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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 2021.

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Continued at end of update.

Quarterly insights

Highlights

- **Looking closely into the composition of prevailing high share market valuations it becomes clear that very low interest rates are the driver.**
- **We believe the relatively high real interest rate environment in China presently provides an opportunity to harness return potential.**
- **Our customised positions within the MLC Inflation Plus and Horizon portfolios have been designed to achieve a targeted exposure to the Chinese assets that we believe will benefit most from government policy settings.**
- **Inflation remains uncertain and is arguably at the behest of the pandemic to a large extent. Under the most optimistic of our scenarios, we believe that inflation will remain stubbornly above central bank targets driven by a combination of supply and demand factors.**

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

The devil is *always* in the detail.

It's almost a truism that exposure to **equity** is the main driver of upside for all multi-asset investors. It's also true, that starting valuations have been a good predictor of equity returns over the ensuing decade: high starting valuations decrease the likelihood of reasonable returns and increase the risk of loss, while low starting valuations lift the prospect of outsized returns and limit risk. Yet, by peeling one layer lower into the composition of the prevailing high equity valuations, it becomes clear that very low interest rates are the culprit. Indeed, from a relative point of view, equities are not expensive relative to government bond yields, a proxy for the risk-free rate.

This pattern of low core interest rates and a more or less stable equity risk premium (shown in Chart 1 for the US) is representative of the state of most developed markets and some more advanced emerging markets. Indeed, excluding the high-risk end of emerging markets, it is difficult to find any global market that has an underlying risk-free real yield (the yield remaining after subtracting inflation) comparable to what was a normal level prior to 2012. Table 1 shows the change in real yields for a select group of countries/regions in the 15 years between 2006 and 2021.

What stands out to us is that China, while evolving considerably over the last 15 years, has not witnessed any attrition in the underlying risk-free real rate of return as have it's now (arguably) peer economies. A number of factors underpin the comparatively elevated level of real rates in China, with sovereign risk an obvious key contributor. China's economic progress, while very impressive, still has a transitionary period ahead, raising the risk of policy error and leaving investors demanding a higher risk premium to invest in what is ostensibly a 'command' economy. Yet that alone cannot explain the divergence between real rates in China and peer economies, given that the spread between real rates in China and other countries has widened, while China's economic development cycle has made strides forward.

Perhaps more notable than the importance of sovereign risk on maintenance of higher real rates in China is that standard monetary policy, despite local nuances and the role of exchange rate management, continues to remain effective: tighter policy rates reduce demand and lower rates spur demand. Unlike peer central banks, the People's Bank of China has not yet stepped into the realm of zero policy cash rates and large-scale quantitative easing, instead preferring to maintain more traditional levels of monetary policy settings.

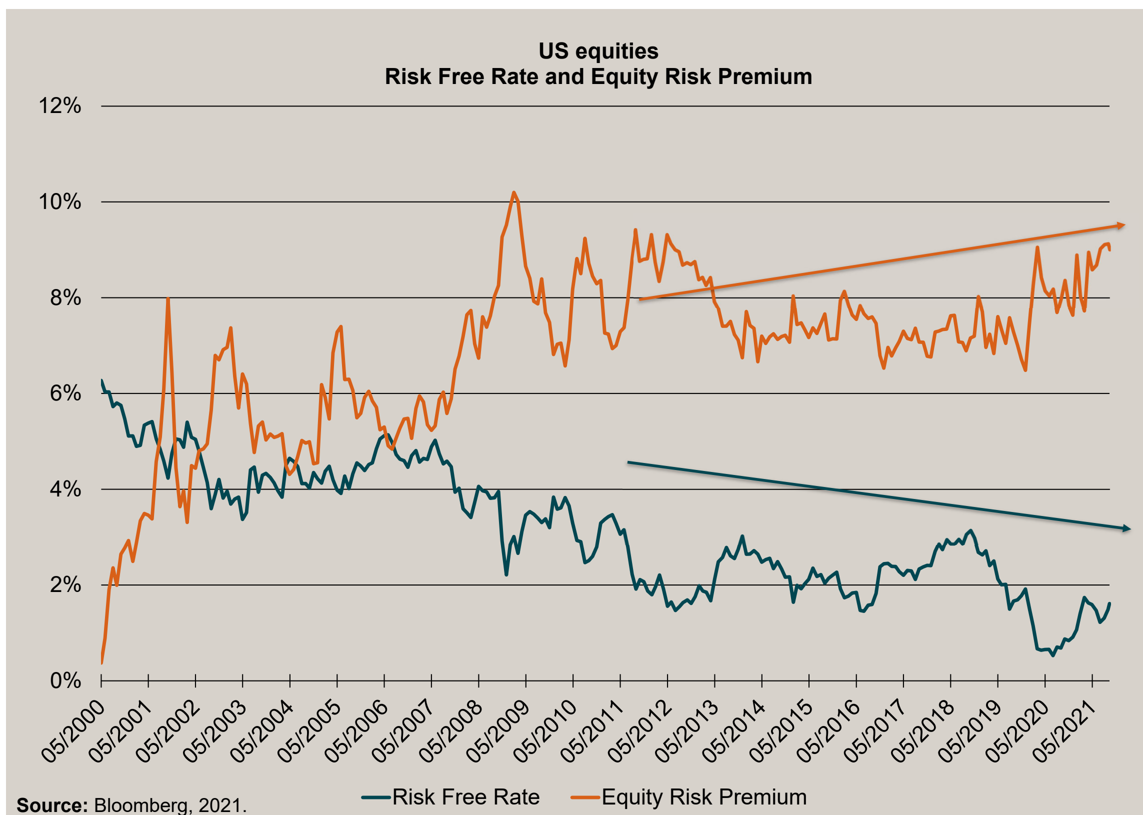
So, if low real interest rates are the ultimate challenge for investors, does the relatively high real interest rate environment in China provide an opportunity to harness return potential? We currently think so and have expressed this view for some time through Chinese shares and bond positions within the MLC Inflation Plus portfolios, and more recently in the MLC Horizon portfolios through an emerging market shares overweight. Importantly, these positions are customised to achieve a targeted exposure to the Chinese assets that we believe will benefit most from government policy settings.

