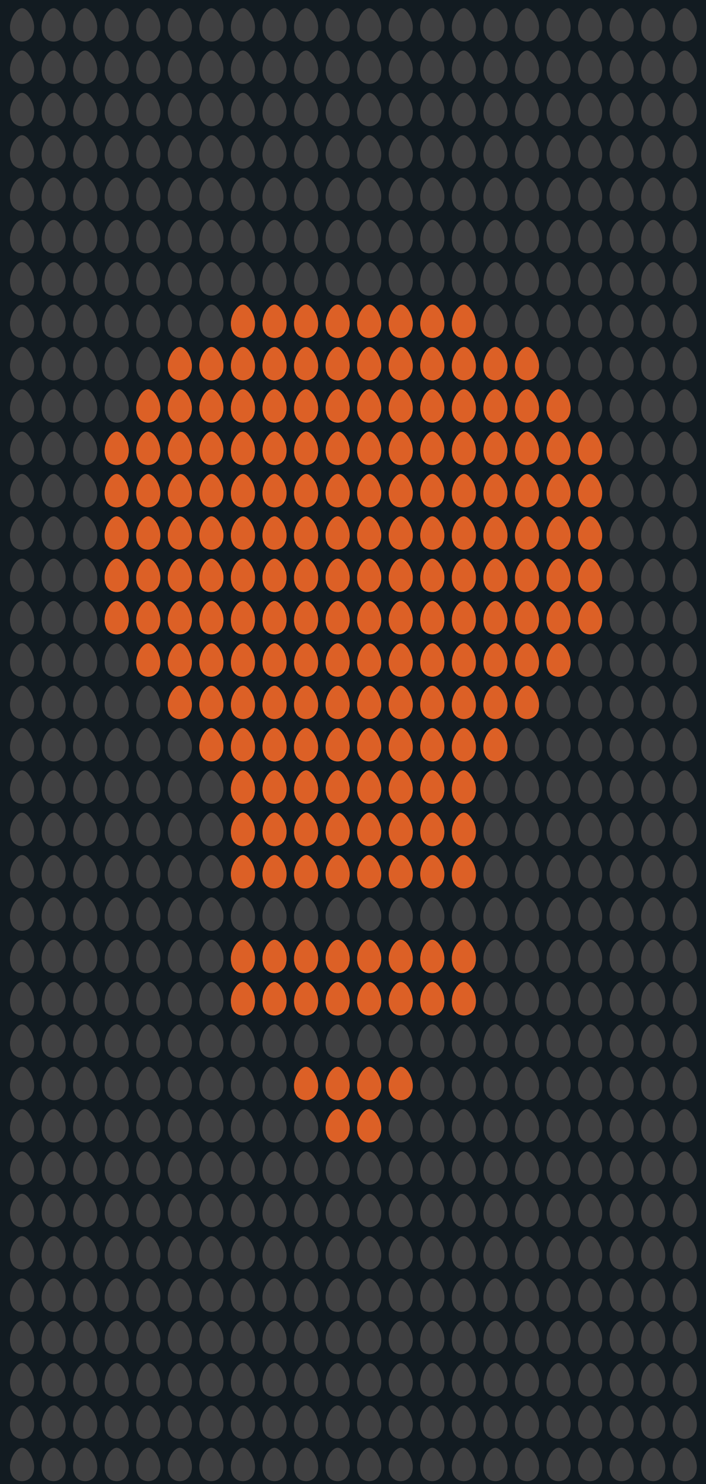

MLC's scenario insights & portfolio positioning

MLC Horizon and MLC Inflation Plus portfolios

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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.

Over the past year we have been highlighting a rise in volatility which has started to fracture the uneasy peace in financial markets. That peace was manufactured by central banks and it rests uneasily on the foundation of ultra-accommodative monetary policy. In other words, policy rather than economics has been the main driver of market behaviour. Today's high asset prices are explained by monetary policy settings, and this creates vulnerability to not only policy tightening but also to a policy mistake or other shock which derails confidence. In recent weeks two vulnerabilities have been troubling financial markets: a potential Greece exit (Grexit) from the eurozone and the bursting of the Chinese stock market bubble. These events remind us of three things:

- ultimately underlying economic fundamentals will drive asset prices
- policy makers are not infallible, and
- policy flexibility faces constraints in the face of a major shock.

While seven years have passed since the Global Financial Crisis (GFC) and the Great Recession, major developed economies continue to grapple with a return to sustained growth, moderate inflation and positive real interest rates. There has been progress including major repairs to the global banking system; regulatory reforms for banks are being put in place and their balance sheets recapitalised. Current account imbalances have also narrowed. But stronger banks have been achieved via a transfer of debt to the government sector rather than by way of a resolution. In other words, the underlying vulnerability of too much debt remains unresolved. And despite the slashing of interest rates, economic recoveries have been disappointing. Importantly even in the US business investment remains lack lustre and there are some tentative signs of emerging wage pressure. Expectations of the future are a central driver of investment decisions, which means that the greatest potential for higher investment comes from increased certainty about robust future economic conditions. Without investment, productivity suffers and wage pressure builds as labour substitutes for capital. Today there is a worrying disconnect between companies' perceptions of high risk and financial market pricing, implying market complacency. This inconsistency and the distress in both Greece and China are just the latest expressions of the fundamental challenge of excessive debt.

Underlying all this is a disquieting longer term reality. Since the late 1980s there have been a number of booms which have inevitably led to a bust, but there is something about this pattern which has to change. To be sure there will continue to be booms which run too far (witness China's share market bubble), the change will come in the way in which the bust plays out. Each successive boom-bust has brought in its wake ever more innovative and accommodative monetary policy responses. For example, during the struggle of the post

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 2.

GFC years, we have learned that central banks can do much more than cut interest rates to zero. Quantitative easing (QE) has become pervasive. QE in the form of central bank purchases of longer duration debt extends monetary policy's influence through a lowering of bond yields. QE can also extend to being a market maker to replace panicking investors in extreme times (as the US Federal Reserve (Fed) did in the US commercial paper market). More recently we've learned that zero is not the lower bound to interest rates.

