

# Perpetual Investments

## PERPETUAL DIVERSIFIED REAL RETURN FUND - CLASS W

31 August 2021



### 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:** \$749.8 million as at 30 June 2021  
**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 AUGUST 2021

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)	1.2	1.5	6.4	12.2	6.3	6.1	7.2	Perpetual Diversified Real Return Fund	3.7	3.3
Perpetual Diversified Real Return Fund (Net)	1.1	1.3	6.0	11.3	5.4	5.2	6.3	Mercer Balanced Growth Median	10.5	7.5

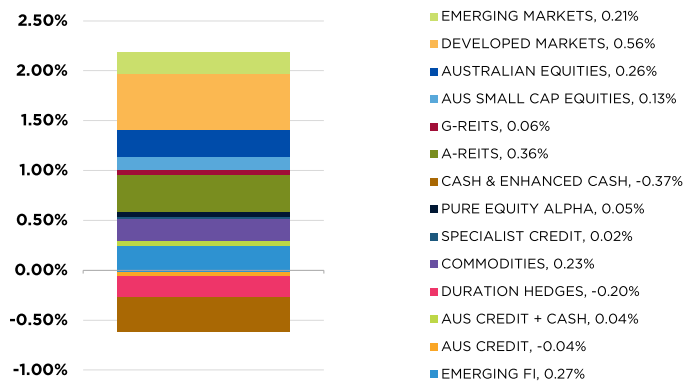
### FUND OBJECTIVE OUTCOME AS AT 31 AUGUST 2021

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

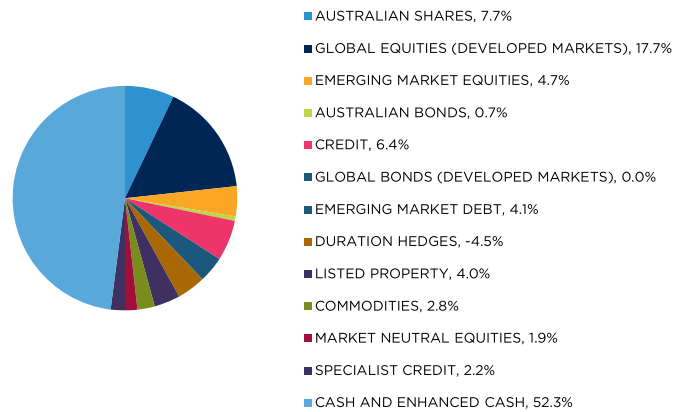
	5 YRS PA	INCEPT PA
Perpetual Diversified Real Return Fund (Gross)	6.1	7.2
CPI plus 5%	7.0	7.1

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

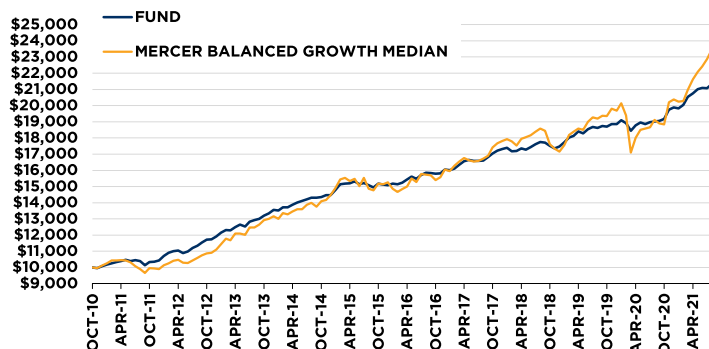
### CONTRIBUTION TO 3MTH PERFORMANCE (GROSS)



