November 2015

Investment market update

Share markets worldwide enjoyed a solid bounce in October. The Australian market was up over 4%, with listed property once again providing a positive contribution. In fact, listed property has been a stellar performer over the past year, so this month's update focuses on the sector and our Listed Property option. After such a strong run we address the question "are we in a bubble?"

Performance of key markets

	% CHANGE				
	MONTH	FYTD	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian Shares (ASX 300)	4.4	-2.3	-0.5	9.6	6.8
US Shares (S&P 500) in US Dollars	8.4	1.5	5.2	16.2	14.3
US Shares (S&P 500) in Australian Dollars	6.8	9.3	29.7	31.6	21.8
Asian Shares (MSCI Asia)	6.4	-9.1	-4.9	2.9	0.7
Australian Dollar (AUD/USD)	1.6	-7.2	-18.9	-11.7	-6.2
Australian Fixed Interest (BBG AUB Composite)	0.3	2.5	6.2	5.0	6.7
Cash (BBG AUB Bank Bill)	0.2	0.7	2.4	2.7	3.5
Balanced option*	**3.5**	**2.3**	**9.5**	**12.4**	**9.4**
Listed Property option*	**4.0**	**9.2**	**19.4**	**17.4**	**14.3**

Returns are for periods to 31 October 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, before deducting account-based fees.

See performance information for all options

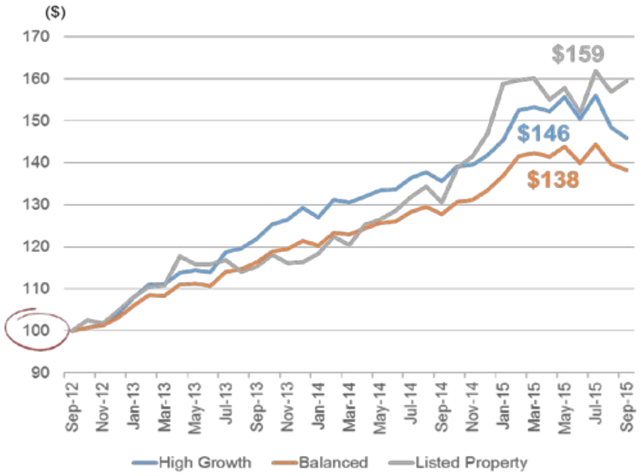
After plunging throughout the September quarter, global share markets rallied back strongly in October, with the broad market indices in the US, Japan, Europe and China all bouncing 8% or more in the month. This marked the strongest month for equities in four years. Pinpointing a specific reason for the rally is problematic, as was the case with the preceding collapse. A swing in investor sentiment is as good an explanation as any given economic fundamentals haven't changed much at all over the past quarter.

After the bounce, the Australian market has now generated a flat return for the past 12 months. However, different sectors within the broad market have delivered wildly different outcomes. While resources have been a large negative detractor, the property sector has been a stellar performer. That said, there is a growing school of thought that the sector is now over-valued, with some commentators alluding to a bubble.

Is a bubble building in property?

Australian listed property has delivered a return of 20% over the past 12 months and just under 60% over the past three years. This has underpinned the strong performance of our Listed Property option on an absolute basis, and relative to other growth options (see graph overleaf). Switching activity in favour of the option indicates that some members are counting on the trend continuing.

Three-year option performance



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Whenever a specific asset class experiences strong outperformance relative to others, it's prudent to take stock of the drivers and question whether the performance is warranted and sustainable.

Key performance drivers of outperformance

Recovering off a low base: The Australian listed property sector was actually the poster child for gross mismanagement in the lead up to the GFC as excess leverage (borrowing) was taken on to fund poor investments and weak business models. The GFC exposed the underlying weakness, and from October 2007 to February 2009 the sector recorded a -69% return. This was a disastrous outcome, particularly given many investors would have expected property to be a relatively steady performer. Against this background many investors shunned the sector in favour of more defensive assets such as bonds or unlisted property which are not exposed to the daily fluctuations of the stock market.

The shunning of all growth assets post-GFC, including property, inevitably produced some bargains so in some respect the past three years of exceptional performance represents a "catch-up" from a low base.

A telling example is the performance of Scentre Group (previously Westfield Retail Trust), one of our largest investments (currently $1.6 billion representing 7.2% of the company). Scentre has returned in excess of 100% (16.6% p.a.) since we first started accumulating in February 2011. At that time we were effectively investing in many of Australia's best shopping centres (owned by Scentre) at a 15% discount to their reported asset values. At the same time, inferior assets in the unlisted markets (also referred to as "direct" property) were trading at a healthy premium to their asset values. Scentre is now trading at a premium to its reported asset backing and is more in line with the unlisted market (though with a superior quality asset base).

Tracking bond yields lower: In terms of risk/return, property is usually categorised somewhere in between shares and bonds. Good quality property with low leverage can generally be expected to provide a steady income based on rents received, and over the long term capital appreciation has kept up with inflation. In a low yielding world, property has become a very popular investment choice for those not quite prepared to take on the higher risk involved with shares, while desiring a higher yield than the bond market provides. However, with bond yields remaining depressed, the flood of money into property shows no signs of abating.

Currency impacts: Approximately 50% of the Listed Property option is allocated to global property securities, which in turn is dominated by American and British companies. The significant depreciation of the Australian dollar against both currencies has therefore worked in favour of the Listed Property option.

Outlook

While we won't attempt to predict the unpredictable, the following points are worth keeping in mind when considering the outlook.

