

Analyst Pack 1H16

31 December 2015

Challenger Limited provides
Australians with financial security
for retirement.

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Table of contents

Challenger Group

Key performance indicators	1
Consolidated profit and loss	2
Group balance sheet	5
Issued share capital	6
Consolidated operating cash flows	8

Life

Life financial results	9
Life balance sheet and Challenger Life Company (CLC) debt facilities	15
Life investment portfolio overview	17
Challenger Life Company (CLC) regulatory capital	27
Risk Management Framework and profit and equity sensitivities	29
Life outlook	33

Funds Management

Funds Management financial results	34
Funds Management outlook	38

Corporate

Corporate financial results	39
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Additional information

Normalised profit framework	40
Glossary of terms	42

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Important Note

Information presented in the 1H16 Analyst Pack is presented on an operational basis (rather than statutory) to reflect a management view of the business. Challenger Limited (ACN 106 842 371) also provides statutory reporting as prescribed under the Corporations Act 2001. The audited half year financial report is available from Challenger's website at www.challenger.com.au.

The analyst pack is not audited. The statutory net profit after tax as disclosed in the consolidated profit and loss (page 2) has been prepared in accordance with Australian Accounting Standards and the Corporations Act 2001. Challenger's external auditors, Ernst & Young, have audited the statutory net profit after tax as disclosed in the consolidated profit and loss. Normalised profit after tax, as disclosed in the consolidated profit and loss (see page 2) has been prepared in accordance with a normalised profit framework. The normalised profit framework has been disclosed in section 2.2 of the Directors' Report in the Challenger Limited Interim Financial Report 2016. The normalised profit after tax has been subject to a review performed by Ernst & Young.

Any forward looking statements included in this document are by nature subject to significant uncertainties, risks and contingencies, many of which are outside the control of, and are unknown to, Challenger, so that actual results or events may vary from those forward looking statements, and the assumptions on which they are based.

Past performance is not an indicator of future performance. While Challenger has sought to ensure that information is accurate by undertaking a review process, it makes no representation or warranty as to the accuracy or completeness of any information or statement in this document. In particular, information and statements in this document do not constitute investment advice or a recommendation on any matter, and should not be relied upon.

Key performance indicators

	1H16	2H15	1H15	2H14	1H14
Earnings					
Normalised NPAT (\$m)	182.1	179.1	154.9	165.2	163.5
Statutory NPAT (\$m)	234.3	168.9	130.1	174.3	166.3
Normalised EBIT (\$m)	238.7	232.0	206.4	195.1	192.8
Underlying operating cash flow (\$m)	147.4	194.3	93.6	177.6	143.4
Normalised cost to income ratio	33.8%	33.3%	34.4%	35.2%	34.0%
Normalised effective tax rate	23.0%	22.1%	24.3%	14.5%	14.2%
Normalised effective tax rate excluding TOFA ¹	23.0%	22.1%	24.3%	22.3%	22.1%
Earnings per share (cents)					
Basic – normalised	32.6	32.4	28.8	32.2	31.8
Basic – normalised excluding TOFA ¹	32.6	32.4	28.8	29.3	28.9
Basic – statutory	41.9	30.5	24.2	34.0	32.3
Diluted – normalised	30.5	30.0	27.0	30.4	30.3
Diluted – normalised excluding TOFA ¹	30.5	30.0	27.0	27.6	27.5
Diluted – statutory	39.0	28.3	22.8	32.1	30.8
Return on equity (%)					
Normalised Return on Equity (ROE) – pre-tax	18.1%	18.6%	17.4%	18.6%	18.9%
Normalised Return on Equity (ROE) – post-tax	14.0%	14.5%	13.2%	15.9%	16.2%
Statutory Return on Equity (ROE) – post-tax	18.0%	13.7%	11.1%	16.8%	16.5%
Capital management					
Net assets – average ² (\$m)	2,592	2,494	2,331	2,090	2,000
Net assets – closing (\$m)	2,696	2,543	2,443	2,153	2,052
Net assets per basic share (\$)	4.80	4.60	4.42	4.22	3.99
Net tangible assets (\$m)	2,111	1,994	1,896	1,607	1,530
Net tangible assets per basic share (\$)	3.75	3.60	3.43	3.15	2.98
Dividend (cps)	16.0	15.5	14.5	13.5	12.5
Dividend franking (%)	100.0	100.0	70.0	40.0	–
Normalised dividend payout ratio	49.1%	47.8%	50.4%	41.9%	39.3%
Sales, net flows and assets under management					
Life sales (\$m)					
Annuity sales	1,641.1	1,178.3	1,574.8	1,341.8	1,457.0
Other Life sales	409.7	395.1	548.9	291.5	290.1
Total Life sales	2,050.8	1,573.4	2,123.7	1,633.3	1,747.1
Life annuity net flows ³ (\$m)	270.5	177.4	560.8	347.2	539.9
Life annuity book (\$m)	8,868.4	8,692.6	8,573.1	7,824.3	7,617.2
Life annuity net book growth ³	3.1%	2.2%	7.2%	4.6%	7.6%
Total Life net flows ³ (\$m)	347.1	212.5	438.4	388.2	(212.1)
Total Life book ⁴ (\$m)	9,903.5	9,637.7	9,527.9	8,896.7	8,617.5
Total Life net book growth ³	3.6%	2.4%	4.9%	4.4%	(2.4%)
Funds Management – net flows ⁵ (\$m)	(4,356.4)	972.7	6,766.2	1,033.6	1,113.8
Total assets under management ⁶	57,617	59,789	57,169	50,725	48,814
Other					
Headcount – closing FTEs	618	560	563	539	498
Weighted average number of basic shares on issue (m)	559.1	553.2	538.2	513.1	514.5
Number of basic shares on issue (m)	562.2	553.4	552.9	510.6	514.1
Share price closing (\$)	8.72	6.72	6.53	7.44	6.20

1 Normalised tax includes the effect of a private binding tax ruling received from the ATO in February 2012 in relation to the application of Taxation of Financial Arrangements (TOFA). The TOFA private tax ruling reduced normalised tax by \$15m in 1H14 and 2H14.

2 Net assets – average calculated on a monthly basis.

3 2H14 excludes maturity of the High Yield Fund annuity (\$284m).

4 Total Life book includes Life annuity book and Guaranteed index return liabilities.

5 Funds Management 1H16 net flows include -\$5.4bn following the sale of Kapstream in July 2015. Fidante Partners will no longer receive distribution fees on Kapstream institutional FUM (\$5.4bn) and as a result has derecognised this FUM in 1H16. Despite the reduction in FUM, Fidante Partners earnings over the short and medium term is not expected to be negatively impacted following new distribution and administration agreements.

6 Refer to page 35 for a reconciliation of total Group Assets and Funds Under Management.

Consolidated profit and loss

\$m	1H16	2H15	1H15	2H14	1H14
Cash earnings	244.5	240.1	223.3	214.4	211.3
Normalised capital growth	48.4	45.9	34.5	29.7	25.9
Normalised Cash Operating Earnings (COE)	292.9	286.0	257.8	244.1	237.2
Net fee income	67.1	61.4	56.1	56.4	53.8
Other income	0.6	0.6	0.7	0.6	1.2
Total net income	360.6	348.0	314.6	301.1	292.2
Personnel expenses	(83.8)	(78.3)	(76.5)	(74.8)	(69.6)
Other expenses	(38.1)	(37.7)	(31.7)	(31.2)	(29.8)
Total expenses	(121.9)	(116.0)	(108.2)	(106.0)	(99.4)
Normalised EBIT	238.7	232.0	206.4	195.1	192.8
Interest and borrowing costs	(2.3)	(2.1)	(1.7)	(1.9)	(2.2)
Normalised profit before tax	236.4	229.9	204.7	193.2	190.6
Normalised tax ¹	(54.3)	(50.8)	(49.8)	(28.0)	(27.1)
Normalised profit after tax	182.1	179.1	154.9	165.2	163.5
Investment experience after tax	30.1	(10.2)	(24.8)	9.1	2.8
Significant items after tax ²	22.1	–	–	–	–
Statutory net profit after tax	234.3	168.9	130.1	174.3	166.3
Performance analysis					
Normalised earnings per share – basic (cents)	32.6	32.4	28.8	32.2	31.8
Shares for basic EPS calculation	559.1	553.2	538.2	513.1	514.5
Normalised cost to income ratio	33.8%	33.3%	34.4%	35.2%	34.0%
Normalised effective tax rate	23.0%	22.1%	24.3%	14.5%	14.2%
Normalised effective tax rate excluding TOFA ¹	23.0%	22.1%	24.3%	22.3%	22.1%
Total net income analysis					
Cash earnings (Life)	67.8%	69.0%	71.0%	71.2%	72.3%
Normalised capital growth (Life)	13.4%	13.2%	11.0%	9.9%	8.9%
Net fee income (Funds Management)	18.6%	17.6%	17.8%	18.7%	18.4%
Other income (Corporate)	0.2%	0.2%	0.2%	0.2%	0.4%
Normalised EBIT by division					
Life	248.9	240.9	215.8	203.6	200.6
Funds Management	21.6	23.3	20.8	22.6	20.7
Corporate	(31.8)	(32.2)	(30.2)	(31.1)	(28.5)
Normalised EBIT	238.7	232.0	206.4	195.1	192.8

1 Normalised tax includes the effect of a private binding tax ruling received from the ATO in February 2012 in relation to the application of Taxation of Financial Arrangements (TOFA). The TOFA private tax ruling reduced normalised tax by \$15m in 1H14 and 2H14.

2 1H16 significant items after tax primarily represents the gain on sale of Challenger's equity investment in Kapstream, offset by boutique impairments and office relocation costs.

Normalised profit after tax

Normalised profit after tax was \$182m in 1H16, up 18% from \$155m in 1H15. The increase in normalised profit after tax reflects a 16% (\$32m) increase in EBIT, partially offset by higher normalised tax (up \$5m).

EBIT increased as a result of AUM growth, driving a \$46m (15%) increase in net income, which was partially offset by a \$14m (13%) increase in expenses.

Normalised Earnings Per Share (EPS)

Normalised EPS increased by 13% from 28.8 cps in 1H15 to 32.6 cps in 1H16. The increase in normalised EPS reflects higher normalised profit after tax (up \$27m), partially offset by a higher weighted average number of shares on issue following the capital initiatives undertaken in 1H15. The weighted average numbers of shares on issue in 1H16 was 4% higher than in 1H15.

Total net income

Total net income increased by \$46m (15%) in 1H16 due to:

- higher Life Cash Operating Earnings (up \$35m or 14%) as a result of higher Life average AUM (up 12%) and an increase in Life's COE margin (up from 4.4% to 4.5%); and
- higher Funds Management net fee income (up \$11m or 20%) as a result of higher average FUM and revenue from the acquisition of Dexion Capital. Funds Management average FUM increased by 4% in 1H16 and was impacted by the sale of Kapstream to Janus Capital in July 2015. Excluding the impact on FUM from the sale of Kapstream, average Funds Management FUM increased by 15%. Refer to page 37 for more details on the sale of Kapstream.

Expenses

1H16 total expenses were \$122m, up \$14m (13%) on 1H15. The increase in expenses relates to higher personnel costs (up \$7m) as a result of an increase in employee numbers, and higher other expenses (up \$6m). Both 1H16 personnel and other costs include Dexion Capital following its acquisition in July 2015.

Employee numbers were 10% (55 FTEs) higher in 1H16 than 1H15. Employee numbers increased following the acquisition of Dexion Capital in July 2015.

Challenger's business remains one of Australia's most efficient financial services companies and is highly scalable. In 1H16 the cost to income ratio fell by 60 bps from 1H15 to 33.8% and is well within Challenger's targeted normalised cost to income ratio range of between 32% to 36%.

Normalised EBIT

1H16 normalised EBIT was \$239m, increasing by \$32m (16%) from \$206m in 1H15. EBIT increased in Life (up \$33m or 15%) and Funds Management (up \$1m or 4%), and was partially offset by a decrease in Corporate EBIT (down \$2m or 5%).

The increase in Life normalised EBIT reflects growth in average assets under management, which increased by 12% in 1H16 and a higher Life COE margin. Life's COE margin was 4.5% in 1H16 and has been in the range of 4.4% and 4.5% since FY13. Refer to page 12 for more detail on Life's COE margin.

The increase in Funds Management EBIT reflects growth in average FUM (up 4%) partially offset by higher expenses.

Corporate EBIT was \$2m lower in 1H16 with lower personnel expenses offset by higher other expenses. Refer to page 39 for more detail.

Normalised Return on Equity (ROE)

1H16 normalised ROE was 18.1% and increased by 70 bps on 1H15. The increase in normalised ROE was driven by higher earnings, and is above Challenger's 18% target.

Normalised tax

Normalised tax was \$54m in 1H16 with an effective tax rate of 23.0%, down 130 bps on 1H15.

The normalised effective tax rate in 1H16 reflects Challenger's current business mix and is at the lower end of Challenger's medium term expected normalised effective tax rate range of between 23% and 25%.

Investment experience after tax

Challenger Life is required by Australian accounting standards to value investment assets and liabilities supporting the Life business at fair value. This gives rise to fluctuating valuation movements on investment assets and liabilities being recognised in the profit and loss. Challenger is generally a long term holder of assets, due to them being held to match the term of life contract liabilities. As a result, Challenger takes a long term view of the expected capital growth of the portfolio rather than focusing on short term movements.

1H16 investment experience (after tax) was a gain of \$30m.

Investment experience relates to the Life business and pre-tax investment experience is disclosed as part of Life's financial results (refer to page 13).

Significant items after tax

Significant one-off items were positive \$22m (after tax) in 1H16 and represent non-recurring and abnormal income and expense items.

1H16 significant items include a \$40m profit resulting from the sale of Kapstream, partially offset by one-off and non-recurring expenses. One-off expenses include boutique impairment costs (\$12m) following the closure of Metisq and Arête (refer to page 37 for more detail) and one-off expenses (\$3m) related to relocating Challenger's Sydney head office.

Statutory net profit after tax

Statutory net profit after tax includes after tax investment experience and significant one-off items.

Statutory net profit after tax was \$234m in 1H16 up from \$130m in 1H15. The increase in statutory net profit after tax reflects higher normalised net profit after tax (up \$27m), higher investment experience after tax (up \$55m) and significant one-off items (up \$22m after tax) in 1H16.

Dividends

Interim dividend

A dividend in respect of 1H16 of 16.0 cents per share (100% franked) has been declared, and is up 10% on 1H15. The normalised payout ratio for the 1H16 dividend was 49% and is within Challenger's dividend payout ratio guidance of between 45% and 50% of normalised profit after tax.

The 1H16 dividend dates are as follows:

- Ex-date: 29 February 2016;
- Record date: 2 March 2016;
- Final DRP election date: 3 March 2016; and
- Payment date: 29 March 2016.

Challenger's franking account balance at 31 December 2015 was \$51m.

Dividend Reinvestment Plan

With the return to full dividend franking, the Challenger Limited Board established a Dividend Reinvestment Plan (DRP) for the final FY15 dividend (paid during 1H16). The DRP provides an effective way for shareholders to reinvest their dividends and increase their Challenger shareholding without incurring any transaction costs.

The DRP participation rate for the final FY15 dividend was 7% of issued capital, with 0.9m new Challenger shares issued (at prevailing VWAP of \$7.01).

The DRP had the effect of reducing the effective cash dividend payout ratio from 48% (for the final FY15 dividend) to 45%.

For the 1H16 dividend, the Board has determined that new Challenger shares will be issued to fulfil DRP requirements; however shares will not be issued at a discount to the prevailing Challenger share price. Under the DRP terms, shares will be issued to DRP participants as determined by a ten day Challenger share price VWAP.

