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MLC's scenario insights & portfolio positioning

MLC Horizon, MLC Inflation Plus and MLC Index Plus portfolios

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Update for the quarter ending
31 December 2019.

Quarterly insights

After a severe sell off in the third quarter of 2018, markets did what they typically do and rallied strongly in 2019. While it is lazy to dismiss the recovery as Pavlovian buying, it is near certain that the core driver of market satisfaction in 2019 was an early year U-turn in US Federal Reserve (Fed) policy. With policy once again standing firmly behind financial markets, the familiar stimulus for risk taking yet again offered a floor for nervous markets. While we never know the counterfactual, it is difficult to imagine that markets could have climbed the 'wall of worry' created by trade tension without support from the Fed. Particularly with company earnings growth in 2019 being lacklustre at best.

At the time of the December quarter 2018 sell-off and following on from a long period of a very low federal funds rate, the Fed was on a path toward rate normalisation. The US economy was neither hot nor cold, wage pressure was contained to narrow segments within the services sector, and inflation expectations were well anchored at a low level. With the policy treading a path toward normalisation without support from either overt or budding consumer or wage price pressures, finding a point of equilibrium for the overnight policy rate was always going to be a forbidding challenge for the Fed's Chair Jerome Powell and the Board. Policy, in effect, lacks a functional compass for the time being. Low rates have not begotten extreme inflation, nor set off a leverage cascade. And what is measured as near full employment has not caused significant wage tension in the broader labour market. With this as the backdrop both the Board and investors had no real basis to assess where policy normalisation might end. For now policy setting is perhaps, more than ever, a function of risk markets rather than fundamental gauges of price stability and labour market optimisation. And while this is not novel, it is more explicit. Since former Fed Chair Alan Greenspan chaired the Fed, investors have become conditioned to expect market support from Fed policy. But in earlier times there was a greater link between economic fundamentals that mattered for the Fed and markets.

Comprehending the ability of central banks to offset growth uncertainty is, without doubt, a critical factor in setting investment strategy. Yet investors must remain attuned to the demarcation between the risks central banks can offset, and those they can't. Extreme geopolitical risk is a case in point. Indeed geopolitical risk perhaps matters most when investors have become conditioned to rely on central banks doing whatever it takes to restore calm and liquidity to markets – for a rise in risk aversion sparked by conflict presents a difficult proposition even for the tactful team of developed market central banks. If history and fundamentals are a guide, conflict brings with it the tax bogeyman of supply side inflation, further complicating the tactical plan for stimulatory monetary policy.

And while monetary policy played a key hand in reflating financial markets in 2019, it was arguably geopolitics that provided the opportunity to buy cheaper assets in the third quarter of 2018. China and the US had begun to seriously lock trade horns together while the Fed was still on a hiking path. At the time, it was unclear the extent to which implementation of disruptive trade policy would inflict collateral damage on the US economy, just as it was unclear how much steam would be removed from China's economic growth engine and how this might feed back into the impetus toward normalisation. It was also unclear just who held the upper hand in the standoff – although then, as now, the cards seem to be stacked in China's favour.

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.

Brexit case study...a key political watchpoint for our portfolios

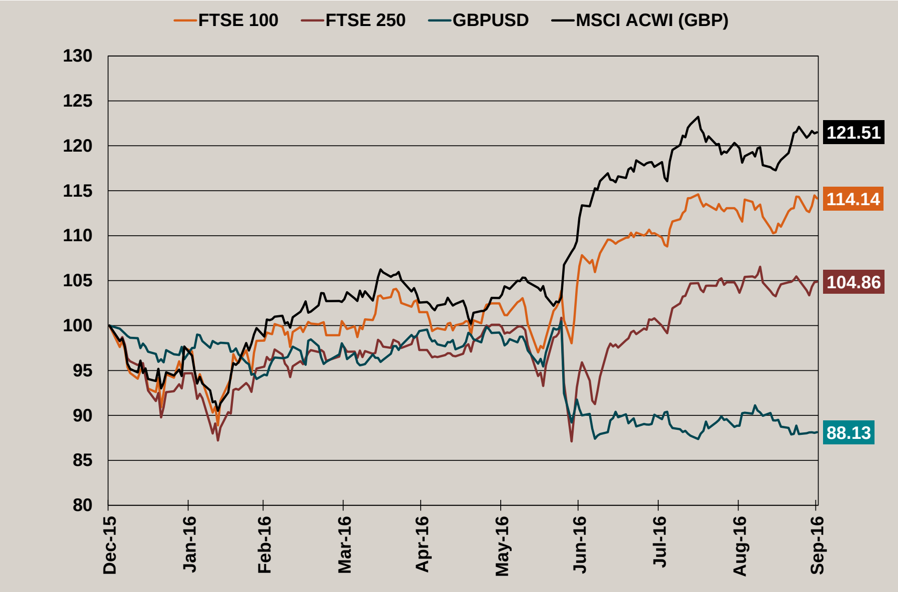
An important political watchpoint over the quarter has been developments in relation to Brexit. Brexit remains an important risk warranting attention for it being a microcosm of the affect populism has on policy action and subsequent financial market sentiment.

