Five questions for the Chief Investment Officer—March 2017

Video transcript

Disclaimer: This webcast discusses UniSuper's investment performance and recent investment decisions designed to suit UniSuper, which may not be appropriate for you personally. We're not suggesting you should make the same decisions.

Consider your situation and read the relevant Product Disclosure statement before making personal decisions about your investments or UniSuper membership. Past performance is not an indicator of future performance.

Danielle Clarke (DC): Welcome to Five Questions with the CIO. I'm Danielle Clarke, UniSuper's Communications Manager, and I'm here with our Chief Investment Officer, John Pearce.

John, it's hard to believe that it's been eight years now since the GFC. After those lows, we're now seeing record highs in some share markets around the world. Do you think we're in a bubble that's likely to pop anytime soon?

John Pearce (JP): Let's see if history can give us any guide, Danielle. We'll look at the US market because it's the one with the longest history, and it's the largest market and other markets tend to follow it. On the graph we have in front of us here, going back to 1926, here are all the bull markets in the US, and you can see the average duration is about nine years. The average total return of a bull market is about 500%. This one is just below eight years, and it's just below 250%. So if history is any guide, it still might have some legs, but of course, you know—history doesn't repeat, it only rhymes. Bull markets, they don't die of old age but they do peter out if valuations get stretched.

What we're seeing in the current market is prices are extended. That means that they are factoring in some pretty optimistic scenarios in terms of profit growth—and somewhat justifiably so, because economic growth is better than it has been. But if the growth in corporate profits don't meet those lofty expectations, we could be in for a correction—and it wouldn't surprise me at all to see a healthy correction of around 10% or so. But that's a big difference from saying we're in a bubble that is likely to crash. For that to happen, you do need extreme valuations, you do need excess leverage, and I don't see any evidence of that right now.

DC: If you're anticipating some kind of correction sometime soon, is it a good time for our members to be considering bonds?

JP: Well, let's be clear. I'm not making any predictions. And indeed, if we do get a correction, we're likely to be accumulators of stock at better prices. Getting back to your bond question—now we all know that bonds also have risk. Our [Australian] Bond option at UniSuper in the last 12 months has

recorded five months where we've had negative returns. And some members are justifiably ringing up and querying that—we've got an option that only invests in government bonds, how can an option such as that record a negative return?

Well, if you think of a government bond, you're buying a 10-year government bond at the moment say at around 3%. You will indeed earn 3% per annum over 10 years. However, between today and the maturity of that bond, the capital value is going to fluctuate. Now I don't want to get overly technical here, but let me try and really simplify it. Think about in terms of resale value. If you buy a bond at 3%, then 6 months later the market's offering yields of 4%, the resale value of your bond will decline. Think about—it's just like any asset.

Of course, while the capital fluctuates in a bond, you're still receiving interest. And that interest does provide some cushion for the volatility. However, today when interest rates are 3%, that cushion is not very large. So, if indeed you are a bit nervous about the market, our preference at the moment would be cash rather than bonds. But of course that's for UniSuper, that's not for individuals—everyone's circumstances are different and they should seek financial advice.

DC: We often receive calls from members about index funds, can you tell us how these work? And what's UniSuper's approach to indexing?

JP: An index fund or a tracker fund or a passive fund—it's really a fund that is structured to replicate the performance of an index. So, an index fund on Australian Equities would perform in line with say the ASX 200. There's been a phenomenal growth in index funds, so it's not surprising that some of our members are also calling. Once again, if we look at the US market, here is the growth of these funds since the GFC. We've seen over $1.5 trillion allocated to index funds. In terms of actively managed funds, they've actually had net outflows. Why is this? Well—cost. Index funds are a low-cost option and cost is a big issue when performance is not there. And what we're seeing here is a reaction to some disappointment with performance while being charged a high cost for active management.

What's UniSuper's position? We've got three broad strategies within our various options. Firstly, we do employ index strategies across all of our diversified options. Secondly, we allocate money to active external managers that we believe are going to add value over and above the index, and by and large, that has worked. And the third element is, over 50% of our money is actually managed in-house. That gives us a massive cost advantage. The combination of those three factors has enabled us to deliver returns in excess of indexes, and at the same time being extremely competitive on cost. As an aside, too, I should mention that active management also gives us the ability to take account of Environmental, Social, and Governance (ESG) considerations when we invest.

DC: John, about six months ago I remember you mentioning rising house prices as something that you were concerned about, or a potential risk. How are you feeling about them now?

JP: More concerned. Since we spoke then, Sydney house prices are up around 9%. And if you look at look at this graph, it really tells a story. It is a Sydney and Melbourne phenomenon, and as a matter of fact, you look at the blue line there that's showing the prices of all the other states—members in those states could be forgiven for questioning what all the fuss is all about. Escalation in prices such as this—unless you are one of the minority that own investment property—is not a very healthy development. And as the saying goes, if something can't go on forever, it will stop, and stop this will. The question is, how?

The best-case scenario is that we see a plateauing of house prices, tracking sideways, and that's pretty much what happened in Sydney and Melbourne for the better part of the last decade. The worst-case outcome of course is a potential crash. And I said before, you need excess leverage, you need extreme evaluations, and there are certain pockets in those markets where we are seeing that. A lot will depend on unemployment and the economy. If unemployment can stay around current levels and we can get steady economic growth, to me, we're likely to avert a crash.

DC: But won’t the Reserve Bank just be forced into a position of raising interest rates to cool the economy and slow things down?

JP: Well, it's clear that the Reserve Bank is quite concerned about this rise in house prices and the increase in household debt. But it's not clear that a hike in rates is going to dampen demand. And bear in mind, too, that rate rises do have negative consequences. We have an economy that's trading at trend at best. A hike in rates also increases pressure on the Australian dollar. We have to look at what's driving this spectacular rise in prices? Well, foreign demand is a big element to this. You know, we've had apartment blocks, stories of apartment blocks where over 50% are going to foreigners. Now you can say, well, that's new apartment dwellings—but that clearly has a knock-on impact to the rest of the market.

Sydney and Melbourne has now become part of the global market, and the marginal buyer is the foreigner. And it's not clear to me that a hike in rates is going to dampen demand from foreigners. So what are we left with? Well, I think the Reserve Bank will continue to jawbone the market, I think they'll continue to point out the risks of excess borrowing. And I think they will very heavily on APRA to formally restrict the banks’ lending activities. Of course, our politicians could also have a look at this and we could seek policy changes in capital gains tax or negative gearing, but we have to be realistic there. When it comes to policy that potentially impacts—adversely impacts—house prices, our politicians aren't known for their bravery.

DC: Thanks John. If you have any questions for John or feedback for us, please email us at **superinformed@unisuper.com.au**. And remember, if you're seeking a change to your investment strategy, please remember to speak with a qualified financial advisor. Thanks for watching.

Disclaimer: Information on this web channel, including accessible video content, is provided by UniSuper Management Pty Ltd. Trustee: UniSuper Limited (ABN 54 006 027 121, AFSL No. 492806). Fund: UniSuper (ABN 91 385 943 850) Administrator: UniSuper Management Pty Ltd (ABN 91 006 961 799, AFSL No. 235907).