### PORTFOLIO SECTORS



### GROWTH OF \$10,000 SINCE INCEPTION



### CHANGES IN ASSET ALLOCATION (%)

	3 MTHS	6 MTHS	1 YR
Australian Shares	-2.0	-2.7	0.8
Global Equities (Developed Markets)	-4.4	-1.3	4.4
Emerging Market Equities	-2.3	-2.6	1.3
Frontier Market Equities	0.0	0.0	0.0
Australian Bonds	0.4	-3.9	-7.3
Credit	-0.6	-1.2	-1.5
Global Bonds (Developed Markets)	0.0	-2.2	-2.3
Emerging Market Debt	-0.2	-0.5	-0.7
Duration Hedges	-1.3	-3.2	-2.9
Secured Private Debt	0.0	0.0	0.0
Unlisted Property	0.0	-1.8	-4.7
Listed Property	0.3	2.3	1.9
Commodities	0.0	0.0	-4.6
Market Neutral Equities	0.0	-0.1	0.1
Infrastructure Debt	0.0	0.0	0.0
Other Investments	0.0	0.0	0.0
Specialist Credit	0.1	0.0	-0.1
Cash and Enhanced Cash	10.1	17.4	15.5
Alternative Beta	0.0	0.0	0.0

## FUND PERFORMANCE

The Diversified Real Return Fund returned 1.2% (gross) for the month of August. Over the past year, the Fund has returned 12.2% (gross) and over the past five years the Fund has returned 6.1% (gross) per annum compared with the objective of 7.0% (CPI plus 5%\* over rolling five years). Since inception (in 2010) the Fund has returned 7.2% (gross) per annum compared with the objective of 7.1% (CPI plus 5%\*).

The key contributor to performance during August was the continued rally in global equities. The Fund's exposure to developed, emerging and Australian equities all performed well, supported by strong earnings results. The Fund's allocation to domestic listed real estate contributed as Australian REITs performed well over the month. Stock selection within Australian equities also contributed to performance with the Fund's Australian equity exposure outperforming the broader market through a robust reporting season.

Global equity stock selection slightly detracted from performance during August. In addition, some of the Fund's portfolio protection positions detracted marginally from performance during the month. These positions continue to offer protection against segments of the market where valuations are most extended.

\*All groups CPI measured and published by the ABS as at June 2021

## MARKET COMMENTARY

Global economic growth expectations continued to be revised down in August as the highly contagious delta variant spreads – most notably in the US and UK. While growth is still expected to be extraordinarily strong through the second half of 2021, it has peaked and will slow significantly in the next year. In the near term, the recovery in the services sector has been restrained by the spread of the delta variant and the manufacturing sector continues to be affected by supply chain disruptions caused by the pandemic. In the medium term, the re-opening spur to growth will be over and fiscal policy will become progressively less stimulative.

At the same time, inflation should moderate. High inflation prints in the US over recent months have been largely attributed to supply chain disruptions and accordingly identified as 'transitory'. Core inflation is expected to subside from recent levels back towards 2% next year as some of these 'one-offs' reverse. This would be consistent with the US Federal Reserve (the Fed) achieving their objective of getting inflation up to 2% or higher on a sustained basis. Of course, there is also a risk that core inflation settles closer to 3% which would be very uncomfortable for the Fed, and therefore financial markets, with the prospect of significantly higher interest rates.

There remains a dichotomy between economies with higher levels of vaccinations and/or natural immunity and those with lower levels. With high rates of vaccination and natural immunity, the UK and Europe (and to a lesser extent, the US) have demonstrably broken the nexus between infections and hospitalisations. This will be tested further through the northern hemisphere winter. Conversely, economies with low natural immunity and low vaccination rates (Australia) or questionable vaccine efficacy (China and many other emerging economies) are more exposed to disruption. The reduced risk of serious infection has allowed the reopening of European economies to continue despite the increasing case numbers. With the benefits of reopening still to be fully realised, Europe and the UK are the regions with the most promising growth outlook.

Conversely, the most dramatic downgrades in growth expectations were seen in China, Australia and New Zealand. Economic activity in China remains highly levered to the path of the virus as the zero-tolerance strategy ensures that strict lockdowns remain a threat. Chinese service sector purchasing manager index plunged below 50 (into contraction), reaching levels last seen in February 2020 while manufacturing slowed for the fifth successive month. In addition, the prospect of more structural reforms and potential stress in Chinese debt markets continues to impact growth expectations and investor confidence.

