Five questions for the Chief Investment Officer—July 2017

Video transcript

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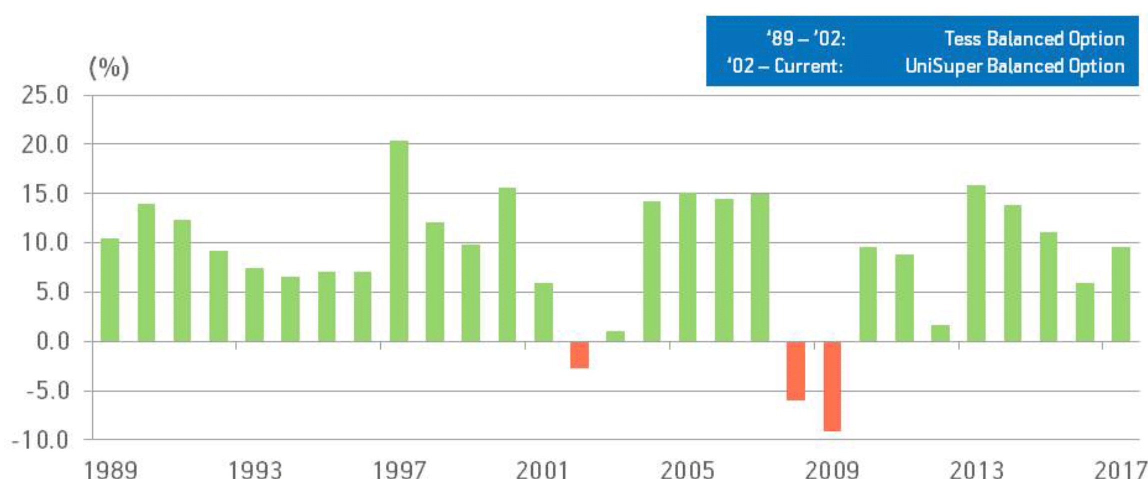
Danielle Clarke (DC): Welcome to *Five Questions for the CIO*. I'm Danielle Clarke, UniSuper's Communications Manager, and I'm here with our Chief Investment Officer, John Pearce. John, we've just closed the door on the last financial year, and with a return of 9.6% for our Balanced option, members should be pretty happy.

John Pearce (JP): Indeed. And if it wasn't for a 1.5% fall in the Australian share market on the 30th of June, we would've hit double digits. But of course, that it is just one-year returns, and it is human nature to look at financial year returns, but we do like to focus on the longer term. And as you'd expect, I have a graph, and here's the Balanced option returns going all the way back to 1989 when it was actually called the TESS Balanced option. Over that term, 8.6% average, which I think you'd agree is pretty healthy.



And a couple of general observations—our Balanced option is pretty similar in construction to default options in the Australian superannuation industry in that we have over 70% allocated to growth assets. Now many commentators have argued that that is way too risky for a superannuation fund. But I think history suggests that that construction has served Australian superannuants pretty well over time. Of course, we've had a couple of setbacks along the way, but the asset allocation is really put in place for the long-term investor in mind.

That's not to say it's appropriate for everyone. For some members, holding a large percentage of defensive assets such as Cash and Fixed Interest is entirely appropriate, and that's why it's always important to seek financial advice.

DC: So while the Balanced option was really solid with that 9.6% result, I imagine that there was a range of different results. Can you talk us through?

JP: Yeah, there certainly was. Here's a list of our option returns over the last financial year. And you can see the range, 25% from the best performing to the worst performing. The one common characteristic of the three best performing options, they're 100% invested in global shares. A couple of sectors in particular had stellar performances—financials, and technology.

Option performance for 2016/17 financial year

Option	Return (%)
Global Environmental Opportunities	21.7
Global Companies in Asia	20.2
International Shares	18.4
High Growth	15.3
Sustainable High Growth	13.1
Growth	12.4
Australian Equity Income	11.7
Australian Shares	11.1
Sustainable Balanced	10.2
Balanced	9.6
Defined Benefit	6.6
Conservative Balanced	4.5
Diversified Credit Income	4.2
Conservative (formerly Capital Stable)	3.0
Cash	1.8
Australian Bonds	-0.4
Listed Property	-3.0

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The best performing option was the Global Environmental Opportunities, and it was very pleasing to see because in the preceding year it actually recorded a loss. This option invests very heavily on what I loosely call 'the greening of the world'. That's not a technical term.

