MLC's scenario insights & portfolio positioning

MLC Horizon and MLC Inflation Plus portfolios

July 2014

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

We continue to invest in extraordinary times. Rising financial markets give us the impression of a return to normality, but we have seen before that this can be illusory.

At the heart of the problem is a level of developed economy debt which risks economic depression and disorderly market declines. Unorthodox monetary policy measures countered these risks and have been successful in avoiding economic stagnation. But even in the US, aggregate debt levels relative to GDP have not declined. Financial repression has not generated enough real growth or inflation to support aggregate deleveraging. This may be because the winners (the wealthy) have a lower propensity to consume than the losers (self-funded retirees). US household debt has declined, but this is offset by higher (non-financial) corporate leverage and soaring Federal government debt (prompting anti-growth austerity measures). Unfortunately, so far corporates have used new credit for financial engineering; though we are now hearing anecdotal reports of a pick-up in investment this has yet to come through convincingly. This leaves market pricing uneasily contingent on the decisions of policy makers and vulnerable to the unexpected.

This environment continues to create perverse responses to the economic data flow, with bad and good news able to be good and bad news. Accordingly, weak economic data from early 2014 allayed US tapering concerns and encouraged risk markets higher. Like it or not, we all suffer from biases of perception. These behavioural foibles come from millennia of evolution and are not easily countered. Experience drives perception. History is littered with mistaken presumptions that recent experience is neutral or normal and therefore will persist. In extraordinary times there are always persuasive arguments as to why 'it's different this time'. Hence there is much debate about the persistence of the financial repression regime, even though the global economy is clearly in disequilibrium. While we have a stable disequilibrium at present, today's contradictory pricing will ultimately prove to be unsustainable.

An example of this is the debate about a 'new neutral' (PIMCO's term) in which interest rates are lower for longer. The persistence or evolution of this scenario is a crucial issue in determining fair value for all markets. Under the new neutral, rates are presumed to remain low indefinitely. Cash rates are unchanged and US bond yields remain around 2.5% for the foreseeable future, and this may mean equity markets can support higher prices (it all depends on what earnings yield is regarded as attractive in a world of low or zero cash rates, and modest growth and inflation). This scenario seems compelling because it's where we currently are. Sooner or later it must change. Before the financial crisis we had the illusion of a low risk world (the so-called 'great moderation'); that illusion has been re-created (or at least investors have been coerced into behaving that way) by central banks.

This debate concerns what can be regarded as normal or neutral. What's neutral is not fixed, but contingent on what happens—in particular, what policy makers do and how

MLC's active investment approach

- Key to MLC's market-leading investment process is our unique Investment Futures Framework (the new name for our 'scenarios 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.

economic agents react. By implication, while we need to take into account that the new neutral scenario could persist, we must also anticipate the ways in which it will ultimately change. We must continue to imagine a variety of futures – some friendly, like the new neutral; others more challenging. We must take into account that yields could rise, gradually or sharply, in response to changing perceptions about economic growth and/or inflation and new understandings of policy evolution. Equally, we still can't rule out that 'Japanification' will still emerge even in the US. In considering possible futures, we pay particular attention to what appear to be underappreciated possibilities.

There are three important themes that we continue to see as underappreciated:

- a harder than expected landing in China
- US earnings reversion, and related to that
- a US wages-led rise in inflation.

On China, to be fair, this has recently become a more mainstream concern, with disquiet about weaker growth and the decline of the RMB over the past few months. Importantly, policy makers understand the trade-off between short-term policy stimulation and medium term stability. Their behaviour continues to be consistent with the announced moderation of policy responses. Accordingly, the focus remains on control of credit creation rather than maintenance of growth at prior levels. This adjustment is necessary but is not without risk. China has had its own financial repression, with low interest rates for savers and cheap loans for state-owned enterprises and local governments. This has created an overhang of bad debts and proliferation of wealth management products, involving both uncertain magnitude and location of risks. China is now starting to go through an adjustment process during which (even assuming the process is well managed) growth will be lower, which has flow on consequences for Australia. This risk is not yet close to being fully factored into currency markets while the focus remains on the persistence of QE and yield differentials.

The issues of earnings reversion and inflation are intertwined. Uncertainty revolves around the question of how much slack is in the labour market, in particular, what proportion of those who have dropped out of the labour force will re-enter. The argument for inflation rising at a higher than anticipated unemployment rate is that falls in the participation rate are due to structural not cyclical factors – exits into retirement and the skill mismatches of the long term unemployed. US Federal Reserve (Fed) Chair Janet Yellen has clearly signalled the Fed's asymmetric inflation preference—rises are preferable to falls—which suggests that if the labour market is tighter than presumed the Fed could end up well behind the curve.

Another trigger for a change in the new neutral would be a change in perceptions about the efficacy of quantitative easing (QE). If market participants lose confidence, this would trigger asset price adjustments, which may force consistency between bond and equity market pricing – current relatively low bond yields and rich equity valuations are inconsistent unless central banks are able to control bond markets. Disillusionment with QE on the part of policy makers could result in a raft of more directed policy measures aimed at the selective encouragement of credit, plus increased resort to macro-prudential constraints. Arguably this has already started to happen. Such policies typically misallocate resources and hence, in the medium term at least, retard growth.

The other obvious sources of risk we have not yet mentioned are the worrying geopolitical instabilities, particularly in Ukraine, where we can hope that sanctions have given Putin pause for thought, and most worryingly, the sectarian anarchy (effectively civil war) in Syria and Iraq. The latter has been made inevitable by the overtly discriminatory policies of Shia Prime Minister Nuri al-Maliki. Iraq presents a horrible dilemma for the US, which has supported the rebel Sunni cause in Syria. Support inevitably flowed through to murderous ultra-extremist group ISIL (formerly ISIS), which has crossed back over the undefended border to foment anarchy in Iraq. The US finds itself in the potentially invidious position of siding with Shiite Iran in support of the Iraqi government against Sunni Saudi Arabia. The best hope is that calls will be heeded for a unity government which satisfies non-extremist Sunni tribal groups. This would also require a curtailing of prime ministerial powers to suppress minority groups. The alternative is ongoing partition of Iraq and smouldering tensions which could spill over more broadly. As an aside, it is notable that the Saudis have been content to leave oil prices at levels which encourage shale gas development, because they need revenue for social programs aimed at heading off unrest. There is clear potential for escalation of the Middle East tensions and for an oil price shock to trigger a risk-off scenario. With a global economy that continues to grapple with ongoing fragilities, these new concerns are particularly unwelcome.

Oil price concerns add to our existing worries about inflation risk complacency. If US unemployment is structurally higher, as seems credible, inflation will rise sooner than is currently discounted by markets (or the Fed will admit). We're suggesting that the bargaining power of labour may have already shifted. If so this has consequences not only for inflation, but it will also impair earnings growth. Not surprisingly, we have been gradually tightening inflation protection across our portfolios.

Clearly, there is a wide range of potential futures that could unfold from this particularly complex starting point. We respond to the contradictions between these different futures by deciding how much risk (and what sort of risk – absolute or relative to benchmark or peers) is tolerable. This inevitably means that we build insurance into portfolio positioning which will help protect the downside, but will likely reduce returns while the world continues to be priced as indefinitely low risk.

The quarter and performance in review

During the first quarter of 2014, doubts increased about persistence of the new neutral scenario as Yellen took over at the Fed and tapering commenced. However, in the June quarter market expectations again shifted and the adjustment path seemed more distant, with rising confidence in Yellen's dovish intentions and less certainty about accelerating economic growth. Instead of rising as was widely expected, US bond yields declined in the second quarter. Reinforcement of the persistence of the 'lower for longer' scenario also came from the policy changes by the European Central Bank (ECB) in June.

