MLC Investment Management

MLC's view and Strategic Overlay positions

March 2013

Dr Susan Gosling
Head of Investments
MLC Investment Management

Dr Ben McCaw
Portfolio Manager
MLC Investment Management

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Investment Management

The strong rise in the prices of riskier assets in 2012 and again in the first quarter of 2013 may seem to indicate that investors have become more optimistic about future economic fundamentals.

To an extent this is true. It would be foolish to ignore central bank pledges to 'do whatever it takes'. But in the manipulated environment in which we find ourselves, nothing is quite as it seems. Policy makers are supporting asset prices and supressing real interest rates to offset the debt burden and hopefully trigger a real economic response. Asset prices are rising partly on that hope, but also because central banks are almost forcing investors into riskier assets by cutting cash rates and pulling down bond yields. Riskier assets become more attractive as the returns of safer assets decline and their risk levels increase. This makes riskier assets look cheap in comparison. But the cheapness is artificial, and the higher prices go the less they are supported by the fundamentals. The sustainability of the equity market rally ultimately relies on economic fundamentals coming through.

Late in the March quarter we had a reminder that many problems remain to be resolved. The risk asset rally and bond yield run was followed by a rise in volatility and bond yield decline with the resurgence in uncertainty across the eurozone. Prior to that, the easy monetary policy and upbeat employment and housing data pushed both equity markets and bond yields higher. In bond markets, longer yields in the US and Australia ratcheted higher on better than expected economic data, but lost momentum on the Cyprus bailout plan.

The Cyprus-driven change of market sentiment wasn't caused by the bailout per se, but the fact that depositors are on the hook for part of the recapitalisation budget. This in turn provoked contagion and a heightened risk of bank runs in larger troubled peripheral countries. This is an unfortunate but (for us) not surprising turn of events. The problems of the eurozone never went away; they were just smouldering in the background while the US caught the market's eye with recoveries in the housing and labour markets and an underwriting commitment by the US Federal Reserve (the Fed) to continue asset purchases. Japan also provided a further leg-up to risk appetite as reflation became more credible—but far from guaranteed—with policy and personnel changes at the Bank of Japan

From a longer term perspective, it is far less clear how current problems embedded in the global economy will work out. A key question is whether the expectation of higher growth can in fact generate higher growth. Soros's concept of 'reflexivity' is helpful here, as it points out that there is a link between beliefs and behaviour. Believing something even if the belief is false can have real effects. Belief can generate a self-fulfilling upward spiral in asset prices. Beliefs can also change spending and investment behaviour and impact the real economy, which is what central banks are hoping for.

What is Strategic Overlay?

- The process we use to make adjustments to our portfolio asset allocations.
- We base these adjustments on our medium-term assessment of the market environment.
- Our assessment of return potential, risk and diversification relies on comprehensively assessing what the future might hold. By considering a range of potential futures (or scenarios) we can build a deeper understanding of risk and generate more reliable returns with the required risk control.
- We contemplate what might go wrong and what might go right, and assess how reliably (or not) different asset allocations will help achieve our investors' objectives. We'll generally reduce exposure to assets if we believe they have high risk that is not matched by a commensurately high return. We prefer exposures with limited downside risk compared to upside potential.

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Our investment approach revolves around understanding what the future might hold, rather than forecasting the one future that will unfold. The power of this process lies in thinking through ahead of time what could happen. Making investment decisions on the basis of possible future risks and opportunities provides clarity about the trade-off between risk and return, and leads to more effective portfolio diversification. Today there is a wide range of possible futures. Some are relatively benign and include a real economic growth response; others are more difficult and take into account both lack of real growth and the potential for a rise in inflation.

As we all know, the problem the developed world faces is too much debt. For debt levels to decline we need economic growth rates in excess of interest rates. While policy makers have good control of the latter, they have much less direct control of the former. The drag of fiscal austerity increases in the US this year and that reduces growth, which leaves monetary policy as the primary policy tool. Monetary policy is pushing share prices higher. To understand what the future might hold, we need to consider the ways in which this might translate into higher growth. We also have to consider whether the impact might be more on nominal rather than real economic growth—in other words, the rise could be in inflation rather than output.

This presents us with a relatively broad range of scenarios that require consideration. This in itself is not a problem; rather, the challenge of the current environment is created by starting valuations for both equities and debt. While equity markets appear to be assuming an uncomfortably low level of risk, debt markets have been manipulated into a position of low starting yields and offer at best very weak diversification. This presents a dilemma for investors while risk is high, as there is no clear safe haven in which to hide.

Looking forward

While experimental monetary policy and financial repression is driving asset prices higher, keeping bond yields low and the Australian dollar (AUD) high, the complexity and uncertainty of the investment environment persists. The range of credible future scenarios is still as wide as it was a year ago. The starting point of high equity valuations and low bond yields further complicates the outlook and challenges the return we can expect for diversified portfolios.

