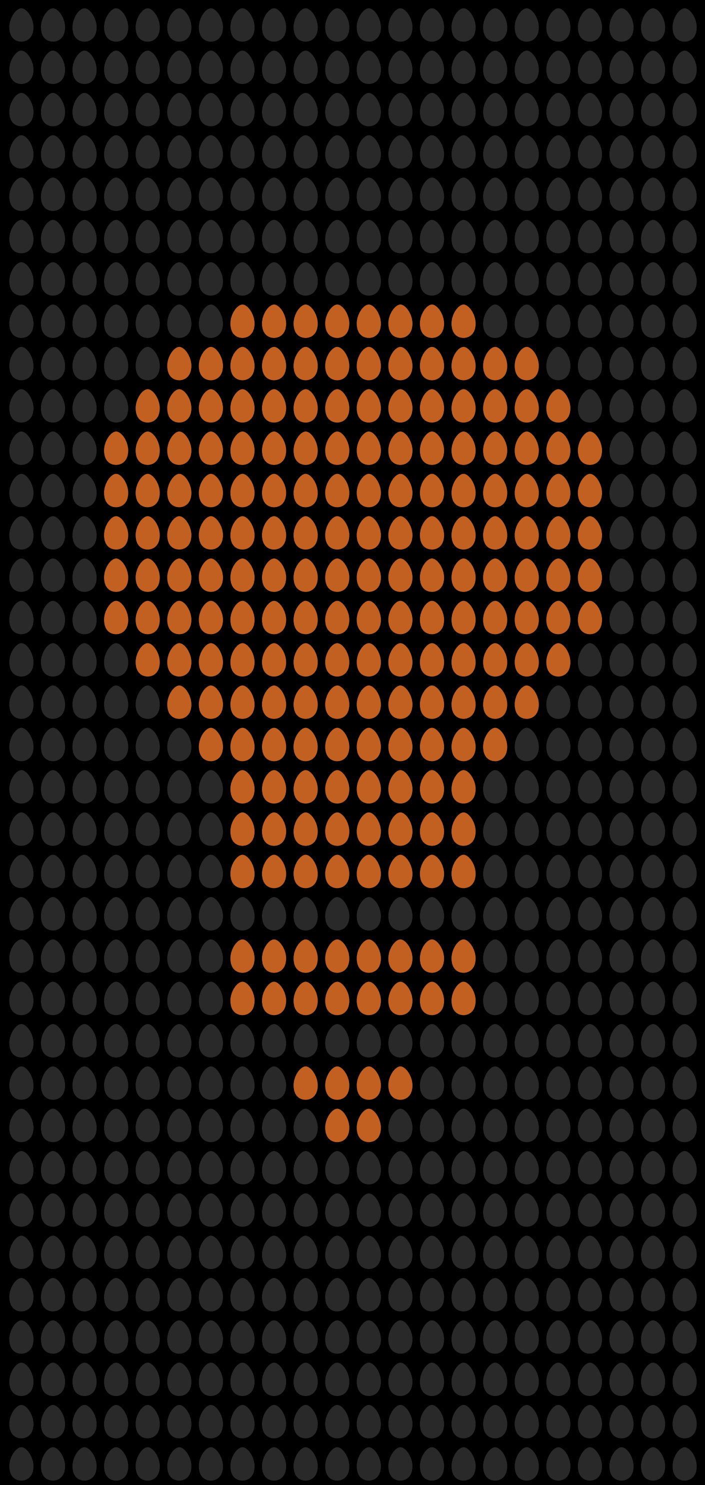

MLC's SCENARIO INSIGHTS & PORTFOLIO POSITIONING

MLC Horizon and MLC Inflation Plus portfolios

October 2016

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MLC Horizon and MLC Inflation Plus portfolios

MLC's scenario insights & portfolio positioning

During September European pharmaceutical company Sanofi and consumer group Henkel sold bonds (of 3.5 and 2 year maturity respectively) with a yield of minus 0.05%. As far as we can tell, this is the first time that private sector corporate paper has been issued at negative nominal interest rates. To state the obvious, negative yields mean investors expect to get back a lower (nominal) amount than they invested. Of course, it's real, after-inflation, yields which matter rather than nominal, but with eurozone inflation hovering a little above zero today there's not much difference between the two. It's estimated that around half of all eurozone debt and the majority of debt in Japan now trades at negative yields. While we can stuff our mattresses with cash, this is not a feasible option for corporates or investment funds. The ability to attract investment at negative rates in part reflects the costs and risks of storing large amounts of physical cash. Quite apart from anything else, there are not enough bank notes. More fundamentally, this situation highlights just how distorted the investment environment has become.

Apparently oblivious to mounting evidence to the contrary, policy makers are persisting with the notion that if they can get interest rates low enough it will encourage consumers to spend and companies to invest. Today's ultra-low interest rates are symptomatic of a mistaken belief that ever looser monetary policy is the key to a stronger economy. On the contrary, the combination of fiscal austerity and loose monetary policy has provided at best weak support for higher wages and asset-building prospects, particularly for the have-nots. We cannot blame low rates for what is a long-term squeeze in the share of income going to wage earners, which is reflected in a long-standing decline in the wages (versus profit) share of income. And we must point out that post 2008 the monetary policy response has supported the return of the US and UK to more or less full employment – this has in particular benefited lower paid workers. However, the rise in asset prices has disproportionately favoured the wealthy and there is growing frustration about stagnant wages. In previous commentaries we have noted that the wages of many US workers' have been stagnant for decades. Looking across countries, the greater the focus of policy makers on fiscal austerity, the more limited the progress in creating employment or boosting wages. Furthermore, the ability of monetary policy to stimulate the real economy without greater fiscal support for demand appears to be diminishing.

Lack of progress on wages and soaring asset prices have stoked social discontent. This has fostered the rise of divisive populist politicians that threaten to escalate the uncertainty that holds back the real economy. Nervousness about employment prospects impedes both wage growth and consumption. Lack of confidence in consumption growth holds back investment. Consumption and investment are low because expectations are low, not because interest rates are too high. This is in part because low interest rates constrain those saving for future consumption or to repair their balance sheets (reduce debt).

We have deep concerns about the evident failure of monetary policy and the apparent lack of concern about growing distortions to the normal functioning of market economies. In short, ultra-low and negative rates result in resource misallocations which can lower productivity and growth. Economic doctrine says that the interest rate reflects the price of capital, like wages reflect the price of labour. Just as low wages imply low labour productivity, so (under this view) very low interest rates suggest capital is unproductive. This is not inconsistent with an observed slowing in productivity growth. Low rates are not the main cause of low productivity, but they may worsen it if they result in misallocation of resources. The focus of companies on the financial engineering of balance sheets as opposed to productive investment is indicative of this. They also exacerbate defined benefit pension plan deficits, and damage the profitability of banks, which may impact their ability to lend. The actions of already cash-rich Sanofi and Henkel illustrate the disruption of negative rates to the normal functioning of the real economy. They are not raising funds to support an expansion of business activities, but because borrowing at negative rates increases cash earnings. This is a sorry state of affairs. Those that don't need to borrow are being induced to do so, and, contrary to the received doctrine, real investment is being constrained by a high cost of equity. It is the cost of equity rather than the interest rate which is the relevant measure of the cost of capital. Firms will only

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.

invest if there is a sufficient prospect of generating a high enough return to satisfy the requirements of share investors (their risk premium). Lack of adequate confidence in future demand is the primary constraining factor. Lower interest rates cannot fix this and indeed may have a counter-productive impact.

