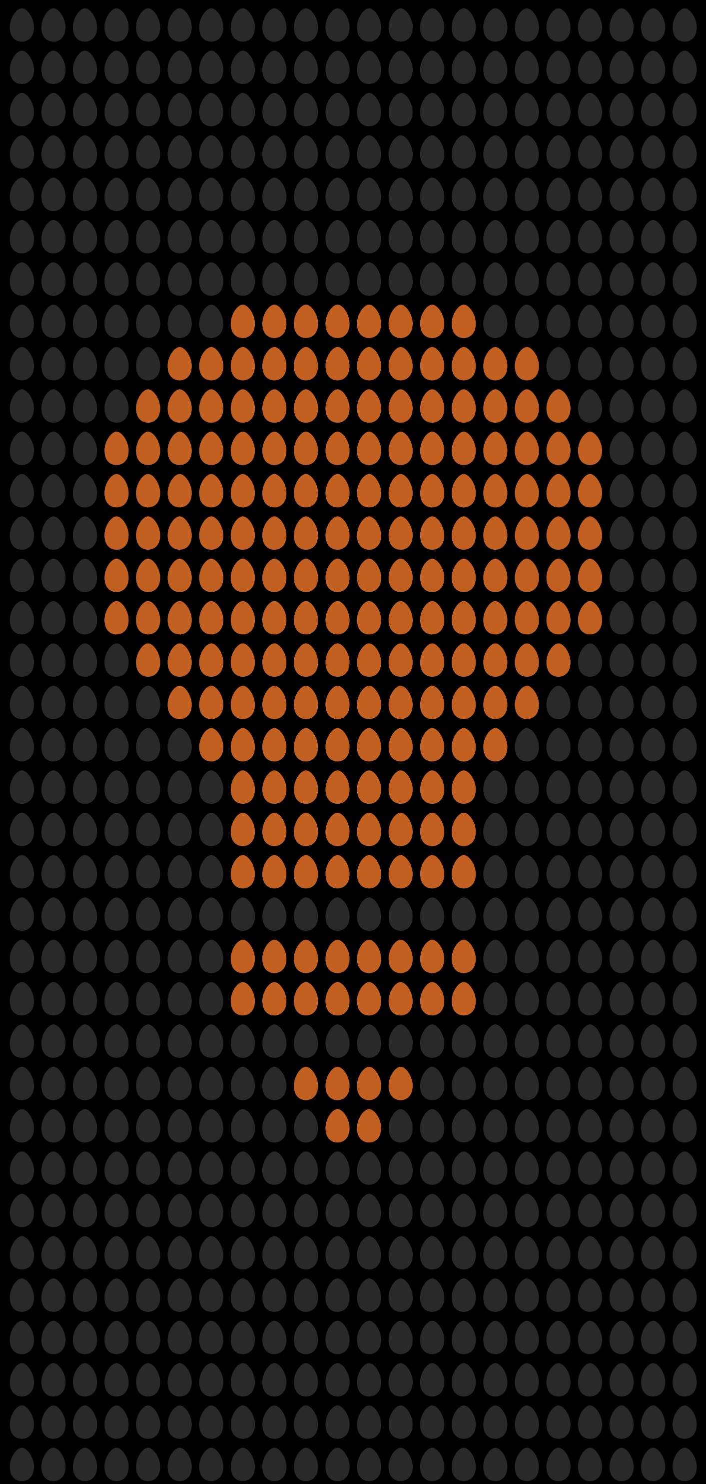

MLC's SCENARIO INSIGHTS & PORTFOLIO POSITIONING

MLC Horizon, MLC Inflation Plus and MLC Index Plus portfolios

July 2017

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We welcome your feedback on this document.
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MLC's scenario insights & portfolio positioning

China's leadership transition

Monetary policy started deviating from traditional settings in 2008 with a domino-wave of quantitative easing across the US, UK, EU and Japan. Global politics eventually followed suit in 2016 with populist outcomes in both the UK (Brexit) and the US (election of President Trump). There is almost no doubt that these political surprises are somehow linked to the unbalanced impact of monetary policy as:

- asset prices rose and the real economy only lumbered
- corporate profits remained high and wages grew slowly, and
- savers were penalised while borrowers were rewarded.

But while populist outcomes have conditioned investors to be wary of political complacency in the West, a different kind of mystery cloaks the upcoming leadership transition in China. Unlike in the West, where the political institution is well understood, but the electorate is unpredictable, the mystery around China's leadership change stems from a lack of transparency and unfamiliarity with the political system. Nonetheless, the fact that the process of leadership selection within the Communist Party of China lacks transparency does not render it impossible to construct meaningful insight ahead of change.

It is important to recognise that perhaps contrary to popular belief, it is the composition of the Politburo Standing Committee that is the core factor driving the path of policy decision-making in China as opposed to who occupies the presidency. Unlike a dictatorship, China is not ruled by one or two men, but rather by the Standing Committee acting as a collegial (rather than advisory) unit. And while there is an established hierarchy within the Party's Standing Committee, neither President Xi Jinping nor Premier Li Keqiang can pursue their agendas without the support of at least some of the other members. This de-concentration of responsibility is further underpinned by the factional nature of the Communist Party. By virtue of this, former leaders maintain a degree of power by brokering factional loyalists into positions of power within their party. Yet due to the slow, but long running drift of China away from traditionalists and towards reformists, the influence - at least by number - of traditionalists is waning.

