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MLC ASSET MANAGEMENT

MLC's scenario insights & portfolio positioning

July 2023

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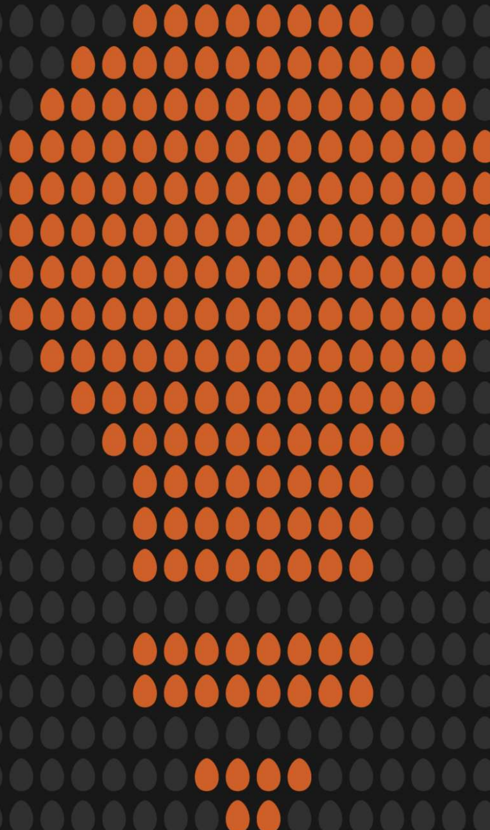
MLC's wholesale investment portfolios
MLC Inflation Plus, MLC Horizon and MLC Index Plus portfolios

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



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MLC Investment Trust:

MLC Wholesale Horizon 1 Bond Portfolio

MLC Wholesale Horizon 2 Income Portfolio

MLC Wholesale Horizon 3 Conservative Growth Portfolio

MLC Wholesale Horizon 4 Balanced Portfolio

MLC Wholesale Horizon 5 Growth Portfolio

MLC Wholesale Horizon 6 Share Portfolio

MLC Wholesale Horizon 7 Accelerated Growth Portfolio

MLC Wholesale Inflation Plus Conservative Portfolio

MLC Wholesale Inflation Plus Moderate Portfolio

MLC Wholesale Inflation Plus Assertive Portfolio

MLC Wholesale Index Plus Conservative Growth Portfolio

MLC Wholesale Index Plus Balanced Portfolio

MLC Wholesale Index Plus Growth Portfolio

MLC Managed Account Strategies:

MLC Premium Conservative 30 Model Portfolio

MLC Premium Moderate 50 Model Portfolio

MLC Premium Balanced 70 Model Portfolio

MLC Premium Growth 85 Model Portfolio

MLC Premium High Growth 98 Model Portfolio

MLC Value Conservative 30 Model Portfolio

MLC Value Moderate 50 Model Portfolio

MLC Value Balanced 70 Model Portfolio

MLC Value Growth 85 Model Portfolio

MLC Value High Growth 98 Model Portfolio

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Quarterly insights

Highlights

- The strong recovery in share markets through the 2023 financial year provided a welcome relief for investors, as a faith in growth and an appetite to stomach higher valuations gave share markets momentum to climb. Fixed income however, a traditionally defensive asset class, continued to be challenged by co-ordinated central bank interest rate rising programs.
- As the tightening in financial conditions continues to dampen inflation, growth across developed economies will likewise continue to fade.
- Even though the economic outlook is considerably less certain now than it was at any time during the decade prior to the pandemic, the broader array of investment opportunities in many ways makes it an easier time for portfolio constructors to build diversified investment strategies.
- The Australian shares exposure of our Inflation Plus portfolios outperformed the broader market in the June quarter, due partly to a lower exposure to banks and higher exposure to high quality mid-cap stocks.
- The narrow leadership of the major indices (including the 'Magnificent Seven') gives us some cause for caution. This leads us to favour income over capital growth and to hold higher allocations to alternative exposures such as insurance-related investments and bespoke private credit.
- Our Investment Futures Framework is designed to first understand the risks facing our portfolios 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 while we pay attention to the most obvious future, we also consider investment consequences of multiple less-obvious potential paths. We believe this open approach, which by design incorporates a wide range of investment perspectives, will be helpful for our clients as we continue to navigate our way through the current inflationary episode.

