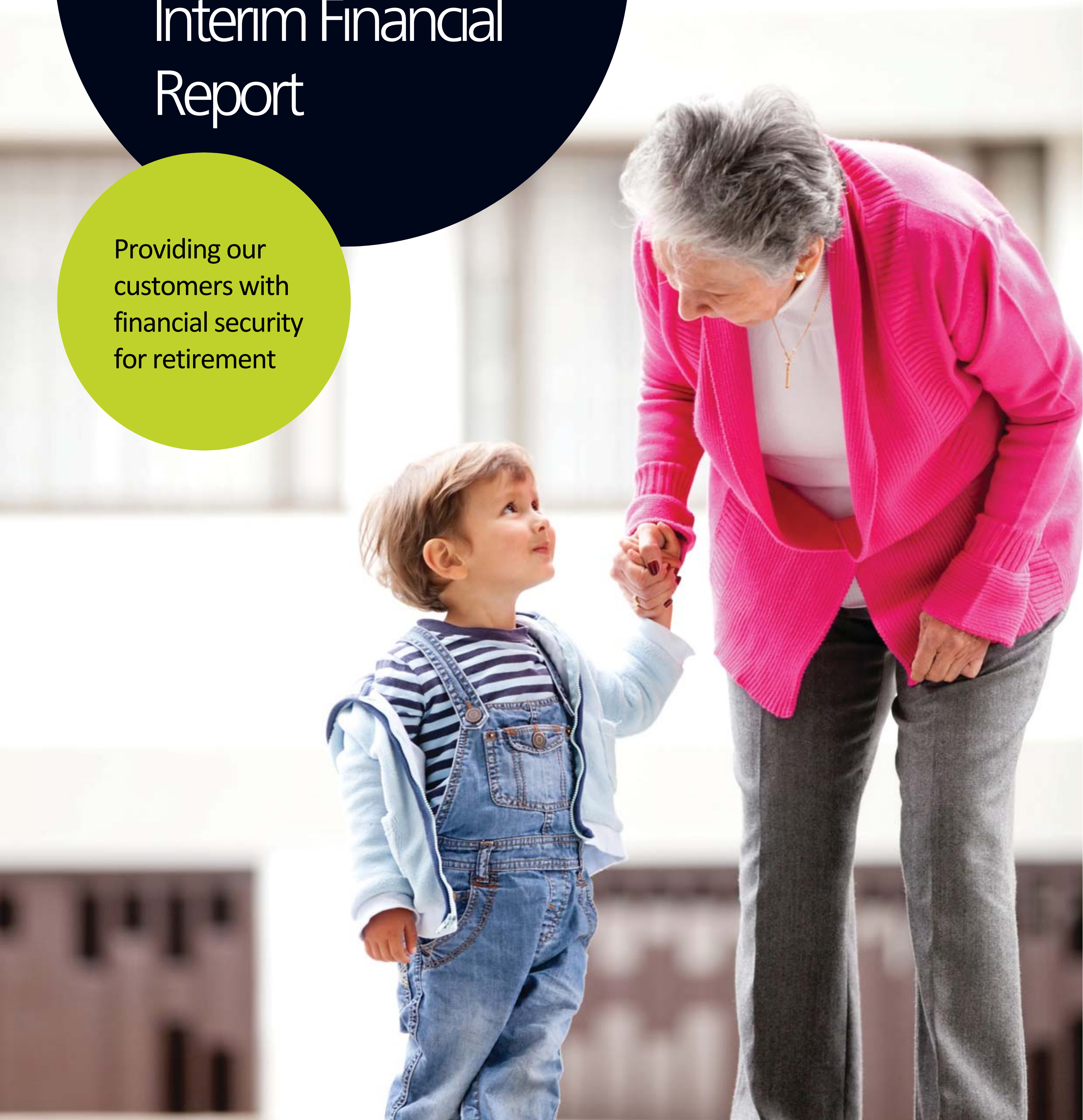
2019
Interim Financial Report

Providing our customers with financial security for retirement



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Challenger Limited ACN 106 842 371

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Key dates

26 March 2019
Interim dividend payment date

13 August 2019
Full year financial results

25 September 2019
Final dividend payment date

31 October 2019
2019 Annual General Meeting

Full listing of key dates available at

› **challenger.com.au/share/keydates**

Dates may be subject to change

About this Interim Financial Report

The 2019 Interim Financial Report can be downloaded from Challenger's online Shareholder Centre at:

› **challenger.com.au/shareholder**

Operating and financial review

1 About Challenger

Challenger Limited (Challenger, CGF, the Group or the Company) is an investment manager founded in 1985. Challenger is the largest annuity provider and one of the largest growing funds managers in Australia. It is also expanding into international markets.

Challenger is listed on the Australian Securities Exchange (ASX) and has offices in Australia, London, New York and Tokyo. Challenger is regulated by the Australian Prudential Regulation Authority (APRA), the Australian banking, superannuation, general insurance and life insurance regulator.

Challenger's activities are also subject to supervision by other regulatory agencies both in Australia and in other markets in which it operates.

Challenger's assets under management were $78.4 billion, up 2% on the prior corresponding period (pcp). Normalised net profit before tax was $270 million, down $5 million or 2% on the pcp. Earnings were impacted by investment market volatility resulting in lower asset returns in the Life business and lower Funds Management performance fees. See sections 2 and 7 for a description of Challenger's operating segments and its normalised cash operating earnings framework.

Normalised net profit after tax was down $8 million or 4% to $200 million. Statutory net profit after tax, which includes investment experience, being the valuation movements on assets and liabilities supporting the Life business, was $6 million mainly due to the volatile equity and fixed income markets in the December quarter. Challenger has total equity of $3.4 billion as at 31 December 2018 and employs 675 people on a full-time equivalent (FTE) basis.

2 Operating segments and principal activities

For internal reporting and risk management purposes, Challenger's principal activities are divided into two operating segments, Life and Funds Management. The Life operating segment is serviced by the Distribution, Product and Marketing team, which is responsible for ensuring the appropriate marketing and distribution of Life's products. Both operating segments and the Distribution, Product and Marketing team are supported by centralised operations which are responsible for appropriate processes and systems and for providing the necessary resources to meet regulatory, compliance, financial reporting, legal and risk management requirements.

Life – the Life segment comprises Challenger Life Company Limited (CLC), Australia's leading provider of annuities and guaranteed retirement income products and Accurium Pty Limited, a provider of self-managed superannuation fund (SMSF) actuarial certificates.

As Australia's largest annuity provider, Life provides reliable guaranteed[1] incomes to approximately 75,000 Australian retirees.

Life's annuity products appeal to retirees because they provide security and certainty of guaranteed income while protecting against risks from 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 are backed by a high-quality investment portfolio, predominantly in fixed income and commercial property investments. These long-term investments generate regular and predictable investment income which is used to fund retirement incomes paid to Life's customers.

Life's products are distributed via both independent financial advisers and financial advisers tied to the administrative platforms serviced by the four major Australian banks and AMP (the 'major hubs'). Life's products are included on all major hub Approved Product Lists (APLs) and are available on other leading investment and administration platforms.

Life is the market leader in Australian retirement incomes, with a 77%[2] annuity market share and has won the Association of Financial Advisers 'Annuity Provider of the Year' for ten consecutive years.

Life also has an annuity relationship with Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary), a leading provider of Australian dollar denominated annuities in Japan.

Funds Management – the Funds Management segment focuses predominantly on the retirement savings phase of Australia's superannuation system by providing products seeking to deliver superior investment returns. Funds Management is also expanding into international markets.

As one of Australia's largest growing asset managers, Funds Management invests across a broad range of asset classes including fixed income, commercial property and Australian and global equities. The Funds Management segment comprises two business divisions, Fidante Partners and Challenger Investment Partners (CIP).

Fidante Partners encompasses a number of investments in boutique investment managers that each operate under their own brands. Fidante Partners provides administration and distribution services to the boutique investment managers and shares in the profits of these businesses through equity ownership. Fidante Partners also has a presence in Europe with interests in UK-based fixed income and alternative asset managers.

[1] The word 'guaranteed' means payments are guaranteed by Challenger Life Company Limited from the assets of its relevant statutory fund.

[2] Strategic Insights – based on annuities in force at 30 September 2018.

2 Operating segments and principal activities (continued)

CIP develops and manages assets for CLC and under Challenger's brand on behalf of third-party institutional investors. The investments managed by CIP are predominantly in fixed income and commercial property.

The Funds Management business is growing strongly, with funds under management (FUM) increasing by more than 80% over the last five years to $75 billion.

Principal activities – there have been no significant changes in the nature of these principal activities or the state of affairs of the Company during the period.

3 Challenger's vision and strategy

Challenger's vision is to provide its customers with financial security for retirement. Challenger has four strategic pillars to ensure that it achieves its vision over the long-term. The four strategic pillars are:

- increase the Australian retirement savings pool allocation to secure and stable incomes;
- be recognised as the leader and partner of choice in retirement income solutions with a broad product offering;
- provide customers with relevant investment strategies exhibiting consistently superior performance; and
- deliver superior outcomes to customers and shareholders through a highly engaged, diverse and agile workforce committed to sustainable business practices and a strong risk and compliance culture.

4 Risk management

An integral part of risk management for Challenger is the maintenance of a strong risk culture amongst its employees. Challenger's expectations of its employees are encapsulated in the 'Challenger Principles' of integrity, commercial ownership, working together, compliance and creative customer solutions. Employees are made aware that these principles should form the basis of all behaviours and actions.

The management of risk is fundamental to Challenger's business and to building shareholder value and has been the key to Challenger's profitable and disciplined growth over many years. At Challenger, risk is everyone's business. The Board's Risk Appetite Statement outlines the level of risk that is acceptable in striving to achieve Challenger's strategic goals and financial objectives. This is combined with a robust risk management framework which monitors, mitigates and manages the risks to which Challenger is exposed.

Challenger's Board recognises the broad range of risks that apply to a participant in the financial services industry. These include funding and liquidity risk, investment and pricing risk, counterparty risk, business and reputational risk, operational risk, licence and regulatory risk, cyber and information security risk and environmental and social risks such as climate change.

5 Challenger's 1H19 strategic progress

1H19 strategic progress

Progress in 1H19 against strategic priorities is set out below:

Increase the Australian retirement savings pool allocation to secure and stable incomes

Industry annuity sales represent less than 5% 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.

1H19 progress includes:

- Australian annuity sales up 4%;
- CarePlus annuity sales up 15%; and
- Long-term annuities representing 29% of total annuity sales.

Life sales mix and focus on long-term products

Challenger's annuity sales mix continues to evolve to long-term products. In 1H19, long-term annuity sales, which represent Australian lifetime annuities and fixed term annuities distributed through MS Primary in Japan, represented 29% of total annuity sales, up from 19% five years ago (1H14). Long-term annuity products accounted for 45% of the total annuity book at 31 December 2018.

Long-term annuity sales embed more value for shareholders as they lengthen the annuity book tenor, improve the maturity profile and typically enhance return on equity.

Strong growth in CarePlus sales

CarePlus is a lifetime annuity that is specifically designed for clients in aged care. It helps manage aged care costs by providing regular payments for life as well as providing peace of mind that 100% of the amount invested will be paid on death to either a nominated beneficiary or to the estate.

CarePlus sales continue to benefit from demographic trends with approximately 300 older Australians entering home or residential care each day. CarePlus sales increased by 14% and represented 8% of Challenger's annuity sales. CarePlus sales are benefiting from an ageing population and advisers having a greater understanding of the product and benefits it provides their aged care clients. The number of financial advisers writing CarePlus increased by 15% during 1H19.

Superannuation reforms engagement and advocacy

The Australian Government is considering a range of superannuation reforms aimed at enhancing the retirement phase of superannuation to better align it with the overall objective of the system – to provide income in retirement to substitute or supplement the age pension.

In 1H19, the Government reconfirmed its commitment to a Retirement Income Framework. 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 members by 1 July 2020.

The second stage of the Retirement Income Framework is to develop simplified, standardised metrics in product disclosures to help members make decisions about the most appropriate retirement income product for them. Key information would ensure members are supported to make informed decisions about the income, risk and flexibility associated with different retirement income products. The Government issued a Retirement Income Disclosure Consultation Paper in December 2018, with consultation closing in March 2019.

In November 2018 the Government introduced the *Social Services Legislation Amendment (Supporting Retirement Incomes)* Bill, which is designed to support the take up of lifetime income stream products. The new means test rules are targeted to commence on 1 July 2019 and will encourage the development of innovative products that can help retirees manage the risk of outliving their income, whilst ensuring a fair and consistent means test treatment for all retirement income products[1].

Maintaining thought leadership position

As a key thought leader in retirement incomes in Australia, Challenger works with industry and consumer organisations and the Government to develop policy outcomes that will benefit older Australians.

In 1H19, Challenger partnered with National Seniors Australia to understand attitudes to the financial aspects of retirement. Challenger has also supported the Council of the Ageing (COTA) to explore consumer-related retirement income issues. Challenger's research function is working with industry funds to help them understand the advantages of pooling longevity risk in retirement.

Throughout the half year, Challenger participated in numerous retirement income policy setting consultations, supporting the retirement income regulatory reform process.

[1] The new age pension means test is subject to legislation being passed by parliament.

3 Challenger's 1H19 strategic progress (continued)

1H19 strategic progress (continued)

Be recognised as the leader and partner of choice in retirement income solutions with a broad product offering	Challenger's strategy includes being the partner of choice for superannuation funds, wealth managers and investment platforms for providing retirement income solutions. Challenger is the market leader in retirement incomes with 77%[1] annuity market share. **1H19 progress includes:** **Leading adviser and consumer ratings** Amongst Australian financial advisers, Challenger continues to be the most recognised retirement income brand. Challenger continues to be recognised by financial advisers as a leader in retirement income, with 95%[2] of financial advisers either agreeing or strongly agreeing with this statement. Challenger's leadership position in retirement increased by 2 percentage points over the year and is 36 percentage points above its nearest competitor. **Increased product access via investment and administration platforms** Challenger's strategic priorities include making its annuity products available on leading investment and administration platforms, allowing financial advisers and their customers easy and efficient access to Challenger annuities. By making Challenger annuities available via investment and administration platforms, advisers and superannuation funds can easily design products that combine lifetime income streams with other products, such as account-based pensions. In August 2018, Challenger's full range of annuity products were made available via BT's Panorama platform, making it simple and easy for their advisers to include secure and stable income streams in their client portfolios. During 1H19, Challenger announced new annuity relationships with Netwealth and Hub24, both fast-growing specialist platform operators, providing access to Challenger's full range of fixed-term and lifetime annuities. Advisers using the Netwealth or Hub24 platforms will also have access to Challenger's retirement tools and resources and retirement income calculators. These annuity relationships will further expand Challenger's distribution reach. Challenger expects to launch on both Netwealth and Hub24 during 2H19. Following the launch on Netwealth and Hub24, over 70% of Australian financial advisers will be able to access Challenger annuities via their primary platform.
Provide customers with relevant investment strategies exhibiting consistently superior performance	Challenger is focused on providing relevant investment strategies that exhibit superior investment performance in order to help build retirement savings. **1H19 progress includes:** **Maintaining superior investment performance** Funds Management has a long track record of achieving superior investment performance, which is helping attract superior net flows. Over five years 92% of Funds Management funds have outperformed their benchmark[3]. For Fidante Partners, over the past ten years, 86% of funds have achieved either first or second quartile investment performance[4], with most funds performing well above average. Over one year, 70% of funds achieved first or second quartile investment performance.

