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MLC's scenario insights & portfolio positioning

MLC Horizon, MLC Inflation Plus and MLC Index Plus portfolios

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Dr Susan Gosling
Head of Investments
MLC

Dr Ben McCaw
Portfolio Manager
MLC

John Woods
Portfolio Manager
MLC

Grant Mizens
Senior Investment Analyst
MLC

We welcome your feedback on this document.
If you have any comments, please email us at
susan.gosling@mlc.com.au, **ben.mccaw@mlc.com.au**,
john.j.woods@mlc.com.au or **grant.mizens@mlc.com.au**

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Since the late 1980s there have been a number of booms which have inevitably led to bust. Each bust has brought ever more innovative and accommodative monetary policy creating a 'debt super-cycle' in which excesses don't get cleaned out, and debt progressively ratcheted up relative to GDP. In 2008 it looked, momentarily, like this had finally run out of road, but central banks pulled quantitative easing out of the hat and debt continued to rise. Investors in risk assets benefited, those relying on interest income have missed out, and wage earners felt left behind in a world with technology and global competition undermining job security.

This manufactured financial peace is looking increasingly fragile for two reasons. Firstly, there is an emergent new consensus (particularly in academic circles which are influential with central banks) that sees monetary policy as having reached (or exceeded) the limits of its power and needing to be wound back; and secondly social discontent (related to income/wealth inequality) is getting political attention and reinforcing the need to change the policy perspective.

As we noted in last quarter's briefing, we may be witnessing the beginning of the end of an era. If so, expect this to challenge asset prices, inflated by the presumption of low rates and easy money.

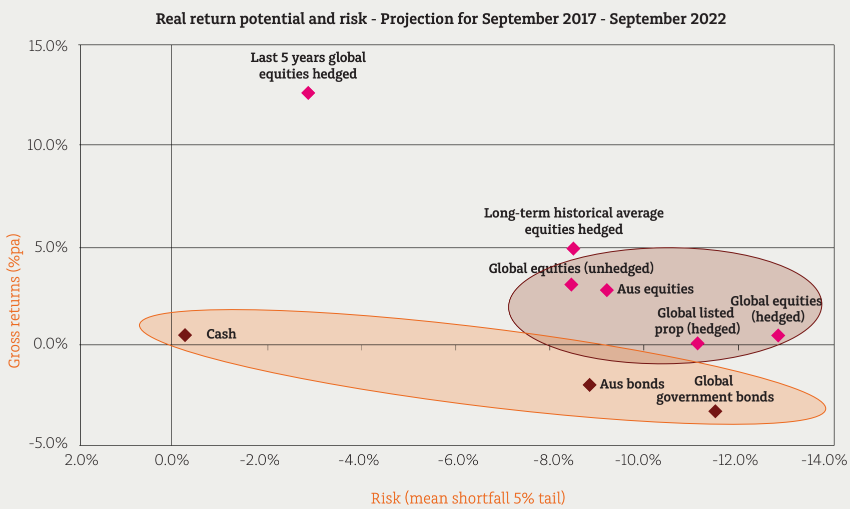
Real returns over the past 5 years have been well in excess of long-term averages. Chart 1 shows, for example, that returns to hedged global equities has been well in excess of long-term averages. After a period of high returns like this, return potential is often low and risk high. This was the case in both 1999 and 2007, and it is the case today. The bottom line is that it is dangerous to extrapolate those past returns. While markets have yet to experience a significant decline, we should take that threat seriously. And we should not deceive ourselves about how hard it will be to make money looking forward. Of course it's quite possible that the strong returns will continue for some time yet (we don't pretend to have any insight into timing). But the critical thing is that we should behave as if we don't know – in other words, we should not presume that those past strong returns will persist. But that is what many are doing or at least many portfolios are taking insufficient account of the risks that lie ahead.

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.

MLC's scenario insights & portfolio positioning

Chart 1: Future returns look limited, risk elevated

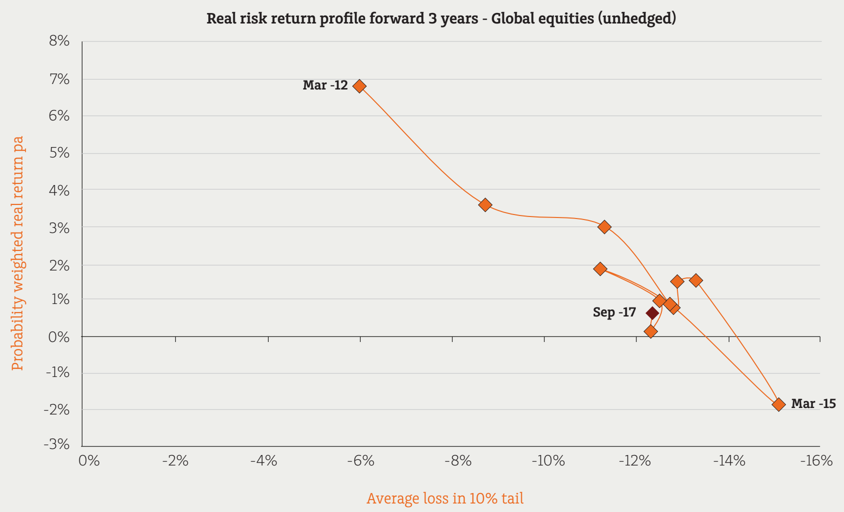


Source: NAB Asset Management Services Limited. Returns are before fees, tax and alpha.

Looking forward from today, return potential is unusually low. This is because interest rates are so low - everything ultimately prices relative to cash rates. Low interest rates make high valuations seem reasonable. Return potential declines when asset prices rise faster than the underlying fundamentals.

Chart 2 shows how global equity return potential and prospective risk have changed through time. Each point shows return and risk looking forward 3 years from particular points in time. Between June 2012 and end September 2017 equity return potential has been eroded as share prices rose faster than earnings (and the Australian dollar (AUD) has declined). And as return potential declines, the risk of negative returns rises because more positive news factored into prices, means there is greater scope for disappointment.

Chart 2: Path of Prospective Risk and Return



Source: NAB Asset Management Services Limited. Returns are before fees, tax and alpha.

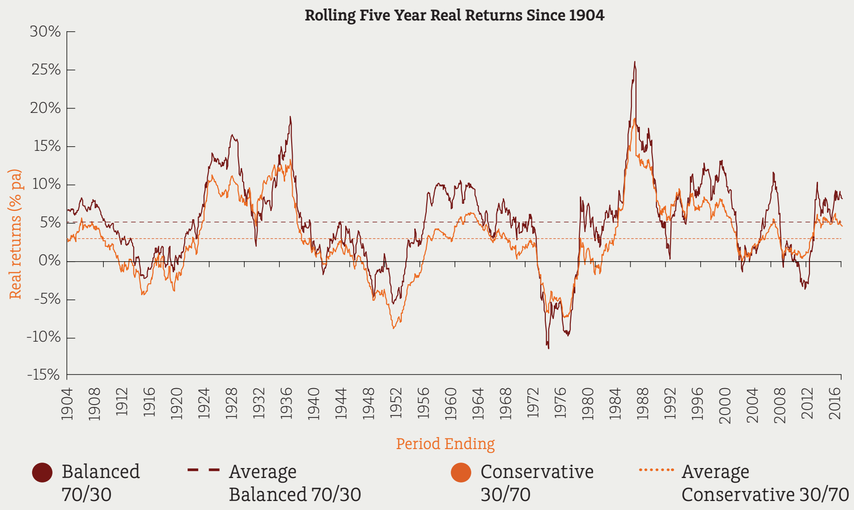
It is not just equities which have compressed return potential today, but debt exposures too. The most important determinant of future bond returns is the starting yields which are very low. Today long nominal bonds not only offer at best low returns and limited diversification – they also appear outright risky in many investment environments. Generally bond yields rise when equities rally and growth is strong. Today, low rates have pushed investors progressively up the risk spectrum making everything expensive at the same time. We are in the difficult position of having no safe havens – there were places to hide in 1999 (old economy stocks) and 2007 (nominal bonds) but not so today.

