Preserving capital and supporting purchasing power: the twin aims of MLC's Inflation Plus portfolios

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Investment management innovation has come a long way since the days when the balanced fund was considered cutting-edge. To be clear, this isn't a put-down of balanced funds.

They remain an important reference and have continued to meet the needs of a broad spectrum of investors. However, rather than just meeting broad investor needs and settling for a version of 'one size fits all', the investment industry has excelled at solving specific investment issues for specific groups of investors.

MLC's Inflation Plus portfolios are a case in point. They were created for investors nearing or in retirement.

The needs and time horizons of this investor group are vastly different from those starting out on their asset accumulation journey or even at the midway point of their working lives.

For this group, loss limitation in falling markets is crucial as they have less time to rebuild the value of their investments in the event of major setbacks.

They are also more likely than their younger counterparts to have accumulated significant financial assets and thus achieving spectacular returns is probably no longer top-of-mind. Rather, achieving returns that can keep their investments growing at a faster clip than living costs is important.

The aptly named MLC Inflation Plus portfolios aim to do both. They are constructed to limit the risk of large losses over different investment timeframes. They also aim to deliver returns that can maintain investors' purchasing power. In other words, strong risk-adjusted, but not 'swing for the fences' returns **(Chart 1)**.

Chart 1: Aiming to achieve good risk-adjusted returns

MLC Wholesale Inflation Plus returns (net of fees to 31 March 2020)

	1 year (%)	3 years (% pa)	5 years (% pa)	7 years (% pa)
MLC Wholesale Inflation Plus Conservative	0.1	1.9	2.1	N/A*
MLC Wholesale Inflation Plus Moderate	0.6	2.4	2.5	N/A*
MLC Wholesale Inflation Plus Assertive	0.2	3.6	3.2	7.0

* The MLC Wholesale Inflation Plus Conservative and Moderate portfolios were launched in October 2013 and don't yet have seven years of returns. All returns provided in this article are calculated after deducting MLC Wholesale Funds' Management Cost which is not reduced by any rebate paid to those investors accessing through a platform. Past performance is not indicative of future performance.
Source: MLC Investments Limited

Preserving capital for wealth accumulation

In an industry where return-seeking often seems the 'be all and end all', we'd argue that preserving investors' capital deserves equal attention.

Our thinking can be summed up by paraphrasing a well-known Warren Buffet quote: *it takes 20 years to build wealth and one market crash to ruin it. If you think about that, you'll do things differently*. [1]

We are prepared to do things differently so that one market crash does not ruin Inflation Plus investors' wealth.

We do this by drawing on our risk-management ethos, which is deep in MLC's DNA. In our view, the Inflation Plus portfolios are the purest expression of our forward-looking, investment risk-management culture.

Some figures from the US share market underscore the importance of active risk-management and diversification to minimising losses when share markets fall far.

From the peak in 2000 to the bottom in 2002, the S&P 500 Index fell 49%, and from the peak in 2007 to the bottom in 2009 it fell 58%.[2]

Meanwhile, the technology-focused Nasdaq Index plunged 78% in 2000-2002 and tanked 56% from 2007-2009.[3] To make matters worse, it took the Nasdaq about 15 years before it reached its previous high point of March 2000.[4]

In this instance, a passive-only investor's money — passive investing being the epitome of investments exposed to market movements with no risk-management guardrails — would have plummeted nearly 80% and they would have been staring at losses for nearly 15-16 years before it got back to even, if they had bought in 2000 during the 'tech boom'.[5]

This supports our strong conviction that long-term investment success is not only about accumulating strong returns in good times. It's perhaps even more important to protect capital on the downside as this has a material impact on total returns due to the power of compounding.

If an investment falls 50% in value, it must rise 100% just to get back to its original value. That's very sobering.

Downside protection, and smoothing investment returns, is best achieved through portfolio diversification as well as by actively using the full array of risk-management investment techniques and strategies available to us.

Diversification may not have the appeal of a singular 'out-of-the-box' idea, but it remains the tried and tested way of mitigating the risks associated with single asset class, single geography or single thematic investing.

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[1] The actual Warren Buffet quote is: "It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you'll do things differently."

[2] *Two Reasons Why Active Management Matters Now*. Adam Sarhan in *Forbes*, August 16, 2018. https://www.forbes.com/sites/adamsarhan/2018/08/16/2-reasons-why-active-managment-matters-now/#709dc52758aa. Accessed 27 January 2020.

