MLC's scenario insights & portfolio positioning

MLC Horizon and MLC Inflation Plus portfolios

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We welcome your feedback on this document.
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MLC's scenario insights & portfolio positioning

Describing what is—and what has been—is, by itself, a far cry from generating true investment insight. True insight requires much more.

Observing the idiosyncrasies' of today's world can only make sense and illuminate opportunity in the context of a consistent analytical framework. Without such a framework, each observation is nothing more than that, and commenting on facts belongs in the news. It may help describe where we are, which can have some bearing on what the future might hold, but it is rarely that simple. The imbalances that we observe and try to navigate on behalf of our clients do not exist in isolation and nor are their evolutionary paths certain. We're saying this at the outset of this commentary to help our stakeholders understand that while a great deal of ink is put to work setting the scene; the real horse power of MLC's investment process is housed within the Investment Futures Framework that turns these observations into opportunities for our portfolios.

Last quarter we used the rapid and unexpected change in the price of oil to illustrate that widely embraced norms do, from time-to-time, become spectacularly challenged. Whereas 12 months ago, thinking of oil stably trading at sub US$50 would have raised many a question, casting back the price 12 months ago is now seen equally as odd by the market. This is classic anchoring, something we try to avoid.

During the March quarter, it wasn't so much volatility within any particular market that gave us fodder to write about; but changes across several fundamentals aspects that defined the early months of 2015.

Europe

Sometime prior to February 2015 markets either forgot about or became too familiar with the potential risks of the European imbalances. Spreads on peripheral debt shrank on top of ever diminishing core rates that netted a running yield of sub-6% for 10 year Greek bonds. And at this time of complacency an arguably insolvent Greece returned to global capital markets raising three billion euro in five year notes followed by a larger three year issue. While the thirst for yield no doubt fuelled the fire under peripheral European debt, the ultimate facilitator for over risking into the bonds was most likely the tendency for investors to de-rate the longer run and over-emphasise whatever the immediate dynamic was. But while yield chasers were buying, Greece spiralled toward yet another notorious milestone in the euro saga as the Greek legislative election of January 2015 threw up an unexpected result. Fed up with the perceived repression imposed on Greece from core Europe and, egged-on by populous sentiment, the Greek electorate opted for the radical left. The 40-year old Alex Tspiras became prime minister, setting the stage for another showdown with creditors and re-elevating the prospect of a Greek exit to the fore of the markets mind.

Since the election Tspiras has, as expected, pushed the envelope, immediately locking horns with the association of official funders in do-or-die negotiations over critical funding.

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.

Greece needs ongoing financial support to cover liabilities and will remain beholden to the financing institutions. Meanwhile, on the funding side of the equation, there is no doubt much awareness that a Greek failure and exit would be de-stabilising in its own right and risk further deterioration in whatever glue continues to bind the likes of Portugal and other second order peripheral problems to the euro core. Greece and its financial partners face a hard road ahead—a road that is all the more bumpy thanks to the confines of the euro collective and all too unfortunate living memories on both sides stemming from history.

As stimulating as it is to second guess such political impasse, it is folly. What we need to do is focus on the economic and investment consequences of distinct outcomes and let the politics take care of itself. We are not in the game of inevitably bias-prone prediction, but rather to make sure we position portfolios in the most efficient way possible to benefit from sensible and measured risk exposure. In our opinion, it is foolhardy to directly embrace the risks embedded within Greek government debt assets. This is because since the handover of power, the outcome for Greek debt has essentially reduced to a binary one—the loans will either return a handsome profit or a terrible loss. The former we can stomach, but the latter we can't. As such, we made a decision in early February to deliberately exclude Greek debt from an underlying strategy within the MLC Inflation Plus portfolios. Exclusion of the debt is not a call that Greece will default—indeed we hope that it does not, but that the consequence of severe and permanent capital impairment is beyond the risk specification of these portfolios.

Meanwhile, recent European growth across the zone is mildly more positive, but the improvement is off highly depressed levels and deflation fears remain well and truly entrenched. These fears finally forced the hand of the European Central Bank (ECB) and its president Mario Draghi to extend policy into what is now almost mainstream unconventional easing. The ECB began its version of quantitative easing (QE) in March 2014 further depressing euro yields and providing yet another source of global liquidity. That this is occurring when US dollar (USD) liquidity is easing under US Federal Reserve (Fed) policy changes is notable, but the more important point is that global liquidity remains massive and assets expensive.

QE in the European Union may or may not work as well as it appears[1] to have helped remedy the US and UK economies. While there are similarities between the programs, critical structural differences in the underlying economy might mute the response. Europe has a far less favourable demographic outlook compared to the US, looking more like—but not as bad—as Japan. The regions also differ in their entrepreneurial zest with the United States' appetite and framework for coupling innovation and risk sorely missing in Europe. And the sovereign boundaries within the common currency don't help. The drama in Europe is far from over.

The US

As with past quarters, global investment markets continue to hang on the words of Janet Yellen (Chair of the US Federal Reserve). While investors seem convinced that the US economy has made significant progress toward righting itself, there is significant discord about the impact of normalising rates on both economic activity and investment returns. Asset prices globally have become inflated on USD liquidity and nobody knows what a change in the basic discount rate will bring to stretched valuations. This uncertainty is well evidenced by the still cryptic price action that sees good news tending to cap gains and/or induce losses in risky assets, while rate dampening bad news pushes risky assets higher. Meanwhile volatility remains low (other than in some commodity and currencies), but given the prevailing perverse relationship between news and price moves it would be a brave person that extends risk while the prospect of a creep toward USD rate normalisation is nigh.

1 We cannot know the counterfactual for either the UK or US under the absence of QE, so qualifying the benefit of QE is impossible.

China

Shifting focus to the East, China has continued to evolve the economic rebalancing 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:

a. currency revaluation

b. wage growth greater than the rate of productivity growth and, most importantly,

c. an end to financial repression (positive real interest rates).

