Spotlight on investments

Despite all the gloomy headlines about falling house prices, slowing credit growth—and a Royal Commission—the Australian share market staged an impressive rally over the 2017-18 financial year.

Including dividends, the ASX200 (which includes the 200 largest companies) returned 13.01%—just below the US market, but above many of the markets in Europe and Asia.

Performance of key markets

	% CHANGE			
	MONTH	1 YEAR	3 YEARS P.A	5 YEARS P.A
Australian shares (S&P/ASX 200)	3.3	13.0	9.0	10.0
Global shares (MSCI All Country World Local Currency)	0.0	10.8	8.5	10.8
Australian dollar (AUD/USD)	-2.4	-3.7	-1.3	-4.2
Australian fixed interest (Bloomberg Composite)	0.5	3.1	3.4	4.4
Cash (Bloomberg Bank Bill)	0.2	1.8	1.9	2.2
Balanced option*	**1.7**	**10.5**	**8.6**	**10.1**

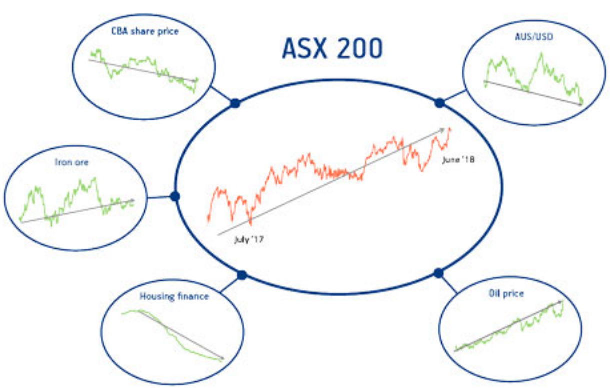
Returns are for periods to 30 June 2018. Past performance is not an indication of future performance.

** 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

Reflections on the past financial year

The majority of our Accumulation members will be pleased to know that the strong performance of global share markets underpinned a double digit (10.5%) return for our Balanced investment option—a highly improbable outcome just a few months ago.



While the Australian share market's overall performance was strong, there was significant variation in performance across sectors and individual companies. Here's a summary of the best and worst performers over the last financial year.*

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

Best performing sectors

With a 41.6% return, the energy sector was the year's star performer, underpinned by a rally in the prices of all forms of energy including oil, gas and coal.

In second place was the IT sector at 32.3%. The good news is that Australia actually has an IT sector—the unfortunate news is that it's only 1.9% of the market.

In third place was the materials sector (which includes iron ore miners) with a return of 29.9%. As with our energy exporters, the companies involved (e.g. Rio and Fortescue) benefitted from strong commodity prices and a lower

Australian dollar, at a time when their marginal costs of production are at all-time lows. The resources sector (energy and materials combined) constitutes 22.6% of the market, so it has a significant impact on overall returns.

Worst performing sectors

Some members may be surprised to learn that our banks were *not* the worst performing sector (although the four major banks returned -1.3% for the year, so they were a large drag on overall returns).

It was actually the telecommunications sector that had this dubious distinction, being dominated by the woes of Telstra (more on this later).

Our utilities sector—which includes the likes of AGL and Spark—was also relatively flat for the year, given the market's concerns about the impact of rising interest rates and the potential for increased regulation. Fortunately, the telco and utilities sectors combined only constitute 5.1% of the total market.

Best performing companies (of significance to UniSuper)

As you'd expect from one of Australia's largest investors, UniSuper's investment focus is skewed towards large companies, so we tend to miss out on the highest and lowest returning companies in any given year. Within the ASX200, the two best performers were Beach Energy and A2 Milk, both returning around 200%. At the other end of the spectrum were Retail Food Group and iSentia, which lost over half their value. The negligible holdings that UniSuper held in the above mentioned companies were mainly via our index portfolio.

For the purposes of this article, we'll narrow the list of best performers to the companies in which our investment exceeds $1 billion, so their performance will definitely have an impact.

Our star performer for the year was BHP (+52.2%), followed by Woodside (+25.3%) and ASX (+24.7%).

BHP

We've already covered the positive factors that underpinned BHP and Woodside's performance. For most of the time since the GFC, our 'growth' investment options were "underweight" (i.e. less than index weight) to the resources sector. This is because we biased the portfolios in favour of companies paying sustainable dividends in a falling rate environment. Since mid-2016—in light of our growing confidence in the sustainability of higher commodity prices and global growth—we balanced the exposure by investing heavily in resource companies. Changing our positioning has been fortuitous and is a key factor behind the top quartile rankings of our growth investment options relative to peers.

Woodside

Our investment in Woodside is particularly noteworthy, as we used our competitive advantages of scale and execution capability to buy a $700 million parcel of shares in a single transaction when Shell sold down their stake in the company at $31.10. We subsequently participated in a discounted rights issue at $27. At the time of writing, Woodside is trading around $36, so it's been a good trade. But don't get too excited because investments rarely work out so well, so quickly.

