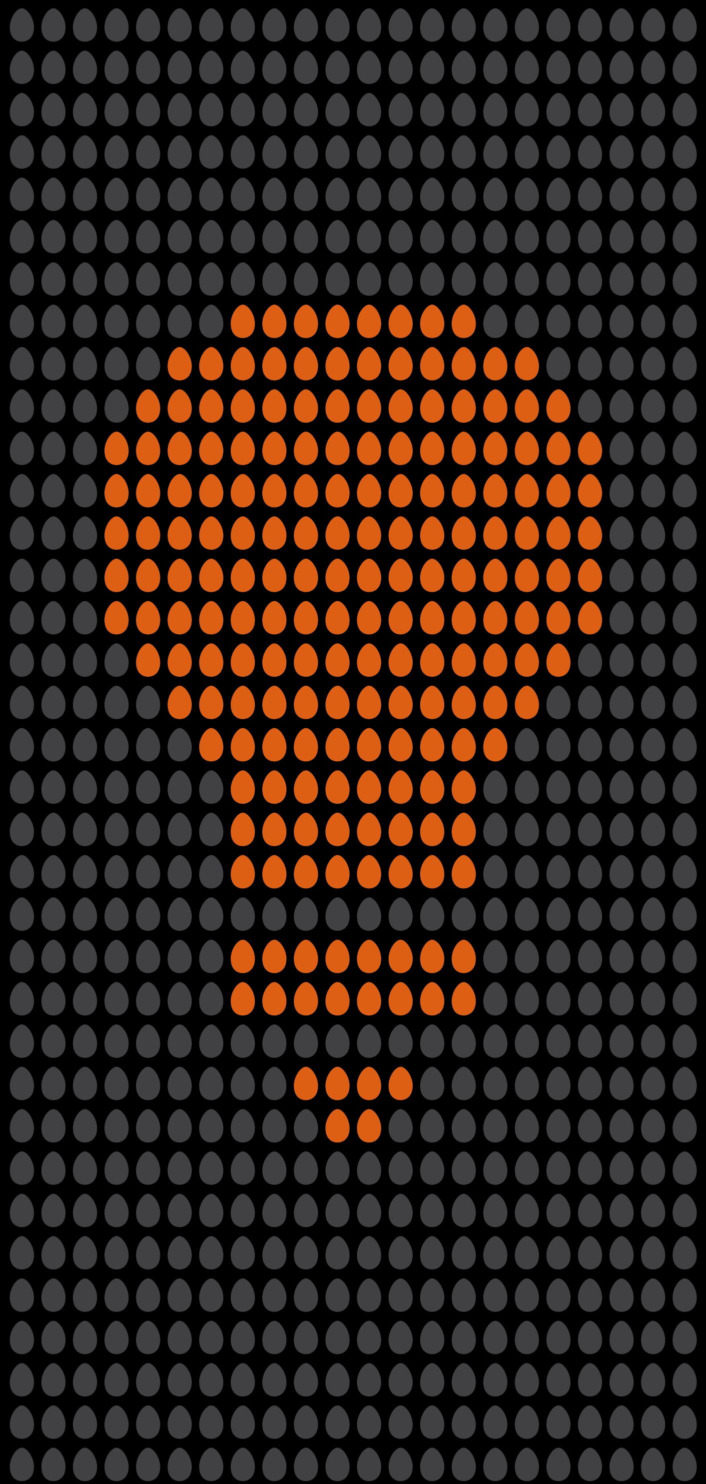

# MLC's scenario insights & portfolio positioning

*MLC Horizon and MLC Inflation Plus portfolios*

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# MLC's scenario insights & portfolio positioning

*Every now and again, something shocks the global economy — and when this happens prices can move abruptly and the anchors underpinning market pricing, however well set, become unstuck.*

In the December quarter it was oil, the world's core source of energy, whose price stability was shaken. If nothing else, the sharp and unexpected re-pricing of oil reminded **all** markets that prolonged stability is often more apparent than it is real. This is not to say that we should anticipate frequent shocks to key economic pillars, but that it is wise to at least consider the impact of profound change, especially when the environment skews enough to coin the term 'a new normal'.

But as with the now extinguished illusion of stable oil prices, the apparent stability embedded across many dimensions of what is still a landscape of deleveraging and financial repression is also at risk of disruption. Indeed, it is safe to say that at some point, the imbalances that lie behind this 'new normal' must resolve one way or another. But what we don't know is how or when — and both matter.

Inflation expectations being anchored at a low level are a critical part of the distorted core that characterises the 'new normal'. But rather than being a 'new normal', it is perhaps more useful to recognise that the current economic situation might be a transient period between a massive balance sheet polarisation and somewhere closer to an equilibrium. To be fair, we have all been well conditioned to expect subdued increases in consumer prices. Sustained disinflation began long ago with central bank discipline under former US Federal Reserve (Fed) Chair Volker, before being supported by a demographic dividend that flowed from East to West. This is now carried forward by deleveraging and haunted by Japan. Many of us who participate in the markets have never seen anything but disinflation. To combat the current fear of outright deflation the Fed, the Bank of England and The Bank of Japan have all aggressively pursed reflationary monetary policy, and without knowing the counterfactual, the extreme reflationary policies have supported asset prices (definitely) and growth (most probably). This is a delicate balancing task. Nobody — including central bankers — knows for sure just how much of the financial and economic buoyancy we have enjoyed is at risk as policy adjusts. Nor do they know how just how much spending demand might emerge if wages continue to rise in an improving US labour market.

Despite the reflationary stance of central banks, inflation and inflation expectations remain well and truly anchored at a low level. Ten-year break-even inflation rates in the US have fallen to 1.70% from a more mid-cycle level of 2.70% in early 2011. That this projection is generated by forward-looking bond markets might provide credence to a sustained low inflation outlook, but history suggests that bond investors do little more than react to current inflation figures.

### MLC's active investment approach

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

But just as was the case with the oil price this quarter, inflation expectations and anchoring can change rapidly — too fast for investors who weren't positioned in advance of the re-adjustment. This is not to say that portfolios should be positioned exclusively for a ramp up in inflation expectations, but that a wise investment strategy at least considers the prospect of an increase in inflation and holds enough protective assets to cushion the impact on real returns without compromising performance under alternate scenarios. This requires a focus on understanding what might happen rather than a fixation on any particular path or forecast.

