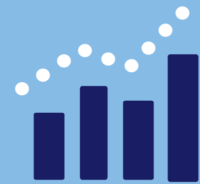
Investment market update



The Australian equity market was caught between two opposing forces in November: the ongoing rise of developed markets against the weakness observed in emerging markets. Overall, the market finished slightly down for the month. In other local markets, the increase in Australian government bond yields weighed on bond returns, while the Australian dollar was weaker. A major driver of the Australian market's strong performance this year was the performance of the four major Australian banks which are up 35% year-to-date on average. In the eyes of many analysts our banks are now overly expensive, so in this month's update we assess our exposure to the sector.

PERFORMANCE OF KEY MARKETS

	% CHANGE				
	MONTH	FYTD	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian Shares (ASX 300)	-1.4	13.1	22.7	9.5	12.1
US Shares (S&P 500)	3.0	13.4	30.3	17.7	17.6
Asian Shares (MSCI Asia)	0.8	8.9	7.5	1.6	14.4
Australian Dollar (AUD/USD)	-3.5	-0.2	-12.4	-1.6	7.0
Australian Fixed Interest (UBSA Composite)	-0.1	0.9	1.6	6.8	5.9
Cash (UBSA Bank Bill)	0.2	1.1	2.9	4.0	4.0
Balanced Option*	0.5	8.0	18.0	9.5	8.9

Returns are for periods to 31 October 2013. 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

The looming wind down of the US Federal Reserve's (the Fed's) current accommodative monetary settings continues to be a dominant factor driving investment markets. However, with the incoming Fed Chair Janet Yellen showing a strong commitment to maintaining near-zero interest rates for an extended period, the market is gradually losing its fear of both the prospect and consequences of the Fed winding down the rate of quantitative easing (known as 'tapering').

Accordingly, the gradual increase in bond yields was accompanied by a steady rise in global share markets, particularly those in developed markets. This was aided by a string of generally positive economic reports.

However, emerging markets generally lagged in performance compared to developed markets. A number of emerging markets, particularly those with large current account deficits, are considered to be vulnerable to Fed tapering and a strengthening US dollar.

The key feature in the Australian market was the weak Australian dollar (AUD). This was aided in part by heavy influence from the Reserve Bank of Australia (RBA), with RBA governor Glenn Stevens describing the AUD as "uncomfortably high", and not ruling out the prospect of RBA intervention. The market drew the (very questionable) inference that RBA intervention was imminent and sold the currency.

While a lower currency will be a net positive for Australian companies in the medium-term, the prospect of a lower currency will typically lead to offshore selling of Australian shares. This appears to be the case at present with the Australian share and bond markets lagging compared with global counterparts.

Why we continue to hold 'expensive' Australian bank shares

UniSuper, like many large Australian institutional investors, holds a significant amount of shares in Australian banks. All UniSuper investment options containing growth assets own bank shares, and the Australian Equity Income and Defined Benefit portfolios in particular have large exposure to banks compared to an average portfolio.

Accordingly, our investment performance has significantly benefited from the 35% rally (average calendar year to date) of the four major banks. Points to note include:

- All four major banks are ranked within the top 20 largest banks in the world (by market capitalisation)
- Australia's four major banks trade on an average price to book ratio (P/B) of 2.2 versus an average P/B of 1.0 for the four largest US banks. In other words, our banks appear to be twice as expensive as the US equivalents.

Given that valuation is the most critical factor underpinning investment decisions, it is reasonable to question whether or not it is time to reduce our exposure to Australian bank shares.

At this point we are 'on hold' and the following attempts to explain why.

ARE AUSTRALIAN BANK SHARES AS EXPENSIVE AS THEY LOOK?

In addressing this question, for illustrative purposes, we compare Westpac and JP Morgan Chase - the second largest banks in Australia and US respectively. We consider both banks to be very high quality institutions.

