UniSuper

March 2017

Investment Market Update

Global share markets continued to rise in February, taking a lead from the US—where investors continue to respond positively to the pro-growth aspects of the Trump administration's policy agenda.

The Australian share market lagged behind global counterparts, despite the fact that the February reporting season threw up more positive surprises than negative. In this month's update, we explore some key themes we saw from company reports.

Performance of key markets

	% CHANGE			
	MONTH	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian shares (S&P/ASX 300)	2.2	12.0	22.0	6.4
Global shares (MSCI All Country World Local Currency)	2.9	14.3	22.2	7.9
Australian dollar (AUD/USD)	1.3	3.3	7.6	-4.9
Australian fixed interest (Bloomberg Composite)	0.2	-1.2	1.4	4.8
Cash (Bloomberg Bank Bill)	0.1	1.2	2.0	2.3
Balanced option*	**1.5**	**5.2**	**11.5**	**8.1**

Returns are for periods to 28 February 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

The February reporting season

Each February, most of Australia's large companies report their half-year (or full-year) earnings for the period to 31 December. Contrary to what might be expected in an efficient market brimming with sophisticated analysts, the reporting season always throws up its share of negative and positive surprises. Fortunately, the latest batch of results to date has tended towards the latter, with profits up a very healthy 18% compared to the previous corresponding period.

The following outlines some of the key results with particular reference to the mining, banking, and infrastructure sectors.

The mining sector—what a difference a year makes

FEBRUARY 2016

"BHP Billiton cuts dividend, as it swings to $US5.7b loss"

FINANCIAL REVIEW

FEBRUARY 2017

"BHP Billiton's bumper profit lifts dividends"

FINANCIAL REVIEW

Our mining sector is dominated by the two global giants, BHP and Rio Tinto. BHP reported a half year profit of US$3.2 billion, which compared to a $5.7 billion loss for the previous corresponding period. Rio recently reported a full-year profit of US$4.6 billion, compared with an $866 million loss for the previous period. To date, the mining sector as a whole has recorded a staggering 165% increase in profits, albeit from a very low base.

The fortunes of our mining companies are a direct product of the boom and bust cycle that characterises commodity markets in general (see Chart 1 below). We discussed this theme in the [March 2016 Investment Market Update,] which stated *"it's a matter of when, not if, we once again experience supply constraints [leading to higher prices] – the cycle might change shape but never dies"*. While this statement might appear a little prophetic, don't be too impressed—everyone knows the shape of the cycle, but nobody knows the timing.

Chart 1: Iron ore price

Source: Bloomberg

The banks—the worst fears were misplaced

2016 was predicted to be a potentially horrible year for our banks, with possible shocks emanating from various sources including:

- large defaults stemming from the collapse in commodity prices
- a housing crash, led by apartments, and
- a large increase in regulatory capital requirements.

Despite the predictions, none of these came to pass and 2016 instead turned out to be a horrible year for *hedge funds* that built large short positions in bank shares (see April 2016 Investment Market Update for further background).

Australia's largest bank, the Commonwealth Bank (CBA), was the only major bank to report its results in February with the others providing a trading update. With their reach into all sectors, the health of our banks is a reasonably good barometer of the general health of the Australian economy. And on this score, it seems that Australia is managing the transition from the mining bust much better than expected.

Characterisations of Australia as a 'one-trick pony', totally dependent on selling raw materials to China, are simply unfounded. While unemployment has certainly increased and wage growth has slowed, we have had to adjust the significant hit to the economy from the collapse in mining investment. Fortunately, housing investment and the services sectors have picked up a lot of the slack, revealing an economy that's more balanced than meets the eye.

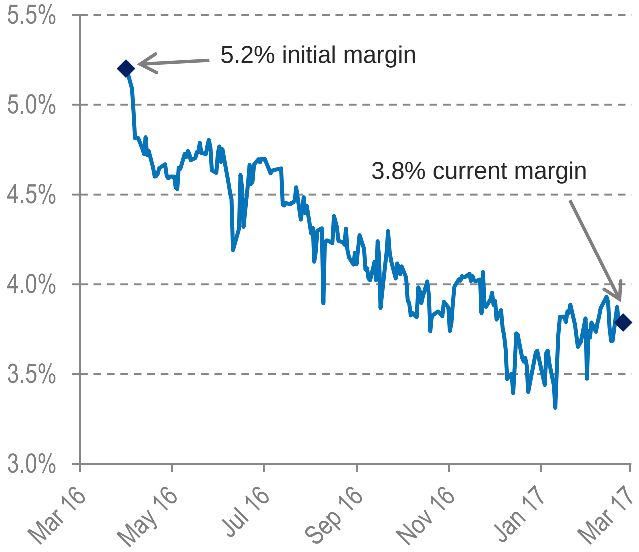
The resilience of the economy has translated into solid bank results. While revenue growth was modest, it was still positive, there is little to no deterioration in their loan books, and the strength of their capital position places them among the best capitalised banks in the world. Whereas twelve months ago the market was panicking about the prospect of hefty capital raisings, there is now a hint at the prospect of capital returns.

A note on CBA PERLS

"PERLS" are hybrid securities issued by the CBA to increase their capital base. They are called hybrids because in the normal course of events they will pay interest in the same way as a bond, but in certain circumstances they can be converted to shares. We think there's a low (but not zero) probability that such circumstances will eventuate.

Up until a year ago, UniSuper avoided hybrids as we didn't see the yield offered being sufficient to compensate for the additional risk. Then in February 2016, CBA issued PERLS VIII at an attractive margin of 5.2% above the bank bill rate, reflecting the very volatile market conditions at the time. It's in volatile times that a long-term investor such as UniSuper needs to search for opportunities, and we invested around $300 million as a cornerstone investor in PERLS VIII. The CBA deal was followed by similar issues from other major banks which we also corner stoned, taking our total purchases of hybrids to around $900 million. These investments turned out to be one of our best for the year, as margins contracted in line with growing confidence in the Australian economy, and the strength of the banks' balance sheets (see Chart 2).

Chart 2: CBA PERLS VIII trading margin



Source: UniSuper, Bloomberg

In a much improved environment from a year ago, CBA has recently launched PERLS IX at a margin of 3.90% above the bank bill rate. The demand for the issue is expected to be some multiple of the volume offered, in contrast to twelve months ago when buyers were much harder to find. One is reminded of a Warren Buffett quote: “The stock market is the only place where people want to buy more of something after the price has risen!”

Infrastructure—some things stay the same

UniSuper members will be aware that we have built up large stakes in infrastructure companies Transurban, Sydney Airport, and APA. While other sectors of the market are full of negative and positive surprises, the most attractive characteristic of our large infrastructure investments is their tendency to deliver *no* surprises.

	REVENUE GROWTH	EARNINGS GROWTH	DIVIDEND GROWTH
transurban	+10%	+12%	+11%
Sydney Airport	+11%	+10%	+22%
APA Group	+12%	+14%	+8%

Source: Company reports

Once again, these three companies delivered solid growth in revenue, profits and dividends. Of course, the numbers are not as exciting as the 165% increase in mining profits but, unlike the mining companies, they didn’t report losses last year. When it comes to investing your super, boring works well for us.