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MLC's scenario insights & portfolio positioning

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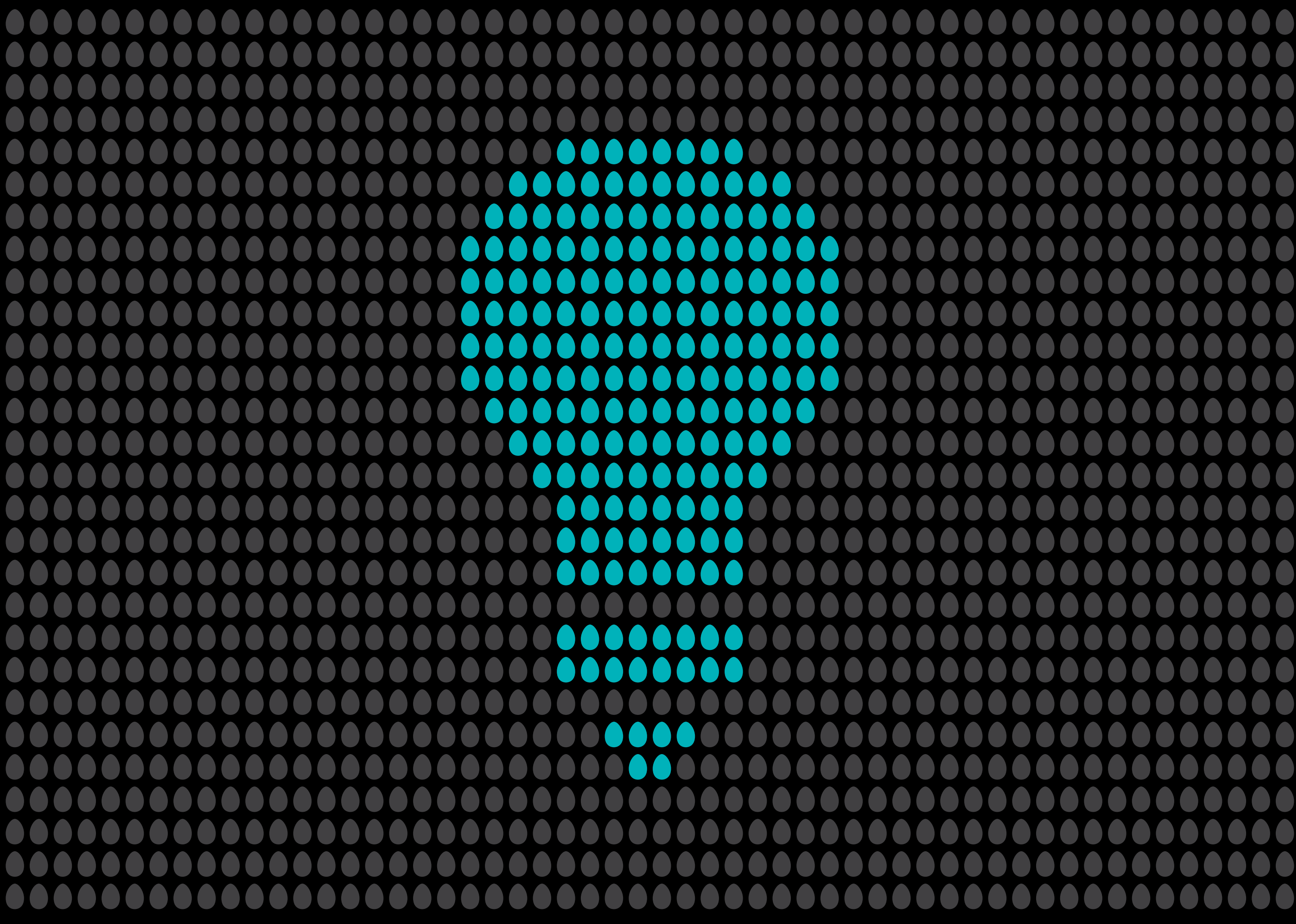
MLC's investment and super portfolios

- *MLC Inflation Plus, MLC Horizon and MLC Index Plus portfolios*

MLC's Managed Account Strategies

- *MLC Premium and Value model portfolios*



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Update for the quarter ending 30 September 2020.

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Continued at end of update.

Quarterly insights

Highlights

- After being challenged by stubbornly high inflation in the 1970's, central banks spent the subsequent 30 years disinflating prices in the real economy (trying to get inflation back down towards a 2% target); the last 10 years have been about reflating (trying to get the Consumer Price Index (CPI) growth back up towards a 2% target). Policies aimed at raising CPI inflation have been largely unsuccessful to date.
- While aggressively loose monetary policy has not created CPI inflation, it has spawned asset price inflation as an abundance of cheap money has been chasing a limited number of investment opportunities.
- Unless there is more widespread adoption of negative deposit rates, central bankers have essentially exhausted the set of monetary tools at their disposal. The CPI 'reflation baton' has been passed to governments to drive the reflationary policy using fiscal tools.
- The first strong phase of fiscal policy response has been designed to address the income lost through pandemic related shutdowns – putting money directly in to people's pockets. Once economies re-open sustainably, fiscal policy will need to continue evolving to overcome the impact of demand lost from the real economy.
- Fiscal deficit spending will be increasing debt burdens in an environment where many developed governments already have record levels of debt to GDP. Inflation is a convenient way for governments to deleverage.
- Why might governments be successful in creating inflation?
  - Secular trends that have underpinned two decades of disinflation may be coming to an end. These include the demographic dividend enjoyed by China and other emerging markets, globalisation and technology.
  - Putting money directly into people's pockets increases the chances it is spent, particularly by the lower and middle classes.
  - If government spending can increase debt loads without suffering the adverse impacts of higher borrowing costs, then deficit spending is theoretically limitless – Modern Monetary Theory (or MMT). This relies on participation by central banks.
- Portfolio implications: The probability of some of the inflation or reflation scenarios increasing, particularly over a 2 to 5 year horizon. Heightened risk of a change in the disinflationary regime **favours exposure to assets with variable cash flows that increase when CPI increases**. Our focus is to find assets that fit this profile and remain reasonably priced, for example, infrastructure, some property, stock baskets with inflation links like miners, financials, energy, and currencies with less deficit spending like Chinese yuan.

