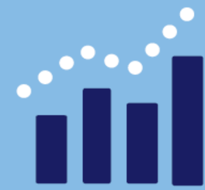
UniSuper

July 2016

Investment market update



With the 2016 financial year just behind us, this month's update focuses on the investment performance over the past 12 months. What worked and what didn't? What were the contributors to—and detractors from—good performance? Join us for a candid look at the financial year that was.

Performance of key markets

	% CHANGE			
	MONTH	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian shares (S&P/ASX 300)	-2.4	0.9	7.7	7.2
Global shares (MSCI All Country World Local Currency)	-1.0	-3.2	8.2	8.0
Australian dollar (AUD/USD)	2.7	-3.1	-6.6	-7.0
Australian fixed interest (Bloomberg Composite)	1.3	7.0	6.2	6.7
Cash (Bloomberg Bank Bill)	0.2	2.2	2.5	3.1
Balanced option*	**-0.5**	**5.8**	**10.2**	**9.5**

Returns are for periods to 30 June 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

Our members ultimately care most about absolute returns—and unless you're in the Listed Property Option (+19.4%), returns across the board for the financial year were nothing to get overly happy about. Our Balanced option managed to return 5.8%, which follows six years of returns averaging over 10%, so some might say we were due for a single-digit year. The result should also be judged in the context of poorly-performing global share markets, as shown in the above table.

While the investment management industry can appear complicated and opaque to many observers, comparing the performance of super funds across the industry is a relatively straightforward exercise, with 'league tables' being published on a monthly basis. In this regard, we're pleased to report that UniSuper continues to be one of the best performing funds in the industry. According to superannuation research company SuperRatings, the performance of our accumulation Balanced option at the end of May ranked third out of 187 funds over the financial year-to-date, and third out of 165 funds over three years*.

We achieved similarly strong relative performances across other investment options. June numbers are not available yet, but we're expecting another strong result.

Of course this doesn't mean we got everything right—it simply means we got more right (and/or less wrong) than most of our peers. Let's look at some of the highlights and lowlights.

Performance highlights

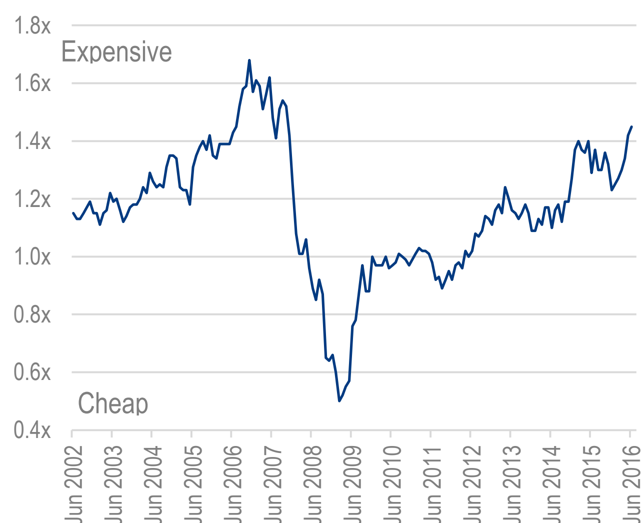
Quality yield continued to deliver

Much has been said of investors' insatiable appetite for yield in a low-growth, volatile world. At time of writing, there is over $10 trillion of bonds in the world with negative yields. No, that's not a typo! While Australian bond yields are still in positive territory, we haven't been immune to the general collapse in yields as capital moves relatively freely around the world searching for the best returns. As bonds get lower

in yield, investors are forced to take more risks and first in line are shares that are perceived as bond lookalikes, such as Australian Real Estate Investment Trusts (AREITs) and infrastructure companies. As regular readers would know, UniSuper has very substantial positions in what we believe are the highest quality AREITs and infrastructure shares, and over the past year they continued to produce some of the best returns in the market, e.g. Transurban (35%), Sydney Airport (45%), Duet (22%), APA (17%), GPT (32%), Scentre (38%). UniSuper is the largest shareholder in the first five companies mentioned, and one of the top three shareholders in Scentre.

The strong performance of the two sectors in question has given rise to fears of a 'yield bubble', and it's not hard to find supporting evidence. For example, Graph 1 shows the market's aggregate valuation of all the companies in the AREIT sector relative to their net tangible assets (NTA). From trading at a discount of about 50% in the aftermath of the GFC, the market is now trading at a 40% premium. In other words, the market is currently valuing the companies well in excess of the value of the tangible assets that the companies own. If we just look at this valuation metric relative to history, the property market is looking very expensive, indeed close to bubble territory.

