

A lower growth environment – a structural framework and return implications

Economic research paper

16 September 2011

- A combination of structural and cyclical factors is likely to see economic growth in the major developed nations remain very moderate in the years ahead.
- This slow growth outlook will be compounded by limited fiscal and/or monetary policy flexibility to stimulate growth further.
- As a result, returns on traditional asset classes in the years ahead may be much lower than has been the case for the decade prior to the global financial crisis.
- This will have three major implications for investors. Firstly, investors will likely have to accept a lower return on assets than they have become used too. Secondly, the need for portfolio diversification is likely to become even greater. Portfolios will need to be able to withstand periods of increased volatility and continual reassessment of the macroeconomic and policy outlook. Thirdly, investing in the structural changes currently flowing through the global economy, or ‘thematic’ investing, will likely become an increased focus for markets.

Structural versus cyclical

Financial market volatility in recent months has led to frank questions being asked over the medium term outlook for the global economy and the implications for potential asset returns. Much of the debate surrounds whether what we are seeing in around the world, particularly in the major developed economies is part of large structural trends or whether we continue to move through a disappointing economic cycle.

Financial markets have begun to react to this weaker economic outlook, leading to a sharp fall in risk assets, particularly equity markets in both the developed and emerging world. Government bond markets have also factored in much slower economic growth in the developed world.

This paper examines this debate and outlines the key structural changes that are underway in the developed world and the likely impact on asset markets. Within this discussion there is an examination of the key economic factors that will impact on the cycle and more importantly how the various regions in the developed world are likely to perform over coming years.

One conclusion to draw is that asset price growth will likely be constrained due to this evolving economic outlook, although, due to structural change in the developing world, key thematic investments will have to be an increasing focus.

In this environment, therefore, investors may also need to look more closely at having a diversified portfolio of assets that is able to withstand significant periods of volatility and a continual re-assessment of the macroeconomic and policy outlook.

The following report provides a framework to consider what the medium term drivers of an economy are and therefore the lessons for the global economy and asset returns. The focus is on developments in the large developed economies and compliments work that has previously been undertaken on structural changes underway in China and India.

[Please click here to view James’ paper on China](#)

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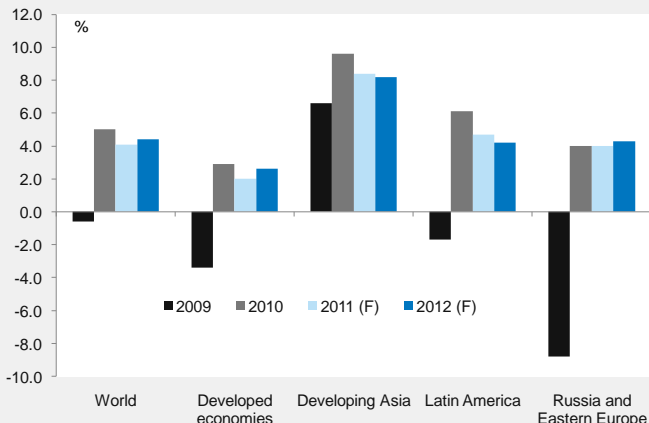
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The economic cycle

As shown in the chart below, the current expectation by the International Monetary Fund (IMF) for world economic growth in 2011 is just on 4.0%/yr¹. This is higher than the average growth rate since 1980 of 3.5%. This growth would represent, however a slowdown from the 5.0%/yr growth achieved in 2010, but would continue the recovery from the 2009 global recession. For 2012 world economic growth is again expected to be just a little above 4%/yr.

Global economic growth



Source: IMF, OECD, RBA, ABS and ABARES

It seems clear, however, that the risks to these 2011 and 2012 growth forecasts are now significantly to the downside given recent events. What is interesting to note from the chart above is the large divergence between growth expectations in a number of regions around the world. This divergence is likely to have significant impact on the source of asset price growth over the medium term.

As at 9 September 2011 the latest survey of financial market economists² indicates consensus world economic growth of 3.7% in 2011, down from an estimated 3.9% in August and 4.2% at the start of the year. For 2012 the forecast had been revised down to 3.9%, from an estimated 4.2% in August and 4.5% at the start of the year. However, it seems logical to assume that further downgrades to global growth expectations will come in the months ahead.

It seems likely, therefore, that global economic growth over 2011 and 2012 will be lower than the current forecasts of just under 4% and closer, if not lower than the 3.5% average growth rate since 1980. This will be highly dependent on the ability of emerging economies to continue to grow in the face of low growth from the developed world.

This poor economic growth rate and potential for further downgrades to growth expectations (ie. not a recession, but below-trend growth) is likely to come from ongoing caution among consumer and households, partly reflecting a negative feed-back loop from high volatility in

financial markets, the need for significant fiscal policy tightening among many countries (especially in Europe), and the limited scope for monetary policy easing, at least in a conventional sense, among a number of key economies.

