MLC's Diversified Portfolios

MLC Investment Management

MLC's view and Strategic Overlay positions

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MLC's investment perspective, scenario insights & portfolio positioning

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Policy makers were again the key drivers of financial markets during the June quarter.

The quarter started with strong equity returns and a positive market response to the dramatic policy shift in Japan, where the government announced three policy 'arrows' aimed at ending deflation. The first arrow is monetary stimulus of a magnitude that completely upstages quantitative easing (QE) in the US (about three times the size). The second is a dramatic fiscal stimulus (2.7% of GDP) and the third, all-important arrow consists of (initially unspecified) structural reforms. Though the efficacy of these policy measures is uncertain and controversial, share markets, particularly in Japan, initially welcomed the news. However, by the end of May, doubts had crept in about whether the third arrow would live up to expectations.

Investors became more uncertain, and markets more volatile, following remarks by US Federal Reserve (Fed) Chairman Bernanke that tapering of QE is not far off. It is, however, far from clear that the US economy is close to meeting the Fed's criteria to commence tapering, as personal consumption expenditure (PCE) growth remains weak. While there is a wealth effect from rising share and house prices, for PCE growth to pick up sustainably it needs support from rising wages, which has a flow-on effect to profit margins, or higher employment. To date, the main reason for the decline in the unemployment rate has been lower participation—discouraged workers have dropped out of the labour force.

It may be that the comments about tapering were aimed at dampening excessive risk-taking behaviour (evidenced by the re-emergence of pre-GFC behaviours such as issuing covenant-light loans). Even if this is the case, markets have had a reminder that QE will not go on forever, which has driven share markets down and bond yields higher. Towards the end of June both bond and equity markets were rallying on weak economic news and selling off on strong. The US 10 year Treasury yield rose from 1.84% to 2.48% at the end of the quarter.

For Australian investors, the other distinguishing characteristic of the June quarter was the decline of our dollar. The AUD started the quarter at 1.04 against the USD and declined sharply through May and June, reflecting concerns about the domestic economy and a downward revision of growth expectations for China. This decline is not unexpected; we have for some time questioned the sustainability of the currency, which has been significantly above a range of fair value measures. We have now seen the AUD lose some of its safe haven status and, while there may be some reversal, we don't expect that previous highs will be revisited any time soon.

Strategic Overlay: MLC's active investment approach

- Strategic Overlay is the process we use to make adjustments to our portfolio asset allocations, currency exposure and sector strategies.
- 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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During the quarter the MLC Investment Management Capital Markets Research team undertook a research trip to China with one of our managers (JF Capital Partners). The team met a range of companies (both state owned and private enterprises), government officials and other analysts and commentators. The major themes that emerged confirmed what we had suspected: that there has been a structural shift towards lower growth. This has important implications for Australia, given that our key exports have been iron ore and, to a lesser extent, metallurgical coal to China. Our fears about the risks created by rising debt levels in China were also confirmed, which creates the potential (though not certainty) for a crisis scenario at some point. While this is not an immediate prospect, what is important in the near term is that it constrains the degree of freedom of monetary policy. In terms of policy settings, it appears China is now in a new era of moderation and significant stimulus should no longer be expected in response to economic weakness. In addition, if the excesses and vulnerabilities created by the post-financial crisis stimulus are not resolved, a crisis may ultimately be unavoidable. Again this has implications for Australia, particularly the extent of tail risk.

More generally, the eurozone remains a potential source of instability. The inconsistency of monetary union without fiscal union remains unresolved. While current accounts in the eurozone periphery have improved, this is due to a collapse in demand, so budget deficits and public debt levels are rising. Europe is still treading water, biding time while bond investors seem to give the political will to act the benefit of the doubt. Yields in peripheral countries rose during the quarter, but only to match global markets (except for a spike in response to the austerity-fed political ructions in Portugal).

Political instability extends beyond Europe. Egypt is a recent flashpoint, with the military taking control after violent protests erupted due to dissatisfaction with the leadership team installed only a year ago. Nearby Turkey is troubled by internal tensions and parts of South America (including Brazil) are watch-points for unrest. Meanwhile, the situation in Syria continues to fester, while North Korea and Iran have slipped off the news radar. While these situations in isolation do not directly threaten global stability, they are a reminder that political and social tensions are a material source of risk.