It is therefore timely to remember that traditional diversified portfolios defined around debt equity mixes can generate disappointing returns over extended periods. Today investment conditions suggest an increased risk that this will be the case.

There is a common presumption that a constant asset allocation will provide a consistent exposure to risk, and ultimately a reliable return outcome. Chart 3 challenges that assumption. It shows rolling 5 year real returns since 1900 for two portfolios: in blue a typical 'balanced' 70/30 (equity/debt) and a 'conservative' 30/70 strategy. The average real returns are 5.1% and 3.0% respectively. But there is considerable variability of returns, which means that investors can be lucky or unlucky depending on the starting point. There are several episodes of negative real returns over rolling 5 years. In some cases returns are still negative over 10 years. Note the downside of the conservative portfolio is sometimes greater, in particular when inflation rises.

What this is telling us is that an inflexible asset allocation that pivots around a benchmark debt/equity mix gives a very variable risk exposure and an uncertain return. The reason for this is that the riskiness and the return potential of all assets changes through time. Today these portfolios we are all familiar with are much riskier than normal, and may now exceed some investors' risk tolerances. To control for the higher risk, asset allocation needs to move well away from the norms for these funds.

CHART 3: RETURNS ARE NOT PREDESTINED



Source: NAB Asset Management Services Limited and Global Financial Data. Returns are before fees, tax and alpha.

But as already mentioned just because return potential is low, it does not follow that strong returns won't persist. In our industry there are strong pressures to succeed over short periods, or if we fail to do so conventionally. Investors can run out of patience with our stories of high risk – asset prices that keep rising are more compelling. This was the case in the years before both 2000 and 2008. How should we invest in a world in which risk is high but returns might stay strong?

As we have seen, today conditions foreshadow at best low returns. When volatility eventually rises, the more important question will not be why it has risen, but why the market pricing failed to factor in well-known risks. While policy uncertainty has increased dramatically (we have an erratic and unpredictable US President and central bank policy is starting to shift with highly uncertain consequences), and yet market volatility has declined. Since 1996, the CBOE Volatility Index (VIX) has closed below 10 just thirty-two times. Twenty-nine (at the time of writing) of those have been in 2017. 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.

So why are well known risks not reflected in market pricing? Part of the answer is that short term fluctuations in share prices don't reflect changes in underlying economic fundamentals. Share prices respond to sequences of positive or negative news which periodically tips investor psychology between optimism and fear; or tolerance and risk aversion. It's about perception and emotion. Emotion is a barrier to objectivity and ability to make the right decisions.

To make the right decisions we need to objectively assess both the positives and negatives – even when all is well on the surface we need to weigh the sources and extent of possible future risks against the upside. However, it is rare for an asset allocation process to assess risk by looking forward.

Standard deviation is a commonly used measure of risk, it relies on past data not future possibilities. Risk not a statistic. We need an understanding of particular risks that may lie ahead. Risk arises from real events such as policy mistakes, geopolitical issues, disappointing earnings, new technology, rising inflation, slumping growth and so on.

The specific risks we face today are underappreciated because:

- There is a strong behavioural tendency to be grounded in what we're currently experiencing.
- This makes it difficult to imagine an environment that's significantly different from today or from what's commonly expected.

This matters, for example it resulted in the illusion before the GFC that we were in a low risk world (remember the so-called Great Moderation). In fact it was clear at the time that risk was high. And now investors tend to assume repressed rates are here to stay. There are valid arguments for why this might be the case, but there is a much more limited focus on why it might not which reflects how difficult it is to imagine what could change.

To avoid being misled by narrow thinking we must take into account that something important could change. But we also must understand that no matter how much clever analysis we do, any one forecast of the future is always unreliable. This means we must remain sceptical and focus on understanding the different possible futures that might occur. We need to know what can go well and badly – perhaps earnings growth will be strong and interest rates won't rise; but perhaps the reverse occurs. In other words, we need to take into account a range of return outcomes or scenarios. And if we do that comprehensively we have a systematic way to generate genuine insight into what drives future market outcomes and to understand the risks that matter today. This is particularly important in today's distorted investment environment. We cannot rely on the past to understand the risks we face today.

We are saying that we must assess risk by looking forward. To do that, rather than trying to forecast the one future that will unfold, the right approach is to seek to understand what could happen, both positive and more challenging.

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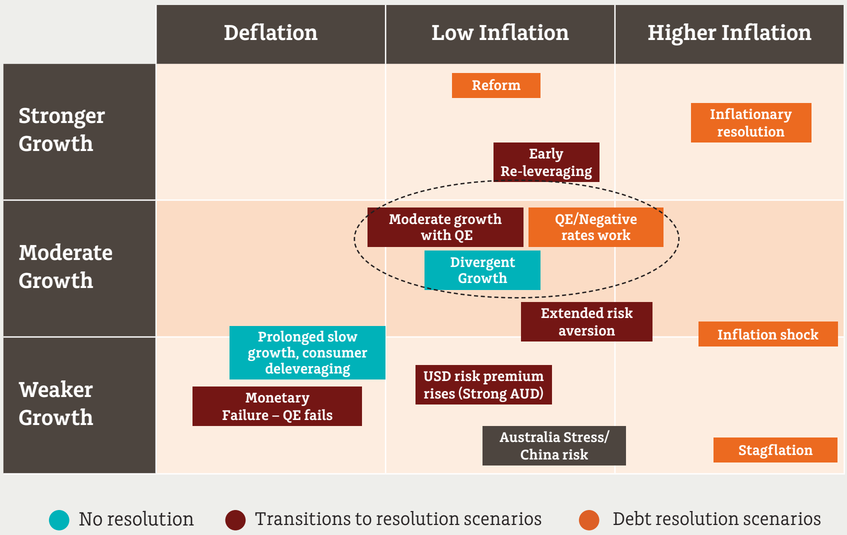
CHART 4: POTENTIAL FUTURES



Source: NAB Asset Management Services Limited.

Looking forward there is a wide range of possible futures that could unfold. Chart 4 looks at some of the most obvious (today we are working with 55 scenarios in total). On the positive side there is the potential for a resynchronisation of growth with the eurozone and Japan; and if we see genuine structural reform that increases growth potential. Such an outcome would help justify today's high asset prices. However, both deflation and rising inflation are possible. Inflation is a possibility, particularly in Japan and the US where labour markets are tightest. There is the potential for significant market corrections as ultra-monetary accommodation is wound back - no one (including policy makers) can be sure at what point the changes become critical for market liquidity. And we should not forget that the fundamental problem which lay behind the GFC – too much debt - remains unresolved.

