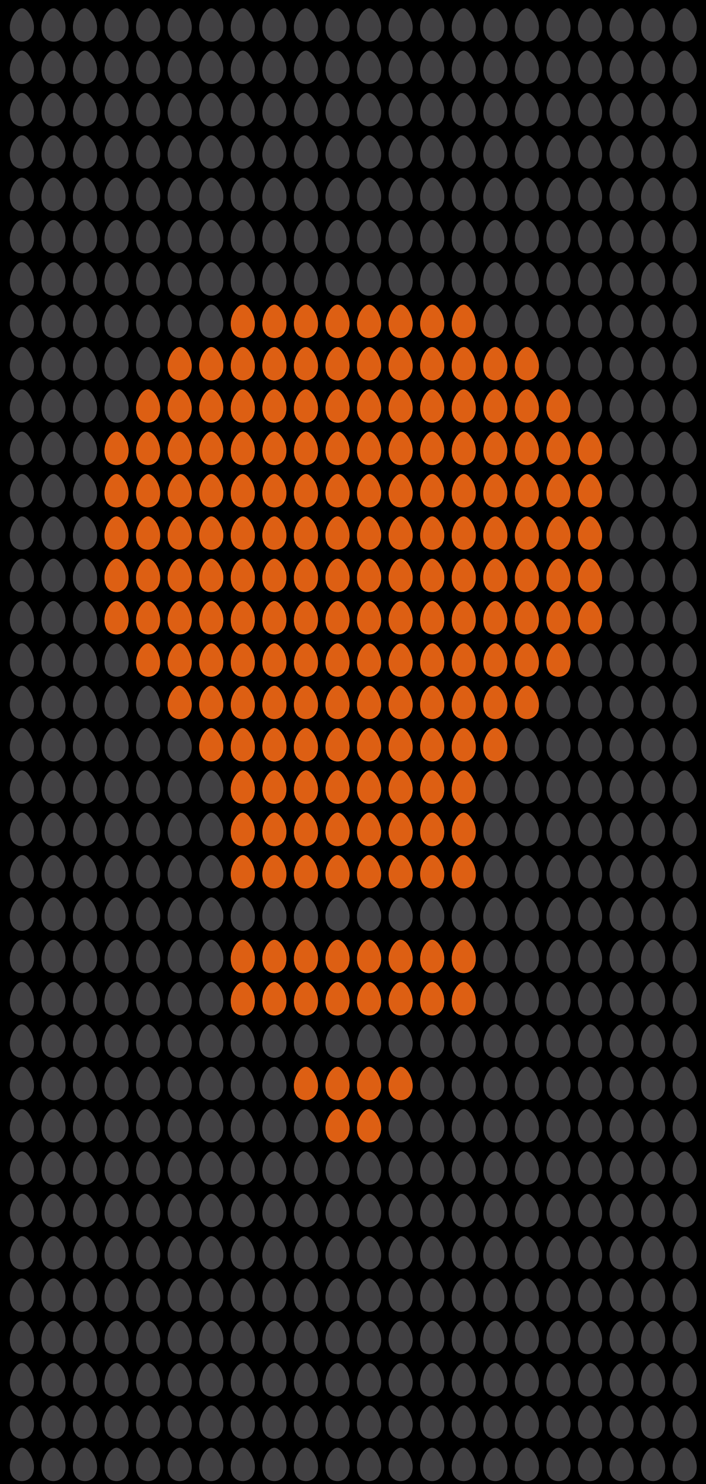


MLC's SCENARIO INSIGHTS & PORTFOLIO POSITIONING

MLC Horizon and MLC Inflation Plus portfolios

April 2017

Read this update to earn CPD points

Dr Ben McCaw
Portfolio Manager
MLC

Dr Susan Gosling
Head of Investments
MLC

We welcome your feedback on this document.
If you have any comments, please email us at
ben.mccaw@jana.com.au or **susan.gosling@jana.com.au**

MLC Horizon and MLC Inflation Plus portfolios

MLC's scenario insights & portfolio positioning

Many words have been written in recent years about the prospect of lower returns across major asset classes. And while markets have yet to experience a decline, the threat of either a prolonged period of lacklustre returns or widespread price declines is something that investors and fiduciaries should take very seriously.

Perhaps not surprisingly, the underpinnings of deflated expectations for investment returns are not simple. Several unrelated phenomena play a role in chipping away the potential for capital to retain its real productivity and reward savers. The underlying cause of diminishing prospective returns and heightened risk of loss is a complex amalgamation of long-term structural issues and shorter, but seemingly persistent, cyclical imbalances.