Credit ratings

In December 2015, Standard & Poor's (S&P) affirmed both Challenger Life Company (CLC) and Challenger Limited's credit ratings.

Ratings were confirmed as:

- CLC: 'A' with a stable outlook; and
- Challenger Limited: 'BBB+' with a stable outlook.

The S&P ratings reflect the financial strength of Challenger Limited and CLC. In particular, the report noted that "Challenger Life has an extremely strong capital and earnings position".

FY16 guidance

Life COE

Life COE guidance for FY16 is a range of \$585m to \$595m (1H16 actual \$293m). The FY16 Life COE guidance reflects growth in Life's annuity book and a lower normalised growth assumption for equities in FY16.

Commencing from 1 July 2015 (FY16), Life's assumed equities normalised growth assumption has been reduced from 6.0% per annum to 4.5% per annum to reflect lower expected returns. This includes both lower global economic growth expectations (i.e. lower equities risk premia) and the nature of Challenger's equities portfolio (refer to page 40 for more detail).

The impact of the lower equities normalised growth assumption has the impact of reducing Life's FY16 COE by approximately \$13m (based on Life's closing FY15 equity investments of \$0.9bn). On a like-for-like basis, the midpoint of the FY16 Life COE guidance range is 11% higher than FY15 actual Life COE.

Dividend policy

Challenger targets a dividend payout ratio in the range of 45% to 50% of normalised profit after tax and aims to frank dividends to the maximum extent possible. Based on current expectations, the Board expects future dividends to be fully franked.

However, the actual dividend payout ratio and franking levels will depend on prevailing market conditions and capital allocation priorities.

Group balance sheet¹

\$m	1H16	FY15	1H15	FY14	1H14
Assets					
Life investment assets					
Fixed income and cash (net)	8,487.6	8,513.7	8,541.1	7,955.7	7,983.2
Property (net)	3,063.2	2,883.7	2,716.4	2,167.8	1,952.0
Equity and other investments	1,060.0	882.8	632.4	400.7	433.1
Infrastructure (net)	536.4	514.4	503.0	563.2	520.9
Life investment assets²	13,147.2	12,794.6	12,392.9	11,087.4	10,889.2
Cash and cash equivalents (Group cash)	89.3	98.6	126.0	141.2	154.8
Receivables	148.5	175.7	217.4	181.9	281.8
Derivative assets	292.6	255.0	356.6	326.3	245.2
Investment in associates	30.2	43.4	39.4	39.4	36.4
Other assets	50.7	27.3	42.6	27.9	49.8
Fixed assets	34.3	8.4	10.9	12.4	12.3
Goodwill and intangibles	585.5	549.4	547.2	545.8	522.1
Less Group/Life eliminations ³	(123.0)	(136.5)	(154.9)	(182.2)	(202.3)
Total assets	14,255.3	13,815.9	13,578.1	12,180.1	11,989.3
Liabilities					
Payables	184.9	180.1	191.0	190.7	191.7
Tax liabilities	182.4	155.3	150.4	165.7	161.2
Derivative liabilities	352.8	370.6	344.5	222.1	327.2
Subordinated debt	576.5	567.0	560.7	525.9	509.5
Challenger Capital notes	337.7	336.8	336.2	–	–
Other interest bearing liabilities	–	1.4	4.0	3.2	103.8
Provisions	21.3	23.8	20.5	22.5	26.1
Life annuity book	8,868.4	8,693.0	8,573.1	7,824.3	7,617.2
Guaranteed index return liabilities	1,035.1	944.7	954.8	1,072.4	1,000.3
Total liabilities	11,559.1	11,272.7	11,135.2	10,026.8	9,937.0
Group net assets	2,696.2	2,543.2	2,442.9	2,153.3	2,052.3
Equity					
Contributed equity	1,576.8	1,527.2	1,524.3	1,237.5	1,263.2
Reserves	(19.7)	23.7	13.8	69.8	52.1
Retained earnings	1,139.1	992.3	904.8	846.0	737.0
Total equity	2,696.2	2,543.2	2,442.9	2,153.3	2,052.3

Change in Group net assets

\$m	1H16	2H15	1H15	2H14	1H14
Opening net assets	2,543.2	2,442.9	2,153.3	2,052.3	1,947.4
Statutory net profit after tax	234.3	168.9	130.1	174.3	166.3
Dividends paid	(87.5)	(81.4)	(71.3)	(65.3)	(55.0)
New share issue	6.3	–	287.2	–	–
Reserve movements	(43.4)	9.9	(56.0)	17.7	2.3
CPP Trust movements	43.3	2.9	(0.4)	(25.7)	(8.7)
Closing net assets	2,696.2	2,543.2	2,442.9	2,153.3	2,052.3

1 Excludes consolidation of Special Purpose Vehicles (SPV's) and non-controlling interests.

2 Detailed Life investment asset disclosures on pages 17 to 26.

3 Group/Life eliminations represent the fair value of the SPV residual income notes (i.e. NIM) held by Challenger Life Company Limited.

Issued share capital

Number of shares (m)	1H16	2H15	1H15	2H14	1H14
Basic share count	562.2	553.4	552.9	510.6	514.1
CPP 'treasury' shares	8.4	16.3	16.8	20.3	16.8
Total issued shares	570.6	569.7	569.7	530.9	530.9
Movement in basic share count					
Opening	553.4	552.9	510.6	514.1	515.6
CPP deferred share purchase	–	–	(4.6)	–	(3.0)
Net treasury shares (acquired)/released	7.9	0.5	8.1	(3.5)	1.5
New share issues	0.9	–	38.8	–	–
Closing	562.2	553.4	552.9	510.6	514.1
Movement in CPP 'treasury' shares					
Opening	16.3	16.8	20.3	16.8	15.3
Shares vested to participants	(9.0)	(0.5)	(13.6)	(0.4)	(3.3)
CPP deferred share purchase	–	–	4.6	–	3.0
Shares bought into CPP Trust	1.1	–	5.5	3.9	1.8
Closing	8.4	16.3	16.8	20.3	16.8

Share capital for EPS calculations

Weighted average number of shares (m)	1H16	2H15	1H15	2H14	1H14
Basic EPS shares					
Total issued shares	570.1	569.7	556.0	530.9	530.9
Less CPP 'treasury' shares	(11.0)	(16.5)	(17.8)	(17.8)	(16.4)
Shares for basic EPS calculation	559.1	553.2	538.2	513.1	514.5
Diluted EPS shares					
Shares for basic EPS calculation	559.1	553.2	538.2	513.1	514.5
Add dilutive impact of equity awards schemes	17.7	18.6	23.0	30.4	25.8
Add dilutive impact of capital notes	41.6	51.2	25.4	–	–
Shares for dilutive EPS calculation	618.4	623.0	586.6	543.5	540.3

Summary of Share Rights

Number (m)	1H16	2H15	1H15	2H14	1H14
Hurdled Performance Share Rights					
Opening	17.3	17.6	26.6	27.0	21.8
New grants	3.4	0.2	2.4	–	6.6
Vesting/forfeiture	(7.7)	(0.5)	(11.4)	(0.4)	(1.4)
Closing	13.0	17.3	17.6	26.6	27.0
Deferred Performance Share Rights					
Opening	3.5	3.6	3.8	3.8	3.3
New grants	2.3	–	2.3	–	2.5
Vesting/forfeiture	(2.0)	(0.1)	(2.5)	–	(2.0)
Closing	3.8	3.5	3.6	3.8	3.8

Issued share capital

Issued share capital and diluted share count

The number of Challenger Limited shares listed on the Australian Securities Exchange (ASX) at 31 December 2015 was 571m shares, and increased by 0.9m shares in 1H16. The increase in shares on issue reflects new shares issued as a result of the September 2015 Dividend Reinvestment Plan (DRP).

The basic share count is used to determine Challenger's normalised and statutory EPS and is based on requirements set out in Australian accounting standards. Under Australian accounting standards:

- the basic share count is reduced for treasury shares;
- the dilutive share count includes unvested equity awards made to employees under the Challenger Performance Plan; and
- the dilutive share count considers convertible instruments (e.g. Challenger Capital Notes), with inclusion in the dilutive share count determined by a probability of vesting test.

In 1H16 the basic share count increased by 9m shares following the release of treasury shares in order to meet Challenger Performance Plan requirements and 0.9m new shares issued under the DRP.

Treasury shares

The Challenger Performance Plan (CPP) Trust was established to purchase shares to satisfy Challenger's employee equity obligations arising from hurdled and non-hurdled equity awards issued under employee remuneration structures. Shares are acquired by the CPP Trust to mitigate shareholder dilution and to provide a mechanism to hedge the cash cost of acquiring shares in the future to satisfy vested equity awards.

The CPP Trust typically acquires physical shares on market or via forward share purchase agreements entered into by Challenger. The use of forward share purchase agreements were implemented in FY13 to increase capital efficiency. Shares held by the CPP Trust are classified as treasury shares.

It is expected that should equity awards vest in the future, the CPP Trust will satisfy equity requirements via a combination of treasury shares and settlement of forward purchase agreements. As such, it is not anticipated that new Challenger shares will be issued to meet future vesting obligations of equity awards.

Unvested equity awards

Hurdled Performance Share Rights (HPSRs)

Challenger's approach to executive remuneration includes providing Long Term Incentive (LTI) awards to ensure alignment between key employees and shareholders. LTI awards are delivered as Hurdled Performance Share Rights (HPSRs), which vest over a period of up to five years and are subject to meeting TSR performance hurdles before vesting.

Deferred Performance Share Rights (DPSRs)

A portion of Short Term Incentive (STI) awards are deferred and vest over a period of up to three years. The deferred STI is delivered as Deferred Performance Share Rights (DPSRs) and vesting is subject to continued employment.

Challenger Capital Notes

In October 2014, Challenger issued Challenger Capital Notes to the value of \$345m, which are subordinated, unsecured convertible notes issued by Challenger Limited.

Under Australian accounting standards convertible debt is considered dilutive whenever the interest per ordinary share obtainable on conversion is less than the basic earnings per share. As such, for Challenger Capital Notes a test is required to be undertaken each reporting period to determine if they are included in the dilutive share count.

At 31 December 2015, Challenger Capital Notes have been considered under Australian accounting standards to be dilutive and are included in Challenger's 31 December 2015 dilutive share count.

Challenger Capital Notes are convertible to ordinary shares at any time before May 2022 on the occurrence of certain events, and mandatorily convertible to ordinary shares thereafter, in both cases subject to meeting certain conditions. However, Challenger also retains the option to redeem or resell Challenger Capital Notes and has an outright option to redeem or resell on 25 May 2020 (both subject to certain conditions being met). If Challenger exercises its option to redeem or resell, there will be no conversion of Challenger Capital Notes to Challenger ordinary shares and subsequent shareholder dilution.

Consolidated operating cash flow

\$m	1H16	2H15	1H15	2H14	1H14
Receipts from customers	281.2	288.8	254.2	259.5	249.0
Dividends received	32.2	43.1	34.0	34.3	26.9
Interest received	344.8	316.3	269.6	279.1	270.2
Interest paid	(223.8)	(225.3)	(213.4)	(203.1)	(203.4)
Payments to suppliers and employees	(256.5)	(206.6)	(207.1)	(180.2)	(197.1)
Income tax paid	(30.5)	(22.0)	(43.7)	(12.0)	(2.2)
Underlying operating cash flow	147.4	194.3	93.6	177.6	143.4
Adjusted for:					
Net annuity policy capital receipts	270.5	177.4	560.8	63.5	539.9
Net other capital (payments)/receipts	78.9	(16.7)	(170.0)	25.3	(770.4)
Other ¹	(29.2)	(7.7)	(15.8)	(5.5)	(26.4)
Operating cash flow per financial report	467.6	347.3	468.6	260.9	(113.5)

Consolidated operating cash flows

Underlying operating cash flows excludes cash flows that are capital in nature such as annuity sales and annuity capital payments.

1H16 underlying operating cash flows were \$147m, up from \$94m in 1H15.

1H16 underlying operating cash flows were \$35m lower than 1H16 normalised profit after tax (\$182m), mainly due to normalised capital growth (\$48m pre-tax which is a non-cash item) and timing differences relating to employee expenses.

Net annuity policy capital receipts

Net annuity policy capital receipts in 1H16 were \$271m and comprise:

- Annuity sales of \$1,641m; less
- Annuity capital payments of \$1,371m.

Annuity capital payments are returns of capital to annuitants and exclude interest payments.

Annuity net book growth can be calculated as annuity net flows (\$270m) divided by the opening period Life annuity book (\$8,693m for 1H16 – refer to page 10). 1H16 annuity net book growth was 3.1%.

Other Life capital payments

1H16 other Life capital receipts of \$79m comprise:

- Other Life sales of \$410m; less
- Other Life capital payments of \$331m.

¹ Other includes net SPV operating cash flow and adjustments for classification differences between statutory operating cash flow and normalised cash operating earnings.

Life financial results

\$m	1H16	2H15	1H15	2H14	1H14
Investment yield - policyholders' funds	382.4	390.2	375.6	365.7	374.5
Interest expense	(206.9)	(209.1)	(204.7)	(197.4)	(199.6)
Distribution expense	(10.2)	(11.5)	(14.0)	(15.0)	(15.2)
Other income ¹	11.6	10.8	9.0	9.9	0.8
Product cash margin	176.9	180.4	165.9	163.2	160.5
Investment yield - shareholders' funds	67.6	59.7	57.4	51.2	50.8
Cash earnings	244.5	240.1	223.3	214.4	211.3
Normalised capital growth	48.4	45.9	34.5	29.7	25.9
Normalised Cash Operating Earnings (COE)	292.9	286.0	257.8	244.1	237.2
Personnel expenses	(26.9)	(25.6)	(25.4)	(24.3)	(21.3)
Other expenses	(17.1)	(19.5)	(16.6)	(16.2)	(15.3)
Total expenses	(44.0)	(45.1)	(42.0)	(40.5)	(36.6)
Normalised EBIT	248.9	240.9	215.8	203.6	200.6
Investment experience	43.0	(14.6)	(35.4)	14.1	4.1
Net profit after investment experience before tax	291.9	226.3	180.4	217.7	204.7
Reconciliation of investment experience to capital growth					
Investment experience	43.0	(14.6)	(35.4)	14.1	4.1
Normalised capital growth	48.4	45.9	34.5	29.7	25.9
Capital growth	91.4	31.3	(0.9)	43.8	30.0
Performance analysis					
Cost to income ratio ²	15.0%	15.8%	16.3%	16.6%	15.4%
Net assets – average ³	2,488	2,385	2,270	2,065	1,908
Normalised ROE (pre-tax)	19.8%	20.4%	18.9%	19.9%	20.9%

1 Other income includes Accurium revenue and Life Risk (premiums net of claims). Refer to page 14 for details.

2 Cost to income calculated as total expenses divided by Normalised Cash Operating Earnings.

3 Net assets - average is calculated based on period opening and closing balances.

Life financial results

\$m	1H16	2H15	1H15	2H14	1H14
Sales					
Fixed Term sales	1,412.4	1,017.6	1,255.6	998.9	1,186.8
Lifetime sales	228.7	160.7	319.2	342.9	270.2
Life annuity sales	1,641.1	1,178.3	1,574.8	1,341.8	1,457.0
Maturities and repayments ¹	(1,370.6)	(1,000.9)	(1,014.0)	(994.6)	(917.1)
Life annuity net flows¹	270.5	177.4	560.8	347.2	539.9
Life annuity book	8,868.4	8,692.6	8,573.1	7,824.3	7,617.2
Life annuity net book growth¹	3.1%	2.2%	7.2%	4.9%	7.6%
Other Life sales	409.7	395.1	548.9	291.5	290.1
Other maturities and repayments	(333.1)	(360.0)	(671.3)	(250.5)	(1,042.1)
Other Life net flows	76.6	35.1	(122.4)	41.0	(752.0)
Assets					
Closing investment assets	13,147	12,795	12,393	11,087	10,889
Fixed income and cash ²	8,409	8,575	8,234	7,911	7,964
Property	3,120	2,906	2,385	2,036	1,870
Equity and other investments	928	742	511	423	371
Infrastructure	545	518	512	533	504
Average investment assets³	13,002	12,741	11,642	10,903	10,709
Liabilities					
Closing liabilities - annuities, GIR, capital notes and sub debt	10,825	10,550	10,436	9,425	9,127
Average liabilities – annuities and GIR	9,786	9,706	9,107	8,617	8,623
Average liabilities – capital notes	345	345	148	–	–
Average liabilities – sub debt	584	582	543	525	509
Average liabilities³	10,715	10,633	9,798	9,142	9,132
Margins⁴					
Investment yield – policyholders' funds	5.9%	6.2%	6.4%	6.8%	7.0%
Interest expenses	(3.2%)	(3.3%)	(3.5%)	(3.7%)	(3.7%)
Distribution expense	(0.2%)	(0.2%)	(0.3%)	(0.3%)	(0.3%)
Other income	0.2%	0.2%	0.2%	0.2%	–
Product cash margin	2.7%	2.9%	2.8%	3.0%	3.0%
Investment yield – shareholders' funds	1.0%	0.9%	1.0%	1.0%	0.9%
Cash earnings	3.7%	3.8%	3.8%	4.0%	3.9%
Normalised capital growth	0.8%	0.7%	0.6%	0.5%	0.5%
Normalised Cash Operating Earnings (COE)	4.5%	4.5%	4.4%	4.5%	4.4%

1 2H14 maturities and repayments, Life annuity net flows and annuity net book growth excludes maturity of the High Yield Fund annuity (\$284m).

