MLC's scenario insights and portfolio positioning

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MLC's scenario insights & portfolio positioning

Maintaining a clear perspective on the underlying investment environment can be challenging when investor sentiment is subject to frequent reversals.

Market pricing continues to be more volatile than the underlying fundamentals warrant. Markets remain very sensitive to the signals and actions of the US Federal Reserve (the Fed). These over-reactions are making it difficult for the Fed to provide forward guidance without generating fear or euphoria, and this in turn impacts the real economy. This sensitivity may well be a feature of ultra-low inflation environments—in other words, current policy settings foster a higher level of inherent instability. The Fed's forward guidance on the tapering of quantitative easing (QE) confused market participants. While the Fed may have missed an opportunity to 'break the ice' with a token taper in September, conditions in the US do not yet appear strong enough for meaningful policy change. Although US companies are in good shape and their economy is leading the global adjustment process, there is not yet a self-sustaining growth cycle.

In summary, developed world public sector debt remains at unsustainably high levels. Progress in resolving this issue has been most significant in the US. Private sector deleveraging in the US has been significant. Maintaining positive economic growth is a key element in successful deleveraging. US growth has been maintained despite fiscal austerity, which has permitted a narrowing of the fiscal deficit. This, coupled with continued low interest rates, means that public sector debt has, for now at least, stopped rising. All this implies that policy makers are successfully muddling through at the moment, but there is a still a long way to go.

The next potential US hiccup is the debt ceiling negotiations—at the time of writing, these were beginning to resurface. These are becoming a regular feature, though this time markets may be more sanguine that there will be a pull-back from the brink, if only at the last possible moment. Hopefully, this will prove not to be an unwise assumption, but we note that political positions have become more entrenched. A failure to raise the debt limit would mean that spending has to be cut until it matches revenue, which means either painful cuts to expenditure or a technical default on interest payments. Even a technical debt default threatens confidence and liquidity and has potential contagion effects, while a sharp fiscal contraction could derail the recovery. Unless political ineptitude reaches new levels, it is difficult to believe that the debt ceiling will not be extended. This suggests that the issues are mostly transient, though repetitive, which can mean some lasting implications for confidence and therefore growth.

Other important developments during the quarter included the German elections, with Chancellor Merkel leading the Christian Democrats to a resounding victory. Merkel

MLC's active investment approach

- Key to MLC's market-leading investment process is our unique Investment Futures Framework (the new name for our 'scenarios framework').
- In an unpredictable world, the Framework helps us comprehensively assess what the future might hold. By taking into account the many scenarios that could unfold—positive and negative—we gain continuing insight into return potential, future risks, and opportunities for diversification.
- The information from the Framework gives us a deep understanding of how risks and return opportunities change over time for both individual assets and total portfolios.
- We can then determine the asset allocations that will help achieve our portfolios' objectives with the required level of risk control, and adjust the portfolio if necessary. We'll generally reduce exposure to assets if we believe risk is too high. We prefer exposures with limited downside risk compared to upside potential.
- More information about MLC's investment approach is in Appendix 3.

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correctly read the electorate's desire for a policy of small steps with no surprises, and a united Europe, while not going so far as to bail out the profligate. This means that any banking union will be on German terms. The fly in the ointment is that her coalition partners, the Free Democrats, have lost all their parliamentary seats, so a new coalition partner is required. Any coalition partner will be in a relatively weak position once in the coalition, which means they will need some policy inducement going in to make it worth their while. Nevertheless, this is a positive result. That said, the eurozone, while calm for now, remains the most likely source of any renewed instability. For example, the fragile ruling coalition in Italy now looks to be fracturing.

For Australia, the September quarter saw another change of sentiment – not due to the change of government, but the return of confidence in China's economy. The S&P/ASX200 price index hit a five year high towards the end of September and the Australian dollar staged a limited recovery. All this confirms how increasingly tied to Asia the Australian economy is. To be fair, Prime Minister Abbott's pro-business credentials and expected scrapping of the carbon tax and resource super profits tax have helped lift the share market. However, it is not all good news. The economy is still constrained by the uncompetitive exchange rate and a high level of household indebtedness.

The Reserve Bank of Australia (RBA) faces an increasingly difficult choice between risking house price instability or a struggling economy. Growth has slipped below potential, with mining capex an increasing drag on growth, outside investment the economy is weak, and both blue and white collar employment looks vulnerable. The household sector still very highly indebted and requires significant stimulation to grow moderately. The RBA cut interest rates to a record low in August. This is the mechanism through which QE is leaking into the Australian economy. There is very little doubt that the array of issues pushing back against growth in Australia warrant easy monetary conditions. The complicating factor for policy-making, however, is the constant risk of pushing housing and other assets to yet more unsustainable levels and in doing so, creating a debt pool that is unserviceable if interest rates rise. Self-regulation and macroprudential policy are obvious tools to manage credit growth and asset price inflation in a low rate environment, but history suggests it is unwise to rely on lenders to maintain vigilance when revenue growth is failing.

