Derivative strategies

Investment update to 30 June 2023

Our derivative strategies are a combination of distinct risk reduction and efficient asset allocation strategies. When share and bond markets fell in 2022, derivative and currency strategies were key to cushioning the impact on MLC's multi-asset portfolios.

The derivative strategies are tailored to each of MLC's multi-asset portfolios by the MLC Asset Management (MLCAM) Portfolio Management team, the team responsible for managing the multi-asset portfolios' asset allocations. The team works closely with our specialist in-house Derivatives team, seeking opportunities to achieve higher returns or manage risks using strategies that aren't available when investing directly in assets. Each portfolio's target allocation to the derivative strategies is shown in Table 1. The MLC Horizon and MasterKey Simple Choice portfolios' main derivatives exposure is through investments in MLC Inflation Plus, and MLC's Index Plus and MasterKey Low Cost portfolios' main derivatives exposure is through the real return strategy (which is managed similarly to MLC's Inflation Plus).

While our investment managers may also use derivatives to manage exposures within their asset classes, the focus of this update is on the derivative strategies which are designed taking into consideration all of a portfolio's exposures.

Table 1: Target allocations to the derivative strategies at 30 June 2023

MLC MasterKey Super & Pension Fundamentals	Derivative strategies	MLC Wholesale	Derivative strategies
MLC Flexible Assertive Portfolio	14.0%	MLC Wholesale Inflation Plus Assertive Portfolio	14.0%
MLC Flexible Moderate Portfolio	9.0%	MLC Wholesale Inflation Plus Moderate Portfolio	9.0%
Real return strategy	7.5%	MLC Wholesale Inflation Plus Conservative Portfolio	8.0%

Source: MLC Asset Management Services Limited. Based on the amount of cash we target the portfolios to invest in derivative strategies. Effective, or notional, exposures are different to these amounts.

What are derivative strategies?

Derivatives are contracts that have a value derived from another source such as an asset, market index or interest rate. Derivatives provide flexibility to efficiently manage both specific risk (eg options to protect against large falls in the US S&P 500 Index) and broad exposures (eg access to emerging markets shares through futures). Through our investments in derivatives, we're able to tailor attractive exposures and reduce (or hedge out) unattractive exposures.

Our portfolios invest in both exchange traded (ie traded on a regulated exchange) and over-the-counter (ie traded off major exchanges). **Appendix 1** provides a short description of commonly used derivative strategies.

Why use derivatives?

In our portfolios, derivatives allow our investment experts to manage risk or enhance returns, as an alternative to buying or selling assets directly.

In this environment of low return potential and significant risks, we are making greater use of derivatives to help:

- generate returns which have a reduced risk exposure
- target attractive market opportunities
- reduce risks in the portfolio, and
- efficiently implement asset allocation decisions (ie quickly, cost effectively and while maintaining high liquidity) more efficiently and at lower cost than investing directly in 'physical' securities such as shares.

ASSET MANAGEMENT

Derivative strategies

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What are the key risks of derivatives?

Similar to other assets, the price of derivatives fluctuates with market conditions. For example, option contracts are sensitive to market expectations of future volatility. We constantly monitor and adjust our strategies to take advantage of favourable pricing when it becomes available. Proactively seeking these opportunities is essential as strategies that protect the portfolio from market falls can become unaffordable when it's most desired eg when market volatility increases significantly. The Derivatives team assists the portfolio managers to maintain affordability across a range of market conditions.

Complexities that are important to understand in using derivatives include the risks that:

- the value of a derivative may not move in line with the underlying asset
- counterparties to an over-the-counter derivative may not be able to meet payment obligations, and
- a particular derivative may be difficult or costly to trade.

MLC's Derivatives team

The MLC Asset Management (MLCAM) Derivatives team was established in 2013. The team was formed to develop and implement derivative strategies and solutions to meet the specific requirements of MLCAM. The team is located in Sydney and Melbourne and employs four experienced investment professionals. Having an in-house team provides MLCAM with the ability to design unique, sophisticated and cost-effective derivative strategies to meet the specific needs of our multi-asset portfolios.

The MLCAM Portfolio Management team is responsible for the performance of the multi-asset portfolios, while the Derivatives team remains responsible for designing, implementing, monitoring of trades, and recommending when to revise or exit strategies.

The Derivatives team is proactive and constantly monitors the market for opportunities which emerge due to market movements or the development of market inefficiencies. Both the Derivatives and Portfolio Management teams need to be nimble, as market pricing often determines the effectiveness of a strategy and prices can move quickly.