The question you may now be asking is: **given so many things are possible, how should portfolios be positioned?** To be clear, the choice is to position portfolios on the basis of either:

- Hope that you can forecast the one future that will unfold - most of the time this involves some extrapolation of the past which is unreliable; or
- An understanding of the things that could happen, good and bad – that is on the basis of an informed decision about how much risk and what sort of risks to take, and what the consequences of that are for return outcomes.

In other words, the choice is between hope-based or risk-based investing. Hoping that things will not go wrong is not a sound strategy – at some point during an investor's retirement a significant market decline is likely.

Risk-based investing prepares for the possibility that things do not turn out as we would prefer. To get the risk control right the scenarios explored must be comprehensive – we can't afford to leave any major risks out. A handful of scenarios won't achieve this.

Since we can't be sure what the future holds the most important question is: **in the event that a negative scenario occurs, can investors tolerate the pain?** For some pre and post retirees the answer may be 'no' – because they don't have an opportunity to recover from significant losses. The solution is that we need to build portfolios with far more resilience in down markets and therefore more certain lifestyle outcomes.

And that's what MLC Inflation Plus portfolios are designed to do far more effectively than traditional diversified funds defined around debt/equity mixes. For MLC Inflation Plus portfolios to be successful in meeting objectives, the critical thing is risk management, asset allocation flexibility and patience. Risk control must be continuous because the future is always uncertain meaning there is always the possibility of an adverse scenario. At some point the investment environment will change – but it is not possible to reliably forecast when.

MLC Inflation Plus portfolios seek an acceptable return regardless of market behaviour. What should investors expect? As we have experienced, the path of returns can vary significantly versus more market relative portfolios. Chart 5 shows the path of $100 looking back 3 years, and forward 3 years – the multiple lines shows the range of possible futures.

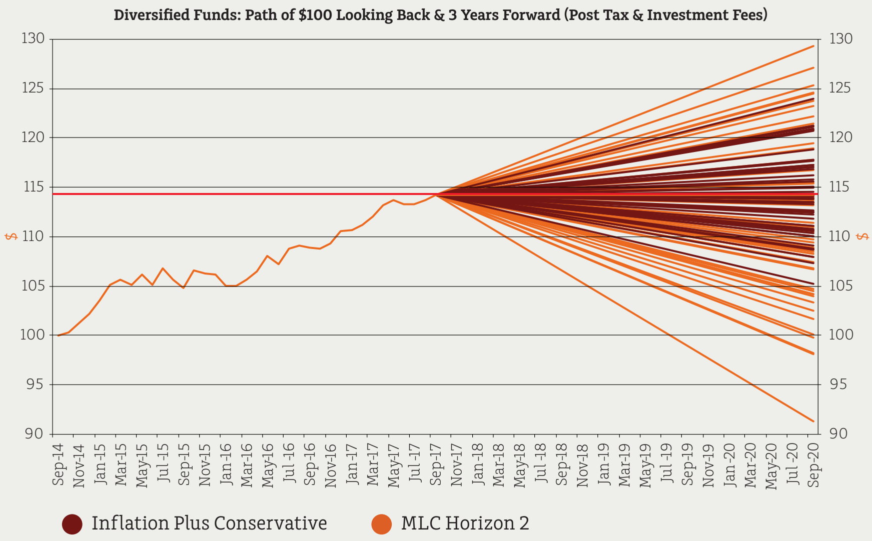
MLC's scenario insights & portfolio positioning

Each line is a scenario. Two funds are shown – a typical conservative 30% debt, 70% equity portfolio in yellow and a tighter range of outcomes for the Inflation Plus Conservative Portfolio (assuming that the current asset allocation does not change) in blue.

Our Inflation Plus portfolios must maintain a low probability of a negative return over the defined time frame, and more importantly the extent of any negative return in a worst case scenario must be limited. Today, this means that we must stand back and keep significant powder dry. We know this will test our investors' patience if returns remain strong because, as the chart illustrates, of the performance lag versus traditional funds in strong scenarios. However, this is the only reliable way to avoid the big drawdowns and underpin more robust lifestyle outcomes. That is essential if we are to protect the real purchasing power of retirees.

In other words, we are seeking to bullet proof the portfolio as far as possible by thinking through ahead of time what could happen. We can of course hope that returns will stay strong (and they may for some time yet) but this is a gamble which at some point will not pay off. Consequently, for many retirees positioning portfolios to limit risk makes sense – this may mean lower returns in the short term – that is the price for safeguarding lifestyle outcomes.

Chart 5: Risk-based investing is essential in a low return world



Source: NAB Asset Management Services Limited.

Investment strategy and research

This section provides a summary of some of the strategy changes we've made this quarter, those under consideration, and research we've undertaken.

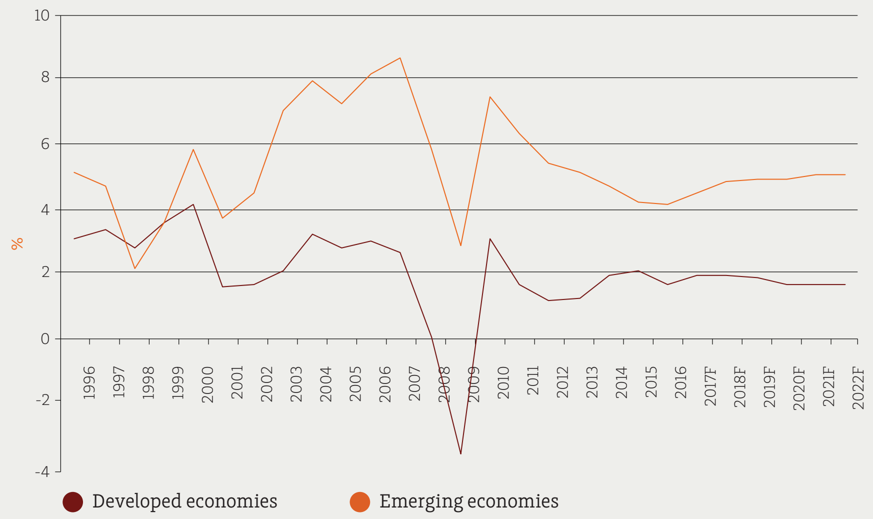
Investment strategy		
Strategy	**Rationale**	**Detail**
AUD/USD upside protection	This is a risk management strategy. Foreign currency (FX) is often a diversifier of equity risk. FX exposure enables a higher allocation to equities in our Inflation Plus portfolios than would otherwise be possible. Our FX exposure enhanced returns while the AUD was declining. At higher levels of FX exposure there is higher risk of AUD appreciation – this strategy reduced exposure to that risk at zero cost.	The strategy involves the purchase of 9 month AUD call options, and selling knockout AUD put options for net zero premium against our underlying foreign currency exposures. Careful structuring resulted in the AUD put options being 'knocked out' after two weeks, resulting in 'free' topside AUD protection. The strategy has been implemented over the last 3 years; the strategy has worked very well. The put options have either knocked out, or expired worthless and increases in the AUD have allowed the portfolio to either add more cover for no cost, or restructure existing cover more favourably. Overall the strategy has provided significant cover at no cost to the portfolios and generated a very small amount of positive return from the restructures.
Defensive equity investment	This is a risk reduced equity exposure that provides the Inflation Plus portfolios exposure to equity index upside and limits downside risk.	Purchased in a ratio of 2:1 equity index options consisting of out of the money calls and puts for net zero premium, cash-backed. This strategy exploits a strong skew in current options pricing. Exposure supported by relatively attractive aggregate equity valuations.
Japan TOPIX allocation	A strategy that reduces downside risk by exploiting the tendency for the Japanese yen and the Japanese share market to move in opposite directions.	Long TOPIX futures, cash-backed and unhedged.
Emerging markets (EM) research	Leverage potentially attractive returns from EM while moderating the exposure to negative returns. EM has an attractive economic growth profile but is burdened with additional risks versus developed market investing. Specialist skills are necessary to avoid the nuanced perils of EM investing. Valuations support a continued EM research effort. This research is ongoing, a summary is provided below.	Research focused on reduced risk EM allocation for Inflation Plus portfolios. Two strategies under assessment: 1. Zero cost options strategy to reduce equity downside risk. 2. Actively managed risk aware EM strategy.