ASX

The Australian Securities Exchange (ASX) is itself a listed company, and with a 12% holding, UniSuper is its largest investor. The ASX doesn't have any net debt and holds dominant market positions, so it fits our definition of a 'fortress asset' that we look to buy at reasonable prices. We started accumulating a large stake in ASX a few years ago at around $35 and at the time of writing it's trading around $64, so it's been a stellar performer. However, don't expect a repeat performance any time soon as the shares now look a touch expensive.

Worst performing companies (of significance to UniSuper)

Aurizon

Over a one-year period, it's near impossible for a large fund to avoid the losers. To market participants any company that underperforms the broader index is considered an 'underperformer'. To UniSuper members, what really matters is outright losses and it's pleasing to report that every company in which we hold a $1 billion-plus investment recorded a positive return. In fact, there was only one company in which we currently hold more that $500 million that lost ground during the year—Aurizon (-

15.3%)—and a large portion of the position has only recently been accumulated at current prices.

Aurizon suffered from a very unfavourable ruling by the Queensland competition regulator and is currently appealing the decision. Even if the appeal isn't successful, Aurizon has 'fortress asset' characteristics and we're of the view that the shares are undervalued and a potential buying opportunity.

Telstra

While we're obviously disappointed with Aurizon's performance, our worst performer of any significance was—by a significant margin—Telstra (-34.4%). The woes of Telstra have been well documented; the NBN has left a huge hole in its revenue base that will be hard to fill and the entrance of a fourth player (TPG) has adversely impacted the profitability of the whole industry. Telstra has to run just to stand still, and it hasn't been running fast enough. Dividends have been slashed from 31 cents to 22 cents per share and most investors believe a sustainable level is somewhere closer to 15 cents. Somewhat mitigating our disappointment is the fact that the holding in Telstra is considerably less than $500 million. Furthermore, before the share price started to free-fall, we were able to trade out of a very large position at a good profit.

Our remaining stake in Telstra is largely held in our Defined Benefit Division (DBD) portfolio where we expect that the dividend yield will be sufficient to meet the hurdle return. Fortunately for the DBD, our holding in Telstra has not had a material impact on its overall health, with the funding levels actually improving over the year—one of the key measures of its financial position, the 'vested benefits index' (VBI) has increased from around 114% to 118%. "Excuses, excuses," you might say and you're probably right. We should have sold the lot.

Best turnaround story

Woolworths

Two years ago, our biggest disappointment was the performance of Woolworths, which bounced back with a 23.8% return last year, placing a very honourable fourth on our list of significant winners. Woolworths is an iconic brand with 'fortress asset' qualities that was in dire need of good management. CEO Brad Banducci and his team have proven to be just that and we applaud them. Let's hope that we will be applauding Telstra's management in two years' time.

Highest returning investment option

Amidst all the negativity about Australia's banks and the dearth of high-flying technology companies, it may come as a big surprise to many that first prize went to the Australian Shares investment option, which recorded a very healthy 18.1% return. Well done to any member who saw that coming, because this writer certainly didn't. Given the relatively small size of the option ($522 million), we have more flexibility to actively manage the portfolio and it was pleasing to see that the return was about 5% above the overall market return (or 5% 'alpha', as the technicians call it). The two main drivers of the outperformance vs. the index were overweight positions in a) the high performing resources sector, and b) fast growing medium size (or 'mid-cap') companies.

Lowest returning investment options

In any year where global share markets perform strongly, we can expect to see defensive investment options (which mainly hold cash and bonds) at the bottom of the performance tables, and that has been the case for the 2017-18 financial year. The options with the year's lowest returns were Diversified Credit Income (+1.6%) and Cash (+1.7%).

The Cash option's portfolio is strictly confined to callable cash and cash-like investments, such as bank bills and term deposits. Our Cash option doesn't invest in instruments such as mortgage-backed securities, hybrids, credit instruments and the like, which—according to a recent APRA report—some other cash funds are comfortable with. Accordingly, our Cash option's return (after fees) is likely to track reasonably closely to the Reserve Bank's official cash rate.

The Diversified Credit option is targeted (but not guaranteed) to return a margin over the Cash option over time, but this may not be the case in any given year due to the exposure to credit risk. In the last financial year, credit spreads widened (so the prices of securities with credit risk fell) and hence the small under performance of the Diversified Credit option.

It's now been six years since a defensive investment option was the best performing option on the UniSuper menu (the last was Australian Bond in November 2012). The vast majority of our members who have exposure to growth assets would like to see this continue forever, but it won't. We can't predict when the good run will stop, but the performance of the past six years is highly unlikely to be an indication of how the next six will pan out.