MLC's scenario insights & portfolio positioning

MLC Horizon and MLC Inflation Plus portfolios

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In the first quarter of 2014, the market's attention was caught by the commencement of tapering and related emerging market volatility, Janet Yellen's first messages as chairman of the US Federal Reserve (the Fed), and Russia's annexation of Crimea.

The tapering of quantitative easing (QE) in the US takes us into a new and uncertain regime. Directional changes in monetary policy—moving from easing to tightening or vice versa—have important implications for expected economic growth and earnings and therefore share prices. What's unclear is the extent to which tapering represents a tightening of monetary conditions.

Our research this quarter included a focus on the possible pace and impacts of tapering. We have had discussions with policy makers, and economists and investment professionals with experience dating back to the 1970s. The pace of tapering depends on the economic performance of the US—not only economic growth, but also how inflation risks evolve. In our view there is far too much complacency about inflation. Very few market practitioners today remember the 1970s, the last major inflationary episode in the developed world, and that may mean some lessons of the past have been lost.

Today's ultra-low interest rates and QE are potentially inflationary. Such accommodative policy is intended to offset the deflationary forces of debt deleveraging. The challenge policy makers face is withdrawing the stimulus to avert inflation without choking off the nascent recovery. They are hoping for a middle ground in which the recovery becomes sustainable while inflation expectations remain well anchored, permitting real growth to exceed real interest rates. Whether or not this middle ground exists is unknown. If it does not, policy choices will hinge on whether the greater evil is seen as inflation or unemployment. Relative to the eurozone, the policy settings of the US and UK and, belatedly, Japan, suggest a bias towards greater inflation flexibility (an increased willingness to countenance higher inflation). Our research during the March quarter has reinforced our perception of a US policy bias towards inflation.

Although QE tapering has commenced, we need to remember that, as with monetary policy generally, there are lags and these can be of long duration. This type of monetary policy tends to increase asset prices and, as a result, wealth effects that feed through eventually to growth. The US stock market has almost completely recovered and house prices have turned around. However, the wealth effect does not work immediately or uniformly. It puts some householders in a position to make bigger purchases when they need to, but there is no automatic increase in spending. This is a key point and it implies that pent-up demand may be higher than is understood. Interpreting the flow of economic data is always complex, and recently extreme weather events (the polar vortex) have created a confusing picture. It is necessary to look into the detail behind the headline numbers, and when we do that we see that wages in the US are starting to pick up. The evidence is clearest for smaller businesses, which form a key part of the labour market. The question is why this is the case while unemployment is still at 6.5%.

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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The most credible answer to this question is that structural unemployment has increased. There is confirmation of this in the rising percentage of small businesses that cannot find qualified applicants. Structural unemployment exists when there is a mismatch between those seeking work and the capabilities required to fill the jobs on offer. The cause may lie in the educational system not responding adequately to the changing needs of companies, an increasing challenge because of competition from robotics as well as cheap offshore labour. Those without a good education find it difficult to get work.

The structural unemployment argument suggests that in judging the tightness of the labour market, the focus should be on those unemployed for less than 26 weeks, as this will give a better indication of wage and price pressure. A key question for the course of US monetary policy is what the Fed thinks about this. Our understanding of Yellen's position is that it is not possible to prove that there is more structural unemployment. It is of course very difficult to get conclusive proof. This implies that the Fed's standard of proof is too high and that they may be in denial, or alternatively they may be well aware that the labour market is tighter than a 6.5% unemployment rate suggests. The latter seems the more likely scenario. It was suggested to us that the Fed are deliberately creating confusion on this issue. If that is the case it confirms the Fed's preference for reducing unemployment over controlling inflation. Under this view, the Fed will end up being seen as behind the curve. When the employment cost index rises they will say that it doesn't make sense because unemployment is high and so will be the last to believe it or the last to admit they believe it. The motivation in being a denier of wage pressures is simply that higher wages boost growth and tend to push up inflation, both of which help erode the real value of debt. However, it is difficult for the Fed to admit that it is tolerant of higher inflation as this will quickly be reflected in bond yields, which depresses growth.

What we're suggesting is that the bargaining power of labour has already shifted and that this has consequences not only for inflation, but also earnings growth. One of the anomalous things about the US economy in recent years is the unusually low share of income generated that goes to labour versus capital (shareholders). Our expectation is that labour is best placed to capture a rising share of income when growth is strong—this is hardly earth-shattering, since higher growth means higher demand for labour—but that a low share of income for labour may persist in low growth scenarios. The implication of this is that stronger growth scenarios will see earnings rise more slowly than would otherwise be the case. The research we undertook in the March quarter supports this view.

Evidence supporting the perception that inflation risks are greater than the market in general appreciates helped prompt an increase in the allocations to inflation-linked bonds across both the MLC Horizon and MLC Inflation Plus portfolios during the quarter.

Performance in review

Concerns about slowing growth in China and coincident volatility in the more fragile emerging markets resulted in a nervous start to the year. Share markets declined, while protective exposures did their job, while bond yields and the AUD declined. The most vulnerable emerging markets are those with significant current account deficits. In particular, Argentina has been unsuccessfully trying to manipulate markets and finally gave up, prompting a 20% decline in its currency, with contagion effects for other fragile emerging markets such as South Africa and Turkey. Over the past few years, trillions of dollars have flowed into emerging countries as a consequence of the Fed's quantitative easing. As QE tapering commences, expectations about future interest rates start to shift, triggering reversals in those capital flows. Consequently, stronger US growth tightens liquidity conditions in emerging markets, which reduces their growth and encourages convergence of emerging and developed market growth.

The bout of risk aversion rapidly reversed in February. There was also a flurry of IPOs at valuations reminiscent of the dot-com era.

