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MLC's scenario insights & portfolio positioning

MLC Horizon, MLC Inflation Plus and MLC Index Plus portfolios

August 2018

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Update for the quarter ending 30 June 2018.

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Quarterly insights

"Global growth is in low gear, the drivers of activity are changing, and downside risks persist".

This was the opening line of the International Monetary Fund's (IMF's) October 2013 World Economic Outlook (WEO). Economic growth across the two years prior to 2013 was ho-hum at best, particularly in the context of a recovery from the sharp pull back of 2008-2010, so the comment on growth was, as it should be, an accurate characterisation of times just passed. Advanced economies were caught in a growth funk with most of the global growth impulse radiating from emerging markets. Advanced economies grew by an average of 1.3% in 2012/2013, while emerging markets and developing economies averaged 5.2%; global growth was averaging 3.4%. But while real growth was sluggish, nominal growth was under even greater pressure, particularly in advanced economies with CPI inflation struggling to rise above 1.3%. Under these conditions, with debt levels still high, the outlook for deleveraging in the face of ongoing unorthodox monetary policy continued to cast a risky backdrop for both the real economy and financial markets.

But fast forward through the path that history eventually weaved and we now know that despite the uncertain outlook painted in 2013 robust growth soon returned to advanced economies, emerging markets moderated and exposure to any type of risk was generally well rewarded. The problem is though, that when we look back, it is easy to forget, or worse still misremember, the precise nature of the economic conditions and sense of uncertainty that prevailed in 2013 when characterising the growth outlook. What we know now for certain that was unknowable in 2013, is that the array of risks underpinning the downside worries for both the real economy and financial markets would not spring a trap strong enough to imprint a lasting impact on either global economic growth or asset prices. Does this mean that the IMF was wrong? No, of course not. By definition, it is impossible to predict manifestation of a risk. 'Risk' no matter how measured, either by estimation or by quantitation, is the chance of enduring an adverse outcome. In this vein, risk is not a forecast, but a contemporary measure of the degree of uncertainty looking forward from this point in time. High risk does not beckon a calamity, nor does low risk mean that nothing untoward will unfold. And just as there are 'black swan events' that can surprise and cause havoc during calm times; 'white swan events' can similarly occur whereby adverse times do not manifest in apparently uncertain times.

Somewhat ironically, the IMF economists' case for downside risk looking forward from 2013 might have been even stronger had one known for sure the eventual outcome of some critically looming political and economic events. After publication of the October 2013 WEO, the global economy experienced an array of shocks, none of which have (yet) derailed growth or upset financial markets with long-lived consequence: The UK voted to leave the European Union; the US elected a populist president; tensions on the Korean Peninsula escalated; energy prices became volatile; interest rates started to rise; and now trade wars between the US and China threaten to inflict significant collateral damage on global growth. Had these political-economic events been known to the authors of the 2013 WEO, then it is likely that their call for downside risks might have been even louder (ours would have been too).

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.

Just as the IMF economists might be mistakenly chastised ex-post for highlighting downside risks to growth in 2013, the dilemma for risk-focussed real-return investors is that clients, who by extension are similarly risk-focussed investors, are unnerved by periods of 'white swans'. The angst of missing out on the cream of outsized market returns is without doubt a difficult pill. Yet chasing returns is a 'hiding to nothing'. Yesterday's returns are earned and gone, and the more that was over-earned yesterday is less that is available tomorrow. But as logical as this sounds, we know that investors have a strong tendency to ground themselves in the current conditions - meaning that risk is often misread as low, when it is high, and high when it is low. The Wall Street Journal article headlined "The Outlook for 2007: Reasonably Pleasant" printed on 22 December 2006 highlights this point. After a prolonged period of strong share market returns earned in the face of building imbalances, but just months ahead of the beginnings of the sub-prime crisis, Wall Street strategists remained confident about the prospects for US share market returns looking forward into 2007 and 2008. The quote "Underpinning confidence is a growing conviction the Federal Reserve Board has achieved a soft landing for the US economy" sat alongside the bullish 86% of strategists expecting further gains and a remarkable **one-third expecting a rally in excess of 10%**. History quickly went on to show just how starkly perceptions of risk can vary from reality.

Paradoxically, the antithesis of a risk-focussed real return investor well highlights this point. Take the 'desperate gambler' - Technically bankrupt but with enough cash for one remaining roll of the dice. The desperate gambler is usually incentivised to play the game with the highest uncertainty without necessary regard to the odds of winning. This is rational behaviour as it maximises the chance of winning the highest payout. Yet, if the odds come through and the gambler loses all, they perhaps have bad luck (or at least lack good luck), but did not make the wrong decision.

The same holds true for risk-focussed real return investors but from the polar opposing angle. The passage of a white swan does not invalidate the risks that were (and may still) threaten future returns; what matters is avoidance of black swans and other intolerable

outcomes; all the while earning a reasonable return given the degrees of freedom afforded by the risk environment.

Liquidity, a silent risk

Factors outside of economics and valuation also play a key role in assessing risk. Less discussed, but highly relevant, liquidity is perhaps one of the more silent but equally important avenues of risk and opportunity that ebbs and flows within financial markets. At certain times and in certain circumstances low levels of liquidity are an opportunity for investors to provide much needed liquidity and in doing so earn a return; while at other times, high levels of liquidity create an artificial support to financial markets that hides underlying vulnerabilities in the financial system.

Liquidity has arguably played a core role in supporting financial markets through what otherwise could have been characterised as highly uncertain times. The combination of central banks and the strong balance sheet of savers, particularly from China, Japan and core Europe have persistently provided strong liquidity support across asset classes. A key consequence of the wave of global liquidity has been strong demand for income yielding assets, resulting in both higher prices and more resilience in asset classes and currencies that under more normalised liquidity circumstances might have exhibited more fragility.

Australia and the Australian dollar (AUD) is a case in point. Domestic assets and the currency have benefited favourably from the serendipitous nexus of high liquidity and a peculiar global macro-economic environment. China's long-running economic transformation, particularly between 2009 and 2015, came at great benefit to the Australian economy. From an almost unique position of being able to supply large volumes of iron ore extracted at near bottom of the global cost curve, Australia was able to enjoy outsized economic growth from the global iron ore demand spurned by China's construction sector. This in turn had a profound impact on Australia's terms of trade and export income.

