CI AUSTRALIAN EQUITIES FUND

COOPER INVESTORS

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"Bad times coupled with good reflections provide some of the best lessons." – **Ray Dalio**

"For a piece of information to be desirable, it has to satisfy two criteria: it has to be important, and it has to be knowable." – **Warren Buffett**

"A clever person solves a problem. A wise person avoids it." – **Albert Einstein**

"Paradoxically, the man who has failed and one who is at the peak of success are in the same position. Each must decide what to do next." – **Jigoro Kano**

MARKET AND PORTFOLIO PERFORMANCE

The portfolio struggled to keep pace with the benchmark during the quarter, rising 6.0% versus the ASX200 Accumulation Index's 9.4%. Frustratingly, this eliminated much of our outperformance in the prior three quarters and the portfolio ended 2022 at 0.6% above the index.

The bulk of the quarter's underperformance is attributable to two stocks: Star Entertainment and Lendlease. Star took yet another blow after the NSW Treasurer surprised the market by announcing a proposal to significantly increase gaming taxes. Lendlease was weighed down as global capital providers paused to consider the impact from higher interest rates and growing economic uncertainty.

We make no excuses here and have reflected deeply on the lessons. For Star, we overestimated organisational capability, while underestimating the mounting threat to operating trends and industry structure from regulatory and exogenous risks. In Lendlease's case, we were not sufficiently responsive to adverse changes in operating trends.

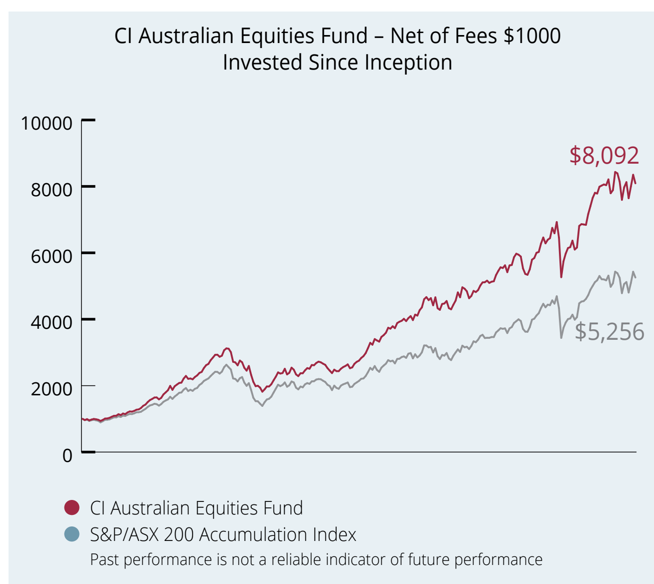
On a brighter note, QBE (further progress on turnaround), EBOS, Orica (favourable operating trends) and Qantas (multiple guidance upgrades) were positive contributors.

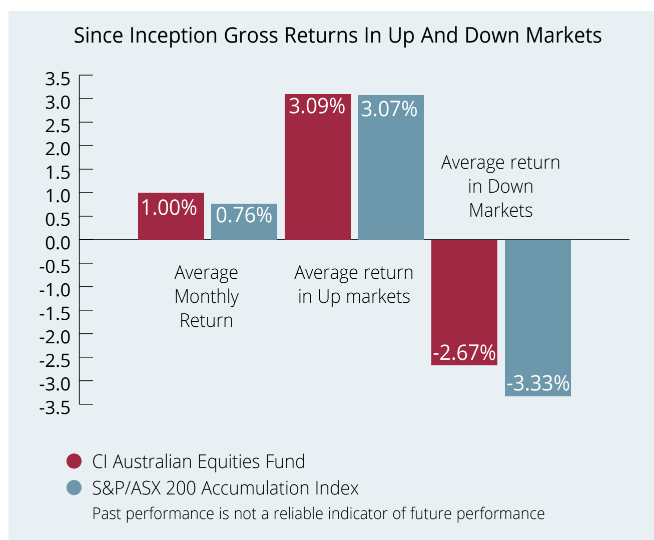
Our sector underweights in banks and miners were modest drags. Bank outperformance in October gradually reversed through the rest of the quarter. Meanwhile, the mining pluses (BHP overweight, no exposure to lithium) were not quite enough to offset the minuses (RIO/FMG underweights).

Like most, we enter 2023 grappling with various financial, macroeconomic and geopolitical considerations that could have profound implications for financial and commodity markets.

