



Pre Select commentaries

Quarter ended 30 June 2021

Contents

Economic and market commentary	1
Investment insights.....	2
Contributors to performance	4
Pre Select Conservative Fund	4
Pre Select Balanced Fund	4
Pre Select Growth Fund.....	5
Pre Select High Growth Fund	5

Economic and market commentary

Asset class returns to 30 June 2021

	CYTD	1 Month to	3 Month to	1 Year to	3 Years to	5 Years to	10 Years to	FYTD
				% p.a.	% p.a.	% p.a.	% p.a.	% p.a.
Australian shares	12.9%	2.3%	8.3%	27.8%	9.6%	11.2%	9.3%	27.8%
Global shares (hedged)	13.2%	2.2%	7.0%	35.3%	13.0%	14.0%	11.9%	35.3%
Global shares (unhedged)	15.4%	4.5%	9.0%	27.7%	14.0%	14.4%	13.9%	27.7%
Emerging markets (unhedged)	10.4%	3.3%	6.6%	29.2%	10.7%	12.8%	8.1%	29.2%
Australian property securities	10.1%	5.6%	10.7%	33.9%	8.2%	6.2%	12.0%	33.9%
Global property securities (hedged)	17.0%	1.8%	9.0%	30.2%	4.9%	4.7%	8.3%	30.2%
Global listed infrastructure (hedged)	7.7%	-0.2%	2.5%	14.9%	6.9%	7.0%	10.6%	14.9%
Australian bonds	-1.7%	0.7%	1.5%	-0.8%	4.2%	3.2%	4.9%	-0.8%
Global bonds (hedged)	-1.6%	0.5%	0.9%	-0.2%	4.0%	2.9%	5.3%	-0.2%
Global high yield bonds (hedged)	2.6%	0.3%	1.3%	10.0%	3.3%	4.3%	0.0%	10.0%
Australian Inflation-linked bonds	0.5%	-0.3%	1.3%	4.3%	3.8%	3.1%	4.3%	4.3%
Cash	0.0%	0.0%	0.0%	0.1%	1.0%	1.3%	2.2%	0.1%
AUD/USD	-2.7%	-3.0%	-1.4%	9.0%	0.5%	0.2%	-3.5%	0.9%

Index data sources: Australian shares - S&P/ASX 200 Total Return Index; Global shares (hedged) - MSCI All Countries World (A\$ hedged) ; Global shares (unhedged) - MSCI All Countries World; Emerging markets - MSCI Emerging Markets; Australian property securities - S&P/ASX 300 LPT Accumulation Index; Global property securities - FTSE EPRA/NAREIT Developed (A\$ hedged); Australian bonds - Bloomberg AusBond Composite 0+ Yr Index; Global bonds (A\$ hedged) - BCGA Global Agg (A\$ hedged); Global high yield bonds (A\$ hedged) - Composite of BCGA US Corp HY BB/B (A\$ hedged) & S&P LSTA BB/B Leveraged Loan Index; Australian inflation-linked bonds - Bloomberg AusBond Inflation Government 0+ Yr Index; Cash - Bloomberg AusBond Bank Bill Index, WM/Reuters Daily (4 pm GMT).

Global

Global shares (unhedged) continued their strong recovery with a 9% return in the three months to June 2021.

Progress with vaccinations as well as supportive measures from governments and central banks were the key drivers of share returns. Global economic data releases also provided encouragement. Positive business surveys and solid employment gains are consistent with the global recovery strengthening.

Wall Street surged to new record highs with the S&P 500 Index making an exceptionally strong 8.4% quarterly gain. US shares were buoyed by the expectation that corporate profits would record more than 60% annual growth in the

June quarter. The US Federal Reserve also maintained guidance that interest rates would remain low but did signal consideration for tapering their bond purchase program later this year.

European shares made a strong 3.6% return (in local currency terms) with the steady vaccination rollout and gradual relaxation of lockdown restrictions. The European Central Bank's guidance of continued low interest rates and bond purchases was also supportive for European shares.

Emerging market shares (unhedged) delivered a very strong 6.6% gain for the quarter. This surge was led by large gains for India (8.7%, in local currency terms) with encouraging signs of lower virus infection cases.