Table 1: Change in 10-year real yields over 15 years

Country/region	30/06/2021	31/10/2006
China	2.2%	2.2%
Australia	-1.6%	3.0%
US	-3.0%	1.9%
Britain	-1.5%	2.9%
eurozone	-1.1%	2.2%
Canada	-0.8%	2.2%
South Korea	0.6%	2.9%
Taiwan	0.4%	1.5%
Japan	1.2%	2.1%

Source: Bloomberg, 2021.

Chart 1: US equity risk premium



Source: Bloomberg, 2021.

The devil is in the detail

At the highest level, China is an enigma. For those of us in the West, it represents an unfamiliar political system, with an underlying ideology that in simplistic terms is taken as being at odds with capitalism. But whereas China's political ideology clearly differs from standard Western capitalism, it also differs from other socialist systems and is known in China as "Socialism with Chinese Characteristics". In our opinion, the *"Chinese Characteristics"* part of the name at least in part embodies the traditional mercantilist nature of Chinese society and the role it plays in helping address the inefficiencies embedded in traditional socialism.

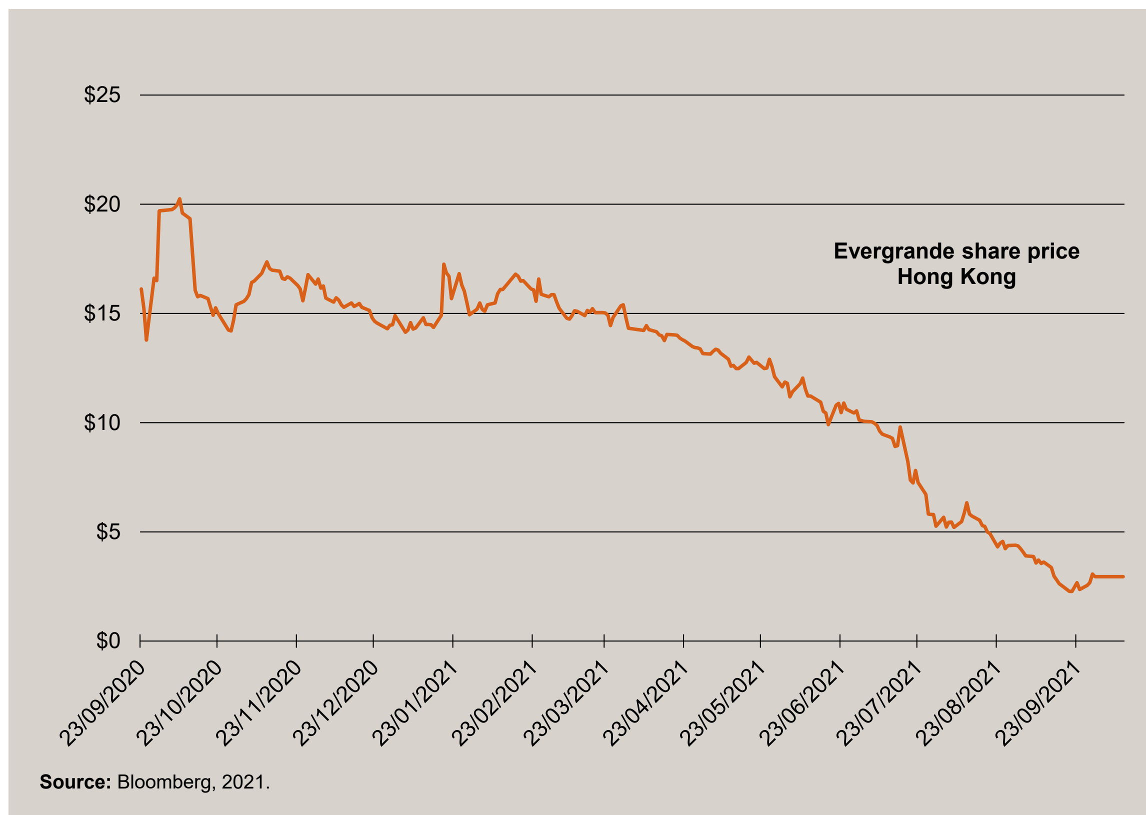
As observers of China, we believe that a useful way to conceptualise China's political structure and social economy is to delineate unified *control* from fragmented *implementation*. China knows well from its own history that the country prospers under the leadership of a united core and stumbles upon fragmentation and erosion from within. This fear of division is well evidenced by the fact that the country, while spanning 54 degrees of longitude only has a single time zone (Australia by way of contrast spans **30** degrees of longitude and has a **three-hour** time zone gap between Perth and Sydney). But while governance is centralised, implementation of policy is delegated both regionally to the provinces and cross-sectionally in the economy to either private-like organisations (state-owned enterprises, SoE) or the private sector.

