MLC's scenario insights & portfolio positioning

MLC Horizon and MLC Inflation Plus portfolios

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We welcome your feedback on this document.
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The investment environment is starting to change, fracturing the prevailing uneasy peace in financial markets.

Extraordinary policy measures have facilitated strong returns, despite shaky economic fundamentals. While the Eurozone and Japan are still struggling with policy efficacy, improving fundamentals in the US are moving us towards more decisive policy normalisation. On one hand, these developments make it more difficult to remain in the liquidity-driven world of strong returns. On the other hand, this reduces risks of another market bust. A consequence of this evolution is that volatility has risen and some asset price realignments may be starting to play out. There are new concerns about policy efficacy as the ability of the US Federal Reserve (the Fed) to soothe market worries comes into question. This, combined with geopolitical pressures, means that we are seeing changed behaviour in shares as well as bond and currency markets.

Key among these developments are those taking place in the US and Chinese economies. In September we returned from a research trip to both these regions which focused on changing risk and opportunities. In this update we share our understanding of what this means for how the future could play out.

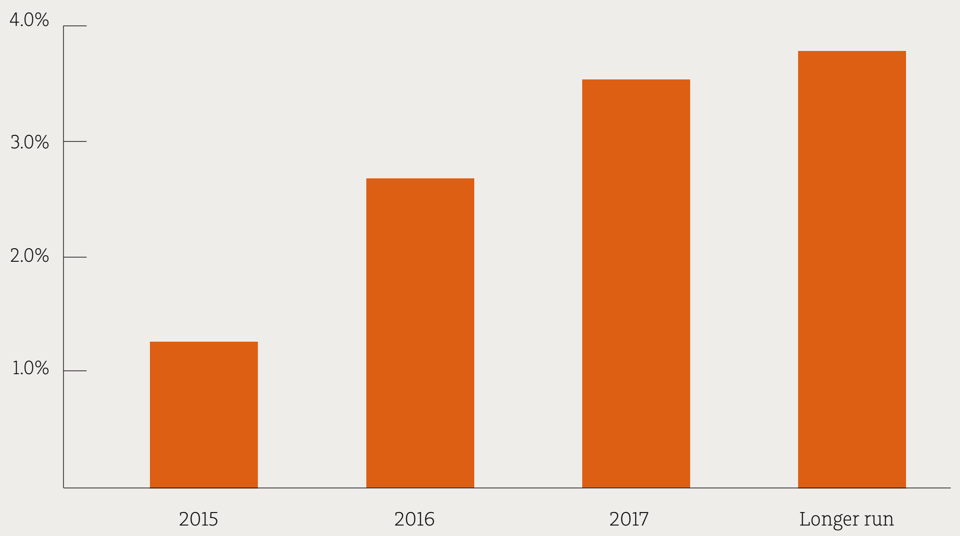
Turning to the US first, we are approaching the second step of what will be a three-step journey of policy normalisation. The first stage is to stop quantitative easing (QE). The pace of Treasury bond and mortgage backed securities buying was cut by $10 billion for the seventh time, to $15 billion, from October; the next step will cease purchases altogether, probably from the end of October unless market jitters cause a rethink. The second step will ease financial repression by allowing short-term rates to rise toward the inflation rate – in other words, the real interest rate will rise towards zero. The final step is the restoration of positive real interest rates, which will signal the end of financial repression.

The key to the pace with which interest rate normalisation proceeds lies in improvement in the labour market, and the Fed's perceptions of underlying slack. The average interest rate expectations of the Federal Open Market Committee (FOMC) are shown in Chart 1 on page 3. Assuming inflation consistent with the Fed's target of 2%, the average FOMC member would not be surprised to see the real after-inflation Federal Funds Rate reach 0% by the end of next year and move into positive territory in 2016. The Federal Funds Rate is the overnight rate on banks' deposits at the Fed, currently in the range 0% to 0.25%.

MLC's active investment approach

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

Chart 1: FOMC member Fed funds rate expectations (annual average)



Source: US Federal Reserve and MLC, 17 September 2014

This forthcoming repricing of cash has implications for the pricing of all other assets. Even if the flow of economic news remains consistent with Fed expectations, it is not necessarily benign for asset prices. When cash is artificially priced that feeds into everything else, and hence when that artificial pricing reverses other asset prices are put under pressure. Bond prices are most obviously vulnerable, but share prices are not immune, with higher yielding stocks, particularly exposed.

Of course, rate rises are contingent on continued improvement in US labour market conditions, plus well-behaved inflation outcomes and expectations. Inflation gives no immediate cause for concern – indeed, recent commodity price declines underline current dominance of global deflationary forces. However, inflation is a lagging indicator and so tells us little, if anything, about the future. We must turn to the labour market to get some idea of what the future might hold. This is not simple: not only is the path forward uncertain, but there's also no certainty about where we are starting from. Most of the Fed members are at the dovish end of the spectrum and see significant remaining 'underutilisation of resources'. We think this is far from clear, as do two dissenters on the FOMC (there are also two dissenters on the Bank of England's Monetary Policy Committee) – clearly those FOMC members' interest rate expectations are contingent on different scenarios playing out. The case for the doves rests on a rebound in the participation rate, which remains below its peak level that occurred at the turn of the century – when the youngest baby boomers were in their mid-30s and oldest, their mid-50s. After that point, as the oldest baby boomers headed towards retirement age, the participation rate started to drop. Besides retiring baby boomers, there are multiple other forces also weighing on the proportion of the working age population that is available for work. The dysfunctional US healthcare and welfare systems represent an underappreciated factor. The issue here is that while the federal government pays disability support, the states make welfare payments. The states are therefore incentivised to transfer welfare recipients to disability schemes, and this is attractive to these recipients due to the free healthcare (Medicaid) which comes with disability status. Hence, this strategy may take them permanently out of the labour force.

