MLC MasterKey Unit Trust IncomeBuilder

Annual distribution commentary, 2019 financial year
25 June 2019

Summary

MLC MasterKey Unit Trust IncomeBuilder (MLC IncomeBuilder) has a successful history of achieving its primary objective of producing a growing, tax-efficient income stream. Over 24 years there has been a fairly steady rise in the fund's underlying income distribution, with the annual underlying distributions increasing by an average of 7% pa since its inception.

On Friday, 31 May 2019 the last cash distribution for the 2019 financial year (FY2019) 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 five years for comparison.

Table 1: MLC IncomeBuilder distributions history

Financial year ending 31 May	2018/19	2017/18	2016/17	2015/16	2014/15	2013/14
Total underlying income distribution* (cpu)	8.60	7.70	7.93	8.45	8.52	8.16
Capital gains (cpu)**	14.24	4.76	9.26	8.09	14.73	5.64
Total distributions (cpu)	22.84	12.46	17.19	16.54	23.25	13.80
Franking level	69%	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 FY2019, the fund's:

- total distribution has increased compared to last year due to an increase in the fund's underlying income, comprising dividend, Real Estate Investment Trust (REIT), interest and other income.
- most of the underlying income is franked dividends which provide investors with a tax-efficient income stream.
- capital gains were higher than prior year's due to stronger returns from the industrials sector of the Australian share market than in FY2018. 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.

Underlying income distribution

The fund's underlying income excludes capital gains and currently comprises around 90% 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.

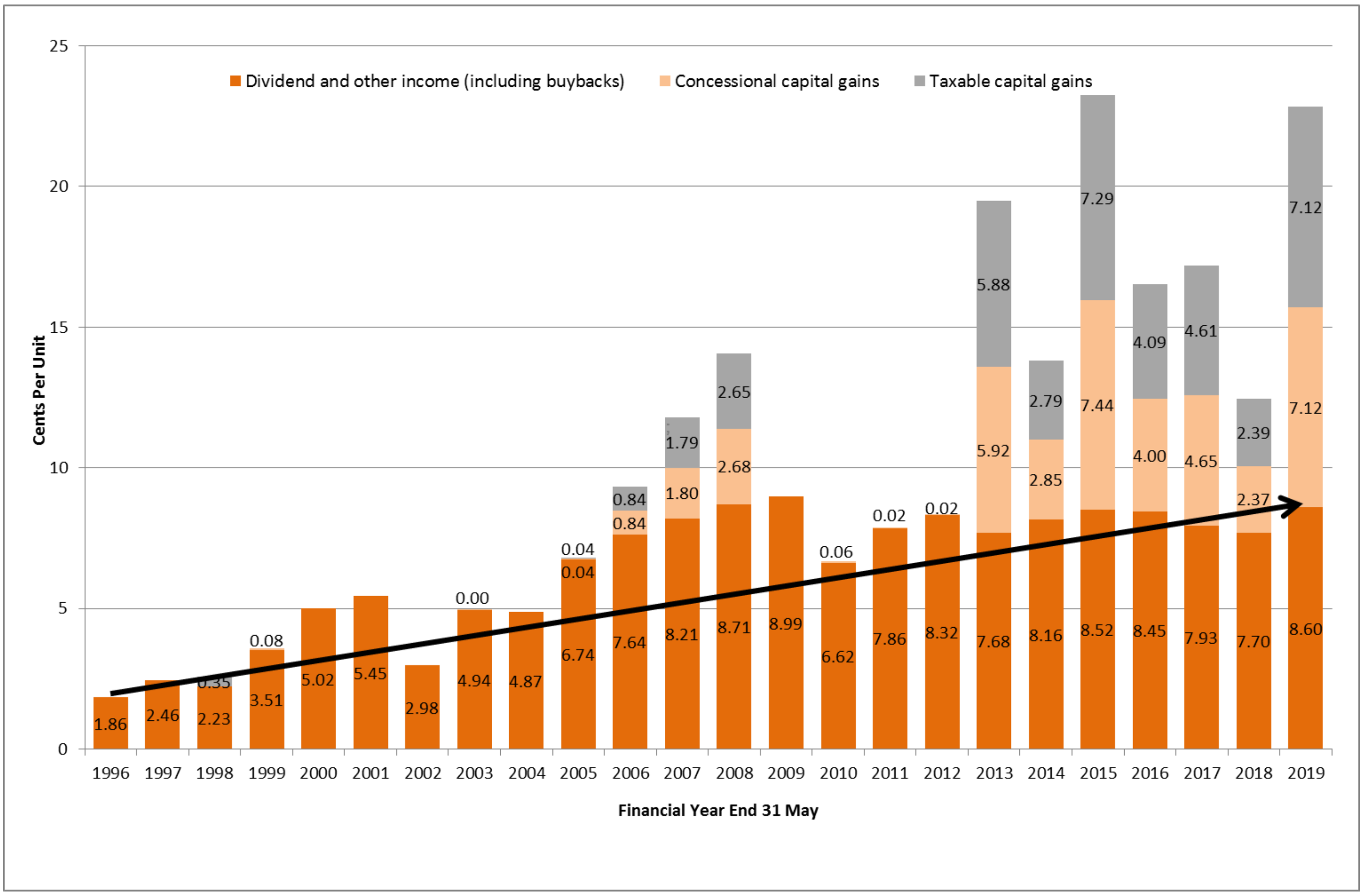
Our current investment managers continue to focus on investing in companies with:

- long-term earnings growth
- reasonable valuations for those earnings, and
- the ability to sustain or grow dividends with good franking levels.

In recent years dividends and returns of capital have been higher than normally associated with the modest earnings growth of listed companies due to changing capital management (eg return of capital to shareholders) and dividend policies, management of franking balances, and payment of special dividends.

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. We believe our approach to investment manager selection and regular fund distributions is a more reliable way of delivering sustainable long-term tax efficient income growth for investors. While there will be years when the fund's underlying income growth (shown by the orange bars in Chart 1) slows as company earnings slow, our approach has resulted in a steady increase in income (shown by the black line) since the fund's inception 24 years ago.

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 graph.

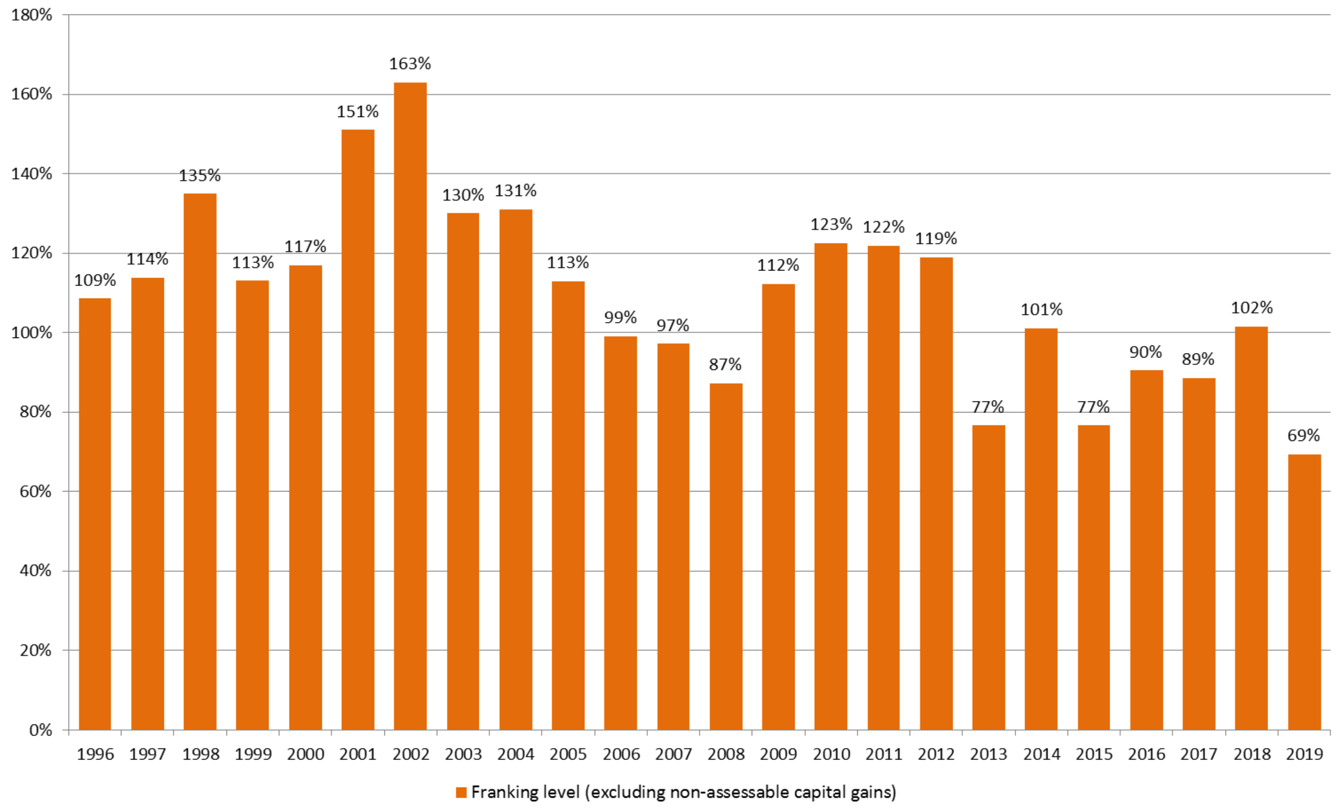
The above amounts are historical distributions and are not indicative of future distributions.