The **real economy** is the production and flow of goods and services in the economy. The **financial economy** is concerned with asset prices (eg shares) and interest rates. Inflation in the real economy is inflation in prices of goods and services; the CPI is a measure of the real economy's inflation in Australia. Inflation in the financial economy is asset price inflation.

- The role of foreign currency in inflation hedging is compromised as most major currencies are pursuing monetary-led devaluation of their currency. In this context, **gold** likely becomes the best performing currency.

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 available on our website and in Appendix 1.

Insights

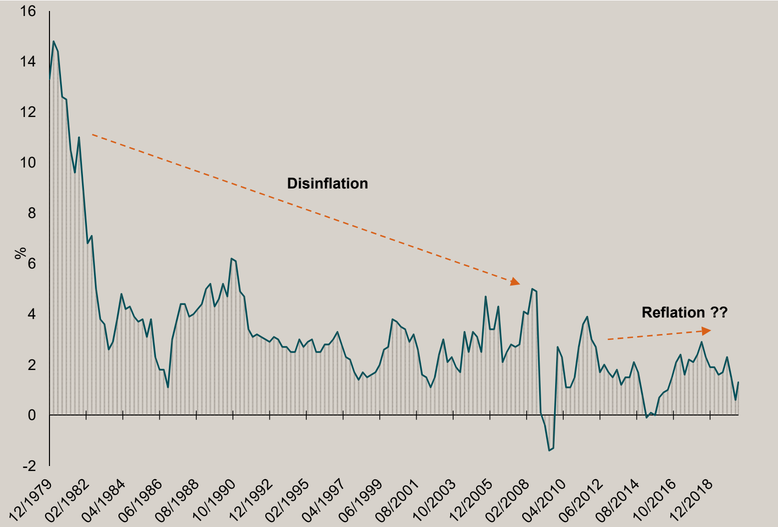
In 1980, following years of rising prices with CPI at 15%, the US Federal Reserve (Fed) embarked on an aggressive campaign of increasing interest rates in an attempt to rid the economy of its pernicious inflation. It was Chairman Paul Volcker who wrote his name into the economic history books by aggressively increasing the prime cash rate to 20% by the middle of 1981. Money supply was severely curtailed, effectively breaking the back of inflation.

Not surprisingly, Volker's success proved instructive for central bankers globally, setting in train a trend amongst global central banks to manage their economies to inflation targets[1]. Anytime inflation appeared, central banks would increase interest rates to ensure inflation stayed under control and on a path to their inflation targets.

This strategy was successful, with Chart 1 showing the consistent disinflationary trend in the US from the early 80's all the way through to the 2008 global financial crisis (GFC). Central bankers diligently pursued interest rate increases any time inflation moved away from their stated targets, which were typically around 2%. Other factors such as technological advances, demographics and labour supply all contributed to help bring inflation down, but central bank policy was a key determining factor.

Yet rarely do phenomenon stay constant and the challenges of yesterday do not necessarily describe the challenges of tomorrow. Where high inflation was the blight of central bankers in the 1970's and early 1980's, persistent **disinflation** has frustrated monetary policy setters for more than a decade now. A combination of secular trends within both the supply and demand sides of the economy lie behind tepid price growth. High levels of indebtedness in both the

Chart 1: US CPI.



Source: Bloomberg, 2020.

public and private sectors as well as unfavourable demographics in some major economic centres have undermined demand growth; while supply side impacts stemming from capacity expansion in emerging markets, a related demographic dividend coupled with globalisation and technological advancements have aided higher levels of supply. Multiple factors, across multiple countries, have forced the supply demand balance lower meaning a central bank-led monetary response to domestic instances of low inflation was unlikely to succeed. Thus, it is not a surprise that despite a strong monetary policy response to counter chronic, sub-target CPI growth in the real economies of most developed nations remains severely challenged.

The acute demand shock invoked by the COVID-19 pandemic has exacerbated the problem. Global central banks have again cut rates, this time from very low levels to essentially the lower nominal bound of the policy window. From here, there is little room to cut nominal interest rates further unless there is broader acceptance that negative rates will prove effective and do more good in the real economy than they do damage to the banking system. Rhetoric out of the US Fed suggests they are reluctant to follow this path[2].

Central banks also embarked on significant quantitative easing (QE) and other unconventional policies in an effort to provide liquidity and cushion the negative impacts of the pandemic. The US Fed balance sheet currently weighs in at over US$7 trillion, 3 times the size it was at the end of the GFC[3]. All this added liquidity has resulted in large increases in money supply (23% increase in M2 in the US this year alone), but reflation is still proving elusive. **Measures of real economy inflation remain below their target levels.**

Whereas the real economy remains bereft of price inflation despite the monetary response, the abundance of liquidity has unquestionably **generated asset price inflation**. A glut of cheap money has been chasing a limited supply of investment opportunities. Anyone who has been trying to buy a house in Sydney for the last decade can attest to this. Replace the name Sydney with virtually any other capital city across the globe, and the dynamic is the same. And it is not just residential property; commercial property, infrastructure, stocks, bonds, art, wine have all seen their prices increase significantly in the era of cheap money.

The unfortunate issue for central banks is **not everyone participates in asset price inflation**. A large portion of the population do not own assets. Rising asset prices exacerbate the plight of aspirational asset owners and in doing so worsens the divide between rich and poor. The economy badly needs inflation in wages, goods and services, particularly at a time when asset prices are inflating so that all members of society can avoid a worsening of their standard of living. To date central bank policies of zero interest rates and QE driven liquidity have failed to provoke a price response in these sectors that are critical to the health of the real economy.

