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MLC's scenario insights & portfolio positioning

MLC Horizon, MLC Inflation Plus and MLC Index Plus portfolios

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Contents

Quarterly insights 3

The Investment Futures Framework: Scenarios, changes in return potential, and portfolio positioning 8

Return potential 10

MLC Inflation Plus portfolios 11

MLC Horizon portfolios 12

MLC Index Plus portfolios 13

Appendix 1 – MLC's market-leading investment process 14

Update for the quarter ending 30 June 2020.

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Quarterly insights

Highlights

- In this unprecedented COVID-19 pandemic environment, investors are searching for ways to protect themselves against extreme market volatility as many find themselves with more risk in their portfolios than usual.
- The core conundrum facing investors in pursuit of an absolute return is that shares are currently expensive relative to history, but attractive relative to other asset classes, particularly bonds. To have any chance of achieving return objectives, shares need to be a meaningful part of the investment solution.
- In a stressed environment, such as now, liquid assets are essential to help manage allocation changes without compromising the integrity of the portfolio. We've maintained a high level of liquidity to protect the MLC multi-asset portfolios from adverse outcomes, preferring to stay nimble and adjust to changing conditions.
- Investing into this level of uncertainty is difficult and requires flexibility and an acceptance that the future is unknowable.
- Investors need to take risk to generate return for their portfolios, but in this volatile environment there is a benefit in utilising a range of defensive strategies. Diversify across assets, currencies, and styles but also diversify across defensive techniques to increase the chances of improving portfolio outcomes.

Insights

'Unprecedented' has been the word of choice for describing the situations we have all faced during the COVID-19 pandemic. Granted the word has been overused, but that makes it no less appropriate. Just look at share markets. March saw the fastest US share market sell-off in history[1] only to be followed by the strongest 50 day positive return ever[2]. In this 'unprecedented' environment, investors are searching for ways to protect themselves against such extreme volatility.

One of the reasons investors feel the need for greater protection is that many find themselves with more risk in their portfolios than usual. With yields on typical income assets such as government bonds and credit severely depressed, investors have gradually been forced further along the risk curve to maintain an adequate level of income and expected return. That this situation exists is without a doubt by design. Central banks in pursuit of economic reflation have depressed risk-free yields in the hope investors take on more risk. For as investors take on more risk, financial conditions relax, consumption and investment grow and the supply-demand balance for goods and labour in the real economy normalise back towards a comfortable inflation rate of 2-3%. This is the theory. Yet in practise, while the impact of ever-lowering of the risk-free rate has spurned inflation in the financial economy, evidence that policy has met its ultimate objectives in the real economy is much more debatable. Much of the monetary stimulus has found its way into existing businesses through acquisitions or share buybacks. Little has been used to create new growth.

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 available on our website and in Appendix 1.

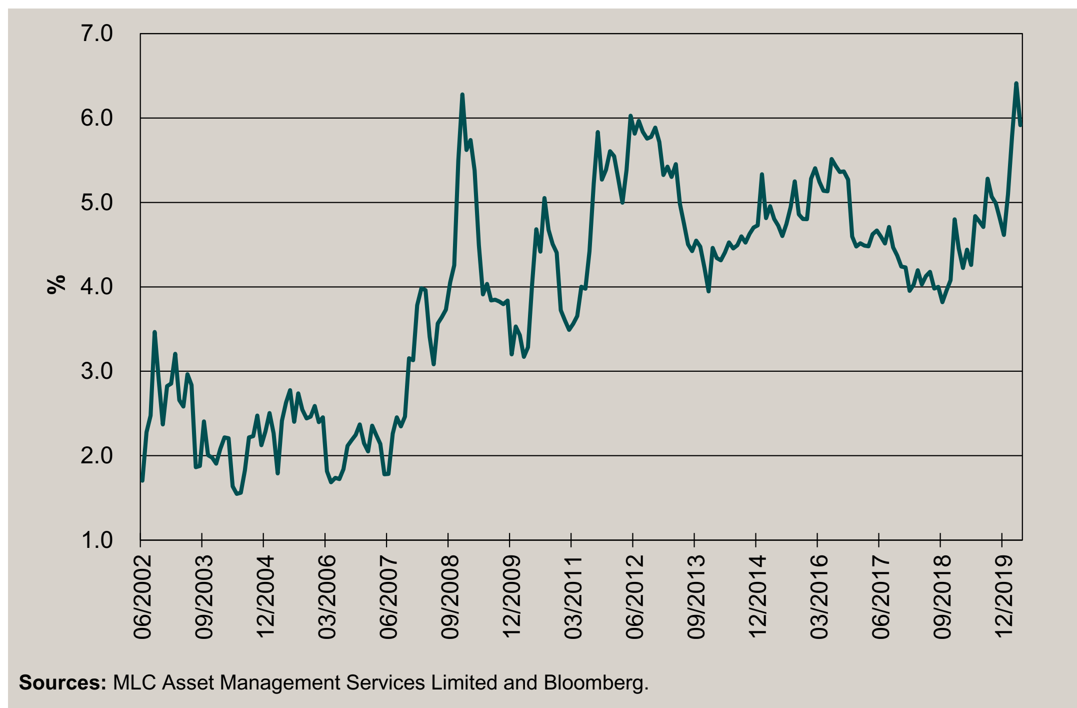
By design, the action of monetary policy has generated significant demand for nearly all financial assets. This is most evident for risk-free or near risk-free assets such as developed market government bonds and investment grade credit. Following on, as assets close to the risk-free benchmark become more expensive, then all-else equal, the relative attractiveness of more risky assets, like shares, also improves. This is clearly illustrated by invoking the Equity Risk Premium (ERP)[3] as a simple comparison of government bonds and shares. Chart 1 shows the current level of the ERP for US assets.

