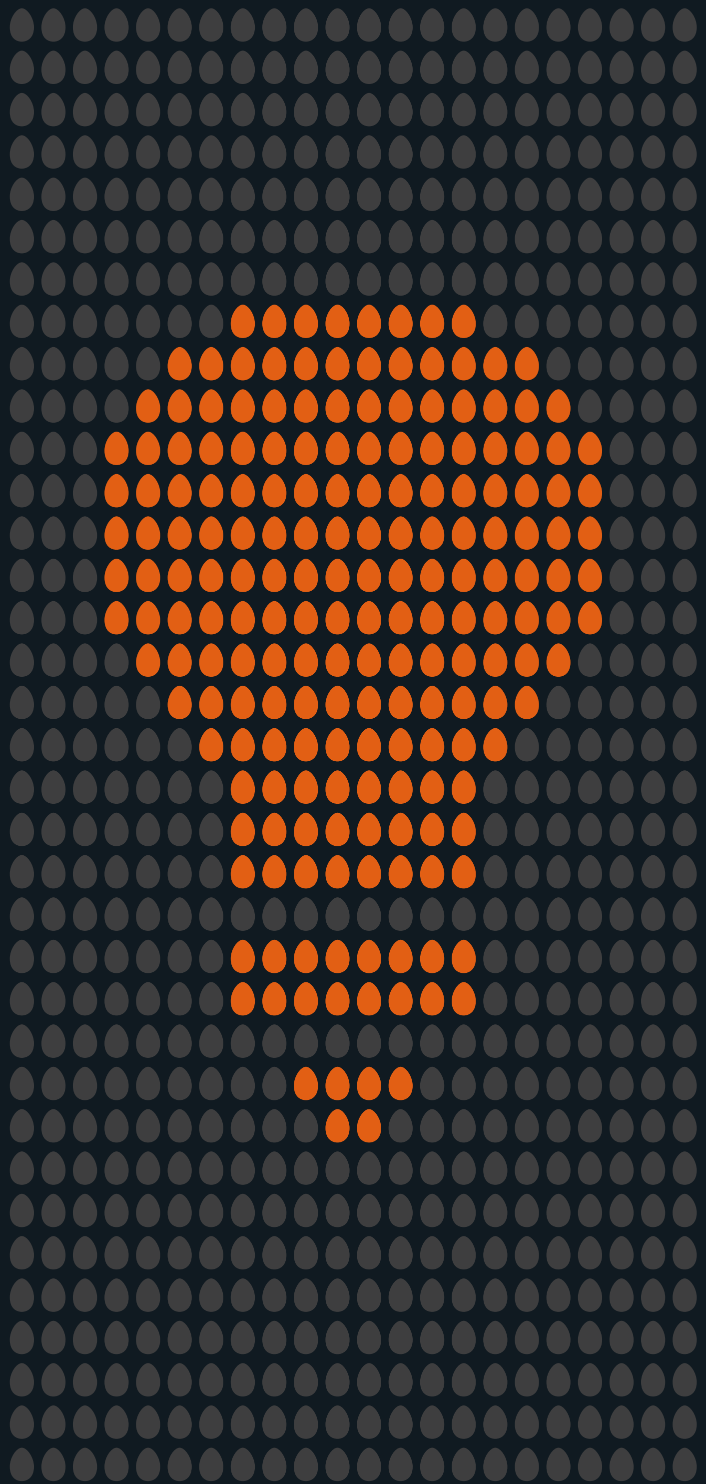

# MLC's scenario insights & portfolio positioning

*MLC Horizon and MLC Inflation Plus portfolios*

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# MLC Horizon and MLC Inflation Plus portfolios
## MLC's scenario insights & portfolio positioning

*The September quarter market gyrations reflected conflicting data flows about when the US Federal Reserve (Fed) will start raising rates, how weak the Chinese economy is and what is going to happen to oil prices.*

Concerns about stalling US earnings also played a part. With US economic strength correlated with rate rises, good economic news is often seen as bad for share prices. But if the US recovery were to falter that would hardly be good news. Ultimately it would imply a failure of quantitative easing (QE) and of central bank policy. This is a circumstance in which confidence in policy makers would be undermined and asset prices generally would be out of line with these revised perceptions. Unfortunately this is a scenario that cannot be entirely discounted. In spite of the raft of extraordinary monetary measures, inflation in the US, UK, Europe and Japan has been declining. Oil prices have certainly played an important part in this but it highlights that while QE has produced asset price inflation, the flow through into the real economy has been limited (and to the extent that there has been an impact it has been via currency depreciation). This is worrisome and leaves us wary about responding to the fall in asset prices, recognising that this is a relatively minor change versus the QE induced asset price rise.

