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MLC's scenario insights & portfolio positioning

MLC Horizon and MLC Inflation Plus portfolios

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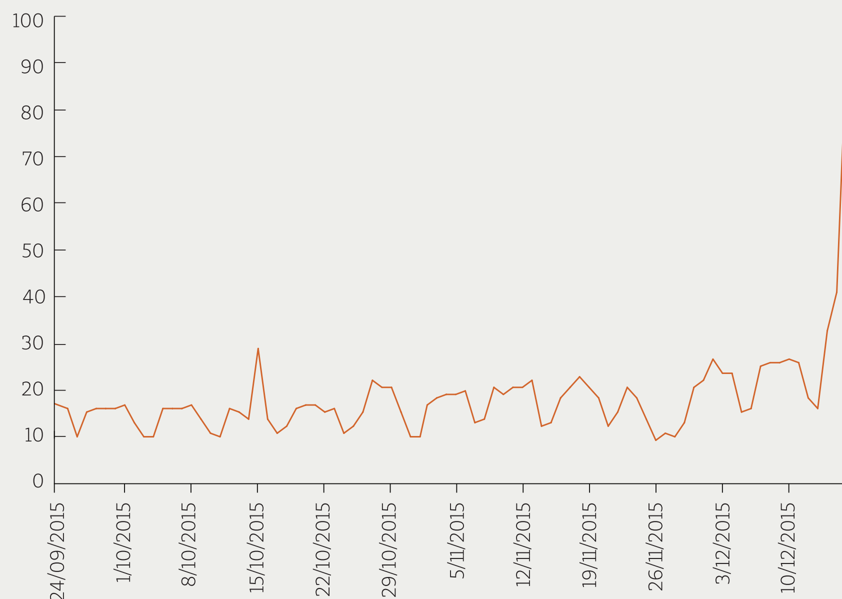
This quarter again begins laced with a feeling of déjà vu as monetary policy once more dominated the flow of news.

While central banks are *always* important institutions, anybody who reads the financial press will well know that they have assumed elevated importance in the eye of the markets since the global financial crisis of 2008. The following Google charts show trends for key terms and illustrate the point.

Monetary policy remains an important influence on markets

Chart 1: Google trends for "The Fed"

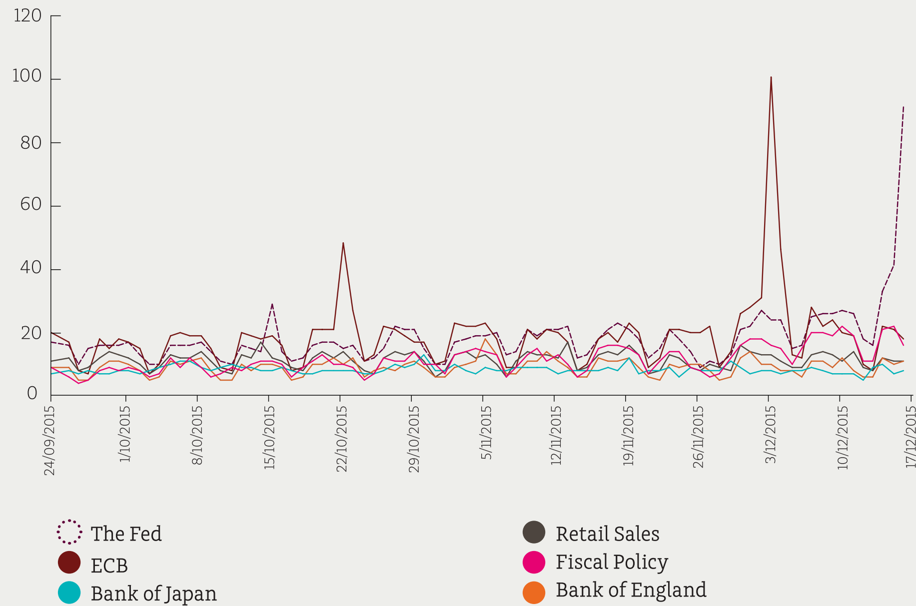


Source: Google Trends

MLC's active investment approach

- Key to MLC's market-leading investment approach is our unique Investment Futures 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.

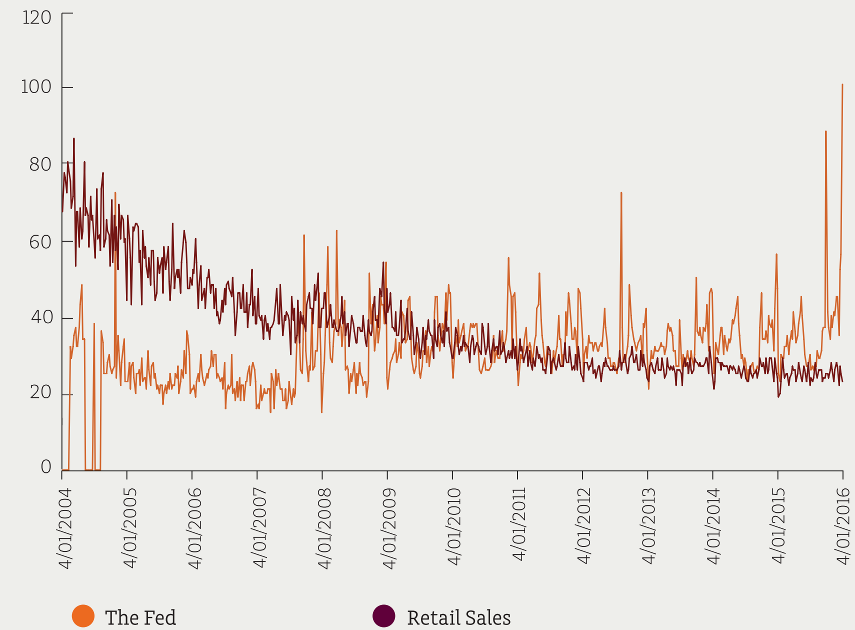
Chart 2: Google trends for various monetary policy search terms



Source: Google Trends

Chart 3: Google trends for Search terms: "The Fed" vs "Retail Sales"

Monetary policy overtakes the real economy



Source: Google Trends

The focus on monetary policy is not wrong or misguided – indeed it would be unwise to remain ignorant of central banks – the attention is simply a sign of the times. First and foremost, it's a sign of the hangover from a long run of over leverage, over investment and over saving, all on a global scale. These three factors combined to leave a wake of overcapacity, pressure on consumption growth, and constrained fiscal latitude – leaving central banks with no choice but to ease policy to extreme levels in order to avoid a depression.

But even with extraordinary monetary policy, growth outcomes have by-and-large been modest at best. The US and UK have recovered, but truly robust real (and nominal) GDP remain elusive; and while employment indicators have recovered well at the headline level, wage growth is only now just beginning to show early signs of vigour.

