MLC Investment Management

MLC MasterKey Investment Service
MLC MasterKey Unit Trust
Annual distribution commentary
May 2012

1. Distributions for FY2012

The table below sets out the cents per unit (cpu) distributions paid for the May 2012 quarter and for the full 2012 financial year (1 June 2011 to 31 May 2012) for the funds in the MLC MasterKey Unit Trust, including those available in the MLC MasterKey Investment Service.[1]

For a breakdown of the taxation components of the distribution for the 2011/12 financial year, please refer to 'MLC Unit Trust/Investment Service Distribution Tax Components 2011/2012', That document is available in July on the 'Performance and other data' page of the adviser section of mlc.com.au

	Quarter cpu	Full year cpu (yield)				
Fund	May 2012	2011/12	2010/11	2009/10	2008/9	2007/8
MLC Horizon 1 – Bond Portfolio	0.55	2.15 (2.2%)	4.67 (4.9%)	3.44 (3.3%)	5.48 (5.7%)	5.0 (5.1%)
MLC Horizon 2 – Income Portfolio	1.25	2.86 (2.9%)	4.65 (4.8%)	3.98 (4.4%)	5.11 (4.8%)	6.0 (5.1%)
MLC Horizon 3 – Conservative Growth Portfolio	1.03	1.85 (2.2%)	3.98 (4.9%)	3.93 (5.1%)	4.46 (4.5%)	8.57 (7.9%)
MLC Horizon 4 – Balanced Portfolio	1.50	2.45 (2.2%)	5.44 (5.0%)	4.46 (4.5%)	6.15 (4.1%)	15.12 (9.4%)
MLC Horizon 5 – Growth Portfolio	1.03	2.42 (2.5%)	5.06 (5.4%)	3.08 (3.6%)	5.39 (3.9%)	14.43 (9.6%)
MLC Horizon 6 – Share Portfolio	1.04	1.04 (1.4%)	4.13 (5.8%)	3.03 (4.7%)	3.97 (4.0%)	12.71 (10.3%)
MLC Horizon 7 – Accelerated Growth Portfolio	0.19	0.19 (0.3%)	3.77 (5.4%)	3.76 (6.2%)	3.57 (3.4%)	14.29 (10.1%)
MLC Australian Share Fund	1.50	4.46 (2.9%)	4.82 (3.2%)	3.20 (2.5%)	7.23 (3.9%)	27.23 (11.5%)
MLC Australian Share Value Style Fund	1.70	4.09 (4.5%)	2.83 (3.2%)	2.30 (3.0%)	6.42 (5.8%)	13.89 (9.7%)
MLC Australian Share Growth Style Fund	0.87	1.76 (1.7%)	2.95 (3.0%)	1.70 (2.0%)	1.28 (1.1%)	7.74 (5.8%)
MLC IncomeBuilder	2.76	8.34 (3.9%)	7.88 (3.6%)	6.68 (3.6%)	8.99 (3.5%)	14.05 (4.3%)

[1] MLC MasterKey Investment Service Fundamentals invests in MLC Wholesale funds, which have a June year end. The MLC Long-Term Absolute Return Portfolio, MLC Diversified Debt Fund, MLC Global Property Fund and MLC Hedged Global Share Fund in MLC MasterKey Investment Service are accessed through the MLC Wholesale funds, so they also have a June year end. As a result, this commentary does not cover those products. A separate commentary will be prepared after the final distribution in June.

Fund	May 2012 quarter cpu	2011/12 cpu (yield)	2010/11 cpu (yield)	2009/10 cpu (yield)	2008/9 cpu (yield)	2007/8 cpu (yield)
MLC Global Share Fund	0.02	0.02 (0.02%)	0.03 (0.03%)	-	-	0.61 (0.4%)
MLC Global Share Value Style Fund	0.17	0.17 (0.2%)	0.05 (0%)	-	-	2.75 (2.0%)
MLC Global Share Growth Style Fund	-	-	-	-	-	-
MLC Property Securities Fund	1.59	2.40 (4.3%)	1.97 (3.7%)	3.29 (7.1%)	4.54 (3.9%)	11.7 (7.4%)
MLC-Platinum Global Fund	-	-	-	6.90 (5.6%)	13.67 (9.9%)	18.58 (10.3%)
MLC-Capital International Global Share Fund	-	-	-	0.30 (0.5%)	1.04 (1.5%)	3.54 (4.2%)
MLC-Vanguard Australian Share Index Fund	5.17	9.19 (4.3%)	6.62 (3.3%)	6.46 (3.6%)	37.45 (12.5%)	17.16 (4.9%)

Commentary on each fund's distribution is in section 3.