Currently only 31% of the bank analyst community rates Westpac as a 'buy', in contrast to 76% of bank analysts who rate JP Morgan as a 'buy'. What is more telling though is that 21% of the analyst community rates Westpac as a 'sell' vs. 5% who rates JP Morgan as a 'sell'.[1]

[1] Source: Bloomberg

The following table looks at the key metrics of both banks.

METRIC	WESTPAC	JP MORGAN CHASE	GLOBAL AVERAGE
Tier 1 Capital Ratio[1]	11.6%	11.9%	12.0%
Return on Equity	15.4%	8.5%	11.4%
Deposit to Loans	71%	175%	N/A
Bad Debts Charge[2]	16bps	10bps	90bps
Non-Performing Loans[3]	0.7%	1.2%	3.4%
Price to book ratio	2.2x	1.1x	1.3x

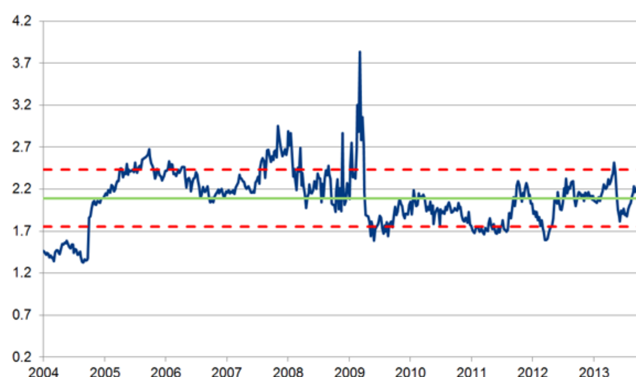
* Data as at 19 November 2013
[1] Fully harmonised Basel III common equity tier 1 ratio.
[2] Bad and Doubtful Debt charge as % of gross loans.
[3] Non-Performing Loans as % of gross loans.

The valuation metric most often cited when describing the expensiveness of Australian banks is the price-to-book (P/B) ratio. The P/B ratio compares the market value of the bank relative to the reported book value.

While there may be slight differences in calculations across the analyst community, there is no doubt that Westpac's P/B is much higher than JP Morgan's.

However, the fact is that Westpac has traded at a valuation premium to JP Morgan for at least a decade —well before the global financial crisis (GFC). As the following graph shows, the current ratio is in line with the average we have seen over the past decade.

WESTPAC VS. JPMORGAN CHASE PRICE TO BOOK



The main reason why Australian banks have traded at a structural P/B premium to the US and global banks over the past 10 years relates to the Australian banks' ability to consistently deliver world leading returns on equity (ROE) in the mid-to-high teens.

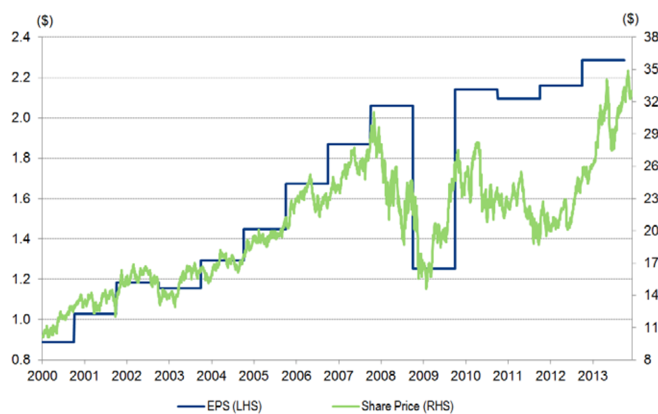
In contrast, US banks' ROEs have fluctuated between low single digits to mid-teens. Simply put, for every dollar of capital invested, Australian banks are able to earn up to double the amount on their investment, compared to their American counterparts.

Of course it's debateable as to whether the superior performance of Australian banks is more due to good luck than good management. It's generally accepted that our banks benefit from a more concentrated industry structure, and a stronger domestic economy. However, credit is also due to the management of our banks and regulators who did not get caught up in the more outrageous practices that were rife in other global banks leading up to the GFC.