Performance in review

The June quarter saw modest returns compared to the financial year as a whole. The first three quarters mirrored our extended quantitative easing (EQE) scenario. EQE is a manipulated environment in which policy makers support asset prices rates to offset the debt burden and hopefully trigger a real economic response. In the June quarter, a reminder from policy makers that QE cannot last forever shook investor confidence and created a different environment, with investors contemplating the consequences of tapering. The policy changes in Japan drove share prices there sharply higher and the yen sharply lower against the US dollar, but weren't enough to more widely offset the prospect of a policy change in the US. It is worth noting that the depreciation of the yen is reflationary for Japan, but delivers a deflationary shock to the rest of the world. For Australia, the change in perception of economic growth potential in China, together with the Fed's expectations about tapering QE, led to the decline in the Australian dollar we have long expected.

Equity market volatility in the June quarter hinted at the vulnerability that occurs when assets are purchased because they look cheap compared with something which is very expensive (nominal bonds). The relative cheapness was artificial, and the sustainability of the equity market rally relies on economic fundamentals improving.

Over the financial year, the strong equity market returns meant that traditional diversified funds like the MLC Horizon portfolios enjoyed robust returns. In such environments real return funds, such as the

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MLC Long-Term Absolute Return Portfolio (LTAR), will tend to lag because managing these funds requires that risk control always be maintained. The risk control focus of the real return portfolios means their positioning will change significantly over time. The benefit is greater certainty of return outcomes, as these funds seek to ensure an acceptable outcome even when markets disappoint. While traditional diversified funds provide a high level of certainty about portfolio positioning, they are more reliant on markets to deliver an acceptable outcome. The difficult June quarter therefore favoured real return funds above traditional funds.

Looking forward

Fed Chairman Ben Bernanke has signalled that the central bank could begin to unwind its massive program of quantitative easing sooner than previously thought. However, asset prices continue to be held aloft by the extraordinarily accommodative stance of monetary policy. Bond yields, although higher, are still very low, and equities, though lower, are still rich relative to earnings. The AUD also remains elevated against rational measures of fair value. 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, as it is unclear how current problems embedded in the global economy will work out.

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 will overwhelm unorthodox monetary loosening, leading to a period of stagnation and poor returns for equity investors without equivalent gains from bonds. On the other hand, it can be argued 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 the difficult and uncharted environment. We hope that they are able to walk the tightrope between asset and price inflation risk and stagnation on the other. The wide-reaching price action spurred by the Fed's attempt to modulate QE expectations—whatever the underlying motive—serves as a blunt reminder that the troubles of yesterday are not solved but have been ushered into the future. Nobody knows for sure if QE 'works', but investors should understand that imbalances that have accrued must be addressed by taking from somewhere. Where this 'take' comes from is uncertain but broadly speaking, savers are on the line. Despite the general reduction in private sector leverage in the US, aggregate levels of indebtedness remain high after growing too fast relative to GDP growth over the last decade. Remembering the basic principle that in a world of net positive equity, every debit is covered by an asset, there is by definition too much asset value relative to economic output. The corollary of this is that balance sheets and therefore the rate of wealth accumulation must, at some stage, grow at a slower pace than GDP. When the adjustment occurs and how the adjustment occurs are both impossible to forecast—all we can do is think about the possibilities of how such an adjustment might take place and the consequences the adjustment paths will have on economic growth, inflation and asset prices. Policy exerts a major influence over the direction of normalisation, but whatever the approach, policy alone does not make avoiding disruption a certainty. Moreover, there is a genuine risk that a declining trend in indebtedness could reverse well before debt levels return to something like normal; such a premature 're-leveraging' is a distinct possibility, particularly in a more confident investment environment.

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We remain wary of an inflationary resolution to the debt problem. History suggests 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 greater than are currently appreciated.

In the near term, ultra-low borrowing costs could discourage private savings, reignite leverage and push against rebalancing, 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) and/or higher employment to elevate growth. This, 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. The medium term scope for a change in policy also forms an important part of our tailored scenario set. Withdrawal of QE without growth could lead to a prolonged period of stagnation, or worse, a depression. Both of these scenarios are problematic for stocks—especially from this starting point—while the relatively low starting yields for bonds dampens the payoff that fixed income investments would 'normally' provide.

