MLC MasterKey Unit Trust IncomeBuilder

Annual distribution commentary, 2021 financial year
22 June 2021

Summary

This financial year was a challenging year for investors who rely on Australian shares for income. Federal and state government measures limiting the spread of COVID-19 resulted in a significant contraction in economic activity and lower profits for many Australian companies across a range of industries.

While there were a small number of companies that weren't affected and maintained their dividends, many companies deferred or cancelled their dividends due to sharply lower earnings. These changes were necessary to preserve their balance sheet strength in an extremely uncertain business trading environment, and included traditionally large dividend-payers like the banks, property trusts and infrastructure companies.

The investment managers we employ in MLC MasterKey Unit Trust IncomeBuilder (MLC IncomeBuilder), Maple-Brown Abbott and Antares Equities, actively adjusted the fund's holdings when COVID emerged in early 2020. They increased exposure to companies expected to continue to sustain earnings, and reduced exposure to those more likely to be negatively impacted. While we believe changes made by our investment managers help position the fund to receive sustained dividends in future years, a significant reduction in the fund's underlying dividend income this financial year was inevitable. However, the distribution of realised capital gains this year is comparable to recent years, bolstering the total distribution paid to investors.

On Monday, 31 May 2021 the last cash distribution for the 2021 financial year (FY2021) was made to investors in MLC IncomeBuilder. Table 1 provides the annual cents per unit (cpu) distribution and its components for this financial year and the previous seven years for comparison.

Table 1: MLC IncomeBuilder distributions history

Financial year ending 31 May	2020/21	2019/20	2018/19	2017/18	2016/17	2015/16	2014/15	2013/14
Total underlying income distribution* (cpu)	2.92	6.84	8.60	7.70	7.93	8.45	8.52	8.16
Capital gains (cpu)**	8.93	9.26	14.24	4.76	9.26	8.09	14.73	5.64
Total distributions (cpu)	11.85	16.10	22.84	12.46	17.19	16.54	23.25	13.80
Franking level	63%	76%	68%	102%	89%	90%	77%	101%

* Underlying distribution consists of dividend and other income and excludes capital gains.

**Part of the capital gains are concessional capital gains which are non-tax assessable for individuals and superannuation investors as follows:

- Individual investors: approximately half of the capital gains are concessional capital gains which are not tax-assessable
- Superannuation fund investors: approximately a third of the capital gains are concessional capital gains which are not tax-assessable.

The above amounts are historical distributions and are not indicative of future distributions.

In summary, for the FY2021, the fund's:

- total distribution is moderately lower than last year due to a decrease in the fund's underlying income, comprising dividends, Real Estate Investment Trust (REIT) income, interest and other income.

- underlying income is mostly franked dividends which provide investors with a tax-efficient income stream.
- capital gains were lower than the prior year's. Half of the capital gains are concessional capital gains and are therefore not tax-assessable for individuals, and a third are not tax-assessable for superannuation fund investors. The remainder of the distributed capital gains is taxed at the investor's marginal tax rate.

While it's uncertain how COVID-19 will affect distributions in coming months and years, it's clear the outlook for corporate earnings, and the fund's ability to generate a growing income stream each year, has improved compared to the same time last year.

Underlying income distribution

We manage the fund to allow all dividends and any other income generated by the fund's investments to flow through to investors rather than 'engineering' an income stream through more frequent portfolio turnover, hybrid investments or using derivatives. In more normal environments the fund's distributions tend to be stable over the medium term, reflecting the dividend policies of the companies the fund invests in. While the current environment is unusual, we've managed the fund through other market dislocations and we continue to believe the investment approaches of our investment managers and regular fund distributions provides a more reliable way of delivering sustainable long-term tax efficient income to investors.

However, there have been times when the fund's underlying income growth (shown by the orange bars in Chart 1) slows or reduces as company earnings slow. Due to the nature of the economic shutdown required to contain COVID-19, dividends were impacted far more than in previous shocks. However, we believe our investment approach will return to producing a steady increase in income, as it has in the past 25 years since the fund's inception.

