MLC Wholesale IncomeBuilder

Annual distribution commentary, 30 June 2016

Summary

MLC Wholesale 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). The annual underlying distributions have increased in 14 of the 19 years since its inception.

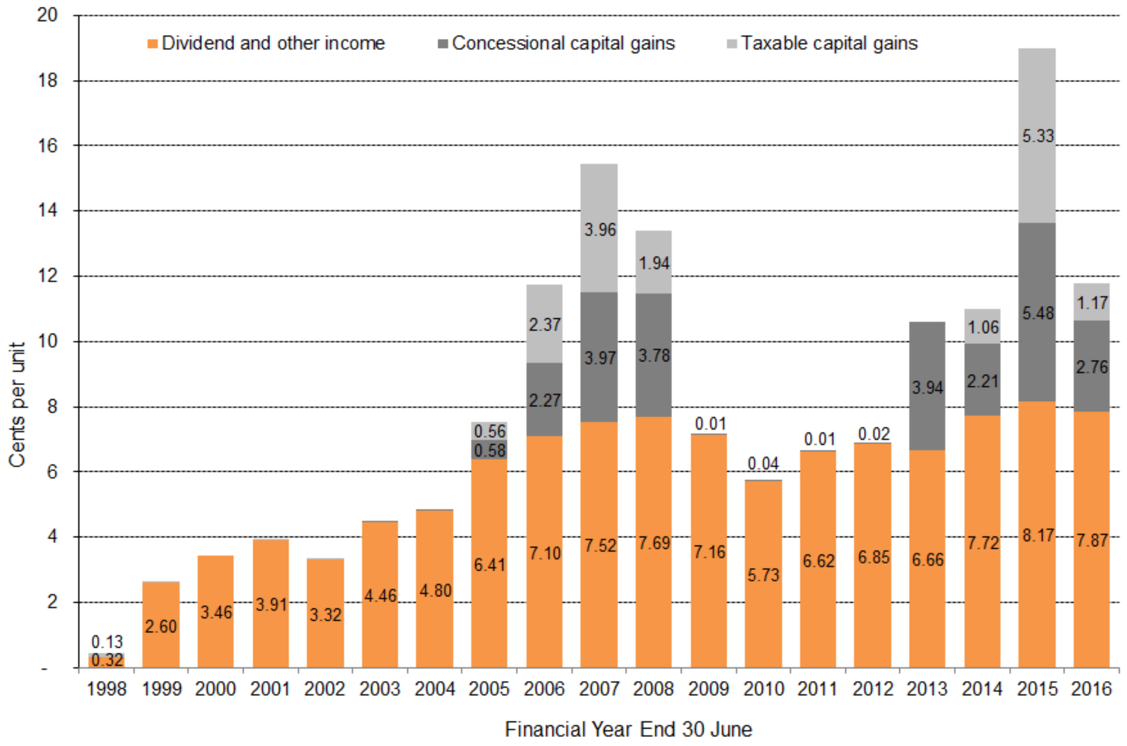
For the financial year ending 30 June 2016, the fund's total distribution decreased to 11.80 cents per unit (cpu), compared to 18.98 cpu for FY2015. This was mostly due to a fall in capital gains. Capital gains in FY2015 were higher largely due to more mergers and acquisitions activity and stronger market performance.

The fund's underlying income, comprising dividend and other income but excluding capital gains, decreased slightly to 7.87 cpu when compared with 8.17 cpu in FY2015. The fund's dividend income increased by a small amount when compared to FY2015 but interest and real estate investment trust income reduced resulting in a decrease to underlying income. Most of the underlying income is franked dividends which provide investors with a tax-efficient income stream.

The capital gains portion of the annual distribution remained fairly high this year, at 3.93 cpu, although much smaller when compared to 10.81 cpu for FY2015. More than two thirds of the capital gains are concessional capital gains, which are tax-free for individuals and superannuation fund 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 **www.mlcinvestmenttrust.com.au/fundprofiletool**.

