

**Analyst(s):** Rodney Lay, Jason Patton

## Standard & Poor's View

Standard & Poor's Fund Services rates the Capital Series Cornerstone (the product) 'STRONG' reflecting our view that the product is characterised by an efficient and effective structure, a clear target market, and adequate value proposition for the suitable investor.

The product comprises two separate equity-linked investment strategies that offer the potential of capital growth and, in the case of the first strategy, income as well. Both provide the safeguard of 100% capital protection at the end of the 5.5-year investment term.

Strategy 1 provides a fixed-income amount of 5% per year (after 1.5 years) plus the potential for capital gains. Capital returns are contingent upon the price performance of a basket of shares a basket of shares comprising 20 of the largest ASX-listed companies by market capitalisation. Capital gains are capped to the upside. When combined with the capital protection and fixed-income component, the minimum and maximum total returns are 4.6% and 11.3% per year, if held to maturity.

Strategy 2 provides for potential capital returns only. Returns are contingent upon the performance of the S&P/ASX 200 price index (the index). Capital gains are capped to the upside at a level equal to 50% gain in the index multiplied by a minimum participation rate of 165%. This translates to a maximum return of 82.5% over the 5.5-year term. When combined with the capital protection, the respective minimum and maximum returns are 0 and 11.6% per year, if held to maturity.

Strategy 1 is a fixed-income alternative. Based on our Monte Carlo analysis, we believe the expected returns profile (8.3% p.a.) is comparatively attractive for suitable investors. We have a similar view with regard to strategy 2 for those investors with a suitable market outlook and risk-return profile.

## Investor Suitability

- Strategy 1 has negligible income risk but higher capital-return risk than strategy 2. Strategy 2 is the higher risk-reward strategy.
- Strategy 1 sits clearly as a fixed-income alternative. In the view of S&P, the expected return and the upside risk make this a competitive offering relative to, for example, a five-year term deposit (7% p.a.).
- Strategy 2 will outperform domestic equities in negative to subdued growth environments. It is designed for investors who believe that the outlook is for a more subdued growth and/or highly volatile market.

## Key Strengths

- Investors have a choice of two investment options with clear risk-return profiles, market exposures, and distinct investor suitability and portfolio component attributes.
- In contrast to an alternative capital-protection structure, the product does not incorporate deleverage risk. The flipside is that returns are capped under the product structure.
- The two strategies may outperform alternative capital-protected structures in low and moderate growth and high volatility market environments, but will underperform in average and high growth environments.

## Key Weaknesses

- Relative to alternative capital-protected structures, strategies 1 and 2 generally only provide a relatively attractive value proposition in a subdued growth or high volatility market environment.
- Strategy 1 is long correlation, with lower correlation between the underlying stocks adversely affecting expected returns. This is more a feature than a weakness.

## Risks

- A period of low correlation in the underlying portfolio constituents will adversely affect strategy 1.
- CBA counterparty risk.

<b>Name:</b>	Capital Series Cornerstone	<b>Open date:</b>	Feb. 14, 2011
<b>Responsible entity:</b>	Commonwealth Bank of Australia	<b>Close date:</b>	April 11, 2011
<b>Portfolio manager:</b>	Not applicable	<b>Start date:</b>	April 18, 2011
<b>Protection provider:</b>	Commonwealth Bank of Australia	<b>Liquidity</b>	Monthly
<b>Minimum investment:</b>	A\$10,000	<b>Maturity date:</b>	Oct. 25, 2016 (5.5 years)
		<b>Release authorised by:</b>	Leanne Milton

## Product Structure

Capital Series Cornerstone is structured as a deferred purchase agreement (DPA) based on a zero-coupon bond (ZCB) plus option structure.

Commonwealth Bank of Australia (CBA) does not charge an explicit fee. Rather, it bases its fees on the pricing of the ZCB and the loan interest rate. We approximate the fee at around 0.7% per year.

There is counterparty risk associated with the capital protection and payment of returns and that risk lies with CBA. We regard the counterparty risk as low given the entity's strong credit rating.

For strategy 1, investors should refer to the product disclosure statement (PDS) for a list of the 20 constituent stocks of strategy 1. The 20 stocks are equally weighted at inception but not subsequently rebalanced during the investment term.