More information on the performance of each fund is available on the Fund Profile Tool on mlc.com.au and is updated monthly.

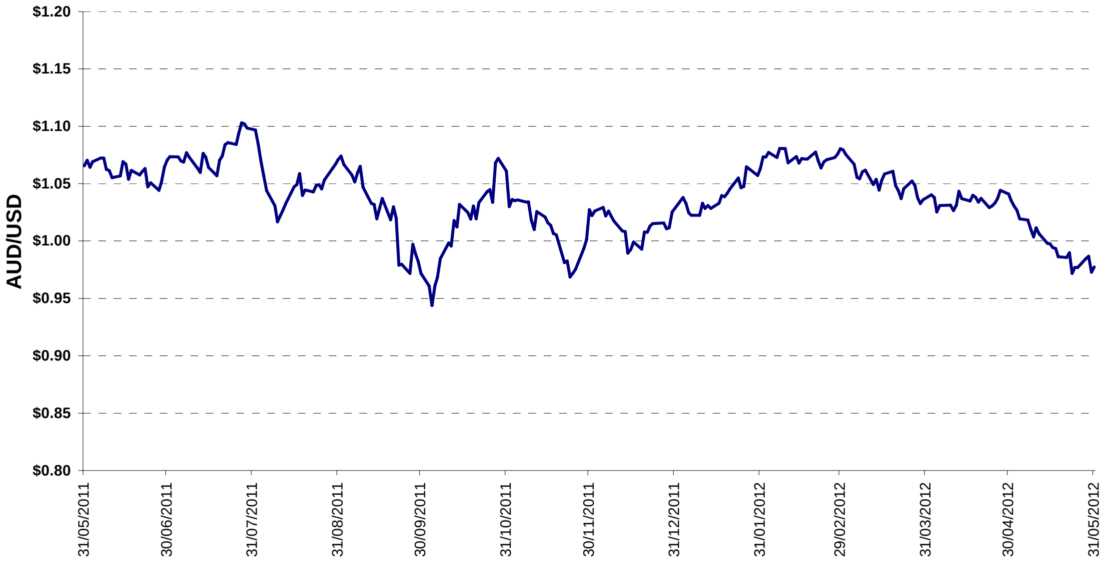
2. Key factors affecting distributions in FY2012

Currency hedging
A number of the funds hold overseas assets – shares, property and bonds – and use currency hedging to reduce their exposure to movements in the Australian dollar (AUD). For these funds, the impact of hedging was one of the most important reasons for their lower distributions this year.

In FY2012, the AUD experienced considerable volatility. For example, in terms of the US dollar (USD) the AUD moved from around USD1.10 to around USD0.96 within the space of a few months (see chart 1). For funds with global assets hedged to the AUD, this market volatility generally led to net losses on hedging contracts and contributed to lower distributions.

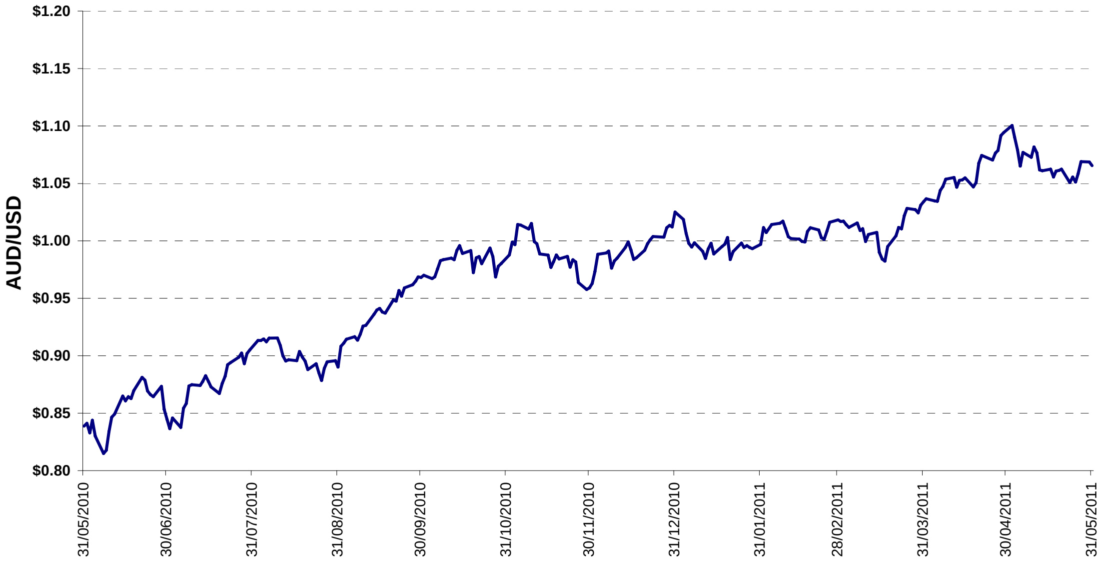
The AUD's movements this year contrast with FY2011, when a steadily strengthening AUD (see chart 2) provided income to portfolios with hedged global exposure, contributing to higher distributions.

