

Investment Strategy Update – Strategic Overlay, December 2009

Below is an edited transcript of a video presentation recorded on 1 December, 2009 by Senior Investment Specialist, Michelle Heinrich and Head of Capital Markets, Susan Gosling.

Michelle: Hello everyone, and welcome to this investment strategy update. I have with me Dr Susan Gosling, who heads up MLC's Capital Markets Research team. Welcome Susan.

Susan: Hello

Michelle: Susan, how we allocate money to the various asset classes, like shares and debt securities, is a crucial investment decision because it's what drives investor returns. What changes are we making to the MLC Horizon portfolios?

Susan: We're increasing the flexibility we have to adjust asset allocation, to take into account the fact that both return potential and risk fluctuate through time.

Sometimes risk is high and we should do something about it. Decisions to change asset allocation are not taken lightly. MLC has a dedicated and experienced asset allocation team with market leading processes, to determine how best to allocate your money.

On the surface, it may seem quite a subtle change to the way we manage portfolios. But it's actually more than that.

I think of it as an evolution to the way we invest. After the extreme and shocking events of 2008, it's important to question the way we manage investors' portfolios.

What can we do better and what will we do better for clients? We know the broad diversification we provide our clients at many levels of their portfolio, is the main way we manage risk. But we believe we can do more.

Michelle: If only we could be certain about what markets were going to do over the next few years, investing and managing risk would be far simpler.

We could simply reduce our exposure to the asset classes before they fall in value. And then increase exposure before they rise. But without a crystal ball, we can't possibly know what markets are going to do, can we?

Susan: Realising we can't know what markets are definitely going to do, doesn't mean we don't know anything about the future. Some future scenarios are more likely than others. Let's look at an example. Even in recent turbulent times, the risk of a collapse in the global financial system was low. While the chances of some form of global economic recovery over the next few years, is high.

Michelle: So does that mean we should position client portfolios for the most likely market conditions?

Susan: No, you just need to look at the events of last year as an illustration of the importance of unlikely outcomes. Some events are extremely unlikely, but if they happen, it really matters for our clients' wealth and it can take quite a few years to recover from.

Michelle: How can we use information about potential future market conditions to help manage our client's exposure to risk?

Susan: No one can predict the future. We'll often see a market bubble for what it is, but no one can know how long it will last.

So we have a choice:

- When risk is high and return potential is shrinking, you can reduce risk exposure... in other words, when returns have been strong... it can be wise to sell out of the strongly performing and now expensive asset classes, and buy into the cheaper ones;
- The other alternative is to hold the same strategy regardless of how cheap or expensive the assets are...

When experiencing booms and busts, this means riding the wave up, and then crashing and burning with everyone else.

We believe we can achieve better outcomes for our investors, by sometimes standing back from the riskiest assets. This can mean accepting a more modest short-term outcome in return for more robust and ultimately higher longer-term returns. This strategy requires persistence and patience. It requires that our investors are patient too, and understand that asset prices can sometimes go too high.

Michelle: I've seen a few bubbles in my 16 years in the industry, including the 1994 bond crisis, the tech boom & bust of 2000 and the recent global financial crisis.

I recall that each time before the bust we told clients that markets were acting irrationally and they should focus on long-term returns. But we didn't change our asset allocations because we didn't know how long the bubble would last. Why do we think we should start changing our asset allocations now?

Susan: We've been running a portfolio since 2005 that does just this. It's the MLC Long-Term Absolute Return Portfolio, which we call LTAR.

We don't have constraints around how much we should have in shares and other asset classes. We have an asset allocation which is set, using the same process we use for the MLC Horizon Portfolios - but in addition, we apply a Strategic Overlay which moves the asset allocation when we see risks building in different asset classes.

Michelle: So Susan, how has the Strategic Overlay worked in LTAR?

Susan: The Strategic Overlay has added to client returns since 2005.

As I explained, we have an asset allocation for LTAR which is based on very long-term expectations, we call that our neutral or strategic asset allocation. The return investors actually receive, depends on how we adjust this asset allocation using the Strategic Overlay.

