MLC MasterKey Investment Service
MLC MasterKey Unit Trust

Annual distribution commentary, May 2015

On Monday, 1 June the last distribution for the 2015 financial year was paid to investors in the MLC MasterKey Unit Trusts, including those in the MLC MasterKey Investment Service[1]. Our analysis of the components of the distributions and key factors affecting the distributions is in the following:

1. Distributions for FY2015
2. Key factors affecting distributions in FY2015
3. Frequently asked questions

Appendix 1 summarises the full financial year (1 June to 31 May) distributions for the last six years.

1. Distributions for FY2015

The table below sets out the cents per unit (cpu) distributions paid for the May 2015 quarter and for the full 2015 financial year (1 June 2014 to 31 May 2015). We've also included commentary on the reasons for the differences between the FY2015 distribution and FY2014. The distribution history for previous years is in Appendix 1.

For a breakdown of the estimated taxation components of the distribution for FY2015, please refer to the MLC Unit Trust/Investment Service Distribution Tax Components 2014/2015 available on **mlc.com.au**. The final taxation components will be available on **mlc.com.au** in July.

Section 2 has important background on the key factors impacting the distributions for FY2015 (eg strong share and real estate investment trust (REIT) markets, the weaker Australian dollar (AUD) and capital losses carried forward). Please read section 2 in conjunction with the fund comments below.

Fund	Quarter cpu	Full year cpu (yield)[2]		Comments
	May 2015	2014/15	2013/14	FY2015 distributions compared to FY2014
MLC Horizon 1 – Bond Portfolio	0.34	0.76 (0.8%)	1.53 (1.5%)	The fund is focused on capital preservation and therefore invests in fixed income securities with a relatively short term to maturity. Income from Australian and overseas bonds and cash decreased from already low levels – cash and bond yields have been low for a number of years. Please refer to section 2 for the factors that affected the distribution this year. At the end of FY2015, the fund still had carried forward losses.
MLC Horizon 2 – Income Portfolio	1.49	2.36 (2.2%)	1.77 (1.7%)	A third of the distribution was income from REITs, a significant increase compared to FY2014. Another third was capital gains, but all were concessional capital gains which have favourable tax treatment. Dividend income increased and interest income from short-term bonds fell. Please refer to section 2 for the factors that affected the distribution this year. At the end of FY2015, the fund still had carried forward losses.
MLC Horizon 3 – Conservative Growth Portfolio	2.25	2.53 (2.6%)	1.50 (1.6%)	Half of the distribution comprised dividends, interest and REIT income. Income from REITs increased significantly compared to FY2014. Capital gains also increased, but all were concessional capital gains which have favourable tax treatment. Please refer to section 2 for the factors that affected the distribution this year. At the end of FY2015, the fund still had carried forward losses.

[1] MLC MasterKey Investment Service Fundamentals invests in MLC Wholesale funds, which have a June year end. The MLC Inflation Plus – Assertive 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.

[2] The distribution yield for a fund is the annual cpu divided by the unit price released the day after the final distribution for the previous financial year.