Europe is further behind the US and UK in terms of the policy cycle and faces its own internal challenges of internal economic rebalancing thus adding additional degrees of difficulty for Mario Draghi, the President of the European Central Bank (ECB), compared to his peers. Meanwhile, Japan has deployed extreme monetary measures as part of a reflationary campaign aimed at bringing long standing deflation to an end. So, while each central bank is focused on its own frameworks and domestic idiosyncrasies, this set of four institutions effectively govern policy over the world's effective funding currencies and as such, their policy decisions flow far offshore. The onward flow of monetary policy crosses not just geographic bounds, but also distorts pricing across all asset classes.

The ECB and the US Federal Reserve (Fed) both executed policy changes during the December quarter. While the ECB eased policy less than anticipated, sending the euro higher and European bonds lower, the Fed surprised only the most extreme disbelievers by making the first change to the overnight cash rate since 2008, and the first outright hike since June 2006.

That the Fed raised the cash rate is noteworthy, but it is not a profound move. US financial conditions have been tightening for some time by virtue of the withdrawal of quantitative easing (QE) and the strengthening US dollar (USD). In this context, a 25 basis point rise is really neither here nor there: for those who prefer to divide the world into "normal" and "abnormal" states; US policy is still very much abnormal, while for those whose thought process is not so absolute; the starting environment has effectively not changed at all. Policy is still very much at the loose end of the spectrum and as always, the defining characteristics of whatever path the future takes is yet to unfold. Indeed, it is very hard to argue against the fact that regardless of how we describe the starting policy environment, this cycle, like all before it, will be characterised by the final tightening steps rather than the first. It is important that we position real return strategies so that they are not in peril whatever circumstances prevail at that point.

Policy tightening in the US will depend on economic progress and emergence of inflationary pressure, both of which are impossible to predict at this point of the cycle even in broad terms. And while we – like everyone else – can easily see obstacles to higher inflation and stronger growth across the developed world, it is a brave investor that believes they know the true prevailing economic state. Those who do, either have a skill that we lack, or more likely, have confused being able to describe the immediate past with carrying a true knowledge of the present.

But it is not today's, yesterdays, or the next change in policy that is important for longer-term risk focused investors. The changes that we are interested in are the evolutionary paths that policy as well as the real economy and asset markets might take from here. Using this "what if" framework to set investment strategy is easy and it is difficult. This is not a contradiction. It's easy because it aligns with our general philosophy on risk management and is divorced from having to make bets on unknowables; but it is made more difficult because the starting environment beckons a wide range of outcomes that are influenced as much by concentrated decisions as they are by economic fundamentals. We need to take the starting environment for what it is and think about the diverse ways forward.

China

Against the ongoing backdrop of economic rebalancing, China recently began "walking the walk" on consolidation of overcapacity within both the industrial economy and also across the massive State Owned Enterprise (SoE) sector. This is an important step as excess manufacturing capacity has dogged not just China domestically, but has been a major contributor to mounting global deflationary pressures. Within China, producer prices have been falling since early 2012 (see Chart 4 on page 5), hurting corporate revenues and making it harder to service rapidly growing indebtedness. Rising default rates are evidence of stresses
in the economy and although the system is well insulated, allowing un-economic projects to continue *en-mass* further exacerbates the capacity problem and threatens China with a Japan-like outcome.

China's emphasis on rationalisation is important for Australia because steel, alongside cement, is at the epicentre of the capacity overhang. The key risk faced by Australia is a profound slowing in steel (production) volume growth, exacerbating the current *nominal* problem caused by a falling iron ore price. China's steel market has until now remained in over supply, partly because of policy that is in the process of change.

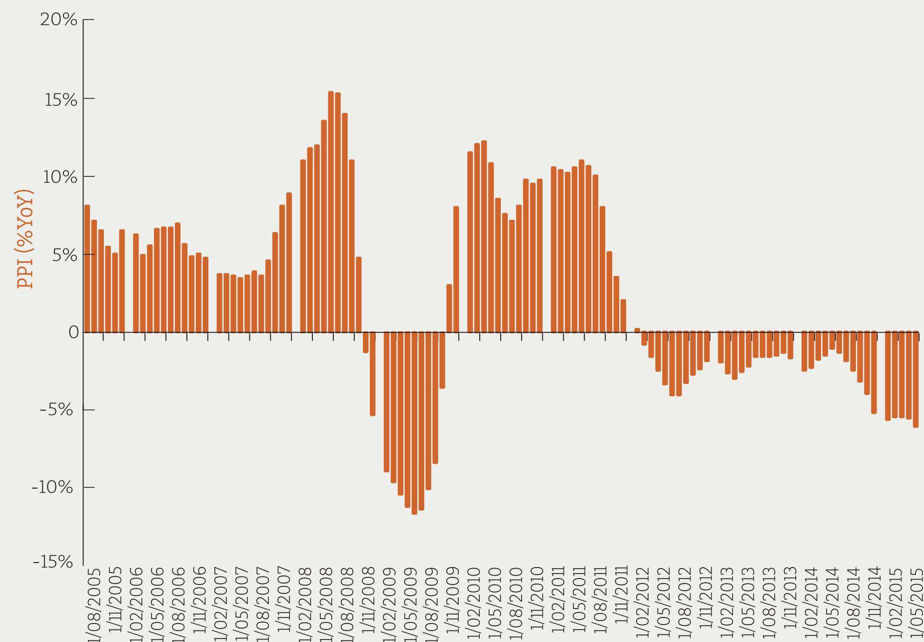
Steel companies within China were previously incentivised to over-produce because local governments taxed production, not profitability. The way to stay out of consolidation's way was to produce and accept razor thin (or negative margins) due to rising input prices and falling output prices. The renewed focus on profitability however, in light of looming consolidation, should reverse that behaviour. Production rates will be further scrutinised and set to better match final domestic demand.

Trade barriers make it difficult to export the steel overhang. India, for example, recently implemented floor pricing for steel exports to protect its failing domestic industry that has been the recipient of significant investment over the past decade.

