

2020 Analyst Pack

Providing
our customers
with financial
security for
retirement



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Challenger Limited ACN 106 842 371

challenger 

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2020 Annual Report

can be downloaded from
Challenger's online
Shareholder Centre

› challenger.com.au/shareholder

Investor Relations

Stuart Kingham
Head of Investor Relations
+61 2 9994 7125
skingham@challenger.com.au

Mark Chen
Senior Investor Relations Manager
+61 2 9994 7815
machen@challenger.com.au

Important note

Information presented in the FY20 Analyst Pack is presented on an operational (rather than statutory) basis 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 2020 Annual Report is available from Challenger's shareholder centre at:

› www.challenger.com.au/shareholder

The FY20 Analyst Pack is not audited. The statutory net profit after tax as disclosed in the consolidated profit and loss (page 14) has been prepared in accordance with Australian Accounting Standards and the *Corporations Act 2001*. Normalised net profit after tax, as disclosed in the consolidated profit and loss (page 14), has been prepared in accordance with a normalised profit framework, which is disclosed as part of the Operating and Financial Review in the Directors' Report in the 2020 Annual Report. The 2020 Annual Report and normalised profit framework have both 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, of which many are outside the control of, and 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.

FY20 financial highlights¹

Group	<p>Normalised net profit before tax \$507m, down 8%</p> <p>Normalised net profit after tax \$344m, down 13%</p> <p>Statutory net loss after tax \$416m</p> <p>Normalised EPS² 56.5 cents per share, down 14%</p> <p>Statutory EPS² negative 68.4 cents per share</p> <p>Net income \$797m, down 3%</p> <p>Expenses \$284m, up 6%</p> <p>Normalised cost to income ratio 35.7%, up 310bps</p> <p>Group assets under management \$85.2bn, up 4%</p> <p>Normalised Return On Equity (pre-tax) 14.8%, down 180bps</p> <p>Full-year dividend 17.5 cents per share (fully franked), down 18.0 cents per share</p> <p>Normalised dividend payout ratio 31.0%</p>
Life	<p>Cash Operating Earnings (COE) \$639m, down 5%</p> <p>COE margin 3.32%, down 30bps</p> <p>Expenses \$114m, up 7% driven by investment in DPM growth initiatives³</p> <p>Normalised EBIT⁴ \$525m, down 7%</p> <p>Total Life sales \$5.2bn, up 13%</p> <p>Total Life book growth \$316m, or 2.1% of opening liabilities</p> <p>Annuity sales \$3.1bn, down 12%, with domestic sales down 27% and Japan sales up 177%</p> <p>Annuity net book growth -\$251m, or -2.0% of opening liabilities</p> <p>Average investment assets \$19.2bn, up 4%</p> <p>Normalised Return On Equity (pre-tax) 16.6%, down 120bps</p> <p>Prescribed Capital Amount (PCA) ratio 1.81 times, up from 1.53 times at FY19</p> <p>Common Equity Tier 1 (CET1) ratio 1.20 times, up from 1.06 times at FY19</p> <p>Capital intensity 10.7%, down from 13.8% at FY19</p>
Funds Management	<p>Net income \$158m, up 5%</p> <p>Expenses \$100m, up 1%</p> <p>EBIT \$58m, up 13%</p> <p>Net flows \$2.5bn</p> <p>Funds Under Management (FUM) \$81.4bn, up 3%</p> <p>Return On Equity (pre-tax) 24.3%, up from 23.5% in FY19</p>

¹ All percentage movements compare FY20 to the prior corresponding period (FY19) unless otherwise stated.

² Earnings per share (EPS).

³ Distribution, Product and Marketing (DPM) growth initiatives in response to industry and market disruption (refer to page 8 for more detail).

⁴ Earnings before interest and tax (EBIT).

Market overview and outlook

Australia's superannuation system commenced in 1992 and is now the fourth largest pension system globally and the fastest growing, with assets increasing by 11% per annum over the past 20 years¹.

Critical features that have contributed to Australia having the fastest growing pension system globally, include Government-mandated contributions, a competitive institutional model and a system based on defined contributions.

Australia's superannuation system growth is underpinned by contributions which are scheduled to increase from the current rate of 9.5% of gross salaries to 12.0% by 2025. Growth in the superannuation system is also supported by changing demographics and the Government's focus on enhancing the retirement phase of superannuation.

The superannuation system is forecast to grow from \$2.7 trillion today² to almost \$7 trillion³ over the next 15 years.

Challenger's Life and Funds Management businesses are both expected to benefit from long-term growth in Australia's superannuation system.

Life

Life focuses on the retirement spending phase of superannuation by providing products that convert retirement savings into safe and secure income. Challenger Life is Australia's leading provider of annuities⁴ and focuses on retirees and the retirement phase of superannuation, which is expected to grow strongly, driven by demographic changes and a maturing of the retirement system.

The number of Australians over the age of 65, which is Life's target market, is expected to increase by over 50% over the next 20 years⁵. Reflecting these demographic changes, and growth in the superannuation system, the annual transfer from the retirement savings phase of superannuation to the retirement spending phase was estimated to be approximately \$70bn⁶ in 2019.

Annuities represent only a small part of the retirement phase, with lifetime annuities representing less than 2% of the annual transfer to the retirement phase.

The purpose of the superannuation system is to provide income in retirement to substitute or supplement the Government-funded age pension. With the transition from Government-funded age pensions to private pensions, retirees are demanding safe, secure retirement income products that convert savings into income and provide financial security.

Australians now have very meaningful superannuation balances when they retire, with an estimated average total financial wealth at retirement of \$680,000⁷, despite the system being in place for only half the working life of today's retirees.

The Australian Government is progressing a range of retirement income regulatory reforms that are designed to enhance the retirement phase and better align it with the overall objective of the superannuation system to provide income in retirement to substitute or supplement the Government-funded age pension (refer to page 31 for more detail). These reforms provide a significant opportunity to

increase the proportion of retirement savings invested in products that deliver stable income, which lasts a lifetime.

As Australia's leading provider of annuities, Challenger Life is expected to continue to benefit from the long-term growth in Australia's superannuation system and regulatory reforms designed to enhance the retirement phase and increase the allocation of retirement savings made to annuities.

Life is also diversifying its range of products and expanding its distribution relationships in both Australia and Japan and building institutional partnerships.

In Australia, Life is broadening access by making annuities available via leading investment and administration platforms. Challenger's range of annuities are accessible by more than 70% of Australia's financial advisers via their primary investment and administration platform.

Challenger has been recognised as a retirement income product innovator and has won the Association of Financial Advisers 'Annuity Provider of the Year' for the last 12 years.

Challenger remains the dominant retirement income brand in Australia and is recognised by 93%⁸ of financial advisers as a leader in retirement incomes.

Life relies on third party financial advisers, both independent and part of the major advice hubs⁹, to distribute its products to retail customers in Australia.

Following the public hearings and completion of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission) in 2019, there has been significant structural change across the Australian wealth management and financial adviser market. Domestic annuity sales have been impacted by the structural change to the wealth management and adviser markets, with FY20 domestic annuity sales down 27% from FY19.

To help drive additional demand for annuities and guaranteed income products, Challenger is investing in a range of Distribution, Product and Marketing (DPM) initiatives. Initiatives are focused on increasing direct customer engagement and education, evolving Challenger's product range and supporting advisers.

The profit-for-member sector of the superannuation system is growing strongly and currently represents ~37% of total superannuation assets¹⁰. As members transition to retirement, focus by profit-for-member funds to provide comprehensive retirement income solutions to their members will continue to increase. The profit-for-member sector provides a significant growth opportunity for Life.

In Japan, Life commenced an annuity relationship with Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary) to provide Australian-dollar annuities in November 2016. MS Primary is a leading provider of annuity products in Japan and part of MS&AD Insurance Group Holdings Inc. (MS&AD).

As part of the reinsurance arrangements with MS Primary, Challenger Life reinsures both an Australian-dollar and US-dollar 20-year term product and an Australian-dollar lifetime annuity product.

¹ Willis Towers Watson Global Pension Study 2020.

² APRA, as at March 2020.

³ Rice Warner 2019 superannuation projections.

⁴ Plan for Life – March 2020 – based on annuities under administration at 30 March 2020.

⁵ 2020 – 2040 comparison based on Australian Bureau of Statistics, Population Projections Series B, cat no. 3222.0.

⁶ Australian Taxation Office.

⁷ Australian Bureau of Statistics Household Income and Wealth 2017-18 cat no. 6523.0. Average household wealth includes superannuation and non-superannuation assets and excludes the family home.

⁸ Market Pulse Adviser Study December 2019.

⁹ Major advice hubs include AMP and the wealth management operations of the major Australian banks.

¹⁰ APRA Quarterly Superannuation Performance Statistics, March 2020.

Under an expanded reinsurance arrangement, which commenced on 1 July 2019, MS Primary will provide Challenger an annual amount of reinsurance, across both Australian and US-dollar annuities, of at least ¥50bn (~A\$670m) per year for a minimum of five years^{1,2}. This is subject to review in the event of a material adverse change for either MS Primary or Challenger Life.

At 30 June 2020, MS&AD held ~15% of Challenger's issued capital. A representative from MS&AD, Mr Masahiko Kobayashi, was appointed as a Non-Executive Director of Challenger Limited in August 2019 and an Alternative Director, Mr Hiroyuki Iio, was appointed on 13 December 2019.

Refer to page 30 for more detail on the MS Primary and MS&AD relationship.

Funds Management

Funds Management focuses on building savings for retirement by providing investment strategies that seek to deliver superior investment returns. Funds Management has operations in Australia, the United Kingdom and Japan and is one of Australia's largest active fund managers³.

Growth in funds under management can be attributed to the strength of Challenger's retail and institutional distribution teams, a market-leading business model focused on investor alignment and strong long-term investment performance.

Funds Management comprises Fidante Partners and CIP Asset Management.

The Fidante Partners business model involves taking minority equity interests in separately branded boutique fund management firms, with Challenger providing distribution, administration and business support, leaving investment managers to focus on managing investment portfolios.

Challenger's Fidante Partners business model has allowed it to attract and build successful active equity, active fixed income and alternative investment managers.

Fidante Partners continues to expand its product offering by adding new boutiques and accessing new distribution channels. Recent examples include launching the ActiveX Series of actively managed Exchange Traded Funds (ETFs) targeting the growing popularity of actively traded exchange products and forming a new strategic joint venture with global alternative asset manager, Ares Management Corporation (NYSE: ARES). The joint venture will provide Australian investors with access to alternative investment products managed by Ares.

Challenger Investment Partners has been rebranded CIP Asset Management as it transitions from an internally focused to an externally focused asset manager. The rebrand demonstrates Challenger's commitment to growing the business and building on the breadth of investment expertise.

CIP Asset Management is an institutional manager that principally originates and manages fixed income and commercial real estate for leading global and Australian institutions, including Challenger Life.

Funds Management is also expanding its presence in Japan and directly manages real estate investments on behalf of Life

and is developing funds management distribution and product opportunities in the region.

COVID-19 pandemic

The COVID-19 pandemic has presented significant challenges to global economies and investment markets.

Looking after the health of our people during this time has been a key business priority for Challenger, which has transitioned almost all its employees to working from home arrangements from mid-March 2020.

Challenger has also been supporting its customers and business partners through the pandemic, which has included supporting advisers, superannuation fund clients and commercial property tenants.

Investment market conditions have been significantly disrupted by the COVID-19 pandemic, resulting in a market-sell off and increased market volatility. This has impacted both Challenger Life's statutory earnings and excess capital position, which both include \$750m (post-tax) of realised and unrealised investment experience losses.

Following the pandemic related market sell-off, Challenger Life has actively managed its investment portfolio and repositioned it to be more defensive, which reduced its capital intensity and subsequently increased Life's excess capital position.

In order to further strengthen Life's capital position and provide flexibility to enhance returns, a \$270m institutional placement was undertaken in June 2020 and a retail Share Purchase Plan was completed in July 2020 raising \$35m. Challenger is prioritising maintaining a strong capital position and has not declared a final FY20 dividend.

Challenger Life is maintaining a strong capital position, which is well above internal capital targets, and there is flexibility to redeploy up to \$3bn of Life's cash and liquids into higher yielding investments. Once fully deployed, these investments are expected to enhance both Life's earnings and Return on Equity (ROE).

Given the uncertain economic outlook, Life expects to continue to maintain a more defensive portfolio setting and Challenger will maintain a disciplined focus on expense management.

Risks

The above outlook for the Life and Funds Management businesses is subject to the following key business risks:

- investment market volatility;
- ongoing impact of COVID-19 pandemic on the global economy and the ability of individuals, businesses, and governments to operate;
- general uncertainty around the global economy and its impact on markets in which Challenger operates and invests;
- regulatory and political changes impacting financial services participants;
- demand for and competition with Challenger products, including annuities and managed funds; and
- operational risk.

¹ Challenger Life entered into a new agreement with MS Primary to commence reinsuring the US dollar version of the 20-year term product from July 2019. Challenger will provide a guaranteed interest rate and assume the investment risk in relation to those policies issued by MS Primary and reinsured by Challenger.

² Based on the exchange rate as at 30 June 2020.

³ Consolidated FUM for Australian Fund Managers – Rainmaker Roundup, March 2020.

Vision and strategy

Challenger's vision is to provide its customers with financial security for retirement and there are four pillars to ensure Challenger achieves its vision



FY20 strategic progress

Increase the use of secure retirement income streams



Industry lifetime annuity sales currently represent less than 2% of the annual transfer from the retirement savings (accumulation) phase to the retirement spending (retirement) phase. Challenger is focused on growing the allocation of Australian retirement savings to secure and stable incomes.

FY20 progress

- Total Life sales up 13%, with annuity sales down 12% and more than offset by a 101% increase in Other Life sales;
- Annuity sales were driven by the following outcomes in Australia and Japan:
 - Australian annuity sales down 27%:
 - Domestic term annuity sales down 19% and impacted by structural changes to the Australian wealth management market and sales disruption from the COVID-19 pandemic. Refer below for additional information.
 - Domestic Lifetime annuity sales down 51%, in addition to the structural changes to the Australian wealth management market, lifetime sales were also impacted by transition to new means test rules and sales disruption from the COVID-19 pandemic. Refer below for additional information.
- Japan annuity sales up 177%, and driven by an expansion to the reinsurance agreement with MS Primary, which included extending reinsurance to include US dollar annuities in addition to Australian dollar annuities.
- Other Life sales, representing Challenger's Index Plus Fund, increased by 101% to \$2.0bn and benefited from a focus on building out the institutional channel and increased client demand. Refer to page 8 for more detail.

Structural change to Australian financial advice market

Following the public hearings and completion of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission) in 2019, there has been significant structural change across the Australian wealth management and financial adviser market.

There have been a range of regulatory changes that have had a significant impact on the economics for many financial advice practices. Regulatory changes include a shift away from commissions to fee-for-service, resulting in lower revenue per client, and the best interests duty which is increasing focus on holistic advice over transaction advice. Advisers are also increasing education and compliance activities, which is reducing focus on the acquisition of new clients and servicing of their existing book.

There have been significant withdrawals of advisers from the market through the major banks generally exiting or reducing their exposure to wealth management, which is contributing to a reduction in the number of financial advisers aligned to the wealth management operations of the major banks.

There has been higher adviser turnover with advisers either migrating from licensees aligned to the major banks to independent adviser networks, switching licensees in the network, becoming self-licensed or leaving the industry altogether.

As a result, the Australian financial advice market continues to undergo significant structural change, with adviser numbers reducing by 16% year on year and advisers moving from the major banks to Independent Financial Advisers (IFA) networks. At 30 June 2020, IFAs accounted for approximately 72% of the advice market, up from 60% five years ago¹.

Representing the shift away from major hubs to privately owned licensees, in 2020, 62% of all advisers were licensed to a privately owned licensee, up from 32% five years ago (2014). Institutionally owned and aligned advisers, which has traditionally been the largest segment, represented 38% of the total advice market, down from 63% five years ago¹.

These industry changes are impacting Challenger's annuity sales, especially term annuity sales, which were well supported by advisers aligned to the major banks.

Challenger believes in the need for financial advice, particularly in the retirement phase of superannuation and is supporting advisers as they move across licensees and ensuring Challenger products are widely available on investment and administration platforms.

Transition to new means test rules

Challenger's FY20 lifetime annuity sales were affected by transition to new age pension means test rules that commenced on 1 July 2019.

The new rules are designed to support the take-up of lifetime income stream products. Refer to page 31 for more detail on the retirement income regulatory reforms.

Australian lifetime annuity sales decreased 51% on FY19, with sales of Liquid Lifetime down 48% in FY20. Sales of CarePlus, a lifetime annuity specifically designed for aged care customers, were down 57% in FY20.

For Liquid Lifetime, under the new means test rules, the Flexible and Enhanced options are more attractive and the Regular product option is generally less attractive.

Advisers are transitioning from the Regular to the Flexible and Enhanced product options and a new cohort of advisers writing the Flexible and Enhanced options is emerging. In FY20, 56% of advisers recommending Liquid Lifetime annuities did not recommend any in the previous financial year.

Despite the social disruption from COVID-19 in the fourth quarter of FY20, lifetime annuity sales remained relatively stable on the preceding three quarters, reflecting an increase in the number of advisers recommending the product, offsetting the impact from COVID-19.

There are over 200 specialist aged care advisers that support the CarePlus product. CarePlus was reviewed and updated in late 1H20 following commencement of new means test rules in order to ensure it provided the best overall outcome for aged care customers. Following the product refresh, sales momentum is building with 2H20 CarePlus sales up 12% on 1H20 despite the COVID-19 disruption during the fourth quarter.

The new means test rules have been designed to support the take-up of longevity protection and lifetime income streams. Challenger remains confident over the long term that lifetime sales will increase under the new means test rules.

Sales disruption from COVID-19 pandemic

From March 2020, the COVID-19 pandemic has impacted financial advisers' ability to meet new clients, and their focus has been on servicing their existing client base, rather than on-boarding new clients. New clients on-boarded at the point of retirement represents an opportunity to recommend annuities.

Lower new client acquisition by financial advisers during the fourth quarter, due to the pandemic, contributed to domestic annuity sales being 27% lower than the prior corresponding quarter.

¹ ASIC Adviser Register June 2020.

CarePlus is a lifetime annuity specifically designed for aged care customers. During the pandemic, there has been a delay in retirees entering aged care. These delays have impacted CarePlus sales in the fourth quarter, which were 16% lower than the third quarter.

Throughout FY20, and particularly during the pandemic-related market sell-off, Challenger has received numerous customer testimonials noting their annuity is providing peace of mind in volatile and uncertain times. Significant market sell-offs highlight the benefits of annuities and guaranteed income relative to market-linked account-based pension products.

Over the past year, Challenger has paid out approximately \$4bn in guaranteed annuity payments to its customers, with payments to customers not impacted by the COVID-19 pandemic or related market sell-off.

New RBA Cash Linked lifetime annuity option

In order to increase the take-up of secure retirement income streams by Australian retirees, Challenger is focused on ensuring its products remain contemporary and are effective for retirees.

In June 2020, the RBA Cash Linked option was added to Challenger's Liquid Lifetime product range.

This innovation allows retirees to link future lifetime annuity payments to prevailing interest rates, with regular payments reset each month based on movements in the RBA cash rate. The RBA Cash Linked monthly payment comprises a fixed component and a variable RBA cash rate component.

The RBA Cash Linked option has been specifically designed for customers and advisers who may be concerned with investing in a lifetime annuity in a low interest rate environment. The RBA Cash Linked option seeks to address these concerns and can be applied to either the immediate or deferred lifetime annuity.

Diversifying distribution channels

Challenger is focused on diversifying its distribution channels and reducing reliance on retail financial advisers. In FY20, the following initiatives were undertaken:

- commenced reinsuring US dollar annuities issued by MS Primary in Japan. As a result, MS Primary FY20 sales increased by 177% and represented 24% of total annuity sales, up from 8% in FY19; and
- expanded institutional relationships and product offering. The Challenger Index Plus product was refreshed with sales increasing by 101% on FY19. Sales benefited from new annuity and Challenger Index Plus clients, including a new institutional annuity client investing \$300m across a range of term annuities.

Life sales mix and focus on long-term products

Challenger's annuity sales mix continues to evolve toward long-term products. Long-term annuities embed more value for shareholders as they lengthen the tenor of the annuity book, improve the maturity profile and typically enhance return on equity.

- In FY20, long-term annuity sales, which include Australian lifetime annuities and 20-year fixed term annuities distributed through MS Primary in Japan, represented 37% of total annuity sales, up from 32% in FY19.
- The annuity book continues to shift toward long-term annuities, with the long-term annuity book now representing 53% of the total annuity book, up from 28% five years ago.

Engaging and educating customers

In May 2020, Challenger launched a Retirement made simple hub on its website, with the goal to educate retirees on the different sources of income in retirement and benefits of lifetime income and annuities.

Challenger also launched a Retire with confidence retirement income tool to help retirees and pre-retirees better understand the financial realities of retirement. The tool is available on Challenger's website and is designed to help retirees understand how long their superannuation will last and demonstrates how an annuity can be part of a comprehensive retirement solution.

Adviser support and focus

Challenger believes in the value of financial advice, particularly in retirement. As the financial advice market transitions to more IFA networks, Challenger is enhancing its focus on IFAs and ensuring its products are available on leading independent platforms.

Challenger is also supporting customers and potential customers seeking high-quality retirement financial advice and commenced an adviser referral pilot. Customers have reported this has reduced the effort of finding an adviser and are feeling well supported by Challenger. Advisers are also reporting a high level of satisfaction with the pilot.

Challenger is also supporting advisers through increased education and thought leadership. In FY20, the number of advisers attending Challenger retirement planning or aged care webinars doubled.

Retirement reforms engagement and advocacy

The Australian Government is considering a range of superannuation reforms aimed at enhancing the retirement phase of superannuation. Reforms include new pension means test rules for lifetime income stream products that commenced on 1 July 2019 and the Retirement Income Framework.

The Government has also commissioned an independent review of the retirement income system (the Retirement Income Review) to improve understanding of its operation and the outcomes it is delivering for Australian retirees.

Refer to page 31 for more detail on the retirement income regulatory reforms.

Maintaining thought leadership position

As an Australian retirement income thought leader, Challenger works with a broad range of industry, consumer and Government organisations to assist in developing retirement income policy outcomes that help provide Australians with financial security for retirement.

Challenger partnered with National Seniors Australia in FY20 to measure retirees' attitudes and confidence in managing the financial aspects of retirement. Challenger also partnered with the Council on the Ageing (COTA) New South Wales to explore consumer-related retirement income issues and understand how COVID-19 is impacting older workers.

Lead the retirement incomes market and be the partner of choice



Challenger's strategy includes being the partner of choice for superannuation fund advisers, wealth managers and investment platforms in providing retirement income solutions. Challenger is the market leader in annuities with 75%¹ market share.

FY20 progress:

Leading adviser ratings

Despite structural changes in the Australian financial advice market and new competitors entering the retirement income market, Challenger has remained the dominant retirement income brand. Among Australian financial advisers, Challenger continues to be the most recognised retirement income provider with 93%² of financial advisers rating Challenger as a leader in retirement income. Challenger's retirement income leadership position, which supports new distribution and product relationships, is 41 percentage points above its nearest competitor.

