Five questions for the Chief Investment Officer—July 2020

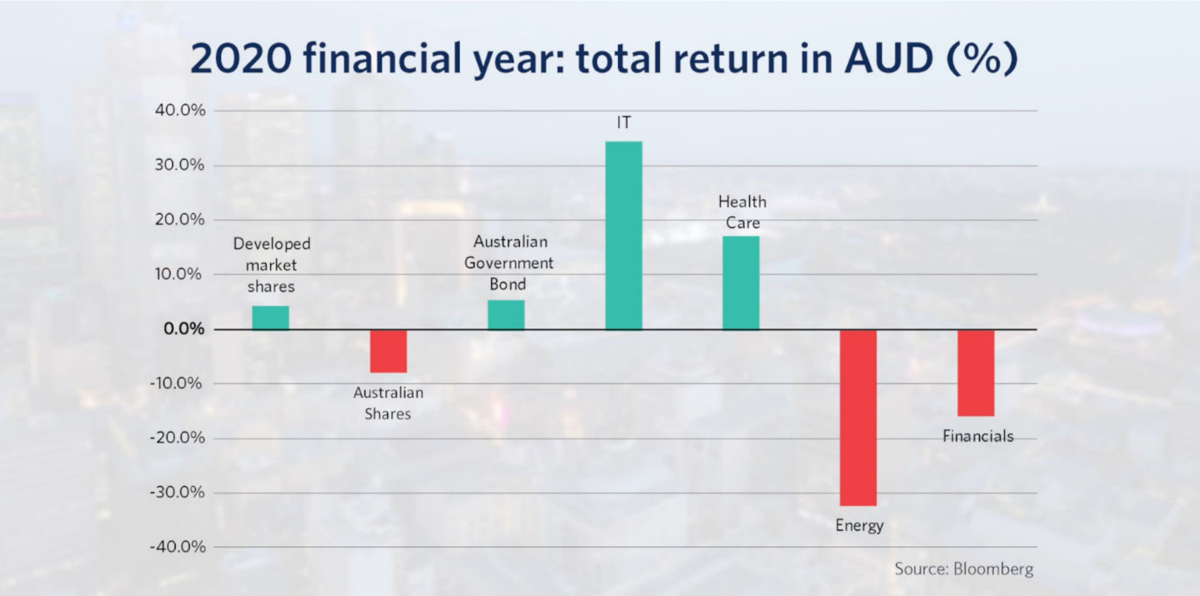
Video transcript

Derek Gascoigne (DG): Welcome to this edition of *Five questions for the Chief Investment Officer*. My name is Derek Gascoigne, and I'm a senior financial advisor for UniSuper Advice. I'm joined by our CIO, John Pearce.

John, our members will soon be receiving their statements for the 2020 financial year, and what a year it has been. I'm sure that many members will be pleasantly surprised to see that their returns aren't as bad as they may have been expecting just a few months ago. Can you provide us with an overview?

John Pearce (JP): Well, Derek, despite the horrors of COVID, you're right. The financial year didn't turn out too badly for superannuation investors. Our Balanced option, which most of our members will have an investment in, eked out a small positive gain for the year, just below 1%. Now, that's not anything to write home about, but consider that it was down about 14% in March, so, not a bad comeback. A feature of this year has been the wide range of performances across the options. And before we delve into that in any detail, let's look at a high level what's driving this difference in performance.

Firstly, Australian shares underperformed global shares. Australian shares also underperformed Australian bonds. Straight away, we can see that if you're fully invested in the Australian share market, you probably had a poor year. These differences don't look too big, but when you apply it over a large amount, they actually add up. Now let's look where the big differences are, and that's sector performance. The best-performing sectors, IT and healthcare, the worst-performing sectors, energy and financials. You can see the difference in performance here between the best and the worst. It's about 70%. So getting the sectors right is really important.



What do we see in terms of how this has then transpired into option performance? You can see the top-performing Global Environmental Opportunities, 30% better than the bottom-performing Listed Property.

Option performance

Option	2020 Financial Year (%)
Global Environmental Opportunities	13.9
Global Companies in Asia	8.0
International Shares	7.8
Sustainable High Growth	6.8
Sustainable Balanced	5.4
Australian Bond	3.8
High Growth	1.8
Growth	1.8
Conservative	1.6
Cash	1.0
Balanced	0.7
Conservative Balanced	0.1
Diversified Credit Income	-0.7
Australian Shares	-2.7
Australian Equity Income	-8.2
Listed Property	-16.2

You can see right at the top of that table the three options that are invested in global shares, outperforming—near the bottom of the table—Aussie share options.

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Our sustainable options, both of them—Sustainable High Growth, Sustainable Balanced—significantly outperforming their standard equivalents.

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Why? Exposure to developed markets, exposure to technology. No exposure to fossil fuels, and therefore, very little exposure to the underperforming energy sector.