The eurozone's problems, as well as imbalances both in China and between China and its trading partners, plus Japan's reflation jolt, add further complexity to an opaque starting point. While these issues are separate, their resolutions have a nexus. For example, austerity in peripheral Europe impacts demand for Chinese exports, and the course of the yen will influence the price of internationally traded goods and therefore offshore CPI levels. Exposure of excess capacity in China (through reduced trade) elevates the reform difficulty faced by the new leadership in Beijing, which in turn increases the risk that Australian commodity exports will fall short of expectations and so expose excess domestic capacity. Combining these relationships into the most credible near-term outcomes to generate insight into the future requires that we apply imagination as well as knowledge.

While complexity and the absence of solutions to the problems facing the world economy remain, asset prices have surged, suggesting an uncomfortable degree of complacency among investors. This means that our decisions tend to be significantly 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 with it the benefit of smoother returns.

Performance expectations

Future portfolio returns depend on the behaviour of financial markets. The management of MLC's portfolios is not based on the shaky foundation of being able to predict the one future that will unfold. We take into account that there is always a range of potential futures. MLC's portfolio positioning relies on understanding that there are things that can go wrong as well as opportunities to generate returns. We use this information to determine the most appropriate balance between risk and return for each portfolio.

[1] Friedman, Milton, and Anna Jacobson Schwartz, 1963a. "Money and Business Cycles," Review of Economics and Statistics, 45(1), Part 2, Supplement, p p. 32-64.

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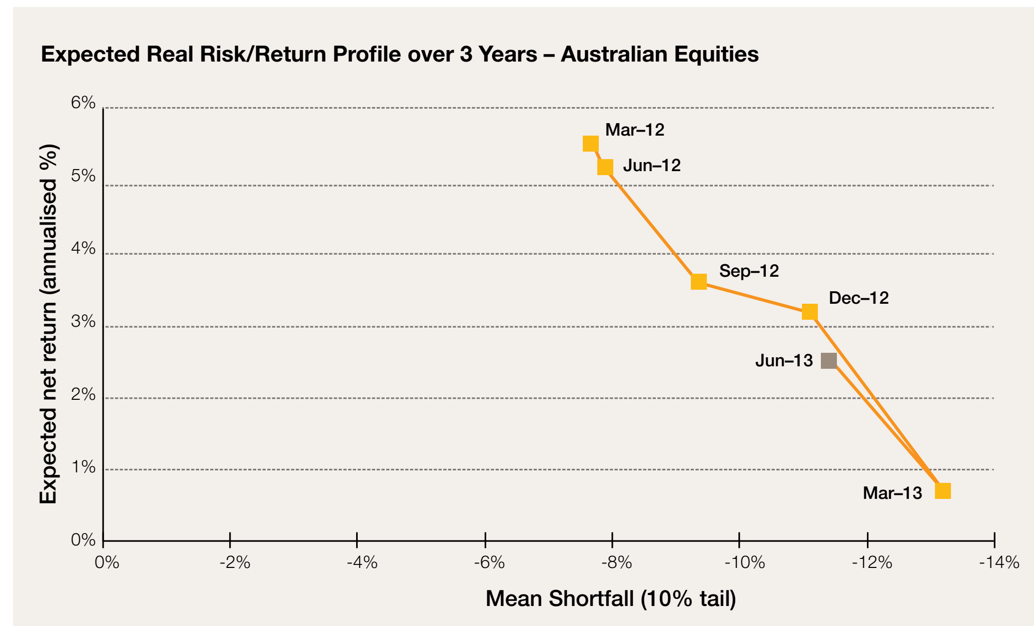
This process recognises that both risk and return change through time. Generally, higher risk is associated with higher return potential. When we compare assets at a point in time we expect the higher risk asset to offer some extra return potential. However, when we look at one asset over time we find that higher return potential is associated with lower risk, and lower return potential with higher risk. The chart to the right shows a recent example of how the relationship between risk and return has changed: the prospective return from Australian shares has diminished as share prices have risen.

We track the relationships between risk and return for all components of MLC's portfolios. We also analyse in detail the sources of risk, such as rising inflation, deflation, financial crises, and policy mistakes. By assessing the spread of these risks we can find the most effective means of controlling risk while retaining return potential.



