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MLC's scenario insights & portfolio positioning

MLC Horizon and MLC Inflation Plus portfolios

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Last quarter we contemplated the ways in which the market environment might change. We noted that *well-directed fiscal policy coupled with structural reform provides the best sustainable prospect for raising productivity, wages, demand and growth*. Following the election of Donald Trump, markets have rapidly priced in such a higher growth scenario based on expectations of infrastructure spending and deregulation.

The rapid abandonment of the **Lower for longer** scenario reminds us of the dangers of being too grounded in the recent past. It is always hard to imagine a scenario which is significantly different from that we are currently experiencing, but it is essential to do so to sustainably generate returns.

Sustainable return generation requires that we control the risk of negative returns. At times this means that we must adopt a defensive position while returns are still strong. This has been the case over the past year, and particularly the final quarter, where our defensive positioning, particularly within the MLC Inflation Plus portfolios, has caused returns to lag. The most challenging environment for us is one where returns remain strong even though risk is high. We understand that this tests the patience of our investors. However, despite the strong run in risk assets over the past year, we believe our strategies were appropriately positioned given what was knowable at the beginning of the period. We recognised the potential for strong returns, but the desire to capture those returns was offset by the need to avoid negative returns. We constantly debate what the right trade-off is between return seeking and risk control.

Potential market returns are always changing, and as they change we re-assess this trade-off.

Future market outcomes depend on where we start from, what changes along the path and the scenario that eventuates. As compared to the end of September, we are facing changes to both the starting point and the possible paths forward:

- There has been a shift in what markets are assuming about future US policy and the real economy – this has changed starting point asset prices.
- Market pricing is anticipating a positive change in US economic policy – however both actual policy and implications for the economy are uncertain.
- Also there remain notable risks outside the US; most obviously we should anticipate the possibility of further popular dissent - 2017's presidential election in France, for which there is a strong anti-euro far right candidate, is an obvious source of potential dislocation. More generally, the rising forces of nationalism (which will tend to intensify as technological innovation continues to displace labour), in combination with US policy shifts which will reverberate around the global economy and associated geopolitical tensions suggest a much more volatile 2017. Adding to this instability are concerns that China will focus on economic growth rather than debt control and reform as President Xi Jinping seeks to concentrate power before the 19th Party Congress.

Recent developments have changed the set of possible future outcomes. Both strong positive returns and significant negative returns have become more likely. To date, markets have focused only on the possibility of a boost to growth and earnings, and are not taking into account that certain risks have also increased.

- **Bond yields have risen** (bond prices have fallen) – this starts to restore return potential for nominal bonds, however long nominal bonds remain unattractive.
- **Share prices have risen** and credit spreads have declined – this reduces return potential and creates risk if expectations for a positive policy shift are disappointed.

This situation is challenging for portfolio positioning. It means that risk is higher, and the costs of risk control have increased. At the same time scenarios in which risk control appears misguided, have become more likely.

Table 1 outlines the range of key scenarios pivoting around US policy direction.

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.

Table 1: The range of key scenarios pivoting around US policy direction

Scenarios from highest to lowest returning	Summary	Real economy	Markets
Speculative bubble	Animal spirits lift the prices of risk assets. We note that even in a highly positive scenario for US Earnings Per Share (with double digit earnings growth supported by a cut in the effective corporate tax rate to 20%) the cyclically adjusted market Price-Earnings ratio is already clearly expensive relative to history.	Moderate growth, modest inflation rise.	Markets continue to anticipate better times leading market valuations towards extreme levels. Bond yields likely to rise as markets continue to discount higher growth and inflation.
Trump optimism validated This can play out in a number of ways including: • **Three speed global economy** • **Reform** • **Inflationary debt resolution with rise in productivity**, and • **Inflationary growth.** If inflation outweighs growth, a **Recession** scenario may ultimately result.	Trump has promised a boost to infrastructure spending. We observe that Trump's cabinet has a pro-business, pro free market bias which increases the prospects for a reduction in regulatory costs and lower taxes. Well directed fiscal stimulus and/or reform boosts confidence (including tax cuts and deregulation in the US; in Japan the Abe government is well positioned to finally implement reforms to tackle the challenges of its aging population and respond to global shifts). US growth is higher. If the focus is primarily on deregulation, rather than stimulating demand, the rise in growth and inflation are more muted (this version of the scenario is less positive for commodity producers). Where there is a more significant boost to demand, the mix of growth and inflation depends on how well-directed policy is and, related to that, the boost to productivity.	Best case has nominal growth 5% pa plus, inflation around 2% pa - also higher inflation and lower growth versions of this scenario.	Shares perform modestly well (earnings rise but risk premiums also rise), fears in bond markets are contained (in part US bond yields are held down by low yields elsewhere). In a higher inflation version of this scenario, US bond yields are sharply higher. Elsewhere yield curves steepen. A strong US dollar (USD) and tighter monetary policy will reverberate across the global economy – most vulnerable are the emerging markets with the highest USD-denominated debt (including Venezuela, Brazil, South Africa and Indonesia). Potentially, if demand feeds through mainly into inflation the scenario ultimately plays out as a recession with the US Federal Reserve (Fed) initially behind the curve and then taking decisive action.

