

Our approach to inflation linked bond management

September 2009

Colonial First State Global Asset Management has a long, successful track record in the management of inflation linked products for clients. We are one of the largest managers of these products in Australia with a disciplined investment process and a highly experienced team.

Recent announcements by the Australian Office of Financial Management (AOFM) that the Australian Government would resume issuing inflation linked bonds, together with new issues by some of the State Governments, have seen a resurgence in interest in the Australian inflation linked bond market.

Inflation linked bonds (ILBs) have cash flows that are linked to movements in the Consumer Price Index. Thus they provide a means of protecting the real value of savings against an unexpected rise in inflation when compared to nominal bonds.

Colonial First State Global Asset Management (CFSGAM) offers a range of products that invest in Australian ILBs. These products are suitable for clients who wish to receive an income-based return that is protected against the effects of inflation over the medium term. With a strong track record, extensive ILB experience and a disciplined investment process, CFSGAM is ideally positioned to provide clients with tailored solutions to their inflation linked portfolio requirements.

This document summarises the key features of the ILB market in Australia and CFSGAM's approach to managing portfolios in this sector.

Commonwealth of Australia issuance of inflation linked bonds

In early August 2009, the Commonwealth of Australia made a welcome announcement that its issuance of ILBs would resume with the first tender in late September 2009. Since 2003, this issuer has been absent from the domestic ILB market. As a consequence, many investors with an underlying appetite for such securities have also been absent.

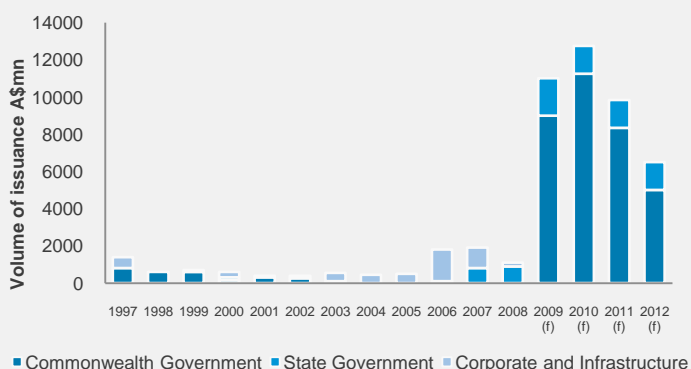
While in the last six years the ILB market has continued to develop even without new Government supply, the resumption of issuance by the Commonwealth promises to restore much greater liquidity and activity to the ILB market.

Benefits of investing with CFSGAM

- One of the major participants in the Australian ILB market at present with over \$3 billion under management in trusts and mandates.
- More than 15 years experience in managing inflation linked portfolios in Australia, including both physical securities and inflation linked derivatives.
- Clear, income maximising investment philosophy and robust process for active management of ILBs.
- Process integrated with nominal fixed interest process to provide maximum rigour and effectiveness of decision-making, including relative value strategies between ILB and nominal bonds.
- Experience in managing mandates with different risk constraints, supported by a large and experienced credit team.
- Client centric management approach, focussing on our fiduciary responsibilities to investors first and foremost.
- We have a strong internal responsible investment team and governance process to ensure we know what environmental, social and governance issues could impact our investments.

The chart below shows the expected significant increase in inflation linked issuance in Australia over the next few years.

Chart 1: CFS GAM's Projected Increase in ILB issuance



Source: Colonial First State Global Asset Management

What are inflation linked bonds?

ILBs enable investors who are concerned about the inflation outlook to hedge against a significant unexpected rise in the Consumer Price Index. ILBs are an ideal investment vehicle for investors with liabilities that increase with the rate of inflation. Portfolios that are a good match against these liabilities can be constructed that are either based on risk free government bonds or non-government bonds that pay an additional credit premium.

