Investment market update

Though the Australian share market ended flat for September, the month was by no means a steady journey. At one point shares were down by more than 4%, before rebounding just as sharply. The initial driver was market concern that the world's major central banks were no longer as willing to flood the global economy with cheap money, leading to a rise in bond yields. This sensitivity to interest rates was drawn out between sectors as well. The interest rate sensitive stocks such as real estate investment trusts (REITs) and telcos were hardest hit, but this was offset by an increase of more than 5% in mining shares which continue to benefit from the recent recovery in commodity prices.

Performance of key markets

	% CHANGE				
	MONTH	FYTD	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian shares (S&P/ASX 300)	0.5	5.2	13.5	6.0	11.0
Global shares (MSCI All Country World Local Currency)	0.2	5.1	10.8	7.7	12.6
Australian dollar (AUD/USD)	1.9	2.8	9.0	-6.5	-4.7
Australian fixed interest (Bloomberg Composite)	-0.2	0.9	5.7	6.2	6.0
Cash (Bloomberg Bank Bill)	0.1	0.5	2.2	2.4	2.9
Balanced option*	**-0.6**	**2.2**	**9.6**	**9.2**	**11.4**

Returns are for periods to 30 September 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 approach to corporate engagement

With Australia's expanding pool of superannuation assets, the focus on super funds' investments has never been greater. And with a large number of baby boomers approaching retirement—combined with the ever-increasing power of social media—super fund members are becoming more involved, putting more onus on funds to be more engaged with the companies they invest in.

In this update we take a look at our position as an **engaged owner**, and how this compares with being an 'activist investor'.

Engaged owners compared with activist investors

While both of these terms may seem similar, their approaches are significantly different and the nuances are important at a practical level. Here's a comparison of typical traits of activist investors and engaged owners.

ACTIVIST INVESTOR	ENGAGED OWNER
"Renter" mentality	"Owner" mentality
Buys companies with perceived problems, hoping to drive rapid change	Invests in good quality companies with sound governance and strategy
Short-term focus seeking immediate action	Long-term holder, sustainable return focus
Disruptive to existing management / board	Supportive of existing management / board
Extensive use of media and public forums to force change and enlist support	Consultations and concerns are communicated privately

Activist investors tend to invest in underperforming, poorly-governed companies and seek to aggressively drive change to shake up company management and boards. A typical foray by such an investor starts with the purchase of a minority stake in a company (sometimes a very small minority stake). The investor will then typically lobby other shareholders to join ranks, usually supported by a well-orchestrated media campaign.

Activist investors can make a range of demands, but their ultimate goal may be to turn a profit as quickly as possible so that funds can be redeployed on the next target. A successful raid will see a board complying with the demands of the investor to increase short-term profits (such as cutting capital expenditure or staff), which results in a rise in the share price, providing the activist with the opportunity to sell.

In the eyes of the law, all investors of common shares have equal rights. Whether someone is an activist seeking a short-term profit, or an owner interested in the long-term sustainability of the business (sometimes at the expense of short-term profits), the law provides that **one share = one vote**.

While activist investors have a reputation for being opportunistic and vulture-like in their methods, it could also be argued that they're a necessary force to guard against lazy, incompetent or corrupt directors, and there will certainly be occasions when their interests are aligned to all investors. For example, we would have all been better off if activists effected board changes with Enron, Lehman and similar companies before they did so much damage!

UniSuper's engaged ownership approach

We now manage over 50% of our investments internally, so we're in an excellent position to focus on investing in quality companies that we're confident will deliver sustainable earnings over the long term. Our investment due diligence includes assessing the governance practices of companies we're considering investing in, including environmental and social practices. In other words, we're actually investing in sound governance and business strategy, rather than problems that will need to be solved down the track.

Once we've invested, we're in regular contact with the board and management of the companies we hold significant stakes in. Ultimately, we believe that being an engaged owner and using our ownership rights responsibly through private and respectful engagement (combined with voting) is the most effective way in which to communicate with and influence these companies. It also goes some way to ensuring that we, as an owner, are likewise treated with respect. UniSuper has always been welcomed on the share register.

Voting with our feet is always an option

There are times when the direction of a company changes, or we lose confidence in the board and management to execute the strategy. In these rare situations our interests may no longer align with a company no matter how well we engage, or how good our relationship with that company is. In such instances, selling our shares can be the most appropriate response. Our position in Aurizon is a good example.