For now, markets cannot make up their minds about what's going to happen. The obsession with the timing of the first rate rise implies an obsession (which we commonly observe) with short term outcomes. This myopic mindset obscures the real issues. What matters for share investors is the fair price to pay for expected future earnings streams. At an aggregate level future earnings depend on the strength of the economy and profit margins, which reflects the relative bargaining power of labour and capital. The job of policy makers is to create the conditions in which economic growth (and hence employment) can flourish and persist (which implies controlled inflation). Past policy mistakes mean that this is a complex and difficult task today. Looking forward, policy mistakes are therefore relatively likely—a small example of this is the Fed's dithering, which is adding to uncertainty. This reflects that central bankers are now much less effective in their control of market volatility. What may be a transition to a higher volatility regime is most apparent in emerging markets thus far; a more significant re-pricing in developed markets may also be yet to unfold. With regard to emerging markets we should note the reversal commencing in what had been a 15 fold build-up in foreign reserves. For example, China has been using its reserves to support the currency, while Saudi Arabia and Russia are drawing on reserves to fill the budget gap resulting from lower oil prices. In the lead up to the financial crisis we warned about the imbalances in global demand which led to the savings glut behind this reserve build up, particularly in Asia and the oil producing countries. This flow of savings pushed asset prices to unsupportable levels. As this stock of savings is drawn down and spent, liquidity conditions tighten unless there is some offset, for example in the form of more QE. If this is not forthcoming there will be pressure for a reversal of what happened when the savings were built up, that may mean higher bond yields and lower share prices.

### 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.

# MLC's scenario insights & portfolio positioning

Clearly the current environment presents some significant challenges, however there are, as always, also positives; it is just that they are not yet sufficient to offset the negatives. Better value opportunities are starting to emerge, particularly in emerging markets. And there will always be innovative companies which can grow regardless of the economic scenario. Offsetting risk also is the abundance of cash on company balance sheets which can be deployed, including via buybacks and higher dividends. If markets decline further, the opportunity side of the equation will start to outweigh the residual risk. In this situation we would be rebalancing our portfolios.

While the focus on small changes in expected Fed rate rise timing to an extent misses the point, we have on the other hand been warning for some time that the prospect of a much slower Chinese economy should be seriously considered. Those that think about growth in China will be well aware that the headline economic growth is not the only critical indicator. Alongside growth, the composition of economic activity as well as the breadth and rate of reform are also very important - and there is an unbreakable link between reform, the composition of economic activity and growth itself. Scenarios with an emphasis on reform are associated with a lower rate of better quality growth and lower risk (to future growth), whereas we expect higher, but unstable growth in scenarios that sidestep important reforms. Whereas China had experienced a decade long build-up of imbalances due to the dominance of construction and exports as growth engines, more recently the scenario has switched toward reform. Under the old scenario commodity prices benefited from a demand squeeze aiding offshore rent-seeking producers, savers subsidised State Owned Enterprises via repressed interest rates and spenders subsidised exporters to a degree through an undervalued currency. The combination of a closed capital account, pegged currency and non-market interest rates helped keep the imbalanced system stable. Yet, despite the restraints, an unavoidable loss of investment efficiency fuelled a rapid uptick in the leverage, forcing the leadership of Xi Jinping to focus on reforms. The Party's reform agenda has included policy ranging from a crackdown on corruption to environmental laws and the important issue of local government financing. These and other measures have had a great impact on construction, tempering the demand for steel and feeding back as we expected under this scenario to commodity producers including Australia.

Another area of strategic importance for China is internationalisation of the Renminbi (RMB) and inclusion of the RMB in the International Monetary Fund's (IMF's) Special Drawing Right (SDR) basket of currencies. The SDRs are foreign exchange assets that supplement member countries' official reserves. In order to achieve inclusion in the SDR, China needs to take a series of steps to improve convertibility. While the IMF does not require currencies to be fully floated as a prerequisite for SDR inclusion, they cannot be completely clean pegs, and there must be a degree of capital account openness. Whereas China had taken several steps to open the capital account prior to this quarter—such as the Hong Kong/Shanghai Stock Connect—the move to widen and devalue the RMB in August sent a shock through global markets and disrupted most emerging market currencies. While it is impossible to dissect with precision, a sensible interpretation of the People's Bank of China's (PBoC's) change in policy is that the move to a wider trading band is strategic, but the timing and reset to a lower point are at least partly a tactical move to support exports in the short term. If this is anywhere near the truth, then the volatile reaction of markets to the PBoC's move is a short lived misread of central bank signalling by markets, but the longer run implication of further deflationary pressure on globally traded goods has global implications.

For example, with the global environment deteriorating, the chances of another round of monetary stimulation in Japan are rising. Exports, boosted by yen depreciation, have been the key driver of improvement in Japan's growth, but over half of their exports are within the Asian region. There is also the complication that a significant portion of Japan's manufacturing takes place in overseas jurisdictions thanks to a long run wave of investment in South East Asia and areas further abroad. The impact of offshoring means that a segment of the gains enjoyed from a lower yen flow to Japan by way of foreign currency translations and increased corporate cash balances. These cash holdings need to find their way into the domestic economy, but it is far from clear that either the demand conditions or the prevailing policy regime encourage deployment of these gains. In parallel with this there is reluctance to ease because a weaker yen is unpopular in Japan and undermines consumer confidence. Their 'new core' inflation rate (which excludes energy as well as fresh food) has been running close to 1% (short of the 2% target but at least still positive) and there is evidence of labour market tightening in basic wages and the increasing ratio of applicants to jobs, but wages are lagging the new core inflation measure. Deflationary pressures have clearly increased —a weaker global environment may force another policy response.

