Australians have been asked to do (or not do) a lot in the six months since last reporting season. The bushfires and the COVID-19 pandemic have highlighted the best and worst in ‘civil obedience’ from both companies and the general public.

Our engagements with companies have highlighted Australia’s ‘civil obedience’ to follow the rules to stay at home and to spend the government stimulus they have been given, as the key theme coming out of reporting season.
INTRODUCTION

Australia’s reporting seasons in February and August this year were both overshadowed by social issues. In February 2020, we were coming off the back of a devastating bushfire season but also seeing the first glimpse of impact of the global COVID-19 pandemic. In the six months since February, Australian companies and the general public have been asked to do (or not do) a lot in terms of social distancing in order to curb the spread of COVID-19 in the community. The Martin Currie Australia (MCA) investment team’s engagements with companies pre and post results have highlighted Australia’s high levels of ‘civil obedience’ as a key theme in this season’s results of businesses that have been able to adapt and even thrive in this environment.

WHAT WE DO EACH REPORTING SEASON

On top of our fundamental analysis and company engagement on individual stocks, we have a framework to overlay an analytical top-down view of the reporting season’s results for the stocks in the S&P/ASX 200 index. This aggregated review of consensus lead-in revisions, surprise (hits vs. misses), follow-on revisions, and the market’s price reaction to the results, allows us to judge the overall pulse of the market from the top down, and assess the themes across the market that would be ‘hard to see’ when looking at each company result in isolation. We can then apply our insight at the stock and portfolio level.

In our bi-annual reporting season paper, our team of Australian investment specialists, led by Reece Birtles, Martin Currie Australia’s Chief Investment Officer, provides:

- A top-down analytical review of the recent company reporting season  Page 2
- Insight into the key fundamental themes from our engagements with company boards and management  Page 6
- Analysis of Australia’s economic and market outlook  Page 10
- Implications for investors in Australian equities  Page 12

KEY DEFINITIONS WE USE

Lead in revision: the average change in broker consensus next 12-month (NTM) forecasts in the three months leading in to the season.

Surprise: where there is a >±2% difference between company reported results and broker consensus forecasts.

Follow on Revisions: the average change in broker consensus NTM forecasts after companies have reported their results.

Price reaction: stock price movement within the two days after companies have reported their results.
TOP-DOWN ANALYTICAL REVIEW

Largest lead-in downgrades since GFC

Leading into this result season, it is clear that COVID-19 has had a wide-ranging impact on consensus sentiment. S&P/ASX 200 stocks have suffered the largest ‘lead-in revision’ downgrades across sales, earnings and dividends since the global financial crisis (GFC).

Expected sales per share (SPS) growth (which often proxies the direction of Australian GDP) was down -8% in the lead in. Earnings per share (EPS) growth was also downgraded significantly on the back of the lower sales expectations, and dividends per share (DPS) even more so.

Actual earnings show positive surprise

Against the already downgraded expectations, actual results generally surprised on the upside. There were more beats than misses at both the sales and EPS levels.

What is quite interesting is the wide dispersion within the EPS surprise. There’s some very large beats and some very big misses, and not many companies came in inline.

This really reflects the uncertainty of the economic outlook, and the lack of guidance companies were able to provide in this environment.

But dividends do disappoint

Despite the chatter around whether dividends should be paid in this environment, and large downgrades in the lead in, dividends came in even further below expectations.

Past performance is not a guide to future returns. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.

Source: Martin Currie Australia, FactSet; as of 31 August 2020. Data for the S&P/ASX 200 Index. Calculated using the weighted average of broker consensus forecasts of each holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed. Percentages may not total 100 due to rounding.
THE POWER OF DIVIDENDS

Earlier this year, we tackled the issue around whether companies should pay out dividends given current economic circumstances in a letter to the Boards of 40 high quality companies in our income investment universe. We pointed out to companies that the COVID-19 induced shutdown of the Australian economy has exacerbated the already downward trend of interest rates to record lows. For retirees, foundations and charities who depend on income from their investments, this is a dire situation.