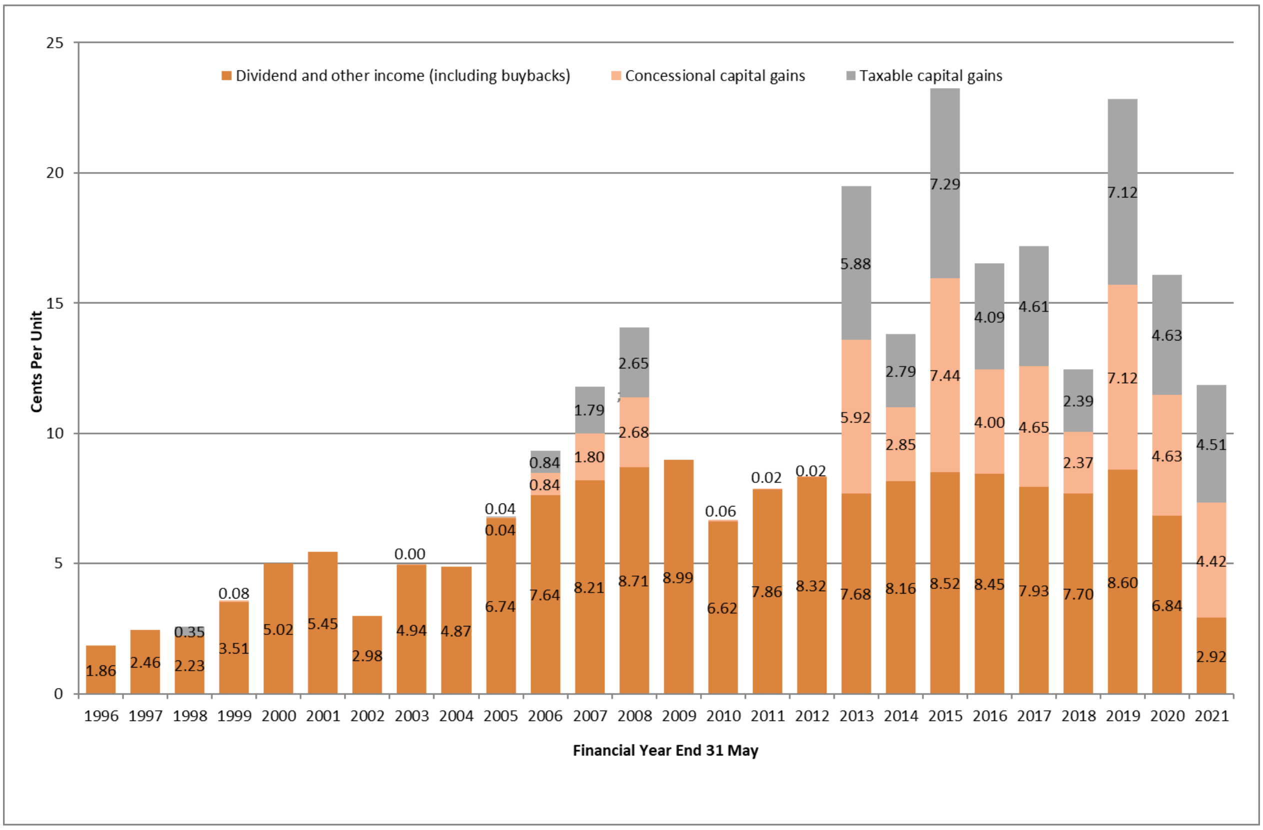
With effective management of infections and the commencement of the vaccination program both here and overseas, the market is already looking to the future with more optimism. Australia's economy has staged a remarkable recovery. As a result, the recent profit reporting period yielded better results than those we saw in August/September last year with some improvement in dividends by a range of companies.

While the economic recovery means the outlook for corporate earnings has improved, many companies are acting with caution before returning to pre-COVID dividend payments. Some industries and companies have performed well despite COVID-19, but many remain vulnerable as government support programs like JobKeeper are withdrawn. These companies are preferring to retain capital rather than paying it to shareholders and continuing to restrict dividend payments until the outlook for their industry and the success of the vaccination program becomes clearer. As a result, dividend income passed through to investors will take some time to return to pre-COVID levels.

The fund paid no distribution in August 2020 because dividends received by the fund were insufficient to cover the expenses, leaving no net income available to distribute. However, by November 2020 the fund's net income was adequate to start distributing again. As expected in this environment, the distributions of underlying income in November, February and May were considerably lower than the same time in FY2020.

