

# Perpetual Investment Funds

## PERPETUAL DIVERSIFIED REAL RETURN FUND - CLASS Z

### 30 September 2023



#### 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:** May 2018  
**Size of Strategy:** \$835.7 million as at 30 June 2023  
**APIR:** PER6115AU  
**Management Fee:** 0.35% 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 Z is the performance fee option.  
 The maximum performance fee is 1%  
 The performance hurdle is 2.5%, the middle of the RBA target inflation rate.

#### TOTAL RETURNS % AS AT 30 SEPTEMBER 2023

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)*	-0.3	1.3	1.5	4.5	5.4	4.7	6.4	Perpetual Diversified Real Return Fund (Class W)	3.2	3.3
Perpetual Diversified Real Return Fund (Net)	-0.4	1.2	1.4	4.1	4.8	4.2	4.4	Mercer Balanced Growth Median	8.7	7.8

#### FUND OBJECTIVE OUTCOME AS AT 30 SEPTEMBER 2023

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

	5 YRS PA	INCEPT PA
Perpetual Diversified Real Return Fund (Gross - Class W)	4.7	6.4
CPI plus 5%	8.60	7.77

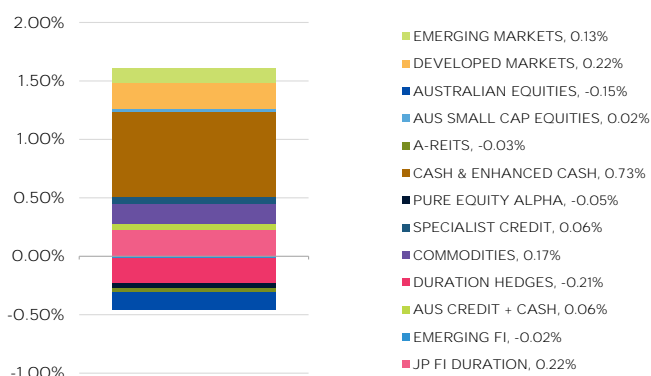
Past performance is not indicative of future performance.

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

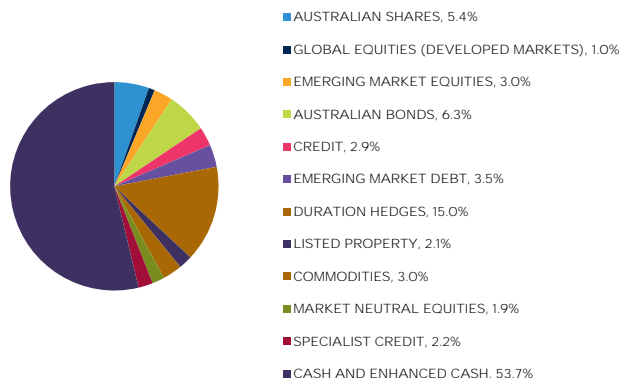
^ Volatility and Mercer Balanced Growth Median data is lagged by 1 month

\* Gross performance presented here is for the Perpetual Diversified Real Return Fund Class W

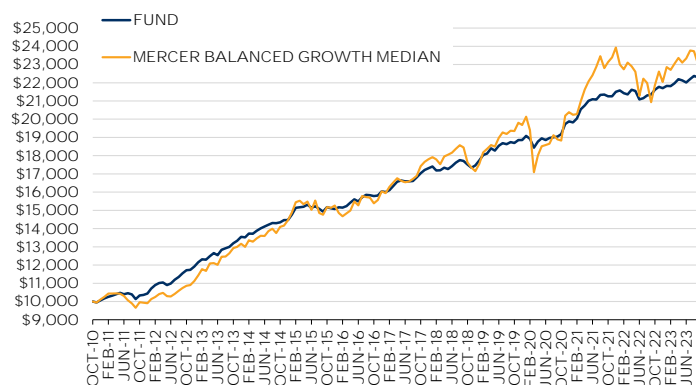
#### CONTRIBUTION TO 3MTH PERFORMANCE (GROSS)



