

# Wholesale Fixed Interest and Credit Funds

## Monthly update

December 2011

### Fixed interest and credit market review

Most major global bond markets rallied in December. Market sentiment continued to be dominated by the ongoing European sovereign debt crisis. European leaders met in Brussels during the month, announcing further plans to contain the crisis, moving the majority of European Union (EU) member states towards a greater fiscal union. New measures were agreed to control government borrowing and to provide further funding support via the International Monetary Fund (IMF). The move boosted risk appetite initially, but given that five 'comprehensive' EU plans have now been announced in the past 18 months without much success in stabilising the region, market participants have become increasingly sceptical about the prospects for the Eurozone. Delays in implementing much needed reforms have moved financial markets closer to the brink and while the EU Summit brought some progress, the muted reaction by market participants indicates that the new fiscal compact agreed by EU governments might mark a new step towards a fiscal union, but the plan only provides a semblance of a credible agreement and is not considered to be the panacea desired by financial markets. International credit ratings agency's reacted to the malaise in Europe, rattling global market confidence after Standard & Poor's (S&P) placed six AAA members on credit negative watch (including Germany), and Fitch Ratings lowered its outlook on France's AAA rating to negative and placed six others on downgrade watch. The latter also spooked markets by suggesting that Europe lacks a credible financial backstop and that a comprehensive solution to the debt crisis appears to be beyond the political and technical capabilities of the EU.

The European Central Bank (ECB) further dampened market sentiment by reiterating that it will not be the financial backstop to the EU with the Bank's leadership confirming that the central bank's main role was to support the European financial system. Which it did later in the month by announcing further support mechanisms for banks through unlimited 3-year liquidity tenders, lower reserve requirements and a relaxation of collateral terms. At its December meeting, the ECB cut its main refinancing rate by a further 0.25% to 1.00%. However, the reduction in the policy rate was not a unanimous decision with some ECB members disagreeing over the timing of the rate cuts. Eurozone Finance Ministers also met and agreed to provide €150 billion in loans to the IMF. Encouragingly, peripheral bond yields stabilised in the second half of the month following some better-than-expected bond auctions in Spain and Italy. Spanish 10-year SPGB yields fell by 116 bps to 5.04% over the month to December-end. Though, Italian 10-year BTPS yields finished the month slightly above the dreaded 7% 'bail-out' level at 7.03%.

Against this risk averse backdrop, US economic data continued to improve in December. Better-than-expected employment, consumer confidence, housing and manufacturing data was released during the month. The US Congress approved a US\$1 trillion spending packaging, averting a possible US government shutdown. The resolution of the US payrolls tax-cut deadlock also boosted sentiment after several months of political wrangling, culminating in the loss of the US' coveted AAA sovereign credit rating. In response, the US S&P 500 Index increased by 0.9% (in US dollar terms), but global equity markets were choppy due to varied, but persistent concerns over the crisis in Europe. Overall, US 10-year Treasury yields declined by 19 bps to 1.88% at year-end, down from 2.07% at the end of November.

The Australian bond market rallied by 26 bps in December. Ten-year CGS yields reached a new record low of 3.67% at year-end, having ended the previous month at 3.93%. Australia's bonds rallied much faster than the US. Instead of tempering the rally, slightly weaker local economic data encouraged AUD yields to fall further. However, Australia recorded GDP growth of 1.0% in the September quarter, slightly above market expectations of 0.8% growth. In recent months, the Eurozone debt crisis has underpinned strong demand for Australian sovereign bonds. Overseas central banks and offshore institutional investors, in particular, continued to be lured to the developed world's highest government bond yields, supported by strong liquidity and the relative safety of the Australian government bond market given the country's sound fiscal position and stronger economic fundamentals. The Reserve Bank of Australia (RBA) reduced its official cash rate (OCR) for a second consecutive month by 25 bps to 4.25%, citing the risk to the global economic outlook due to a likely contraction in Europe.