At 6%, the difference between the expected earnings yield on shares and government bond yields is basically the same as it was in 2008. How is this possible at the end of a 10 year bull market in shares?

For over a decade now, central bank monetary policy has either directly or indirectly depressed the entire yield curve of government bonds, which in turn has pushed capital further out along the risk curve in search of return. This in turn has forced investment grade bond yields to compress with a follow on impact to property yields, by high yield debt and so on... After 10 years of this behaviour investors now face into a severely compressed outlook for returns. To generate any sort of reasonable return, shares become the only game in town.

This is an uncomfortable reality for many investors as they see the Price to Earnings multiple at 25[4] and view shares as expensive. And herein lies the core conundrum facing investors in pursuit of an absolute return – shares are indeed expensive relative to their own history, but attractive relative to other asset classes, particularly bonds. To have any chance of achieving return objectives, shares need to be a meaningful part of the investment solution. It makes sense for investors to want to protect themselves in this situation as buying an 'expensive' asset is an uncomfortable exercise. It becomes particularly uncomfortable when the environment into which you are investing is as uncertain as the one we are currently experiencing.

Chart 1: Equity Risk Premium for US assets



How can investors protect themselves in this environment? At MLC, we've looked at a number of different ways of trying to play defence:

1. Diversification

Although a central tenant of investing, it is worth calling out diversification as a point of thought at this vexing time for investors. For not only does financial repression raise the level of absolute risk for nearly all assets, it also reduces the potential to build portfolio diversification as all assets become more sensitive to an increase in real interest rates. Yet, with diversification compromised, facing into the current level of economic, social and financial uncertainty, investors must continue to value diversification, be it within traditional or alternative asset classes. The aftershock of the pandemic will reach beyond simple lost revenue from the shutdown. We expect behaviours to be changed because of the current crisis, but it's difficult to know with any clarity exactly what they will look like in the post-crisis landscape. It is challenging to allocate capital facing into this level of uncertainty, so spreading your bets makes sense.

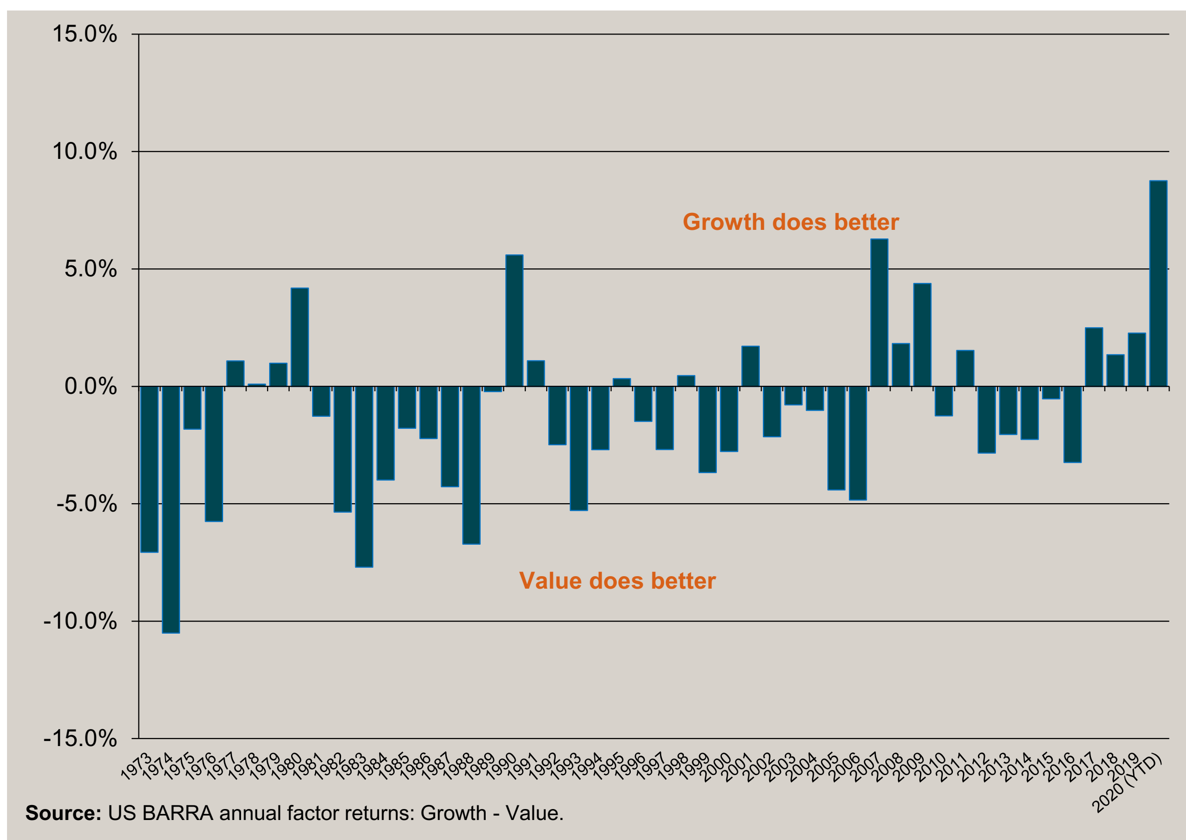
Currently our portfolios look like barbells, with risk concentrated at either end of the spectrum – cash-like at one end and developed market shares at the other end. This is not surprising when considering what was discussed earlier regarding shares being the only way to achieve a reasonable return. The heightened risk of expensive shares is then balanced at the other end of the barbell by using cash or cash replacements like short-dated, high-quality credit. This construct makes sense when shares are the only game in town, but carries the concentration risk of having only one meaningful driver of growth in the portfolios.

