UniSuper

October 2015

# Investment market update

*The weak trajectory that took hold of the world's share markets in August continued into September as investors remain concerned about the risk of a major global slowdown.*

*The Australian market underperformed again, and the major banks were a key cause. Given the level of retail participation in the recent bank share offerings, this month's update takes a closer look at the recent share price weakness in the Australian banks. While such steep price falls are always concerning, we certainly haven't turned our backs on the sector.*

## Performance of key markets

| | % CHANGE | | | | |
|---|---|---|---|---|---|
| | MONTH | FYTD | 1 YEAR | 3 YEARS P.A. | 5 YEARS P.A. |
| Australian Shares (ASX 300) | -2.9 | -6.5 | -0.7 | 9.1 | 6.3 |
| US Shares (S&P 500) in US Dollars | -2.5 | -6.4 | -0.6 | 12.4 | 13.3 |
| US Shares (S&P 500) in Australian Dollars | -1.6 | 2.4 | 23.8 | 28.1 | 20.9 |
| Asian Shares (MSCI Asia) | -1.6 | -14.6 | -8.8 | 0.6 | -0.2 |
| Australian Dollar (AUD/USD) | -0.9 | -8.6 | -19.7 | -12.3 | -6.2 |
| Australian Fixed Interest (BBG AUB Composite) | 0.3 | 2.2 | 6.9 | 4.9 | 6.6 |
| Cash (BBG AUB Bank Bill) | 0.2 | 0.5 | 2.5 | 2.7 | 3.5 |
| **Balanced option*** | **-1.1** | **-1.3** | **8.2** | **11.4** | **8.9** |

Returns are for periods to 30 September 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

## Markets in September

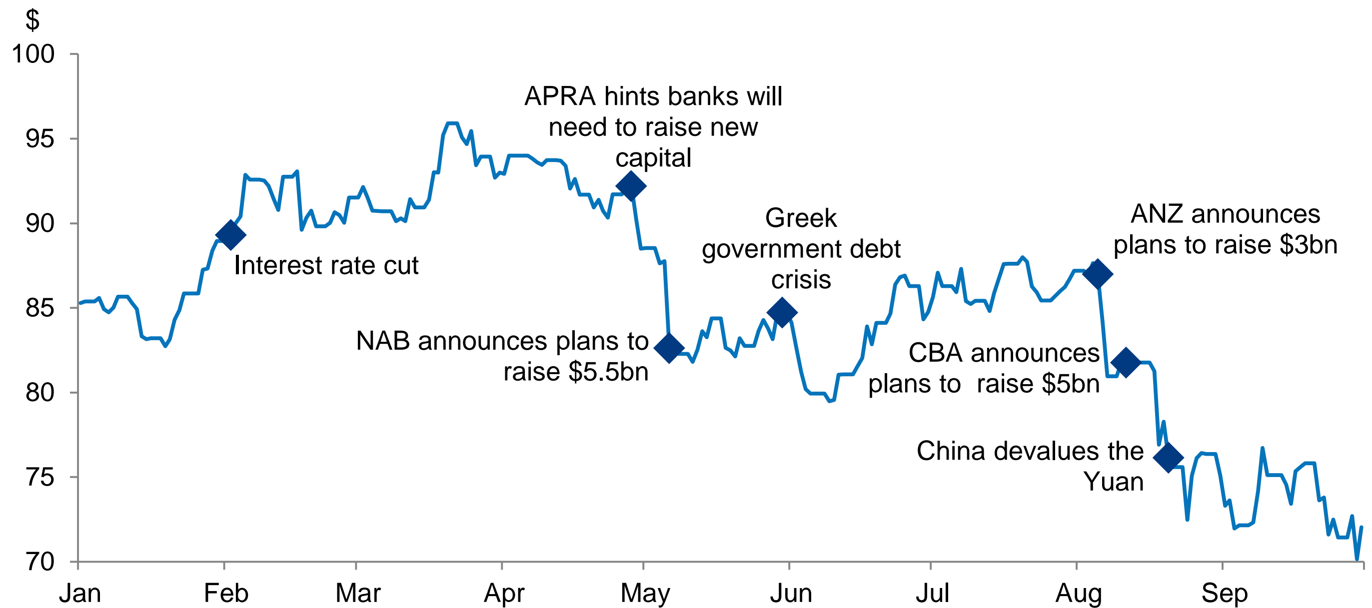
The weak trajectory that took hold of the world's share markets in August continued into September, with most major markets down again in the month. With a range of economies (including Canada, Russia, Brazil, Japan, Singapore) now in or very near to recession, investors remain worried the global economy and China in particular may be heading towards a hard landing. Even the decision by the US Federal Reserve to delay their first rate hike in more than 10 years failed to boost investor sentiment.

