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

June 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

We made further changes to increase the portfolios' defensive positioning before the increase in volatility in share and bond markets towards the end of the June quarter.

Potential risk or opportunity	Change in MLC Inflation Plus portfolios and reason
Risk of a market correction	The portfolios are managed with a strong focus on capital preservation. In today's highly uncertain investment environment, risk control is critically important. Therefore we are placing a greater emphasis on risk control as opposed to return generation. High share market returns in the March quarter increased market risk looking forward. Therefore early in the June quarter we made further reductions to the Australian shares allocation and increased the allocation to defensive global shares and the low correlation strategy. This reallocation significantly reduced the portfolios' exposure to risk prior to the adverse market environment in June, which was made worse by the uncertainty about the ability of Greece to meet its loan obligations and remaining in the eurozone together with China's sharp share market reversal. If this volatility persists, the US Federal Reserve could delay the commencement of interest rate rises and we may see further monetary stimulus in the eurozone and Japan to restore market confidence. This has the potential to result in resumption of the strong return environment. However we continue to be concerned about stretched share market valuations and the continuing high levels of debt in the global economy. There are particular vulnerabilities for Australia flowing from slower and less investment intensive growth in China. Therefore we continue to maintain the portfolios' defensive positioning.
Risk of an eventual rise in interest rates	While we value the inflation protection of inflation-linked bonds, the decline in yields to extremely low levels in the first quarter of 2015 increased their risk so we reduced allocations. Scenarios in which there is clear risk include **Early re-leveraging** and **Sovereign yield re-rating**. We have halved the allocation to Australian inflation-linked bonds and redirected the money to Australian non-government bonds, which has a short term to maturity, and global bank loans, which are largely floating rate securities.

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	Foreign currency exposure has provided an opportunity to limit risk in adverse environments, 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 Australian dollar (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 significant 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 an **Australian stress scenario**. 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.	The AUD rose slightly in the last three months. However, over the past year our foreign currency exposure worked well, helping offset volatile share market returns.

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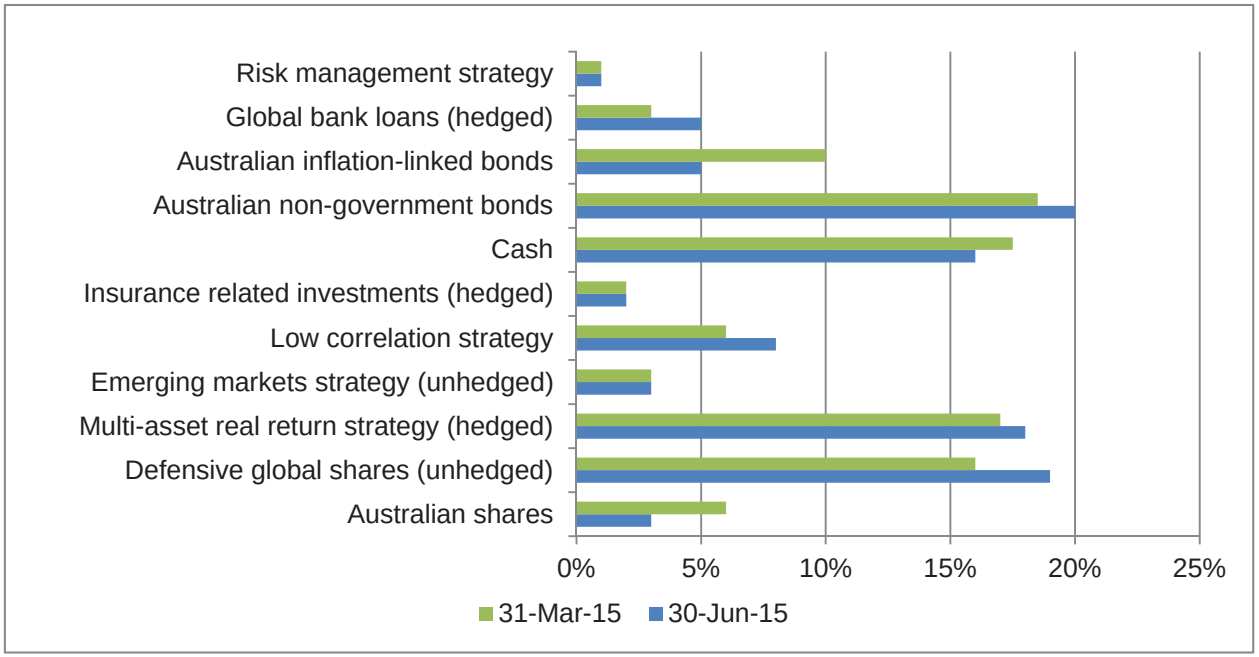
Asset class or strategy	Role in the MLC Inflation Plus portfolios	Performance implications
Defensive global shares, risk management, low correlation and multi-asset real return strategies	For the last few years share market returns, supported by unusually low interest rates, have been strong and have 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. Investing in these strategies rather than just share markets helps protect the portfolios in weak global growth scenarios such as **Developed market austerity**, **Recession**, **Stagnation** and an **Australian stress scenario**.	These positions may mean the portfolios' returns will be lower if share markets produce strong returns. However, we consider this positioning is appropriate given the current risk level and the increased protection it provides if adverse scenarios occur.
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 • 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.	By avoiding the risks of traditional bonds, we have been able to increase the portfolios' exposure to other risks, which have delivered better returns.
Australian inflation-linked bonds	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. Unlike traditional bonds, inflation-linked bonds returns move with changes in inflation and can therefore help provide protection against unexpected rises in inflation in scenarios such as **Stagflation** and **Inflation shock**. However, inflation-linked bonds (like all bonds) are still exposed to the risk that the interest rate on the bond may rise. In May we halved the portfolios' exposure to Australian inflation-linked bonds because yields had declined to extremely low levels resulting in an increase in their risk.	Inflation linked bonds were weak in the last quarter, particularly in June after we halved the portfolios' exposure.

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, Australian inflation-linked bonds and cash and increased exposure to defensive global shares, the multi-asset real return strategy, the low correlation strategy, Australian non-government bonds and global bank loans.

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



Source: MLC Investments Limited

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 of currently 12 scenarios, which focus on the particular circumstances we are experiencing now.