We stated that the need for companies to pay out their dividends for these investors has never been greater, and if a company has reasonable cashflow and a sound financial position, dividends should be paid, even if it must be reduced. The response we received from companies was positive. A sample of the responses is below:

• Wesfarmers: Chairman:

“Back in 1988 we were the first company to recognise the value of franking credits and were widely acclaimed for raising our payout ratio in order to ensure that our credits were distributed to our shareholders - on the basis that they were of no value to the company but of great value to our owners.”

• Coca-Cola Amatil: Chairman:

“Thank you for your letter regarding the power of dividends, especially for investors requiring higher income streams such as retirees. The Board understands your views and appreciates the heightened pressure for these investors created by COVID-19 health and economic impacts.”

• Coles: Investor relations

“I passed along your letter to our chairman. He asked me to acknowledge receipt to yourself, and of course, will duly consider the contents with the Coles Board.”

• NAB: Chairman:

“I acknowledge that this is a very difficult and uncertain time, and assure you that the Board is acutely aware of the importance of dividends to our shareholders, including those shareholders who are self-funded retirees that rely on dividends for income. I want to assure you that the Board does not make decisions on dividend settings lightly. Decisions, including those relating to dividends, are made with consideration of the Board’s fundamental duty to act in the best interests of the company.”

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However, what we found was that dividend surprise was positive for high quality companies, whereas low quality companies had more dividend disappointment.

This is not surprising for us. Empirically we have found that Quality is a very good indicator of a company’s Sustainable Dividend payment ability, and this forms part of our process for fundamental analysis.

Payout ratios, however, have fallen across the board, but particularly in financials due to APRA guidance to cap dividends.

Despite positive EPS surprise, follow on revisions are down further

Looking at how consensus brokers revised their forecast earnings post result announcements, and post any meetings with management, there were slightly more downgrades than upgrades to future forecasts across all key lines.

Most of the positive EPS revisions were in the higher-flying resources and cyclicals sectors, with the worst downgrades in the real asset space, where social distancing is still heavily impacting activity.

These downgraded ‘follow-on revisions’ reflect an ongoing pessimistic outlook by the street, despite already significantly downgrading companies in April and May.

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Source: Martin Currie Australia, FactSet; as of 31 August 2020. Data for the S&P/ASX 200 Index. Calculated using the weighted average of broker consensus forecasts of each holding - because of this, the returns quoted are estimated figures and are therefore not guaranteed. Percentages may not total 100 due to rounding.
Cashflow metrics reveal true economic stress

Digging a little bit deeper, we have looked at revisions within the all-important cash flow metric lines.

We saw free cash flow (FCF) revisions were worse than EPS, despite extensive use of provisions in the period.

What is quite surprising here is that despite the difficult operating environment, we are even seeing some increasing capital expenditure (capex) expectations.

When we drill into it, what we find is that it’s all either in companies with strong earnings growth, or in the resources space where there has been lack of spend in recent years. Now, with strong commodity prices, there is reinvestment going into new mines and expansions.

It’s also quite evident that the AASB16 (accounting for leases) change is still flowing through the data. The change in January 2019 removed the distinction between operating and finance leases for lessees, obscuring cashflows between operating and financing activities. We note that the street appears to yet be not fully adapted to it. For a number of companies this has resulted in the EBITDA line looking better than their FCF metrics would imply.
Capital raisings have de-risked balance sheets
Given the uncertain outlook, there has been a significant number of capital raisings, taking advantage of the ASX relaxing the limit on placement capacity from 15% to 25%. As a result, debt metrics for the broader market are not looking particularly stressed.
Since March this year, the aggregate level of debt of S&P/ASX 200 companies has reduced from what had been a relatively stable level of A$800 billion to A$700 billion dollars.

On an optimistic note, debt metrics versus revenue, EBITDA and FCF head into next year at improved levels despite cyclical low earnings.
We believe that companies are broadly comfortable at this position, unless the COVID-19 social restrictions continue for a much more extended period.

Price reaction reflects market understanding of cycle bottom
Moving on to how the market has reacted to results and revisions, the following chart compares the share ‘price reaction’ on the two days post results to the announcement of each company to the revisions.

