ASSET MANAGEMENT

MLC's scenario insights & portfolio positioning

July 2022

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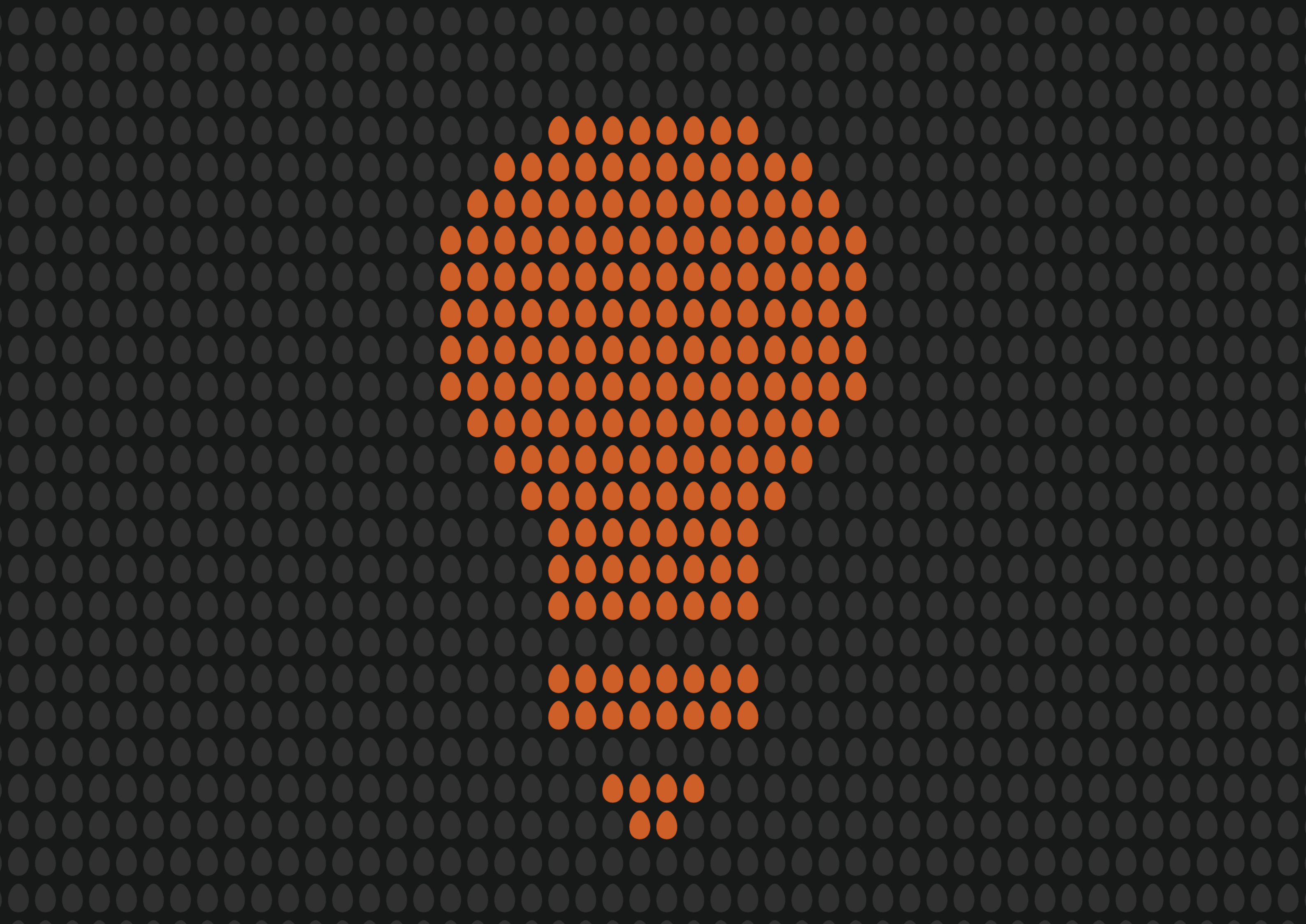
MLC's investment and super portfolios
MLC Inflation Plus, MLC Horizon and MLC Index Plus portfolios