Investors required to maintain low risk, liquid investments are effectively being taxed by negative rates. Negative cash rates, regulation and an inability to hold physical cash create demand for bonds offering negative yields - we hear corporates that bought the Sanofi and Henkel paper saw it as an attractive alternative to available deposit rates of negative 0.7%. Effectively, we are seeing a cross-subsidisation between forced lenders and induced borrowers. Negative rates distort the 'time value of money'. This concept says that a given amount of money is worth more today than tomorrow because of its earning power between today and tomorrow. With negative rates this reverses. This results in firms (and individuals if ultimately they face negative rates) wanting to pay as fast as possible and be paid as late as possible. This distorts behaviour in ways that we cannot yet fully understand. Also, the more negative rates are, the greater the incentive to store value in other ways – using assets that are a store of value (gold being the obvious one; certain durable goods could also play a role). These things suggest that we are approaching the limits of monetary policy in key economies. This may imply that the feedback from lower rates to higher share prices has limited (though not zero) further potential.

More fundamentally, while lower rates are designed to keep debt serviceable, this policy encourages further debt build-up, creating a vicious cycle. Low rates, which are in part an attempt to avoid default on still excessive and growing debt stocks, aggravate the problem they are trying to solve. The corollary of this is that defaults or at least debt restructuring (a soft form of default) or a (likely problematic) inflating away of the real value of debt are unavoidable.

In normal times, rate cuts ease demand constraints for debtors (notably mortgage holders and leveraged corporates) and encourage demand and productive investment. In these highly distorted times, with debt service costs already low and wages growth lacklustre, demand growth has been too limited or uncertain to induce firms to invest. Instead, two alternative monetary policy transmission mechanisms have been relied upon. First, competitive exchange rate devaluations which do provide a demand boost but are effectively a zero sum game. Second, the forcing of investors up the risk spectrum has meant that asset prices have soared, arguably creating wealth effects which increase demand. However, policy makers appear oblivious to the plight of self-funded retirees who either face cuts to income or are forced into higher risk assets to preserve lifestyle aspirations (reinforcing the asset price spiral). These interest rate constraints must to some extent offset any effect on retirees' wealth. As a consequence, we also suspect that the adverse impact of rising rates may be to an extent mitigated by rising retiree incomes - and the expected income streams of future retirees and others who are saving for future purchases. There may also be reinforcing confidence effects. The potential extent of this is an empirical matter which we have not fully assessed.

The key to higher demand is more positive expectations about the future. Low rates have boosted asset prices, putting the goal of house ownership beyond reach for many. A lower for longer scenario also threatens the ability of younger investors to accumulate sufficient assets to support a comfortable retirement. In a sobering calculation, John Kay (one of the UK's leading economists) says 'to provide 70% of gross income for 25 years of retirement when real interest rates are zero requires setting aside 45% of gross income every year'. This is a crucial issue. If we remain in this 'lower for longer scenario', this wealth boost for savers with a lot of risk assets will persist and potentially intensify. In contrast, a change in policy can mean a reversal of the wealth transfer – in other words, it means a fall in the prices of risk assets which threatens the wealth of our investors but restores the prospect of wealth accumulation for younger investors.

While we regard today's monetary policy settings as unsustainable (meaning interest rates must rise), we cannot know when that change will occur. The Japanese experience suggests that the 'lower for longer' scenario can run into decades. However, it is a mistake to simply extrapolate the Japanese experience – for example, the rise of populist politicians and protest voting in the US, UK and eurozone is in contrast to the apparent forbearance of the Japanese in the face of persistent economic pain. This may prove to be a crucial difference; it suggests the potential for a much faster shift in policy and an unwinding of the current scenario.

As always, there are a range of potential futures; today they are particularly challenging. There are three main high level sets of possibilities:

- **More of the same** – 'lower for longer' scenario where monetary policy settings continue to manipulate share prices higher. We are observing a decline in monetary policy efficacy and as we suggest above, there are arguments which imply that scope for further policy manipulation of share prices is now limited. Policy makers may have succeeded in allaying market fears and, for now, averted a bond bear market with flow-on consequences for shares. Despite being pleased with economic strength, the US Federal Reserve (Fed) again declined to tighten rates in September – having cried wolf a number of times, it may now be difficult for the Fed to persuade market participants that a rise will occur in the foreseeable future. And the new 0% target for 10 year Japanese government bonds creates a soft limit on yields in other markets too. We must therefore take into account the potential for share valuations to reach extreme levels, while acknowledging this is getting more difficult. Also, were it to occur it would progressively increase the risk of another crisis – to which policy makers have limited fire-power to respond. While this is a high returning scenario in the near term, we should fear it (this is our 'Negative rates' scenario).

- **Stuck in a low growth-stagnation** – low returns world. Here we see a stabilisation in yields at low levels, with risk assets broadly maintaining current valuations. This means that share market returns are driven primarily by dividends and earnings growth. Companies able to prosper in a low growth environment include those than can create attractive new products and technologies, or which can increase productivity through other means. The valuations of higher yielding assets may also expand in this scenario. (Our 'Global deleveraging – slow growth' scenario is the clearest example of this environment).
- **A new scenario emerges** - this could be:
  - Market driven: for example investors lose confidence in central banks, as in our 'Rise in USD risk premium' scenario or the 'Extended risk aversion' scenario which could be triggered by a Trump presidency. The latter could then morph into an unpleasant trade protection scenario which we include in our generic scenario set
  - A flow-through in unintended policy consequences (for example a rapid jump in inflation, as in our 'Inflation shock' scenario)
  - Real economy driven: for example if growth is strong enough to tighten labour markets a positive wage-demand feedback can emerge – however, positive economic performance does not translate in a simple way into share price rises because interest rates also rise (though the extent may be limited given overall debt levels). Or if policy makers don't respond as economic slack is consumed then inflation rises (as in our 'Inflationary debt resolution' scenario), or
  - Predicated on a change in policy settings: if we are to understand what the future could hold, we must anticipate the changes that could occur to economic policy. Perhaps the most obvious place to start is with a continuation of progressively looser and looser monetary policy settings. As we have already mentioned, policy makers may find the ramifications of wider or deeper application of negative interest rates to be counterproductive. Speculation has increased that the next monetary policy frontier may be so-called 'helicopter money'. However, helicopter money is basically fiscal stimulus financed by (monetised) government borrowing. High levels of public sector debt have put fiscal policy politically off-limits in the developed world. We have argued that the persistent contractionary fiscal bias adopted by Japan's Ministry of Finance has been a long-standing impediment to economic growth (see our commentary for July 2016). Over the past year there has been an apparent shift in attitudes to fiscal policy driven by more vocal social discontent. At present however, fixed income markets are not pricing in this risk. Well-directed fiscal policy coupled with structural reform provides the best sustainable prospect for raising productivity, wages, demand and growth (this possibility is modelled in our 'Reform' scenario).

