Inflation Linked Bonds (ILBs) – issuance for Financial Year 2010
November 2009

Following from the recent issuance of the 2025 bond, the Australian Office of Financial Management (AOFM) has provided further detail on the intended Commonwealth issuance in the ILB sector for the remainder of this Financial Year.

What will be issued?

AOFM has announced a monthly tender programme to allot between $1.5-$2 billion ILBs. Starting on 16th November, the first tender will be for the issue of $300 million of the 2020 security. After a break in December, tenders of approximately $250 million each will recommence in January 2010 and are planned to be held generally around the middle of each proceeding month until the end of the Financial Year.

Since the beginning of the issuance programme, AOFM has been very receptive to market demand and feedback. Therefore, details surrounding bond lines and amounts to be offered in subsequent tenders for this Financial Year will be determined on a monthly basis. The market will be informed ten calendar days prior to the tender. Our view is that this programme will be used to issue into demand for existing lines.

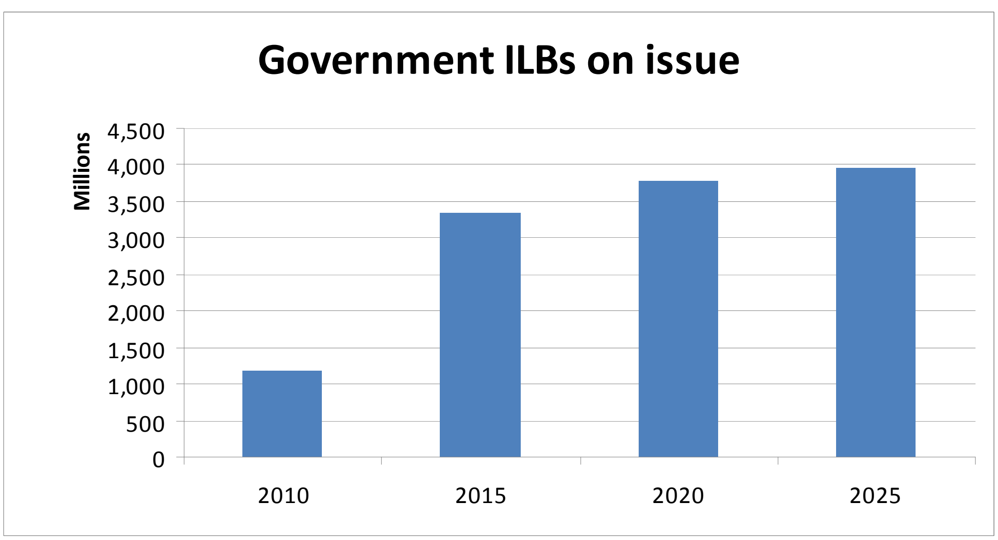
How will it operate?

Interestingly, tenders will be conducted as a single price auction such that all successful bidders will pay the same price. This is a departure from the October issuance and also from tenders conducted for nominal bonds which are multiple price auctions. AOFM's reasoning for this is that, as the physical ILB market is not as liquid as the nominal market, price discovery is more difficult.

Ultimately, a single price auction is good for investors and is likely to encourage a wider variety of participants into the ILB sector.

What will be the market impact of this?

This programme through to the remainder of the Financial Year is expected to beef up the existing bonds on issue, currently valued at $13 billion and shown below:



It is likely that, if sufficient demand exists, that the 2015 line will be the subject of new issuance.

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What will be the impact on the benchmark?

As the 2020 bond has a duration very similar to the total index duration (8.7 years vs 9.0 years), there will be no impact on the duration of the benchmark due to the new issuance.

It is important to be aware that, due to the issuance of the 2025 bond in October, the duration of the Government Inflation Index extended by approximately 1.6 years. The current duration of the Index is 9.13 years (Macauley Duration).

How will this impact valuation in the sector?

Increased supply and widespread demand has combined with increasing inflation expectations, pushing out the breakeven curve. ILBs are currently at the edges of fair value and we expect that they will move deep into expensive territory before normal pricing ranges are restored.

What will future issuance look like?

The size of this programme is larger than anticipated by the market but AOFM is demonstrating that it is seeing demand and is committed to ILB issuance into the future. Total Commonwealth ILB issuance this Financial Year could be up to $6 billion. This is before the 2030 bond is issued, which we expect to occur in the first half of 2010. If the monthly tender programme also continues into Financial Year 2011, total Commonwealth issuance could surpass $7 billion.

Furthermore, the semi government segment is also issuing ILBs. NSW TCorp have committed to a $1.5-$2 billion raising this year with speculation that NSW TCorp, Queensland Treasury and the ACT could add another $2-$3 billion liquidity into the market in Financial Year 2011.

Given new supply, is passive or active management better suited to the ILB sector going forward?

One of the most common responses from investors is that ILBs should be a "set and forget" strategy and that ILBs are best used to keep the bottom drawer full. For investors using ILBs to provide direct protection against future inflation, there can be little need to actively trade a portfolio. However, the structure of the ILB market, particularly with increasing levels of supply, allows passive investors to be exposed to a range of benchmark and market risks.

The increase in supply, particularly the issuing of new lines of ILBs, markedly influences valuation and duration in the market. Investment banks and brokers are well aware that, in order to keep pace with benchmark changes, buy-and-hold and/or passive investors need to purchase large amounts and are price-takers.

For investors wishing to adopt a passive approach, we would recommend Ardea's *intelligent replication* approach. This can ensure that ahead of any major index changes that investors adjust their portfolios to match the future risk profile of the index, without being forced to trade when the market is most expensive. By implementing this strategy during the benchmark's duration extension in October 2009, Ardea was able to generate sizeable returns for our clients relative to benchmark.

Intelligent replication strategies may also be extended to include active strategies, introducing the possibility of accessing other anomalies in the ILB market.

Inflationary outlook – Ardea's analysis

The last six months has seen an extraordinary turnaround in sentiment and economic activity. From the depths of despair, the Australian sharemarket has experienced a strong rebound, consumer sentiment has been rejuvenated and economic activity is once again back on track. In this environment, ILBs have outperformed as inflation expectations have risen, underpinned by demand for the Commonwealth issuance programme.

The key question for us is whether the scale of this economic revival will be repeated in the coming six months. As the Australian economy has found surer footing, we expect that while improvements are likely to continue, the magnitude will be more subdued.

Accordingly, it is our expectation that ILBs will continue to outperform nominals in the near term, however, at a more measured pace than the extreme gains of recent months. With the potential for increased offshore investment (with the removal of withholding tax on coupon payments) and further index extensions, this could lead to a further period of strong outperformance.

Ardea Investment Management

Ardea offers distinctive expertise in inflation-linked bonds (ILBs), which are attracting significant interest in the current economic climate.

Ardea's focus is on protecting capital for their clients with the potential for capital appreciation. To achieve this, Ardea are fundamentally driven investors who apply a strong quantitative and risk framework to their investment decisions. In essence, Ardea combine a top-down approach to economic analysis with a bottom-up security selection process.

Ardea offers both passive and active investment strategies. For active portfolios, Ardea customise their investment approach to meet their clients' needs by switching on or off, or scaling, three broad investment strategies - credit, interest rates and arbitrage. Within each of these strategies, Ardea have the ability to further diversify a portfolio by implementing multiple trade ideas, which can be tailored to meet specific investment needs.

Ardea commenced operation in November 2008 with their first client mandates in May 2009. As at 30 September 2009, the team managed over $330 million with further commitments currently being finalised.