Five questions for the Chief Investment Officer—June 2018

Video transcript

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Melinda McMullan (MM): Welcome to *Five questions for the CIO*. I'm Melinda McMullan, one of UniSuper's Private Client Advisers, and I'm with John Pearce, our Chief Investment Officer.

John, we're increasingly being told that the bull market for shares is late in the cycle. What is your view?

John Pearce (JP): Let's talk about what you mean by late in the cycle. A bull market in shares is usually brought to a halt by central banks raising interest rates, and that's usually done to prevent an overheating economy. The share market anticipates slowing economic growth, lower profits, and share prices fall. And indeed, as the economy slows, central banks then want to guard against a deep recession, so they start easing financial conditions by lowering rates and then you have the opposite—share markets anticipate higher economic growth, higher profits, and rise. Then, of course, the cycle continues.

When you say late cycle, what we're really referring to is the US situation. The US has pretty much been in a bull market for nine years. Its economy is at full employment and we see now the central bank in the US, the Federal Reserve, tightening interest rates.

We can say that the US is at the 12 o'clock position. If you look at that cycle, you're thinking, 'maybe it's time to really get out of US shares'.

It's not really that simple. What we see quite often is the largest rallies taking place in the late stages of a bull market. That's particularly the case when you still have low interest rates, as we do have, and when valuations aren't extremely overvalued. That's what we believe to be the case. So, while we're cautious on the US and we're taking a bit of profit, we're certainly pretty comfortable.

MM: So where do you see Australia in the cycle?

JP: If I'm depicting the US at 12 o'clock, I think Australia may be at around a quarter to 12. I think that's a similar situation with Europe and Japan, etc., and other developed countries. The US is a bit of an outlier.

You think of Australia's situation, we have a balance between positives and negatives. On the positive side, economic growth is pretty robust, around 3.1% at the moment. We're still creating jobs—although with unemployment at 5.4%, it's still got a little bit of fat in it. Mining investment is really picking up. We've had mining investment fall off a cliff and then flatten out, and now we're actually seeing a pick-up in mining investment. That's fantastic, particularly for the more depressed areas of Australia, such as Western Australia.

On the negative side, it's all about households and house prices. We've seen a dramatic reduction in investment from foreigners, particularly the Chinese, in new dwellings; we've seen a fall-off in the construction of new dwellings; we've seen a decline in housing loan approvals and credit flowing throughout the economy. Banks have been restricted by the regulator—in terms of investment loans in particular—and then we have, of course, the repercussions of the Royal Commission. On top of that, we have, by some accounts, the most indebted household sector in the world. So you add all this together and you see a nation-wide fall in house prices. These are the numbers since their recent peaks, and you see Sydney, a 7% decline. That's adding fuel to the argument of the pessimists that we are on the edge of some sort of perfect storm.

But I think some perspective is warranted here.

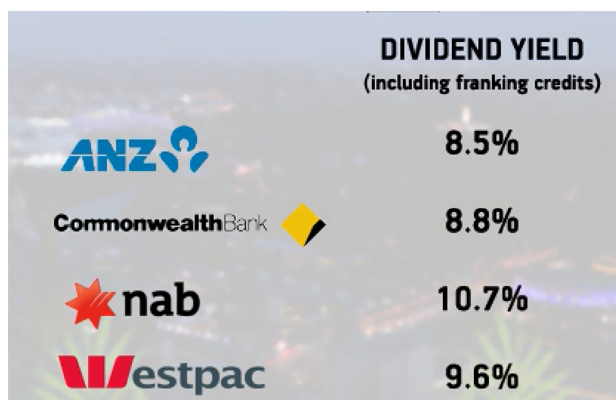
Sure, we are seeing a fall in house prices, but we saw an explosion in house prices, particularly in places like Sydney and Melbourne—Sydney itself up around 60% over the last five years—so it's understandable you had to have a correction. It was inevitable. Housing loan growth—sure, it is falling, but once again, off very high levels. The growth we're seeing now, even though it's lower than it was a year ago, it's well above the levels we saw four and five years ago.

This is a very healthy sort of correction or slowdown that we really needed to have, and the regulators, I'm sure, are feeling exactly the same way. They'd be delighted at what they're seeing.

MM: And so what are the investment implications?

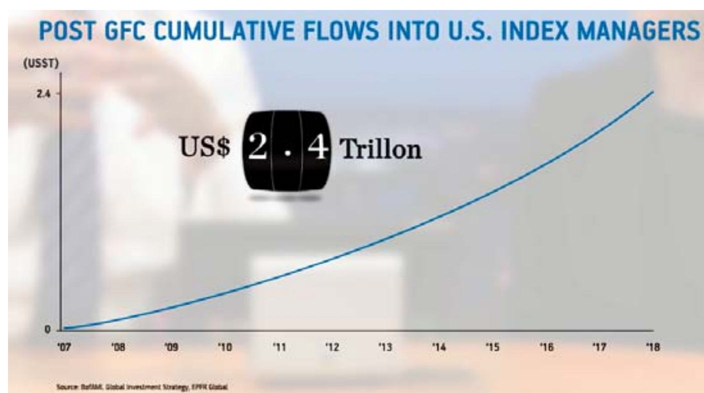
JP: For Australia, my belief is that rates are on hold for a very long time. I just can't see us having the conditions for the Reserve Bank to tighten rates, and I wouldn't even think that a rate cut is out of the question, although that's certainly not the base case. From a big picture point of view, the share market I think will continue to look attractive relative to other assets—in particular, bonds. Getting down to a stock level—and this is a somewhat contrarian view—but our banks might even be good value. We know that the Royal Commission, there's an overhang there; we know that house prices are falling; and we know that there are low growth prospects. But this is reflected in the share prices of banks now. There is a fair bit of bad news there.

