

Perpetual Investments

PERPETUAL DIVERSIFIED REAL RETURN FUND - CLASS W

31 October 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: \$830.2 million as at 30 September 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 OCTOBER 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)	-0.4	0.8	2.4	10.8	6.7	6.1	7.1	Perpetual Diversified Real Return Fund	3.6	3.3
Perpetual Diversified Real Return Fund (Net)	-0.5	0.6	2.0	9.9	5.8	5.2	6.2	Mercer Balanced Growth Median	10.2	7.5

FUND OBJECTIVE OUTCOME AS AT 31 OCTOBER 2021

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

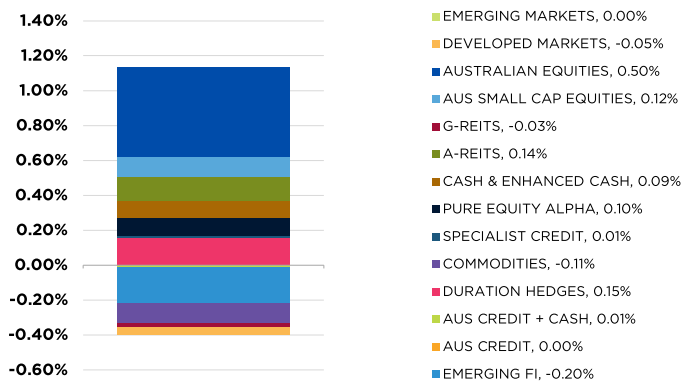
	5 YRS PA	INCEPT PA
Perpetual Diversified Real Return Fund (Gross)	6.1	7.1
CPI plus 5%	7.2	7.2

Past performance is not indicative of future performance.

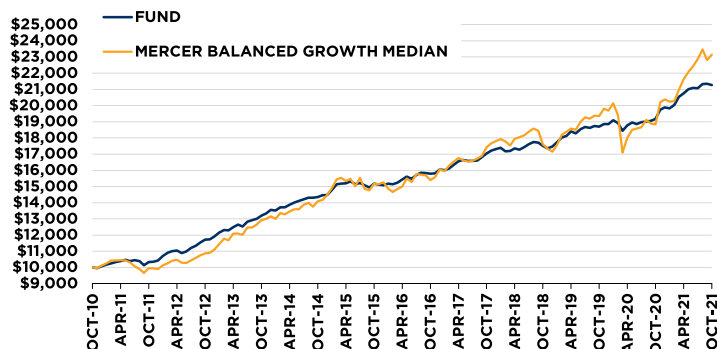
^{^^} Information on Management Costs (including estimated indirect costs) is set out in the Fund's PDS

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

CONTRIBUTION TO 3MTH PERFORMANCE (GROSS)



GROWTH OF \$10,000 SINCE INCEPTION



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.

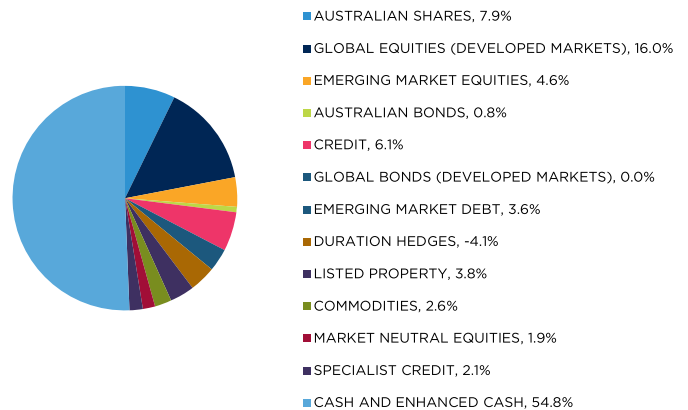
FUND RISKS

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



CHANGES IN ASSET ALLOCATION (%)

	3 MTHS	6 MTHS	1 YR
Australian Shares	0.2	-0.9	0.7
Global Equities (Developed Markets)	-2.7	-7.1	2.7
Emerging Market Equities	0.1	-2.4	1.2
Frontier Market Equities	0.0	0.0	0.0
Australian Bonds	0.1	-0.7	-7.0
Credit	-0.6	-1.2	-1.6
Global Bonds (Developed Markets)	0.0	-2.1	-2.3
Emerging Market Debt	-0.6	-0.8	-1.1
Duration Hedges	-0.8	-2.8	-2.5
Secured Private Debt	0.0	0.0	0.0
Unlisted Property	0.0	0.0	-4.5
Listed Property	0.0	0.0	1.8
Commodities	-0.2	0.0	-1.5
Market Neutral Equities	0.0	-0.2	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	4.6	18.2	14.0
Alternative Beta	0.0	0.0	0.0

FUND PERFORMANCE

The Diversified Real Return Fund returned -0.4% (gross) for the month of October. Over the past year, the Fund has returned 10.8% (gross) and over the past five years the Fund has returned 6.1% (gross) per annum compared with the objective of 7.2% (CPI plus 5%* over rolling five years). Since inception (in 2010) the Fund has returned 7.1% (gross) per annum compared with the objective of 7.2% (CPI plus 5%*).