The Australian dollar, emerging Asia and tapering of QE are inextricably linked. Talk of tapering triggered a withdrawal of funds from emerging markets, leading to weaker currencies and higher bond yields. Roughly half of Australia's debt is funded from offshore, meaning the actual cost of funds is vulnerable to changes in capital flows. This is a key downside risk in an adverse domestic scenario. While Australia is now running at or near a balanced goods and services account, the income account is in chronic deficit and, on a normalised basis, continuing to decline. This in itself could cause an unwelcome rise in interest rates if Australia's external funding conditions deteriorate. It will be critical to monitor the dynamic between the goods and services and the income component as mining investment decreases and the terms of trade decline. In the initial phases of QE, the emerging markets complained about their stronger currencies; now they are urging for QE to continue. As South Korea's Finance Minister said, QE is everyone's business.

Performance in review

The September quarter saw strong returns from share markets. This followed the 'taper-tantrum' of the June quarter. Following the Fed's surprise failure to taper in September, shares rallied and bond yields declined, and emerging markets in particular recovered strongly. Bond yields reversed after the US 10-year nominal bond touched 3% pa, declining to 2.6% pa at quarter end.

While the June quarter saw modest returns compared to the 2013 financial year as a whole, the rest of the 2013 financial year's strong returns were consistent with a policy-induced, rather than fundamentally-driven, rally. The September quarter continued that trend and was partly a reversal of the shock realisation that QE cannot last forever. It is unclear whether investors have now become more comfortable with the impact of a gradual QE taper, or whether there will be renewed jitters when tapering talk starts. Whatever the answer to this, we should not forget the share market volatility in the June quarter which 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 share market rally relies on economic fundamentals improving.

Over the September quarter, the strong share market returns meant traditional diversified funds like the MLC Horizon portfolios enjoyed robust returns. By contrast, in such environments real return funds, such as the MLC Long-Term Absolute Return Portfolio (now called the MLC Inflation Plus – Assertive Portfolio), will tend to lag because managing these funds requires that risk control always be maintained. Since rising share prices imply lower future return potential and rising risks, we increased the risk control in the MLC Inflation Plus – Assertive Portfolio during the quarter. This portfolio, and the two new MLC Inflation Plus portfolios launched on 1 October 2013 (the Moderate and Conservative portfolios) maintain consistent risk control through time. The benefit of this approach 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 strong share market returns of the September quarter favoured the MLC Horizon portfolios, while the MLC Inflation Plus – Assertive Portfolio delivered a return consistent with its investment objectives.

Looking forward

Developed world monetary policy and interest rates will ultimately normalise. While we can be confident about this end point, what we cannot know is how long it will take to get there or what the path to it will be. Policy makers continue to face difficult challenges in extracting benefits from the ultra-stimulative policy, while trying to control the risks, which take the form of excessive risk taking. The Fed's communications about tapering in the June quarter were an attempt to remind markets that the party must eventually end. This was modulated in the September quarter with the Fed's delay in commencing tapering. The Fed is trying to walk a fine line. In MLC's language, they do not want to see continuation of a high returning 'Extended Quantitative Easing' scenario because it results in excessive risk-taking and potentially puts the US back onto an unstable path. They will be much more comfortable with a 'muddle-through' scenario with modestly higher share prices, which constitutes a stable adjustment path. Looking forward, there are a number of risks, including the shenanigans over the debt ceiling and a change of Fed chairman. Fed vice-chair Janet Yellen is the front runner and should provide policy continuity. And most importantly, tapering has not gone away: the commencement and pace of tapering will be pivotal for markets.

Elsewhere, the UK economy has been performing better. In the UK, an easing of austerity and measures to boost house prices and so boost spending are supporting growth. The latter is not without risk; unlike the US, house prices in the UK have not meaningfully corrected from boom levels. Pushing them higher still risks a nasty adjustment scenario later. For now, however, the UK is succeeding in simultaneously growing and deleveraging, though public sector debt (as a percentage of GDP) has not yet peaked.

Some improvement in economic performance and funding in Europe also assisted the UK, but it cannot be said that the eurozone is at or even near a stable

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adjustment path—that is still nowhere in sight. After the German elections we are expecting announcements that map out the deleveraging process. There is as yet no certainty as to how the interconnections between governments and banks, and regulatory pressures on banks, will be managed. Given the fragility of the peripheral eurozone (including Italy) there are many potential sources of risk.

