

Challenger Howard Mortgage Fund

Challenger Howard Mortgage Fund
(ARSN 090 464 074)

Responsible Entity
Challenger Managed Investments Limited
(ABN 94 002 835 592)
(AFSL 234668)



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Annual report - 30 June 2011

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The Directors' and financial report covers Challenger Howard Mortgage Fund as an individual entity.

The responsible entity of Challenger Howard Mortgage Fund is Challenger Managed Investments Limited (ABN 94 002 835 592). The responsible entity's registered office is Level 15, 255 Pitt Street, Sydney NSW 2000.

Financial highlights

Return from the Challenger Howard Mortgage Fund (the Fund), assuming monthly re-investments, averaged 4.62% p.a. (2010: 3.00% p.a.) for the twelve months to 30 June 2011.

Performance

Performance shown is effective annual returns to 30 June 2011, using rolling monthly nominal rates, assuming monthly reinvestment of distributions taking into account all management fees but excluding any entry/exit fees. Nominal rates are the actual income earned by the Fund assuming there is no reinvestment of income distributions. Effective rates assume the reinvestment of income distributions, therefore returns reflect the compounding effect of reinvestment of income and that interest rates remain constant.

	2011 %	2010 %	2009 %	2008 %	2007 %
Challenger Howard Mortgage Fund					
Nominal	4.53	2.96	5.95	6.87	6.36
Effective	4.62	3.00	6.11	7.09	6.55

Consistent with the statements in the current product disclosure statement, future performance is not guaranteed. Investors should exercise care in using past performance as a predictor of future performance.

Indirect Cost Ratio (ICR)

The Indirect Cost Ratio (ICR) is the ratio of the Funds management costs over the Funds average net assets attributable for the year, expressed as a percentage. The ICR of the various classes of the Fund for the past five years has been:

2011 %	2010 %	2009 %	2008 %	2007 %
1.42	1.40	1.40	1.40	1.40

Management costs include management fees and other expenses or reimbursements deducted in relation to the Fund, but do not include transactional and operational costs such as brokerage. Management costs are not paid directly by the unitholders of the Fund. The Fund incurred 0.02% abnormal expenses during the year as a result of legal fees relating to court proceedings.

Unit redemption prices

Unit redemption prices (quoted ex-distribution and exclusive of exit fees) are shown as follows:

	2011 \$	2010 \$
At 30 June	1.0000	1.0000
Year to 30 June:		
High	1.0000	1.0000
Low	1.0000	1.0000

Directors' report

The directors of Challenger Managed Investments Limited, the responsible entity of Challenger Howard Mortgage Fund, present their report together with the financial report of Challenger Howard Mortgage Fund (the Fund) for the year ended 30 June 2011.

Directors

The following persons held office as directors of Challenger Managed Investments Limited (the Responsible entity) during the year and up to the date of this report:

BJ O'Connor
 BR Benari
 PD Rogan
 RJ Woods
 RW Adams (resigned 25 January 2011)
 R Willis (appointed 25 January 2011)

Principal activities

The principal activity of the Fund during the year was to invest in accordance with the provisions of the Fund Constitution.

There were no significant changes in the nature of the Fund's activities during the year.

Review and results of operations

During the year, the Fund continued to invest funds in accordance with target asset allocations as set out in the current product disclosure statement that continues to be adhered to. The Fund maintains its strategy of investing in diversified portfolio of commercial mortgage loans and interest bearing securities, cash and other short-term investments.

Results

The performance of the Fund, for the year was as follows:

	30 June 2011	30 June 2010
Operating profit before finance costs (\$'000)	<u>70,529</u>	70,805
Distribution paid and payable (\$'000)	<u>69,393</u>	70,844
Distribution (cents per unit)	<u>4.45</u>	2.93

As the fund allocates all of its revenue less expenses to the liability to unitholders, the profit for the year was zero.

Significant changes in state of affairs

As a result of a unitholder meeting held on 28th October 2010, the withdrawal process of the Fund was amended. Four times per year, the Fund intends to make available at least 10% of the Fund's net assets for unitholders seeking to withdraw. Challenger Managed Investments Limited intends to manage the Fund with a view to maintaining sufficient liquidity to make available the ongoing withdrawal facility each quarter.

Matters subsequent to the end of the financial year

On 13 July 2011 the Fund paid \$123,138,000 being 10% of net assets to unitholders as part of the ongoing withdrawal facility for the period ending 1 April 2011 to 30 June 2011.

No other matter or circumstance has arisen since 30 June 2011 that has significantly affected, or may significantly affect:

- (i) the operations of the Fund in future financial years, or
- (ii) the results of those operations in future financial years, or
- (iii) the state of affairs of the Fund in future financial years.

Directors' report (continued)

Likely developments and expected results of operations

The Fund will continue to be managed in accordance with the investment objectives and guidelines as set out in the governing documents of the Fund and in accordance with the provisions of the Fund's Constitution.

Further information on likely developments in the operations of the Fund and the expected results of those operations have not been included in this report because the responsible entity believes it would be likely to result in unreasonable prejudice to the Fund.

Indemnity and insurance of officers

No insurance premiums are paid for out of the assets of the Fund in regards to insurance cover provided to the officers of the responsible entity. So long as the officers of the responsible entity act in accordance with the Fund's Constitution and the *Corporations Act 2001*, the officers remain indemnified out of the assets of the Fund against losses incurred while acting on behalf of the Fund. The auditors of the Fund are in no way indemnified out of the assets of the Fund.

Fees paid to and interests held in the Fund by the responsible entity or its related entities

Fees paid to the responsible entity and its related entities out of Fund property during the year are disclosed in note 9 of the financial report.

No fees were paid out of Fund property to the directors of the responsible entity during the year.

The number of interests in the Fund held by the responsible entity or its related entities as at the end of the financial year are disclosed in note 9 of the financial report.

Interests in the Fund

The movement in units on issue in the Fund during the year is disclosed in note 4 of the financial report.

Environmental regulation

The operations of the Fund are not subject to any particular or significant environmental regulations under a Commonwealth, State or Territory law.

