MLC's scenario insights and portfolio positioning

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

This quarter, like the quarter past and the one before that, was again characterised by a keen focus on central bank policy. While the theme is the same, the reaction of financial markets to potential policy is as enigmatic as ever. Share markets in particular have moved through phases of 'good news is good news, and bad news is good news' to 'good news is bad news, and bad news is bad news'. This is confusing, especially if you are trying to second-guess tomorrow's markets.

After unnerving investors earlier in the year with guidance toward less quantitative easing (QE), the US Federal Reserve (the Fed) took a first step toward policy normalisation by announcing a slowdown of asset purchases. Starting in January, the Fed will begin to pare back bond purchases from US$85 billion to US$75 billion per month. This time around, the move toward policy normalisation was viewed positively. Share markets rallied, while core bond yields remained more or less steady after creeping up over the past quarter. So for now, it appears that investors are willing to give the US recovery the benefit of the doubt and as a result treat less loose policy as an informed endorsement of real progress in the world's largest economy. While this is a good news story for positively biased investors, share markets are both expensive and erratic. Further gains in shares require either continued financial repression to force investors to buy risk or earnings growth to justify the lofty valuations born of post-crisis policy.

Markets in Europe and the euro have likewise been driven by local and offshore policy, as have Japan and the yen. Europe, while showing fragile signs of economic growth emerging across the continent, is still stymied by shrinking credit, high unemployment and a wad of unproductive debt. Europe has benefitted more from a pickup in global trade through exports to emerging markets than it has from improved domestic demand. While this is positive and has helped balance current accounts, it leaves the recovery dependent on maintaining external demand. Ideally, continuation of the recovery would flow from a balance between income and credit growth. As it stands, income is beholden to exports, while credit growth is hamstrung by a large debt stock and blocked credit pipes. The European Central Bank (ECB) realises this but does not have the same degree of policy freedom as the Fed, Bank of England or Bank of Japan (BoJ). Yet policy evolution at the ECB is a key dimension of uncertainty that has wide ranging implications for international markets. There are indications that the consensus at the ECB is they are now less concerned about inflation, so there is some prospect of further unconventional monetary policy measures in 2014.

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 2.

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Japan, meanwhile, is exercising extreme policy flexibility. Debasement via aggressive balance sheet expansion is supporting the highly polarised savings dynamic and weakening the yen. While this is almost certainly positive for sentiment in the immediate term given the implications for offshore corporate earnings and stability in the government bond market, it generates an array of risks. The benefits of a weakened yen might be undone in the longer term through the impost of rising energy costs on Japan's near balanced trade profile. Re-starting nuclear facilities is one way to fend off this risk, though public sentiment remains highly negative and was reinforced this month as former PM Koizumi spoke out against nuclear plants. Energy and the current account are only the most obvious risk to the BoJ's brazen approach; many other hazards could potentially stem aggressive balance sheet expansion and not all can be easily identified. Perhaps inevitably, the BoJ's determination to overcome deflation, coupled with unsustainable levels of public debt, flirts more closely with the risk of uncontained inflation than other deflation-fearing central banks.

Central bank policies collide in currency markets. Extrapolation of the Fed's tilt toward normalisation has pushed the USD higher, while the yen continues to weaken. This has helped the AUD fall from an extremely high level but it remains expensive on fundamentals. While this is welcome for the AUD, it has caused problems for similarly impacted emerging market countries. Depreciation and capital outflows seeking improved US growth prospects and rising yields can in turn tighten conditions in emerging markets via higher import costs or higher cash rates to support local currency. This is a key point given the importance of emerging markets in generating global demand.

Australia is not immune from this effect. Households are heavily indebted, with significant funding support from overseas markets. Although there are no immediate signs of pressure on bank funding costs, the reliance on overseas funding renders a large component of domestic borrowings sensitive to foreign perception.

