

Greencape Wholesale Broadcap Fund

Fund report and commentary – 31 December 2009

Performance	Quarter (%)	1 year (%)	2 years (%) p.a.	3 years (%) p.a.	Inception (%) p.a.
Greencape Wholesale Broadcap Fund	4.49	45.37	-4.21	5.19	10.08
Growth return	4.13	41.50	-7.48	-0.28	4.88
Distribution return	0.36	3.87	3.28	5.47	5.21
S&P/ASX 300 Accumulation Index	3.37	37.59	-8.33	-0.78	3.36
Active return (net)	1.12	7.78	4.12	5.97	6.72

Returns are calculated after fees have been deducted, assuming reinvestment of distributions. No allowance is made for tax. Past performance is not a reliable indicator of future performance.

Investment objective

The Fund aims to provide capital growth over the medium to long term investment horizon through a diversified portfolio of large, mid and small capitalisation Australian shares and provide returns above the benchmark, the S&P/ASX 300 Accumulation Index, over rolling three-year periods.

Investment manager

Greencape Capital Pty Ltd

Investment strategy

Greencape is an active, bottom-up stock picker. Whilst not targeting a specific investment style and investing in stocks displaying 'value' and 'growth' characteristics, Greencape's focus is on a company's qualitative attributes, which will generally lead to 'growth' oriented portfolios. This is an outcome of Greencape's bottom up process. As such, Greencape's investment style may be classified as 'growth at a reasonable price' (GARP).

Distribution frequency

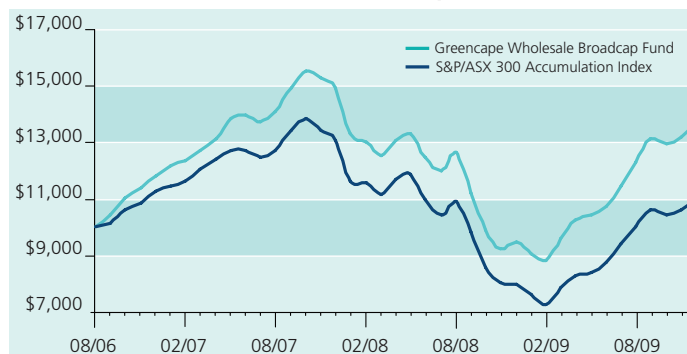
Quarterly

Suggested minimum investment timeframe

At least five years

Greencape Broadcap Fund

Growth of \$10,000 invested since inception (net of fees)

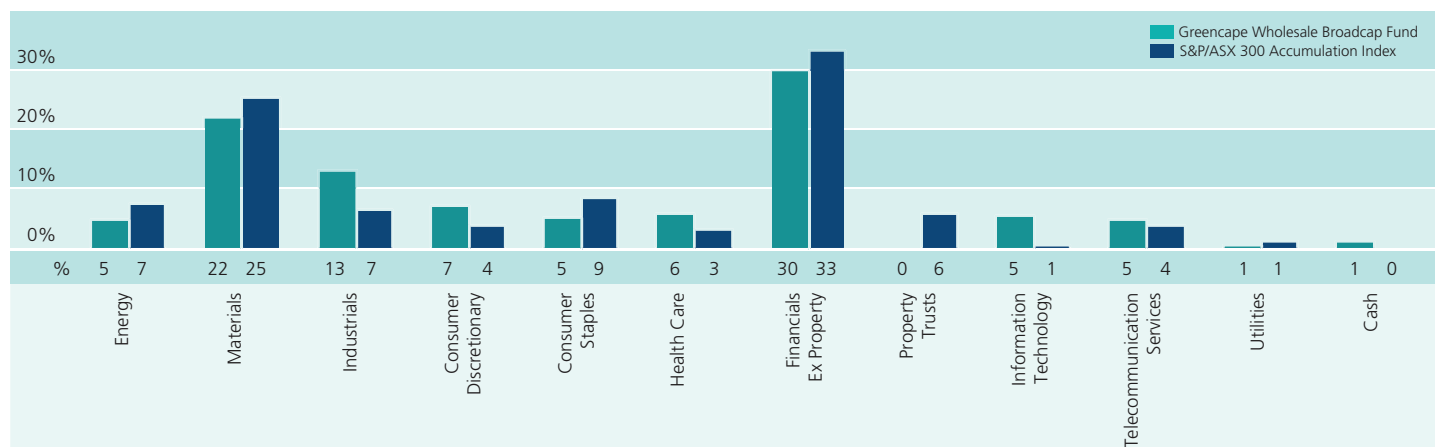


Asset allocation	Current (%)	Range (%)
Securities	98	85–100
Cash	2	0–15

Fund facts	Greencape Wholesale Broadcap Fund
Inception date	11/09/2006
APIR code	HOW0034AU

Fees	Greencape Wholesale Broadcap Fund
Entry fee	Nil
2008/09 ICR	1.49%
Management fee	0.95% p.a.
Performance fee	15% of the Fund's after management fee return above the Fund's benchmark.
Buy/sell spread	+0.30%/-0.30%

Sector exposures as at 30 November 2009



Market Review

The S&P/ASX 200 Accumulation Index returned 3.4% for the quarter and 37.0% for 2009, marking a 60% rebound from the March low. This was the third consecutive quarter of positive returns following the six consecutive quarters of negative returns that preceded it. The Greencape Wholesale Broadcap Fund outperformed the market and delivered a 4.5% return over the quarter.