All this demonstrates that we remain in an environment of excess liquidity for which there is a continuing search for an adequate home. While the rally was interrupted by escalation of the Ukraine crisis in March, overall share markets recovered and ended the quarter roughly flat. The Australian dollar strengthened, despite a greater focus on vulnerabilities in China.

During March there were a series of credit events in China which provide evidence of the bad debt issue we have talked about for some time. As we have noted previously, there is uncertainty about the extent of these problems and how they will play out—this one of the key 'known unknowns' for 2014. Despite this, the Australian dollar (AUD) was buoyed by some tentatively positive economic data and encouraging comments from the Reserve Bank of Australia about a 'so-called handover from mining-led demand growth to broader private demand growth' beginning. In addition, Chinese premier Li Keqiang added further to AUD support at the end of March, commenting that there were 'policies in store to counter economic volatility for this year'. He also referred to the launch of 'relevant and forceful measures' already planned, which include infrastructure spending in the central and western provinces. Even so, the degree to which China can continue to support growth through infrastructure has diminished since the rapid deployment of capital between 2008 and 2012. The party now faces the difficult balancing act of limiting credit creation while at the same time promoting growth. This would be an easier task if global trade had picked up commensurate with growth in the developed world, but it has not. As a consequence, capacity utilisation across the Middle Kingdom remains low which, coupled with a mismatch in housing construction and demand, make it hard to deploy effective stimulus without further denting the internal credit dynamics.

Despite the impact of any China stimulus, there are still looming headwinds for Australia in the form of lower resource-related spending, with little sign so far of an offset elsewhere in the economy. However, the news has been positive enough to change interest rate expectations and consequently the AUD, given the ongoing obsession with yield.

The overweight to foreign currency position reduced the downside exposure in our diversified portfolios during the January decline, but reduced returns overall for the March quarter. Importantly, the correlations between the currency and share markets are playing out as expected, and the foreign currency exposure remains a key component of our approach to controlling risk in what continues to be a difficult investment environment. We again reduced allocations to emerging markets in January, prior to the share market volatility; this was the latest in a series of reductions that reflected the increased vulnerability of these markets in a QE tapering regime. The Inflation Plus – Assertive Portfolio (previously called the MLC Long-Term Absolute Return Portfolio) has the highest allocation; it was more than halved prior to the January volatility.

Looking forward

As a precursor to considering what the future might hold, this quarter we look back to remind ourselves how we got to where we are. To start the story we must go back to the time when Alan Greenspan took over as Fed Chairman, shortly before the 1987 crash. After that, whenever the economy looked like slipping into recession or the sharemarket started to slide, the Fed lowered interest rates. By the late 1990s the era of disinflation and prosperity was fading but the 'Greenspan put' kept the party going.

Excesses that would have been resolved in an economic downturn instead increased. As a consequence, when the tech bubble turned to bust a deep recession was in prospect. However, the Fed cut interest rates and averted the recession, sowing the seeds of the housing bubble and related leverage boom. This was the so-called era of the 'great moderation'; economic cycles, we were asked to believe, were a thing of the past. It behoves us to remember that this, like other 'new paradigms' before it, were (and those yet to come are) an illusion. The Fed had unwittingly duped investors into believing risk was low when in fact it was high. When the housing bubble burst in 2007, there was massive risk built into the system and a depression loomed. This time, policy makers had no choice but to act decisively, and they have been successful in that the US and UK have avoided depression—the eurozone is another matter. In the eurozone, although growth rates have improved, depressed activity continues to put downward pressure on prices, which implies that the ECB's monetary offset has so far been insufficient.

The big question for us today is whether the day of reckoning has been avoided altogether or delayed yet again. There are some prominent and rightly respected commentators predicting another, perhaps even larger, market bust. This cannot be ruled out in a world where zero interest rates are distorting all asset prices. The underlying problem is that the cumulative excesses (too much debt, much of which is now on public sector balance sheets) have not yet been cleaned out of the system. However, these can be resolved without another crisis if, as is currently the case, interest rates are held below the rate of inflation, which reduces the real value of debt. That's the good news, but it's also the bad news because interest rates below the rate of inflation erode the real value of savings and erode the purchasing power of retirement savings. That is the conundrum we face.

Whether inflation rises or not, the environment we are in is one where real return potential is compressed—ultra-low interest rates mean investors are already facing an inflationary haircut in the form of lower prospective returns. And as discussed earlier, inflation risk is higher than generally presumed. However, we cannot know the path to an ultimate inflationary workout. The balance between the deflationary forces of debt deleveraging and the inflationary forces of the monetary stimulus will determine how the environment evolves. We cannot know how that balance will play out, which implies that there is a wide range of possible futures.

Managing potential risk and return in MLC's diversified portfolios

MLC's portfolios are managed by building a comprehensive understanding of how the future could unfold. This provides an understanding not only of the return potential but also, importantly, of the sources and the magnitude of risk and how these change through time. The process provides a deep and detailed understanding of future risks, return potential and the opportunity for diversification. Portfolios are positioned to achieve as high an expected return as possible using diversification opportunities, while maintaining risk within appropriate boundaries.

For the MLC Horizon portfolios, risk is primarily benchmark-related (and by implication peer relative), with absolute outcomes being important but secondary to this, because these funds must remain true to label (for example, the asset allocation of MLC Horizon 4 will not become the same as MLC Horizon 2).