The key determinant of performance during October was the performance of the Australian dollar. The Australian dollar was supported by rising interest rates and strong commodity prices, surging 4% against the greenback. The Fund maintains a significant exposure to foreign denominated cash including US Dollars and emerging market currencies both of which detracted from performance during the month.

The fund's equity exposures contributed to performance. Developed market equities performed strongly over the month, led by US equities. This was somewhat offset by the fund's downside protection positions including US, UK and Euro equity puts which detracted from performance.

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

MARKET COMMENTARY

Global share markets performed very well through October, more than reversing the sell-off seen in September. US equities (+7.0%) led developed markets (+5.5%), supported by yet another quarter of robust company profit results. Australian equities (-0.1%) trailed as inflation concerns dominated and the market began to price in tighter monetary policy while emerging market equities (+0.9%) continue to under-perform developed markets weighed down by the poor performance of Chinese equities.

Global bond markets have been quite volatile as upside inflation surprises accumulate and the outlook for monetary policy changes. In the past month, this was most obvious in Australia where 3-year bond yields rose by 90 bps in the month. The Reserve Bank of Australia's yield curve control policy (which anchored the 3-year rate at 10 bps) was already under pressure before the September quarter CPI surprised to the upside which effectively rendered the policy unsustainable. After many months of weakness, the \$A was stronger, in line with the general risk-on tone in markets.

The investment landscape in developed markets is going through a period of significant transition:

- Global economic growth is still very strong, but has peaked and in less than a year growth will be back down to trend as the re-opening boost fades and fiscal contraction kicks in.
- Inflation continues to surprise to the upside reflecting persistent supply side disruptions as well as, more recently, a doubling in natural gas prices in Europe.
- Profit growth is still surprising to the upside, but it could potentially slow dramatically over the next year as the economy slows, corporate taxes increase and margins are squeezed.

- The monetary policy outlook has changed dramatically as central banks react to persistently higher inflation by bringing forward tightening timetables -- by either winding up quantitative easing programs earlier or raising policy rates or both.

In our judgement, it is the persistent inflation surprise and the resulting change to the monetary policy outlook that are the two most important developments in the past month. Equity markets and other growth related assets, have performed exceptionally well in the past 18 months with many key markets trading to new all-time highs in 2021. Valuations for equity markets are extremely expensive on all metrics, except relative to interest rates. If, as we expect, monetary policy is tightened earlier and interest rates continue to move higher, the liquidity backdrop for markets will deteriorate at the same time as valuation metrics become more stretched.

Moreover, in the next few months the Fed's preferred measure of inflation is likely to increase further before potentially moderating next year (as some of the supply chain issues ease and there are price falls in goods like used cars). In the meantime, the US Federal Reserve is in a very uncomfortable position as they try to unwind extreme policies without causing undue volatility in markets.

The emerging market landscape is, of course, impacted by these changes, but it also has a powerful dynamic of its own driven by events in China:

- A general anti-corruption drive in capital markets carries clear short term risks for an economy that is afflicted by many structural challenges.
- The property sector remains under enormous pressure as the 'three red lines' policy continues to restrict the flow of credit to a heavily levered sector.
- Zero tolerance for COVID leaves the Chinese economy particularly exposed to lockdowns.

These objectives are being pursued at the same time as the authorities target 6% growth in 2021. It is a tricky balancing act managing these conflicting aims and it appears that this is increasingly being done under a new era of one-man autocratic leadership.

The Australian economy is finally recovering from extended lockdowns in NSW, Victoria and the ACT. The initial signs are very encouraging and the economy is sure to rebound strongly in the next six months. Beyond that, there are big structural challenges for the Australian economy at a time when the tail wind provided by stunning growth in China is coming under question.

The combination of lower economic growth, higher inflation and tighter monetary policy suggests a more challenging fundamental backdrop for equity markets and other growth assets. Equity markets have been on a tear for 18 months - particularly the US market which has more than doubled from the lows in March 2020. The US market is now trading at an all-time record high more than one third higher than the previous record in early 2020. We are cautious on the market outlook as the mix of growth and inflation becomes more problematic and the anchor provided for extreme valuations by record low bond yields is at risk of being unmoored.

CURRENT POSITIONING

In the next year, some of the extreme macroeconomic policies will be unwound in the US (and globally) as the impact of the pandemic is receding and the economy is recovering. This carries clear risks for financial markets.

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. We have been cautious about the outlook for some major parts of the investment universe for some time 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 has low or no exposure to these assets. Equity holdings are concentrated in 'value' stocks and 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 retains a 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 substantial risk allocation to diversifying opportunities (including equity alpha and currency positions). In addition, a USDCNH call option position has been implemented at low cost with an asymmetric pay off in the event that the authorities in China respond to the evolving property sector crisis by devaluing their currency.

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 18 months. 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

Adviser Services 1800 062 725

Investor Services 1800 022 033

Email investments@perpetual.com.au

www.perpetual.com.au

