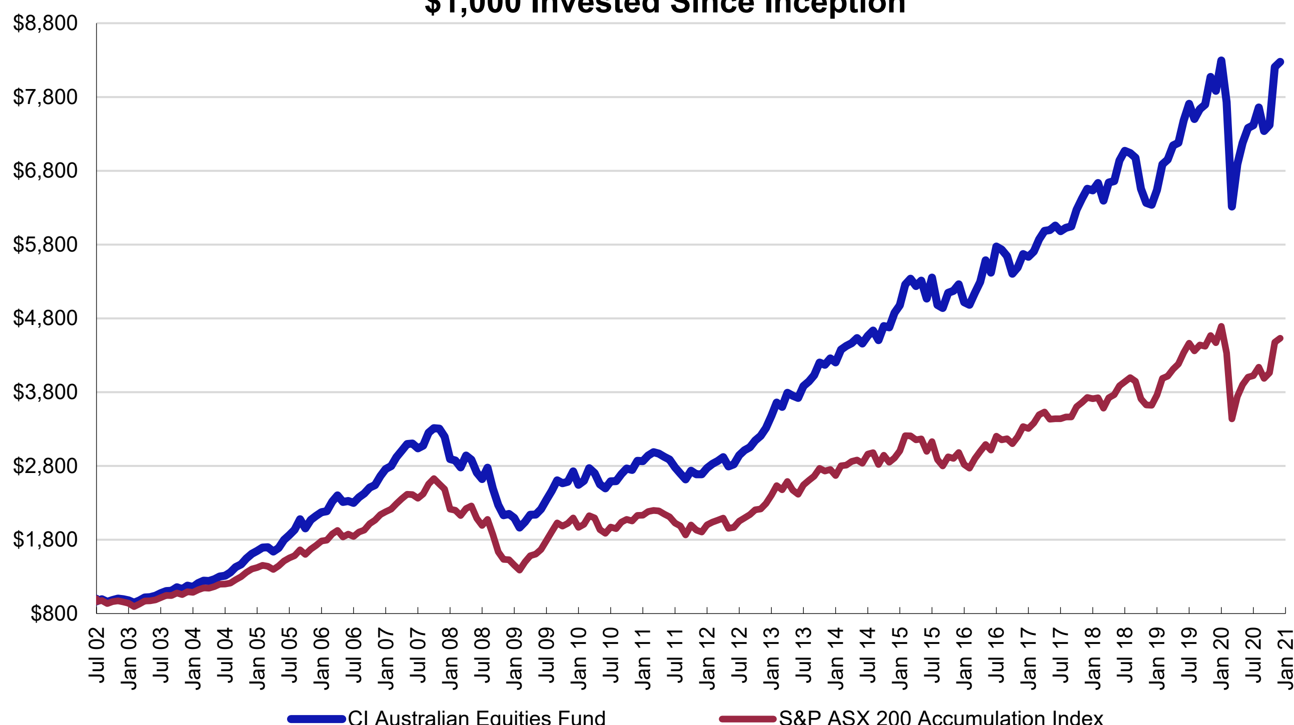
Cooper Investors Pty Limited AFS Licence Number 221794 ABN 26 100 409 890

For current performance information please refer to the Monthly Performance Report.

DECEMBER 2020

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	12.76%	13.70%	-0.94%
ROLLING 1 YEAR	4.98%	1.40%	3.58%
ROLLING 3 YEAR	8.08%	6.73%	1.35%
ROLLING 5 YEAR	9.47%	8.72%	0.75%
ROLLING 7 YEAR	9.96%	7.38%	2.58%
ROLLING 10 YEAR	11.17%	7.84%	3.33%
SINCE INCEPTION*	12.10%	8.51%	3.59%
SINCE INCEPTION^	727.65%	353.21%	374.44%

*Annualised
^Cumulative (4 July 2002)
**Before fees and expenses
#S&P ASX 200 Accumulation Index
Past performance is not necessarily a reliable indicator of future performance



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"The key is not to predict the future but prepare for it." ***Pericules***

"Uncertainty should not bother you. We may not be able to forecast when a bridge will break, but we can identify which ones are faulty and poorly built. We can assess vulnerability." Nassim Taleb

Market and Portfolio Performance

The equities markets rallied in the final quarter of the year as news on the progress of COVID-19 vaccines more than offset concerns regarding the deteriorating state of the pandemic in the northern hemisphere. The S&P/ASX 200 returned 13.7% for the quarter, helping the market deliver a positive return of 1.4% for the 2020 calendar year. Quite an extraordinary outcome considering the disruptions faced during the year and the continuing escalation in the pandemic currently being seen. Perhaps even more surprising is the strength seen in the US market, with the S&P500 rising 16.3% over the year and finishing the year at a record high.

