MLC MasterKey Unit Trust IncomeBuilder

Annual distribution commentary, 31 May 2014

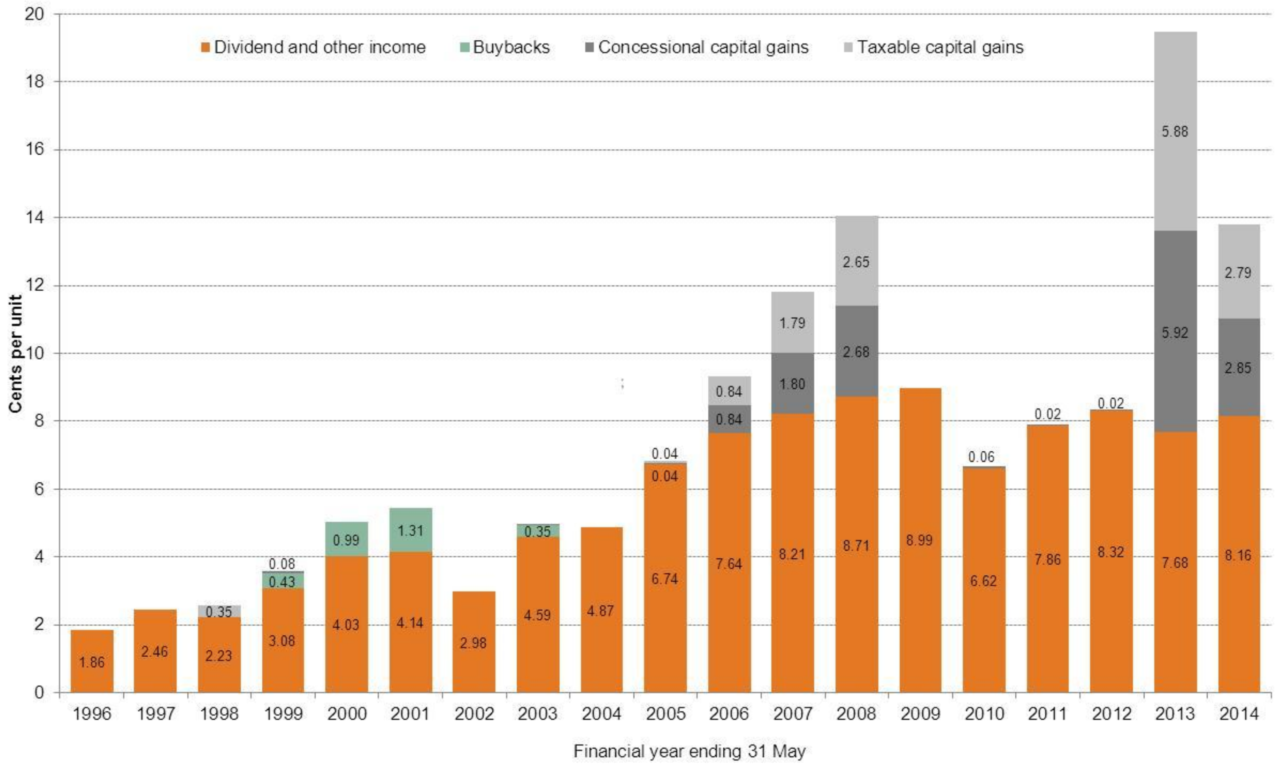
Summary

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 19 years, there has been a fairly steady rise in the fund's underlying income distribution (shown by the orange bars in Chart 1).

For the financial year ending 31 May 2014, the fund's total distribution decreased to 13.80 cents per unit (cpu). This was mostly because the capital gains component of the distribution declined from last year's unusually high level, although this component still remained quite high by the fund's historical standards. The fund's underlying income rose to 8.16 cpu, mainly due to an increase in dividend income.

While strong share markets contributed to capital gains in the fund, it also meant the value of the fund's assets increased this year.

Chart 1: MLC IncomeBuilder annual distributions



Source: MLC IncomeBuilder. Distributions are calculated net of fees.

The market environment

The Australian share market had another year of strong performance, although it didn't match the extremely high returns of FY2013. The S&P/ASX 200 Industrials Accumulation Index rose 17% over the year.

Across the Australian market, company earnings generally met expectations in FY2014. The recent profit reporting season confirmed the Australian market as a whole is on track to record high single-digit earnings growth for the financial year. However, market valuations suggest share prices already reflect this positive profit outlook.

