

# ORB International Enhanced Income

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## YIELDS<sup>2</sup>

October 2004

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## ORB International Enhanced Income YIELDS2

Product Name	Rating Summary	Comment
ORB International Enhanced Income Yield Income Enhanced Listed Deferred Securities 2 (YIELDS2)	Investment Grade	Citigroup has structured a product designed to provide investors with exposure to a large-cap, value-biased portfolio of international stocks whilst ensuring that an investor's initial capital is protected at maturity.

### Key Issues

ORB International Enhanced Income is a second offering of the capital guaranteed product, **Yield Income Enhanced Listed Deferred Securities (YIELDS2)**. The product is designed to deliver income by providing investors with exposure to both the dividends of 30 stocks selected from the Dow Jones Global Titans 50 Index (DJGT 50) and the premiums generated from the selling of call options on the stocks, whilst utilising a capital guarantee structure. That is, the product is structured as a deferred purchase agreement to ensure that, at maturity in six years, investors are guaranteed their initial invested capital.

YIELDS2 provides investors with exposure to the Income Plus Trading Strategy ("the Strategy"). The Strategy is designed to track the performance of a portfolio of 30 stocks selected from the DJGT 50. Stocks are selected for the Strategy to maximise dividend yield whilst also providing the portfolio with a degree of sector diversity. The DJGT 50 is composed of the 50 largest global companies by market capitalisation. The underlying portfolio of stocks is a contractual obligation of Citigroup. Citigroup is obligated to match the capital gains and losses along with the dividends which pertain to the underlying stocks within the Strategy.

Citigroup intends to enhance the dividend income received on the stocks by writing (i.e. selling) call options over these stocks. Each quarter, the option overlay writes 3-month options on the underlying stocks selected within the Strategy. Citigroup has previously identified through its research that 3-month options systematically generates the maximum premium whilst offering the greatest liquidity.

Dynamic management of the stock portfolio utilises a mechanism known as Constant Proportion Portfolio Insurance. This process facilitates the allocation between the risky asset (i.e. the stock portfolio) and the cash asset (i.e. referred to as a Bond Portfolio). As the stock portfolio is valued in 'real time', Citigroup has the ability to dynamically allocate between it and the Bond Portfolio. The chance of the entire stock portfolio being reallocated to the Bond Portfolio is minimal.

Dynamic management is not a guarantee of capital value. Rather it is a Citigroup entity that guarantees

payment of the investors' capital at maturity. The performance of YIELDS2 is not guaranteed.

YIELDS2 is targeting an income yield of 12% per annum, as previously indicated by the sponsor's research. Based on that research, the target yield arises from 4% dividend income and 8% premium income, assuming there is a 100% allocation of capital to the Strategy during the full six-year term of the investment. The actual allocation to the Strategy may however fluctuate between 0% and 150%.

YIELDS2 is intended to be a 'buy & hold' investment. YIELDS2 will however be listed on the ASX where it is expected that Citigroup will again offer liquidity by providing both a bid price and offer price as a spread to the Net Asset Value (NAV). The spread compensates Citigroup for the cost of unwinding the exposures which Citigroup uses to hedge its liabilities to holders of YIELDS2.

The fee structure of YIELDS2 is transparent allowing investors to determine the cost of each component and the overall cost of YIELDS2. The estimated fees & embedded costs of YIELDS2 are 3.78% per annum, based on a 100% allocation to the Strategy during the full term, plus an upfront sales fee of 3.5875% in the first year. An additional cost for leverage is also payable. When leverage is used, its cost is the RBA cash rate + 1.25% per annum. For a description of the fees & embedded costs, refer to the Product Disclosure Statement, pages 29-30.

Citigroup retains the right to bring an early maturity date to the product. The limited events that can trigger this ending include the inability of Citigroup to legally offer the product or a market event which makes it impossible for continued servicing of the product. Although investors will then lose their capital protection on an early maturity, they will receive the NAV of YIELDS2 less the costs of Citigroup unwinding the positions. As such the investors would as a minimum receive the present value of the guaranteed amount discounted by a factor derived from the Bank Bill Swap interest rate.

The product may be suitable for investors seeking international equity exposure whilst seeking the surety that their capital will be guaranteed at maturity.

# ORB International Enhanced Income YIELDS2

## Purpose of the Report

The purpose of this report is to determine an ASSIRT Research's recommendation of the ORB International Enhanced Income (YIELDS2). This assessment focuses on the product structure and investment strategy and is not designed to assess the underlying portfolio of stocks, bonds and derivatives or the suitability of the offering to specific individual investors. The study involved a review of the Product Disclosure Statement dated 24 September 2004 along with a review of the processes used by Citigroup in order to identify the key product issues.

