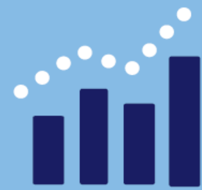
UniSuper

March 2016

Investment market update



January's market woes continued in the early weeks of February as most markets reached fresh lows. While global markets stabilised and rebounded from around mid-month, this wasn't enough to offset the earlier falls, leaving most markets down over the month.

At time of writing, however, it's pleasing to note that March is off to a good start and has more than reversed February's losses. The rally has coincided with a general rally in global risk assets, and was also supported in Australia by a solid "reporting season". This month's update focuses on the latest company reports with particular focus on our major investments, and the woes of the world's largest miner – BHP.

Performance of key markets

	% CHANGE				
	MONTH	FYTD	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian Shares (S&P/ASX 300)	-1.7	-7.4	-13.4	2.9	4.6
US Shares (S&P 500) in US Dollars	-0.1	-4.9	-6.2	10.8	10.1
US Shares (S&P 500) in Australian Dollars	-1.1	2.3	2.8	24.9	18.2
Asian Shares (MSCI All Country Asia ex Japan)	-0.6	-18.6	-18.2	-3.1	-1.2
Australian Dollar (AUD/USD)	0.9	-7.1	-8.8	-11.3	-6.8
Australian Fixed Interest (Bloomberg Composite)	1.0	4.3	3.0	5.4	6.8
Cash (Bloomberg Bank Bill)	0.2	1.5	2.2	2.6	3.3
Balanced option*	**-0.9**	**-0.1**	**-1.3**	**8.8**	**8.2**

Returns are for periods to 29 February 2016. 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

Report season to December 2015

It's the time of the year again when Australian companies listed on the stock exchange report their semi-annual (or annual) earnings results to 31 December 2015. The earnings report is typically presented by the CEO and CFO and large investors like UniSuper dedicate quite a bit of time analysing the information, looking for evidence that either supports or questions our investment thesis. While the reports and commentary provide us with valuable insights, caution (and a touch of cynicism) is also warranted for the following reasons:

- Financial statements (such as profit and loss and cash flow) are a record of history—and a balance sheet statement captures a moment in time. They may not tell you much about the future.
- Good performance tends to be attributed to good management and bad performance attributed to bad luck. Tailwinds from macroeconomic factors beyond the control of management (such as a falling currency, energy costs, interest rates, etc.) are downplayed as contributors to success. Conversely, macroeconomic headwinds beyond management's control invariably feature heavily when accounting for the poor performance of a company.
- New CEOs tend to put a negative slant on historical performance—providing of course they haven't been part of the history.
- CEOs have now become adept at 'under-promising and over-delivering', so outlook statements can often be conservative. Outlook statements that provide information on company strategy, product pipeline, client order books and the like are very useful. Outlook statements that are based on forecasts of economic variables such as commodity prices are useless. In early 2015 when the iron ore price was around $66 per tonne, Rio Tinto's CEO was asked to comment on the prospect of iron ore falling to $30. His response was "…that's fantasy land, it simply can't happen". In December iron ore hit $38.

Putting the writer's cynicism aside, reporting season *can be quite useful*, so let's reflect on the one just past.

Reports from our major investments

Some good news

Contrary to what the gyrations of the sharemarket might imply, the Australian economy is growing steadily—translating into higher revenues and profits for most of our major investments in companies exposed to the domestic economy. The following table lists our large investments in Australian-listed property. It shows the growth in revenue (i.e. sales), earnings per share (EPS), and dividends per share (DPS) compared to the corresponding period one year ago. As regular readers would know, we have built large positions in these companies over many years and we're one of the top three shareholders in each company. The single digit growth results shown are nothing to get overly excited or concerned about and that's exactly why we like them.

Table 1: Major REIT investments

	REVENUE GROWTH (%)	EARNINGS GROWTH (%)	DPS GROWTH (%)
Scentre Group	3	4	3
Vicinity Centres	4	9	5
GPT	6	6	6

ASX announcement.

While on face value the results reported by our large infrastructure investments look spectacular (see table 2), they're actually steady performers as well. Transurban and APA made large acquisitions in 2015 and their reported results include revenue contributions by these new acquisitions, so are not directly comparable. However, it's pleasing to note that the acquisitions haven't impeded their ability to pay higher dividends. Sydney Airport continues to perform strongly, demonstrating how perfectly positioned it is to capture the growing affluence of Asia. In the past year China has surpassed New Zealand as the largest source of inbound tourism, and Sydney is one of their favoured destinations.