The recent ructions in China's property market are a good example of how the system manages centralised policy and localised implementation. While the broad directive out of Beijing is for tightening of the property sector, weak conditions in predominantly tier-3 and tier-4 cities are being addressed by loosening of regional policy. Thus, while bustling new economic hot zones such as Hainan are restricting lending and inhibiting liquidity, stagnant markets such as Zhuhai are relaxing liquidity and supporting prices.

Evergrande

Evergrande is worth touching on at this point. Whereas headlines are suggestive of an impending calamity, our view is that China makes no major policy decision without first carefully considering the consequences against the country's long-term goals and short-term situation. That's not to say that decision-making is without risk, but that the risk of unintended consequence is low. In this case, property developer Evergrande's fate was most likely sealed in late 2020 when China's regulators implemented the 'Three Red Lines' policy that governs access to leverage for property developers. The market quickly read Three Red Lines as a risk to Evergrande, prompting a slide in the share price that began long before the company grabbed headlines (Chart 2). And if the market could see what potentially lay in store, we believe it is highly unlikely that regulators had not considered contingencies for large property developers at that point.

Chart 2: Evergrande's share price



Source: Bloomberg, 2021.

Failure of Evergrande is very unlikely to ignite contagion either domestically or offshore. For now, the Chinese government will most probably prioritise the welfare of home buyers exposed to Evergrande through sale contracts and contractors exposed to commercial loss. The financial system may well incur losses, but analysts believe that exposure of both the formal and shadow banking systems to Evergrande debt is low enough to be absorbed without system wide disruption. Evergrande debt represents less than 0.25% of Chinese bank loans.

Although China is a socialist command economy it is *certainly not* anti-enterprise. Policy well recognises that innovation requires optimisation of both capital and talent. So, while recent headlines in offshore press have focused on a crackdown against a narrow segment of mega-rich technology fortunes, the move by SoE's to re-align employment incentives to enable greater sharing of commercial interest with employees has almost gone unnoticed. These seemingly contradictory moves are in fact serving two purposes. The former limiting further evolution of commercial entities that threaten centralisation, and the latter aimed at continuation of what is becoming a rapidly competitive and productive technology sector in China.

Our guide to investing in China is to follow *policy* signals. As eluded to above, *strategic* policy is clearly communicated in China by the command economy. The trick we believe is not to get lost in *cyclicality*, but to focus instead on *strategic* priorities. Since the trade war and subsequent pandemic, China's inward focus has accelerated. Coined 'dual circulation', China has made a sharp turn toward development of self-sustaining domestic-led growth as a substitute for reliance on exports and capital formation. This has led to a series of policy measures that directly support small to medium-sized enterprises (SMEs) and foster less reliance on offshore markets. Policies aimed at supporting SME's range from access to credit, through to taxation and support for employees. In our view, the support offered to the SME sector trumps the cyclical drag from monetary policy in the short term and, if we are right, won't necessarily run countercyclical when monetary conditions change (ie SME's could coincidently benefit from both monetary and strategic policies).

