MLC's scenario insights & portfolio positioning

MLC Horizon, MLC Inflation Plus and MLC Index Plus portfolios

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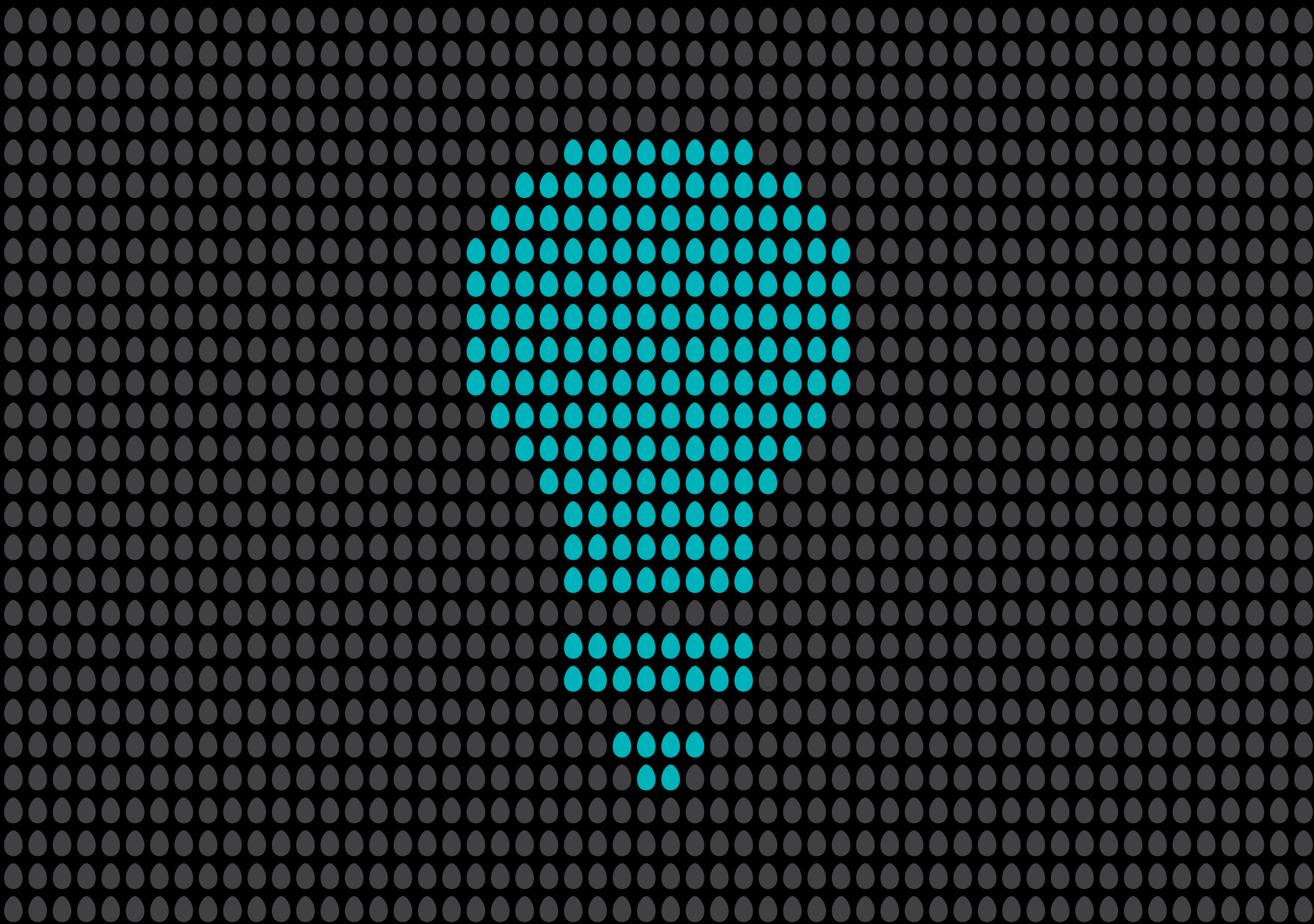

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Update for the quarter ending 30 September 2019.

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Quarterly insights

The seesaw of market trepidation rose once more in the September quarter as global trade policy and other political risks subdued investors' enthusiasm to embrace risk. Trade tensions flared again with the US once more provoking both China and the European Union with further tariffs and regulation targeted at foreign corporations. Meanwhile, politics in the UK descended into further chaos with another change of prime minister and a heightened risk of a no-deal Brexit; a drone attack damaged significant oil infrastructure in Saudi Arabia; and Anti-China protests in Hong Kong disrupted key sectors of the economy.

With the deterioration in global trade conditions as the overriding backdrop, evidence is quickly emerging in both hard and soft economic data that protectionist policy and other political risks are undermining both corporate earnings and credit fundamentals. Global growth has slowed, particularly within the manufacturing sector, which in turn creates a latent knock-on risk for the larger non-manufacturing sector and clouds the outlook for corporate earnings.

In the US, continuation of the moderate, but long running, economic expansion is under threat. Signs of weakness have begun to emerge in the labour market as September new payrolls softened to a 136K increase (compared to a 168K increase in August), raising the possibility of an uptick in unemployment. This is inconvenient for President Trump who faces an election in a little over a year, squeezing the time available to push antagonistic policy further. Whether or not this was a central factor behind the US agreeing to a truce with China is unclear. Yet, whatever the case, the trade accord reached on 12 October between China and the US appears to be another temporary reprieve rather than a major breakthrough in the trade conflict. Hot-cold negotiations have more or less defined the skirmish with no less than three temporary ceasefire periods (December 2018, June 2019 and October 2019) interspersed by shock and awe type tariff-announcements from the US. This on-again, off-again pattern of negotiations should temper enthusiasm toward the recent truce.

Whatever the politics and driving ideology, the uncertainty and economic impost of tariffs and other cross-border commercial regulation impedes economic growth. This is a truism. Whether it is a UK-based firm facing an unknown trading and regulatory future, or a US multinational grappling with supply chain optimisation. Regulatory meddling in cross-border trade is a disruptive force that ultimately lands at the feet of investors.

