

Asset Allocator

INVESTMENT STRATEGY

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Stay overweight International; reduce small caps

- Over the past quarter International equities have outperformed, led by the US and Japan, with returns further enhanced by Australian dollar (AUD) weakness. Australian equities were flat, whilst global bond yields generally rose, implying low total returns. Oil continued to rally. In this note we update our Tactical-Dynamic Asset Allocation views.
- Within equities, earnings growth is strong, led by the US and Japan. Strong fundamentals within developed markets should drive ongoing robust earnings growth. Whilst valuation in the US is a modest headwind, other major markets are relatively attractive. Outside the Federal Reserve, no other major central bank is lifting rates. We reiterate our overweight International equities, with a preference for Japan and Europe. We lift our overweight in Japan at the expense of emerging markets (EM). We also recommend a switch from Platinum International Fund (PIXX.AXW) into Antipodes Global Investment Company (APL.ASX).
- For Australia, earnings momentum is sluggish, valuation is not attractive, and the Reserve Bank of Australia remains on hold. With small caps at record valuations, we recommend investors move further underweight that asset sub-class.
- We remain underweight fixed income, seeing further upside in bond yields for the following reasons: bonds are expensive in absolute and relative terms, vulnerable to strong US growth and firming inflation, and subject to sharply deteriorating supply-demand dynamics. Rising bond yields should again pressure the A-REITs, with structural and cyclical challenges for retail REITs. We remain underweight Property and Infrastructure.
- Whilst the AUD has fallen about 10% YoY against the US dollar, we see further material downside due to a strong US dollar, deteriorating relative growth, elevated Australian political risks, Australia-US interest rate spreads at record lows, the challenges of refinancing net foreign debt of 56% of GDP, and China downside risks. We continue to leave our offshore positions unhedged.
- The key risks to our outlook would be a sharp surge in bond yields or deepening US-China tensions, which could unsettle equities. Solid earnings growth should limit downside risk.

FIG.1: TACTICAL-DYNAMIC ASSET ALLOCATION RECOMMENDATIONS

Asset Class	Slight Underweight		Benchmark	Slight Overweight		Extreme Overweight	
	Extreme Underweight	Underweight		Overweight	Overweight	Overweight	Overweight
Australian Equities							
Large Cap							
Small-Mid Cap							
International Equities							
United States							
Europe							
Japan							
Emerging Markets							
Property & Infrastructure							
AUS Property & Infrast.							
Fixed Income							
Australian Fixed Income							
Australian Credit & Hybrids							
Cash							
Cash							
Currency							
AUD							

Source: Baillieu Holst

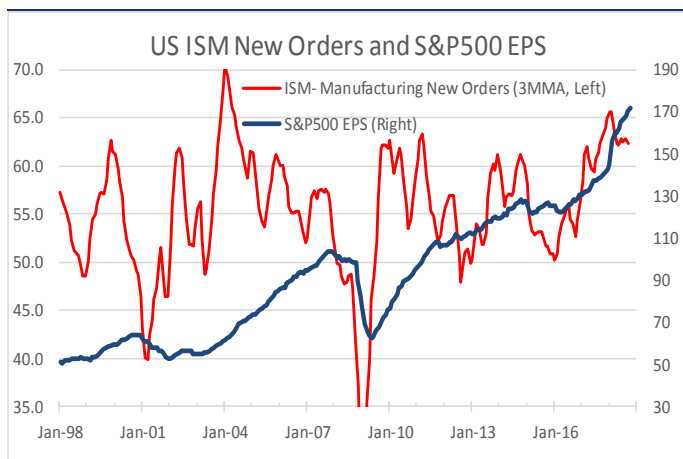
Stay overweight International; reduce small caps

- World equity markets have rallied another 4.9% over the past three months (in US dollars) and are up 8.6% YoY, led by the US (7.8% QoQ and 15.3% YoY) and Japan (11.3% QoQ and 17.2% YoY), with emerging markets lagging (-2.0% QoQ and -6.1% YoY). Australia's ASX 200, though flat over the past quarter, is still up 9.6% YoY (in Australian dollars). Within fixed income, major 10-year bond yields have risen 12-35bps over the past quarter (implying lower prices), and over the past year are flattish-to-90bps higher. The Australian dollar fell another 3.9% QoQ and is down 9.8% YoY. Amongst major commodities, Brent oil rose a further 9.8% QoQ (up 54.0% YoY) while gold and copper fell 3-5% QoQ (down 3-6% YoY).
- Our tactical calls to overweight international equities and to underweight the Australian dollar, bonds and cash have worked well. While we have been correct to overweight growth assets, our call to overweight Europe and underweight Australia has not worked so far. Our positive view on oil has continued to perform. In this note we update our Tactical-Dynamic Asset Allocation views.

