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MLC's scenario insights & portfolio positioning

July 2021

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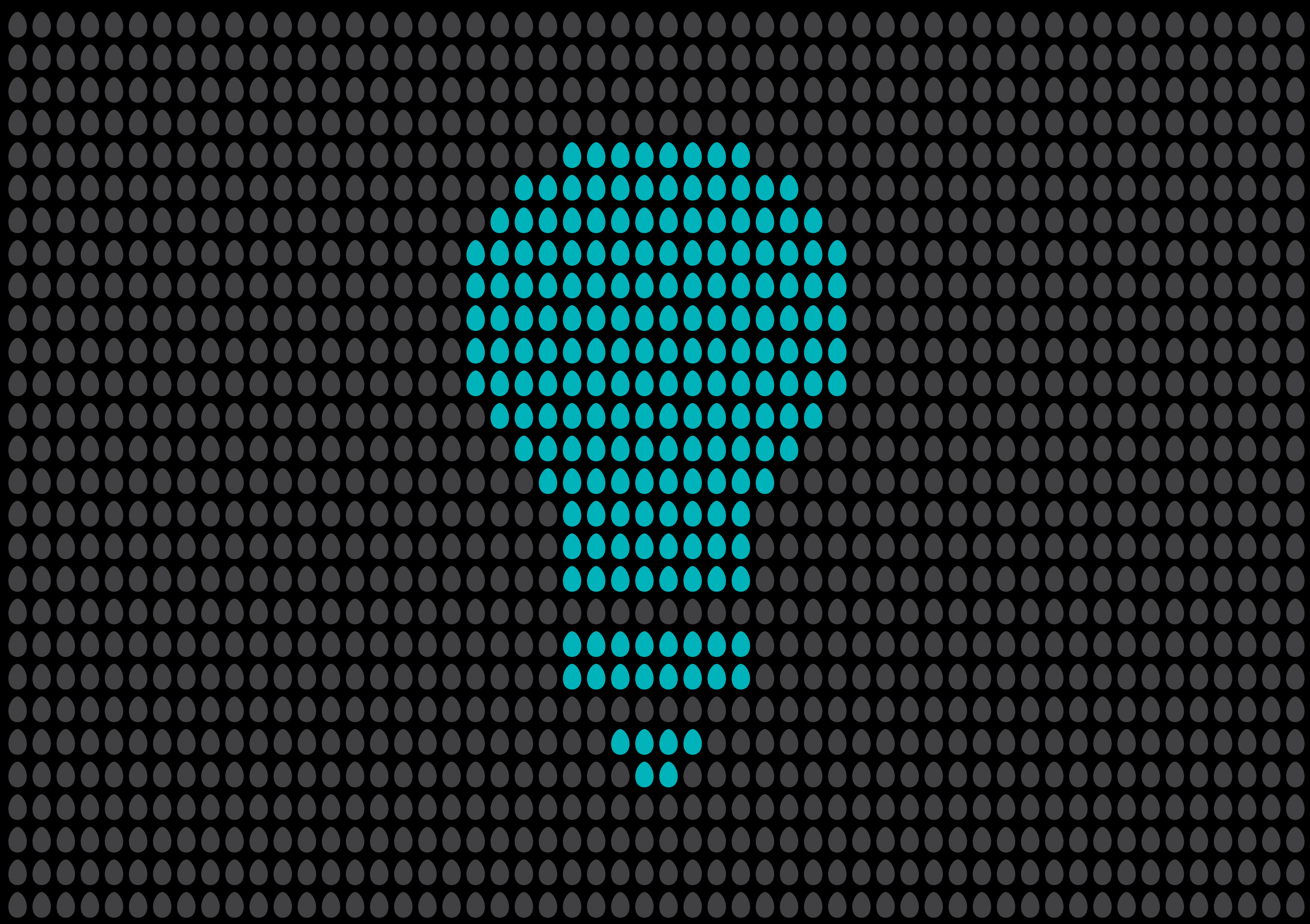
MLC's investment and super portfolios

- *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 June 2021.

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Continued at end of update.

Quarterly insights

Highlights

- **While the general principal of 'participate and protect' remains intact and we continue to follow this mantra for our multi-asset portfolios, the specific drivers have shifted. The combination of high valuations, an unstable inflationary outlook and tempered but lingering risks to growth from COVID-19, means we need to balance the reward we receive for investing against the risks of high valuations and inflation.**
- **While the inflation regime remains uncertain we continue to seek innovative solutions to insulate real returns from the sapping impact of inflation, rather than simply paying whatever price for standard inflation hedges.**
- **We believe the key to success for risk-aware strategies is to participate in returns by embedding as much risk as possible into our multi-asset portfolios while structuring risk controls to be as aligned with portfolio objectives as possible.**

Insights

With the new financial year upon us, we thought it worthwhile to audit our key investment themes and check their continued relevance to meeting portfolio objectives. This is a useful discipline for investors to follow particularly at this juncture, as a lot has changed in the last 12 months. The speed at which themes are moving from idea to fully priced market concept is passaging faster as well.

Looking back over our shoulders, the themes we wrote about last year are summarised below:

1. Follow a **'participate and protect'** mantra for our objective-based multi-asset portfolios. The rationale at the time being that there exist strong reasons to expect upside (extremely easy monetary and fiscal policy) but also a realistic chance of the pandemic causing sustained divergence across economic and social outcomes (June 2020 quarterly insight). Participate and protect facilitates participation in the upside to a limit whilst also limiting losses on the downside. It avoids needing to make a binary decision which in the end will either be right or wrong and in the context of prevailing uncertainties is at best an educated guess and at worst a gamble.
2. The heightened **risk** of a change in the inflationary regime from disinflation to inflation leads us to favour assets with variable cash flows that increase as inflation increases (**real cash flows**). We think it is a prudent time to build inflation hedges into our portfolios (September 2020 quarterly insight).
3. The actual experience of capital invested across the last decade has almost consistently been at odds with expectations. What started as low real and nominal interest rates at the beginning of each year, progressively inched lower rewarding any asset with long duration cash flows. **This pattern of ever decreasing rates cannot go on forever**, at some point both nominal and real rates must at least plateau and perhaps even rise (December 2020 quarterly insight).