Global bonds (hedged) delivered a positive 0.9% return for the quarter. Government bond yields have stabilised over recent months as central banks maintained their guidance of low interest rates despite higher inflation.

Global high yield bonds (hedged) also made a positive gain of 1.3% for the quarter. Credit spreads have narrowed given improving risk appetites due to the gains in global share markets and more promising economic indicators.

Australia

Australian shares generated an exceptionally strong 8.3% return for the past three months. Apart from the positive global and domestic economic prospects, low interest rates have been a significant tailwind to Australian shares. The Reserve Bank of Australia (RBA) has also provided encouraging guidance that the cash interest rate is expected to remain steady at 0.1% until 2024.

Australia's Financial sector delivered a robust 8.8% gain with confidence that low interest rates and stronger economic activity should revive credit growth. The Consumer Discretionary (11.2%) sector also benefitted with the view of improving consumer appetite for spending. Resources recorded a strong 7.1% quarterly gain given higher iron ore and metal commodity prices. However, both the Energy (-2.8%) and Utilities (-4.5%) sectors disappointed.

Australia's economy is showing optimistic signs of a sustained expansion with robust job gains and encouraging signs from business and consumer confidence surveys. However, the lockdown experienced in Melbourne and Sydney in June are reminders of the continued virus threat until Australian vaccination rates are higher.

Looking forward...

The global economy is showing positive signs of a strong and sustainable recovery. The combination of extensive fiscal and monetary policy support measures and steady progress in vaccinations across Europe and the US are promising. However, the virus remains a threat particularly in emerging nations with limited access to vaccines. Hence increased vaccination rates across the world are still necessary to ensure that this global recovery does not falter.

Investment insights

Humility is a good value to live by. It's especially important for investment professionals. Markets have a knack for knocking down those who become a little too sure of themselves. With that context, we're quietly gratified that three themes we previously wrote about over the last financial year have materialised. It means we've been able to make some calls that have benefited clients' portfolios.

We've unpacked the three themes and how we responded in our multi-asset portfolios.

Theme 1: 'Participate and protect'

There were (and are) too many uncertainties to justify taking 'either or' decisions. Obviously, being right would be rewarding. However, being wrong would be costly for clients' portfolios. Humility, and realism, led us towards dual-track 'participate and protect' strategies.

There are still reasons for participating in 'risk' assets, but the reasons have changed as the pandemic has morphed and policy responses evolved. Governments can't keep spending at the pace they've been, and it's harder to justify central banks persisting with emergency policies. In other words, a gentle path towards policy normalisation is called for and economies and markets need to be pushed forward by something other than government and central bank support.

Share markets have rotated from the narrow Technology and Health Care leadership of 2020 to a broader set of winners including cyclicals like Financials and Industrials. Our clients' portfolios have participated in this transition.

On the other hand, share market valuations are elevated reflecting abundant optimism. Inflation risks have reappeared after a decades-long absence. These are reasons for 'protecting.' The negative relationship between bond prices and inflation is well documented. What may be less well understood is the negative relationship between inflation and share market valuations, as measured by the price to earnings ratio¹ (P/E). Our research is not suggesting that inflation is bad for shares, but is bad for P/E ratios – inflation can compress them.

Theme 2: Address inflation risk by accessing assets with variable cash flows

Consumer Price Index (CPI) levels are up, as are inflation expectations. With this as the backdrop, our inclination to favour real cash flows to build inflation hedges (as opposed to taking inflation bets) into the portfolios has been rewarded with strong returns to assets with variable cash flows, like cyclical shares. The threshold issue is whether recent higher inflation readings will be transitory, or prove to be sticky. No doubt some of the reported issues like high US car prices because of semiconductor and chip shortages will be overcome when the supply of those inputs ramps up.

But there are reasons to think that the long-standing disinflationary regime we've become accustomed might be weakening, and maybe, an upturn in inflation is ahead:

- Central banks appear to be changing their function from keeping inflation within their target ranges, to allowing it to breach the top end of their ranges in an attempt to achieve higher 'average' inflation.
- Tight-fisted fiscal hawks are a dying breed as governments are embracing deficit spending.
- Company behaviour post-pandemic looks like leaning more towards local production rather than relying on global supply chains. Think of it as 'just-in-case' local production versus 'just-in-time' global production. It's good from a supply-security perspective, but also likely to be more expensive.
- Competition for labour is increasing as immigration is reduced and the cost of off-shoring to developing markets has increased.