A more fundamental factor concerns the skill sets of the unemployed, who may not be as employable as the Fed presumes. Evidence of labour market tightness comes from growing reports of skill shortages. The long-term unemployed are not easily retrained to fill skilled vacancies, which suggests that US unemployment is now more structural than cyclical and may remain stubbornly high. These things increase our sense that the Fed is giving the labour market the benefit of the doubt, and hence may end up 'behind the curve'. In other words, they may end up reacting to rising wages and inflation, rather than being pre-emptive. This may be a deliberate choice rather than misperception. We know that the Fed would prefer inflation to be above its 2% target rate than below – we ignore this at our peril! The incentive for the Fed lies in avoidance of deflation, which it rightly sees as the most worrying, destructive and difficult scenario. And high inflation helps erode the real value of debt that occurs with higher inflation – though this depends on interest rates and bond yields remaining well enough behaved (in other words it relies to an extent on misperception). Moderately higher inflation and moderate growth may represent the most benign adjustment path.

While the behaviour of wages and flow-through to inflation remain uncertain, shifting market perceptions about the imminence of rate rises has caused a sharp reversal in this year's downward trend in bond yields, though geopolitics rapidly restored the safe haven status of US Treasuries. The move lower in share markets may also have been more about risk aversion following air strikes on 'Islamic State' than the return of the 'good news is bad news' response to policy tightening. The clearest impact of US policy evolution has been on the US dollar. The strength of the consensus on US dollar appreciation is disconcerting but this could be one of those rare occasions when the consensus gets it right! Nevertheless, we never presume that the future can be foreseen. Instead, our research focuses on understanding the factors that are pivotal and their implications for markets under alterative assumptions. This is what provides us with the understanding required to achieve the most reliable return outcome – which means we work out how to control risk most efficiently, with as little return sacrifice as possible.

Turning to China, there have been important developments which promote a rebalancing of the economy away from investment-led to consumption-led growth. This is essential to ensure a sustainable (though more moderate) growth path for China, but it has challenging consequences for Australia. To both reduce the incentive to invest and transfer income to households, the following is required:

a. currency revaluation
b. wage growth greater than the rate of productivity growth and, most importantly,
c. an end to financial repression (positive real interest rates).

During the past three years, there has been progress on each of these. Wages have soared; the RMB has appreciated; and financial repression has eased considerably, though has not yet entirely ended. Importantly, this means that the imbalances in the Chinese economy are no longer getting worse, which greatly reduces the risks of a financial crisis over coming years.

This first step was quite difficult. China is impressive for its vastness and seemingly inexorable progress, but also for its complexity. Nothing in China is straightforward. The second step involves getting growth in debt down. If credit growth slows, the investment share of GDP will decline, enabling the consumption share to rise. A raft of interrelated reforms is required to transfer wealth from the state to the household sector. The impact of land reforms which transfer wealth to the rural poor depends on hukou (right of residency) reforms, availability of social housing, and expansion of social services (health and education). There are political and control issues as well as institutional, legal and economic questions to resolve. The issue of redistribution is linked with the anti-corruption campaign. If China went in with full force to tackle corruption it is probably not much of an exaggeration to say that the Communist Party would be wiped out; on the other hand, if nothing changes, China's future is in considerable doubt. While the anti-corruption measures have certainly been selective, what we hear and observe is not merely a factional power struggle, but is consistent with intent to institutionalise an anti-corruption mentality. As always in China, there are complexities and consequences which need to be managed. For example, no one in China is supposed to own more than two houses, but owning 10 or more (even as many as 50) is not uncommon because there are such limited investment opportunities. The anti-corruption campaign is generating anxiety about this at a time when house prices are already falling and there is record oversupply (particularly in smaller cities). In response, there already has been some easing of restrictions and even subsidies to encourage sales, and most recently a cut in the minimum equity down payment from 60% to 30% for second home buyers. However, in the new era of policy moderation and rebalancing the overwhelming constraint is credit availability, and mortgage rates remain high in real terms.

The implications for Australia of these developments revolve around changes in demand for our most important exports, most particularly iron ore, which accounts for almost a quarter of the value of our exports and goes predominantly to China. While China may achieve a relatively smooth rebalancing of its economy, the result will be both slower growth and a lower investment share of GDP, which has consequences for iron ore demand. Roughly 50% of Chinese steel consumption is demanded by the construction sector which, due to the unfavourable nexus of extremely rapid growth and the strong possibility of a deceleration in capital investment, means that iron ore demand is at risk of undershooting expectations. This comes at a time when the lagging supply response is finally bearing fruit, quickly helping to flip the market from deficit to surplus with obvious implications for pricing and Australia's terms of trade. While this is almost textbook when viewed from a normalised perspective, commodity cycles are of long enough duration to beckon a perception of structural change across the broad spectrum of industry, investors and policy makers. In

September we met with officials from the National Development and Reform Commission (NDRC), the state planning agency which has broad planning control over the Chinese economy. The NDRC intends to 'build the infrastructure needed for the next 30 years by 2020'. Officials at the NDRC see an inflection point occurring at the end of the current five year plan in 2015, after which there will be a slower rate of infrastructure development. In the 13th five year plan, which starts in 2016, there are expected to still be more high speed roads and railways, airports and deep water ports but the level of infrastructure spend is lower. And that will step down again in the 14th five year plan, which commences in 2020. For example, in 2014 and 2015, 54 new airports are projected to be opened; this compares with a total of 30 new airports in the whole of the next five year plan. The obvious implication is progressively moderating demand for Australia's mineral exports.