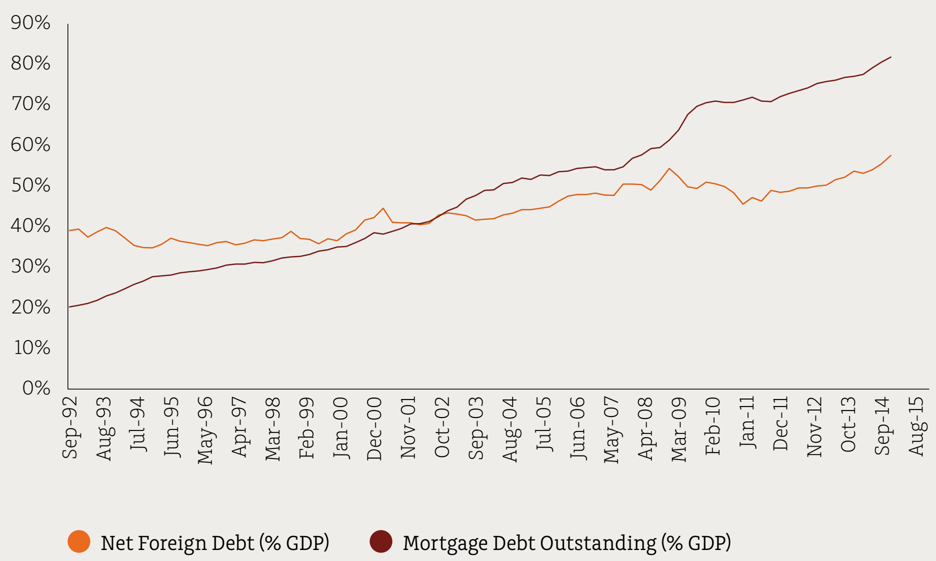
Chinese President Xi Jinping's determined rebalancing of the Chinese economy remained this quarter with continued focus on the high profile anti-corruption campaign and further focus on the environmental quality. But rebalancing is a delicate task, even for a command economy. While corruption and the environment are important and not merely symbolic—the crux of China's rebalancing must take care of the massive overcapacity and associated debt generation that reverberated around the globe as another wave of disinflationary pressure. China alone represents more manufacturing capacity than global demand can digest for low and middle value-add sectors. In a not-so-rare display of foresight, China's leadership released details of a radical plan to reignite the Silk-Road, which if it materialises, will bring a profound change to the way goods are traded between China and important Westward sources of growing demand. The plan, in its current draft, will see a portion of China's significant foreign reserves invested along a corridor of nations between China's Western Xinjiang border and the Mediterranean coast. Much needs to be done to complete the road, rail and power links, and the obstacles to progress are not trivial—but the vision represents more than sensible meshing of:

1. China's national funding surplus
2. the need to maintain a level of infrastructure development, and
3. much needed trade stimulation—which will remain a very important factor as developing nations continue to add more sophisticated manufacturing capacity to global supply chains.

Removal of capacity from a growing economy is difficult, especially when the labour force is grounded in the current capacity. Nonetheless, China's central government has taken notable steps over the last month to rationalise a significant degree of steel manufacturing from China's central provinces. We had previously observed growth in the Chinese steel manufacturing capacity running well ahead of demand, resulting in a fragmented industry that outbid each other for inputs during times of iron ore deficit. This produced a flood of product into a slowing consumption market as the domestic property overbuild slowed. Moves to cull capacity from China's steel markets at a time of rapid growth in seaborn iron ore supply has in turn pushed sentiment in the raw iron ore markets lower from already depressed levels. Iron ore trades at near $48 USD a tonne at the time of writing, significantly away from the extended prices of 2013/4 when buyers paid in excess of $USD180 a tonne. At the same time, dynamics within the Chinese domestic iron ore market have wrong-footed low- and mid-cost suppliers into the seaborn market. Whereas many forecasters believed that domestic costs in China limited any price downside to somewhere near $80USD per tonne, recent price action belies that prior belief. The reasons behind China's mines remaining productive at prices significantly lower than expected, is, like always, driven by a combination of factors that span policy (eg a large cut in the mining tax), productivity improvements and structural market dynamics.

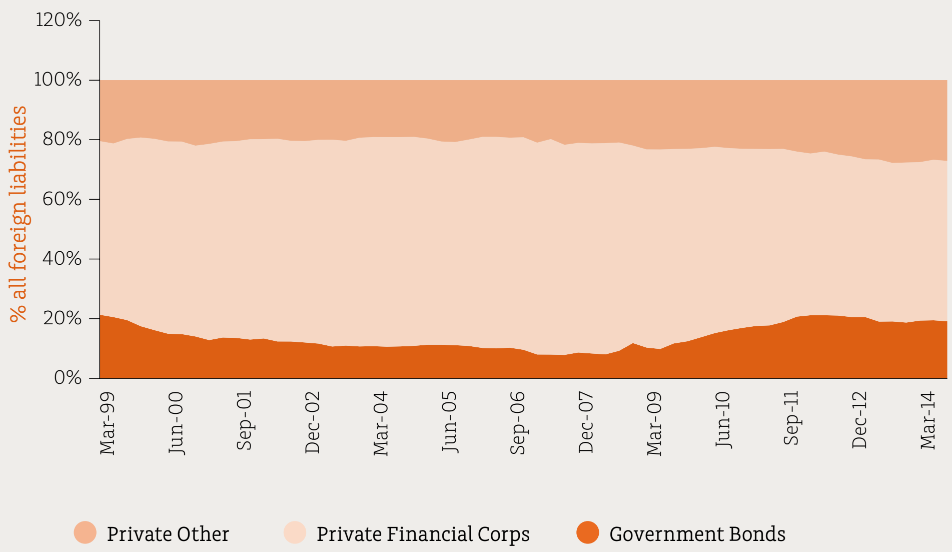
While it hasn't yet caused alarm, the rapid reset of iron ore prices does not bode well for Australia. The problem for Australia lies not in the impact of reduced iron ore income for miners per se, but at the nexus of extremely high national debt and slowing national income. Evidence of slowing national income was starkly evident in the December 2014 national accounts with nominal growth running at only 1.6%, compared to the headline 2.4% real rate. While we often and quite rightly focus on real output, we must remember that debts are not paid back in volumes, but in dollars.