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.

First theme audit

While the general principal of **'participate and protect'** remains intact, the specific drivers have shifted. There are still solid reasons to anticipate upside and seek participation, but the reasons have morphed as the pandemic and policy responses have evolved. Reliance on fiscal support is no longer as compelling a reason to invest in risk. Whereas a year ago, investors could take comfort from the promises of extraordinary fiscal reactions, we now face a transition phase where immediate stimulus tapers and longer-run support faces deployment risks. Governments are still looking to provide stimulus as evidenced by the US debate over the size of their infrastructure spending, it is just not as necessary now economies have entered a stronger growth trajectory. At the same time, the tailwind from easy monetary policy has curtailed somewhat as central banks shift gears to removing stimulus measures. Step one has already arrived insofar as the Reserve Bank of Australia (RBA) will begin tapering domestic quantitative easing in September 2021.

The more compelling reasons to participate are now around trying to capture the earnings streams generated by this stronger global growth trajectory. Vaccines have enabled economies to re-open (Australia excluded) and pent up consumer demand is driving spending. Share markets have rotated from the narrow Technology and Health Care leadership of 2020 to a broader range of industry sector drivers including cyclicals like Financials and Industrials. The 'on the couch' winners of last year are being outdone by the 'off the couch' stocks as people take advantage of their newfound freedoms.

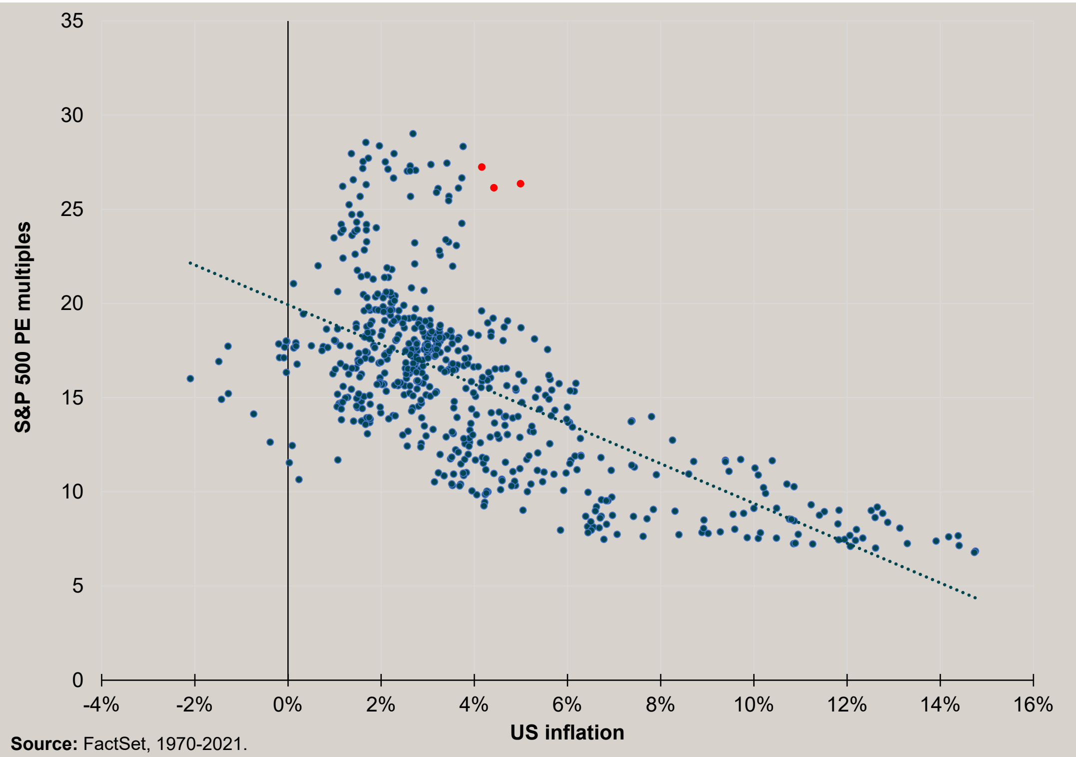
The rationale to protect is also intact, but the axis of risk has shifted. What were potentially widely divergent outcomes of the pandemic have narrowed, mainly due to vaccines building a floor on the downside. Science saved us from the worst, but mutations still threaten flareups that could leave a lasting impact. The mutant Delta COVID-19 variant is a case in point, for while evidence suggests that current vaccines remain effective, further mutation of the strain to its advantage hangs as a risk not to be ignored. But while direct risks from COVID-19 are tamer than they were a year ago, elevated prices and valuations beg protection. The stellar returns from share markets the past 12 months have pushed many share markets to all-time highs, and the valuation multiples are top decile across most metrics.

This is not a time to ignore the risks posed by valuations. Extended valuations typically reflect an abundance of optimism and as such are prone to disappointment when so much good news is already incorporated into the price. We have already mentioned some reasons to be optimistic, we just also need to be mindful that a misstep in earnings could deliver an outsized negative response in share markets. Buy the rumour, sell the fact, pummel the miss.

