Five questions for the Chief Investment Officer

Video transcript

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Michelle: Hello. I'm Michelle Jones, and I'm here today with John Pearce, our Chief Investment Officer, and this is our monthly investment update. Now John, looking at the latest investment update, you talk about the Australian banks being the 'next big short'. Now, what's actually meant by that expression?

John: Hi, Michelle. Well, firstly for those people who'd like an entertaining expose on the GFC and eventually the GFC, they should watch the movie "The Big Short." It's not a bad movie.

Now, 'short' in "The Big Short" refers to short selling. And short selling literally means selling something you don't own. Now, to the average person, that actually sounds quite bizarre. But in the share market, you can actually do this. And I might describe it by using an example. Last August, ANZ shares were trading at about $30. Now, an American hedge fund manager who thinks the ANZ share price is falling but doesn't own any ANZ shares will sell those ANZ shares at $30, and indeed, they did this. Simultaneously, they'll borrow ANZ shares from an Australian superannuation fund, for example. Now, today ANZ shares are trading at around $24. So that same hedge fund manager could buy back those shares, repay them to the Australian lender, and make $6, less obviously transaction costs, which are usually minimal. So that's what we refer to as short selling.

Currently, about $7 billion of Australia bank shares have been short sold, that's up to GFC top high. So it gives you an indication as to exactly how pessimistic, particularly the offshore investors are on our banks, and the reasons why our bank share prices have been so weak.

Michelle: Okay. So the market seems to be quite pessimistic about our banks, which I find surprising considering well, how solid they've been particularly and even over through the GFC. So why the pessimism?

John: Look, there's general pessimism on all banks around the world. And you might recall last time we met, we talked about the commodity crash and the impact of falling commodity prices on bank loan books. Australian banks have been also targeted for reasons specific to Australia.

I have a couple of graphs for you here which I think captures the sentiment pretty well. On the left-hand side, we have Australian house prices to income. And the graph is saying that in December '86, and we go back to that date because that was really when the banks started to deregulate and many economists will say that's what started this whole debt bubble.

On average, our house prices to our income levels is about 2.5 times. These days, it's over 5 times. So you can see that that's quite an increase. If you look at the right-hand side, this tracks Australian household debt, so the debt you have, your mortgage for example, to your annual income. In one

scale we see quite a large rise here. It's now around 180%. Another way of looking at this graph is, it would take you about two years on average to repay your debt if you use all your income. So if you look at this, we've got a combination of inflated house prices, high debt. Historically, this is a toxic combination, and it doesn't end well.

Michelle: Yeah, those graphs do look concerning. Should our members be worried?

John: Well, first thing, Michelle, let's bear in mind that our banks are very, very strong. And relative to other banks in the world, they literally sailed through the GFC. Sure, dividends were cut, but they certainly weren't slashed. So you can take some comfort from that.

However, if property prices do crash, our banks are not immune. They will be adversely impacted, and of course, UniSuper won't be immune from that.

Let's get back to the main two risks that I mentioned before. I want to show another two graphs which paint a completely different picture. On the left-hand side, we have household debt as a percentage of your assets. So if you think about your mortgage, then you think about the value of your house plus any other assets you have. It turns out that the value of our assets are somewhere between four and five times the value of our debt. Hardly a concern, right?

Michelle: Yeah

John: You look at the right-hand side, you've got the debt servicing levels. So what do we mean by that? On average, how much of your annual income is being used to repay interest? Once again, it's 7%. Hardly anything to worry about, right? So sure debt has risen, so have house prices and other assets. As debt has risen, interest rates have fallen. So the ability to service that debt has increased. I take a lot of comfort from these graphs. If you think about inner-city apartments, I'm sure they're going to be falling. We've already seen them. But these graphs tell me that the chances of a systemic crash across house prices is pretty low.

It really does come back to employment. If we can keep creating jobs, if the unemployment rate can hover around these levels and not explode up to around the 10% mark, I think we'll be absolutely fine. As a matter of fact, this morning the latest unemployment statistics were released. We created 24,000 jobs last month, and the unemployment rate has actually fallen to 5.7%. So that's certainly positive news for our banks.

Michelle: Now, John, just moving on, I understand you've recently spent some time in Asia. So how are you feeling about the region? More positive or negative in terms of the region?

John: A bit of a mixed bag actually, Michelle. The region is dominated by China, so it makes sense for us to focus a lot of our time on China. In the first quarter, there was clearly a bounce-back in Chinese activity. And I guess that is good news. So to me, there's no signs at all of a Chinese crash.

Now, the bad is...well, the not so good news, I guess, is that it seems to be growth that's, once again, fuelled by the old formula of increasing debt levels used for investment expenditure. So you've got China really still is not going through that process of reform where you've got inefficient businesses closed down, more privatization of assets, etc. And having an unbalanced economy that really is all investment-led, it's not consumption-led and is fuelled by debt, it's really not a sustainable picture.

So my fear of China is not so much a crash; it's more that we'll get to growth levels of around 3%. Not bad for the second largest economy in the world, but we'll get to those levels much sooner than people expect. So I would say that would be my main concern.

Now, on a much brighter note is India. And if you do want to feel positive in a generally negative world, I suggest that you take a trip to India. The three major negatives that are afflicting most developed countries around the world and even countries like China is one, demographics, two, deflation and three, deleveraging. Everyone is just deleveraging, particularly in the developed world.

In India you've got those three big factors actually working in reverse. India has got a fantastic demographic story. About 50% of its population is under the age of 26. So it's got a young, vibrant

population. Deleveraging is actually companies are in good shape, so they're able to lever up, and deflation is not an issue.

Michelle: All right. Thank you. And one final question. We're in April, less than a quarter to go in terms of the end of financial year. How are our investment returns looking?

John: One final table. So here we have a table showing just a selection of options, and it's going in various terms. Now, we don't like focusing on the short term, but nine months to the end of March, which is this financial year. I think there are some interesting numbers here. The first one, the Balanced option and the Balanced option obviously is our largest key option. It's our default option for our key members. And we've heard a lot of negative news. We've heard about share market volatility and bank prices and resource prices falling. But the Balanced option is up 1.6% for nine months. So I think that's not too bad particularly given how strong the five-year numbers and three-year numbers have been.

The worst performing option over the last nine months has been the Global Environmental Opportunities option. That doesn't come as a big surprise to me, because if you look at the three-year numbers, very strong. So it's not unsurprising that you have a correction in those returns. What has surprised me, I must say, is the ongoing strong performance of the Listed Property option. If you look at the three-year numbers, the five-year numbers, 14% for five years, I would expect that we'd have a correction by now. But it still powers along, and for the nine months of this year, indeed close to 12% returns. So look, overall, I'm pretty happy with the way things have gone, but the usual caveat applies. We can't predict the future, and historical returns are no predictor.

Michelle: Thank you, John. That's been very insightful. Now, if you do have any questions, you can email us at **{** HYPERLINK "mailto:superinformed@unisuper.com.au" **}**. Thank you for your time today.