The US election

Although the US election race is not looking as uncomfortably tight as it was, it has been surprising that financial markets have not shown more nervousness about the possibility of Donald Trump becoming US president, a man who has been described as a 'con man' and a 'duplicitous demagogue'. Brexit provided us with a reminder that in any two-horse race, each potential outcome should be taken seriously, so we must carefully consider the disquieting possibility of a Trump presidency.

Some of the apparent complacency in financial markets may come from a belief (or hope) that the powers of a US president are limited. While it is true that there are important constraints, the president does have more discretion than is comfortable in current circumstances. A key concern is, he can 'un-sign' the executive orders of previous presidents. Apparently Trump's transition team are identifying orders issued by President Obama which could be rescinded – this does not mean that things can be reversed overnight, but these are genuine powers. For example, Trump could suspend the Syrian refugee program. More worryingly, he could ask the Commerce department to impose tariffs on Chinese goods (the World Trade Organisation would rule this illegal but Trump could ignore that and leave the WTO).

One of the biggest areas of concern is US interaction with the rest of the world. Particularly worrying are suggestions that the US may reduce its role in tackling global problems – and may not provide guaranteed support for North Atlantic Treaty Organization (NATO) countries under attack, which would fundamentally change the balance of power in Europe. Equally concerning are his beliefs that free trade and immigration are bad for the economy.

Trump will need the support of federal employees to get things done, which could prove an obstacle, even after appointing loyalists to senior positions. This is why Trump is looking at weakening the high level of employment security currently enjoyed by government officials.

Trump has the potential to damage the economy simply by undermining confidence. He has commented "I am the king of debt...I would borrow, knowing that if the economy crashed, you could make a deal." This statement shows Trump's astounding naivety. The implication that the world's safe haven asset, US treasuries, might be much riskier than perceived would represent a more fundamental shift in risk perceptions than seen with housing debt in 2008. His naivety with respect to NATO treaty obligations to treat an attack on one as an attack on all is equally alarming.

The worst case Trump scenario is that he triggers a shift in risk perceptions which leads to sharp declines in both fixed income and share prices. At the other end of the spectrum, being unconstrained by prevailing dogma, a Trump best case scenario for the economy could result from significant fiscal stimulus in the form of badly needed infrastructure spending. Though this would present challenges for financial markets, a properly targeted range of measures could stimulate demand in a sustainable fashion.

Our base expectation is that a Trump victory would be destabilising for financial markets. We can hope that November will result in a new President Clinton; however, Trump has changed the political landscape and we also hope that policy makers will reflect on what has brought us to the current predicament. The rise of Trump and extremist political parties in Europe, plus the Brexit vote, are a wake-up call for the establishment. We can hope that these forces empower governments to act more boldly and take on more of the burden of simulating the economy, rather than relying on the central banks.

Looking forward

We continue to see alternating episodes of market weakness and recovery pivoting primarily around central bank decision making. Returns over the year to end September look markedly more positive versus those to the year to end June. Overall this was a 'risk-on' period with risk exposures (including the Australian dollar) moving higher. With significant risk control built into portfolios, particularly the MLC Inflation Plus portfolios, this has not been a favourable period for us. Looking forward, market behaviour remains contingent on monetary policy decisions. As we have argued, the ability of policy to push share prices sustainably higher may be diminishing. This means that it's becoming more important to understand the consequences of a reversal in the prolonged decline in yields.

While the link between bond prices and increasing yields is well understood; the relationship with share prices is more complex. Historically, as interest rates have tightened this has more often than not been a period of positive performance for share markets (and negative for bonds). Essentially what has happened is that growth expectations have risen sufficiently to offset the increase in the cost of capital. However the evidence from recent price action and the deterioration in economic releases since July suggests that this time growth is likely to struggle to keep up with increasing rates.

Using a discounted cash flow model at a market level, rather than a stock level, we can get a sense of how sensitive the market is to rising rates; and how much growth expectations need to increase to offset them. In the second week of September when US 10 year bond yields increased by 19 basis points, we saw share markets decline by over 3% - suggesting that not only was risk free cost of capital increasing, but so was the equity risk premium, or even that growth expectations were falling as expectations firmed for tightening of monetary policy in the US. Indeed, when we look at the increase in yields for high yield debt over the same period, it suggests that risk premiums were rising at the same time as bond yields were increasing – but shares declined even further, indicating that growth expectations were also falling. With the benefit of hindsight we can observe that share market analysts have continued to cut earnings per share (EPS) forecasts for the S&P500 Index since the middle of September.

The Bloomberg Consensus Economics forecast is for US interest rates to reach 1% (ie double from current levels) within 1 year, and similarly for US 10 year bond yields to reach 2.17% by the end of next year. If that occurs, growth expectations do not increase, and relationships remain as in September, we would expect the US share market to decline by ~5% (refer to Table 1 for outcomes in other scenarios). It's important to note that it's not sufficient for growth as currently forecast to be delivered; earnings expectations must increase from here to offset the increase in the cost of capital. This is not without its challenges given share market analysts are already forecasting over 10% earnings growth across the S&P500 Index for each of the 2016, 2017 and 2018 calendar years! As noted in previous quarterly updates, US earnings are currently very elevated versus longer term trends and the profit share of income is unusually high. These things increase our nervousness about the future path of earnings and robustness of share prices.

For sectors like Real Estate Investment Trusts (REITS), which have lower growth expectations and a lower cost of capital already, there is even more sensitivity to changes in bond yields. Using the same model, but calibrated for valuations and growth expectations for the US REIT sector, we would expect the same 50 basis points increase in the cost of capital to coincide with more than an 11% decline in REIT valuations (see Table 2); over double the decline suggested for US shares overall.

