Super Cash

Investment objective

To match and, where possible, enhance performance relative to the benchmark (UBS Bank Bill Index) over rolling three year periods by investing predominately in Australian short-term cash deposits and cash equivalent securities.

Passive index manager trust

Ibbotson selects specialist index manager(s) to manage passively to a customised notional index with the aim of achieving returns that match or are moderately above their performance benchmark.

Australian short-term securities

A defensive portfolio which invests in Australian short-term cash deposits and cash equivalent securities with very high credit ratings.

The Trust aims to deliver a return similar to the performance benchmark but may also strategically hold securities with maturities longer than the 90 day bank bill index (out to three years), to passively capture the expected interest rate premium further out along the yield curve.

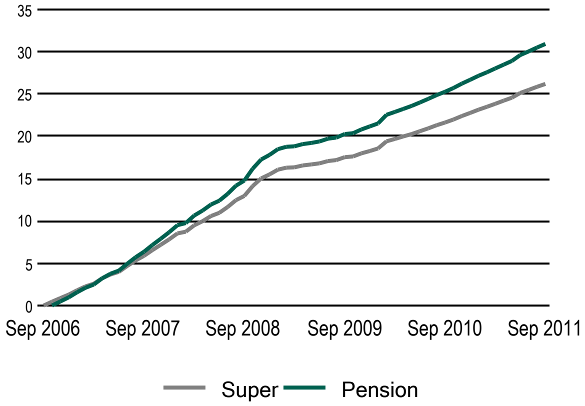
Key attributes

- A defensive portfolio with a focus on absolute capital preservation
- Seeks to deliver returns that match the market index for Australian short-term securities provided at a low cost

Performance[1] to 30 September 2011

	1 year	3 years	5 years
Super	3.8%	3.8% pa	4.8% pa
Pension	4.5%	4.5% pa	

Cumulative return (net)



[1] Performance measures are expressed after fees and taxes are deducted.
The above returns reflect BNP's unit prices and are not necessarily representative of the performance of the underlying Ibbotson Trust.

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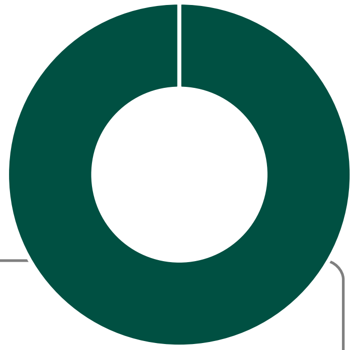
Super Cash



Product features

Risk profile	Low
Investment time horizon	No minimum
Fund size	$38.8 million
Unit pricing	Weekly
Management fee [3]	0.14% pa
Buy/Sell spread	0.00% / 0.00%
Performance benchmark	UBS Bank Bill Index

[3] The Management fee is inclusive of GST.

Manager weightings [4]

Vanguard	Passive	100%

[4] Total may not add to 100% due to rounding of individual components.

Manager style explanation

Passive: An approach that aims to attain returns at or moderately above the benchmark while still maintaining the risk characteristic of a nominated benchmark.

Executive Summary – September 2011

Economic and market environment

The September 2011 quarter was a very difficult time for financial markets, as investors were gripped by concerns about the global economy and Europe's debt problems. Market confidence fell sharply as politicians and central bankers appeared unable to respond effectively, and investors fled to traditional 'safe haven' assets such as cash. Although the worst appears to have passed, investors continue to watch the situation carefully. We remain cautious about the outcome of the current deliberations, but hopeful that the next wave of decisions will decisively tackle the debt issues and economic problems.

Many economic indicators in the developed world continued to deteriorate over the September quarter. This led investment markets to believe that the weaker data in the second quarter may not have just been a result of the shocks to the world economy following the earthquake, tsunami, and nuclear breakdown in Japan.

These fears were confirmed by weaker-than-expected growth in the United States in the second quarter. Similarly, revisions to previous quarters also signalled that the US economy was in worse shape than forecasters had believed. Other developed economies have also been weaker than anticipated, which has prompted leading forecasters to downgrade their outlook for global growth in 2011 to below four percent, down from an expectation of 4.50 percent six months earlier.