Australian and global investment grade credit securities whip-sawed throughout December, but generally tightened into year-end, driven primarily by developments in Europe. Credit markets priced-in the benefit of wider collateral and national central bank guarantees, and sentiment was enhanced by the release of better-than-expected US economic data. The US high yield market finished 2011 strongly with the Merrill Lynch broad market and BB/B Constrained indices outperforming 10-year US Treasuries and investment grade corporates.

### Fund strategies

#### Interest rate strategies:

Australian 10-year CGS yields decreased in December. Our short duration strategy detracted value as a result. Ten-year CGS yields rose by 7 bps, back up to 4% on 1 December as financial markets reacted very positively to offshore news that a band of global central banks acted to provide US dollar support to the global banking system. Risk assets were also buoyed by news that the People's Bank of China had cut its reserve requirement ratio. This provided us with the opportunity to incrementally lengthen our duration position. The RBA rate cut on 6 December also supported bond yields. But, cautious optimism ahead of the EU Summit saw the Australian bond market sell-off slightly. We lengthened our duration position, accordingly. Stronger European bond yield auctions mid-month provided a small boost to Australian bond market confidence, generating a modest pull-back in yields. Though, this was short-lived as ECB support diminished on negative comments by the Bundesbank President, who confirmed that Germany isn't interested in printing more money. Nevertheless, we further lengthened our duration position. The reason for desiring a smaller short duration position is that, although the valuation of the market continues to argue for a larger short position, the near-term downside risks to yields continue. Positive sentiment from the EU Summit has evaporated with all Eurozone solutions pointing towards contractionary fiscal policies and a poor economic growth outlook. Negative comments by international credit ratings agencies about the EU's handling of the crisis has added to the malaise. The RBA's intention to ease the OCR further remains in play going into the new year, especially with its focus now more on European concerns than inflationary pressures.

The 3- to 10-year part of the AUD yield curve flattened by 25 bps in December. The entire yield curve continues to trade well below the cash rate, with the market clearly expecting further rate cuts of at least another 100 bps over the coming 12 months, as moderating growth and inflation expectations lead to a more neutral stance of monetary policy from the RBA. We maintained our neutral curve strategy, which has been in place since early October.

As mentioned earlier, 10-year US Treasury yields declined over the month. Our short duration strategy detracted value as a result. Given the deteriorating global backdrop, stemming from events in Europe, we expect continued pressure for US yields to remain below fair value in the short-term. The cost of carrying a short duration position in the US is also significant. Therefore, given the current mix of value and risk factors, we believe that a smaller short position is warranted.

US Treasuries benefited from their 'safe-haven' status as the European sovereign debt crisis continues with uncertainty. As a result, the 2- to 10-year part of the USD yield curve flattened by about 15 bps during December. This movement has been driven by the falling trend in 10-year bond yields. Our 2- to 10-year strategy with a 37.5% flattener in this part of the curve benefited and added value. The US 10- to 30-year part of the curve has seen almost no change, ending the month 1 bp steeper. We maintained our neutral strategy in the long-end of the curve.

#### Sector:

During the month of December, overweight positions were retained in investment grade and high yield credit, supranationals and semi-government bonds. Our sector allocation strategies added value during the month. At the beginning of the month, we increased our non-default spread risk by 5% to 100% of limit. This was to be implemented with increased exposure to supranationals in the first instance with the balance being allocated to semi-government securities. Spreads for semi-government and supranationals widened significantly in November. Therefore, we considered supranational and to a lesser extent, semi-government securities, to have offered very good value at the time. Supranational spreads relative to CGS tightened over December, adding value, whilst semi-government securities underperformed CGS and was a detractor from Fund performance. Global credit spread tightening also contributed to relative Fund returns during the month.

#### Inflation-linked:

We retained our short real duration strategy throughout December. This strategy detracted from relative Fund performance as 2020 Government Treasury Indexed Bond (TIBs) yields decreased by 21 bps to 1.12% over the month – a new all-time low. Break-even inflation (BEI) levels also declined with the 2020 BEI down by 5 bps to 2.44% at December-end, as European-induced risk aversion drove nominal yields lower than real yields. We also maintained our moderately long break-even inflation (BEI) position throughout the month. Our current strategy is to be long ILBs and short nominal bonds. This detracted marginal value from our Fund's relative performance as the BEI decreased.