Brexit echoes the same message that was sent by a US heartland that ushered in a President Donald Trump administration – and by extension the US-China Trade War – in that globalisation has been an experiment that has abandoned many in the non-service sector and contributed to accelerated wealth disparities. Simplistically, if globalisation has not helped these people, then it is understandable to think that anti-globalisation (protectionism and anti-immigration) will be the remedy. Herein lies the investment risk, as the proliferation of anti-globalisation introduces greater impediments in the efficient allocation of capital and resources which subsequently impact economic growth for the UK and globally.

A disorderly hard Brexit can pave the way for these risks to become the new norm for not only how the UK and European Union economies function going forward, but also have spill over effects into the rest of the world. Whilst these factors would play out over the medium term, shorter-term impacts would likely see material downside pressures on asset prices, as evidenced by the sterling and other UK assets in response to the result of the 2016 Brexit referendum (chart 1), as well as the ongoing seesaw of global shares in response to any developments to the US-China Trade War (chart 2). This backdrop of global macro and UK-specific risks has direct impact to our portfolios, particularly to those with direct exposures to the sterling and UK domestically-orientated assets.

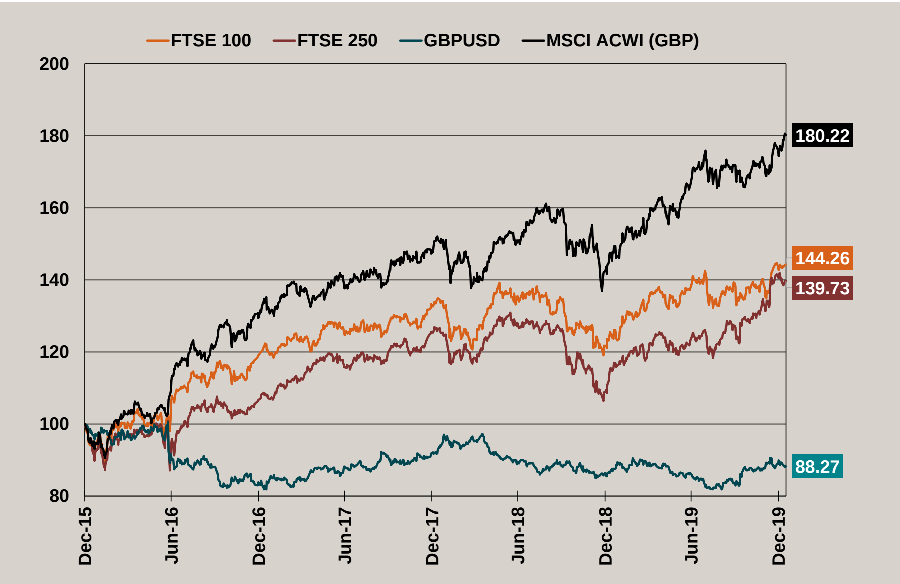
Quarterly insights

Chart 1: Material downside pressures on asset prices caused by shorter-term impacts – Brexit referendum



Source: FactSet, indices rebased to 100 on 31 December 2015.

Chart 2: Material downside pressures on asset prices caused by shorter-term impacts – US-China Trade War

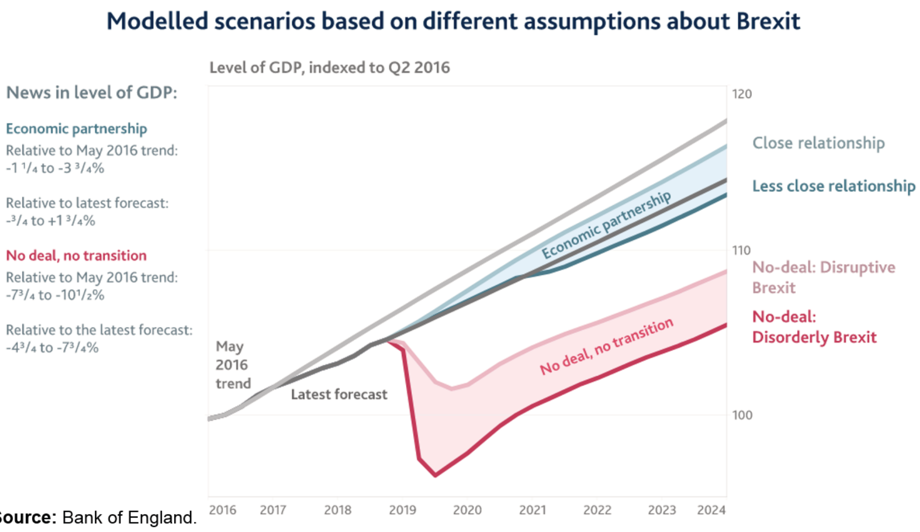


Source: FactSet, indices rebased to 100 on 31 December 2015.

So, is the solution to de-risk portfolios, with a focus on de-risking from the UK? Perhaps, but perhaps not.

Firstly, despite the simplicity of the initial referendum options, the path to resolving Brexit is multifaceted with different endpoints. These range from the previously mentioned disorderly 'hard' Brexit to a milder 'disruptive' Brexit all the way to a 'soft' Brexit – a Brexit in name only, whereby many of the same arrangements still exist – and even potentially a 'no-exit'. All these paths have different economic and financial market effects that are captured in chart 3. It's worth highlighting that while there is a significant tail risk associated with Brexit, there are also upside risks if the resolution is more optimistic than markets have priced in. No doubt, this would be positive for the sterling and UK shares, which are trading at discounts relative to global peers.

