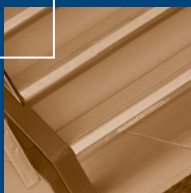


3 | Investments

- > Investment management
- > Events during the year
- > Fund performance
- > Performance by asset class
- > Crediting and exit rate policy



Investment management

Investment structure

The Board has divided the Fund into asset classes and appointed professional fund managers to invest those assets. In most cases, the funds allocated to an asset class are managed by a number of specialist managers.

Investment arrangements

The investment team (see appendix B) provides investment advice to the Board, implements Board investment decisions, and monitors, reviews and reports on investment performance to the Board.

The Board also uses JANA Investment Advisers Pty Ltd as its principal external investment advisor and retains Macquarie Investment Management Ltd to provide advice on Australian private equity and Pinnacle for property advice.

Custodian services

The Fund's master custodian is JPMorgan, whose custodial function in relation to investment management includes:

- settling trades
- physical custody and safekeeping of securities
- collecting dividends, preparing accounts and disbursing dividends
- receiving all monies available for investment from the scheme administrator and allocating them on the instruction of the investment team to investment managers in accordance with the mandates set down by the Board
- holding (but not owning) the assets that comprise the Fund
- maintaining consolidated accounts and tax records for the Fund; and
- reporting to the Board on individual fund manager and aggregated investment returns.

Investment managers

All investment managers are paid a fee that is generally based on the value of assets under their control. The fee reflects the investment costs applicable to each particular sector and the investment style (i.e. index tracking or active) employed by each manager. In addition, some managers are paid a performance incentive, which is generally a share of any excess performance above an agreed benchmark.

Table 7: Default Fund investment managers at 30 June 2006

INVESTMENT MANAGER
452 Capital Pty Limited
AMP Capital Investors Limited
AMP Life Limited
AXA Rosenberg Investment Management Ltd
Balanced Equity Management Pty Ltd
Barclays Global Investors Australia Limited
BlackRock Financial Management
Brandywine Asset Management LLC
Bridgewater Associates, Inc
Colonial First State Investments Limited
Concord Capital Limited
Eureka Funds Management Company
Fiducary Trust Company International
GMO Australia Limited
Harris Alternatives LLC
Lend Lease Real Estate Investments Limited
Loomis Sayles & Company LLC
Macquarie Investment Management Limited
Marathon Asset Management Limited
Marvin & Palmer Associates Inc
Mesirow Advanced Strategies Inc
MIR Investment Management Limited
Mondrian Investment Partners Limited
Orbis Investment Management Limited
Perpetual Investments
Platinum Asset Management
Rexiter Capital Management Limited
State Street Global Advisors Limited
Suncorp Investment Management
Templeton Capital Advisors Ltd
Vanguard Investments Australia Limited
Wallara Asset Management
Wellington International Management Company Pte Limited

Note: The above table only shows Managers who manage more than 1% of the Fund's assets



Table 8: Cash Investment Option investment managers at 30 June 2006

INVESTMENT MANAGER
Colonial First State Investments Limited

Investment objectives

With the accumulation part of members' total benefits tied to the investment performance of the Fund, achieving a good return over the long term is clearly of vital importance. This is explicitly recognised in the objective that the Board has set for the Fund, which is to maximise the long-term real return of the Fund within acceptable risk parameters.

Members' interests are best served by seeking to maximise real returns over the long-term. However, managing shorter-term volatility is also important, particularly for members exiting from the CSS.

Default Fund

The investment objectives of the Fund specify the target, or acceptable, levels of portfolio risk and return. The Board expects to achieve an average real return of no less than 4.5% after tax and fees over the longer term. In the current inflation environment, this equates to a nominal return of 7% per annum.

In developing an investment strategy to achieve the real return objective of 4.5% per annum on average, and recognising that the average person might have a working life of around 30 years, the Board has adopted the following constraint in order to manage the level of any short-term market volatility:

- on average, nominal fund returns are expected to be positive 24 years out of 30.

This criterion defines the 'tolerable' level of volatility specified in the Fund's objective. Furthermore, for prudential reasons, not more than 25% of the Fund's investments are to be invested in illiquid assets, with a minimum cash allocation of 2%.

Cash Investment Option

The Cash Investment Option's key investment objective is to preserve its capital and earn a return (before tax) close to that of the official cash rate (that is, the 11am cash rate determined by the Reserve Bank of Australia).

Strategic review

During each year, the Board reviews its investment strategy. This year's review endorsed the appropriateness of the Board's investment objectives for both the Default Fund and the Cash Investment Option, but some fine-tuning was made to the Default Fund investment strategy to meet those objectives.