Global growth, particularly in developed markets, is at risk of slowing due to the impact of a structural decline in demographics on potential growth, and slowing rates of productivity gains. At the same time, what remains on the table in terms of potential growth is further undermined by cyclical deleveraging pressure - the result of long standing global imbalances between savers in the East and consumers in the West. Monetary policy has evolved to counteract the impact of these disparate forces. However, repression of the cost of money has systematically pushed already high asset valuations higher, which further robs returns from the future.

That long-run and short-term phenomenon exist at the same time is not novel or peculiar. What is profound though is that the prevailing structural and cyclical issues that we face have acted together to repress risk premia, distorting the relationship between risk and return that is central to all investment decision making. But what is truly underappreciated is the influence of our innate biases when trying to explain complex phenomenon, especially when cause and effect are separated by great distance and interference as they often are within the real and financial economies. This might seem like a moot point, but oversimplification brings with it the risk of rationalising something that is irrational and as a consequence remaining dangerously ignorant of risk.

Perhaps the most disruptive factor facing the industry is that analysts and investors are ineffectual agents within the systems that we're trying to manage and exploit. They're confounded by prior beliefs, all have similar information, and have deep rooted beliefs or denial of efficient markets and pricing. This is clearly not a perspective shared widely by investors, for if it was we'd rarely hear somebody ask the unanswerable question "What's priced in?".

Yet the circumstances are what they are, and we must play the hand we've been dealt. And while these are unequivocally challenging times for savers and investors, understanding the truth behind the complexity is a necessary step towards steering a portfolio towards its achievable objectives in the most efficient manner possible. Indeed maintaining efficiency within each strategy is where the investment team has greatest scope to add value to clients over the medium to long-term and particularly at this difficult time.

Returning to the overarching issue of why we perceive risk as high and return potential low. It's important to recognise that both structural and cyclical factors have driven down the opportunity for capital to earn decent compensation for risk. Yet understanding the contribution of either of these factors to repression of prospective returns with precision is difficult, if not impossible. This is partly because of the combined impact of the structural and cyclical components, but also because the future path of key drivers, such as policy and market behaviour, remains contingent on many unknowable outcomes.

MLC's active investment approach

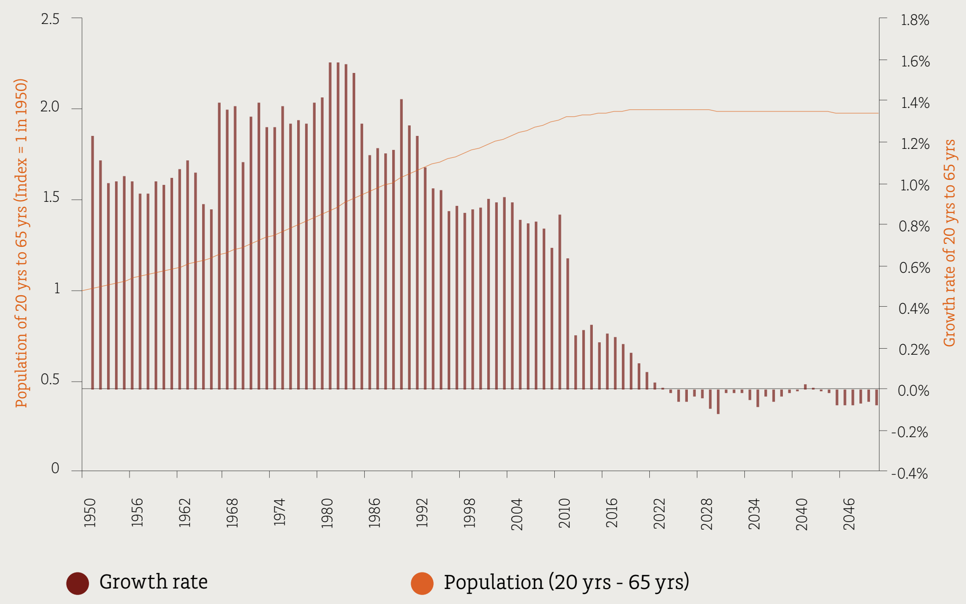
- Key to MLC's market-leading investment approach is our unique Investment Futures Framework.
- In an unpredictable world, the Framework helps us comprehensively assess what the future might hold. By taking into account the many scenarios that could unfold – positive and negative – we gain continuing 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.

At the highest level, we should expect that the opportunity for capital to earn a return depends heavily on the prospects for economic growth. If the outlook for economic growth is low, then all else equal, we expect lower returns from capital invested within the economy. Economic growth is a function of both changes in the working age population and changes in productivity. And while it is arguable whether or not the decade long decline in productivity that has plagued developed economies will continue, the future path of demographics is very visible and therefore knowable a long time in advance.