Chart 3: Bank of England Brexit scenarios analysis



Source: Bank of England.

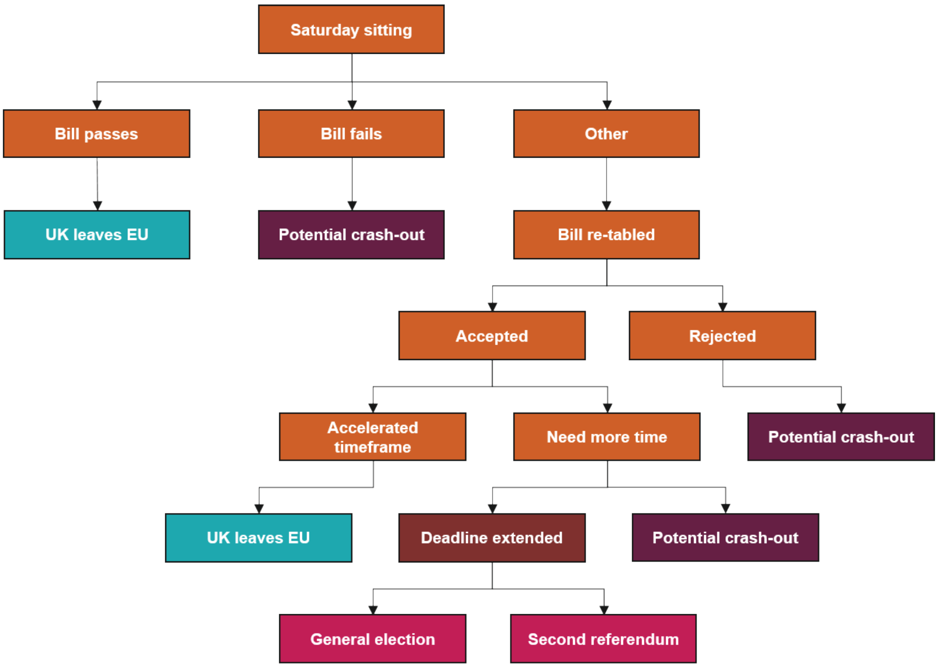
Secondly, removing a portfolio's exposure to any risk will result in a risk-free return – which is close to zero in the current environment – and worse still when you consider inflation risk. This is 'risk management' in face value only and instead the focus should be on which risk exposures for portfolios to take on and how those exposures are constructed.

Finally, although the risks appear clear, it's critical to understand the nature of the exposures within our portfolios to appropriately assess whether any portfolio changes are required. While the currency exposure is straightforward, the exposure to domestically orientated UK shares is delivered via Ruffer LLP – an underlying multi-asset real return manager within our MLC Inflation Plus portfolios. As a result, the equity risk needs to be considered in tandem with Ruffer's other exposures which act as a 'partial hedge' to the shares in the portfolio.

Mitigating Brexit risks in our portfolios

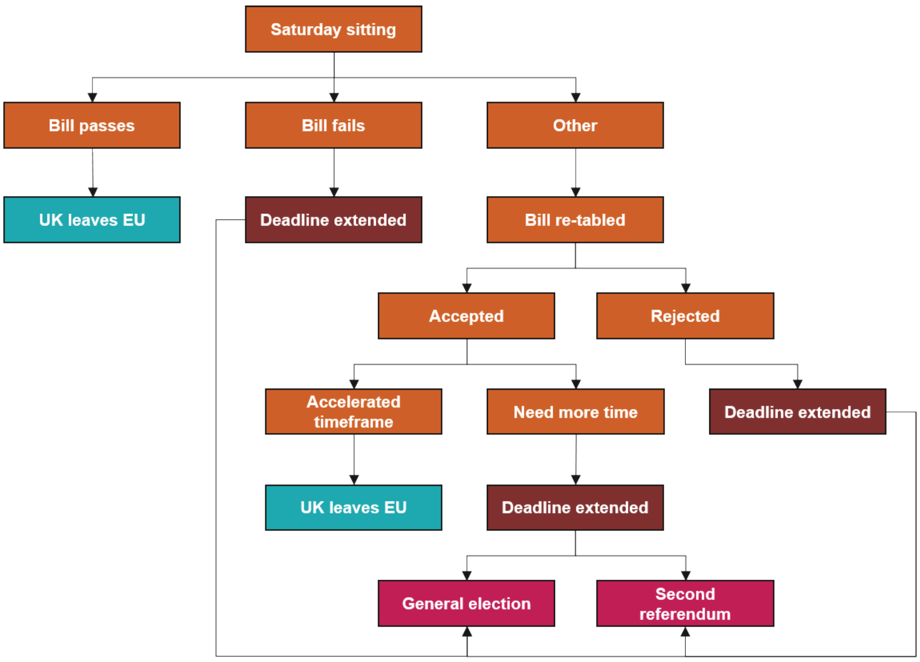
In light of these considerations, we explored ways of managing our Inflation Plus portfolios' risks. We considered reducing sterling and buying low-cost put options over the UK shares in the portfolios. A key contingency for the use of derivatives was whether voting on British Prime Minister Boris Johnson's Brexit deal would be done under the threat of a disorderly hard Brexit as the default if nothing could be put forward before the 31 October 2019 deadline. If this was the case, the put options would be purchased. If not, the options would not be purchased and the situation would be monitored to assess whether the path to a hard Brexit was probable. Charts 4 and 5 demonstrate the different paths to various Brexit outcomes under the different default solution scenarios.