The biggest dilemma facing investors is the heightened risk of what are usually rare outcomes. On the one hand it is possible that the forces of deleveraging overwhelm unorthodox monetary loosening, leading to a period of stagnation and poor returns for equity investors without commensurate gains from bonds. On the other hand, it is pretty easy to argue that it's folly to fight the Fed and that financial repression will drive risk and asset prices higher, perhaps to bubble levels. This presents a conundrum: the probability of both a highly positive and a highly negative scenario may be rising.

Our scenarios approach not only identifies the risks, but also seeks the best case paths out of the current problems. Policy makers are doing their best to navigate these difficult and uncharted waters. We can hope that they are able to walk the tightrope between asset and price inflation risk on one and stagnation on the other. But, regardless of how close they come to the best case, events in Cyprus remind us that the path is unlikely to be smooth. The threat of a prolonged slowdown in the real economy globally will remain throughout the deleveraging cycle and austerity pressures will persist until poor fiscal positioning in the developed world begins to change. Europe will remain a source of risk until significant political, structural and economic (rebalancing) progress is made. There is still no convincing roadmap to a sustainable, stable eurozone.

We remain wary of an inflationary resolution to the debt problem. History suggests

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that we should be worried that today's experimental monetary policy settings will result in rising inflation. We think in simple terms—if the supply of something increases massively its price falls. If a single country 'prints money', its exchange rate falls. If there is collective printing, all currencies are devalued through inflation. We must take note of the old adage that 'inflation is always and everywhere a monetary phenomenon'.[1] With no roadmap for the withdrawal of policy stimulus, the inflation risks from quantitative easing are much bigger than currently appreciated.

In the near term, ultra-low borrowing costs could discourage private savings, reignite leverage and push against eventual rebalancing of the economy, and set a path toward inflation, bust or both. There is a chance, though, that policy and psychology somehow mesh globally to restore balance and maintain growth, and that any inflation outbreak remains contained. Such an outcome relies on either productivity gains (mainly from reform but maybe also from technology, eg, shale gas, and further trade liberalisation) to elevate growth. This, together with a dose of stable inflation, is what's required to defeat debt. Unfortunately, while this is in many respects an attractive and benign scenario, higher inflation spells risk for savers.

As we have said before, complexity remains more static than pricing. This means that decisions tend to be most influenced by movements in asset class pricing. For now, we believe that exposure to foreign currency continues to provide an efficient source of diversification that partially offsets the loss of diversification from extremely low government bond yields. Stock selection becomes a more important component of return generation, meaning that private equity—with a very high 'alpha' component—is an attractive allocation that brings the benefit of smoother returns.

Our scenarios

We assess investment strategy using our proprietary scenarios model. The scenarios model provides a detailed map of what the future might hold—both the things that could go right and the risks that may be faced. This framework enables more informed choices to be made in positioning portfolios, with greater clarity about exposure to both risk and opportunity and the trade-offs between these.

The scenarios framework comprises both the generic broad set of 40 scenarios which are designed to have relevance from any starting point and which provide a consistent barometer of risk and return through time, and a smaller set of focused or tailored set of scenarios which pivot around the key characteristics and uncertainties in the current environment. The tailored set might be seen as consisting of the most obvious potential futures—though we are aware that what seems most obvious now may not be after the event. These two scenario sets in combination are used to assess portfolio positioning. Both sets of scenarios are used in our active investment process that we refer to as Strategic Overlay.

The tailored scenario set consists of the same 13 scenarios we have had for some months. They pivot primarily around the decisions of policy makers, the impact of these decisions on investors' expectations and behaviour, and the flow through into the real economy. In looking at the tailored scenarios, it seems to us that the most credible transition paths to growth normalisation are still likely to involve an inflationary resolution of the debt overhang and a significant contribution from high growth markets. However, we also take into account the potential for decisive reforms to restore growth potential faster than is currently anticipated. The prospect of austerity-fed deflationary scenarios is also captured within the set.

1 Friedman, Milton, and Anna Jacobson Schwartz, 1963a. 'Money and Business Cycles', Review of Economics and Statistics, 45(1), Part 2, Supplement, pp. 32–64.

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The following tailored scenarios are current at 31 March 2013 and are shown in order from highest probability to lowest probability.