Due to its knowability in advance, the impact of demographics on potential growth is straightforward. Growth of the global working age population has begun to slow and will continue to taper for over a decade (see Chart 1). And while regions such as India have favourable dynamics, geographic opportunities are difficult to exploit due to either regulatory issues or simply because they are obvious and therefore priced well in advance. Although the impacts of demographics on GDP growth are clear, the flow through to inflation is more complex. Both supply-side and demand-side dynamics change with demographics, so the ultimate experience of CPI will be more nuanced. As the population ages, the dependency ratio will rise with relatively fewer workers to support retirees. All else equal, this supply side squeeze should put upward pressure on wages (particularly in service industries) and therefore inflation. But, at the same time, a lull in consumption is negative for the demand side of the economy. Where inflation settles, and what this looks like from a cross-sectional point of view, is very hard to predict.

Japan is often framed as a case study for the economic impact of an unfavourable decline in demographics, and under the Japanese model, the deflationary impulse clearly trumped inflationary tendencies. But key idiosyncrasies, both within Japan's economic system and between Japan and the rest of the world, mean that relying on Japan as a blueprint for demographic change is dangerous. For starters, Japan's consumers are net savers, whereas in the West, consumers are net borrowers. Moreover, the onset of Japan's demographic blight coincided with a correction in severely distorted asset values, compounding the saving mentality and subduing consumption. While at the same time social cohesion and obedience at the core of Japanese society as well as a heavily regulated labour market generally act to subdue wage pressure.

CHART 1: GROWTH OF THE GLOBAL WORKING AGE POPULATION HAS BEGUN TO SLOW



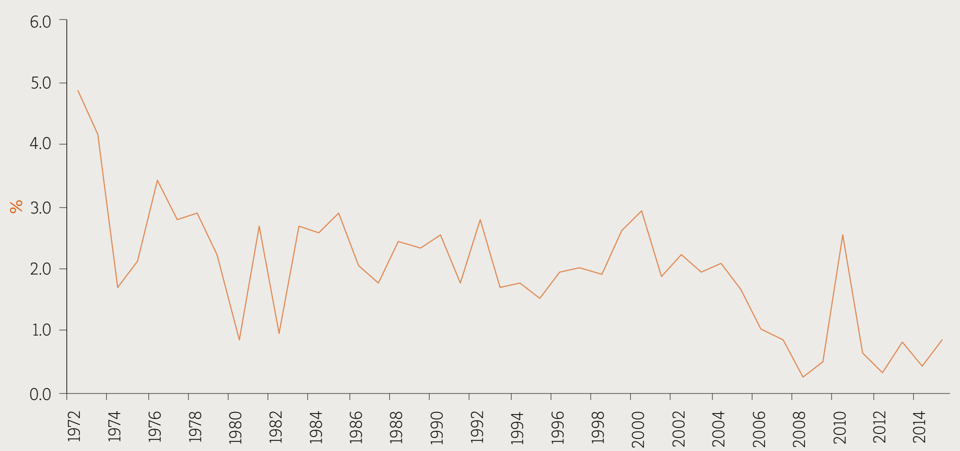
Source: The Organization for Economic Cooperation and Development (OECD).

The economic boost from a reversal of a seemingly long-run retardation of productivity gains, especially within mature economies, has countered the slowing workforce growth. Changes in productivity only last a short time and their impact is less precise than labour force dynamics (see Chart 2). Productivity tends to exist in regimes that ebb and flow with technological evolution. Furthermore, the impact of productivity can be evasive at times as the value added impact of innovation is not well captured by GDP. There can be long lags because diffusion of new technology takes time. Its impact on productivity is hard to measure when the quality, diversity or emergence of new products - rather than quantity - are the main effects. By way of example, the growing role of mobile entertainment and the sharing economy are currently not represented in GDP measurement.

MLC Horizon and MLC Inflation Plus portfolios

MLC's scenario insights & portfolio positioning

Chart 2: Productivity growth for the G7 (1972 to 2016)



Source: OECD. The Group of Seven (G7) comprises the United States, Canada, France, Germany, Italy, Japan and the United Kingdom.

While the impact of structural forces on future investment returns are relatively straightforward, implications that arise from cyclical considerations is profoundly more complex. In part, this is due to the obscure cause and effect relationship between consumption, savings, leverage and policy and how each of these acts on return potential. Monetary policy has for a long time stimulated leverage and consumption in the developed world, and more recently repressed investment. Under former Chairman Alan Greenspan, the US Federal Reserve (Fed) tended to run monetary policy on the loose side with continually lowers peaks and higher troughs in the official cash rate through business cycles in the noughties. At the same time, policy in China supported domestic over-saving and investment. Policies in the US and China acted in concert to reduce the effective cost of funds and stimulate consumption in the West. A decade on, this imbalance continues to exist, albeit in a disguise. While the recycling of capital from China to the rest of the world has slowed, it retains a large footprint on the asset side of the global balance sheet.

