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MLC ASSET MANAGEMENT

MLC's scenario insights & portfolio positioning

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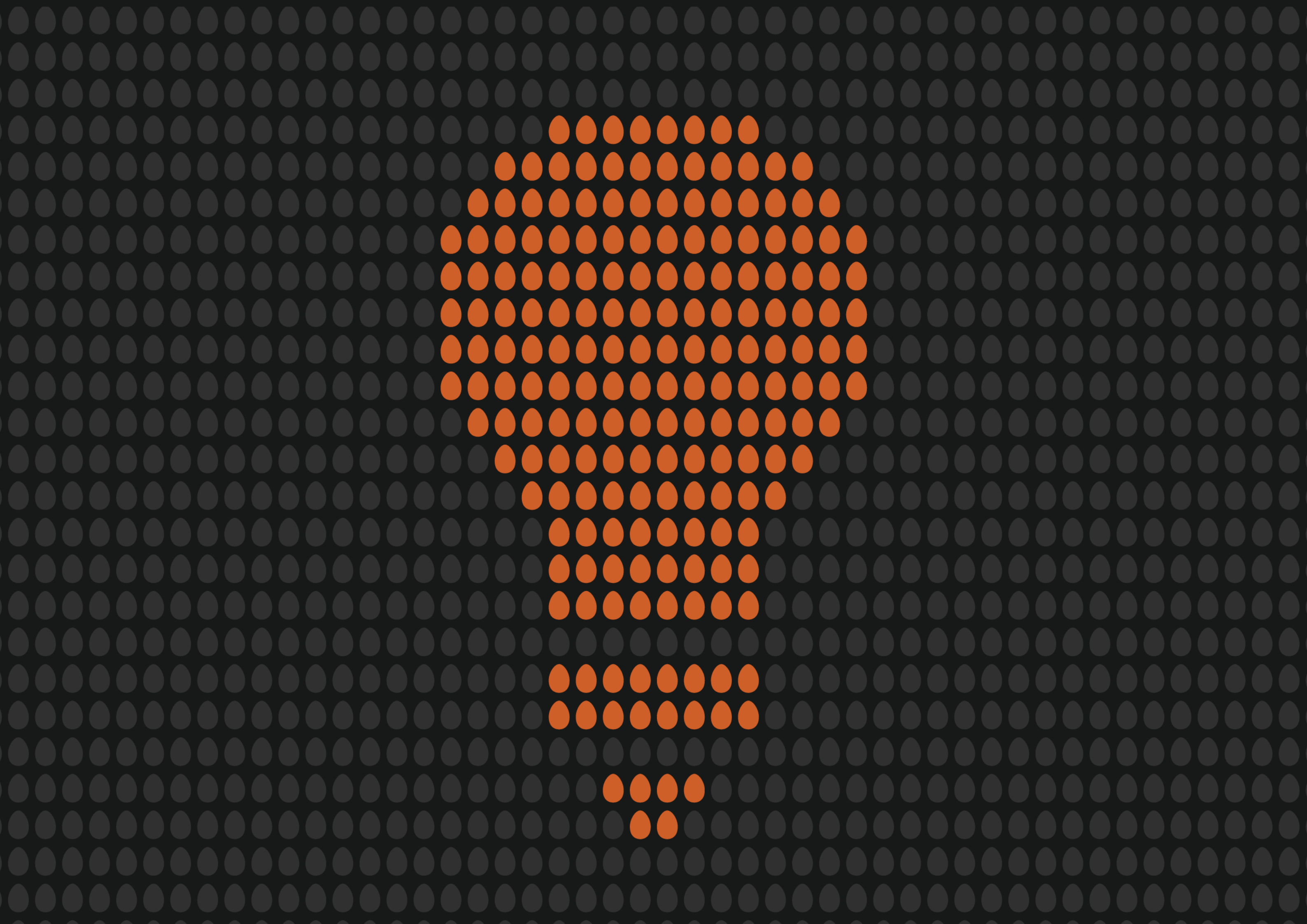
MLC's investment and super portfolios
MLC Inflation Plus, MLC Horizon and MLC Index Plus portfolios

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



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MLC Investment Trust:	MLC Super Fund:	MLC Managed Account Strategies:
MLC Wholesale Horizon 1 Bond Portfolio		MLC Premium Conservative 30 Model Portfolio
MLC Wholesale Horizon 2 Income Portfolio	MLC Stable	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	

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Quarterly insights

Highlights

- The two i's — inflation, and interest rates — have upended investment markets over the past year causing a break from the lengthy post-GFC period where ultra-low interest rates, stubbornly low inflation, unusually low bond yields (high bond prices), and lofty share market valuations, seemed so set.
- Market fundamentals have shifted meaningfully the past year. An unprecedented 2.5% rise in US real rates and a related dramatic revaluation in US shares has resulted in the prospective returns for bonds and shares looking significantly better than a year ago.
- Our approach when facing into such a volatile environment is to avoid being drawn into a single portfolio path and instead consider the range of credible paths that the assets we hold could potentially follow.
- The Investment Futures Framework allows us to assess these variable outcomes through the scenarios process and build portfolios that will be resilient across a range of possible futures.

Insights

It is that time of year again when market scribes share their expectations for markets in the year ahead, typically including a point forecast on where the various market indices will finish the year. We have previously discussed our aversion to point forecasts. We have no confidence in our ability to distil an inherently complex system into one future path; a task which appears particularly difficult in the current environment as the system tries to digest decades high inflation and an aggressive increase in the cost of capital.