Equities: International offers solid earnings at fair-to-attractive valuations

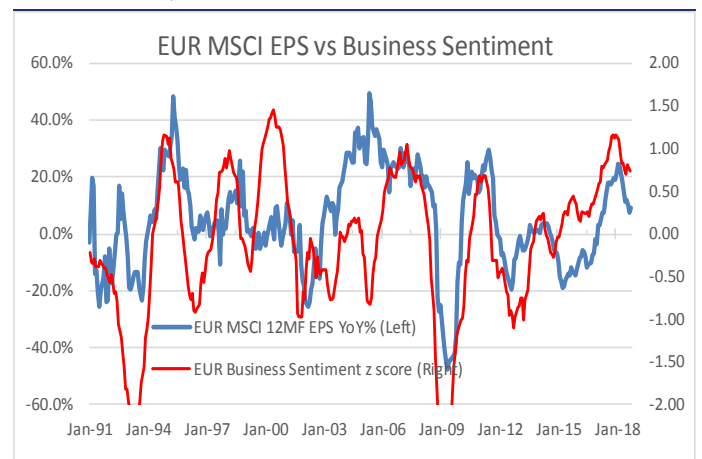
- Earnings expectations have been mixed over the past 3-6 months, with ongoing strength in the US and Japan, softness in Europe and EM, and sluggish growth in Australia, a contrast to the broad-based strength of 2017:
 - US strong at 3.4% over 3 months, 7.9% over 6 months and 23.0% YoY (Figure 2);
 - Japan strong at 3.1% (3 mths), 7.2% (6 mths) and 16.0% YoY;
 - Europe soft at +2.3% (3 mths) and 0.1% (6 mths), but 9.2% YoY;
 - EM weak at -2.0% and -5.0%, but 7.1% YoY; and
 - Australia sluggish at +1.4% and 3.3%, but a better 9.1% YoY.
- The drivers of the divergences in earnings momentum include:
 - US tax cuts, directly lifting US earnings estimates by ~8%;
 - Robust underlying reported US earnings growth of ~18% YoY in 1H18 – a reflection of strong US fundamentals driving 9-10% sales growth, a 6-7% contribution from margin expansion and ~2% from buybacks;
 - Positive Japanese GDP growth, and rising margins and profitability;
 - A slowdown in European indicators, albeit from multi-decade highs to still healthy levels (Figure 3);
 - A slowdown in China indicators to multi-decade lows, while rising US rates have pressured EMs like Turkey, Argentina and Brazil.

FIG.2: THE US ISM MANUFACTURING NEW ORDERS INDEX AT VERY HIGH LEVELS IS DRIVING EARNINGS UP 23% YOY



Source: Datastream, Baillieu Holst

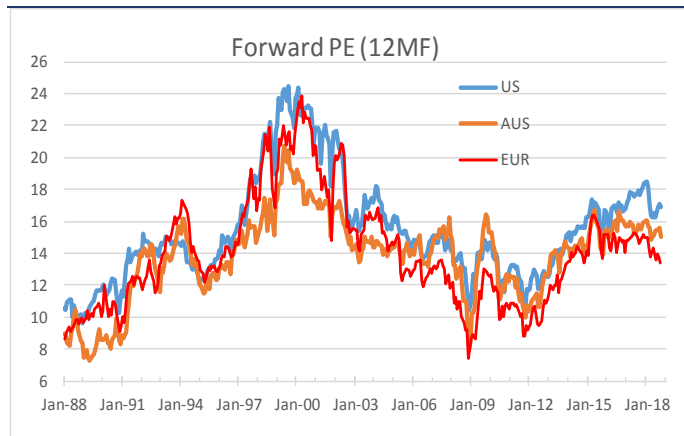
FIG.3: EUROPEAN BUSINESS SENTIMENT HAS EASED, BUT IS STILL STRONG, SUPPORTING BETTER THAN 9% EARNINGS YOY



Source: Datastream, Baillieu Holst

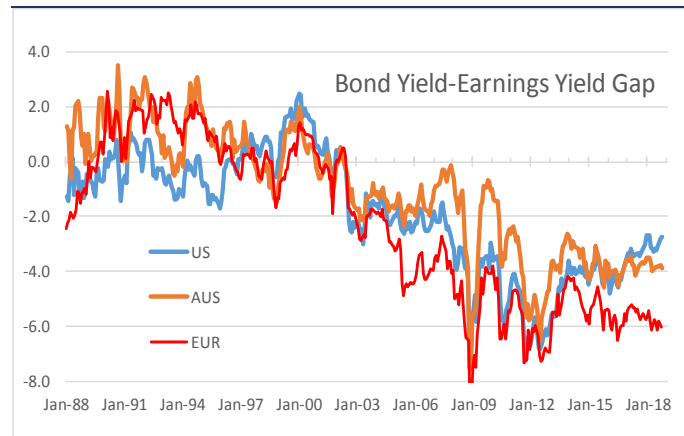
- Looking ahead, we expect strong US fundamentals to drive further double-digit US earnings growth, mitigated somewhat by a strong US dollar. A strong US dollar should assist earnings growth in Japan and Europe.
- Fears of a trade war, which have particularly impacted EM, are likely to further pressure EM earnings growth over the next year. In our view, US\$250 billion of tariffs on Chinese exports to the US hits China at a vulnerable moment, with key indicators at multi-decade lows and debt ratios at record highs. We estimate the trade hit, including the flow-on impact on employment and investment, could be 1-2% of GDP. While the impact should be moderated by policy easing, to-date China’s fiscal stimulus has been limited.
- With US earnings growth outpacing the rise of the S&P 500, the US forward PE has fallen from a recent peak of 18.5x to just under 17x, still moderately above-average (Figure 4). Australia is on ~15.4x, also an above-average valuation, but around the average 10% discount to the US. By contrast, Europe at 13.4x is below its long-term average, while Japan at 12.9x and EM at 10.9x are well-below average.
- When compared to bonds or cash, equity valuations remain very attractive, particularly outside the US (Figure 5). Overall, using our range of preferred valuation metrics, the US market is moderately expensive, Australia slightly undervalued, whilst Japan, Europe and EM all appear very attractive.
- Liquidity conditions in major markets outside the US remain very accommodative. The ECB is in the final stages of tapering its quantitative easing (QE) asset purchase program but intends to leave rates at record lows until at least mid-2019. The Bank of Japan has committed to its current policy for “an extended period.” By contrast, some parts of EM with structural challenges, particularly Argentina and Turkey, have been forced to dramatically lift rates, while less vulnerable countries like Indonesia and India have also lifted rates. In the US, we expect the Federal Reserve to continue to tighten at a moderate 100bps pace, gradually lifting the real cash rate into positive territory. The US yield curve has steepened back to a slightly flatter-than-normal +80bps.
- Overall, in our view international equity markets offer solid returns, given solid earnings growth and fair-to-attractive valuations. We prefer Japan and Europe, but also see solid upside in the US.

