UniSuper

March 2014

Investment market update

February was a strong month for global share markets, as emerging market concerns were put to one side (at least for the moment) and the market looked through weather-impacted weakness in US economic data. Domestically, 'reporting season' (reporting of company financial results) dominated this month. While revenue growth remains tepid, management focus on reducing costs underpinned solid earnings growth which, combined with more positive outlook comments, helped to push the Australian market higher. In this update, we take a look at the positives and negatives coming out of reporting season.

PERFORMANCE OF KEY MARKETS

	% CHANGE				
	MONTH	FYTD	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian Shares (ASX 300)	4.9	16.0	10.2	8.2	14.9
US Shares (S&P 500)	4.6	17.4	25.4	14.4	23.0
Asian Shares (MSCI Asia)	2.8	6.2	0.0	1.2	14.1
Australian Dollar (AUD/USD)	2.6	-2.2	-12.6	-4.2	7.0
Australian Fixed Interest (UBSA Composite)	0.3	2.9	3.1	7.0	6.0
Cash (UBSA Bank Bill)	0.2	1.8	2.8	3.8	3.9
Balanced option*	2.5	11.4	13.7	9.4	10.7

Returns are for periods to 28 February 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 on all options

A strong month

February was a strong month for global share markets. Aggressive interest rate hikes in late January by a number of emerging economy central banks helped allay concerns about the imbalances that have built in these economies (at least for the moment) and helped give legs to an extended rally during the month. While the information flow was marked by a string of weak data reports in the United States and China, the market was happy to look through these on the assumption that the weakness was caused by the unseasonably cold winter in the former and the Lunar New Year in the latter. Increasing tensions in Ukraine also appeared to have little initial impact, though this may now be changing in March as the geopolitical tensions broaden to a global scale.

While global share markets were generally in a bullish mood, global bond markets were more cautious, resulting in a general fall in yields.

February is bottom line time

THE AUSTRALIAN MARKET WAS UP OVER 5% IN FEBRUARY, FOLLOWING A VERY WEAK PERFORMANCE IN JANUARY (3%). SO WHAT'S HAPPENED?

February is one of the most important months of the year for the Australian market. It's when the majority of companies stock exchange-listed report their semi-annual (or annual) earnings results to 31 December. Accompanying the numbers is management commentary, in which we often see good performance attributed to good management, and poor performance attributed to a poor economy.

Notwithstanding the doom and gloom that tends to dominate Australian economic commentary, reporting season in Australia beat expectations, and was the main driver of the strong rally seen for the month.

Simply put, given that shares represent a claim (literally one share) of a company's profit, it's reasonable to expect share prices to rise if profits grow and the outlook for future growth improves.

SO WHAT ABOUT THE REPORTING SEASON JUST PASSED?

Generally, the vast majority of listed Australian company earnings (as per the S&P/ASX 200 Index) were either better than or in-line with consensus expectations. The table below shows this in terms of earnings per share (EPS), dividends per share (DPS) and earnings forecasts. For our purposes, the term 'earnings' can be used interchangeably with 'profits'. Typically, if earnings and dividends are better than expected and earnings forecasts are revised up, the market follows suit.

	BETTER OR IN-LINE WITH MARKET (CONSENSUS) EXPECTATIONS	BELOW MARKET (CONSENSUS) EXPECTATIONS
EARNINGS PER SHARE (EPS)	69%	31%
DIVIDENDS PER SHARE (DPS)	79%	21%
EARNINGS FORECASTS	74% of forecasts maintained or revised upwards	26% revised forecasts down

Source: Citigroup

REVENUE, EARNINGS AND DIVIDEND GROWTH

Earnings = revenues - costs

For the overall market, earnings and dividends per share were up over 14% and 12% respectively for the six months to 31 December 2013, compared with the same period in 2012. However, earnings growth actually exceeded revenue growth, in some sectors by a considerable margin as the following table shows:

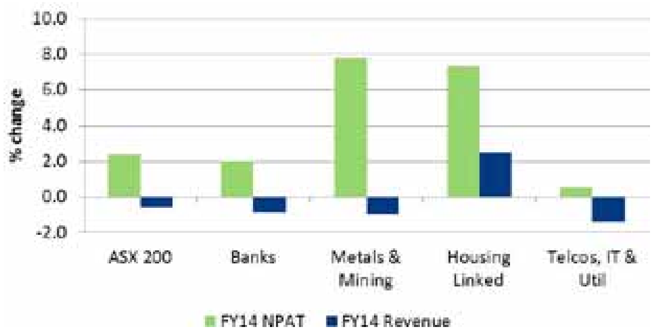
	REVENUE GROWTH	EPS GROWTH	DPS GROWTH
All companies	7.4%	14.6%	12.4%
Resources	13.0%	39%	28.1%
Banks	5.0%	13.9%	11.4%
Industrials	5.1%	3.5%	7.2%

Source: UBS

Referring back to earnings = revenues - costs, it logically follows that if growth in total earnings has exceeded the growth in revenues generated from sales, then costs grew slower than revenues, and that's exactly what happened. Furthermore, not only are Australian companies improving their productivity, the outlook is for further productivity gains, as you can see from the following charts. Despite the positive near-term outlook for profitability, we need to be aware of the limits of cost cutting as a means of driving future growth.