The ECB has increased stimulus to support its inflation target by cutting key interest rates by 0.10%. The base lending rate is now 0.15%, while the rate they pay on deposits was cut to -0.1%. Forward guidance was also enhanced, with liquidity being injected via a number of programs. A new 4 year term targeted long term refinancing operations (TLTRO) program starts in September at a fixed low rate (base rate plus 0.1%, which is currently 0.25%). This is a very attractive lending rate and will ease funding pressure further on banks in the periphery. However, it remains to be seen whether it will induce banks to expand lending, particularly to small businesses in the periphery and France, where credit remains tight. The issue is no longer a shortage of liquidity but the credit risk banks have to take on to make loans and the capital that must be held against these risks. These measures ease these constraints. Importantly, the ECB also confirmed it is preparing for outright asset purchases from the private sector (quantitative easing) though this remains problematic. These policy shifts are consistent with historical experience, which is that in a debt deleveraging scenario, in the end everyone prints money in order to increase inflation expectations. Further steps towards outright QE are expected over coming months; however the ECB still remains a long way behind the adjustment processes of the US and UK.

While the ECB interest rate cut is marginal in terms of magnitude, it is notable in that negative rates have rarely been used and the consequences are less certain. This is not just another interest rate cut; there can be behavioural responses involved that are difficult to predict. The two examples of negative rates in modern times occurred in Denmark in 2012, to stem capital inflows, and Sweden in 2009. In 2012 Danish banks reportedly worried about losing depositors and did not pass on their central bank's rate cut, which squeezed margins and had the perverse effect of making them less willing to lend. The ECB is not yet facing this risk and President Draghi has indicated that rates have reached their lower bound. If that is the case, deposit rates offered by banks are unlikely to move below zero. Were further cuts to occur, that would be a possibility—particularly in Germany, where deposit rates are around 40bps.

The moves are wide-ranging but are likely still insufficient, though there are some contrary opinions foreshadowing a growth surprise. The focus will be on follow-through on QE. At least initially, markets appeared unconvinced by the changes, with the euro largely unmoved. Monetary policy alone cannot in any case provide the entire solution, and governments are now under greater pressure to act. Europeans have shown a remarkable amount of forbearance, which is now wearing thin. European elections, which saw the euro-sceptic parties in the ascendency, are a reminder that the voting public will eventually censure any administration which imposes persistent economic pain. Meanwhile, there may be too much complacency about the upcoming EU regulators' adverse scenario stress tests and asset quality review (AQR). While there have been tests before, finally the tests are more stringent, though still less so than those applied by the Fed in the US – the EU has not included a deflation scenario, which is a significant omission. We have heard comments that 30 out of 124 banks could fall short of the required standards. Those failing the AQR have six months to fix their problems through common equity. There are clear risks here that are not currently discounted by the market.

Elsewhere, in Japan there has been a shift in tone from Bank of Japan's (BOJ) governor Haruhiko Kuroda. He has expressed strongly the BOJ's concern that, while its QE program has had some success, 'the real growth may be disappointing' unless Mr Abe delivers on his structural reform program. This is an admission that monetary policy cannot do the job alone. It also shows impatience with the slow pace of reform. While Abe countered with a list of reforms to date and comments that 'Structural reforms are a never-ending theme for the Abe administration', Kuroda's call for more radical action (including the opening up of Japan to foreign workers) reflects the reality that the changes have disappointed. The government announced the new growth strategy at the end of June. Measures include a cut in the corporate tax rate from 35% towards the OECD average of 25%; public pension reforms which should increase portfolio diversification away from Japanese bonds; action to increase use of foreign workers; changes to labour regulations (to encourage female participation and use of foreign workers); and, importantly for investors, measures to strengthen corporate governance and boost return on equity. To date, the flow-through of policy measures to the economy has come almost entirely from the yen depreciation. With some signs that the yen could start to reverse last year's decline, decisive action may be required. Nevertheless, estimated first quarter growth was a robust annualised 6.7% supported by strong capex.

MLC's scenario insights & portfolio positioning

Non-manufacturing remained strong, while manufacturing accelerated sharply. Importantly, consumer confidence was stronger in May following the consumption tax hike. Notably, more people expect sustained price rises and more are positive on the employment environment. The impact of the tax hike on inflation and demand, and the extent of wage rises, are key indicators looking forward.

In Australia, economic growth over 3% has been supported by around a 10% rise in commodity export volumes over the past year. This export surge accounts for the bulk of the March quarter's economic growth. The volume increase has thus far swamped declining terms of trade—the price of Australia's biggest export, iron ore, has declined by 35% since the start of the year. While there are expectations that the price will rebound as China again adds stimulus to offset weak property sector activity, this seems unlikely given oversupply particularly in tier 3–5 cities and the policy focus on rebalancing growth which implies a move away from blue collar to white collar job creation. The missing element in Australia's growth story is a rise in non-resource sector business investment. Without this, it will be difficult to overcome the headwinds for the domestic economy in the form of lower resource-related spending from China. An ongoing challenge for industry is the still high Australian dollar which erodes competitiveness—we have seen references to the AUD now being 'weak', another example of the perspective-distorting effects of short memories.

As tapering fears eased and confidence in the 'lower for longer' scenario increased, yield trade demand pushed the AUD higher, which meant that the overweight foreign currency position reduced portfolio returns during the quarter. This scenario also encouraged sharemarkets higher, and so importantly, the correlations between the currency and share markets continue to play out as generally expected. For the financial year as a whole portfolio returns are robust, supported by strong equity market returns. The MLC Inflation Plus portfolio returns are more modest than those of the MLC Horizon portfolios, reflecting increasing risk control as risks for share markets rise.

Changes to the MLC Inflation Plus portfolios during the quarter included a trimming of insurance-related investments (also called catastrophe bonds) in response to lower yields, and an increase in inflation-linked bond and multi-asset real return (MARR) exposures. The MARR strategy has also been rebalanced to increase the inflation protection focus. We continue to carefully reassess the portfolio risk exposures. We have reduced the MLC Horizon portfolios' Australian equities allocations, which takes total equity exposures to a small underweight, and re-allocated primarily to the MLC Inflation Plus strategies. Our focus is on ways of increasing risk return efficiency for both the MLC Horizon portfolios and MLC Index Plus portfolios, with some allocation adjustments expected during the September quarter.

Looking forward

We recognise that the future is always uncertain. MLC's portfolios are managed by building a comprehensive understanding of what the future might hold. Our comprehensive assessment of future possibilities provides detailed insight into return potential and, most importantly, of the sources and the extent of risk. We track how future risk and return potential change through time. The process provides a deep and detailed understanding of future risks, return potential and the opportunity for diversification. Portfolios are positioned to achieve as high an expected return as possible using diversification opportunities, while maintaining risk within appropriate boundaries.

For the **MLC Horizon portfolios**, risk is primarily benchmark-related (and by implication peer relative), with absolute outcomes being important but secondary to this, because these portfolios must remain true to label (for example, the asset allocation of MLC Horizon 4 will not become the same as MLC Horizon 2).

MLC's scenario insights & portfolio positioning

For the **MLC Inflation Plus portfolios**, risk is absolute not relative, in particular:

- in adverse scenarios, we limit exposure to negative returns to preserve capital in after-inflation terms over the defined time frame, and
- in other scenarios, we aim to deliver attractive inflation plus returns over the defined time frame.