In Japan, the challenge is not just the debt burden but also demographics. The fiscal and monetary policy arrows (through a weaker currency) have been doing their work, but the effect is starting to fade. Higher share prices and a lower yen boosted the economy, but markets have now stabilised and the boost to growth needs to come from higher demand. In step with growth, prolonged CPI deflation has turned to inflation, but the coincident impact of increased reliance on imported energy and a weaker yen has played a significant role. Whether this delays interest rate tightening and pushes against discretionary spending, or helps undo the deflationary mindset entrenched in Japan, remains to be seen. Stimulation of stagnant wage growth is the key missing ingredient needed to propel Japan to sustainably healthy CPI increases. With a consumption tax rise looming next April, what's needed is a boost from Abe's third, structural reform, arrow. It's said that while the Japanese are often slow to act, once they have determined a course of action they will surprise the sceptics. We may be about to find out how much truth there is in this.

Looking at the future for financial markets, the starting point of high share valuations and low bond yields creates a challenging outlook. Return potential is relatively compressed and risk remains relatively high. Coupled with that, the opportunity for diversification is limited. From the perspective of an Australian investor, the most reliable diversifier of share risk continues to be foreign currency exposures. The future path depends on the balance between the global deflationary forces of deleveraging versus the inflationary unorthodox monetary loosening. On one hand, if deflationary forces dominate, a prolonged period of little or no growth (stagnation) can result; on the other, there is at best a prolonged muddle-through towards normality. It can be argued that it's often folly to fight the Fed and that monetary conditions will remain easy enough to drive risk and asset prices higher, perhaps to bubble levels. However, this becomes more uncertain as QE is gradually withdrawn. And there is potential for heightened instability if an extreme policy stance is reversed. All this presents a conundrum: the probability of both a highly positive and a highly negative scenario may be rising. In this process, inflation remains a continuous watch point. There may be no early warning of a rise in inflation expectations. QE makes expectations vulnerable and potentially volatile. Rising emerging market wages are a possible early source of incrementally higher inflation that could act as a trigger to an expectations-driven rise.

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'. 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.

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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.

Our Investment Futures Framework, which considers many possible future scenarios, 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 on one hand 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 reduction in leverage across the US economy, even there aggregate levels of indebtedness remain high after growing too fast compared with GDP growth over the last decade. Balance sheets 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.

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.

We continue to be concerned that there is too great a degree of complacency among investors. For the MLC Horizon portfolios we must be aware of the relative risks posed by continued strong returns supported by market-friendly policy. However, we seek to mitigate those risks as far as possible. 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. And private equity valuations are not as stretched as listed markets.

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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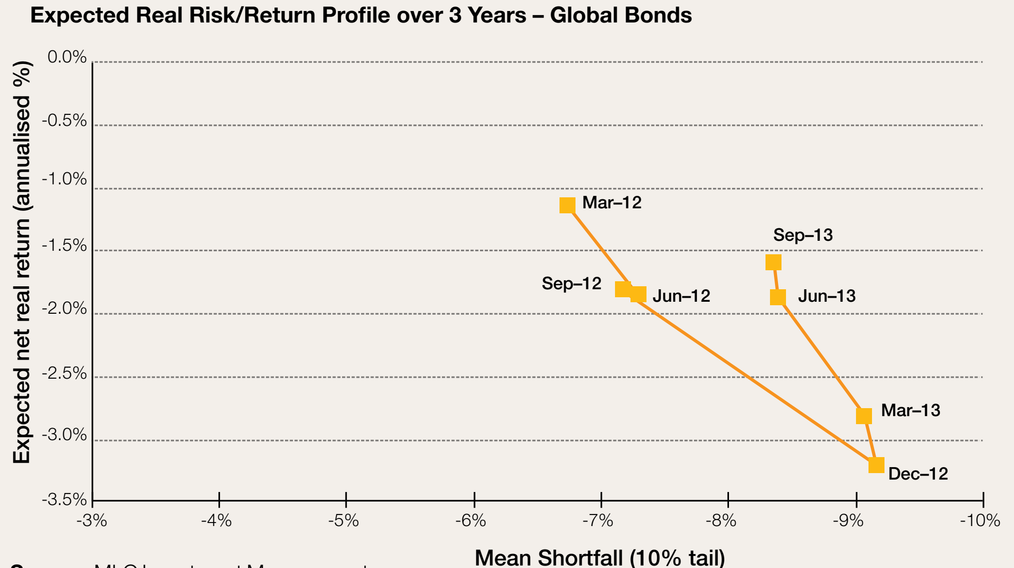
Performance expectations

Future portfolio returns depend on where we are starting from, the path that markets and economies take, and where we end up. The management of MLC's portfolios is not based on the shaky foundation of being able to predict the one future that will unfold. Instead, 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 recognising opportunities to generate returns. We use this information to determine the most appropriate balance between risk and return for each portfolio.

