Derivative strategies

Investment update to 30 September 2019

Our derivative strategies are a combination of distinct risk reduction and efficient asset allocation strategies. The strategies are tailored to each of MLC's multi-asset portfolios by the Capital Markets Research (CMR) team, the team responsible for managing the multi-asset portfolios' asset allocations. CMR 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 allocations to the derivative strategies are shown in Table 1. The MLC Horizon portfolios main derivatives exposure is indirect and achieved through their investments in the MLC Inflation Plus strategies.

Table 1: Target allocations to the derivative strategies as at 30 September 2019

MLC MasterKey Super & Pension Fundamentals	Derivative strategies %	MLC Wholesale	Derivative strategies %
MLC Inflation Plus Assertive Portfolio	10.00	MLC Wholesale Inflation Plus Assertive Portfolio	10.50
MLC Inflation Plus Moderate Portfolio	6.75	MLC Wholesale Inflation Plus Moderate Portfolio	6.25
MLC Inflation Plus Conservative Portfolio	3.00	MLC Wholesale Inflation Plus Conservative Portfolio	2.75

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.

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

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.

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

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

CMR 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 CMR 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 Derivative Policy further outlines how MLC manages derivatives.

Current portfolio positioning

Table 2 outlines some of our derivative strategies. It's important to note that while the returns of the strategies outlined in Table 2 feed into the portfolios' returns, looking at individual strategy returns in isolation is meaningless. For example, while the tail risk protection strategy allows us to have a greater exposure to shares, on its own it would be expected to produce negative returns if there isn't a tail risk event in the market. Therefore our share allocation and tail risk protection strategy need to be considered in combination. By combining these strategies we are able to extract as much return as we can while limiting the portfolios' exposure to negative returns in the event of a market fall.

Table 2: Examples of our derivative strategies in place during the September 2019 quarter

Strategy	Benefits
Role: Risk reduction	
AUD/USD upside protection	This strategy manages the risk of an appreciating Australian dollar (AUD). Foreign currency exchange (FX) exposure enables a higher allocation to shares in our MLC Horizon and Inflation Plus portfolios than would otherwise be possible. Since the AUD:USD has fallen from significant overvaluation levels and is now close to fair value, the risk of it rising has increased and needs to be protected against. This strategy has reduced exposure to that risk with net zero upfront cost on a net zero premium basis.
Tail risk protection	Designed to provide some protection for our portfolios in the event of a major market correction. Also able to lock in protection cheaply over longer periods of time when in low volatility environments. This protection strategy aims to produce a cushioning effect when share markets fall. The strategy resets regularly so that it continues to provide protection if the share market rises.

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Strategy	Benefits
Defensive shares	This strategy aims to gain a long exposure to shares with some defensive characteristics. It seeks to achieve this by using a combination of buying equity index call options and selling equity index put options.
Role: Efficient asset allocation	
Exposure to share index markets	Exposure to individual share markets has been achieved through the use of index futures. Using derivatives in this way allows us to adapt portfolio positioning quickly and cheaply should the need arise. Current positioning includes exposure to Japan, Europe, UK and emerging market shares.
Gold exposure	Gold helps protect the portfolio against a range of shocks and inflationary scenarios. However the gold price can be volatile and the concept of fair value is imprecise. We have gained exposure to gold through futures.
China share market exposure	Using a combination of swaps and put options the portfolio has gained exposure to positive performance of China's share market but with limited exposure to negative returns.

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.