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.

Asset class market performance over the quarter and financial year

Alongside steady anchoring from cash and alternatives, the strong recovery in share markets through the 2023 financial year (FY23) provided a welcome relief for investors. If not for the above average return from shares, multi-asset fund investors would have had scant little real-return to show for the financial year as bonds, a traditionally defensive asset class, continued to be challenged by co-ordinated central bank interest rate rising programs. Higher interest rates forced bond yields up and bond prices down. Net-net, the income earned by bond investors was essentially offset by capital losses from the decline in bond prices.

Under normal circumstances, shares too would have struggled in what looks like late cycle dynamics, but a faith in growth and an appetite to stomach higher valuations gave share markets momentum to climb. The significant concentration in share market drivers, coinciding with fresh descriptors such as the 'Magnificent Seven' US technology basket within Wall Street's benchmark S&P500 Index, present an interesting backdrop to commence the new financial year. The Australian dollar (AUD) performed well against currencies with steady or declining interest rates such as the Chinese yuan and the Japanese yen, however depreciated against the euro, sterling and US dollar (USD).

Key events in economic markets

Following on from the first calendar quarter of 2023, most major economies continue to digest tightening financial conditions. Inflation in both goods and services appear to be in retreat or 'rolling over' and for now, it appears that central banks have not broken either the financial or real economies. Liquidity issues that arose in the first quarter appear to have been resolved with debt markets continuing to function normally albeit under tighter lending conditions. Labour markets have softened slightly, but not to the point where a central banker might consider the war on inflation to be won.

Hard economic data across major developed economies are sturdy, but it's worth noting that recent softer economic data releases appear to be signalling fragility and potentially the beginning of a downwards trajectory. Household savings accrued during the pandemic are becoming exhausted, credit card funding is on the rise and retail sales have dipped - all of which are indicating that households are under pressure The downturn in softening data is reflected in consensus earnings forecasts with S&P500 Earnings Per Share (EPS) growth falling 7% year-over-year and 4%

quarter-over-quarter on a seasonally adjusted basis. Earnings estimates for the Australian share market are mixed with upward revisions for metals and mining and downward revisions for financials and retailers.

The recovery in China's growth has not met investor expectations but remains in line with our base case. Confidence across the economy remains dented by a year of disruption to income and balance sheets either flat-lining or contracting as property prices stall or in some cases fall. Despite this, consumer activity in select service categories including travel and leisure remains solid and company results indicate a strong preference from consumers to 'trade-up' to higher value-added goods albeit at lower volumes. We believe the lack of a major Chinese stimulus is not a surprise. Economic policy in China has transitioned from big-bang investment to more subtle but targeted support for strategic industries and sectors. This is partly driven by the need to increase productivity of capital and partly driven by the longer-term strategic priority of higher quality growth and greater self-reliance, both of which are threatened by continued misallocation of capital under a 'bazooka stimulus' approach.

Outlook

From here, the probability-weighted base case is for the decline in inflation to continue, however it remains unclear where it will settle. Pricing of inflation in the US anticipates a glide to near 2% over the coming few years, whereas expectations for inflation in Australia are that it will remain higher. The reasons for this are unclear. Inflation in Australia has lagged US inflation both on the up and the down swing, but there is nothing obvious to suggest that inflation in Australia should settle higher. Australian households are more indebted than their US counterparts and have more direct exposure to interest rate rises through variable interest rate mortgages. This in turn means that higher interest rates should impact household consumption more in Australia. The outlook for domestic energy prices might explain some of the difference, but looking out past 2023 it is not clear that inflation in the cost of domestic energy will persist.

As the tightening in financial conditions continues to dampen inflation, growth across developed economies will likewise continue to fade, which we believe places increasing pressure on corporate margins and bottom-line earnings. At the same time, global trade volumes are weakening, investment intentions are slackening, and activity surveys point to a broader softening in activity. So, while the labour market remains tight, signs are that employment will weaken. Central banks are probably close to or at the end of their tightening cycle but are unlikely to begin cutting back interest rate policy anytime soon. Thus, for now the environment shows strong signs of being in late cycle with considerable dispersion in a range of potential future outcomes from here. This is well acknowledged by the market which appears to be pricing a (tentative) soft economic landing.