Rounding of amounts to the nearest thousand dollars

The Fund is an entity of the kind referred to in Class Order 98/0100 (as amended) issued by the Australian Securities and Investments Commission relating to the rounding off of amounts in the directors' report and financial report. Amounts in the directors' report and financial report have been rounded to the nearest thousand dollars in accordance with that Class Order, unless otherwise indicated.

Auditor's independence declaration

A copy of the Auditor's independence declaration as required under section 307C of the *Corporations Act 2001* is included on page 5 and forms part of this report.



BJ O'Connor
Director

Sydney
16 September 2011

Auditor's Independence Declaration to the Directors of Challenger Howard Mortgage Fund

In relation to our audit of the financial report of Challenger Howard Mortgage Fund for the financial year ended 30 June 2011, to the best of my knowledge and belief, there have been no contraventions of the auditor independence requirements of the *Corporations Act 2001* or any applicable code of professional conduct.



Ernst & Young



Clare Sporle
Partner
16 September 2011

Statement of comprehensive income

		30 June 2011 \$'000	30 June 2010 \$'000
	Notes		
Revenue			
Interest revenue		144,997	194,279
Net losses on financial instruments held at fair value through profit or loss		(1,103)	(932)
Other revenue		498	306
Total revenue		<u>144,392</u>	<u>193,653</u>
Expenses			
Responsible entity's fees	9	23,094	32,889
Other expenses		3,606	8,402
Administration expense	9	233	1,505
Impairment of loans and receivables		46,930	80,052
Total expenses		<u>73,863</u>	<u>122,848</u>
Operating profit		70,529	70,805
Finance costs			
Distributions to unitholders	5	(69,393)	(70,844)
Movement in undistributed income due to unitholders		(1,136)	39
Other comprehensive income for the year		-	-
Profit and total comprehensive income for the year		<u>-</u>	<u>-</u>

The above statement of comprehensive income should be read in conjunction with the accompanying notes.

Statement of financial position

	Notes	30 June 2011 \$'000	30 June 2010 \$'000
Assets			
Cash and cash equivalents ¹		328,840	893,928
Financial assets held at fair value through profit or loss	6	-	19,420
Loans and receivables	7	906,878	1,364,489
Other receivables		3,131	8,303
Total assets		<u>1,238,849</u>	<u>2,286,140</u>
Liabilities			
Distributions payable	5	5,679	5,612
Other payables		1,777	3,433
Total liabilities (excluding net assets attributable to unitholders)		<u>7,456</u>	<u>9,045</u>
Net assets attributable to unitholders - liability	4	<u>1,231,393</u>	<u>2,277,095</u>

¹Corporate bonds of \$805,000,000 included within financial assets held at fair value through profit and loss at 30 June 2010 have been reclassified to cash and cash equivalents in the current year. Refer to note 2(s).

The above statement of financial position should be read in conjunction with the accompanying notes.

Statement of changes in equity

	30 June 2011 \$'000	30 June 2010 \$'000
Total equity at the beginning of the year	-	-
Profit for the year	-	-
Other comprehensive income	-	-
Total equity at the end of the year	<u>-</u>	<u>-</u>

Under Australian Accounting Standards, net assets attributable to unitholders are classified as a liability rather than equity. As a result there was no equity at the start of the year or end of the year.

The above statement of changes in equity should be read in conjunction with the accompanying notes.

Statement of cash flows

	30 June 2011 \$'000	30 June 2010 \$'000
Notes		
Cash flows from operating activities		
Interest received	156,365	179,488
Other income received	497	1,712
Responsible entity's fees paid	(24,255)	(33,229)
Payment of other expenses	(5,470)	(10,961)
Net cash inflow from operating activities	<u>127,137</u>	<u>137,010</u>
	10(a)	
Cash flows from investing activities		
Net proceeds from investments designated at fair value through profit and loss	18,317	275,787
Net proceeds from mortgage loans repaid	405,625	704,322
Net cash inflow from investing activities	<u>423,942</u>	<u>980,109</u>
Cash flows from financing activities		
Proceeds from applications by unitholders	241	55,278
Payments for redemptions by unitholders	(1,058,975)	(364,500)
Distributions paid and reinvestments to unitholders	(57,433)	(60,642)
Net cash outflow from financing activities	<u>(1,116,167)</u>	<u>(369,864)</u>
Net (decrease)/increase in cash and cash equivalents	<u>(565,088)</u>	<u>747,255</u>
Cash and cash equivalents at the beginning of the year ¹	893,928	146,673
Cash and cash equivalents at the end of the year	<u>328,840</u>	<u>893,928</u>
	10(b)	

¹Corporate bonds of \$805,000,000 included within financial assets held at fair value through profit and loss at 30 June 2010 have been reclassified to cash and cash equivalents in the current year. Refer to note 2(s).

The above statement of cash flows should be read in conjunction with the accompanying notes.

1 General Information

This financial report covers Challenger Howard Mortgage Fund (the Fund) as an individual entity. The Fund is an Australian registered scheme, and was constituted on 18 July 1985. The Fund will terminate on 17 July 2065 unless terminated earlier in accordance with the provisions of the Fund Constitution. The responsible entity of the Fund is incorporated and domiciled in Australia.

The financial report was authorised for issue by the Directors on 16 September 2011. The Directors of the responsible entity have the power to amend and reissue the financial report.

The nature of the operating and principal activities of the Fund are described in the Directors' Report.

2 Summary of significant accounting policies

The principal accounting policies applied in the preparation of the financial report are set out below. These policies have been consistently applied to all years presented, unless otherwise stated in the following text.

(a) Basis of preparation

This general purpose financial statement has been prepared in accordance with the Fund's Constitution, Australian Accounting Standards as issued by the Australian Accounting Standards board, and the *Corporations Act 2001* in Australia.

The financial report are presented in Australian dollars and have been prepared on the basis of fair value measurement of assets and liabilities except where otherwise stated.