2 Includes NIM (1H16: \$123m, 1H15: \$168m, 1H14: \$212m).

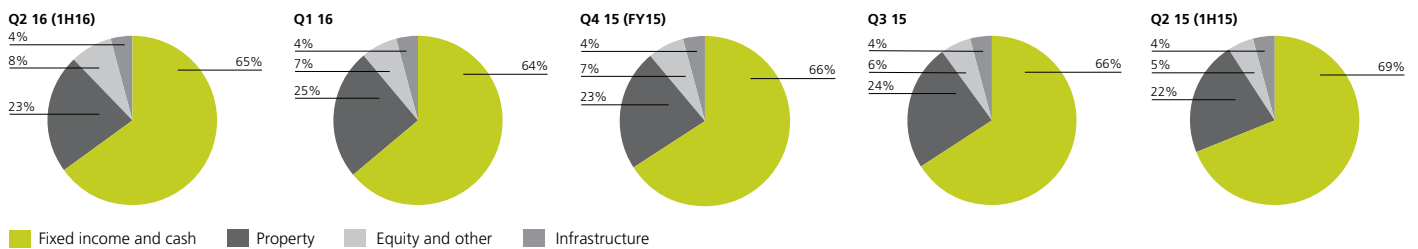
3 Average investment assets and average liabilities are calculated on a monthly basis.

4 Ratio of Normalised Cash Operating Earnings components divided by average investment assets.

Quarterly Life sales and investment assets

Life sales	Q2 16	Q1 16	Q4 15	Q3 15	Q2 15
Fixed Term	801	611	652	365	727
Lifetime (including Care)	133	96	81	80	158
Total annuity sales	934	707	733	445	885
Other Life sales	233	177	–	395	451
Total Life sales	1,167	884	733	840	1,336
Life					
Fixed income and cash ¹	8,488	8,336	8,514	8,514	8,541
Property ¹	3,063	3,218	2,884	3,046	2,717
Equity and other	1,060	909	883	736	632
Infrastructure ¹	536	558	514	527	503
Total Life investment assets	13,147	13,021	12,795	12,823	12,393
Average Life investment assets²	13,047	12,962	12,857	12,647	12,001

Life asset allocation



Life financial results

Challenger Life Company (CLC) is Australia's leading provider of annuities and guaranteed retirement income products. Products appeal to investors seeking the security and certainty of guaranteed cash flows with protection against market, inflation and longevity risks.

Products are distributed via financial advisers, both independent and part of the major hubs. Being an independent product manufacturer, CLC's products are included on all major hubs.

CLC has won the Association of Financial Advisers/Plan for Life 'Annuity Provider of the Year' for the past seven years.

The Life business also includes Accurium, Australia's leading provider of Self Managed Superannuation Fund (SMSF) actuarial certificates and has been repositioned by Challenger as an SMSF retirement specialist (refer to page 14 for additional detail).

CLC diversifies its capital and earnings base by participating in wholesale reinsurance longevity and mortality transactions

(Life Risk). Life is experienced in managing, pricing and reinsuring longevity risk. Refer to page 14 for additional details on Life Risk.

CLC is an APRA regulated entity and its financial strength is rated by Standard & Poor's with an 'A' rating and stable outlook. CLC is strongly capitalised with significant excess capital above APRA's minimum requirements. CLC's regulatory capital base and excess capital above prescribed capital amount are disclosed on page 27.

Normalised EBIT and ROE

1H16 normalised EBIT increased by \$33m (15%) on 1H15 to \$249m due to an increase in normalised cash operating earnings (up \$35m), partly offset by higher expenses (up \$2m).

1H16 Life ROE (pre-tax) was 19.8% and was 90 bps higher than in 1H15, driven by higher Life EBIT.

Challenger targets an 18% (pre-tax) ROE and expects to continue to meet this target over the medium term.

¹ Fixed income, property and infrastructure reported net of debt.

² Average Life investment assets calculated on a monthly basis.

Normalised Cash Operating Earnings (COE) and COE margin

1H16 normalised COE increased by 14% to \$293m. The increase in normalised COE is a result of higher average AUM (up 12%), and an increase in Life's COE margin.

Life's 1H16 COE margin was 4.5% and is up 0.1% on 1H15.

The 1H16 Life COE margin includes the following:

- Product cash margin of 2.7% which was down 0.1% on 1H15 due to lower asset returns partially offset by lower annuity funding rates and distribution expense. Product cash margin includes a contribution from Accurium and Life Risk of 0.2% (1H15 0.2%);
- Return on shareholder funds of 1.0% which is unchanged on 1H15. Lower investment returns were offset by higher shareholder capital. Shareholder capital is not hedged for interest rate movements; and
- Normalised capital growth of 0.8% which was up 0.2% on 1H15. The increase reflects a higher proportion of Life's investment portfolio invested in property and equities. The property and equity allocation of average investment assets was 31% in 1H16, up from 25% in 1H15.

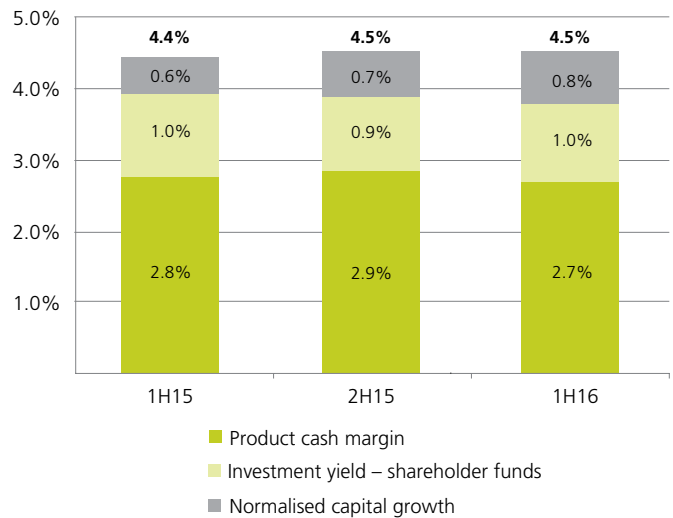
1H16 normalised COE includes other income of \$12m, which increased from \$9m in 1H15. Other income includes Accurium revenue of \$5m (1H15 \$5m) and Life Risk (premiums net of expected claims on wholesale reinsurance longevity and mortality transactions) of \$7m (1H15 \$4m).

Life's COE margin of 4.5% was unchanged from 2H15, with movements in Life's COE margin including;

- lower product cash margin (down 0.2%);
- higher shareholder return (up 0.1%); and
- higher normalised capital growth (up 0.1%).

Life's COE margin has been in the range of 4.4% and 4.5% for the last seven consecutive half years.

Life COE margin composition



Expenses

1H16 total expenses were \$44m, up \$2m (5%) on 1H15. Life expenses increased as a result of an increase in employee numbers in order to support Life's distribution initiatives, including annuities on platform.

Despite the increase in expenses on 1H15, the cost to income ratio fell by 130 bps to 15.0% in 1H16.

1 RBA aggregated measures of Australian corporate bond spreads and yields.

2 1H15 included Care Annuity sales of \$100m and 1H16 included CarePlus sales of \$14m.

Investment experience overview

Challenger Life is required by Australian accounting standards to value investment assets and liabilities supporting the Life business at fair value. This gives rise to fluctuating valuation movements on investment assets and liabilities being recognised in the profit and loss. Challenger is generally a long term holder of assets, due to them being held to match the term of life contract liabilities. As a result, Challenger takes a long term view of the expected capital growth of the portfolio rather than focusing on short term movements.

Investment experience represents the difference between actual investment gains/losses (both realised and unrealised) and expected gains/losses based on Challenger's long term expected returns. Refer to page 40 for details on Challenger's assumed long term expected returns by asset class.

Investment experience also includes any impact of changes in economic variables and assumptions, including changes in discount rates, used to value Life's liabilities (refer to page 41 for more detail).

1H16 investment experience was a \$43m (pre-tax) profit, comprising an \$81m loss on Life's investment assets and a \$124m gain from changes in Life's annuity liabilities due to changes in economic variables and assumptions.

Asset investment experience

The 1H16 loss on Life's investment assets (\$81m) was primarily due to:

- losses on the fixed income portfolio (\$65m) as a result of expansion in domestic and offshore credit spreads. For example A-rated 3 year credit spreads increased by 65 bps in 1H16¹. As Challenger is generally a hold to maturity investor, any revaluation of Challenger's fixed income investments are expected to reverse over time;
- losses on the equity portfolio (\$53m) as a result of equity market volatility; and
- partially offset by strong property valuation gains, including properties disposed of as part of Life's property portfolio remix. In 1H16 a total of \$430m of property was sold, at an average premium to book value of 13%. In addition, the value of Life's property portfolio increased by 2% (excluding write-off of property transaction costs) during 1H16.

Annuity valuation investment experience

Investment experience includes the impact of changes in macroeconomic variables on the valuation of Challenger Life's policy liabilities. Economic and actuarial assumption changes include changes to bond yields and inflation factors, expense assumptions, losses on new business and other factors.

In accordance with Prudential Standards (LAGIC) and Australian Accounting Standards, Challenger Life values term annuities at fair value and lifetime annuities using a risk-free discount rate, both of which are based on the Australian Commonwealth Government bond curve plus an illiquidity premium.

Movements in credit spreads impact the fair value of assets as well as the illiquidity premium which forms part of the discount rate for policy liabilities.

The illiquidity premium that is included for policy liabilities is calculated in accordance with APRA's prudential standard LPS 112 Capital Adequacy: Measurement of Capital, AASB 1038 Life Insurance Contracts and AASB 139 Financial Instruments: Recognition and Measurement.

1H16 investment experience

Asset class (\$m)	Actual capital growth	Normalised capital growth	Investment experience
Fixed income	(80)	(15)	(65)
Property	76	31	45
Infrastructure	3	11	(8)
Equity and other	(32)	21	(53)
Asset investment experience	(33)	48	(81)
Annuity valuation experience	124	–	124
Total investment experience	91	48	43

Sales and AUM

1H16 Life annuity sales were \$1.6bn, and increased by 4% on 1H15. Term annuity sales increased by 12% on 1H15 and lifetime annuity sales fell by 28%.

Lifetime annuity sales were \$229m in 1H16, down from \$319m in 1H15. Lifetime annuity sales represented 14% of total 1H16 annuity sales, down from 20% in 1H15. The reduction in lifetime annuity sales reflects the discontinuation of the Care Annuity, in November 2014.

Excluding Care product sales, lifetime annuities sales in 1H16 were broadly inline with 1H15 and total Life annuity sales were 10% higher than 1H15.

The Care Annuity was discontinued in November 2014 following the Department of Social Services decision to reconsider how the Care Annuity would be treated for social security purposes. In order to reduce uncertainty for customers, Challenger discontinued the Care Annuity and launched a replacement aged care product (CarePlus) in August 2015.

During 1H16 Challenger was focused on getting the CarePlus product on the Approved Products Lists (APLs) of the major hubs. With the APLs now secured, 2H16 will see a focus on the CarePlus product education process for advisers. CarePlus

¹ RBA aggregated measures of Australian corporate bond spreads and yields.

sales were \$14m in 1H16 and they are expected to grow significantly in Q3 16 as CarePlus was ultimately approved for sale by all major hubs in December 2015 and January 2016.

Annuity sales benefit from favourable demographic trends, including an ageing population and retirees taking a more conservative approach to retirement investing. These favourable demographic trends are being leveraged by Challenger's product innovation and extensive distribution footprint, including new initiatives to add Challenger annuities to leading platforms.

Annuity sales also benefit from strong reinvestment rates for term annuities with a residual capital value of 50% or more. Approximately 80% was reinvested in 1H16, which is consistent with long term trends.

1H16 Life annuity net flows (i.e. annuity sales less capital repayments) were \$270m, down from \$561m in 1H15. Based on the closing 2H15 Life annuity book (\$8,693m), annuity net book growth in 1H16 was 3.1%. Annuity net book growth was also impacted by the discontinuation of the Care Annuity. The Care Annuity added 1.3% to annuity net book growth in 1H15, however was a 0.3% drag in 1H16 due to maturities and capital repayments on the Care Annuity.

1H16 average tenor of new business sales was 5.6 years, and was down from 6.6 in 1H15. The reduction in average tenor is due to lower lifetime annuity sales, including the discontinuation of the Care Annuity resulting in a greater proportion of term annuity sales.

1H16 other Life sales of \$410m represent sales of Challenger's Guaranteed Index Return (GIR) product.

Life's 1H16 average investment assets (AUM) were \$13.0bn, and increased by 12% (\$1.4bn) on 1H15. The increase in average investment assets is due to Life earnings (net of dividends to Group), annuity net flows and growth in the Guaranteed Index Return product and positive currency impacts.

Accurium

Accurium is Australia's leading provider of Self Managed Superannuation Fund (SMSF) actuarial certificates. An actuarial certificate is required by a SMSF when one (or more) members are in the retirement phase of superannuation and one (or more) are in the savings phase of superannuation. Accurium has approximately 60% share of the SMSF actuarial certificate market.

Accurium's vision is to become Australia's SMSF retirement specialist and leverage existing relationships with SMSF practitioners to increase the level of engagement and education for SMSF retirement solutions.

In FY15, Accurium launched a SMSF Retirement Healthcheck in order to help build an understanding of the sustainability of retirement spending and retirement issues, including life expectancy, market performance and inflation. The Healthcheck has been rolled out to Accurium clients with approximately 10,000 Healthchecks undertaken since launch.

Accurium has an ROE above 18% and revenue of \$5m in 1H16, which is included in other income under Life's normalised profit framework.

In early 2H16 Challenger is launching a new SMSF product, the SMSF Cashflow Manager, which is a term annuity branded for the SMSF market. The SMSF Cashflow Manager is aligned with the Accurium Healthcheck to show how SMSF retiree outcomes can be improved using annuities.