## Key Features of YIELDS2

<b>Issuer</b>	Citigroup Global Markets Australia Pty Ltd
<b>Security</b>	Yield Income Enhanced Listed Deferred Securities 2 (YIELDS2)
<b>Strategy Sponsor</b>	Citigroup Global Markets Ltd.
<b>Domicile of issue</b>	Australia
<b>Underlying Strategy</b>	Rules-based, non-discretionary trading model that combines high-yielding stocks with covered call option writing.
<b>Offer Open Date</b>	20 October 2004
<b>Offer Close Date</b>	30 November 2004
<b>Issue Date</b>	6 December 2004
<b>Maturity Date</b>	6 December 2010
<b>Investment Term</b>	6 Years
<b>Denomination</b>	Australian dollars
<b>Minimum Investment</b>	\$5,000 then \$1,000 increments
<b>Deferral Payment amount (i.e. Coupon)</b>	Targeting 12% pa, based on historical estimates by the sponsor, comprising 4% dividend income and 8% premium income, provided there is a 100% allocation of capital to the Strategy during the full six-year term
<b>Deferral Payment frequency</b>	Quarterly in arrears
<b>Upfront Sales Commission</b>	Application fee of 3.5875%
<b>Ongoing Sales Commission</b>	Trailing fee of 1.2813% pa
<b>Dynamic Portfolio Fee</b>	0.75% pa based on issue price
<b>Trading Strategy Fee</b>	1.75% pa based on \$A amount allocated to stock portfolio.
<b>Leverage Facility Cost</b>	RBA cash rate + 1.25% pa based on initial leverage facility
<b>Capital Guarantor</b>	Citigroup Global Markets Holdings Inc., rated Aa1/AA- (Moody's/S&P)
<b>ASX Listing</b>	Citigroup will apply for official quotation of YIELDS2 on the ASX

# ORB International Enhanced Income YIELDS2

## Explaining YIELDS2

YIELD2S is a capital guaranteed product designed to provide a stable income derived from dividends and writing call options whilst utilising a capital guarantee structure.

The product is structured as a deferred purchase agreement which ensures that, at maturity in six years, investors are guaranteed their initial invested capital. The performance of YIELDS2 is not guaranteed.

## Income Plus Trading Strategy

The underlying stock portfolio consists of 30 stocks selected from the Dow Jones Global Titans 50 Index (DJGT 50). Stocks are selected to maximise dividend income whilst also providing a degree of sector diversity. The DJGT 50 is composed of the 50 largest global companies by market capitalisation. The highest dividend yielding stocks are selected on an annual basis, subject to a diversification rule that excludes the portfolio from including more than 10 stocks from any single sector. Citigroup has previously indicated to us that the historical dividend yield on the portfolio is approximately 4% per annum. Investors should be aware that the resulting portfolio is likely to be heavily biased towards banking & financial stocks. Shares of Citigroup will however be excluded from the portfolio.

The Strategy intends to enhance the dividend income received by writing call options on the stocks in the portfolio. The underlying portfolio of 30 stocks is a contractual obligation of Citigroup. From the investors' perspective, Citigroup is obligated to match the capital gains and losses, along with the dividends, which pertain to the underlying securities within the Strategy, so ensuring that the Strategy tracks the performance of the underlying portfolio.

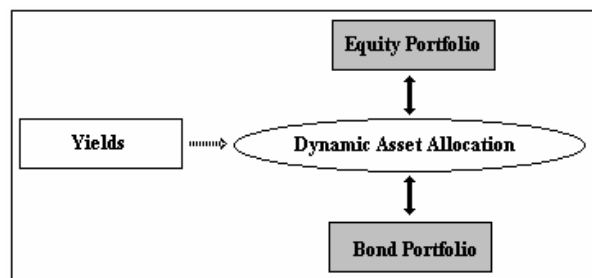
Quarterly, the option overlay writes 3-month options on the underlying stocks. Citigroup has previously identified through its research that 3-month options systematically generate the maximum premium whilst offering the greatest liquidity. The option overlay mimics a 'Dutch Auction' where Citigroup seeks bids for 'European-style' cash-settled call options on the underlying stocks from a minimum of three independent brokers, and then accepts the counterparty which will offer the highest premium for a given strike. The strike price of the options is targeted to generate a cash flow of 12% per annum (in combination with the dividends on the underlying stocks). The Strategy will write 'out-of-the-money' options between 105% - 130% of the current market value of the underlying stock. For any given quarter, this would imply a minimum potential capital gain of 5% on the stocks during the quarter.

## Cash Asset

The cash asset is a notional Bond Portfolio. The present value of the Bond Portfolio is calculated using a discount factor determined from the current bank bill interest swap rate. This obligation is backed by Citigroup Global Markets Holdings Inc. which is rated Aa1 by Moody's and AA- by S&P.

## Dynamic Management Mechanism

Dynamic management utilises a mechanism known as Constant Proportion Portfolio Insurance. The portfolio is dynamically allocated between the Strategy and the Bond Portfolio. This mechanism aims to ensure that the net asset value of YIELDS2 at maturity in six years is at least equal to the guaranteed amount. The rules governing this process are non-discretionary and performed systematically by Citigroup.