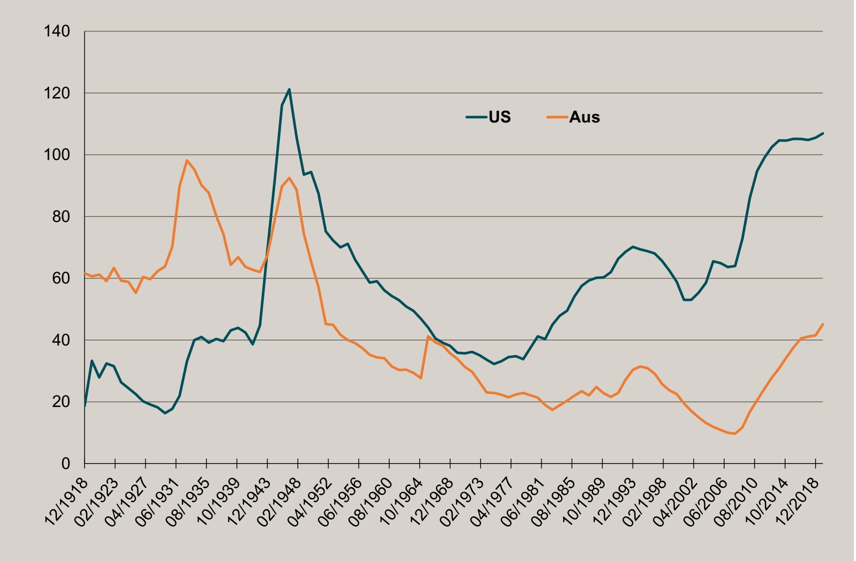
If central banks can't cut rates any further, and QE is proving ineffective, how do we reflate economies and generate the type of inflation we need?

The responsibility falls to governments and fiscal policy to drive the reflationary efforts from here on. While it has been obvious for some time that a return to robust CPI inflation required demand support from the public sector, it was arguably the shock from COVID-19 that has finally forced their hand. Social distancing, either enforced or voluntary, has led to significant losses in company revenue and wages for large parts of the economy. Governments had little choice but to step in, putting money directly into people's pockets to supplement income lost by the economy – JobKeeper in Australia; the Cares Act in the US; Kurzarbeit in Germany; job retention scheme in the UK. These programs have all provided temporary income support to those who had lost employment as a result of the pandemic.

Government income support programs have done an excellent job in reducing the income shortfall created by the pandemic, but they are finite and nearing the end of their intended lifetimes. Australia's JobKeeper has already reduced to lower levels and will do so again in the new year, before being phased out. The similar programs offshore are following the same fate, with this collective pending fiscal tightening being termed the 'fiscal cliff'[4]. If economies have not recovered sufficiently to fill the income gap, a deeper recession looms.

Given the importance of fiscal policy as the main mechanism for reflating economies, governments will need to be flexible in how they manage the 'fiscal cliff'. The debate over the JobKeeper extension in Australia or the political gridlock surrounding the next fiscal stimulus package in the US highlight the sensitivity around further spending. There are some concerns that with many developed countries already laden with large amounts of government debt, embarking on even more deficit spending will be too much burden on future generations.

Chart 2: Gross government debt to GDP ratio – Australia vs US.



Source: Bloomberg.

Chart 2 highlights the elevated debt position of the US government, with levels higher than at any time other than funding a war effort. Many other developed countries have similar debt profiles. Australia finds itself in an enviable starting position, with a debt to GDP ratio much lower than other countries. Either way, elements of society are reluctant to increase government debt levels from here as it runs the risk of 'crowding out' important investments for future growth, saddling future generations with the interest burden and less opportunities for growth.

How can governments manage their debt levels lower? There are three potential scenarios:

1. Balance their budgets by cutting spending – not politically palatable in the current environment of managing pandemic fallout.
2. Default - but governments don't default debts in their own currency given they can print money to settle the debt.
3. Inflate away the debt.

If governments can keep inflation higher than nominal interest rates (ie negative real rates), then all else being equal the 'inflated' nominal taxation revenues pay down the nominal debt faster, essentially **inflating the debt away**.

If this is indeed the case, and governments are in pursuit of higher inflation, then who would buy nominal debt? Who is it that doesn't care about losing purchasing power? The obvious agent is a central bank. Central banks don't care about purchasing power, they care about reaching their mandated targets of price and employment outcomes. Central banks can purchase large quantities of government bonds and keep nominal rates depressed across the yield curve.

Essential to being able to inflate away debt is the capacity for a country to create inflation. As discussed earlier, central banks have been trying in vain to create inflation for the past decade. Why will governments suddenly be successful? We can think of a few reasons.

Firstly, one of the key secular trends that was driving disinflation may be weakening, or even ending. The supply of cheap labour from emerging markets has been a key driver of lower wages and prices. As wages have been rising in these countries, particularly Asia, the strength of this disinflationary force is weakening. The pandemic has also highlighted the sensitivity many companies have to supply chain disruption. Companies are looking to shorten supply chains to reduce this sensitivity, resulting in less offshoring of capacity. This type of de-globalisation will result in increased wages and prices as companies re-engineer supply chains.

Another factor in favour of governments being able to create inflation are the policy choices made to provide support for those that have suffered lost income as a result of the pandemic. Programs like JobKeeper that we discussed earlier are unashamedly designed to put money straight into the pockets of people who, while they spend and create demand, are at least transiently not able to contribute to supply. There is little doubt that over the long-run, policies of this ilk must put some pressure on the relativity between supply and demand: Aggregate supply does not increase, but aggregate demand surely does.

Finally, **governments are incentivised to create inflation**. If an elected government wants to keep spending rather than balance their budget, then stoking inflation to reduce the value of nominal debt is one method to help achieve this goal. Traditional economics suggests that debt reflation is easier said than done. Ballooning deficits increase the supply of bonds, raise inflation concerns and eat away at demand for fixed income assets. Taken together these forces put upward pressure on interest rates. At the same time, spenders worry about the impact of future tax rises to offset the deficit and as such reduce consumption. Yet **willingness of central banks to effectively fund government deficits** through owning an unlimited amount of government bonds, changes the system completely. While major central banks are not yet explicitly financing governments, their presence in the markets and ever-growing quantitative programs represent a step towards outright monetisation however it might ultimately be achieved.

In our view, the co-evolution of fiscal and monetary policy towards reflation means that it is highly unlikely that real rates can rise meaningfully from here. Nominal rates too, are limited, at least while inflation remains subdued. Longer-term rates might be at risk of steepening slightly if the bond market becomes concerned about inflation, but we must keep in mind that central bank policy now extends to all maturities, not just short-term rates.