Default Fund asset allocation

As a result of the strategic review, one change was made to the Fund's strategic asset allocation. The change involved increasing the Fund's SAA weight to international equities from 20% to 22% and reducing the allocation to bonds from 18% to 16%. It was also decided that the extra 2% in international equities would be invested in emerging market equities.

The following table sets out the actual asset allocation for the Default Fund as at 30 June 2006:

Table 9: Default Fund—Asset allocation

Asset class	Asset allocation %	
	2005	2006
Australian shares	28.4	32.2
International shares	24.3	22.5
Bonds	8.2	13.3
Market neutral strategies	9.0	10.1
Long/short equity funds	5.2	5.4
Property	10.9	13.7
Cash	14.0	2.8
Total Fund	100	100

Events during the year

Apart from the strategic review and the changed investment arrangements described above, a number of other changes were made during the year, including:

Equities

Four new Australian equity managers were appointed during the year—MIR, Perpetual, Suncorp and AMP. By doing this, we increased the number of different sources of returns, or styles, within the asset class. This aims to help improve long term returns without increasing the volatility of returns over shorter time periods. At the same time, the mandate with one existing manager was terminated.

In international equities, one new manager, Platinum, was appointed to increase our allocation to Asian equities. A mandate with an existing manager was terminated. As noted on the previous page, the Fund's strategic asset allocation to international equities was increased during the year.

Alternative investments

The Fund's exposure to alternative investments continued to grow during the year. Commitments were made to six new Australian private equity funds, five new opportunistic international property funds and two new international private equity funds. Some of the funds previously committed to private equity, infrastructure, and opportunistic property were drawn down during the year and some investments were realised and the proceeds returned to the Fund. The net result of these flows was that the Fund's investments in these assets rose from a valuation of \$275.1 million at the start of the year (reflecting commitments of \$746 million) to a valuation of \$311.3 million (commitment of \$865 million) at 30 June 2006.

Market-neutral funds

One new market-neutral manager, Loomis Sayles, was appointed during the year and one existing manager was terminated. During the year we completed the full allocation of 10% to the asset class.

Bonds

The Fund remained underweight bonds throughout the year because of a belief that bond yields would rise in line with increases in short term interest rates and thereby diminish the return from holding fixed interest securities. The benchmark for international bonds continues to exclude Japanese bonds, reflecting that Japanese bond yields have the potential to rise significantly in an environment where economic growth returns to more normal levels.

The Fund appointed one new international bond manager, Brandywine, during the year. At the same time, the benchmark for an existing international bond manager, Bridgewater, was changed from international bonds to Australian bonds, although the manager can, and does, still invest in international bonds. The Fund's only specialist Australian bond manager was terminated during the year.

As noted above, the decision to increase the Fund's strategic asset allocation to international equities during the year was funded by reducing the exposure to bonds.

Property

Two specialist Australian property managers, Eureka and Arcadian, were appointed during the year. Eureka will manage the assets contained within a unit trust that CSS previously held units in. Arcadian, who manages exclusively on behalf of CSS and PSS, will manage a number of new properties.

Cash

The Fund's cash manager was replaced at the end of the year. The new manager, Macquarie, will manage both the Default Fund's cash and the Cash Investment option.



Fund performance

Default Fund

The Fund posted a net return of 13.3%, the third consecutive year of double digit returns.

Despite increased volatility in the latter part of the year, all asset classes with the exception of bonds contributed to this strong result. Australian equities advanced by 21.1%, buoyed by robust domestic economic growth and a significant rise in commodity prices. International equities rose by 19.4% in local currency terms, supported largely by a pick-up in economic growth in Europe and Japan.

The Fund's long/short equity strategies delivered a strong return of 11.7%, while property achieved a return of 14.5%. By way of contrast, the Fund's bond portfolio recorded a return of just 2.0%, weighed down by a rise in bond yields, which helps to constrain the overall return from bonds.

The Fund's longer-term investment performance remains ahead of target. Over the past three years the Fund returned an earning rate of 13.7% per annum, compared with an average inflation rate of 3.0% per annum over this period, while over 10 years the Fund returned an earning rate of 9.2% per annum compared with average inflation of 2.3% per annum.

Cash Investment Option

The Cash Investment Option posted a net return of 4.9%, which is in line with its benchmark once account is taken of the impact of tax on returns.

Performance by asset class— Default Fund

Fund performance figures in the following paragraphs on asset classes are quoted before tax but after fees.

Australian shares

The Australian share market again performed strongly throughout the year. Despite heightened volatility towards the end of the year, the market still advanced by 24.7%. This increase reflected continued strong corporate profitability and a large increase in commodity prices, which buoyed the return from basic material and energy stocks.

The Fund's Australian equity investments underperformed the market to return 21.1%. This reflected underperformance from the Fund's private equity investments.

International shares

International equity markets also performed well throughout the year, although heightened volatility was also a feature during the June quarter. In hedged Australian dollar terms international equities rose by 18.1%.