What’s quite evident in this reporting season compared to history is that there was a lack of negative price reaction when there was a downgrade to earnings or dividends.
This really suggests that the market understands that we are looking at low cycle earnings. The market wasn’t punishing companies that had further downgrades, but it also wasn’t really rewarding upgrades.

Past performance is not a guide to future returns.
Source: Martin Currie Australia, FactSet; as of 31 August 2020. Data for the S&P/ASX 200 Index. Calculated using the weighted average of broker consensus forecasts of each holding - because of this, the returns quoted are estimated figures and are therefore not guaranteed.
Best and worst results – consumer stand out

Taking the average of the company’s actual results, the surprise versus consensus, revisions of future forecasts, as well as the price reaction to those announcements, we can generate a reporting score card for each stock and sector.

Looking at where the best and worst results were, the stand out area was the consumer discretionary general merchandise space.

‘Reporting Score’ by industry

![Image of a bar chart with 'Reporting Score' by industry.](chart)

This reflects the extremely positive results coming out of companies like Harvey Norman, Supercheap Retail Group, JB Hi-Fi, Nick Scali, as well as the casinos like Skycity Entertainment Group.

The other stand out area was really in iron ore, where you saw very strong results from Fortescue Metals Group and Rio Tinto, with very strong cash flow coming off that high iron ore price.

The worst space was in the coal and energy areas, with Whitehaven Coal, Viva Energy and Ampol having very weak results.

INSIGHT GAINED THROUGH COMPANY INTERACTION

The top down results clearly show that we are going through significant earnings declines for S&P/ASX 200 companies, but in aggregate, forward-looking consensus expectations are very flat, with near zero consensus expectations for a return of growth.

What concerns us is that the consensus approach appears to have taken the low cycle results for impacted industries (such as real assets, tourism etc.) and used them as the new base - they have not built in any expectations of bounce back.

Conversely, areas that have really seen strength in earnings, consensus is seeing this high as the new base - they have not considered what will happen heading into next year when the stimulus measures are removed.

While the analytical and aggregated view of the reporting season’s results provides a broader framework to judge what the street is thinking and doing, our fundamental analysis and company engagement of individual stocks allows us to do a deeper dive into the issues and strategies of each business.

Over the four-week reporting period the MCA investment team conducted around 100 meetings with company management teams following the release of results, and this has helped us to refine our views on each investment case and the fundamental themes impacting them.

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Source: Martin Currie Australia, FactSet; as of 31 August 2020. Data for the S&P/ASX 200 Index. Calculated using the weighted average of broker consensus forecasts of each holding - because of this, the returns quoted are estimated figures and are therefore not guaranteed.
KEY FUNDAMENTAL THEMES EMERGING

‘Civil obedience’

We have explored several trends that have resulted from, or accelerated during, COVID-19 and this has helped us to have what we think is a more balanced outlook on company earnings than the street. Australians have been asked to do a lot in terms of social distancing in order to curb the spread of COVID-19 in the community. In the main, both Australian companies and the general public have done their bit, particularly in Victoria’s second lockdown.

While the impact has been more damaging in certain industries, to us, our engagements with companies have highlighted Australia’s ‘civil obedience’ to follow the rules to stay at home, and to spend the government stimulus they have been given, as the key theme coming out of reporting season.

Underpinning the ‘civil obedience’ theme is:

• the strength of Australian consumers ability to spend on consumer goods when they haven’t been able to spend on services;
• the extent the JobKeeper and early super withdrawal benefits from the Government; has transferred readily through to the economy;
• how companies have continually adapted their business models to deliver what consumers wanted and needed during social distancing; and
• the shift in company behaviour toward staff and customers, through delays in redundancies, or loan & rental relief and insurance premium discounts.

Culture and quality are a winning combination

High quality companies that have good cultures, strong management teams and engaged staff have really done a much better job than others in adapting to the environment and the required change in behaviour from consumers.