While Chart 1 shows MLC IncomeBuilder's history of achieving its primary objective of producing a growing, tax-efficient income stream, this year's underlying income is understandably significantly lower than recent years.

Chart 1: MLC IncomeBuilder annual distributions



Source: MLC IncomeBuilder. Distributions are calculated net of fees. Concessional capital gains are shown for individual investors; superannuation fund investors will have lower concessional capital gains and higher taxable capital gains than shown in the chart.

The above amounts are historical distributions and are not indicative of future distributions.

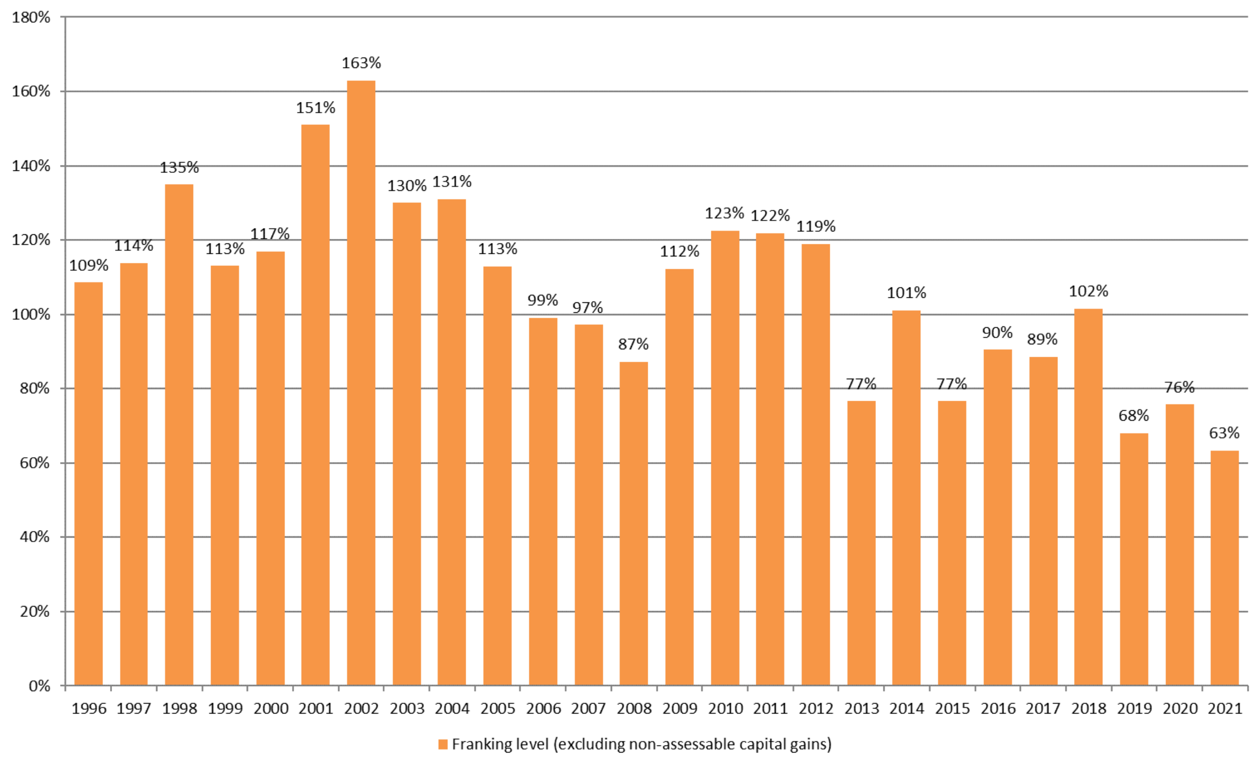
The fund's underlying income excludes capital gains and currently comprises 70% dividend income with the remainder from a small exposure to distributions of Australian REITs and interest income from the immaterial cash exposure. Most of the underlying income is franked dividends which provide investors with a tax-efficient income stream.

Franking levels

MLC IncomeBuilder has delivered a tax-efficient income stream with a franking level of 63% this year (see Chart 2). The franking level is lower than last financial year because the distribution in FY2021 comprises a much larger component of assessable capital gains than dividend income. FY2021 is the only year the fund's assessable capital gains (grey bars) have exceeded the dividend income (dark orange bars), a result of the earnings environment companies have experienced since COVID-19 reached our shores in early 2020.