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 Conservative 30 Model Portfolio
MLC Wholesale Horizon 2 Income Portfolio	MLC Horizon 2 Capital Stable Portfolio	MLC Premium Moderate 50 Model Portfolio
MLC Wholesale Horizon 3 Conservative Growth Portfolio	MLC Horizon 3 Conservative Growth Portfolio	MLC Premium Balanced 70 Model Portfolio
MLC Wholesale Horizon 4 Balanced Portfolio	MLC Horizon 4 Balanced Portfolio	MLC Premium Growth 85 Model Portfolio
MLC Wholesale Horizon 5 Growth Portfolio	MLC Horizon 5 Growth Portfolio	MLC Premium High Growth 98 Model Portfolio
MLC Wholesale Horizon 6 Share Portfolio	MLC Horizon 6 Share Portfolio	MLC Value Conservative 30 Model Portfolio
MLC Wholesale Horizon 7 Accelerated Growth Portfolio	MLC Horizon 7 Accelerated Growth Portfolio	MLC Value Moderate 50 Model Portfolio
MLC Wholesale Inflation Plus Conservative Portfolio	MLC Inflation Plus Conservative Portfolio	MLC Value Balanced 70 Model Portfolio
MLC Wholesale Inflation Plus Moderate Portfolio	MLC Inflation Plus Moderate Portfolio	MLC Value Growth 85 Model Portfolio
MLC Wholesale Inflation Plus Assertive Portfolio	MLC Inflation Plus Assertive Portfolio	MLC Value High Growth 98 Model 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 MLC Stable	

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Update for the quarter ending 30 June 2022.

Quarterly insights

Highlights

- **The 2022 financial year (FY2022) will be disappointing for many investors as the poor performance across asset classes unravelled the gains made in 2021. Notably, the numbers delivered for FY2022 look likely to be *worse* than those delivered to clients during the *global pandemic*.**
- **Two main reasons lie behind these more meagre FY2022 returns, being the strong starting point for global shares at the beginning of the financial year, and the role of fixed income, particularly nominal bonds. By any historical measure, bonds have been uber-expensive for the past two years and expensive for a decade.**
- **The loss of scope for fixed income to play defence is at the core of why we and many other investors have been significantly underweight core nominal fixed income for the past few years, preferring to seek out alternate defensive exposures to diversify share market risk in our multi-asset portfolios.**
- **Our multi-asset portfolios have generally been able to avoid exposure to nominal fixed income though holding a collection of alternate defensive exposures, including inflation-linked bonds, Chinese government bonds, foreign currency, gold, defensive alternatives and a range of innovative derivative structures to control risk and maintain some income.**
- **Taken together as a basket, these strategies filled the diversification and income void created by avoiding exposure to very expensive and arguably somewhat ineffective nominal fixed income, and in most cases, have played their intended role. The question we now face is when to begin reversing course on core nominal fixed income strategies. While our team doesn't have a magic number to start that journey, we'll maintain vigilance and begin to make modest changes as and when the opportunities present.**

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 second quarter of 2022 took off where the first quarter left off. A multi-point supply side shock with heightened geopolitical uncertainty and most major asset classes in the grip of a 'valuation recalibration' driven sell-off.

Not surprisingly, the poor performance across asset classes in 2022 has undone gains made in 2021 and resulted in some fairly unpleasant 2022 financial year (FY2022) returns for multi-asset fund investors. Notably, the numbers delivered for FY2022 look likely to be worse than those delivered to clients during the *global pandemic*, when global shares as measured by the performance of the MSCI All Country World Index drew down more than 34% from peak to trough during the 2020 financial year. The same index fell only 21% from peak to trough in FY2022, yet it looks like the average multi-asset portfolio will have undershot FY2020 returns.

Given the dominance of shares in multi-asset portfolio allocations, clients could be well forgiven for any head scratching trying to square away what on the surface looks like a contradiction and an underwhelming outcome.

Two main reasons lie behind the greater disappointment for multi-asset investors in FY2022 compared to the year cursed by emergence of the pandemic (FY2020). The first, and undoubtably the least interesting of the two, is that global shares started FY2022 within 5% of their all-time high (reached in early January 2022), whereas the high watermark reached in FY2020 prior to the pandemic crash was nearly 11% higher than the June 2019 starting notch. So, although shares fell 34% peak to trough in 2020, the peak was 11% higher than the starting level at June 2019; while in 2022, when markets fell 21% peak to trough, the peak was only 5% higher than it was at 30 June 2021. This means that from a 30 June performance-year point of view, global shares fell about 25% in the FY2020 and 16% in the FY2022. Still a big gap, but not as big as the comparative drawdowns.

The second and more interesting driver of weaker multi-asset fund performance in FY2022 compared to the year the pandemic crashed markets is the role of bonds, particularly nominal bonds.

By any historical measure, bonds have been uber-expensive for the past two years and expensive for a decade. Indeed, since mid-2011, the yield on the 10-year US government bonds has not exceeded the level reached at the nadir of the 2002 recession easing cycle save for a handful of trading days toward the end of 2018. More recently, depressionary-like conditions that threatened the global economy during the early stages of the pandemic compressed safe-haven yields to extreme levels.

Two things happen when bonds become expensive. The first is that the range of scenarios where bonds retain defensive characteristics narrows, this in turn means that greater and greater depressionary shocks are needed to force bond prices higher and offset growth-related losses. The second problem is that when bond prices are high and yields low, the return on offer becomes almost all capital gain/loss and very limited income. While this is okay from an upside point of view, it leaves bond holders without an income cushion to offset capital losses in the event that bond prices fall.