Chart 1: US dollar to Australian dollar exchange rate for 12 months to 31 May 2012



Source: WMR

Chart 2: US dollar to Australian dollar exchange rate for 12 months to 31 May 2011



Source: WMR

The FAQ in section 4 explains how a hedging contract works.

Despite the losses on hedging contracts in FY2012, hedging to the AUD reduces exposure to currency risk and remains an appropriate strategy for some of the funds. While hedging can result in uneven distributions from year to year, it reduces the volatility of a fund's total return.

Due to tax rules, some foreign losses from previous years (such as foreign exchange losses) continued to be carried forward this year. This also impacted distributions. You can read more about this in the FAQ.

Australian shares

FY2012 was also a volatile year for Australian and international share markets, reflecting investors' concerns about the risks in Europe and China. Overall, the Australian market fell in value over FY2012, ending the year lower than it began.

Dividends paid by Australian companies, which fell sharply during the global financial crisis, have recovered over the last few years. However, that recovery tapered off during FY2012. Compared to last year, dividend income for the funds was lower overall.

While there was an increase in company earnings among many companies, dividend payout ratios generally declined this year. The uncertain economic environment meant that companies tended to keep their earnings to fund their businesses, rather than paying them to investors as dividends and having to raise funds from the markets, or increase their debt, in future.

In addition, last year funds that held Australian shares participated in the BHP share buyback. The payment the funds received in exchange for their shares led to much higher dividend income for these funds last year.

Global shares

Many international companies, particularly those in the US, have increased their earnings this year. However, overseas companies tend to pay lower levels of dividends than Australian companies. As a result, the expenses of a fund tend to mostly offset dividend income from global shares.

Because the global sharemarket has been weak, most funds have suffered capital losses on share trades, rather than making capital gains.

Australian property securities

Occupancy rates in the Australian property market were higher this year. This led to an increase in rental income and a higher distribution from property assets.

Global property

Currency losses from the AUD hedge strategy and losses carried forward from previous years have led to a small distribution of income from global property. This income is all tax deferred, which can benefit tax-paying investors.

Fixed income

Short term bonds

Fixed income strategies with short terms to maturity (up to two years) produced lower levels of income this year. That is because bond yields have now been relatively low for a number of years.

Longer term bonds

For fixed income strategies with longer terms to maturity, distributions haven't changed much from last year. In the weak economic environment, returns from longer-term bonds have been relatively strong, particularly in Australia.

A change in tax legislation this year led to increased income from some longer-term Australian bonds. On the other hand, gains from currency hedging were lower, and losses from previous years also reduced the distribution from longer-term bonds compared to last year.

3. Fund commentaries

MLC Horizon Series of portfolios

The MLC Horizon Series is a range of multi-manager, multi-asset class funds tailored to meet the needs of investors with different return expectations, time frames and tolerances for volatility. The income distributions for these funds are largely based on the income from the underlying asset classes. The allocations to the asset classes are different for each of the MLC Horizon Series of portfolios.

All of these portfolios had lower distributions for the year compared to FY2011.

MLC Horizon 1 – Bond Portfolio

MLC Horizon 1 – Bond Portfolio made a FY2012 distribution of 2.15 cpu, compared to 4.67 cpu for FY2011. The fund is focused on capital preservation and therefore invests in fixed income securities with a relatively short term to maturity. As bond yields have been low for a number of years, the distribution of interest was low.

