MLC MasterKey Unit Trust IncomeBuilder

Annual distribution commentary, 2017 financial year

Summary

MLC MasterKey Unit Trust IncomeBuilder (MLC IncomeBuilder) has a successful history of achieving its primary objective of producing a growing, tax-efficient income stream. Over 22 years, there has been a fairly steady rise in the fund's underlying income distribution (shown by the orange bars in Chart 1). The annual underlying distributions have increased in 16 of the 22 years since its inception.

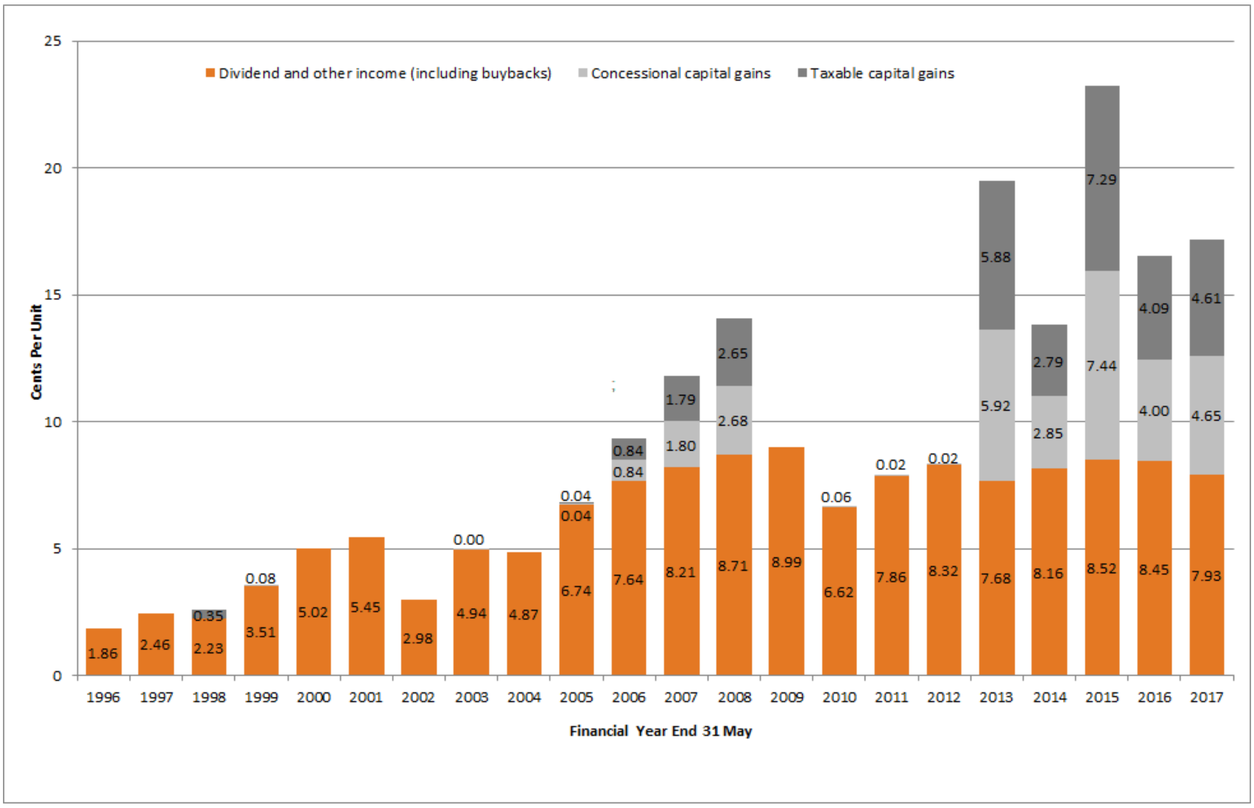
On Sunday, 28 May 2017 the last distribution for the 2017 financial year (FY2017) was made to investors in MLC IncomeBuilder. For the financial year ending 31 May 2017, the fund's total distribution increased to 17.19 cents per unit (cpu), compared to 16.54 cpu for FY2016. This was mostly due to an increase in capital gains. Capital gains in FY2017 were higher largely due to stronger market performance.