The portfolio struggled to keep pace with the rapidly rising market in the quarter, with the outperformance of the Bank sector and Technology stocks constraining performance. Key contributors to portfolio performance for the quarter included Sims (strong recovery in both scrap steel and non-ferrous prices), BlueScope Steel (the company upgraded guidance due to strong domestic demand in Australia and elevated steel spreads, particularly in North America) and Seek (recovery in employment demand post the lock-downs in Victoria). Stocks which were the larger detractors from performance for the quarter included Orica (continued customer disruption due to pandemic and coal market uncertainty), ASX (technology related issues saw equities market closed for a period of time) and Aurizon (Chinese import restrictions create uncertainty in coal markets).

A key support for equities markets has been the significant levels of monetary and fiscal stimulus that has been undertaken on a global scale in an effort to offset the economic disruption caused by the pandemic. This environment of ample liquidity and cheap money has been very supportive of asset prices in general and equities prices in particular. The scale of this stimulus has seen equities market PE ratios rise to historically elevated levels, making markets appear over-extended on an absolute valuation basis (see chart below). However, with low, and in many cases negative, bond yields, the earnings yield on equities remains within reasonable levels relative to bonds.

MSCI 12m forward PE and global bond yields

Source: JP Morgan, Datastream, IBES

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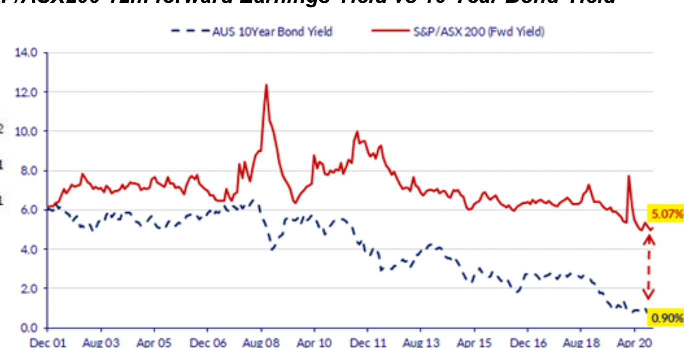
In Australia, the gap between the earnings yield and the bond yield has actually expanded, making equities market valuations appear reasonable despite the S&P/ASX 200 PE ratio approaching 20x (see the charts below). That said excluding Resources, Financials and Property the PE ratio is >30x, an earnings yield of just over 3%, indicating that there are pockets of the market that are priced with little margin for error.

S&P/ASX200 12 month forward PE

S&P/ASX200 12m forward Earnings Yield vs 10 Year Bond Yield



Source: Datastream, Factset, CLSA

As market valuations continue to push to elevated levels, it is worth reminding our clients that valuation is just one component of Cooper Investors' VoF process. Valuation itself is as much an art as a science, as can be evidenced by the tendency for market analysts' valuations to follow the share prices of the companies they cover, both up and down. There is no doubt that the low interest rate/low growth world that we find ourselves in creates a range of challenging issues for traditional valuation techniques. However over our careers we have seen many mistakes made, including by ourselves, due to the over-emphasis of valuation in the decision making process.

Value Latency, the "V" in VoF, is not the same as "value", in the way strategists think about the value/growth dichotomy, or valuation as some intrinsic measure, but is a more nuanced assessment of the latent potential of a company to outperform. To this end, our strategy is to invest in companies that have the opportunity to create value over the longer term, with management teams that have both the capability and the intentionality to execute on that opportunity. This speaks to the core of the VoF process, which is much more than just seeking out "value".

