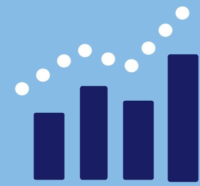
UniSuper

February 2014

# Investment market update



Market disruptions in emerging markets continued to escalate in January. While initially resisting these developments late last year, developed share markets have now also relented and were universally weak last month. Even as one of the better performers, the Australian market was still down 3.0%. This month we take a closer look at the recent modest performance of our Australian Bond option. Following the very solid returns experienced over recent years, it delivered just a 1.22% return in 2013 as interest rates rose.

## PERFORMANCE OF KEY MARKETS

| | % CHANGE | | | | |
|---|---|---|---|---|---|
| | MONTH | FYTD | 1 YEAR | 3 YEARS P.A. | 5 YEARS P.A. |
| Australian Shares (ASX 300) | -3.0 | 10.6 | 10.6 | 7.3 | 12.8 |
| US Shares (S&P 500) | -3.5 | 12.3 | 21.5 | 13.9 | 19.2 |
| Asian Shares (MSCI Asia) | -4.2 | 3.3 | -2.8 | -1.0 | 12.7 |
| Australian Dollar (AUD/USD) | -2.5 | -4.7 | -16.3 | -4.3 | 6.5 |
| Australian Fixed Interest (UBSA Composite) | 1.1 | 2.5 | 3.3 | 7.0 | 5.6 |
| Cash (UBSA Bank Bill) | 0.2 | 1.6 | 2.8 | 3.9 | 4.0 |
| Balanced option* | -1.0 | 8.6 | 13.5 | 8.9 | 9.3 |

Returns are for periods to 31 January 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

## Emerging market concerns escalate

Concerns that have seen emerging share markets on a downward trend over recent months continued to escalate in January. In an environment of abundant liquidity and low interest rates, economic imbalances have built up in a number of emerging economies and becoming exposed as the Fed begun the process of winding back its expansionary monetary policy. Policy makers in a number of countries have now started making the tough decisions necessary to put these economies on a sounder footing with rate hikes delivered in Turkey, Brazil, South Africa and India as well as major currency devaluation in Argentina.

Fuelling the market volatility was some weaker Chinese manufacturing data and speculation that a prominent Chinese investment trust was going to be allowed to default (though this was later averted). Despite initially resisting the emerging market weakness, developed share markets also relented and were universally weak in January. Even as one of the better performers, the Australian market was still down 3.0% last month.

Even though a number of emerging economies will need to undergo significant economic adjustment, the main question for investors is whether these developments merely reflect a short term disruption or whether it will represent a more profound setback for financial markets. Despite emerging economies now representing a large of share of economic activity, at this point we think these re-alignments don't pose a significant risk to broader growth, however we remain sensitive to these risks.

Meanwhile in Australia, economic data highlighted the difficult environment that policy makers are now navigating. With a significant drag from the wind-down of the mining boom still to come, the unemployment rate hit 5.8% in December which is nearly a 12 year high. Despite this weakness, inflation data revealed a pick up in price pressure, which when combined with the strength of in house prices and the strong AUD saw the Reserve Bank of Australia (RBA) signal that further easing is unlikely.

## 2013: A poor year for the Australian Bond option

After providing consistently solid returns through periods of financial market volatility over recent years, our Australian Bond option delivered a more modest outcome in 2013. A 1.22% return represented the lowest annual return across UniSuper's 15 investment options and compares unfavourably to the option's three and five-year performance returns of 5.69% and 4.65% respectively. This month, we look at some of the reasons for that performance and prospects for returns going forward.

### OVERVIEW ON THE AUSTRALIAN BOND OPTION

The Australian Bond option predominantly invests in bonds issued or guaranteed by the Australian Governments (Federal and State) and cash.

Given the strong creditworthiness of these governments, such assets are considered to be 'risk-free'. That is, all scheduled interest payments and the return of principal are expected to be paid on time and in full.

### QUALIFYING THE OPTION'S 'RISK-FREE' STATUS

As mentioned in the May and September 2012 market updates, the debt of various Australian Governments may be as safe as an asset can be in terms of the principal repayment, however that isn't to say that a portfolio of these bonds is 'risk-free'. There are two main risks associated with the Australian Bond option:

**1. Inflation risk:** Though the interest rate and principal on a standard nominal coupon bond is fixed its real (i.e. inflation-adjusted) value isn't. If there's an unexpected bout of inflation, then the purchasing power of the future fixed payments are eroded through time.

**2. Price volatility:** Though a bond's interest rate (or yield) is set if held to maturity, bond prices vary on a daily basis. This is because the bond market constantly reassesses interest rates based on factors that include monetary policy direction, growth, inflation, and borrower credit worthiness. Bond prices have an inverse relationship with interest rates, so lower interest rates mean higher bond prices, and vice versa. This is because a fixed payment in the future is worth less today if the market demands a higher return between now and the payment date.

Consider for example the US 10-year bond which is often considered the ultimate 'risk-free' asset. The holder of a US 10-year bond lost 7.2% over the course of 2013 as bond yields rose from 1.76% to 3.03%—hardly an outcome we would consider 'risk-free'.

Rather than invest in a single bond as above, the Australian Bond option invests in a portfolio of bonds. Each has a different yield, maturity and sensitivity to interest rates.

Nevertheless the same principle applies—the value of the portfolio changes relative to interest rates. At UniSuper, we value the Bond option on a 'mark-to-market' basis so that as members join or leave, they pay or receive a fair market price that doesn't disadvantage other members.