Chart 1 on page 7 shows selected scenario returns for the MLC Horizon and Inflation Plus portfolios looking forward 5 years from mid June. Each line on the chart represents a different scenario. Some of these scenarios are from our tailored set in Appendix 1; others are from our generic set of 40 scenarios. We have selected a number of adverse scenarios to illustrate potential risks to help explain positioning, together with more positive scenarios with varying levels of return. Scenarios relating to three important risks have been included. The most negative scenario for the MLC Horizon portfolios is **Stagflation**; here rising inflation and low growth make a difficult environment for both debt and equities. In this scenario the relatively short duration position of MLC Horizon 2, in particular, is protective. Also, both the MLC Horizon and Inflation Plus portfolios have their highest duration exposures in inflation-linked bonds.

Stagflation is not the worst case scenario for the MLC Inflation Plus portfolios; instead, the **Sovereign yield re-rating** scenario is the most challenging. This represents an environment of risk aversion with equity market declines but (unusually) loss of confidence in the US (due to excessive government debt levels) and this results in a strong AUD. The MLC Inflation Plus portfolios are leveraging what are generally risk-reducing effects of a foreign currency exposure (given the strong AUD starting point and Australia's vulnerability to weak global growth) to a greater extent than the MLC Horizon portfolios. This, however, increases a vulnerability of the MLC Inflation Plus portfolios in this scenario, to a rising AUD, which we highlight in this particular scenario. Finally, a China hard landing scenario has been included because this represents a significant risk which appears under-appreciated. Here the foreign currency exposure of the MLC Inflation Plus portfolios and their low bias to domestic equities are protective. The foreign currency overweight for the MLC Horizon portfolios also reduces exposure to negative returns.

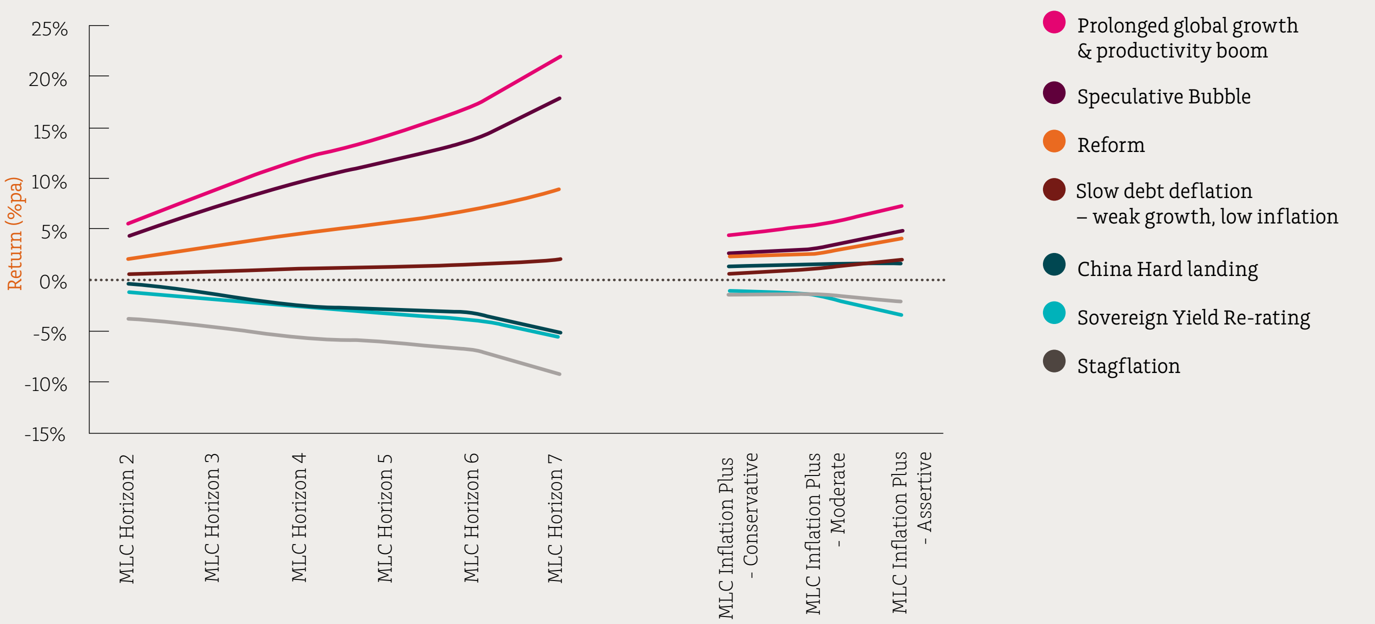
Four more positive scenarios are shown on the chart. The most modest of these is a **Slow debt deflation** scenario, where rates are 'lower for longer'. In this scenario there is a slow grind out of the debt problem, but outright deflation is avoided. The **Reform** scenario is more positive; here, after a process of structural adjustment, growth potential increases which supports higher share prices. Our **Mild inflationary resolution** scenario (not included in Chart 1) has similar portfolio returns to the **Reform** scenario. This scenario is important in illustrating that higher inflation does not inevitably result in negative returns. The final two scenarios have the highest returns: **Speculative bubble** and **Prolonged global growth boom**. The **Speculative bubble** scenario is, as the name suggests, superficially attractive. Here, abundant liquidity drives risk asset prices higher, and they reach unsustainable levels. This is not a scenario we should wish for. Finally, given the structural impediments to global growth in the form of the debt over-hang, the **Prolonged global growth boom** scenario is unlikely to be in immediate prospect. The best opportunity for this scenario to occur is following a multi-year reform process. What this implies is that from this particular starting point, the fundamental supports to continuing strong returns are weak, and we should set our expectations in terms of more modest returns going forward. In fact, a continuation of strong rises in share prices will be indicative of a continuing rise in risk. We regard the most positive sustainable environment as one of moderate returns supported by structural reform, with perhaps mild inflation to speed the adjustment process. Given modest sustainable return potential and the presence of some significant risks, the MLC Inflation Plus portfolios are maintaining a defensive positioning at the current time, awaiting better opportunities to deploy capital. This is consistent with the risk control objectives of these portfolios. It is also consistent with the views of a number of our managers who, like us, are concerned about valuations that are already stretched, and a worrying level of complacency which is eerily reminiscent of the pre-GFC environment.

MLC Horizon and MLC Inflation Plus portfolios

MLC's scenario insights & portfolio positioning

Looking at return potential for the MLC Horizon portfolios in Chart 1, as would be expected, the more defensive portfolios are less exposed to the risks but also have a lower return in positive scenarios than the portfolios with higher allocations to equities. What stands out for the MLC Inflation Plus portfolios is their significantly lower level of volatility versus the MLC Horizon portfolios. As can be seen, we are seeking to tightly constrain risk exposure of these portfolios and are prepared to forgo returns, particularly in the strongest scenarios which are difficult to rationalise or where returns may prove illusory, and await a more attractive risk-return trade-off. The MLC Horizon portfolios are also in relatively defensive positions versus their benchmark asset allocations. For both sets of portfolios, we continually seek to increase portfolio diversity to increase the reward for investment risk taken.