Emerging markets research

Emerging markets (EM) are always a tempting investment – they promise higher growth and often trade at lower valuations than developed markets. However, the investment return has been frustrating when compared to the robust levels of economic growth. Over the last 20 years the emerging countries have delivered consistently higher economic growth than the developed world – only in 1998 did their growth rate dip below developed markets, and in 2009 they held their ground while developed markets contracted significantly (Chart 6). The story for investors however had been far less impressive - the MSCI Emerging Markets Index has underperformed the MSCI's developed markets index, the MSCI World Index, over the same period (Chart 7).

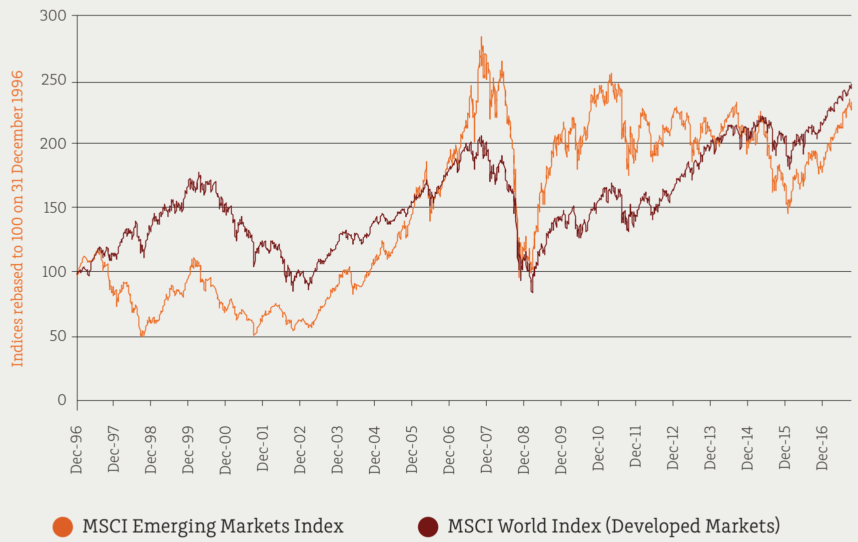
Investors who successfully anticipated the extraordinary growth of the Chinese economy from 1992 following the opening up of China by former leader Deng Xiaoping, have been disappointed. Deng's objectives were encapsulated in the phrase "To get rich is glorious". Those who followed Deng understood the potential that growth in China could transform the economy into a global leader. However, investing in Chinese equities would have been incredibly disappointing. Tsingtao Brewery was the first Chinese stock listed on the Hong Kong exchange in July 1993. If you continued to buy the basket of Chinese equities available, almost 25 years on, investors in the MSCI China Index are still 20% below the initial level and 40% below the high watermark (Chart 8).

Chart 6: Real annual GDP growth – developed and emerging economies



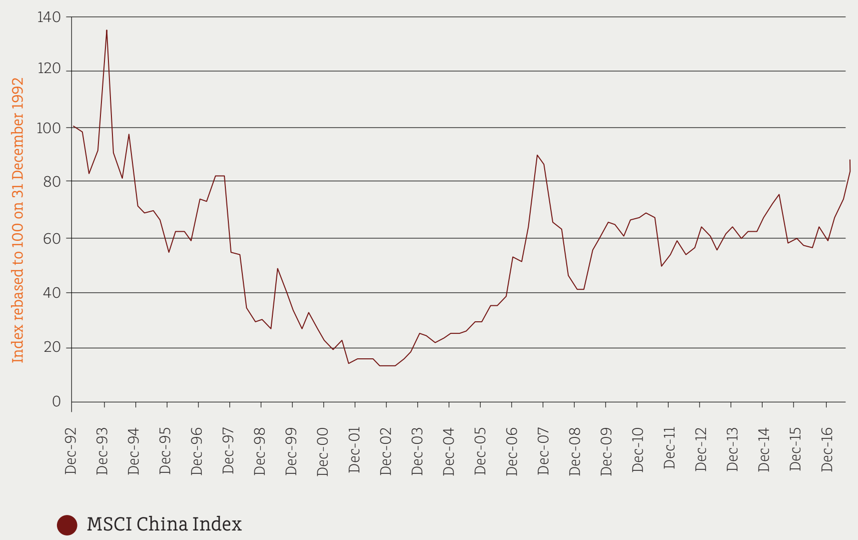
Source: International Monetary Fund.

Chart 7: MSCI Emerging Markets Index vs MSCI World Index historical returns



Source: Bloomberg, data in local currency terms.

CHART 8: MSCI China Index historical returns



Source: Bloomberg, data in local currency terms.

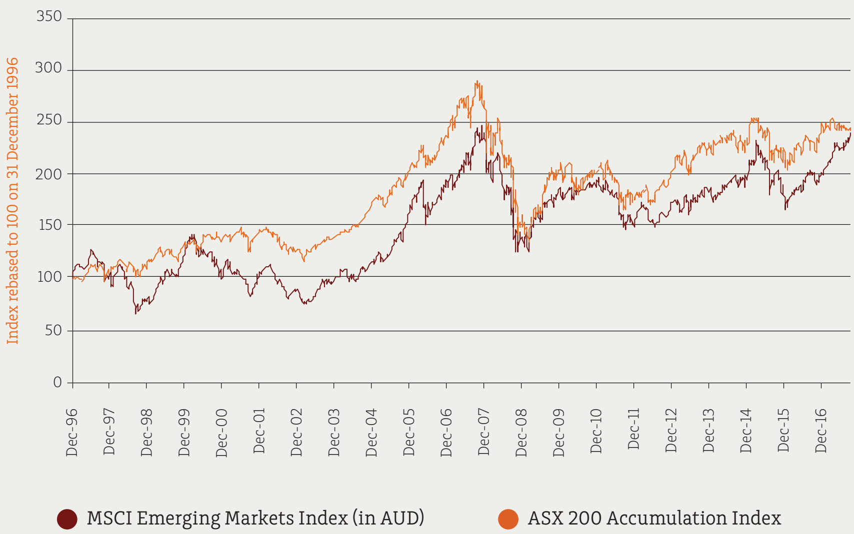
With return potential now compressed amongst more traditional asset classes we are forced to scour the world for opportunities. This includes EM, which our scenarios analysis indicates has relatively attractive return potential in a return constrained world. However, this is a relatively high risk asset class and, given what we perceive as fragility in the global investment environment, we must seek a way to benefit from the return potential while reducing downside risk. While this year, fears of populist trade policies and the threat of higher interest rates (the classic EM crisis trigger) have not prevented markedly more synchronised economic growth across EM, there remain clear threats. Also this growth has attracted equity investor attention, increasing the vulnerability if expectations are disappointed. Rising US inflation or an interest rate surprise from the US Federal Reserve (Fed) could quickly unwind the rise in EM share prices.

