MLC MasterKey Unit Trust IncomeBuilder

Annual distribution commentary, 31 May 2015

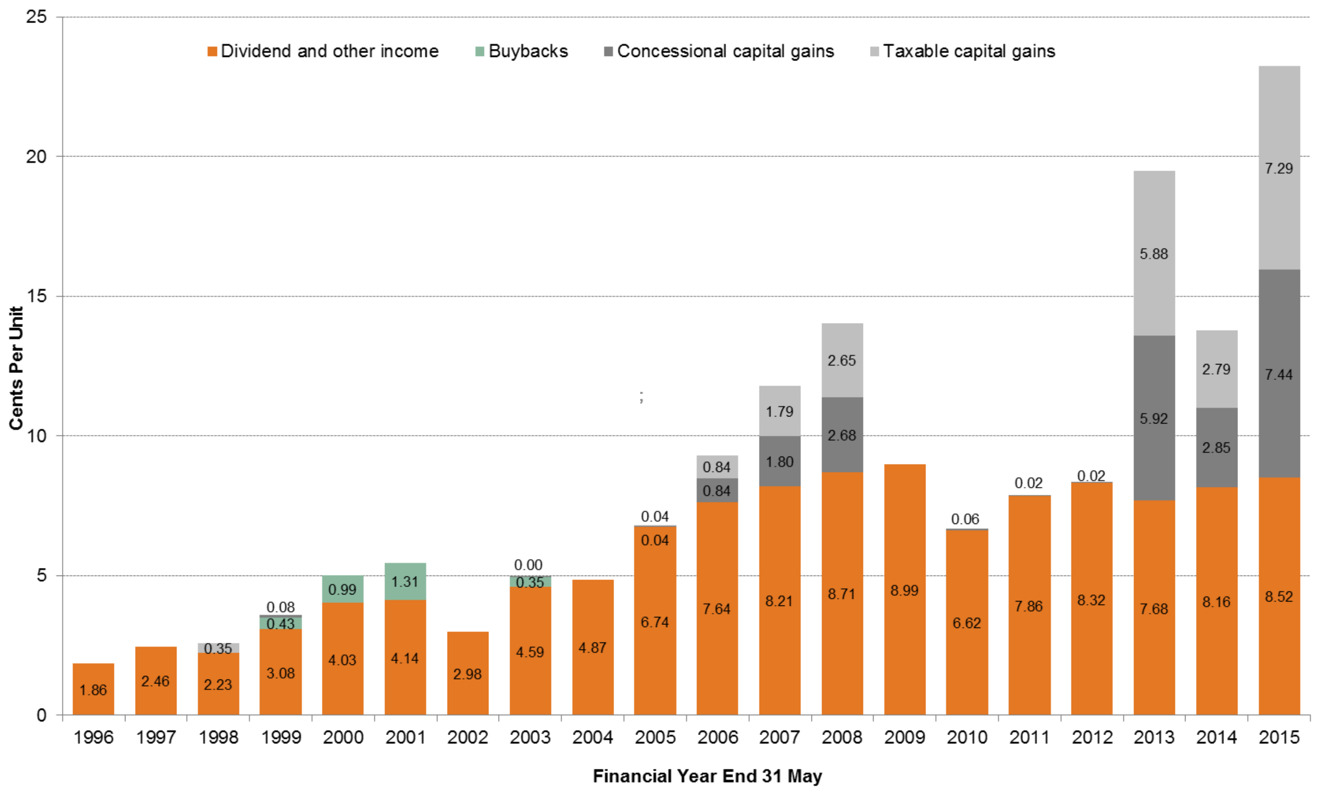
Summary

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 20 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 16 of the 20 years since its inception.

For the financial year ending 31 May 2015, the fund's total distribution increased to 23.25 cents per unit (cpu), compared to 13.80 cpu for FY2014. This was mostly due to increases in the dividend income and capital gains. The fund's underlying tax efficient income rose to 8.52 cpu, mainly due to the companies the fund invests in increasing their dividends in FY2015. These dividends that form the underlying income typically have a high level of franking which provides investors in the fund with a tax efficient income stream.

While strong share markets contributed to capital gains in the fund, it also meant the value of the fund's assets increased this year. The capital gains portion of the annual distribution remained high this year, at 14.73 cpu, as markets have risen strongly over recent years. Approximately half of the capital gains are concessional capital gains, which have favourable tax treatment.