Table 1: The potential impact of interest rate changes on the US share market (S&P 500 Index)

Change in interest rate

Change in terminal growth	-	0.25%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.00%
-2.00	-12.4%	-14.3%	-16.1%	-17.9%	-19.5%	-21.1%	-22.7%	-24.2%	-25.6%
-1.50	-9.7%	-11.8%	-13.7%	-15.5%	-17.3%	-19.0%	-20.7%	-22.2%	-23.8%
-1.00	-6.8%	-9.0%	-11.0%	-13.0%	-14.9%	-16.8%	-18.5%	-20.2%	-21.8%
-0.50	-3.6%	-5.9%	-8.2%	-10.3%	-12.3%	-14.3%	-16.2%	-17.9%	-19.7%
-	0.0%	-2.6%	-5.0%	-7.3%	-9.5%	-11.6%	-13.6%	-15.5%	-17.4%
0.50	4.0%	1.2%	-1.5%	-4.0%	-6.4%	-8.6%	-10.8%	-12.9%	-14.8%
1.00	8.4%	5.3%	2.4%	-0.3%	-2.9%	-5.4%	-7.7%	-10.0%	-12.1%
1.50	13.3%	9.9%	6.7%	3.7%	0.9%	-1.8%	-4.3%	-6.8%	-9.1%
2.00	18.9%	15.1%	11.6%	8.3%	5.2%	2.2%	-0.6%	-3.2%	-5.7%

Source: JANA analysis, DataStream data.

Table 2: US REITs (MSCI US Real Estate) sensitivity to changes in interest rates

Change in interest rate

Change in terminal growth	-	0.25%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%	2.00%
-2.00	-29.6%	-32.4%	-35.1%	-37.5%	-39.7%	-41.8%	-43.8%	-45.6%	-47.3%
-1.50	-24.3%	-27.6%	-30.7%	-33.5%	-36.1%	-38.5%	-40.7%	-42.8%	-44.7%
-1.00	-17.9%	-21.9%	-25.5%	-28.8%	-31.8%	-34.6%	-37.1%	-39.5%	-41.6%
-0.50	-10.0%	-14.9%	-19.2%	-23.2%	-26.7%	-30.0%	-32.9%	-35.6%	-38.1%
-	0.0%	-6.1%	-11.5%	-16.3%	-20.6%	-24.4%	-27.9%	-31.1%	-34.0%
0.50	13.1%	5.2%	-1.7%	-7.7%	-13.0%	-17.7%	-21.9%	-25.7%	-29.1%
1.00	30.9%	20.2%	11.2%	3.4%	-3.3%	-9.2%	-14.4%	-19.0%	-23.1%
1.50	56.8%	41.3%	28.7%	18.2%	9.3%	1.7%	-4.9%	-10.7%	-15.8%
2.00	97.4%	73.0%	54.1%	38.9%	26.5%	16.2%	7.5%	0.0%	-6.5%

Source: JANA analysis, DataStream data.

The Investment Futures Framework: Scenarios and changes in return potential

In managing MLC's multi-asset portfolios we assess potential future risks and opportunities. We invest by understanding what would happen as opposed to picking the single future that will unfold. The future is not forecastable, indeed it is not predetermined. If we seek to understand what could happen, we can then seek at least an acceptable outcome regardless of what the future holds. Our approach assesses and analyses a comprehensive set of possible future scenarios –this is referred to as the Investment Futures Framework. 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. Risk is not a statistic; it arises from a range of real economic, political and business events. Using our Framework's comprehensive assessment of the potential sources of future risk we are equipped to position portfolios to extract return potential while maintaining the required risk control.

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 – as asset prices change, future return potential and possible future risks change. We take this evolution into account in positioning our portfolios.

The tailored scenario set currently consists of 13 scenarios (refer to Appendix 1). Due to the prevailing distortions, these scenarios contain more complexity and a wider range of outcomes for assets than would normally be the case. The pressure exerted by high debt loads, on both the real economy and policy, mean that outcomes will not just pivot along fundamental paths, but will be heavily influenced by central bankers, legislators, and importantly the reaction of agents within the economy to whatever path policy takes. Credible outcomes range from continuation of the status quo (ie 'Global growth convergence' scenario) to favourable improvements in nominal prices and improvements in capital productivity (ie 'Inflationary debt resolution' scenario) through to the stagnation and risk aversion environments that we expect would eventuate should today's unorthodox monetary policies fail. And while further disinflation and deflation appear to be the obvious near term direction of prices, we take account of the possibility of an ultimate inflationary outbreak – which like any risk needs to be addressed before it manifests. We also take into account the potential for decisive reforms to restore growth potential faster than is currently anticipated.

As the future unfolds, we reassess the nature of the starting point – which scenario are we in? – and the propensity for that environment to transition into a range of other scenarios. Our perceptions of this evolution point include a potential diminution of monetary policy efficacy and a growing concern about the behavioural distortions flowing from policy settings. We note that central bank rhetoric appears to be shifting at the same time that social unrest (expressed in the Brexit vote, the course of the US presidential campaign, and rise of euro-sceptic/anti-immigration parties in Europe) is encouraging a more expansionary fiscal stance and rising risk of protectionist policies. Greater reliance on fiscal policy may increase inflation risks but help bolster growth, while protectionism increases inflation risk while constraining economic growth potential. There appears to be a heightened fragility and vulnerability to shocks. Our scenario design and probabilities largely capture these tendencies, we are again reviewing how we are placed to take greater account of a potential policy shift.

What also drives quarter to quarter changes in return potential and risk are changes in asset prices through the quarter. For example, the rise in share prices over the past quarter has reduced future return potential and increased risk. This has been an unfavourable period for our defensive positioning. The past year has been characterised on average by a risk-on environment with shares and the Australian dollar (AUD) rallying. While over longer periods our foreign currency positioning has been beneficial, over the past year we have given back from returns despite reducing our foreign currency exposures.

The potential real returns for each asset class are shown in Chart 1 on page 9. 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 2, on page 9, shows return potential for the MLC Horizon and Inflation Plus portfolios.

The return potential for long nominal bonds remains highly adverse. The current risk/reward trade-off for Australian shares still compares favourably to global shares, however this is largely a reflection of large differences between industry sectors of the Australian and global share markets. Depressed commodity prices and poor sentiment towards Mining and Energy stocks has dampened valuations within these (highly cyclical) sectors to levels significantly below the broader market; while other important sectors (including Financials) trade at a premium, which in some cases is extreme (eg Healthcare, Utilities and Consumer Staples). This means that a key issue in determining the appropriate allocation to Australian shares revolves around the assessment of the extent to which potential risks are fully reflected into current Mining and Energy share prices. Also, we remain concerned about the potential for a highly adverse scenario arising from the nexus of high household debt, elevated residential property prices and a reliance on foreign funding. This creates unpleasant tail risk for Australian shares. The impact of sector concentration is clear in the models of our tailored set of scenarios.

Our current positioning

The past year has been a difficult period for our defensively managed portfolios. 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 over longer periods, we are far from complacent about the future challenges. Nimbleness and flexibility are more important than ever if we are to both generate returns and control risk, but it is undeniable that the challenges of doing both have 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 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 fixed income markets. These asymmetries remain to an extent but the medium-run fall in the AUD significantly weakens our key risk diversifier. As the AUD fell towards purchasing power parity (PPP), our Framework led us to reduce exposure to foreign currencies across the MLC Inflation Plus portfolios early in 2016. Since then, the AUD's recovery during the past year to the mid-70's against the US dollar (USD) has partially restored the upside/downside skew, but not to the extent required to extend our recently reduced foreign currency positioning in the MLC Inflation Plus portfolios. In fixed income markets, we observe that while bond yields could follow what is now a very long-term trend and decline even further, the extent of this is very limited relative to the potential for yields to rise. This means that the opportunity cost from shortening duration (ie having a lower than benchmark exposure to interest rate risk) is low relative to the risks faced by owing duration should yields rise. During the quarter we shortened the duration of our inflation-linked bond exposures, this enabled us to maintain inflation risk while reducing interest rate exposure.