Chart 1: Annualised 5 year Returns for Selected Scenarios Looking Forward From Mid June 2014



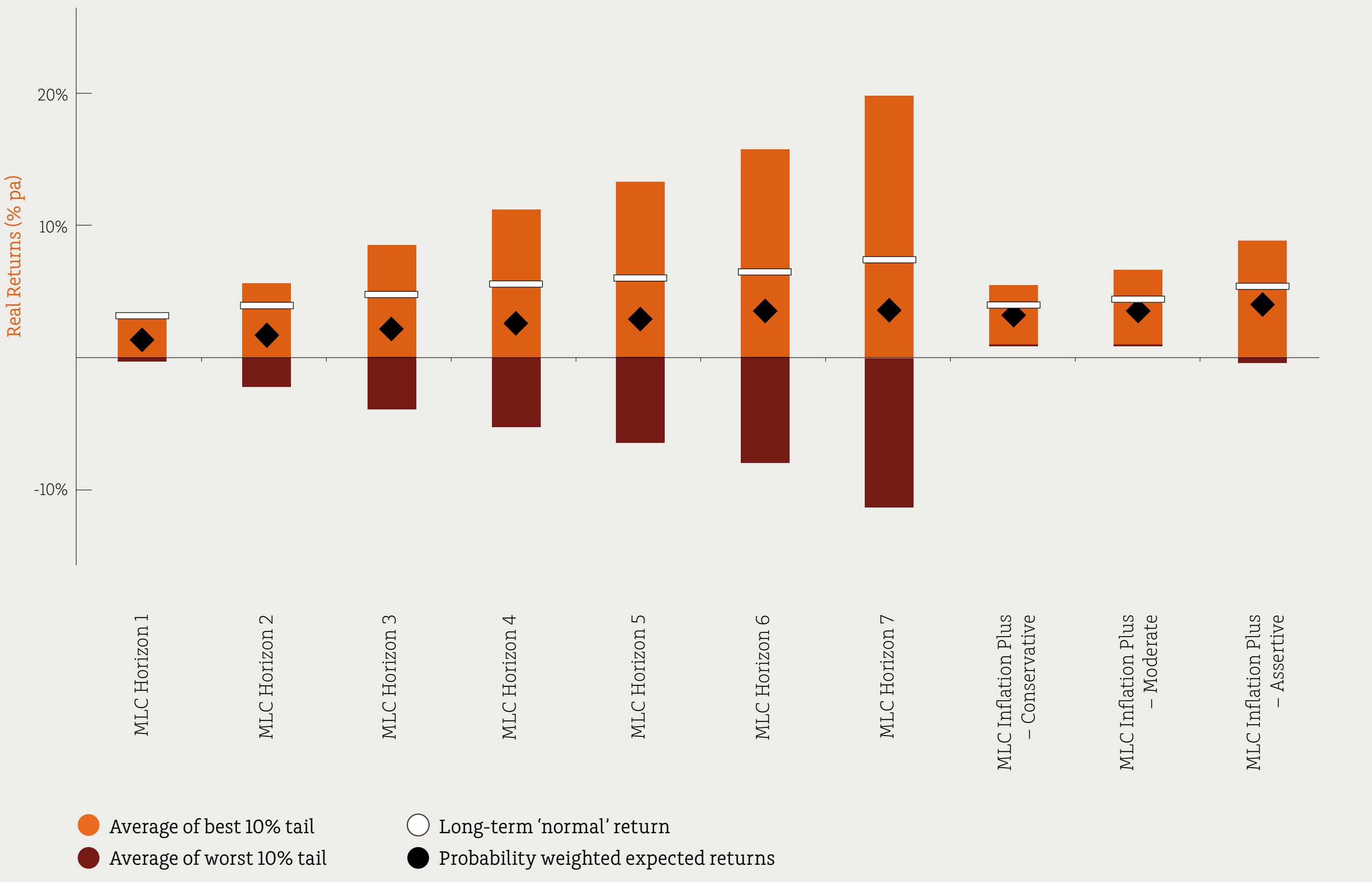
Source: MLC

Performance expectations

Future portfolio returns depend on where we are starting from, the path that markets and economies take, and where we end up. The management of MLC's portfolios is not based on the shaky foundation of predicting the one future that will unfold. Instead, we take into account that there is always a range of potential futures. MLC's portfolio positioning relies on understanding that there are things that can go wrong as well as recognising opportunities to generate returns. We use this information to determine the most appropriate balance between risk and return for each portfolio.

Chart 2 looks at our barometer of risk and return—based on our 40 scenario set, described on page 9—for the MLC Horizon and MLC Inflation Plus portfolios looking forward from the end of June 2014. The probability-weighted real returns are shown in the graphs (diamonds). For comparison, we've provided long-term 'normal' return expectations which are set by considering a stable fair value world – these are shown by the horizontal lines. Also, as an indicator of how uncertain these returns are, we've taken the bottom (and top) 10% of the scenario real returns and calculated the probability-weighted average in those 'tail' outcomes. These are shown in the bars.

Chart 2: 40 scenario set probability Weighted Real Returns – Target Asset allocations (5 years, 0% tax with franking credits, pre fees, pre alpha)



Source: MLC

MLC Horizon and MLC Inflation Plus portfolios

MLC's scenario insights & portfolio positioning

The chart continues to show that on average, looking across the whole scenario set, the potential reward for taking additional risk is limited. In the event that a scenario with relatively higher returns occurs, such as our **Extended quantitative easing** scenario, the returns to those portfolios with higher share allocations will be sharply higher. However, looking across the range of future possibilities and using our assessment of their probabilities, there is a clear concern that the reward for risk-taking could disappoint.

Comparing the MLC Inflation Plus and MLC Horizon portfolios, the stronger risk focus of the MLC Inflation Plus portfolios is evident. Consistent with their objectives, these portfolios have responded to shrinking return potential and rising risks by reducing exposures to riskier assets. This reduces return potential in strong scenarios but provides tight risk control in the event that an adverse environment occurs.

Note that it is incorrect to infer from the chart that negative real returns **cannot** occur for the MLC Inflation Plus Conservative and Moderate Portfolios. The maroon bars represent the average return in the worst 10% of outcomes. If we reduce this probability and look, say, at the worst 5% to 1% of outcomes, then the return declines and can be negative. In positioning all our portfolios we take into account outcomes in all scenarios. For the MLC Inflation Plus portfolios, our focus is on strictly limiting both the probability and extent of negative real returns in the event that an adverse scenario occurs, while at the same time extracting as much return potential as possible.

Also in relation to the MLC Inflation Plus portfolios, the chart suggests that with a single static asset allocation a relatively 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.

We track the relationships between risk and return for all components of MLC's portfolios, and for our portfolios as a whole. We also analyse in detail the sources of risk, such as rising inflation, deflation, financial crises, and policy mistakes. By assessing the spread of these risks we can find the most effective means of controlling risk while retaining return potential.

Our scenarios

We assess investment strategy using our unique Investment Futures Framework. The Framework provides a detailed map of what the future could hold—both the things that could go right and the risks that may be faced. It also provides a forward-looking understanding of return potential, risk and diversification. There are few other approaches to asset allocation that have this forward-looking understanding and insight. This is important because it enables us to make more informed choices in positioning portfolios, with greater clarity about exposure to both risk and opportunity and the trade-offs between these.

The scenarios covered by the Framework comprise both the generic broad set of 40 scenarios which pivot around the main drivers of returns—the macro-economic drivers and investor behaviour (the level of optimism or pessimism)—and a tailored scenario set which includes as many scenarios as is necessary to capture distinctive possibilities 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 now may not be after the event. These two scenario sets in combination are used to assess portfolio positioning. Both sets of scenarios are constantly assessed in our investment process.

MLC's scenario insights & portfolio positioning

The tailored scenario set consists of the same 13 scenarios we have had for some months. The tailored set revolves primarily around the decisions of policy makers, the impact of these decisions on investors' expectations and behaviour, and the flow-through into the real economy. Looking at the tailored scenarios, it seems to us that the most credible transition paths to growth normalisation are still likely to involve an inflationary resolution of the debt overhang and a significant contribution from high growth markets. However, we also take into account the potential for decisive reforms to restore growth potential faster than is currently anticipated. The prospect of deflationary deleveraging scenarios is also captured within the set.

Our current positioning

Unconventional monetary policy continues to impact pricing in major asset classes, particularly currency, bonds and shares. These distortions mean that risk-aware real return strategies (such as the MLC Inflation Plus portfolios) need to accept a lower prospective return in order to avoid taking unacceptable risks. Greater participation in genuinely uncorrelated strategies and benchmark-agnostic investing help, but do not fill the gap entirely. During the quarter we increased the risk control in the MLC Inflation Plus – Assertive Portfolio. Our portfolios with less flexible asset allocations (the MLC Horizon portfolios and MLC Index Plus portfolios) benefit not from large changes in asset allocation but by maximising diversification efficiency as much as is feasible.