Scenario	Probability	Description
Extended quantitative easing	Higher	Central banks of the US, UK and Japan continue to print currency. The ECB also embarks on quantitative easing. This scenario includes the impact of expanded USD, GBP, JPY and EUR liquidity which principally finds its way into asset prices, rather than spurring consumption. Bubbles are particularly pronounced for high growth economies (Asia and even Australia) and real assets as investors seek inflation protection. The AUD remains very strong against major trading crosses. China continues to maintain a closed capital account but tends to accept more foreign direct investment. Sourcing these funds externally—rather than from within China—could act as a 'backdoor bailout' of China's poorly performing projects from the 2008/9 stimulus.
Two speed recovery		Asia continues to over-invest while the developed world more or less continues to stagnate or at best, achieve only modest growth. Could evolve into a three speed economy or precede a hard landing for China. This scenario is differentiated by economic behaviour of emerging markets and Australia (by virtue of the continued investment in fixed assets). This is a strong scenario for both the Australian economy and the AUD. Demand for bulk metals remains high, with supply continuing to lag. Energy demand is also high, as is the demand for industrial metals.
Three speed global economy (China soft landing)		The world splits into three distinct economic growth zones. China and other emerging markets continue to grow strongly, the US grows below trend (but is not woeful), while Europe stagnates. This scenario is a variant of the two Euro-scenarios that do not involve a break-up. The key difference is that the US and emerging markets do not suffer as distinctly as they do in the Euro-specific scenarios. In other words, the trade disruption assumed in the other scenarios is augmented by increased ex-Europe international trade—Europe is essentially excised and isolated. Greater domestic activity also plugs the output gap to a degree.
One speed slow growth world		There is growth convergence as persistent slow growth in the developed world spills over into the emerging world.
Early re-leveraging		Low yields and a period of policy stability prompt a resumption of credit growth in developed economies. Economic growth picks up more quickly than expected and unemployment recedes. Debt imbalances begin worsening again as the developed world quickly re-levers and Asia focuses on investment. This scenario could precede an inflation shock, a second crisis or, if policy makers are nimble enough, a transition to a mild inflationary resolution.
Developed market austerity, recession, stagnation		A distinctive and hence important scenario. Prolonged deleveraging of both the private and public sectors combined with lack of policy reform removes growth potential for developed economies. This scenario is not dependent on a particular European outcome, but simply assumes that the environment is highly constrained. Developed market economic expansion is negligible and emerging markets slow down significantly but avoid a crash. Equities perform poorly. Commodities fall. Nominal yields rally further and remain low.
(Mild) inflationary resolution	Lower	Monetary stimulus and some form of resolution for Europe are combined with sensible policy to stimulate growth. Widespread USD, GBP (and Euro) liquidity provides inflationary pressure that is countered to a degree by slightly sub-capacity growth … a very fine balance, and as such a very low probability. Inflation is high enough to help inflate away the debt burden. Emerging markets experience more severe inflation than the developed world, slightly normalising the growth differential across the emerging markets/developed markets divide.

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Scenario	Probability	Description
Reform	Higher	A growth upside scenario contingent upon coordinated reforms that address inefficiencies that are idiosyncratic to particular economies (eg labour in the UK, infrastructure in the US, sector contribution to growth in China and structural issues in the Eurozone). This is an unlikely scenario, but is possible and has distinctive growth outcomes. Most economies return to trend growth with moderate inflation.
China hard landing		A combination of poor allocation of capital, greater than anticipated loan losses, lower external demand, currency appreciation and monetary policy error causes a crash in Chinese output. This most likely emanates from a property crash, though failure to contain inflation and/or social unrest are also possible flash points. Australia suffers severely under this scenario (recession). Income is shocked and the AUD corrects to sub-PPP rates. This causes a flow-on impact through to employment (weakness) and housing crashes. Thus, both materials and financials are hit, causing very poor Australian shares performance. Japan and Korea also suffer due to their export trade exposure to China. The US, Europe and the UK are somewhat insulated from the Chinese crash, the main effect being a disruption to imports.
Inflation shock		Similar to stagflation, though assumed growth is higher. Sharp rise in inflationary expectations.
Stagflation		With no roadmap for the withdrawal of policy stimulus, the inflation risks from quantitative easing may be much bigger than are currently appreciated. In this scenario, policy stimulus is not withdrawn fast enough, perhaps coupled with increased policymaker tolerance for an inflationary work-out which gets out of hand. Run-away inflation in this scenario is likely to be negative for real growth, which could in turn lead to 'stagflation'.
Extended risk aversion		A generic scenario to capture prolonged aversion to risk.
Sovereign yield re-rating	Lower	Low starting yields are a valuation risk for bonds. Yields could rise to more normal levels even in the context of low growth/inflation expectations. High government debt burdens (UK/core Europe/Japan/USA) provide the potential for a bond vigilante-style re-rating of sovereign yields. This is not a likely near-term scenario, but given the low yields and high level of indebtedness as a starting point, there is a risk that the environment could progress to one where apparently safe paper becomes compromised. This in turn increases the cost of funding and reduces corporate activity. At the same time, government spending is curtailed by enforced austerity in an effort to limit yield increases, remain liquid and stay solvent. This may be a precursor to a 'Prolonged stagnation' scenario.