Bank of Japan's (BOJ's) buying of Japanese government bonds (JGBs) is already at extreme levels. The BOJ is buying ¥80 trillion of JGBs versus net issuance of ¥37 trillion. Effectively the BOJ is monetising the fiscal deficit. This blurs the distinction between monetary and fiscal policy. As mentioned such unprecedented levels of monetisation risks loss of confidence. While there have been warnings about the inflationary consequences of these policies, these fears have been increasingly dismissed with deflation persisting as the overwhelmingly stronger force. However an undermining of policy maker credibility could conceivably be the trigger that leads to a shock rise in inflation.

## 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 thorough assessment of the different ways in which the future might unfold provides us detailed insight into return potential and, most importantly, the sources and the extent of risk and the means of efficiently controlling risk. We track how future risk and return potential changes 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.

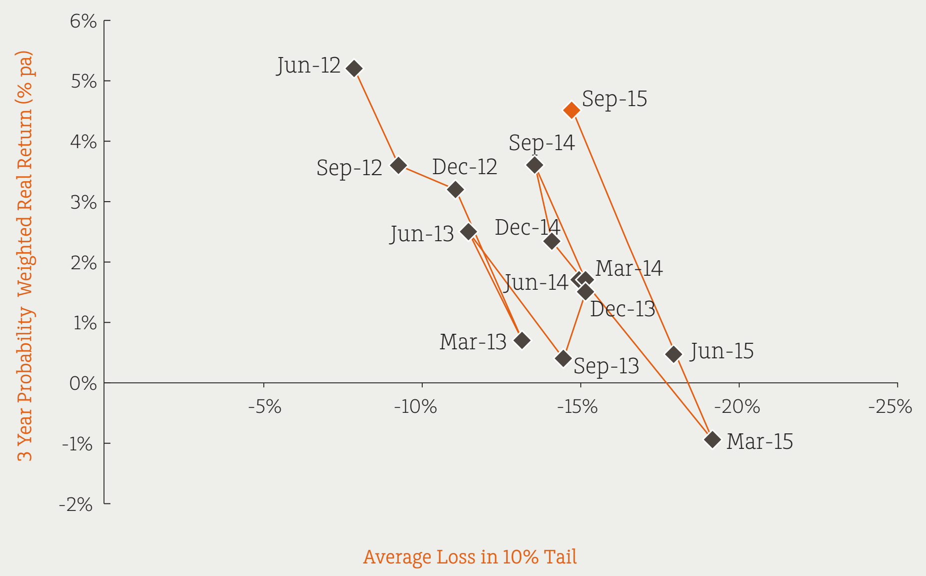
For the active management of the **MLC Horizon portfolios**, risk is primarily benchmark-related. Benchmarks have been designed to efficiently generate above inflation outcomes on the basis of long-term investment assumptions. Target allocations deviate from the benchmark when (as is typically the case) the prospective investment environment differs from these long-term assumptions. Our scenarios analysis is used to identify target allocations which are more risk-return efficient than the benchmark which, because these portfolios must remain true to label, are limited in the extent to which they can deviate from the benchmark. In particular, these traditional multi-asset portfolios have constraints to the mix of fixed income and shares 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 assets changes through time, we vary the asset allocation to position the portfolios to achieve a higher reward for risk than the benchmark. The risk aware nature of our investment process tends to mean that value is added via the adoption of defensive positioning when risk is high, which reduces loss exposure.

The **MLC Inflation Plus portfolios** have flexible asset allocations with few constraints which enable us to target tight control of 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.

The market declines in the September quarter restore some return potential looking forward. Chart 1 shows probability weighted scenarios

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




**Source**: JANA Corporate Investment Services Limited

# MLC's scenario insights & portfolio positioning

outcomes looking forward three years from a series of different starting points. While three years is a relatively short period of time for many scenarios to play out, this short time frame helps illustrate the impact of changes in starting valuations. The chart 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. 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 market decline of the past quarter, the average across these scenarios become more positive looking forward – however again we caution that were we to look over longer periods the average annual return would be projected to be lower though still positive.

Chart 2 shows a similar outcome for three of the MLC Horizon portfolios. As was the case for Australian shares, there was a significant increase in return potential and increase in risk exposure by the end of the September quarter. Having implemented a significant reduction in risk exposure prior to the adverse market environment of the September quarter, the portfolios (particularly Inflation Plus) were well positioned for an increase in volatility. 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 first half of the year which required reallocations in order to hold the risk discipline for these portfolios.

**Chart 2: Change in risk and return potential through time for MLC Horizon portfolios**


**Source**: JANA Corporate Investment Services Limited

# MLC Horizon and MLC Inflation Plus portfolios
# MLC's scenario insights & portfolio positioning

As we have outlined previously, today's investment environment remains very difficult. The investment challenge is what to do in a world in which almost everything is expensive relative to the risks involved, 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 MLC Index Plus portfolios we are maintaining a relatively defensive orientation.

*Over the past year we have been able to both extract strong returns and tightly control risk exposure in MLC Inflation Plus. It is important to explain that this combination is becoming more difficult to achieve and that we will maintain the risk discipline and will be patient in seeking return upside.* While markets have declined in the third quarter and return potential has to an extent increased, at the same time risk diversifiers have weakened. The consequence of this is that we are maintaining the more defensive strategy that we adopted prior to the September quarter volatility.