The chart below shows that despite the rebound, the index is still 21% below the October 2007 peak, although the total market capitalisation is only 15% below the peak given the level of equity raisings recently.

S&P/ASX 200 Accumulation Index



The S&P/ASX 200 opened the quarter at 4,677 and traded within the range of 4,508 to 4,860 before rising 236 points in late December to close at 4,871 for the year.

The Materials sector (includes Resources) performed strongly with BHP Billiton and Rio Tinto up 14% and 26% respectively. The Utilities sector was led by Spark Infrastructure which was up 19% and Wesfarmers rose 18% for the quarter, more than offsetting the 4% decline of Woolworths within the Consumer Staples sector.

Property Trusts were the worst performing sector for the quarter with Westfield declining 10% on concerns over their UK exposure and development pipeline. The Energy sector was down with Woodside falling 9% due to production delays and concerns over cost overruns, and Santos (down 7%) and Oil Search (down 5%) being used as funding sources for the Woodside capital raising in December. Financials underperformed, led by the big four banks (excluding the Commonwealth Bank) which underperformed by between 4% and 11% following NAB's surprise bid for AXA on 17 December. If successful, this would make it NAB's fourth large financial services acquisition within seven months as summarised below:

Dec 09	AXA Australia & NZ businesses	\$4,610m
Aug 09	Challenger's mortgage management business	\$385m
Jul 09	80% of Goldman Sachs JBWere Private Wealth	\$99m
Jun 09	Australia (wealth management and life insurance)	\$825m
		\$5,519m

	December quarter	2009
Market (S&P/ASX 200 AI)	3.4%	37.0%
Best performing sectors:		
Materials	13.9%	50.9%
Utilities	5.1%	8.0%
Consumer Staples	4.7%	31.5%
Worst performing sectors:		
Property Trusts	-5.0%	7.9%
Energy	-2.3%	30.3%
Financials	-0.6%	50.2%

Company visits and observations

- In November we travelled to China and met with international shipping companies, international fashion and electronic wholesalers/retailers, China HR, online employment businesses, and Chinese domestic based operators across the retail and transport sectors. Some of our observations from the trip were:
 - From Chinese exporters and international freight forwarders into the US:
 - No peak season leading up into Christmas unlike prior years.
 - No sign yet of the US consumer coming back.
 - Asia export volumes down 50% into US .
 - In 3Q 2009 the top 15 shipping companies were all loss making for the first time ever and were forced to raise prices.
 - Container capacity is 140% of demand and demand is still falling.
 - International fashion wholesalers and retailers:
 - Idle capacity growing in China's export oriented manufacturing base.
 - No demand improvement seen yet from the US or Europe.
 - Inventory levels stabilised, but a lot of in-season order (JIT) vs forward orders (consistent with our recent US trip observations).
 - Concerns over cost inflation from recent 30% increase in cost of manufacturing from China labour law changes.
 - China based freight forwarders, transport and Chinese Ports:
 - Focused on domestic and intra-Asia freight, not exports.
 - FY10 forecast further declined on export freight movements.
 - In exports, seeing small rushed orders only.
 - China Domestic observations:
 - Government stimulus has a heavy infrastructure focus which underpins demand for resources.
 - Retailers and employment related businesses seeing month-on-month growth through Q3. We expect growth to continue into 2010.
 - Lots of property speculation! Plenty of vacant retail and housing. Its seems standard practice for individuals to buy a vacant property, hold it for a short period, then sell for a profit whilst still vacant. RMB \$300m (A\$50m) was being asked for a Beijing penthouse – most expensive ever! To date China would appear to have misallocated too much capital into property.
- We attended the Lend Lease investor tour in Melbourne and witnessed their increasing focus on sustainability in respect of the new ANZ building development:
 - The building is rated 6-star since it produces additional energy for the neighbourhood via wind turbines and solar panels on the roof.
 - Grey water is used to cool and heat the building.
 - Transport needs are catered for with the addition of a new tram stop and all new Lend Lease buildings provide for bikes, with space for 500 bikes in the ANZ building.

'It takes considerable effort to see facts while withholding judgment and resisting explanations.'

'... be a fox with an open mind.'