Similarly, while there are circumstances in which the AUD could regain further strength (and we assume it does in a number of our scenarios), on current pricing the downside factors are arguably still an efficient diversifier of some portfolio risk. Because of this, while our exposures to foreign currency have reduced, it remains significant exposure within the MLC Inflation Plus portfolios (particularly the Assertive portfolio), and we remain overweight to foreign currencies across the MLC Horizon 2 to MLC Horizon 7 and Index Plus portfolios. 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. The market dynamics of the AUD in the first half of 2016 are a sharp reminder that the AUD can rally quickly. This reinforces the importance of our option-based risk management strategies to complement exposure to foreign currencies, particularly the strong USD.

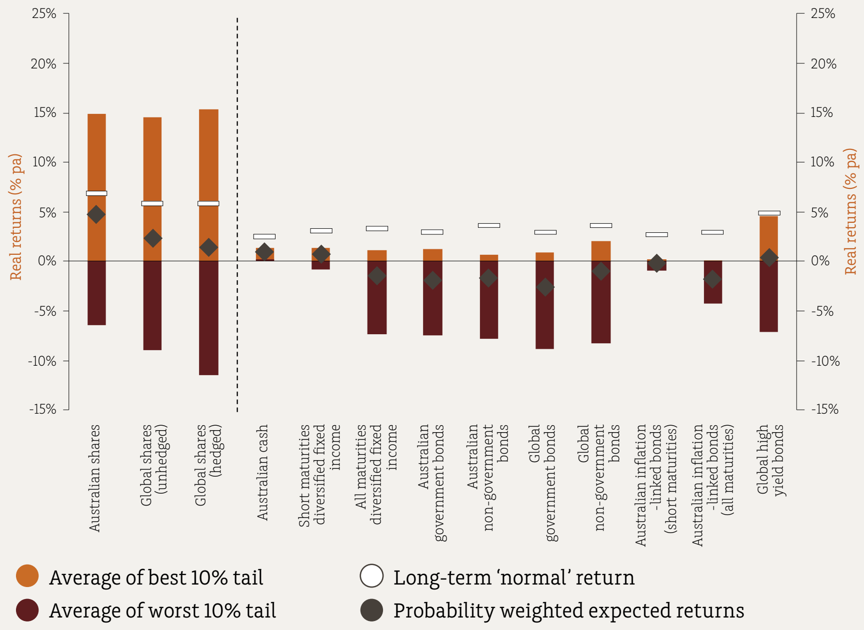
Performance expectations

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

MLC HORIZON AND MLC INFLATION PLUS PORTFOLIOS

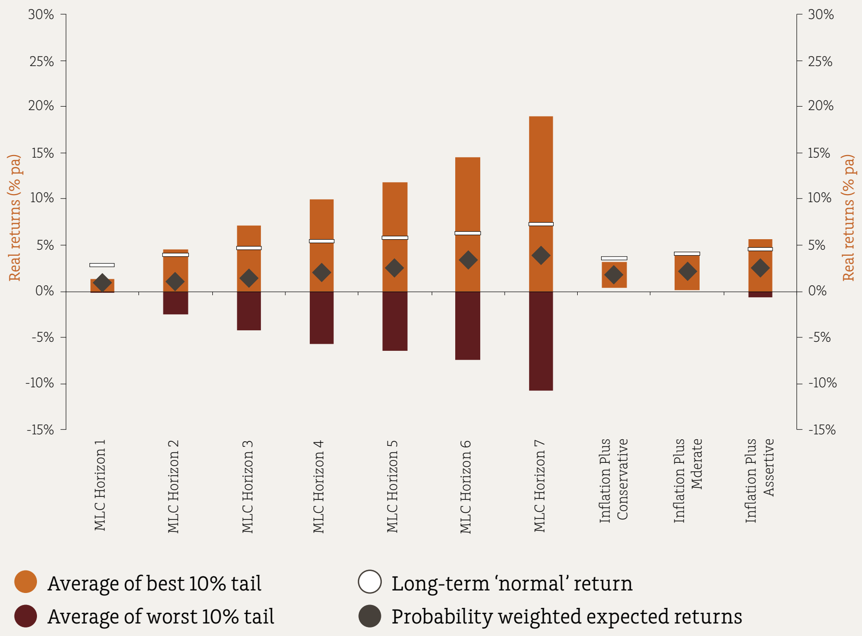
MLC'S SCENARIO INSIGHTS & PORTFOLIO POSITIONING

CHART 1: 40 SCENARIO SET (GENERIC SCENARIOS) POTENTIAL REAL RETURNS (SEPTEMBER 2016)
5 YEARS, 0% TAX WITH FRANKING CREDITS, PRE-FEES, PRE-ALPHA



Source: JANA Corporate Investment Services Limited.

CHART 2: 40 SCENARIO SET (GENERIC SCENARIOS) POTENTIAL REAL RETURNS (SEPTEMBER 2016)
5 YEARS, 0% TAX WITH FRANKING CREDITS, PRE-FEES, PRE-ALPHA



Source: JANA Corporate Investment Services Limited.

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 2 on page 9 looks at our barometer of risk and return – based on our generic (40) scenario set, described on page 7 – for the MLC Horizon and Inflation Plus portfolios looking forward from the end of September 2016. 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 risk 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.

MLC Inflation Plus portfolios

The MLC Inflation Plus portfolios have flexible asset allocations with few constraints which enable targeting tight control of risk over each portfolio'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 capital preservation over each portfolio's investment time frame.

Returns over the past year have been very modest, particularly relative to those generated in prior years. The past 12 months have been challenging for our defensive positioning. While the AUD has declined over longer periods, over the past year it has had some renewed strength and this has reduced returns. The portfolios' multi-asset real return allocations has been value adding, while defensive global shares have not fully participated in recent share price rises, with a strong focus on risk control being maintained. During the quarter we have increased inflation protection with the addition of the short duration inflation-linked bonds strategy.

Here is a summary of changes to the positioning over the quarter for the MLC Inflation Plus portfolios.