Life Risk

1H16 Life COE includes \$7m as a result of Life Risk transactions and represents premiums net of expected claims (1H15 \$4m contribution).

As at 31 December 2015, the present value of future profits arising from Life Risk transactions undertaken was \$244m, representing the present value of expected future cash inflows (premiums) and cash outflows (claims). The present value of expected future cash flows increased by \$64m in 1H16 following the execution of a longevity swap transaction.

The Life Risk portfolio has an average duration of 15 years.

Undertaking wholesale longevity and mortality transactions is a natural business extension for Life. Life is participating in established markets, has specialised expertise and is taking a disciplined approach to the wholesale Life Risk opportunity.

Life balance sheet

\$m	1H16	FY15	1H15	FY14	1H14
Assets					
Life investment assets					
Cash and equivalents	1,631.9	728.4	1,307.3	1,243.7	1,331.5
Asset Backed Securities	3,951.8	4,238.7	4,082.1	3,477.2	3,425.4
Corporate credit	2,811.2	3,444.7	3,024.3	3,146.1	3,075.3
Other	92.7	101.9	127.4	88.7	151.0
Fixed income and cash (net)	8,487.6	8,513.7	8,541.1	7,955.7	7,983.2
Australian – Office	1,385.2	1,359.0	1,138.2	805.5	657.6
Australian – Retail	986.1	818.0	721.6	480.3	437.4
Australian – Industrial	98.6	96.7	162.8	165.1	134.6
Japanese	203.6	225.1	204.3	203.4	233.9
REITS and other	389.7	384.9	489.5	513.5	488.5
Property (net)	3,063.2	2,883.7	2,716.4	2,167.8	1,952.0
Equity and other investments	1,060.0	882.8	632.4	400.7	433.1
Infrastructure (net)	536.4	514.4	503.0	563.2	520.9
Life investment assets	13,147.2	12,794.6	12,392.9	11,087.4	10,889.2
Other assets (including intangibles)	460.1	456.4	601.4	659.1	490.4
Total assets	13,607.3	13,251.0	12,994.3	11,746.5	11,379.6
Life annuity book	8,868.4	8,693.0	8,573.1	7,824.3	7,617.2
Guaranteed Index Return (GIR) liabilities	1,035.1	944.7	954.8	1,072.4	1,000.3
Subordinated debt	576.5	567.0	560.7	525.9	509.5
Challenger Capital Notes	345.0	345.0	345.0	–	–
Other liabilities	215.2	292.3	199.8	144.8	301.2
Total liabilities	11,040.2	10,842.0	10,633.4	9,567.4	9,428.2
Net assets	2,567.1	2,409.0	2,360.9	2,179.1	1,951.4

Challenger Life Company (CLC) debt facilities

\$m	1H16	FY15	1H15	FY14	1H14
Controlled property debt	652.9	566.1	679.2	721.4	823.1
Subordinated debt	576.5	567.0	560.7	525.9	509.5
Repurchase agreements	1,875.1	1,267.3	1,163.3	978.3	729.2
Infrastructure debt	206.0	206.0	205.0	206.1	206.1
Other finance	19.5	1.4	3.3	3.2	103.8
Total CLC debt facilities	3,330.0	2,607.8	2,611.5	2,434.9	2,371.7

Life balance sheet

Life maintains a high quality investment portfolio in order to generate cash flows to meet future annuity cash flow obligations.

Life investment assets

Life's investment asset allocation reflects both the relative value of different asset classes and the tenor of annuity sales as Life maintains a cash flow matched portfolio.

Life's investment assets at 31 December 2015 comprises:

- Fixed income and cash 65%;
- Property 23%;
- Equities and other investments 8%; and
- Infrastructure 4%.

Life investment portfolio overview



Detailed disclosure on Life's investment assets is included on pages 17 to 26.

CLC debt facilities

CLC debt facilities includes debt which is non-recourse to the Challenger Group and is secured against assets held in investment vehicles by CLC, including direct properties and infrastructure investments. CLC debt facilities increased by \$722m during 1H16, as a result of an increase in property debt and an increase in repurchase agreements used to hedge for interest rate movements.

Repurchase agreements

CLC enters into repurchase agreements whereby fixed income securities are sold for cash whilst simultaneously agreeing to repurchase the fixed income security at a fixed price and fixed date in the future. The use of repurchase agreements is part of Challenger's strategy to hedge interest rate movements.

CLC uses Australian Commonwealth Government Bonds (ACGBs) and repurchase agreements, interest rate swaps and bond futures to hedge for movements in interest rates on its asset portfolio, annuity policy liabilities and Guaranteed Index Return mandates. During 1H16 swap spreads, being the difference in yield between interest rate swaps and government bonds, fell approximately 20bps to historical lows. As a result, bonds provided a more cost effective hedge than using swaps and so CLC's holding in ACGBs increased by \$1.1bn in 1H16.

Derivatives such as interest rate swaps and bond futures are self-financing, whereas the use of bonds requires the use of repurchase agreement financing. As a consequence, outstanding repurchase agreements as at 31 December 2015 increased by \$0.6bn to \$1.9bn.

Life investment portfolio overview

Life's asset allocation reflects both the relative value of different asset classes and the tenor of annuity sales as Life maintains a cash flow matched portfolio.

Life's investment assets at 31 December 2015 comprised:

- Fixed income and cash 65%;
- Property 23%;
- Equities and other investments 8%; and
- Infrastructure 4%.

Fixed income portfolio overview

Life's fixed income and cash portfolio was \$8.5bn (net of debt) at 31 December 2015, representing 65% of Life's total investment assets down from 66% at 30 June 2015.

Challenger manages credit risk by maintaining a high quality investment portfolio and applying a rigorous investment process. The fixed income portfolio is diversified across different industries, rating bands, asset classes and geographies.

Life's liabilities and cash flows are long term in nature and contracted. This provides the opportunity to invest in long dated and illiquid fixed income investments, allowing life to earn an illiquidity premium on the fixed income investment.

The fixed income portfolio comprises over 1,100 different securities with 79% of the fixed income portfolio investment grade (i.e. BBB or higher), up from 76% at 30 June 2015.

A total of 87% of the fixed income portfolio is externally rated (Standard & Poor's, Fitch or Moody's) and 13% is based on internal ratings calibrated to the Standard & Poor's or Moody's ratings framework and determined in accordance with APRA prudential standards.

The fixed income and cash portfolio is Australian focused, with domestic cash, domestic asset backed securities and domestic corporate credit accounting for 73% of the portfolio.

Approximately 30% of Life's fixed income portfolio represents fixed income investments that have been originated by Challenger. Direct fixed income origination includes senior secured loans, asset backed securities and commercial real estate lending. Life's direct origination capability has been in place for over ten years and provides opportunities to capture relative value including illiquidity premiums as Life is generally a hold-to-maturity investor.

Credit defaults

The credit default allowance recognised in the profit and loss in 1H16 was -\$5m or -6 bps (FY15 -\$24m or -26 bps), which is well below the normalised growth assumption of 35 bps per annum. The overall fixed income portfolio is highly diversified and continues to generate high quality cash flows.

Detailed disclosure of Life's fixed income portfolio is included on pages 17 to 26. The fixed income disclosures include the following tables:

1. Table 1 - fixed income portfolio overview
2. Table 2 - fixed income portfolio credit quality
3. Table 3 - fixed income portfolio by rating type
4. Table 4 - fixed income portfolio by industry sector
5. Table 5 - fixed income portfolio by geography and credit rating

Table 1: Fixed income portfolio overview

31 December 2015		% portfolio	
Liquids		19%	Includes cash and equivalents and Government Bonds.
	RMBS	21%	Residential mortgage backed securities (RMBS). RMBS expertise developed when Challenger was Australia's largest non-bank securitiser of RMBS (via Mortgage Management business sold in 2009). Also includes NIM notes.
Asset Backed Securities (ABS)			
	Other ABS	10%	Financing secured against underlying assets. Asset security includes motor vehicle, equipment and consumer finance.
	Senior Secured Bank Loans	10%	Senior debt secured by collateral and typically originated by Challenger.
	Aviation Finance	4%	Secured commercial aircraft financing.
	CMBS	3%	Commercial Mortgage Backed Securities (CMBS).
Corporate Credit			
	Banks & Financials	11%	Corporate loans to banks, insurance companies and fund managers.
	Infrastructure	8%	Long dated inflation linked bonds issued by PPP projects and loans to infrastructure companies.
	Non-Financial Corporates	7%	Traded commercial loans to industrials and retailers.
	Commercial Real Estate	7%	Loans secured against commercial real estate assets and typically originated by Challenger.
Total		100%	

Table 2: Fixed income portfolio credit quality

31 December 2015 (\$m)	Investment grade						Non-investment grade			Total
	Liquids	AAA	AA	A	BBB	Total	BB	B or lower	Total	\$m
Liquids										
Government Bonds	901	–	–	–	–	901	–	–	–	901
Cash & equivalents	731	–	–	–	–	731	–	–	–	731
Asset Backed Securities (ABS)										
RMBS	–	700	362	209	230	1,501	85	236	321	1,822
Other ABS	–	98	70	161	107	436	280	171	451	887
Senior Secured Loans	–	271	22	151	265	709	103	44	147	856
Aviation Finance	–	–	–	19	85	104	49	93	142	246
CMBS	–	9	–	27	44	80	133	21	154	234
Corporate credit										
Banks & Financials	–	–	58	370	482	910	–	–	–	910
Infrastructure	–	8	151	103	382	644	51	22	73	717
Non-financial Corporates	–	–	–	79	173	252	242	113	355	607
Commercial Real Estate	–	28	18	152	244	442	118	17	135	577
Total	1,632	1,114	681	1,271	2,012	6,710	1,061	717	1,778	8,488
Fixed income portfolio %	19%	13%	8%	15%	24%	79%	13%	8%	21%	100%
Average duration (years)	0.0	2.4	3.7	2.9	3.7	–	3.8	3.7	–	–

31 December 2015 (%)	Investment grade						Non-investment grade			Total
	Liquids	AAA	AA	A	BBB	Total	BB	B or lower	Total	%
Liquids										
Government Bonds	100%	–	–	–	–	100%	–	–	–	100%
Cash & equivalents	100%	–	–	–	–	100%	–	–	–	100%
Asset Backed Securities (ABS)										
RMBS	–	38%	20%	11%	13%	82%	5%	13%	18%	100%
Other ABS	–	11%	8%	18%	12%	49%	32%	19%	51%	100%
Senior Secured Loans	–	32%	3%	18%	30%	83%	12%	5%	17%	100%
Aviation Finance	–	–	–	8%	34%	42%	20%	38%	58%	100%
CMBS	–	4%	–	12%	18%	34%	57%	9%	66%	100%
Corporate credit										
Banks & Financials	–	–	6%	41%	53%	100%	–	–	–	100%
Infrastructure	–	1%	21%	14%	54%	90%	7%	3%	10%	100%
Non-Financial Corporates	–	–	–	13%	29%	42%	40%	18%	58%	100%
Commercial Real Estate	–	5%	3%	26%	43%	77%	20%	3%	23%	100%
Total	19%	13%	8%	15%	24%	79%	13%	8%	21%	100%

Table 3: Fixed income portfolio by rating type

31 December 2015 (\$m)	Investment grade					Total	Non-investment grade			Total \$m
	Liquids	AAA	AA	A	BBB		BB	B or lower	Total	
Liquids										
Externally rated	1,632	-	-	-	-	1,632	-	-	-	1,632
Internally rated	-	-	-	-	-	-	-	-	-	-
Asset Backed Securities (ABS)										
Externally rated	-	929	424	462	362	2,177	191	200	391	2,568
Internally rated	-	149	30	105	369	653	460	364	824	1,477
Corporate credit										
Externally rated	-	36	227	682	1,052	1,997	29	22	51	2,048
Internally rated	-	-	-	22	229	251	381	131	512	763
Total	1,632	1,114	681	1,271	2,012	6,710	1,061	717	1,778	8,488
Externally rated	100%	87%	96%	90%	70%	87%	21%	31%	25%	74%
Internally rated	-	13%	4%	10%	30%	13%	79%	69%	75%	26%

31 December 2015 (%)	Investment grade					Total	Non-investment grade			Total %
	Liquids	AAA	AA	A	BBB		BB	B or lower	Total	
Liquids										
Externally rated	100%	-	-	-	-	100%	-	-	-	100%
Internally rated	-	-	-	-	-	-	-	-	-	-
Asset Backed Securities (ABS)										
Externally rated	-	36%	17%	18%	14%	85%	7%	8%	15%	100%
Internally rated	-	10%	2%	7%	25%	44%	31%	25%	56%	100%
Corporate credit										
Externally rated	-	2%	11%	33%	52%	98%	1%	1%	2%	100%
Internally rated	-	-	-	3%	30%	33%	50%	17%	67%	100%

Table 4: Fixed income portfolio by industry sector

31 December 2015 (\$m)	Investment grade						Non-investment grade			Total
	Liquids	AAA	AA	A	BBB	Total	BB	B or lower	Total	\$m
Industrials and Consumers	–	263	108	256	555	1,182	597	389	986	2,168
Residential property	–	714	334	257	240	1,545	86	252	338	1,883
Banks, Financials & Insurance	731	3	70	479	489	1,772	49	21	70	1,842
Government	901	–	–	–	–	901	–	–	–	901
Commercial Property	–	37	18	130	289	474	250	26	276	750
Infrastructure & Utilities	–	8	151	103	382	644	51	22	73	717
Other	–	89	–	46	57	192	28	7	35	227
Total	1,632	1,114	681	1,271	2,012	6,710	1,061	717	1,778	8,488

31 December 2015 (%)	Investment grade						Non-investment grade			Total
	Liquids	AAA	AA	A	BBB	Total	BB	B or lower	Total	%
Industrials and Consumers	–	12%	5%	12%	26%	55%	28%	17%	45%	100%
Residential property	–	38%	18%	14%	12%	82%	5%	13%	18%	100%
Banks, Financials & Insurance	40%	–	4%	26%	26%	96%	3%	1%	4%	100%
Government	100%	–	–	–	–	100%	–	–	–	100%
Commercial Property	–	5%	2%	17%	39%	63%	33%	4%	37%	100%
Infrastructure & Utilities	–	1%	21%	14%	54%	90%	7%	3%	10%	100%
Other	–	39%	–	20%	26%	85%	12%	3%	15%	100%
Total	19%	13%	8%	15%	24%	79%	13%	8%	21%	100%

Table 5: Fixed income portfolio by geography and credit rating

31 December 2015 (\$m)	Investment grade						Non-investment grade			Total
	Liquids	AAA	AA	A	BBB	Total	BB	B or lower	Total	\$m
Australia	1,553	734	522	865	1,299	4,973	761	417	1,178	6,151
United States	13	121	29	159	331	653	116	113	229	882
Rest of World	18	213	49	149	135	564	62	89	151	715
Europe	47	46	33	63	223	412	82	57	139	551
New Zealand	1	–	48	35	24	108	40	41	81	189
Total	1,632	1,114	681	1,271	2,012	6,710	1,061	717	1,778	8,488

31 December 2015 (%)	Investment grade						Non-investment grade			Total
	Liquids	AAA	AA	A	BBB	Total	BB	B or lower	Total	%
Australia	25%	12%	8%	14%	22%	81%	12%	7%	19%	100%
United States	1%	14%	3%	18%	38%	74%	13%	13%	26%	100%
Rest of World	3%	30%	7%	21%	18%	79%	9%	12%	21%	100%
Europe	9%	8%	6%	11%	41%	75%	15%	10%	25%	100%
New Zealand	1%	–	25%	19%	12%	57%	21%	22%	43%	100%
Total	19%	13%	8%	15%	24%	79%	13%	8%	21%	100%

Property portfolio overview

Life's property portfolio of \$3.1bn (net of debt) at 31 December 2015 represented 23% of total of Life's total investment assets, consistent with the 30 June 2015 allocation.