Source: MLC Investment Management

The most challenging environments for this process occur when, for a broad range of assets, their prices rise faster than their fundamentals. We saw this scenario in the first three quarters of the 2013 financial year. We observed a general reduction in return potential, increase in risk and reduction in the opportunity for diversification during this period. There was some respite in the June quarter, but despite the recent rise in bond yields, yields are generally low and cash rates meagre on an after-inflation basis. The rise in share prices during the year has reduced their future returns and increased the potential downside. These factors suggest a more defensive positioning, but there remains the real possibility of continued strong returns if the EQE scenario again becomes dominant. This creates a difficult balancing act for traditional funds, as their sensitivity to peer relative comparison means the extent of risk control is constrained.

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The following table summarises some current scenario insights. The scenarios are not simply those that are most likely but more importantly those that are most distinctive.

Scenario	Considerations	Implications
Extended quantitive easing	This scenario may re-emerge in response to weak economic data, which perversely pushes risk assets higher.	Traditional funds such as the MLC Horizon portfolios perform strongly in the scenario, though the relative risk control focus of these funds means they may lag peers. Real return funds such as LTAR will lag due to overriding need for risk control, but will meet or exceed their return objectives.
Inflation shock – possibly driven by expectations	Nominal bonds at risk. Outcomes for equities depend on economic growth —economic impediments to growth suggest caution.	Despite low yields, maintain some inflation-linked bond exposure.
China slowdown, Australia loses safe haven status	Lower AUD.	Maintain overweight to foreign currencies.
Stagnation/deflationary slump	Growth falters in the developed world and the emerging world converges to a slower growth world.	Recent rise in yields increases deflation protection of bonds, but it is still relatively weak. Traditional portfolios maintain more duration exposure than would otherwise be the case. Rely on reducing risk asset exposures and defensive equity focus in real return portfolios
Renewed crisis	Multiple potential sources exist, with the most likely in the eurozone	Seek hedges for specific risks which offer greater downside risk control compared with loss of upside. For example, a euro-US dollar hedge.

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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 us to make more informed choices 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, which we refer to as the Strategic Overlay.

The tailored scenario set consists of the same 13 scenarios we have had for some months. These are outlined in **Appendix 2** from page 18. 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. 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.

During the quarter we took the rare step of resetting the fair value of the Australian dollar. This is a noteworthy, as changes in fair value assessment occur very rarely. Our assumption of AUD fair value was stable until pricing pushed the exchange rate up to the extent that virtually all scenarios had an end point assumption for the level of the AUD that was significantly below the prevailing exchange rate. This created a strong skew in the scenario set, which we were uncomfortable with because it took us too close to predicting the future, rather than understanding what could happen. In raising our fair value exchange rate, we effectively gave the AUD the benefit of the doubt, giving a high level of credence to the presumption of a structural shift (resulting from the emergence of China) which would result in a persistently higher exchange rate.

Most importantly, we were skewing the scenario outcomes against the views of the Capital Markets Research team at a time of persistent, though in our view, aberrant, market behaviour. Such adjustments are essential in persistent extreme environments to ensure that portfolio returns remain within acceptable tolerances for our investors and that we manage the (unlikely) risk that it really is a different environment this time. This is important to ensure that portfolios are positioned to withstand the rise, as well as benefit when the ultimate reversion occurs. As that reversion occurs, we are likely to gradually unwind the previous upward adjustment to the fair value assumption. The downward adjustment we have made to our fair value assumption marks the start of that normalisation process.

Our current positioning

Unconventional monetary policy continues to impact pricing in major asset classes, particularly currency, bonds and equities. These distortions mean that risk-aware strategies (such as 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

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help, but do not fill the gap entirely. On the other hand, our portfolios with less flexible asset allocations (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 compared with the level of risk. There are two important asymmetries at present: in currency and bond markets. These asymmetries remain, although slightly weaker, after the rise in yields and fall in the AUD. In bond markets, we observe that while bond yields could decline, 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 resume rising (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 risks than we would otherwise 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 debt 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. While a bubble in equity markets would be welcome in the short term, it would create additional unpleasant risks.

Active and unorthodox mandates are very important to our diversified strategies. Just as the diversification benefit of bonds has been eroded by yield seeking capital, the typically defensive equity of solid, income producing businesses that are resilient in low growth environments has been aggressively bid to historically high valuations. Given these elevated valuations, there is a real danger that these equities no longer provide the kind of defensive properties desired by investors. We know that having experienced, active managers with the flexibility to deviate from benchmarks will help our strategies remain exposed to growth upside while traversing what could be challenging times ahead. What constitutes relatively safe assets is fluctuating as this distorted environment evolves.