#### PORTFOLIO SECTORS



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



#### CHANGES IN ASSET ALLOCATION (%)

	3 MTHS	6 MTHS	1 YR
Australian Shares	-0.2	-0.9	-0.9
Global Equities (Developed Markets)	-0.7	-5.9	-1.6
Emerging Market Equities	0.0	0.0	0.1
Frontier Market Equities	0.0	0.0	0.0
Australian Bonds	0.0	-0.5	-2.1
Credit	0.1	0.1	0.0
Global Bonds (Developed Markets)	0.0	0.0	0.0
Emerging Market Debt	-0.1	-0.1	-0.1
Duration Hedges	13.0	22.9	25.1
Secured Private Debt	0.0	0.0	0.0
Unlisted Property	0.0	0.0	0.0
Listed Property	-0.2	-0.2	0.1
Commodities	-3.7	-4.1	-1.6
Market Neutral Equities	0.0	0.0	-0.1
Infrastructure Debt	0.0	0.0	0.0
Other Investments	0.0	0.0	0.0
Cash and Enhanced Cash	-8.1	-11.5	-19.1
Alternative Beta	0.0	0.0	0.0

## FUND PERFORMANCE

The Diversified Real Return Fund returned 1.3% (gross) in the September quarter. Over the past year, the Fund has returned 4.5% (gross) and over the past 5 years the Fund has returned 4.7% (gross) per annum compared with the objective of 8.6% (CPI plus 5%\*) over rolling 5 years. Since inception (in 2010) the Fund has returned 6.4% (gross) per annum compared with the objective of 7.8% (CPI plus 5%\*).

The Fund's elevated cash allocation was the most substantial contributor to return during a quarter where equities and bonds recorded capital losses. Cash continues to offer robust returns following the 400bps of rate increases since early 2022, with the Fund's US dollar exposure also rewarded as the Greenback appreciated against peers, reflecting the strength of the US economy in addition to its higher interest rates.

Equity exposures were mixed for performance over the quarter. Equities markets fell over the course of August and September as bond yields rose and weighed on equity valuations, but the Fund's equity put options increased in value and provided solid protection.

Meanwhile, the Fund's allocation to fixed income detracted over the quarter as US and Australian bond yields rose sharply in August and September, as did the small allocation to a diversified basket of commodities including Gold.

\*All groups CPI measured and published by the ABS as at 30 June 2023

### 1. RETURN SEEKING ASSET CLASSES

Beginning of the Quarter: Low Allocation  
End of the Quarter: Low Allocation

The outlook for global equity markets remains challenging as rising nominal and real interest rates negatively impact both valuations in the near-term and earnings growth over the medium term. High starting valuations means that expected returns are relatively modest where re-asset risks are quite elevated given the large-scale and abrupt rise in policy rates and bond yields.

During the quarter, the Fund added exposure to a Heng Seng China Enterprise index via a call spread trade. That said, the Fund has maintained a low exposure to return seeking assets given the valuation and earnings backdrop, and has a diversified range of growth assets and markets including:

- Global equities in addition to exposures in emerging markets and Australian equities all with a value and quality style bias;
- Global and Australian listed property; and
- Australian credit and modest position in emerging market debt.

### 2. DIVERSIFYING OPPORTUNITIES

Beginning of the Quarter: Medium Allocation  
End of the Quarter: Medium Allocation

With 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 the US creates a relative yield position; 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 which have strong balance sheets and highly resilient operating models. Notwithstanding the resurgence of growth equities throughout 2023, we expect value and quality factors to be rewarded in an environment of restrictive policy rates and slowing economic and earnings growth.

### 3. DOWNSIDE PROTECTION

Beginning of the Quarter: Medium Allocation  
End of the Quarter: Medium Allocation

Equities face headwinds from tightening policy, slowing economic growth, elevated cost pressures and highly optimistic earnings profiles out to the end of 2024. We continue to manage these risks by limiting overall exposure to equities and credit, as well as maintaining little or no exposure to the most expensive parts of equity and credit markets.

Currently the Fund has exposure to 2-year US government bonds and a modest exposure to 10-year US and Australian government bonds. The Fund materially increased its allocation to 2-year US government bonds during the quarter which has a running yield close to 5%. The duration of these positions is partially offset by the previously mentioned short Japanese government bond position.

The Fund's defensive position is supported by a very substantial cash allocation which benefits when central banks lift interest rates. These cash holdings give us a good running yield and provides significant optionality as it enables us to quickly allocate to any asset with a displaced asset price.

The Fund also has put options on the S&P 500 and European equities alongside 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

The portfolio has a low (direct and indirect) sensitivity to higher interest rates which should provide resilience if persistent inflation extends the current monetary policy tightening cycle.

The portfolio also maintains a small allocation to a basket of commodities (which includes gold, grains, livestock, silver, palladium, platinum, uranium and copper).

### MARKET COMMENTARY

The September quarter saw increased volatility and weakness in financial markets as investors contended with the possibility that restrictive monetary policy settings were likely to persist for longer than initially anticipated.