Chart 1: Australian debt



Source: Australian Bureau of Statistics and JANA Corporate Investment Services Limited

Chart 2: Australian foreign liabilities by sector



Source: Australian Bureau of Statistics and JANA Corporate Investment Services Limited

That debt levels are still rising does not help. Chart 1 above shows the continual creep upward in Australia's net foreign debt liabilities as a % of GDP, as well as the ever-upward trajectory of domestic mortgage stock as it approaches 90% of annual GDP; while Chart 2 shows the dominance of bank-sector lending in the composition of Australia's foreign liabilities. For now, capital flows continue to obscure Australia's funding vulnerability, but with national income threatened and public financing seemingly on a rapid unwind toward higher indebtedness, it remains **perhaps** only a matter of time before the flows we have become accustomed to receiving at little premium begin to dry up. What might drive a depression in flows toward Australia is guess work, but a ratings downgrade is an obvious candidate, especially with strained public finances, an all-enduring current account deficit and globally high levels of household debt. Unfortunately for Australia, the reliance on foreign funding limits the scope for domestic rates to remain low if conditions deteriorate. This is made all the more difficult if USD rates begin to normalise: a scenario in which the appetite to fund Australia might require a lift in either domestic cash rates or the spread paid by domestic borrowers to foreign lenders.

Either way, rates paid by borrowers would remain relatively high. This is of course not a given, but it is a key risk that we spend a significant amount of time trying to manage our portfolios' exposure to.

MLC's scenario insights & portfolio positioning

Looking forward

We recognise that the future is always uncertain. MLC's portfolios are managed by taking into account a comprehensive understanding of what the future could hold. Our comprehensive assessment of the different ways in which the future might unfold 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.

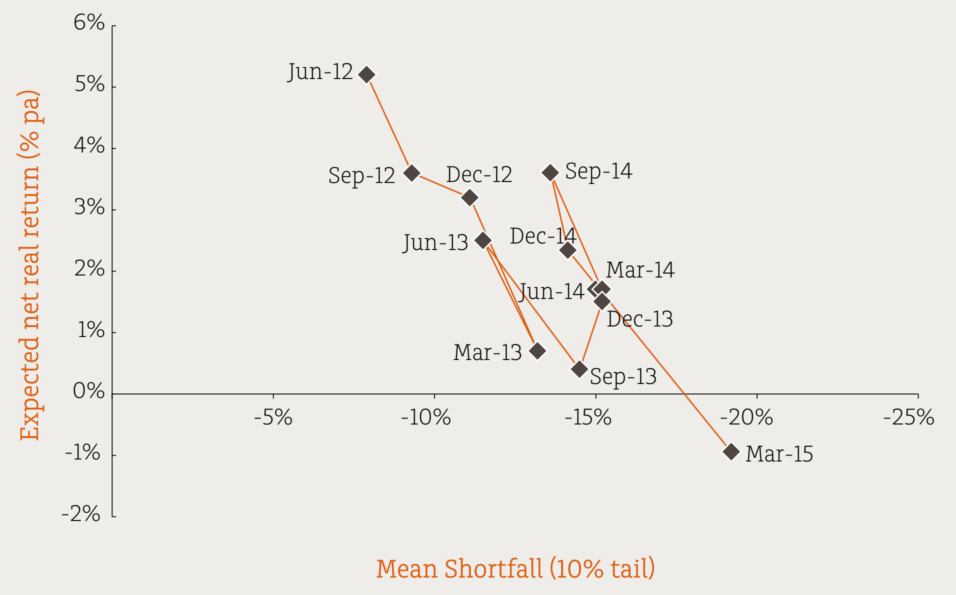
For the **MLC Horizon portfolios**, risk is primarily benchmark-related (and by implication peer relative), with absolute outcomes being important but secondary to this, because these portfolios must remain true to label. In particular, these traditional multi-asset portfolios have constraints to the mix of debt and equities which they can hold. This provides a level of certainty to investors about where their money will be invested, however it also means that portfolio risk is primarily a function of market risk. As the riskiness of different assets changes through time, we have limited scope to adjust portfolio risk.

The MLC Inflation Plus portfolios have flexible asset allocations with few constraints which enable us to control risk. In particular:

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

Chart 3 across illustrates the change in risk exposure (as measured by the average return for the worst 5% of outcomes) and probability weighted return potential for Australian shares looking forward three years for different starting points commencing in June 2013 and with the last look forward being from the end of March 2015. The chart hides a lot of detail, behind it are many scenarios in which robust returns are generated, as well as scenarios which produce negative real returns. Following the strong market returns of the March quarter, the average across these scenarios is now negative looking forward over the next three years. If we used a longer time frame, say five years, the situation would be more positive. However what it illustrates is the on-going compression of the reward for risk across a range of asset classes. The same chart for global equities shows similar characteristics. This picture is the result of strong market returns which have run ahead of the underlying economic fundamentals. In other words, future returns have been brought forward. It is also a function of the economic challenges faced by Australia and the global economy in general. Importantly, the MLC Inflation Plus portfolios are managed to maintain risk control and then seek returns subject to adequate risk management. Today we are increasingly standing back because risk is high and the reward for risk is low, keeping 'powder dry' for better opportunities. This means that achievement of the CPI plus objectives will require a sequence of strategies which exploit those opportunities as they arise through time.

Chart 3: Change in risk and return potential through time for Australian equities
Expected real risk/return profile over 3 years – Australian equities



Source: JANA Corporate Investment Services Limited

We are also seeking to evolve the MLC Horizon portfolios to add more risk control, which again may have an impact on returns, however with a diminishing prospective reward for risk we regard this as appropriate.

The continuing investment 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 also increasing the use of optionality (using options to help manage tail risk) to reduce risk exposure while maintaining upside potential.

If share markets were to correct to the point where risk declines significantly, expect that the MLC Inflation Plus portfolios would increase share exposures and the MLC Horizon portfolios to move back to neutral share allocations. If we remain in 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.

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 5 on page 8 looks at our barometer of risk and return—based on our generic (40) scenario set, described on page 21—for the MLC Horizon and MLC Inflation Plus portfolios looking forward from the end of March 2015. The complete range of potential returns for each portfolio, are shown in the bars. The darker the shade, the closer the outcomes are to the median. Portfolios with wider ranges could have more extreme return outcomes than those with narrow ranges.