Asset class	Change in allocation to asset classes in the MLC Inflation Plus portfolios (in MLC MasterKey's super and pension products) 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	Call options protection maintained	Call options protection maintained	Call options protection maintained	The rally in the AUD has resulted in our sold put options expiring; this means that effectively we have a zero cost long call options exposure. We are now in a position to build in more protection against AUD strength and will look to do so if the AUD weakens.
Gold			Maintained small allocation	Gold helps protect the portfolio against a range of shocks and inflationary scenarios. However the gold price can be volatile and the concept of fair value is nebulous.
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.
Real return strategy	Steady allocation	Steady allocation	Steady allocation	
Emerging markets strategy	Steady allocation	Steady allocation	Steady allocation	Allocation recognises emerging economies and markets are vulnerable to US monetary policy normalisation.
Global private assets	Steady allocation	Steady allocation	Steady allocation	The private assets allocation for the MLC Inflation Plus - Assertive Portfolio (in MLC MasterKey's superannuation and pension products) has been above target.
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 REITs in scenarios in which monetary policy normalises.

MLC Inflation Plus portfolios
continued

Asset class	Change in allocation to asset classes in the MLC Inflation Plus portfolios (in MLC MasterKey's super and pension products) over the September quarter			Comment
	Conservative	**Moderate**	**Assertive**	
Global government bonds	Zero direct exposure	Zero direct exposure	Zero direct exposure	Deeply unattractive, with limited diversification benefit.
Australian inflation-linked bonds	**Shorter duration allocation introduced – exposure increased**	**Shorter duration allocation introduced -exposure increased**	**Shorter duration allocation introduced - exposure increased**	We have introduced an exposure to short duration inflation-linked bonds. This was funded from a reduced exposure to cash and all maturities inflation-linked bonds. For MLC Inflation Plus - Assertive a small exposure to the all maturities inflation-linked securities strategy has been retained.
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	**Reduced allocation**	**Reduced allocation**	**Reduced allocation**	Reduced exposure. 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 continue to keep significant powder dry (in cash) waiting for better opportunities. The benefit of cash allocations comes from the optionality it provides in a risk-off environment.
Borrowings			No borrowings	Reward for risk is too limited.

MLC HORIZON AND MLC INFLATION PLUS PORTFOLIOS

MLC'S SCENARIO INSIGHTS & PORTFOLIO POSITIONING

MLC Horizon portfolios

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 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.

For MLC Horizon and Index Plus portfolios we are maintaining a relatively defensive orientation. Over the past year the defensive positioning and particularly the foreign currency overweight have detracted from returns. However, while we continually test our thinking, we retain high conviction in the appropriateness of this positioning.

MLC Horizon portfolios
continued

	MLC Horizon 4 Balanced Portfolio (Super & Pension) weights at end of the September quarter			Comment
	Under	Benchmark	Over	
Growth assets		●		
Australian shares		●		Allocations have been reduced over the past year, However we have reduced both target and benchmark allocations leaving a neutral positioning versus benchmark.
Global shares (unhedged)			●	We continue to be overweight foreign currencies (underweight the AUD), with an overweight allocation to unhedged global shares at the expense of hedged global shares. While foreign currency remains an important source of risk control, its power as a risk diversifier has reduced as the AUD declined significantly in 2015. Over the past year the fall in the AUD has significantly detracted from returns.
Global shares (hedged)	●			
Global property securities		●		Retain benchmark allocation – the benchmark allocations are underweight versus peers.
Defensive assets	●			
Cash			●	Overweight reduced for MLC Horizons 2, 3, 4 and 5 and Index Plus portfolios.
Australian bonds – All Maturities	●			Underweight maintained in Australian bonds for MLC Horizons 3 and 4 and Index Plus this quarter.
Australian inflation-linked bonds	●			MLC Horizons 2 to 5 and Index Plus have introduced an exposure to short duration inflation-linked bonds. This was funded through a reduced exposure to cash and all maturities inflation-linked bonds.
Global bonds – All Maturities	●			Underweight maintained.
Global non-investment grade bonds (high yield bonds and loans)		●		Retain benchmark allocation.

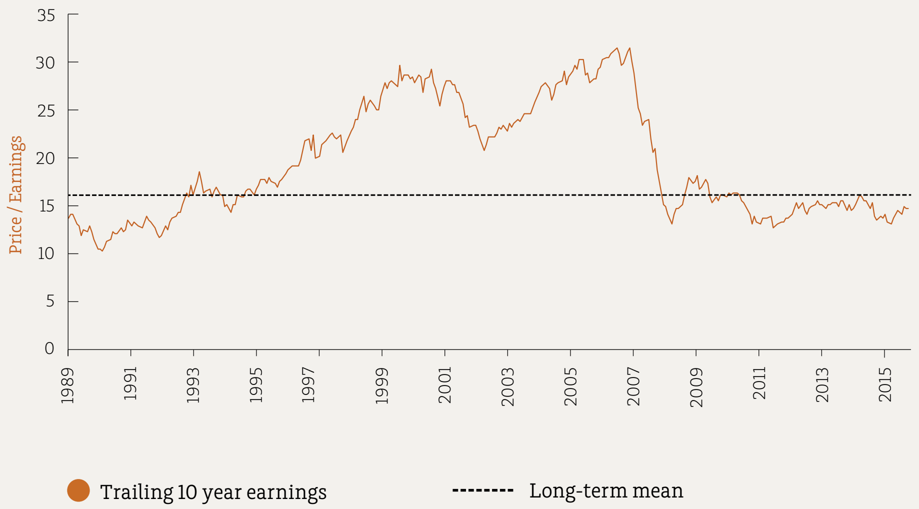
MLC Horizon portfolios
continued

	MLC Horizon 4 Balanced Portfolio (Super & Pension) weights at end of the September quarter			Comment
	Under	Benchmark	Over	
Alternatives			●	
Global private assets		●		Retain benchmark allocation.
Real return strategies (including Inflation Plus)			●	MLC Horizon 4 remains overweight real return strategies, other portfolios are at benchmark. We believe the allocation to real return strategies provides the portfolio with a greater potential ability to preserve investors' capital in volatile markets and provides our investors with potentially better investment returns for the level of risk we take.
Low correlation strategy		●		This fund of hedge funds strategy aims to generate a return above cash and deliver returns that are mostly independent of share market performance.

Asset class indicators

Our view of the main asset classes is as follows.

AUSTRALIAN SHARES
Market indicator *S&P/ASX 200*



Source: Global Financial Data.