- The MSCI World Total Return Index fell (-2.7%) over the quarter as investors responded negatively to central bank guidance that policy rates would stay at elevated levels for a considerable period, which sparked a significant sell off in bond markets and weighed on elevated valuations.
- US equities (-3.3%) marginally underperformed global equities reflecting high starting valuations and the sharp move higher in US long term bond yields. This weighed more heavily on long-duration equity sectors such as tech shares which comprises just half of the US sharemarket's capitalisation.
- European equities (-4.9%) trailed the broader developed market led by a selloff Germany (-4.7%) as aggressive hikes by the ECB occurred at a time where regional growth materially slowed, thereby weighing on both valuations and earnings growth. In contrast, the UK equities (+2.2%) were the only major equity market in positive territory over the quarter, supported by its defensive index composition and a sharp depreciation in Sterling which increased the local currency value of the USD dividends paid by global companies which are listed on the LSE.
- Australian Equities (-0.7%) declined moderately, but outperformed most of its international peers supported by a depreciating currency, defensive index composition, a pause in rate hike cycle by the RBA, and our large scale immigration influx which is cushioning the economic impact of previous rate hikes on consumer spending.
- Emerging markets (-1.4%) outperformed their developed market peers as low starting valuations and early speculation of some Chinese regulatory easing and additional stimulus buoyed sentiment, but this gave way to primarily soft Chinese economic data and a lack of follow through on stimulus leaks. The impact here was amplified by a rising US Dollar and higher US bond yields..
- Bond markets experienced sharp capital losses as resilient economic data and signs of sticky inflation prompted the US Federal Reserve to raise the Fed Funds Rate by +0.25 to a 22-year high of 5.5%. The capital price downside here has amplified when the central bank guided markets that that rate would be staying higher-for-longer than markets had initially expected. The bond sell off was driven by increases in real interest rates, not inflation, and losses were much larger at the long-end of the yield curve (+76bps) than for the 2-yr bond (+15 bps) or the and Australian 10-yr bond (+46bps)
- Energy commodities – led by Oil (+28.5%) – rallied strongly as cuts to OPEC production decreased supply, and strong US economic growth buoyed demand, thus creating a supply squeeze.

For some time, we have been highlighting that risks in the current market environment were underpriced. Notwithstanding recent elevated volatility, equity markets continued to price an optimistic scenario where earnings growth was expected to be close to double its historical average and that central banks would succeed in returning inflation to target levels without much damage to the economy.

We remain of the opinion that the global economy is set to experience an ongoing deceleration in 2024, as restrictive monetary policy rates and credit withdrawal reduce spending and hiring. While US data has been characterised by resilience, there remains a wealth of leading indicators that suggest that recession has more likely been delayed into 2024 rather than has completely dissipated. Despite the recent surge in long term yields, yield curves have remained inverted across a number of regions including in the US since July 2022. Other reliable recession indicators including tightening credit standards in senior loan officer surveys, deteriorating small business confidence and negative credit growth all suggest that global growth is set to slow as higher rates progressively weigh on activity.

The impact of central bank tightening on economic activity is a study of pressure and time, governed by the price of money and how long it stays elevated. While we are near peak interest rates following between 400 and 550bps of tightening, September saw the expected duration of restrictive monetary policy settings increase. As this higher-for-longer paradigm continues, we expect the impact of restrictive policy rates to become clearer. Already, Europe looks increasingly weak, the UK appears stagflationary, Australian corporate profit expectations have been heavily downgraded, and China could have sustained deflation unless material stimulus is provided.

In this environment, the risk of an extended credit contraction remains elevated. While the US economy continues to exhibit resilience, its financial system is vulnerable to contagion given the highly leveraged commercial and industrial sector which face refinancing at much higher rates and stricter lending standards. So far, the impact of the tightening cycle has been several US regional bank collapses, sharp price declines across speculative assets including cryptocurrencies and non-fungible tokens, and rising bond yields. For some time, we have been warning about the build-up of excesses in financial markets and we expect to see more of these excesses wash out over time, with China particularly exposed given its high debt and deflation.

Facing an uncertain outlook for global markets, our focus remains on identifying investments that can generate CPI plus 5% per annum over a five-year horizon while maintaining an asset allocation that ensures that no individual position or cluster of positions will risk the medium-term investment objective.

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## MORE INFORMATION

Adviser Services 1800 062 725

Investor Services 1800 022 033

Email [investments@perpetual.com.au](mailto:investments@perpetual.com.au)

[www.perpetual.com.au](http://www.perpetual.com.au)