But while Australia's external economy rode the coat tails of China's construction activity, the domestic economy took a different path. Household debt ballooned as mortgage growth fuelled a property frenzy, consumption growth slowed and real wages froze. Behind the shift in Australian households' indebtedness lie a number of factors, but perhaps the most culpable are low borrowing interest rates and availability of credit that in turn owe their existence to liquidity. On one side, the central bank has been forced to maintain cash rates in line with global peers as a strong AUD wrought damage on the non-mining corporate sector of the economy; while at the same time a global search for yield, combined with high liquidity and an external perception of Australia's strong economy, encouraged foreign investors to fund Australian banks and thus indirectly help provide low cost credit into the domestic economy.

As it stands now, Australia's gross external debt is currently a smidge over A$2 trillion (approximately 115% of GDP), more or less doubling from near 60% of GDP in 2000 (Chart 1). Of this, the private financial sector accounts for slightly more than half of the current stock (63% of GDP). Interest paid on total external debt to overseas investors claims just over 2% of GDP, while interest paid to foreign creditors by the financial sector draws down approximately 1% of GDP (A$18 billion). Yet, even at the prevailing extremely low interest rates, Australia's foreign interest bill is still approximately 20% of nominal trend growth, making any deleveraging difficult unless either growth accelerates, or credit is redirected from households to more productive parts of the economy (Chart 2).

Chart 1: Australia's foreign debt has been expanding

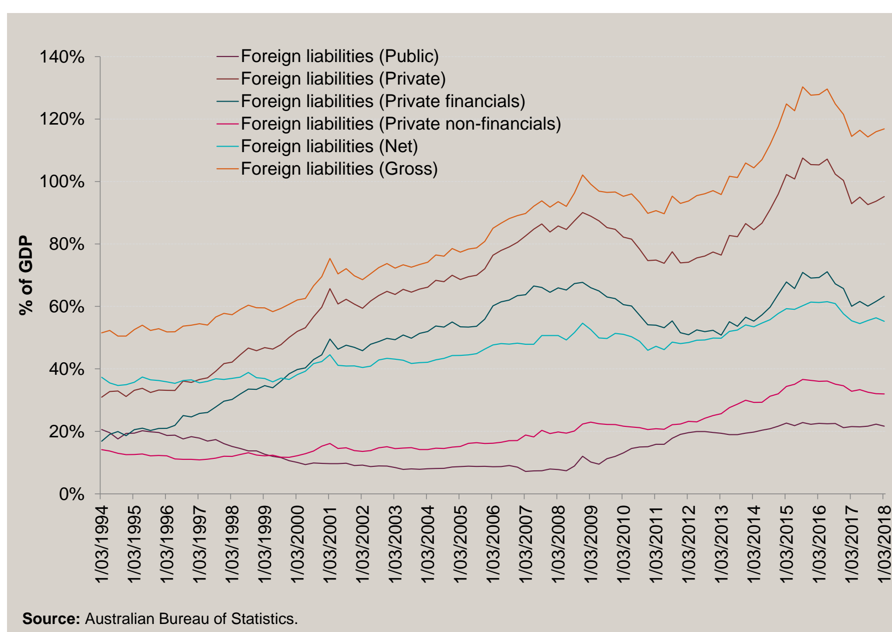
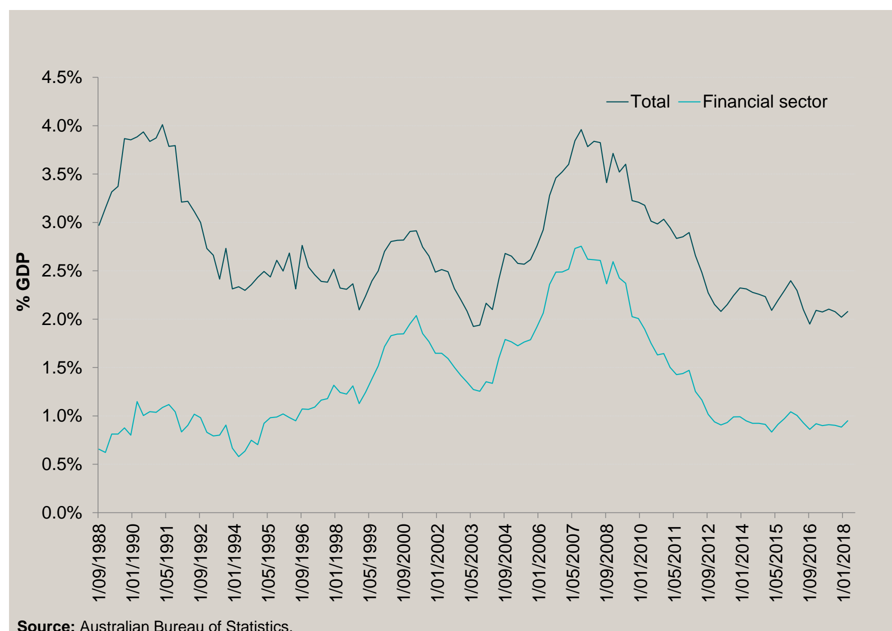


Chart 2: Australia's interest payments overseas as a % of GDP



Source: Australian Bureau of Statistics.

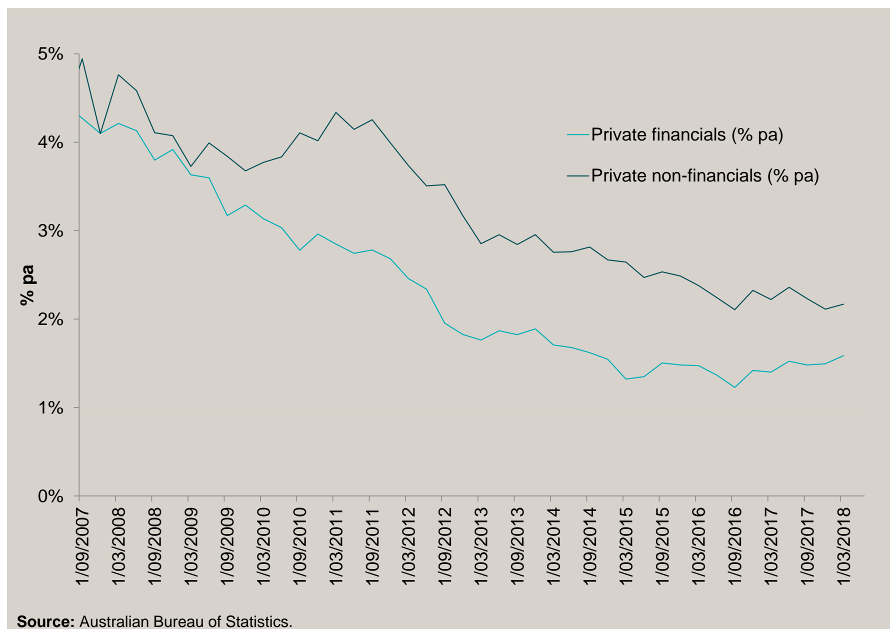
The challenge to Australia's balance sheet problem - at least over the medium term - is not solvency, but liquidity. Australia's domestic financial assets and the value of extractable natural resources within Australia's territory are far in excess of the nation's current level of net external liabilities. Indeed, it might be the case that the obviousness of Australia's underlying solvency has played a major role in elevating the liquidity risk hanging over Australia's foreign liabilities.