Table 1: The range of key scenarios pivoting around US policy direction continued

Scenarios from highest to lowest returning	Summary	Real economy	Markets
'Lower for longer' returns (Trump ineffective) This can play out in a number of ways including: • **Extended quantitative easing** • **Negative nominal interest rates**, and • **Monetary failure.**	No policy shift materialises.	Moderate growth, low inflation.	Recent market moves reverse. But the path forward depends on confidence in monetary policy – if that continues to wane shares face a more challenging scenario.
Trump disappoints For example, **Inflation shock** scenario.	Badly directed fiscal stimulus fails to increase efficiency; rorting undermines confidence. Tight labour markets mean that wages rise rapidly.	Inflation rises, real growth impact limited.	Adverse environment for both bonds and shares. US bond yields rise – to some extent dragging up yields elsewhere.
Risk aversion This can play out in a number of ways including: • **Extended risk aversion** • **Rise in USD risk premium** • **Australian stress**, and • **Eurozone slow disintegration.**	Trump optimism replaced by fear as trade protectionism escalates, or stimulus translates into higher inflation rather than growth; and/or the eurozone faces existential risk. There is also the possibility of rising geopolitical or security risks which undermine confidence.	Protectionism version of this scenario reduces growth and increases inflation. The selective imposition of US trade barriers with China risks both trade and security responses.	Share prices sharply lower. Bonds are a safe haven in some versions of this scenario, but bond prices are sharply lower in other cases, particularly where the US risk premium rises.

Table 2: Expected performance of the MLC Inflation Plus portfolios across different key scenarios

Table 2 discusses how we expect our multi-asset portfolios, MLC Inflation Plus portfolios in particular, to perform across these different scenarios and the trade-offs in determining portfolio positioning.

Scenarios from highest to lowest returning	How the portfolios are expected to perform	Trade-offs in portfolio positioning
Speculative bubble	Inflation Plus portfolio returns will appear very modest relative to strategies with high share allocations. Some offsetting benefit from interest rate risk control. In this environment index tracking strategies continue to do well.	We have some comfort in performance lagging in a **Speculative bubble** scenario since ultimately valuations will revert – however, we are aware that this will be challenging for investors and that we must retain investors' confidence if we are to serve their best interests.
Trump optimism validated This can play out in a number of ways including: • **Three speed global economy** • **Reform** • **Inflationary debt resolution with rise in productivity**, and • **Inflationary growth.** If inflation outweighs growth, a **Recession** scenario may ultimately result.	Inflation Plus portfolio returns will appear modest relative to strategies with high share allocations. However, active stock selection reasserts its superiority in these scenarios – economic fundamentals are the key driver. Where inflation rises, higher bond yields will support relative returns for MLC Horizon, Index Plus and Inflation Plus portfolios. If a recession scenario ultimately eventuates, bond markets would normally be stronger - our limited and underweight exposures in MLC Horizon and Index Plus would detract from returns. However, the extent of this is still out-weighed by the benefits of this positioning in other scenarios. Despite zero nominal bond allocations Inflation Plus portfolios should be resilient, particularly relative to traditional multi-asset portfolios generally.	The increase in the chance of a best case 'Trump' scenario has prompted a review of the Inflation Plus portfolios' positioning which is on-going. The most likely response is that (assuming this higher probability is maintained) we will be more nimble in buying following market dips, and hence tending to increase upside participation, most notably in Inflation Plus Assertive.
'Lower for longer' returns (Trump ineffective) This can play out in a number of ways including: • **Extended quantitative easing** • **Negative nominal interest rates**, and • **Monetary failure.**	If share markets resume rising, Inflation Plus portfolio returns will appear limited. However the probability of this outcome has been diminishing.	While the **Extended quantitative easing** scenario has been challenging for our defensive positioning in Inflation Plus, the risks of this persisting have diminished. Inflation Plus portfolios are expected to be well-positioned for a monetary failure scenario.