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MLC Long-Term Absolute Return Portfolio

The risk profile of LTAR is increasingly defensive, with risk control increasing in the first two quarters of 2013. LTAR's absolute return focus means that the portfolio's positioning is very different to that of the MLC Horizon Series, so its performance in any scenario compared with the MLC Horizon Series of portfolios can be quite different. The opportunities for diversification have been progressively shrinking as relative safe havens are consumed, and this is the current challenge in positioning LTAR. We continue to seek to enhance return potential while controlling risk exposure, but this is becoming more difficult and some return potential must be sacrificed to ensure adequate risk control. A summary of LTAR's current positioning is shown to the right.

	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	Reduced allocation	Exposure reduced in response to strong rise in share prices and increase in prospective risk.
Defensive global shares (unhedged)	Steady allocation	The portfolio has a strong bias to absolute, not index-relative, equities.
Foreign currency exposure	Steady allocation	The power of foreign currency as a risk diversifier reduces as the AUD declines, but it remains an important source of risk control. However, the weaker diversification power means that risk asset exposures are reduced further than would otherwise be the case.
Hedge funds	Steady allocation	High quality, transparent hedge fund strategies are a relatively important source of return potential in a world where it has become more difficult to generate returns.
Multi-asset real return strategy	Steady allocation	This remains a key part of the portfolio's strategy: to offer efficiencies by breaking down asset class barriers and through an absolute return focus.
Emerging markets strategy	Reduced allocation	The prospect of US tapering (and stronger US dollar) and the Japanese reflationary policy (and lower yen) present a deflationary shock to emerging markets. Risk has risen relative to return potential and a lower allocation is appropriate.
Global private assets	Steady allocation	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.
Global property securities	Zero direct exposure	We prefer the broader opportunity and absolute return orientation of defensive global equities. There is potential reversion in the prices of higher yielding assets as expectations of QE tapering increase and bond yields rise.
Global government bonds	Zero direct exposure	Unattractive, with still limited diversification benefit.
Australian inflation-linked bonds	Steady allocation	Inflation hedge remains attractive as a risk hedge, despite low yields.
Borrowings	Lower allocation	Reward for risk is shrinking as asset prices rise.

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MLC Horizon Series of portfolios

There were changes to the inflation-linked bonds strategy in the June quarter.

	MLC Horizon Series of portfolios weights			Comment
	Under	Neutral	Over	
Growth assets		**X**		The environment is one of relatively high risk but the traditional diversifier (nominal bonds) is unusually weak and adds to risk in a number of important scenario.
Australian shares		X		From a valuation perspective, Australian shares have some attraction, but the risks for the domestic economy from a slowing in growth in China outweigh the positives.
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 a still very strong local currency and significant global economic uncertainty.
Global shares (hedged)	X			
Global property securities		X		Retain neutral allocation – the allocation is underweight versus peers.
Global private assets		X		Retain neutral allocation – noting that currently the actual allocation to private equity is ahead of the target level.
Multi-asset strategies				
Emerging markets multi-asset strategy		X		Maintained
Multi-asset real return 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			Underweight given extent of duration in this sector and risk of sharply higher bond yields. However, longer term this is an important exposure and a move back to neutral allocation can be expected at higher yields.
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

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MLC Index Plus portfolios

There were changes to the inflation-linked bonds strategy in the June quarter.

	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 a still very strong local currency and significant global economic uncertainty.
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			Underweight given extent of duration in this sector and risk of sharply higher bond yields. However, longer term this is an important exposure and a move back to neutral allocation can be expected at higher yields.
Global bonds – All Maturities	**X**			1% overweight (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 to the 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 Australian equities increased slightly while the return potential for 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.

