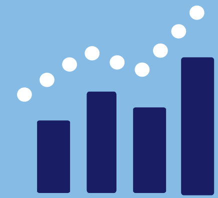
UniSuper

August 2013

Investment market update



UniSuper's Chief Investment Officer John Pearce provides a market update for members.

The 2014 financial year is off to a strong start. Share markets have been rallying around the world, and our Balanced Option recorded a positive gain of 3.1% for the month. While not overly expensive, share markets appear to be fully priced, rendering them particularly vulnerable to any bad news. However, in the absence of bad news, shares may still grind higher as other asset classes do not look cheap either. In this update we take a closer look at bonds: an asset class that still looks expensive despite the recent rise in yields.

PERFORMANCE OF KEY MARKETS*

	% CHANGE				
	MONTH	FYTD	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian Shares (ASX 300)	5.3	5.3	23.2	8.5	4.8
US Shares (S&P 500)	5.1	5.1	25.0	17.7	8.3
Asian Shares (MSCI Asia)	1.7	1.7	6.9	2.2	2.6
Australian Dollar (AUD/USD)	-1.9	-1.9	-14.7	-0.3	-0.9
Australian Fixed Interest (UBSA Composite)	0.9	0.9	3.3	7.0	7.6
Cash (UBSA Bank Bill)	0.3	0.3	3.2	4.3	4.4
Balanced Option (*)	3.1	3.1	17.9	9.0	5.8

* Returns are for periods to 31 July 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.

Bond yields still imply inflation will stay low for a long time

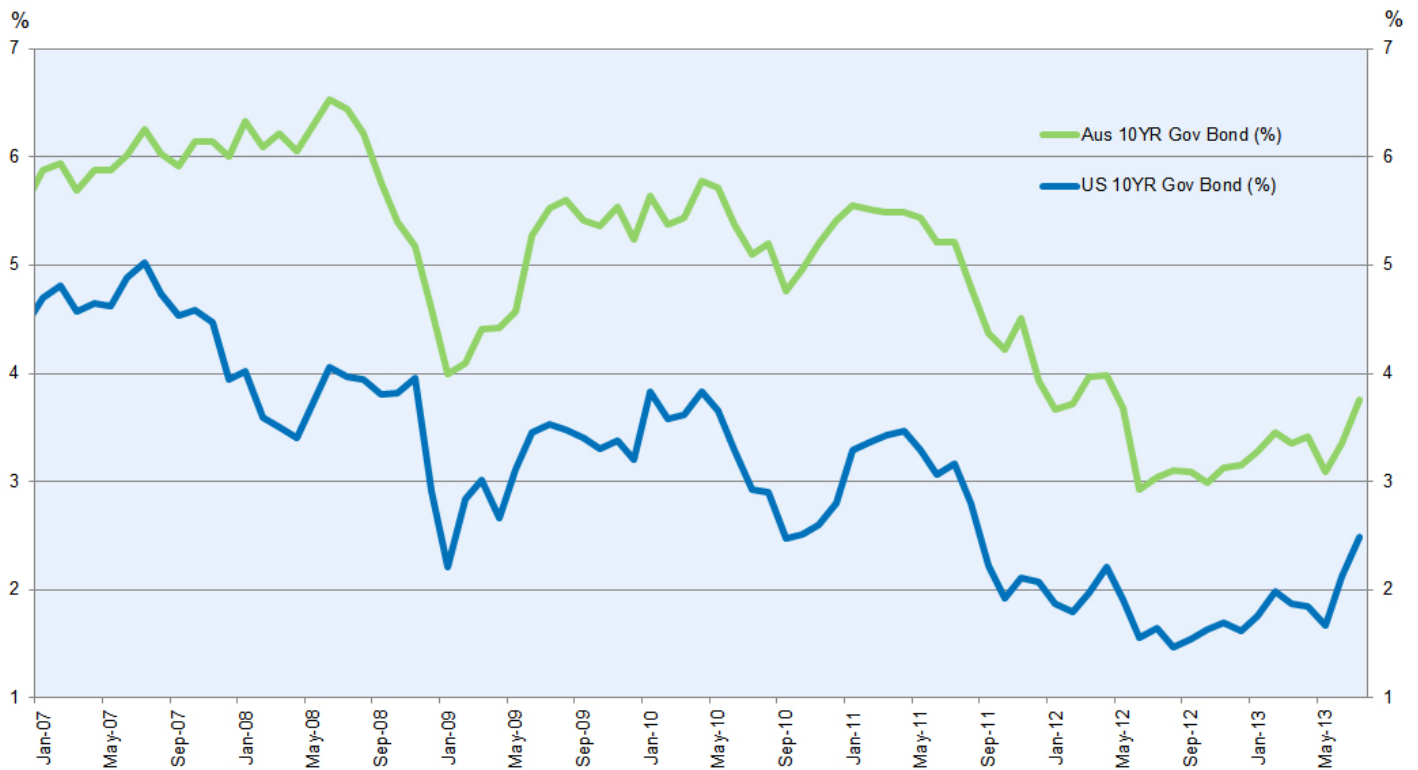
In 'normal' times the main variable investors take into account, when considering the relative attraction of bonds, is the outlook for inflation. Of course the GFC and its aftermath has not been normal, so in recent times the 'flight to safety at any cost' has invariably been the over-riding influence on bond yields, particularly in the US.