We believe that several nuances of the upcoming 19th Congress of the Communist Party of China make it possible to draw a meaningful degree of insight as to how the high level characteristics of the new Standing Committee will differ from the incumbent group of leaders. Firstly, we know almost for certain, that five of the current seven members will step down due to reaching the Party's mandatory retirement age of 67. Of the current Standing Committee members, all but Xi and Li have turned 67 since the 18th Congress. Importantly, we also know that apart from Wang Qishan (a senior leader of the Communist Party and public face of the anti-corruption campaign), the five departing members, despite their factional differences, are predominantly hard-line traditionalists.

Another key consideration is that the pool of potential Standing Committee members is relatively straight forward to define. Aside from the handpicked potential future presidents and prime ministers that are sometimes fast tracked from outside the Politburo into the Standing Committee, candidates are by and large selected from the current Politburo membership. At this transition, there are approximately 21 Politburo members who are under 67 years and therefore eligible for ascent to the Standing Committee. And while the group as a whole represents both princeling and populist factions, the overarching tendency of nearly all candidates during their path to power is a predisposition to pursue reform over traditional policy within their remit. This is interesting as it runs at odds with the overarching traditionalist nature of the five departing members, who have all favoured traditionalist policy throughout their careers, and who have probably acted as a headwind to Xi's seeming objective of pursuing reform.

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.

With these factors in mind, this upcoming 19th Congress could well mark a critical juncture in China's political evolution where the pivot to genuine economic reform becomes cemented as the way forward for the world's second largest, and most influential economy.

If this scenario does indeed transpire, then what does this mean in terms of the outlook for policy? And how might the migration to a more reform-minded Standing Committee impact the economy?

Firstly, and perhaps most importantly, the transition does not signal an imminent swing in policy toward reform acceleration. Rather the new leadership will most likely continue the gradual step-by-step like shift towards further liberalisation within key segments of the domestic and external sectors of the economy, but with significantly lower risk of derailment of the reform process. This means that over time:

- the economic power of State-Owned Enterprises will wane in favour of the private sector
- the social safety net will rise
- the importance of trade and investment will diminish in favour of the tertiary (service) economy, and
- the financial system will continue to liberalise and the move toward renminbi (RMB) internationalisation will continue.

Growth will most likely tend to be slower but of higher quality and more sustainable. Nonetheless, in our opinion the most important consequence of impending change within the Standing Committee is not a profound acceleration of economic reforms. Rather, it is a lessening of the predisposition of policy to regress back to the old model of state sponsored growth by investment should conditions turn adverse.

Under the current regime, diversion from the reform agenda was an omnipresent risk that could have manifested, especially if economic conditions were to become pressured. If either global growth slowed, or impact of reform flowed too quickly, the incumbent regime might have acted hastily to stimulate the old economy. And while it is obviously far too early to call time on the possibility of another rapid investment stimulus, we believe that the new congress will be significantly more tolerant of slower growth than the incumbent. If this is true, then all else equal, China's economic future after the leadership change should be on a safer footing towards greater liberalisation, albeit at a sensibly moderate pace but with less risk of slippage toward conditions that render a hard landing scenario more likely.

Investment environment – beginning of the end of an era

Global growth over the past year has been close to long-term averages, with almost all major economies having expanded by early 2017. This is being supported by consumption growth (business investment is also showing signs of rebound) with unemployment continuing to decline. However, we still face a far from normal investment environment. Central banks have unparalleled challenges with policy normalisation. There is an unusual level of uncertainty that emanates from the unresolved conundrum of high government debt-to-GDP ratios and fiscal deficits. Countries that were not at the epicentre of the GFC, and therefore not burdened by high public sector debt, instead tend to have high household debt and a reliance on inflows of foreign capital – this includes Australia and some emerging markets. This debt also becomes an important drag on demand when interest rates rise.

Over the past year there has been what may prove to be a pivotal change in perceptions. As mentioned above, political uncertainty emanating from issues of inequality has come to the fore. Declining labour bargaining power is related to many factors, notably ongoing labour force globalisation and automation. First, the Brexit vote (and subsequent UK election) and second, the election of President Trump, illustrate the dangers of protest politics. (Hopefully President Macron in France will represent the constructive side of anti-establishment politics). These events send important signals to policy makers and this has been a driver of changes about the perceptions of policy efficacy, and the costs of today's monetary policies. Consequently, the factors driving markets are changing with central banks becoming less dominant, and the policy influences now more broadly defined. There is an emergent new consensus that:

- monetary policy has reached (or exceeded) the limits of its power
- other policy levers (notably fiscal) must play a more pivotal role, and
- there needs to be a gradual reversal in current monetary policy settings.

While there have been important changes to perceptions, this has so far had limited market implications. Paradoxically while policy uncertainty has increased dramatically, market volatility has declined. The consequences of unwinding the unusual dependence of financial markets and the real economy on ultra-monetary accommodation are not well understood. The potential consequences for market volatility seem underappreciated. Current bond yields and share prices rest on the foundation of extreme monetary accommodation. Central banks are signalling a gradual approach to normalisation, but gradualism risks further risk-taking, which could ultimately result in reduced policy room to manoeuvre.

