

Perpetual Investments

PERPETUAL DIVERSIFIED REAL RETURN FUND - CLASS Z

31 May 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 Strategy: \$691.4 million as at 31 March 2021
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

TOTAL RETURNS % AS AT 31 MAY 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)	1.2	4.5	6.0	10.1	6.4	-	6.4	Perpetual Diversified Real Return Fund (Class W)	3.7	3.4
Perpetual Diversified Real Return Fund (Net)	1.1	4.4	5.8	9.7	6.1	-	6.1	Mercer Balanced Growth Median	10.5	7.5

FUND OBJECTIVE OUTCOME AS AT 31 MAY 2021

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

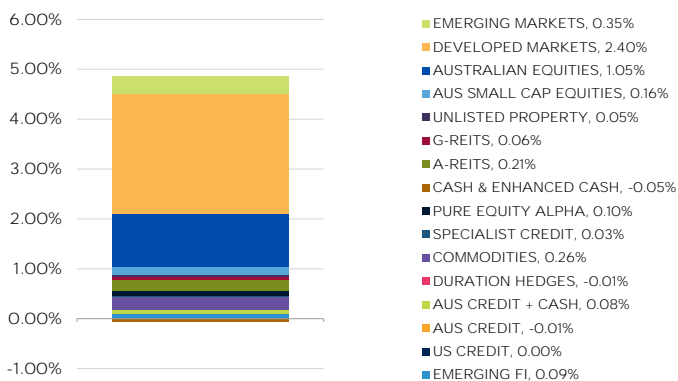
	5 YRS PA	INCEPT PA
Perpetual Diversified Real Return Fund (Gross - Class W)	6.1	7.3
CPI plus 5%	7.1	7.2

Past performance is not indicative of future performance.

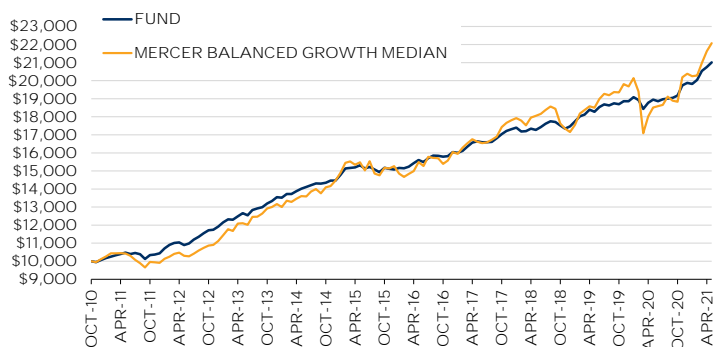
^^ Information on Management Costs (including estimated indirect costs) is set out in the Fund's PDS

* 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.

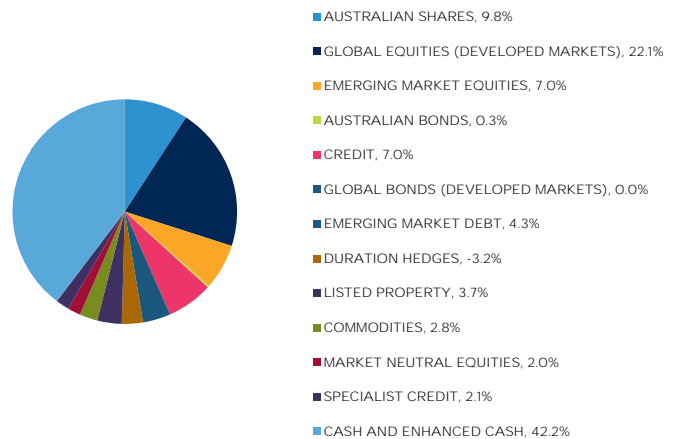
FEE OPTION

Class 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

PORTFOLIO SECTORS



CHANGES IN ASSET ALLOCATION (%)