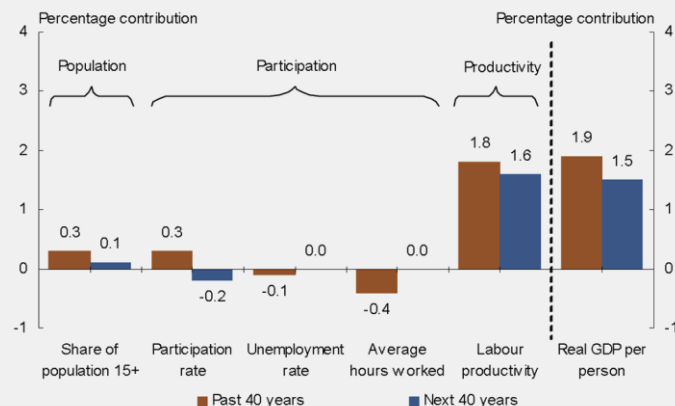
The potential flow-on from this sub-par economic growth outlook and the limited ability of governments to stimulate their economies is likely to be a period of lower returns on investment in financial assets.

A structural framework

To help frame thinking around the structural changes flowing through the global economy, we highlight the chart below from the Commonwealth Treasury on Australia's past and future economic growth. This is a rough guide to what drives real economic growth per person from the supply side factors of an economy and helps provide a framework to consider the medium term view of global economic growth.

As the chart below shows, economic growth over time is effectively driven by the three Ps; population, participation and productivity.

3Ps of real GDP per person³



Source: Commonwealth Treasury

In key regions of the global economy the three Ps suggest that economic growth will be moderate, at best, and that this will also likely limit the returns received on financial assets. Much of this will be driven by unfavourable demographics and the difficulty in implementing productivity enhancing reforms.

Other key issues to consider outside the supply side of an economy include:

- credit growth and appetite for debt,
- fiscal policy, and
- monetary policy

¹ Forecasts are from official bodies such as the IMF and OECD.
² Bloomberg

³ IGR 2010: Challenges and Priorities for Australia, Presentation to CEDA, 14 July 2010 by Ken Henry.

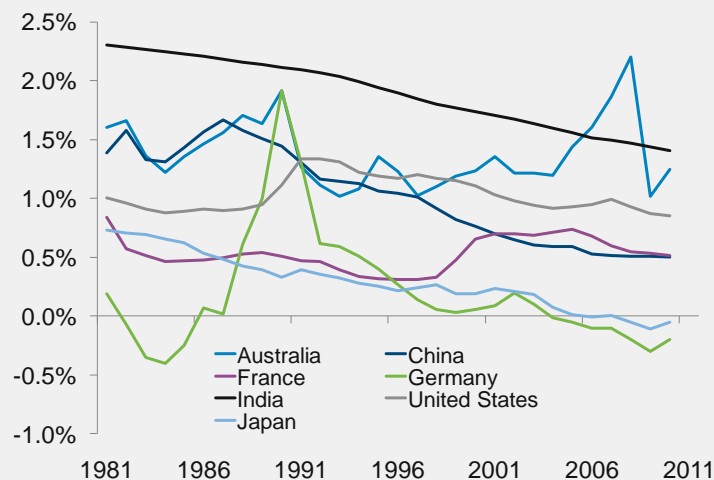
Demographics:

A recent study in the US by the Federal Reserve Board of San Francisco ⁴ highlighted the risk to the equity market from the retirement of the baby-boomer generation, classified as those born between 1946 and 1964. While this is a factor that is likely to play-out over the longer-term, and based on individual investor behaviour, it is certainly worth paying some attention to.

This research paper states that “historical data indicate a strong relationship between the age distribution of the US population and stock market performance. A key demographic trend is the ageing of the baby boom generation. As they reach retirement age, they are likely to shift from buying stocks to selling their equity holdings to finance retirement. Statistical models suggest that this shift could be a factor holding down equity valuations over the next two decades.”

Population growth in many large economies, both developed and emerging has been declining for a number of years. See chart below for details.

Annual population growth – major economies (%)



Source: IMF

A slower population growth rate usually implies a slower pace of nominal GDP growth, which can restrain potential asset price growth. This dynamic is magnified if the population is ageing. See table below showing median age of each population.

The slowdown in population growth has long been known to be a key issue in Japan, and has been partly to blame for the benign economic growth (average of 0.7% pa over the past 15 years) and deflation (average of -0.1% pa over past 15 years) experienced in Japan. The Nikkei has never regained its 1989 peak and is currently trading at 77% below this level.