Chart 1: MLC IncomeBuilder annual distributions



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

The market environment

The Australian share market continued its robust performance in FY2015, with the S&P/ASX200 Index rising 9.9% over the year. The high return by the All Industrials Accumulation Index (14.9%) offset the comparatively poor return (-10.0%) by the All Resources Accumulation Index. The market has now been strong for three years averaging 17.4% pa. Although fund managers have generally had low levels of trading (ie buying and selling companies in the funds), when fund managers sold shares, they often received prices higher than the original purchase prices of the shares, and would lock in, or 'realise', capital gains.

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.

Across the Australian market, company earnings were low single digit and generally met market expectations, however companies with offshore earnings tended to exhibit higher growth. The non-mining economy was boosted throughout the year by lower interest rates and the continued weakness in the AUD. Many companies chose to return capital to their shareholders rather than re-investing for expansion. Dividend payout ratios generally remained high, and many companies increased their dividends in-line with earnings growth, particularly the major banks. Some large mining companies increased dividends as a result of large cuts to capital expenditure. These dividend paying companies have generally experienced strong price growth, driven by investors seeking income yield in a period of record low interest rates.

Mergers and acquisitions activity has also been healthy in 2015, with MLC IncomeBuilder a beneficiary of the recent takeover of Toll Holdings Limited by Japan Post at a 40% price premium.

These factors led to an increase in franked dividend income and capital gains cpu distributions for MLC IncomeBuilder.

Underlying income distributions

For the 2015 financial year, the fund made an underlying income distribution of 8.52 cpu. This was 4.4% higher than the previous year's underlying income distribution of 8.16 cpu.

The fund's higher underlying tax efficient income was due to the companies the fund invests in, increasing their dividends in FY2015. These dividends that form the underlying income typically have a high level of franking which provides investors in the fund with a tax efficient income stream.

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 FY2014.

Table 1: Total dividends from selected MLC IncomeBuilder investments

Company	2014/15 dividend ($ per share)	% change from 2013/14 dividend
ANZ	1.81	4.0
AMP	0.26	13.0
ASX Limited	1.82	6.4
BHP Billiton Limited	1.47	13.9
Commonwealth Bank	4.16	8.6
Harvey Norman	0.17	54.5
National Australia Bank	1.98	1.0
Suncorp Group	0.78	20.0

Company	2014/15 dividend ($ per share)	% change from 2013/14 dividend
Telstra Corporation	0.30	5.3
Toll Holdings	0.28	1.8
Wesfarmers Limited	1.94	3.2
Westpac Banking Corp.	1.85	3.9
Woodside Petroleum	3.03	45.7

Source: Reuters, ASX, IRESS.

The major banks continue to be a source of higher dividends. ANZ, Commonwealth Bank, National Australia Bank and Westpac all declared higher dividends. However, the rate of dividend growth compared to the previous year has slowed, with Commonwealth Bank the only exception. Its dividend this year was 8.6% higher, exceeding the previous year's 6.1% growth rate. National Australia Bank's 1% dividend growth this year was the lowest of the major banks, down from a growth rate of 7.1% in 2013-14. Unlike the previous year, Westpac chose not to pay a special dividend.

Elsewhere in the Financials sector, some companies managed to increase their dividend by substantial margins. AMP raised its dividend by 13% while Suncorp's was 20% higher than last year's. For the third year in a row, Suncorp also paid a special dividend (30 cents per share compared to 20 cents per share in the 2013/14 year).

Harvey Norman continues to grow its dividend by an impressive margin. This year's $0.17 cents per share dividend was 54.5% higher than last year's as a result of continued earnings growth. The company also paid a special dividend of 14 cents per share.