Table 2: Expected performance of the MLC Inflation Plus portfolios across different key scenarios continued

Scenarios from highest to lowest returning	How the portfolios are expected to perform	Trade-offs in portfolio positioning
Trump disappoints For example, **Inflation shock** scenario.	Portfolios have relatively strong risk control. MLC Inflation Plus portfolios are expected to be generally robust in higher inflation scenarios. MLC Horizon and Index Plus portfolios have been designed to have relative inflation robustness.	In making any changes to Inflation Plus portfolios to increase share allocations, we will be paying careful attention to scenarios in which share markets are under pressure.
Risk aversion This can play out in a number of ways including: • **Extended risk aversion** • **Rise in USD risk premium** • **Australian stress**, and • **Eurozone slow disintegration.**	The more defensive the positioning, the better the return outcome. In negative scenarios in which the Australian dollar is stronger outcomes are less favourable. However we continue to use a zero cost options overlay to reduce this risk exposure.	In making any changes to Inflation Plus we must carefully weigh the trade-off between increasing returns in strong scenarios versus increasing exposure to negative returns where share markets decline. Getting this trade-off right, and ensuring that risk control is as low cost as possible, are the most important challenges we face.

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The evolution in the investment environment is reflected in changes to scenario probabilities and some recalibration of the tailored scenario set. Notably the **Eurozone slow disintegration** scenario, which has had a zero probability, now comes into the set at 4% in addition to the more general **Extended risk aversion** scenario. These two increase the negative tail, while the most positive scenarios: **Reform** and **Three speed global economy**, are up-weighted too. In the comprehensive generic set of scenarios, both speculative and fundamentally supported stronger returning scenarios have increased probabilities, as do the tail scenarios. Overall probability-weighted returns are little changed, however the distribution of returns has shifted. The tensions between risk control and return seeking have intensified.

A key consideration in working out the appropriate trade-off is the assessment of the potential upside for share markets. The positives, if the Trump agenda delivers, include the prospect of higher nominal and real GDP which should boost corporate revenue and raise inflation expectations. Yet, perhaps more so than usual, the array of issues embedded in the current environment mean that the mix of growth and inflation is important. For example, while it is clear that US banks should benefit from a steeper yield curve, the ability of industrial companies to maintain margins is more challenging in the context of rising wages, funding costs and a stronger US dollar (USD), especially if pricing power has truly eroded. The swing factor may turn out to be the extent of corporate tax reform which has the potential to provide a significant earnings boost. The flow through of any rise in earnings into share market returns depends on what happens to market valuations. Even taking into account the possibility of double-digit earnings growth from tax cuts, current valuations are clearly elevated. Also, if fundamentals are improving and we have stronger growth, a higher risk-free rate and higher bond yields, this should lead to a rising equity risk premium. This would mean that while revenues and perhaps earnings rise, the translation into returns is not straightforward – it depends on the strength of 'animal spirits'. Surveys of market sentiment show a large surge in the number of people expecting the US share market to rise. While this is not necessarily a bullish signal (in fact, quite the contrary), the past reminds us that, in a speculative bubble, a shrinking risk premium is no barrier to ongoing share price gains.

The past year has been a difficult period for our defensively managed portfolios and we recognise the potential for the current environment to persist. 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. Our defensive positioning ahead of the strong rally in risk assets was well considered and appropriate given what was knowable at the time: despite the sell-off in risk at the start of 2016, the combination of elevated political and economic uncertainty, ongoing valuation richness and the muted scope for true diversification meant that we were unable to extend the risk within the portfolios to a meaningful degree. 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 further patience before return expectations are met.

MLC Horizon and MLC Inflation Plus portfolios

MLC's scenario insights & portfolio positioning

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 predetermined; it depends on what policy makers do, how companies behave and how these things compare to investors' expectations. As we start 2017 we are acutely aware that investors have become more optimistic.

Looking forward today we see growing uncertainty. Our aim is to understand the key things that could happen and then find at least an acceptable outcome regardless of what happens. With potential market outcomes bifurcated - meaning that both significant positive returns and significant negative returns are credible - we must accept either a greater risk of negative returns or of lagging strong markets. Our promise, particularly to our Inflation Plus investors, is to maintain the risk control discipline – this means that in a worst case scenario we must avoid significant negative returns over each portfolios' time horizon. However, our awareness of the possibility of a prolonged strong speculative rally means we need to be nimble and rapidly re-assess positioning, particularly on market pull backs. We also need to re-double efforts to seek new risk controlled market exposures. At the same time we see conditions which imply a cautious stance. Financial constraints are starting to tighten and share markets are more than fully priced. While we have the hope of US fiscal stimulus, its impact is uncertain given the constraint of a largely fully employed labour force.

Our tailored scenario set currently consists of 14 scenarios (refer to Appendix 1). We have added into the set a **Eurozone slow disintegration** scenario to capture the specific risks for Europe from rising populism. Due to the prevailing distortions and policy uncertainty, these scenarios contain more complexity and a wider range of outcomes for assets than would normally be the case.

It remains the case that 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 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 policies fail and fiscal stimulus disappoints or fails to materialise. We note that while the environment has for an extended period been characterised by disinflation and deflation this balance is starting to change, making it

The Investment Futures Framework scenario sets explained

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 our **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.

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essential to understand that the possibility of an inflationary outbreak is no longer remote. We must also take into account the potential for decisive reforms which restore growth potential faster than has been anticipated. However, at the same time, there is a heightened fragility and vulnerability to shocks.

