CI Australian Equities Fund

COOPER INVESTORS

QUARTERLY COMMENTARY | DECEMBER 2023

AFS LICENCE NUMBER 221794 ABN 26 100 409 890

"It's not supposed to be easy. Anyone who finds it easy is stupid" - **Charlie Munger, Vice Chairman - Berkshire Hathaway**

"People calculate too much and think too little" – **Charlie Munger, Vice Chairman - Berkshire Hathaway**

"If you don't know where you are going, every road will get you nowhere" – **Henry Kissinger**

"The absence of alternatives clears the mind marvellously" – **Henry Kissinger**

Rest In Peace to two of the greats.

MARKET AND PORTFOLIO PERFORMANCE

The portfolio returned 7.1% for the December quarter, underperforming the S&P/ASX 200 by 1.3%.[1]

The bulk of this underperformance came late in the quarter as the market rallied aggressively on falling bond yields.

The largest detractors were Fortescue (not owned during a period of rising iron ore prices), QBE and Computershare (negative sentiment towards beneficiaries of higher interest rates), and CBA (large stock not owned during period of outperformance).

Key positive contributors included Woodside Energy (not owned during a period of oil price weakness), Seek (positive AGM update), CSL (improving operating trends), Reece (strong performance from building material stocks), and WiseTech (benefiting from falling bond yields).

GENERAL OBSERVATIONS

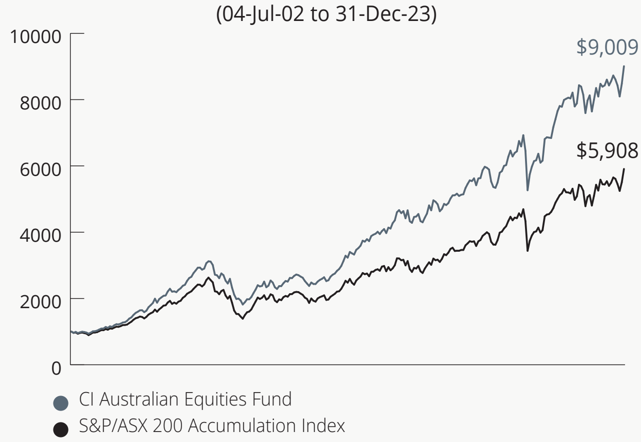
Stock movements during the quarter were heavily influenced by a dramatic reversal in interest rate expectations. The US 10-year Treasury yield fell by ~0.5% and the market is now pricing five US rate cuts in 2024. This was the catalyst for a sharp equity market rally (ASX 200 up 8.4%), including significant outperformance from lower rate beneficiaries such as growth stocks and bond-like equities, along with underperformance from stocks that are adversely affected (e.g., insurers, and financial/tech companies like Computershare).

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

	**Portfolio	#Benchmark	Relative
3 months	7.11%	8.40%	-1.29%
1 year	12.16%	12.42%	-0.26%
3 year*	10.40%	9.25%	1.15%
5 year*	11.93%	10.28%	1.65%
7 year*	10.12%	8.52%	1.60%
10 year*	10.09%	7.93%	2.16%
Since inception*	11.87%	8.62%	3.25%
Since inception^	1013.50%	490.84%	522.66%

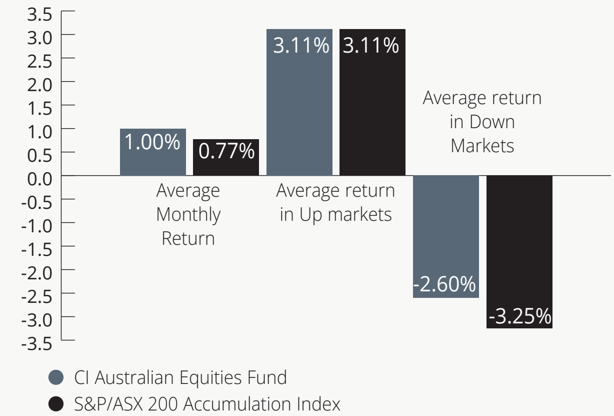
* Annualised
^ Cumulative (since the inception date of 4 July 2002)
** Gross of fees and expenses
# S&P/ASX 200 Accumulation Index
Past performance is not a reliable indicator of future performance
Source: Internal CI data reports, 31 December 2023

CI Australian Equities Fund – Net of Fees $1000 Invested Since Inception
(04-Jul-02 to 31-Dec-23)



Past performance is not a reliable indicator of future performance
Source: Internal CI data reports, 31 December 2023

Since Inception Gross Returns In Up And Down Markets



Past performance is not a reliable indicator of future performance
Inception Date of the Fund was 4 July 2002
Source: Internal CI data reports, 31 December 2023