Source: MLC Investment Management

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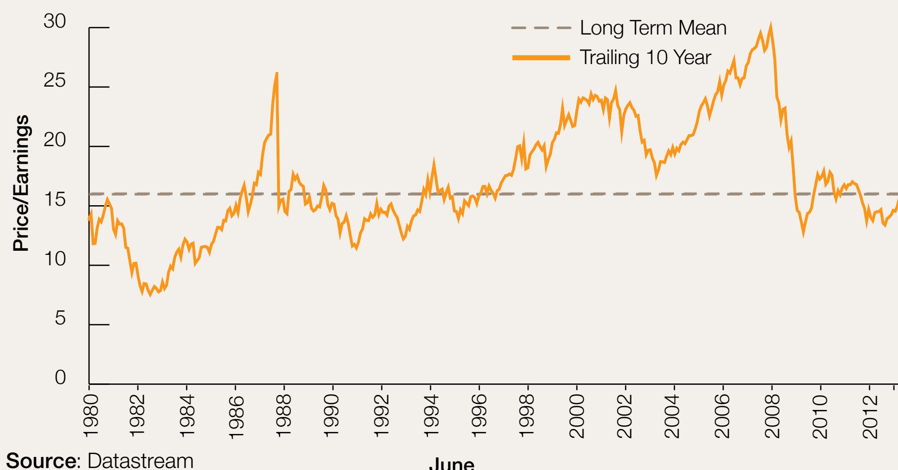
Asset class indicators

Our view of the main asset classes is as follows.

Australian shares

Market indicator

S&P/ASX 200



Source: Datastream

Comment

Australian shares reversed in Q2 2013, partly offsetting the strong performance in the first three quarters of the financial year. For the year as a whole share prices were sharply higher. P/E expansion was the sole driver of this positive market return.

Global shares (including currency)

Market indicator

Datastream World Index

Source: Datastream World Index

Comment

Global share prices were weaker in Q2 2013, but for the financial year as a whole, share prices were sharply higher.

P/E multiple expansion accounted for most of the returns experienced—global share markets are effectively borrowing returns from the future.

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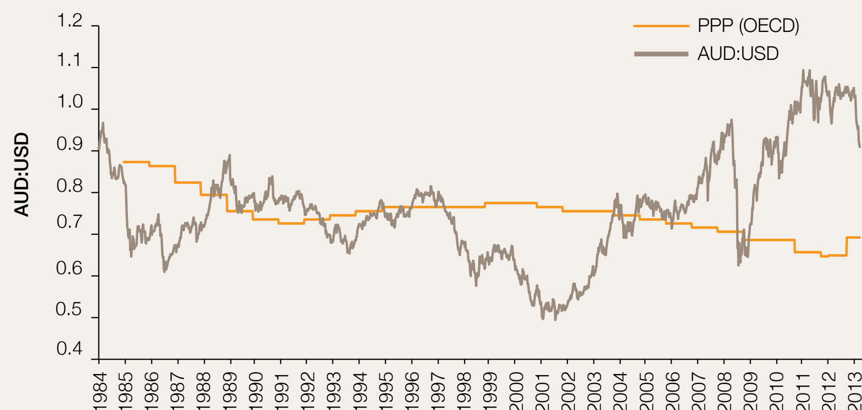
Asset class indicators continued

Australian dollar

Market indicator

Australian Dollar Purchasing Power Parity



Source: Bloomberg **June**

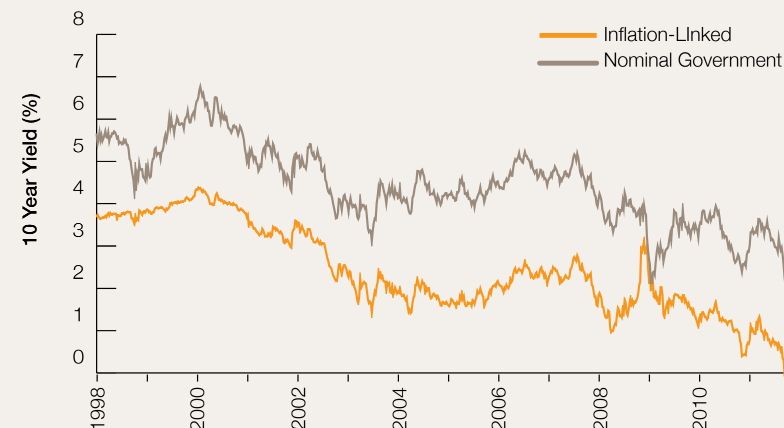
Comment

The Australian dollar declined sharply in response to expectations of Fed tapering and changing perceptions about the strength of China's growth. However, the AUD remains at values which are sharply elevated compared with measures of fair value.

Global government bonds

Market indicator

10 Year Bond Yields – United States



Source: Bloomberg **June**

Comment

Nominal yields on US Treasuries were only slightly higher over the quarter. The Strategic Overlay position to reduce our exposure to global government bonds and instead favour exposure to domestic cash in the All Maturities fixed income Strategy added to performance during the quarter. In addition, the allocation to inflation-linked bonds, which has a relatively high duration, was moved to underweight during the quarter.