FIG.4: THE FORWARD PEs HAVE EASED FOR MOST MARKETS, BUT ARE RELATIVELY LOW FOR EUROPE, JAPAN AND EM



Source: Datastream, Baillieu Holst

FIG.5: EQUITIES ARE ATTRACTIVE RELATIVE TO BONDS, PARTICULARLY IN EUROPE AND JAPAN

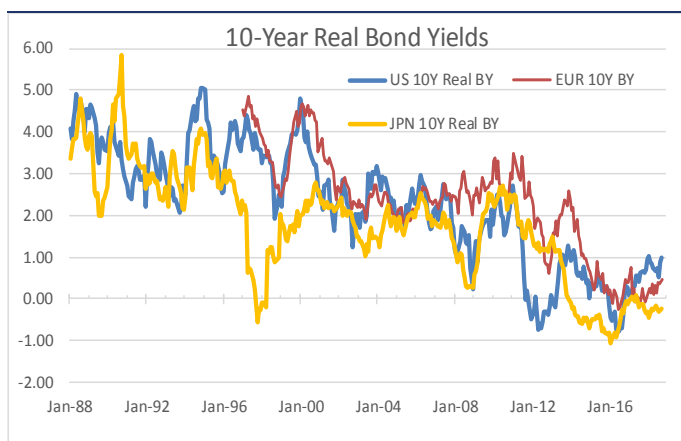


Source: Datastream, Baillieu Holst

Fixed Income: Five reasons to stay underweight long-term bonds

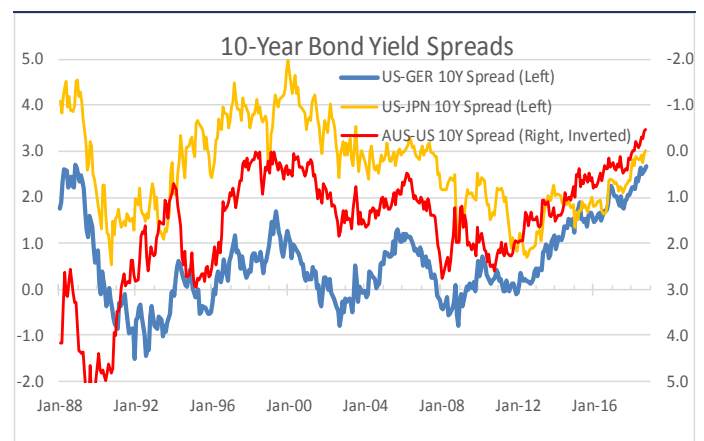
- Major market bond yields have been flat-to-higher in 2018, with US and Italian yields up 80 and 140bps on the back of strong growth and political risks respectively. Slower growth and ongoing easy monetary policy, as well as some flight-to-safety in core Europe, has kept the rise in yields to 10-40bps elsewhere. Looking ahead, we see five continuing sources of risk that are likely to push yields materially higher:
 - **Expensive absolute valuations:** Real yields are well below average levels, with: the US real 10-year yield of 1.0% low compared to the long-term average 2.1%; Europe at 0.5% versus an average 2.3%; Japan -0.2% versus an average 1.5%; and Australia 0.9% versus an average 3.1% (Figure 6).
 - **Relatively unattractive valuations:** Bonds remain very expensive when compared to equities (see again Figure 5). In our view, this means that equities can absorb a gradual rise in bond yields.
 - **Growth outlook:** Despite a moderation in global economic momentum, business activity indicators remain at healthy levels, especially in the US (Figures 2 & 3), a negative for defensive assets.
 - **Inflation outlook:** US inflation is gradually rising as wages slowly pick-up on the back of the tightening labour market.
 - **Deteriorating bond market supply-demand:** The supply-demand balance is deteriorating as US budget deficits surge on Trump’s fiscal stimulus, the Fed accelerates its balance sheet normalisation program and the ECB ends its asset purchase program.
- In our view, this combination will drive US bond yields solidly to 3.5-4.0% over the next year, up ~50bps. The rise in US yields should be muted by extreme yield spreads – US-German spreads at 30-year highs, Australia-US spreads at 37-year lows – which should drive the US dollar much higher (Figure 7). This should also limit the rise in yields outside the US.
- Given this outlook, we expect the sluggish-to-weak performance of fixed income to continue. Within our asset allocation we have a strong preference for floating rate securities, which offer protection against duration risk (long-term bonds have a relatively high duration, a technical term which means that their price declines relatively more when interest rates rise).