Adding to the fundamental sources of risk is the growth of an array of unusual and poorly understood sources of financial fragility. In the repressed interest rate environment, a host of financial 'microstructures' have emerged as investors seek to construct alternative or modified return sources. These include risk parity, smart beta (such as minimum volatility), volatility targeting strategies, volatility tracking exchange-traded funds (ETFs), trend following strategies, and other structured products involved in selling volatility to meet yield targets. These strategies act to supress current market volatility, while making it more reactive to sell-offs. In other words, one of the negative effects of ultra-low rates is an incentive to build structures to generate returns which makes the system collapse-prone when policy changes. Complacency results from volatility becoming so suppressed that investors are being misled into thinking or behaving as if risk really is low. This increases our nervousness.

Also not well understood is the volatility dampening effects of the US Federal Reserve's (Fed) large holdings of mortgage-backed securities (MBS). The duration of these securities changes in response to interest rate changes because mortgage pre-payments change (known as 'negative convexity'). The central bank does not hedge this risk, but many private sector investors do. This lower level of hedging reduces bond market volatility. Consequently as the Fed reduces its MBS holdings and private sector holdings increase, we should expect that the extent of hedging will increase. This is a much bigger problem because the starting rates are very low, which greatly increases the convexity. Hence, if rates rise as the unwind in Fed holdings proceeds, there could be a significant shock to volatility. If this occurs the robustness of these micro-structures will be tested.

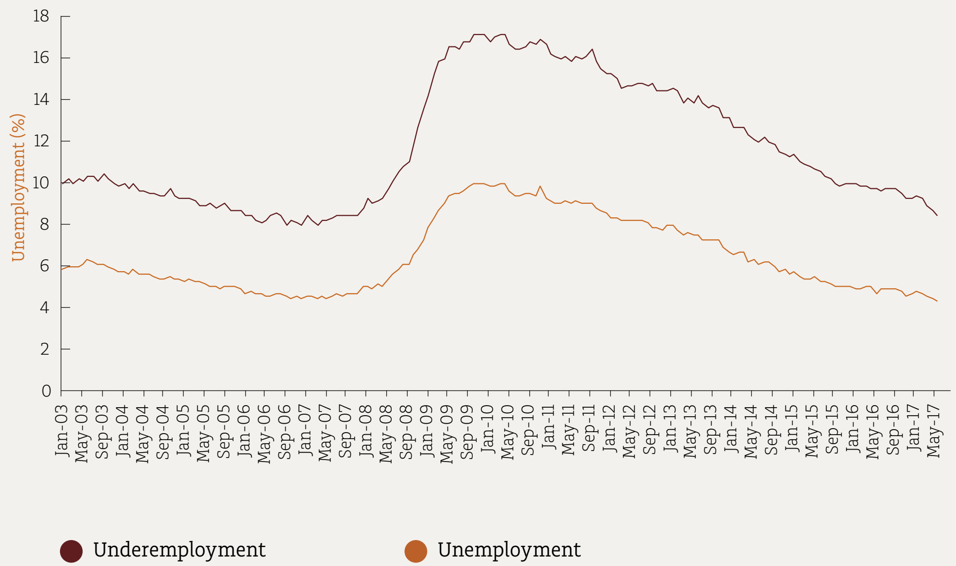
As an aside, taking into account potential risks of this nature requires that the assessment of risk be forward-looking. A central strength of our investment process is the ability to capture future possibilities, as distinct from drawing on past market outcomes. This is particularly important in an environment which has limited historical parallels, in particular where (as today) there is significant non-market (central bank) meddling in asset markets.

Our investment process focuses on understanding the potential financial vulnerabilities; what happens depends on the evolution of the broad package of policy measures, what the implications are for the real economy and consequent changes in perceptions and behaviour. The robustness of demand as monetary stimulus is gradually withdrawn, and the extent and focus of any fiscal component (and other policy measures) will determine whether a bond or share market tantrum is more likely or whether a benign path can be engineered.

With regard to the real economy, the classic trigger for a recession is a rise in interest rates prompted by a rise in inflation. While headline inflation rates have inched higher over the past year, subdued inflation continues to defy the classic prediction that prolonged loose monetary policy will result in rising consumer price inflation. To date that inflation has instead occurred in asset prices. However, if fiscal policy starts to play a more central role, that may change. The simultaneous exhaustion of labour market slack in several countries, most notably the US (Chart 1) and Japan, suggests that rising inflation has become more likely. But so far inflation has been much slower to rise than has been typical in the past. While not well understood, the reasons may lie in some combination of entrenched low inflation expectations and job security concerns related to automation and globalisation. We note that higher wage inflation is evident in the US service sectors (Chart 2), which are less vulnerable to international competition.

