COOPER INVESTORS ENDOWMENT FUND
QUARTERLY COMMENTARY REPORT

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

SEPTEMBER 2021

	**PORTFOLIO	#BENCHMARK	VALUE ADDED
ROLLING 3 MONTH	6.82%	2.29%	4.53%
ROLLING 1 YEAR	32.08%	32.16%	-0.08%
ROLLING 2 YEAR	12.42%	9.53%	2.89%
ROLLING 3 YEAR	12.26%	11.10%	1.16%
ROLLING 5 YEAR	12.46%	11.94%	0.52%
SINCE INCEPTION*	11.80%	10.07%	1.73%
SINCE INCEPTION^	132.87%	106.93%	25.94%

*Annualised
^Cumulative (3 March 2014)
**Before fees and expenses and adjusted for franking credits
#S&P ASX200 Accumulation Index – adjusted for franking credits
Past performance is not necessarily a reliable indicator of future performance

The purpose of the Cooper Investors Endowment Fund (the "Fund") is to provide a conservative equities portfolio that may be suitable for investors who are in the pensions/decumulation phase. The portfolio may also be suitable for charities, foundations and others who are looking for a conservative equities exposure.

Whilst return is important the portfolio also aims to perform much better in down markets and to exhibit lower than market volatility.

The Fund commenced in March 2014. Over the ensuing seven and a half years the portfolio has achieved its objectives of delivering a higher return than the market with a lower level of risk. These objectives have been achieved through stock selection and portfolio construction. The strategy is unchanged since the commencement of the Fund.

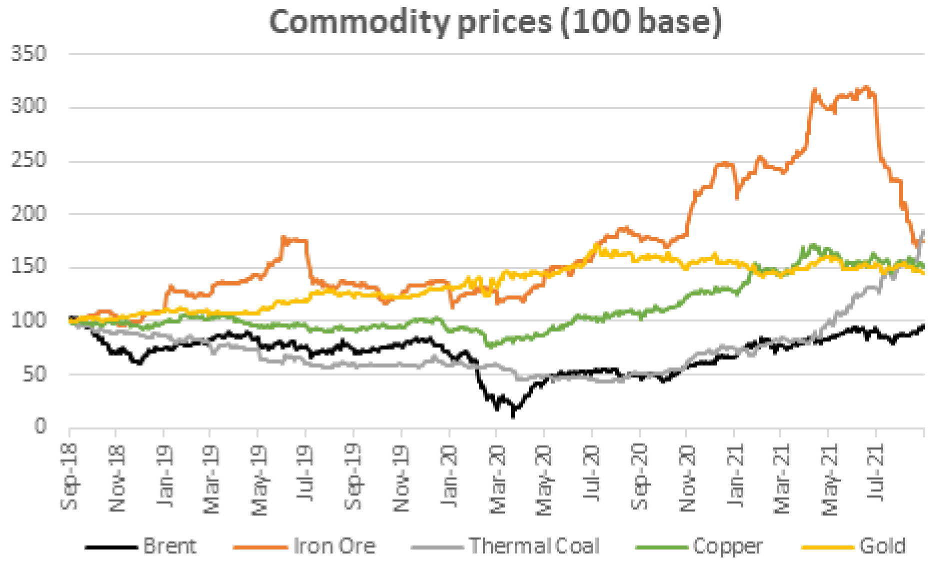
Market and Portfolio Performance

The S&P/ASX 200 Accumulation Index (adjusted for franking credits) returned 2.3% over the September quarter and for the 12 month period to September 2021 returned 32.2%. The Endowment Fund returned 6.8% and 32.1% for the quarter and last 12 months respectively.

The ASX200 Accumulation Index rose 1.7% over the quarter, despite falling 1.8% during the month of September – remarkably the first negative month for the market since September 2020. Energy (7.6% outperformance) and Industrials (4.9%) were the top sectors. On the flipside, Materials underperformed by a substantial 11.6%.

The key driver of this sharp decline was a collapse in the iron ore price, which fell 44% to under $120/tonne. This reflects a number of factors, including: i) recovering supply from Brazil; ii) a slowdown in property activity in China; iii) escalating concerns around the solvency of China's second largest property developer, Evergrande; iv) a crackdown on steel production given environmental concerns; and v) no doubt, an unwind of speculative fervour when the iron ore price was over $200/tonne.