Fund name	Market value (A\$m)	Fund duration	Benchmark duration	Portfolio yield	Investment grade	High yield	Domestic allocation	International allocation	Inception
Australian Bond Fund	743.3	2.82	3.80	5.41%	100.00%	0.00%	79.90%	20.10%	Oct-95
Diversified Fixed Interest Fund	2,340.5	2.14	3.80	5.99%	86.08%	13.92%	59.95%	40.05%	May-97
Government Inflation-Linked Bond Fund	47.2	6.38	9.11	4.77%	100.00%	0.00%	100.00%	0.00%	Mar-10
Australian Inflation-Linked Bond Fund	320.2	7.80	8.97	5.06%	100.00%	0.00%	93.95%	6.05%	Jun-00
Global Bond Fund	178.2	5.01	6.72	6.14%	100.00%	0.00%	0.00%	100.00%	Nov-00
Global Corporate Bond Fund	1,033.2	5.47	5.57	9.04%	84.54%	15.46%	18.79%	81.21%	Dec-09
Global Credit Income Fund	4,134.0	0.14	0.12	8.03%	78.24%	21.76%	20.11%	79.89%	Sep-00
International High Yield Fund*	483.4	3.47	4.22	10.84%	12.76%	87.24%	0.00%	100.00%	Aug-99

### Wholesale Australian Bond Fund

The Fund returned 0.51% in December, underperforming its benchmark by 27 bps. Our short duration strategy was negative for relative Fund performance this month as 10-year CGS yields decreased. Modest increases in 10-year CGS yields at various stages of the month, caused by renewed optimism in Europe and the RBA rate cut, provided us with an opportunity to reduce our active duration position. We maintained a neutral curve position throughout the month which was negligible for relative Fund performance. At the beginning of the month, we increased our overweight exposures to supranationals and semi-government securities as they offered very good value, having been oversold in November due to concerns over the European debt crisis. The spread of 10-year EIB and Council of Europe supranational bonds over 10-year CGS contracted by around 50 bps and 30 bps, respectively, adding to relative Fund performance in December. However, our overweight position in 10-year semi-government bonds detracted from performance. Semi spreads widened by around 9 bps relative to 10-year CGS over the month, underperforming CGS. Credit spreads generally tightened into year-end. Credit markets priced-in the benefit of wider collateral and national central bank guarantees in Europe, and sentiment was enhanced by the release of better-than-expected US economic data. Therefore, our overweight position in credit securities added to relative Fund returns.

### Wholesale Diversified Fixed Interest Fund

The Fund returned 0.59% in December, underperforming its benchmark by 19 bps. Our short duration strategy was negative for relative Fund performance this month as 10-year CGS yields decreased. Modest pull-backs in 10-year CGS yields at various stages of the month, caused by renewed optimism in Europe and the RBA rate cut, provided us with an opportunity to reduce our active duration position. A neutral AUD curve position was maintained throughout the month. Overall, our sector allocation strategies contributed positively to relative Fund performance. At the beginning of the month, we increased our overweight exposures to supranationals and semi-government securities as they offered very good value, having been oversold in November due to concerns over the European debt crisis. The spread of 10-year EIB and COE supranational bonds over 10-year CGS contracted by around 50 bps and 30 bps over the month, respectively, adding to relative Fund performance. However, our overweight position in 10-year semi-government bonds detracted from relative Fund performance. Semi spreads widened relative to 10-year CGS over the month, underperforming CGS. Credit spreads generally tightened into year-end. Global credit and high yield markets priced-in the benefit of wider collateral and national central bank guarantees in Europe, and sentiment was enhanced by the release of better-than-expected US economic data. We retained our long BEI position throughout the month.

