MLC Wholesale IncomeBuilder

Annual distribution commentary, 2020 financial year
27 July 2020

Summary

MLC Wholesale IncomeBuilder (MLC IncomeBuilder) has a history of achieving its primary objective of producing a growing, tax-efficient income stream. However, in the final quarter of the 2020 financial year (FY2020) we've started to see the impact of COVID-19 on the ability of MLC IncomeBuilder to grow its income.

On Tuesday, 30 June 2020 the last cash distribution for the FY2020 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 six years for comparison.

Table 1: MLC Wholesale IncomeBuilder distributions history

Financial year ending 30 June	2019/20	2018/19	2017/18	2016/17	2015/16	2014/15	2013/14
Total underlying income distribution* (cpu)	6.76	8.05	7.39	7.56	7.87	8.17	7.72
Capital gains (cpu)**	2.13	7.99	2.50	5.87	3.93	10.81	3.27
Total distributions (cpu)	8.89	16.04	9.89	13.43	11.80	18.98	10.99
Franking level	79%	62%	82%	75%	86%	62%	86%

* 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 FY2020, the fund's:

- total distribution has decreased compared to last year due to a decrease in the fund's underlying income, comprising dividend, Real Estate Investment Trust (REIT) distributions, 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 deteriorated compared to recent years.

Underlying income distribution

Measures implemented by the Australian and state governments to combat the spread of COVID-19 have led to a dramatic drop in economic activity. The speed and magnitude of the decline that occurred is unprecedented. Some industries (travel, gaming, hospitality) effectively shut down overnight, while companies operating in sectors normally considered to have defensive characteristics experienced a sudden fall in demand for their products.

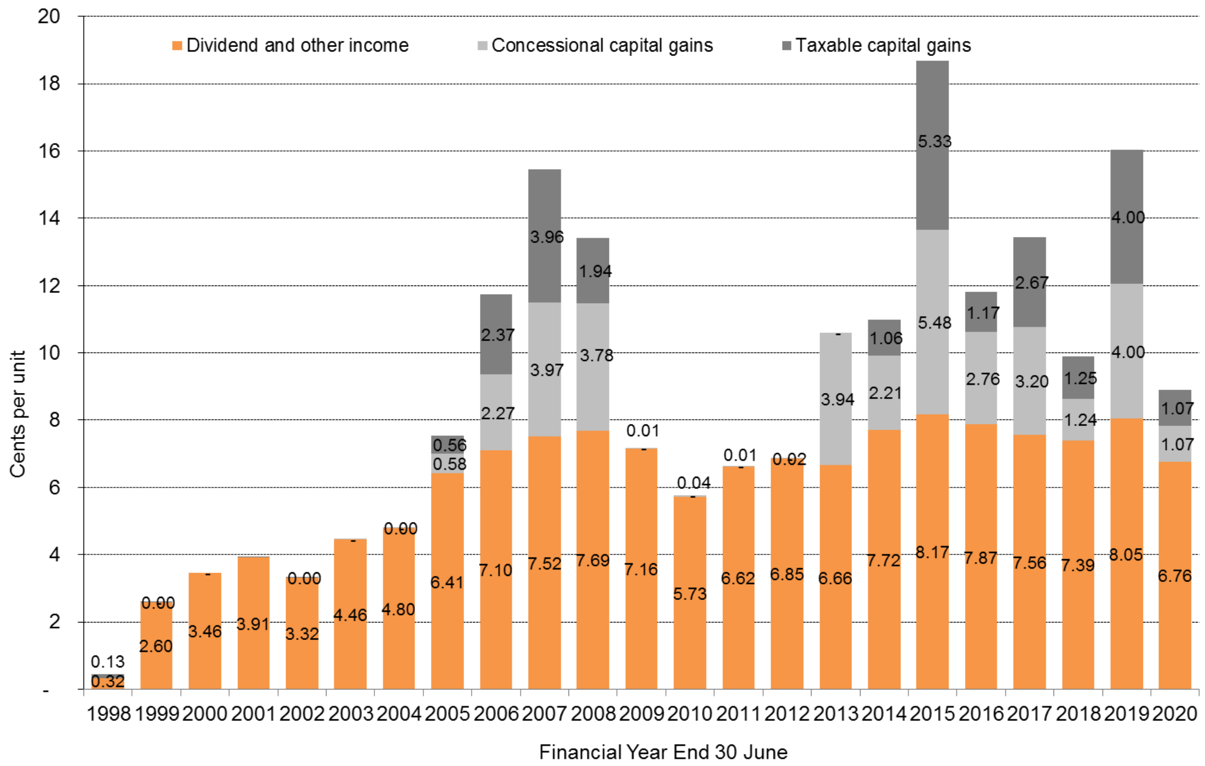
While there are a small number of companies that aren't negatively affected and are likely to maintain their dividends, some companies have deferred their dividends for the foreseeable future and will reassess when the economic impacts on their business are clearer, while others have cancelled dividends indefinitely. These changes are necessary to preserve their balance sheet strength in an extremely uncertain business trading environment, and includes large dividend-payers like the banks, property trusts and infrastructure companies.