Another influence prompting our desire to protect is the *risk* of a change in the inflationary regime from long-run disinflation to inflation. To be clear, our concerns are that inflation poses a risk to real returns, not a call that inflation will necessarily materialise. This is an important distinction. For if we were convinced that inflation was nigh, then we'd throw away 'participate and protect' and instead position the portfolios to win if inflation rises and lose if reflation fades. But we are not.

Persistent inflation has the capacity to destabilise, not just nominal bonds, but all asset classes. The negative relationship between bond prices and inflation is well documented. What may be less well understood is the negative relationship between inflation and equity multiples. Chart 1 shows a scatterplot of US inflation (x axis) against the corresponding S&P 500 Price to Earnings (PE) multiple (y axis) over the last 50 years. As can be seen, as inflation rises, PE multiples decrease. The red dots represent the most recent three months' observations, highlighting how equity multiples have not been this high when annual inflation has been above 4%. The research is not suggesting inflation is bad for shares, but that it is bad for equity valuation multiples.

Chart 1: US inflation vs S&P 500 PE multiples over the last 50 years



Source: FactSet, 1970-2021.

The combination of high valuations, an unstable inflationary outlook and tempered but lingering risks to growth from COVID-19, means we need to balance the reward we receive for investing against the risks of high valuations and inflation. So we will continue to follow a 'participate and protect' mantra for our portfolios.

Second theme audit

Last September we first mentioned the chance of a change in inflationary regime. Since then, reported CPI has jumped higher and inflation expectations are elevated globally. With this as the backdrop, our inclination to favour **real cash flows** as a means to build *inflation hedges* (as opposed to inflation bets) into the portfolios has been rewarded with strong returns to assets with variable cash flows like cyclical shares.

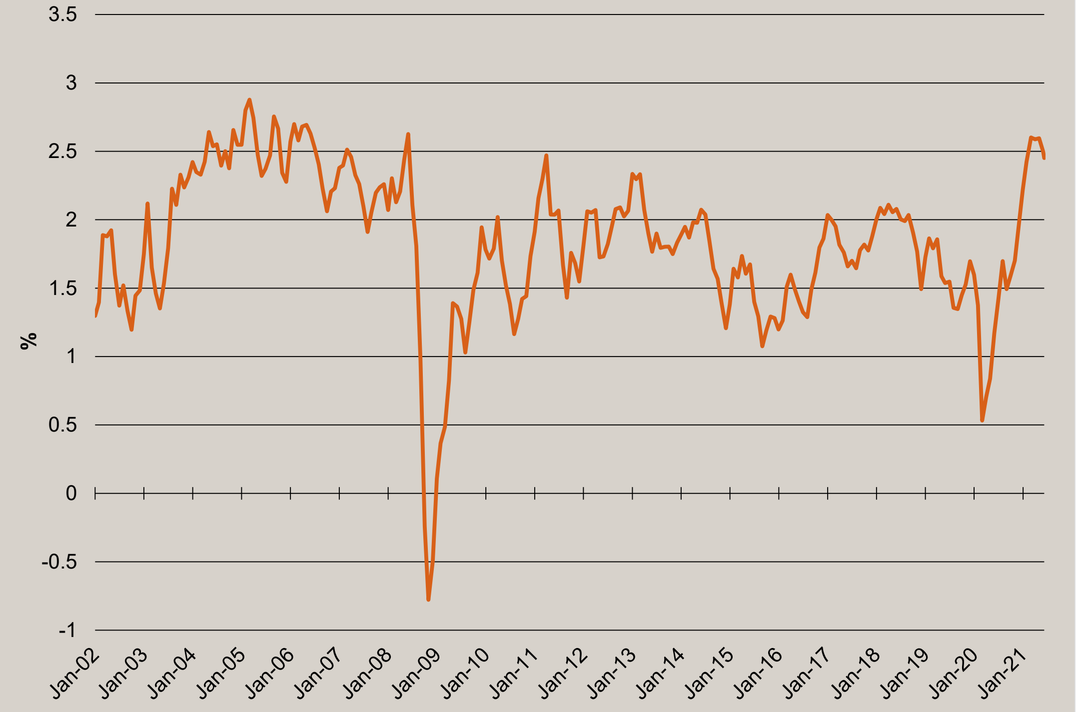
Markets moved aggressively in the first half of 2021 to re-price inflation, with investors concerned a confluence of factors would drive prices higher:

- Base effects – prices a year ago were severely depressed by the pandemic, causing a low base from which to measure changes in prices.
- Supply shortages – key materials/goods were in short supply (think semiconductors, lumber, used cars) and producers faced bottlenecks as they tried to address the shortages.
- Pent-up demand – consumers flush with disposable income (from fiscal stimulus packages) would start spending as vaccines allow economies to open up.

Indeed, prices in the real economy reared higher at a rate worse than feared. The annual change in US consumer prices (CPI) printed at 5% for May 2021, and just as expected, the cost of inflation hedges also rose with inflation linked bonds, cyclical shares, emerging markets (ex-China) and commodities, all outperforming. With the price of inflation-sensitive assets now higher, the valuation gap we flagged last year has now closed to a large degree. Being positioned ahead of the change in pricing of inflation was critical for inflation hedges to deliver their role in a multi-asset portfolio.

Markets have taken a breather on the reflation trade in the last few months. Inflation breakevens, a useful market proxy for inflation expectations, peaked in the US in May 2021 and have drifted lower recently (Chart 2). Although at 2.5% for five years, they are still at elevated levels in the context of their reported history. This suggests markets are still more worried about inflation now than they have been at any time since the global financial crisis.

Chart 2: US 5 year breakeven inflation rate



Source: Bloomberg, 2021.