For example, in calendar 2008 the Strategic Overlay reduced losses by 18.3 percentage points. On a portfolio of \$50,000 that amounts to more than \$9,000. If you'd invested \$100 in the neutral strategy at inception in November 2005 it would have declined to \$94 by 30 September 2009 - this is an aggressive strategy. But due to the defensive positioning of the Strategic Overlay, your actual value would have been over \$113.

A positive return in a difficult environment, and a significant saving of capital.

Michelle: Well the Strategic Overlay certainly added more to returns than it detracted. How was that possible?

Susan: Essentially by being underweight risky assets like shares and property during 2006, and increasing that underweight as risks continued to build. This was based on our view that an extreme risk scenario was more likely than normal, because of a serious imbalance in consumption and savings in the global economy.

This environment persisted, returns were strong but risk continued to rise. We progressively reduced risk exposure through 2008 and this provided significant protection to investor's portfolios.

Today this sounds like an obvious thing to have done. As it turned out, it was a correct view in the end. But through 2006 and 2007 it meant lower returns.

And this is an important point. Doing the right thing, can look wrong for quite some time. We're prepared for this and our clients need to be prepared for this too.

Michelle: Is it like a train wreck about to happen? Although we can't stop it, we can at least get our clients off the train before it happens.

Susan: That's one way of thinking about it. We need to be aware though that there's only so much we can do because we only have a limited ability to change the asset allocation.

In LTAR, we have more flexibility because we told our clients from the start that we would sometimes make very significant changes. That's not what our MLC Horizon clients bought, so we think that changes of 5% around the strategic asset allocation to defensive and growth assets is enough to change their outcomes, while remaining true to label.

We can also make changes within the share and property allocations; or within the debt securities mix.

Michelle: Susan, how often do you think you'll make changes to the asset allocation using the Strategic Overlay?

Susan: This depends on how markets and economies behave. In relatively normal conditions, our strategic allocations represent the best asset mix. Our main focus is on risk. If risk is unusually high or investors are unlikely to be rewarded for taking risk, it will be right to adjust portfolio positioning.

There could be many opportunities in the next few years or none. But using Warren Buffett's baseball analogy, the intention is to swing only at the fat pitches that are easier to hit.

Michelle: A lot of research shows that tactically adjusting asset allocations doesn't improve returns. How is the strategic overlay different to tactical asset allocation?

Susan: Tactical asset allocation is generally defined as making calls over short periods, months rather than years, which we view as very unreliable.

Tactical managers also have a heavy incentive to make changes, because that's what they're paid for.

A key strength of our strategic approach is the ability to take a longer view. We focus on sound information about the underlying investment fundamentals.

We're not punting on short term market outcomes but understanding the opportunity for return and the risks involved. We don't seek to forecast the future but we build understanding of what could happen in markets, which is the only way to comprehensively assess investors' risk exposures.

Michelle: But if for example, you reduce the exposure to global shares because you think the risk is too high for the potential reward, and you think it could take a few years before this risk is recognised, what happens if global shares fall and the position pays off after only a couple of months?

Susan: When we make a change to the asset allocation we anticipate that positions may be in place for years. The reality is that it depends on how quickly markets adjust towards what we think is fair or acceptable value.

Often strong returns persist, making already expensive assets more expensive still. This was the case in 2005-2007, before a dramatic adjustment eventually came.

At other times, the adjustment may occur quickly. Sometimes, we may also change our position because the risks we'd been concerned about are resolved.

In 2006, we recognised that the global imbalance might be resolved in a benign way. If it had been, we believe it would still have been correct to control for the risks of a crisis because such an outcome has such a dramatic impact on client portfolios. It's like insuring your house even though you don't expect it to burn down.

Michelle: Well that's been a very enlightening session Susan thanks again for your time.

We hope that we've provided some insights on how the strategic overlay will work in your MLC Horizon Portfolio in superannuation, pension and ordinary money tax structures.

Keep in mind that the adjustments we're making to the portfolios are only 5% at the most, around the strategic asset allocation. And changes will likely be infrequent, and usually when we think risk is no longer being rewarded with high enough returns.

As always additional information is available on mlc.com.au or please speak to your financial adviser.

For more information visit www.mlc.com.au.