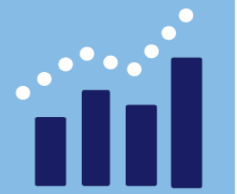
UniSuper

October 2014

# Investment Market Update



**ASX dragged down in Black September**

Max Mason and Sally Rose — Australian Financial Review, 1 October 2014

The Australian sharemarket is trading below the level at which it started 2014, after a shocker month wiped out all the gains of the first eight months of the year.

## *Performance of key markets*

| | % CHANGE | | | | |
|---|---|---|---|---|---|
| | MONTH | FYTD | 1 YEAR | 3 YEARS P.A. | 5 YEARS P.A. |
| Australian Shares (ASX 300) | -5.4 | -0.6 | 5.7 | 14.4 | 6.6 |
| US Shares (S&P 500) in US Dollars | -1.4 | 1.1 | 19.7 | 23.0 | 15.7 |
| US Shares (S&P 500) in Australian Dollars | 5.4 | 9.1 | 28.0 | 27.4 | 15.9 |
| Asian Shares (MSCI Asia) | -4.3 | -0.8 | 6.2 | 8.6 | 4.2 |
| Australian Dollar (AUD/USD) | -6.4 | -7.3 | -6.4 | -3.4 | -0.2 |
| Australian Fixed Interest (UBSA Composite) | -0.3 | 1.0 | 6.0 | 5.8 | 6.7 |
| Cash (UBSA Bank Bill) | 0.2 | 0.7 | 2.6 | 3.4 | 3.9 |
| **Balanced (MySuper) option*** | **-1.4** | **1.3** | **9.8** | **13.1** | **8.2** |

*Returns are for periods to 30 September 2014. 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

## Behind the Aussie share market rout

Global share markets fell in September and Australian shares suffered more than most, losing -5.4%. This was the largest monthly loss in more than two years. Concerns about the extent of a Chinese economic slowdown, particularly in the housing sector, weighed on the price of iron ore (Australia's largest export earner) and mining shares more generally.

Meanwhile, US bond yields rose as the market anticipated that interest rate hikes from the US Federal Reserve may be drawing closer. This weighed on the price of high dividend yield stocks (particularly the banks) which have benefitted from low interest rates. Rising US interest rates also contributed to a -6% fall in the Australian dollar, which reinforced the weakness in share prices. While a weaker A$ boosts company earnings in the medium term, it can weigh on shares initially as foreign investors sell their shares as the dollar falls. For a foreign investor, the US$ value of Australian shares fell by more than -12% in the month.

### *The good news about falling asset prices*

The -5.4% loss on Australian shares in September brings the cumulative loss this financial year to -0.6%. After returns of about 22% and 17% in the previous two financial years respectively, the latest poor performance would have come as an unpleasant surprise to those hoping for the good times to roll on. While it is commonly understood that markets are volatile, it would also be fair to say that a rising market feels good, and a falling market feels bad. Although there is a general understanding that superannuation is a long-term investment, it is hard to avoid media commentary on the adverse impact that a falling share market has on monthly and quarterly superannuation returns.

The reality is that the majority of people who look at their returns will see that their balances have fallen since the start of the 2015 financial year. However, whether or not this news is as bad as it looks requires perspective. Specifically, it depends on whether you are a buyer or a seller. In this regard the share market is no different to the property market. Rising property prices are great for those fortunate enough to own a couple of properties, but not so good news for those who want to buy.

Around 80% of UniSuper members are in 'accumulation mode' in options that are exposed to the share market. This means that when their super is topped up at every payday, they are effectively *buyers* of shares.

Consider the dynamic using the example of Commonwealth Bank (CBA) shares, which are a common holding across all UniSuper's growth portfolios (and most Australian super funds for that matter). After paying a dividend of $2.18, CBA shares were trading at a recent peak of $82. At time of writing they are trading at about $74.50, representing a -9% fall in price. CBA is expected to make a profit of about $9 billion this financial year which equates to $5.50 per share. Most importantly, the profit outlook for CBA has not been downgraded despite the fall in share price. In essence a share represents a claim on a company's profit, so a falling share price in the absence of profit downgrades is great news for a buyer. In dividend yield terms a buyer of CBA shares at $82 was expected to receive about 5% (before franking credits). At the current price the dividend yield jumps to about 5.5%.

The opposite perspective would be that of a retiree who is in 'de-cumulation' mode. Basically, those needing to sell shares to supplement their income have a vested interest in *rising* share prices.

## The bigger picture

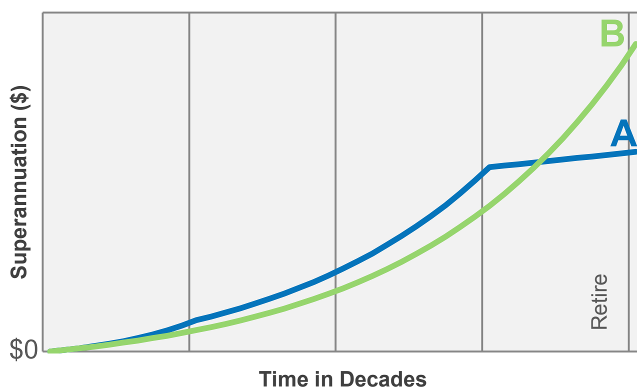
Extending on the CBA example above, consider the hypothetical investment returns over four decades for the two superannuation accounts shown in Table 1. For simplicity, let's assume that both accounts have the same fixed annual contributions.