For the MLC Inflation Plus portfolios, risk is absolute not relative, in particular:

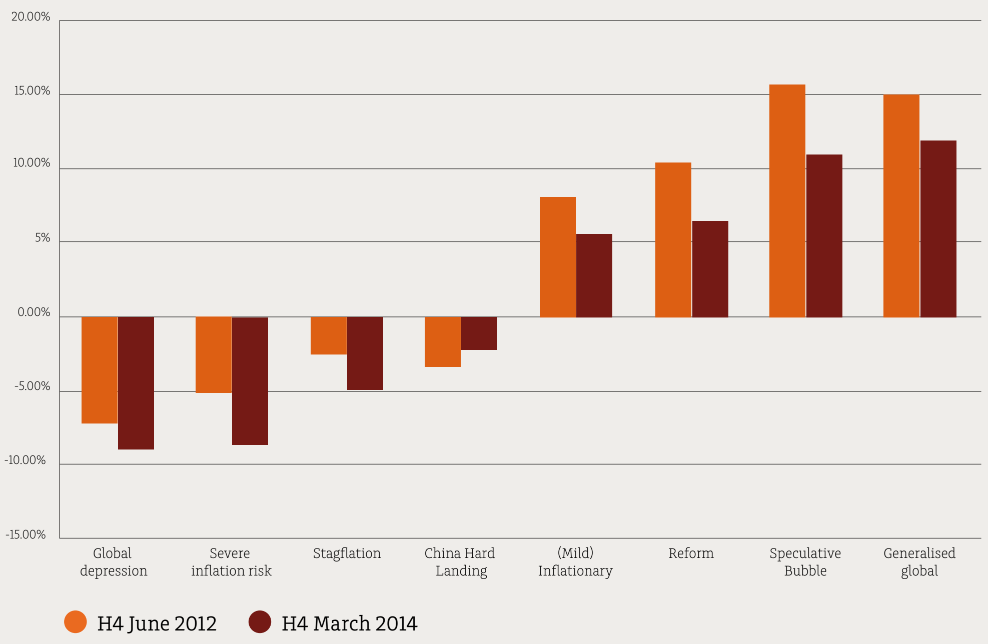
- in adverse scenarios, we limit exposure to negative returns to preserve capital in after-inflation terms over the defined time frame, and
- in other scenarios, we aim to deliver attractive inflation plus returns over the defined time frame.

Chart 1 on the next page shows, for MLC Horizon 4, return potential across selected possible future scenarios looking forward from two different points in time: mid 2012 (orange bars) and the end of Q1 2014 (marone bars). As can be seen, in all but the China Hard Landing scenario, the return potentials are now lower than they were in 2012. This reflects very strong equity return and a weakening of the AUD since mid 2012.

This return compression applies to all our diversified funds. It also applies across our entire set of scenarios—all 40 in the generic set and thirteen in the tailored set. A similar picture can be generated for the other MLC Horizon portfolios. The simple reason is share and other risk asset prices have increased faster than the underlying fundamentals.

MLC's scenario insights & portfolio positioning

Chart 1: MLC Horizon 4 (H4) annualised 5 year forward net returns from different starting points



For **Chart 1**, we have selected scenarios that illustrate some important sources of risk: inflation, weak growth or recession and dislocation in China, which has important consequences for Australia. We also have a number of more positive scenarios: a speculative bubble in which, despite tapering, QE drives asset prices ever higher; a strong growth regime in which returns are supported by surprisingly strong fundamentals; a scenario in which structural reform eventually boosts productivity and therefore growth; and a mild version of an inflation debt work-out where inflation does not cause alarm and growth remains on track.

As **Chart 1** suggests, continued strong returns remain possible. However, we see the probability of a strong growth scenario as being limited in the near term and reliant on a period of structural reform, particularly outside the US. Our selected scenarios also illustrate that inflation is not inevitably negative for shares. Mild inflation in which the growth cycle continues can generate above-inflation returns for shares, though returns to nominal long duration bonds will be more challenged. On the other hand, if growth falters while inflation moves sharply higher, as in our stagflation scenario, negative after-inflation returns would be in prospect from both bonds and shares. Similarly, in the worst case scenarios for inflation (Severe inflation risk) or growth (Global depression) there is obvious downside risk.

The compression of return potential and increase in downside risk intensify our focus on risk control and search for diversifying opportunities. The increase in inflation-linked allocations during the quarter has moved the portfolios in the direction of greater risk control. We have also maintained our overweight to foreign currency as an important risk diversifier which reduces the downside in a broad range of risk scenarios.

MLC's scenario insights & portfolio positioning

Chart 2: MLC Inflation Plus – Assertive (IPA) Portfolio annualised 5 year forward net returns from different starting points