The changes are symptomatic of China starting to move out of its fast development phase: part of the transition from an emerging to a developed economy. This transition also implies changing perceptions of Australia, which will be riding to a much reduced extent on China's back. Also, while China will remain a highly important economy, it will not be as important a driver of global growth as it has been in recent years. This realisation may take some time to dawn but it poses some obvious risks for the Australian dollar and mining companies which have new supply coming onstream, as well as opportunities for other exporters which may look forward to a boost in their competitiveness. As we have been saying for some time, while we can't predict with any certainty the path of the Australian dollar (AUD), the risks to the downside far outweigh the risks to the upside. We also observe that environments most negative for the AUD tend to be (though are not always) associated with weaker share markets. From a portfolio positioning point of view, this means that foreign currency exposures provide an important source of risk diversification in a world where such things are a rare commodity.

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 yet declined. Financial repression has not generated enough real growth or inflation to support aggregate deleveraging. In both the US and China, the world's two most important economies, financial repression has eased or easing is in prospect. We anticipate that this will change the investment landscape, particularly from an Australian investor perspective.

The quarter and performance in review

This year started with market nervousness about the start of monetary policy normalisation in the US; then confidence increased in the June quarter, with rising confidence in Fed Chair Yellen's dovish intentions, which made the adjustment path seem more distant. Aside from jitters caused by Russia and the introduction of sanctions, these benign markets persisted well into the third quarter until the Fed's September FOMC statement was released. That triggered a reversal in the downward slide of bond yields and halted the rise the AUD, both of which had characterised much of the year. While the rise in bond yields reversed again with the start of US intervention against Islamic State in Iraq, and currency volatility rose in GBP cross-rates due to the Scottish referendum, the policy fundamentals are no longer as supportive, which suggests higher real yields are coming. These same pressures and paradoxically improving economic fundamentals are also weighing on share markets. Margin expansion in the US seems to have plateaued, with tentative signs that skilled labour shortages are feeding through into wage growth, which presents challenges for company earnings.

There is a clear dichotomy between the more robust economies: the US in particular, versus Japan and particularly Europe, where there is concern that the region's stalwart economy, Germany, is faltering. In the US, monetary tightening reduces the policy offset to what is still an underlying global deflationary bias – which is consistent with the ongoing commodity price decline. While the Eurozone is moving in the direction of more stimulation with a limited form of quantitative easing being introduced, the level of stimulation remains a long way short of that required to generate inflation close to 2%. Eurozone inflation has been falling for several years, core inflation has fallen to 0.5% and with economic activity depressed, downward pressure on inflation can be expected to persist. Without much more decisive policy measures, a slow drift into deflation with falling wages reminiscent of Japan may be inevitable. The Eurozone's relatively underdeveloped financial markets make QE difficult. Non-bank financing channels are limited, securitisation is difficult and costly, and the corporate bond market is mostly limited to large companies. Structural reforms cannot pay off within the time frame of electoral cycles, which means that there will continue to be stop-gap reforms and 'can kicking'. In the short term, this probably means the fragile equilibrium in Europe will continue, but this could be upset at any point. The most important impact of the stimulus announcements is the impact on the euro, which has depreciated by 9%. This improves competitiveness and helps offset the deflationary forces (Draghi's rule of thumb is that a 10% depreciation increases inflation by 0.4–0.5%). Growing divergence between

MLC's scenario insights & portfolio positioning

monetary policy in the US and the Eurozone and flow-on effects to an increasingly weaker Euro provide the best hope of real progress.

In Japan, meanwhile, fiscal tightening has resulted in a sharp slowing in economic growth. However, there is some optimism that consumption tax hikes will turn out to be a temporary interruption to the expansion. Thus far, firms' hiring plans have not changed, which means the gradual improvement in employment and wages seen in the first half may continue. The challenge remains getting the right balance between growth, and reform and fiscal discipline. A further consumption tax rise is planned for 2015 and progress on structural reform remains frustratingly slow. However, after many years of deleveraging and conservatism corporate sector balance sheets are strong and leverage is low, which puts them in a good position to invest and hire if there is sufficient confidence in demand. The hope is for a self-sustaining virtuous circle of higher employment, incomes, demand and investment. Companies are well positioned to play their part but there are many challenges to overcome, including countering the demographic challenges with increased labour market flexibility. Further stimulation via further currency weakness would also be particularly helpful.

In summary, the prospect is for aggregate monetary tightening – tighter US policy will probably not be entirely offset by further Eurozone easing. At some point this starts to reduce the distortions produced by abundant liquidity, which means that the risks associated with the search for yield will become more apparent, and risk will be an increasingly important driver of increasing differentiation in pricing of assets. September was an illustration of what happens when confidence in the 'lower for longer' scenario wanes, putting downward pressure on the AUD and share markets and upward pressure on bond yields.