We will retain these positions given the still low level of yields in these markets and the heightened risk of capital loss. This positioning recognises that yields will rise if and when confidence in a self-sustaining recovery emerges.

MLC's investment perspective, scenario insights & portfolio positioning

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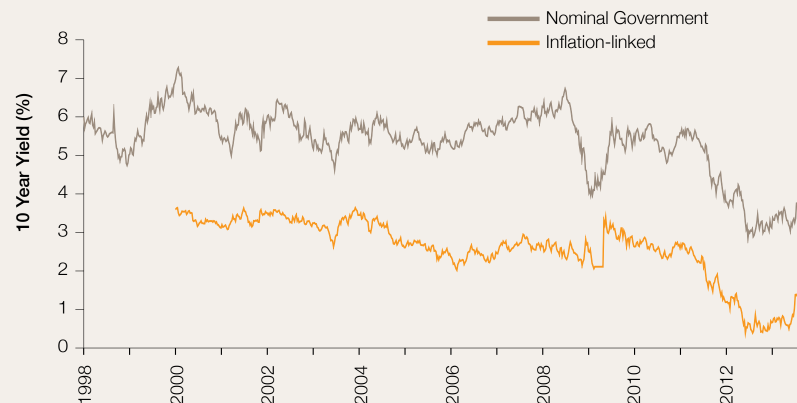
Asset class indicators continued

Australian government bonds

Market indicator

10 Year Bond Yields – Australia



Source: Bloomberg **June**

Comment

Australian government nominal bonds yields were higher during the quarter following the rise in US yields. Domestic economic data over the quarter reflected the difficulty facing the economy in adjusting to weakening demand from China, lower commodity prices and a stubbornly strong currency.

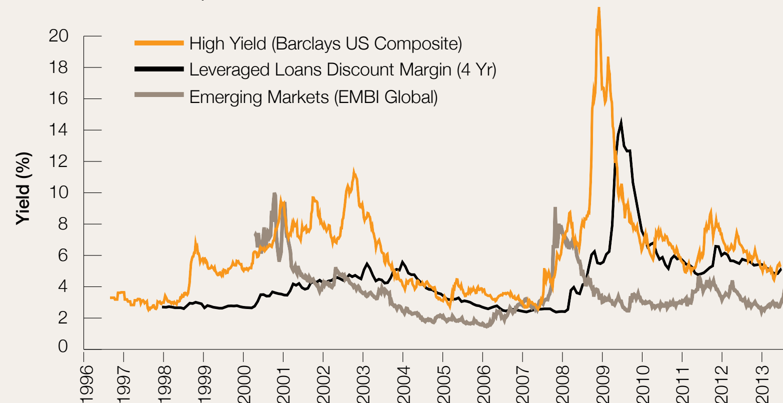
The Reserve Bank of Australia reduced the official cash rate by 0.25% over the quarter. This follows the 50bps of cuts at the end of 2012. The current cash rate of 2.75% is a historic low.

Given the inflation priming by many 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. However, the high duration of these assets means that we have to carefully balance the inflation protection against the interest rates risks.

Non-investment grade bonds

Market indicator

Fixed Income Spreads



Source: Credit Suisse, Barclays **June**

Comment

High yield bonds gave up some of the solid performance that has accrued across 2012. Most of the increase in yield was driven by the increase in yields in core government bonds, as spreads stayed relatively flat during the quarter. Leveraged loans were steady as these assets carry very little duration.

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Appendix 1 – MLC Horizon prospective returns

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

Source: MLC Investment Management

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Appendix 2 – Our tailored scenarios

Scenario	Probability Ranking	Description
Three speed global economy (China soft landing)	1	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.
Early re-leveraging	2	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.
Extended quantitative easing	3	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.
(Mild) inflationary resolution	4	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.
Developed market austerity, recession, stagnation	5	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.
Two speed recovery	6	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.

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Scenario	Probability Ranking	Description
Sovereign yield re-rating	6	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.
One speed slow growth world	8	There is growth convergence as persistent slow growth in the developed world spills over into the emerging world.
Reform	8	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	10	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.
Extended risk aversion	10	A generic scenario to capture prolonged aversion to risk.
Inflation shock	12	Similar to stagflation, though assumed growth is higher. Sharp rise in inflationary expectations.
Stagflation	13	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'.

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