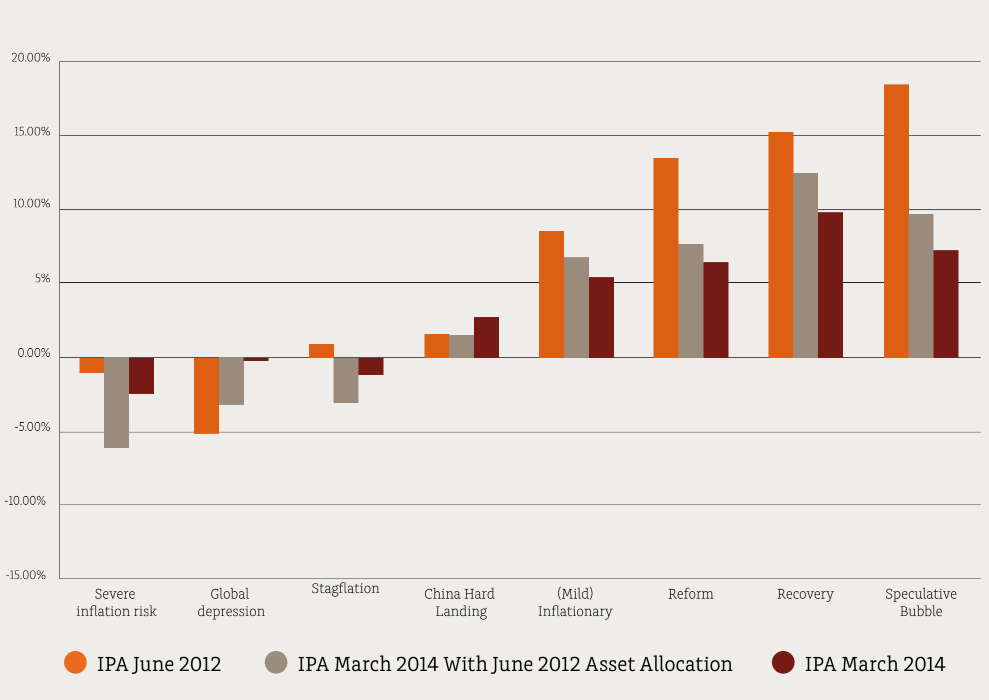


Chart 2 provides a similar analysis for the MLC Inflation Plus – Assertive Portfolio. The chart has three return potential bars: as at mid-2012 (orange); as at end March 2014 but with the mid 2012 asset allocations (grey); and as at the end of March 2014 with the current allocation (marone). Again we can see the reduction in return potential and increase in risk between the two dates where the strategy is held constant. However, it can also be seen that changes to the strategy since mid 2012 have offset the increase in risk. With the opportunity for diversification limited, tighter risk control inevitably reduces return potential. The main equity diversifier, nominal bonds, remains weak, and the foreign currency diversifier has weakened as the AUD has declined.

The continuing challenge is to maintain return potential while limiting downside risk exposure. With both the potential for strong returns as a result of QE driving asset prices higher, and ongoing risks which could trigger an asset price reversion, we are increasing use of optionality (using options to help manage tail risk) to reduce risk exposure while maintaining upside potential. Our primary focus is to maintain the risk discipline, which has resulted in a sequence of reductions in risk asset exposures and more recently, an increase in defensive allocations, notably inflation-linked bonds. Given our concerns about inflation risk complacency, we will be moving to tighten risk exposure in inflation scenarios.

MLC's scenario insights & portfolio positioning

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.

Chart 3 looks at our barometer of risk and return—based on our 40 scenario set, described on page 10—for the MLC Horizon and MLC Inflation Plus portfolios looking forward from the end of March 2014. The probability-weighted real returns 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.

The chart continues to show that on average, looking across the whole scenario set, the potential 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, the returns to those portfolios 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 stronger risk focus of the MLC Inflation Plus portfolios is evident. Consistent with their objectives, these funds 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.

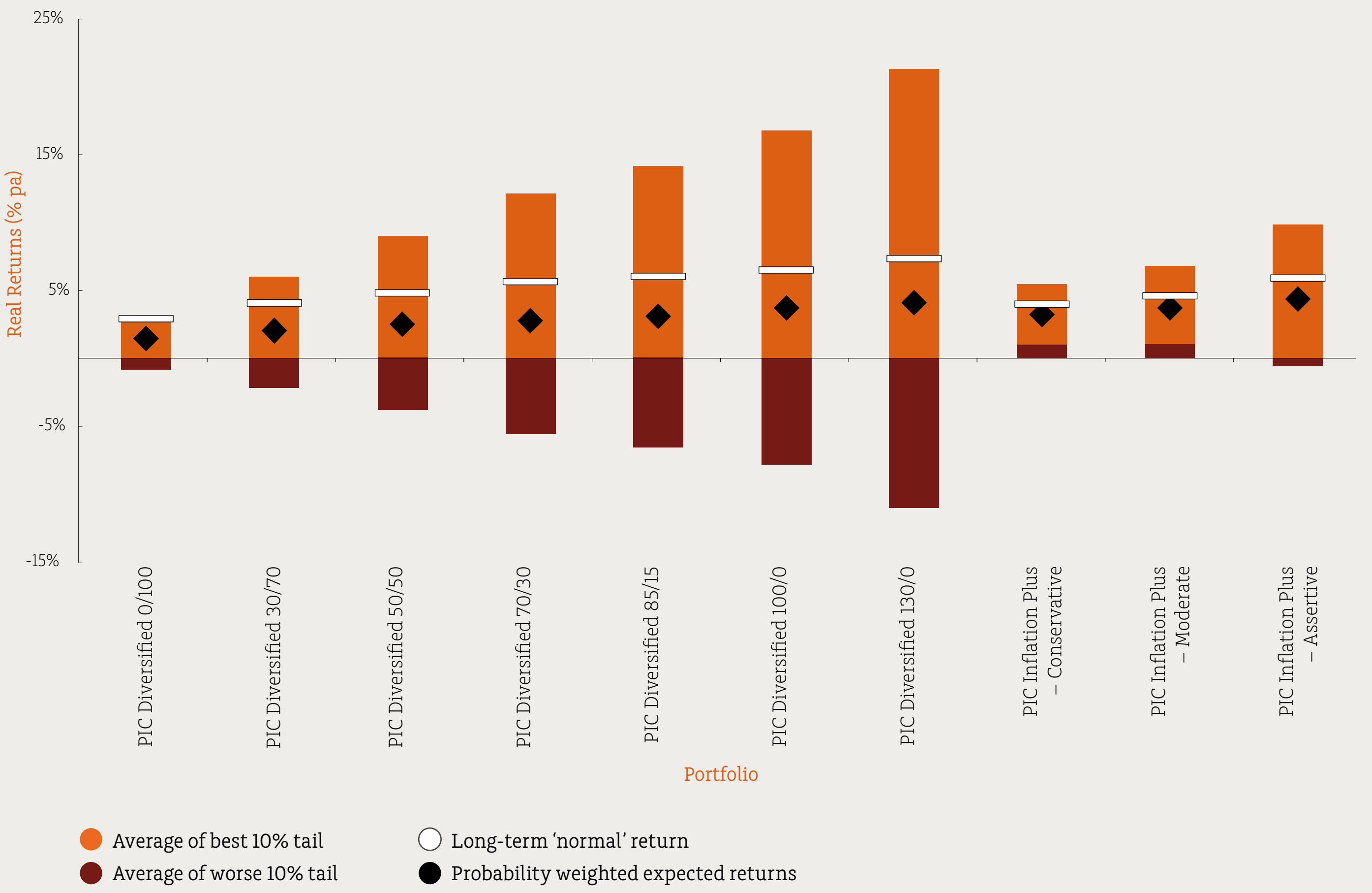
Note that it is incorrect to infer from the chart that negative real returns cannot occur for the MLC Inflation Plus Conservative and Moderate Portfolios. The grey bars represent the average return in the worst 10% of outcomes. If we reduce this probability and look, say, at the worst 5% to 1% of outcomes, then the return declines and can be negative. In positioning all our portfolios we take into account outcomes in all scenarios. 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 the funds are unlikely to meet their return hurdles by holding their current asset allocation for the next four years. However, in practice these asset allocations are not static. We evolve the MLC Inflation Plus portfolios' allocations dynamically through time and will exploit opportunities as they arise, though we do not chase returns to meet the return hurdle if that requires too great a risk exposure.