	**Portfolio	#Benchmark	Relative
3 months	6.08%	9.40%	-3.32%
1 year*	-0.51%	-1.08%	0.57%
3 year*	7.99%	5.55%	2.44%
5 year*	8.65%	7.11%	1.54%
7 year*	9.49%	8.43%	1.06%
10 year*	11.60%	8.66%	2.94%
Since inception*	11.85%	8.43%	3.42%
Since inception^	892.76%	425.57%	467.19%

* 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





These include:

- The trajectory and pace of China's reopening.
- The extent to which a developing slowdown in the rest of the world will offset this.
- How long inflation remains high and how central banks respond.
- The sustainability and implications of widespread quantitative tightening.
- The outlook for international affairs, including Russia-Ukraine and US-China relations.

In truth, we simply do not know all the answers. No one does. While these 'big picture' questions clearly satisfy the first criteria in Buffett's earlier quote of being "important", we cannot delude ourselves into thinking the outcomes are "knowable" with a high degree of conviction. The world is simply too complex, with innumerable contributing factors and reflective interactions.

That is why we view macro forecasts with scepticism. Such predictions rarely prove correct. When they do, we suspect this is more a function of good luck than a consistently repeatable process that one can rely on. As such, we will avoid adding to the chorus of year-ahead prognostications. Rather than engage in guesswork, we prefer to focus our efforts on pattern recognition and the observable facts, information, behaviours and actions that are precursors to long-term value creation.

What we can observe is:

- In our frequent travel during 2022, we consistently witnessed buoyant consumer behaviour.
- However, anecdotes of weakening activity are starting to emerge.
- Unemployment is incredibly low, though it is hard to discern transient versus structural effects.
- Inflation is higher than this time last year but seems to be moderating.
- Interest rates continue to rise, albeit the market is now better anticipating each move.
- The level of debt in the world is truly enormous, particularly at government level.

- Liquidity is shrinking and so are asset prices in 'bubble-like' pockets.
- Sharp reactions to events like the UK pension fund solvency crisis show that fragility is high.
- China is emerging from a prolonged lockdown with elevated personal savings and looser policy.
- However, Chinese authorities are showing little appetite for very large-scale stimulus.

If we step back further and dwell on longer-term thematic trends, we can also observe:

- A heavily financialised world with a reliance on ever-increasing leverage to sustain growth.
- Worsening demographics in Developed Markets and Emerging Markets (e.g. China, Japan).
- Inequality is creating social tensions, which is fuelling distrust, populism and balkanisation.
- Big investments into addressing climate change, accompanied by underinvestment into conventional energy.

These all matter insofar that they feed into our assessments of the opportunities, operating trends, industry conditions and management behaviours that determine risk-adjusted value latency. In turn, this drives our stock selection and portfolio management decision-making. History has taught us that it is the disciplined execution of our process that determines successes and failures, rather than brave directional bets based on bold binary predictions.

THE PORTFOLIO

The banks reported their results during the quarter. With the good news well-anticipated (higher margins, benign asset quality), and the bad (higher costs) not, they have underperformed since. Looking forward, rising cash rates and an elevated swap curve will continue to support profit growth into FY23. However, the outlook becomes tougher after that given intense mortgage competition, rising deposit betas, falling credit growth, continuing cost pressure and the spectre of asset quality deterioration as cost-of-living pressures rise.

The domestic retail banks fall into our "Stalwart" Subset of Value Latency. We look for strength, sturdiness, best-in-class competitive positions and robust track-records in such companies. Among the retail banks, we still consider **CBA** and **NAB** to best demonstrate these qualities.

Miners saw particularly sharp moves during November as enthusiasm around China reopening grew. While more accommodating government directives provide cause for optimism, observable evidence remains mixed with various activity indicators still weak. The evolving nature of government priorities (e.g. shrinking appetite for very large-scale debt-intensive stimulus, less reliance on commodity-intensive exports, desire to stamp-out housing speculation) also calls into question the extent of potential upside. Overall, the demand outlook for most commodities looks uncertain, with hopes for a Chinese re-opening/stimulus balanced by the prospect

of slowing activity elsewhere. Supply trends are commodity-specific but often risk exceeding demand growth, leaving markets in surplus.

We prefer to adopt a contrarian approach when investing into Cyclical stocks, like miners. The best opportunities usually come when operating conditions are at their worst and cost curve support is strong. While many commodities started to approach (and in some cases like aluminium, dig deep into) the cost curve, equities valuations remained frustratingly high. This presents a dilemma, with the prospect of Chinese reopening clearly creating a potential tailwind, but valuation support being minimal post the recent rally. Our preferred exposure remains **BHP**, which we believe has the highest quality assets and management team. **Oz Minerals (OZL)** has long been a favourite of ours, but its acquisition by **BHP** now looks a formality.