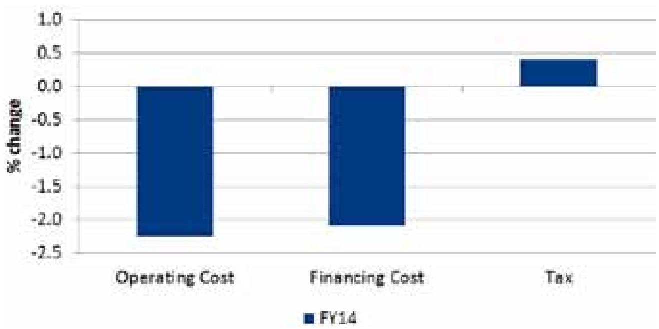
In corporate history it's difficult to find a company that has shrunk itself to greatness. Great companies grow profits by investing in business and creating jobs.

CONSENSUS NPAT AND REVENUE REVISIONS



Source: IBES, Morgan Stanley

CONSENSUS COST REVISIONS



Which businesses are doing well and which are struggling?

SECTORS OF STRENGTH AND IMPROVEMENT:

- Resources – the extent of productivity gains in the leading mining companies (like BHP and Rio Tinto) surprised the market. Earnings and cash generation were outstanding over the last six months, and there may still be more to come.
- Banking – while credit growth is relatively subdued, Australian banks have continued to generate solid profit growth as bad debts have been extremely low (which actually shows corporate Australia's strength) and cost discipline maintained.
- Infrastructure – companies such as Sydney Airport and Transurban have consistently produced solid earnings growth due to the quality of their asset bases and management.
- Housing – this sector has finally been improving after many weak years. Lower interest rates have definitely played an important part, like in the US.
- Retail – similar to housing, there appeared to be some recovery as demonstrated in the results of companies such as JB Hi-Fi and Carsales.com.

SECTORS THAT ARE STRUGGLING:

- Mining services – with the leading resources companies focused on productivity, the mining services sector has unfortunately taken the brunt of these cost outs.
- Specific areas where competition has significantly increased – companies such as Coca-Cola Amatil, Goodman Fielder and Pacific Brands are currently experiencing intense levels of competition in their industries, which have negatively impacted their earnings.

Earnings results for UniSuper's key shareholdings have been strong

As an active investor, we take positions in companies in accordance with our investment philosophy and process. As a custodian of our members' retirement savings, our investment preferences are heavily biased towards quality companies at a reasonable price, rather than weaker companies at bargain price.

By quality, we mean companies that have robust balance sheets, are profitable, and have strong industry positions. As you might recall, we lean towards 'fortress assets' that have business models and industry positions (bordering on monopolistic) that are better able to withstand economic downturns and market dislocations.

The infrastructure companies that we hold large positions in (Transurban, APA, Aurizon, and Sydney airport) all reported results that exceeded market expectations. The premium retail real estate investment trusts we hold (GPT, Colonial Retail, and Westfield Retail) also reported very solid results against a tough retail environment. Other major positives for us were dividend increases from CBA and Telstra, another two of our larger positions. Suffice to say that earnings season has given us no cause to be concerned about our major positions.

Of course, an investment strategy based on favouring quality companies also means that there will be some companies that we *don't* favour, which can rally quite strongly when the markets worst fears are not realised. For example, in February QBE and Newcrest Mining were up 11.6% and 17.5% as they reported results that exceeded expectations. They are companies that do not, at this point, pass our quality filters, and we accept that from time to time we will miss out when such companies outperform the market. Such is the nature of investing.

Valuations look fair

With the reporting season almost over we now have another key factor for share valuations.

ASX300 - 12 MONTH FORWARD PRICE EARNINGS

Past performance is not an indication of future performance.

One of the most common valuation metrics used is the company's price per share relative to its expected earnings per share. These calculations are conducted for every individual stock in our portfolio.

The numbers can be aggregated to give us a rough guide on the valuation of the market as a whole. As the graph above shows, the market is currently trading at valuations close to historical averages. This means the price/earnings ratio alone is not providing a strong buy or sell signal.

If you missed last month's investment update webinar, you can visit [MemberOnline] to watch it.

Issued by: UniSuper Management Pty Ltd ABN 91 006 961 799, AFSL No. 235907 on behalf of UniSuper Limited the trustee of UniSuper, Level 35, 385 Bourke Street, Melbourne Vic 3000.

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Trustee: UniSuper Limited, ABN 54 006 027 121
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