For strategy 2, the underlying index is the S&P/ASX 200 price index rather than the total returns index.

A capital investment loan is available (except for superannuation funds). An investor may borrow up to 100% of their investment amount. An interest-in-advance loan is also available to fund 100% of the yearly interest owing.

There are three interest rate structure options: variable monthly in arrears (indicative interest rate of 9.10% p.a.), fixed payable monthly in arrears (9.6% p.a.), and fixed payable yearly in advance (9.40% p.a.). The indicative rate for the interest-in-advance loan is 9.35% p.a.

## ⇒ Taxation

Income from strategy 1 may be on income account in the year earned, whereas capital returns upon exit are likely to be on capital account. For strategy 2, a tax event is expected to occur only upon exit, whereas for strategy 1, tax events are expected to occur both during the term and upon exit.

In regard to the interest deductibility on the investment loan, the loan is full recourse and, therefore, not classified as a capital-protected borrowing. Consequently, interest paid on the loan may be fully deductible. As a full recourse loan, loan investors are required to repay any shortfall between the loan amount and the value of the investment. However, at maturity the value of the investment is expected to at least equal the investment loan amount.

The DPA structure introduces a degree of interest deductibility risk. Specifically, the Australian Taxation Office (ATO) has not made any public determination or ruling as to whether interest expense incurred in relation to DPAs will be deductible.

The ATO may take the view that interest expense incurred in an income year in relation to DPAs may only be deductible up to the amount of any income derived from the investment in that income year and that any interest paid in excess of the income derived may be non-deductible and should instead be included in the cost base of the investment (which is relevant to calculating a capital gain only). However, there are alternative views to this position.

At maturity, investors may elect to receive a delivery asset consisting of units in the SPDR S&P/ASX 200 Fund. Irrespective, a CGT event will occur at the maturity of the product.

S&P notes that tax consequences depend on individual circumstances and investors should seek their own taxation advice. The above comments regarding taxation treatment are based on S&P's understanding, but cannot be considered tax advice.

## ⇒ Fees

Fees are detailed in table 1. Investors should note that commissions paid to advisers are subject to commercial terms between adviser and investor.

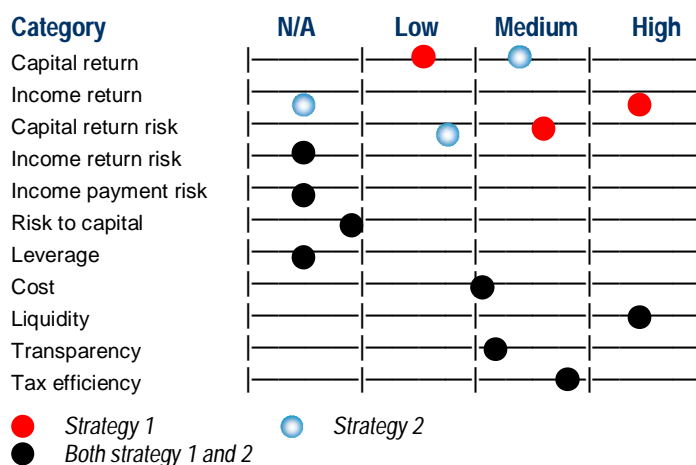
**Table 1: Fees And Costs**

Type	Amount
Brokerage fee	Up to 0.55% of the maturity value
Upfront commissions *	2.2%
Trailing commissions *	0.55% p.a. on the loan balance
MER	Approximately 0.7% p.a.
Early exit fee	An amount up to \$500

\* Subject to commercial terms between adviser and investor.

Source: CBA.

**Table 2: Risk—Return Profile <sup>1</sup>**



## Payoff Profile

Investors should note that the payout profiles as described below assume the investment is held to maturity. For investors who redeem early, the return may be less than the capital-protected amount and will be determined according to an option-based pricing method.

Investors should also note that they have no entitlement to any dividend income or franking credits that may be paid by the underlying securities or constituent stocks of an index.

## ⇒ Strategy 1

Five annual income amounts of 5% are paid to investors on the coupon payment dates, which fall on Oct. 25, 26, or 27, from 2012 to 2016. The first payment is made 1.5 years after the issue date. With a 5.5-year investment term, the five 5% coupon payments equate to an effective payment of 4.6% per year over the full term. The income payment is not contingent upon the performance of the underlying basket of the 20 stocks. It is fixed and guaranteed, subject to the credit risk of CBA.