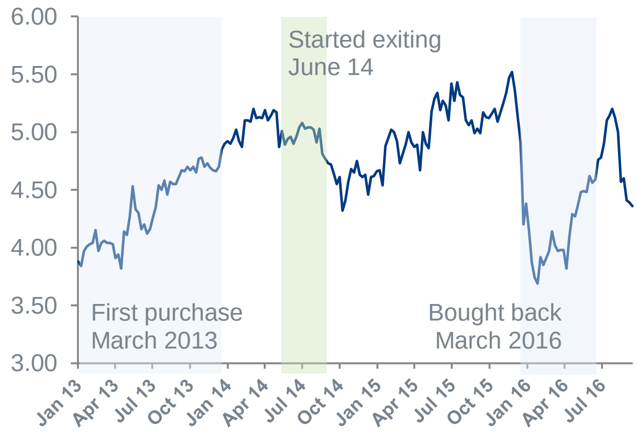
Aurizon, previously known as Queensland Rail, was floated by the Queensland Government in 2010. Aurizon owns an extensive rail freight network and operates in an industry structure with few competitors.

In 2013 we took a large position in Aurizon given the quality of its asset base and long-term contracts, making the company an excellent fit for a number of our investment options, particularly the Defined Benefit Division.

However, around a year after our initial investment, Aurizon decided to invest in the iron ore industry through an investment in Aquila Resources, which owned iron ore assets in the Pilbara. The deal exposed Aurizon to a high-cost miner, together with the risk associated with developing new railways and a port (activities it hadn't done before). The iron ore industry is hyper-competitive, dominated by likes of BHP, Rio Tinto and Vale. The timing of their investment was highly questionable as the mining industry in general was under considerable pressure.

While Aurizon positioned this as an opportunity to diversify its revenues, it was a substantial change in strategy that potentially threatened the stable revenues and dividends that attracted us to it in the first place. After a number of private, robust discussions with management and the board, we sold our position because we weren't comfortable with the company's direction.

Aurizon



Source: Bloomberg
* Past performance is not an indication of future performance.

Subsequently, Aurizon decided not to pursue the Pilbara development, and in fact wrote off its entire investment in Aquila. After constructive discussions with the new Chairman, in which we were assured that the strategy was back on track, we recommenced building a position in Aurizon. While we voted with our feet, we did so in a respectful manner and maintained good relationships with the company. Aurizon was always clear on what we were doing and why. When the time was right we decided to reinvest and could do so with the relationship intact.

Voting our shares

As an engaged owner, we have a policy of voting on all company resolutions. On average, we tend to vote against 10% of company resolutions in any given period. This is not a target we aim for, but intuitively seems about right. Bear in mind that the vast bulk of resolutions are non-contentious and procedural in nature. Voting in line with management and the board 100% of the time might suggest insufficient rigour and scrutiny on our part. Voting against more frequently would indicate that we're not being sufficiently discerning about the companies that we invest in.

The 'two strikes rule'

- The Corporations Act 'two strikes' rule was introduced in 2011 and provides that if a company receives a vote against its remuneration report of more than 25% in two consecutive years, there is an automatic board spill resolution with all board members up for re-election.
- This change was welcomed by investors. Some companies were concerned that activist investors would use the 'two strikes' rule for agendas unrelated to remuneration. However, this generally has not come to pass and UniSuper has seen the two strikes rule lead to greater levels of engagement and dialogue.

Therefore, in the majority of instances, we are supportive of the general direction of a company and feel that our members' interests are best served with business as usual.

Importantly, where we have concerns (e.g. where a corporate action is detrimental to our interests), we first seek to engage with the company and, if this doesn't work, we will vote against relevant resolutions being put to shareholders. You can access our voting here.

Remuneration will always be a key focus

As in previous years, we will be paying particular attention to executive remuneration practices in the upcoming Annual General Meeting (AGM) season. In general, we want to see sufficiently demanding hurdles tied to financial performance. Any successful business will obviously set goals of a non-financial nature (such as environmental and social goals). However, the subjectivity of these goals render them prone to "gaming"; a cynic might suggest that a heavy weighting to non-financial goals provides a board with scope to overly reward management at times when the financial performance of a company is poor.

Engaged ownership approach to Australian listed REITs

- The global financial crisis focused the attention of investors and the public alike on executive remuneration.
- UniSuper had specific concerns over the levels of remuneration across REITs, and commissioned detailed research in to a number of aspects of remuneration at all major Australian REITs.
- This research then formed the basis for us to engage constructively with those companies about remuneration, including the amount and persistently high levels of 'at risk' remuneration being paid year in year out.
- We are now seeing some downward pressure on remuneration in the sector, and are confident that we've played a part in the process.