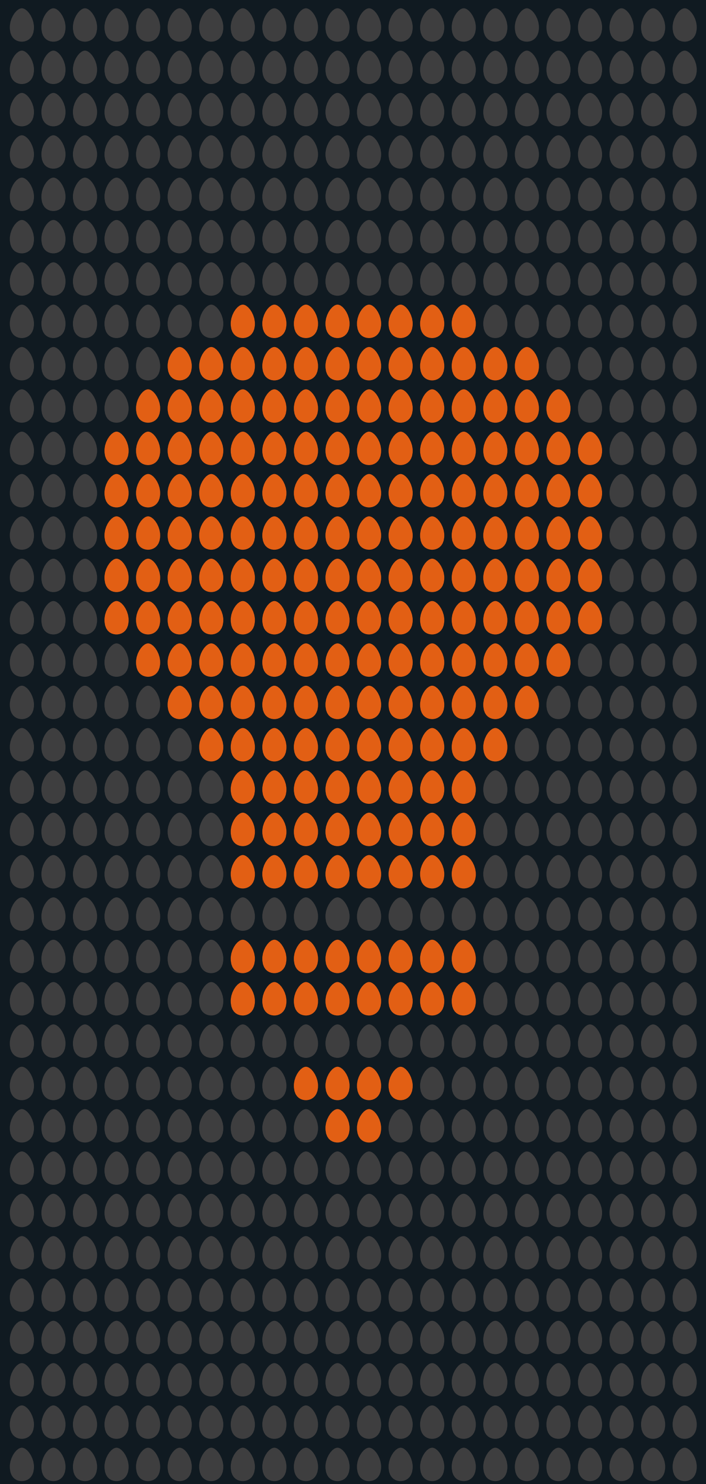

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MLC's scenario insights & portfolio positioning

MLC Horizon and MLC Inflation Plus portfolios

April 2016

Read this update to earn CPD points

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We welcome your feedback on this document.
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MLC Horizon and MLC Inflation Plus portfolios

MLC's scenario insights & portfolio positioning

There is no doubt that the first quarter of 2016 was volatile.

After a sharp sell-off across risk markets in early 2016 that perhaps ominously began at Christmas, a subsequent low volume rally dragged most markets back towards, and in some cases, beyond levels reached near the end of 2015. What is not so certain though is *why* markets have behaved this way.

While a temporary lull in some key economic indicators no doubt played a role, it's important to recognise that extended valuations likely contributed to the volatility. But to really get a handle on the degree of vulnerability conferred by starting valuations, we must address the ultimate question of what is priced in – and this is, of course, a 'mug's game'. The breadth of factors required to solve this pivotal question are, for the most part, uncertain. This means that any deduction cannot be precise and, without precision, we are left facing the same question that we set out to solve. So rather than ponder what is priced in, we focus our efforts on trying to understand what might happen in the context of where we are now. This frees us from needing to understand what is priced in, we can instead focus on assimilating the factors that have driven us to where we are today.

Part of the distortion in today's markets is the extreme valuation levels within assets traditionally thought of as safe. In prior quarters we have discussed the profound outperformance of defensive and yield stocks over cyclical securities. The contradictory connection between risk aversion and the search for growth in an environment of declining interest rates, has pushed the valuation of assets that bear traditional trademarks of quality and stability versus cyclical peers to historically extreme levels.

Not surprisingly, this phenomenon exists at the asset allocation level too. The obvious example is the continued compression in core bond yields and investment grade credit spreads, leaving little room to offset equity risk in stressed scenarios. The valuation and performance divergence between traditionally safe and risky assets is also evident within global shares between emerging and developed markets (see charts on following page).

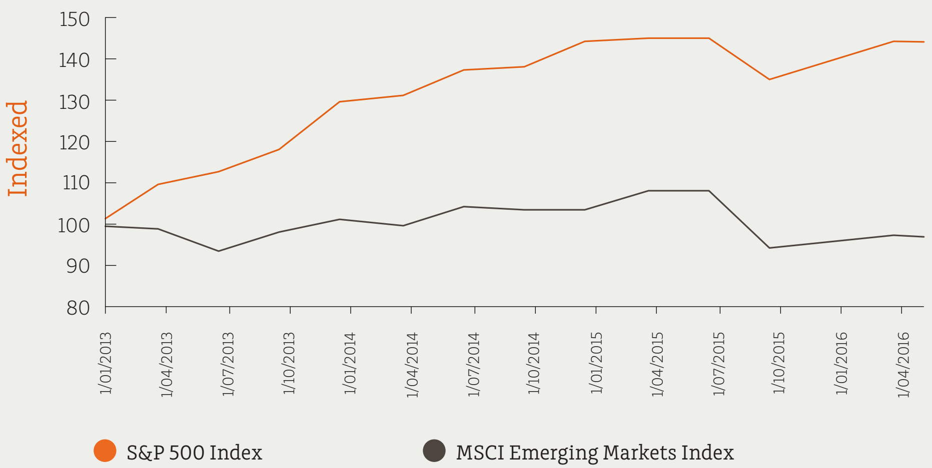
Despite recent commodity price weakness, emerging markets continue to provide faster growth potential than developed markets, but it's the emerging markets that have de-rated, while developed markets have re-rated. The stark divergence between developed and emerging market shares presents a paradox for risk aware investors, especially while return potentials remain compressed.

The traditionally safer developed markets are contaminated by valuation risk - particularly in the US - yet the more compelling valuations and prospective growth rates offered by emerging markets remain vulnerable and sensitive to shocks. For us, the answer to this conundrum lies within the specifics of some of our scenarios. For example, the stresses that might un-nerve emerging markets run together with a stronger US dollar (USD) or Japanese yen, meaning that foreign currency exposure coupled with emerging markets might make sense – especially for strategies with a longer investment horizon. Getting this balance right is critical and it requires significant attention to the factors driving each exposure and the interplay between them in diverse environments.