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Our current positioning

Unconventional monetary policy is distorting all major asset classes, particularly currency, bonds and equities. These distortions mean that risk-aware strategies (such as the MLC Long-Term Absolute Return portfolio, 'LTAR'), need to accept a lower prospective return in order to avoid taking unacceptable risks. Greater participation in genuinely uncorrelated strategies and benchmark-agnostic investing help, but do not fill the gap entirely. On the other hand, our more peer-aware portfolios (the MLC Horizon Series and MLC Index Plus portfolios) benefit not from large changes in asset allocation but by maximising diversification efficiency as much as is feasible.

With traditional sources of diversification compromised, we need to look hard for alternative forms of portfolio protection. Our scenarios framework helps us understand the difference between upside potential and downside risk. Where there is a significant asymmetry (ie the upside potential is not equal to the downside risk) we have an opportunity that we can exploit to increase the return to risk taken. There are two important asymmetries at present: in currency and bond markets. In bond markets we observe that while bond yields could decline further, the extent of this is limited relative to the potential for yields to rise. This means that the potential loss from shortening duration is low relative to the potential gain. Similarly, while there are circumstances in which the AUD could appreciate (and we assume it does in a number of our scenarios), on current pricing the upside factors are largely priced in, while the downside risks are not. Because of this, we have significant exposure to unhedged foreign assets within LTAR and remain overweight to foreign currencies across MLC Horizon 2 to MLC Horizon 7.

Our positioning against the AUD does not mean that the scenarios process 'expects' the Australian dollar to fall—indeed, two of our tailored scenarios expect the dollar to rise (others expect the AUD to fall, and by a greater amount). Instead, the model suggests that the AUD is an efficient source of diversity that decreases overall risk, allowing greater exposure to other sources of risk than we would otherwise not have carried in the portfolios. In short, in many scenarios the AUD is a perceived safe haven that turns out to be something of an illusion.

Shortening the duration of nominal fixed income exposures is particularly appropriate given the concerns about an eventual rise in inflation. Although this will not necessarily be a highly adverse scenario, it does present investment challenges. Inflation is like a tax on savers. We no longer just need positive returns; we need returns that exceed the moving target of rising inflation. The most obvious risks lie in nominal bonds, which are extremely expensive, have very limited diversification potential, and are vulnerable to rising inflation. On the other hand, despite also looking expensive, inflation-linked bonds can still be a valuable inflation hedge. Hiding in cash may not help—increasingly this is true in Australia as the policies of the major central banks spill over into the domestic economy through an overvalued exchange rate which forces cash rates lower. Equities offer inflation hedge potential (though this is not uniform—stock selection matters)—but this will be negated if share prices run too far ahead of fundamentals. A bubble in equity markets would no doubt be welcomed in the short term, but would create additional unpleasant risks.

If we are to navigate this environment successfully, we must not only be cognisant of the potential for higher inflation and position portfolios accordingly, but we must also continuously review the effectiveness of our inflation hedge both across and within asset classes.

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MLC Long-Term Absolute Return Portfolio

The risk profile of LTAR remains somewhere between MLC Horizon 4 and MLC Horizon 3. However, LTAR's absolute return focus means that the portfolio's positioning is very different to that of the MLC Horizon Series and so performance in any specific scenario compared with the MLC Horizon Series of portfolios is quite variable. The opportunity for diversification has been progressively shrinking as relative safe havens are progressively being consumed—this is the current challenge in positioning LTAR. We continue to seek to enhance return potential while controlling risk exposure.

	MLC Long-Term Absolute Return Portfolio weights	Comment
Australian shares	Steady allocation	Relatively attractive in terms of probability weighted outcomes but relatively high tail risk
Global shares (unhedged)	Steady allocation	We continue to prefer unhedged global equity exposures. This is for risk control reasons, appropriate on the basis of an exceptionally strong local currency and significant global uncertainty.
Global shares (hedged)	Steady allocation	
Defensive global shares (unhedged)	Steady allocation	The portfolio has a strong bias to absolute rather than index relative equities.
Low Correlation Strategy	Reduced allocation	We will be reducing exposure as discrete insurance-related investments exposure comes into the strategy.
Multi-asset real return strategy	Steady allocation	This remains a key part of the strategy – offers efficiencies by breaking down asset class barriers via absolute return focus.
Emerging markets strategy	Steady allocation	Multi-asset exposure with absolute return and risk orientation.
Global private assets	Steady allocation	Less efficient market coupled with top tier manager make this attractive.
Global property securities	Zero direct exposure	Prefer the broader opportunity and absolute return orientation of defensive global equities.
Global government bonds	Zero direct exposure	Unattractive, with very limited diversification benefit.
Australian inflation-linked bonds	Steady allocation	Inflation hedge remains attractive.
Borrowings	Lower allocation	Reward for risk is shrinking as asset prices rise.

