ASSET MANAGEMENT

MLC's scenario insights & portfolio positioning

April 2022

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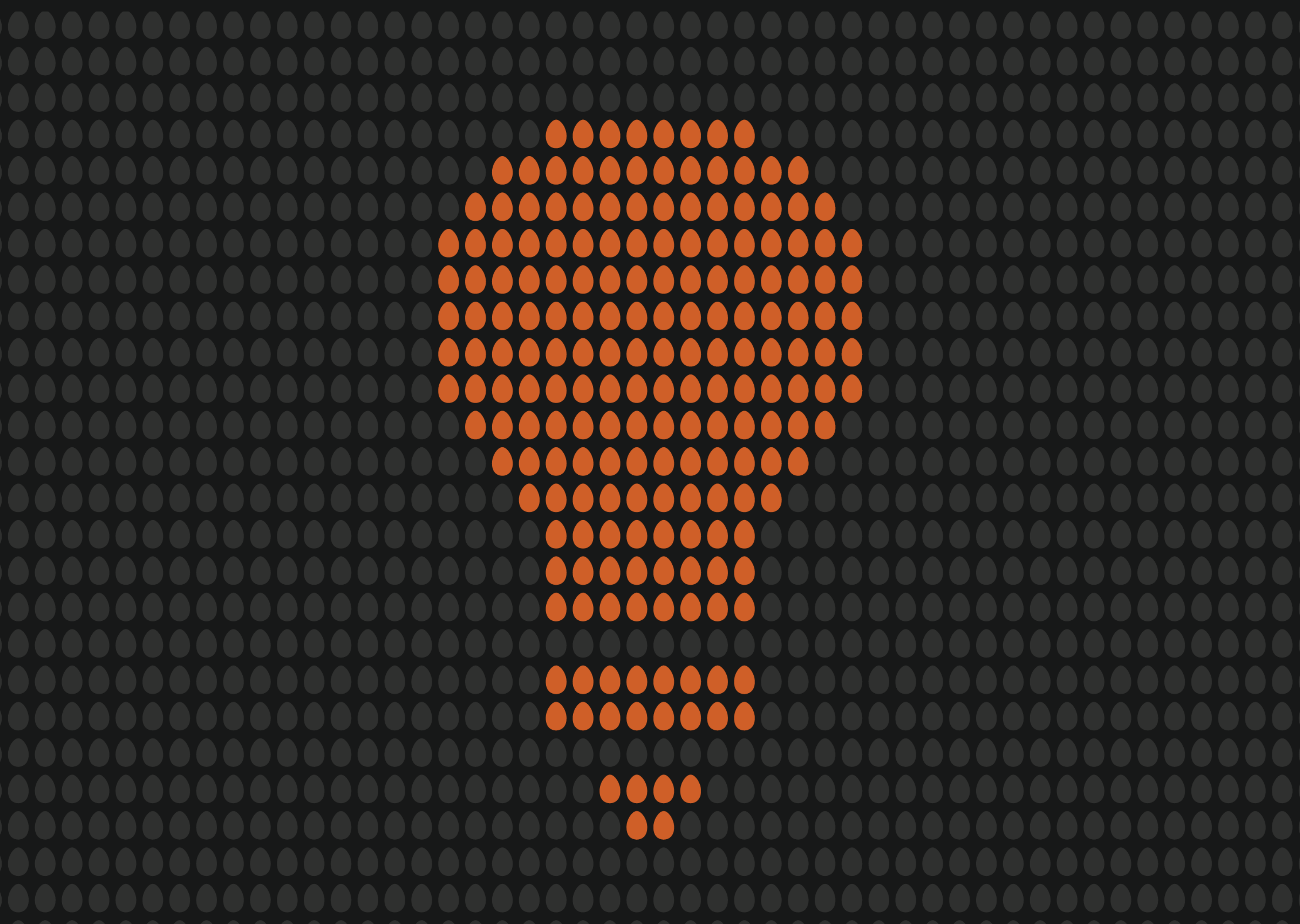
MLC's investment and super portfolios
MLC Inflation Plus, MLC Horizon and MLC Index Plus portfolios

MLC's Managed Account Strategies
MLC Premium and Value model portfolios



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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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Update for the quarter ending 31 March 2022.

Quarterly insights

Highlights

- **The Reserve Bank of Australia is an outlier with it's extremely accommodating cash rate of 0.1%, as the majority of global central banks are already on the path to normalising interest rates to combat inflation.**
- **As the 'transitory' nature of inflation lasted longer than central bankers initially expected, there are challenging times ahead as an entrenched regime shifts to something unfamiliar - a regime where inflation averages above central bankers 2-3% targets rather than sitting stubbornly below.**
- **For the first time in a while, investors need to consider the impact prolonged inflation could have on their portfolios. Assets that previously played a defensive role may be rendered ineffective if inflation causes the need for defence. Growth assets that outperformed in a disinflationary world, may underperform in an inflationary one. Correlations that appeared stable between assets may look meaningfully different going forward.**
- **At MLC, using our proprietary Investment Futures Framework, our approach to these challenging times is to first consider the range of potential inflationary scenarios that could impact our portfolios and to understand how the assets in our portfolios will behave. Rather than trying to forecast which scenario will prevail, we prefer to think about credible possibilities and examine the consequence of a range of growth and inflation scenario outcomes.**

Insights

The March quarter consumer price index (CPI) print for Australia will be released on 27 April 2022. The last inflation number for the December 2021 quarter came in at 3.5% for the year, and expectations are for the April number to rise again to 4.6%[1]. It is widely expected this will finally jolt the Reserve Bank of Australia (RBA) into action, compelling the Board to raise the overnight cash rate from the current *extremely* accommodating level of 0.1%. While the RBA has dithered, the majority of global central banks are already on the path to normalising interest rates to combat inflation, making the RBA an outlier that might need to play catchup. To be fair, at least part of the RBA's delay is mechanical given the Australian Bureau of Statistics (ABS) only releases Australian inflation data on a quarterly basis, compared to monthly for many other countries. Despite this, it is still fair to say that Australia's central bank has been slower than peers in adjusting policy, willing to 'be patient'[2] while waiting to get a better sense of how entrenched the inflation pressures have become. A high CPI print may test their patience to breaking, or at least conceding, point.