MLC's active investment approach

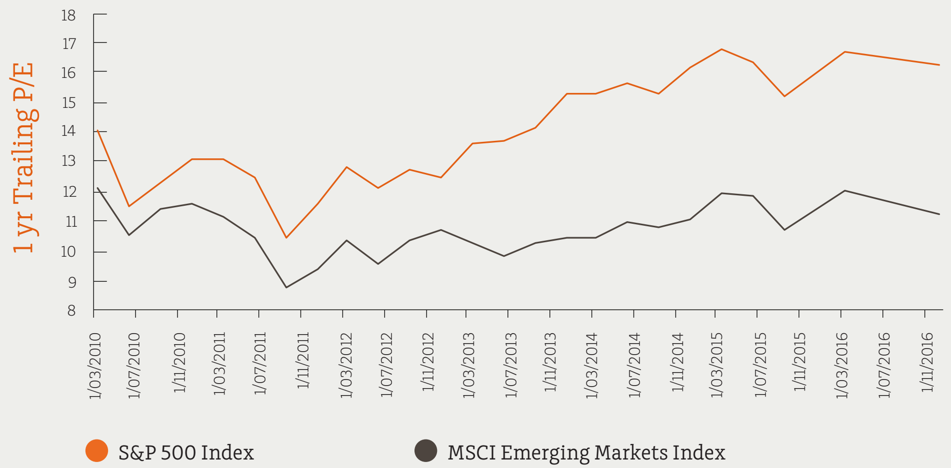
- Key to MLC's market-leading investment approach is our unique Investment Futures Framework.
- In an unpredictable world, the Framework helps us comprehensively assess what the future might hold. By taking into account the many scenarios that could unfold – positive and negative – we gain continuing insight into return potential, future risks, and opportunities for diversification.
- The information from the Framework gives us a deep understanding of how risks and return opportunities change over time for both individual assets and total portfolios.
- We can then determine the asset allocations that will help achieve our portfolios' objectives with the required level of risk control, and adjust the portfolio if necessary. We'll generally reduce exposure to assets if we believe risk is too high. We prefer exposures with limited downside risk compared to upside potential.
- More information about MLC's investment approach is in Appendix 2.

Chart 1(a): Developed markets continue to outperform emerging markets...



Source: Factset

Chart 1(b): ...driven by valuations



Source: Factset

MLC Horizon and MLC Inflation Plus portfolios
MLC's scenario insights & portfolio positioning

On the topic of risks within emerging markets, we have recently noted a subtle but important development in the official news flowing out of China. Key policy makers within various governing and regulatory agencies have begun to articulate policies to deal with the stock of non-performing loans that have built up within the domestic banking system. If precedent is anything to go by, the uptick in frequency of official communications focused on resolution of soured loans within China's financial system should be interpreted as an indication that action - while perhaps not imminent - sits squarely in the priority queue of China's policy evolution.

Monitoring the path of financial regulation and policy within China's financial system is an important barometer for global investors: if not for the details, then at least for the intent and direction of focus. China's policy makers have developed a reputation of acting decisively, but usually only after telegraphing their intentions to those that are watching and listening. Last year's Chinese renminbi (RMB/CNY) devaluation is a case in point. Whereas a large segment of investors were caught off guard by last year's currency adjustment, policy communications in the months leading up to the first adjustment gave a hint of what was to come.

From a risk point of view, initiation of reforms within China's financial system to manage soured assets probably challenges sentiment more so than the domestic financial system itself. Unlike some prior infamous debt failures within emerging markets, asset impairments within China are contained within a well-funded financial system without reliance on external funding. While this does not give China a "get out of jail free" card, it does make managing the process of reform easier and gives policy makers more degrees of freedom to pursue appropriate policy.

Although we are concerned for short-term sentiment in the event of reform-driven write downs, a more significant risk for China is the potential long-run impact of not acting to remove bad debts from the system. Japan's lost decade is a clear case in point of just how damaging maintenance of uneconomic assets within a banking system can be for an economy, and from our discussions, in China it is clear that policy makers have taken strong note of Japan's errors. This in turn raises the likelihood that China will eventually execute strategic decisions to help steer the economy away from longer deleveraging and stagnation risks and toward reinvestment in productive parts of the economy; but the timing, nature and the short-run consequences of this path remain impossible to predict.

On a broader level, the path of reform in China continues to exert an impact on Australia's real economy and its asset markets. Iron ore remains the principal transmission mechanism, but legitimate and clandestine capital flows continue to play a role. While the backdrop is still one of an undershoot in steel demand growth, some signs of stimulus as well as mill restocking and reactionary short covering in the relatively liquid traded iron-ore market were the key drivers behind a snap-back rally early in the quarter. The rise in iron ore, as well as a fall in US interest rate expectations, provided support to a resilient Australian dollar (AUD). Resilience of the AUD was a key performance detractor across the MLC Inflation Plus portfolios during the quarter, even though we had made earlier moves to reduce exposure to foreign currencies by both increasing allocations to AUD hedged assets and through options strategies.

The recent rally in iron-ore however represents only a micro recovery in a market that has deflated from cyclical highs of over US$180 per tonne as the supply-demand balance of this key commodity began to invert in 2012. Meanwhile, the steel sector - although buoyant in the first quarter - is still burdened by overcapacity with global blast furnace utilisation rates falling to historical lows. An estimated 400 megatonnes of capacity needs to be removed from the system to restore a balance between supply and demand. To put this in context, global steel production in 2015 ran at 1,599 megatonnes with China accounting for just over 50% of total output. Recent reports suggest that supply side reforms in China have slowed; meaning that deflationary pressures within the sector are skewed to persist for longer than most rational observers of China previously thought.

Turning to monetary policy, the marginal loosening of financial conditions in China early in the new year was minor compared to the decisive, but sensible, policies extended by the European Central Bank (ECB). ECB ploughed deeper into unorthodox policy in early March by expanding asset purchases to €80 billion per month and further reducing the benchmark deposit rate by 10 basis points to -0.40% pa. Yet importantly, after having observed the damage to both European and Japanese banks in response to deepening negative rates, the ECB has at the same time oriented policy to help offset the profitability burden on banks. With the caveat of maintaining a stable or increasing balance sheet, the ECB is essentially offering compliant financial institutions access to funding at negative rates. Combined, these policies represent a notable effort to craft policy in a highly constrained and complex regulatory system that is trying to steer a diverse group of economies through a period where growth faces major cross currents and headwinds.

However, as with other heavily indebted economies, whether or not credit growth and ultra-loose monetary setting are both the solution and the true remedy to the specific case of today's generally low growth rates remains to be seen. Under more normal circumstances, it's almost unarguable that looser monetary conditions should have a positive impact on the demand side of the economy. But today's conditions are far from normal and it is unclear whether negative rates, on balance, create or solve problems.

The crux of today's issues stem from the accumulated impact of unproductive lending that prevailed across the decades leading to the financial crisis. When interpreted in this light, it becomes more obvious that monetary policy alone is an unlikely magic bullet in its own right. Higher levels of nominal productivity from capital lent into the real economy are the ultimate solution and these are much more likely to manifest if supply side reforms, fiscal policy and monetary policy are allowed to play a role. In the meantime, investors are forced to contend with a mix of circumstances that drive up the level of uncertainty, meaning that the trade-offs between risk and return remains starker than most of us are used to.

Looking forward

Our scenarios

We recognise that the future is always uncertain. In managing MLC's portfolios we implement the Investment Futures framework – a process that takes into account that there can be no certainty about future market outcomes. We examine possible return outcomes across a comprehensive range of possible futures. This thorough assessment of the different ways in which the future might unfold provides us with detailed insight into return potential and, most importantly, the sources and the extent of risk and the means of efficiently controlling risk. We track how future risk and return potential changes through time.