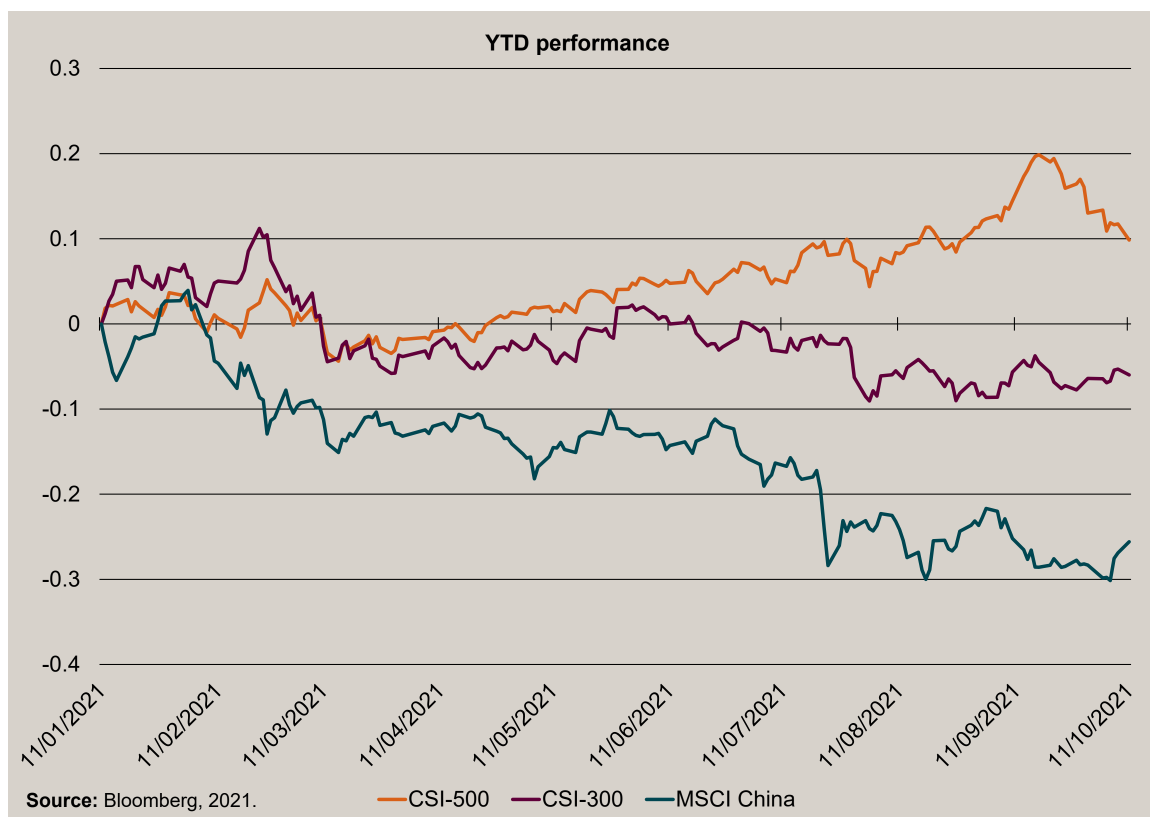
Portfolio implications

Our view that Chinese SME's represent an attractive risk-reward given the prevailing high base-real rates and supportive strategic policy is currently expressed in the Inflation Plus portfolios via a protected derivatives exposure to small capitalisation Chinese companies (a total return swap on the CSI-500 equity index with a high level of guaranteed outperformance of greater than 10%). This position has been in place for over 18 months and has delivered very close to our expectations given the continued backdrop of SME supportive policy. And, while our thesis has played out well on an absolute return basis, the importance of being selective in our allocation to China appears even stronger. For while the CSI-500 Index is up 10% year-to-date, domestic large enterprises (the CSI-300 equity index) are down 5% and the tech-heavy and more globalised MSCI China Index is down almost 25% (Chart 3).

We continue to view domestic policy in China as supportive and plan on retaining our exposures to the CSI-500 Index. In the meantime, our exposure remains risk controlled to the downside through the purchase of equity put options that are more than fully funded by the outperformance received on the swap. We also hold a small allocation to Chinese government bonds as a risk offset. The allocation to Chinese bonds serves purposes beyond offsetting share market risk, helping to diversify our currency exposure away from the US dollar (USD) and providing much needed carry, particularly to the risk averse conservative portfolio.

The MLC Horizon portfolios maintain an overweight to China via a derivative exposure to the MSCI Emerging Markets Index that substitutes in the CSI-300 Index for the MSCI China Index holdings. This is our way of balancing tracking error and our insights that domestic exposure to China is preferred over entities that have more offshore exposure.

Chart 3: China's share market year-to-date performance



Source: Bloomberg, 2021.

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.

As the pandemic progresses to normalisation in the developed world, other issues have begun to compete for importance in determining the opportunities and challenges faced by investors. Nonetheless, we believe that COVID-19 remains strong enough a determinant of near-term risk to continue anchoring our short-term scenarios thinking and mapping the outcome of many critical issues into one of the three scenarios.

Inflation remains uncertain and is arguably at the behest of the pandemic to a large extent. Under the most optimistic of our three scenarios, we believe that inflation will remain stubbornly above central bank targets driven by a combination of supply and demand factors. Monetary policy will react, but most likely lag the inflationary tendency, tempering real interest rates and steepening yield curves. By contrast, lingering risks from the pandemic, should delta continue to repress activity in the developed world, will drive an ambiguous inflation environment and the debate regarding supply-side impacts will persist. Yet, should the COVID-19 pandemic take a turn for the worst, with the emergence of a strain that is both virulent and more resistant to vaccines than delta, the resultant shock to demand will most likely drive inflation expectations lower and prompt a sharp rise in risk aversion.

There is however, one critical factor that sits outside the pandemic but remains acutely important for Australian investors. China's economic fortunes and bilateral relationship with the West are an axis of uncertainty that require careful consideration. For now, Australia's relationship with China is precarious but it remains unclear how much further China can go with economic reprisals. But while Australia draws confidence from being a choice amongst one for adequate volumes of high-quality iron ore, uncertainty over China's property construction sector and demand for steel are a risk for both price and volumes of iron ore. Our base case is that China's supply cuts will be met and iron ore will settle at a level somewhere below US$100 per tonne. Yet, while $100 is a far cry from the US$240 per tonne that prevailed in September, it is more than adequate to support domestic income and maintain a high level of profitability for major domestic iron ore miners. A significant drop in iron ore volumes represents the downside case for Australia. Thus, a **sharp drop** (as opposed to a step-down) in Chinese residential construction remains the critical risk to monitor. For now, the signals remain comfortably above the negativity embedded in community and share market prices. Steel prices indicate that the output curbs implemented to date are greater than the drop in demand (stronger prices), inventory levels are dropping and infrastructure plans in China and abroad continue to grow.