The fund's underlying income, comprising dividend and other income but excluding capital gains, decreased to 7.93 cpu when compared with 8.45 cpu in FY2016. Almost all of the underlying income is franked dividends which provide investors with a tax-efficient income stream.

The capital gains portion of the annual distribution remained fairly high this year, at 9.26 cpu. This compares to 8.09 cpu in FY2016. Approximately half of the capital gains are concessional capital gains and are therefore not tax-assessable for individuals and superannuation fund investors.

Monthly commentary about the performance of MLC IncomeBuilder, including information on the dividends declared by underlying companies, is available on the Fund Profile Tool on **www.mlc.com.au/fundprofiletool.**

Chart 1: MLC IncomeBuilder annual distributions



Source: MLC IncomeBuilder. Distributions are calculated net of fees.

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.

Effect of the economy on dividends

There are many factors that affect the share prices and dividends of companies listed on the share market. Economic growth is a common factor that affects most companies. In a growing economy, customers generally have more money to pay off their debts or spend on the goods and services companies produce. When customers spend more, company earnings and profits may increase, leading to higher dividends and share prices. An economy growing slowly or contracting has the opposite effect on dividends and share prices.

The global economic environment has been more positive this year compared to FY2016 which has been feeding through to rising share prices. However, the fund's distribution for FY2017 has been affected by company dividends remaining at the same levels or lower than FY2016 because:

- Australian company earnings haven't generally risen as strongly as overseas companies, with many Australian companies trimming their earnings outlook for 2017. Earnings growth has been flat to weak for many companies.
- Australia's economic growth hasn't been as strong in recent years because the end of the mining boom has left a gap in our growth that's only partially being filled by exports and housing construction. Retail sales growth has slowed and consumers appear reluctant to spend, given concerns over the global economy, the mining sector downturn, high household debt, and subdued wages growth.
- The cut to special dividends paid by companies observed in 2015/16 is continuing into 2016/17.
- Payout ratios (the percentage of earnings paid to shareholders as dividends) were previously elevated.

Underlying income distributions

The fund's underlying income excludes capital gains and therefore comprises around 90% dividend income with the remainder from Australian real estate investment trusts and a small amount of interest income.

For FY2017, the fund made an underlying income distribution of 7.93 cpu which is 6% lower than the previous year's underlying income distribution of 8.45 cpu.

Both dividend income and interest income reduced when compared to FY2016, resulting in the decrease to underlying income. Almost all of the underlying income is franked dividends which provide investors with a tax-efficient income stream.

Table 1 provides a comparison of the quarterly underlying income distributions for this financial year against FY2016. For the May distribution quarter, the fund's total distribution increased slightly to 2.94 cents per unit (cpu), compared to 2.89 cpu for the same period in the previous year.

Table 1: Quarterly underlying income distribution* comparison

Quarter	FY2017	FY2016	Change from FY2016
Quarter 1 (August)	1.38	1.33	+ 4%
Quarter 2 (November)	2.03	2.63	- 23%
Quarter 3 (February)	1.58	1.60	- 1%
Quarter 4 (May)	2.94	2.89	+ 2%
Total (year to date)	**7.93**	**8.45**	**- 6%**

* Underlying distribution consists of dividend and other income and excludes capital gains.

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Table 2 shows the dividends of the fund's largest 10 holdings and how their dividend has changed compared to FY2016. Almost 60% of the fund is invested in these companies.