MLC Horizon 2 – Income Portfolio

MLC Horizon 2 – Income Portfolio made a 2012 distribution of 2.86 cpu, compared to 4.65 cpu for FY2011. Most of the fund's income was generated by its investment in fixed income securities. As bond yields have been low for a number of years, the distribution of interest was low. Income from share and property investments was similar to last year. The main reason the distribution was lower this year was the losses resulting from AUD hedging on global investments in shares, property and fixed income securities.

MLC Horizon 3 – Conservative Growth Portfolio

MLC Horizon 3 –Conservative Growth Portfolio made a FY2012 distribution of 1.85 cpu, compared to 3.98 cpu for FY2011. Most of the fund's income was generated by its investment in bonds. As bond yields have been low for a number of years, the distribution of interest was low. Dividend income from Australian share investments was less than last year. However, the main reason the distribution was lower this year was the losses resulting from AUD hedging on global investments in shares, property and fixed income securities.

MLC Horizon 4 – Balanced Portfolio

MLC Horizon 4 – Balanced Portfolio made a 2012 distribution of 2.45 cpu, compared to 5.44 cpu for FY2012. Most of the fund's income was generated from dividend income from shares in Australian and overseas companies, although dividend income was lower than last year. Income from fixed income securities was also less. However, the main reason the distribution was much lower than last year was the losses resulting from AUD hedging on global investments in shares, property and fixed income securities.

MLC Horizon 5 – Growth Portfolio

MLC Horizon 5 – Growth Portfolio made a FY2012 distribution of 2.42 cpu, compared to 5.06 cpu for FY2011. Most of the fund's income was generated from dividend income from shares in Australian and overseas companies, although dividend income from Australian shares was much lower than last year. Income from fixed income securities was also less. However, the main reason the distribution was much lower than this year was the losses resulting from AUD hedging on global investments in shares, property and fixed income securities.

MLC Horizon 6 – Share Portfolio

MLC Horizon 6 – Share Portfolio made a FY2012 distribution of 1.04 cpu, compared to 4.13 cpu for FY2011. Most of the fund's income was generated by dividends from shares in Australian and overseas companies. Dividend income from Australian shares was considerably lower than last year. However, the main reason the distribution was much lower than last year was the losses resulting from AUD hedging on global share investments.

MLC Horizon 7 – Accelerated Growth Portfolio

The distribution for MLC Horizon 7 – Accelerated Growth Portfolio for FY2012 was 0.19 cpu, compared to 3.77 cpu for FY2011. Most of the fund's income was generated by dividends from shares in Australian and overseas companies. Dividend income from Australian shares was much less than last year. Gearing costs (such as interest) reduced the fund's income further. However, the main reason the distribution was much lower this year was the losses resulting from AUD hedging on global share investments.

Australian share funds

MLC Australian Share Fund

The fund's FY2012 distribution decreased from last year due to the factors affecting Australian shares outlined on page 4. Most of this year's distribution consisted of fully franked dividends.

MLC Australian Share Value Style Fund

The fund's FY2012 distribution increased from last year. This was because it invests in an underlying trust that distributes in June, and last June's distribution was high due to rising dividend income in FY2011. Most of this year's distribution consisted of fully franked dividends.

MLC Australian Share Growth Style Fund

The fund's FY2012 distribution decreased from last year due to the factors affecting Australian shares outlined on page 4. Most of this year's distribution consisted of fully franked dividends.

MLC IncomeBuilder
The fund provided a total distribution of 8.34 cpu for the financial year, with underlying income of 8.32 cpu, mainly from dividends. This is 5.8% higher than the previous year's 7.86 cpu underlying distribution and reflects the continued recovery in company profits and dividends by a number of companies the fund invests in. However, the earnings growth environment was challenging for many companies, particularly those who had to contend with a high Australian dollar or with exposure to weak consumer sentiment. For these companies, operating conditions were challenging and dividends either remained flat or were lower.

The capital gains portion of the annual distribution was again very low at 0.02 cpu and consisted solely of concessional capital gains. Capital gains realised during the year were a result of normal buying and selling, and were largely offset by capital losses.

For more information about the distribution of MLC IncomeBuilder please refer to the MLC IncomeBuilder™ annual distribution commentary, which is available on the 'Performance & pricing' page of the adviser section of mlc.com.au

MLC-Vanguard Australian Share Index Fund
The fund increased its distributions from 6.62 cpu last year to 9.19 cpu this year. MLC took advantage of weakness in the share market this year to restructure the pool of assets the fund invests in. We brought together several pools managed by Vanguard, as the increased scale of the combined pool should create some efficiencies. Share trading activity in the restructure led to some realised capital gains.