[1] Strategic Insights – based on annuities in force at 30 September 2018.
[2] Marketing Pulse Adviser Study December 2018.
[3] Percentage of Funds Management Australian boutiques and CIP funds meeting or exceeding performance benchmark over five years.
[4] Mercer as at December 2018.

5 Challenger's 1H19 strategic progress (continued)

1H19 strategic progress (continued)

Provide customers with relevant investment strategies exhibiting consistently superior performance (continued)

Adding new investment strategies
Funds Management continues to expand its product offering by adding new boutiques and new investment strategies for existing managers.

In early January 2019, Fidante Partners launched a new London based boutique offering, FME Asset Management. The boutique focuses on intraday absolute return trading in liquid futures and has a low correlation with traditional benchmarks and the broader hedge fund industry.

During 1H19 Funds Management expanded its product offering:

- Ardea Investment Management commenced development of the High Alpha Real Outcome Fund, which is a higher returning version of the flagship Ardea Real Outcome Fund;
- Kapstream launched the Kapstream Absolute Return Income Plus strategy, which targets an absolute return of 3-4% above the cash rate; and
- Whithelm Capital commenced development of the Whitehelm Listed Core Infrastructure Fund, a UCITs[1] compliant fund replicating its existing strategy.

Award winning investment strategies
The quality of Fidante Partners' investment managers continues to be externally recognised. During 1H19, the following funds won investment manager awards:

- Ardea Investment Management – Kanganews Australian Rates Fund Manager of the Year (2018);
- Bentham Asset Management – Money Magazine Best of the Best Award for Best Income Fund (2019);
- Greencape Capital – Money Magazine Best of the Best Award for best Australian Share Fund (2019);
- Kapstream – Kanganews Australian Credit Fund Manager of the Year (2018); and
- Lennox Capital Partners – SuperRatings & Lonsec Rising Star Award (2018).

Highly rated investment products
Fidante Partners' investment managers and funds are highly rated by external asset consultants. For Fidante Partners' funds rated by asset consultants:

- 34% of ratings are the top rating (e.g. 'Highly Recommended') compared to an average of approximately 10% across the Australian funds management industry; and
- 98% of ratings are a 'buy' rating compared to an average of approximately 70% across the Australian funds management industry.

Expanding capability into Exchange Traded Fund (ETF) market
There is strong demand from investors for simple and easy to access liquid investment products. ETFs have experienced very strong growth in a number of markets as they provide the ability to deliver diversified investment strategies in a liquid and simple to execute format. ETFs have traditionally focused on passive or factor-based investments; however, Funds Management identified an opportunity to expand ETF usage to active manager products.

In December 2018, Funds Management launched one of Australia's first active fixed income ETFs, the ActiveX Ardea Real Outcome Bond Fund (ASX: XARO). The fund was listed on the Australian Securities Exchange in December 2018 and is managed by Ardea Investment Management.

Expanding into Japanese funds management market
Funds Management is expanding its presence in Japan. Following the opening of a Tokyo office to support the MS&AD strategic relationship, in 2H18 the business was granted a license to manage real estate assets in Japan. During 1H19, an application was lodged with the Japanese regulator for an investment advisory licence which, once granted, will facilitate distribution of other investment asset classes in the Japanese market, including Fidante Partners products and CIP's capabilities.

[1] Undertakings for the Collective Investment in Transferable Securities (UCITs) is a regulatory framework of the European Union that creates a harmonised regime throughout Europe for the management and sale of mutual funds.

5 Challenger's 1H19 strategic progress (continued)

1H19 strategic progress (continued)

Deliver superior outcomes to customers and shareholders through a highly engaged, diverse and agile workforce committed to sustainable business practices and a strong risk and compliance culture

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

1H19 progress includes:

Diversity and gender pay equality
Challenger seeks to create an inclusive workforce and values the capability and experience that diversity brings to the organisation. 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.

Challenger set diversity targets in December 2015, which included a target of 38% of management roles being held by women in 2020. In 1H19, the 2020 target for women in management roles was increased from 38% to 40%.

Challenger is committed to pay equality. The Leadership Team and the Board review gender pay equality annually as part of our remuneration process. This focus has ensured that for the past five years, the gender pay gap has been closed and gender pay equality for similar roles has been maintained.

Flexible work
Challenger has a focus on providing its employees with flexibility. Over the past year, almost 100 employees moved to a formal flexible working arrangement, representing approximately 15% of Challenger's people. In addition, a large number of men and women took advantage of informal flexible work arrangements throughout the year.

Maintain superior cost to income ratio
Challenger's business is highly scalable and efficient. Challenger's normalised cost to income ratio target is a range of 30% to 34%. The cost to income ratio was 32.7% in 1H19 and has fallen by 11 percentage points over the past ten years.

Challenger maintains one of the leading cost to income ratios in the Australian wealth management industry.

Enhancing sustainability capability
As one of the largest investment managers in Australia, Challenger recognises its responsibilities in relation to sustainability. Challenger has established a clear sustainability strategy and has significantly enhanced its sustainability reporting, including independent assurance of emission reporting.

Challenger is a constituent of the FTSE4Good Index and is focused on ensuring all key stakeholders understand Challenger's approach to sustainability. Challenger also believes there are links between long-term sustainable returns and the quality of an organisation's Environment, Social and Governance (ESG) practices.

Challenger is a signatory to the Principles for Responsible Investment (PRI) and has adopted an integrated investment management approach to deliver responsible investment outcomes.

To help employees and other stakeholders understand Challenger's approach to sustainability, a video was created in 1H19 which is available on Challenger's public website.

In order to support Fidante Partners' and CIP's ESG approach, a dedicated ESG specialist was appointed in 2018 to accelerate Challenger's investment manager ESG credentials and reporting to meet increasing client interest in how their monies are invested and the impact of their investment.

During 1H19, a number of Fidante Partner boutique managers joined the Climate Action 100+ initiative, focused on coordinating investor engagement with the world's largest carbon emitters. Fidante Partners also hosted a number of education sessions on ESG for its investment managers and is in the process of integrating ESG reporting across its investment funds and mandates.

6 Market overview and outlook

Challenger is an investment management company with a vision to provide its customers with financial security for retirement.

Challenger has two businesses, Life and Funds Management, both providing products for Australia's growing superannuation system, and is expanding into international markets.

Australia's modern superannuation system commenced in 1992 and is now the fourth largest[1] pension system globally, with pension assets having increased by 12% per annum over the past 20 years[2].

Growth in Australia's superannuation system is underpinned by mandatory contributions, which are scheduled to increase from 9.5% of gross salaries currently to 12.0% by 2025. The superannuation system is forecast to grow from $2.8 trillion today to over $10 trillion by 2035[3]. Growth in the superannuation system is also supported by changing demographics and the Government enhancing the retirement phase of superannuation.

Both Life and Funds Management are expected to benefit from growth in Australia's superannuation system.

Life outlook

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 annuities[4], providing reliable guaranteed[5] incomes to approximately 75,000 Australian retirees.

The retirement spending phase of superannuation is expected to grow strongly over the next 20 years, driven by demographic changes and maturing of the superannuation system.

The number of Australians over the age of 65, which is Life's target market, is expected to increase by ~60% over the next 20 years[6].

Reflecting the demographic changes underway, and growth in Australia's superannuation system, the annual transfer from the retirement savings phase of superannuation to the retirement spending phase was estimated to be ~$60bn[7] in 2018. Industry annuities sales currently represent less than 5% of the annual transfer to the retirement phase. Lifetime annuity sales represent less than 2% of the annual transfer.

There is growing recognition that retirees need to take a different approach to investing in retirement. As retirees 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.

The superannuation system is helping Australians build savings for their retirement. Australians now have meaningful superannuation balances when they retire, with the median balance being over $300,000[8], despite the system only being in place for half the working life of today's retirees.

There are a range of Government retirement income regulatory reforms currently proposed, 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 age pension. These reforms provide a significant opportunity to increase the proportion of retirement savings invested in longevity products, including annuities.

Life is diversifying its range of products and expanding its distribution relationships in Australia and Japan.

In Australia, Life is broadening access by making annuities available via leading investment and administration platforms. Following the launch of Challenger annuities on the BT platform during 1H19, Challenger formed new annuity distribution relationships with speciality platform providers Netwealth and Hub24. Challenger annuities are expected to be available on both the Netwealth and Hub24 platforms during 2H19. Once available, over 70% of Australian financial advisers will have access to Challenger annuities via their primary investment and administration platform.

Challenger has been recognised as a product innovator and has won the Association of Financial Advisers Annuity Provider of the Year for the last ten consecutive years. Challenger is also recognised by 95%[9] of advisers as the Australian leader in retirement incomes.

The Life business is resilient and well positioned to capture the long-term growth opportunity. Over the short term, the operating environment is challenging due to volatile investment markets and industry disruption impacting wealth managers and the Australian financial advice market.

Volatility in global investment markets increased in 1H19, resulting in investment experience losses on Life's investment portfolio. With the ongoing low interest rate environment and compressed asset premiums, relative value is shifting across different asset classes. Life is responding by making changes to its investment portfolio, reducing the capital intensity across its portfolio and remaining strongly capitalised with a PCA ratio (refer to section 7.2) toward the top end of its target range. The increased investment market volatility increases the appeal of guaranteed incomes for retirees and Life's product offering is well positioned for these market conditions.

Life relies on financial advisers, both independent and part of major hubs, to distribute its products. Following the hearings on financial advice at the Royal Commission into Misconduct in the Banking and Financial Services Industry (Royal

[1] Willis Towers Watson Global Pension Study 2018.
[2] Australian Prudential Regulation Authority (APRA) Quarterly Superannuation Performance – September 2018.
[3] Rice Warner 2017 superannuation projections.
[4] Strategic Insights – based on annuities in force at 30 September 2018.
[5] The word 'guaranteed' means payments are guaranteed by Challenger Life Company Limited from the assets of its relevant statutory fund.
[6] Australian Bureau of Statistics population projections.
[7] Australian Taxation Office.
[8] APRA June 2018.
[9] Market Pulse Adviser Study December 2018.

6 Market overview and outlook (continued)

Life outlook (continued)

Commission), there has been reduced customer confidence in retail financial advice and significant disruption across the adviser market. This includes increased adviser churn and reduced acquisition of new clients by financial advisers. While there is a relatively less direct impact from the Royal Commission final report on Challenger, and Life's customers are not questioning the quality of it's products or services, the disrupted industry environment is impacting Life's sales.

Life has a strong reputation with adviser trust in the quality of its products and services and is broadening its distribution reach by making its annuities available on platforms targeting the independent financial advisers market.

The Australian government has been implementing a range of retirement income reforms to help develop the retirement phase of superannuation. While there has been bipartisan support for retirement income reforms over many years, the implementation of these reforms is being impacted by short-term political uncertainty and the federal election cycle. There is broad industry support for increasing focus on the retirement phase and Challenger continues to support constructive public policy settings for retirees.

In Japan, Life commenced an annuity relationship with Mitsui Sumitomo Primary Life Insurance Company Limited (MS Primary), a subsidiary of MS&AD Insurance Group Holdings Inc. (MS&AD), in November 2016. MS Primary is a leading provider of Australian dollar-denominated annuity products in Japan. The relationship with MS Primary provides Challenger with access to Japan's foreign currency annuity market.

Japan has one of the world's most rapidly ageing populations and has a very low domestic interest rate environment, which is making higher returning foreign currency annuities popular.

MS Primary is a key Challenger annuity partner and in recognition of the importance of the relationship, in August 2017 Challenger formed a strategic relationship with its parent MS&AD. The strategic relationship provides access to the Japanese market and broadens Challenger's existing international footprint, whilst providing opportunities for both MS&AD and Challenger. Through an equity placement and subsequent on-market purchases, MS&AD held an 11% equity interest in Challenger at 31 December 2018.

As Australia's leading provider of annuities, Life is expected to continue to benefit from long-term growth in Australia's superannuation system and regulatory reforms designed to enhance the retirement phase. Life is also expected to benefit from diversifying its products and distribution through the MS Primary annuity relationship.

Funds Management outlook

Funds Management focuses on the retirement savings phase of superannuation by providing products seeking to deliver superior investment returns. Funds Management is one of Australia's largest[1] active funds managers.

Challenger's Funds Management business is growing faster than the broader funds management market.

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.

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

This strong investor alignment is driving superior long-term investment performance, with 92%[2] of Funds Management funds outperforming their benchmark over the past five years. This long-term performance track record is underpinning net flows.

Following the success of Challenger's Fidante Partners business model in Australia, it is being replicated in Europe, providing access to the United Kingdom funds management market, and providing global distribution opportunities for existing investment managers. As part of its expansion, Fidante Partners Europe is attracting new international boutique managers, with two United States-based boutiques joining Fidante Partners Europe in 2018 and a London-based boutique joining Fidante Europe in January 2019. Funds Management is also expanding its capability into the exchange traded funds market, with the ActiveX series launched in December.

Funds Management also includes Challenger Investment Partners (CIP), an institutional manager that originates and manages fixed income and property assets for leading global and Australian institutions, including Challenger Life. CIP clients benefit from the broad product offering and market insights CIP gains through its experienced team and scale of its investment business.

Funds Management is also expanding its presence in Japan, with Challenger opening a Tokyo office in order to support the MS&AD strategic relationship and to develop distribution opportunities in the region. A Japanese real estate funds management licence has been granted and an application has been lodged for an investment advisory licence, which will facilitate distribution of investment products in Japan.

Funds Management is expected to continue to benefit from the overall growth in Australia's superannuation system and Challenger's expansion into international markets.

Risks

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

- regulatory and political changes impacting financial services participants;
- demand for and competition with Challenger products, including annuities and managed funds;
- investment market volatility; and
- general uncertainty around the global economy and its impact on markets in which Challenger operates and invests.

[1] Consolidated FUM for Australian Fund Managers – Rainmaker Roundup September 2018.

[2] Percentage of Funds Management Australian Boutiques and CIP funds meeting or exceeding performance benchmark over five years.

7 Key Performance Indicators (KPIs)

7.1 Profitability and growth

KPIs for the period ended 31 December 2018 (with the 6 months to 31 December 2017 being the prior comparative period (PCP), unless otherwise stated) include:

	31 Dec 2018	31 Dec 2017	Change %
Profitability			
Statutory profit attributable to equity holders ($m)	6.1	195.4	(96.9)
Normalised NPAT ($m)	199.8	207.9	(3.9)
Statutory EPS (cents)	1.0	33.1	(97.0)
Normalised EPS (cents)	33.1	35.2	(6.0)
Interim dividend (cents)	17.5	17.5	-
Interim dividend franking	100%	100%	-
Normalised cost: income ratio	32.7%	32.1%	0.6
Statutory RoE after tax	0.3%	11.9%	(11.6)
Normalised RoE pre-tax	15.6%	16.8%	(1.2)
Normalised RoE after tax	11.5%	12.7%	(1.2)
Growth			
Total Life annuity sales ($m)	2,140.5	2,289.5	(6.5)
Life annuity net book growth ($m)	493.5	758.2	(34.9)
Life annuity net book growth (%)	4.2%	7.3%	(3.1)
Total FM net flows ($bn)	(1.0)	3.9	(125.6)
Total AUM ($bn)	78.4	76.5	2.5

Challenger's statutory profit attributable to equity holders of $6.1 million was 96.9% lower than the prior comparative period primarily as a result of lower investment experience. This is explained further in Section 8 below.

Normalised net profit after tax decreased by 3.9% compared to the prior period, reflecting lower Life cash operating earnings and Funds Management performance fees partially offset by disciplined cost management.

An interim dividend of 17.5 cents was announced, franked at 100%, consistent with PCP.

Challenger's normalised cost to income ratio of 32.7% remains within the targeted range and is slightly higher than the ratio in prior period (32.1%) primarily as a result of lower income earned in the period.