The process provides a deep and detailed understanding of future risks, return potential and the opportunity for diversification. Using this framework helps us position portfolios to achieve as high an expected return as possible using diversification opportunities, while maintaining risk within appropriate boundaries.

The Investment Futures Framework comprises both the generic broad set of 40 scenarios which pivot around the main drivers of returns – the macro-economic drivers and investor behaviour (swings in the level of optimism or pessimism, and rational changes in risk perception) – and a tailored scenario set which includes as many primary distinctive scenarios as is necessary looking forward from the current starting point.

The generic set of scenarios is designed to have relevance from any starting point and provide a consistent barometer of risk and return through time. The smaller, tailored set of scenarios pivot around the key characteristics and uncertainties in the current environment. The tailored set might be seen as consisting of the most obvious potential futures, though we are aware that what seems most obvious today may not be after the event – the future is only ever obvious once it has become the past. These two scenario sets in combination are used to assess portfolio positioning. Both sets of scenarios are updated as asset prices change.

The tailored scenario set currently consists of 13 scenarios. Due to the prevailing distortions discussed in Appendix 1 these scenarios contain more complexity and a wider range of outcomes for assets than would normally be the case. The pressure exerted by high debt loads, on both the real economy and policy, mean that outcomes will not just pivot along fundamental paths, but will be heavily influenced by central bankers, legislators and importantly, the reaction of agents within the economy to whatever path policy takes.

Credible outcomes range from continuation of the status quo (global growth convergence) to favourable improvements in nominal prices and improvements in capital productivity (ie Inflationary Debt Resolution) through to the stagnation and risk aversion environments that we expect would eventuate should today's unorthodox monetary policies fail. And while further disinflation and deflation appear to be the obvious near term direction of prices, we take account of the possibility of an ultimate inflationary outbreak – which like any risk needs to be addressed before it manifests. We also take into account the potential for decisive reforms to restore growth potential faster than is currently anticipated – albeit with a relatively low probability at this stage.

MLC Horizon and MLC Inflation Plus portfolios

MLC's scenario insights & portfolio positioning

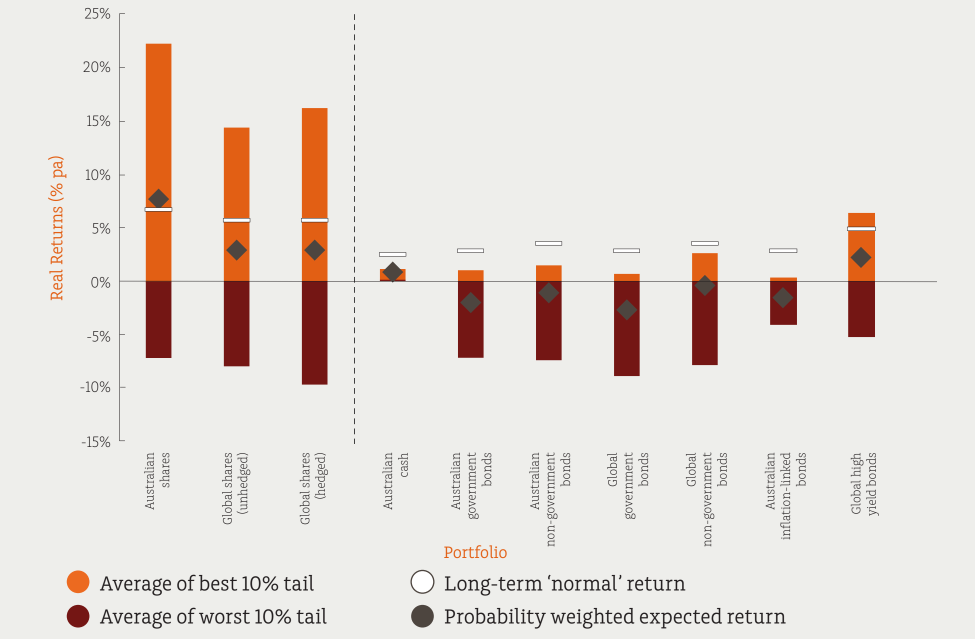
In terms of changes to our risk and return assessment over the quarter, the sell-off and then recovery of pricing in risky asset markets –including extreme volatility in high yield bond markets - meant that the price impact on prospective risk and return potential remained virtually unchanged since our last update. This quarter however, we have taken the rare step of changing the way we assess the starting level of earnings per share, which in turn has had a slight impact on our measure of starting valuations for global and Australian shares. The review of earnings per share (EPS) is part of our ongoing attempt to improve the way we execute our Investment Futures Framework process. The new EPS measurement gives us a more reliable measure that we believe better represents the true level of sustainable company profits across listed markets.

As an extension of this work, we now model Australian shares at the Global Industry Classification Standard (GICS) sector level (L1) for each scenario and combine the models into a market aggregate. This gives our process further insight into risks and opportunities in the heavily concentrated domestic share market. Overall the impact of the change is a marginal increase in the return potential of both global and Australian shares and a similar reduction in tail risk.

The potential real returns for each asset class are shown in Chart 2 on the right. The probability-weighted real returns are shown in the graph (diamonds). For comparison, we've provided long-term 'normal' return expectations which are set by considering a stable fair value world – these are shown by the horizontal lines. Also, as an indicator of how uncertain these returns are, we've taken the bottom (and top) 10% of the scenario real returns and calculated the probability-weighted average in those 'tail' outcomes. These are shown in the bars. Asset classes with wider ranges could have more extreme return outcomes than those with narrow ranges. Chart 4, on page 11, shows return potential for the MLC Horizon and MLC Inflation Plus portfolios.

At a glance, the current risk/reward trade-off for Australian shares compares favourably to global shares (see Chart 2) because Australian shares have a higher probability weighted return, and similar downside tail to global shares. However, the highly concentrated nature of the Australian market clouds this comparison. The large differences between industry sectors of the Australian and global share markets, exert a significant impact on broad market valuations. To help us better account for the impact of these industry sector skews on prospective risk and return profiles, we have begun to model Australian shares at the sector level within our Investment Futures Framework. The impact of sector concentration is clear in the models of our tailored set of scenarios. Depressed commodity prices and poor sentiment towards Mining and Energy stocks has dampened valuations within these (highly cyclical) sectors to levels

Chart 2: 40 scenario set (generic scenarios) potential real returns (March 2016)
(5 years, 0% tax with franking credits, pre fees, pre alpha)



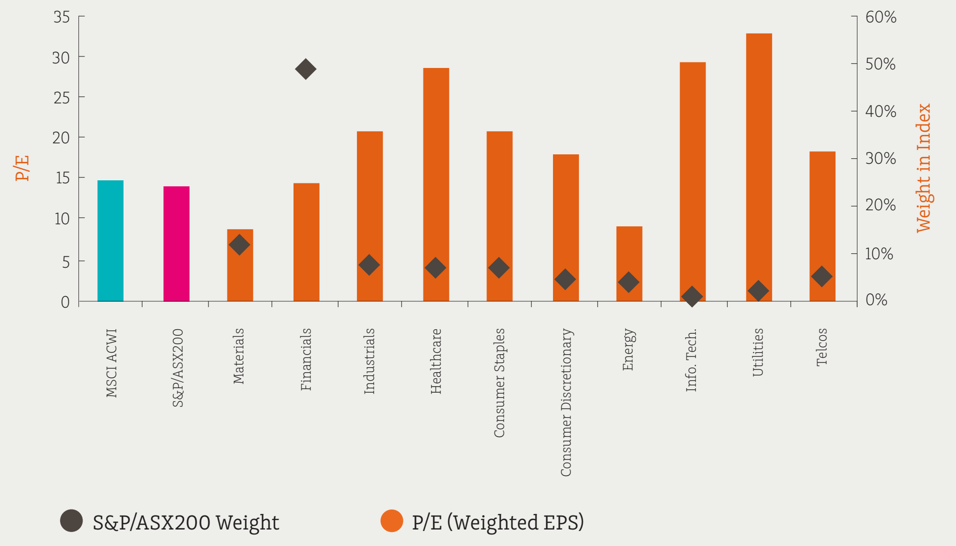
Source: JANA Corporate Investment Services Limited significantly below the broader market; while other important sectors (including Financials) trade at a premium, which in some cases is extreme (eg Healthcare, Utilities and Consumer Staples). The combined impact of both sector composition and valuation skew on comparisons between global and Australian shares is evident in the following three charts.

