

Perpetual Investment Funds

PERPETUAL DIVERSIFIED REAL RETURN FUND - CLASS W

30 September 2022



FUND FACTS

Investment objective: The Fund targets a pre-tax return of 5% per annum above inflation (before fees and taxes) over rolling five-year periods. The Fund aims to provide investors with exposure to a balanced portfolio that is constructed with reference to risk premiums (risk contribution to the overall portfolio) rather than capital allocations

Inception date: October 2010

Size of fund: \$800.0 million as at 30 September 2022

APIR: PER0556AU

Management Fee: 0.85% pa ^^ Refer to PDS for Management Costs

Investment style: Diversified risk budgeting, active, value

Suggested minimum investment period: Five years or longer

FUND BENEFITS

Provides investors with access to a broadly diversified portfolio that weights asset classes according to their overall risk contribution to the total portfolio rather than capital allocations.

Provides a more efficient portfolio that seeks to reduce the uncertainty of investment outcomes and protect returns against inflation.

FUND RISKS

All investments carry risk and different strategies may carry different levels of risk. The relevant product disclosure statement or offer document for a fund should be considered before deciding whether to acquire or hold units in that fund. Your financial adviser can assist you in determining whether a fund is suited to your financial needs

FEE OPTION

Class W is the standard fixed fee class

TOTAL RETURNS % AS AT 30 SEPTEMBER 2022

PERFORMANCE	1 MTH	3 MTHS	6 MTHS	1 YR	3 YRS PA	5 YRS PA	INCEPT PA	VOLATILITY [^]	3 YRS PA	INCEPT PA
Perpetual Diversified Real Return Fund (Gross)	0.2	1.2	-0.1	0.0	4.4	4.9	6.6	Perpetual Diversified Real Return Fund	3.7	3.3
Perpetual Diversified Real Return Fund (Net)	0.2	1.0	-0.5	-0.9	3.6	4.0	5.7	Mercer Balanced Growth Median	11.1	7.8

FUND OBJECTIVE OUTCOME AS AT 30 SEPTEMBER 2022

Objective: Gross returns of CPI plus 5% over rolling 5 year periods

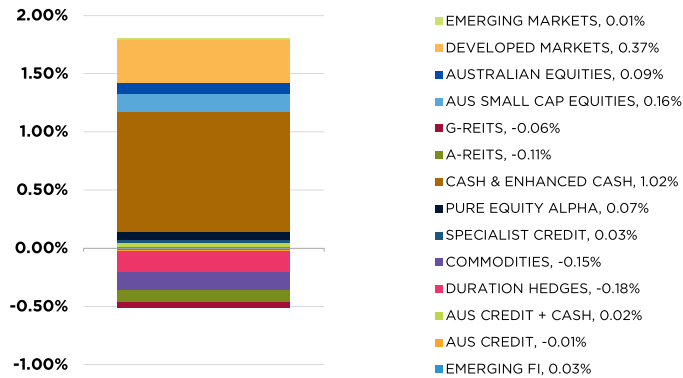
	5 YRS PA	INCEPT PA
Perpetual Diversified Real Return Fund (Gross)	4.9	6.6
CPI plus 5%	7.7	7.5

Past performance is not indicative of future performance.

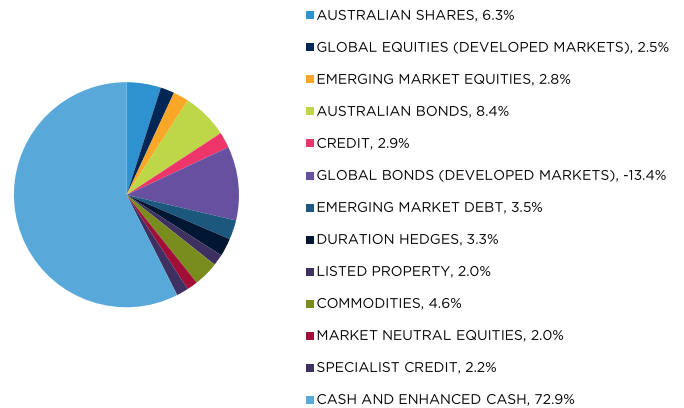
^^ Information on Management Costs (including estimated indirect costs) is set out in the Fund's PDS

[^] Volatility and Mercer Balanced Growth Median data is lagged by 1 month

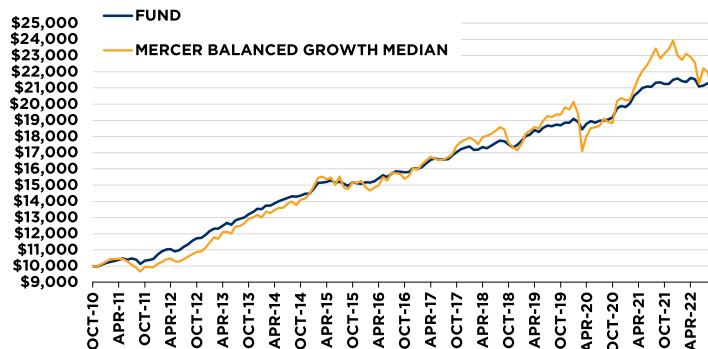
CONTRIBUTION TO 3MTH PERFORMANCE (GROSS)