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Fund	Quarter cpu	Full year cpu (yield)[2]		Comments
	May 2015	2014/15	2013/14	FY2015 distributions compared to FY2014
MLC Horizon 4 – Balanced Portfolio	4.44	4.86 (3.5%)	2.36 (1.9%)	Income from the fund's investments in shares, bonds and REITs increased with more than a third of the distribution comprising dividends, interest and REIT income. Capital gains also increased, but all were concessional capital gains which have favourable tax treatment. Please refer to section 2 for the factors that affected the distribution this year. At the end of FY2015, the fund still had carried forward losses.
MLC Horizon 5 – Growth Portfolio	3.89	4.10 (3.4%)	2.04 (1.9%)	Income from the fund's investments in shares, bonds and REITs increased with a third of the distribution comprising dividends, interest and REIT income. Capital gains also increased, but all were concessional capital gains which have favourable tax treatment. Please refer to section 2 for the factors that affected the distribution this year. At the end of FY2015, the fund still had carried forward losses.
MLC Horizon 6 – Share Portfolio	3.10	3.10 (3.2%)	1.55 (1.8%)	Two thirds of the distribution was capital gains which were higher than FY2014. However, all capital gains were concessional capital gains which have favourable tax treatment. Income from the fund's investments in shares also increased. Please refer to section 2 for the factors that affected the distribution this year. At the end of FY2015, the fund still had carried forward losses.
MLC Horizon 7 – Accelerated Growth Portfolio	2.62	2.62 (2.6%)	1.28 (1.5%)	The distribution was almost entirely capital gains but all were concessional capital gains, which have favourable tax treatment. Almost all the income from share and property investments was offset against the fund's gearing costs (such as interest). The distribution has franking credits attached to it of 0.83 cpu. Please refer to section 2 for the factors that affected the distribution this year. At the end of FY2015, the fund still had carried forward losses.
MLC IncomeBuilder	17.59	23.25 (8.6%)	13.80 (5.6%)	The fund's FY2015 distribution increased from last year due to increases in the dividend income and capital gains. The fund provided a total distribution of 23.25 cpu for the financial year with underlying, mostly dividend, income of 8.52 cpu. The underlying income is 4% higher than last year's 8.16 cpu underlying distribution. The higher underlying tax efficient income was due to the companies the fund invests in increasing their dividends in FY2015. These dividends forming the underlying income typically have a high level of franking providing investors with a tax efficient income stream. The capital gains portion of the annual distribution remained high this year, at 14.73 cpu. Approximately half of the capital gains are concessional capital gains, which have favourable tax treatment. Capital gains can arise when the fund sells shares at prices higher than their original purchase price. These gains typically feature in the fund distributions 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 All Industrials Accumulation Index rising 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 at a 40% price premium. The realised capital gains portion of the income 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. For more information about the distribution of MLC IncomeBuilder please refer to the MLC IncomeBuilder annual distribution commentary, which will be available on **mlc.com.au** by COB 12 June.

Fund	Quarter cpu	Full year cpu (yield)[2]		Comments
	May 2015	2014/15	2013/14	FY2015 distributions compared to FY2014
MLC Australian Share Fund	5.94	7.92 (4.5%)	6.12 (3.8%)	The fund's FY2015 distribution increased from last year due to an increase in capital gains and dividend income. All the capital gains are concessional, receiving favourable tax treatment. Almost half the distribution was dividend income which had franking credits attached. Please refer to page 5 for the factors that affected Australian shares this year. At the end of FY2015, the fund still had carried forward losses.
MLC Australian Share Value Style Fund	3.43	4.61 (4.6%)	2.67 (3.0%)	The fund's FY2015 distribution increased from last year due to an increase in capital gains and to a lesser extent dividend income. All the capital gains are concessional, receiving favourable tax treatment. Almost half the distribution was dividend income which had franking credits attached. Please refer to page 5 for the factors that affected Australian shares this year. At the end of FY2015, the fund still had carried forward losses.
MLC Australian Share Growth Style Fund	3.47	4.82 (3.9%)	2.54 (2.3%)	The fund's FY2015 distribution increased from last year due to an increase in capital gains and to a lesser extent dividend income. All the capital gains are concessional, receiving favourable tax treatment. More than half the distribution was dividend income which had franking credits attached. Please refer to page 5 for the factors that affected Australian shares this year. At the end of FY2015, the fund still had carried forward losses.
MLC-Vanguard Australian Share Index Fund	9.10	13.23 (5.4%)	12.62 (5.6%)	The fund's FY2015 distribution increased from last year due to an increase in dividend income. Half of the distribution is dividend income which had franking credits attached. Capital gains were slightly lower than FY2014. Approximately half of the capital gains are concessional capital gains, which have favourable tax treatment. Please refer to page 5 for the factors that affected Australian shares this year.
MLC Property Securities Fund	0.92	3.00 (4.2%)	2.29 (3.2%)	The fund's FY2015 distribution increased over the previous year, mostly due to an increase in tax deferred income from investments in REITs and capital gains. More than half of the distribution consisted of income that was tax deferred, franked dividends and concessional capital gains, which have favourable tax treatment. Please refer to page 5 for the factors that affected Australian REITs this year. At the end of FY2015, the fund still had carried forward losses.
MLC Global Share Fund	2.01	2.01 (1.3%)	1.16 (0.9%)	The fund's distribution increased compared to FY2014. All the distribution was concessional capital gains, which have favourable tax treatment. Please refer to page 5 for the factors that affected global shares this year. At the end of FY2015, the fund still had carried forward losses.
MLC Global Share Value Style Fund	0.82	0.82 (0.8%)	0.89 (1.0%)	The fund's distribution decreased compared to FY2014. Unlike our other global share funds, the fund's realised capital gains were slightly lower than FY2014. The fund's investment managers are value-biased and have lower levels of trading activity (ie turnover) than our other global share managers. Therefore the realised capital gains decreased, despite strong share market performance. All the capital gains are concessional, receiving favourable tax treatment. Please refer to page 5 for the factors that affected global shares this year. At the end of FY2015, the fund still had carried forward losses.
MLC Global Share Growth Style Fund	3.20	3.20 (2.7%)	1.49 (1.5%)	The fund's distribution increased compared to FY2014. All the distribution was concessional capital gains, which have favourable tax treatment. Please refer to page 5 for the factors that affected global shares this year. At the end of FY2015, the fund still had carried forward losses.
MLC-Platinum Global Fund	30.52	30.52 (15.3%)	-	This distribution follows four years in which the fund didn't distribute any income. The fund distributed a small amount of foreign dividend income in FY2015, however the majority of the distribution was capital gains. Almost half of the capital gains are concessional capital gains, which have favourable tax treatment. Please refer to page 5 for the