As mentioned above, falling interest rates and a depreciating Australian dollar have provided very significant tailwinds for the Listed Property option. While both interest rates and the Australian dollar can stay at current levels, the probability that they continue to fall at the same rate has greatly diminished.

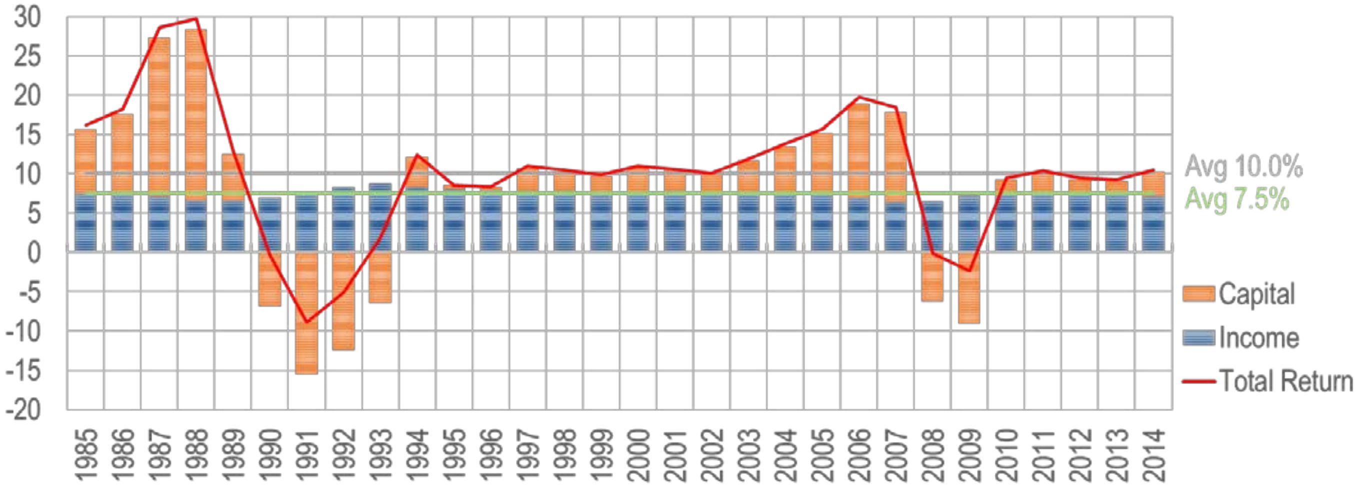
When considering valuations it's important to be aware that property is not a homogenous asset class. The term "property bubble" has become more prevalent as prices have risen, although the label is mostly used in the context of residential housing. Furthermore, it's typically confined to areas in Sydney and Melbourne where there are clearly some pockets of overheating. However, less than 5% of the property listed on the Australian stock exchange is directly related to residential housing. The listed market is dominated by retail (65%), followed by office (20%), and industrial (10%).

The retail sector is dominated by the owners of the large shopping centres, of which Scentre is the largest, and provides a useful guide to the health and valuations of the sector. While Scentre's share price has appreciated significantly over the past few years, it has also managed to grow its rental income.

Consequently, the dividend yield generated by Scentre is still around 5%. A high quality business generating a sustainable yield well in excess of the bond rates will continue to find a place in our portfolio.

The following graph also supports a view that the Australian property market as a whole is not in the bubble territory we witnessed during the late 1980s and leading up to the GFC.

Direct property returns (annual rolling (%))



Source: MSCI Past performance isn't an indicator of future performance.

The graph shows total annual returns of Australian direct (unlisted) property over the past three decades with the blue bars showing income and orange bars showing capital gains and losses. Note the remarkable consistency of rental income over such a long period, in contrast to the volatility of capital values. In a similar fashion to the share market, the property market is also subject to bouts of exuberance and despair. While history is not always a good guide to the future, it seems that if property is generating a total return over 10% for any length of time it is probably over-earning, and due for a correction.

Using history as a guide, we can take some comfort that the strong performance of the property sector over the recent past has not appeared to escalate to the 'irrational exuberance' levels of previous bubbles. Excessive leverage hasn't happened, nor have the convoluted corporate structures that saw a number of property companies collapsing during the last downturn. Centro was probably the highest profile example at the time: a market darling in the lead up to the GFC—only to be an immediate casualty. At its peak, Centro had leverage (borrowing) levels of 70%, which compares to average levels for the total market of closer to 30% today, at a time when interest rates (debt servicing requirements) are also much lower.

Conclusion

For the past 12 months, one of the best performing investment options on our platform has been the Listed Property (Accumulation) option, which has returned 19.5% (after fund taxes and investment expenses, but not including account-based fees). This outcome is particularly noteworthy given that the overall market has been quite strong, and property is typically expected to generate returns somewhere in between shares and bonds, given the growth and defensive nature of the asset class.

Strong returns tend to attract more funds as investors chase the best performers, although it's probably the time when investors need to be most cautious.

Fortunately, recent returns haven't escalated to the point where there's an obvious bubble for the market as a whole. Much of the gain can be attributed to a catch-up effect from the depressed levels prevailing in the aftermath of the GFC. Rental yields, which are the most relevant guide to property valuations, remain healthy in most sectors, particularly in the high quality retail sector that we favour.

We can take further comfort that we’re not currently seeing the excessive gearing typically associated with a bubble. However, with property valuations in the listed market now trading at or above the assessed value of the underlying assets, it’s highly unlikely that the rate of capital appreciation can continue in the immediate future. Of course, this doesn’t mean it can’t or won’t happen, but if prices continue to escalate at the same rate, talk of a bubble will hold more substance.

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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