The task now facing investors, is to identify the signposts that will provide clues as to the path of inflation from here on and consider the best investment strategy given the balance of risks. Is inflation transitory, or persistent? Will the bottlenecks resolve, and demand recede; or, will expectations prime behaviours that lead to sustained price rises for goods and labour? Can consequences of the pandemic induced shock overcome the long run and well established secular forces that push against pricing power?

We have little insight into how this will play out, other than to make the observation that some of the secular trends that were contributing to the long-standing disinflationary regime have weakened and may be turning inflationary:

- Central banks have changed their reaction function from capping inflation at a target to allowing it to breach the upside in order to manage an average level through time.
- Fiscal hawks are a dying breed as governments are given greater rein to deficit spend.
- Company behaviour post pandemic is more engineered toward localisation than globalisation through shorter supply chains: just-in-case rather than just-in-time.
- Competition for labour is increasing as immigration is reduced and the cost of off-shoring to developing markets has increased.

This is a far from exhaustive list, but highlights the growing risks stacking up against a continuation of the disinflationary regime that has prevailed for the majority of the last 20 years. Rather than make a binary decision on inflation being transitory or sticky, our approach has been to seek to be innovative in creating exposures that can act as inflation hedges but still be implemented at a reasonable price. One of our approaches to handling the inflation dichotomy, is to build a customised basket of high-quality mining and energy shares that we know are sensitive to inflation and offer a high dividend yield and robust free cash flow. The basket is tightly hedged with near-cost neutral collars that have been constructed to earn at least the dividend yield with a performance floor that should prevent anything greater than bond type losses. If we are right, the basket has equity-like income return characteristics with corporate bond type risks.

The mining and energy basket, together with some of our other holdings, are a partial solution to the inflation problem. Pricing of inflation hedges is in a continual state of flux, so while today's exposures make sense now, they won't at some point in the future. As such, while the inflation regime remains uncertain we must continue to seek innovative solutions to insulate real returns from the sapping impact of inflation, rather than simply paying whatever price for standard inflation hedges.

Third theme audit

Our observation last December that **the pattern of ever decreasing rates cannot go on forever** proved prescient as interest rates quickly moved higher in the first quarter of 2021. This coincided with markets aggressively pricing the risk of increasing inflation that we discussed earlier. Our bias for keeping portfolio duration low and preferring inflation-linked to nominal bonds performed well through this period.

Bond yields remain low, particularly real yields as shown in Table 1.

Table 1: 10 year real bond yields

10 year real yields	Average (2006-2021)	Current
US	0.73%	-1.02%
Australia	0.90%	-0.75%
Germany	0.25%	-1.72%
UK	-0.64%	-2.74%
Japan	0.15%	-0.18%

Source: Bloomberg, 2021.

Why is this important? The technical definition of real yields is simply the rate that the marginal savings dollar meets the marginal zero default borrowers demand for a dollar after allowing for expected inflation. For us as investors, the real yield represents the foundational source for pricing risk. If we think of a government bond as being the sum of expected inflation and expected real yield, then we can take expected inflation out (using market observations) and now have a yield that shows us the cost of taking on risk. Everything else is priced off this yield, so if it is extremely low, then the risk premium we can expect from other riskier return sources will also be low. Hence with real yields strongly negative, we currently see corporate bonds at 0.5% yields and shares only paying dividends of 2% with PE multiples at 25 times (4% earnings yield).

This poses a risk for any investor seeking a return stream that is preserved after inflation – a real return. Our portfolio targets are likely to be CPI+3-5%, set in a time when real rates were closer to their historical averages. Unfortunately the price we receive for taking on risk at the moment is extremely low, meaning we are caught in the tension of needing to increase portfolio risk exposure to achieve return targets whilst knowing full well the price we are paying for this risk is not being adequately compensated.

This tension is not new, as yields have been low and prices high for a number of years. And as we have entered each year expecting bond yields to rise, they have actually fallen further and dragged the compensation for taking risk down with them. Each year the actual experience of invested capital has almost been at odds with the expectation. It has oft been repeated that bond yields can't keep falling forever and yet this has lasted longer than anyone expected. If nothing else, we are closer to the bottom.

The earlier discussion on inflation is instructive in exposing where our bias may lie. We have no certainty in knowing when bond yields will meaningfully rise, but with a number of secular inflationary tailwinds weakening and potentially turning inflationary, it is prudent to consider this pattern of ever decreasing rates may be close to its finale. A shift in interest rates will catalyse a repricing of risk across all asset classes.

For now, we will continue to favour low levels of nominal duration, particularly for assets not exposed to growth upside, to ensure our portfolios are insulated against a shift in the structure of rates. We will also continue to hold a balance of shares, with an emphasis on quality and efficient risk control, such as 'participate and protect'. Real assets and emerging markets remain important building blocks for the objective-based strategies and the mining basket broadens exposure of the funds to real cash flows. Alongside these, we continue to seek out opportunities to exploit structural opportunities on offer in markets that enhance return. To this end we hold an exposure to Chinese shares that pays a guaranteed excess return of over 10% pa with part of the outperformance used to fund downside protection over what is expected to be a volatile exposure. In our view, the key to success for risk-aware strategies is to embed as much risk as possible while structuring risk controls to be as aligned with portfolio objectives as possible.

Portfolio implications

For a risk-aware portfolio like Inflation Plus, this means minimising cash, holding risk assets to the greatest extent possible and giving up outsized gains to allow hedging against outcomes that breach our clients' tolerance for loss.

