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Investment management

Investment structure

The Board has divided both the PSS Fund and the PSSap investment options into asset classes and appointed professional fund managers to invest those assets. In most cases the funds allocated to an asset class are managed by a number of specialist managers. The PSS Fund and PSSap investment options tap into the same asset class pools, and therefore investment managers, with the exception of property.

Investment arrangements

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

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

Custodian services

The master custodian for the PSS Fund and the PSSap investment options is JPMorgan, whose custodial function in relation to investment management includes:

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

Investment managers

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

Table 9: PSS Default Fund and PSSap investment managers at 30 June 2006

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

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



Table 10: PSS Cash Investment Option investment manager at 30 June 2006

INVESTMENT MANAGER
Colonial First State Investments Limited

Investment objectives

PSS Default Fund

The total benefit payable to members is set by the governing legislation and rules of the PSS. It does not depend on the earning rate of the Fund. This differs for preserved benefit members where investment performance has a more direct impact on their final benefit.

The difference between the total benefit payable to a member and the accumulated member and productivity contributions (including interest) invested in the Fund is paid by the employer from Consolidated Revenue. The call on Consolidated Revenue will depend on the investment performance of the Fund. The better the investment performance of the Fund, the smaller the call on Consolidated Revenue. In these circumstances, it is the employer who bears the investment risk arising from the investment of the Fund.

If the call on Consolidated Revenue is to be minimised, achieving a good return over the long term is of vital importance. This is explicitly recognised by the Fund's investment objective, which is to maximise the long-term real return of the Fund.

The Fund has a long-term perspective (maximising real returns in the accumulation fund), but managing shorter-term volatility is also an imperative. The investment objectives of the Fund specify the target, or acceptable, levels of portfolio risk and return. They are distilled from the characteristics of the scheme, including benefit design, crediting rate policy and liability position. The Board expects to achieve an average real return after tax and fees of no less than 4.5% per annum, which derives from a nominal return of 7.0% per annum over the longer term.

In developing an investment strategy to achieve that objective, and recognising that the average

person might have a working life of around 30 years, the Board has adopted the following constraint in order to manage the level of any short-term market volatility:

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

This criterion defines the 'tolerable' level of volatility specified in the Fund's objective.

Furthermore, for prudential reasons, not more than 25% of the Fund's investments are to be invested in illiquid assets, with a minimum cash allocation of 2%.

PSS Cash Investment Option

Preserved benefit members of the PSS may choose to have their funds invested in a Cash Investment Option. This fund's key investment objective is to preserve its capital and earn a return (before tax) close to that of the official cash rate (that is, the 11am cash rate determined by the Reserve Bank of Australia).

PSSap Trustee Choice Investment Option

The key investment objective is to maximise the long-term real return within appropriate risk constraints. This is expected to translate to an average real return, after tax and fees of no less than 4.5% per annum over the long-term. At the same time, the Fund is expected to achieve a positive annual return in at least 24 out of every 30 years.

PSSap Conservative Investment Option

The key investment objective is to maximise the long-term real return within appropriate risk constraints. This is expected to translate to an average real return over the long-term of 3.0% per annum after tax and fees.

PSSap Balanced Investment Option

The key investment objective is to maximise the long-term real return within appropriate risk constraints. This is expected to translate to an average real return over the long-term of 4.0% per annum after tax and fees.

PSSap Aggressive Investment Option

The key investment objective is to maximise the long-term real return within appropriate risk constraints. This is expected to translate to an average real return over the long-term of 5.0% per annum after tax and fees.

PSSap Bonds / Fixed Interest Investment Option

The key investment objective is, before taxes and fees are deducted from returns, to at least match the return of a composite index of global and Australian fixed interest securities.

PSSap Australian Shares Investment Option

The key investment objective is, before taxes and fees are deducted from returns, to at least match the return of the Australian share market.

PSSap International Shares (unhedged) Investment Option

The key investment objective is, before taxes and fees are deducted from returns, to at least match the return of the unhedged international share market.

PSSap International Shares (hedged) Investment Option

The key investment objective is, before taxes and fees are deducted from returns, to at least match the return of the hedged international share market.

PSSap Property Investment Option

The key investment objective is, before taxes and fees are deducted from returns, to at least match the return from the Mercer Direct Property Index.

PSSap Sustainable Investment Option

The key investment objective is, before taxes and fees are deducted from returns, to at least match the return of the Australian share market.

PSSap Cash Investment Option

The key investment objective is, before taxes and fees are deducted from returns, to at least match the return from the UBS Warburg Australian Bank Bill Return Index.