With traditional sources of diversification compromised, we rely to a greater extent on exposure to alternative forms of portfolio protection.

Our analysis of scenarios in our Investment Futures Framework helps us understand the difference between upside potential and downside risk. Where there is a significant asymmetry (i.e. the upside potential is not equal to the downside risk) we have an opportunity that we can exploit to increase the return compared with the level of risk.

There are two important asymmetries at present: in currency and bond markets. These asymmetries remain, although slightly weaker, after the continued rise in yields and fall in the AUD from its high. In bond markets, we observe that while bond yields could decline, the extent of this is limited relative to the potential for yields to rise. This means that the potential loss from shortening duration is low relative to the potential gain. Similarly, while there are circumstances in which the AUD could resume rising (and we assume it does in a number of our scenarios), on current pricing the upside factors are largely priced in, while the downside risks are not. Because of this, we have significant exposure to unhedged foreign assets within the MLC Inflation Plus – Assertive Portfolio and remain overweight to foreign currencies across MLC Horizon 2 to MLC Horizon 7. Our positioning against the AUD does not mean that the scenarios process 'expects' the AUD to fall—indeed, two of our tailored scenarios expect the dollar to rise (others expect the AUD to fall, and by a greater amount). Instead, the model suggests that the AUD is an efficient source of diversity that decreases overall risk, allowing greater exposure to other sources of risk than we would otherwise have carried in the portfolios. In short, in many scenarios the AUD is a perceived safe haven that turns out to be something of an illusion.

Shortening the duration of nominal bond exposures is particularly appropriate given the concerns about an eventual rise in inflation. Although this will not necessarily be a highly adverse scenario, it does present investment challenges. Inflation is like a tax on savers. We no longer just need positive returns; we need returns that exceed the moving target of rising inflation. The most obvious risks lie in nominal bonds which, despite some increase in yields, are still expensive, offer very limited diversification potential, and are acutely sensitive to rising inflation. Inflation-linked bonds, on the other hand, are still a valuable component of an inflation-hedge strategy despite offering compressed yields. Hiding in cash may not help—increasingly this is true in Australia as the policies of the major central banks spill over into the domestic economy through an overvalued exchange rate which forces cash rates lower. Shares offer inflation hedge potential (though this is not uniform—stock selection matters), but this will be negated if share prices run too far ahead of fundamentals. While a bubble in share markets would be welcome in the short term, it would create additional unpleasant risks.

Real return funds: MLC Inflation Plus portfolios

Here is a summary of the current positioning considerations for the MLC Inflation Plus portfolios.

Asset class	Change in allocation to asset class in the MLC Inflation Plus portfolios over the June quarter			Comment (for Assertive)
	Conservative	Moderate	Assertive (previously LTAR)	
Australian shares	Steady allocation	Steady allocation	Steady allocation	Relatively attractive in terms of probability-weighted outcomes but relatively high tail risk.
Global shares	Steady allocation	Steady allocation	Steady allocation	Limited exposure due to strong preference for a defensive equities allocation in a relatively high risk environment.
Defensive global shares (unhedged)	Steady allocation	Steady allocation	Steady allocation	Primary global share exposure is defensive. The portfolio has a strong bias to absolute, not index-relative, shares.
Foreign currency exposure	Steady allocation	Steady allocation	Steady allocation	The power of foreign currency as a risk diversifier reduces as the AUD declines, but it remains an important source of risk control. However, the weaker potential diversification benefit means that risk asset exposures are reduced further than would otherwise be the case.
Low Correlation Strategy	Steady allocation	Steady allocation	Steady allocation	High quality, transparent hedge fund strategies are a relatively important source of return potential in a world where it has become more difficult to generate returns with reasonable risk. However, these strategies are exposed to a variety of risks, and allocations must be sized accordingly.
Multi-asset real return strategy	Increased allocation	Increased allocation	Increased allocation	Allocations increased with the inflation focus of this strategy.
Emerging markets strategy	Steady allocation	Steady allocation	Steady allocation	While on an aggregate valuation basis these markets look cheap, the higher quality stocks were relatively immune to the recent selloff. The emerging economies and markets also remain vulnerable to monetary policy normalisation.
Global private assets	Steady allocation	Steady allocation	Reducing allocation	The private assets allocation for the MLC Inflation Plus - Assertive Portfolio (in MLC MasterKey's superannuation and pension products) has been above target and is currently in the process of rebalancing.

Real return funds: MLC Inflation Plus portfolios continued

Asset class	Change in allocation to asset class in the MLC Inflation Plus portfolios over the June quarter			Comment (for Assertive)
	Conservative	Moderate	Assertive (previously LTAR)	
Global property securities	Zero direct exposure	Zero direct exposure	Zero direct exposure	We prefer the broader opportunity and absolute return orientation of defensive global shares and multi-asset strategies. There is potential reversion in the prices of higher yielding assets in monetary policy normalisation scenarios.
Global government bonds	Zero direct exposure	Zero direct exposure	Zero direct exposure	Unattractive, with limited diversification benefit.
Australian inflation-linked bonds	Higher allocation	Higher allocation	Higher allocation	Inflation hedge remains attractive, despite low yields. Inflation-linked markets have lagged rallying nominal bond markets and created an opportunity to increase exposures. We have also increased allocations on concerns of undue inflation complacency.
Insurance related investments	Zero allocation	Exposure trimmed	Exposure trimmed	Yield compression has made the risk-return trade-off less compelling.
Bank loans	Steady allocation	Steady allocation	Zero direct exposure	Floating rate loans offer some exposure to diversifying income-based risk premia without as much capital risk as fixed coupon bonds. While this is attractive in the current environment, tight spreads increase price risk and a tendency for low liquidity in adverse environments limits the degree to which a portfolio should have exposure.
Cash	Reduced allocation	Reduced allocation	Reduced allocation	This is a challenging environment in which allocations to cash are higher than we prefer because abnormally low cash rates and abundant liquidity have caused an adverse shift in the risk-return trade-off for all assets.
Borrowings			No borrowings	Reward for risk is shrinking as asset prices rise.

MLC's scenario insights & portfolio positioning

MLC Horizon portfolios

The MLC Horizon portfolios are designed to maximise risk-return efficiency within defined asset allocation considerations. Like other traditional diversified portfolios, for the MLC Horizon portfolios the mix of bonds and shares is regarded as a defining characteristic. While some flexibility around allocations is acceptable, these portfolios must remain true to label. For these portfolios, allocations pivot around the benchmark allocation with the aim of increasing risk-return efficiency, in particular by reducing exposure to assets which offer a less attractive reward for risk taken. We have progressively introduced diversifying exposures which offer a more defensive element—in particular inflation plus, multi-asset real return, defensive global shares and the Low Correlation Strategy. These exposures help increase the defensive characteristics of the portfolio in an environment where risk is elevated. We also continue to view foreign currency exposures as an important diversifier in an environment where nominal bonds are a weak diversifier and are themselves risky in some scenarios. During the quarter we moved inflation-linked bonds back to benchmark, reflecting ongoing inflation concerns.