Rather than making a binary decision on inflation being transitory or sticky, our approach has been to create inflation hedges implemented at a reasonable price. One of the ways we've done this is to build a customised basket of high-quality mining and energy shares, that we know are sensitive to inflation, and offer a high dividend yield. The basket is then tightly hedged with options over those shares so that even if markets sour, they can, at a minimum, earn the dividend yield and not suffer anything worse than bond-type losses.

Theme 3: Prepared for higher market interest rates

We've been killjoys for a few years, shouting 'interest rates can't keep going lower'. But they have! Belated vindication, of sorts, arrived in the first quarter of 2021 when market interest rates moved higher. This rewarded our bias for keeping portfolio duration low (interest rate risk low) by preferring inflation-linked to nominal bonds.

We've also taken advantage of structural opportunities on offer in markets that can enhance returns. An example being exposure to Chinese shares that pay a guaranteed excess return of over 10% pa, with part of the outperformance used to fund downside protection over what is expected to be a volatile investment.

Portfolio positioning

Asset allocation positioning of the Pre Select funds was largely unchanged over the June quarter. However, the following underlying manager changes were made to the fixed income and Australian shares components of the portfolios:

- We appointed Ardea Investment Management as a global absolute return manager, and removed BNP Paribas and Insight. We have strong confidence in Ardea's ability to consistently outperform the cash plus objective of our global absolute return bonds strategy.

¹ The price-to-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its earnings-per-share (EPS). The price-to-earnings ratio is also sometimes known as the price multiple or the earnings multiple.



- We appointed Macquarie Investment Management as an 'enhanced index' Australian shares manager, and removed Redpoint. We are confident that Macquarie will be able to outperform the market more consistently, through a range of different market conditions, while controlling risk.

Pre Select funds also investment in Inflation Plus and a real return strategy, providing important real return exposure and sources of low correlation return streams. Activity in Inflation Plus over the quarter was focused on introducing thematic strategies. As explained earlier they're baskets of high-quality mining and energy companies that act as inflation hedges because their earnings and dividends are sensitive to inflation. We're also wary of the correlation between the Australian dollar (AUD) and global shares shifting over time which we manage with an AUD/US dollar (USD) risk reversal strategy which will increase in value if the AUD rises. We've used this strategy in the past and reinstated it this quarter.

Contributors to performance

Pre Select Conservative Fund

The Fund increased in value by 2.7% for the quarter (before fees). Weak returns in February and March 2020 due to the 'COVID crash' have now dropped out of the one year returns so the fund is up 9.3% for the year to 30 June 2021.

Key contributors to performance for the quarter ended 30 June 2021 are:

- The global shares strategy delivered another exceptionally strong return in the June quarter of 8.7%. Share markets continue to climb reflecting rising expectations of a broadening economic recovery against a backdrop of improving vaccine rollouts and ongoing central bank and government stimulus. The recovery in 'value stocks' took a pause this quarter following remarkably strong moves in the December 2020 and March 2021 quarters. Of the six managers in the strategy, two outperformed over the quarter.
- The Australian shares strategy produced a very strong return of 8.5% for the June quarter. Australia's economic recovery and improved earnings growth contributed to the market's positive return. Since the company profit reporting period early in the year exceeded expectations, the ongoing release of good economic data has resulted in upgraded earnings' forecasts for the 2021 and 2022 financial years. Additionally, our active managers have outperformed over the quarter. However, these positive market developments occurred before the deterioration in COVID-19 infections with the outbreak of the Delta variant in Sydney requiring an extended lockdown.
- The portfolio's exposure to Inflation Plus provides an alternative source of returns which is especially important in the current low interest rate environment. Returns from Inflation Plus provided a solid return of 2.4% over the quarter, driven by strong performance of its 'protected' shares and derivatives strategies.

Note: Returns for the asset classes above are before fees and tax.

Pre Select Balanced Fund

The Fund increased in value by 4.1% for the quarter (before fees). Weak returns in February and March 2020 due to the 'COVID crash' have now dropped out of the one year returns so the fund is up 15.0% for the year to 30 June 2021.

