MLC Wholesale IncomeBuilder

Annual distribution commentary, 2022 financial year
26 July 2022

Summary

This financial year was a positive year for investors who rely on Australian shares for income. This was unlike the 2021 financial year (FY2021), where 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. This led many companies to defer or cancel dividends due to significant uncertainty and 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.

However in the 2022 financial year (FY2022), with economic recovery and an improved outlook for corporate earnings we have seen an increase in dividend payments, in particular there were strong increases in dividend payments made by Australian banks, ANZ, NAB and Westpac. There has also been strong dividend payments generated by the resources sector, in particular from BHP and Woodside Energy.

The investment managers we employ in MLC Wholesale 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. We believe changes made by our investment managers helped position the fund to receive sustained dividends in future years, and while a significant reduction in the fund's underlying dividend income for the last financial year was inevitable, this financial year the fund's underlying dividend income and distribution of realised capital gains has bolstered the total distribution paid to investors.

On Thursday, 30 June 2022 the last cash distribution for the FY2022 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 eight years for comparison. We note that the franking of underlying dividends paid remains high.

Table 1: MLC Wholesale IncomeBuilder distributions history

Financial year ending 30 June	2021/22	2020/21	2019/20	2018/19	2017/18	2016/17	2015/16	2014/15	2013/14
Total underlying income distribution* (cpu)	5.98	3.49	6.76	8.05	7.39	7.56	7.87	8.17	7.72
Capital gains (cpu)**	12.07	2.80	2.13	7.99	2.50	5.87	3.93	10.81	3.27
Total distributions (cpu)	18.05	6.29	8.89	16.04	9.89	13.43	11.80	18.98	10.99
Franking level of distributed income (excluding non-assessable capital gains)	48%	70%	79%	62%	82%	75%	86%	62%	86%
Franking level of dividend income	97%	99%	92%	93%	96%	101%	99%	102%	98%

* 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 FY2022, the fund's:

- total distribution is significantly higher than last year due to an increase in the fund's underlying income, comprising dividends, Real Estate Investment Trust (REIT) income, interest and other income.
- approximately half of the underlying income is franked dividends which provide investors with a tax-efficient income stream.
- capital gains were higher than the prior year's. In less volatile markets we tend to see low turnover of stocks within the fund. However, turnover has been naturally higher through COVID and subsequent market recovery. With strong brought forward consumer expenditure during COVID and strong commodity prices, consumer facing companies and other businesses in the fund substantially benefited over the recent past. Some of the fund's companies continued to face growth challenges post COVID and were unable to recommence paying dividends. Our investment managers took the opportunity to trim some of these exposures and gain exposure to other companies with more sustainable dividends over the medium to long term and more reasonable valuations.
- <u>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</u> investors. The remainder of the distributed capital gains is taxed at the investor's marginal tax rate. 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 environment of the last two years has been 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.

