CSC Annual Member Meeting 2022: CIO Presentation, Alison Tarditi

Introduction by Peter Jamieson, Chief Customer Officer: Before I hand over to Alison Tarditi, I just wanted to reflect once again on a comment that Garry made about the difference between our two types of superannuation schemes that you are members of. The first is our defined contribution schemes, PSSap, ADF Super and CSCri which are highly impacted by three key things: your contributions, the investment returns that we generate on those contributions and the composition of the portfolio that we use to generate those returns which is all about risk and how our team led by Alison manages that risk on your behalf. So Alison's comments are going to be highly relevant to customers of our defined contribution schemes.

The second type of scheme we operate is our defined benefit schemes and I've already spoken to a number of you who are members of those schemes. They are of course linked predominantly or primarily to your final average salary and your defined benefit multiple which is comprised of your years of service in the scheme. So, they are not impacted by investment returns but if you have one of our - and that is PSS - but if you have one of our hybrid schemes, then you have a bit of both. You have a defined benefit and you also have an element predominately your own contributions which is impacted by investment returns and so Alison's comments will be relevant to those customers. So, I just wanted to make that clarification both for those in the room and those online tonight, the difference between our three types of scheme. And with those comments, I'll now pass over to our Chief Investment Officer, Alison Tarditi. Thank you, Alison.

Alison Tarditi: Thanks Peter. Good evening and let me add my welcome to that of our Chair, Chief CEO, sorry, and our Chief Customer Officer. Welcome in particular to the two youngest customers as I look around the room that I can see at the back of the room. You're never too young to start investing.

Now my investment team is small, specialised and really laser-focused on delivering all of you a comfortable retirement outcome. So, I'm really pleased to be able to have the opportunity to share some of our thinking with you this evening. Now as Peter noted, again my comments are most relevant to our defined contribution schemes. However, for others of you in the room who may have savings outside of super, I hope that my comments on our investment landscape are of some value to you also.

Now we invest according to enduring principles that have really defined our guardrails since the outset. But I'm mindful again as I look around the room of Voltaire's comments who said the secret of being really boring is to say everything. So, with that in mind, I won't cover all of our principles. I have tried to focus on just four of the most important of those to try and give you some insight and to illustrate how we translate our investment insights into captive value for you.

Now it will come as no surprise to you at all I think that paramount amongst our principles is that of risk control. In rising markets taking higher risks can certainly result in above average returns but those excess returns can evaporate quickly when the good times turn bad and that's what this slide tries to illustrate. We're really focused on what lies under the surface, the things that you can't see.

Investment performance that fluctuates between top 10 results in great years and bottom 10 results in bad years makes your retirement date very risky. By prioritising loss prevention and stewarding our portfolio assets

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conscientiously, the outcomes to all of our customers will be superior we believe because they'll be more dependable. The results of our risk controls are observable consistently in all of our products, so let's look at our default product, the My Super option. As this slide tries to depict, the past decades increasingly speculative market place has resulted in a wide range of returns for balanced funds. Our My Super product has returned around the median of those available in the market place. Strong in absolute return terms at around 7.4% per annum but not the best available.

Now when you consider the risk of losses that you have to continue to bear in order to achieve those returns by retirement, something that's independently assessed by super ratings, our performance as you can see in this chart is consistently above that of the median fund. It's this relative ranking that is the better indicator of the quality and reliability of your investments and thereby your retirement outcomes. But this discipline requires a strong stomach in more speculative markets where our returns might look less exciting relative to those of others whose risks have yet to surface. Undercompensated risks only become evident when market prices revert to their fundamental values as they're doing right now.

In these periods historically, we've preserved between 30% and 40% more of your savings than the median fund has been able to when equity markets fall precisely because of our risk control processes. And official comparisons today are even more complicated because different funds treat private asset values very differently. League tables have likely understated our performance relative to other funds over the past 12 months because when the price of companies and infrastructure assets fall on publicly listed markets, we objectively and systematically revalue their unlisted counterparts in our portfolios. Many other funds only revalue their unlisted assets when they receive information from their managers with a considerable lag. You may have seen this referred to in public commentary about regulatory investigations of some funds because of this activity.

Our approach, which has been consistent, provides transparent and fair outcomes to all of our customers, whether you're retiring soon or have many years to go.

Our second principle recognises the power of diversification and specialisation to life stage because we believe this offers the surest path to the results that you need both at the beginning and the later stages of your life journey. Almost 20% of our defined contribution customers, PSSap and ADF customers, have actively chosen one of our life stage options and for those of you who have not made these choices, I do encourage you to talk to your financial planner because this is one of the most important determinants of your retirement outcome. For our younger customers or those happy to take a higher investment risk, our aggressive option is a consistently strong performer. You can see that, I hope, in this chart which replicates the discussion I took you through for our default option. Our aggressive option accepts higher volatility compared to our balanced fund but only from targeted risks that we expect you to be compensated for taking while avoiding unintended risks and diversifying to reduce the impact from risks that simply cannot be avoided. The result is strong relative returns regardless of market direction.