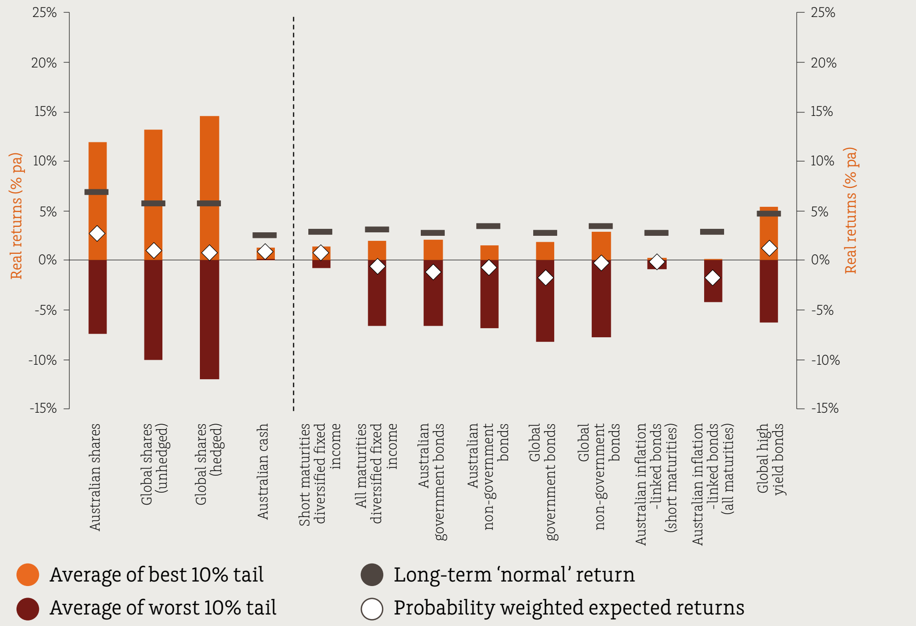
What also drives quarter to quarter changes in return potential and risk are changes in asset prices through the quarter. For example, the rise in share prices over the past quarter has further reduced future share market return potential and increased risk. This has been an unfavourable period for our defensive positioning. In contrast the rise in bond yields, for which portfolios were well positioned, has slightly improved the risk return trade-off for nominal bonds. The past year has been characterised on average by a risk-on environment with the US and Australian share markets having returned around 11%. For the US this occurred despite a decline in earnings over the year. A rebound in commodity prices supported the domestic market. Importantly we have introduced a defensive Australian shares strategy which will now enable us to access the parts of the share market offering an acceptable reward for risk, while avoiding risks we regard as unacceptable - we have continued to be concerned about risks for the Australian banking sector in certain adverse scenarios.

The potential real returns for each asset class are shown in Chart 1 on page 10.

The return potential for long nominal bonds is slightly improved but remains highly adverse. The current risk/reward trade-off for Australian shares still compares favourably to global shares, however this is mainly 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 Health Care, 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.

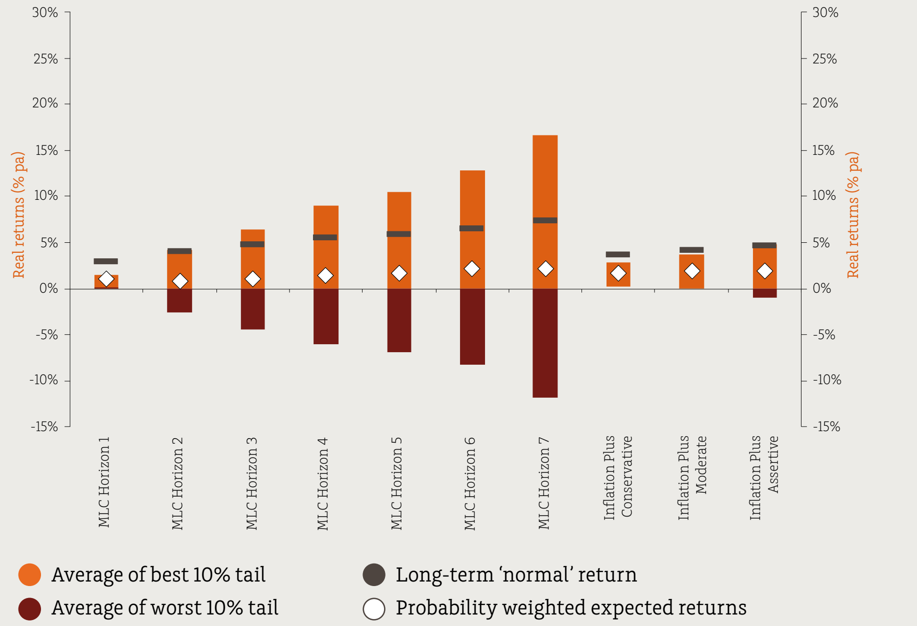
MLC's scenario insights & portfolio positioning

**Chart 1: 40 scenario set (generic scenarios) potential real returns (December 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 (December 2016)
5 years, 0% tax with franking credits, pre-fees, pre-alpha**



Source: JANA Corporate Investment Services Limited.