FIG.6: THE US REAL 10-YEAR YIELD AT 1.0% IS FAR BELOW THE LONG-TERM AVERAGE 2.1%



Source: Datastream, Baillieu Holst

FIG.7: US BOND SPREADS ARE REACHING 30-40 YEAR HIGHS, WHICH SHOULD HELP DRIVE THE US DOLLAR HIGHER

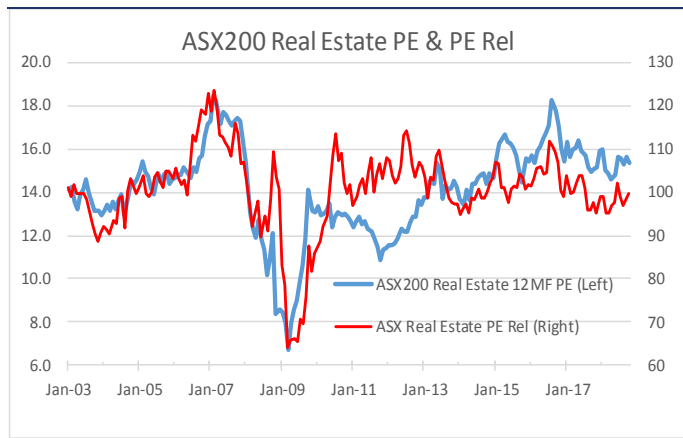


Source: Datastream, Baillieu Holst

Property: Underweight given bond yield and retail risks

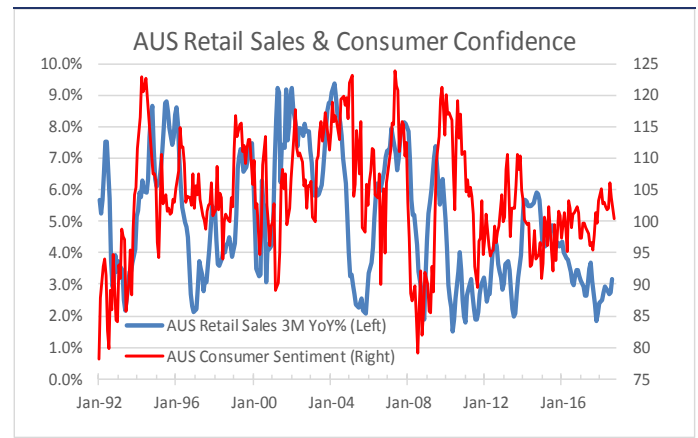
- The ASX A-REITs have fallen 1.2% over the past quarter, but risen 7.9% over the past year, moderately underperforming the broader Australian equities market (Figure 8). In line with our call for higher bond yields, we see risk in the A-REIT sector. With property cap rates at low levels, a rising risk-free bond yield is likely to increase the discount rate or cap rate used to value a property, lowering its valuation. For example, other things equal, an increase in the cap rate from 4% to 5% would lower the valuation by 20%.
- The largest sub-sector within A-REITs is retail. We remain concerned about this sub-sector for two key reasons:
 - The household sector is being squeezed by flat real wages, rising interest and debt burdens, tax bracket creep, a depleted savings buffer and falling home prices. Retail sales are up just 3.2% YoY (Figure 9). For specialty stores within the major mall operators, sales are sluggish – Scentre 1.6% YoY, Vicinity 0.9% YoY and Stockland 1.1% YoY, though Mirvac is up 3.7% YoY and GPT 4.4% YoY.
 - Intensifying online competition, with the launch of Amazon Prime and eBay Plus in Australia, ensuring bricks and mortar sales growth trails total sales.