This increasing accommodation has meant that excesses generated in one boom were never entirely reversed, creating what's been called a 'debt super-cycle' in which debt progressively ratchets up relative to GDP. This extra credit has supported economic growth, but also excesses build up in one cycle tend to persist which means that successive cycles involve progressively bigger risks, and hence bigger busts. This process cannot go on forever. Ultimately investors will come to understand that there is too much risk versus realistic return potential. For the real economy this inevitably discourages investment; and for financial markets it increases the vulnerability of risky assets to significant declines which re-set return potential. While the timing of market reversals can never be known in advance, these issues will keep us cautious in positioning portfolios. We are acutely aware that monetary policy options are now very limited in response to another major bust.

Another deflationary shock emanating from a severe market bust may have to rely more on a fiscal response. Fiscal stimulus offers more direct support to consumption, and so there is a potential flow through to inflation. If interest rates are then held below the rate of inflation the debt overhang starts to resolve, but this presents significant challenges for savers. Preservation of real capital in this environment, were it to eventuate, would be our primary focus. We are well aware of these risks and we start to build risk hedges even when such risks may seem remote.

China's share price volatility

The extreme volatility in the Chinese share market provides a timely reminder that policy makers are not infallible; and that their ability to manipulate their way out of the consequences of past policy shortcomings may not be as great as they would wish. As we have explained in previous updates, the policy response to the GFC has resulted in China becoming over-indebted with much of that debt being unproductively deployed by state-owned enterprises (SOE) and local governments. The consequence has been over-building with surplus capacity in those areas driving growth – notably real estate which has been the main driving force of the economy. This is being dealt with via a planned rotation away from investment led growth towards consumption. This rotation inevitably means that debt problems (for example many property developers are technically insolvent) are being revealed and both credit and economic growth are slowing (growth is likely well below the official 7% target, it may be no more than half that level) with contractions in particular in the SOE and local government sectors. At the same time there are efforts to stimulate the economy in new more market driven ways. One potential channel has been via the encouragement of share ownership – this has included offering participation in under-priced initial public offerings (IPOs) which has had the unfortunate effect of pulling money out of the secondary market and making it vulnerable to a sharp decline. The plan was that while the share market continued to rise, it could help boost consumption and in a best case scenario, help bailout debtors. Though the share market is a fraction of the size of the property market, an ability to swap SOE and other debt for equity potentially provides a means of easing the debt burden. This might help explain the rather extreme measures used to stem the share price slide. A raft of measures (including China's state-owned banks lending $209bn) have been deployed in a demonstration that the authorities were prepared to do whatever it takes to manipulate share prices higher. It is not clear how normal market functioning will be restored given the complex array of non-market measures. This includes the suspension of more than 1,400 companies - which is more than half the companies trading on the Shanghai and Shenzhen markets. With margin debt, at the peak reportedly an uncomfortable 9% of the value of shares available for investment (though only an estimated 4% of households total deposits), estimated to be only around one third unwound in absolute terms.

MLC's scenario insights & portfolio positioning

Some of the measures introduced are in contradiction to the Chinese government's intention to allow the economy to become more market driven. This episode sets back the time it may take China to assume its full place in the global economy (it will also likely delay its entry into the MSCI global index). But the biggest issue we face comes from the vulnerability of Australia to a slowing Chinese economy. It is not simply the level of growth that matters but its composition – the move away from investment to consumption has a disproportionate impact on demand for our resources. Chinese commodity imports are declining at a double digit rate. 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 around $50 US dollar (USD) per tonne at the time of writing, significantly away from the extended prices of 2013/4 when buyers paid in excess of $180 USD per 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 $80 USD per tonne, recent prices have already fallen to below that level. 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.

The problem for Australia lies not in the impact of reduced iron ore income for miners per se, but in the connection between very high national debt and slowing national income. Evidence of slowing national income was starkly evident in the March 2015 national accounts with nominal growth running at only 1.15%, compared to the headline 2.43% 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. That debt levels are still rising does not help. There is a 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. 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.

A Greek tragedy

A second example of policy ineptitude in the June quarter occurred in the eurozone. With a nascent recovery in Europe, we might hope that policy makers would seek to minimise factors that could derail growing confidence. Unfortunately that desire did not appear to be reflected in the negotiation process with Greece during the June 2015 quarter. The sorry saga in Greece represents a failure on the part of both the ruling Syriza party and eurozone finance ministers. On one side Germany has tried to force out (democratically elected) the left-wing anti-austerity Greek government. While on the other, the Syriza led government verges on the delusional or at least incompetent. But also the eurozone austerity plan can also be accused of being delusional – cutting public spending to reduce the budget deficit causes GDP to shrink. Over the five years of the austerity program Greece's GDP has shrunk by 25%. Not surprisingly debt has risen rather than declined. The human cost is also immense with, for example, over 50% of youth unemployed. Despite this, Greece's Prime Minister Alexis Tsipras has been willing to gamble everything to get debt write-offs without showing evidence of change. Greece has a seriously mal-functioning economy in which even paying tax and (for public servants) attending work appears optional. They are also desperately uncompetitive versus Germany's manufacturing power house. The two bickering sides have failed to understand the other's point of view and each has been unwilling to compromise. (As an aside, of course, the biggest mistake occurred when Greece was allowed to join the eurozone.) Meanwhile the tragedy plays out for the most vulnerable Greeks. The poor would have faced a possible Cyprus-style hair-cut to meagre bank balances and a certain dramatic devaluation under a Grexit scenario. Tsipras underestimated the difficulty of navigating the referendum and its aftermath both politically and economically.

In the end, rather than risk a Grexit, Tsipras capitulated and agreed an even more stringent deal that was rejected via the referendum. The suggestion by German Finance Minister Wolfgang Schaeuble of a 'temporary' exit from the eurozone, is off the table for now. Greece was given just days to implement a raft of measures including sales tax increases, pension cuts, and spending cuts which are to be made automatic if budget targets are missed. The program at best kicks the can down the road yet again. At least one leading economist has referred to these measures as 'madness'. Eurozone finance ministers made more bailout aid conditional on the changes being passed and demanded the right of veto over legislation. This is a clear wake up call for other eurozone electors contemplating voting for anti-austerity parties – and a reminder that eurozone membership entails some loss of sovereignty (and hence risks an unwelcome backlash in the form of a resurgence in nationalism).

