Derivative strategies

Investment update to 30 June 2021

Our derivative strategies are a combination of distinct risk reduction and efficient asset allocation strategies. When share markets fell in late February and in March, 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 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 target allocation to the derivative strategies are shown in Table 1. The MLC Horizon portfolios' main derivatives exposure is inherited through investments in MLC Inflation Plus, and MLC Index Plus portfolios through the real return strategy which is managed similarly to Inflation Plus.

Table 1: Target allocations to the derivative strategies as at 30 June 2021

MLC MasterKey Super & Pension Fundamentals	Derivative strategies %	MLC Wholesale	Derivative strategies %
MLC Inflation Plus Assertive Portfolio	16.0	MLC Wholesale Inflation Plus Assertive Portfolio	16.0
MLC Inflation Plus Moderate Portfolio	11.5	MLC Wholesale Inflation Plus Moderate Portfolio	10.5
MLC Inflation Plus Conservative Portfolio	8.5	MLC Wholesale Inflation Plus Conservative Portfolio	8.5
Real return strategy	10.0		

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.

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.

Table 2: Examples of our derivative strategies in place during the June 2021 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. We also maintain a put option to protect the portfolio from a steep fall in the gold price.
Protected China share market exposure	Using a combination of swaps and put options the portfolios have gained exposure to positive performance of China's share market with reduced exposure to negative returns.
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.
Protected emerging markets shares exposure	Emerging markets shares are attractive in a reflationary environment so we've maintained exposure using a 'participate and protect' strategy. This strategy allows the portfolios to participate in the first 15% of market upside while limiting capital losses. The strategy is implemented using a combination of total return swaps, bought puts and sold calls.

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Strategy	Benefits
Protected US share market exposure	We're using a 'participate and protect' strategy, through options, to implement a protected US share market exposure. The structure allows for cheap participation in rises in the US share market (up to a point) while avoiding exposure to falls beyond a lower bound.
Purchased USD/JPY call option	We purchased a currency option to protect against the possibility of share markets falling at the same time as interest rates rise. The Japanese yen performs poorly in this scenario. However, we are keeping an existing yen exposure we have in the portfolios as it is expected to help in most weak share market scenarios.
Global infrastructure exposure	We implemented a low-cost exposure to global listed infrastructure using a total return swap over the FTSE Developed Core Infrastructure 50/50 Index hedged back to the Australian dollar (AUD). The Index comprises three broad categories: 50% Utilities, 30% Transport, and 20% Other (including pipelines, satellites, and telecommunication towers). We believe infrastructure should benefit the portfolios in potential reflationary/inflationary scenarios because: • infrastructure assets deliver stable revenues and cash flows which tend to increase as inflation rises, and • the real (above inflation) income yield from infrastructure assets is typically higher than competing alternatives. While higher interest rates could pose future share price risk, economically sensitive infrastructure assets adversely impacted by COVID-19 have already reduced in price, providing upside return potential as vaccines are increasingly rolled out. The allocation to infrastructure complements exposure to economically sensitive investments added in 2020 via metals and mining stocks, as well as controlled risk-taking through strategies deployed in Chinese shares and emerging markets.
Thematic strategies	We've introduced thematic strategies (within defensive Australian shares) this quarter which are baskets of high-quality mining and energy companies that act as inflation hedges because their earnings and dividends are sensitive to inflation. Derivatives are used for downside risk protection. The strategy provides 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, but there remains the risk of the AUD rising. 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.

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.