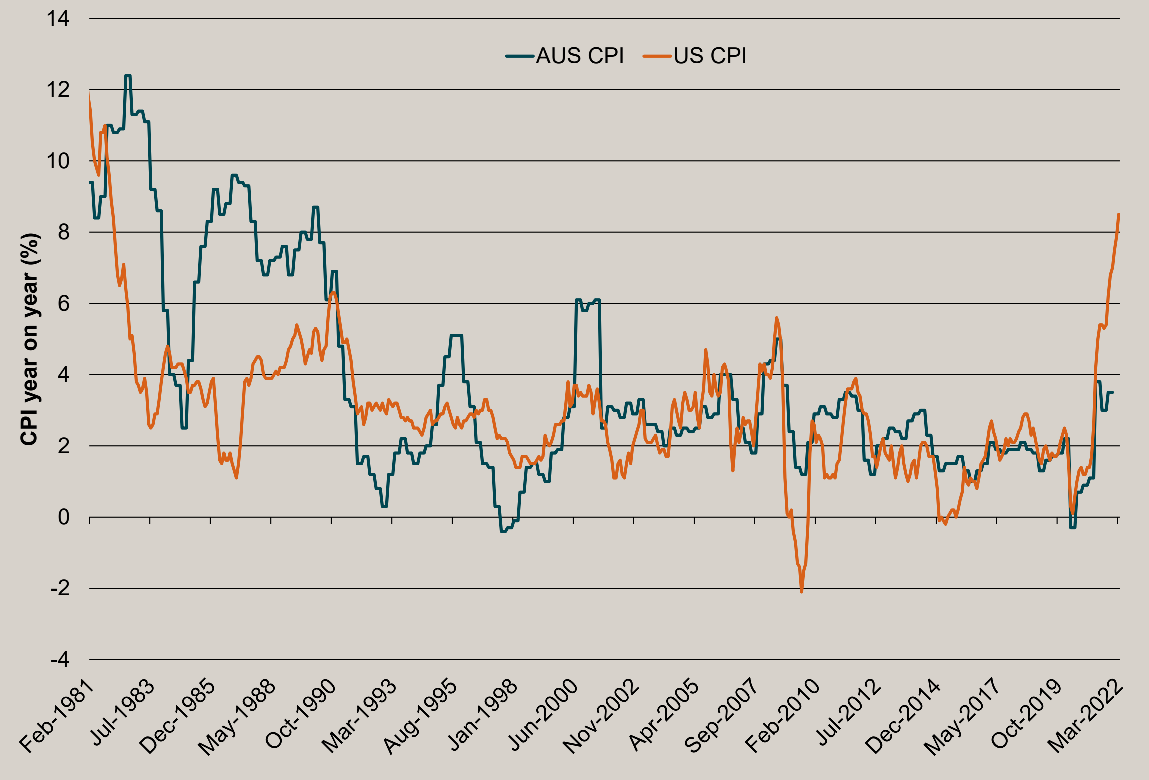
MLC'S active investment approach

- 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.

Chart 1 shows the size of the current spike in consumer price inflation. The 'transitory' nature of inflation has lasted longer than central bankers initially expected. Supply disruptions from the pandemic coupled with extreme easing in fiscal and monetary policy initially pushed prices up. Yet more recently, the Ukraine conflict has further disrupted energy and commodity supplies, exacerbating the increase in consumer prices and broadening inflation pressures. Chart 1 also highlights how long it has been since *society* has had to deal with a meaningful increase in inflation and the concept of scarcity. Many within the current cohort of investors and policy makers cut their teeth in a stable disinflationary regime, where deflation was the devil and inflation a bogeyman of the past. As a consequence, most portfolios are robust in a *disinflationary* world. However, if inflation proves more persistent this time around, investors need to be comfortable that their investment strategies are equipped to handle a new regime. This is indeed a challenging time as it always is when an entrenched regime shifts to something unfamiliar...a regime where inflation averages above central bankers 2-3% targets rather than sitting stubbornly below.

At MLC, our approach to answering this question is to first consider the range of potential inflationary scenarios that could impact our portfolios. Table 1 lists the scenarios in our Investment Futures Framework (scenarios process) where expected inflation is above the typical central bank targets of 2-3%. The scenarios are ranked based on their expected real growth, reflecting the resilience of the underlying economy in each scenario to the impact of rising inflation.

Chart 1: Global inflation is currently spiking



Source: FactSet.

Table 1: Investment Futures Framework - inflationary scenarios

Scenario	Real growth	Inflation
Severe inflation risk	-2%	14%
Oil price shock	0%	5%
Stagflation	1%	7%
Rising inflation / Productivity weak	2%	4%
Policy supports higher inflation	3%	3%
Resources boom	4%	3%
Inflationary growth	5%	5%

Source: MLC Asset Management Services Limited.