China's new leadership reinforced commitment to reform at the important Third Plenum meeting in early December. Pursuit of reforms and rebalancing of the investment-led economy are pivotal to achieving sustainable and stable growth, though at a slower pace. Reform of the financial sector is critical for pricing money, helping savers earn a fair return and forcing corporates to consider capital allocations against hurdles that are not subsidised by savers. This in turn will help increase capital efficiency and reduce building the latent risks of misallocation. At the same time, the incentives for provincial governments to pursue growth look like being re-stated to budgetary discipline. Land reform, Hukou and the one child policy are also keen areas of activity. Combined, these reforms represent a big step forward but are difficult and pose adjustment risks as the profile of economic growth shifts from subsidised industries to new higher value-add sectors. This risk is partly offset by the tendency of the Chinese leadership to enact changes slowly and carefully. But perhaps the biggest risk for the Chinese is loss of momentum. The reform list is long and it will be important for us, as investors with large indirect exposure to China, to monitor progress.

Performance in review

Central bank-sourced liquidity averted tail risk scenarios throughout 2013 and continued to buoy share markets and other risk assets in the December quarter. In spite of some weakness in emerging markets, global share markets posted very strong returns. Unhedged global shares had another strong quarter, boosted by a falling Australian dollar. The start of tapering lifted confidence in the US dollar and reinforced downward pressure on the local currency.

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Investment Management

The Australian dollar weakened from near 0.95 US cents to just below US 0.90 cents at quarter-end. While this helped returns in both the MLC Horizon and MLC Inflation Plus portfolios, the risk-reducing benefits of a strong AUD aided the MLC Inflation Plus portfolios more, due to their ability to take more meaningful positions to manage the risks in global markets. Equally, as the AUD has declined, the risk control benefits of foreign currency exposures diminish, which requires adjustment in share allocations in the MLC Inflation Plus portfolios if portfolio risk is to remain tightly controlled.

Australian and global bond markets produced positive returns over the quarter, despite yields rising in most major government bond markets. Some high-yielding shares—notably property trusts—also came under pressure. Non-government bonds outperformed government bonds over the quarter, with credit spreads continuing to contract. Both the MLC Horizon and MLC Inflation Plus portfolios have benefited from the credit spread contraction. And while the MLC Horizon portfolios have a reduced exposure to nominal bond duration, the MLC Inflation Plus portfolios continue to have a zero exposure to these assets. We are progressively reviewing the positioning with regard to nominal bonds as bond yields rise; however, yields are still well away from levels where an increased allocation is appropriate.

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, and affirmed in December with an announcement that the rate of bond purchasing will be wound back to $75bn a month from January 2014. 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 takes the helm at the Fed in February and should provide policy continuity. Most importantly, tapering has not gone away: the pace of tapering will be pivotal for markets in 2014. Importantly, the Fed is not tapering because QE has done its job, but because its efficacy is waning. They have lost confidence that it will boost the real economy and fear an asset price bubble. This presents a conundrum: the choice between a deflationary slump and an inflationary path out of the debt overhang remains. We can hope that there is a muddle-through middle ground but we cannot be certain about that.

Improved economic performance across Europe has proved fragile, but at least conditions remain calm. It cannot be said that the eurozone is at or even near a stable adjustment path—the ECB cannot resolve the solvency problems of the periphery, and the political and solvency tensions in the periphery are central to the sustainability of the currency union in its current form. German policy and influence remains key while the zone remains banded together. We are expecting announcements from Berlin that map out the deleveraging process sometime after the new CDU/SPD coalition settles into office. 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.

In the medium term, Australia's prosperity is dependent on demand for primary exports. After a long run of mining investment and consequent run-up in national indebtedness, exports need to generate enough income to support servicing international debt obligations. Much of this hinges on economic activity in China, which at its core is much more complicated and nuanced than a potential 'hard versus soft landing?' question. China's massive growth across the noughties was driven by investment, creating a huge demand shock for Australia's main export. This in turn created a much lagged supply response which is just now beginning to produce enlarged volumes of seaborne trade. At the same time, China is pushing towards a new growth model that is less reliant on investment and more focused on consumption. And while this implies a slowing in the rate of investment growth, the levels demanded by a rebalancing China might still generate a healthy level of annual demand. Nonetheless, just as the strong growth in iron ore demand was unanticipated by miners, it is also possible that the rate of consumption might undershoot by more than producers expect. A discussion of iron ore necessarily focuses on the outcome of much more fundamental issues within China, where Xi Jinping looks to have begun the hard, but necessary, road to reform.

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

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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] There is still no roadmap for the withdrawal of policy stimulus, and 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.

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.

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

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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 MLC's diversified 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.

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.