Sustained high prices and resulting bond issuance at low yields further amplifies this dominance of capital gains/losses over income and sensitivity to interest rate movements (lengthening duration). It is this very feature that explains why the 10 year US government bond has just experienced its *worst* financial year performance for at least the past 60 years (-11.7%). Over the past 12 months, the 1.54% change increase in the 10 year yield precipitated a total return loss of -11.70% for the 10 year US Treasury note, outstripping losses recorded on the same bond in 1981 and 1986 where yields rose 3.77% and 2.94% respectively.

That the past 12 month change in yield of 1.54%, a full 2.23% less than the change of 1981, caused the largest losses in the 60+ years of history highlights the riskiness of investing in bonds when yields are at or near zero and duration has lengthened. This, plus the loss of scope for bonds to play defence, sits at the core of why we and other investors have been significantly underweight core nominal fixed income for the past few years, preferring to seek out alternate defensive exposures to diversify share market risk within our multi-asset portfolios.

Portfolio activity

The MLC Horizon and Index Plus portfolios, both with a mandated exposure to growth and defensive assets, have long questioned the ability of core nominal fixed income to perform the defensive role historically expected of it, yet still required the role to be filled. To achieve this the portfolios allocated away from long duration nominal fixed income into inflation-linked bonds, shorter duration fixed income, defensive alternative assets and foreign currency.

Long term allocations to inflation-linked bonds have reduced exposure to inflationary risks while protecting against expectations of lower economic growth. This has been important in the recent environment where rising inflation has battered nominal fixed income prices and the sustainability of positive economic growth is being questioned as financial conditions tighten.

Horizon and Index Plus portfolios have maintained a long term underweight to the most interest rate and inflation sensitive fixed income securities, by allocating more to fixed income with a shorter maturity debt profile. This active positioning reduced the impact of the bond market sell-off on the portfolios.

Alternative allocations to insurance-related investments that are exposed to natural peril reinsurance risks rather than the at times violent swings in shares and bond asset prices has proven an important diversifier. Returns generated by accepting risk related to a well-diversified portfolio of potential natural perils around the world, have historically shown low or no correlation to shares or bond prices.

Alternative allocations to the Low Correlation Strategy, managed by MLC's Alternatives Strategies team, offering exposures to niche and often complex private credit, speciality finance and skill-based strategies has once again provided important diversification by generating positive returns against severe market sell-offs. Identification and implementation of these strategies requires significant expertise and typically multi-year relationships however the portfolio benefits are invaluable when the simple and easily accessible traditional portfolio diversifiers fail.

For many years an overweight to foreign currency has been utilised by the Horizon and Index Plus portfolios to fill the diversification void left by unattractive nominal fixed income prices. This position has proven effective in cushioning the portfolios during large falls in share markets, where the Australian dollar (AUD) was expected to be in less demand for commodity purchases as global growth expectations fell. However, this once reliable behaviour is now in question as central banks around the world aggressively raise interest rates to combat inflation, re-injecting two material drivers of exchange rates (interest rates and inflation) that have been dormant for many years. The portfolios continue to utilise foreign currency exposure for diversification but at lower active levels.

The past 12 months has challenged diversified portfolios, especially those constructed based on an extrapolation of the past 10 years or basic textbook theory that labels nominal bonds as diversifying, regardless of the starting circumstances. Long ago and supported by the Investment Futures Framework, the Horizon and Index Plus portfolios questioned the efficacy of nominal bonds as a diversifier and sought other means to improve the risk profile of the fixed income allocations, all of which have played a role at either minimising or avoiding losses.

The MLC Inflation Plus portfolios are underpinned by substantial flexibility in growth/defensive allocations, and have been able to avoid exposure to developed market nominal core fixed income while maintaining defensiveness and yield though a similar collection of exposures. As a substitute for core nominal bonds, the portfolios have instead held a collection of inflation-linked bonds, Chinese government bonds, foreign currency, gold, defensive alternatives and a range of innovative derivative structures to control risk and maintain some income.

- *Inflation-linked bonds* provided a duration substitute without direct inflation risk, meaning that in the case that yields continued to fall, the portfolios would likely benefit, while at the same time being somewhat insulated from the caustic impact of rising inflation on fixed income.
- *Chinese government bonds* diversified the portfolios holding in Chinese shares while trading at a healthy real yield some 1.5% in excess of Australian and US yields. The higher real yield on Chinese bonds helped lift income and reduced the chance of severe losses.
- *Foreign currency* helped diversify as it is defensive from an AUD point of view, given the tendency of the AUD to rise in tandem with shares and fall when shares sell-off.
- *Gold* helped the strategy diversify against shocks while also providing a potential hedge against inflation.
- *Defensive alternatives* helped maintain income and return without direct exposure to growth risk.
- And finally, equity and currency *derivative structures* helped build resilience into the portfolios while controlling premium spend

and transferring the cost of hedging to upside scenarios where the portfolios underlying assets would be performing well.