Chart 4: Brexit roadmap with hard Brexit as the default solution scenario



Source: MLC Asset Management Services Limited.

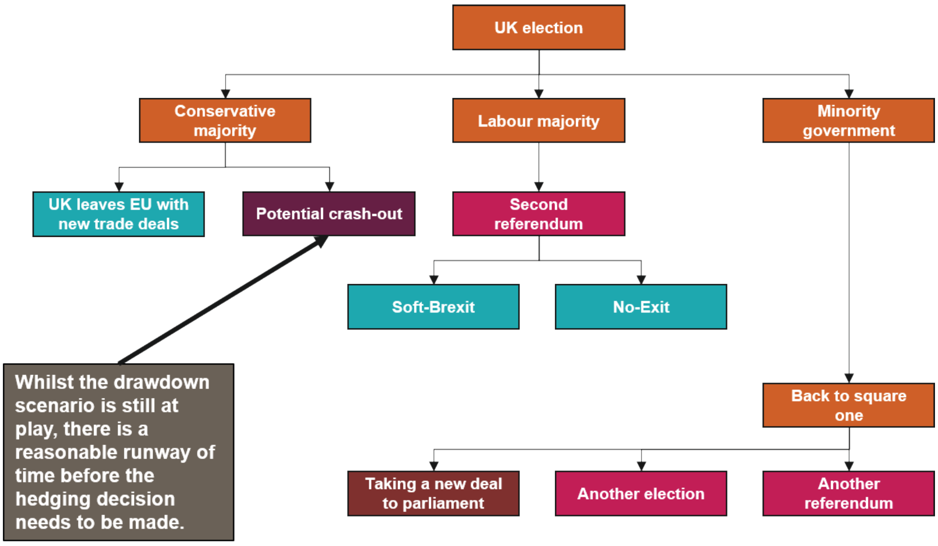
Chart 5: Brexit roadmap with extension as the default solution scenario



Source: MLC Asset Management Services Limited.

History will show that reality followed chart 5, whereby the path to a hard Brexit was deferred to the future – the same outcome for the decision for purchasing put options – pending the outcomes from the December 2019 UK general election. Chart 6 shows a roadmap for the UK election. Even though the risk event in concern is still at play, the path to this scenario is contingent on the UK electing to not extend their negotiation timeframe – by the allowable deadline – as part of the government's new Withdrawal Agreement Bill (WAB) which, if passed, will take the UK out of the European Union on 31 January 2020. This will require that Brexit remain on investor's radars throughout 2020 as the post-Brexit transition begins on 31 January.

Chart 6: UK election roadmap



Source: MLC Asset Management Services Limited.

After three years of Brexit fatigue and uncertainty plaguing both investment markets and UK business decision-making, investors could be forgiven for questioning whether the effort and attention put to this is value-adding for portfolios. However, with return potential across assets at some of their lowest levels in history combined with limited diversifying investment opportunities, UK assets (shares in particular) present themselves as an opportunity – both due to their discounted starting valuations and high dividend yield relative to other developed share markets. While the sterling posted healthy gains in the run-up to the election, its reaction to the WAB to restrict further extensions to negotiations saw the sterling retrace. The market had overemphasised short-term relief to uncertainty regarding Brexit and underappreciated that at its core, the hard Brexit scenario was still at play – still shrouded in smoke and mirrors. This serves as a telling reminder of the significance of understanding potential scenarios in understanding the risk embedded in assets.

So, where to from here? With the amended WAB passing the House of Commons late December, watchpoints lie with the bill's ratification through January. Beyond this, progress on UK and European Union trade negotiations will be integral, especially the decision to delay with a deadline of 1 July 2020. Amongst this, the importance of economic data and earnings fundamentals cannot be forgotten.

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. These shorter-term scenarios will complement our existing generic broad set of 40 scenarios. We continue to be vigilant with respect to an unexpected rise in inflation, although we also appreciate that deflationary forces continue to dominate consumer prices. 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.