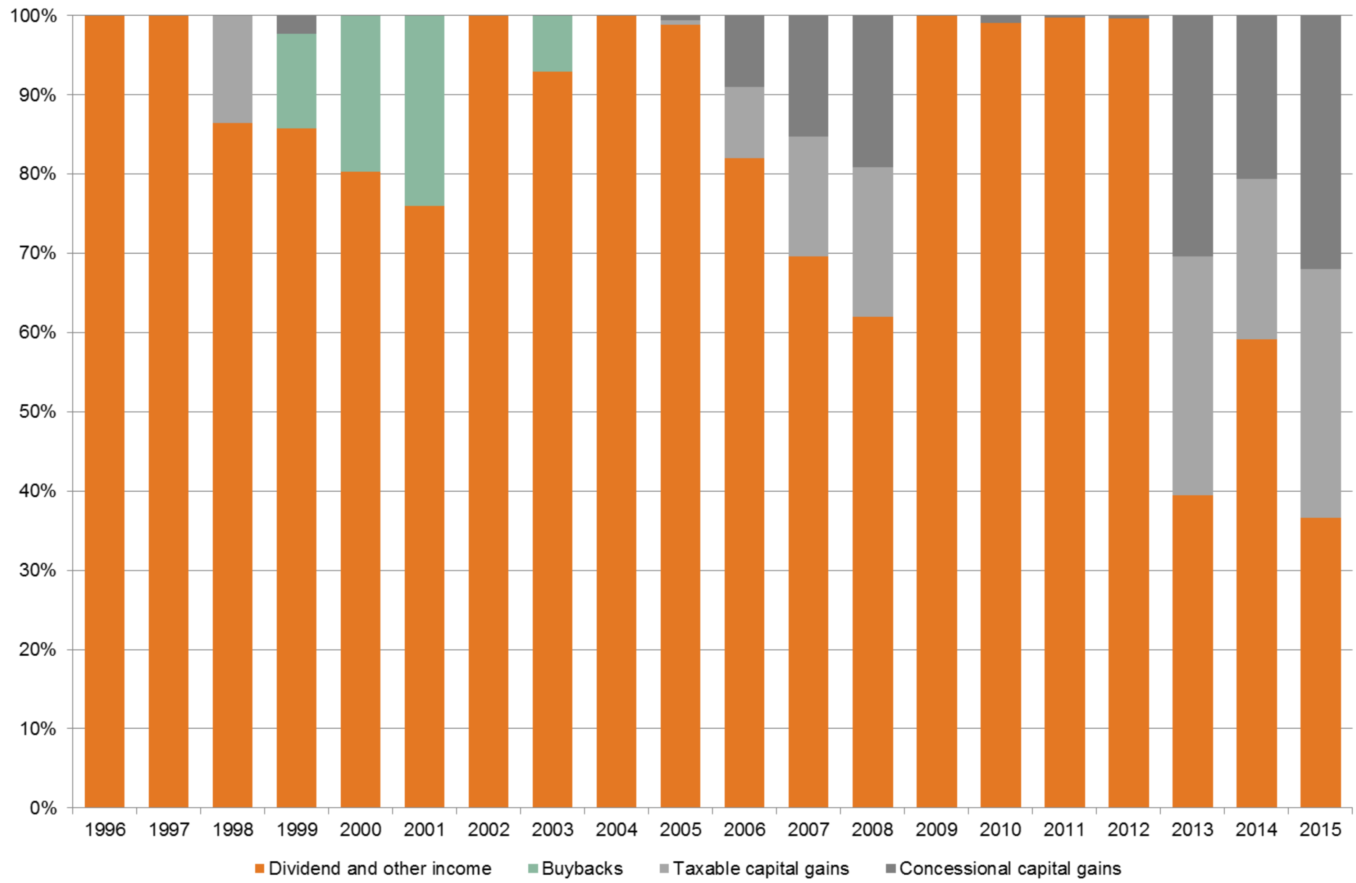
Wesfarmers 3.2% dividend growth this year was lower than the previous year's. However, shareholders benefitted from two special dividends totalling 35 cents per share.

Resource companies remained a beneficial investment with BHP Billiton and Woodside Petroleum (who has raised its dividend payout policy to 80% of after-tax earnings) growing dividends this year by 13.9% and 45.7% respectively.

Capital gains

As Chart 2 shows, the capital gains portion of the annual distribution remained fairly high this year, at 14.73 cpu (63% of the distribution). Approximately half of this was concessional capital gains, which have favourable tax treatment. This FY2015 capital gain was significantly higher when compared to 5.64 cpu (41% of the distribution) for FY2014.

Chart 2: Composition of MLC IncomeBuilder's distributions



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

What caused the high 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. 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. This has been the case for FY2015, with indices such as the S&P/ASX 200 Industrials Accumulation Index rising around 17% and 23% pa in the year and three years respectively to 31 May 2015.

The fund was also a beneficiary of the recent takeover of Toll Holdings Limited by Japan Post at a 40% price premium.