Global share funds

MLC Global Share Fund
The fund made a very small distribution of 0.02 cpu, similar to last year's distribution of 0.03 cpu. Weak global share markets meant there were no realised capital gains.The distribution consisted of capital gains tax concessional income.

MLC Global Share Value Style Fund
The fund's distribution of 0.17 cpu was very small, though higher than last year's distribution of 0.05 cpu. Weak global sharemarkets meant there were no realised capital gains. The distribution consisted of foreign dividends and capital gains tax concessional income.

MLC Global Share Growth Style Fund
This year, as last year, the fund did not have any income to distribute. Most of the fund's distributions usually consist of realised capital gains. This year, the weak global sharemarkets has meant meant there were no capital gains.

MLC-Platinum Global Fund
Like last year, the fund paid no distribution this year. Most of the fund's distribution usually consists of gains from share trading and currency contracts. This year these have been offset by capital losses, due to weak global sharemarkets, and hedging losses.

MLC-Capital International Global Share Fund
Like last year, the fund paid no distribution this year. Income was offset by expenses and sharemarket weakness has resulted in capital losses.

Property securities

MLC Property Securities Fund
The distribution this year of 2.40 cpu increased over last year's of 1.97 cpu. This slight increase was due to higher rental income from increased occupancy rates.

4. Frequently asked questions

Q. How is the level of distributions determined?

A. Distributions are made up of income from the underlying investments held by the managed fund and are paid to investors after fees are deducted. These investments may be shares, property, bonds or cash, or a combination of these. This means a distribution could include interest earned, franked and unfranked dividends, tax deferred income, rental income and any realised capital gains (after deducting any capital losses) made from selling investments (which usually occurs in the last quarter of the financial year). For global investments, currency movements resulting in changes in the value of hedging contracts can also affect income distributions.

Q. Why do distributions continue to be low for many funds this year?

A. Distributions remain low this year because tough economic conditions have resulted in:

- weakness in sharemarkets. Falling share prices means trading activity by the funds this year has generally resulted in realised capital losses. Even if markets do improve, many of the funds also have losses carried forward from previous years which will continue to hold back distributions (see the later FAQ on prior losses)
- low rates on cash and on bond investments with shorter terms to maturity, and
- volatility in the value of the AUD, which means that funds that hedge currency exposure to the AUD have generally realised losses this year.