Many companies in the share market chose to increase their dividends this year, particularly the major banks.

Underlying income distributions

For the 2014 financial year, the fund made an underlying income distribution of 8.16 cents per unit (cpu). This was 6% higher than the previous year's underlying income distribution of 7.68 cpu.

The fund's higher underlying income this year was mainly from increased dividends, as a number of companies the fund invests in raised their dividend payout rates in FY2014.

Table 1 shows the total of the most recent interim and final dividend of selected companies and how their dividend rate has changed compared with the total for FY2013.

Table 1: Total dividends from selected MLC IncomeBuilder investments

Company	2013/14 dividend ($ per share)	% change from 2012/13 dividend
ANZ	1.74	14.5
AMP	0.23	-8.0
ASX Limited	1.71	-1.4
Commonwealth Bank	3.83	6.1
Harvey Norman	0.11	23.5
National Australia Bank	1.96	7.1
Suncorp Group	0.65	44.4
Telstra Corporation	0.29	1.8
Toll Holdings	0.28	5.8
Wesfarmers Limited	1.88	9.3
Westpac Banking Corp.	1.78	4.7
Woodside Petroleum	2.08	66.6
Woolworths Limited	1.36	5.4

Source: Reuters, ASX, IRESS.

Banks remain a substantial part of the fund's portfolio and an important source of dividends. All four of the big banks increased their dividends, with ANZ recording the highest growth over the previous year (14.5%). Dividends paid by Commonwealth Bank and National Australia Bank increased 6.1% and 7.1% respectively over the last year. Although Westpac's 4.7% dividend growth was the lowest of the big four banks, it also paid two special dividends this year, totalling 20 cents per share.

For the second year in a row, Suncorp Group substantially increased its dividend (by 44.4% this year) as well as paying a special dividend of 20 cents per share. Its recent interim dividend, of 35 cents per share, was equivalent to its full year dividend in each of 2010 and 2011.

Not all companies in the Financials sector raised their dividends. AMP's full year dividend of $0.23 was 8.0% below last year’s, reflecting a fall in its underlying profit due to continuing challenges for its life insurance division.

Highlights this year included Telstra's decision to increase its dividend after years of no dividend growth. Wesfarmers continued its impressive track record of dividend growth since the global financial crisis (GFC): its total dividend of $1.88 this year was 9.3% higher than last year's.