There are broadly two types of inflation linked bonds:

- Capital indexed bonds (CIBs) offer regular coupon payments that are fixed in real terms. In Australia these are usually paid quarterly. Both the dollar value of the coupons and the principal component payable on maturity change in value with movements in the Consumer Price Index. The coupon payments increase through time since they are a fixed percentage of an increasing capital value.
- Indexed annuity bonds (IABs) offer annuity-style payments that increase in value with the movements in the Consumer Price Index. With IABs, each payment is implicitly part principal and part interest, with the principal amount repaid gradually over the life of the security. There is no separate principal payment at maturity.

The Commonwealth Government currently issues only CIBs, but the AOFM has not ruled out the possibility of IAB issues in future.

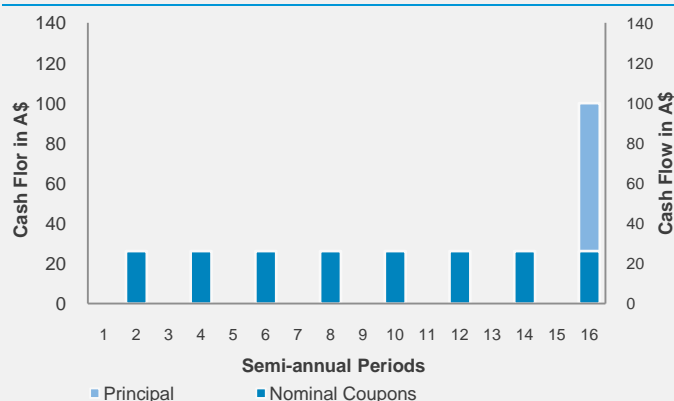
How do ILBs compare with nominal bonds?

ILBs offer cash flows that are linked to movements in the Consumer Price Index. The cash flows are designed to be constant in real terms and indexed in nominal terms.

Nominal fixed interest bonds offer regular (normally semi-annual) fixed coupon payments, together with a fixed principal component payable on maturity. The nominal coupon payments are static through time as the payment is a constant percentage of a static capital value. The cash flows are designed to be fixed through time.

The following diagrams illustrate the cash flow differences:

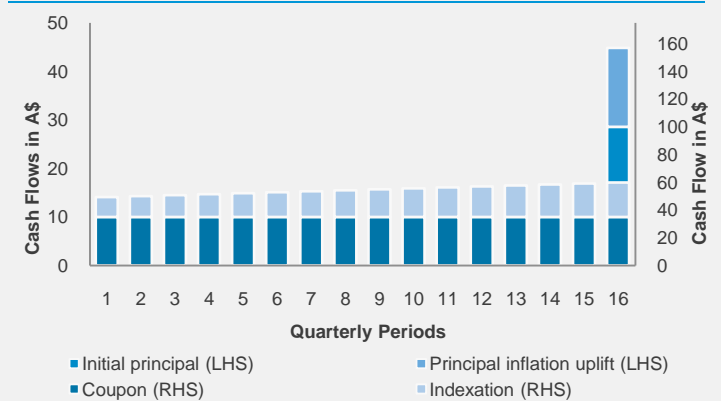
Chart 2: Nominal Fixed Rate Bond cash flow structure



Source: Colonial First State Global Asset Management

Coupon payments and repayment of principal on maturity are fixed and known at the time of investment in a nominal fixed rate bond.

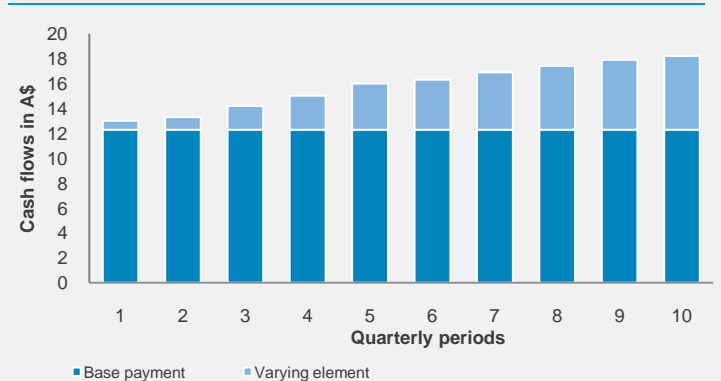
Chart 3: Capital Indexed Bond (CIB) cash flow structure



CPI projected assuming 2.5% pa inflation
Source: Colonial First State Global Asset Management

CIBs offer quarterly coupon payments that increase along with the CPI, together with a CPI indexed principal component payable on maturity (initial principal plus principal inflation uplift).