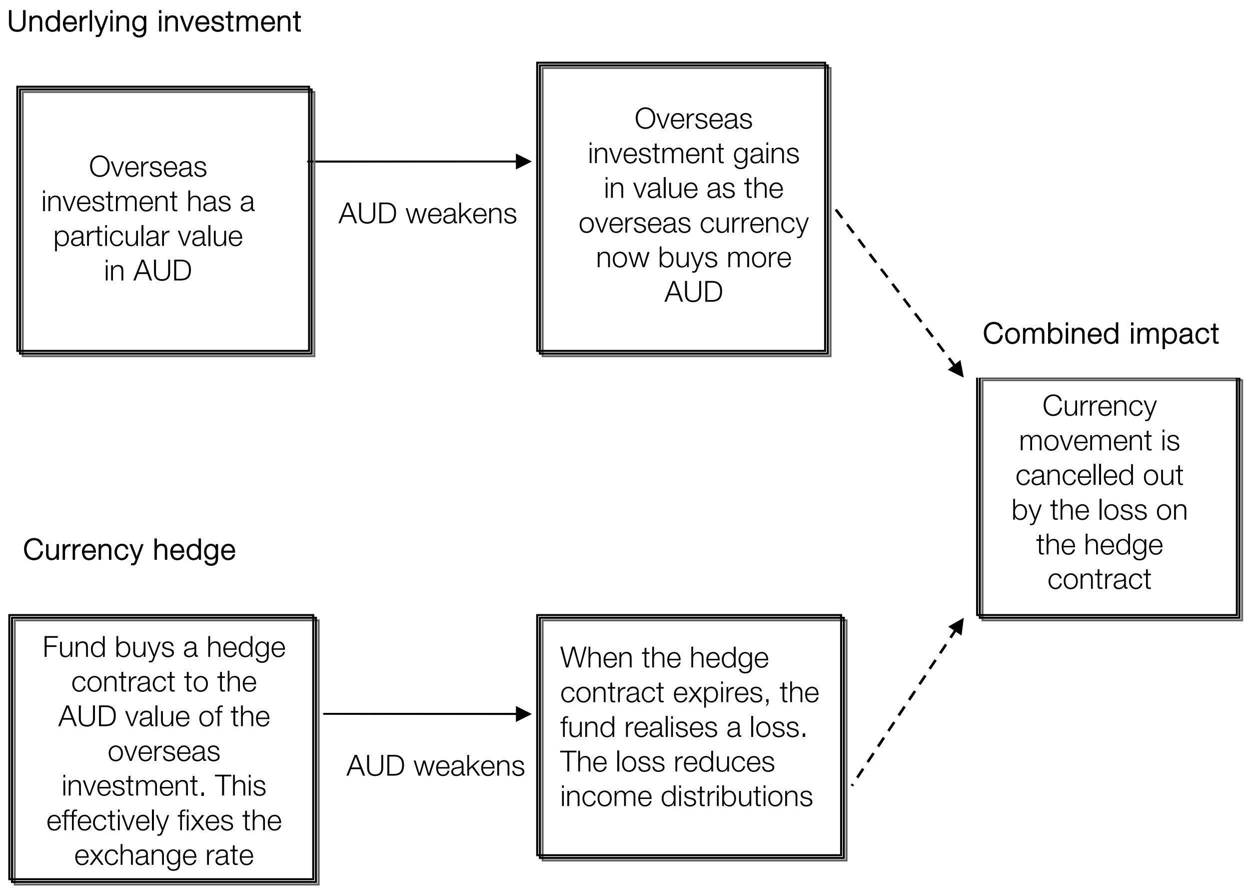
Q. Why are company dividend levels still relatively low?

A. Despite a pick-up in corporate profits, dividend pay-out ratios and company dividends generally remain relatively low. Lower company dividends can be due to a number of factors, including pressure on profit margins, poor sales and the need for companies to retain profits to fund their businesses. A company may choose not to pay dividends because it's cheaper for them to reinvest profits in their business than raise money by borrowing or raising funds in the sharemarket.

Q. How does currency hedging provide protection from currency movements?

A. If you invest in funds that hold overseas assets, such as global shares, property or bonds, your income and capital are exposed to currency fluctuations. This can impact your return positively or negatively, depending on your exposure to various currencies and movements in their exchange rates. If a fund has an AUD currency hedging strategy, it helps reduce the impact of currency movements on global exposures and smooth out the overall return on your investment. However, the income and growth components of the overall return, particularly for share and property investments, can still be quite volatile.

When MLC hedges exposure to global investments, our intention is to remove most of the effect of currency losses and gains from your global exposures. That way, overall returns are driven by the performance of the underlying investment rather than currency movements. The following example explains how the hedging contract largely removes the impact of currency when the AUD depreciates or weakens in value.[2]



So the loss from the currency hedge offsets the increase in value (in AUD) of the overseas investment.

The currency hedge means the total return you receive depends on the performance of the underlying investment – not the movement in the value of the AUD.

Q. How does hedging impact income distributions?

A. As the example above explains, currency hedging can help smooth the impact of foreign currency fluctuations on an investor's total return. The length of MLC's hedging contracts varies, but is typically one month. Any hedging gains or losses the fund realises when the hedging contract expires impact the income distributions for investors. Hedging gains are treated as income, while hedging losses are offset against other sources of income such as interest, dividends and hedging gains.

[2] In practice, the value of the hedging contract may differ slightly from the underlying investment value so the investment may not always be 100% hedged.

Q. How do prior foreign losses impact future distributions?

A. In 2009, there was a change in the tax treatment of foreign losses (such as currency losses). Until then, a fund could only offset losses on foreign hedging contracts against foreign hedging contract gains. This meant many of our global funds had accumulated substantial foreign losses.

The change in the tax rules allows a fund to offset foreign losses against any income. However, to deal with the foreign losses accumulated before 1 June 2009, the tax rules permit a fund to offset a maximum of only 20% of those losses each year for up to five years.

As a result, some of the foreign losses incurred before 1 June 2009 are still being carried forward and will continue to offset gains over the next two years. This may reduce distributions from funds that have hedged global exposures.