We believe that both the magnitude of the inflation spike and the ability of the underlying economy to digest that inflation will dictate which scenario (or complexion of scenarios) in Table 1 prevails from here. As at 31 December 2021, US nominal gross domestic product (GDP) was measured at 11.8%[3] for the year. The December US CPI was 7% so that places real growth around 5%. Amongst the scenarios in Table 1, these parameters look most similar to the '***inflationary growth***' scenario, but there are some critical disclaimers. Growth is expected to decrease in the March quarter following the marked reduction in fiscal support and the tightening of financial conditions. Inflation is also expected to weaken as supply constraints ease and demand reduces. Because of these changes and the complex feedback processes within the real economy, the future path of inflation is difficult to accurately forecast. But while it is very difficult to pre-empt the actual path economic growth and inflation will take, it is not so difficult to identify distinct forks in the road and follow where they might lead. It is because of this that we prefer to think about credible possibilities and examine the consequence of a range of growth and inflation outcomes. In other words, ***we believe it is more valuable to understand how the assets in our portfolios will behave if nominal growth skews inflationary (stagflation scenario) or skews real (inflationary growth scenario) rather than trying to forecast which one will prevail***.

If growth skews inflationary

Scenarios where nominal growth skews inflationary are bad for people's standard of living and present a stiff challenge for investors to produce meaningful real returns. Amongst the scenarios listed in Table 1, those with growth that is predominately driven by price increases are grouped at the top of the list. In these scenarios where growth skews inflationary, the underlying economy is not robust enough to grow under the pressure from inflation that hinders consumption (ie higher prices are a rent for primary producers and suppliers), and typically stem from the supply side. Nominal growth remains higher than normal, but it is driven predominantly by increasing prices. Productivity is lower than normal as supply constraints hamper productive use of existing capacity. Real rates are low to negative as investment demand is weak given the lack of growth in the real economy.

Growth assets that could perform well if growth skews inflationary are:

- *Companies with pricing power* – identify companies with the ability to pass the increase in input costs on as higher prices, thus preserving their margins.
- *Assets at the heart of the supply constraints* – if the inflation shock is driven by a shortage of oil for example, investing in energy companies is the simplest way to profit from the supply shock. Identify areas that are supply constrained and have the capacity to expand their margins.
- *Sources of real cash flow* – revenues that are linked to inflation will be resilient in these environments.

Environments where growth skews inflationary are typically difficult for growth assets as activity in the underlying economy is subdued given supply constraints and cost pressures. This combination of low growth and rising costs are difficult to navigate for many companies, particularly those without pricing power.

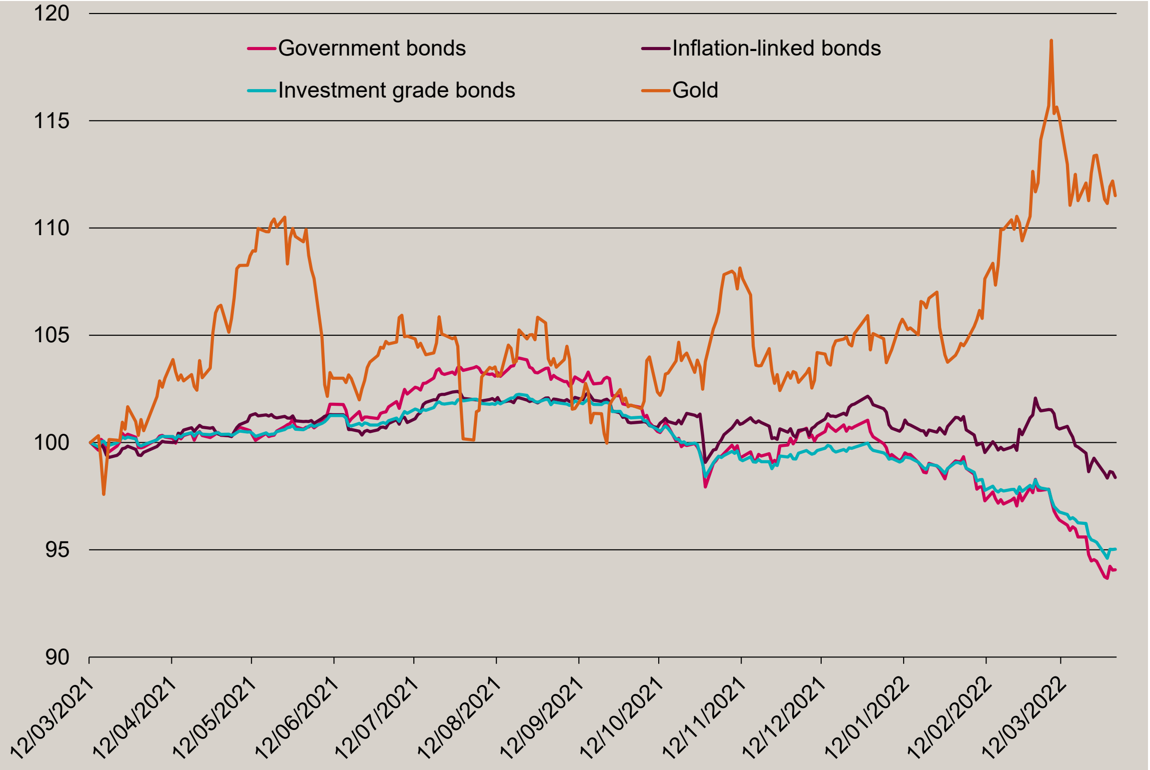
Defensive assets that could perform well if growth skews inflationary are:

- *Stores of value* – gold and digital currencies offer potential inflation protection through scarcity. With real rates low, the opportunity cost of owning non-income paying assets is low.
- *Inflation-linked bonds* – the explicit link to inflation through capital indexation protects inflation-linked bond holders. Expected to outperform nominal bonds in an inflationary environment with low real yields.
- *Protected credit* – customised credit strategies with low duration and strong collateral protection. These offer a defensive allocation in an inflationary environment where traditional credit will struggle, both from their longer duration issuance and the default risk of the issuers in a low growth world.