It is in more difficult environments like that in September that we expect the risk control built into the MLC Inflation Plus portfolios to be more apparent, and we also expect that the MLC Horizon portfolios will perform well versus benchmarks and potentially peers. The foreign currency exposures of all our diversified funds were significant in protecting performance during the quarter, as were low or underweight Australian share and nominal duration allocations. Changes to the MLC Horizon portfolios during the quarter included a further reduction in Australian share allocations and increase in the hedge funds allocations via the Low Correlation Strategy (LCS). The increase in the underweight to shares was implemented before the start of the decline in share markets. The increase in the LCS allocation helps retain portfolio return potential while reducing exposure to share market volatility. MLC Inflation Plus portfolios' allocations to Australian shares were also selectively reduced and inflation-linked securities increased, particularly for the Conservative portfolio. The decline in the Australian dollar enhanced return outcomes for all diversified portfolios.

For the MLC Inflation Plus portfolios we are carefully reviewing risk exposures because the lower the Australian dollar, the weaker its risk diversification properties. This means that risk levels have risen as the AUD has declined, which is a trigger to review portfolio positioning. However, this impact is reduced in our analysis by partial normalisation in our fair value AUD modelling assumption. We had artificially increased AUD fair value in our models to reduce the risks of over-reliance on diversification from this source. As the AUD declines we are normalising that assumption.

MLC's scenario insights & portfolio positioning

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, 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).

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

- we limit vulnerability to negative returns to preserve capital in after-inflation terms over the defined time frame – if there is higher prospective risk this means tighter risk control, and at the same time
- in other scenarios, we aim to deliver attractive inflation plus returns over the defined time frame, and
- we will not chase higher returns if the risks of doing so are inconsistent with real capital preservation over each portfolio's investment time horizon.

For the MLC Inflation Plus portfolios we are sometimes asked how we can achieve the CPI plus objectives given current defensive positioning and low return potential. For us, the more important question is how to provide effective risk control. When cash rates are artificially low, all assets become mispriced. When there are bubbles which affect certain assets, these can be avoided. But when all assets are mispriced it is difficult to avoid or diversify away the risks. That is the world we find ourselves in today. Generating a reliable real return in this environment requires that we have patience and that we are nimble in exploiting opportunities to generate risk-controlled returns as they arise. The month of September provided an illustration of what to expect as monetary policies normalise and markets follow suit. During September our risk controls – particularly our foreign currency exposures – worked well and offset negative market returns. What also became clearer were the reasons for our cautious stance with respect to both share and nominal bond exposures. If share markets were to continue to correct to the point where risk declines significantly, expect the MLC Inflation Plus portfolios to increase share exposures and the MLC Horizon portfolios to move back to neutral share allocations. If we return to an environment of strong returns, expect that our positioning will remain cautious and defensiveness will increase as risk rises. This is still a time for patience, of keeping 'powder dry' and awaiting better opportunities. We will deploy risk when there is an expectation of an adequate reward for that risk. Avoiding the significant negatives is the key to providing investors with the positive real return outcomes that they require.

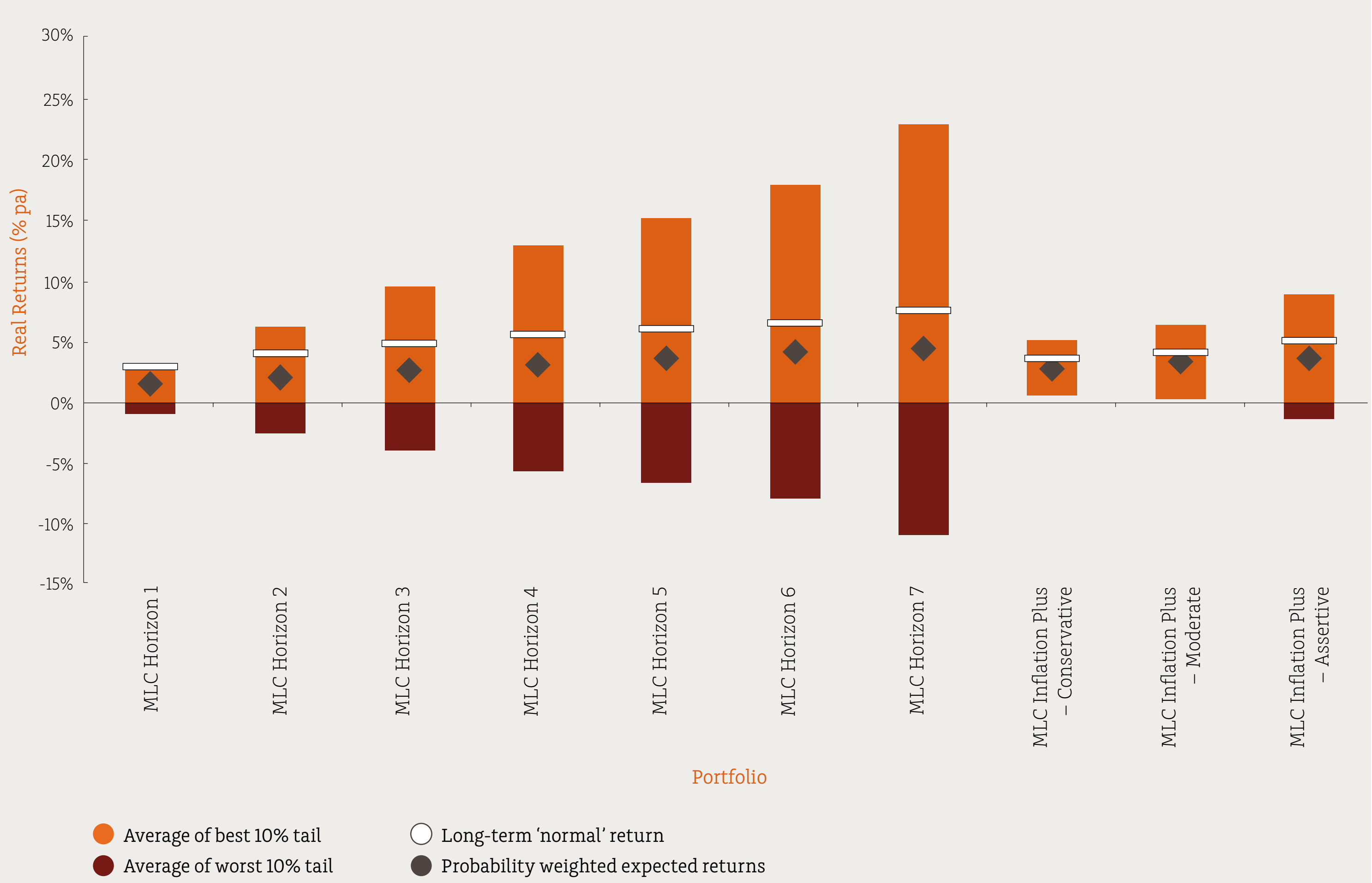
MLC's scenario insights & portfolio positioning