As the next table shows, developed economies face a demographic headwind due to an ageing population. Emerging economies are not immune, but are in a relatively better position.

Country	Median age (years)
Japan	44.6
Germany	43.7
France	39.7
Australia	37.5
US	36.8
China	35.2
World	28.4
India	25.9

Source: CIA World Factbook

Participation rate and employment growth:

One of the most important of all the economic indicators to watch globally, if not the most important, is the unemployment rate. This feeds into the demographic challenge discussed above, as increasing labour force participation is one way to reduce government debt levels. Older workers will rely less on public services and the public balance sheet if they remain in the workforce.

One challenge going forward will be to ensure that workers remain employed for longer before retirement and that they continue to add to private savings balances. In some European countries, as part of fiscal consolidation measures, we have seen an increase in retirement ages for public sector workers. Examples include France, where the minimum retirement age was increased from 60 to 62 and in Germany from 65 to 67. This trend is likely to continue.

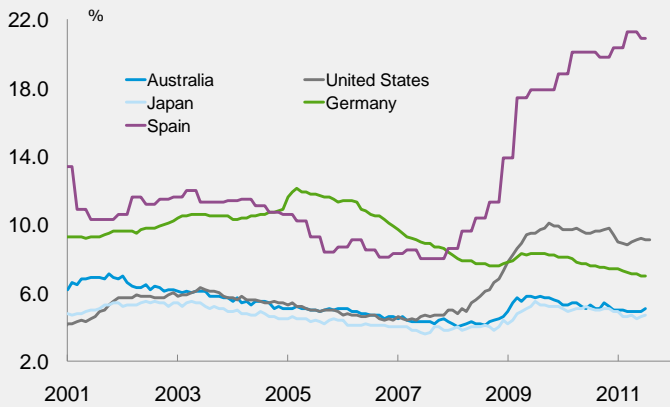
One key issue though is that unemployment rates around the world remain at uncomfortably high levels. Even though governments are aiming to have workers retire later in life, employment growth and hiring intentions are weak, making this prospect unlikely in most developed economies.

One of the key risks for the global outlook is, therefore, that the pace of economic growth over the next few years is insufficient to see a meaningful decline in the unemployment rate (see chart below). The risk of this outcome seems high, given that the public sector in the developed world are generally still shedding jobs, while private sector job creation remains muted.

Much of this lack of hiring can be put down to a high degree of uncertainty around the global economic outlook and political situation, particularly in the US and Europe and the lack of policy options to improve growth.

⁴ Federal Reserve Board of San Francisco Economic Letter, August 22, 2011

Comparative unemployment rates (%)



Source: Bloomberg

Without a meaningful decline in unemployment rates it is difficult, therefore, to see the Western consumer or housing sectors growing strongly.

Given that the consumer/household still accounts for a significant percentage of any developed economy, this would reinforce the view that the medium-term outlook for the developed world remains for sub-par economic growth. See table below for specific consumption shares of GDP.

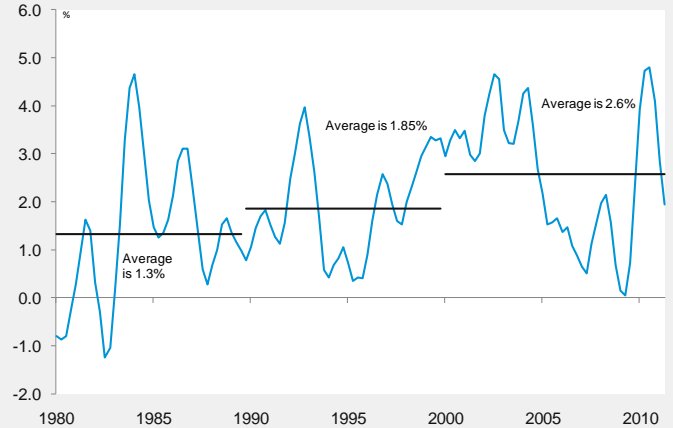
Country	Consumption share of GDP
Japan	59%
Germany	57%
France	57%
Australia	54%
US	70%
China	35%
India	60%

Source: Bloomberg, McKinsey Global Institute

Labour productivity growth

One of the factors that may, however, help support developed world growth is improvements in productivity. As shown in the chart below, trend US labour output per hour has actually been on the increase over the past three decades. The US has a history of productivity improvements and this should help offset some of the negatives from the very weak state of the labour market and declining population growth rates.

US non-farm labour output per hour



Source: Bloomberg

With monetary policy and fiscal policy constrained in many parts of the developed world, productivity gains could be a key driver of economic growth going forward. While these reforms historically have not been easy, it can occur at the individual company level, rather than left up to the political process. More and more, companies are announcing “efficiency programs” as a way to bring control back to management and away from the macroeconomic outlook. This was a particular feature from the recent Australian reporting season, although on the whole these programs are easier announced than implemented.