### Wholesale Government Inflation-Linked Bond Fund

The Fund returned 1.23% in December, underperforming its benchmark by 76 bps. Our short real duration strategy detracted value as real yields decreased to fresh lows over the month. The Fund retained a short real duration position of around 2.7 shorter than benchmark throughout the month. We also retained our moderately long BEI position throughout December. Therefore, our current strategy is to be long ILBs and short nominal bonds. Break-even inflation (BEI) levels declined with the 2020 BEI down by 5 bps to 2.44% at December-end, as European-induced risk aversion drove nominal yields lower than real yields. This further detracted value from our Fund's relative performance during the month. The real yield curve flattened over the month on the back of a flatter nominal curve, and a lack of linker supply from the AOFM. The Fund was mainly short in the long-end of the curve, adding a small amount of value. The 2020 NSWTC CIB spread to TIBs widened by 5 bps in December, following nominal semi spreads wider due to the general risk-off environment, lack of liquidity and dislocated AUD supra market. The Fund retained a large overweight position in semi-government ILBs, which further reduced relative returns.

### Wholesale Australian Inflation-Linked Bond Fund

The Fund returned 1.71% in December, underperforming its benchmark by 24 bps. Our short real duration strategy detracted value as real yields decreased to fresh lows over the month. The Fund retained a short real duration position of around 1.2 shorter than benchmark throughout the month. The real yield curve flattened over the month on the back of a flatter nominal curve, and a lack of linker supply from the AOFM. The Fund was mainly short in the long-end of the curve, adding a small amount of value. The 2020 NSWTC CIB spread to TIBs widened by 5 bps in December, following nominal semi spreads wider due to the general risk-off environment, lack of liquidity and dislocated AUD supra market. The Fund retained a large overweight position in semi-government ILBs, which further reduced relative returns.

### Wholesale Global Bond Fund

The Fund returned 1.52% in December, underperforming its benchmark by 58 bps. Major global bond markets rallied in December. Market sentiment continued to be dominated by the continuing problems in Europe, which triggered a fall in rates globally. In response, 10-year German bund yields decreased by 45 bps to 1.78%. US Treasuries underperformed in the rally with the 10-year US Treasury yield declining by 19 bps to 1.88%, as better-than-expected US economic data releases boosted market sentiment and counterbalanced European sovereign debt concerns. Overall, our short duration strategies detracted value as a result. Given the deteriorating global backdrop, stemming from events in Europe, we expect continued pressure for US yields to remain below fair value in the short-term. The cost of carrying a short duration position in the US is also significant. Therefore, given the current mix of value and risk factors, we believed that a smaller short position was warranted. We also lengthened duration in European peripheral countries, Spain and Italy, during the month with the trend to higher yields/spreads over German bunds receding after a huge sell-off over recent months. The 2- to 10-year part of the USD yield curve flattened by about 15 bps during December. This movement has been driven by the falling trend in 10-year bond yields. Our 2- to 10-year strategy with a 37.5% flattener in this part of the curve benefited and added value. Overall, the Fund's curve strategies added moderate value in December.

### Wholesale Global Corporate Bond Fund

The Fund returned 2.39% in December, underperforming its benchmark by 4 bps. Global credit markets continued to whipsaw in December, with the sovereign crisis in Europe remaining the key driver of spread volatility. Credit spreads on European Financials tightened by 24 bps during the month, rebounding after the ECB announced support for European banks via 3-year liquidity tenders, lower reserve requirements and a relaxation of collateral terms. The Fund retained its sizeable underweight exposure to Financials, which detracted moderately from overall relative Fund performance in December. High yield securities finished the month strongly, outperforming investment grade credit as market optimism increased despite the deteriorating global backdrop, as US economic data releases continued to steadily improve on the back of better-than-expected employment, consumer confidence, housing and manufacturing data. The resolution of the US payrolls tax-cut deadlock also boosted sentiment after several months of political wrangling, culminating in the loss of the US' coveted AAA sovereign credit rating. This off-benchmark exposure (the Fund is managed against an investment grade credit benchmark) added to overall relative Fund returns. The 5-year AUD/EUR basis swap moved out by 10 bps over the month, dragging down relative Fund performance as the Fund hedges its EUR exposures in basis swaps. During the month, the Fund participated in a new issue from Petrobras, topping-up its existing exposure to this name.