Japan

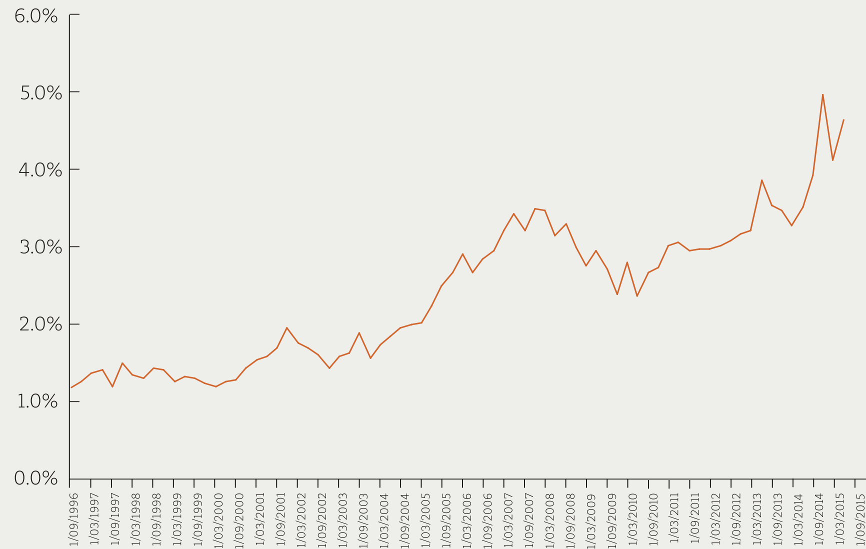
Japan's economic growth again disappointed and inflation fell back to uncomfortable levels in the December quarter – which coincided with the strengthening yen, raising the spectre of further action from the Bank of Japan (BoJ). Here again, central bank policy is key for investors. The BoJ's policy has had command of both the yen and the domestic share market since the first round of debasement in 2013 at the outset of "Abenomics" and its three economic arrows (aggressive monetary policy, expansionary fiscal policy and growth strategy). Despite some early success, structural issues pose a significant impediment to the "monetary missile". For decades now, Japanese manufacturers have invested in migrating capacity to lower cost destinations in offshore jurisdictions as evidenced by rising levels of foreign income in Japan's national accounts (see Chart 5 on page 6). In part, offshoring was fuelled by a strengthening yen in nominal terms, but it was also driven by labour cost differentials and proximity to growth markets. But while offshoring has served Japanese corporates well, it has also created a structural blockage to currency mediated manufacturing stimulus in the short term. Instead of stimulating export activity, the bulk of gains flowing from the weaker yen have accrued to corporates in the form of currency translation benefits that have become stuck as cash balances (see Chart 6 on page 6). These cash balances need to move off corporate balance sheets and into the real economy – via a combination of wage gains which remain anemic (see Chart 7 on page 7), domestic investment, or increased dividends. Japan needs to act decisively to encourage domestic deployment of the bloated corporate cash or risk further offshore investments that in turn create larger hurdles to the domestic economy.

Chart 4: China's annual Producer Price Index (PPI) has been falling since 2012



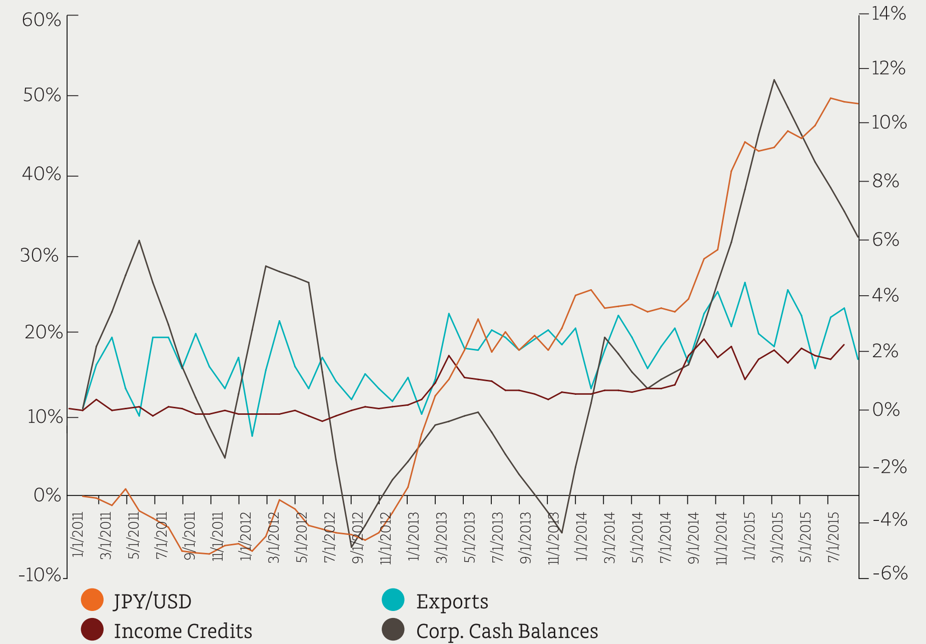
Source: NBC (China)

Chart 5: Japanese manufacturers have been investing in offshore lower cost destinations



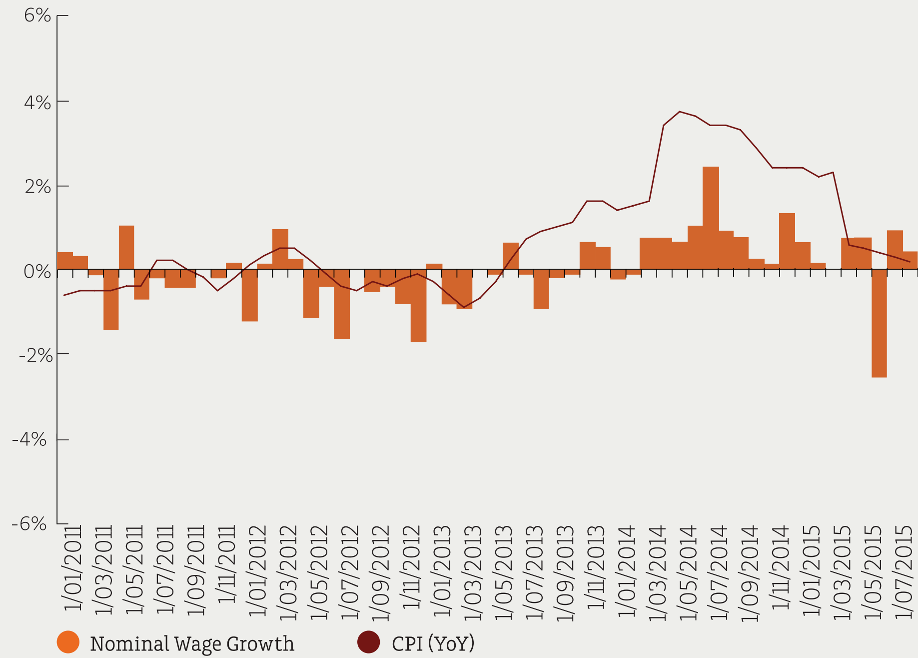
Source: Japan Offical Cabinet Office Statistics

Chart 6: Weaker yen has caused gains to accrue as cash balances



Source: Japan Ministry of Finance

Chart 7: Japanese inflation has fallen back to uncomfortable levels



Source: JANA Corporate Investment Services Limited

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Europe

Growth across the European Union (EU) continues to exhibit signs of a fragile recovery with GDP expanding 1.6% in 2015, the fastest annual rate since 2011. A combination of depressed energy prices, ultra supportive ECB policy and improving labour markets have helped to support a recovery in domestic demand while exports from the eurozone remain challenged by slowing import demand from emerging markets. The pocket of stability enveloping the EU has attracted risk capital back into Europe from the September low. But even though the markets seem complacent for now, just as they were before the re-flaring of the Greek debt crisis in early 2015, the same core risks still linger. Public debt within the periphery – Greece in particular remains unsustainable under the current terms and further concessions are necessary to re-float the economy. Ultimately, this means that markets will again need to deal with more rounds of negotiations and, in all likelihood, more brinkmanship between debtors and lenders. And while markets might have become somewhat immunised to the impact of peripheral debt flare-ups, the perception of insurance, if indeed it does exist, cuts only so far as a passive solution exists and all bets will be off in the case of default or breakup of the zone.