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 reflect dividend policies of the companies the fund invests in, which tend to be more stable over the medium term. 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 growth for investors.

However, there will be times like the present, when the fund's underlying income growth (shown by the orange bars in Chart 1) slows as company earnings slow. Our experience during the GFC, which is probably the most serious market dislocation, prior to COVID-19, that we have seen in Australia in the last 30 years, where company earnings declined significantly in a very short timeframe, resulting in the fund not growing its income for two financial years.

Despite shocks to company earnings in the past, our investment approach has resulted in a steady increase in income when you look back over the entire 23 years since the fund's inception.

Chart 1: MLC Wholesale IncomeBuilder annual distributions



Source: MLC Wholesale 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. Figures are rounded to two decimal places.

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

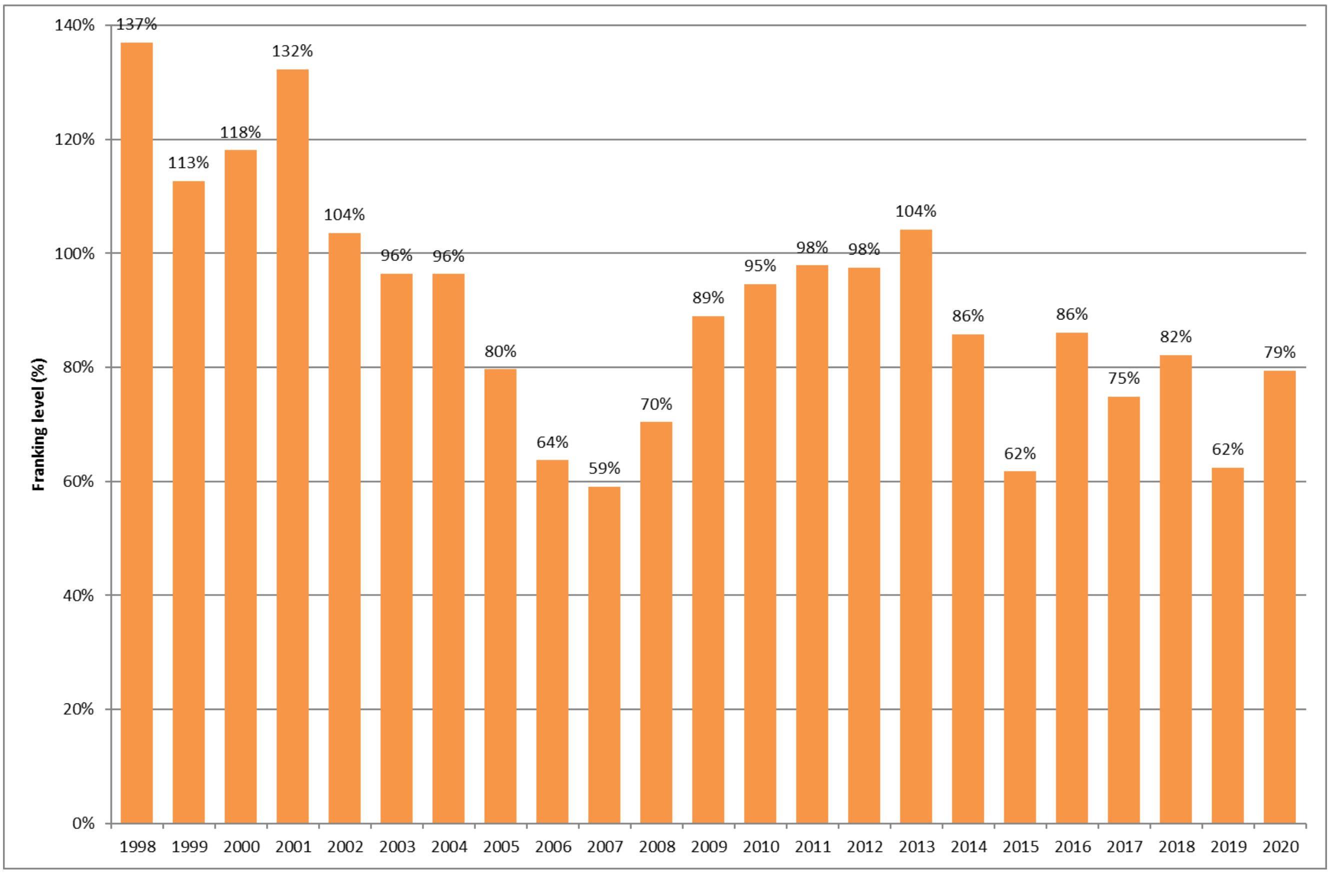
The fund's underlying income excludes capital gains and currently comprises around 59% dividend income with the remainder from a small exposure to distributions of Australian REITs and interest income from the immaterial cash exposure. Most of the underlying income is franked dividends which provide investors with a tax-efficient income stream.