FIG.8: A-REIT VALUATIONS ARE ABOVE AVERAGE, BUT IN RELATIVE TERMS IN-LINE WITH THE LONG-TERM AVERAGE



Source: Datastream, Baillieu Holst

FIG.9: SLUGGISH RETAIL SALES ARE A HEADWIND FOR RETAIL A-REITs

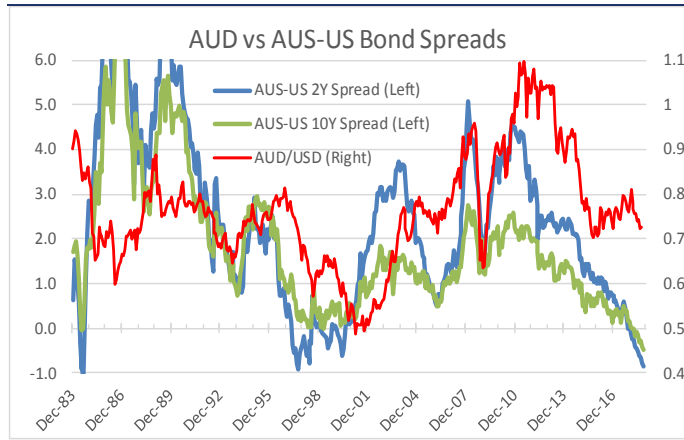


Source: Datastream, Baillieu Holst

Currency: Downside risks for the AUD continue to build

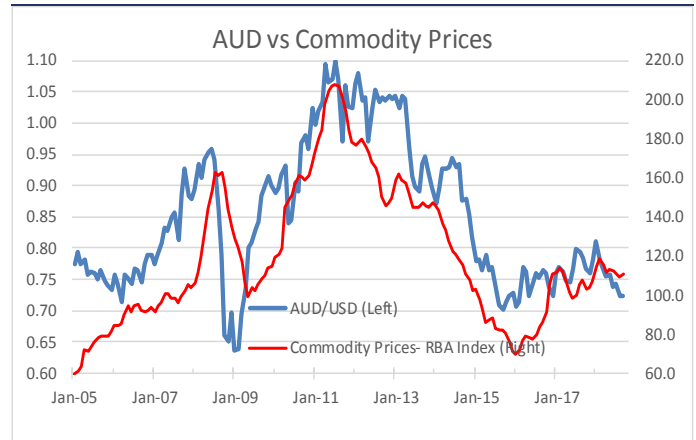
- We see material further downside in the Australian dollar (for details see our Strategy Insight, [‘Australian dollar downside risks’](#)) given:
 - **US dollar strength:** Reflecting US growth and interest rates well above other major markets, as well as pro-growth policy reforms;
 - **Record low rate spreads:** The Australia-US cash rate spread has just fallen to a post-float record -63bps, and the 2-year spread at -88bps is around the post-float (35-year) low of -90bps;
 - **Deteriorating relative growth and economic fundamentals:** Reflective of elevated political risk, downside economic risks and deteriorating productivity performance;
 - **Structurally lower rates than the US:** Reflecting Australia’s unsustainable household debt at ~190% of income;
 - **Australia’s high net foreign debt at 56% of GDP;** and
 - **China downside risks:** Record low growth in money supply (8.2% YoY) and broad credit growth (9.5% YoY), record high debt ratios and the potential 1-2% of GDP hit from the US-China trade war.