Our Inflation Plus portfolios currently have only a small exposure to EM via derivative markets, which enables rapid adjustment. MLC Horizon and Index Plus portfolios have exposure via mandates that allow managers to invest across both developed and emerging markets. However, we are cognisant of the historical record of disappointment of investing in EM and we continue to approach the asset class from a broad perspective considering the full range of opportunities from the illiquid to liquid and across companies' capital structures. The challenge is how to benefit from strong economic growth while controlling the risks inherent in these markets.

Investors typically reach for EM looking for growth, and thus equities seem the obvious choice. However, historically the returns for EM debt and equities are similar, and for both currency risk is very significant (less dominant for equities but still a major source of return volatility). For the Australian investor there is some offset because as EM asset prices fall, the AUD tends to weaken. Consequently, the drawdown for AUD based investors in EM have been significantly lower for both debt and equity investors than for those approaching the asset class from a euro or USD perspective. In fact for AUD based investors the drawdowns in EM equities over the past 20 years have been smaller than those in the ASX 200 (Chart 9)!

It is important though, not to understate the risk of investing in EM, while the drawdowns have been smaller – significant drawdowns have been more frequent. Also, we cannot presume that the future will look like the past.

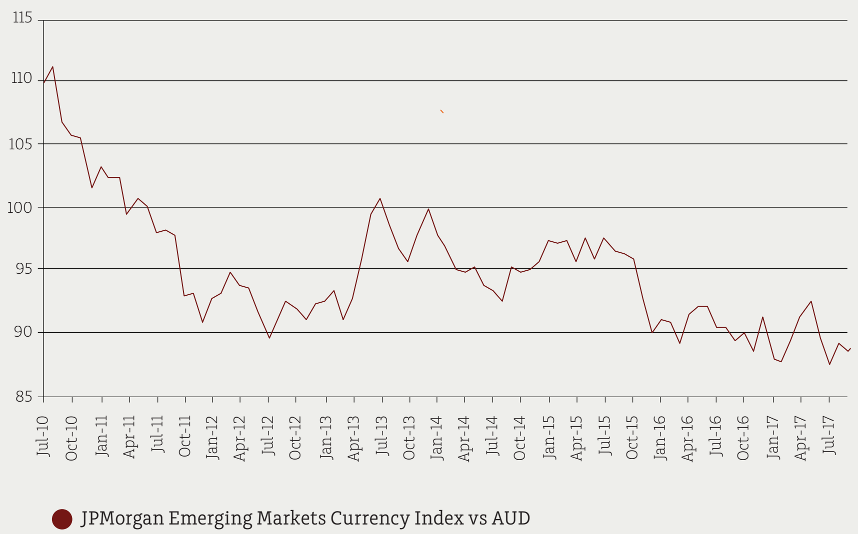
CHART 9: MSCI Emerging Markets Index (in AUD) historical returns vs ASX 200 Accumulation Index



Source: Bloomberg.

Additionally, just as EM valuations appear relatively attractive, today a basket of EM currencies is close to all-time lows versus the AUD (Chart 10). While EM currencies have rallied recently as the threat of Trump's protectionist policies to global trade has receded (and economies in Latin America have reformed), the AUD has also rallied, supported by the resurgence of raw material prices.

Chart 10: JPMorgan Emerging Markets Currency Index



Source: Bloomberg.

Despite the significant volatility of EM currencies, this driver of volatility tends to be overlooked in managing asset class exposures. In particular, investors in USD denominated debt issued by emerging markets' countries regularly ignore the currency risk. While the security has limited currency risk in USD terms and the yields have looked attractive, the currency risk becomes the major source of credit risk when the economy is distressed. As a currency depreciates, the USD denominated obligations balloon for the issuing emerging market country. This has caused a number of EM crises (Mexico in '94 and Argentina in '02).

Also equity market investors' currency risk is rarely actively managed. Most equity EM mandates are unhedged, most managers unwilling to explicitly manage the currency exposure. Interestingly EM equity investors often site the currency as too expensive to hedge, while local currency debt investors see it as an important source of returns. In seeking a risk controlled physical exposure these issues tend to bias us towards EM debt managers.

Higher growth potential is a persistent advantage for EM. There is some expected loss of dynamism as countries move along the development spectrum, but on the other hand there has arguably been a general increase in macroeconomic credibility and rising resilience. Looking forward emerging countries are expected to account for 95% of the world's population growth, and already account for more than 60% of global GDP (however, they only make up 10% of investable global share market capitalisation). These countries still have positive real interest rate regimes. Also risk may be lower than the past to the extent that a series of fiscal prudence lessons have been learned. The follies of populist rule (for example in Argentina) are also clearer in EM; while key developed countries appear more vulnerable to these follies than has been the case for some time.

Nevertheless we remain sceptical that the leopard has entirely changed its spots, it's clear that EM provide a broad range of possibilities. Markets like Korea and Taiwan are difficult to differentiate from an investment perspective from developed market neighbours Japan and Hong Kong. Yet opportunities in the same asset class extend to the fast growing economies of Ethiopia and India which have no developed market peers in growth terms (the closest is Iceland which barely ranks in the top 20 of fastest growing economies in 2017). At the same time the opportunities offered by EM are not lost on developed market companies which understand the potential revenues available if EM expansion plans are executed well.

To exploit those opportunities, manage the risk and minimise a potential outcome similar to that experienced by early investors in China, will require the flexibility to ignore the benchmark and access investments that offer the most attractive risk reward trade-off. A key to achieving our objectives involves managing the risks posed by EM currency exposure. Controlling for these risks either directly through active management or indirectly (via derivatives) will have a very significant focus on understanding those threats.

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 from today we see the potential for the strong returns that we have seen over recent years to persist, but this environment is not based on strong foundations and fragility is increasing. While policy makers might manage to engineer a benign path forward, we should take seriously the possibility of a significant market decline. Our aim is to understand the key things that could happen and then identify the most appropriate trade-off of risk and return, given the objectives and constraints for each portfolio, to find at least an acceptable outcome regardless of what happens.

Our promise, particularly to our Inflation Plus portfolio investors, is to maintain the risk control discipline – this means that in a worst case scenario we must avoid significant negative returns over each portfolio's 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.

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.

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 **Stagflation** and **Extended 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 more clearly 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 political pressures that arise from what are now multiple displays of voter discontent with the status quo reinforces the need to change the policy agenda. This is a risk point to watch closely, particularly as it has coincided with changing perceptions about monetary policy efficacy.

The potential real returns for each asset class are shown in Chart 11 on page 15.