But while globalisation of capital has provided Australia with cheap funding, the flipside is that so long as the nation remains a net international debtor with mismatched lending and borrowing terms (ie lending long term into the domestic market and borrowing short term from international markets), domestic monetary conditions are no longer under the complete control of the central bank. Unlike the US, that is somewhat insulated from a disruption to liquidity while the US dollar retains its place as a core reserve currency, Australia's options under the stress of a withdrawal of liquidity are significantly limited. There is a material risk that ultra-loose or unorthodox policy from the Reserve Bank of Australia (RBA) would not have the same impact on the financial system as it did in the US, UK, European Union and Japan – all of which remain global reserve currencies. Under stressed conditions, there is a chance that domestic policy steps would be undone by further increases in external funding rates and significant AUD weakening, in effect either undoing the work of the RBA, or transferring the pain to another part of the economy. And while the RBA has tools to manage liquidity, moral hazards mean that the RBA might choose to be reactionary, rather than pre-emptive in managing the impact of an externally led tightening. Indeed, the recent ebb in global liquidity conditions has begun to show up in the cost of offshore borrowing by the financial sector. Despite the RBA maintaining the cash rate at 1.50% pa during a period of tightening by the US Federal Reserve (+1.50% between December 2016 and July 2018), the cost of offshore borrowing by the domestic financial sector has nonetheless begun to creep higher (Chart 3). That this is happening at a time when the sensitivity of outbound interest payments to changes in offshore borrowing rates sits near an all-time high - approximately 2.5% of GDP for every 1% increase in offshore borrowing rates (Chart 4) - adds to the worry. This in turn means that without a further cut in the cash rate, domestic banks will need to decide whether to absorb the increased cost of funding via lower margins, or pass the cost on at the expense of the credit volumes and household consumption. Either way, the economy pays a price.

Interestingly, the increased cost of external funding has not yet shown up in private non-financial sector borrowings data. Within the domestic non-financials, mining is the largest issuer of offshore debt. One interpretation of the differing behaviour of financial and non-financial offshore borrowing rates is that while the financial sector sits in front of highly leveraged households and the property market, the strong cash flow situation of the mining sector has effectively been able to counterbalance upward pressure from liquidity forces.

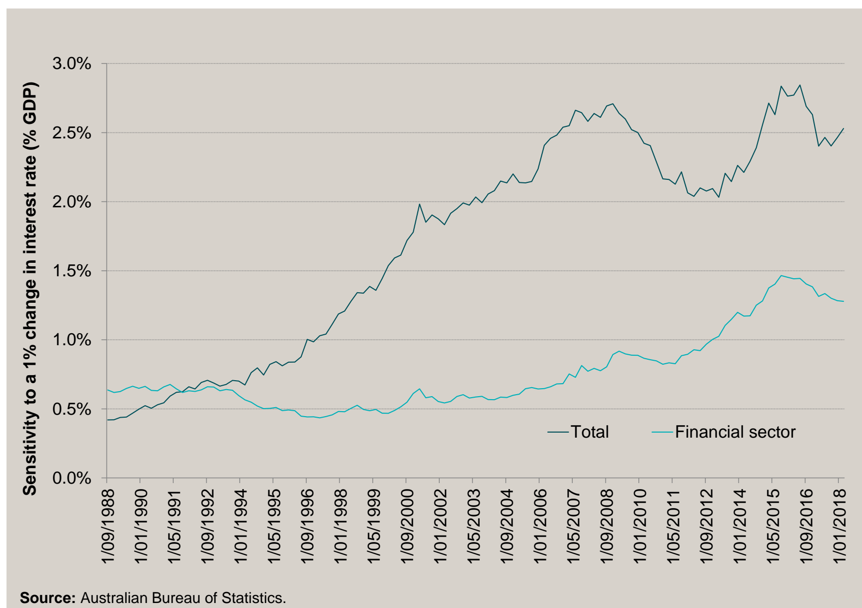
Whichever way it is cut, there is no ambiguity regarding Australia's current household debt and international deficit positions. Combined these hang over the Australian economy as a material risk. Nonetheless, as alluded to at the outset, existence of this easily identifiable risk does not mean that grief will come to pass. Nor does it mean that the consequence of a financially-related upset to Australia's economic situation should be ignored, or bet on.

Chart 3: Australia's cost of offshore borrowing has begun to creep higher



Source: Australian Bureau of Statistics.

Chart 4: Australia's sensitivity to changes in interest rates is high



Source: Australian Bureau of Statistics.

What really matters is whether or not it is possible to engineer exposure to Australian growth into investment portfolios while at the same time avoiding, or at least mitigating, the consequence of an adverse change in Australia's debt dynamics. MLC's solution within the MLC Inflation Plus portfolios has been to take advantage of our internally managed defensive Australian shares strategy, where we continue to own exposure to the banking sector and enjoy relatively healthy yields, while at the same time explicitly removing the downside risk via specific protection strategies that are funded using part of the banking sector dividend. Net-net this leaves the portfolios in a position of not needing to avoid exposure to rich sources of return all the while without carrying full exposure to what we see as a key risk to the domestic economy. This is one of the ways we've been able to position the Inflation Plus portfolios to capture as much return as possible while limiting the risk of the portfolios to an acceptable level, in line with our pledge to clients.

The Investment Futures Framework: Scenarios and changes in return potential

In managing MLC's multi-asset portfolios we assess potential future risks and opportunities. We invest by understanding what could happen as opposed to picking the single future that will unfold. The future is not predetermined; it depends on what policymakers do, how companies behave and how these things compare to investors' expectations.

By understanding the different ways in which the future might unfold we are able to make informed choices about the trade-offs between risk and return. A higher exposure to shares will increase returns in some scenarios, but reduce returns in others. Where there are assets that generate positive returns when share markets decline, we can have a higher share market weighting. Nominal bonds played an important diversification role through the global financial crisis. But today, low starting bond yields mean they are at best poor diversifiers of share market risk and are outright risky in some circumstances.