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MLC Horizon Series of portfolios

There were no changes to the strategy in the March quarter. However, the duration exposure in the debt strategy remains under careful review.

	MLC Horizon Series of portfolios weights			Comment
	Under	Neutral	Over	
Growth and other assets		**X**		
Australian shares		X		
Global shares (unhedged)			X	We continue to be overweight foreign currencies (underweight the Australian dollar), with an increased allocation to unhedged global shares at the expense of hedged global shares. This is a risk control position, appropriate on the basis of an exceptionally strong local currency and significant global economic uncertainty.
Global shares (hedged)	X			
Global property securities		X		Retain neutral allocation
Global private assets		X		Retain neutral allocation
Emerging markets multi-asset strategy		X		Maintained
Multi-asset real return strategy		X		Maintained
Low Correlation Strategy		X		Maintained
Fixed income		**X**		Reduced duration maintained
Australian bonds – All Maturities			X	1% overweight (MLC Horizon 4 and 5 only)
Australian inflation-linked bonds		X		Retain neutral allocation
Global bonds – All Maturities	X			1% underweight MLC Horizon 4 and 5 only
Global absolute return bonds		X		Retain neutral allocation
Global government bonds	X			Retain underweight global government bonds and overweight cash
Global non-government bonds		X		Retain neutral allocation
Global multi-sector bonds		X		Retain neutral allocation
Global non-investment grade bonds • high yield bonds • bank loans • mortgages		X		Retain neutral allocation

MLC's view and Strategic Overlay positions

MLC Index Plus portfolios

There were no changes to the strategy in the March quarter. However, the duration exposure in the debt strategy remains under careful review.

	MLC Index Plus portfolio weights			Comment
	Under	Neutral	Over	
Growth assets		**X**		
Australian shares		X		Retain neutral allocation
Global shares (unhedged)			X	We continue to be overweight foreign currencies (underweight the Australian dollar), with an increased allocation to unhedged global shares at the expense of hedged global shares. This is a risk control position, appropriate on the basis of an exceptionally strong local currency and significant global economic uncertainty.
Global shares (hedged)	X			
Global property securities		X		Retain neutral allocation
Fixed income		**X**		Reduced duration maintained
Australian bonds – All Maturities			X	1% overweight (Index Plus Balanced and Growth only)
Australian inflation-linked bonds		X		Retain neutral allocation
Global bonds – All Maturities	X			1% underweight (Index Plus Balanced and Growth only)
Global absolute return bonds		X		Retain neutral allocation
Global government bonds	X			Retain underweight global government bonds, and overweight cash
Global non-government bonds		X		Retain neutral allocation
Global multi-sector bonds		X		Retain neutral allocation

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Return potential

The return potential chart shown right provides a perspective on prospective return and risk. Bond sectors continue to show very compressed return potential and relatively high risk. The implications are clear: bonds remain risky. Over the quarter, the return potential for both Australian and global equities shifted down slightly as the market rallied and valuations expanded.

The probability-weighted real returns are shown in the graphs (diamonds). For comparison, we've provided long-term 'normal' return expectations which are set by considering a stable fair value world—these are shown by the horizontal lines. Also, as an indicator of how uncertain these returns are, we've taken the bottom (and top) 10% of the scenario real returns and calculated the probability-weighted average in those 'tail' outcomes. These are shown in the bars.

We've also included a return potential graph for the portfolios in Appendix 1.

40 Scenario Set Probability Weighted Real Returns (March 2013)

(5 years, 0% tax with franking credits, pre fees, pre alpha)

Source: MLC Investment Management

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The probability-weighted real returns are shown in the graphs (diamonds). For comparison, we've provided long-term 'normal' return expectations which are set by considering a stable fair value world—these are shown by the horizontal lines. Also, as an indicator of how uncertain these returns are, we've taken the bottom (and top) 10% of the scenario real returns and calculated the probability-weighted average in those 'tail' outcomes. These are shown in the bars.