Meanwhile however, monetary policy across the developed world has gone into overdrive, profoundly distorting the price of cash by providing unprecedented liquidity that by one means or another has had a flow on impact to valuations and risk premia in all major asset classes. It has also distorted economic outcomes. Low interest rates and high liquidity have had a more profound impact on the financial economy than the real economy with asset inflation running ahead of CPI. More importantly, asset inflation is running significantly faster than the growth in nominal cash flow returns to assets. However, the longer this monetary policy persists the more the damaging effects on the real economy accumulate, and therefore the greater the eventual reset.

It is amongst this backdrop of vexed conditions that investors and savers are left in the uncomfortable position of facing both subdued potential growth and elevated starting valuations across nearly all asset classes. And while low yields and high valuations may be explained as a by-product of low growth expectations, the diverse set of possible resolutionary paths through the global debt overhang suggest caution against adopting an overly simplistic opinion. Much lies on the shoulders of productivity to maintain living standards and support potential growth and this is in part dependant on policy to allocate capital sensibly and stimulate productive innovation. These are formidable tasks and need to transpire in the face of a debt burden that effectively constrains the degrees of freedom available to manoeuvre favourably without stimulating uncomfortable levels of inflation and avoiding a relapse toward deflation. In the meantime, we continue to believe that positioning portfolios for any particular future is unwise and that managing against downside risk remains paramount on the path to achieving investment objectives.

We included the following paragraph in our last quarterly update. It continues to remain relevant and we've repeated in this update due to its importance in understanding the return patterns of our funds: "**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."

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 progress through 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). Due to the prevailing distortions and policy uncertainty, these scenarios contain more complexity and cover a wider range of outcomes for assets than would be the case from a less distorted starting point.

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.

MLC Horizon and MLC Inflation Plus portfolios

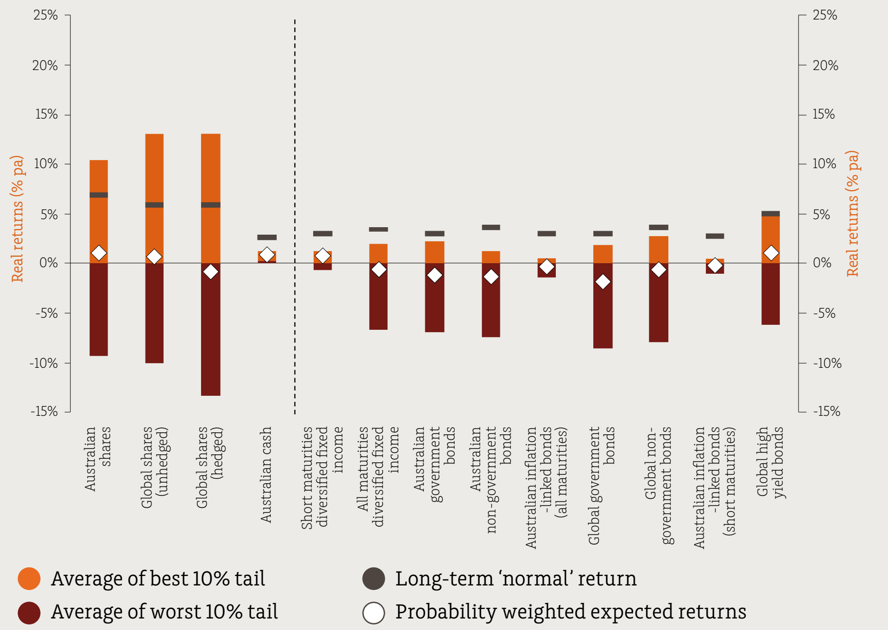
MLC's scenario insights & portfolio positioning

As for now, it remains the case that pressure on the real economy from widespread high debt loads, 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 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. This is however dependent on the political path forward, and after witnessing improbable voter outcomes in the UK and US, it is rational to be unnerved by the upcoming French election, especially at a time when we believe markets are probably primed to be sensitive to shock.

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 again further reduced future share market return potential and increased risk. Prices have again run ahead of earnings growth, inching valuations higher from an already elevated base. Owing to our defensive positioning, the continued rally in risk assets has been unfavourable from a relative point of view but absolute returns remain healthy. At the same time, core bond yields have continued to ebb higher aiding relative returns within the MLC Horizon portfolios due to their underweight to interest rate risk.

The potential real returns for each asset class are shown in Chart 3.

Chart 3: 40 scenario set (generic scenarios) potential real returns (March 2017) 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 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.

Performance expectations

Chart 4 shows return potential for the MLC Horizon and Inflation Plus portfolios based on our generic (40) scenario set looking forward from the end of March 2017.

