Perpetual Investment Funds

# PERPETUAL DIVERSIFIED REAL RETURN FUND - CLASS Z

30 November 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:** May 2018

**Size of Strategy:** $800.0 million as at 30 September 2022

**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 NOVEMBER 2022

| PERFORMANCE | 1 MTH | 3 MTHS | 6 MTHS | 1 YR | 3 YRS PA | 5 YRS PA | INCEPT PA |
|---|---|---|---|---|---|---|---|
| Perpetual Diversified Real Return Fund (Gross)* | 0.8 | 2.2 | 1.1 | 2.5 | 4.9 | 4.8 | 6.6 |
| Perpetual Diversified Real Return Fund (Net) | 0.7 | 2.2 | 0.9 | 2.1 | 4.3 | - | 4.7 |

| VOLATILITY^ | 3 YRS PA | INCEPT PA |
|---|---|---|
| Perpetual Diversified Real Return Fund (Class W) | 3.7 | 3.3 |
| Mercer Balanced Growth Median | 11.2 | 7.9 |

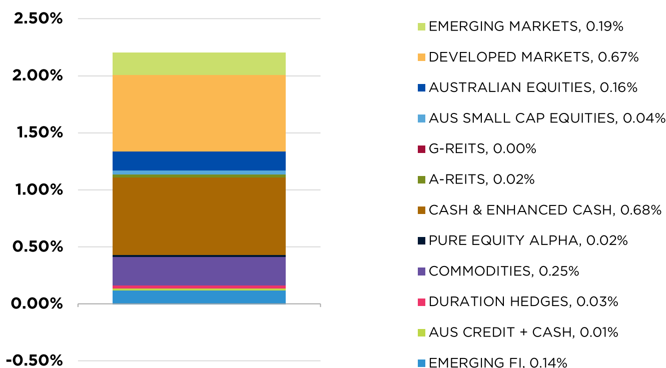
## FUND OBJECTIVE OUTCOME AS AT 30 NOVEMBER 2022

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

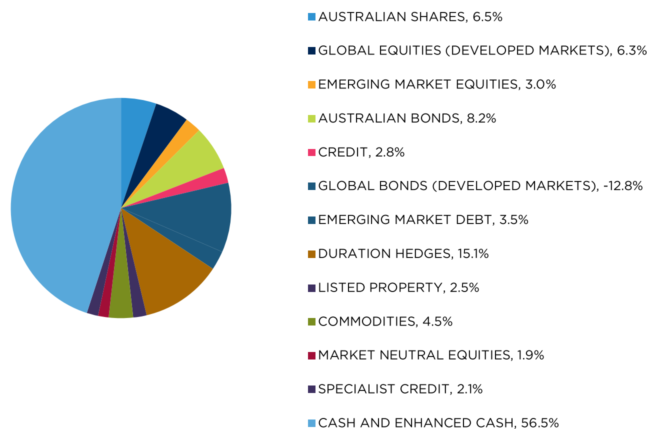
| | 5 YRS PA | INCEPT PA |
|---|---|---|
| Perpetual Diversified Real Return Fund (Gross - Class W) | 4.8 | 6.6 |
| CPI plus 5% | 8.13 | 7.60 |

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

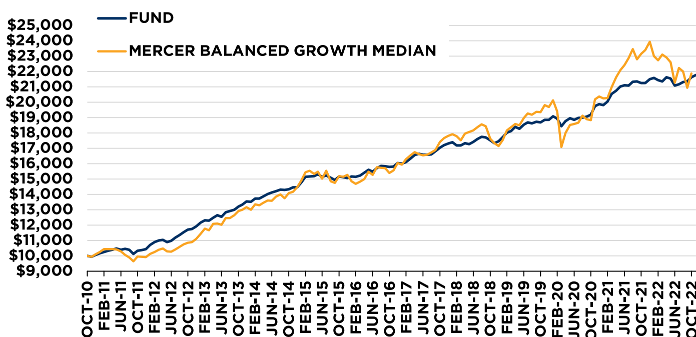
## CONTRIBUTION TO 3MTH PERFORMANCE (GROSS)




## PORTFOLIO SECTORS




## GROWTH OF $10.000 SINCE INCEPTION




## CHANGES IN ASSET ALLOCATION (%)

| | 3 MTHS | 6 MTHS | 1 YR |
|---|---|---|---|
| Australian Shares | -0.4 | -1.1 | -1.0 |
| Global Equities (Developed Markets) | 3.7 | -6.4 | -8.7 |
| Emerging Market Equities | 0.0 | 0.4 | 0.0 |
| Frontier Market Equities | 0.0 | 0.0 | 0.0 |
| Australian Bonds | -0.4 | 5.2 | 7.5 |
| Credit | -0.2 | -3.2 | -3.2 |
| Global Bonds (Developed Markets) | -5.7 | -12.8 | -12.8 |
| Emerging Market Debt | -0.1 | -0.2 | -1.4 |
| Duration Hedges | 13.4 | 15.2 | 20.2 |
| Secured Private Debt | 0.0 | 0.0 | 0.0 |
| Unlisted Property | 0.0 | 0.0 | 0.0 |
| Listed Property | 0.1 | -0.7 | -1.4 |
| Commodities | 0.1 | -0.8 | 1.8 |
| 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 | 0.2 | 0.1 |
| Cash and Enhanced Cash | -10.4 | 4.4 | -1.1 |
| Alternative Beta | 0.0 | 0.0 | 0.0 |

## FUND PERFORMANCE

The Diversified Real Return Fund returned 0.8% (gross) during November. Over the past year, the Fund has returned 2.5% (gross) and over the past 5 years the Fund has returned 4.8% (gross) per annum compared with the objective of 8.1% (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 continued rally in global equities drove performance during November with the Fund's domestic and global equity exposure the key contributors to return. This contribution was partially offset by the negative performance of the Fund's equity put options.