The Portfolio

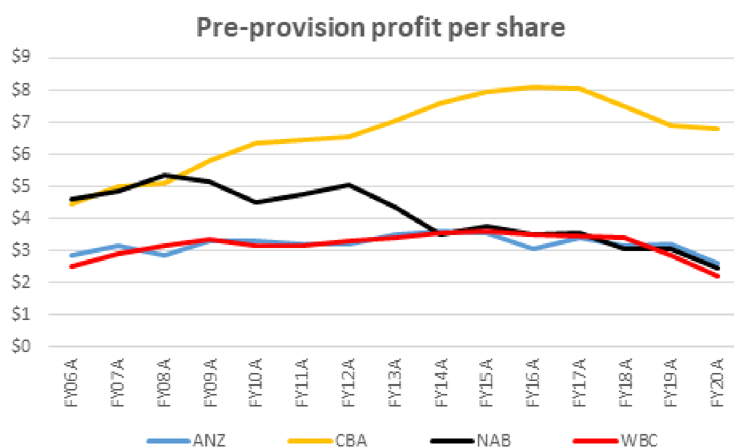
During 2020 there has been significant debate amongst global equities market strategists regarding the potential for a resurgence in performance of the value style. This comes after many years of underperformance of the value style and increasingly divergent valuation metrics between value and growth stocks. While we have never found the value/growth construct particularly enlightening in the context of the Australian equities market, a major rotation into value stocks globally could have implications for the Australian market and the portfolio. Financials, and in the Australian market this is mostly banks, typically sit within the value segment of the market. So a rotation into value stocks globally could become a tail wind for bank sector performance in Australia.

However, as a concentrated long-term investor, we seek more than short-term tactical rebounds from oversold levels or being on the right end of style rotations. We look to back management teams with the capability, opportunity and intentionality to add value over a multi-year time horizon.

The major banks' cash profit fell 37% in FY20, with materially higher impairment charges the key culprit. With the vast bulk of these impairment charges reflecting provisions for potential (but uncertain) future credit losses, and the banks having underperformed by ~50% in the last five years, it is appropriate to consider whether to retain our

underweight stance. Absent a commercial property market collapse, the banks appear to be adequately provisioned and well capitalised.

Adjusting for the often volatile impact of credit impairment charges, the major banks have only delivered pre-provision profit growth above 5% once in the last 10 years (5.8% in FY15). FY20 was the worst performance in recent memory, falling another 13%. The headwinds have been persistent and multi-faceted. This includes falling net interest margins (down 38bp in last 10 years), slowing credit growth (from mid-single digits to flat now), a big fall in non-interest income (down 33% in the last three years) and stubbornly high expenses (3.5% 10-year CAGR). This has pushed ROEs (ex. CBA) into single-digits. Add to this significant share issuance through capital raisings and dividend reinvestment plans, and pre-provision profit per share for most major banks is now lower than it was 15 years ago (the notable exception is CBA). This speaks to all three of capability, opportunity and intentionality.



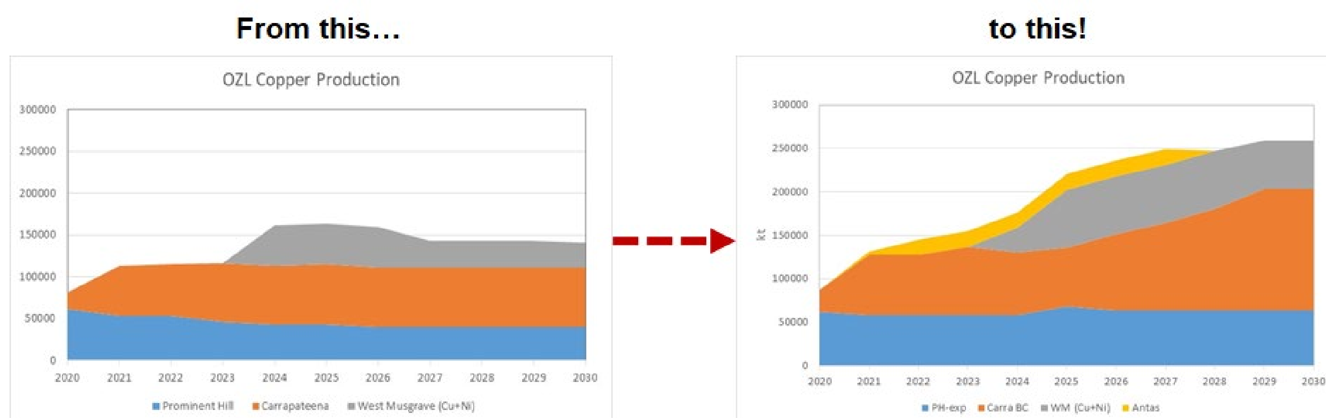
Looking forward, record low interest rates look set to intensify the margin headwind. While low rates could provide some support to credit growth, Australia already has among the highest household debt in the world; as such, the capacity (and desirability) to take on more debt is limited. Non-interest income trends should remain weak as banks exit non-core businesses, egregious fees and charges are eliminated and trading income normalises. Expenses are hard to remove given the need for continued investment into technology, risk management and compliance. Pulling this all together, low single-digit pre-provision profit growth seems the most likely – perhaps even an optimistic – outcome.