Table 2: Major infrastructure investments

	REVENUE GROWTH (%)	EARNINGS GROWTH (%)	DPS GROWTH (%)
Transurban	19	15	15
Sydney Airport	6	6	9
APA	42	66	9

ASX announcement

Commonwealth Bank (CBA) was the only major bank to announce results, while ANZ, NAB, and Westpac provided a trading update. CBA announced growth in revenue of 4% and declared a dividend of $1.98, which was flat versus the previous year. Most importantly, CBA confirmed that its capital levels are among the highest in the world, and there has been no deterioration of any note in the loan book. This rock-solid report is obviously not consistent with the views of the hedge fund industry, who have been short selling major banks' shares with great fervour. In the absence of an unemployment spike or housing crash, the short sellers are likely to remain disappointed.

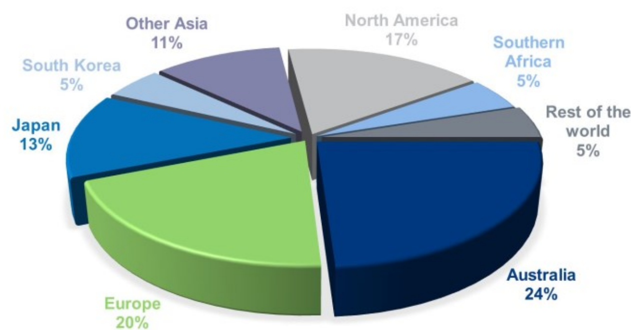
And the bad news

After 15 years of steadily growing profits and dividends, Woolworths announced a 33% reduction in profits to $926 million and cut their dividends 34% to 44 cents, demonstrating the extent to which the company has been mismanaged. Our investment in Woolworths represents 0.6% of the Balanced Option. The highest weighting any single investment option has in Woolworths is the Australian Equity Income option with 4.5%. While these weightings are fortunately quite low, and both options have recorded very strong overall performance, it does not detract from the fact that investing in Woolworths at around $32 per share was a mistake. Woolworths now has a new Board and CEO, and so far they are saying the right things. However, we are holding on to our Woolworths shares *not* because we expect a quick turnaround in the company's fortunes; it's simply a case that at $22 we think the shares have more upside than downside. Caution: we had the same view when the shares were trading at $27.

The woes of the mining industry have been well documented and the reporting season showed just how bad things have got. For the industry as a whole, revenues were down 28% and profits were down a whopping 56% due to the write-down in asset values. Our biggest miner (BHP) reported a loss of $5.7 billion. In August 2015 the prospect of BHP cutting its dividend was mooted by a number of analysts. The CEO of BHP responded to such speculation by saying words to the effect *"over my dead body".* On February 2016 the same (and still very much alive) CEO announced a cut to BHP's dividend from 62 cents to 16 cents. Given its status in the mining industry, BHP is the perfect case study of what has gone terribly wrong, so it's worth reflecting on some key aspects.

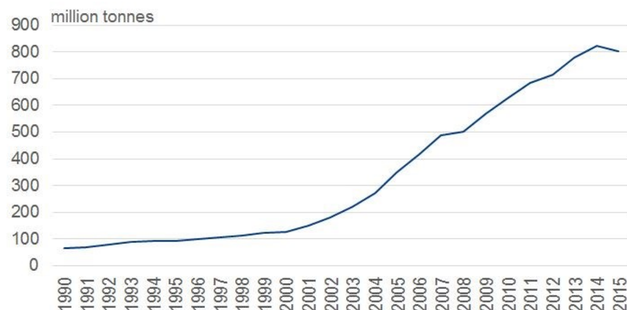
BHP's recent history

Chart 1: BHP sales by destination 2001



This chart was presented by BHP in 2001 and shows the composition of its customers by region or country. *The most extraordinary feature of the chart is that China doesn't rate a mention!* China joined the World Trade Organisation in 2001, and its industrialisation proceeded at an exponential pace with an accompanying ramp up in steel production and iron ore imports (see chart 2). It wasn't long before China accounted for about 50% of global growth in the consumption of *all* commodities.