We understand that both risk and return change through time, and our investment approach allows us to track forward-looking returns, risks and diversification. 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 opposite looks at our barometer of risk and return for global bonds (hedged) from March 2012 through to the end of September 2013. As bond yields have risen (fallen) future return potential rises (falls) and risk falls (rises).



Source: MLC Investment Management

We track the relationships between risk and return for all components of MLC's portfolios, and for our portfolios as a whole. 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.

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 2012/13 financial year and there were signs of it re-emerging in the September quarter. The consequence was a general reduction in return potential, increase in risk and reduction in the opportunity for diversification during these periods, with some respite in the June quarter. While these trends suggest a more defensive positioning, there remains the real possibility of continued strong returns if the extended quantitative easing (EQE) scenario again becomes dominant. This creates a difficult balancing act for traditional funds, as their sensitivity to peer and benchmark 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 the MLC Inflation Plus portfolios 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 shares 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 this protection 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 unique Investment Futures Framework. The Framework provides a detailed map of what the future could hold – both the things that could go right and the risks that may be faced. It also provides a forward-looking understanding of return potential, risk and diversification. There are few other approaches to asset allocation that have this forward-looking understanding and insight. This is important because it 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 covered by the Framework comprise both the generic broad set of 40 scenarios which pivot around the main drivers of returns—the macro-economic drivers and investor behaviour (the level of optimism or pessimism)—and a tailored scenario set. The generic set of scenarios are designed to have relevance from any starting point and provide a consistent barometer of risk and return through time. The smaller, tailored set of scenarios (shown in Appendix 2) 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 constantly assessed in our investment process.

The tailored scenario set consists of the same 13 scenarios we have had for some months. They revolve 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.

Our current positioning

Unconventional monetary policy continues to impact pricing in major asset classes, particularly currency, bonds and shares. These distortions mean that risk-aware real return strategies (such the MLC Inflation Plus portfolios) 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. During the quarter we increased the risk control in the MLC Inflation Plus – Assertive Portfolio. Our portfolios with less flexible asset allocations (the MLC Horizon portfolios 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 have increased exposure to alternative forms of portfolio protection.

Our analysis of scenarios in our Investment Futures 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

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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 the MLC Inflation Plus – Assertive Portfolio 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 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. Shares 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 share 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 shares 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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Real return funds – MLC Inflation Plus portfolios

The risk profile of the MLC Inflation Plus – Assertive Portfolio was moved to more defensive during the September quarter. The absolute return focus of the MLC Inflation Plus portfolios is very different to that of the MLC Horizon portfolios, and this results in performance differences. In very strong performance scenarios, we expect that because of their tight risk control the MLC Inflation Plus portfolios will lag the MLC Horizon portfolios. In adverse scenarios this risk control comes to the fore, meaning that the MLC Inflation Plus portfolios will be less exposed to negative returns. In the current environment, with few opportunities for diversification and a lack of genuine safe havens, the MLC Inflation Plus portfolios are forced to reduce exposure to risk assets to maintain adequate risk control as asset prices rise.

A summary of the current positioning considerations for the MLC Inflation Plus – Assertive Portfolio is shown in the following table.

	MLC Inflation Plus – Assertive 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 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, shares.
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.
Low Correlation Strategy	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 with reasonable risk. However, these strategies are exposed to a variety of risks, and allocations must be sized accordingly.
Multi-asset real return strategy	Steady allocation	This remains a key part of the strategy: to offer efficiencies by breaking down asset class barriers through an absolute return focus.
Emerging markets strategy	Reduced allocation	While on an aggregate valuation basis these markets look cheap, the higher quality stocks were relatively immune to the recent selloff. The emerging economies and markets also remain vulnerable to tapering.
Global private assets	Steady allocation	Private equity has lagged listed markets. This has created a valuation discrepancy in favour of private equity, though it is uncertain how long this will persist (and it would be expected to increase in an EQE scenario). The very high 'alpha' component of private equity returns is attractive in a return-constrained environment.
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	Slightly higher allocation	Inflation hedge remains attractive, despite low yields. Inflation-linked markets have lagged rallying nominal bond markets and created an opportunity to increase exposures slightly.
Borrowings	Lower allocation	Reward for risk is shrinking as asset prices rise. At the end of the quarter the portfolio was on a path to remove all gearing.

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MLC Horizon portfolios

	MLC Horizon portfolio 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 scenarios. While on an absolute basis share returns are sub-par and risk is elevated, on a relative basis shares are attractive.
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, the extent of the underweight has been reduced. 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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Return potential

At the heart of our Investment Futures Framework are scenarios that provide insight into many alternative futures. We generate return forecasts in each scenario based on where we are starting from, the assumed path that's taken and where it ends up. The path and the end point are normally defined and fixed; what changes over time are the starting asset prices. If share prices rise strongly, future return potential is reduced. That happened in the September quarter.