With this in mind, we retain our three core pandemic scenarios with very similar probabilities to last quarter.

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.
- Further lockdowns are avoided.
- Government stimulus fades.
- Consumer behaviour returns to near pre-COVID profile.
- Elevated inflation persists.
- Interest rates rise, but lag inflation.

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.
- Inflation outlook remains ambiguous.

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 than inflation.

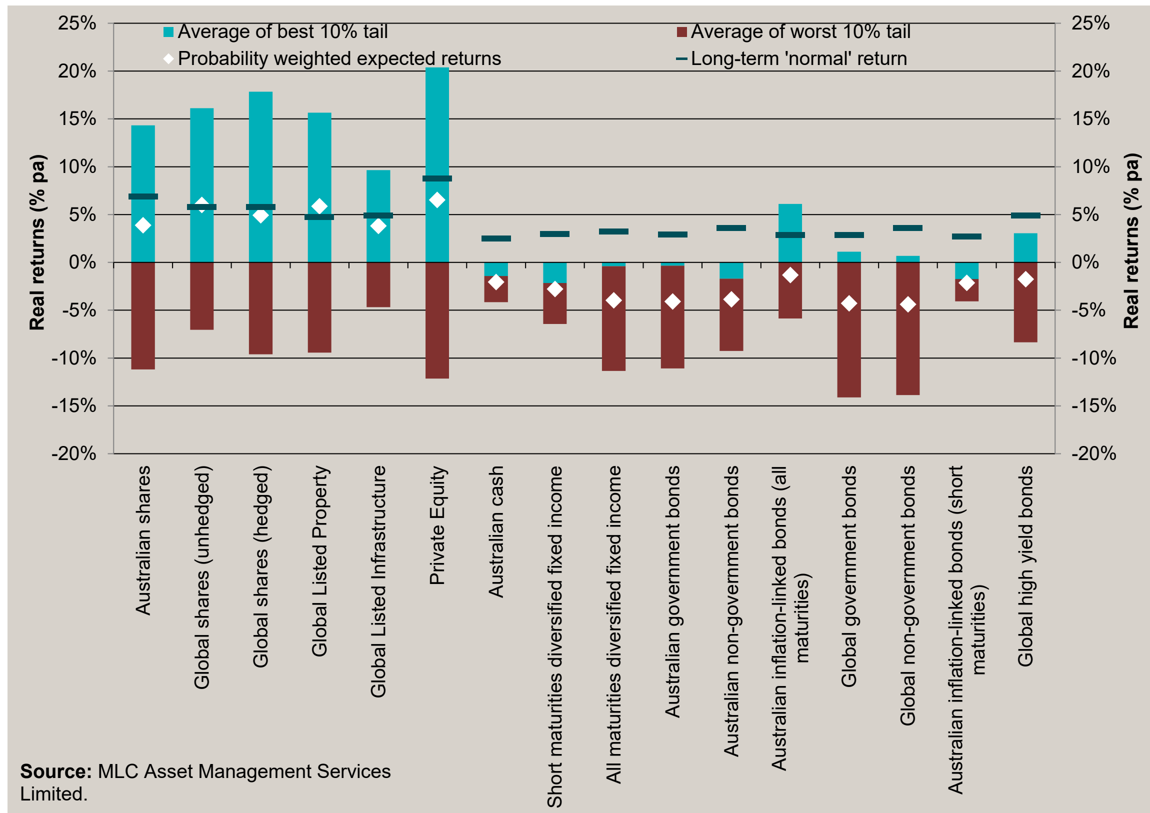
Changes in return potential for asset classes

The return potential across most asset classes remained more or less unchanged from the end of the June quarter (Chart 4).

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.

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

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



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.

Portfolio positioning

This quarter market movements proffered many opportunities for us to take profits and enter into additional participate and protect strategies in the Inflation Plus portfolios. We also made a new allocation in the MLC Horizon portfolios to global listed infrastructure implemented through a strategy that provides market exposure after deducting fees, and swapped over Inflation Plus portfolios' infrastructure exposure which was previously implemented via derivatives. We believe the addition of infrastructure further broadens the drivers of growth within the portfolios while at the same time contributing valuable real income in an environment where traditional sources of yield are anaemic at best.