Potential future alternative scenarios

Nonetheless, with the economy in a phase of adjustment and the world facing ongoing geopolitical uncertainty, our confidence in the probability-weighted base case is lower than it would be under more stable conditions. Alternate scenarios, both with greater upside, and the potential for disappointment, challenge this central scenario. Inflation is the obvious villain with potential challenges from both the supply and demand side. Energy supply is perhaps the most acute risk that could restoke goods inflation, but ongoing geopolitics tension continues to cast a broad shadow over supply chain reliability.

From this point, the re-emergence of inflation almost guarantees a stagflationary outcome, which is very challenging for nearly all asset classes. Across major developed market economies, we see the UK as facing the greatest existential threat from this type of scenario playing out. Upside risks from growth are also possible. Interest rates might be close enough to neutral to facilitate mild inflation growth which, if it materialises, provides an opportunity for the economy to deleverage in a benign way, thus supporting higher valuations and validating the consensus view that corporate earnings will avoid a recession.

Portfolio implications

From a forward-looking perspective, the reset in bond prices and rise in cash yields has been a 'long time coming' and provides a welcome relief for investors and capital allocators alike.

For more than a decade, low yields have limited the ability of bonds to provide meaningful diversification during periods of economic stress. This in turn lowered the potential to effectively build resilience into a multi-asset portfolio and made it harder to hold higher share allocations. At the same time, depressed cash rates raised the opportunity cost of holding an asset that maintains its value in nominal terms. This combination of circumstances threw up a very difficult decade for multi-asset portfolio managers investing in traditional asset classes in a conventional way. It also provided a conducive environment for an expansion into alternative and unlisted asset classes as well as risk-reducing and, in some instances, return enhancing derivative overlays.

So perhaps paradoxically, even though the economic outlook is considerably less certain now than it was at any time during the decade prior to the pandemic, the broader array of investment opportunities in many ways makes it an easier time for portfolio constructors to build diversified investment strategies. Nominal bonds have regained their ability to offer diversification against a slowdown in growth, and inflation-linked bonds should protect against both a slowdown in growth and a resurgence of inflation. With an awareness of valuation, quality, risk and reward, we believe this in turn means that portfolios can tolerate higher levels of absolute risk than they could when bond yields were plumbing the lower bound. In deploying risk, we think it's wise to acknowledge that while developed market shares have performed well in aggregate, valuations are now high and earnings expectations appear optimistic.

The narrow leadership of the major indices as colourfully described and outlined above using terms such as the 'Magnificent Seven' also gives us some cause for caution. This leads us to favour income over capital growth and to hold higher allocations to alternative exposures such as insurance-related investments and bespoke private credit. Sensible use of optionality also plays a role in maintaining portfolio upside exposure, while better protecting capital in the event that the base case descends into a risk scenario.

Stock stories

The Australian shares exposure of our Inflation Plus portfolios outperformed the broader market in the June quarter. Outperformance was partly due to low exposure to banks and higher exposure to high quality mid-cap stocks such as James Hardie Industries, Aurizon and Reliance Worldwide. During the quarter, the strategy exited several holdings including Qantas and JB HiFi using the proceeds to re-build exposure to BHP and National Australia Bank. The opportunistic overweight to Qantas was established mid-pandemic after it became clear that the restructured business was well positioned to compete when air travel resumed. Over the last 12 months, strong demand for domestic air travel and pandemic-related capacity reduction resulted in high airfares, that coupled with an improvement in cost performance, drove strong operating results for the airline. Stronger operating performance is now reflected in the share price. At the same time, demand for travel is beginning to soften as the economy slows. Given the change in risk return, we have decided to be cautious and take profits for investors.

From a risk control perspective, the Inflation Plus portfolios continue to opportunistically build broad downside protection in what looks like a fragile market.

The internally managed 'mining and energy' income basket also performed well during the quarter, avoiding losses as resources sold off. Losses were avoided due to put options held within the strategy.