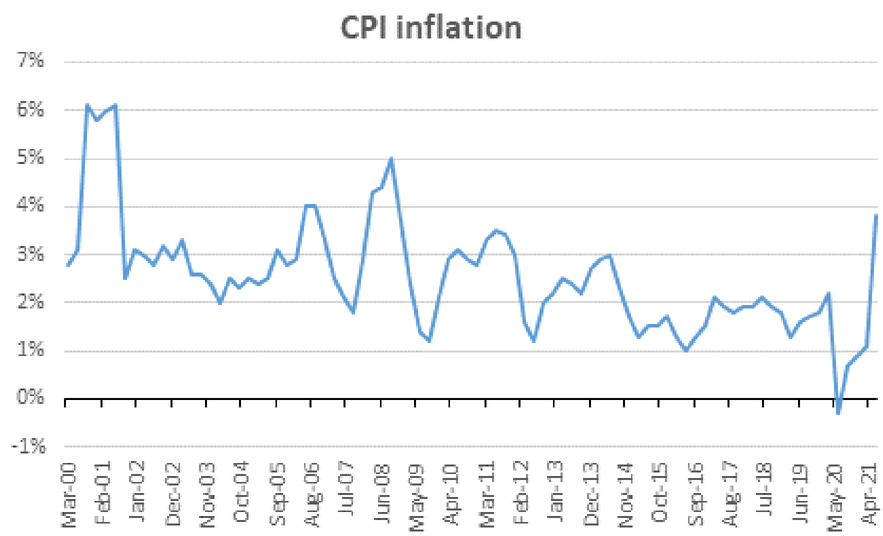
Unsurprisingly, this led to large sell-offs in the likes of BHP, Rio Tinto, Fortescue and Mineral Resources. While this is clearly a weakening of significant magnitude, it is worth noting that the price has simply retraced to where it was one year ago and is still a long way above the cost of production.



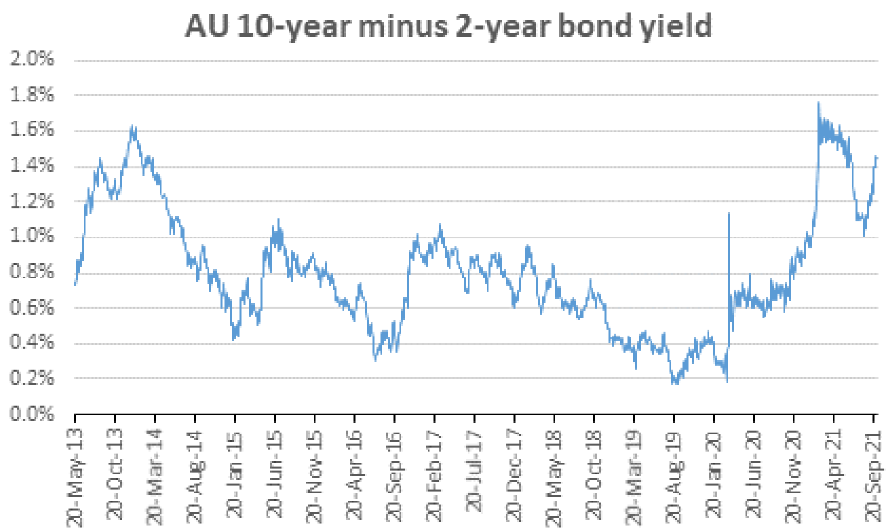
Source: FactSet

Reporting season in August saw generally solid results, albeit this was overshadowed by an increasingly uncertain outlook as the COVID Delta strain hit NSW and then Melbourne. This caused most management teams to provide cautious guidance, or none at all, and analysts to downgrade forecasts. Notwithstanding, the market appeared willing to look through this uncertainty. This likely reflects a combination of COVID fatigue and confidence that rapidly rising vaccination rates would soon benefit so-called reopening plays.