The Investment Futures Framework scenario sets explained

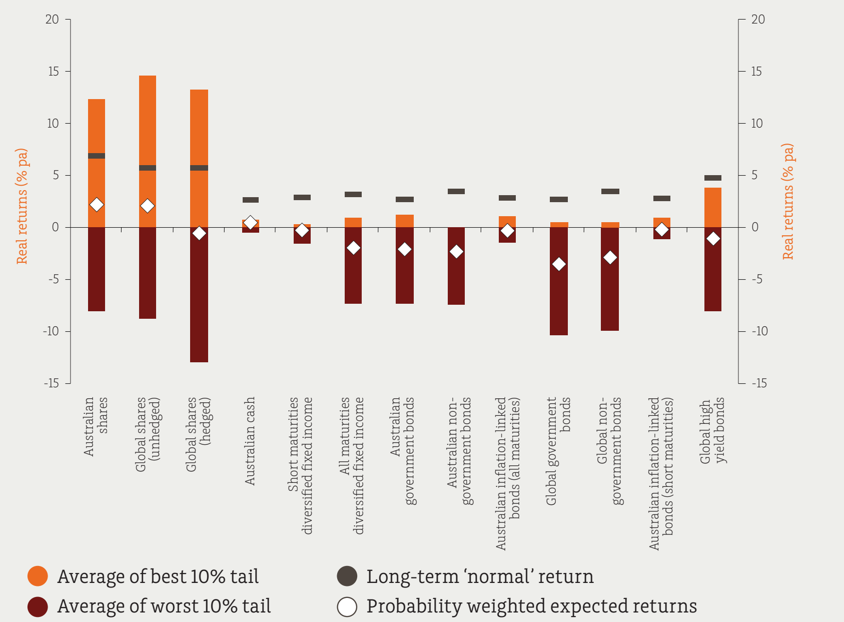
Our approach assesses and analyses a comprehensive set of possible future scenarios – this is referred to as the Investment Futures Framework. This thorough assessment of the different ways in which the future might unfold provides us with detailed insight into return potential and, most importantly, 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.

CHART 11: 40 SCENARIO SET (GENERIC SCENARIOS) POTENTIAL REAL RETURNS (SEPTEMBER 2017) – 5 YEARS, 0% TAX WITH FRANKING CREDITS, PRE-FEES, PRE-ALPHA



Source: NAB Asset Management 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 12, on page 16, shows return potential for the MLC Horizon, Inflation Plus and Index Plus portfolios based on our generic (40) scenario set looking forward from the end of September 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 to the MLC Horizon and Index Plus portfolios, the stronger risk focus of the Inflation Plus portfolios is evident. Consistent with their objectives, these portfolios have responded to shrinking return potential and weakening risk diversifiers by reducing exposures to riskier assets. This reduces the return potential in strong scenarios but provides tight risk control in the event that an adverse environment occurs.

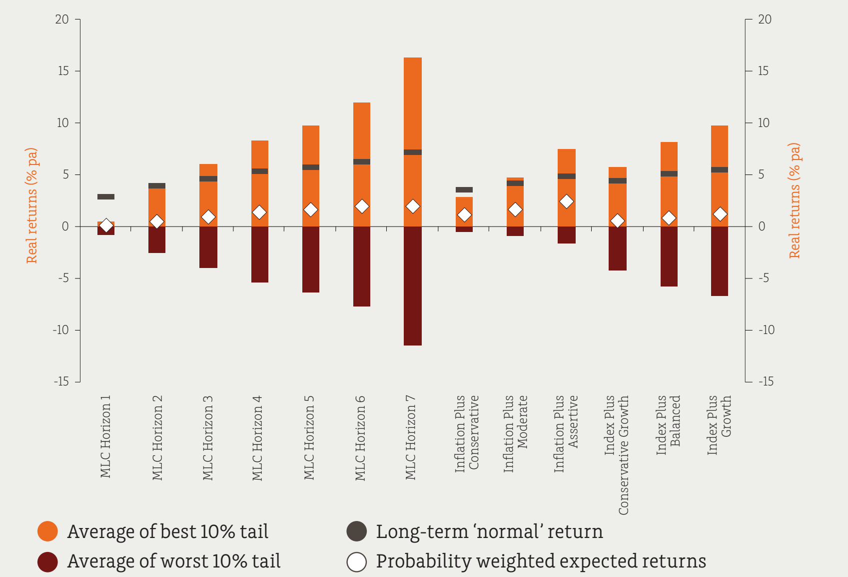
In positioning the MLC multi-asset portfolios we take into account outcomes in all our scenarios. For the MLC Inflation Plus portfolios, our focus is on strictly limiting both the probability and most importantly the extent of negative real returns over each portfolio's time horizon in the event that an adverse scenario occurs, while extracting as much return potential as possible subject to this risk constraint.

Also, in relation to the MLC Inflation Plus portfolios, the chart suggests that with a single static asset allocation, a particularly positive scenario is required to meet the return hurdle. Of course, in practice the portfolios' asset allocations are not static. We evolve the MLC Inflation Plus portfolios' allocations dynamically through time to control risk as required and exploit opportunities as they arise. However, we will not chase returns to meet the return hurdle if that requires too great a risk exposure.

MLC Horizon, MLC Inflation Plus and MLC Index Plus portfolios

MLC's scenario insights & portfolio positioning

CHART 12: 40 SCENARIO SET (GENERIC SCENARIOS) POTENTIAL REAL RETURNS (SEPTEMBER 2017) – 5 YEARS, 0% TAX WITH FRANKING CREDITS, PRE-FEES, PRE-ALPHA



Source: NAB Asset Management 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 September quarter			Comment
	Conservative	**Moderate**	**Assertive**	
Defensive Australian shares	Steady allocation	Steady allocation	Steady allocation	Our defensive shares investment process directly takes account of the risks identified in our scenarios analysis. By investing in defensive Australian share 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)	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	**AUD/USD upside protection** (explained on page 9) maintained.
Gold exposure	Zero allocation	Zero allocation	Steady 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**	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. This quarter we've slightly reduced exposure in the Moderate portfolio to increase portfolio liquidity.
Real return strategy	Steady allocation	Steady allocation	Steady allocation	Allocation to our multi-asset real return manager, Ruffer, maintained.
Derivatives strategies	Steady allocation	Steady allocation	Steady allocation	Focus has increased on risk controlled equity exposures using derivative strategies opportunistically, taking advantage of favourable market pricing where this is consistent with our scenarios insights. Two strategy refinements this quarter, **Defensive equity investment** and **Japan TOPIX allocation**, are explained on page 9.