For unhedged \$A-based investors, the rise in world equity markets was somewhat enhanced by the positive impact on returns of a modest decline in the value of the \$A. The currency movement benefited unhedged \$A-investors by around 2.5% over the year. The international assets exposure of the CSS remained largely fully hedged.

Australian bonds

Continued strong rates of domestic economic growth, together with a rise in domestic short term interest rates and rising global bond yields, resulted in a disappointing year for the Australian bond market. Although the market achieved a modest positive return of 3.4%, this outcome was below the 5.8% return from cash. Reflecting a view that cash would prove a better investment than Australian bonds in 2005/06, the Fund's strategic asset allocation to Australian bonds was kept in cash throughout the year, meaning the fund had no exposure to Australian bonds in 2005/06

International bonds

Continued strong rates of economic growth within the US, signs of emerging strength in Europe and Japan, and increased inflationary fears led

to increases in the bond yields of all developed markets. This resulted in a return of just 1.2% from international bonds. The Fund's investments did better than markets generally, returning 2.0%.

Market-neutral funds

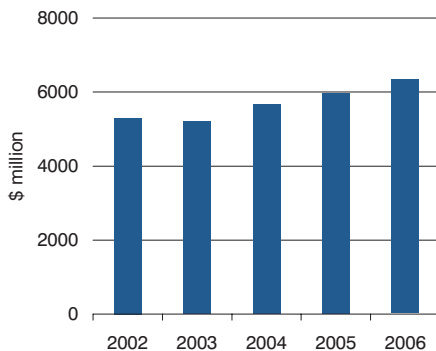
The Fund achieved its desired exposure of 10% of its assets to this asset class during the year. For the year as a whole these investments returned a relatively modest 6.1%.

Long/short equity funds

The Fund has invested in this asset class since October 2004. Over the course of the year, the

Fund investments

Chart 1: Fund size at 30 June for past five years



Fund return was 11.7%. This compares with a benchmark return of 13.8%.

Property

The Australian property market, as measured by the Mercer Australian Unlisted Property Index, performed strongly during the year, returning 17.2%. The Fund's property investments returned 14.5%.

Cash

The return from cash was buoyed by a rise in short term interest rates during the year. For the year as a whole, cash returned 5.8%.

Chart 2: Fund performance comparison over 10 years

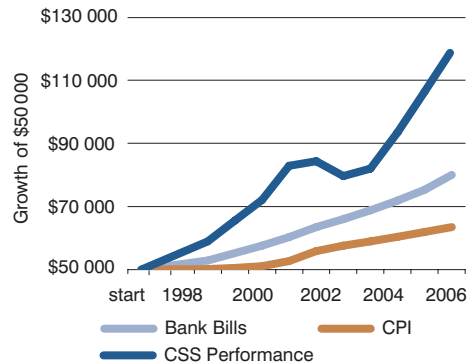


Table 10: Default Fund investments 2005/06

Investments	Holdings at 30 June 05	Holdings at 30 June 06	Proportion
Sector	\$m	\$m	%
Australian shares	1 691.3	2 034.6	32.2
International shares	1 449.7	1 422.4	22.5
Bonds	486.4	839.0	13.3
Market neutral funds	537.0	637.0	10.1
Long/short equities	312.5	341.7	5.4
Property	646.3	867.5	14.0
Cash	833.8	169.8	2.5
Total Fund Investments	5 811.1	6 147.0	100.0

Note: Sectors are post-fees and pre-tax. Total fund is post tax and fees.



Table 11: Default Fund performance 2005/06

	One-year performance	Three-year performance	Five-year performance
	Portfolio %	Portfolio %	Portfolio %
Australian shares	21.1	23.0	13.0
International shares	19.4	18.5	6.1
Bonds	2.0	6.6	6.2
Market neutral funds	6.1	9.3	n/a
Long/short equities	11.7	n/a	n/a
Property	14.5	13.3	11.8
Cash	4.6	5.1	4.7
Total Fund Investments	13.3	13.6	7.5

Table 12: Cash Investment Option Fund investments 2005/06

	Holdings at 30 June 2005 \$m	Holdings at 30 June 2006 \$m	One year performance	Three year performance	Five year performance
			Portfolio %	Portfolio %	Portfolio %
Total Fund	133.0	118.1	4.9	n/a	n/a

Investment information

Further information on investment performance can be obtained from:

Web: www.css.gov.au
Post: Australian Reward Investment Alliance (ARIA)
GPO Box 1907
Canberra City ACT 2601
Phone: (02) 6263 6999
Fax: (02) 6263 6900
Email: secretary@aria.gov.au

Crediting and exit rate policy

No changes were made to the Fund's crediting and exit rate policy during 2005/06. That policy was introduced in August 2004, when the Board made a change to the way earnings are allocated.

