Low Correlation Strategy

Investment update to 30 June 2019

The Low Correlation Strategy (LCS), managed by MLC's Alternative Strategies team, is made up of a range of diversifying alternative strategies, including hedge funds.

A distinctive alternative strategy, LCS is designed to increase the diversity of sources of return and risk in our MLC Horizon and Inflation Plus portfolios. The MLC Horizon and Inflation Plus portfolios' allocations to LCS are shown in Table 1. By combining several carefully selected alternative strategies, LCS aims to provide a pattern of returns that is mostly independent of, or 'uncorrelated' with, share market returns. We expect this will help to smooth out the pattern of returns in these portfolios.

Table 1: MLC Horizon and Inflation Plus portfolios' target allocation to LCS as at 30 June 2019

MLC MasterKey Super & Pension Fundamentals	LCS %	MLC Wholesale	LCS %
MLC Horizon 2 Capital Stable Portfolio	3.0	MLC Wholesale Horizon 2 Income Portfolio	1.5
MLC Horizon 3 Conservative Growth Portfolio	3.0	MLC Wholesale Horizon 3 Conservative Growth Portfolio	3.0
MLC Horizon 4 Balanced Portfolio	3.0	MLC Wholesale Horizon 4 Balanced Portfolio	3.0
MLC Horizon 5 Growth Portfolio	3.0	MLC Wholesale Horizon 5 Growth Portfolio	3.0
MLC Horizon 6 Share Portfolio	2.0	MLC Wholesale Horizon 6 Share Portfolio	2.0
MLC Horizon 7 Accelerated Growth Portfolio	2.0	MLC Wholesale Horizon 7 Accelerated Growth Portfolio	2.0
MLC Inflation Plus Assertive Portfolio	4.0	MLC Wholesale Inflation Plus Assertive Portfolio	4.0
MLC Inflation Plus Moderate Portfolio	5.0	MLC Wholesale Inflation Plus Moderate Portfolio	5.0
MLC Inflation Plus Conservative Portfolio	6.0	MLC Wholesale Inflation Plus Conservative Portfolio	6.0

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

An explanation of how fees are deducted from LCS's returns is in Appendix 2.

Investment objectives

LCS focuses on finding strategies that are both high quality and lowly correlated. This is reflected in its three broad investment objectives:

1. **Return:** to provide returns that are different to mainstream asset classes such as shares. The return objective is to generate returns of cash[1] plus 3% pa, net of investment fees and indirect costs, over rolling 3 year periods.
2. **Risk:** to add diversification and reduce risk, the strategy seeks to have a beta to shares[2] of less than 0.2, over 3 year periods. Beta is essentially an indicator of how much a strategy's returns are linked to shares. For example, if shares went up 10% and a strategy had a beta of 0.2, the strategy would go up 2% and vice versa if shares fell.
3. **Capital preservation:** to avoid capital losses, particularly losses that coincide with falling share markets. This matters because you want to reduce losses but it also matters from a return perspective because if we can avoid losing money, then that increases our ability to compound investors' capital through time.