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

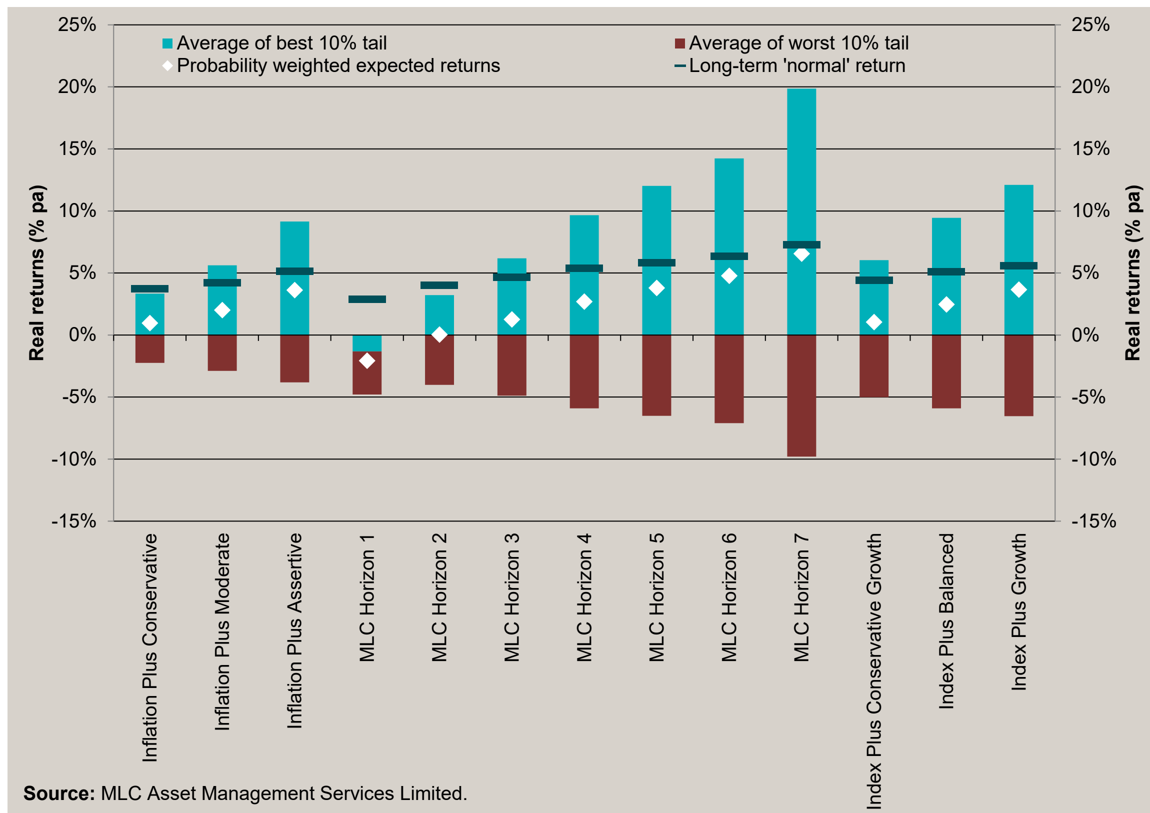
Return potential

Charts 5 and 6 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 2021.

The stronger risk focus of the Inflation Plus portfolios is evident (Chart 5).

Consistent with their objectives, the Inflation Plus portfolios have responded to shrinking return potential and weakening risk diversifiers by continuing to pursue a 'Participate and Protect' strategy – adding to appropriately priced sources of return potential in a risk-controlled way. This reduces the return potential in strong scenarios but provides tighter risk control in the event of an adverse environment.

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



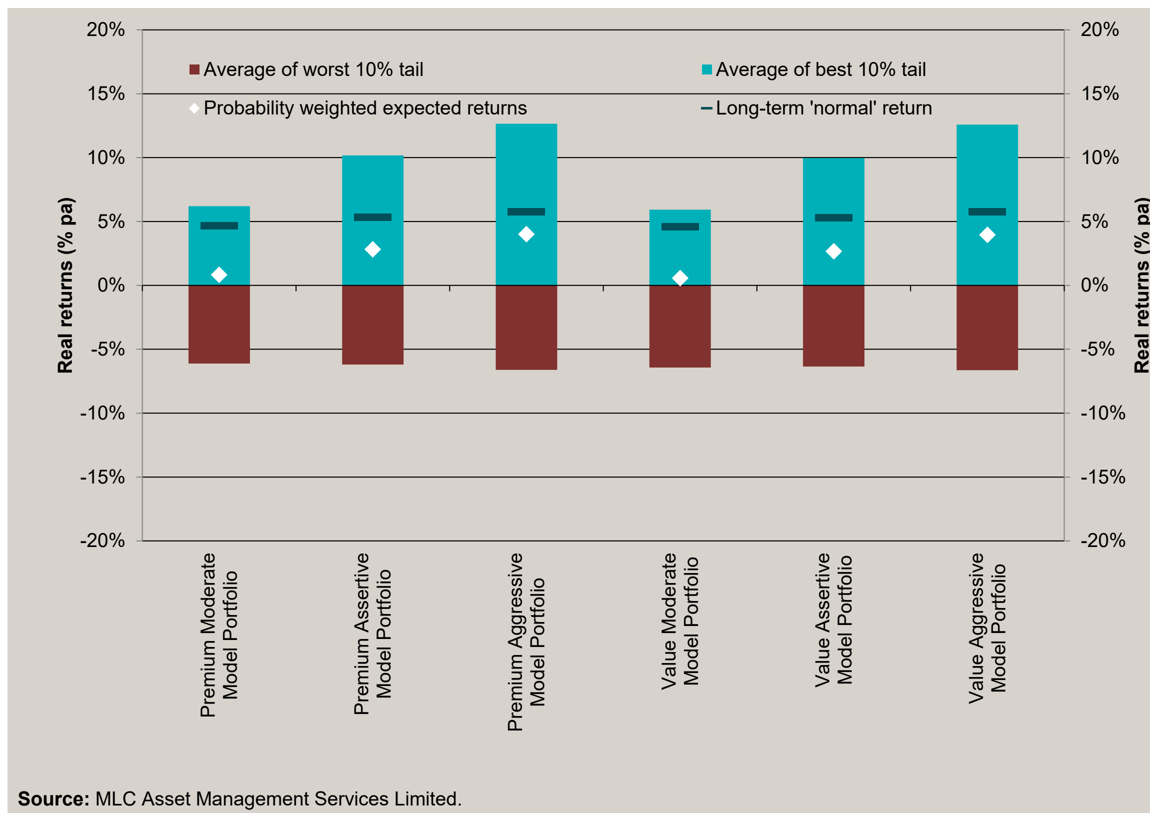
The probability-weighted real returns are shown above (diamonds). For comparison we've included long-term 'normal' return expectations which are set by considering a stable fair value world - these are shown by the horizontal lines. Also, as an indicator of how uncertain these returns are, we've taken 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.

