Five questions for the Chief Investment Officer—November 2017

Video transcript

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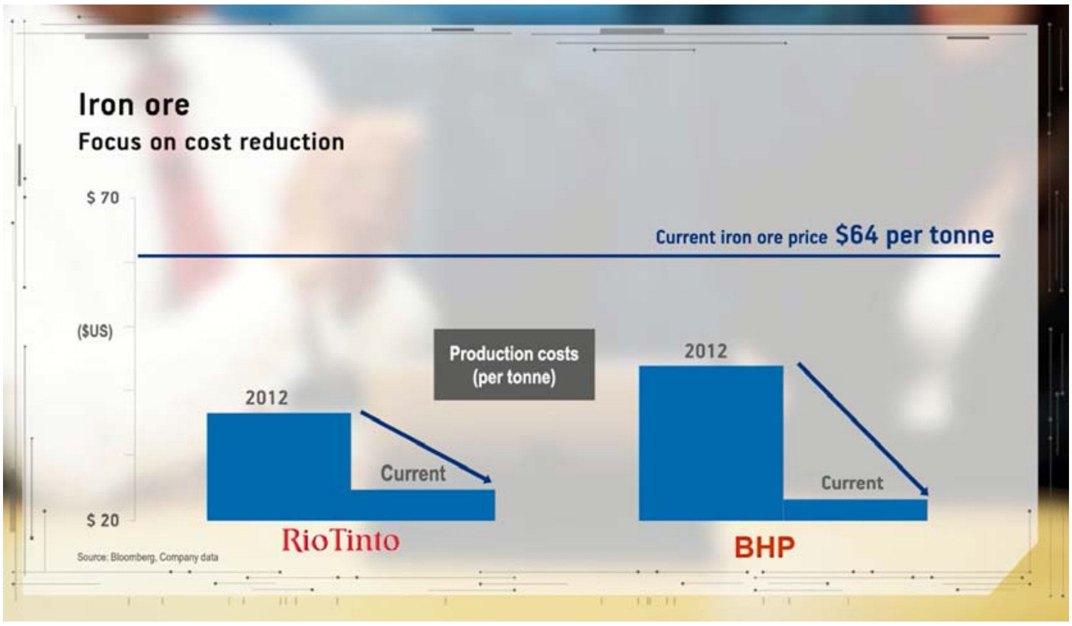
Jade Khao (JK): Welcome to *Five questions for the CIO*. I'm Jade Khao, one of UniSuper's private client advisers and I'm here with John Pearce, our Chief Investment Officer.

Hi, John. Since we last met, the Australian share market has performed quite well, even reaching the elusive 6,000 level for a short time. What's the main driver for that?

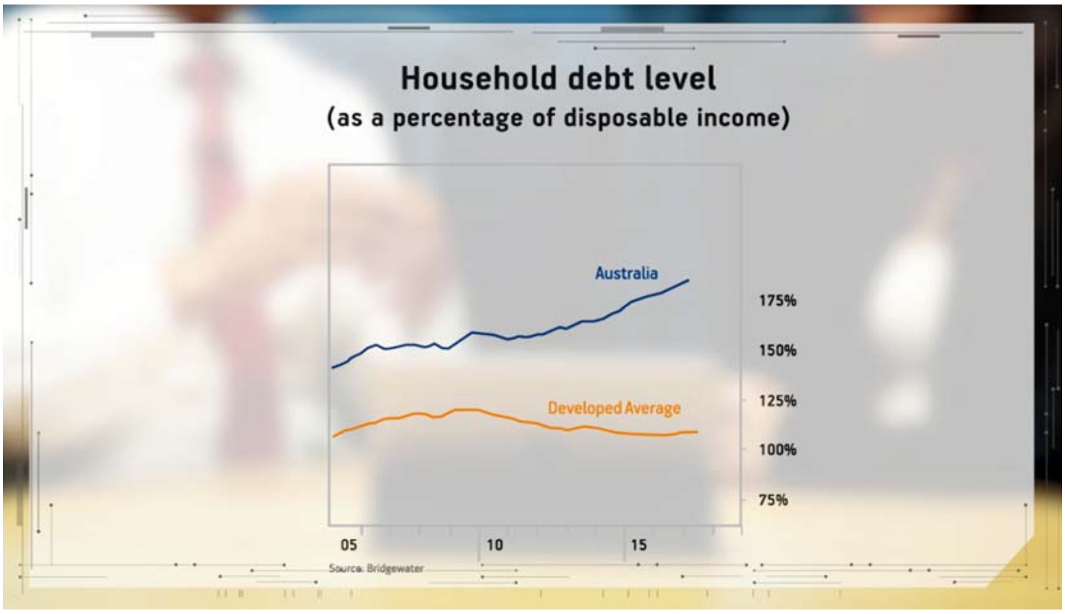
John Pearce (JP): Yes, Jade. Well, last time we met I was lamenting the fact that Australia is underperforming the rest of the world, and since then, we've outperformed. So maybe, we should do this more often. The pleasing thing is that it's actually been quite a broad-based rally, and one of the best performers has been our resources sector. And I think it's worthwhile just reflecting on some of the key trends that's underpinning an improvement in the profitability of that sector. Firstly, we're experiencing synchronised global growth, and that's underpinning strong commodity prices—and of course, that's the price of what these companies sell their goods at. But here's the big story. Have a look at this graph.