Table 2: Total dividends from the top 10 companies in MLC IncomeBuilder

Company	2016/17 dividend ($ per share)	% change from 2015/16 dividend
Westpac Bank	$1.88	+ 1%
ANZ Bank	$1.60	- 9%
National Australia Bank	$1.98	-
Wesfarmers	$1.98	- 2%
Telstra	$0.31	-
Commonwealth Bank of Australia	$4.21	-
Woolworths	$0.67	- 42%
AMP	$0.28	-
Suncorp	$0.71	- 11%
BHP Billiton	$0.72	- 34%

Source: Reuters, ASX, IRESS.

Securities mentioned in this commentary may no longer be in MLC IncomeBuilder.

It has been a challenging year for earnings and dividend growth with only Westpac paying higher dividends. NAB, Telstra, CBA, and AMP dividends were all flat this financial year compared to FY2016.

There are indications FY2018 may be more positive for company earnings growth. Early in 2017, the company earnings reporting season signalled a rebound in profit growth across Australian listed companies. Industrials, banks and resources all contributed to the earnings recovery but the resource sector was the standout. Resource half yearly net profit growth soared, driven by mining companies that benefited from strength in key commodity prices, particularly iron ore and coal. Net profit growth for industrials (companies other than resources and banks) rebounded solidly and the previous weakness in bank profits was reversed, largely due to lower than expected bad and doubtful debts. Wesfarmers and Woolworths also reported stronger than expected earnings growth.

Capital gains

Over the long term the fund has demonstrated that the majority of its distributions have been franked dividend income. However, the fund is also required to distribute any realised capital gains at the end of its financial year. Capital gains can arise when the fund sells shares at prices higher than their original purchase price.

The fund is managed by two high quality active investment managers, Antares and Maple-Brown Abbott. Where the managers believe share values have reached their full potential, we expect the managers to seek better long-term risk and return opportunities. In this way our managers seek to grow and preserve investor's capital over the long term, from which future franked dividend income may be generated. However, these portfolio changes can result in the realisation of capital gains.

These gains typically feature in the fund's distribution after periods of very strong market performance and as a result of corporate actions such as takeovers and buybacks. The Australian share market has risen strongly in recent years. Additionally, due to the strong market performance, since 2013 the fund had no realised capital losses carried forward from previous years to offset realised capital gains. This meant all realised capital gains were distributed. If share prices continue to rise or remain high relative to the past, it's likely some capital gains will continue to be realised.

Our fund managers tend to hold shares for long periods of time and don't generally buy and sell the same company within a year. Therefore the benefit of the capital gain discount is passed onto investors. That's why approximately half of the capital gains distributed this year (shown by the light grey bars in Chart 1) were concessional capital gains, which are not tax-assessable for individuals and superannuation fund investors. This is further evidence of the fund's tax efficiency.