Given its large weighting towards resource companies (which were down more than 8%), the Australian market fared particularly poorly. The -3% return in September capped off the worst quarter for shares since 2011.

## Australian bank shares: why the panic?

September's *Investment market update* outlined some reasons why the Australian share market has suffered more than other global markets over recent months, citing the multiple capital raisings conducted by the major banks as the key factor. This month we take a closer look at the banks and explain why we're not joining the scramble for the exit. Given the familiarity most people have with the Commonwealth Bank (CBA), the following will tend to focus on that bank although the issues are generally applicable to the four major banks.

## *CBA share price 2015 year-to-date*




Source: Bloomberg. UniSuper

During the first few months of the year CBA's share price was supported (in line with the broader market) by the Reserve Bank of Australia (RBA) cutting interest rates along with expectations of more cuts to come. Falling interest rates are generally positive for share markets because they reduce the relative attractiveness of interest rate-based products like bonds. Also (for the more technically-minded), the current value of a company is fundamentally the discounted value of future earnings. If future earnings are discounted at a lower rate then, *all things being equal*, company values and share prices should rise. Of course in reality all things are rarely equal, so falling rates don't always lead to rising share markets.

The run up in CBA's share price came to an abrupt end in late April when the Chairman of the Australian Prudential Regulation Authority (APRA), Australia's banking regulator, forewarned higher capital requirements would be imposed on the sector. While the thrust of APRA's position has been known for some time, the timing seemed to catch the market off guard.

In response, NAB, ANZ and CBA raised a combined $13.5 billion in new capital by September. To raise capital, the banks actually create and sell their shares on the market. Capital raisings of this size are difficult for the market to absorb during the best of times let alone over a period when markets were affected by yet another drawn out bailout for Greece and increasing concerns over the health of the Chinese economy. As an added headwind the newly-issued shares were offered at discounts compared with prevailing prices at the time. The timing of APRA's announcements also coincided with consistently weak growth numbers reported in China. Given that Australian banks are highly leveraged to the Australian economy which in turn is highly dependent on the Chinese economy, bad news from China is immediately construed as bad news for our banks. Indeed, (anecdotally at least) "shorting" Australian banks appears to be a favoured trade for global hedge fund managers who want to take a negative position on China. Shorting is the practice of investors selling stock that they don't already own. At time of writing, so-called "short" interest in Australian banks was $5.6 billion, which is an all-time high.

### *A note on regulation*

The seemingly ever-lasting impact of the GFC is not confined to economic variables—the more onerous capital requirements demanded of banks can be seen as a direct regulatory response, and political backlash to the bank bail outs experienced in major economies. While Australian banks got through the GFC without any calls on the taxpayer to top up their capital, we're now following the rest of the world regarding regulatory response.

The centrepiece of the more stringent regulatory framework is the banks' requirement to hold more pure loss-absorbing capital (known as "tier 1" capital) on their balance sheets. In terms of asset composition they are also required to hold more low risk, low return, and liquid securities such as government bonds. Australian banks are

now targeting a minimum tier 1 ratio of 10%, which has steadily grown from 4% over the last decade. At this level Australian banks will be deemed to be "unquestionably strong", to use the term adopted in the recent Financial Systems (Murray) Inquiry.

While it's clear that it's in everyone's interests to have a strong banking system and that taxpayers should not be used as a bailout mechanism, there is also a downside to excessive regulation. The fundamental role of a bank in an economy is *risk transformation*. So by definition, banks cannot avoid risk. Impinging on a banking systems' ability to create credit has real economic impacts. Indeed, banking regulators around the world appear to be working at odds with central banks. In a global economy experiencing anaemic growth, major central banks are keeping real interest rates at zero to encourage risk taking, spur economic activity and avoid deflation. On the other hand, regulators are effectively reducing the banking systems' ability to take on risk and the impacts are already being felt with some banks pulling out of lower margin activities such as trade finance. Furthermore, with governments around the world reluctant or unable to loosen the fiscal purse strings, there is an unsustainable over-reliance on monetary policy to drive growth.