Nassim Taleb, *The Black Swan*, 2007

- Sustainability is now a key driver for commercial developments and Lend Lease believe they are leading the industry. One comment during the tour was that a corporate won't take a building today unless it's Green Star rated, and that residential buildings will follow commercial's lead over the next five years.
- The capital cost for a 'Green' building is only 5% more, yet they are typically 10% cheaper to run (cost saving expected to be greater as energy costs rise).
- We visited BGC, a builder that recently completed a large brick manufacturing plant in Western Australia and is a direct competitor to Boral. The plant manager told us (referring to the business owner and economic returns on capital) 'Len has no interest in returns... his directive to me is "we are here to make bricks, so make as many as you can".'

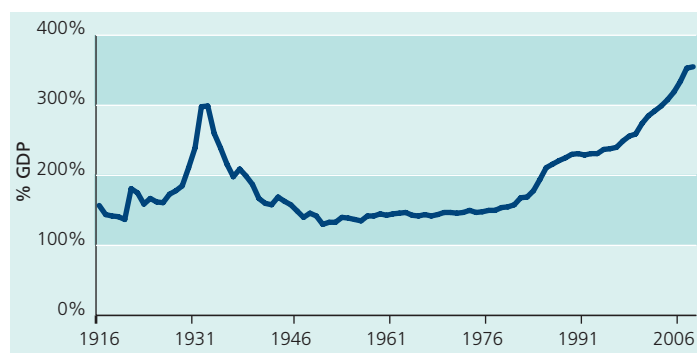
Macro observations

Given 2009 saw such large fiscal intervention in economies around the world, as we look towards 2010 and beyond, we thought it timely to take an in depth look at current debt levels, particularly for world's largest economy and its government.

US debt levels

The chart below shows the level of debt within the US economy over the last 93 years. The two early spikes in debt were in 1921, following World War I and in 1930 – 1933 during the Great Depression.

US total Debt to GDP



Source: US Federal Reserve

In the Great Depression of the early 1930's the US government followed 'Keynsian' economic policy of taking on significant debt to stimulate the economy before it reduced (at least as a percentage of GDP) from 1934 – 1941. Whilst the Obama administration is applying the same approach today, it is worth noting that the starting debt position is much higher than that which preceded the Depression.

	US Govt. Debt/GDP	Total US Debt/GDP
Then:		
Year prior to Depression – 1929	29%	185%
Peak debt level in Depression – 1933	72%	299%
Now:		
Year prior to Recession – 2007	52%	340%
4 years later – 2011*	82%	??
4 years later – 2011**	95%	454%

* Congressional Budget Office forecast for federal debt, assumes state debt grows 5% p.a.

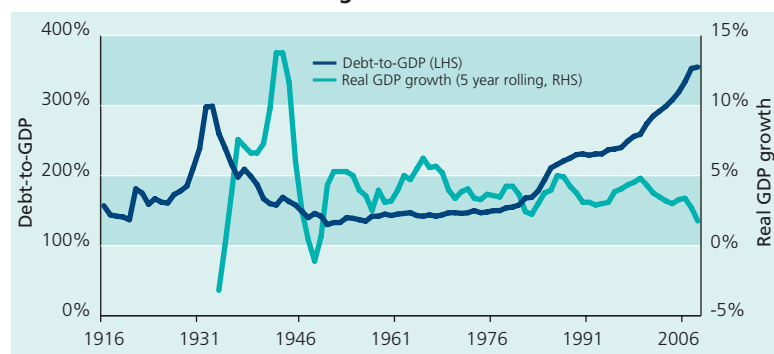
** Level required to give the same stimulatory effect as during the Depression

'Wealth is not created by financial engineering. Financial engineering tends to be a transfer of wealth.'

Stephen Barrow, August 2007

The chart below shows that the run-up in system-wide US debt during the early 1930's was followed by a rebound in GDP growth from 1934 onwards. The World War II period led to strong economic growth which fell away immediately following the war, taking real GDP until 1951 to surpass its 1944 peak. The chart also shows that the run up in debt from the 1980's until today has not led to an increase in GDP growth compared to earlier in the century.

US Debt-to-GDP vs Real GDP growth



Source: US Federal Reserve

A recent report¹ examined the relationship between high government debt levels and economic growth since 1790. We provide the following report excerpts below:

Using a benchmark of 14 earlier severe post-World-War II financial crises, we demonstrated that central government debt rises, on average, by about 86% within three years after the crisis. (p. 2)

As for inflation, an obvious connection stems from the fact that unanticipated high inflation can reduce the real cost of servicing the debt. Of course, the efficacy of the inflation channel is quite sensitive to the maturity structure of the debt. Whereas long-term nominal government debt is extremely vulnerable to inflation, short term debt is far less so. Any government that attempts to inflate away the real value of short term debt will soon find itself paying much higher interest rates when it comes time to refinance. (p. 6)