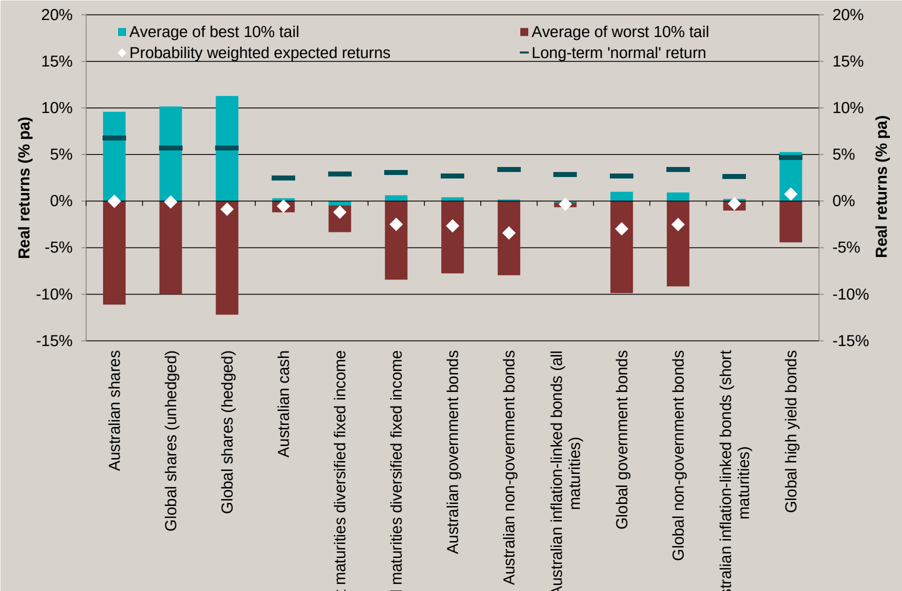
The generic set of scenarios is designed to have relevance from any starting point and provide a consistent barometer of risk and return through time. The smaller tailored set of scenarios pivot around the key characteristics and uncertainties in the current environment. The tailored set might be seen 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 7.

Chart 7: 40 scenario set (generic scenarios) potential real returns December 2019) – 5 years, 0% tax with franking credits, pre-fees, pre-alpha



Source: MLC Asset Management Services Limited.

Both global and Australian shares rose faster than earnings growth in the December quarter, causing valuations to expand. At times of valuation expansion, the return potential of shares typically declines.

Despite the deterioration in the return potential of Australian shares, we continue to maintain the increased exposure established across the Inflation Plus portfolios in the first half of 2019. These portfolios are 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.

In response to the strong performance of the US share market, we took the opportunity to take some profit from a defensively structured option exposure to the S&P500 Index. In addition to extracting some profit from the position, the restructured exposure is more defensive than the original strategy.

Longer-dated bond yields rose in the second half of 2019 as yield curves steepened. As a result, the return potential for most fixed income securities improved from the June quarter, although most nominal bond sectors still remain unattractive from a risk-reward point of view.

The probability-weighted real returns are shown in chart 7 (diamonds). The return potential of most share markets declined over the quarter, while the return potential of bonds tended to rise slightly. 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 8 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 December 2019.

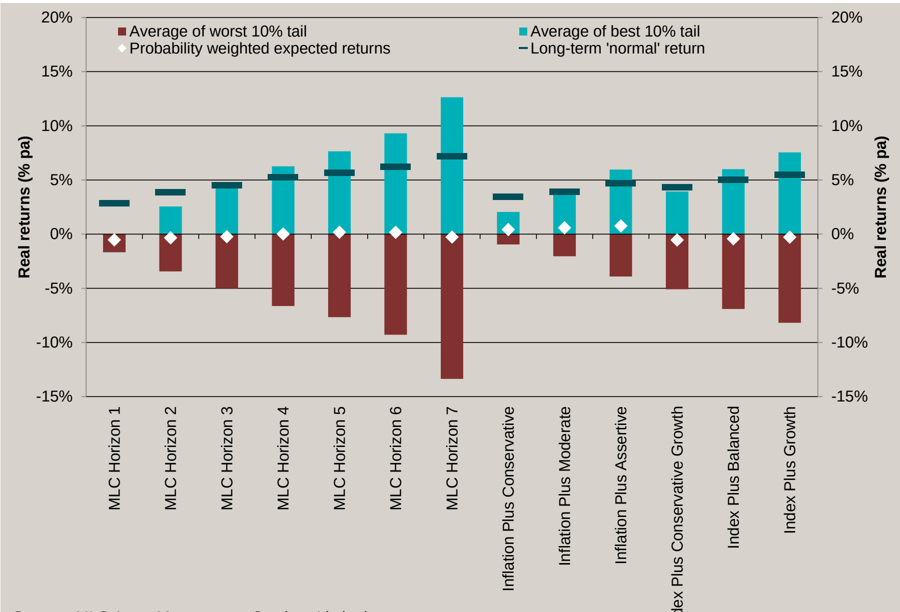
As with previous quarters, the chart shows that on average, looking across the whole scenario set, the potential reward for taking risk is depressed against what we would normally expect. Yet, while a low return is likely, it is not guaranteed. If real interest rates continue to decline and corporate earnings remain robust then it is reasonable to assume that strong investment returns will continue. 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 8: 40 scenario set (generic scenarios) potential real returns (December 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 8 (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.

The strong returns to growth assets in 2019 even helped defensively positioned portfolios perform above long-term expectations. Yet, despite the strong year, both three and five year performance of our Inflation Plus portfolios remain slightly below our expectations. 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 31 December 2019**			**Comment**
	Conservative	**Moderate**	**Assertive**	
China A-shares with downside limit of -20% (through derivative strategies)	Steady (zero) allocation	Steady allocation	Steady allocation	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 including a defensively structured option on the S&P500 Index.
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)	Steady allocation	Steady 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. Exposure to gold is through our derivative strategies using futures.

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 31 December 2019			Comment
	Conservative	**Moderate**	**Assertive**	
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 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	Steady allocation	Steady allocation	Steady allocation	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	Steady allocation	Steady allocation	Steady 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	Steady allocation	These short-duration bonds offer some return enhancement while limiting additional risk.
Cash	**Lower allocation**	Steady allocation	Steady 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 31 December 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 maintained at 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 31 December 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.