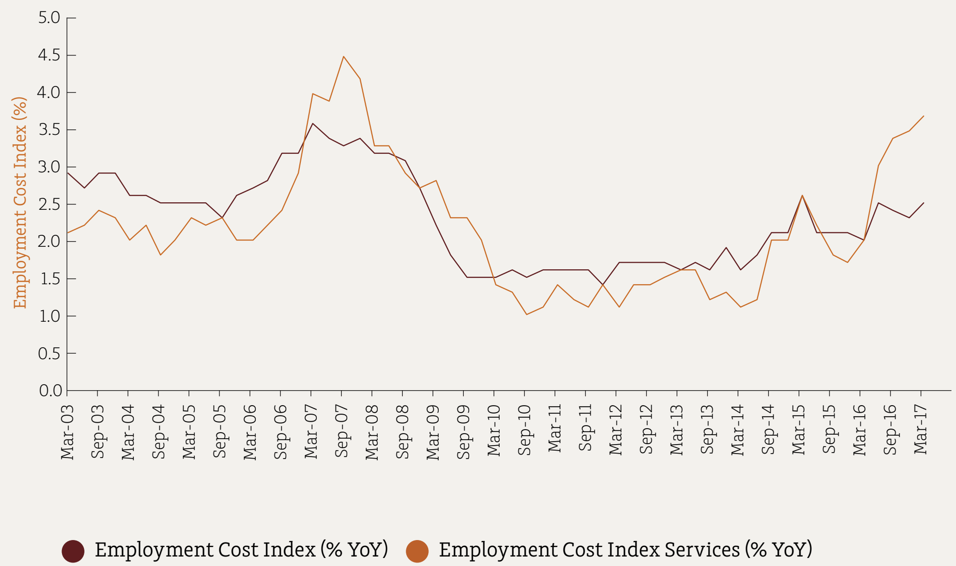
We are also aware that in some cases, notably in Japan, headline wage data may be distorted by labour market peculiarities. Under the lifetime employment system, the highest paid workers are also the oldest. Hence as they exit the labour force they tend to depress aggregate wage data. Beneath the surface we are seeing the emergence of wage pressure with a tight Japanese labour market pushing up part-time and graduate wages. Labour shortages are also squeezing the weakest firms and forcing reduced hours of operation. Inflexibilities in large firm wages-setting remains, but are now starting to be challenged.

chart 1: US is near full employment



Source: US Bureau of Labor Statistics.

chart 2: Rising US services sector wages



Source: US Bureau of Labor Statistics.

CHART 3: Global government debt still rising

Source: International Monetary Fund.

Market participants expect the low inflation, subdued wages environment to persist, and hence are discounting inflation risks. But we need to be aware that any fiscal stimulus involves risk given near full employment in a number of key economies; there are also risks arising from any acceleration in public sector debt. Clearly, a focus on flexible resource allocation and productivity enhancing (growth-friendly) structural reform makes more sense than simple deficit spending. Structural reform that builds economic resilience and increases the potential growth rate of the economy is in principle ideal, but more complex in practice.

More generally, there is an increased acceptance that experience since the mid-1990s indicates a need for greater symmetry in policy settings – failing to limit financial booms while aggressively easing in the bust has led to progressive magnification of financial vulnerabilities (and more pronounced boom-bust cycles). There is much in this to explain current circumstances. Previous policy asymmetry has resulted in monetary policy being progressively pushed towards its limits of efficacy (benefit versus cost) and workouts of previous debt overhangs have resulted in unsustainable fiscal positions in a number of economies (particularly so given the issues of ageing populations). With global debt to GDP ratios still rising (Chart 3) policy measures have clearly been ineffective in controlling excesses. The policy response when the next bust comes is likely to be different given perceptions about the limitations of monetary policy. Policy makers are aware of the need to build some 'dry powder' with which to respond.

Recently we have noted greater discussion of the possibility of some form of government debt write-offs, notably among Japan economists. This highlights the extent of the debt problem versus available policy degrees of freedom. While not on any current policy agendas, another crisis could force policy makers devoid of other options to move down this extreme policy track. Ultimately the question may be whether a combination of debt write-offs in some form, fiscal stimulus and gradual monetary policy normalisation can generate enough nominal growth to reduce real debt burdens, and whether or not that nominal growth consists more of inflation than real growth.

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 could 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 outlined, looking forward today we see the potential for the veneer of low risk to be shattered, but we also see the possibility that the manipulated low risk environment may persist for longer. And we must also recognise that policy makers might manage to engineer a benign path forward. 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. As this tightening process proceeds, the potential for very strong returns to persist may diminish.

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.

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 now changing, 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. The improbable voter outcomes in the UK and US are a cause of concern, but the French Presidential election provides hope of real reform in France.

What also drives quarter to quarter changes in return potential and risk are changes in asset prices through the quarter. For example, US bond yields inched lower during the quarter further depressing future return potential. While the Australian share market was subdued, the continued rally in global share markets in aggregate weighed on future return projections. The continued rally in risk assets however is challenging from a relative point of view given our defensive positioning.

The potential real returns for each asset class are shown in Chart 4 on page 8.

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.

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 5, on page 9, shows return potential for the MLC Horizon and Inflation Plus portfolios based on our generic (40) scenario set looking forward from the end of June 2017.

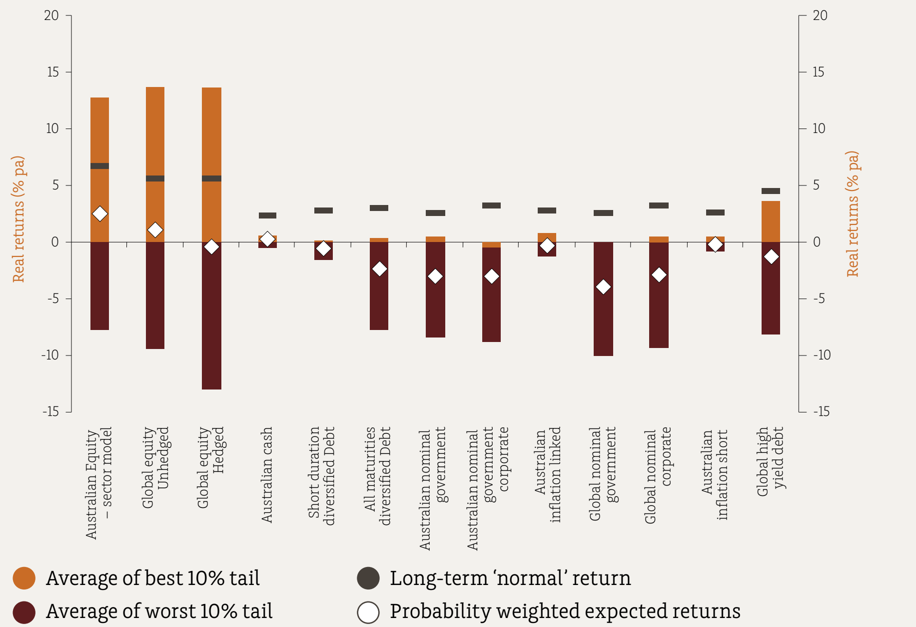
The chart continues to show that on average, looking across the whole scenario set, the potential reward for taking risk is still limited. In the event that a scenario with relatively higher returns occurs, the returns of those portfolios with larger share allocations will be sharply higher. However, 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 probability weighted real returns (forward from June 2017) (5 years, 0% tax with franking credits, pre-fees, pre-alpha)