One of the best examples of success in adapting is JB Hi-Fi. They completely changed their stores to focus on click and collect. They also hired 100 vans for their staff to use to deliver directly from the stores during the second lock down in Victoria. Dan Murphy’s, part of the Woolworths group, managed to create a successful car park pick up service from scratch in March to overcome the potential of store closures during lockdown. Woolworths also used crowd services to deliver from the back of store given lack of space for larger trucks.

We think high quality companies that can innovate should continue to thrive in whatever the new normal is. When we look at stocks that have been most impacted by restrictions and the reopening schedule (e.g. travel), we see that most companies have managed to reduce their cash burn to low levels and reduce their debt levels to such a point that they could withstand even an 18-month shutdown reasonably well.

In the shift to online, the last mile is key

Retailers have long been worried about the Amazon business model and how distribution centres and delivery from a large Amazon distribution centre would threaten Australian businesses. What’s been surprising during COVID-19 is that that hasn’t been the winning business model, and as online sales accelerate, it is unlikely to be.

The winning business model has really been about using physical stores as fulfilment centres for deliveries, as companies like JB Hi-Fi, Harvey Norman, Super Retail Group have done. By having stores closer to the customers, they can reduce that last mile delivery time.

This shift to e-commerce will mean that shopping malls will still have a purpose and will not become obsolete as many had feared.

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Working from home (WFH) and the home is a ‘hub’

Again, consumer focused companies like JB Hi-Fi, Wesfarmers (Bunnings) and Harvey Norman have really benefited from the enforced WFH theme, as well as increased family entertainment.

The experience of many people this year, including at Martin Currie, has proved that mass WFH is achievable. As a result, we expect that the pre-COVID-19 trends of working outside the office will accelerate, and these companies will continue to see further benefits into the future.

These companies also have a very strong position going forward too, with the focus on the home as a hub expected to continue.

The stay at home theme has provided media companies such as Nine Entertainment with an opportunity to offset the decline in the in traditional areas. They are benefitting from the resurgence of free to air TV due to demand for news, but also at the same time they had strong demand for their Stan entertainment platform. This has accelerated the shift in their business mix towards online.

Despite the WFH trend, office REITs have also continued to collect rents with large companies not taking advantage of rental abatements.

Going forward, the view is office space is going to need to be more flexible, and some older buildings may face obsolescence unless they are repurposed.

Loads of pent up demand to flow through

While consumers have been willing to spend in lockdown, our company engagements revealed that there is still pent up demand which can be released once restrictions ease.

Without the ability to travel overseas, and without all the spending that would normally go offshore, consumers have shown already that they are very willing to get back out, visit casinos, dine at restaurants, travel domestically. This bodes well for companies such as Skycity Entertainment Group and Star Entertainment.

While there is a clear reluctance from some people to go out for safety reasons, companies have shared that those who are going out are in fact spending a lot more than before.

While retail REITs do continue to be impacted by social distancing, we have seen local shopping centres go back to previous levels of foot traffic, which is very encouraging for the permanency of local shopping.

Financial stress may be an issue for banks

The banks have been integral in ‘doing their bit’ through allowing 10-15% of their customers to defer repayments and interest payments during the crisis. This has occurred for both mortgage and small and medium enterprise (SME) customers.

On the flip side of all of this, there is a concern about the financial stress building, and that’s a key theme for the banks and some of the financials.

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The banks are telling us that the low-income segment is actually doing quite well with JobKeeper and being able to pay down credit card and buy now pay later (BNPL) debts. We’ve also seen a lot of this cash flow going to strong deposit growth for the banks.

The high-income end generally has remained unaffected by huge income hits and are also enjoying the very low interest rates.

Where they are seeing stress emerge is in the middle-income segment, an area that has seen quite sharp hits to income, and related small businesses that have suffered. For the banks, that’s where the bulk of their mortgage book is and is a key watch area for how customers come off deferral.

Given that banks have moved very quickly into forbearance and restructuring mode, it has the potential to help them better manage problem credits and avoid a deeper cycle. That said, this remains a balancing act for understanding the nature of the stress to customers and helping them through it, versus pushing the problem down the road too long.

We’ve seen banks raise very large bad debt provisions upfront, but actual collections are going pretty well at this point, write-offs are low and the truly delinquent customers are still quite low.