European Central Bank (ECB) President, Jean-Claude Trichet⁵ has also suggested that “fiscal consolidation and structural reforms must go hand in hand to strengthen confidence, growth prospects and job creation.” Trichet suggests comprehensive structural reforms are needed to “strengthen competitiveness, increase the flexibility of economies and enhance their longer-term growth potential”.

Key reforms should include the labour market “with a focus on removal of rigidities and the implementation of measures which enhance wage flexibility”. Suggestions include elimination of automatic wage indexation clauses and ability for firms to individually set wage agreements. Europe as a whole has a largely unionised workforce.

Other suggestions by Trichet include; increased competition in product markets, liberalisation of closed professions and further privatisations.

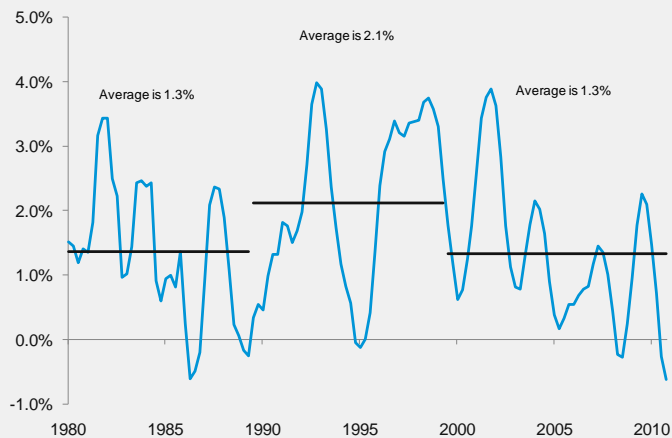
Productivity gains are also increasingly being discussed in Australia as a solution to long term growth challenges and inflationary pressures. As the chart below shows, Australia has had a mixed productivity record, with the major reforms of the 1980s and early 1990s leading to a period of stronger productivity growth in the 1990s. Governor of the Reserve Bank of Australia (RBA), Glenn Stevens has suggested⁶ “there is only one source of ongoing higher rates of growth of real per capita

⁵ European Central Bank - Introductory statement to the press conference. 8 September 2011

⁶ The Cautious Consumer, Address to The Anika Foundation Luncheon, 26 July 2011, Glenn Stevens

incomes, and that is higher rates of growth of productivity”.

Australia productivity growth – GDP per hour worked



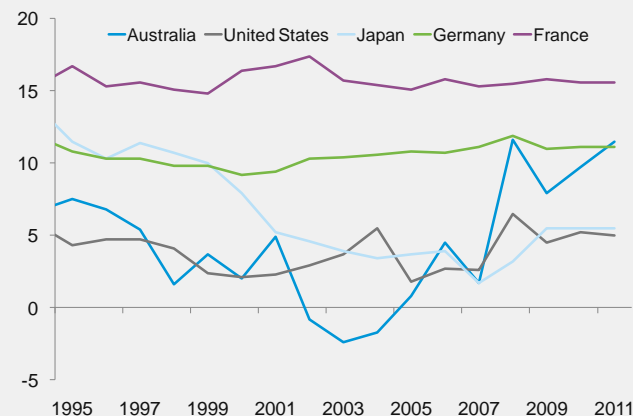
Source: ABS. Data to 30 June 2011

In the US, Federal Reserve Chairman Ben Bernanke also highlighted the view that policies on housing, taxation, trade, the regulatory environment, population, education, health, investment in R&D and technology would also be critical to the long-term economic outlook for the US.

Credit growth/leverage:

The converse of lower consumption is higher household savings. Savings rates have risen in some countries, reflecting the high degree of economic uncertainty and consumer caution. There is also a growing awareness that lower levels of government spending will mean less reliance on government funding for essential services and in retirement. Households have reacted rationally to this, especially in the US and Australia by raising savings levels.

Savings rate as % disposable income

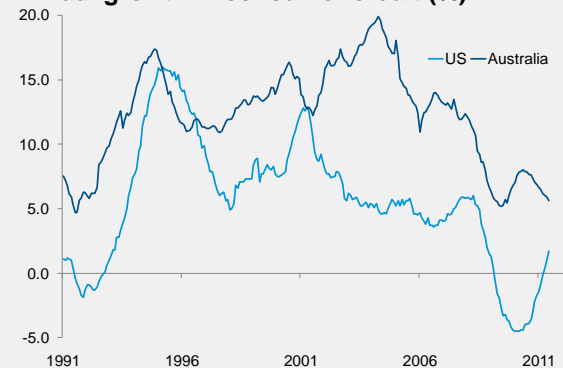


Source: Bloomberg

One of the key features of the economic ‘recovery’ from the financial crisis is a sharp reduction in the pace of credit growth and leverage by the consumer in many countries, including Australia and the US.