Both the US Federal Reserve and the Bank of England conveyed an increasingly hawkish tone during the quarter, which resulted in bond yields rising. While the RBA's language remains dovish, the prospect of higher interest rates offshore and evidence of rising inflation domestically resulted in the yield curve steepening again.

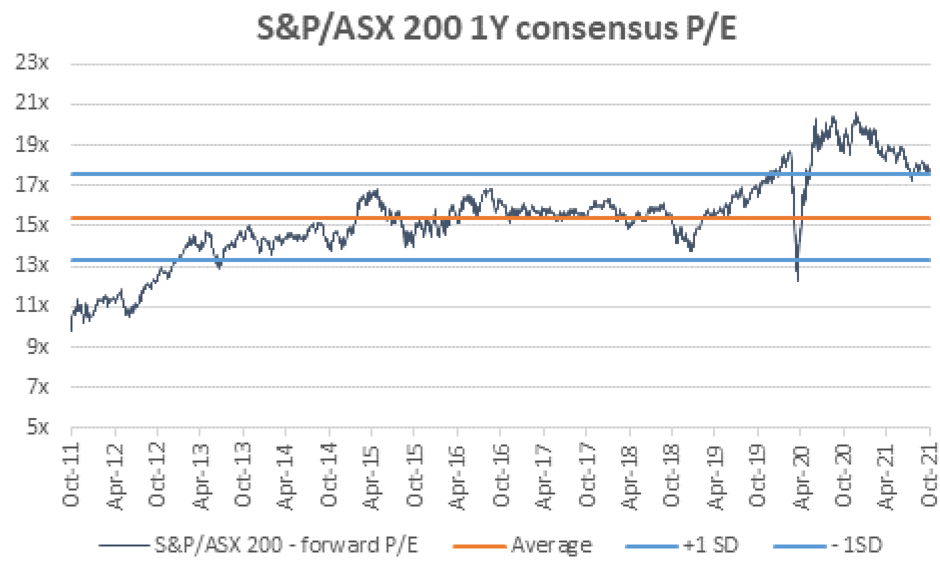


Source: ABS



Source: ABS, RBA

Unsurprisingly, the steepening has coincided with a contracting market multiple. Notwithstanding the multiple moderation, it remains high by historical standards. This likely reflects a combination of low (but rising) bond yields, still generally buoyant sentiment and significant liquidity.



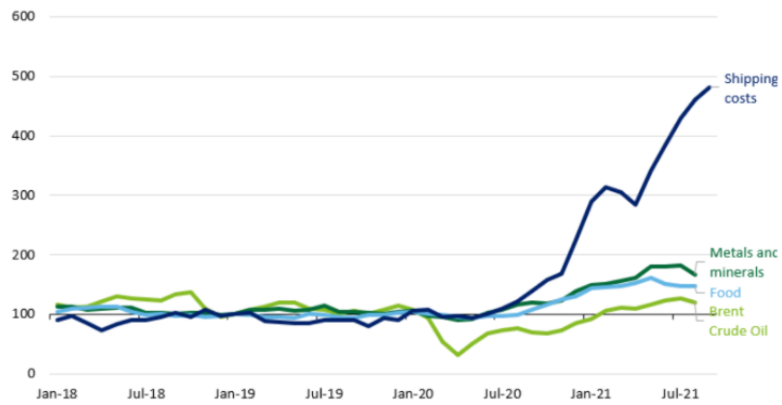
Source: FactSet

Central banks face some difficult choices in the months ahead. On the one hand a normalisation of the global economy on the back of rising western world vaccination rates and re-openings might lead one to believe that current historically low interest rate settings may finally start to move sustainably higher.

