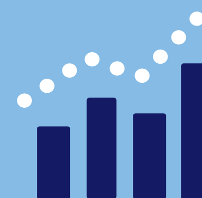
UniSuper

May 2013

Investment market update



UniSuper's Chief Investment Officer John Pearce provides a market update for members.

	% CHANGE				
	Month	FYTD	1 Year	3 Years p.a.	5 Years p.a.
Australian Shares (ASX 300)	4.3	30.8	22.7	7.0	2.9
US Shares (S&P 500)	1.9	19.4	16.9	12.8	5.2
Asian Shares (MSCI Asia)	1.0	13.1	6.1	3.4	0.0
Australian Dollar (AUD/USD)	-0.2	1.3	-0.3	3.7	2.0
Australian Fixed Interest (UBSA Composite)	1.5	3.9	7.0	8.3	8.2
Cash (UBSA Bank Bill)	0.3	2.8	3.5	4.4	4.6
Balanced Option *	**2.4**	**16.3**	**14.4**	**7.4**	**4.4**
Australian Equity Income Option*	**6.8**	**37.2**	**37.0**	-	-

Returns are for periods to 30 April 2013. Returns for the month of April 2013 are estimates and subject to finalisation. 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. Returns for the Australian Equity Income Option include the value of franking credits for the Accumulation investment option. Visit our **Options and Performance** page for performance information on all options.

Almost without exception, global economic data in April was disappointing. Yet, almost without exception, the major global share markets rose. Financial markets appear to be operating on the perverse logic that bad news is good news. That is, poor economic data will strengthen the resolve of central banks to maintain and, in many cases, increase their 'easy money' policies.

The **January market update** pointed out that the strong performance of the equity markets in 2012 was a case of strong financial fundamentals (high liquidity, attractive valuations) outweighing poor economic fundamentals (low GDP, employment growth). The update also suggested that similar conditions could persist in the early parts of 2013 and that certainly appears to be the case.

Over April the Australian share market outperformed most of the major global markets, continuing a trend that was highlighted in the **March market update**. Once more, Australian economic data is hardly encouraging. Unemployment is higher, manufacturing activity is lower, construction is down, commodity prices are weaker, credit growth is stagnant, and so on.

However, the plethora of bad news has resulted in lower bond yields and heightened expectations of a rate cut: bad news = good news. The case for more rate cuts is very compelling. Mining capital expenditure—or capex—falling is a given, however (in my opinion) the Reserve Bank of Australia and economists are likely to be underestimating just how quickly it will fall.

Regardless of what the surveys of capex intentions may be saying, shareholders are demanding cost cuts—and capital returns—and the boards of mining companies are finally listening. Projects in the pipeline that have not already commenced are likely to be shelved indefinitely. Even projects that have commenced are being downgraded in scope. It's hard to see how the non-mining sectors of the economy are going to seamlessly pick up the slack without more interest rate relief and, hopefully, a lower currency.

Can the Australian share market reach its pre-GFC high?

The answer is yes, because we are almost there!

The ASX 300 is the index most widely used by professionals when measuring the performance of the Australian share market (and it moves broadly in line with the oft-quoted "All Ordinaries" index).

As at 30 April the ASX 300 was 5150, which is 25% lower than its pre-GFC high of 6845. Therefore, on the face of it, we still appear to be a long way off the highs.

However, the ASX 300 does not take into account dividends paid along the way, so it understates the total return to investors. This is a particularly important point for Australian investors as our companies tend to pay much higher dividends than their global counterparts.

Depending on what historical time frame is used, it is estimated that somewhere between 60% and 70% of total returns from the Australian market have been from dividends. A high dividend payout ratio combined with the magic of compounding, and it's no surprise that over very long periods Australia has been one of the best performing markets in the world.

This brings us to the ASX 300 **Accumulation** Index, which takes account of dividends paid. As at 30 April 2013, this index was only 4% below its pre-GFC high. So—we are almost there.

THE SEARCH FOR YIELD CONTINUES

In almost all major economies, interest rates are the lowest in recorded history (see last **October's market update**). The paltry returns available on bonds and term deposits have encouraged investors to seek riskier assets offering higher returns. However, this has not translated into a general appetite for all types of equities. Many sectors have lagged as investors specifically seek equities with 'bond-like' characteristics, and a major beneficiary of this trend has been our Australian Equity Income option. This option has returned a phenomenal 37% over the past 12 months for our Accumulation members, after fund taxes and investment expenses and including the value of franking credits for the Accumulation investment option. Bear in mind, though, that the past isn't necessarily an indicator of the future.

UniSuper's Australian Equity Income Option (AEI)

Launched in April 2012, and managed by our in-house team, the AEI is offered exclusively to UniSuper members. As a standalone option the AEI has attracted member flows of $224 million, and the strategy is also employed extensively across the various diversified options in the UniSuper range.

A large asset allocation to the AEI is a major factor underpinning the very strong performance of the Defined Benefit Division portfolio (+19.5% over the past 12 months, after fund taxes and investment expenses), although, again, the past performance is not a guarantee of future performance.

