

CI Australian Equities Fund



AFS LICENCE NUMBER 221794
ABN 26 100 409 890

QUARTERLY COMMENTARY | MARCH 2023

“No amount of sophistication is going to allay the fact that all of your knowledge is about the past and all your decisions are about the future” – **Ian E. Wilson (former Chairman of GE)**

“The great joke is that the next time is never like the last time, and yet we can't help readying ourselves for it anyway.” – **Peter Lynch**

“There are no new eras – excesses are never permanent” – **Bob Farrell**

“I was seldom able to see an opportunity until it had ceased to be one” – **Mark Twain**

MARKET AND PORTFOLIO PERFORMANCE

The portfolio rose 4.4% during the quarter, outperforming the index by 0.9%

The biggest positive contributors were Westpac (not owned at a time of bank sector weakness), Brambles (strong result, upgraded guidance), Woolworths (defensive characteristics, progress on cost out), Aristocrat (resilient demand, encouraging early signals on RMG strategy) and QBE (continued progress on turnaround).

The key detractors were Newcrest (not owned when bid by Newmont, gold price rebound), Star Entertainment (capital raise), NAB (bank sector underperformance), Cleanaway (general weakness) and Tabcorp (challenging industry conditions).

Our underweight position in banks, which struggled on the back of growing earnings headwinds and systemic concerns following the emergence of banking system stress offshore, was a notable tailwind. Our underweight in gold miners, which rallied strongly on the back of these same systemic fears, partly offset this.

OBSERVATIONS FROM THE ROAD

After a couple of COVID-interrupted years, our team is back on the road in earnest. These trips are an invaluable part of our investment process given they provide unique insights into the observable facts, information and behaviours that are the precursors to value creation. Through repetitive observations we build networks and enhance our ability to identify subtle inflections in opportunity sets, operating trends, the strategic environment and management actions. The more often we do it, the greater the compounding return on time invested.

	**Portfolio	#Benchmark	Relative
3 months	4.37%	3.46%	0.91%
1 year*	0.91%	0.10%	0.81%
3 year*	17.95%	16.53%	1.42%
5 year*	10.13%	8.70%	1.43%
7 year*	10.51%	9.39%	1.12%
10 year*	11.15%	8.18%	2.97%
Since inception*	11.94%	8.51%	3.43%
Since inception^	936.19%	443.77%	492.42%

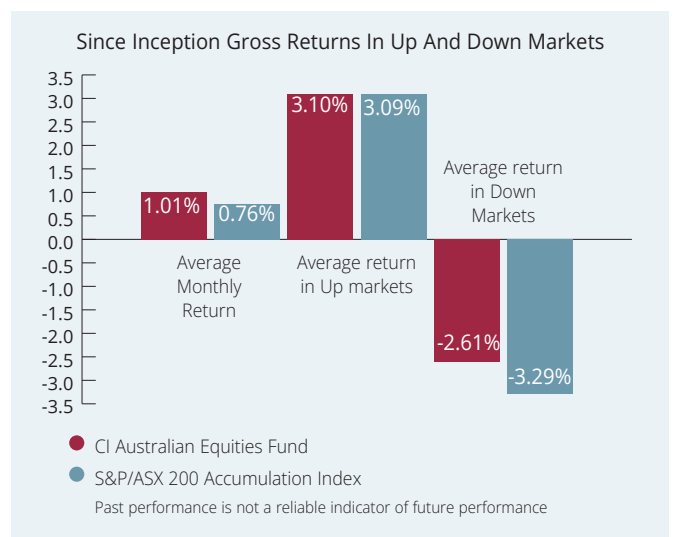
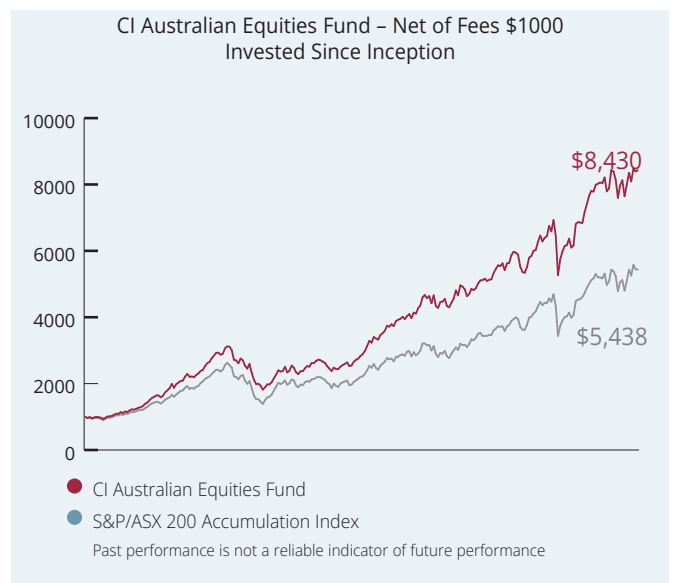
* Annualised