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

Chart 4: MLC Inflation Plus portfolios' – positioning and the investment environment

	Limited diversification	Diversification opportunities available
Assets generally fair or cheap	**Moderate return potential & risk** Moderate equity exposure	**Highest return potential & lowest risk** Highest equity allocation
Assets generally expensive	**Lowest return potential & highest risk** Lowest equity allocation *We are here today*	**Moderate return potential & risk** Moderate equity exposure

Source: JANA Corporate Investment Services Limited

MLC's scenario insights & portfolio positioning

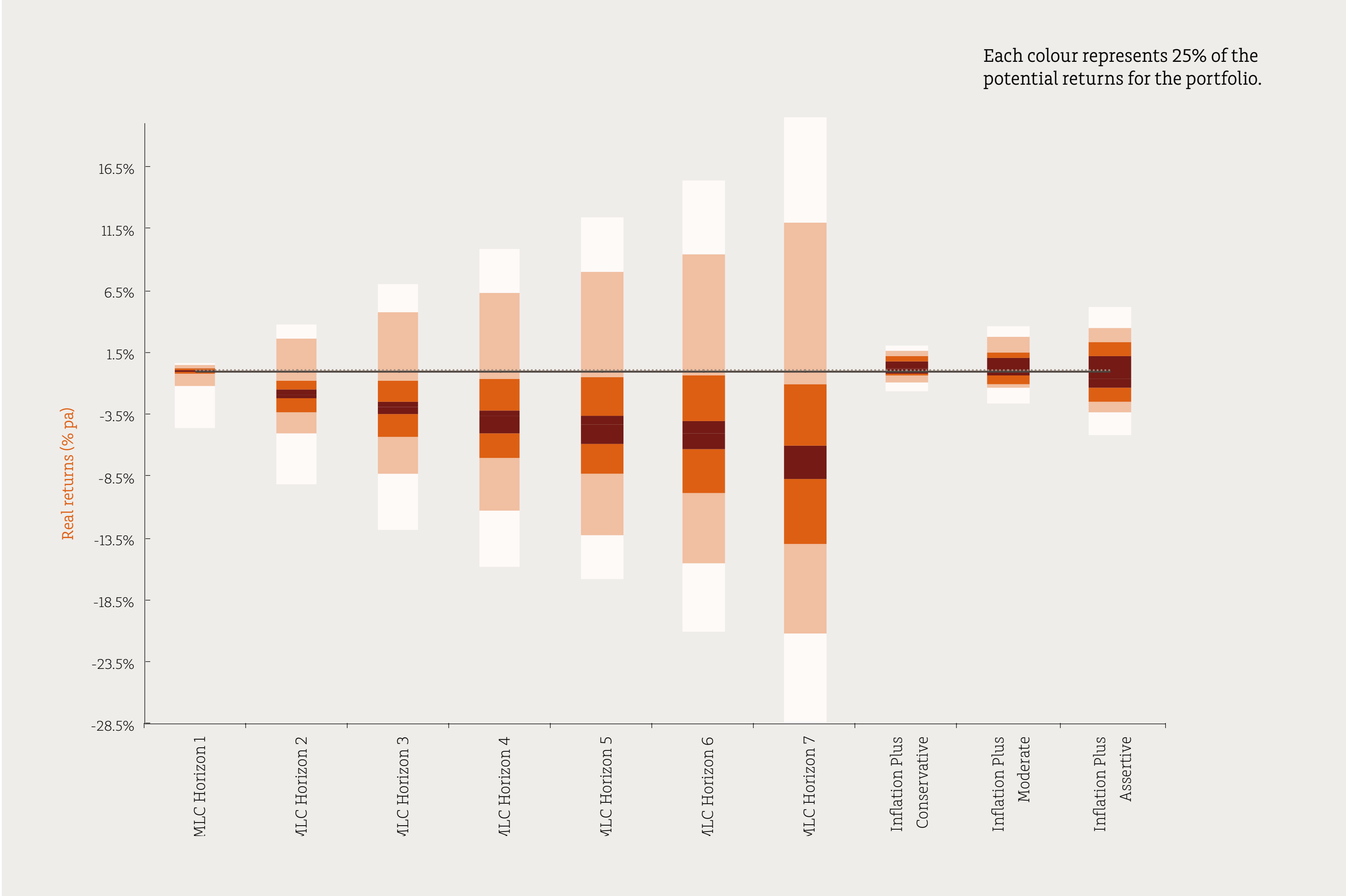
the range of future possibilities and using our assessment of their probabilities, it is clear that the reward for risk-taking could disappoint.

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.

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.

Chart 5: 40 scenario set (generic scenarios) potential real returns (March 2015)
5 years, 0% tax with franking credits, pre-fees, pre-alpha



Source: JANA Corporate Investment Services Limited

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 provides a forward-looking understanding of return potential, risk and diversification. There are few other approaches to asset allocation that generate insight into future sources of both positive and negative returns, and tracks how these change through time. 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 Investment Futures 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 (swings in the level of optimism or pessimism, and rational changes in risk perception)—and a tailored scenario set which includes as many primary distinctive scenarios as is necessary looking forward 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 today may not be after the event—the future is only ever obvious once it has become the past. These two scenario sets in combination are used to assess portfolio positioning. Both sets of scenarios are updated as asset prices change.

The tailored scenario set consists of 13 scenarios. We continue to evolve our thinking about the relative important of these scenarios and their specification. We are also increasingly aware of the greater immediacy of risks for Australia, even assuming a well managed rebalancing of the Chinese economy. We are exploring tailored scenarios which reflect the vulnerabilities posed for Australia by high levels of household debt, elevated residential property prices and an uncomfortable reliance on foreign savings. These risks occur against a backdrop of rebalancing challenges posed by declining terms of trade and income (with flow on effects for public finances) versus competitive gains as the Australian dollar (AUD) devalues in response.

The tailored set continues to revolve around the decisions of policy makers, the impact of these decisions on investors' expectations and behaviour, and the flow-through into the real economy. It seems to us that the most credible transition paths to growth normalisation are still likely to involve an ultimate 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

Portfolio positioning continues to focus on managing risk in a world where the actions of policy makers have distorted asset prices and nullified safe haven investments. The prospective unwinding of unconventional monetary policy setting in the US may significantly change the environment – though the introduction of QE in the eurozone may provide some offset. The challenges to yield-driven investing may be increasing, with investors continuously recalibrating their expectations about the pace of US policy normalisation. We look forward to 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) but we are not holding our breaths. We are acutely aware that 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 persists 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 provides the level of confidence to maintain appropriate positioning through extended periods in which markets behave perversely—this is critical to ultimately delivering for investors. While we are comfortable with the performance of the portfolios, we are not complacent about the future challenge. Nimbleness and flexibility are more important than ever if we are to both generate returns and control risk.