For our older customers, or those preferring to take less investment risk, our income focused option purposefully targets a lower level of risk compared to both the balanced and aggressive options but still delivers very strong performance. So, you can invest, we hope, with confidence knowing that your savings are both safe but also

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growing over time because we wish you all a very long and active life post-retirement. So, you want those savings to continue to work for you.

Our third principle respects the very important difference between risk and genuine uncertainty. Now investment risk, back to that boring category, is generally discussed in statistical terms. You will see, for example, that all superfunds must state their expectations for the number of negative years that options are probably going to experience out of every 20. That's very probabilistic. But uncertainty, far less boring, is also much less black and white and in my view, that is the real risk because it involves surprises and unknowable outcomes.

Now soothsayers and stargazers predict investors prepare a far less glamorous role unfortunately for me but considerably a much more reliable service. So, instead of forecasting macroeconomic outcomes, we analyse the performance of your portfolios under multiple different but plausible future scenarios to find their vulnerabilities and then to proactively address them. We believe this is the best way to achieve consistently excellent and dependable long term performance. Remember that over the six or seven decades of economic, political and market cycles that make up your working and retirement lives and to which your savings are exposed, much can change. I suspect we all need a little reminding of that after the past two and a half years of pandemic induced lockdowns all around the world accompanied by economic and social adjustment never experienced, at least in my lifetime.

Now for the 40 years before 2020, we had relatively stable and positive economic growth and low inflation. They were called the Goldilocks Era. Globalised supply chains could always find lower cost substitutes to meet our demands in an integrated competitive but relatively peaceful planet. These conditions seem to imply an increasingly low risk world and financial markets responded [rationally] by valuing financial assets at ever higher prices. But that equilibrium has now broken. You can see that central banks in this chart are now withdrawing liquidity and today, as we enter the final quarter of 2022, exactly what lies ahead is not clear to anyone, including our own policymakers which is why their commentary is continuously changing.

Now you might recall this next graphic. I showed this at last year's annual member meeting. Our view then was that risks were building, with inflation a particularly underappreciated threat. This was not a consensus view then either within the investment or central bank communities and despite that, and as I noted at the time, we resisted the fear of missing out in public equity markets. In our view they were no longer supported by the pathways realistically available to policymakers. Instead we gradually added to your inflation protection because it was recognised by us as a persistent risk to your savings and we invested before that persistent risk was recognised by others and these assets became expensive which is what they are today.

Now it's difficult for any portfolio anywhere in the world to generate a strong positive real return through an extreme inflation spike and a sharp rise in interest rates central banks are using to try to combat it. But inflation resilience can be built gradually to reduce the erosion in purchasing power of your savings over the long term and that was our priority for you last year and the year before that. Your portfolios today contain numerous assets with revenues that are contractually linked to inflation via high creditworthy counterparties and that last point is important - highly creditworthy counterparties. Characteristics designed to grow your savings sustainably and to protect their real value and the real value of your retirement income.

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Now I can only show you a brief few examples, again mindful of being boring, on this chart. But our August 2021 acquisition of an interest in Amplitel, which is Australia's largest telecommunications tower infrastructure provider, is a case in point. Amplitel's revenues benefit from decades long inflation linked leases and its capital value can grow with the roll out of 5G and mobile data demand that is expanding at more than 20% per annum.

Our fourth principle, and the last one that I'll discuss with you this evening at least, is to leverage our unique comparative advantages to access opportunities that individual retail investors usually can't. Now I think we all appreciate that public markets are very efficient at processing financial information because they have a large number of participants including in an increasing rate superfast computer algorithms with access to very big databases. We prefer to focus where our knowledge and operational advantages enable us to access opportunities beyond the range of individual investors and where markets are far less efficient at pricing value.

As well as assets with inflation linked cashflows that have already mentioned, we take a proactive interest in assets and businesses that are well positioned to benefit from long term productivity and secular trends. This makes your savings much more resilient to fluctuations or disruptions in economic activity and growth that are cyclical. Examples include private digital assets like broadband fibre internet providers across the United States, the Netherlands and also back home here in Australia via Unity Group. Datacentres like the Canberra datacentres originally based in Canberra and now with extensions across Australia and across the Strait into New Zealand. This investment has achieved exceptional growth performance of 46% per annum since we acquired it back in 2016. We've more recently made additional complementary datacentre investments in Asia and the US to leverage what is now a domain expertise for us and take further advantage of the unremitting advance of digitalisation.

Now I think we all know that investing is competitive. So the best returns come from identifying opportunities well before others do and we recognised the needs of energy transition early, investing first in windfarms. As these assets appreciated strongly as others recognise their value and our domain expertise increased, we've been able to recycle that capital into higher returning development platforms, platforms that build new renewable assets across solar, wind, biomass and hydro. These businesses are valuable to your retirement outcomes because their financial returns are largely insulated from short term economic conditions. Instead their cashflows benefit from long term power purchase agreements or regulated inflation linked tariffs. But they're also impactful in the world beyond your portfolios because they're adding to the stock of renewable assets, not just trading existing ones. Even Bill Gates now argues that what matters most for environmental improvement is not so much what you don't invest in but rather what you do invest in.