FIG.10: AUS-US INTEREST RATE SPREADS ARE AT-OR-AROUND POST-FLOAT RECORD LOWS



Source: Datastream, Baillieu Holst

FIG.11: AUSTRALIAN COMMODITY PRICES HAVE BEEN SOFTER SINCE 1Q18, AND LARGELY SIDWAYS FOR THE PAST 2 YEARS

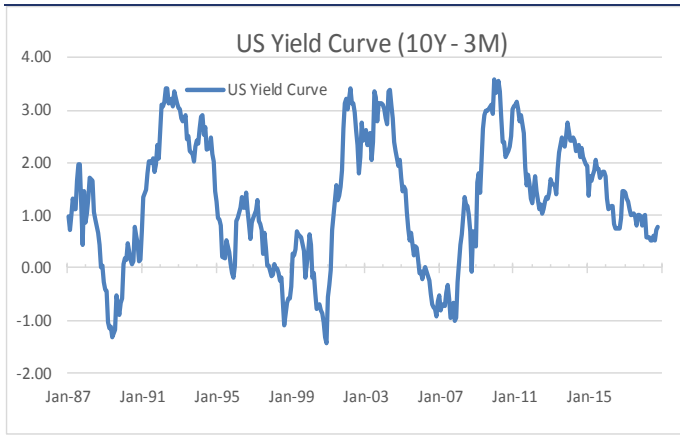


Source: Datastream, Baillieu Holst

Updating our Tactical-Dynamic Asset Allocation signals

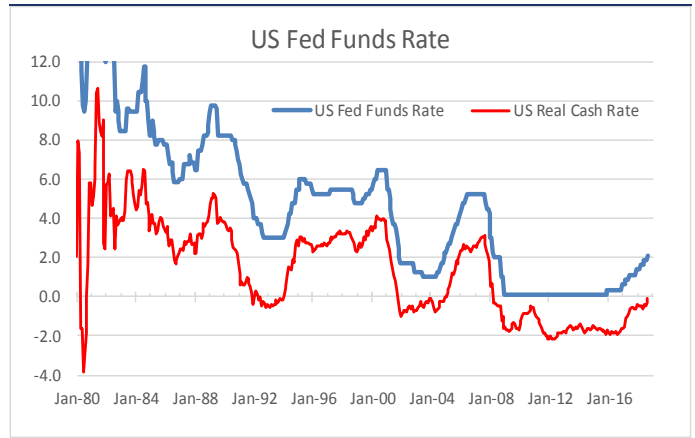
- In our initiation piece we outlined eight key TAA signals that we use. Updating these signals:
 - **#1: Relative valuation: Equities very attractive versus both bonds and cash** (Figure 5). While the US bond yield-earnings yield gap has narrowed, it is still well below pre-GFC levels. Japan and Europe remain close to extreme lows.
 - **#2: Absolute valuation: Bonds remain very expensive; equities are mixed.** Bonds suffer from low real yields (Figure 6). US equities have de-rated to modestly above-average levels, which should improve further with strong earnings growth (Figure 4). Australia is also at above-average valuations, but ex-US international markets are generally cheap.
 - **#3: Slope of the US Yield curve (10-year bond yield less 3-month rate): Slight negative for equities.** The US yield curve, a reliable recession indicator, is modestly flatter-than-average at ~80bps, partly due to extreme yield spreads, trade war fears and idiosyncratic issues in Italy and some EMs (Figure 12).
 - **#4: Liquidity conditions: Still equity positive.** Fed tightening is a headwind, but real rates are only about zero and the pace of tightening is about one-third the average (Figure 13). Europe, Japan and Australia remain ultra-accommodative.
 - **#5: Credit spreads (the yield difference between the same maturity corporate and government bonds): Credit negative, equity positive.** Spreads have widened slightly, but are just above post-GFC lows, a negative for credit, but positive for equities (Figure 14).
 - **#6: Business activity expectations: International equity positive.** Business surveys in the US and Japan remain very strong, while Europe has moderated to still high levels (Figure 15). By contrast, confidence in Australia is back to average levels.
 - **#7: Consumer expectations: US equity positive.** US consumer confidence is at 18-year highs; Europe has moderated but remains high; while Australia has softened back to around average levels (Figure 16).
 - **#8: Unexpected inflation: Moderate bond negative.** US implied inflation at ~2.1% pa is around the current core CPI inflation of 2.2% YoY. Bonds appears vulnerable to rising inflationary pressures from higher wage costs.
- **Conclusions:** Overweight: International equities, especially non-US; Underweight bonds and credit; Underweight Australia versus International equities.