During the quarter, we also attended a mining tour in Chile. This included seeing the largest lithium salar globally, a lithium carbonate processing plant and meeting companies with producing assets, development options and new technologies such as Direct Lithium Extraction (DLE). The size and scale of the Chilean lithium brine assets was astounding, as is their now proven ability to expand. This is evidenced by the two producing operators, SQM and Albemarle, having quadrupled capacity in the last three years (with the expectation to continue to ramp up production over the next 12-18 months). While the Chilean resource base could facilitate such expansions multiple times over, it is likely to be significantly more modest over the short to medium-term given uncertain fiscal/government positions on lithium and environmental concerns around brine extraction. That said, the time and money going into DLE technologies was evident, as was the ability for such technologies to address extraction concerns. Whilst these direct extraction technologies have a long way to go, if proven at scale, they have the potential to be a material supply side shock, unlocking the significant production latency in brine assets globally. With increasing evidence of elevated inventory levels across the lithium supply chain in China (both batteries and electric vehicles), the scaling back of Chinese EV subsidies and a weak global economic environment, risks around demand growth over the next 6-12 months relative to expectations remain high. Coupled with significant new supply into development and pricing at extremely elevated levels relative to the cost curve, we remain cautious on lithium in the short term.

The period started positively for **Star Entertainment (SGR)**, with the NSW Independent Casino Commission (NICC) announcing disciplinary action in accordance with our expectations. Specifically: (i) licence suspension, not termination; (ii) the appointment of an external manager; and (iii) a $100mn penalty covering all breaches outlined in the Bell Review report. Star received notice of similar disciplinary action for its Queensland operations later in the quarter. The AGM trading update on 21 November highlighted softer trading than expected for the Sydney casino, but not materially different to our estimates and partly offset by strong results in Queensland.

The exogenous shock we weren't expecting was the NSW government's proposal for higher casino gaming taxes. Details were limited, but the stated quantum of the tax increase relative to earnings is as severe as we have seen for any business, let alone a major employer and generator of economic activity for the state. It also comes after Star agreed gaming tax rates with the NSW government for 20 years until 2041. It remains to be seen whether the additional tax is introduced given the pending NSW election (25 March), with no parliament sitting dates between now and then. Star is now trading at its net tangible asset value of around $1.80 per share, which theoretically ascribes no value to the company's casino licences.

More broadly, this highlights some important themes to watch across our broader portfolio: (i) the potentially severe consequences of losing your social licence to operate; (ii) the broad-ranging implications of budget deficits; and (iii) the increasingly interventionist nature of Australian governments (another example is the recent intervention into gas markets). When all three come together, as has been the case with Star, the outcomes can be dire.

During the quarter, portfolio company **Woolworths (WOW)** announced the acquisition of a 55% stake in Petspiration for $586mn (11x EV/EBITDA multiple). Woolworths will fund the transaction from the recent selldown of a 5.5% stake in **Endeavour Group (EDV)**. Petspiration offers premium pet food, accessories and services through various brands across Australia and New Zealand, most notably via the PETstock retail stores. The company has 276 retail locations, 65 vet clinics, 162 grooming salons, an online offering and over 2.4mn loyalty members.

In isolation, the acquisition appears sensible. An 11x multiple strikes us as relatively full given elevated earnings in the pet category. However, we have long viewed animal care as an attractive category and already maintain exposure via our holding in EBOS (owners of leading pet brands Black Hawk and Vitapet). Industry conditions are supportive. Since the beginning of the pandemic, the Australian pet population has grown ~7%, with ~70% of households now owning a pet. The underlying trend of pet "humanisation" has compelled owners to spend more on their pet's needs, fuelling sales of premium pet food, treats and accessories. WOW is guiding to a mid-teen IRR and expects to add value to Petspiration through

supply chain optimisation, improved commodity sourcing, store merchandising and promotional effectiveness, advanced use of data analytics and an improvement in the current ecommerce offering.

WOW has been increasingly active in its capital allocation recently, including a number of acquisitions (i.e. PFD, MyDeal, Shopper Media Group, Quantium). Although individually small, these acquisitions involve both a financial investment (cumulative ~$1.8bn) and allocation of management focus. We continue to seek evidence these investments can deliver meaningful returns for shareholders.

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