There can be no doubt that the turbulent global trade policy environment is a set-up for heightened risk, and while share markets have reacted to key trade milestones by either galloping or falling heavily on days of progress or setback, pricing of company earnings still appears to suggest that investors expect at least a benign outcome of the trade conflict. This can be seen in forward earnings in both China and the US, where growth expectations do not appear tempered, and in the 'UBS Synthetic Trade War Monitor' which is currently printing numbers in the lower one-third of its history since the conflict began (ie two-thirds of the time risk has been perceived as being higher).

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.

With the backdrop of an already challenged growth environment born of an inconvenient union between long-term secular pressure from unfavourable demographics and the medium-term growth impost flowing from the high stock of debt, trade friction and other policy uncertainties will only drive growth and growth expectations lower.

Fiscal policy remains the growth-restoration beacon, but progress here needs to first overcome the politically difficult task of pushing levels of public debt on beyond what in earlier years would have been considered extreme. What's different now, is that while the current stock of debt viewed from a historical perception of normality might seem colossal, the prevailing level of interest rates and other monetary policy settings likewise seem just as absurd. Yet, this 'new' normal of high debt and super-low rates (relative to history) is not so normal anymore. In just over a month, it will be 10 years since the US 10-year real interest rate has been above 1.5%, and eight years since UK 10-year real rates have been above zero.

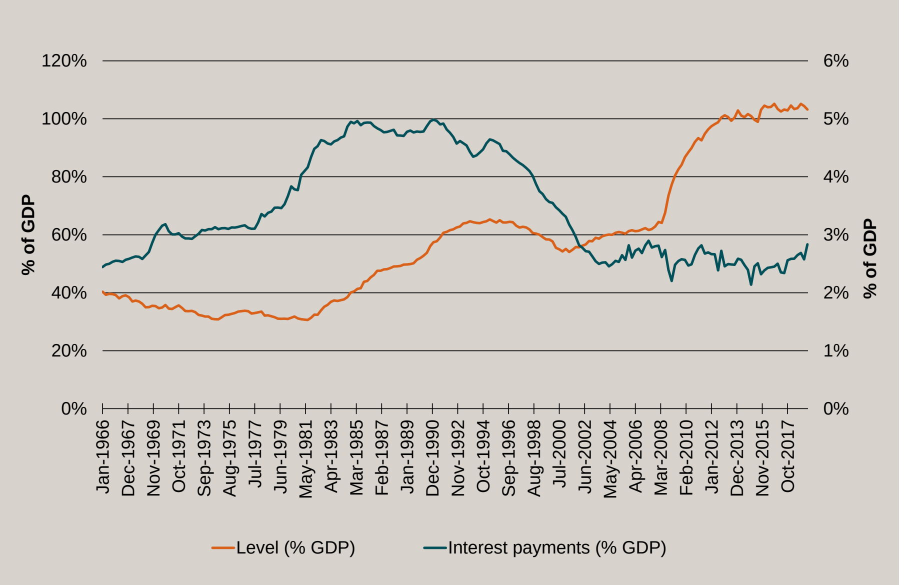
Should this signal a change in the way we view things? Perhaps. But the (awkward) reality is that economics and particularly investment lacks a true, easily defined reference point for defining and comparing where we are versus where we should be. This in turn makes it impossible to measure using static assumptions. Different economic and financial factors will have a different bearing on risk at different points in time.

The high stockpile of global debt and its influence over economic growth and financial risk is a case in point. Debt means different things to different investors. Some of us tend to focus on stock (the level of debt), whereas others focus on serviceability (ie interest burden). Should we measure corporate leverage via the balance sheet (stock) or income statement (solvability). Segmenting the risk posed by debt into stock and flow helps us think about the consequence of debt and, in doing so, leads to a better understanding of where the ultimate risks lie in a leveraged world.

If the level of debt determines risk, then the current starting picture is one of severe distortion and high risk. Compared to history, aggregate debt is high and the sector distribution is skewed. In some regions, debt is distributed towards the private sector and away from the public sector eg Australia; while in other regions public debt is high and private debt low eg Japan. There also exists a polarisation of savings between nations with Japan, China and Germany essentially funding the rest of the world.

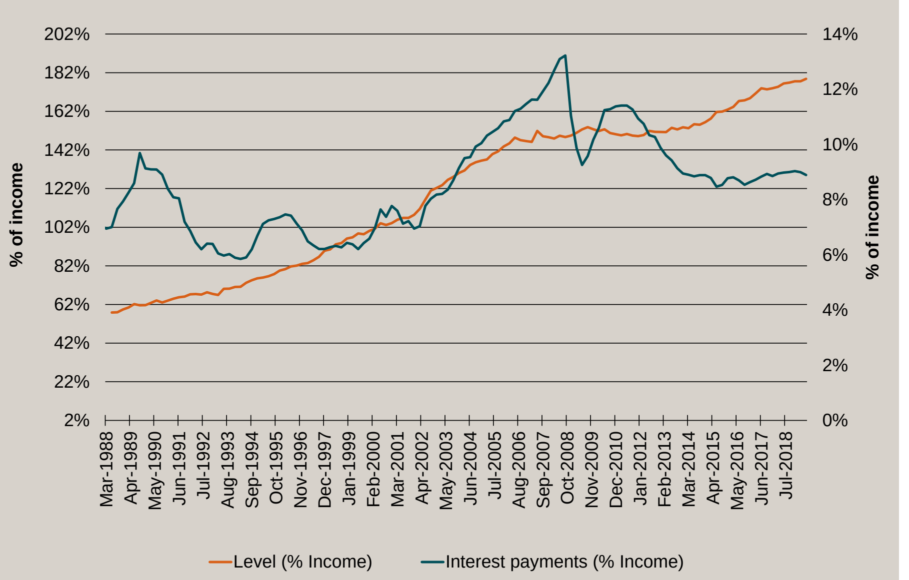
Yet, in the context of low interest rates it is arguable – and indeed a widely held view – that a singular focus on the stock level of debt overstates the risk posed by large borrowings as it ignores the impact of interest rates on debt serviceability. When viewed through the lens of serviceability, debt is less of a burden now than it has been at many times in the past. US public debt for instance continues to hover within the top 95th percentile of history when measured by stock as a % of GDP (currently 103% of GDP), whereas interest payments made by the US federal government to lenders is at the lower end of its historical range. A similar situation exists in other economic sectors, including Australian household debt (see charts 1 and 2).