There was some positive news. Inflationary pressures which had been building earlier this year began to moderate. This was most obvious in the emerging markets, but inflation also looks set to be lower in the developed markets over the remainder of this year.

International sharemarkets fell substantially and were very volatile over the past quarter, because of the deteriorating economic picture and concerns that governments would be unable to address their debt woes. These falls were despite the fact that many global companies have strong balance sheets and have been producing solid earnings. However, Australian investors were cushioned by the substantial fall in the $A relative to most other major currencies. The direction of the $A was driven by sentiment rather than economic fundamentals, as offshore investors looked to reduce their risk exposures.

Sharemarket returns from the different regions varied. Europe was unsurprisingly one of the worst performers, down -17.50 percent over the quarter as European bank share prices suffered because of insolvency fears. The best-performing market was Japan, down -10.70 percent. The Australian sharemarket was not immune from the global jitters, and was down -11.60 percent over the September quarter. However, this was a slightly better result than the US sharemarket, which was down -14.0 percent.

There were also meaningful differences at the sector level. Traditionally defensive sectors such as consumer staples and healthcare stocks significantly outperformed more cyclical sectors such as materials, industrials, and financials stocks, which were sold off heavily. The telecommunications, utilities, and consumer staples sectors delivered the best results in the Australian sharemarket.

Bond markets had a particularly strong quarter while investors were worried about the global economy and heightened concerns about 'contagion' potentially spreading from the European debt problems. The yield on US 10-year Treasury debt fell over 1.20 percent over the quarter, closing at 1.92 percent and having reached as low as 1.72 percent, which produced strong returns. This was despite the US also losing its coveted AAA rating from Standard & Poor's. Not all developed markets were so healthy. Italian and Spanish government debt, for instance, was caught up in the frenzy of concern about other peripheral European countries like Greece.

Australian government bonds had a strong September quarter. The 10-year government bond yield fell one percent to 4.21 percent. This was despite the comparatively healthy state of the Australian economy, and the likelihood that both growth and inflation should continue to grow at around trend level for the next few years. However, some economic indicators were softer over the quarter, with unemployment beginning to increase, and consumer and business confidence falling. This had led some commentators to call for an interest rate cut.

The Reserve Bank of Australia cut the cash rate by 0.25 percent to 4.50 percent on 1 November, citing inflation likely to be close to target, but only moderate overall growth, and subdued confidence outside the resources sector. We agree with the view that economic indicators have weakened. However, in the absence of a global financial crisis in the remainder of 2011, we believe that it's unlikely that the Reserve Bank will cut interest rates by 100 basis points over the next 12 – 18 months, which the market is currently pricing in.

In summary, the September quarter was a poor one for most markets. More positively, valuations for many growth assets have improved while the fundamentals for many remain in comparatively good shape. Current market conditions therefore present some good opportunities to buy selected assets which are likely to generate above-average returns over the medium to long term.

Investment outlook

As we enter the fourth quarter of the year, sharemarkets have staged a recovery from the third quarter's lows. There is renewed optimism that European leaders will be able to come up with a workable solution to their debt problems. However, markets will be taking their cue from evidence of successful implementation, rather than just announcements.

The extension of the US' debt ceiling showed that Europe is not alone in having to grapple with issues. Again, although there seems to be increasing realisation about the need for the problems to be addressed conclusively, politics could get in the way of addressing the mounting debt burden in the US, as well as stimulating the stuttering economy. This wrangling has already cost the US its AAA debt rating.

If the political bickering continues in the run-up to next year's presidential elections, financial markets are likely to remain volatile. Perhaps perversely, though, if political squabbles prevent arrival at a solution, the US Federal Reserve could be forced to provide further stimulus to try and drag the US away from recession. Such actions have over the past two years provided a strong impetus for growth assets like shares. Although we don't expect the same rally as occurred after the last two attempts to kick-start economic activity, any further stimulus could be a good support for markets.

In light of this near-term outlook and the substantial sharemarket falls over the last quarter, we believe that the medium- to long-term outlook for risk assets such as shares is moderately attractive. This does not mean that we are looking to move aggressively away from our existing relatively defensive positioning. However, it means that we are now more comfortable adding risk in selected areas of the portfolio. For instance, global share valuations are now more attractive than they have been recently, so we would look to add selectively to this asset class. Australian shares are likely to perform well in the short term if there is a worldwide sharemarket rally, even though they are not as attractive on a longer-term basis.