This can be seen in the chart below of annual growth in consumer credit.

Annual growth in consumer credit (%)



Source: Bloomberg, RBA

It seems reasonable to conclude that this very slow pace of credit growth by the US consumer is both a demand and supply issue. In Australia, there seems to have been a conscious decision by consumers to reduce debt, with the banking system continuing to be willing to extend mortgage credit and other personal credit.

On the demand side in Australia, despite the relatively low unemployment rate, ongoing consumer caution is seeing demand for credit remain very soft, with consumers seemingly unwilling to leverage their balance sheets as much as was the case in the past.

This is likely to slow the pace of consumer and economic growth, as consumption will only be able to increase at the pace of income growth, rather than in a more aggressive pace.

On the supply side in the US, it seems clear that given that part of the financial crisis was brought on by too easy credit quality controls, that the US banking system has tightened standards, impacting the availability of credit.

Regulatory changes with the introduction of tighter liquidity standards and increased capital requirements through Basel III will continue to mean that bank balance sheets will shrink, reducing the total amount of leverage in the global economy.

This decline in consumer credit and the willingness/ability to take on leverage is likely, therefore, to be a significant factor in limiting the potential growth rate of the US economy for a number of years to come.

Policy options; Fiscal

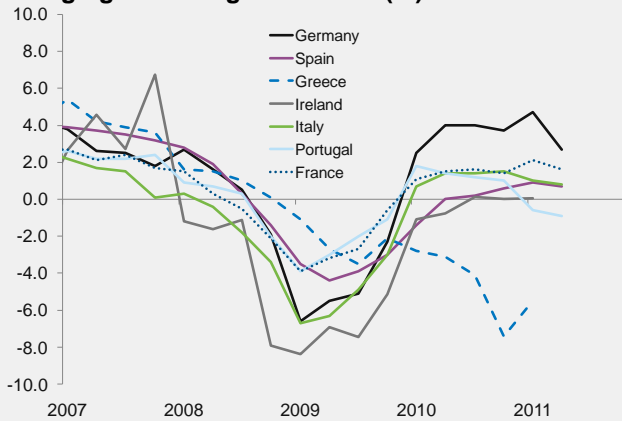
One of the most significant factors for the outlook of the global economy is the constrained nature of public balance sheets in the developed world.

In US and Europe, the focus is on long term fiscal consolidation to reduce government budget deficits and reduce overall debt levels. Negative economic consequences are evident due to this deleveraging from the public sector. Social unrest has occurred in the UK and Greece and political uncertainty is elevated,

compounding already low consumer and business confidence levels.

An easy way to see this is through the next chart. This shows the divergence in key European economies GDP growth rates with countries like Germany, Portugal and France performing significantly stronger than Greece and Ireland, where the fiscal challenges are more severe.

Diverging EU GDP growth rates (%)

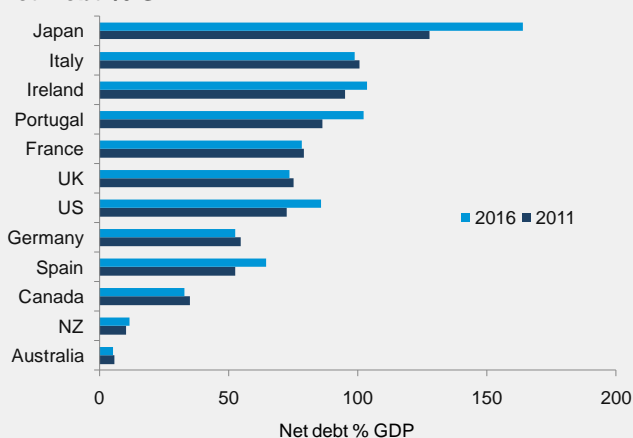


Source: Bloomberg. Data to 30 June 2011, Greece and Ireland to 31 March 2011

Despite a recent attempt at fiscal stimulus by the US President, fiscal consolidation will likely continue to constrain economic growth rates in the developed economies for years ahead.

Most announced fiscal consolidation plans are weighted to 2012 and 2013, with economic growth in these years likely to be held back by further budget cuts. As the chart below shows, the US, Japan and some EU countries have a lot of work to do prior to 2016 to at least stabilise debt levels before being able to lower government debt levels. This challenge will become greater as economic growth slows.

