UniSuper

March 2015

Investment market update

Though the Australian economy remains weak, the Reserve Bank of Australia's (RBA's) move in February to cut interest rates has spurred the share market higher. Australian shares have returned more than 10% in the first two months of the year and remain close to a seven-year high. A feature of the Australian market rally has been the stellar run of our major banks which, to some analysts, are in 'bubble territory'. This month we take a closer look at the rise in Commonwealth Bank (CBA) shares, concluding that the evidence doesn't necessarily support the bubble theory.

Performance of key markets

	% CHANGE				
	MONTH	FYTD	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian Shares (ASX 300)	6.9	13.0	14.2	15.8	9.5
US Shares (S&P 500) in US Dollars	5.7	8.8	15.5	18.0	16.2
US Shares (S&P 500) in Australian Dollars	5.2	31.2	32.0	31.4	19.4
Asian Shares (MSCI Asia)	1.9	5.6	11.1	4.9	5.6
Australian Dollar (AUD/USD)	0.5	-17.1	-12.5	-10.2	-2.7
Australian Fixed Interest (UBSA Composite)	0.3	7.0	10.3	7.1	7.3
Cash (UBSA Bank Bill)	0.2	1.8	2.7	3.1	3.8
Balanced (MySuper) option*	**3.4**	**12.4**	**14.9**	**14.6**	**10.3**

Returns are for periods to 28 February 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

The start of 2015 has provided a good example of the disconnect that can occur between financial markets and the broader economy. During February, with the Australian unemployment rate already at a 12-year high, the RBA cut its forecast for economic growth and projected a further increase in unemployment. Against this backdrop, the RBA then lowered the cash rate to a new record low after a long period of leaving the policy rate unchanged. While this may not seem like an environment that instils confidence or inspires risk-taking, the Australian equity market actually delivered a 6.9% return (including dividends) in February, taking total returns to more than 10% for the first two months of the year. This translates to Australian share markets being close to a seven-year high.

While this may seem counterintuitive, it is not unusual. In recent months, central banks in the Asia-Pacific region (including the RBA) have moved to stimulate their economies by cutting interest rates and printing money. These actions are very supportive of a dividend yield-focussed market like Australia. Generally solid profit results for the first half of the financial year also contributed to the market high.

Chanticleer

UniSuper doubles down on CBA

Are Commonwealth Bank shares in a yield bubble?

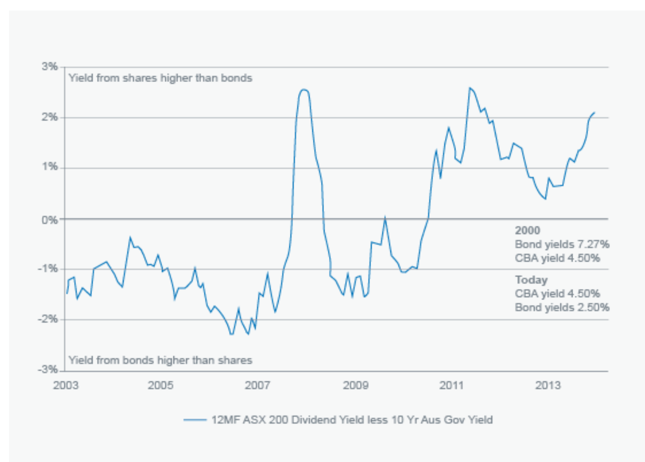
For the record, UniSuper is not doubling down on CBA shares and even if we intended to do so it would not be part of our approach to inform media beforehand. What we did tell the media is:

1. While CBA shares are a lot more expensive than they have been over the past few years, they still look cheaper than bonds, and
2. Predictions from equity analysts on the CBA share price should generally be treated with caution given their poor track record.

Dividend yields and bond yields revisited

Given the growing interest in CBA shares as the price approaches $100, we take a closer look at whether or not it's in a proverbial 'bubble'. Let's first revisit the general status of the share market versus the bond market.

Chart 1



Source: Datastream, Morgan Stanley Research. Past performance is not an indicator of future performance.

In the ***February 2013 investment update***, we talked about the positive gap between share yields (i.e. the dividend yield), and yields offered on safer assets like bonds. We inferred that the relatively attractive yield offered by shares is likely to support a share price rally, and that's indeed what has transpired. But as the above chart shows, even though shares have rallied strongly, the yield offered *still* remains very attractive relative to bonds. In fact the yield premium offered on shares is almost as high as it was during the GFC because bond prices have also rallied very strongly, pushing bond yields to historical lows. We appear to be in a period of "investment nirvana" in which buyers of bonds and shares are all making healthy returns, while those sitting on cash (the safest asset) are losing out.