Low real rates provide a cushion that supports the performance of *some* but *not all* traditional defensive assets if growth skews inflationary. Nominal bonds however will *not* be defensive if inflation is high and growth nominal, so we need to balance our portfolios to include an appropriate allocation across a range of assets listed above to ensure a level of protection should our growth assets stumble.

The performance of traditional defensive assets like government bonds and investment grade credit in the recent March quarter may be instructive (Chart 2). As concerns about inflation pushed shares lower, bonds offered no protection. Instead, bonds suffered one of their worst quarters of performance in recent history. ***If inflation is the factor causing growth assets to stumble, nominal bonds are highly unlikely to offer any offsetting protection for portfolios.***

Chart 2: Australian bond performance



Source: Bloomberg. Reindexed to 100 on 12 March 2021.

If growth skews real

High(er) inflation in itself does not spell disaster for the economy. It is not a foregone conclusion that an uptick in prices will snuff real economic growth. What matters here is both the policy response and behaviour of corporates, labour and consumers in adjusting to the new conditions. Whereas the supply side problems decrease productivity and act as a tax on consumption in the short-term, there are always avenues to unlock productivity across and within productive endeavours, to more efficiently re-direct resources. We should not forget that it has only been very recently that the world has worried about the deflationary consequences of technology, demographics, debt and globalisation. And while globalisation is facing obvious challenges, the remaining set of disinflationary forces (technology in particular) are still working away behind the scenes. Scenarios indicative of these types of outcomes are those at the bottom of Table 1. Nominal growth remains high with a contribution from both prices and volumes. Productivity is mixed depending on the specific scenario, but overall supportive of productive capacity utilisation. Real rates are higher than normal as investment demand is strong.

Growth assets that will perform well if growth skews real are:

- *Quality* – strong balance sheets become valuable as the cost of capital rises. Identify assets with high quality cash flows and low leverage that will be resilient to rising rates.
- *Companies with pricing power* – similar to the previous section on pricing power if growth skews inflationary, this time we again want to identify companies that can pass on higher input costs. The major difference is growth will be positive in these scenarios so with top line growth improving, margin preservation is not an imperative.
- *Sources of real cash flow* – revenues that are linked to inflation will be resilient in these environments.

In the scenarios where growth skews real, the potential for growth assets to perform well is much higher given the increased level of activity in the economy. We do need to be mindful that as real rates rise in these scenarios, the gap between cost of capital and the return earned on that capital shrinks, so companies with weaker balance sheets and lower pricing power would be more likely to come under pressure.

Defensive assets that will perform well if growth skews inflationary are few and far between. The combination of rising inflation and rising real rates renders many defensive assets of little use. Finding assets with income streams that are completely uncorrelated to inflation is one potential source of protection. Insurance-related investments satisfy this requirement as the insurance income on natural disasters is in no way linked to inflation in the economy.

The one saving grace is the reduced need for defensive assets in scenarios where growth skews real. The higher level of activity in the real economy lowers the probability of protection being required in the portfolios.

Portfolio construction challenges

For the first time in a while, investors need to consider the impact prolonged inflation could have on their portfolios. Assets that previously played a defensive role may be rendered ineffective if inflation causes the need for defence. Growth assets that outperformed in a disinflationary world, may underperform in an inflationary one. ***Correlations that appeared stable between assets may look meaningfully different going forward***. We have seen examples of this over recent months in the way that particular sectors behave with respect to changes in both interest rates and inflation expectations. It has also spurned an increase in cross-sectional volatility and increased the volatility of currency. By way of example, while commodities have soared in price, the US dollar (USD) likewise has appreciated. This is an unusual combination. Under normal circumstances, commodities tend to rise when the USD falls, and fall when the USD rises. The dual appreciation of commodities and the USD can be economically damaging exerting a 'double-whammy' on non-USD regions that import USD denominated commodities.

Portfolio activity

We have been building inflation resilience across our multi-asset portfolios for a number of years, trying to create a balance in our growth and defensive assets that will perform irrespective of whether growth skews real or inflationary:

- *Minimised exposure to nominal cash flows* – across the MLC Horizon, Index Plus and Inflation Plus portfolios we have minimal risk exposure to nominal bonds, preferring to use inflation-linked bonds to replace government bonds and low duration exposures in credit. This positioning was beneficial for the portfolios during the recent spike in global bond yields.
- *Used gold as a hedge if growth skews inflationary* – we have held gold in the Inflation Plus portfolios as a defensive allocation if inflation proves persistent and compromises growth. The recent concerns around stagflation have seen gold perform well.
- *Increased exposure to real cash flows* – last year's addition of global listed infrastructure in the Horizon and Inflation Plus portfolios provided a valuable inflation-linked revenue stream. This allocation has been resilient during the recent disruptions, outperforming broader global shares by over 10% calendar year to date.
- *Identified companies with pricing power* – the creation of the 'miners and energy basket' for Inflation Plus was designed to identify companies with high quality, real cash flows that would be resilient in an inflationary environment. Performance of the basket has been strong, particularly during the recent energy supply disruptions.
- *Added sources of uncorrelated income* – insurance-related investments provide a return stream that is uncorrelated to inflation and were added to the Horizon and Inflation Plus portfolios to serve as a defensive source of meaningful income.

