Insurance-related investments strategy

Investment update to 30 June 2023

The insurance-related investments strategy, managed by MLC's Alternative Strategies team, uses carefully selected reinsurance managers from around the world.

Insurance-related investments are investments in natural catastrophe risks. Investors take on the role of an insurer. They receive a yield – effectively an insurance premium – for taking the risk of a particular natural catastrophe causing losses above a certain level. As the occurrence of natural catastrophes has no expected correlation with share market movements, the strategy is an attractive source of diversification. For example, during the global financial crisis, shares fell but insurance-related investments performed well.

MLC's multi-asset portfolio target allocations to the insurance-related investments strategy are shown in Table 1. MLC Horizon portfolios also have an indirect allocation through their investment in the MLC Inflation Plus strategies.

Table 1: Target allocations to insurance-related investments as at 30 June 2023

MLC MasterKey Super & Pension Fundamentals / MySuper	Insurance-related investments %	MLC Wholesale	Insurance-related investments %
MLC Conservative Balanced Portfolio	3.0	MLC Wholesale Horizon 2 Income Portfolio	3.0
MLC Balanced Portfolio	3.0	MLC Wholesale Horizon 3 Conservative Growth Portfolio	3.0
MLC Growth Portfolio	2.0	MLC Wholesale Horizon 4 Balanced Portfolio	3.0
MLC Flexible Assertive Portfolio	4.0	MLC Wholesale Horizon 5 Growth Portfolio	2.0
MLC Flexible Moderate Portfolio	4.0	MLC Wholesale Inflation Plus Assertive Portfolio	4.0
MySuper Growth Portfolio	3.0	MLC Wholesale Inflation Plus Moderate Portfolio	4.0
MySuper Conservative Growth Portfolio	3.0	MLC Wholesale Inflation Plus Conservative Portfolio	4.0

Source: MLC Asset Management Services Limited. Based on the portfolios' target allocations.

An explanation of how fees are deducted from returns is in Appendix 1.

Investment objective

The strategy seeks to provide our portfolios with sources of risk and return that are not correlated to mainstream asset classes.

Why invest in insurance-related investments?

While insurance-related investments have a long-term return and risk profile similar to other types of fixed income investments, insurance-related investments' returns can be distinctly different over short periods because the underlying assets generating the income are linked to the insurance market. As a result, insurance-related investments provide excellent diversification benefits to other types of fixed income, reducing total portfolio risk and improving the risk-return efficiency of the portfolios.

Insurance-related investments are unusual because their returns are independent of the economic factors that influence the performance of most other investments. This makes them a rare and valuable source of fixed income returns that are also largely 'uncorrelated' with returns from shares.