The Fund's exposure to diversified basket of metals including gold performed well during November as materials saw gains as China softened their COVID protocols and offered support to the property sector. The Fund's fixed income exposure also contributed during November. Bond yields rallied as markets priced the possibility of a pause or slower rate of monetary tightening.

The key detractor from return during the month was the Fund's significant US Dollar exposure. The Fund has direct exposure to the USD as well as a USDCNH call option and emerging market currencies which are closely correlated. These exposures detracted from return as the greenback had its worst month in a decade, giving back a portion of its gains over the past year.

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

## MARKET COMMENTARY

Global equity markets rose in November as investors anticipated a slower pace of monetary tightening and lower terminal rates.

- US equities (5.6%) extended their October rally, pushing higher throughout the month before surging on the last trading day following dovish comments in a speech from US Federal Reserve (The Fed) chairman Jerome Powell.
- Emerging markets (11.7%) outperformed developed markets (5.7%) led by surging Chinese equities (28.4%). Hong Kong equities (26.8%) had their strongest month since 1998.
- Australian equities (6.6%) responded well to the slowing pace of rate increases from the Reserve Bank of Australia (RBA).
- European equities (9.7%) continued to rally strongly with gains from Germany (8.6%) and France (7.6%) as well as the UK (7.1%).
- The US 10-year bond yield (-38bps) rallied back below 4% on the back of below expectation October CPI print.

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

- Even though equity valuations have improved this year, they still remain above levels which are attractive, given the weakening earnings backdrop across most regions.
- 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 the US and Asia and acute recession risk in Europe have contributed to a moderation in profit growth with a significant fall in profits in prospect next year.
- 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.

While markets continued to strengthen in anticipation of a slowing pace of rate increases, the path back to the Fed's target level of inflation remains challenging. Jerome Powell's comments that "the time for moderating the pace of rate increases may come as soon as the December meeting" was extremely well received by the market, propelling a strong rally in US and global equities. The path to a soft landing however, remains very narrow with a US recession in 2023 the base case and the number of leading indicators of recession continuing to mount. In particular, the US 2 year 10 year yield has now been inverted for over 4 months (ie the 2 year rate is higher than the 10 year rate), reaching a multi decade high in November and the 3 month 10 year curve is also inverted which has been an extremely reliable indicator of recession within 12-months. PMIs weakened over the month with the ISM manufacturing PMI (49.0) going into contraction for the first time since May 2020.

Recession may yet be the most direct path to taming inflation. There has been a shift in the key drivers of inflation over recent months, with goods prices moderating while services sector inflation remains entrenched. Services sector inflation is more intractable as a result of greater pricing power and lower sensitivity to supply chain issues and commodity prices. With extremely tight labour markets (unemployment in many key economies running at 50-yr lows) we believe that the pressure on services sector inflation will persist with a recession required to ease conditions. This is reflected in the Fed's policy reaction function which now has a sizable rise in US unemployment at its heart. At the same time, the size and speed of recent rate increases have made it more challenging to control recession risks as central banks have less room to evaluate policy impacts and the risk of financial accidents is elevated as a result.

We remain concerned about the outlook for corporate profits and the risks presented by high levels of leverage. While revenues have thus far proved resilient, the impact of the Fed's aggressive tightening on earnings has yet to be fully realised. More importantly, financial conditions are set to tighten further in the months ahead as the Fed accelerates the reduction of its balance sheet by selling US Treasuries and some mortgage-backed securities, which will place upward pressure on corporate financing costs and 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) being exposed given their weak operating models. Already we have observed some recent market excesses being purged from the system including the crash in cryptocurrency valuations and the collapse of FTX during November.

While the actions of the Fed remain the most crucial determinant of the market outlook, other major central banks are grappling with similar circumstances. The European Central Bank (ECB) faces a very challenging backdrop of double-digit inflation, an energy crisis and a sharply slowing economy. Meanwhile, Australia's path to a soft landing remains more viable than the US or Europe. The RBA has a more potent

mechanism to address household spending given highly leveraged household balance sheets and the majority of local 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 the negative rate differential with the US resulting in a lower Australian Dollar.

Chinese equities surged during the month on a combination of easing COVID restrictions, relaxed collateral and equity issuance standards in the property sector and stimulatory monetary policy. The path to reopening remains the most crucial consideration for the Chinese growth outlook. While the Chinese government may be beginning to shift away from their zero-COVID policy, challenges remain as successful reopening requires a huge and effective vaccination program and cases have already risen sharply. During November, the government issued a series of measures intended to support the property sector which has languished since 2020. Measures included credit support for heavily leveraged housing developers, financing to ensure completion and transfer of projects and loan assistance for home buyers. These measures further fuelled the sharp rally seen in November.

## CURRENT POSITIONING

Rising interest rates, tightening financial conditions, 40-yr highs in inflation and slowing economic growth are a challenging environment for investors to navigate. High equity valuations were only supported by bond yields staying low as long 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 align 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 cause a recession, 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 including put options on US equities. 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 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 exposure to US and Australian duration.

The Fund also maintains exposure to a small position in metals and soft commodities which offer inflation protection.

Lastly, the Fund 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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