If you look at the dividend yields on the four major banks—these are pretty healthy yields, and usually these sort of yields are only achievable when you've got strong expectations of a recession, and that's certainly not our base case. So if indeed we can avoid a recession, I think we'll find that these are attractive valuations.



MM: So a change of subject now. We do get a lot of queries from our members about our approach to index strategies. What is UniSuper's position?

JP: Let's quickly define an index strategy or index fund. It's simply a fund that is structured to replicate the performance of a specified index. For example, if you are investing in Australian Shares indexed fund, that fund would be expected to perform similar to the ASX 300. We've seen an explosion of growth in index strategies, particularly since the GFC. If you look at the US market—and the US tends to lead all these big trends—we've had no less than $2.4 trillion allocated to index funds. So that's out of ‘active’ and into ‘index’ funds.



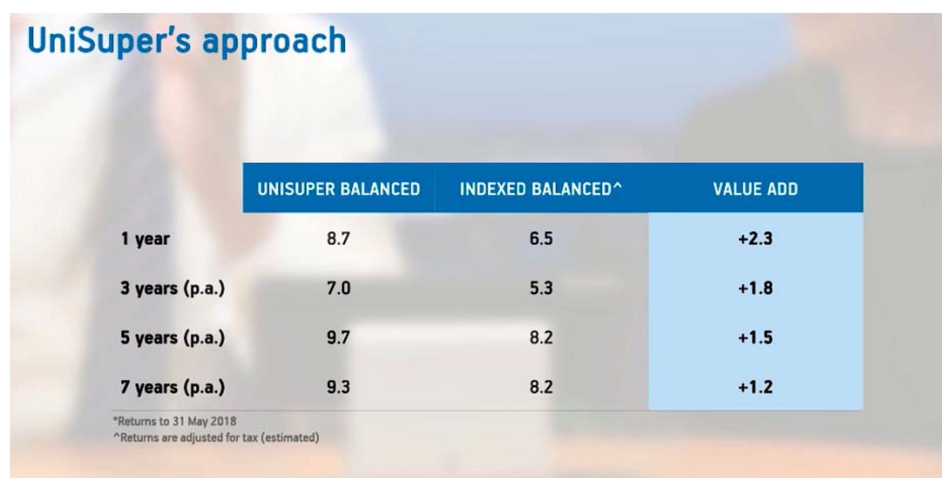
That's enormous, and there's a couple of very compelling reasons. Firstly, they are cheap. The second reason is that there's quite a lot of disaffection with the returns that many people are getting from active managers for the fees that they are paying. So we can see what is underpinning this massive trend.

In terms of UniSuper's philosophy, we are first and foremost an active house. We actively manage our portfolios. However, we do employ quite a few index strategies within our diversified investment options. For example, in our Balanced option at the moment, we have index strategies covering various countries and regions such as the US, Europe and Australia. We've also got strategies that cover sectors, such as US banks, US technology, US healthcare.

There are two main reasons that we use index strategies. The first one is that it can be a holding pattern—so, we're looking for an active manager, and an index strategy gives us quick exposure to a country or a sector in anticipation of allocating to an active manager. And the other is for tactical purposes—an index strategy is a really cost efficient way of tactically allocating into and out of a country or a sector.

MM: Would UniSuper consider index options on our product platforms?

JP: Well, you never say never, but we always have to balance increasing the options that we have on our platform with the costs involved. Then there's the question of whether we would actually consider replacing some of our active options within index options. And that will pretty much come down to members' best interests. I'm really pleased to say that we've got some runs on the board. Our active strategies have added value. If you look at the performance of our Balanced investment option relative to the performance of a balanced index option provided by a world-leading index provider that I won't name, to keep the lawyers happy—you can see that we've managed to add value over every period.



We've been able to use our size, our access to liquidity, our in-house management, our long term horizon, all these things have added to that outperformance.

If you go to the single sector options, two of our more popular ones—International Shares and Australian Shares—and you compare the performance relative to the market indices that they're benchmarked against, once again, across all periods we're seeing value being added.

UniSuper's approach

% P.A.	UNISUPER INTERNATIONAL SHARES	MARKET INDEX^	VALUE ADD
1 year	12.4	8.6	+3.8
3 years	9.4	7.1	+2.3
5 years	14.3	13.0	+1.3
7 years	13.0	12.4	+0.5

*Returns to 31 May 2018
^ MSCI World
Returns are adjusted for tax (estimated)

% P.A.	UNISUPER AUSTRALIAN SHARES	MARKET INDEX^	VALUE ADD
1 year	16.5	9.1	+7.4
3 years	6.9	5.6	+1.3
5 years	9.4	8.0	+1.4
7 years	8.9	7.5	+1.4

*Returns to 31 May 2018
^ASX 300
Returns are adjusted for tax (estimated)

Of course, past performance is not an indicator of future performance, but so far so good, and I like to think that we can continue with that outperformance in future.

MM: Thank you for your time, John. If you have any questions for John, or feedback for us, please email us at **superinformed@unisuper.com.au**. Thank you for watching.

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