Portfolio implications

With the above in mind, we are increasingly seeking exposure to a diverse set of assets that offer some degree of inflation protection at a reasonable cost. Gold has a robust relationship to real rates, but like real bonds, is expensive to own outright, at least relative to its own history. But while an elevated price does not preclude us from owning exposure to gold, it does force us to hedge downside by either owning the exposure via calls or protecting a long gold position with puts. The portfolios have accrued meaningful gains from holding gold over the past several years. By protecting the portfolios from losses while the gold price remains elevated we're able to preserve profits the portfolios have already made, while maintaining exposure to further upward price movements. We also continue to hold real (inflation-linked) bonds albeit it at high prices and are looking closely at opportunities in infrastructure and property.

But while gold and real interest rates are an expensive inflation hedge, cyclical stocks and commodities currently offer cheaper hedges to successful reflation of the economy The revenue base of cyclical shares is typically linked to inflation, providing a 'real' component to cash flows that will be valuable if reflation is successful., Yet while cyclicals are compelling due to their cheaply valued real cash flows, they are exposed to further downside if the real economy fails to recover and reflation fails. We are acutely cognisant of the potential downside for cyclicals and as such are researching efficient ways of coupling downside protection to strategies that we think fit a '**participate and protect**' approach. Emerging markets and miners are examples of sectors where this type of approach makes sense, and we continue to research other sectors with similar properties. Chinese government debt is another area that we believe helps the strategies at this point, particularly from an interest rate carry and currency point of view.

All in all, a prudent approach to building inflation hedges into a diversified strategy is well warranted at this point in time, but attention must be paid to the consequence of further bouts of disinflation or deflation. Rather than betting on reflation by simply buying expensive assets that are linked to inflation and hoping we're right, we prefer to invest time to identify exposures that are likely to react positively to a reflationary environment but are not as sensitive to a continuation of what is now a very long period of disinflation. This obviously brings with it a series of trade-offs that limit the reward of being 'right', but at the same time reduce the consequence of being wrong. Given that it's impossible to have perfect foresight, and that we are ultimately risk managers not gamblers, we believe this is the right way to invest in these highly unusual times.

References:

[1] The Bank of New Zealand was the first to introduce an official inflation target in 1990, with the Reserve Bank of Australia following suit a few years later. Although the US Fed did not officially follow inflation targeting until 2012, they have regularly released inflation target ranges as part of their price stability mandate.

[2] Fed Chair Powell stated in May 2020 that the Fed is averse to using negative interest rates to combat the pandemic. Federal Open Market Committee 2020.

[3] According to Bloomberg, the US Fed balance sheet was $7.056 trn on 30/09/20. This compares to $2.234 trn on 31/12/09.

[4] The Grattan Institute estimates the pending fiscal cliff for Australia at 25% of GDP by the end of October if all the pandemic support programs rolled off. It should be noted this was before the recent extension to JobKeeper.

The Investment Futures Framework: Scenarios, changes in return potential, and portfolio positioning

Scenarios

In managing MLC's multi-asset portfolios using our Investment Futures Framework, following are the short-term scenarios that we have assessed as currently providing the highest potential future risks and opportunities.

This remains a highly unusual time. Following on from last quarter, the near set of future scenarios continue to pivot around evolution of the COVID-19 pandemic and as such our three key scenarios remain more or less unchanged. While the pandemic continues to persist, heightened uncertainty will linger. The current situation remains finely balanced as a second wave emerges across the northern hemisphere, but unlike the first wave, health care systems are significantly better prepared to deal with the challenge. The virus is now a known quantity. Treatment options have expanded and testing and tracing have bolstered containment. There is now a ray of hope that should a second wave prove less vicious than the initial breakout, that policy will evolve towards implementation of economically sustainable measures to stem the spread of the COVID-19 virus. Nonetheless, we cannot rule out an escalation in severity as the northern hemisphere heads into winter.

Our core short-term scenarios continue as:

- **Global pandemic: Short disruption with no second wave**
  - The northern hemisphere summer helps rid the community of COVID-19. No substantial second wave of infections arise and seasonality does not emerge.
  - Lockdowns end with only mild earnings implications for this year and next.
- **Global pandemic: Drawn-out lockdown with mild second wave of infections**
  - A mild second wave of infections arises across the globe. Partial lockdowns are re-established.
  - Earnings suffer in both FY20 and FY21.
  - Hospitality and other impacted sectors are severely disrupted.
- **Global pandemic: Drawn-out lockdown with severe second wave**
  - A severe second wave of COVID-19 emerges. Full lockdowns are re-established.
  - Fiscal and monetary stimulus near the point of exhaustion.
  - Populism.
  - High risk of global depression.

Changes in return potential for asset classes

There were no major changes in return potential across core shares, fixed income and currency in the September quarter (Chart 3). Global shares continue to offer a better risk return trade off compared to Australian shares, partly due to a decrease in domestic payout ratios and increase in equity issuance, and partly due to a subdued outlook for earnings growth in the financials sector. Also of note, the rise in inflation expectations paused recently after expanding significantly in response to widespread government stimulus programs. This means that inflation-linked bonds remain expensive in outright terms, but attractive compared to nominal bonds. The rally in gold was also interrupted by reduced conviction by the market in reflation.

Portfolio positioning

In line with the stability in return potentials, there were no major changes to the MLC Horizon and Index Plus portfolios' positioning during the third quarter.

There was activity in the Inflation Plus portfolios, which MLC Horizon, Premium and Value portfolios inherit through investments in Inflation Plus, and MLC Index Plus portfolios through the real return strategy which is managed similarly to Inflation Plus.