Our investment approach

Our Investment Futures Framework is designed to first understand the risks facing our portfolios 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 while we pay attention to the most obvious future, we also consider investment consequences of multiple less-obvious potential paths. It is our belief this open approach, which by design incorporates a wide range of investment perspectives, 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

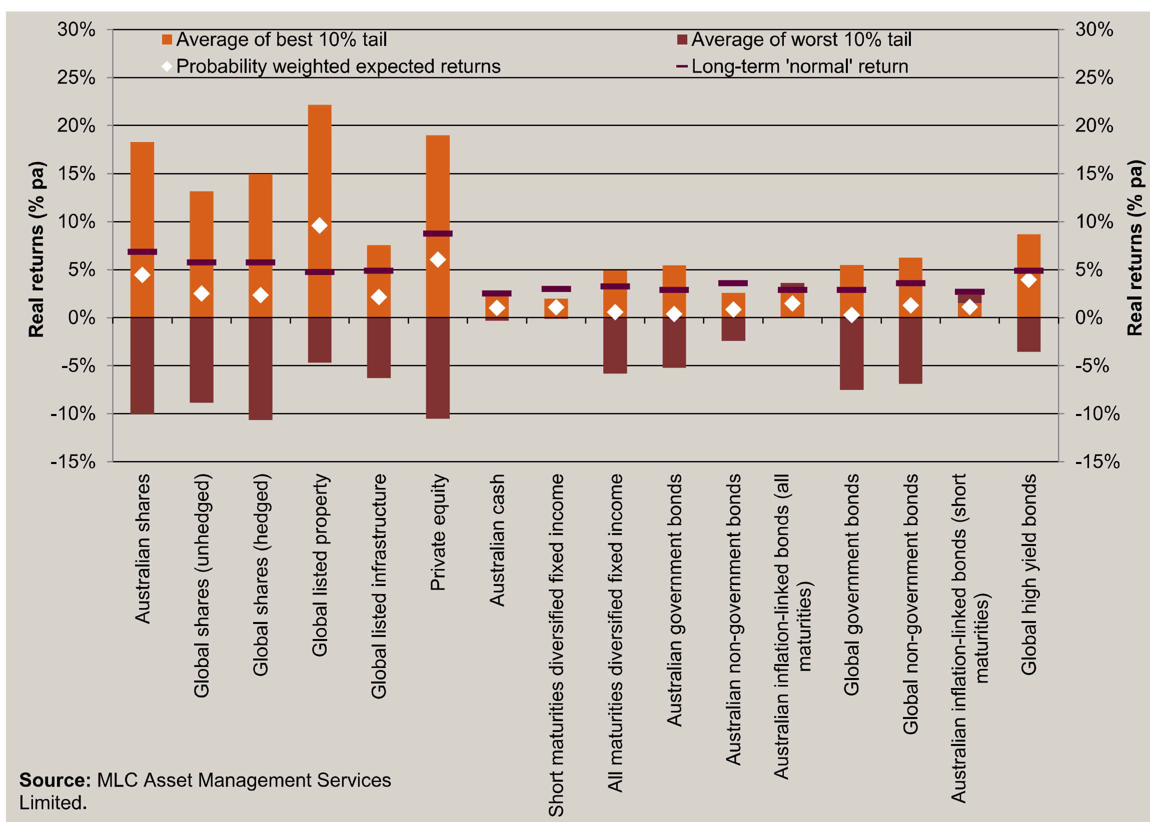
Changes in return potential for asset classes

The return potential of global shares declined during the June quarter (Chart 1). The fall in return potential was mainly attributable to strength in index prices that were not matched by an increase in the outlook for growth in earnings per share. Narrow market leadership during the quarter (refer to earlier 'Portfolio implications' section) distorts the analysis to an extent, particularly for benchmark unaware strategies. Exclusion of the 'Magnificent Seven' from the analysis pushes return potentials slightly higher.

The return potential for Australian shares remained steady.

Fixed income return potentials again improved during the quarter, and while on balance the probability weighted return for core fixed income looks uninspiring, yields are at a level where the asset class can provide valuable diversification against a demand led slowdown in growth. Inflation-linked bonds have less downside than nominal bonds due to their inherent protection against a rise in inflation. Inflation poses the greatest risk to the pricing of nominal bonds. High yield stands out amongst fixed income as having a favourable return profile.