The outlook for Australia is delicately poised given the combination of a highly contagious variant and low (but rapidly increasing) levels of vaccination. The National Accounts show the economy was slowing before the full impact of the lockdowns and a substantial fall in activity in the September quarter is inevitable. More recently, the Covid zero strategy has been abandoned by NSW and Victoria. As a result, this re-opening is going to be very different to what happened in the second half of last year. Added to that commodity prices, including iron ore, are now falling precipitously (from extraordinarily high levels) due to the slowdown in the commodity intensive sectors of China.

As a result, ongoing fiscal support in Australia will be crucial to the path of recovery. In the lead up to next year's Federal election there is little doubt that further stimulus is in prospect which is likely to underpin a robust recovery. There remains however, an unusual amount of uncertainty about the outlook.

Notwithstanding falling economic growth expectations, equity markets continue to perform very well reflecting a number of factors:

- Earnings remain extraordinarily strong in all key regions – the US, Europe and Asia;
- Monetary policy settings are extremely accommodative globally with central banks indicating that stimulus will only be withdrawn very slowly over coming years; and
- In part due to central bank policies, bond yields remain close to all-time record lows. Against this backdrop, equities have become the yield of last resort.

One exception has been Chinese equities which continue to under-perform. Credit growth has been slowing for many months in response to a tightening of policy which is creating stress in the highly levered parts of the economy, including a liquidity crisis faced by property developer, China Evergrande. Alongside the economic slowdown, Chinese equities are pricing in an increasing regulatory risk following the clamp down on the technology and education sectors in July.

Much of the stunning rally in risk assets over the past 18 months has been fuelled by abundant liquidity which has underpinned high investor risk appetites. With the recovery fully priced into markets, any upward shift to interest rates could negatively impact equity market valuations. While the global economic recovery is now well established, there has been very little change so far in the guidance for monetary policy from the key central banks (the Fed, the European Central Bank and the Bank of Japan). The Fed now appears likely to begin tapering late this year. Nonetheless, the strongest year of economic growth in many decades and a series of upside inflation surprises sits very awkwardly with current policy settings.

While the actions of central banks shapes to be the most significant factor in financial market performance over the coming months, as always there are also a number of tail risks. Failure of the vaccination rollout to curb the spread and public health impact of the delta variant or the emergence of a subsequent strain remains a key risk. During the month, we were also reminded of heightened geopolitical risks by the US's messy withdrawal from Afghanistan. While not consequential for markets during the month, the geopolitical climate (most notably, the US's strained relationship with China) remains a critical risk for the future market outlook.

## CURRENT POSITIONING

The extraordinary monetary and fiscal policy response to the COVID-19 crisis has been very successful in minimising the damage of a massive shock to the global economy. It has also had profound implications for portfolio construction. In particular, the role of bonds in portfolios as a defensive anchor is under question. Long-term interest rates remain at extraordinarily low levels supported by zero cash rates and aggressive quantitative easing. Indeed, other than last year, they have never been lower. A key feature of portfolio construction for the past four decades has been the diversification benefit of owning bonds (with bonds rallying when equities are in bear markets). This time, bonds appear vulnerable and could continue to be the cause of a significant rotation within equity markets.

Our focus remains on investments that can generate CPI plus 5% per annum over a five-year horizon. Against this backdrop, we remain cautious about the outlook for some major parts of the investment universe including:

- the US equity market (which on some measures is the most expensive it has ever been) and specifically the technology sector.
- credit markets -- very little compensation for the risk of default.
- government bonds – yields are negative after allowing for inflation.

The Fund equity exposures retain their longstanding value and quality biases. This style positioning is complemented by elevated exposure to UK and European equities which we believe offer attractive medium term return prospects. The Fund also holds reduced exposure to areas of the market where valuations are fullest and interest rate risk is high. This includes put spreads on the S&P 500 and the US technology heavy Nasdaq.

The Fund also retains a significant 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 by a substantial risk allocation to diversifying opportunities (including equity alpha and currency positions).

There is also significant optionality in holding cash. This is an extreme environment for the economy and for markets. Valuations are extremely extended in some parts of the equity market and bond yields have never been lower than in the past year. Financial markets history is replete with dire warnings about the risks of investing when valuations are as extended as they are now. 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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