Chart 3(a) shows the contrast in our preferred measure of earnings valuation across sectors in the Australian share market relative to the market aggregate for both Australian and global shares. Variation within sector valuations in the Australian market is notably higher than the difference between global and domestic shares (eg Materials and Energy trade at much lower valuations than Industrials).

But the real insight is generated in Chart 3(b) which illustrates the impact of normalising domestic market valuation by either removing the distorting sectors (ie Materials, Energy and Financials) or recasting the Australian market's price to earnings ratio using global sector weights (to remove the impact of sector composition). In the last column we applied global sector weights to the Australian market, re-rating Australian shares from roughly 14.5x sustainable earnings to closer to 17x, leap-frogging global shares at approximately 16x. These findings reinforce the notion that the main driver of the valuation gap between Australian and global shares is explained by sector composition. And while this doesn't necessarily render the trade-off between global and Australian shares illegitimate, it does provide some insight into the underlying nature of our portfolio positioning between the two markets. What appears to be an opportunity in Australian shares at the broad market level should in our view be interpreted as an exposure to cyclicality, primarily via depressed commodity prices and weak sentiment towards the Materials and Energy sectors. Recognising this is a key step in understanding the true nature of risk and return of the Australian market.

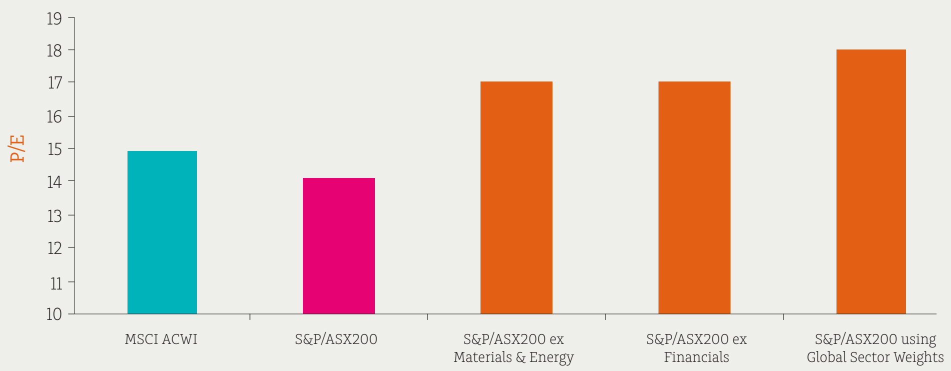
As we have pointed out in prior quarters, we are not averse to commodities at this time. While commodities had a terrible skew in the years leading up to 2014, severe price declines since then have switched the position to a more balanced, and perhaps favourable, prospective outlook – especially when paired with foreign currency exposure. But whether or not Australian shares represents the best way to exploit any opportunity offered by commodity repricing is not clear. The high concentration of Financials is particularly problematic with banks dominating the tail (see Chart 3(c)). Exposures to Australian shares with tolerable levels of banking exposure are hard to find, and continuously hedging is expensive. Nonetheless, we are painfully aware that in this extremely difficult environment of scarce opportunity, every avenue must be examined thoroughly and as such we continue to assess different methods of potential commodity exposure, including a customised Australian shares solution.

Chart 3(a): Australian Shares Sector Valuations



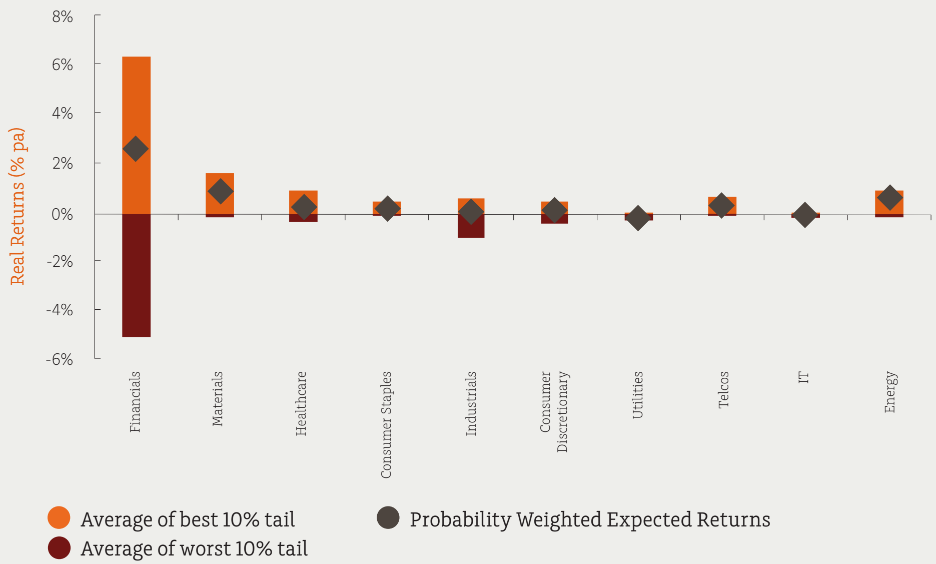
Source: Factset, as at 31 March 2016

Chart 3(b): Behind the Cheapness of Australian Shares Valuation



Source: Factset, as at 31 March 2016

Chart 3(c): Australian Shares (Tailored Scenarios) Contribution to Probability Weighted Real Returns by Sector (3 years, 0% tax, pre fees, pre alpha)



Source: Source: JANA Corporate Investment Services Limited

MLC's scenario insights & portfolio positioning

Our current positioning

Portfolio positioning continues to reflect the challenges of a world in which actions of policy makers have distorted asset prices and removed safe haven investments. Although the first tentative step has been taken by the US Federal Reserve (Fed) in reversing ultra-low interest rates, a stop-start mentality has again taken over. Taking the Fed at face value (sensible), the pace of future US interest rate rises remains data dependent, while we may see a continuation of offsetting new stimulus in the eurozone and Japan which could foster market complacency.

However, the challenges to yield-driven investing are increasing and the potential for renewed stimulus to boost or even calm markets is becoming more uncertain. Indeed prospective policy decisions remain a source of uncertainty. Nevertheless, while ultimately there must be an end to the challenging liquidity-driven distorted environment which has resulted in the mis-pricing of risk, we understand that it could still be of long duration.

We are acutely aware that, while volatility has increased, the strong return environment could still resume. This is challenging because the logic of our strategy only becomes entirely apparent once previously disguised risks are revealed. The past teaches us that distorted market behaviour persists for longer than seems possible which tests perceptions and patience, but then when it unwinds it can do so more rapidly than anticipated. 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. While we are comfortable with the performance of the portfolios over meaningful periods, we are far from complacent about the future challenges. Nimbleness and flexibility are more important than ever if we are to both generate returns and control risk, but it is undeniable that the challenges of doing both have increased. We will maintain the risk discipline even if this requires some patience before return expectations are met.

Our analysis of scenarios is designed to build an understanding of return potential and downside risk. Where there is significant asymmetry (ie the upside potential is less than the downside risk) we have an opportunity that we can exploit to increase the return compared with the level of risk.