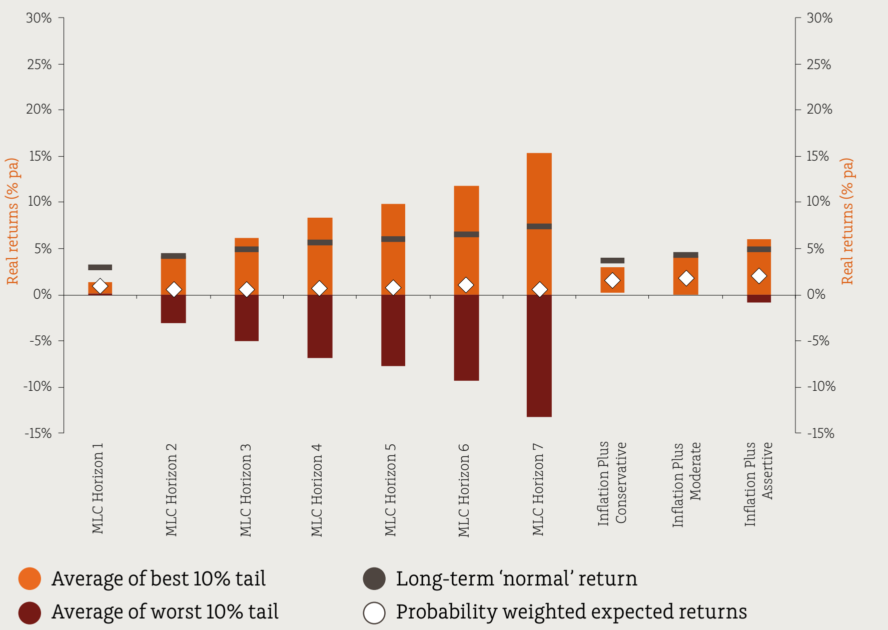
The chart continues to show that on average, looking across the whole scenario set, the potential reward for taking risk is still limited. In the event that a scenario with relatively higher returns occurs, the returns of those portfolios with larger share allocations will be sharply higher. However, 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.

CHART 4: 40 SCENARIO SET (GENERIC SCENARIOS) POTENTIAL REAL RETURNS (MARCH 2017)
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 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.

MLC's scenario insights & portfolio positioning

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 March quarter			Comment
	Conservative	Moderate	Assertive	
Australian shares	Steady allocation	Steady allocation	Steady allocation	Approximately half of the Australian shares exposure is invested through MLC's defensive Australian shares strategy. Because our defensive shares investment process directly takes account of the risks identified in our scenarios analysis, we are able to have a higher exposure to Australian shares than we otherwise would.
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	Upside protection over AUD/USD maintained. We have also begun to change the foreign exchange exposure across Inflation Plus by down weighting the USD at the expense of JPY and GBP. We are contemplating including EUR, but will wait until after the upcoming presidential election in France.
Gold exposure	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. Exposure to gold is through our derivatives strategy using futures.
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 exposure	Steady allocation	Steady allocation	Steady allocation	Exposure to emerging markets is now through our derivatives strategy using futures. Derivatives allow us to maintain the portfolios' emerging markets exposure, but more cost effectively. We've removed our emerging markets manager, Capital International. Valuations of emerging markets remain attractive and although they have a degree of vulnerability to a rise in US interest rates, the risk return profile is relatively attractive. We have recently begun to increase our allocation to emerging markets from a low base.

Asset class	Change in allocation to asset classes in the MLC Inflation Plus portfolios (in MLC MasterKey's super and pension products) over the March quarter			Comment
	Conservative	Moderate	Assertive	
Global private assets	Steady allocation	Steady allocation	**Increased allocation**	The target private assets allocation for the MLC Inflation Plus - Assertive Portfolio (in MLC MasterKey's superannuation and pension products) has been increased.
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	**Increased allocation**	Uncorrelated though risky exposure is appropriate where time horizon is sufficient.
Bank loans	Steady allocation	Steady allocation	**Increased 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	**Increased allocation**	Offer some return enhancement while limiting additional risk.
Cash	**Increased allocation**	**Increased allocation**	**Decreased 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. We substantially reduced the cash allocation in MLC Inflation Plus - Assertive portfolios this quarter through increasing exposure to a range of strategies.
Borrowings	Borrowing not permitted	Borrowing not permitted	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.

	MLC Horizon 4 Balanced Portfolio (Super & Pension) weights at end of the March 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 maintained.
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 portfolios continued

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.

