Low Correlation Strategy

Investment update to 30 June 2021

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 2021

MLC MasterKey Super & Pension Fundamentals	LCS %	MLC Wholesale	LCS %
MLC Horizon 2 Capital Stable Portfolio	3.0	MLC Wholesale Horizon 2 Income Portfolio	3.0
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	2.0	MLC Wholesale Horizon 5 Growth Portfolio	2.0
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	8.0	MLC Wholesale Inflation Plus Conservative Portfolio	8.0

Source: MLC 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 we 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.

[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).

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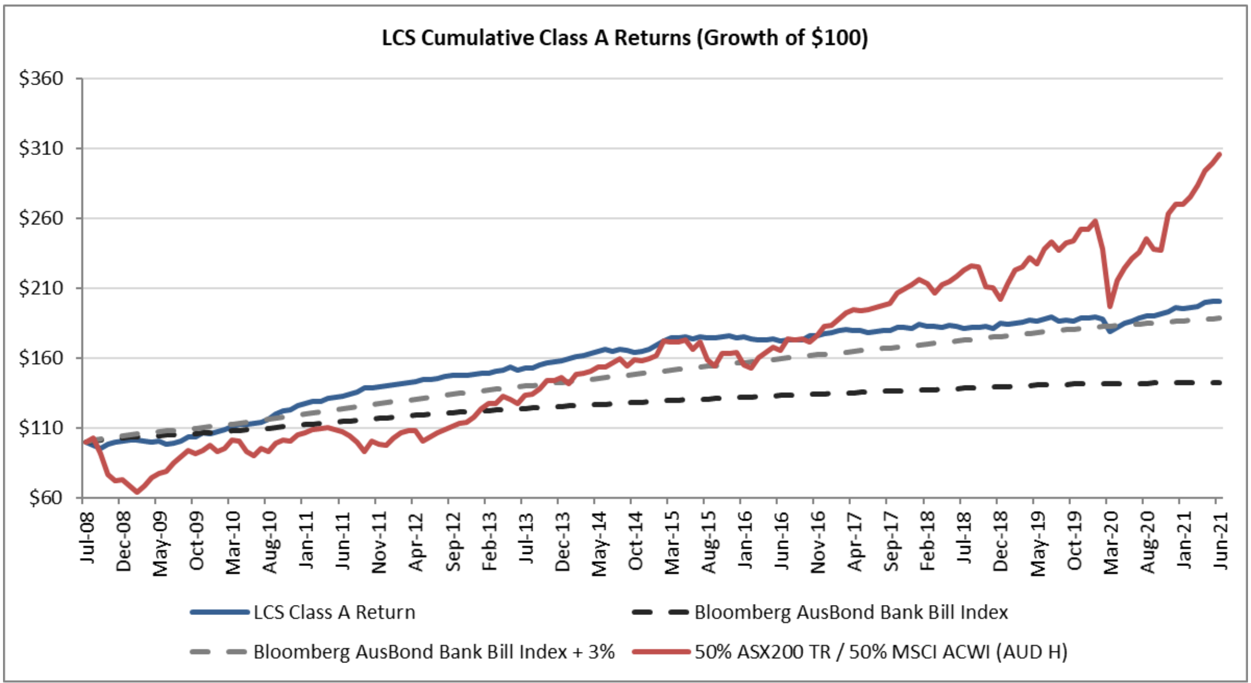
Performance

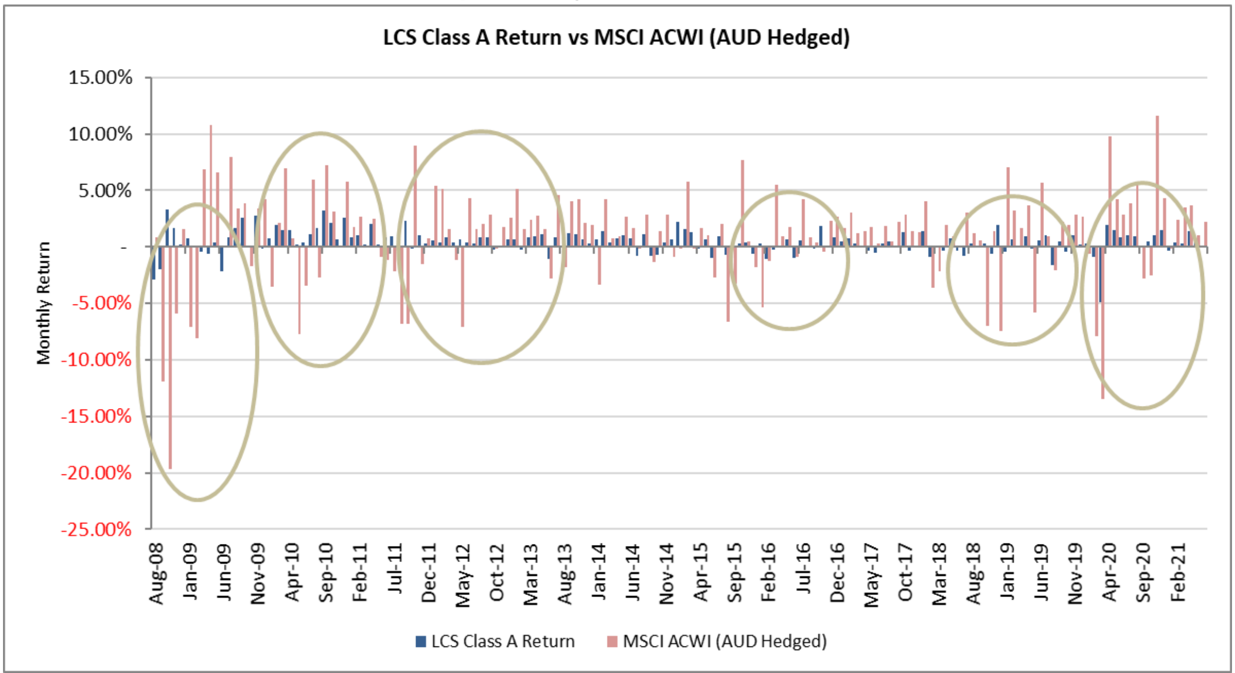
Chart 1: LCS returns relative to objectives