The statement of financial position is presented on a liquidity basis. Assets and liabilities are presented in decreasing order of liquidity and are not distinguished between current and non-current. All balances are expected to be recovered or settled within twelve months, except for investments in financial assets and net assets attributable to unitholders. The amount expected to be recovered or settled in relation to these balances cannot be reliably determined.

Statement of compliance

The financial report has been prepared in accordance with the Australian Accounting Standards as issued by the Australian Accounting Standards Board and International Financial Reporting standards as issued by the International Accounting Standards Board

(b) New accounting standards and interpretations

Certain new accounting standards and interpretations have been published that are not mandatory for 30 June 2011 reporting period and have not yet been applied in the financial report. The directors' assessment of the impact of these new standards (to the extent relevant to the Fund) and interpretations is set out below:

(i) AASB 9 *Financial Instruments* and AASB 2009-11 *Amendments to Australian Accounting Standards arising from AASB 9 (effective from 1 January 2013)*

AASB 9 Financial Instruments addresses the classification and measurement of financial assets. The standard is not applicable until 1 January 2013. The current four categories of financial assets, stipulated in AASB 139 Financial Instruments: Recognition and Measurement will be replaced with two measurement categories: fair value and amortised cost. AASB 9 only permits the recognition of fair value gains/(losses) in other comprehensive income if they relate to equity investments that are not held for trading. Fair value gains/(losses) on debt investments, for example, will therefore have to be recognised directly in profit or loss. The Fund does not expect any significant impact on the Fund's financial report arising from an adoption of the Standard.

(ii) IFRS13 *Fair value measurement (effective from 1 January 2013)*

In May 2011, the IASB issued IFRS 13 Fair value measurement, which establishes a single source of guidance under IFRS for determining the fair value of assets and liabilities. IFRS 13 does not change when an entity is required to use fair value, but rather, provides guidance on how to determine fair value under IFRS when fair value is required or permitted by IFRS. Application of this definition may result in different fair values being determined for the relevant assets. IFRS 13 also expands the disclosure requirements for all assets or liabilities carried at fair value, including information about the assumptions made and the qualitative impact of those assumptions on the fair value determined. The valuation of a financial instrument will be assessed based on the facts at the date of initial application. The AASB is yet to release the Australian equivalent standard, but the Fund is in the process of assessing the impact based on the international standards.

2 Summary of significant accounting policies (continued)

(c) Financial Instruments

(i) Classification

The Fund's financial assets are classified as at fair value through profit or loss. Loans and receivables, comprise of amounts due to or from the Fund and include mortgages issued by the Fund.

Financial instruments designated at fair value through profit or loss or upon initial recognition. Financial instruments designated at fair value through profit and loss comprised debt securities in the prior year.

(ii) Recognition/derecognition

The Fund recognises financial assets and financial liabilities on the date it becomes party to the contractual agreement (trade date) and recognises changes in fair value of the financial assets or financial liabilities from this date.

Investments are derecognised when the right to receive cash flows from the investments has expired or the Fund has transferred substantially all risks and rewards of ownership.

(iii) Measurement

Financial assets and liabilities held at fair value through profit or loss

Financial assets and liabilities held at fair value through profit and loss are measured initially at fair value excluding any transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. Transaction costs on financial assets and financial liabilities at fair value through profit or loss are expensed immediately. Subsequent to initial recognition, all instruments held at fair value through profit or loss are measured at fair value with changes in their fair value recognised in the statement of comprehensive income.

Further details on how the fair values of financial instruments are determined are disclosed in note 8(f).

- Fair value in an active market

The fair value of financial assets and liabilities traded in active markets is based on their quoted market prices at the reporting date without any deduction for estimated future selling costs. Financial assets are priced at current bid prices at the close of statement of financial position date, while financial liabilities are priced at current offer prices.

Gains or losses on investments held for trading or designated at fair value through profit or loss are recognised in the statement of comprehensive income.

- Loans and receivables

Loan assets are measured initially at fair value plus transaction costs and subsequently amortised using the effective interest rate method, less impairment losses. Impairment losses are recognised in the statement of comprehensive income. Such assets are reviewed at the end of each reporting period to determine whether there is objective evidence of impairment, for example, when there has been significant or prolonged decline in the fair value of recoverable amount below cost.

(d) Net assets attributable to unitholders

The fair value of redeemable units is measured at the redemption amount that is payable (based on the one dollar redemption unit price) at the reporting date if unitholders exercised their right to redeem units in the Fund.

(e) Cash and cash equivalents

For the purpose of the statement of cash flows, cash and cash equivalents includes cash on hand, deposits held at call with financial institutions, other short-term highly liquid investments with original maturities of three months or less that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value, and bank overdrafts. Bank overdrafts are shown within borrowings in current liabilities on the statement of financial position.

Payments and receipts relating to the purchase and sale of investment securities held for trading are classified as cash flows from operating activities, as movements in the fair value of these securities represent the Fund's main income generating activity.

Payments and receipts relating to the purchase and sale of investment securities designated at fair value are classified as cash flows from investing activities, as movements in the fair value of these securities represent the Fund's investment.

2 Summary of significant accounting policies (continued)

(f) Investment revenue

Interest income and expenses are recognised in the statement of comprehensive income for all debt instruments that are not held at fair value through profit or loss using the effective interest method. Other changes in fair value for such instruments are recorded in accordance with the policies described in note 2(c).

The effective interest method is a method of calculating the amortised cost of a financial asset or financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts throughout the expected life of the financial instrument, or a shorter period where appropriate, to the net carrying amount of the financial asset or liability. When calculating the effective interest rate, the Fund estimates cash flows considering all contractual terms of the financial instrument (for example, prepayment options) but does not consider future credit losses. The calculation includes all fees paid or received between the parties to the contract that are an integral part of the effective interest rate, including transaction costs and all other premiums or discounts.

(g) Expenses

All expenses, including responsible entity's fees and custodian fees, are recognised in the statement of comprehensive income on an accruals basis.

(h) Income tax

Under current legislation, the Fund is not subject to income tax as unitholders are presently entitled to the income of the Fund.