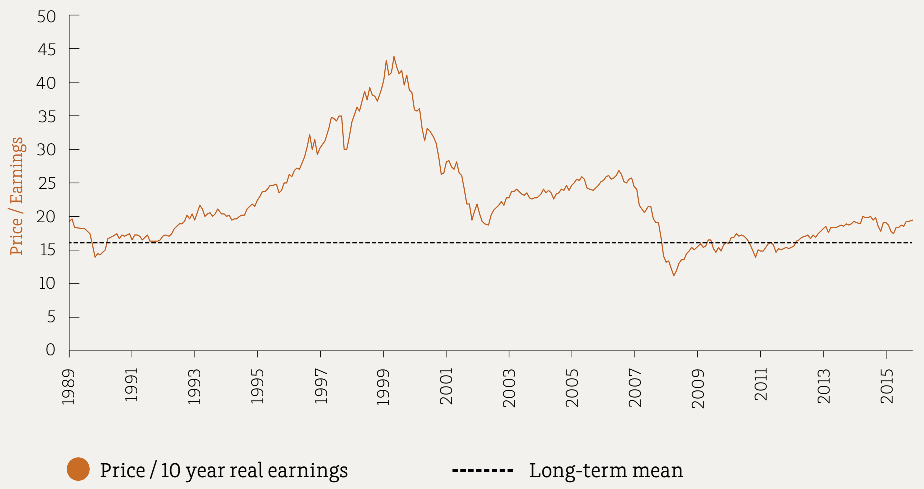
Comment

Australian shares recorded a solid 5.1% return for the quarter (S&P/ASX 200 Accumulation Index). Notably investors favoured the Resources sector (13.4%) given the rebound in coal and oil prices. The Consumer Discretionary sector (8.1%) benefited from the Reserve Bank of Australia's (RBA's) interest rate cut in August. However Telecommunications (-6.6%) and Utilities (-2.4%) both disappointed given their acute interest rate sensitivity.

Asset class indicators continued

GLOBAL SHARES

Market indicator *MSCI All Country World Index*



Source: Factset.

Comment

Global shares managed to make solid returns in the September quarter, recording a robust 5.4% return in hedged currency terms. However the stronger AUD lowered the unhedged global share performance to 2.6% for the quarter.

US economic activity was mixed but modest in the September quarter. There has been a moderation in US jobs growth and retail spending. While the Fed has delayed raising US interest rates, September's policy meeting did note that the case for higher interest rates had "strengthened". America's low unemployment at 4.9% and progressive increases in labour costs suggests that US inflationary pressures are building.

European economic data has been surprisingly resilient. European business surveys have been positive and the unemployment rate has gradually fallen to 10%, which is the lowest jobless rate since 2011. Yet European price pressures remain sedate with annual inflation near 0%. This is well below the central bank's 2% inflation target. Accordingly the European Central Bank (ECB) has maintained their assertive policy stimulus program of negative deposit interest rates and asset purchases.

Britain's vote to withdraw from the European Union in June ("Brexit") initially undermined confidence with a dramatic fall in the sterling exchange rate. However investors have taken comfort with the UK central bank's interest rate cut in August which has supported UK shares so far.

China's economic activity is solid and stable. China's industrial production has managed a 6% annual growth rate while retail spending remains robust at 10% growth. China's residential property markets are exuberant with new house prices recording strong gains.

Japan appears to have struggled in terms of economic activity. The sharp surge in the yen has dented business confidence and industrial production while inflationary pressures have faded. Japan's central bank has announced a 0% yield target for longer government bonds to maintain low interest rates.

Emerging markets have provided positive signals allowing for the political concerns. Turkey's attempted military coup on 15 July caused initial turbulence. However the rapid restoration of Turkey's political leadership calmed financial markets. India's economic growth is running at a robust 7% annual rate while inflation has moderated to 5%. Even Brazil's recession has moderated with a change in the political leadership. Emerging markets shares (unhedged) delivered an impressive 6.2% return for the quarter.

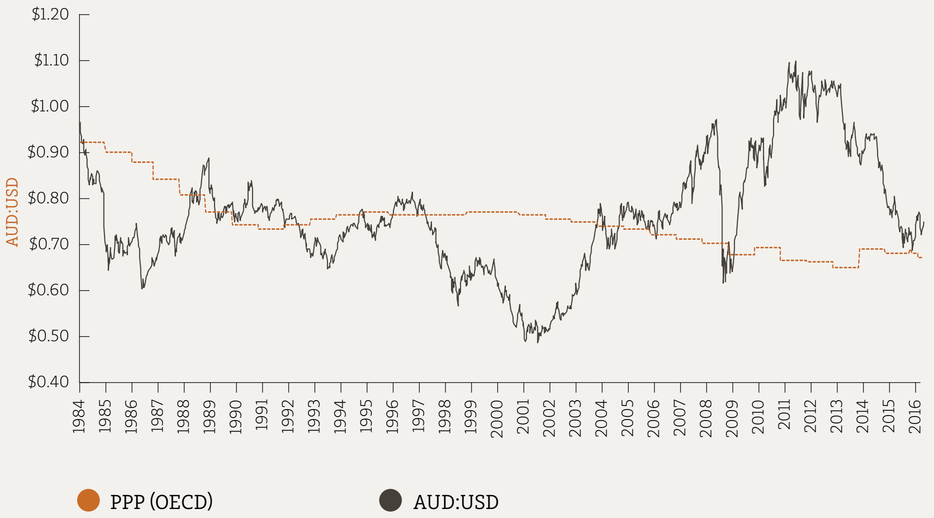
MLC Horizon and MLC Inflation Plus portfolios

MLC's scenario insights & portfolio positioning

Asset class indicators continued

Australian dollar

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



Source: Bloomberg.

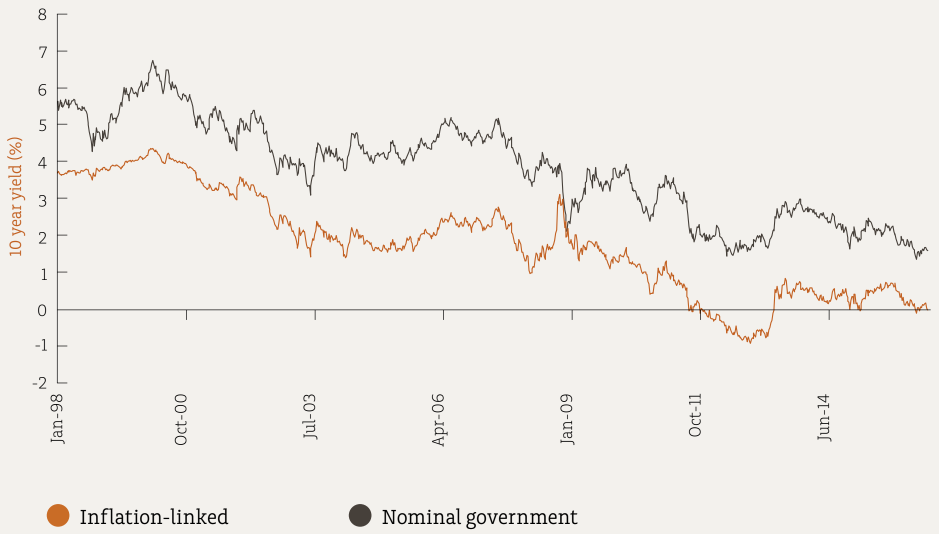
Comment

The AUD performed strongly during both the quarter and year.