The flipside to this argument is the amount of indebtedness globally across various sectors of the economy today and the impact that even a relatively small move in interest rates may have. On top of this conundrum there are a number of other unusual events occurring at the same time which companies are having to face:

- Surging energy prices as the prices of gas, oil and coal rise – leading to power rationing in China and bankruptcies of suppliers and other disruption in the UK;
- At the same time as prices are rising, production of these commodities is (and will likely remain) under pressure due to growing environmental concerns;
- Pressure across the global trade and transport network has seen ongoing increases in shipping costs which continues to feed its way through global supply chains:

Chart: Price changes through COVID, 2019 = 100



Source: OECD, via Macrobusiness

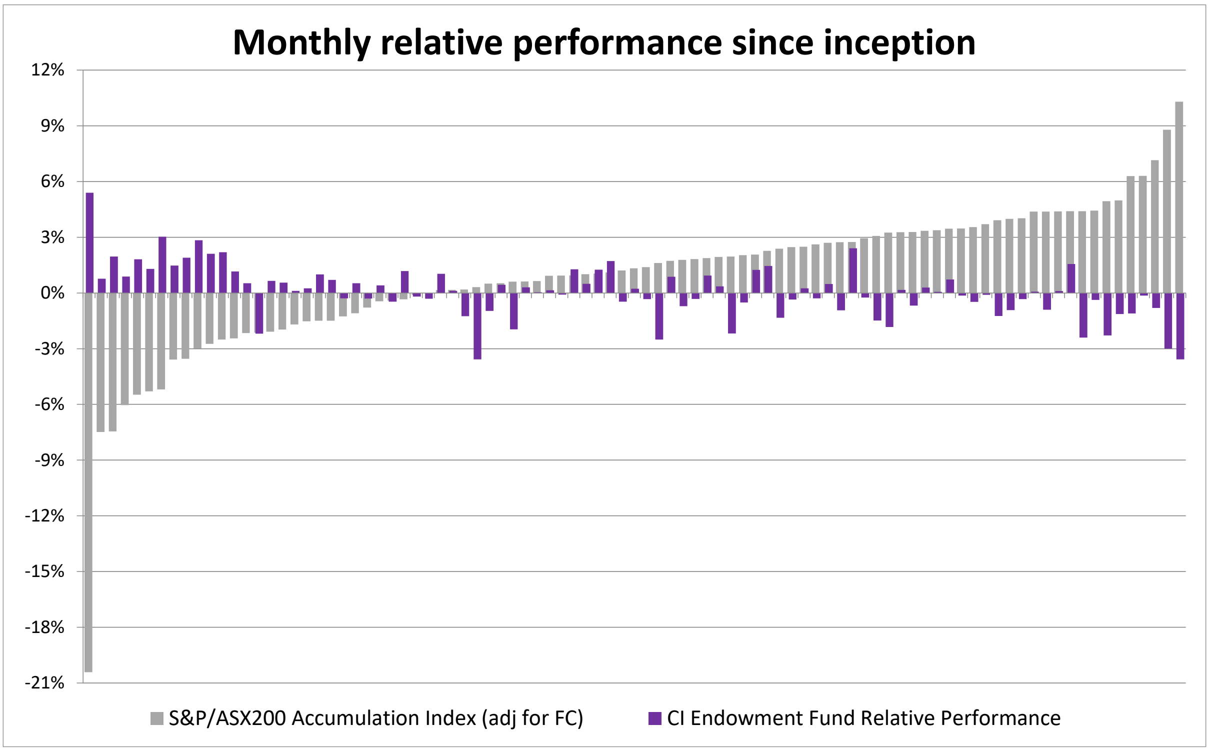
- A number of companies we have had contact with recently have spoken to difficulty in accessing sufficient suitable labour due either to covid or other reasons. It seems likely labour, as well as other costs, will continue to rise as demand improves with global re-awakening from covid shut downs; and
- Geopolitical tensions are rising between the world's two major powers China and the USA.

Stocks that performed well over the quarter **Lifestyle Communities (LIC)** (additions to pipeline, inclusion in S&P/ASX 200 Index), **Mainfreight (MFT)** (strong FY21 result, ongoing benefit from freight rates) and **Arena REIT (ARF)** (strong FY21 result, additional Govt support announced for child care operators, inclusion in FTSE EPRA NAREIT Index).

Portfolio stocks that performed relatively poorly included **Mineral Resources (MIN)** (declining iron ore prices and investor concerns regarding Evergrande), **Franco Nevada (FNV)** (Canadian-listed gold royalty business, gold price fell in the quarter), and **YUM China** (reduced short term guidance, COVID restrictions still impact some provinces).