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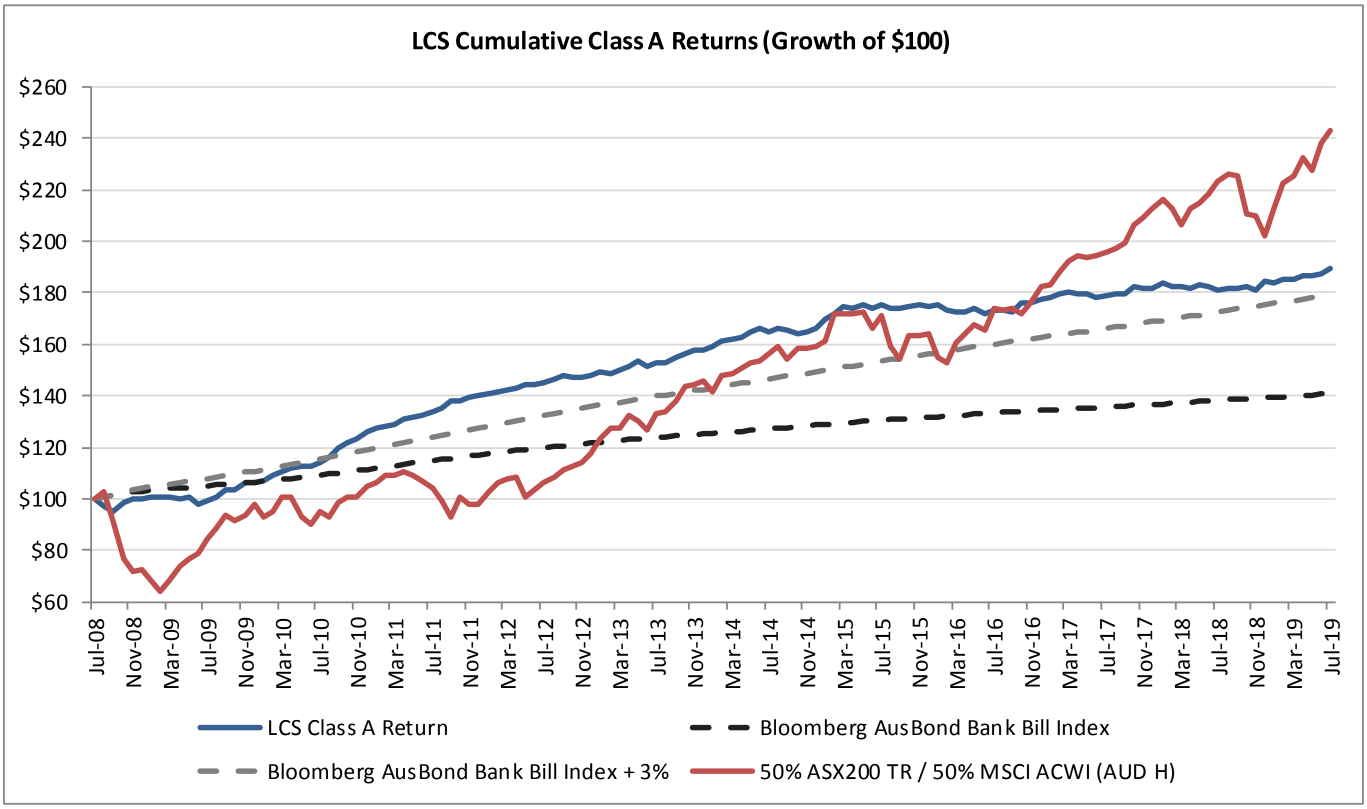
[1] Benchmark is the Bloomberg AusBond Bank Bill Index.

[2] Shares benchmark comprises of 50% S&P/ASX200 Total Return Index and 50% MSCI All Country World Index (A$ hedged).