Dynamic management is simple for Citigroup to operate. Generally speaking, when the Strategy is performing well, most of the invested capital is exposed to the stock portfolio's performance. The actual proportion exposed is a function of a constant (i.e. 5 times) 'gearing factor' multiplied by the 'trading equity' (equal to the amount by which the unlevered or net asset value exceeds a 'bond floor' which is the present value of the protected capital discounted at an interest rate). In other words, the gearing factor is an implied source of leverage and Citigroup will maintain enough of a cushion, in theory, to maintain the initial invested capital at maturity. It monitors the value of assets in the stock portfolio, the leverage level and the bond floor. When the Strategy is not performing, more of the capital is diverted to the Bond Portfolio.

Dynamic management is preferred in a low interest rate environment. Alternative static mechanisms are too expensive or only achieve sufficient participation in the underlying investment strategy with excessive leverage.

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## Net Asset Value (NAV) Determination

The NAV of YIELDS2 will be determined where possible from ‘real-time’ market prices of the underlying stocks within the portfolio. Where the market is closed for an underlying stock in the portfolio, the stock will be priced based on the closing price of the stock on its particular exchange. The diagram below indicates the total NAV determination of YIELDS2.

$$\begin{array}{c}
 \left[ \begin{array}{c}
 \text{\$A Value Equity Portfolio} \\
 + \\
 \text{\$A Value Bond Portfolio}
 \end{array} \right] \\
 - \\
 \left[ \begin{array}{c}
 \text{\$A Leverage Facility} \\
 + \\
 \text{\$ A allocation of discount amount}
 \end{array} \right]
 \end{array}$$

The dividends and the option premiums will accrue to the portfolio continuously during each quarter. The NAV will decrease by the coupon amount when YIELDS2 goes ‘ex-coupon’.

## ASX Listing

YIELDS2 is intended to be a ‘buy & hold’ investment. YIELDS2 will however be listed on the ASX where it is expected that Citigroup will again offer liquidity by providing both a bid price and offer price as a spread to the NAV. The spread compensates Citigroup the costs of unwinding the positions which Citigroup uses to hedge its liabilities to YIELDS2 holders.

## Fees

The fee structure of YIELDS2 is transparent allowing investors to determine the costs of each component and the overall cost of YIELDS2. The estimated fees & embedded costs of YIELDS2 are 3.78% per annum, based on a 100% allocation to the Strategy during the full term, plus an upfront sales fee of 3.5875% in the first year. An additional cost for leverage is also payable. When leverage is used, its cost is the RBA cash rate + 1.25% per annum. For a description of the fees & embedded costs, refer to the Product Disclosure Statement, pages 29-30.

## The Risks

Investors need to be aware that the terminal capital value of this product and cash flows received over the products’ life are dependant on a large number of exposures including the following factors.

## Interest Rate Exposure

The market value of the Bond Portfolio component is reliant on the prevailing interest rates.

## Foreign Exchange Exposure

The stocks in the portfolio may be denominated in a number of currencies. The stock portfolio itself will be denominated in USD while the bond portfolio will be denominated in AUD. As such YIELDS2 will be exposed to foreign exchange rate movements. For example, a rising USD will increase the stock portfolio value in AUD terms, thereby decreasing the likelihood of a de-leveraging dynamic allocation into the bond portfolio. A falling USD will however decrease the stock portfolio value in AUD terms, and increase the likelihood that the portfolio will be de-leveraged in to the bond assets.

## Equity Exposure

The performance of YIELDS2 is driven by the performance of the underlying assets in the stock portfolio. A brief description on how this covered call option strategy will perform in different market conditions is shown below.

If Global equity market performance is...	The Strategy performance is likely to be...	Relative to a direct equity investment, the Strategy is likely to...	Relative to a cash deposit, the Strategy is likely to...
Very positive / strong bull market	Very positive	Underperform	Outperform strongly
Moderately positive / rising market	Positive	Outperform	Outperform
Flat	Positive	Outperform	Outperform
Moderately negative / falling market	Slightly positive to slightly negative	Outperform	Underperform slightly
Very negative / bear market	Negative	Outperform	Underperform

Source: Citigroup

## Early Maturity

Citigroup retains the right to bring an early maturity date to YIELDS2 in limited circumstances. The events that may provide Citigroup with the ability to bring an early maturity include if a force majeure event occurs such that Citigroup determines in good faith that it is simply unable, is prohibited by law, or

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is directed by the government that it is unable to continue to perform its obligations under the product. Although investors then lose their capital protection at maturity, they will receive the NAV of YIELDS2 less the costs of unwinding the positions. As such the investors would at least be guaranteed the present value of the guaranteed amount discounted by a discount factor derived from the swap interest rate.

### **Investor Profile**

The product may be suitable for investors seeking international equity exposure whilst seeking the surety that their capital will be guaranteed at maturity.

YIELDS2 may be suitable for investors:

- who want exposure to international equity markets;
- who are seeking regular income, the potential for capital growth and principal protection at maturity;
- seeking to add an equity-linked investment to a portfolio to further diversify existing fixed income and equity assets; and
- who can accept a holding period of 6 years.