Table 1: Top 10 contributors to the Australian Equity Income option's overall performance (for the 12 months ended 30 April 2013)

	Capital Growth (%)	Dividend Return (%)	Franking Credit (%)	Total Return (%)
Insurance Australia Group	64.4	5	0.8	70.1
Jb Hi-Fi Ltd	60.8	8	1.4	70.0
Westpac Banking Corp	48.1	7	1.3	56.6
Telstra Corp Ltd	39.5	8	1.4	48.7
Wesfarmers Ltd	41.3	5	0.9	47.6
Commonwealth Bank Of Australia (CBA)	39.0	6	1.1	46.4
Woolworths Ltd	40.5	5	0.9	46.2
National Australia Bank Ltd	34.9	7	1.3	43.3
Aust and NZ Banking Group	32.7	6	1.1	39.8
Transurban Group	15.6	5	0.9	21.5

Past performance is not an indicator of future performance. The above table includes the value of franking credits for the Accumulation investment option, not the Pension investment option. Fees and transaction costs are not reflected in the above returns. This is not an endorsement of the above securities for inclusion in personal portfolios. The above securities reflect historical views which were determined having regard to UniSuper's circumstances at the time and may not be suitable for other investors.

The AEI has been designed to deliver a higher yielding portfolio than the broader market, and we are very confident in achieving this objective.

However a higher dividend yield typically involves a trade-off with a lower expected capital return, particularly in the context of a strongly rising market. So the fact that the capital growth of the portfolio has managed to significantly outperform traditional growth stocks has been a surprise.

Consider that over the same 12 months the capital return of BHP was -9%. We expect the companies in the AEI option will, over the long term, generate a high proportion of their total returns from franked dividends. As Table 1 shows, over the past 12 months dividend returns have been totally swamped, and this should be seen as a (fortunate) aberration.

REASONS TO BE CAUTIOUS

In the context of a market desperate for assets that yield in-excess of bond and term deposit rates, the AEI still looks well placed, despite having such a strong 12 months.

At current prices the gross yield on the portfolio (assuming the standard 15% tax rate for accumulation members) is about 6.4%. This is comfortably above the overall market yield, and very significantly above bond yields.

If we also compare the dividend yields we are receiving at current prices with the dividend yields received when these shares were at their pre-GFC highs, one could argue there is still some price upside.

For example, Commonwealth Bank (CBA) shares could trade at $80 and still offer a dividend yield higher than pre-GFC levels. Furthermore, the pre-GFC the dividend yield of the CBA was well below bond yields, and by contrast is comfortably above them today.

Bear in mind also that the rally in share prices were off levels that, with the benefit of hindsight of course, look ridiculously cheap. In April 2012 for example, CBA shares were trading at around $51 (currently $73), and Telstra at around $3.40 (currently $5.00), equating to gross yields of 10% and 12% respectively.

So as recent as 12 months ago, the market was effectively pricing in expectations of a significant deterioration in the profitability of both companies. The point is that the very large capital gains we have recently witnessed, does not necessarily imply a share is too expensive, if the starting point was too cheap.

Against the above supportive factors one should be cautious for the following reasons:

- The yields currently on offer are predicated on the assumption that dividends will not be reduced. While the companies in the AEI portfolio are in excellent shape they are not immune to deteriorating economic conditions. The major Australian banks, in particular, are leveraged to general economic conditions and a recession in Australia would lead to impairments in their loan books and capital position. Under such a scenario dividends could be cut (or more capital could be raised which effectively dilutes the yield). This is not our base case scenario, but nevertheless needs to be considered as a possibility.
- Comparing dividend yields to bond yields as a basis for investing in equities is a rational process in normal circumstances. It makes sense to value a risky asset against the benchmark of a risk free asset. However one needs to be mindful of the abnormally low level of bond yields that many would argue are artificially and unsustainably low. A sharp sell-off in the bond market could result in an underperformance of the AEI. This risk would be somewhat mitigated if the selloff in bonds was in response to stronger economic conditions, which tends to support dividend growth.

Even in the absence of a cut in dividends or a selloff in bonds, one should be realistic with respect to the prospects of the AEI to repeat the type of return experienced over the past 12 months.

While mathematically possible, it's highly improbable that defensive, high yielding, blue chip companies could deliver capital returns of around 40% in consecutive years.

As is the case with all my investment market updates, the above should not be construed as advice to invest in this option or to redeem. It simply points out the drivers behind what has been an exceptional 12-month performance, and hopefully manages the expectations of anyone who expects a repeat performance.

This is not intended to be an endorsement of any of the listed securities named above for inclusion in personal portfolios. The above material reflects UniSuper's view at a particular point in time having regard to factors specific to UniSuper and its overall investment objectives and strategies.

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This information is current as at May 2013 and is based on our understanding of legislation at that date. Information is subject to change. To the extent that this fact sheet contains information which is inconsistent with the UniSuper Trust Deed and Regulations (together the Trust Deed), the Trust Deed will prevail.

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