While this is a human tragedy for Greece the main issue for us is what the potential fallout may be for our investors. Greece is a very small country – its GDP is less than 2% of the eurozone. The main risk scenario was a Grexit which would have demonstrated that eurozone membership was reversible. We cannot be sure what the ultimate consequences of that might have been (likely more limited if Greece exits but later re-joins – though we suspect any exit will turn out to be permanent). The risk comes not from the direct impact on growth but from the impact on confidence. Perhaps most importantly, monetary unions are vulnerable to loss of confidence which causes citizens in one country to fear that a euro in their local bank is worth less than a physical one or a euro in a foreign bank. This has nothing to do with solvency, fiscal strength, or the desire of the population to remain in the eurozone. It is runs on banks that end monetary unions. This fact will not be lost in the European Central Bank (ECB) which is no doubt ready to do 'whatever it takes' in this case – but we cannot be completely sure that will be successful.

Japan making slow progress

Finally, while it hasn't been in the headlines, it is timely to comment on the Japanese economy because it provides an illustration of the worst that could happen. Japan has been in the grip of a severe asset price deflation for more than two decades. Its prolonged slump shows what happens when excessive levels of debt are not addressed. As an aside, had it been a member, Japan would have been ejected from the eurozone a long time ago. It is only in the last two years that decisive policy moves have been taken to combat severe and persistent problems. The policy program involves a combination of structural reform, fiscal stimulus and monetary stimulation (the so-called three arrows). Most effectively so far a radical QE program (the Bank of Japan is buying around 70% of net Japanese government bonds issued) has been successful in pushing the yen down by around 30%, boosting Japan's competitiveness. Hence exports have been the key driver of the improvement in growth, but this remains vulnerable to reversal through global demand weakness and/or currency appreciation. The two may be correlated - witness for example the re-emergence of the yen as a safe haven currency during the latest bout of market volatility. The currency devaluation has meant that some progress has been made; inflation has increased but is still well short of the 2% target (though partly because of lower oil prices which is stimulatory) and nominal growth is now marginally above interest rates (which is necessary to reduce debt but this gets much harder if interest rates rise).

To tackle Japan's massive debt the growth rate must exceed the interest rate. Japan needs to boost growth in other ways which is difficult given a declining work force (and an aversion to foreign workers), there is only so far they can go to increase participation. This implies that the focus needs to be on boosting labour productivity, which means that companies need to be induced to deploy their substantial cash reserves preferably on investment or otherwise at least on wages to boost consumption (and hopefully investment subsequently). Importantly, the Japanese government has for the first time introduced a corporate governance code, in an attempt to change the mindset of companies – this includes the requirement to appoint at least two external directors. There is a long way to go, cosy cross holdings between companies still encourage actions contrary to shareholders interests. And difficulty in hiring and firing of workers discourages recruitment. But as aging workers with entrenched benefits and beliefs exit, change becomes easier. And both market and political pressure for change is increasing. Pressure for change can come (for example) via the huge Government Pension Investment Fund which is now a significant equity investor. Some companies are embracing change but too many still have risk averse bureaucracies which are hard to change. So while progress may not be rapid, it is moving in the right direction.

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.

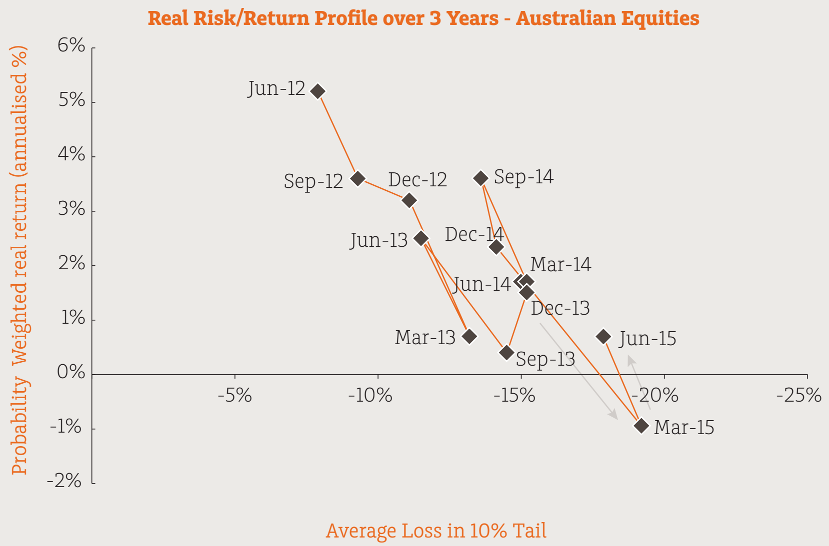
For the **MLC Horizon portfolios**, risk is primarily benchmark-related (and by implication peer relative), with absolute outcomes being important but secondary to this, because these portfolios must remain true to label. In particular, these traditional multi-asset portfolios have constraints to the mix of fixed income and shares 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 portfolio 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 are inconsistent with real capital preservation over each portfolio's investment time frame.

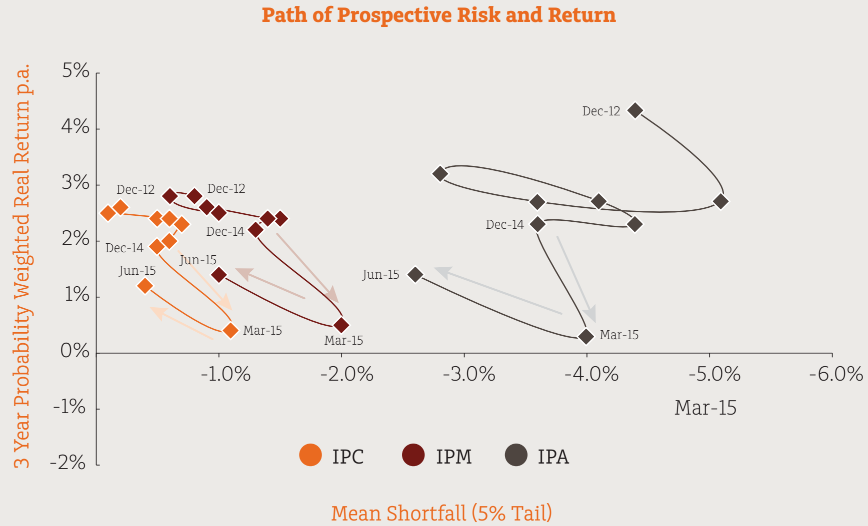
MLC's scenario insights & portfolio positioning

Chart 1:
Change in future risk and return potential through time for Australian shares



Source: JANA Corporate Investment Services Limited. Past performance is not a reliable indicator of future performance.