Our preference instead is to try and understand a range of credible future paths from the current starting point and assess the impact they could have on the assets we hold. With this as our toolset, rather than provide readers with forecasts in which we have little conviction, the following is our view of current market pricing and an assessment of the risks posed to the bond and share markets.

MLC'S active investment approach

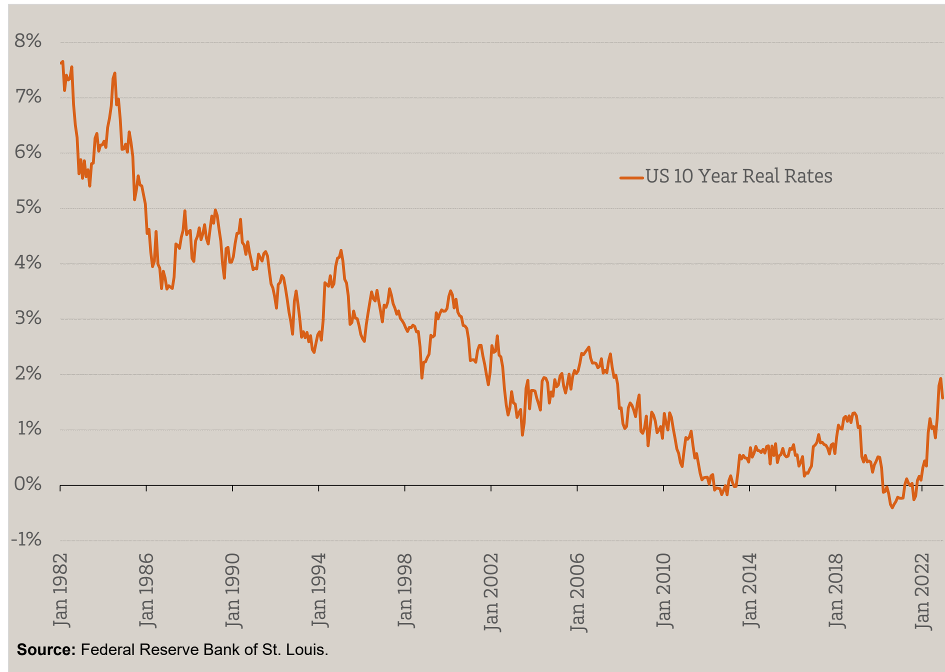
- Key to MLC's market-leading investment approach is our unique Investment Futures Framework.
- In an unpredictable world, the Framework helps us comprehensively assess what the future might hold. By taking into account the many scenarios that could unfold – positive and negative – we gain continuing 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.

Bond markets:

To get a clear picture of current pricing across the bond markets, it is helpful to decompose the nominal bond into its major constituent parts, the real interest rate plus inflation expectations. Market pricing was extreme at the start of 2022, with real rates in the US at an all time low and expectations for inflation just starting to climb. At the time, bonds offered little in the way of income or protection in the face of rising inflation. Fast forward to the start of 2023 and pricing looks meaningfully different. ***Prospective returns from real rates look a lot more attractive, whereas inflation expectations may be a little optimistic***. Indeed, this is the first time in a decade we've started the year with the real-yield on the US 10-year bond higher than 1.5% (see Chart 1 below).

Focussing first on the real yield, the Chart 1 shows just how hawkish the US Federal Reserve have been in tightening financial conditions for the real economy. This has resulted in an unprecedented increase in real rates. This aggressive increase in the cost of capital has implications for any balance sheet that employs leverage – either current or intended. Those with existing high levels of debt will suffer as servicing costs increase and those with the intention to access leverage are faced with tighter liquidity conditions.

Chart 1: US 10 Year Real Rates



Source: Federal Reserve Bank of St. Louis.

Assessing the impact of this rise in cost of capital on different sectors will take time and is dependent on multiple factors like:

- Existing level of leverage – the higher the leverage, the more difficult it will be to meet servicing costs
- Inflation resilience – the ability to preserve margins in the face of rising input costs
- Access to growth – capacity to maintain revenue in the current environment of shifting preferences

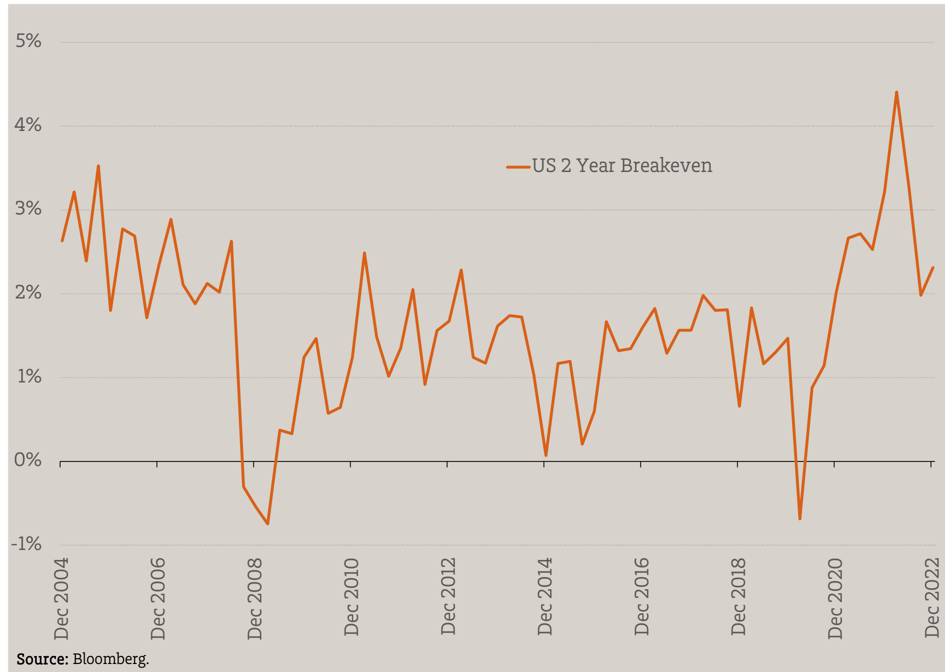
The speed with which real rates increased also means it will take some time to assess the impact, as these changes necessarily operate with a lag, particularly when interest rates rise quickly. Given the rapid increase in interest rates, we suspect the path forward will be volatile for some time as expectations recalibrate.