Life's property portfolio increased by \$0.4bn (net of debt) since 1H15 as a result of domestic commercial office and retail shopping centre acquisitions, partially offset by property disposals as part of Life's ongoing property portfolio remix.

Life's property portfolio principally comprises directly held properties and investments in Australian REITs. The Australian property portfolio is diversified across office and retail properties, with a small (3%) exposure to industrial properties.

Property includes a net \$204m exposure to Japanese property (7% of the property portfolio), consisting of suburban shopping centres, focused on non-discretionary retailing.

Rental income is diversified across sectors and tenants, with 49% (by forecasted 2016 gross rental income) of tenants classified as investment grade (i.e. rated BBB or higher). The Australian Government is a major tenant, leasing a range of commercial office buildings and is expected to account for approximately 31% of FY16 gross rental income.

Life is currently undertaking a property portfolio remix to ensure the portfolio delivers the required cash flows to match Life's annuity liabilities and remains a high quality and diversified portfolio. As part of Life's property portfolio remix, a number of properties have been sold during 1H16. All properties sold were at or above book value, and on average represented a 13% premium to book value.

Property acquisitions incur stamp duty and acquisition costs. Under Australian accounting standards, property acquisition and transaction costs are required to initially be capitalised. When the property is subsequently revalued, there is generally no value ascribed to the acquisition costs which may result in a reduction in the property valuation and corresponding negative investment experience.

In 1H16, all properties acquired in 2H15 were subject to either an independent valuation or a directors' valuation, with \$22m of transaction costs (including stamp duty) offset against property valuation gains.

1H16 property acquisition costs, including stamp duty of \$25m, will be offset against property revaluations in 2H16.

Challenger Life has a policy that all properties are independently valued each year with approximately 50% valued in June and 50% valued in December. Internal valuations are also undertaken for properties not independently valued each June and December.

An independent valuation is subsequently undertaken if the internal valuation shows a significant variance to the most recent independent valuation.

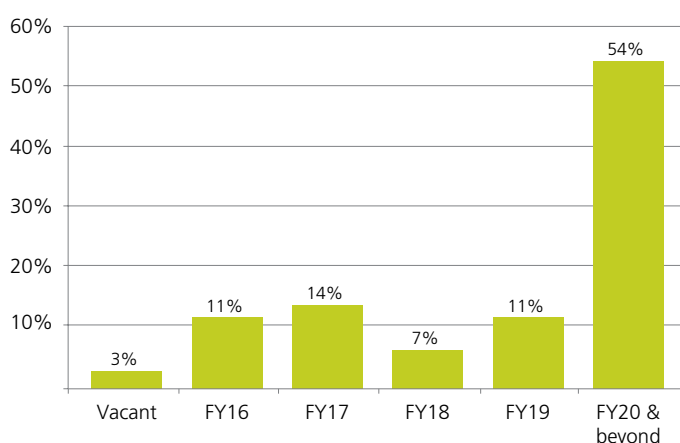
Independent valuations were undertaken for 49% of Life's direct property portfolio in 1H16. On average the portfolio increased by 2% in 1H16 (excluding properties that were disposed of) and exceeded Life's normalised growth assumption of 2% per annum.

Full details of all Life's property portfolio are listed on pages 24 and 25.

Property portfolio summary

% of total portfolio	1H16	FY15
Australian office	45%	47%
Australian retail	32%	28%
Australian industrial	3%	3%
Australian REITs	9%	9%
Australian total	89%	87%
Japanese retail	7%	8%
Other (including offshore)	4%	5%
Total	100%	100%

Portfolio lease expiry overview



The property portfolio generates long term cash flows in order to match long term liabilities. Approximately 54% of contracted leases expire in FY20 and beyond demonstrating the long term nature of property cash flows.

Direct property portfolio overview¹

31 December 2015		Office	Retail	Industrial	Total
Total rent (%) ²		50%	44%	6%	100%
WALE		4.0	5.4	3.0	4.5
Tenant credit ratings					
	AAA	23%	0%	0%	23%
	AA	7%	1%	0%	8%
	A	1%	3%	1%	5%
	BBB	2%	10%	1%	13%
	BB	10%	21%	1%	32%
	B or below	2%	2%	1%	5%
	Not rated	3%	6%	2%	11%
	Vacant	2%	1%	0%	3%
	Total	50%	44%	6%	100%
% of total gross rent	Government tenant	31%	0%	0%	31%
	Investment grade	33%	14%	2%	49%
	Non-investment grade	12%	23%	2%	37%

1. Direct property portfolio and jointly held assets only and excludes Australian REITS and development assets.

2. Includes vacant floors/suites available for lease.

Direct property investments

31 December 2015	Acquisition date ¹	Total cost \$m ²	Carrying value \$m	Cap rate 1H16 % ³	Last external valuation date
Australia					
Office					
31 Queen Street, VIC	31-Mar-11	94.0	111.5	6.75	31-Dec-15
35 Clarence Street, NSW	15-Jan-15	144.9	143.5	6.75	31-Dec-15
53 Albert Street, QLD	12-Dec-14	222.3	215.6	6.63	30-Jun-15
215 Adelaide Street, QLD	31-Jul-15	238.0	237.8	7.00	–
565 Bourke Street, VIC	28-Jan-15	85.9	84.5	6.75	31-Dec-15
ABS Building, ACT	01-Jan-00	120.1	126.2	7.75	30-Jun-15
County Court, VIC	30-Jun-00	211.0	287.5	6.50	31-Dec-15
DIBP (formerly DIAC) Building, ACT	01-Dec-01	103.2	121.1	7.75	30-Jun-15
Discovery House, ACT	28-Apr-98	87.4	103.0	7.75	31-Dec-15
Elder House, SA	21-Jun-02	47.9	26.3	9.25	30-Jun-15
Executive Building, TAS	30-Mar-01	30.2	37.8	7.75	31-Dec-15
Makerston House, QLD	14-Dec-00	66.6	65.0	8.50	31-Dec-15
Retail					
Bunbury Forum, WA	03-Oct-13	151.8	151.5	6.75	30-Jun-15
Century City Walk, VIC	16-Oct-06	30.0	40.3	7.50	30-Jun-15
Channel Court, TAS	21-Aug-15	79.7	79.8	8.00	–
Golden Grove, SA	31-Jul-14	138.8	137.2	6.75	30-Jun-15
Innaloo Cinema, WA	17-Dec-01	32.1	45.6	7.25	30-Jun-15
Karratha, WA	28-Jun-13	52.0	59.5	7.00	30-Jun-15
Kings Langley, NSW	29-Jul-01	15.9	19.9	7.25	30-Jun-15
Lennox, NSW	27-Jul-13	27.0	30.2	7.00	30-Jun-15
Next Hotel, QLD	25-Mar-15	142.0	136.0	6.85	31-Dec-15
North Rocks, NSW	18-Sep-15	135.2	135.2	7.00	–
Industrial					
12-30 Toll Drive, Altona North, VIC	31-Dec-08	13.9	13.7	7.50	31-Dec-15
1-9 Toll Drive, Altona North, VIC	31-Dec-08	3.3	4.0	7.50	31-Dec-15
2-10 Toll Drive, Altona North, VIC	31-Dec-08	6.3	7.1	7.00	31-Dec-15
6 Foray Street, Fairfield, NSW	31-Dec-08	17.9	12.5	9.50	31-Dec-15
Cosgrave Industrial Park, Enfield, NSW	31-Dec-08	56.9	67.0	6.75	30-Jun-15
Spotlight, Laverton North, VIC	31-Dec-08	16.2	20.1	7.25	31-Dec-15
Mixed use					
The Barracks, QLD	31-Oct-14	153.1	149.0	7.50	30-Jun-15
Total Australia		2,523.6	2,668.4		

1 Acquisition date represents the date of CLC's initial acquisition or consolidation of the investment vehicle holding the asset.

2 Total cost represents the original acquisition cost plus capex.

3 The capitalisation rate is derived by dividing property income over carrying value of an investment property.

Direct property investments

31 December 2015		Acquisition date ¹	Total cost \$m ²	Carrying value \$m	Cap rate 1H16 % ³	Last external valuation date
Japan						
Retail						
	Aeon Kushiro	31-Jan-10	27.8	28.6	5.60	30-Jun-15
	Carino Chitosedai	31-Jan-10	118.3	111.3	4.90	31-Dec-15
	Carino Tokiwadai	31-Jan-10	77.0	72.7	4.90	30-Jun-15
	DeoDeo Kure	31-Jan-10	31.4	27.9	5.90	30-Jun-15
	Fitta Natalie Hatsukaichi	28-Aug-15	11.4	12.6	6.00	31-Dec-15
	Izumiya Hakubaicho	31-Jan-10	68.8	64.9	5.10	31-Dec-15
	Kansai Super Saigo	31-Jan-10	13.1	12.1	5.60	30-Jun-15
	Kojima Nishiarai	31-Jan-10	12.0	11.1	5.00	30-Jun-15
	Life Asakusa	31-Jan-10	27.8	28.6	4.80	30-Jun-15
	Life Higashinakano	31-Jan-10	32.8	32.6	4.80	31-Dec-15
	Life Nagata	31-Jan-10	25.2	24.5	5.10	30-Jun-15
	MaxValu Tarumi	28-Aug-15	16.9	17.6	5.80	31-Dec-15
	Seiyu Miyagino	31-Jan-10	9.7	9.4	5.80	30-Jun-15
	Valor Takinomizu	31-Jan-10	26.8	23.0	6.10	31-Dec-15
	Valor Toda	31-Jan-10	42.5	39.0	5.80	30-Jun-15
	Yaoko Sakato Chiyoda	31-Jan-10	18.2	16.6	5.10	31-Dec-15
Total Japan			559.7	532.5		
Europe						
Industrial						
	105 Route d'Orleans, Sully sur Loire	31-Dec-08	27.1	10.3	9.75	31-Dec-15
	Gennevilliers, 140 Rue Marcel Paul	31-Dec-08	14.0	10.5	9.50	31-Dec-15
	Parcay-Meslay, ZAC Papillon	31-Dec-08	10.1	7.2	9.25	31-Dec-15
	Rozalia Park	12-Apr-07	80.6	18.5	9.78	31-Dec-15
	Villeneuve les Beziers, Rue Charles Nicolle	31-Dec-08	18.3	13.1	8.50	31-Dec-15
Retail						
	Aulnay sous Bois, Avenue de Savigny	31-Dec-08	20.3	14.8	7.00	31-Dec-15
Total Europe			170.4	74.4		
Total Overseas			730.1	606.9		
Development						
	Gateway	01-Jul-15	33.1	33.1		–
	Enfield	31-Dec-08	21.2	7.7		–
	TRE Data Centre site	14-Apr-10	12.6	12.6		–
	Maitland	06-Dec-06	69.3	53.9		–
Total development			136.2	107.3		
Total direct portfolio investments			3,389.9	3,382.6		

1 Acquisition date represents the date of CLC's initial acquisition or consolidation of the investment vehicle holding the asset.

2 Total cost represents the original acquisition cost plus capex.

3 The capitalisation rate is derived by dividing property income over carrying value of an investment property.

Equity and other portfolio overview

Life's equity and other portfolio was \$1.1bn representing 8% of Life's investment assets, up from 7% at 30 June 2015.

Equity and alternatives portfolio

31 December 2015 (\$m)	Domestic	Offshore	Total
Listed beta ¹	38.6	329.6	368.2
Unlisted beta ²	69.3	159.0	228.3
Alternatives and others ³	138.2	325.3	463.5
Total	246.1	813.9	1,060.0
Equity %	23%	77%	

Infrastructure portfolio overview

Life's infrastructure portfolio of \$0.5bn (net of debt) represented 4% of Life's investment assets, consistent with 1H15 allocation.

Challenger Life seeks infrastructure assets that generate reliable and consistent cash flows, which are preferably inflation linked, giving rise to sustainable income growth over time. Infrastructure investments comprise directly held infrastructure assets and indirectly held listed and unlisted investments. Approximately 75% of the infrastructure portfolio is unlisted.

The infrastructure portfolio is diversified across a number of geographic regions and sectors. Approximately half the portfolio is invested in logistics and utility assets predominately in Australia and the United Kingdom.

Infrastructure portfolio by sector

31 December 2015	\$m	%
Logistics	117	22
Utilities	132	24
Patronage	102	19
Airport	53	10
Power Generation	27	5
Renewable	105	20
Total	536	100%

Infrastructure portfolio by geography

31 December 2015	\$m	%
United Kingdom	198	37
Europe	21	4
North America	27	5
South America	30	5
Asia	6	1
Australia	254	48
Total	536	100%

1 Listed beta includes investments in long only equities, including ETFs. Returns are expected to be in line with equity market returns.

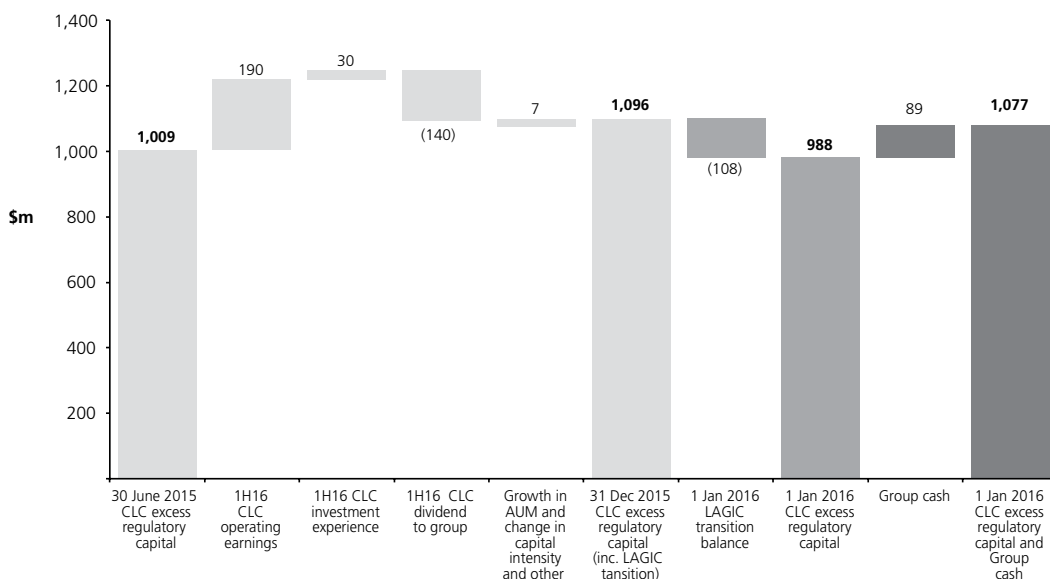
2 Unlisted beta includes investments managed by a range of investment managers. This includes private equity and other unlisted investments. Returns are expected to correlate to equity market returns.

3 Alternatives and others includes a range of investments including private equity. Returns are considered to be uncorrelated to equity markets.