	3 MTHS	6 MTHS	1 YR
Australian Shares	-0.7	0.2	1.1
Global Equities (Developed Markets)	3.1	7.8	12.8
Emerging Market Equities	-0.3	-0.2	3.9
Frontier Market Equities	0.0	0.0	0.0
Australian Bonds	-4.3	-7.1	-7.9
Credit	-0.6	-0.9	-0.7
Global Bonds (Developed Markets)	-2.2	-2.5	-2.4
Emerging Market Debt	-0.3	-0.1	-0.2
Duration Hedges	-1.9	-1.5	-1.9
Secured Private Debt	0.0	0.0	0.0
Unlisted Property	-1.8	-4.3	-4.9
Listed Property	2.0	1.7	1.6
Commodities	0.0	-0.7	-4.7
Market Neutral Equities	-0.1	0.0	0.0
Infrastructure Debt	0.0	0.0	0.0
Other Investments	0.0	0.0	0.0
Specialist Credit	-0.2	-0.2	-0.2
Cash and Enhanced Cash	7.2	7.7	3.5
Alternative Beta	0.0	0.0	0.0

FUND PERFORMANCE

The Diversified Real Return Fund returned 1.2% (gross) for the month of May. Over the past year, the Fund has returned 10.9% (gross) and over the past five years the Fund has returned 6.1% (gross) per annum compared with the objective of 7.1% (CPI plus 5%* over rolling five years). Since inception (in 2010) the Fund has returned 7.3% (gross) per annum compared with the objective of 7.2% (CPI plus 5%*).

Performance in May was predominantly driven by exposure to equities. Equity markets rose broadly and the portfolio's allocation to developed and emerging markets both contributed. The portfolio's value style also performed well during the month. Lastly, the portfolio's gold exposure performed well in an environment of persistent negative real yields.

*All groups CPI measured and published by the ABS as at 31 March 2021

MARKET COMMENTARY

Equity markets continued to rally through May supported by the strong economic outlook and continued vaccine rollout.

- US equities (+0.7%) rose, despite marginally trailing the broader developed market.
- France (+4.0%) led European markets from Germany (+1.9%) and the UK (+1.1%)
- Asian markets were mixed with Korea (+1.8%) and Hong Kong (+2.1%) consolidating recent gains while Japan (+0.2%) moved sideways and Taiwan (-2.8%) fell on resurgent COVID concerns.
- Australian equities (+2.3%) performed well, supported by strong economic tailwinds including a fiscally expansionary Federal budget.
- In fixed income, credit markets were quiet while global bond yields fell slightly in spite of elevated inflation concerns.

Throughout May, the daily global COVID case counts continued to fall. The vaccine rollout continued in earnest, with Chinese vaccinations surging over the month. China now joins the UK, Europe and the US on track to reach herd immunity thresholds before the end of 2021. European markets were buoyed in early May by the decision of the European Commission to ease tourism restrictions in recognition of the success of the vaccine rollout across the continent. Meanwhile, the situation in India remains dire, although daily cases eased over the latter half of the month.

In Australia, community transmitted COVID cases were discovered in Victoria in late May. To combat the cluster, the Victorian government announced a "seven-day circuit breaker lockdown" with an accompanying fiscal support package for small businesses and casual workers. While the COVID situation in Australia is broadly positive, the very low level of vaccinations and potential for snap lockdowns may continue to have a broader implication for activity and employment in services sectors including tourism.

Global growth in 2021 is still set to be the strongest since the 1970s as social mobility restrictions ease, monetary and fiscal stimulus remains potent and consumers start to run down elevated savings. Notwithstanding some US economic data disappointing elevated expectations, activity is lifting dramatically with explosive growth either underway (in the US) or in prospect (in Europe) later this year.

The outlook for growth in the major developed economies this year is underpinned by the massive fiscal expansion implemented over the past year. The Biden administration followed up their US\$2 trillion infrastructure package proposal and March's 'American Rescue Plan' stimulus with an equally aggressive budget. The budget proposal called for continued large deficits in order to bring growth back into line with its pre-pandemic trend. While there remain significant legislative hurdles, and the proposed fiscal policy are more aspirational than realistic, the commitment of the Biden administration to fiscal expansion continues to support the extraordinary economic expectations for the second half of 2021 and 2022.

In Australia, expansionary fiscal policy remained on the agenda with the level of stimulus in the Federal budget exceeding expectations. A significant portion of the package is to stimulate business investment with the expectation that consumers will continue to draw down elevated savings. During the month, Australian equities outperformed the broader developed market supported by the expansive budget and the continued surge in commodity prices. Elsewhere, the April employment report was released during the month and demonstrated the resilience of the Australian labour market to the end of the JobKeeper program.