War debts are arguably less problematic for future growth and inflation than large debts that are accumulated in peace time. Post-war growth tends to be high as war-time allocation of manpower and resources funnels to the civilian economy. Moreover, high war-time government spending, typically the cause of the debt build-up, comes to a natural close as peace returns. In contrast, a peacetime debt explosion often reflects unstable underlying political economy dynamics that can persist for very long periods. (p. 6)

Over the past two centuries, debt in excess of 90% has typically been associated with mean GDP growth of 1.7% versus 3.7% when debt is low (under 30% of GDP)... (p. 11)

The sharp run-up in public sector debt will likely prove one of the most enduring legacies of the 2007-2009 financial crises in the United States and elsewhere. (p. 22)

Seldom do countries simply 'grow' their way out of deep debt burdens. (p. 23)

...as debt levels rise towards historical limits, risk premia begin to rise sharply, facing highly indebted governments with difficult tradeoffs. (p. 23)

...countries that choose to rely excessively on short term borrowing to fund growing debt levels are particularly vulnerable to crises in confidence that can provoke very sudden and 'unexpected' financial crises. Similar statements could be made about foreign versus domestic debt. (p. 23)

"Trade and technology are twin engines of growth and prosperity. No boom is sustained without one or the other."

Andy Xie, 10/11/09

'The challenge of producing a positive outcome via pulling the fiscal-stimulus lever is compounded by the fact that the degree of public indebtedness weights heavily on the effectiveness of discretionary fiscal policy.... The impact of fiscal policy on the strength of recovery is weaker for economies that have higher levels of debt relative to GDP.'

Rodney Sullivan CFA Institute

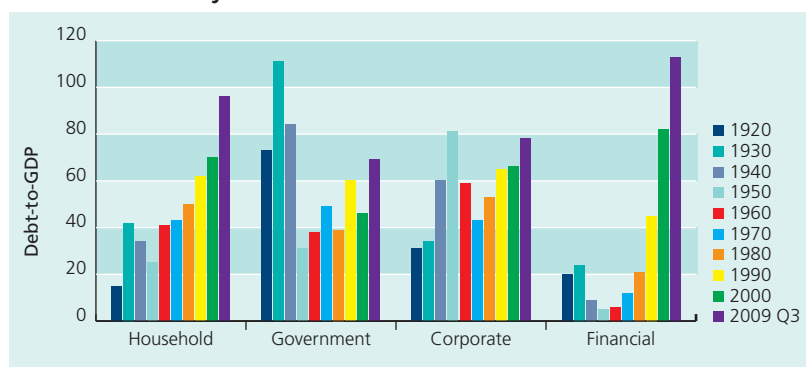
¹ 'Growth in a Time of Debt', Carmen Reinhart and Kenneth Rogoff, 31 December 2009

The things that struck us in the report in relation to the US government's current position are:

- US government debt is now 69% of GDP², and going to 78%³ in 2010;
- the debt has been amassed in peacetime (at least not during a major global conflict) and hence above-trend future GDP growth cannot be relied upon;
- the Congressional Budget Office is forecasting US real GDP growth to average 2.6%p.a. for the next decade, relative to the 2.9% rate averaged since 1970; and
- the debt is being financed increasingly by short term treasuries, as discussed later.

The chart below breaks down the US debt load by sector.

US Debt-to-GDP by sector



Source: US Federal Reserve

Regarding the chart above:

- Household debt increased throughout the century, but the last decade showed the strongest increase. From 1933 it fell from 54% of GDP to a trough of 13% in 1945, before peaking again at 98% in 2007. It currently stands at 96% (in comparison, Australia household debt was 118%⁴ of GDP in June 2009).
- Government debt reached 72% of GDP in 1933, declined, then peaked at 118% in 1945 following WWII, before declining as a percentage of the economy until 1974 at 36%. It currently stands at 63%.
- Corporate debt went into the Great Depression starting at 98% of GDP and currently stands at 78%.
- Financial sector debt has been the real story of where the debt accumulation took off in the US. In the 1920's it hovered around 20 – 25% of GDP, declined to a low of 4% in 1958, then from 1980 it grew from 21% to a peak of 120% in early 2009. At last check it had declined to 113% of GDP.

An interesting thing to watch in 2010 and beyond is whether US government borrowing will keep pace with the deleveraging of the household, corporate and financial sectors. In the context of the last century, the government appears to be the only sector with the capacity (albeit it narrowing) and the willingness to continue leveraging up to support GDP growth. However as the earlier chart shows, more debt doesn't always lead to prosperity, but it does increase systemic risks should the tap of credit be unexpectedly turned off, as we witnessed in 2008/09.

US Government debt issuance

Despite the large amount of debt issuance, the net interest bill paid by the US government is actually estimated to fall to US\$177 billion in 2009 from \$253 billion in 2008 (out of interest, this equals the Australian government's entire annual taxation revenue!). The charts on the following page show that the interest expense as a percentage of government revenue has held steady from 2002

'Using GDP as the main financial indicator is equivalent to judging a man's success by the cost of his house, car, and wristwatch. Rather than gauging income, these figures merely indicate a level of spending and have nothing to do with earning power.'

