

Perpetual Investment Funds

PERPETUAL DIVERSIFIED REAL RETURN FUND - CLASS W

31 December 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: \$834.4 million as at 31 December 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

TOTAL RETURNS % AS AT 31 DECEMBER 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)	-0.4	1.6	2.9	0.9	4.8	4.6	6.6	Perpetual Diversified Real Return Fund	3.7	3.3
Perpetual Diversified Real Return Fund (Net)	-0.4	1.4	2.5	0.1	3.9	3.7	5.7	Mercer Balanced Growth Median	11.4	8.0

FUND OBJECTIVE OUTCOME AS AT 31 DECEMBER 2022

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

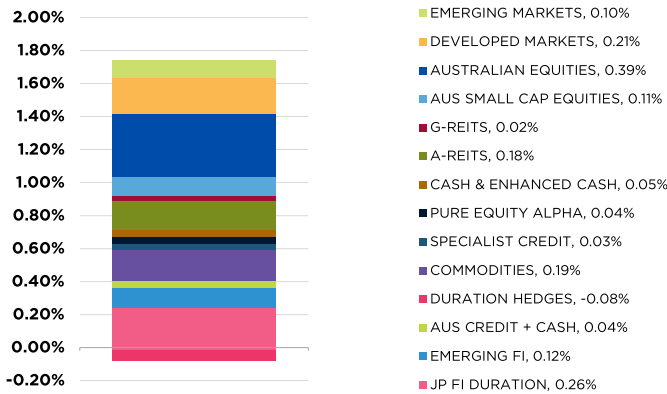
	5 YRS PA	INCEPT PA
Perpetual Diversified Real Return Fund (Gross)	4.6	6.6
CPI plus 5%	8.0	7.6

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)



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.

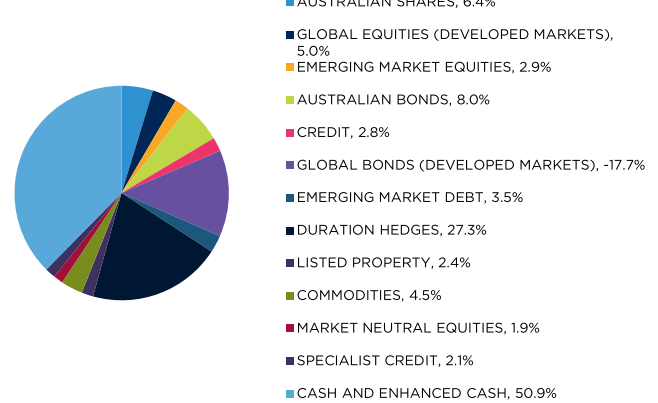
FUND RISKS

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

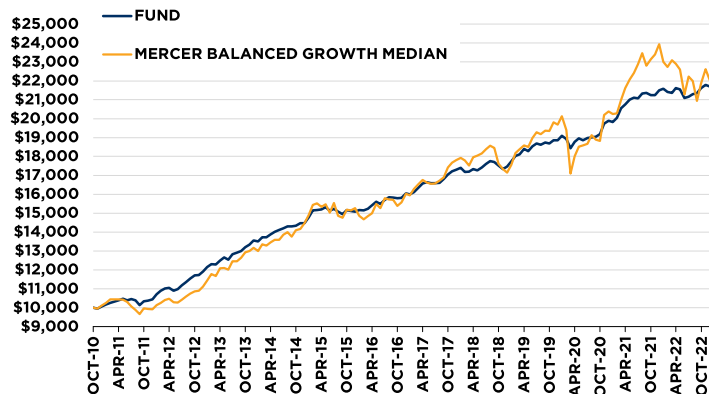
FEE OPTION

Class W is the standard fixed fee class

PORTFOLIO SECTORS



GROWTH OF \$10,000 SINCE INCEPTION



CHANGES IN ASSET ALLOCATION (%)