Whether or not an increase in a bank's tier 1 capital base by 2% makes them "unquestionably strong" is a moot point. The strength of a banking system ultimately depends on the confidence of depositors, and in a crisis of confidence any notion of "unquestionably strong" goes out the door. As an aside, the reported tier 1 capital ratios of the four major Greek banks were, on average, higher than the Australian banks when Greek depositors were queuing up to pull their money out.

It's the writer's opinion that at least in a practical sense, the recent increase in bank capital requirements is likely to have marginal impact on the strength of our banking system—at best. Our banking system derives its strength from the quality of the institutional framework in which it operates. On top of a sound regulatory framework, we have an unquestionably prudent Reserve Bank, which has repeatedly assured depositors that our banks have access to unlimited liquidity. In developed markets, bank failures have typically occurred due to lack of liquidity, not a lack of capital, so such assurances from the Reserve Bank are all-important.

## UniSuper's position on banks

While market gyrations are a fact of life, such steep falls in share prices as experienced by our banks are a concern because in one respect it represents a challenge to our investment thesis. One has to always ask the question: What if the market is right and we are wrong?

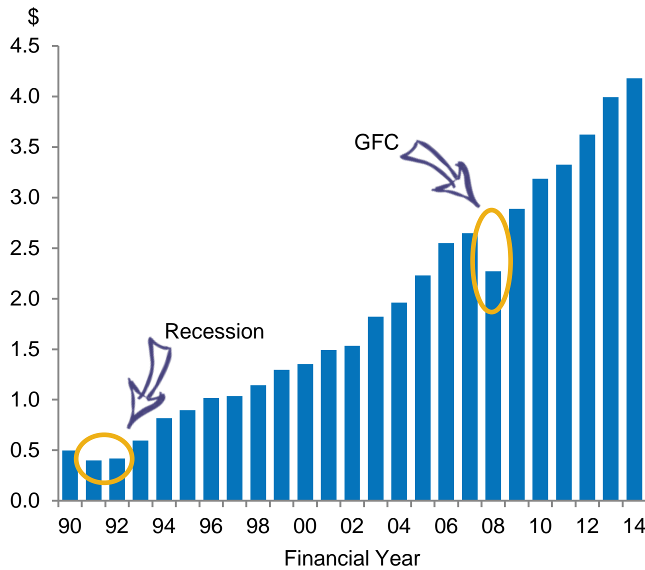
Our current thinking is that the recent sell-off is overdone and we've used the opportunity to add to our bank holdings for the following reasons.

At least some (and maybe a lot) of the recent share price weakness is a natural function of the market having to absorb a large volume being issued in a short period of time. But increasing capital to meet higher regulatory requirements is entirely different to replenishing capital that has been destroyed (as per the GFC experience). In this regard bank fundamentals remain strong. Apart from some industry-specific issues in the mining and agricultural sectors, the banking system is in good health. Loan delinquencies across the sector are at historical lows, reflecting the robustness of Australian corporate and household balance sheets. While these will eventually increase, the latest results from the likes of CBA, NAB and Bendigo Bank provide us with comfort.

Valuations have now become very attractive, at least if history is any guide. At $74.00, CBA's dividend yield is 5.7%. For investors with 0% or 15% tax rates (like pension members and accumulation members respectively), the effective yields are 8.1% and 6.9%. Yields on offer for the other banks are actually higher. Even in a normal interest rate environment this would represent an attractive yield. In the context of a market in which interest rates are hovering around 2% the relative attractiveness is self-evident.

Of course the hedge funds who've shorted bank shares stock will argue that the dividends will inevitably be cut if and when Australia endures a recession, so the yields are unsustainable. They could well be right, although a recession would need to be severe before dividends were cut to a point that the yield was unattractive. To provide some perspective, consider the following chart which shows the dividend performance of CBA over the past 25 years. Over this period dividends were cut twice; once during the very severe recession of the early 90s when unemployment hit 10%, and then during the worst financial crisis in a century. Following the setbacks, the upward trajectory in dividends resumed quite rapidly.

## *CBA dividend per share history*




*Source: Bloomberg*

When analysing banks our primary focus is testing the sustainability of dividends. When we meet with bank directors and management one of our favourite opening lines is *"let's start with the dividend and work backwards".* Other investors have similar priorities. Suffice to say that Bank's management understand the importance of dividends to their shareholders.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