The Derivatives team focuses on keeping costs low both through the design process and by obtaining the best execution rates.

MLC's Derivatives Policy further outlines how MLC manages derivatives.

Current portfolio positioning

Table 2: Examples of our derivative strategies in place during the June 2023 quarter

Strategy	Benefits
Gold exposure	Gold may be defensive in an environment of rising inflation, where central banks keep money cheap by placing a lid on interest rates. Until the June quarter, we used a ‘participate and protect’ strategy through options to gain exposure to gold. This allowed the portfolios to participate in a rise in the gold price up to a point, while protecting the portfolio from a steep fall in the gold price. However during the quarter we removed the allocation to gold. Gold has performed better than expected during a period of rising real interest rates and an appreciating US dollar (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.
Protected China share market exposure	Chinese small to medium-sized companies are attractive in a reflationary environment. We use a ‘participate and protect’ strategy to gain exposure to the CSI-500 Index as it provides the portfolios exposure to a high growth opportunity in China that is receiving the benefits of government policy support. It allows the portfolios to participate in market upside up to a point, with reduced exposure to falls. During the quarter we slightly increased the 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.
Chinese government bonds exposure	Investment in a Chinese government bond exchange-traded fund (ETF), that has exposure to the Chinese yuan, provides: • diversification benefits against Chinese share market exposure • a source of interest rate carry, and • diversification of currency exposure.
Defensive US share market exposure	The hedge was initially established to offset some of the risk posed by what was a very rich prevailing US share market. With volatility continuing to fall, it became possible to replace this defensive share exposure with a tail risk hedge and therefore this strategy was closed out.
Bullish USD/JPY option	This quarter we removed this position from the portfolios. It was a small position and we had been taking profits on it prior. We’ve retained the yen exposure in the portfolios, as it’s expected to benefit in most weak share markets.
Thematic strategies	We have thematic strategies (within defensive Australian shares) which are baskets of high-quality, high-yielding mining and energy companies that act as inflation hedges because their earnings and dividends are firmly linked to inflation. Derivatives are used for downside risk protection. The strategy earns at least the dividend yield with a performance floor, providing the portfolios equity-like income with corporate bond-type risks.
AUD/USD upside protection	Foreign currency exposure enables a higher allocation to shares in our portfolios than would otherwise be possible, because historically the Australian dollar (AUD) and global shares have been positively correlated. By not hedging global shares, Australian investors are less exposed when global share markets fall. But we are wary there remains the risk of the AUD rising when share markets fall. We manage this risk with an AUD/USD risk reversal strategy. This strategy reduces exposure to the risk of the AUD rising, particularly if combined with a falling share market.
Tail risk hedge	We have re-established our tail risk hedging program utilising forward starting, deep out of the money, S&P500 options. With volatility back to pre-COVID levels this is now affordable within the portfolios.
Duration exposure	We have entered into a duration adjustment for Australian interest rate positions by purchasing 10 year Australian bond futures. As the Reserve Bank of Australia gains control on inflation and it moves back to target levels, we expect the longer dated part of the rates curve to provide diversification if shares sell off and this is an efficient and better way to express that view by maintaining full control of the position rather than moving assets between managers.

Source: MLC Asset Management Services Limited. These strategies are not used in all MLC multi-asset portfolios.

Appendix 1: Commonly used derivative strategies

Futures	An agreement to buy the underlying asset at an agreed price at a set future date. Futures contracts are traded on an exchange and settled daily. As the futures price changes the holder of the contract makes or loses money. The upfront cost is typically less than 10% of the value of the asset and therefore the strategy is very cost effective.
Options	When buying an option, you have the right, but not the obligation, to buy the underlying asset at an agreed price (strike price) on an agreed date. You pay an amount upfront, called the premium for this right. On the maturity date (or before, if you choose to sell) if the price of the underlying asset has gone up, you can exercise the option. The profit is the difference between the price at maturity and the strike price (after deducting the option premium). Conversely, if the price has gone down the option expires worthless.
SWAPs	An exchange of cash flows between two parties whereby the terms of the swap are agreed at the outset. Swaps can be customised to meet both parties' requirements. They are most commonly used to swap fixed payments for floating and vice versa. Equity swaps allow investors to pay the return on an index and receive the return on another asset. For example, Manager A wants to maintain their equity exposure long-term but is concerned with a short-term market correction and doesn't want to incur transaction costs by selling and buying back later. Manager B is looking for a better return than cash and is bullish on the index. They agree to swap cash flows quarterly for one year.