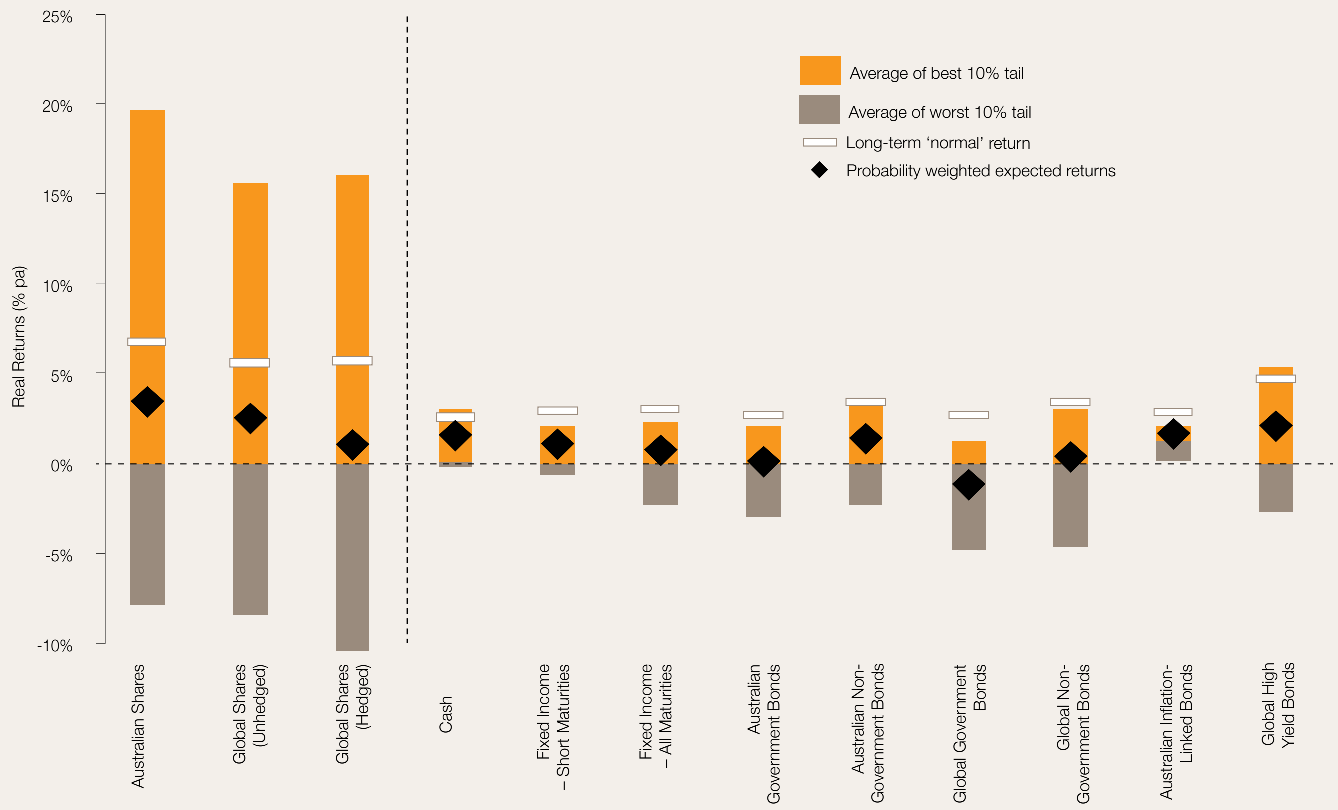
Our generic scenario set can be seen as a consistent barometer of risk and return through time. Today our barometer shows a difficult picture. Future return potential is compressed across equity and debt assets. The higher asset prices go, the lower future returns must eventually be – 'eventually' because with strong monetary stimulus, share prices in particular can run further and for longer than seems reasonable given economic fundamentals.

The graphs show the probability-weighted real returns (diamonds). For comparison, we've provided long-term 'normal' return expectations, set by considering a stable fair value world (horizontal lines). Also, to indicate 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.

A return potential graph for the portfolios is in Appendix 1.