Our analysis of scenarios is designed to build an understanding of both return potential and downside risk. Where there is a significant asymmetry (ie the upside potential is less than the downside risk) we have an opportunity that we can exploit to increase the return compared with the level of risk. There continues 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

MLC's scenario insights & portfolio positioning

foreign assets within the MLC Inflation Plus – Assertive Portfolio, and remain overweight to foreign currencies across the MLC Horizon 2 to MLC Horizon 7 portfolios. 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.

We have increased the MLC Horizon portfolios' underweight to all maturities debt during the quarter, this reduces exposure to interest rate risk. We are also exploring opportunities to reduce the interest rate risks posed for the MLC Inflation Plus portfolios by the inflation linked bond exposure. 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.

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 classes in the MLC Inflation Plus Super & Pension portfolios over the March quarter			Comment (for Assertive portfolio)
	Conservative	Moderate	Assertive	
Australian shares	Lower allocation	Lower allocation	Lower allocation	Relatively attractive in terms of probability-weighted outcomes but relatively high tail risk which we assess to be rising.
Global shares	Close to zero allocation	Lower allocation, close to zero	Lowered to zero allocation	Limited exposure due to strong preference for a defensive share allocation in a relatively high risk environment.
Defensive global shares (unhedged)	Lower allocation	Lower allocation	Higher allocation	Primary global share exposure is defensive. The portfolio has a strong bias to absolute, not index-relative, shares. Allocations have been reduced in favour of a cash covered futures exposure which builds in a higher level of strategy flexibility.
Foreign currency exposure	Small reduction	Small reduction	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. During the quarter Singapore dollar exposures were removed from the portfolios following a strong appreciation in that currency versus the AUD.
Low Correlation Strategy	Steady allocation	Steady allocation	Lower 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	Higher allocation	Higher allocation	Higher allocation	Significant allocations reflecting preference for highly flexible strategies with total return focus
Emerging markets strategy	Lower allocation	Lower allocation	Lower 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	Reducing 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.

Real return funds: MLC Inflation Plus portfolios continued

Asset class	Change in allocation to asset classes in the MLC Inflation Plus Super & Pension portfolios over the March 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	Higher allocation	Higher allocation	Inflation hedge remains attractive, despite low yields. However we are cognisant of duration risks and are currently working on reducing those risks.
Insurance related investments	Zero allocation	Steady Allocation	Steady Allocation	Uncorrelated though risky exposure appropriate where time horizon is sufficient.
Bank loans	Steady allocation	Steady 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	Steady allocation	Lower allocation	Higher 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 significant powder dry 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 asset allocation of the MLC Horizon portfolios is being finalised. 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 March 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. Allocations were reduced further prior to the September market decline.
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 benchmark allocations are underweight versus peers.
Global private assets		•		Allocations are in the process of rebalancing to target from overweight.
Emerging markets strategy		•		Retain benchmark allocation.
Multi-asset real return strategies (including inflation plus)			•	Overweight maintained
Low Correlation Strategy			•	Overweight increased
Fixed income		•		Reduced duration stance increased.
Cash			•	Overweight increased
Australian bonds - All Maturities			•	Overweight (MLC Horizon 4 and 5 only).
Australian inflation-linked bonds		•		Benchmark weight.
Global bonds - All Maturities	•			Underweight increased
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.

MLC's scenario insights & portfolio positioning

Return potential

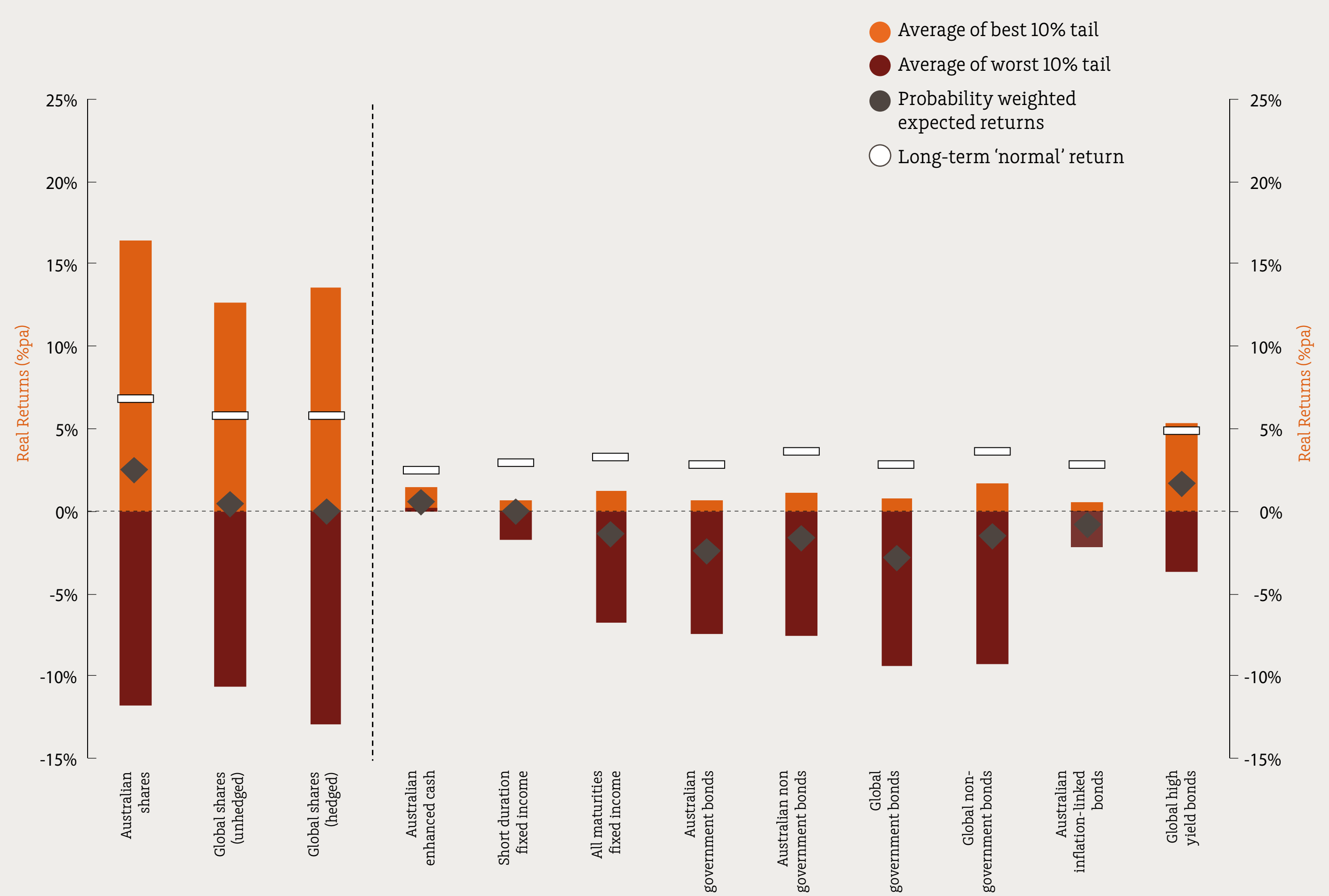
At the heart of our Investment Futures Framework is specifying scenarios which capture what the future might hold. We systematically build a map of potential futures which capture important uncertainties about economic, market and investor behaviour. We then generate return forecasts in each scenario 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 potential real returns for each asset class are shown in Chart 6 (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 5, on page 8, shows return potential for the MLC Horizon and MLC Inflation Plus portfolios.