Peter Schiff 14/12/09

'... the world's net indebtedness is always zero; yet if A owes a million to B, and B owes a million to C, and so on down the line, till we find Z owing a million back to A, the failure of A may bankrupt B, who may then cause the bankruptcy of C, and so on to Z. Thus a net debt of zero may bankrupt 26 millionaires, like a row of nine-pins.'

Irving Fisher, 1933

'... over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system.'

Hyman Minsky 1992

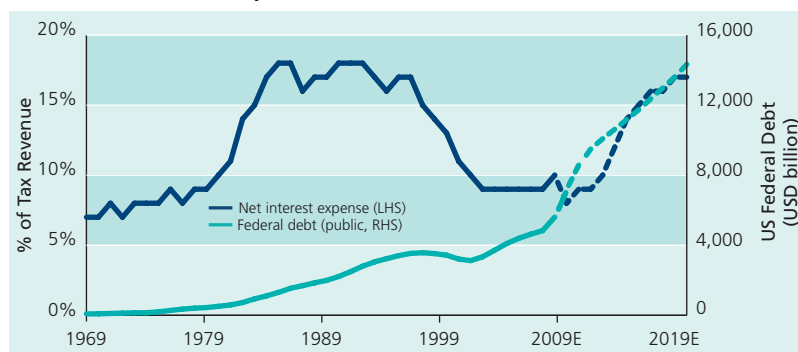
² US federal & state government debt held by public (excluding 'intra-governmental' debt) at Sep 2009

³ US Congressional Budget Office forecast for Federal debt and GDP, assumes state debt grows 5%

⁴ Source: Morgan Stanley, ABS

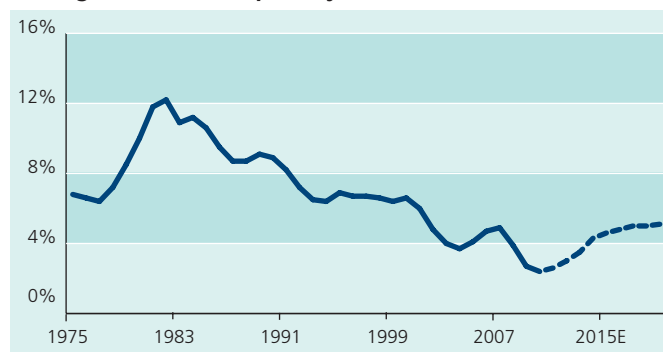
despite a growing debt balance as the average interest rate paid declined. The net interest expense is forecast to increase from 8% of government revenue in 2009 to 17% in 2018, with the underlying assumption being that the average interest rate will increase modestly, to reach 5.1% in 2019⁵.

US federal interest expense vs federal debt



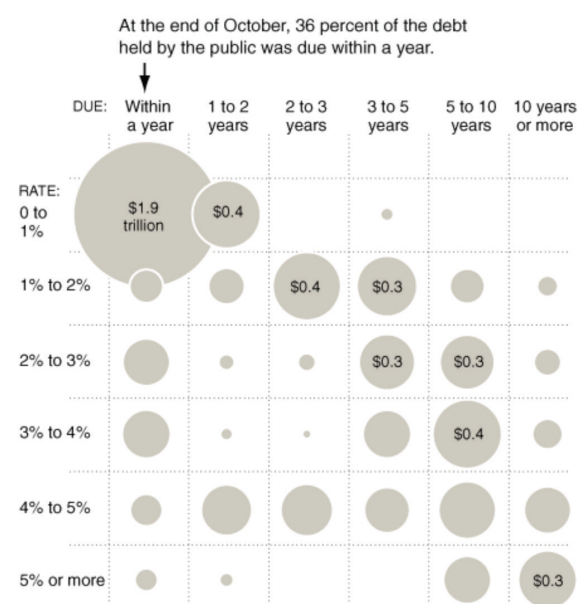
Source: Congressional Budget Office

Average interest rate paid by US Federal Government



Source: Morgan Stanley, Congressional Budget Office forecast

The lower interest expense has been possible as the US government has funded its outstanding debt with a greater mix of shorter-term securities, i.e. more Treasury Bills (< 1 year duration) vs Treasury Notes (2 – 10 year duration) and Treasury Bonds (30 year duration). For instance the weighted average interest rate paid 3 years ago was 5.0%, compared to the November 2009 average of 3.3%. That is a 34% reduction! The diagram below from a recent NY Times article puts the current duration of outstanding debt into perspective.



⁵ US Congressional Budget Office forecasts

'I estimate it will [US federal interest cost as a percentage of government revenues] reach 35% within just five years.'