Chart 1: 40 scenario set (generic scenarios) potential real returns (June 2023) - 5 years, 0% tax with franking credits, pre-fees, pre-alpha



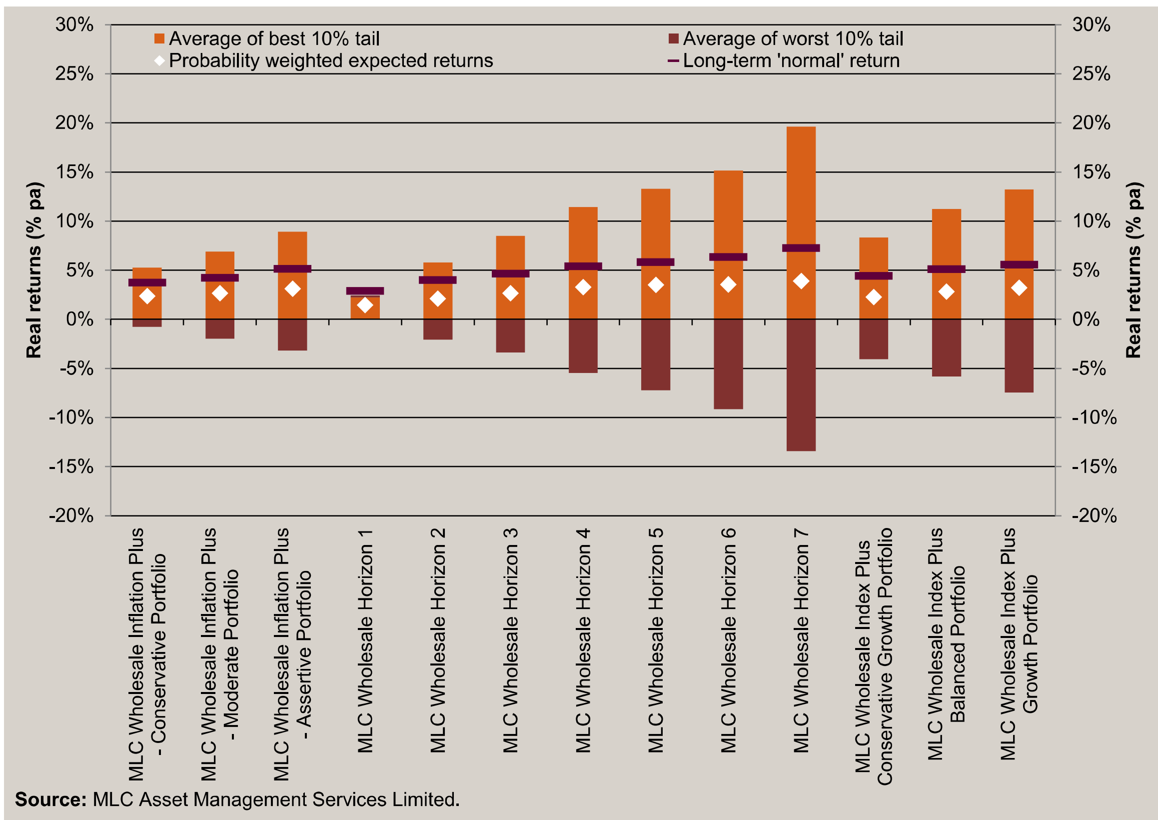
The potential real returns for each asset class are shown above. The probability-weighted real returns are shown as diamonds. For comparison we've included long-term 'normal' return expectations which are set by considering a stable fair value world – these are shown by the horizontal lines. Also, as an indicator of how uncertain these returns are, we've taken the bottom (and top) 10% of the scenario real returns and calculated the probability-weighted average in those 'tail' outcomes. These are shown in the bars. Asset classes with wider ranges could have more extreme return outcomes than those with narrow ranges.

Return potential

Charts 2 and 3 show the 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 2023.

