How MLC is tackling the problem of our concentrated share market

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If you need a solution, build a solution

Australia's share market is one of the most concentrated in the world. The S&P/ASX 200, which covers the biggest 200 companies in the market, is dominated by two sectors, Financials and Materials (including mining companies), which together make up more than half the market[1]. The banks together account for 24% of the S&P/ASX 200[2], making our market very vulnerable to events that could negatively affect the banking sector.

So how do you gain access the potential returns of our share market − with less risk?

At MLC, we've met this challenge by developing the unique Defensive Australian Shares Strategy. In this strategy, we invest in a large number of high quality Australian companies across many industries. This extensive diversification reduces risk, compared with the overall market, because risk is spread much more widely and lower quality companies are excluded from the strategy.

We've been managing this strategy since November 2015 and it has achieved returns above the Australian share market over that time, with much less risk[3].

We developed the strategy for our MLC Inflation Plus portfolios. These portfolios target above-inflation returns by carefully managing risk, especially the potential loss of investors' capital when markets are volatile. The strategy aligns with the goals of achieving returns while controlling risk and means we can hold a larger allocation of Australian shares than we'd otherwise be comfortable with.

Not the usual portfolio construction process

Most Australian share managers measure their performance against a market benchmark like the S&P/ASX 200. They aim to make returns by picking the 'winners' that will deliver the highest return. However, these managers are often forced to include substantial allocations to the benchmark's dominant sectors − whatever their view of the risk – to avoid a level of portfolio risk that's too different to the benchmark.

In the Defensive Australian Shares Strategy, our approach is completely different. While our starting point is the companies in the S&P/ASX 200, we ignore benchmark weightings and focus on controlling risk by identifying and eliminating riskier companies (such as those with weak financials) and limiting the amount we invest in individual companies and sectors. Our allocation to some sectors is much lower than the market index.

The result: a broadly diversified portfolio of high quality companies

Our portfolio looks very different to the portfolio of a typical Australian shares manager. It's far more diversified: while a typical manager might invest in just 20 to 30 companies, we invest in around 100 good quality companies. We also tend to include more small and medium-sized companies.

Figures 1 shows how different the sector weightings in MLC's strategy are to those of the S&P/ASX 200. In particular, our allocations to the banking and mining sectors are significantly lower.

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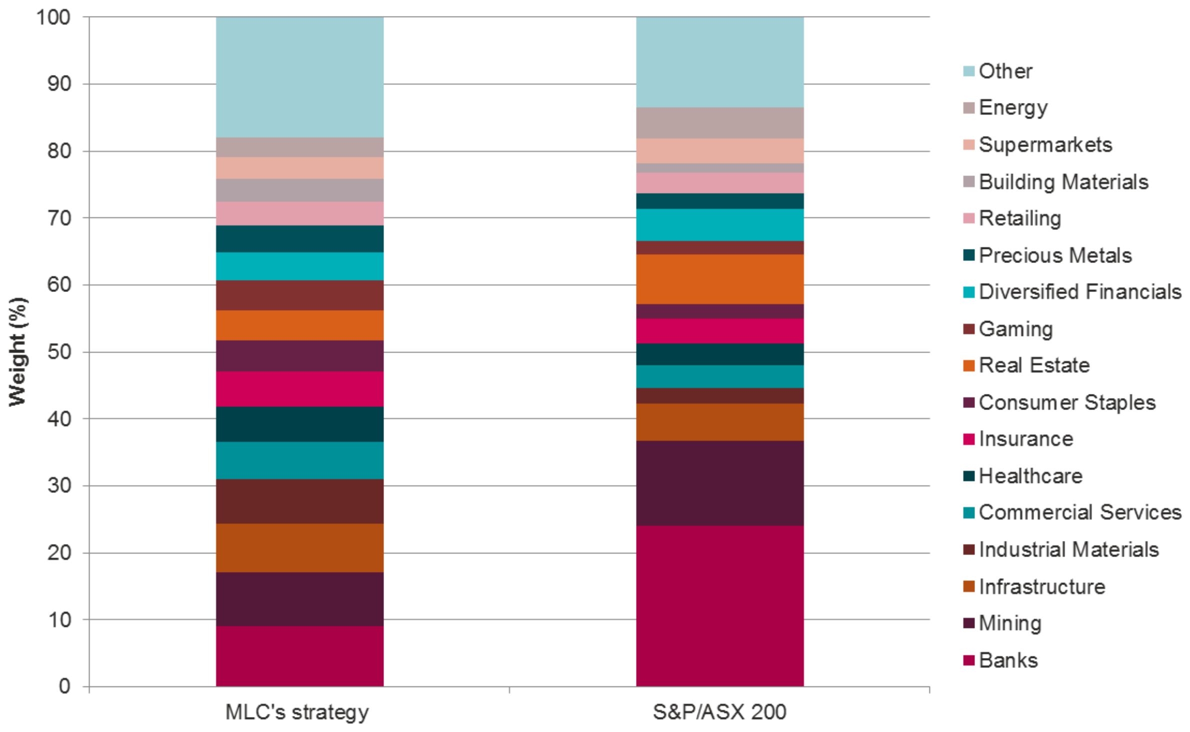
[1] At 31 December 2018

[2] At 31 December 2018

[3] Past performance is not a reliable indicator of future performance. The value of an investment may rise or fall with the changes in the market

Figure 1: Sector holdings in MLC's Defensive Australian Shares Strategy and S&P/ASX 200 at 31 December 2018



Source: NAB Asset Management Services Limited.

There are also other differences in our strategy. Unlike many managers, we won't compromise the quality of our holdings just to be fully invested. If there aren't enough good opportunities available, we'll hold cash rather than make inferior investments.

Sometimes we use derivatives to give us exposure to a high quality company if it has risks we want to mitigate. For example, a utilities company may have strong dividends and a stable outlook, but future regulatory changes in the sector could affect its share price. We may use derivatives to manage this risk.

An effective way to manage risk in volatile markets

Since we began managing the strategy, it's fulfilled its role of providing broader exposure to Australian shares while limiting investors' potential capital losses. In falling or volatile share markets, including those we saw in late 2018, the strategy has provided returns above the S&P/ASX 200 – in general, the weaker the market, the greater the strategy's outperformance. And as expected, when share markets are rising, it has delivered returns slightly lower than the market.

Over a full market cycle of around seven years, we expect the strategy's returns will smooth out to provide returns at least equal to the market, but with much lower risk.

The Defensive Australian Shares Strategy illustrates how at MLC, we're always searching for better ways to generate returns and manage risk. This often leads us to find original strategies for dealing with investment problems, which is especially important in today's challenging investment environment.