

COLONIAL FIRST STATE WHOLESALE EQUITY INCOME FUND

Adviser Investment Series

May 2018

Why invest in this strategy?

In volatile markets, many investors tend to favour defensive stocks with higher-than-average dividend yields in order to generate an income stream. However, this strategy can be flawed for two important reasons:

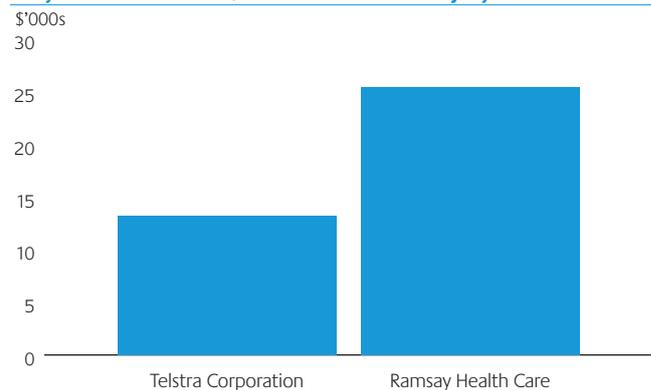
1. Only focusing on high yielding companies reduces the universe of investible stocks which, in turn, can lead to increased and undesired concentration risk.
2. Contrary to popular belief, high yielding stocks don't necessarily deliver more income in absolute dollar terms over the long term. This is because each year's capital return provides the base upon which the following year's income is generated. As a result, yields can hide the truth.

For example, a \$10,000 investment in Ramsay Health Care (regarded as a 'growth' stock) over the 15 years to June 2017 generated significantly more income than an identical investment in Telstra Corporation (regarded as an 'income' stocks). This is because the smaller yield of Ramsay Health Care has been delivered from a capital base which has grown much more strongly than that of Telstra, as this chart illustrates.

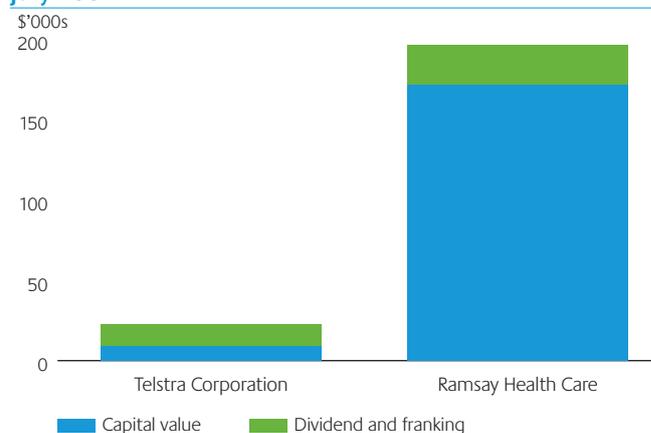
Grossed-up yields	July 2002	Average	July 2017
Telstra Corporation (TLS)	6.48%	9.81%	9.81%
Ramsay Health Care (RHC)	3.95%	4.13%	2.84%

Sources: Colonial First State Global Asset Management, UBS, IBES, IRESS. Forecast yield data calculated from consensus IBES data. Average income and capital over 15 years calculated assuming \$10,000 is invested in July 2002.

Income (dividends and franking credits) generated over 15 years from a \$10,000 investment in July 2002



Total wealth over 15 years from a \$10,000 investment in July 2002



Sources: Colonial First State Global Asset Management, UBS, IBES, IRESS. Forecast yield data calculated from consensus IBES data. Average income and capital over 15 years calculated assuming \$10,000 is invested in July 2002. Any fund or stock mentioned in this presentation does not constitute any offer or inducement to enter into any investment activity. Past performance is not an indication of future performance.

Importantly, this is not an isolated example. The table below shows the highest ranked stocks from the S&P/ASX 100 based on average gross dividend yield over the 15 year period. It can be seen that higher dividend yields do not ensure higher levels of income will be generated over the long term. The adverse impact that this approach can have on total wealth outcomes is also evident.

Stock	Average yield rank	Actual income generated rank	Actual total wealth rank
Telstra Corporation	1	34	52
TABCORP Holdings	2	17	47
Tatts Group	3	53	59
Suncorp Group	4	29	43
National Australia Bank	5	41	56
Spark Infrastructure Group	6	57	55
Westpac Bank	7	16	31
ANZ Banking Group	8	27	41
Commonwealth Bank	9	14	22
Bendigo and Adelaide Bank	10	20	36
Bank of Queensland	11	21	37
Perpetual	12	39	49
Wesfarmers	13	26	35
Insurance Australia Group	14	23	29
APA Group	15	9	16

