MLC Investment Management

# MLC MasterKey Unit Trust IncomeBuilder

## Annual distribution commentary

## 31 May 2013

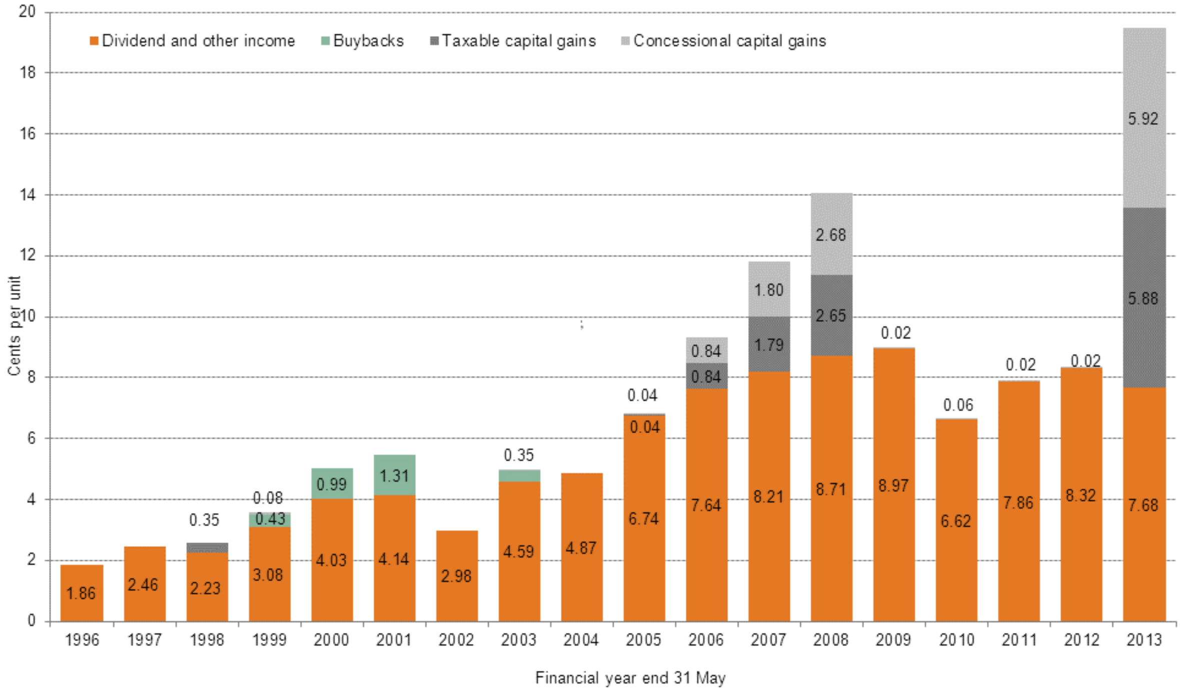

## Summary

MLC MasterKey Unit Trust IncomeBuilder (MLC IncomeBuilder) has a successful history of achieving its primary objective of producing a growing, tax-effective income stream. Over 18 years, there has been a fairly steady rise in the fund's underlying income distribution (shown by the orange bars in Chart 1).

For the financial year ending 31 May 2013, the fund's total distribution increased to 19.48 cents per unit (cpu). However, underlying income declined slightly. Most of the rise in the total distribution was because the capital gains component of the distribution was unusually high this year.

While remarkably strong share markets contributed to the rise in capital gains, it also meant the value of the fund's assets increased considerably this year.


**Chart 1: MLC IncomeBuilder annual distributions**




Source: MLC IncomeBuilder

## The market environment

The Australian share market had an extremely strong year. The fund's benchmark, the S&P/ASX 200 Industrials Accumulation Index, surged 37% over the year on investors' expectations that company earnings will improve in future. However, for this financial year, company earnings were generally flat. Business conditions remained challenging, with the global and domestic environment still uncertain, business and consumer confidence wavering, and some firms having to contend with the persistently high Australian dollar.

With interest rates and bond yields low, investors increasingly looked for companies with a high dividend yield, which pushed the share prices of those companies still higher. Despite subdued earnings growth, some firms chose to make small increases in their dividend payout rates. Others cut back their dividend payout rates.

## Underlying income distributions

For the 2013 financial year, the fund made an underlying income distribution of 7.68 cents per unit (cpu). This was 7.6% lower than the previous year's distribution of 8.32 cpu.

The fund's lower underlying income this year was due to:

- a lower dividend payout rate of some companies in the fund, which outweighed the small growth in the dividend payout rate of others, and
- the managers reducing their holdings in some companies they considered overpriced, and that subsequently reported higher dividends, to invest in companies they expect will deliver higher sustainable earnings and dividends in future.