The news is not all bad for bond markets. Despite the fact rates have moved up dramatically, the absolute level of real rates is not high compared to historical averages. Looking at Chart 1 it is evident US 10-year real rates are currently higher than they have been in the past decade but below the 3% average of the past 40 years. This highlights the perverse level to which real rates sunk post the pandemic. It also raises the question of how tight financial conditions really are? Should the next 10 years run to the same tempo as the prior ten, then financial conditions are indeed tight. If not, then it is arguable that the real economy might be well placed to endure current settings.

The simple question posed above has no simple answer. We are currently faced with an unprecedented pace of increase in the real interest rate but only to a level that is still low in the historical context. No doubt, there will be casualties, particularly where debt has been used to fund low productivity. Will the system be more resilient given the fact real rates are not that high? Real rates are a byproduct of where inflation intersects with nominal growth, so the future path of inflation will play a major role in determining where real rates settle – a nice segue to the second component of our bond analysis – inflation expectations.

Inflation expectations followed a very different path to real rates over 2022, experiencing a sharp rise earlier in the year but quickly settling back to more normal levels. Concerns that inflation expectations would become unanchored were quickly quashed as lower energy prices, central bank commitment to task, supply side alleviations and concerns over ongoing demand all contributed to lower price expectations. This can be seen clearly on Chart 2 where the US 2 Year Breakeven (a market representation of inflation expectations) broke out to above 4% but then reversed to end the year at 2.2%.

Chart 2: US 2 Year Breakeven



With US CPI recently printing at 6.5% year-on-year, is the market too optimistic expecting inflation to revert to 2% in the next 2 years? Goods inflation has reverted quickly as supply chains have freed up and consumers have shifted their preferences from goods to services as economies have opened up. The energy contribution to CPI has been volatile but declining as the geopolitical landscape has not worsened and demand from developed markets has slowed. So both these contributors support the optimism.

The clear outlier is the contribution to inflation from services, which is driven primarily by rents and wages. These are still at elevated levels and have historically proven to be sticky and slow to move lower. The residential market in the US has slowed considerably, but this is from very high levels and the stock of housing still suffers from undersupply following the dramatic reduction in building post the GFC. Rents should fall from their current 8% pace of growth, but a fast reduction would be unusual.

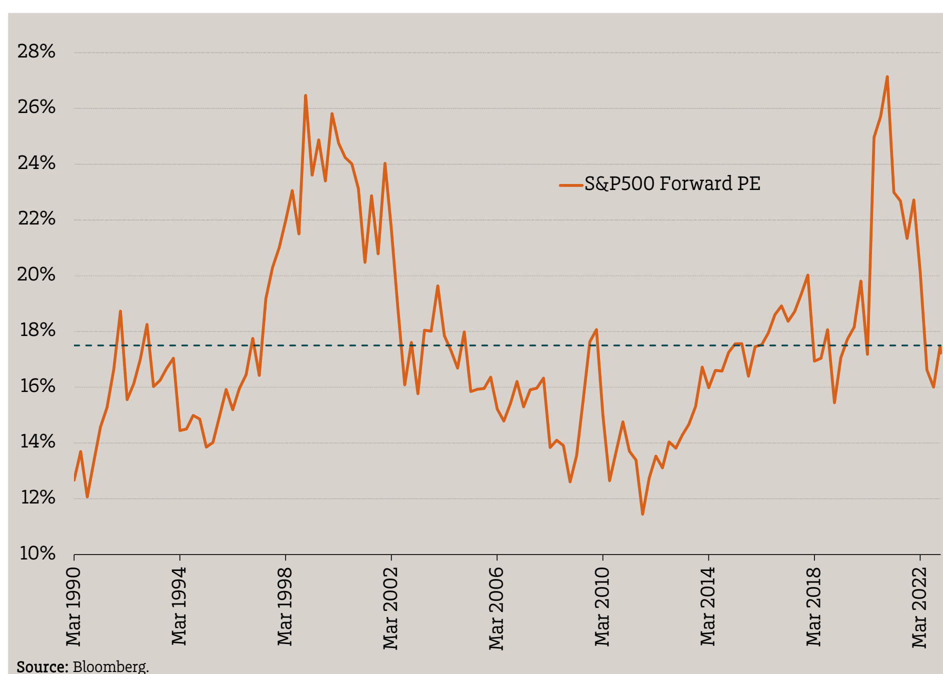
Similarly with wages, the 'great resignation', lower cross-border mobility, and post-pandemic preference shifts in demand have combined to create a tight labour market in the US. Wage growth has slowed recently but given the balance of power appears to be shifting to the worker, there is a risk it remains at elevated levels for longer than expected. These are slow moving dynamics, suggesting it may take longer than 2 years to return inflation back to its 2% target.

