Summary of portfolio positions and scenario insights – MLC Inflation Plus portfolios

March quarter 2015

These are currently the main positions in the MLC Wholesale Inflation Plus portfolios. For more information about how these portfolios are managed, please refer to the MLC Inflation Plus brochure.

Changes in asset allocation this quarter

The portfolios have been positioned defensively for some time. We fine-tuned these positions during the March quarter.

Potential risk or opportunity	Change in MLC Inflation Plus portfolios and reason
Risk of a market correction	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. Given these risks and stretched market valuations, we have continued to increase the defensive position of the portfolios by making further reductions to Australian and global shares and the emerging markets strategy, and increasing the allocations to the risk management strategy and the multi-asset real return (MARR) strategies. The MARR strategies invest flexibly across many types of assets, but also focus strongly on controlling risk. These strategies have some exposure to share markets, but their tight risk control will help the portfolios in more negative scenarios.
Risk of an eventual rise in inflation	We seek to deliver returns higher than the rate of inflation, which is a moving target. While the forces of deflation are currently strong, we are concerned about an eventual rise in inflation. Inflation-linked bonds can help provide protection against unexpected rises in inflation in scenarios such as **Stagflation** and **Inflation shock**. To lessen exposure to this risk, we made further increases in the allocations to Australian inflation-linked bonds this quarter in the Moderate and Assertive portfolios.

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Key asset allocation positions that were unchanged this quarter

Asset class or strategy	Role in the MLC Inflation Plus portfolios	Performance implications
Foreign currency exposure	We manage the portfolios by having the right asset allocation at the right time and continuously reposition the portfolios to limit risk in adverse environments. Foreign currency exposure has provided an opportunity to limit risk, permitting the portfolios to hold a higher allocation to shares than would otherwise be the case. This risk reduction impact comes from the tendency of global share markets and the AUD to move in the same direction. By having an exposure to foreign currencies (for example, by 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 an important diversifier of risk for the portfolios. We expect it will help generate more robust returns in a number of difficult potential scenarios for which there are currently few other opportunities for diversification. While the fall in the AUD was positive for the portfolios' returns, it does weaken the potential future diversification benefit of foreign currency exposure. We have partially hedged the risk of renewed AUD strength via options in our risk management strategy. This position reduces the risk of significant negative returns if the AUD rises. Our significant foreign currency exposure is intended to reduce the portfolios' vulnerability to negative returns in a number of adverse scenarios, including a **China hard landing**. 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**.	The AUD continued to fall in the last three months. Our foreign currency exposure worked well, offsetting volatile Australian share market returns in previous quarters.

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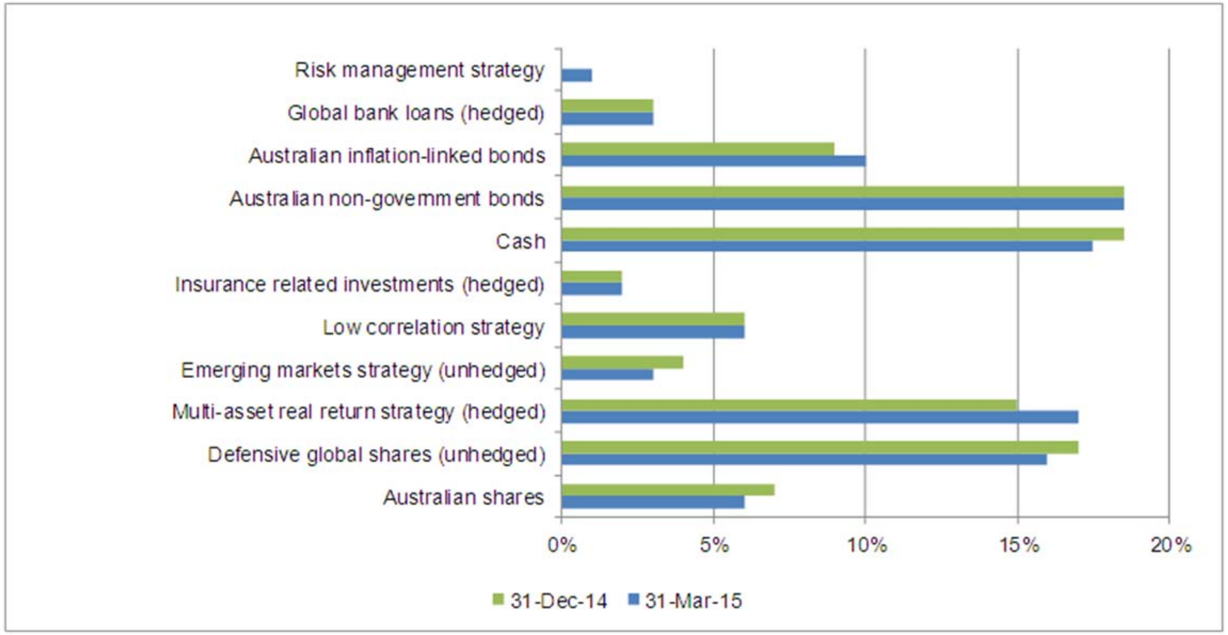
Asset class or strategy	Role in the MLC Inflation Plus portfolios	Performance implications
Defensive global shares strategy	The main global shares exposure in the portfolios is through our defensive global shares strategy. This strategy has a capital protection focus and aims to sustainably grow wealth, rather than beat the market. In this strategy there is flexibility to invest in a range of assets (not just global shares). This helps protect the portfolios' capital in weak global growth scenarios such as **Developed market austerity**, **Recession**, **Stagnation** and **China hard landing**. 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. In these circumstances, we need to 'keep some powder dry' by investing more defensively. This requires that we limit exposure to significant negative returns and wait for more favourable conditions in which to seek higher returns.	Good stock selection in the defensive global shares strategy generated robust returns while share markets remained strong. The strategy also performed well in volatile markets during previous quarters, assisted by its substantial allocation to assets other than global shares.
No direct allocation to long duration traditional bonds	The portfolios have limited vulnerability to changes in bond interest rates. This is reflected in the following positions: • no direct exposure to long duration traditional bonds, and • exposure to short duration Australian non-government bonds, global bank loans (largely floating rate bonds) and cash. Government bonds, a traditional source of diversification, still have very low yields. They offer limited potential for both real returns and diversification. At their present valuations, these aren't attractive investments for the portfolios. The portfolios have exposure to inflation-linked bonds. Unlike traditional bonds, their returns move with changes in inflation. This means they can help protect against the risk of rising inflation, although (like all bonds) they are still exposed to the risk that the interest rate on the bond may rise. We are currently working on reducing the interest rate risk of these bonds.	By avoiding the risks of traditional bonds, we have been able to increase the portfolios' exposure to other risks, which have delivered better returns.

Changes in the asset allocation of MLC Inflation Plus – Moderate Portfolio

Chart 1 shows how we've adjusted the asset allocation of the MLC Inflation Plus – Moderate Portfolio this quarter. We've reduced the exposure to Australian shares, defensive global shares, cash and the emerging markets strategy and increased exposure to inflation-linked bonds, MARR strategies and the risk management strategy.

Chart 1: MLC Inflation Plus – Moderate Portfolio changes to asset allocation over the quarter



Source: MLC Investments Limited

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December quarter 2014

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 Inflation Plus portfolios to achieve an 'inflation plus' return over their time frames, while limiting their exposure to negative returns in adverse scenarios. The risk focus may reduce return potential in positive scenarios, but provides tight risk control in adverse scenarios.

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, currently of 13 scenarios, which focus on the particular circumstances we are experiencing now.