New integrated brand campaign

In June 2019, Challenger launched a new integrated brand campaign, 'Look forward with confidence' based on extensive adviser and customer research. The campaign focused on building brand awareness and familiarity, with a strong emphasis on educating customers and advisers on annuities being an important component when creating confidence in retirement.

Following the campaign launch, several educational initiatives were undertaken, aimed to get more retirees to understand the role annuities can play as part of a comprehensive

¹ Plan for Life – March 2020 – based on annuities under administration at 30 March 2020.

² Marketing Pulse Adviser Study December 2019.

retirement income plan. Challenger also sponsored the NSW Seniors Expo and developed the 'Retire with Confidence' tool (refer below) to support customer education and engagement.

Campaign performance indicators show an increase in brand awareness and familiarity, with both measures above target for retirees aged 65 to 74, Challenger's target audience.

Investing in Distribution, Product and Marketing (DPM) growth initiatives

The Australian wealth management and financial advice market is undergoing significant structural change. Refer to page 4 for more detail.

To help drive additional demand for annuities and guaranteed income products, Challenger is investing in a range of Distribution, Product and Marketing (DPM) initiatives.

The initiatives focus on increasing direct customer engagement and education, evolving Challenger's product range, supporting advisers and building more diversified distribution networks, including institutional partnerships.

Building institutional partnerships

Challenger's institutional guaranteed annuity business is growing strongly, with sales increasing by 101% to \$2.0bn in FY20. Sales are benefiting from a number of new institutional relationships and a focus on solutions-led strategies for profit-for-member and superannuation fund clients.

Clients are increasing their focus on providing retirement income solutions for their members and how Challenger's capabilities can support them in building comprehensive retirement solutions.

Life Risk (wholesale longevity and mortality) progress

Life is undertaking wholesale longevity and mortality transactions, principally in the established United Kingdom market. Life has specialised expertise and commenced this business in 2013.

The present value of future profits arising from the Life Risk portfolio was \$829m at 30 June 2020, an increase of 67% (\$335m) from \$495m at 30 June 2019. The increase in the present value of future profits was due to three longevity risk transactions completed in the UK pension market.

Provide customers with excellent funds management solutions



Challenger is focused on providing excellent funds management solutions in order to help build retirement savings.

FY20 progress:

Maintaining superior investment performance

Funds Management has a long track record of achieving superior investment performance, which has helped attract strong net flows over many years.

Long-term investment performance for Fidante Partners Australian boutiques remains strong with 85% of FUM outperforming benchmark over five years¹. Since fund inception, 84% of Fidante Partners' funds have achieved either first or second quartile investment performance².

CIP Asset Management's fixed income capability also continues to achieve strong investment performance. All of CIP Asset Management's third party fixed income mandates and funds beat their investment performance benchmark over three and five years.

Award-winning investment strategies

Fidante Partners' investment managers continue to be externally recognised. During FY20, the following funds won investment manager awards:

- Ardea Investment Management – Zenith Fund Awards Australian Fixed Income winner (2019);
- Ardea Investment Management – Kanganews Australian Rates Fund Manager of the Year (2019); and
- Kapstream – Kanganews Australian Credit Fund Manager of the Year (2019).

¹ As at 30 June 2020. Percentage of Fidante Partners Australian boutiques meeting or exceeding performance benchmarks.

² Mercer as at June 2020.

Highly rated retail investment products

Fidante Partners' investment managers and funds are highly rated by external asset consultants:

- 37% of ratings are the top rating (e.g. 'Highly Recommended' or 'Gold') compared to an average of approximately 12% across the Australian funds management industry; and
- 90% of ratings are a 'buy' rating compared to an average of approximately 75% across the Australian funds management industry.

The quality and performance of Fidante Partners' investment managers and funds continue to receive strong independent validation. During FY20, two of Alphinity Investment Management's Australian share funds were upgraded from Recommended to Highly Recommended by a primary research house. This same research house upgraded the Alphinity Global Fund to Recommended. Eiger Capital was also awarded a 'Highly Recommended' rating by Zenith. Greencape Capital continues to be the only Australian large cap equities manager to hold the top rating across all three major Australian retail research consultants.

Adding new boutiques and investment strategies

Fidante Partners continues to expand its product offering by adding new boutiques, forming new partnerships and developing new investment strategies for existing managers.

In September 2019, Fidante Partners and global alternative asset manager Ares Management Corporation (NYSE: ARES) established a new strategic joint venture, Ares Australia Management. The joint venture will provide Australian investors with access to alternative investment products managed in the United States by Ares Management Corporation.

In May 2020, Ares Australia Management launched its first product, the Ares Global Credit Income Fund, which offers Australian investors access to a higher income strategy with a focus on capital preservation. The Ares Global Credit Income Fund targets a return of between 3% and 4% per annum, with distributions paid monthly.

During FY20, Fidante Partners expanded its boutique product offering through:

- launching Ardea Pure Alpha, which is a higher returning version of the flagship Ardea Real Outcome Fund;
- launching a retail share class for the Kapstream Absolute Return Income Plus strategy, which targets an absolute return of 3–4% above the cash rate;
- launching the Whitehelm Global Listed Infrastructure Fund for Australian investors which has previously only been available in Europe; and
- launching the Nikko AM Developed Countries Government Bond Relative Value Strategy managed by Ardea. The strategy targets the Japanese institutional market and is an institutional Toshin Fund marketed by Nikko to their large institutional client base.

Expanding distribution channels through active ETF market

There continues to be strong demand from investors for simple and easy-to-access liquid investment products. Exchange Traded Funds (ETFs) continue to experience strong growth in a number of markets as they provide the ability to deliver diversified investment strategies in a liquid and easy-to-execute format. While ETFs have historically focused on passive or factor-based investments, the demand for more actively managed products continues to grow. In 2019, active ETFs accounted for approximately half of all new Australian ETF market listings¹.

In December 2018, Fidante Partners launched one of Australia's first active fixed income ETFs, the ActiveX Ardea Real Outcome Bond Fund (ASX: XARO), managed by Ardea Investment Management. In October 2019, Fidante Partners launched its second active ETF in the ActiveX Series, the ActiveX Kapstream Absolute Return Income Fund. The fund aims to provide a steady stream of income and capital stability over the medium term while outperforming its benchmark through different market cycles.

Fidante Partners is committed to growing the ActiveX Series and expects to launch more active ETFs. Total Fidante Partners FUM invested in ETF strategies at 30 June 2020 was \$202m and increased by \$186m for the year.

¹ BetaShares Australian ETF Review -2019.

CIP Asset Management rebrand

Challenger Investment Partners has been rebranded CIP Asset Management as it starts to target more retail FUM. Challenger Investment Partners was formed over 20 years ago, with the business evolving from servicing just Challenger Life to providing solutions to a broad range of third party clients. At 30 June 2020, third party clients represented 25% of CIP Asset Management FUM.

The rebrand demonstrates Challenger's commitment to growing the business and building on the breadth of investment expertise.

CIP Asset Management fixed income and Credit Income Fund

The CIP Asset Management Fixed Income team manage funds and investment mandates across multiple strategies, comprising both public and private credit investments.

The CIP Asset Management Credit Income Fund, launched in October 2017, is a floating rate, multi-sector credit income strategy that invests across high-quality, predominantly investment grade public and private debt investments. With an investment-grade average portfolio credit rating¹, the fund provides investors with a higher income, defensive and diversified portfolio without taking excessive levels of credit or interest rate risk.

In FY20, the CIP Asset Management Credit Income Fund continued to attract interest from third party institutions and expanded distribution to target Australian high-net-worth individual investors.

The fund continues to perform strongly and, since inception, has outperformed the bank bill rate by 2.3% p.a.

The CIP Asset Management Credit Income Fund FUM at 30 June 2020 was \$282m and increased by 73% for the year.

CIP Asset Management Multi-Sector Private Lending Credit Income Fund

The CIP Asset Management Multi-Sector Private Lending Fund, which is an open-ended fund targeting a net return of the bank bill swap rate (BBSW) plus a margin of 5% was launched in February 2020. The Fund is a multi-sector credit strategy which invests across Australian and New Zealand private securitised, corporate and real estate lending.

The fund had ~\$190m of FUM at 30 June 2020, and despite significant market turmoil since launch, the fund has provided positive returns over its first five months.

CIP Asset Management appointed investment manager by AOFM

In December 2019, the Australian Office of Financial Management (AOFM) appointed CIP Asset Management as the investment adviser to assist with the evaluation of investment proposals and provide ongoing portfolio management for the Federal Government's Australian Business Securitisation Fund (ABSF). The ABSF was established to improve access to credit for Australian small businesses. CIP Asset Management will provide advisory services and generate transaction and investment management fees from the ABSF. During 2H20, the first ABSF transaction was approved.

CIP Asset Management Real Estate

The CIP Asset Management Real Estate team manage real estate mandates across Australia and Japan on behalf of Australian and international investors. Through FY20 CIP Asset Management expanded its Japanese real estate portfolio, targeting non-discretionary retail and retail-related logistics assets. CIP Asset Management continues to explore domestic opportunities in Japan, including partnering with Japanese investors to invest in Australian real estate investment strategies.

During the COVID-19 pandemic, CIP Asset Management has been actively managing both its fixed income and property portfolios. For Real Estate, this has included working closely with approximately 60% of its tenants who have been directly impacted by the COVID-19 disruption.

¹ Based on Moody's Investors Service Inc. weighted average rating factors.

Maintain leading operational and people practices



Challenger believes maintaining a highly engaged, diverse and agile workforce committed to sustainable business practices with a strong risk and compliance culture is essential for providing customers and shareholders with superior outcomes.

FY20 progress:

Redefining Challenger's values and new employee Code of Conduct

Challenger's values are integral to its culture and linked to everything employees do. They set out the behaviours needed to meet community expectations and ensure Challenger can deliver on its vision and strategy, now and into the future.

In FY20 Challenger redefined and launched new values. Challenger's values are:

- Act with integrity;
- Aim high;
- Collaborate; and
- Think customer.

The new Challenger values are clear, meaningful and memorable and define what is expected of all employees.

In FY20, Challenger also launched a new employee Code of Conduct. The Code of Conduct sets out expectations for employees on how to act, solve problems and make fair and balanced decisions. It brings together Challenger's values and links them to Group policies and statements.

Health and wellbeing of our people during the COVID-19 pandemic

Looking after the health of employees during the COVID-19 pandemic is a key business priority. Almost all of Challenger's employees have worked from home from mid-March 2020 and have adapted well, with business continuity maintained throughout the period.

Internal employee surveys show high employee engagement, with the majority feeling positive towards Challenger, notwithstanding the difficult working environment. An employee survey in May 2020 showed 94% of staff felt Challenger cared, and 98% were confident in the Leadership Team's ability to navigate through the disruption. Importantly it showed 97% of employees felt positive about their ability to adjust to work-from-home arrangements, and 94% felt well connected to their teams during this time.

Employee engagement

Employee engagement measures the nature of the relationship between an organisation and its employees. Challenger believes having a highly engaged team with a positive attitude towards the organisation and its values will lead to superior shareholder and customer outcomes.

Challenger measures employee engagement through a biennial survey, which was last conducted by Willis Towers Watson in March 2019. The survey recorded a sustainable employee engagement score of 84%. The result is above both the Australian company and global financial services average.

Diversity and inclusion

Challenger believes that diversity and inclusion deliver better outcomes for its people, its business and the community.

In July 2019, Challenger updated its diversity and inclusion strategy to focus on three key areas:

1. Providing a diverse and inclusive workplace;
2. Gender equality; and
3. Supporting employment outcomes for people aged over 50.

New employee-led diversity and inclusion working groups have been established to develop and support age, culture, LGBTQI+ and gender inclusion in the company.

To encourage greater representation of women at senior levels of the organisation, Challenger continues to develop initiatives targeted at improving gender equality, including setting gender diversity targets. As at 30 June 2020, 38% of leadership roles were held by women, compared to Challenger's FY20 target for women in management roles of 40%, representing an 11 percentage point increase since targets were first introduced in 2016.

Challenger is committed to pay equity. Management and the Board review gender pay equity annually as part of the remuneration process. This focus has ensured that for the past five years gender pay equity for similar roles has been maintained.

In FY20, Challenger was recognised as an Employer of Choice for Gender Equality (Workplace Gender Equality Agency) for the third year running. Reflecting continued commitment and progress towards achieving gender equality, Challenger was recognised for the first time as a global top 100 employer for gender equality in the 2019 Equileap Global Gender Equality rankings, and was also included on the Bloomberg Global Gender Equality Index, positioning Challenger among the leading organisations globally making progress towards gender equality in the workplace.

Flexible work practices

Challenger has a focus on providing employees with flexible work arrangements.

At 30 June 2020, 92 employees, representing approximately 12% of Challenger employees, have formal flexible working arrangements. Thirty percent are men.

The number of employees with flexible working arrangements is expected to increase significantly following the COVID-19 pandemic. Challenger is well positioned to support this shift in work practices.

Enhancing sustainability capability

Considering environmental, social and governance (ESG) risks and opportunities supports Challenger in delivering on its vision to provide financial security for retirement. Throughout FY20, Challenger made significant progress in implementing its sustainability strategy.

Challenger's long-term sustainable returns are achieved through the integration of ESG practices across the business.

Challenger continued to develop its ESG practices and supported Fidante Partners to develop ESG practices within their boutique fund managers. All boutiques have developed their own stand-alone ESG policies and are now signatories to the United Nations Principles for Responsible Investment (PRI).

During the year Challenger held internal presentations to provide opportunities for employees and boutiques to further understand ESG risks and opportunities. External experts also provided insights on climate risk and considerations under the modern slavery legislation.

Challenger is well progressed in its assessment of supply chain and investment processes against new modern slavery regulatory reporting requirements.

Challenger continues to be a constituent of the FTSE4Good Index and a signatory to the United Nations PRI.

Supporting the community

In September 2019, Challenger announced a strategic three-year partnership with the Council on the Ageing (COTA) New South Wales. Through this partnership, Challenger will deliver a community program aimed at addressing the underemployment of people aged over 50. Challenger understands that continuing to work as you age is a key driver for financial security in retirement. The program will celebrate the value older Australians bring to the workplace and improve workplace practices to attract and retain older employees.

Challenger also aims to contribute to the communities in which it operates. Through its workplace giving program, company matching, fundraising events and other initiatives, Challenger donated over \$250,000 to charitable and not-for-profit organisations throughout the year. This included raising \$45,000 for the 2020 bushfire appeal.

Key performance indicators

	FY20	FY19	FY18	2H20	1H20	2H19	1H19	2H18	1H18
Earnings									
Normalised NPBT (\$m)	506.5	548.3	547.3	227.9	278.6	278.3	270.0	272.7	274.6
Normalised NPAT (\$m)	343.7	396.1	406.1	152.3	191.4	196.3	199.8	198.2	207.9
Statutory NPAT (\$m)	(416.0)	307.8	322.5	(636.4)	220.4	301.7	6.1	127.1	195.4
Underlying operating cash flow (\$m)	194.7	236.9	197.4	54.7	140.0	133.2	103.7	143.6	53.8
EBIT margin (%)	64.3%	67.4%	67.3%	61.9%	66.5%	67.5%	67.3%	66.8%	67.9%
Normalised cost to income ratio (%)	35.7%	32.6%	32.7%	38.1%	33.5%	32.5%	32.7%	33.2%	32.1%
Normalised effective tax rate (%)	32.1%	27.8%	25.8%	33.2%	31.3%	29.5%	26.0%	27.3%	24.3%
Earnings per share (cents)									
Basic – normalised	56.5	65.5	68.1	25.0	31.5	32.4	33.1	32.9	35.2
Basic – statutory	(68.4)	50.9	54.0	(104.4)	36.3	49.8	1.0	21.1	33.1
Diluted – normalised	46.9	56.0	64.2	21.1	27.7	27.8	30.1	30.9	33.8
Diluted – statutory	(68.4)	44.8	52.2	(104.4)	31.5	41.2	1.0	20.9	31.9
Return On Equity (%)									
Normalised ROE – pre-tax	14.8%	15.8%	16.5%	14.0%	15.2%	16.2%	15.6%	16.1%	16.8%
Normalised ROE – post-tax	10.0%	11.4%	12.2%	9.4%	10.4%	11.4%	11.5%	11.7%	12.7%
Statutory ROE – post-tax	(12.1%)	8.9%	9.7%	(39.2%)	12.0%	17.5%	0.3%	7.5%	11.9%
Capital management									
Net assets – average ¹ (\$m)	3,424	3,462	3,323	3,257	3,634	3,469	3,443	3,419	3,249
Net assets – closing (\$m)	3,250	3,600	3,485	3,250	3,716	3,600	3,388	3,485	3,470
Net assets per basic share (\$)	4.90	5.94	5.79	4.90	6.12	5.94	5.60	5.79	5.75
Net tangible assets (\$m)	2,619	3,019	2,893	2,619	3,079	3,019	2,793	2,893	2,878
Net tangible assets per basic share (\$)	3.95	4.98	4.81	3.95	5.07	4.98	4.61	4.81	4.77
Dividend (cps)	17.5	35.5	35.5	-	17.5	18.0	17.5	18.0	17.5
Dividend franking (%)	100.0	100.0	100.0	-	100.0	100.0	100.0	100.0	100.0
Normalised dividend payout ratio (%)	31.0%	54.2%	52.1%	-	55.5%	55.6%	52.9%	54.7%	49.7%
Sales, net flows and assets under management									
Life annuity sales (\$m)	3,127.4	3,543.1	4,000.7	1,170.5	1,956.9	1,402.6	2,140.5	1,711.2	2,289.5
Other Life sales (\$m)	2,024.0	1,006.9	1,554.9	841.8	1,182.2	407.1	599.8	520.4	1,034.5
Total Life sales (\$m)	5,151.4	4,550.0	5,555.6	2,012.3	3,139.1	1,809.7	2,740.3	2,231.6	3,324.0
Life annuity flows (\$m)	(251.1)	685.8	1,392.7	(344.7)	93.6	192.3	493.5	634.5	758.2
Life annuity book (\$m)	12,581	12,870	11,728	12,581	12,845	12,870	12,324	11,728	11,116
Life annuity book growth (%)	(2.0%)	5.8%	13.5%	(2.7%)	0.7%	1.6%	4.2%	6.2%	7.3%
Total Life flows (\$m)	315.8	474.8	1,796.3	(607.8)	923.6	(108.9)	583.7	848.4	947.9
Total Life book ² (\$m)	14,997	14,836	13,863	14,997	15,551	14,836	14,496	13,863	13,025
Total Life book growth (%)	2.1%	3.4%	15.0%	(4.1%)	6.2%	(0.8%)	4.2%	7.1%	7.9%
Funds Management – net flows (\$m)	2,540.9	(2,438.4)	5,301.2	661.3	1,879.6	(1,461.3)	(977.1)	1,366.9	3,934.3
Total Group AUM (\$m)	85,237	81,770	81,143	85,237	86,339	81,770	78,386	81,143	76,523
Other									
Headcount – closing FTEs ³	735	687	676	735	717	687	675	676	682
Weighted average number of basic shares on issue (m)	608.3	605.0	596.7	609.6	607.1	605.7	604.4	602.2	591.1
Number of basic shares on issue (m)	663.1	605.8	601.7	663.1	607.6	605.8	605.4	601.7	603.3
Share price closing (\$)	4.41	6.64	11.83	4.41	8.09	6.64	9.49	11.83	14.03

¹ Net assets – average calculated on a monthly basis.

² Total Life book includes the Life annuity book and Challenger Index Plus Fund liabilities.

³ Full time equivalent employees.

Consolidated profit and loss

\$m	FY20	FY19	FY18	2H20	1H20	2H19	1H19	2H18	1H18
Cash earnings	518.7	515.0	539.1	244.5	274.2	263.5	251.5	262.7	276.4
Normalised capital growth	120.2	155.1	130.5	49.6	70.6	77.0	78.1	70.8	59.7
Normalised Cash Operating Earnings (COE)	638.9	670.1	669.6	294.1	344.8	340.5	329.6	333.5	336.1
Net fee income	158.1	149.9	151.2	80.4	77.7	74.7	75.2	79.2	72.0
Other income	0.4	1.0	1.0	0.2	0.2	0.5	0.5	0.5	0.5
Total net income	797.4	821.0	821.8	374.7	422.7	415.7	405.3	413.2	408.6
Personnel expenses	(174.0)	(185.3)	(187.8)	(82.7)	(91.3)	(93.2)	(92.1)	(96.8)	(91.0)
Other expenses	(110.4)	(82.1)	(80.6)	(60.1)	(50.3)	(41.8)	(40.3)	(40.5)	(40.1)
Total expenses	(284.4)	(267.4)	(268.4)	(142.8)	(141.6)	(135.0)	(132.4)	(137.3)	(131.1)
Normalised EBIT	513.0	553.6	553.4	231.9	281.1	280.7	272.9	275.9	277.5
Interest and borrowing costs	(6.5)	(5.3)	(6.1)	(4.0)	(2.5)	(2.4)	(2.9)	(3.2)	(2.9)
Normalised profit before tax	506.5	548.3	547.3	227.9	278.6	278.3	270.0	272.7	274.6
Normalised tax	(162.8)	(152.2)	(141.2)	(75.6)	(87.2)	(82.0)	(70.2)	(74.5)	(66.7)
Normalised profit after tax	343.7	396.1	406.1	152.3	191.4	196.3	199.8	198.2	207.9
Investment experience after tax	(750.3)	(88.3)	(76.0)	(788.7)	38.4	105.4	(193.7)	(63.5)	(12.5)
Significant items after tax ¹	(9.4)	-	(7.6)	0.0	(9.4)	-	-	(7.6)	-
Statutory net profit after tax	(416.0)	307.8	322.5	(636.4)	220.4	301.7	6.1	127.1	195.4
Performance analysis									
Normalised EPS – basic (cents)	56.5	65.5	68.1	25.0	31.5	32.4	33.1	32.9	35.2
Shares for basic EPS calculation (m)	608.3	605.0	596.7	609.6	607.1	605.7	604.4	602.2	591.1
Normalised cost to income ratio (%)	35.7%	32.6%	32.7%	38.1%	33.5%	32.5%	32.7%	33.2%	32.1%
Normalised tax rate (%)	32.1%	27.8%	25.8%	33.2%	31.3%	29.5%	26.0%	27.3%	24.3%
Total net income analysis (%)									
Cash earnings (Life)	65.0%	62.7%	65.6%	65.2%	64.9%	63.4%	62.1%	63.6%	67.7%
Normalised capital growth (Life)	15.1%	18.9%	15.9%	13.2%	16.7%	18.5%	19.3%	17.1%	14.6%
Net fee income (Funds Management)	19.8%	18.3%	18.4%	21.5%	18.4%	18.0%	18.5%	19.2%	17.6%
Other income (Corporate)	0.1%	0.1%	0.1%	0.1%	0.0%	0.1%	0.1%	0.1%	0.1%
Normalised EBIT by division (\$m)									
Life	524.7	563.6	562.7	238.9	285.8	285.7	277.9	279.7	283.0
Funds Management	57.7	50.9	57.9	29.8	27.9	24.8	26.1	30.8	27.1
Corporate	(69.4)	(60.9)	(67.2)	(36.8)	(32.6)	(29.8)	(31.1)	(34.6)	(32.6)
Normalised EBIT	513.0	553.6	553.4	231.9	281.1	280.7	272.9	275.9	277.5

¹ 1H20 significant items (after tax) of \$9m represents the write-off of a Fidante Partners boutique intangible asset and wind-up costs following the closure of the FME Asset Management boutique investment manager. 2H18 significant items (after tax) of \$8m represents one-off expenses, including the impairment of residual software and a Fidante Partners boutique following its closure and restructure costs, offset by one-off revenue, including partial writeback of deferred consideration in respect of the acquisition of Fidante Partners Europe.