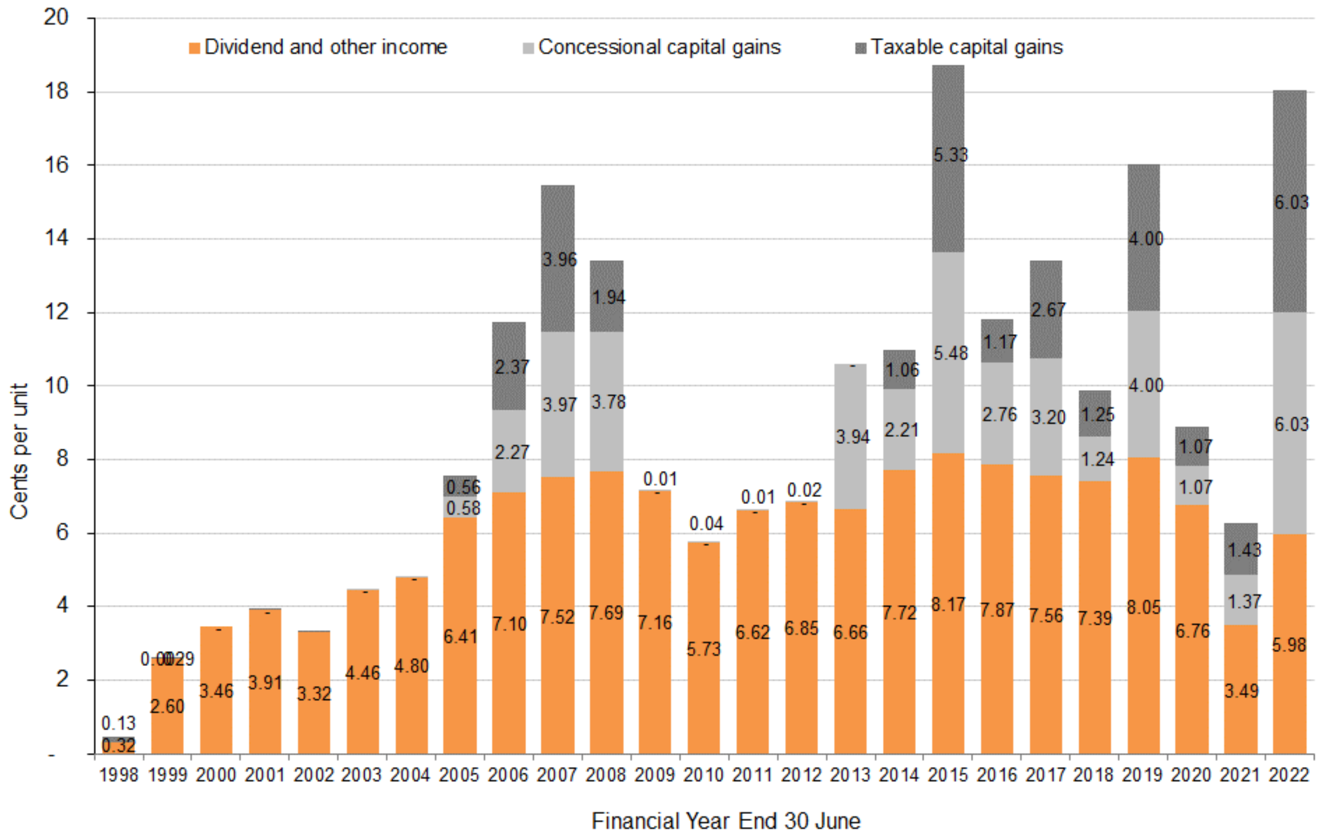
However, there have been times when the fund's underlying income growth (shown by the orange bars in Chart 1) slows or reduces as company earnings slow. Due to the nature of the economic shutdown required in the last two years to contain COVID-19, dividends were impacted far more than in previous shocks. However, as FY2022 has shown, our investment approach has returned to producing a steady increase in income, as it has in the past 25 years since the fund's inception.

The economic recovery means the outlook for corporate earnings continues to improve, and as a result, dividend income passed through to investors is returning to pre-COVID levels.

Unlike FY2021 when the distributions of underlying income in September 2020, December 2020, March 2021 and June 2021 were considerably lower than the same time in FY2020, in FY2022 the fund's net income was adequate to distribute in each quarter at levels close to pre-COVID-19.

Despite the income in FY 2021 being understandably significantly lower than recent years, Chart 1 shows that when you look back over the entire 25 years since the fund's inception, that it has a history of achieving its primary objective of producing a growing, tax-efficient income stream.

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.