As outlined, looking forward from today we see the potential for the strong returns that we have seen over recent years to persist, but this environment is not based on strong foundations and fragility is increasing. It may still be possible for policymakers to engineer a benign path forward, but we must take seriously the possibility of a significant market decline. Our aim is to understand the key things that could happen and then identify the most appropriate trade-off of risk and return, given the objectives and constraints for each portfolio, to find at least an acceptable outcome regardless of what happens.

Our promise, particularly to our Inflation Plus portfolio investors, is to maintain the risk control discipline – this means that in a worst case scenario we must avoid significant negative returns over each portfolio's time horizon. However, our awareness of the possibility of an on-going speculative rally means we need to be nimble and rapidly re-assess positioning on pull-backs - though we suspect further strong rises have a declining probability. We also need to continue our efforts to seek new risk controlled market exposures.

Our tailored scenario set currently consists of 14 scenarios (refer to Appendix 1). Due to the prevailing distortions and policy uncertainty, these scenarios contain more complexity and cover a wider range of outcomes for assets than would be the case from a less distorted starting point. The current inflation circumstances assume an appropriately high level of importance in design of the tailored scenario set, and have been up-weighted in the generic scenario set versus 'normal' levels.

The Investment Futures Framework scenario sets explained

Our approach assesses and analyses a comprehensive set of possible future scenarios – this is referred to as the Investment Futures Framework. 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. Risk is not a statistic; it arises from a range of real economic, political and business events. Using our Framework's comprehensive assessment of the potential sources of future risk we are equipped to position portfolios to extract return potential while maintaining the required risk control.

The Investment Futures Framework comprises both our **generic** broad set of 40 scenarios which pivot around the main drivers of returns – the macroeconomic 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.

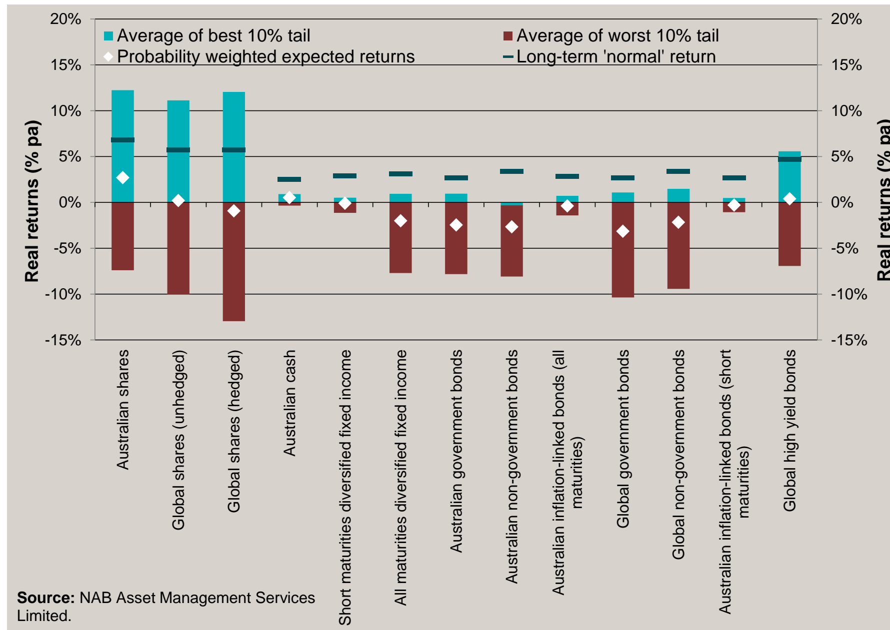
The generic set of scenarios is designed to have relevance from any starting point and provide a consistent barometer of risk and return through time. The smaller tailored set of scenarios pivot around the key characteristics and uncertainties in the current environment. The tailored set might be seen 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 – as asset prices change, future return potential and possible future risks change. We take this evolution into account in positioning our portfolios.

Regardless of inflation, it remains the case that pressure persists on the real economy from widespread high debt loads. This means that outcomes will not just pivot along inflation paths, but will be heavily influenced by decisions to either save or borrow in both the private and public sectors and by the direction of policy that might or might not foster an improvement in efficiency and a pickup in potential growth.

The Investment Futures Framework: Scenarios and changes in return potential

Chart 5: 40 scenario set (generic scenarios) potential real returns (June 2018) - 5 years, 0% tax with franking credits, pre-fees, pre-alpha



Credible outcomes range from favourable improvements in nominal prices and improvements in capital productivity (ie **Inflationary debt resolution** scenario) through to the **Stagflation** and **Extended risk aversion** environments that we expect would eventuate should today's unorthodox policies fail and fiscal stimulus disappoints or fails to materialise. The political pressures that arise from what are now multiple displays of voter discontent with the status quo reinforces the need to change the policy agenda. This is a risk point to watch closely, particularly as it has coincided with changing perceptions about monetary policy efficacy.

The potential real returns for each asset class are shown in Chart 5.

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.

Performance expectations

Chart 6 shows return potential for the MLC Horizon, Inflation Plus and Index Plus portfolios based on our generic (40) scenario set looking forward from the end of June 2018.

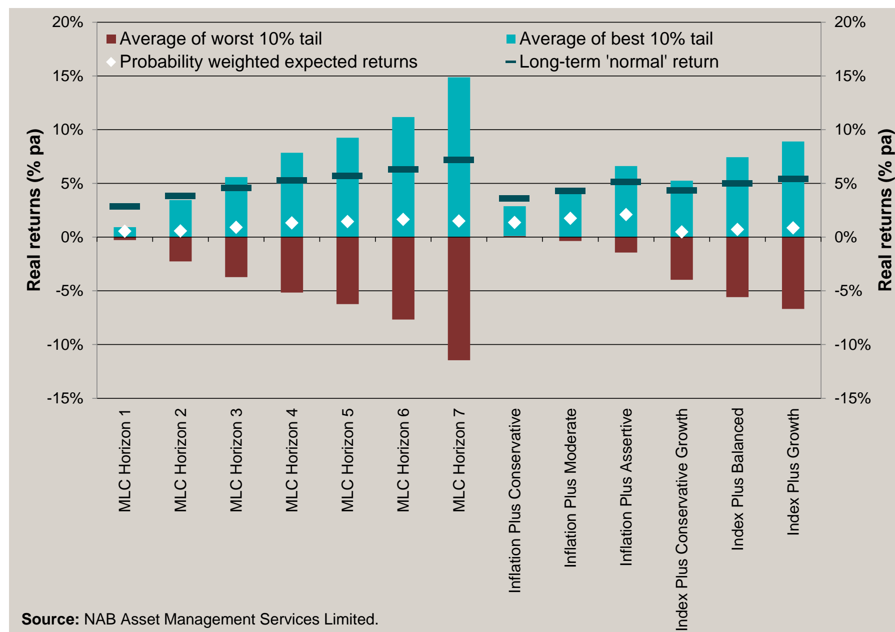
As with previous quarters, the chart continues to show that on average, looking across the whole scenario set, the potential reward for taking risk is very limited. In the event that a scenario with relatively higher returns occurs, the returns of those portfolios with larger share allocations will be 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 investor expectations.

