UniSuper

April 2015

Investment market update

Though the Australian share market was broadly flat in March, strong returns in January and February meant that overall, the March quarter was the strongest in more than five years.

This month we summarise Australia's recent 'reporting season' (reporting of company financial results). In a difficult environment for revenue growth, Australian companies have been focussed on cost-cutting and boosting dividends.

Performance of key markets

	% CHANGE				
	MONTH	FYTD	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian Shares (ASX 300)	-0.1	12.9	13.9	15.3	8.3
US Shares (S&P 500) in US Dollars	-1.6	7.1	12.7	16.1	14.5
US Shares (S&P 500) in Australian Dollars	0.8	32.3	36.7	28.5	18.7
Asian Shares (MSCI Asia)	0.8	6.4	11.5	6.0	4.6
Australian Dollar (AUD/USD)	-2.4	-19.0	-17.5	-9.6	-3.6
Australian Fixed Interest (UBSA Composite)	0.8	7.8	11.1	7.1	7.6
Cash (UBSA Bank Bill)	0.2	2.0	2.7	3.0	3.8
Balanced (MySuper) option*	**0.5**	**13.0**	**15.8**	**14.0**	**9.7**

Returns are for periods to 31 March 2015. 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

Global share markets were mixed in March. Continued moves towards easier monetary policy (lower interest rates and/or printing money) helped boost shares in Europe, Japan & especially China—where shares surged more than 13% in the month! Meanwhile, shares in the US fell as the likely first rate hike by the US Federal Reserve draws closer and evidence mounts that the stronger US$ is starting to weigh on corporate earnings.

Shares in Australia were in the middle of the pack—including dividends in the assessment meant returns were flat for the month. Continued falls in iron ore prices (Australia's largest export commodity) underpinned a fall in mining shares by more than 6%. However, lower interest rates helped boost bank and industrial shares. Despite these lacklustre returns for March, the Australian share market returned more than 10% in the March quarter — the strongest outcome in more than five years.

The latest 'reporting season'

February and March are important months for the Australian share market. Dubbed the 'reporting season', it's when the majority of stock exchange-listed companies report their semi-annual (or annual) earnings results to 31 December with follow up presentations and briefings from company management.

There are, of course, many ways of analysing a company's operating performance but the reality is that earnings (and the quality and sustainability of those earnings) represent an important 'scoreboard' for investors to monitor a company and its management team's progress. We think about company results in many contexts such as:

- Is the industry and company performing in line with management and the market's expectations?
- Is company management doing what they said they would?
- How do the results and commentary compare to others in the same industry?
- Are there any trends, cyclical or structural changes occurring that are showing in the numbers?
- (Most importantly) do the results give rise to any change in expectations of the ongoing

sustainability of a company's earnings and dividend stream?

The latest reporting season scoreboard

By and large, Australian companies (on the S&P/ASX 200 Index) reported flat earnings growth, a result that was broadly in line with expectations. However, the flat result belies the considerable differences in performance reported across the different sectors.

The following table compares the growth in revenue (i.e. sales), earnings per share (EPS), and dividends per share (DPS) versus the previous corresponding period across different sectors.

	REVENUE GROWTH (%)	EPS GROWTH (%)	DPS GROWTH (%)
All companies	**0.8**	**+0.4**	**9.2**
All companies ex-resources	2.6	7.6	7.6
Resources	-4.5	-23.4	14.6
Banks	3.0	2.6	3.6
Industrials	1.9	7.9	8.3

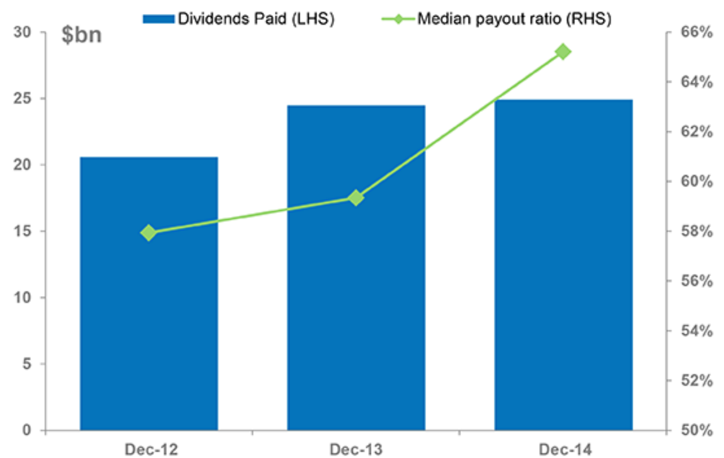
Source: Macquarie/UBS

Some key points to take away from the table include:

- Revenue growth continues to be very difficult to achieve across most industries – this has been a consistent trend post the financial crisis, and is prevalent in most developed economies.
- Sales growth (excluding resources) was lower than earnings growth, implying that the latter has been largely driven by productivity gains and cost cutting (note: earnings = sales revenues - costs).
- Earnings in the resources sector have taken a big hit, driven by significant commodity price weakness, particularly oil (-46%) and iron ore (-24%).
- Dividend growth was greater than earnings growth yet curiously this was driven by the sector which experienced the most significant earnings downturn over the period, i.e. resources. This trend is unlikely to be sustained for the following reasons.