Shares:

Similar to bonds, it is also helpful to break shares into their constituent parts; earnings times valuations. Starting with valuations, the share market has demanded a higher risk premium for shares cash flow, as evidenced by the fall in Price to Earnings multiple (PE) in 2022. This makes sense given the multitude of risks companies are trying to assess. We will cover these in more detail when we discuss earnings later, but the operating environment for many sectors of the economy has become more volatile as supply and demand dynamics keep shifting post pandemic. ***Investors have sensibly reduced the multiple they are willing to pay for these more volatile earnings streams***.

Looking at Chart 3, the dramatic reversion in valuation is evident. The chart depicts the Forward PE for US shares which is the valuation multiple applied to expected earnings. We can see the size of the fall in the share market multiple is similar to the experience of US shares post the bursting of the tech bubble in 2000, but the speed of the fall is unmatched in the past 30 years. The other observation to make is the PE starts 2023 at around 17, slightly below the average multiple of 17.5 shown by the dotted line on the chart. This suggests US shares are currently neither cheap nor expensive if we use the average multiple of the past 30 years as the yardstick for 'fair value'.

Chart 3: S&P500 Forward PE



Source: Bloomberg.

Earlier we highlighted the unusual circumstances faced by real rates – an unprecedented increase in rates but to a level below the long-term average. A similar event has occurred in equity valuations – the sharpest correction in PE multiples in 30 years but only to a level that suggests an average valuation. This is not a coincidence given both these metrics represent a competition for capital that is not happening in a vacuum. High real rates attract capital in the same way low share valuations do and vice versa. But it does highlight that similar to real rates, PE multiples reached perverse levels post the pandemic.

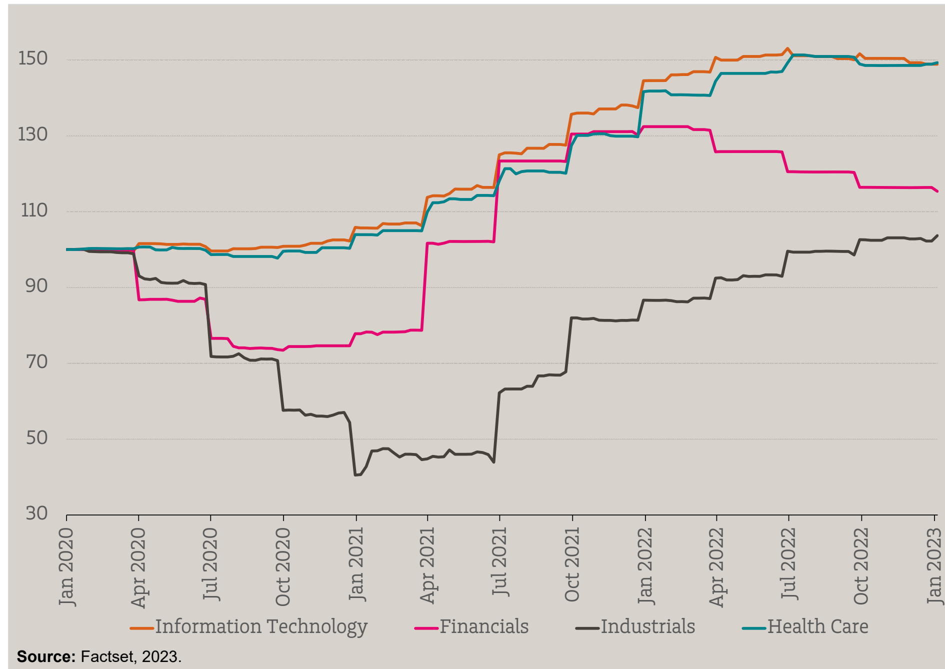
Despite having already fallen at an unprecedented speed, PE multiples could fall further from here. It is worth noting that in previous high inflation episodes like the late 1970's and early 1980's, PE multiples were significantly lower down into the single digits. However, the starting level of PE was significantly lower than this current episode. A share market at 'fair value' does not necessarily lend itself to highly convicted views on whether to increase (or decrease) allocations. It makes sense to move on to the other shares constituent – earnings.

Markets went into 2022 expecting around 10% earnings growth for US shares over the year, with the majority expected to come from sales growth given margins were at elevated levels and under pressure from rising input costs. The reality ended up being pretty close to expectations. US shares delivered 7% earnings growth over the year, driven solely by sales as margins actually contracted. Forecasts were close for earnings but whiffed completely for share market returns, as the severe PE multiple contraction drove the S&P500 down 18.5% in local currency terms for 2022.

The negative share market return has influenced market expectation. Fast forward to today and consensus has halved, with markets expecting 5% earnings growth for 2023 driven in equal parts by sales and margin growth. Such a low level of expected earnings for the S&P500 is unusual and has only been lower twice in the past 25 years – the GFC and the pandemic. Interestingly the current earnings expectation is lower than at any time during the early 2000's recession. ***The point we are trying to make is these are not optimistic earnings forecasts, and it may take a meaningful recession to drive them lower***.