The addition of these strategies has created a more robust risk profile for the multi-asset portfolios in scenarios where inflation proves more persistent. In general, the strategies that we had incorporated prior to the recent inflation shock have delivered as expected. Listed infrastructure has outperformed global shares, and our customised basket of mining and energy stocks has generated strong absolute returns. Both have outperformed more traditional inflation hedges such as inflation-linked bonds. Despite the re-rating in price, both the mining and energy basket and our listed infrastructure strategies remain relevant and are not yet too expensive to compromise their role as sources of real cash flows.

Recent portfolio activity has also been directed to one of the more troubling areas of our portfolios – currency. We have written previously about our concern the Australian dollar (AUD) may not adequately fulfill the role of a risk hedge moving forward. Inflation has destabilised a number of past relationships, and this is being felt acutely in the currency markets. In the past when share markets fell, the AUD would typically do the same. This allowed us to hold foreign currencies as a way of reducing the losses on our share holdings. This strategy worked very well during the onset of the pandemic. Unfortunately, recent AUD behaviour has been uncorrelated with movements in risk assets and the behaviour of foreign currencies like the Japanese yen and British pound have been unstable. Differing inflation expectations across currencies is leading to different relationships / correlations with other asset classes.

Our response in the portfolios to this changing dynamic has been to reduce our reliance on currency as a risk hedge and increase exposure to the AUD. We have reduced foreign currency exposure across all the multi-asset portfolios, with Inflation Plus seeing the largest shifts. All things equal, we will need to find another source of protection for the portfolios. The recent spike in bond yields offers a potential source of protection that we are currently investigating.

Stock stories

The following highlights some stock activities that occurred during the quarter. As we're constantly reviewing and making changes to the portfolios, these investments may no longer be included in the portfolios.

MLC Inflation Plus portfolios: Amongst the changes in positioning during the quarter, the defensive Australian shares strategy increased exposure to Qantas and other companies exposed to a resumption in domestic leisure and business travel. After completing a significant cost reduction program across a wide portion of its cost base, Qantas is well positioned to harvest gains in productivity as travel volumes return to normal post pandemic. Early signs from the December quarter are that the airline's leaner operation is translating into a more profitable, more operationally leveraged business.

Alongside this, the portfolio took advantage of the sell down in several healthcare and biotechnology related names such as Sonic, Healius, Pro-Medicus and CSL, all of which operate high quality reliable businesses. We also retain bullish exposure to metals and mining with a balanced focus on de-carbonisation (eg IGO) and high free cash flow bulk metals (eg RIO and BHP).The extended exposure to metals and mining, as well as some of our exposure to industrials and financials is partly hedged by buying puts that should mute a sudden drawdown. Puts held in the strategy are, by and large, funded by selling calls that are comfortably out of the money.

Our investment approach

Our Investment Futures Framework is designed to first understand the risks facing our portfolio and to then assess the cost associated with mitigating those risks. We accept the inherent complexity of markets makes it difficult to predict their path with any consistency, and so we consider the portfolio impact of multiple different potential paths. It is our belief this open approach will be helpful for our clients as we continue to navigate our way through the current inflationary episode.

References:

[1] NAB Economics March CPI forecast as at 31 March 2022.

[2] RBA Governor Lowe has previously stated the RBA will be willing to 'be patient' in assessing the need to increase cash rates.

[3] US Nominal GDP for December 2021 was measured at 11.8% according to Bloomberg.

The Investment Futures Framework: Changes in return potential and portfolio positioning

Changes in return potential for asset classes

The probability weighted expected potential returns across most asset classes remained more or less unchanged from the end of the December quarter (Chart 3).

In terms of absolute levels, the five year return potential of the majority of asset classes remains significantly below normalised long-term returns. Indeed, for some asset classes the long-term return now lies close to the most bullish of our 40 scenarios, particularly for fixed income sectors whose long-term 'normal' returns sit beyond the average of the best 10% of scenarios on a five year basis. However, it is worth noting that the increase in bond yields over the quarter has resulted in an improvement to both the negative and positive tails for fixed income. This change better positions fixed income to play a more beneficial role in protecting and diversifying exposure within the portfolios for some adverse growth scenarios while also improving income opportunities.