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 the previous two financial years, 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 into clients' accounts. This ensures an investor's capital base, from which their dividend income is generated, continues to grow by being re-invested in the fund. The fund has operated in this way since it was established, as it helps investors remain focussed on maintaining a growing tax efficient income stream.

Will future distributions include capital gains?

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

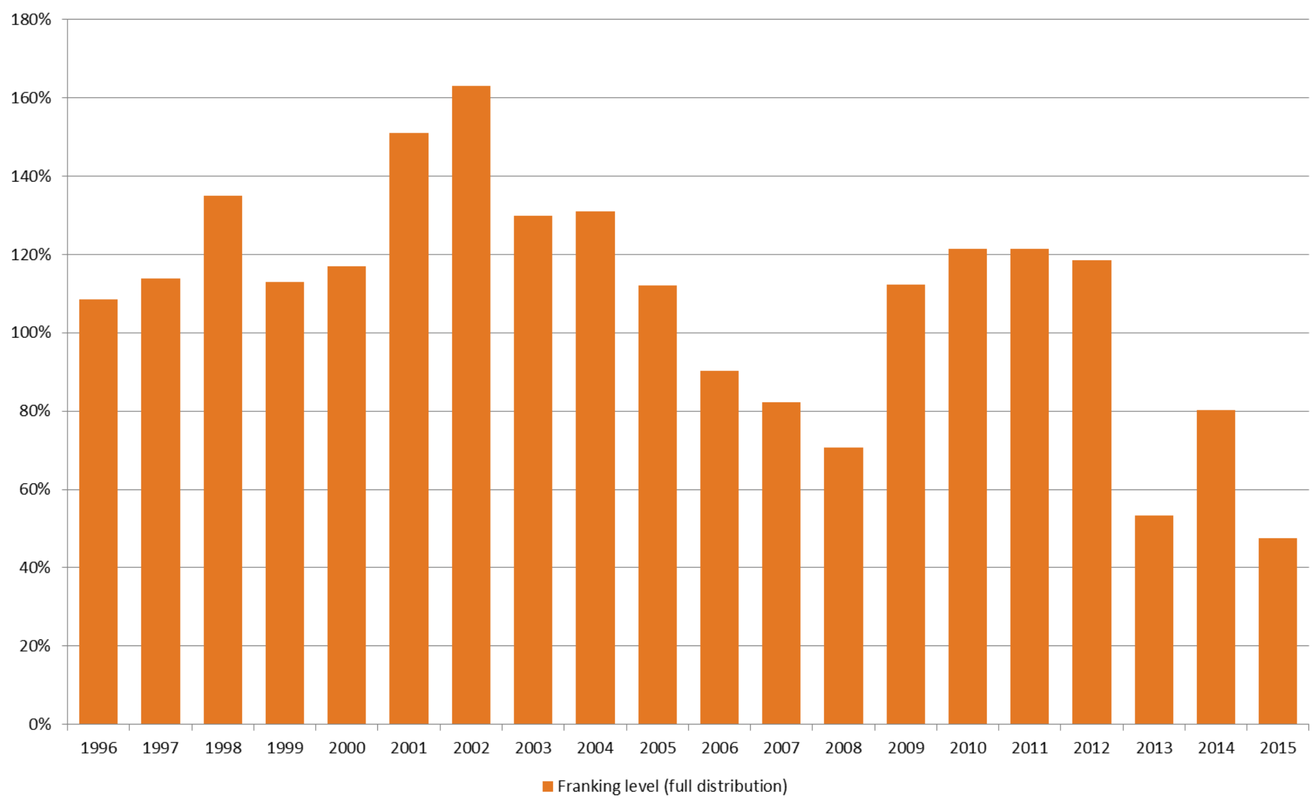
However, because our investment managers focus on investing in companies for the long term, a large portion of the capital gains that has been distributed in the past (shown by the grey bars in Chart 2) is concessional capital gains, which have favourable tax treatment. Essentially this means capital gains are discounted because the stocks have been held for greater than 12 months. This is further evidence of the fund's tax efficiency and we'll continue to manage the fund as tax-efficiently as possible.

Franking levels

The franking level of MLC IncomeBuilder this year is 52% (see Chart 3), a decrease from 80% in FY2014. This is the third consecutive year where the franking levels on the total distribution were below 100%. This is due to the increase in distributed capital gains in recent years, as the franking level is calculated as a percentage of the total distribution.

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. The outlook both here and internationally is uncertain and remains very modest. 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.