This shows how BHP and Rio, our two biggest companies, have slashed the cost—we're looking at iron ore but the same story can be said of others—slashed the cost of iron ore to around $25 per tonne. Now look what they're getting. The iron ore price is around $64 per tonne. So you can see the profits being generated there. And the story actually gets better, because unlike previous years, these profits are not being squandered. Both of these companies now have new management and boards in place and they're a lot more prudent, in terms of capital management, than their predecessors. So shareholders are seeing the benefit of this profit generation.

JK: Does that mean investors are no longer worried about Australia's debt bubble?

JP: Not quite, but a bull market climbs a wall of worry. Let's talk about the debt bubble. Firstly, it might surprise you, it's actually not a government debt bubble. Our public finances are in reasonable shape. And it’s not a corporate debt bubble—our corporates are in reasonable shape. It's a housing debt bubble. Have a look at this graph.



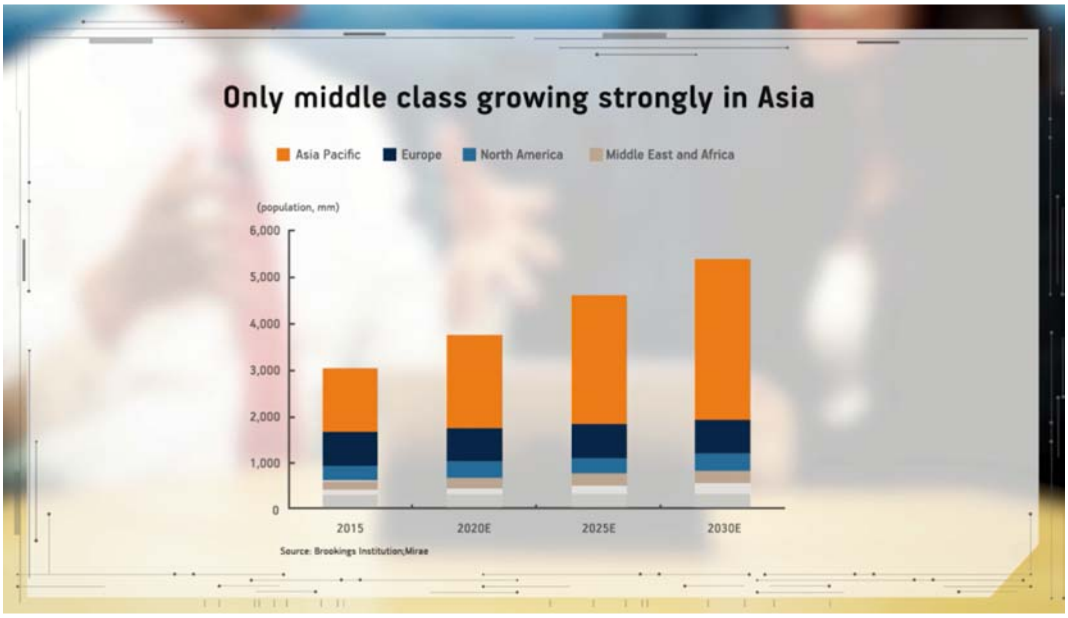
It basically shows that, on average, Australian households have debt that is about two times their annual disposable income. And that is much higher than the average for the rest of the developed world. What's happening is we've been increasing our debt to fund an increase in consumption in the absence of real wage growth. So, Australian households, on this measure, are in a pretty fragile state and prone to some sort of shocks.