In the spirit of humility, we recognise the risks to our underweight stance. The margin headwinds could get some offset from changes to the funding mix, including access to cheap government facilities. Further, if – as we suspect could be the case – provisioning proves excessive, large write-backs would support cash earnings growth. Bank capital looks very robust (11-12% CET1 ratios), which should support the quick resumption of dividends and potentially capital returns for the likes of CBA.

As such, we balance our underweight sector stance with positions in CBA and NAB. While CBA is persistently dismissed as “too expensive”, we believe this underappreciates the quality of the franchise. As the chart above highlights, it clearly has the best track record over the past decade. This reflects superior scale, funding cost advantages, ongoing investment into technology and management capability. We believe NAB has become more stalwart-like in recent years given the exit from problematic offshore units and higher-risk exposures. While the track-record over the past decade is weak, we are willing to back the new Chair (Phil Chronican) and CEO (McEwen) given their strong backgrounds and clear mandate for change.

Oz Minerals (OZL) has had a busy finish to what was a year of substantial activity for them, and a strong year of outperformance. Management announced that the ramp-up of the new Carrapateena mine was complete in the December quarter, 6 months ahead of schedule. Additionally the company completed the acquisition of Cassini early in the quarter, as well as delivering updates on the Prominent Hill expansion study and the pre-feasibility study for their West Musgrave development. Both of which show the potential of these projects to add value for shareholders. On top of this, each of their operations and projects has the potential to deliver value above what we ascribe today. This includes development of additional resources at Carrapateena, exploration and development near their Antas processing facilities in Brazil, moving forward on CentroGold, and bringing in additional resources in the West Musgrave province.

This is a far cry from the state that the business was in when Andrew Cole took over as CEO in 2014. At that time the Prominent Hill mine was struggling with costs and looked to have minimal mine life, and the Carrapateena project was a high capital cost development that the company did not have the ability to fund. Even within the last 12 months the progression of the Carrapateena block cave expansion and the West Musgrave, Antas Hub and Prominent Hill expansions have significantly changed the potential production profile of the company and added value in the process. When we talk about investing in management teams with capability and intentionality this is what we mean.



Source: Cooper Investors, Oz Minerals company documents

Currently, our key concern with OZ Minerals as an investment proposition is the elevated level of speculative activity evident in the copper market. The copper price currently sits above US$3.50/lbs. This is at the top end of the cost curve in a market that appears to be broadly balanced in terms of supply and demand. We do see the need for elevated prices over time to incentivise additional supply, particularly if the electrification of the economy becomes the primary solution to deliver a reduction in greenhouse gas emissions. However, as we have seen in other "green' linked commodities, speculative bubbles have a tendency to come and go, driven by periods of excess of supply or demand, even as the longer term trends continue to play out. It would appear as if the cheap money and excess liquidity, mentioned in the introduction above, is not just flowing into equities markets.

Irrespective of shorter term fluctuations in the copper price, we are confident that OZL's management team will continue to execute on the opportunities they have with a clear intent of creating value for shareholders, as has been evidenced over the past year.