## 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 and the opportunities to diversify risk. We use this information to determine the most appropriate balance between risk and return for each portfolio. Importantly we use information about risk and diversification that is forward looking and we track how these characteristics change through time.

Chart 3 on page 7 looks at our barometer of risk and return—based on our generic (40) scenario set, described on pages 7 and 8—for the MLC Horizon and MLC Inflation Plus portfolios looking forward from the end of September 2015. The probability-weighted real returns are shown in the graph (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. 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 has improved but is still limited. In the event that a scenario with relatively higher returns occurs, the returns of 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 the 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 most importantly the extent of negative real returns in the event that an adverse scenario occurs, while extracting as much return potential as possible subject to this risk constraint.

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.

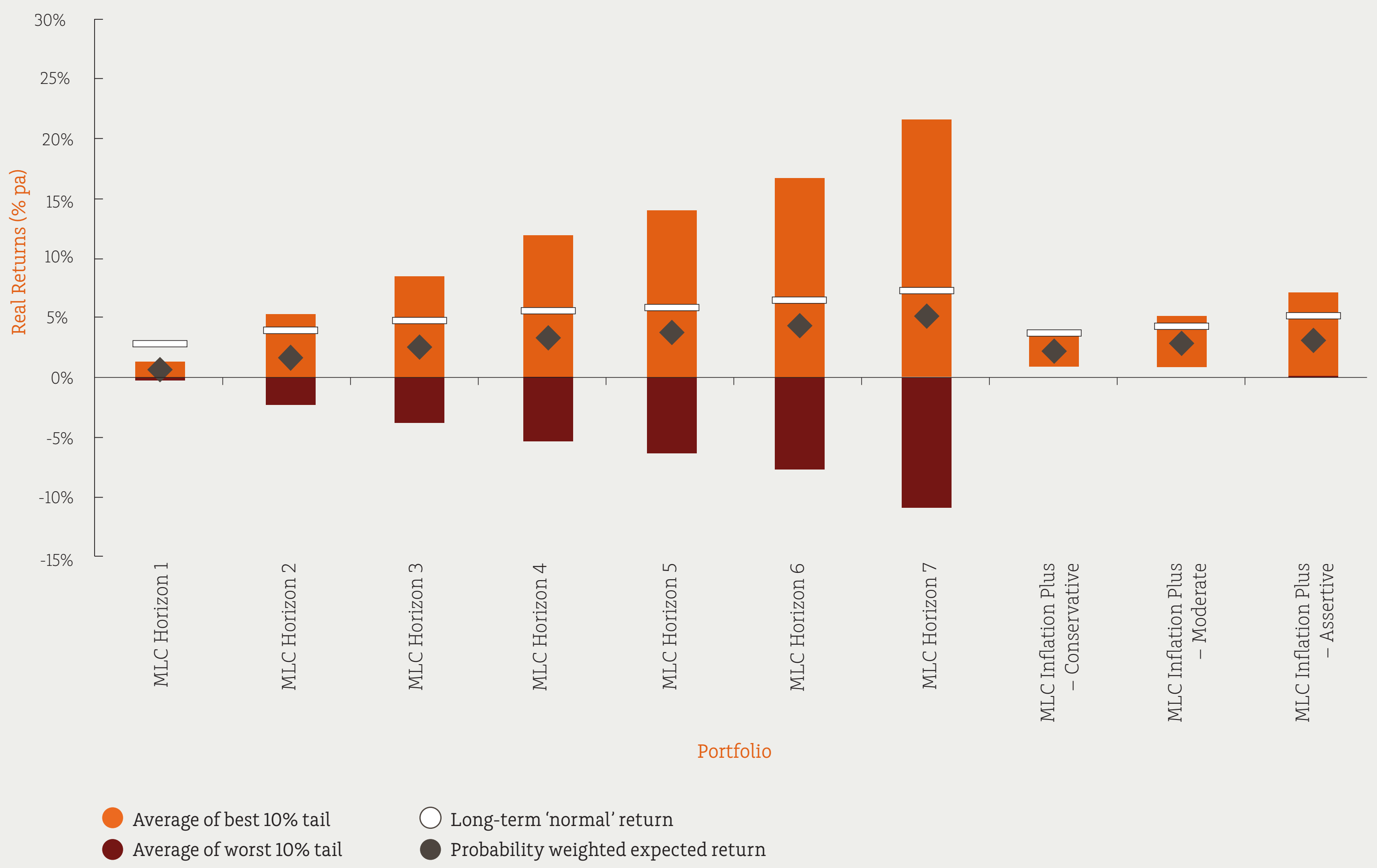
# MLC's scenario insights & portfolio positioning

## 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. Investment approaches that generate insight into future sources of both positive and negative returns (and track how these change through time) are scarce. This capability 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

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




**Source**: JANA Corporate Investment Services Limited

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 have been aware for some time of the risks for Australia, even assuming a well-managed rebalancing of China's 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. We continue to contemplate the potential consequences of current monetary policy settings, including perceived policy failure involving loss of confidence in policy makers. In our view certain potential paths remain under-appreciated, particularly an ultimate inflation resolution. We regard a credible transition path to growth normalisation as likely to involve an *ultimate* inflationary resolution of the debt overhang. 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 generic scenario 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. While the prospective unwinding of unconventional monetary policy setting in the US presents challenges for market perceptions, we may see offsetting further stimulus in the eurozone and Japan which could restore 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 and uncertainty about the rate rise itself starting to be a source of volatility. While ultimately there must be an end to the challenging liquidity-driven distorted environment which has resulted in the mis-pricing of risk, we understand that it could still be of long duration.