Challenger Life Company (CLC) regulatory capital

\$m	1H16	FY15	1H15	FY14	1H14	
CLC's excess capital under LAGIC						
Common Equity Tier 1 (CET1) regulatory capital	1,951.8	1,907.6	1,886.7	1,783.1	1,719.0	
Additional Tier 1	345.0	345.0	345.0	-	-	
Tier 2 regulatory capital - subordinated debt ¹	477.5	474.0	504.7	476.8	486.8	
CLC total regulatory capital base	2,774.3	2,726.6	2,736.4	2,259.9	2,205.8	
CLC Prescribed Capital Amount (PCA)						
Asset risk charge	1,731.3	1,773.6	1,718.0	1,530.5	1,517.0	
Insurance risk charge	132.7	120.5	143.5	83.9	68.5	
Operational risk charge	22.7	22.6	23.9	22.8	20.6	
Aggregation benefit	(100.4)	(91.9)	(108.5)	(64.7)	(53.2)	
CLC Prescribed capital amount – excluding transition relief	1,786.3	1,824.8	1,776.9	1,572.5	1,552.9	
Transition relief	(107.6)	(107.6)	(215.2)	(215.2)	(322.8)	
CLC prescribed capital amount	1,678.7	1,717.2	1,561.7	1,357.3	1,230.1	
CLC excess over prescribed capital amount	1,095.6	1,009.4	1,174.7	902.6	975.7	
PCA ratio (times)	1.65	1.59	1.75	1.66	1.79	
Tier 1 ratio (times)	1.37	1.31	1.43	1.31	1.40	
CET1 ratio (times)	1.16	1.11	1.21	1.31	1.40	
PCA ratio (times) – 1 January 2016	1.55					
Tier 1 ratio (times) – 1 January 2016	1.29					
CET1 ratio (times) – 1 January 2016	1.09					
Tier 2 regulatory capital – subordinated debt¹						
First call date after 1 Jan 2013	Maturity date	1H16	FY15	1H15	FY14	1H14
7 Jun 2013	7 Dec 2016	67.6	63.5	88.3	77.6	107.2
7 Dec 2016	7 Dec 2026	35.2	33.9	31.0	27.5	28.3
7 Nov 2017	7 Nov 2037	374.7	376.6	385.4	371.7	351.3
		477.5	474.0	504.7	476.8	486.8

Change in CLC excess regulatory capital and Group cash



1 1H16 Tier 2 regulatory capital – subordinated debt (\$478m) differs to the management balance sheet (\$577m) due to inadmissible sub-debt (\$101m) less accrued interest and amortised costs (\$2m).

Challenger Life Company Limited (CLC) regulatory capital

CLC holds capital in order to ensure that under a range of adverse scenarios it can continue to meet its regulatory and contractual obligations to customers. CLC is regulated by the Australian Prudential Regulation Authority (APRA) and is required to hold a minimum level of regulatory capital.

CLC's regulatory capital base and prescribed capital amount have been calculated based on regulatory capital standards. APRA issued new capital standards in October 2012 (LAGIC standards) which became effective from 1 January 2013.

Following the introduction of LAGIC standards, CLC's regulatory capital requirements increased by \$323m. APRA provided a three-year transition period to meet the new requirements, which concluded on 1 January 2016.

CLC excess regulatory capital

CLC's excess capital above APRA's prescribed capital amount at 31 December 2015 (1H16) was \$1.1bn, representing an increase of \$0.1bn for the half year. The increase in excess regulatory capital was mainly due to:

- an increase in regulatory capital as a result of increased retained earnings; and
- a reduction in the Prescribed Capital Amount as a result of a higher quality fixed income portfolio, including a lower proportion of securitised debt investments.

CLC's capital ratios at 31 December 2015 were as follows:

- PCA ratio of 1.65 times (including the final LAGIC transition balance);
- Total Tier 1 ratio of 1.37 times (including the final LAGIC transition balance); and
- Common Equity Tier 1 (CET1) ratio of 1.16 times (including the final LAGIC transition balance).

Following the amortisation of the final LAGIC transition balance (\$108m) on 1 January 2016, CLC's PCA ratio, Total Tier 1 and CET1 ratios were 1.55 times, 1.29 times and 1.09 times respectively.

APRA requires CET1 capital to be at least 60% of the PCA and Total Tier 1 capital to be at least 80% of the PCA.

CLC maintains a target level of capital representing APRA's prescribed capital amount plus a target surplus. The target surplus is a level of excess capital that CLC seeks to carry over and above APRA's minimum requirement.

CLC's target surplus is set to ensure it provides a buffer against adverse market conditions and to ensure sufficient capital is maintained to cover insurance risk. CLC uses internal capital models to determine its target surplus, which are risk-based and responsive to changes in CLC's asset allocation and market conditions.

While CLC does not target a specific PCA ratio, CLC's internal capital models generate a PCA ratio based upon asset allocation and economic circumstances which is currently in the range of 1.4 to 1.6 times. This range may change over time.

Since the introduction of the LAGIC capital framework, CLC has increased AUM by \$3.0bn (up 29%). During the same period, CLC has increased its regulatory capital base by \$0.8bn (up 43%).

Subordinated debt

CLC's total regulatory capital base includes \$478m of admissible subordinated debt. Subordinated debt issued prior to 1 January 2013 (implementation date of new LAGIC capital standards) will continue to be fully eligible as Tier 2 regulatory capital under LAGIC until each tranche's first call date after 1 January 2013, and will then amortise over four years.

CLC's subordinated debt includes \$169m which had a call date on 7 June 2013. As a result, under APRA's transition arrangements, only \$68m (i.e. 40% of the total amount) is included as Tier 2 regulatory capital on 31 December 2015.

The largest tranche of CLC's existing subordinated debt is a \$375m tranche with a call date in November 2017. As such this tranche will continue to be fully eligible as Tier 2 regulatory capital until its call date in November 2017 and will continue to be partially eligible until November 2021.

Group cash

In addition to CLC's excess regulatory capital, Challenger maintains cash at a Group level, which can be utilised to meet regulatory requirements. Group cash at 31 December 2015 (1H16) was \$89m, down \$9m from 30 June 2015 (FY15).

Challenger also maintains an undrawn Group banking facility of \$350m, which is maintained to provide additional financial flexibility. The banking facility was undrawn throughout 1H16.

APRA's Level 3 (conglomerate) proposals

APRA has developed a supervisory framework for Level 3 (conglomerate) groups, which was due to be effective from 1 January 2015. Level 3 are groups of companies that perform material activities across more than one APRA-regulated industry.

In August 2014, APRA deferred a decision in its Level 3 final capital standards and implementation until the Federal Government responded to the Financial System Inquiry recommendations. The Government did so in October 2015, however APRA has made no further comments in relation to implementing Level 3 capital standards.

Based on draft level 3 standards issued by APRA, Challenger does not expect any material impact on its regulatory capital base.

Risk Management Framework

Challenger is exposed to a variety of financial risks, including market risk (currency risk, interest rate risk, equity risk) credit default risk and liquidity risk.

The management of these risks is fundamental to Challenger's business and building long term shareholder value.

The Challenger Limited Board is responsible, in conjunction with senior management, for understanding the risks associated with the business and implementing structures and policies to adequately monitor and manage these risks.

The Board has established the Group Risk Committee (GRC) and Group Audit Committee (GAC) to assist in discharging certain responsibilities. In particular, these committees assist the Board in setting the risk appetite and ensuring Challenger has an effective Risk Management Framework, incorporating management, operational and financial controls.

The Executive Risk Management Committee (ERMC) is an executive committee, chaired by the Chief Risk Officer (CRO), which assists the GRC, GAC and Board in the discharge of their risk management obligations by implementing the Board-approved Risk Management Framework.

The Group's Risk Management division has day-to-day responsibility for monitoring the implementation of the framework with oversight, analysis, monitoring and reporting of risks. The CRO provides regular reporting to the GRC and the Board.

Risk appetite

Challenger's risk appetite requires a range of financial risks, including foreign exchange, interest rate, and inflation risk to be minimised. As a result Challenger takes an active approach to hedging and limits these financial risks.

Challenger's risk appetite statement provides that subject to acceptable returns, Challenger can retain exposure to credit risk, property risk, equity risk and Life insurance risk.

Accept exposure (subject to appropriate returns)	Minimise exposure
✓ Credit risk	✗ Foreign exchange risk
✓ Property risk	✗ Interest rate risk
✓ Equity risk	✗ Inflation risk
✓ Life insurance risk	✗ Liquidity risk
	✗ Licence risk
	✗ Operational risk

Credit default risk

Credit default risk is the risk of loss in value of an asset due to a counterparty failing to discharge an obligation. Challenger's approach to credit management utilises a credit risk framework to ensure that the following principles are adhered to:

- independence from risk originators;
- recognition of the different risks in the various businesses;
- credit exposures are systematically controlled and monitored;
- credit exposures are regularly reviewed in accordance with existing credit procedures; and
- credit exposures include such exposures arising from derivative transactions.

Challenger makes use of external ratings agencies (Standard & Poor's, Fitch, Moody's) to determine credit ratings.

Where a counterparty or debt obligation is rated by multiple external rating agencies, Challenger will use Standard & Poor's ratings where available.

All credit exposures with an external rating are also reviewed internally and cross-referenced to the external rating, if applicable. Where external credit ratings are not available, internal credit ratings are assigned by appropriately qualified and experienced credit personnel who operate separately from the risk originators.

Credit spread risk sensitivity

Challenger is exposed to price movements resulting from credit spread fluctuations through its fixed income securities net of subordinated debt. As at 31 December 2015, a 50 basis point increase/decrease in credit spreads results in an unrealised loss/gain of \$70m (after tax).

Refer to sensitivities on page 32 for more detail.

Property risk

Property risk is the potential impact of movements in the market value of property investments on Challenger's profit and includes leasing risk which may impact the potential cash flow from these investment cash flows.

Challenger holds property as part of its investment portfolio in order to provide diversification across the investment portfolio and to provide longer term cash flows to match longer term annuity liabilities.

Property risk sensitivity

Challenger is exposed to movements in the market value of property investments, both directly held investment properties and property securities.

The direct property sensitivities included on page 32 show the impact of a change in property valuations on balance date and are based on Life's gross direct property investments of \$3.7bn (net investments of \$3.1bn plus debt of \$0.6bn).

The property securities sensitivities show the impact of a change in valuation of listed and unlisted property securities, such as real estate investment trusts.

Property sensitivities do not include the impact of property acquisition costs (e.g. stamp duty) or the impact on Funds Management fee income.

Equity risk

Equity risk is the potential impact of movements in the market value of listed and unlisted equities on Challenger's profit.

Challenger holds equities as part of its investment portfolio in order to provide diversification across the investment portfolio.

Equity risk sensitivity

Challenger is exposed to movements in the market value of listed and non-listed equity investments.

The equity risk sensitivity included on page 32 show the impact of a change in equity valuations on balance date and include both listed and unlisted equities.

Liquidity risk

Liquidity risk is the risk that Challenger will encounter difficulty in raising funds to meet cash commitments associated with financial instruments and contracted payment obligations to annuitants. This may result from either the inability to sell financial assets at face value; a counterparty failing on repayment of a contractual obligation; or the inability to generate cash inflows as anticipated.

Challenger's liquidity policy aims to ensure that it has sufficient liquidity to meet its obligations on a short, medium and long term basis. In setting the level of sufficient liquidity, Challenger considers new business activities in addition to current contracted obligations. In determining the required levels of liquidity, Challenger considers:

- minimum cash requirements;
- collateral and margin call buffers;
- Australian Financial Services (AFS) Licence requirements;
- cash flow forecasts;
- associated reporting requirements;
- other liquidity risks; and
- contingency plans.

Required annuity cash outflows are met from contracted investment cash flows together with assets in Challenger's liquidity pool. As a result, cash flows are well-matched and continue to be rebalanced through time, with Challenger hedging unwanted financial risks.

Life insurance risk

Lifetime annuities provide guaranteed payments to customers for life. Through selling lifetime annuities and assuming wholesale reinsurance agreements, CLC is assuming longevity risk, which is the risk annuitant customers live longer, in aggregate, than expected. This is in contrast to mortality risk, which is the risk that people die earlier than expected. CLC is exposed to mortality risk on the wholesale maturity reinsurance business.

CLC is required under APRA Prudential Standards to maintain regulatory capital in relation to the longevity, mortality and morbidity risks it carries.

CLC manages some of its longevity risk exposure by using reinsurance for closed lifetime annuity portfolios (e.g. AXA portfolio) as well as regularly reviewing the portfolio for longevity experience to ensure longevity assumptions remain appropriate.

Mortality and morbidity rates are based on industry standards which are adjusted for CLC's own recent experience, and include an allowance for future rates of mortality improvement.

CLC assumes that future mortality rates for individual lifetime annuities will improve by between 0% and 4% per annum (depending on different age cohorts). This has the impact of increasing the life expectancy of a male aged 65 from 22 years (per the base mortality rates) to 27 years.

Mortality, morbidity and longevity sensitivities

The mortality sensitivities on page 32 set out the expected impact of an improvement in mortality. This is in addition to the mortality improvements Challenger already assumes. A 50% increase in mortality improvement rates would increase the life expectancy of a male aged 65 from 27 years to 32 years.

Foreign exchange risk

It is Challenger's policy to hedge the exposure of all balance sheet items for movements in foreign exchange rates. Currency exposure arises primarily as a result of Life's investments in Europe, Japan, and the United States. As a result, currency risk arises from fluctuations in the value of the Euro, British Pound, Japanese Yen, and US Dollar against the Australian Dollar.

In order to protect against foreign currency exchange rate movements, Challenger has entered into foreign currency derivatives which limit Challenger's exposure to currency movements.

Foreign exchange sensitivity

The impact of movements in foreign currencies on Challenger's profit and balance sheet are set out on page 32. As a result of foreign currency derivatives in place, Challenger's profit and loss is not materially sensitive to movements in foreign currency rates.

Interest rate risk

Interest rate risk is the risk of fluctuations in Challenger's earnings arising from movements in market interest rates, including changes in the absolute level of interest rates, the shape of the yield curve, the margin between the different yield curves and the volatility of interest rates.

CLC's market risk policy sets out the relevant risk limits for interest rate exposure. It is CLC's policy to minimise the impact of interest rate movements on its projected future cash flows. The management of the risks associated with life investment and life insurance contracts, including interest rate risk, are subject to the prudential requirements of the Life Act and APRA. This includes satisfying capital adequacy requirements, which in turn include consideration of how the interest rate sensitivity of assets and liabilities are matched.

Interest rate sensitivity

The impact of movements in interest rates on Challenger's profit and loss and balance sheet are set out on page 32.

The sensitivities assume the change in variable occurs on 31 December 2015, and are based on assets and liabilities held at that date. It is Challenger's policy to minimise the impact of movements in interest rates via the use of interest rate swaps, Australian Commonwealth Government bonds and bond futures. As a result the interest rate sensitivities on page 32 show Challenger's profit is not materially sensitive to changes in base interest rates.

Profit and equity sensitivities

Profit and equity sensitivities set out the expected impact from changes in a range of economic and investment market variables on Challenger's earnings and balance sheet. These sensitivities represent the after-tax impact, assuming a tax rate of 30%.

The sensitivities are not forward looking and make no allowance for events occurring after 31 December 2015.

If using these sensitivities as forward looking, an allowance for changes post 31 December 2015, such as sales and asset growth, should be made.

These sensitivities assess the risk of changes in economic and investment markets on the valuation of assets, which in turn impact earnings. The earnings impact is included in investment experience and does not take into consideration the impact of any under or over performance of normalised growth assumptions for each asset category. Refer to page 40 for normalised growth assumptions.

These sensitivities do not include the indirect impact on fees for the Funds Management business.

Refer to the Risk Management Framework (pages 29 to 31) for additional detail on how to apply the profit and equity sensitivities.