Comparing the MLC Inflation Plus to the MLC Horizon and Index Plus portfolios, the stronger risk focus of the Inflation Plus portfolios is evident. Consistent with their objectives, 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 the MLC multi-asset 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. If a higher level of volatility persists, this may result in new opportunities to enhance returns in an appropriately risk controlled manner.

Chart 6: 40 scenario set (generic scenarios) potential real returns (June 2018) - 5 years, 0% tax with franking credits, pre-fees, pre-alpha



Source: NAB Asset Management Services Limited.

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.

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 portfolio'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 capital preservation over each portfolio's investment time frame.

Returns over the past year have been very modest, particularly relative to those generated in prior years. The past 12 months have been challenging for our defensive positioning.

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

Asset class	Change in allocation to asset classes in the MLC Inflation Plus portfolios (in MLC MasterKey's super and pension products) over the June quarter*			Comment
	Conservative	**Moderate**	**Assertive**	
China A-shares with downside limit of 20% (through derivatives strategy)	Steady (zero)	**New (+0.5%)**	**New (1.0%)**	This quarter we've engineered exposure to the onshore China A-share market using the combination of a Total Return Swap (TRS) and a 20% out-of-the-money put. As the put is completely funded by the fee received from the TRS (ie it is cost neutral), the payoff profile for this exposure is performance of the China A-share market (AUD unhedged) with a downside limit of -20%. Due to the high growth potential and volatility of Chinese onshore shares, this type of exposure has a favourable prospective payoff profile. Yet, to compensate for the increased risk, we have made a commensurate de-allocation from emerging market shares (see below).
Emerging market shares	Steady (zero)	**Decreased**	**Decreased**	This quarter we made a de-allocation from emerging markets shares to make room for an exposure to the China A-share market in Inflation Plus Moderate and Assertive (see above).
Defensive Australian shares	Steady allocation	Steady allocation	Steady allocation	Our defensive shares investment process directly takes account of the risks identified in our scenarios analysis. By investing in defensive Australian shares we're able to have a higher exposure to Australian shares than we otherwise would.
Global shares (through derivatives strategies)	Zero allocation	**Increased allocation**	**Increased allocation**	Tailored exposure to specific markets via futures on the basis of fundamental value and risk offsets via currency exposure plus, during the quarter, a call options exposure was put in place to provide a risk controlled exposure to share market upside with a limited and predefined downside. This strategy exploited very low levels of volatility at the start of the year making the options unusually inexpensive.
Defensive global shares (unhedged)	Steady allocation	Steady allocation	Steady allocation	Primary global share exposure is defensive. The portfolios have a strong bias to absolute, not index-relative, shares.
Foreign currency exposure	Call options protection maintained	Call options protection maintained	Call options protection maintained	**AUD/USD upside protection** maintained at a lower level and the currency basket to which the portfolios were exposed were diversified with a lower US dollar exposure and higher exposure to euro, yen and UK pound during the quarter.
Gold exposure (through derivatives strategies)	Zero allocation	Zero allocation	Steady allocation	Gold helps protect the portfolio against a range of shocks and inflationary scenarios. However the gold price can be volatile and the concept of fair value is nebulous.
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	Steady allocation	Steady allocation	Steady allocation	Allocation to our multi-asset real return manager, Ruffer, maintained.

Asset class	Change in allocation to asset classes in the MLC Inflation Plus portfolios (in MLC MasterKey's super and pension products) over the June quarter*			Comment
	Conservative	**Moderate**	**Assertive**	
Derivatives strategies	Steady allocation	Steady allocation	Steady allocation	Focus has increased on risk controlled equity exposures using derivative strategies opportunistically, taking advantage of favourable market pricing where this is consistent with our scenarios insights.
Global private assets	Steady allocation	Steady allocation	Steady allocation	Within the private equity portfolio some rebalancing is underway which reduces the venture capital exposure. This locks in what have been very strong returns in this part of the market and reduces the overall risk profile of the portfolio.
Global property securities	Zero direct exposure	Zero direct exposure	Zero direct exposure	In the portfolio we are limiting exposure to interest rate sensitive assets. 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	Deeply unattractive, with limited diversification benefit.
Australian inflation-linked bonds	Steady allocation	Steady allocation	Steady allocation	Maintaining emphasis on short duration inflation-linked bonds, which helped protect returns as yields rose during the quarter.
Insurance-related investments	Zero allocation	Steady allocation	Steady allocation	Insurance-related investments are uncorrelated to other asset classes though it's a risky exposure that we believe is appropriate in portfolios with a sufficient investment time horizon.
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.
Australian non-government bonds (short duration)	Steady allocation	Steady allocation	Steady allocation	Offer some return enhancement while limiting additional risk.
Cash	Steady allocation	Steady allocation	Steady allocation	We continue to keep significant powder dry (in cash) waiting for better opportunities. The benefit of cash allocations comes from the optionality it provides in a risk-off environment.
Borrowings	Borrowing not permitted	Borrowing not permitted	No borrowings	Reward for risk is too limited.

* Based on target asset allocations.

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 constraints on 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 portfolios we are maintaining a relatively defensive orientation, in part this comes from exposures to Inflation Plus but also through significant deviations from benchmark debt allocations. We continually test our thinking, and we retain high conviction in the appropriateness of this positioning. While the flexibility is more limited and exposure lower, we are utilising similar derivative strategies, as for Inflation Plus portfolios, to enhance the defensiveness of equity exposures and manage exchange rate risk.