Australia recorded solid economic activity over the September quarter. Australia's labour market has managed reasonable jobs growth with the unemployment rate edging down to 5.6%. The National Australia Bank's business survey shows positive business conditions. However the surprisingly low 1% annual inflation result for the June quarter motivated the RBA to cut the official cash rate from 1.75% to 1.50% in August.

Global government bonds

Market indicator *10 year bond yields – United States*



Source: Bloomberg.

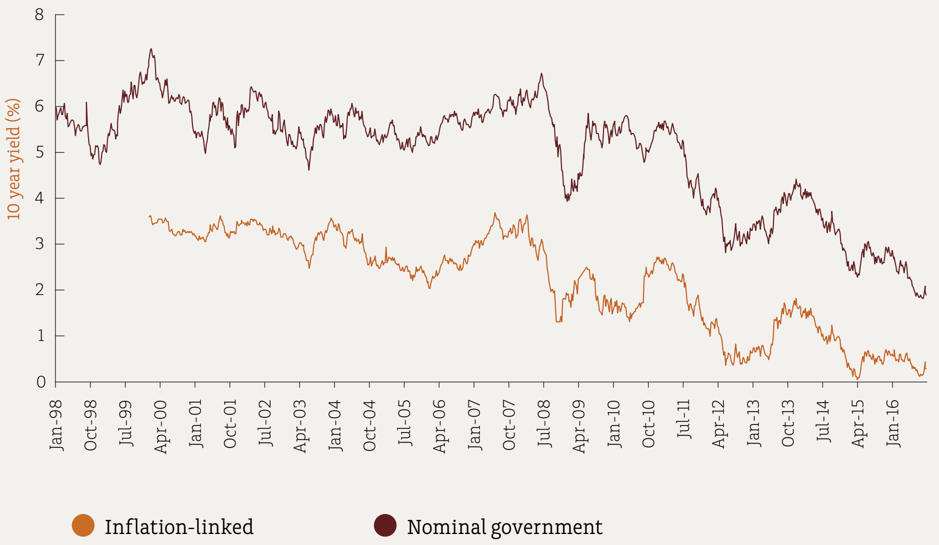
Comment

Global government bond yields (hedged) delivered a more modest 0.8% return for the quarter. Concerns over Europe's prospects after Brexit have partially faded. The prospect of the Fed raising US interest rates and the revival in commodity prices has seen investors become less positive about low government bond yields.

Asset class indicators continued

AUSTRALIAN GOVERNMENT BONDS

Market indicator *10 year bond yields – Australia*



Source: Bloomberg.

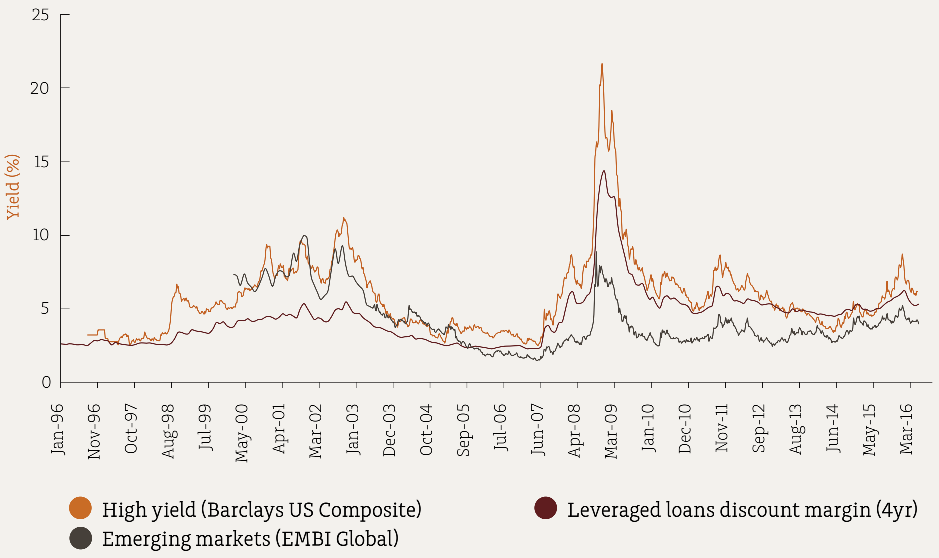
Comment

Australian government bond yields have essentially moved sideways over the quarter with Commonwealth 10 year bond yields trading between 1.8% and 2.1%. This has allowed Australian bonds to deliver a solid 0.9% return for the quarter.

Asset class indicators continued

NON-INVESTMENT GRADE BONDS

Market indicator *Fixed income spreads*



Source: Credit Suisse, Barclays and Bloomberg.

Comment

Global credit spreads narrowed over the quarter. The solid rebound in global risk appetites after Brexit has been very evident in credit markets. Investors are taking the view that the central bank guidance of low policy interest rates for a considerable period favours credit as an asset class. Global high yield bonds (hedged) delivered a strong 3.2% return for the quarter.

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 led 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 and AUD vs JPY and euro.
Negative nominal interest rates	2	Central banks of Japan and Europe move further into negative deposit rates with the Fed and the Bank of England inching towards negative policy rates. 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 further extensions of monetary policy have less impact on asset market pricing. 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. China's 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.
Slow global growth deleveraging	3	A prolonged and slow consumer deleveraging. Slowing consumption growth and falling nominal prices extend the deleveraging cycle. There is global growth convergences as persistent slow growth and further disinflation in the developed world spills over into the now highly indebted emerging world.
Inflationary debt resolution	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 and global productivity levels decline. Emerging markets experience more severe inflation than the developed world, slightly normalising the growth differential across the emerging markets and developed markets.
Synchronised moderate growth	5	Japan's and Europe's growth approach trend levels, while the US, UK and China moderate resulting in a synchronised modest global growth scenario.
Early re-leveraging	6	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.

Appendix 1 – tailored scenario set continued

Scenario	Probability ranking	Description
Reform (path to growth normalisation)	7	A growth upside scenario contingent upon coordinated reforms that address inefficiencies that are idiosyncratic to particular economies (eg labour in 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 reduces growth constraints.
Australian stress	8	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 banks which requires central bank intervention.
Rise in USD risk premium	9	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 that undermines key safe haven currencies including the USD. 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.
Stagflation	10	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 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.
Monetary failure	12	A distinctive and hence important scenario that accounts for the possibility of unorthodox monetary policy to fail. Ineffective or stop-go policy, in the absence of meaningful fiscal stimulation, could result in this scenario that could lead to global stagnation, recessionary or even hyperinflationary conditions. In this scenario investors and consumers lose faith in the ability of monetary policy to resolve critical imbalances within the global economy. Developed market economic expansion is negligible and emerging markets slow down significantly, running the risk of a crash. Shares perform poorly. Commodities fall. Nominal yields rally further and remain low.
Extended risk aversion	13	A generic scenario to capture prolonged aversion to risk. An immediate potential trigger for this scenario is the disorderly exit of countries 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. Similar to stagflation, though assumed growth is higher. Sharp rise in inflationary expectations.

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.

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