Chart 1: US government debt serviceability



Source: Federal Reserve Bank of St Louis.

Chart 2: Australian household debt serviceability



Source: Reserve Bank of Australia.

With a focus on serviceability, it seems reasonable to believe that ***if*** (IF) interest rates remain low, or continue to fall, the stock of debt can maintain itself or indeed rise. The key point being that low rates are almost a precondition for the stock of debt to remain a benign economic factor. *Are low rates guaranteed?* Perhaps, but perhaps not. This is where time becomes a crucial factor. Central banks will only enjoy the grace of being able to hold rates low for as long as the inflationary landscape remains subdued. This in turn relies on a continuation of the lower supply and demand balance for consumer goods and services that has re-established itself over the past decade. And while commodity supply shocks might seem like the most acute risk to maintenance of the disinflationary consumption landscape, re-emergence of demand growth or a dampening of supply growth could shift the balance back toward an inflationary regime over time.

Interestingly, both the supply and demand side of the disinflationary tendency are both in the gunsight of populist policy. From a supply perspective, protectionist policy threatens to undo some of the global efficiency gains that have been made in many durable and non-durable consumer products; while fiscal loosening could prompt a re-emergence of rapid demand growth. Both sides of this coin are reflected in the populist agenda. Alongside fiscal stimulus, ongoing rapid consumption growth in the emerging world (particularly China) will continue to claim a growing part of finite resources. And while consumption growth in China has begun to slow, the rate of expansion and underlying base level are both high. Even with the slowdown, consumption growth in China continues apace at 8.3% pa (compared to 2.2% pa in the US) having grown to account for more than 30% of global consumption across a range of key consumer markets (eg auto, luxury and mobile phones). So, whereas investors have become accustomed to a disinflationary force flowing outward from China, over the coming years it is conceivable that the reverse will be true.

Returning to the influence of debt over risks to economic progress and investment outcomes, in our view both stock levels and serviceability matter; they just matter to different degrees over different time horizons. In this framework – and with the assumption that monetary policy still has potency to counter a revenue downturn - it becomes possible to square the notion that debt is both dangerous and safe. Safe, in so far as low interest rates will likely support serviceability in the near term, yet dangerous, in light of the vulnerability to higher rates should inflation move higher. At this point in time, posturing of key central banks makes us more open to the notion that a sustained rise in inflation is required to prompt a policy pivot. A close focus on CPI dynamics should help investors navigate when to begin switching emphasis from serviceability to stock when considering the investment strategy in the context of what is unarguably, at least by historical standards, a colossal stockpile of global debt.

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 policy makers do, how companies behave and how these things compare to investors' expectations.

By understanding the different ways in which the future might unfold we 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 GFC. But today, low starting bond yields mean they are at best poor diversifiers of share market risk and are outright risky in some circumstances.

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 ongoing volatility means we need to be nimble and rapidly re-assess positioning – though we still suspect further strong rises have a declining probability we recognise that animal spirits can mean that challenging news is ignored.

Our tailored scenario set is consistent with previous quarters' and we have been developing some shorter-term scenarios to examine more closely the dynamics of a changing and more volatile environment. We continue to be vigilant with respect to a coincident inflation pick-up across major economies. Another important issue is the strength of the forces supporting a continuing depreciation in the Australian dollar (AUD). Refer to Appendix 1 for the current tailored scenarios set.

Due to the prevailing distortions and policy uncertainty, the tailored scenarios contain more complexity and cover a wider range of outcomes for assets than would be the case from a less distorted starting point.

As explained above, the fundamental underlying challenge remains widespread high debt loads. This means that outcomes will not just pivot along inflation and growth 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, and the ways in which this could impact.

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.

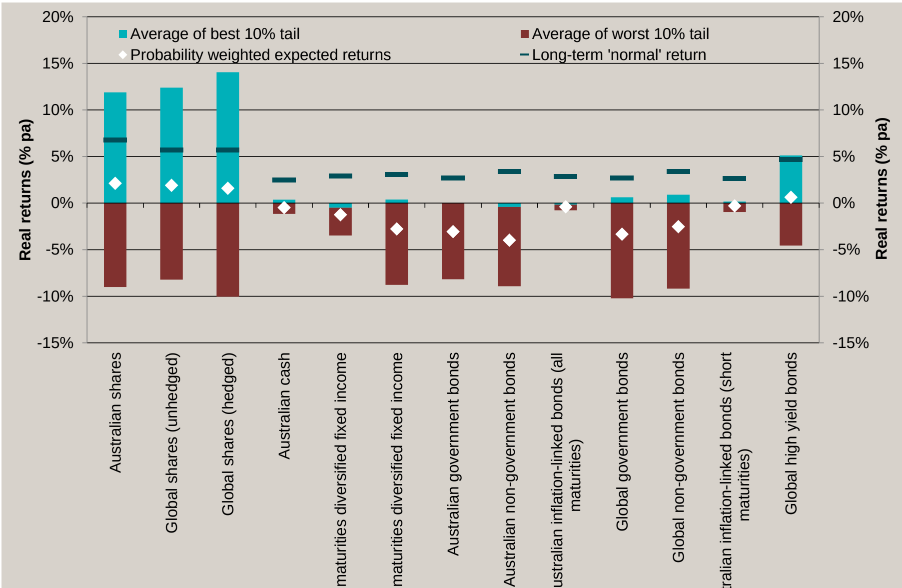
The generic set of scenarios is designed to have relevance from any starting point and provide a consistent barometer of risk and return through time. The smaller tailored set of scenarios pivot around the key characteristics and uncertainties in the current environment. The tailored set might be seen 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.