MLC's scenario insights & portfolio positioning

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.

Chart 3: 40 Scenario Set Probability Weighted Real Returns – Target Asset allocations (5 years, 0% tax with franking credits, pre fees, pre alpha)



Source: MLC Investment Management

MLC's scenario insights & portfolio positioning

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 comprises 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 which includes as many scenarios as is necessary to capture distinctive possibilities from the current starting point. The generic set of scenarios is 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 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. The tailored set revolves 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 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

MLC's scenario insights & portfolio positioning

and remain overweight to foreign currencies across MLC Horizon 2 to MLC Horizon 7. Our positioning against the AUD does not mean that the scenarios process 'expects' the Australian dollar to fall—indeed, two of our tailored scenarios expect the dollar to rise (others expect the AUD to fall, and by a greater amount). Instead, the model suggests that the AUD is an efficient source of diversity that decreases overall risk, allowing greater exposure to other sources of risks than we would otherwise have carried in the portfolios. In short, in many scenarios the AUD is a perceived safe haven that turns out to be something of an illusion.

Shortening the duration of nominal debt exposures is particularly appropriate given the concerns about an eventual rise in inflation. Although this will not necessarily be a highly adverse scenario, it does present investment challenges. Inflation is like a tax on savers. We no longer just need positive returns; we need returns that exceed the moving target of rising inflation. The most obvious risks lie in nominal bonds which, 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, are still a valuable component of an inflation hedge strategy despite offering compressed yields. 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.

Real return funds: MLC Inflation Plus portfolios

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. The risk profile of the MLC Inflation Plus – Assertive Portfolio was relatively static during the March quarter given an absence of major moves in risk. The most important market change was the rise in the Australian dollar, which reduces the riskiness of the portfolios. The multi-asset real return strategy allocation was increased to leverage further the opportunity for efficiency increases arising from the merging of macro and stock fundamentals. In addition, inflation-linked exposures were raised to tighten inflation risk protection.

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.

The current positioning considerations for the MLC Inflation Plus series are summarised in the table.

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 allocation	Steady allocation	Steady allocation	Relatively attractive in terms of probability-weighted outcomes but relatively high tail risk.
Global shares	Steady allocation	Steady allocation	Steady allocation	Limited exposure.
Defensive global shares (unhedged)	Steady allocation	Steady allocation	Steady allocation	Primary global share exposure is defensive. The portfolio has a strong bias to absolute, not index-relative, shares.
Foreign currency exposure	Steady allocation	Steady allocation	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	Steady allocation	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	Increased allocation	Increased allocation	Steady allocation	This remains a key part of the strategy: to offer efficiencies by breaking down asset class barriers and merging macro and stock selection considerations through an absolute return focus.
Emerging markets strategy	Reduced allocation	Steady allocation	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	Steady allocation	Targeting reduced 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 Extended quantitative easing scenario). The very high 'alpha' component of private equity returns is attractive in a return-constrained environment. However, the private equity allocation for the MLC Inflation Plus – Assertive Portfolio, in particular, has been above target and given risk considerations, we are targeting a lower exposure.

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Real return funds: MLC Inflation Plus portfolios continued

Asset class	Change in allocation to asset class in the MLC Inflation Plus portfolios			Comment (for Assertive)
	Conservative	Moderate	Assertive (previously LTAR)	
Global property securities	Zero direct exposure	Zero direct exposure	Zero direct exposure	We prefer the broader opportunity and absolute return orientation of defensive global shares. 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	Higher allocation	Higher allocation	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. We have also increased allocations on concerns of undue inflation complacency.
Global bank loans	Reduced allocation	Reduced allocation	Zero direct exposure	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.
Borrowings			No borrowings	Reward for risk is shrinking as asset prices rise.

MLC's scenario insights & portfolio positioning

MLC Horizon portfolios

The MLC Horizon portfolios are designed to maximise risk-return efficiency within defined asset allocation considerations. Like other traditional diversified portfolios, for the MLC Horizon portfolios the mix of debt and shares is regarded as a defining characteristic. While some flexibility around allocations is acceptable, these portfolios must remain true to label. For these portfolios, allocations pivot around the benchmark allocation with the aim of increasing risk return efficiency, in particular by reducing exposure to assets which offer a less attractive reward to risk. In recent years we have introduced diversifying exposures which offer a more defensive element—in particular multi-asset real return, defensive global shares and the Low Correlation Strategy. These exposures help increase the defensive characteristics of the portfolio in an environment where risk is elevated. We also continue to view foreign currency exposures as an important diversifier in an environment where nominal bonds are a weak diversifier and are themselves risky in some scenarios. During the quarter we moved inflation linked securities back to benchmark, reflecting ongoing inflation concerns.