Return potential

Consistent with their Horizon and Index Plus multi-asset counterparts, the medium-term return potential of all the MLC Managed Account Strategies remains significantly below the returns similar asset allocations have produced in the past (Chart 6).

While both the Premium and Value Model Portfolios are expected to deliver similar returns, the additional levers and active management dimensions afforded by the higher cost of the Premium Model Portfolios result in slightly more positively skewed potential outcomes, with incrementally higher returns in the most positive scenarios and less negative returns in the worst.

Chart 6: MLC Managed Account Strategies - 40 scenario set (generic scenarios) potential real returns (September 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 September 2021 quarter, including up until the time of writing, were:

- Introducing a second Australian dollar (AUD)/USD risk reversal trade. The leg-down in the AUD during September provided a second opportunity for the portfolios to use optionality to reduce exposure to the USD. The zero-premium collar protects the fund from losses above an exchange rate of $0.76, with the cost being loss of the covered portion of USD exposure below $0.68 cents.
- The fall in the AUD also provided the opportunity to profitably reduce some of the portfolios' exposure to the British pound (GBP). UK economic fundamentals have deteriorated recently, with inflation surprising to the upside. The GBP is providing little by way of currency diversification across scenarios, so the recent move higher relative to the AUD provided an opportune time to reduce the portfolios' GBP position.
- Rolling our protected China exposure for another 12 months using the same total return swap already in place. The CSI-500 Index provides the portfolios with an exposure to a high growth opportunity in China that is currently receiving the benefits of policy support. The swap contract pays a fixed outperformance over the underlying total return index providing a budget to build put protection that caps losses if the market falls beyond a pre specified threshold.
- Taking profits on our Japanese yen (JPY) call and rolling the strike up and out. This position is designed to protect against a weakening of the JPY. The portfolios' exposure to JPY forms part of a protective core but is vulnerable to a rise in real rates. Other parts of the portfolio have a similar sensitivity to changes in real rates (eg gold, inflation linked bonds, infrastructure etc) making this a pain point for the portfolios under an adverse interest rate scenario. Optionality over JPY is the cheapest means of offsetting this risk.
- A further allocation to our mining and energy thematic basket. We took the strong sell off in resources and energy to increase the portfolios' exposure to real cash flows. Prior to the sell off and in recognition of price risk, the portfolios had made only a small allocation to the basket. We are now close to full weight.

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.

- We've replaced the exposure to global listed infrastructure. Since December 2020 we've gained exposure through derivatives which we've now replaced with a strategy that provides market exposure after deducting fees. Infrastructure fulfils a role in the portfolios, across multiple potential scenarios:
  - In scenarios where inflation moves higher (a scenario that's increasing in probability), returns from infrastructure may be beneficial because infrastructure assets, particularly in regulated sectors like utilities, deliver stable earnings growth and cash flows which tend to increase as inflation rises.
  - The long-term nature of infrastructure cash flows sees them perform well in environments of falling real yields (ie yields in excess of inflation), not unlike the one that's prevailed for much of the last decade.
  - The long-term characteristics of infrastructure means they tend to outperform other growth assets should economic conditions sour.

  More details are available at **mlc.com.au**

MLC Inflation Plus portfolios

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 asset allocation over the 3 months ended 30 September 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)	Steady	Steady	Steady
Global shares (through derivative strategies)	Steady	Steady	Steady
Global listed infrastructure	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	Steady	Steady
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)	Steady	Steady	No allocation
Cash	Steady	Steady	Steady
Borrowings	Not permitted	Not permitted	No borrowings

MLC Horizon portfolios

MLC Horizon portfolios made a new allocation to global listed infrastructure during the September quarter through a strategy that provides market exposure after deducting fees. This strategy is benchmarked against the FTSE Developed Core Infrastructure 50/50 Index ($A hedged), providing the Horizon portfolios with an economically and geographically diversified basket of infrastructure stocks.

Infrastructure assets are a useful addition to the portfolios at this time, as they can fulfil a role across multiple potential scenarios. Their revenue streams are typically positively linked to inflation, particularly in the regulated sectors like utilities, which can provide a steady source of real income in scenarios where inflation moves higher. We believe this will be beneficial for the portfolios moving forward as the probability of higher inflation is increasing across our scenario set.

The long-dated nature of infrastructure cash flows also sees them perform well in an environment of falling real rates, not unlike the one that has prevailed for much of the last decade. This 'long duration' characteristic means infrastructure can outperform other growth assets should economic growth sour. This dual profile of inflation linkage and protected growth makes infrastructure an appealing addition to the portfolios.