The international stocks in the portfolio (8 stocks, 16% of the portfolio) performed very well over the quarter, with the exception of Franco-Nevada and Yum China. The A$/US$ was a modest tailwind falling 3.6% over the quarter.

The chart below shows the Fund's monthly relative returns. The grey bars show each month's market return sorted from the worst to best month and the purple bars show the portfolio's return relative to the market for each month.



Since inception the market (adjusted for franking credits) has shown a monthly negative return 29 times and in these months the portfolio has performed better than the market 23 times (79%). Over the last 12 months there was only one down month which occurred in September 2021, and pleasingly the portfolio did better than the market in this down month. The portfolio has also outperformed on 94% of 'meaningful' down days where the market fell 50bps or more.

When assessed using monthly data the portfolio has captured 70% of the market's downside and 88% of the market's upside. Since inception the volatility of the portfolio has been 80% of the market's volatility.

The portfolio owns 36 securities including eight global stocks (~16%) and four New Zealand stocks (~11%). The cash weighting is around 6%.

The Portfolio

During the quarter we added Arena REIT and Cosmos Pharmaceutical to the portfolio, and increased our positions in Chorus, Franco-Nevada, and Ryman Healthcare. We sold our holdings in Alumina and IAG.

Arena REIT (ARF) is a Bond-like Equity focused on owning social infrastructure assets (child care centres ~86% and GP clinics ~14%), with a property portfolio diversified by both tenant and geography. ARF provides investors with a high quality, low risk, inflation-protected income stream. Rents are underpinned by a 14-year weighted average lease expiry (WALE), triple-net lease structure (maintenance capex paid by the tenant) and reputable tenant counterparties.

Over 90% of rents are subject to CPI-linked reviews (most with minimum ratchets), with around 8%-9% on fixed 3%-4% escalators. The portfolio may also be under-rented evidenced by market rent reviews historically averaging at least 6%. Organic rental growth can be further augmented by acquisitions and developments given the ARF's fortress balance sheet, which should also hold the company in good stead in a downturn.

Demand for child care centres is robust, aided by increased Government funding and support for increased workforce participation (where the benefits are seen to outweigh the costs). Importantly, Government backing for the child care sector faced its largest stress test in during COVID, and (while bumpy) it passed with flying colours. This significantly reduces the underlying risk profile given operators receive 70% of their revenue from the Govt.

The company has a good track record of capital allocation with a strong focus on risk-adjusted returns. CEO Rob de Vos displays deep industry knowledge and management has been very adept at reading the industry demand/supply dynamics. ARF does not have a history of controversies and in our view has good Responsible Investing credentials. Child care is strongly supported by the Government, and is broadly considered a social good by giving people the opportunity to return to the workforce. Ultimately this contributes to increased levels of community access, inclusion and wellbeing.

ARF provides us with an attractive distribution yield of 4.0-4.5% growing at 3-4% p.a., providing a relatively low risk total return of at least 7%-8% p.a. This is very acceptable within the context of a diversified portfolio and the explicit objectives of our Fund.

At the end of August the Fund sold **Intuit (INTU)** and bought **Cosmos Pharmaceutical (Cosmos)**. The switch out of Intuit into Cosmos will reduce the portfolios exposure to Growth, and increase defensive positioning by owning a high quality Japanese Stalwart. After such a strong run up in markets over the last 12-18 months we considered this to be a prudent course of action given one of our core objectives is to perform much better in down markets, and we want the portfolio to be ready for the next downturn.

Cosmos provides the portfolio with a pure Japanese exposure given 100% of the business is in-country, compared to our other Japanese holding, Unicharm, which has 60% of its business offshore. Together, our two Japanese holdings, represent just under 4% of the portfolio. In our view Japanese stocks can increase downside protection in the event of a market crash as well as improving portfolio diversification. This is driven by the safe haven nature of the Japanese Yen (typically appreciates during drawdowns) and the low correlation between Japanese stocks and other exchanges.

Cosmos operates drug stores in suburban locations across Japan with a customer proposition based on every-day-lower-prices (~10% lower than local supermarkets and drug stores); selling "daily necessities" including health and personal care products (90% national brands); and convenience given customers can be in-and-out of the store in 20mins.