^ 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



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This quarter's trips included:

Visiting **Orica's (ORI)** manufacturing operations in Peru and Canada, including meeting local management and personnel. We came away with increased confidence in the margin recovery opportunity that has begun to play out, which is a function of both improved commercial discipline and industry supply constraints. We also gained comfort in the potential for incremental growth and value creation from the increasing market penetration of electronic and wireless detonators over the medium-to-longer term.

The increased commercial discipline and linkage of product manufacturing with commercial targets/outcomes has been assisted by the long-delayed, but now complete, implementation of the SAP enterprise management system. The signs are encouraging and continue to support our investment thesis of both a nearer-term reversionary opportunity and longer-term value creation potential. Industry operating trends remain supportive, although we will continue to be vigilant as to the potential for price-based competitive pressures.

We also attended **Macquarie's (MQG)** three-day investor tour in the US. While we were already familiar with the key themes, the various presentations and asset tours allowed us to peel back the layers of opportunity further. Crucially, this included exposure to the key divisional personnel involved in delivering on the opportunity set. As is often the case with Macquarie, we were impressed with what we saw. This further enhanced our comfort in the investment thesis predicated on backing expert value creators with an outstanding track-record, leadership in attractive industries and deep culture and capability.

Examples of material value latencies include:

1. **Structural energy trading tailwinds:** changing production and consumption patterns, years of underinvestment into pipeline and storage capacity, and continued project development hurdles have resulted in a US energy infrastructure that is structurally prone to dislocation.
2. **Underappreciated decarbonisation upside:** The Inflation Reduction Act of 2022 could have far-reaching consequences, with US\$369bn funding for climate and clean energy. This should add to opportunities in asset management, principal investing and advisory.
3. **The quiet (re)emergence of private credit:** the rapid growth in the private credit book, at a time when returns are attractive for those that manage risk well (something that Macquarie has historically done very well), will underpin near-term growth in net interest income.

On another trip, we visited companies in the commercial property sector (primarily office and retail) in Singapore and Malaysia. What was evident was the recovery of the retail asset class, with sales at or above pre-COVID levels in all our discussions (up to 150% in some cases). While there is likely an element of "revenge" shopping associated with the unwinding of COVID-related restrictions (as we have observed in the western world), the strength of the sector is notable given tourism is only running at ~50% of 2019 levels. With China-related tourism starting to show signs of improvement, the outlook for the retail asset class across both regions appears robust.

On the office front, our meetings primarily focussed on Singapore. The country appears a standout in the context of global office markets. While we observed similar trends to other regions (such as the bifurcation between primary and secondary assets, the importance of sustainability and presence of hybrid working), physical occupancy has recovered to 80-90% of pre-COVID levels, grade A vacancy is low at ~5-6% and rents are slightly above pre-pandemic levels. Although not immune from the uncertainty associated with the broader macroeconomic environment in the short-term, Singapore continues to benefit from positive net migration and a constrained supply pipeline.

