

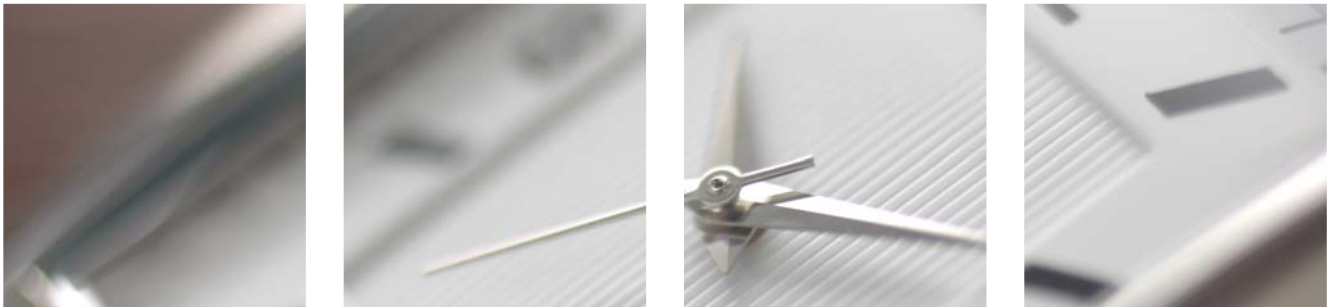
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Fixed interest library

Volume two: benchmarks



This is the second issue in a series of papers that aims to demystify a number of fixed interest concepts. In this issue we will examine the benchmark – what it is, how its performance is calculated, how it is used and how it is constructed.

What is a benchmark?

Very simply, a benchmark is a way of measuring the change in value or performance of a market over time. Another word often used to refer to a benchmark is 'index'.

An example:

The most commonly referred to benchmark in investment markets is the All Ordinaries Index. This measures the movement in the share price of nearly all the companies that are listed on the Australian Stock Exchange. This includes names such as BHP, NAB, Qantas, etc. We understand that if the All Ordinaries has risen, the value of shares in general has risen.

Benchmarks have been around for years. They cover almost every industry sector and asset class, including Australian and international shares, property and fixed interest (bonds).

The benchmark that is used to measure the performance of many of the securities in the Australian fixed interest market is the UBS Australian Composite Bond Index.

The UBS Australian Composite Bond Index consists of approximately 300 fixed interest securities issued by the Commonwealth Government, the State Government and semi government authorities as well as investment grade (ie. high quality) corporate issuers. This index provides a good representation of the movements in value and interest rates of this important asset class.

How is benchmark performance calculated?

	Day 1		Day 2	
	Value of bonds	Benchmark value	Value of bonds	Benchmark value
Bond 1	100		98	
Bond 2	100		105	
Bond 3	100	500 ÷ 5	110	520 ÷ 5
Bond 4	100		105	
Bond 5	100		102	
		100		104

The benchmark value at the end of Day 1 is calculated by adding the value of each bond and then dividing by the number of bonds in the benchmark. This example has 5 bonds (500 ÷ 5), so the benchmark value is 100.

By the end of Day 2, the bonds have moved in value (Volume 1 of this series explores how the value of a bond changes). If we add the value of the 5 bonds and divide by 5 (ie. 520 ÷ 5), the new benchmark value is 104.

So the performance of the benchmark from Day 1 to Day 2 is 4%. This is calculated by subtracting 100 from 104 and then dividing by 100. One would say the benchmark rose 4 points, or 4%.

How is the benchmark used?

Fund managers have a decision to make everyday: from all the bonds that are in the marketplace which should they select to buy, given their view about the market? If they select the ones that fall in value, or do not rise by the same amount as the majority, then their portfolio of bonds will not perform as well as the benchmark. This is referred to as 'underperforming the benchmark'. However if they select the bonds that go up more than the majority, then the fund manager has 'outperformed the benchmark'.

An active manager seeks to outperform the benchmark. In the case of an index (benchmark) manager, they purchase most of the bonds in the market so they can replicate the benchmark performance. Therefore, their performance should match the performance of the benchmark.

Benchmarks give fund managers a reference point, ie. something that both they and their clients can compare them against. This in turn enables investors to compare different fund managers against the one benchmark, as well as each other. Investors are then able to assess which fund managers have the skill to select the better performing bonds in the market.

Benchmarks also give a sense of the long term performance of the asset sector.

How is the benchmark constructed?

The UBS Australian Composite Bond Index covers fixed interest bonds of all maturities in the Australian debt market. However this does not include any inflation linked bonds or short term debt such as **floating rate notes** or **bank bills**.

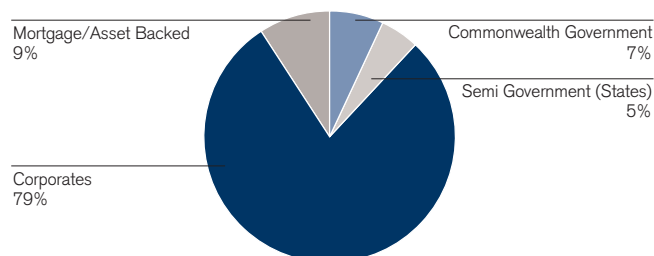
The table below summarises the characteristics that are required for a bond issue to be included in the benchmark.

Characteristics

Sectors	Commonwealth Government Securities, Semi Government (States), Investment Grade Credit (Companies), Fixed Mortgage Backed Securities, Fixed Asset Backed Securities
Bond types included	Nominal fixed rate bonds, mortgage backed and asset backed securities
Minimum size	AUD 100 million
Minimum credit rating	Non government securities must have a minimum credit rating of A- (as rated by Standard & Poor's or Moody's)
Maturity	No restriction
Coupon	Fixed interest only
Pricing	Pricing and valuation daily (hence benchmark level is calculated)

Within the UBS Australian Composite Bond Index there are 147 issuers and 337 issues. This includes all the bonds that satisfy the characteristics listed in the table above.

The pie chart below shows the split of issuers within the Australian bond market into broad sectors:



Source: UBS.

Glossary

Bank bill – is essentially a form of an IOU (similar to a cheque, which in itself is a bill of exchange) with the exception that bank bills have a specific maturity date when they are payable. Apart from having a specific maturity date, their make up is very similar to that of a cheque.

Floating rate note – a bond whose coupon is not fixed, ie. it is periodically adjusted according to the level of some floating index.

Asset backed security – a financial instrument that is secured by a pool of assets eg. property, credit card receivables, car loans etc.

Mortgage backed security – a financial instrument that is secured by a pool of mortgages.

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