Chart 4: Indexed Annuity Bond (IAB) cash flow structure



Source: Colonial First State Global Asset Management

The payment received from investing in indexed annuity securities comprises a coupon and a partial repayment of capital and is CPI indexed. This regular payment is higher than capital indexed bonds' coupons because principal repayment occurs over time.

As a result of these cash flow structures, ILBs produce a known real return reflecting a real yield, but an unknown nominal return. On the other hand, nominal bonds produce a known nominal return reflecting a nominal yield, but an unknown real return. The common link between the two types of bonds and the ultimate returns they produce is the path of inflation. In other words, as future CPI is unknown, the ILB investor does not know what the nominal returns will be, but knows that the investment is inflation protected. The nominal investor knows what the nominal returns will be, but the investment is not inflation protected, hence does not know the real return on the investment.

The corollary is that the difference between nominal and real yields implies a future path for inflation. Thus, a key concept in understanding the working of the ILB market is that of the Break-Even Inflation rate (BEI).

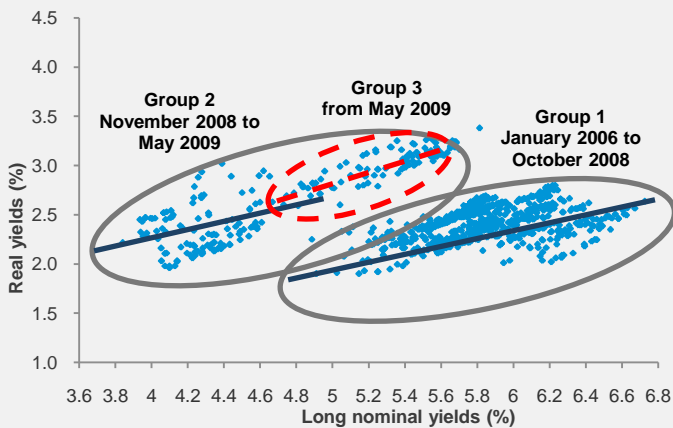
Break-even inflation

The BEI is the inflation expectation that equates a traded real yield with a traded nominal yield of the same maturity. The BEI is approximated by subtracting the real yield from the nominal yield, although to be accurate the calculation has to adjust for the different coupon periods (semi-annual versus quarterly) and allow for compounding. Understanding and assessing the BEI is an important element of managing ILB portfolios and for making relative value decisions between the ILB and nominal bond markets.

Over the past couple of years, the ten year BEI has fluctuated between 1.3% and 4.1%. However, it has tended to remain in a narrow range for reasonably lengthy periods of time, then adjust relatively quickly, creating a dynamic three-way relationship between nominal and real yields and the BEI over time.

Consider the following diagram which plots nominal yields against real yields on a daily basis.

Chart 5: Nominal / real yield correlation patterns



Source: Colonial First State Global Asset Management

The data points in Group 1 of the diagram are from January 2006 to October 2008. Over this period there was a relationship between the two markets such that when nominal yields moved between 5% and 6.5% real yields moved between 1.75% and 2.75% in a reasonably linear fashion.

However, beginning in Nov 2008 there has been a new relationship forming between the two markets. The data points in Group 1 shifted to the left and formed a new group labelled as Group 2. The slope of the line remained similar, so that changes in nominal yields have been associated with similar degrees of change in real yields as in the prior time period. However, during the more recent period, real yields have been trading at a higher level for any given nominal bond yield level. This shift to the left can be associated with the Global Financial Crisis which led to deflation fears and a flight to quality that drove nominal yields lower.