From 30 September 2020 we will start to see a lot of those deferral customers being asked to move back to full payments again, however the real test is going to be in the first half next calendar year when Government stimulus also rolls off.

COVID-19 has amplified the focus on sustainability

COVID-19 has brought to the fore an interest in social and environmental issues, and this has resulted in increased ‘civil obedience’ behaviour from companies.

We have seen important changes from businesses behaviour towards staff, customers, and even suppliers, and their attitude towards climate change.

We see these as a welcome and likely permanent sustainable change.

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The analysis of Environmental, Social and Governance (ESG) factors form an important part of the investment process and helps inform investment decisions. The strategies discussed do not necessarily target particular sustainability outcomes.

Social license to operate

Very early in the crisis, Transurban devoted additional resources to customers in distress who couldn’t pay their tolls, and they actually openly advertised assistance measures for those customers. Transurban also provided relief to customers providing healthcare and other essential services.

The banks have done a number of loan deferrals for their mortgage customers and also for their small to medium sized businesses.

Telstra had planned a significant cost reduction program as part of their T22 strategy, but have delayed planned redundancies twice.

Decarbonisation

ANZ Bank are asking their top 100 customers to show proof they are going to move in relation to decarbonisation and lowering climate emissions.

More shopping centres are putting place long term purchasing power agreements in renewables such as with Red Energy/Snowy Hydro.

We need to talk about China

While not 100% related to reporting season, the situation with China is an important theme to touch on.

China has come out of COVID-19 quicker than a lot of countries because of their high levels of stimulus. This has created high demands for iron ore, which is driving strong prices, cash flows and dividends for companies Fortescue Metals Group and Rio Tinto.

However, we are now seeing a hit to Australian industry from geopolitics, in sectors where China knows they can hurt Australia but are not completely dependent upon. For example, they can cut back areas like wheat, barley and wine (impacting for example Treasury Wine Estates), without an impact on what they do need from us, the iron ore.

This is an area we are going to need to watch closely over the coming months.
THE ECONOMIC AND MARKET ‘BIG PICTURE’

Divergent views of the future
Our company interactions have given us a positive view on the resilience in the type of Australian companies we invest in.

Looking at the broader picture, there are many ways to look at the current state of the economy and the size of the investment opportunity. However, depending on which lens you look at it through, you will get a divergent view as to whether COVID-19 still has a significant impact to go, or if we are on the mend.

Labour market → wait and see
The direct payment nature of the Australian government’s Fiscal stimulus is helping to address unemployment risk and prevent permanent damage, but there’s a massive division between the underlying health of households when you include stimulus payments or not.

If you look at household incomes before government stimulus, they’ve fallen around -5% in aggregate. After JobKeeper and other stimulus payments are considered, household incomes are up +7%.

Like what we mention above regarding the banks, this indicator really places a lot of emphasis on what happens post-JobKeeper in 2021 and when people must start repaying mortgages.

PMI → no longer falling, but not great
Looking at the Purchasing Managers Index (PMI), it has already come off significantly from its lows. It is important to remember, however, that PMI is a change measure, and so it’s saying that things are no longer deteriorating, rather than things are strong.

Bond yields → stagnating
Bond yields, which would normally follow expectations of future economic growth, have remained extremely low and are not showing any signs of going up.

Market earnings → recession confirmed
When you look at consensus Australian market earnings, they do paint a bleak picture. Next twelve-month EPS for the S&P/ASX 200 is expected to be flat in 2021 after falling ~40% in CY2020.

Equity prices → up and up!
On the other hand, it’s quite incredible to think that the equity market indices globally are basically at record levels despite going through a period when earnings have been cut significantly.

We would say that share prices are not factoring in any prolonged downturn, and are likely reacting more to the low interest rates and accommodative fiscal and monetary positions of governments and a reopening of the economy in 2021.
Style factors distorting equity markets

The divergent readings are impacted by the stark difference between areas of the market that are doing fine during COVID-19 versus those that are not. This comes out particularly strong in terms of style returns, and the difference between Growth and Value is one of the most important themes in our investment outlook. Despite equity index levels being relatively stable, there is massive divergent within the Growth and Value style.