	MLC Horizon portfolio weights			Comment
	Under	Neutral	Over	
Growth assets		•		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		•		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)			•	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)	•			
Global property securities		•		Retain neutral allocation – the allocation is underweight versus peers.
Global private assets		•		Retain neutral allocation – noting that currently the actual allocation to private equity is ahead of the target level.
Multi-asset strategies		•		
Emerging markets strategy		•		Maintained.
Multi-asset real return strategy		•		Maintained.
Fixed income		•		Reduced duration maintained.
Australian bonds – All Maturities			•	1% overweight (MLC Horizon 4 and 5 only).
Australian inflation-linked bonds		•		Moved back to neutral given perceptions of undue inflation complacency.
Global bonds – All Maturities	•			1% underweight (MLC Horizon 4 and 5 only).
Global absolute return bonds		•		Retain neutral allocation.
Global government bonds	•			Retain underweight global government bonds and overweight cash.
Global non-government bonds		•		Retain neutral allocation.
Global multi-sector bonds		•		Retain neutral allocation.
Global non-investment grade bonds: high yield bonds, bank loans, mortgages		•		Retain neutral allocation.

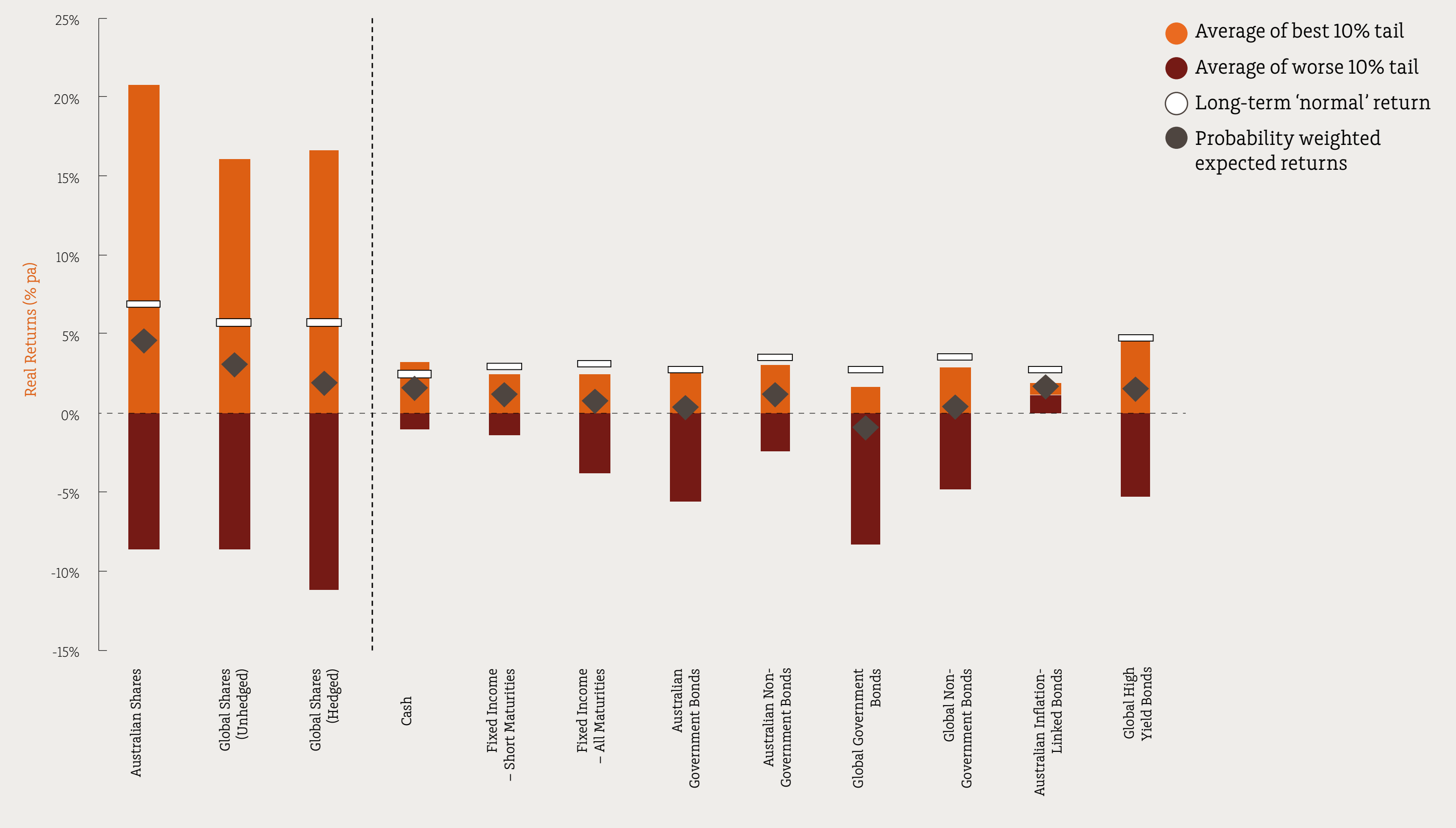
Return potential

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 points are normally defined and fixed; what changes through time are the starting asset prices. For example, if share prices rise strongly, future return potential is reduced.

Our broad-based generic scenario set can be viewed as a consistent barometer of risk and return through time. Today our barometer is continuing to paint 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 Chart 4 (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.