Net Debt % GDP

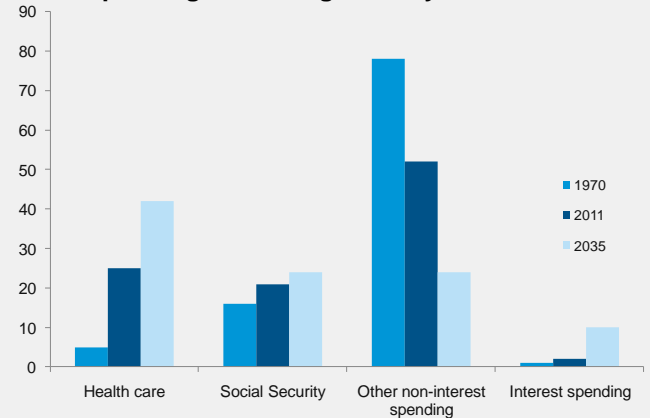


Source: IMF Fiscal Monitor

The demographic challenge also compounds this problem; with a growing health care and social security burden globally still to be dealt with. As the chart below shows, health care spending in the US has already increased from 5% of government outlays in 1970 to 25% in 2011 and is forecast to increase to 42% in 2035

on the current trend - due largely to the ageing of the population and inefficiency within the system.

Sector spending as % budget outlays

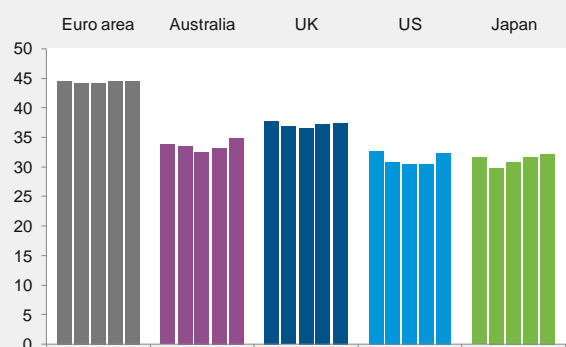


Source: Congressional Budget Office. June 2011 baseline projections

In addition, as the recent debate over the US debt ceiling so dramatically demonstrated, the US political system seems incapable of delivering a bi-partisan approach to returning the US fiscal position to a sustainable path and makes the fiscal job the US has ahead of it even more challenging.

Globally, more innovative solutions will have to be found to raise revenue by governments. Tax reform is one area that should be a renewed focus. Some countries in particular, as the chart below shows, notable the US and Japan will need to lift government revenue as a share of GDP to improve balance sheets. Europe surprisingly looks reasonable by comparison, although in some countries actual tax collected is well below the level implied by the tax laws.

Government revenue % GDP; 2008 - 2012



Source: IMF Fiscal Monitor

Policy options; Monetary

Central banks are also constrained in both the ability and desire to implement further monetary stimulus measures. With interest rates at near zero percent in the US, UK and Japan further easing measures are focussed on alternative measures, such as bond buying programs and communication policies.

There appears to be growing dissent within some central banks on the need and/or structure of further stimulus measures and ultimately this could limit the central banks'

ability to continue to implement unconventional monetary policy.

This is already being seen on the US Federal Reserve, with three dissenters (the highest proportion on record) at the August 2011 meeting where forward guidance was firmed.

The FOMC's language was altered as follows; "The Committee currently anticipates that economic conditions – including low rates of resource utilization and a subdued outlook for inflation over the medium run – are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013".

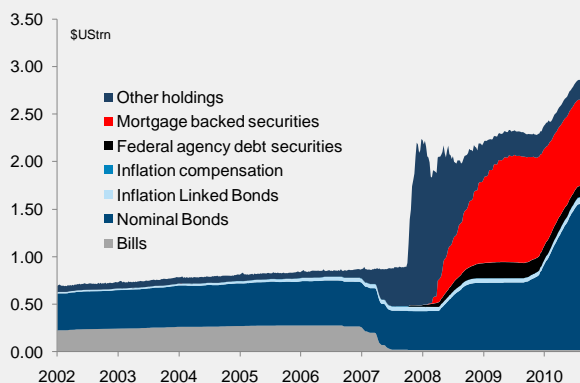
Given the current weak state of the US economy, Chairman Bernanke has also said that the FOMC "will continue to consider (the use of its additional tools) and other pertinent issues at our meeting in September." It is worth noting, however that the September FOMC will now be a two-day meeting (20th-21st) "to allow a fuller discussion."

In this regard, the option of further, unconventional, monetary policy easing does look to be a "live" debate for the two-day September meeting – given that no further policy change would likely have taken only one day (as originally scheduled) to discuss. The longer meeting should allow Fed Chairman Bernanke time to debate the economic outlook with the other FOMC members, including the three dissenters on the FOMC who did not vote for the specific interest rate timeframe.

While the Fed Chairman did not discuss them in detail, some of the other policy "tools" open to the FOMC include increasing the maturity of their existing bond holdings (colloquially known as 'operation twist'), embarking on a third round of quantitative easing (QE3) through increasing the already substantial size of the Fed's balance sheet and lowering the interest rate on excess reserves (which currently is set at 0.25%).