The other complicating factor is the relatively benign index level expectations mask the larger dispersion in expectations at the sector level. Chart 4 highlights the asynchronous nature of the sector cycles caused by the pandemic. Sectors like IT and Healthcare thrived during and immediately post the pandemic, whereas more cyclical sectors like Financials and Industrials suffered significant earnings downgrades. This divergence is now working the other way as expectations are picking up for cyclicals and the pandemic dominant sectors are suffering as consumer preferences shift.

Chart 4: S&P Sector Earnings



Source: Factset, 2023.

Even within cyclical sectors, the expectations diverge. The Energy sector delivered 164% earnings growth in 2022 and now earnings are expected to contract by 14%. The Financial sector earnings contracted by 15% in 2022 and are expected to grow 14% in 2023. This level of dispersion at the sector level makes it more difficult to hold a highly convicted view at the index level. The fact that a similar dispersion is also occurring at the country level between the two largest economies (US slowing as China opens up) makes it even more difficult to hold a convicted view at the asset class level.

Market fundamentals have shifted meaningfully the past year. An unprecedented 2.5% rise in US real rates and a related dramatic revaluation in US shares has resulted in the prospective returns for bonds and shares looking significantly better than a year ago. The troubling issue investors have to consider is the ability of the system to digest this unprecedented change in fundamentals - will it endure or is a recession imminent? An issue made even more complex by the asynchronous position being experienced by different sectors of the economy, probably most simply delineated by goods versus services.

Our approach when facing into such a volatile environment is to avoid being drawn into a single portfolio path and instead consider the range of credible paths that the assets we hold could potentially follow. The Investment Futures Framework allows us to assess these variable outcomes through the scenarios process and build portfolios that will be resilient across a range of possible futures.

Portfolio comments

Positioning in Inflation Plus was rewarded in several allocations during Q4. Our exposure to small cap Chinese shares participated in the broad recovery across Chinese shares, although with lower volatility than the offshore facing large cap sector. Exposure to small cap Chinese shares is a reasonably priced growth exposure that should continue to benefit from directed policy support.

The JPY also added to performance, mainly driven by a reversal in the markets expectation for USD rates. Gains from the rally were greater than losses from earlier depreciation of the yen as the fund held option protection over some of the exposure that limited losses but did not reduce gains. Inflation Plus holds yen as a defensive exposure that the team believes is more efficient than traditional growth offsets. Our lower than usual exposure to the USD helped performance as the US dollar index (DXY) gave back gains over the quarter. We have been concerned about USD weakness and AUD strength for some time now and continue to maintain exposure to the USD at a relatively low level.

Stock stories

There were several changes to the Australian shares allocation of Inflation Plus during the quarter. The strategy took the opportunity of higher yields on offer in the A-REIT sector to add exposure to high-quality names in industrial real-estate assets (e.g. Centuria Industrial). We also added to select industrials after a series of down-grades and de-ratings created an opportunity to add what we perceive to be high quality growth at a reasonable price (e.g. Reliance Worldwide and James Hardie Industries Plc). At the same time, we reduced exposure to Qantas after a rapid increase in price. While we continue to believe the company is in much better position than it was prior to the pandemic, the outlook for travel has weakened as the share price has strengthened, thus it is prudent to take some profit and reduce the risk of disappointment.

Inflation Plus also benefited from the internally managed "*Mining and Energy Income Basket*" that owns a portfolio of high-quality domestic companies in the mining and energy sectors, most of which maintain a high dividend yield. The final quarter of 2023 was a very strong quarter for Australia's mining sector as sentiment towards the sector turned positive in response to the re-opening of China's economy after a prolonged period of lockdown. Alongside the improvement in sentiment, production levels across most of the sector remained robust in Q3, while cost growth softened and capital expenditure discipline continued to endure. The positive operational dynamics of our main holdings continue to give us confidence that dividends will be supported in 2023.

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.