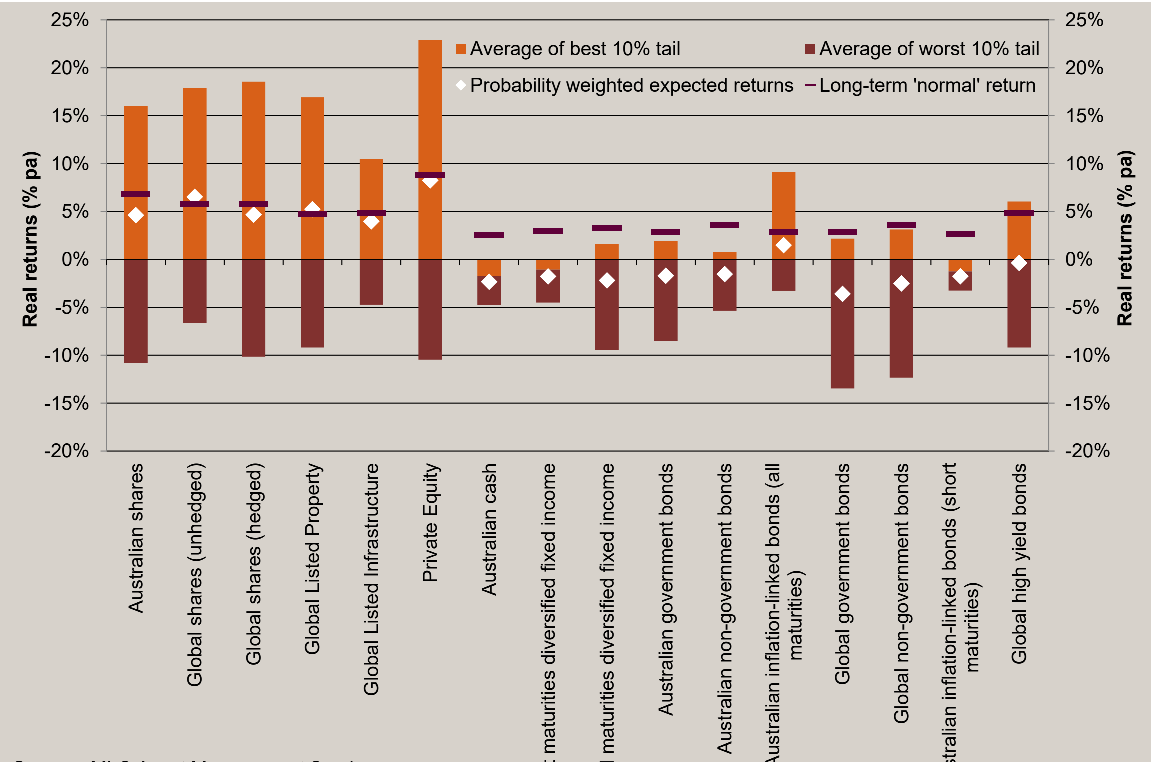
The five year probability weighted expected returns of some asset classes are in-line with their long-term 'normal' returns – particularly global shares. While valuations for these markets continue to be stretched and punitive for forward-looking returns, earnings growth expectations continue to remain strong and help in compensating for the headwind from valuations. However a disappointing earnings result would mean that one pillar for the probability weighted expectation is no longer supported and hence could see a return outcome that is closer to the 10% worst tail. This example highlights how there are a multitude of return potentials that exist and exemplifies the merits of the scenarios framework. While the probability weighted outcomes provide a measure of central tendency, the full spectrum of outcomes provides the richness of information needed to appropriately understand the risks present in the current investment environment.

Portfolio positioning

This quarter the trading activity across all portfolios was focussed on managing the increased volatility in bond and currency markets. The extreme rise in bond yields over the quarter provided the opportunity to reduce the significant duration underweight in the more conservative funds. Volatility in global currencies also allowed the funds to profitably close out some of the long standing foreign currency positions.

Details 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 (March 2022) - 5 years, 0% tax with franking credits, pre-fees, pre-alpha



Source: MLC Asset Management Services Limited.

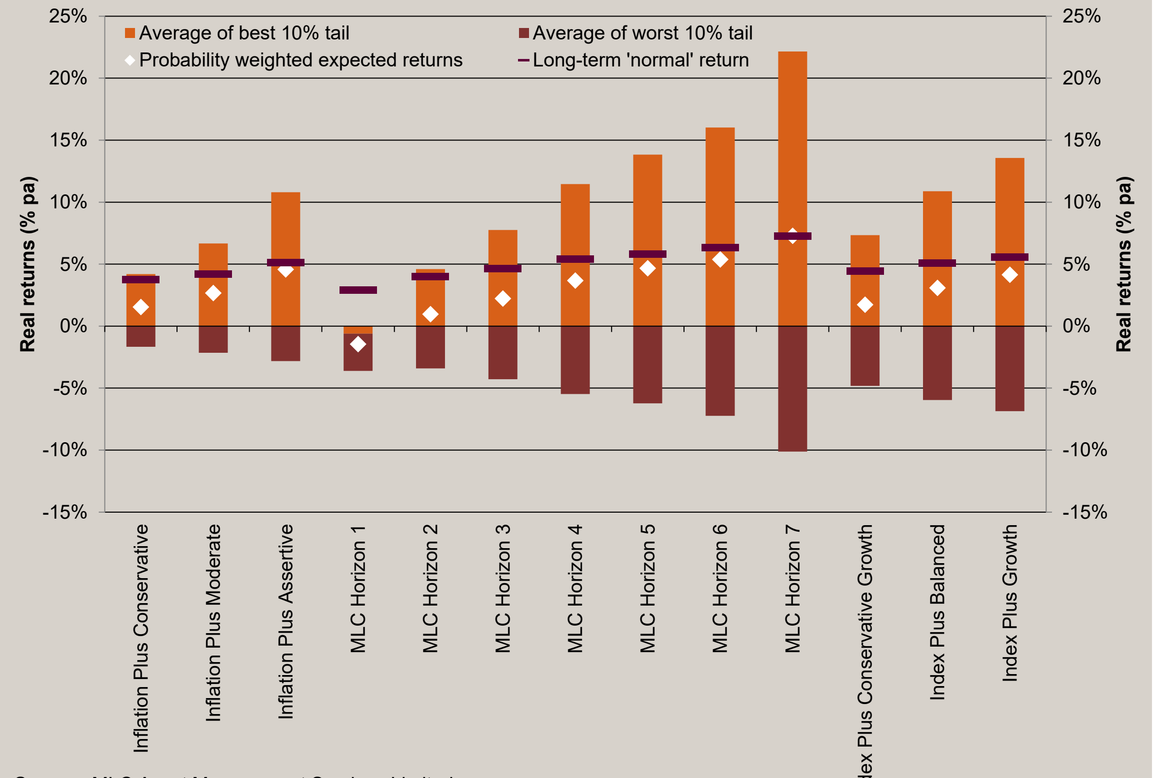
The potential real returns for each asset class are shown above. The probability-weighted real returns are shown as diamonds. For comparison we've included long-term 'normal' return expectations which are set by considering a stable fair value world – these are shown by the horizontal lines. Also, as 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 March 2022.