We are acutely aware that, while volatility has increased, the strong return environment could still resume. This is challenging because 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 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 have been two important asymmetries: 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 and Index Plus 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. We have increased allocations to multi-asset real return strategies since the flexibility and absolute outcome focus of these strategies is relatively attractive in complex risky environments. Changes to the MLC Inflation Plus allocations include reductions to inflation-linked bonds and emerging markets; reallocations were made into the enhanced cash strategy.

# 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 September quarter | | | Comment |
|---|---|---|---|---|
| | Conservative | Moderate | Assertive | |
| Australian shares | Zero allocation | Steady allocation | Steady allocation | Low or zero allocation maintained. |
| 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) | Steady allocation | Steady allocation | Steady allocation | Primary global share exposure is defensive. The portfolios have a strong bias to absolute, not index-relative, shares. |
| Foreign currency exposure | Steady allocation | Steady allocation | 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 we've reduced the risk asset exposures further. |
| Low correlation strategy | Steady allocation | Steady 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 are sized accordingly. |
| Multi-asset real return strategy | Steady allocation | Steady allocation | Steady allocation | Significant allocations reflecting preference for highly flexible strategies with total return focus. |
| Emerging markets strategy | Reduced allocation | Reduced allocation | Reduced allocation | The vulnerability of emerging economies and markets to US monetary policy normalisation became more apparent in the past quarter. Allocations were trimmed early in September to help protect against the downside risks. |
| 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. |
| 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 such as real estate investment trusts (REITs) in scenarios in which monetary policy normalises. |
| Global government bonds | Zero direct exposure | Zero direct exposure | Zero direct exposure | Unattractive, with limited diversification benefit. |

## 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 September quarter | | | Comment |
|---|---|---|---|---|
| | Conservative | Moderate | Assertive | |
| Australian inflation-linked bonds | Reduced allocation | Reduced allocation | Reduced allocation | Allocations were again trimmed due to our concerns about the inherent risks associated with the very low current yields. |
| Insurance related investments | Zero allocation | Steady Allocation | Steady Allocation | Uncorrelated though risky exposure is appropriate where time horizon is sufficient. |
| Bank loans | Steady allocation | Steady allocation | Steady allocation | 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 portfolios should have exposure. |
| Australian non-government bonds (short duration) | Steady allocation | Steady allocation | Steady allocation | Offer some return enhancement while limiting additional risk. |
| Cash | Increased allocation | Increased allocation | Increased 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 | Not applicable | Not applicable | 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. Like other traditional diversified portfolios, for the MLC Horizon portfolios the mix of bonds and shares is regarded as a defining characteristic. Some flexibility around allocations is used to re-position the portfolios in response to changes in prospective investment conditions. For these portfolios, allocations tend to 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 looking forward, taking into account how this changes through time.

| | MLC Horizon Super & Pension portfolio weights at end of the September quarter | | | Comment |
|---|---|---|---|---|
| | Under | Benchmark | Over | |
| Growth assets | ● | | | The environment remains 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. |
| 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 local currency which is still not fully pricing risks in the global environment. |
| 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 increased this quarter. |
| Low correlation strategy | | | ● | Overweight maintained. |
| Fixed income | ● | | | Reduced allocation this quarter following declines in bond yields in August, reallocated into multi-asset real return (Inflation Plus) strategies. |
| Cash | | | ● | Overweight maintained. |
| Australian bonds - All Maturities | | | ● | Overweight reduced. |
| 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. |