Performance

Chart 1: LCS returns relative to objectives

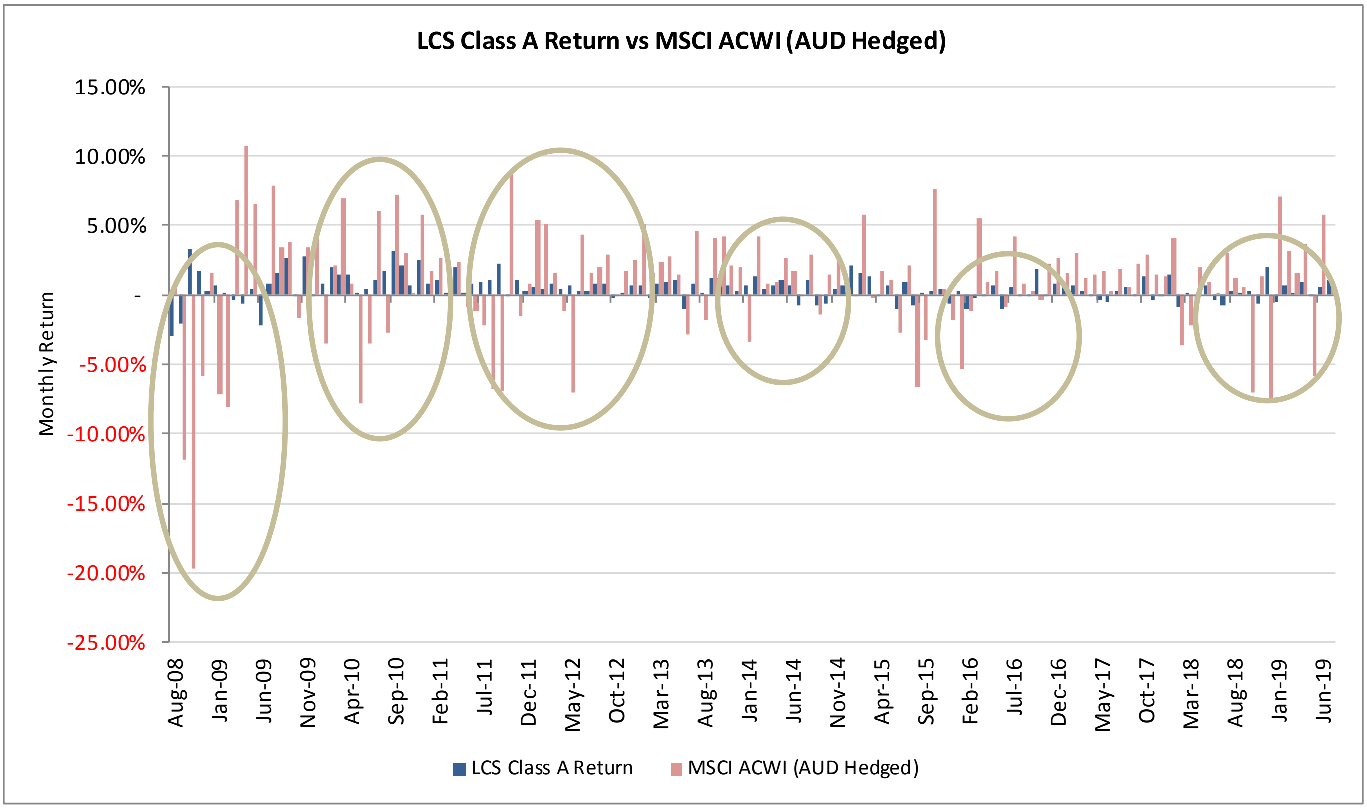


Source: NAB Asset Management Services Limited. LCS returns are net of investment fees and indirect costs. Past performance is not a reliable indicator of future performance. The value of an investment may rise or fall with the changes in the market.

Chart 1 demonstrates LCS's success - it has achieved, after investment fees and indirect costs, a return of 5.9% pa since inception in August 2008 to 30 June 2019. Up until the December 2016 quarter, where there was a strong rally in shares, LCS's returns had been higher than shares, even though that period includes several years of a bull share market.

Over the last quarter LCS has returned 1.3% and is up 2.9% for the 12 months ending 30 June 2019 (net of investment fees and indirect costs). While returns over the last year have been below cash plus 3% pa, over rolling 3 years, LCS has achieved its cash plus 3% pa objective around 50% of the time (since inception).

Chart 2: Monthly returns of LCS compared to global share markets



Source: NAB Asset Management Services Limited. LCS returns are net of investment fees and indirect costs. 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.

Chart 2 shows LCS has provided relatively smooth returns, by generating flat or mostly positive returns during those periods of weakness in share markets, including the global financial crisis in 2008/09 and the pronounced volatility in Europe in 2011/12. While the strategy hasn't had the big up movements of shares, it does avoid those big down movements, thereby helping to smooth the returns for our portfolios.

Since August 2008 LCS has had a beta of 0.01, achieving its risk investment objective. This means that regardless of what's happened in share markets, its performance has been largely independent. So in months when share markets have risen, LCS has generally returned about 0.5% per month, and in months when share markets have fallen, LCS has returned around 0.4% per month. So LCS has generally had a consistent return profile, uncorrelated with markets. Table 2 shows the 10 worst performing share market months and the relative performance of LCS.

Table 2: LCS performance in 10 worst share market months

Month	Shares performance (%)*	LCS net performance (%)	LCS outperformance (%)
Oct 2008	-16.3	+3.4	+19.6
Sept 2008	-10.9	-2.0	+8.9
May 2010	-7.6	+2.0	+7.9
Aug 2015	-7.2	-0.7	+6.5
May 2012	-6.9	+0.7	+7.6
Oct 2018	-6.5	+0.3	+6.9
Sep 2011	-6.5	+2.6	+9.1
Feb 2009	-6.3	+0.2	+6.5
Nov 2008	-6.0	+1.7	+7.7

Month	Shares performance (%)*	LCS net performance (%)	LCS outperformance (%)
Jan 2009	-6.0	+0.8	+6.8