With capital returns the performance of the basket is based on the average performance of each of the 20 stocks. The exposure to each stock is limited to 70% above the initial level of each stock at the maturity date. The performance of the underlying basket is then reduced by 25%, reflecting the sum of all fixed annual income paid over the tenure. Consequently, the maximum capital return of the underlying

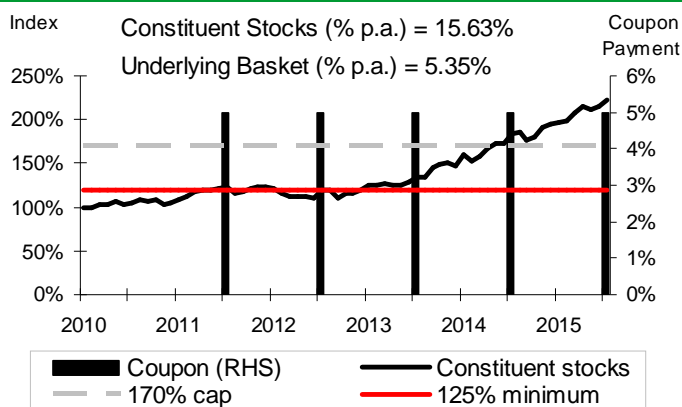
basket over the 5.5 years is 45% and capital growth is only achieved if the performance of the underlying portfolio is greater than 25% over the full term. With a 25% income return, the maximum total return is 70% over the 5.5-year term.

Investors have no entitlement to dividends paid by the 20 constituent stocks nor associated franking credits.

There is an inherent asymmetry of downside risk in the performance calculation. That is, the calculation method captures the full negative performance of each stock, but limits positive performance to 70% over the term. As such, the lower the average correlation and the higher the volatility of the stocks, then the lower the expected return of the underlying basket will be for any given market-return environment.

Chart 1 shows a randomly generated example of the payout profile of strategy 1 over the 5.5-year term. In the example, the constituent stocks generated a 122% gain over the term (15.6% per year). In contrast, the gain of the underlying basket was 33% (5.4% per year). While the positive performance of the constituent stocks exceeded 70%, this does not mean the underlying basket captures the full 70% gain. This is because the performance calculation is based on the capped performance of each individual stock. Income is paid out annually in October and is a fixed 5% per year.

**Chart 1: Strategy 1 Payout Structure**



Source: S&P Fund Services.

Strategy 1 may be suitable for investors seeking an enhanced, regular income stream but who are prepared to risk the income that would be otherwise be available from a low-risk income-only alternative (up to 7% per year for a five-year term deposit). This is in exchange for capturing some of the equity market's upside risk but with the safeguard of 100% capital protection.

### ⇒ Strategy 2

At maturity, strategy 2 captures a maximum 50% gain in the S&P/ASX 200 price index above the initial level on the issue date then multiplies this return by a minimum 165% participation rate (exact participation rate is set on Start Date). Consequently, the maximum return over the 5.5-year term is 82.5%, or 11.6% per year.

On account of the participation rate, and in combination with the cap and floor, strategy 2 will outperform domestic equities where the S&P/ASX 200 price index records growth of less than approximately 6% p.a. over the term of the product, assuming a dividend yield consistent with the long-term average of approximately 4%.

The capital growth risk profile of strategy 2 is higher than strategy 1 due to the correlation risk in strategy 2.

The strategy has been designed for investors with a positive view on domestic equities who either believe there is a material risk that growth will prove relatively subdued or, by way of the capital protection, are simply risk averse.

## Simulated Risk-Return Analysis

We have conducted a Monte Carlo analysis to assess the simulated expected return profile of the two investment strategies.

We conducted the analysis separately for each of the two strategies running three risk-return scenarios. We based the three scenarios on the rolling five-year historical risk-and-return performance of the underlying indices. For strategy 1, we used the performance of the S&P/ASX 20 price index as a proxy.

Using this data, we based the three market-environment scenarios on first, second (historical median), and third percentile rolling five-year price returns while basing the level of risk on the second quartile level. The risk and return variables are detailed below.