Franking levels

MLC IncomeBuilder has delivered a tax-efficient income stream with this year's franking level of 69% (see Chart 2). The franking level is lower this financial year due to an increase in capital gains generated by the fund. However, the concessional capital gains distributed by the fund as income also increased this year and these tax-efficient amounts are excluded from the franking level calculation. Concessional capital gains aren't tax-assessable for individuals and superannuation fund investors.

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.

Dividends from the fund's investments

The fund's distribution for FY2019 is higher than FY2018 due to Australian companies generally experiencing positive earnings growth.

Table 2 shows dividends paid by MLC IncomeBuilder's largest company holdings in the FY2019 and how their dividend has changed compared to the same time last year. 80% of the fund is invested in these companies. Of these companies, those that have increased their dividend in FY2019 comprise 39% of the fund. The big four banks are some of the fund's largest holdings and they had virtually no growth in their dividends due to weak housing loan growth, remediation costs, and narrowing profit margins.

Table 2: Dividends paid in FY2019, by MLC IncomeBuilder's largest company holdings

Company	Dividend ($ per share) for FY2019	% change compared to FY2018
Westpac Bank	$0.94	-
ANZ Bank	$0.80	-
National Australia Bank	$0.99	-
Commonwealth Bank	$4.31	+ 0.2%
Telstra	$0.19	-
Suncorp	$0.82	+ 12%
Stockland	$0.27	+ 4%
Woolworths	$1.05	+ 13%
Wesfarmers	$3.20	+ 43%
Woodside Petroleum	$2.00	+ 60%
QBE Insurance	$0.22	+ 92%
Tabcorp	$0.21	- 9%
BHP Billiton	$3.08	+ 148% (this increase is extraordinary due to BHP paying a special dividend in January 2019)
Coles Group	No dividend has been paid yet as Coles only became a listed company in November 2018 when it demerged from Wesfarmers	-
Brambles	$0.29	-
Harvey Norman	$0.30	+ 25%
Orica	$0.53	+ 11%
Coca-Cola Amatil	$0.47	-
AGL Energy	$1.18	+ 13%

Company	Dividend ($ per share) for FY2019	% change compared to FY2018
AMP	$0.14	- 52%
Incitec Pivot	$0.06	- 33%
Star Entertainment	$0.23	+ 47%
Sydney Airport	$0.38	+ 10%

Source: ASX, NAB Asset Management Services Limited.
Securities mentioned in this commentary may no longer be in MLC IncomeBuilder.

Capital gains

Over the long term the fund has demonstrated that 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.

The fund is managed by two high quality active investment managers, Antares and Maple-Brown Abbott. Where the managers 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. The Australian share market has risen strongly in recent years, up by an average of more than 10% each year for the past three years. If share prices continue to rise or remain high relative to the past, it's likely some capital gains will continue to be realised.

The 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. This is further evidence of the fund's tax efficiency.

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.

Outlook

Australian and global economic growth is slowing. Australian company earnings prospects had improved in recent years helped by slow wages growth, reasonable global growth, and accommodative central bank monetary policies. However earnings growth is still likely to be low single digit. With dividend payout ratios already at high levels and only modest earnings growth expected, growth in dividends is likely to be minimal at best.

In this environment, MLC IncomeBuilder is well positioned. It's diversified across industries and companies with attractive long-term prospects for earnings and sustainable 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-efficient income stream for investors.

Monthly commentary about 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**.**