Chart 6: 40 scenario set (generic scenarios) probability weighted potential real returns (March 2015) (5 years, 0% tax with franking credits, pre fees, pre alpha)

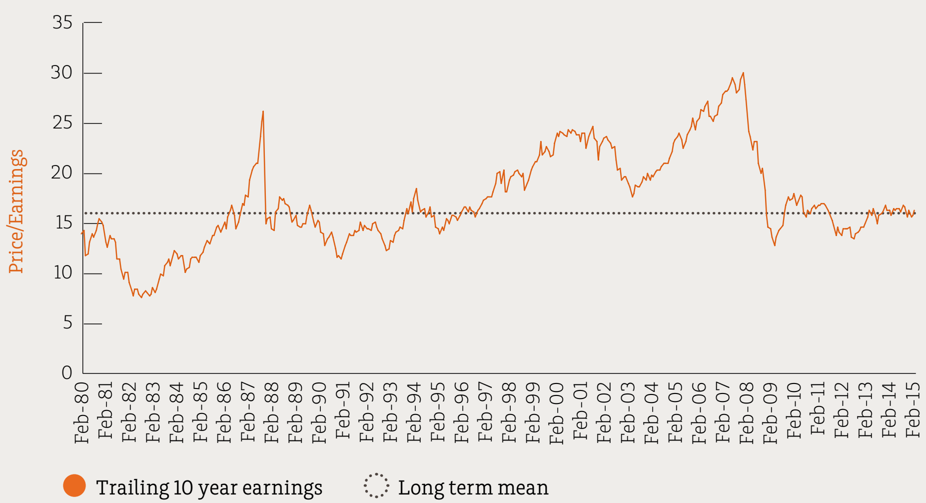


Source: JANA Corporate Investment Services Limited

Asset class indicators

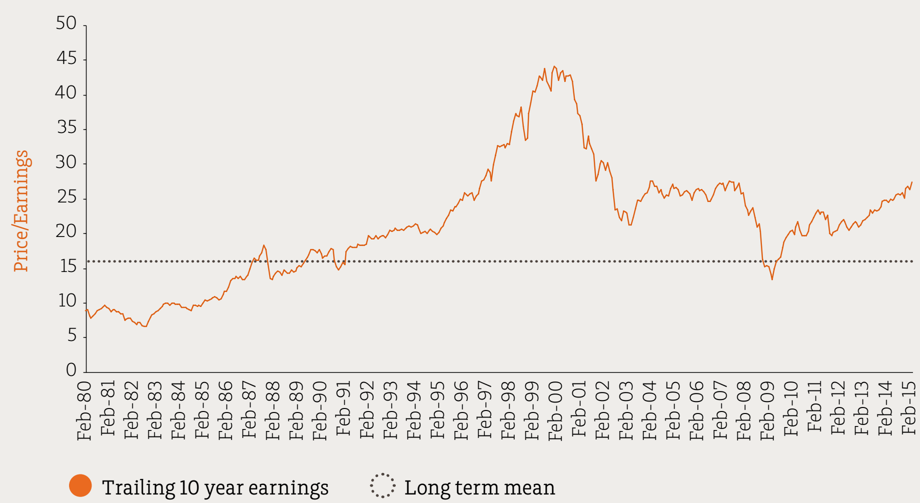
Our view of the main asset classes is as follows.

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



Source: Datastream

Global shares
Market indicator *S&P500*



Source: Datastream World Index

Comment

The Australian share market continued its run from last year, rising over 10% in the first quarter of 2015. The main drivers of performance were financials, particularly banks and real estate which contributed more than 50% of the market's return as investors continued to favour high yielding stocks. Materials also rebounded after detracting last quarter following sharp falls in key export commodities like iron ore.

The Reserve Bank of Australia's (RBA) 25 basis point interest rate reduction surprise in February was the major catalyst for equity markets to again re-rate higher. Nonetheless, the RBA's pause in March prompted a short pull back, demonstrating the domestic fixation on interest rates. This was exemplified by the market rallying on P/E expansion rather than earnings growth. Implied earnings growth based on 12 month forward P/E's for the next 12 months is essentially flat.