Marc Faber 01/01/10

'They're making our situation worse [the US Government]. They said the solution to our problems is to spend more money, to spend us out of this! I mean that's what got us into this problem, too much debt, too much consumption, and now we're going to solve it with more debt and more consumption? That's like saying to Tiger Woods, you get another girlfriend and you'll solve your problems, or 5 more girlfriends and you'll solve your problems!'

Jim Rogers, 12/10/09

'The issue with excessive public debt levels as we exit the recession is the deterioration of sovereign risk, and its adverse affect on debt servicing, as debt could spiral once concerns over sustainability are factored in.'

Societe Generale, Nov 2009

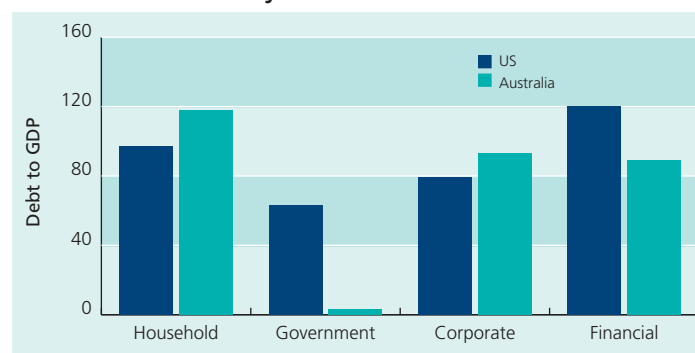
The concern with issuing shorter term debt is that not only will the debt markets this year have to absorb the estimated \$1.4 trillion in new treasuries required to fund the 2010 budget deficit, but on top of that there will be the increasing magnitude of previously issued debt that will need to be repaid and then re-issued into the market. If interest rates rise in the meantime, this will be little different to the effect of having a 'honeymoon' interest rate on your mortgage...eventually the honeymoon ends!

Should treasury buyers demand higher rates, which seems likely in the medium term given the huge amount of debt issuance by governments globally, then the US government may have to get used to paying a much higher interest bill than currently.

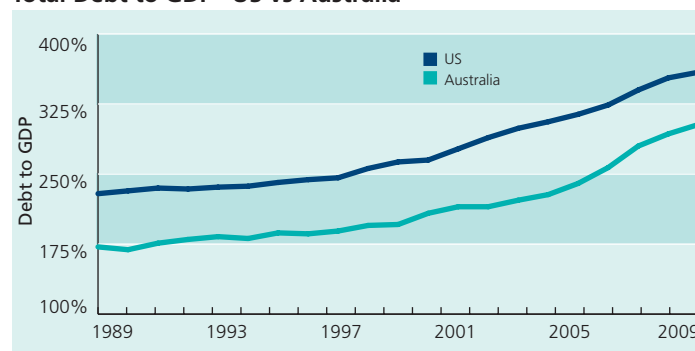
Australia's debt

Market commentators often point out Australia's benign debt position relative to the US in response to risks facing the Australian economy. Whilst this is certainly true with respect to government debt, the below charts show Australia's debt relative to GDP has increased significantly over the last 20 years driven by the household and financial sectors, whilst corporate debt remained relatively steady.

Current Debt to GDP by sector – US vs Australia



Total Debt to GDP –US vs Australia



Source: US Federal Reserve, ABS, Morgan Stanley

'... debt thresholds are importantly country-specific...'

Reinhart & Rogoff, 31/12/09

'Australians have long borrowed more than we have saved. The gap thus created has been met by Australian banks borrowing money offshore to lend for domestic purposes.'

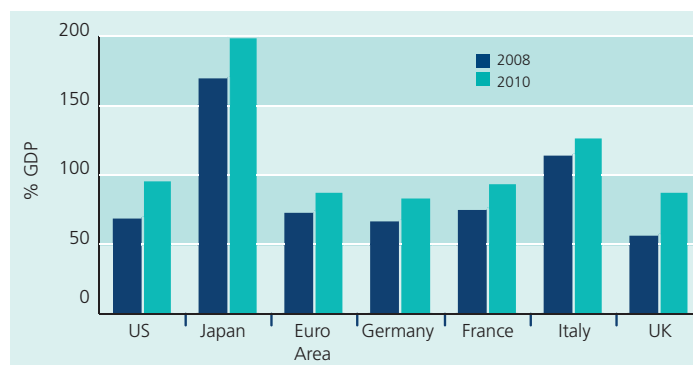
Gail Kelly, Westpac CEO, 12/01/09

Sovereign Risk

Given the size of the run-up in developed countries' government debt levels from the unprecedented level of stimulus packages, questions have begun to be raised as to how all of this debt gets paid back. As with any individual who hits hard times, a new loan may help them get back on their feet, but if the reasons for their hardship persist and/or they borrow too much, default becomes a risk.

The US is not alone in its run-up of government debt levels, nor is it the most leveraged of developed nations as shown in the below chart.