Liquidity

Over the past 12 months, we have increasingly begun to worry about diminishing liquidity across financial markets. Evident liquidity within both fixed income and share markets has narrowed for some time – primarily as a consequence of regulatory change, but also because of a partial rebalancing of global foreign exchange reserves: Oil's plunge has forced petro-economies to turn net sellers of global assets and China's foreign exchange reserve profile has slowed.

Tightening USD financial conditions also push against global liquidity, but this is offset to a degree by countervailing pressure from loosening of the yen and euro. And while some headline indicators of liquidity remain "healthy" (eg overall volumes and bid-ask spreads), we are sceptical that these are reliable measures. Overall gross volumes are bloated by erratic high frequency trading; and while bid-ask spreads also appear well behaved, best-bid (and offered) volumes are often only skinny veneers of liquidity in fixed income markets. Also, several traders that we spoke to during our recent global research trip noted periods of exaggerated pullbacks in liquidity across bond markets in 2016.

Liquidity management is fundamental for risk-focused investors like MLC. Much like the thirst for "high yielding" assets, illiquidity is a tempting source of return when the opportunity to build wealth appears to be near depletion. But unlike more conventional sources of returns, illiquidity risk cannot be diversified, making risk management reliant on position sizing and timing. Indeed, the only way to safely embrace any "illiquidity premium" (when it is offered) is by being in a position to align the term structure of assets and underlying liabilities. For others that fall outside these bounds (like our daily priced funds), the scope to pursue returns from illiquid assets is low and must be managed tightly.

Looking forward

We recognise that the future is always uncertain. In managing MLC's portfolios we take into account that there can be no certainty about future market outcomes. We examine possible return outcomes across a comprehensive range of possible futures. This thorough assessment of the different ways in which the future might unfold provides us with 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 medium term 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, have limitations 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

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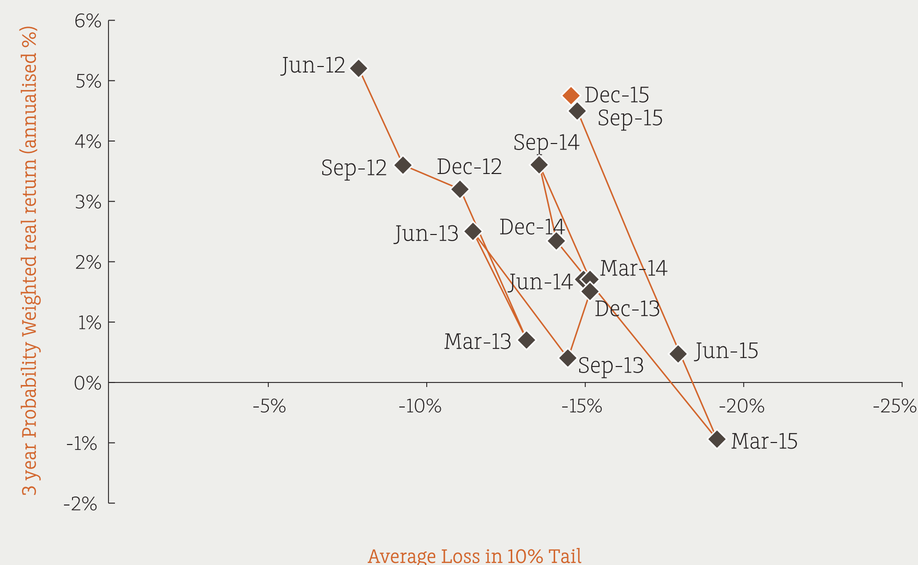
time, we vary the asset allocation to position the portfolios to achieve a higher reward for risk than the benchmark. The risk aware nature of our investment process tends to mean that value is added via the adoption of defensive positioning when risk is high, which reduces loss exposure.

The **MLC Inflation Plus portfolios** have flexible asset allocations with few constraints which enable us to target tight control of risk over each fund's time horizon. 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 so are inconsistent with real capital preservation over each portfolio's investment time frame.

Markets initially rallied in the December quarter reversing the September quarter declines, but then reversed again as the Fed rate rise loomed leaving prospective risk and return potential little changed overall. Chart 8 shows probability weighted scenarios 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 projected would be lower though still positive.

Chart 8: Change in risk and return potential through time for Australian shares



Source: JANA Corporate Investment Services Limited

Chart 9 shows a broadly similar outcome for three of the MLC Horizon portfolios. For these multi-asset portfolios, prospective risk was slightly lower and return potential higher primarily due to a stronger Australian dollar (AUD) which increased the diversifying properties of foreign currency exposures.

As we have outlined previously, today's investment environment remains very complex. 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.

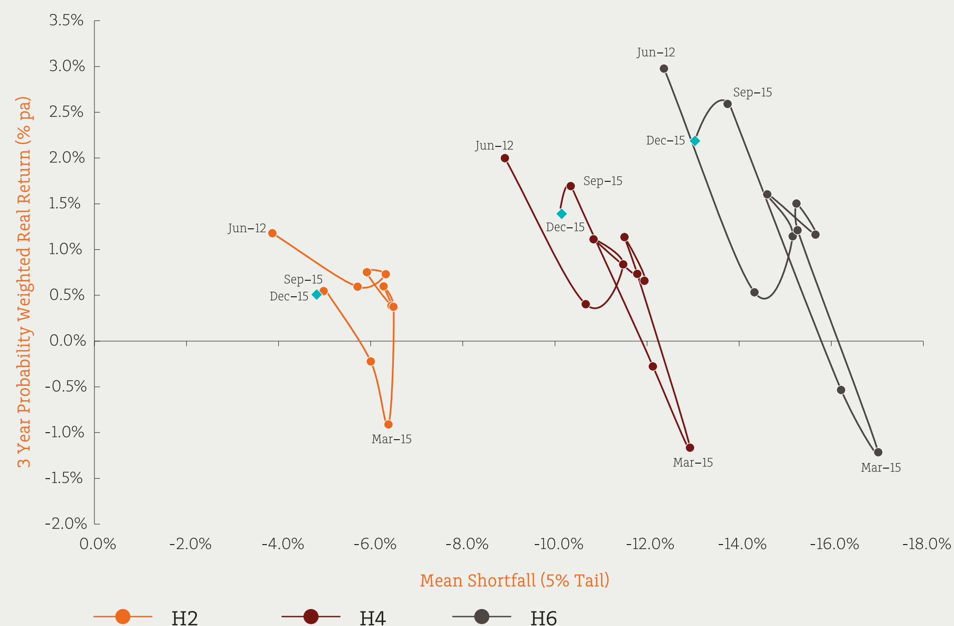
Over the past year we have been able to both extract strong returns and tightly control risk exposure in MLC Inflation Plus. It is important to explain that this combination is becoming more difficult to achieve and that we will maintain the risk discipline and will be patient in seeking return upside. During the December quarter the positioning for MLC Inflation Plus was adjusted in response to rising concerns about market liquidity. A number of adjustments are also being implemented for the MLC Horizon portfolios.