This reflects continued cost discipline throughout the business and the benefits of scale. Challenger's medium-term expected normalised cost to income ratio target is 30–34%.

Statutory return on equity (RoE) after tax of 0.3% has decreased compared to the prior period (31 December 2017: 11.9%) as a result of lower normalised earnings together with the impact of fair value changes on both assets and liabilities. Normalised ROE after tax decreased from 12.7% in the prior period to 11.5% primarily reflecting the lower normalised net profit after tax.

7.2 Capital management

Challenger's capital position is managed at both the Group and the prudentially-regulated Challenger Life Company Limited (CLC) level, with the objective of maintaining the financial stability of the Group and CLC whilst ensuring that shareholders earn an appropriate risk adjusted return. Refer to Note 9 Contributed equity for further information on the Group's Internal Capital Adequacy Assessment Process.

The following table highlights the key capital metrics for CLC and the Group:

Capital	31 Dec 2018	31 Dec 2017	Change
Net assets attributable to equity holders ($m)	3,387.9	3,469.5	(81.6)
CLC excess capital over PCA ($m)	1,303.6	1,265.8	37.8
Group cash ($m)	87.7	121.9	(34.2)
CLC excess capital over PCA + Group cash ($m)	1,391.3	1,387.7	3.6
CLC PCA ratio (times)	1.54	1.49	0.05
CLC Tier 1 ratio (times)	1.37	1.33	0.04

CLC regulatory capital base

CLC holds capital in order to ensure that, under a range of adverse scenarios, it can continue to meet its regulatory and contractual obligations to its customers. CLC is regulated by APRA and is required to hold a minimum level of regulatory capital. CLC has ongoing and open engagement with APRA.

CLC maintains a level of capital representing the Prescribed Capital Amount (PCA) plus a target surplus. The target surplus is a level of excess capital that CLC seeks to carry over and above APRA's minimum requirement in order to provide a buffer against adverse market conditions, having regard to CLC's credit rating.

CLC's PCA at 31 December 2018 benefited from a reduction in capital intensity due to changes to Life's investment portfolio, including increasing the fixed income credit quality and implementing an equities collar strategy. As a result, CLC's capital intensity, as measured by the PCA to investment assets decreased from 14.1% at 30 June 2018 to 13.0% at 31 December 2018.

7 Key Performance Indicators (KPIs) (continued)

7.2 Capital management (continued)

CLC uses internal capital models to determine its target surplus, which are risk-based and are responsive to changes in CLC's asset allocation and market conditions. While CLC does not target a specific PCA ratio, CLC's internal capital models result in a PCA ratio under current circumstances in the range of 1.3 to 1.6 times. This range may change over time and is dependent on a number of factors.

In addition to CLC's excess regulatory capital, Challenger maintains cash at a Group level which can be used to meet regulatory capital requirements. Challenger further maintains a Group corporate debt facility of $400.0 million in order to provide additional financial flexibility. The facility remained undrawn at the end of the period.

APRA's Level 3 (conglomerate) proposals

The Group is a Level 3 Head (as defined in Prudential Standard 3PS 001) under the APRA conglomerates framework. Level 3 groups are groups of companies that perform material activities across more than one APRA-regulated industry and/or in one or more non-APRA regulated industries.

APRA's non capital conglomerate prudential standards relating to measurement, management, monitoring, reporting aggregate risk exposures and intragroup transactions and exposures came into effect from 1 July 2017. In March 2016, APRA announced that it would defer the implementation of conglomerate capital requirements until a number of other domestic and international policy initiatives were further progressed. To date, there has been no additional update from APRA on the likely timing of any potential implementation of the conglomerate capital requirements.

Dividends and dividend reinvestment plan

Dividends	31 Dec 2018	31 Dec 2017	Change	Change %
Interim dividend (cents)	17.5	17.5	-	-
Interim dividend franking	100%	100%	-	-
Normalised dividend payout ratio	52.9%	49.7%	3.2	6.4

The Board targets a dividend payout ratio of 45% to 50% of normalised profit after tax. The normalised dividend payout ratio for the period ended 31 December 2018 was slightly above this range at 52.9%.

The Company also seeks to frank its dividend to the maximum extent possible and expects future dividends over the medium term to be fully franked. However, the actual dividend payout ratio and franking will depend on prevailing market conditions and capital allocation priorities at the time.

The Company continued to operate its dividend reinvestment plan (DRP) during the period. The DRP participation rate for the 2018 final dividend was 3.1% of all issued shares, and 329,710 ordinary shares were issued to satisfy the 2018 DRP requirements on 26 September 2018.

The DRP will continue in operation for the 2019 interim dividend and the Board has determined that new shares will be issued to fulfil DRP requirements in respect of the interim dividend. However, the new shares will not be issued at a discount to the prevailing Challenger share price.

No shares were bought back during the period.

7.3 Credit ratings

Challenger Limited and CLC are rated by Standard & Poor's (S&P). In December 2018, S&P reaffirmed both Challenger Limited and CLC's credit ratings.

Ratings were confirmed as:

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

The S&P ratings reflect the financial strength of Challenger Limited and CLC. In particular, the report noted that CLC has an extremely strong capital and earnings position with significant financial flexibility.

8 Normalised profit and investment experience

Normalised framework (Non IFRS)

CLC and its consolidated entities are required by AASB 1038 *Life Insurance Contracts* to value all assets and liabilities at fair value where permitted by other accounting standards.

This gives rise to fluctuating valuation movements on assets and liabilities being recognised in the profit and loss in CLC and on consolidation in Challenger Limited. CLC is generally a long-term holder of assets, due to holding assets 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. Investment experience represents the difference between actual investment gains/losses (both realised and unrealised) and expected gains/losses based on CLC's medium to long-term expected returns together with the new business strain[1] that results from writing new annuities. Investment experience also includes any impact from changes in economic and other actuarial assumptions.

[1] New business strain is a non-cash valuation adjustment which reflects annuity rates on new business being higher than the risk-free rate used to fair value annuities together with certain maintenance expenses. The new business strain reverses over the annuity contract.

8 Normalised profit and investment experience (continued)

A reconciliation between statutory revenue and the management view of revenue and net income is included in the financial report as part of Note 3 Segment information. This note also includes a reconciliation of statutory profit after tax and normalised net profit after tax (the management view of post-tax profit). The application of the normalised profit framework has been reviewed by Challenger's independent auditor to ensure that the reported results are consistently applied in accordance with the methodology described in Note 3 Segment information in the financial report.

Management analysis – normalised results

	31 Dec 2018 $m	31 Dec 2017 $m	Change $m	Change %
Net income[1]	405.3	408.6	(3.3)	(0.8)
Comprising:				
– Life normalised COE	329.6	336.1	(6.5)	(1.9)
– FM net income	75.2	72.0	3.2	4.4
– Corporate and other income	0.5	0.5	-	-
Operating expenses[1]	(132.4)	(131.1)	(1.3)	1.0
Normalised EBIT	**272.9**	**277.5**	**(4.6)**	**(1.7)**
Comprising:				
– Life normalised EBIT	277.9	283.0	(5.1)	(1.8)
– FM normalised EBIT	26.1	27.1	(1.0)	(3.7)
– Corporate and other normalised EBIT	(31.1)	(32.6)	1.5	(4.6)
Interest and borrowing costs	(2.9)	(2.9)	-	-
Tax on normalised profit	(70.2)	(66.7)	(3.5)	5.2
Normalised NPAT	**199.8**	**207.9**	**(8.1)**	**(3.9)**
Investment experience after tax	(193.7)	(12.5)	(181.2)	(Large)
Statutory net profit after tax attributable to equity holders	**6.1**	**195.4**	**(189.3)**	**(96.9)**

[1] 'Net income' and 'Operating expenses' are internal classifications and are defined in Note 3 Segment information in the financial report. These differ from the statutory revenue and expenses classifications, as certain costs (including distribution expenses, property expenses, management fees, special purpose vehicle expenses and finance costs) are netted off against gross revenues. These classifications have been made in the Directors' report and in Note 3 Segment information to reflect how management measures business performance. Whilst the allocation of amounts to the above items and investment experience differ to the statutory view, both approaches result in the same total net profit after tax attributable to equity holders.

Life normalised cash operating earnings (COE) and earnings before interest and tax (EBIT) decreased as a result of higher Life investment assets, offset with a decreased margin being earned on those assets and lower equity distributions. Life's average assets under management (AUM) increased by 11.1% as a result of the net book growth in annuities, net flows on external unit holders' liabilities and valuation movements on those assets.

Funds Management net income increased (up $3.2 million) due to increased management and transaction fee revenue together with increased equity accounted profits offset by lower performance fee and distribution fee revenue. Funds Management average FUM increased by 9.0% as a result of mark-to-market gains on investments and net inflows over the past year.

Operating expenses increased by $1.3 million (1.0%) for the period ended 31 December 2018. Challenger's employee numbers decreased by 7 (or 1.0%) to 675 (on a full time equivalent basis) when compared to the prior period.

Normalised tax for the period was $70.2 million, reflecting a normalised effective tax rate for the period of 26.0% (24.3% at 31 December 2017).

Management analysis – investment experience

	31 Dec 2018 $m	31 Dec 2017 $m
Actual capital growth[1]		
– Cash and fixed income	(67.4)	52.1
– Infrastructure	4.1	(26.0)
– Property (net of debt)	38.9	67.0
– Equity and other investments	(110.2)	(8.8)
Total actual capital growth	**(134.6)**	**84.3**
Normalised capital growth[2]		
– Cash and fixed income	(20.8)	(19.4)
– Infrastructure	14.8	11.1
– Property (net of debt)	36.8	33.7
– Equity and other investments	47.3	34.3
Total normalised capital growth	**78.1**	**59.7**
Investment experience		
– Cash and fixed income	(46.6)	71.5
– Infrastructure	(10.7)	(37.1)
– Property (net of debt)	2.1	33.3
– Equity and other investments	(157.5)	(43.1)
– Policy liability experience[3]	(21.6)	(9.1)
Asset and policy liability experience	(234.3)	15.5
New business strain[4]	(35.9)	(37.4)
Investment experience before tax	(270.2)	(21.9)
Tax benefit/(expense)	76.5	9.4
Investment experience after tax	**(193.7)**	**(12.5)**

[1] Actual capital growth represents net realised and unrealised capital gains or losses and includes the attribution of interest rate, inflation and foreign exchange derivatives that are used to hedge exposures.
[2] Normalised capital growth is determined by multiplying the normalised capital growth rate for each asset class by the average investment assets for the period. The normalised capital growth rates represent Challenger's expectations for each asset class over the investment cycle. The annual normalised growth rate is +4.5% for equity and other investments, +4.0% for infrastructure, +2.0% for property and -0.35% for cash and fixed income in order to allow for credit defaults. The rates have been set with reference to medium to long-term market growth rates and are reviewed to ensure consistency with prevailing market experience.
[3] Policy liability experience represents the impact of changes in macroeconomic variables, including bond yields and inflation factors, expense assumptions and other factors applied in the valuation of life contract liabilities.
[4] New business strain is a non-cash valuation adjustment which reflects annuity rates on new business being higher than the risk-free rate used to fair value annuities together with certain maintenance expenses. The new business strain reverses over the annuity contract.

8 Normalised profit and investment experience (continued)

Investment experience after tax relates to changes in the fair value of Life's assets and liabilities. Investment experience is a mechanism employed to remove the volatility arising from asset and liability valuation movements and new business strain from Life business earnings so as to more accurately reflect the underlying performance of the Life business.

Pre-tax investment experience for the period comprised an asset and policyholder liability experience loss of $234.3 million and a loss of $35.9 million from Life's new business strain. Life's asset portfolio experienced fair value losses across the cash and fixed income and equity and other portfolios. These losses are largely unrealised and were primarily due to the deterioration of global fixed income and equity markets during the period.

9 Life segment results

The Life segment includes CLC, Australia's leading provider of annuities and guaranteed retirement income products and Accurium Pty Limited. CLC has won the Association of Financial Advisers/Plan for Life annuity provider of the year for the past ten consecutive years.

CLC is regulated by APRA, and its financial strength is rated by S&P, with an 'A' credit rating and positive outlook. CLC is strongly capitalised, with significant excess capital above APRA's minimum regulatory requirements.

Life normalised results	31 Dec 2018 $m	31 Dec 2017 $m	Change $m	Change %
Normalised COE	329.6	336.1	(6.5)	(1.9)
– Cash earnings	251.5	276.4	(24.9)	(9.0)
– Normalised capital growth	78.1	59.7	18.4	30.8
Operating expenses	(51.7)	(53.1)	1.4	(2.6)
Normalised EBIT	**277.9**	**283.0**	**(5.1)**	**(1.8)**

Life normalised EBIT decreased by $5.1 million (down 1.8%) due to lower normalised COE (down $6.5 million or 1.9%), which was partially offset with operating expenses decreasing by $1.4 million (or 2.6%). The lower normalised COE was as a result of higher investment assets, with Life average investment assets increasing by 11.1% offset by a lower COE margin and lower equity distributions.

Life generated a normalised return on equity (pre-tax) of 17.5%, down by 1.5 percentage points from the prior period as a result of a lower normalised EBIT combined with increased average net assets.

Total Life sales declined from the prior period (down 22.7%), with reduced fixed term sales (down 9.0%) and other Life sales (down 58.4%) offset by increased Lifetime sales (up 4.6%).

Fixed term sales reduced due to lower MS Primary (Japan) sales, which reduced by 56.0% on the prior period due to higher US interest rates affecting demand for Australian dollar products.

In May 2018, the Government finalised the means test review for lifetime income streams, with new rules expected to apply from 1 July 2019 (subject to the passage of legislation by Parliament). The new means test rules support the development of innovative products that can help retirees manage the risk of outliving their savings, while ensuring a fair and consistent means test treatment of all retirement income products.

The Government has also announced a new Retirement Income Framework to increase focus on the retirement phase of superannuation and increase flexibility and choice for retirees to help boost living standards. The first stage of the proposed framework is the introduction of a Retirement Income Covenant requiring trustees to develop a strategy that would help members achieve their retirement income objectives.

In November 2016, Life began issuing Australian dollar fixed rate annuities with a 20-year term to support its reinsurance agreement with MS Primary. Under the terms of the product, the customer can choose an annuity payment period of 5, 10 or 20 years, with a benefit payable upon death. In 1H19, Challenger also commenced reinsuring an Australian dollar lifetime annuity.

Life sales	31 Dec 2018 $m	31 Dec 2017 $m	Change $m	Change %
Fixed-term annuities	1,698.9	1,867.2	(168.3)	(9.0)
Lifetime annuities	441.6	422.3	19.3	4.6
Total Life annuity sales	2,140.5	2,289.5	(149.0)	(6.5)
Other Life sales	430.5	1,034.5	(604.0)	(58.4)
Total Life sales	**2,571.0**	**3,324.0**	**(753.0)**	**(22.7)**
Annuity net flows	493.5	758.2	(264.7)	(34.9)
Other Life net flows	90.2	189.7	(99.5)	(52.5)

Annuity net flows (new annuity sales less capital repayments) decreased by 34.9% to $493.5 million driven by lower annuity sales and higher maturities. Based on the opening Life annuity book for the 2019 financial year ($11,728.3 million), annuity net book growth for the period was 4.2%, which was down from 7.3% in the prior period.

Other Life sales represents Guaranteed Index Return (GIR) mandates and the Challenger Index Plus Fund. Other Life sales decreased due to the timing of GIR mandate rollovers and sales in the Challenger Index Plus Fund.