The chart on page 8 looks at our barometer of risk and return for the MLC Horizon and MLC Inflation Plus portfolios at the end of December 2013. 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.

The chart shows that on average, looking across the whole scenario set, the reward for taking additional risk is limited. In the event that a scenario with relatively higher returns occurs, such as our 'Extended quantitative easing' scenario, then returns to those funds with higher share allocations will be sharply higher. However, looking across the range of future possibilities and using our assessment of their probabilities, there is a clear concern that the reward for risk-taking could disappoint. Comparing the MLC Inflation Plus and MLC Horizon portfolios, the strong risk focus of the MLC Inflation Plus portfolios is evident. In those portfolios, we have responded to shrinking return potential and rising risks by reducing exposures to riskier assets. This reduces return potential in strong scenarios but provides tight risk control in the event that an adverse environment occurs. However, it should not be inferred from the chart that negative real returns cannot occur for the MLC Inflation Plus Conservative and Moderate portfolios. The light grey bars represent the average return in the worst 10% of outcomes. If instead we look at the worst 5% to 1% of outcomes the average return declines and can be negative. In positioning all portfolios we take outcomes in all scenarios into account. For the MLC Inflation Plus portfolios our focus is on strictly limiting both the probability and extent of negative real returns in the event that an adverse scenario occurs, while at the same time extracting as much return potential as possible.

Also in relation to the MLC Inflation Plus portfolios, the chart suggests that unless a relatively positive scenario occurs these portfolios are unlikely to meet their return hurdles by holding the current asset allocation. However, the MLC Inflation Plus portfolios' allocations evolve dynamically through time and will exploit opportunities as they arise over time, though they will not chase returns to meet the return hurdle if that requires a large risk exposure.

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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 easing environment again becomes dominant, or credit fuelled growth resumes, adding to the still large stockpile of global debt. 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.

40 Scenario Set Probability Weighted Real Returns – Strategic Overlay allocations

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

Source: MLC Investment Management

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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. The AUD remains strong in this scenario.	Traditional funds such as the MLC Horizon portfolios perform strongly in this scenario. However, the relative risk control focus of these portfolios means they may lag peers as private equity lags listed markets and the AUD remains strong. MLC Inflation Plus portfolios will increasingly lag if the environment persists due to our overriding need for risk control. However, the portfolios should meet or exceed their return objectives, at least until risk becomes extreme. Risk control must progressively tighten if this scenario persists. The challenge is to maximise diversification opportunities so as high an allocation to shares as possible can be maintained.
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 shares focus in MLC Inflation Plus 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 (outlined in Appendix 2). 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 pivot around the key characteristics and uncertainties in the current environment. The tailored set, listed in Appendix 1, 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 deflationary deleveraging 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 continued 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 and MLC Index Plus portfolios. 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, despite some increase in yields, are still expensive, offer very limited diversification potential and are acutely sensitive to rising inflation. Inflation-linked bonds, on the other hand, despite offering compressed yields, are still a valuable component of an inflation hedge strategy. 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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MLC Inflation Plus portfolios

The risk profile of the MLC Inflation Plus – Assertive Portfolio was again moved to more defensive during the December 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 portfolios (in MLC super products) is in the table to the right.

The new MLC Inflation Plus – Assertive Portfolio was previously called the MLC Long Term Absolute Return Portfolio (LTAR).

Asset class	Change in allocation to asset class in the MLC Inflation Plus portfolios			Comment (for Assertive)
	Conservative	Moderate	Assertive (previously LTAR)	
Australian shares	Steady	Reduced	Steady	Relatively attractive in terms of probability-weighted outcomes but relatively high tail risk.
Global shares	Steady	Steady	Reduced	Exposure reduced in response to rise in share prices and increase in prospective risk.
Defensive global shares (unhedged)	Steady	Increased	Steady	The portfolio has a strong bias to absolute, not index-relative, shares.
Foreign currency exposure	Steady	Steady	Steady	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	Steady	Reduced	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	Steady	Steady	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	Steady	Steady	Steady	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	Steady	Steady	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 Extended quantitive easing scenario). The very high 'alpha' component of private equity returns is attractive in a return-constrained environment.
Global property securities	Zero direct exposure	Zero direct exposure	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	Zero direct exposure	Zero direct exposure	Unattractive, with still limited diversification benefit.
Australian inflation-linked bonds			Slightly increased	Inflation hedge remains attractive, despite low yields. Inflation-linked markets have lagged rallying nominal bond markets and created an opportunity to increase exposures slightly.
Cash	Steady	Slightly Increased	Increased	Cash allocations have increased as share allocations have been reduced following strong returns.