Profit and equity sensitivities

\$m	Change in variable	Profit/(loss) after tax 1H16	Change in equity 1H16	Profit/(loss) after tax FY15	Change in equity FY15
Credit risk					
Fixed income assets (change in credit spreads)	+50bps	(69.6)	(69.6)	(80.5)	(80.5)
	-50bps	69.6	69.6	80.5	80.5
Property risk					
Direct property	+1%	22.9	22.9	21.2	21.2
	-1%	(22.9)	(22.9)	(21.2)	(21.2)
Australian listed property securities	+10%	13.2	13.2	12.4	12.4
	-10%	(13.2)	(13.2)	(12.4)	(12.4)
Other property securities	+10%	9.0	9.0	8.4	8.4
	-10%	(9.0)	(9.0)	(8.4)	(8.4)
Total		45.1	45.1	42.0	42.0
		(45.1)	(45.1)	(42.0)	(42.0)
Infrastructure and equity risk					
Infrastructure investments	+10%	21.8	21.8	20.3	20.3
	-10%	(21.8)	(21.8)	(20.3)	(20.3)
Equity investments	+10%	74.2	74.2	50.9	50.9
	-10%	(74.2)	(74.2)	(50.9)	(50.9)
Total		96.0	96.0	71.2	71.2
		(96.0)	(96.0)	(71.2)	(71.2)
Life insurance risk					
Mortality, morbidity and longevity¹					
Life insurance contract liabilities	+50%	(40.2)	(40.2)	(37.7)	(37.7)
	-50%	40.2	40.2	37.7	37.7
Interest rate risk					
Change in interest rates	+100bps	3.8	3.8	5.1	5.1
	-100bps	(3.8)	(3.8)	(5.1)	(5.1)
Foreign exchange risk					
British Pound	+10%	(0.5)	(0.5)	0.3	0.3
	-10%	0.5	0.5	(0.3)	(0.3)
US Dollar	+10%	(6.5)	(6.5)	1.9	1.9
	-10%	6.5	6.5	(1.9)	(1.9)
Euro	+10%	0.1	0.1	(0.3)	(0.3)
	-10%	(0.1)	(0.1)	0.3	0.3
Japanese Yen	+10%	–	0.1	–	0.3
	-10%	–	(0.1)	–	(0.3)
Other	+10%	0.1	0.1	(0.2)	(0.2)
	-10%	(0.1)	(0.1)	0.2	0.2

¹ Mortality, morbidity and longevity life insurance contract liabilities sensitivity is net of any reinsurance with third parties.

Life outlook

The Australian retirement incomes market is expected to grow strongly over the next 20 years as Australia's Baby Boomers (born 1946 to 1964) move from retirement 'saving' to retirement 'spending'. Over the next 20 years the number of Australians over 65, which is Life's target demographic, is expected to increase by 75%¹.

Challenger Life is well positioned to benefit from changes in retiree risk preferences, including the focus on longevity risk by retirees and their advisers. Annuities address many of the financial concerns retirees face in retirement.

Challenger is investing in technology to allow its annuities to easily integrate with account-based pensions as there is a growing acceptance that annuities are part of the optimal retirement income solution. Integrating annuities with account-based pensions supports income layering and enables guaranteed incomes to be combined with other products to build more comprehensive retirement income solutions.

During 1H16 Challenger's annuities were launched on the Colonial First State platform, Australia's leading investment platform, providing access to half of Australia's financial adviser firms.

In the industry fund segment, Challenger backed term and lifetime annuities have been integrated with VicSuper account-based pensions to create Australia's first Comprehensive Income Product for Retirement.

Challenger has also formed a strategic alliance with the Link Group/AAS, who service the needs of 10m Australian superannuation members. The AAS alliance will see Challenger annuities available on the AAS platform to their industry fund clients. The AAS technology build is currently underway and it is expected the capability will be available to AAS clients by mid-calendar year 2016. A number of AAS clients have already indicated they will be connecting to Challenger annuities once available via AAS, with other industry funds expected to follow.

These retail and industry platform innovations are providing Challenger with access to one third of Australia's superannuation industry.

The retirement phase of superannuation is a high growth market driven by ageing demographics and rising superannuation balances from mandatory superannuation contributions. Over the past 10 years the annual flow moving from the accumulation phase to the retirement phase has increased by 10% CAGR and is expected to increase by 12%² CAGR over the next 10 years.

There is a growing recognition that retirees need to take a different approach to investing in retirement and there is a move toward income layering investing. As retirees transition from Government funded aged pensions to private pensions, they are demanding safe, secure retirement income products that convert savings to income and provide financial security in retirement. Annuities provide safe, secure retirement incomes.

The industry is responding to consumer demand with a range on new retirement income products, including the emergence of Comprehensive Income Products for Retirement as recommended by the Financial System Inquiry (refer below for additional detail) and retirement income models.

The Australian Federal Government commissioned the Financial System Inquiry (FSI) to provide a 'blueprint' for Australia's financial system over the next decade. The FSI report (released December 2014) recommended the retirement phase of superannuation would benefit greatly from pre-selected retirement products for members. These products would provide regular and stable income streams with longevity protection. Annuities were recognised as providing this and could be part of pre-selected retirement products offered by all superannuation funds.

The FSI also recommended the impediments to longevity product development be removed. This would clear the way for Challenger to develop and issue Deferred Lifetime Annuities, expanding Life's product offering. Deferred Lifetime Annuities are expected to be popular as they provide protection against the risk of running out of money late in life.

The Federal Government responded to the FSI recommendations in October 2015, and supported all major retirement income recommendations, including the implementation of Comprehensive Income Products for Retirement and will consult on legislation by the end of 2016. The Federal Government also supports the recommendation that regulatory barriers to longevity products, including Deferred Lifetime Annuities, be removed.

There are a range of Federal Government reforms underway to enhance the retirement income phase of Australia's superannuation system.

As Australia's leading retirement income specialist, Challenger is uniquely positioned to benefit from growth in Australia's retirement incomes market and the move to more guaranteed retirement incomes. Challenger's growth is being amplified through market-leading distribution, product innovation and strong retirement incomes brand recognition.

¹ Deloitte – Dynamics of the Australian superannuation system: the next 20 years 2015-2035.

² Rice Warner 2014 Super Projections – forecasted growth over next 10 years based on existing regulatory environment.

Funds Management financial results

\$m	1H16	2H15	1H15	2H14	1H14
Fidante Partners					
Fidante Partners income ¹	30.7	16.9	18.7	18.7	15.0
Equity accounted profits ²	10.6	13.3	13.4	15.1	16.1
Net income	41.3	30.2	32.1	33.8	31.1
Challenger Investment Partners					
Net management fees	19.8	16.0	17.2	20.4	19.1
Performance and transaction fees	6.0	15.2	6.8	2.2	3.6
Net income	25.8	31.2	24.0	22.6	22.7
Total net fee income	67.1	61.4	56.1	56.4	53.8
Personnel expenses	(30.9)	(25.4)	(24.8)	(24.4)	(23.4)
Other expenses	(14.6)	(12.7)	(10.5)	(9.4)	(9.7)
Total expenses	(45.5)	(38.1)	(35.3)	(33.8)	(33.1)
EBIT	21.6	23.3	20.8	22.6	20.7
Performance analysis					
Fidante Partners – income margin (bps) ³	20	14	16	20	20
Challenger Investment Partners – income margin (bps) ³	39	47	39	41	40
Cost to income ratio	67.8%	62.1%	62.9%	59.9%	61.5%
Net assets – average ⁴	151.3	121.7	127.1	134.3	131.0
ROE (pre-tax)	28.4%	38.6%	32.5%	33.9%	31.3%
Fidante Partners	41,605.1	44,667.0	42,502.5	35,879.4	33,670.8
Challenger Investment Partners	13,092.9	13,235.4	12,709.4	11,247.1	11,315.0
Closing FUM - total	54,698.0	57,902.4	55,211.9	47,126.5	44,985.8
Fidante Partners	41,710.0	44,381.9	40,493.9	34,850.7	31,550.2
Challenger Investment Partners	13,127.5	13,358.2	12,066.9	11,153.7	11,399.8
Average FUM - total⁵	54,837.5	57,740.1	52,560.8	46,004.4	42,950.0
FUM and net flows analysis					
Fidante Partners ⁶	(3,941.8)	678.3	5,426.1	1,148.1	1,263.6
Challenger Investment Partners	(414.6)	294.4	1,340.1	(114.5)	(149.8)
Net flows	(4,356.4)	972.7	6,766.2	1,033.6	1,113.8
Distributions	(338.0)	(97.2)	(164.5)	(105.9)	(129.0)
Market linked movement	1,490.0	1,815.0	1,483.7	1,213.0	2,897.6
Total FUM movement	(3,204.4)	2,690.5	8,085.4	2,140.7	3,882.4

1 Fidante Partners income includes distribution, administration fees and other income.

2 Equity accounted profits represent Challenger's share of boutiques investment manager pre-tax earnings.

3 Income margin represents net income divided by average FUM.

4 Net assets – average calculated on a monthly basis.

5 Average FUM calculated on a monthly basis.

6 Funds Management 1H16 net flows include -\$5.4bn following the sale of Kapstream in July 2015. Fidante Partners will no longer receive distribution fees on Kapstream institutional FUM (\$5.4bn) and as a result has derecognised this FUM in 1H16. Despite the reduction in FUM, Fidante Partners earnings over the short and medium term is not expected to be negatively impacted following new distribution and administration agreements.

Assets and Funds Under Management and net flows

\$m	Q2 16	Q1 16	Q4 15	Q3 15	Q2 15
Funds Management					
Fidante Partners					
Equities	18,754	17,096	17,323	18,011	16,626
Fixed income ¹	17,305	17,273	23,085	22,952	21,795
Alternatives ¹	5,546	6,141	4,259	4,178	4,082
Total Fidante Partners	41,605	40,510	44,667	45,141	42,503
Challenger Investment Partners					
Fixed income	8,541	8,532	9,231	8,985	8,624
Property	4,552	4,498	4,004	4,609	4,085
Total Challenger Investment Partners	13,093	13,030	13,235	13,594	12,709
Total funds under management	54,698	53,540	57,902	58,735	55,212
Average Fidante Partners	41,071	42,049	45,018	43,936	41,567
Average Challenger Investment Partners	13,029	13,201	13,585	13,191	12,339
Average total funds under management²	54,100	55,250	58,603	57,127	53,906
Analysis of flows					
Funds Management net flows					
Equities	492	766	473	(170)	220
Fixed Income ³	199	(5,050)	240	520	653
Alternatives ⁴	(765)	416	(120)	(265)	4
Total Fidante Partners	(74)	(3,868)	593	85	877
Challenger Investment Partners	131	(545)	(314)	609	609
Net flows	57	(4,413)	279	694	1,486

Reconciliation of Total Group Assets and Funds Under Management

\$m	Q2 16	Q1 16	Q4 15	Q3 15	Q2 15
Funds Management (FUM)	54,698	53,540	57,902	58,735	55,212
Life investment assets	13,147	13,021	12,795	12,823	12,393
Adjustments to remove double counting of cross holdings	(10,228)	(10,466)	(10,908)	(11,128)	(10,436)
Total Assets and Funds Under Management	57,617	56,095	59,789	60,430	57,169

1 In Q1 16 WyeTree Asset Management FUM (\$0.7bn) was reclassified from fixed income to alternatives.

2 Average total funds under management and Life investments calculated on a monthly basis.

3 Funds Management 1H16 net flows include -\$5.4bn following the sale of Kapstream in July 2015. Fidante Partners will no longer receive distribution fees on Kapstream institutional FUM (\$5.4bn) and as a result has derecognised this FUM in 1H16. Despite the reduction in FUM, Fidante Partners earnings over the short and medium term is not expected to be negatively impacted following new distribution and administration agreements.

4 Q1 16 alternatives net flows includes a \$0.5bn inflow following the acquisition of Dexion Capital.

Funds Management financial results

Challenger's Funds Management business is Australia's eighth largest investment manager and largest fixed income manager¹.

Over the last five years Funds Under Management (FUM) has increased by approximately 150%. The business is benefiting from a clear business strategy, which is focused on investor alignment.

Fidante Partner's multi-boutique platform comprises separately branded, investment management businesses. The model aligns the interests of investors, boutique investment managers and Fidante Partners. In 1H16 Fidante Partners expanded its presence in Europe where it already held interests in UK-based alternative asset managers through the acquisition of Dexion Capital (refer to page 37 for more detail).

Challenger Investment Partners (CIP) manages fixed income and property under the Challenger brand for the Life Company and for third party institutional investors.

EBIT and ROE

Funds Management EBIT was \$22m and increased by \$1m (4%) on 1H15. Higher total net fee income (up \$11m) was offset by higher expenses (up \$10m), with both the 1H16 net fee income and expense base including Dexion Capital following its acquisition in July 2015.

1H16 Funds Management ROE was 28.4%, a decrease of 410 bps on 1H15, as a result of higher net assets, including capital allocated to fund the acquisition of Dexion Capital.

Total net fee income

1H16 total net fee income increased by \$11m (20%) due to higher Fidante Partners net fee income (up \$9m) and higher Challenger Investment Partners net income (up \$2m).

Fidante Partners net fee income includes distribution fees, administration fees and a share in the equity accounted profits of boutique investment managers. Fidante Partners' net income also includes a share of performance fees earned by boutique investment managers.

1H16 Fidante Partners net income was \$41m, up 29% (\$9m) on 1H15. Distribution and administration fees increased by \$12m (including Dexion Capital), however were offset by lower equity accounted profits (down \$3m) due to no equity accounted profit contribution from Kapstream in 1H16 following the sale of Fidante Partner's equity interest in July 2015.

Fidante Partners net income of \$41m includes \$4m in relation to performance fees, which was unchanged from 1H15.

Fidante Partners income margin (net income to average FUM) was 20 bps, up 4 bps from 1H15. The increase in net income

margin is primarily due to \$5.4bn of institutional Kapstream FUM being derecognised following the sale of Kapstream in July 2015 and income from Dexion Capital.

Challenger Investment Partners net income increased by \$2m (7%) in 1H16, with higher net management fees (up \$3m) partially offset by lower performance and transaction fees (down \$1m).

Challenger Investment Partners management fees increased as a result of new third party property mandate clients.

Performance and transaction fees fell by \$1m, with lower fixed income fees offset by higher property performance and transaction fees.

Challenger Investment Partners 1H16 income margin (net income to average FUM) was 39 bps which was unchanged from 1H15. The income margin benefited from higher net management fees, offset by lower performance and transaction fees.

Expenses

1H16 total expenses were \$46m, representing an increase of \$10m (29%) on 1H15. The \$10m increase in expenses in 1H16 predominately relates to the operating expenses of Dexion Capital, with personnel costs increasing by \$6m and other expenses by \$4m.

The 1H16 cost to income ratio was 67.8%, up from 62.9% in 1H15, with higher net fee income offset by higher expenses.

FUM

Total Funds Under Management (FUM) at 31 December 2015 was \$54.7bn and decreased by 6% in 1H16.

FUM decreased in 1H16 due to:

- derecognising Kapstream institutional FUM (\$5.4bn – refer to page 37 for more detail) following the sale of Fidante Partner's equity interest in Kapstream to Janus Capital in July 2015; and
- was partially offset by \$0.5bn of FUM included following the acquisition of Dexion Capital in 1H16.

Fidante Partners FUM and net flows

Fidante Partners 1H16 FUM was \$41.6bn, down \$0.9bn (2%) on 1H15. Excluding the impact of the Kapstream sale and Dexion Capital acquisition, Fidante Partners FUM increased by 4% in 1H16.

Fidante Partners net outflows were \$3.9bn, and include an outflow following the sale of Kapstream (-\$5.4bn) and an inflow following the Dexion Capital acquisition (+\$0.5bn). Excluding these one-off net flows from business acquisitions and disposals, Fidante Partners organic net flows were \$1.0bn in 1H16.

¹ Consolidated FUM for Australian fund managers – Rainmaker Roundup September 2015.

Fidante Partners achieved strong organic net flows in equity (\$1.3bn) and fixed income (\$0.6bn) products, partially offset by alternative outflows (\$0.9bn). The alternative outflows reflect a number of asset sales on behalf of Whitehelm Capital clients, with clients realising profits on the sale of the underlying assets.

