MLC Investment Management

MLC MasterKey Investment Service
MLC MasterKey Unit Trust
Annual distribution commentary
May 2013

1. Distributions for FY2013

The table below sets out the cents per unit (cpu) distributions paid for the May 2013 quarter and for the full 2013 financial year (1 June 2012 to 31 May 2013) for the funds in the MLC MasterKey Unit Trust, including those available in the MLC MasterKey Investment Service.[1]

For a breakdown of the estimated taxation components of the distribution for the 2013 financial year, please refer to the MLC Unit Trust/Investment Service Distribution Tax Components 2012/2013. The document is also available on **mlc.com.au**. The final taxation components will be available on **mlc.com.au** in July.

Fund	Quarter cpu	Full year cpu (yield)[2]				
	May 2013	2012/13	2011/12	2010/11	2009/10	2008/9
MLC Horizon 1 – Bond Portfolio	1.00	2.27 (2.3%)	2.15 (2.2%)	4.67 (4.9%)	3.44 (3.3%)	5.48 (5.7%)
MLC Horizon 2 – Income Portfolio	1.66	2.98 (3.0%)	2.86 (2.9%)	4.65 (4.8%)	3.98 (4.4%)	5.11 (4.8%)
MLC Horizon 3 – Conservative Growth Portfolio	1.17	1.95 (2.3%)	1.85 (2.2%)	3.98 (4.9%)	3.93 (5.1%)	4.46 (4.5%)
MLC Horizon 4 – Balanced Portfolio	1.65	2.49 (2.3%)	2.45 (2.2%)	5.44 (5.0%)	4.46 (4.5%)	6.15 (4.1%)
MLC Horizon 5 – Growth Portfolio	1.20	1.75 (1.9%)	2.42 (2.5%)	5.06 (5.4%)	3.08 (3.6%)	5.39 (3.9%)
MLC Horizon 6 – Share Portfolio	0.76	0.76 (1.1%)	1.04 (1.4%)	4.13 (5.8%)	3.03 (4.7%)	3.97 (4.0%)
MLC Horizon 7 – Accelerated Growth Portfolio	0.13	0.13 (0.2%)	0.19 (0.3%)	3.77 (5.4%)	3.76 (6.2%)	3.57 (3.4%)
MLC Australian Share Fund	1.52	3.58 (2.7%)	4.46 (2.9%)	4.82 (3.2%)	3.20 (2.5%)	7.23 (3.9%)
MLC Australian Share Value Style Fund	0.77	3.40 (4.5%)	4.09 (4.5%)	2.83 (3.2%)	2.30 (3.0%)	6.42 (5.8%)

[1] MLC MasterKey Investment Service Fundamentals invests in MLC Wholesale funds, which have a June year end. The MLC Long-Term Absolute Return Portfolio, MLC Diversified Debt Fund, MLC Global Property Fund and MLC Hedged Global Share Fund in MLC MasterKey Investment Service are accessed through the MLC Wholesale funds, so they also have a June year end. As a result, this commentary does not cover those products. A separate commentary will be prepared after the final distribution in June.
[2] The distribution yield for a fund is the annual cpu divided by the unit price released the day after the final distribution for the previous financial year.

Fund	Quarter cpu	Full year cpu (yield)[2]				
	May 2013	2012/13	2011/12	2010/11	2009/10	2008/9
MLC Australian Share Growth Style Fund	1.11	1.59 (1.8%)	1.76 (1.7%)	2.95 (3.0%)	1.70 (2.0%)	1.28 (1.1%)
MLC IncomeBuilder	14.06	19.48 (9.8%)	8.34 (3.9%)	7.88 (3.6%)	6.68 (3.6%)	8.99 (3.5%)
MLC Global Share Fund	0.13	0.13 (0.1%)	0.02 (0.02%)	0.03 (0.03%)	-	-
MLC Global Share Value Style Fund	0.31	0.31 (0.5%)	0.17 (0.2%)	0.05 (0%)	-	-
MLC Global Share Growth Style Fund	-	-	-	-	-	-
MLC Property Securities Fund	0.82	1.54 (2.7%)	2.40 (4.3%)	1.97 (3.7%)	3.29 (7.1%)	4.54 (3.9%)
MLC-Platinum Global Fund	-	-	-	-	6.90 (5.6%)	13.67 (9.9%)
MLC-Vanguard Australian Share Index Fund	4.98	8.88 (4.8%)	9.19 (4.3%)	6.62 (3.3%)	6.46 (3.6%)	37.45 (12.5%)

Commentary on each fund's distribution is in section 3.