The recent crisis has provided an opportunity to start filling in some of the barbell. With credit spreads widening and some real assets like property and infrastructure performing poorly, an opportunity exists to purchase some new return drivers at more attractive levels. It makes sense to fill in the barbell by diversifying across the risk spectrum, reducing the reliance on any single growth allocation.

2. Value

Value as a style is considered defensive. Investors are buying stocks that are cheap and so simply have less room to fall. This makes intuitive sense but the empirical evidence is a little more mixed. If the value stocks happen to be in the sector that is the epicentre of the unfolding crisis, they will not outperform. This happened in 2008 when bank stocks owned by value investors offered little defensiveness as they were in the sector at ground zero of the Global Financial Crisis (GFC).

Chart 2: Value versus growth stocks (annual returns)



Source: US BARRA annual factor returns: Growth - Value.

March this year saw it happen again when governments shut down large sectors of the economy in an effort to contain the virus. Hardest hit were the cyclical companies that feature heavily in the portfolios of value managers, resulting in these stocks underperforming significantly and providing no protection (chart 2). Unfortunately, the proposed 'innate defensiveness' of value stocks has sometimes deserted investors when it was needed most.

At MLC, we seek defensiveness in stocks not through style bias but rather through giving portfolio managers the freedom to control risk in the best way they see fit. One example would be our proprietary defensive Australian shares strategy, where the Australian shares manager uses optionality through calls and puts to manage portfolio risk. By trading away some of the upside in exchange for downside protection of risky stocks or sectors, we end up with a more certain path of returns. This type of defence makes sense in an environment of heightened uncertainty.

3. Currency

Australian dollar (AUD) domiciled investors are advantaged in risk control due to the typical behaviour of the local currency in relation to share markets. Historically the AUD and global shares have been positively correlated, providing the opportunity for investors to play defence by holding offshore shares in less risky currencies like the US dollar (USD) or Japanese yen (JPY). The defensiveness works through the offshore currency outperforming the AUD, so if share markets fall, the value of the foreign shares falls less in AUD terms.

This defence is all contingent on the correlation between the AUD and growth assets remaining positive. In the past, the AUD was viewed as a risky currency for a few reasons:

- Pro-cyclical economy with a large portion of GDP driven by commodities like iron ore and, more recently, gas
- Balance sheet concerns with long-standing current account and fiscal deficits
- Used as a proxy for investing in Asia, as such, acting pro-cyclically

Yet, nothing in the global macro-economy is static. Change, however glacial in nature, can shift the balance of power for key drivers of exchange rates and alter the way a currency behaves. There is no guarantee that the AUD will remain a risk-on currency forever. Recent years have seen Australia's classic external position of twin deficits improve markedly, especially relative to peer exchange rates. Recent government spending to address the costs of the virus will increase the fiscal deficit, but it was heading toward surplus before the bushfires and virus hit. The current account went into surplus last year for the first time in 40[5] years as the trade balance has grown. An argument could be made to suggest the AUD is no longer as risky from a balance sheet perspective, particularly from a rate-of-change point of view. Whereas net foreign debt is still relatively high amongst peers, it is improving at a notable rate. Offsetting this improvement, the pro-cyclicality from commodities and the ties to Asia are still intact for the foreseeable future and support the 'risky' case.

The other consideration is the outright level of the AUD itself, particularly against the USD. While the AUD was a cheap hedge at levels significantly above estimates of fair value, the trade-off becomes far less clear with the currency closer to 65 US cents.

Part of the AUD valuation concern relates to appreciation of the USD itself, and what seems to be the ebbing higher of risks to the US economy. This is a point of high tension for those seeking defensiveness through passive currency exposure of offshore assets. Roughly half of the currency exposure within the main global share benchmarks is US, meaning that the course of the USD is second in idiosyncratic importance only to the AUD for a passive exposure. Further diversification of currency exposure is the approach we have lent on to control for USD pressure, preferring to upweight other currency crosses with defensive profiles and down weight the USD.