MLC Inflation Plus portfolios continued

Asset class	Change in allocation to asset classes in the MLC Inflation Plus portfolios (in MLC MasterKey's super and pension products) over the September quarter			Comment
	Conservative	Moderate	Assertive	
Global private assets	Steady allocation	Steady allocation	Steady allocation	Within the private asset strategy some rebalancing is underway which reduces the venture capital exposure. This locks in what have been very strong returns in this part of the market and reduces the overall risk profile of the portfolio.
Global property securities	Zero direct exposure	Zero direct exposure	Zero direct exposure	In the portfolio we are limiting exposure to interest rate sensitive assets. We prefer the broader opportunity and absolute return orientation of defensive global shares and multi-asset strategies. There is potential reversion in the prices of higher yielding assets such as Real Estate Investment Trusts (REITs) in scenarios in which monetary policy normalises.
Global government bonds	Zero direct exposure	Zero direct exposure	Zero direct exposure	Deeply unattractive, with limited diversification benefit.
Australian inflation-linked bonds	Steady allocation	Steady allocation	Steady allocation	Maintaining emphasis on short duration inflation-linked bonds which helped protect returns as yields rose during the quarter.
Insurance-related investments	Zero allocation	Steady allocation	Steady allocation	Uncorrelated though risky exposure is appropriate where time horizon is sufficient. The portfolio was resilient in the face of multiple time horizons
Bank loans	Steady allocation	Steady allocation	Steady allocation	Floating rate loans offer some exposure to diversifying income-based risk premia without as much capital risk as fixed coupon bonds. While this exposure has been attractive in the current environment, tight spreads increase price risk and a tendency for low liquidity in adverse environments limits the degree to which portfolios should have exposure.
Australian non-government bonds (short duration)	Steady allocation	Steady allocation	Steady allocation	Offer some return enhancement while limiting additional risk.
Cash	Steady allocation	**Increased allocation**	**Increased allocation**	We continue to keep significant powder dry (in cash) waiting for better opportunities and have been increasing liquidity in the Assertive portfolio in particular. 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 Horizon portfolios

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

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

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

For MLC Horizon portfolios we are maintaining a relatively defensive orientation. However, while we continually test our thinking, we retain high conviction in the appropriateness of this positioning. While the flexibility is more limited and exposure lower, we are utilising similar derivative strategies as for Inflation Plus to enhance the defensiveness of equity exposures and manage exchange rate risk.

Asset class	MLC Horizon 4 Balanced Portfolio (Super & Pension) weights at end of the September 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

Asset class	MLC Horizon 4 Balanced Portfolio (Super & Pension) weights at end of the September quarter			Comment
	Under	Benchmark	Over	
Alternatives			●	
Global private assets		●		Retain target benchmark allocation.
Real return strategies (including Inflation Plus)			●	MLC Horizons 4 and 5 portfolios 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.

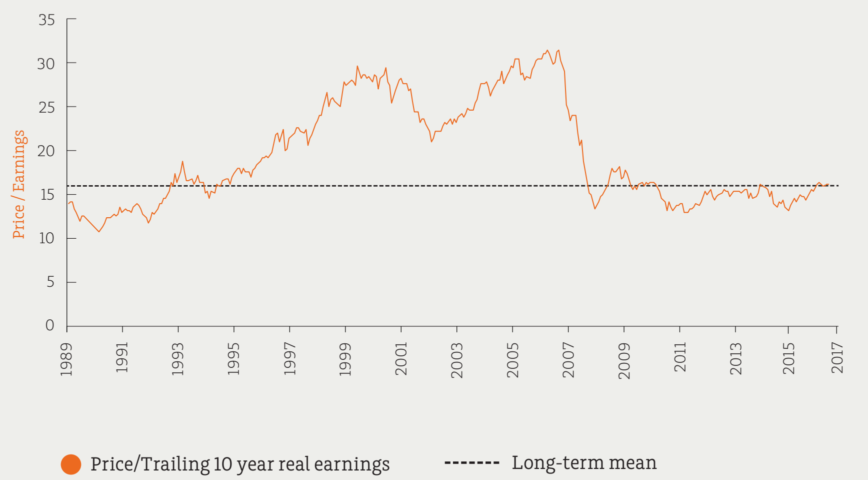
For MLC Index Plus portfolios we are maintaining a relatively defensive orientation. Over the past year the defensive positioning and particularly the foreign currency overweight have detracted from returns. However, while we continually test our thinking, we retain high conviction in the appropriateness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

Asset class	MLC Horizon 4 Balanced Portfolio (Super & Pension) weights at end of the September 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.
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 13: AUSTRALIAN SHARES
Market indicator *S&P/ASX 200 Index*



Source: Global Financial Data.

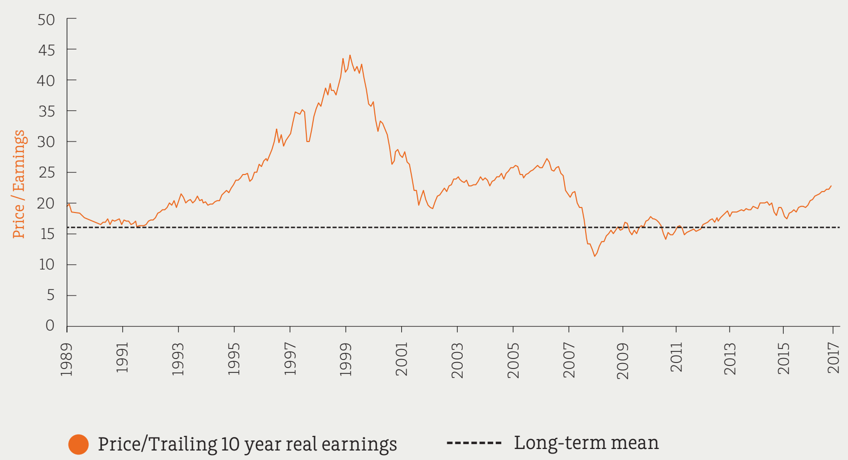
Comment

Australia has recorded positive economic data. Stronger jobs growth has seen Australia's unemployment rate stabilise at 5.6%. The National Australia Bank business surveys are also showing strong results for confidence and conditions. The Reserve Bank of Australia has kept the official cash rate steady at 1.5%.

Australian shares posted a modest return of 0.7% for the September quarter. Investors favoured the Resources (9.3%) sector given the strong rebound in key commodity prices such as iron ore. However there was weak performance from the Telecommunications (-15.4%) sector given subdued profit results with Telstra cutting its dividend. There were also significant declines for the Utilities (- 5.9%) and Health Care (- 5.2%) sectors due to their sensitivity to potentially higher interest rates.

Asset class indicators continued

CHART 14: GLOBAL SHARES
Market indicator *MSCI All Country World Index*



Source: Factset.

Comment

Global shares made strong returns over the past three months to September 2017 and delivered 4.7% in local currency terms. However a stronger AUD performance limited the unhedged global shares return to 2.9%.

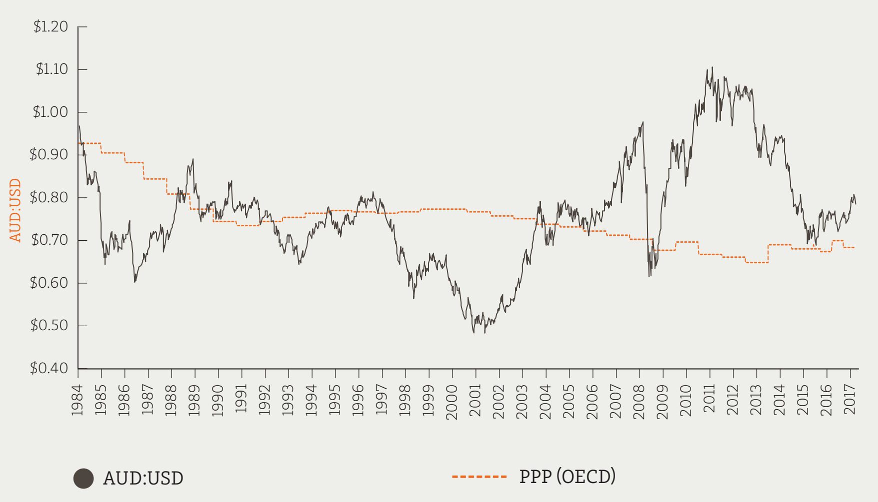
US shares achieved record highs with the benefit of strong corporate profit reports, solid economic data and President Trump's promises of corporate tax cuts. Notably technology shares surged with the NASDAQ posting a strong 6.1% gain for the quarter. US economic data has also been favourable in terms of solid jobs growth, lower unemployment and very positive business surveys. The Fed held interest rates steady during the quarter but did announce a plan to gradually reduce its balance sheet.

