UniSuper

December 2015

Investment market update

Global share markets diverged in November as markets started preparing for a world in which we're seeing the major central banks moving in opposite directions. Markets in Europe and Japan were stronger given speculation of more money printing there, while the US and emerging markets are bracing for the first US Fed rate hike in nearly 10 years. While the term 'market volatility' is typically applied to share markets, global bond and credit markets also experience significant volatility, directly impacting investment portfolios supposed to be 'defensive' in nature. UniSuper has three single-sector defensive investment options being Cash, Australian Bond, and Diversified Credit Income. This month, we take a look at these options with particular emphasis on Diversified Credit Income, which recently hit its one-year anniversary.

Performance of key markets

	% CHANGE				
	MONTH	FYTD	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian Shares (ASX 300)	-0.7	-3.0	2.1	9.2	6.9
US Shares (S&P 500) in US Dollars	0.3	1.8	2.7	16.1	14.4
US Shares (S&P 500) in Australian Dollars	-1.2	8.0	21.1	31.1	21.0
Asian Shares (MSCI Asia)	-2.8	-11.7	-9.0	1.1	0.2
Australian Dollar (AUD/USD)	1.6	-5.7	-15.1	-11.4	-5.5
Australian Fixed Interest (BBG AUB Composite)	-0.9	1.6	4.0	4.7	6.6
Cash (BBG AUB Bank Bill)	0.2	0.9	2.4	2.7	3.4
Balanced option*	**-0.5**	**1.8**	**8.6**	**12.1**	**9.4**

Returns are for periods to 30 November 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 Diversified Credit Income (DCI) option – one year on

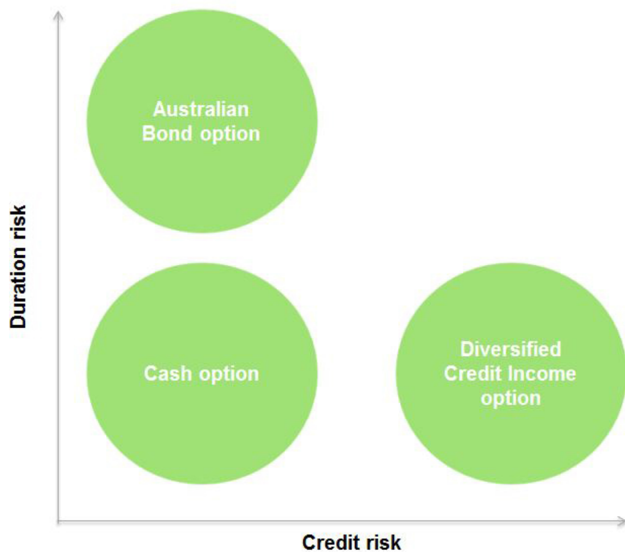
On 1 September 2014, we introduced a new investment option—Diversified Credit Income (DCI). It predominantly invests in corporate bonds issued by investment grade companies in developed markets (both domestic and global).

DCI was created to fill a perceived gap in our defensive single sector options, in that it provides members with the ability to invest in corporate credit exposure. Our other defensive single sector options include Cash and Australian Bond, neither of which invests in corporate bonds.

Since its launch, DCI has underperformed its defensive peers and this month we look at the drivers underpinning the different performances. Before dealing with specifics, though, it's worth refreshing on some fundamentals.

Fundamentals of income-based investment options

DCI, Cash and Australian Bond are considered to be defensive in nature because the bulk of their return is generated by ***income*** rather than ***capital growth.*** Given that there is more certainty around income generation than capital growth, these assets are generally considered to be less risky than shares. They're also less risky than shares because, in the event of a company collapsing, bond investors and lenders get paid out before shareholders. However, just because an asset is defensive, it doesn't mean it's risk-free. The following graph shows the main risks inherent in our three income-based options.



As you can see, cash is considered to be the safest asset class. At UniSuper, the underlying investments in our Cash option are predominantly deposits with banks so it's as close to 'risk-free' as you can find. The trade-off is that cash returns are low and generating higher returns within these defensive asset classes will involve more risk which typically comes in the form of credit or duration risk.

Interest rate (duration) risk

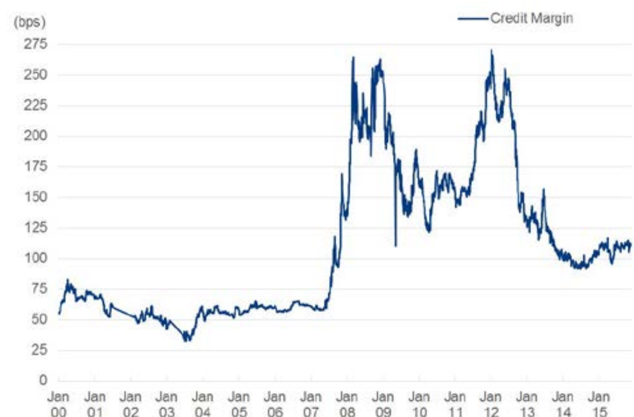
In normal times, longer term interest rates are higher than short-term rates because investors need to be compensated for committing funds over a longer term. This extra return is referred to as the term premium. Once again, though, there is a trade-off because the volatility in the capital value of a bond increases in proportion to the tenor (or duration) of the bond.