4. Duration-like assets

The low or negative yields on government bonds makes nominal duration a particularly unattractive way to get defensiveness into portfolios. Low yields shift the risk-reward trade-off for core fixed income to one where the upside in economically poor scenarios is lessened and the downside in inflationary scenarios amplified. This is well exemplified by the performance of long duration core fixed income assets in the recent extreme market turbulence where 30 year US government bonds generated about half the performance that they did in the 2008 crisis. Given the poor symmetry of future returns from core bonds, we continue to explore the search for other assets that might protect investors in scenarios when growth is stressed and rates fall. Gold may have a role to play here, particularly in scenarios where real interest rates fall. We continue to hold an allocation to gold in Inflation Plus portfolios via call options after locking in significant profit from a direct exposure in late February. The current exposure allows the portfolios to benefit should the gold price rise, but limits losses in the case that gold declines in price.

Much like nominal bonds, gold has historically been negatively correlated with changes in real interest rates. The recent episode is a useful case in point as gold has rallied while real rates have fallen. This should be intuitive. Gold is a store of value so when real yields on the other stores of value fall, gold becomes a more viable alternative. The issue for investors at this point is gold has already rallied to around $1,800 USD (or $2,600 in AUD), which is close to all-time high levels. It is not a coincidence that at the same time the majority of developed market real yields are negative. What could make real yields fall further into negative territory and potentially drive gold higher?

Rising inflation combined with central banks keeping a cap on nominal bond yields is one scenario. The central bank rate capping is already in place[6], so any increase in inflation from here will push real yields lower. Rising inflation may appear a bit fanciful in an environment of high unemployment and falling demand, but one major piece of the puzzle has changed. The recent government stimulus programs are specifically designed to get money straight into people's hands to address the loss of income suffered during the virus shutdown. This has shown up as an explosion in M2[7] money supply, beyond anything seen during the 2008 GFC. Individuals have a higher propensity to spend than companies in this environment, so the stimulus has a better chance of actually being used this time around. For a monetarist, this would be an inflation red flag.

To fund these programs, governments will need to run up significant fiscal deficits. This is on top of debt loads that are already close to record levels. It may not be spelled out explicitly, but one way for governments to manage the excessive debt loads would be to consistently run negative real rates. Central banks keep money cheap by placing a lid on nominal rates and allow inflation to do the heavy lifting for them. With governments incentivised to keep real rates negative, gold may still have a defensive role to play in portfolios.

5. Volatility

Volatility tends to spike when share markets sell-off, which makes holding a volatility exposure a useful defensive component in a portfolio. The problem is buying volatility costs a premium that only pays off intermittently. So for it to be a successful strategy, deciding when and how to own volatility is important. Simply put (pardon the pun), only buy volatility when it is cost-effective to do so.

At the start of 2020, volatility was cheap. Using the CBOE Volatility Index (VIX)[8] as a proxy, implied volatility started the year at 13%. This was a useful time to own volatility, which we did in our Inflation Plus portfolios, as it was possible to get cheap and meaningful downside protection. A simple deep out-of-the-money put option (20% below the market) on the S&P500 share index was selling for only a few index points. By the middle of March, the same put option was selling for over 300 index points (100x purchase price) as the share market fell and the VIX index spiked to over 80% implied volatility. This is a classic example of the defensive role volatility can play in a portfolio, but it is not always that easy.

The price of volatility changes quickly in response to market stress. This is favourable for those who took advantage of the prevailing low level of implied volatility leading into the pandemic, but problematic for establishing protection at this moment of market disruption. At the time of writing, the S&P500 was only down 4% for the year and yet the VIX was trading above 30%. This is more than double the level from the start of the year, making it a lot more expensive to try and protect portfolios using volatility. At times like this volatility can still play a defensive role, but investors need to be willing to think outside the box on the type of option structures they want to use. Put spreads, collars, skew trades, and a myriad of possible other structures may be able to deliver investors the protection trade-off they require.

6. Liquidity

A key part of the defensive strategy for a portfolio is the role played by liquidity. Falling share markets tend to introduce different pressures that need to be managed by investors. These pressures may come in the form of redemptions to meet other liabilities, switches to adjust the nature of the investment strategy, rebalances away from outperforming assets into underperforming assets, or simply the need to adjust allocations to accommodate an increased concentration in illiquid assets. It's worth acknowledging there is a good chance all these will occur at the same time, as the conditions in place to generate a falling share market are usually associated with all the above portfolio outcomes.

In a stressed environment, liquid assets are essential to help manage allocation changes without compromising the integrity of the portfolio. What do we mean by integrity? In a portfolio context, falling markets create a tension between being able to sell an asset at a reasonable price or holding onto an asset and allowing its weight in the portfolio to increase relative to all the other assets. Maintaining portfolio integrity means managing this tension in an efficient way – avoiding fire sales or excessive concentration. Portfolios with a sufficient allocation to liquid assets make it immeasurably easier to manage this tension.