Overall, the observable trends are supportive for **Lendlease's (LLC)** development work-in-progress in the region, a key driver of the recovery in earnings we expect in FY24 despite broader uncertainty in commercial property markets globally.

In late March we visited **CSL's (CSL)** manufacturing facilities in Germany and Switzerland. We combined the trip with a series of industry meetings across the plasma value chain. Our key takeaways included:

1. **CSL remains a step ahead of peers:** the expansion of plasma fractionation and purification facilities over the past 2-3 years represents a material increase in capacity to support top-line growth. Operational efficiencies are also a focus, including automation, quality control and yield gains. This should support margin expansion and higher returns.
2. **Advanced preparations for the manufacture of CSL112:** the therapy remains subject to successful Phase 3 trials (readout due early CY24), but the scale of investment suggests the company is confident of at least that time frame.
3. **CSL Vifor's manufacturing process provides some protection against patent expiry:** while the competitive moat around this franchise might not be as strong as plasma, the manufacturing process appears to have enough complexity to limit generic competition. The business is also investing for

growth, with construction of a “multicube” facility expected to increase reactor capacity by 50%.

4. **A longer investment time horizon that most:** while partly a function of the industry, it also reflects the quality of the company's strategy and management.

More broadly, operating trends are positive as plasma earnings continue to recover and Vifor sales benefit from geographic and indication expansion. Key value latencies include operational efficiencies in the plasma business, which should see margins exceed historical levels, and a strong late-stage R&D pipeline.

GLOBAL BANKING RUPTIONS

During the second half of the quarter, stresses emerged in US tech-focussed Silicon Valley Bank (SVB). Concerns then cascaded to other US regional banks, before spreading to the globally systemically important, Credit Suisse. This culminated in a fire sale to a larger rival, UBS, at a price that would have been inconceivable even one month earlier.

While there were company-specific risk management shortcomings that contributed to both unravelling, as is often the case in a banking crisis, it was liquidity concerns brought them undone. Ironically, at 144%, Credit Suisse most recent quarterly Liquidity Coverage Ratio (LCR) was well above the regulatory minimum. Incredibly, it was close to 200% in the prior quarter (3Q22).

Despite their good intent and apparent sophistication, the post-GFC liquidity standards proved inadequate. The LCR framework appears to underestimate the potential for sustained outflows for longer than 30 days, correlated outflows across the system and the speed with which outflows can occur in a digital world.

As the opening quotes from Ian Wilson and Peter Lynch reminds us, each crisis is subtly different. As such, we cannot rely exclusively on protective mechanisms built on historical experiences. Trying to predict the next crisis, or “Black Swan” is a futile exercise. Rather, we seek anti-fragile companies that are more robust against such shocks (i.e. favourable risk adjustments) or have a sufficiently large margin of safety (i.e. material value latency).

The recent banking system disturbances also reinforce useful general principles:

1. **The importance of strong risk management:** these banks had major inadequacies in their financial, operational and customer risk management, which were significant factors in creating their problems.

2. **The importance of trust:** the fractional reserve banking system is an inherently fragile construct built on trust. When trust disappears, so does liquidity. Your business soon follows.

3. **The importance of prudent investing:** SVB operated a very risky asset-liability mismatch; a fact that various debt and equity investors seem to either miss or willingly ignore.

Australia's major banks are among the strongest and most tightly regulated in the world; hence, we do not harbour any serious systemic concerns here. However, this does not make them immune to the global fallout. Funding costs are likely to rise, which compounds the existing pressure forming from intense mortgage competition, rising deposit betas, falling credit growth, cost inflation and the spectre of asset quality deterioration as cost-of-living pressures rise.