For our more traditionally managed strategies like the Horizon, Index Plus, Premium and Value portfolios, the level of risk is dictated to a large degree by the growth/defensive categorisation chosen by each portfolio – Horizon 5 will run more risk than Horizon 4. For these portfolios our approach is more nuanced as the cost of giving up gains to allow for hedging is more sensitive and needs to be balanced against the portfolio's requirement to deliver on its benchmark promise.

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 the March quarter, the near-term set of future scenarios that are important for financial markets continue to pivot around the evolution of the COVID-19 pandemic, and as such our three key scenarios remain more or less unchanged. A changing geopolitical landscape also brings risk and we continue escalation of global tension in the context of the evolving pandemic situation.

During the March quarter, the main northern hemisphere economic centres made significant progress in vaccination and opening of economies. Australia meanwhile has fallen a step and a half behind, continuing to battle sporadic outbreaks without the support of widespread vaccination.

But while the March quarter saw significant progress toward returning to 'normal' across the US, European Union, UK and China, COVID-19 continues to show worrying signs that it might quickly lose sensitivity to the first panel of vaccines developed in 2020. Already, the Delta variant is both less sensitive to vaccines and more virulent than other strains indicating that whatever changes have occurred to the spike protein to evade antibodies invoked by vaccination have not impeded its ability to infect cells. This is a worrying dynamic that raises the likelihood that Delta (or another strain) might be able to continue their evolution towards lower vaccine sensitivity and higher infectivity.

With this in mind, we retain our three core pandemic scenarios, but reduce the probability of the most optimistic scenario and increase the likelihood of a re-escalation in the pandemic.

- **Global pandemic: Immunity drives a return to growth (reduced probability)**
  - Rollout of vaccines and innate immunity supress COVID-19 across the northern hemisphere winter and spring season.
  - Lockdowns end.
  - Government stimulus fades.
  - Consumer behaviour returns to near pre-COVID profile.
  - Inflation is more likely than disinflation.
- **Global pandemic: Slow return to normality (higher probability)**
  - Vaccine rollout continues at a moderate pace.
  - Infection rates fall slowly.
  - Earnings suffer in both FY21 and FY22.
  - Consumers remain cautious
  - Both inflation and disinflation are possible.
- **Global pandemic: Emergence of vaccine resistance (higher probability)**
  - A severe vaccine-resistant strain of COVID-19 emerges. Full lockdowns are re-established.
  - Fiscal and monetary stimulus near the point of exhaustion.
  - Acceleration of populism.
  - High risk of global depression.
  - Disinflation or deflation are more likely that inflation.

Changes in return potential for asset classes

The return potential for Australian and global shares fell again across the June quarter following a similar contraction in the March quarter (Chart 3). The fall in return potential reflects a degree of valuation expansion as prices moved ahead faster than earnings growth expectations. Better valuations across listed property and infrastructure help maintain what looks like a good risk return trade-off against shares, but investors should still expect these asset classes to lag shares should buoyant market conditions remain. Fixed income continues to offer a poor risk-return proposition, paying off only in a narrow set of scenarios where nominal interest rates continue to fall. While this is possible and should not be ignored, it becomes less likely as rates fall lower and remains challenged by the prospect of fiscally-primed stimulus.

In terms of absolute levels, the five year return potential of all asset classes remains significantly below normalised long-term expectations. Indeed, for some asset classes the long-term expectation now lies close to the most bullish of our 40 scenarios, particularly for fixed income sectors whose long-term expectations sit beyond the average of the best 10% of scenarios on a five year basis.

Portfolio positioning

The broadening of economic activity drove solid earnings growth for many companies, largely reflected in the elevated prices and valuations. Similar to our addition to emerging market shares in the Horizon portfolios in the March quarter, we prefer to make allocations to reasonably priced risk that we believe has the potential to perform well across a wide range of scenarios. We haven't therefore made major changes to the **Horizon** or **Index Plus** portfolios' positioning during the June quarter.

There was activity in the **Inflation Plus** portfolios, which the 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:

- We continue to pursue our 'participate and protect' strategy, as we believe it affords us the necessary flexibility to participate in attractive growth exposures while at the same time protecting against the adverse outcomes associated with elevated prices and valuations. During the quarter we reinstated our swap exposures to emerging market shares (with a protective collar) and China (with a protective put), using the outperformance premiums we received on the swaps to cheapen the cost of the option protection. We also rolled our US shares skew trade as the difference between the cost of puts versus calls moved in our favour, and initiated an internally managed basket of 'Protected Mining and Energy Income' shares within Inflation Plus.
- Volatility in the foreign exchange markets in June provided the opportunity to re-instate an Australian dollar (AUD)/US dollar (USD) risk reversal. The move down to 75c in the AUD/USD gave us the chance to buy an AUD call at 79c that was funded by selling a put on the AUD around 71c. We have been using foreign currency as a protective mechanism in the portfolios for a while now. This option structure helps us manage the risk that the AUD strengthens

idiosyncratically, particularly if this is combined with a falling share market.

