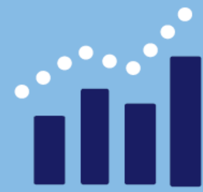
UniSuper

December 2016

Investment market update



The surprise result of the US presidential election has dominated market movements in recent weeks. While the initial reaction was negative for shares, this soon gave way to a sense of market optimism as the realisation dawned that Trump's pro-business, big spending and low taxing policies could boost both growth and inflation. One consequence of the election has been a further increase in government bond yields. In this month's update, we explore the impact this has had on UniSuper's large investments in listed property and infrastructure.

Performance of key markets

	% CHANGE			
	MONTH	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian shares (S&P/ASX 300)	2.8	5.8	10.1	5.4
Global shares (MSCI All Country World Local Currency)	2.1	6.7	4.2	6.2
Australian dollar (AUD/USD)	-2.8	-0.7	2.0	-6.8
Australian fixed interest (Bloomberg Composite)	-1.4	-1.8	3.4	5.3
Cash (Bloomberg Bank Bill)	0.1	0.8	2.1	2.4
Balanced option*	**1.5**	**1.5**	**5.6**	**8.0**

Returns are for periods to 30 November 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

The bond market has been 'Trumped'

After hitting all-time lows in July, bond yields in America are now rising. On top of firming expectations of a hike in rates by the US Federal Reserve funds in December, a further catalyst was provided by promising signs of real wage growth, which has been notably absent lately despite a dramatic fall in American unemployment. A gradual increase in rates turned into a 'melt-up' with the election of Donald Trump. Of the almost 1% rise in US 10-year rates, about half the move has occurred in the short time since the election. Outside of the election, there hasn't been news of any major economic significance. Various explanations have been put forward to account for the bond market's reaction to Trump's election, including:

- Expansionary fiscal policies (increased expenditure and lower taxes) will provide an immediate reflationary impetus to the US economy, lifting inflation expectations and driving bond yields higher.
- A larger budget deficit implies a greater financing requirement, and a greater supply of bonds.
- Janet Yellen will be replaced as Chair of the Fed Reserve by a Trump appointee who will be more inclined to raise interest rates.

The movement seen across all markets in the wake of Trump's victory has been somewhat perplexing, in particular the degree of confidence in Trump's willingness and ability to deliver on his election promises. The market is also taking a leap of faith in assuming Trump's policies will quickly trigger an inflation impulse, when central

banks have been manifestly unsuccessful despite throwing trillions of dollars, Euros, and Yen at the problem.

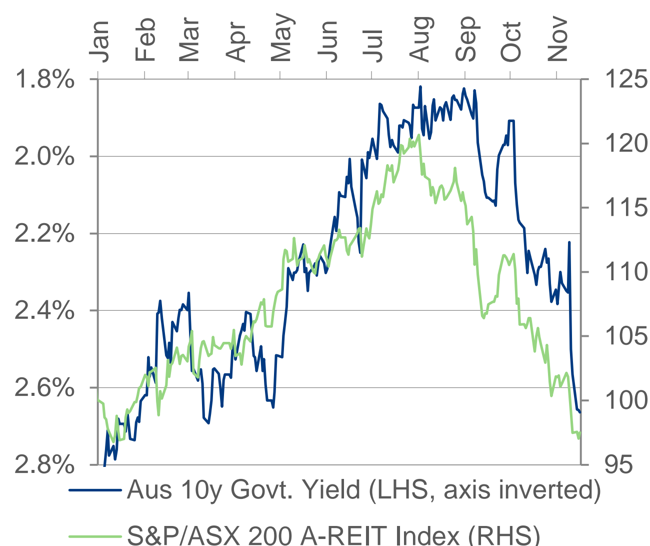
Of course, another more likely explanation of the latest movements is that the trend towards higher rates had firmly taken hold before Trump's election, and his victory simply put fuel on a smouldering fire. Regardless of cause and effect, the reality is that bond yields are materially higher than they were three months ago, and that is having a dramatic impact on a number of asset classes.

A rise in yields has driven a sharp sell-off in Australian listed infrastructure and property

The Australian bond market has moved in lock-step with the American market despite our economies' contrasting outlooks. In particular, the upward pressure on wages in a tightening American employment market is in sharp contrast to Australia's situation, where high levels of underemployment is resulting in flat wage growth. It's difficult to see how Australian bond yields can rise too far in the face of deflationary forces. If the Reserve Bank moves on interest rates within the next 12 months it is far more likely to be a cut, not a hike.