Consolidated profit and loss (continued)

Normalised profit after tax

FY20 normalised profit after tax was \$344m and decreased by \$52m (13%) from \$396m in FY19. The decrease in normalised profit after tax reflects lower normalised profit before tax (down \$42m) and higher normalised tax (up \$11m).

Normalised earnings per share (EPS)

Normalised EPS decreased by 14% in FY20 to 56.5 cps. The decrease in normalised EPS reflects lower normalised profit after tax (down 13%) and a slightly higher average number of shares on issue.

The weighted average number of shares on issue in FY20 was 608m shares, up 3m shares on FY19. The weighted average number of shares increased as a result of a \$270m institutional placement in June 2020, new shares issued to support Challenger's DRP, and the net release of Treasury Shares to meet CPP Trust requirements.

Net income

Net income was \$797m decreasing by \$24m (down 3%) on FY19, with:

- Life Cash Operating Earnings (COE) decreasing by \$31m as a result of repositioning the portfolio to more defensive settings following the COVID-19 impact on global investment markets and lower normalised capital growth due to a lower equities and other normalised capital growth assumption applied from 1 July 2019; and
- Funds Management fee income increasing by \$8m from higher FUM-based revenue and higher performance fees.

Expenses

FY20 total expenses were \$284m and increased by \$17m (up 6%) on FY19. The increase in expenses predominately relates to an investment in Distribution, Product and Marketing (DPM) initiatives to help drive sales growth (refer to page 8 for more detail). Excluding the DPM growth initiatives (\$13m), FY20 total expenses increased by only \$4m (1%).

The FY20 normalised cost to income ratio was 35.7% and increased by 310bps on FY19. The increase in the cost to income ratio was driven by expense growth (up 6%) and lower net income (down 3%). The FY20 normalised cost to income ratio was above Challenger's target range of between 30% and 34%.

Normalised EBIT

FY20 normalised EBIT was \$513m, down \$41m (7%) on FY19. Lower Life EBIT (down \$39m) and lower Corporate EBIT (down \$9m), were partially offset by an increase in Funds Management EBIT (up \$7m).

Life EBIT decreased by \$39m (down 7%) to \$525m and reflected lower COE (down \$31m) and higher expenses (up \$8m) as a result of DPM initiatives.

Funds Management EBIT increased by \$7m (up 13%) to \$58m, from higher average FUM and higher Fidante Partners performance fees.

Corporate EBIT decreased by \$9m (down 14%) due to higher expenses.

Normalised Return On Equity (ROE)

FY20 normalised ROE (pre-tax) was 14.8% and decreased by 100bps on FY19. Lower normalised ROE reflects lower normalised profit before tax (down 8%) and broadly stable average Group net assets. Group net assets includes movements in retained profits, including FY20 Life investment experience losses (refer to page 27 for more detail) and the proceeds from a \$270m institutional placement in June 2020 (refer to page 45 for more detail). While average Group net assets was broadly stable on FY19, closing Group net assets was down 10% on FY19.

Normalised tax

Normalised tax was \$163m in FY20 and increased by \$11m on FY19. The higher normalised tax reflects a higher effective tax rate, which was 32.1%, up from 27.8% in FY19.

The increase in the effective tax rate above the statutory tax rate of 30% is predominantly due to the loss of tax credits for foreign tax already paid during the year, which are not available given the domestic tax losses incurred in FY20 and lower utilisation of available group losses.

The effective tax rate is above 30% also due to the non-deductible interest payments on both Challenger Capital Notes and Challenger Capital Notes 2.

Investment experience after tax

Challenger Life Company Limited (CLC) 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.

Changes in macroeconomic variables impact the value of Life's assets and liabilities, with the impact included as investment experience.

Investment experience also includes new business strain, being the requirement to apply the risk-free discount rate plus an illiquidity premium to value annuity liabilities, rather than the actual interest rate paid on annuity liabilities (refer to page 56 for more detail).

FY20 investment experience was a loss of \$750m (after tax) and driven by the COVID-19 pandemic-related market sell-off. With the portfolio repositioned in 2H20 in response, approximately half of investment experience is realised and half is unrealised. Refer to page 27 for more detail, including investment experience by asset class.

Significant items

FY20 significant items were \$9m and relate to the write-off of a Fidante Partners boutique intangible asset and costs associated with the wind-up of the FME Asset Management boutique.

Statutory net profit after tax

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

Statutory net loss after tax was \$416m in FY20 and includes \$750m of Life investment experience losses (refer to page 27 for more detail).

Dividends

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

FY20 dividend

The interim FY20 dividend paid was 17.5 cps (fully franked).

In April 2020 following the immediate impact of COVID-19, APRA wrote to all authorised deposit taking institutions (ADIs) and insurers noting APRA's expectation that ADIs and insurers limit dividends given the uncertain outlook.

The Challenger Board has not declared a final FY20 dividend, reflecting the significant statutory loss incurred in FY20, and is prioritising maintaining a strong capital position during the COVID-19 pandemic.

Challenger's franking account balance at 30 June 2020 was \$12m. This amount is calculated from the balance of the franking account as at the end of the period, adjusted for franking credits that will arise from the settlement of current income tax liabilities and interest on Challenger Capital Notes.

Dividend Reinvestment Plan (DRP)

Challenger operates a DRP, providing an effective way for shareholders to reinvest their dividends and increase their shareholding without incurring transaction costs.

The DRP participation rate for the interim FY20 dividend (paid in March 2020) was 2% of issued capital, with 0.3m new Challenger shares issued. Under the terms of the DRP, new Challenger shares were issued based on a 10-day Challenger volume-weighted average price (VWAP), with no share price discount applied.

No final dividend has been declared for FY20, and as a result the DRP will not operate in September 2020.

FY21 outlook

Normalised profit before tax guidance

Challenger's FY21 normalised profit before tax guidance is a range of \$390m to \$440m.

A key consideration in setting FY21 guidance is the speed of deployment of Life's strong capital position. This deployment will be implemented through up to \$3bn of cash and liquids on hand at 30 June 2020 being invested into higher returning assets in order to enhance Life's returns. Challenger's FY21 normalised net profit before tax guidance assumes gradual and prudent deployment over the course of FY21.

The COVID-19 situation and its impacts on markets create an inherently uncertain environment. This could, among other

things, impact the speed of deployment of Life's capital and therefore impact guidance.

Challenger's FY21 normalised profit before tax guidance also assumes Life's defensive portfolio settings will be maintained and up to \$22m of rental abatements to Life's property tenants have been assumed.

Normalised Return On Equity (ROE) target

Challenger's normalised ROE (pre-tax) target has been set as the Reserve Bank of Australia (RBA) cash rate plus a margin of 14%. Using an ROE target linked to the RBA cash rate removes the direct impact of interest rate changes from the ROE target.

Notwithstanding a lower normalised profit before tax guidance range for FY21, Challenger continues to maintain its ROE target over the medium term. This is subject to speed of capital deployment and market conditions.

Normalised cost to income ratio target

Challenger's business is highly efficient and very scalable. As a result, Challenger is one of Australia's most efficient financial services companies.

For FY20, Challenger's normalised cost to income ratio was 35.7% and exceeded the upper end of Challenger's target of between 30% and 34%, due to \$13m invested in a range of Distribution, Product and Marketing initiatives.

Given the uncertain economic outlook, Challenger is maintaining ongoing disciplined expense management across the Group and expects FY21 expenses to be lower than FY20.

Normalised effective tax rate target

The FY20 normalised effective tax rate was 32.1% and is above 30% for reasons outlined above.

Over the medium term, Challenger expects a normalised effective tax rate of approximately 30%.

Dividend

Challenger continues to target a normalised dividend payout ratio of between 45% and 50% of normalised profit after tax and seeks to frank the dividend to the maximum extent possible. However, the actual dividend payout ratio and franking will depend on prevailing market conditions and capital allocation priorities at the time.

Credit ratings

In March 2020, Standard & Poor's Global Ratings (S&P) completed its annual ratings review and affirmed both Challenger Life Company Limited's (CLC) and Challenger Limited's credit ratings.

Reflecting the significant market volatility from the COVID-19 pandemic, S&P removed the positive outlooks for both CLC and Challenger Limited and reverted to stable outlooks.

S&P ratings are as follows:

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

Group balance sheet¹

\$m	FY20	1H20	FY19	1H19	FY18	1H18
Assets						
Life investment assets						
Fixed income and cash (net)	13,970.6	12,956.7	12,459.8	12,014.5	11,727.8	11,076.5
Property (net)	3,292.1	3,337.8	3,382.0	3,739.4	3,840.5	3,654.6
Equity and other investments	837.9	2,541.6	2,315.1	2,113.4	1,799.1	1,642.7
Infrastructure (net)	202.7	833.2	853.5	757.0	717.7	666.3
Life investment assets	18,303.3	19,669.3	19,010.4	18,624.3	18,085.1	17,040.1
Cash and cash equivalents (Group cash)	146.1	141.2	91.5	87.7	84.9	121.9
Receivables	163.0	121.2	182.7	167.7	198.3	155.1
Derivative assets	522.9	403.3	331.2	158.7	150.7	243.4
Investment in associates	63.0	56.1	58.1	53.4	62.4	54.2
Other assets	65.8	60.3	76.6	57.0	50.6	53.3
Fixed assets	25.9	27.3	28.3	29.7	31.2	32.2
Right-of-use lease assets ²	32.4	34.4	-	-	-	-
Tax assets	43.1	-	-	-	-	-
Goodwill and intangibles	598.0	602.0	581.2	594.9	592.9	591.3
Less Group/Life eliminations ³	(41.0)	(44.8)	(62.4)	(63.5)	(73.7)	(83.8)
Total assets	19,922.5	21,070.3	20,297.6	19,709.9	19,182.4	18,207.7
Liabilities						
Payables	191.4	189.6	256.1	306.5	303.8	249.1
Tax liabilities	-	204.8	158.2	31.8	89.0	95.2
Derivative liabilities	136.2	118.8	227.0	276.3	229.6	158.7
Subordinated debt	395.7	404.9	403.9	400.6	403.7	405.3
Challenger Capital Notes	799.5	798.3	796.5	794.7	793.0	791.2
Group Debt	50.0	-	-	-	-	-
Lease liabilities ²	67.6	70.2	-	-	-	-
Provisions	35.5	17.0	19.2	16.1	14.6	13.6
Life annuity book	12,581.2	12,845.3	12,870.2	12,323.7	11,728.3	11,115.8
Challenger Index Plus Fund liabilities	2,415.8	2,705.6	1,966.2	2,172.3	2,135.0	1,909.3
Total liabilities	16,672.9	17,354.5	16,697.3	16,322.0	15,697.0	14,738.2
Group net assets	3,249.6	3,715.8	3,600.3	3,387.9	3,485.4	3,469.5
Equity						
Contributed equity	2,377.6	2,110.8	2,093.7	2,090.2	2,051.7	2,071.0
Reserves	(50.9)	(61.0)	(52.4)	(66.0)	(33.3)	(47.5)
Retained earnings	922.9	1,666.0	1,559.0	1,363.7	1,467.0	1,446.0
Total equity	3,249.6	3,715.8	3,600.3	3,387.9	3,485.4	3,469.5

¹ Excludes consolidation of Special Purpose Vehicles and non-controlling interests.

² Reflects the adoption of AASB 16 Leases on 1 July 2019.

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

Change in Group net assets

\$m	2H20	1H20	2H19	1H19	2H18	1H18
Opening net assets	3,715.8	3,600.3	3,387.9	3,485.4	3,469.5	2,888.1
Statutory net profit after tax	(636.4)	220.4	301.7	6.1	127.1	195.4
Dividends paid	(106.7)	(109.7)	(106.4)	(109.4)	(106.1)	(99.5)
New share issue	266.8	2.6	3.4	3.4	3.3	503.3
Reserve movements	10.1	(8.6)	13.7	(32.7)	14.2	(31.0)
CPP ¹ Trust movements	-	14.5	-	35.1	(22.6)	13.2
Transition of new leasing standard ²	-	(3.7)	-	-	-	-
Closing net assets	3,249.6	3,715.8	3,600.3	3,387.9	3,485.4	3,469.5

¹ The Challenger Performance Plan (CPP) Trust.

² Reflects the adoption of AASB 16 Leases on 1 July 2019.

Issued share capital, dilutive share count and earnings per share

	FY20	FY19	FY18	2H20	1H20	2H19	1H19	2H18	1H18
Earnings per share (cents)									
Basic – normalised	56.5	65.5	68.1	25.0	31.5	32.4	33.1	32.9	35.2
Basic – statutory	(68.4)	50.9	54.0	(104.4)	36.3	49.8	1.0	21.1	33.1
Diluted – normalised	46.9	56.0	64.2	21.1	27.7	27.8	30.1	30.9	33.8
Diluted – statutory	(68.4)	44.8	52.2	(104.4)	31.5	41.2	1.0	20.9	31.9
Number of shares (m)									
Basic share count	663.1	605.8	601.7	663.1	607.6	605.8	605.4	601.7	603.3
CPP ¹ Trust treasury shares	4.4	5.8	9.2	4.4	4.4	5.8	5.8	9.2	7.3
Total issued shares	667.5	611.6	610.9	667.5	612.0	611.6	611.2	610.9	610.6
Movement in basic share count									
Opening	605.8	601.7	561.9	607.6	605.8	605.4	601.7	603.3	561.9
CPP ¹ Trust deferred share purchase	-	(0.8)	(4.0)	-	-	-	(0.8)	(2.0)	(2.0)
Net Treasury shares (acquired)/released	1.4	4.2	4.9	-	1.4	-	4.2	0.1	4.8
New share issues	55.9	0.7	38.9	55.5	0.4	0.4	0.3	0.3	38.6
Closing	663.1	605.8	601.7	663.1	607.6	605.8	605.4	601.7	603.3
Movement in CPP Trust Treasury shares									
Opening	5.8	9.2	10.1	4.4	5.8	5.8	9.2	7.3	10.1
Shares vested to participants	(1.4)	(4.2)	(5.7)	-	(1.4)	-	(4.2)	(0.1)	(5.6)
CPP ¹ Trust deferred share purchase	-	0.8	4.0	-	-	-	0.8	2.0	2.0
Shares bought into CPP Trust	-	-	0.8	-	-	-	-	-	0.8
Closing	4.4	5.8	9.2	4.4	4.4	5.8	5.8	9.2	7.3
Weighted average number of shares (m)									
Basic EPS shares									
Total issued shares	612.8	611.2	605.2	614.0	611.8	611.4	611.0	610.9	599.4
Less CPP ¹ Trust Treasury shares	(4.5)	(6.2)	(8.5)	(4.4)	(4.7)	(5.7)	(6.6)	(8.7)	(8.3)
Shares for basic EPS calculation	608.3	605.0	596.7	609.6	607.1	605.7	604.4	602.2	591.1
Diluted shares for normalised EPS									
Shares for basic EPS calculation	608.3	605.0	596.7	609.6	607.1	605.7	604.4	602.2	591.1
Add dilutive impact of unvested equity awards	4.2	4.5	10.7	4.2	4.3	2.9	7.1	10.5	11.9
Add dilutive impact of Capital Notes	145.5	117.8	65.6	145.5	99.5	117.8	85.1	65.6	57.8
Add dilutive impact of subordinated notes	59.1	58.5	19.6	59.1	49.5	58.5	42.3	32.6	5.9
Shares for diluted normalised EPS calculation	817.1	785.8	692.6	818.4	760.4	784.9	738.9	710.9	666.7
Diluted shares for statutory EPS									
Shares for basic EPS calculation	608.3	605.0	596.7	609.6	607.1	605.7	604.4	602.2	591.1
Add dilutive impact of unvested equity awards	-	4.5	10.7	-	4.3	2.9	7.1	10.5	11.9
Add dilutive impact of Capital Notes	-	117.8	65.6	-	99.5	117.8	-	65.6	57.8
Add dilutive impact of subordinated notes	-	58.5	19.6	-	49.5	58.5	-	32.6	5.9
Shares for diluted statutory EPS calculation	608.3	785.8	692.6	609.6	760.4	784.9	611.5	710.9	666.7
Summary of shares rights (m)									
Hurdled Performance Share Rights									
Opening	7.2	8.2	10.2	10.2	7.2	7.4	8.2	8.2	10.2
New grants	3.9	2.2	2.0	-	3.9	-	2.2	-	2.0
Vesting/forfeiture	(1.3)	(3.2)	(4.0)	(0.4)	(0.9)	(0.2)	(3.0)	-	(4.0)
Closing	9.8	7.2	8.2	9.8	10.2	7.2	7.4	8.2	8.2
Deferred Performance Share Rights									
Opening	2.5	2.8	3.7	2.1	2.5	2.6	2.8	2.9	3.7
New grants	1.1	1.4	1.3	-	1.1	-	1.4	-	1.3
Vesting/forfeiture	(1.5)	(1.7)	(2.2)	-	(1.5)	(0.1)	(1.6)	(0.1)	(2.1)
Closing	2.1	2.5	2.8	2.1	2.1	2.5	2.6	2.8	2.9

¹ The Challenger Performance Plan (CPP) Trust.

Issued share capital

Issued share capital and diluted share count

The number of Challenger Limited shares listed on the ASX at 30 June 2020 was 668m shares. The number of shares on issue increased by 56m shares during FY20, predominantly due to approximately 55.2m new fully paid ordinary shares issued to institutional investors as part of a \$270m equity raising completed in June 2020.

Challenger also undertook a share purchase plan (SPP) which completed in July 2020, raising \$35m with 8.1m new shares issued.

The basic share count used to determine Challenger's normalised and statutory EPS is based on requirements set out in Australian Accounting Standards, as follows:

- 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 (CPP); and
- the dilutive share count considers convertible instruments (e.g. Challenger Capital Notes, Challenger Capital Notes 2, and subordinated debt) as determined by a probability of vesting test (refer to page 20 for more detail on the accounting treatment).

Treasury shares

The CPP Trust was established to purchase shares to satisfy Challenger's employee equity obligations arising from hurdle and deferred performance share rights issued under employee remuneration structures.

Shares are acquired by the CPP Trust to mitigate shareholder dilution and 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. The use of forward share purchase agreements was implemented to increase capital efficiency. Shares held by the CPP Trust and share forward purchase agreements 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.

Weighted average share count

The basic weighted average number of shares used to determine both the normalised and statutory basic EPS increased by 3m shares (up 1%) in FY20 to 608m shares. The increase reflects the weighted impact of 55.2m new shares issued to institutional shareholders in June 2020 and new shares issued to support Challenger's DRP and the net release of Treasury shares to meet CPP Trust requirements.

The weighted average number of shares used to determine the normalised diluted EPS increased by 31m shares (up 9%) in FY20 to 817m shares. The increase primarily reflects a higher dilutive impact from Challenger Capital Notes, Challenger Capital Notes 2, and subordinated debt as a result of the lower Challenger share price used to calculate the potential dilution. Refer to page 20 for more detail.

The weighted average number of shares used to determine the statutory diluted EPS is the same as the statutory basic EPS, given Challenger has recorded a statutory loss for the year. This is because the dilutive impact of issuing more shares means that the loss incurred is spread over a higher share count, which results in a lower loss per share. In these circumstances, the dilutive EPS cannot be lower than the basic EPS.

Dilutive share count and earnings per share

Dilutive share count

Dilutive impact of unvested equity awards

Challenger's approach to executive remuneration includes providing equity awards to ensure alignment between key employees and shareholders.

Hurdled Performance Share Rights (HPSRs) vest over a period of up to five years, with vesting subject to meeting total shareholder return performance hurdles and continued employment.

A portion of variable remuneration is awarded in Deferred Performance Share Rights (DPSRs) which vest over a period of up to four years, subject to continued employment.

The dilutive impact of these awards in any given period is based on the probability of future vesting.

Accounting treatment of Capital Notes and subordinated debt

Challenger Capital Notes, Challenger Capital Notes 2 and subordinated debt are an effective source of funding for Challenger.

Each of the Capital Notes, Capital Notes 2 and subordinated debt have convertibility features which would result in these instruments converting to ordinary shares under certain circumstances, including the Australian Prudential Regulation Authority (APRA) determining Challenger Life to be non-viable. It is Challenger's intention to refinance each of these instruments at their respective call dates and therefore conversion to ordinary shares is unlikely.

However, under Australian Accounting Standards, convertible debt is considered dilutive whenever the interest per potential ordinary share for each of these instruments is less than Challenger's basic EPS for the period. As such, a test is required to be undertaken each reporting period to determine if they are included in the dilutive share count.

Dilutive impact of Capital Notes and subordinated debt

The dilutive share count for Challenger's convertible debt (Challenger Capital Notes and subordinated debt) is based on the following formula:

$$\frac{\text{Face value of debt}}{\text{Conversion factor} \times \text{Challenger's 20-day VWAP share price}}$$

The conversion factor for all of Challenger's convertible debt is 99%. The weighted average Challenger share price is determined over the last 20 days of trading in each reporting period, subject to a minimum VWAP floor. Challenger's 20-day VWAP share price leading up to 30 June 2020 was \$4.98.

Mandatory conversion of Challenger's convertible debt is subject to a VWAP floor, being 50% of the issue date VWAP. As a result, under mandatory conversion, the VWAP floor for mandatory conversion is as follows:

Issue	Issue date	Face value	VWAP floor
Challenger Capital Notes	9 Oct 2014	\$345m	\$3.6140
Challenger Capital Notes 2	7 Apr 2017	\$460m	\$6.1500
Subordinated debt	24 Nov 2017	\$400m	\$6.8400

For both Challenger Capital Notes 2 and subordinated debt, the minimum VWAP floor price is lower than the Challenger VWAP share price leading up to 30 June 2020 (\$4.98). Therefore, the VWAP floor is used at 30 June 2020 to determine the dilutive share count for both Challenger Capital Notes 2 and subordinated debt. The 20-day Challenger VWAP share price is used to determine the potential dilutive impact from Challenger Capital Notes.

Earnings per share

Normalised diluted EPS

The normalised basic EPS for FY20 of 56.5 cps is greater than the interest cost per potential ordinary share for each of the Challenger Capital Notes, Challenger Capital Notes 2, and subordinated debt. As a result, all instruments were considered to be dilutive in FY20.

The weighted average number of shares used to determine the normalised diluted EPS increased by 31m shares in FY20.

The increase is due to the weighted average Challenger share price for the last 20 trading days of FY20 (\$4.98) or the VWAP minimum floor price as relevant being lower than \$6.90, being the VWAP share price for the last 20 trading days of FY19.