Taken together as a basket, these strategies filled the diversification and income void created by avoiding exposure to very expensive and largely ineffective nominal bonds, and in most cases have played their intended role. The question now though, is when to begin reversing some of this aversion to core nominal fixed income strategies. Investment grade credit is a starting point with higher yields and lower duration. But ultimately, if yields continue to rise then at some point it will begin to make sense to bring nominal bonds back into the Inflation Plus portfolios and reduce reliance on more esoteric diversifiers such as currency and derivatives. And while our team doesn't have a magic number or defined threshold to start that journey, we will maintain vigilance and begin to make modest changes as and when the opportunities present.

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 took advantage of the broad sell-off in the 'high-PE' segment of the market to increase positioning in a select group of companies that have a robust growth outlook and high-quality balance sheets. Amongst these, the portfolio increased its exposure to CSL, WiseTech Global and Seek. Each of these businesses occupies a dominant commercial position in their industry and each has a clear pathway to continued earnings growth with little risk of margin compression.

Alongside this, the broad sell-off in miners created an opportunity for the portfolio to selectively add exposure to high quality producers of metals that are required for decarbonisation such as IGO Ltd and OZ Minerals Limited. The portfolio also took profits on several stock specific hedges that were established prior to the recent sell-off. These included selling partial hedges held over CBA, South32, Qantas, Seek, IGO and OZ Minerals. Hedges held over these stocks limited losses in the portfolio due to recent falls in stock prices. Selling out of the hedges means that the portfolio has crystalised gains on the risk control puts without crystalising losses on the underlying shares. This means that the portfolio now has greater exposure to a rebound in the underlying stocks than it would have if the hedges were left in place. A small amount of the profit earned on the hedges was used to re-establish risk control, but further out of the money. These hedges will become valuable if the market continues to fall.

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, pragmatic approach will be helpful for our clients as we continue to navigate our way through the current inflationary market environment.

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

Changes in return potential for asset classes

The largest change in probability weighted returns for the quarter were in assets with a direct link to interest rates (Chart 1). Both listed property and most of the fixed income sectors experienced a moderate increase in return potential and decrease in downside risk.

The increase in listed property is notable as the sector is likely to benefit under sustained inflation, particularly for sectors of the market with healthy balance sheets and longer-term debt. As for fixed income, and following on from the discussion in our 'Quarterly insights' section above, the 5 year probability weighted real return for core nominal government bonds is now near zero after sitting well below zero for the past few years (last quarter -4% pa). Yet, despite the market improvement in core nominal fixed income sectors, the risk/return profile remains unattractive. This is partly because the yield curve remains inverted with long dated yields still low relative to fair value, and partly because of the pervasive risk of stubborn inflation which continues to threaten the real return outlook for long-term nominal fixed income securities.

In step with the sell-off in shares, high yield bond spreads jumped during the quarter. The increase in high yield spreads combined with the relatively short duration of the high yield bond universe drove an increase in the sectors return potential that lifts the probability weighted return close to long-term averages. As a caution, it's worth noting that the sector is exposed to the risk of a US recession. Should the US fall into recession it is likely that both default rates will exceed expectations and recovery rates will undershoot. This is reflected in the negative tail (see grey bars).

Share market return potentials remained near the levels recorded last quarter. Behind the stability in share market return potentials, better valuation added to expected returns, which was largely offset by the slide in earnings expectations. The deterioration in earnings was driven more by expectations that margins are at risk of decline as input costs, particularly raw materials and wages, continue to add to corporate overheads.