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

Changes in return potential for asset classes

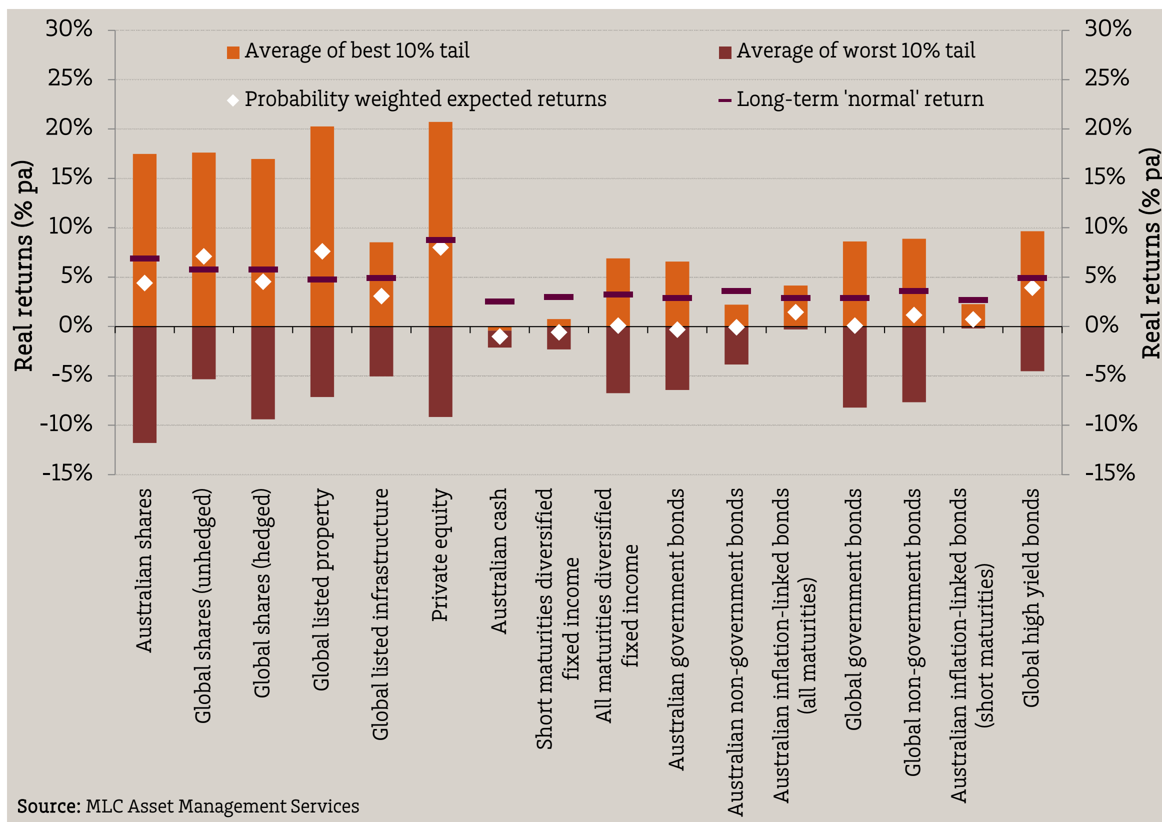
The notable changes in probability weighted returns for the quarter were in fixed income assets which continue to improve and in share market return potentials which has slightly declined from last quarter reflecting valuations rebounding from the September 2022 lows.

Fixed income returns continue to improve over the quarter however remain low in absolute terms and will be challenged in an environment of higher-than-expected inflation. Inflation-linked bonds continue to take favour in the scenario where inflation is higher than expected and is further supported by the reset in real rates. Additionally, duration continues to become more attractive as a mechanism to protect portfolios against the typical deflationary impacts of a recession.

Return potential for High Yield bonds declined slightly as spreads contracted over the quarter however still rival shares from a prospective risk/return outlook.

Share market return potentials have slightly declined mainly driven by valuations rebounding over the quarter from the lows of September. Valuations in ex-US regions continue to trade cheaper relative to history and add to expected returns, however earnings expectations across all regions are not optimistic and will be a watchpoint for further deterioration as the cycle continues.

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



Source: MLC Asset Management Services

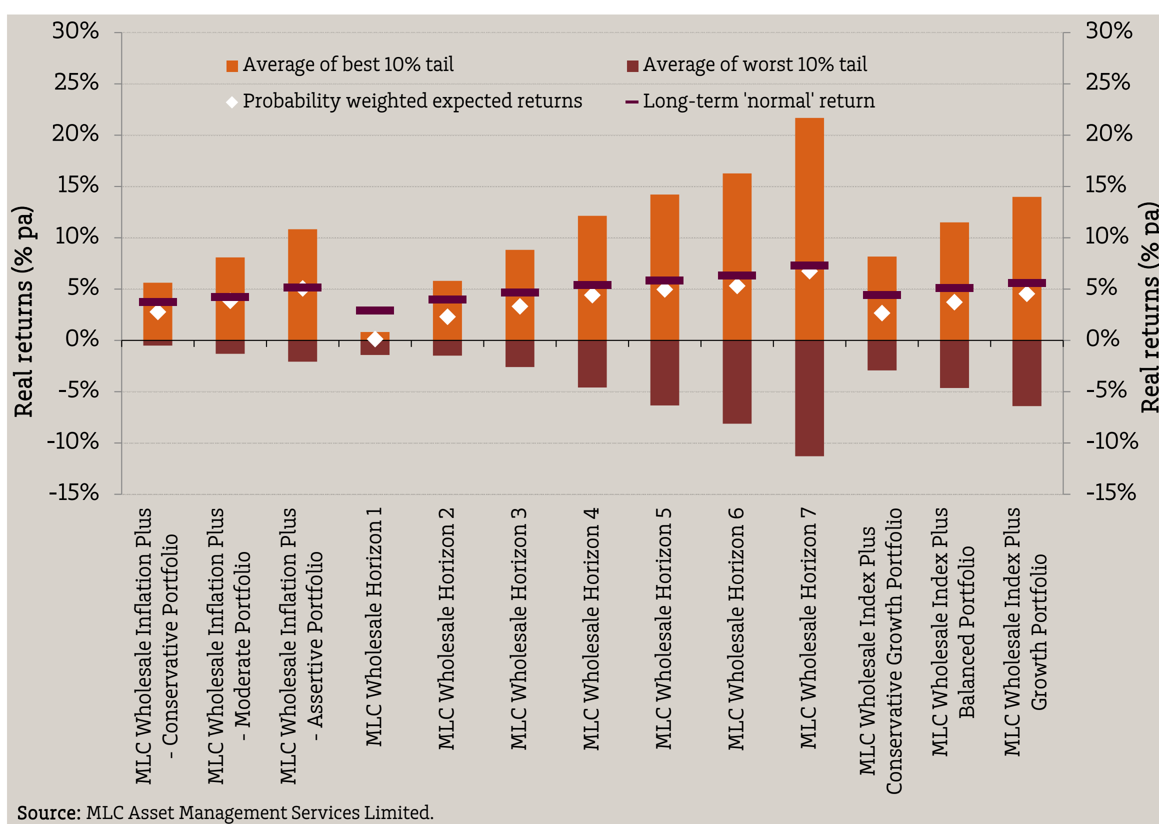
The potential real returns for each asset class are shown above. The probability-weighted real returns are shown as diamonds. For comparison we've included long-term 'normal' return expectations which are set by considering a stable fair value world – these are shown by the horizontal lines. Also, as 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 6 and 7 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 December 2022.