We also suspect that any potential regulatory relief, such as a softening of APRA's unique Interest Rate Risk in the Banking Book (IRRBB) capital requirement, is now unlikely too. Indeed, it seems more likely that regulators will give closer scrutiny to the methodologies involved in calculating liquidity stress scenarios. Holding more and higher quality liquidity would grind down further on industry returns.

However, in the spirit of Mark Twain's quote above, we remain open-minded to the possibility that further underperformance could eventually make risk-adjusted value latency look more attractive for the banks.

REPORTING SEASON HIGHLIGHTS

Rather than trying to identify big picture themes, we tend to view reporting season as an opportunity to observe and evaluate the incremental progress companies are making against our investment theses. Our focus is primarily on the factors that drive our assessments of risk-adjusted value latency (Value Latency, Operating Industry & Strategy Trends and Focussed Management Behaviour).

Several larger exposures demonstrated encouraging progress, including:

Brambles (BXB) delivered a strong first half result, upgrading both revenue and profit guidance for the full year. Continued price realisation was the driver, compensating for both the inflationary environment and changes in customer behaviours associated with broader supply chain uncertainty. Pleasingly, the asset efficiency trials also appear to be delivering value. When combined with line of sight to an improvement in free cash flow over the next 12-18 months, this continues to support our investment proposition.

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QBE (QBE) delivered further progress on our low-risk turnaround thesis. This included improved returns in North America, which was profitable in FY22 for the first time in four years. While the outcome was pleasing, we were most encouraged by how it was achieved: a focus on deliberate portfolio optimisation to deliver higher and more consistent sustainable returns. Operating trends have support from pricing above claims inflation, rising investment yields and more rational industry behaviour as capital withdraws from the industry. Management is demonstrating an intentional focus on long-term value creation, even when it involves short-term sacrifices (e.g. conservative reinsurance and quota share deals).

WiseTech (WTC), a leading provider of software solutions to the logistics industry, produced an exciting first half result announcing a significant new customer win. WiseTech's flagship product, CargoWise, is well-regarded as a best-in-breed forwarding solution used by some of the world's largest Freight Forwarders (e.g. DHL, DSV, UPS). In recent years, management have invested heavily in the development of a customs clearance module via a combination of acquisitions and internal R&D. This product would logically appeal to WiseTech's existing freight forwarding customer base who regularly navigate the highly complex customs ecosystem to clear goods. WiseTech announced that they have won a global rollout of their customs clearance module with the world's largest freight forwarder Kuehne + Nagel. This is a "watershed" moment according to CEO, Richard White. It signals to the rest of the freight forwarding community that the customs module is ready for use on a global scale. This announcement strengthens our confidence in the future potential for the customs module as a source of value latency. Further, it moves WiseTech towards its vision of becoming the "operating system for global logistics."

A NOTE ON THE SAFEGUARD MECHANISM

The Australian Federal Government has released details regarding their Safeguard Mechanism, which aims to reduce greenhouse gas emissions from Australia's largest emitters. This policy was well flagged and is less onerous than the climate change scenario analysis that we have undertaken across our universe of companies.

The Government is also reviewing a carbon border adjustment mechanism to ensure domestic companies are not at a competitive disadvantage versus imported products. This is a necessary step to ensure emissions are not simply transferred offshore and would significantly mitigate the potential economic impact of the Safeguard Mechanism for domestic companies (while at the same time encouraging those companies to invest in continued emission abatement).

The two companies in the portfolio that have the potential for material risk under the proposed legislation are **Orica (ORI)** and **Santos (STO)**. Orica is already well on the path to mitigating associated greenhouse gas emissions from their manufacturing facilities and we are comfortable with their ability to effectively mitigate any material valuation impact within this framework. Santos is also advanced in their strategy to reduce greenhouse gas emissions across their portfolio, with a focus on electrification in the field and carbon capture and storage across the asset base. We believe these projects can effectively mitigate material valuation impacts associated with the Safeguard Mechanism.

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