

# Perpetual Investment Funds

## PERPETUAL DIVERSIFIED REAL RETURN FUND - CLASS Z

### 31 July 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 <sup>^^</sup>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 31 JULY 2023

PERFORMANCE	1 MTH	3 MTHS	6 MTHS	1 YR	3 YRS PA	5 YRS PA	INCEPT PA	VOLATILITY <sup>^</sup>	3 YRS PA	INCEPT PA
Perpetual Diversified Real Return Fund (Gross)*	0.9	0.1	1.8	5.0	5.4	4.7	6.4	Perpetual Diversified Real Return Fund (Class W)	3.1	3.3
Perpetual Diversified Real Return Fund (Net)	0.9	0.0	1.6	4.6	4.8	4.2	4.4	Mercer Balanced Growth Median	8.6	7.8

#### FUND OBJECTIVE OUTCOME AS AT 31 JULY 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%	8.70	7.81

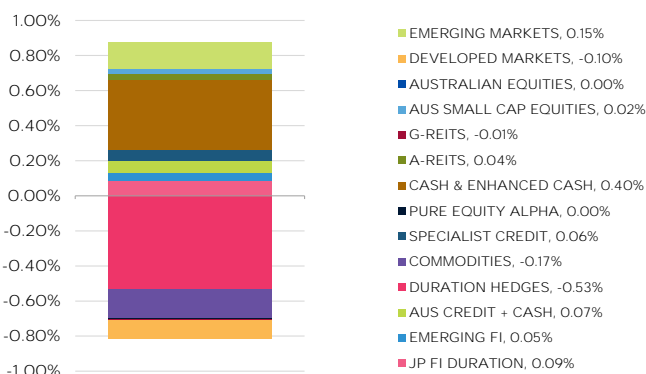
Past performance is not indicative of future performance.

<sup>^^</sup> Information on Management Costs (including estimated indirect costs) is set out in the Fund's PDS

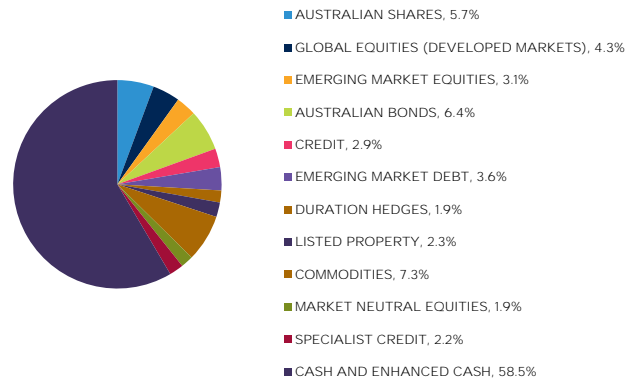
<sup>^</sup> Volatility and Mercer Balanced Growth Median data is lagged by 1 month

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

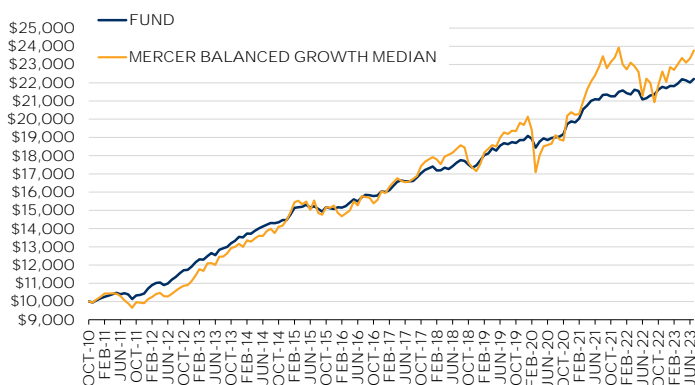
#### CONTRIBUTION TO 3MTH PERFORMANCE (GROSS)



#### PORTFOLIO SECTORS



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



#### CHANGES IN ASSET ALLOCATION (%)

	3 MTHS	6 MTHS	1 YR
Australian Shares	0.3	-0.9	-1.0
Global Equities (Developed Markets)	-1.5	-1.3	-3.7
Emerging Market Equities	0.1	0.2	0.2
Frontier Market Equities	0.0	0.0	0.0
Australian Bonds	-0.3	-1.9	-2.8
Credit	0.1	0.1	-0.1
Global Bonds (Developed Markets)	0.0	0.0	0.0
Emerging Market Debt	0.1	0.1	-0.1
Duration Hedges	-0.3	-7.1	3.6
Secured Private Debt	0.0	0.0	0.0
Unlisted Property	0.0	0.0	0.0
Listed Property	-0.2	-0.3	-0.2
Commodities	0.0	2.6	3.1
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
Cash and Enhanced Cash	1.6	8.3	1.1
Alternative Beta	0.0	0.0	0.0

## FUND PERFORMANCE

The Diversified Real Return Fund returned 0.9% (gross) in July. Over the past year, the Fund has returned 5.0% (gross) and over the past 5 years the Fund has returned 4.7% (gross) per annum compared with the objective of 8.7% (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%\*).

Global equities extended their rally during July, contributing to portfolio return. The Fund's exposure to developed and emerging markets as well as Australian equities were all key positive contributors as investors responded positively to data which suggested that global recession risks had declined, although they remain quite significant. Meanwhile, price gains in global and Australian REIT in response to firming expectations that central banks are close to ending their tightening cycles also added to returns. These contributors were partially offset by the cost of the Fund's equity put options and negative stock selection within Australian equities.