More information on the performance of each fund is available on the Fund Profile Tool on mlc.com.au and is updated monthly.

2. Key factors affecting distributions in FY2013

MLC's share funds (except for MLC IncomeBuilder), and the MLC Horizon portfolios with high allocations to shares, are designed to provide capital growth. Athough they make distributions, their main objective is to increase the value of their assets for investors, rather than to deliver an income stream.

Here are the key factors that affected distributions in FY 2013.

Capital losses carried forward

Capital losses had a significant impact on the level of distributions. During the global financial crisis (GFC) of 2008-9 and the first few years afterwards, markets were weak and volatile. Most funds suffered large capital losses when they sold investments. Capital losses are kept in the fund and are carried forward until they can be offset against capital gains.

Share markets across the world have mostly strengthened this year and many funds have generated capital gains. However, for most funds the gains won't be distributed, as they're offset by the losses carried forward. In most funds, these losses will continue to reduce distributions.

The impact of a high Australian dollar
A number of the funds hold overseas shares. We hedge part of these holdings to reduce the funds' exposure to movements in the Australian dollar (AUD).

Over most of FY2013 the AUD remained fairly high compared with FY2012 and with other major currencies (for example, the AUD traded between around USD0.96 and USD 1.06). The stronger AUD meant that income distributions from unhedged global shares, and the amount received if the shares were sold, were worth less in Australian dollars. For funds that have a large allocation to unhedged shares, this reduced distributions.

The FAQ in section 4 explains more about hedging.

Foreign losses
Due to tax rules, some foreign losses from previous years (such as foreign exchange losses) continued to be carried forward this year. This also impacted distributions. You can read more about this in the FAQ.

Australian shares
The Australian share market performed very strongly in FY2013, with the S&P/ASX200 market index rising 27% over the year. The market's upward trend contrasted with its volatile performance in FY2012. It created opportunities for share fund managers to sell investments at higher prices, locking in (or 'realising') capital gains. However, most funds that invest in Australian shares have large capital losses from previous years and these tended to offset the capital gains.

Across the Australian market, company earnings were flat. Despite this, some firms chose to make small increases in their dividends. Investors increasingly looked for companies with a high dividend yield, which pushed up their share prices. MLC's Australian shares portfolio managers balanced their portfolios between some of these companies and firms with stronger growth prospects. While this mix of investments meant dividend income for the Australian shares funds was lower in FY2013, these funds are well positioned to provide future capital growth.

MLC IncomeBuilder, which is managed differently to MLC's other Australian shares portfolios, is discussed on page 6.

Global shares
International share markets rose over FY2013 as investors became more optimistic about the global outlook. Although company earnings remained flat, companies generally increased their dividends to meet investors' expectations. However, overseas companies tend to pay lower levels of dividends than Australian companies. As a result, the expenses of a fund mostly offset dividend income from global shares.

The rising markets meant many funds realised capital gains when they sold investments. In most cases these gains were offset by capital losses that remained in the funds from the GFC and the years of weak markets that followed.

Australian property securities
Listed Australian real estate investment trusts (REITs) performed very strongly in FY2013. Income yields on many REITs were higher than on bonds or term deposits, and investor demand pushed up REIT prices. REITs are generally in good financial shape, with less debt and distribution payout policies at more sustainable levels than during the GFC.

The rising REIT market meant the MLC Property Securities Fund realised capital gains when it sold investments. These gains were offset by capital losses that remained in the fund from the GFC and the years of weak markets that followed.

The distribution from Australian REITs was lower in FY2013, mainly because of a change to the treatment of distribution components of three large REITs: Stockland Trust, Westfield Retail Trust and Westfield Group. A part of each of their distributions was classed as capital gains this year. This was offset against the fund's capital losses carried forward, reducing the distribution.

Global property

Global REIT market conditions have also been robust. Although in most markets REIT income yields are low compared with historic averages, prices for global REITs have risen because their yield is higher than global bond yields.

The rising markets meant the global property strategy in the MLC Horizon portfolios realised capital gains when investments were sold. These gains were offset by capital losses from the GFC and the years of weak markets afterwards.

Currency gains from the AUD hedge strategy led to an increase in income this year. Other income was at similar levels to FY2012.

Fixed income

Cash

Income from cash was lower because the Reserve Bank of Australia cut their cash rate target from 3.75% to 2.75% in FY2013.

Short term bonds

Fixed income strategies with short terms to maturity (up to two years) produced slightly higher levels of income this year. This was mainly due to the continuing impact of a change in tax legislation in FY2012 that affected how income from bonds is calculated. Income from short-term bonds remained low both in Australia and overseas.