Bonds are also labelled 'fixed income' securities which while technically correct, can sometimes cause confusion. While the coupon of a bond is indeed fixed, the capital value will fluctuate as market interest rates fluctuate, which in turn results in a variable total return. For the same reason, it's somewhat misleading to think of an Australian Government bond as a 'risk-free' asset. While they're risk-free in terms of credit risk, their capital value will increase or decrease depending on the movement in market rates; that's why the Australian Bond option falls in value from time to time. The term 'fixed income' is also potentially misleading in the context of a diversified portfolio of bonds. While individual bonds have a fixed coupon, a portfolio will be investing at different times in a range of bonds with different coupons.

Credit risk

Credit risk is the risk that a borrower will default on interest or principal repayments. The term typically applies to a corporate borrower, although banks and some governments also come with credit risk (witness Greece). To compensate for the risk of default, investors are paid a credit margin (which is also referred to as a 'premium' or 'spread') over and above a government security of equivalent tenor. For example, bonds issued by Woolworths with a term of three and a half years are trading at 3.87%, which compares to 2.11% for an Australian Government bond of the same maturity, implying a credit margin of 1.76%.

Just as share prices will move up or down based on the market outlook for earnings, credit margins move up and down based on expectations surrounding the probability of default. While in general, credit margins won't be as volatile as the share market, they're certainly more volatile than many may suspect. The following graph shows the movement of credit margins on a basket of bonds issued by Australia's major banks since January 2000.



Source: Commonwealth Bank of Australia

The graph shows that in the years before the GFC, bonds issued by our banks were considered almost as safe as Government bonds, with the credit margin being as low as 0.30%. Then during the GFC there were genuine concerns about the possibility of a major bank default and credit margins increased substantially, peaking at around 2.70%. Widening credit spreads implies falling bond prices, as the market demands a higher return for taking on credit risk. In hindsight, the GFC proved to be a wonderful buying opportunity for credit, although the same could be said of many risky assets.

Noteworthy, and particularly relevant to the DCI option, has been the increase in credit margins over the course of 2015. The market is implying that our banks are now less creditworthy than they were in 2014, which is difficult to rationalise. To us it demonstrates that just like the share market, the credit market is also driven in part by sentiment. Given the large amount of loss absorbing equity capital that has been raised by banks, they're in fact more creditworthy than they were a year ago, in our opinion.

The (under)performance of DCI

Source: UniSuper. Past performance is not an indicator of future performance. Graph shows the change in value of $10,000 invested in August 2015 for Accumulation (not Pension) members, after tax and fund expenses, but ignoring account-based fees. Read the PDS on our website before choosing your investment options.

The graph above shows the performance of our three income-based (defensive) investment options since DCI's launch. Since then:

- Cash rates have remained steady, so the Cash option has provided consistent positive returns as expected.
- Bond yields have fallen (as bond prices have risen), resulting in the Australian Bond option being the best performer. Note it has also been the most volatile performer over the period in question, and changes to the measurement period could throw up vastly different results. For example, if the graph started in March 2015, the Australian Bond option would have been the worst performer. That's why we hesitate to call it a 'fixed income' option.
- Credit margins have widened, which implies that prices paid for credit-related securities has fallen, resulting in DCI being the worst performer.

The outlook for DCI

Making financial market predictions is at best educated guesswork, and at worst a waste of time.

Investors should understand the drivers of performance and then assess how those drivers are likely to behave in different scenarios. We know that the most important driver of DCI's performance is the creditworthiness of the underlying securities and the margin (or premium) being received for taking on the associated credit risk. In this regard we observe that:

- The average credit rating of the underlying securities in the option is A-rated, signifying a very solid 'investment grade' portfolio.
- Credit margins are currently at levels we consider to be about average in a non-recessionary environment. That is, the price paid to earn credit premium looks reasonably fair.
- Corporate balance sheets are in reasonably good shape, the cost of servicing debt is low and is expected to stay low, and the economic outlook is for below trend growth without a recession.

If these conditions hold, which is our base case, there is a good chance DCI will generate returns above the Cash option over the medium term.

While the base case is only one scenario, constructing an investment strategy that profits from every possible scenario is impossible, so working with the base case is the best we've got.

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