Elsewhere, the Fund's allocation to a diversified basket of commodities was a substantial contributor, led by gold which rebounded from a weak second quarter as the US Dollar depreciated against its peers.

Similarly, the Fund's fixed income allocation performed well as our short position in 10-year Japanese government bond added value as the yield curve steepened in response to speculation that the Bank of Japan was set to tweak its yield curve control policy at its late-July meeting which was subsequently occurred. The gains from this exposure were partially offset by higher US bond yields in response to a stronger set of economic data.

Lastly, the Fund's substantial cash allocation continues to contribute to returns as 15 months of rate hikes are now rewarding patient investors who are concerned about elevated valuations and highly optimistic earnings expectations for the second half of 2023 and 2024.

\*All groups CPI measured and published by the ABS as at 31 March 2023

## MARKET COMMENTARY

Global financial markets consolidated in July following a strong first half for risk assets.

- US equities (+3.2%) rallied, outperforming the broader developed market (+2.9%). Performance during July was more broad based than recent months in contrast to the strong year-to-date returns which have been concentrated in a narrow group of large cap tech stocks. Indeed, traditional cyclical sectors including financials (+4.8%) and materials (+3.9%) outperformed most tech related sectors such as IT (+2.6%) and consumer discretionary (+2.3%).
- Meanwhile, Australian equities (+2.9%) were supported by the RBA's decision to keep rates on hold as well as the rally in traditional value sectors such as financials, materials, and energy.
- Elsewhere, Emerging markets (+6.1%) performed strongly, led by China (+10.1%) which recovered its 2nd quarter losses, supported by regulatory easing and expectations of increased stimulus.
- In fixed interest markets, the US 10-year yields (+14bps) rose further as the US Federal Reserve (The Fed) raised rates another 25bps to 5.25%-5.5%, whereas Australian 10-yr yields rose marginally while the short end of the curve rallied as the RBA left the cash rate (4.1%) unchanged for a second meeting of the past four, which suggested that official Australian interest rates are close to peaking.
- In credit markets, both USD and EUR denominated credit rallied, as economic data which detailed resilient economic growth and falling inflation provided some optimism to investors that the odds of a US soft landing from 16 months of aggressive rate hikes were higher than previously thought.

Rising equity valuations throughout 2023 seem mis-aligned with a high-risk macro-outlook underpinned by both credit tightening and the delayed effects of previous interest rate hikes. Recent strong economic and inflation print (in addition to the seeming fading threat from regional bank stresses) saw several investment banks reverse their 2023 recession call. However, our concern is that the market is already pricing a scenario where earnings growth is double its historic average, inflation returns to target with a cost to the economy and central banks have the room to ease rates many times. While trailing US data is supportive, leading recession indicators, stubborn core inflation, and tighter lending conditions suggest a much more challenging outlook than is reflected in equity valuation and market expectations.

While US headline CPI moderated to +3%Y in June, the resilient US labour market and sticky services inflation are keeping the pressure on a data-dependant Fed to maintain its tightening bias at the very least. Likewise, inflation remains elevated in Europe and the UK, providing impetus to the European Central Bank and Bank of England with expectations ripe for further increases over the remainder of 2023. While the probability of a 2023 US recession has been lowered by market participants, the impact of monetary policy tightening is subject to long and variable lags and markets will observe over coming months, how restrictive rates actually are. Meanwhile, there remains a cavalcade of leading indicators that suggest that recession is more likely delayed into 2024 rather than has completely dissipated. In the US, the yield curve has been inverted since the July-22 with similar inversions 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 which all suggest that a material weakening in growth is likely ahead.

The risk of an accident or a significant credit contraction remain elevated. 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 rapidly declining inflation rate.

For some time, we have been highlighting that risk in this environment is underpriced by markets. We are concerned about the outlook for a global equity market that has factored in an environment where inflation returns quickly to 2%, where earnings growth is double its 50-yr average and where central banks are all cutting rates within 12 months. High starting valuations means that expected returns are relatively modest whereas cycle risks are elevated and not priced. Facing these challenges, 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.

## CURRENT POSITIONING

The key consideration in the prevailing investment environment is to not overpay for an investment. Global equity valuations are well above average levels - especially in the US - and the environment remains one of weak profit growth, high interest rates and elevated recession risks. As such, the Fund's equity exposures in its return seeking quadrant remain modest and are concentrated in traditional value markets, sectors stocks which have valuations which have a higher likelihood of delivering investors a return of CPI +5%pa in the next five years, and which should outperform the broad index given their more conservative valuation and higher earnings resilience.

Meanwhile, the Fund has maintained the inflation protection quadrant's exposure to metals (including gold) and soft commodities. Elsewhere, the downside protection quadrant has exposure to Australian and US government bonds but the overall portfolio weight in duration is lessened by a risk controlled short position in Japanese bonds which forms part of our diversifying opportunities quadrant.

The modest government bond exposure is supplemented by a large cash position (which provides a high running yield as well as optionality in the event of a market selloff) as well as a call option on the US Dollar and a put option on the US sharemarket both of which would provide positive convexity to the portfolio in the event of a selloff, which we expect in the wake of the most aggressive hiking cycle in 40 years.

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## MORE INFORMATION

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