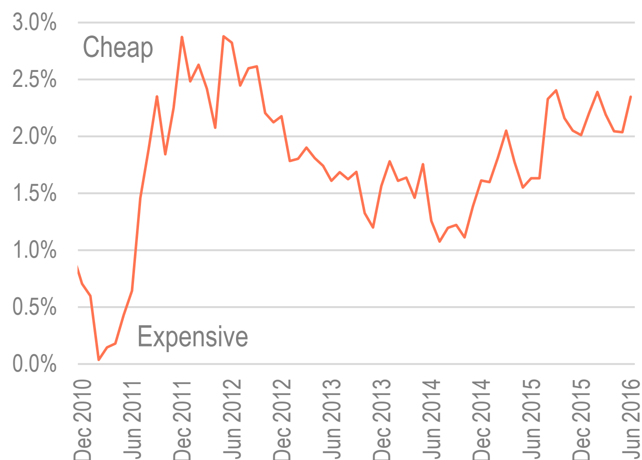
Graph 1: AREIT market value relative to NTA



Source: Bloomberg

However, Graph 2 compares the dividend yield generated by the sector and it paints an entirely different picture. It shows dividend yields from property are still well in excess of bond yields—so using this valuation metric, property still looks like a reasonable buy.

Graph 2: AREIT dividend yield minus 10-year bond yields



Source: Bloomberg

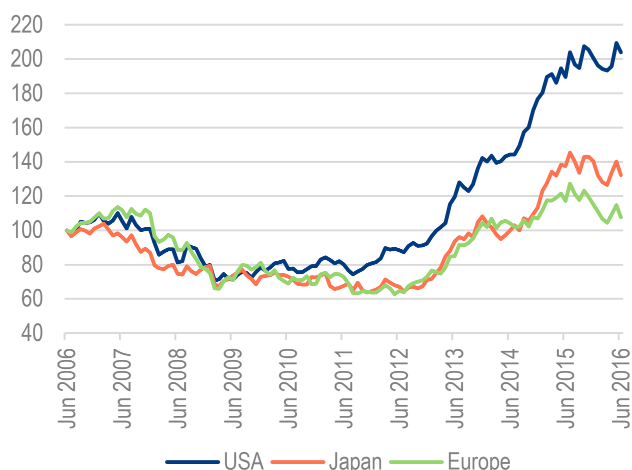
So we are left in a quandary as to what metric we use to guide our decision making. Graph 1 is sending a *sell* signal and Graph 2 is sending a *buy or hold* signal. Notwithstanding that we expect to see a correction in property at some point, we are currently inclined to hold because (a) we expect bond yields to remain low for a long time, (b) other asset classes don't offer much greater appeal, and (c) the bulk of our investments are in the best quality shopping centres in the country which we expect to deliver solid returns over the long term.

The right mix of global investments

Outperforming in the global space involves picking the better performing regions, countries or sectors. Getting the big picture right is far more important than individual company selection—a solid company in a high-performing sector or country will invariably prove a much better investment than a great company in a poorly-performing country or sector.

Over the past few years our global positioning has been quite favourable, and this continued last year. Global markets are dominated by the large developed markets of the U.S., Europe and Japan—and the difference in their respective performances has been stark, as Graph 3 shows.

Graph 3: Returns of the U.S., Europe and Japan



Source: Bloomberg

Our diversified portfolios have been consistently overweight in the U.S. and underweight Europe and Japan. The recent political turmoil created by Brexit has reinforced our dim outlook for Europe as an investment proposition, and the poor performance of Japan is particularly noteworthy given the country's reputation as a technology leader with world class manufacturing capabilities. Unfortunately, the Japanese corporate environment is characterised by systemically poor governance frameworks in which shareholder interests are seemingly subordinated to all others. On top of this is a poor economic backdrop that sees the country mired in a deflationary spiral, so it's a country that has also developed a reputation as the place where 'capital goes to die'.

Given the woes of Europe and Japan, avoiding such places in favour of the U.S. would appear to be an obvious strategy. Of course, when something looks like an obvious winner it is usually reflected in the price, and the American market has been consistently more expensive than Europe and Japan. And notwithstanding the poor overall performance of the markets in which they operate, there are some great Japanese and European companies that are worthy inclusions in any diversified portfolio. On balance, however, we are currently of the view that Europe and Japan are relatively cheap for a reason and could stay that way for some time.

In terms of global sector allocation we have consistently had a high allocation to technology, and it continues to pay off. On top of the sector outperforming the overall market, one of our external managers (T. Rowe Price) had another excellent year (+11.4%), bringing their three-year performance to 31.2% p.a.

Performance lowlights

Given that even the most heralded investors in the world also make poor investments, it would take a fool or a liar to claim they wouldn't do at least some things differently if they had their time again. When managing a large pool of funds over a long period, missing out on bargains and failing to sell some losers is inevitable.

