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ASSET MANAGEMENT

Derivative strategies

Investment update to 31 December 2024

Our derivative strategies are a combination of distinct risk management and efficient asset allocation strategies. They are tailored to each of MLC's diversified funds by the MLC Asset Management (MLCAM) Portfolio Management team, the team responsible for managing the diversified funds' 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.

MLC Real Return and Wholesale Inflation Plus

Within MLC's suite of diversified funds, derivatives strategies are used most extensively in our real return funds. Target allocations to derivative strategies for MLC's real return funds are shown in Table 1.[1]

Table 1: MLC real return funds with allocations to derivative strategies as at 31 December 2024

Fund series	% of portfolio invested in derivative strategies
MLC Real Return Assertive	13.0%
MLC Real Return Moderate	13.0%
MLC Wholesale Inflation Plus Conservative Portfolio	8.0%

Source: MLC Asset Management Services Limited. The allocations shown in Table 1 are based on the amount of cash we target the funds to invest in derivative strategies. Effective, or notional, exposures are different to these amounts. The amounts allocated to derivative strategies differ based on each fund's investment objective, strategy and risk profile.

Wholesale Horizon, MultiActive, Index Plus and Premium & Value SMA's

The MLC Wholesale Horizon Funds (2-5), the MLC MultiActive High Growth and the MLC Premium and MLC Value Separately Managed Account (SMA) Model Portfolios, have allocations to the MLC real return funds shown in Table 1, and therefore their derivative strategies indirectly.

Outside of these allocations to the MLC real return funds, the MLC Wholesale Horizon funds (2-5) and the MLC MultiActive funds can also use derivatives as part of their investment strategies. Examples of recent derivatives strategies used by these funds are detailed in Tables 3 and 4.[1]

MLC's Index Plus funds gain an exposure to derivative strategies through their alternatives strategy.[1] These derivative strategies have been largely consistent with those employed within the MLC real return funds in Table 1, although percentage allocations may have differed^.

^ Note: From time to time, MLC Index Plus may choose not to invest in a derivative strategy shown in Table 1 if it is deemed unsuitable for the lower-cost nature of the MLC Index Plus funds.

[1] This update is for MLC's diversified investment funds listed in this report. Refer to the 'Important Information' section of this report for details about the funds. MLC offers diversified funds in investments, superannuation and pension. While there may be similarities between MLC's diversified funds offered in investments, superannuation and pension, this update is focused on the funds listed in this report.

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) 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. We make 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 (i.e. quickly, cost effectively and while maintaining high liquidity) more efficiently and at lower cost than investing directly in 'physical' securities such as shares.

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 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 three 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 diversified funds.

The MLCAM Portfolio Management team is responsible for the performance of the diversified funds, 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.

MLC Real Return and Wholesale Inflation Plus Derivative Strategies

Table 2: Examples of derivative strategies in place during the six months to 31 December 2024