Other Life net flows for the period were $90.2 million decreasing compared to $189.7 million in the prior period. Total Life net flows were $583.7 million representing total Life net book growth of 4.2% (31 December 2017: $947.9 million or 7.9% book growth).

10 Funds Management segment results

Challenger's Funds Management segment is one of Australia's largest growing investment managers.

Fidante Partners' multi-boutique platform comprises a number of separately branded funds management businesses. The model seeks to align the interests of investors, boutique investment managers and Fidante Partners.

The Funds Management model is delivering superior investment performance, with 90% of strategies exceeding benchmark over the last five years.

Challenger Investment Partners (CIP) develops and manages assets under Challenger's brand for CLC and third party institutional investors.

FM normalised results	31 Dec 2018 $m	31 Dec 2017 $m	Change $m	Change %
Net income	75.2	72.0	3.2	4.4
– Fidante Partners	46.3	42.9	3.4	7.9
– CIP	28.9	29.1	(0.2)	(0.7)
Operating expenses	(49.1)	(44.9)	(4.2)	9.4
Normalised EBIT	**26.1**	**27.1**	**(1.0)**	**(3.7)**

Funds Management normalised EBIT decreased by 3.7% for the period, with increased net income offset by expense growth during the period.

Fidante Partners' net income includes distribution fees, transaction fees, administration fees and a share in the equity accounted profits for the boutique fund managers (inclusive of performance fees) in which it has an equity interest.

Fidante Partners' net income increased for the period primarily as a result of transaction fees (up $5.1 million) and FUM based income (up $2.2 million), which was partially offset by lower performance fees than in the prior period (down $3.9 million).

CIP's net income decreased slightly due to lower transaction fees (down $2.0 million) being offset by higher net management fees (up $1.8 million).

Funds Management's normalised RoE (pre-tax) for the period was 24.4%, down by 3.2 percentage points from the prior period.

FM FUM and flows	31 Dec 2018 $bn	31 Dec 2017 $bn	Change $bn	Change %
Total FUM	75.0	73.4	1.6	2.2
– Fidante Partners	56.3	56.0	0.3	0.5
– CIP	18.7	17.4	1.3	7.4
Net flows	(1.0)	3.9	(4.9)	(125.6)
– Fidante Partners	(1.0)	2.5	(3.5)	(140.0)
– CIP	0.1	1.4	(1.3)	(92.9)

Fidante Partners' FUM increase ($0.3 billion) was driven by net inflows ($0.3 billion) and positive impact from investment markets ($0.7 billion) offset by distributions ($0.7 billion).

CIP FUM growth (up $1.3 billion) is primarily a result of additional fixed income flows (up $0.2 billion) and property flows (down $0.1 billion), from both CLC and third party investors and positive impact from investment markets ($1.2 billion).

11 Corporate and other segment results

The Corporate and other segment comprises central functions such as the Group executive, finance, treasury, legal, human resources, risk management and strategy.

The financial results also include interest received on Group cash balances and any interest and borrowing costs associated with Group debt facilities.

Corporate and other normalised results	31 Dec 2018 $m	31 Dec 2017 $m	Change $m	Change %
Net income	0.5	0.5	-	-
Operating expenses	(31.6)	(33.1)	1.5	(4.5)
Normalised EBIT	**(31.1)**	**(32.6)**	**1.5**	**(4.6)**
Interest and borrowing costs	(2.9)	(2.9)	-	-
Normalised loss before tax	**(34.0)**	**(35.5)**	**1.5**	**(4.2)**

Normalised EBIT for the Corporate and other segment was higher (up $1.5 million) as a result of lower operating expenses.

12 2019 financial year outlook

Challenger continues to be well positioned with strong product offerings, expanding distribution networks and highly efficient operations.

For 2019, Challenger has revised its expected earnings range from 8% to 12% growth on 2018 ($591.0 million to $613.0 million) and now expects normalised net profit before tax of between $545 million and $565 million. The lower expectation reflects the first half normalised net profit before tax and flow on into 2H19 (including lower equity distributions and lower annuity book growth) and changes to Life's investment portfolio to reduce capital intensity.

The normalised cost to income ratio is also forecast to remain in the range of 30–34% over the medium term.

Challenger Group RoE and dividend

The normalised pre-tax RoE in 2019 is not expected to reach the 18% target due to lower earnings in 2019.

Challenger expects to achieve a fully franked dividend payout ratio of 45% to 50% of normalised profit, subject to prevailing market conditions and capital allocation priorities.

Directors' report

1 Directors

The names and details of the Directors of Challenger Limited holding office during the six months to 31 December 2018 and as at the date of this report are listed below. Directors were in office for this entire period unless otherwise stated.

Directors	
Peter Polson	Independent Chair
Richard Howes (appointed 2 January 2019)	Managing Director and Chief Executive Officer
Brian Benari (retired 1 January 2019)	Former Managing Director and Chief Executive Officer
Graham Cubbin (retired 26 October 2018)	Independent Non-Executive Director
John M Green	Independent Non-Executive Director
Steven Gregg	Independent Non-Executive Director
JoAnne Stephenson	Independent Non-Executive Director
Duncan West (appointed 10 September 2018)	Independent Non-Executive Director
Melanie Willis	Independent Non-Executive Director
Leon Zwier	Independent Non-Executive Director

The information appearing on pages 1 to 13 forms part of the Directors' report for the six months to 31 December 2018 and is to be read in conjunction with the following information.

2 Significant events after the balance date

At the date of this financial report, no matter or circumstance has arisen that has affected, or may significantly affect, the Group's operations, the results of those operations or the Group's state of affairs in future financial years which has not already been reflected in this report.

3 Rounding

The amounts contained in this report and the financial report have been rounded to the nearest $100,000 unless otherwise stated, under the option available to the Group under Australian Securities and Investments Commission (ASIC) Corporations Instrument 2016/191.

4 Authorisation

Signed in accordance with a resolution of the Directors of Challenger Limited:

P Polson
Independent Chair

Sydney
11 February 2019

R Howes
Managing Director & Chief Executive Officer

Sydney
11 February 2019

5 Auditor's independence declaration

The Directors received the following declaration from the auditor of Challenger Limited:

Building a better working world

Ernst & Young
200 George Street
Sydney NSW 2000 Australia
GPO Box 2646 Sydney NSW 2001

Tel: +61 2 9248 5555
Fax: +61 2 9248 5959
ey.com/au

Auditor's independence declaration to the Directors of Challenger Limited

As lead auditors for the review of Challenger Limited for the half-year ended 31 December 2018, we declare to the best of our knowledge and belief, there have been no contraventions of:

a) the auditor independence requirements of the Corporations Act 2001 in relation to the review; and
b) any applicable code of professional conduct in relation to the review.

This declaration is in respect of Challenger Limited and the entities it controlled during the financial period.

Ernst & Young

T Johnson
Partner

Sydney
11 February 2019

L Burns
Partner

Sydney
11 February 2019

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This financial report covers Challenger Limited (the Company) and its controlled entities (the Group or Challenger).

Statement of comprehensive income

For the six months ended 31 December	Note	2018 $m	2017 $m
Revenue	1	893.5	1,128.1
Expenses	2	(784.9)	(763.2)
Finance costs		(125.3)	(130.0)
Share of profits of associates		11.7	13.2
(Loss)/profit before income tax		**(5.0)**	**248.1**
Income tax benefit/(expense)	4	11.2	(52.0)
Profit for the period after income tax		**6.2**	**196.1**
Profit attributable to shareholders of Challenger Limited		6.1	195.4
Profit attributable to non-controlling interests		0.1	0.7
Profit for the period after income tax		**6.2**	**196.1**
Other comprehensive income			
Items that may be reclassified to profit and loss, net of tax			
Translation of foreign entities		26.8	(6.5)
Hedge of net investment in foreign entities		(24.0)	8.8
Cash flow hedges – SPV[1]		0.2	0.1
Other comprehensive income for the year		3.0	2.4
Total comprehensive income for the period after tax		**9.2**	**198.5**
Comprehensive income attributable to shareholders of Challenger Limited		9.1	197.8
Comprehensive income attributable to non-controlling interests		0.1	0.7
Total comprehensive income for the period after tax		**9.2**	**198.5**
Earnings per share attributable to ordinary shareholders of Challenger Limited		**Cents**	**Cents**
Basic	12	1.0	33.1
Diluted	12	1.0	31.9

[1] SPV = Special Purpose Vehicles.

The statement of comprehensive income should be read in conjunction with the accompanying notes.

Statement of financial position

As at	Note	31 Dec 2018 $m	30 Jun 2018 $m	31 Dec 2017 $m
Assets				
Cash and cash equivalents		475.6	741.7	895.6
Cash and cash equivalents – SPV		74.1	97.3	98.2
Receivables		618.5	436.5	484.1
Current tax assets		50.7	-	15.9
Derivative assets		429.3	421.1	675.8
Financial assets – fair value through profit and loss	5	18,786.8	17,591.6	16,070.1
Investment property held for sale	6	279.6	452.2	55.1
Investment and development property	6	3,812.3	3,583.7	3,711.0
Mortgage assets – SPV		945.3	1,044.5	1,152.6
Finance leases		53.1	50.8	50.6
Property, plant and equipment		221.3	161.4	113.7
Investment in associates		53.4	62.4	54.2
Other assets		57.1	50.6	52.7
Goodwill		571.6	571.6	571.6
Deferred tax assets		7.9	13.8	15.6
Other intangible assets		23.3	21.3	19.7
Total assets of shareholders of Challenger Limited and non-controlling interests		**26,459.9**	**25,300.5**	**24,036.5**
Liabilities				
Payables		792.1	642.1	500.3
Current tax liability		-	0.9	-
Derivative liabilities		533.5	453.0	537.9
Interest bearing financial liabilities	10	6,267.5	5,773.1	5,278.3
Interest bearing financial liabilities – SPV		855.3	959.8	1,071.1
External unit holders' liabilities		2,172.3	2,135.0	1,909.3
Provisions		22.1	20.6	13.6
Deferred tax liabilities		90.3	101.9	126.6
Life contract liabilities	7	12,323.7	11,728.3	11,115.8
Total liabilities of shareholders of Challenger Limited and non-controlling interests		**23,056.8**	**21,814.7**	**20,552.9**
Net assets of shareholders of Challenger Limited and non-controlling interests		**3,403.1**	**3,485.8**	**3,483.6**
Equity				
Contributed equity	9	2,090.2	2,051.7	2071.0
Reserves		(66.0)	(33.3)	(47.5)
Retained earnings		1,363.7	1,467.0	1,446.0
Total equity of shareholders of Challenger Limited		**3,387.9**	**3,485.4**	**3,469.5**
Non-controlling interests		15.2	0.4	14.1
Total equity of shareholders of Challenger Limited and non-controlling interests		**3,403.1**	**3,485.8**	**3,483.6**

The statement of financial position should be read in conjunction with the accompanying notes.

Statement of changes in equity

		Attributable to shareholders of Challenger Limited								
For the period ended 31 December 2017	Note	Contributed equity $m	Share-based payment reserve $m	Cash flow hedge reserve – SPV $m	Foreign currency translation reserve $m	Adjusted controlling interest reserve $m	Retained earnings $m	Total shareholder equity $m	Non-controlling interests $m	Total equity $m
Balance at 1 July 2017		1,554.5	(23.2)	(0.2)	(5.2)	12.1	1,350.1	2,888.1	13.2	2,901.3
Profit for the year		-	-	-	-	-	195.4	195.4	0.7	196.1
Other comprehensive income for the year		-	-	0.1	2.3	-	-	2.4	-	2.4
Total comprehensive income for the year		**-**	**-**	**0.1**	**2.3**	**-**	**195.4**	**197.8**	**0.7**	**198.5**
Other equity movements										
Ordinary shares issued[1]	9	503.3	-	-	-	-	-	503.3	-	503.3
Treasury shares purchased	9	(49.4)	-	-	-	-	-	(49.4)	-	(49.4)
Treasury shares vested	9	47.6	-	-	-	-	-	47.6	-	47.6
Deferred Treasury share purchases	9	(23.9)	-	-	-	-	-	(23.9)	-	(23.9)
Settled forward purchases of Treasury shares	9	38.9	-	-	-	-	-	38.9	-	38.9
Share-based payment expense net of tax less releases		-	(33.4)	-	-	-	-	(33.4)	-	(33.4)
Dividends paid	11	-	-	-	-	-	(99.5)	(99.5)	-	(99.5)
Other movements		-	-	-	-	-	-	-	0.2	0.2
Balance at 31 December 2017		**2,071.0**	**(56.6)**	**(0.1)**	**(2.9)**	**12.1**	**1,446.0**	**3,469.5**	**14.1**	**3,483.6**
For the period ended 31 December 2018										
Balance at 1 July 2018		2,051.7	(43.0)	0.3	(3.3)	12.7	1,467.0	3,485.4	0.4	3,485.8
Profit for the year		-	-	-	-	-	6.1	6.1	0.1	6.2
Other comprehensive income for the year		-	-	0.2	2.8	-	-	3.0	-	3.0
Total comprehensive income for the year		**-**	**-**	**0.2**	**2.8**	**-**	**6.1**	**9.1**	**0.1**	**9.2**
Other equity movements										
Ordinary shares issued[1]	9	3.4	-	-	-	-	-	3.4	-	3.4
Treasury shares purchased	9	(32.8)	-	-	-	-	-	(32.8)	-	(32.8)
Treasury shares vested	9	42.6	-	-	-	-	-	42.6	-	42.6
Deferred Treasury share purchases	9	(7.5)	-	-	-	-	-	(7.5)	-	(7.5)
Settled forward purchases of Treasury shares	9	32.8	-	-	-	-	-	32.8	-	32.8
Share-based payment expense net of tax less releases		-	(29.5)	-	-	-	-	(29.5)	-	(29.5)
Dividends paid	11	-	-	-	-	-	(109.4)	(109.4)	-	(109.4)
Other movements		-	-	-	-	(6.2)	-	(6.2)	14.7	8.5
Balance at 31 December 2018		**2,090.2**	**(72.5)**	**0.5**	**(0.5)**	**6.5**	**1,363.7**	**3,387.9**	**15.2**	**3,403.1**

[1] On 23 August 2017, the Company issued 38,295,689 new ordinary shares to MS&AD. The Company also issued 272,955 ordinary shares on 27 March 2018 (28 March 2017: 329,428 shares) and 329,710 ordinary shares on 26 September 2018 (27 September 2017: 285,232 shares) to shareholders who took part in the Company's Dividend Reinvestment Plan (DRP).

The statement of changes in equity should be read in conjunction with the accompanying notes.

Statement of cash flows

For the six months ended 31 December	Note	2018 $m	2017 $m
Operating activities			
Receipts from customers		332.7	316.9
Annuity and premium receipts	7	2,150.1	2,296.8
Annuity and claim payments	7	(1,839.1)	(1,714.0)
Payments to reinsurer	7	(5.9)	(6.1)
Receipts from external unit holders		599.7	1,034.4
Payments to external unit holders		(599.7)	(865.3)
Payments to vendors and employees		(332.4)	(317.2)
Dividends received		67.3	54.3
Interest received		403.5	385.3
Interest paid		(78.1)	(66.0)
Income tax paid		(43.6)	(152.4)
Net cash inflows from operating activities	8	**654.5**	**966.7**
Investing activities			
Payments on net purchases of investments		(1,202.9)	(1,003.0)
Net mortgage loan repayments		82.3	116.4
Payments for net purchases of property, plant and equipment		(41.4)	(16.4)
Payments for purchase of associate interest		(2.8)	(2.5)
Net cash outflows from investing activities		**(1,164.8)**	**(905.5)**
Financing activities			
Proceeds from issue of ordinary shares	9	3.4	503.3
Net proceeds from borrowings – interest bearing financial liabilities	10	366.7	(73.5)
Payments for Treasury shares		(39.7)	(34.8)
Net dividends paid	11	(109.4)	(99.5)
Net cash inflows from financing activities		**221.0**	**295.5**
Net (decrease)/increase in cash and cash equivalents		**(289.3)**	**356.7**
Cash and cash equivalents at the beginning of the period		839.0	637.1
Cash and cash equivalents at the end of the period		**549.7**	**993.8**

The statement of cash flows should be read in conjunction with the accompanying notes.