40 Scenario Set Probability Weighted Real Returns (September 2013)

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



Source: MLC Investment Management

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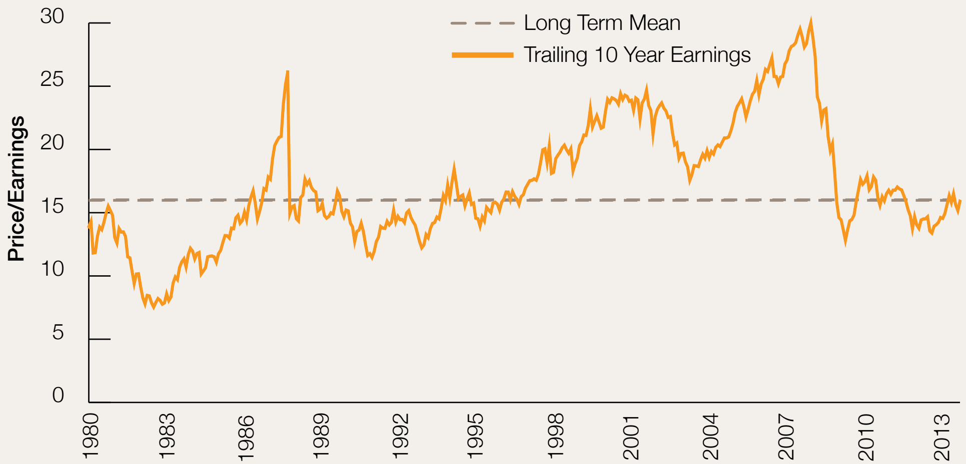
Asset class indicators

Our view of the main asset classes is as follows.

Australian shares

Market indicator

S&P/ASX 200



Source: Datastream

Comment

Australian shares rallied in the September quarter. P/E expansion continues to be the main driver of this positive market return. Earnings in the Materials sector have been strong, while Industrials were flat, though in line with expectations. The forward guidance for Industrials was soft.

Global shares (including currency)

Market indicator

S&P500

Source: Datastream World Index

Comment

Global share prices were stronger in the September quarter. As for Australian shares, P/E expansion accounted for most of the returns experienced—global share markets are effectively borrowing returns from the future.

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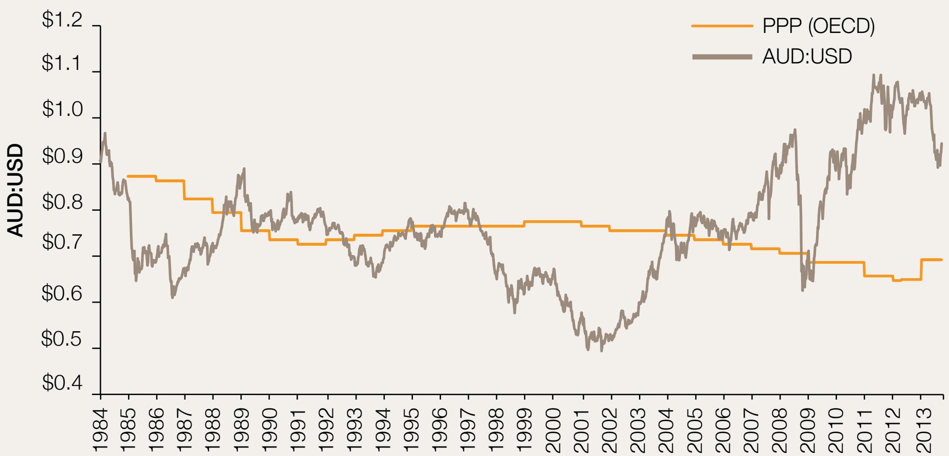
Asset class indicators continued

Australian dollar

Market indicator

Australian Dollar Purchasing Power Parity



Source: Bloomberg

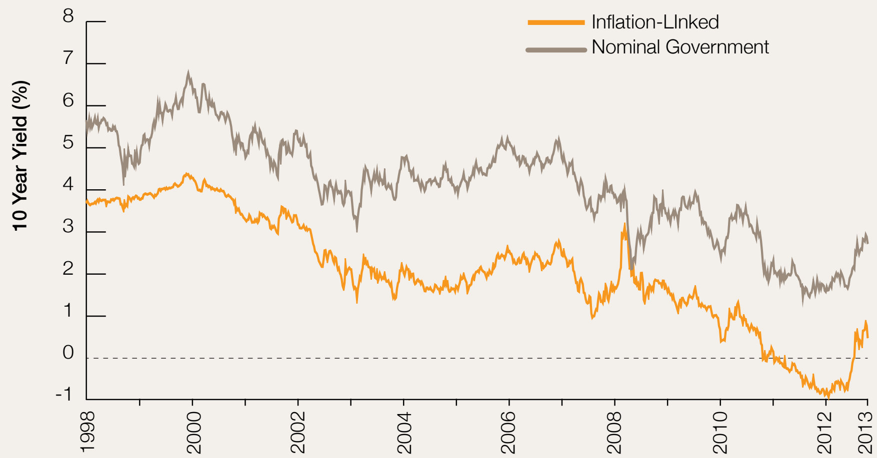
Comment

The Australian dollar staged a modest rebound on firmer China growth indicators and the delay in the start of tapering. The currency 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

Comment

Nominal yields on US Treasuries rose during the first two months of the quarter, unnerved by the Fed's guidance on tapering. However, when that failed to materialise, bond yields started to reverse some of the rise. How far this process will go is uncertain. Also uncertain is the possible impact of the debt ceiling negotiations on perceptions of US Treasuries as a safe haven.