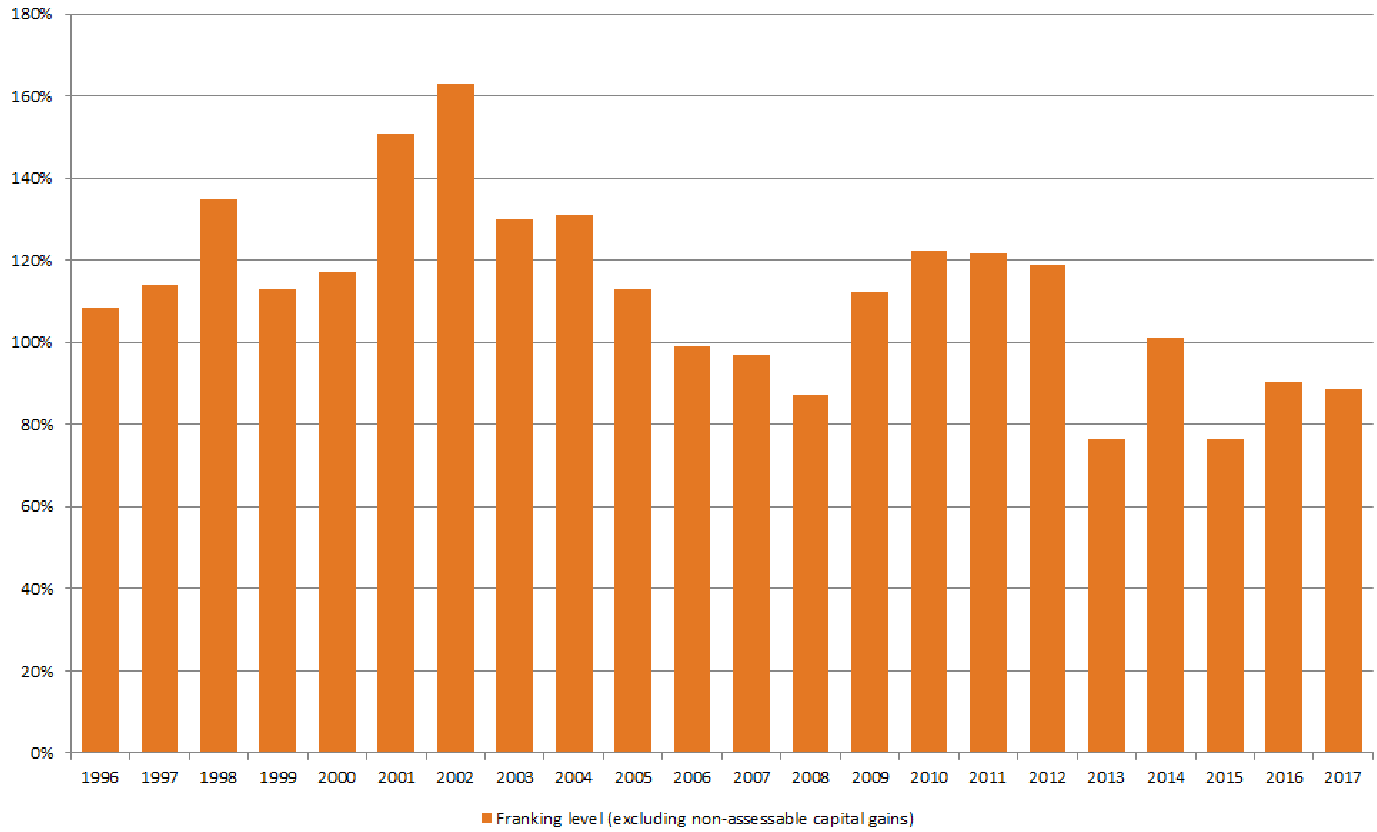
The realised capital gains portion of the annual distribution is automatically reinvested into clients' accounts. This ensures an investor's capital base, from which their dividend income is generated, continues to grow by being re-invested in the fund. The fund has operated in this way since it was established, as it helps investors remain focussed on maintaining a growing tax-efficient income stream.

Franking levels

The franking level of MLC IncomeBuilder this year is 89% (see Chart 2), a small decrease from 90% in FY2016. The franking level is below 100% because the distribution includes assessable capital gains and the franking level is calculated as a percentage of the total distribution with only non-assessable capital gains excluded.

The managers of MLC IncomeBuilder continue to focus on companies with growing and sustainable dividends with high franking levels.

Chart 2: Franking levels for MLC IncomeBuilder



Source: MLC IncomeBuilder. Franking levels are calculated net of fees and exclude non-assessable capital gains, in accordance with FSC's standard.

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Outlook

The Australian economy and operating environment remains challenging. The outlook both here and globally is uncertain and growth remains modest. Although there are early signs of a recovery in earnings, company earnings and dividend growth are likely to be modest over the next 12 months.

In this environment, MLC IncomeBuilder is well positioned. It's diversified across industries and companies with attractive long-term prospects for earnings and sustainable dividend growth. The portfolio is managed by two experienced investment firms, Maple-Brown Abbott and Antares. We believe these active managers, with their different but complementary investment approaches, will continue to deliver on the fund's objective of producing a growing, tax-efficient income stream for investors.

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