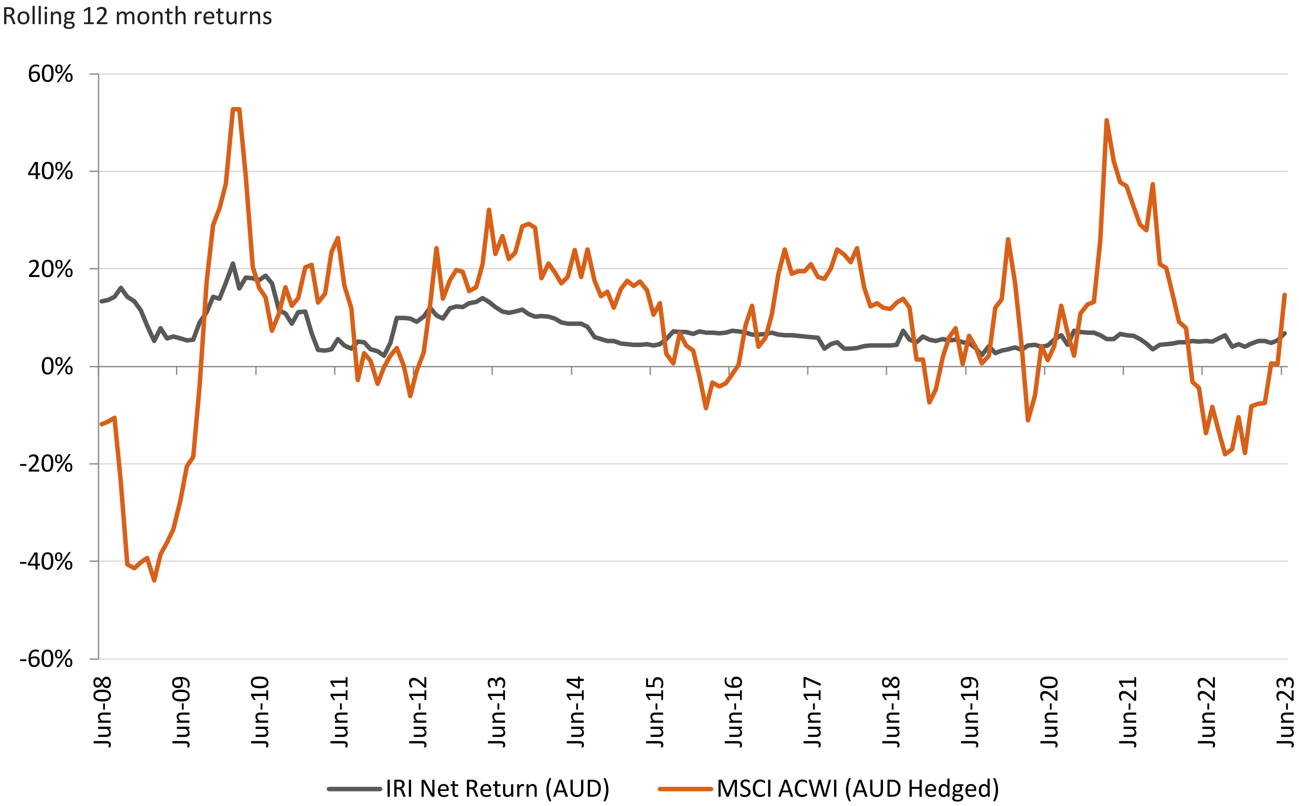
Another distinctive feature of these investments is the visibility regarding its risk-return profile. Unlike other asset classes, where generally the expected returns are higher when risks are higher, in reinsurance the risks of a catastrophe occurring does not change materially from year to year, but the pricing can. This provides us with the ability to dial up and down our portfolio exposure according to the relative attractiveness of the pricing.

Certain risks tend to get paid relatively better returns. This is because there is a large economic exposure in the US to densely populated areas with expensive real estate – Florida (hurricane) and California (earthquake) being prime examples – that also happen to be exposed to major natural catastrophes. It therefore makes sense for the reinsurance industry to reduce some of their exposure to these risks, particularly the very low probability, high impact events (which could jeopardise their solvency). This enables MLC's investors to get paid well for taking these 'remote peak peril' risks, while also benefiting from the diversification benefits.

Performance

The insurance-related investments strategy has worked well for our portfolios, making an important contribution to real returns and helping to moderate risk, particularly in periods of share market volatility like the past 12 months. The strategy has low correlation to shares and has delivered 7.6% pa (hedged into Australian dollars and net of indirect costs) from July 2007 to 30 June 2023.

Chart 1: Performance of insurance-related investments relative to global shares



Source: MLC Asset Management Services Limited. Insurance-related investment strategy returns are hedged into Australian dollars and net of indirect costs. Past performance is not a reliable indicator of future performance.