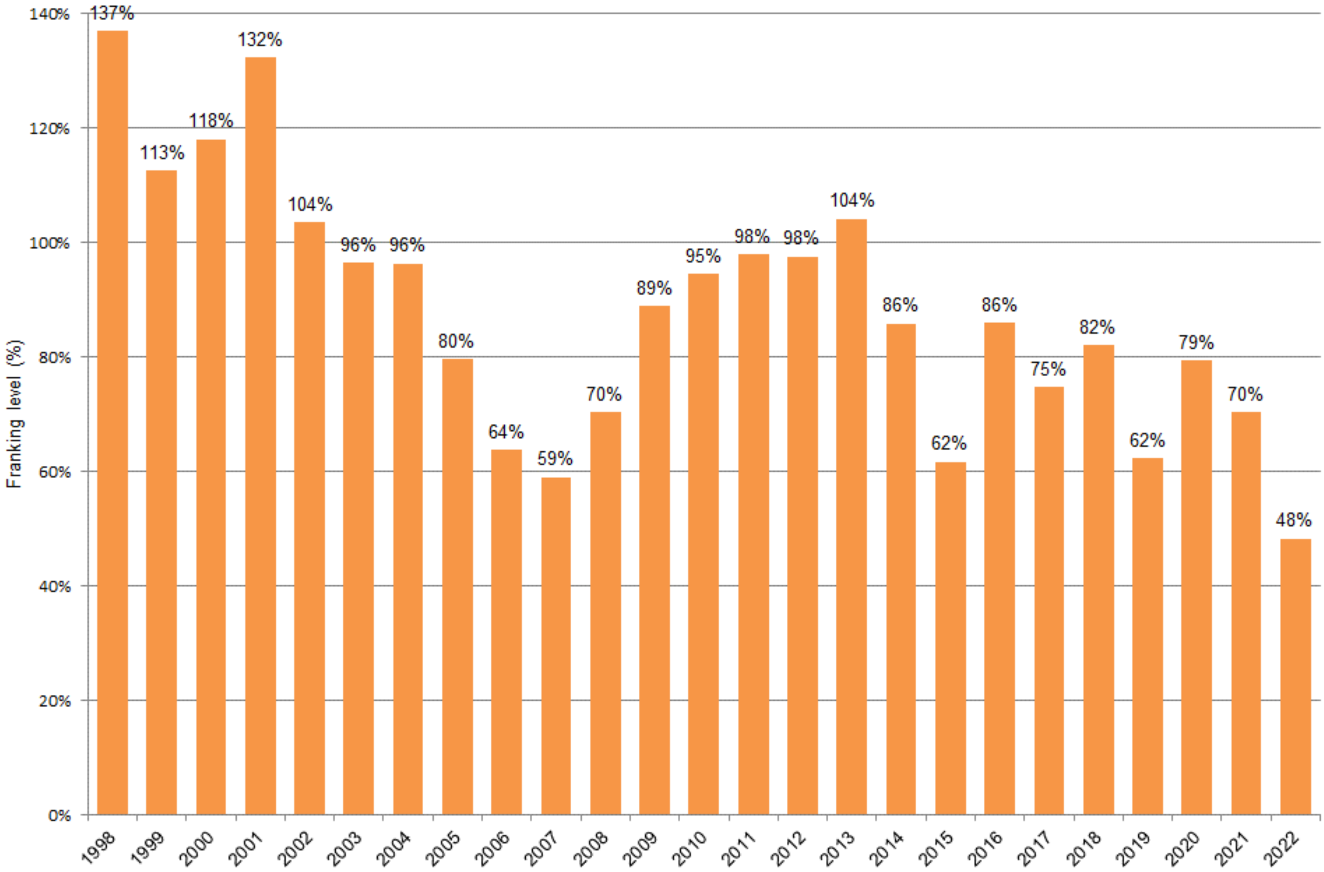
The fund's underlying income excludes capital gains and currently comprises mostly dividend income with a small exposure to distributions of Australian REITs and interest income from the immaterial cash exposure.

Franking levels

MLC IncomeBuilder has delivered a tax-efficient income stream with a franking level of 48% this year (Chart 2). The franking level is significantly lower than last financial year because the distribution in FY2022 comprises a larger component of assessable capital gains than dividend income. FY2022 is the only year the fund's assessable capital gains (dark grey bars) have exceeded the dividend income (orange bars), a result of the earnings environment companies experienced since COVID-19 reached our shores in early 2020.

Since its inception, the fund has generally 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.

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 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.

Dividends from the fund's investments

Table 2 shows dividends paid by MLC IncomeBuilder's larger company holdings in FY2022 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. While some companies didn't change, or decreased, their dividends compared to this time last year, the majority have increased their dividends significantly this financial year.

In general, Australian companies reported strong operating performance over the December half of FY2022. Around half of all companies reporting beating earnings expectations, while a quarter were in-line. Notably, retail sales remained resilient and confidence in a post-COVID economic recovery was high. The major banks in particular performed well on expectations of interest rate rises and the positive flow on effect this could have on their net interest margins.

Table 2: Dividends paid in FY2022, by MLC Wholesale IncomeBuilder's largest company holdings, ordered from large to small exposures

Company	Dividend ($ per share)	% change in dividend compared to FY2021
NAB	$1.27	112%
Westpac	$1.21	290%
ANZ	$1.42	137%
Telstra	$0.16	0%
Coles Group	$0.61	2%
Commonwealth Bank	$3.75	52%
Suncorp	$0.31	-14%
Woodside Energy	$1.87	260%
BHP	$4.80	132%
Brambles	$0.29	13%
Origin Energy	$0.20	-11%
QBE Insurance	$0.30	650%
Orica	$0.37	12%
Amcor Depository Interests	$0.50	-24%
CSL	$3.01	7%
Incitec Pivot	$0.09	Dividend in FY2021 was $0.00
Insurance Australia Group	$0.19	171%
Link Administration	$0.08	6%
Star Entertainment	$0.10	5%
Nine Entertainment Group	$0.13	79%

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

Outlook

It's clear the outlook for corporate earnings, and the fund's ability to generate a growing income stream each year as improved compared to the same time last year. While the fund's stable distribution trend was disrupted by the COVID-19 shutdowns, significantly impacting earnings of companies, distributions are now starting to recover.

We believe the fund is well placed to access the 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. These managers' investment approaches have proven they can provide a reliable way of delivering sustainable long-term tax efficient income to investors. 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 gradually return their dividends and payout ratio policies back towards pre-pandemic levels.

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