60% of sales are generated from food that is sold at lower gross margins in order to drive foot traffic to their stores, which in turn drives the remainder of sales in higher margin health and personal care products (e.g. over-the counter drugs, cosmetics, etc). The business model generates very attractive unit economics of >20% (pre-tax) returns, which means Cosmos can organically reinvest in their business at very good rates of return.

There is laser-like focus on the customer value proposition which has been received favourably in Japan, underpinning significant growth in the business over the past decade. Around 55% of Cosmos' stores are in Kyushu (southern Japan) which represents less than 15% of Japan's population. As such there is significant value latency in a store rollout strategy across Japan and margins can increase as the growing store network matures.

The balance sheet is net cash and earnings quality is good with the main drag on free cash flow being investment in the store rollout program (a positive in our view given the strong incremental returns). Investment in growth means the dividend payout ratio is only 10% which helps to internally fund store rollout capex, and therefore the dividend yield is a modest 0.4% which is acceptable given the other compensating factors outlined above.

Cosmos is a Founder-led Company with a culture of focus and conservatism, and Founder and Chairman Masateru Uno maintains around a 50% stake in the company. The company does not have a history of controversies and the focus on affordably-priced daily necessities strikes us as a very sustainable business model.

Recent results have shown evidence of market share gains, solid like-for-like sales growth, and retaining customers who first visited a store during COVID and are now returning to shop. The observed positive operating trends were confirmed in a recent meeting with the company which increased our conviction in the investment proposition.

In summary, Cosmos has attractive Stalwart characteristics with very stable cash flows underwritten by the resilient nature of the business, a strong competitive position and a significant and steady runway for store growth.

Stock News

In conjunction with their half yearly results, **Ampol (ALD)** announced it has submitted a non-binding indicative proposal to acquire Z Energy (NZ$2.8bn). On one hand we view the acquisition as potentially opportunistic, acquiring a highly free cash flow generative business whose returns are currently depressed relative to history with clear and relatively low hanging synergies in the form of removal of duplicate corporate costs, fuel supply and retail network optimisation opportunities.

On the other hand, the alternative which we see as a material share buy-back whilst both ALD's returns and share price are depressed that would also distribute a portion of the ~$650m of surplus franking credit balance back to shareholders as an attractive, low risk latency opportunity. As such, we seek to better understand from management the extent of the opportunity they see to create value (not just EPS accretion in a largely debt funded deal) through the potential acquisition once due diligence is complete.

Brambles (BXB) held an investor day during the quarter, their first since 2018. The focus was very much on ~US$450-500m of investment over the next 24 months into the digitalisation of the pallet pool and further automation of service centres to drive improved free cash flow generation and high single digit earnings growth (vs the mid-single digit CAGR BXB has delivered over the past ~20 years).

The service automation is very much in BXB's wheelhouse and a natural progression of the successful program they have recently completed in the US. Whilst small and targeted pallet digitiisation trials have been successful, wide scale tracking is still very much in proof of concept phase with further trials over the next 12 months to test the concept at larger scale. Ultimately, if successful BXB utilising tracking technology will be an example of an old age company taking advantage of a privileged competitive position and using technology to materially improve the core business. Conceptually, the opportunity here is significant with BXB spending an average of US$650m p.a over the last 5 years replacing lost pallets. If through digitalisation of the pallet pool BXB is able to halve the current loss rates, this would free up ~US$325m in cash flow p.a. more than doubling the free cash flow the business has generated historically.

The stock fell 10% post the above-mentioned strategy day due, we believe, to a number of factors including greater opex and capex over the next two years than anticipated, a resultant lower trajectory in earnings growth, and nervousness over the outcome of the plastic pallet trial currently underway with Costco (seen as likely to dilute returns once the trial is taken into full production in 2023 and beyond). We believe, based on the success to date of similar initiatives, management will achieve its required return on the automation project, and the digital spend is necessary and will be gated to ensure minimal unnecessary expense. We await with interest the results of the Costco plastic pallet trial – it seems inevitable BXB will have to proceed further in order not to lose its market leading position so the real question will be the the rate of return the company can earn on a closed loop plastic pallet pool.