The principal amendments to the exit rate and crediting rate policies, with effect from 13 August 2004, were as follows:

1. Not to declare a crediting rate for all CSS members for 2003/04 and to declare its intention that crediting rates not be declared for future financial years.
2. To amend the exit rate policy for all CSS members as follows:
 - i. 'The exit rate shall be the net investment earnings of the Fund from 1 July 2003, where net investment earnings are determined as earnings after tax, fees and after replenishment of the negative reserve that existed at 30 June 2003.
 - ii. This exit rate will fluctuate. Members are guaranteed never to exit the Fund with less than their account balance as at 30 June 2003 plus contributions since that date.
 - iii. Exit rates will be determined on a Tuesday, based on the estimated net investment earnings of the Fund as at the end of the previous Friday. They will be published on the next business day to apply to benefit payments from that day.
 - iv. A determined weekly rate will be varied where market movements have an estimated 0.5% or greater effect on the Fund's investment performance.'

Allocating earnings

With the changes to the Fund's crediting and exit rate policies, effective 13 August 2004, the Board limits the use of any reserving mechanism to those situations, should they occur, where members' credited balances exceed the assets of the Fund. In such a situation, a negative reserve may again be created and would need to be replenished from future earnings.

Because the Board is no longer determining annual crediting rates, but is instead allocating members their share of the Fund's assets when they exit, the Fund has a notional balance that represents unallocated earnings. This notional balance is invested in exactly the same way it would be if it were allocated to members, and members earn a return on this balance in exactly the same way they would if it were allocated to them. The notional balance as at 30 June 2006 was approximately \$1809 million.

Legislation has been passed by Parliament to enable the Board to allocate more equitably Fund earnings between members who leave the scheme during a period of negative earnings and those that stay. This legislative change will mean that member returns will more accurately reflect the actual investment earnings of the Fund. The Board intends crediting unallocated earnings to member accounts as soon as systems issues allow it to do so.

CSS investment governance

The Board's approach to investment governance

The CSS Board's investment governance focuses on managing risk. It is driven by the Board's primary investment objective—to maximise long-term real returns while minimising short-term risks in order to safeguard the long-term interests of members.

The Board believes it has a responsibility to ensure the Fund is not exposed to undue risk because of poor governance behaviour. Therefore it pursues the principles of good governance in its own operations, in service providers and in the companies in which it invests.

The Board considers investment governance to be the next frontier in risk management. It recognises that poor environmental, corporate and social practices can lead to a decline in investment values as much as financial risks can.



CSS investment governance is undertaken through a number of initiatives, including:

- the Governance Advisory Service
- proxy voting.

Governance Advisory Service

The objective of the CSS Governance Advisory Service is to protect and enhance shareholder value for members by identifying environmental, social and corporate governance risks of present and future investments; and to actively communicate those risks to relevant stakeholders.

In December 2001, the CSS Board appointed Westpac Investment Management (now called BT Financial Group, or BT) to research governance risk in the Fund's Australian equities investments and make recommendations to the Board on how to diminish or eliminate such risks.

BT researches and monitors potential environmental, social and corporate governance risks in CSS's Australian company investments, which represent around \$4.5 billion, in combination with the Public Sector Superannuation Scheme (PSS).

Proxy voting

The Board values good governance in its own operations, service providers and the companies in which it invests.

In keeping with this principle, the CSS Board exercises its right to cast proxy votes in the companies in which it invests. This more active role for the Board underscores its commitment to ensure long-term shareholder value for members. It also sends a clear signal to company management groups that the Board, as a shareholder, will vote on every resolution in the best interests of its members.

The CSS is one of the first Australian super funds to take this proactive step, which began in Australia in November 2002 and was extended in March 2003 with the appointment of an international proxy voting service.

Table 13: Investment governance milestones 2005/06

Date	Milestone
Whole year	67 companies were engaged by the Governance Advisory Service on behalf of the CSS on issues including business ethics, director share trading, conflict of interest, environmental risk and executive remuneration. 70% of this engagement occurred in face-to-face meetings (including a small number by teleconference).
Whole year	CSS mandated the Governance Advisory Service to undertake new research into risks relating to: <ul style="list-style-type: none"> • Governance in internally managed and externally managed entities • Customer information protection • Critical infrastructure protection (short) • Environmental risk (containers and packaging; paper and forest products/construction materials sectors).
November 2005	CSS called on Australian company directors to have and make publicly available a policy on share trading that includes: <ul style="list-style-type: none"> • Disclosure on how any breaches of a share trading policy are enforced • Disclosure to investors on the reasons behind major sales by directors and executives; and • Notification to the market of changes in director interests in accordance with the law.