A situation in which yields on shares are higher than bonds is abnormal. Shares of a company represent part ownership of a company, and a claim on (a "share" of) profits. Profits are paid in dividends and as the company grows, dividends can be expected to grow so the share price can also be expected to grow over time. Therefore, in normal circumstances we would expect the dividend yield offered by shares to trade *below* bond yields, reflecting the fact that shares have potentially unlimited upside while the maximum a bond will pay (when it matures) is its face value. Let's keep this in mind when considering CBA shares.

CBA dividend yields versus bond yields

The next chart shows the CBA dividend yield (the annual dividends received divided by the share price) compared to the 10-year bond yield from January 2000 to the present. In early 2000 CBA shares were trading at around $26 and I don't recall many analysts suggesting they were in a yield bubble. In those heady days of the dot-com bubble CBA was considered to be a "stodgy old company."

Coincidently, the yield on CBA shares in 2000 was around 4.5% which is about where they are today. In other words, using dividend yield as a valuation metric, CBA is no more expensive today than it was in 2000. While it is true that CBA shares are now trading at a record high, their profit is also at record levels. In 2000, CBA's price per share was about **15.5** times earnings per share (known as the price-earnings or "P/E": ratio) — the current P/E multiple is **16.4**. So based on this valuation metric, CBA still doesn't look much more expensive than it did in 2000.

Now check what has happened to bond yields over the same period; they have been crunched from around 7.3% to around 2.5%. That *does* look like a yield bubble! Bonds have been caught in the middle of a perfect storm in which central banks around the world have embraced drastic measures to flood economies with liquidity to ward off deflation threats.

Chart 2

Source: Bloomberg. Past performance is not an indicator of future performance.

Where to from here?

The CBA dividend yield return of about 2% more than 10-year bond yields (or about 3.5% more if one includes the full benefit of franking credits), is abnormal. At some point in the future, the CBA share yield will trade below the yield on bonds, although nobody knows when that will happen. *But it is a matter of when, not if.* Another unknown is the precise path by which normality will return, though it could be through:

i. CBA could cut dividends significantly (for example, if Australia experienced a severe recession creating a large spike in unemployment and loan defaults), and / or
ii. Bond prices fall and bond yields rise, and / or
iii. The CBA share price rallies even further.

While none of the above can be ruled out, it is relevant to note that the CBA's track record of paying dividends is very solid. Even during the GFC it managed to pay a healthy dividend of $2.28 (compared with $2.66 the year prior), and paid $2.90 the following year.

Also worth mentioning is that CBA is a fundamentally stronger bank now than it was pre-GFC. Since 2000, tier 1 capital (the bank's core capital) has increased from 7.5% to over 11%, and retail deposits as a percentage of total borrowings have increased from about 57% to 67%. Looking at the quality of the asset portfolio, bad and doubtful debts as a proportion of total assets is about 0.14%, and non-performing loans about 0.54%, so not much to be concerned about on that front.

Contrary to UniSuper's high level of comfort with CBA, the bulk of the analyst community (16 out of 18 analysts) rate the shares as a "hold", "sell", or "underperform". This shouldn't alarm anyone, given roughly the same number has had a similar rating since the shares traded at $50!

The generally negative outlook for Australian banks is typically based on analysts' views that their share prices are far too expensive relative to companies in other industries or relative to banks outside Australia.

A favourite metric employed to compare valuation is the price per share relative to the book value per share. For example, CBA's "price/book" is a multiple of 3.0, which looks incredibly expensive compared to a multiple of 1.1 for JP Morgan. Even taking into account that CBA earns about double the return on equity, compared to JP Morgan, CBA does look expensive based on this metric.

Another interpretation is that JP Morgan is very cheap. 'Book value' (the value at which an asset is carried on a balance sheet) is a very questionable metric, though, as it is only an accounting concept with many inconsistencies in how it's applied. How can we compare the book value of an Australian housing loan to a Portuguese small business loan? The actual value of a bank's assets will only ever be known if the total loan book was liquidated, an event we're not anticipating with CBA for the foreseeable future. In any case, try paying for an overseas trip with book value!

While dividends are real, comparing them to bond returns is a far too simplistic valuation metric to be used by professional analysts who employ very sophisticated modelling techniques. Also too simplistic in the eyes of most analysts is looking at the absolute dividend yield in the context of a super fund that is targeting a return objective of inflation + 3% p.a. for some investment options^.

Perhaps this is an overly simplistic view, but we reckon simplicity and a reasonable income might be just what our members want.

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.

^Different performance objectives apply to different investment options. These are not promises or predictions of any particular rate of return.

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