UniSuper

September 2014

# Investment Market Update

*Australian shares were able to reverse early losses and post a modest positive return in August, although were unable to keep up with global counterparts given Australia's large exposure to relatively weak resource stocks. This month we summarise some of the positives and negatives to come out of the August 'reporting season' (reporting of company financial results). We also outline some of the implications of the significant changes recently implemented to our two sustainable investment options.*

## Performance of key markets

| | % CHANGE | | | | |
|---|---|---|---|---|---|
| | MONTH | FYTD | 1 YEAR | 3 YEARS P.A. | 5 YEARS P.A. |
| Australian Shares (ASX 300) | 0.6 | 5.1 | 14.1 | 14.0 | 9.1 |
| US Shares (S&P 500) in US Dollars | 4.0 | 2.6 | 25.2 | 20.6 | 16.9 |
| US Shares (S&P 500) in Australian Dollars | 3.4 | 3.5 | 19.3 | 26.2 | 14.5 |
| Asian Shares (MSCI Asia) | 0.1 | 3.7 | 15.1 | 6.6 | 6.4 |
| Australian Dollar (AUD/USD) | 0.6 | -0.9 | 5.0 | -4.4 | 2.1 |
| Australian Fixed Interest (UBSA Composite) | 1.0 | 1.3 | 6.9 | 6.2 | 6.9 |
| Cash (UBSA Bank Bill) | 0.2 | 0.5 | 2.7 | 3.4 | 3.9 |
| **Balanced (MySuper) option*** | **1.0** | **2.8** | **12.9** | **12.6** | **9.1** |

*Returns are for periods to 31 August 2014. 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

## Reporting season: market responds well to higher dividends

In Australia, the local share market was dominated by 'reporting season'. This is when the majority of Australian companies listed on the stock exchange announce their annual financial results (or semi-annual results if the company has a December end of financial year).

This reporting season continued the trend seen in recent years in which growth in the 'top line' (or revenues) of industrial companies remained very subdued. Meanwhile growth in the 'bottom line' (or earnings), was marginally stronger, as companies remain focussed on containing costs.

In some aspects reporting season was a little disappointing. Looking across the whole market, average reported earnings growth of +10.5% was a little bit weaker than expectations for growth of +11.3%. Additionally forecasts of future earnings were downgraded after cautious outlook comments by company management. Reporting season was not all bad news, however. The market reacted positively to a number of companies that were able to deliver bigger dividend payments than expected by paying out a larger share of profits as dividends. Payout ratios in the industrial sector rose from 72% to 75%. Higher dividend payouts can be a double-edged sword. On the one hand, investors benefit from a higher income stream. On the other hand, however, higher dividends imply less retained capital to invest in future growth. Indeed in some cases a higher dividend reflects a company's subdued growth outlook.

Either way, cost cutting has natural limitations, and companies will need to grow top line earnings to sustain dividend growth in the future.

## Changes to our sustainable options effective 1 September

UniSuper offers two sustainable investment options (previously known as socially responsible): Sustainable Balanced, and Sustainable High Growth.

You might recall that our [April 2014 investment market update] flagged some material portfolio changes planned for these options. Those changes described are now in place. The April '14 update followed direct communication to members invested in these options.

So as of 1 September 2014, these two options will exclude companies with significant exposure to alcohol, gambling, weapons, and fossil fuel exploration or production. This will be in addition to the pre-existing exclusion of tobacco companies.

Given the materiality of the changes, the following outlines some of the implications in relation to portfolio construction, and potential performance outcomes.

### *Challenges created by the new exclusions*

As a result of excluding companies that have significant exposure to alcohol, tobacco, gambling, weapons and fossil fuel exploration or production, the potential investment universe naturally shrinks, creating potential problems from a diversification perspective. This is particularly true for Australian shares, as a feature of our market is the domination of large companies in concentrated sectors. To get an idea of the potential challenges consider that the following large companies will be excluded from the new portfolios:

#### *BHP Billiton (BHP) & Rio Tinto (RIO)*

Despite being well diversified mining companies, both BHP and RIO have a mixture of coal, oil and gas exploration and production operations.

#### *Woodside Petroleum (WPL)*

WPL is Australia's largest independent oil and gas company, with liquefied natural gas operations and oil fields throughout Australia.

#### *Woolworths (WOW)*

WOW operates over 300 licensed venues across Australia (including those offering electronic gaming) via the ALH group. ALH is Australia's leading pub operator of electronic gaming machines, wagering, sports betting outlets and KENO. In addition, WOW operates more than 500 retail liquor outlets including the BWS and Dan Murphy's brands.

#### *Coca-Cola Amatil (CCL)*

Although predominantly known for its soft drink brands, CCL is excluded from the Sustainable options due to its exposure to alcohol. The Alcohol, Food & Services business accounts for a significant proportion of CCL's trading revenue.

The market capitalisation of these five companies account for about $380 billion, and there are a number of other (albeit smaller) companies that will also be excluded. While the above companies may be attractive from an investment perspective, they are excluded from the Sustainable options by virtue of their business involvement in the sectors that have been screened out. Given the relatively small and concentrated nature of the Australian market replacing these stocks is not a simple task.

### *Dealing with the challenges*

Two significant changes to portfolio construction are being introduced to mitigate the concentration risks posed by the additional sector exclusions.

