UniSuper

August 2016

Investment market update

Despite some uncertainty after the British public voted to leave the European Union towards the end of June, July was a strong month for shares with solid gains around the world's major markets. Investors seemed to reach the collective conclusion that 'Brexit's' global growth impact would be limited and more than overweighted by further interest rate cuts.

The Australian share market fared even better than most, returning more than 6% in the month—helped by a price rebound for Australia's major commodity exports and high concentration of yield-sensitive stocks, which benefitted from the interest rate fall.

In this month's update we take a look at UniSuper's three investment options dedicated to global markets—International Shares, Global Companies in Asia, and Global Environmental Opportunities. Some members have asked us to account for the difference in performance across these options, so this update attempts to shed some light on the subject.

Performance of key markets

	% CHANGE			
	MONTH	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian shares (S&P/ASX 300)	6.4	6.4	2.9	8.1
Global shares (MSCI All Country World Local Currency)	4.1	4.1	-0.9	8.1
Australian dollar (AUD/USD)	2.0	2.0	3.4	-5.4
Australian fixed interest (Bloomberg Composite)	0.7	0.7	6.4	6.2
Cash (Bloomberg Bank Bill)	0.2	0.2	2.2	2.5
Balanced option*	**3.4**	**3.4**	**6.1**	**10.3**

Returns are for periods to 31 July 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

UniSuper's global share options

UniSuper members can invest in global share markets through our range of diversified investment options, or more directly by choosing single sector options that are close to 100% invested in off-shore markets—International Shares (IS), Global Companies in Asia (GCA), and Global Environmental Opportunities (GEO).

The long term objective of all three options is to achieve a return of CPI + 5%. Over the short term, however, returns can vary across the options as shown in Table 1. We've only included one-year and three-year returns in the table as International Shares is the only option with a longer track record.

Table 1: Option returns to 30 June 2016

	1 year (%)	3 years (% p.a.)
International Shares	0.9	13.7
Global Companies in Asia	-0.8	11.5
Global Environmental Opportunities	-3.0	9.3

* Past performance is not an indication of future performance.

Similar long-term objectives but different strategies

As well as a common return objective, the three global options have a recommended minimum holding period of seven years, and the likelihood of negative returns is expected to be five years in every 20. All three options are also almost fully invested in shares listed on international stock exchanges. But that is where the commonalities end—with the options employing different strategies, giving rise to different portfolio compositions as shown in Table 2.

Table 2: Key features of the three overseas shares options

	INTERNATIONAL SHARES (IS)	GLOBAL COMPANIES IN ASIA (GCA)	GLOBAL ENVIRONMENTAL OPPORTUNITIES (GEO)
Objective	Return objective – CPI + 5.0% p.a. over seven years		
Strategy	To invest in a diversified portfolio of international shares.	To take advantage of the growth in emerging Asian economies.	To invest in companies whose business activities seek to profit from addressing current and emerging environmental issues.
Portfolio management and composition	Managed by a combination of external and in-house teams. Strategies cover both active and passive (i.e. index-based) management, investing across a range of regions and sectors.	The portfolio is managed by our in-house team. Portfolio construction involves the use of quantitative techniques to identify companies listed in developed markets with a growing Asian revenue base.	The portfolio is managed externally on a passive basis against a global environmental index.
Diversification	The portfolio is highly diversified with over 3,000 companies.	The portfolio is relatively concentrated with around 100 companies.	A relatively concentrated portfolio of around 200 companies.

The IS option is the most generic of the three options in that it is not driven by any individual theme, although there is a bias towards the fast-growing healthcare and information technology (IT) sectors. As the most diversified of the options, it could be expected (but not assured) to more closely track the general global share indices.

GCA invests in companies where favourable demographics—such as population growth, urbanisation, growth in the middle classes and increased spending—are likely to drive higher company earnings. As such, the option is heavily skewed towards well-established global brands that have an exposure to the faster-growing consumption trends in emerging Asian economies. Healthcare and technology are also significant themes in this option.

Given its particular focus, GEO is quite different to the other two options. GEO invests in companies that focus on offering products or services that are expected to contribute to a more environmentally sustainable economy. In practice, this option is comprised of companies that generate more than 50% of their revenues from involvement in five environmental themes—alternative energy, clean technology, sustainable water, green building and pollution prevention. As such, this option has a focus on technology, industrial companies—specifically electrical equipment manufacturers—and utilities. The expectation is that these types of companies should be well positioned to take advantage of regulatory and societal changes in the shift to a low carbon emission future.