Financial instruments held at fair value may include unrealised capital gains. Should such a gain be realised, that portion of the gain that is subject to capital gains tax will be distributed so that the Fund is not subject to capital gains tax.

Realised capital losses are not distributed to unitholders but are retained in the Fund to be offset against any realised capital gains. If realised capital gains exceed realised capital losses, the excess is distributed to unitholders.

The benefit of imputation credits and foreign tax paid are passed on to unitholders.

The Fund currently incurs withholding tax imposed by certain countries on investment income. Such income is recorded gross of withholding tax in the statement of comprehensive income.

(i) Distributions

In accordance with the Fund's Constitution, the Fund distributes income adjusted for amounts determined by the responsible entity, to unitholders by cash or reinvestment. The distributions are recognised in the statement of comprehensive income as finance costs attributable to unitholders.

(j) Change in net assets attributable to unit holders

Income not distributed is included in net assets attributable to unit holders. Movements in net assets attributable to unitholders are recognised in the statement of comprehensive income as finance costs.

(k) Goods and Services Tax (GST)

The GST incurred on the costs of various services provided to the Fund by third parties such as custodial services and investment management fees have been passed onto the Fund. The Fund qualifies for Reduced Input Tax Credits (RITC) at a rate of 75% hence investment management fees, custodial fees and other expenses have been recognised in the statement of comprehensive income net of the amount of GST recoverable from the Australian Taxation Office (ATO). Accounts payable are inclusive of GST. The net amount of GST recoverable from the ATO is included in receivables in the statement of financial position. Cash flows relating to GST are included in the statement of cash flows on a gross basis.

2 Summary of significant accounting policies (continued)

(l) Other receivables

Receivables may include amounts for dividends, interest and fund distributions. Dividends and fund distributions are accrued when the right to receive payment is established. Interest is accrued at the reporting date from the time of last payment in accordance with the policy set out in note 2(f) above. Amounts are generally received within 30 days of being recorded as receivables.

Receivables include such items as reduced income tax credits and application monies receivable from unitholders. The Fund has a documented arrears and collections management policy that operates in the event that a borrower is in arrears in respect of their mortgage repayments or is in default for another reason. Under this policy a variety of measures may be employed in relation to accounts that are in arrears or default, including enforcing the mortgage and selling the mortgaged property. The Fund continuously monitors the level of mortgage loans that are in arrears or default.

(m) Payables

Payables include liabilities and accrued expenses owing by the Fund which are unpaid as at balance date.

Trades are recorded on trade date, and normally settled within three business days. Purchases of financial instruments that are unsettled at reporting date are included in payables.

The distribution amount payable to unitholders as at the reporting date is recognised separately on the statement of financial position when unitholders are presently entitled to the distributable income under the Fund's Constitution.

(n) Applications and redemptions

Applications received for units in the Fund are recorded net of any entry fees payable prior to the issue of units in the Fund. Redemptions from the Fund are recorded gross of any exit fees payable after the cancellation of units redeemed. Units of the Fund are purchased and redeemed for \$1.00.

(o) Use of estimates

The Fund makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates are continually evaluated and based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

Some of the Fund's financial instruments including unquoted securities are fair valued using valuation techniques. Where valuation techniques (for example, pricing models using observable data) are used to determine fair values, they are validated and periodically reviewed by experienced personnel of the responsible entity, independent of the area that created them.

Models use observable data, to the extent practicable. However, areas such as credit risk (both own and counterparty), volatilities and correlations require management to make estimates. Changes in assumptions about these factors could affect the reported fair value of financial instruments.

For certain other financial instruments, including amounts due from/to brokers and payables, the carrying amounts approximate fair value due to the short-term nature of these financial instruments

(p) Unit prices

Unit prices are determined in accordance with the Fund's Constitution and are calculated as the net assets attributable to unitholders of the Fund, less estimated costs, divided by the number of units on issue, on a forward pricing basis, as determined by the responsible entity.

(q) Terms and conditions on units

Each unit issued confers upon the unitholder an equal interest in the Fund and is of equal value per class. A unit does not confer any interest in any particular asset or investment of the Fund. Unitholders have various rights under the Constitution and the *Corporations Act 2001*, including the right to:

- have their units redeemed;
- receive income distributions;
- attend and vote at meetings of unitholders; and
- participate in the termination and winding of the Fund.

The rights, obligations and restrictions attached to each unit are identical in all respects.

2 Summary of significant accounting policies (continued)

(r) Rounding of amounts

The Fund is an entity of the kind referred to in Class Order 98/0100 (as amended) issued by the Australian Securities and Investments Commission relating to the "rounding off" of amounts in the directors' report and financial report. Amounts in the directors' report and financial report have been rounded to the nearest thousand dollars in accordance with that Class Order, unless otherwise indicated.

(s) Comparatives

Where necessary, comparative figures have been reclassified to conform to changes in these financial report.

In particular, term deposits of \$805,000,000 were classified as Corporate Bonds in the prior year. All positions had a maturity of three months or less and have been reclassified to cash and cash equivalents.

3 Auditor's remuneration

During the year the following fees were paid or payable for services provided by the auditor of the Fund:

	30 June 2011 \$	30 June 2010 \$
Audit services		
<i>Ernst & Young</i>		
Audit and review of financial reports	42,750	42,750
Total remuneration for audit services	<u>42,750</u>	<u>42,750</u>

4 Net assets attributable to unitholders

Movements in number of units and net assets attributable to unitholders during the year were as follows:

	30 June 2011 No. '000	30 June 2010 No. '000	30 June 2011 \$'000	30 June 2010 \$'000
Net assets attributable to unitholders				
Opening balance	2,277,134	2,575,370	2,277,095	2,575,370
Applications	241	55,278	241	55,278
Redemptions	(1,058,975)	(364,500)	(1,058,975)	(364,500)
Units issued upon reinvestment of distributions	11,896	10,986	11,896	10,986
Undistributed operating profit due to unitholders	-	-	1,136	(39)
Closing balance	<u>1,230,296</u>	<u>2,277,134</u>	<u>1,231,393</u>	<u>2,277,095</u>
Total net assets attributable to unitholders			<u>1,231,393</u>	<u>2,277,095</u>

Capital risk management

Daily applications and redemptions are reviewed relative to the liquidity of the Fund's underlying assets on a daily basis by the responsible entity. Under the terms of the Fund's Constitution, the responsible entity has the discretion to reject an application for units and to defer or adjust redemption of units if the exercise of such discretion is in the best interests of unitholders.