PORTFOLIO SECTORS



GROWTH OF \$10,000 SINCE INCEPTION



CHANGES IN ASSET ALLOCATION (%)

	3 MTHS	6 MTHS	1 YR
Australian Shares	-0.2	-1.5	-1.7
Global Equities (Developed Markets)	-4.1	-7.4	-16.4
Emerging Market Equities	0.1	0.1	-1.7
Frontier Market Equities	0.0	0.0	0.0
Australian Bonds	1.8	5.0	7.6
Credit	0.0	-3.5	-3.3
Global Bonds (Developed Markets)	-13.4	-13.4	-13.4
Emerging Market Debt	-0.1	-0.4	-0.3
Duration Hedges	3.4	7.6	7.7
Secured Private Debt	0.0	0.0	0.0
Unlisted Property	0.0	0.0	0.0
Listed Property	-0.2	-1.7	-1.8
Commodities	-3.2	-1.2	1.9
Market Neutral Equities	0.0	0.0	0.0
Infrastructure Debt	0.0	0.0	0.0
Other Investments	0.0	0.0	0.0
Specialist Credit	0.0	0.1	0.1
Cash and Enhanced Cash	16.0	16.2	21.4
Alternative Beta	0.0	0.0	0.0

FUND PERFORMANCE

The Diversified Real Return Fund returned 1.2% (gross) in the September quarter. Over the past year, the Fund has returned -0.0% (gross) and over the past 5 years the Fund has returned 4.9% (gross) per annum compared with the objective of 7.7% (CPI plus 5%*) over rolling 5 years. Since inception (in 2010) the Fund has returned 6.6% (gross) per annum compared with the objective of 7.5% (CPI plus 5%*).

Through another very challenging quarter for financial markets, the Fund's defensive positioning performed well. The Fund's low equity allocation, low duration, elevated cash position and use of downside protection have all contributed throughout a torrid year for equity and bond markets.

The Fund's small global and Australian equity allocation detracted from return as global equity market sold off on recession concerns and aggressive central bank tightening. This was offset by the strong performance of the fund's equity put options which contributed to performance as US and European equities fell.

The Fund's elevated US dollar exposure contributed significantly to returns during the quarter as the greenback strengthened substantially against global peers on both safe haven and increased yield differentials. Alongside direct US dollar exposure, the Fund's USDCNH call options and Australian dollar put options also contributed.

The Fund maintains a small exposure to US and Australian bonds which detracted from performance during the quarter as yields rose on hawkish central bank commentary. The Fund's allocation to commodities and Real Estate Investment Trusts also detracted slightly from absolute returns.

*All groups CPI measured and published by the ABS as at June 2022

1. RETURN SEEKING ASSET CLASSES

Beginning of the Quarter: Low Allocation

End of the Quarter: Low Allocation

The current financial market outlook presents a challenge for generating attractive real returns with equity valuations still relatively high. Interest rates are still under considerable upward pressure given the inflation backdrop, and recession risks are rising. As a result, the Fund maintains its very cautious approach to return seeking assets.

The Fund has exposure to a diversified range of growth assets across asset classes and markets including:

- In equities, global equities with a value style bias as well as exposure to emerging markets and Australian equities;
- Global and Australian listed property; and
- Australian credit and emerging market debt;

2. DIVERSIFYING OPPORTUNITIES

Beginning of the Quarter: Medium Allocation

End of the Quarter: Medium Allocation

With equity valuations facing challenges and the Fund's cautious positioning with regards to return seeking assets, diversifying opportunities remain a key focus.

The Fund retains:

- A range of FX exposures including the US dollar and some emerging market currencies.
- Stock selection alpha (through the Australian Share Fund, Australian Small Cap Fund and Global Share Fund). The equity holdings are concentrated in high quality 'value' companies. This positioning performed well throughout the recent rotation from growth towards value. This trend is expected to persist as central banks continue to tighten monetary policy and as economic and corporate profit growth slows.

3. DOWNSIDE PROTECTION

Beginning of the Quarter: Medium Allocation

End of the Quarter: Medium Allocation

Equities face significant headwinds in the form of tightening financial conditions and slowing economic growth. We continue to manage these risks by limiting exposure to the most expensive parts of equity and credit markets.