Chart 2:
Change in future risk and return potential through time for MLC Inflation Plus portfolios



Source: JANA Corporate Investment Services Limited.

Chart 1 illustrates the change in risk exposure (as measured by the average return for the worst 10% of outcomes) and probability weighted return potential for Australian shares looking forward three years for different starting points commencing in June 2012 through to the end of June 2015. The chart hides a lot of detail. Behind the data 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 real return across these scenarios become negative looking forward over the next three years. This illustrates the on-going compression of the reward for risk across a range of asset classes. In the June quarter return potential increased as a consequence of falls in share prices and prospective risk eased slightly.

Chart 2 shows a similar chart for the MLC Inflation Plus portfolios. We have marked with arrows the changes to risk and return potential looking forward from the end of both the March and June quarters. As was the case for Australian shares, there was a significant reduction in return potential and increase in risk exposure by the end of March. In response we rebalanced the portfolios in May before the increase in market volatility. Risk was reduced via reallocations including reductions to the Australian shares allocation, which was removed entirely from the Conservative portfolio. As a consequence of these reallocations there was a significant reduction in risk exposure prior to the adverse market environment of the June quarter. This does not reflect any skill on our part with respect to short term timing; rather it was our typical response to the rise in risk that occurred in the March quarter which required reallocations in order to hold the risk discipline for these

MLC's scenario insights & portfolio positioning

portfolios. Consequently, looking at the change over the quarter, there was a greater proportionate reduction in the risk profile of the MLC Inflation Plus portfolios. We maintain this tight risk control of MLC Inflation Plus through time by making significant changes to its investment strategy. The return potential of the prevailing strategy will change through time to a much greater extent than the risk exposure. In contrast both the return profile and the risk exposure of the MLC Horizon and Index Plus portfolios will vary with market conditions since our ability to offset changes in risk is more constrained. (For example, a traditional 70/30 portfolio may have experienced around a 4% increase in shortfall risk between December 2012 and March 2015.)

As we have outlined previously, today's investment environment remains very difficult. The investment challenge is what to do in a world in which everything is expensive, there is no place to hide, and almost anything could happen. In such an environment preservation of capital is the dominating objective for the MLC Inflation Plus portfolios. For MLC Horizon and Index Plus we have moved to a more defensive orientation and are more aware in managing these funds of the potential for strong returns to resume as markets are buoyed by a further round of stimulation and the Fed may keep interest rates on hold for longer than previously anticipated.

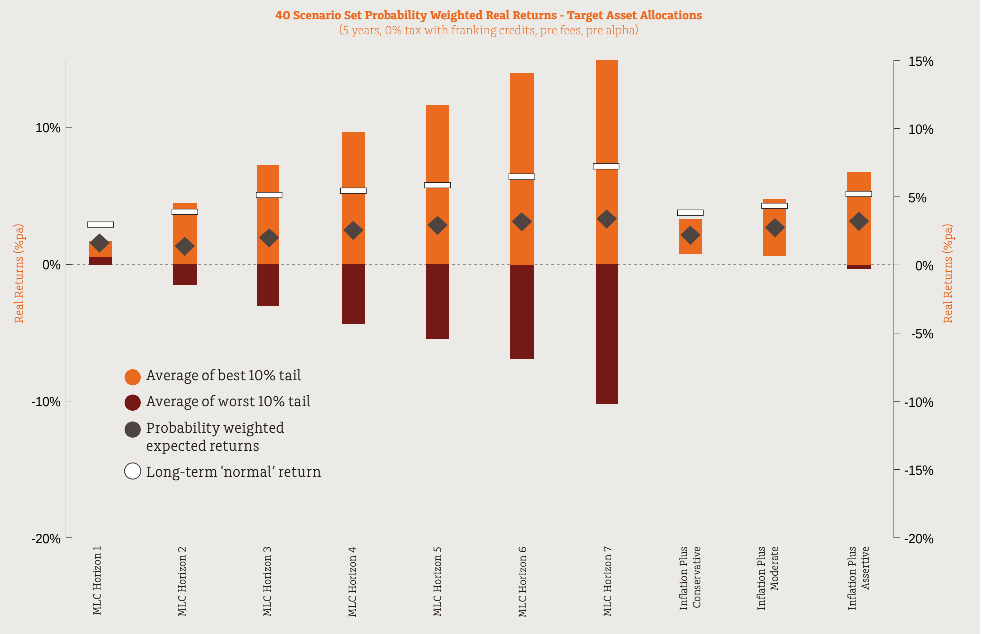
Performance expectations

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 looks at our barometer of risk and return – based on our generic (40) scenario set, described on page 9 – for the MLC Horizon and MLC Inflation Plus portfolios looking forward from the end of June 2015. 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

Chart 3:
40 scenario set (generic scenarios) potential real returns (June 2015)
5 years, 0% tax with franking credits, pre-fees, pre-alpha



Source: JANA Corporate Investment Services Limited.

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.

MLC's scenario insights & portfolio positioning

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.

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 12 scenarios. We continue to evolve our thinking about the relative importance 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.

MLC's scenario insights & portfolio positioning

Our current positioning

Our 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. While the unwinding of unconventional monetary policy setting in the US may be delayed in the light of recent market volatility and we may see further stimulus in the eurozone and Japan which restores market complacency. However, looking further out we see that the challenges to yield-driven investing may be increasing, with investors continuously recalibrating their expectations about the pace of US policy normalisation. While looking 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 understand it could still be a long way off.