Getting back to oil, the relatively low volatility we had become conditioned to expect as prices held between US$100 and US$110 has passed and the market appears headed toward a regime where supply and demand fundamentals play a greater role in price discovery. The major driver of this partial move away from artificial price control is an abrupt and deliberate change in stance by Saudi Arabia, the pivotal 'swing producer' in OPEC and the largest global supplier of oil. Until the September quarter of 2014, the Saudis played a champion's role stabilising global oil supply — the regime supplemented capacity as it was removed from supply and then reduced supply as the idled capacity restarted. However, this role as swing producer and stabiliser of global output remained economically tenable only as long as production cuts were transient rather than systemic — that is, when cuts and re-starts balance each other out over a period of time. And while this was the status quo, development of shale fields in North America began to shift the Saudis' role of swing producer to systemic absorber. To put the impact of US shale into perspective, global oil demand **growth** is currently running at approximately 800,000 barrels per day (bpd), while US shale output is growing 50% faster, at roughly 1.0–1.2 million bpd. This, alongside the re-emergence of supply out of Libya and Iran, seems to have pushed the Saudis to their limit — no longer willing to carry the burden of volume adjustment for their more recalcitrant OPEC peers. If this is indeed the case then, at least to some degree, the global energy supply chain has lost an artificial supply modulator and it follows that supply/demand dynamics will have a greater impact on price discovery, which in turn implies greater volatility. All else being equal, changes in demand will have a greater impact on price, and the rate of new supply will move closer toward being governed by fundamentals rather than by an artificially stable and high price. The immediate impact of lower prices should benefit consumers, much like a tax break, given that energy is a significant inelastic burden on global consumption. However, such deflation would be much more welcome in a world of greater general price pressures than the current disinflationary regime that most of the world is in right now.

The value of the Australian dollar (AUD) as measured against the US dollar (USD) is another pivotal factor that has partly reset over the past 12 months. Whether the AUD's fall was due to creeping normalisation in the US or the more idiosyncratic investment slowdown in China and correction in Australia's terms of trade is guess work. Looking at other currencies doesn't shed much light on this, as both the euro and yen have themselves depreciated significantly due to domestic factors. In either case, the overriding reason behind the decline is less important than the prior recognition that the AUD was trading at a much higher level than was warranted by sustainable fundamentals in light of what might transpire in future. While this type of dislocation did not itself necessarily mean that the currency would fall, it did create scope for diversification that could be harnessed in a way that mitigated risk in most, but not all, scenarios. Recognising that the currency was a sensible source of diversification meant pushing against two strong forces: firstly, the army of sell-side analysts and strategists that extrapolated the then rising exchange rate to further rises, and secondly, the risky, but popular, harvest of carry from owning the AUD against lower-yielding peers. But holding steadfast against these forces allowed our strategies to leverage the diversification benefit of owning foreign currency, which in turn enabled us to hold more equity risk than we could have done without such a benefit.

The strengthening of the USD continued in the December quarter, with the trade-weighted index up a little over 10% since June 2014. Rate normalisation extending from the end of quantitative easing (QE) and founded on domestic growth has spurred a strong but crowded bid for the USD. This is less a problem for US exports than it is for macroeconomic stability within countries with a challenged balance of payments. Deficit spenders and investors across the emerging and commodity production world now face the bane of higher debt burdens (measured in local currency) and rising tradable inflation as growth slows. For now, the pull-back in oil and other commodities has softened the blow and indeed provided some fiscal relief for oil subsidising governments (eg India and Indonesia, where the fuel subsidy runs at approximately 2% of GDP). While the offset from oil and other commodities is welcome, further falls are needed to continue the offset if the USD continues to rise. While this can't be known, what we do know with certainty is that a pervasively strong USD and a return of capital to the US from the capital needy at a time of accelerating import prices is a scenario that will squeeze emerging markets just as it did during the dollar bull market of the 1980s that triggered the Latin American debt crisis.

A strong USD is helpful for the struggling Japanese and Eurozone economies. The Bank of Japan, prompted by the growing likelihood that it will not reach its inflation target, announced a surprise increase to stimulus in

October, potentially providing some offset to the end of US QE. In addition, in November, with Japan's economy struggling following the first consumption tax hike, Prime Minister Shinzo Abe announced a delay in the second consumption tax hike from October 2015 to April 2017. He also announced a snap election, which was held in December. With the opposition parties still in disarray after being trounced last time, Abe has been opportunistic in extending his tenure before they get their act together. This may be a shrewd move with growing public discontent about the pace of change. With ultra-loose monetary policy already in place, we expect further fiscal stimulus in Japan and wait for meaningful structural reform. We hope (but are far from certain) that Abe can now overcome the entrenched interests which are a barrier to increased productivity and service sector responsiveness. As in the Eurozone, structural reform and increased competitiveness are essential to boost growth potential.

In Europe, Germany is — hopefully — gradually getting on board with more decisive changes. Germany maybe teetering on the brink of recession, but the obsession with balancing the budget remains strong. The European Union did announce an infrastructure initiative during the quarter but it is unclear that there is much new money involved. Fiscal stimulus aimed at infrastructure seems like no-brainer in Germany and elsewhere in the Eurozone where years of austerity have seen a progressive deterioration in all manner of public sector assets. This would assist with short term stability and increase longer term growth potential. Expectations of more decisive QE in the Eurozone are growing. This is positive, but will create a policy divergence between Europe and Japan on the one hand and the US (and UK) on the other. This, of course, reflects a divergence in growth between these regions, and we should expect further currency volatility in 2015 in consequence.

An added vulnerability for Europe is an escalation in the Russia situation. Russia is in a parlous situation facing recession, inflation and an ongoing challenge to stabilise the currency. Its credit rating is expected to be reduced to junk status, with exports cut by half given insufficient reserves to meet all needs. The best case is that Putin, stung by the oil price decline, re-engages with the West. The worst case is that he distracts his electorate by widening exploits with neighbours along the Russian border. This would lead to more sanctions, and potentially counter-sanctions, which would likely impact Europe's energy supply, with serious flow-on effects for growth. Europe is exposed and vulnerable to this risk. Closer to home, risks for the Eurozone persist in the periphery. The most obvious are posed by Greece, which still has excessive debt levels (requiring yet another bail-out or other debt reduction strategy) and appears on the verge of political turmoil. If an election is triggered by failure to agree a presidential candidate, the left wing anti-austerity radicals of the Syriza party seem likely to win power. This would precipitate a crisis in Greece, with contagion risks for the periphery. However, the threat of a broader crisis may be the catalyst for decisive policy action. A European Central Bank (ECB) sovereign bond-buying program which includes Greece would help limit these risks. Expectations that full QE will commence soon are for now allaying contagion fears.

