Five questions for the Chief Investment Officer—October 2016

Video transcript

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

John, last week you presented to more than 1,000 of our pension members. A big issue on member's minds was the 3% drop in our Listed Property option. That's our worst-performing option now for the quarter. Can you share some of your insights as to why Listed Property had such a large fall, especially since the broader market seems to be doing quite well?

John Pearce (JP): Indeed, Danielle. The Listed Property option is down about 3% for September. It's down about 2% for the quarter. So for those members who have recently joined the option, obviously they'd be disappointed. But I think we have to look at the returns in a long-term context. And on that front, have a look at this slide. That's an incredible performance—over five years, a compound annual return of over 15%.

If you invested in this option five years ago, you'd have doubled your money. So in a sense, it was due for a correction. And it was almost defying gravity, to be quite frank. And it's not the only correction we've had. As the graph shows, we've had previous corrections—they're typically in response to a fear of rising rates. Property is seen as a bit of a bond proxy—bond rates rise, property tends to fall.

Now let me reflect once more on the members who might have recently joined. I want to show you a slide on switching activity. Positive blue bars represent switches into the option and the negative bars represent switches out, and the orange line represents the quarterly rolling returns over the last two years. Once again, you can see a familiar pattern. Members switch in, tend to chase high returns, and then they get pessimistic at the bottom after some losses are sustained, and once again the pattern continues. And that's happened over the last quarter or so.

I think there are a couple of lessons once again here. Investing is for the long term, and frequent switching to chase hot returns can destroy value.

DC: So from what we're seeing, it looks like this month might bring more of the same. When do you expect it will stabilise and what needs to happen for that to occur?

JP: Well, the value in the market is actually coming back. If you look at a company like Scentre—Scentre owns all the Westfield Shopping Centres, which I'm sure most people will be very familiar with—at its highest, that was trading on a dividend yield of around 4%. That's now trading on a dividend yield of around 5%. So if you compare that to bond yields, that's looking pretty attractive.

Now, speaking of bond yields, you might recall this slide that we presented at the last session that we had. It shows that the dividend yields from the property market—the listed property market—is about 2.5% above bond yields. Now that's a pretty healthy margin when you take into account [the fact that] you're also expecting capital growth from property.

Since we last met, the situation has actually improved. We now have dividend yields about 2.7% above bond yields. So I'd imagine we'll find some sort of support of these levels, and in fact we are buying ourselves, after not getting involved in the market for some time. But of course, over the short term, markets always overreact, so we can't rule out further weakness.

DC: John, during last week's In Retirement seminars, you spoke about some of the short-term risks you're seeing, one them being the oversupply in the apartment market. Can you tell us a little bit more about this?

JP: Well for those people living in Melbourne, Sydney, or Brisbane, you'd only be too well-aware of the massive build-up in apartments across every city. Every road you seem to go down, we've got apartments being built. Of course, now we have fears of a glut.

It's hard to get your finger on exactly what the number is. CLSA have produced some pretty good research. Interestingly, they don't believe Sydney is a problem—in fact, they think Sydney might still have a bit of a shortage. The problem, however, appears to be Brisbane and Melbourne. They're saying that over the next 24 months, total apartments surplus to requirements could be in the vicinity of around 30,000—that equates to settlements of around $16 billion.

Now, in the grand scheme of things, looking at total Australian housing, they are not huge numbers. The problem is if we have some sort of perfect storm. For example, I'm hearing that up to 50% of new dwellings are being purchased by foreigners. If the Chinese become a lot more successful in terms of their capital controls and prevent their residents from buying offshore; if the state governments whack up stamp duty—we saw that in Vancouver and immediate cessation of foreign investment; if the banks start reining in their lending to these types of assets or indeed if APRA forces their hand. This could all lead to some sort of panic, whereby, in order to make the settlements, people are actually selling their primary residence or other investments etc., and this is what we call 'contagion'. This is when panic-selling takes place, and what starts off as a relatively small problem becomes a much more widespread problem.

Now, this is not our base case, I must say. We think there'll be an orderly settlement of this problem, this surplus—but we've just got to be aware of the risk.

DC: John, we've recently changed the target returns for some of our defensive investment options, which we'll be writing to member about soon. What's the rationale for this?

JP: In short, Danielle, it reflects the fact that we're in a ‘zero real interest rate’ environment. Let's look at the [Australian] Bond option as an example. Now in that option, we can only hold government bonds. And Australian Government bonds are trading at somewhere near the inflation rate or below the inflation rate. So in this environment, it's imprudent and impractical to actually target a return above the inflation rate, hence you see the new target return is actually CPI flat—that's come down from CPI + 1%. And the same sort of rationale underpins the changes in the other investment options.

Now, importantly, we haven't adjusted the target returns for our growth options. And that's because our expected return on equities has not fallen to the same extent as our expected return on the defensive—of the bonds and other defensive assets. And we also have more time to achieve those target returns. So at this stage, [we’re] holding course on the growth options, [but] as you can see, [there’s] a reduction in target returns for the defensive options.

DC: So John, it can't be all bad news. I know that markets are gradually rising overall, so there must be some good news out there.

JP: It's not all bad, Danielle, it never is. The prospect of the Federal Reserve actually tightening rates is a positive sign. It means that we're getting back to some semblance of normality. Commodity prices have stabilised, the world economy is chugging along, it's not firing on all six cylinders, but it's not going backwards. So in this context, we're actually looking for opportunities. Now we know that the share market and the economy can go in different directions over the short term. But volatility, to us, is an opportunity, not just a risk, and that's the way we're seeing it.

DC: Thanks, John. If you've got any questions for John, or feedback for us, please email us at **superinformed@unisuper.com.au**. Thanks for watching.

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