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 3.

Chart 3: 40 scenario set (generic scenarios) potential real returns (September 2019) – 5 years, 0% tax with franking credits, pre-fees, pre-alpha



Source: MLC Asset Management Services Limited.

Both global and Australian shares, while somewhat volatile during the September quarter, ended near where they began, leaving the return potentials across markets more or less unchanged from the June quarter. Looking within the global shares sector, most major markets (in local terms) were flat, with the exception of the UK (0.98%, FTSE 100 Total Return) and Japan (3.39%, TOPIX Total Return). However, while UK shares look attractive from a return point of view, escalation in Brexit risk suggests caution. Japanese shares on the other hand, despite the 2.36% price gain (TOPIX Price Return) experienced in the September quarter, continue to look attractive on a risk-reward basis across the scenarios, particularly on an unhedged basis. Part of this is valuation driven, and part is driven by the return profile of the Japanese yen (JPY).

Despite the lack of improvement in the return potential for Australian shares, we have taken the opportunity to increase exposure across the Inflation Plus portfolios due to the underlying defensive nature of the domestic shares portfolio run by MLC. The portfolio is invested in a way that maintains exposure to high yielding sources of return (such as domestic banks and utilities) but dampens the sensitivity to sector or business specific tail events through cost-effective hedging.

Global shares don't have the same concentration risk as the Australian share market. We've also been able to access a defensively-focused global shares manager for the Inflation Plus portfolios which aims to outperform the global market index via stock selection as well as providing risk control via the flexibility to hold cash and other assets if market opportunities are unattractive. We have however been disappointed that this defensive global shares strategy has not performed as well as expected - this is an important issue which we are well advanced in addressing.

Bond yields continued their decline in the third quarter as nominal growth expectations fell and central banks cut rates. As a result, the return potential for most fixed income sectors is less attractive now than at the end of the June quarter.

The probability-weighted real returns are shown in chart 3 (diamonds). Most share market sectors held steady quarter-on-quarter, while the return potential of bonds tended to decline further. For comparison we've included 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 4 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 September 2019.

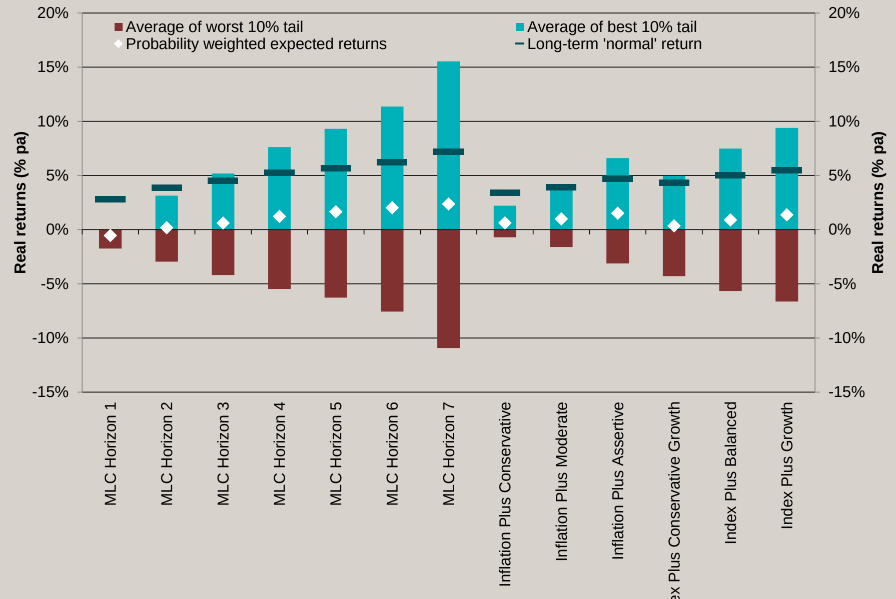
As with previous quarters, the chart shows that on average, looking across the whole scenario set, the potential reward for taking risk is depressed against what we would normally expect. Yet, while a low return is likely, it is not guaranteed. If real interest rates continue to decline and corporate earnings remain robust then it is reasonable to assume that strong investment returns will resume. In the event that a scenario with relatively higher returns does occur, the returns of 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 is more likely to disappoint rather than exceed 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 actively evolve the MLC Inflation Plus portfolios' allocations 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 4: 40 scenario set (generic scenarios) potential real returns (September 2019) – 5 years, 0% tax with franking credits, pre-fees, pre-alpha



Source: MLC Asset Management Services Limited.

The probability-weighted real returns are shown in chart 4 (diamonds). For comparison we've included 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.

Recent returns have been very modest, particularly relative to those generated in prior years. It's been a challenging time for our defensive positioning. We are seeking to extract higher returns by taking greater advantage of market declines, exploiting low market volatility which reduces the cost of options, keeping a focus on risk moderation in the defensive Australian shares portfolio (which permits a higher allocation), and carefully reviewing manager allocations and expected outcomes from those strategies across a range of scenarios. We are also responding to lower cash rates by reducing cash exposures while seeking to maintain adequate risk control.

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

Asset class	Change in target allocation to asset classes in the MLC Inflation Plus portfolios (in MLC MasterKey's super and pension products) over the 3 months ended 30 September 2019			Comment
	Conservative	**Moderate**	**Assertive**	
China A-shares with downside limit of -20% (through derivative strategies)	Steady (zero) allocation	**Higher allocation (+1.0%)**	**Higher allocation (+2.0%)**	We increased our exposure to the on-shore 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, 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 shares, this type of exposure has a favourable prospective payoff profile. This strategy has performed strongly during the past quarter.
Emerging market shares (through derivative strategies)	Steady (zero) allocation	Steady allocation	Steady allocation	Small emerging markets shares exposure.
Defensive Australian shares	Steady allocation	Steady allocation	Steady allocation	Our defensive shares investment process directly takes into account 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 derivative strategies)	Steady allocation	Steady allocation	Steady allocation	Tailored exposure to specific markets via futures and options.
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. Walter Scott, an existing manager in Inflation Plus Assertive, has been added to Conservative and Moderate to improve diversity of manager insight.
Foreign currency exposure	Call options protection maintained	Call options protection maintained	Call options protection maintained	AUD/USD upside protection maintained at a lower level.
Gold exposure (through derivative strategies)	**Higher allocation**	**Higher allocation**	**Higher 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. Exposure to gold is through our derivative strategies using futures.
Low correlation strategy	**Higher 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. In an environment of lower cash rates this strategy offers diversification of risk to the existing cash and credit exposures while