Chart 4: 40 Scenario Set Probability Weighted Real Returns (March 2014)
(5 years, 0% tax with franking credits, pre fees, pre alpha)



Source: MLC Investment Management

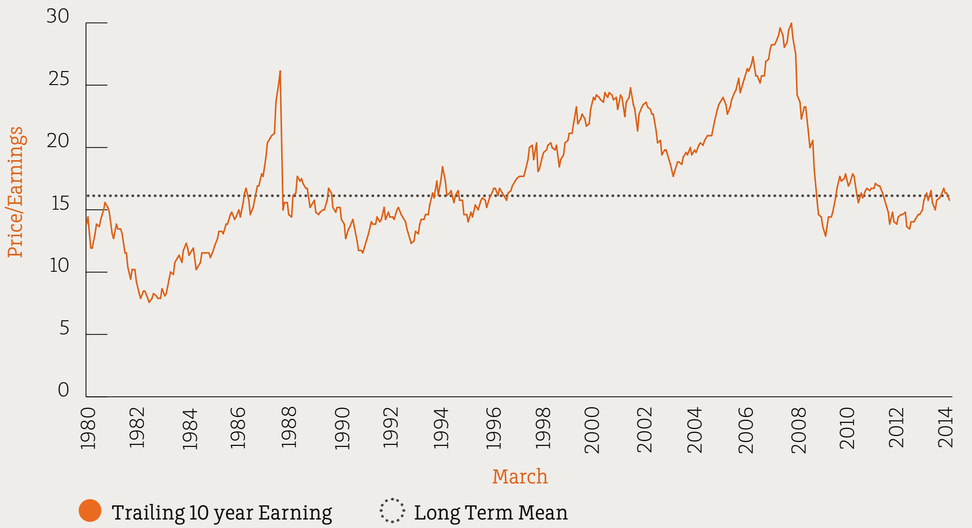
The return potentials looking forward from the end of March 2014 are similar to those for December 2013, with market moves muted in aggregate for the quarter. The most significant change is a rise in the AUD, which restores some return potential to global shares on an unhedged basis and reduces the riskiness of this exposure.

Chart 3, on page 9, shows return potential for the MLC Horizon and MLC Inflation Plus portfolios in our generic scenarios.

Asset class indicators

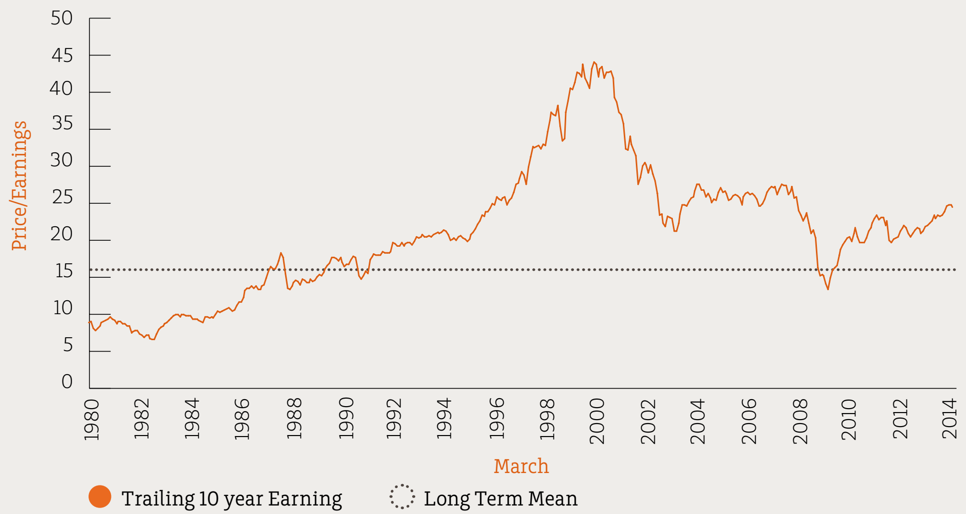
Our view of the main asset classes is as follows.

Australian shares
Market indicator *S&P/ASX 200*



Source: Datastream

Global shares
Market indicator *S&P500*



Source: Datastream World Index

Comment

Australian share volatility continued in the March quarter, with weak employment figures and declining prices for key exports like iron ore, coking coal and steaming coal. However, there were some signs that the non-mining economy is starting to improve as building approvals, housing finance and retail sales delivered solid numbers.

Despite the volatility, Australian shares ended the quarter higher as investors became more confident that the RBA will be able to successfully transition the economy from its dependence on mining.

In terms of valuations, P/E multiples are currently at their long term averages.

Comment

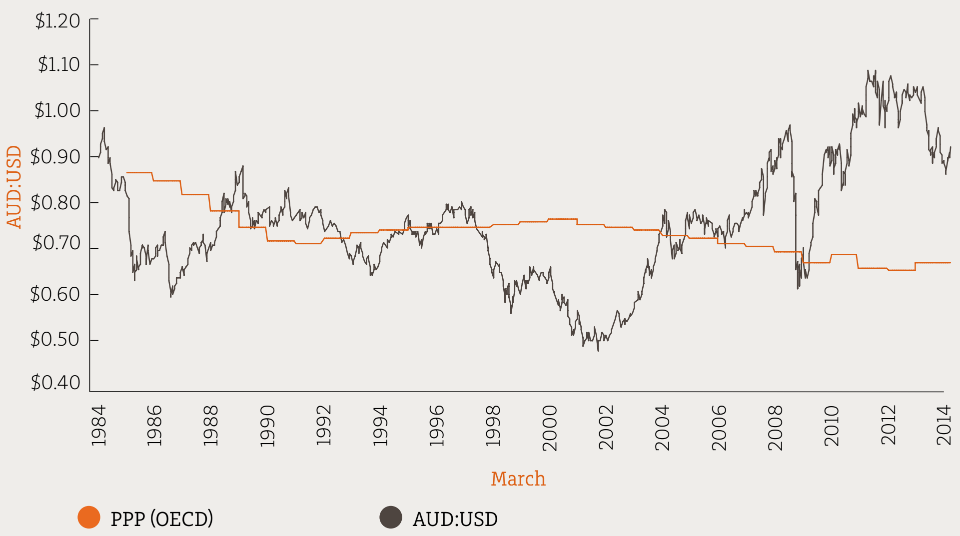
Global shares were unsettled by geopolitical risks in Ukraine and weak emerging market data, especially from China. However, investors tended to the view that positive momentum in the US and UK and continued stimulus in Japan would more than compensate for the potential for lower growth in emerging markets.

