Five questions for the Chief Investment Officer—January 2017

Video transcript

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Angelina Wu (AW): Welcome to our latest edition of *Five questions for the CIO*. My name is Angelina Wu, one of UniSuper's Private Client Advisers. I'm with our Chief Investment Officer, John Pearce.

Hi, John. In the previous video, you mentioned that you were surprised at the speed the market has rebounded following Donald Trump's election. Are you surprised the strength has continued into 2017?

John Pearce (JP): Pleasantly surprised, Angelina. Markets both in the US and Australia are up about 12%, and there's basically been two main drivers. One is hope. Hope is not usually a great strategy and the hope is based on Trump enacting the spending initiatives, cuts in taxation, cuts to regulation, that are supposed to spur on US economic growth. These hopes may prove to be misplaced. Let's see.

On a more fundamental basis though, we do seem to be entering into a cyclical upswing in the business cycle, and we've seen that most remarkably and quickly in the commodity cycle. And you're now seeing economists revising upwards their expectations on economic growth. And if those expectations are realised, the share market could be on a much firmer footing.

Donald Trump, in that instance, could find himself to be in the right place at the right time.

AW: While the broader market has been performing pretty well, it hasn't been all plain sailing for some of our big investments in infrastructure, in property. Can you elaborate on the reasons why?

JP: Well, have a look at this slide here, I think it captures the answer to your question. I've used here the listed infrastructure market—I could have just as easily used the property market. The green line shows the returns of listed infrastructure, the blue line shows movement in bond yields. And we see over the last year, they pretty much move in lockstep.

So the infrastructure, the fall in prices has really been a result of the hike in bond yields. Now, why the strong correlation? Well, these sectors typically have very persistent dividends. And because they are

persistent, they're almost treated like bond coupons. In fact, you hear people talk about these as bond proxies. Now, I really don't like that label at all. I think it's misleading and potentially dangerous. But you have to concede, because of the persistency of the dividends, they tend to be a lot more rate sensitive than other sectors.

AW: Our pre-mixed options, especially the defensive options—such as Capital Stable—have a higher weighting toward the asset classes you just mentioned, which has shown in the volatility in the recent returns. Are you considering a change to these strategies, given the environment we find ourselves in?

JP: You know, you're not the first one to ask me that question. So let me acknowledge firstly that we have seen volatility. Here's the returns over the last six months for the Capital Stable option. And four negative months, you'd have to say that that would be uncomfortably volatile for some of our members in this option. But I do urge, we always urge our members to look at the long term. And over the long term, they're the five-year annual returns, averaging over 7%, that's an excellent return in relation to our target return, which for most of that period was CPI plus 2%. It's also an excellent return relative to our peers that run similar sorts of options. In fact, this is a top quartile performer.

But back to the question of a change strategy. The short answer is no, we're not looking at a change in strategy, because the underlying fundamentals of the companies just haven't changed. I'll use an infrastructure example. Transurban, it's the toll road that is well-known to most of our members, particularly on the eastern seaboard. Here's a profile of Transurban's earnings—dark blue showing earnings, light blue showing potential earnings going forward. Now, if interest rates rise in response to a stronger economy, those earnings are actually going to rise even faster than that.

Now what we see here is that Transurban basically has not missed a beat, since we started acquiring. The red line is Transurban's share price, and you see, by and large over that period, the rise in share price has followed the rise in earnings. And this is what you'd expect in an efficient market. Having said that, it did become extended. You see the disconnect there with the share price, so it was really a correction that was somewhat inevitable.

Now, I could have shown you a graph for APA or Sydney Airport or our REIT stocks, and you'll see similar patterns in those graphs.

AW: It's interesting you mentioned Transurban, as their share price, I've noticed, has extended. And if I remember it correctly, you mentioned something very similar to the listed property markets as well. Do we think of selling the profit at some stage?

JP: Well, in hindsight, that would seem to have been a smart move. But look, there are some pretty compelling reasons why we tend to hold these types of stocks, even when they appear to be a bit expensive.

First thing, we have to remember that UniSuper is a large fund. We are in a strong inflow position, so we're constantly on the lookout for quality companies at a reasonable price. Playing the timing game is particularly hazardous for any fund, let alone a fund of our size. So we really do stick to the mantra that investing is for the long term. So you're better off thinking of UniSuper as a disciplined buyer, rather than an opportunistic seller.

And on that score, I'm very pleased to say that all those stocks that we own in the listed infrastructure and the property space have been acquired at prices well below current market levels. Nevertheless, there are times when we will aggressively sell our holdings. It is usually in response to a change in a

company's fundamentals, a change in strategy, a change in management that we don't like, and we have done that in the past. On occasion, there'd also be compelling offers in the market. And I'm pleased to say there's one right at the moment.

CKI, which is a Hong Kong-based company, has made a takeover offer for Duet, which is the Australian company that we happen to be the largest shareholder in. Duet owns various infrastructure assets, and we started acquiring Duet about 18 months ago, at around $2. Since then, we've received 37 cents in dividends. The takeover offer is for $3.03, so if indeed this deal goes through, it will be a great result for our members.

AW: Are you as optimistic about 2017, and in particular, the Trump effect, as the market appears to be?

JP: Well, if you were nervous about Trump before he got elected, I don't think you'd be any less nervous now. He does seem to overreact to even the most trivial of things, and there's an issue of inconsistency in some of his comments. For example, he's very critical of the Fed for keeping interest rates too low. On the other hand, he's complaining about the currency, the US dollar being too high. I think one of his advisers should pull him aside and say, “Sorry, Mr. President, but engineering higher interest rates and a lower currency is pretty tricky and might be too hard to pull off.”

But as I've previously said, we do appear to be in a business cycle upswing. And so regardless of policy, there are grounds for optimism. Then there comes the question of how much of that optimism is currently priced? Bear in mind, when Obama was inaugurated, the Dow Jones was trading at around 8,000. We’re now at Trump's inauguration, the Dow is flirting with 20,000. That's a 150% rally. So the market’s pricing in some pretty good news, and when the market is in that sort of point, it's not that difficult to derail.

So in terms of 2017, I wouldn't be at all surprised to see 5%, 10% corrections, but also wouldn't be too concerned. Because that will give us an opportunity to buy quality assets at a reasonable price.

AW: Thank you, John. If you have any feedback for us, please send us an email to **superinformed@unisuper.com.au**. Thanks for watching. See you next time.

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