The probability-weighted real returns are shown in the graphs (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 and portfolios with wider ranges could have more extreme return outcomes than those with narrow ranges.

MLC Horizon and MLC Inflation Plus portfolios

MLC's scenario insights & portfolio positioning

Performance expectations

Chart 2, on page 10, shows return potential for the MLC Horizon and Inflation Plus portfolios based on our generic (40) scenario set looking forward from the end of December 2016.

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 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 the MLC multi-asset 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 us to target 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.

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 December quarter			Comment
	Conservative	Moderate	Assertive	
Australian shares	**Increased allocation**	**Increased allocation**	**Increased allocation**	Allocation increased with the introduction of the defensive Australian shares strategy. Our new defensive Australian shares strategy aims to more effectively control the risks involved in investing in Australian stocks. In this new strategy, we take into account risks identified in our scenarios analysis when making the stock selection. This creates a stronger alignment between our asset allocation and stock selection. Because risk control is more effective this facilitates a higher allocation to shares.
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	Protection maintained, we are reviewing increasing upside protection following the recent Australian dollar (AUD) decline.
Gold	Zero allocation	Zero allocation	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	Allocation to our multi-asset real return manager, Ruffer, maintained.
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.

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 December quarter			Comment
	Conservative	Moderate	Assertive	
Global property securities	Zero direct exposure	Zero direct exposure	Zero direct exposure	We prefer the broader opportunity and absolute return orientation of defensive global shares and multi-asset strategies. There is potential reversion in the prices of higher yielding assets such as Real Estate Investment Trusts (REITs) in scenarios in which monetary policy normalises.
Global government bonds	Zero direct exposure	Zero direct exposure	Zero direct exposure	Deeply unattractive, with limited diversification benefit.
Australian inflation-linked bonds	Steady allocation	Steady allocation	Steady allocation	Maintaining emphasis on short duration inflation-linked bonds which helped protect returns as yields rose during the quarter.
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	Steady allocation	Steady allocation	Steady allocation	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	Borrowing not permitted	Borrowing not permitted	No borrowings	Reward for risk is too limited.

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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.

	MLC Horizon 4 Balanced Portfolio (Super & Pension) weights at end of the December 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 from peak levels. 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 increased for MLC Index Plus portfolios.
Australian bonds – All Maturities	•			Underweight maintained in Australian bonds for MLC Horizons 3 and 4 and Index Plus.
Australian inflation-linked bonds		•		This allocation to inflation-linked bonds in MLC Horizons 2 to 5 and Index Plus portfolios includes exposure to both short and all maturities duration inflation-linked bonds. The portfolios are underweight all maturities exposure, and overweight the short duration exposure which reduces interest rate risk.
Global bonds – All Maturities	•			Underweight maintained.
Global non-investment grade bonds (high yield bonds and loans)		•		Retain benchmark allocation.

MLC Horizon and MLC Inflation Plus portfolios
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MLC Horizon portfolios
continued

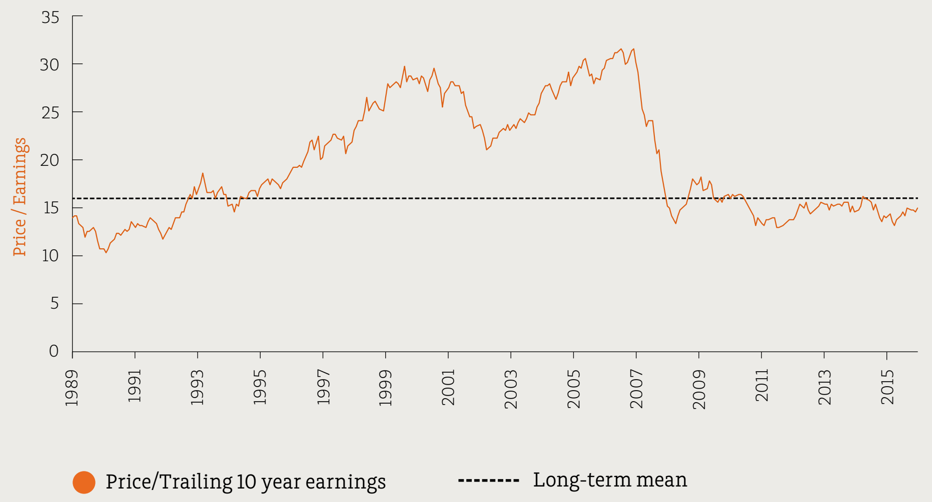
For MLC Horizon and Index Plus portfolios we are maintaining a relatively defensive orientation. Over the past year the defensive positioning and particularly the foreign currency overweight have detracted from returns. However, while we continually test our thinking, we retain high conviction in the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

	MLC Horizon 4 Balanced Portfolio (Super & Pension) weights at end of the December quarter			Comment
	Under	Benchmark	Over	
Alternatives			●	
Global private assets		●		Retain target benchmark allocation.
Real return strategies (including Inflation Plus)			●	MLC Horizons 4 and 5 remain 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. From December the MLC Index Plus portfolios also have an allocation to a real return strategy.
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.