Graph 1 (next page) shows just how low yields have traded since the GFC. The situation has been compounded in the US where the Federal Reserve has been engaged in buying bonds outright, otherwise known as quantitative easing.

However Australia has not engaged in quantitative easing, and yields have also declined significantly here. So there must be another force at work. The other force is the reduction in inflationary expectations. That is, investors are prepared to accept low nominal yields, based on expectations that inflation will stay low, and could even get lower.

At the time of writing Australian Government bonds with a 10-year maturity are trading at about 3.50% and inflation is about 2.5%. This equates to a real yield of about 1%, assuming inflation stays at around these levels for the duration of the bond. While we cannot be certain about the trajectory of inflation, we can also invest in inflation-linked bonds that effectively guarantee a real rate of return of just over 1% at current market levels.

GRAPH 1: AUSTRALIAN AND US GOVERNMENT BOND RATES



Source: Bloomberg

Current bond yields (both nominal and inflation-linked) imply that investors are confident inflation will remain subdued—the premise for such expectations is the below-trend outlook for the global economy.

Traditional sources of inflation, such as rising wages and commodity prices, are likely to be kept well under control in an environment of high unemployment, weak demand, and rising supplies of commodities.

Against this argument is the school of thought that loose monetary policies pursued by policymakers around the world will inevitably lead to high inflation. While this argument appears to be theoretically sound, it's not gaining much traction with the bond market. Indeed the 'low inflation' school will point to the deflationary spiral Japan has been in for the past decade or so, despite various attempts at quantitative easing and maintaining ultra-low interest rates.

Inflation-linked bonds (ILBs) versus nominal bonds

Unlike nominal bonds, which (if held to maturity) pay a fixed rate of return, the typical ILB pays a fixed coupon on a principal that is indexed to the inflation rate. That is, the capital value, of the bond is adjusted by the CPI on a quarterly basis.

ILBs sound like a great deal, particularly for those who are convinced that loose monetary policy will ultimately lead to inflation. However like all apparently great deals there are drawbacks.

The bottom line is that a 1% real rate of return equates to nominal return of around 3.50% if inflation stays within the 2–3% band targeted by the Reserve Bank. The actual nominal return earned over the life of the bond will therefore depend on the inflation rate: the higher the rate the higher the return, and vice versa.

Whether or not to invest in ILBs or nominal bonds essentially depends on your outlook for inflation relative to the outlook implied by the market. At UniSuper we have not held any government-backed ILBs for some time. We sold ILBs at a time when we felt the market was being overly concerned about a break-out in inflation, and was placing a high price on ILBs relative to nominal bonds.

However since then ILBs have become cheaper relative to nominal bonds, as the market has become more comfortable with the inflation outlook. Indeed it may get to the point where we think ILBs are great value. But before we consider a large investment in them, we will not only compare them to nominal bonds, we will also compare them to other assets.