Currency hedging is another important issue to consider for global shares. We continue to favour being unhedged against movements in the $A relative to other currencies. The $A continues to trade above parity with the $US, and very strongly relative to the euro and the pound sterling. In the event of another financial crisis or sharemarket plunge, our predominantly unhedged exposure should provide good protection against the fall in the value of the underlying shares, as was the case in the September quarter.

Our investment in Australian listed property securities should continue to help maintain the defensive qualities of the growth portion of the portfolio. Listed property performed well during the third quarter's market turmoil. Given this, in the near term we could look to 'bank' some of the recent outperformance as a result of our relatively large exposure, but we still expect to keep a significant allocation to listed property. As we have said in past quarters, we believe that Australian listed property is now much healthier than before the financial crisis in 2008. This is because the property trusts now have more robust earnings, less debt, and lower payout ratios. Maintaining a meaningful investment in listed property is consistent with our total portfolio objective, which is to deliver more consistent and less volatile returns.

The most defensive part of our portfolio is the investment in bonds. The outlook for global bonds remains challenging. This is particularly because their strong performance in the September quarter had made their valuations look even more stretched. There is real potential for capital to be eroded if yields were to rise as little as half a percent. Australian government bonds are a slight exception to this, given their higher running yields, but with 10-year yields having fallen below the cash rate, managing the portfolio duration is a key challenge.

This does not mean that there is no value in bonds at the present time. Credit spreads – the differences in yield between different fixed interest securities – have widened significantly following the recent financial turmoil. Although most of this has been down to the financial sector, high-quality corporate bonds have also been caught up in the contagion. As we've mentioned already, many large global companies are pretty healthy. Because of this, we continue to strongly favour holding corporate bonds rather than developed market government debt at the present time.

In summary, we are becoming more positive about the outlook for growth assets, because of their improved valuations after the recent falls, and because of the more concrete steps being taken to resolve Europe's debt problems. Additional investment in these growth assets is likely to be financed by reducing exposure to bonds, in particular global government debt, as well as drawing on some of the cash reserves accumulated over recent quarters.

The outcome is that the portfolios are slightly less defensive, although it's worth noting that the unhedged global shares exposure and the Australian listed property allocation still make the portfolios comparatively defensive. We believe that this approach leaves the portfolios well-positioned to benefit from improved sentiment about growth assets in the short to medium term, while also helping deliver the longer-term objective of producing returns which are more consistent while also being less volatile.

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REI Super Cash Option

September 2011

By Ibbotson Associates

What does the REI Super Cash Option aim to achieve?

The REI Super Cash Option aims to match and, where possible, outperform the benchmark, the UBS Bank Bill Index, over rolling three-year periods. The REI Super Cash Option's main attribute is capital preservation.

How does the REI Super Cash Option attempt to achieve this?

The REI Super Cash Option attempts to achieve this by investing primarily in Australian short-term cash deposits and equivalent cash and short-term debt securities.

What is the REI Super Cash Option's benchmark and how does it work?

The benchmark – the yardstick against which the REI Super Cash Option's performance is measured – is the UBS Bank Bill Index. This reflects wholesale bank lending rates. The UBS Bank Bill Index comprises 13 separate bank bills which have the same face value, each having a term to maturity seven days apart. (A security's term to maturity is the time between the present and the date when the security matures.) This means that the shortest of the bank bills has a term to maturity of seven days, and the longest 91 days. The Index overall has an average term to maturity of approximately 45 days. This is rather like investing in 13 separate term deposits, the first of which matures in seven days, the second in 14 days, the third in 21 days, and so on, until the last which matures in 91 days. The REI Super Cash Option seeks to deliver returns that match those of this UBS Bank Bill Index.

What are the REI Super Cash Option's key characteristics?

The REI Super Cash Option has several important characteristics.

The first is **credit quality**. This refers to the ability of an issuer of a debt security to pay the scheduled interest payments and repay the principal in a timely manner. The REI Super Cash Option invests in short-term cash deposits and similar securities which have very high credit ratings. (These ratings are issued by organisations such as Standard & Poor's and Moody's, and attempt to judge the likelihood that the issuer will be able to pay their scheduled interest and repay the entire principal.)