Sustainability of dividend growth

Dividends are paid out of a company's earnings. In most cases companies pay out less than 100% of their earnings, retaining a portion to invest in the future. The percentage of earnings paid out as dividends is referred to as the "payout ratio" and the following graph shows how this ratio has been creeping up over the past two years.



Source: JP Morgan

On the face of it, the healthy growth in dividends announced in the latest reporting season was welcome news. However caution is warranted once we dig a bit deeper. Ultimately, dividend growth can only be sustained by growing earnings, which in turn can only be sustained by reinvesting in the business. In the absence of underlying earnings growth, increasing dividend payout ratios are tantamount to a "sugar shot". This appears to be what is happening with our resource companies that have an unfortunate history of being pro-cyclical in their investment activities. That is, they invest heavily at the top of the cycle (keeping dividend payout ratios low) when everything is expensive, and rein capital expenditure in at a time when prices are much lower.

In a slow growth economy, sales growth will continue to be hard to come by, so higher earnings will still be heavily dependent on genuine productivity gains, as distinct from cutting costs by reducing investment; companies don't shrink to greatness. Falling input prices (particularly energy), lower wage growth, and a more competitive currency will also act as tailwinds for many Australian companies.

Performance of UniSuper's major holdings

The following table shows the reported earnings growth of 10 companies that represent our Balanced option's (for both accumulation and pension) major holdings. Also shown is the subsequent movement in the company's share price in the week following the reporting season announcement. A positive share price movement typically reflects a positive surprise and the opposite applies to a negative share price movement.

COMPANY	EARNINGS GROWTH VERSUS PREVIOUS YEAR	SHARE PRICE MOVEMENT
TELSTRA	+7%	+2%
TRANSURBAN	+14%	0%
CBA	+7%	0%
SYDNEY AIRPORT	+6%	+1%
SCENTRE GROUP	+2%	+3%
BHP BILLITON	-31%	+6%

COMPANY	EARNINGS GROWTH VERSUS PREVIOUS YEAR	SHARE PRICE MOVEMENT
GPT GROUP	+1%	+1%
APA GROUP	+9%	+6%
WOOLWORTHS	+5%	-12%
CSL LIMITED	+7%	-4%

Observations

- Most of our key holdings reported results and provided future guidance that were in line with market expectations, resulting in a flat share price response.
- Our core infrastructure assets (Transurban, Sydney Airport, and APA) all recorded healthy earnings growth. The "fortress" nature of these assets combined with capable management teams continue to look attractive to us despite the significant share price appreciation they have experienced over the past couple of years.
- Despite announcing a -31% decline in profits, BHP's share price actually rose 6%, indicating that the market was expecting the company to report even lower profits.
- The biggest disappointment of the season for us was Woolworths. While the reported earnings was broadly in line with expectations, future guidance was weak and they took a $148 million write-off in their Big W business. The doomsayers are predicting further deterioration as competitors (particularly ALDI) force them into cutting margins, which ultimately means lower profits. We are not exiting out of our position in Woolworths at this stage. While we accept that ALDI does indeed represent a threat, we feel that Woolworths is suffering more from poor management execution, such as the Masters Hardware rollout. Coles is also under threat from ALDI, yet they were able to report a much healthier growth in sales.

At the current share price of $29.50, Woolworths is generating a dividend yield of around 4.7% (or 6.7% including franking credits). Given the compression in yields we see across all markets, it is clear that a lot of bad news is already being priced into Woolworths shares. In six months they will report their results for the full financial year, and it will be one of the most heavily scrutinised results of the season. If Woolworth's management can demonstrate that they have steadied the ship, it would not surprise to see a sharp appreciation in the share price. Unfortunately, the converse also applies.

This is not intended to be an endorsement of any of the listed securities named above for inclusion in personal portfolios. The above material reflects UniSuper's view at a particular point in time having regard to factors specific to UniSuper and its overall investment objectives and strategies.

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