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

	MLC Horizon 4 Balanced Portfolio (in MLC MasterKey's super and pension products) weights at end of the June quarter*			Comment
	Under	**Benchmark**	**Over**	
Growth-focussed assets		•		
Australian shares		•		Retained benchmark allocation.
Global shares (unhedged)			•	We continue to be overweight foreign currencies (underweight the AUD), with an 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 from peak levels.
Global shares (hedged)	•			
Global property securities		•		Retained benchmark allocation – the benchmark allocations are underweight versus peers.
Income-focussed assets	•			
Cash			•	To further reduce interest rate risk in MLC Horizon 2 to 5 portfolios we've increased the overweight to cash and decreased exposure to Australian and global bonds. We've made these changes in response to low bond yields, gradually rising risks of higher inflation and potential headwinds from a slow tightening in monetary conditions.
Australian bonds - All Maturities	•			Underweight to longer duration Australian bonds increased for MLC Horizon 2 to 5 portfolios, to further reduce interest rate risk.
Australian inflation-linked bonds		•		This allocation to inflation-linked bonds in MLC Horizon 2 to 5 portfolios includes exposure to both short and all maturities duration inflation-linked bonds. The portfolios are underweight all maturities exposure, and overweight the short duration exposure which reduces interest rate risk. To further reduce interest rate risk in MLC Horizon 2 and 3 portfolios we reduced their allocation to all maturities inflation-linked bonds this quarter.
Global bonds - All Maturities	•			Underweight to longer duration global bonds increased for MLC Horizon 2 to 5 portfolios, to further reduce interest rate risk.
Global non-investment grade bonds (high yield bonds and loans)		•		Retain benchmark allocation.
Alternatives			•	
Global private assets		•		Retain target benchmark allocation.

	MLC Horizon 4 Balanced Portfolio (in MLC MasterKey's super and pension products) weights at end of the June quarter*			Comment
	Under	**Benchmark**	**Over**	
Real return strategies (including Inflation Plus)			•	MLC Horizon 4 and 5 portfolios remain overweight real return strategies, other portfolios are at benchmark. We believe the allocation to real return strategies provides the portfolios with a greater potential ability to preserve investors' capital in volatile markets and provides our investors with potentially better investment returns for the level of risk we take.
Low correlation strategy		•		This fund of hedge funds strategy aims to generate a return above cash and deliver returns that are mostly independent of share market performance.

* Based on target asset allocations.

MLC Index Plus portfolios

Risk is primarily benchmark-related for the Index Plus portfolios. Benchmarks have been designed to efficiently generate above-inflation outcomes on the basis of long-term investment assumptions. 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 Index Plus portfolios we are maintaining a relatively defensive orientation, this is through adjustments made to the fixed income strategy and allocation to the real return strategy. We continually test our thinking, and we retain high conviction in the appropriateness of this positioning.

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

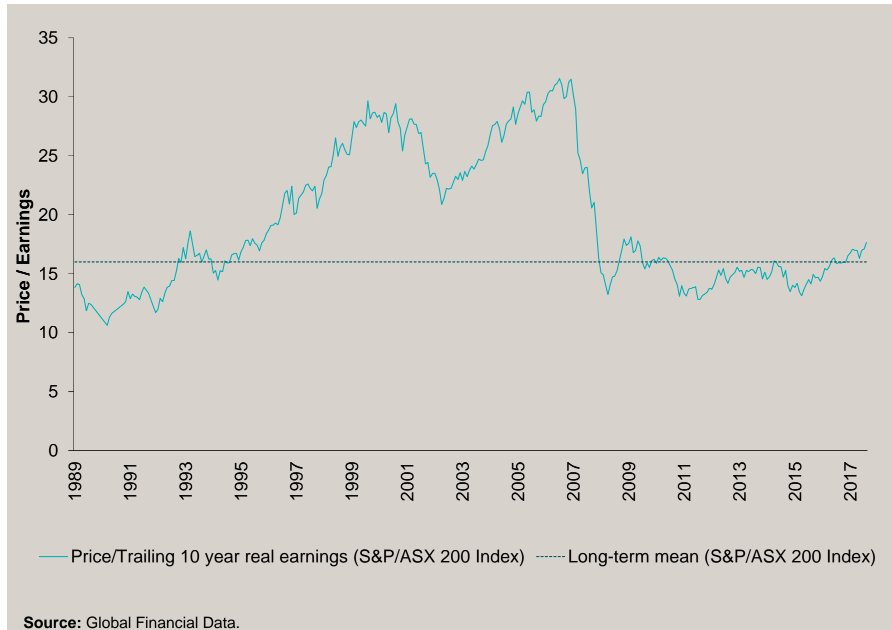
	MLC Index Plus Balanced Portfolio weights at end of the June quarter*			Comment
	Under	Benchmark	Over	
Growth-focussed assets	•			
Australian shares		•		Retained benchmark allocation.
Global shares (unhedged)			•	We continue to be overweight foreign currencies (underweight the AUD), with an overweight 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 from peak levels.
Global shares (hedged)	•			
Global property securities		•		Retain benchmark allocation – the benchmark allocations are underweight versus peers.
Income-focussed assets			•	
Cash			•	To further reduce interest rate risk in all Index Plus portfolios we've increased the overweight to cash and decreased exposure to Australian and global bonds. We've made these changes in response to low bond yields, gradually rising risks of higher inflation and potential headwinds from a slow tightening in monetary conditions.
Australian bonds – Short maturities			•	Overweight maintained.
Australian bonds - All maturities	•			Underweight to longer duration Australian bonds increased for all Index Plus portfolios, to further reduce interest rate risk.
Australian inflation-linked bonds		•		This allocation to inflation-linked bonds includes exposure to both short and all maturities duration inflation-linked bonds. The portfolios are underweight all maturities exposure, and overweight the short duration exposure which reduces interest rate risk.
Global bonds - Short maturities			•	Overweight maintained.
Global bonds - All maturities	•			Underweight to longer duration global bonds for all Index Plus portfolios, to further reduce interest rate risk.
Alternatives		•		
Real return strategies		•		We believe the allocation to real return strategies (through the Simple Real Return strategy) provides the portfolios with a greater potential ability to preserve investors' capital in volatile markets and provides our investors with potentially better investment returns for the level of risk we take.

* Based on target asset allocations.

Asset class indicators

Commentary on the main asset classes follows.