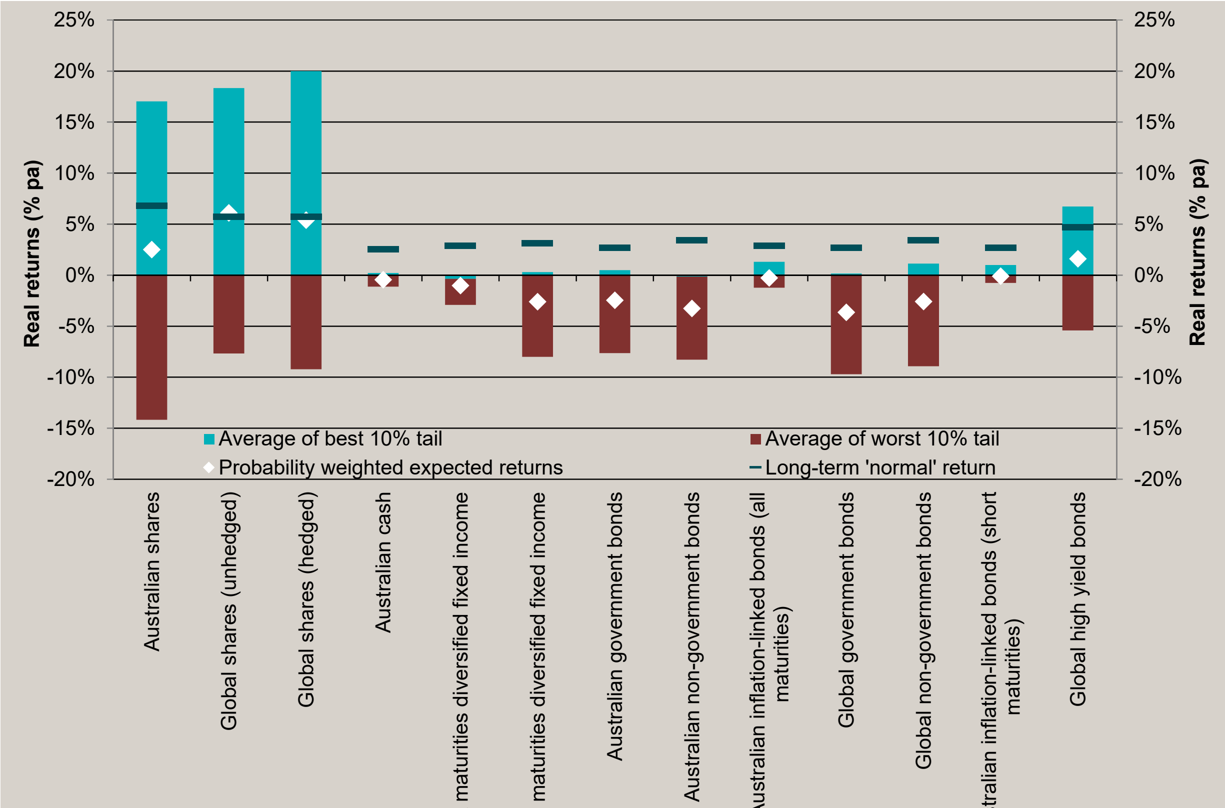
Exposure to gold was modified slightly to take profit and increase hedging to protect the portfolio from a steep fall in the gold price. We also extended our exposure to both Chinese and emerging market shares, but in a manner that minimised downside at the expense of selling away gains that would be realised if the market rallied more than 15% in the next three months. We are currently exploring similar risk controlled cyclical strategies and hope to broaden out our 'participate and protect' strategy in Inflation Plus.

We also made some changes to the MLC Premium and Value model portfolios (MLC Managed Account Strategies). This included maintaining the level of foreign currency exposure and adjusting the direct Australian share holdings – which has seen the inclusion of more stocks that could benefit in an inflationary environment.

More information on portfolio positioning is in the sections: MLC Inflation Plus, Horizon, Index Plus, Premium, and Value portfolios.

The Investment Futures Framework: Scenarios, changes in return potential, and portfolio positioning

Chart 3: 40 scenario set (generic scenarios) potential real returns (September 2020) - 5 years, 0% tax with franking credits, pre-fees, pre-alpha



Source: MLC Asset Management Services Limited.

The potential real returns for each asset class are shown above. The probability-weighted real returns are shown as 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. Asset classes with wider ranges could have more extreme return outcomes than those with narrow ranges.

Return potential

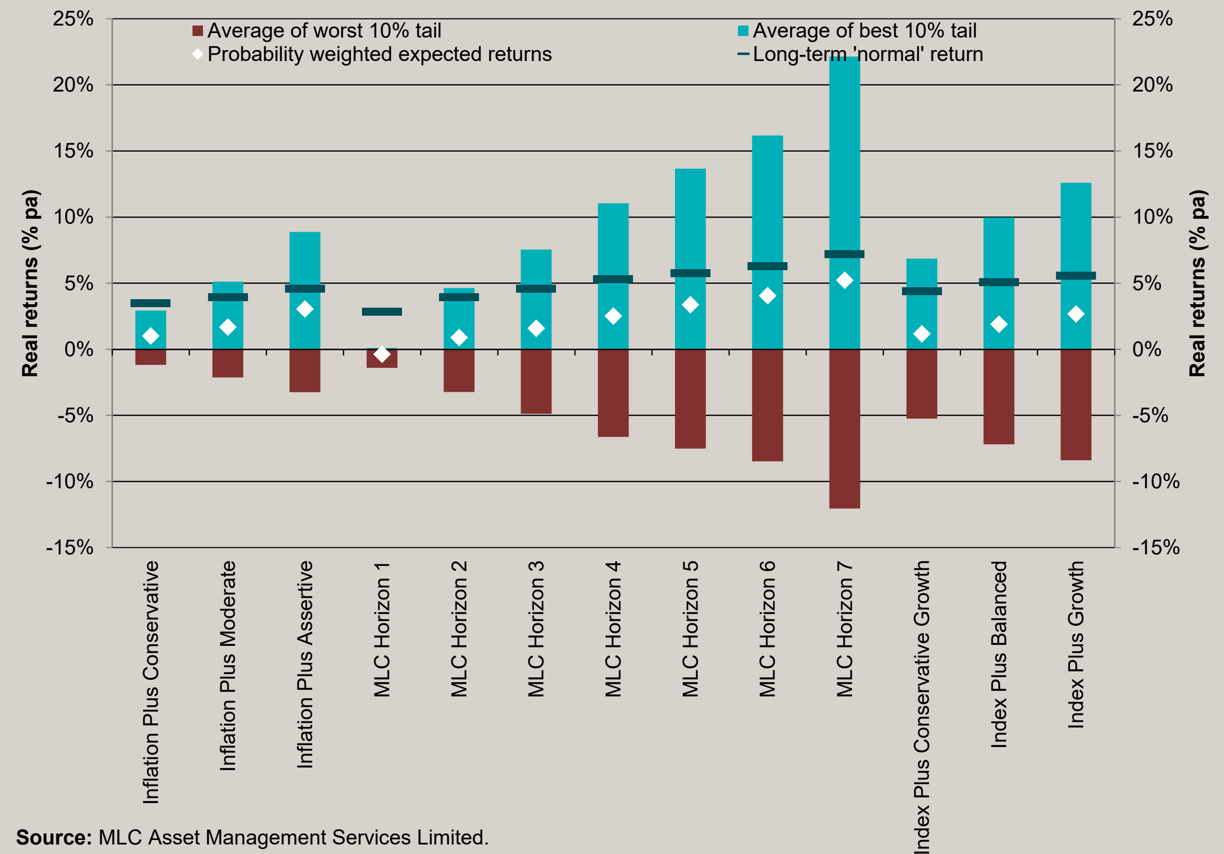
Charts 4 and 5 show return potential for the MLC Horizon, Inflation Plus and Index Plus portfolios, and the Managed Account Strategies respectively, based on our generic (40) scenario set, looking forward from the end of September 2020.

