UniSuper

March 2018

Investment market update

The Australian share market was caught up in the plunge experienced by global markets in early February (watch our recent video for more on this), but it finished broadly flat for the month—helped by a generally positive earnings reporting season.

While February's volatility may be a sign of things to come, the overall positive tone of share markets over the past year has resulted in healthy returns across our diversified growth options—although some have fared better than others. In this month's update, we take a closer look at our sustainable investment options and discuss why their recent performance hasn't kept pace with their mainstream equivalents.

Performance of key markets

	% CHANGE				
	MONTH	FYTD	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian shares (S&P/ASX 300)	0.3	8.5	10.3	5.2	7.9
Global shares (MSCI All Country World Local Currency)	-3.6	10.4	15.0	8.1	11.4
Australian dollar (AUD/USD)	-3.8	1.6	1.4	-0.2	-5.3
Australian fixed interest (Bloomberg Composite)	0.3	1.4	2.9	2.4	4.1
Cash (Bloomberg Bank Bill)	0.1	1.1	1.7	2.0	2.3
Balanced option*	**-0.8**	**5.9**	**10.3**	**6.7**	**9.7**

Returns are for periods to 28 February 2018. 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

Performance of our sustainable investment options

UniSuper offers two sustainable options—Sustainable High Growth and Sustainable Balanced—and both of these have mainstream equivalents (High Growth and Balanced). The sustainable options have the same risk and return objectives as their mainstream equivalents—the High Growth options target a return of CPI + 5.0%p.a. over seven years, and the Balanced options target a return of CPI + 3.0%p.a. over six years (with the MySuper option having a legislated period of 10 years).

Despite these common objectives, we can still expect to see differences in the performance of the respective options, particularly over the short term, as Table 1 shows.

Table 1: Performance of the sustainable options and their mainstream equivalents over the longer term

As at 28 February 2018	RETURNS (% P.A.)		
	1 YEAR	3 YEAR	5 YEAR
Sustainable High Growth (Accum)	11.7	6.5	11.2
High Growth (Accum)	16.2	8.8	12.1
Difference	**4.5**	**2.3**	**0.9**
Sustainable Balanced	9.1	5.2	9.0
Balanced	10.3	6.7	9.7
Difference	**1.2**	**1.5**	**0.7**

** Past performance in not an indication of future performance.*

We can see that over the past year, the sustainable options have underperformed their mainstream counterparts—by a fair margin in the case of High Growth. Members invested in these options can take some comfort that performance has been more closely aligned over the longer term. And there have been periods when the sustainable options have actually outperformed their mainstream equivalents.

But most importantly, all options are achieving their long-term investment objectives.

Not surprisingly, the driver of the differences in performance is the way the different portfolios are composed—primarily, the exclusion of various industry sectors (those involved in alcohol, gambling, weapons, and fossil fuel exploration and production) from the sustainable options. These exclusions can have positive or negative performance outcomes.

Why the underperformance of our sustainable options?

In 2017, investor perceptions significantly improved as global growth momentum improved and became broad-based across most economies. This led to the robust performance of cyclical sectors like commodities and emerging markets, and lower returns in more defensive, income-oriented investments like real estate. It's these sectors where the sustainable options have materially different exposures than their mainstream counterparts.

Table 2: Sector returns and option weights

As at 31 December 2017	% RETURN 1 YEAR	SUSTAINABLE HIGH GROWTH PORTFOLIO WEIGHT %	HIGH GROWTH PORTFOLIO WEIGHT %
Australian Resources (ASX300 Accum Resources)	25.7	0	12
Australian Real Estate (ASX 300 AREITS Accum)	6.4	10	3
Emerging Asia (MSCI AC Asia Ex. Japan Index) (in AUD)	31.2	1	8

** Past performance in not an indication of future performance.*

Australian resources

In 2015, [we highlighted the importance of the Australian resource sector] as a driver of performance, noting that "the structural underweight position to the resources sector in the sustainable options, the relative performance of that sector will be a key driver in determining the relative performance of those options."

At that time, the resources sector had underperformed the broader market for a significant period. More recently the pattern has reversed, with the sector recording a total return of +25.8% on the back of a strong rebound in commodity prices.

Members invested in the High Growth option had considerable exposure to mining stocks like BHP Billiton and Rio Tinto, which gained +18.0% and +26.6% respectively. Our sustainable options, however, have no exposure to these companies—and many other high performing companies in the energy sector—due to their fossil fuel operations. These exclusions have played a significant role in the lower returns of the Sustainable High Growth option relative to the mainstream option.

Australian real estate

With the sustainable options having no exposure to energy and resources, remaining sectors like real estate have a higher weighting. The Australian real estate market is highly concentrated in retail, which has suffered from a combination of low wage growth and online competition—contributing to lower relative performance.

Emerging markets

Emerging markets present a number of challenges with respect to environmental, social, and governance (ESG) considerations, with less developed corporate governance standards and the lower availability of the data necessary to screen companies for ESG risks. For these reasons, the sustainable options' global shares portfolio is dominated by companies listed in developed markets such as the United States, Europe and Japan.

Unfortunately for the sustainable options, which have very small investments in the region, 'Emerging Asia' was one of the best performing geographic regions in global shares in 2017. This region represents around 8% of the High Growth option, compared to 1% of the Sustainable High Growth option.

Investing in a low carbon future isn't straightforward

There are clear concerns about the long-term viability of high carbon fuels, with global agreement to restrict future emissions. However, current electricity generation and manufacturing stock means that there's still demand over the short to medium term for a variety of fuels—from coal through to natural gas. While some lower carbon fuels will have a longer future in a carbon-constrained world, the buyers of resources today are operating with an existing plant that relies on more carbon intensive energy—and so demand is currently strong.

Somewhat counter-intuitively, lower investment in new mines may support prices, and reduce the cyclicality (and therefore the risk) of these sectors, as supply could be more predictable and less subject to competition. On the other hand, demand may drop off more rapidly than forecast, which could lead to lower prices. Another possibility is that the volatility will remain, but not reach the peaks that we've seen historically, making market timing more important.

It's also important to note that the renewable energy sector is not protected from this boom-bust investment cycle.

Together, all of this highlights some of the real challenges around investing in the energy sector. Furthermore, divesting particular sectors of the market, based on expectations of long-term trends, won't protect members from lower relative returns at various points in time.

Looking forward

The mining and energy sectors have delivered widely varying returns from year to year for many decades, and they tend to be prone to investor over-exuberance and despair. It's these large swings in sentiment that play a major role in driving the relative performance of the sustainable options relative to their mainstream equivalents.

The unique sector and geographic composition of the sustainable options will likely continue, at times, to result in dramatically different performance relative to the mainstream options. Over the long term, however, we continue to believe their differences may not be as pronounced.

Ultimately, what is most important for members is the performance of the options against their stated objectives—rather than relative to other investment options.