Source: MLC 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 5.5% pa since inception in August 2008 to 30 June 2021, outperforming its return objective of cash plus 3%. It's also outperformed its objective over the last 12 months but has underperformed by -0.8% pa over the last 3 years – mainly driven by the negative performance of a global macro manager which is now at a reduced weight.

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



Source: MLC 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 0.07 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 0.6% per month, and in months when share markets have fallen, LCS has returned around 0.2% 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 (%)
Mar-2020	-17.1%	-4.9%	12.2%
Oct-2008	-16.1%	3.3%	19.5%
Sep-2008	-10.9%	-2.0%	8.8%
Feb-2020	-7.8%	-0.9%	6.9%
May-2010	-7.6%	0.2%	7.8%
Aug-2015	-7.2%	-0.7%	6.5%
May-2012	-6.9%	0.7%	7.5%
Oct-2018	-6.5%	0.3%	6.8%
Sep-2011	-6.5%	2.3%	8.8%
Feb-2009	-6.3%	0.1%	6.5%

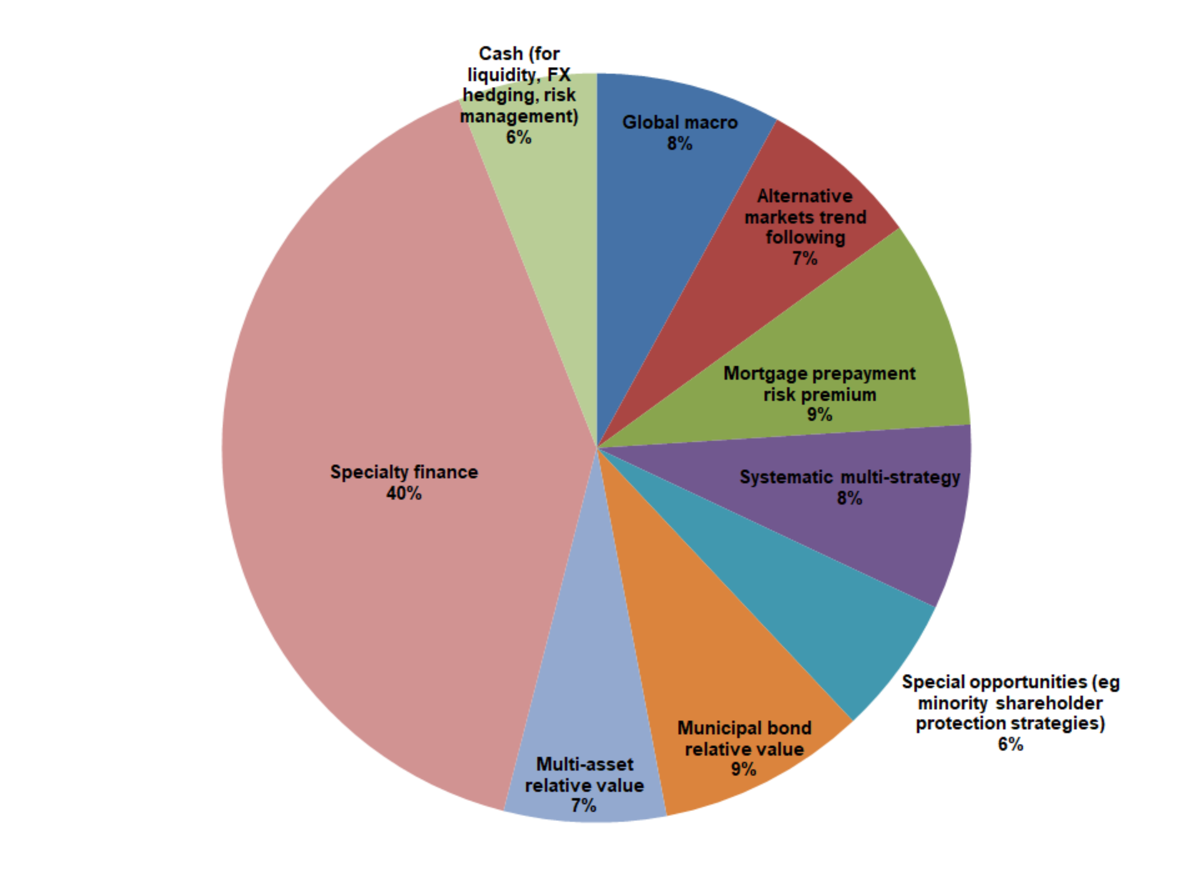
* Shares benchmark comprises of 50% S&P/ASX200 Total Return Index and 50% MSCI All Country World Index (A$ hedged)