At first glance, this is logical given lower discount rates increase the value of future earnings. However, on deeper reflection, various uncertainties have become more acute. These include:

- How does one reconcile the expectation for such aggressive rate cuts, which imply significantly weaker growth, with such a sharp equity market rebound?
- If the expectation is for a 'goldilocks' scenario of moderating inflation without demand destruction, how does one justify this confidence given central banks' patchy record at managing cycles, and the fact that the lagged effects from the period of aggressive tightening are still working their way through the system?
- With the Federal Reserve's Quantitative Tightening programme subtracting ~$250bn per quarter from US money supply, bank lending slowing and reverse repo rapidly drawing down, could a liquidity squeeze unfold that causes a self-reinforcing downturn?
- How much structural damage was caused to the system by unproductive capital misallocation during years of loose monetary and fiscal policy? Once the dust settles, do we simply return to the pre-COVID world of secular stagnation with minimal growth?

These are important questions with meaningful consequences. However, the history of macro forecasting is littered with failed prognostications. This is unsurprising – macro forecasting is complex and influenced by a vast array of reflective feedback loops. Rather than engage in guesswork, our approach is to remain disciplined around the observational practice. We seek to identify the behaviours, facts and figures that are the precursors to long-term value creation and then position accordingly. Observation not prediction.

While conceptual questions such as the above are on our mind, our recent travels have also observed an underlying resilience in most economies. This appears to reflect a combination of cyclical (e.g., low unemployment, still plentiful liquidity) and structural (e.g. substantial economically-insensitive policy support for initiatives like decarbonisation and onshoring) drivers.

Given the range of uncertainties, we continued to endeavour to run a balanced portfolio that is resilient to various scenarios and driven by evolving assessments of risk-adjusted value latency. An example of this was our increased allocation to Growth stocks in the last quarter as we saw this subset become relatively more attractive.

TRIP INSIGHTS

Asia

Iron ore's continued strength (+13% to over US$135/t) was another feature during the quarter. This resilience is particularly stark given the widespread view that iron ore had a poor fundamental outlook based on supply/demand imbalances and the weakness observed in other parts of the commodity complex, such as nickel being down 12%.

While this was partly driven by speculation of potential Chinese stimulus, there is also evidence of tightness in physical markets. Observations from our November trip to China include a subdued, albeit stable, property market with anecdotal evidence of green shoots in leading indicators such as visitations. This was countered by anecdotes of disappointing seasonal trends.

Outside of the weak property market, there was broad evidence of resilience in the general economy. The consensus is that the government is shifting the policy focus away from property as the economic driver, and towards less steel-intensive infrastructure and manufacturing. Any property stimulus, such as shanty town redevelopment, is likely to be focussed on addressing developer inventory.

Chinese steel mills appear to be loss-making due to subdued domestic demand; subsequently, there is an increased focus on export markets to place volume. However, there was no observable evidence of meaningful mill closures to date. Ultimately, it is lower steel mill utilisation (or closures) that are required to see a downward change in iron ore demand.

A widespread theme across various industries (e.g., steel, EV supply chain, solar) was oversupply relative to domestic demand. This is resulting in product being placed into export markets. This dynamic does not appear to be driven by slowing domestic demand (with the potential exception of steel), with observable evidence of underlying resilience in the economy (excluding property). Instead, the driver appears to be the quantum of supply that has come to market over the last ~12 months following a period of heightened profitability in these industries. The weak supply/demand fundamentals across these sectors have resulted in falling end product prices and weak industry profitability.

This theme was particularly evident across our lithium industry meetings. On the raw material side, the pace of development in both Chinese and Chinese-owned African supply is remarkable; it now represents ~30% of global lithium raw material supply. Producers continue to expand and develop mines in China and Africa at marginal costs that are competitive with western world supply. At the chemical level, independent lithium hydroxide convertors have been loss-making for the past 3-6 months with clear signs of oversupply.

On the demand side we observed consistent feedback of weaker-than-expected demand, both in China and the western world (Europe/US), with inventory build across the supply chain (EV's, batteries). The nature of incremental demand in China appears to be changing as increasing EV penetration relies more on Tier 2 and 3 cities given EV's in Tier 1 cities already account for 50-70% of new car sales. In Tier 2 and 3 cities, hybrids appear the most popular option for a range of cultural, cost and infrastructure reasons. Given that hybrid batteries are about a quarter of the size of those in BEV's, they require significantly less lithium, therefore, despite the significant fall in lithium prices we remain cautious given the observation of supply and demand trends.