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 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 10 on page 11 looks at our barometer of risk and return – based on our generic (40) scenario set, described on page 12 – for the MLC Horizon and MLC Inflation Plus portfolios looking forward from the end of December 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'

Chart 9: Change in risk and return potential through time for MLC Horizon portfolios



Source: JANA Corporate Investment Services Limited

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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 larger 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 our 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 over each portfolio's time horizon 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.

Chart 10: 40 scenario set (generic scenarios) potential real returns (December 2015) (5 years scenarios, 0% tax with franking credits, pre fees, pre alpha)

Source: JANA Corporate Investment Services Limited

MLC Horizon and MLC Inflation Plus portfolios

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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 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 currently consists of 12 scenarios, an additional scenario 'Global growth convergence' is currently being specified and is likely to join the set in coming quarters. We continue to evolve our thinking about the composition and relative importance of the scenarios and their specification. 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 reflect the challenges of a world in which actions of policy makers have distorted asset prices and removed safe haven investments. The first tentative step has been taken by the Fed in reversing ultra-low interest rates. However, the pace of future US rate rises remains data dependent, and we may see offsetting new stimulus in the eurozone and Japan which could foster market complacency. However, the challenges to yield-driven investing are increasing and the potential for renewed stimulus to boost or even calm markets is becoming more uncertain. Indeed prospective policy decisions remain a source of uncertainty. Nevertheless, 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 then when it unwinds it can do so more rapidly than anticipated. 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 to date, we are far from complacent about the future challenge. Nimbleness and flexibility are more important than ever if we are to both generate returns and control risk, but it is undeniable that the challenge of doing both has increased. We will maintain the risk discipline even if this requires some patience before return expectations are met.

Our analysis of scenarios is designed to build an understanding of return potential and downside risk. Where there is significant asymmetry (ie the upside potential is greater 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 to an extent but the fall in the AUD significantly 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 arguably not fully priced in. Because of this, we still have significant exposure to unhedged foreign assets within MLC Inflation Plus (particularly the 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. 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 and hence return potential 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 strategy flexibility of MLC Inflation Plus, particularly the Assertive portfolio, during the December quarter. This is in part a response to tightening liquidity conditions. In the Assertive Portfolio (in MLC MasterKey Superannuation and Pension products), allocations to private assets and the low correlation strategy were reduced in favour of cash. There are changes forthcoming in the Horizon portfolios which also increase strategy flexibility.

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 December 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	Reduced 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. With increasing concern about challenging market liquidity conditions, the low correlation strategy allocation for the Assertive portfolio has been reduced.
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	Steady allocation	Steady allocation	Steady allocation	Emerging economies and markets are vulnerable to US monetary policy normalisation.
Global private assets	Steady allocation	Steady allocation	Reduced allocation	The private assets allocation for the MLC Inflation Plus – Assertive Portfolio (in MLC MasterKey's superannuation and pension products) has been above target, during the quarter the target allocation was reduced.
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.

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 December quarter			Comment
	Conservative	Moderate	Assertive	
Global government bonds	Zero direct exposure	Zero direct exposure	Zero direct exposure	Unattractive, with limited diversification benefit.
Australian inflation-linked bonds	Steady allocation	Steady allocation	Steady allocation	We remain concerned 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	Reduced 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. A small reduction was made to bank loan allocations in the Moderate portfolio.
Australian non-government bonds (short duration)	Steady allocation	Steady allocation	Steady allocation	Offer some return enhancement while limiting additional risk.
Cash	Steady 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. Cash allocations for the Assertive portfolio in particular were raised during the quarter.
Borrowings	Not applicable	Not applicable	No borrowings	Reward for risk is too limited.

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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.

	MLC Horizon Super & Pension portfolio weights at end of the December 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		●		Steady target allocation.
Emerging markets strategy		●		Retain benchmark allocation.
Multi-asset real return strategies (including Inflation Plus)			●	Overweight maintained.
Low correlation strategy			●	Overweight maintained.
Fixed income	●			Underweight maintained.
Cash			●	Overweight maintained.
Australian bonds – All Maturities			●	Overweight maintained
Australian inflation-linked bonds		●		Benchmark weight.
Global bonds – All Maturities	●			Underweight maintained.
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.

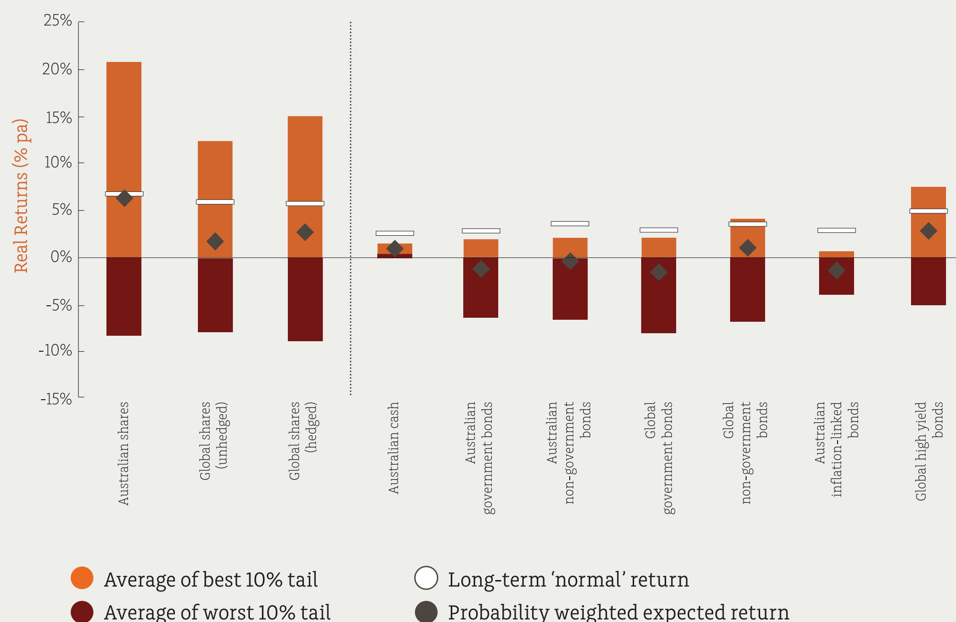
Return potential

At the heart of our Investment Futures Framework is specifying scenarios which capture what the future might hold. We build a systematic 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 what the ultimate outcome is. 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 risk asset prices performed strongly early in the December quarter, they later reversed as nervousness increased about the first rate rise by the Fed. Overall most asset prices were little changed, leaving return potential broadly in line with the position at the end of September. Future return potential remains 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 11. 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 10, on page 11, shows return potential for the MLC Horizon and MLC Inflation Plus portfolios.