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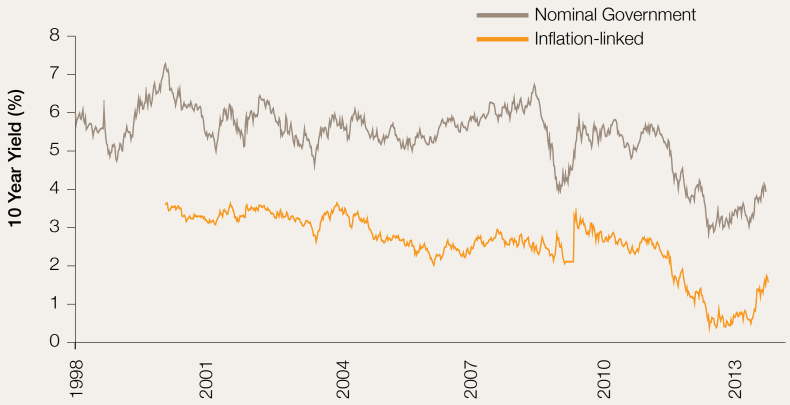
Asset class indicators continued

Australian government bonds

Market indicator

10 Year Bond Yields – Australia



Source: Bloomberg

Comment

Australian government nominal bond yields took their cue from the US, following the rise in yields and then reversing much of the rise.

Domestic economic data over the quarter continues to reflect the difficulty facing the economy in adjusting to weakening demand from China, lower commodity prices and a stubbornly strong currency.

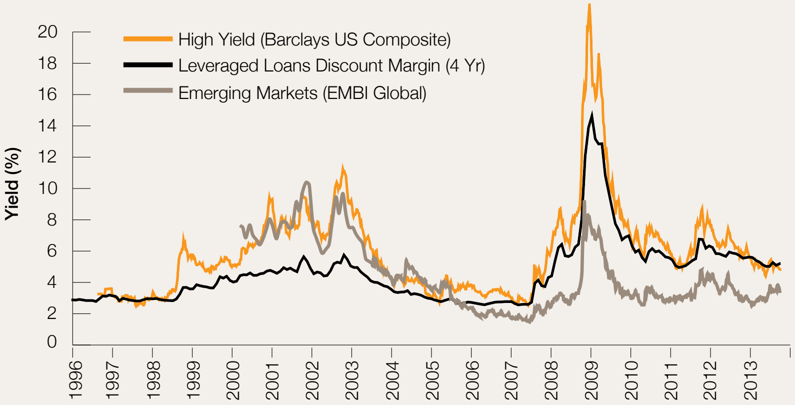
The RBA reduced the official cash rate by 0.25% over the quarter. This follows the 0.25% of cuts in the previous quarter and 0.5% at the end of 2012. The current cash rate of 2.5% is a new historic low.

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 rate risks.

Non-investment grade bonds

Market indicator

Fixed Income Spreads



Source: Credit Suisse, Barclays

Comment

High yield bond markets were increasingly volatile during the September quarter as investors reacted to changing prospects of tapering in the Fed's bond buying program. As it turned out, the Fed decided to delay any tapering and the market soon focussed again on the sector's positive aspects: current low default rates and an expanding US economy.

Inspite of the volatility, returns for high yield bonds for the September quarter were positive. The solid performance was driven by a contraction in high yield bond spreads which resulted in yields falling during the quarter.

