October 2018

Investment market update

The good news is that the US economy is running hot and its sharemarket keeps hitting new highs. The bad news is that the US central bank looks more intent than ever to "take away the punchbowl" before the party gets out of control. The US dollar is effectively the sole global currency, dominating trade and financial flows, so collateral damage on a global scale is inevitable when the US central bank increases interest rates. Consequently, while the US goes from strength to strength, highly indebted countries such as Argentina and Turkey find themselves in a downward spiral. Furthermore, the impact of tighter financial conditions is being exacerbated by Trump's commitment to an escalation in the trade war with China. Against this backdrop it is somewhat surprising that returns for the first quarter of the financial year have been broadly positive—although October is off to a shaky start and more short term volatility seems inevitable.

In this month's update we remove ourselves from the short term gyrations of the market and take a look at what looks to be a trend that is set to continue for some time - the increasing popularity of index management.

Performance of key markets

	% CHANGE			
	MONTH	1 YEAR	3 YEARS P.A.	5 YEARS P.A.
Australian shares (S&P/ASX 300)	1.5	14.0	12.2	8.2
Global shares (MSCI All Country World Local Currency)	4.7	11.1	13.4	10.5
Australian dollar (AUD/USD)	-2.1	-7.8	1.0	-5.0
Australian fixed interest (Bloomberg Composite)	0.5	3.7	2.9	4.3
Cash (Bloomberg Bank Bill)	0.5	1.9	1.9	2.2
Balanced option*	**1.1**	**10.0**	**9.5**	**9.3**

Returns are for periods to 30 September 2018. 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

The rise and rise of index funds

In broad terms an 'index fund' attempts to replicate the performance of a selected market. For example, a typical Australian share index fund will aim to generate the same return as the Australian market as measured by the ASX300 index. Index funds can also be constructed to replicate the performance of sectors within selected markets. As they effectively replicate the composition of a selected market, index funds are often referred to as being 'passively' managed. Conversely, an 'actively' managed fund is one in which a manager constructs a portfolio in an attempt to outperform the market return.

The use of Index funds have been steadily growing since the legendary Jack Bogle launched the First Index Investment Trust (later renamed Vanguard Index Trust) in 1975. An inflection point was reached during the GFC, and the once steady growth profile has turned into a torrent of inflows in recent years. Vanguard and Blackrock are the two heavyweights in the market and according to Morningstar; in 2017 US investors directed an astonishing 81 cents of every new fund investment dollar into their funds.

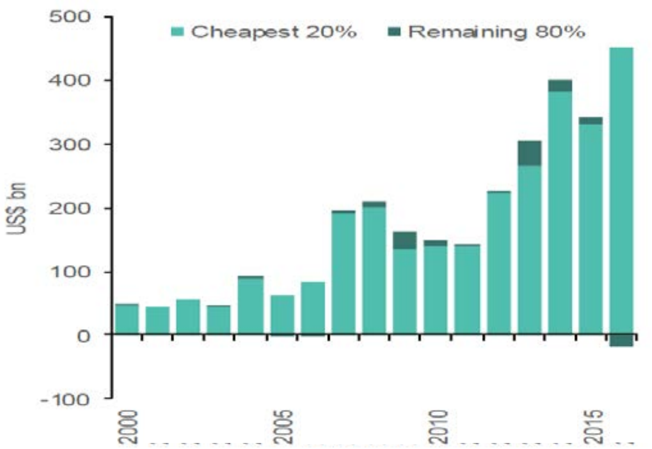
It's all about the price

The active versus index (passive) debate has been raging for decades. Active managers, attempt to justify their higher fees by claiming they're well-equipped to exploit market mis-pricings (or 'inefficiencies' as economists would call them). The pro-index crowd, often led by academics, allude to the futility of trying to beat the index, which in part is based on their view that markets are indeed efficient. And the academics have mathematics on their side; given the world only contains index and active managers, the aggregate performance of active managers must be equal to the index less fees.

The cause of active managers isn't helped either when the greatest among them, Warren Buffet, says: "If a statue is ever erected to honour the person who has done the most for American investors, the hands-down choice would be Jack Bogle". Let's leave aside the fact that Buffett himself has managed to outperform the index by a wide margin over a long period.

Of course the average fund investor is unlikely to be bothering too much about market efficiency arguments. The move into index funds appears to be driven by a more prosaic reason—they're cheap—and the chart below illustrates the money trail.

Inflows directed towards cheapest index funds



Source: Morningstar Direct

UniSuper's use of index strategies

At UniSuper, we position ourselves as active managers so we don't offer index options. However, we do employ various index strategies within our options. For example, our flagship Balanced option currently has index positions in various sectors and regions such as Australian resources, US Healthcare, and the European and Chinese markets. Index strategies enable us to efficiently and quickly deploy capital when we are considering tactical allocations to different markets. For example, we're currently optimistic about the outlook for the resources sector so we've allocated funds to an active manager that specialises in resources, and have also allocated funds to a resources index portfolio. Any change in our views on the resources sector will likely be executed initially via an adjustment of the index portfolio, as it is cheaper and easier to do so. Of course over time we expect the active manager to outperform the index so we tend to think of that allocation as longer term and strategic in nature.

Index strategies are also useful to employ in lieu of finding an active manager when investing in a new country or sector. For example, last year we decided to increase our dedicated exposure to India. We initially allocated funds to an index strategy, while we searched for a manager that we are confident will outperform the index over time. Index strategies also assist us in delivering one of the lowest cost investment platforms in Australia, although lower costs are only one consideration and not the prime one.

Why doesn't UniSuper offer index options?

Our product strategy is inextricably linked to our core value proposition—competitive returns and excellent service at a low cost. Key to delivering on this proposition is limiting the range of products on offer to keep costs (and fees) down. In essence, when considering the trade-off between providing value for money versus a wider range of investment options, we will more often than not opt for value.

Accordingly, if we were to offer an index option(s) we would probably convert an existing actively managed option, rather than adding more investment options. At this point in time we do not believe it's in our members' best interests to go down that path, and we can point to a solid track record to support our view. The vast majority of our investment options have outperformed their respective index equivalents *after fees* over the long term.

Table 1 shows the performance of our largest accumulation option, the default Balanced option, over the long term. Outperformance has been recorded for most of our other diversified and single sector options*. At first glance the value-add may not appear significant. However, for someone with a balance of $250,000, a 1% difference over 10 years adds up to approximately $26,100 dollars. Active management has been worth the effort.

**For the performance of our other diversified and single sector options go to https://www.unisuper.com.au/investments/investment-options-and-performance*

Table 1

	UNISUPER BALANCED % P.A.	INDEXED BALANCED^ % P.A.	VALUE ADD % P.A.
3 years	9.4	8.1	+1.3
5 years	9.3	8.1	+1.2
7 years	10.8	9.8	+1.0
10 years	7.9	7.1	+0.8

Past performance is not an indication of future performance
**Returns to 30 September 2018*
^Returns are adjusted for tax (estimated)

Short terminism, liquidity constraints and basing investment decisions on non-financial factors are persistent sources of market inefficiency. At UniSuper we're in the fortunate position of having a large and growing fund that enables us to take long term positions in illiquid or mispriced assets and our well-resourced internal investment team have the capability and authority to exploit short term opportunities as they arise. When we outsource we tend to focus on managers that we believe can outperform the index of a specific region, country, or sector and the managers we've selected have also added value in aggregate over the long term.

Of course, there may come a time when these advantages no longer exist and the numbers are not as positive. At this point we don't see any compelling reason to divert from our actively managed offering, however if the facts change, our strategy may also have to change.