Turning to China, there have been important developments which promote a rebalancing of the economy away from investment-led to consumption-led growth. This is essential to ensure a sustainable (though more moderate) growth path for China, but it has challenging consequences for Australia. To both reduce the incentive to invest and transfer income to households, the following is required:

- currency revaluation
- wage growth greater than the rate of productivity growth and, most importantly,
- an end to financial repression (positive real interest rates).

During the past three years, there has been progress on each of these. Wages have soared; the RMB has appreciated; and financial repression has eased considerably, though has not yet entirely ended. Importantly, this means that the imbalances in the Chinese economy are no longer getting worse, which greatly reduces the risks of a financial crisis over coming years.

This first step was quite difficult. China is impressive for its vastness and seemingly inexorable progress, but also for its complexity. Nothing in China is straightforward. The second step involves getting growth in debt down. If credit growth slows, the investment share of GDP will decline, enabling the consumption share to rise. A raft of interrelated reforms is required to transfer wealth from the state to the household sector. The impact of land reforms which transfer wealth to the rural poor depends on Hukou (right of residency) reforms, availability of social housing, and expansion of social services (health and education). There are political and control issues as well as institutional, legal and economic questions to resolve. The issue of redistribution is linked with the anti-corruption campaign. If China went in with full force to tackle corruption it is probably not much of an exaggeration to say that the Communist Party would be wiped out; on the other hand, if nothing changes, China's future is in considerable doubt. While the anti-corruption measures have certainly been selective, what we hear and observe is not merely a factional power struggle, but is consistent with intent to institutionalise an anti-corruption mentality. As always in China, there are complexities and consequences which need to be managed. For example, no one in China is supposed to own more than two houses, but owning 10 or more (even as many as 50) is not uncommon because there are such limited investment opportunities.

# MLC's scenario insights & portfolio positioning

The anti-corruption campaign is generating anxiety about this at a time when house prices are already falling and there is record oversupply (particularly in smaller cities). In response, there already has been some easing of restrictions and even subsidies to encourage sales, and most recently a cut in the minimum equity down payment from 60% to 30% for second home buyers. However, in the new era of policy moderation and rebalancing the overwhelming constraint is credit availability, and mortgage rates remain high in real terms.

The implications for Australia of these developments revolve around changes in demand for our most important exports, most particularly iron ore, which accounts for almost a quarter of the value of our exports and goes predominantly to China. While China may achieve a relatively smooth rebalancing of its economy, the result will be both slower growth and a lower investment share of GDP, which has consequences for iron ore demand. Roughly 50% of Chinese steel consumption is demanded by the construction sector which, due to the unfavourable nexus of extremely rapid growth and the strong possibility of a deceleration in capital investment, means that iron ore demand is at risk of undershooting expectations. This comes at a time when the lagging supply response is finally bearing fruit, quickly helping to flip the market from deficit to surplus with obvious implications for pricing and Australia's terms of trade. While this is almost textbook when viewed from a normalised perspective, commodity cycles are of long enough duration to beckon a perception of structural change across the broad spectrum of industry, investors and policy makers. In September we met with officials from the National Development and Reform Commission (NDRC), the state planning agency which has broad planning control over the Chinese economy. The NDRC intends to 'build the infrastructure needed for the next 30 years by 2020'. Officials at the NDRC see an inflection point occurring at the end of the current five year plan in 2015, after which there will be a slower rate of infrastructure development. In the 13th five year plan, which starts in 2016, there are expected to still be more high speed roads and railways, airports and deep water ports but the level of infrastructure spend is lower. And that will step down again in the 14th five year plan, which commences in 2020. For example, in 2014 and 2015, 54 new airports are projected to be opened; this compares with a total of 30 new airports in the whole of the next five year plan. The obvious implication is progressively moderating demand for Australia's mineral exports.

The changes are symptomatic of China starting to move out of its fast development phase: part of the transition from an emerging to a developed economy. This transition also implies changing perceptions of Australia, which will be riding to a much reduced extent on China's back. Also, while China will remain a highly important economy, it will not be as important a driver of global growth as it has been in recent years. This realisation may take some time to dawn but it poses some obvious risks for the Australian dollar and mining companies which have new supply coming on stream, as well as opportunities for other exporters which may look forward to a boost in their competitiveness. As we have been saying for some time, while we can't predict with any certainty the path of the AUD, the risks to the downside far outweigh the risks to the upside. We also observe that environments most negative for the AUD tend to be (though are not always) associated with weaker share markets. From a portfolio positioning point of view, this means that foreign currency exposures provide an important source of risk diversification in a world where such things are a rare commodity.

We continue to invest in extraordinary times. Rising financial markets give us the impression of a return to normality, but we have seen before that this can be illusory. At the heart of the problem is a level of developed economy debt which risks economic depression and disorderly market declines. Unorthodox monetary policy measures countered these risks and have been successful in avoiding economic stagnation. But even in the US, aggregate debt levels relative to GDP have not yet declined. Financial repression has not generated enough real growth or inflation to support aggregate deleveraging. In both the US and China, the world's two most important economies, financial repression has eased or easing is in prospect. We anticipate that this will change the investment landscape, particularly from an Australian investor perspective.

# MLC's scenario insights & portfolio positioning

## Looking forward

We recognise that the future is always uncertain. MLC's portfolios are managed by building a comprehensive understanding of what the future might hold. Our comprehensive assessment of future possibilities provides detailed insight into return potential and, most importantly, the sources and the extent of risk. We track how future risk and return potential 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 portfolios 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:

- we limit vulnerability to negative returns to preserve capital in after-inflation terms over the defined time frame — if there is higher prospective risk this means tighter risk control, and at the same time
- in other scenarios, we aim to deliver attractive inflation plus returns over the defined time frame, but
- we will not chase higher returns if the risks of doing so are inconsistent with real capital preservation over each portfolio's investment time horizon.