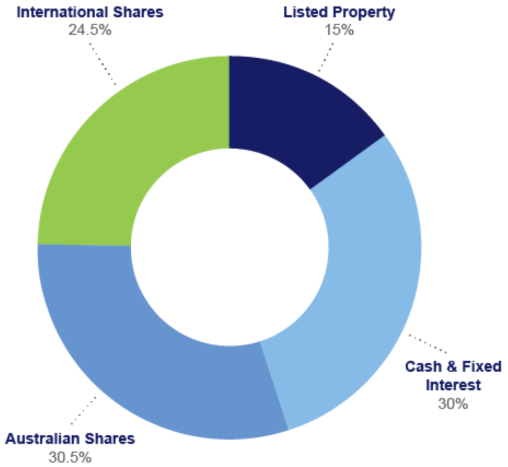
1. The Australian share component of the new options will continue to be based on a selection of companies that have been highly rated in the Dow Jones Sustainability Index. However, the weighting of any individual share in the portfolio will be actively determined by UniSuper's in-house equity team, which represents a departure from the passive index approach previously adopted. Simply applying 'index' weights, as we have in the past, would result in an overly concentrated portfolio.
2. Both options will have a separate allocation to Australian listed property. This sector is dominated with companies such as Scentre Group, GPT and Colonial Retail that tend to hold quality Australian retail shopping centres and office towers.

Note that there will be no change to the portfolio construction of the global share component of both options. This means it will continue to be passively managed as the size and diversity of the market overcomes the concentration risk described above. The cash and fixed interest component of the Sustainable Balanced option will also not change and will continue to include an allocation to 'green' bonds issued by the World Bank.

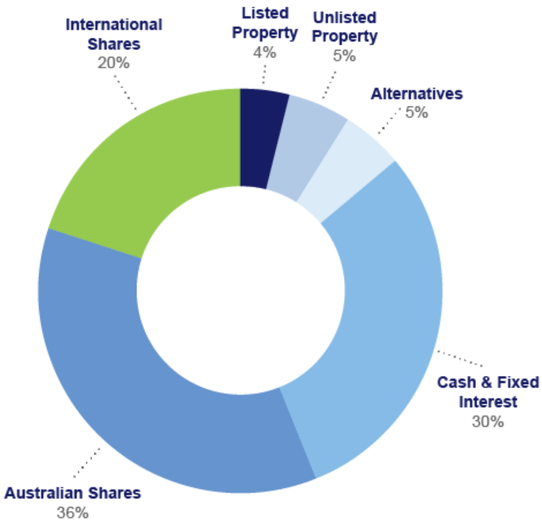
## *Portfolio implications*

The following pie charts contrast the neutral asset allocations of the Sustainable Balanced option to the mainstream Balanced option. Whereas in the past they have been quite similar, there is now a material difference.

### *Sustainable Balanced option*



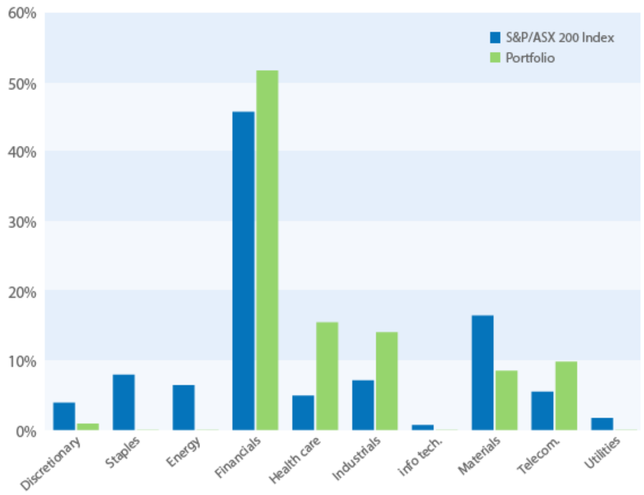

### *Mainstream Balanced option*




*Actual allocations may deviate from the above neutral allocations within approved ranges. Neutral allocations are also subject to change.*

Furthermore, the sector allocation of the Australian share component is also materially different to the general market as the following chart highlights.

### *Sector composition*




As you can see from this chart, the Australian shares portion of the sustainable options now has minimal exposure to energy, information technology, utilities and consumer staples, whilst weighting more to financials, health care and industrial stocks.

## *Performance implications*

Historically, the performance of the Sustainable Balanced option and the mainstream Balanced option were broadly similar as the following table shows:

| | Sustainable Balanced Returns (% pa) | Mainstream Balanced (%pa) |
|---|---|---|
| 1 year | 12.0 | 12.9 |
| 3 year | 12.2 | 12.6 |
| 5 year | 8.2 | 9.1 |

*Returns are for periods to 31 August 2014. Past performance is not an indication of future performance.*

This shouldn't come as a major surprise as the neutral asset allocations for both were broadly similar, and (apart from tobacco) there was no exclusion of specific sectors. That is, the investible universe was broadly the same.

***However, given the material changes outlined above, members should be aware that going forward there is a much greater chance that the performance of the sustainable options will significantly diverge from the performance of their respective mainstream equivalents.***

For example, all things being equal, we could expect the sustainable options to *underperform* the mainstream options if the resource sector outperforms, given the negligible exposure the former has to that sector. Another example; all things being equal, we could expect the sustainable options to *outperform* the mainstream options if the Australian listed property market outperforms, given the relatively high exposure the former has to the sector.

Determining which option will perform better in future is of course impossible. Importantly, the target return for both options remains at CPI + 3% over a seven year time horizon.