Basis of preparation and overarching significant accounting policies

Challenger Limited (the Company or the parent entity) is a company limited by shares, incorporated and domiciled in Australia, whose shares are publicly traded on the Australian Securities Exchange (ASX).

The interim financial report for Challenger Limited and its controlled entities (the Group or Challenger) for the six months ended 31 December 2018 was authorised for issue in accordance with a resolution of the Directors of the Company on 11 February 2019.

(i) Basis of preparation and statement of compliance

This is a general purpose interim financial report for the six months ended 31 December 2018 that has been prepared in accordance, and complies with the requirements of the *Corporations Act 2001* and AASB 134 *Interim Financial Reporting.* Challenger Limited is a for-profit entity for the purposes of preparing financial statements.

The interim financial report does not include all the notes normally included in an annual financial report. It is recommended that this interim financial report be read in conjunction with the financial report for the year ended 30 June 2018 and any public announcements made by the Group in accordance with the continuous disclosure obligations of the ASX listing rules.

Unless otherwise stated, amounts in this financial report are presented in Australian dollars and have been prepared on a historical cost basis. The assets and liabilities disclosed in the statement of financial position are grouped by nature and listed in an order that reflects their relative liquidity.

(ii) New and revised accounting standards and interpretations

The accounting policies applied in these interim financial statements are the same as those applied in the Group's financial statements as at and for the year ended 30 June 2018. In addition, the following new accounting standards have been applied from 1 July 2018.

AASB 9 *Financial Instruments*

AASB 9 *Financial Instruments* replaces AASB 139 *Financial Instruments: Recognition and Measurement* and is effective for the Group from 1 July 2018.

The standard makes changes to the classification of financial assets for the purpose of determining their measurement basis, as well as the recognition of changes in fair values. The standard replaces the incurred loss model of AASB 139 with a new expected loss model which can result in the acceleration of impairment recognition on financial instruments.

The standard requires entities to account for expected credit losses on financial instruments at the point at which the financial instruments are first recognised and to estimate the expected loss applicable to those financial instruments over the period for which they are held. In addition, there are also significant changes to hedge accounting requirements, including changes to hedge effectiveness testing, treatment of hedging costs, risk components that can be hedged and associated disclosures.

The Group has performed an assessment and concluded that no transitional adjustments were required as a result of complying with the new requirements. This is because the majority of the Group's assets are already measured at fair value through profit and loss as required by AASB 1038 *Life Insurance* and as permitted under both AASB 139 and AASB 9. The impact to the Group from the adoption of the expected credit loss model on the *Mortgage assets – SPV* is minimal because the historical provisioning methodology of the Group is materially consistent with the provision estimated under the expected credit loss model.

AASB 15 *Revenue from Contracts with Customers*

The new revenue standard establishes a single, comprehensive framework for revenue recognition and is effective for the Group from 1 July 2018 and replaces the previous revenue standards AASB 118 *Revenue* and AASB 111 *Construction Contracts*. The standard does not apply to leases, financial instruments or insurance contracts. The core principle of AASB 15 is that an entity recognises revenue to depict the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services.

The Group has performed an assessment on existing revenue streams and concluded that no transitional adjustments were required as a result of complying with the new requirements. The majority of Funds Management fee revenue is accrued when earned and the adoption of AASB 15 does not have a significant impact on the accounting policies or the amounts recognised. Life revenue is mainly derived from income on financial instruments and life insurance contract premiums which are not within the scope of the standard.

Note 1 Revenue

	31 Dec 2018 $m	31 Dec 2017 $m
Investment revenue		
Fixed income securities and cash[1]	529.4	471.3
Investment property and property securities	207.7	272.8
Equity and infrastructure investments	(16.4)	7.4
Realised and unrealised (losses)/gains on hedges and foreign exchange translation	(178.0)	43.7
Management fee revenue	115.9	102.6
Other revenue		
Life insurance contract premiums and related revenue[2]	234.9	230.3
Total revenue	**893.5**	**1,128.1**

[1] Includes fair value and realised movements in subordinated debt and includes interest revenue of $432.7 million, $402.7 million was calculated using the effective interest rate method.
[2] Changes in life insurance and investment contract liabilities arising from new business, annuity payments, discount rates, inflation rates and other assumptions are recognised as revenue, with other movements being included in Note 2 Expenses.

Note 2 Expenses

	31 Dec 2018 $m	31 Dec 2017 $m
Life insurance contract claims and expenses[1]	525.2	447.2
Investment property related expenses[2]	57.9	86.5
Fee expense	53.3	54.2
Distribution expenses	24.5	23.5
Employee benefits expenses	93.0	92.6
Other expenses	31.0	59.2
Total expenses	**784.9**	**763.2**

[1] Cost of life contract liabilities recognised as an expense consists of the interest expense on the liability and any loss on the initial recognition of new business less the release of liability in respect of expenses incurred in the current period. The interest expense on the liability represents the unwind of the discount on the opening liability over the period, whereas the impacts of changes in the discount rate applied for the current valuation are included in the change in life contract liabilities disclosed in Note 1 Revenue.
[2] Investment property-related expenses relate to rental income generating investment properties.

Note 3 Segment information

The reporting segments[1] of the Group have been identified as follows:

	Life		Funds Management		Total reporting segments		Corporate and other[2]		Total	
For the six months ended 31 December	**2018 $m**	**2017 $m**	**2018 $m**	**2017 $m**	**2018 $m**	**2017 $m**	**2018 $m**	**2017 $m**	**2018 $m**	**2017 $m**
Net income	329.6	336.1	75.2	72.0	404.8	408.1	0.5	0.5	405.3	408.6
Operating expenses	(51.7)	(53.1)	(49.1)	(44.9)	(100.8)	(98.0)	(31.6)	(33.1)	(132.4)	(131.1)
Normalised EBIT	**277.9**	**283.0**	**26.1**	**27.1**	**304.0**	**310.1**	**(31.1)**	**(32.6)**	**272.9**	**277.5**
Interest and borrowing costs	-	-	-	-	-	-	(2.9)	(2.9)	(2.9)	(2.9)
Normalised net profit/(loss) before tax	**277.9**	**283.0**	**26.1**	**27.1**	**304.0**	**310.1**	**(34.0)**	**(35.5)**	**270.0**	**274.6**
Tax on normalised profit									(70.2)	(66.7)
Normalised net profit after tax									**199.8**	**207.9**
Investment experience after tax									(193.7)	(12.5)
Profit attributable to the shareholders of Challenger Ltd									**6.1**	**195.4**
Other statutory segment information										
Revenue from external customers[3]	372.2	619.7	88.6	85.8	460.8	705.5	-	0.1	460.8	705.6
Interest revenue	427.6	421.8	-	-	427.6	421.8	5.1	0.7	432.7	422.5
Interest expense	(103.7)	(109.0)	(0.1)	(0.3)	(103.8)	(109.3)	(21.5)	(20.7)	(125.3)	(130.0)
Intersegment revenue	(21.8)	(20.4)	21.8	20.4	-	-	-	-	-	-
Depreciation and amortisation	(3.0)	(3.0)	(0.3)	(0.1)	(3.3)	(3.1)	(4.2)	(4.9)	(7.5)	(8.0)
As at 31 December										
Segment assets	19,185.2	17,684.2	248.6	260.4	19,433.8	17,944.6	7,010.9	6,077.8	26,444.7	24,022.4
Segment liabilities	(16,114.6)	(14,531.5)	(25.8)	(48.6)	(16,140.4)	(14,580.1)	(6,916.4)	(5,972.8)	(23,056.8)	(20,552.9)
Net assets attributable to shareholders	**3,070.6**	**3,152.7**	**222.8**	**211.8**	**3,293.4**	**3,364.5**	**94.5**	**105.0**	**3,387.9**	**3,469.5**

[1] Refer below for definitions of the terms used in the management view of segments.
[2] Corporate and other includes corporate companies, corporate SPV, non-controlling interests and Group eliminations.
[3] Funds management revenue from external customers is predominantly management fees.

Definitions

Operating segments

The following segments are identified on the basis of internal reporting to key management personnel, including the Chief Executive Officer (the chief operating decision maker) of the Group, and comprise component parts of the Group that are regularly reviewed by senior management in order to allocate resources and assess performance:

Life

The Life segment principally includes the annuity and life insurance business carried out by CLC and Accurium Pty Limited (provision of self-managed superannuation fund actuarial certificates). CLC offers fixed rate retirement and superannuation products that are designed for investors who are seeking a low-risk, fixed term or lifetime investment and seek capital protection. CLC invests in assets providing long-term income streams for customers.

Funds Management

Funds Management earns fees from its Fidante Partners and Challenger Investment Partners operations, providing an end-to-end funds management business. Funds Management has equity investments in a number of the Fidante Partners boutique fund managers and, through the Challenger Investment Partners business, offers a range of managed investments across fixed income and property.

Note 3 Segment information (continued)

Definitions (continued)

Corporate and other

The corporate segment, which is not considered an operating segment of the Group, is used to reconcile the total segment results back to the consolidated results and consists of other income and costs that fall outside the day-to-day operations of the reportable segments. These include the costs of the Group CEO and CFO, shared services across the Group, long-term incentive costs, Directors' fees, corporate borrowings and associated borrowing costs and shareholder registry services.

To reconcile to Group results, the Corporate and other segment also includes eliminations and non-core activities of the Group.

Transactions between segments

All transactions and transfers between segments are generally determined on an arm's length basis and are included within the relevant categories of income and expense. These transactions eliminate on consolidation.

Normalised vs. statutory results

Net income and operating expenses differ from revenue and expenses as disclosed in the statement of comprehensive income as certain direct costs (including distribution expenses, property expenses and management fees) included in expenses are netted off against revenues in deriving the management view of net income above. Net income consists of the following sub-categories of management views of revenue:

- Normalised cash operating earnings (Life segment);
- Net income (Funds Management segment); and
- Other income (Corporate and other segment).

In addition, the revenues, expenses and finance costs from Special Purpose Vehicles (SPV) are separately disclosed in the statutory view but are netted off in net income.

Revenue also includes investment gains and losses which are excluded from the management view as they form part of investment experience (refer below).

Normalised cash operating earnings

This is calculated as cash earnings plus normalised capital growth (refer below). Cash earnings represents the sum of investment yield (being the management view of revenue from investment assets, such as net rental income, dividends and interest), interest expense, distribution expenses and fees.

Normalised EBIT

Normalised earnings before interest and tax (EBIT) comprises net income less operating expenses, as defined above. It excludes investment experience, corporate interest and borrowing costs and tax.

Interest and borrowing costs differ from finance costs as disclosed in the statement of comprehensive income for similar reasons to revenue and expenses, with the major difference arising from the netting of SPV finance costs against SPV revenue in net income in the management view.

Tax on normalised profit

Represents the consolidated statutory tax expense or benefit for the period, less tax attributable to non-controlling interests and investment experience.

Investment experience after tax

The Group is required by accounting standards to value applicable assets and liabilities supporting the life insurance business at fair value. This can give rise to fluctuating valuation movements being recognised in the statement of comprehensive income, particularly during periods of market volatility. As the Group is generally a long-term holder of assets, due to assets being held to match the term of life contract liabilities, the Group takes a long-term view of the expected capital growth of the portfolio rather than focusing on short-term volatility. Investment experience is a mechanism employed to isolate the volatility arising from asset and liability valuation within the results so as to more accurately reflect the underlying performance of the Group.

Investment experience is calculated as the difference between the actual investment gains/losses (both realised and unrealised) and the normalised capital growth (refer below) plus life contract valuation changes and new business strain. Investment experience after tax is investment experience net of tax at the prevailing income tax rate.

Normalised capital growth

This is determined by multiplying the normalised capital growth rate for each asset class by the average investment assets for the period. The normalised growth rates represent the Group's medium to long-term capital growth expectations for each asset class over the investment cycle.

The annual normalised growth rates are +4.5% for equity and other investments, +4.0% for infrastructure, +2.0% for property and -0.35% for cash and fixed income and are consistent with the rates applied in the prior period. The rates have been set with reference to medium to long-term market growth rates and are reviewed to ensure consistency with prevailing market conditions.

Life contract valuation assumption changes represent the impact of changes in macroeconomic variables, including bond yields and inflation factors, expense assumptions and other factors applied in the valuation of life contract liabilities. It also includes the attribution of the corresponding interest rate, foreign exchange and inflation derivatives used for hedging.

New business strain is a non-cash valuation adjustment recognised when annuity rates on new business are higher than the risk-free rate used to fair value life contracts. Maintenance expense allowances over the expected future term of the new business are also included in the life contract valuation. New business strain reported in the period represents the valuation loss on new sales generated in the current period net of the reversal of new business strain of prior period sales.

Note 3 Segment information (continued)

Major customers

No individual customer amounted to greater than 10% of the Group's revenue.

Geographical areas

The Group operates predominantly in Australia; hence, no geographical split is provided to the chief operating decision maker.

	31 Dec 2018 $m	31 Dec 2017 $m
Reconciliation of management to statutory view of after-tax profit		
Operating segments normalised net profit before tax	304.0	310.1
Corporate and other normalised net loss before tax	(34.0)	(35.5)
Normalised net profit before tax (management view of pre-tax profit)	**270.0**	**274.6**
Tax on normalised profit	(70.2)	(66.7)
Normalised net profit after tax	**199.8**	**207.9**
Investment experience after tax	(193.7)	(12.5)
Profit attributable to the shareholders of Challenger Limited	**6.1**	**195.4**
Profit attributable to non-controlling interests excluded from management view	0.1	0.7
Statutory view of profit after tax	**6.2**	**196.1**
Reconciliation of management view of revenue to statutory revenue		
Operating segments	404.8	408.1
Corporate and other	0.5	0.5
Net income (management view of revenue)	**405.3**	**408.6**
Expenses and finance costs offset against revenue		
SPV expenses and finance costs offset against SPV income	12.6	14.4
Distribution expenses offset against related income	24.5	23.5
Change in life contract liabilities and reinsurance contracts recognised in expenses	525.2	447.2
Property related expenses offset against property income	57.8	60.1
Interest and loan amortisation costs	91.1	94.5
Fee expenses	53.3	54.2
Adjustment for non-controlling interests and other items	(6.1)	47.5
Difference between management view of investment experience and statutory recognition		
Actual capital growth	(134.6)	84.3
Normalised capital growth	(78.1)	(59.7)
Life contract valuation experience	(21.6)	(9.1)
New business strain	(35.9)	(37.4)
Statutory revenue (refer Note 1 Revenue)	**893.5**	**1,128.1**

Note 4 Income tax

Reconciliation of income tax benefit/(expense)	31 Dec 2018 $m	31 Dec 2017 $m
(Loss)/profit before income tax	(5.0)	248.1
Prima facie income tax based on the Australian company tax rate of 30%	1.5	(74.4)
Tax effect of amounts not assessable/deductible in calculating taxable income:		
– Challenger Capital Notes distributions	(5.0)	(4.9)
– non-assessable and non-deductible items	14.9	24.8
– tax adjustment in respect of non-controlling interests	-	0.2
– other items	(0.2)	2.3
Income tax benefit/(expense)	**11.2**	**(52.0)**
Underlying effective tax rate[1]	**219.6%**	**21.0%**

[1] The calculation of the underlying effective tax rate excludes the non-controlling interests' profit of $0.1 million (31 December 2017: $0.7 million).