At MLC, we have always valued liquidity. Our portfolios hold a meaningful allocation to liquid assets to ensure we can appropriately manage investment outcomes. In the current uncertain environment, we have maintained a high level of liquidity to protect portfolios from adverse outcomes, preferring to stay nimble and adjust to changing conditions.

Final word

The COVID-19 pandemic is a once in 100 year shock to demand in the real economy, the effect of which will persist for some time to come. The reactions of governments and central banks will continue to evolve to try and accommodate these impacts. Individuals will change behaviours in ways it is difficult to predict with any accuracy.

Investing into this level of uncertainty is difficult and requires flexibility and an acceptance that the future is unknowable. Investors still need to take risk to generate return for their portfolios, but in this volatile environment we believe there is a benefit in utilising a range of defensive strategies. Our multi-asset portfolios benefited from holding a range of risk control exposures prior to the March sell-off. The portfolios had different levels of protection depending on their objectives, however most benefited from tail risk protection, currency exposure, and use of call options over gold and some share markets which meant they avoided incurring losses that would have resulted from direct market exposure.

We continue to diversify across assets, currencies, and styles but also diversify across defensive techniques to increase the chances of improving portfolio outcomes.

References:

[1] As reported by Bank of America, S&P500 Index fell 30% in just 22 days making it the fastest sell-off of that magnitude in share market history. 1934 was second at 23 days.

[2] As reported by LPL Research, the 50 days to 3 June delivered 37.7% in the S&P500 and was the strongest 50 day period ever. 1982 was second at 35.6%.

[3] We use a proprietary dividend discount model to forecast the yield on the S&P500 Index minus the US Treasury 10 year government bond yield as our expression of the Equity Risk Premium.

[4] According to Bloomberg, the S&P500 1 year Forward PE was 24.8 on 15 June 2020.

[5] According to the Reserve Bank of Australia (RBA), the last time Australia ran a current account surplus was 1979 – it went into surplus in the June quarter of 2019.

[6] The RBA targets a yield of 0.25% in the 3 year government bond. The Bank of Japan also target a rate around 0% for the 10 year.

[7] M2 is a calculation of the money supply that includes all cash and cash-type replacements. It is considered a useful, broad description of monetary aggregates.

[8] The VIX index is a measure of US share market volatility. It is constructed using a series of put and call options on the S&P500 Index to get an aggregate measure for implied volatility.

The Investment Futures Framework: Scenarios, changes in return potential, and portfolio positioning

Scenarios

In managing MLC's multi-asset portfolios using our Investment Futures Framework, following are the short-term scenarios that we have assessed as currently providing the highest potential future risks and opportunities.

This is a highly unusual time. While at most points in time the outlook relies on multiple sources of uncertainty, the next 12 to 18 months will continue to pivot around the COVID-19 pandemic. As a result, our thoughts on short-term scenarios continue to be sub-versions of the main global pandemic scenario (within our generic broad set of scenarios):

- **Global pandemic: Short disruption with no second wave**
  - The northern hemisphere summer helps rid the community of COVID-19. No substantial second wave of infections arise and seasonality does not emerge.
  - Lockdowns end with only mild earnings implications for this year and next.
- **Global pandemic: Drawn-out lockdown with mild second wave of infections**
  - A mild second wave of infections arises across the globe. Partial lockdowns are re-established.
  - Earnings suffer in both FY20 and FY21.
  - Hospitality and other impacted sectors are severely disrupted.
- **Global pandemic: Drawn-out lockdown with severe second wave**
  - A severe second wave of COVID-19 emerges. Full lockdowns are re-established.
  - Fiscal and monetary stimulus near the point of exhaustion.
  - Populism.
  - High risk of global depression.

Changes in return potential for asset classes

Due to a strong rally in risk assets after the sharp sell-off late in the March quarter/early June quarter, the return potential of all share market sectors has decreased (chart 3). The rebound in share markets has been entirely driven by valuation expansion as the growth outlook remains both subdued and uncertain. Markets appear to have adopted a glass half full perspective as valuations imply a return to earnings growth in the coming year.

Core bond return potentials have remained relatively steady compared to last quarter and remain deeply unattractive. Investment grade credit return potentials are low considered in isolation, but remain a better option for portfolio interest rate exposure than core bonds.

The return potential and diversification benefit of foreign currency exposure has improved over the quarter due to appreciation of the AUD from below estimates of fair value to near fair value during the quarter.

Combined, the changes in return potential across shares, interest rates, credit and foreign currency have prompted some measured changes to our multi-asset portfolios.

Portfolio positioning

During the June quarter, positioning across MLC Horizon 2 to 7 portfolios was adjusted to increase our unhedged global shares overweight ie foreign currency overweight. The AUD and global share markets tend to move in the same direction, after a rally in the AUD across the June quarter the appeal of foreign currency has improved to near where it was at the beginning of 2020. This decision to increase foreign currency reverses a move back to benchmark (from overweight) in the March quarter, and locks in profit from the appreciation in the AUD.