Since its inception, the fund has maintained a high franking level by investing in Australian companies that derive most of their earnings from Australian sources, and therefore pay domestic tax on those earnings.

Chart 2: Franking levels for MLC IncomeBuilder



Source: MLC IncomeBuilder. Franking levels shown in the graph are calculated net of fees and exclude non-assessable capital gains for individual investors, in accordance with FSC's standard. Superannuation fund investor franking levels would be lower than shown in the graph as their concessional capital gains will be lower, and taxable capital gains higher.

The above amounts are historical franking levels and are not indicative of future franking levels.

The fund's franking level is a measure of the imputation credits attached to its income distribution.

Capital gains

Over the long term the fund has demonstrated the majority of its distributions have been franked dividend income. However, the fund is also required to distribute any realised capital gains at the end of its financial year. Capital gains can arise when the fund sells shares at prices higher than their original purchase price.

Where our active investment managers, Antares and Maple-Brown Abbott, believe share values have reached their full potential, we expect the managers to seek better long-term risk and return opportunities. In this way our managers seek to grow and preserve investor's capital over the long term, from which future franked dividend income may be generated. However, these portfolio changes can result in the realisation of capital gains.

These gains typically feature in the fund's distribution after periods of very strong market performance and as a result of corporate actions such as takeovers and buybacks. After the stringent measures imposed on companies by Federal and state governments, the Australian economy and company earnings swiftly rebounded, and the share market responded with strong price rises. Realised capital gains have therefore been generated this financial year.

Our investment managers tend to hold shares for long periods of time and don't generally buy and sell the same company within a year. Therefore the benefit of the capital gain discount is passed onto investors. That's why half of the capital gains distributed this year (shown by the light orange bars in Chart 1) were concessional capital gains, which are not tax-assessable for individuals, and a third are not tax-assessable for superannuation fund investors.

The net taxable realised capital gains portion of the annual distribution is automatically reinvested as additional units. This ensures an investor's capital base, from which their dividend income is generated, continues to grow by being re-invested in the fund. The fund has operated in this way since it was established, as it helps investors remain focussed on maintaining a growing tax-efficient income stream.

Dividends from the fund's investments

Table 2 shows dividends paid by MLC IncomeBuilder's larger company holdings in FY2021 and how their dividend has changed compared to the same time last year. More than 80% of the fund is invested in the companies below. Only 2 of these 23 companies have increased their dividend in FY2021.

Table 2: Dividends paid in FY2021, by MLC IncomeBuilder's largest company holdings, ordered from large to small exposures

Company	Dividend ($ per share)	% change in dividend compared to FY2020
Westpac	$0.31	-82%
NAB	$0.60	-64%
ANZ	$0.60	-63%
Telstra	$0.16	0%
Commonwealth Bank	$2.48	-42%
Suncorp	$0.36	-48%
Coles	$0.60	-8%
Tabcorp	0.08	-66%
Woolworths	$1.01	-2%
Amcor Depository Interests	$0.65	+27%
BHP	$2.07	-3%
Brambles	$0.26	-8%
QBE Insurance	$0.04	-84%
Star Entertainment	$0.10	+5%
Woodside Petroleum	$0.52	-62%
Scentre Group	$0.07	-69%
Incitec Pivot	$0.00	Dividend in FY2020 was $0.05
Orica	$0.33	-40%
Spark Infrastructure	$0.13	-10%
CSL	$2.82	-4%
Link Administration	$0.08	-58%
Stockland	$0.22	-21%
Medibank Private	$0.12	-22%

Securities mentioned in this commentary may no longer be held in MLC IncomeBuilder.

Outlook

We believe the fund is well placed to access the gradual recovery in dividends and resume annual distribution growth with tax benefits due to the experience and research skills of Maple-Brown Abbott and Antares Equities.

The active investment style and deep company research practiced by both managers will help position the fund's investments appropriately as the economy continues to recover and companies revise their dividends and payout ratio policies back towards pre-pandemic levels.

Additional information on company results and portfolio changes our managers have undertaken in recent months are outlined in our article MLC IncomeBuilder – the improving outlook for dividends available at mlc.com.au.

Up-to-date commentary on the performance of MLC IncomeBuilder, including information on the dividends declared by underlying companies, is available on the Fund Profile Tool on https://www.mlc.com.au/fundprofiletool**.**