We are acutely aware that the strong return environment may resume and that the logic of our strategy only becomes 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 challenges. 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 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 continue 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 fixed income during the quarter; this reduces exposure to interest rate risk. Changes to the MLC Inflation Plus portfolios' allocation include reductions in shares and, because of extremely low yields, inflation-linked bond allocations. These changes were made early in the quarter prior to the volatility in both bond and share markets.

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 classes in the MLC Inflation Plus Super & Pension portfolios over the June quarter			
	Conservative	Moderate	Assertive	
Australian shares	Zero allocation	Lower allocation	Lower allocation	Allocations reduced as the risk return trade-off deteriorated following the strong returns of the first quarter.
Global shares	Close to zero allocation	Close to zero allocation	Zero allocation	Limited exposure due to strong preference for a defensive share allocation in a relatively high risk environment.
Defensive global shares (unhedged)	Higher allocation	Higher allocation	Higher allocation	Primary global shares exposure is defensive. The strategy 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.
Low correlation strategy	Higher allocation	Higher 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	Higher allocation	Steady allocation	Steady allocation	Significant allocations reflecting preference for highly flexible strategies with total return focus.
Emerging markets strategy	Marginally higher 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.

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 June quarter			
	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	Reduced allocation	Reduced allocation	Reduced allocation	While we regard an inflation hedge as highly desirable, declining yields in the first quarter changed the risk return trade-off.
Insurance related investments	Zero allocation	Steady Allocation	Steady Allocation	Uncorrelated though risky exposure appropriate where time horizon is sufficient.
Bank loans	Higher allocation	Higher allocation	Higher allocation	Floating rate loans offer some exposure to diversifying income-based risk premia without as much capital risk as fixed rate 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 non-government bonds (short duration)	Steady allocation	Higher allocation	Steady allocation	Offer some return enhancement while limiting additional risk.
Cash	Higher allocation	Lower allocation	Lower 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" in cash, 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.

	MLC Horizon Super & Pension portfolio weights at the end of the June 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 multi asset real return strategies (notably MLC Inflation Plus) 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 a small increase in the allocation to hedged global shares at the expense of unhedged global shares this quarter. This overall underweight to unhedged global shares 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)			•	Increased overweight allocation this quarter.
Low correlation strategy			•	Overweight increased.
Fixed income	•			Reduced duration stance increased again.
Cash			•	Overweight increased again this quarter.
Australian bonds	•			Increased underweight allocation this quarter.
Australian inflation-linked bonds	•			Moved to underweight allocation this quarter.
Global absolute return bonds			•	Increased overweight allocation this quarter.
Global government bonds	•			Increased underweight allocation this quarter.
Global non-government bonds	•			Reduced underweight allocation this quarter.
Global multi-sector bonds	•			Increased underweight allocation this quarter.
Global non-investment grade bonds: high yield bonds, bank loans, mortgages	•			Retained benchmark allocation with a slight decrease to high yield bonds in favour of bank loans.