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 2023) - 5 years, 0% tax with franking credits, pre-fees, pre-alpha



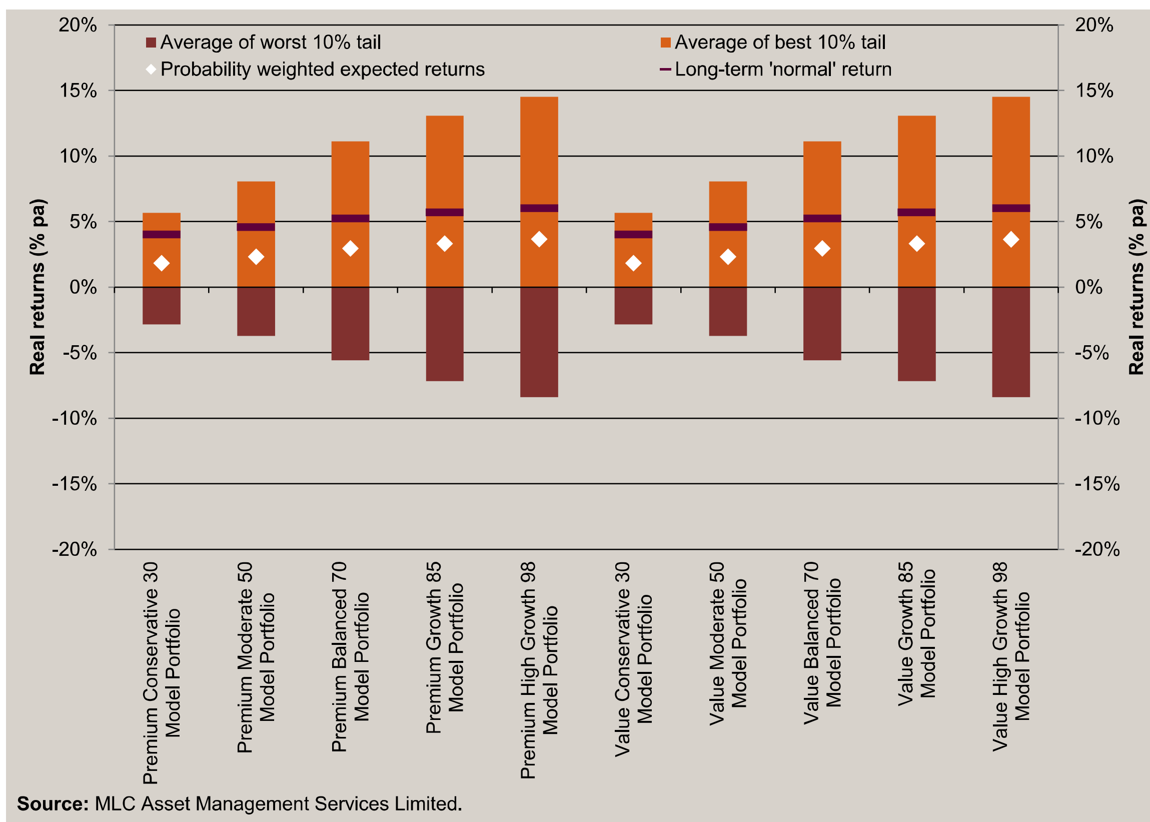
Source: MLC Asset Management Services Limited.

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

Chart 3: MLC Managed Account Strategies - 40 scenario set (generic scenarios) potential real returns (June 2023) - 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 2023 quarter, including up until the time of writing, were:

- The allocation to gold was removed from Inflation Plus. Gold has performed better than expected during a period of rising real interest rates and an appreciating USD. Now that interest rates are higher, the opportunity cost of holding gold as a defensive asset has risen. Given the high gold price and increase in opportunity cost we took the decision to replace gold with Australian government bonds.
- Australian government bonds were added to the strategy. The yield on longer dated Australian government bonds is high enough to justify a defensive allocation.
- There was a slight increase in exposure to China shares through the Shenzhen Composite Index. The underlying exposure of the Shenzhen Composite Index has more exposure to sectors of the Chinese economy that we believe will benefit from strategic policy. However, given that China's growth is at a critical juncture, we have hedged the exposure with a put.
- The return of low implied volatility provided an opportunity to add cheap tail risk protection to Inflation Plus. Tail risk protection offsets losses in a sharp sell off. Owning tail protection allows Inflation Plus to hold more growth risk.

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.