Approximately 42% of Fidante Partner's 1H16 FUM is invested in fixed income, 45% in equity products and 13% in alternatives (e.g. infrastructure) products.

Fidante Partner's investment performance

The investment performance across the range of Fidante Partner boutiques has remained very strong, with 93% of FUM exceeding benchmark over a 5 year period. Over 1 year, 71% of FUM exceeded benchmark and over 3 years 93% of FUM exceeded benchmark.

Challenger Investment Partners FUM and net flows

Challenger Investment Partners 1H16 FUM was \$13.1bn, which was down \$0.1bn (1%) for 1H16. The reduction in FUM was driven by a reduction in Life's fixed income mandate (down \$0.9bn), partially offset by positive third party client inflows in both property and fixed income, and positive investment returns. Life reduced its CIP fixed income mandate managed by Challenger Investment Partners.

Approximately 65% of Challenger Investment Partners 1H16 FUM is invested in fixed income and approximately 35% of FUM is invested in property. Third party clients account for 27% of Challenger Investment Partner's FUM.

Sale of Kapstream and new distribution agreements

In early July 2015, Fidante Partners sold its 25% equity interest in global fixed income boutique investment manager, Kapstream to US-based Janus Capital Group Inc. (Janus) for \$45m. Fidante Partners also entered into new distribution and administration agreements with both Kapstream and Janus.

Challenger recognised a \$40m pre-tax profit on sale which is disclosed as a significant item in 1H16.

Kapstream FUM at 30 June 2015 was \$9.2bn and comprised retail FUM of \$3.8bn and institutional FUM of \$5.4bn. Following the sale of Kapstream, Fidante Partners will continue to receive administration and distribution fees on retail FUM (\$3.8bn), however will not receive distribution fees on institutional FUM (\$5.4bn). As a result, on 1 July 2015, Fidante Partners derecognised institutional FUM of \$5.4bn. Despite the reduction in FUM, Fidante Partners earnings over the short and medium term are not expected to be negatively impacted following the introduction of new distribution and administration agreements.

Boutique impairments

In 1H16 the decision was made to exit both the Arete and Metisq boutique funds management businesses. This decision was made as they lacked sufficient scale, with low levels of FUM and made an immaterial contribution to Funds Management earnings. The closure of both Arete and Metisq resulted in a \$12m impairment cost (after tax) in 1H16 significant items.

Dexion Capital

In July 2015 Fidante Partners acquired 100% of Dexion Capital Holdings Limited, a European alternative investments group comprising interests in three specialist fund managers, as well as an investments distribution business. Dexion Capital employs approximately 40 staff, predominately based in London.

The strategic acquisition substantially expands Fidante Partners' presence in Europe where it already holds interests in UK-based alternative asset managers Whitehelm Capital (global infrastructure) and WyeTree Asset Management (asset-backed securities). The acquisition also provided Fidante Partners with established distribution to UK and European alternative asset focused investors.

The acquisition completed in July 2015 for an agreed fixed payment of ~\$45m to Dexion Capital's shareholders. The final acquisition price is dependent on profitability over a period of up to six years, under earn-out arrangements with key Dexion Capital executives.

Since the acquisition of Dexion Capital completed in July 2015, Fidante Partners has:

- substantially integrated the business and combined London offices;
- prepared the business to be rebranded Fidante reflecting the need to unite Fidante Partners people across the business as part of one brand and culture;
- updated the European boutique sourcing strategy to ensure boutiques meet the demand from European alternatives investors; and
- achieved positive boutique net flows in 1H16 with further commitments received.

With the Dexion Capital business being integrated in 1H16, it made an immaterial contribution to Funds Management EBIT for the period.

The Dexion Capital acquisition is expected to meet Challenger's 18% pre-tax return on equity target over the medium term.

Funds Management outlook

The Australian funds management market remains an attractive market underpinned by mandated superannuation contributions. Contributions increased to 9.5% of gross salaries on 1 July 2014 and are scheduled to increase to 12% by 2025. The mandated nature of Australia's superannuation system is expected to significantly grow the size of Australia's superannuation assets from \$2 trillion to \$10 trillion¹ over the next 20 years.

Fidante Partners continues to identify new investment manager talent and is adding capacity to existing managers as well as expanding its platform in Europe. The platform has a variety of managers across Australian equities, international equities, fixed income and alternatives.

The acquisition and integration of Dexion Capital has substantially expanded Fidante Partners' successful multi-boutique model into the European market, whilst opening up global distribution opportunities for existing boutique investment managers.

Challenger Investment Partners continues to build out its client base and product offering. There are opportunities to add new mandates from domestic and international institutions, superannuation funds and sovereign wealth funds, in order to grow its third party fiduciary business.

Challenger's Funds Management business is well positioned to benefit from growth in Australia's superannuation system. The Funds Management platform has multiple brands and strategies with scalable platforms in Australia and Europe. Coupled with Challenger's distribution capability, institutional strength, administration platform and strong boutique investment manager performance, the Funds Management business is well positioned to continue to increase returns to shareholders.

¹ Deloitte – Dynamics of the Australian superannuation system: the next 20 years 2015-2035.

Corporate financial results

\$m	1H16	2H15	1H15	2H14	1H14
Other income	0.6	0.6	0.7	0.6	1.2
Personnel expenses	(18.0)	(18.5)	(18.3)	(17.7)	(16.6)
Other expenses	(6.4)	(5.5)	(4.6)	(5.6)	(4.8)
Total expenses (excluding LTI)	(24.4)	(24.0)	(22.9)	(23.3)	(21.4)
Long term incentives (LTI) ¹	(8.0)	(8.8)	(8.0)	(8.4)	(8.3)
Total expenses	(32.4)	(32.8)	(30.9)	(31.7)	(29.7)
Normalised EBIT	(31.8)	(32.2)	(30.2)	(31.1)	(28.5)
Interest and borrowing costs	(2.3)	(2.1)	(1.7)	(1.9)	(2.2)
Normalised profit/(loss) before tax	(34.1)	(34.3)	(31.9)	(33.0)	(30.7)

Corporate financial results

The Corporate division comprises central functions such as group executives, finance, treasury, legal, human resources, risk management and strategy.

Corporate also includes interest received on Group cash balances and any interest and borrowing costs associated with Group debt facilities.

Normalised profit/(loss) before tax

1H16 Corporate normalised loss before tax was \$34m and increased by \$2m (7%) compared to 1H15 as a result of higher total expenses (up \$2m).

Other income

Other income includes interest received on Group cash balances and was unchanged from 1H15.

Total expenses

1H16 total expenses were \$32m, up \$2m on 1H15. The increase in expenses is due to higher other expenses (up \$2m) in 1H16.

Long term incentive costs relate to the non-cash amortisation of equity grants and were unchanged from 1H15.

Interest and borrowing costs

1H16 interest and borrowing costs were \$2m and were unchanged from 1H15.

The Group debt facility was undrawn during 1H16, with interest and borrowing costs reflecting debt facility fees.

The Group maintains a banking facility in order to provide additional financial flexibility.

¹ Corporate financial results include all of the Group's long term incentives provided under the Challenger Performance Plan and Long Term Incentive Plan. Short term incentives under the Employee Incentive Plan are accounted for within each operating division's personnel expenses.

Normalised profit framework

Life normalised cash operating earnings

Normalised cash operating earnings is Challenger's preferred profitability measure for the Life business, as it aims to reflect the underlying performance trends of the Life business.

The Life normalised cash operating earnings framework was introduced in June 2008 and has been applied consistently

since. The framework removes the impact of market and economic variables, which are generally non-cash and a result of external market factors. The normalised profit framework is subject to a review performed by Ernst & Young each half year.

Life normalised cash operating earnings includes cash earnings plus normalised capital growth, but excludes investment experience (refer below).

Cash earnings	<p>Cash earnings represents investment yield, less interest expenses and distribution expenses.</p> <p>Investment yield Represents the investment return on assets held to match annuities and the return on shareholder investment assets. Investment yield includes net rental income, dividends received, infrastructure distributions, accrued interest on fixed income and cash, and discounts/premiums on fixed income assets amortised on a straight line basis.</p> <p>Interest expense Represents interest accrued at contracted rates to annuitants and Life subordinated debt holders and other debt holders.</p> <p>Distribution expenses Represents payments made for the acquisition and management of Life products, including annuities and commissions to third party mortgage brokers on term funded residential mortgage assets (NIM).</p> <p>Other income Other income includes revenue from Accurium and profits on Life Risk wholesale longevity and mortality transactions (refer to page 14).</p>
Normalised capital growth	<p>Normalised capital growth represents the expected capital growth for each asset class through the investment cycle and is based on Challenger's long term expected investment returns for each asset class.</p> <p>Normalised capital growth can be determined by multiplying the normalised capital growth assumption (see below) by each asset class average balance for the period (net of debt).</p> <p>Normalised capital growth assumptions for 1H16 are as follows:</p> <ul style="list-style-type: none"> • Fixed income and cash – negative 0.35% representing an allowance for credit defaults; • Property – 2.00%; • Infrastructure – 4.00%; and • Equity and alternative asset classes – 4.50% (reduced from 6.00% in FY15). <p>Normalised capital growth assumptions have been set with reference to long term market growth rates and are reviewed regularly to ensure consistency with prevailing medium to long term market conditions.</p> <p>From 1 July 2015 (FY16), the assumed equities normalised growth assumption reduced from 6.0% per annum to 4.5% per annum to reflect lower expected returns. This includes both lower global economic growth expectations (i.e. lower equities risk premia) and the nature of Challenger's equities portfolios, which consists of both listed and unlisted equities.</p>

Normalised profit framework

Investment experience

Challenger Life is required by accounting standards and prudential standards to value all assets and liabilities supporting the Life business at fair value. This gives rise to fluctuating valuation movements on assets and liabilities being recognised in the profit and loss, particularly during periods of market volatility. As Challenger is generally a long-term holder of assets, due to them being held to match the term of life liabilities, Challenger takes a long term view of the expected capital growth of the portfolio rather than focusing on short term movements.

Investment experience is a mechanism employed to remove the volatility arising from asset and liability valuation movements from Life business earnings so as to more accurately reflect the underlying performance of the Life business.

The asset and liability valuation movements are reported as investment experience. These movements are generally non-cash, and by separating them from the Life business result, Life's reported earnings more closely represent the cash earnings of the business.

Impact from economic variables

Investment experience also includes the impact of changes in macroeconomic variables on the valuation of Life's assets and liabilities. Economic and actuarial assumption changes include changes to bond yields and inflation factors, expense assumptions, losses on new business and other factors applied in the valuation of life contract liabilities.

Investment experience is calculated as the difference between actual investment gains/losses (both realised and unrealised) and the normalised capital growth plus any economic and actuarial assumption changes for the period.

Glossary of terms

Terms	Definitions
Additional Tier 1 regulatory capital	High quality capital that provides a permanent and unrestricted commitment and is freely available to absorb losses.
Cash earnings (Life)	Investment yield and other income less interest and distribution expenses.
CET1 ratio	Common Equity Tier 1 regulatory capital divided by prescribed capital amount.
Common equity tier 1 regulatory capital	The highest quality capital comprising items such as paid-up ordinary shares and retained earnings. Common equity tier 1 capital is subject to certain regulatory adjustments including in respect of intangibles and adjusting policy liabilities.
Earnings per share	Net profit after tax divided by weighted average number of shares in the period.
Equity accounted profits (FM)	Challenger's share of Fidante Partners boutique investment manager pre-tax profits.
Distribution expenses (Life)	Payments made for the acquisition and management of annuities and other Life products.
Fidante Partners income (FM)	Distribution and administration fees and other income from boutique investment managers.
Funds under management (FUM)	Total value of listed and unlisted funds/mandates managed by the Funds Management business.
Group cash	Cash available to Group excluding cash held by Challenger Life Company Ltd.
Interest and borrowing costs (Corporate)	Interest and borrowing costs associated with group debt and group debt facilities.
Interest expenses (Life)	Interest accrued and paid to annuitants, subordinated debt note holders and other debt providers.
Investment experience (Life)	The difference between actual investment gains/losses (both unrealised and realised) and the normalised capital growth plus any economic and actuarial assumption changes for the period.
Investment yield (Life)	Net rental income, dividends received and accrued interest and discounts/premiums on fixed income securities amortised on a straight line basis.
Investment yield – shareholder funds (Life)	Represents the return on shareholder capital held by the Life business.
Life investment assets	Total value of investment assets that are managed by the Life business.
Life net book growth	Life net annuity policy capital receipts over the period divided by the opening Life annuity book.
Life net annuity policy receipts	Life retail annuity sales less annuity capital payments.
Net assets – average (Group)	Average net assets over the period (excluding non-controlling interests) calculated on a monthly basis.
Net fee income (FM)	Fidante Partners income, equity accounted profits (FM) and Challenger Investment Partners net management fees and performance and transaction fees.
Net management fees (FM)	Management fees for managing investments.
Net tangible assets	Consolidated net assets less goodwill and intangibles.
Net Interest Margin (NIM)	Net interest margin on term funded prime mortgages and included as part of Life's investment assets.
Normalised capital growth	Long term expected capital growth based on long term return assumptions calculated as long term capital growth assumption multiplied by average investment assets.
Normalised Cash Operating Earnings (NCOE) (Life)	Cash earnings plus normalised capital growth.

Glossary of terms

Terms	Definitions
Normalised cost to income ratio	Total expenses divided by total net income.
Normalised dividend payout ratio	Dividend per share divided by normalised earnings per share (basic).
Normalised EBIT (Life)	Normalised cash operating earnings less total Life expenses.
Normalised EBIT (FM)	Net income less total FM expenses.
Normalised effective tax rate	Normalised tax divided by normalised profit before tax.
Normalised Return on Equity (ROE) – pre-tax	Normalised Life EBIT, FM EBIT or Normalised NPBT (Group) divided by average net assets.
Normalised Return on Equity (ROE) – post-tax	Group's normalised NPAT divided by average net assets.
Other expenses	Non-employee expenses, including external professional services, occupancy costs, marketing and advertising, travel, technology and communications costs.
Other income (Corporate)	Includes interest received on Group cash balances.
Other income (Life)	Relates to Accurium revenue and Life Risk. Refer to page 14 for more detail.
Performance and transaction fees (FM)	Fees earned for outperforming benchmarks and fees earned for the origination, disposal and restructuring of assets.
Personnel expenses	Includes fixed and short term variable incentive components of remuneration structures. The amortisation of long term incentive plans is reported separately within the Corporate results.
PCA ratio	The ratio of the total CLC tier 1 and tier 2 regulatory capital base divided by the prescribed capital amount.
Prescribed capital amount (PCA)	Amount of capital that a life company must hold which is intended to be sufficient to withstand a 1 in 200 year shock and still meet adjusted policy liabilities and other liabilities. For further details refer to APRA's LPS110 Capital Adequacy.
Product cash margin (Life)	Represents the return on assets backing annuities and other income, less interest and distribution expenses.
Significant items	Non-recurring or abnormal income or expense items.
Statutory Return on Equity (ROE) – post-tax	Statutory NPAT divided by average net assets.
Tier 1 regulatory capital	Tier 1 regulatory capital comprises common equity tier 1 regulatory capital and additional tier 1 regulatory capital.
Tier 2 regulatory capital	Tier 2 Capital is capital that contributes to the overall strength of a life company and its capacity to absorb losses but does not satisfy all the criteria to be included as Tier 1 regulatory capital.
Total expenses	Personnel expenses plus other expenses.
Total net income	Normalised Cash Operating Earnings (Life) plus net fee income (FM) plus other income (Corporate).