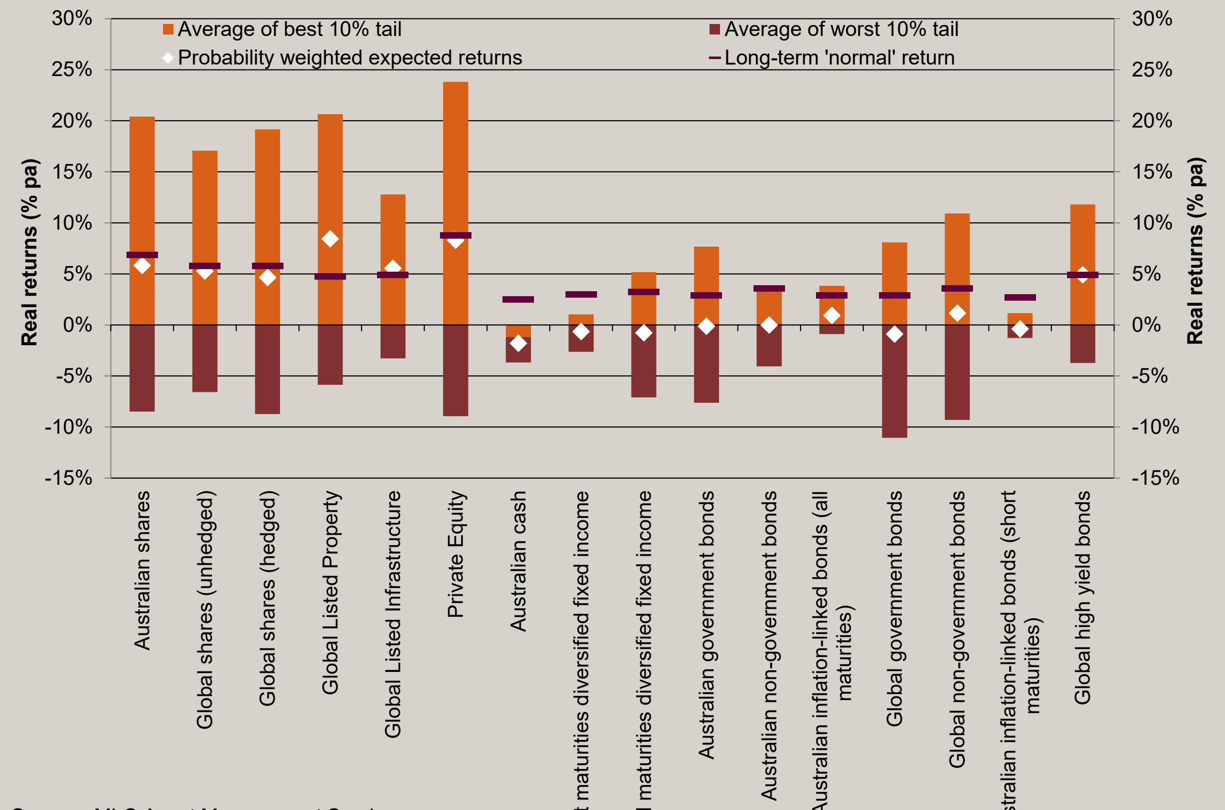
Portfolio positioning

This quarter the trading activity across all portfolios continued to focus on managing the increased volatility in share markets and currency markets.

During the quarter we introduced four additional Model Portfolios to our Managed Account Strategies. These include two Value and two Premium Model Portfolios (Conservative and High Growth). Refer to the MLC Managed Account Strategies section below for details.

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

Chart 1: 40 scenario set (generic scenarios) potential real returns (June 2022) - 5 years, 0% tax with franking credits, pre-fees, pre-alpha



Source: MLC Asset Management Services Limited.

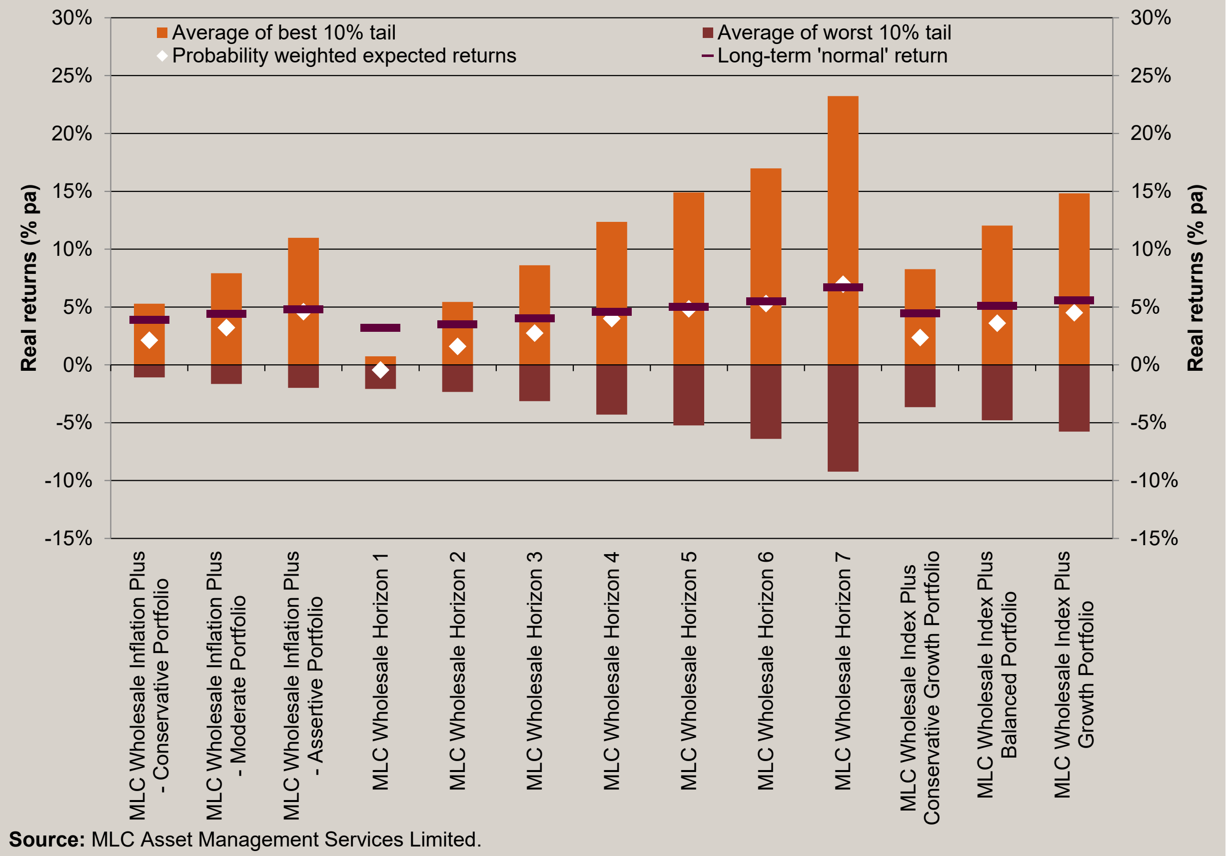
The potential real returns for each asset class are shown above. The probability-weighted real returns are shown as diamonds. For comparison we've included long-term 'normal' return expectations which are set by considering a stable fair value world – these are shown by the horizontal lines. Also, as 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 2 and 3 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 2022.