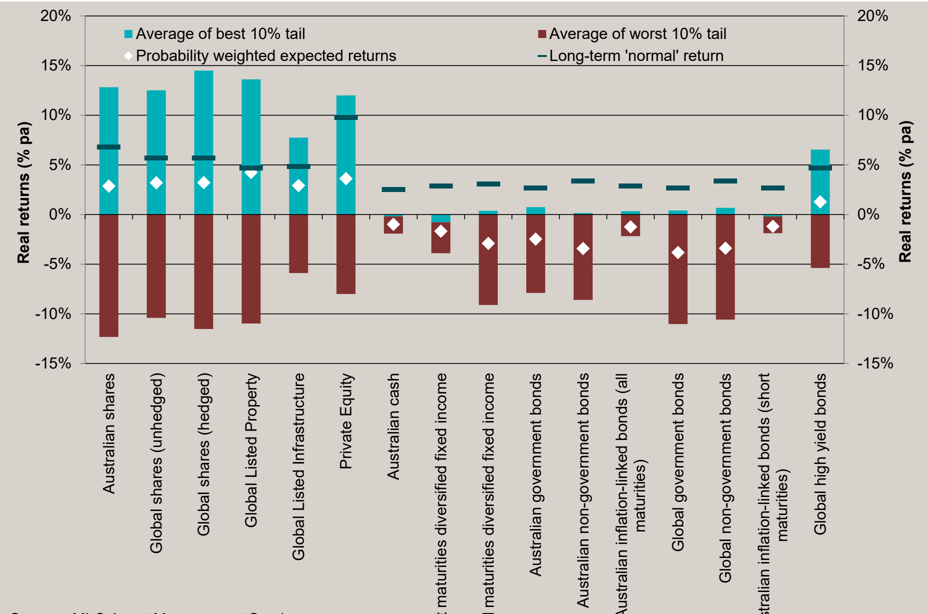
After the strong share market rally, we rebalanced the **MLC Value and Premium** portfolios (MLC Managed Account Strategies) back toward target growth allocations in April. Funds were allocated to fixed income and deallocated from outperforming share managers. We believe this discipline will result in more consistent returns over the long term. Additionally, income distributions for Premium portfolios at the end of the financial year also provided the opportunity to reallocate funds across fixed income and alternatives exposures.

The current investment environment represents a challenging point in the economic cycle. The combination of high share market valuations, low return potential from cash and fixed income, an unstable inflationary outlook and lingering risks to growth from new COVID-19 variants justifies our participate and protect strategy for the Managed Account Strategies. Over the June quarter we've positioned the portfolios in the following key ways:

- We're helping buffer the portfolios from share market falls by providing some protection through shortening the duration of the fixed income exposure to reduce its sensitivity to rising interest rates, while continuing to provide a foundation of regular income and diversification. We're also selectively pursuing investments in credit across global fixed income markets. The portfolios' fixed income funds are actively managed, which we believe is essential in effectively navigating a rising interest rate environment.
- We're participating in a reflationary environment most notably through investments in Australian and global shares. Inflation expectations are key to the uncertain economic environment in the medium term due to elevated global share market values, and very accommodative central bank policies and government stimulus measures. Retaining exposure to global and Australian shares is one way we can ensure the portfolios benefit from company earnings linked to inflation.
- We're continuing to seek innovative solutions to provide returns above inflation. MLC Wholesale Inflation Plus, for example, provides the portfolios with important real return exposure.

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

Chart 3: 40 scenario set (generic scenarios) potential real returns (June 2021) - 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.

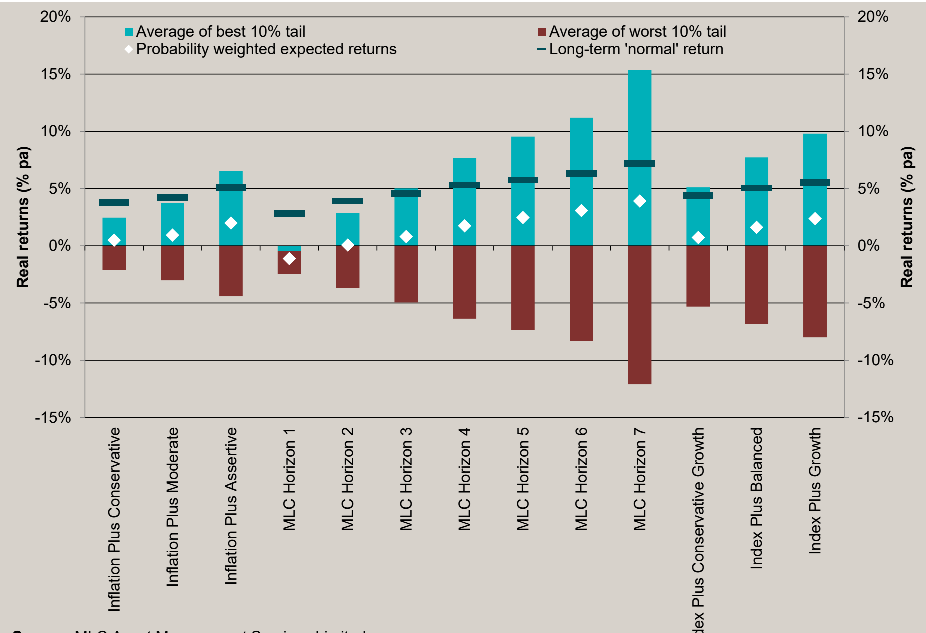
Return potential

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 June 2021.

Due to a decrease in the return potential for growth assets, the medium-term return potential of all the MLC multi-asset portfolios fell slightly during 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.

