UniSuper

July 2015

Investment market update

Roiled by yet another chapter in the never ending Greek crisis, the Australian share market recorded its worst return in nine months. While a -5.3% hit to the ASX 300 was a very unpleasant way to finish the financial year, members can take some comfort from the fact that returns for the past 12 months remained comfortably in positive territory. Given that members will soon receive their 30 June benefit statements, this month's update takes a look at the positive and negative contributors to our investment performance over the past year.

Performance of key markets

	% CHANGE			
	MONTH	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian Shares (ASX 300)	-5.3	5.6	14.7	9.5
US Shares (S&P 500) in US Dollars	-1.9	7.4	17.3	17.3
US Shares (S&P 500) in Australian Dollars	-2.3	31.9	29.1	19.6
Asian Shares (MSCI Asia)	-4.1	6.0	8.2	5.3
Australian Dollar (AUD/USD)	0.4	-18.6	-9.2	-1.9
Australian Fixed Interest (UBSA Composite)	-0.9	5.6	4.8	6.4
Cash (UBSA Bank Bill)	0.2	2.6	2.9	3.6
Balanced (MySuper) option*	**-2.8**	**10.9**	**13.5**	**10.1**

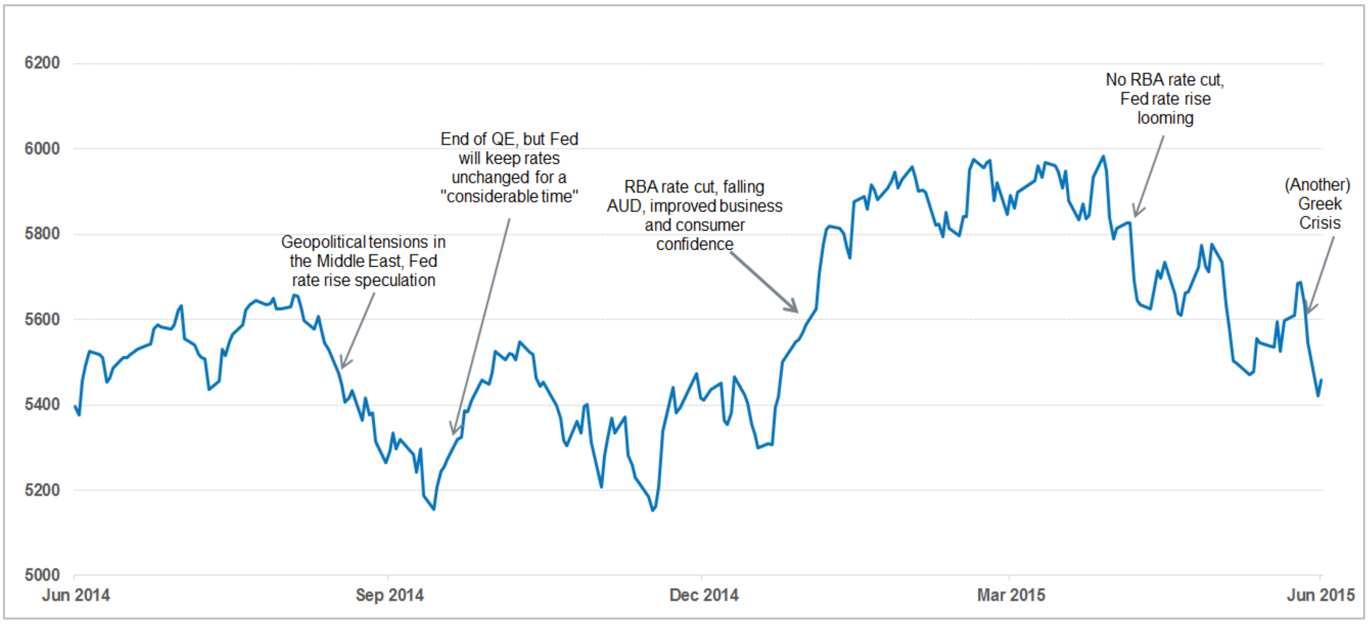
Returns are for periods to 30 June 2015. Past performance is not an indication of future performance.

* *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

2014 - 15 financial year in review

S&P/ASX200 Index over past 12 months



With the 2015 financial year just behind us, it's an appropriate juncture to take stock of investment performance over the previous 12 months.