Key drivers of performance—geographic and sector exposures

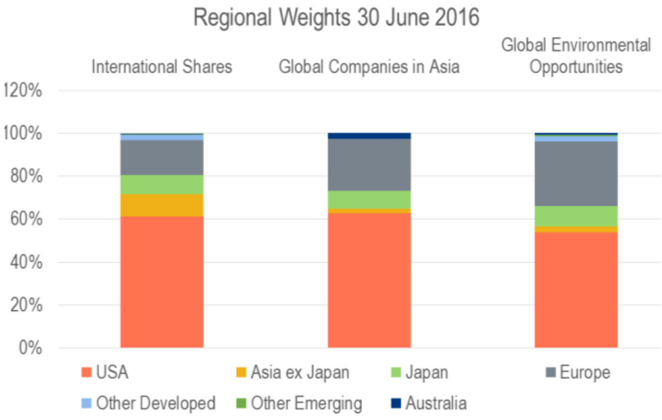
The fundamental driver of absolute return for any share portfolio is the return for the overall market, which is of course something beyond any investment manager's control. If the overall market is down 20%, it would be all but impossible for a super fund to generate a positive return, regardless of what strategy is employed. To gauge the effectiveness of a strategy, we therefore tend to look at returns relative to a benchmark, or compare returns across strategies.

Table 2 shows the different strategies employed across our global options and, as a result, different performance outcomes are generated as shown in Table 1. The differences can be largely explained by the different geographic and sector biases which are shown in Charts 1 and 2.

Fortunately, over the past three years, absolute returns in most geographic regions have been solid, but there have been significant variations—North American markets have returned 18.5% p.a., significantly outperforming Asia (up

9.7% p.a.) and Europe (up 9.5% p.a.). With higher exposures to North American markets than GEO, this pattern of returns has particularly benefitted the performance of both the IS and GCA options.

Chart 1: The geographic exposures of the international shares options

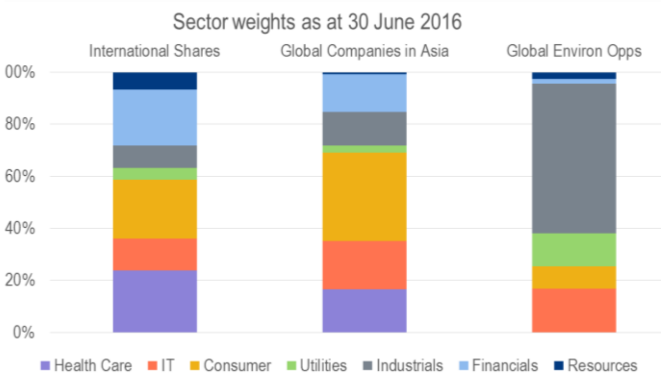


Source: Bloomberg

We can conduct a similar analysis of returns by reference to the differing underlying sector composition of each of the options. Over this three-year period, the strongest performing sectors were Health Care and IT (which both returned 21% p.a.)—these two sectors are significant holdings in IS and GCA and were key drivers of their performance. The Utilities, Consumer Discretionary and Industrials sectors all returned around the benchmark return of 14% - 18% p.a.—these sectors comprise the majority of the GEO portfolio.

The weakest performing sectors over this time period have been Financials (9% p.a.), Materials (7% p.a.) and Energy (4% p a.) and, given their relative weighting across the options, their relative "detraction" from performance most impacted the International Shares option, but not by enough to negate the positive impact on performance from exposures to the outperforming Health Care and IT sectors.

Chart 2: The sector exposures of the international shares options



Source: Bloomberg

What the market does in future is of course unpredictable, so we are not going to attempt to forecast absolute returns. However, given that we are not currently contemplating any significant changes to the sector or regional mix of the options, relative performance in the near term is likely to be driven by the same underlying factors as described above. For example, a crash in energy prices will have a much smaller adverse impact on GEO relative to the other options. A strongly performing U.S. market will likely benefit the IS and GCA options more than GEO, and the converse would apply if Europe outperformed—and so on.

Currency management

Australian investors are obviously interested in returns in Australian dollar terms, and this gives rise to currency risk whenever offshore assets are purchased. If the share price of an American company increases by 10% and the Australian dollar rises in value against the US dollar by 10%, the returns to an Australian investor would be zero in the absence of any currency hedge in place. The change in value of the Australian dollar relative to other currencies will have a very significant bearing on the absolute return of a global portfolio, so hedging strategy is important.

Our website contains a section on currency management, in which the following two points summarise our overarching philosophy at a high level:

1. Currency is not an asset class in its own right; i.e. currencies do not, of themselves, generate an income stream.
2. Calculation of a currency's 'fair value' is highly problematic at best over the longer run, and effectively impossible over the short- to medium-terms.

In the above context, unlike some other asset managers, we don't allocate capital for the purposes of currency trading as this would be akin to outright speculation. We do, however, adjust the currency hedge ratio based on various considerations that are prevailing at any given time. For the three global portfolios discussed in this update, the currency hedge ratio can vary between 0% and 100%. For the past few years the actual hedge ratio has been around 15%, which is at the low end of the permitted range, so the investment options were able to almost fully capture the benefit of the -6.7% fall in the Australian dollar versus the U.S. dollar over that period.

The Reserve Bank of Australia has just cut rates to an all-time low of 1.50%, and the U.S. Central bank has flagged the possibility of future rate hikes in that country. The difference in monetary policy stances reflect the difference in the near-term outlook for the respective economies, and the dynamics are likely to maintain downward pressure on the Australian dollar. Of course, that is a matter of opinion—not a prediction.