FIG.12: US YIELD CURVE – NOW FLATTER THAN AVERAGE- EXPECT PERIOD SIMILAR TO MID-TO-LATE 90s



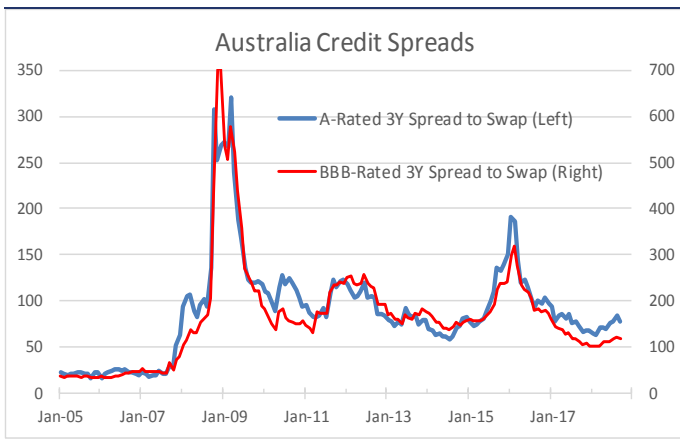
Source: Datastream, Baillieu Holst

FIG.13: US REAL FED FUNDS RATE IS ONLY BACK TO ZERO, VERSUS A PRE-GFC AVERAGE OF 160BPS



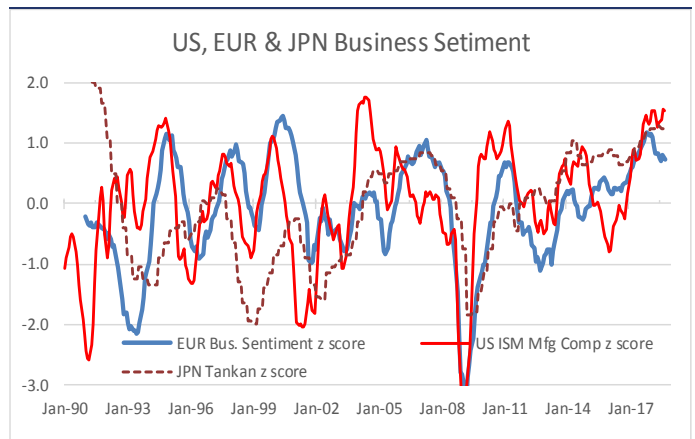
Source: Datastream, RBA, Baillieu Holst

FIG.14: CREDIT SPREADS – AUS HAVE WIDENED: “A” TO NEAR- “AVERAGE” LEVELS; “BBB” IS STILL RELATIVELY TIGHT



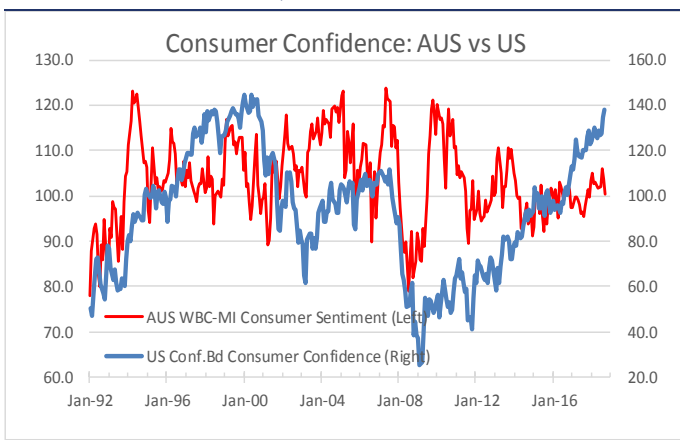
Source: Datastream, Baillieu Holst

FIG.15: BUSINESS EXPECTATIONS – US & JAPAN VERY STRONG; EUROPE HAS MODERATED, BUT REMAINS HIGH



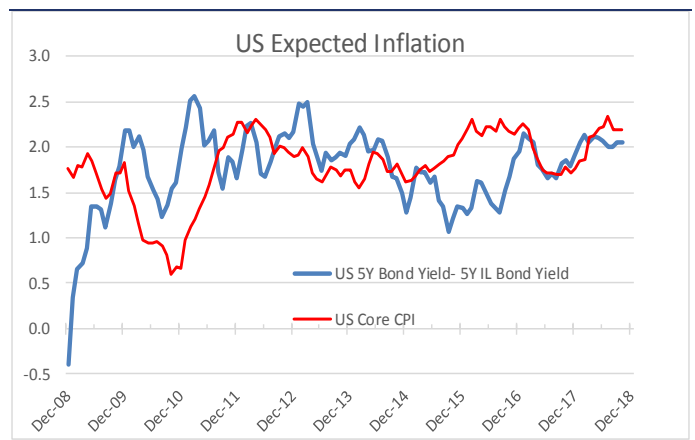
Source: Datastream, Baillieu Holst

FIG.16: CONSUMER CONFIDENCE– US AT 18-YEAR HIGH ON STRONG FUNDAMENTALS; AUS BACK TO AVERAGE



Source: Datastream, Baillieu Holst

FIG.17: UNEXPECTED INFLATION – LOW, WITH US IMPLIED INFLATION AT 2.1% PA VERSUS THE CURRENT CORE 2.2% YoY

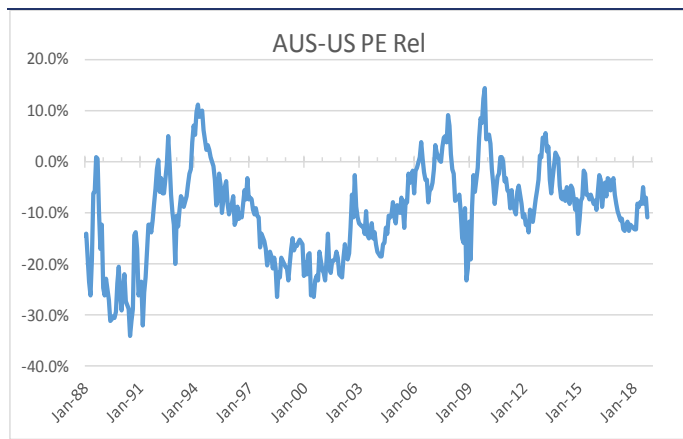


Source: Datastream, Baillieu Holst

Investment implications

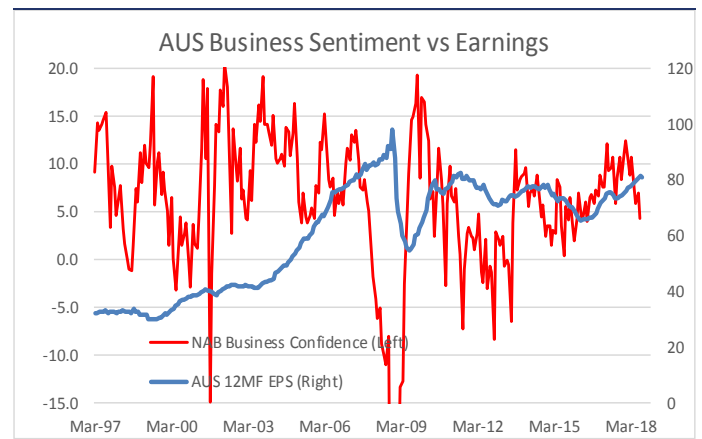
- We remain underweight Australian equities. Whilst the past quarter has seen relative underperformance, Australia is only back to an average 10% PE discount to the US (Figure 18), whilst earnings momentum is probably rolling over following the softening of business confidence (Figure 19). In our view, investors are not being compensated for Australia’s elevated political risks and downside economic risks in an environment of gradually tightening global liquidity.
- Australian small caps are unusually expensive (Figure 20). Given downside domestic political and economic risks, we increase our underweight to extreme (Figure 22). Anecdotal evidence of a material credit tightening poses a near-term earnings risk to more domestic-oriented small caps.
- We moderately increase our Japan overweight, given positive earnings momentum, attractive valuation and ongoing ultra-accommodative liquidity conditions. We reduce EM where liquidity pressures are likely to keep markets at low valuations.
- In our asset allocation implementation models, within our international equity exposure we recommend a switch from Platinum International Fund (PIXX) into Antipodes Global Investment Company (APL). Antipodes is a global equities listed investment company trading at a 7-8% discount to its diluted net tangible asset value. On the 9th of October options will cease trading, with the last day for exercise being the 15th of October. In the past we have seen shares of LICs trade poorly into an options event, but subsequently recover. APL has a similar value investment philosophy to Platinum, and has a relatively high exposure to Asia, including China, Japan and Korea.

