UniSuper

April 2017

Investment market update

In March, global share markets consolidated the strong gains of the past few months. In good news for most of our members, the Australian market was one of the stronger performers as interest rate-sensitive sectors—like property and infrastructure—benefitted from a fall in bond yields.

With the 24-hour news cycle and all forms of media in a fierce battle for customers, we're constantly reminded how volatile the share market has 'apparently' become since the GFC. But has it really? In this month's update, we explore whether that perception holds up.

Performance of key markets

	% CHANGE			
	MONTH	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian shares (S&P/ASX 300)	3.3	20.2	7.5	10.8
Global shares (MSCI All Country World Local Currency)	1.1	17.0	8.1	10.8
Australian dollar (AUD/USD)	-0.8	-0.8	-6.3	-5.9
Australian fixed interest (Bloomberg Composite)	0.4	2.1	5.0	5.0
Cash (Bloomberg Bank Bill)	0.2	1.9	2.3	2.6
Balanced option*	**1.8**	**11.6**	**8.9**	**10.6**

Returns are for periods to 31 March 2017. 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


"Market volatility is here to stay"

The Australian, 12 January 2016

We live in volatile times—or do we?

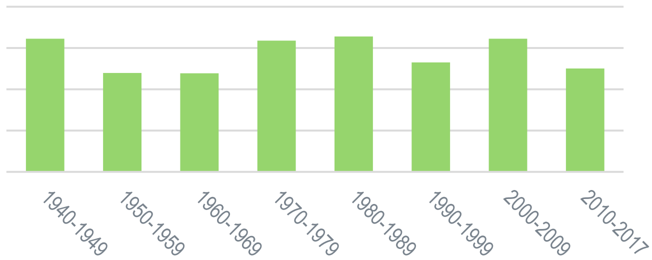
The above headline was published during a particularly volatile period in early 2016. Since then, we've seen tremors created by Brexit and Donald Trump's election, so arguably, the headline proved to be a reasonably accurate prediction.

It's worth noting, though, the speed with which the panic that accompanied these tremors dissipated—share markets finishing the year considerably higher than where they started. Indeed, for most of 2016—contrary to what the headlines might have you believe—the markets were rather calm and this has generally been the case for most of the eight years since the GFC.

By some measures, we actually live in calm times

Chart 1 shows the volatility of the US stock market's monthly returns since 1940. The US market tends to lead global markets, and when looking at long-term history we use US data because the equivalent Australian data only covers a few decades. We've used a stylised graph to illustrate the broad pattern of volatility, without getting overly technical.[1]

Chart 1: Volatility of monthly market returns (%)



Source: Bloomberg

[1] *For the statisticians among you, the left axis is the annualised standard deviation of monthly returns. Since the GFC, it has been about 12.5%, which compares to about 16.1% for the previous decade. Source: US S&P Composite Index*

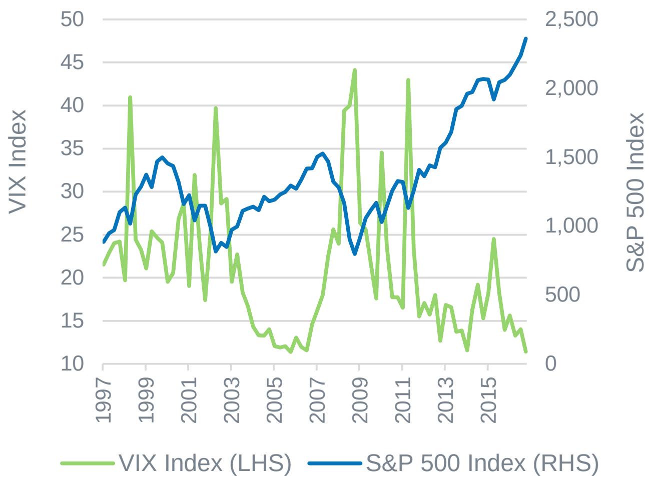
According to the graph, the commonly-held view that the GFC ushered in an era of excessive volatility is more than likely a case of perception over reality. While the last decade was indeed one of the most volatile in history, this decade to date has been one of the calmest. So think twice the next time you hear a market expert say they expect markets to remain volatile.

Low volatility = low fear

The more stable a market behaves, the more people expect it to stay that way. As fear dissipates and confidence builds, investors are more likely to take more risk. We can actually observe this behaviour by tracking the US share market in response to changes in the 'VIX index'. In simple terms, the VIX is an index that tracks market volatility. Once again, we'll try to avoid getting bogged down in technicalities, particularly given that it's almost impossible to explain something as arcane as the VIX in plain English!

Chart 2 plots the VIX index against the US share market. Not surprisingly, spikes in volatility coincide with sharp sell-offs in the share market. One can see why the VIX is also referred to as the 'fear gauge'.

Chart 2: The share market thrives on stability



Source: Bloomberg

There have been four periods of 'peak fear' since the index was established in the '90s: The Asian crisis, the dot-com crash, the GFC and the European debt crisis. Since inception, the VIX has averaged around 20 and hit just over 40 during these times of crisis. These days, the VIX is around 12—almost as low as it's ever been, illustrating just how calm the market has recently become. The last time the VIX traded below 15 for over 100 days, as is now the case, was back in 2007.

The instability of stability

When people feel confident about the future they tend to spend more, borrow more and take extra risk. It's against this backdrop that extended periods of stability tend to sow the seeds of the next bubble, which can sometimes—but not every time—burst and create the next crisis.

In the years leading up to the GFC, the VIX was trading at the lows it is today, and we know how that ended. Of course, that's not to say there's another crisis around the corner. While the bull market in shares has now lasted for over eight years, we certainly don't see the extreme valuations and excessive leverage that were evident in the lead-up to the GFC. Furthermore, the global economy is showing signs of a synchronised pick-up in growth, providing more support for corporate profits and share prices.

Nevertheless, history suggests that when fear is low, there's a danger that complacency is creeping higher—creating an environment in which the market becomes susceptible to a sharp sell-off when confronted with an unpleasant surprise. It's against this backdrop that UniSuper is holding more cash than we typically would, in order to exploit such an opportunity if it arose.

Of course, in stable times, it's hard to see where a shock could come from—but that's what makes it a shock. As Mark Twain said: *"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."*