Chart 4: 40 scenario set (generic scenarios) potential real returns (June 2021) - 5 years, 0% tax with franking credits, pre-fees, pre-alpha



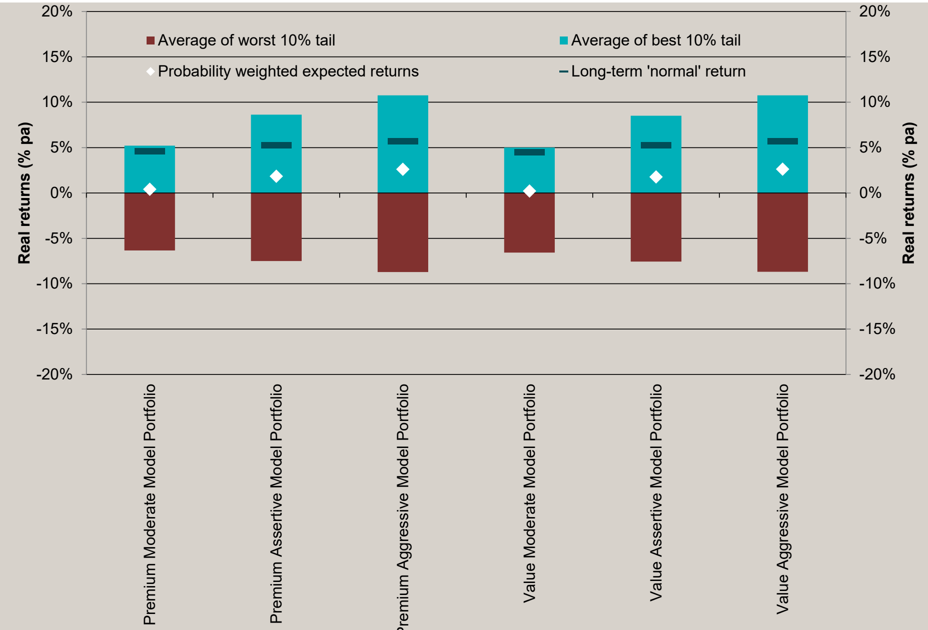
Source: MLC Asset Management Services Limited.

The probability-weighted real returns are shown above (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.

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 slightly more positively skewed potential outcomes, with higher returns in the most positive scenarios and less negative returns in the worst.

Chart 5: MLC Managed Account Strategies - 40 scenario set (generic scenarios) potential real returns (June 2021) - 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 (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 key portfolio activities during the June 2021 quarter, including up until the time of writing, were:

- Rolling our protected emerging markets and China swap exposures for another three months. The previous structures delivered as expected and we continue to believe exposure to emerging markets shares and China will benefit in a reflationary environment.
- Re-instating our US shares skew trade through an option structure that provides cheap participation in rallies without participation in shallow reversals. The pricing on the skew was more attractive than last quarter as the market continues to value puts more highly than calls. We remain concerned at the elevated valuation levels of the US share market but understand the level of financial stimulus and boost from vaccine led re-openings could continue to fuel earnings growth. The skew structure allows the portfolios to participate in any market rally through the purchase of a call option, while at the same time avoiding losses by not gaining any exposure to the market until it is 10% lower.
- Introducing an AUD/USD risk reversal. The AUD/USD move down to 75c gave us the opportunity to buy an AUD call at 79c that was funded by selling a put on the AUD around 71c. This option structure helps us manage the risk that the AUD strengthens idiosyncratically, particularly if combined with a falling share market.

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.

- Rolling our call option on USD/yen to protect against the adverse scenario of the Japanese yen depreciating at the same time as share markets fall. We hold the yen as a defensive currency that typically performs well when share markets do poorly and want to maintain exposure to this protection. We have identified certain scenarios where rising interest rates may lead to the yen underperforming, and as such use the call option to mitigate losses in these scenarios.
- Introduction of a customised basket of 'protected income' mining and energy shares. We manage the basket which holds a number of large- and mid-cap mining and energy stocks skewed towards companies with solid free cashflow, healthy dividend yields and disciplined capital management. Each holding is hedged with options that truncates downside losses at the expense of upside in excess of typical share market returns.

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

Asset class	MLC Wholesale Inflation Plus portfolios change in target allocation over the 3 months ended 30 June 2021		
	Conservative	**Moderate**	**Assertive**
Chinese government bonds (through derivative strategies)	Steady	Steady	Steady
China A-shares with downside limit of -20% (through derivative strategies)	Steady	Steady	Steady
Emerging market shares (through derivative strategies)	Steady	Steady	Steady
Defensive Australian shares (including protected income mining and energy shares)	**Increased**	**Increased**	**Increased**
Global shares (through derivative strategies)	Steady	Steady	Steady
Listed infrastructure (through derivative strategies)	Steady	Steady	Steady
Global shares (unhedged)	Steady	Steady	Steady
Foreign currency exposure	Diversified basket maintained	Diversified basket maintained	Diversified basket maintained
Gold exposure (through derivative strategies via call options)	Steady	Steady	Steady
Low correlation strategy	Steady	Steady	Steady
Real return strategy	Steady	**Reduced**	**Reduced**
Australian inflation-linked bonds	Steady	Steady	Steady
Insurance-related investments	Steady	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	Steady
Australian non-government bonds (short-maturity)	**Reduced**	**Reduced**	No allocation
Cash	**Reduced**	**Reduced**	**Reduced**
Borrowings	Not permitted	Not permitted	No borrowings

MLC Horizon portfolios

Asset allocation positioning of the MLC Horizon portfolios was largely unchanged over the June quarter. However, the following underlying manager changes were made to the fixed income and Australian shares components of the portfolios:

- We appointed Ardea Investment Management as a global absolute return manager, and removed BNP Paribas and Insight. We have greater confidence in Ardea's ability to consistently outperform the cash plus objective of our global absolute return bonds strategy. Details are available at **mlc.com.au**
- We appointed Macquarie Investment Management as an 'enhanced index' Australian shares manager, and removed Redpoint. We have greater confidence in Macquarie's ability to outperform the market more consistently, through a range of different market conditions, while controlling risk. Details are available at **mlc.com.au**

MLC Horizon portfolios also inherit exposures through investment in Inflation Plus, providing important real return exposure and sources of low correlation return streams.

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.

Inflation Plus' activity this quarter was focused on introducing a customised basket of 'protected income' mining and energy shares, rolling emerging markets and China downside protected derivative strategies, reinstating protected US share market exposure, introducing an AUD/USD risk reversal derivatives strategy, rolling our USD/JPY call options to protect against an adverse scenario of the JPY depreciating at the same time as share markets fall.