Chart 1 shows return potential for MLC Horizon 4 across selected possible future scenarios looking forward from two different points in time: July 2012 (aqua bars) and the end of 2014 (orange bars). The brown bars show the return potential looking forward from today but with the asset allocation from mid 2012, and the grey bars show return potential for the benchmark. As can be seen, return potential looks lower today than in mid 2012 and risk is higher. The reason for this is that share and other risk asset prices have increased faster than their underlying economic fundamentals.

A key focus for our active investment approach is moderating risk when it is high, while maintaining return potential as far as possible. For the MLC Horizon portfolios, management must take into account the risks of underperforming the benchmark and peer funds. These considerations increase the focus on maintaining return potential and reduce the focus on limiting the risk of adverse returns. Nevertheless, particularly when risk is high, active asset allocation is used to reduce risk in the MLC Horizon portfolios. This is illustrated in Chart 1 by the tendency for the portfolio's potential return (orange bars) to be higher in negative-returning scenarios than both the benchmark (grey bars) and than it would have been with no allocation changes (brown bars). However, the cost of this risk control is underperforming the benchmark in strong scenarios.

# MLC's scenario insights & portfolio positioning

### Chart 1: MLC Horizon 4 return potential in selected possible future scenarios

# MLC's scenario insights & portfolio positioning

Chart 2 provides a similar analysis shows for the MLC Inflation Plus — Assertive Portfolio. It shows return potential looking forward from the same two points in time: July 2012 (aqua bars) and the end of 2014 (orange bars). The brown bars show the return potential looking forward from today but with the asset allocation from mid 2012. Again, return potential looks lower today than in mid 2012 and if the asset allocation were unchanged, risk would now be significantly higher. As can also be seen by looking at the orange bars, which show the return profile for the portfolio at the end of 2014, changes to the strategy since mid 2012 have offset the increase in risk. However, with the opportunity for diversification limited, tighter risk control inevitably reduces return potential. The main equity diversifier, nominal bonds, remains weak and risky and the foreign currency diversifier has weakened significantly as the AUD has declined.

Importantly, Chart 2 illustrates that the portfolio is managed to maintain risk control and then seek returns subject to adequate risk management. We will stand back when risk is high, waiting for better opportunities. This means that achievement of the CPI plus objective will require a sequence of strategies that exploit those opportunities as they arise.

The continuing challenge is to maintain return potential while limiting downside risk exposure. With both the potential for strong returns as the result of QE driving asset prices higher, and ongoing risks which could trigger an asset price reversion, we are increasingly using 'optionality' (that is, using options to help manage tail risk) to reduce risk exposure while maintaining upside potential. The 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.

For the MLC Inflation Plus portfolios we are sometimes asked how we can achieve the CPI plus objectives given current defensive positioning and low return potential. For us, the more important question is how to provide effective risk control. When cash rates are artificially low, all assets become mispriced. When there are bubbles which affect certain assets, these can be avoided. But when all assets are mispriced it is difficult to avoid or diversify away the risks. That is the world we find ourselves in today. Generating a reliable real return in this environment requires that we have patience and that we are nimble in exploiting opportunities to generate risk-controlled returns as they arise. Volatility in September and again in December provided illustrations of what to expect as monetary policies normalise and markets follow suit. During these episodes our risk controls — particularly our foreign currency exposures — worked well and offset negative market returns. What also became clearer were the reasons for our cautious stance with respect to both share and nominal bond exposures.

If share markets were to correct to the point where risk declines significantly, expect the MLC Inflation Plus portfolios to increase share exposures and the MLC Horizon portfolios to move back to neutral share allocations. If we return to an environment of strong returns, expect that our positioning will remain cautious and defensiveness will increase as risk rises. This is still a time for patience, of 'keeping powder dry' and awaiting better opportunities. We will deploy risk when there is an expectation of an adequate reward for that risk. Avoiding the significant negatives is the key to providing investors with the positive real return outcomes that they require.

# MLC's scenario insights & portfolio positioning

Chart 2: MLC Inflation Plus Assertive return potential in selected possible future 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 predicting 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 on page 11 looks at our barometer of risk and return — based on our generic (40) scenario set, described on page 12 — for the MLC Horizon and MLC Inflation Plus portfolios looking forward from the end of December 2014. 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 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, 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, it is clear that the reward for risk-taking could disappoint.