The Fund monitors the level of daily applications and redemptions relative to the liquid assets in the Fund. Sufficient liquid assets are maintained within the Fund predominantly made up of cash and cash equivalents.

As a result of a unitholder meeting held on 28th October 2010, the withdrawal process of the Fund was amended. Four times per year, the Fund intends to make available at least 10% of the Fund's net assets for unitholders seeking to withdraw. Challenger Managed Investments Limited intends to manage the Fund with a view to maintaining sufficient liquidity to make available the ongoing withdrawal facility each quarter.

5 Distributions to unitholders

Timing of distributions

The distributions for the year were as follows:

The component of the final distribution for the year which was unpaid at the reporting date is shown in the statement of financial position.

	30 June 2011 \$'000	30 June 2011 CPU*	30 June 2010 \$'000	30 June 2010 CPU*
Distributions				
31 July interim paid	5,802	0.25	6,051	0.23
31 August interim paid	5,718	0.26	5,949	0.24
30 September interim paid	5,406	0.25	5,649	0.23
31 October interim paid	5,585	0.25	5,874	0.23
30 November interim paid	5,406	0.25	6,049	0.25
31 December interim paid	5,482	0.40	6,226	0.26
31 January interim paid	6,480	0.48	6,177	0.25
28 February interim paid	5,860	0.43	5,516	0.23
31 March interim paid	6,489	0.48	5,994	0.25
30 April interim paid	5,656	0.46	5,800	0.25
31 May interim paid	5,830	0.48	5,917	0.26
30 June interim payable	5,679	0.46	5,612	0.25
Distributions paid on full redemptions	-	-	30	-
	<u>69,393</u>		<u>70,844</u>	

*Cent per unit

6 Financial assets held at fair value through profit or loss

	30 June 2011 \$'000	30 June 2010 \$'000
Designated at fair value through profit or loss		
Debt securities	-	19,420
Corporate Bonds ¹	-	-
Total financial assets held at fair value through profit or loss	<u>-</u>	<u>19,420</u>

¹Corporate bonds of \$805,000,000 included within financial assets held at fair value through profit and loss at 30 June 2010 have been reclassified to cash and cash equivalents in the current year. Refer to note 2(s).

7 Loans and receivables

	30 June 2011 \$'000	30 June 2011 \$'000
Mortgage loans	896,397	1,336,309
Mortgage loans interest receivable	10,481	28,180
Total loans and receivables	<u>906,878</u>	<u>1,364,489</u>

8 Financial Risk Management

(a) Overview

The Fund's activities expose it to a variety of financial risks: market risk (including cash flow interest rate risk and price risk), credit risk and liquidity risk.

The Fund's overall risk management programme focuses on ensuring compliance with the Fund's Product Disclosure Statement and seeks to maximise the returns derived for the level of risk to which the Fund is exposed. The Fund may use derivative financial instruments to alter certain risk exposures. The responsible entity is responsible for identifying and controlling the risks that arise from these financial instruments.

The allocation of assets between the various types of financial instruments is determined by the Fund Manager who manages the Fund's assets to achieve the Fund's investment objectives.

Divergence from target allocations and the composition of the assets is monitored on a regular basis.

The responsible entity of the Fund is aware of the risks associated with the business of investment management. A financial risk management framework has been established to ensure that procedures and controls adequately manage the risks arising from current business activities. Central control include (but are not limited to):

- clear policies and procedures covering operations;
- post-trade investment compliance monitoring;
- segregation of the dealing and investment management function from the administration and settlement function;
- an independent service provider for the valuation of securities; and
- a compliance function with a separate reporting line from the funds management team.

As part of the risk management framework, the responsible entity is subject to regular reporting and committee meetings regarding risk and compliance issues. The purpose is to facilitate a flow of information between the business and the responsible entity's Board and Committees. Any material matters identified are promptly investigated and reported.

As part of its risk management strategy, the Fund may use derivatives including Australian exchange traded derivatives such as index futures and warrants, to manage exposures resulting from changes in index prices, equity risks and exposures arising from forecast transactions.

(b) Market risk

Market risk is the risk that changes in market prices, such as foreign exchange rates, interest rates and equity prices will affect the Fund's income or the value of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimising the return on risk.

The Fund is exposed to market risks influencing investment valuations. The Fund may utilise derivatives to manage this risk.

The Fund is exposed to interest bearing securities and price risk. This arises from investments held by the Fund for which prices in the future are uncertain. These investments are classified on the statement of financial position as at fair value through profit or loss. All investments present a risk of loss of capital.

(i) Price risk

The Fund is exposed to interest bearing securities and price risk. This arises from investments held by the Fund for which prices in the future are uncertain. These investments are classified on the statement of financial position as at fair value through profit or loss. All investments present a risk of loss of capital.

8 Financial risk management (continued)

(b) Market risk (continued)

(ii) Cash flow and fair value interest rate risk

The Fund's interest bearing financial assets expose it to risks associated with the effects of fluctuations in the prevailing levels of market interest rates on its financial position and cash flows. A significant, sustained increase in the differential between the Bank Bill Swap Rate (BBSW) and the Reserve Bank of Australia's (RBA) cash rate can have material increase in the cost of funding and therefore on net spread earned on the mortgages funded in the Fund.

The business manages this risk by actively adjusting the interest rate changes to borrowers if a sustained adverse differential to the benchmark level is evidenced.

The Fund has established limits on the total interest rate exposure, which are monitored on a regular basis. The Fund may use derivatives to hedge unexpected increases in interest rates.

The table in part (c) of this note demonstrates the sensitivity of the Fund's statement of comprehensive income to a reasonably possible change in interest rates, with all other variables held constant.