From an absolute return perspective—which is ultimately what really counts to members—the year has been another good one, notwithstanding the very poor returns in June. The Balanced option, the default option for Accumulation members, returned 10.9%, representing the sixth consecutive year for positive returns for the option, with the cumulative return over those years being 77.6%, with an average return of 10.1%.

While strong *absolute* returns are good news for members, it doesn't necessarily indicate that we are doing a great job. Absolute returns are largely driven by broad market moves that we have no control over; as the saying goes "a rising tide lifts all boats". To get a sense of whether or not a good job has been done, we need to compare our performance to our peers, and in this regard it is very pleasing to note that our *relative* performance has also been very strong.

Our five diversified options, ranging from Capital Stable to High Growth, recorded returns that placed them within the top-quartile of their respective peer groups. More importantly, the long-term track record of all diversified options is also top-quartile.

To cap it all off, it was pleasing that our investment performance has been recognised by ChantWest, with UniSuper being awarded Super Fund of the Year and Best Fund: Investments.

In any given year an investment manager will make good calls and poor calls. Given our recent results it would be fair to say that we've got more right than wrong. Here we take a brief look at calls that have turned out well, together with some regrets of the past year.

Our best investment calls

1. **Sticking to the Australian equity 'yield' theme.** Our large positions in top quality, high yielding listed Australian property trusts and listed infrastructure continued to deliver excellent returns over the past year (GPT +17%, Scentre +21%, Transurban +32%, Sydney Airport +24% and APA +30%). We also have large positions in Telstra (+24%), and ASX (+17%).

   We've now held most of these stocks for over three years, having initially bought them at prices well below where they are currently trading. In sticking with these stocks we have effectively rejected the school of thought that they are caught up in a 'yield bubble', supposedly driven by loose and unsustainable global monetary policies. We have not invested in these companies simply because they pay a high dividend yield. In fact we have avoided a number of companies (e.g. MetCash, Seven West and Myer) that were trading on much higher yields in the past. We have invested in the likes of Transurban and Sydney Airport because of the high quality 'fortress' nature of their assets. Furthermore, we are in a relatively unique environment in which assets of such quality are delivering yields well in excess of bond yields, with strong prospects of sustainable growth.

2. **Concentrated exposure in outperforming sectors and regions.** Australian superfunds tend to source offshore assets by allocating to general global share funds, typically with separate allocations to developed markets and emerging markets. At UniSuper we break down the allocation to the next level by selecting sectors, countries or regions that we believe will outperform the general global indices. By doing this we are able to better diversify our portfolio (e.g. we don't see much point in buying global mining companies when we have so much exposure to the sector in Australia). Highlights of our global investment strategy over the past year have been:
   - a concentrated exposure to US technology and healthcare sectors, which returned 36% and 52% respectively over the past 12 months, and
   - restricting our emerging market exposure to Asia (+27%), while avoiding poorly performing emerging markets such as Russia (-11%), Greece (-48%) and Brazil (-13%).

3. **External manager selection.** At UniSuper we run a hybrid investment management model whereby about 50% of the funds are currently managed in-house, and the other half outsourced to external managers. While in-house management has proven to be a very cost effective way of generating strong returns, we remain committed to sourcing external managers that bring complementary capabilities to the table. External managers recorded solid contributions to outperformance across the board, however, four managers in particular deserve special mention for their strong one- and three-year contributions. Their performance and links to their websites for those of you who want to learn more about them are given here.

MANAGER	3 YEAR RETURNS	OUT PERFORMANCE*
Lazard (Aust. Large Companies)	20.0%	+5.3%
Novaport (Aust. Small Companies)	21.4%	+18.9%
T. Rowe Price (US Technology)	37.8%	+10.4%
Arrowstreet (Global Small Companies)	33.0%	+5.6%

Based on estimated returns for the month of June 2015. Past performance is not an indication of future performance.

**Versus respective market benchmarks.*

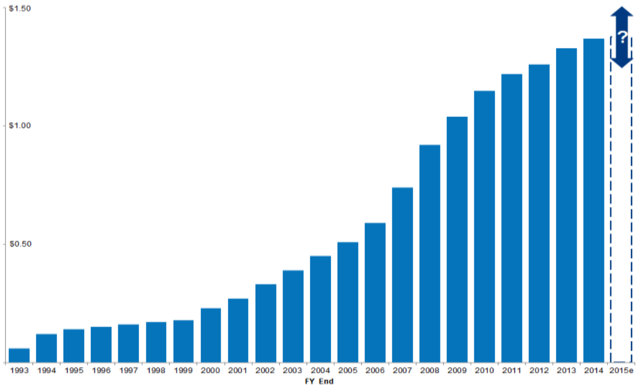
Regrets for the year

Our in-house management capability enables us to take large ‘single stock’ positions in which we have a particularly high conviction, involving companies that fit with our quality bias and risk/return objectives. By and large, these positions have paid off handsomely, as you can see from the examples already mentioned.