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

Asset class	MLC Wholesale Horizon 4 Balanced Portfolio target asset allocation at 30 June 2021		
	Under	Strategic asset allocation	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)		•	
Real return strategies (including Inflation Plus)		•	
Low correlation strategy		•	

MLC Index Plus portfolios

Asset allocation positioning of the MLC Index Plus portfolios was little changed in the June quarter. However, the following underlying manager changes were made to the fixed income and Australian shares components of the portfolios:

- We appointed Ardea Investment Management as a global absolute return manager, and removed BNP Paribas and Insight. We have greater confidence in Ardea's ability to consistently outperform the cash plus objective of our global absolute return bonds strategy. Details are available at **mlc.com.au**
- We appointed Macquarie Investment Management as an 'enhanced index' Australian shares manager, and removed Redpoint. We have greater confidence in Macquarie's ability to outperform the market more consistently, through a range of different market conditions, while controlling risk. Details are available at **mlc.com.au**

MLC Index Plus portfolios also inherit exposures through investment in the real return strategy, providing important real return exposure and sources of low correlation return streams.

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.

The real return strategy's activity this quarter was focused on introducing a customised basket of 'protected income' mining and energy shares, rolling emerging markets and China downside protected derivative strategies, reinstating protected US share market exposure, introducing an AUD/USD risk reversal derivatives strategy, rolling our USD/JPY call options to protect against an adverse scenario of the JPY depreciating at the same time as share markets fall.

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

Asset class	MLC Wholesale Index Plus Balanced Portfolio target asset allocation at 30 June 2021		
	Under	Strategic asset allocation	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. We've positioned the portfolio for diverse and resilient returns across asset classes in the following key ways:

- **Rebalanced growth assets allocation to the 'inner' rebalancing band** – We see the likely continuation of the 'recovery and reopening' thematic supporting slightly higher allocations to Australian and global shares. During April we took the opportunity to rebalance growth allocations back toward targets as share markets rallied strongly.
- **Foreign currency diversification** – Within global shares we continue to see foreign currency exposure as an important diversifier (holding both hedged and unhedged global shares).
- **Active fixed income** – Fixed income funds are actively managed, which we believe is essential in effectively navigating a rising interest rate environment. Our fixed income duration is relatively short to help reduce the portfolio's exposure to rising interest rates, and we selectively pursue investments in credit through Bentham's funds.

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.

- **Inflation Plus changes** – MLC Wholesale Inflation Plus portfolios' provide important real return exposure and sources of low correlation return streams. Activity was focused on introducing a customised basket of 'protected income' mining and energy shares, rolling emerging markets and China downside protected derivative strategies, reinstating protected US share market exposure, introducing an AUD/USD risk reversal derivatives strategy, rolling our USD/JPY call options to protect against an adverse scenario of the JPY depreciating at the same time as share markets fall.

Details of stock changes made since 30 June 2021 and the rebalance in early July using income distributions, are available in the Portfolio Activity Reports at **mlcam.com.au**

Asset class	MLC Premium Model Portfolios change in target allocation over the 3 months ended 30 June 2021		
	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	Steady	Steady	Steady
- Active, absolute return, hedged	Steady	Steady	Steady
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

MLC Managed Account Strategies

Asset class	MLC Value Model Portfolios change in target allocation over the 3 months ended 30 June 2021		
	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

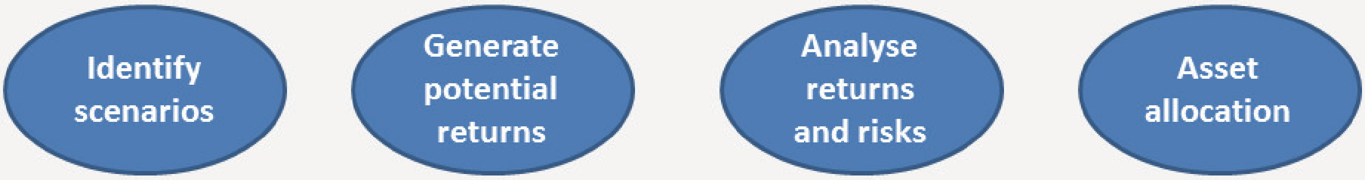
Any portfolio change shown above is not a guarantee of a change to a client's portfolio. There may be differences between the Model Portfolio and a client's portfolio due to the timing and transaction prices for portfolio changes, client investments and withdrawals during the period, timing of receipt 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.

Appendix 1 – MLC's market-leading investment process

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 1 Bond Portfolio	MLC Horizon 1 Bond Portfolio	MLC Premium Moderate Model Portfolio
MLC Wholesale Horizon 2 Income Portfolio	MLC Horizon 2 Capital Stable Portfolio	MLC Premium Assertive Model Portfolio
MLC Wholesale Horizon 3 Conservative Growth Portfolio	MLC Horizon 3 Conservative Growth Portfolio	MLC Premium Aggressive Model Portfolio
MLC Wholesale Horizon 4 Balanced Portfolio	MLC Horizon 4 Balanced Portfolio	MLC Value Moderate Model Portfolio
MLC Wholesale Horizon 5 Growth Portfolio	MLC Horizon 5 Growth Portfolio	MLC Value Assertive Model Portfolio
MLC Wholesale Horizon 6 Share Portfolio	MLC Horizon 6 Share Portfolio	MLC Value Aggressive Model Portfolio
MLC Wholesale Horizon 7 Accelerated Growth Portfolio	MLC Horizon 7 Accelerated Growth 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	

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