Source: MLC 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 2021, LCS invested in 14 different strategies, each chosen because their returns are largely unconnected both with one another and share markets. We have grouped these strategies into the categories in Chart 3. Appendix 1 provides a short description of each category.

Chart 3: Strategies LCS is invested in (based on target asset allocation at 30 June 2021)



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

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

LCS focuses on three main types of strategies:

1. Uncorrelated risk premiums

Examples include speciality finance, and mortgage prepayment risk. We have found increasingly attractive opportunities in speciality finance strategies in recent years, which we have added to as a result of identifying attractive opportunities and having increased flexibility to invest in less liquid strategies. These strategies generally involve bilateral private lending to a stressed counterparty - who is willing to pay a high cost of capital to us for solving their capital needs - and who is able to provide high quality collateral that is in most scenarios lowly correlated to broader markets (equity and corporate credit). This enables us to capture returns significantly in excess of the risk. We invest in both funds and co-invests, which has so far helped to both enhance net returns and reduce fees.

2. Skill-based strategies

We are generally sceptical on zero sum trading strategies, and the hurdle for these types of strategies are high (for example, requiring a compelling research or technology edge aligned with hungry, humble investors with evidence of both success and continuous evolution in approach). We like managers operating in market niches where there are characteristics that enable them to add value from providing a solution to other market participants, which often also coincides with some complexity or barriers to entry or role as a liquidity provider.

3. Asymmetric right tail opportunities

These can include litigation related opportunities with material upside and somewhat capped downside, such as what we call minority shareholder protection strategies – where there is the opportunity to litigate for fair value after a minority squeeze out takeover.

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.

The strategy gained 1.8% during the June 2021 quarter, and returned 7.5% for the 12 months ending 30 June 2021, significantly exceeding its cash plus 3% objective for the year. The strategy's returns were broadly based with 10 of 14 underlying managers delivering positive returns during the quarter.

Over the quarter:

- Our systematic multi-strategy manager was the largest positive contributor in the quarter (+58bp contribution / +6.8% return), with gains primarily generated by their global share market neutral strategy, particularly within North American shares.
- One of our specialty finance managers was also a large positive contributor in the quarter (+36bp contribution / +3.6% return). The manager's investment comprises a fund investment into a legal financing strategy that provides working capital to top tier global law firms and participates in purchasing claims in post-settlement legal judgements, and a co-investment in a large US anti-trust settlement claim. Both components of the manager's investment performed well over the quarter.
- One of our specialty finance managers was the standout from a return perspective (+33bps contribution / +11.6% return). The manager focuses on making opportunistic investments primarily in senior secured privately originated loans in Europe to both corporates and a range of other collateral types including real estate, legal receivables, and hard assets. Our exposure to this manager's flagship fund is complemented by a co-investment in a senior secured loan against a UK land development; both components performed well in the quarter,

Portfolio activity during the quarter included:

- The quarter was very active within the specialty finance segment of the strategy, with multiple capital calls and returns on several funds and existing co-investments. One of our manager's co-investments was fully realised in the quarter. The senior secured private loan to a US based insurance company was refinanced early after being outstanding for 12 months and generated a ~15% net internal rate of return.
- One new strategy was introduced, being an alternative markets trend following manager. This strategy takes directional long and short positions across a range of smaller, less liquid commodity, shares, foreign exchange and interest rate markets, using a trend following investment approach. The target allocation to this manager was increased at quarter end, reflective of an improved opportunity set and continued confidence in the manager.

Appendix 1: Description of investment strategies

Alternative markets trend following	Uses a trend following investment approach to focus on directional long and short positions across a range of smaller, less liquid commodity, equity, foreign exchange and interest rate 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, corporate 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.