January 2018

Investment market update

Is it logical to think that the longer a bull market continues, the closer we must be to a healthy correction—and maybe even a year of negative returns? This update focuses on what might bring about such an outcome, while highlighting that no outcome should be considered inevitable.

Performance of key markets

	% CHANGE			
	MONTH	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian shares (S&P/ASX 300)	1.9	11.9	8.8	10.1
Global shares (MSCI All Country World Local Currency)	1.3	19.8	9.8	12.7
Australian dollar (AUD/USD)	3.0	8.0	-1.5	-5.5
Australian fixed interest (Bloomberg Composite)	-0.5	3.7	3.1	4.2
Cash (Bloomberg Bank Bill)	0.1	1.7	2.1	2.3
Balanced option*	**0.8**	**11.9**	**8.9**	**10.8**

Returns are for periods to 31 December 2017. Past performance is not an indication of future performance.

** Returns relate to our Accumulation (not Pension) investment options and are published after fund taxes and investment expenses, other than account-based fees.*

See performance information for all options

2017: another good year—but what lies ahead?

The 2017 calendar year delivered strong returns for most UniSuper members, particularly those invested in options with a large allocation to global share markets. Our top three performing investment options were Global Environmental Opportunities, Global Companies in Asia and International Shares, with returns of 20.1%, 19.3%, and 17.2% respectively.

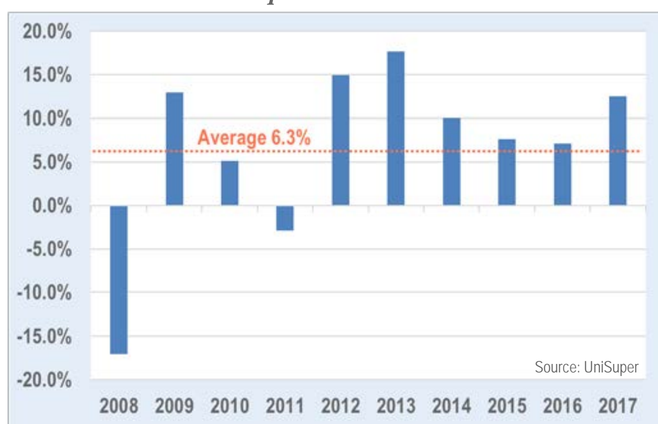
Our Balanced option, which has almost $20 billion in assets, recorded a healthy 11.9% (13.2% for pension members), and has now notched up six consecutive calendar years of positive returns.

This update focuses on the Balanced option—our 'default' investment option where most Accumulation members are invested—although commentary on risks equally applies to most of our other options.

The Balanced option—what would it take to have a negative year?

Over the past 10 calendar years, the Balanced option has returned 6.3% (7.1% for pension members). This exceeds the option's target objective of CPI + 3.0% p.a.—a reasonable outcome given that the period encompasses the biggest financial crisis in a century. As **Chart 1** shows, the Balanced option recorded a loss of -17.1% in 2008, so its recovery has been very strong.

Chart 1: Balanced option returns



Based on our modelling, we expect the Balanced option to experience a negative annual outcome four times in every 20 years. Of course, our modelling is susceptible to the generic flaws of any model, in that it relies on assumptions about future market performances that may or may not turn out to be accurate. The future is unpredictable. So, while we've already experienced six positive years and we expect a negative year in four out of every 20 years, that doesn't necessarily mean a negative year in 2018 is inevitable. However, it's reasonable to assume the *chances* of a negative year have increased. So it's worth taking a look at what might bring about such an outcome.

Table 1 describes what we believe are the four key risks that would have the potential to deliver negative returns for the Balanced option (and for most options with a high proportion of growth assets) if they eventuated.

Geopolitical risk hasn't been mentioned because most (but certainly not all) geopolitical confrontations tend to have minimal lasting impacts on the markets we invest in.