MLC Inflation Plus portfolios

Asset class	Change in target allocation to asset classes in the MLC Inflation Plus portfolios (in MLC MasterKey's super and pension products) over the 3 months ended 30 September 2019			Comment
	Conservative	**Moderate**	**Assertive**	
				avoiding additional share market risk.
Real return strategy	Steady allocation	Steady allocation	Steady allocation	Allocation to our multi-asset real return manager, Ruffer, maintained.
Global private assets	Steady allocation	Steady allocation	Steady allocation	The very high 'alpha' component of private equity returns is attractive in a return-constrained environment.
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.
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.
Global high yield bonds and loans	**Increased diversification**	**Increased diversification**	**Increased diversification**	Risks in the high yield bank loan market have become too concentrated so we've replaced with a more diversified exposure of floating rate high yield bonds and loans.
Global non-government bonds	**Increased allocation**	**Increased allocation**	**Increased allocation**	We've increased the duration of the portfolios by introducing a short duration exposure to global investment grade bonds.
Australian non-government bonds (short duration)	Steady allocation	Steady allocation	**Reduced allocation**	These short-duration bonds offer some return enhancement while limiting additional risk.
Cash	**Reduced allocation**	**Reduced allocation**	**Reduced allocation**	With lower central bank cash rates, exposures have been reduced.
Borrowings	Borrowing not permitted	Borrowing not permitted	No borrowings	Reward for risk is too limited.

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 and taking into account that over time a broad range of scenarios could play out. For setting our benchmark asset allocations we use our comprehensive 'generic' set of scenarios which comprises a broad set of distinctive potential futures which are not grounded in current conditions. 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 (taking into account current starting conditions) 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 partly from exposures to Inflation Plus, but also through deviations from benchmark fixed income allocations, though these have been reduced in size. We continually test our thinking, and we retain high conviction in the appropriateness of this positioning but recognise that the period of compressed bond yields could be prolonged. 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 share exposures and manage exchange rate risk. We are starting to reduce foreign currency exposures recognising the strong terms of trade and significant improvement in the current account.

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) target asset allocation at 30 September 2019			**Comment**
	Under	**Benchmark**	**Over**	
Australian shares	•			Small reduction from Australian shares to reduce home bias.
Global shares (unhedged)		•		The overweight to foreign currency has been reduced to benchmark weight this quarter. 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.
Cash			•	To reduce interest rate risk we've maintained an overweight to cash and underweight exposure to Australian and global bonds. We've taken this position in response to low bond yields, gradually rising risks of higher inflation and potential headwinds from a slow tightening in monetary conditions. With lower central bank cash rates, we have been reducing our overweight to cash.
Australian bonds - all maturities	•			Underweight to longer duration Australian bonds, to reduce interest rate risk, was maintained but has been moderated.
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.
Global bonds - all maturities	•			Underweight to longer duration global bonds, to reduce interest rate risk, was maintained but has been moderated.
Global non-investment grade bonds (high yield bonds and loans)		•		Retain benchmark allocation.
Global private assets		•		Retain benchmark allocation.

MLC Horizon portfolios

	MLC Horizon 4 Balanced Portfolio (in MLC MasterKey's super and pension products) target asset allocation at 30 September 2019			Comment
	Under	**Benchmark**	**Over**	
Real return strategies (including Inflation Plus)			•	MLC Horizon 2 to 5 portfolios remain overweight real return strategies, Horizon 6 and 7 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.

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 and taking into account that over time a broad range of scenarios could play out. For setting our benchmark asset allocations we use our comprehensive 'generic' set of scenarios which comprises a broad set of distinctive potential futures which are not grounded in current conditions. 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 (taking into account current conditions) 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 (which have been reduced in magnitude) and allocation to the real return strategy. We continually test our thinking, and we retain high conviction in the appropriateness of this positioning but recognise that the period of compressed bond yields could be prolonged.

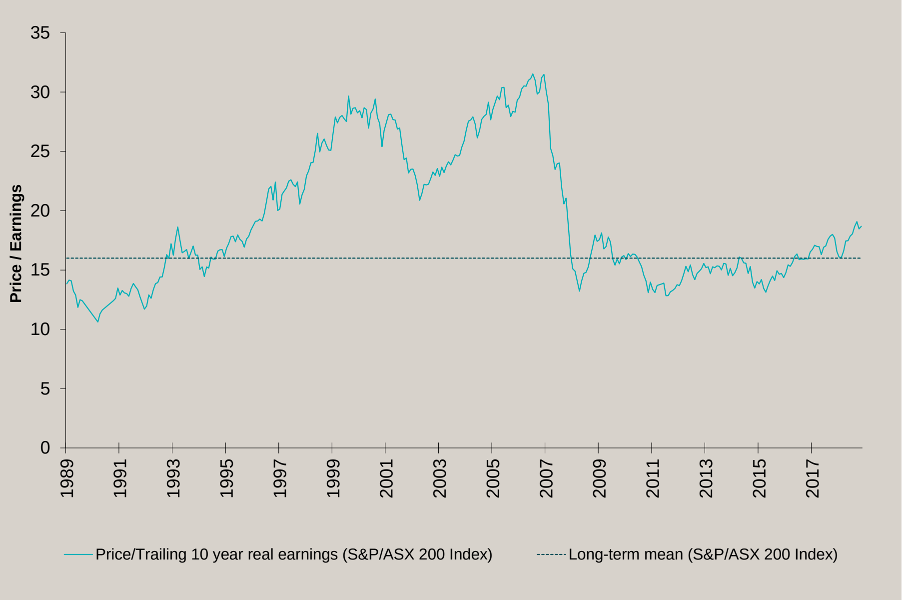
Here is a summary of the positioning of the MLC Index Plus Balanced Portfolio.

