Summary of portfolio positions and scenario insights – MLC Horizon portfolios

March quarter 2015

These are currently the main positions in the MLC Wholesale Horizon 4 portfolio. There were no changes in the March quarter and the portfolio continued to be positioned fairly defensively compared with its benchmark.

In recent quarters, several factors have combined to increase market volatility, with uncertain consequences for global growth. These factors include falling commodity prices – particularly for oil and iron ore - and the prospect of less aggressive monetary policy in the US, although the introduction of quantitative easing in the eurozone may to an extent act as a mitigant.

The Australian dollar (AUD) and resource-related companies remain vulnerable to slowing growth in China given its importance for Australian exporters. This vulnerability is increased by our high levels of household debt, elevated residential property prices, slowing national income and ongoing reliance on inflows of foreign savings.

These issues, and stretched market valuations, led to our continued defensive positioning.

Portfolio position compared with benchmark	Why we have the position	Impact on performance
Below benchmark exposure to growth assets We have implemented this position by: • increasing exposure to multi-asset real return strategies • reducing the Australian shares allocation, and • increasing exposure to the low correlation strategy.	The portfolio has a large exposure to shares to generate long-term returns. However, because shares can be volatile, we've increased the portfolio's diversification over time to manage risk and generate more robust returns. These risk-controlled exposures include multi-asset real return strategies, the low correlation strategy, a multi-asset emerging markets strategy and the defensive global shares strategy. As these strategies were introduced to the portfolio, we reduced allocations that invest in the broader Australian and global share markets. The most important of the more recent allocations to multi-asset real return strategies is our allocation to the MLC Inflation Plus strategies. These strategies provide a packaged, tailored means of increasing return potential and managing risk. For the last few years share market returns, supported by unusually low interest rates, have been strong and have tended to run ahead of actual company earnings. When market returns have been strong for a long period, there is increased risk that share valuations become stretched, and that markets may fall. Potential negative scenarios for growth assets (such as shares) include **Developed market austerity**, **Recession**, **Stagnation**, and **China hard landing**. The portfolio will continue to benefit from strong returns in positive scenarios for growth assets, such as a **Mild inflationary resolution** or an **Early re-leveraging** scenario. In these scenarios, growth assets should perform strongly compared to bonds. Our below benchmark exposure to growth assets is consistent with the views of a number of	This position may mean the portfolio's returns will be slightly lower if share markets continue to produce strong returns. However, we consider the position is appropriate given the current risk level and the increased protection it will provide if negative scenarios occur.

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<table>
<tr><th>Portfolio position compared with benchmark</th><th>Why we have the position</th><th>Impact on performance</th></tr>
<tr><td></td><td>our investment managers that the risk of a negative environment for growth assets has risen.</td><td></td></tr>
<tr><td>Below benchmark exposure to interest rate risk

We have implemented this position by:
reducing the duration (exposure to changes in bond interest rates) of our fixed income strategy, and
tilting the portfolio away from global bonds and towards cash and Australian bonds.</td><td>While bond yields (interest rates on bonds) could decline from their already low levels, the potential for further falls is less than the potential for yields to rise. Rising yields means bond prices fall and there is the potential for negative returns. By reducing the duration, we've reduced the risk of negative returns if yields rise, such as in a Sovereign yield re-rating scenario.

Reducing our exposure to nominal bonds and shortening the duration of our fixed income strategy gives the portfolio some protection if bond yields rise. In a Rising inflation or Inflation shock scenario, traditional bonds would perform poorly and could deliver negative returns.</td><td>Bond yields continued to fall in recent months, which meant our current positioning marginally detracted from performance.

Yields also fell earlier in the year, reducing the portfolio's one year returns.</td></tr>
<tr><td>Above benchmark exposure to foreign currencies

We have implemented this position by:
reducing the allocation to global shares whose foreign currency exposure is hedged to the AUD
increasing exposure to unhedged global shares, and
maintaining unhedged exposures in most global growth assets.</td><td>When designing the portfolio, we aim to combine assets and strategies which perform differently in different scenarios. Global share markets and the AUD tend to move in the same direction. So by having an exposure to foreign currencies (that is, not hedging some of our overseas assets to the AUD) we can help insulate our portfolios against some losses when share markets fall.

Foreign currency exposure is therefore a diversifier of risk for the portfolio. We expect it will help generate more robust returns, even though the AUD has declined from its highest point. Our above benchmark position is intended to reduce the portfolio's exposure to negative returns in a number of negative scenarios, including China hard landing.

It's important to note that our portfolio positioning doesn't assume that the AUD will decline. We also consider scenarios in which the AUD rises, including Extended quantitative easing and Sovereign yield re-rating. However, in many scenarios we expect the AUD to fall further, particularly if share prices fall sharply. These scenarios include China hard landing.</td><td>Partly because of the decline in the iron ore price, but also because of other macroeconomic issues, the AUD has continued to fall against the US dollar. Australia's weak national accounts, depressed Chinese steel production and the prospect of a fall in interest rates in Australia also meant there was less upward pressure on the AUD.

Our foreign currency exposure worked well over the last three months and year, offsetting volatility in Australian share market returns in previous quarters.</td></tr>
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Why MLC uses a scenarios approach

Key to MLC's market-leading investment process is our scenarios-based Investment Futures Framework. In an uncertain world, we can never be sure what the future holds. This means that relying on a single prediction of the future to position a portfolio leads to very uncertain returns.

Instead, we aim to understand the wide range of future economic and market conditions, or 'scenarios', that could occur, both good and bad. The Investment Futures Framework helps us continually identify these scenarios. It then helps us analyse how the scenarios could affect our portfolios. Using these insights, we adjust the portfolios' strategies to control potential risks and capture opportunities for returns. We constantly reassess our portfolios' positioning as potential risks and opportunities change over time.

We position the MLC Horizon portfolios to deliver returns above the portfolios' benchmarks or reduce risk in the portfolios when market risk is high. Over long time frames, reducing risk at the right times will result in higher returns.

The Investment Futures Framework includes two sets of scenarios. They are a comprehensive generic set of 40 scenarios, which focus on the main drivers of returns (macroeconomic influences and investor behaviour), and a tailored set of currently 13 scenarios, which focus on the particular circumstances we are experiencing now.

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