[3] Ibid

[4] Ibid

[5] Ibid

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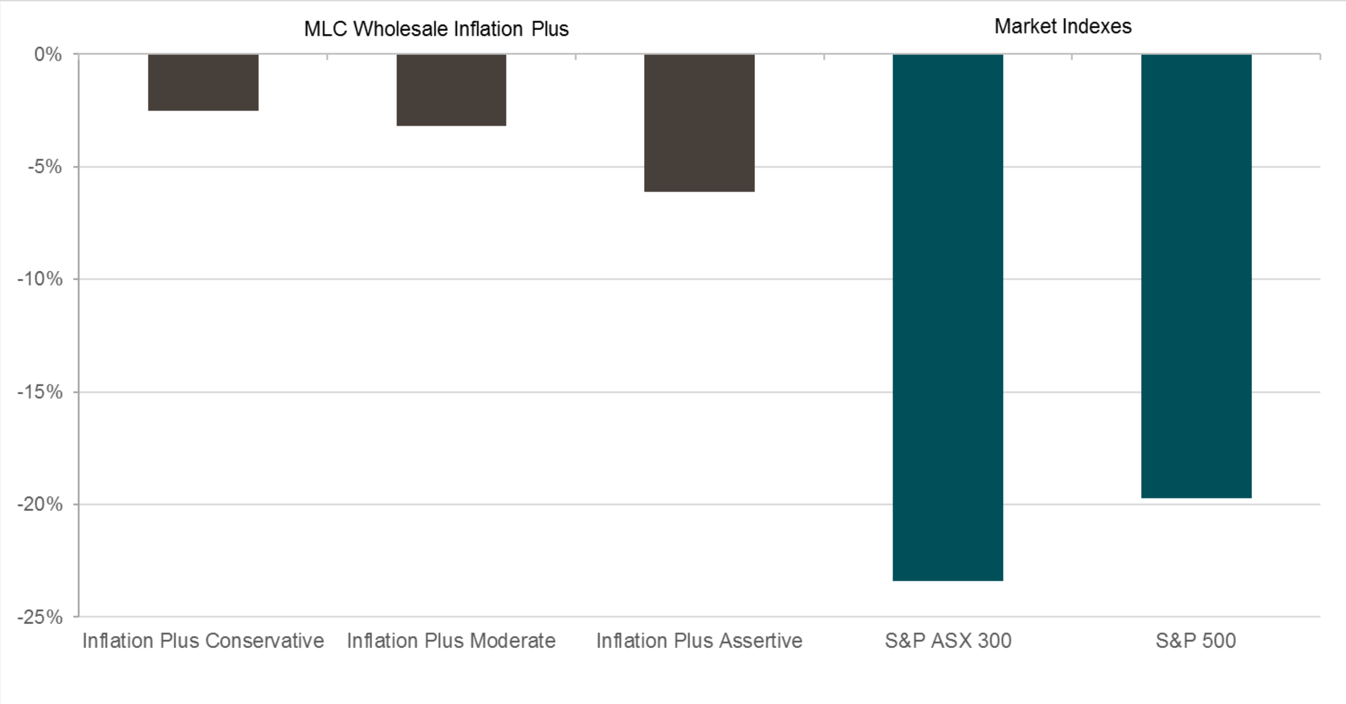
In managing the Inflation Plus portfolios, we're completely indifferent to peer-relative returns and peer asset allocation. Our eyes are not on what our industry counterparts are doing. They are exclusively on the twin objectives of loss minimisation and delivering returns ahead of rises in annual living costs as measured by Australia's official inflation rate.

So far, at least, our management of the Inflation Plus portfolios has succeeded in cushioning investors from the worst impacts of COVID-19 related market turbulence **(Chart 2)**.

Chart 2: Minimising losses, so far during COVID-19

MLC Wholesale Inflation Plus (net of fees) and share market index returns for March quarter 2020



All returns provided in this article are calculated after deducting MLC Wholesale Funds' Management Cost which is not reduced by any rebate paid to those investors accessing through a platform. Return for US S&P 500 Index is in US dollars.
Source: MLC Asset Management Services Limited and FactSet.
Past performance is not indicative of future performance.

Anticipating 'black swans' and other scenarios

Managing risks intelligently — those that can be reasonably anticipated all the way to 'long shots' — is the core of investment management and The Investment Futures Framework (Framework) is our way of doing so.

A feature of the Framework is the way it forces us to think about the range of things that can happen **(Chart 2)** as distinct from guessing what will happen.

Chart 3: Thinking about what could happen, rather than guessing what will happen

Source: MLC Asset Management Services Limited

Investment professionals can easily fall into the trap of trying to land on a preferred 'base case' and position portfolios accordingly.

However, a single base case scenario, or even instances where an upside case and downside case are also developed, runs up against the world's complexity. The Framework provides an antidote to the risk of biases inherent in trying to 'narrow cast' by minimising the range of issues for consideration.

In a world of endless information, this kind of narrow casting is a perfectly normal impulse. Unfortunately, mental short cuts can also result in reaching emotionally satisfying but far-from-accurate conclusions.

