

Perpetual Investment Funds

PERPETUAL DIVERSIFIED REAL RETURN FUND - CLASS Z

30 June 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: \$841.0 million as at 31 March 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 JUNE 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)*	-0.5	0.2	1.5	4.4	5.3	4.8	6.4	Perpetual Diversified Real Return Fund (Class W)	3.1	3.3
Perpetual Diversified Real Return Fund (Net)	-0.5	0.1	1.3	4.0	4.7	4.2	4.3	Mercer Balanced Growth Median	8.6	7.8

FUND OBJECTIVE OUTCOME AS AT 30 JUNE 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)	4.8	6.4
CPI plus 5%	8.52	7.76

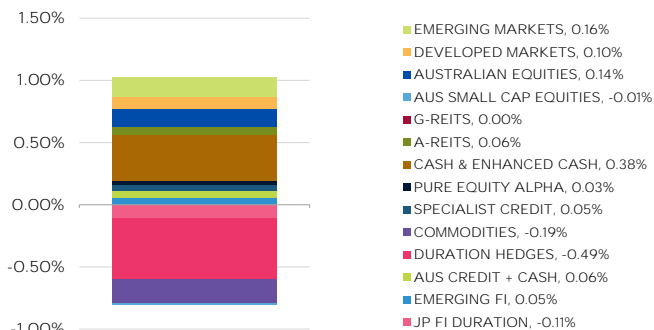
Past performance is not indicative of future performance.

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

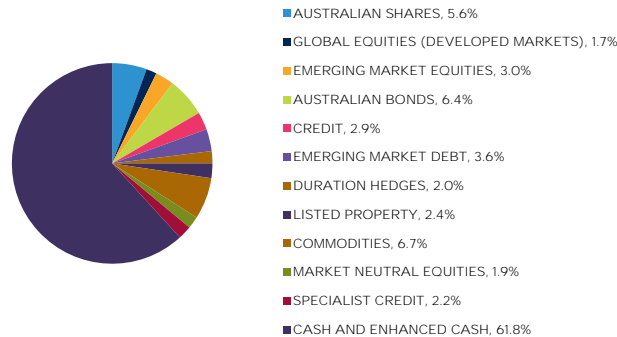
[^] Volatility and Mercer Balanced Growth Median data is lagged by 1 month

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

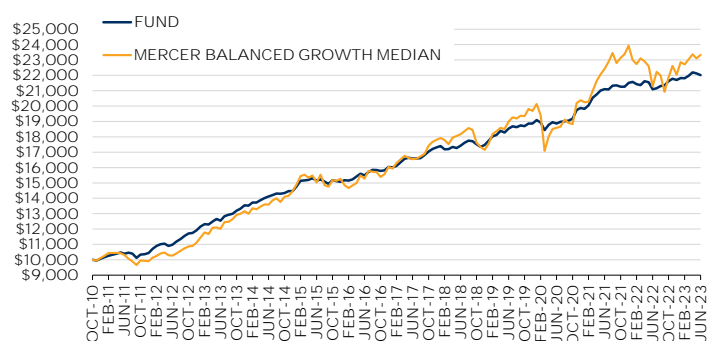
CONTRIBUTION TO 3MTH PERFORMANCE (GROSS)



PORTFOLIO SECTORS



GROWTH OF \$10,000 SINCE INCEPTION



CHANGES IN ASSET ALLOCATION (%)

	3 MTHS	6 MTHS	1 YR
Australian Shares	-0.7	-0.8	-0.8
Global Equities (Developed Markets)	-5.1	-3.3	-5.0
Emerging Market Equities	0.0	0.1	0.3
Frontier Market Equities	0.0	0.0	0.0
Australian Bonds	-0.4	-1.7	-0.3
Credit	0.0	0.0	-0.1
Global Bonds (Developed Markets)	0.0	0.0	0.0
Emerging Market Debt	0.0	0.1	-0.1
Duration Hedges	9.9	-7.6	2.1
Secured Private Debt	0.0	0.0	0.0
Unlisted Property	0.0	0.0	0.0
Listed Property	0.0	0.0	0.1
Commodities	-0.4	2.2	-1.0
Market Neutral Equities	0.0	0.0	0.0
Infrastructure Debt	0.0	0.0	0.0
Other Investments	0.0	0.0	0.0
Specialist Credit	0.0	0.0	0.0
Cash and Enhanced Cash	-3.4	10.9	4.9
Alternative Beta	0.0	0.0	0.0

FUND PERFORMANCE

The Diversified Real Return Fund returned 0.2% (gross) in the June quarter. Over the past year, the Fund has returned 4.4% (gross) and over the past 5 years the Fund has returned 4.8% (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%*).

Allocation to global equities was the most substantial contributor to return during the June quarter, with price gains underpinned by higher valuations in the tech sector as investors were buoyed by recent developments in artificial intelligence. Elsewhere, Australian equities were also constructive for performance, but were partially offset by the cost of Fund's equity put options and stock selection alpha also weighed on performance.

The Fund's substantial cash allocation also contributed to return reflecting the 400bps of rate increases over the past 13 months. During the first two months of the quarter, the Fund's US dollar and Emerging market currency exposures performed well before the Australian dollar rallied in June.

The Fund's fixed income allocation was the most significant detractor from return during the period, as real and nominal bond yields moved higher in May and June in response to sustained elevated inflation and hawkish central bank commentary which signalled that their respective tightening cycles had further to go.

Elsewhere, the Fund's small allocation to a diversified basket of commodities including Gold detracted as weakening Chinese demand weighed on prices.