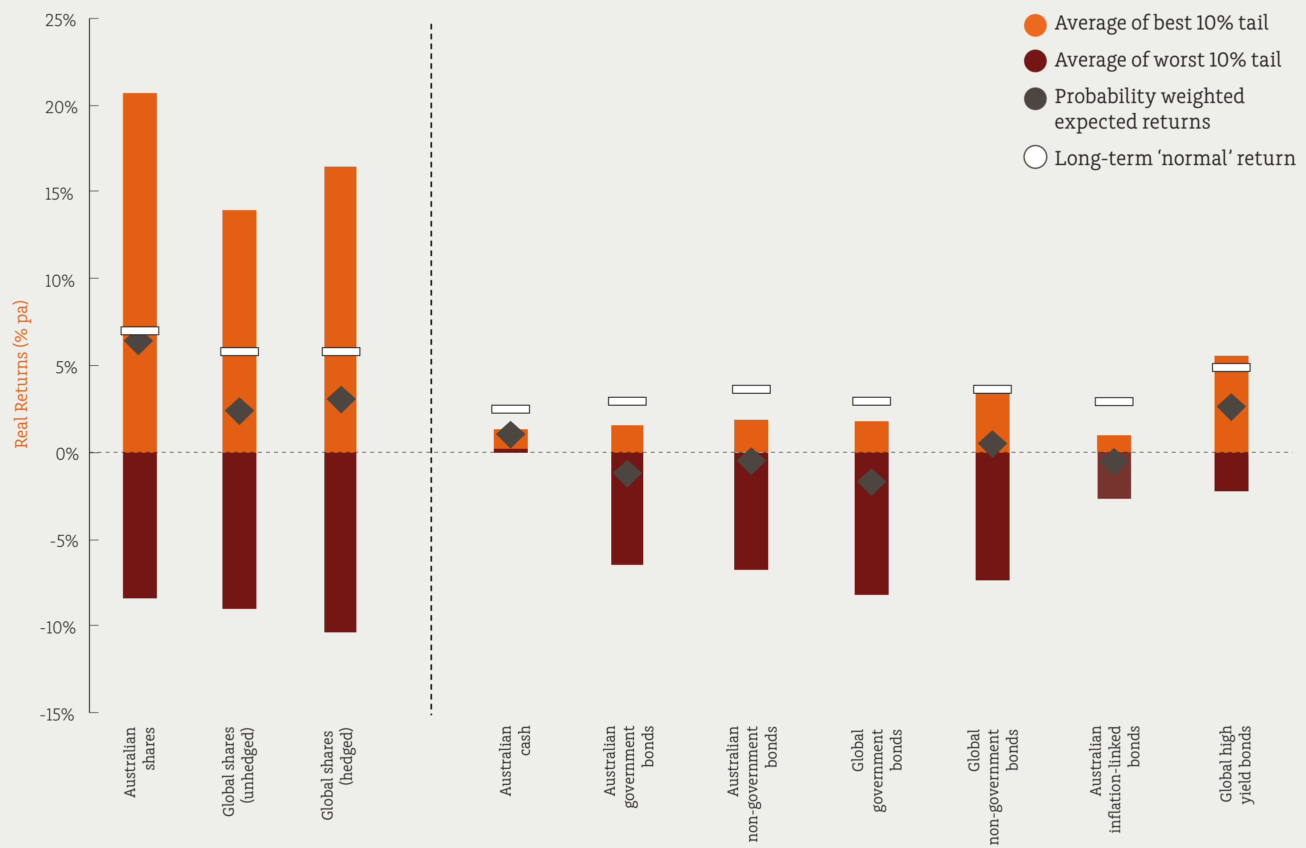
## Return potential

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. While there was some improvement by the end of the quarter, 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 rise, 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 potential real returns for each asset class are shown in Chart 4. The probability-weighted real returns are shown in the graph (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. Asset classes with wider ranges could have more extreme return outcomes than those with narrow ranges. Chart 3, on page 7, shows return potential for the MLC Horizon and MLC Inflation Plus portfolios.

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

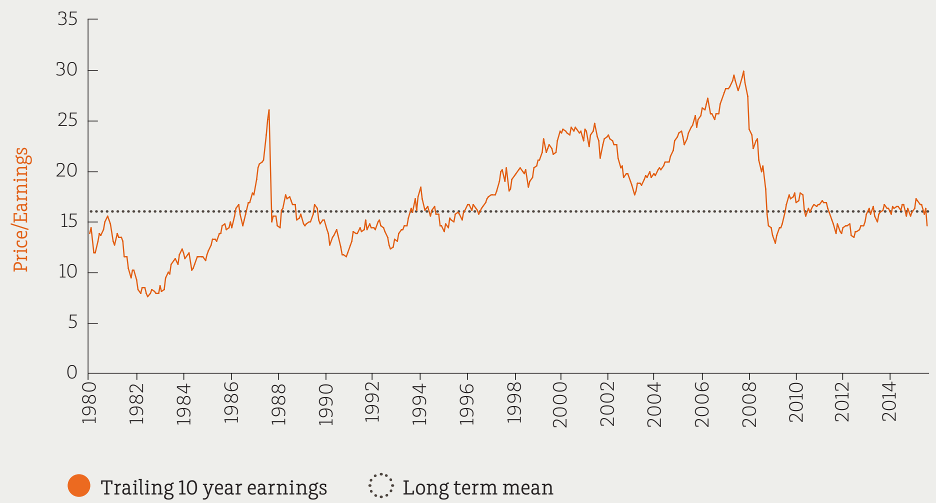



**Source:** JANA Corporate Investment Services Limited

## Asset class indicators

Our view of the main asset classes is as follows.

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




**Source:** Datastream

### Comment

The Australian market continued its downward trend in the September quarter, falling an additional 6.6% on last quarter's fall of the same magnitude. The worst performing sector over the quarter was Energy which fell 24%, followed by Materials (-11%) and Financials ex-AREITs (-10%) whilst Industrials, Utilities and Consumer Staples all proved marginally positive. The August reporting season again highlighted the difficulty companies are having in growing revenues leading to a focus on cost control. The willingness of management to return capital to shareholders continued. Over the quarter the Reserve Bank of Australia decided changes to the cash rate were not warranted, which was consistent with market expectations.