The stronger risk focus of the Inflation Plus portfolios is evident (Chart 2). 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 2: 40 scenario set (generic scenarios) potential real returns (June 2022) - 5 years, 0% tax with franking credits, pre-fees, pre-alpha



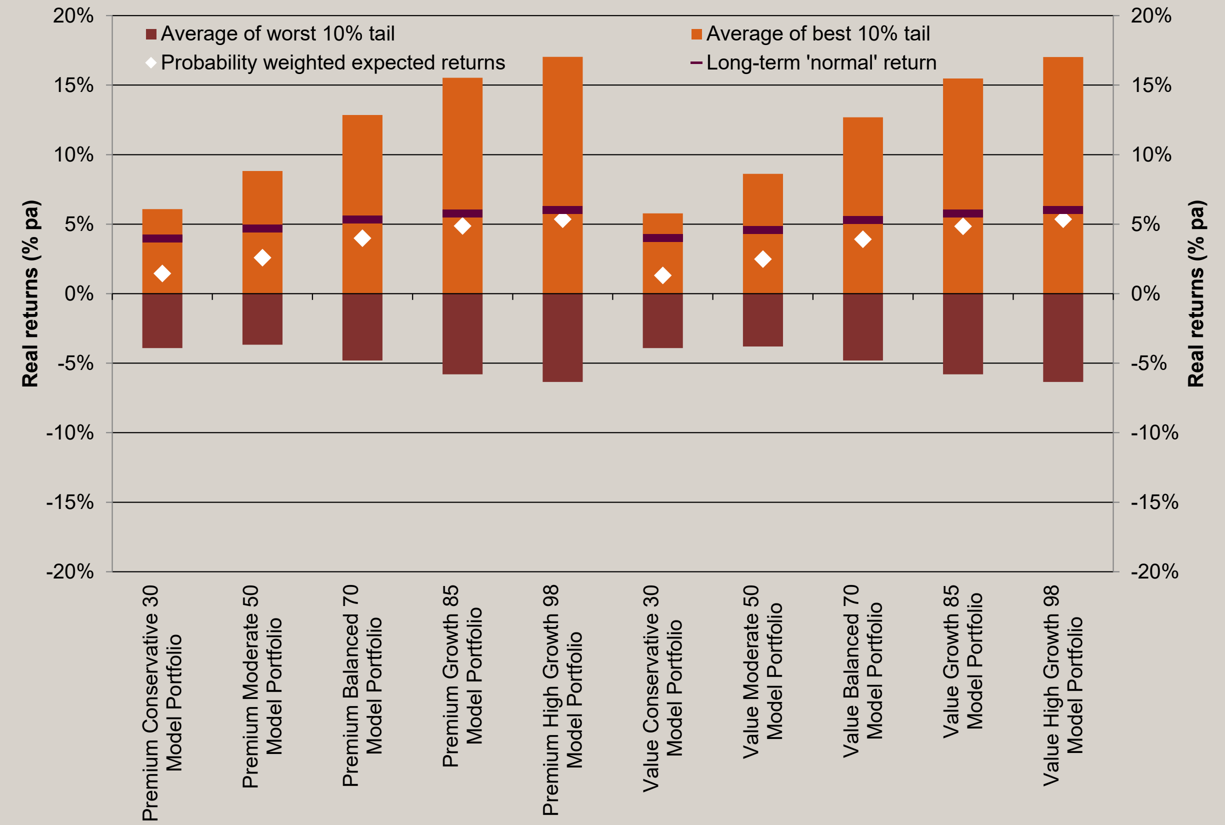
Source: MLC Asset Management Services Limited.