Franking levels

MLC IncomeBuilder has delivered a tax-efficient income stream with a franking level of 79% this year (see Chart 2). The franking level is higher than last financial year due to a decrease in capital gains generated by the fund.

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 Wholesale IncomeBuilder



Source: MLC Wholesale 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.

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 rose strongly up until March 2020, resulting in the generation of realised capital gains in FY2020.

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 grey 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.

Dividends from the fund's investments

Table 2 shows dividends paid by MLC IncomeBuilder's larger company holdings in FY2020 and how their dividend has changed compared to the same time last year. More than 75% of the fund is invested in the companies below. Of these companies, those that have increased their dividend in FY2020 comprise only 20% of the fund.

Table 2: Dividends paid in FY2020, by MLC Wholesale IncomeBuilder's largest company holdings, ordered from large to small exposures

Company	Dividend ($ per share)	% change in dividend compared to FY2019
Westpac	$0.80	- 15%
ANZ Bank	$0.80	No change
Telstra	$0.16	- 16%
NAB	$1.66	+ 68%
Coles Group	$0.65	N/App First financial year since Coles' demerger from Wesfarmers
Suncorp Group	$0.70	- 15%
Commonwealth Bank	$4.31	No change
Star Entertainment	$0.10	- 57% Decrease due to delay in payment of Feb 2020 dividend of $0.10 until July 2020
BHP Group	$2.11	- 31% Decrease is due to BHP paying a special dividend in FY2019
Woolworths Group	$1.03	- 2%
Boral	$0.23	N/App Wasn't held in the fund for FY2019
Coca-Cola Amatil	$0.51	+ 8%
QBE Insurance	$0.52	+ 136%
Tabcorp Holdings	$0.22	+ 5%
Brambles	$0.45	+ 55% A large increase due to the payment of a special dividend
Woodside Petroleum	$1.36	- 32%
Stockland	$0.28	+ 2%
Nine Entertainment	$0.10	N/App Wasn't held in the fund for FY2019
AGL	$1.11	- 6%
Origin Energy	$0.30	+ 200%
Wesfarmers	$1.53	- 52% The decrease is largely due to Coles' dividend being paid separately since its demerger from Wesfarmers

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

MLC Wholesale IncomeBuilder

Annual distribution commentary, 2020 financial year
27 July 2020

Outlook

Beyond FY2020 we expect dividend income to be cut materially in the short term, but it's still too early to estimate the extent of dividend cuts to be made by most companies and how long it will be for company earnings and dividends to recover.

However, we believe the experience and research skills of the two investment managers we've appointed to manage IncomeBuilder, Maple-Brown Abbott and Antares Equities, will allow us to again meet the fund's objective in future years. The active investment style of both managers will help position the fund's investments appropriately through the challenging period ahead and when company earnings eventually recover. Our managers continue to research and engage with companies on a regular basis, and many companies continue to provide stock market updates, as relevant information about their business's trading conditions becomes available.

While we're closely monitoring company dividend reduction and deferment announcements, our investment managers have been looking through to the other side of this economic downturn in determining the companies they believe will provide income growth in the future. We're cognisant that leading dividend-paying companies in the Australian market will change as a result of COVID-19. Additional information on company results and portfolio changes our managers have undertaken in recent months are outlined in our article MLC IncomeBuilder – 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 at mlcam.com.au

---