There have been two important asymmetries: in currency and fixed income markets. These asymmetries remain to an extent but the medium-run fall in the AUD significantly weakens our key risk diversifier. As the AUD fell towards purchasing power parity (PPP), our framework led us to reduce exposure to foreign currencies across the MLC Inflation Plus portfolios early in 2016. Since then, the AUD's recovery during this quarter to the mid-70's against the USD has partially restored the upside/downside skew, but not to the extent required to extend our recently reduced foreign currency positioning in Inflation Plus.

In fixed income markets, we observe that while bond yields could follow what is now a very long term trend and decline even further, the extent of this is limited relative to the potential for yields to rise. This means that the opportunity cost from shortening duration (ie having a lower than benchmark exposure to interest rate risk) is low relative to the risks faced by owning duration should yields rise.

Similarly, while there are circumstances in which the AUD could regain strength (and we assume it does in a number of our scenarios), on current pricing the downside factors are arguably still an efficient diversifier of some portfolio risk. Because of this, while our exposures to foreign currency have reduced, it remains significant exposure within the MLC Inflation Plus portfolios (particularly the Assertive portfolio), and we remain overweight to foreign currencies across the MLC Horizon 2 to MLC Horizon 7 and Index Plus portfolios.

Our positioning against the AUD does not mean that we 'expect' the AUD to continue to fall – indeed, two of our tailored scenarios expect the dollar to rise. Instead, our analysis continues to suggest that the AUD is an efficient source of diversity that decreases overall risk, allowing greater exposure to other sources of risk and hence return potential 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 – this reality is now starting to be priced in. The market dynamics of the AUD in quarter 1, 2016 are a sharp reminder that the AUD can rally quickly. This reinforces the importance of option-based risk management strategies to complement exposure to foreign currencies, particularly the strong USD.

MLC Horizon and MLC Inflation Plus portfolios
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 and to diversify risk. We use this information to determine the most appropriate balance between risk and return for each portfolio. Importantly we use information about risk and diversification that is forward looking and we track how these characteristics change through time.

Chart 4 on the following page looks at our barometer of risk and return – based on our generic (40) scenario set, described on page 5 – for the MLC Horizon and MLC Inflation Plus portfolios looking forward from the end of March 2016. The probability-weighted real returns are shown in the graph (diamonds). For comparison, we've provided long-term 'normal' return expectations which are set by considering a stable fair value world – these are shown by the horizontal lines. Also, as an indicator of how uncertain these returns are, we've taken the bottom (and top) 10% of the scenario real returns and calculated the probability-weighted average in those 'tail' outcomes. These are shown in the bars. Portfolios with wider ranges could have more extreme return outcomes than those with narrow ranges.

The chart continues to show that on average, looking across the whole scenario set, the potential reward for taking additional risk has improved but is still limited. In the event that a scenario with relatively higher returns occurs, the returns of those portfolios with larger share allocations will be sharply higher. However, looking across the range of future possibilities and using our assessment of their probabilities, it is clear that the reward for risk-taking could disappoint.

Comparing the MLC Inflation Plus 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 weakening risk diversifiers by reducing exposures to riskier assets. This reduces the return potential in strong scenarios but provides tight risk control in the event that an adverse environment occurs.

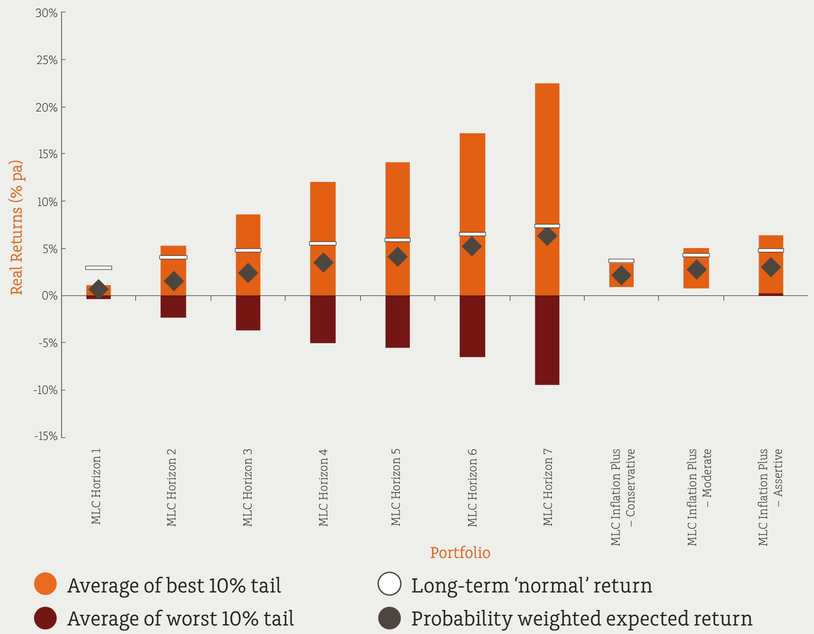
In positioning all our portfolios we take into account outcomes in all our scenarios. For the MLC Inflation Plus portfolios, our focus is on strictly limiting both the probability and most importantly the extent of negative real returns over each portfolio's time horizon in the event that an adverse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

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

MLC Horizon and MLC Inflation Plus portfolios

MLC's scenario insights & portfolio positioning

Chart 4: 40 scenario set (generic scenarios) potential real returns (March 2016)
(5 years, 0% tax with franking credits, pre-fees, pre-alpha)



Source: JANA Corporate Investment Services Limited

MLC's scenario insights & portfolio positioning

MLC Inflation Plus portfolios

The MLC Inflation Plus portfolios have flexible asset allocations with few constraints which enable us to target tight control of risk over each fund's time horizon. In particular:

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

As we alluded to last quarter, maintenance of the Inflation Plus portfolios' prior year's strong returns would be a dangerous extrapolation. The past 12 months (and particularly the past quarter) have proven difficult to navigate. Resumed strength of the AUD has eaten into short-term returns and may continue to do so if the AUD continues to rise. The portfolios are, however, less exposed to AUD topside risks now than they were last quarter as we took steps to reduce our foreign currency exposure prior to the rally and have since increased protection against a rise in the AUD through option strategies.

Another drag on returns was the defensive nature of our global share allocation which lagged traditional strategies over the quarter.

The coincidence of a strong AUD and defensive shares exposure in a recently buoyant market are the main contributors to a lull in returns for the portfolios. Nonetheless, we remain very confident that the strategies are as robust as possible in this challenging, risk/return distorted environment.

MLC Inflation Plus portfolios
continued

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

Asset class	Change in allocation to asset classes in the MLC Inflation Plus Super & Pension portfolios over the March quarter			Comment
	Conservative	Moderate	Assertive	
Australian shares	Zero allocation	Steady allocation	Steady allocation	Low or zero allocation maintained.
Global shares	Close to zero allocation	Close to zero allocation	Zero allocation	Limited exposure due to strong preference for a defensive share allocation in a relatively high risk environment.
Defensive global shares (unhedged)	Increased allocation	Increased allocation	Increased allocation	Primary global share exposure is defensive. The portfolios have a strong bias to absolute, not index-relative, shares. After the significant share market falls of recent months there was a reduction in future risk, in response we have slightly increased the exposures to defensive global shares.
Foreign currency exposure	Reduced allocation	Reduced allocation	Reduced allocation	While foreign currency remains an important source of risk control, its power as a risk diversifier has reduced as the AUD declined significantly in 2015. While this decline was positive for the portfolios' returns we are concerned about scenarios which could result in the dollar rising again. Therefore in early 2016 we significantly reduced foreign currency exposures, reflecting the reduction in the diversification benefit provided by such exposures.
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 are sized accordingly.
Real return strategy	Reduced allocation	Reduced allocation	Reduced allocation	Slightly reduced allocations, in favour of defensive global shares after significant weakness in the global share market. We maintain our preference for highly flexible strategies with total return focus.
Emerging markets strategy	Reduced allocation	Steady allocation	Reduced allocation	Emerging economies and markets are vulnerable to US monetary policy normalisation.
Global private assets	Steady allocation	Steady allocation	Steady allocation	The private assets allocation for the MLC Inflation Plus - Assertive Portfolio (in MLC MasterKey's superannuation and pension products) has been above target, during the quarter the target allocation was reduced.