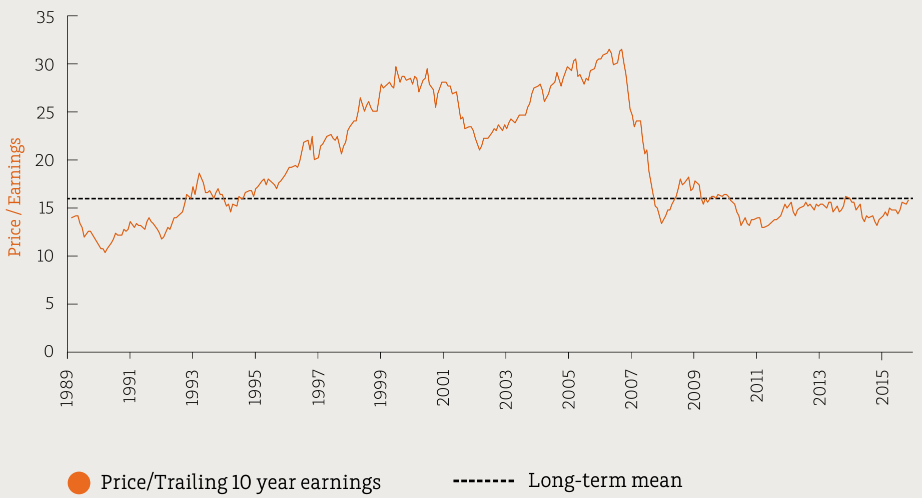
For MLC Horizon and Index Plus portfolios we are maintaining a relatively defensive orientation. Over the past year the defensive positioning and particularly the foreign currency overweight have detracted from returns. However, while we continually test our thinking, we retain high conviction in the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

	MLC Horizon 4 Balanced Portfolio (Super & Pension) weights at end of the March 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 (including MLC Index Plus portfolios) are at benchmark. We believe the allocation to real return strategies provides the portfolios 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

Commentary on the main asset classes follows.

CHART 5: AUSTRALIAN SHARES
Market indicator *S&P/ASX 200*



Source: Global Financial Data.

Comment

Australia has recorded mixed economic data with subdued jobs growth and the unemployment rate edging higher to 5.9%. The National Australia Bank surveys are more encouraging with solid results for business confidence and conditions. The housing markets are recording strong price gains, particularly in the Sydney and Melbourne markets. Australia's consumer price pressures are gradually turning up, with the December quarter annual inflation rate at 1.5%. This stabilisation in price pressures combined with strong property prices has seen the Reserve Bank of Australia keep the official cash rate steady at 1.5%.

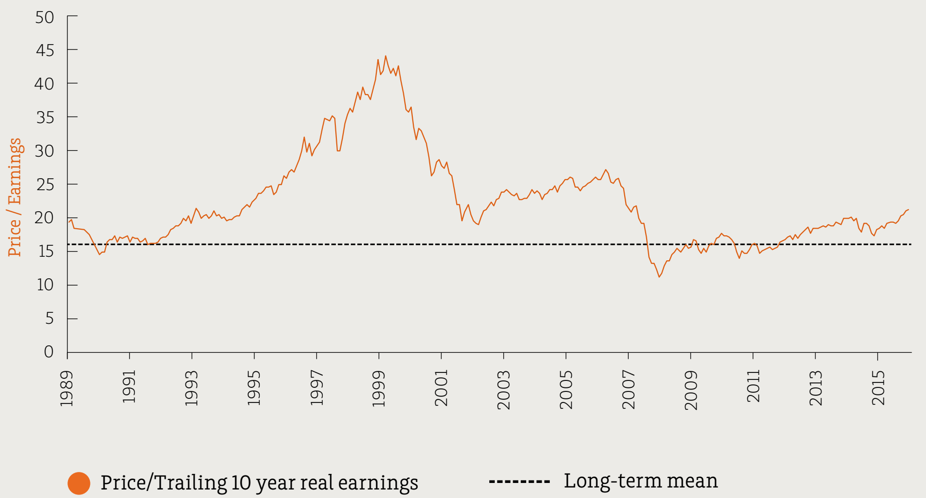
Australian shares posted a robust return of 4.8% for the quarter. Investors favoured the Health Care (14.9%), Utilities (10.7%) and Consumer Staples (10.8%) sectors given the stabilisation in government bond yields. However Telecommunications (-4.6%) disappointed with a more sedate corporate profit performance.

MLC Horizon and MLC Inflation Plus portfolios

MLC's scenario insights & portfolio positioning

Asset class indicators continued

CHART 6: GLOBAL SHARES
Market indicator *MSCI All Country World Index*



Source: Factset.

Comment

Global shares made strong returns over the past three months to March 2017. Global shares delivered 6.0% in local currency terms and 1.6% in unhedged terms due to the strong performance of the Australian dollar.

US shares reached record highs. President Donald Trump's bold promises of corporate tax cuts and higher infrastructure spending boosted Wall Street. US shares surged by 5.9% for the quarter (S&P 500).

