

MLC Diversified Debt Fund

September 2008 Annual Commentary

Executive Summary:

The last year has been very challenging for most sectors of the debt market. Despite the weak condition, your portfolio managed to produce a positive return. While returns were well below cash for the year, the portfolio was somewhat insulated from the weak market conditions due to its

- broad diversification across many different types of debt, particularly real return strategies and inflation linked securities
- active management by exceptional investment managers.

Australian inflation linked securities and nominal bonds were the main contributors to your returns this year, benefiting from falling yields. Even the real return strategies managed to produce a return above inflation this year despite being hurt by poor performing inflation linked and high yield securities. Global nominal bonds were helped by the easing in monetary policy in the US and UK. High yield was the only sector to produce a negative return.

Objective

Your fund aims to provide returns higher than cash, over the medium to long-term, from a diverse range of mostly debt investments.

The table below details how your fund performed up to 30 September 2008:

FUND NAME	3 mths (%)	6 mths (% pa)	1 yr (% pa)	2 yrs (% pa)	3 yrs (% pa)	5 yrs (% pa)
MLC MasterKey Super – Diversified Debt Fund^	2.1	N/Av	N/Av	N/Av	N/Av	N/Av
MLC MasterKey Super Fundamentals – Diversified Debt Fund^	2.2	N/Av	N/Av	N/Av	N/Av	N/Av
MLC MasterKey Pension – Diversified Debt Fund^	2.1	N/Av	N/Av	N/Av	N/Av	N/Av
MLC MasterKey Pension Fundamentals – Diversified Debt Fund^	2.2	N/Av	N/Av	N/Av	N/Av	N/Av
MLC Wholesale – Diversified Debt Fund (including MLC MasterKey Investment Service Fundamentals) *	2.2	N/Av	N/Av	N/Av	N/Av	N/Av

N/Av: Returns for this period are not available, because the fund has not existed for this period of time.

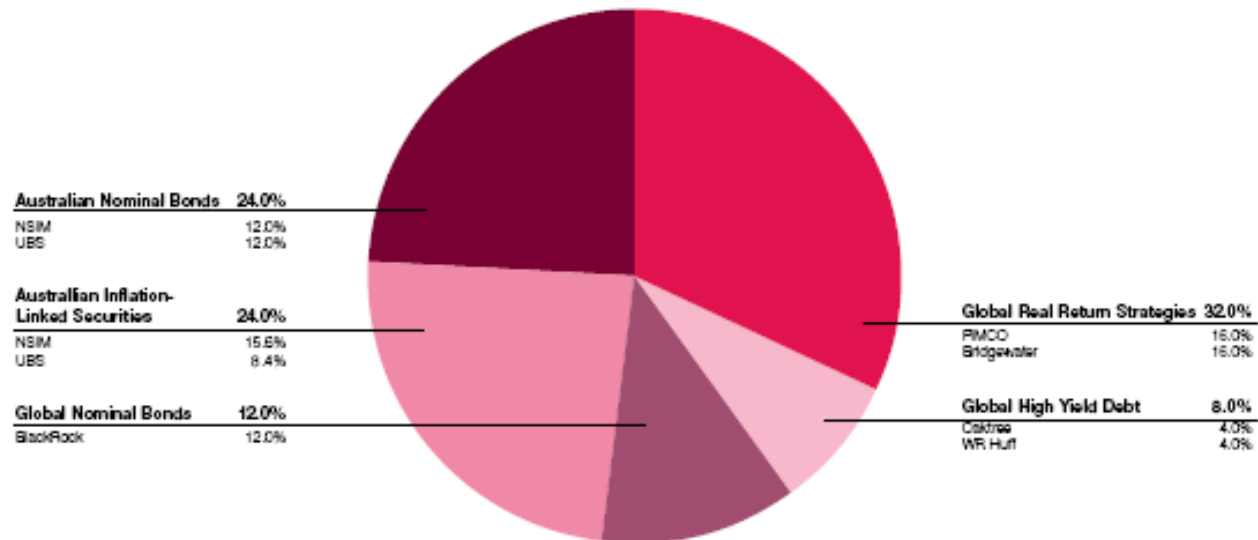
^Returns are after management fees and taxes

*Returns are after management fees and before tax

MLC Diversified Debt Fund

Your fund is invested across 7 managers, with different but complementary investment styles. The diagram below shows the strategic manager allocation of your Diversified Debt Fund.

MLC Diversified Debt Fund¹



¹ Strategic manager weights as at 30 September 2008.