MLC Inflation Plus portfolios
continued

Asset class	Change in allocation to asset classes in the MLC Inflation Plus Super & Pension portfolios over the March quarter			Comment
	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 such as real estate investment trusts (REITs) in scenarios in which monetary policy normalises.
Global government bonds	Zero direct exposure	Zero direct exposure	Zero direct exposure	Unattractive, with limited diversification benefit.
Australian inflation-linked bonds	Steady allocation	Steady allocation	Steady allocation	We remain concerned about the inherent risks associated with the very low current yields.
Insurance related investments	Zero allocation	Steady Allocation	Steady Allocation	Uncorrelated though risky exposure is appropriate where time horizon is sufficient.
Bank loans	Steady allocation	Steady allocation	Steady allocation	Floating rate loans offer some exposure to diversifying income-based risk premia without as much capital risk as fixed coupon bonds. While this exposure has been attractive in the current environment, tight spreads increase price risk and a tendency for low liquidity in adverse environments limits the degree to which portfolios should have exposure. A small reduction was made to bank loan allocations in the Moderate portfolio.
Australian non-government bonds (short duration)	Steady allocation	Steady allocation	Steady allocation	Offer some return enhancement while limiting additional risk.
Cash	Reduced allocation	Steady 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. Although we have reduced the allocation to cash slightly after the share market weakness, we continue to keep significant powder dry (in cash) waiting for better opportunities.
Borrowings			No borrowings	Reward for risk is too limited.

MLC Horizon and MLC Inflation Plus portfolios

MLC's scenario insights & portfolio positioning

MLC Horizon portfolios

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

Our scenarios analysis is used to identify target allocations which are more risk-return efficient than the benchmark which, because these portfolios must remain true to label, have limitations in the extent to which they can deviate from the benchmark. In particular, these traditional multi-asset portfolios have constraints to the mix of fixed income and shares which they can hold. This provides a level of certainty to investors about where their money will be invested, however it also means that portfolio risk is primarily a function of market risk. As the riskiness of assets changes through time, we vary the asset allocation to position the portfolios to achieve a higher reward for risk than the benchmark. The risk aware nature of our investment process tends to mean that value is added via the adoption of defensive positioning when risk is high, which reduces loss exposure.

For MLC Horizon and MLC Index Plus portfolios we are maintaining a relatively defensive orientation.

	MLC Horizon Super & Pension portfolio weights at end of the March quarter			Comment
	Under	Benchmark	Over	
Growth assets				
Australian shares		•		The benchmark allocation was reduced in January, in favour of alternatives. The portfolios' previously underweight allocations are now neutral. 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 a slightly overweight allocation to unhedged global shares at the expense of hedged global shares. While foreign currency remains an important source of risk control, its power as a risk diversifier has reduced as the AUD declined significantly in 2015.While this decline was positive for the portfolios' returns we are concerned about scenarios which could result in the dollar rising again. Therefore we have started to hedge the risk of renewed AUD strength by increasing the allocation to hedged global shares. This adjustment to our position reduces the risk of significant negative returns if the AUD rises.
Global shares (hedged)	•			
Global property securities		•		Retain benchmark allocation – the benchmark allocations are underweight versus peers.
Defensive assets				
Cash			•	Overweight maintained.
Australian bonds – All Maturities	•			Moved to an underweight in Australian bonds and increased the overweight to cash.
Australian inflation-linked bonds		•		Benchmark allocation.
Global bonds – All Maturities	•			Underweight maintained.
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.

MLC Horizon portfolios
continued

	MLC Horizon Super & Pension portfolio weights at end of the March quarter			Comment
	Under	Benchmark	Over	
Global multi-sector bonds		●		Retain benchmark allocation.
Global non-investment grade bonds: high yield bonds and loans		●		Retain benchmark allocation.
Alternatives				
Global private assets		●		Retain benchmark allocation.
Real return strategies (including Inflation Plus)		●		The benchmark allocation was increased in January so the portfolios' previously overweight allocations are now neutral. We believe increasing the allocation to real return strategies provides the portfolio with a greater potential ability to preserve investors' capital in volatile markets and provide our investors with potentially better investment returns for the level of risk we take.
Low correlation strategy		●		The benchmark allocation was increased in January so the portfolios' previously overweight allocations are now neutral. This fund of hedge funds strategy aims to generate a return above cash and deliver returns that are mostly independent of share market performance.

MLC Horizon and MLC Inflation Plus portfolios
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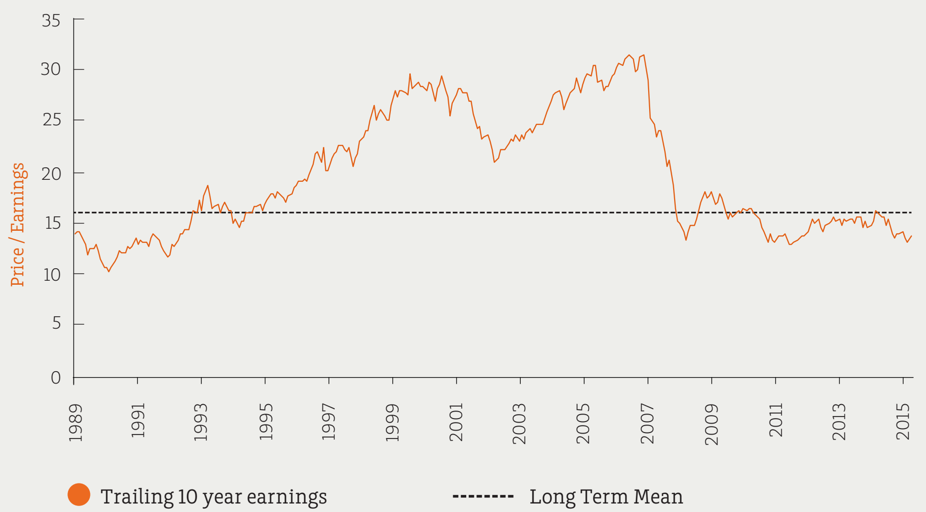
Asset class indicators

Our view of the main asset classes is as follows.

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



Source: Global Financial Data

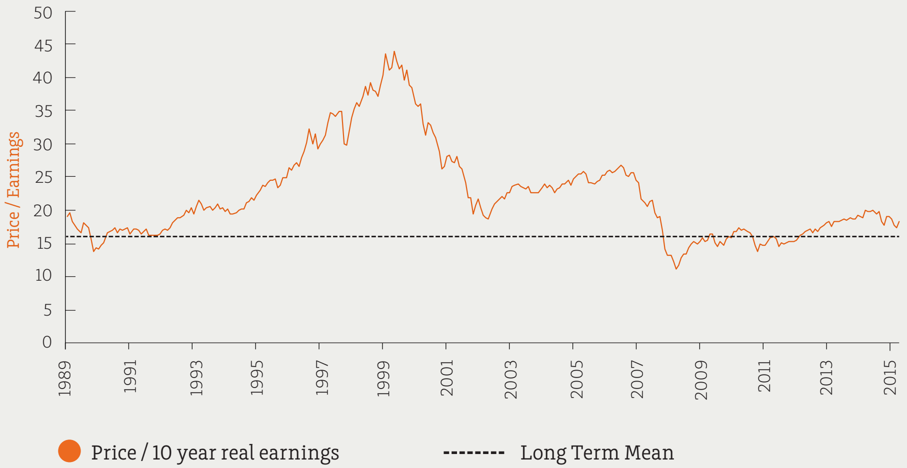
Comment

The Australian share market started the quarter in free-fall amid a period of volatility and riskoff (negative) sentiment. A rally throughout February and March provided some relief, seeing the S&P/ASX200 Index close out the quarter down only 4%.