**Global shares**
Market indicator *S&P500 Index*

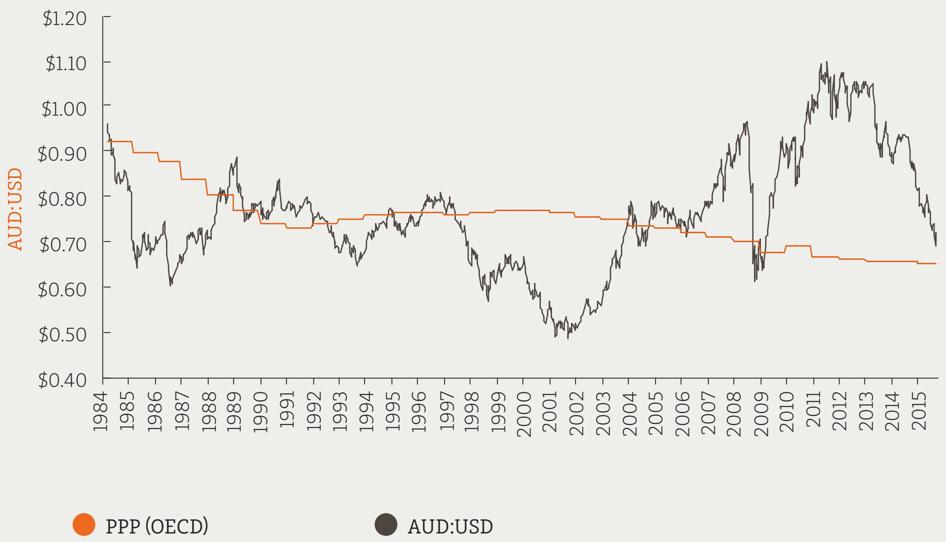

**Source:** Datastream World Index

### Comment

China's share market continued its decline this quarter, displaying heightened volatility following the actions of the PBoC to devalue the RMB. The Shanghai Composite Index fell 28.6% in local currency terms. In aggregate it was a poor quarter for most global share markets, with the UK FTSE 100 Index down 6.1%, Euro's STOXX 50 Index down 8.3%, Japan's TOPIX 100 Index down 14.8%, and the S&P 500 Index down 6.4%. From a valuation standpoint shares remain expensive relative to their own long-term history. Once again the US Federal Reserve delayed lift off with respect to US interest rate normalisation. The market's eyes have now shifted to the remaining two meetings of this year.

## Asset class indicators continued

**Australian dollar**
Market indicator *Australian Dollar Purchasing Power Parity*

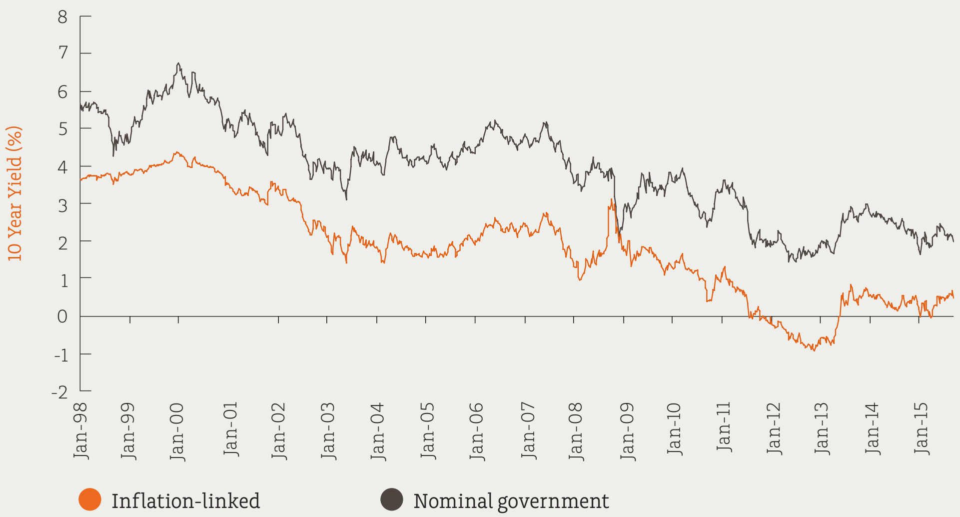



**Source**: Bloomberg

### Comment

Over the quarter the AUD has continued its fall in response to a number of events including but not limited to further evidence of a slowing Chinese economy and falling commodity prices heavily affecting Australia's terms of trade. We continue to believe that the AUD downside risks are not yet fully appreciated.