Table 1: Four key risks and mitigating factors

KEY RISKS	MITIGATING FACTORS
China's debt bubble bursts, resulting in a sharp slowdown in GDP growth	• China's debt is largely owned domestically (so it's an internal problem). • The Chinese Government has proven remarkably adept at steering the economy and avoiding crises over the past two decades. • The Government has powerful tools at its disposal, including control of the capital account, huge foreign reserves, fiscal and monetary policy.
A breakout in inflation (as labour markets tighten), forcing central banks to rapidly increase interest rates	• Labour markets in some countries (particularly the US) have been tight for some time, yet wage pressures remain subdued. • While a cyclical upswing in inflation is possible (off a low base), there are powerful deflationary forces that are secular in nature. Demographics and technology advancement exert strong downward pressure on prices and interest rates.
Central bank policy error • Central banks are wary of financial instability created by asset price bubbles. • Tightening liquidity too much in order to control asset price bubbles, in the absence of inflation, runs the risk of sparking a recession.	• Central banks appear to be acutely aware of the balancing act they are performing and potential risks of tightening too quickly. (They've learnt from the Japanese mistakes). • Any recent tightening of rates (e.g. Federal Reserve, Bank of England) has been accompanied by statements reassuring the market that interest rate policy normalisation will occur gradually and rates are expected to remain low for a long time.

KEY RISKS	MITIGATING FACTORS

Australian housing crash

Pockets of the Australian housing market are showing signs of a bubble. Oversupply of apartments, regulatory restrictions on lending for investment property, capital controls in China, and an over-indebted household sector could combine to create the 'perfect storm' for Australian house prices.

- While Australian household debt has significantly increased, so has the value of assets (i.e. on a net wealth basis, the average Australian has never been better off).
- When drilling down to the components of debt, most is held by cohorts who can most afford it.
- With the employment market remaining robust, households can continue to service their debts and non-performing loans remain very low.
- The sharp gains we have seen in prices have been largely confined to Sydney and Melbourne, and the strong population growth of those states can ultimately absorb excess supply.
- Regulatory measures are already having an impact, and an orderly decline/plateauing of house prices is a strong possibility.

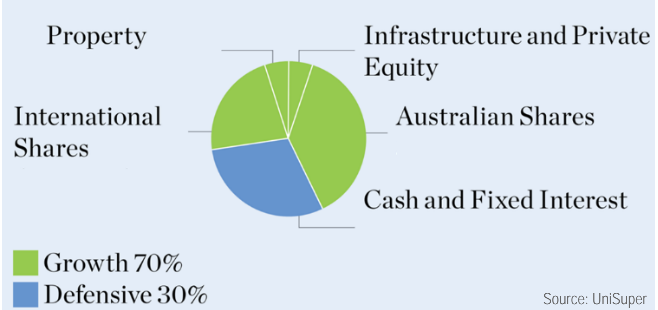
While it's possible that one or more of these risks could eventuate, such a possibility is not our base case given the mitigating factors outlined above. In other words, while we think there's a chance bad things will happen, there is a greater chance they won't.

Diversification is also a risk mitigator

Members invested in the Balanced option can also take some comfort that diversification is also a risk mitigator (albeit not a risk eliminator). The Balanced option is diversified across growth and defensive assets, domestic and offshore, across various asset classes and industry sectors (see **Chart 2**). Negative shocks don't impact all assets equally and, in some cases, gains in some assets (such as bonds) can partially offset losses in others. Our Constructing the Balanced option video provides more information if you're interested in learning more.

Another important point to bear in mind is that, given our strong bias towards quality, the vast bulk of assets held in our portfolios generate income in the form of dividends or interest. So even in the event of a negative shock, we can rely on income generation to partially offset capital losses. The Australian share market, for example, currently generates a dividend yield of about 4.5%. So if the share market's value was to fall by 4.5%, an investor holding the index would actually break even after accounting for dividends.

Chart 2: Balanced option asset allocation



Given the construction of the Balanced option, its relatively long run of positive returns should come as no surprise. As an aside, the default option under the Tertiary Education Superannuation Scheme (a forerunner to UniSuper which had a more aggressive asset allocation to growth assets) recorded positive returns for 13 consecutive years from 1989 to 2001.

However, as we often remind our members, past performance should not be taken as a guide to the future. It's been a good six years, and positive annual returns may continue for longer than people think, but they won't continue forever. We just don't know when they will end.

Past performance is not an indicator of future performance. This information is of a general nature only and may include general advice. It has been prepared without taking into account your individual objectives, financial situation or needs. UniSuper's investment strategies will not necessarily be appropriate for other investors. Before making any decision in relation to your UniSuper membership, you should consider your personal circumstances, the relevant product disclosure statement for your membership category and whether to consult a licensed financial adviser. This information is current as at 8 January 2018.

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