Global shares (unhedged in AUD) fell over the March quarter as the stronger AUD more than offset the slight gain recorded in local currency terms.

Asset class indicators (cont.)

Australian dollar

Market indicator *Australian Dollar Purchasing Power Parity*



Source: Bloomberg

Global government bonds

Market indicator *10 Year Bond Yields – United States*

Source: Bloomberg

Comment

After falling in the December quarter, the Australian dollar appreciated over the March quarter, despite weaker commodity prices and China's weak data. Much of the strength in the AUD may be because the market is pricing in future rate hikes.

Our currency remains at values that are elevated compared with measures of fair value.

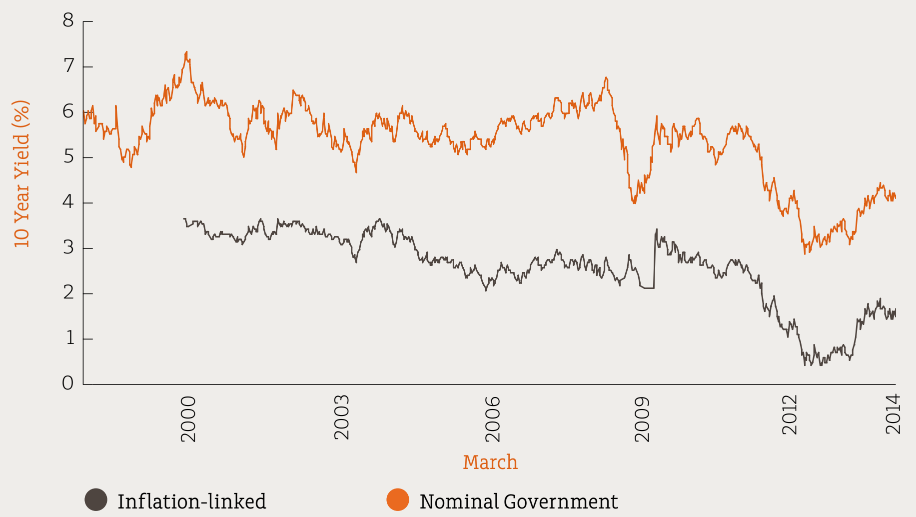
Comment

Nominal yields on US Treasuries fell during the quarter, despite the Fed's gradual unwinding of their QE program. Low inflation figures in the US and the dovish views of the Fed's new governor, Janet Yellen, kept yields relatively low. Investors seem content that if data disappoints and has the potential to destablilise markets, Yellen is unlikely to keep reducing QE.

Although real yields also fell, break-even rates (a measure of investors' inflation expectations) declined given the lower inflation numbers recorded.

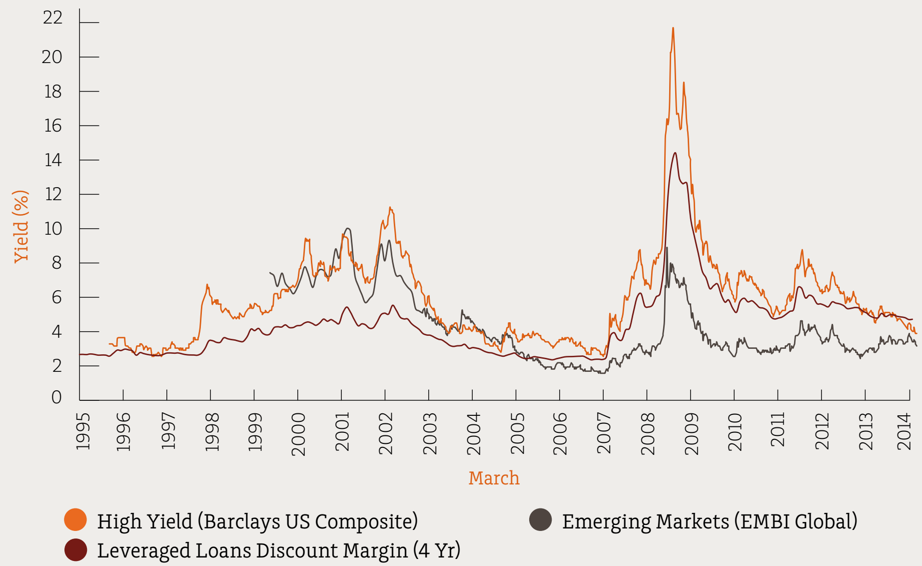
Asset class indicators (cont.)

Australian government bonds
Market indicator *10 Year Bond Yields – Australia*



Source: Bloomberg

Non-investment grade bonds
Market indicator *Fixed Income Spreads*



Source: Credit Suisse, Barclays

Comment

Australian government nominal bond yields followed the lead of the US and fell over the March quarter.

The cash rate was unchanged at an historic low of 2.5% pa. With signs of healthier retail sales, credit growth and housing indicators, the non-mining component of our economy is starting to improve, reducing the RBA's need to cut cash rates further. In fact, the market has priced in the potential for rate hikes over the next 12 months.

Domestic inflation-linked bonds remain an attractive asset compared with nominal equivalents as real yields have become more attractive and inflation remains at the top end of the RBA's target levels. However, the high duration of these assets means we have to carefully balance the inflation protection against the interest rate risk.

Comment

Non-investment grade credit markets fared well through early 2014. High yield spreads continued to narrow due to continued stimulus around the world and strong demand from investors searching for yield in the low yield environment. The contraction in yields was the main contributor to strong high yield bond returns over the quarter.

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. 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.
(Mild) inflationary resolution	2	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. 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.

Appendix 1 – tailored scenario set (cont.)

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 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'.

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.