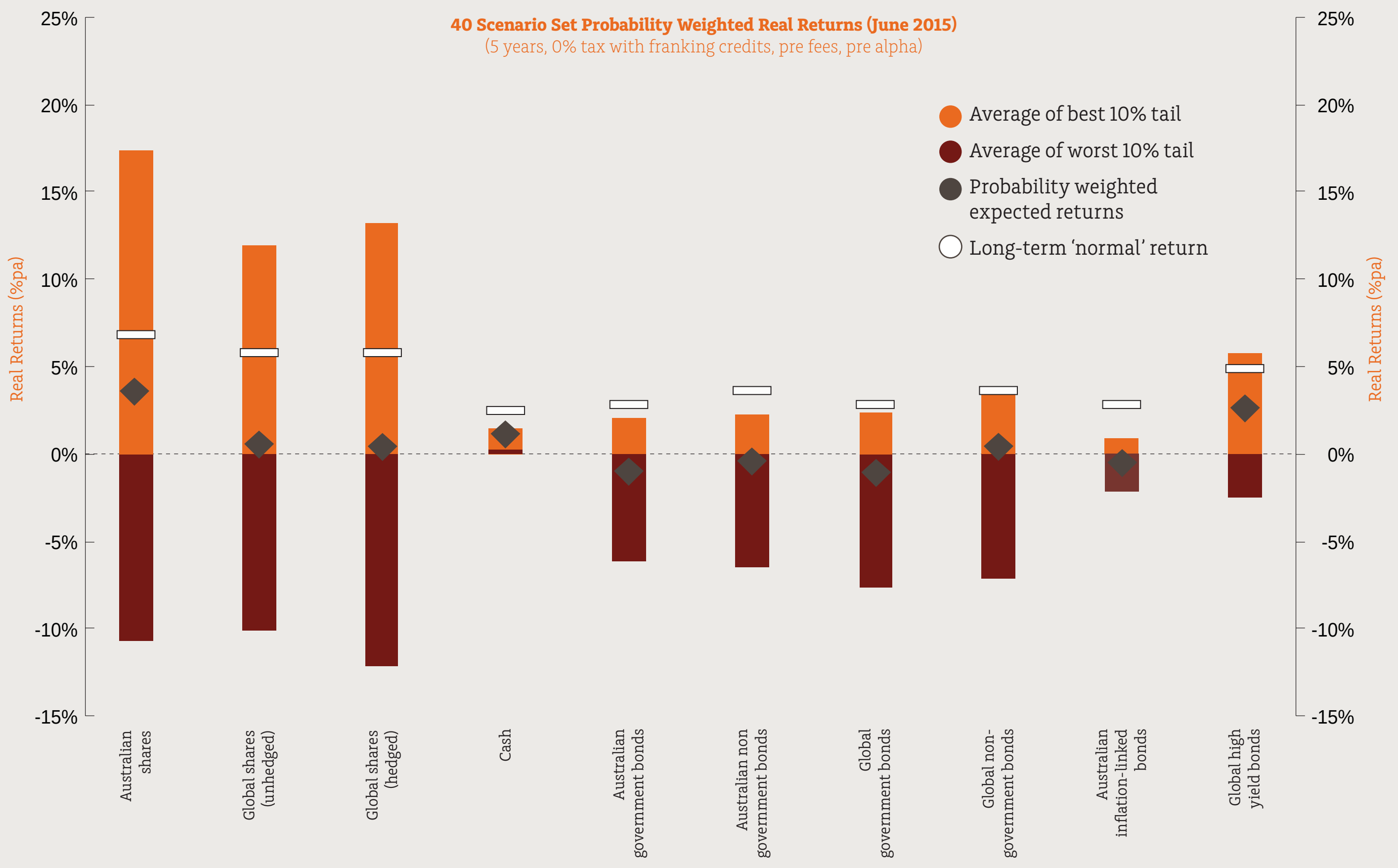
Return potential

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 fixed income 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 4 opposite (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 8, shows return potential for the MLC Horizon and MLC Inflation Plus portfolios.

Chart 4: 40 scenario set (generic scenarios) potential real returns (June 2015)
5 years, 0% tax with franking credits, pre-fees, pre-alpha

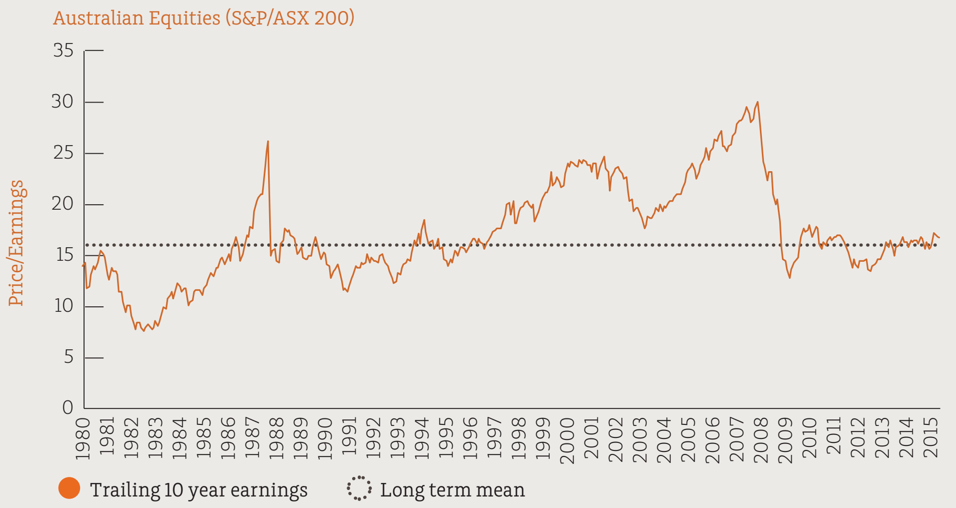


Source: JANA Corporate Investment Services Limited

Asset class indicators

Our view of the main asset classes is as follows.

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



Source: Datastream

Comment

The Australian share market reversed the direction in the June quarter declining 6.6% versus the previous quarter's rise of over 10%. Consumer stocks, healthcare and financials led the decline, while energy, telecoms, industrials and utilities were relatively resilient.

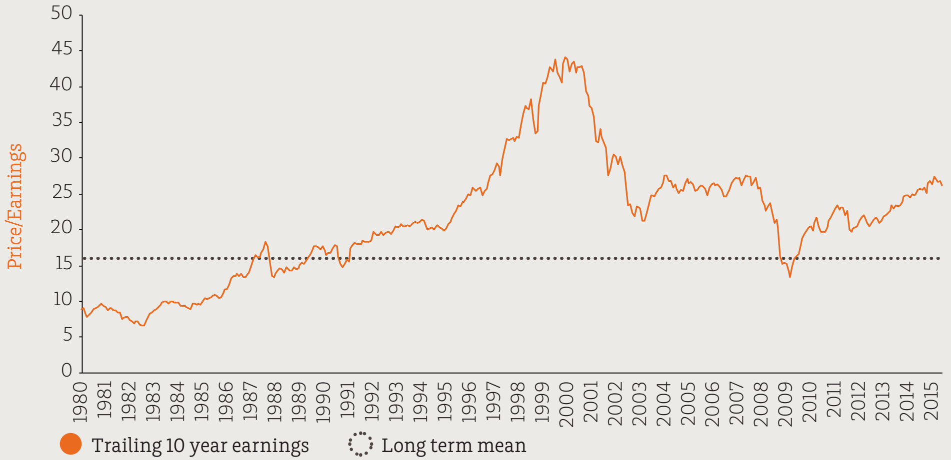
The market decline occurred despite another rate cut by the Reserve Bank of Australia's (RBA) of 25 basis points taking the rate to a record low of 2%.

MLC's scenario insights & portfolio positioning

Asset class indicators

Our view of the main asset classes is as follows.

Global shares
Market indicator *S&P 500*



Source: Datastream World Index

Comment

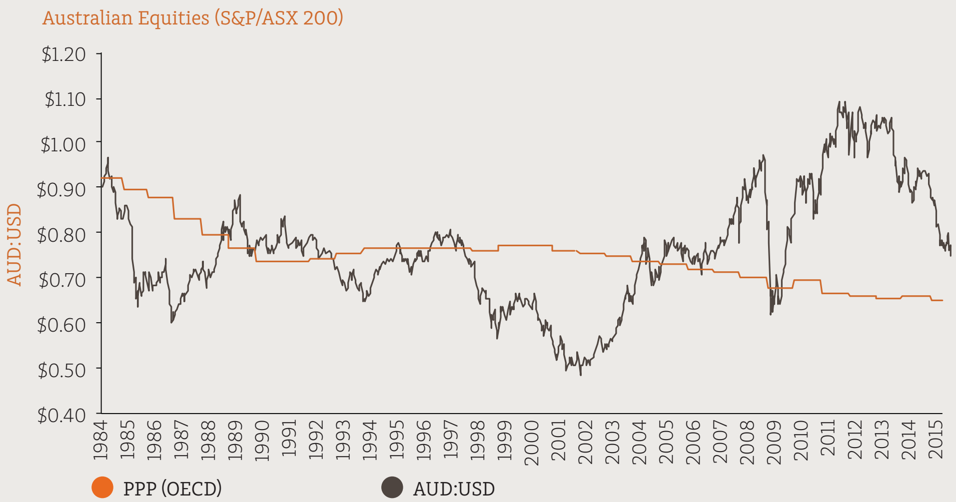
Despite the extreme volatility in the Chinese share market, global share returns were close to zero for the quarter. In fact the Shanghai Composite advanced by 14% over the quarter while the Euro Stoxx 50 price index declined by 7.4%. For the year unhedged global shares recorded a stellar rise of over 24%, more than half of this rise was due to the decline of the AUD.