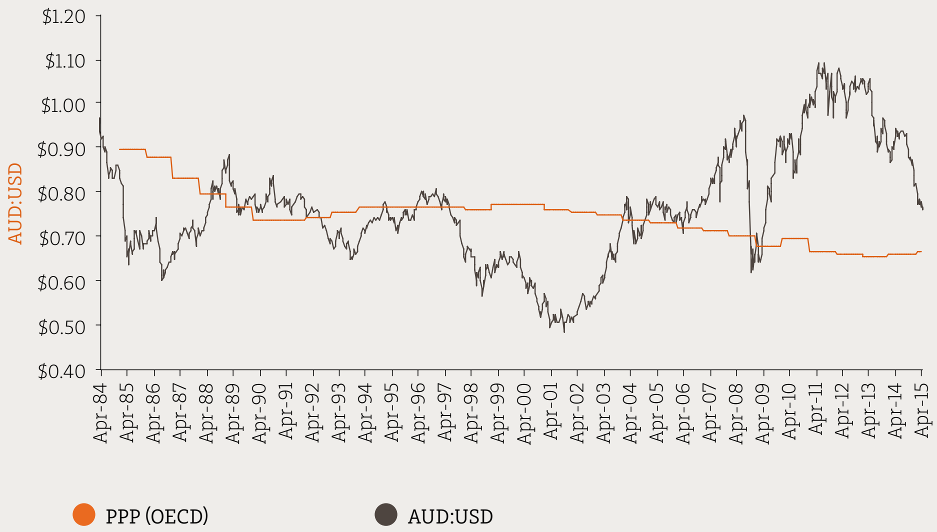
Comment

World share markets enjoyed good gains over the quarter, rising 9.7% in unhedged AUD terms. However most of the performance came from a falling AUD, with the currency declining more than 7%. Strong returns in Europe were driven by the ECB's announcement to start their own stimulus package by buying 60 billion euros a month of predominantly European sovereign debt. Japanese equities also rallied strongly over the quarter, on the back of another round of stimulus by its central bank.

In terms of valuations, equities continue to remain expensive relative to their history, but as evident in the chart, this can persist for some time. This again highlights the importance of understanding the current difficult starting point and the potential catalysts for mean reversion in equity valuations.

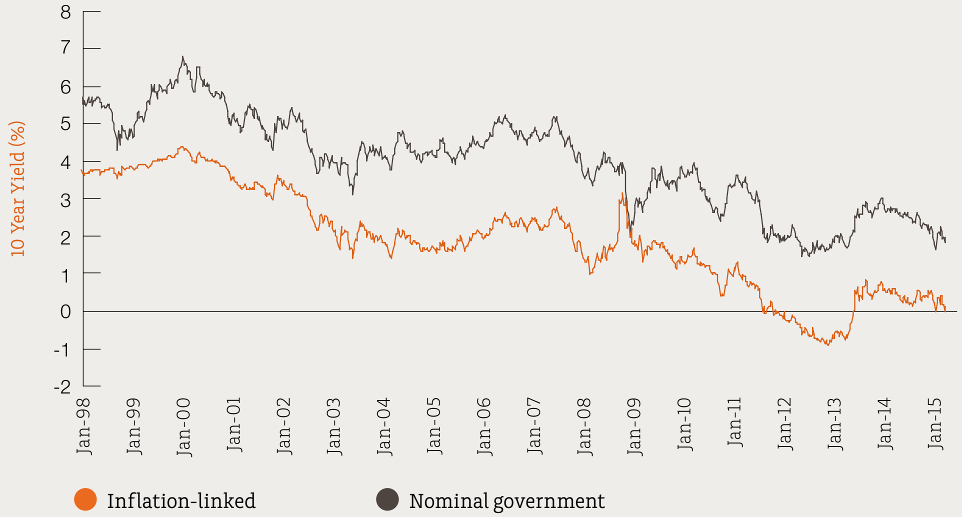
Asset class indicators continued

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

A stronger USD versus all major currencies and easing monetary policy in Australia saw the AUD continue its fall, ending the quarter down 7.3% to 76 cents. The RBA's rate cut in February was justified by the central bank on the basis of lower future inflation and economic growth. This is being driven by weak domestic growth from below trend wage growth and a decline in the terms of trade reducing income growth for both the public and private sector. The rate of unemployment was also flagged as a concern as they expect it to trend slightly higher. The RBA believes a lower exchange rate is needed to achieve balanced growth in the economy and that fundamental value should be lower given the large decline in commodity prices. This is consistent with the IMF's AUD purchasing power parity exchange rate (a long term measure of fair value) which is currently 66 cents against the USD.

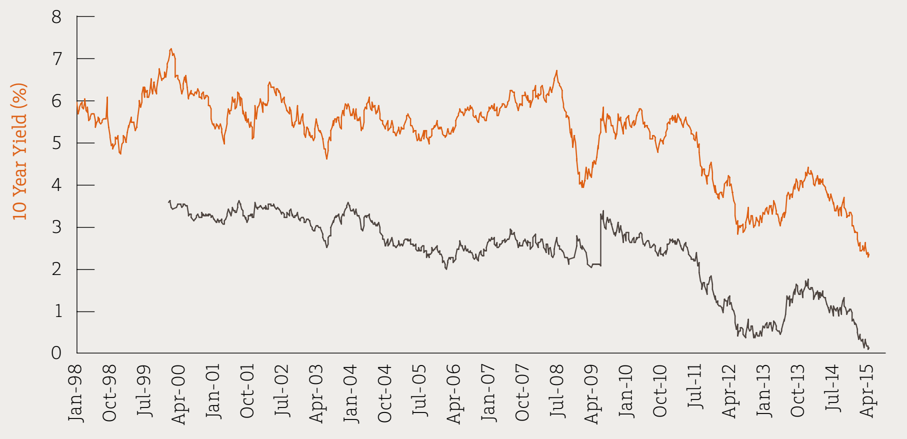
Comment

Bond yields were volatile and lower across the world as central banks in both Europe and Japan conducted large scale QE programs in an attempt to drag yields lower to boost credit growth. Europe in particular saw yields fall drastically with German's 10 year bond yields sitting precariously close to 0%. Although the United States has ended its stimulus program, bond yields continued to fall given dovish comments by the Fed despite market anticipation of a change in rhetoric to a more hawkish stance.

Although inflation expectations remained largely unchanged from the previous quarter, the decline in nominal yields dragged real yields lower, resulting in strong performance over the quarter.