The lower Challenger share price results in a higher number of shares being issued should the debt ever convert to equity.

To determine the normalised diluted EPS, the normalised profit after tax is increased by \$40m of interest expense in relation to Challenger Capital Notes, Challenger Capital Notes 2 and subordinated debt.

Consolidated operating cash flow

\$m	FY20	FY19	FY18	2H20	1H20	2H19	1H19	2H18	1H18
Receipts from customers	683.3	700.9	670.2	348.8	334.5	364.6	336.3	333.7	336.5
Dividends received	66.0	101.7	94.8	20.3	45.7	34.1	67.6	41.0	53.8
Interest received	711.9	780.4	750.1	327.0	384.9	367.0	413.4	364.5	385.6
Interest paid	(686.2)	(729.2)	(571.9)	(415.6)	(270.6)	(362.7)	(366.5)	(296.9)	(275.0)
Payments to suppliers and employees	(564.5)	(561.5)	(548.3)	(258.9)	(305.6)	(258.0)	(303.5)	(253.6)	(294.7)
Income tax (paid) / refunded	(15.8)	(55.4)	(197.5)	33.1	(48.9)	(11.8)	(43.6)	(45.1)	(152.4)
Underlying operating cash flow	194.7	236.9	197.4	54.7	140.0	133.2	103.7	143.6	53.8
Net annuity policy capital receipts	(251.1)	685.8	1,392.7	(344.7)	93.6	192.1	493.7	634.5	758.2
Net other Life capital receipts/(payments)	566.9	(211.0)	403.6	(263.1)	830.0	(301.2)	90.2	214.0	189.6
(Purchase)/Proceeds of investments	(1,467.7)	(904.8)	(2,479.7)	(568.5)	(899.2)	333.8	(1,238.6)	(1,447.0)	(1,032.7)
Capital expenditures	(9.3)	(59.9)	(69.9)	(3.3)	(6.0)	(18.5)	(41.4)	(53.5)	(16.4)
Net equity placement proceeds	264.1	-	499.8	264.1	-	-	-	-	499.8
Net (repayments)/proceeds from borrowings	820.0	506.3	538.7	825.7	(5.7)	35.6	470.7	476.4	62.3
Payments for Treasury shares	(8.3)	(47.5)	(36.7)	(4.5)	(3.8)	(7.8)	(39.7)	(1.9)	(34.8)
Net dividends paid	(211.0)	(209.0)	(198.8)	(103.9)	(107.1)	(103.0)	(106.0)	(102.8)	(96.0)
Net non-operating cashflows SPV's	(28.3)	(43.9)	(45.2)	(19.8)	(8.5)	(22.0)	(21.9)	(18.1)	(27.1)
Other cash flow	(324.7)	(284.0)	4.5	(218.0)	(106.7)	109.0	(393.0)	(298.4)	302.9
Net increase/(decrease) in cash and cash equivalents	(130.0)	(47.1)	201.9	(163.3)	33.3	242.2	(289.3)	(154.8)	356.7

Underlying operating cash flow

Underlying operating cash flow excludes cash flows that are capital in nature, such as annuity sales and annuity capital payments, and investing and financing-related cash flows.

FY20 underlying operating cash flow was \$195m, down \$42m on FY19. The decrease in underlying operating cash flow reflects lower interest and dividends received net of interest paid to customers, partially offset by lower income tax paid.

FY20 underlying operating cash flow of \$195m is \$149m lower than normalised net profit after tax mainly due to non-cash normalised capital growth of \$120m and Fidante Partners equity-accounted profits.

Net annuity policy capital receipts

FY20 net annuity policy capital receipts were -\$251m and comprised:

- annuity sales of \$3,127m; less
- annuity capital payments of \$3,378m.

Annuity capital payments represent the return of capital to annuitants and exclude interest payments.

FY20 annuity net flows (-\$251m) represents annuity book growth of -2.0% for the year and is calculated as FY20 annuity total net flows divided by the opening period annuity liability of \$12,870m.

FY20 annuity net flows (-\$251m) include lower domestic annuity sales, offset by strong growth in Japanese annuity sales. Total annuity sales were down 12%.

FY20 annuity net flows were also impacted by a \$150m early withdrawal across a portfolio of clients advised by one adviser, which had the impact of reducing FY20 annuity book growth by ~1.2%.

Net other Life capital receipts

FY20 net other Life capital receipts were \$567m and comprised:

- other Life sales of \$2,024m; less
- other Life capital payments of \$1,457m.

FY20 other Life net flows of \$567m were \$778m higher than FY19 and are benefiting from a focus on expanding institutional partnerships and strong client demand for guaranteed income in the low interest rate and volatile investment markets.

FY20 total Life book growth was 2.1% (FY19 3.4%) and can be calculated as total FY20 net flows (\$316m) divided by the sum of the opening period liabilities of \$14,836m (Life annuity book and Challenger Index Plus Fund – refer to page 29 for more detail).

Life financial results

\$m	FY20	FY19	FY18	2H20	1H20	2H19	1H19	2H18	1H18
Investment yield – policyholders' funds	840.5	871.3	869.0	398.4	442.1	438.8	432.5	433.6	435.4
Interest expense	(473.6)	(515.4)	(485.4)	(227.8)	(245.8)	(255.3)	(260.1)	(250.7)	(234.7)
Distribution expense	(10.5)	(18.3)	(22.1)	(4.8)	(5.7)	(7.3)	(11.0)	(10.4)	(11.7)
Other income ¹	47.2	33.6	22.8	31.2	16.0	15.3	18.3	12.0	10.8
Product cash margin	403.6	371.2	384.3	197.0	206.6	191.5	179.7	184.5	199.8
Investment yield – shareholders' funds	115.1	143.8	154.8	47.5	67.6	72.0	71.8	78.2	76.6
Cash earnings	518.7	515.0	539.1	244.5	274.2	263.5	251.5	262.7	276.4
Normalised capital growth	120.2	155.1	130.5	49.6	70.6	77.0	78.1	70.8	59.7
Normalised Cash Operating Earnings	638.9	670.1	669.6	294.1	344.8	340.5	329.6	333.5	336.1
Personnel expenses	(68.6)	(68.9)	(67.7)	(32.0)	(36.6)	(34.8)	(34.1)	(33.9)	(33.8)
Other expenses	(45.6)	(37.6)	(39.2)	(23.2)	(22.4)	(20.0)	(17.6)	(19.9)	(19.3)
Total expenses	(114.2)	(106.5)	(106.9)	(55.2)	(59.0)	(54.8)	(51.7)	(53.8)	(53.1)
Normalised EBIT	524.7	563.6	562.7	238.9	285.8	285.7	277.9	279.7	283.0
Asset and liability experience ²	(1,102.4)	(70.2)	(45.0)	(1,157.3)	54.9	164.1	(234.3)	(60.5)	15.5
New business strain ²	31.9	(33.3)	(58.9)	30.9	1.0	2.6	(35.9)	(21.5)	(37.4)
Total investment experience	(1,070.5)	(103.5)	(103.9)	(1,126.4)	55.9	166.7	(270.2)	(82.0)	(21.9)
Net profit after investment experience before tax	(545.8)	460.1	458.8	(887.5)	341.7	452.4	7.7	197.7	261.1
Reconciliation of investment experience to capital growth									
Asset and liability experience	(1,102.4)	(70.2)	(45.0)	(1,157.3)	54.9	164.1	(234.3)	(60.5)	15.5
Normalised capital growth	120.2	155.1	130.5	49.6	70.6	77.0	78.1	70.8	59.7
Asset and liability capital growth	(982.2)	84.9	85.5	(1,107.7)	125.5	241.1	(156.2)	10.3	75.2
Performance analysis									
Cost to income ratio ³ (%)	17.9%	15.9%	16.0%	18.8%	17.1%	16.1%	15.7%	16.1%	15.8%
Net assets – average ⁴ (\$m)	3,163	3,164	3,034	2,982	3,388	3,164	3,151	3,127	2,959
Normalised ROE (pre-tax) (%)	16.6%	17.8%	18.5%	16.1%	16.8%	18.2%	17.5%	18.0%	19.0%

¹ Other income includes Accurium revenue and Life Risk revenue (premiums net of claims).

² Investment experience comprises asset and liability experience and net new business strain. Refer to page 56 for more detail.

³ Cost to income ratio calculated as total expenses divided by Normalised Cash Operating Earnings.

⁴ Net assets – average calculated on a monthly basis.

Life financial results

\$m	FY20	FY19	FY18	2H20	1H20	2H19	1H19	2H18	1H18
Sales									
Fixed term sales	2,712.8	2,689.8	3,145.8	966.8	1,746.0	990.9	1,698.9	1,278.6	1,867.2
Lifetime sales	414.6	853.3	854.9	203.7	210.9	411.7	441.6	432.6	422.3
Life annuity sales	3,127.4	3,543.1	4,000.7	1,170.5	1,956.9	1,402.6	2,140.5	1,711.2	2,289.5
Maturities and repayments	(3,378.5)	(2,857.3)	(2,608.0)	(1,515.2)	(1,863.3)	(1,210.3)	(1,647.0)	(1,076.7)	(1,531.3)
Life annuity flows	(251.1)	685.8	1,392.7	(344.7)	93.6	192.3	493.5	634.5	758.2
Closing Life annuity book	12,581.2	12,870.2	11,728.3	12,581.2	12,845.3	12,870.2	12,323.7	11,728.3	11,115.8
Annuity book growth¹	(2.0%)	5.8%	13.5%	(2.7%)	0.7%	1.6%	4.2%	6.2%	7.3%
Other Life sales	2,024.0	1,006.9	1,554.9	841.8	1,182.2	407.1	599.8	520.4	1,034.5
Other maturities and repayments	(1,457.1)	(1,217.9)	(1,151.3)	(1,104.9)	(352.2)	(708.3)	(509.6)	(306.5)	(844.8)
Other Life flows	566.9	(211.0)	403.6	(263.1)	830.0	(301.2)	90.2	213.9	189.7
Closing Challenger Index Plus Fund liabilities	2,415.8	1,966.2	2,135.0	2,415.8	2,705.6	1,966.2	2,172.3	2,135.0	1,909.3
Other Life net book growth¹	28.8%	(9.9%)	23.9%	(13.4%)	42.2%	(14.1%)	4.2%	12.7%	11.2%
Total Life sales	5,151.4	4,550.0	5,555.6	2,012.3	3,139.1	1,809.7	2,740.3	2,231.6	3,324.0
Total maturities and repayments	(4,835.6)	(4,075.2)	(3,759.3)	(2,620.1)	(2,215.5)	(1,918.6)	(2,156.6)	(1,383.2)	(2,376.1)
Total Life net flows	315.8	474.8	1,796.3	(607.8)	923.6	(108.9)	583.7	848.4	947.9
Closing total Life book ²	14,997.0	14,836.4	13,863.3	14,997.0	15,550.9	14,836.4	14,496.0	13,863.3	13,025.1
Total Life book growth¹	2.1%	3.4%	15.0%	(4.1%)	6.2%	(0.8%)	4.2%	7.1%	7.9%
Assets									
Closing investment assets	18,303	19,010	18,085	18,303	19,669	19,010	18,624	18,085	17,040
Fixed income and cash	13,287	12,022	11,189	13,691	12,836	12,241	11,802	11,380	10,984
Property	3,321	3,588	3,543	3,308	3,336	3,535	3,661	3,714	3,388
Equity and other investments	1,956	2,122	1,671	1,591	2,405	2,154	2,090	1,807	1,532
Infrastructure	658	762	620	475	866	785	739	681	566
Average investment assets³	19,222	18,494	17,023	19,065	19,443	18,715	18,292	17,582	16,470
Liabilities									
Closing liabilities	16,198	16,045	15,072	16,198	16,761	16,045	15,702	15,072	14,235
Annuities and Challenger Index Plus Fund	15,410	14,414	13,051	15,499	15,341	14,646	14,194	13,530	12,568
Capital Notes	805	805	805	805	805	805	805	805	805
Subordinated debt	402	405	404	400	406	405	405	407	401
Average liabilities³	16,617	15,624	14,260	16,704	16,552	15,856	15,404	14,742	13,774
Margins⁴									
Investment yield – policyholders' funds	4.37%	4.71%	5.11%	4.20%	4.52%	4.73%	4.69%	4.97%	5.25%
Interest expense	(2.46%)	(2.79%)	(2.85%)	(2.40%)	(2.51%)	(2.75%)	(2.82%)	(2.87%)	(2.83%)
Distribution expense	(0.06%)	(0.10%)	(0.13%)	(0.05%)	(0.06%)	(0.08%)	(0.12%)	(0.12%)	(0.14%)
Other income	0.25%	0.19%	0.13%	0.33%	0.16%	0.16%	0.20%	0.14%	0.13%
Product cash margin	2.10%	2.01%	2.26%	2.08%	2.11%	2.06%	1.95%	2.12%	2.41%
Investment yield – shareholders' funds	0.60%	0.77%	0.91%	0.50%	0.70%	0.78%	0.78%	0.89%	0.92%
Cash earnings	2.70%	2.78%	3.17%	2.58%	2.81%	2.84%	2.73%	3.01%	3.33%
Normalised capital growth	0.62%	0.84%	0.76%	0.52%	0.72%	0.83%	0.84%	0.82%	0.72%
Normalised Cash Operating Earnings (COE)	3.32%	3.62%	3.93%	3.10%	3.53%	3.67%	3.57%	3.83%	4.05%

¹ Total Life book growth percentage represents Life annuity net flows and other Life net flows over the period divided by the opening Life annuity book, and Challenger Index Plus Fund liabilities.

² Life annuity book and Challenger Index Plus Fund liabilities.

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

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

Life financial results

Life quarterly sales and investment assets

\$m	Q4 20	Q3 20	Q2 20	Q1 20	Q4 19
Life sales					
Fixed term sales	480	487	999	747	488
Lifetime sales ¹	98	106	116	95	252
Life annuity sales	578	593	1,115	842	740
Maturities and repayments	(926)	(590)	(1,023)	(840)	(614)
Life annuity flows	(348)	3	92	2	126
Annuity book growth²	(2.7%)	0.0%	0.7%	0.0%	1.0%
Other Life sales	486	356	246	936	199
Other maturities and repayments	(783)	(322)	(180)	(172)	(264)
Other Life flows	(297)	34	66	764	(65)
Other Life net book growth²	(15.2%)	1.7%	3.4%	38.9%	(3.0%)
Total Life sales	1,064	949	1,361	1,778	939
Total maturities and repayments	(1,709)	(912)	(1,203)	(1,012)	(878)
Total Life net flows	(645)	37	158	766	61
Total Life book growth²	(4.3%)	0.2%	1.0%	5.2%	0.4%
Life					
Fixed income and cash ³	13,970	14,571	12,957	13,076	12,460
Property ³	3,292	3,320	3,338	3,288	3,382
Equity and other	838	866	2,541	2,431	2,315
Infrastructure ³	203	203	833	888	853
Total Life investment assets	18,303	18,960	19,669	19,683	19,010
Average Life investment assets⁴	18,393	19,696	19,693	19,253	18,752

¹ Lifetime sales includes CarePlus, a product that pays income for life and is specifically designed for the aged care market.

² Book growth percentage represents net flows for the period divided by opening book value for the financial year.

³ Fixed income, property and infrastructure reported net of debt.

⁴ Average Life investment assets calculated on a monthly basis.

Life asset allocation



Life financial results

Life focuses on the retirement spending phase of superannuation by providing products that convert retirement savings into safe and secure income for life. Challenger Life is Australia's leading provider of annuities¹.

Life's annuity products appeal to retirees as they provide security and certainty of guaranteed² income while protecting against risks of market downturns and inflation. Lifetime annuities protect retirees from the risk of outliving their savings by paying guaranteed income for life.

The retirement incomes Life pays is backed by a high-quality investment portfolio, predominantly invested in high-grade fixed income. These investments generate investment income to fund retirement incomes paid to customers.

Life's products are distributed in Australia via both independent financial advisers and financial advisers tied to the administrative platforms serviced by the major banks and hubs. Life's products are available on leading independent investment and administration platforms.

Life is a market leader in Australian retirement incomes, with a 75%¹ annuity market share, and has won the Association of Financial Advisers 'Annuity Provider of the Year' for the last 12 years. In FY20, Challenger won four awards at the inaugural 2019 Plan for Life Longevity Cover Excellence Awards, which recognise Australian life insurance companies and fund managers who design products to assist retirees in meeting the challenges of rising longevity.

Challenger remains the dominant brand in retirement income and is recognised by 93%³ of advisers as a leader in retirement incomes.

Life also has an annuity relationship with Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary), a leading provider of foreign currency annuities in Japan (refer to page 30 for more detail).

The Life business includes Accurium, one of Australia's largest providers of self-managed superannuation fund (SMSF) actuarial certificates. Life also participates in wholesale reinsurance longevity and mortality transactions (refer to page 26 for more detail).

CLC is an APRA-regulated entity and its financial strength is rated by Standard & Poor's with an 'A' rating and stable outlook. CLC's capital strength is outlined on page 44.

Normalised EBIT and ROE

Life's normalised EBIT was \$525m in FY20 and decreased by \$39m (7%) on FY19. The decrease in EBIT reflects a \$31m decrease in Normalised Cash Operating Earnings (COE) and an \$8m increase in expenses.

Life's normalised ROE (pre-tax) was 16.6% in FY20 and decreased by 120bps on FY19, driven by more challenging investment market conditions.

During the COVID-19 pandemic, Life is prioritising maintaining a strong capital position and repositioned its investment portfolio in 2H20 to more defensive settings in order to reduce capital intensity and maintain CLC's strong capital position.

Challenger undertook a \$270m institutional placement in June 2020 and injected the proceeds into CLC to further strengthen its capital position and provide flexibility to enhance returns.

CLC's excess regulatory capital above APRA's minimum requirement was \$1.6bn at 30 June 2020, resulting in a PCA ratio of 1.81 times, which is well above CLC's internal capital targets. Refer to pages 44 and 45 for more details on CLC's excess capital position.

Normalised Cash Operating Earnings (COE) and COE margin

FY20 normalised COE was \$639m and decreased by \$31m (5%) on FY19. Normalised COE reduced as a result of lower yields on the major asset classes of fixed income and property, partially offset by a 4% increase in average investment assets and lower interest and distribution costs. Normalised COE also declined due to a 1% lower equity and other normalised growth assumptions applied from 1 July 2019.

The 30bps reduction in COE margin includes lower normalised capital growth (-22bps) mainly due to a lower equities normalised growth assumption, lower return on shareholder capital (-17bps), partially offset by a 9bps increase in the product cash margin. The product cash margin benefited from a higher contribution from Life Risk, partially offset by more defensive portfolio settings.

Life COE margin composition

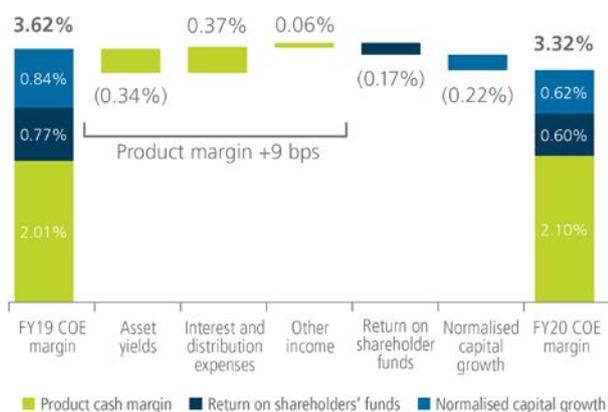


¹ Plan for Life – March 2020 – based on annuities under administration at 31 March 2020.

² The word 'guaranteed' means payments are guaranteed by Challenger Life Company Limited (CLC) from assets of its relevant statutory fund.

³ Market Pulse Adviser Study December 2019.

FY19 to FY20 COE margin



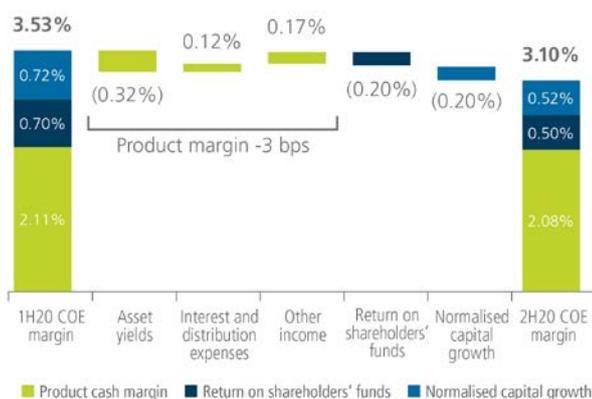
Life's FY20 COE margin was 3.32% and decreased by 30bps on FY19. The change in COE margin was a result of:

- Higher product cash margin: +9bps. The product cash margin reflects lower investment asset yields of 34bps, which were more than offset through lower interest and distribution expenses, which reduced by 37bps. Lower asset yields were primarily a result of lower fixed income and property returns. Lower asset yields also reflect more defensive settings in 2H20.

Other income increased by 6bps due to a higher contribution from Life Risk.

- Lower return on shareholder capital: -17bps. The return on shareholder capital fell due to a reduction in shareholder capital following the pandemic market sell-off, and lower interest rates as shareholder capital is not hedged for interest rate movements. For example, the 3-month bank bill rate was approximately 110bps lower in FY20 than in FY19.
- Lower normalised capital growth: -22bps. The decline was a result of moving to a more defensive portfolio allocation in 2H20 and a reduction in the equity and other normalised growth assumption from 4.5% to 3.5% per annum from 1 July 2019.

1H20 to 2H20 COE margin



Life's 2H20 COE margin was 3.10% and decreased by 43bps on 1H20. The change in COE margin was a result of:

- Lower product cash margin: -3bps. The product cash margin includes lower asset yields of 32bps, partially offset by lower interest and distribution expenses (down 12bps) and an increase in other income (up 17bps).

Lower asset yields reflect lower returns on the fixed income and equities portfolio and includes the impact of

repositioning the portfolio to more defensive settings in 2H20 (approximately 20bps). 1H20 also included 8bps in relation to a perpetual fixed income bond that was fully repaid.

- Lower income on shareholder capital: -20bps. The return on shareholder capital fell due to a reduction in shareholder capital following the pandemic market sell-off and the impact of lower interest rates, as shareholder capital is not hedged for interest rate movements. For example, the 3-month bank bill rate was 82bps lower in 2H20 than in 1H20.
- Lower normalised capital growth: -20bps. The decline was a result of moving to a more defensive portfolio allocation in 2H20 and a reduction in the equity and other normalised growth assumption from 4.5% to 3.5% per annum from 1 July 2019.

Life Risk

Life Risk revenue represents premiums net of expected claims on wholesale reinsurance longevity and mortality transactions.

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

FY20 Life COE includes \$41m of income from Life Risk transactions, representing the release of profit and expense margins, up from \$27m in FY19. Life Risk income increased as a result of three longevity transactions completed in the UK pension market in 1H20 and includes \$10m in relation to the termination of a contract at the request of a client, resulting in the one-off recognition of additional earnings in FY20.

The present value of future profits arising from the Life Risk portfolio was \$829m at 30 June 2020, an increase of 67% (\$334m) from \$495m at 30 June 2019.

The Life Risk portfolio has an average duration of 18 years.