**Table 3: Risk – Return Scenarios**

Scenario	S&P/ASX 20	S&P/ASX 200
Poor	3.8%	4.6%
Historical	8%	7.7%
Good	10.8%	10%
Risk	12.9%	12%

Source: S&P Fund Services.

### ⇒ Strategy 1

Table 4 summarises the expected performance of strategy 1 under the three scenarios and chart 2 shows the probability distribution of expected returns. The key results include:

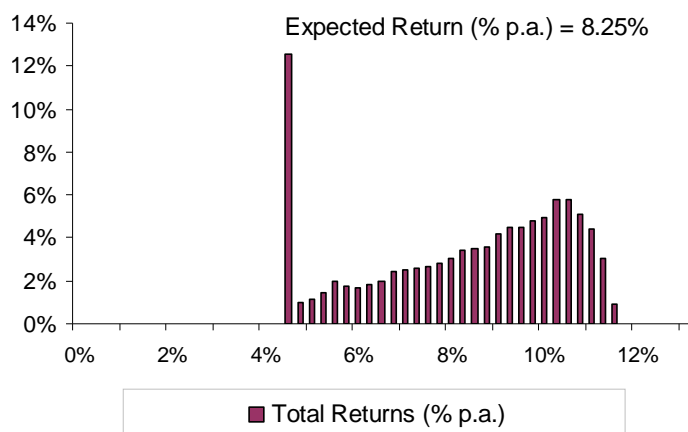
- In a risk-and-return environment consistent with the long-term average of the S&P/ASX 20 price index ("historical" scenario), there is roughly a 70% probability of a return that exceeds the most competitive five-year term deposit rates (7% per year). This may provide an attractive alternative for investors with a positive market outlook who are prepared to take on a degree of equity risk.
- Due to the cap-and-floor payout structure, the expected level of returns is narrow and investors forgo a degree of capital upside in exchange for a guaranteed income level; and
- The strategy is long correlation and short volatility; the higher the average level of correlation between the 20 stocks the higher the expected returns, while the higher the volatility the lower the expected returns.

**Table 4: Simulated Expected Returns**

Scenario	Poor	Average	Good
Capital return	1.4%	3.7%	4.4%
Income return	4.6%	4.6%	4.6%
Total return	6%	8.3%	9.1%

Source: S&P Fund Services.

Chart 2: Strategy 1 Payout Structure



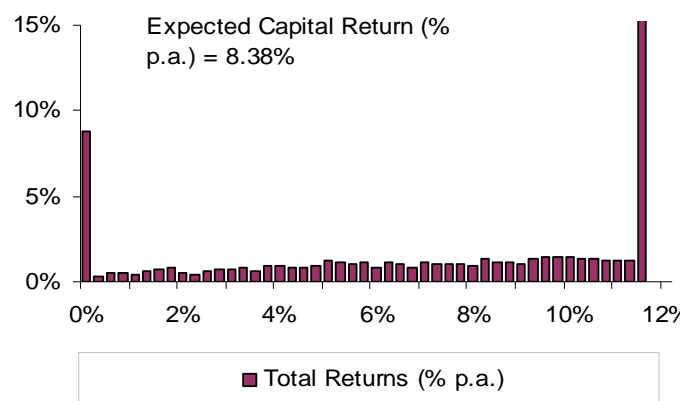
Source: S&amp;P Fund Services.

## ⇒ Strategy 2

Based on the expected payout profile, S&P regards strategy 2 as potentially suited to investors who believe market growth prospects are subdued and who remain concerned about volatility. Key results include:

- There is a material probability of receiving the maximum or minimum return on account of the cap-and-floor and participation-rate payout structure. However, the likelihood of the highest payout (11.5% p.a.) is significant, occurring in around 50% of outcomes in a historical market environment.
- Relative to the alternative capital-protection structures, strategy 2 will outperform in low and moderate growth environments and may also possibly do so in a high volatility environment but may underperform in average and good environments.

Chart 3: Strategy 2 Payout Structure



Source: S&amp;P Fund Services.

In undertaking this analysis, S&P has also assessed the expected returns of alternative capital-protected offerings currently in the market. These include the constant proportion portfolio insurance (CPPI) structure and a structure that essentially works like a put and call. A comparative analysis table has also been included above for information purposes.

The comparison is not relevant to strategy 1 due to the lower risk-return profile and guaranteed-income component of these strategies.