Despite some intra-quarter volatility, the medium-term return potential of all the MLC multi-asset portfolios at the end of the September quarter remained more or less unchanged compared to the end of the June quarter.

The stronger risk focus of the Inflation Plus portfolios is evident (Chart 4). Consistent with their objectives, the Inflation Plus 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.

The medium-term return potential of all the MLC Managed Account Strategies, like the other multi-asset portfolios, remain significantly below the returns similar asset allocations have produced in the past (Chart 5). While both the Premium and Value Model Portfolios are expected to deliver similar returns, the additional levers afforded by the higher cost of the Premium Model Portfolios result in more positively skewed potential outcomes, with higher returns in the most positive scenarios and less negative returns in the worst.

Chart 4: 40 scenario set (generic scenarios) potential real returns (September 2020) - 5 years, 0% tax with franking credits, pre-fees, pre-alpha

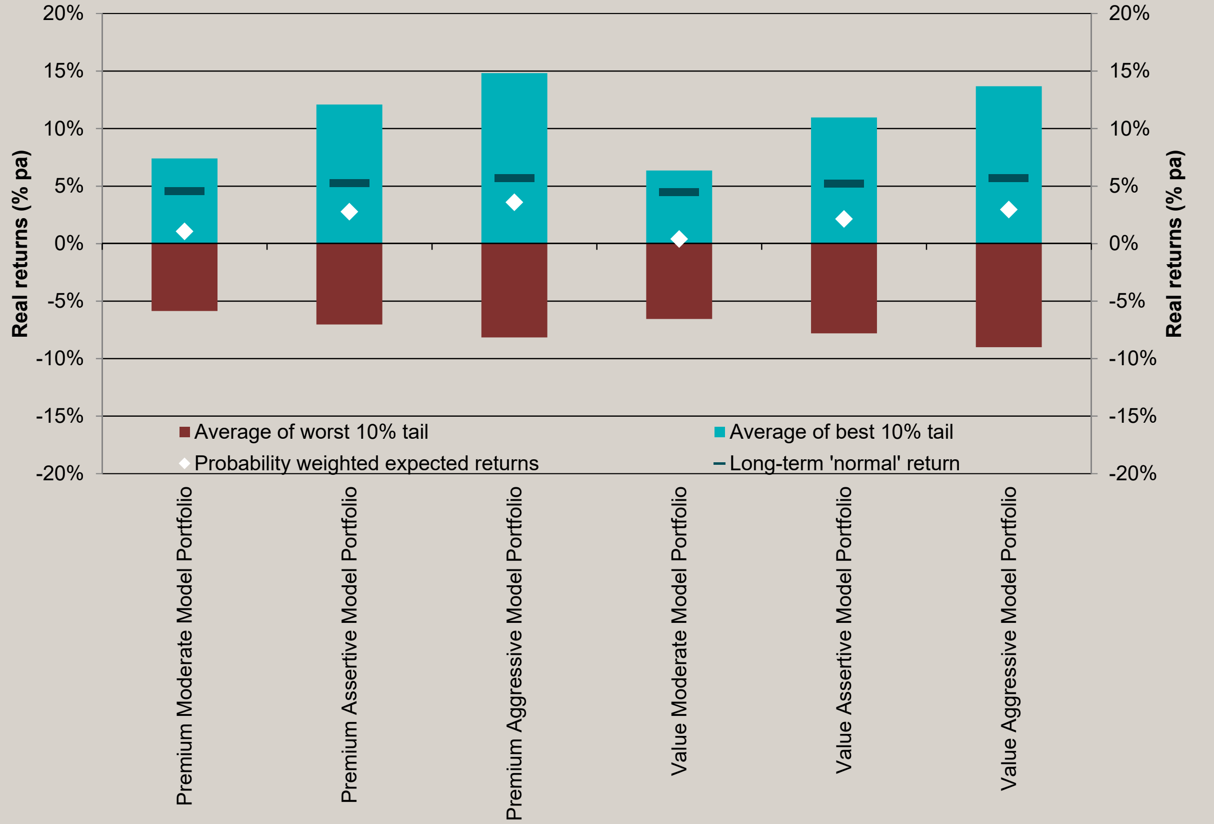


Source: MLC Asset Management Services Limited.

The probability-weighted real returns are shown above and below (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.

Return potential

Chart 5: MLC Managed Account Strategies - 40 scenario set (generic scenarios) potential real returns (September 2020) - 5 years, 0% tax with franking credits, pre-fees, pre-alpha



Source: MLC Asset Management Services Limited.

MLC Inflation Plus portfolios

Following on from portfolio rebalancing and profit taking in the June quarter, the MLC Inflation Plus portfolios were repositioned to hold slightly more risk in the September quarter. Specifically, key portfolio activity during the September 2020 quarter, including up until the time of writing is:

- Added a 'participate and protect' exposure to emerging market shares allowing the portfolio to participate in the first 15% of market upside while limiting capital losses. The strategy is implemented using a combination of total return swaps, bought puts and sold calls.
- Took advantage of the strong gold price to take profits and restructure downside protection.

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.

- Established a position in Chinese government debt with exposure to the Chinese yuan. The bonds are a source of interest rate carry, and the yuan exposure helps diversify the currency composition of Inflation Plus.