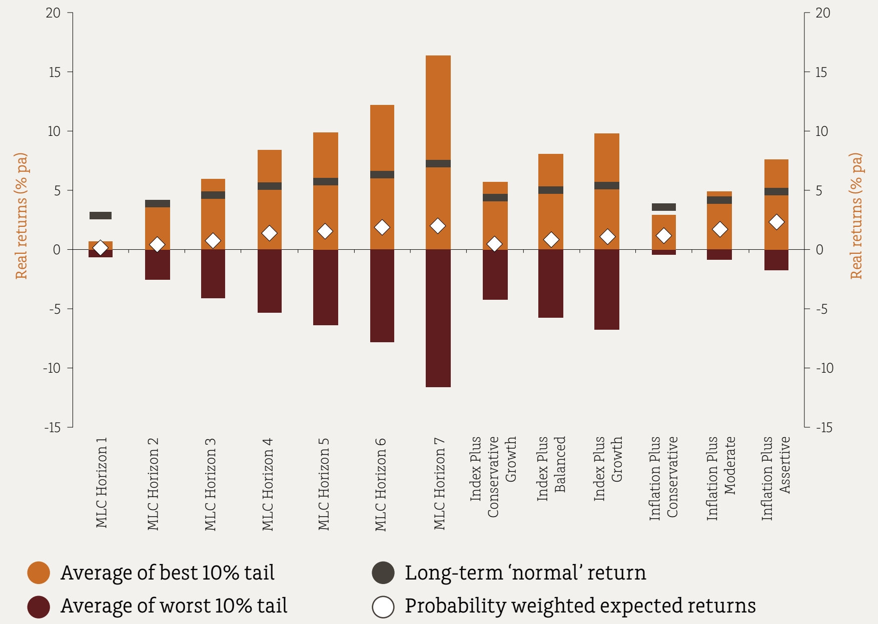
Source: JANA Corporate Investment Services Limited.

MLC Horizon, MLC Inflation Plus and MLC Index Plus portfolios

MLC's scenario insights & portfolio positioning

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.

CHART 5: 40 SCENARIO SET PROBABILITY WEIGHTED REAL RETURNS (FORWARD FROM JUNE 2017) 5 YEARS, 0% TAX WITH FRANKING CREDITS, PRE-FEES, PRE-ALPHA



Source: JANA Corporate Investment Services Limited.

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 June quarter			Comment
	Conservative	Moderate	Assertive	
Australian shares	Zero allocation	**Decreased to zero allocation**	**Decreased to zero allocation**	We've reallocated the remaining Australian shares exposures from the broad market Australian shares strategy to defensive Australian shares.
Defensive Australian shares	Steady allocation	**Increased allocation**	**Increased allocation**	Our defensive shares investment process directly takes account of the risks identified in our scenarios analysis. By investing in defensive Australian shares we're 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)	**Decreased 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 mix across Inflation Plus by down weighting the USD and increasing JPY and GBP.
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	**Decreased allocation**	**Decreased 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. This quarter we've reduced exposures in the Moderate and Assertive portfolios to increase portfolio liquidity.
Real return strategy	**Decreased allocation**	Steady allocation	Steady allocation	Allocation to our multi-asset real return manager, Ruffer, maintained.
Derivatives strategies	**Increased allocation**	**Increased allocation**	**Increased allocation**	Derivatives allow us to maintain the portfolios' exposure to investment markets more cost effectively than directly investing in securities. Exposure is through our derivatives strategy using futures. We've reduced our emerging markets futures to lock in recent strong returns and we've introduced an exposure to TOPIX to gain exposure to unhedged Japanese equities futures which have greater risk control due to an inverse relationship between share prices and the currency in a number of scenarios.

MLC's scenario insights & portfolio positioning

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 June 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	**Decreased 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	**Decreased 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	**Decreased allocation**	Offer some return enhancement while limiting additional risk.
Cash	**Decreased allocation**	**Increased allocation**	**Increased 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.

MLC's scenario insights & portfolio positioning

MLC Horizon portfolios

For the active management of the MLC Horizon portfolios, risk is primarily benchmark-related. Benchmarks have been designed to efficiently generate above inflation outcomes on the basis of long-term investment assumptions. Target allocations deviate from the benchmark when (as is typically the case) the prospective medium-term investment environment differs from these long-term assumptions.