Table 1 compares the total of the most recent interim and final dividend of selected companies owned by the fund with the total for the previous year.

**Table 1: Total dividends from selected MLC IncomeBuilder investments**

| Company | 2011/12 dividend ($) | 2012/13 dividend ($) | % change |
|---|---|---|---|
| AMP | 0.29 | 0.25 | -13.8% |
| ANZ | 1.40 | 1.45 | 3.6% |
| Boral | 0.145 | 0.085 | -41.4% |
| Brambles | 0.26 | 0.265 | 1.9% |
| Coca Cola Amatil | 0.525 | 0.56 | 6.7% |
| Commonwealth Bank | 3.25 | 3.61 | 11.1% |
| CSR | 0.113 | 0.10 | -11.5% |
| Fairfax | 0.035 | 0.02 | -42.9% |
| National Australia Bank | 1.72 | 1.80 | 4.7% |
| Suncorp | 0.40 | 0.60 | 50.0% |
| Telstra | 0.28 | 0.28 | 0.0% |
| Wesfarmers | 1.55 | 1.72 | 11.0% |
| Westpac | 1.56 | 1.66 | 6.4% |
| Woolworths | 1.24 | 1.29 | 4.0% |

Source: IRESS

The banking sector continues to be a substantial part of the fund's portfolio and an important source of dividends. Despite low earnings growth, all four of the big banks increased their dividends this year. The Commonwealth Bank's dividend grew 11.1%, by far the highest rate, while ANZ's was the lowest at 3.6%. National Australia Bank and Westpac's increased by 4.7% and 6.4% respectively. Looking ahead, the banks continue to face an uncertain environment globally and domestically, and their dividend growth is likely to be lower.

Two of the fund's other investments that have continued to deliver strong dividend growth are Suncorp and Wesfarmers. Suncorp's total dividend for the year was 60 cents, 50% higher than last year's, and included a special dividend of 15 cents. The company's finances benefited from cost reductions, fewer insurance claims due to benign weather conditions, and lower than expected losses on its non-core banking operations.

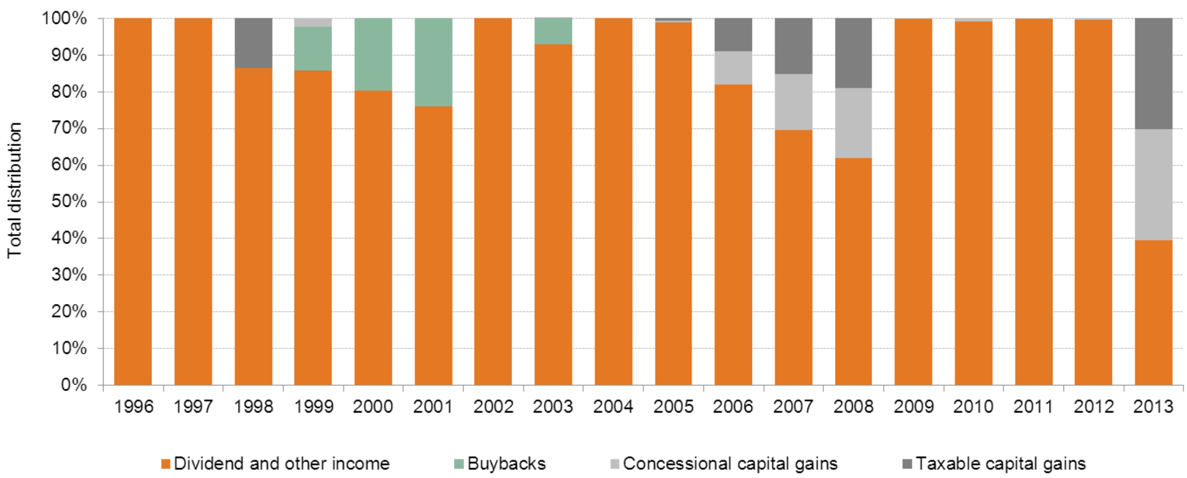
Wesfarmers' total dividend for the year of $1.72 was an 11% increase on last year. While the company's total revenue increased only modestly over the year, its measures to control costs in businesses such as Coles and Bunnings helped performance.

However, a number of the fund's investments produced lower dividends, and this contributed to the slight decrease in underlying dividend income this year. For example, AMP's total distribution of 25 cents was a 13.8% decrease over the previous year. This reflected the company's expectations of increasing demand for capital-intensive products and that it would also require more capital to meet regulatory requirements.