	MLC Index Plus Balanced Portfolio target asset allocation at 30 September 2019			**Comment**
	Under	**Benchmark**	**Over**	
Australian shares	•			Slight underweight to reduce home bias.
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. The overweight to foreign currency has been reduced this quarter.
Global shares (hedged)	•			
Global property securities		•		Retain benchmark allocation – the benchmark allocations are underweight versus peers.
Cash			•	To reduce interest rate risk in all Index Plus portfolios we've maintained an overweight to cash and underweight exposure to Australian and global bonds. We've taken this position in response to low bond yields, gradually rising risks of higher inflation and potential headwinds from a slow tightening in monetary conditions. With lower central bank cash rates, we have been reducing our overweight to cash.
Australian bonds – short maturities			•	Overweight increased.
Australian bonds – all maturities	•			Underweight to longer duration Australian bonds, to reduce interest rate risk, was maintained but has been moderated for all Index Plus portfolios.
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 increased.
Global bonds - all maturities	•			Underweight to longer duration global bonds, to reduce interest rate risk, was maintained but has been moderated for all Index Plus portfolios.
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.

Asset class indicators

Commentary on the main asset classes follows.

Chart 5: Australian shares

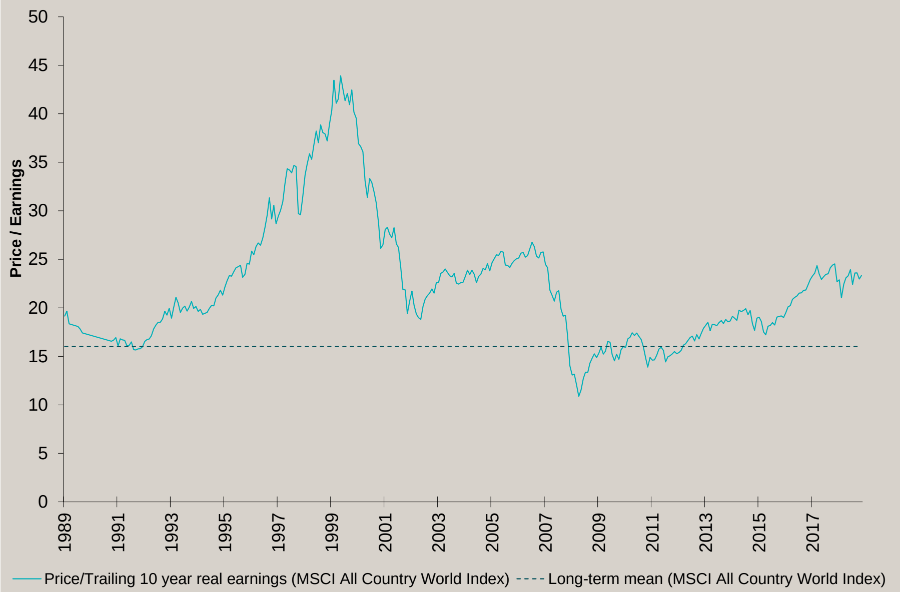


Source: Global Financial Data.

Australian economic data released in the September quarter were modest. Australia's real economic growth was only 1.4% in the year to June 2019. This is the weakest annual growth since 2009 and is well below Australia's potential growth rate of circa 2.7%. Housing construction continues to fall while consumer spending remains sedate. However, a strong export performance and solid government spending remain the key positives. There are also more promising signs with Australian house prices making solid gains in recent months after the interest rate cuts in June and July by the Reserve Bank of Australia.

Australian shares made a solid return of 2.4% for the quarter. Essentially the benefit of lower cash interest rates and bond yields has countered the key concerns over the health of the Australian economy. A surge in the Consumer Staples (11.6%) and Health Care (7.0%) sectors have led the Australian share market's gains. However lower iron ore prices with Chinese growth concerns has seen the Resources sector disappoint with a 3.7% fall.

Chart 6: Global shares



Source: FactSet.

Global shares (unhedged) made a strong return of 4.2% over the past three months to September 2019. The sharp 3.9% fall in the AUD against the US dollar (USD) was the primary driver for these strong global share returns. Encouraging comments from the US and European central banks suggesting lower interest rates were also helpful, allowing global shares (hedged) to make a positive but more modest 1.0% return in local currency terms.

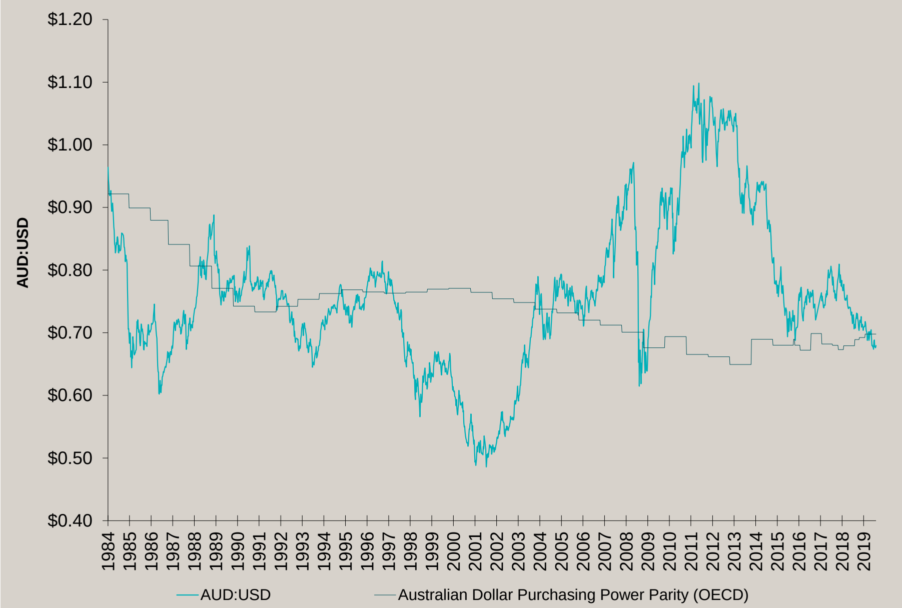
US shares made record highs in July with expectations that slowing global growth and muted inflation pressures would allow the US Federal Reserve (Fed) to lower interest rates. The Fed consequently cut US interest rates by 0.25% in both July and September. However, trade tensions between the US and China returned in August. This trade tension has generated considerable volatility in global share markets. After raising tariffs in August and threatening further measures, there have been some calmer trade signals between the US President Donald Trump and China's President Xi Jinping in September. Both sides have agreed to resume trade negotiations in October. Notably the announcement of a Congressional impeachment inquiry into President Trump also caused considerable volatility in global financial markets in the final week of September.

