UniSuper

October 2017

Investment market update

Despite widespread strength across major global share markets (the US in particular), Australian shares continue to track 'sideways'. These market differences are manifesting in wide-ranging returns across our range of investment options, which you can learn more about in our recent video. Topping the list of our best performers in recent times, returning over 22% last financial year, is the Global Environmental Opportunities (GEO) option. Many of the companies held in GEO, such as Tesla and Cleanaway Waste have recorded short-term share price gains that are nothing short of spectacular. While the growth outlook for these companies is promising, so much good news is factored in that it won't take much bad news to impact these lofty share prices. Against this backdrop, we felt it was timely to take a closer look at our GEO option.

Performance of key markets

	% CHANGE			
	MONTH	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian shares (S&P/ASX 300)	0.0	0.8	9.0	7.1
Global shares (MSCI All Country World Local Currency)	2.1	4.3	18.3	8.9
Australian dollar (AUD/USD)	-1.1	2.3	2.5	-3.6
Australian fixed interest (Bloomberg Composite)	-0.3	-0.1	-0.7	3.9
Cash (Bloomberg Bank Bill)	0.1	0.4	1.8	2.1
Balanced option*	**0.4**	**1.4**	**8.7**	**8.9**

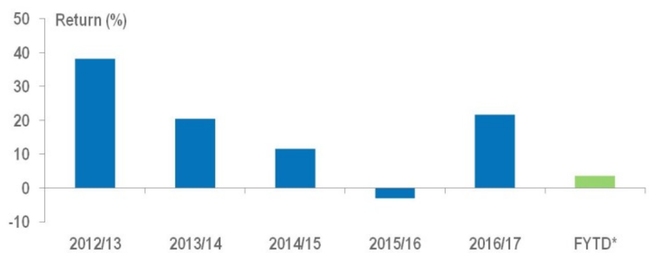
Returns are for periods to 30 September 2017. Past performance is not an indication of future performance.
** Returns relate to our Accumulation (not Pension) investment options and are published after fund taxes and investment expenses, other than account-based fees.*

See performance information for all options

The Global Environmental Opportunities (GEO) option: buyer beware

The GEO option was our top performer for the 2016-17 financial year, and the strong performance has continued into this financial year (up 5% already). Since we launched the GEO option on 17 April 2012, it has returned 15.2% p.a., and members who invested in the early days have already doubled their money!

Chart 1 GEO option performance



History tells us that such a strong performance can last for longer than people think, but not forever—and markets have generally been unkind to investors who chase a "hot" asset class. The recent case of the Listed Property option is a good example. After four years of extremely strong performance (17% p.a. on average), a familiar pattern emerged, with many members switching into the option. This then resulted in disappointment for the return chasers, with the Listed Property option our worst performer over the last financial year.

The GEO strategy and portfolio characteristics

The GEO option invests in a diversified portfolio of global companies seeking to address and benefit from current and emerging environmental issues. Since its inception, the companies targeted for inclusion have been those deriving at least 50% of their revenue from business activities in alternative energy, energy efficiency, pollution mitigation, sustainable water, and green building. Until July 2017 the strategy adopted an index approach, but is now managed more actively by our global in-house team. The transition to in-house management has enabled a more refined approach, to the point where we're now able to target a portfolio of companies earning around 75% of its aggregate revenues in these business activities.

For companies and asset managers, the environment—and climate change in particular—as a key investment theme is a relatively recent phenomenon. We find that many of the companies involved tend to be less established and have higher growth prospects than the 'average' company. They also tend to have higher capital requirements to support adopting emerging technologies and building new markets. In fact, almost 25% of the companies in the GEO option do not generate what is known as 'free cash flow'. All the cash they generate is generally invested back into the business, rather than distributed to shareholders. In the broader market, the number of companies not generating free cash flow is much lower, at closer to 10%.

Re-investing in the business rather than paying large dividends, is typical of companies with high growth prospects—and indeed essential for these companies to achieve their potential. Problems arise, however, when a company doesn't achieve a satisfactory return on the invested capital and/or the share market becomes overly optimistic about the prospects of the company. This typically results in an inflated share price. To illustrate just how optimistic the share market has become, let's consider the case of Tesla.