As you know as an advisor, our sustainable options, and our Global Environmental Opportunities option, are pretty popular with our Advice clients, so I'm particularly pleased that they've ended up having a pretty good year.

DG: We've seen a V-shaped recovery in many share markets, but economic news is downright dismal. Can you explain what appears to be an extreme disconnect between the two?

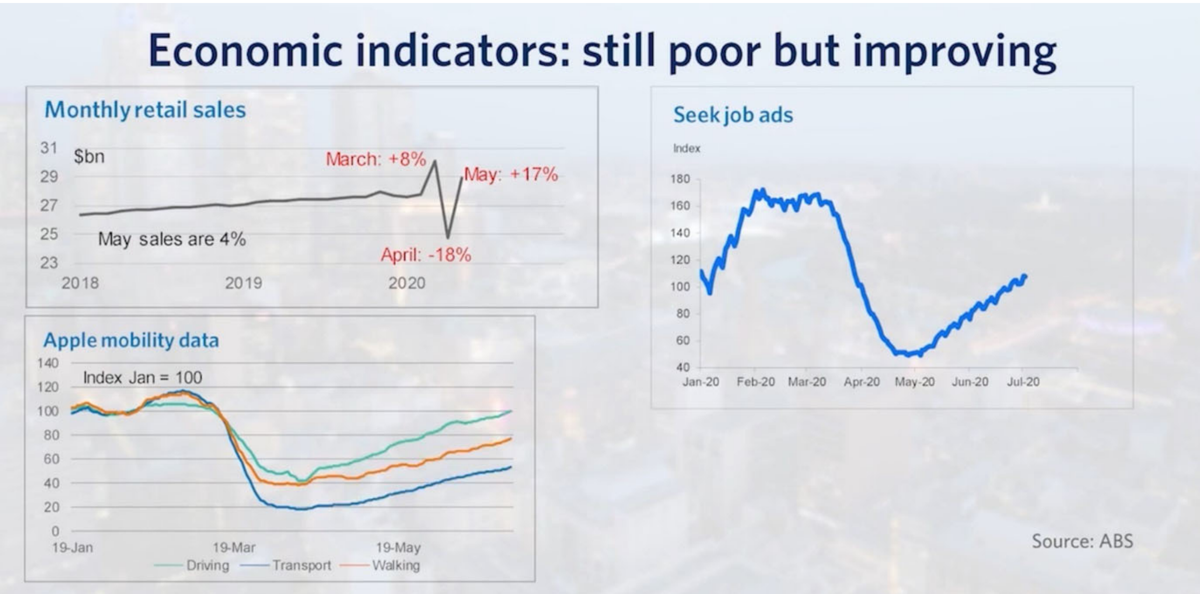
JP: We've spoken at times in the past how the market can be disconnected with the real economy, but yes, this time, it's more extreme than I've ever seen it. So let's try and make sense of it. How can we have such a V-shaped market recovery? Well, the market, to rally, needs two basic conditions.

One, ample liquidity. What do we mean by that? Ample access to funds at low interest rates. And we know that that condition has been satisfied, because central banks have been flooding the world with liquidity.

The second thing is we need to see an improvement in economic conditions. Now, ‘improvement’ is the key word here. To the market, the actual level of unemployment is not as important as the change in job prospects and the outlook for jobs. And that is actually what we've seen from March to April to May. Things are still poor, but they're improving. Why is that the case? It's really all about governments and fiscal policy. Globally, governments have stimulated economies by about $9 trillion. That dwarfs the stimulation we saw during the GFC.

If you look at the Australian context, household cash flows, with the addition of JobKeeper, JobSeeker supplement, we then got early access to superannuation—household cash flows are actually higher than they were pre-crisis, and that's incredible. And what's that translating into? Well, have a look at retail sales. They've really improved. If we look at job ads as a leading indicator—ads are still lower than they were pre-crisis, but in May, they were much better than they were in April.

What about mobility? Well, people are not as out and about as they used to be, but they're out and about more than they were in March and April.



So once again, we're talking about this improvement. Of course, the question then is can this continue?

DG: The bounce in markets has certainly been welcomed. But it's pretty obvious that there are still some big winners and losers across asset classes. Can you briefly elaborate on our best and worst performers over the year?

JP: Let's start with the worst, Listed Property, with a decline of around 16% over the financial year. This option is dominated by investments in retail shopping, and we know the impact that lockdowns have had on shopping centres. Indeed, our worst-performing large investment over the last financial year was Scentre Group, down about 40%. Retail landlords do have contracts with tenants, and they're legally binding. But if the tenants are going out of business, and unable to pay rents, compromises have to be made. Investors are now adjusting their expectations about rental flow and dividends, and hence the crash in stock prices. Personally, I feel it's a bit overdone, but it's also hard to see what the catalyst is going to be to see these stocks increasing faster than the market in the future.