The stronger risk focus of the Inflation Plus portfolios is evident (Chart 6). 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 6: 40 scenario set (generic scenarios) potential real returns (December 2022) - 5 years, 0% tax with franking credits, pre-fees, pre-alpha



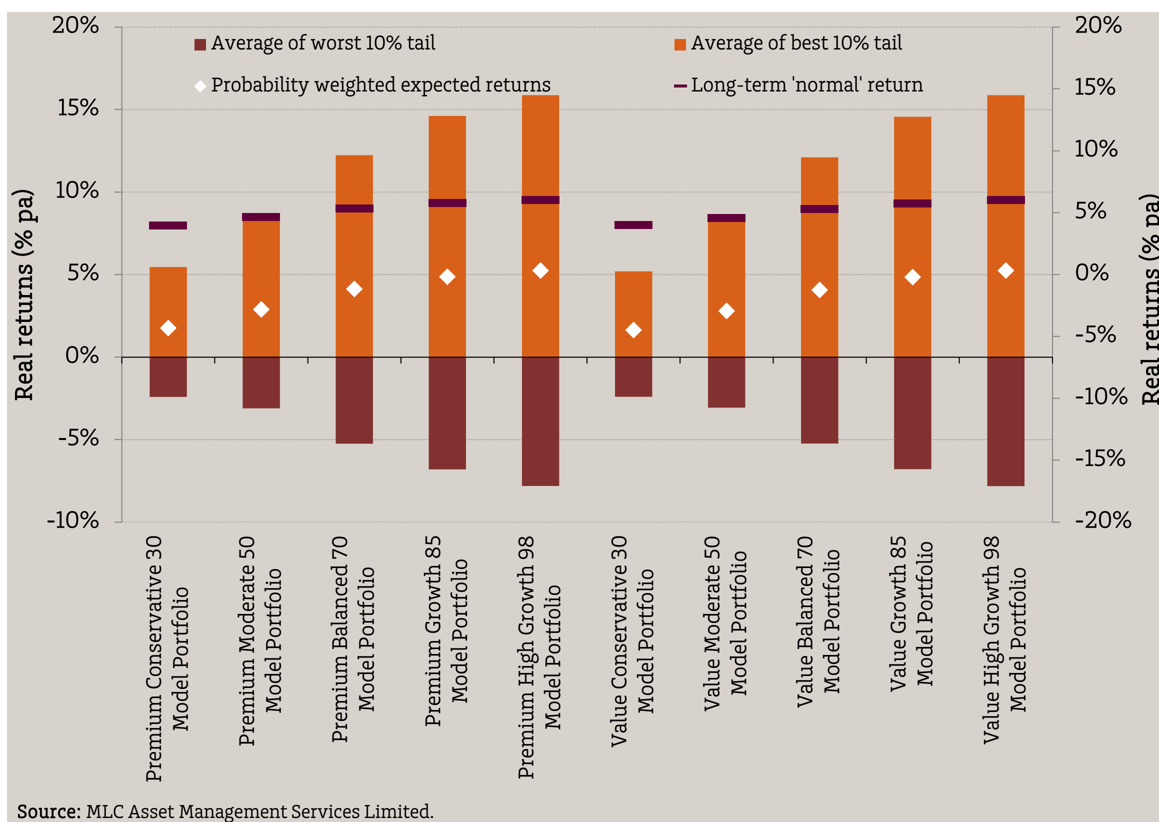
Source: MLC Asset Management Services Limited.

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 7).

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

Chart 7: MLC Managed Account Strategies - 40 scenario set (generic scenarios) potential real returns (December 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 December 2022 quarter, including up until the time of writing, were:

- Adjusted our global credit allocations, replacing longer dated global corporate bonds with those of a shorter maturity. The inverted yield curve in the US has provided an opportunity to access better yields in the short end of the curve. This is part of a broader strategy to refresh our credit allocations to take advantage of the new opportunity set presented in income assets.
- Reduced our USD/JPY call options as the Japanese currency weakened significantly, providing an opportunity to take profit on existing call options and replace them with lower delta options. JPY is held as a protective mechanism in the event of a global risk off event and the USD/JPY calls enabled the portfolio to maintain the position without suffering significant losses as the currency weakened over 2022.

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.

- Extension of our emerging market shares swap replication strategy for another 3 months. The strategy employs a China CSI300 index swap to access our preferred onshore China shares allocation and adds an EM ex-China swap to create an aggregate EM shares exposure. The whole structure has a protective collar. The re-opening of China provides a catalyst for EM shares to outperform developed markets and so we are comfortable maintaining this protected exposure.