The dispersion between valuations on MSCI Australia Value and Growth Index stocks is looking a lot like peak tech bubble in the early 2000s, and well exceeding what we saw during the GFC. Wide Value spreads have then historically preceded strong future alpha for Value-biased managers.

Empirically, a key reason why Value has typically outperformed Growth in the long run is Value’s superior EPS growth relative to Growth stocks. However, when you decompose the EPS growth versus the price of the style indexes, Growth earnings are well down on GFC levels, having been in decline for last 10 years and have suffered more in this COVID downturn, whereas prices have held up. For Value, both earnings and prices are down.

To us, this highlights that in Australia, growth stocks are just nowhere near as high quality as the Googles and Amazons of the World index. The Australian market is paying up for Growth companies like Afterpay that have losses or no earnings.

What this means is the dispersion of Growth and Value stocks in Australia is just not warranted based on the underlying quality of the companies. This cannot go on forever and gives us confidence that the Value style will prevail when the market focusses on underlying fundamentals.

Past performance is not a guide to future returns. The information provided should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the security transactions discussed here were, or will prove to be, profitable.

Source: Martin Currie Australia, FactSet; as of 31 August 2020.

*Long term average PE for the market.
Income spreads also at extremes

And while Value spreads for our MCA Value Equity strategy, and S&P/ASX 200 are almost at GFC-like off the chart extremes levels, we are also seeing the same in the Income space.

INVESTORS NEED TO FOCUS ON THE FUNDAMENTALS

No matter what the direction the market sentiment is, our analysts continue to focus on the true fundamentals which drive companies' long-term earnings power. We understand that periods of market disconnect can offer significant opportunities for research-driven stock picking.

Based on our top down analysis, fundamental views from our company engagements, and our big picture work, we expect that the full COVID-19 impacts will have been felt in Australia during 2020, and we should expect a recovery in company earnings and dividends into 2021 and 2022.

The timing of economic recovery does remain somewhat uncertain, but as the market shifts its focus from the recession to the recovery, we expect the Value style to swiftly come back into favour.

Today’s situation of very wide Value spreads at GFC-like levels, and an expensive market, offers longer term investors attractive opportunities at “once in a life time” valuations.

In order to take advantage of this shift, investors will need to ensure that they are positioned in Value-exposed opportunities well ahead of the inflection point, to fully capitalise on future narrowing spreads.

Now is the truly the time to position for Value.

Companies earnings have clearly been hurt by COVID-19, and dividends have been reduced. However, even on these lower dividend metrics the franked yield and dollar income stream payable for our MCA Equity Income strategy, and Australian equities in general, is well in excess of any income alternative available to retirees, such as bonds or term deposits.

Past performance is not a guide to future returns. The investment vehicles shown may have different risk profiles and a direct comparison may not be appropriate.

Source: Martin Currie Australia, FactSet; as of 31 August 2020. Data calculated for the representative Martin Currie Australia Value Equity and Equity Income account. Next 12 Months (NTM) Income yield is calculated using the weighted average of broker consensus forecasts of each portfolio holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed. Assumes zero percent tax rate and full franking benefits realised in tax return. RFTV: return to fair value. *80-20: spread between 80th percentile and 20th percentile stock. The opinions contained in this document are those of the named managers. They may not necessarily represent the views of other Martin Currie managers, strategies or funds.
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Risk warnings - Investors should also be aware of the following risk factors which may be applicable to the strategy shown in this document:

- Investing in foreign markets introduces a risk where adverse movements in currency exchange rates could result in a decrease in the value of your investment.
- This strategy may hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the strategy’s value than if it held a larger number of investments.
- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.
- Income strategy charges are deducted from capital. Because of this, the level of income may be higher but the growth potential of the capital value of the investment may be reduced.
- These strategies may invest in derivatives (Index futures) to obtain, increase or reduce exposure to underlying assets. The use of derivatives may restrict potential gains and may result in greater fluctuations of returns for the portfolio. Certain types of derivatives may become difficult to purchase or sell in such market conditions.

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