### Wholesale Global Credit Income Fund

The Fund returned 1.11% in December, outperforming its benchmark by 70 bps, reflecting the tightening in global credit spreads. Credit markets priced-in the benefit of wider collateral and national central bank guarantees, and sentiment was enhanced by the release of better-than-expected US economic data. Credit spreads on European Financials tightened by 24 bps during the month, rebounding after the ECB announced support for European banks via 3-year liquidity tenders, lower reserve requirements and a relaxation of collateral terms. Therefore, the Fund's overweight exposure to Financials added to overall Fund performance. High yield securities finished the month strongly, outperforming investment grade credit as market optimism increased despite the deteriorating global backdrop, as US economic data releases continued to steadily improve on the back of better-than-expected employment, consumer confidence, housing and manufacturing data. The resolution of the US payrolls tax-cut deadlock also boosted sentiment after several months of political wrangling, culminating in the loss of the US' coveted AAA sovereign credit rating. The Fund had around 22% exposure to high yield securities, contributing positively to overall Fund returns. During the month, the Fund participated in new issues from BNP Paribas and Santander, taking advantage of the issuer exchange offers to move out of lower tier two subordinated debt into senior unsecured debt. Amgen issued debt to fund a share buy-back. We were able to purchase this name at a good spread given the amount of debt the company needed to issue.

### Wholesale International High Yield Fund

The Fund returned 2.36% in December, underperforming its benchmark by 39 bps. Despite a mid-month pause, the US high yield market finished 2011 on a strong note, as the Merrill Lynch broad market and BB/B Constrained indices posted monthly returns of 2.48% and 2.37%, respectively. High yield spreads narrowed by 38 bps in December to 740 for the broad market and by 33 bps to 646 for the BB/B Constrained Index. Current spreads are now in-line with spreads back in the December quarter of 2009. All sectors rose in the month, led by Insurance (+4.6%), Building Materials (+4.5%), and Cable TV (+4.1%). Our name selection in Building Materials and Metals & Mining detracted from relative Fund performance. Meanwhile, our name selection in Telecommunications and overweight in Health Care contributed to relative Fund returns. The Fund participated in select new issues, topping-up in names where we are comfortable from a risk/return perspective – Ford Motor Credit, Senior Housing Trust and Fidelity National. With respect to Ford, although the pricing was somewhat tight, we believe there continues to be upside with this name as it eventually moves into investment grade. The secondary market was also quiet during the month and we only made very modest changes to the portfolio.