But I will caution against getting too gloomy about this for a few reasons. Firstly, averages can be misleading, and it's important to understand who actually owes this debt. And if you look at the Reserve Bank statistics for example, it seems that the bulk of the debt is actually owed by people who can afford to have the debt. So that's important.

Secondly, our debt servicing, or the interest that we pay as a proportion of our annual disposable income, is quite low—around 7%. So that's quite manageable. And finally, we're all wealthier because asset prices have appreciated quite remarkably. So, if you look at the value of our assets to the value of our debt, we're in pretty healthy shape compared to the rest of the world. Of course, that's no reason for complacency, and you'll note that regulators are really clamping down on some of the banks’ lending activities. And while debt remains at these sort of levels, I expect those pretty stringent measures to continue for some time.

JK: John, last time, you highlighted that the Global Environmental Opportunities option has been our strongest performer in recent times. But our Global Companies in Asia option is not far behind. Can you go through some of the features of that investment option?

JP: Sure. Just quickly on performance—24% over the last 12 months, around 16.5% per annum over the last five years—so, a very strong performance indeed. So, in terms of this option's strategy, what we're looking for [are] companies that we believe are best placed to leverage the growing wealth in Asia. One statistic you might find quite amazing—over the last nine years, the US economy has expanded by about 15%, the European economy by about 6%. The Chinese economy has doubled. So you can just imagine the growth and wealth in this region. Have a look at this chart.



It's a chart by the Brookings Institute, and it shows the expected growth in the middle classes around the world. And this is important, because when you think about the prosperity of an economy, a society, it's all about the middle class. And according to this forecast, it's all about Asia. Now, not surprisingly, the companies that are very well-placed to take advantage of this are your big global brands.

So the strategy is very well diversified across all regions. I'm sure many of our members will recognise these leading brands. So the performance has been good but, of course, past performance is no indicator of future performance.

JK: You were concerned about prices looking a bit stretched. Do you share the same concerns for the Global Companies in Asia [option]?

JP: Well unfortunately, there is nothing cheap in the world at the moment. So, when we look at prices and valuations, we're looking at the valuation of one asset relative to another. I just want to refer to a very simple but popular valuation metric, and that's what we call the price-earnings multiple. A very simple example—if a company is earning profits of, say, $1 per share and the share price of that company is $20, we say that that share is trading on an earnings multiple of 20 times. Now the Global Companies in Asia [option], on average, is trading on a multiple of around 21 times, which is about the same as the market average. So we think that's a pretty fair price, given that the growth prospects of companies, in this portfolio, we believe are higher than market average, very much because of their exposure to Asia.

JK: Well, back to the domestic front, John. It's that time of the year where companies are holding their annual general meetings and shareholders get to vote on company resolutions. I understand that the CBA report is creating some controversial news out there in the market.

JP: I just got off the phone from a journalist, explaining our position. And I know that other institutions are quite publicly against the CBA's remuneration report. I'll talk about our rationale, but first a bit of context. We have in Australia what is known as the ‘two strikes’ rule. Now this provides that a board of a listed company can be spilled if more than 25% of shareholders vote against its remuneration report over two consecutive years. Now, this gives institutions like UniSuper quite a lot of power, and that power has to be exercised judiciously. In 2016, the CBA actually had one strike, and we voted against their remuneration report because there were various elements of it that we just did not like.

Since that report, we've had the AUSTRAC debacle. And, of course, that's been the catalyst for the calls for an ‘against’ vote. We're voting ‘for’, because we believe that Catherine Livingstone, the new chair of the CBA, who we have utmost confidence in, has acted swiftly and firmly with the AUSTRAC issue. Executives have left, directors have left, and bonuses have been cut to zero. So to our mind, we don't have reasonable grounds to vote against the remuneration report, and we won't be. Now, as this video goes to air we will know the results of the report. And I do hope that many other shareholders feel the same way we do, because the last thing we need is more instability on the CBA Board.

JK: Thanks 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.