- The allocation to US shares was increased. Addition of tail risk protection and the increase in diversification from adding Australian government bonds provided a small budget to increase exposure of Inflation Plus to the US share market.
- Fixed income manager changes occurred in the global non-investment grade bond strategy with the appointment of Bentham Asset Management and Stone Harbor Investment Partners. Bentham provides diversified exposure to securities across global credit markets with the flexibility for opportunistic investments as market conditions arise. Bentham invests in a relatively conservative manner focusing on higher quality securities. Stone Harbor are a specialist emerging market debt manager offering deeply researched exposures into the sovereign credit risk sector. These appointments are expected to improve alpha diversification within the global non-investment grade bond strategy. More details are available at **mlc.com.au**

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 2023		
	Conservative	Moderate	Assertive
Chinese government bonds (derivative strategies)	Steady	Steady	Steady
China A-shares with downside limit of -20% (derivative strategies)	**Slight increase**	**Slight increase**	**Slight increase**
Emerging market shares (derivative strategies)	Steady	Steady	Steady
USD/JPY call option	**Removed**	**Removed**	**Removed**
Defensive Australian shares (including protected income mining and energy shares)	Steady	Steady	Steady
Global shares (derivative strategies)	**Increased**	**Increased**	**Increased**
Global listed infrastructure	Steady	Steady	Steady
Global shares (unhedged)	Steady	Steady	Steady
Private equity	No allocation	Steady	Steady
Foreign currency exposure	Steady	Steady	Steady
Gold	**Removed**	**Removed**	**Removed**
Opportunistic growth strategy	Steady	Steady	Steady
Real return strategy	Steady	Steady	Steady
Australian government bonds	No allocation	**Added**	**Added**
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

Asset class	MLC Wholesale Inflation Plus portfolios change in target asset allocation over the 3 months ended 30 June 2023		
Global non-government bonds (all maturity)	Steady	Steady	Steady
Australian non-government bonds (short maturity)	Steady	Steady	No allocation
Tail risk protection (long volatility)	No allocation	**Added**	**Added**
Cash	Steady	Steady	Steady
Borrowings	Not permitted	Not permitted	No borrowings

MLC Horizon portfolios

The key portfolio activities during the June 2023 quarter were:

- Fixed income manager changes occurred in the global non-investment grade bond strategy with the appointment of Bentham Asset Management and Stone Harbor Investment Partners. Bentham provides diversified exposure to securities across global credit markets with the flexibility for opportunistic investments as market conditions arise. Bentham invests in a relatively conservative manner focusing on higher quality securities. Stone Harbor are a specialist emerging market debt manager offering deeply researched exposures into the sovereign credit risk sector. These appointments are expected to improve alpha diversification within the global non-investment grade bond strategy. More details are available at **mlc.com.au**
- Asset allocation over the quarter remained steady. The cautious outlook on shares is reflected in a benchmark share weight for the portfolio, which has proven to be a rewarding position as share markets have risen over the year.
- Allocations to inflation-linked bonds remains important for inflation protection in a scenario where rapidly falling inflation does not materialise as expected by the market.

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.

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 2023		
	Under	Strategic asset allocation	Over
Australian shares		•	
Global shares (unhedged)		•	
Global shares (hedged)		•	
Private equity		•	
Global property securities		•	
Global listed infrastructure		•	
Cash	•		
Australian inflation-linked bonds	•		
Fixed income (short maturity credit)			•
Fixed income (all maturities)		•	
Global non-investment grade bonds (high yield bonds and loans)		•	
Real return strategies (including Inflation Plus)		•	
Insurance-related investments		•	
Opportunistic growth strategy			•

MLC Index Plus portfolios

The key portfolio activities during the June 2023 quarter were:

- Asset allocation over the quarter remained steady. The cautious outlook on shares is reflected in a benchmark share weight for the portfolio, which has proven to be a rewarding position as share markets have risen over the year.
- Fixed income managers continue to source attractive and resilient credit exposures for the portfolio. This is particularly important against a highly uncertain macroeconomic outlook.
- Allocations to inflation-linked bonds remain important for inflation protection in a scenario where rapidly falling inflation does not materialise as expected by the market.

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 30 June 2023		
	Under	Strategic asset allocation	Over
Australian shares		•	
Global shares (unhedged)		•	
Global shares (hedged)		•	
Global property securities		•	
Infrastructure		•	
Cash	•		
Australian inflation-linked bonds		•	
Fixed income (short maturity credit)			•
Fixed income (all maturities)	•		
Real return strategies		•	

MLC Managed Account Strategies

As described in the **1 June 2023 'Portfolio Changes' report**, there was a meaningful change in our target asset allocation over the June quarter across the suite of Managed Account Strategies. This was the most material asset allocation change thus far in what is now three years since launching these model portfolios.