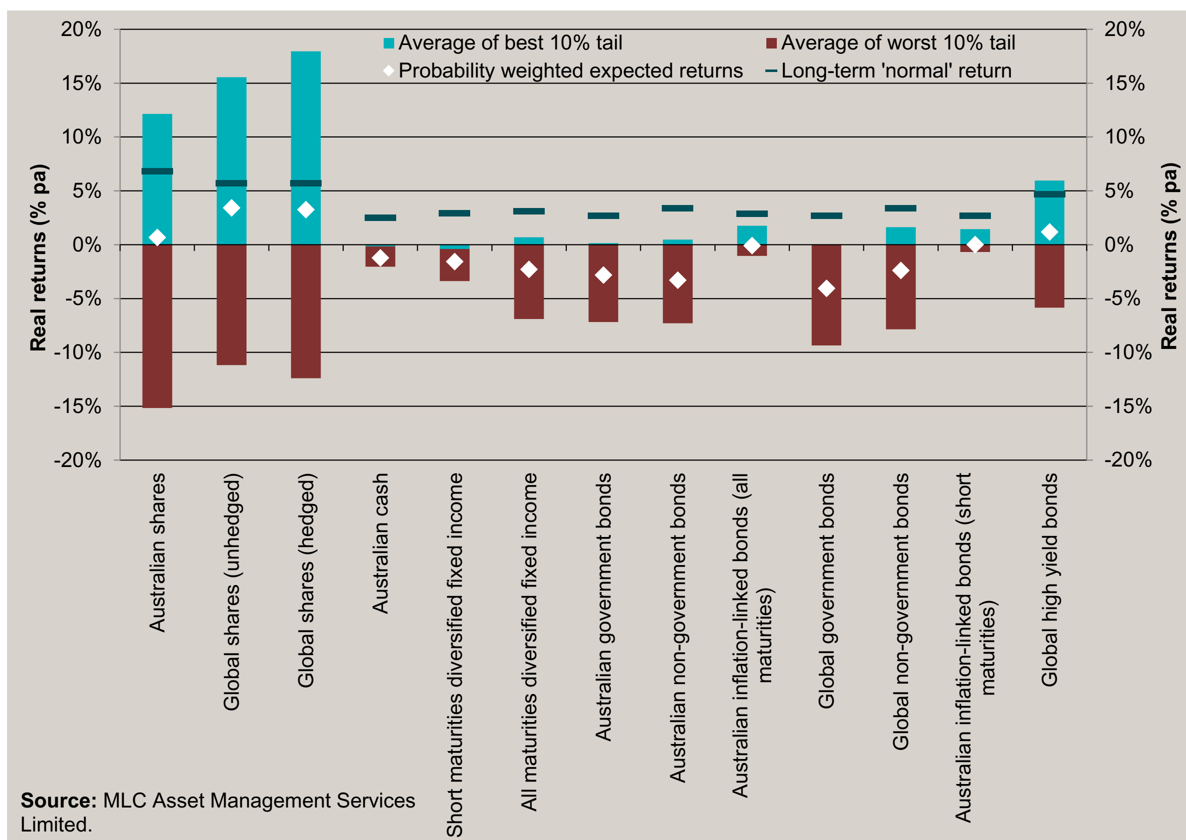
Aside from the above profit-taking move in foreign currency, key recent portfolio activity and positioning has been directed at the MLC Inflation Plus portfolios. MLC Horizon portfolios inherit these exposures through investments in Inflation Plus, and MLC Index Plus portfolios through the real return strategy which is managed similarly to Inflation Plus.

The changes to the MLC Inflation Plus portfolios include:

- An initial allocation to all-maturity global investment grade credit. This new exposure sits alongside an exposure to short-maturity global investment grade credit and Australian credit. Additionally, our Horizon and Index Plus portfolios' existing exposures to all-maturity global investment grade credit were increased.
- Locked in some profits by rebalancing from well-performing shares exposures.
- Increased the exposure to China's share market.

More information on portfolio positioning is in the sections: MLC Inflation Plus portfolios, MLC Horizon portfolios, and MLC Index Plus portfolios.

Chart 3: 40 scenario set (generic scenarios) potential real returns (June 2020) - 5 years, 0% tax with franking credits, pre-fees, pre-alpha



Source: MLC Asset Management Services Limited.

The potential real returns for each asset class are shown above. The probability-weighted real returns are shown as diamonds. For comparison we've included 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.