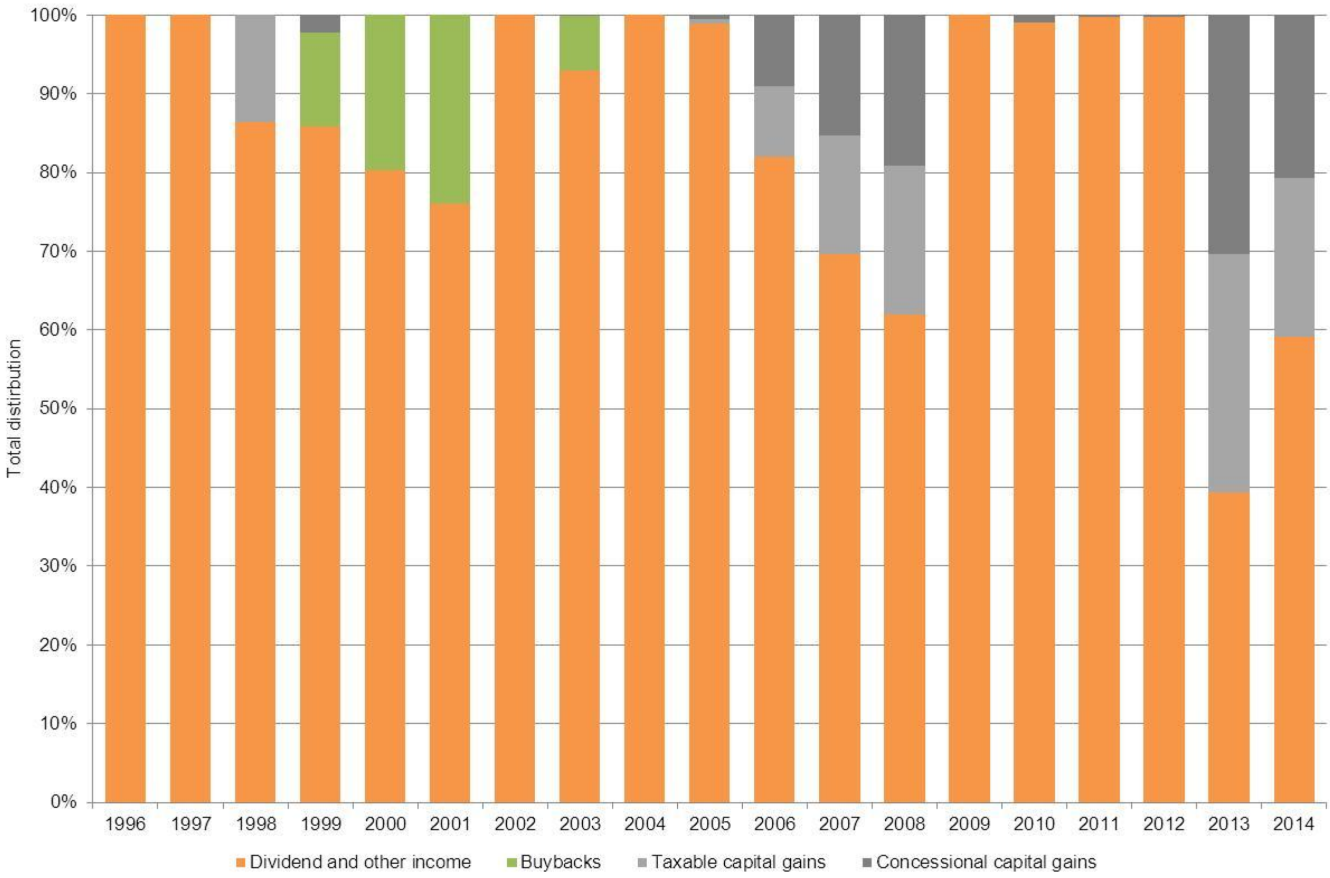
There were also rewards from the decision last year of Maple-Brown Abbott, one of the fund's investment managers, to increase holdings in companies they expected to achieve a recovery in earnings and pay higher dividends. One of those companies, Harvey Norman, recorded a 36% increase in half year net profit compared to the previous year and then raised its half year dividend by 33.3% to 6.5 cents per share. Total dividends for the last year are 23.5% above the previous year. Fairfax Media’s underlying profit increased in the most recent half year and it subsequently increased its interim dividend 100%, to 2 cents per share. However, earnings and dividends remain significantly below pre-GFC results.

Some companies increased their dividends after revising their dividend payout policies. For example, Woodside Petroleum raised its dividend payout ratio to 80% of after-tax earnings due to the company's strong liquidity position and substantial franking credit balance. The company expects to maintain this higher dividend payout policy for several years. As a result of this change, Woodside's last two dividends, totalling $2.08 per share, were 66.6% higher than last year's corresponding total dividend.

Capital gains

As Chart 2 shows, the capital gains portion of the annual distribution remained fairly high this year, at 5.64 cpu (41% of the distribution). However, more than half of this was concessional capital gains, which have favourable tax treatment.

Chart 2: Composition of MLC IncomeBuilder's distributions



Source: MLC IncomeBuilder. Distributions are calculated net of fees.

What caused the high capital gains?

As trading in the fund's investments took place in a strong market, with elevated share prices, the level of capital gains was quite high (though lower than in FY2013).

The fund realised capital gains during FY2014 due to:

- normal buying and selling of investments, and
- trading activity by the fund's managers. The fund has had full active management (rather than one active and one passive manager) since January 2013 and as we anticipated, this has meant turnover is slightly higher than in the past.

Another significant factor was that the fund had no realised capital losses carried forward from previous years to offset FY2014's realised capital gains. This meant all realised capital gains were distributed.

As Chart 2 shows, MLC IncomeBuilder has distributed realised capital gains at previous times when the share market has performed strongly. These included FY2013, when there were extremely strong returns in the Australian market, and financial years 2006 to 2008, a period of robust markets leading up to the global financial crisis.

The realised capital gains portion of the annual distribution is automatically reinvested in investors' 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.

Will future distributions include capital gains?

We expect turnover will continue to be slightly higher than before the fund moving to full active management in January 2013, due to the managers' investment activity. If share prices remain high, it's likely some capital gains will be realised.