European shares performed strongly with a 4.2% gain (MSCI Europe unhedged) over the quarter. Europe's positive business surveys and employment growth have been supportive while the German election result in September appears to favour Angela Merkel achieving a fourth term as Chancellor.

Emerging markets (unhedged) made robust returns of 5.6% for the quarter. Chinese shares led the way with a 12.1% quarterly return (MSCI China unhedged) given encouraging signs that China's economic activity has maintained a solid growth pace.

Asset class indicators continued

CHART 15: AUSTRALIAN DOLLAR
Market indicator *Australian Dollar Purchasing Power Parity (PPP)*

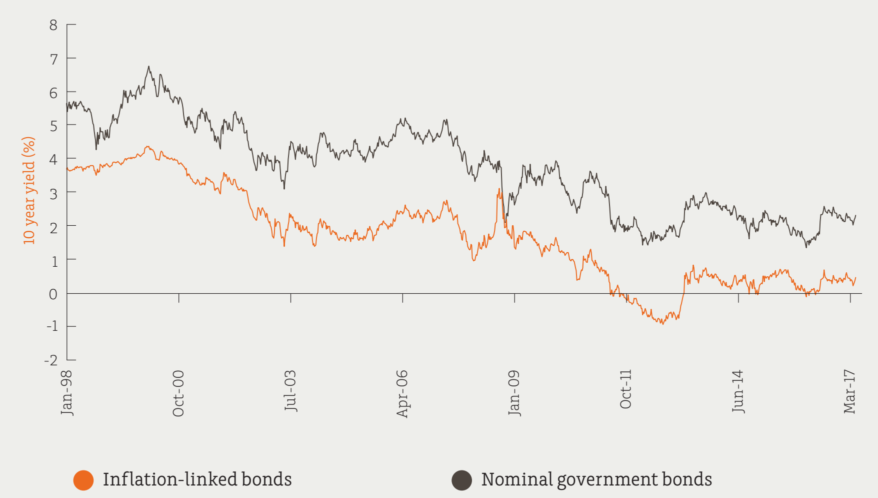


Source: Bloomberg.

Comment

The AUD made solid gains in the September quarter, particularly against a weaker US dollar and Japanese yen. A strong rebound in iron ore and metal prices as well as improving Australian employment growth were the key drivers for the AUD's gains.

CHART 16: GLOBAL GOVERNMENT BONDS
Market indicator *10 year bond yields – United States*



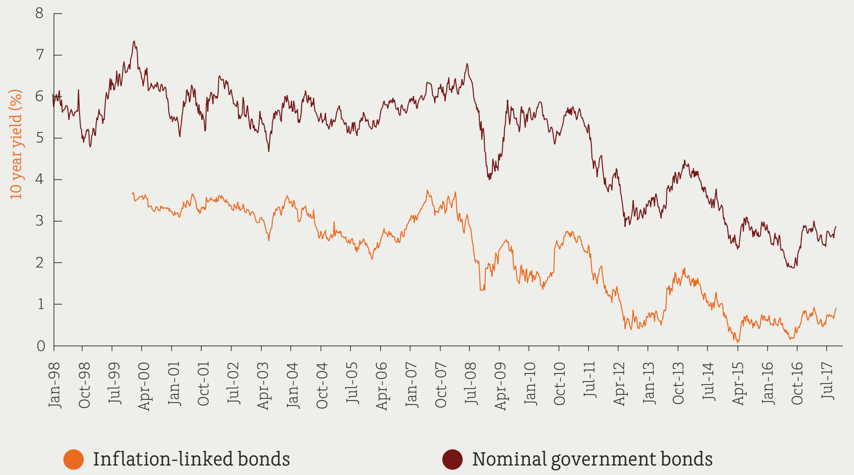
Source: Bloomberg.

Comment

Global bonds (hedged) delivered a modest 0.9% return for the quarter. While there was stronger global economic activity data, mild inflation outcomes have supported global bonds.

Asset class indicators continued

CHART 17: AUSTRALIAN GOVERNMENT BONDS
Market indicator *10 year bond yields – Australia*

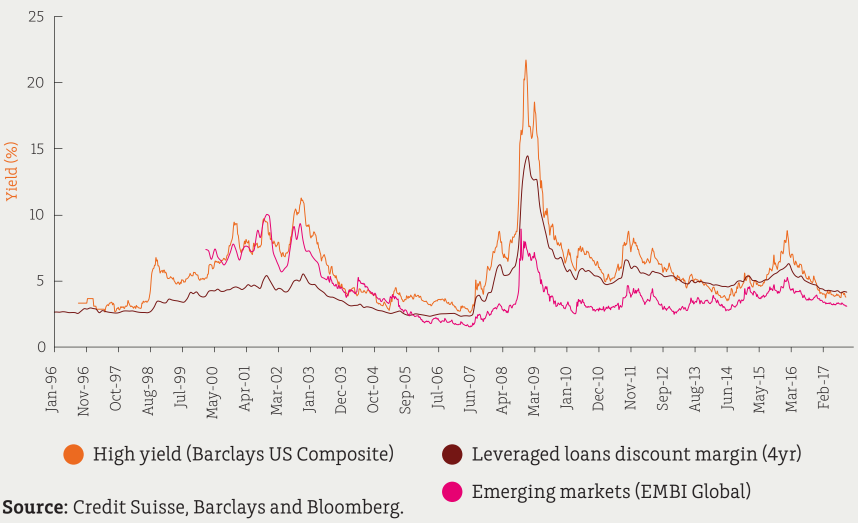


Source: Bloomberg.

Comment

Australian government bond yields moved higher over the quarter given the stronger economic data. This resulted in a disappointing -0.1% return for Australian bonds.

CHART 18: NON-INVESTMENT GRADE BONDS
Market indicator *Fixed income spreads*



Source: Credit Suisse, Barclays and Bloomberg.

Comment

Global high yield bonds (hedged) made a strong 1.1% return for the quarter given optimism for higher corporate profits with President Trump's tax plan.

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.

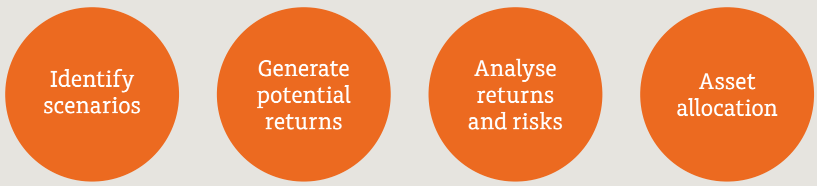
Appendix 1
– Tailored scenario set continued

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

The Investment Futures Framework



- 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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