Global Environmental Opportunities Financial year returns (%)

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And the companies within the option—there were some spectacular results of the companies within the option—for example, Tesla, the electric car company that everyone, I'm sure, is aware of, up 70% for the year. A word of caution though, we are seeing some members switching into the option and I suspect that some of that switching is chasing a 'hot' asset class. Companies like Tesla are attracting investors that are buying the dream and if these dreams do not convert into solid profits, I fear that we will see quite a correction in prices.

DC: So that's the good news, John. What about the poor performers?

JP: Well you can see from the list—not surprisingly when the share market is so strong—at the bottom of the list we've got a couple of defensive asset classes, Cash and Fixed Interest. However, the worst performing option is invested in a growth asset, Listed Property. We've spoken about this option before and basically there are three main reasons.

The first reason, if you look at the performance of this option, in the four years preceding last year, the returns were so strong, about 17% per annum. So one could argue it was the correction that we had to have. The option is heavily exposed to retail and in the Australian context that has been hampered by a stressed household base, low wage growth, leading to poor retail sales. In the US, you can add the Amazon impact which is really crunching down profit margins, forcing store closures and that's putting pressure on shopping centres.

Where do we go from here? Well, in the Australian market it's currently yielding an income of over 5% and you're seeing support at around these levels. However, it would be fair to say that those heady days of 2013 to 2016 are not likely to return anytime soon.

DC: You mentioned that the Australian share market generally underperformed compared to its global peers. Was the performance about banks a key driver of this?

JP: It was actually quite nuanced. The absolute return of our banks was pretty solid. It was actually around 20%. That was well below the returns of their global peers and hence the relative underperformance. Our banks were actually having a pretty good run and then we had the May [Federal] Budget and the introduction of the bank levy, and in the following month or so we saw bank prices fall about 10%. I'm not going to dwell on the bank levy because a lot has already been said about it. I will make a couple of general comments though. The banks constitute over 25% of the Australian market. So anything that is bad for bank valuations is unequivocally bad for superannuation returns. That's irrefutable logic.

The second point is, I believe there is a perception that the banks are 'the big end of town' so they're fair game. Well, let's consider the CBA shareholder base. 54% is pure Australian retail, 26% is Australian institutional, and the remaining 20% is foreign. Now that 26% institutional, 'the big end of town'—well, that's institutions like UniSuper. And we're actually just pooled retail.

So in effect, 80% of [the] CBA shareholder base is Australian retail. The point I'm making is, slamming the banks is actually not slamming 'the big end of town'. If anything, that's detrimental to bank profitability and valuations is actually borne by Australian retail investors. And I do hope both sides of politics understand that when they're framing policy.

DC: John, I'm hearing more and more talk of global interest rate hikes. Do you share those concerns for the coming 12 months?

JP: Not really. Firstly, we're coming from a very low base. The other point is that the central bankers have been at pains to reassure us that any rises are going to be quite gradual and at the end of the cycle, rates are still going to be quite low.

So to use an analogy, rather than slamming their foot on the brakes, I see this much more akin to just easing pressure off the accelerator. I'd also like to address what I believe is a bit of a misconception. There's one school of thought that the rally in share markets, some hitting record highs, is fuelled purely by low interest rates—this cheap money is basically creating a bubble in share markets. Well a bubble in share markets occurs when the course of share prices diverges completely from underlying company fundamentals, and in particular, company earnings.

Have a look at this graph. Here we have the US market. It's the biggest share market and it's also hit all-time highs, so it's a pretty good one to look at. We're looking at the comparison of company earnings growth versus share price growth over the past two decades. And we see that they've roughly tracked each other. So pessimists would argue that the share market rally that we've seen over the last five years has been built on very shaky foundations. I think this graph represents some evidence to the contrary.

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

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