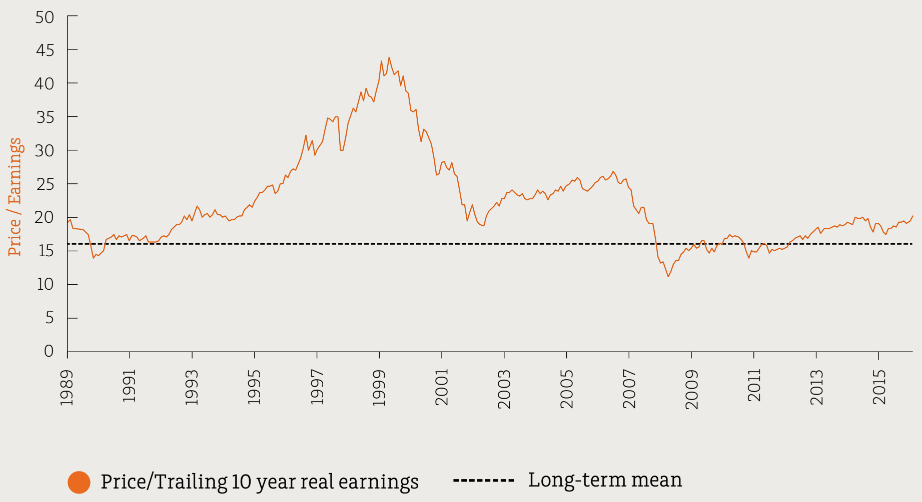
Comment

Australia has recorded mixed economic data. Australia's economic activity fell in the September quarter with real GDP declining by 0.5%, thereby raising concerns over a possible recession. This was countered by solid monthly job gains, stronger retail sales and a stable National Australia Bank business survey. This suggests that Australia's weak GDP result should only be a temporary growth setback. Australia's inflationary pressures are turning up with the September quarter annual inflation rate recorded at 1.3%. This has tempered expectations for any further Reserve Bank of Australia (RBA) cuts to the official cash interest rate at 1.5%.

Australian shares posted a robust return of 5.2% for the past quarter (S&P/ASX 200 Accumulation Index). Notably investors favoured banks (Financials ex REITs 12.8%) and the Resources sector (8.7%) given the recovery in coal and iron ore prices. Previously favoured defensive sectors such as Health Care (-8.8%) and Telecommunications (-4.3%) were penalised during the quarter as investors switched out of these sectors. Interest sensitive sectors such as Australian REITs (–0.8%) also underperformed given the sharp rise in global government bond yields.

Asset class indicators continued

Global shares
Market indicator *MSCI All Country World Index*



Source: Factset.

Comment

Global shares made strong returns in the final quarter of 2016. Global shares rose by 4.1% in local currency terms (MSCI All Country World Index). Global shares were notably resilient considering the political risks with the US Presidential election and Italian referendum as well as the sharp rise in government bond yields.

US economic activity has been solid in terms of jobs growth and retail spending. The Fed raised US interest rates in December by 0.25% given the improving labour market and growth performance. Donald Trump's surprising Presidential election victory boosted Wall Street with the promises of corporate tax cuts and more infrastructure spending. US shares surged by 3.7% for the quarter (S&P 500 Index).

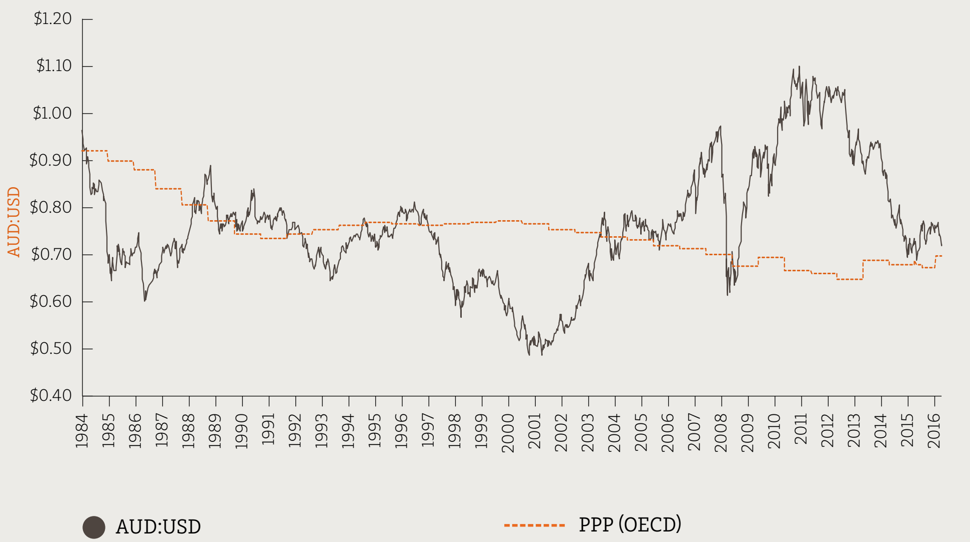
Concerns on the health of the European banking system and Italy's constitutional referendum in December initially weakened European shares. However the European share market staged a remarkable rebound in December which has allowed the region to post a positive gain of 8.0% for the quarter (Euro STOXX).