Chart 2: China – crude steel output



Source: Bloomberg

To explain the boom and bust in commodity prices, BHP's capital expenditure (capex) pattern is the final piece of the puzzle. Mining is an extreme example of a 'capital-intensive' business. Big mining companies need to spend billions of dollars on exploration, securing additional reserves and drilling simply to stay in business over the long term. While a minimum amount of investment is required at any point in the cycle, investment is typically ramped up or reduced in anticipation of the likely demand. Ideally, investment will be ramped up so that production capacity is maximised at the point of maximum demand, and vice versa. At the peak of a cycle, mining companies should be winding down investment in anticipation of lower prices in future. Nice theory; shame about reality.

Chart 3: BHP's capital expenditure pattern

Source: CBA Company reports and estimates

Chart 3 suggests that like most other mining companies, BHP simply didn't see China coming, or at least they completely misgauged the impact of her rise. In the late 1990s BHP's capex was marginally increased, only to fall in response to the Asian crisis in the early 2000s. In fact it wasn't until the mid-2000s that capex was restored to mid-1990s levels, despite the fact that China was well and truly in the middle of one of the largest industrialisation programs in history. It was almost as if BHP didn't believe what it was seeing.

China's loosening of monetary policy in response to the GFC was, relative to the size of its economy, actually larger than America's. A direct outcome was a sharp increase in demand for energy and raw materials as property development and infrastructure spending boomed. These were heady days indeed for mining companies; the lack of prior investment meant that supply couldn't keep up with demand and prices escalated. Every bubble needs a plausible story to justify itself, and in this case the story was self-evident, or so it seemed.

Boards and CEOs quickly adopted the "stronger for longer" mantra, in the belief that China's boom was in its early stages and there was no end in sight. Belief was transmitted into capital expenditure, which in BHP's case peaked in 2013 (see chart 3). In other words BHP maximised its capital expenditure close to the very peak of demand. As the saying goes, if you can spot a gravy train it means you've missed it. The mining sector is now dramatically reigning in its capital expenditure. Whereas CEOs once proudly announced their pipeline of exciting investment opportunities, they now proudly announce how much they are going to rein it in. Of course most of the CEOs are new recruits who vow not to repeat the sins of the past. However, it's a matter of when, not if, we once again experience supply constraints—the cycle might change shape but never dies.

A word from "Mr. Market"

On the day BHP announced its worst loss in its history and cut its dividend, its shares rose +3%. On the day Qantas announced its best profit since 2008 (+688m) and a record dividend, its shares fell -5%. As Warren Buffett would say, it is probably just a case of Mr. Market going through one of his drunken psychotic episodes.

The BHP result was bad, but not as bad as the market's worst fears so the share price rallied. The Qantas result was good, but not as great as some were hoping so the share price fell. In aggregate, the reporting season was actually well received by the market. While strong revenue growth is still hard to find, it is certainly not collapsing, in line with an economy that is doing ok. While the dividends of our mining companies have been slashed, there is a feeling that we are close to the bottom of the commodity crash.

At the time of writing the Australian market (ASX 200) was up 3.9% for the month, so it has clawed back the -1.7% lost in February, although has some way to go before breaking even for the year given how poor January was.

Most importantly, the reporting season has thrown up no nasty surprises for our key positions, which is a repeat of the past few years and supports our heavy focus on quality companies with sustainable earnings. Relative to our peers we have been heavily underweight resource companies, and this has shown up in competitor tables. SuperRatings' latest league table (as at 31 January) lists our accumulation Balanced option as the number one performer over three years among 168 competitors. Our accumulation Capital Stable and Conservative Balanced options we also ranked first for the same periods. We understand that members are ultimately interested in absolute returns, not relative returns, but we figure it's better being number one than not! Of course it also means that this is as good as it gets. The cycle never dies.

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Past performance is not an indicator of future performance. The SuperRatings data is based on the SuperRatings Fund Crediting Rate Survey for periods ending 31 January 2016 of all super funds with Balanced options within a 60%-76% growth asset range, a Conservative Balanced option within a 41%-59% growth asset range, and Capital Stable option within a 20%-40% growth asset range which took part in the survey published on 19 February 2016. The SuperRatings data does not take into account any subsequent revisions or corrections made by SuperRatings.

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