Chorus (CNU) passed another milestone on the regulatory journey during the quarter. The regulator (Commerce Commission or 'ComCom') announced in mid-August their final draft Regulatory Asset Base decision of NZ$5.4b which is just below CNU's proposal of NZ$5.5b. This was good news as there was significant uncertainty around where this would land with market concerns it could be much worse than the actual outcome.

Importantly this announcement removes downside risk and will help to provide a clearer line of sight to FY25 cash flows and dividends. The growing income profile is attractive in a low interest rate world and infrastructure assets are highly valued as we've seen from recent transactions – this suggests there is a favourable skew between upside risk and downside protection. Post this announcement we added to our position in CNU as in our view the material free cash flow and dividend growth was not appropriately captured in the share price.

At their July results, **Cosmos Pharmaceutical (Cosmos)**, a chain of over 1,000 drugstores in Japan, announced that they would accelerate their expansion into pharmaceutical dispensing in coming years.

Whilst dispensing was previously said to be an unattractive category for Cosmos, management have now identified an opportunity to enter as 'mom and pop' pharmacies become uneconomical and the ability to hire pharmacists improves. We spoke to a range of dispensing competitors over the quarter, who supported this view on a consolidating industry and attractive economics.

We also spoke with Cosmos management who were able to clearly articulate the industry trends that make entry into dispensing attractive and the unit economics to grow their dispensing footprint. We believe that dispensaries will be able to leverage the store traffic generated by Cosmos' competitively priced food offering (60% of Cosmos' sales derive from food), particularly as Cosmos has retained some of its share gains from 2020 into 2021.

Assuming gross profit margin of 30%, dispensary sales will be incremental to margin (FY21 group gross profit margin ~18%). Capital investment for dispensaries is low, limited to two parking spaces where there is no space built for a dispensary currently. Alongside Cosmos' store roll out opportunity in the Kanto and Kansai regions, we are excited by this strategic move and see this as an example of a first-class management team taking advantage of opportunities at the right time.

During the quarter **Intuit (INTU)** acquired Mailchimp for $12bn. Intuit has reinvented itself over the last decade and thrived with a leadership position in QuickBooks Online, the financial accounting software for small businesses (effectively the 'Xero of the US').

We originally invested in Intuit in March 2020, excited by the QuickBooks prospects. Management have executed exceptionally well on the opportunity set which has seen the shares double since our initial purchase. However, the company has now conducted two meaningful deals in Mailchimp and Credit Karma worth a combined US$20bn over the last 12 months. The investment proposition has shifted from a focus on QuickBooks to now being a financial and small business software conglomerate.

We continue to very much admire the company, but with Intuit now trading on 50x forward earnings we no longer see such attractive latency on offer, nor the rewards for the level of execution risk and thus we have exited the position

During the quarter **Mainfreight (MFT)** provided an update on performance for the 22 weeks of the half (~5 of the 6 months) to end of August. The result was very strong with Revenue +43% and profit before tax +83%. While the prior period (April-August 2020) was impacted by the initial covid lockdowns, MFT's business is currently impacted by lockdowns in Australia and NZ, which have likely reduced transport revenues by ~30% (particularly in NZ).

Based on current observations, operating trends are likely to stay strong over the near term. In particular, the group's Air and Ocean business continues to benefit from tight capacity and a global surge in freight rates as demand has accelerated over the last 12 months.

In late September **Transurban (TCL)** announced that Sydney Transport Partners (STP) would acquire the remaining 49% equity stake in WestConnex from the NSW Government for $11.1 billion, taking STP's total ownership interest in WestConnex to 100%. STP is funding the acquisition entirely with equity upfront, with TCL's 50% share of the acquisition to be funded by a $4.22 billion equity raise (1-for-9 entitlement offer at $13.00 per share) and the balance from available cash.

We participated in the entitlement offer which we viewed as attractive at $13.00 per share. The transaction was expected and, in our view, offers investors both a compelling strategic rationale as well as the potential for numerous future growth opportunities, if history is any guide. TCL now controls one of the best toll road assets in the market, an asset it knows intimately, with the long concession life on WestConnex (~40 years) increasing TCL's average concession life to approximately 30 years.