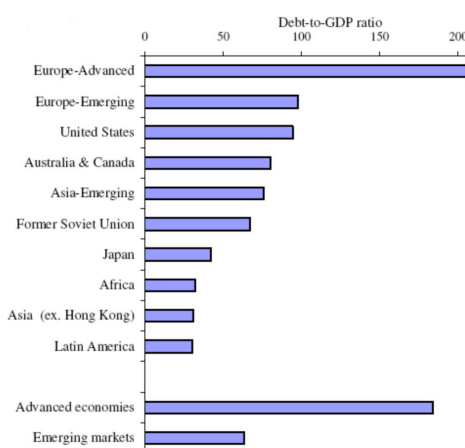
Gross Government Debt/GDP



Source: Macquarie Bank

Total government debt levels relative to GDP are only one indicator of sovereign risk. For instance, despite Japan's enormous government debt they have maintained support for debt issuance (as witnessed by low interest rates to date) given a high level of household and corporate savings. Whilst this has been the case for Japan, we expect sovereign risk to become a greater concern over the next few years given the synchronised level of high government indebtedness around the world, combined with high starting levels of private debt in many of these countries. After all, the only means by which a government has to raise revenue is to tax the private sector. Below are Fitch sovereign debt ratings for each of the countries along with the amount of foreign debt owed by various countries.

Fitch Sovereign Ratings			
	Rating	Outlook	Last change
Japan	AA	Stable	May 05
Italy	AA-	Stable	Oct 06
Greece	BBB+	Negative	Dec 09
US	AAA	Stable	Sep 00
UK	AAA	Stable	Sep 00
Ireland	AA+	Stable	Nov 09
Australia	AA+	Stable	Feb 03



Source: 'Growth in a Time of Debt'
Reinhart & Rogoff

'... the conventional view that government bonds should be "risk free" and tied to nominal GDP is at risk of changing. Periodically, high quality corporate bonds have traded at lower yields than sovereign debt. That could happen again.'

David Einhorn 19/10/09

'The Dubai announcement is a reminder that a flood of government-induced liquidity cannot mask all excesses, all the time.'

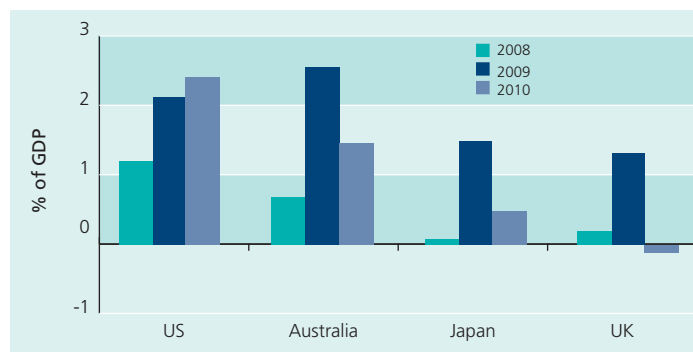
'When the government calculates its debt and deficit it does so on a cash basis. This means that deficit accounting does not take into account the cost of future promises until the money goes out the door. According to shadowstats.com, if the federal government counted the cost of its future promises, the 2008 deficit was over \$5 trillion and total obligations are over \$60 trillion. And that was before the crisis.'

David Einhorn 19/10/09

Stimulus unwind in 2010

2010 will see the gradual unwind of fiscal stimulus in most developed countries and it will be interesting to watch how economic growth holds up as this unfolds. Early anecdotal evidence of weak pre-Christmas sales by some retailers indicates that the unwinding effect of the Australian government's cash handouts is already playing out.

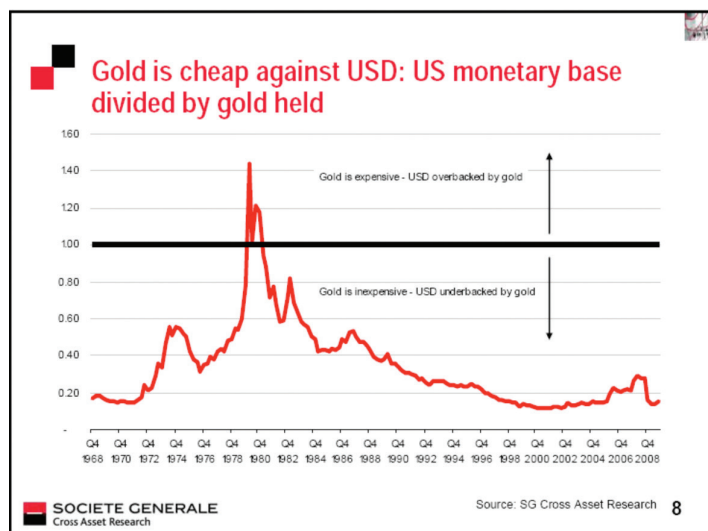
Distribution of Fiscal Stimulus, 2008-2010



Source: OCED, Morgan Stanley

Gold

A lot has been written about the gold price and whether the price has run too hard recently. Gold has been used as a currency by civilisations for over 2,000 years and was used to back the US Dollar until as recently as 1971, when the Bretton Woods International Monetary System was abandoned. The chart below shows the quantity of gold held in the world relative to the quantity of US dollars in circulation. If viewing the gold price this way, its current price looks relatively cheap.