Hence, the reason for the change between the data periods is the BEI. In the January 2006 to October 2008 period the BEI averaged around 3.35%. Since then, the BEI has been more volatile and averaged around 2.10%. There is potential that yet another new relationship is forming following the AOFM announcement in May 2009 that they were considering issuance of ILBs which was confirmed in August 2009. This can be seen in Group 3 on the above chart, which may in the month ahead become a confirmed new relationship.

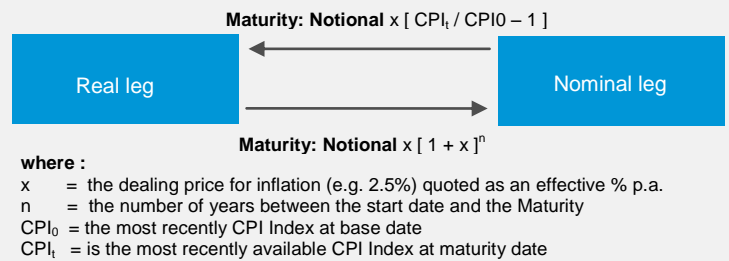
An understanding of this dynamic is an important component of our investment process in managing ILBs and sector allocation between nominal and ILB markets.

Inflation swaps

In addition to ILBs, investors can obtain access to inflation protection through the use of inflation linked derivatives, which are commonly used by market participants to structure transactions. They are also used to trade the BEI explicitly, since the level at which the swaps trade in the market generally moves with the BEI. An advantage of using inflation swaps is that the term of the transaction can be agreed with the swap counterparty, rather than the investor being tied to the tenure of the physical ILB in the market.

Cash flows are generally exchanged at maturity, although this can be adjusted, for example by having difference payments on an annual basis. The diagram below demonstrates a typical structure.

Chart 6: Zero – Coupon Inflation Swap diagram

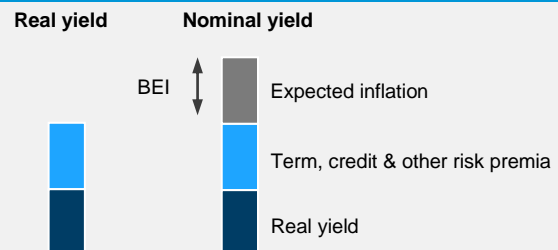


Source: AFMA/Colonial First State Global Asset Management

Hence, if we expect higher inflation than what the market implies in the BEI, then we would like to receive inflation and pay a fixed lower rate.

Managing ILB portfolios – an introduction to our process
Our ILB investment process uses the relationship between the nominal and inflation-linked bonds and builds upon our nominal duration process. The most important component of the duration process is the determination of a 'Fair Value' (FV) level, which is a hurdle yield that we believe, compensate investors for inflation and term risk. The FV levels for nominal bonds and inflation-linked bonds can be schematically represented as follows:

Chart 7: Components of FV in nominal and ILB bonds



Source: Colonial First State Global Asset Management

An important element is to determine the rate of expected inflation that we factor into our bond valuation process. We use an adaptive expectations model, in which historical inflation and trends in inflation are the key starting point.

In Australia, a key structural input is the Reserve Bank of Australia's (RBA's) target range for inflation. We note that the RBA has said:

"In pursuing the goal of medium term price stability, both the Bank and the Government agree on the objective of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. This formulation allows for the natural short run variation in inflation over the business cycle while preserving a clearly identifiable performance benchmark over time."

Source: RBA Third Statement on the Conduct of Monetary Policy 18 September 2006

This extract states clearly that, occasionally, inflation will move outside of the 2 to 3 percentage points range, but that monetary policy will seek to achieve an outcome within the range over the medium term. This is an important 'anchor' for our adaptive expectations model. The outcomes are reviewed regularly by our Fair Value Committee, which also takes into account short term developments in the economy and inflation formation process.

An important consideration when aligning nominal and real FV levels is the fact that future inflation is uncertain. Nominal yields not only compensate an investor for expected inflation, but also include a risk premium above expected inflation to compensate for this uncertainty. Thus, the FV real yield for an ILB is less than the implied real yield within the FV estimate for nominal yields.