MLC Diversified Debt Fund

Market Commentary

Over the year to September, Australian Real Estate Investment Trusts (A-REITs) have been the worst performing of the major asset classes (-42%) followed by Australian shares (-27%) hedged global REITs (-22%) and unhedged global shares (-17%). REITs, traditionally a defensive asset class, have been plagued by concerns over excessive debt levels in the sector and concerns over the level of risk inherent in some of those vehicles. In contrast, truly defensive assets, such as Australian bonds (+8%), cash (+8%) and global bonds (+7%) posted solid returns.

Throughout the past year or so, investors became increasingly concerned about the possible impact of the US sub-prime mortgage crisis on the US and global economies, and about the health of financial institutions. The uncertainty over just who has exposure to sub-prime loans and in what size has made it harder for even high quality institutions to obtain funds from the money markets. All of this unsettled global share markets, and the Australian share market was not immune. What we now face is much more than just a US sub-prime mortgage crisis, or a US housing crisis – this is a global financial crisis.

During September, the crisis in the US financial system came to something of a head. Institutions such as the investment banks Merrill Lynch and Lehman Brothers, the world's largest insurer AIG, and key US mortgage lenders Fannie Mae and Freddie Mac have been taken over, nationalised, or sent into bankruptcy. Institutions in the UK and Europe have faced similar difficulties. In response, a package of measures was (eventually) steered through the US Congress that would allow the US Treasury to acquire distressed assets from financial institutions, and hopefully free up the supply of credit, which has been severely curtailed as a result of the crisis.

More recently (since the end of the September quarter) the Reserve Bank of Australia reduced official interest rates by an aggressive 100 basis points – the first cut of that magnitude in around 16 years. The RBA's move was followed by rate cuts from the US Federal Reserve, the European Central Bank, the Bank of England, the Swiss National Bank, the Bank of Canada, and the Swedish Riksbank. In addition measures have been announced in the UK, Europe, and most recently in the US under which taxpayers will take equity stakes in banks in the latest efforts to recapitalise the financial sector.

Despite the best efforts of the US Federal Reserve and Treasury, it is now highly likely that the US economy has

fallen into recession. Elsewhere, economic indicators in Europe and Japan have also taken a turn for the worse. While there are certain to be relative winners and losers in the current environment, no economy is likely to be totally immune from the effects of what is clearly a global financial crisis.

In Australia, our economy has slowed over the course of 2008. Consumer demand in particular, has slowed significantly – in fact the volume of consumer spending fell in the June quarter for the first time in 15 years. While consumer spending and housing activity appear set to remain quite weak for a while yet, demand for Australia's key resource exports continues unabated, and there remains a massive pipeline of investment projects – largely, but not exclusively in the resources sector – that are likely to underpin Australia's economic growth. The RBA's recent rate cut, together with further rate cuts over the coming months should provide further support to consumer spending and housing activity over the coming year. At time of writing, the Australian Government's has announced that it will guarantee all Australian banks deposits for a period of three years, in a move which broadly mirrors similar moves offshore. Rather than reflecting any significant problems in the Australian banking system, the move is largely designed to put Australian banks on an equal footing with their global counterparts as they compete for funding.

The fact that the economic environment continues to worsen has serious implications for both the health of the financial system and for assessments of value in bond and share markets. So far, efforts at repairing financial institutions' balance sheets have focused on the damage done by the downturn in the US property market. However, as growth weakens, credit issues are likely to emerge in other sectors of the economy. Corporate credit markets have sold off aggressively on fears of wider credit problems. While buying opportunities do appear to be presenting themselves in these markets, it is unclear if enough bad news has been factored into current prices.

In share markets, traditional measures of valuation suggest shares offer excellent value at current levels. However, past corporate earnings are not going to be sustained in the face of a global slowdown or recession, and consensus forecasts for corporate earnings – both here in Australia and elsewhere – look far too optimistic. Nevertheless, our investment managers are taking advantage of greatly improved value on offer, in both the Australian and global share markets.

MLC Diversified Debt Fund

We have no way of knowing when the turmoil in world financial markets will come to an end, just as it is well-nigh impossible to identify when such crises are likely to start. We do know that crises of varying magnitudes and durations happen regularly, and that every crisis (financial or otherwise), every recession and every bear market comes to an end. When that happens, share markets not only recover lost ground, but inevitably move higher. We also know that crises provide opportunities for long-term investors to acquire quality assets at beaten-down prices – opportunities that our investment managers are taking during this time.