Chart 7: Australian shares



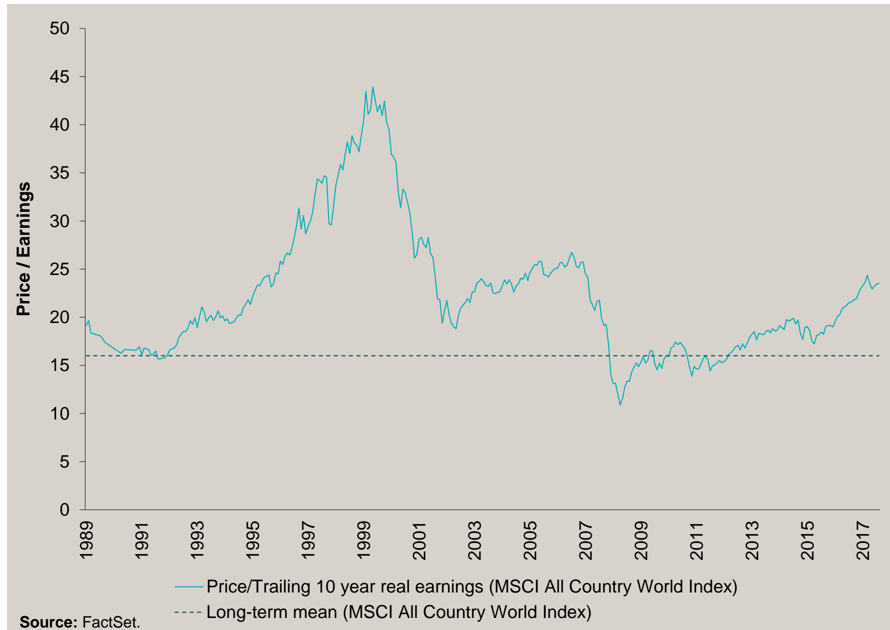
Source: Global Financial Data.

Australian economic data shows modest improvement. Business surveys are positive while the labour market continues to generate solid jobs growth. Australia's economic growth picked up to a 3% annual pace in the March quarter given stronger exports and government spending. However consumers remain cautious as seen in sedate retail spending. Consumer price pressures are also subdued with annual inflation at 1.9% for the March quarter. This has allowed the RBA to keep the cash interest rate on hold at 1.5%.

Australian shares posted an exceptionally strong return of 8.5% for the quarter. The Energy sector achieved a remarkable 19.7% return given higher oil prices. There were also robust returns of 16.5% for the Health Care and 16.4% for the Resources sectors. However this was partly countered by the sharp 13.7% fall in the Telecommunications sector, with Telstra a notable underperformer.

Asset class indicators

Chart 8: Global shares



Global shares (hedged) made a strong return of 3.0% over the past three months to June 2018. A lower Australian dollar helped boost global shares (unhedged) to a stronger 4.6% quarterly return.

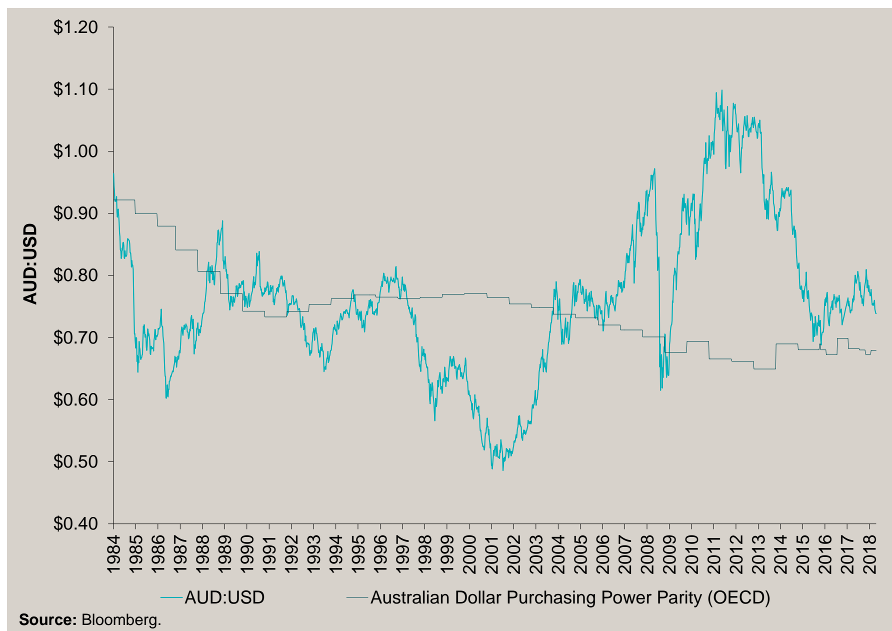
US shares rebounded in the June quarter after the weakness in February and March. Strong corporate profit reports have countered concerns over the US central bank raising interest rates as well as President Trump's trade policy. The US has implemented tariffs on steel and aluminium and also proposed tariffs on selective imports from China and Europe. The Federal Reserve raised US interest rates by another 0.25% in June.

European shares also delivered a solid return of 2.5%. Solid business surveys and a lower currency have supported Europe. However political concerns returned in May with a new Italian government advocating contentious budget and immigration policies.

Asian shares provided mixed performance. Some notable mainland Chinese share indices such as the Shanghai Composite recorded a sharp fall of -10% given tighter credit conditions and trade tensions with the US. However the larger capitalised Chinese shares comprising the MSCI Index for China was more resilient with a flat return for the quarter.

Emerging market shares disappointed with a sharp negative return of -4.3% (unhedged). Concerns over inflation and political risks in Argentina and Turkey as well as higher US interest rates have seen emerging markets struggle.

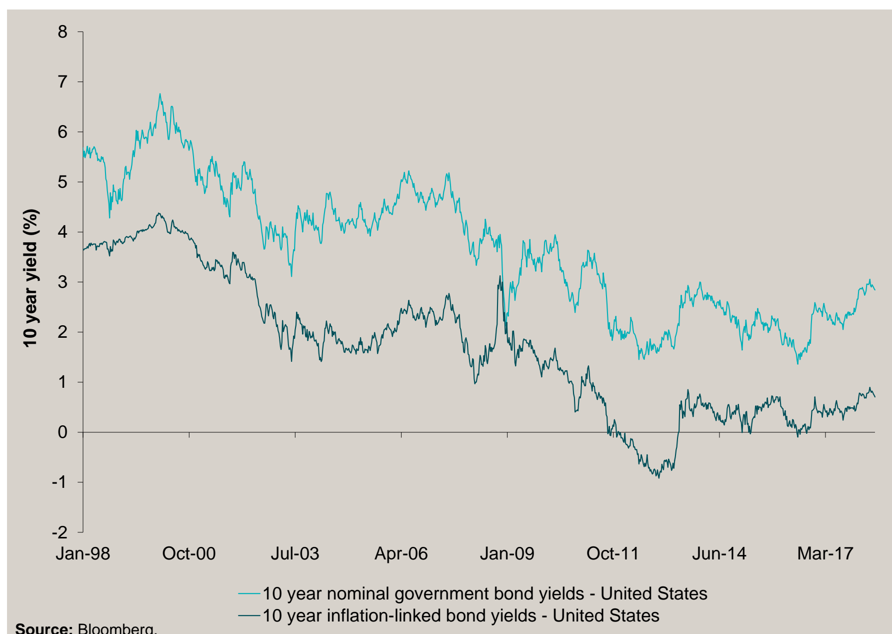
Chart 9: Australian dollar



Source: Bloomberg.