Here is a summary of the changes to positioning of the MLC Inflation Plus portfolios over the recent quarter.

Asset class	MLC Inflation Plus portfolios (in MLC MasterKey's super and pension products) change in target allocation over the 3 months ended 30 September 2020		
	Conservative	**Moderate**	**Assertive**
Chinese government bonds (through derivative strategies)	**New**	**New**	**New**
China A-shares with downside limit of -20% (through derivative strategies)	**Increased**	**Increased**	**Increased**
Emerging market shares (through derivative strategies)	**Increased**	**Increased**	**Increased**
Defensive Australian shares	Steady	Steady	Steady
Global shares (through derivative strategies)	Steady	Steady	Steady
Global shares (unhedged)	Steady	Steady	Steady
Foreign currency exposure	Call options protection maintained	Call options protection maintained	Call options protection maintained
Gold exposure (through derivative strategies via call options)	Steady	Steady	Steady
Low correlation strategy	Steady	Steady	Steady
Real return strategy	Steady	Steady	Steady
Global private assets	Steady	Steady	Steady
Australian inflation-linked bonds	Steady	Steady	Steady
Insurance-related investments	Zero	Steady	Steady
Global high yield bonds and loans	Steady	Steady	Steady
Global non-government bonds (short-maturity)	Steady	Steady	Steady
Global non-government bonds (all-maturity)	Steady	Steady	**Increased**
Australian non-government bonds (short-maturity)	Steady	Steady	**Removed**
Cash	**Reduced**	**Reduced**	**Reduced**
Borrowings	Not permitted	Not permitted	No borrowings

MLC Horizon portfolios

Positioning of the MLC Horizon portfolios was little changed in the September quarter. The portfolios achieved a relatively defensive orientation partly from exposures to Inflation Plus (explained above), and partly from exposure to foreign currency through unhedged global shares. Exposure to fixed income continues to offer some defensiveness, but lower yields mean that the scope for interest rates to protect the funds under adverse economic conditions remains challenged.

We'll be making some small changes to the portfolios in coming weeks as a result of the strategic asset allocation review we've recently completed. Every three to five years we review the strategic (benchmark) asset allocation so it remains a relevant benchmark. We consider new asset classes and strategies that are available, changes in the competitive landscape, and risk and return efficiency of the portfolios. Some of the changes resulting from our recent review, include:

- Slight increase to growth assets for Horizon 4 and 5 portfolios to improve the competitiveness relative to industry funds, which tend to have higher growth exposures.

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.

- Reducing home country bias by decreasing Australian shares and increasing global shares (hedged). This improves portfolio diversification and access to more investment opportunities.
- Moving alternatives exposures up the risk and return spectrum in MLC Horizon 3 to 5 portfolios.
- Reducing inflation-linked bonds' maturity profile.
- Aligning MLC Horizon 2 Income Portfolio's Australian shares and property securities strategies with MLC Horizon 2 Capital Stable Portfolio.
- Adjusting the asset allocation ranges to accommodate the above changes.

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

Asset class	**MLC Horizon 4 Balanced Portfolio (in MLC MasterKey's super and pension products) target asset allocation at 30 September 2020**		
	Under	**Benchmark**	**Over**
Australian shares	•		
Global shares (unhedged)			•
Global shares (hedged)	•		
Global property securities		•	
Cash			•
Australian bonds - short maturities			•
Australian bonds - all maturities	•		
Australian inflation-linked bonds		•	
Global bonds - short maturities			•
Global bonds - all maturities	•		
Global non-investment grade bonds (high yield bonds and loans)		•	
Global private assets		•	
Real return strategies (including Inflation Plus)			•
Low correlation strategy		•	

MLC Index Plus portfolios

Positioning of the MLC Index Plus portfolios was little changed in the September quarter. The portfolios achieved a relatively defensive orientation partly from exposures to the real return strategy which is managed similarly to Inflation Plus (explained earlier) and partly from exposure to foreign currency. Exposure to fixed income continues to offer some defensiveness, but lower yields mean that the scope for interest rates to protect the funds under adverse economic conditions remains challenged.

We'll be making some small changes to the portfolios in coming weeks as a result of the strategic asset allocation review we've recently completed. Every three to five years we review the strategic (benchmark) asset allocation so it remains a relevant benchmark. We consider new asset classes and strategies that are available, changes in the competitive landscape, and risk and return efficiency of the portfolios. Some of the changes resulting from our recent review, include:

- Slight increase to growth assets to improve competitiveness.
- Reducing home country bias by decreasing Australian shares and increasing global shares. This improves portfolio diversification and access to more investment opportunities.
- Reducing inflation-linked bonds' maturity profile and some small adjustments to other fixed income strategies.
- Adjusting the asset allocation ranges to accommodate the above changes.

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.

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

Asset class	MLC Index Plus Balanced Portfolio target asset allocation at 30 September 2020		
	Under	Benchmark	Over
Australian shares	•		
Global shares (unhedged)			•
Global shares (hedged)	•		
Global property securities		•	
Cash			•
Australian bonds – short maturities			•
Australian bonds – all maturities	•		
Australian inflation-linked bonds		•	
Global bonds - short maturities			•
Global bonds - all maturities	•		
Real return strategies			•

MLC Managed Account Strategies

The MLC Managed Account Strategies were launched on 1 July 2020. No major changes have been made to the portfolio asset allocations since then, however in response to appreciation in asset prices and the Australian dollar, the models have been rebalanced to maintain the level of foreign currency exposure. Foreign currency is an important diversifier as global shares and the Australian dollar tend to move in the same direction. Further, we've reinvested across the portfolio any dividends and distributions received for those accounts where they are retained in the model.

For the directly held stocks, there have been a number of changes through the quarter. These changes are consistent with our top down concerns of the risk that a change to the inflation regime poses, as discussed earlier in the 'Insights' section.