The significant underperformance of infrastructure since the start of the pandemic has provided an opportunity for the Horizon portfolios to get access to this asset class at an attractive valuation level. The addition of infrastructure further broadens the drivers of growth within the portfolios whilst at the same time contributing valuable real income in an environment where traditional sources of yield are anaemic at best.

The allocation to infrastructure has been funded by reducing exposure to global shares (hedged), inflation-linked bonds and Inflation Plus.

More details are available at **mlc.com.au**

For the active management of the MLC Horizon portfolios, risk is primarily benchmark-related. Strategic (benchmark) asset allocations 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.

During the quarter we also removed one of the Australian fixed income managers, UBS Asset Management, from the Horizon 1 portfolio. UBS's focus on the macro economic environment was previously complementary to our other short duration Australian fixed income manager, Antares', focus on credit. However, in recent years UBS hasn't provided sufficient diversification of returns from Antares. The Horizon 1 portfolio continues to have diversification across fixed income sectors and investment managers.

MLC Horizon portfolios also inherit exposures through investment in Inflation Plus, providing important real return exposure and sources of low correlation return streams. Inflation Plus' activity this quarter was focused on reducing exposure to the USD by introducing a second AUD/USD risk reversal trade after the fall in the AUD in September, the AUD fall also provided the opportunity to profitably reduce GBP exposure, we rolled the protected exposure to Chinese shares, took some profits on our strategy that provides protection against a fall in the JPY, and after a sell-off in resources and energy stocks we took the opportunity to make a further allocation to the mining and energy thematic basket.

MLC Horizon portfolios

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 September 2021		
	Under	**Strategic asset allocation**	**Over**
Australian shares		•	
Global shares (unhedged)			•
Global shares (hedged)	•		
Global property securities		•	
Global listed infrastructure			•
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 September quarter.

MLC Index Plus portfolios inherit exposures through investment in the real return strategy, providing important real return exposure and sources of low correlation return streams. The real return strategy's activity this quarter was focused on accessing reasonably priced return sources whilst at the same time controlling for adverse outcomes:

- Additional growth exposure was added through the customised basket of mining and energy stocks, as well as rolling the China shares exposure via a CSI-500 Small Cap Index swap. Both these strategies have embedded option protection to limit losses, consistent with our 'Participate and Protect' mantra.

Risk is primarily benchmark-related for the Index Plus portfolios. Strategic (benchmark) asset allocations 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 foreign currency basket was also adjusted through the addition of an AUD/USD derivatives strategy and a resetting of the USD/JPY calls. Currency remains an important risk control mechanism in the real return strategy, but the fall in the AUD over the quarter provided the opportunity to profitably reduce some of the foreign currency exposure.

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 September 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:

- **Investing growth asset distributions to re-establish asset allocation targets** – Reinvestment of what were in some instances substantial year-end distributions within global shares. While slightly moderated from prior levels, we retain our positioning towards a reflationary environment and are keen to benefit from the real cash flows of assets with revenues linked to inflation, most notably Australian and global shares. During July we took the opportunity to rebalance growth allocations back toward targets following payment of year-end distributions.
- **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. During July we took the opportunity to rebalance fixed income allocations back toward targets following payment of year-end distributions, most notably from global share managers.

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. Inflation Plus' activity this quarter was focused on reducing exposure to the USD by introducing a second AUD/USD risk reversal trade after the fall in the AUD in September, the AUD fall also provided the opportunity to profitably reduce GBP exposure, we rolled the protected exposure to Chinese shares, took some profits on our strategy that provides protection against a fall in the JPY, and after a sell-off in resources and energy stocks we took the opportunity to make a further allocation to the mining and energy thematic basket. During July we took the opportunity to rebalance the alternatives allocations back toward targets following payment of year-end distributions, most notably from global share managers.

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

While there was a reasonable level of portfolio rebalancing activity over July and August for both the Premium and Value series of MLC's Managed Account Strategies, there were no changes in target allocations during the quarter.

Asset class	MLC Premium Model Portfolios change in target asset allocation over the 3 months ended 30 September 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

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

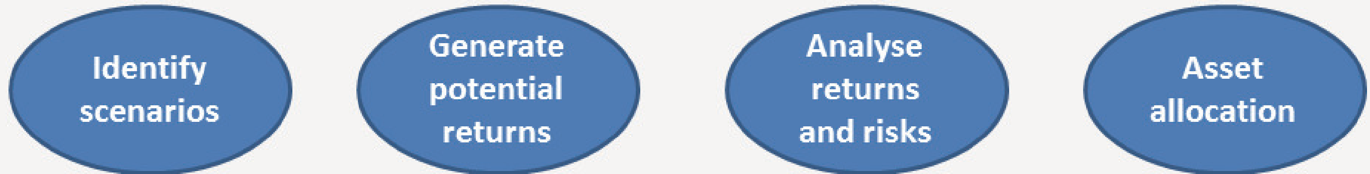
Any portfolio change shown above is not a guarantee of a change to a client's portfolio. There may be differences between the Model Portfolio and a client's portfolio due to the timing and transaction prices for portfolio changes, client investments and withdrawals during the period, timing of receipt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

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	

We welcome your feedback on this document.

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