The themes that emerged out of the March reporting season continued to be cost-cuts and subdued top line growth, but were overall in line with expectations. Over the quarter the Reserve Bank of Australia (RBA) once again held the cash rate steady against the backdrop of low inflation expectations.

Asset class indicators continued

Global shares
Market indicator *S&P 500 Index*



Source: Global Financial Data

Comment

Global markets struggled over the quarter with the MSCI All Country World Index falling 4% in local currency terms, reversing some of the gains made during the previous quarter.

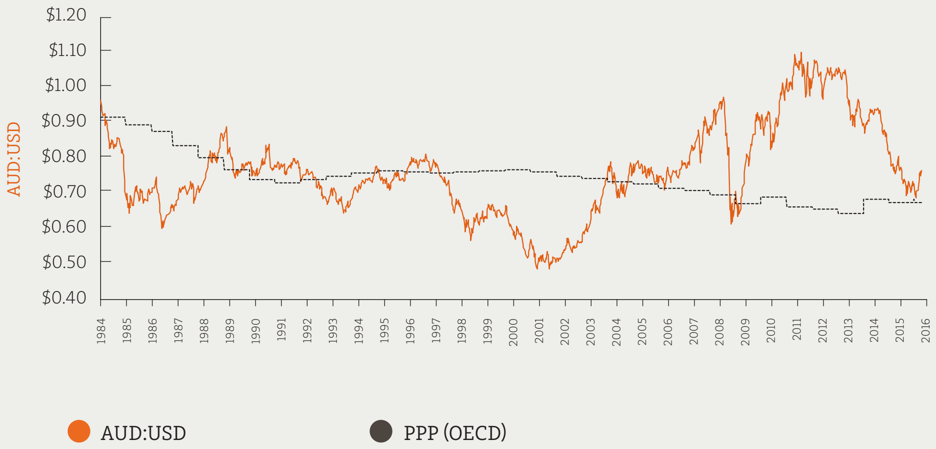
Continued divergence of central bank policy saw the Fed revise rate hike projections from four down to two; the Bank of Japan surprise by moving policy rates below zero; and the ECB following through with a better telegraphed and more thoughtful negative rate policy. Negative deposit rates undermine bank profitability which explains the poor performance of Financials, particularly in Japan in quarter 1.

Commodity prices recovered to buoy market sentiment however it was not enough as most major indices fell despite a rally in March.

In China the Shanghai Composite Index decreased by 15.1%, the UK FTSE 100 Index was down by 1%, the EURO STOXX 50 Index by 8% and the Japanese TOPIX100 Index by 14.1%.

Asset class indicators continued

Australian dollar
Market indicator *Australian Dollar Purchasing Power Parity (PPP)*

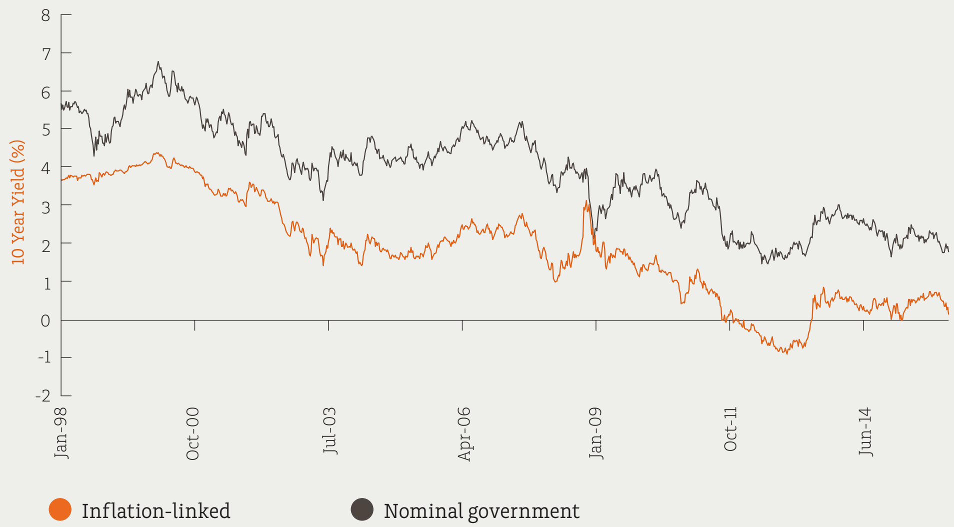


Source: Bloomberg

Comment

The AUD gained 5.7% against the USD as commodity prices rebounded during the quarter. The Fed's downward revision of rate hike projections for 2016 along with dovish commentary by the Fed's Chair, Janet Yellen, also helped to provide a further lift to the AUD. Combined, these two factors continue to provide strong short-term support for the AUD.

Global government bonds
Market indicator *10 year bond yields – United States*



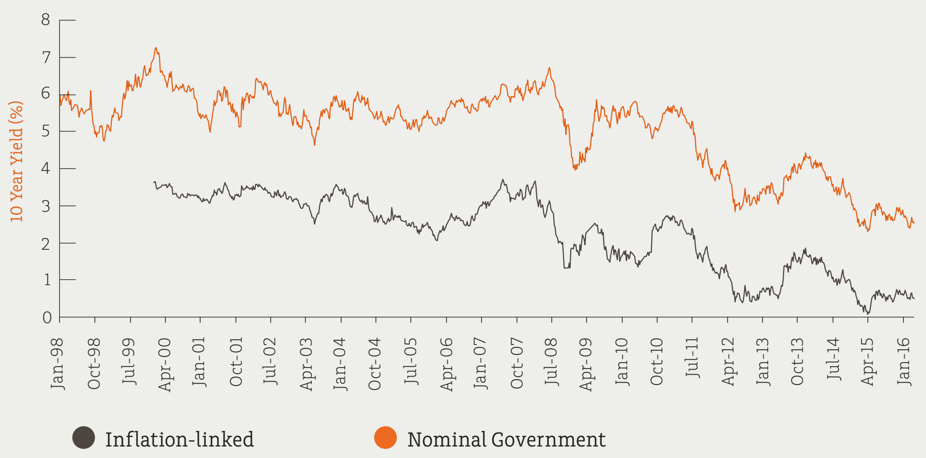
Source: Bloomberg

Comment

Most regions of the world saw yields fall sharply over the March quarter. The US 10 year treasury and the UK gilts dropped by 63 basis points and 57 basis points to 1.77% and 1.42% respectively. The German bunds fell below 0.10% for the first time since April 2014 but finished at 0.16%. Meanwhile the yield on Chinese 10 year government bonds increased marginally from 2.82% to 2.87% as the economy continued to rebalance.