Our scenarios analysis is used to identify target allocations which are more risk-return efficient than the benchmark which, because these portfolios must remain true to label, have limitations in the extent to which they can deviate from the benchmark. In particular, these traditional multi-asset portfolios have constraints to the mix of fixed income and shares which they can hold. This provides a level of certainty to investors about where their money will be invested, however it also means that portfolio risk is primarily a function of market risk.

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

	MLC Horizon 4 Balanced Portfolio (Super & Pension) weights at end of the June quarter			Comment
	Under	Benchmark	Over	
Growth assets		●		
Australian shares		●		Retained benchmark allocation.
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.
Global shares (hedged)	●			
Global property securities		●		Retained 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 2 to 5 portfolios.
Australian inflation-linked bonds		●		This allocation to inflation-linked bonds in MLC Horizons 2 to 5 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

For MLC Horizon 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 June 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 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.

MLC Index Plus portfolios

Risk is primarily benchmark-related for the Index Plus portfolios. 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 Index Plus Balanced Portfolio weights at end of the June quarter			Comment
	Under	Benchmark	Over	
Growth assets	●			
Australian shares		●		Retained benchmark allocation.
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.
Global shares (hedged)	●			
Global property securities		●		Retain benchmark allocation – the benchmark allocations are underweight versus peers.
Defensive assets			●	
Cash			●	Overweight maintained.
Australian bonds – Short maturities			●	Overweight maintained.
Australian bonds – All maturities	●			Underweight maintained in longer duration bonds.
Australian inflation – linked bonds		●		This allocation to inflation-linked bonds 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 – Short maturities			●	Overweight maintained.
Global bonds – All maturities	●			Underweight maintained in longer duration bonds.

MLC's scenario insights & portfolio positioning

MLC Index Plus portfolios continued

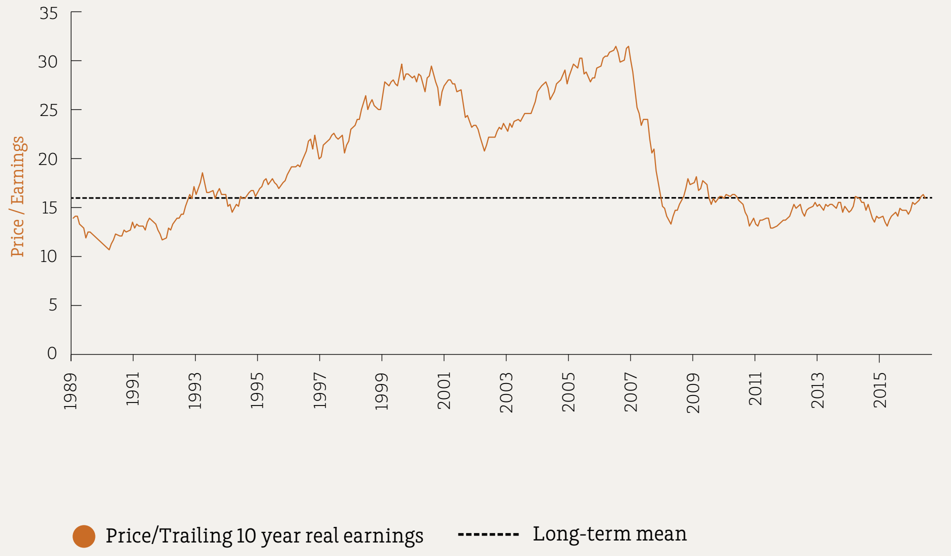
For MLC Index Plus portfolios we are maintaining a relatively defensive orientation. Over the past year the defensive positioning and particularly the foreign currency overweight have detracted from returns. However, while we continually test our thinking, we retain high conviction in the appropriateness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

	MLC Index Plus Balanced Portfolio weights at end of the June quarter			Comment
	Under	Benchmark	Over	
Alternatives		●		
Real return strategies		●		We believe the allocation to real return strategies (through the Simple Real Return strategy) 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.

Asset class indicators

Commentary on the main asset classes follows.

CHART 6: AUSTRALIAN SHARES
Market indicator *S&P/ASX 200*



Source: Global Financial Data.

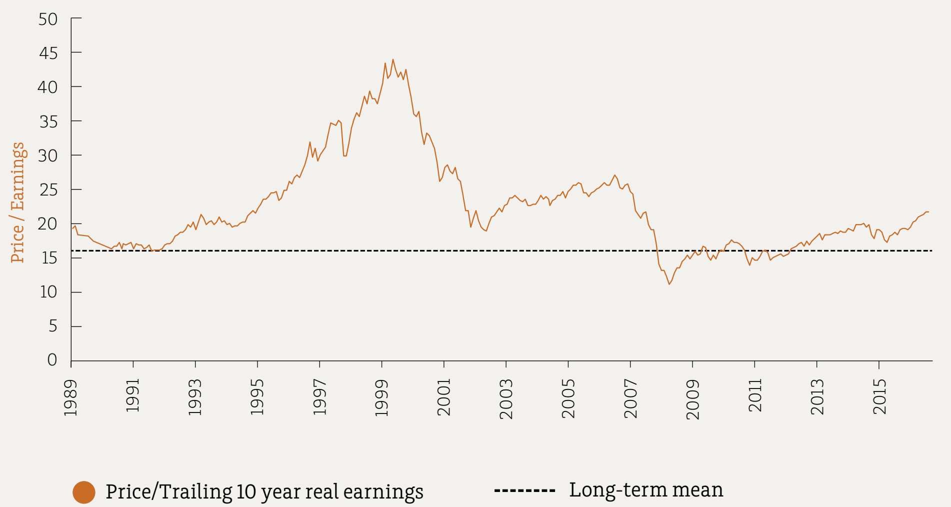
Comment

Australia recorded mixed economic data. While housing apartment construction is moderating, there has been positive data with higher jobs growth and the unemployment rate edging down to 5.5%. The National Australia Bank business surveys are more encouraging with solid results for confidence and conditions. The Reserve Bank of Australia has kept the official cash rate steady at 1.5%.