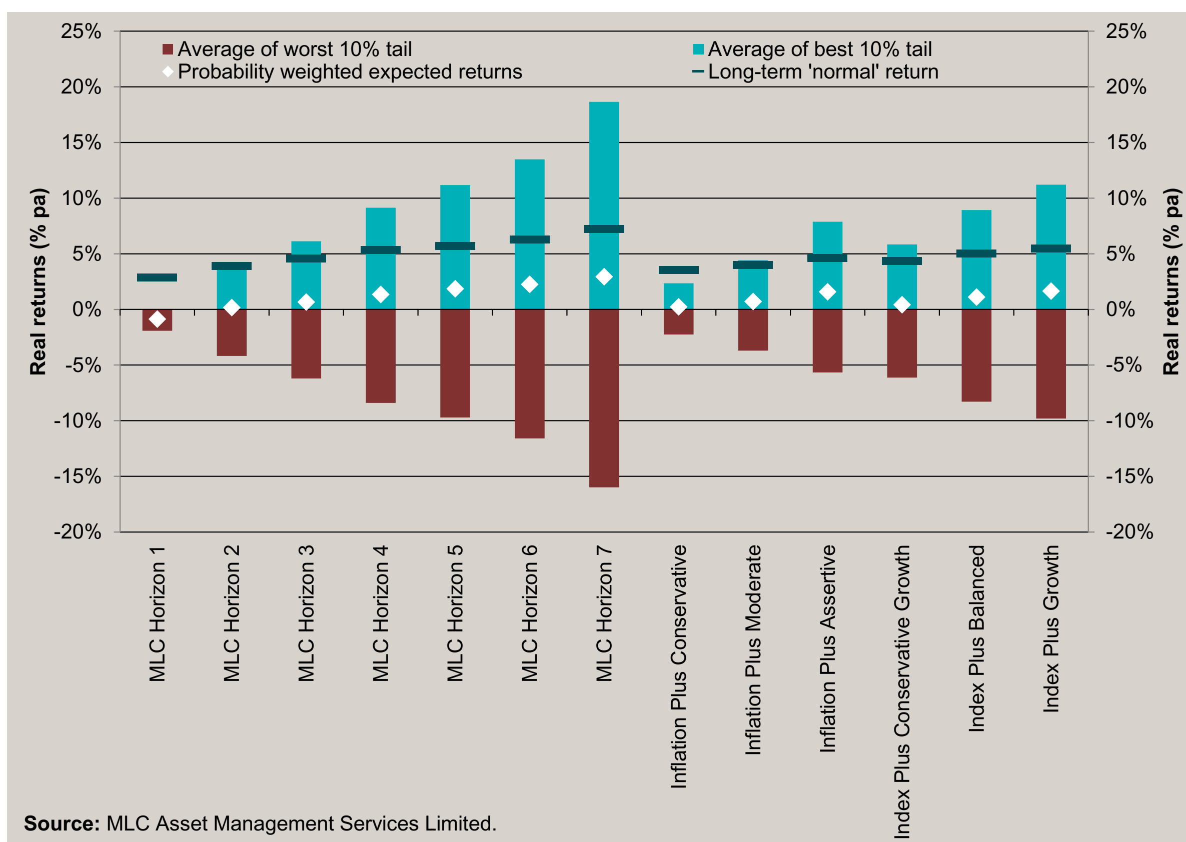
Return potential

Chart 4 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 June 2020.

The medium-term return potential of all the MLC multi-asset portfolios have decreased relative to last quarter (chart 4). As described earlier, this is due to valuation expansion across most asset classes, with some offset from foreign currency due to a rise in the AUD. The outlook over shorter time horizons remains clouded and uncertain due to the ongoing COVID-19 pandemic. We will continue to monitor the environment and assess the trade-off of making portfolio shifts as return potentials change.

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, the Inflation Plus 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.

Chart 4: 40 scenario set (generic scenarios) potential real returns (June 2020) - 5 years, 0% tax with franking credits, pre-fees, pre-alpha



Source: MLC Asset Management Services Limited.

The probability-weighted real returns are shown above (diamonds). For comparison we've included 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 Inflation Plus portfolios

The MLC Inflation Plus portfolios were repositioned to hold more risk and less foreign currency in the March quarter 2020. Following on in the June quarter, we again repositioned the portfolios in response to rallies in global shares and the AUD. Specifically, key portfolio activity during the June 2020 quarter, including up until the time of writing is:

- Established an exposure to all-maturity global investment grade credit. The new exposure sits alongside an exposure to short-maturity global investment grade credit and Australian credit. The exposure to all-maturity credit is a step towards increasing the level of diversification of the defensive sleeve of the portfolios.
- Took advantage of the strong price performance of the global and Australian shares strategies to take some profits and rebalance the exposures of Walter Scott's global share strategy and the Australian defensive shares strategy.

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.

- Increased the exposure to China's share market. Using a combination of swaps and put options the portfolios have gained exposure to positive performance of China's share market but with limited exposure to negative returns.
- Currency was adjusted slightly using options to reduce the downside impact on the portfolios' returns, of an appreciation of the AUD.
- Maintained exposure to gold by rolling the gold calls bought earlier in the year.