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Asset class	Change in allocation to asset class in the MLC Inflation Plus portfolios			Comment (for Assertive)
Australian non-government bonds	Steady	Steady	Increased	Duration hedged non-government bonds provide a defensive allocation with some return enhancement.
Global bank loans	Decreased	Decreased	Increased	Floating rate loans offer some exposure to diversifying income based risk premia without as much capital risk as fixed coupon bonds. While this is attractive in the current environment, tight spreads increase price risk and a tendency for low liquidity in adverse environments limits the degree to which a fund should have exposure. Due to differences in starting allocation and risk considerations, the change in allocation to loans this quarter is different across the series. Conservative and Moderate lightened their exposure, while Assertive gained a small initial exposure as share allocations have been reduced.
Borrowings			No borrowings	Reward for risk is shrinking as asset prices rise. Over the quarter all gearing was removed.

MLC's scenario insights & portfolio positioning

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 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% overweight (MLC Horizon 4 and 5 only).
Global absolute return bonds		X		Retain neutral allocation.
Global government bonds	X			Retain underweight global government bonds and overweight cash.
Global non-government bonds		X		Retain neutral allocation.
Global multi-sector bonds		X		Retain neutral allocation.
Global non-investment grade bonds: high yield bonds, bank loans, mortgages		X		Retain neutral allocation.

MLC's scenario insights & portfolio positioning

Return potential

At the heart of our Investment Futures Framework are scenarios that provide insight into a range of 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 through time are the starting asset prices. If share prices rise strongly, future return potential is reduced. That is what has happened over the December quarter.

Our broad-based generic scenario set can be viewed as a consistent barometer of risk and return through time. Today our barometer is painting a difficult picture. Future return potential is compressed across the spectrum of shares and debt assets. The higher asset prices go, the lower future returns must eventually be. The word 'eventually' is an important one—in environments with strong monetary stimulus, share prices in particular can run further and for longer than seems reasonable on the basis of the economic fundamentals.

The probability-weighted real returns for each asset class are shown in the graph (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.

40 Scenario Set Probability Weighted Real Returns (December 2013)

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

Source: MLC Investment Management

Return potential for shares continues to compress as returns for risk assets run ahead of their underlying fundamentals. The most significant change from the September quarter is the decline in return potential for unhedged global shares. This is due to both the rise in share prices and the decline in the Australian dollar. A small rise in bond yields has marginally improved return potential for bonds, but probability-weighted real returns for global nominal bonds remain negative and the distribution highly negatively skewed.

MLC's scenario insights & portfolio positioning

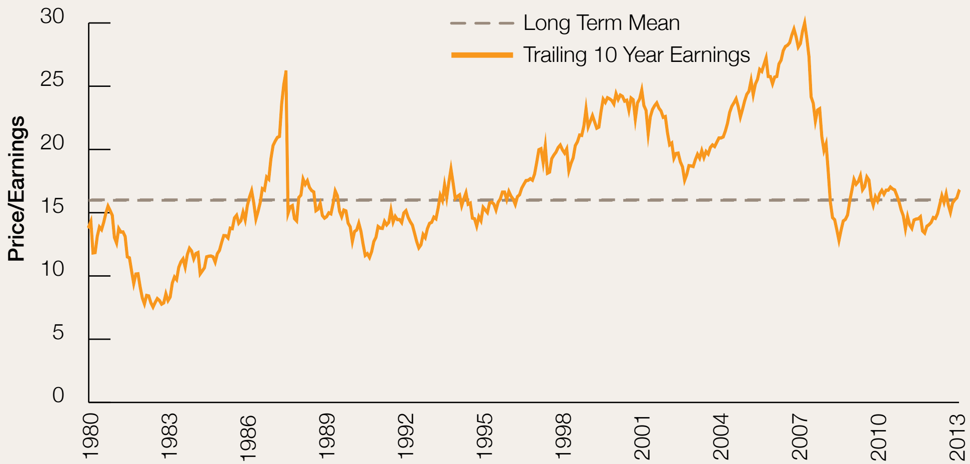
Asset class indicators

Our view of the main asset classes is as follows.