Accurium

Accurium is one of Australia's leading providers of SMSF actuarial certificates. An actuarial certificate is required by an SMSF when one (or more) members are in the retirement phase of superannuation and one (or more) are in the savings (accumulation) phase of superannuation.

Accurium's FY20 revenue was \$6m (FY19 \$6m) and is included in other income within Life's Normalised COE.

Expenses

FY20 Life expenses were \$114m and increased by \$8m on FY19. The increase in expenses was driven by \$13m of additional expenses in relation to Distribution, Product and Marketing (DPM) initiatives to help drive sales growth. Refer to page 8 for more detail on the initiatives.

Life's FY20 cost to income ratio was 17.9% and increased by 200bps on FY19, as a result of DPM initiatives.

Investment experience overview

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 policy liabilities being recognised in the statutory 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 liabilities, Challenger takes a long-term view of the expected capital growth of the portfolio rather than focusing on short-term movements.

Investment experience removes the volatility arising from asset and liability valuation movements to better reflect the underlying performance of the Life business.

Investment experience includes both asset and liability experience and net new business strain.

FY20 investment experience was a loss of \$1,070m (pre-tax), comprising a \$1,102m loss on the fair value of Life's assets and policy liabilities, and a \$32m gain in relation to net new business strain.

Following changes to Life's investment portfolio in 2H20, approximately half of the FY20 investment experience has been realised.

(\$m)	Actual capital growth	Normalised capital growth	Investment experience
Fixed income	(529)	47	(482)
Property	(155)	(67)	(222)
Equity and other	(269)	(72)	(341)
Infrastructure	(115)	(28)	(143)
Policy liability	86	-	86
Assets and policy liability experience	(982)	(120)	(1,102)
New business strain	32	-	32
Total investment experience (pre-tax)	(950)	(120)	(1,070)

Assets and policy liability experience

Assets and policy liability experience is calculated as the difference between actual investment gains/losses (both realised and unrealised) and normalised capital growth in relation to assets, plus any economic and actuarial assumption changes in relation to policy liabilities for the period.

Assets and policy liability experience includes the impact of changes in macroeconomic variables on the valuation of Life's assets and liabilities and assumption changes to bond yields and inflation factors, expense assumptions and other factors applied in the valuation of life contract liabilities.

Assets and policy liability experience was -\$1,102m in FY20, comprising:

- Fixed income (-\$482m) – representing actual capital growth of -\$529m and normalised capital growth of \$47m. The actual capital growth includes valuation loss of \$463m and credit default experience recognised in the profit and loss of \$66m or 50bps.

The \$463m valuation loss reflects the significant widening in credit spreads across the fixed income portfolio in 2H20, with investment-grade fixed income spreads widening significantly at the height of the pandemic and then

contracting following the public policy responses. From December 2019, Credit spreads increased by ~40bps and sub-investment-grade fixed income spreads increased by ~240bps. Approximately two-thirds of the fixed income valuation loss is unrealised.

- Property (-\$222m) – reflects the revaluation of Life's property portfolio, with all properties independently valued in June 2020. Carrying values across the portfolio were reduced by ~5%, with Australian retail properties reduced by 8%. The reduction in carrying values is mainly attributed to the COVID-19 pandemic and is entirely unrealised.
- Equity and other portfolio (-\$341m) – reflects the impact of the COVID-19 pandemic market sell-off, with ~\$2bn of equities sold in the third quarter of FY20 in order to reduce the portfolio's capital intensity. As a result of the disposal of equity investments in 2H20, only one-quarter of equity and other investment experience remain unrealised.
- Infrastructure (-\$143m) – reflects a 25% fall in listed infrastructure valuations in the March quarter with all listed infrastructure sold. Unlisted infrastructure investments increased by +10% for the year.
- Policy liability (+\$86m) – reflects illiquidity premium (refer below), and changes in economic and actuarial assumptions, including changes to bond yields used to hedge policy liabilities, expected inflation rates and expense assumptions on policy liabilities.

Illiquidity premium

In accordance with prudential standards 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 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 used to value policy liabilities.

The illiquidity premium used to value policy liabilities is calculated in accordance with AASB 1038 *Life Insurance Contracts* and AASB 139 *Financial Instruments: Recognition and Measurement*.

New business strain

Life offers annuity rates to customers that are higher than the rates used to value liabilities. As a result, a loss is recognised when issuing a new annuity contract due to using lower discount rates together with the inclusion of an allowance for future maintenance expenses in the liability.

New business strain is a non-cash item and, subsequently, reverses over the future period of the contract. The new business strain reported in the period represents the non-cash loss on new sales net of reversal of the new business strain of prior period sales.

The FY20 net new business strain was a gain of \$32m (FY19 \$33m loss) reflecting negative annuity net book growth.

Life sales and AUM

Total Life sales

Total Life sales were \$5.2bn in FY20 and increased by 13% or \$0.6bn on FY19 and include:

- Domestic annuity sales of \$2.4bn, down 0.9bn (down 27%);
- Japanese annuity sales of \$0.7bn, up \$0.5bn (up 177%); and
- Institutional sales of \$2.0bn, up \$1.0bn (up 101%).

Domestic annuity sales

Life relies on third party financial advisers, both independent and part of the major advice hubs to distribute its products.

Following the public hearings and completion of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission) in 2019, there has been significant structural change across the Australian wealth management and financial adviser market.

There have been a range of regulatory changes that have had a significant impact on the economics for many financial advice practices. Regulatory changes include a shift away from commissions to fee-for-service, which is resulting in lower revenue per client, and the best interests duty which is increasing focus on holistic advice over transaction advice. Advisers are also increasing education and compliance activities, which is reducing focus on new client acquisition.

The major banks are generally exiting or reducing their exposure to wealth management, which is dramatically reducing the number of financial advisers aligned to the wealth management operations of major banks.

Advisers are either migrating from the licensees aligned to the major banks to independent adviser networks or leaving the industry.

As a result, the Australian financial advice market is undergoing structural change, with adviser numbers reducing by 16% year on year, and advisers moving from major banks and hubs to Independent Financial Adviser (IFA) networks. At 30 June 2020, IFAs accounted for approximately 72% of the advice market, up from 60% five years ago¹.

These industry changes are impacting Challenger's annuity sales, especially term annuity sales, which were well supported by advisers aligned to the major banks. In order to help drive additional demand for annuities and guaranteed income products, Challenger is continuing to invest in a range of Distribution, Product and Marketing (DPM) initiatives. The initiatives focus on increasing direct customer engagement and education, evolving Challenger's product range and supporting advisers. Refer to page 8 for additional detail on progressing these strategic DPM initiatives. During FY20, \$13m was spent on these initiatives and is included in Life's FY20 expenses.

Social distancing measures as a result of the COVID-19 pandemic have impacted financial advisers' ability to meet new clients, with annuities typically recommended to newly retired clients. This social disruption has impacted both client interactions and new client acquisition by advisers. Challenger's fourth quarter annuity sales were 27% lower than the prior corresponding quarter.

Japanese annuity sales

In November 2016, Challenger formed an annuity relationship with Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary), a leading provider of foreign dollar annuity and life insurance products in Japan (refer to page 30 for more information). The MS Primary annuity relationship provides access to the Japanese foreign currency annuities market and is helping to diversify Challenger's distribution channels and product offering.

Term annuity sales

FY20 term annuity sales were \$2.7bn and increased by 1% (\$23m) on FY19. Term annuity sales increased as a result of higher MS Primary (Japan) annuity sales (up \$0.5bn) and institutional annuity sales (up \$0.3bn), largely offset by lower domestic annuity sales (down \$0.9bn).

MS Primary annuity sales increased by 177% (\$0.5bn) from \$268m in FY19 to \$743m in FY20. The increase follows Challenger commencing reinsurance of US dollar-denominated annuities on 1 July 2019. Under the reinsurance arrangements, MS Primary will provide Challenger an annual amount of reinsurance, across both Australian and US dollar annuities, of at least ¥50bn (currently ~A\$670m²) per year for a minimum of five years. This is subject to review in the event of a material adverse change for either MS Primary or Challenger.

FY20 MS Primary sales of \$743m exceeded the ¥50bn minimum amount and accounted for 24% of Challenger's annuity sales, up from 8% in FY19.

Term annuity sales include \$300m of institutional annuities from a new institutional relationship in FY20.

Domestic term annuity sales were \$1,969m and were 19% (\$452m) lower than FY19. These annuity sales were impacted by structural changes to the Australian wealth management market and especially lower term sales by advisers aligned to major banks. In FY20, advisers aligned to the major banks accounted for 12% of domestic term annuity sales, down from 38% in FY19.

In FY20, 44% of domestic term sales were written by either independent financial advisers or advisers aligned to specialised advice businesses outside of the major banks and 44% of sales represented either direct or institutional sales.

Lifetime annuity sales

Lifetime annuity sales were \$415m in FY20 and decreased by 51% (\$439m) from FY19. FY20 lifetime sales comprise Liquid Lifetime sales of \$272m and CarePlus sales of \$143m.

Liquid Lifetime sales were down 48% on FY19 and were impacted by the transition to new means test rules, which commenced on 1 July 2019.

Under the new means test rules, the Liquid Lifetime Regular option is less attractive, while the Flexible and Enhanced options are generally more attractive. Advisers are transitioning from the Regular to the Flexible and Enhanced options, which accounted for 94% of FY20 Liquid Lifetime sales and increased by 21%.

The Flexible and Enhanced options represent a different client proposition. The client proposition of Regular centred on the capital guarantee, the Flexible and Enhanced proposition

¹ ASIC Adviser Register.

² Based on the exchange rate as at 30 June 2020.

revolves around longevity protection with a new cohort of advisers emerging. 56% of advisers recommending either the Flexible or Enhanced options in FY20 did not recommend a Challenger lifetime annuity in FY19.

In June 2020, the RBA Cash Linked option was added to Challenger's Liquid Lifetime product range. The RBA Cash Linked option has been specifically designed for customers and advisers that may be concerned with investing in a lifetime annuity in a low interest rate environment. The product allows retirees to link future lifetime annuity payments to prevailing interest rates, with regular payments reset each month based on movements in the RBA cash rate.

CarePlus, launched in early FY16, is a product that pays income for life and is specifically designed for the aged care market. CarePlus sales were \$143m in FY20, a decrease of \$193m (down 57%) on FY19.

The CarePlus product was reviewed and updated following the commencement of the new means test rules. The regulatory change was one factor in the review, which focused on providing the best overall product and outcomes for aged care customers.

Following the refresh of CarePlus, sales momentum is increasing, with 2H20 CarePlus sales 12% higher than 1H20 despite to disruption from the COVID-19 pandemic in the fourth quarter.

Focus on long-term annuity sales

Challenger is focused on growing its long-term annuity business as it embeds significant value for Challenger shareholders. Of FY20 annuity sales, 37% were either lifetime annuities or long-term MS Primary annuities, up from 32% in FY19.

Lifetime and long-term MS Primary annuities accounted for just over 53% of total annuities in force at 30 June 2020, up from only 28% five years ago (FY16). FY20 was the first period the lifetime and long-term MS Primary annuities book exceeded the size of the term annuity book.

Long-term annuity business is attractive for Challenger as it:

- lengthens the annuity book tenor;
- improves the maturity outlook;
- assists future book growth;
- enhances overall book quality; and
- allows investing in longer term less liquid assets generating an illiquidity premium.

New business tenor

With Challenger's focus on long-term annuities, the tenor of new business sales has been increasing. New business tenor over the past five years has increased from 6.5 years in FY16 to 9.9 years in FY20.

New business tenor is benefiting from an increase in the portion of long-term annuity sales, being either domestic lifetime annuities or 20-year fixed rate MS Primary (Japan) sales.

Long-term annuity sales accounted for 37% of Life's total sales, up from 32% and was the highest level ever recorded.

Other Life sales

Other Life sales represent Challenger's Index Plus range of products which provide customers a guaranteed return and typically backed by high-grade liquid fixed income.

FY20 Other Life sales were \$2.0bn, and increased by 101%, driven by a focus on building institutional partnerships and strong demand from superannuation and institutional clients seeking guaranteed returns in the low interest rate environment.

Life book liability maturity profile

The annuity maturity rate, which represents annuity maturities and repayments (excluding interest payments) divided by the opening period annuity liability was 26% in FY20.

FY20 maturities includes a ~\$150m early withdrawal across a portfolio of clients advised by one adviser, which increased the maturity rate by ~1.2%. A surrender penalty was paid in respect of the early withdrawal and is included in investment experience.

The maturity rate is expected to be approximately ~27% in FY21.

Net book growth

Life annuity book growth

FY20 Life annuity net flows (i.e. annuity sales less capital repayments) were -\$251m.

Based on the opening Life annuity book liability (\$12,870m), FY20 annuity book growth was -2.0%, down from 5.8% in FY19. Annuity net book growth was lower as a result of lower annuity sales and higher maturities, including the ~\$150m early withdrawal.

Other Life book growth

Other Life net flows (i.e. other Life sales less capital repayments) represent net flows on Challenger's Index Plus products. In FY20, Other Life net flows were \$567m, up \$778m on FY19.

Average AUM

Life's average investment assets were \$19.2bn in FY20 and increased by 4% (\$0.7bn) on FY19. The increase in average investment assets reflect total Life net flows and changes in retained earnings.

Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary) and MS&AD relationship

Consistent with Challenger's strategy to diversify its range of products and expand its distribution relationships, in November 2016 Challenger commenced a new annuity relationship with Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary).

MS Primary provides annuity and life insurance products to Japanese customers and is part of MS&AD Insurance Group Holdings Inc. (MS&AD), a Nikkei 225 company.

Japan has one of the world's most rapidly ageing populations who are looking for income from longer dated products due to the low Japanese interest rate environment. This has driven significant demand for foreign currency annuities.

In August 2016, MS Primary launched an innovative Australian dollar product with a 20-year fixed rate in Japan. The product is being distributed through the Japanese bancassurance channel.

In relation to reinsuring this product, from 1 November 2016, Challenger commenced issuing Australian dollar fixed rate annuities with a 20-year term to support the reinsurance agreement with MS Primary. Challenger provides a guaranteed interest rate and assumes the investment risk on a portion of each new policy issued by MS Primary.

During FY18, Challenger and MS Primary developed a new Australian dollar lifetime annuity product for the Japanese market, with Challenger reinsuring a portion of each new policy issued by MS Primary. Challenger began reinsuring this product in FY19.

In March 2019, Challenger and MS&AD announced an expansion to its strategic relationship. This expanded partnership supports Challenger's growth strategy both domestically and internationally. Under the expanded strategic relationship, from 1 July 2019, Challenger commenced a quota share reinsurance of US dollar-denominated annuities issued in the Japanese market by MS Primary.

MS Primary will provide to Challenger an annual amount of reinsurance, across both Australian and US dollar annuities, of at least ¥50bn (currently ~A\$670m¹) per year for a minimum of five years. This is subject to review in the event of a material adverse change for either MS Primary or Challenger.

The MS Primary annuity portfolio is invested in broadly similar key asset classes Challenger currently invests in and is accounted for under Australian Generally Accepted Accounting Principles and Challenger's normalised profit framework, consistent with Challenger's Life business.

MS Primary is responsible for marketing and providing the products in Japan, including making payments to policyholders. Challenger guarantees a rate to MS Primary, which effectively includes Challenger's contribution toward marketing, distribution and administration costs in Japan. As such, for these products Challenger incurs limited distribution and operational costs as part of its direct expense base.

Under the reinsurance agreement, the guaranteed interest rate on new business can be revised and there are mechanisms to regulate volumes between MS Primary and Challenger. The agreement also includes the usual termination rights for both parties, including material breach, failure to make payments and events that may be triggered by changes in MS Primary's regulatory environment.

Expanding the strategic relationship

MS&AD's subsidiary, MS Primary, is a key Challenger strategic partner in both co-development and distribution of annuity products.

As part of the strategic relationship, MS&AD has become a significant investor in Challenger and as at 30 June 2020, held ~15% of Challenger's issued capital.

In August 2019, a representative from MS&AD, Mr Masahiko Kobayashi, was appointed as a Non-Executive Director of Challenger Limited. In December 2019, Mr Hiroyuki Iio was appointed as Alternate Director to Mr Kobayashi.

¹ Based on the exchange rate as at 30 June 2020.

Retirement income regulatory reforms

The Government has noted the retirement phase of the superannuation system is currently underdeveloped and there is limited availability and take-up of products that manage the risks people face in retirement, in particular the risk of outliving their savings. Currently most people invest their superannuation savings in an account-based pension and withdraw only legislated minimum amounts, without being aware of all choices.

The Australian Government is progressing a range of reforms to enhance the retirement phase of superannuation.

These reforms include:

- removing impediments to longevity product development through the Retirement Income Streams Review, which came into effect on 1 July 2017;
- introducing new means test rules for lifetime products from 1 July 2019; and
- creating a Retirement Income Framework.

The Government has also commissioned an independent review of the retirement income system (the Retirement Income Review), following a recommendation by the Productivity Commission, to improve understanding of its operation and the outcomes it is delivering for Australian retirees.

New means test rules for lifetime products

The means test rules govern the eligibility and level of access to the Government-provided age pension and are based on a retiree's level of income and/or assets owned. The new rules commenced on 1 July 2019 and have been designed to encourage the development of innovative lifetime income products that will help retirees manage the risk of outliving their savings, while ensuring a fair and consistent means test treatment for all retirement income products.

Complying products are assessed under the income test at 60% of all pooled lifetime product payments, and under the asset test at 60% of the purchase price of the product until age 84, or a minimum of five years, and then 30% for the rest of the person's life.

Retirement Income Framework

The Government has proposed a Retirement Income Framework to increase flexibility and choice for retirees and help boost living standards.

The first stage of the proposed Retirement Income Framework is to include a Retirement Income Covenant in the *Superannuation Industry (Supervision) Act 1993*, which would require superannuation trustees to have a retirement income strategy in place for their members.

The Government released a position paper on the Retirement Income Covenant in May 2018. The position paper notes the proposed Retirement Income Framework is intended to:

- enable individuals to increase their standard of living in retirement through increased availability and take-up of products that more efficiently manage longevity risk, and in doing so increase the efficiency of the superannuation system and better align the system with its objective; and
- enable trustees to provide individuals with an easier transition into retirement by offering retirement income products that balance competing objectives of high income, flexibility and risk management.

In May 2020 the Government announced the deferral of the Retirement Income Covenant, which had been scheduled to commence on 1 July 2020. In July 2020, the Government confirmed the new start date for the Covenant will be 1 July 2022. The deferral is to allow continued consultation, and legislative drafting to take place following the coronavirus crisis. Deferral will also allow drafting to be informed by the Retirement Income Review.

Retirement Income Review

In December 2018, the Productivity Commission recommended an independent review of the role of compulsory superannuation in the broader retirement incomes system. The Government commissioned the review in September 2019, with the final report provided to the Government in July 2020.

Life balance sheet

\$m	FY20	1H20	FY19	1H19	FY18	1H18
Assets						
Life investment assets						
Cash and equivalents	3,002.7	760.0	361.0	1,518.3	1,671.6	950.1
Asset backed-securities	6,385.1	6,289.3	5,293.3	5,062.2	4,763.1	4,542.2
Corporate credit	4,582.8	5,907.4	6,805.5	5,434.0	5,293.1	5,584.2
Fixed income and cash (net)	13,970.6	12,956.7	12,459.8	12,014.5	11,727.8	11,076.5
Australian – Office	1,912.7	1,919.4	1,833.9	2,097.1	2,011.3	1,855.6
Australian – Retail	709.3	751.2	883.3	954.1	954.8	962.5
Australian – Industrial	187.5	193.3	185.2	180.4	159.5	152.0
Japanese	390.1	359.5	325.6	314.6	297.4	234.0
Other	92.5	114.4	154.0	193.2	417.5	450.5
Property (net)	3,292.1	3,337.8	3,382.0	3,739.4	3,840.5	3,654.6
Equity and other investments	837.9	2,541.6	2,315.1	2,113.4	1,799.1	1,642.7
Infrastructure (net)	202.7	833.2	853.5	757.0	717.7	666.3
Life investment assets	18,303.3	19,669.3	19,010.4	18,624.3	18,085.1	17,040.1
Other assets (including intangibles)	1,178.4	915.9	702.3	560.9	509.5	644.1
Total assets	19,481.7	20,585.2	19,712.7	19,185.2	18,594.6	17,684.2
Liabilities						
Life annuity book	12,581.2	12,845.3	12,870.2	12,323.7	11,728.3	11,115.8
Challenger Index Plus Fund liabilities	2,415.8	2,705.6	1,966.2	2,172.3	2,135.0	1,909.3
Subordinated debt	395.7	404.9	403.9	400.6	403.7	405.3
Challenger Capital Notes	805.0	805.0	805.0	805.0	805.0	805.0
Other liabilities	345.6	350.6	348.5	412.9	317.7	296.1
Total liabilities	16,543.3	17,111.4	16,393.8	16,114.5	15,389.7	14,531.5
Net assets	2,938.4	3,473.8	3,318.9	3,070.7	3,204.9	3,152.7

Life investment portfolio overview

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

Life reviews its investment asset allocation based on the relative value of different asset classes, expected ROE, and tenor of annuity sales as Life maintains a cash flow matched portfolio.

Accordingly, Life's investment asset allocation may vary from time to time. Life's investment assets are as follows:

\$m	FY20	Pro forma
	30 June 2020	1 July 2020
Fixed income and cash	76%	76%
Property	18%	18%
Equity and other	5%	-
Infrastructure	1%	-
Equity and infrastructure	-	2%
Alternatives	-	4%



Life investment portfolio repositioned

Through the COVID-19 pandemic in 2H20, Challenger Life has actively managed its investment portfolio and repositioned it to be more defensive, which reduced capital intensity and increased Life's excess capital position. Exposure to equities, infrastructure and sub-investment grade fixed income have been reduced and higher levels of liquidity have been maintained. At 30 June 2020, Life held approximately \$3bn of cash and liquids.

Challenger Life's strong capital position (refer to pages 44 and 45 for more detail) provides flexibility to progressively deploy Life's \$3bn of cash and liquids into higher returning assets. There are compelling risk-adjusted returns available, predominantly in high-grade fixed income, which may generate ROEs (pre-tax) in excess of 20% on the capital backing these investments.

Pro forma 1 July 2020 Life investment portfolio

Commencing in FY21 (from 1 July 2020), Life's investment portfolio categories have been amended to more accurately reflect Life's investment portfolio following changes in portfolio composition in 2H20.

From 1 July 2020, the equity and infrastructure categories have been combined and represent 2% of Life's investment assets, and absolute return funds and insurance-related investments have been reclassified from equities to alternatives as both are relatively uncorrelated to equity market returns and are proportionately significant in their own right.

Normalised growth assumptions have been updated for both the category changes and to ensure they reflect both the nature of the investments and long-term expected investment returns. Refer to page 55 for revised normalised growth assumptions.

Fixed income portfolio overview

Life's fixed income and cash portfolio was \$14.0bn (net of debt) at 30 June 2020 and increased by 12% for the year.

The fixed income and cash portfolio represented 76% of Life's total investment assets at 30 June 2020 and comprises approximately 1,400 different securities.