Let's move now to the better news, and that's our best-performing option, Global Environmental Opportunities. That saw a return of around 14%. Here we have an option that is invested in companies that are benefiting from two powerful themes. That being the technology revolution, and the green revolution. So we're not talking about a flash in the pan result here. As a matter of fact, since we launched this option, it’s returned about 13.5% per annum, so it's been a fantastic performer.

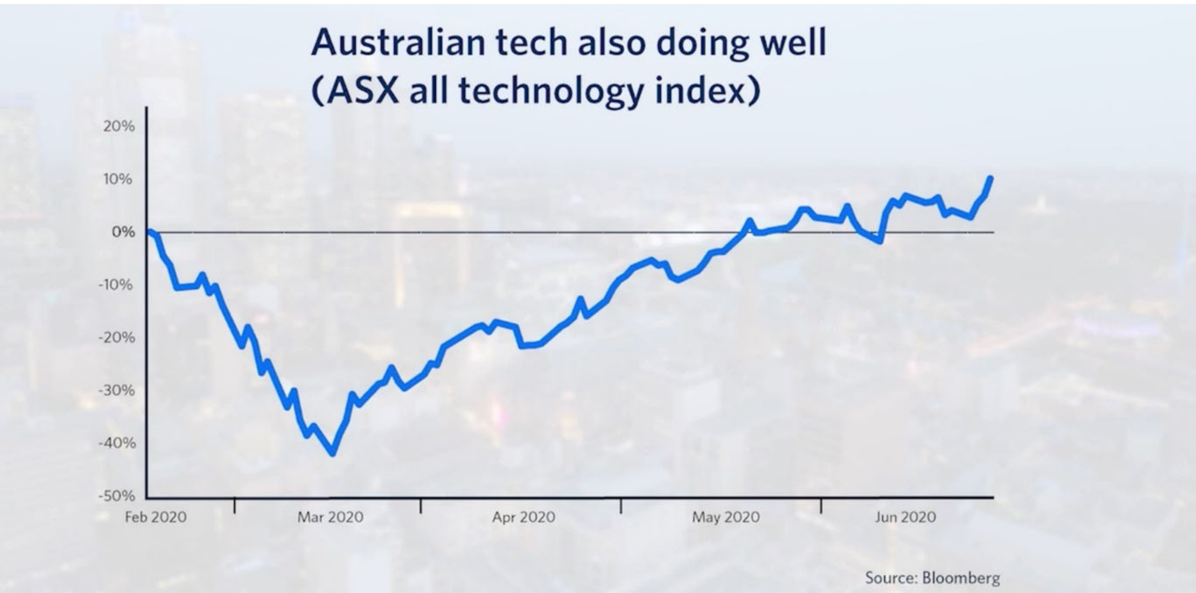
Questions are arising as to whether we now have overvaluation. The pin-up child for this option is Tesla. It's been the strongest contributor. It is now the most valuable car company in the world. On some metrics, we are seeing evidence of overvaluation here, but Tesla is also a classic case where I've got it wrong, I'm going to stop calling the top in Tesla. Growth prospects are fantastic, as they are with many of these companies, but you are paying a high price for the high growth prospects.

DG: It seems to me that another way of looking at the winners and losers is finding companies on the right side of the technology revolution. Are you concerned that bubbles are forming in the sector?

JP: Generally speaking, I'm pretty comfortable. I'm comfortable because the level of profitability and the growth in profits in the technology sector outstrip all other sectors. So, the increase in share prices is backed by the right fundamentals. If we look at the star performers, it's the household names, the so-called ‘FAAANM’ stocks—that's the Facebook, Amazon, Apple, etc. In fact, if you take their performance out of the US stock market, the US stock market has actually performed about the same as other global developed markets.

If you look at these companies, Apple, it makes about $60 billion a year. Microsoft, about $50 billion a year. Their resilience during COVID. Think about the extra demand for Netflix services. Think about the extra online shopping—Amazon, the beneficiary. The Microsoft CEO recently stated that he has seen two years of digital transformation in two months, as companies readjust to remote working. So, the resilience is another feature of these companies.

Having said that, there are some bubble elements forming in the sector, and I'm actually going to refer you this time to the Australian example. Now, that's right, Australia does actually have a tech sector. It's small. We indeed started a technology index at the start of this year, which wasn't great timing, because it proceeded to crash.



It has recovered, and one of the stars of the show is afterpay. Most of our members I'm sure have heard of afterpay. It's a financial technology company. The proposition is you buy now, you receive now, and you pay later, so that's a pretty attractive proposition. You can see why it's popular. Let's have a look at afterpay's valuation. It's got a market value of about $18 billion. It has about 8 million customers, and that's pretty impressive, because it’s really only been the last few years that it's taken off. But afterpay loses about $50 million a year at the moment. So, $18 billion for a company that loses money.