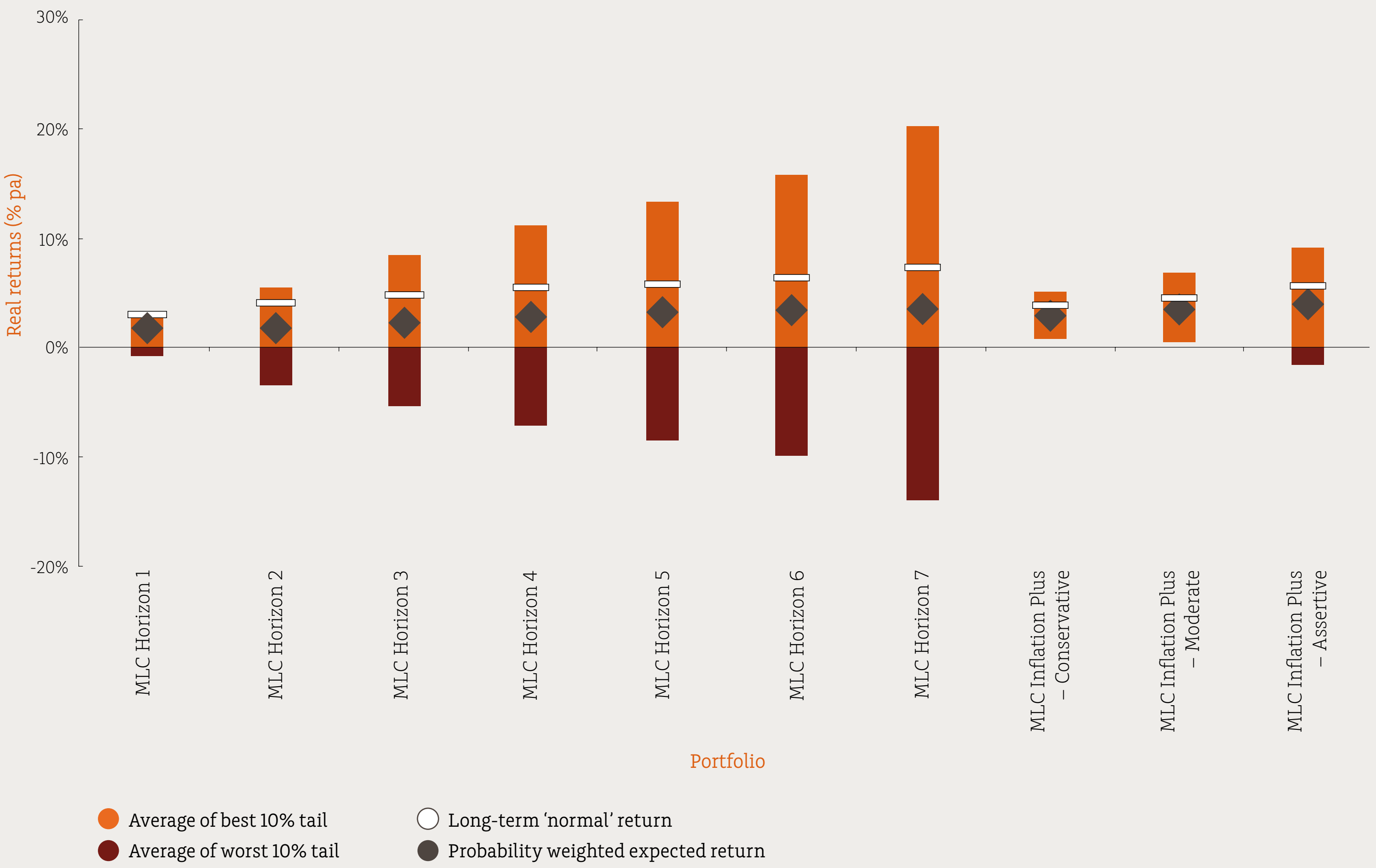
Comparing the MLC Inflation Plus and MLC Horizon portfolios, the stronger risk focus of the MLC Inflation Plus portfolios is evident. Consistent with their objectives, these portfolios have responded to shrinking return potential and weakening risk diversifiers by reducing exposures to riskier assets. 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 maroon 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 with a single static asset allocation a particularly positive scenario is required to meet the return hurdle. Of course, in practice the portfolios' asset allocations are not static. We evolve the MLC Inflation Plus portfolios' allocations dynamically through time to control risk as required and exploit opportunities as they arise. However, we will not chase returns to meet the return hurdle if that requires too great a risk exposure.

# MLC's scenario insights & portfolio positioning

**Chart 3: SAA Scenario probability Weighted Real Returns (December 2014)**
**(5 years, 0% tax with franking credits, pre fees, pre alpha)**




**Source**: NAB Asset Management

# MLC's scenario insights & portfolio positioning

## Our scenarios

We assess investment strategy using our unique Investment Futures Framework. The Investment Futures 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 Investment Futures Framework comprises both the generic broad set of 40 scenarios which pivot around the main drivers of returns — the macroeconomic 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, though we are now reviewing these in light of recent policy and market development (notably the path of policy normalisation in the US and the decline of the AUD). 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

The prospective unwinding of unconventional monetary policy settings in the US is starting to change market behaviour. We may now be seeing the beginnings of change to the yield-chasing, risk-impervious actions of many investors. We are hopeful of being towards the end of the liquidity-driven distorted environment which is so difficult for risk-aware real return strategies (such as the MLC Inflation Plus portfolios). The need to stand back from strong returns tests the patience of investors, with the logic of the strategy only becoming entirely apparent once previously disguised risks are revealed. The past teaches us that distorted market behaviour can persist for longer than seems possible, which tests perceptions and patience, but when it unwinds it does so more quickly than expected. Importantly, the thoroughness and depth of our assessment of future return potential and future risks gives us the confidence to maintain appropriate positioning through extended periods in which markets behave perversely. This is critical to ultimately delivering for investors. During the first half of December the risk control inherent in the MLC Inflation Plus portfolios' positioning was again evident as the risk diversifiers more than offset the drag from declining risk asset prices. Our portfolios with less flexible asset allocations (the MLC Horizon portfolios and MLC Index Plus portfolios) also benefited from the insights from our scenarios framework, particularly the progressive increase in real return-oriented components supported by underweight shares and short duration positioning.

Our analysis of scenarios in our Investment Futures Framework builds understanding of 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 continue to be two important asymmetries at present: in currency and bond markets. These asymmetries remain but the significant fall in the AUD weakens our key risk diversifier. In bond markets, we observe that while bond yields could decline further, the extent of this is limited relative to the potential for yields to rise. This means that the potential loss from shortening duration is low relative to the potential gain. Similarly, while there are circumstances in which the AUD could regain strength (and we assume it does in a number of our scenarios), on current pricing the downside factors are still not fully priced in. Because of this, we still have significant exposure to unhedged foreign assets within the MLC Inflation Plus — Assertive Portfolio and remain overweight to foreign currencies across MLC Horizon 2 to MLC Horizon 7. Our positioning against the AUD does not mean that we 'expect' the AUD 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, our analysis continues to suggest that the AUD is an efficient source of diversity that decreases overall risk, allowing greater exposure to other sources of risk than we would otherwise have carried in the portfolios. In short, in many scenarios the AUD is a perceived safe haven that turns out to be something of an illusion. This reality is now starting to be priced in.

Shortening the duration of nominal bond exposures is particularly appropriate given the concerns about an eventual rise in inflation. Although this will not necessarily be a highly adverse scenario, it does present investment challenges. Inflation is like a tax on savers. We no longer just need positive returns; we need returns that exceed the moving target of rising inflation. The most obvious risks lie in nominal bonds, which are 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. Shares offer some 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 multi-asset portfolios. 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.