Table 5: Simulated Expected Returns

Scenario	Poor	Average	Good
Cornerstone	5.8%	8.4%	10.1%
CPPI	4.7%	9.1%	13%
Put-and-Call	4.9%	9%	12.2%

Table 6: Comparative Analysis

Structure	Cornerstone	Put-and-Call	CPPI
Feature:			
Liquidity	Monthly	Quarterly	Mthly/Qtrly
Withdrawals	No	No	No
Rising protection	No	No	Possible
Market risk	No	No	Yes
Vesting period	Maturity	Maturity	Maturity
Participation	100% – 165% up to cap	100%	0 – 100%
Distributions	None	None	None
Performance	Near Linear	Near Linear	Path dependent, non-linear
Term (years)	5.5	Five	Five to seven
Cash lock risk	No	No	Yes
Tax efficiency	Average – High	Low – Average	Low – Average
Tax treatment	Capital only	Income only	Income and capital
Direct costs	Low	High	Average

Source: S&amp;P Fund Services.

### Structured Product Rating Philosophy

The performance of a structured product is a function of the interaction of the two separate components. Importantly, the performance will not match that of the underlying growth asset. Consequently, the rating is a product of the assessment of the two underlying components in isolation to each other plus the expected performance based on the interaction of those two components.

### Structured Product Rating Definitions

STRUCTURED PRODUCT RATING <b>VERY STRONG</b>	S&P has assigned a 'Very Strong' rating to the product based on its conviction that it can meet its objectives over the stated time period. The product has scored exceptionally in a number of categories but may not be suitable for all investors.
STRUCTURED PRODUCT RATING <b>STRONG</b>	S&P has assigned a 'Strong' rating to the product based on its conviction that it can meet its objectives over the stated time period. The product has scored strongly in a number of categories but may not be suitable for all investors.
STRUCTURED PRODUCT RATING <b>SOUND</b>	S&P has assigned a 'Sound' rating to the product based on its conviction that it can meet its objectives over the stated time period. The product has scored satisfactorily in a number of categories but may not be suitable for all investors.
STRUCTURED PRODUCT RATING <b>PASS</b>	S&P has assigned a 'Pass' rating to the product based on its conviction that it can meet its objectives over the stated time period. The product has passed a number of categories but may not be suitable for all investors.
STRUCTURED PRODUCT RATING <b>WEAK</b>	S&P has assigned a 'Weak' rating to the product based on its conviction that it can not meet its objectives over the stated time period. The product has scored weakly in a number of categories and may not be suitable for most investors.
STRUCTURED PRODUCT RATING <b>ON HOLD</b>	An 'On Hold' designation is a suspension of a rating pending further analysis of a material change in the characteristics of a product.

### Structured Product Rating Process

The evaluation of a structured product addresses: the underlying growth asset; the structural component; strengths and weaknesses; component complementarities; investment philosophy; fees and costs; expected absolute and relative risk-adjusted performance; and exogenous risks.

### Glossary Of Terms

<b>Expected Risk-Return</b>	Expected risk and return measures are based on an output of the Monte Carlo analysis using a risk-return scenario consistent with the historical performance of the underlying asset class. Returns relate to both capital and income. Risk represents the annualised standard deviation.
<b>Income Payment Risk</b>	The risk income is not paid on a payment date as a contingency test is not met.
<b>Risk To Capital</b>	The risk of a loss on invested capital. Capital protected products, for example, can be regarded as having limited risk.
<b>Counterparty Risk</b>	The risk that a loss will be incurred if a counterparty to a transaction does not fulfil its financial obligations in a timely manner.
<b>Management Expense Ratio (MER)</b>	This ratio is a calculation of investment management, marketing, trusteeship, legal, accounting and auditing costs amongst others, of an investment expressed as a percentage of the investment's net asset value. It is the ongoing charges for managing the investment.
<b>Monte Carlo Analysis</b>	A probability distribution of (typically) risk-return outcomes using random samples. In most cases, the random sample represents performance of the broader asset class market or the investment strategy by which the performance of the investment structure is determined. The random samples are guided by particular market risk (volatility) and return assumptions scenarios.
<b>Standard Deviation</b>	Measure of the variability or volatility of the monthly returns of the fund.

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