Insurance-related investments strategy

Investment update to 30 June 2021

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.

The MLC Inflation Plus portfolios' and MySuper 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: MLC Inflation Plus portfolios' and MySuper target allocations to insurance-related investments as at 30 June 2021

MLC MasterKey Super & Pension Fundamentals / MySuper	Insurance-related investments %	MLC Wholesale	Insurance-related investments %
MLC Inflation Plus Assertive Portfolio	4.0	MLC Wholesale Inflation Plus Assertive Portfolio	4.0
MLC Inflation Plus Moderate Portfolio	3.0	MLC Wholesale Inflation Plus Moderate Portfolio	3.0
MLC Inflation Plus Conservative Portfolio	3.0	MLC Wholesale Inflation Plus Conservative Portfolio	3.0
MySuper Growth Portfolio	2.5		
MySuper Conservative Growth Portfolio	2.5		

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?

These investments are expected to deliver a return that is between the more traditional assets of shares and fixed income. In addition, its significant diversification characteristics reduce total portfolio risk, which improves 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 returns that are largely 'uncorrelated' with returns from shares.

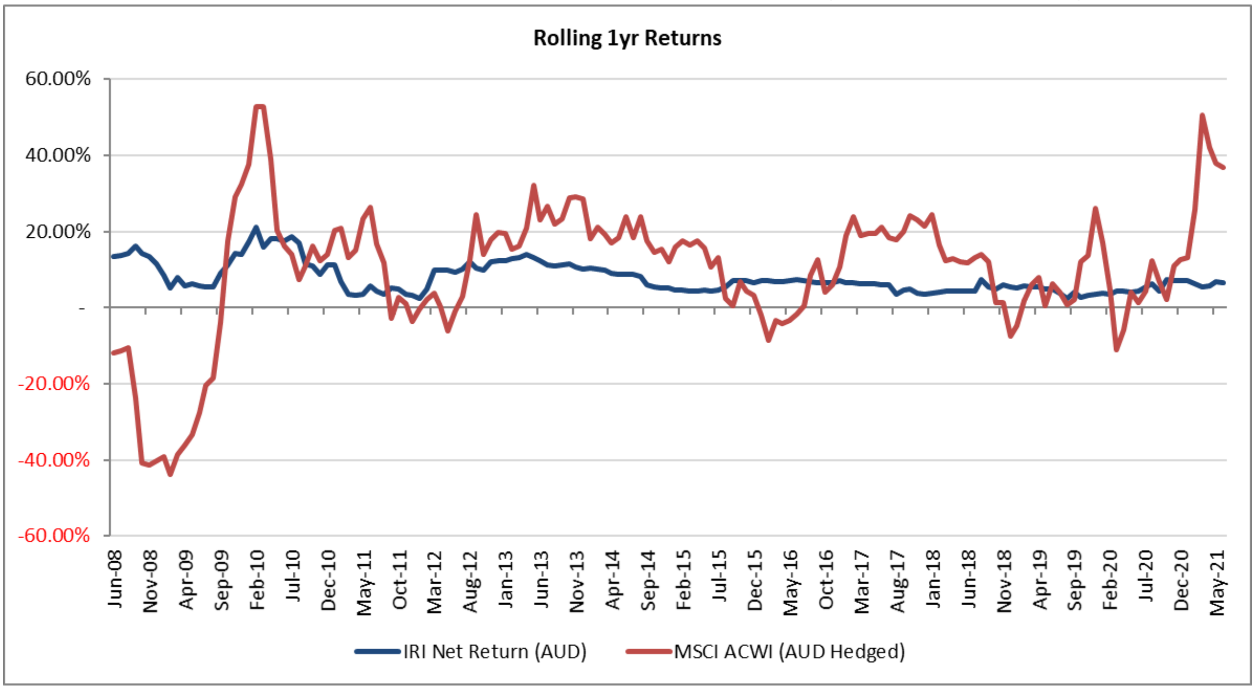
Another distinctive feature of these investments is the visibility regarding its risk-return profile. Unlike other asset classes, where generally the expected returns are higher when risks are higher, in reinsurance the risks of a catastrophe occurring does not change materially from year to year, but 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 7.8% pa (hedged into Australian dollars and net of indirect costs) from July 2007 to 30 June 2021.