(c) Summarised sensitivity analysis

The following table summarises the sensitivity of the Fund's operating profit and net assets attributable to unitholders to interest rate risk for financial assets and liabilities held at balance date. The reasonably possible movements in the risk variables have been determined based on management's best estimate, having regard to a number of factors, including historical levels of changes in interest rates. However, actual movements in the risk variables may be greater or less than anticipated due to a number of factors, including unusually large market shocks resulting from changes in the performance of the economies, markets and securities in which the Fund invests. As a result, historic variations in risk variables are not a definitive indicator of future variations in the risk variables.

	Interest rate risk	
	Impact on operating profit/Net assets attributable to unitholders	
	+100 bps \$'000	-100 bps \$'000
30 June 2011	(7,338)	7,336
30 June 2010	(32,732)	32,733

(d) Liquidity risk

Liquidity risk is the risk that the Fund will encounter difficulty in meeting obligations associated with financial liabilities. This risk is controlled through the Fund's investment in financial instruments, which under normal market conditions are readily convertible to cash. In addition, the Fund maintains sufficient cash and cash equivalents to meet normal operating requirements.

At all times, the Fund undertakes to ensure the yield on the mortgage loan assets is sufficient to enable payment of all expense obligations as and when they fall due.

Under the terms of its Constitution, the Fund has the ability to manage liquidity risk by delaying redemptions to unitholders, if necessary, until the funds are available to pay them. As a result of the economic environment, its severe implications for financial markets and the resultant impact on liquidity, the withdrawal process for the Fund was amended on 21 October 2008. During the period in which the Fund operates as an illiquid scheme, unitholders are only able to withdraw from the Fund if Challenger Managed Investments Limited makes an offer of withdrawal. Offers were made throughout the year with the last withdrawal offer being made for period ending 30 June 2011.

8 Financial risk management (continued)

(d) Liquidity risk (continued)

Maturity analysis for financial liabilities

Financial liabilities for the Fund comprise trade and other payables, distributions payable, and net assets attributable to unitholders. Trade and other payables and distributions payable have no contractual maturities but are typically settled within 30 days.

All cash and cash equivalents are at call.

The majority of mortgage loans have a maturity of less than 5 years.

The Fund's Product Disclosure Statement provides for daily redemption of units and it is therefore exposed to liquidity risk of meeting unitholder's redemption at any time.

(e) Credit risk

The primary source of the Fund's credit risk is mortgage investment.

Credit risk is the risk that a counterparty will fail to perform contractual obligations, either in whole or in part, under a contract. Concentrations of credit risk are minimised primarily by:

- ensuring counterparties, together with the respective loan to underlying real estate security ratio are approved; and
- ensuring that transactions are undertaken with a large number of counterparties.

The credit risk relating to financial assets of the Fund, which have been recognised in the statement of financial position is generally equal to the carrying amount. Mortgage loans comprise mortgage investments averaging an initial loan to underlying real estate security ratio of 65.1% (30 June 2010: 63.2%).

Mortgage loan sizes are limited to alleviate a concentration of credit risk. The maximum individual loan represented 4.6% (30 June 2010: 2.6%) of total assets. The average loan size was \$895,502 (June 2010: \$891,226). Loans were spread geographically with the highest concentration of 57.4% (30 June 2010: 59.9%) by value in the state of New South Wales. Loans were also backed by varying types of property, with the highest concentration of 34.3% (30 June 2010: 32.5%) represented by commercial properties.

The following table presents the maximum exposure to credit risk of financial instruments held on the statement of financial position. For financial assets held on statement of financial position, the exposure to credit risk is their carrying amount.

	30 June 2011 \$'000	30 June 2010 \$'000
Cash and cash equivalents	328,840	893,928
Financial assets held at fair value through profit or loss ¹	-	19,420
Loans and receivables	906,878	1,364,489
Other receivables	3,131	8,303
Total	1,238,849	2,286,140

¹Corporate bonds of \$805,000,000 included within financial assets held at fair value through profit and loss at 30 June 2010 have been reclassified to cash and cash equivalents in the current year. Refer to note 2(s).

8 Financial risk management (continued)

The following table details the spread of mortgage book by maturity and settlement value for the Fund.

30 June 2011 Maturity	Number of loans	% of Total No. of Loans	Principal balance \$'000	% of Total Principal balance
Past maturity	140	13.99	189,113	21.35
<= 1 year	462	46.15	446,497	49.65
> 1 year to 3 year	399	39.86	260,787	29.00
> 3 year to 5 year	-	-	-	-
> 5 year	-	-	-	-
Total	1,001	100.00	896,397	100.00

30 June 2010 Maturity	Number of loans	% of Total No. of Loans	Principal balance \$'000	% of Total Principal balance
Past maturity	171	11.21	293,672	21.97
<= 1 year	355	23.28	288,336	21.58
> 1 year to 3 year	970	63.61	735,393	55.03
> 3 year to 5 year	29	1.90	18,908	1.42
> 5 year	-	-	-	-
Total	1,525	100.00	1,336,309	100.00

30 June 2011 Principal balance	Number of loans	% of Total No. of Loans	Principal balance \$'000	% of Total Principal balance
<=500,000	636	63.54	162,103	18.10
>500,000 to 1,500,000	263	26.27	216,156	24.11
>1,500,000 to 3,000,000	59	5.89	118,900	13.26
>3,000,000 to 4,500,000	18	1.80	65,555	7.31
>4,500,000 to 6,000,000	7	0.70	35,827	4.00
>6,000,000 to 7,500,000	2	0.20	12,302	1.37
>7,500,000 to 9,000,000	6	0.60	45,939	5.12
>9,000,000	10	1.00	239,615	26.73
Total	1,001	100.00	896,397	100.00

30 June 2010 Principal balance	Number of loans	% of Total No. of Loans	Principal balance \$'000	% of Total Principal balance
<=500,000	951	62.35	222,777	16.68
>500,000 to 1,500,000	403	26.43	330,396	24.72
>1,500,000 to 3,000,000	100	6.56	203,263	15.21
>3,000,000 to 4,500,000	29	1.90	106,158	7.95
>4,500,000 to 6,000,000	15	0.98	76,838	5.76
>6,000,000 to 7,500,000	4	0.26	25,583	1.91
>7,500,000 to 9,000,000	10	0.65	78,726	5.89
>9,000,000	13	0.87	292,568	21.88
Total	1,525	100.00	1,336,309	100.00

8 Financial risk management (continued)

Debt securities

In previous periods the Fund has invested in discount securities and mortgage backed securities which had an investment grade as rated by Standard and Poors. For unrated assets a rating was assigned by the Investment Manager using an approach that is consistent with the approach used by ratings agencies.