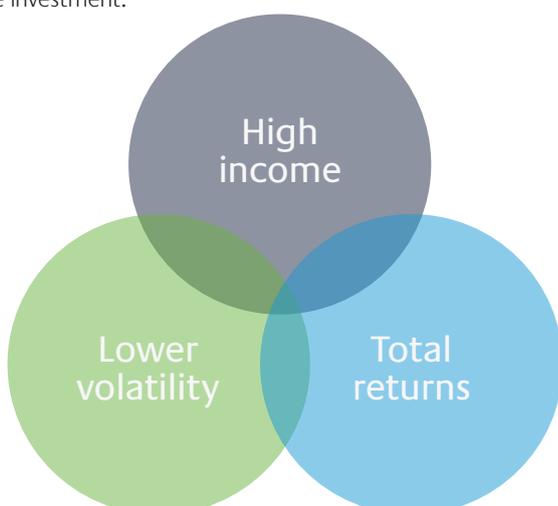
Source: Colonial First State Global Asset Management, UBS, IBES, IRESS. Forecast yield data calculated from consensus IBES data. Average income and capital over 15 years calculated assuming \$10,000 is invested in July 2002. Based on stocks from S&P/ASX100 with sufficient income/stock price history June 2002 – June 2017 (66 stocks in total)

Consequently, the Fund seeks to select stocks based on their expected total return, rather than just their dividend yield. The Fund then utilises a buy-write options strategy to generate extra income and manage volatility.

A better balance

Typically, investors have three main objectives:

1. High income – generating cash flow from the investment.
2. Low volatility – reducing short-term fluctuations so an investment grows more smoothly over time.
3. Total return – generating an attractive return over time to grow the investment.



The Fund aims to better balance these three investment objectives by utilising a fundamental bottom-up stock selection approach that seeks to identify the best opportunities at any point in the market cycle and combining it with a strategy that reduces volatility and generates greater income.

Reasons to invest

The Fund is an Australian share strategy that integrates total returns, income generation and volatility management to help provide a smoother path to wealth creation than strategies which are focused solely on high yield stocks. The Fund provides:

- a total return focus, with lower volatility than typical Australian share funds
- leverage to a proven stock selection process that provides exposure to attractive stock ideas that are often overlooked by more conservative, income-seeking equity investors
- a cushion in down markets that provides an added layer of risk management beyond what can be delivered through traditional asset allocation alone, and
- Significant experience and expertise in delivering objectives-based solutions to investors

How the Fund is managed

There are two main steps in the management of the Fund:

1. Selecting stocks and building the portfolio

Regardless of market conditions, the Fund uses a fundamental bottom-up stock research process to select stocks. Importantly, no screening or tilting towards high yield is carried out; the team analyses all companies in the investible universe in order to identify the most attractive potential investment opportunities.

The team's investment approach involves:

- a. Stock assessment – industry and company analysis. The stock fundamental research process addresses management quality, industry position, financial strength, valuation and sustainability.
- b. Stock intelligence – company engagement and in-depth Industry Cross-Check. Excellent access to company management teams provides an information advantage when undertaking analysis of both industries and individual stocks.
- c. Stock modelling – financials and valuation assessment
- d. Stock research output – investment view & recommendation – Expressed through 5 Calls (Strong Buy through to Strong Sell) based on expected 'total shareholder return' for each stock in the investment universe.
- e. Stock implementation decision – portfolio manager make the decision for stocks to include in the portfolio based on expectations of return, confidence and volatility and additional assessment of other potential market factors that may impact the market sentiment for a stock for a period of time and may affect the timing of implementing positions in the portfolio

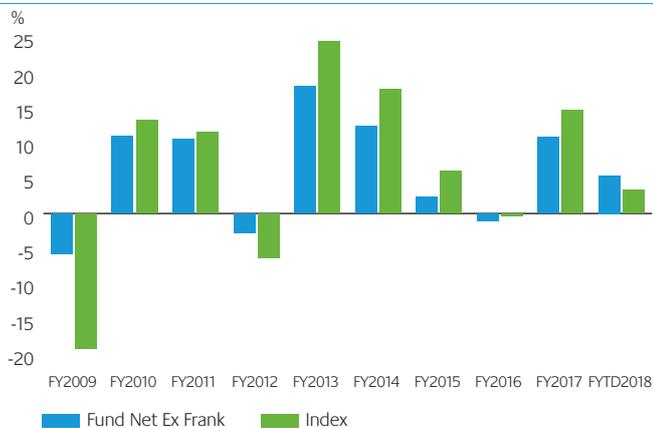
2. Increasing income and smoothing returns

This step involves applying a range of equity options to the portfolio. Equity options are financial instruments that have various uses. For this Fund, they are used to boost income and smooth out the capital gains, or losses, of the portfolio. Options are never used to provide leverage. Implementing an option position on a particular stock typically has three impacts:

- a. Generating income: sold options generate cash flow for the Fund. This adds to the income which is received from dividends and franking credits.
- b. Lowering volatility: the income received from sold options will at least partly offset any decline in the share price. The income generated from options can provide a meaningful cushioning of losses during adverse market conditions.
- c. Limiting capital gain: the opportunity cost of using options to generate income is that the potential upside in share prices is limited. The Fund effectively foregoes some potential capital gain from shareholdings in return for a known amount of income up front.