Australian shares posted a disappointing return of -1.6% for the June quarter. Financial shares fell by 4.4% after the Federal Government's announcement of a bank levy in May. There were also significant declines for the Telecommunications sector (-8.3%) given a sedate corporate profit performance. Investors favoured the Industrials (8.9%) and Health Care (7.2%) sectors during the quarter given their yield.

Asset class indicators continued

CHART 7: GLOBAL SHARES
Market indicator *MSCI All Country World Index*



Source: Factset.

Comment

Global shares made strong returns over the past three months to June 2017. Global shares delivered 3.6% in local currency terms and 3.9% in unhedged returns due to a weaker Australian dollar.

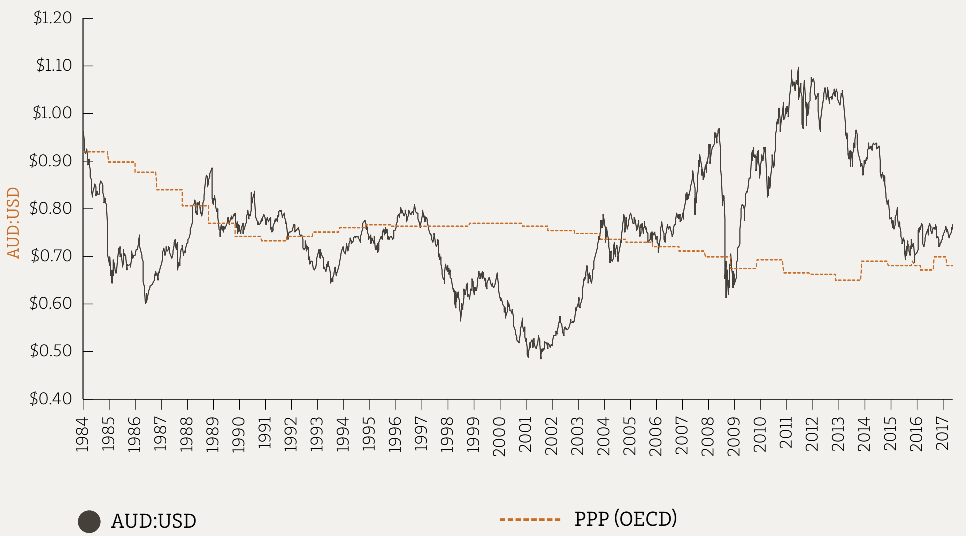
US shares achieved record highs. President Trump's bold promises of corporate tax cuts and higher infrastructure spending continue to boost Wall Street. Notably technology shares surged with the NASDAQ posting a strong 4.2% gain for the quarter. US economic data was also favourable in terms of solid jobs growth, lower unemployment and very positive business surveys. The Fed raised interest rates in both March and June given this improving economic performance.

European shares also delivered strong returns of 6.6% (MSCI Europe) given positive economic data and the election of Emmanuel Macron as French President. This election result was particularly welcomed by investors as it ensures that France remains within the European Union.

Emerging markets (unhedged) made robust returns of 5.8% for the quarter. Chinese shares made a solid return of 10% (MSCI China unhedged), with more encouraging signs that China's economic activity has stabilised at a solid growth pace.

Asset class indicators continued

CHART 8: Australian dollar
Market indicator *Australian Dollar Purchasing Power Parity (PPP)*

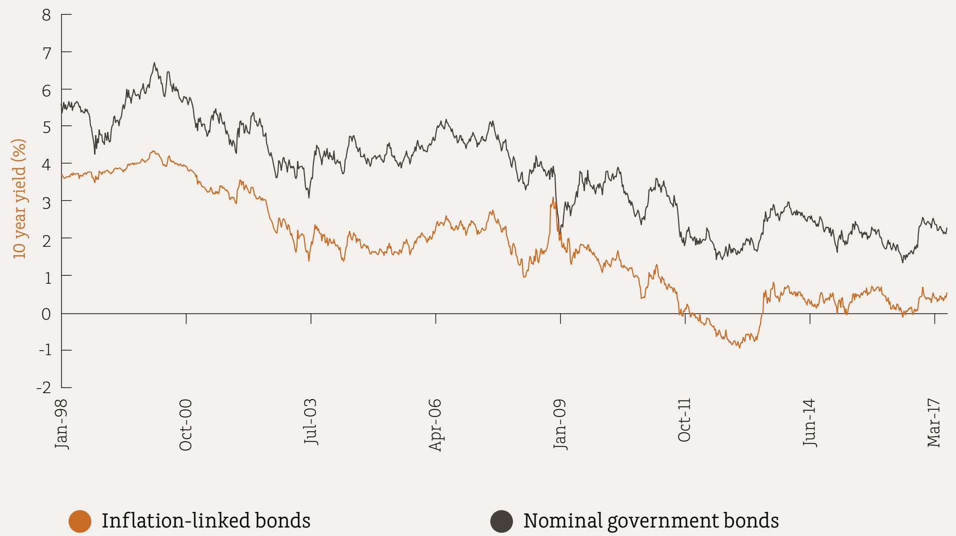


Source: Bloomberg.