An analysis of debt securities by rating is set out in the table below.

Rating	30 June 2011 \$'000	30 June 2010 \$'000
AAA	-	11,318
A+	-	1,386
A	-	3,919
A-1+	-	52
BBB+	-	1,735
BBB	-	1,010
Total	-	19,420

Credit losses and impairment

Management has a credit policy in place and on a regular basis, monitors the exposure to credit risk.

The credit policy imposes standards which quantifies and controls risk, both on an individual loan basis, and across the portfolio. The credit policy ensures appropriate diversification across the portfolio, defines authority levels and controls around credit decisions, outlines benchmarks of performance criteria, to enable ongoing monitoring of credit risk, and also outlines standards in relation to individual loans so as to ensure adequate security and serviceability for each loan.

Mortgage loans are only accepted where:

- First mortgage security over real estate is held;
- At the time the loan is written it does not exceed 75% of the value of the security property;
- The borrowers demonstrate an ability to meet loan commitments;
- A valuation on the security properties is carried out by a qualified and independent valuation expert;
- The valuation is not more than three months old at the time the loan facility is made; and
- The loan meets other requirements under the credit rating policy.

Security is not taken over specialised properties or development projects, nor construction projects or second mortgages.

Assets that are past due are monitored and assessed on a regular basis for any credit loss provision which may be required. The estimated impairment loss provided for is measured as the difference between the carrying amount of the loan and the estimated value of security (net costs of realisation).

The tables below highlight the portion of the mortgage interest receivables past due and/or impaired.

30 June 2011	Neither past due or impaired \$'000	1 - 2 Month \$'000	2 - 3 Month \$'000	Greater than 3 Month \$'000	Past due and impaired \$'000	Total \$'000
Receivable	3,617	1,051	116	5,697	-	10,481

30 June 2010	Neither due or impaired \$'000	1 - 2 Month \$'000	2 - 3 Month \$'000	Greater than 3 Month \$'000	Past due and impaired \$'000	Total \$'000
Receivable	13,302	1,430	535	12,913	-	28,180

8 Financial risk management (continued)

(f) Fair value estimation

Financial assets and liabilities held at fair value through profit or loss are measured initially at fair value excluding any transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. Transaction costs on financial assets and financial liabilities at fair value through profit or loss are expensed immediately. Subsequent to initial recognition, all instruments held at fair value through profit or loss are measured at fair value with changes in their fair value recognised in the statement of comprehensive income.

The carrying amounts of the Fund's assets and liabilities at the end of each reporting period approximate their fair values.

(g) Fair value hierarchy

Accounting standards require the Fund to classify fair value measurements using a fair value hierarchy that reflects the subjectivity of the inputs used in making the measurements. The fair value hierarchy has the following levels:

- Quoted prices (unadjusted) in active markets for identical assets or liabilities (level 1).
- Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices) (level 2).
- Inputs for the asset or liability that are not based on observable market data (that is, unobservable inputs) (level 3).

The determination of what constitutes "observable" requires significant judgement by the responsible entity. The responsible entity considers observable data to be that market data that is readily available, regularly distributed or updated, reliable and verifiable, not proprietary, and provided by independent sources that are actively involved in the relevant market.

The table below sets out the Fund's financial assets (by class) measured at fair value according to the fair value hierarchy at 30 June 2011.

	30 June 2011	30 June 2010
	Level 2	Level 2
	\$'000	\$'000
Financial assets		
Mortgage backed securities	-	19,420
Corporate bonds ¹	-	-
Total	-	19,420

¹Corporate bonds of \$805,000,000 included within financial assets held at fair value through profit and loss at 30 June 2010 have been reclassified to cash and cash equivalents in the current year. Refer to note 2(s).

Investments, whose values are based on quoted market prices in active markets, and therefore classified within level 1, include active listed equities and exchange traded derivatives.

Financial instruments that trade in markets that are not considered to be active but are valued based on quoted market prices, dealer quotations or alternative pricing sources supported by observable inputs are classified within level 2. These include investments in unlisted unit Funds and over-the-counter derivatives. As level 2 investments include positions that are not traded in active markets and/or are subject to transfer restrictions, valuations may be adjusted to reflect illiquidity and/or non-transferability, which are generally based on available market information.

The Fund does not hold any level 3 investments at 30 June 2011 (2010: Nil).

9 Related party transactions

Responsible entity

The responsible entity of Challenger Howard Mortgage Fund is Challenger Managed Investments Limited whose immediate parent company is Challenger Funds Management Holdings Pty Limited and ultimate parent company is Challenger Limited (formerly Challenger Financial Services Group Limited).

Challenger Commercial Lending Limited administers the mortgage assets of the Fund and is a related party of the responsible entity.

Key management personnel

(a) Directors

Key management personnel includes persons who were directors of Challenger Managed Investments Limited at any time during the year and up to the date of the report as follows:

BJ O'Connor
BR Benari
PD Rogan
RJ Woods
RW Adams (resigned 25 January 2011)
R Willis (appointed 25 January 2011)

(b) Other key management personnel

In addition to the directors noted above, the responsible entity is considered to be key management personnel with authority for the strategic direction and management of the Fund.

Key management personnel unitholdings

At 30 June 2011 no key management personnel held units in the Fund (2010: Nil).

Key management personnel compensation

No amount is paid by the Fund directly to the Directors of the responsible entity.