# MLC's scenario insights & portfolio positioning

## Real return funds: MLC Inflation Plus portfolios

Here is a summary of the current positioning considerations for the MLC Inflation Plus portfolios.

| Asset class | Change in allocation to asset class in the MLC Inflation Plus Super & Pension portfolios over the December quarter | | | Comment (for Assertive portfolio) |
|---|---|---|---|---|
| | Conservative | Moderate | Assertive | |
| 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 due to strong preference for a defensive share allocation in a relatively high risk environment. |
| 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 potential diversification benefit 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 | Steady allocation | Steady allocation | Steady allocation | Significant allocations reflecting preference for highly flexible strategies with total return focus. |
| Emerging markets strategy | Steady allocation | Steady allocation | Steady 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 monetary policy normalisation. |
| Global private assets | Steady allocation | Steady allocation | Steady allocation | The private assets allocation for the MLC Inflation Plus - Assertive Portfolio (in MLC MasterKey's superannuation and pension products) has been above target and is currently in the process of rebalancing. |

# MLC's scenario insights & portfolio positioning

## Real return funds: MLC Inflation Plus portfolios continued

| Asset class | Change in allocation to asset class in the MLC Inflation Plus Super & Pension portfolios over the December quarter | | | Comment (for Assertive portfolio) |
|---|---|---|---|---|
| | Conservative | Moderate | Assertive | |
| 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 and multi-asset strategies. There is potential reversion in the prices of higher yielding assets in monetary policy normalisation scenarios. |
| Global government bonds | Zero direct exposure | Zero direct exposure | Zero direct exposure | Unattractive, with limited diversification benefit. |
| Australian inflation-linked bonds | Steady allocation | Steady allocation | Steady allocation | Inflation hedge remains attractive, despite low yields. |
| Insurance related investments | Zero allocation | Steady allocation | Steady allocation | Uncorrelated though risky exposure appropriate where time horizon is sufficient. |
| Bank loans | Lower allocation | Lower allocation | Zero exposure in super/pension (steady exposure in investment trust) | Floating rate loans offer some exposure to diversifying income-based risk premia without as much capital risk as fixed coupon bonds. While this exposure has been 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 portfolio should have exposure. |
| Australia credit short duration | Steady allocation | Steady allocation | Steady allocation | Offer some return enhancement while limiting additional risk. |
| Cash | Higher allocation | Higher allocation | Steady allocation | This is a challenging environment in which allocations to cash are higher than we prefer because abnormally low cash rates and abundant liquidity have caused an adverse shift in the risk-return trade-off for all assets. We are currently 'keeping powder dry' through our cash allocation, waiting for better opportunities. |
| Borrowings | | | No borrowings | Reward for risk is too limited. |

# 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, including allocation constraints and benchmark and peer relative factors. Like other traditional diversified portfolios, for the MLC Horizon portfolios the mix of bonds 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 for risk taken. A review of the benchmark, or strategic asset allocation, of the MLC Horizon portfolios is currently underway and is expected to lead to some changes to allocations in 2015. The objective of the review is to increase the competitive positioning and the risk-return efficiency of the portfolios.

| | MLC Horizon Super & Pension portfolio weights at the end of the December quarter | | | 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. Positioning biased to a small underweight position, with real return (Inflation Plus) investments being overweight. |
| 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 AUD), 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 benchmark allocation — the allocations are underweight versus peers. |
| Global private assets | | ● | | Allocations are in the process of rebalancing to target from overweight. |
| Emerging markets strategy | | ● | | Benchmark weight. |
| Multi-asset real return strategies (including Inflation Plus) | | | ● | Overweight maintained |
| Low Correlation Strategy | | | ● | Overweight maintained |
| Fixed income | | ● | | Reduced duration maintained. |
| Australian bonds — All Maturities | | | ● | Overweight (MLC Horizon 4 and 5 only). |
| Australian inflation-linked bonds | | ● | | Benchmark weight. |
| Global bonds — All Maturities | ● | | | Underweight (MLC Horizon 4 and 5 only). |
| Global absolute return bonds | | ● | | Retain benchmark allocation. |
| Global government bonds | ● | | | Retain underweight global government bonds and overweight cash. |
| Global non-government bonds | | ● | | Retain benchmark allocation. |
| Global multi-sector bonds | | ● | | Retain benchmark allocation. |
| Global non-investment grade bonds: high yield bonds, bank loans, mortgages | | ● | | Retain benchmark allocation. |

## Return potential

At the heart of our Investment Futures Framework is the specification of scenarios which capture what the future might hold. We systematically build a map of potential futures which capture important uncertainties about economic, market and investor behaviour. We then 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.

Our broad-based generic scenario set can be viewed as a consistent barometer of risk and return through time. 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 opposite 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 3, on page 11, shows return potential for the MLC Horizon and MLC Inflation Plus portfolios in our generic scenarios.

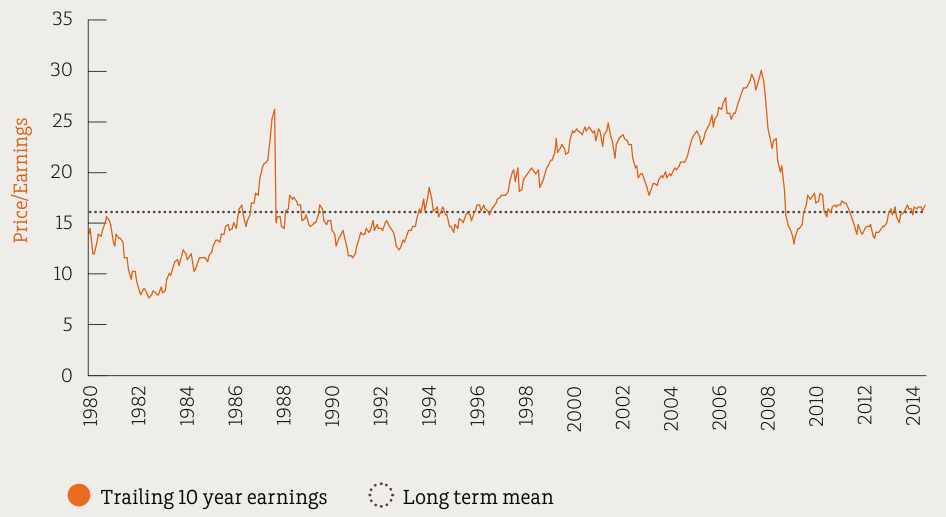
**Chart 4: 40 Scenario Set Probability Weighted Real Returns (December 2014)**
**(5 years, 0% tax with franking credits, pre fees, pre alpha)**


**Source**: NAB Asset Management

## Asset class indicators

Our view of the main asset classes is as follows.