Analysis of income tax benefit/(expense)	31 Dec 2018 $m	31 Dec 2017 $m
Current income tax expense for the period	(5.6)	(35.9)
Current income tax benefit prior period adjustment	5.4	3.2
Deferred income tax benefit/(expense)	13.6	(19.6)
Deferred income tax (expense)/benefit prior year adjustment	(2.2)	0.3
Income tax benefit/(expense)	**11.2**	**(52.0)**
Income tax (expense)/benefit on translation of foreign entities	(10.8)	3.2
Income tax benefit/(expense) on hedge of net investment in foreign entities	10.3	(3.8)
Income tax expense from other comprehensive income	**(0.5)**	**(0.6)**

Recognised deferred tax balances	31 Dec 2018 $m	30 Jun 2018 $m
Tax consolidated group losses[1]	61.0	-
Non-tax consolidated group losses	28.1	25.3
DTA on losses	**89.1**	**25.3**

[1] The Challenger tax consolidated group has recognised current period revenue losses of $61.0 million which are included in the deferred tax balance

Unrecognised deferred tax balances	31 Dec 2018 $m	30 Jun 2018 $m
Non-tax consolidated group revenue losses – tax effected	7.4	19.3
Tax consolidated group capital losses – tax effected	55.7	55.8

Note 5 Financial assets – fair value through profit and loss

	31 Dec 2018 $M	30 June 2018 $m	31 Dec 2017 $m
Domestic sovereign bonds and semi-government bonds	6,807.8	6,003.9	5,183.2
Floating rate notes and corporate bonds	5,577.5	5,602.4	5,649.6
Residential mortgage and asset-backed securities	3,889.2	3,466.8	2,891.2
Non-SPV mortgage assets	264.7	208.6	183.7
Fixed income securities	**16,539.2**	**15,281.7**	**13,907.7**
Shares in listed and unlisted corporations	105.7	69.7	73.3
Unit trusts, managed funds and other	1,236.7	1,073.6	914.1
Equity securities	**1,342.4**	**1,143.3**	**987.4**
Units in listed and unlisted infrastructure trusts	465.7	479.6	489.6
Other infrastructure investments	306.8	304.3	305.8
Infrastructure investments	**772.5**	**783.9**	**795.4**
Indirect property investments in listed and unlisted trusts	132.7	382.7	379.6
Property securities	**132.7**	**382.7**	**379.6**
Total financial assets – fair value through profit and loss	**18,786.8**	**17,591.6**	**16,070.1**

Note 6 Investment and development property

	31 Dec 2018 $m	30 June 2018 $m	31 Dec 2017 $m
Investment property held for sale[1]	279.6	452.2	55.1
Investment property in use	3,426.9	3,328.6	3,626.0
Investment property under development	384.7	254.4	84.7
Total investment property	**4,091.2**	**4,035.2**	**3,765.8**
Development property held for resale[2]	0.7	0.7	0.3
Total investment and development property[3]	**4,091.9**	**4,035.9**	**3,766.1**

[1] Held for sale properties: The Barracks, Makerston House, 140 Rue Marcel Paul, Gennevilliers, Zac Papillon, Parcay-Meslay, Rue Charles Nicolle, Villeneuve les Beziers and 105 Route d'Orleans, Sully sur Loire (30 June 2018: 35 Clarence Street and 53 Albert Street).

[2] Development property held for resale is held at the lower of cost or net realisable value.

[3] Investment property held for sale and development property held for resale are considered current. All other investment property is considered non-current.

Note 7 Life contract liabilities

Fair value of life contract liabilities	31 Dec 2018 $m	30 June 2018 $m	31 Dec 2017 $m
Life investment contract liabilities – at fair value	6,750.1	6,635.3	6,448.8
Life insurance contract liabilities – at margin on services value	5,501.4	5,016.7	4,591.3
Reinsurance contract liabilities – at margin on services value	72.2	76.3	75.7
Total life contract liabilities	**12,323.7**	**11,728.3**	**11,115.8**

	Life investment contract liabilities		Life insurance contract liabilities		Outward reinsurance contract liabilities		Total life contract liabilities	
Movement in life contract liabilities	31 Dec 2018 $m	31 Dec 2017 $m	31 Dec 2018 $m	31 Dec 2017 $m	31 Dec 2018 $m	31 Dec 2017 $m	31 Dec 2018 $m	31 Dec 2017 $m
Balance at the beginning of the period	6,635.3	6,356.5	5,016.7	3,885.5	76.3	80.2	11,728.3	10,322.2
Deposits and premium receipts	1,524.3	1,478.8	625.8	818.0	-	-	2,150.1	2,296.8
Payments and withdrawals	(1,526.7)	(1,485.4)	(312.4)	(228.6)	(5.9)	(6.1)	(1,845.0)	(1,720.1)
Revenue per Note 1	(2.9)	(21.5)	(232.7)	(209.2)	0.7	0.4	(234.9)	(230.3)
Expense per Note 2	120.1	120.4	404.0	325.6	1.1	1.2	525.2	447.2
Balance at the end of the period	**6,750.1**	**6,448.8**	**5,501.4**	**4,591.3**	**72.2**	**75.7**	**12,323.7**	**11,115.8**

Accounting policy

The operations of the Group include the selling and administration of life contracts through Challenger Life Company Limited (CLC). These contracts are governed under the *Life Insurance Act 1995* (the Life Act) and are classified as either life insurance contracts or life investment contracts. Life insurance and life investment contract liabilities are collectively referred to as life contract liabilities or policy liabilities.

Life investment contract liabilities

Life investment contracts are contracts regulated under the Life Act but which do not meet the definition of life insurance contracts under AASB 1038 *Life Insurance Contracts* and similar contracts issued by entities operating outside of Australia.

For fixed term policies, the liability is based on the fair value of the income payments and associated expenses, being the net present value of the payments and expenses using an appropriate discount rate curve as determined by the Appointed Actuary.

Life insurance contract liabilities

Life insurance contracts are contracts regulated under the Life Act that involve the acceptance of significant insurance risk. Insurance risk is defined as significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance (i.e. have no discernible effect on the economics of the transaction).

The financial reporting methodology used to determine the value of life insurance contract liabilities is referred to as margin on services (MoS). Under MoS, the excess of premiums received over payments to customers and expenses (the margin) is recognised over the life of the contract in a manner that reflects the pattern of risk accepted from the policyholder (the service) unless future margins are negative, in which case the future losses are recognised in the statement of comprehensive income in the period in which they occur. The planned release of this margin is recognised in the statement of comprehensive income as part of the movement in life insurance contract liabilities.

Life insurance contract liabilities are usually determined using a projection method, whereby estimates of policy cash flows (premiums, payments and expenses) are projected into the future. The liability is calculated as the net present value of these projected cash flows using a risk-free discount rate curve.

The key areas of judgement in the determination of the actuarial assumptions are the duration of claims/policy payments, acquisition and maintenance expense levels, and economic assumptions for discount and inflation rates.

Life insurance premium revenue

Life insurance premiums are recognised as revenue when received.

Life insurance claims expense

Life insurance claims expense is recognised in expenses when the liability to the policyholder under the contract has been established.

Inwards reinsurance

The Group has maintained inwards reinsurance arrangements during the period that meet the definition of a life insurance contract. The MoS methodology requires the present value of future cash flows arising from reinsurance contracts to be included in the calculation of life insurance contract liabilities.

Note 7 Life contract liabilities (continued)

Valuation

The MoS valuation, calculated in accordance with APRA Prudential Standards, results in the systematic release of planned margins over the life of the policy via a 'profit carrier'. The Group maintains life insurance contracts including individual lifetime annuities, wholesale mortality, wholesale morbidity and longevity reinsurance. Annuity payments are used as the profit carrier for individual lifetime annuities and premium receipts or best estimate claim payments are used as the profit carrier for wholesale mortality, wholesale morbidity and longevity reinsurance.

Key assumptions applied in the valuation of life contract liabilities

Tax rates

The bases of taxation (including deductibility of expenses) are assumed to continue in accordance with legislation current at the reporting date.

Discount rates

Under APRA Prudential Standards and AASB 1038 *Life Insurance Contracts*, life insurance contract liabilities are calculated by discounting expected future cash flows at a risk-free rate, set at the Commonwealth Government Bond curve plus an illiquidity premium where applicable or for foreign-denominated liabilities, a curve derived from the yields of highly liquid AAA-rated sovereign risk securities in the currency of the policy liabilities plus an illiquidity premium where applicable. The illiquidity premium is determined by reference to observable market rates including Australian sovereign debt, corporate, securitised and collateralised debt publicly placed in the domestic market, and market swap rates.

Life investment contract liabilities are calculated under the fair value through profit and loss provisions of AASB 139 *Financial Instruments: Recognition and Measurement*. The discount rates are determined based on the current observable, objective rates that relate to the nature, structure and term of the future liability cash flows.

For both insurance and investment contracts the approach is the same as adopted at 30 June 2018. Discount rates applied for Australian liabilities were between 2.4-3.7% (30 June 2018: 2.4-3.7%) per annum.

Expenses

Forecast expenses for the next year are allocated between acquisition, maintenance and investment based on the nature of the expense. Forecast maintenance expenses then are converted to a per-contract unit cost or percentage of account balance, depending on the nature of the expense.

Inflation

Inflation estimates are based on long-term expectations and reviewed at least annually for changes in the market environment based on a comparison of real and nominal yields of instruments of equivalent term and credit risk. The current assumption for Australia is 1.3% per annum for short-term inflation and 2.1% per annum for long-term (30 June 2018: 1.7% short-term, 2.3% long-term).

Surrenders

For life investment contracts, no surrenders or voluntary discontinuances are assumed. For Australian life insurance contracts where a surrender value is payable on withdrawal, a rate of surrenders is assumed in line with Challenger's own experience on these products, currently between 1.3%-1.7% per annum. For inwards reinsurance of Japanese business, a rate of surrenders is assumed in line with local experience in relation to similar contracts, currently 3.5% per annum (30 June 2018: 3.5%).

Where policyholders have the option to commute a life insurance contract, the value of this option is included within the life contract liabilities. We also assume surrender rates based on past experience for this business which vary by product types and duration in-force for the contract.

Mortality

Base mortality rates for individual lifetime annuities are determined as a multiple of annuitant experience based on LML08 and LFL08 tables, adjusted for Challenger's own recent experience. LML08 and LFL08 are mortality tables developed by the Continuous Mortality Investigation (CMI) based on United Kingdom annuitant lives experience from 2007–2010. The tables refer to male and female lives respectively. Rates are adjusted for expected future mortality improvements based on observed and expected improvements. Rates of future mortality improvement for individual lifetime annuities applied are between 0.0-2.6% per annum (30 June 2018: 0.0-2.6%).

Base mortality rates for wholesale mortality and longevity reinsurance are determined as a multiple of pensioner mortality rates (based on the self-administered pension schemes or SAPS2 tables mortality investigation developed by the Institute and Faculty of Actuaries (UK) using United Kingdom data collected between 2004–2012). Rates are adjusted for expected future mortality improvements based on observed and expected improvements.

For the age ranges and cash flow projection periods that contribute the majority of CLC's exposure, rates of future mortality improvement applied are between 0.6%-2.1% per annum (30 June 2018: 0.6%-2.1%). Base mortality rates for the inwards reinsurance of Japanese business are determined as a multiple of Japanese population mortality rates.

Impact of changes in assumptions on life insurance contracts

Under MoS, changes in actuarial assumptions are recognised by adjusting the value of future profit margins in life insurance contract liabilities. Changes in future profit margins are released over future periods unless that product group is in an expected net loss position (loss recognition), in which case changes in assumptions are recognised in the statement of comprehensive income in the period in which they occur. The valuation impact of changes to discount rate assumptions as a result of market and economic conditions, such as changes in benchmark market yields, are recognised in the statement of comprehensive income in the period in which they occur.

Note 7 Life contract liabilities (continued)

Restrictions on assets

Financial assets held in Challenger Life Company Limited (CLC) can only be used within the restrictions imposed under the Life Insurance Act 1995 (the Life Act). The main restrictions are that the assets in a statutory fund can only be used to meet the liabilities and expenses of that statutory fund, to acquire investments to further the business of the statutory fund or as distributions when capital adequacy requirements are met.

Statutory fund information

The life contract operations of CLC are conducted within four separate statutory funds as required by the Life Act. Both the shareholders' and policyholders' interests in these statutory funds are reported in aggregate in the financial report of the Group. Fund 1 is a non-investment-linked fund and Fund 3 is investment-linked. Both of these are closed to new business. Funds 2 and 4 are the principal operating funds of the Group. Fund 2 contains non-investment-linked contracts, including the Group's term annuity business, lifetime annuity policies and the related outwards reinsurance, plus the wholesale mortality, wholesale morbidity and longevity inwards reinsurance. Fund 4 was established on 7 March 2017 and contains inwards reinsurance of annuity business written in Japan.

Life contract liabilities for Funds 1, 2, 3 and 4 are $2.1 million, $11,166.5 million, $2.7 million and $1,152.4 million respectively (30 June 2018: $2.4 million, $10,688.0 million, $2.9 million and $1,035.0 million).

Life insurance risk

The Group is exposed to longevity risk on its individual lifetime annuities (both direct and reinsured) and wholesale longevity reinsurance. Longevity risk is the risk that policyholders may live longer than expectations. The Group is exposed to mortality risk on the wholesale mortality reinsurance and reinsurance of fixed term business written in Japan. This is the risk that death rates in the reference portfolios exceed expectations. The Group is also exposed to morbidity risk on the wholesale morbidity reinsurance. That is the risk that morbidity rates in the reference portfolios exceed expectation. The Group manages the longevity risk by regular reviews of the portfolio to confirm continued survivorship of policyholders receiving income plus regular review of longevity experience to ensure that longevity assumptions remain appropriate. In addition, the Group has entered into reinsurance arrangements to manage longevity risk in respect of closed books of individual lifetime annuities. The Group manages the mortality and morbidity risk by regular reviews of the portfolio to ensure that mortality and morbidity assumptions remain appropriate. The Company's insurance risk policy is approved by the Board and sets out the relevant risk limits for insurance exposures, to ensure the insurance risk portfolio is appropriately diversified and contains no significant concentrations of insurance risk.

Actuarial information

Mr A Kapel FIAA, as the Appointed Actuary of CLC, is satisfied as to the accuracy of the data used in the valuations of life contract liabilities in the financial report and the tables in this note. The life contract liabilities have been determined at the reporting date in accordance with the Life Act.

Note 8 Notes to statement of cash flows

Reconciliation of profit to operating cash flow	31 Dec 2018 $m	31 Dec 2017 $m
Profit for the period	**6.2**	**196.1**
Adjusted for		
Net realised and unrealised gains on investment assets	55.8	(168.1)
Share of associates' net profit	(11.7)	(13.2)
Change in life contract liabilities[1]	290.3	216.9
Depreciation and amortisation expense	7.5	7.9
Impairment/(reversal of impairment) in associates and other investments	(24.8)	4.5
Share-based payments	10.9	11.0
Dividends from associates	23.5	14.4
Change in operating assets and liabilities		
Decrease in receivables	53.4	19.0
(Increase)/decrease in other assets	(6.5)	3.7
Decrease in payables	(30.8)	(19.9)
Increase in provisions	1.5	0.1
Increase in life contract liabilities	305.1	576.7
Increase in external unit holders' liabilities	37.3	221.5
Decrease in net tax liabilities	(63.2)	(103.9)
Net cash flows from operating activities	**654.5**	**966.7**

[1] Changes relate to movements through the statement of comprehensive income.