Fund	Quarter cpu	Full year cpu (yield)[2]		Comments
	May 2015	2014/15	2013/14	FY2015 distributions compared to FY2014
				factors that affected global shares this year. In the previous four years the fund's capital gains had been offset against capital losses carried forward. At the end of FY2015, the fund doesn't have any carried forward capital losses.

Past performance is not indicative of future performance. The value of an investment may rise or fall with the changes in the market.

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 FY2015

The MLC Horizon portfolios are 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 described above (ie shares, property and fixed income). The allocations to the asset classes are different for each of the MLC Horizon portfolios.

MLC's share funds (except for MLC IncomeBuilder), and the MLC Horizon portfolios with high allocations to shares, are designed to provide capital growth. Although they make distributions, their main objective is to increase the value of their assets for investors, rather than to deliver a regular income stream.

Here are the key factors that affected distributions in FY2015.

The weaker Australian dollar

Most of our multi-asset funds hold overseas shares. We hedge part of these holdings to reduce the funds' exposure to movements in the Australian dollar (AUD).

Similar to FY2014, over FY2015, the AUD remained weak compared with other major currencies like the US dollar (USD). The AUD fell from around USD 0.92 at the end of May 2014 compared to around USD 0.77 at the end of May 2015. The AUD also fell relative to the value of the British pound and rose relative to the euro.

The generally weaker AUD meant that income distributions from unhedged global shares, and the amount received if these shares were sold, were worth more in Australian dollars. For funds that have a large allocation to unhedged global shares, this increased distributions. For funds with large hedged allocations, this produced currency hedging losses that decreased distributions.

The FAQ in section 3 explains more about hedging.

Capital losses carried forward

Capital losses had a significant impact on the level of distributions. During the global financial crisis (GFC) of 2008-9 and the first few years afterwards, markets were weak and volatile. Most funds suffered large capital losses when they sold investments. Capital losses are kept in a fund and are carried forward until they can be offset against capital gains.

Share markets across the world have generally strengthened in recent years and many funds have generated substantial capital gains. In some funds, those gains largely offset the losses carried forward. Other funds still had carried forward losses at the end of FY2015, and these will continue to reduce distributions of capital gains until they are offset in future years.

However, most funds distributed concessional capital gains, which were generated by investments in underlying trusts. Concessional capital gains have favourable tax treatment.