Strategic review

During each year, the Board conducts a review of its investment strategy. This year's review endorsed the appropriateness of the Board's investment objectives for the PSS Default Fund, the PSS Cash Investment Option and each of the PSSap diversified, pre-mixed Investment Options.

Asset allocation

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

Table 11: PSS Default Fund asset allocation

Asset class	Asset allocation %	
	2005	2006
Australian shares	28.7	32.1
International shares	24.1	23.0
Bonds	8.2	12.7
Market neutral strategies	8.9	9.9
Long/short equity funds	4.7	4.8
Property	10.1	11.2
Cash	15.3	6.3
Total Fund	100	100



The following table sets out the asset allocation for the PSSap diversified, pre-mixed investment options as at 30 June 2006:

Table 12: PSSap pre-mixed investment options asset allocation

Asset class	SAA %			
	Trustee Choice	Conservative	Balanced (50/50)	Agressive
Listed Australian shares	29.2	15.0	18.2	39.3
International shares	25.9	12.0	17.2	35.8
Long/short equity funds	5.0	-	5.0	5.0
Property	9.8	2.9	9.8	9.9
Bonds	12.5	37.3	27.9	-
Market neutral fund	10.0	-	9.9	8.0
General cash	7.6	32.8	12.0	2.0
Total Fund	100	100	100	100

Events during the year

Apart from the strategic review, a number of other changes were made during the year, including:

Equities

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

In international equities, one new manager, Platinum, was appointed to increase our allocation to Asian equities. A mandate with an existing manager was terminated.

Alternative investments

The exposure to alternative investments continued to grow during the year. Commitments were made to six new Australian private equity funds, five new opportunistic international property funds and four new international private equity funds. Some of the funds previously committed to private equity, infrastructure and opportunistic property were drawn down during the year, while some

investments were realised and the proceeds returned. The net result of these flows was that the investments in these assets rose from a valuation of \$346.7 million at the start of the year (reflecting commitments of \$854 million) to a valuation of \$416.9 million (commitment of \$1244 million) at 30 June 2006.

Market-neutral funds

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

Bonds

The benchmark for international bonds continues to exclude Japanese bonds, reflecting that Japanese bond yields have the potential to rise significantly in an environment where economic growth returns to more normal levels.

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

Property

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

Cash

The existing cash manager was replaced at the end of the year by Macquarie Investment Management Limited.

Fund performance

PSS

PSS Default Fund

The Fund posted a net return of 13.1%, the third consecutive year of double digit returns.

Despite increased volatility in the latter part of the year, all asset classes with the exception of bonds contributed to this strong result. Australian equities advanced by 22.9%, buoyed by robust domestic economic growth and a significant rise in commodity prices. International equities rose by 18.1% in local currency terms, supported largely by a pick-up in economic growth in Europe and Japan.

The Fund's long/short equity strategies delivered a strong return of 11.5%, while property achieved a return of 14.8%. By way of contrast, the Fund's bond portfolio recorded a return of just 2.0%, weighed down by a rise in bond yields, which helps to constrain the overall return from bonds.

The Fund's longer-term investment performance remains ahead of target. Over the past three years the Fund returned an earning rate of 13.7% per annum, compared with an average inflation rate of 3.0% per annum over this period, while over 10 years the Fund returned an earning rate of 9.1% per annum compared with average inflation of 2.3% per annum.

PSS Cash Investment Option

The Cash Investment Option posted a net return of 4.8%, which is in line with its benchmark once account is taken of the impact of tax on returns.

PSSap

The performance of the various options in 2005/06 was as follows:

Table 13: PSSap performance

PSSap Trustee Choice Investment Option	14.3%
PSSap Conservative Investment Option	7.7%
PSSap Balanced Investment Option	10.2%
PSSap Aggressive Investment Option	16.1%
PSSap Bonds / Fixed Interest Investment Option	2.0%
PSSap Australian Shares Investment Option	22.3%
PSSap International Shares (unhedged) Investment Option	17.8%
PSSap International Shares (hedged) Investment Option	15.5%
PSSap Property Investment Option	11.7%
PSSap Sustainable Investment Option	19.0%
PSSap Cash Investment Option	4.6%

Performance by asset class

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

PSS Default Fund

Australian shares

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

The Fund's Australian equity investments underperformed the market to return 22.9%. This reflected underperformance from the Fund's private equity investments.



International shares

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

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

Australian bonds

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

International bonds

Continued strong rates of economic growth within the US, signs of emerging strength in Europe

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

Market-neutral funds

The Fund achieved its desired exposure of 10% of its assets to this asset class during the year. For the year as a whole these investments returned a relatively modest 6.6%.