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 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 4: 40 scenario set (generic scenarios) potential real returns (March 2022) - 5 years, 0% tax with franking credits, pre-fees, pre-alpha



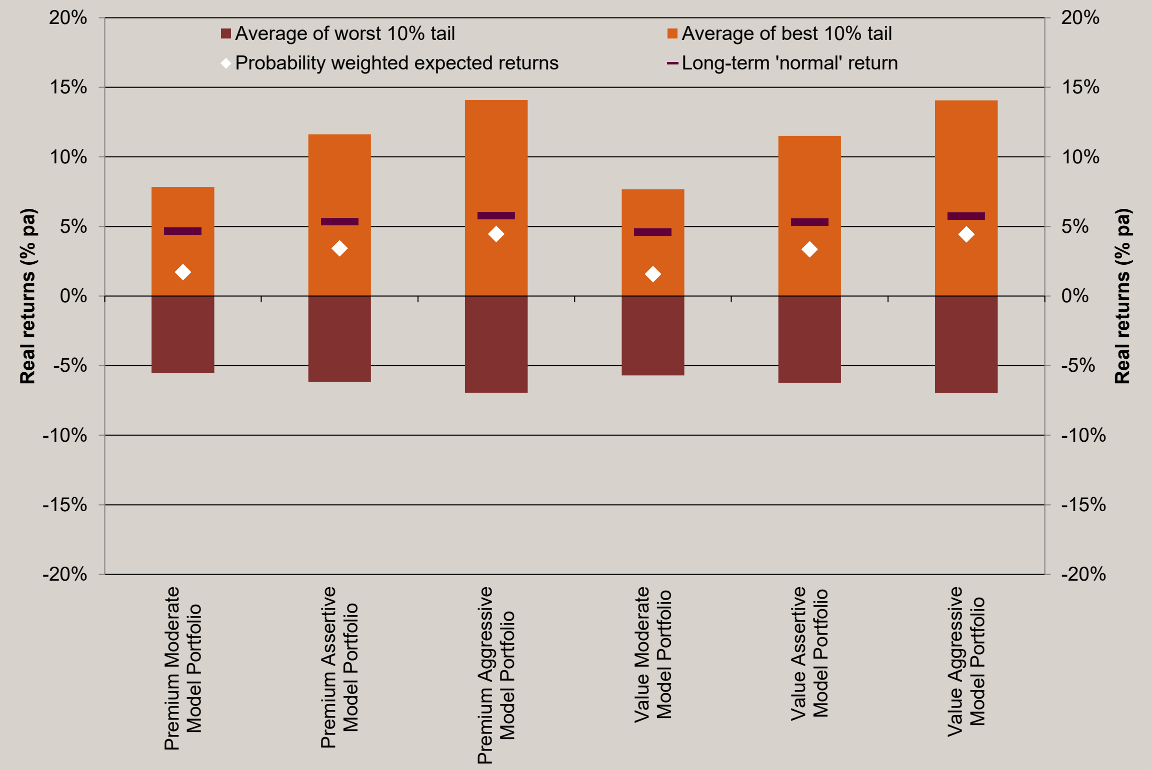
Source: MLC Asset Management Services Limited.

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.

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 5).

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 5: MLC Managed Account Strategies - 40 scenario set (generic scenarios) potential real returns (March 2022) - 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 March 2022 quarter, including up until the time of writing, were:

- Rolling our protected emerging market exposure for another three months using the same total return swaps already in place. We still believe a combination of the China onshore CSI-300 and MSCI Emerging Market-ex China indices provide us with the most appropriate exposure to emerging market growth. The domestic focus of Chinese policy and the outperformance we receive on the CSI-300 swap means we continue to prefer it to MSCI China. The potential losses on the swap structure are mitigated by a protective option collar, which was helpful in the March quarter as onshore China share markets fell.
- Establishing a protective collar around our gold holdings. Gold has traded to the upper end of its price range for the last two years. Having participated in the strong rally, we have protected against losses from these elevated levels by purchasing a put option. This is funded by selling a call 10% above the market. Whenever we sell away upside on a volatile hedge, we make the tenure shorter so this structure is only for three months.

  Continuing to use cheap option protection in the US market to protect against market falls. The risk of holding US shares has increased in the current environment of rising inflation and a hawkish US Federal Reserve (Fed) increasing interest rates. We increased the size of the contingent S&P500 put structure, which includes a vanilla S&P 500 put that only pays off if the AUD/USD exchange rate remains above 0.725 cents. This is appealing for the Inflation Plus portfolios as we currently hold foreign currency to help reduce losses if share markets perform poorly. The contingent option is a cheap way for us to reduce the portfolio's reliance on the correlation between AUD and global shares remaining positive.

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.

- 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 interest 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.

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 31 March 2022**		
	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
USD/JPY call option	**Decreased**	**Decreased**	**Decreased**
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 reduced**	**Diversified basket reduced**	**Diversified basket reduced**
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

The key portfolio activities during the March 2022 quarter were:

- The overweight allocation to emerging market shares was rolled in March. This allocation is expressed through a swap structure that is a combination of the onshore China CSI-300 and Emerging Market-ex China indices, similar to the Inflation Plus portfolios. This continues to be our preferred means of gaining exposure to emerging market growth.
- The overweight allocation to foreign currency was reduced through the purchase of an AUD/USD call option. This structure allows us to increase our AUD holding as the currency market rallies. Recent behaviour of the AUD has been inconsistent with past correlations to growth assets like shares, heightening our concern that holding foreign currency may not be a reliable risk hedge moving forward. For that reason we have been reducing our exposure to foreign currency across the portfolios.
- MLC Horizon portfolios also inherit exposures through investment in Inflation Plus, providing important real return exposure and sources of low correlation return streams. Activity in Inflation Plus this quarter continues to be focused on 'Participating and Protecting' by rolling our protected emerging market exposure for another three months. We also increased put protection over our US shares exposure in the form of a contingent put option. This is appealing for the Inflation Plus portfolios as we currently hold elevated levels of foreign currency whose role is to reduce losses if share markets perform poorly. We also took profits on our Japanese yen (JPY) call.