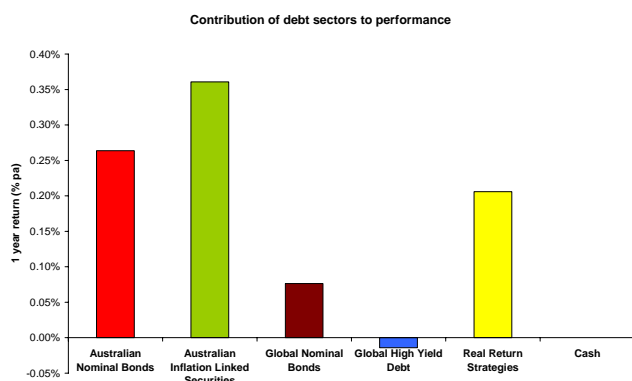
At the end of the day, the share market is a snapshot of the businesses that comprise the economy. Over time, those businesses profit from meeting the needs of their customers, pay dividends, and reinvest in order to grow. Share markets mostly reflect that reality. Extended periods where share markets fail to deliver are rare, but they have happened. Consequently, not everybody can or should have all their eggs in the basket labelled 'shares'.

Our best defence against not knowing the unknowable is to diversify our investments as widely as possible, take enough risk in our portfolios to enable us to meet our clients' return objectives and to, as much as possible, fully understand the risks attached to every investment we make.

MLC Diversified Debt Fund

Strategy Commentary

The following graph provides a further breakdown of the “Debt assets” return shown in the graph above. It highlights the sectors which had the greatest impact on your total return from debt assets.



The last year has been very challenging for most sectors of the debt market.

In prior years credit was easy and lending standards were poor as most assets continued to grow in leaps and bounds. The sub-prime crisis in mid 2007 was the trigger event which has resulted in a squeeze on liquidity as institutions and other lenders became concerned about their exposure to loans with a higher risk of defaulting ie those that were backed by lower quality assets.

Interest charged on higher risk loans has risen sharply over the last year as debt markets adjust to a more appropriate pricing of risk. In other words higher default risk loans are being charged much higher interest rates (aka yields).

Debt securities are effectively loans to governments and companies all over the world. While your portfolios have been deliberately diversified so you have exposure to many different types of debt securities, you have some exposure to credit risk. In strong economic conditions high credit risk (high yield) debt securities are usually one of the best performing debt sectors however, in a credit crunch as risk is repriced, they are usually one of the worst performing.

Despite this rather grim backdrop, your portfolio managed to produce a positive return. While returns were well below cash for the year, the portfolio was somewhat insulated from the weak market conditions due to its

- broad diversification across many different types of debt, particularly real return strategies and inflation linked securities
- active management by exceptional investment managers.

As shown in the graph above, Australian inflation linked securities were your strongest performing debt sector this year. Real yields fell significantly and inflation expectations are virtually unchanged from where they were a year ago. Since the collapse of Lehman Bros on 14 September, Australian inflation linked securities have suffered a spike in real yields which has hurt performance since the end of September.

Australian nominal bonds were also a driver of your returns over the year, outperforming cash. The yield curve slopes negatively to 3 year bonds due to the market's expectation of falling interest rates – this expectation is already coming to fruition with the 1% cut in the official cash rate by the RBA early in October. For bonds maturing in greater than 3 years the curve is positive sloping. While the official cash rate at the end of September was 7%, yields on 3 year bonds were 5.1% and 10 year bonds 5.4%. Over the past year the RBA increased official cash rates by 1.25% and reduced them by 0.25% in September. The further cut in October brings the official cash rate back to 6%, the same as it was a year ago. To a degree your portfolio was hurt by the increases in interest rates earlier in the year but this was reversed when the market started to price in expectations of a cut in interest rates. Your performance was further bolstered by UBS outperforming the index as they positioned the portfolio for a fall in yields which came late in the year. NSIM's performance was hurt by their exposure to credit risk.

The real return strategies, managed by Bridgewater and PIMCO, are designed to help your portfolio exceed the rate of inflation over the long term. While these strategies far exceeded inflation last year, they produced a return marginally above inflation this year (before the deduction of fees and taxes). The investment managers both held global inflation linked securities which helped earlier in the year, particularly in July and August when inflation expectations were high and real yields fell, this reversed dramatically as real yields have increased sharply in recent months, despite falling nominal yields. Bridgewater also held global government nominal bonds and commodities which paid off in this environment. High yield debt represents a small sub-component of PIMCO's real return strategy which hurt their

MLC Diversified Debt Fund

performance this year. When the yield differential (spread) between lower and higher risk credit widens, securities with credit risk are sold down. This was accentuated following the collapse of Lehman Bros.

The global nominal bond market benefited from the easing in monetary policy in the US and UK. The slope of the US yield curve ended the year positive as yields on shorter dated bonds fell more than longer maturity bonds. BlackRock underperformed the market as they had credit exposure in their strategy which was punished most of the year.

While global high yield was one of the star performing strategies in previous years, this year it was the worst. The two high yield investment managers, W.R. Huff and Oaktree outperformed the market spectacularly which is why your high yield debt investments did not suffer more substantial losses. While the process of widening yields between higher and lower credit risk debt can be painful, investors in high yield debt are now better compensated with a higher yield for the risk taken.