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

Life's policy liability cash flows are generally long term in nature, and contracted, providing the opportunity to invest in longer dated and less liquid fixed income investments, allowing Life to earn an illiquidity premium on fixed income.

Life targets to hold ~75% of fixed income as investment grade (i.e. BBB or higher), with 85% of the fixed income portfolio investment grade at 30 June 2020, up from 74% a year earlier.

A total of 83% of the fixed income portfolio is externally rated (Standard & Poor's, Fitch or Moody's) with the remainder internally rated based on methodologies calibrated to Standard & Poor's or Moody's ratings framework.

The fixed income and cash portfolio is predominantly Australian focused, with approximately 78% of the fixed income portfolio invested in Australian-based securities.

Approximately 17% of Life's fixed income portfolio represents fixed income investments originated by Challenger. Direct fixed income origination includes senior secured loans, asset-backed securities and commercial real estate lending. Life's direct origination capability provides opportunities to capture additional earnings including illiquidity premiums.

The average direct fixed income illiquidity premium generated over the last five years has been between 1% and 2% and has remained attractive throughout the COVID-19 pandemic.

Fixed income credit default experience

Challenger's normalised growth assumption for fixed income is -35bps, representing an allowance for credit default losses. In FY20, the credit default loss recognised in investment experience was -50bps, (-\$66m).

Over the past five financial years, the average credit default loss experience recognised in investment experience has been -23bps per annum.

Detailed disclosure of Life's fixed income portfolio is included on pages 34 to 37. The fixed income disclosures include the following tables:

1. Table 1 – Fixed income portfolio overview;
2. Table 2 – Fixed income portfolio by credit rating;
3. Table 3 – Fixed income portfolio by rating type;
4. Table 4 – Fixed income portfolio by industry sector; and
5. Table 5 – Fixed income portfolio by geography and credit rating.

Table 1: Fixed income portfolio overview

30 June 2020		\$m	% portfolio	
Liquids		3,003	21%	Includes cash and equivalents and Government Bonds (net of repurchase agreements).
Asset-Backed Securities (ABS)	Residential Mortgage-Backed Securities (RMBS)	3,486	26%	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.
	Other ABS	1,863	13%	Financing secured against underlying assets. Asset security includes motor vehicle, equipment and consumer finance.
	Senior Secured Bank Loans	693	5%	Senior debt secured by collateral and typically originated by Challenger.
	Aviation Finance	137	1%	Secured commercial aircraft financing.
	CMBS	206	1%	Commercial mortgage-backed securities (CMBS).
Corporate Credit	Banks and Financials	1,021	7%	Corporate loans to banks, insurance companies and fund managers.
	Infrastructure	1,226	9%	Long-dated inflation-linked bonds issued by Public Private Partnership projects and loans to infrastructure companies.
	Non-Financial Corporates	1,496	11%	Traded commercial loans to non-financial corporates (includes exposures to retail, construction, hotels, media, mining and health care).
	Commercial Real Estate	840	6%	Loans secured against commercial real estate assets and typically originated by Challenger.
Total		13,971	100%	

Table 2: Fixed income portfolio by credit rating

30 June 2020 (\$m)	Investment grade						Non-investment grade			Total
	Liquids	AAA	AA	A	BBB	Total	BB	B or lower	Total	\$m
Liquids										
Government bonds ¹	2,843	-	-	-	-	2,843	-	-	-	2,843
Covered bonds	160	-	-	-	-	160	-	-	-	160
Asset-Backed Securities										
RMBS	-	1,805	561	599	306	3,271	135	80	215	3,486
Other ABS	-	549	211	241	175	1,176	499	188	687	1,863
Senior Secured Bank Loans	-	316	57	40	162	575	118	-	118	693
Aviation Finance	-	-	-	90	29	119	15	3	18	137
CMBS	-	33	23	69	55	180	20	6	26	206
Corporate Credit										
Banks and Financials	-	-	88	287	623	998	21	2	23	1,021
Infrastructure	-	-	132	485	548	1,165	42	19	61	1,226
Non-Financial Corporates	-	4	43	115	528	690	289	517	806	1,496
Commercial Real Estate	-	30	6	391	320	747	68	25	93	840
Total	3,003	2,737	1,121	2,317	2,746	11,924	1,207	840	2,047	13,971
Fixed income portfolio (%)	21%	20%	8%	17%	19%	85%	9%	6%	15%	100%
Average duration (years)	-	2.0	2.7	3.5	2.9	2.7	2.2	2.2	2.2	2.6

30 June 2020 (%)	Investment grade						Non-investment grade			Total
	Liquids	AAA	AA	A	BBB	Total	BB	B or lower	Total	%
Liquids										
Government bonds ¹	100%	-	-	-	-	100%	-	-	-	100%
Covered bonds	100%	-	-	-	-	100%	-	-	-	100%
Asset-Backed Securities										
RMBS	-	52%	16%	17%	9%	94%	4%	2%	6%	100%
Other ABS	-	29%	11%	13%	10%	63%	27%	10%	37%	100%
Senior Secured Bank Loans	-	46%	8%	6%	23%	83%	17%	-	17%	100%
Aviation Finance	-	-	-	66%	21%	87%	11%	2%	13%	100%
CMBS	-	16%	11%	33%	27%	87%	10%	3%	13%	100%
Corporate Credit										
Banks and Financials	-	-	9%	28%	61%	98%	2%	-	2%	100%
Infrastructure	-	-	11%	40%	44%	95%	3%	2%	5%	100%
Non-Financial Corporates	-	-	3%	8%	35%	46%	19%	35%	54%	100%
Commercial Real Estate	-	4%	1%	47%	37%	89%	8%	3%	11%	100%
Total	21%	20%	8%	17%	19%	85%	9%	6%	15%	100%

¹ Gross Government Bonds are shown net of \$2,447m of Australian Government Bonds and \$2,948m of Australian Semi-Government Bonds, that are held via repurchase agreements. Government Bonds refinanced with repurchase agreements are used to hedge movements in interest rates. Refer to page 43 for more detail.

Table 3: Fixed income portfolio by rating type

30 June 2020 (\$m)	Investment grade						Non-investment grade			Total
	Liquids	AAA	AA	A	BBB	Total	BB	B or lower	Total	\$m
Liquids										
Externally rated	3,003	-	-	-	-	3,003	-	-	-	3,003
Internally rated	-	-	-	-	-	-	-	-	-	-
Asset-Backed Securities										
Externally rated	-	2,583	809	826	409	4,627	267	101	368	4,995
Internally rated	-	120	42	213	319	694	519	177	696	1,390
Corporate Credit										
Externally rated	-	34	235	1,261	1,869	3,399	104	162	266	3,665
Internally rated	-	-	35	17	149	201	317	400	717	918
Total	3,003	2,737	1,121	2,317	2,746	11,924	1,207	840	2,047	13,971
Externally rated	100%	96%	93%	90%	83%	92%	31%	31%	31%	83%
Internally rated	0%	4%	7%	10%	17%	8%	69%	69%	69%	17%

30 June 2020 (%)	Investment grade						Non-investment grade			Total
	Liquids	AAA	AA	A	BBB	Total	BB	B or lower	Total	%
Liquids										
Externally rated	100%	-	-	-	-	100%	-	-	-	100%
Internally rated	-	-	-	-	-	-	-	-	-	-
Asset-Backed Securities										
Externally rated	-	52%	16%	17%	8%	93%	5%	2%	7%	100%
Internally rated	-	9%	3%	15%	23%	50%	37%	13%	50%	100%
Corporate Credit										
Externally rated	-	1%	6%	34%	52%	93%	3%	4%	7%	100%
Internally rated	-	-	4%	2%	16%	22%	34%	44%	78%	100%
Total	21%	20%	8%	17%	19%	85%	9%	6%	15%	100%

Table 4: Fixed income portfolio by industry sector

30 June 2020 (\$m)	Investment grade						Non-investment grade			Total
	Liquids	AAA	AA	A	BBB	Total	BB	B or lower	Total	\$m
Industrials and consumers	-	845	343	477	884	2,549	847	655	1,502	4,051
Residential property	-	1,804	529	592	347	3,272	136	86	222	3,494
Banks, financials & insurance	160	25	88	303	635	1,211	29	2	31	1,242
Government	2,843	-	-	-	-	2,843	-	-	-	2,843
Commercial property	-	63	29	460	330	882	87	25	112	994
Infrastructure and utilities	-	-	132	485	548	1,165	43	19	62	1,227
Other	-	-	-	-	2	2	65	53	118	120
Total	3,003	2,737	1,121	2,317	2,746	11,924	1,207	840	2,047	13,971

30 June 2020 (%)	Investment grade						Non-investment grade			Total
	Liquids	AAA	AA	A	BBB	Total	BB	B or lower	Total	%
Industrials and consumers	-	21%	8%	12%	22%	63%	21%	16%	37%	100%
Residential property	-	52%	15%	17%	10%	94%	4%	2%	6%	100%
Banks, financials & insurance	13%	2%	7%	24%	52%	98%	2%	-	2%	100%
Government	100%	-	-	-	-	100%	-	-	-	100%
Commercial property	-	6%	3%	46%	34%	89%	8%	3%	11%	100%
Infrastructure and utilities	-	-	11%	40%	44%	95%	3%	2%	5%	100%
Other	-	-	-	-	2%	2%	54%	44%	98%	100%
Total	21%	20%	8%	17%	19%	85%	9%	6%	15%	100%

Table 5: Fixed income portfolio by geography and credit rating

30 June 2020 (\$m)	Investment grade						Non-investment grade			Total
	Liquids	AAA	AA	A	BBB	Total	BB	B or lower	Total	\$m
Australia	2,914	2,048	788	1,605	1,858	9,213	937	715	1,652	10,865
United States	51	196	28	261	328	864	116	54	170	1,034
United Kingdom	-	187	107	182	228	704	9	-	9	713
Europe	2	111	71	114	247	545	24	30	54	599
New Zealand	-	144	75	121	69	409	81	38	119	528
Rest of world	36	51	52	34	16	189	40	3	43	232
Total	3,003	2,737	1,121	2,317	2,746	11,924	1,207	840	2,047	13,971

30 June 2020 (%)	Investment grade						Non-investment grade			Total
	Liquids	AAA	AA	A	BBB	Total	BB	B or lower	Total	%
Australia	27%	19%	7%	15%	17%	85%	8%	7%	15%	100%
United States	5%	19%	3%	25%	32%	84%	11%	5%	16%	100%
United Kingdom	-	26%	15%	26%	32%	99%	1%	-	1%	100%
Europe	-	27%	14%	23%	13%	77%	16%	7%	23%	100%
New Zealand	15%	22%	22%	15%	7%	81%	18%	1%	19%	100%
Rest of the world	-	19%	12%	19%	41%	91%	4%	5%	9%	100%
Total	21%	20%	8%	17%	19%	85%	9%	6%	15%	100%

Property portfolio overview

Life's property portfolio principally comprises directly held properties and is diversified across office, retail and industrial properties.

Life's property portfolio was \$3.3bn (net of debt) at 30 June 2020 and declined by \$0.1bn in FY20 following the revaluation of properties. Property represented 18% of Life's investment portfolio at 30 June 2020.

Life's property portfolio is mainly focused on domestic properties that provide long-term income streams. Australian properties accounted for 88% of the portfolio, and Australian office 58%.

Challenger Life has a policy that all properties are independently valued each year. Given the economic uncertainty as a result of the COVID-19 pandemic, all properties were independently valued in June 2020.

In FY20, there were significant property write-downs to reflect the uncertainty as a result of the COVID-19 pandemic. The average valuation write-down across the portfolio was ~5%, with Australian retail properties reduced by 8%.

Life maintains a more defensive property portfolio than the broader market, with a focus on long-term income streams. Australian office accounts for 58% of the portfolio, with the Australian Government a major tenant accounting for approximately 30% of FY20 gross rental income across the entire property portfolio¹.

Australian retail assets account for 22% of the portfolio and comprises eight grocery-anchored convenience-based shopping centres. Approximately half of the rental income is derived from a major supermarket chain, major Australian banks or essential services, which have continued to trade through the pandemic.

The weighted average cap rate on Life's Australian direct portfolio² was 5.89% at 30 June 2020, up 5bps for the year.

Property includes a net \$390m exposure to Japanese property (12% of the portfolio), consisting of suburban shopping centres that are focused on non-discretionary retailing. Over half of the Japanese rental income comes from supermarkets or pharmacies.

The property portfolio generates long-term cash flows to match long-term liabilities, with a weighted average lease expiry of six years and 59% of leasing area having contracted leases expiring in FY24 and beyond. The portfolio had an occupancy rate of 92% at 30 June 2020.

Approximately 60% of contracted leases have either annual fixed increases or inbuilt increases based on inflation outcomes (e.g. CPI).

The impact of COVID-19 on the future net rental yield of the property portfolio is uncertain. Restrictions imposed by the Australian Government to combat COVID-19 has impacted many retail businesses from operating effectively from their premises. In response to this and the Government's Code of Conduct for commercial tenancies, Challenger is currently working through a cost sharing or rental abatement programme in compliance with the Code of Conduct for each tenant that has been affected. This involves either deferring or waiving rent owed by the tenant depending on individual circumstances. The estimated impact of the rental abatement

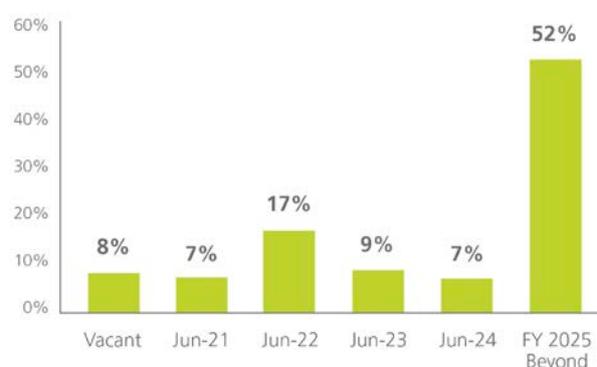
programme for FY21 is a reduction in net rental income of \$22m compared to FY20. This outcome may change over FY21 as the COVID-19 restrictions and economic impacts are inherently uncertain.

Full details of Life's property portfolio are listed on pages 39 to 41.

Property portfolio summary

% of total portfolio	FY20	FY19
Australian office	58%	55%
Australian retail	22%	26%
Australian industrial	6%	5%
Other	2%	4%
Australian total	88%	90%
Japanese retail	12%	10%
Other (including offshore)	0%	0%
Total	100%	100%

Portfolio lease expiry overview³



¹ Represents total gross passing income attributable to the direct property portfolio.

² Excluding the Victorian County Court.

³ Direct property portfolio and jointly held assets only and development assets.

Direct property portfolio overview¹

30 June 2020		Office	Retail	Industrial	Total
Total rent (%) ²		49%	44%	7%	100%
WALE ³ (years)		6.3	6.5	3.2	6.2
Tenant credit ratings					
	AAA	28%	0%	0%	28%
	AA	5%	1%	0%	6%
	A	0%	2%	0%	2%
	BBB	2%	10%	3%	15%
	BB	6%	12%	3%	21%
	B or below	1%	7%	1%	9%
	Not rated	2%	9%	0%	11%
	Vacant	5%	3%	0%	8%
	Total	49%	44%	7%	100%
% of total gross net					
	Investment grade	35%	13%	3%	51%
	Non-investment grade	9%	28%	4%	41%
	Vacant	5%	3%	0%	8%

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

² Includes vacant floors/suites available for lease.

³ Weighted Average Lease Expiry (WALE) assumes tenants do not terminate leases prior to expiry of specified lease term.

Direct property investments

30 June 2020	Acquisition date ¹	Total cost (\$m) ²	Carrying value (\$m)	Cap rate FY20 (%) ³	Last external valuation date
Australia					
Office					
6 Chan Street (formerly DIBP Building), ACT	01 Dec 01	121.0	202.0	5.50	30 Jun 20
14 Childers Street, ACT	01 Dec 17	97.5	91.0	6.50	30 Jun 20
35 Clarence Street, NSW	15 Jan 15	153.6	235.0	5.00	30 Jun 20
45 Benjamin Way (formerly ABS Building), ACT	01 Jan 00	148.6	223.0	5.75	30 Jun 20
82 Northbourne Avenue, ACT	01 Jun 17	61.0	53.3	6.00	30 Jun 20
215 Adelaide Street, QLD	31 Jul 15	252.0	230.5	6.13	30 Jun 20
565 Bourke Street, VIC	28 Jan 15	106.1	147.5	5.00	30 Jun 20
839 Collins Street, VIC	22 Dec 16	212.0	238.5	4.75	30 Jun 20
County Court, VIC	30 Jun 00	218.4	326.0	n/a	30 Jun 20
Discovery House, ACT	28 Apr 98	102.6	152.5	5.63	30 Jun 20
Executive Building, TAS	30 Mar 01	34.5	46.5	7.00	30 Jun 20
Retail					
Bunbury Forum, WA	03 Oct 13	155.7	82.0	7.50	30 Jun 20
Channel Court, TAS	21 Aug 15	84.2	76.0	7.75	30 Jun 20
Gateway, NT	01 Jul 15	122.2	105.1	6.34	30 Jun 20
Golden Grove, SA	31 Jul 14	157.6	147.0	6.25	30 Jun 20
Karratha, WA	28 Jun 13	55.9	44.3	7.50	30 Jun 20
Kings Langley, NSW	29 Jul 01	16.2	23.0	6.25	30 Jun 20
Lennox, NSW	27 Jul 13	62.8	61.0	6.75	30 Jun 20
North Rocks, NSW	18 Sep 15	185.1	171.1	6.25	30 Jun 20
Industrial					
21 O'Sullivan Circuit, NT	27 Jan 16	47.7	32.1	8.50	30 Jun 20
31 O'Sullivan Circuit, NT	27 Jan 16	29.2	23.5	8.50	30 Jun 20
Cosgrave Industrial Park, Enfield, NSW	31 Dec 08	92.3	131.9	5.00	30 Jun 20
Total Australia		2,516.2	2,842.8	5.89	

¹ Acquisition date represents the date of Challenger Life Company Limited's (CLC's) initial acquisition or consolidation of the investment vehicle holding the asset.

² Total cost represents the original acquisition cost plus additions less full and partial disposals since acquisition date.

³ The capitalisation rate is the rate at which net market income is capitalised to determine the value of the property. The rate is determined with regard to market evidence.

Direct property investments

30 June 2020	Acquisition date ¹	Total cost (\$m) ²	Carrying value (\$m)	Cap rate FY20 (%) ³	Last external valuation date
Japan					
Retail					
Aeon Kushiro	31 Jan 10	30.5	38.5	5.40	30 Jun 20
Carino Chitosedai	31 Jan 10	118.4	138.6	4.50	30 Jun 20
Carino Tokiwadai	31 Jan 10	77.0	85.9	4.70	30 Jun 20
DeoDeo Kure	31 Jan 10	32.2	35.3	5.60	30 Jun 20
Fitta Natalie Hatsukaichi	28 Aug 15	11.4	14.8	6.00	30 Jun 20
Izumiya Hakubaicho	31 Jan 10	69.4	78.0	5.00	30 Jun 20
Kansai Super Saigo	31 Jan 10	13.2	14.7	5.30	30 Jun 20
Kojima Nishiarai	31 Jan 10	12.2	16.4	4.40	30 Jun 20
Kotesashi Towers	28 Nov 19	25.2	24.3	5.10	30 Jun 20
Life Asakusa	31 Jan 10	27.8	38.6	4.30	30 Jun 20
Life Higashi Nakano	31 Jan 10	32.9	40.7	4.40	30 Jun 20
Life Nagata	31 Jan 10	25.2	30.3	4.20	30 Jun 20
MaxValu Tarumi	28 Aug 15	16.9	20.6	5.60	30 Jun 20
Seiyu Miyagino	31 Jan 10	9.8	12.0	5.20	30 Jun 20
TR Mall Ryugasaki	30 Mar 18	86.7	98.7	5.60	30 Jun 20
Valor Takinomizu	31 Jan 10	26.9	26.5	5.50	30 Jun 20
Valor Toda	31 Jan 10	42.5	46.3	5.10	30 Jun 20
Yaoko Sakato Chiyoda	31 Jan 10	19.7	22.8	4.90	30 Jun 20
Yorktown Toride	05 Mar 20	31.9	29.3	5.30	30 Jun 20
Industrial					
Aeon Matsusaka XD	26 Sep 19	14.7	14.5	5.80	30 Jun 20
Total Japan		724.5	826.8	4.99	
Europe					
Retail					
Aulnay sous Bois, Avenue de Savigny, France	31 Dec 08	20.3	10.1	7.33	30 Jun 20
Total Europe		20.3	10.1	7.50	
Total overseas		744.8	836.9	5.02	
Development					
Maitland, NSW	06 Dec 06	5.6	6.2	n/a	30 Jun 20
Total development		5.6	6.2		
Total direct portfolio investments		3,266.6	3,685.9	5.68	

¹ Acquisition date represents the date of Challenger Life Company Limited's (CLC's) initial acquisition or consolidation of the investment vehicle holding the asset.

² Total cost represents the original acquisition cost plus additions less full and partial disposals since acquisition date.

³ The capitalisation rate is the rate at which net market income is capitalised to determine the value of the property. The rate is determined with regard to market evidence.

Equity and other portfolio overview

Life's equity and other portfolio of \$0.8bn decreased by \$1.5bn in FY20. The reduction reflects approximately \$1.5bn of equities sold in the March quarter as part of repositioning the investment portfolio to more defensive settings.

Equity and other investments represented 5% of Life's total investment assets at 30 June 2020, down from 12% at 30 June 2019.

Challenger maintains a diversified equities portfolio, with beta, low beta, absolute return funds and alternative investments. In the March 2020 quarter, exposures were reduced across all equity investments, including a ~\$1bn reduction in low beta and ~\$0.6bn reduction in absolute return funds.

For beta investments, the total return is expected to be correlated to the MSCI World Net Daily Total Return Index.

The absolute return portfolio includes systematic global macro funds and market-neutral long/short equity funds. Investment returns are expected to have a lower correlation to listed equity markets. Over the long term, the total return on Life's absolute return portfolio is expected to be correlated to the Société Générale CTA Index.

Life's alternatives portfolio of \$0.3bn includes insurance-related and other investments. These investments are expected to have a low correlation to listed equity markets. There is no appropriate index that can be used to track total returns on the alternative portfolio.

Equity and other portfolio

30 June 2020	Domestic	Offshore	Total
Equity beta	52	80	132
Low beta	49	10	59
Absolute return funds	38	342	380
Alternatives	-	267	267
Total	139	699	838

Infrastructure portfolio overview

Life's infrastructure portfolio of \$0.2bn (net of debt) decreased by \$651m (down 76%) in FY20. The reduction in infrastructure investments is a result of management action to reposition the portfolio to more defensive settings during the COVID-19 pandemic, with all listed infrastructure sold in the March 2020 quarter.

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.

The infrastructure portfolio is held entirely in unlisted investments, predominantly utility and renewable energy assets.

Australian infrastructure accounted for 72% of the infrastructure portfolio with the remainder of the portfolio diversified across other geographic regions and sectors.