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.

We will continue to look to diversify the MLC Horizon portfolios' drivers of growth as we progress through 2022, taking advantage of any attractive pricing opportunities that may present as a result of market dislocations.

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 31 March 2022		
	Under	Strategic asset allocation	Over
Australian shares		•	
Global shares (unhedged)			•
Global shares (hedged)	•		
Global property securities		•	
Global listed infrastructure			•
Cash			•
Australian inflation-linked bonds	•		
Bonds (short maturities)			•
Bonds (all maturities)	•		
Global non-investment grade bonds (high yield bonds and loans)		•	
Real return strategies (including Inflation Plus)	•		
Infrastructure			•
Insurance-related investments			•
Low correlation strategy		•	

MLC Index Plus portfolios

Asset allocation positioning of the MLC Index Plus portfolios was little changed in the March quarter. The only adjustment was a reduction in the size of the foreign currency overweight, expressed through holdings in global shares (unhedged). We have become concerned on the reliability of foreign currency as a risk mitigant moving forward, and so have reduced holdings in foreign currency.

MLC Index Plus portfolios' inherit exposures through investment in the real return strategy (similar to Inflation Plus), provides 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:

- The exposure to emerging markets was rolled with the onshore China CSI-300 and Emerging Market ex-China swap exposures extended for another three months. This strategy has embedded option protection to limit losses, consistent with our 'Participate and Protect' mantra.
- Cheap downside protection was increased through a vanilla S&P500 put contingent on the AUD/USD exchange rate remaining above a certain barrier. Outright volatility protection remains expensive so we continue to seek low cost ways of maintaining exposure to US shares while reducing the risk of meaningful capital losses.

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.

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 31 March 2022		
	Under	Strategic asset allocation	Over
Australian shares		•	
Global shares (unhedged)			•
Global shares (hedged)	•		
Global property securities		•	
Cash	•		
Australian inflation-linked bonds	•		
Bonds (short maturities)			•
Bonds (all maturities)	•		
Real return strategies		•	

MLC Managed Account Strategies

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.

Consistent with our view of the current investment environment, a target asset allocation change was implemented in March 2022. This increased exposure to Australian shares and global shares (hedged), and reduced exposure in global shares (unhedged). In the Moderate model portfolios, from a starting position of materially shorter duration within the fixed income program, we reduced all maturities nominal bonds and increased exposure to domestic short maturities. We've positioned the portfolio for diverse and resilient returns across asset classes in the following key ways:

- **Maintaining growth asset exposure** – We have increased the portfolio's positioning towards a reflationary environment, continuing to seek out the benefits of accessing real cash flows of assets with revenues linked to inflation. Increasing Australian shares exposure over the quarter provides this with the major drivers of the Australian economy being commodity-exposed major miners, resource-related industrials, and domestically-orientated financials.
- **Foreign currency diversification** – During the quarter we reduced our foreign currency exposure (by increasing hedged global shares exposure) as we expect the AUD to be more resilient in this environment, diminishing the diversification benefits of having exposure to foreign currencies when global share markets weaken. However, we continue to see foreign currency exposure as an important diversifier (holding both hedged and unhedged global shares).
- **Active fixed income** – We believe active management is necessary to effectively navigate 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 have selective investments in credit through Bentham's fund.
  For the Moderate model portfolios, during the quarter, we further reduced interest rate exposure (by reducing longer duration fixed income). Rising interest rates tend to have a negative impact on traditional fixed income returns, so we're providing a bit more insulation from this risk in our more defensive moderate portfolio.
- **Inflation Plus changes** – MLC Wholesale Inflation Plus portfolios' provide important real return exposure and sources of low correlation return streams. As outlined above, Inflation Plus' activity this quarter included:
  - Rolling our protected emerging market exposure (China onshore CSI-300 and MSCI Emerging Market-ex China indices) for another three months using the existing total return swaps structure.
  - Increasing put protection over our US shares exposure in the form of a contingent (AUD/USD 0.7250 currency level) US shares put option.
  - Taking profits on our JPY call and rolling the strike up and out; designed to protect against a weakening of the JPY.

Portfolio rebalancing activity over the March quarter was primarily driven by the above target asset allocation change. Beyond this for the Value series of model portfolios, direct ASX equity activity focused on the index upweighting in BHP Group (BHP), following its unification vote to make Australia (via the ASX) its primary listing. Details of recent stock changes are available in the portfolio activity reports at **mlcam.com.au**

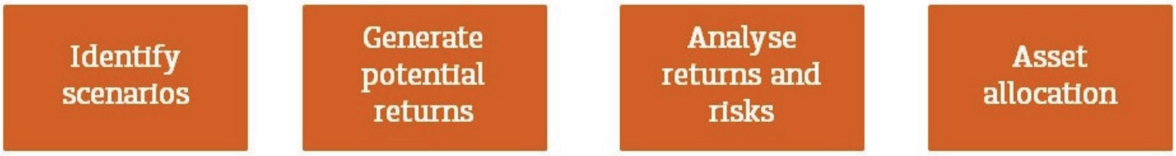
The latest portfolio updates are available at **mlcam.com.au**

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.

For more information, visit mlcam.com.au or contact your MLC representative.

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