However, when investing around $50 billion across myriad strategies, it is inevitable that we will get some calls wrong. Our position in Woolworths has, to date, been an unequivocal disappointment. As the graph below shows, Woolworths has an outstanding track record of delivering dividend growth over the past two decades. During the GFC it did not miss a beat—we all still have to buy groceries after all. With this track record as context we accumulated the bulk of our position at around $33, after the shares had sold off from a high of $38. Alas, the stock is now trading at around $27 following two earnings’ downgrades.

Our decision to hold on to Woolworths is based on our view that their problems are fundamentally related to poor management, as distinct from structural challenges posed by the likes of Aldi. While Aldi clearly represents a competitive threat, Woolworths has an undoubtedly superior franchise and industry positioning. Noteworthy is the fact that Coles has managed to grow sales at a healthy rate while under the same competitive pressures as Woolworths. The latest earnings downgrade saw Grant O’Brien (Woolworths CEO) announcing his retirement, which now paves the way for a broader refresh of the management and board.

Woolworths dividend per share



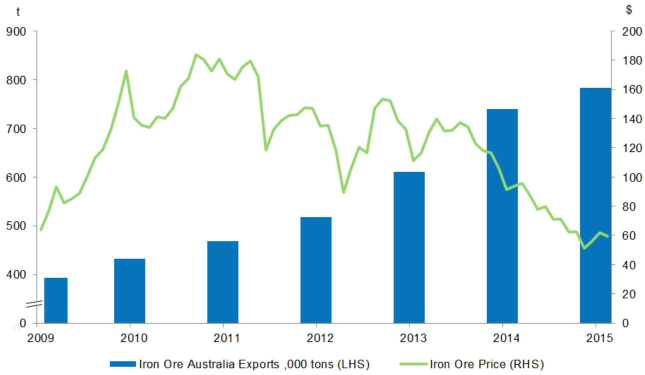
Hindsight is a wonderful thing in all aspects of life, not just investments. In hindsight, a market or a single stock can look like an obvious ‘sell’ or ‘buy’, although in real time it’s not as straightforward. However, when looking back at the past year, there were a couple of big market moves that we didn’t profit from, and arguably should have. Two in particular come to mind.

Australian 10-year bonds traded at an all time low yield of 2.28%, which is well below Australia’s long-term average inflation rate. Ten-year bonds trading at negative real yields cannot be described as anything other than extremely expensive. They’re now trading at a yield of just over 3%, so the move (up in yield and down in price) has seen the value of a typical bond portfolio fall nearly 3% in recent months.

Unfortunately we didn’t sell any bonds at those low yields; the good news, however, is that we didn’t buy any either.

Predicting commodity prices is a particularly hazardous exercise as there are so many factors to take into account. If we look at commodities such as oil, there are myriad demand and supply forces at work, about which an Australian investor is unlikely to have any particular information advantage. However, in the iron ore industry, in which Australia dominates seaborne trade, we should at least have a good handle on supply dynamics. Indeed, even without the benefit of hindsight, it was pretty obvious to us that the iron ore and coal markets were going to be significantly oversupplied (see graph below), and the probability of a sharp decline in price was much higher than the probability of steady or higher prices. While we foresaw a potentially large decline in the price of iron ore and coal, we misjudged the impact on the profitability and share prices of Australian resource companies, and were not aggressive enough in reducing our exposure to the sector. We’ve taken some comfort from the fact that most of our peers didn’t catch the move, but we still have regrets nonetheless.

Iron ore price and Australian supply



At the time of writing, the Australian share market is trading about 10% below its recent highs, fuelled by fears of a Greek exit from the Eurozone. The shares of a number of companies that will not in any way be impacted by the goings-on in Greece are being indiscriminately sold with the broader market. They look like an ‘obvious’ buy to us, so that is exactly what we are doing.

In 12 months’ time we will be able to report whether our current buying has turned out to be a good call or a bad call ... with, of course, the benefit of hindsight.