\* The Wholesale International High Yield Fund is part managed by HIH Money

Performance (before fees and expenses)	3 mths	6 mths	1 yr	3 yrs pa	5 yrs pa	10 yrs pa	Since Inception pa
<b>Wholesale Australian Bond Fund</b>	<b>0.23%</b>	<b>3.44%</b>	<b>8.01%</b>	<b>6.24%</b>	<b>7.05%</b>	<b>6.54%</b>	<b>7.30%</b>
UBS Australian Composite Bond Index 0+ Yr	1.94%	6.66%	11.37%	6.31%	7.40%	6.46%	7.28%
Relative performance	-1.71%	-3.23%	-3.37%	-0.07%	-0.35%	0.08%	0.01%
<b>Wholesale Diversified Fixed Interest Fund</b>	<b>1.36%</b>	<b>2.41%</b>	<b>6.93%</b>	<b>9.60%</b>	<b>6.88%</b>	<b>6.95%</b>	<b>7.14%</b>
UBS Australian Composite Bond Index 0+ Yr (Note 1)	1.94%	6.66%	11.37%	8.17%	7.44%	6.93%	6.95%
Relative performance	-0.58%	-4.25%	-4.44%	1.43%	-0.56%	0.02%	0.19%
<b>Wholesale Government Inflation-Linked Bond Fund</b>	<b>2.39%</b>	<b>8.54%</b>	<b>14.76%</b>	–	–	–	<b>11.07%</b>
UBS Government Inflation Linked 0+	4.60%	12.49%	19.33%	–	–	–	13.15%
Relative performance	-2.21%	-3.95%	-4.57%	–	–	–	-2.08%
<b>Wholesale Sovereign Australian Bond Fund*</b>	<b>0.80%</b>	<b>4.45%</b>	<b>8.98%</b>	<b>5.91%</b>	<b>7.45%</b>	–	<b>6.73%</b>
UBS Australian Government Index 0+ Yr	2.55%	7.86%	12.61%	5.99%	7.71%	–	6.80%
Relative performance	-1.75%	-3.41%	-3.64%	-0.07%	-0.27%	–	-0.07%
<b>Wholesale Australian Inflation-Linked Bond Fund</b>	<b>3.35%</b>	<b>10.63%</b>	<b>17.13%</b>	<b>8.56%</b>	<b>6.47%</b>	<b>6.98%</b>	<b>7.03%</b>
UBS Australian Inflation Index 0+ Yr	4.29%	12.17%	19.02%	8.81%	6.83%	7.11%	7.13%
Relative performance	-0.94%	-1.54%	-1.88%	-0.25%	-0.35%	-0.13%	-0.10%
<b>Wholesale Global Bond Fund</b>	<b>1.35%</b>	<b>4.49%</b>	<b>8.31%</b>	<b>6.54%</b>	<b>8.11%</b>	<b>7.91%</b>	<b>8.04%</b>
Hedged	1.84%	7.16%	10.53%	7.42%	8.51%	7.96%	8.07%
Relative performance	-0.49%	-2.67%	-2.21%	-0.88%	-0.40%	-0.05%	-0.04%
<b>Wholesale Global Corporate Bond Fund</b>	<b>3.15%</b>	<b>5.61%</b>	<b>11.21%</b>	–	–	–	<b>12.66%</b>
Barclays Glb Agg Corp (AUD Hedged)	2.71%	4.74%	9.45%	–	–	–	10.35%
Relative performance	0.44%	0.86%	1.77%	–	–	–	2.31%
<b>Wholesale Global Credit Income Fund</b>	<b>2.12%</b>	<b>-0.77%</b>	<b>3.19%</b>	<b>11.17%</b>	<b>4.90%</b>	<b>5.91%</b>	<b>5.94%</b>
UBS Australian Bank Bill Index	1.22%	2.47%	5.00%	4.38%	5.48%	5.45%	5.46%
Relative performance	0.90%	-3.24%	-1.81%	6.79%	-0.58%	0.46%	0.47%
<b>Wholesale International High Yield Fund</b>	<b>6.09%</b>	<b>4.28%</b>	<b>10.99%</b>	<b>20.41%</b>	<b>9.94%</b>	<b>10.86%</b>	<b>8.91%</b>
(AUD Hedged)	6.58%	2.04%	9.42%	24.46%	8.82%	10.10%	8.29%
Relative performance	-0.49%	2.24%	1.57%	-4.05%	1.12%	0.76%	0.63%

**Note 1.** The benchmark from inception was the Diversified Fixed Interest Custom benchmark. From 1 October 2009, the benchmark was changed to the UBS Australian Composite Bond Index 0+Yr

\*Wholesale Sovereign Australian Bond Fund inception date is June 2004.

1. Colonial First State Wholesale Australian Bond Fund (ARSN 087 570 885)

2. Colonial First State Wholesale Diversified Fixed Interest Fund (ARSN 087 570 634)

3. Colonial First State Wholesale Government Inflation-Linked Bond Fund (ARSN 140 777 153)

4. Colonial First State Wholesale Australian Inflation-Linked Bond Fund (ARSN 109 437 041)

5. Colonial First State Wholesale Global Bond Fund (ARSN 094 727 965)

6. Colonial First State Wholesale Global Corporate Bond Fund (ARSN 140 189 984)

7. Colonial First State Wholesale Global Credit Income Fund (ARSN 093 045 713)

8. Colonial First State Wholesale International High Yield Fund (ARSN 087 570 683)

Portfolio yield uses the horizon rate of return (HROR) measure of yield. HROR brings the time period over which the future return is estimated of all of the bonds in the fund back to 30 days, then calculates the expected return over that 30 day period and annualises it. This provides a best conservative estimate of the expected future returns of the current portfolio in the current economic state with no changes to the markets or portfolio. For further information please contact your client relationship manager.

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