It is worth noting that the Fed's balance sheet is already large (at \$US2.85tr) and government bond yields are already at very low levels (As at 14th September 2011, 2 year Treasuries were trading at 0.20%, 10-year Treasuries at 1.96% and 30-year Treasuries at 3.30%).

Fed's balance sheet



Source: US Federal Reserve, data to 18 August

Given bond yields are already very low, another round of quantitative easing is unlikely to stimulate the US economy as expected.

However, it seems clear that the Fed Chairman views the downturn in the US economy and current high unemployment rate as cyclical and not structural. The implication here is that the Fed believes that they can continue to support a return to trend growth rates and lower unemployment through ongoing monetary policy stimulus – both in the traditional sense and in more unconventional tools.

Fed Chairman Bernanke has also made the point that "although important problems certainly exist, the growth fundamentals of the United States do not appear to have been permanently altered by the shocks of the past four years. It may take some time, but we can reasonably expect to see a return to growth rates and employment levels consistent with those underlying fundamentals."

In terms of the very modest recovery to date for the US economy, the Chairman highlighted two features that had weighed on growth, the ongoing weakness of the housing market (due largely to the number of foreclosure sales and tighter credit conditions) and the elevated level of uncertainty in both the consumer and business sectors as a result of the financial crisis and political situation.

The Fed Chairman also highlighted that there is only so much that monetary policy can do to support economic growth and that other policies – especially fiscal, were also important.

The Chairman also took the time to highlight the importance of combating the current high level of long-term unemployment, with the risk being that people who are unemployed for long periods of time can be left behind and their potential to add to the economic wellbeing of the nation (not to mention themselves and their families) seriously compromised through loss of skills. This is where the economic cycle can turn into a longer term structural issue that is much harder to resolve.

It remains debatable, however, whether these unconventional monetary policy tools can correct the path of the US economy and encourage economic growth on its own. Fiscal policy, even in an environment of fiscal consolidation has an important role to play, as recently highlighted by the President's budget plans.

It is becoming clearer that a refocus on productivity enhancing policies and creating confidence in the political framework are what is needed to ensure a return of the US economy to its potential growth rate. Individual companies and households may well have to take the brunt of these much needed reforms.

In Europe, the European Central Bank (ECB) has also had its fair share of dissents. The first came early in 2011 when favoured candidate to replace Jean-Claude Trichet as President of the ECB, Axel Weber resigned with theories suggesting it was due to differences of opinion about the best way forward for ECB stimulus. A second member of the ECB Board, Chief Economist, Jurgen

Stark resigned in September 2011, with expectations that this was due to disagreement about the ECB bond buying program.

Implications for asset markets

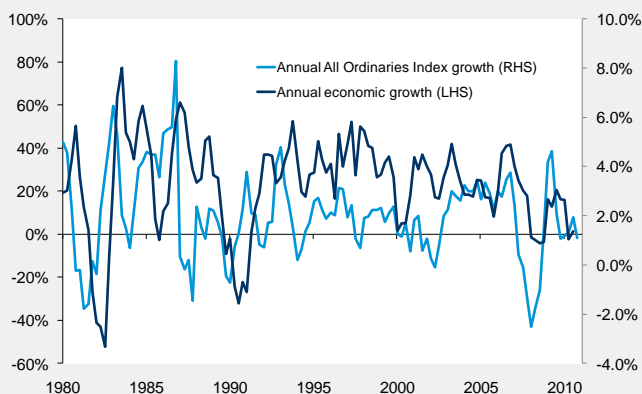
There would seem, therefore, to be a number of significant factors acting to constrain economic growth in the key developed economies in years ahead. A combination of structural headwinds and lack of fiscal and monetary policy options for developed economies have largely led to this outcome.

This will, no doubt have an impact on potential asset price growth, with a lower economic growth world expected to lead to lower asset price growth than has been realised in the decade prior to the global financial crisis. The absence of leverage is likely to compound this.

Equity markets

Historically, economic growth and equity market returns have been closely linked. For Australia, the correlation is 52% when economic growth is lagged by six-months, as shown in the chart below.

Australian equity returns vs GDP growth



Source: Bloomberg, CFS GAM.

