UniSuper

February 2017

Investment Market Update

The positive tone that has prevailed in global share markets since Donald Trump's election as US President continued into January, though a sense of uncertainty is starting to creep in. Australian shares, on the other hand, were a clear disappointment—with sentiment impacted by a number of downgrades to the projected earnings of some high profile companies. This month we focus on the recent performance of the Australian Bond investment option. Despite its 'defensive' label, this option has recently been one of the poorer performers in our portfolio.

Performance of key markets

	% CHANGE			
	MONTH	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian shares (S&P/ASX 300)	-0.8	17.3	7.4	10.4
Global shares (MSCI All Country World Local Currency)	1.6	17.1	8.3	11.2
Australian dollar (AUD/USD)	4.9	7.3	-4.5	-6.5
Australian fixed interest (Bloomberg Composite)	0.6	2.3	4.9	5.1
Cash (Bloomberg Bank Bill)	0.2	2.0	2.3	2.7
Balanced option*	**-0.4**	**8.7**	**8.5**	**10.7**

Returns are for periods to 31 January 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

What's behind the Australian Bond option's recent negative returns?

Over the past four months to the end of January 2017, the Australian Bond option has returned -2.4%. Bonds are considered to be 'defensive' assets, and bonds backed by the Australian state and federal governments are often referred to as 'risk-free' assets. In this context, it's not surprising that a number of members have recently questioned how the Australian Bond option can generate a negative return. We looked at the risk/return dynamics of bonds in a previous update. Let's take another look, and explore some further trends.

Defensive investment options still come with risk

'Defensive' is a term that the asset management industry applies to assets deriving most of their total return from income (in contrast to 'growth' assets, which are expected to derive a substantial part of their total return from capital appreciation). So it's best to think of defensive as a relative—rather than absolute—term. What does that mean? Simply that defensive assets are considered relatively less risky than growth assets—but they can still be risky.

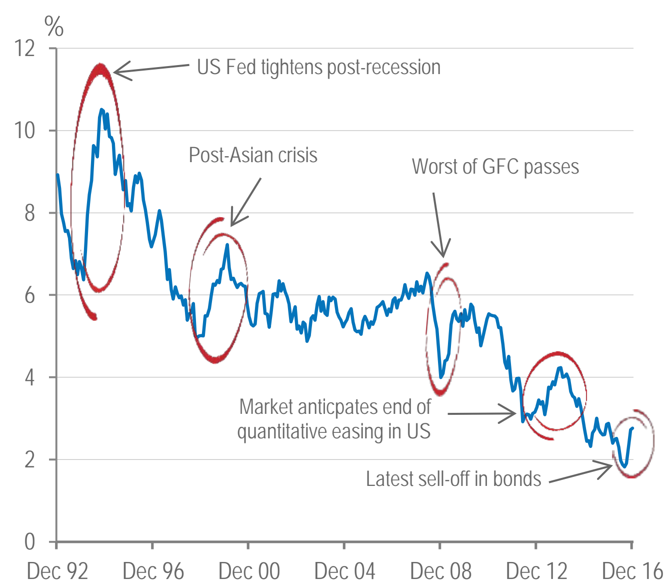
'Risk-free' can also be a misleading term. A bond backed by the Australian Government is indeed a risk-free asset, but only if it's held to maturity. However, from the time a bond is purchased until its maturity date, the capital value (price) of a bond will fluctuate in line with the market. As market interest rates rise, the price of a government bond will decline and vice versa.

To ensure all members entering and exiting the Australian Bond option are treated fairly, we adjust the price of the option to reflect these market movements. This is technically referred to as 'marking to market'.

Chart 1 shows what's happened to market rates over the last couple of decades. The strong downward trend in bond yields has been punctuated with some sharp spikes, and on all of these occasions the capital value of bonds—and bond funds—would have declined in value. On the face of it, the latest spike in yields—partly driven by a post-Trump increase in inflationary expectations—doesn't look too savage compared to some of the other spikes. But looks can be deceiving.

The latest spike has come off a very low base, so the impact is magnified. Without getting too technical, a 1% increase from a starting point of 2% has a far greater impact than the same increase from, say, a 5% starting point. Also, when yields are at such low absolute levels, the income provided from the bond provides less of a buffer to absorb any capital losses.

Chart 1: Australian Government bond yield



Source: Bloomberg

Different defensive assets are exposed to different risks

The Australian Bond option is one of three defensive investment options we offer at UniSuper. The other two are Cash and Diversified Credit Income (DCI). While they're all considered defensive in nature, Table 1 shows how they're exposed to different sources of risk.

Our Cash option is the lowest risk asset class. At UniSuper, the underlying investments in our Cash option are predominantly deposits with banks, so it's as close to risk-free as you can find. The trade-off is that cash returns are low. Generating higher returns within these defensive asset classes means taking on more risk. This can be done by either taking on credit risk or term risk (technically known as duration risk). Table 1 shows the two options available to our members in order of increasing potential returns, while at the same time taking on more risk.

Table 1: Sources of risk within defensive options

	Cash	Diversified Credit Income	Australian Bond
Return target	RBA Cash Rate	CPI+0.5%	CPI
Income risks	Lowest yielding. Income will rise and fall in line with RBA cash rate	Higher yielding than cash and will rise and fall in line with short-term rates	Higher yielding than cash and will rise and fall in line with bond yields
Capital risks	Zero to negligible capital volatility	Exposed to change in capital value, positive or negative, as credit outlook improves or worsens respectively	Exposed to changes in capital value, positive or negative, as market rates move down or up respectively

Performance outlook for our defensive options

When considering the outlook for returns on defensive assets, you should remember that, notwithstanding the recent surge in bond yields,

we're likely to be stuck in a low rate environment for some time to come. And our recent reductions in target returns on selected defensive options reflect just that.

The return on a single bond over its life is simply its current yield. The average yield across the portfolio of bonds in the Australian Government benchmark is currently around 2.43%. Given that the average bond in the portfolio has a maturity of about five years, this yield (less taxes and fees) is a good starting point as the expectation of the average returns over the next five years. However, as discussed above, the path over the next five years is likely to be anything but smooth and the actual returns experienced in any option over a shorter term (say, one year) will vary, depending on the key variables like economic growth and inflation.

The strategy an investor adopts within defensive assets will therefore depend on how they feel about these key variables. Table 2 outlines three possible scenarios that could unfold over the next 12 to 18 months, and the defensive option that's likely (but not definitely) to perform best and worst under each scenario.

Table 2: Likely relative performance of defensive options under different scenarios

Scenario	Likely best	Likely worst
- No change to cash rate - Economic growth stable - Bond yields steady	Australian Bond/Diversified Credit Income	Cash
- Weaker than expected economic growth and inflation - Fall in yields	Australian Bond	Diversified Credit Income
- Stronger than expected economic growth and inflation - Rising yields	Diversified Credit Income	Australian Bond

This table is obviously not an exhaustive list of possible scenarios. Most importantly, it doesn't assign any probabilities to the different scenarios. This deliberate omission is very important because a cursory look at the table might suggest that the Cash option is undesirable because it doesn't feature as the 'likely best' in any scenario.

But Cash is the safest option, and will only be the worst performer if everything remains stable. Of course, we don't know how the future will ultimately play out—but we do know that stability hasn't been a feature of the past few years.

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