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

Asset class	**Change in target allocation to asset classes in the MLC Inflation Plus portfolios (in MLC MasterKey's super and pension products) over the 3 months ended 30 June 2020**		
	Conservative	**Moderate**	**Assertive**
China A-shares with downside limit of -20% (through derivative strategies)	**Up**	**Up**	**Up**
Emerging market shares (through derivative strategies)	Zero allocation	Steady allocation	Steady allocation
Defensive Australian shares	Steady allocation	Steady allocation	Steady allocation
Global shares (through derivative strategies)	Steady allocation	Steady allocation	Steady allocation
Defensive global shares (unhedged)	Steady allocation	Steady allocation	Steady allocation
Foreign currency exposure	Call options protection maintained	Call options protection maintained	Call options protection maintained
Gold exposure (through derivative strategies)	Steady allocation (via call options)	Steady allocation (via call options)	Steady allocation (via call options)
Low correlation strategy	Steady allocation	Steady allocation	Steady allocation
Real return strategy	Steady allocation	Steady allocation	Steady allocation
Global private assets	Steady allocation	Steady allocation	Steady allocation
Global property securities	Zero direct exposure	Zero direct exposure	Zero direct exposure
Global government bonds	Zero direct exposure	Zero direct exposure	Zero direct exposure
Australian inflation-linked bonds	Steady allocation	Steady allocation	Steady allocation
Insurance-related investments	Zero allocation	Steady allocation	Steady allocation
Global high yield bonds and loans	Steady allocation	Steady allocation	Steady allocation
Global non-government bonds (short-maturity)	Steady allocation	Steady allocation	Steady allocation
Global non-government bonds (all-maturity)	**New allocation**	**New allocation**	**New allocation**
Australian non-government bonds (short duration)	**Down**	**Down**	**Down**
Cash	Steady allocation	Steady allocation	Steady allocation
Borrowings	Not permitted	Not permitted	No borrowings

MLC Horizon portfolios

This quarter the MLC Horizon portfolios achieved a relatively defensive orientation partly from exposures to Inflation Plus (explained above), and partly from exposure to foreign currency through unhedged global shares. Exposure to fixed income continues to offer some defensiveness, but lower yields mean that the scope for interest rates to protect the funds under adverse economic conditions remains challenged.

During the June quarter, positioning across MLC Horizon 2 to 7 portfolios was adjusted to overweight the portfolios' foreign currency exposure through unhedged global shares, from a near neutral position at the beginning of the quarter. The AUD and global share markets have a general tendency to move in the same direction meaning that that foreign currency exposure can be an attractive source of risk control, particularly when the AUD trades at a higher level. The rallying AUD has improved the return potential from foreign currency to near where it was at the beginning of 2020. This decision to increase unhedged global shares reverses a move back to benchmark (from overweight) in the March quarter, and locks in profit from the appreciation in the AUD.

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 and taking into account that over time a broad range of scenarios could play out.

Additionally, we increased existing exposures to all-maturity global investment grade credit (non-government bonds).

Here is a summary of the positioning of the MLC Horizon 4 Balanced Portfolio.

	MLC Horizon 4 Balanced Portfolio (in MLC MasterKey's super and pension products) target asset allocation at 30 June 2020		
	Under	**Benchmark**	**Over**
Australian shares	•		
Global shares (unhedged)			•
Global shares (hedged)	•		
Global property securities		•	
Cash			•
Australian bonds - short maturities			•
Australian bonds - all maturities	•		
Australian inflation-linked bonds		•	
Global bonds - short maturities			•
Global bonds - all maturities	•		
Global non-investment grade bonds (high yield bonds and loans)		•	
Global private assets		•	
Real return strategies (including Inflation Plus)			•
Low correlation strategy		•	

MLC Index Plus portfolios

This quarter the MLC Index Plus portfolios achieved a relatively defensive orientation partly from exposures to the real return strategy which is managed similarly to Inflation Plus (explained earlier) and partly from exposure to foreign currency. Exposure to fixed income continues to offer some defensiveness, but lower yields mean that the scope for interest rates to protect the funds under adverse economic conditions remains challenged.

In the June quarter, we increased existing exposures to all-maturity global investment grade credit (non-government bonds).

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 and taking into account that over time a broad range of scenarios could play out.

Here is a summary of the positioning of the MLC Index Plus Balanced Portfolio.

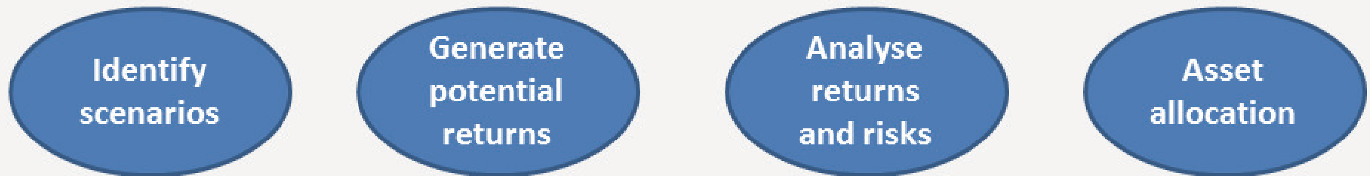
	MLC Index Plus Balanced Portfolio target asset allocation at 30 June 2020		
	Under	**Benchmark**	**Over**
Australian shares	•		
Global shares (unhedged)			•
Global shares (hedged)	•		
Global property securities		•	
Cash			•
Australian bonds – short maturities			•
Australian bonds – all maturities	•		
Australian inflation-linked bonds		•	
Global bonds - short maturities			•
Global bonds - all maturities	•		
Real return strategies			•

Appendix 1 – 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.

We welcome your feedback on this document.
If you have any comments, please email us at al.clark@mlc.com.au or ben.mccaw@mlc.com.au