Key contributors to performance for the quarter ended 30 June 2021 are:

- The global shares strategy delivered another exceptionally strong return in the June quarter of 8.7%. Share markets continue to climb reflecting rising expectations of a broadening economic recovery against a backdrop of improving vaccine rollouts and ongoing central bank and government stimulus. The recovery in 'value stocks' took a pause this quarter following remarkably strong moves in the December 2020 and March 2021 quarters. Of the six managers in the strategy, two outperformed over the quarter.
- The Australian shares strategy produced a very strong return of 8.5% for the June quarter. Australia's economic recovery and improved earnings growth contributed to the market's positive return. Since the company profit reporting period early in the year exceeded expectations, the ongoing release of good economic data has resulted in upgraded earnings' forecasts for the 2021 and 2022 financial years. Additionally, our active managers have outperformed over the quarter. However, these positive market developments occurred before the deterioration in COVID-19 infections with the outbreak of the Delta variant in Sydney requiring an extended lockdown.

- The global shares (hedged) strategy also delivered another very strong return in the June quarter of 7.0%. The return from the hedged strategy was a little lower than the unhedged strategy because the Australian dollar declined relative to major currencies over the quarter.

Note: Returns for the asset classes above are before fees and tax.

Pre Select Growth Fund

The Fund increased in value by 5.7% for the quarter (before fees). Weak returns in February and March 2020 due to the 'COVID crash' have now dropped out of the one year returns so the fund is up 21.1% for the year to 30 June 2021.

Key contributors to performance for the quarter ended 30 June 2021 are:

- The global shares strategy delivered another exceptionally strong return in the June quarter of 8.7%. Share markets continue to climb reflecting rising expectations of a broadening economic recovery against a backdrop of improving vaccine rollouts and ongoing central bank and government stimulus. The recovery in 'value stocks' took a pause this quarter following remarkably strong moves in the December 2020 and March 2021 quarters. Of the six managers in the strategy, two outperformed over the quarter.
- The Australian shares strategy produced a very strong return of 8.5% for the June quarter. Australia's economic recovery and improved earnings growth contributed to the market's positive return. Since the company profit reporting period early in the year exceeded expectations, the ongoing release of good economic data has resulted in upgraded earnings' forecasts for the 2021 and 2022 financial years. Additionally, our active managers have outperformed over the quarter. However, these positive market developments occurred before the deterioration in COVID-19 infections with the outbreak of the Delta variant in Sydney requiring an extended lockdown.
- The global shares (hedged) strategy also delivered another very strong return in the June quarter of 7.0%. The return from the hedged strategy was a little lower than the unhedged strategy because the Australian dollar declined relative to major currencies over the quarter.

Note: Returns for the asset classes above are before fees and tax.

Pre Select High Growth Fund

The Fund increased in value by 6.8% for the quarter (before fees). Weak returns in February and March 2020 due to the 'COVID crash' have now dropped out of the one year returns so the fund is up 25.7% for the year to 30 June 2021.

Key contributors to performance for the quarter ended 30 June 2021 are:

- The global shares strategy delivered another exceptionally strong return in the June quarter of 8.7%. Share markets continue to climb reflecting rising expectations of a broadening economic recovery against a backdrop of improving vaccine rollouts and ongoing central bank and government stimulus. The recovery in 'value stocks' took a pause this quarter following remarkably strong moves in the December 2020 and March 2021 quarters. Of the six managers in the strategy, two outperformed over the quarter.
- The Australian shares strategy produced a very strong return of 8.5% for the June quarter. Australia's economic recovery and improved earnings growth contributed to the market's positive return. Since the company profit reporting period early in the year exceeded expectations, the ongoing release of good economic data has resulted in upgraded earnings' forecasts for the 2021 and 2022 financial years. Additionally, our active managers have outperformed over the quarter. However, these positive market developments occurred before the deterioration in COVID-19 infections with the outbreak of the Delta variant in Sydney requiring an extended lockdown.
- The global shares (hedged) strategy also delivered another very strong return in the June quarter of 7.0%. The return from the hedged strategy was a little lower than the unhedged strategy because the Australian dollar declined relative to major currencies over the quarter.

Note: Returns for the asset classes above are before fees and tax.



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