Chart 1: MLC IncomeBuilder annual distributions



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

Effect of slower economic growth

Volatility in the Australian share market has made it a challenging year for many investors.

There are many factors that affect the share prices and dividends of companies listed on the share market. Economic growth is a common factor that affects most companies. In a growing economy, customers generally have more money to pay off their debts or spend on the goods and services companies produce. When customers spend more, company earnings and profits may increase, leading to higher dividends and share prices. But an economy growing slowly or contracting has the opposite effect on dividends and share prices.

The global economic environment has been mixed this year, with America and Europe seeing mild growth and China gradually slowing. Australia's economic growth is likely to be sedate given the impact of falling mining investment and low wages growth. Solid retail spending and housing construction are partly compensating for this "growth gap".

Many Australian companies did not increase their earnings and dividends in FY2016. Fewer companies have paid special dividends and share buybacks than in prior years. Merger and acquisition activity was also lower than in previous years.

The combination of weak share markets and company earnings and lower merger and acquisition activity has resulted in a decrease in the fund's FY2016 distributions.

Underlying income distributions

The fund's underlying income excludes capital gains and therefore comprises around 60% dividend income with the remainder from Australian real estate investment trusts and a small amount of interest income.

For the 2016 financial year, the fund made an underlying income distribution of 7.87 cpu which is around 4% lower than the previous year's underlying income distribution of 8.17 cpu, but was higher than FY2014.

While dividend income increased slightly when compared to FY2015, interest and real estate investment trust income reduced resulting in the decrease to underlying income. Most of the underlying income is franked dividends which provide investors with a tax-efficient income stream.

Table 1 shows the dividends of the fund's largest 10 holdings and how their dividend has changed compared to FY2015. Almost 60% of the fund is invested in these companies.

Table 1: Total dividends from the top 10 companies in MLC IncomeBuilder

Company	2015/16 dividend ($ per share)	% change from 2014/15 dividend
AMP	$0.80	↑ 2%
ANZ Bank	$1.81	↑ 2%
Commonwealth Bank of Australia	$4.20	↑ 1%
National Australia Bank	$1.98	-
Stockland	$0.24	↑ 1%
Suncorp	$0.80	↓ 26%*
Telstra	$0.31	↑ 3%
Wesfarmers	$2.02	↓ 12%*
Westpac Bank	$1.87	↑ 1%
Woolworths	$1.16	↓ 17%

* These companies didn't pay a special dividend in FY2016.

Source: Reuters, ASX, IRESS.

It has been a challenging year for earnings and dividend growth. Of these ten companies, six paid dividends that were higher than the corresponding period last year. However, dividend increases were modest compared to those that decreased.

The major banks continue to be a source of higher dividends. ANZ, Commonwealth Bank and Westpac all increased their dividends. However, the rate of dividend growth is lower than the previous year, with no increase in National Australia Bank's dividend this year.

Woolworth's dividend decreased because they had a significant fall in earnings this year. Dividends from Wesfarmers and Suncorp also fell sharply because they didn't pay special dividends this year.

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. While FY2016 was a relatively weak year for the Australian share market, the market had risen strongly in the prior five years. Additionally, due to the strong market performance, since 2013 the fund had no realised capital losses carried forward from previous years to offset realised capital gains. This meant all realised capital gains were distributed. If share prices continue to rise or remain high relative to the past, it's likely some capital gains will continue to be realised.

