# Five questions for the Chief Investment Officer—April 2018

*Video transcript*

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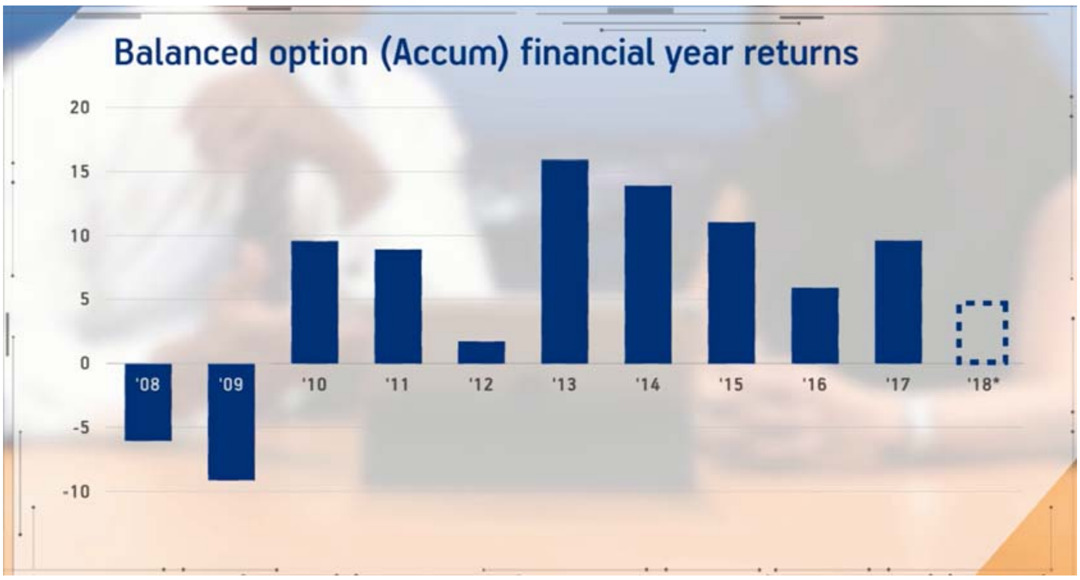
**Jade Khao (JK)**: Welc ome to *Five questions for the CIO*. I'm Jade Khao, one of UniSuper's private client advisers, and I'm here with John Pearce, our Chief Investment Officer.

John, I know we should be focusing on the long term, but financial years always attract attention. Am I correct in assuming that this financial year's returns are unlikely to be as strong as the past five years or so?

**John Pearce (JP):** There's still two and a half months to go, Jade, so anything is theoretically possible, but I must agree with you. If we look at our Balanced investment option, which is our largest accumulation option (being the default option), you can see that financial year to date, returns are about 4.5%. So highly unlikely that we're going to see the double digit returns that we've seen over the last five years, and I must say it's quite extraordinary what's happened in the market the last couple of months.



We've certainly got over the euphoria of the Trump tax cuts, and we now find ourselves in the middle of some sort of mini storm. As usual, the origins are in the US. The storm, in particular, is centred around fears of a trade war—and also the tech industry has got some issues, in particular with Facebook.

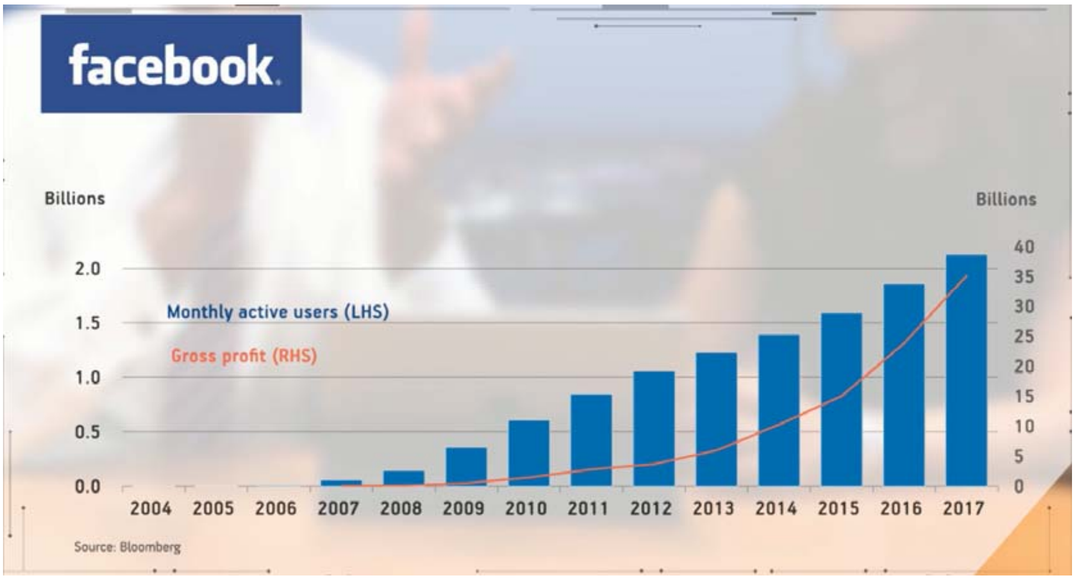
**JK:** So, are the share market's fears of a trade war warranted?