The rationale for making this change is consistency with our investment process and more closely aligning portfolio positioning with our assessment of risk and reward opportunities. While the ultimate timing and severity of any slowdown is difficult to predict, the increasing probabilities attached to several of our market/economic slowdown scenarios suggest it is prudent to begin shifting portfolio capital to positions more suited to those environments. For now, we've refrained from being too heroic on asset allocation (in particular, going 'too defensive too early'), and instead favoured a reweighting of risk positions within asset classes and subtle tilt to overall defensiveness and flexibility rather than a wholesale reduction in total portfolio risk.

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

- **Maintaining growth asset exposure –** Within Australian shares we've reduced our exposure to Antares ex-20 (mid-caps) and the Fairview Emerging Companies Funds (small caps), reflecting our view of the relative vulnerability of these segments to potential economic slowdown and market correction scenarios. In the Premium portfolios, we've reduced our global developed markets shares exposure via a combination of Intermede, Polaris and Arrowstreet redemptions.
- **Inflation Plus real return –** MLC Wholesale Inflation Plus portfolios' provide important real return exposure and sources of low correlation return streams. Our objective of cautiously de-risking the Managed Account portfolios must be balanced against the ultimate goal of delivering on target return objectives for investors. Given the wide range of potential market scenarios that could play out from here, our preferred method of building further diversification and versatility in downside protection is via a high quality, dynamic real return strategy, particularly one with a healthy allocation to genuine alternative assets. MLC's Inflation Plus strategy (either Moderate or Assertive depending on the portfolio selected) remains our preferred building block to achieve this objective. As outlined above, Inflation Plus' activity this quarter included:
  - removed the allocation to gold.
  - added longer dated Australian government bonds.
  - slightly increased exposure to Chinese shares through a protected total return swap.
- **Foreign currency diversification –** For relevant portfolios, developed market redemptions have been partly redeployed to the existing emerging markets exposure via Walter Scott. We believe emerging market shares, and in particular China and emerging market Asia, do not appear to be on this same economic cycle as the broader developed markets and currently offer a superior risk-reward opportunity under a range of potential market scenarios, particularly on an unhedged basis. We continue to see foreign currency exposure as an important diversifier (holding both hedged and unhedged global shares) and being valuable through periods of increased volatility and potential market turbulence.
- **Active fixed income –** We believe active management is necessary to effectively navigate a rising interest rate and potentially more turbulent environment. While somewhat moderating their inflation fighting resolve, in light of increasing banking system stresses, central bank interest rate rising activity continues to drive bouts of elevated bond market volatility. We have leaned out of the lower-duration Antares Income and Realm Short Terms Income and in the Premium portfolios we've also retired our allocation to Ardea Real Outcome. The Ardea change reflects less need for a low/no duration, absolute return building block given the more attractive traditional cash and bond yields now on offer. These redemptions, along with some of the net proceeds from the share portfolio reductions, have been redeployed into a combination of:
  - longer duration Australian fixed income (via Janus Henderson Australian Fixed Interest) and an increase to high quality domestically orientated credit (via Janus Henderson Diversified Credit).
  - increased/new allocations to global credit and syndicated loan exposures (via the Bentham Global Income and Syndicated Loans funds). We consider these strategies to be 'mid-risk' assets within the context of available fixed income options, providing a clear step down the risk spectrum vs the shares allocations used to fund them, while delivering the desired increase in interest rate sensitivity at an attractive yield premium to more traditional fixed income sectors.

> 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.

Beyond the asset allocation changes, portfolio rebalancing activity over the June quarter was essentially limited to the direct ASX sub-portfolio within the Premium series of model portfolios. This included the addition/upweighting of BHP Group (BHP),The Lottery Corporation (TLC), QBE Insurance (QBE) and Rio Tinto (RIO) funded via a removal/reduction in exposure in Brambles (BXB), National Australia Bank (NAB) and Worley (WOR).

Within the direct ASX sub-portfolio within the Value series of model portfolios, South32 (S32) was added and James Hardie Industries (JHX) removed during the quarter.

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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