Chart 11: 40 scenario set (generic scenarios) potential real returns (December 2015)
(5 years, 0% tax with franking credits, pre fees, pre alpha)

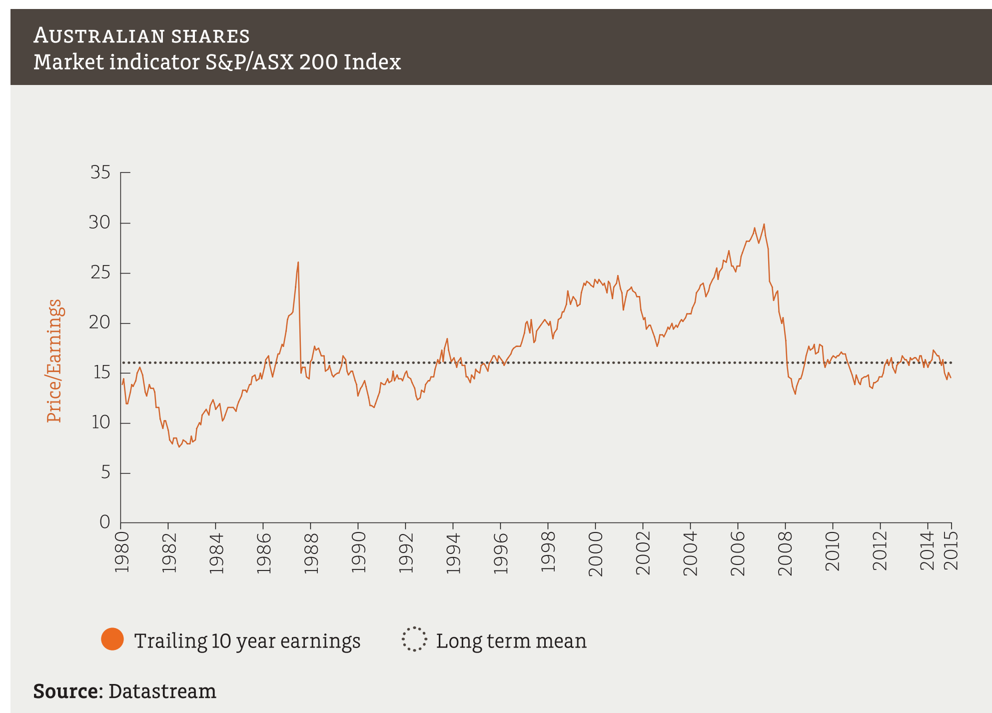


Source: JANA Corporate Investment Services Limited

Asset class indicators

Our view of the main asset classes is as follows.

Australian shares
Market indicator S&P/ASX 200 Index

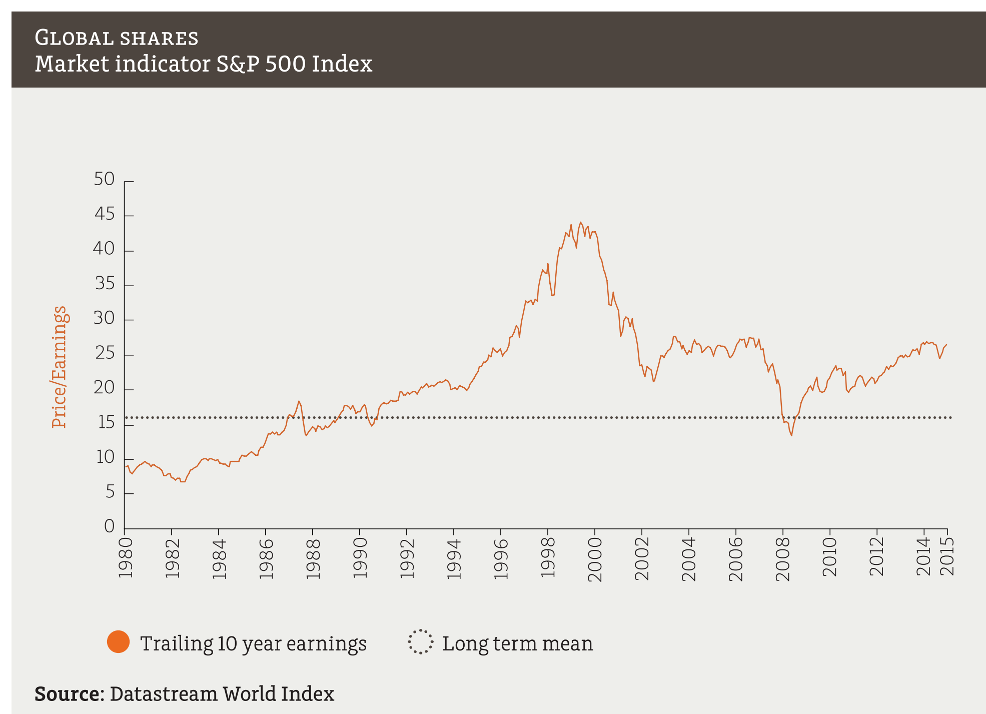


Source: Datastream

Comment

The Australian market posted strong gains over the December quarter with a positive return of 6.5%. The materials and energy sectors were notable underperformers as the combination of tapering global demand and buoyant supply continued to place downward pressure on commodity prices. During the quarter the AGM season saw management provide trading updates, overall confirming the continued difficulty generating sales growth leading to an extension of cost cutting programs. Over the quarter the Reserve Bank of Australia (RBA) held the cash rate steady against the backdrop of benign inflation data and a steady domestic growth rate.