*Table 1: Returns for scenario A and B*

| SCENARIO | INVESTMENT RETURNS (% p.a.) | | | |
|---|---|---|---|---|
| | DECADE 1 | DECADE 2 | DECADE 3 | DECADE 4 |
| A | 15 | 7 | 7 | - |
| B | 7 | 7 | 7 | 7 |

What scenario would you choose? While both scenarios generate around 7% compound annual returns, scenario B is ultimately superior to scenario A for someone in 'accumulation mode'.

*Projected superannuation*




Based on some simple assumptions, member B is about 50% better off than member A at retirement. While member A will have the satisfaction of feeling richer after a decade, the final outcome is worse than B's because:

i) Additional contributions made by A are invested in the share market at higher prices than those paid by B; and

ii) Just when A's balance is near its peak, the market delivers a zero return for the final decade as the overall return reverts to the long term average.

The negative impact outlined in point ii) above is sometimes referred to as sequencing risk — the risk that markets are going to fall when someone has reached their highest point in savings, typically just before they retire.

This example hopefully shows how sequencing risk is exacerbated by markets that rise well in excess of long-term averages.

## Another look at the long term

On the subject of long-term averages, Table 2 shows the returns of the Australian share market over the past century, after inflation.

*Table 2: Real total returns of Australian shares**

| DECADE ENDING | DECADE RETURN % P.A. |
|---|---|
| 1910 | 11.7 |
| 1920 | 3.1 |
| 1930 | 17.2 |
| 1940 | 9.7 |
| 1950 | 4.0 |
| 1960 | 9.0 |
| 1970 | 10.4 |
| 1980 | -6.6 |
| 1990 | 9.2 |
| 2000 | 8.2 |
| 2010 | 5.9 |
| **Average** | **7.4** |

* Calculated from Credit Suisse Investment Returns Source Book, MSCI and ABS data. Past performance is not an indicator of future performance.

When looking at the table a few observations come to mind. The most obvious conclusion is that over the long course of history, investing in Australian shares has been a rewarding experience. A 7.4% return in excess of inflation has been achieved despite massive market dislocations created by wars, natural disasters and asset bubbles.

The value of the share market is the discounted value of future income streams, and a change in share prices reflect the changes in expected income streams. Hence the two components of real returns are **dividend income** and **capital growth**. Over the very long term, capital growth can be expected to grow broadly in line with real economic growth of around 3%. However, the share market has bouts of

exuberance and bouts of depression as it projects recent short-term changes in profit growth into the future. But history suggests that growth in profits ultimately revert back to the mean. Similarly, although we know that swings in share prices can be huge over short periods, after a period of abnormally high returns there is a chance that—for the market as a whole—a major correction is potentially just around the corner.

Table 2 illustrates the tendency for returns to 'mean-revert' from decade to decade. It's important to remember that over the past century we never experienced two consecutive decades with returns below the 7.4% long-term average.

Let's hope that history repeats itself. For those who believe in mean-reversion, consider that the previous decade was below par with returns averaging 5.9%. Furthermore, the start of this decade has not been good, thus far returning 3.5% per annum. To average a real return of 7.4% from here implies returns of 11.1% per annum until the end of the decade!

Of course, maybe history won't repeat; maybe we are in an era of 'secular stagnation'. Only time will tell, although betting against a pattern observed over a century is going against the odds.

As an aside, the data in Table 2 featured in the book *The triumph of the Optimists* written by Dimson, Marsh and Staunton.

## Conclusion

The -5.4% loss on the Australian market in September will make for some disappointing reading for those who look at the short-term performance of their superannuation accounts. Whether or not the fall represents genuine bad news, or a buying opportunity, depends on perspective.

For a retiree who needs to sell assets to complement other sources of income, an actual loss (as distinct from a paper loss) may need to be realised. However, this should be seen in the context of a market that has risen by about 40% in total over the past two years.

For the majority of our members who are in the accumulation phase, and therefore buyers of assets, consolation can be taken by virtue of the fact that assets are now being accumulated at a cheaper price and with higher yield.

Warren Buffett says that he wakes up every morning hoping that "Mr. Market is going to have a bad day". While Buffett has a very large portfolio he also has the task of investing a constant stream of funds he receives from his investments, particularly premiums received from his insurance company.

The challenge for super funds is somewhat similar to Buffet's challenge, although at UniSuper we have members in accumulation phase and retirement phase so we don't share Buffet's enthusiasm hoping for Mr. Market to have a bad day! We are however much happier to see a gradually rising market, rather than a raging bull market. It's in this context that we see the latest market pullback as a healthy correction that will ultimately mitigate the risk of a real crash.

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