Foreign losses

Due to tax rules, some foreign losses from previous years (such as foreign exchange losses) continued to be carried forward this year. This had a small impact on distributions from some funds with overseas investments. You can read more about foreign losses in the FAQ in section 3.

Australian shares

The Australian share market continued its robust performance in FY2015, with the S&P/ASX200 Index rising 10% over the year. This was despite continued weakness in mining investment. The market has now been strong for three years averaging 17% 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.

Many funds that invest in Australian shares had capital losses carried forward from previous years. These losses offset most of this year's capital gains. The capital gains that were distributed this year were mainly concessional capital gains, which have favourable tax treatment.

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 distribution for MLC IncomeBuilder and other Australian share funds.

Global shares

Overall, international share markets rose strongly over FY2015 as economic data improved and investors became more optimistic about the global outlook. The performance of individual countries' share markets varied widely.

Many companies raised their dividends over the year. And the decrease in the value of the AUD meant that dividend income from unhedged global shares were worth more in Australian dollars. These factors led to an increase in the distributions from global shares that were unhedged. However, overseas companies tend to pay lower levels of dividends than Australian companies. As a result, the expenses of a fund mostly offset dividend income from global shares.

The rising markets meant many funds realised capital gains when they sold investments. In most cases these gains were offset by capital losses carried forward in the funds. The capital gains that were distributed were mainly concessional capital gains, which have favourable tax treatment.

Australian property securities

The market performance of listed Australian real estate investment trusts (AREITs) was very strong this year, at around 29% (based on the S&P/ASX 300 AREIT Accumulation Index), compared with their modest performance of around 6% in FY2014. Over the year, the AREIT sector outperformed the broader share market by 19% and was one of the best sector performers in the Australian market. This reflects the investor interest in sectors like AREITs that have attractive income yields when compared with bonds and term deposits.

Rental income, payout ratios and AREIT borrowings appears to be at more sustainable levels than in years pre-GFC. Most AREITs either increased or maintained the level of their distributions driven by modest earnings growth.

Global property

The market performance of listed global REITs was very strong this year, at around 29% (based on the FTSE EPRA/NAREIT Global Developed Index), compared with a lower return of around 13% in FY2014. In most global markets, operating conditions for real estate continued to be favourable this year.

The funds' exposure to global property is hedged to the AUD. The decrease in the value of the AUD produced currency hedging losses that decreased distributions.

Fixed income

Cash

Income from cash was lower this year because the Reserve Bank of Australia cut their cash rate target from 2.5% to 2.0% in FY2015.

Short-term bonds

Fixed income strategies with short terms to maturity (up to two years) produced lower levels of income this year than in FY2014. Income from short-term bonds remained low both in Australia and overseas. Although interest income from overseas bonds was higher than from Australian bonds, the weaker AUD produced currency hedging losses that decreased distributions from funds invested in overseas bonds.

Falling bond yields didn't increase the distribution from short-term bonds investments.

Longer-term bonds

For fixed income strategies with longer terms to maturity, distributions generally increased in FY2015. Returns and distributions from longer-term bonds were generally higher than last year due to falling yields. Income from overseas bonds was higher than from Australian bonds, but the weaker AUD produced currency hedging losses that decreased distributions from funds invested in overseas bonds.

Australian inflation-linked bonds have long terms to maturity and are included in some of the MLC Horizon portfolios to help provide protection against unexpected rises in inflation. These bonds had solid returns resulting in higher distributions this year than in FY2014.

3. Frequently asked questions

How is the level of distributions determined?

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.

If share prices rose in FY2015, why didn't distributions for all share funds increase?

The share prices of the fund's investments influence the unit price of the fund, but not the distributions paid. The fund's distribution depends on the income from the fund's investments (see the question above).

How does currency hedging help protect you from currency movements?

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, the total return you receive depends on the performance of the underlying investment – not the movement in value of the AUD.

How does hedging impact income distributions?

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.

How do prior foreign losses impact future distributions?

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 were carried forward into this year and may have reduced distributions from funds that have hedged global exposures.