By contrast, the Investment Futures Framework actively steers us away from comfort zone thinking towards understanding the many things that could happen and then identifying the most appropriate trade-off between risk and return for each of the portfolios we manage for clients.

Capturing pandemics in investment scenarios

Rather than imagining one or even several sets of outcomes and their associated investment returns, the Framework recognises the possibility of a vast number of scenarios with a great breadth of return possibilities. This includes more likely scenarios as well as remote possibilities like pandemics **(Chart 4)**, such as the current coronavirus outbreak.

The coronavirus pandemic and the way it is disrupting societies, economies and markets demonstrates the Framework's practicality and elasticity. Having pandemics as a possibility, even if remote, means that we aren't caught completely 'off-guard' even when low probability events occur.

We're not caught scrambling to analyse on the run. Perhaps the worst time to begin thinking about a low probability event is when it's already underway.

Chart 4: Many futures are possible, including a global pandemic (scenario 25)

Investment Futures Framework

1	2	3	4	5	6	7	8	9	10
Steady state	Deflation – (reform driven productivity driven boom)	Stagflation (generic)	Rising inflation /shock (weak productivity)	Debt-driven growth	Disinflation	Inflationary growth	Investor pessimism –rise in risk premiums	Prolonged global growth and productivity boom	Strong growth, Australia and resources boom
11	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20**
Australia-only bust (world economy not weak)	Aust. economic crisis (world weak)	Profit share mean reversion	Credit / monetary expansion	Credit / monetary contraction	Steady/trend growth with mean reversion	Slowdown	Recession	Recovery	Aust. deflation – destructive (Japan 1990s)
21	**22**	**23**	**24**	**25**	**26**	**27**	**28**	**29**	**30**
Global depression stagnation (1930s)	Severe inflation risk	Financial collapse risk	Oil price shock – geopolitical risk	Global pandemic	Global catastrophe	Global catastrophe adverse economic environment	Global war / conflict	Protectionism – adverse growth and inflation	Exogenous risk drives investor uncertainty
31	**32**	**33**	**34**	**35**	**36**	**37**	**38**	**39**	**40**
China and emerging market risk aversion	Multi-speed world (zero probability)	Adverse productivity shock	Asian growth leadership	Paradigm shift – lower values for shares (higher return potential)	Paradigm shift – higher values for equities (lower return potential)	Speculative bubble	Bubble bursts (economy okay)	Policy supports higher inflation (expectations lag)	Debt deflation (weak growth, low inflation)

Source: MLC Asset Management Services Limited

The Framework also helps to keep us within our 'lane' of expertise as investment professionals and not to second-guess the expertise of others in their chosen fields.

Human nature tempts people into trying to become instant experts when a Black Swan, like COVID-19, suddenly emerges. Arguably, it's most visible in the media where commentators, including social media 'influencers,' opine on coronavirus and medical researchers' and doctors' efforts to combat the virus.

But this temptation to trying to become quick experts on new and highly complex subjects is not exclusive to the media. The investment management industry also exhibits this trait.

In this context, focusing on the pandemic specifically as a flash point for risk is perhaps misleading – for the mayhem wrought on society need not necessarily have come by way of COVID-19. Other triggers could have been a major war, a different kind of global catastrophe, or a sudden rise in inflation, for example.

Instead, the learnings ought to be that risk can ignite from the non-obvious, and that low probability, high impact events should at least be considered when setting investment strategy.

The world is not short of disease modelling expertise. Yet, investors caught out by the pandemic too often scramble to build expertise in an area that requires years of education and training. This expertise resides in academic institutes, think tanks and consultancies, less amongst investment teams.

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At times like this, true investors, true managers of risk, need to focus on identifying uncertainty and hammering out solutions to deal with the unknown, all the while preserving as much investor wealth as possible.

We accept that asset prices have moved because of the virus and are unlikely to begin moving back towards anything approaching normalcy until health experts achieve disease containment, at the very least, or better yet, a vaccine becomes available.

Moreover, even when this current period ends, 'normal' may look different to what was assumed to be normal over recent decades.

Countries may be tempted to pull back on globalisation and instead gravitate towards greater self-sufficiency to mitigate against a repeat of the risks that have been laid bare.

We think such possibilities will only increase the relevance of the Investment Futures Framework as it permeates all aspects of our investment approach, including risk management.

With government, household and private sector debts now at extraordinary levels, an investment approach that actively sets out the many future possibilities that can happen, as distinct from what will happen, is invaluable.

For Inflation Plus investors, it means that we will be leaning on the Investment Futures Framework to identify potential dangers ahead, to avoid them. If we succeed in doing that, we will have achieved the ultimate aim of the Inflation Plus portfolios – maintaining the purchasing power of investors as they head into retirement or those already in retirement.