Note 9 Contributed equity

	6 months to 31 December 2018		Year to 30 June 2018		6 months to 31 December 2017	
	No. of shares m	Value of shares $m	No. of shares m	Value of shares $m	No. of shares m	Value of shares $m
Analysis of contributed equity						
Ordinary shares issued and fully paid	611.2	2,151.9	610.9	2,148.5	610.6	2,145.2
CPP Trust shares treated as Treasury shares	(3.0)	(30.6)	(4.4)	(40.4)	(4.5)	(41.3)
CPP deferred share purchases treated as Treasury shares	(2.8)	(31.1)	(4.8)	(56.4)	(2.8)	(32.9)
Total contributed equity	**605.4**	**2,090.2**	**601.7**	**2,051.7**	**603.3**	**2,071.0**
Movements in contributed equity						
Ordinary shares						
Balance at the beginning of the year	610.9	2,148.5	572.0	1,641.9	572.0	1,641.9
Equity placement	-	-	38.3	499.7	38.3	499.8
Issued under dividend reinvestment plan	0.3	3.4	0.6	6.9	0.3	3.5
Balance at the end of the year	**611.2**	**2,151.9**	**610.9**	**2,148.5**	**610.6**	**2,145.2**
CPP Trust						
Balance at the beginning of the year	4.4	40.4	5.3	39.5	5.3	39.5
Shares purchased (including settled forwards)	2.8	32.8	4.8	49.4	4.8	49.4
Vested shares released to employees	(4.2)	(42.6)	(5.7)	(48.5)	(5.6)	(47.6)
Balance at the end of the year	**3.0**	**30.6**	**4.4**	**40.4**	**4.5**	**41.3**
CPP deferred share purchases						
Balance at the beginning of the year	4.8	56.4	4.8	47.9	4.8	47.9
CPP deferred share purchases	0.8	7.5	4.0	47.4	2.0	23.9
Settled forward purchases	(2.8)	(32.8)	(4.0)	(38.9)	(4.0)	(38.9)
Balance at the end of the year	**2.8**	**31.1**	**4.8**	**56.4**	**2.8**	**32.9**

Capital management

Dividend Reinvestment Plan (DRP)

The Company maintained a DRP for the 2018 final dividend. On 26 September 2018, the Company issued 329,710 ordinary shares to shareholders under the DRP. The DRP issue price per share for the 2018 final dividend was $10.4334 and represents the volume weighted average share price over the ten trading days from 5 to 18 September 2018. The DRP participation rate was 3.1 per cent of all issued shares, resulting in proceeds of $3.4 million.

Internal Capital Adequacy Assessment Process (ICAAP) Summary Statement – CLC

CLC is a life insurance company regulated under the Life Act. The Life Act, via prudential standards issued by APRA, imposes minimum statutory capital requirements on all life insurance companies. Under these standards a life company must have in place an ICAAP, documented in an ICAAP Summary Statement. CLC complied with these requirements at all times during the period.

Prescribed capital amount (PCA)

CLC holds capital in order to ensure that under a range of adverse scenarios it can continue to meet its regulatory and contractual obligations to its customers. CLC is regulated by APRA and is required to hold a minimum level of regulatory capital.

CLC's regulatory capital base and PCA have been calculated based on the Life and General Insurance Capital (LAGIC) regulatory standards issued by APRA.

While CLC does not target a specific PCA ratio, CLC's internal capital models result in a PCA ratio under current circumstances in the range of 1.3 to 1.6 times. This range can change over time and is dependent on numerous factors. CLC's PCA ratio is currently within this range of 1.3 to 1.6 times.

The PCA ratio at 31 December 2018 was 1.54 times (30 June 2018: 1.53 times), reflecting changes in asset allocation, net AUM growth, increased Common Equity Tier 1 capital and changes in retained earnings.

Note 9 Contributed equity (continued)

Capital management (continued)

CLC's target surplus

CLC maintains a target level of capital representing APRA's PCA plus a target surplus. The target surplus is a management guide to the level of excess capital that CLC seeks to hold over and above APRA's minimum requirements. CLC's target surplus is set to ensure that it provides a buffer against adverse market conditions and having regard to CLC's credit rating. CLC uses internal capital models to determine its target surplus, which are risk-based and are responsive to changes in CLC's asset allocation and market conditions.

Details of the CLC capital adequacy multiple are below:

CLC capital	31 Dec 2018 $m	30 June 2018 $m	31 Dec 2017 $m
CLC's excess capital under LAGIC			
Common Equity Tier 1 regulatory capital	2,517.6	2,677.8	2,638.4
Additional Tier 1 regulatory capital	805.0	805.0	805.0
Tier 2 regulatory capital – subordinated debt[1]	402.2	405.4	406.8
CLC total regulatory capital base	**3,724.8**	**3,888.2**	**3,850.2**
Prescribed capital amount			
Asset risk charge[2]	2,355.2	2,484.7	2,502.4
Insurance risk charge	83.3	70.0	164.9
Operational risk charge	47.5	46.4	42.8
Aggregation benefit	(64.8)	(54.8)	(125.7)
CLC prescribed capital amount	**2,421.2**	**2,546.3**	**2,584.4**
CLC excess over prescribed capital amount	**1,303.6**	**1,341.9**	**1,265.8**
Capital adequacy ratio (times)	**1.54**	**1.53**	**1.49**

[1] Differs from $400.6 million (30 June 2018: $403.7 million) disclosed in Note 10 Interest bearing financial liabilities due to $1.6 million (30 June 2018: $1.7 million) of accrued interest.

[2] Asset risk charge includes the combined stress scenario adjustment and default stress.

Note 10 Interest bearing financial liabilities

	30 June 2018		Cash flows	Non-cash movements			31 Dec 2018	
	Facility $m	Opening balance $m	Proceeds/ (repayments) $m	Foreign Exchange $m	Fair value changes $m	Other $m	Closing balance $m	Facility $m
Bank loans								
Corporate	400.0	-	-	-	-	-	-	400.0
Controlled property trusts[1]	551.2	548.4	(107.0)	23.8	0.4	0.8	466.4	467.2
Controlled infrastructure trusts	197.2	197.2	(2.5)	-	-	-	194.7	194.7
Repurchase agreements	3,816.0	3,816.0	581.4	-	-	-	4,397.4	4,397.4
Total bank loans	**4,964.4**	**4,561.6**	**471.9**	**23.8**	**0.4**	**0.8**	**5,058.5**	**5,459.3**
Non-bank loans								
Subordinated debt	403.7	403.7	-	-	(3.1)	-	400.6	400.6
Challenger Capital Notes 1	341.9	341.9	-	-	-	0.8	342.7	342.7
Challenger Capital Notes 2	450.9	450.9	-	-	-	0.9	451.8	451.8
Other finance	15.0	15.0	(1.1)	-	-	-	13.9	13.9
Total non-bank loans	**1,211.5**	**1,211.5**	**(1.1)**	**-**	**(3.1)**	**1.7**	**1,209.0**	**1,209.0**
Total interest bearing financial liabilities	**6,175.9**	**5,773.1**	**470.8**[2]	**23.8**	**(2.7)**	**2.5**	**6,267.5**	**6,668.3**
Current		3,839.5					4,707.9	
Non-current		1,933.6					1,559.6	
		5,773.1					**6,267.5**	

[1] Total facility limit consists of non-redraw loan facility limits totalling $467.2 million (30 June 2018: $450.2 million of non-redraw loan facility and $101.0 million of redraw loan facility).
[2] Differs to Statement of cash flows due to $104.1 million (30 June 2018: $258.2 million) repayments relating to SPV. Net cash proceeds comprise $581.4 million (30 June 2018: $988.7 million) proceeds from borrowings and $214.7 million (30 June 2018: $708.3 million) repayments of borrowings.

Repurchase agreements

CLC has entered into repurchase agreements with certain counterparties whereby fixed income securities are sold for cash whilst simultaneously agreeing to repurchase the fixed income security at a fixed price and a fixed date in the future. These agreements finance bonds held for hedging purposes and are interest bearing, with interest included in the price at which the bonds are repurchased and paid on repurchase. All agreements as at 31 December 2018 are current and all except $1,057.0 million matured in January 2019. The remaining agreements mature in February 2019. They will continue to be rolled into new agreements in the future.

Note 11 Dividends paid and proposed

	31 Dec 2018 $m	31 Dec 2017 $m
Dividends declared and paid during the year		
Final 30 June 2018 100% franked dividend: 18.0 cents (30 June 2017: 17.5 cents 100% franked dividend)	109.4	99.5
Dividend proposed (not recognised as a liability at 31 December)		
2019 interim 100% franked dividend: 17.5 cents (2018 interim: 17.5 cents 100% franked)	106.4	106.1

A dividend reinvestment plan will be in operation for the interim 2019 dividend.

Note 12 Earnings per share

	31 Dec 2018 cents	31 Dec 2017 cents
Basic earnings per share	1.0	33.1
Diluted earnings per share	1.0	31.9
	$m	**$m**
Profit attributable to ordinary shareholders	6.1	195.4
Add back interest expense on Challenger Capital Notes 1 and 2	-	16.2
Add back interest expense net of tax on CLC Subordinated Notes	-	1.1
Total earnings used in the calculation of diluted earnings per share	**6.1**	**212.7**
Number of shares	**Number**	**Number**
Weighted average of ordinary shares issued	611,029,546	599,415,537
Weighted average number of Treasury shares	(6,654,339)	(8,283,329)
Weighted average ordinary shares for basic earnings per share	**604,375,207**	**591,132,208**
Adjusted for potential ordinary shares:		
Weighted average effect of Challenger Performance Plan	7,140,117	11,887,169
Weighted average effect of Challenger Capital Notes 1 and 2	-	57,750,803
Weighted average effect of CLC Subordinated Notes	-	5,926,358
Weighted average ordinary shares for diluted earnings per share	**611,515,324**	**666,696,538**

In determining the weighted average number of ordinary shares used in the calculation of earnings per share, a reduction is made for the average number of Treasury shares held. The weighted average number of Treasury shares for the period was 6.7 million (31 December 2017: 8.3 million).

Diluted earnings per share is calculated by dividing the total profit attributable to equity holders of the Company by the weighted average number of ordinary shares outstanding during the period adjusted for the effects of dilutive shares that may be converted under the terms of Challenger Capital Notes 1 and 2 (Notes), CLC Subordinated Notes and shares granted under the Challenger Performance Plan (CPP).

The diluted share count has been increased by 7.1 million shares (31 December 2017: 11.9 million shares) for shares that may be converted under the terms of the CPP. However, since the CPP Trust commenced operation in December 2006, no shares have been issued to the CPP Trust. Instead, shares are acquired by the CPP Trust to mitigate shareholder dilution.

The Notes and Subordinated Notes are considered non-dilutive when the interest cost per share is greater than the earnings per share. No adjustment was required in the period for Challenger Capital Notes 1 and 2 (Notes) and CLC Subordinated Notes (31 December 2017: 57.8 million shares for Notes and 5.9 million shares for Subordinated Notes).

The profit attributable to ordinary shareholders is adjusted by interest on the Notes and CLC Subordinated Notes for the diluted calculation when the Notes and CLC Subordinated Notes are considered dilutive.

Note 13 Fair values of financial assets and liabilities

Fair value determination and classification

Fair value reflects the price that would be received on sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The majority of the Group's financial instruments are held in the *life insurance statutory funds of CLC* and, as a result, are required by AASB 1038 Life Insurance Contracts to be designated at fair value through profit and loss where this is permitted under *AASB 139 Financial Instruments: Recognition and Measurement*.

Financial instruments measured at fair value are categorised under a three level hierarchy, reflecting the availability of observable market inputs when estimating the fair value. If different levels of inputs are used to measure a financial instrument's fair value, the classification within the hierarchy is based on the lowest level that is significant to the fair value measurement. The three levels are:

Level 1	unadjusted quoted prices in active markets are the valuation inputs for identical assets or liabilities (i.e. listed securities).
Level 2	valuation inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (as prices) or indirectly (derived from prices) are used.
Level 3	there are valuation inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The unobservable inputs into the valuation of the Group's Level 3 assets and liabilities are determined based on the best information available, including the Group's own assessment of the assumptions that market participants would use in pricing the asset or liability. Examples of unobservable inputs are estimates about the timing of cash flows, discount rates, earnings multiples and internal credit ratings.

Valuation techniques

The majority of the Group's listed and unlisted fixed income securities, over-the-counter derivative financial instruments and interest bearing liabilities are classified as Level 2. This recognises the availability of a quoted price but not from an active market as defined by the standard.

Fixed income securities where market observable inputs are not available are classified Level 3. The Group's derivative financial instruments are traded over-the-counter so, whilst they are not exchange traded, there is a market observable price. All of the fixed income and government/semi-government securities have prices determined by a market.

Externally rated unlisted fixed income securities are valued by applying market observable credit spreads on similar assets with an equivalent credit rating. Internally-rated fixed income securities are Level 3 as the determination of an equivalent credit rating is a significant non-observable input.

Equity, infrastructure and property securities that are exchange traded are generally classified Level 1. Where quoted prices are available, but are not from an active market, they are classified Level 2. If market observable inputs are not available, they are classified Level 3. Valuations can make use of cash flow forecasts discounted using the applicable yield curve, earnings-multiple valuations or, for managed funds, the net assets of the trust per the most recent financial report.

External unit holders' liabilities are valued at the face value of the amounts payable and classified as Level 2. The portion of life investment contract liabilities classified as Level 2 represent products or product options for which the liability is determined based on an account balance, rather than a discounted cash flow as applied to the rest of the portfolio.

Cash and cash equivalents are carried at amortised cost. To determine a fair value where the asset is liquid or maturing within three months, the fair value is approximate to the carrying amounts. This assumption is applied to liquid assets and the short-term elements of all other financial assets and financial liabilities.

The mortgage SPVs have total equity attributable to residual income unitholders (RIU) holders at amortised cost of $0.5 million (30 June 2018: $0.3 million). The fair value of this RIU holders' asset is $63.5 million (30 June 2018: $73.7 million) and would be classified as Level 3 in the fair value hierarchy.

Challenger Capital Notes 1 and 2 have carrying values of $345.0 million and $460.0 million. The fair value of these notes is $349.4 million and $480.7 million respectively and they are classified as Level 1 in the fair value hierarchy.

Valuation process

For financial instruments and investment properties categorised within Level 3 of the fair value hierarchy, the valuation process applied in valuing such instruments is governed by the CLC Practice Note on Investment Asset and Financial Liability Valuation. The Practice Note outlines the Valuation Committee's responsibilities in the valuation of investment assets and financial liabilities for the purposes of financial reporting. All significant Level 3 financial instruments are referred to the Valuation Committee which generally meets monthly, or more frequently if required.

All financial instruments and investment properties are measured on a recurring basis. The table on the following page summarises the financial instruments and investment properties measured at fair value at each level of the fair value hierarchy as at the statement of financial position date.