Tailored Scenario Set Probability Weighted Real Returns (March 2013)

(5 years, 0% tax with franking credits, pre fees, pre alpha)

Source: MLC Investment Management

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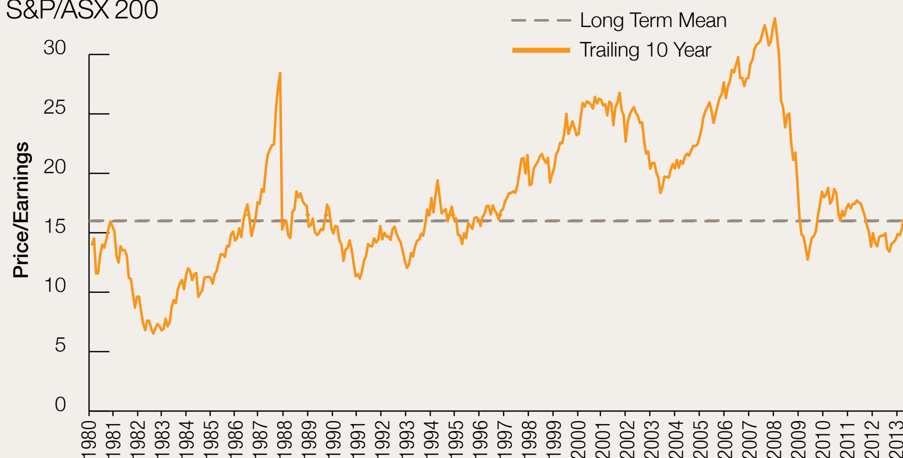
Asset class indicators

Our view of the main asset classes is as follows.

Australian shares

Market indicator

S&P/ASX 200



Source: Datastream **March**

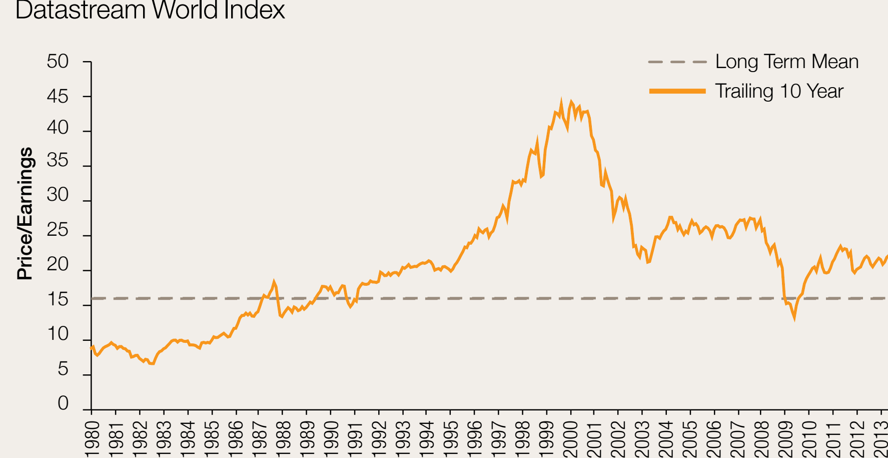
Comment

Australian shares continued to rally in Q1 2013, adding to the strong 2012 performance. Earnings continue to be revised down, leaving P/E expansion as the sole driver of positive market return. Performance over the quarter was strong across most sectors, with the notable exception of Materials, which has been impacted by lower commodity prices. While the market is less attractive than at this point last year, it remains within a reasonable range of normal valuation levels.

Global shares (including currency)

Market indicator

Datastream World Index



Source: Datastream **March**

Comment

Global share prices rose in Q1 2013, continuing on from the positive returns in 2012. Global earnings per share are now a little higher than Q4 2012, but still lower than this time last year. P/E multiple expansion continues to account for most of the returns experienced—global share markets are effectively borrowing returns from the future.

The AUD tends to be correlated with risk appetite. When share markets decline, the AUD tends to depreciate, which partly offsets the decline in global share returns. While there are some changes to correlations in today's unusual environment, there is still benefit in reducing exposure to the AUD to increase the robustness of returns in a number of (though not all) risk scenarios.

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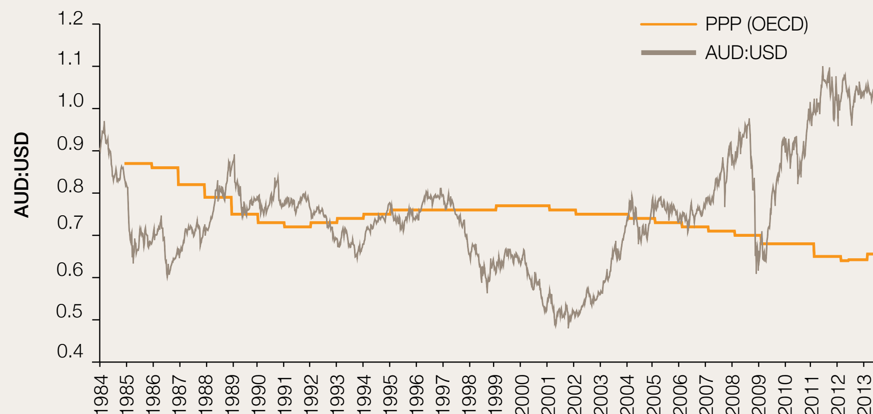
Asset class indicators continued