Chart 1: Performance of insurance-related investments relative to global shares (rolling 12 month returns)



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 two 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.

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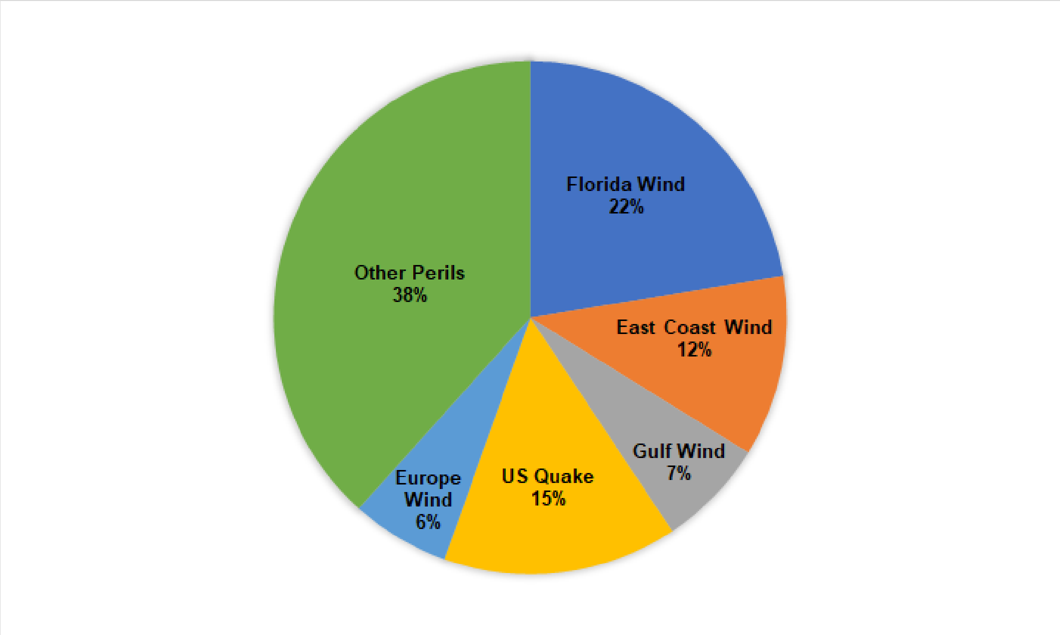
Risk exposure

Chart 2: Expected risk by catastrophe type (at 30 June 2021)



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 1.2% (hedged into Australian dollars) during the June 2021 quarter, and 6.4% for the 12 months ending 30 June 2021. Reinsurance premium accrual was the primary driver of performance in the quarter.

The underlying managers recently completed their mid-year reinsurance renewal period for Florida specific reinsurance contracts, with indications of risk adjusted premium increases in the +10-15% range versus last year. The strategy renewed several contracts at attractive prices and opportunistically added several new exposures.

The strategy is heading into the US hurricane season which officially commenced in June. This period which stretches over the coming six months is when the strategy's risk profile is at seasonal peak, but also when the majority of the reinsurance premiums for the calendar year are accrued and recognised in investment income.

The current combined strategy in-force for 2021 has an expected no loss return of cash +8.8% pa and an expected return after accounting for expected catastrophe losses of cash +5.8% pa. We continue to consider this return profile as very attractive, given the strategy remains focused on top layer remote risk contracts and has strong diversification benefits in the context of a multi-asset class portfolio.

At quarter end we increased our exposure to one of our underlying managers to take advantage of the favourable market pricing and increase the strategy's capital deployed. To ensure the overall strategy's risk profile remains in line with target we also introduced a 7% cash allocation to the Antares Enhanced Cash Strategy.

The overall strategy remains well-diversified across both US and non-US reinsurance exposures, through a combination of traditional reinsurance contracts and to a lesser degree catastrophe bonds.

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

As MLC Horizon and Inflation Plus 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.