In terms of valuations, shares 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 share valuations.

Historically a strong USD, rising US interest rates and weak commodity prices present headwinds for emerging markets. However, higher US rates are to some extent offset by a stronger US economy. Also lower oil prices have reduced current account deficits for some countries. A number of countries, notably China and India, are committed to major reform programs which will strengthen fundamentals. Our emerging market managers have a preference for well-managed companies able to benefit from a growing middle class in the developing world and increased demand for consumer goods and financial services.

Asset class indicators continued

Australian dollar
Market indicator *Australian Dollar Purchasing Power Parity*



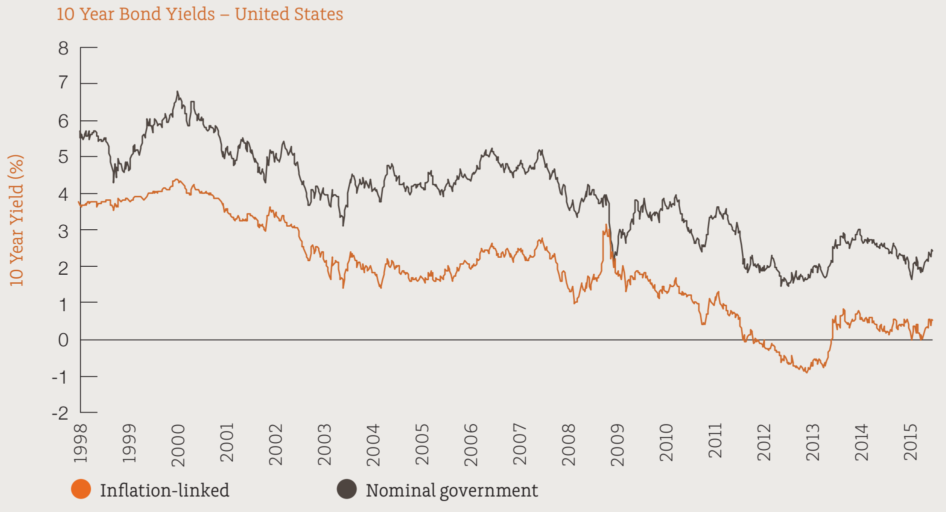
Source: Bloomberg

Comment

The AUD continues to depreciate in response to rising awareness of changing perceptions about the level and composition of China's growth and Australia's vulnerability to those changes. However we continue to believe that the risks are still not fully appreciated.

Asset class indicators continued

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



Source: Bloomberg

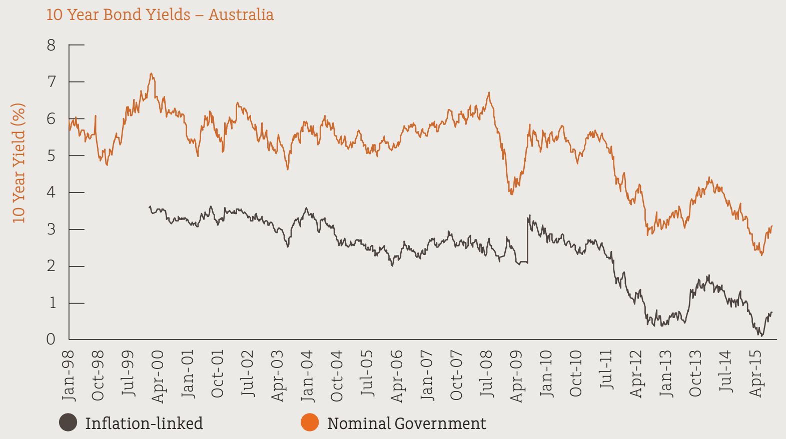
Comment

Bond yields were volatile and moved higher across the world following what proved an unsustainable decline in yields during the March quarter. Europe in particular saw a reversal in yields which had fallen drastically in the March quarter with Germany's 10 year bond yields sitting precariously close to 0%.

Greece dominated headlines but anticipated US Fed moves were a more significant driver of bond yields. 10 year Bunds market saw continued selling of long positions, rising 0.30% to close at 0.76%, (hit a high of 0.92% pre Greek default fears). There were similar moves in the US with 10 year yields up 23bp to close at 2.35% (with a high of 2.48%). June US non-farm employment was around consensus at +223k (May +280k) with the unemployment rate edging lower to 5.3% thanks to a 0.3% fall in the participation rate. The ISM Manufacturing Index was strong, rising from 52.8 to 53.5, with the employment sub-component particularly strong. The June Federal Open Market Committee meeting was widely perceived as being dovish, however Fed Chairman Janet Yellen emphasised that the total trajectory of the rate was more important than the date of the first move, which caused US 10 year yields to jump 18bps.