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



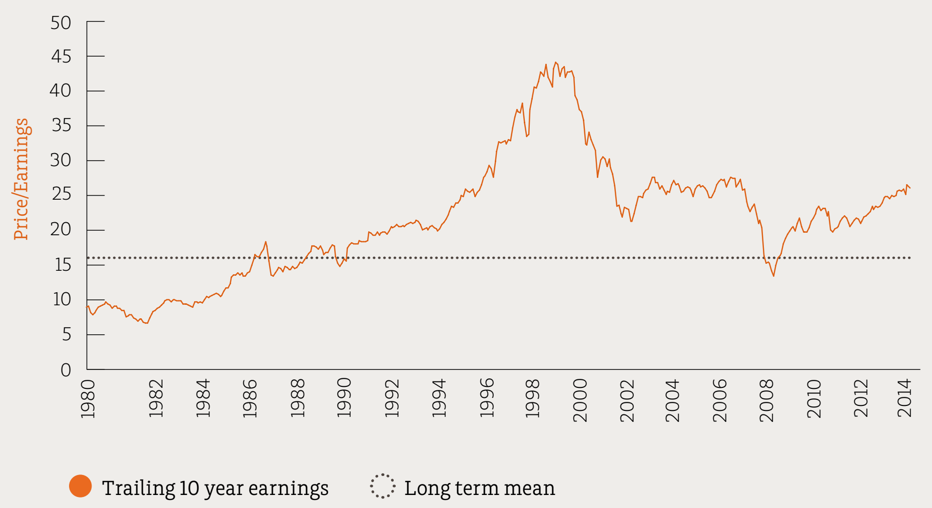

**Source:** Datastream

### Comment

The Australian share market rose in the December quarter, despite continued weakness in key exports. The iron ore price fell by 8% over the quarter and nearly 47% over the year, while the oil price was down almost 50% over the quarter. As a result, mining and energy stocks fell, but not enough to offset the solid recovery in bank shares and some good returns from industrial and healthcare companies.

Australia's latest GDP figure grew 0.3% for the quarter and 2.7% for the year, falling short of expectations. Although economic growth is reasonable, consumer sentiment is fragile. Low interest rates have supported house prices, giving the Reserve Bank the dilemma of trying to boost growth without overheating house prices.

**Global shares**
Market indicator *S&P500*




**Source:** Datastream World Index

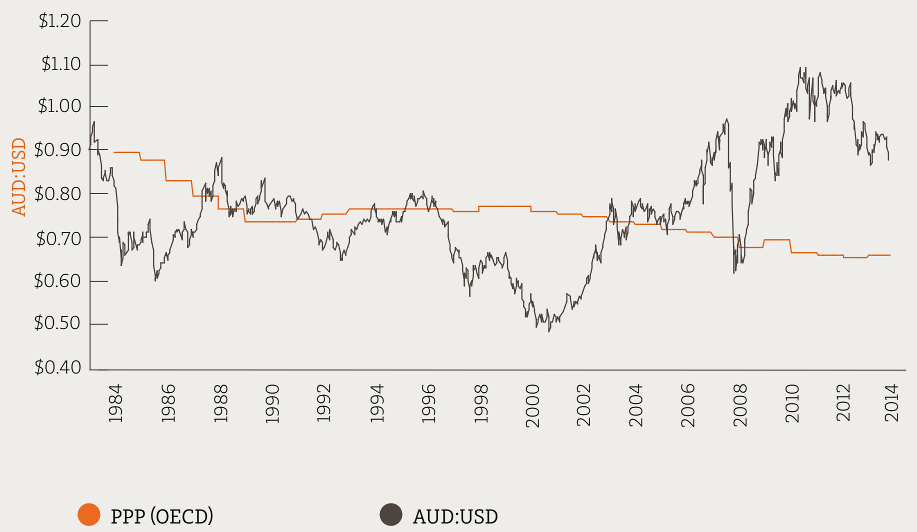
### Comment

World share markets enjoyed good gains over the quarter, largely due to gains in Japan and the US. Japan's strong returns followed the announcement of a dramatic increase in the Bank of Japan's QE program. The US ended their QE program, but this was largely anticipated by the market. Unhedged global shares outperformed hedged global shares this quarter due to a weaker Australian dollar.

In terms of valuations shares, particularly US shares, continue to remain expensive relative to their history. This has been driven by Fed stimulus and corporate activity, such as dividends and share buybacks, which have made shares appealing in a low yielding world.

## **Asset class indicators** continued

**Australian dollar**
Market indicator *Australian Dollar Purchasing Power Parity*

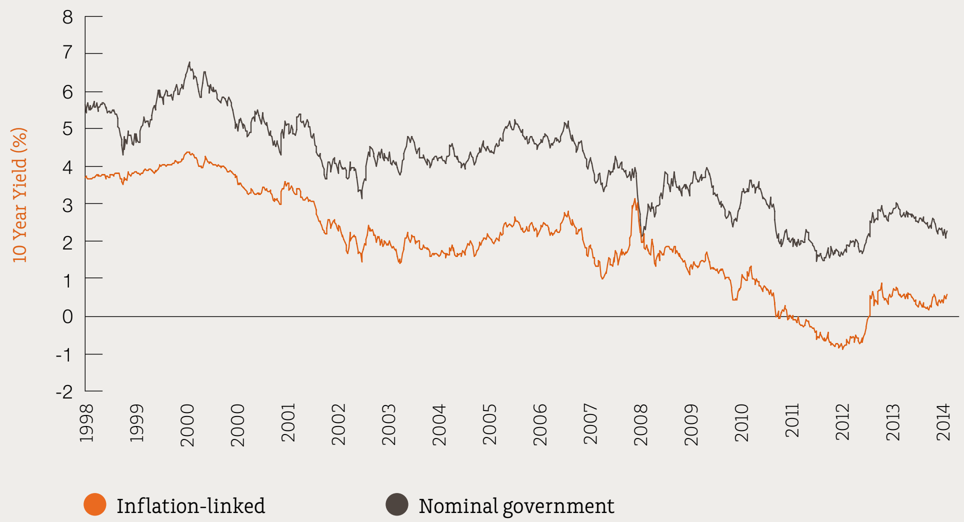



**Source**: Bloomberg

### Comment

The AUD continued its fall, ending the year at around 82 cents, down 6.5% over the December quarter. A weak September quarter GDP figure confirmed investors' concerns about the AUD's safe haven status and the flow-on effects of weaker commodity prices on Australia's national income. This, along with continued USD strength due to strong US data and expectations of normalising US monetary policy, put further pressure on the AUD. However, the AUD remains at values that are high compared with measures of fair value. The IMF's AUD purchasing power parity exchange rate (a long term measure of fair value) is currently 66 cents against the US dollar.