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 opposite looks at our barometer of risk and return – based on our generic (40) scenario set, described on page 9 – for the MLC Horizon and MLC Inflation Plus portfolios looking forward from the end of September 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: SAA Scenario probability Weighted Real Returns (September 2014)
(5 years, 0% tax with franking credits, pre fees, pre alpha)



Source: MLC

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

Our scenarios

We assess investment strategy using our unique Investment Futures Framework. The Investment Futures 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 Investment Futures 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.

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

While the prospective unwinding of unconventional monetary policy setting in the US is starting to change market behaviour, we have not yet seen a decisive end to the yield-chasing, risk-impervious actions of many investors. We are hopeful of being towards the end of the liquidity-driven distorted environment which is so difficult for risk-aware real return strategies (such as the MLC Inflation Plus portfolios). The need to stand back from strong returns tests the patience of investors, with the logic of the strategy only becoming entirely apparent once previously disguised risks are revealed. Importantly, the thoroughness and depth of our assessment of future return potential and future risks provides the level of confidence to maintain appropriate positioning through extended periods in which markets behave perversely – this is critical to ultimately delivering for investors. During the September quarter the risk control inherent in MLC Inflation Plus portfolios' positioning was evident as the risk diversifiers more than offset the drag from declining risk asset prices. Our portfolios with less flexible asset allocations (the MLC Horizon portfolios and MLC Index Plus portfolios) also benefited from the insights from our scenarios framework, particularly the progressive increase in real return-oriented components supported by underweight shares and short duration positioning.

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 (ie 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 continue to be 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 still 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.

Active and unorthodox mandates are very important to our multi-asset portfolios. Just as the diversification benefit of bonds has been eroded by yield-seeking capital, the typically defensive equity of solid, income-producing businesses that are resilient in low growth environments has been aggressively bid to historically high valuations. Given these elevated valuations, there is a real danger that these shares no longer provide the kind of defensive properties desired by investors. We know that having experienced, active managers with the flexibility to deviate from benchmarks will help our strategies remain exposed to growth upside while traversing what could be challenging times ahead. What constitutes relatively safe assets is fluctuating as this distorted environment evolves.

MLC's scenario insights & portfolio positioning

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 Super & Pension Plus portfolios over the September quarter			Comment (for Assertive)
	Conservative	Moderate	Assertive	
Australian shares	Reduced allocation	Steady allocation	Reduced 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 share allocation in a relatively high risk environment.
Defensive global shares (unhedged)	Steady allocation	Steady allocation	Steady allocation	Primary global share exposure is defensive. The 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	Steady allocation	Steady allocation	Significant allocations reflecting preference for highly flexible strategies with total return focus
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 sell-off. 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.

MLC's scenario insights & portfolio positioning

Real return funds: MLC Inflation Plus portfolios continued

Asset class	Change in allocation to asset class in the MLC Inflation Super & Pension Plus portfolios over the September quarter			Comment (for Assertive)
	Conservative	Moderate	Assertive	
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	Increased allocation	Steady allocation	Steady allocation	Inflation hedge remains attractive, despite low yields. Inflation-linked markets have lagged rallying nominal bond markets and created an opportunity to increase exposures.
Insurance related investments	Zero allocation	Steady allocation	Steady allocation	Uncorrelated though risky exposure appropriate where time horizon is sufficient.
Bank loans	Steady allocation	Steady allocation	Zero exposure in super/pension (steady exposure in investment trust)	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.
Australian credit short duration	Higher allocation	Steady allocation	Steady allocation	Offer some return enhancement while limiting additional risk.
Cash	Reduced allocation	Steady allocation	Increased 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 too limited.

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 increased the Australian shares underweight (prior to the September decline) and increased exposure to the Low Correlation Strategy.