Long/short equity funds

The Fund has invested in this asset class since October 2004. Over the course of the year, the Fund return was 11.5%. This compares with a benchmark return of 13.8%.

Property

The Australian property market, as measured by the Mercer Australian Unlisted Property Index, performed strongly during the year, returning 17.2%. The Fund's property investments returned 14.8%.

Cash

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

Table 14: PSS Default Fund investments 2005/06

Investments	Holdings at 30 June 05	Holdings at 30 June 06	Proportion
Sector	\$m	\$m	%
Australian shares	2 220.2	2 984.5	32.0
International shares	1 858.6	2 137.6	23.0
Bonds	632.6	1 178.1	12.7
Market neutral funds	689.8	921.6	9.9
Long/short equities	361.2	444.3	4.8
Property	778.5	1 042.0	11.2
Cash	1 182.6	592.2	6.4
Total Fund Investments	7 723.5	9 104.2	100.0

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

Table 15: Default Fund performance 2005/06

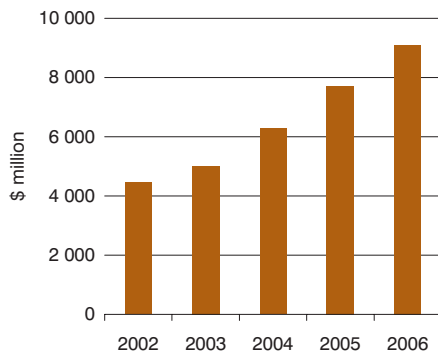
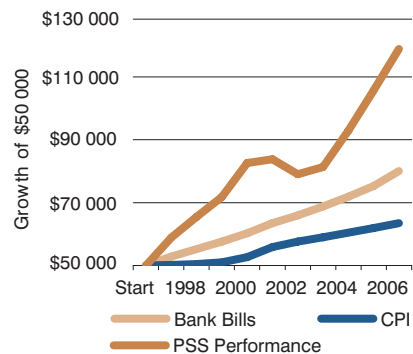
	One-year performance	Three-year performance	Five-year performance
	%	%	%
Australian shares	22.9	23.2	12.3
International shares	18.1	18.5	6.6
Bonds	2.0	6.4	6.1
Market neutral funds	6.6	9.4	n/a
Long/short equities	11.5	n/a	n/a
Property	14.8	13.0	11.6
Cash	5.9	5.6	5.2
Total Fund Investments	13.1	13.7	7.3

Note: Return numbers in the table above are post fees and pre tax, except Total Fund Investments, which is post tax and fees

Table 16: PSS Cash Investment Option fund performance 2005/06

	Holdings at 30 June 2005 \$m	Holdings at 30 June 2006 \$m	One year performance	Three year performance	Five year performance
			%	%	%
Total Fund	7.0	7.9	4.8	n/a	n/a

Fund investments

Chart 1: Fund size at 30 June for past five years**Chart 2: PSS Default Fund performance comparison over 10 years**



Investment information

Further information on investment performance can be obtained from:

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

PSS crediting and exit rate policy

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

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

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

where market movements have an estimated 0.5% or greater effect on the Fund's investment performance.

Members were advised of these changes in the 2004 Annual Member Statement Pack and the Guide to the PSS Cash Investment Option for preserved benefit members, issued in 2004.

Allocating Earnings

PSS

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

Because the Board is no longer determining annual crediting rates, but is instead allocating members their share of the Fund's assets when they exit, the Fund has a notional balance that represents unallocated earnings. This notional balance is invested in exactly the same way it would be if it were allocated to members, and members earn a return on this balance in exactly the same way they would if it were allocated to them. The notional balance as at 30 June 2006 was approximately \$2533 million.

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

PSSap

Members' interests in the PSSap are valued in units. Contributions and other amounts transferred to the PSSap are used to buy units which are invested in accordance with members' investment choices. There are 11 investment options to choose from.

The Fund's net earnings are allocated to members' accounts through changes in the unit price which fluctuate in line with investment markets. The unit price for an investment option reflects the total value of assets in the investment option (net of taxes and expenses) divided by the number of units issued in the investment option. A buy/sell spread is applied to all the investment options to reflect the costs associated with the purchase or sale assets.

Calculation of the value of assets in each investment option is generally based on the latest available market value at the end of each business day and published on the Fund's website at www.pssap.gov.au daily.

Where fees are payable directly from a member's account (for example, insurance premiums and switching fees), units are sold to the extent required for payment.

PSS investment governance

The Board's approach to investment governance

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

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

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

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

- the Governance Advisory Service
- proxy voting.

Governance Advisory Service

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

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

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

Proxy voting

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

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

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



**Table 17: Investment governance milestones
2005/06**

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