When deciding duration strategy within our ILB portfolios we compare real yields trading in the market with our estimated FV real yield. When the market is trading at real yields that we believe are low (below FV), we favour short duration strategies, because investors are not being sufficiently well compensated to reward long duration risk. Conversely, when the market pays an attractive real yield (above FV), we will favour long duration positions that seek to lock in those relatively high real yield levels. Strategic positions will be accumulated gradually, protecting against overshooting by the market. We seek to have maximum positions in place for when real yields start to move back towards FV.

Relative value

In the long term, nominal yields and real yields both react to events that have the potential to affect the general level of market interest rates. However, nominal bonds and BEIs usually react more quickly, and only later do inflation-linked real yields adjust. This creates relative value opportunities and we switch actively between ILBs and nominal bonds for the portfolios that allow us to do so.

The BEI can, therefore, be used as an indication of relative value between nominal and inflation linked bonds of similar maturity. When our inflation expectation exceeds the BEI, then the future cash flows on ILBs would be expected to exceed those currently priced into the market and an ILB would be expected to outperform a similar maturity nominal fixed-rate investment over the life of the assets. Conversely, if the BEI is above our expected future rate of inflation then relative value favours the nominal fixed-rate market as the ILB cash flows would be expected to fall short of what the market was pricing in.

Managing non-Government ILBs

Although the focus of attention at the moment is on Commonwealth Government ILB issuance, there are, and will continue to be, assets issued by other entities that provide inflation protection. CFSGAM's team of credit analysts has a strong risk assessment focus and the expertise to analyse credit risk, structuring and documentation of infrastructure and public private partnership (PPP) related ILBs.

Credit risk management is paramount, given that ILBs typically have a long tenure with increasing nominal principal value, so that credit risk can increase over time. The output of credit assessment for CFSGAM is quantitative and designed to communicate an assessment of risk, and not simply a Buy/Hold/Sell recommendation. Once this risk is evaluated, portfolio managers are able to assess investment opportunities for the appropriate risk adjusted returns.

ILBs related to infrastructure or PPPs can be highly structured and unique. We have dedicated, specialist resources to assess and monitor credit, structure and support arrangements for these assets. Over the years we have analysed, assessed and invested in most of the securities in connection with infrastructure projects or PPPs.

Why Colonial First State Global Asset Management?

- In summary, CFSGAM represents a very strong option for investors wishing to access the ILB market, either as a standalone investment or in conjunction with nominal bond portfolios. We are an active manager, with a strong focus on risk management to achieve optimal risk/return outcomes.
- Our philosophy and investment process across the fixed interest and credit markets ensures that the longer term income objectives of clients are at the forefront of our thinking. Our process is adaptable to all risk tolerances and is robust across the investment cycle.
- Our team is one of the largest in Australia and has extensive experience of global bond markets across many cycles. The team comprises 29 investment professionals with 14 years experience on average in the industry and 8 years with the business. CFSGAM also has one of the largest team of credit analysts in Australia.
- We have multi-strategy mandates with ILB benchmarks which allow us to move into nominal bonds, while others allow ILB investments on an opportunistic basis in a nominal or globally diversified portfolio. We also have experience in the global ILB markets, and have been managing a UK 'Linker' portfolio for several years.

Fixed Interest - Australian Inflation Linked Composite - 1 July 2003 to 30 September 2009

Calendar Year End	Gross Return	Benchmark Return	Number of Portfolios	Composite Dispersion (Quartile returns)		Total Composite Assets at end of Period (A\$ mn)	% of Firm Assets (%)	Total Firm Assets at end of Period (A\$ mn)
				Lower	Upper			
2009 CYTD	-1.29%	-1.42%	5	-1.29%	-1.27%	3,161	-	-
2008	5.61%	3.71%	5	3.99%	4.50%	3,149	4.3%	73,705
2007	3.96%	4.11%	<5	N/A	N/A	2,277	2.3%	100,650
2006	1.92%	1.86%	5	1.90%	1.99%	1,729	2.3%	75,515
2005	10.37%	10.01%	<5	N/A	N/A	1,577	2.3%	67,186
2004	11.89%	11.93%	<5	N/A	N/A	406	0.7%	60,282