	MLC Horizon portfolio weights over the June quarter			Comment
	Under	Neutral	Over	
Growth assets	•			The environment is one of relatively high risk but the traditional diversifier (nominal bonds) is unusually weak and adds to risk in a number of important scenarios. Positioning biased to a small underweight position, with real return (Inflation Plus) investments being overweight.
Australian shares	•			From a valuation perspective, Australian shares have some attraction, but the risks for the domestic economy from a slowing in growth in China outweigh the positives.
Global shares (unhedged)			•	We continue to be overweight foreign currencies (underweight the AUD), with an increased allocation to unhedged global shares at the expense of hedged global shares. This is a risk control position, appropriate on the basis of a still very strong local currency and significant global economic uncertainty.
Global shares (hedged)	•			
Global property securities		•		Retain benchmark allocation – the allocations are underweight versus peers.
Global private assets		•		Allocations are in the process of rebalancing to target from overweight.
Emerging markets strategy		•		Benchmark weight.
Real return strategies (Inflation Plus and multi-asset real return)			•	Overweight.
Fixed income		•		Reduced duration maintained.
Australian bonds – All Maturities			•	Overweight (MLC Horizon 4 and 5 only).
Australian inflation-linked bonds		•		Benchmark weight.
Global bonds – All Maturities	•			Underweight (MLC Horizon 4 and 5 only).
Global absolute return bonds		•		Retain benchmark allocation.
Global government bonds	•			Retain underweight global government bonds and overweight cash.
Global non-government bonds		•		Retain benchmark allocation.
Global multi-sector bonds		•		Retain benchmark allocation.
Global non-investment grade bonds: high yield bonds, bank loans, mortgages		•		Retain benchmark allocation.

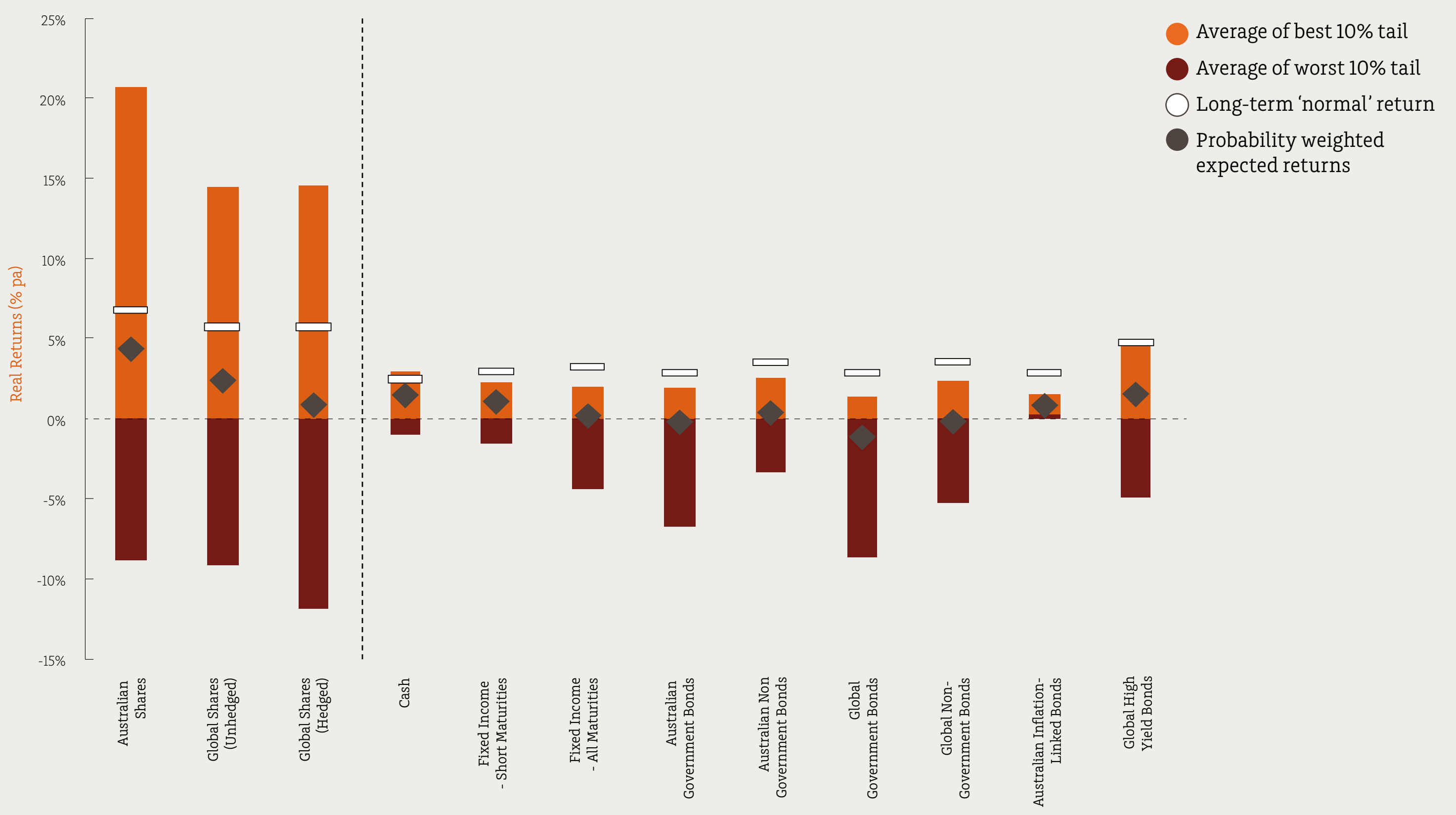
Return potential

At the heart of our Investment Futures Framework are scenarios that provide insight into a range of alternative futures. We generate return forecasts in each scenario based on where we are starting from, the assumed path that's taken and where it ends up. The path and the end point are normally defined and fixed; what changes through time are the starting asset prices. If share prices rise strongly, future return potential is reduced.

Our broad-based generic scenario set can be viewed as a consistent barometer of risk and return through time. Our barometer is continuing to paint a difficult picture. Future return potential is compressed across the spectrum of shares and debt assets. The higher asset prices go, the lower future returns must eventually be. The word 'eventually' is an important one—in environments with strong monetary stimulus share prices in particular can run further and for longer than seems reasonable on the basis of the economic fundamentals.

The probability-weighted real returns for each asset class are shown in Chart 3 (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.

Chart 3: 40 Scenario Set Probability Weighted Real Returns (June 2014)
(5 years, 0% tax with franking credits, pre fees, pre alpha)



Source: MLC

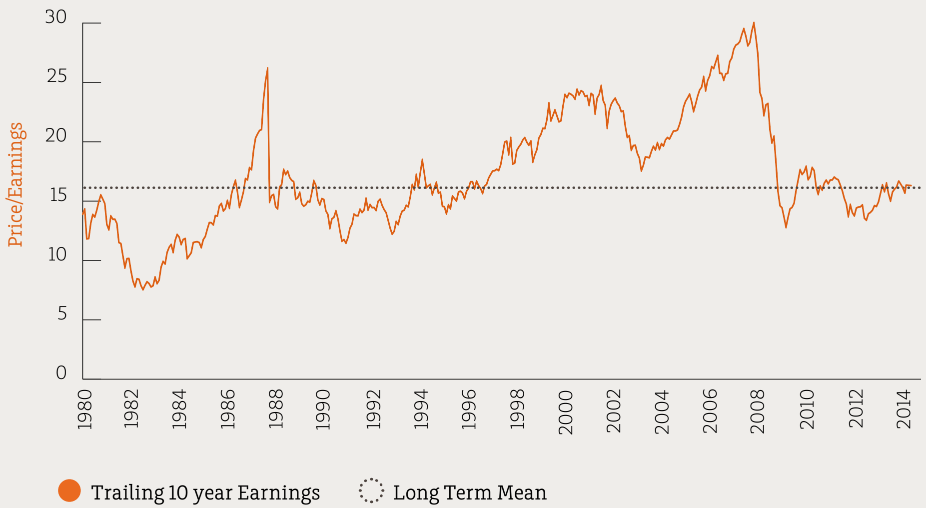
The return potentials are generally tighter, looking forward from the end of June 2014, because of the rise in share prices and decline in bond yields during the quarter.