Compensation is paid to the responsible entity in the form of fees and is disclosed below.

Responsible entity's fees and other transactions

Under the terms of the Fund's Deed, the responsible entity is entitled to receive management fees, calculated by reference to the average daily net assets (excluding net assets attributable to unitholders) of the Fund as follows:

- (i) A management fee up to 1.4% per annum (exclusive of GST) of the daily capital value of the Fund;
- (ii) A withdrawal fee (inclusive of GST) of 1.00% per annum on amounts withdrawn within twelve months of investment.

A related party to the responsible entity is entitled to receive administration fees from the underlying mortgagees in the Fund for providing administration services. The administration fee is up to 0.2% (exclusive of GST) of the daily principal loan balance.

All related party transactions are conducted on normal commercial terms and conditions. The transactions during the year and amounts payable at year end between the Fund and the responsible entity were as follows:

	30 June	30 June
	2011	2010
	\$'000	\$'000
Management fees for the year paid directly to the responsible entity	24,255	32,889
Administration fee for the year paid directly to the responsible entity	233	1,505
Aggregate amounts payable to the responsible entity at the reporting date	1,374	2,534

9 Related party transactions (continued)

Parties related to the Fund (including Challenger Managed Investments Limited, its related parties and other schemes managed by Challenger Managed Investments Limited), held units in the Fund as follows:

2011

Unitholder	Number of units held opening (Units)	Number of units held closing (Units)	Interest held (%)	Number of units acquired (Units)	Number of units disposed (Units)	Distributions paid/ payable by the Trust (\$)
Challenger Howard Wholesale Mortgage Fund	1,219,842,085	563,813,585	46	-	656,038,500	37,224,657
Total	1,219,842,085	563,813,585	46	-	656,038,500	37,224,657

2010

Unitholder

Challenger Howard Wholesale

Mortgage Fund	1,443,622,231	1,219,842,085	54	51,293,633	275,073,779	38,800,794
Total	1,443,622,231	1,219,842,085	54	51,293,633	275,073,779	38,800,794

10 Reconciliation of operating profit to net cash flows from operating activities

30 June	30 June
2011	2010
\$'000	\$'000

(a) Reconciliation of operating profit to net cashflows from operating activities

Net profit attributable to unitholders	70,529	70,805
Change in the fair value of financial assets	1,103	932
Impairment of loans and receivables	46,930	80,052
Net change in trade debtors and other assets	10,231	(13,482)
Net change in payables and other liabilities	(1,656)	(1,297)
Net cash inflow from operating activities	127,137	137,010

(b) Non - cash financing activities

- reinvestment of unitholder distributions	11,896	10,986
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11 Events occurring after the reporting period

On 12 July the Fund paid unitholders \$123,138,000 being 10% of net assets as part of the ongoing withdrawal facility for the period 1 April 2011 to 30 June 2011.

No other significant events have occurred since the reporting date which would impact on the financial position of the Fund disclosed in the statement of financial position as at 30 June 2011 or on the results and cash flows of the Fund for the year ended on that date.

12 Contingent assets and liabilities and commitments

There are no outstanding contingent assets and liabilities or commitments as at 30 June 2011 (30 June 2010:\$nil).

Directors' declaration

In accordance with the resolution of the Directors of Challenger Managed Investments Limited, I state that:

In the opinion of the Directors of the responsible entity:

- (a) the financial report and notes set out on pages 6 to 23 are in accordance with the *Corporations Act 2001*, including:
 - (i) complying with Accounting Standards (including the Australian Accounting Interpretations), the *Corporations Regulations 2001*; and other mandatory professional reporting requirement; and
 - (ii) giving a true and fair view of the Fund's financial position as at 30 June 2011 and of its performance for the financial year ended on that date;
- (b) the financial report also comply with the International Financial Reporting Standards as disclosed in note 2(a); and
- (c) there are reasonable grounds to believe that the Fund will be able to pay its debts as and when they become due and payable.

On behalf of the Board of Directors of Challenger Managed Investments Limited.



BJ O'Connor
Director

Sydney
16 September 2011

Independent auditor's report to the unitholders of Challenger Howard Mortgage Fund

We have audited the accompanying financial report of Challenger Howard Mortgage Fund, which comprises the statement of financial position as at 30 June 2011, the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, notes comprising a summary of significant accounting policies and other explanatory information, and the directors' declaration.

Directors' responsibility for the financial report

The directors of the Responsible Entity are responsible for the preparation of the financial report that gives a true and fair view in accordance with Australian Accounting Standards and the *Corporations Act 2001* and for such internal controls as the directors determine are necessary to enable the preparation of the financial report that is free from material misstatement, whether due to fraud or error. In Note 2(a), the directors also state, in accordance with Accounting Standard AASB 101 *Presentation of Financial Statements*, that the financial statements comply with International Financial Reporting Standards.

Auditor's responsibility

Our responsibility is to express an opinion on the financial report based on our audit. We conducted our audit in accordance with Australian Auditing Standards. Those standards require that we comply with relevant ethical requirements relating to audit engagements and plan and perform the audit to obtain reasonable assurance about whether the financial report is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial report. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial report, whether due to fraud or error. In making those risk assessments, the auditor considers internal controls relevant to the Responsible Entity's preparation of the financial report that gives a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal controls. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial report.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Independence

In conducting our audit we have complied with the independence requirements of the *Corporations Act 2001*. We have given to the directors of the Responsible Entity a written Auditor's Independence Declaration, a copy of which is attached to the directors' report.

Opinion

In our opinion:

- a. the financial report of Challenger Howard Mortgage Fund is in accordance with the *Corporations Act 2001*, including:

- i giving a true and fair view of Challenger Howard Mortgage Fund's financial position of as at 30 June 2011 and of its performance for the year ended on that date; and
 - ii complying with Australian Accounting Standards and the *Corporations Regulations 2001*; and
- b. the financial report also complies with *International Financial Reporting Standards* as disclosed in Note 2(a).



Ernst & Young
Ernst & Young



Clare Sporle
Partner
Sydney
16 September 2011

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