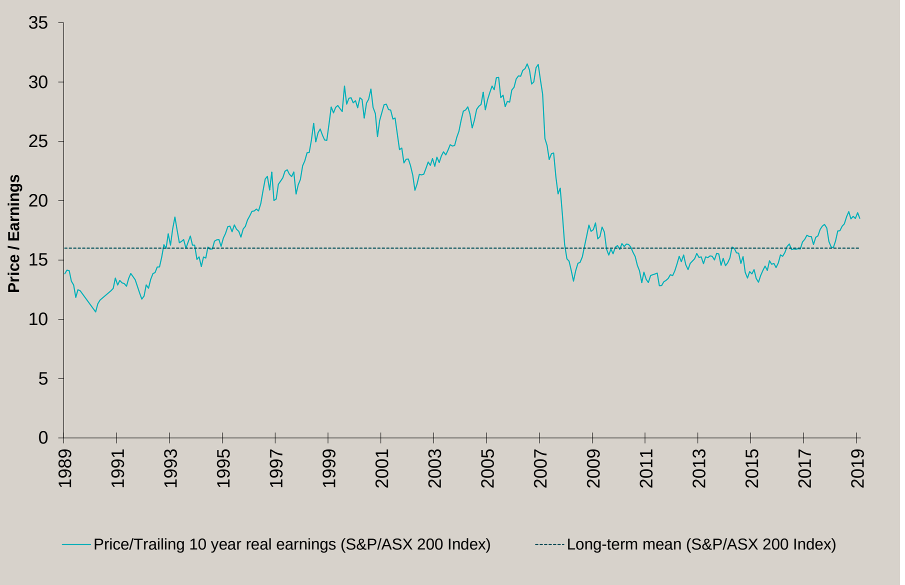
Here is a summary of the positioning of the MLC Index Plus Balanced Portfolio.

	MLC Index Plus Balanced Portfolio target asset allocation at 31 December 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			•	Underweight to longer duration Australian bonds and overweight to shorter duration Australian bonds, to reduce interest rate risk.
Australian bonds – all maturities	•			
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			•	Underweight to longer duration global bonds and overweight to shorter duration global bonds, to reduce interest rate risk.
Global bonds - all maturities	•			
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 9: Australian shares

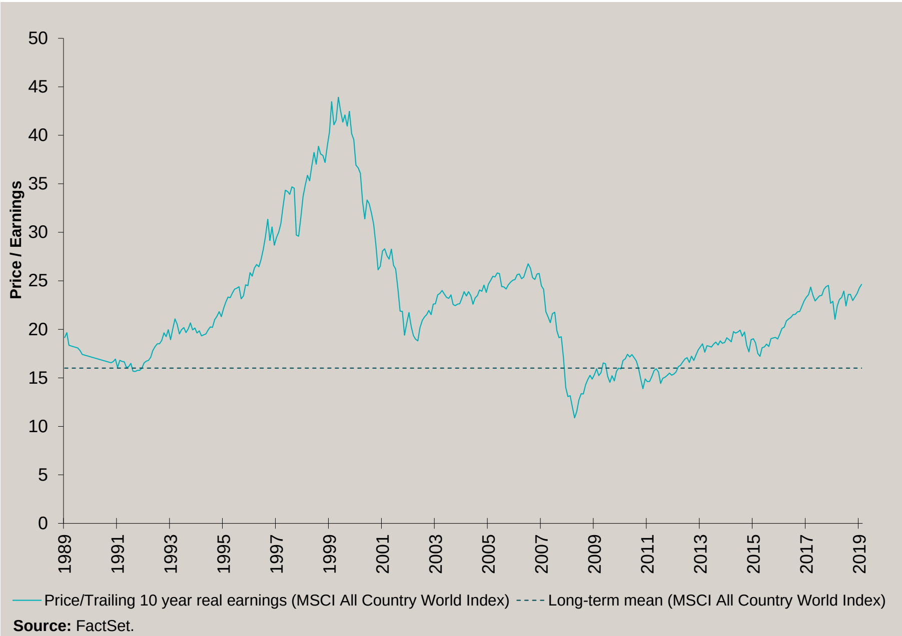


Source: Global Financial Data.

Recent Australian economic data releases have been disappointing. Housing construction and car sales are weak while consumer spending remains sedate. Jobs growth has slowed and the unemployment rate has edged upwards to 5.2%. The Reserve Bank of Australia cut the cash interest rate to a historic low of 0.75% in October in response to slow economic activity and mild inflation. There have been some more promising signs with the rebound in house prices in response to lower interest rates.

Australian shares made a positive gain of 0.7% for the December quarter. Essentially the benefit of lower Australian interest rates and a revival in housing prices are being counterbalanced by concerns over the health of the Australian economy. A surge in the Health Care (14.0%) and Energy (6.4%) sectors were key positive contributors. However the Financial (-6.4%) sector performance was particularly disappointing as concerns over consumer spending and future credit demand weighed.

Chart 10: Global shares



Global shares (unhedged) made strong returns of 4.6% over the past three months to December 2019. Lower interest rates from key central banks and positive expectations that the US-China trade dispute are resolved were beneficial for shares.