Strategy	Description	Benefits / Rationale
Protected China share market exposure	The strategy allows the portfolios to participate in the upside of the Chinese market, with reduced exposure to large falls. It is executed via Total Return Swaps which provide an index outperformance opportunity, in combination with purchasing deep out of the money put options using a small amount of the premium received from the outperformance swap. The exposure is currently targeted to the Shenzhen Composite Index due to the high representation of small and mid-cap enterprises.	Chinese small to medium-sized companies in the technology, healthcare and consumer space are well positioned to benefit from structural changes underway in the Chinese economy. They also benefit from government policy support, have relatively cheap valuations and have potential for high growth. Attractive characteristics notwithstanding, China will continue to face risks from re-balancing the economy and geopolitical tension, hence the need to protect against significant losses with a deep out of the money put.
US share market protection	This strategy allows the portfolios to participate in the upside of the US share market, whilst providing downside protection should markets fall. The protection strategy is executed via put options on the S&P 500 at various levels. The puts currently owned by the strategy are look-back options. Look-back puts are well suited to high momentum markets as the strike rises in line with gains in the market.	The US share markets provide the portfolios with exposure to some of the world's best businesses. However, after a strong rally, valuations now appear stretched. We have offset some of the cost of owning the puts by selling calls over parts of the portfolio with high implied volatility.
US share dispersion	An options strategy that focusses on the dispersion of returns in select US shares. Dispersion options increase in value when the difference in performance of shares increases. Based on our research, we have identified a group of US listed shares that are likely to be affected by changes in US government policy. If this is right, then the return performance of the shares we have identified will vary considerably and the option will increase in value.	Prior to the US election in November 2024, it was clear that the two candidates had vastly different policy agendas (e.g. de-carbonisation, de-regulation etc). While we had no insight on who would be the "winners" and "losers", we had high conviction regarding which shares would be candidates for winning or losing. Buying a dispersion option over this basket of shares meant that we didn't need to pick the winners, only the shares that would be impacted.
AUD/USD upside protection	An AUD/USD hedging strategy (known as a risk reversal strategy) that reduces exposure to the AUD rising, particularly if combined with a falling share market.	When markets fall, the AUD often falls in tandem as investors seek safety by buying USD. For Australian investors holding foreign assets in their local currency, this helps to offset the negative impact of falling markets. However, there is always the risk that the AUD appreciates and reduces the AUD value of these foreign unhedged assets. This strategy enables more unhedged foreign exposure to be maintained knowing the adverse risks of an appreciating AUD are being managed.
CNY/USD downside protection	An CNY/USD hedging strategy (known as a risk reversal strategy) that reduces exposure to the CNY falling.	Our share exposure to China introduces exposure to the Chinese currency. While we are happy to bear a degree of currency risk, we have effectively hedged out the potential for more than modest currency losses if China depreciates the yuan. We believe the risk of currency devaluation is currently higher than normal due to the ongoing trade conflict with the US.

Strategy	Description	Benefits / Rationale
MSCI World Futures	A futures strategy that adds a small amount of exposure to global shares.	This is an implementation use of derivatives that provides a flexible exposure to global share markets, complementing our existing exposures via our global share managers. It allows us to move in and out of global shares more quickly should the need arise.
Hang Seng China Enterprises Index (HSCEI) Futures	A futures strategy that manages risk from a short call sold to generate premium income.	In order to offset some of the cost of our S&P500 puts, we sold calls over the portfolios' exposure to China. The calls we sold were over the HSCEI. In order to manage the top-side risk of the sold calls, we hold a small amount of HSCEI futures.
Duration exposure	A strategy that adds duration to the portfolios via the purchase of Australian bond futures. This increases the portfolios sensitivity to changes in interest rates. For this exposure, we have used 10 year futures.	With the long end of the interest rate curve at levels not seen for many years, bonds have returned to providing important diversification benefits. If shares or risk assets sell off, bonds yields tend to fall (prices rise). Futures have been purchased as opposed to purchases of physical bonds because they are the simplest, most liquid and efficient way to adjust the duration exposure.

Source: MLC Asset Management Services Limited. These strategies are used in the funds in Table 1 of this report and not used in all MLC diversified funds.

MLC MultiActive Derivative Strategies (ex-High Growth & Geared)

Table 3: Examples of derivative strategies in place during the six months to 31 December 2024

Strategy	Description	Benefits / Rationale
Duration Exposure	A strategy that adds duration to the portfolios via the purchase of bond futures.	The added duration offsets the lower duration of the credit allocations and reduces the tracking error against the fixed income benchmark. It also improves risk control.

Source: MLC Asset Management Services Limited. These strategies are used in the MultiActive Capital Stable, Conservative, Moderate, Balanced and Growth funds, and not used in all MLC diversified funds.

MLC Wholesale Horizon 2-5 and MultiActive High Growth Derivative Strategies

Table 4: Examples of derivative strategies in place during the six months to 31 December 2024

Strategy	Description	Benefits / Rationale
Emerging markets replication	A strategy that adds additional exposure to Emerging Markets shares via the purchase of futures.	Increased diversification given the heightened concentration of developed market shares. Used when valuations of emerging market shares look attractive compared to developed markets, providing a return opportunity for the portfolios.

Source: MLC Asset Management Services Limited. These strategies are used in the Wholesale Horizon 2-5 funds and MultiActive High Growth and not used in all MLC diversified funds.

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.

Important information

Unless otherwise specified, the information is this communication has been prepared based on data as at 31 December 2024.

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