**Global government bonds**
Market indicator *10 year bond yields – United States*




**Source**: Bloomberg

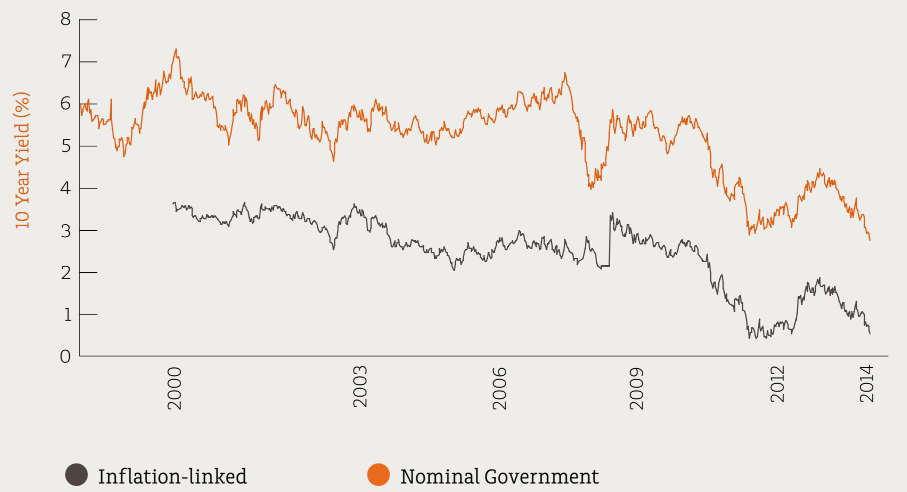
### Comment

Bond yields were lower, but volatile, over the quarter due to lower inflation expectations, However, these expectations were countered by strong payroll numbers (averaging 246,000 new jobs per month) and the Fed officially ending its QE program.

Lower inflation expectations (as measured by 'break-even' rates) hurt inflation-linked bonds as real yields rose over the quarter.

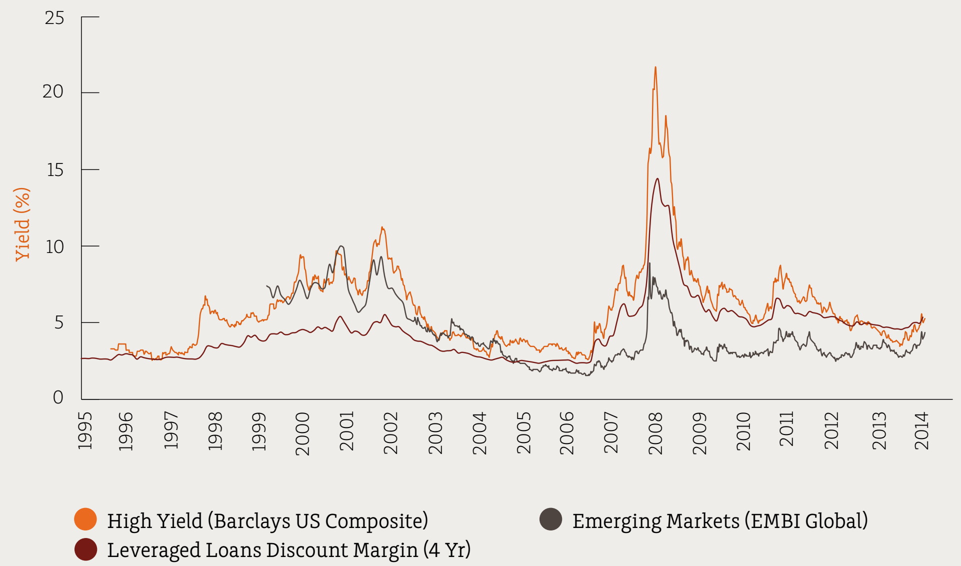
## **Asset class indicators** continued

**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 bonds performed well over the quarter as yields moved significantly downward — for example, Australian government bond 10 year yields fell from around 3.5% to 2.9%. This was driven by investors' continued thirst for yield in a low yielding environment and also by expectations the Reserve Bank will cut rates in 2015.

Domestic inflation-linked bonds performance followed the same path, as real yields also fell. Real rates are now quite low relative to history, so we must carefully balance their inflation protection against the risk of potential rises in interest rates.

### Comment

Both non-investment grade credit (high-yield corporate bonds) and investment grade corporate credit spreads increased during the quarter. The US high-yield corporate bond spread over Treasuries increased by around 0.75% to 516bps. High yield mutual fund outflow continued for the sixth consecutive month. This was due to potential adverse repercussions for corporate funding and debt levels from the end of the Fed's QE program, and falling crude prices. Lower crude prices can reduce company profitability and increase company debt levels. This is of concern as Energy is the largest sector in the US high yield market, at around 15%.

## 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. |

## Appendix 1 – tailored scenario set continued

| Scenario | Probability ranking | Description |
|---|---|---|
| Sovereign yield re-rating | 6 | Low starting yields are a valuation risk for bonds. Yields could rise to more normal levels even in the context of low growth/inflation expectations. High government debt burdens (UK/core Europe/Japan/USA) provide the potential for a bond-vigilante style re-rating of sovereign yields. This is not a likely near-term scenario, but given the low yields and high level of indebtedness as a starting point, there is a risk that the environment could progress to one where apparently safe paper becomes compromised. This in turn increases the cost of funding and reduces corporate activity. At the same time, government spending is curtailed by enforced austerity in an effort to limit yield increases, remain liquid and stay solvent. This may be a precursor to a 'Prolonged stagnation' scenario. |
| 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. |

## Appendix 1 – tailored scenario set continued

| Scenario | Probability ranking | Description |
|---|---|---|
| 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 Futures Framework**

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

- We can never be certain what the future will hold. To adequately understand risk 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 builds a detailed understanding of how returns vary in each scenario. This also provides detailed information about the nature and extent of investment risks, the means to diversify those risks and how these change through time.
- 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.

## Important information

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