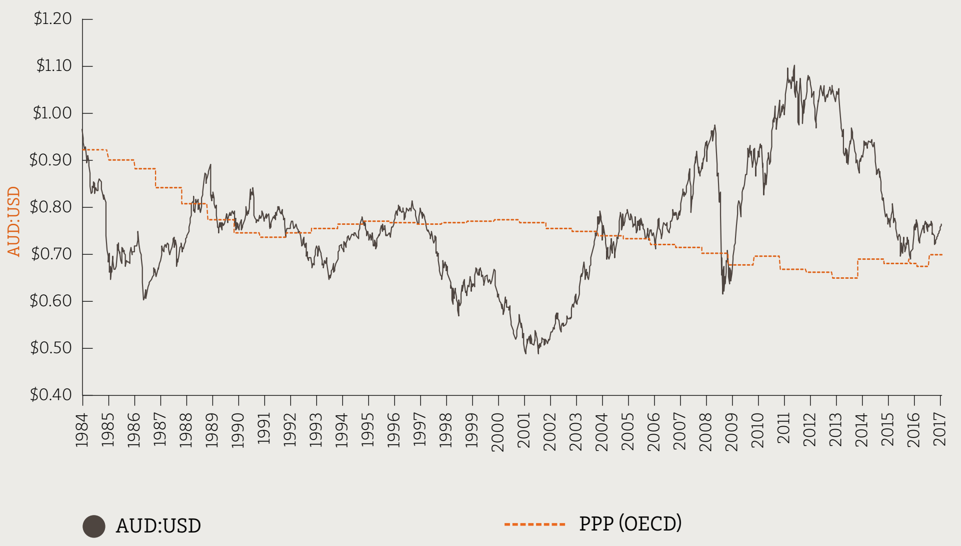
US economic activity has also been favourable in terms of strong jobs growth and consumer spending. The Fed raised interest rates in March given the improving economic performance.

European shares delivered solid returns given positive economic activity and encouraging business surveys. Concerns over Europe's banking system and Dutch parliamentary elections have faded. However the upcoming French presidential election in April-May could provide a considerable challenge for European political stability.

Emerging markets (unhedged) delivered strong returns of 5.8% for the quarter. Chinese shares made a robust return of 7.2% (MSCI China unhedged) with more encouraging signs that China's economic activity has stabilised at a solid growth pace. Brazil's share market surged higher with the central bank aggressively cutting interest rates.

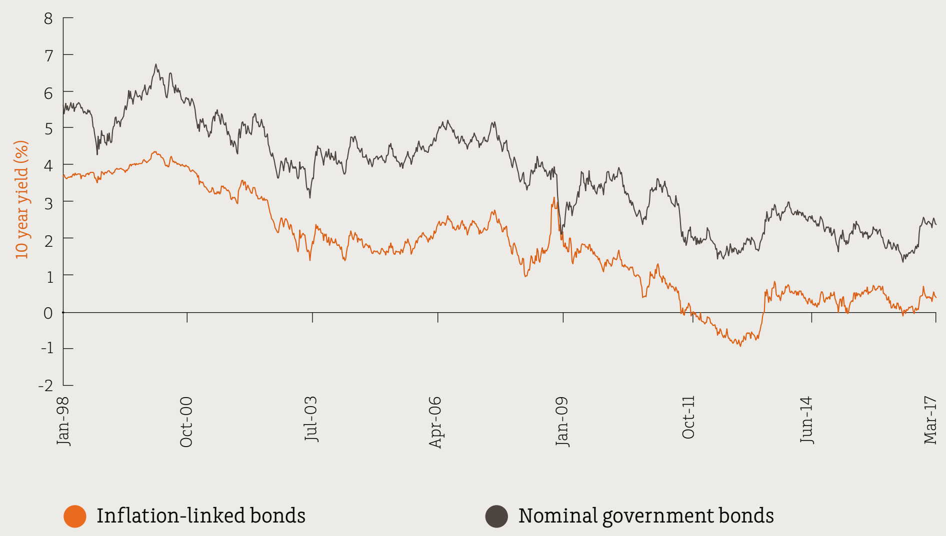
Asset class indicators continued

CHART 7: **Australian dollar**
Market indicator *Australian Dollar Purchasing Power Parity (PPP)*



Source: Bloomberg.

CHART 8: **Global government bonds**
Market indicator *10 year bond yields – United States*



Source: Bloomberg.