	3 MTHS	6 MTHS	1 YR
Australian Shares	0.1	-0.1	-1.6
Global Equities (Developed Markets)	2.5	-1.7	-10.2
Emerging Market Equities	0.1	0.2	0.0
Frontier Market Equities	0.0	0.0	0.0
Australian Bonds	-0.4	1.4	7.2
Credit	-0.1	-0.1	-3.0
Global Bonds (Developed Markets)	-4.2	-17.7	-17.7
Emerging Market Debt	-0.1	-0.2	-1.2
Duration Hedges	24.0	27.4	32.1
Secured Private Debt	0.0	0.0	0.0
Unlisted Property	0.0	0.0	0.0
Listed Property	0.3	0.1	-1.5
Commodities	-0.1	-3.3	1.9
Market Neutral Equities	-0.1	0.0	0.1
Infrastructure Debt	0.0	0.0	0.0
Other Investments	0.0	0.0	0.0
Specialist Credit	-0.1	-0.1	0.1
Cash and Enhanced Cash	-22.0	-6.0	-6.2
Alternative Beta	0.0	0.0	0.0

FUND PERFORMANCE

The Diversified Real Return Fund returned 1.6% (gross) in the December quarter. Over the past year, the Fund has returned 0.9% (gross) and over the past 5 years the Fund has returned 4.6% (gross) per annum compared with the objective of 8.0% (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 7.6% (CPI plus 5%*).

The rally in global and Australian equities through the first two months of the December quarter was the key driver of absolute return. Global equity stock selection contributed to performance as the value sectors and securities outperformed their growth peers. However, these gains were partially offset by the Fund's exposure to the US dollar which gave back some of its very strong performance over the past year.

While the Fund's exposures in Australian and US duration were little changed over the quarter, they experienced heightened volatility as safe-haven flows, inflation and policy decisions took their turn driving market trends. However, the Fund's short position in Japanese government bonds was rewarded when the Bank of Japan lifted the cap on its yield curve control measures to 0.5%. Meanwhile, the Fund's exposure to a diversified basket of metals including gold added to performance after China abandoned their zero-Covid-19 protocols and offered increased support to the beleaguered property sector. Elsewhere, the Fund's Australian listed real estate exposure performed well, with the sector regaining a portion of recent losses.

*All groups CPI measured and published by the ABS as at 30 September 2022

1. RETURN SEEKING ASSET CLASSES

Beginning of the Quarter: Low Allocation

End of the Quarter: Low Allocation

The market outlook remains opaque given restrictive policy rates, still solid revenue growth, elevated cost structures, negative real income growth and declining goods price inflation. The largest concern is centred around the US where the cycle is most advanced, policy rates are the most restrictive, valuations remain well above their 20-year average and equity risk premia is at 22 year low. For the world ex-US, the outlook has improved as China walked back its three red line and Covid-zero policies, and gas prices declined in Europe, but the latter has a severe inflation problem which will be met with a policy response.

Accordingly, the Fund, on balance, maintains its cautious exposure to return seeking assets and has a diversified range of growth assets and markets including:

- 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 for risk management and returns. The Fund retains:

- A range of FX exposures including the US Dollar and some emerging market currencies;
- A short 10-year Japanese government bond position which combined with our duration exposures in Australia and US creates a relative yield trade; and
- 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 headwinds from restrictive policy rates whose impact will become evident in 2023, slowing economic growth and elevated cost pressures. We continue to manage these risks by limiting exposure to the most expensive parts of equity and credit markets.

Despite the dramatic selloff in bonds throughout 2022, the Fund remains selective in investing in fixed income and credit. During the quarter, 0.25% of a year of US duration at the 2-year tenor was added to take advantage of the value offered by the sustained flattening and subsequent inversion of the US yield curve.

Meanwhile, the Fund maintains some downside protection via a put option on US equities, and a call option on the USD versus the Hong Kong Dollar (which is a low-cost downside protection for tail risks around China).

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 includes gold, grains, livestock, silver, palladium, platinum and copper).

MARKET COMMENTARY

Global equity markets strengthened through October and November before giving back a portion of recent gains over the last month of the year.

- European equities (14.6%) led the pace of gains in regional sharemarkets with strong advances in Germany (14.9%) and France (12.6%) as well targeted government stimulus and falling gas prices enable the region to perform much better-than-feared which suggested that the expected regional earnings decline may be considerably less than expected.
- US equities (7.6%) peaked in late November as markets anticipated a decline in the pace of policy tightening given softness in lead economic indicators. Among styles, 'value' (12.4%) had another very strong quarter relative to 'growth' (2.2%) which continues to be hindered by the poor performance of large-cap tech stocks.
- Australian equities (9.4%) outperformed as markets responded well to the slowing pace of rate increases from the Reserve Bank of Australia (RBA), and the continued strength of economic data outside housing.
- Chinese equities (12.5%) surged over the final weeks of the year following the abandonment of the government's zero-COVID policy, which was one of two key market unfriendly policies which had been holding growth down.
- Domestic long term bond yields in Australia and US yields were little changed over the quarter after rallying through October and November before rising back above 4% in December.