I want you to contrast this with traditional financial companies. It turns out that afterpay's market value of about $18 billion is the equivalent to the sum of the market value of Bendigo, Bank of Queensland, and Suncorp combined. Now, these companies actually made profits of around $1.1 billion.

	afterpay	SUNCORP + BOQ + Bendigo Bank
Market value	$18.3B	$18.1B
Customers	$8.4M	$11.7M
Revenue	$372M	$17.8B
Net profit	-$53M	$1.1B

Source: Bloomberg

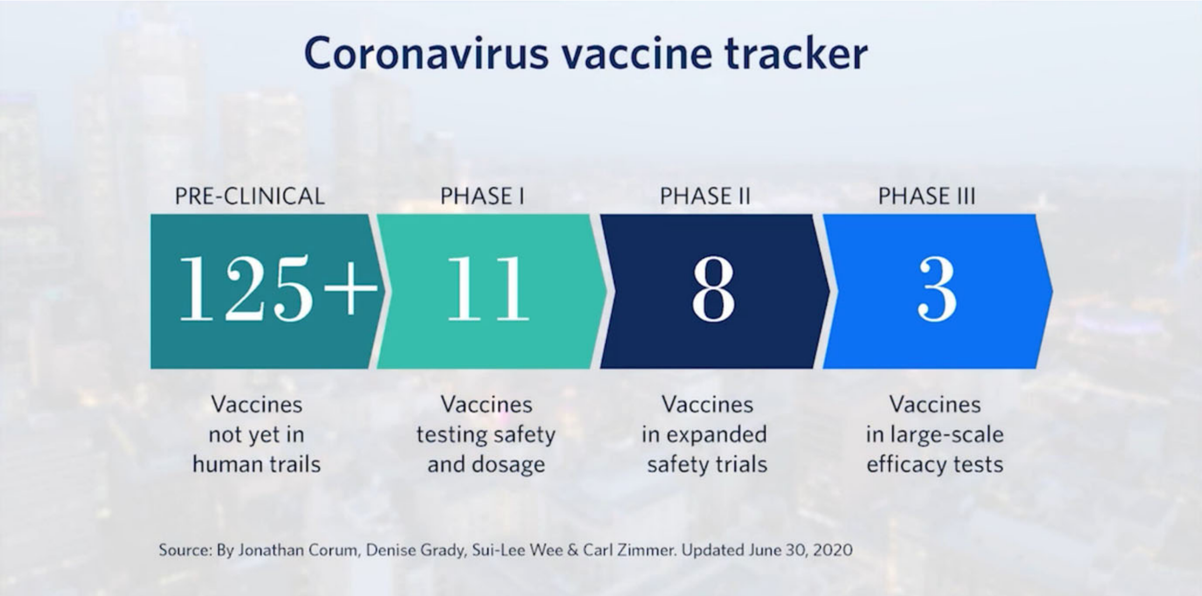
Of course, afterpay's growth prospects are far greater than those banks. But once again, you're paying a very high price for that growth.

DG: What needs to occur for the recent rally to be sustained, and maybe take markets even higher?

JP: Let's go back to those conditions. Firstly, ample liquidity, tick. Interest rates will stay low for a very long time, so that won't be a problem. The question then becomes economic conditions. Will they improve? This I have some doubts about from where we stand, and the reason being the virus has not gone away. As a matter of fact, if you look at the US situation, in some states it's actually getting worse. What does this mean? This means that governments have to be committed to expanding their fiscal programs. If we look at the Australia situation, JobKeeper is due to roll off in September. But we know in October that the level of employment is not going to be back to pre-COVID levels. So we need the Australian Government to be committed to some form of assistance. It might not be the same level, but it has to be targeted assistance, because without that, the economy will fall into a pretty big hole.

That's for the short term. I think over the short term, we've really seen the easy gains made in the market. Longer term, to get the market to rally even higher, we really need to see progress, in terms of treatment and a vaccine. There are some positive developments on that front. If we look at the pipeline for vaccines, it's very impressive. A lot of resources have been thrown at this problem, as you can imagine. There's about 125 potential vaccine candidates in the pipeline. These are pre-testing, so it's really early stages there. Then you go through the phases of clinical trials, and the most important one being that phase three, where we're looking at large-scale efficacy tests on humans.

There's three in the pipeline.



There is some optimism that we could have something as early as the end of this year or first quarter next year. We've even got manufacturers gearing up for this possibility. It would be nothing short of incredible if that actually happened, but given what's happened this year, I guess we shouldn't be amazed about anything anymore.

DG: Thanks, John. And thanks for answering those questions. If you have any questions you'd like answered, please email us at **superinformed@unisuper.com.au**. Thanks for watching.