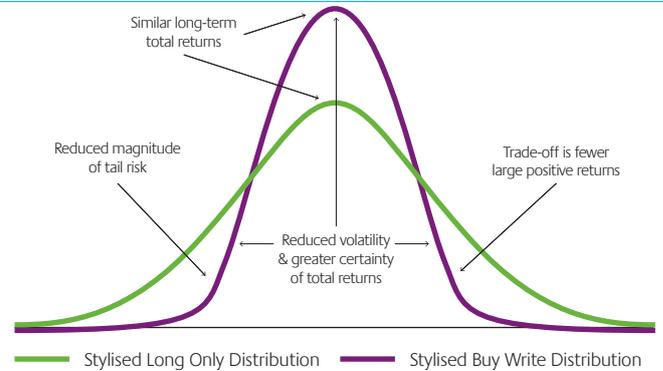
The use of option strategies means that the Fund is likely to outperform the sharemarket in flat or declining markets. Conversely, the Fund's performance is expected to lag during periods of strongly rising markets. This results in a more consistent return from Australian shares over the long term, as the chart below illustrates.

A more consistent return from Australian shares



Benchmark is S&P/ASX 100 Accumulation Index. Data shown is financial year performance in Australian dollar terms for full years from 30 June 2008 to 20 June 2017 and financial year to date to 31 March 2018. Financial Performance is net of fees and excluding franking credits. Past performance is no indication of future performance.

Alters an investors risk/return profile to better reflect their risk tolerance



The chart is for illustrative purposes only.

An experienced and specialised team

The Equity Income team comprises of three dedicated portfolio managers who each have specialised derivatives expertise. Rudi Minbatiwala, Jason Moodie and Marlon Chan manage the Fund and have managed equity income funds together for over a decade. The team has a well-established track record in the management of equity portfolios that utilise options. Their roles include selection of the stocks for inclusion in the portfolio in addition to managing and implementing options strategies, which are used to generate income and provide a downside cushion for the portfolio. The portfolio managers are supported by a large group of equity analysts with a proven track record of fundamental bottom-up stock research. The significant analyst resource in the team enables the portfolio managers to fully understand both the long and short-term return expectations and risks inherent in each stock.

Colonial First State Wholesale Equity Income

Objective

To provide a total return comprised of regular income, franking credits and some capital growth from Australian shares over the long term, delivered with consistently lower volatility than the S&P/ASX 100 Accumulation Index. The option aims to deliver risk-adjusted returns that exceed the S&P/ASX 100 Accumulation Index before fees and taxes over a full market cycle.

Minimum suggested timeframe

At least 7 years

Risk



Portfolio managers



Rudi Minbatiwala
Head of Equity Income



Marlon Chan
Portfolio Manager – Equity Income



Jason Moodie
Senior Portfolio Manager – Equity Income

For further information please contact:

	Telephone	Email
Harry Moore Head of Business Development, Australia and New Zealand	03 8618 5532	hmoore@colonialfirststate.com.au
Chris King Head of Investment Sale and Key Accounts	02 9303 2018	cking@colonialfirststate.com.au
Jacqui Crothers Business Development – NSW	02 9303 6830	jcrothers@colonialfirststate.com.au
Nick Everitt Business Development – VIC/TAS	03 8628 5668	neveritt@colonialfirststate.com.au
Quin Smith Business Development – QLD	0455 095 505	quin.smith@colonialfirststate.com.au
Nathan Robinson Business Development – WA/SA/NT	0403 272 440	nathan.robinson@colonialfirststate.com.au

Disclaimer

Product Disclosure Statements (PDS) and Information Memoranda (IM) for the [Colonial First State Wholesale Equity Income Fund, ARSN 129 259 552] issued by Colonial First State Investments Limited ABN 98 002 348 352 AFSL 232468 (CFS) are available from Colonial First State Global Asset Management. Investors should consider the relevant PDS or IM before making an investment decision. Past performance should not be taken as an indication of future performance.

The Commonwealth Bank of Australia (Bank) and its subsidiaries do not guarantee the performance of the fund or the repayment of capital by the fund. Investments in the fund are not deposits or other liabilities of the Bank or its subsidiaries, and investment-type products are subject to investment risk including loss of income and capital invested.

No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of Colonial First State Asset Management (Australia) Ltd ABN 89 114 194 311 AFSL 289017(CFSAMA). This material has been prepared for the general information of clients and professional associates of CFS and CFSAMA and not for retail clients. No person should act on the basis of any matter contained in this material without obtaining specific professional advice.

Strategy

The option's returns are generated from a number of sources, including dividends, franking credits and capital returns from Australian shares, as well as option premium income. The option uses derivatives to modify the return profile of its Australian share holdings. The use of equity options in conjunction with Australian shares is expected to result in a greater proportion of the total return delivered as income and reduced volatility in returns. In the selection of Australian shares. Investment opportunities are identified by detailed fundamental research, including a high number of company visits and utilising a proprietary database to analyse company financials. The option predominantly invests in Australian dollar denominated securities and therefore does not hedge currency risk.

Allocation



¹ The ranges reflect the option's effective exposure (ie after taking derivatives into account).