BANK SHARE PRICES ARE AT RECORD HIGHS, BUT SO ARE PROFITS

A share in a company represents a claim on the profits of a company, so all things being equal, a rise in profits should ultimately be reflected in rising share prices. The following graph shows that the rise in Westpac's share price has been consistent with the rise in earnings per share (a point that often seems overlooked).

WESTPAC: EARNINGS PER SHARE VS. SHARE PRICE



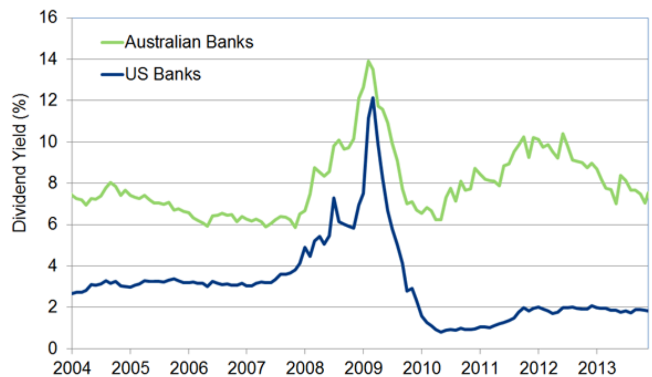
DIVIDEND YIELD IS VERY IMPORTANT TO US

There is a growing school of thought that the market is in a 'yield bubble' and investors are "irrationally favouring shares based on yield and not fundamentals". We don't quite understand the argument. After all, we believe yield is one of the most important fundamentals. Indeed for many of our retired members, yield is the most important fundamental.

Perhaps the key differentiating feature of the Australian banks (and a key reason why we continue to hold them) is their high dividend yield. This is particularly so given that as Australian investors we also benefit from the tax dividend imputation system which passes franking credits (tax already paid) back to shareholders.

The following chart illustrates the dividend yield (grossed up for franking credits) between Australian and US banks. Australian banks on average have delivered a gross dividend yield of 4%+ higher than their US counterparts over the past decade. This includes the spike in yields in early 2009 when the US bank index dropped 80% from its peak to trough, pushing their dividend yield up to 12%.

AUSTRALIAN VS. US BANKS - 'GROSS' DIVIDEND YIELD



Additionally, given that the Australian gross dividend yield is not markedly lower than the historical average (in an era when yields on bonds and cash are significantly lower), it is clear that record bank share prices correlate to record dividends. Note that three of the four major banks are paying a higher dividend than they paid in 2008. In comparison, after cutting their dividends from 2008 to 2009 by 62% to 99%, not one of the four largest US banks has yet reached the peak dividend of 2008.

DON'T FORGET THE RISKS

Given the importance of yield in our investment proposition on Australian banks, the most important question is the sustainability of the dividends.

Banks are highly leveraged companies, with Australian banks heavily exposed to the economic cycle. The biggest threat to dividends would therefore be a downturn in the economy sharp enough to create a material increase in unemployment. This in turn would lead to a rise in defaults and arrears, and a fall in house prices (real estate being the main collateral held as security by the banks).

Australian banks have very strong balance sheets with high levels of capital, so their creditworthiness is not in doubt. However, a sharp rise in unemployment (possibly around 8-9%) could represent a potential threat to the level of dividends. Australia's unemployment rate is gradually worsening as the economy readjusts from the mining boom, although estimates point to a manageable situation.

Accordingly, the current outlook has not caused us to alter our position as a significant holder of bank shares, although we will remain vigilant in looking for signs of deterioration.

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This information is current as at November 2013 and is based on our understanding of legislation at that date. Information is subject to change. To the extent that this fact sheet contains information which is inconsistent with the UniSuper Trust Deed and Regulations (together the Trust Deed), the Trust Deed will prevail.

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