	MLC Horizon Super & Pension portfolio weights as at the September 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. Allocations were reduced further prior to the September market decline.
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.
Multi-asset real return strategies (including inflation plus)			•	Overweight maintained.
Low Correlation Strategy			•	Overweight increased
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

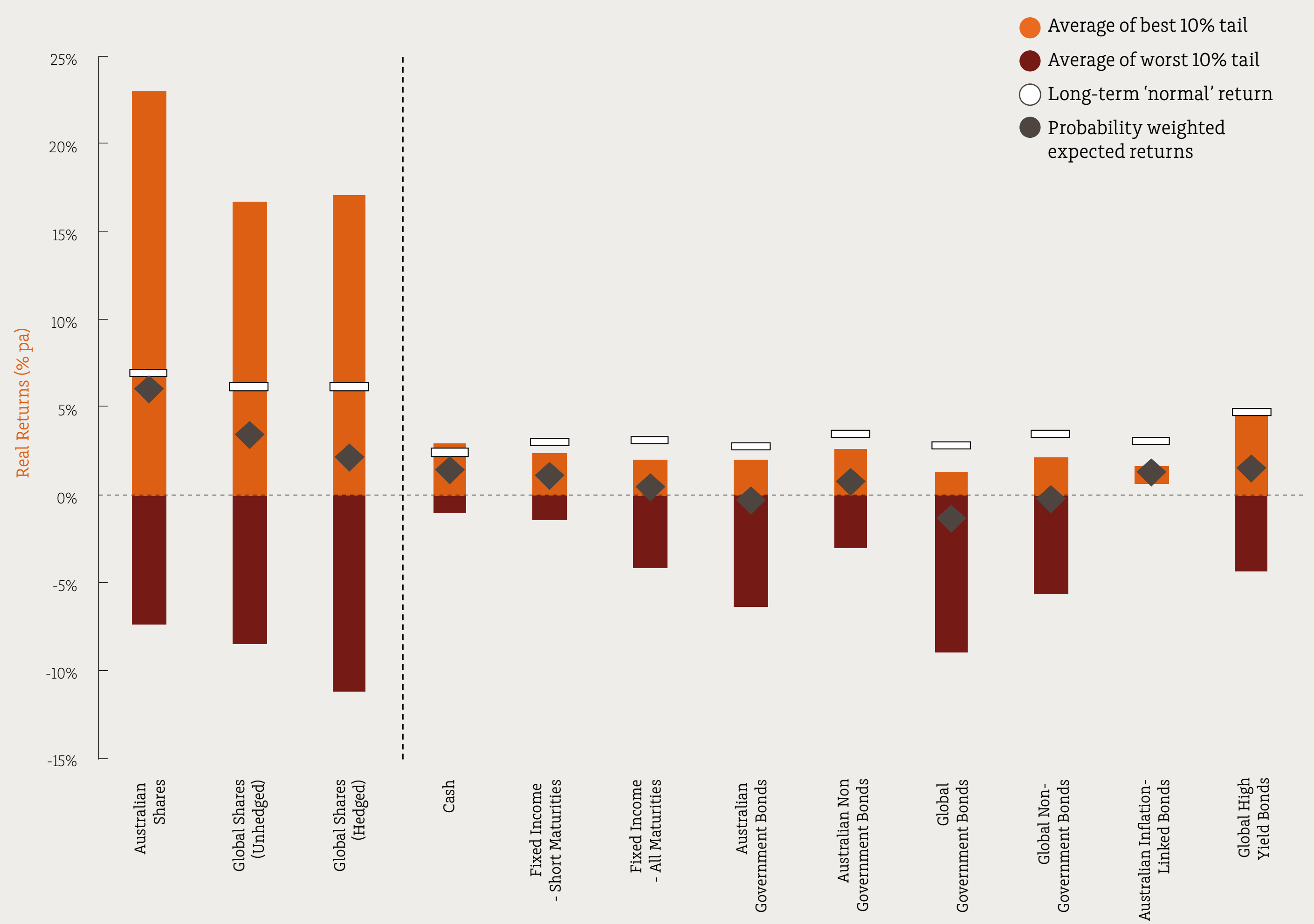
At the heart of our Investment Futures Framework are scenarios that provide insight into a range of alternative futures. We generate return forecasts in each scenario based on where we are starting from, the assumed path that's taken and where it ends up. The path and the end point are normally defined 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 opposite (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, on page 3, shows return potential for the MLC Horizon and MLC Inflation Plus portfolios in our generic scenarios.