As an aside, the most effective way to avoid large swings in the value of principal invested is to place funds in cash. Our Cash option invests in short term securities and deposits issued and held by Australian banks.

This option doesn't lose value when interest rates change and is a less risky option overall, even though the banks themselves may not be as secure as the Australian Government. Of course, the cost of investing in the (least risky) Cash option is lower expected returns over the medium to long term.

### WHY WERE RETURNS SO POOR IN 2013?

Chart 1: Australian Government Bond benchmark returns

Source: Bloomberg, UniSuper

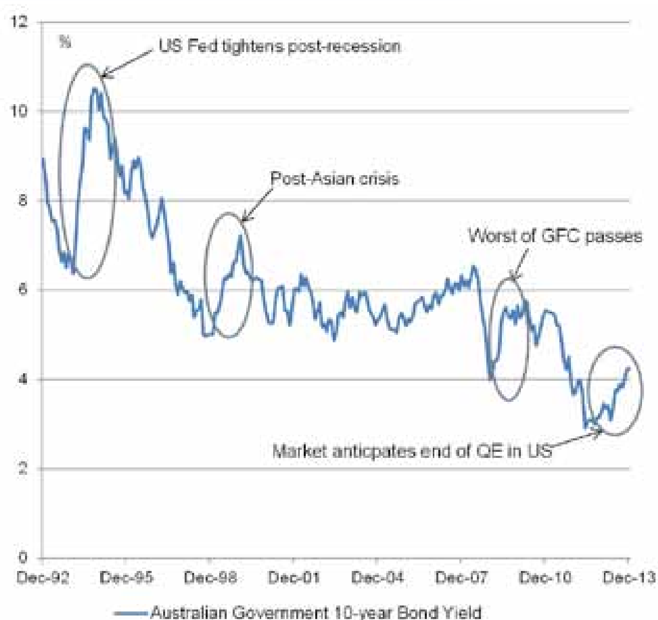
In Chart 1, we show the rolling 12 month returns from a standard benchmark index of Australian Government bonds since 1992. Though returns on the Australian Bond option are reported after taxes and fees relative to this benchmark, it is a reasonable representation of the variability of the returns on a portfolio of bonds that are typically held in the Australian Bond option.

As the chart shows, over short periods returns on this portfolio are far from 'risk-free'.

Though infrequent, there are a few points over the 20-year period where returns over the preceding 12 months were actually negative. These three periods coincide with rapid increases in bond yields, which tend to occur when economies are recovering from downturns. During these periods monetary policy is typically being tightened. (To highlight the strength of this relationship, we've also superimposed the percentage point change in the Australian Government 10-year bond yield onto Chart 1 - note the reverse scale).

In terms of that history, 2013 is unusual but not unprecedented. As Chart 2 shows, last year the 10-year bond yield increased by nearly 1% from a historically low 3.27% to 4.23%. This occurred alongside an even larger move in the US as financial markets anticipated the end of quantitative easing. This weighed heavily on the Bond option last year.

Chart 2: Australian Government Bond Yield




Source: Bloomberg

**WHAT'S THE PROSPECT FOR RETURNS AND THE RISKS GOING FORWARD?**

The return on a single bond over its life is simply its current yield. The average yield across the portfolio of bonds in the Australian Government benchmark is currently around 3.43%. Given that the average bond in the portfolio has a maturity of about five-years, then this yield (less taxes and fees) is a good starting point as the expectation of the average returns over the next five years.

However, as we saw in 2013, one-year returns can be higher or lower than this 'running yield' depending on what happens to interest rates over that time. The Australian 10-year yield ended 2013 at 4.23%. This is still well below the 5.3% average rate that has existed since financial markets became accustomed to low inflation in the late 90s (see Chart 2). While there are good reasons to think that rates could remain lower than that average for some time, investors in the Bond option should at least be aware of the risk that yields may rise.

**WHAT COULD DRIVE YIELDS HIGHER?**

- Global interest rates: There is a strong correlation between long term interest rates in various countries. Should global (and the US in particular) rates continue to move higher as the global economy improves, or if inflation risks emerge, then Australian interest rates would likely move higher also.
- Stronger than expected outcomes for domestic growth, inflation and/or monetary tightening would also likely push rates higher if they were to occur.

**WHAT COULD DRIVE YIELDS LOWER?**

- Yields fall mainly when downside risks emerge. Should the Australian economy weaken further to the point that the unemployment rate rose and the RBA were forced to cut rates, yields would likely fall.
- Meanwhile, the re-emergence of Euro break-up fears or concerns over an impending credit crisis in China head up a long list of potential downside risk factors that could emerge from offshore that may push yields lower.

Even if the Australian Bond option were to deliver below average returns again in 2014, it still may perform well relative to equities in certain environments. For those considering their current allocation, we suggest seeking financial advice to ascertain which investment options best meets your needs.

Past performance is not an indicator of future performance. This information is of a general nature only and may include general advice. It has been prepared without taking into account your individual objectives, financial situation or needs. UniSuper's investment strategies will not necessarily be appropriate for other investors. Before making any decision in relation to your UniSuper membership, you should consider your personal circumstances, the relevant product disclosure statement for your membership category and whether to consult a licensed financial adviser.

This is not intended to be an endorsement of any of the listed securities named above for inclusion in personal portfolios. The above material reflects UniSuper's view at a particular point in time having regard to factors specific to UniSuper and its overall investment objectives and strategies.

This information is current as at 5 February 2014 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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