Asset class indicators continued

Australian government bonds
Market indicator *10 year bond yields – Australia*



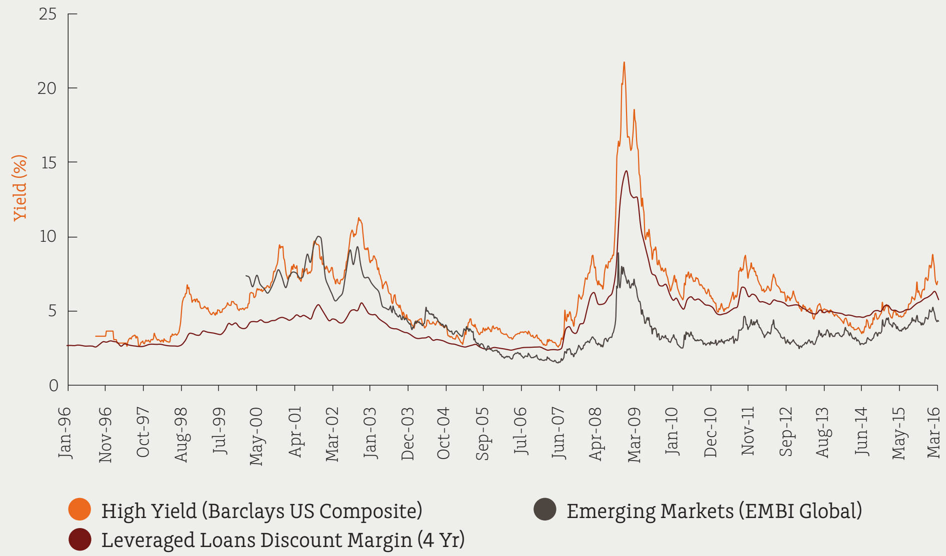
Source: Bloomberg

Comment

The Australian 10 year government bond yield reversed its December quarter increase by falling to 2.48%. The March quarter saw seasonally-adjusted GDP increase 0.6% quarter-on-quarter and unemployment falling to 5.8%. Once again, the RBA left monetary policy unchanged.

Asset class indicators continued

Non-investment grade bonds
Market indicator *Fixed income spreads*



Source: Credit Suisse, Barclays

Comment

Global non-investment grade credit spreads expanded and then contracted aggressively during the first quarter. Reduced levels of liquidity within the high yield market due to regulatory changes that limit the scope for financial institutions to carry balance sheet exposure means that re-pricing in both depressed and frothy markets is prone to occur quicker than in the past. The retreat in spreads was primarily driven by a recovery in the oil price as well as an increase in risk appetite toward the end of the quarter.

Appendix 1 – tailored scenario set

Scenario	Probability ranking	Description
Three speed global economy (China soft landing)	1	The world continues to split into three distinct economic growth zones. Emerging markets lead global growth with some rebalancing and moderation in China, the US and UK grow at or above trend; while Europe continues to stagnate. Japan struggles to escape stagnation for now. Strong USD, AUD strong vs JPY and euro.
Negative nominal interest rates	2	Central banks of Japan and Europe move further into negative deposit rates with the Fed and the Bank of England inching towards negative policy rates. This scenario includes the impact of expanded USD, GBP, JPY and EUR liquidity which principally finds its way into asset prices, rather than spurring consumption. The character of this scenario has changed as further extensions of monetary policy have less impact on asset market pricing. Important drivers to change include rising confidence on robust US growth, and moderation in China's resources demand with consequent flow on effects for the Australian economy and interest rates. Consequently it is not anticipated that the AUD would re-visit recent peaks in this scenario, though could remain elevated versus measures of fair value particularly versus the euro and yen. China's economy continues to rebalance and growth moderates. China accepts more foreign direct investment. Sourcing these funds externally – rather than from within China – could act as a 'backdoor bailout' of China's poorly performing projects from the 2008/9 stimulus.
Synchronised moderate growth	3	Japan and Europe's growth approach trend levels, while the US, UK and China moderate resulting in a synchronised modest global growth scenario.
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.
Inflationary debt resolution	5	Central banks err on the side of supporting growth while economic reforms do not occur fast enough to entirely offset inflationary pressure, resulting in an orderly rise in inflation. Upward pressure on skilled wages supports demand but squeezes profits. Widespread USD, GBP, JPY and euro liquidity support asset prices, but this is offset by earnings reversion in the US. Bond markets are reasonably well behaved, but yields do rise. Inflation is high enough to help inflate away the debt burden and global productivity levels decline. Emerging markets experience more severe inflation than the developed world, slightly normalising the growth differential across the emerging markets and developed markets.

Appendix 1 – tailored scenario set continued

Scenario	Probability ranking	Description
Reform (path to growth normalisation)	6	A growth upside scenario contingent upon coordinated reforms that address inefficiencies that are idiosyncratic to particular economies (eg labour in the many European economies and Japan, infrastructure in the US, sector contribution to growth in China and structural issues in the eurozone). This scenario has become more likely with recent policy initiatives. The US and UK grow at or above trend, reforms and stimulus in Japan boost growth to above trend; reforms continue in the eurozone which start to increase growth potential and easing of austerity eases growth constraints.
Global deleveraging – slow growth and disinflation	7	A prolonged and slow consumer deleveraging. Slowing consumption growth and falling nominal prices extend the deleveraging cycle. There is global growth convergences as persistent slow growth and further disinflation in the developed world spills over into the now highly indebted emerging world.
Rise in USD risk premium	8	Low starting yields are a valuation risk for bonds. Yields could rise to more normal levels even in the context of low growth/inflation expectations. High government debt burdens (UK/core Europe/Japan/USA) provide the potential for a bond-vigilante style re-rating of sovereign yields that undermines key safe haven currencies including the USD. This is not a likely near-term scenario, but given the low yields and high level of indebtedness as a starting point, there is a risk that the environment could progress to one where apparently safe paper becomes compromised. This in turn increases the cost of funding and reduces corporate activity. At the same time, government spending is curtailed by enforced austerity in an effort to limit yield increases, remain liquid and stay solvent. This may be a precursor to a 'Prolonged stagnation' scenario. AUD strong but does not re-visit highs vs USD.
Monetary failure	9	A distinctive and hence important scenario that accounts for the possibility of unorthodox monetary policy to fail. Ineffective or stop-go policy, in the absence of meaningful fiscal stimulation, could result in this scenario that could lead to global stagnation, recessionary or even hyperinflationary conditions. In this scenario investors and consumers lose faith in the ability of monetary policy to resolve critical imbalances within the global economy. Developed market economic expansion is negligible and emerging markets slow down significantly, running the risk of a crash. Shares perform poorly. Commodities fall. Nominal yields rally further and remain low.
Australian stress scenario	10	This vulnerability increases as China's growth slows - a more pronounced slowdown is a potential trigger for this scenario. A consequence of moderating demand for Australia's mineral exports is deteriorating terms of trade which erodes national income. In this scenario, positive real growth could disguise an income recession. Since interest payments must be made in nominal rather than real terms this stress becomes more acute at higher levels of foreign debt. Where this occurs coincident with an unravelling of the over-extended residential property market a worst case scenario loss of confidence in Australia causes funding stress to for banks which requires central bank intervention.

Appendix 1 – tailored scenario set continued

Scenario	Probability ranking	Description
Stagflation	11	With no clear roadmap for the withdrawal of policy stimulus, the inflation risks from quantitative easing may be much bigger than are currently appreciated. In this scenario, policy stimulus is not withdrawn fast enough, perhaps coupled with increased policymaker tolerance for an inflationary work-out (due to a much stronger aversion against deflation than inflation) which gets out of hand. Run-away inflation in this scenario is likely to be negative for real growth, which could in turn lead to 'stagflation'. The scenario is likely to involve monetary policy reversals reminiscent of the 70s. US economy is getting closer to the point at which an inflationary policy mistake could occur.
Inflation shock	12	Similar to stagflation, though assumed growth is higher. Sharp rise in inflationary expectations.
Extended risk aversion	13	A generic scenario to capture prolonged aversion to risk. An immediate potential trigger for this scenario is the disorderly exit of Greece from the eurozone with consequent loss of confidence in the eurozone periphery. This is most likely expressed in the form of withdrawal of cash from banks in countries where an exit is feared, potentially prompting capital controls and raising questions about the union. While there is a widely held view that such contagion effects would be limited, this remains conjecture.

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.

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