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



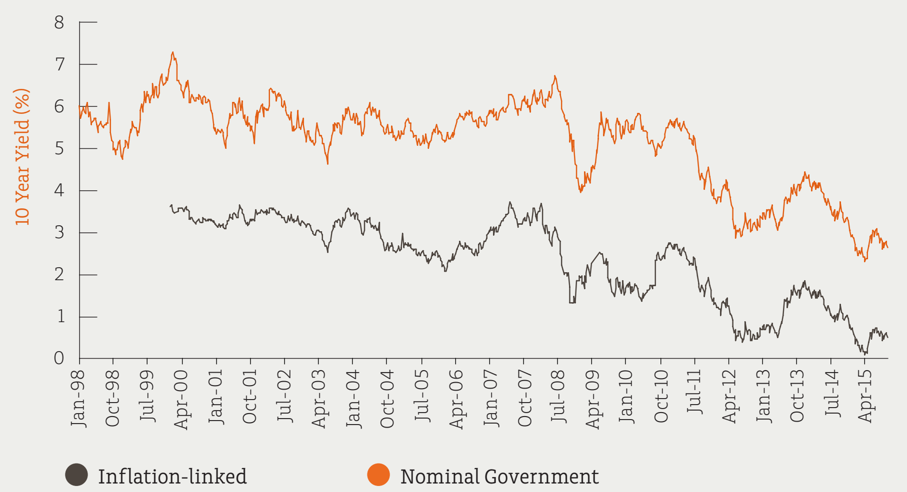

**Source**: Bloomberg

### Comment

Most regions of the world saw yields decline amidst bouts of elevated volatility during the September quarter. The US Federal Reserve's decision not to raise rates in the September meeting due to softer domestic data and global volatility also supported lower yields at quarter end. The yield on the 10 year German government bond fell slightly finishing the quarter at 0.59%. The UK saw the yield on 10 year gilts fall 0.56% to 1.66%, with the yield on the US 10 year note also falling 0.31% to 2.14%. China's 10 year government bond yield fell 0.32% as investors speculated on the degree to which the Chinese economy will continue to slow.

## **Asset class indicators** continued

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




**Source**: Bloomberg

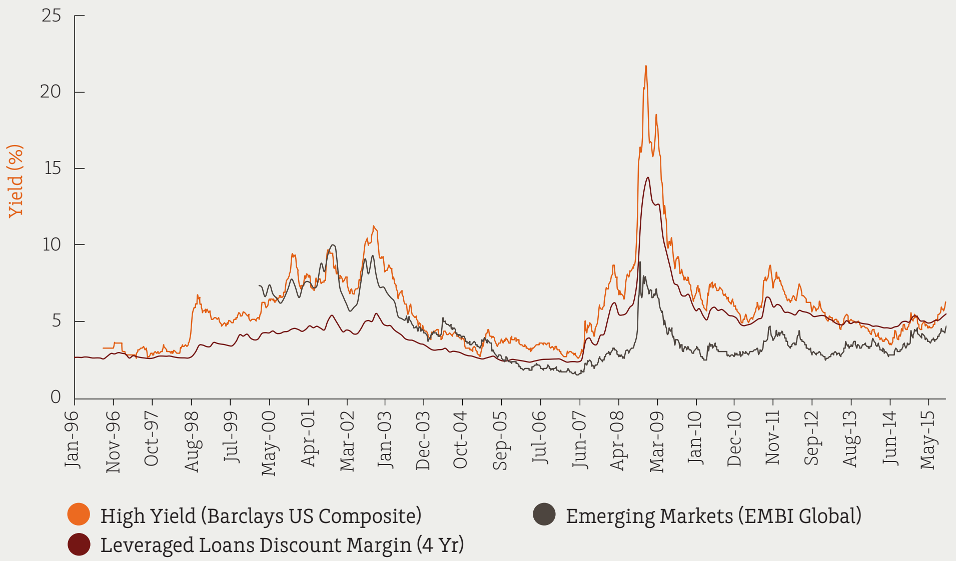
### Comment

Global volatility over the quarter supported domestic bond prices and drove yields lower. The yields on Australia's 10 year government bond declined from 3.01% to 2.61% among mixed economic data. Employment figures remained resilient rising marginally to 6.2% however the underutilisation rate remains elevated and poses a risk to future jobs growth. Seasonally adjusted quarter-on-quarter GDP also came in at 0.2%, below the consensus of 0.4% for the June quarter.

## **Asset class indicators** continued

### Non-investment grade bonds

Market indicator *Fixed income spreads*




**Source**: Credit Suisse, Barclays

## Comment

The September quarter was challenging for high yield bonds. Perceived weakness in global growth, especially in China, drove non-investment grade credit spreads sharply wider. In AUD hedged terms the Barclays High Yield Index returned -4.5% versus a positive 0.5% in the June quarter. This contrasts to the positive performance of investment grade markets with the Global Aggregate Index returning 1.9% this quarter in AUD hedged terms, a turnaround from the negative return in the June quarter. The poor performance from the high yield bond market was in large part driven by weakness in the Energy sector. WTI Crude Oil prices declined from as high as US$60 to as low as US$40 before rebounding to US$45 per barrel. For the market as a whole, high yield bond spreads widened by 143 basis points against equivalent maturity government bonds. The Energy sector was significantly weaker with spreads widening by 386 basis points. A meaningful proportion of the broad market index is made up of Energy companies (approximately 15%). The high yield bank loan market, which is secured and has a lower exposure to the Energy sector, performed much better, returning -0.4% in AUD hedged terms. The portfolios mainly held high yield bank loans and had minimal exposure to high yield bonds.

## 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 and 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. |

## Appendix 1 – tailored scenario set continued

| Scenario | Probability ranking | Description |
|---|---|---|
| Inflation shock | 11 | Similar to stagflation, though assumed growth is higher. Sharp rise in inflationary expectations. |
| 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

- 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.

## Important information

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