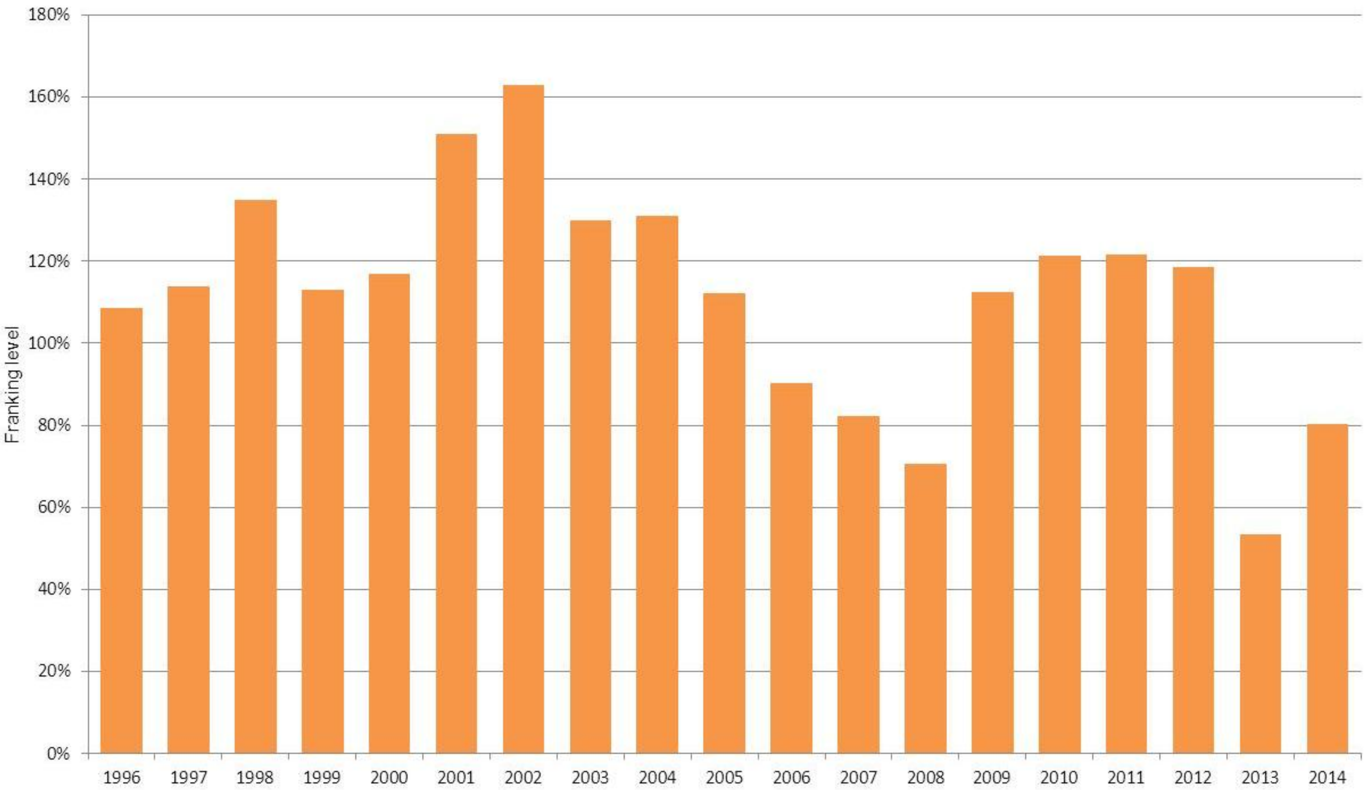
We'll continue to manage the fund as tax-efficiently as possible.

Franking levels

The franking level of MLC IncomeBuilder this year is 80% (see Chart 3), an increase from 53% in FY2013. For the four years prior to FY2013, the franking levels on the total distribution were above 100%. The decrease from that high level this financial year and last were due to the increase in distributed capital gains in those years, as the franking level is calculated as a percentage of the total distribution. Without the capital gains component, the franking levels for FY2014 and FY2013 would have been similar to FY2012.

The managers of MLC IncomeBuilder continue to focus on companies with growing and sustainable dividends and high franking levels.

Chart 3: Franking levels for MLC IncomeBuilder



Source: MLC IncomeBuilder. Franking levels are calculated net of fees

Outlook

While Australian companies are generally in good financial health, the domestic operating environment remains challenging and the outlook both here and internationally is uncertain. Although lower interest rates and the fall in the Australian dollar over the last year have eased some pressure, company earnings and dividend growth are likely to remain subdued over the next 12 months.

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.

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