Chart 2, on page 8, shows return potential for the MLC Horizon and MLC Inflation Plus portfolios in our generic scenarios.

Asset class indicators

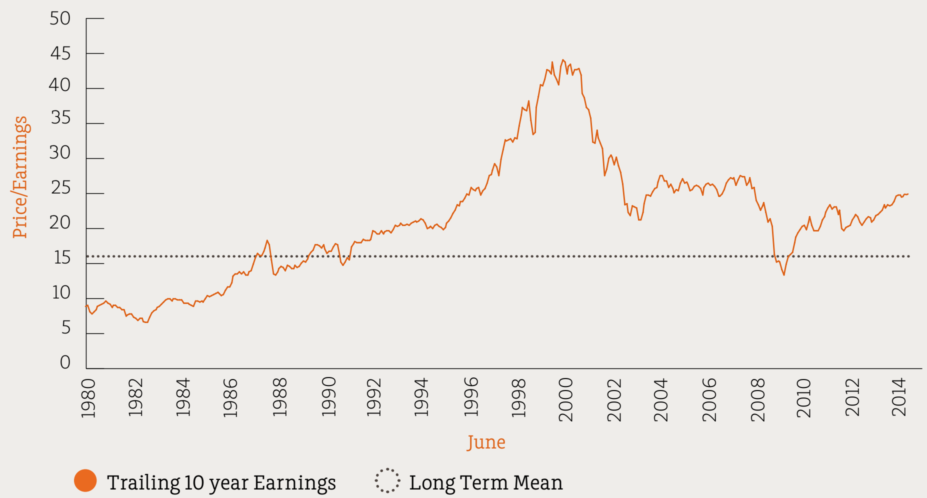
Our view of the main asset classes is as follows.

Australian shares
Market indicator *S&P/ASX 200*



Source: Datastream

Global shares
Market indicator *S&P500*



Source: Datastream World Index

Comment

The Australian share market produced a positive return this quarter, although it significantly underperformed overseas markets, as mining stocks weakened in response to a falling iron ore price.

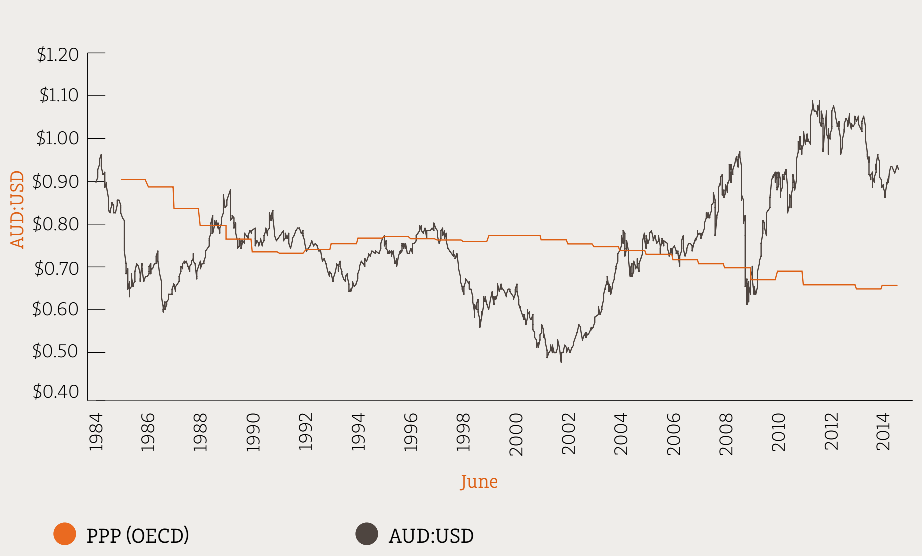
The Australian economic data released over the quarter were quite mixed. Australia's economy expanded at a faster than expected pace in the March quarter. Employment growth has improved, there are some signs of a pick-up in investment outside of the mining industry, and private sector credit is still expanding. However, both business and consumer confidence remain fragile, and investment in mining is expected to continue declining. The Reserve Bank of Australia left interest rates unchanged over the quarter, and has signalled its intention to leave rates unchanged for some time to come.

Comment

World share markets enjoyed good gains over the quarter, although a stronger Australian dollar detracted from unhedged global share returns. However, geopolitical risks remain a concern for global share markets, particularly the unstable situation in Iraq. Despite these developments, markets remained well supported by an improving US economy, some better economic news from China, and the fact that monetary conditions remain favourable for financial markets. The focus on the healing of the US economy has consequences for the pace of monetary policy normalisation. Good news for the real economy may, ironically, be less positive for equities.

Asset class indicators continued

Australian dollar
Market indicator *Australian Dollar Purchasing Power Parity*

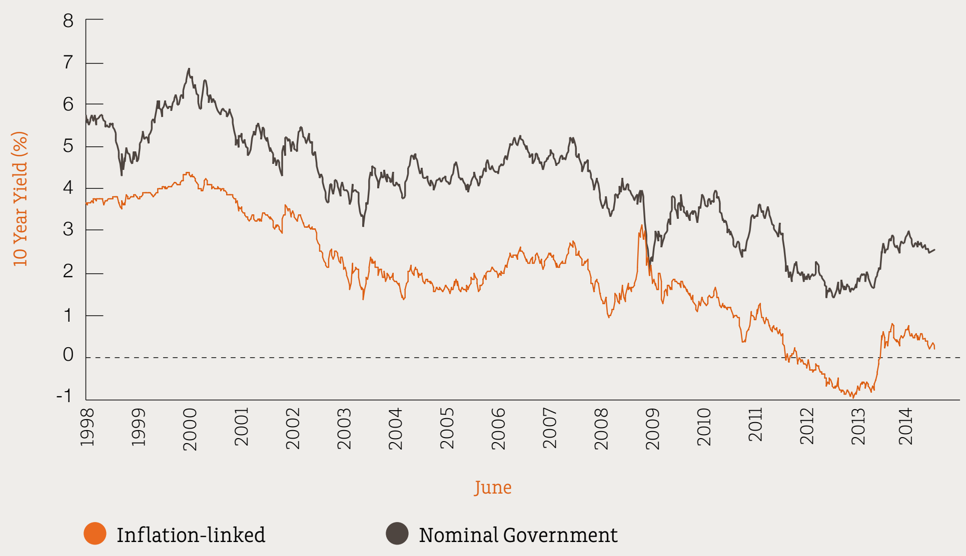


Source: Bloomberg

Comment

The Australian dollar continued to appreciate over the June quarter, prompting comments about its elevated level from the Reserve Bank The AUD remains at values that are high, compared with measures of fair value.

Global government bonds
Market indicator *10 Year Bond Yields – United States*



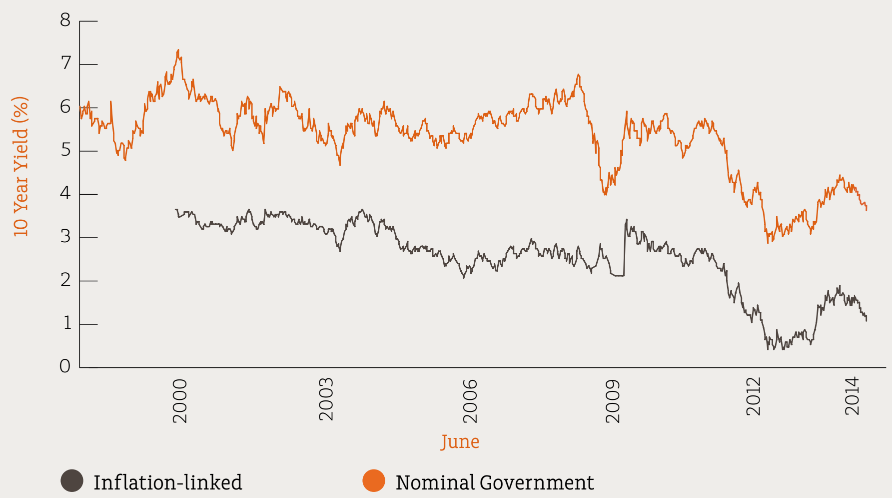
Source: Bloomberg

Comment

Bond yields fell slightly in all the major world bond markets, producing gains for investors. The ECB's policy announcements of additional stimulus led yields lower, and increased confidence that rates will stay lower for longer.