Outlook

The sharp rebound in markets in 2009 was largely driven by investors' willingness to bid up PE multiples for stocks. In 2010 the potential for this trend to continue appears limited and so we see the upside coming more from deliverance of earnings ahead of expectations. On balance the Australian economy looks reasonably well positioned going into 2010 in light of the following:

2010 tailwinds vs 2009:

- Greater business and consumer confidence
- Recovery in commodity prices and expected increase in export volumes
- LNG project development spend in WA and Queensland

'We are now being told that the most important thing is to not remove the fiscal and monetary support too soon. Christine Romer, a top advisor to the President, argues that we made a great mistake by withdrawing stimulus in 1937. Just to review, in 1934 GDP grew 17.0%, in 1935 it grew another 11.1%, and in 1936 it grew another 14.3%. Over the period unemployment fell by 30%. That is three years of progress. Apparently, even this would not have been enough to achieve what Larry Summers has called "exit velocity".... An alternative lesson from the double dip the economy took in 1938 is that the GDP created by massive fiscal stimulus is artificial.'

David Einhorn 19/10/09

'Gold is my favourite currency.' Marc Faber

'Gold did very well during the Great Depression when FDR debased the currency. It did well again in the money printing 1970s, but collapsed in response to Paul Volcker's austerity. It ultimately made a bottom around 2001 when the excitement about our future budget surpluses peaked. Prospectively, gold should do fine unless our leaders implement much greater fiscal and monetary restraint than appears likely. Of course, gold should do very well if there is a sovereign debt default or currency crisis.'

David Einhorn 19/10/09

2010 headwinds:

- Higher interest rates (tailwind in 2009)
- Withdrawal of fiscal stimulus (tailwind in 2009)

Whilst financial market participants around the world are much more confident than they were during 2009, and the consensus is that government and central bank actions have successfully staved off disaster, we are still wary of the ever present global imbalances which preceded the GFC and the potential 'unknown unknowns' which may strike in 2010. So we remain cautious and as always we continue to focus on finding companies with solid balance sheets, competent management teams and strong franchises. Rather than go out on a limb and make explicit forecasts (a game which we have little faith in anyone's ability to do) in such uncertain times, we've compiled a brief summary of what a few market commentators are predicting:

Australian outlook – Investment Banks:

Goldman Sachs	2010: GDP + 3.6%, ASX200 to close at 5,700 (up 17%). Macro themes less pronounced re individual stock returns, M&A activity to increase Overweight – Banks, Transport, Industrial Services/Materials Underweight – Retail, Property Trusts and Healthcare
Macquarie	2010: GDP + 3.0%, ASX200 to close at 5,600 (up 15%)
UBS	2010: GDP + 3.3%, ASX200 to close at 5,300 (up 9%) – Banks, Resources to lead the way with Energy and Property Trusts to be a drag

Global outlook – Investment Banks:

Goldman Sachs	2010: Compare 2010 to 2004, US stocks + 15%, European stocks + 20%
Deutsche Bank	2010: Bullish in Q1, but more cautious late 2010 – sovereign debt and inflation the risks. Base case is for US stocks be up 20%
Morgan Stanley	2010: US stocks to continue to rally for now given earnings growth but down 5% over the year due to the withdrawal of stimulus packages

Global outlook – Investors:

PIMCO	2010: US Real GDP growth + 1.5 – 2.5% but a wide range of outcomes possible and 'forecasting is a dangerous game!'
Marc Faber	2010: Stocks to outperform bonds but expect a lot of volatility, US to outperform emerging markets 3 – 5 years outlook: Large US fiscal deficits to continue => inflation will increase, interest rates will increase, US Dollar will decrease and the Gold price will go significantly higher.

'The reason for such an extreme bear market rally simply comes down to the fact that we have just seen the most unprecedented stimulus program in modern history. However, that cannot stop the deleveraging of the greatest credit and real estate bubble in history, nor can it stop the natural rise in Baby Boom saving and the fall in spending ahead. In fact, we think that this failed stimulus program may mark the beginning of the end for Keynesian economics....'

Harry Dent Jr, 01/11/09

'Give me a one-handed economist! All my economists say, 'On the one hand? On the other.'

Harry S Truman

'... we're making a very active decision to run light on risk. At this point, we know this is not going to be a particularly high-yielding portfolio. You can only eat what's in the cafeteria, and right now the cafeteria doesn't have anything particularly appetizing in it.'

Paul McCulley, MD PIMCO, Dec 2009



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