We also partner with skilled specialists like Blackstone Life Sciences to invest in promising new medical innovations. Again, activities that are resilient to business cycle dynamics and impactful in the real world beyond finance. Anthos Therapeutics is just one example. Its development of novel anti-coregulation medication is relevant to improving the lives of a large population of patients with a broad range of cardiovascular and metabolic diseases. I encourage you to take a look at our website for further examples of the health collaborations we're making. I'm most proud of these.

There are many other aspects to your portfolios which I don't have the time to take you through. For example, we build new investment management businesses so that you can own the engines that generate your active

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public market returns. This means you all share in the revenue of those managers as they manage money not just for you but for investors all over the world.

The point is this: diversified sourcing of real returns does not mean that we can completely avoid negative return years or deliver you the highest return when public equity markets are running super-hot. But it does mean that we're able to improve the resilience of your savings so that both inflation and recession risk matters less, so that the buffer compounded through good years that you can see across each of our options sustains to and through retirement.

Now today's primary economic challenge a question I get asked more than many is no longer inflation risk, it might surprise you to hear me say that. But that's because inflation risk has now been recognised. The open question that remains is where the developed market policymakers can combat that inflation the highest rate across the developed world since the 1980s without requiring deep recessions or triggering financial crises. US inflation at over 8% per annum as it is today is currently four times their central bank target and unemployment, a reasonable indicator of the strength of future demand, remains at an historical low despite 3.75% point rises in the US policy rate over a very short six month period.

Now exactly how rising interest rates interact with historically high levels of post-pandemic debt across the developed world, political instability arising in my view from the hollowing out of the middle classes across much of the developed world and financial markets are customed to, actually addicted to, excessively plentiful low cost capital and low economic volatility is all genuinely uncertain. Geopolitical fracturing and changes in the structure of our economies to incentivise the shift away from fossil fuel dependency are additional new challenges. Energy is complex because it is a foundational input into societal function and the critical issue around that is that demand cannot adjust easily, costlessly or quickly. Instead the most expedient route that is being taken is through skyrocketing prices to ration use. That's a regressive process that has to continue until the availability and affordability of substitutes is achieved. Hence our investments into renewables development and innovation platforms and the inflation proofing assets that we've been investing in for you for more than three or four years now. As our third principle you might recall guides, markets don't like uncertainty.

So, there are complex and unusual risks around the outlook for financial assets and for world growth. As policymakers balance on one hand the costs of temporary recession and the structural change in our energy system with on the other hand the costs of unchecked and broad-based inflation that will erode living standards permanently. Uncertainty itself creates its own dynamic. But there's also a plethora of innovation occurring. It's occurring across health, new energy storage and transmission, digital security, robotics, automation, water and waste reduction to name just a few and I've tried to take you through some of the examples in your portfolios that are working in these areas. There's every chance that one or more of these will be genuinely disruptive enabling the world to leapfrog some of the challenges that today feel insurmountable. As I've tried albeit briefly to example to you this evening your capital importantly managed for the risks of doing so is working precisely to enable this and that's not boring at all.

The big picture I leave you with is that we have entered a very different environment. Investing requires us to put your capital at risk to earn a return sufficient to generate you a comfortable retirement. But the market conditions of the past, in particular the past two decades, masked many of the risks that were accumulating

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under the surface. Decision making will be, or at least should be, much more disciplined now that risks are clearer and present for established businesses, for entrepreneurs, for governments and for investors. In this world, as I cautioned last year, it is more important than ever to focus on risk adjusted returns. That simply means focus on the iceberg, not the tip to paraphrase Paul Keating.

The paper returns reported by any fund at any point in time are no guarantee of a comfortable retirement outcome and there I'm paraphrasing someone I really admire, my mum. But it is also a world in which we're able to play to our demonstrated investor strengths building and stewarding portfolios that prioritise two things: the avoidance of permanent capital loss so that your savings are not running to stand still and secondly, the early provision of capital to future fit companies with secular tailwinds so that your savings benefit from those who are running to catch up. As I said before, I won't pretend that it's possible to avoid losses through a period of high inflation or its corollary a recession should that come to pass. But your investments are fit, they are high quality and they are able to recover fully and strongly. And we will be scanning for opportunities to reinvest your cash buffers as high quality assets see their prices fall below fundamental value and we can once again step into purchase them with confidence.

We remain focused on ensuring that our defined contribution customers achieve a comfortable financial outcome in retirement, something our defined benefit customers are assured. Now it's been impossible for me to do justice to all that I'd like to cover in the time allotted to me this evening but I do hope, as my colleagues do, to be able to address the issues that are important to you or that are worrying you at this point in time through our question time. So, thank you for listening.

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