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

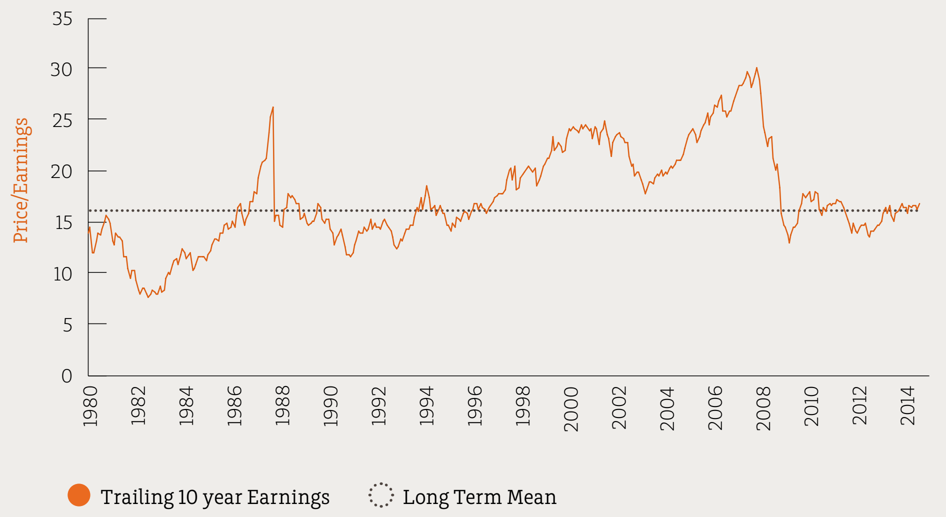


Source: MLC

Asset class indicators

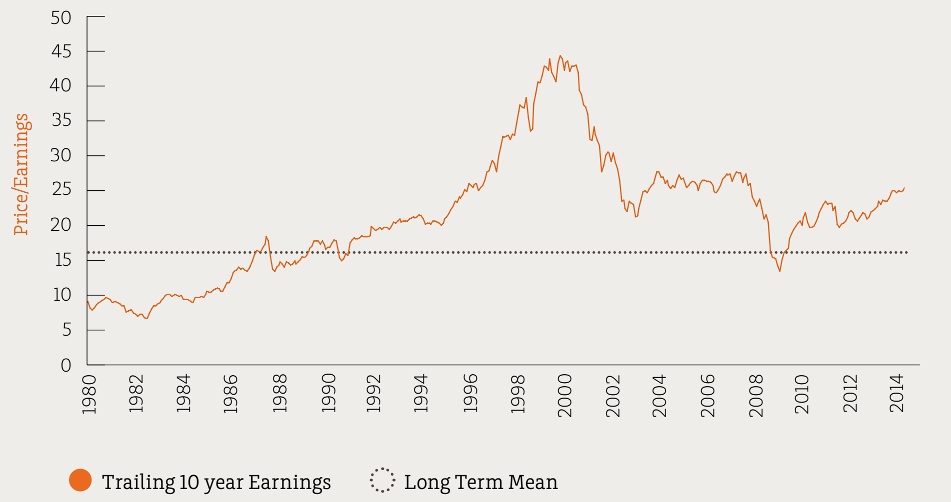
Our view of the main asset classes is as follows.

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 declined in the September quarter – commodity-related, energy, financial and property stocks dragged the market down. Underlying this were further falls in some key commodity prices, notably iron ore.

Economic growth remains reasonable, but not spectacular. Signs of a recovery in the non-mining economy are coming through – lower interest rates are helping, housing activity indicators remain solid and demand for credit, especially business credit, has picked up. However, mining investment continues to taper off, and the sharp fall in the iron ore price is significantly detracting from our national income. The uncertain environment probably means the Reserve Bank of Australia will leave interest rates on hold for quite a while.

Comment

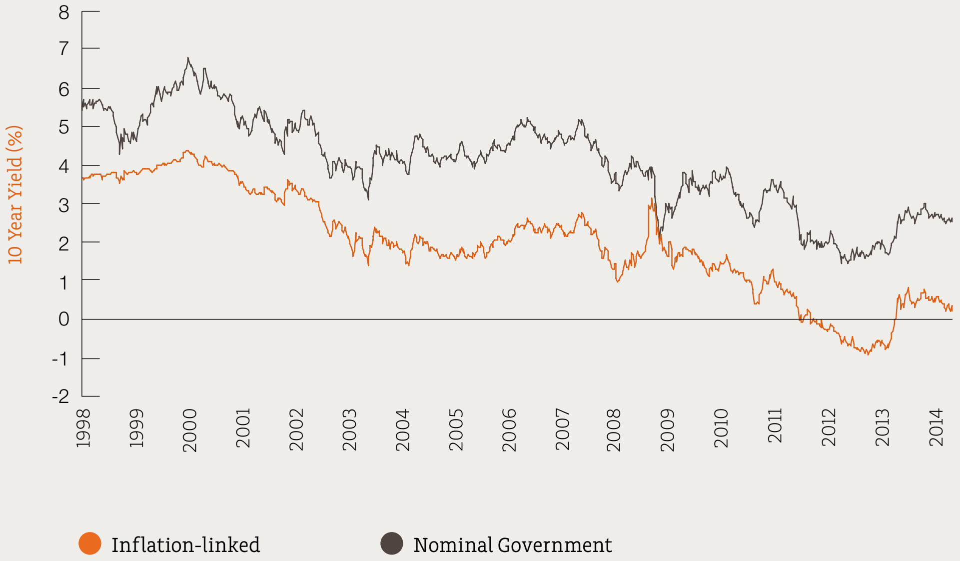
World share markets enjoyed good gains over the quarter. Unhedged global shares outperformed hedged global shares due to a weaker Australian dollar over the quarter. However, geopolitical risks remain a concern for global share markets, particularly the unstable situation in Iraq. Despite these developments, 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 shares.

Asset class indicators continued

Australian dollar
Market indicator *Australian Dollar Purchasing Power Parity*

Source: Bloomberg

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



Source: Bloomberg

Comment

The Australian dollar reversed direction in the September quarter, with shifting perceptions about its safe haven status, weaker commodity prices and firming expectations of US monetary policy normalisation. However, the AUD remains at values that are high compared with measures of fair value. The IMF's AUD purchasing power parity exchange rate (a long term measure of fair value) is currently 64 cents versus the US dollar.