Japanese shares also performed strongly with a 16.4% gain (Nikkei 225 Index) as the central bank's commitment to low bond yields and a weaker yen supported risk taking.

Emerging markets have struggled given concerns over capital flows and currency stability with the Fed raising US interest rates. Emerging market share returns slipped by 1.4% in local currency terms for the December quarter (MSCI Emerging Markets Index). Hong Kong shares (Hang Seng Index) fell by 5.6% despite more encouraging signs that China's economic activity has stabilised at a solid growth pace.

Asset class indicators continued

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

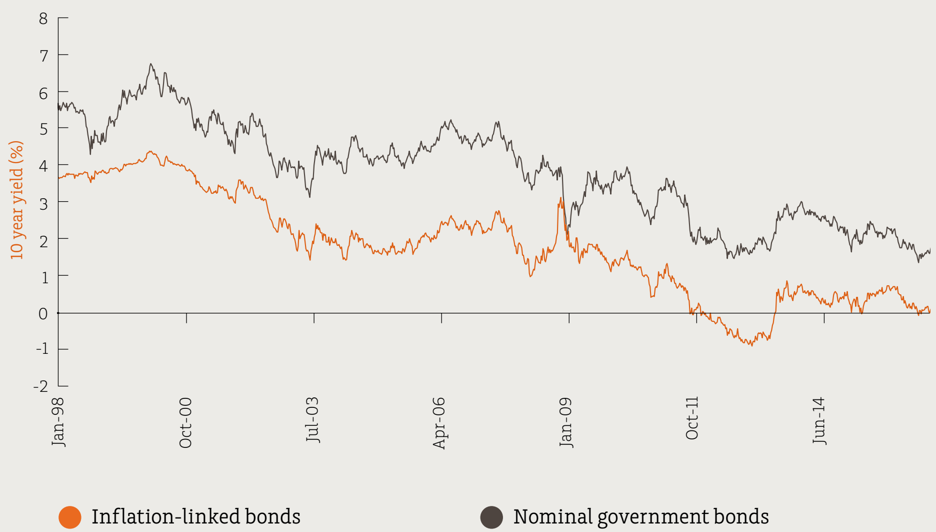


Source: Bloomberg.

Comment

The AUD weakened in the quarter against the stronger USD. The prospects of further US interest rate rises in 2017 favoured the USD.

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



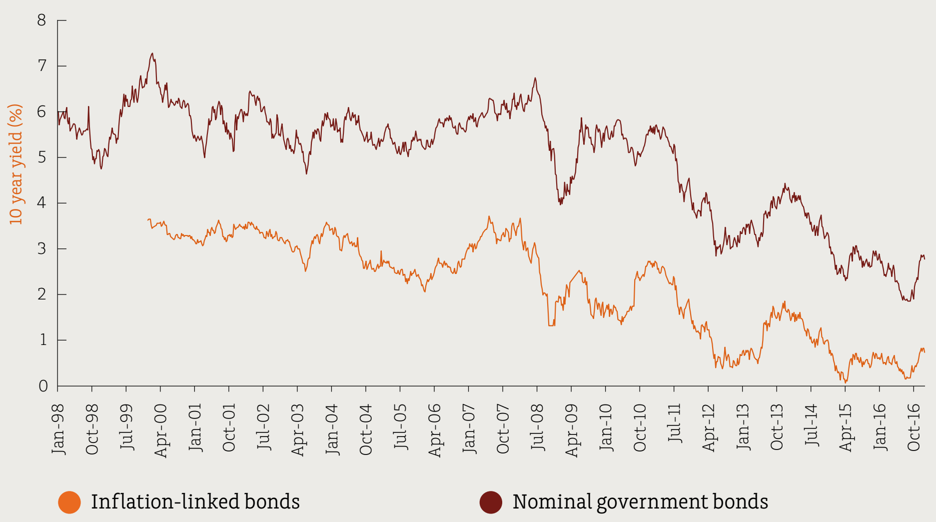
Source: Bloomberg.