Notwithstanding the dramatic selloff in bonds throughout 2022 yields remain low relative to historical levels and the Fund remains very selective in investing in fixed income and credit. During the quarter, the Fund's US and Australian duration was further increased, partially offset by the addition of a small short (negative) position in Japanese bonds. Nonetheless, the Fund retains its elevated cash position which provides downside protection.

The Fund maintains some downside protection via put options on US and European equities. During the quarter, the Fund added a call spread on the VIX index which benefits from higher US equity volatility. The Fund also utilizes currency options to protect against 'tail risks'. The Fund retains a call option on the USD versus the CNH, given a weaker CNH could cushion the economy as China attempts to address its numerous economic challenges. The Fund maintains a US\$HKD call option as a low-cost downside protection.

4. INFLATION PROTECTION

Beginning of the Quarter: Low to Medium Allocation

End of the Quarter: Low to Medium Allocation

Direct inflation hedges are quite expensive at present, but the portfolio has a low (direct and indirect) sensitivity to higher interest rates which will assist its resilience as monetary policy is tightened in response to persistently high inflation.

The portfolio also maintains a small allocation to a basket of commodities which historically perform well in inflationary environments. The Fund's commodity exposure is diversified across gold, softs, silver, palladium, platinum and copper. During the quarter, a small uranium position was added recognising the looming energy transition in Europe.

MARKET COMMENTARY

Global financial markets saw elevated volatility over the September quarter as a strong rally gave way to a sharp selloff predicated on hawkish central bank rhetoric and elevated global recession risk.

- US equities (-4.9%) gave back all their gains made in the June-July rally with September being the worst month for US stocks since the start of the pandemic.
- Australian equities (+0.4%) outperformed global peers, supported by robust corporate profit results, a lower currency and a less hawkish central banks.
- Emerging market equities (-8.0%) underperformed, led by China (-21.6%) which was impacted by moderating global demand, strict COVID protocols and the worsening property crisis.
- European equities (-3.7%) fell as the energy crisis intensified, while UK equities (-1.1%) were resilient despite turmoil in British bond and currency markets.
- Developed market bond yields rose substantially as monetary policy expectations were recalibrated yet again, giving back all their gains since June. Benchmark 10-year yields in the US rose by 82 bps, Australia by 23 bps and the UK soared 143 bps as a result of an unfunded fiscal expansion by the new British government.
- The US dollar powered to 20 year highs against a number of global peers on recession concerns and aggressive monetary policy tightening.

We maintain our view of the key pressures currently weighing on the market outlook.

- Even though equity valuations have improved this year, they remain expensive on many metrics.
- The transformation of the monetary policy outlook has caused a nasty bear market in government bonds and much tighter liquidity conditions.
- A slowdown in economic growth with elevated recession risks in the US and Asia and acute recession risk in Europe contributing to a likely sharp slowdown in profit growth.
- Growing geo-political risks in Europe due to the Russia/Ukraine war and in Asia reflecting a much more assertive China and heightened tensions over Taiwan's future.

The US Federal Reserve (the Fed) has a far more challenging task to bring inflation under control while avoiding recession. The Fed's tightening cycle thus far has been the most aggressive in 40 years. Alongside rising rates, financial conditions are set for further tightening in the months ahead as the Fed accelerates the reduction of its balance sheet by selling treasuries and some of its mortgage back securities. Recession indicators mounted during the September quarter with the US yield curve inverting between the 2 and 10 year tenors. At the same time, July saw the confirmation of a technical recession in the US with two successive quarters of marginally negative GDP growth, although private sector demand remained solid, with the consecutive contractions driven by small parts of the economy such as net exports and inventories.

With the US inflation driver switching from higher commodity prices to tight labour markets, the US Fed has refocused its strategy putting employment at the core of their plan to reduce inflation. Notwithstanding slight reduction in payrolls over the quarter, the labour market remains very tight relative to pre COVID levels. At quarter end, the unemployment rate of 3.5% was within striking distance of the lowest level in 50 years.

Thus far, central bank rhetoric and action has been determinative for asset valuations while having less impact on employment and demand. Hawkish commentary from Fed Chair Jerome Powell at the annual Jackson Hole Economic symposium during the quarter precipitated a sharp fall in equity valuations. Powell seemingly ruled out a short-term pivot of Fed policy given the inflation backdrop and warned of "some pain" while maintaining the aggressive monetary policy tightening which roiled markets in the first half of 2022. Financial markets are also proving very sensitive to shifts in the economic outlook through the prism of the implications for interest rates. Stronger than expected August PMI data saw risk assets selloff sharply as the market priced in a more aggressive Fed.