Longer term bonds

For fixed income strategies with longer terms to maturity, distributions decreased in FY2013. Although returns from longer-term bonds were strong, they were lower than last year, so distributions were lower.

3. Fund commentaries

MLC Horizon Series of portfolios

The MLC Horizon Series is a range of multi-manager, multi-asset class funds tailored to meet the needs of investors with different return expectations, time frames and tolerances for volatility. The income distributions for these funds are largely based on the income from the underlying asset classes described above. The allocations to the asset classes are different for each of the MLC Horizon Series of portfolios.

For MLC Horizon Series 1 to 4, there was a small increase in distributions for the year compared to FY2012. For MLC Horizon Series 5, 6 and 7, which are growth-oriented funds, the distributions decreased moderately compared to the previous year.

MLC Horizon 1 – Bond Portfolio

MLC Horizon 1 – Bond Portfolio made a FY2013 distribution of 2.27 cpu, compared to 2.15 cpu for FY2012. The fund is focused on capital preservation and therefore invests in fixed income securities with a relatively short term to maturity. While there was a small increase in the fund's distribution, interest income remained low as bond yields have been low for a number of years.

MLC Horizon 2 – Income Portfolio

MLC Horizon 2 – Income Portfolio made a 2013 distribution of 2.98 cpu, compared to 2.86 cpu for FY2012. Half of the fund's distribution was generated from its investment in bonds. Income from share and property investments was less than last year. The main reason the distribution rose this year was an increase in realised capital gains and in currency gains from AUD hedging on global investments in shares, property and fixed income securities.

MLC Horizon 3 – Conservative Growth Portfolio

MLC Horizon 3 – Conservative Growth Portfolio made a FY2013 distribution of 1.95 cpu, compared to 1.85 cpu for FY2012. Most of the fund's distribution was interest on its investment in bonds. Dividend income from Australian share investments was slightly less than last year.

MLC Horizon 4 – Balanced Portfolio

MLC Horizon 4 – Balanced Portfolio made a FY2013 distribution of 2.49 cpu, compared to 2.45 cpu for FY2012. Most of the fund's distribution was dividend income from shares in Australian and overseas companies. Income from fixed income securities was also a large component of the distribution.

MLC Horizon 5 – Growth Portfolio

MLC Horizon 5 – Growth Portfolio made a FY2013 distribution of 1.75 cpu, compared to 2.42 cpu for FY2012. Most of the fund's distribution was dividend income from shares in Australian and overseas companies, although dividend income was lower than last year. Income from bonds also fell. The distribution was also less than last year because most of the fund's global shares exposure is not hedged to the AUD.

MLC Horizon 6 – Share Portfolio

MLC Horizon 6 – Share Portfolio made a FY2013 distribution of 0.76 cpu, compared to 1.04 cpu for FY2012. Most of the fund's distribution was dividend income from shares in Australian and overseas companies, and dividend income was lower than last year. The distribution was also lower than in FY2012 because most of the fund's global shares exposure is not hedged to the AUD.

MLC Horizon 7 – Accelerated Growth Portfolio

The distribution for MLC Horizon 7 – Accelerated Growth Portfolio for FY2013 was 0.13 cpu, compared to 0.19 cpu for FY2012. Most of the fund's distribution consisted of dividends from shares in Australian and overseas companies, although dividend income was less than last year. Gearing costs (such as interest) further reduced the fund's distribution. The distribution was also lower than last year because most of the fund's global shares exposure is not hedged to the AUD.

Australian share funds

MLC Australian Share Fund

The fund's FY2013 distribution decreased from last year due to the factors affecting Australian shares outlined on page 3. Most of this year's distribution consisted of fully franked dividends.

MLC Australian Share Value Style Fund

The fund's FY2013 distribution decreased from last year, mainly due to the factors affecting Australian shares outlined on page 3. Last year's distribution also included more concessionally taxed capital gains. Most of this year's distribution consisted of fully franked dividends.

MLC Australian Share Growth Style Fund

The fund's FY2013 distribution decreased from last year due to the factors affecting Australian shares outlined on page 3. Most of this year's distribution consisted of fully franked dividends.

MLC IncomeBuilder

The fund provided a total distribution of 19.48 cpu for the financial year with underlying income of 7.68 cpu, mainly from dividends. While the total distribution is 133.5% higher than last year, the underlying income is 7.6% lower than last year's 8.32 cpu underlying distribution.