The issuers of the securities the REI Super Cash Option invests in, include the Commonwealth government, the state governments, and large institutions such as the banks. These all have very

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high credit ratings, indicating that they are very high credit quality. This means that the REI Super Cash Option has minimal exposure to the risk of the issuer of the bank bills defaulting.

The Cash option is further designed to provide a safeguard against the risk of default, by using the simple but effective strategy of spreading its investments across numerous different issuers. (This is also referred to as "not putting all your eggs in one basket".) This an important difference between the REI Super Cash Option and a single term deposit.

The second important characteristic of the REI Super Cash Option is **daily liquidity**. This makes the REI Super Cash Option useful for maintaining lower risk when used as part of a diversified investment strategy. This liquidity is different to term deposits, which as the name implies, are fixed for specified periods. While it may be possible to get access to the money in a term deposit before the end of the term, there are typically penalties for doing this.

Why are the REI Super Cash Option's returns lower than current term deposit rates?

As we discussed previously, the REI Super Cash Option invests in bank bills of high credit quality while still delivering daily liquidity. Term deposits do not offer the same liquidity – you generally have to pay a penalty for getting your money out before the end of the term. Because banks and investors are exposed to just one name, and not a diversified portfolio of high-quality names, they have to offer a premium over normal cash rates to attract investment.

This is why typical bank deposit rates have recently been higher than the REI Super Cash Option's returns. However, term deposit rates have begun to fall, and are likely to continue to do so, as over the next couple of years banks are not likely to need to raise as much money from investors as they have done in the recent past.

Why not invest in assets to increase the REI Super Cash Option's returns?

There are several potential ways of increasing the REI Super Cash Option's returns. As with most things in life, though, there are no 'free lunches', and these come with significant potential risks.

One would be to invest in debt securities which are lower credit quality, and therefore more risky. The REI Super Cash Option does not currently invest in riskier securities such as mortgage-backed securities or collateralised debt obligations. These more complicated investments typically pay higher rates of interest, because of their increased risks.

Another way of potentially increasing the REI Super Cash Option's returns would be to invest in bank bills and debt securities which have longer terms to maturity. As we have seen, the REI Super Cash Option has an average maturity of 45 days. There are other debt securities which have maturities of up to two years.

Generally, in an environment where inflationary expectations are positive, we would expect longer-dated securities to yield higher returns than their shorter-dated counterparts. This enables investors

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to earn a premium for investing in the longer-dated securities. This is a valid potential strategy, and one which we have used for the REI Super Cash Option in the past.

However, we also believe that it's most appropriate to use this strategy in times when interest rates are high and are either expected to remain so or potentially fall. In these circumstances, it makes sense to lock in higher interest rates. But because the Australian economy is currently so strong compared to other countries, and because expectations are for interest rates to remain flat for the next year or so, we think it is too early to consider using this strategy, because rising interest rates would erode the underlying capital of the investment.

We believe that increasing the REI Super Cash Option's risks would need to be compensated by increased returns. However, because the REI Super Cash Option's principal characteristic is supposed to be capital preservation, we do not believe that investing in riskier assets is appropriate. This is particularly the case in the current economic and market environment, when many countries are facing severe debt challenges, and the world continues to experience fallout from the global financial crisis. Although the returns from the REI Super Cash Option may at present be lower than those from term deposits, there is a negligible risk of default from the debt securities in which the Cash Option invests.

Investors who want to pursue higher rates of return may want to consider fixed income and inflation-linked securities which can generate higher returns in a risk-controlled manner. The REI Super Stable Option is one such strategy that targets a higher return within a reasonably conservative risk profile. The REI Super diversified investment portfolios are constructed for investors targeting higher returns and who are willing to assume a higher risk profile. For the REI Super Cash Option, we believe that capital preservation, in all market environments, is the priority.

As always, we will continue to monitor the changing economic environment and market pricing closely, in order to continue to seek the most competitive returns for investors in the REI Super Cash Option, while also focusing on managing risks carefully and preserving investors' capital.

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