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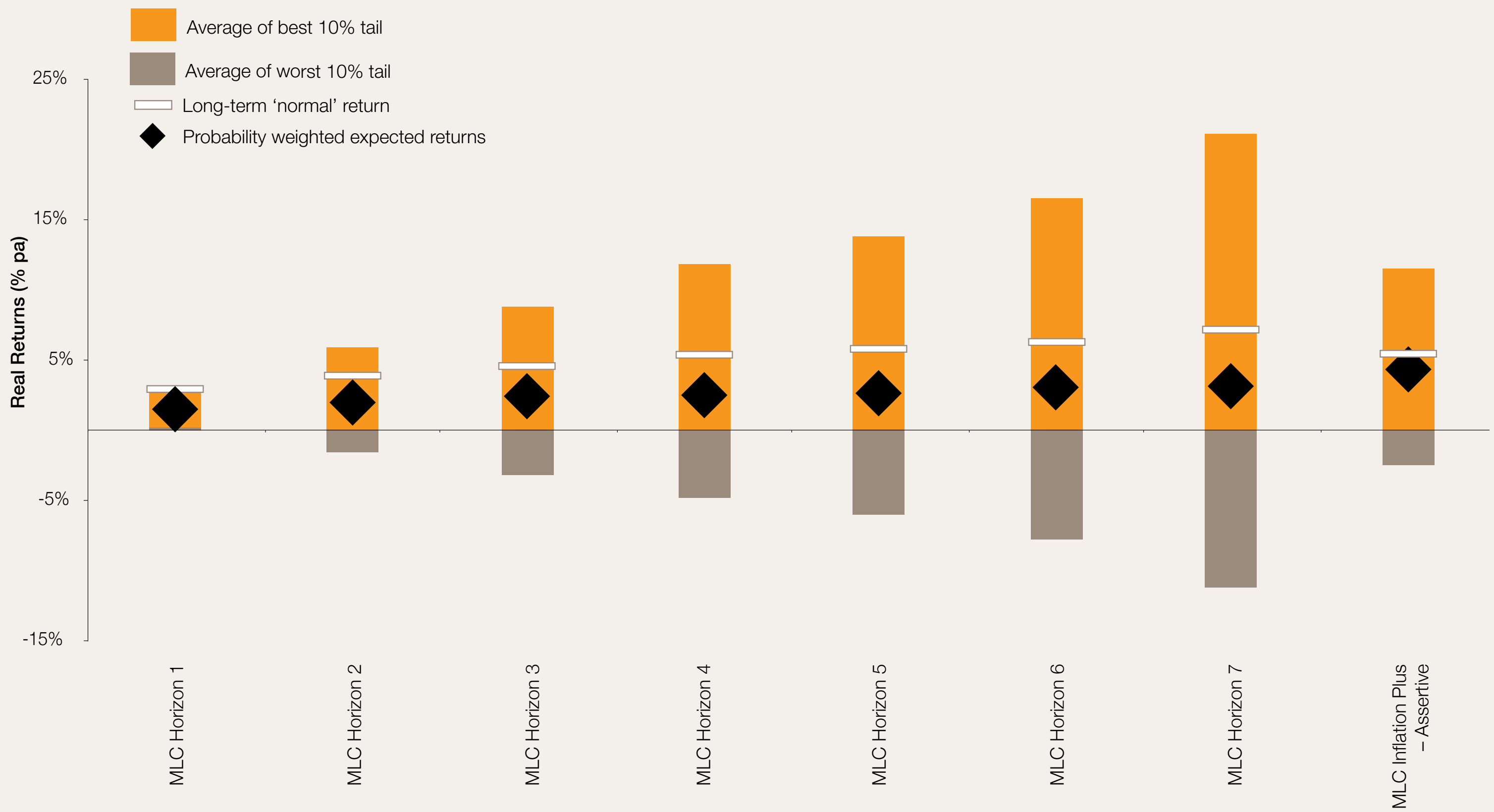
Appendix 1 – prospective returns

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.

40 Scenario Set Probability Weighted Real Returns

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



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.
Extended quantitative easing	2	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	3	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.
Early re-leveraging	4	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.
One speed slow growth world	5	There is growth convergence as persistent slow growth in the developed world spills over into the emerging world.
Developed market austerity, recession, stagnation	6	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. Shares perform poorly. Commodities fall. Nominal yields rally further and remain low.

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Scenario	Probability Ranking	Description
(Mild) inflationary resolutiona	7	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.
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	9	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	10	Similar to stagflation, though assumed growth is higher. Sharp rise in inflationary expectations.
Sovereign yield re-rating	11	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.
Stagflation	12	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	13	A generic scenario to capture prolonged aversion to risk.

MLC's scenario insights & portfolio positioning

Appendix 3 – MLC's market leading investment proces

Step 1: Scenario analysis and portfolio construction

Investment Future Framework

Identify scenarios | Generate potential returns | Analyse returns and risks | Asset allocation

- We can never be certain what the future will hold. This means we must take into account the things that **could** happen.
- We do this by building a comprehensive understanding of the possible future investment environments or scenarios that could occur. This includes not just those things most likely to occur, but also unlikely but very distinctive environments (such as financial crises and other 'tail risk' environments).
- The Investment Futures Framework gives a detailed view of how returns vary in each scenario. This also provides detailed information about the nature and extent of investment risks.
- Understanding how returns and risks can change over time means we can determine the best combination of assets, strategies and managers to generate returns while controlling risks in all scenarios—the asset allocation.

Step 2: Implementation

We implement the asset allocation as efficiently as possible to minimise costs.

Step 3: Review

We continuously apply our Investment Futures Framework to determine if portfolio adjustments are appropriate.

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Important information

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