FIG.18: AUSTRALIA IS BACK AT AN AVERAGE 10% DISCOUNT TO THE US MARKET



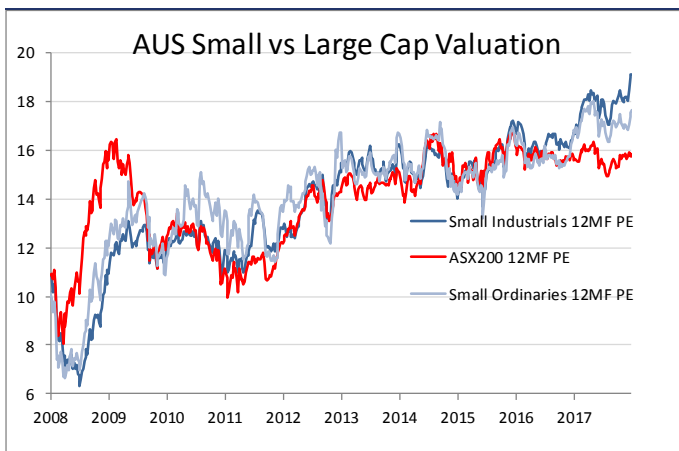
Source: Datastream, Baillieu Holst

FIG.19: SOFTENING AUSTRALIAN BUSINESS CONFIDENCE POINTS TO SLOWER EARNINGS EXPECTATIONS



Source: Datastream, Baillieu Holst

FIG.20: AUS SMALL CAPS ARE UNUSUALLY EXPENSIVE



Source: Bloomberg, Baillieu Holst

FIG.21: ANTIPODES GLOBAL INVESTMENT COMPANY REGIONAL EXPOSURE

Region	Long	Short	Net
North America	28.2	-15.0	13.2
Developed Asia	21.9	-4.2	17.7
Korea/Taiwan	9.9	-0.8	9.0
Japan	12.0	-3.3	8.7
Developing Asia	20.4	-3.0	17.3
China/Hong Kong	19.6	-2.4	17.2
India	0.8	-0.6	0.1
Western Europe	18.9	-4.4	14.5
Eurozone	16.7	-2.0	14.7
United Kingdom	0.0	-0.7	-0.7
Rest Western Europe	2.2	-1.7	0.5
Australia	1.6	-2.3	-0.7
Rest of World	0.7	0.0	0.7
Total Equities	91.5	-28.9	62.6
Other	1.3	0.0	1.3
Cash	7.2	-	-
Totals	100.0	-28.9	63.9

Source: Company report

Tactical-Dynamic Asset Allocation: detailed recommendations

FIG.22: TACTICAL-DYNAMIC ASSET ALLOCATION RECOMMENDATIONS

Asset Class	Extreme Underweight	Underweight	Slight Underweight	Benchmark	Slight Overweight	Overweight	Extreme Overweight
Australian Equities							
Large Cap							
Small-Mid Cap							
International Equities							
United States							
Europe							
Japan							
Emerging Markets							
Property & Infrastructure							
AUS Property & Infrast.							
Fixed Income							
Australian Fixed Income							
Australian Credit & Hybrids							
Cash							
Cash							
Currency							
AUD							

Source: Baillieu Holst. Note: colour scheme illustrates BH's TAA views on the different asset classes and sub-sectors within the asset classes

FIG.23: TACTICAL-DYNAMIC ASSET ALLOCATION DETAILED RECOMMENDATIONS BY INVESTOR TYPE

Asset Class	ASX/mFund Code	Conservative	Moderate	Balanced	Growth	High Growth
Australian Equities		6.0%	10.0%	18.0%	27.5%	27.5%
Aus Direct Equities	-	6.0%	10.0%	18.0%	27.5%	27.5%
International Equities		18.0%	29.5%	41.5%	52.5%	72.5%
US Equities	VTS*	6.2%	9.6%	13.1%	16.0%	21.4%
European Equities	VEQ	3.1%	5.0%	7.4%	9.3%	12.6%
Japanese Equities	IJP*	2.0%	3.1%	4.3%	5.4%	7.2%
Emerging Market Equities	VGE	1.4%	2.8%	4.2%	5.6%	7.9%
Active Exposure US	MFF	2.4%	4.1%	5.7%	7.3%	10.5%
Active Exposure Europe	TGG	1.6%	2.7%	3.8%	4.9%	7.0%
Active Exposure Asia	APL	1.4%	2.3%	3.2%	4.1%	5.9%
Property & Infrastructure		0.0%	3.0%	4.5%	5.5%	0.0%
Aus Direct Property & Infrast-		0%	3%	4.5%	5.5%	0%
Fixed Income		19.0%	25.0%	22.0%	10.0%	0.0%
Australian Fixed Income	IAF	5.5%	7%	6%	2%	0%
Active Domestic Diversified	PMF04	5.5%	7%	6%	2%	0%
Australian Hybrids	-	8%	11%	10%	6%	0%
Cash		57.0%	32.5%	14.0%	4.5%	0.0%
Cash		57%	32.5%	14%	4.5%	0%

Source: Baillieu Holst. Note: * means cross-listed.

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