The lower underlying income was mainly because the fund has reduced its holding in some companies that reported higher dividends. The funds raised from reducing those holdings have been invested in companies we expect to report higher earnings and dividends in future.

The capital gains portion of the annual distribution was high this year, at 11.8 cpu. However, more than half of this was concessional capital gains, which have favourable tax treatment. Capital gains were realised during the year due to:

- normal buying and selling in an environment of extremely strong share prices
- a change in managers, which resulted in more stock being sold than usual, and
- the last of the fund's prior years' capital losses being offset in FY2012, which meant all this year's realised capital gains were distributed.

The realised capital gains portion of the income is automatically reinvested into clients' accounts. This ensures an investor's capital base, from which their dividend income is generated, is not eroded by paying capital gains out of the fund. The fund has operated in this way since it was established, as it helps investors maintain a growing income stream.

For more information about the distribution of MLC IncomeBuilder please refer to the MLC IncomeBuilder annual distribution commentary, which will be available on mlc.com.au in the week starting 3 June.

MLC-Vanguard Australian Share Index Fund

The fund's FY2013 distribution decreased from last year's due to the factors affecting Australian shares outlined on page 3. Most of this year's distribution consisted of fully franked dividends.

Global share funds

MLC Global Share Fund
The fund made a small distribution of 0.13 cpu. Strong share markets meant the fund generated realised capital gains, but all were concessional capital gains, which have favourable tax treatment. All other income was offset against capital losses carried forward.

MLC Global Share Value Style Fund
The fund's distribution of 0.31 cpu was higher than last year's distribution of 0.17 cpu. Most of the distribution was capital gains concessional income due to capital gains made in the strong share markets.

MLC Global Share Growth Style Fund
This year, as last year, the fund did not have any income to distribute. Capital gains were offset against capital losses carried forward.

MLC-Platinum Global Fund
As for the last two years, the fund paid no distribution this year. The fund generated substantial capital gains in FY2013, which were offset against capital losses carried forward.

Property securities

MLC Property Securities Fund
The fund's FY2013 distribution decreased from last year due to the factors affecting Australian property securites outlined on page 3. Most of the distribution consisted of tax deferred and capital gains concessional income.

4. Frequently asked questions

Q. How is the level of distributions determined?

A. Distributions are made up of income from the underlying investments held by the managed fund and are paid to investors after fees are deducted. These investments may be shares, property, bonds or cash, or a combination of these. This means a distribution could include interest earned, franked and unfranked dividends, tax deferred income, rental income and any realised capital gains (after deducting any capital losses) made from selling investments (which usually occurs in the last quarter of the financial year). For global investments, currency movements resulting in changes in the value of hedging contracts can also affect income distributions.

Q. If share prices rose in FY2013, why didn't distributions for share funds increase?

A. The share prices of the fund's investments influence the unit price of the fund, but not the distributions paid. The fund's distribution depends on the income from the fund's investments (see the question above).

Q. How do prior foreign losses impact future distributions?

A. In 2009, there was a change in the tax treatment of foreign losses (such as currency losses). Until then, a fund could only offset losses on foreign hedging contracts against foreign hedging contract gains. This meant many of our global funds had accumulated substantial foreign losses.

The change in the tax rules allows a fund to offset foreign losses against any income. However, to deal with the foreign losses accumulated before 1 June 2009, the tax rules permit a fund to offset a maximum of only 20% of those losses each year for up to five years.

As a result, some of the foreign losses incurred before 1 June 2009 are still being carried forward and will continue to offset gains over the next years. This may reduce distributions from funds that have hedged global exposures.

Q. How does currency hedging help protect you from currency movements?

A. If you invest in funds that hold overseas assets, such as global shares, property or bonds, your income and capital are exposed to currency fluctuations. This can impact your return positively or negatively, depending on your exposure to various currencies and movements in their exchange rates.

If a fund has an AUD currency hedging strategy, it helps reduce the impact of currency movements on global exposures and smooth out the overall return on your investment. However, the income and growth components of the overall return, particularly for share and property investments, can still be quite volatile.

When MLC hedges exposure to global investments, our intention is to remove most of the effect of currency losses and gains from your global exposures. That way, the total return you receive depends on the performance of the underlying investment – not the movement in value of the AUD.

Q. How does hedging impact income distributions?

A. Currency hedging can help smooth the impact of foreign currency fluctuations on an investor’s total return. The length of MLC’s hedging contracts varies, but is typically one month. Any hedging gains or losses the fund realises when the hedging contract expires impact the income distributions for investors. Hedging gains are treated as income, while hedging losses are offset against other sources of income such as interest, dividends and hedging gains.

Important information