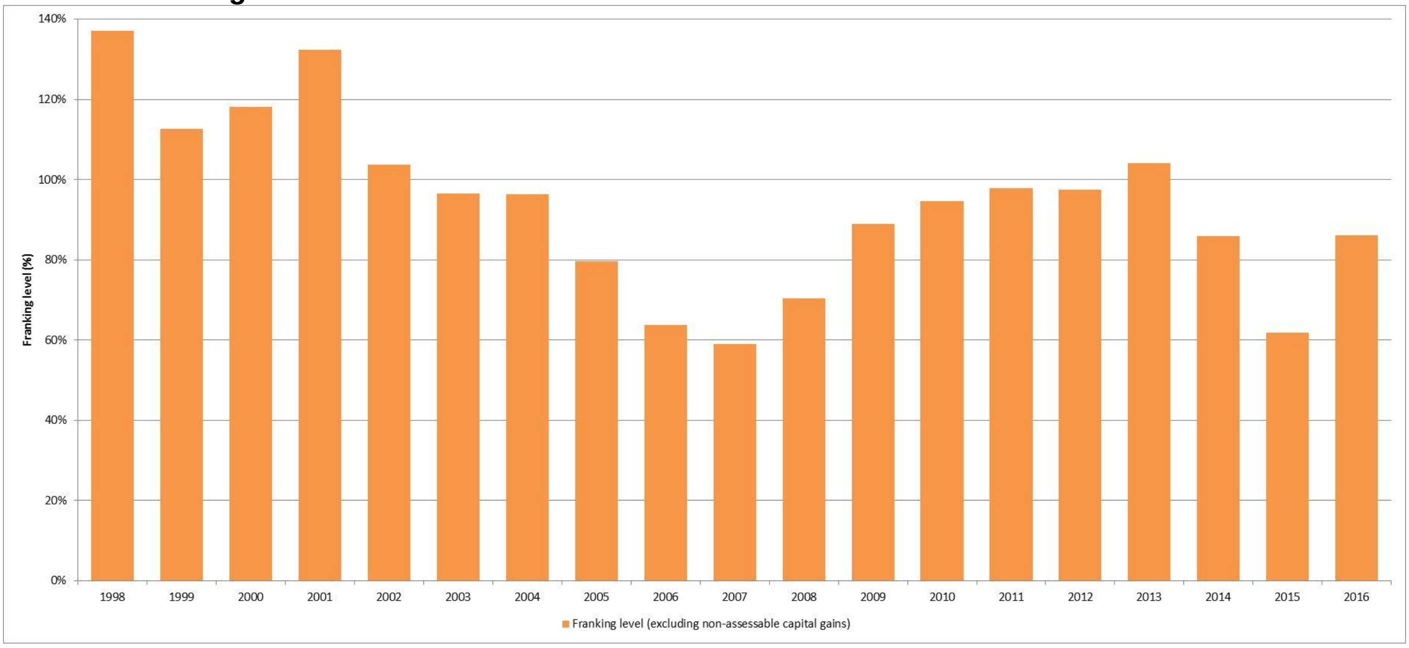
Our fund managers tend to hold shares for long periods of time and don't generally buy and sell the same company within a year. Therefore the benefit of the capital gain discount is passed onto investors. That's why more than two thirds of the capital gains distributed this year (shown by the dark grey bars in Chart 1) were concessional capital gains, which are tax-free for individuals and superannuation fund investors. This is further evidence of the fund's tax efficiency.

Franking levels

The franking level of MLC IncomeBuilder this year is 86% (see Chart 2), an increase from 62% in FY2015. The franking level is below 100% because the distribution includes assessable capital gains and the franking level is calculated as a percentage of the distribution excluding non-assessable capital gains.

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

Chart 2: Franking levels for MLC IncomeBuilder



Source: MLC IncomeBuilder. Franking levels are calculated net of fees. We've recalculated historical franking levels to remove non-assessable capital gains. FSC's standard includes assessable capital gains in the calculation but prior to this financial year we had included non-assessable capital gains too, resulting in lower franking levels. We've now removed non-assessable capital gains from the franking levels shown.

Outlook

The Australian economy and operating environment remains challenging. The outlook both here and globally is uncertain and growth remains modest. Although lower interest rates and the weaker 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.

Dividend growth is likely to be at a slower pace as payout ratios (the % of earnings paid to shareholders as dividends) are already elevated. Also, a number of companies who paid special dividends last year (Suncorp, Tabcorp, Harvey Norman, Wesfarmers) have either paid lower special dividends this year or not paid one at all.

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.