Rolling Cumulative to 30 September 2009

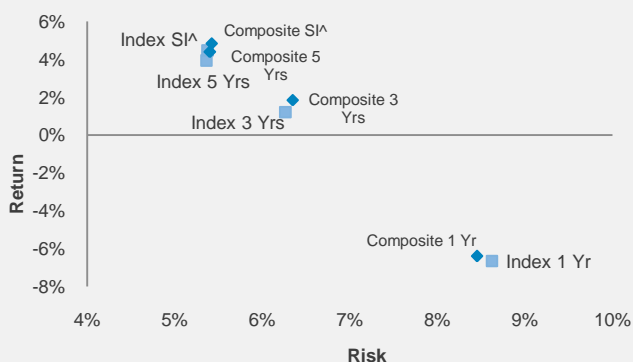
	Gross return	Index return
1 Year	-6.40%	-6.65%
2 Years	4.60%	2.77%
3 Years	5.61%	3.70%
4 Years	15.38%	13.22%
5 Years	23.94%	21.26%
6 Years	37.13%	33.83%

Rolling Annualised to 30 September 2009

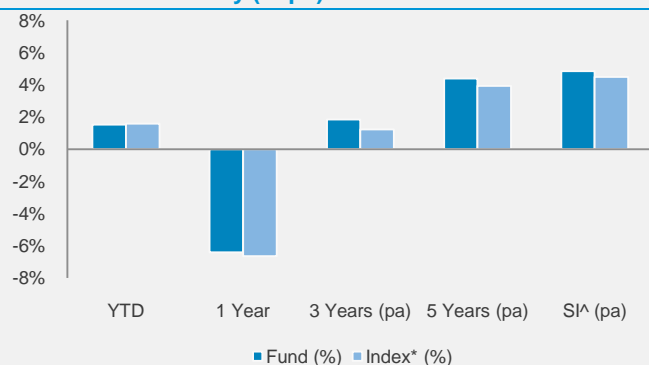
	Gross return	Index return
1 Year	-6.40%	-6.65%
2 Years	2.27%	1.37%
3 Years	1.84%	1.22%
4 Years	3.64%	3.15%
5 Years	4.39%	3.93%
6 Years	5.40%	4.98%

The table and charts below supplement the Fixed Interest - Australian Inflation Linked Composite presentation

Risk return plot



Performance Summary (% pa)



	Composite	Index*	Active Return	Tracking Error	Information Ratio (x)
YTD	1.51 %	1.59%	-0.08%	-	-
1 year	-6.40%	-6.65%	0.25%	0.88%	0.28
3 years (pa)	1.84%	1.22%	0.62%	0.72%	0.86
5 years (pa)	4.39%	3.93%	0.45%	0.57%	0.80
Since Inception ^ (pa)	4.83%	4.48%	0.35%	0.56%	0.63

*UBS Australian Inflation Linked Bond Index. Figures are before fees and expenses.

^Inception date: 1 July 2003

Longer than one year performance numbers are annualised. **Past performance is no indication of future performance**

Source: Colonial First State Global Asset Management

Colonial First State Asset Management (Australia) Ltd has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®).

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For further information

cfsinstitutional@colonialfirststate.com.au

Regional Managing Director, Australia and New Zealand

Joanna Davison +61 2 9303 7007

Institutional Business Development and Consultant Relationships

Matt Russell +61 2 9303 7024

Ali Karmali +61 2 9303 6070

Tracey McNaughton +61 2 9303 2695

Institutional Relationship Management

Liz Krajewski +61 2 9303 2927

Daniel Bristow +61 2 9303 6311

Helen Squadrino +61 2 9303 6142

Hugh O'Neill +61 2 9303 6116

Nadene Moore +61 3 8628 5615

Simon Good +61 3 8628 5681

Lucas Rooney +61 7 3328 5875

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