European shares made solid returns despite considerable political concerns. Britain's pending exit from Europe (Brexit) dominated the headlines. However, investors gained comfort from the European Central Bank (ECB) signalling in July that interest rates are set to fall. The ECB subsequently cut interest rates by 0.1% and resumed their government bond purchase program in September.

Emerging market shares disappointed with a weak -0.2% return over the quarter. Trade tensions and economic slowdown signs evident in China and the South American economies remain headwinds.

Asset class indicators

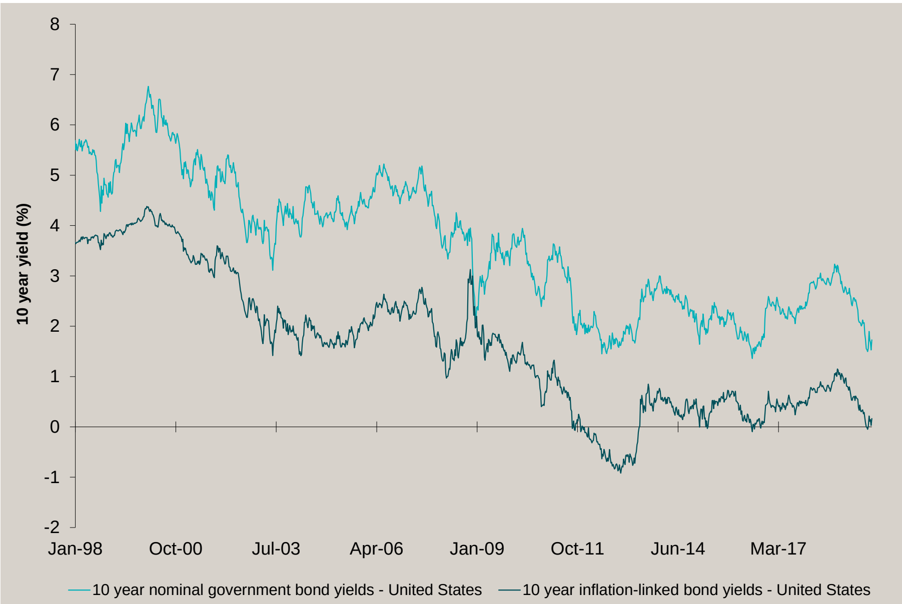
Chart 7: Australian dollar



Source: Bloomberg.

The AUD continued to fall against the USD in the September quarter. Weaker global economic activity data, softer commodity prices and the Reserve Bank of Australia cutting Australian interest rates all served to cast a shadow over the AUD.

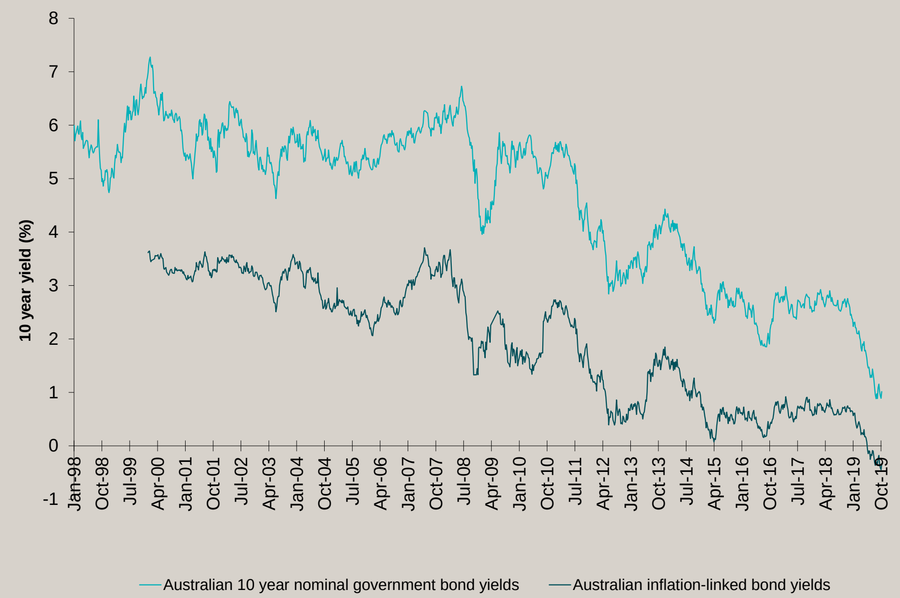
Chart 8: Global government bonds



Source: Bloomberg.

Global bonds (hedged) delivered a solid return of 2.3% for the quarter. Softer economic activity and business survey data in Asia and Europe as well as mild inflation data led to a sharp downward shift in government bond yields.