We remain concerned about the outlook for economic growth and profits. The leading indicators suggest that recession risks remain elevated as the Fed attempts to get inflation back under control. But monetary policy operates with long and variable lags and the tightening cycle has a long way to play out. As a result, tighter financial conditions will continue to be required, implying higher bond yields and credit spreads and weaker equity markets and a continuation of the strength in the US Dollar. The combination of tightening financial conditions and slowing or negative growth also highlights the risk of zombie companies; heavily leveraged unprofitable firms that have only survived due to the incredibly low interest rates over the past decade.

While we highlight the actions of the Fed as the most crucial determinant of the market outlook, other major central banks have also embarked on aggressive tightening programs. The European Central Bank (ECB) raised interest rates by 125bps during the September quarter, representing the first increase in 11 years. Meanwhile, the likelihood of a deep European recession continues to increase against a backdrop of an ongoing energy crisis. The ECB faces a diabolical predicament, and the risk of policy error is high as the bank wrestles with the prospect of double-digit inflation, an energy crisis and a sharply slowing economy. Meanwhile, UK financial markets were in turmoil during September. Following a change in leadership, the British government embarked on an unfunded fiscal expansion which saw UK GILTs selloff dramatically. Sterling also plummeted which forced the Bank of England to temporarily cease its policy tightening to buttress the broader financial system.

Meanwhile, the Reserve Bank of Australia (RBA) continued its aggressive tightening cycle, having increased the target cash rate by 250bps between May and early October. Inflation remains the key concern for the RBA with trimmed mean inflation – the RBA's preferred measure – rising to 4.9% yoy in the June quarter, remaining well outside the target range (of 2 to 3%). While surging inflation will provide little comfort to the central bank, the print came in short of estimates and saw monetary policy tightening expectations wound back somewhat as a result. The RBA has a somewhat more favourable predicament – relative to the US and Europe – as inflation and wages growth are lower. The RBA also has a more powerful

mechanism to address household spending as a result of highly leveraged household balance sheets which have greater sensitivity to policy rates given the prevalence of variable rate mortgages. While the Australian economy looks robust thus far, the RBA also has a delicate balance to maintain.

CURRENT POSITIONING

Tightening financial conditions, very high inflation and slowing economic growth are a challenging environment for investors to navigate. High equity valuations were only supported while bond yields stayed low as inflation was contained. Equity valuations have adjusted (although there could be more to come), but now profit expectations need to be lowered to more closely aligned with the economic backdrop.

The portfolio remains well positioned to defend capital in an extremely uncertain environment. The current asset allocation ensures that no individual position or cluster of positions will risk the medium-term investment objective in one of the likely scenarios presented by the central bank tightening cycle.

- In a persistent inflationary environment, the portfolio's relatively low duration, quality and value biases and long volatility positioning would be expected to significantly outperform conservative funds.
- In a 'Goldilocks' scenario, where the central bank response succeeds in returning inflation to long term target levels without a recession, we expect the portfolio's equity exposure would perform well.
- In a deflationary environment, where central bank actions slow the economy too sharply, the portfolio's long volatility and elevated cash positions would defend capital and provide the ability to add exposure to equities and other growth assets at attractive valuations.

For the Return Seeking part of the portfolio, our focus remains on investments that can generate CPI plus 5% per annum over a five-year horizon. The Fund's equity exposures are low and concentrated in value and quality markets where medium term return prospects are reasonable. This adds to the defensive characteristics of the portfolio, particularly in a rising interest rate environment.

The Fund also employs a range of portfolio protection strategies to defend capital. During the quarter, the Fund added put options on US and European equities which performed well in August and September. The Fund also maintains a USDCNH call option position offering an asymmetric pay off should the authorities in China respond to their growing economic challenges by further depreciating their currency. The People's Bank of China marginally cut policy rates during August and the US dollar appreciated considerably which saw the USDCNH call option perform well.

The sharp selloff in bonds and the rising recession risks through the first half of 2022 have increased the attractiveness of government bonds in some markets relative to post-pandemic levels. The Fund maintains a modest exposure to US and Australian duration. During the quarter, the Fund's US and Australian duration was further increased, partially offset by the addition of a small short (negative) position in Japanese bonds. The Fund also maintains exposure to small parcel of metals and soft commodities which offer inflation protection.

The Fund also retains a very substantial cash allocation reflecting the winnowing out of investments with poor prospects of generating the target return of CPI plus 5% in the medium term. This cash position is balanced to some extent by a significant risk allocation to diversifying opportunities (including equity alpha and currency positions). This cash allocation is held across a broad range of currencies including a significant US Dollar allocation which performed very well during the quarter.

There is also significant optionality in holding cash. For some time, we have been highlighting that this is an extreme environment for the economy and for markets. Notwithstanding the recent weakness in equity markets, valuations remain extended in some parts of the equity market and bond yields remain under pressure. As a result, we want to hold cash to take advantage of attractive investment opportunities in the broader investment universe that we expect to arise in the period ahead.

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MORE INFORMATION

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