ILBs versus other assets

Concerns about an outbreak in inflation would logically result in a preference for ILBs over nominal bonds. However ILBs are not the only asset that provides protection against inflation. Many market practitioners and academics will point to the inflation protecting characteristics of such asset classes such as commodities, precious metals, property and equities.

We do not directly invest in commodities or precious metals as we consider them to be more akin to instruments of speculation, rather than assets that we can fundamentally value. We believe that certain property sectors (for example high quality retail or office property with low leverage) exhibit excellent inflation-protecting characteristics over time. This is why these assets receive a high weighting across our portfolios.

While equities as an asset class have certainly outperformed inflation over long periods, it would be a mistake to simply compare the total asset class to inflation outcomes, because this relationship is very unstable over short and medium terms.

TRANSURBAN: ONE OF OUR MAJOR HOLDINGS

There are, however, certain companies that can be expected to grow their earnings by (at the least) the level of inflation. Transurban is one of those companies, which is why we have chosen it as one of our major investments.

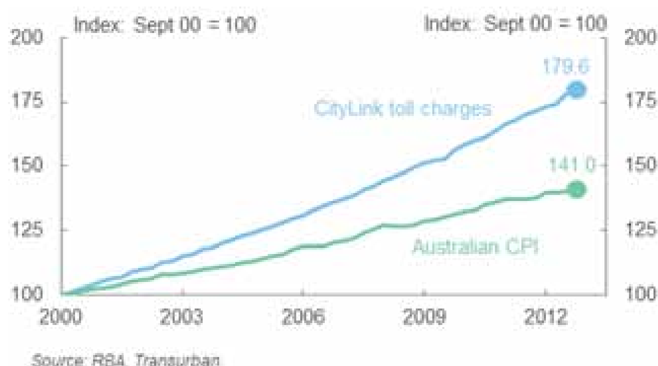
As many of you may know. UniSuper is a major shareholder of Transurban, an ASX-listed company that owns the concessions to operate arguably the best toll roads in Australia (see last April's Investment update).Although

We are very confident that Transurban is an inflation-protecting asset that will perform well in an environment of elevated inflation. This is not only due to the prime location of the toll roads, but also because of the specific conditions of its concessions.

To demonstrate this point, consider CityLink, the road that takes you from Melbourne's airport to the CBD (without a competing rail line). CityLink constitutes 50% of Transurban's asset base.

Under the conditions of the CityLink concession, Transurban is permitted to escalate tolls quarterly by the greater of CPI or 1.1065% (being 4.5% p.a. as a quarterly compound rate) for the first 15 years, then quarterly by CPI. This is subject to a cap of annual CPI plus 2.5%. Graph 2 (below) shows the actual experience over the past 13 years. While inflation has increased by approximately 2.75% p.a. over that time, tolls have increased by about 4.5%. If we assume that traffic will grow broadly in line with population growth, total revenues will rise by more than the toll increase. If someone knows of a better inflation hedging asset we'd be very interested to hear about it.

GRAPH 2: CITILINK TOLLS VS INFLATION



Not only are we confident in Transurban's performance during times of high inflation, but if inflation remains moderate (which is our base case), we also expect Transurban to outperform bonds. This is because the dividend yield is already well in-excess of competing bond yields. We concede though that if there's a breakout of stagflation (high unemployment and inflation), Transurban will underperform ILBs. Having said that though, we don't attribute a high probability to a stagflation scenario.

Although we're satisfied Transurban is compatible with the broader investment strategies and risk objectives of our diversified holdings, different investors have different priorities and needs. So we are not suggesting Transurban would necessarily be suitable for others to include in their portfolios.

Of course the above analysis is based on Transurban's current business mix, and (most importantly) relative valuation. Some time in future bond yields may rise, and/or Transurban's yield may fall to the point where the former becomes more attractive. We think that's still some time away, but things can change quickly in investment markets so we are constantly reassessing the relative merits of competing assets.

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 information is current as at 6 August 2013.

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This information is current as at August 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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