Summary of portfolio positions and scenario insights – MLC Inflation Plus 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 portfolios' exposure to shares to exploit return opportunities.

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

Asset class or strategy	Role in the MLC Inflation Plus portfolios	Performance implications
Foreign currency exposure	Foreign currency exposure has provided an opportunity to limit risk in adverse environments, permitting the portfolios to hold a higher allocation to shares than would otherwise be the case. This risk reduction impact comes from the tendency of global share markets and the Australian dollar (AUD) to move in the same direction. By having an exposure to foreign currencies (for example, by not hedging some of our overseas assets to the AUD) we can help insulate our portfolios against some losses when share markets fall.	The AUD fell over the past three months and year. Our foreign currency exposure worked well for the portfolios' performance, helping offset volatile share market returns.

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	Foreign currency exposure is therefore an important diversifier of risk for the portfolios. We expect it will help generate more robust returns in a number of difficult potential scenarios for which there are currently few other opportunities for diversification. While the significant fall in the AUD over the past year has been positive for the portfolios' 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. Our significant foreign currency exposure is intended to reduce the portfolios' vulnerability to negative returns in a number of adverse scenarios, including an **Australian stress scenario**. We also consider scenarios in which the AUD rises, including **Extended quantitative easing** and **Sovereign yield re-rating**. However, in many scenarios we expect the AUD to fall further, particularly if share prices fall sharply.	
Defensive global shares, risk management, low correlation and multi-asset real return strategies	For the last few years share market returns, supported by unusually low interest rates, have been strong and have tended to run ahead of actual company earnings. In these circumstances, we need to 'keep some powder dry' by investing more defensively. This requires that we limit exposure to significant negative returns and wait for more favourable conditions in which to seek higher returns. Investing in these strategies rather than just share markets helps protect the portfolios in weak global growth scenarios such as **Developed market austerity**, **Recession**, **Stagnation** and an **Australian stress scenario**.	The reduced allocation to share markets decreased the portfolios' exposure to risk during recent share market falls. These positions may mean the portfolios' returns will be lower if share markets produce strong returns. However, we consider this positioning is appropriate given the current risk level and the increased protection it provides if adverse scenarios occur.
No direct allocation to long duration traditional bonds	The portfolios have limited vulnerability to changes in bond interest rates. This is reflected in the following positions: • no direct exposure to long duration traditional bonds • exposure to short duration Australian non-government bonds, global bank loans (largely floating rate bonds) and cash. Government bonds, a traditional source of diversification, still have very low yields. They offer limited potential for both real returns and diversification. At their present valuations, these aren't attractive investments for the portfolios.	By avoiding the risks of traditional bonds, we have been able to increase the portfolios' exposure to other risks, which have delivered better returns.

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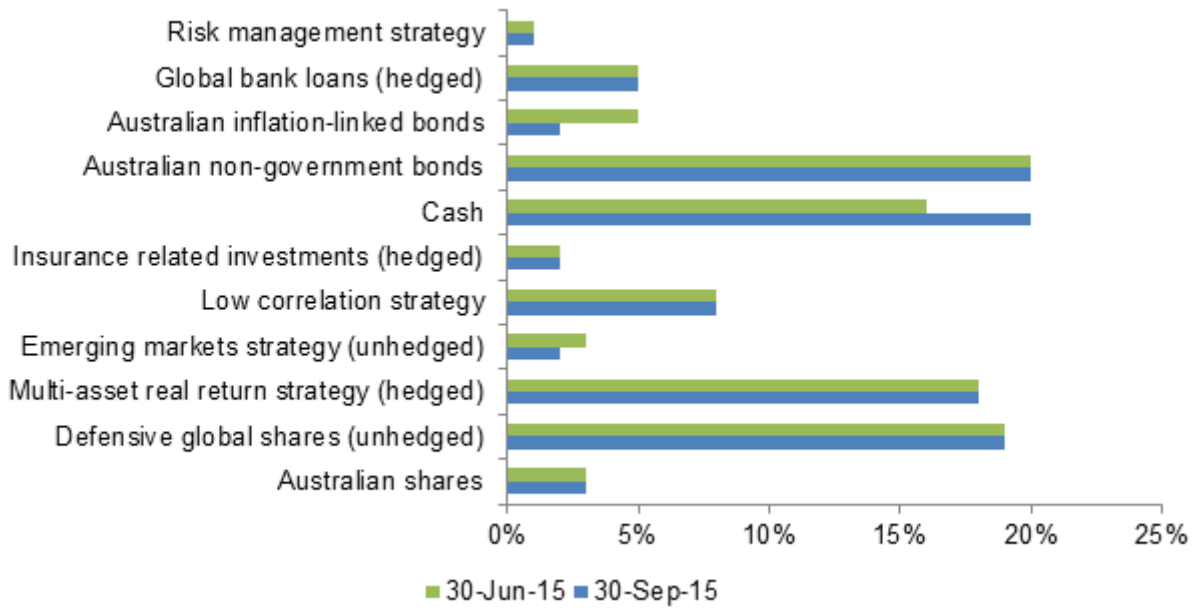
Australian inflation-linked bonds	We seek to deliver returns higher than the rate of inflation, which is a moving target. Unlike traditional bonds, inflation-linked bond returns move with changes in inflation and can therefore help provide protection against unexpected rises in inflation in scenarios such as **Stagflation** and **Inflation shock**. While the forces of deflation are currently strong, we are concerned about an eventual rise in inflation. We've therefore made substantial reductions to the portfolios' allocations to Australian inflation-linked bonds since May, when yields had declined to extremely low levels resulting in an increase in their risk.	Inflation linked bonds produced weak returns in the last three months, particularly in the month of September as yields rose.

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

Over the past year we've been able to both extract strong returns and tightly control risk exposure in the portfolios. Chart 1 shows how we've adjusted the asset allocation of the MLC Wholesale Inflation Plus – Moderate portfolio this quarter. We've increased the allocation to enhanced cash and reduced inflation-linked bonds and emerging markets exposures. We are remaining flexible and nimble 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 for preservation of capital.

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



Source: MLC Investments Limited

Why MLC uses a scenarios approach

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

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

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

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