Comment

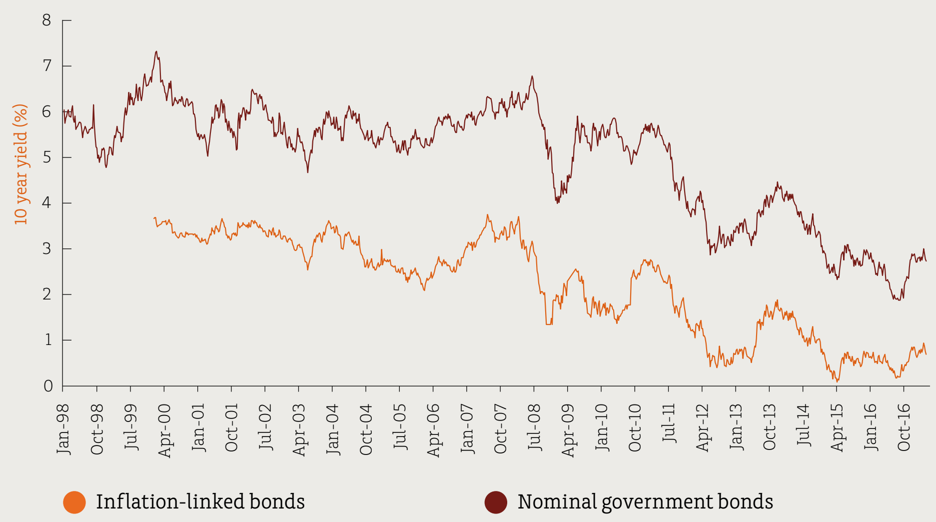
The Australian dollar (AUD) made solid gains against a softer US dollar over the quarter due to higher commodity prices. However, the AUD's strength was tempered in the month of March due to lower commodity prices (particularly iron ore and energy prices) and the Fed's March interest rate rise.

Comment

Global government bonds (hedged) delivered 0.7% for the quarter (Barclays Global Aggregate Treasuries) as yields stabilised. While there was stronger global economic activity as well as the Fed raising US interest rates, concerns over Europe's political stability has seen bond yields move sideways in 2017.

Asset class indicators continued

CHART 9: **Australian government bonds**
Market indicator *10 year bond yields – Australia*

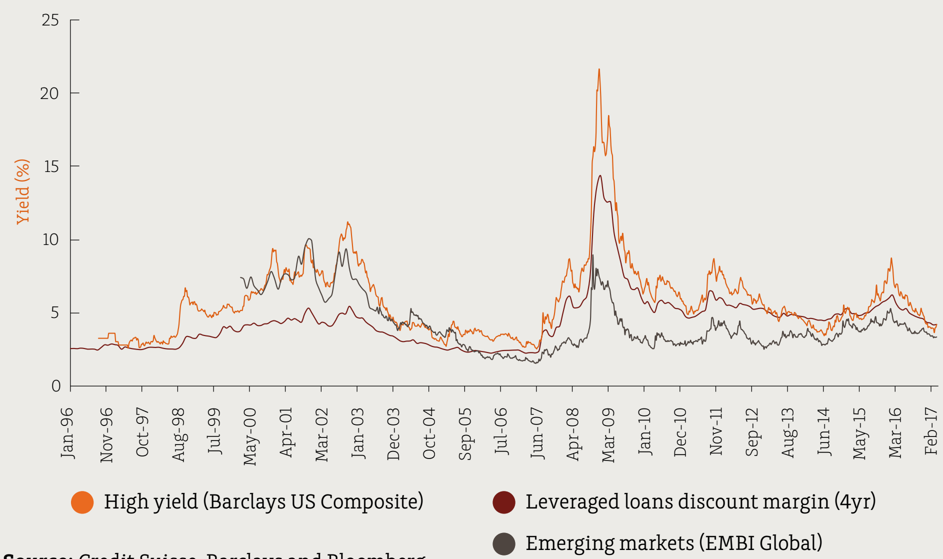


Source: Bloomberg.

Comment

Australian government bond yields moved sideways over the quarter. This has helped Australian bonds deliver a solid 1.2% return for the quarter.

CHART 10: **Non-investment grade bonds**
Market indicator *Fixed income spreads*



Source: Credit Suisse, Barclays and Bloomberg.

Comment

Global high yield bonds (hedged) managed a strong 1.1% return for the quarter as optimism for stronger global growth and higher corporate profits 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 (2)	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 (3)	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 (4)	Japan's 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 (5)	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 (6)	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 (7)	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 (8)	Similar to **Stagflation**, though assumed growth is higher. Sharp rise in inflationary expectations.
Australian stress	9 (9)	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 (10)	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 (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 (12)	With no clear roadmap for the withdrawal of policy stimulus, the inflation risks from quantitative easing may be much bigger than are currently appreciated. In this scenario, policy stimulus is not withdrawn fast enough, perhaps coupled with increased policymaker tolerance for an inflationary work-out (due to a much stronger aversion against deflation than inflation) which gets out of hand. Run-away inflation in this scenario is likely to be negative for real growth, which could in turn lead to **Stagflation**. The scenario is likely to involve monetary policy reversals reminiscent of the 70s. 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 (14)	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.

Earn your CPD points now

Important information

a nab company

MLC Limited ABN 90 000 000 402 AFSL 230694. Part of the National Australia Bank Group of Companies.

A124099-0417