Tesla—a great story with a high price

The electric car company co-founded in 2003 by its charismatic and visionary leader, Elon Musk, is now one of the most recognised brands in the world, almost synonymous with the term 'innovation'. Until recently, Tesla was our largest holding in the GEO option and one of the best-performing shares in the last financial year (up 70%). While the prospects for Tesla continue to look bright, the question is whether or not the share price is now factoring in an overly optimistic picture of the future. If we compare some metrics with other leading car manufacturers, you'll quickly get the picture. **Table 1** shows that Tesla is valued similar to that of BMW and higher than Ford, yet produces a fraction of the vehicles. And while Tesla is still reporting a loss, the other two are making healthy profits.

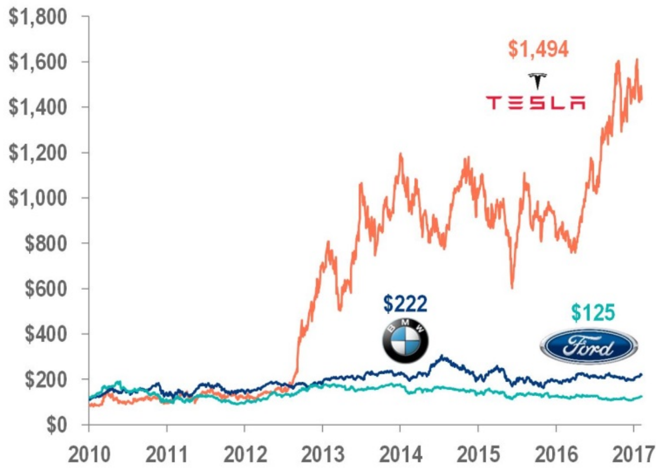
Table 1 *Comparing the sales and profits of Tesla, BMW and Ford*

	Market value ($)	Vehicles delivered (2016)	Profit/loss (2016) ($)
TESLA	59 billion	76k	-0.8 billion
BMW	61 billion	2 million	7.3 billion
Ford	45 billion	7 million	4.6 billion

Source: Company reports, Bloomberg

Chart 2 below plots the respective performance of their share prices, illustrating the vast divergence in how quickly the market has upgraded Tesla's prospects while expectations for Ford and BMW have remained static. Bear in mind that if electric vehicles are adopted in the volumes implied by the Tesla share price, you can be absolutely certain that Ford and BMW will be competing for their piece of the action.

Chart 2 *Performance: Tesla vs. BMW and Ford*



Source: Bloomberg

Tesla isn't alone in the high price category

One popular metric used to compare the valuations of companies is the price / earnings multiple (see the box for definition). **Table 2** shows that, on a P/E basis, the whole GEO portfolio is more expensive than the market average. In market parlance, they are trading at a significant 'premium' to the index. Of course, the vast majority of these would also have better growth prospects than average, so a premium is justified—the question is by how much? When a company is trading at a 66% premium, there is very little room for error. A downgrade in growth prospects due to such factors as changing market tastes, competition, failing technology and so on are bound to have huge adverse impacts on the share price.

Table 2 Valuation of GEO option companies grouped by size

Option holdings	% of portfolio	P/E multiple	Premium to broader market*
Top 10	41%	27x	66%
Next 20	25%	26x	57%
Next 40	18%	25x	51%
Equities remainder	13%	17x	3%

*Market P/E is 16.4x as measured by MSCI World Index

Price/Earnings ratio (P/E)

Share price

Earnings per share (EPS)

E.g. If the share price is $1.00 and earnings (or profits) per share is 10 cents, then the P/E multiple is 10 times. When a company trades on a PE multiple higher than the market average, the market is implying that the company has better growth prospects than the average (and vice versa).

What does all this mean for UniSuper?

We've designed the GEO option to meet the needs of members seeking to invest in companies that are expected to address and benefit from the environmental challenges we face. This is a compelling and somewhat seductive theme, so it's not surprising that the valuations of many companies involved are factoring in 'blue-sky' potential.

In some instances, such lofty valuations will turn out to be entirely warranted, as a diversified portfolio invariably throws up a big winner. There would have been a time (and not too far back) when today's tech titans like Apple, Google, and Facebook had valuations that looked optimistic—even ridiculously high to some—only to see the pessimists proven wrong. So it goes without saying that none of the above should be construed as advice or even a 'sell' signal. It's just a case of buyer beware.

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