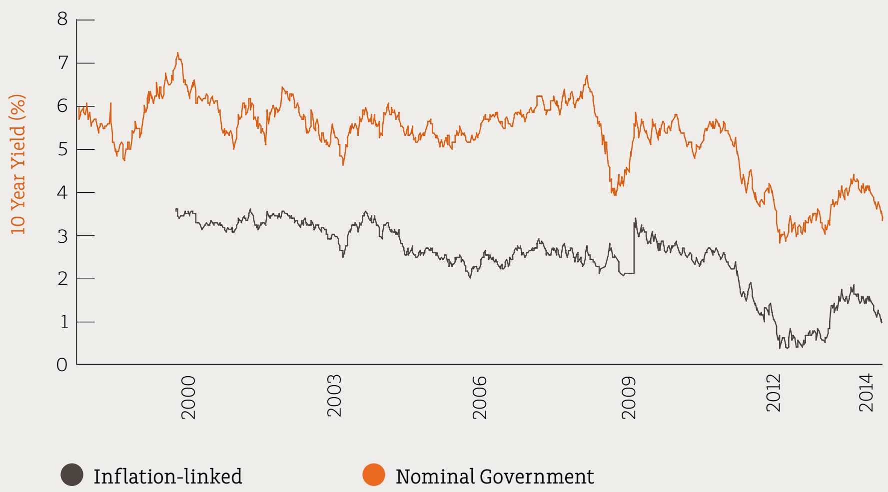
Comment

Bond yields were volatile during the quarter: first declining on the 'lower for longer' story, then rising following the Fed's comments in September, and falling again on geopolitical concerns. Over the quarter, real yields rose due to falling 'break-even' rates (a measure of the market's expectations for future inflation).

Asset class indicators continued

Australian government bonds

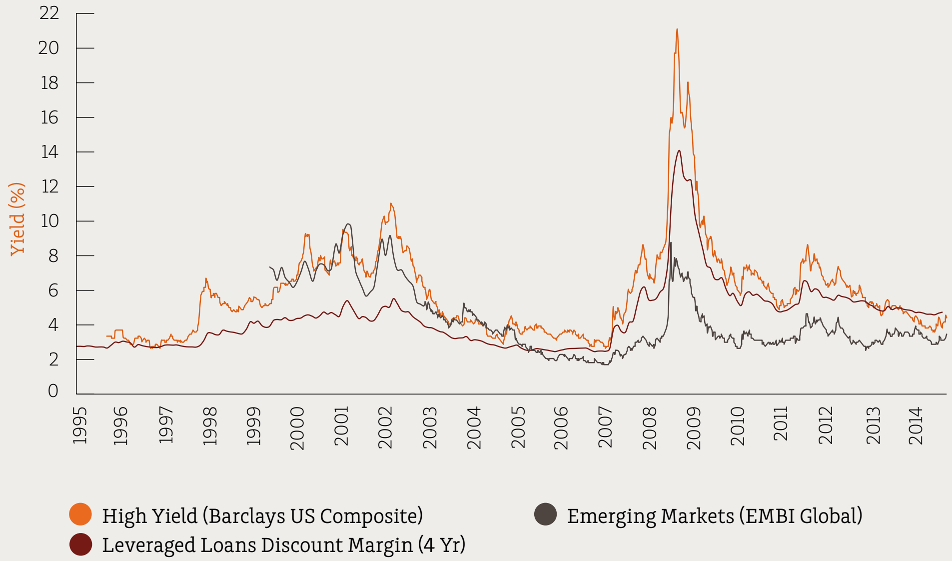
Market indicator *10 Year Bond Yields – Australia*



Source: Bloomberg

Non-investment grade bonds

Market indicator *Fixed Income Spreads*



Source: Credit Suisse, Barclays

Comment

Australian bonds followed those in the US, with significant volatility during the September quarter. While yields rose during the month of September, they were down for the quarter and the year.

Domestic inflation-linked bonds were little changed by the end of the quarter. AUD weakness increases domestic inflation risks and these bonds remain an important risk hedge.

However we must carefully balance their inflation protection against the risk of potentially rising interest rates.

Comment

Both non-investment grade credit (high-yield corporate bonds) and investment grade corporate credit spreads increased during the quarter. The US high-yield corporate bond spread over Treasuries increased by more than 1%, resulting in negative returns for investors. This highlights the risks of yield-chasing, which has been a dominant market behaviour for some time and has pushed spreads to near historically low levels.

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.

Appendix 1 – tailored scenario set continued

Scenario	Probability ranking	Description
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.
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.

Appendix 1 – tailored scenario set continued

Scenario	Probability ranking	Description
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 Futures Framework

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

- We can never be certain what the future will hold. To adequately understand risk we must take into account the things that **could** happen.
- We do this by building a comprehensive understanding of the possible future investment environments or scenarios that could occur. This includes not just those things most likely to occur, but also unlikely but very distinctive environments (such as financial crises and other 'tail risk' environments).
- The Investment Futures Framework builds a detailed understanding of how returns vary in each scenario. This also provides detailed information about the nature and extent of investment risks, the means to diversify those risks and how these change through time.
- Understanding how returns and risks can change over time means we can determine the best combination of assets, strategies and managers to generate returns while controlling risks in all scenarios - the asset allocation.

Step 2
Implementation

We implement the asset allocation as efficiently as possible to minimise costs.

Step 3
Review

We continuously apply our Investment Futures Framework to determine if portfolio adjustments are appropriate.

Important information

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