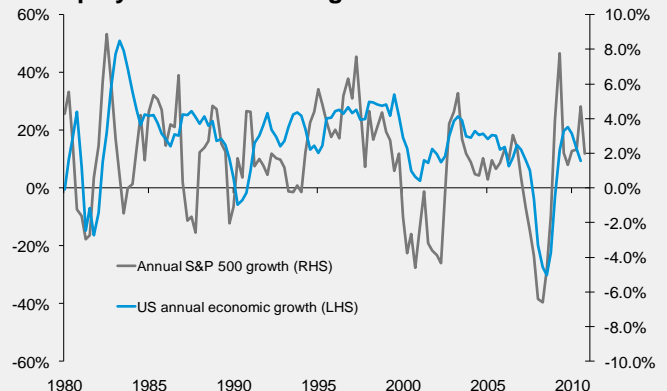
For Australia therefore, the issue remains one where the 'two-speed' nature of the Australian economy will likely remain a key feature of equity market performance.

Those stocks closely linked to the domestic side of the economy, non-resource exporters and import competitors and those with closer links to the US or European economy could struggle to make significant gains.

On the other hand, those companies and investments with exposure to the faster growing emerging nations, which are expanding due to structural reasons, such as China, could be expected to benefit from the stronger economic environment and better medium-term potential growth.

For the US, the correlation between S&P 500 annual returns and US annual GDP growth is a very high 62% when economic growth is lagged by six-months.

US equity returns vs GDP growth



Source: Bloomberg, CFS GAM.

The implication for the US seems clear. If we are correct and the economic outlook for the US in the years ahead is, at best, for very moderate growth, then investors should also expect to see very moderate return on investments in the US equity market.

Constraints on employment, credit, demand and government stimulus are all likely to add up to a more difficult environment for US equity markets over the medium-term, most certainly when compared with the period just prior to the onset of the financial crisis.

However there will be exceptions, companies exposed to structural changes in the global economy could still deliver above index returns, as well those companies who undertake operational efficiency exercises.

In Europe, the ongoing sovereign debt crisis and risks of contagion into a banking crisis is also likely to act to limit the medium-term economic growth outlook and the performance of the equity markets.

While European companies and countries (such as Germany) with a high exposure to developing nations could be expected to outperform, the structural negatives within the European financial system are likely to weigh on both economic and asset market performance for a number of years to come.

Bond markets

By historical standards, government bond yields in the major developed nations are already at extraordinary low levels, with US 10-year yields at just 1.96% (see chart below), Germany at 1.79%, the UK at 2.41%, Japan at 0.99% and Australia at 4.09% as at 14th September 2011.

US 10 year bond yields

10 year US Treasury yields since 1962



Source; Bloomberg

Bond markets have already, therefore, factored in a very weak economic and inflation environment for the major developed nations for a number of years to come – and this seems a sensible conclusion.

The issue for bond market investors is, therefore, whether this very weak economic/inflation environment that is priced into market turns out to be too negative, which would then likely send bond yields sharply higher (i.e. prices lower).

A primary concern here is that the significant amount of liquidity being pumped into the developed nations by their central banks will lead to a sharp rise in inflation and, perhaps more importantly, inflation expectations that then sends bond yields higher.

In the near-term, ie. over the next year or so, it would seem that the risk of a break-out in inflation expectations that would force central banks to tighten monetary policy and see bond yields rise substantially is low - especially given the outlook for employment and wages in the developed world. Indeed, the US Federal Reserve has already signalled their intention to keep the Fed Funds target rate in the 0%-0.25% range until mid-2013, while interest rates in Europe, the UK and Japan are unlikely to be increased any time soon.

Another key factor for government bond markets over the medium-term is, however, ongoing worries about credit quality. While a number of countries have already had their credit ratings downgraded (including the US by S&P), the risk is that further deterioration of fiscal fundamentals will bring more credit rating downgrades in the years ahead for a number of developed nations.

On a medium-term perspective, therefore, the danger exists for a sharp sell-off in government bond markets that would have a negative impact of investor returns.

Alternative investments

In an environment where the macro-economic outlook looks set to be very muted and provide challenging circumstances for both equity and bond investments, looking at alternative investments makes sense.

This could include asset classes such as infrastructure and property, where income growth is linked to inflation and/or determined by government regulation.

Investment conclusions

If the economic outlook for the major developed nations is as moderate as expected over the medium-term there would appear to be three key lessons for investors.

Firstly, a slower macro-economic growth rate (ie. lower nominal GDP growth) would imply a period of lower returns on traditional assets classes than many investors have come to expect, especially given the returns experienced over the decade prior to the global financial crisis. As a result, investors may need to adjust downwards their expectations for future returns in markets.

Secondly, investment portfolios will likely need to be diversified in such a way as to be able to cope with periods of depressed expectations for economic growth, increased financial market volatility, greater regulation by governments and a reduced ability for governments to support growth through either fiscal or monetary policy.

Thirdly, exposure to the large structural forces underway in the global economy will become more important in providing growth in a portfolio. Cyclical trends will be important to understand, but investing for the structural change in a diversified manner should continue to become a focus for investors.

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