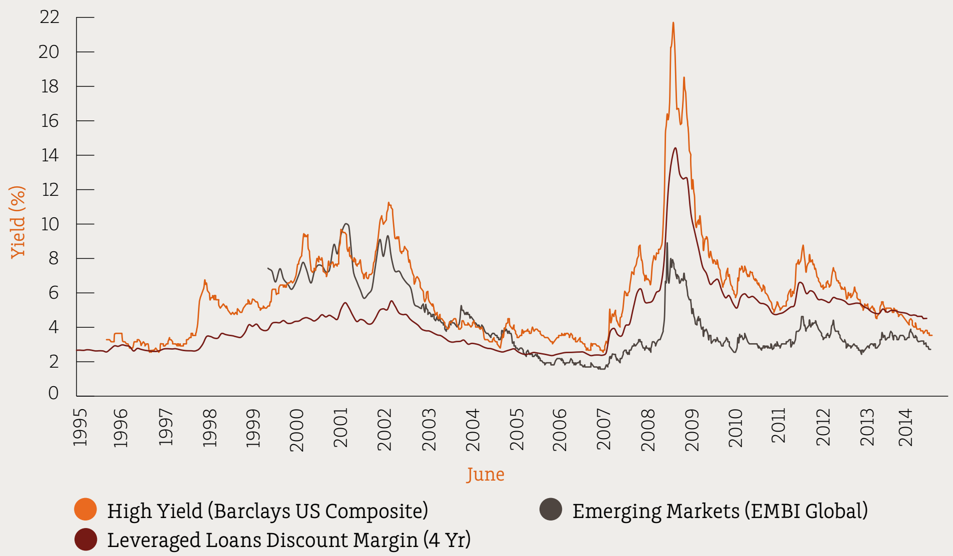
Asset class indicators continued

Australian government bonds
Market indicator *10 Year Bond Yields – Australia*



Source: Bloomberg

Non-investment grade bonds
Market indicator *Fixed Income Spreads*



Source: Credit Suisse, Barclays

Comment

A sharp rally in bond yields—around 50 basis points for the Australian government 10 year nominal bond—was in part a catch-up with global markets. Most of the rally came during June in response to a change in forward guidance from our Reserve Bank, which moved from a tightening to an easing bias.

Domestic inflation-linked bonds remain an attractive asset compared with nominal equivalents as real yields have become more attractive and inflation remains at the top end of the RBA's target levels. However, the high duration of these assets means we have to carefully balance the inflation protection against the interest rate risk.

Comment

Spreads tightened marginally during the June quarter for both investment grade credit and high yield bonds. The markets have fared well since early 2014. The narrowing of spreads is due to continued monetary stimulus, which results in strong demand from investors searching for yield in the low yield environment.

Appendix 1 – tailored scenario set

Scenario	Probability ranking	Description
Three speed global economy (China soft landing)	1	The world splits into three distinct economic growth zones. China and other emerging markets continue to grow strongly, the US grows below trend (but is not woeful), while Europe stagnates. This scenario is a variant of the two euro-scenarios that do not involve a break-up. The key difference is that the US and emerging markets do not suffer as distinctly as they do in the euro-specific scenarios. In other words, the trade disruption assumed in the other scenarios is augmented by increased ex-Europe international trade—Europe is essentially excised and isolated. Greater domestic activity also plugs the output gap to a degree.
(Mild) inflationary resolution	2	Monetary stimulus and some form of resolution for Europe are combined with sensible policy to stimulate growth. Widespread USD, GBP (and euro) liquidity provides inflationary pressure that is countered to a degree by slightly sub-capacity growth...a very fine balance. Inflation is high enough to help inflate away the debt burden. Emerging markets experience more severe inflation than the developed world, slightly normalising the growth differential across the emerging markets/developed markets divide.
Developed market austerity, recession, stagnation	3	A distinctive and hence important scenario. Prolonged deleveraging of both the private and public sectors combined with lack of policy reform removes growth potential for developed economies. This scenario is not dependent on a particular European outcome, but simply assumes that the environment is highly constrained. Developed market economic expansion is negligible and emerging markets slow down significantly but avoid a crash. Shares perform poorly. Commodities fall. Nominal yields rally further and remain low.
Early re-leveraging	4	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.
Extended quantitative easing	5	Central banks of the US, UK and Japan continue to print currency. The ECB also embarks on quantitative easing. 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. Bubbles are particularly pronounced for high growth economies (Asia and even Australia) and real assets as investors seek inflation protection. The AUD remains very strong against major trading crosses. China continues to maintain a closed capital account but tends to accept 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.
Sovereign yield re-rating	6	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. 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.

Appendix 1 – tailored scenario set continued

Scenario	Probability ranking	Description
Reform	7	A growth upside scenario contingent upon coordinated reforms that address inefficiencies that are idiosyncratic to particular economies (eg labour in the UK, infrastructure in the US, sector contribution to growth in China and structural issues in the eurozone). This is possible and has distinctive growth outcomes. Most economies return to trend growth with moderate inflation.
China hard landing	8	A combination of poor allocation of capital, greater than anticipated loan losses, lower external demand, currency appreciation and monetary policy error causes a crash in Chinese output. This most likely emanates from a property crash, though failure to contain inflation and/or social unrest are also possible flash points. Australia suffers severely under this scenario (recession). Income is shocked and the AUD corrects to sub-PPP rates. This causes a flow-on impact through to employment (weakness) and housing crashes. Thus, both materials and financials are hit, causing very poor Australian shares performance. Japan and Korea also suffer due to their export trade exposure to China. The US, Europe and the UK are somewhat insulated from the Chinese crash, the main effect being a disruption to imports.
Inflation shock	9	Similar to stagflation, though assumed growth is higher. Sharp rise in inflationary expectations.
Two speed recovery	10	Asia continues to over-invest while the developed world more or less continues to stagnate or at best, achieve only modest growth. Could evolve into a three speed economy or precede a hard landing for China. This scenario is differentiated by economic behaviour of emerging markets and Australia (by virtue of the continued investment in fixed assets). This is a strong scenario for both the Australian economy and the AUD. Demand for bulk metals remains high, with supply continuing to lag. Energy demand is also high, as is the demand for industrial metals.
Extended risk aversion	11	A generic scenario to capture prolonged aversion to risk.
One speed slow growth world	12	There is growth convergence as persistent slow growth in the developed world spills over into the emerging world.
Stagflation	13	With no 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 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'.

Appendix 2 – MLC's market leading investment process

Step 1
Scenario analysis and portfolio construction

Investment Future Framework

Identify scenarios → Generate potential returns → Analyse returns and risks → Asset allocation

- We can never be certain what the future will hold. This means 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 gives a detailed view of how returns vary in each scenario. This also provides detailed information about the nature and extent of investment risks.
- 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.

Important information

This information has been provided by MLC Investments Limited (ABN 30 002 641 661) and MLC Limited (ABN 90 000 000 402), members of the National Australia Bank group of companies, 105–153 Miller Street, North Sydney 2060.

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