# Summary of portfolio positions and scenario insights – MLC Horizon portfolios

June quarter 2015

We made further changes to increase the portfolios' defensive positioning before the increase in volatility in share and bond markets towards the end of the June quarter. These are currently the main positions in the MLC Wholesale Horizon 4 portfolio.

| Portfolio position compared with benchmark | Why we have the position | Impact on performance |
|---|---|---|
| **Below benchmark exposure to growth assets** | The portfolio has exposure to shares to generate long-term returns. However, for the last few years share market returns, supported by unusually low interest rates, have been strong and have tended to run ahead of actual company earnings. When market returns have been strong for a long period, there is increased risk that share valuations become stretched, and that markets may fall.<br><br>To manage risk and generate more robust returns we've increased the portfolio's diversification over time by investing in risk-controlled strategies including multi-asset real return strategies, the low correlation strategy and defensive global shares. As we introduced these strategies to the portfolio, we reduced allocations to broader Australian and global share markets.<br><br>Investing in these strategies rather than just share markets helps protect the portfolio in weak global growth scenarios such as **Developed market austerity**, **Recession**, **Stagnation** and an **Australian stress scenario**.<br><br>High share market returns in the March quarter increased market risk looking forward. Therefore in early May we made further reductions to the allocation to Australian shares and increased the allocation to multi-asset real return strategies, before the adverse market environment in June.<br><br>If this volatility persists, the commencement of interest rate rises in the US could be delayed, and we may see further monetary stimulus in the eurozone and Japan to restore market confidence. This has the potential to result in the return of a strong share market return environment. However we continue to be concerned about stretched share market valuations and the continuing high levels of debt in the global economy. There are particular vulnerabilities for Australia flowing from slower and less investment intensive growth in China. Therefore we continue to maintain the portfolio's underweight positioning to growth assets, particularly Australian shares.<br><br>As the portfolio has a large allocation to shares it will benefit from strong returns in positive scenarios for growth assets, such as a **Mild inflationary resolution** or an **Early re-leveraging scenario**. In these scenarios, growth assets should perform strongly compared to bonds. | The reduced allocation to growth assets reduced the portfolio's exposure to risk prior to the adverse market environment in June, made worse by uncertainty about Greece meeting its loan obligations and remaining in the euro together with China's sharp share market decline. |

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| Portfolio position compared with benchmark | Why we have the position | Impact on performance |
|---|---|---|
| **Below benchmark exposure to interest rate risk**<br>We have implemented this position by:<br>• reducing the duration (exposure to changes in bond interest rates) of our fixed income strategy<br>• reducing the exposure to Australian inflation-linked bonds, and<br>• tilting the portfolio away from global bonds and towards cash and Australian bonds. | While bond yields (interest rates on bonds) could decline from their already low levels, the potential for further falls is less than the potential for yields to rise. Rising yields means bond prices fall and there is the potential for negative returns. By reducing the duration, we've reduced the risk of negative returns if yields rise, such as in a Sovereign yield re-rating scenario.<br>Reducing our exposure to nominal bonds and shortening the duration of our fixed income strategy gives the portfolio some protection if bond yields rise. In a **Rising inflation** or **Inflation shock scenario**, traditional bonds would perform poorly and could deliver negative returns.<br>While we value the inflation protection of inflation-linked bonds, the decline in yields to extremely low levels in the first quarter of 2015 increased their risk so we reduced allocations early in May. Scenarios in which there is clear risk include **Early re-leveraging** and **Sovereign yield re-rating**. | Bond yields rose in June with the increased share market volatility. Our current positioning helped protect the portfolio from declines in bond prices. |
| **Above benchmark exposure to foreign currencies**<br>We have implemented this position by:<br>• reducing the allocation to global shares whose foreign currency exposure is hedged to the AUD<br>• increasing exposure to unhedged global shares, and<br>• maintaining unhedged exposures in most global growth assets. | When designing the portfolio, we aim to combine assets and strategies which perform differently in different scenarios. Global share markets and the Australian dollar (AUD) tend to move in the same direction. So by having an exposure to foreign currencies (that is, not hedging some of our overseas assets to the AUD) we can help insulate the portfolio against some losses when share markets fall.<br>Foreign currency exposure is therefore a diversifier of risk for the portfolio. We expect it will help generate more robust returns, even though the AUD has declined from its highest point. Our above benchmark position is intended to reduce the portfolio's exposure to negative returns in a number of negative scenarios, including an **Australian stress scenario**.<br>It's important to note that our portfolio positioning doesn't assume that the AUD will decline. We also consider scenarios in which the AUD rises, including **Extended quantitative easing** and **Sovereign yield re-rating**. However, in many scenarios we expect the AUD to fall further, particularly if share prices fall sharply.<br>While we continue to prefer foreign currencies over the AUD, we trimmed our unhedged global shares allocation in May and redirected the money into hedged global shares. Recent falls in the value of the AUD, while positive for the portfolio's returns, weakens the potential benefit of foreign currency exposure. | The AUD rose slightly in the last three months. However, over the past year our foreign currency exposure worked well because the AUD fell sharply over the year.<br>The AUD has fallen against the US dollar over the year partly because of the decline in the iron ore price, but also because of other macroeconomic issues. Australia's weak national income growth, depressed Chinese steel production and the prospect of a fall in interest rates in Australia also meant there was less upward pressure on the AUD. |

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## Why MLC uses a scenarios approach

Key to MLC's market-leading investment process is our scenarios-based Investment Futures Framework. In an uncertain world, we can never be sure what the future holds. This means that relying on a single prediction of the future to position a portfolio leads to very uncertain returns.

Instead, we aim to understand the wide range of future economic and market conditions, or 'scenarios', that could occur, both good and bad. The Investment Futures Framework helps us continually identify these scenarios. It then helps us analyse how the scenarios could affect our portfolios. Using these insights, we adjust the portfolios' strategies to control potential risks and capture opportunities for returns. We constantly reassess our portfolios' positioning as potential risks and opportunities change over time.

We position the MLC Horizon portfolios to deliver returns above the portfolios' benchmarks or reduce risk in the portfolios when market risk is high. Over long time frames, reducing risk at the right times will result in higher returns.

The Investment Futures Framework includes two sets of scenarios. They are a comprehensive generic set of 40 scenarios, which focus on the main drivers of returns (macroeconomic influences and investor behaviour), and a tailored set of currently 12 scenarios, which focus on the particular circumstances we are experiencing now.