The AUD has continued to fall against the US dollar this quarter. Concerns over US tariff announcements and the Federal Reserve raising US interest rates again in June have weighed on the AUD in the June quarter.

Chart 10: Global government bonds



Source: Bloomberg.

Global bonds (hedged) delivered a positive return of 0.1% for the quarter. Notably US government bond yields managed to stabilise after a sharp rise earlier this year with concerns over future inflation risks. However global inflation risks still appear to be building as evidenced by rising oil prices and stronger jobs growth.

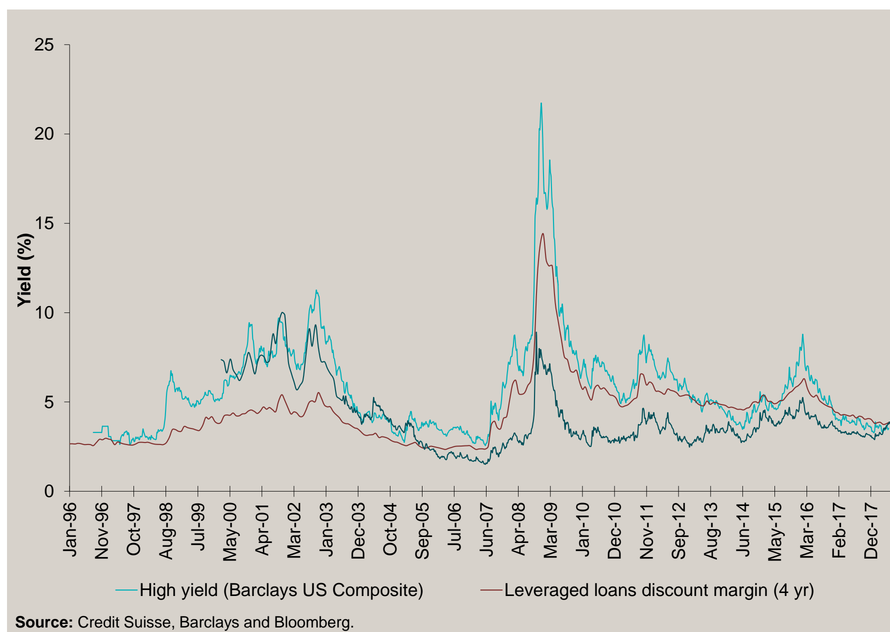
Asset class indicators

Chart 11: Australian government bonds

Source: Bloomberg.

Australian government bonds managed a positive return of 0.8% for the quarter. The RBA's steady cash interest rate and mild inflation data has seen bond yields move slightly lower over recent months.

Chart 12: Non-investment grade bonds



Source: Credit Suisse, Barclays and Bloomberg.

Global high yield bonds (hedged) delivered 0.6% for the quarter. Credit markets were generally resilient despite concerns over the impact of US trade tariffs on corporate profits as well as future US interest rates settings.

Appendix 1 – Tailored scenario set

Scenario	Probability ranking (previous rank)	Description
Inflationary debt resolution	1 (1)	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 EUR 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.
Three speed global economy (China soft landing)	2 (2)	The world continues to split into three distinct economic growth zones. Emerging markets led 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 and AUD vs JPY and EUR.
Reform (path to growth normalisation)	3 (3)	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 is increasingly more likely in light of 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 reduces growth constraints.
Synchronised moderate growth	4 (4)	Japan's and Europe's growth approach trend levels, while the US, UK and China moderate, resulting in a synchronised modest global growth scenario.
Slow global growth deleveraging	5 (5)	A prolonged and slow consumer deleveraging. Slowing consumption growth and falling nominal prices extend the deleveraging cycle. There is global growth convergence as persistent slow growth and further disinflation in the developed world spills over into the now highly indebted emerging world.
Inflation shock	6 (6)	Similar to **Stagflation**, though assumed growth is higher. Sharp rise in inflationary expectations.
Australian stress	7 (7)	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 banks which requires central bank intervention.
Extended risk aversion	8 (8)	A generic scenario to capture prolonged aversion to risk. The probability of a **Eurozone slow disintegration** scenario was previously included in this generalised risk aversion scenario. Potential triggers include policy disappointment, in particular a protectionist Trump presidency with rising tension with China.
Rise in USD risk premium	9 (9)	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.
Stagflation	10 (10)	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. The US economy is getting closer to the point at which an inflationary policy mistake could occur.
Early re-leveraging	11 (11)	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 debt resolution**.

Appendix 1 – Tailored scenario set

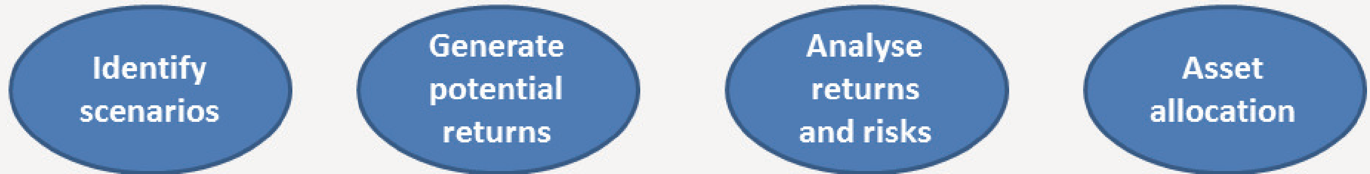
Scenario	Probability ranking (previous rank)	Description
Negative nominal interest rates	12 (12)	Central banks of Japan and Europe move further into negative deposit rates with the Fed and the Bank of England inching towards negative policy rates. This scenario includes the impact of expanded USD, GBP, 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 Chinese 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 EUR and JPY. 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.
Eurozone slow disintegration (possibly leading to reform)	13 (13)	Rising risk of anti-eurozone politicians gaining power, most notably in France with consequent loss of confidence in the stability of the eurozone periphery. A worst case version of this scenario 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. The path a **Eurozone slow disintegration** might take is highly uncertain. A positive version of this scenario occurs if existential fears lead to a meaningful policy change including on the contentious issues of closing the output gap which requires a significant shift from Germany, and external immigration. In a best case situation there is meaningful reform which potentially influences Brexit - this possibility is captured in the **Reform** scenario.
Monetary failure	14 (14)	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.

Appendix 2 – MLC's market-leading investment process

Step 1

Scenario analysis and portfolio construction

The Investment Futures Framework



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

Step 2

Implementation

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

Step 3

Review

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

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