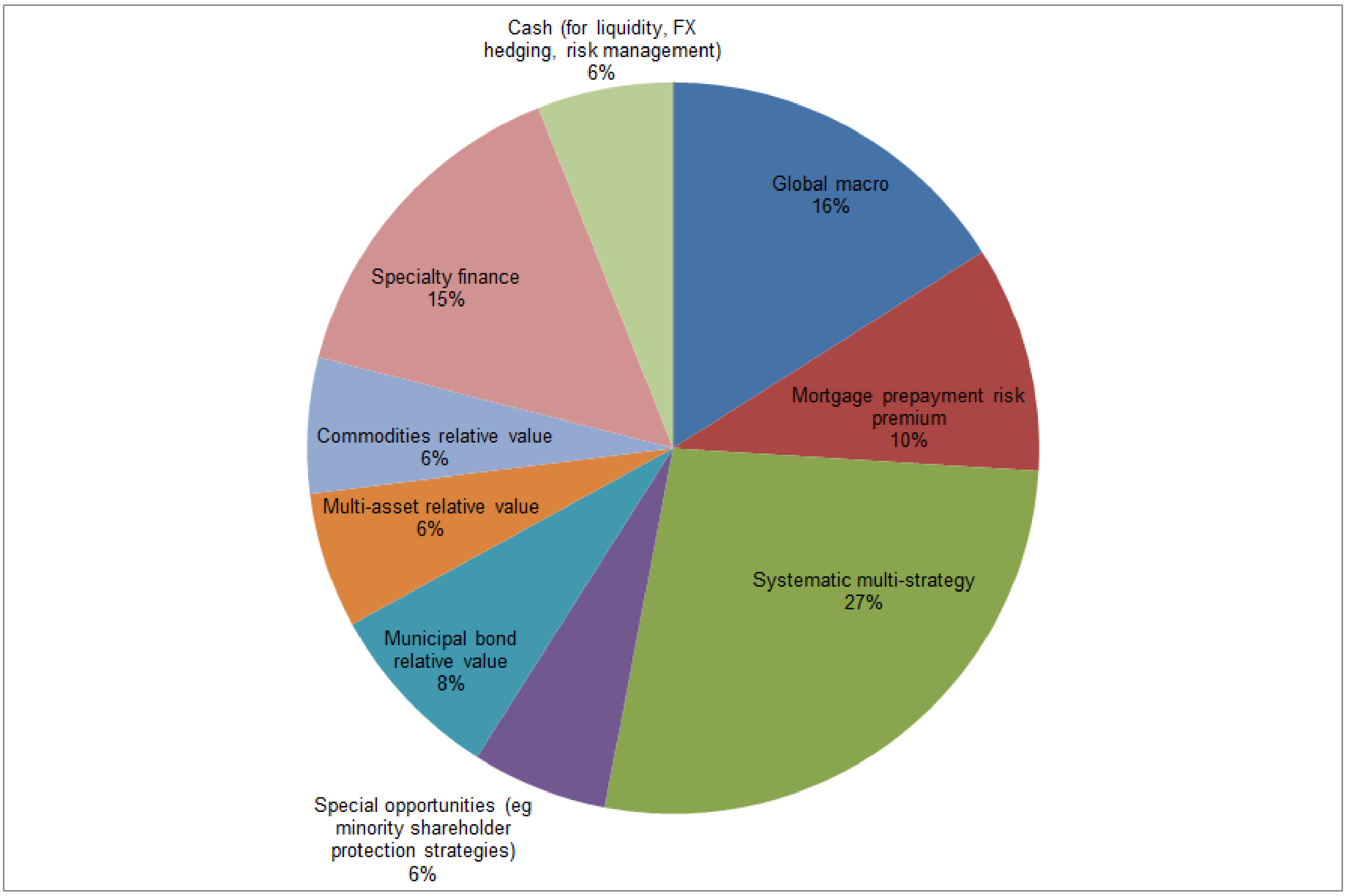
* Shares benchmark comprises of 50% S&P/ASX200 Total Return Index and 50% MSCI All Country World Index (A$ hedged)

Source: NAB Asset Management Services Limited. LCS returns are net of investment fees and indirect costs. 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.

Asset allocation

As at end June 2019, LCS invested in 13 different hedge funds, each chosen because their returns are largely unconnected both with one another and share markets. We have grouped the hedge funds into the categories in Chart 3. Appendix 1 provides a short description of each category.

Chart 3: Hedge funds LCS is invested in (based on target asset allocation at 30 June 2019)



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

Notes: We haven't provided our hedge fund manager names because some contracts we have with managers prevent us from disclosing information on them.

When choosing the hedge funds, there are two main drivers of return we are generally looking for:

1. Exposure to unique assets

Some hedge funds pay a return to investors for taking on a specific type of risk that isn't correlated with the usual investment risks such as share market and interest rate risks. These hedge funds can be unusual and hard to find. An example of one is mortgage prepayment risk. These are investments in the risk that US mortgagees prepay their mortgages faster than expected. As mortgagees prepaying their mortgage isn't directly connected to share market movements, the strategy is an attractive source of diversification.

2. Active management, generally via hedge funds

Hedge funds have a structure that will attract the best investment talent. They're attracted for two main reasons. One is simply that if you're a skilled fund manager, hedge funds tend to pay the best. The second is that hedge funds also provide the most flexible investment vehicle for that talent to manifest - there's no need to hug benchmarks, they can be opportunistic and focus on absolute returns, they can focus on exploiting their skills in a very precise manner (eg hedging out unwanted risks), they can go long and short etc.