Your global debt securities are mostly hedged back into Australian dollars to reduce the impact of changes in the value of the Australian dollar on your returns. Therefore your portfolio did not really benefit from the significant depreciation of the Australian dollar in the later part of the year.

While the market environment has been and may continue to be volatile, your exposure to risk is managed via very broad diversification. And you have exceptional investment managers, with good credit research skills (not relying on public credit rating agencies), who are actively seeking out securities that would survive in a poor credit environment.

We have also been pro-active in continuing to engage with our investment managers to assess both market risks, as well as opportunities. Specifically, MLC implemented an opportunistic investment with Oaktree to add an allocation to global bank loans for superannuation and pension investors. Essentially, MLC has sought to benefit from the dislocation caused by the current supply/demand imbalance within this market as underwriters and arrangers struggle to find bank loan financing for their commitments. Again we view this as a prudent and conservative allocation, to quality assets trading at a discount, offering superannuation and pension investors secured exposures at the top of a company's capital structure. More broadly, we continue to maintain dialogue with both incumbent and prospective managers regarding investment opportunities arising from debt market volatility.

The de-leveraging cycle within the global financial system has now been in place for over twelve months, with little sign of abatement. We have seen credit spreads widen further than in the previous two credit crunches in 1991 and 2001/02. There may still be more shocks to come, however we have already seen governments in the developed world willing to intervene and provide a floor to some debt securities. Inevitably when markets tumble, quality securities are thrown out with the bad, providing active investment managers opportunities to purchase quality assets at "fire sale" prices. Good investment managers use volatile and uncertain market conditions to lay the foundations for their future strong long-term performance.

Note: Please refer to the appendix for manager return tables.

MLC Diversified Debt Fund

APPENDIX

Debt Assets

MANAGER	1 yr (%)	2 yrs (% pa)	3 yrs (% pa)	5 yrs (% pa)	7 yrs (% pa)	10 yrs (% pa)
NSIM (short maturities)	8.6	7.1	6.6	N/Ap	N/Ap	N/Ap
NSIM (all maturities)	7.5	5.6	5.4	5.5	5.6	5.7
NSIM Inflation-linked	10.6	5.7	6.9	7.7	7.4	7.3
NSIM Cash	7.6	7.1	6.7	6.3	5.9	5.8
UBS (short maturities)	8.9	7.1	6.5	N/Ap	N/Ap	N/Ap
UBS (all maturities)	8.8	6.1	5.7	5.7	5.8	5.9
UBS Inflation linked	12.2	6.5	7.4	N/Ap	N/Ap	N/Ap
BlackRock (short maturities)	4.8	5.3	5.2	N/Ap	N/Ap	N/Ap
BlackRock (all maturities)	4.7	4.0	4.3	N/Ap	N/Ap	N/Ap
PIMCO (short maturities)	1.0	3.2	3.9	N/Ap	N/Ap	N/Ap
PIMCO (all maturities)	2.4	3.9	4.2	6.3	7.2	6.7
Bridgewater	7.1	6.5	5.6	N/Ap	N/Ap	N/Ap
Oaktree (High Yield)	-1.5	3.4	4.8	N/Ap	N/Ap	N/Ap
W R Huff (High Yield)	-1.1	4.4	4.6	6.6	8.2	N/Ap
Diversified bond strategy	6.4	5.2	5.4	6.6	6.8	6.6
Debt Assets Benchmark	9.1	5.6	6.2	6.9	7.1	6.7

Notes to tables:

The performance reported in the above tables is before fees and taxes

N/Ap: Returns for this manager are not applicable, because the manager was not appointed to the fund for this period of time.

Disclaimer:

Please note that all figures reported in this fund commentary are before management fees and taxes, unless otherwise mentioned.

Any advice in this communication has been prepared without taking account of your objectives, financial situation or needs. Because of this you should, before acting on any advice in this communication, consider whether it is appropriate to your objectives, financial situation and needs. You should obtain a Product Disclosure Statement or other disclosure document relating to any financial product issued by MLC Investments Limited ABN 30 002 641 661 and MLC Limited ABN 90 000 000 402 and consider it before making any decision about whether to acquire or continue to hold the product. A copy of the Product Disclosure Statement or other disclosure document is available upon request by phoning the MLC call centre on 132 652 or on our website at www.mlc.com.au

An investment in any product offered by a member company of the National group does not represent a deposit with or a liability of the National Australia Bank Limited ABN 12 004 044 937 or other member company of the National Australia Bank group of companies and is subject to investment risk including possible delays in repayment and loss or income and capital invested. None of the National Australia Bank Limited, MLC Limited, MLC Investments Limited or other member company in the National Australia Bank group of companies guarantees the capital value, payment of income or performance of any financial product referred to in this publication