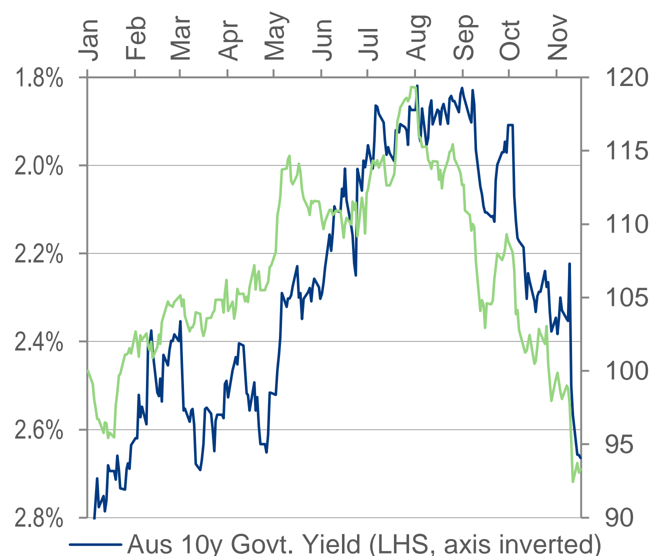
The jump in bond yields has resulted in a sharp sell-off across the sectors that had previously been considered as the primary beneficiaries of the fall in yields, such as listed property and infrastructure. Graphs 1 and 2 illustrate just how strongly correlated the valuation of these sectors have been with movements in bonds since the beginning of the year.

Graph 1: Listed property



Source: Bloomberg, Macquarie research

Graph 2: Listed infrastructure



Source: Bloomberg, Macquarie research

Regular readers would know that UniSuper holds some very concentrated positions in these sectors. In the infrastructure space, we are the largest shareholder of Transurban, Sydney Airport and APA, which have seen share price declines of around 25% from their recent highs. In the property sector, we have large positions in GPT, Scentre and Vicinity, and they have recorded falls of a similar magnitude. Given that these companies are included to varying degrees in all of our growth-oriented investment options, our investment performance has been adversely

impacted—particularly relative to other funds that do not hold such concentrated positions. Of course, the strong returns of the same companies have been the key driver of top quartile performance over the past five years.

Are we concerned?

The short answer is no. While it's never a pleasant experience to see such a steep drop in the share prices of companies we have significant stakes in, we need to recognise that volatility is part and parcel of investing in the share market. In the same way the share market can often be disconnected with the underlying performance of an economy, the movement in individual shares can often become disconnected with the underlying performance of a company. In this regard, it's important to keep in mind that the companies mentioned above have not "missed a beat" since we invested in them, and the outlook is for more of the same.

Let's look at Transurban, for example—which represents the largest single position we hold in a single company. Graph 3 plots the share price against its earnings profile. Graphs of Sydney Airport, APA, GPT, Scentre, and Vicinity would show a broadly similar pattern.

Graph 3: Transurban: earnings vs. share price

Source: Bloomberg, Macquarie research

A few points worth noting:

- The rise in Transurban's share price is not just a story about falling interest rates. Up until the last 12 to 18 months, the share price has moved broadly in tandem with the rise in earnings. This is what one would expect in an efficient market.
- The notion that Transurban is simply a "bond proxy" (and by implication should trade like a bond) is clearly irrational because Transurban has steadily grown its earnings (bonds pay a fixed interest rate), and its future growth prospects are excellent. We expect cash earnings to grow by at least 9% over the next three years, and the company has a project pipeline of over $9 billion. Furthermore, unlike nominal bonds, Transurban has pricing power which provides an efficient hedge even if inflation does reappear.
- Notwithstanding the solid underlying performance and strong growth prospects, Transurban's valuation became stretched, having moved too far too fast. Indeed, when it was trading at its recent highs, we were anticipating a correction, so didn't add to our holdings. However, we also didn't sell, which in hindsight appears to be a bad decision, but we have our reasons—which we'll now explain.

Why didn't we take profit when valuations looked stretched?

It's tempting to say that "hindsight is a wonderful thing" although a correction looked somewhat inevitable to us even before the event. However, we were not inclined to sell for a few important reasons. First and foremost, we need to bear in mind that, as a large and growing super fund, we

are a natural accumulator of high quality assets. Other large super funds have tended to focus their large positions in unlisted assets (recent examples being the Melbourne Port and NSW electricity assets). To date, we have preferred the listed market because we are able to pay less for better quality assets, while accepting a potentially volatile share price.

In light of the above, if indeed we were to take profit on our holdings (which is relatively easy to do in a rising market), we would have been doing so with a view to buying back the shares at a lower price. Playing the timing game is difficult for most investment managers, but particularly for one of our size. Given that we are likely to be very long-term holders of quality assets, it's therefore more important that we exercise discipline regarding the price we pay, rather than opportunistically looking for a price to sell. We therefore take some comfort that the large positions we've accumulated in the companies highlighted have been at prices well below current levels. The operating performance of these companies has met or exceeded expectations, as has been the case with the dividends received. Suffice to say that, notwithstanding the sharp recent declines in their share prices, they don't owe us anything.

Return objectives are not promises or predictions of any particular rate of return. Negative returns may occur more or less regularly than expected. Returns specified relate to our Accumulation (not Pension) investment options and are published after fund taxes and investment expenses, other than account-based fees.

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