Australian banks

The Australian banking sector, including dividends, returned -10.4%, marking it the second worst-performing sector in the market (energy being the worst). Furthermore, the banking sector constitutes close to 30% of the Australian market, so poor performance has a significant impact. Graph 4 shows the share price movement of the worst performing major bank (ANZ), and it doesn't make for pleasant reading.

Graph 4: ANZ share price

Source: Bloomberg

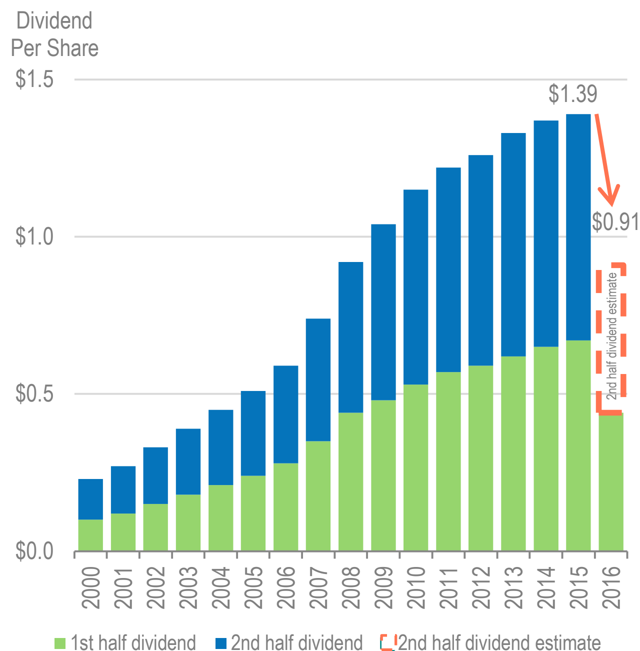
As mentioned in previous updates, Australian banks have been caught in the middle of a perfect storm. First and foremost, prior to last year they had recorded large gains which saw their share prices at all-time highs, so they were 'priced to perfection'. Then the bad news came—in the form of higher capital requirements, an increase in credit losses, and heightened concerns over exposures to troubled sectors such as resources, dairy, and apartment construction. Market pessimism was vindicated when ANZ announced a cut in its dividend, without providing much comfort that there wasn't any more to come.

On a positive note, all of our diversified options have held an underweight position in the banks (relative to their respective weight in the market) as we have been wary of the headwinds facing the sector. However, in such a large sector one can be underweight relative to the index and peers, but still hold too much exposure—and that has proven to be the case. Over the past few months we have continued to lower our weighting to bank shares, as we can see a period of flat dividend growth while they continue to bolster capital levels. Their valuations are now at levels that should find support, although it's hard to see the sector outperforming in the near term given the headwinds outlined above. Note that our banks remain fundamentally strong institutions and our cautious outlook on bank shares compares to a very favourable outlook on their credit quality. Accordingly, we invested heavily in the latest hybrid issues that we believe offered excellent value.

Woolworths

Last year we identified our investment in Woolworths as one of our major regrets, and it unfortunately qualifies for a dishonourable mention again this year. We started accumulating Woolworths shares at around $33, they peaked at around $38 and this time last year they were trading at around $27 following two earnings downgrades. We decided to hold on to Woolworths because in our view their problems were fundamentally related to poor management (as distinct from structural challenges posed by competitors like Aldi). The good news is that the new board and management in charge of Woolworths have been refreshingly candid about past mistakes. The bad news is that we underestimated just how poorly the business had been run, resulting in another downgrade and the first dividend cut in Woolworths' history.

Graph 5: Woolworths dividend per share



Source: Bloomberg

The Woolworth's share price has fallen 22.5% over the past year and is now trading at around $21, making it the worst performer among the companies that we hold a significant stake in—albeit, fortunately, much smaller than our stakes in the high-performing shares mentioned above. At the risk of looking stubborn, we are continuing to hold on to our investment, but without a strong conviction that the company can be turned around any time soon. It's more a case of the share price likely being closer to the bottom than the top, and we don't want to look silly selling at the bottom. Of course, we could have said the same thing this time last year. The market has a habit of making investors look silly.

*SuperRatings data is based on the SuperRatings Fund Crediting Rate Survey for periods ending 31 May 2016 of all super funds with Balanced options with a 60% - 76% growth asset range which took part in the survey published on 21 June 2016. The SuperRatings data does not take into account any subsequent revisions or corrections by SuperRatings. Go to www.superratings.com.au for details of its ratings criteria. SuperRatings does not issue, sell, guarantee or underwrite any product.

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