*All groups CPI measured and published by the ABS as at 31 March 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 should weigh on both valuations in the near-term and earnings growth (with a lag). Global equity valuations are well above average levels especially in the US, and the environment remains one of weak profit growth and elevated recession risks. Regions including Australia, UK and Europe which have more attractive valuations than the US, but these have elevated cycle risks given the sharp rise in interest rates over the past year, not to mention intense pressure on margins from elevated labour costs and waning revenue growth. The sustained pressure of revenue growth and margins from high wages growth and slowing economic growth are expected to be one of the key themes in upcoming US reporting seasons where expectations are for an earnings decline of around -4%.

The Fund has maintained its 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 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. 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

The key long-term consideration in the prevailing investment environment is to not overpay for an investment. Equities face headwinds from tightening policy, slowing economic growth and elevated cost pressures. 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 holds a modest exposure to 10-year US and Australian government bonds and added allocation to 2-year US government bonds during the quarter. The Fund's allocation to traditional defensive assets remains limited, reflecting valuation concerns as real bond yields in many jurisdictions remain in negative territory. Additional rate hikes or persistent inflation could see yields rise more, thereby culminating in capital losses on bonds at a time when equities would be vulnerable to a valuation decline. Consequently, the Fund's defensive position is supported by a very substantial cash allocation which benefit 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 consolidated its defensive positioning during the quarter, increasing its allocation to put options on the S&P 500 while maintaining 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

Global equity markets rallied over the quarter in response to stronger-than-expected March quarter growth in China and Europe, the Fed's large-scale backstop for the US regional banks and the potential widespread benefit from artificial intelligence over time, all of which provided a solid foundation for the near-term macro backdrop. While this facilitated modest earnings upgrades in key markets including the US and Japan, the Q2'23 rise in regional sharemarkets was underpinned by rising valuations, defying a strong quarterly rise in real 10-yr bond yields as measures of the equity risk premia were pulled down to levels not seen since the aftermath of the tech boom.

- Japanese equities (+18.54%) surged on the back of a potent mix of reopening dynamics, a surge of inbound tourism, strong nominal income growth, a renewed focus on listed equity return on equity, and strengthening signs that the economy has finally resolved 30 years of chronic deflation. This combination of factors sparked a modest increase from foreign investor interest in the Japanese market given its attractive valuation, but most investors remain cautious having seen multiple false recovery signals for over 20 years.
- US equities (+8.74%) continued to rally strongly, dominated by the strong performance of a handful of large cap technology stocks which underpinned double-digit price growth in IT (+17.2%), consumer discretionary (+14.6%) and Communication services (+13.1%) which were more than double the returns in all other sectors.
- European equities (+4.3%) advanced as their recent recession was far milder than expected several months ago, but UK equities (-0.3%) declined as the Bank of England accelerated the pace of monetary tightening in response to a surge in wages growth and core inflation.
- Australian equities (+1.0%) continued to lag the performance of global equities given the local market's defensive composition and heightened sensitivity to rising bond yields and falling commodity prices.
- Chinese equities (-8.9%) retreated from their Mar-23 quarter bounce as signs emerged that the reopening boom was lacking momentum amid signs of moribund activity in the construction sector, inflation approaches deflation territory, and its credit impulse turned negative.

Rising equity valuations throughout 2023 seems mis-aligned with a high-risk macro outlook. Headline index returns continue to be dominated by a highly concentrated set of large cap tech stocks while the remainder of the equity market grapples with expectations of weakening profits and slowing economic growth.

Meanwhile, very few data points are pointing to an economic recovery which is needed to justify lofty valuations, whereas numerous lead indicators are signalling elevated growth risks in the period ahead. In the US, the yield curve has been inverted since the middle of last year and during the quarter, short end rates moved materially higher thereby steepening the degree of inversion. This trend is not limited to the US with inverted curves also evident in Canada, UK, Germany, France, Spain, Sweden, Netherlands, Switzerland, Australia, and New Zealand. Other reliable recession indicators including manufacturing PMIs, senior loan officer surveys and current activity indicators are all suggesting a material weakening in growth is likely ahead. At the same time, while the temporary raising of the debt ceiling soothed concerns of a US default, the restrictions on government spending growth limit the capacity for fiscal policy to stimulate activity.

During the quarter, moderating headline inflation data (in the US and Australia) was well received by markets. While US annual inflation fell to +4.0%, resilient regional labour markets and sticky core inflation are keeping the pressure firmly on a data-dependant Fed to continue its tightening cycle. In June, the Fed elected to pause rate hikes to assess the impact of 500 bps of tightening since March 2022. At home, the RBA elected to pause its hiking cycle in April to assess whether inflation was declining in line with its expectations, before recommencing rate increases in May and June. Other global central banks continued to combat persistently high core inflation by raising rates, including an outsized 50 bps move from the Bank of England at its June meeting.

Robust labour markets fuelling elevated services inflation remains a significant challenge for central banks. A sustained decline in services inflation typically require a negative output gap which implies a material increase in unemployment from its current 50-yr lows. However, policy normally takes 12 to 24 months before its impact on the economy is clearly visible – in coming months all central banks will approach the mid-point of this timeframe which is an appropriate time to judge whether policy is truly restrictive.

As financial conditions continue to tighten, risks of an accident or a significant credit contraction are elevated. So far, the impact of this aggressive monetary 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.

The aggressive tightening of financial conditions alongside elevated inflation and rising growth risks present a very challenging environment for investors to navigate. 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

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