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 December 2022		
	Conservative	Moderate	Assertive
Chinese government bonds (derivative strategies)	Steady	Steady	Steady
China A-shares with downside limit of -20% (derivative strategies)	Steady	Steady	Steady
Emerging market shares (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 (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 (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)	**Decreased**	**Decreased**	**Decreased**
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 December 2022 quarter were:

- The Horizon portfolios reduced foreign currency exposure via a reduction in global shares unhedged back to benchmark weight, and an equivalent increase to global shares hedged also back to benchmark weight. The active overweight foreign currency position had been held for a long time to provide the portfolio diversification benefits where there was little confidence in nominal fixed income to play it's traditional defensive role.
- Some Horizon portfolios saw a modest increase to longer maturity fixed income. More attractive pricing has driven higher forward looking return potential and diversification benefits from the asset class. The portfolios remain cautious on nominal debt as elevated inflation is aggressively targeted by central banks through rising interest rates.

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 manager changes were made to the Horizon global shares strategy. Royal London and Pzena were appointed, replacing Kiltearn and Tweedy Browne. The changes are expected to improve the consistency of active management excess returns.

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 December 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		•	
Private equity		•	

MLC Index Plus portfolios

The Index Plus portfolios reduced foreign currency exposure via a reduction in global shares unhedged back to benchmark weight, and an equivalent increase to global shares hedged also back to benchmark weight. The active overweight foreign currency position had been held for a long time to provide the portfolio diversification benefits where there was little confidence in nominal fixed income to play it's traditional defensive role.

Index Plus experienced a modest increase to nominal fixed income over the quarter. The repricing of nominal bonds over 2022 has improved the potential for fixed income to once again provide more meaningful diversification benefits to the portfolios. Index Plus remains cautious on nominal debt against the uncertain inflationary outlook and continues to carry less interest rate risk than the benchmark.

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.

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

MLC Managed Account Strategies

Consistent with our view of the current investment environment, our target asset allocation was refined over the December quarter. This activity was implemented within the more growth-oriented portfolios, specifically Premium and Value Growth 85 and High Growth 98 models and involved an increase in Australian shares (High Growth 98), increase in Global shares hedged (Growth 85), and decrease in Global shares unhedged (High Growth 98 and Growth 85).

The investment rationale for this asset allocation shift is positioning the Managed Account Strategies' model portfolios to have incrementally higher Australian shares and AUD exposure, during a period which may see:

- Australian shares, via commodity-exposed major miners, resource-related industrials, and domestically-orientated financials, continue to deliver solid cash flows, and
- the diversification benefits of holding foreign currency exposure prove less effective at this time (AUD presenting better value relative to USD and other major foreign currencies)

We've positioned the portfolios for diverse and resilient returns across asset classes in the following key ways:

- **Maintaining growth asset exposure** – 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 and insurers. Global shares (hedged) exposure was also expanded over the quarter (High Growth 98 and Growth 85 portfolios).
- **Foreign currency diversification** – During the quarter we incrementally reduced our foreign currency exposure (by increasing hedged global shares) as we see the AUD becoming more attractive at lower levels. Thus slightly reducing the diversification benefits of having exposure to foreign currencies when global share markets weaken. We continue to see foreign currency exposure as an important diversifier (holding both hedged and unhedged global shares) and being valuable through periods of market adjustment and increased volatility.
- **Active fixed income** – We believe active management is necessary to effectively navigate a rising interest rate environment. As outlined in the main CMR perspectives, the inflation fighting resolve of central banks has led to bouts of elevated bond market volatility. The marked adjustment in traditional all maturity nominal bonds has provided a demonstrably improved starting value and more attractive risk-reward potential across a range of potential future outcomes. As outlined in a prior section, within fixed income we see duration appearing more attractive as a mechanism for providing portfolio protection against the deflationary effects from a potential recession.

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 portfolio's provide important real return exposure and sources of low correlated return streams. As outlined above, Inflation Plus' activity this quarter included:
    - Extension of our emerging market shares swap replication strategy for another 3 months. The strategy employs a China CSI300 index swap to access our preferred onshore China shares allocation and adds an EM ex-China swap to create an aggregate EM shares exposure. The whole structure is protected using a protective collar. The re-opening of China provides a catalyst for EM shares to outperform developed markets and so we are comfortable maintaining this protected exposure.
    - Adjusted our global credit allocations, replacing longer dated global corporate bonds with those of a shorter maturity. The inverted yield curve in the US has provided an opportunity to access better yields in the short end of the curve. This is part of a broader strategy to refresh our credit allocations to take advantage of the new opportunity set being presented in income assets.
    - Reduced our USD/JPY call options as the yen weakened significantly, providing an opportunity to take profit on the existing call options and replace them with lower delta options. The yen is held as a protective mechanism in the event of a global risk off event and the USD/JPY calls enabled the portfolio to maintain the position without suffering significant losses as the currency weakened over 2022.

Portfolio rebalancing activity over the December quarter was primarily driven by the above refinement of target asset allocation for the High Growth 98 and Growth 85 Premium and Value series model portfolios. Beyond this for the Premium series of model portfolios, direct ASX shares activity focused on bringing more diversity and resilience into the direct ASX shares sub-portfolio via the addition / upweighting of BHP Group (BHP), IDP Education (IEL), The Lottery Corporation (TLC) and Wesfarmers (WES) funded via a removal / reduction in exposure in Alumina (AWC), Amcor (AMC), APA Group (APA) and Australian and New Zealand Banking Group (ANZ).

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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