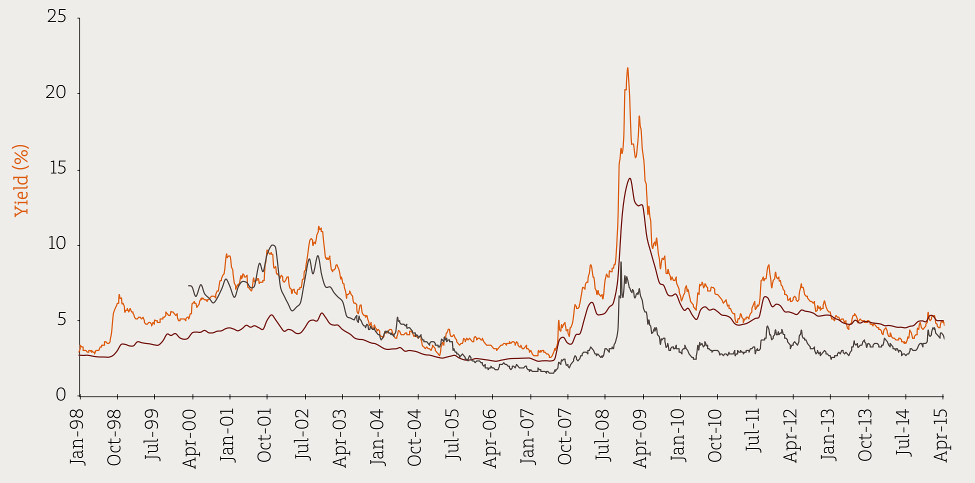
Asset class indicators continued

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, falling 50bps to 2.36%. A cut in interest rates by the RBA along with market anticipation of further cuts sometime in the next year was the main catalyst for the decline in bond yields. Furthermore, a weaker domestic growth outlook and the RBA's expectations for inflation to remain somewhat weak, saw the treasury yield curve flatten.

Domestic inflation-linked bonds performance followed the same path, as real yields fell in line with nominal yields. Real rates are now quite low relative to history and very close to 0%. Although inflation protection is a key focus, we must carefully balance their inflation protection against the risk of a potential rise in real rates.

Comment

Both non-investment grade credit (high-yield corporate bonds and bank loans) spreads increased over the quarter as mutual fund and exchange-traded fund (ETF) outflows from retail investors continued. Despite this, high yield bond issuance has been running high, with issuance year to date 35% higher than its previous corresponding period last year.

Appendix 1 – tailored scenario set

Scenario	Probability ranking	Description
Three speed global economy (China soft landing)	1	The world continues to split into three distinct economic growth zones. China and other emerging markets deliver robust (though in the case of China at least more moderate) growth; the US and UK grow at or above trend; while Europe continues to stagnate. Japan struggles to escape stagnation. Strong USD, AUD strong vs JPY and euro. 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 made worse by increased ex-Europe international trade – Europe is essentially excised and isolated. Greater domestic activity also plugs the output gap to a degree.
Early re-leveraging	2	Low yields and a period of policy stability prompt a resumption of credit growth in developed economies. Economic growth picks up more quickly than expected and unemployment recedes. Debt imbalances begin worsening again as the developed world quickly re-levers and Asia focuses on investment. This scenario could precede an inflation shock, a second crisis or, if policy makers are nimble enough, a transition to a mild inflationary resolution.
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.
(Mild) inflationary resolution	4	Reforms do not occur fast enough to entirely offset inflationary pressure, but the inflation rise is orderly. Upward pressure on skilled wages supports demand but squeezes profits. Widespread USD, GBP, JPY and euro liquidity support asset prices, but this is offset by earnings reversion in the US. Bond markets are reasonably well behaved. Inflation is high enough to help inflate away the debt burden. Emerging markets experience more severe inflation than the developed world, slightly normalising the growth differential across the emerging markets/developed markets divide.
Reform	5	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 scenario has become more likely with recent policy initiatives. The US and UK grow at or above trend, reforms and stimulus in Japan boost growth to above trend; reforms continue in the eurozone which start to increase growth potential and easing of austerity reduces growth constraints.

Appendix 1 – tailored scenario set continued

Scenario	Probability ranking	Description
Extended quantitative easing	6	Central banks of the US, UK and Japan continue to print currency, and are joined by the ECB. This scenario includes the impact of expanded USD, GBP, JPY and euro liquidity which principally finds its way into asset prices, rather than spurring consumption. The character of this scenario has changed as the yield and safe haven supports to commodity currencies have diminished. Important drivers to change include rising confidence on robust US growth, and moderation in Chinese resources demand with consequent flow on effects for the Australian economy and interest rates. Consequently it is not anticipated that the AUD would re-visit recent peaks in this scenario, though could remain elevated versus measures of fair value particularly versus the euro and yen. The Chinese economy continues to rebalance and growth moderates. The Chinese 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.
Extended risk aversion	7	A generic scenario to capture prolonged aversion to risk.
Inflation shock	8	Similar to stagflation, though assumed growth is higher. Sharp rise in inflationary expectations.
One speed slow growth world	9	There is growth convergence as persistent slow growth in the developed world spills over into the emerging world.
China hard landing	10	A combination of poor allocation of capital, greater than anticipated loan losses, lower external demand, currency appreciation and monetary policy error causes a crash in Chinese output. This most likely emanates from a property crash, though failure to contain inflation and/or social unrest are also possible flash points. Australia suffers severely under this scenario (recession). Income is shocked and the AUD corrects to sub-PPP rates. This causes a flow-on impact through to employment (weakness) and housing crashes. Thus, both materials and financials are hit, causing very poor Australian shares performance. Japan and Korea also suffer due to their export trade exposure to China. The US, Europe and the UK are somewhat insulated from the Chinese crash, the main effect being a disruption to imports.
Sovereign yield re-rating	11	Low starting yields are a valuation risk for bonds. Yields could rise to more normal levels even in the context of low growth/inflation expectations. High government debt burdens (UK/core Europe/Japan/USA) provide the potential for a bond-vigilante style re-rating of sovereign yields. This is not a likely near-term scenario, but given the low yields and high level of indebtedness as a starting point, there is a risk that the environment could progress to one where apparently safe loan 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 continued

Scenario	Probability ranking	Description
Stagflation	12	With no clear roadmap for the withdrawal of policy stimulus, the inflation risks from QE 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 (due to a stronger aversion against deflation) 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'. The scenario is likely to involve monetary policy reversals reminiscent of the 70s. US economy is getting closer to the point at which an inflationary policy mistake could occur.
Two speed recovery	13	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 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.

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