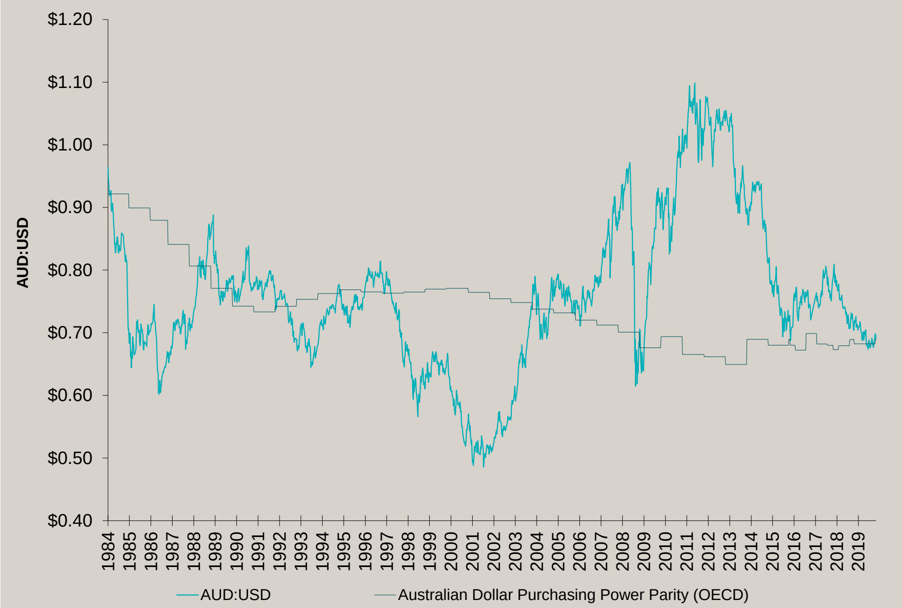
US shares made new record highs during the quarter with the tailwind of lower interest rates and trade tensions. The US Fed lowered interest rates in both September and October. Trade tensions between the US and China also appear to have moderated with a “phase one agreement” between the US President Donald Trump and China’s President Xi Jinping. Notably the announcement of a Congressional impeachment inquiry into President Trump only caused temporary volatility in global financial markets.

European shares made solid returns despite considerable political concerns. Britain’s pending exit from Europe (Brexit) and the general election on 12 December were prominent issues. However, investors gained comfort from the Conservative Party gaining a large parliamentary majority in December’s election as well as the European Central Bank cutting interest rates in September.

Emerging market shares (unhedged) made a very strong recovery returning 7.4% over the quarter. Hopes that trade tensions are resolved and lower global interest rates proved supportive.

Asset class indicators

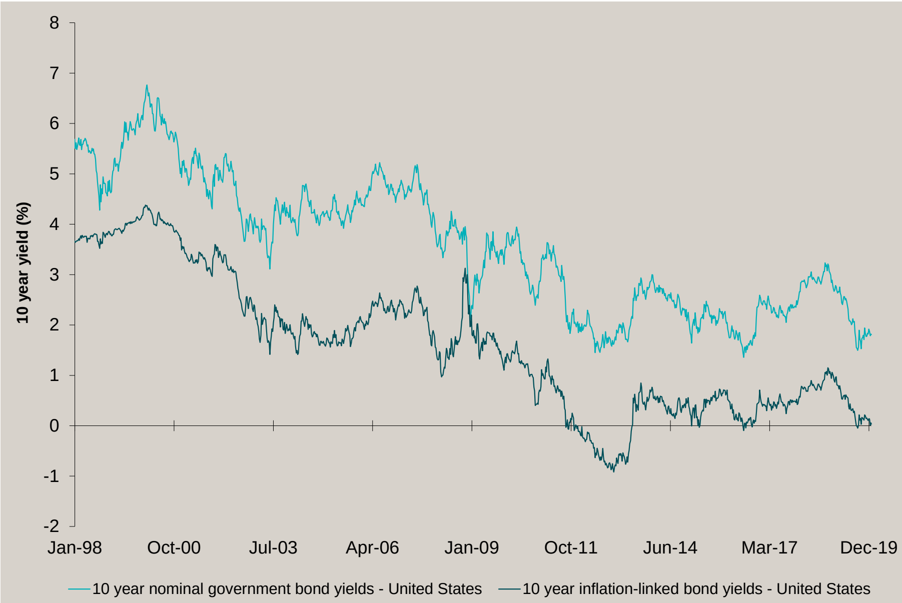
Chart 11: Australian dollar



Source: Bloomberg.

The AUD made sharp gains in the December quarter. Lower interest rate settings by the US and European central banks and positive expectations that the US-China trade dispute is being resolved were particularly beneficial for the AUD.