US

We have previously commented on the increased investment sweeping the US economy in the form of the Inflation Reduction Act (IRA), the Infrastructure Law and the onshoring of US industry. We see this as one of the most significant structural trends in the western world today. Observations from our trip to the US in December reinforce this developing trend. US businesses are excited by, preparing for, or already benefitting from all these investments. Onshoring, or near-shoring, is here and now in terms of impacting activity levels, whereas the IRA and infrastructure programs are nascent.

Onshoring activity is well underway and has potentially significant implications across the US supply chain. We spoke to several participants in the steel supply chain who are already benefitting from the subsidies that encourage chip manufacturing on US soil. This is creating greater demand for steel used in these state-of-the-art facilities. Demand for engineering and construction expertise to support local development is at all-time highs.

In 2021, President Biden signed off on the Bipartisan Infrastructure Law. This program includes US$1.2 trillion of investment into transportation, energy and climate infrastructure projects. Some describe this as the most significant infrastructure investment that we will see in our careers. This expenditure is gradually working its way through the various regulatory and bureaucratic processes needed before projects can begin. Infrastructure investors are beginning to access funding that enhances the economics of infrastructure projects across the US. Supporting industries and services are gearing up to meet this demand. The steel industry in particular is investing in additional capacity in preparation for the next wave of infrastructure investment.

We spoke to several industry contacts preparing for investment associated with the IRA (climate legislation that contains significant funding for programs that will accelerate the US transition to Net Zero). It 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 storage and green hydrogen. Although there are still administrative bottlenecks within the bureaucracy that make securing IRA funding a challenge, this has improved since our trip in June, and more projects are receiving funding approvals.

Perspectives are mixed as to whether a change in administration would materially impact the nature and quantum of these spending programs. Our conclusion is it is too early to tell. There are several structural factors that may ensure investment persists, including reduced reliance on China, transition to Net Zero, and an underinvestment in infrastructure across the US.

The ramifications of this investment spend are multi-faceted in nature, from both an industry and economic perspective. The availability of capacity across a range of industries will be a constraint and the availability of labour to meet the demand will be challenged.

From an Australian equity market perspective, there are limited avenues for getting direct exposure to this trend. We remain positioned for these developments through our positions in Worley (WOR) and Macquarie (MQG).

Despite the optimism these spending programs are creating across certain industries, we observed softer demand trends across a range of industries that suggest a weakening of the US economy. This included persistent destocking in consumer staples, consumer discretionary spend, housing-related products and declining waste volumes. This leaves us somewhat cautious regarding US demand growth as we head into the new year.

BANK REPORTING SEASON REFLECTIONS

The major banks' pre-provision profit fell 9% sequentially in 2H23 – the equal worst outcome in the last 15 years. Trends were consistent across all the banks: lower revenues (intense retail competition) and higher costs (widespread inflationary pressure). Some protected margins but lost volumes, with others gaining volume but sacrificing margin. In other instances, some focussed on deposits but were hit on lending, with others focussing on lending which impacted deposits. In the end it didn't matter – they all netted out to roughly the same. None could defy gravity.

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The sector was remarkably resilient given the circumstances, broadly tracking the market. We suspect this reflects a combination of subdued expectations, undemanding valuations, strong capital positions supporting buybacks, and solid net profit trends given impairment charges remain incredibly low.

As a concentrated investor with a long horizon, we seek materially more risk-adjusted value latency before becoming positive. This could take one of two forms: a pullback in valuations creates significant latency or upgrades to our risk adjustments. For now, operating trends continue to disappoint, the industry is behaving irrationally, and management teams have struggled to generate value for most of the past two decades.

Our two retail banking exposures remain **NAB** (continued disciplined execution should narrow the valuation gap to CBA) and **ANZ** (underappreciated risk-adjusted value latency from initiatives taken to reshape the institutional division into a higher-returning, lower-risk business).

OTHER STOCK NEWS

In early December, **Santos (STO)** confirmed it has engaged in preliminary discussion with **Woodside (WDS)** regarding a potential merger. Our investment proposition in Santos centres around a low cost, highly cash flow generative base business, with an opportunity to create significant value beyond this through a suite of development projects in traditional Oil and Gas (O&G) as well as Carbon Capture and Storage (CCS). Such projects include Barossa, Dorado, Narrabri, future Pikka phases, Moomba CCS and Bayu Undan CCS. This opportunity set, combined with a management team who have the capability and intentionality required to execute underpins our investment proposition.

The execution of this development pipeline does not require a merger with WDS, or any other industry participant, to be delivered. Hence, for a potential merger to be compelling it would require compensation for the risk adjusted value latency that we see in Santos' portfolio today.