Australian shares

Market indicator

S&P/ASX 200



Source: Datastream

Comment

Australian shares were volatile in the December quarter. Early global systemic concerns regarding the impact of a US default were later offset by gains. P/E expansion continues to be the main driver of this positive market return.

Global shares (including currency)

Market indicator

S&P500

Source: Datastream World Index

Comment

Global share prices ended stronger in the December quarter after initial weakness on concerns regarding US debt ceiling negotiations in Washington. Premium compression (P/E expansion) accounted for most of the returns experienced – global share markets are effectively borrowing returns from the future.

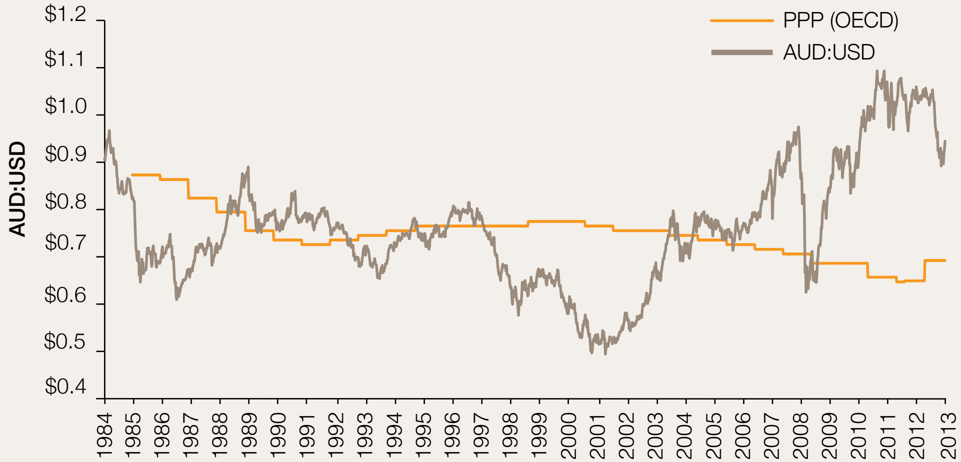
MLC's scenario insights & portfolio positioning

Asset class indicators continued

Australian dollar

Market indicator

Australian Dollar Purchasing Power Parity



Source: Bloomberg

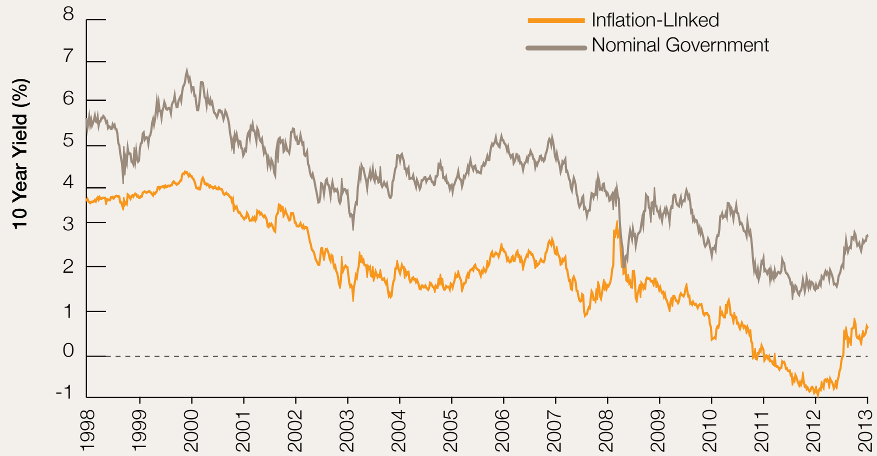
Comment

The Australian dollar declined over the quarter, more than reversing gains from the September quarter. The currency remains at levels which are 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 December quarter, perhaps as a genuine step toward normalisation in yields. The US Federal Reserve declared its intention to reduce the rate of bond purchases, and short run economic data in major regions over the quarter was positive compared with earlier data. While this could be the beginning of yield normalisation, the environment is still fragile. Also uncertain is the possible impact of the debt ceiling negotiations early in 2014 on perceptions of US Treasuries as a safe haven.