Asset class indicators continued

Australian government bonds
Market indicator *10 year bond yields – Australia*



Source: Bloomberg

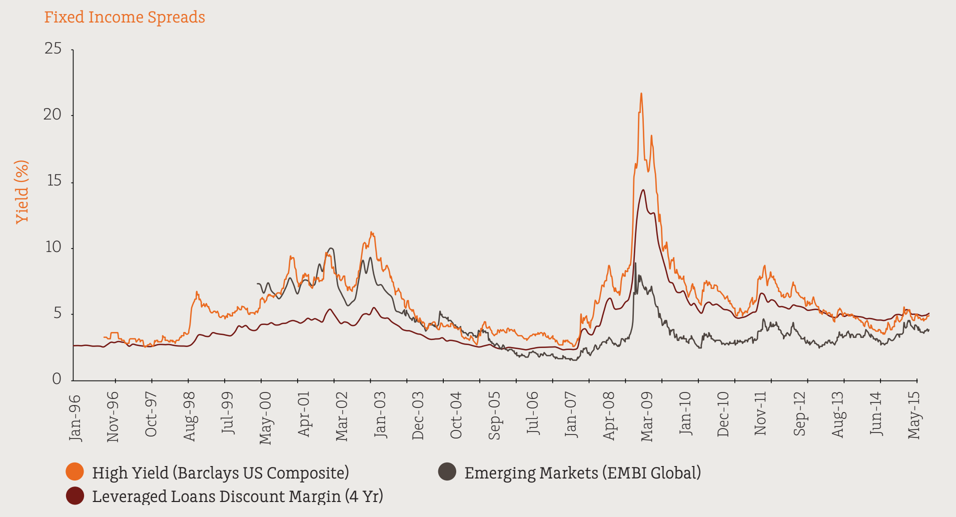
Comment

The dominant feature of June was a global bear steepener as bond yields were repriced in anticipation of the Fed tightening rates in September. In parallel, deteriorating Greek negotiations through the month saw a "risk off" widening in credit spreads.

Australian economic data was mixed over the month. May employment was strong with 42K jobs created and the unemployment rate falling from 6.2% to 6.0%, helped by a 0.1% fall in the participation rate. March quarter GDP was stronger than expected rising 0.9% (2.3% yoy) versus consensus of 0.7%. However the components were weak, with Gross Domestic Income going backwards with incomes 0.2% lower than a year ago.

Asset class indicators continued

Non-investment grade bonds
Market indicator *Fixed income spreads*



Source: Credit Suisse, Barclays

Comment

Against a backdrop of heightened volatility in share markets and growing concerns of a potential Greek default, leveraged loans (bank loans) performed solidly returning 1.4% over the quarter (in AUD$ hedged terms). Relative to other asset classes, loans comfortably outperformed investment grade bonds and to a lesser extent high yield bonds. Leveraged loan BB/B spreads on average tightened very marginally over the quarter due to tighter BB spreads while single B spreads were unchanged. More broadly, higher quality BB/B loans significantly outperformed split B/triple C rated loans. At an industry level, energy, financials and chemicals were the best performers while metals/mining were the worst performers. The underlying fundamentals of bank loan issuers remain strong supported by low principal maturities occurring in the next 2-3 years. The demand / supply technicals improved over the quarter with net new issuance absorbed by demand from institutions and strong issuance.

High yield bonds fared less well given that interest rates rose resulting in BB/B bonds returning 0.45% over the quarter (in AUD$ hedged terms). Yields on BB/B bonds rose 30bps over the quarter while spreads were largely unchanged. More broadly, single B bonds outperformed while the more interest rate sensitive BB bonds underperformed. At the industry level, energy was the best performer (as oil prices lifted from their lows). Although default volumes picked up marginally during the quarter, this was mainly accounted for by issuers in the energy and metals/mining sectors. Abstracting from these two sectors, credit fundamentals remain strong supported also by low levels of principal maturing over the next 2-3 years. The demand/supply technicals deteriorated over the quarter with new issue supply largely unchanged, while the demand from mutual funds and exchanged traded funds softened.

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. Emerging markets lead global growth with some rebalancing and moderation in China, the US and UK grow at or above trend; while Europe continues to stagnate. Japan struggles to escape stagnation for now. Strong USD, AUD strong vs JPY euro.
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.
Extended quantitative easing	3	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 EUR 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. China accepts 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.
(Mild) inflationary resolution (path to debt normalisation)	4	Central banks err on the side of supporting growth while economic reforms do not occur fast enough to entirely offset inflationary pressure, resulting in an orderly rise in inflation. 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, but yields do rise. 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 and developed markets.
Australian stress scenario	5	This vulnerability increases as China's growth slows - a more pronounced slowdown is a potential trigger for this scenario. A consequence of moderating demand for Australia's mineral exports is deteriorating terms of trade which erodes national income. In this scenario, positive real growth could disguise an income recession. Since interest payments must be made in nominal rather than real terms this stress becomes more acute at higher levels of foreign debt. Where this occurs coincident with an unravelling of the over-extended residential property market a worst case scenario loss of confidence in Australia causes funding stress to our banks which requires central bank intervention.

Appendix 1 – tailored scenario set continued

Scenario	Probability ranking	Description
Developed market austerity, recession, stagnation	6	A distinctive and hence important scenario. Ineffective or stop-go policy could result in this scenario, it could also occur post a stagflation or be the ultimate consequence of premature releveraging. In this scenario prolonged deleveraging of both the private and public sectors combined with lack of effective policy reform removes growth potential for developed economies. This scenario is not dependent on a particular eurozone 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.
Sovereign yield re-rating	7	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. AUD strong but does not re-visit highs vs USD.
Reform (path to growth normalisation)	8	A growth upside scenario contingent upon coordinated reforms that address inefficiencies that are idiosyncratic to particular economies (eg labour in the many European economies and Japan, 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 eases growth constraints.
One speed slow growth world	9	There is growth convergence as persistent slow growth in the developed world spills over into the emerging world.
Extended risk aversion	10	A generic scenario to capture prolonged aversion to risk. An immediate potential trigger for this scenario is the disorderly exit of Greece from the eurozone with consequent loss of confidence in the eurozone periphery. This is most likely expressed in the form of withdrawal of cash from banks in countries where an exit is feared, potentially prompting capital controls and raising questions about the union. While there is a widely held view that such contagion effects would be limited, this remains conjecture.
Inflation shock	11	Similar to stagflation, though assumed growth is higher. Sharp rise in inflationary expectations.

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 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 (due to a much stronger aversion against deflation than inflation) 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.

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

Step 2
Implementation

Step 3
Review

- 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.

We implement the asset allocation as efficiently as possible to minimise costs.

We continuously apply our Investment Futures Framework to determine if portfolio adjustments are appropriate.

Important information

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