Note 13 Fair values of financial assets and liabilities (continued)

Valuation process (continued)

	Level 1 $m	Level 2 $m	Level 3 $m	Total $m
31 Dec 2018				
Derivative assets	-	428.7	0.6	429.3
Fixed income securities[1]	-	14,534.5	2,004.7	16,539.2
Equity and other alternatives	7.2	991.3	343.9	1,342.4
Infrastructure investments[1]	176.5	197.3	398.7	772.5
Property securities	-	-	132.7	132.7
Investment and development property	-	279.6	3,811.6	4,091.2
Total assets	**183.7**	**16,431.4**	**6,692.2**	**23,307.3**
Derivative liabilities	0.7	532.7	0.1	533.5
Interest bearing financial liabilities	841.6	445.6	13.6	1,300.8
External unit holders' liabilities	-	2,172.3	-	2,172.3
Life investment contract liabilities	-	60.0	6,690.1	6,750.1
Total liabilities	**842.3**	**3,210.6**	**6,703.8**	**10,756.7**
30 June 2018				
Derivative assets	-	420.5	0.6	421.1
Fixed income securities	-	13,389.6	1,892.1	15,281.7
Equity and other alternatives	38.4	738.3	366.6	1,143.3
Infrastructure investments[1]	165.8	204.4	413.7	783.9
Property securities	240.4	-	142.3	382.7
Investment and development property	-	452.2	3,583.0	4,035.2
Total assets	**444.6**	**15,205.0**	**6,398.3**	**22,047.9**
Derivative liabilities	0.6	452.3	0.1	453.0
Interest bearing financial liabilities	818.2	454.6	14.8	1,287.6
External unit holders' liabilities	-	2,135.0	-	2,135.0
Life investment contract liabilities	-	64.9	6,570.4	6,635.3
Total liabilities	**818.8**	**3,106.8**	**6,585.3**	**10,510.9**
31 Dec 2017				
Derivative assets	-	675.7	0.1	675.8
Fixed income securities	-	11,706.4	2,201.3	13,907.7
Equity and other alternatives	46.7	700.3	240.4	987.4
Infrastructure investments[1]	169.6	211.7	414.1	795.4
Property securities	237.9	-	141.7	379.6
Investment and development property	-	55.1	3,710.7	3,765.8
Total assets	**454.2**	**13,349.2**	**6,708.3**	**20,511.7**
Derivative liabilities	0.2	537.7	-	537.9
Interest bearing financial liabilities	-	461.1	16.0	477.1
External unit holders' liabilities	-	1,909.3	-	1,909.3
Life investment contract liabilities	-	70.4	6,378.4	6,448.8
Total liabilities	**0.2**	**2,978.5**	**6,394.4**	**9,373.1**

[1] The Group has exposures to structured entities (entities designed so that voting or similar rights are not the dominant factor in determining who controls the entity; for example, when any voting rights relate purely to administrative tasks) via investments in asset-backed finance vehicles (where it may act as a lender or purchaser of notes and/or residual income units) and securitisations (such as mortgages, finance leases and other types of collateralised vehicles). The Company assesses, at inception and at each reporting date, whether a structured entity should be consolidated based on the accounting policy. The maximum exposure to loss is limited to the reported fair value of the underlying securities plus any guaranteed undrawn commitments to the counterparties. At 31 December 2018 the carrying value of asset-backed financing assets was $42.9 million (30 June 2018: $57.3 million) with zero undrawn commitments (30 June 2018: none) and securitisations was $3,176.9 million (30 June 2018: $3,010.8 million) plus $128.4 million undrawn commitments (30 June 2018: $88.2 million).

Note 13 Fair values of financial assets and liabilities (continued)

Level 3 sensitivities

The following table shows the sensitivity of Level 3 financial instruments to a reasonable change in alternative assumptions in respect of the non-observable inputs into the fair value calculation:

	Level 3 value[1] $m	Positive impact $m	Negative impact $m	Valuation technique	Reasonable change in non-observable input[2,3]
31 Dec 2018					
Derivative assets	0.6	0.1	(0.1)	Discounted cash flow	Primarily credit spreads
Derivative liabilities	(0.1)	0.3	(0.2)	Discounted cash flow	Primarily credit spreads
Fixed income securities	2,004.7	10.9	(48.3)	Discounted cash flow	Primarily credit spreads
Interest bearing financial liabilities	(13.6)	0.1	(0.1)	Discounted cash flow	Primarily credit spreads
Equity and other alternatives	343.9	24.6	(26.2)	Pricing model	Earnings multiple, Mortality rate
Infrastructure investments	398.7	6.4	(6.3)	Discounted cash flow, External financial report	Primarily discount rate on cash flow models
Property securities	132.7	6.6	(6.6)	Market capitalisation, Discounted cash flow	Primarily capitalisation rate
Investment contract liabilities	(6,690.1)	3.5	(3.5)	Discounted cash flow	Primarily expense assumptions
Investment and development property	3,811.6	173.3	(161.9)	Market capitalisation, Discounted cash flow	Primarily capitalisation rate
Total Level 3	**(11.6)**	**225.8**	**(253.2)**		
30 June 2018					
Derivative assets	0.6	0.1	(0.1)	Discounted cash flow	Primarily credit spreads
Derivative liabilities	(0.1)	0.3	(0.2)	Discounted cash flow	Primarily credit spreads
Fixed income securities	1,892.1	10.2	(77.1)	Discounted cash flow	Primarily credit spreads
Interest bearing financial liabilities	(14.8)	-	-	Discounted cash flow	Primarily credit spreads
Equity and other alternatives	366.6	25.5	(27.2)	Pricing model	Earnings multiple, Mortality rate
Infrastructure investments	413.7	7.3	(7.2)	Discounted cash flow, External financial report	Primarily discount rate on cash flow models
Property securities	142.3	7.1	(7.1)	Market capitalisation, Discounted cash flow	Primarily capitalisation rate
Investment contract liabilities	(6,570.4)	3.6	(3.6)	Discounted cash flow	Primarily expense assumptions
Investment and development property	3,583.0	151.3	(138.6)	Market capitalisation, Discounted cash flow	Primarily capitalisation rate
Total Level 3	**(187.0)**	**205.4**	**(261.1)**		
31 Dec 2017					
Derivative assets	0.1	0.5	(0.1)	Discounted cash flow	Primarily credit spreads
Fixed income securities	2,201.3	32.7	(29.3)	Discounted cash flow	Primarily credit spreads
Interest bearing financial liabilities	(16.0)	(0.4)	-	Discounted cash flow	Primarily credit spreads
Equity and other alternatives	240.4	18.8	(20.3)	Pricing model	Earnings multiple, Mortality rate
Infrastructure investments	414.1	7.1	(7.0)	Discounted cash flow, External financial report	Primarily discount rate on cash flow models
Property securities	141.7	7.1	(7.1)	Market capitalisation, Discounted cash flow	Primarily capitalisation rate
Investment contract liabilities	(6,378.4)	4.4	(4.4)	Discounted cash flow	Primarily expense assumptions
Investment and development property	3,710.7	153.9	(141.3)	Market capitalisation, Discounted cash flow	Primarily capitalisation rate
Total Level 3	**313.9**	**224.1**	**(209.5)**		

[1] The fair value of the asset or liability would increase/decrease if the credit spread discount rate or expense assumptions decrease/increase or if the other inputs increase/decrease.
[2] Specific asset valuations will vary from asset to asset as each individual industry profile will determine appropriate valuation inputs to be utilised.
[3] The effect of a change to reflect a reasonable possible alternative assumption was calculated by adjusting the credit spreads by a +/- one tier movement in internal credit rating bands, discount rates by between 50bps – 100bps, changing the valuation of the unlisted schemes by 5% and adjusting the expense assumption splits by 10%.

Note 13 Fair values of financial assets and liabilities (continued)

Level 3 reconciliation

The following table shows a reconciliation of the movement in the fair value of financial instruments categorised within Level 3 of the fair value hierarchy during the period:

	31 Dec 2018		30 June 2018		31 Dec 2017	
	Assets $m	Liabilities $m	Assets $m	Liabilities $m	Assets $m	Liabilities $m
Balance at the beginning of the period	6,398.3	6,585.3	6,459.4	6,691.2	6,459.4	6,691.2
Fair value gains/(losses)	85.9	117.0	315.2	190.6	104.7	105.1
Acquisitions	1,450.2	1,483.6	2,431.3	2,510.2	1,189.3	1,460.2
Maturities and disposals	(1,176.4)	(1,482.1)	(2,308.0)	(2,806.7)	(1,026.1)	(1,862.1)
Transfers to other categories[1, 2]	(65.8)	-	(499.6)	-	(19.0)	-
Balance at the end of the period	**6,692.2**	**6,703.8**	**6,398.3**	**6,585.3**	**6,708.3**	**6,394.4**
Unrealised gains/(losses) included in the statement of comprehensive income for assets and liabilities held at the statement of financial position date	62.4	(117.3)	264.3	(177.1)	125.4	(91.5)

[1] The Group transfers between levels of the fair value hierarchy as at the end of the reporting period during which the transfer has occurred.
[2] Transfers to/from other categories are due to changes in the market observability of inputs used in the valuation of financial instruments. There were no transfers between Level 1 and Level 2 during the reporting period. There were $216.0 million (30 June 2018: $39.8 million) of transfers into Level 3 and $281.8 million (30 June 2018: $539.4 million) of transfers out of Level 3 and into Level 2 during the reporting period.

Note 14 Collateral arrangements

Accounting policy

CLC receives collateral, where it is considered necessary, when entering into certain financial arrangements. The amount of collateral required is subject to management's credit evaluation of the counterparty which is performed on a case-by-case basis. At 31 December 2018, $125.4 million (30 June 2018: $173.8 million) of cash received from third parties as collateral is recorded in payables. CLC is not permitted to sell or repledge financial or non-financial assets held as collateral in the absence of default by the owner of the collateral.

CLC is required to pledge collateral, as part of the standard terms of transactions, when entering into certain financial arrangements. Cash paid to third parties as collateral is recorded in receivables. Other financial assets transferred as collateral are not derecognised from the statements of financial position as the risks and rewards of ownership remain with CLC. At the balance sheet date the fair value of cash and financial assets pledged are as follows:

Collateral pledged as security	31 Dec 2018 $m	30 June 2018 $m
Cash	279.7	241.3
Other financial assets[1]	5,682.2	4,986.8
Total collateral pledged	**5,961.9**	**5,228.1**

[1] Includes assets sold under repurchase agreements. Please refer Note 10 Interest bearing financial liabilities for more information.

Note 15 Contingent liabilities, contingent assets and other commitments

Warranties

Over the course of its corporate activity the Group has given, as a seller of companies and as a vendor of assets, including real estate properties, warranties to purchasers on several agreements that are still outstanding at 31 December 2018. Other than noted below, at the date of this report no material claims against these warranties have been received by the Group.

Parent entity guarantees and undertakings

The Company has extended the following guarantees and undertakings to entities in the Group:

1. A guarantee supporting the corporate banking facility and certain other financial commitments, such as hedging arrangements;
2. Letters of support in respect of certain subsidiaries in the normal course of business. The letters recognise the Company's intention to provide support to those subsidiaries so that they can continue to meet their obligations;
3. Australian Financial Services Licence deeds of undertaking as an eligible provider; and
4. Guarantees to support contractual commitments on warranties to certain third parties.

Third party guarantees

Bank guarantees have been issued by a third party financial institution on behalf of the Group and its subsidiaries for items in the normal course of business, such as rental contracts. The amounts involved are not considered to be material to the Group.

Contingent future commitments

CLC has made capital commitments to external counterparties for future investment opportunities such as development or investment purchases. As at 31 December 2018 there are potential future commitments totalling $366.9 million (30 June 2018: $408.8 million) in relation to these opportunities. Currently there are no requests from any of these parties to make payments. Contractual obligations for future property repairs and maintenance are in place but cannot be quantified until required.

Subsidiary guarantees

CLC has provided a guarantee to a third party regarding the performance of its subsidiary in respect of certain reinsurance arrangements.

Contingent tax assets and liabilities

From time-to-time the Group has interactions with the Australian Taxation Office in relation to the taxation treatments of various matters. Any potential tax liability resulting from these interactions is only provided for when it is probable that an outflow will occur and a reliable estimate of the amount can be made.

Other information

In the normal course of business, the Group enters into various contracts that could give rise to contingent liabilities in relation to performance obligations under those contracts. The information usually required by Australian Accounting Standards is not disclosed for a number of such contracts on the grounds that it may seriously prejudice the outcome of the claims. At the date of this report, significant uncertainty exists regarding any potential liability under these claims.

Note 16 Subsequent events

At the date of this financial report, no matter or circumstance has arisen that has affected, or may significantly affect, the Group's operations, the results of those operations or the Group's state of affairs in future financial years which has not already been reflected in this report.

Directors' declaration

In accordance with a resolution of the Directors of Challenger Limited, we declare that, in the opinion of the Directors:

a) the financial statements and notes of Challenger Limited and its controlled entities (the Group) are in accordance with the *Corporations Act 2001*, including:

   (i) giving a true and fair view of the Group's financial position as at 31 December 2018 and of its performance for the six month period ended on that date; and

   (ii) complying with Australian Accounting Standard AASB 134 *Interim Financial Reporting* and the *Corporations Regulations 2001*; and

b) there are reasonable grounds to believe that the Group will be able to pay its debts as and when they become due and payable.

On behalf of the Board

P Polson
Independent Chair

Sydney
11 February 2019

R Howes
Managing Director and Chief Executive Officer

Sydney
11 February 2019

Building a better working world

Independent Auditor's Review Report to the Members of Challenger Limited

Report on the Half-Year Financial Report

Conclusion

We have reviewed the accompanying half-year financial report of Challenger Limited (the Company) and its subsidiaries (collectively the Group), which comprises the statement of financial position as at 31 December 2018, the statement of comprehensive income, statement of changes in equity and statement of cash flows for the half-year ended on that date, notes comprising a summary of significant accounting policies and other explanatory information, and the directors' declaration.

Based on our review, which is not an audit, nothing has come to our attention that causes us to believe that the half-year financial report of the Group is not in accordance with the *Corporations Act 2001*, including:

a) giving a true and fair view of the consolidated financial position of the Group as at 31 December 2018 and of its consolidated financial performance for the half-year ended on that date; and
b) complying with Accounting Standard AASB 134 *Interim Financial Reporting* and the *Corporations Regulations 2001*.

Directors' Responsibility for the Half-Year Financial Report

The directors of the Company are responsible for the preparation of the half-year financial report that gives a true and fair view in accordance with Australian Accounting Standards and the *Corporations Act 2001* and for such internal control as the directors determine is necessary to enable the preparation of the half-year financial report that is free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express a conclusion on the half-year financial report based on our review. We conducted our review in accordance with Auditing Standard on Review Engagements ASRE 2410 *Review of a Financial Report Performed by the Independent Auditor of the Entity*, in order to state whether, on the basis of the procedures described, anything has come to our attention that causes us to believe that the half-year financial report is not in accordance with the *Corporations Act 2001* including: giving a true and fair view of the Group's consolidated financial position as at 31 December 2018 and its consolidated financial performance for the half-year ended on that date; and complying with Accounting Standard AASB 134 *Interim Financial Reporting* and the *Corporations Regulations 2001*. As the auditor of the Group, ASRE 2410 requires that we comply with the ethical requirements relevant to the audit of the annual financial report.

A review of a half-year financial report consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Australian Auditing Standards and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Independence

In conducting our review, we have complied with the independence requirements of the *Corporations Act 2001*.

Ernst & Young

Ernst & Young

T Johnson	L Burns
Partner	Partner
Sydney	Sydney
11 February 2019	11 February 2019

Additional information

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Richard Howes (Managing Director and Chief Executive Officer)
John M Green
Steven Gregg
JoAnne Stephenson
Duncan West
Melanie Willis
Leon Zwier

Company secretaries

Michael Vardanega
Andrew Brown

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Go electronic

Challenger can deliver all of your shareholder communications electronically, just update your details via Computershare Investor Services.

Online digital version of this report

The 2019 Interim Financial Report is available at:

› **challenger.com.au/shareholder**

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