**JP:** Firstly, a bit of context. Donald Trump sees himself as a masterful negotiator. As a matter of fact, he's written a book on the subject which I'm not endorsing, but he's certainly taking a more aggressive stance than his predecessors towards China. He believes that China really hasn't abided by the rules of global trade and effectively accuses them of stealing American intellectual property. The other political context here is that Trump is facing mid-term elections, so I think we could have always expected some kind of populist rhetoric to be elevated during the year. So where are we in negotiations? The US trade representative has proposed that about 1,300 Chinese goods should be subject to a 25% increase in tariffs, and that impacts about $50 billion of Chinese imports. In a tit-for-tat response, the Chinese have identified $50 billion of American exports that they say could be subject to an increase in tariffs. Subsequent to that, Trump has ordered the US treasury to have a look at a potential $100 billion of additional goods that could be subject to tariff, and the Chinese have responded by saying, "Look, we will respond in equal measure."

Where does this leave us? Firstly, at this stage it is just a proposal, and it'll be many months before a final decision is made. So there is plenty of time for negotiations to take place. The second point to note is that these dollars sound pretty big to you and I, but in the context of US/Chinese trade, it's less than 15% and certainly just a small fraction of the size of their economies. Having said that, the risk of a trade war has clearly elevated and the repercussions of a trade war between China and the US will be felt everywhere. We're talking about the two elephants of the global economy, and when elephants fight, the ants get trampled and that includes Australia. So we're all hoping for a sensible, negotiated outcome here.

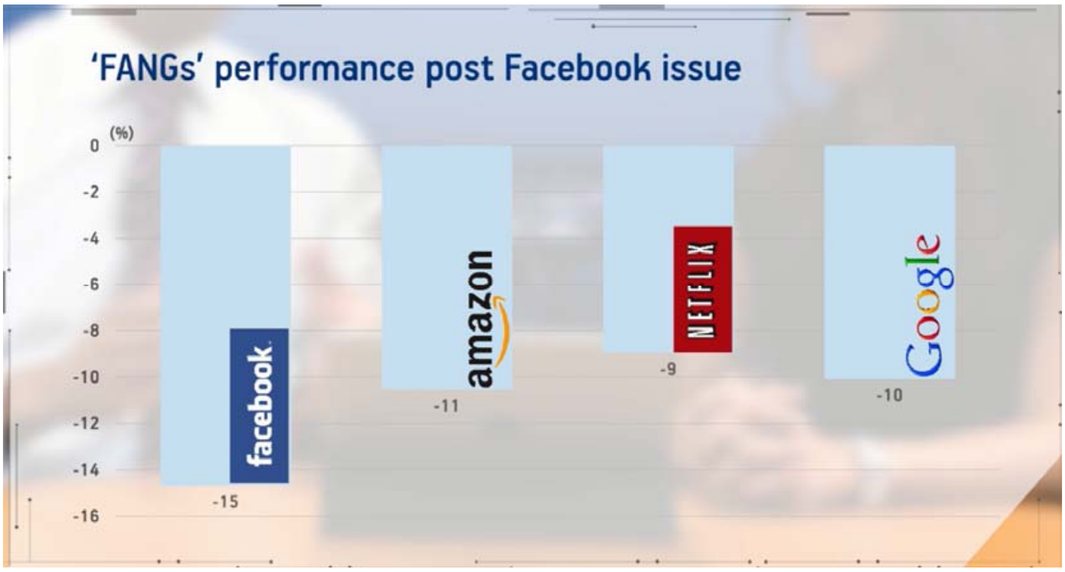
**JK:** And the problems confronting Facebook have also added to market jitters. Can you elaborate?