Asset class indicators continued



Global shares
Market indicator S&P 500 Index

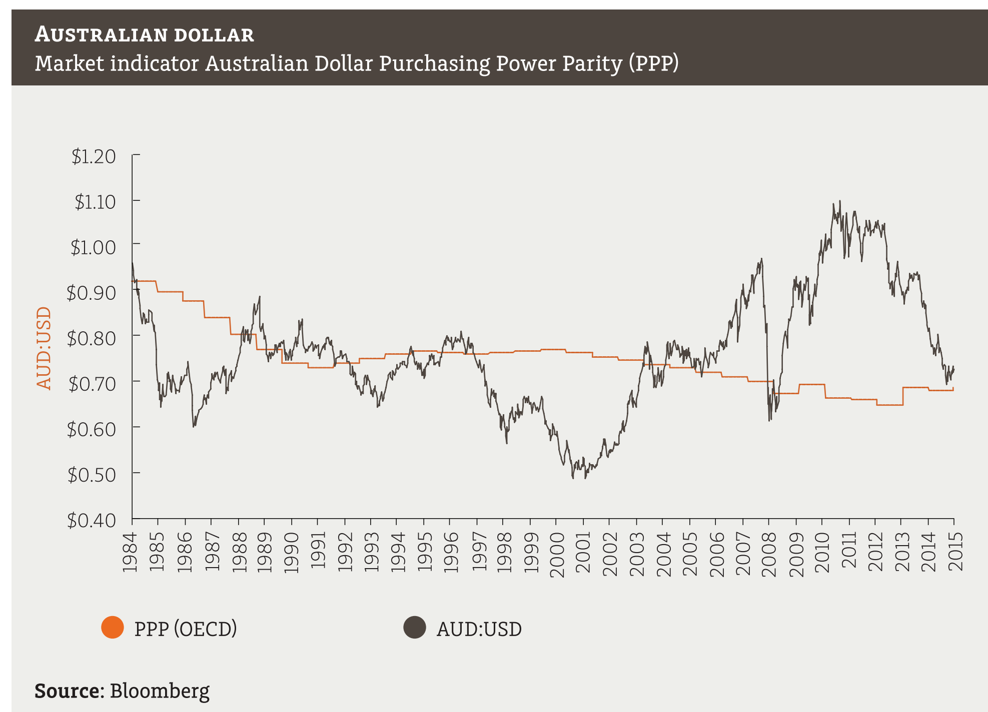
Source: Datastream World Index

Comment

Global markets rebounded strongly over the quarter with the MSCI All Country World Index increasing 5.9% in local currency terms, recovering most of the losses incurred throughout the volatile September quarter. Despite few changes to underlying economic fundamentals and a continued softening of commodity prices, optimism returned. Stock markets took little interest in the Fed cash rate increase, yet continued to enjoy the continued support of accommodative monetary policy across the globe. Most countries experienced strong returns such as China where the Shanghai Composite Index rose 15.9% in local currency terms. The UK FTSE 100 Index increased 3.7%, Euro STOXX 50 Index was up 5.7%, Japan's TOPIX 100 Index 10.1%, and the S&P 500 Index rose 7.0%. Emerging markets increased by 1.6% over the quarter as many of the commodity and USD sensitive countries saw little or no relief on either front.

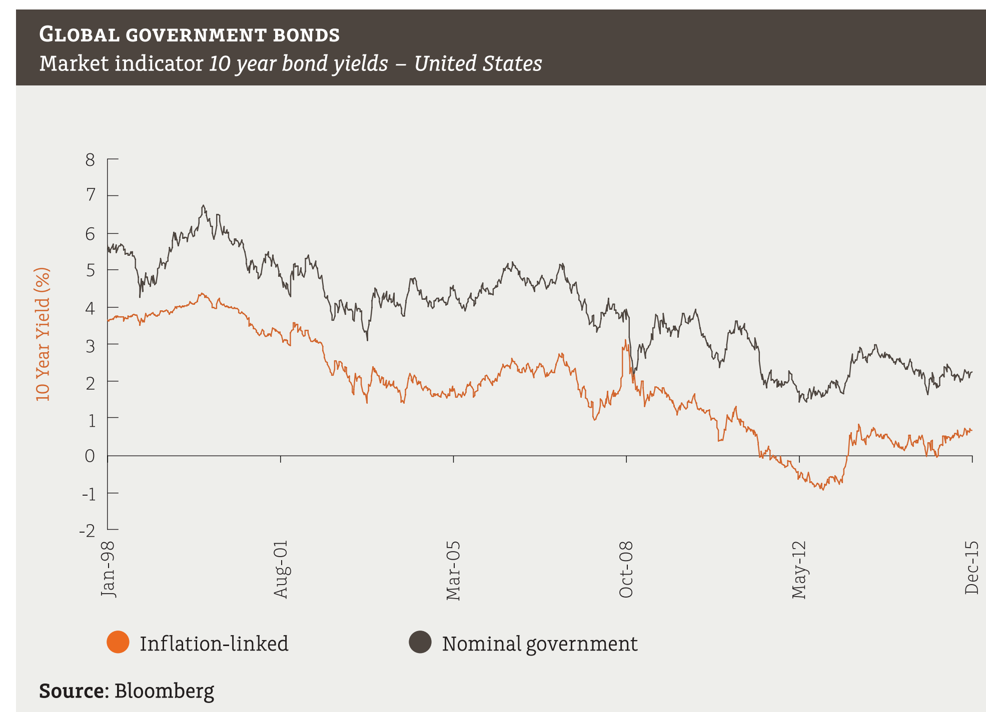
Asset class indicators continued

Australian dollar
Market indicator Australian Dollar Purchasing Power Parity (PPP)



Source: Bloomberg

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



Source: Bloomberg

Comment

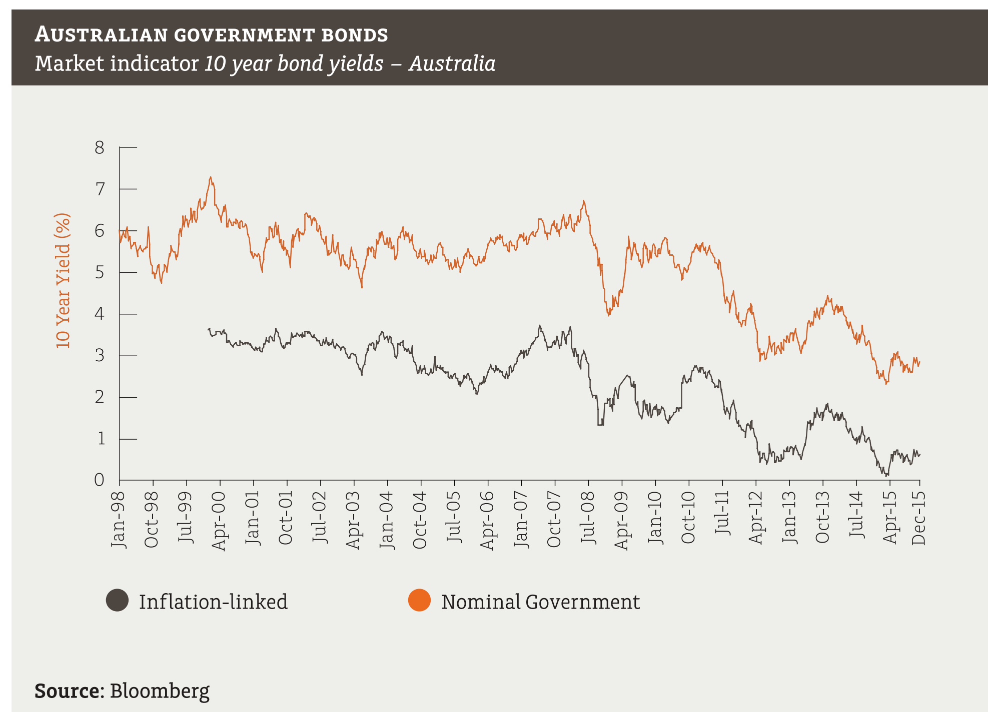
The AUD was resilient over the quarter rising 3.8% as concerns around global growth paused, although this did little to support commodity prices with most commodity sensitive currencies depreciating against the USD. The first increase in the official US cash rate in seven years was well anticipated by the market resulting in a benign impact upon the official announcement. The RBA also indicated that recent inflation and GDP data provided no need for an immediate cut to the domestic cash rate therefore maintaining a higher rate compared to the rest of the world and adding support to the AUD.