Comment

The Australian dollar (AUD) was surprisingly stable during the June quarter considering the falls in key commodity prices such as iron ore and base metals. Despite the Fed raising US interest rates in June, the AUD even managed to rise towards the 0.77 level against the US dollar. However the AUD did weaken against the euro given more positive European sentiment after the French Presidential election.

CHART 9: Global government bonds
Market indicator *10 year bond yields – United States*



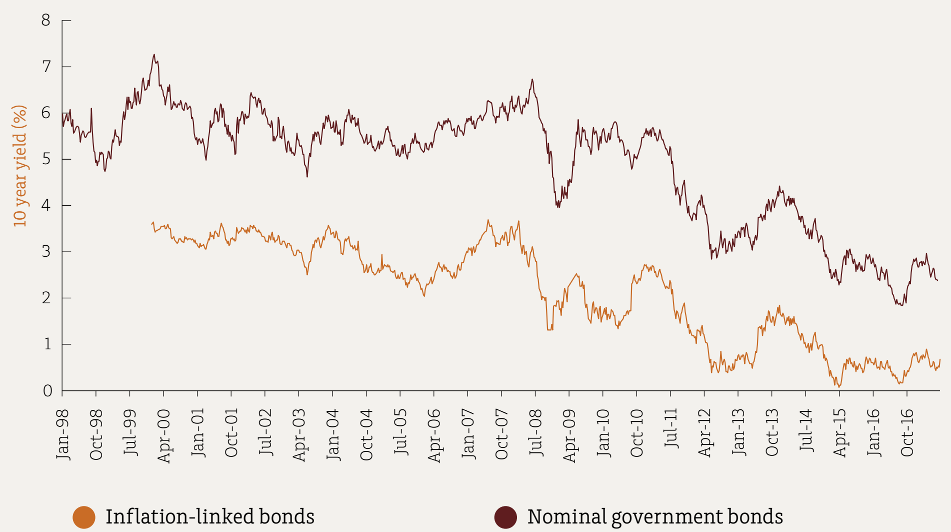
Source: Bloomberg.

Comment

Global government bonds (hedged) delivered 1.2% for the quarter. While there was stronger global economic activity as well as the Fed raising US interest rates, the lower energy prices were also supportive of bonds.

Asset class indicators continued

CHART 10: AUSTRALIAN GOVERNMENT BONDS
Market indicator *10 year bond yields – Australia*

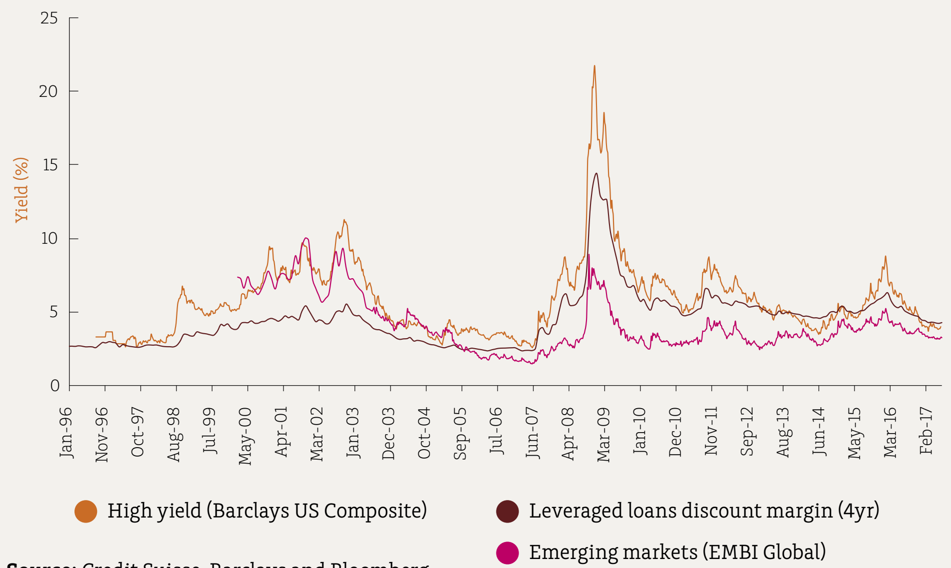


Source: Bloomberg.

Comment

Australian government bond yields were broadly stable over the quarter. This helped Australian bonds deliver a solid 1.0% return.

CHART 11: NON-INVESTMENT GRADE BONDS
Market indicator *Fixed income spreads*



Source: Credit Suisse, Barclays and Bloomberg.

Comment

Global high yield bonds (hedged) made a solid 1.0% return for the quarter given optimism for higher corporate profits.

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/USA) provide the potential for a bond-vigilante style re-rating of sovereign yields that undermines key safe haven currencies including the USD. This is not a likely near-term scenario, but given the low yields and high level of indebtedness as a starting point, there is a risk that the environment could progress to one where apparently safe paper becomes compromised. This in turn increases the cost of funding and reduces corporate activity. At the same time, government spending is curtailed by enforced austerity in an effort to limit yield increases, remain liquid and stay solvent. This may be a precursor to a **Prolonged stagnation** scenario. AUD strong but does not re-visit highs vs USD.
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. 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.

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