Australian dollar

Market indicator

Australian Dollar Purchasing Power Parity

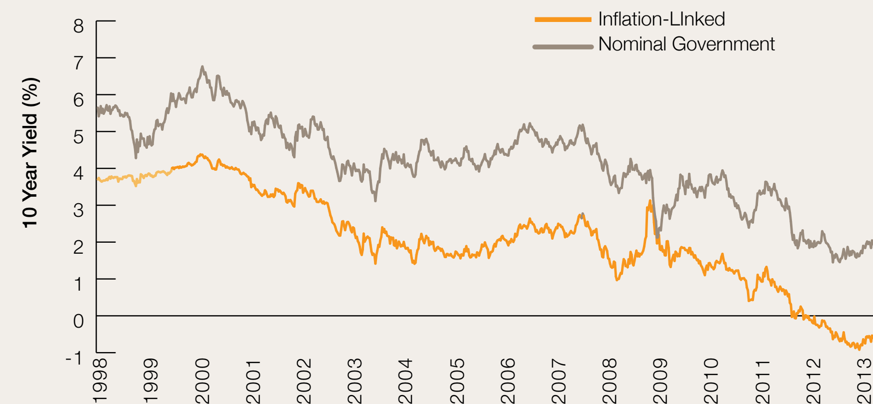


Source: Bloomberg **March**

Global government bonds

Market indicator

10 Year Bond Yields – United States



Source: Bloomberg **March**

Comment

Nominal yields on US treasuries were only marginally higher over the quarter. The Strategic Overlay position to reduce our exposure to global sovereign and instead favour exposure to domestic cash in the All Maturities Debt Strategy detracted from performance during the quarter. We will retain this position, given the extremely low level of yields in these markets and the risk of capital loss. This position reflects the increasing risks of spiralling public sector debt, but also recognises that yields will rise if and when confidence in a self-sustaining recovery begins to emerge.

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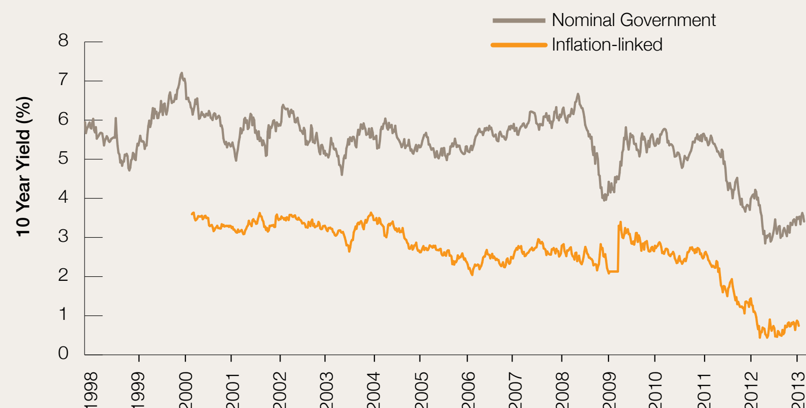
Asset class indicators continued

Australian government bonds

Market indicator

10 Year Bond Yields – Australia



Source: Bloomberg **March**

Comment

Australian government nominal bonds yields inched higher during the quarter, following the rise in US yields. Domestic economic data over the quarter was relatively mixed, reflecting the difficulty facing the economy of adjusting to lower commodity prices and a stubbornly strong currency.

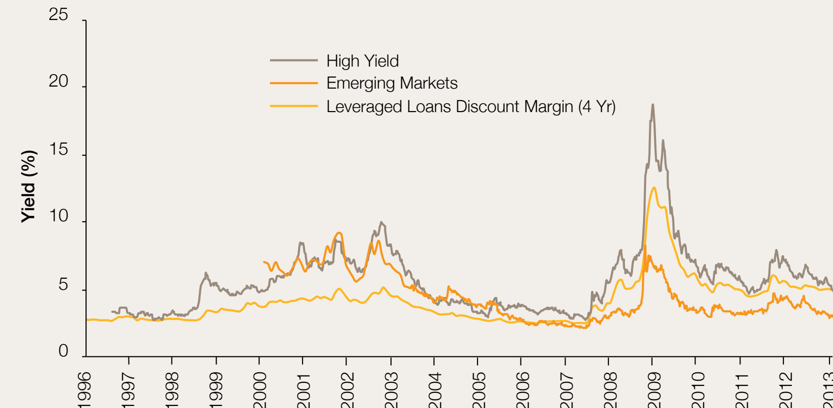
The Reserve Bank of Australia held the official cash rate steady over the quarter following the 50 bps worth of cuts at the end of 2012. The cash rate is presently 3.0%, which is equal to its historic low, last seen during the GFC in early 2009.