In the Value portfolios, the direct share holdings were rebalanced to the ASX20 Index, resulting in the addition of Fortescue and Coles this quarter. Both the Metals and Mining and supermarket sectors have witnessed signs of inflation, pushing these companies into Australia's large cap indices. Supermarkets were one of the first sectors to be impacted by rising prices, with food prices increasing on the back of agricultural disruption due to the bushfires, and the second impact led by demand as COVID-19 forced more at-home dining. For the Metals and Mining sector, iron ore prices saw an initial support as a key component in a stimulus response from China to counteract the economic impacts of COVID-19 and then continued positive price support due to supply disruptions in Brazil (also linked to COVID-19).

> The MLC Managed Account Strategies are focused on providing investors with above-inflation returns through professionally managed portfolios that are extensively diversified across asset classes, specialist investment managers, and stocks.

In the Premium portfolios, BHP has been the largest stock weight in the portfolios since inception. Coles was also a significant position at inception and in recent weeks Woolworths was added to the portfolio – providing additional exposure to the food inflation theme.

Here is a summary of the changes to positioning of the MLC Managed Account Strategies over the quarter.

Asset class	MLC Premium Model Portfolios change in target allocation over the 3 months ended 30 September 2020		
	Moderate	**Assertive**	**Aggressive**
Australian shares	Steady	Steady	Steady
- Active, direct, all cap	Steady	Steady	Steady
- Active, ex-20	Steady	Steady	Steady
- Active, small cap	Zero	Steady	Steady
Global shares	Steady	Steady	Steady
- Active, quant, hedged	Steady	Steady	Steady
- Active, growth, unhedged	Steady	Steady	Steady
- Active, value, unhedged	Steady	Steady	Steady
- Active, emerging markets, unhedged	Zero	Steady	Steady
Global property securities	Steady	Steady	Steady
- Active, hedged			
Alternatives and other	Steady	Steady	Steady
- Inflation Plus			
Fixed income	Steady	Steady	Steady
- Australian, active, short maturity	Steady	Steady	Steady
- Australian, active, all maturity	Steady	Steady	Steady
- Global, active, all maturity, hedged	Steady	Steady	Steady
- Global, active, high yield, hedged	Steady	Steady	Steady
- Active, absolute return, hedged	Steady	Steady	Steady
Cash	Steady	Steady	Steady

Asset class	MLC Value Model Portfolios change in target allocation over the 3 months ended 30 September 2020		
	Moderate	**Assertive**	**Aggressive**
Australian shares	Steady	Steady	Steady
- Passive, direct, large cap	Steady	Steady	Steady
- Passive, all cap	Steady	Steady	Steady
- Active, small cap	Zero	Steady	Steady
Global shares	Steady	Steady	Steady
- Passive, developed markets, unhedged	Steady	Steady	Steady
- Passive, developed markets, hedged	Steady	Steady	Steady
- Active, emerging markets, unhedged	Zero	Steady	Steady
Global property securities	Steady	Steady	Steady
- Passive, hedged			
Alternatives and other	Steady	Steady	Steady
- Inflation Plus			
Fixed income	Steady	Steady	Steady
- Australian, active, short maturity	Steady	Steady	Steady
- Australian, active, all maturity	Steady	Steady	Steady
- Global, active, all maturity, hedged	Steady	Steady	Steady
- Global, active, high yield, hedged	Steady	Steady	Steady
Cash	Steady	Steady	Steady

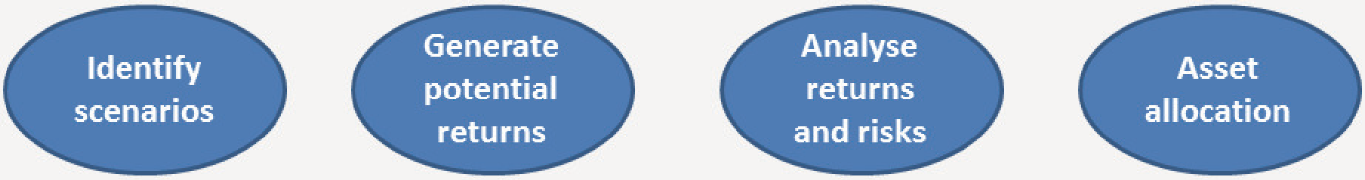
Any portfolio change shown above is not a guarantee of a change to a client's portfolio. There may be differences between the Model Portfolio and a client's portfolio due to the timing and transaction prices for portfolio changes, client investments and withdrawals during the period, timing of receipt of dividends and income distributions, platform administration fees, transactional costs associated with the client's portfolio, and any portfolio exclusions required by the client.

Appendix 1 – 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.

Important information (continued from page 2)

MLC funds and Managed Account Strategies referenced in this communication are listed below. These funds appear on MLC's platforms, in addition to a number of external platforms:

MLC Investment Trust:	MLC Super Fund:	MLC Managed Account Strategies:
MLC Wholesale Horizon 2 Income Portfolio	MLC Horizon 2 Capital Stable Portfolio	MLC Premium Moderate Model Portfolio
MLC Wholesale Horizon 3 Conservative Growth Portfolio	MLC Horizon 3 Conservative Growth Portfolio	MLC Premium Assertive Model Portfolio
MLC Wholesale Horizon 4 Balanced Portfolio	MLC Horizon 4 Balanced Portfolio	MLC Premium Aggressive Model Portfolio
MLC Wholesale Horizon 5 Growth Portfolio	MLC Horizon 5 Growth Portfolio	MLC Value Moderate Model Portfolio
MLC Wholesale Horizon 6 Share Portfolio	MLC Horizon 6 Share Portfolio	MLC Value Assertive Model Portfolio
MLC Wholesale Horizon 7 Accelerated Growth Portfolio	MLC Horizon 7 Accelerated Growth Portfolio	MLC Value Aggressive Model Portfolio
MLC Wholesale Inflation Plus Conservative Portfolio	MLC Inflation Plus Conservative Portfolio	
MLC Wholesale Inflation Plus Moderate Portfolio	MLC Inflation Plus Moderate Portfolio	
MLC Wholesale Inflation Plus Assertive Portfolio	MLC Inflation Plus Assertive Portfolio	
MLC Wholesale Index Plus Conservative Growth Portfolio	MLC Index Plus Conservative Growth Portfolio	
MLC Wholesale Index Plus Balanced Portfolio	MLC Index Plus Balanced Portfolio	
MLC Wholesale Index Plus Growth Portfolio	MLC Index Plus Growth Portfolio	

We welcome your feedback on this document.

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