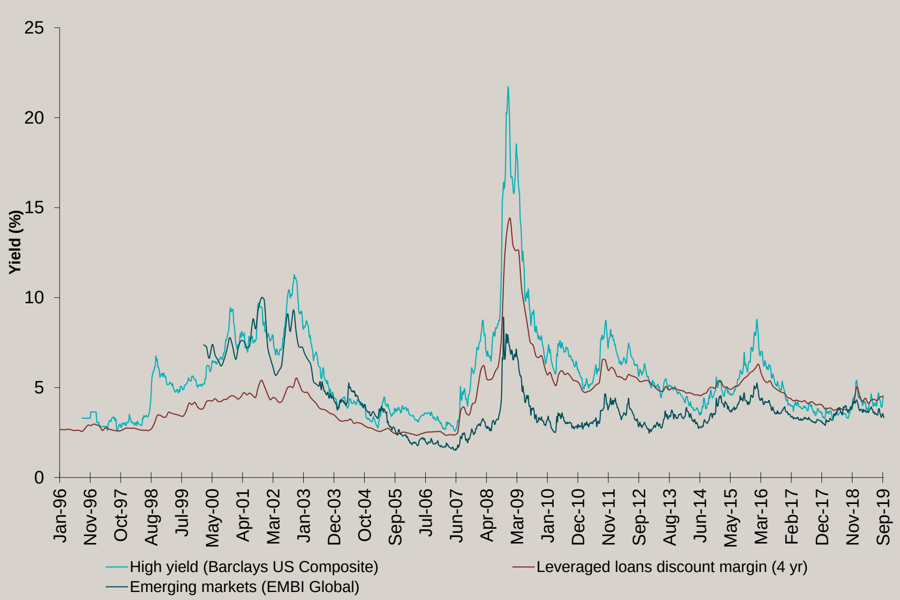
Chart 9: Australian government bonds



Source: Bloomberg.

Australian bonds managed a solid return of 2.0% for the quarter. Sedate Australian economic activity data and mild inflation have been particularly supportive of lower bond yields and interest rates.

Chart 10: Non-investment grade bonds



Source: Credit Suisse, Barclays and Bloomberg.

Global high yield bonds (hedged) delivered a positive return of 0.8% for the quarter. Credit markets were buffeted by global growth and trade concerns but have managed to remain generally resilient.

Appendix 1 – Tailored scenario set

Scenario	Probability ranking (previous rank)	Description
Inflationary debt resolution	1 (1)	Forces tending to push inflation higher include monetary and fiscal policy, demographics and populism. Central banks prefer inflation over deflation, and are increasingly signalling a tolerance for inflation above target levels. Fiscal stimulus is the most reliable way to increase inflation. Higher demand for labour where labour markets are tight, puts upward pressure on wages which supports demand but squeezes profit margins. Where interest rates (on debt) are lower than the rate of nominal growth, debt burdens can decline. This is a longer-term scenario that at times will seems less relevant.
Extended monetary stimulus	2 (3)	Central banks reduce rates in response to growth weakness. Asset prices rise. Escalation of trade concerns could see an additional increase in fiscal stimulus which is the most effective policy for targeting higher inflation. The mix of real growth and inflation that results are pivotal for market returns. Initially asset prices rise, but nominal growth recovery proves challenging for bond markets.
Three speed global economy (China soft landing)	3 (2)	With or without a trade war, 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 (if orderly or no Brexit) grow at or above trend; while Europe continues to stagnate. Japan struggles to escape stagnation with inadequate fiscal stimulus – the value-added tax (VAT) increase is implemented. Strong USD and AUD vs JPY and EUR.
Slower global growth deleveraging	4 (4)	A prolonged and slow consumer deleveraging. Slowing consumption growth and falling nominal prices extend the deleveraging cycle. There is persistent slow growth and further disinflation in the developed world which spills over into the now highly indebted emerging world. An escalation of trade concerns results in weak confidence and growth.
Inflation shock	5 (5)	Economic growth recovers and the inflation rise (in the US in particular) surprises prevailing inflationary expectations.
Synchronised moderate growth	6 (6)	Japan's and Europe's growth approach trend levels, while the US, UK and China moderate, resulting in a synchronised modest global growth scenario. This scenario may rely on increased fiscal stimulus – this seems least likely in the eurozone at present.
Reform (path to growth normalisation)	7 (7)	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). In light of recent policy initiatives, the US and UK (if there is no disruptive Brexit) 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.
Brexit & risk of eurozone slow disintegration (possibly leading to reform)	8 (8)	Following on from Brexit, 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 - this possibility is captured in the **Reform** scenario.
Extended risk aversion	9 (9)	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 now include policy disappointment, in particular, a protectionist Trump presidency with rising tension with China.
Australian stress	10 (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 overextended residential property market, a worst-case scenario is loss of confidence in Australia, causing funding stress to banks, which requires central bank intervention.
Rise in USD risk premium	11 (11)	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/US) provide the potential for a bond-vigilante style rerating 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

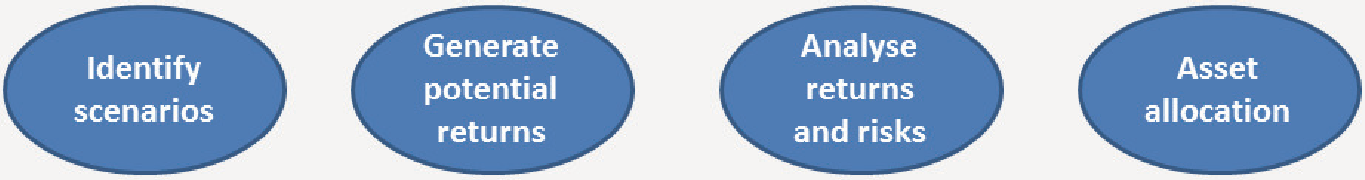
Scenario	Probability ranking (previous rank)	Description
		to a prolonged stagnation scenario. AUD strong but does not re-visit highs vs USD.
Stagflation	12 (12)	With no clear roadmap for the withdrawal of policy stimulus, the inflation risks from quantitative easing may be much bigger than are currently appreciated. In this scenario, policy stimulus is not withdrawn fast enough, perhaps coupled with increased policymaker tolerance for an inflationary workout (due to a much stronger aversion against deflation than inflation) which gets out of hand. Runaway 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 1970s. The US economy is getting closer to the point at which an inflationary policy mistake could occur.
Early re-leveraging	13 (13)	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 employment rises. 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**.
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 inflationary 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.

We welcome your feedback on this document.
If you have any comments, please email us at ben.mccaw@mlc.com.au or susan.gosling@mlc.com.au