## Capital gains

As chart 2 shows, the capital gains portion of the annual distribution was high this year at 11.8 cpu (61% of the distribution). However, more than half of this was concessional capital gains, which have favourable tax treatment.

**Chart 2: Composition of MLC IncomeBuilder's distributions**




Source: MLC IncomeBuilder

### What caused the high capital gains?

As trading in the fund's investments took place in an extremely strong market, with elevated share prices, the level of capital gains was very high.

The fund realised capital gains during the 2013 financial year due to:

- normal buying and selling of investments, and
- a change in the managers of the fund, which led to more investments being bought and sold than usual.

Another significant factor this year was that capital losses weren't available to offset all the realised capital gains. Although the fund has realised capital gains in recent years, it hasn't distributed them, as the gains had to be offset against realised capital losses carried forward from previous years. Those capital losses were incurred on the sale of shares during the weak markets of the global financial crisis of 2008-9 and the first few years afterwards. Some capital losses were carried forward into the 2013 financial year, but once these were used the remaining realised capital gains had to be distributed.

As chart 2 shows, the fund also distributed realised capital gains in financial years 2006 to 2008. This was another period of strong markets, leading up to the global financial crisis.

The realised capital gains portion of the annual distribution is automatically reinvested in investors' accounts.

**Will future distributions include capital gains?**
Since January 2013, the fund has had full active management, rather than one active and one passive manager. We expect turnover will increase slightly due to the managers' investment activity and if share prices remain high, it's likely some capital gains will be realised.

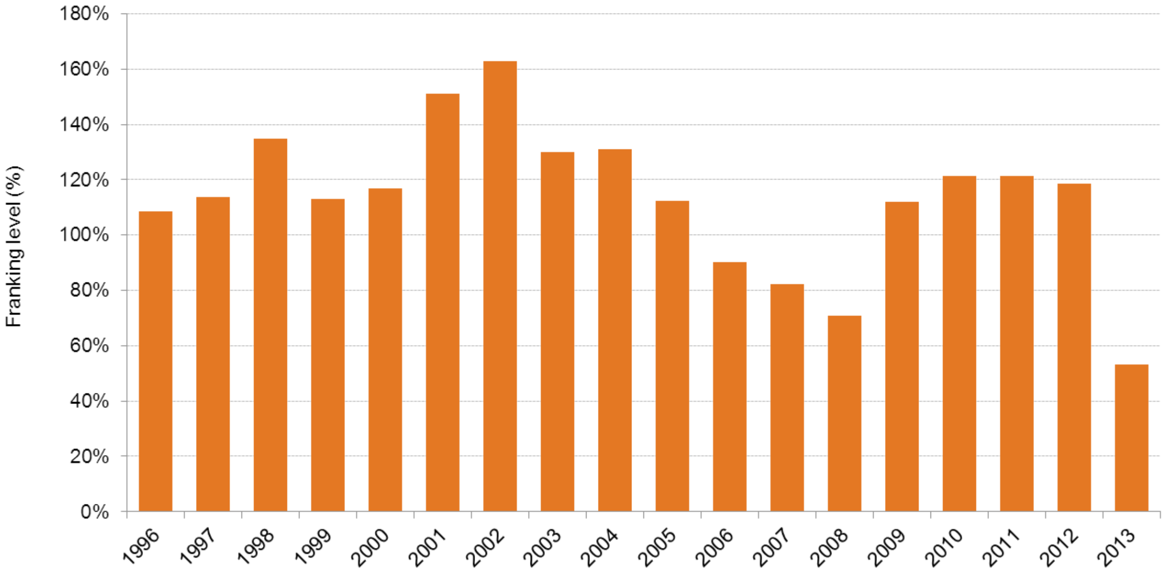
While we expect the capital gains component of future distributions will generally be a little above where it has been in the past, we don't anticipate it will be as high as this year. We'll continue to manage the fund as tax-effectively as possible.

## Franking levels

The franking level of MLC IncomeBuilder this year was 53% (see chart 3). For the last four years the franking levels on the total distribution have been above 100%. This year's decrease is due to the increase in distributed capital gains, as the franking level is calculated as a percentage of the total distribution. Without the capital gains component, the franking level would have been similar to last year.

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

**Chart 3: Franking levels for MLC IncomeBuilder**




Source: MLC IncomeBuilder

## Outlook

While Australian companies are generally in good financial health, the domestic operating environment remains challenging and the outlook both here and internationally is uncertain. Although lower interest rates and the recent fall in the Australian dollar will ease some pressure, company earnings and dividend growth are likely to remain subdued 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 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-effective income stream for investors.