The path of US monetary policy and pricing of recession risks remained the key considerations for financial markets through the December quarter. Through the first 2 months of the quarter, there was renewed speculation that the US Fed would lessen the pace of rate hikes in order to increase the chances of engineering a soft landing. After the November CPI showed headline inflation declining to a 10-month low, the Fed slowed its pace of tightening with a 50 bps increase at the December meeting which further buoyed equity markets. However, sentiment weakened in the latter half of December after the Fed's updated Statement of Economic Projections suggested an expected increase in the Fed's terminal rate to 5.1% which raised questions about market's expectations about the future rates path. While one can never say a recession is certain the path to a soft landing still appears quite narrow with several leading US recession indicators already pointing to an upcoming contraction. These include the US 2-year - 10-year yield curve slope which is the most inverted since 1981, a negative score on the US Conference Board Leading Index and a sub-50 score on the ISM manufacturing PMI (49.0) which declined to an 18-month low.

Despite looming recession risks, the Fed still has an inflation problem to deal with, and while goods sector inflation has declined faster and further than expected, services inflation (+7.1%Y which is adding 4.0% to headline and core inflation) continued to accelerate. Inflation in this sector is far less sensitive to policy and supply chain issues, and traditionally has only ever materially declined after a negative output gap has led to higher unemployment and lower wages growth. The Fed's policy reaction function now has a sizable rise in US unemployment at its centre, and the US labour market remains very tight with U3 unemployment at a 50 year low of 3.5%, jobless claims anaemic in the low 200ks and job openings relative to idle workers remains very elevated at 1.9.

We also remain concerned about the outlook for corporate profits. While revenues have thus far proved resilient, the impact of the Fed's aggressive tightening on earnings has yet to be fully realised and the Bank has recently accelerated its monthly sales of US Treasuries and mortgage-backed securities, which will drain liquidity from the system that drives higher asset prices. The combination of tightening monetary conditions and slowing or negative earnings growth also highlights the risk of zombie companies (heavily leveraged unprofitable firms which have only survived due to incredibly low interest rates over the past decade) being exposed to market forces.

Australia's path to a soft landing remains more viable than the US. The RBA slowed the pace of interest rate hikes during the December quarter and minutes from the final meeting of the year revealed that the possibility of no increase was discussed for the first time this cycle. The RBA has a more potent mechanism to address household spending given highly leveraged household balance sheets and a large amount of mortgages being at variable rates which are highly sensitive to changes in the RBA's overnight cash rate. At the same time, the economy looks quite solid at present and stands to benefit from Chinese reopening and improved relations between Canberra and Beijing.

The outlook for China has improved materially on the back of a combination of easing COVID restrictions, relaxed collateral and equity issuance standards in the property sector and stimulatory monetary policy. The abandonment of the zero-COVID policy is expected to be very supportive for economic activity following an initial surge in cases. The government also issued a series of measures intended to support the property sector which has languished since 2020, including credit support for highly leveraged housing developers, financing to ensure completion and transfer of projects, and loan assistance for home buyers.

CURRENT POSITIONING

Restrictive interest rates, still elevated inflation and slowing economic growth are a challenging environment for investors to navigate. We maintain our view of the key pressures currently weighing on the market outlook:

- While US equity valuations have improved, they remain above levels which are attractive, given the weakening earnings backdrop.
- Inflation and the tightening of monetary policy has caused a nasty bear market in government bonds and much tighter liquidity conditions.
- A slowdown in economic growth with elevated recession risks in numerous economies is expected to spark a significant fall in profits in 2023.
- Constant 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 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 where central banks put a cap on yields, 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. The sharp selloff in bonds and the rising recession risks throughout 2022 have increased the attractiveness of government bonds in some markets relative to post-pandemic levels. The Fund maintains a modest overall exposure to duration, but that masks a sizable position in US and Australian Government bonds which is partially offset by a short (negative) position in Japanese bonds.

The Fund also maintains exposure to small parcel of metals and soft commodities which offer inflation protection and 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.

Cash-type investments are providing investors with higher returns than has been the case for many years, and 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

Adviser Services 1800 062 725

Investor Services 1800 022 033

Email investments@perpetual.com.au

www.perpetual.com.au