Comment

Most regions of the world saw yields increase over the December quarter. German Bunds, which in the last quarter decreased slightly, reversed direction climbing 4 basis points to close at 0.63% on the ten year term. The United Kingdom saw the yield on its 10 year Gilts increase 30 basis points and the US 10 year increased 23 basis points to end at 1.95% and 2.27% respectively. China's 10 year government bond yields continued its fall from last quarter by another 38 basis points as investors speculated both on the degree to which the economy will slow and the implications of the US rate hike.

Asset class indicators continued

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



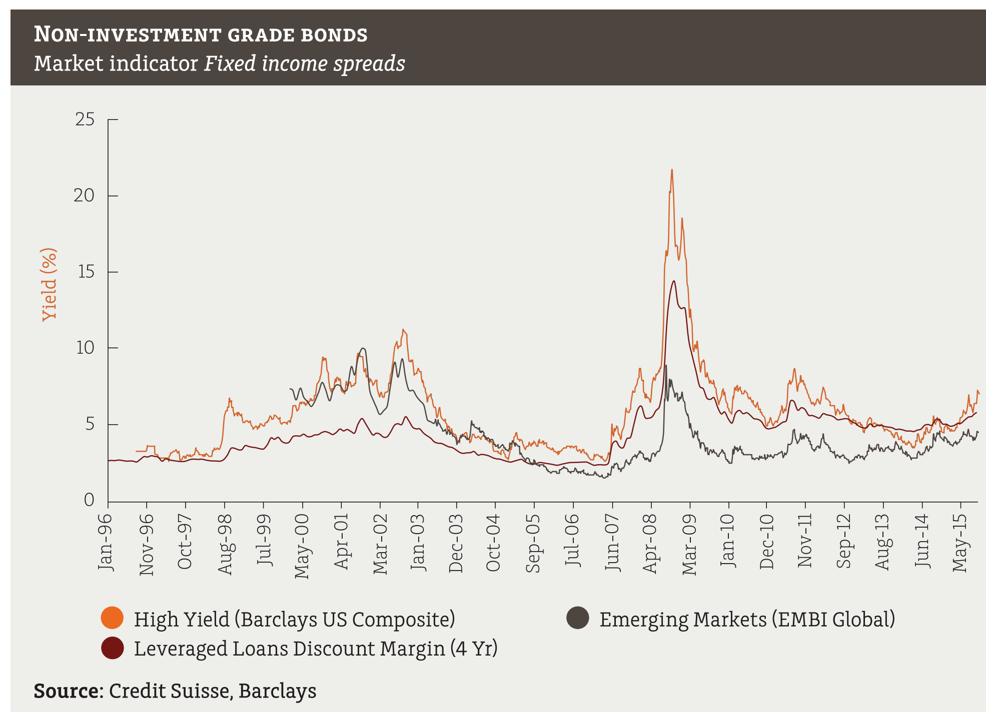
Source: Bloomberg

Comment

The December quarter saw the Australian 10 year government bond yield reverse its September quarter decline by increasing 21 basis points from 2.61% at the end of September to 2.82% at the end of December. Economic data was mostly positive, unemployment remained stable at 6.2% whilst seasonally adjusted employment strongly surprised on the upside with the November numbers coming in at positive 71.4K against a negative expectation, however much of this can be attributed to sample rotation. Seasonally adjusted quarter-on-quarter GDP also came in at 0.9%, above the consensus of 0.7%. The December quarter also saw the RBA leave monetary policy unchanged, contrasting to the decision of the Fed to tighten.

Asset class indicators continued

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



Source: Credit Suisse, Barclays

Comment

During the December quarter the US High Yield Bond Ba/B 2% Issuer Cap Index AUD hedged returned -0.50%, underperforming its duration matched government bond equivalent by 0.10%. The continued poor performance of the high yield bond market continues to be driven by weakness in the energy sector where the December quarter saw spreads widen significantly more than the aggregate index as a result of the continued deterioration in oil prices. High yield bonds outperformed the leveraged loans market over the quarter, however over the 6 months and 1 year time frames leveraged loans still provided superior returns over the high yield market. The leveraged loans market was negatively impacted by outflows from mutual funds and underwriting banks holding leveraged loans that had to be cleared into the year end. This occurred during a period of deteriorating liquidity, particularly in December, driving poor performance.

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 for banks which requires central bank intervention.

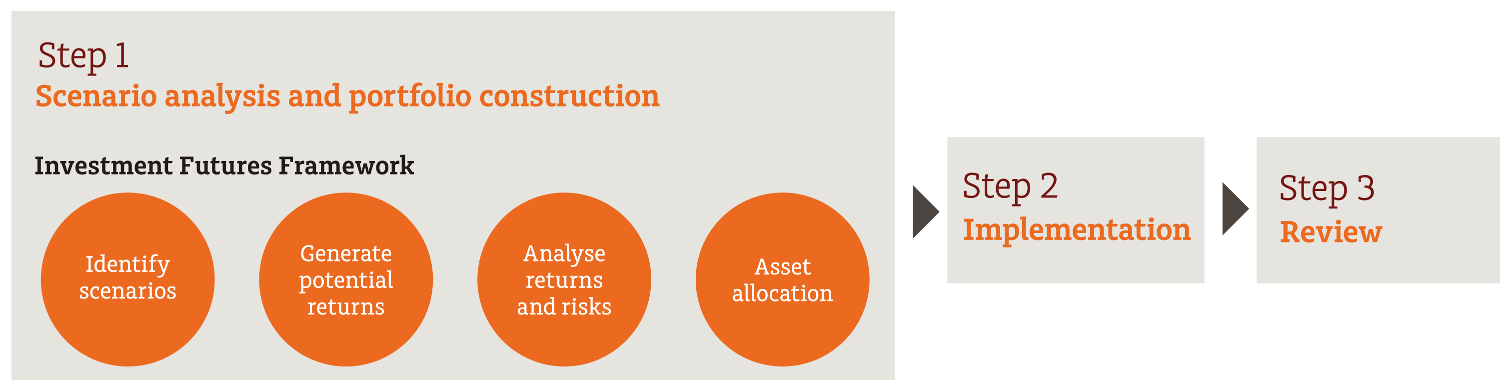
Appendix 1 – tailored scenario set continued

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.
Global growth convergence	New scenario currently being specified	Japanese and European growth surprise, while the US, UK and China moderate resulting in a synchronised modest global growth scenario.

Appendix 2 – MLC's market-leading investment process



- 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.

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