Appendix 1: Financial year distribution history

The table below sets out the cpu distributions paid for the May 2015 quarter along with the full financial year (1 June to 31 May) distributions for the last six years.

Fund	Quarter cpu	Full year cpu (yield)[3]					
	May 2015	2014/15	2013/14	2012/13	2011/12	2010/11	2009/10
MLC Horizon 1 – Bond Portfolio	0.34	0.76 (0.8%)	1.53 (1.5%)	2.27 (2.3%)	2.15 (2.2%)	4.67 (4.9%)	3.44 (3.3%)
MLC Horizon 2 – Income Portfolio	1.49	2.36 (2.2%)	1.77 (1.7%)	2.98 (3.0%)	2.86 (2.9%)	4.65 (4.8%)	3.98 (4.4%)
MLC Horizon 3 – Conservative Growth Portfolio	2.25	2.53 (2.6%)	1.50 (1.6%)	1.95 (2.3%)	1.85 (2.2%)	3.98 (4.9%)	3.93 (5.1%)
MLC Horizon 4 – Balanced Portfolio	4.44	4.86 (3.5%)	2.36 (1.9%)	2.49 (2.3%)	2.45 (2.2%)	5.44 (5.0%)	4.46 (4.5%)
MLC Horizon 5 – Growth Portfolio	3.89	4.10 (3.4%)	2.04 (1.9%)	1.75 (1.9%)	2.42 (2.5%)	5.06 (5.4%)	3.08 (3.6%)
MLC Horizon 6 – Share Portfolio	3.10	3.10 (3.2%)	1.55 (1.8%)	0.76 (1.1%)	1.04 (1.4%)	4.13 (5.8%)	3.03 (4.7%)
MLC Horizon 7 – Accelerated Growth Portfolio	2.62	2.62 (2.6%)	1.28 (1.5%)	0.13 (0.2%)	0.19 (0.3%)	3.77 (5.4%)	3.76 (6.2%)
MLC IncomeBuilder	17.59	23.25 (8.6%)	13.80 (5.6%)	19.48 (9.8%)	8.34 (3.9%)	7.88 (3.6%)	6.68 (3.6%)
MLC Australian Share Fund	5.94	7.92 (4.5%)	6.12 (3.8%)	3.58 (2.7%)	4.46 (2.9%)	4.82 (3.2%)	3.20 (2.5%)
MLC Australian Share Value Style Fund	3.43	4.61 (4.6%)	2.67 (3.0%)	3.40 (4.5%)	4.09 (4.5%)	2.83 (3.2%)	2.30 (3.0%)
MLC Australian Share Growth Style Fund	3.47	4.82 (3.9%)	2.54 (2.3%)	1.59 (1.8%)	1.76 (1.7%)	2.95 (3.0%)	1.70 (2.0%)
MLC-Vanguard Australian Share Index Fund	9.10	13.23 (5.4%)	12.62 (5.6%)	8.88 (4.8%)	9.19 (4.3%)	6.62 (3.3%)	6.46 (3.6%)
MLC Property Securities Fund	0.92	3.00 (4.2%)	2.29 (3.2%)	1.54 (2.7%)	2.40 (4.3%)	1.97 (3.7%)	3.29 (7.1%)
MLC Global Share Fund	2.01	2.01 (1.3%)	1.16 (0.9%)	0.13 (0.1%)	0.02 (0.02%)	0.03 (0.03%)	-
MLC Global Share Value Style Fund	0.82	0.82 (0.8%)	0.89 (1.0%)	0.31 (0.5%)	0.17 (0.2%)	0.05 (0%)	-
MLC Global Share Growth Style Fund	3.20	3.20 (2.7%)	1.49 (1.5%)	-	-	-	-
MLC-Platinum Global Fund	30.52	30.52 (15.3%)	-	-	-	-	6.90 (5.6%)

Past performance is not indicative of future performance. The value of an investment may rise or fall with the changes in the market.

[3] The distribution yield for a fund is the annual cpu divided by the unit price released the day after the final distribution for the previous financial year.

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