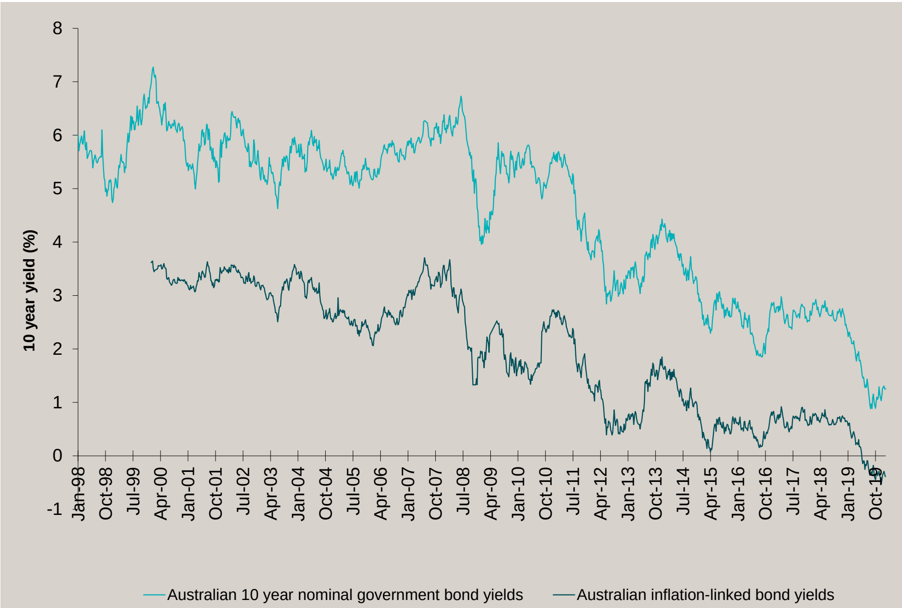
Chart 12: Global government bonds



Source: Bloomberg.

Global bonds (hedged) delivered a weak return of -0.8% for the quarter. Strong gains in global shares and hopes for a trade agreement diminished investor's appetite for low yielding government bonds.

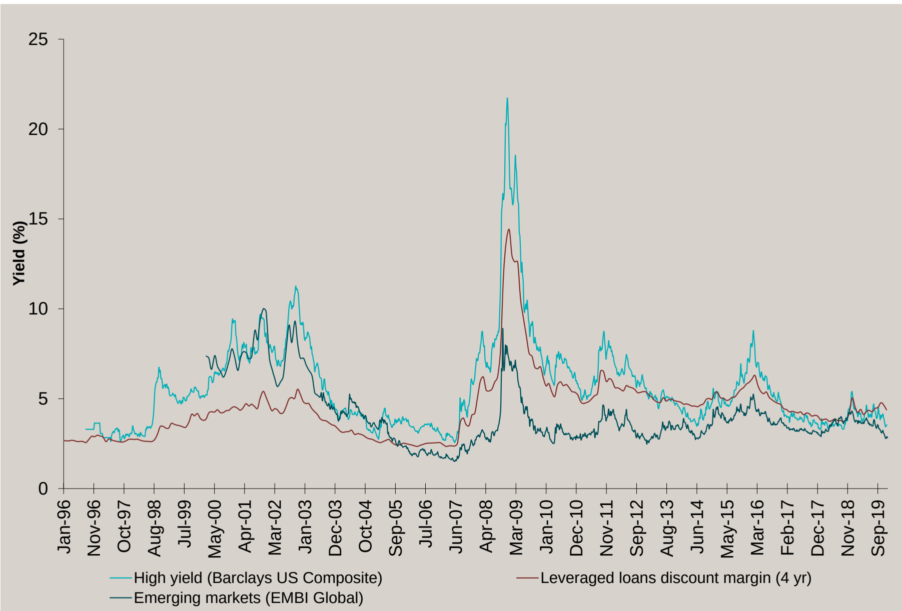
Chart 13: Australian government bonds



Source: Bloomberg.

Australian bonds provided a disappointing return of -1.3% for the December quarter. While recent Australian economic data releases have been soft with weak housing construction and retail spending, the Australian bond market experienced a sharp rise in bond yields during the quarter. This rise in Australian bond yields largely reflected global bond markets. Global bonds saw a rise in yields with the optimistic view that the US-China trade deal and lower interest rate settings by central banks would generate stronger growth and prices pressures in 2020.

Chart 14: Non-investment grade bonds



Source: Credit Suisse, Barclays and Bloomberg.

Global high yield bonds (hedged) delivered a solid return of 1.6% for the quarter. Credit markets were boosted by more positive signs on US-China trade as well as lower interest rate settings by central banks.

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 (2)	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 (3)	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

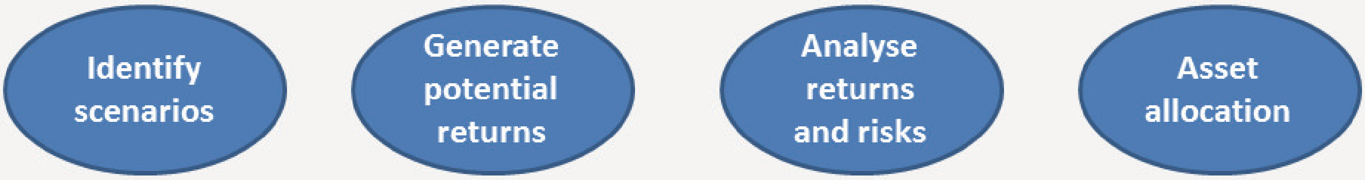
Scenario	Probability ranking (previous rank)	Description
		to a prolonged stagnation scenario. AUD strong but does not re-visit highs vs USD.
Stagflation	12 (12)	With no clear roadmap for the withdrawal of policy stimulus, the inflation risks from quantitative easing may be much bigger than are currently 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.
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