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 somewhat below the returns similar asset allocations have produced in the past (Chart 3).

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 equivalent or incrementally higher returns in the most positive scenarios and equivalent or less negative returns in the worst.

Chart 3: MLC Managed Account Strategies - 40 scenario set (generic scenarios) potential real returns (June 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 June 2022 quarter, including up until the time of writing, were:

- Early in the quarter, adjustments were made to the growth assets in the Inflation Plus Assertive portfolio to introduce more inflation resilience. Allocations to global shares were reduced in favour of increasing exposure to Australian shares and our customised 'miners and energy basket'. The sectoral decomposition of the Australian share market is less susceptible to de-rating in an inflationary environment given the higher weighting to Materials, Financials and Energy when compared to a global share market index. The customised nature of the Australian shares exposures in Inflation Plus also provides the portfolios with protection through optionality should growth surprise to the downside.
- Taking profit on hedges held over the portfolio's exposure to the CSI-500 (China small cap shares). Following on from steep falls in mid-April driven by a new round of COVID-zero lockdowns, the portfolio sold out of well in the money puts, spending a small amount of the gains to re-purchase a hedge further out of the money. Re-structuring the hedge in this way meant that the portfolio crystalised gains on the hedge without crystalising losses on the CSI-500, all the while maintaining further tail risk protection. Post re-structuring, the CSI-500 has rebounded, gaining approximately 15%. Selling out of the hedges at a lower level means that while losses were reduced during the fall, the portfolio was able to participate in the majority of the subsequent gains. We continue to believe that small-medium enterprises in China are well positioned to benefit from Government policy and that valuations within this sector are attractive. We continue to monitor the path of policy and impact of COVID lockdowns.
- 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.

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.

- Portfolio allocations to global credit were adjusted over the quarter with the focus on increasing diversification both at the country and credit risk premia level. The allocations to Australian short corporate debt were reduced in favour of global short credit to improve diversification at the country and issuer levels. Increased allocations were also made to extended credit and insurance-related investments in an effort to further broaden the type of credit risk being taken in the portfolios. The recent widening in credit spreads provided an attractive entry point to both bank loans and high yield debt – the underlying constituents of extended credit.
- 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 global 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. We believe optionality over JPY is the cheapest means of offsetting this risk.
- The de-rating in global share markets provided the opportunity for Inflation Plus Conservative and Inflation Plus Moderate portfolios to increase their exposures through capital allocations to Arrowstreet and Walter Scott. Both these portfolios had been under risked in global growth assets and so were able to take advantage of a more attractive valuation opportunity in global shares.

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 June 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)	**Increased**	**Increased**	**Increased**
Global shares (through derivative strategies)	**Increased**	**Increased**	**Decreased**
Global listed infrastructure	Steady	Steady	**Increased**
Global shares (unhedged)	**Increased**	**Increased**	**Decreased**
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	**Increased**
Real return strategy	**Decreased**	**Decreased**	**Decreased**
Australian inflation-linked bonds	Steady	Steady	Steady
Insurance-related investments	**Increased**	**Increased**	Steady
Global high yield bonds and loans	**Increased**	**Increased**	**Increased**
Global non-government bonds (short maturity)	**Increased**	**Increased**	**Increased**
Global non-government bonds (all maturity)	**Decreased**	**Decreased**	**Decreased**
Australian non-government bonds (short maturity)	**Decreased**	**Decreased**	No allocation
Cash	**Decreased**	**Decreased**	**Decreased**
Borrowings	Not permitted	Not permitted	No borrowings

MLC Horizon portfolios

The key portfolio activities during the June 2022 quarter were:

- The overweight allocation to emerging market shares was rolled in June. This allocation is expressed through a swap structure that is a combination of the onshore China CSI-300 and MSCI 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.
- Sharply rising bond yields provided an opportunity for the Horizon portfolios to reduce the long held underweight to longer maturity nominal fixed income. Bond prices fell sharply in response to increasingly concerning inflation prints and aggressive interest rate forward guidance by central banks, which allowed the underweight to be reduced by adding back some nominal exposure at more attractive levels. The portfolios remain cautiously underweight as nominal debt remains a risky proposition against volatile inflation.
- A small increase was made to non-investment grade credit for the Horizon portfolios that have lower allocations to share market risk. Credit spread widening pushed prices down during the quarter, providing the opportunity to modestly increase the existing low allocation to non-investment grade credit.
- 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.
- We also appointed new bond managers to improve returns and manage risks in the Horizon 2 to 5 portfolios. These new managers have more flexibility to take market opportunities. Ardea Investment Management and Janus Henderson Investors have been appointed as Australian bond managers in the all maturities strategy, replacing UBS Asset Management. Brandywine Global Investment Management and PGIM Fixed Income have been appointed as global bond managers in the all maturities strategy, replacing Amundi Asset Management, Insight Investment Management, Loomis Sayles and Wellington Management. 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.