Comment

Global government bond yields delivered -2.3% return for the past quarter (Bloomberg Barclays Global Aggregate Government A$ Hedged Index). Stronger global economic activity, the Fed raising rates and President-elect Trump's bold promises with the prospect of higher US budget deficits all contributed to higher government bond yields.

Asset class indicators continued

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

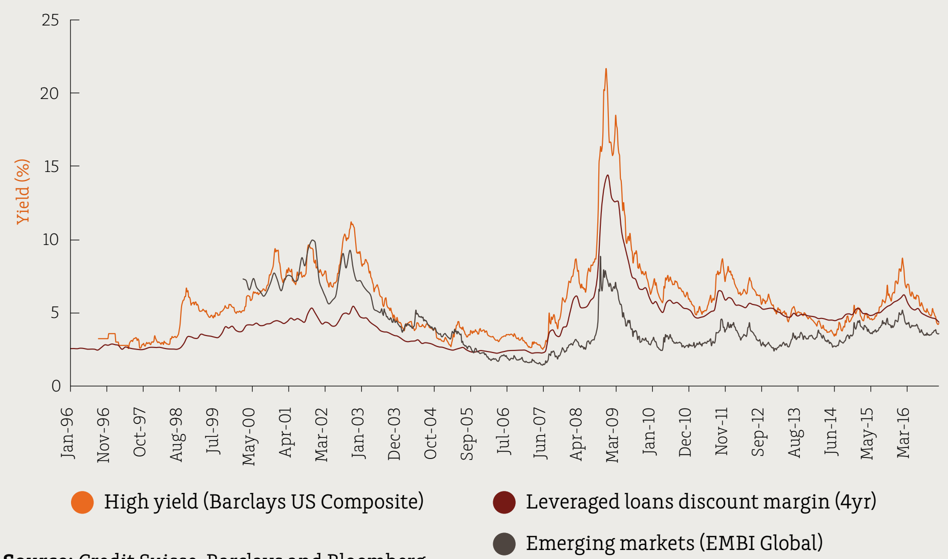


Source: Bloomberg.

Comment

Australian government bond yields moved sharply higher over the past quarter. This penalised returns with a negative return (-3.3%) for the past three months (Bloomberg AusBond Govt (0+ years) Index).

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



Source: Credit Suisse, Barclays and Bloomberg.

Comment

Global high yield bonds (hedged) managed to make a solid 1.2% return for the quarter (Bloomberg Barclays Global High Yield A$ Hedged Index) as optimism of stronger global economic growth and higher corporate profits have narrowed credit spreads.

Appendix 1 – Tailored scenario set

Scenario	Probability ranking (previous rank)	Description
Three speed global economy (China soft landing)	1 (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 EUR.
Inflationary debt resolution	2 (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 EUR 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.
Reform (path to growth normalisation)	3 (7)	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 reduces growth constraints.
Synchronised moderate growth	4 (5)	Japan and Europe's growth approach trend levels, while the US, UK and China moderate resulting in a synchronised modest global growth scenario.
Negative nominal interest rates	5 (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 EUR and JPY. 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	6 (3)	A prolonged and slow consumer deleveraging. Slowing consumption growth and falling nominal prices extend the deleveraging cycle. There is global growth convergence as persistent slow growth and further disinflation in the developed world spills over into the now highly indebted emerging world.

Appendix 1 – Tailored scenario set
continued

Scenario	Probability ranking (previous rank)	Description
Early re-leveraging	7 (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.
Inflation shock	8 (11)	Similar to **Stagflation**, though assumed growth is higher. Sharp rise in inflationary expectations.
Australian stress	9 (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	10 (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/US) 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.
Eurozone slow disintegration (possibly leading to reform)	11 (-)	Rising risk of anti-eurozone politicians gaining power, most notably in France with consequent loss of confidence in the stability of the eurozone periphery. A worst case version of this scenario 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. The path a **Eurozone slow disintegration** might take is highly uncertain, in this scenario we are anticipating if not a Marine Le Pen presidential win in France a sufficient scare to either rattle market confidence or promote change. A positive version of this scenario occurs if existential fears lead to a meaningful policy change including on the contentious issues of closing the output gap which requires a significant shift from Germany, and external immigration. In a best case situation there is meaningful reform which potentially influences Brexit – this possibility is captured in the Reform scenario.

Appendix 1 – Tailored scenario set continued

Scenario	Probability ranking (previous rank)	Description
Stagflation	12 (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. The US economy is getting closer to the point at which an inflationary policy mistake could occur.
Extended risk aversion	13 (13)	A generic scenario to capture prolonged aversion to risk. The probability of a **Eurozone slow disintegration** scenario was previously included in this generalised risk aversion scenario. Potential triggers include policy disappointment, in particular a protectionist Trump presidency with rising tension with China.
Monetary failure	14 (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.

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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