**JP:** The first thing about Facebook that we have to recognise is that it is a phenomenal company. Look at its rise in subscriber numbers. We now have about two billion users per month, and unlike social media companies such as Twitter, Facebook has been very successful in monetising these numbers—last year alone, Facebook made gross profits of about $35 billion.



But it finds itself in some pretty hot water. A firm by the name of Cambridge Analytica was able to, via a third party, use data that was harvested from about 87 million Facebook users. Cambridge Analytica was then used by the Trump campaign to help craft messages and ads that this data was used for. So you can imagine the concerns here. Privacy concerns, misuse of data concerns, this is getting everyone very interested. Mark Zuckerberg, the CEO of Facebook, is having to front up to the US Senate. He's quite contrite at the moment.

And this is not just a Facebook problem. Think of the broader context here. We have the so-called ‘FANGs’—Facebook, Amazon, Netflix and Google. These are very powerful companies and the concentration of power is getting greater. Facebook and Google, arguably, are already monopolies—and whether you think they're monopolies or not, one thing that's absolutely certain is that they have unrivalled access to data. We have a growing chorus of calls for tighter regulation on this, and that's spooking the market. So you can see after the Facebook announcement, not only is Facebook being hit—all the ‘FANGs’ have been hit pretty hard, and because of their size, that's impacting the whole market.




This will take a long time to play out. There probably will be some tighter regulation but my view is that, notwithstanding, the FANGs will still have some bite. Sorry, that was a pretty poor joke.

**JK:** In your latest investment update, you highlighted the recent underperformance of the sustainable options. Can you summarise the main points?

**JP:** Sure. Two of our more popular accumulation investment options are the Sustainable High Growth and Sustainable Balanced options. Both these options give our members access to strategies that screen out companies that are heavily involved in armaments, alcohol, tobacco, gambling, and in particular, fossil fuels. And given this screening out and the difference in compositions, we can expect that certainly over short term we'll have differences in performances.

If you look at the Sustainable High Growth option compared to the standard High Growth option, you can see over the last year there's been a 5% difference in performance. And that's quite a large amount.


So what has actually driven this? Firstly, because it can't invest in fossil fuels, it hasn't been exposed to the resources industry, by and large—and that was a high performing industry last year. ASX resources sector was up by about 18%. That's a big number. Emerging markets—they have quite low exposure to emerging markets because companies in emerging markets tend to fall short of the high governance standards that we expect of companies.

And to compensate for these underweights in these sectors, we actually have overweights in other sectors, and in particular, in this case, overweight to listed property—and that's been a poor performer. It's flat over the last year. So you can see how this combination has driven this underperformance.

Over the long term, we expect performance to converge more and we can see over five years, for example, the differential is actually much narrower.


Of course past performance is no indicator of future performance, and the performance of ‘sustainable’ will be heavily influenced by the performance of the energy sector, and that's been notoriously cyclical and unpredictable.

**JK:** John, can we finish on a positive note with some good news?

**JP:** Firstly, let me reemphasise that a healthy correction is nothing to be worried about. It happens all the time. As a matter of fact, if you are an accumulation member, it's positive news because you're buying assets at cheaper prices. The other point I want to stress is that fears of this being some sort of a harbinger of a crisis etc., to me, are completely mislaid. If you look at the path of global share prices since 1990—that's the blue line—they broadly follow the path of corporate profitability.


So we have a fairly strong connection here and that tells me that the share market rally that we've seen is on pretty solid grounds. What's more, the global growth story is still intact, and global growth leads to corporate profits in future and enhances companies' abilities to pay dividends, most importantly.

Of course, if we do end up in a trade war, the analysis changes, but at this stage—because, as we said before, in a fully-fledged trade war everyone loses—our base case is that we'll get to a sensible, negotiated outcome.

**JK:** 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**. Thanks for watching.