- 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.

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 30 June 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)	•		
Insurance-related investments			•
Low correlation strategy		•	

MLC Index Plus portfolios

Asset allocation positioning of the MLC Index Plus portfolios changed in the June quarter by a reduction in the foreign currency overweight and a reduction in the long maturity nominal fixed income underweight. The size of the foreign currency overweight was reduced, 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.

Sharply rising bond yields provided an opportunity for the Index Plus portfolios to reduce the long held underweight to longer maturity nominal fixed income. Bond prices fell sharply in response to increasingly concerning inflation prints and aggressive interest rate forward guidance by central banks, which allowed the underweight to be reduced by adding back some nominal exposure at more attractive levels. The portfolios remain cautiously underweight as nominal debt remains a risky proposition against volatile inflation.

We also appointed new bond managers to improve returns and manage risks in the Index Plus portfolios. These new managers have more flexibility to take market opportunities. Ardea Investment Management and Janus Henderson Investors have been appointed as Australian bond managers in the all maturities strategy, replacing UBS Asset Management. Brandywine Global Investment Management and PGIM Fixed Income have been appointed as global bond managers in the all maturities strategy, replacing Amundi Asset Management, Insight Investment Management, Loomis Sayles and Wellington Management. Details are available at **mlc.com.au**

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.

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.

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 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

During the quarter we expanded our Managed Account Strategies by introducing four additional Model Portfolios. These include two Value and two Premium Model Portfolios (Conservative and High Growth). The addition of these new portfolios provide advisers with more choice to suit the diverse needs of their clients.

With the expansion of the portfolio range to include both Conservative and High Growth, we also took the opportunity to align the existing portfolios naming convention with industry standards. As such, the Assertive portfolios have been renamed to Balanced and the Aggressive portfolios to Growth. We've also enhanced the Model Portfolio names by including the % of growth assets within the portfolio name 30, 50, 70, 85 or 98 in an effort to increase transparency and functionality.

The markedly higher exposure to fixed income within the Conservative 30 Model Portfolios saw an expansion of the fixed income manager program. Within short maturity domestic exposure, the Realm Short Term Income Fund was introduced to complement the existing Antares Income Fund.

- the Realm Short Term Income Fund is expected to deliver an incrementally higher total return within the domestic short maturity allocation, while retaining a strong focus on appropriately managing risk across an investment grade investment universe

Within the investment grade and non-investment grade credit exposure, the Janus Henderson Diversified Credit Fund was introduced to complement the existing Bentham Global Income Fund.

- the Janus Henderson Diversified Credit Fund is expected to deliver an incrementally lower-risk exposure within the 'high yield' allocation, while retaining flexibility to capture sub-investment grade opportunities within the expanded investment universe.

The investment rationale for the expanded fixed income manager program was evaluated to equally apply within the Moderate 50 Model Portfolios. In June 2022 rebalancing activity was undertaken for both the Premium and Value series Moderate 50 Model Portfolios to introduce these two fund exposures.

We continue to position the portfolio for diverse and resilient returns across asset classes in the following key ways:

- **Maintaining growth asset exposure** – We have maintained 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. Incrementally increased global shares exposure over the quarter (funded from AUD cash) via adding to global shares (hedged) and emerging market shares (unhedged).
- **Foreign currency diversification** – During the quarter we incrementally reduced our foreign currency exposure (by increasing hedged global shares exposure slightly more than emerging markets shares exposure). We continue to see foreign currency exposure as an important diversifier (holding both hedged and unhedged global shares).

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.

- **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 (and Janus Henderson Diversified Credit Fund for the Conservative and Moderate Model Portfolios). While still delivering a negative total return over the quarter, the fixed income program delivered a total return demonstrably higher than all maturity nominal bonds (domestic and global).
- **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.
  - Establishing a protective collar around our gold holdings. Having participated in the strong rally, we have protected against losses from these elevated levels by purchasing a put option, funded by selling a call 10% above the market.
  - Increasing put protection over our US shares exposure in the form of a contingent 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 June quarter was primarily driven by the above fixed income manager expansion (Conservative and Moderate Model Portfolios) as well as deployment of AUD cash received from ASX share dividends and fixed income fund distributions into global shares. Beyond this for the Premium series of model portfolios, Australian shares activity focused on bringing more diversity and resilience into the direct ASX shares sub-portfolio via the addition/upweighting of Scentre Group (SCG), Transurban (TCL) and Woolworths (WOW), funded via a reduction in exposure in Commonwealth Bank (CBA), Harvey Norman (HVN) and National Australia Bank (NAB). 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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