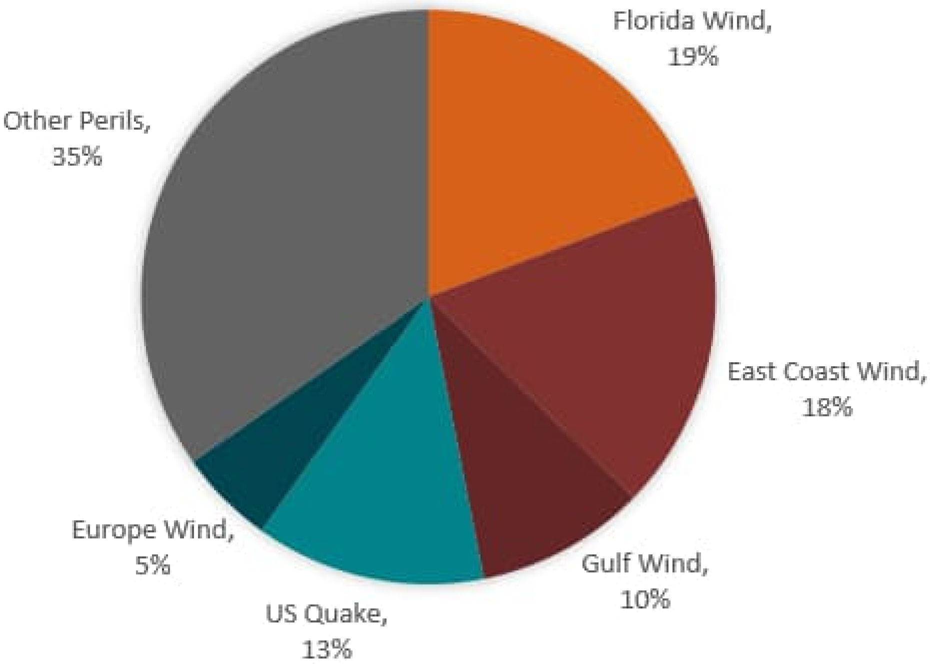
How we manage insurance-related investments

MLC's Alternative Strategies team have appointed three investment managers with expertise in the management of natural catastrophe and weather-related reinsurance risk exposures.

Our insurance-related investments strategy consists of a combination of catastrophe bonds (~15%) as well as direct reinsurance. The direct reinsurance market is a much larger pool of exposures compared to the catastrophe bond market, which creates more opportunity. This is where investing through specialist reinsurance managers is most advantageous to our investors. These managers and their parent companies are extremely well positioned to source and sift attractive risks from insurance companies and analyse these risks accurately. One example of this is demonstrated in the research team of one of our managers, which consists of 30+ people, including seismologists and weather experts, whose job is to accurately assess the risk of loss from various events. Importantly, this manager retains exposure to all the risks to which MLC's portfolios are exposed, which creates a strong alignment of interest.

Risk exposure

Chart 2: Expected risk by catastrophe type (at 30 June 2023)



Source: MLC Asset Management Services Limited. Figures have been rounded to the nearest percent.

Current strategy positioning

Returns are net of indirect costs.

The strategy returned 2.9% (hedged into Australian dollars) during the June quarter, and 6.7% for the 12 months ending June 2023. The primary driver of the positive return for the quarter was premium accrual, which is lower in the second quarter of each year due to this being non-US hurricane season (June-November). The strategy outperformed the broader Insurance-Linked Investment (ILS) manager peer group, as measured by the Eurekahedge ILS Advisers Index, by 2.2% over the year. This outperformance is consistent with the remote risk nature of the insurance-related investments strategy which we have deliberately designed to have a lower than industry average risk profile.

June is an important date each year when a large portion of reinsurance contracts renew and as with January renewals, we are pleased to report that this year's 'renewals season' was extremely favourable. The prospective returns on our strategy are as attractive as we have seen in more than a decade. The last six years of above average industry losses from natural catastrophes have caused reinsurers to demand a much larger premium to compensate them for taking this risk. This 'market hardening' has been favourably exacerbated by the fact that many large global reinsurers experienced large losses on the asset side of their balance sheets in 2022 due to the rise in bond yields causing mark to market losses on their leveraged fixed income portfolios. This has further reduced the available capital pool to fund reinsurance and added to the upward pricing pressure.

The net effect of this is that across the industry there has been an increase of around 40% in the yields paid for taking the type of remote reinsurance risk that our strategy focuses on, while our remote risk approach has enabled us to largely avoid the losses incurred across the industry over the last six years, with positive returns in excess of cash in each of these years.

Appendix 1: Understanding fees that are deducted from returns in this investment update

As these MLC multi-asset portfolios invest in the insurance-related investments strategy and a range of other asset classes and strategies, only some of the fees disclosed in the Product Disclosure Statements (PDSs) relate directly to the management of the insurance-related investments strategy. Therefore, the insurance-related investments strategy performance is reported before deducting most of the fees and taxes disclosed in the PDSs. However, we have deducted from the insurance-related investments strategy's performance indirect costs where these costs directly apply to the management of insurance-related investments strategy's investments. The insurance-related investments strategy's indirect costs are incurred when it invests in external investment funds. They aren't additional fees retained by MLC.