Infrastructure portfolio by sector

30 June 2020	\$m	%
Utilities	44	22%
Patronage	3	1%
Power generation	5	2%
Renewable	137	68%
Core infrastructure	14	7%
Total	203	100%

Infrastructure portfolio by geography

30 June 2020	\$m	%
North America	27	13%
Australia	147	72%
United Kingdom	12	6%
Asia	3	1%
Europe	4	2%
South America	10	5%
Total	203	100%

Equity and infrastructure and alternatives portfolio classifications from 1 July 2020

Commencing in FY21, Life's investment portfolio categories have been amended to more accurately reflect Life's investment portfolio following changes in portfolio composition in FY20. The equities and infrastructure categories have been combined (represents 2% of Life's investment assets), and absolute return funds and insurance-related investments have been reclassified from equities to alternatives (represents 4% of Life's investment assets) as both are relatively uncorrelated to equity market returns.

1 July 2020	Domestic	Offshore	Total
Absolute return funds	38	342	380
General insurance	-	157	157
Life insurance	-	110	110
Total alternatives	38	609	647

1 July 2020	Domestic	Offshore	Total
Equity beta	52	80	132
Low beta	49	10	59
Infrastructure	147	56	203
Total equity & infrastructure	248	146	394

Normalised growth assumptions have been updated for both category changes, and to ensure they reflect both the nature of the investments and long-term expected investment returns (refer page 55 for revised normalised growth assumptions). However, the total returns are expected to remain broadly around the same levels with the net impact on FY21 Normalised Cash Operating Earnings expected to be less than \$10m.

Challenger Life Company Limited (CLC) debt facilities

\$m	FY20	1H20	FY19	1H19	FY18	1H18
Repurchase agreements	5,393.4	4,460.0	4,448.5	4,397.4	3,816.0	3,387.9
Controlled property debt	458.0	455.0	466.6	476.9	560.5	491.9
Subordinated debt	395.7	404.9	403.9	400.6	403.7	405.3
Challenger Capital Notes	805.0	805.0	805.0	805.0	805.0	805.0
Infrastructure debt	185.8	189.0	192.0	194.7	197.2	199.2
Other finance	0.7	0.7	13.2	13.9	15.0	16.0
Total CLC debt facilities	7,238.6	6,314.6	6,329.2	6,288.5	5,797.4	5,305.3

Life debt facilities

Life debt facilities include debt which is non-recourse to the broader Challenger Group and secured against assets held in Challenger Life investment vehicles, including direct properties and infrastructure investments.

Life debt facilities increased by \$909m during FY20, primarily due to an increase in repurchase agreements used to hedge interest rate movements (up \$945m).

Repurchase agreements

Life enters into repurchase agreements whereby fixed income securities are sold for cash while 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.

Life uses Australian Government and Semi-Government Bonds with repurchase agreements, interest rate swaps and bond futures to hedge movements in interest rates and inflation on its asset portfolio, annuity policy liabilities, and the Challenger Index Plus liabilities.

Derivatives such as interest rate swaps and bond futures are self-financing, whereas the use of bonds requires repurchase agreement financing. Repurchase agreements at 30 June 2020 were \$5.4bn up from \$4.4bn at 30 June 2019.

Subordinated debt

In November 2017, Challenger Life Company Limited (CLC) issued \$400m of Tier 2 subordinated notes. The subordinated notes fully qualify as Tier 2 regulatory capital under APRA's prudential standards and are floating rate notes, paying interest at a margin of 2.10% above the 90-day Bank Bill rate.

The subordinated notes mature in November 2042, with CLC having the option to redeem the notes in November 2022, subject to APRA approval.

The subordinated notes qualify 100% as Tier 2 regulatory capital until November 2038.

The subordinated notes include a holder conversion option, allowing the noteholder to convert the notes into Challenger ordinary shares in November 2024 if CLC has not already called the subordinated notes in November 2022.

If CLC exercises its option to redeem, there will be no conversion of subordinated debt to Challenger ordinary shares and no subsequent shareholder dilution.

Capital Notes

Over the past five years, Challenger has issued two separate tranches of subordinated, unsecured convertible notes (Challenger Capital Notes and Challenger Capital Notes 2), with proceeds used to fund qualifying Additional Tier 1 regulatory capital of CLC.

Challenger Capital Notes (ASX code: CGFPA)

In October 2014, Challenger issued Challenger Capital Notes to the value of \$345m, which are subordinated, unsecured convertible notes issued by Challenger Limited. Challenger Capital Notes pay a margin of 3.40% above the 90-day bank bill rate, with the total distribution reduced by available franking credits.

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 may choose to redeem or resell (rather than convert) Challenger Capital Notes on the occurrence of some of the events referred to above, including on the 'Optional Exchange Date' of 25 May 2020 (subject to certain conditions being met).

Challenger intended to exercise its option to redeem the Capital Notes and concurrently launch a replacement Capital Notes Offer; however, investment markets leading up to the Optional Exchange Date in May 2020 were significantly disrupted and volatile as a result of the COVID-19 pandemic.

Given the unprecedented market conditions, APRA has confirmed Challenger can repurchase all or some of the Challenger Capital Notes for their face value on any future quarterly future distribution date to 25 May 2022.

Subject to market conditions and APRA approval, Challenger expects to launch a replacement Capital Notes offer and redeem Challenger Capital Notes in 1H21.

Challenger Capital Notes 2 (ASX code: CGFPB)

In April 2017, Challenger issued Challenger Capital Notes 2, to the value of \$460m, which are subordinated, unsecured convertible notes issued by Challenger Limited. Challenger Capital Notes 2 pay a margin of 4.40% above the 90-day bank bill rate, with the total distribution reduced by available franking credits.

Challenger Capital Notes 2 are convertible to ordinary shares at any time before May 2025 on the occurrence of certain events, and mandatorily convertible to ordinary shares thereafter, in both cases subject to meeting certain conditions.

However, Challenger may choose to redeem or resell (rather than convert) Challenger Capital Notes 2 on the occurrence of some of the events referred to above, including on the Optional Exchange Date of 22 May 2023 (subject to certain conditions being met). If Challenger exercises its option to redeem or resell, there will be no conversion of Challenger Capital Notes 2 to Challenger ordinary shares and no subsequent shareholder dilution.

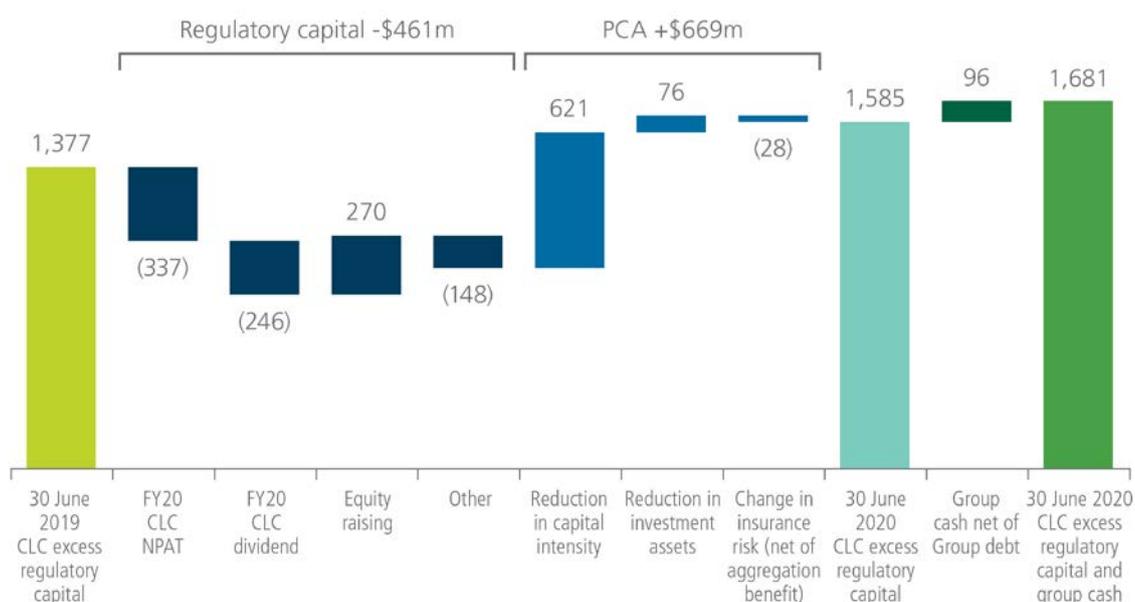
Challenger Life Company Limited (CLC) regulatory capital

\$m	FY20	1H20	FY19	1H19	FY18	1H18
CLC regulatory capital						
Common Equity Tier 1 (CET1) regulatory capital	2,337.0	2,811.3	2,789.4	2,517.6	2,677.8	2,638.4
Additional Tier 1	805.0	805.0	805.0	805.0	805.0	805.0
Tier 2 regulatory capital – subordinated debt ¹	396.7	406.2	405.3	402.2	405.4	406.8
CLC total regulatory capital base	3,538.7	4,022.5	3,999.7	3,724.8	3,888.2	3,850.2
CLC Prescribed Capital Amount (PCA)						
Asset risk charge	1,842.8	2,523.6	2,539.5	2,355.2	2,484.7	2,502.4
Insurance risk charge	199.5	164.6	135.3	83.3	70.0	164.9
Operational risk charge	56.5	53.4	51.8	47.5	46.4	42.8
Aggregation benefit	(144.8)	(125.4)	(104.0)	(64.8)	(54.8)	(125.7)
CLC PCA	1,954.0	2,616.2	2,622.6	2,421.2	2,546.3	2,584.4
CLC excess over PCA	1,584.7	1,406.3	1,377.1	1,303.6	1,341.9	1,265.8
PCA ratio (times)	1.81	1.54	1.53	1.54	1.53	1.49
Tier 1 ratio (times)	1.61	1.38	1.37	1.37	1.37	1.33
CET1 ratio (times)	1.20	1.07	1.06	1.04	1.05	1.02
Capital intensity ratio (%) ²	10.7%	13.3%	13.8%	13.0%	14.1%	15.2%

¹ FY20 Tier 2 regulatory capital – subordinated debt (\$396.7m) differs to the Group balance sheet (\$395.7m) due to accrued interest and amortised costs (\$1.0m).

² Capital intensity ratio is calculated as CLC PCA divided by Life closing investment assets.

Movement in CLC excess regulatory capital and Group cash (\$m)



Challenger Life Company Limited (CLC) regulatory capital

Capital management

Challenger Life Company Limited (CLC) holds capital to ensure that under a range of adverse scenarios it can continue to meet its regulatory requirements and contractual obligations to customers.

CLC is regulated by APRA and is required to hold a minimum level of regulatory capital.

CLC's regulatory capital base and prescribed capital amount (PCA) have been calculated based on APRA prudential capital standards.

CLC's regulatory capital base

CLC's regulatory capital base at 30 June 2020 was \$3.5bn and decreased by \$461m in FY20. The decrease in the regulatory capital base reflects CLC's FY20 statutory net loss after tax and dividends paid by CLC to the Challenger Group. The regulatory capital base benefited by \$270m following the injection of the proceeds from the Group's institutional placement in June 2020.

Challenger also undertook a share purchase plan (SPP) for retail investors, raising \$35m, which completed in July 2020. The majority of the SPP proceeds (\$30m) was injected into CLC as CET1 on 31 July 2020.

CLC's Prescribed Capital Amount (PCA)

In response to the significant market sell-off and in order to maintain a strong capital position, within Challenger Life's target PCA ratio range, Challenger actively managed its investment portfolio in 2H20.

Exposure to equities, infrastructure and sub-investment grade bonds were reduced, which lowered the capital intensity of the portfolio and reduced CLC's PCA requirement.

CLC's PCA at 30 June 2020 was \$1,954m and decreased by \$669m in FY20, reflecting:

- lower capital intensity (-\$621m);
- lower investment assets (-\$76m); offset by
- increased insurance risk charge (net of aggregation benefit) and changes in operational risk (+\$28m).

CLC's capital intensity, as measured by the ratio of PCA to investment assets, decreased from 13.8% at 30 June 2019 to 10.7% at 30 June 2020.

CLC's excess capital position

CLC's excess capital above PCA at 30 June 2020 was \$1.6bn and increased by \$208m in FY20, with the impact of lower capital intensity more than offsetting the lower regulatory capital base.

CLC's capital ratios at 30 June 2020 were as follows:

- Common Equity Tier 1 (CET1) ratio 1.20 times – up 14bps from 30 June 2019.
- PCA ratio 1.81 times – up 28bps from 30 June 2019; and
- Total Tier 1 ratio 1.61 times – up 24bps from 30 June 2019.

APRA's prudential standards require Total Tier 1 capital to be at least 80% of the PCA and CET1 capital to be at least 60% of the PCA. Both Challenger's Total Tier 1 capital ratio (1.61 times) and CET1 capital ratio (1.20 times) are well in excess of APRA's minimum requirements.

CLC maintains a target level of capital representing APRA's PCA plus a target surplus. The target surplus is a level of excess capital CLC seeks to carry over and above APRA's minimum requirement to ensure it provides a buffer for adverse market or insurance risk experience.

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.

CLC does not target a specific PCA ratio. CLC's target PCA ratio range is a reflection of internal capital models, not an input to them and reflects asset allocation, business mix and economic circumstances. The target surplus produced by these internal capital models currently corresponds to a PCA ratio of between 1.3 times to 1.6 times. This range may change over time.

In assessing CLC's capital targets, the internal capital models consider various constraints, including the total capital base (which is assessed by the PCA ratio) and CET1 requirements. The target surplus produced by the internal capital models currently corresponds to a CET1 ratio of between 0.8 times to 1.1 times. This ratio may also change over time.

Additional Tier 1 regulatory capital and subordinated debt

Challenger Limited has issued two separate subordinated, unsecured convertible notes (Challenger Capital Notes and Challenger Capital Notes 2), with proceeds used to fund qualifying Additional Tier 1 regulatory capital for CLC.

For Challenger Capital Notes, Challenger has an option to redeem or repurchase, all or some of the Challenger Capital Notes for their face value on any future quarterly future distribution date prior to 25 May 2022. Subject to market conditions and APRA approval, Challenger expects to launch a replacement Capital Notes Offer and redeem Challenger Capital Notes in 1H21.

For Challenger Capital Notes 2, Challenger has an option to redeem or repurchase, all or some of the Challenger Capital Notes 2 for their face value in May 2023.

In November 2017, CLC issued new Tier 2 subordinated notes (\$400m) which fully qualify as Tier 2 regulatory capital under APRA's prudential standards.

Further details on Challenger's convertible debt instruments are included on page 43.

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 30 June 2020 was \$146m.

Challenger has additional financial flexibility, including a \$400m group banking facility. At 30 June 2020 \$350m was undrawn, with the \$50m drawn included in Group cash.

Profit and equity sensitivities

\$m	Change in variable	Profit/(loss) after tax FY20	Change in equity FY20	Profit/(loss) after tax FY19	Change in equity FY19
Credit risk					
Fixed income assets (change in credit spreads) ¹	+50bps	(102.9)	(102.9)	(133.6)	(133.6)
	-50bps	102.9	102.9	133.6	133.6
Policy liabilities (illiquidity premium change in credit spreads)	+50bps	77.8	77.8	59.7	59.7
	-50bps	(77.8)	(77.8)	(59.7)	(59.7)
Property risk					
Direct and indirect properties	+1%	26.3	26.3	25.8	25.8
	-1%	(26.3)	(26.3)	(25.8)	(25.8)
Equity and infrastructure risk					
Investments	+10%	27.6	27.6	143.2	143.2
	-10%	(27.6)	(27.6)	(143.2)	(143.2)
Alternatives risk					
Investments	+10%	45.3	45.3	78.6	78.6
	-10%	(45.3)	(45.3)	(78.6)	(78.6)
Life Insurance risk					
Mortality, morbidity and longevity²					
Life insurance contract liabilities	+50%	(35.7)	(35.7)	(20.3)	(20.3)
	-50%	35.7	35.7	20.3	20.3
Interest rate risk					
Change in interest rates	+100bps	0.5	0.5	0.5	0.5
	-100bps	(0.5)	(0.5)	(0.5)	(0.5)
Foreign exchange risk					
British pound	+10%	0.4	0.4	0.1	0.1
	-10%	(0.4)	(0.4)	(0.1)	(0.1)
US dollar	+10%	2.2	2.2	-	-
	-10%	(2.2)	(2.2)	-	-
Euro	+10%	0.2	0.2	0.7	0.7
	-10%	(0.2)	(0.2)	(0.7)	(0.7)
Japanese yen	+10%	-	1.0	-	(0.4)
	-10%	-	(1.0)	-	0.4

¹ Credit risk sensitivities excludes Australian Government Bonds and Australian Semi-Government bonds.

² Mortality, morbidity and longevity life insurance contract liabilities sensitivity is net of any reinsurance with third parties.

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

The sensitivities are not forward looking and make no allowance for events occurring after 30 June 2020. If using these sensitivities as forward looking, an allowance for changes post-30 June 2020, such as sales, asset growth and changes in asset allocation, should be made.

These sensitivities assess changes in economic, insurance and investment markets on the valuation of assets and liabilities, 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 55 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 for additional detail on how to apply the profit and equity sensitivities.

Risk management framework

CLC is required under APRA prudential standards to maintain regulatory capital in order to ensure that under a range of adverse scenarios it can continue to meet its regulatory and contractual obligations to customers.

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

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

Challenger's Board is responsible, in conjunction with senior management, for the management of 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 its risk management responsibilities. In particular, these committees assist the Board in setting the appropriate risk appetite and for ensuring Challenger has an effective risk management framework that is able to manage, monitor and control the various risks to which the business is exposed.

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 discharging their risk management obligations by implementing the Board-approved risk management framework.

On a day-to-day basis, the Risk division, which is separate from the operating segments of the business, has responsibility for monitoring the implementation of the risk framework, including the monitoring, reporting and analysis of the various risks faced by the business, and providing effective challenge to activities and decisions that may materially affect Challenger's risk profile.

Risk appetite

Challenger's risk appetite statement provides that, subject to acceptable returns and limits, Challenger can retain exposure to credit risk, property risk, equity and infrastructure risk, life insurance risk and other active trading strategies.

Accept exposure (subject to appropriate returns)	Minimise exposure
✓ Credit default risk	✗ Asset and liability mismatch risk
✓ Property risk	✗ Foreign exchange risk
✓ Equity and infrastructure risk	✗ Interest rate risk
✓ Life insurance risk	✗ Inflation risk
✓ Other active trading strategies	✗ Liquidity risk
	✗ Licence risk
	✗ Operational risk

Asset and liability mismatch risk

Challenger's asset allocation strategy is based on running a cash flow-matched portfolio of assets and liabilities and to minimise the risk of cash flow mismatch. Annuity cash payments are generally met from contracted investment cash flows together with assets held in Challenger's liquidity pool,

which are continually rebalanced through time. As a result, liabilities and asset cash flows are well matched and are continually rebalanced through time.

Credit default risk

Credit default risk is the risk of loss in value of an investment due to a counterparty failing to discharge its contractual obligations when they fall due.

Challenger's approach to credit management utilises a credit risk framework to ensure that the following principles are adhered to:

- credit risk management team separation from risk originators;
- recognition of the different risks in the various businesses;
- credit exposures being systematically controlled and monitored;
- credit exposures being regularly reviewed in accordance with existing credit procedures; and
- ensuring credit exposures include the impact 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 ratings 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 asset 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) and the fair value of annuity and other liabilities.

As at 30 June 2020, a 50bps increase/decrease in credit spreads would have resulted in an unrealised loss/gain of \$103m (after tax) on fixed income investments (net of debt).

In accordance with prudential standards 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 Government bond curve plus an illiquidity premium. Movements in fixed income credit spreads impact the illiquidity premium.

As at 30 June 2020, a 50bps increase/decrease in credit spreads would have resulted in an unrealised gain/loss of \$78m (after tax) on the fair value of annuity liabilities.

Property risk

Property risk is the potential impact of movements in the market value of property investments on Challenger's profit and loss.

Property risk sensitivity

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

The property sensitivities included on page 46 show the impact of a change in property valuations at balance date and are based on Life's gross property investments of \$3.8bn (net investments of \$3.3bn plus debt of \$0.5bn). A 1% move in the direct and indirect property portfolio at 30 June 2020 would result in a \$26m (after tax) movement in property valuations.

Equity and infrastructure risk

Challenger is exposed to movements in the market value of equities and infrastructure investments.

Life maintains listed equity beta investments and unlisted private equity investments.

Life maintains unlisted infrastructure investments, predominantly in renewable energy and utilities and does not currently hold any listed infrastructure exposures.

Equity and infrastructure risk sensitivity

The equity and infrastructure risk sensitivities included on page 46 show a 10% move in the equity and infrastructure portfolio at 30 June 2020 would have resulted in a \$28m (after tax) movement in the valuation of equity and infrastructure investments.

Alternatives risk

Alternatives risk is the potential impact of movements in the market value of alternative investments. Alternative investments include exposure to equity markets through absolute return strategies and insurance related investments, both expected to have a low correlation to listed equity markets.

Challenger holds alternative investments as part of its investment portfolio in order to provide diversification.

Alternatives risk sensitivity

The alternatives risk sensitivity on page 46 assumes a 10% market move in the alternatives portfolio at 30 June 2020 would have impacted the valuation of equity and other investments by 10% or \$45m (after tax).

Liquidity risk

Liquidity risk is the risk 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 to repay contractual obligations, or the inability to generate cash inflows as anticipated.

Challenger's Liquidity Management 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 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 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.

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 annuitants 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 and morbidity risks on its wholesale mortality reinsurance business.

CLC is required under APRA prudential standards to maintain regulatory capital in relation to the longevity, mortality and morbidity risks. CLC manages some of its longevity risk exposure by using reinsurance for a closed lifetime annuity portfolio. CLC regularly reviews 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 mortality improvements.

CLC assumes future mortality rates for individual lifetime annuities will improve by between 0.3% and 2.5% per annum, depending on different age cohorts and sex. This has the impact of increasing the life expectancy of a male aged 65 from 22 years (per the base mortality rates) to 25 years.

Mortality, morbidity and longevity sensitivities

The mortality sensitivities on page 46 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 the annual mortality improvement rates already assumed would increase the life expectancy of a male aged 65 from 25 years to 26 years and increase the policy liability valuation by \$36m (after tax).

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 and the margin between different yield curves.

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, which are required to meet future annuitant obligations.

CLC does not seek to minimise the impact of fluctuations of interest rates on shareholder capital earnings. As a result, the investment yield on CLC's shareholder capital will be impacted by changes in interest rates.

Interest rate sensitivity

The impact of movements in interest rates on Challenger's profit and loss and balance sheet are set out on page 46.

The sensitivities assume the change in variable occurs on 30 June 2020 and is based on assets and liabilities held at that date.

The impact of movements in interest rates is minimised through the use of interest rate swaps, Australian Government bonds, Semi-Government bonds and bond futures. As a result, the interest rate sensitivities on page 46 show Challenger's profit is not materially sensitive to changes in base interest rates.

The sensitivities on page 46 do not include the impact of changes in interest rates on earnings from CLC's shareholder capital as investment earnings are earned over the period, whereas the sensitivities on page 46 assume a change in interest rates occurred on 30 June 2020.

Foreign exchange risk

It is Challenger's policy to seek to hedge the exposure of all balance sheet items for movements in foreign exchange rates.