Orica (ORI) has been one of the more disappointing performers for us this year having been the largest detractor from performance for 2020. What makes this year most disappointing is that it has come after the company began to deliver solid results and outperformance in 2019. The company's performance in 2020 can in part be explained by the impact of the pandemic which has resulted in some of ORI's customers' operations being disrupted, particularly in Europe and South America. Mine closures and restrictions on staffing levels have diminished the demand for

blasting services and equipment. However, this does not explain all of the underperformance, as despite this disruption the company still reported $605m EBIT for the financial year ended 30th September 2020, down 9% from the previous year. Additional uncertainty has been added with China reportedly banning imports of Australian sourced coal. The Australian east coast coal producers are a key market for Orica's explosives and initiating systems. Although China was approximately 23% of Australia's coal exports in 2019, the ongoing bans from China may have less of an impact than feared on Australian coal exports, over the longer term, as supply chains adjust and the higher quality coal that is supplied from Australia is still in demand. This demand is evident by the strong recovery seen in NSW export thermal coal prices towards the end of last year, which are up more than 50% from their lows of the year.

Despite the more challenging than expected conditions experienced in 2020, Orica continues to improve the business through investment, rationalising operations and implementation of new enterprise planning software. This will put the business in a position, post-pandemic, to take full advantage of improving end-markets. This opportunity for self-help, combined with the company's investment in technology that has the potential to transform the drill and blast operations of mining companies and improve end-to-end mine process productivity, underpin our investment proposition for Orica. That said, it is absolutely critical that management deliver on the opportunity through excellent execution that ensures delivery of the earnings promised to the market. This inability to meet their own earnings expectations has been our key disappointment with the company over the last few years. We believe the company's communication has left a lot to be desired. Although the pandemic can be used to explain the initial reduction in profit forecasts, management's inability to adequately reflect the uncertain industry conditions in their outlook has subsequently led to further downgrades, loss of credibility and poor stock price performance. We hope the company has learnt from the last two results presentations and will cater for the uncertainty in such a way that they do not keep providing negative updates to the market.

Unfortunately the pandemic has delayed the realisation of the earnings potential we see in Orica, however the company is well positioned to come out of the pandemic in a stronger position leveraged to the mining industry that should see strong demand once the pandemic subsides.

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 (~$3ps). 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.

The **Santos (STO)** investor day in November highlighted the number of value creation opportunities across their portfolio that are all within management's control. The intentionality and capability of management to deliver on these opportunities was also evident both by progress on existing growth projects and the focus on additional latency opportunities. Progress on growth projects include the tolling agreement between Barossa and DLNG (final investment decision (FID) targeted for 1H21), the Moomba carbon capture and storage (CCS) project now FID ready, subject to Australian Carbon Credit Units eligibility, the Narrabri gas projects receiving government approvals and drilling of potential additional low cost tie backs to Dorado being planned to maximise value at FID (targeted for 1H22). Management have also identified an opportunity to drive value from the midstream infrastructure assets, by running them as a separate infrastructure business, delivering increased efficiency, utilisation and reducing emissions, as well as providing optionality for ownership level flexibility moving forward. This combination of opportunity, intentionality and capability to add value over the next 2-3 years, in our view, sets STO apart from large cap, ASX listed oil and gas peers.

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

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a timeline for monetisation of its mobile towers. The stock has substantially underperformed both on an absolute and relative basis over the past 5 years, and the value creation opportunity within its infrastructure assets plays a key part in turning around this underperformance.

The new corporate structure under the Telstra Group will be split into three subsidiaries: 1. InfraCo Fixed, 2. InfraCo Towers, and 3. ServeCo.

InfraCo Towers will own and operate the passive tower assets, whilst ServeCo will own the active components of the network including the radio access network equipment, spectrum and other electronics. This, when combined with the tenancy arrangements between the two entities, will ensure that Telstra preserves its network advantage in the mobile market. The monetisation process of the towers will commence in CY21.

InfraCo Fixed will own and operate Telstra's remaining passive infrastructure, which includes the five separate entities; Ducts, Fibre, Data Centres, Subsea cables and Exchanges. This provides flexibility to monetise parts of the individual assets or de-merge/sell as a group in the future. ServeCo, along with owning the active components of the infrastructure assets, will own and operate the retail businesses.

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.

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