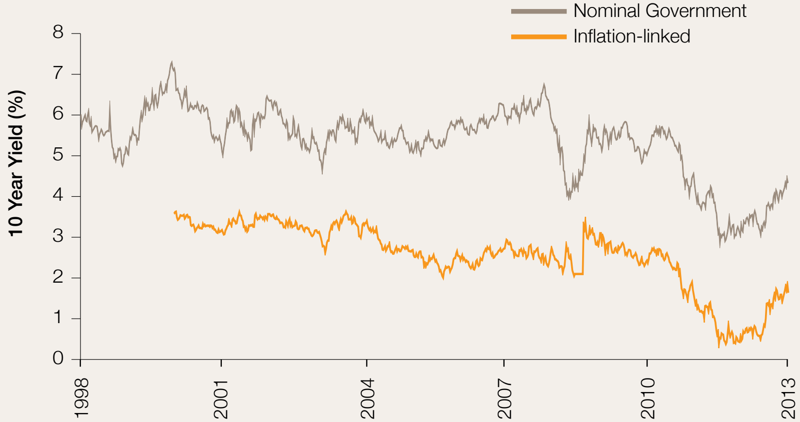
MLC's scenario insights & portfolio positioning

Asset class indicators continued

Australian government bonds

Market indicator

10 Year Bond Yields – Australia



Source: Bloomberg

Comment

Australian government nominal bond yields again took their cue from the US following the rise in yields, especially at the longer end of the yield curve.

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.

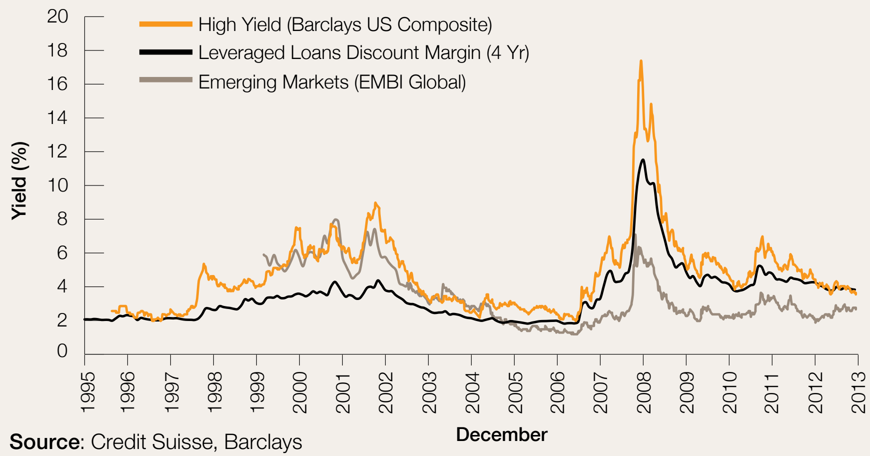
The cash rate remains at an historic low of 2.5% pa.

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 performed well in the December quarter as spreads narrowed in the face of rising longer term rates. Low default rates support compressed spreads, but the market remains vulnerable to a decline in economic conditions as starting valuations are very high.

Returns for high yield bonds for the December quarter were positive. The sector's solid performance was driven by a contraction in high yield bond spreads, which resulted in yields falling during the quarter

MLC's scenario insights & portfolio positioning

Appendix 1 – tailored scenario set

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. The key difference from weaker scenarios is that the US and emerging markets are stronger. 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.
(Mild) inflationary resolution	2	Monetary stimulus and some form of resolution for Europe are combined with sensible policy to stimulate growth. Widespread USD and GBP (and euro) liquidity provides inflationary pressure that is countered to a degree by slightly sub-capacity growth…a very fine balance. 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	3	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.
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.
Extended quantitative easing	5	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.
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.

MLC's scenario insights & portfolio positioning

Scenario	Probability ranking	Description
Reform	7	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	8	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	9	Similar to stagflation, though assumed growth is higher. Sharp rise in inflationary expectations.
Two speed recovery	10	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.
Extended risk aversion	11	A generic scenario to capture prolonged aversion to risk.
One speed slow growth world	12	There is growth convergence as persistent slow growth in the developed world spills over into the emerging world.
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.

MLC's scenario insights & portfolio positioning

MLC Investment Management

Appendix 2 – MLC's market leading investment process

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.

MLC Investment Management

Important information

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