Summary of portfolio positions and scenario insights – MLC Horizon portfolios

September quarter 2015

The September quarter share market volatility reflected conflicting economic data about when the US Federal Reserve (Fed) will start raising interest rates, how weak the Chinese economy is and what's going to happen to oil prices. Concerns about stalling US company earnings also played a part. For now, markets cannot make up their minds about what's going to happen. With US interest rate rises linked to US economic strength, good economic news is often seen by the market as bad for share prices.

But if the US recovery were to falter that would hardly be good news for share prices. Ultimately it would imply a failure of quantitative easing (QE) and of central bank policy. Unfortunately this is a scenario that cannot be ignored. 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 led to asset price rises, the flow through into the economy has been limited. This leaves us wary about investing more aggressively in share markets despite the recent price falls.

The obsession with the timing of the first US interest rate rise implies a market obsession (which we commonly observe) with short term outcomes. This short-sighted mindset obscures the real issues. What matters for share investors is the fair price to pay for expected future earnings streams. Future earnings depend on the strength of the economy and profit margins. The job of policy makers is to create the conditions in which economic growth (and hence employment) can flourish and persist.

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 market uncertainty created by the Fed's dithering on interest rates. This reflects that central banks are now much less effective at controlling market volatility. What may be a transition to an environment of higher volatility is most apparent in emerging markets so far. A more significant re-pricing in developed markets may also be yet to unfold.

Clearly the current environment presents some significant challenges however there are, as always, also positives. They are just 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 is also the abundance of cash on company balance sheets which can be deployed to share buybacks and higher dividends. If markets decline further, a buying opportunity may therefore start to outweigh the risks. In this situation we would increase the portfolio's exposure to shares to exploit return opportunities.

Over the past year we have been able to both extract strong returns and reduce risk exposure in the portfolio. Changes we've made to the portfolio this quarter include increasing the portfolio's underweight to fixed income to reduce exposure to the risk of an increase in interest rates. We've increased allocations to multi-asset real return strategies since the flexibility and absolute return focus of these strategies is relatively attractive in a world in which almost everything is expensive relative to the risks involved, and almost any scenario could unfold. In such an environment we've focused on positioning the portfolio defensively relative to benchmark.

These are currently the main positions in the MLC Wholesale Horizon 4 portfolio.

Portfolio position compared with benchmark	Why we have the position	Impact on performance
Below benchmark exposure to growth assets	The portfolio has exposure to shares to generate long-term returns above inflation. Prior to the recent adverse market environment share market returns had been strong for years, supported by unusually low interest rates. As a result share prices had tended to run ahead of actual company earnings increasing the risk that share valuations become stretched, and that markets may fall. To manage risk and generate more robust returns we had increased the portfolio's diversification over time by underweighting allocations to broader Australian share markets and overweighting risk-controlled strategies including multi-asset real return strategies, the low correlation strategy and defensive global shares. Investing in these strategies rather than just share markets helps protect the portfolio in weak global growth scenarios such as **Developed market austerity**, **Recession**, **Stagnation** and an **Australian stress scenario**. Despite recent share market falls, we continue to be concerned about stretched share market valuations and the continuing high levels of debt in the global economy. There are particular vulnerabilities for Australia flowing from slower and less investment intensive growth in China. Therefore we continue to maintain the portfolio's underweight positioning to growth assets, particularly Australian shares. However, as the portfolio has an allocation to shares it will still benefit from strong returns in positive scenarios for growth assets, such as a **Mild inflationary resolution** or an **Early re-leveraging scenario**. In these scenarios, growth assets should perform strongly compared to bonds.	The reduced allocation to growth assets decreased the portfolio's exposure to risk prior to the start of the market volatility in June.

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Below benchmark exposure to interest rate risk We have implemented this position by: • reducing the duration (exposure to changes in bond interest rates) of our fixed income strategy • reducing the exposure to Australian inflation-linked bonds, and • tilting the portfolio away from global bonds and towards cash and Australian bonds.	While bond yields (interest rates on bonds) could decline from their already low levels, the potential for further falls is less than the potential for yields to rise. Rising yields means bond prices fall and there is the potential for negative returns. By reducing the duration, we've reduced the risk of negative returns if yields rise, such as in a **Sovereign yield re-rating** scenario. Reducing our exposure to nominal bonds and shortening the duration of our fixed income strategy gives the portfolio some protection if bond yields rise. In a **Rising inflation** or **Inflation shock** scenario, traditional bonds would perform poorly and could deliver negative returns. While we value the inflation protection of inflation-linked bonds, the decline in yields to extremely low levels in the June quarter increased their risk so we reduced allocations. Scenarios in which there is clear risk include **Early re-leveraging and Sovereign yield re-rating**.	Yields on bonds with higher credit risk rose over the quarter. Our reduced duration positioning helped protect the portfolio from declines in the prices of these bonds over the last three months.
Above benchmark exposure to foreign currencies We have implemented this position by: • reducing the allocation to global shares whose foreign currency exposure is hedged to the Australian dollar (AUD) • increasing exposure to unhedged global shares, and • maintaining unhedged exposures in most global growth assets.	When designing the portfolio, we aim to combine assets and strategies which perform differently. Global share markets and the AUD tend to move in the same direction. So by having an exposure to foreign currencies (that is, not hedging some of our overseas assets to the AUD) we can help insulate the portfolio against some losses when share markets fall. Our above benchmark position is intended to reduce the portfolio's exposure to negative returns in a number of negative scenarios, including an **Australian stress scenario**. While the significant fall in the AUD over the past year has been positive for the portfolio's returns, it does weaken the potential future diversification benefit of foreign currency exposure. We have therefore partially hedged the risk of renewed AUD strength via options in our risk management strategy. This position reduces the risk of significant negative returns if the AUD rises. Scenarios in which the AUD rises, include **Extended quantitative easing** and **Sovereign yield re-rating**.	Our foreign currency exposure worked extremely well for the portfolio's performance, helping offset volatile share market returns. The AUD has fallen significantly against the US dollar over the past three months and year. Declining terms of trade (driven by the decline in the iron ore price) are a cause of Australia's weaker national income growth. Depressed Chinese steel production and the prospect of a fall in interest rates in Australia also increased downward pressure on the AUD.

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Why MLC uses a scenarios approach

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

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

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

The Investment Futures Framework includes two sets of scenarios. They are a comprehensive generic set of 40 scenarios, which focus on the main drivers of returns (macroeconomic influences and investor behaviour), and a tailored set of currently 12 scenarios, which focus on the particular circumstances we are experiencing now.

Important information

This information has been provided by MLC Investments Limited (ABN 30 002 641 661 AFSL 230705), a member of the National Australia Bank group of companies, 105–153 Miller Street, North Sydney 2060.

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