Given the inflation priming by multiple central banks and the prospect of higher inflation from a depreciating AUD, our analysis indicates that domestic inflation-linked bonds remain an attractive asset compared with nominal equivalents.

Non-investment grade bonds

Market indicator

Fixed Income Spreads



Source: Credit Suisse, Barclays **March**

Comment

Performance across the various credit sectors was solid, in spite of ongoing bond market volatility. US high yield corporate bond spreads narrowed by almost 50 bps during the quarter as investors continued to look for higher yielding assets. Global USD emerging markets bonds sold off slightly, with relative bond spreads expanding by approximately 35 bps during the quarter. The solid performance of many credit sensitive assets continues to be due mainly to the combination of relatively low developed bond market yields and confidence that central banks will continue to provide monetary stimulus and keep official cash and government bond rates low.

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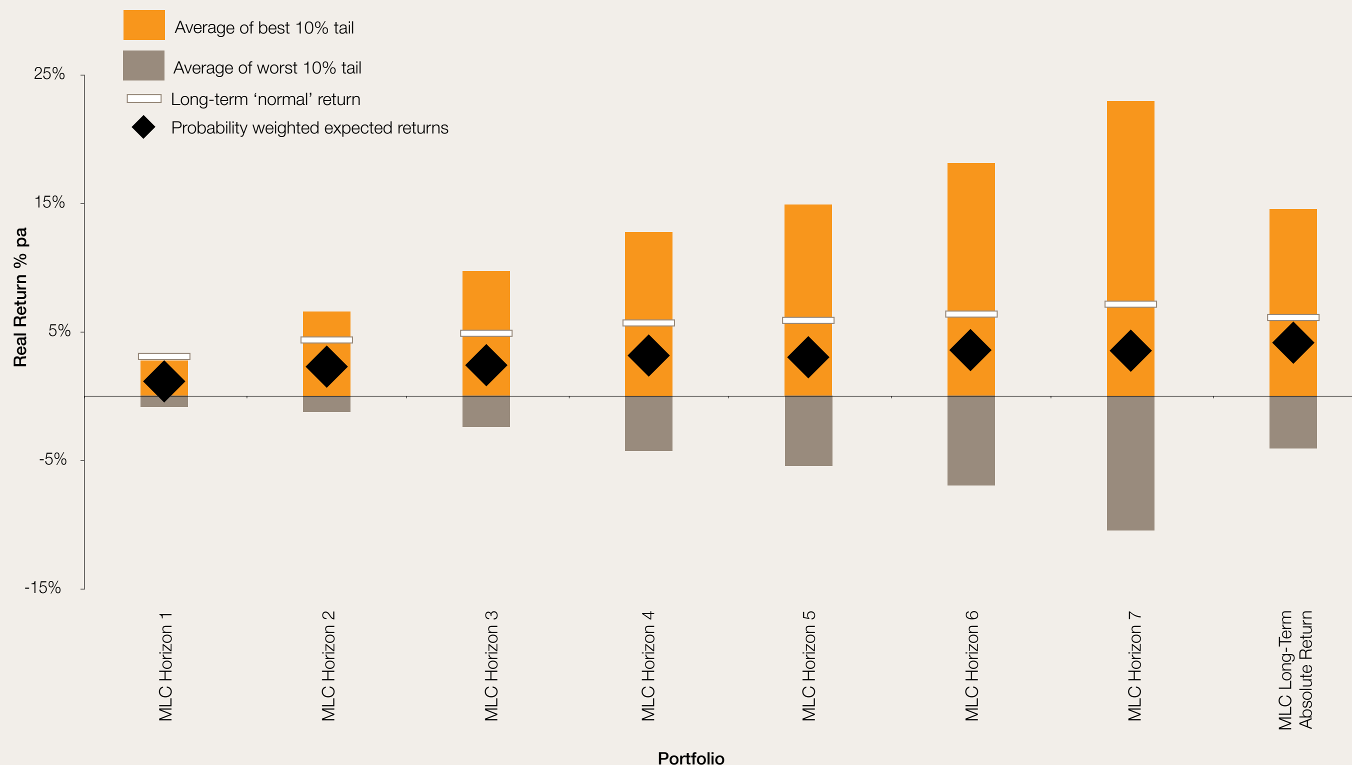
Appendix 1

Diversified portfolio prospective return potential is below typical levels when viewed from the perspective of the broad (or generic) 40 scenario set. This is primarily due to very low starting yields for debt assets,which are offsetting reasonable (though sub-par) prospective returns from shares.

40 Scenario Set Probability Weighted Real Returns - Strategic Overlay allocations

(5 years, 0% tax with franking credits, pre fees, pre alpha)



Source: MLC Investment Management

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