There are a plethora of these types of hedge funds but they are very diverse. In our experience, identifying the best hedge funds requires deep research. 'Systemic multi-strategy' hedge funds look for inefficiencies in markets that they can systematically exploit using sophisticated models and techniques to generate returns. These hedge fund managers are looking at fundamental relationships between company balance sheets, earnings, cash flows etc on a large scale, making lots and lots of investments.

Most of the strategies we invest in are either only open to institutional money or are closed to new clients, which makes LCS a useful way for investors to gain exposure to strategies that would otherwise be largely inaccessible.

Current strategy positioning

Returns are net of investment fees and indirect costs.

LCS returned 1.3% during the June 2019 quarter and 2.9% for the 12 months ending 30 June 2019. During the quarter, 12 of the 15 underlying managers generated investment gains.

One of our systematic multi-strategy managers was the biggest positive contributor to the strategy during the quarter, returning 5.5% and contributing 0.45% to overall returns. The manager's gains in the directional futures strategy came from shares and commodities early in the quarter and fixed income later in the quarter. Equity statistical arbitrage was also a positive contributor, especially during May when long/short positioning in US consumer and cyclical stocks added value.

Gains across other managers were evenly distributed, with four of the strategy's underlying managers all contributing between 0.15% and 0.25% each to overall returns. On the negative side, one of our systematic multi-strategy managers was the most meaningful negative contributor, albeit at only -9bps. The strategy is encouraged by the broadly distributed nature of return contributions this quarter, reflective of efforts over the last year to improve both the quality of returns and breadth of return sources within the strategy.

Activity within the strategy was above average this quarter, with two new managers receiving capital allocations, while capital reductions were made to three underlying managers:

- In April we appointed a US-based specialty finance manager focused on lending against legal receivables. The manager's current portfolio is a combination of accounts receivable factoring from top global law firms and post judgement legal settlements, both of which are expected to be a high-quality source of short-term secured lending exposure for the overall strategy.
- The second new appointment was a multi-asset relative value manager. This manager is active across corporate bonds, convertibles, credit default swaps, and shares at the individual issuer/security level.

These new allocations were primarily funded from reductions in exposure to our global macro manager and one of our systematic multi-strategy managers. Finally, the strategy's capital was fully returned from a position it held in our opportunistic restructuring/litigation manager as they had been unsuccessful in their wind up of the securitised bond they had sought to acquire and restructure.

The two new underlying managers are consistent with our strategic goal of increasing the diversification in the strategy to more 'non-zero-sum game' strategies, where there is a clear economic driver to returns that is somewhat uncorrelated to the broader strategy and share markets.

Appendix 1: Description of investment strategies

Commodities relative value	Focuses on exploiting the relative pricing dynamics between onshore Chinese base metal futures markets and the corresponding offshore global base metal futures markets
Commodity trading	A niche strategy focused on trading a range of energy commodities, particularly electricity and natural gas markets
Credit relative value	Focused primarily on long/short relative value strategies within US and euro credit markets
Global macro	Research driven, systematically implemented and diversified across 100+markets
Mortgage prepayment	Focused on US agency and non-agency mortgage derivatives
Municipal bond relative value	Focuses primarily on exploiting the demand/supply imbalances that result from US municipal bond new issue and coupon/maturity cycles
Multi-asset relative value	Uses a long/short approach to identify mispriced idiosyncratic volatility, typically within corporate capital structures.
Opportunistic restructuring/litigation	Includes opportunities relating to the restructuring of asset backed bonds
Special opportunities	Includes strategies that are not easily described within our strategies (eg commodity related, minority shareholder protection strategies)
Specialty finance	Focuses on short duration lending against senior secured collateral – often government related receivables or legal receivables.
Systematic	Focused on global share market neutral strategies, futures trading and volatility strategies

Appendix 2: Understanding fees that are deducted from returns in this investment update

As MLC Horizon and Inflation Plus portfolios invest in LCS 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 LCS. Therefore, LCS's performance is reported before deducting most of the fees and taxes disclosed in the PDSs. However, we have deducted from LCS's performance indirect costs and investment fees where these costs directly apply to the management of LCS's investments:

- LCS's indirect costs are incurred when LCS invests in external investment funds. They aren't additional fees retained by MLC.
- LCS's investment fees are the costs that relate directly to the management of LCS's assets eg paid to the MLC Alternatives team for management of LCS.

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