Currency exposure arises primarily in relation to Life's investments in Europe (including the United Kingdom), Japan and the United States. As a result, currency risk arises primarily from fluctuations in the value of the euro, British pound, Japanese yen and US dollar against the Australian dollar.

In order to minimise foreign currency exchange rate risk, Challenger enters into foreign currency derivatives to limit Challenger's exposure to currency movements.

Foreign exchange sensitivity

The impact of movements in foreign currencies on Challenger's profit and loss and balance sheet are set out on page 46. As a result of foreign currency derivatives in place, Challenger's profit and loss is not materially sensitive to movements in foreign currency rates.

Challenger invests with a range of third party managers, for example absolute return fund managers. While Challenger does not actively seek to take foreign exchange risk, some foreign exchange exposure can be embedded in those third party managed portfolios.

Funds Management financial results

\$m	FY20	FY19	FY18	2H20	1H20	2H19	1H19	2H18	1H18
Fidante Partners									
Fidante Partners income ¹	81.4	83.2	73.6	39.4	42.0	39.4	43.8	37.1	36.5
Performance fees	14.9	3.5	19.3	11.4	3.5	1.0	2.5	12.9	6.4
Net income	96.3	86.7	92.9	50.8	45.5	40.4	46.3	50.0	42.9
CIP Asset Management									
CIP income ²	61.8	63.2	58.3	29.6	32.2	34.3	28.9	29.2	29.1
Total net fee income	158.1	149.9	151.2	80.4	77.7	74.7	75.2	79.2	72.0
Personnel expenses	(63.9)	(64.8)	(62.3)	(32.2)	(31.7)	(32.9)	(31.9)	(32.4)	(29.9)
Other expenses	(36.5)	(34.2)	(31.0)	(18.4)	(18.1)	(17.0)	(17.2)	(16.0)	(15.0)
Total expenses	(100.4)	(99.0)	(93.3)	(50.6)	(49.8)	(49.9)	(49.1)	(48.4)	(44.9)
EBIT	57.7	50.9	57.9	29.8	27.9	24.8	26.1	30.8	27.1
Performance analysis									
Fidante Partners – income margin (bps) ³	16	15	17	17	15	14	16	18	16
CIP Asset Management – income margin (bps) ³	31	33	33	30	32	36	31	32	34
Cost to income ratio	63.5%	66.0%	61.7%	62.9%	64.1%	66.8%	65.3%	61.1%	62.4%
Net assets – average ⁴	237.8	216.7	197.2	242.9	232.5	221.8	212.3	201.6	194.9
ROE (pre-tax)	24.3%	23.5%	29.4%	24.7%	23.8%	22.6%	24.4%	30.8%	27.6%
Fidante Partners	62,393	58,912	59,630	62,393	62,693	58,912	56,330	59,630	56,031
CIP Asset Management	19,042	20,117	18,354	19,042	20,153	20,117	18,684	18,354	17,397
Closing FUM – total	81,435	79,029	77,984	81,435	82,846	79,029	75,014	77,984	73,428
Fidante Partners	60,737	58,556	55,825	60,866	60,887	58,173	58,621	57,559	54,120
CIP Asset Management	19,837	18,911	17,575	19,550	20,170	19,042	18,747	18,272	16,853
Average FUM – total⁴	80,574	77,467	73,400	80,416	81,057	77,215	77,368	75,831	70,973
FUM and net flows analysis									
Fidante Partners	3,797.8	(3,636.1)	3,872.3	1,854.4	1,943.4	(2,590.3)	(1,045.8)	1,375.3	2,497.0
CIP Asset Management	(1,256.9)	1,197.7	1,428.9	(1,193.1)	(63.8)	1,129.0	68.7	(8.4)	1,437.3
Net flows	2,540.9	(2,438.4)	5,301.2	661.3	1,879.6	(1,461.3)	(977.1)	1,366.9	3,934.3
Distributions	(762.2)	(794.7)	(657.7)	(297.5)	(464.7)	(353.0)	(441.7)	(318.6)	(339.1)
Market-linked movement	627.6	4,278.5	6,434.7	(1,774.3)	2,401.9	5,829.2	(1,550.7)	3,507.4	2,927.3
Total FUM movement	2,406.3	1,045.4	11,078.2	(1,410.5)	3,816.8	4,014.9	(2,969.5)	4,555.7	6,522.5

¹ Fidante Partners income includes equity-accounted profits, distribution fees, administration fees, and Fidante Partners Europe transaction fees.

² CIP income includes asset-based management fees and other income. Other income includes leasing fees, asset acquisition and disposal fees, development and placement fees.

³ Income margin represents net income divided by average FUM.

⁴ Calculated on a monthly basis.

Funds Management financial results

Funds Under Management and net flows

\$m	Q4 20	Q3 20	Q2 20	Q1 20	Q4 19
Funds Under Management					
Fidante Partners					
Equities	26,295	22,672	28,107	26,726	25,864
Fixed income	29,590	26,073	27,452	26,890	25,988
Alternatives	6,508	7,240	7,134	7,107	7,060
Total Fidante Partners	62,393	55,985	62,693	60,723	58,912
CIP Asset Management					
Fixed income	13,629	13,218	14,618	14,788	14,568
Property	5,413	5,576	5,535	5,448	5,549
Total CIP Asset Management	19,042	18,794	20,153	20,236	20,117
Total Funds Under Management	81,435	74,779	82,846	80,959	79,029
Average Fidante Partners	59,021	61,491	61,760	59,999	58,540
Average CIP Asset Management	18,799	20,112	20,247	20,110	19,308
Total average Funds Under Management¹	77,820	81,603	82,007	80,109	77,848
Analysis of flows					
Equities	(195)	587	836	22	(2,345)
Fixed income	2,955	(430)	628	659	1,128
Alternatives	(199)	(864)	-	(201)	(1,327)
Total Fidante Partners	2,561	(707)	1,464	480	(2,544)
CIP Asset Management	404	(1,597)	(21)	(43)	1,120
Net flows	2,965	(2,304)	1,443	437	(1,424)

¹ Average total Funds Under Management calculated on a monthly basis.

Reconciliation of total group assets and Funds Under Management

\$m	Q4 20	Q3 20	Q2 20	Q1 20	Q4 19
Funds Management Funds Under Management	81,435	74,779	82,846	80,959	79,029
Life investment assets	18,303	18,960	19,669	19,683	19,010
Adjustments to remove double counting of cross-holdings	(14,501)	(14,286)	(16,176)	(16,292)	(16,269)
Total Assets Under Management	85,237	79,453	86,339	84,350	81,770

Funds Management financial results

Funds Management focuses on building savings for retirement by providing specialist investment strategies that seek to deliver superior investment returns. Funds Management has operations in Australia, the United Kingdom and Japan and is one of Australia's largest active investment managers¹.

Funds Management invests across a broad range of asset classes including fixed income, commercial property, Australian and global equities and alternatives.

Funds Management is growing strongly, with funds under management (FUM) of \$81bn at 30 June 2020, up from \$20bn ten years ago. Growth in FUM can be attributed to the strength of Challenger's retail and institutional distribution platform, a market-leading business model focused on investor alignment and strong long-term investment performance.

Funds Management comprises Fidante Partners and CIP Asset Management.

Fidante Partners is a multi-boutique platform and forms long-term alliances with investment teams to create, support and grow specialist asset management businesses. Fidante Partners' deep experience in asset management, extensive investor distribution networks and operational infrastructure enable investment teams to focus on managing investment portfolios.

Fidante Partners has been successful in attracting new investment managers, adding new investment strategies and building its manager and distribution footprint. Fidante Partners also continues to expand its distribution channels and has recently expanded into the actively managed exchange-traded funds (ETFs) market.

Challenger Investment Partners has been rebranded CIP Asset Management as it transitions from an internally focused to an externally focused manager. CIP Asset Management originates and manages assets, principally across fixed income and real estate, for leading global and Australian institutions, including Challenger Life.

EBIT and ROE

Funds Management EBIT was \$58m and increased by \$7m (13%) on FY19. The increase in Funds Management EBIT was due to higher fee income (up \$8m) partially offset by a modest \$1m increase in expenses.

Funds Management ROE was 24.3% and increased from 23.5% in FY19. ROE benefited from higher earnings (up 13%) partially offset by an increase in net assets following investment to support growth in Funds Management operations.

Total net fee income

FY20 total net income was \$158m and increased by \$8m (up 5%). Net income benefited from higher average FUM and higher performance fees, partially offset by lower Fidante Partners UK transaction fees (down \$4m) and lower CIP Asset Management transaction fees.

Expenses

FY20 Funds Management expenses were \$100m and increased by \$1m (1%) on FY19. Personnel expenses were \$1m lower and other expenses increased by \$2m due to increased technology and investment operations costs.

The FY20 cost to income ratio was 63.5% and reduced by 250bps from 66.0% in FY19.

Fidante Partners' net income

Fidante Partners' net fee income includes distribution and administration fees, transaction fees from Fidante Partners Europe, performance fees and a share in the equity-accounted profits of boutique investment managers.

Fidante Partners' net income was \$96m in FY20, up \$10m for the year. Fidante Partners' net income benefited from higher performance fees (up \$11m), higher FUM-based income (up \$7m), partially offset by lower Fidante Partners Europe transaction fees (down \$8m).

Fidante Partners' income margin (net income to average FUM) was 16bps in FY20, up 1bps from FY19. Fidante Partners' income margin benefited from higher performance fees (+2bps), partially offset by lower Fidante Partners Europe transaction fees (-1bps).

Fidante Partners' FUM and net flows

Fidante Partners' FUM at 30 June 2020 was \$62.4bn and increased by \$3.5bn (6%) for the year and included:

- net flows of \$3.8bn, including \$2.2bn of institutional flows and \$1.6bn of retail flows;
- positive impact from investment markets of \$0.4bn; and
- net distributions of \$0.7bn.

Fidante Partners' 30 June 2020 FUM is invested in the following asset classes:

- 42% in equities (FY19 44%);
- 47% in fixed income (FY19 44%); and
- 11% in alternatives (FY19 12%).

Fidante Partners Europe

Fidante Partners includes a European distribution platform with interests in a number of specialist boutique fund managers.

Fidante Partners Europe is an important part of Funds Management's international distribution and product expansion. It provides an established and scalable platform to expand global investment capability and distribution. Fidante Partners Europe FUM was \$6.4bn at 30 June 2020, down \$465m for the year.

¹ Consolidated FUM for Australian Fund Managers – Rainmaker Roundup, March 2020.

CIP Asset Management

CIP Asset Management’s net income was \$62m in FY20 and decreased by \$1m (2%) on FY19. The lower net income was a result of lower transaction fees (down \$4m) with Life completing its property sell-down in FY19.

CIP Asset Management’s income margin (net income to average FUM) was 31bps in FY20 and was down 2bps from FY19. The lower margin reflects lower transaction fees.

CIP Asset Management FUM and net flows

CIP Asset Management’s FUM at 30 June 2020 was \$19.0bn and decreased by \$1.1bn for the year and included:

- net outflows for Life of \$1.8bn, predominantly in relation to managing less fixed income for Life following the repositioning of its investment portfolio;
- net inflows from third party clients of \$0.5bn, predominantly in fixed income; and
- positive market movement of \$0.2bn.

CIP Asset Management’s 30 June 2020 FUM is invested in the following asset classes:

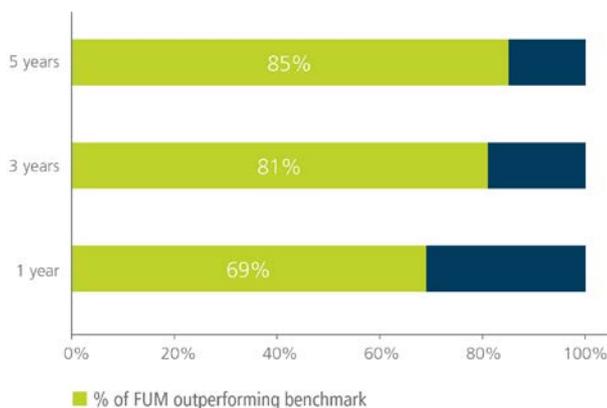
- 72% in fixed income (FY19 72%); and
- 28% in property (FY19 28%).

26% of CIP Asset Management’s FUM is from third party clients.

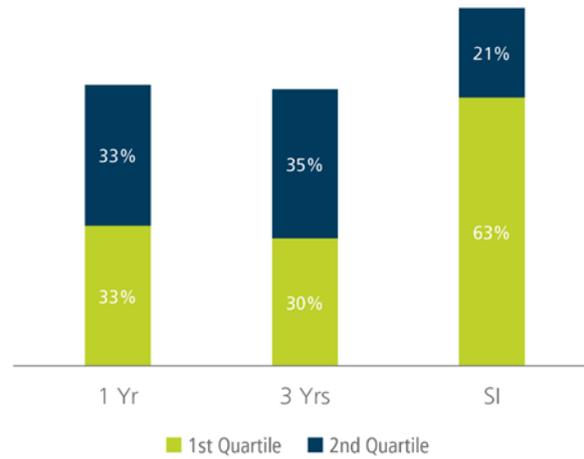
Funds Management investment performance

Investment performance represents the percentage of FUM meeting, or exceeding performance benchmarks, with performance weighted by FUM.

Long-term performance for Fidante Partners Australian boutiques remains strong with 85% of FUM outperforming benchmark over five years. Over one year, 69% of FUM outperformed benchmark¹.



For Fidante Partners, 66% of funds achieved first or second quartile performance over one year and 84% of funds have achieved either first or second quartile investment performance since inception².



¹ As at 30 June 2020. Percentage of Fidante Partners Australian boutiques meeting or exceeding performance benchmark.

² Mercer as at June 2020.

Corporate financial results

\$m	FY20	FY19	FY18	2H20	1H20	2H19	1H19	2H18	1H18
Other income	0.4	1.0	1.0	0.2	0.2	0.5	0.5	0.5	0.5
Personnel expenses	(32.5)	(38.6)	(41.8)	(14.4)	(18.1)	(19.6)	(19.0)	(21.7)	(20.1)
Other expenses	(28.3)	(10.3)	(10.4)	(18.5)	(9.8)	(4.8)	(5.5)	(4.6)	(5.8)
Total expenses (excluding LTI)	(60.8)	(48.9)	(52.2)	(32.9)	(27.9)	(24.4)	(24.5)	(26.3)	(25.9)
Long-term incentives (LTI)	(9.0)	(13.0)	(16.0)	(4.1)	(4.9)	(5.9)	(7.1)	(8.8)	(7.2)
Total expenses	(69.8)	(61.9)	(68.2)	(37.0)	(32.8)	(30.3)	(31.6)	(35.1)	(33.1)
Normalised EBIT	(69.4)	(60.9)	(67.2)	(36.8)	(32.6)	(29.8)	(31.1)	(34.6)	(32.6)
Interest and borrowing costs	(6.5)	(5.3)	(6.1)	(4.0)	(2.5)	(2.4)	(2.9)	(3.2)	(2.9)
Normalised loss before tax	(75.9)	(66.2)	(73.3)	(40.8)	(35.1)	(32.2)	(34.0)	(37.8)	(35.5)

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 EBIT

Corporate normalised EBIT was a loss of \$69m in FY20, up \$8m on FY19 as a result of higher expenses.

Other income

FY20 other income represents interest received on Group cash and was \$0.4m in FY20, down \$0.6m on FY19 due to lower interest rates.

Group cash at 30 June 2020 was \$146m, up \$55m and benefited from \$50m drawn from the Group debt facility.

Total expenses

FY20 Corporate expenses were \$70m and increased by \$8m on FY19.

Corporate expenses include personnel costs of \$33m, which decreased by \$6m on FY19 as a result of lower variable reward. Other expenses of \$28m, which increased by \$18m due to restructuring costs and accelerated amortisation of capitalised IT software in response to the COVID-19 environment as well as increased insurance costs, professional fees, IT costs and industry levies.

Long-term incentive (LTI) costs relate to the non-cash amortisation of equity grants. LTI costs were \$9m in FY20 and decreased by \$4m from the forfeiture of unvested equity awards.

Interest and borrowing costs

Interest and borrowing costs relate to debt facility fees on the Group's \$400m banking facility.

During 2H20, the \$400m facility was fully drawn in order to provide additional financial flexibility during the pandemic market sell-off. Once the market stabilised in late 2H20, \$350m of the \$400m was repaid. Group debt at 30 June 2020 was \$50m.

FY20 interest and borrowing costs were \$6m and were \$1m higher than FY19, reflecting the drawdown of the Group debt facility, which was undrawn throughout FY19.

Normalised Cash Operating Earnings framework

Life Normalised Cash Operating Earnings (COE) 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 COE 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 the result of external market factors. The normalised profit framework is subject to a review performed by Ernst & Young each half year.

Life normalised COE includes cash earnings plus normalised capital growth and excludes investment experience (refer below).



Cash earnings

Cash earnings represents investment yield and other income, less interest expenses and distribution expenses.

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, dividend income, infrastructure distributions, accrued interest on fixed income and cash, and discounts/premiums on fixed income assets amortised on a straight-line basis.

Interest expense

Represents interest accrued at contracted rates to annuitants and Life subordinated debt holders and other debt holders.

Distribution expense

Represents payments made for the acquisition and management of Life's products, including annuities.

Other income

Other income includes revenue from Accurium and profits on Life Risk wholesale longevity and mortality transactions (refer to page 26).



Normalised capital growth

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. 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 returns.

Normalised capital growth can be determined by multiplying the normalised capital growth assumption (see below) by the average investment assets for the period.

Commencing in FY21 (from 1 July 2020), Life's investment portfolio categories have been amended to more accurately reflect Life's investment portfolio following changes in portfolio composition in 2H20.

From 1 July 2020, the equities and infrastructure categories have been combined and represent 2% of Life's investment assets, and absolute return funds and insurance related investments have been reclassified from equities to alternatives as both are relatively uncorrelated to equity market returns.

Normalised growth assumptions have been updated for both the category changes and to ensure they reflect both the nature of the investments and long-term expected investment returns.

Normalised capital growth assumptions for FY20 and FY21 are as follows:

\$m	FY20	FY21
Fixed income and cash (representing allowance for credit defaults)	-35bps	-35bps
Property	2.0%	2.0%
Infrastructure	4.0%	n/a
Equity and other	3.5%	n/a
Equity and infrastructure	n/a	4.0%
Alternatives	n/a	0.0%



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 policy 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 removes the volatility arising from asset and liability valuation movements so as to more accurately reflect the underlying performance of the Life business.

Investment experience includes both asset and liability experience and net new business strain.

Asset and liability experience

Challenger Life is required by accounting standards and prudential standards to value all assets and liabilities supporting the Life business at fair value. Asset and liability experience is calculated as the difference between actual investment gains/losses (both realised and unrealised and based on fair value) and the normalised capital growth in relation to assets plus any economic and actuarial assumption changes in relation to policy liabilities for the period.

Changes in macroeconomic variables impact the value of Life's assets and liabilities.

Macroeconomic variables and actuarial assumption changes include changes to bond yields, inflation factors, expense assumptions, and other factors applied in the valuation of life contract liabilities.

New business strain

In accordance with 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 Government bond curve plus an illiquidity premium.

Life tends to offer annuity rates which are higher than these rates. As a result, on writing new annuity business, a non-cash loss is recognised when issuing the annuity contract due to a lower discount rate used to value the liability. In addition, maintenance expense allowances over the expected future term of new business are also included in the policy liability valuation.

New business strain is a non-cash item and subsequently reverses over the future period of the contract. The new business strain reported in the period represents the non-cash loss on new sales net of the reversal of the new business strain of prior period sales.

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, but does not satisfy all the criteria to be included in Common Equity Tier 1 regulatory capital.
Capital intensity ratio	CLC Prescribed Capital Amount (PCA) divided by Life investment assets.
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.
Challenger Index Plus Fund	Institutional product providing guaranteed excess return above a chosen index. Index Plus is available on traditional indices and customised indices.
CIP income	CIP Asset Management income includes asset-based management fees, and other income such as leasing fees, acquisition and disposal fees, development and placement fees.
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 in respect of intangibles and adjusting policy liabilities.
Cost to income ratio	Total expenses divided by Normalised Cash Operating Earnings (Life) or Total net fee income (FM)
Distribution expenses (Life)	Payments made for the acquisition and management of annuities and other Life products.
Earnings per share (EPS)	Net profit after tax divided by weighted average number of shares in the period.
Fidante Partners' Income	Distribution and administration fees; Fidante Partners' share of boutique manager profits; 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 assets under management (AUM)	Total value of Life's investment assets and Funds Management FUM.
Group cash	Cash available to Group, excluding cash held by Challenger Life Company Limited.
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 and other debt providers (including Challenger Capital Notes and Challenger Capital Notes 2).
Investment experience (Life)	Represents fair value movements on Life's assets and policy liabilities and net new business strain. Refer to page 56 for more detail.
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 – shareholders' funds (Life)	Represents the return on shareholder capital held by the Life business.
Life annuity book growth	Net annuity policy capital receipts over the period divided by opening policy liabilities (Life annuity book).
Life book growth	Net annuity and other policy capital receipts over the period divided by the opening policy liabilities (Life annuity book and Challenger Index Plus Fund liabilities).
Life investment assets	Total value of investment assets that are managed by the Life business.
Net annuity policy receipts	Life retail annuity sales less annuity capital payments.
Net assets – average	Average net assets over the period (excluding non-controlling interests) calculated on a monthly basis.
Net fee income (FM)	Fidante Partners' income and performance fees (FM) and Challenger Investment Partners' income and performance fees.
Net Interest Margin (NIM)	Net Interest Margin on term-funded prime mortgages and included as part of Life's investment assets.
Net management fees (FM)	Management fees for managing investments.

Glossary of terms

Terms	Definitions
Net tangible assets	Consolidated net assets less goodwill and intangibles.
New business tenor	Represents the maximum product maturity of new business sales. These products may amortise over this period.
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.
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 (FM)	Net income less total expenses.
Normalised EBIT (Life)	Normalised Cash Operating Earnings less total Life expenses.
Normalised net profit after tax (NPAT)	Statutory net profit after tax, excluding investment experience and net new business strain; and significant items (refer to page 56 for more detail on investment experience).
Normalised net profit before tax (NPBT)	Statutory net profit after tax, excluding normalised tax; investment experience and net new business strain; and significant items (refer to page 56 for more detail on investment experience).
Normalised Return On Equity (ROE) – pre-tax	Normalised Life EBIT, FM EBIT, and/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.
Normalised tax rate	Normalised tax divided by normalised profit before tax.
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 26 for more detail.
Performance fees (FM)	Fees earned for outperforming benchmarks.
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.
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 <i>Capital Adequacy</i> .
PCA ratio	The ratio of the total CLC Tier 1 and Tier 2 regulatory capital base divided by the Prescribed Capital Amount.
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 regulatory capital contributes to the overall strength of the 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).

Key dates

Challenger Limited (CGF)

Q1 2021 Sales and AUM	14 October 2020
2020 Annual General Meeting	29 October 2020
2021 Half-year financial results	9 February 2021
Q3 2021 Sales and AUM	15 April 2021
2021 Full-year financial results	10 August 2021
2021 Annual General Meeting	28 October 2021