Meanwhile, monetary policy remains on 'tilt' settings globally led by the US Federal Reserve's (the Fed) policy of zero rates supported by a massive quantitative easing (QE) program. While the minutes from the Fed's late April meeting included consideration of reducing the pace of QE (so called tapering), the Fed is unlikely to move towards tapering in the short term as employment goals are still not met, as evidenced by weak April US non-farm payroll figures.

One consideration which may point to a bring forward of the tightening process is the inflation outlook. The US CPI for April was a huge upside surprise, reigniting inflation concerns. While the CPI increase was notable, it is likely to be mostly transitory in nature. The spike in prices was primarily driven by base effects attributable to supply side constraints. Markets reacted negatively to higher than expected inflation figures in the US and UK before quickly recovering in late May. We expect to have better clarity on the path of inflation later in the year once the supply constraints have settled. As airline traffic increases and shortages in key supply chain assets – including materials and semi-conductors – ease, inflation is expected to moderate. But it will remain a key uncertainty for markets.

The Reserve Bank of Australia also remains similarly steadfast in its pursuit of inflation and employment goals before changing monetary policy settings. Inflation in the March quarter in Australia was below expectations, further supporting our belief that policy rates will remain on hold for an extended period. Decisions on the continuation or tapering of the RBA's various unconventional monetary policy tools are due for evaluation at upcoming meetings in June and July. Nonetheless, these extraordinary monetary policy conditions continue to be extremely supportive for equity and credit markets as liquidity remains abundant and the discount rate used to value equity markets remains incredibly low.

This is a very unusual cycle with the combination of:

- an extraordinary global pandemic;
- a deep recession in 2020 followed by a boom in 2021;
- extreme policy settings; and
- asset markets being priced off the lowest interest rates ever in recorded history.

As a result, we are mindful that unusual things may occur in markets. Nonetheless, at this stage of the economic cycle (ie growth recovery at the same time as central banks are committed to keeping interest rates low), the yield curve usually steepens significantly as long-term interest rates rise while short term interest rates are anchored. The beginning of this process was observed in February as long-term yields sold off, fuelling the rotation in equity markets from growth to value as discount rates increased. We expect the current conditions of continued massive fiscal support and rising bond yields will continue to be supportive for value stocks while growth stocks and other interest rate sensitive assets may struggle.

CURRENT POSITIONING

The extraordinary monetary and fiscal policy response to the COVID-19 crisis has been very successful in minimising the damage of a massive shock to the global economy. It has also had profound implications for portfolio construction. Most importantly, the role of government bonds as the defensive anchor of multi-asset portfolios has come under question. A key feature of portfolio construction for the past four decades has been the diversification benefit of owning bonds (with bonds rallying when equities are in bear markets) – this time, bonds appear vulnerable and could continue to be the cause of a significant rotation within equity markets.

In part due to ultra-low interest rates, equity markets in aggregate are extremely expensive – particularly growth sectors and the euphoria in some significant parts of the market is reminiscent of the bubble in technology stocks in the late 1990s. Just as importantly, there are some parts of the market that are very attractively priced -- particularly value stocks, including some cyclical sectors adversely impacted by the lockdowns.

These developments led to a significant restructure of the portfolio which began late last year:

- The equity portfolio has been restructured to be more defensive by reducing exposure to the US (and the technology sector in particular) and **increasing exposure to a number of different ‘value’ opportunities including the UK, Europe, Australia and emerging markets.** These investments should be well placed to out-perform if the strong economic recovery we expect plays out through the remainder of 2021. We expect **outsized profit recoveries in many cyclical stocks as well as some upward pressure on interest rates which favours ‘value’ over ‘growth’.**
- During the month, in recognition of the vulnerability and rich valuation of bond and credit markets, portfolio exposure to US credit was reduced and government bond exposure further reduced.
- The Fund remains selective in applying downside protection. A key feature of this Fund is that downside protection strategies are not mechanically implemented. Options were prohibitively expensive for a long time after the turmoil created by the pandemic early last year. Added to that, the success of the vaccine trials late last year lessened the need for downside protection as a very strong recovery in 2021 became central case. More recently, option volatility has cheapened significantly and the risks of a significant correction have increased somewhat so put option positions in Australian and US equities have been implemented as well as put options on Australian dollar versus the US dollar and the Pound.
- **In April, the last of the Fund’s direct industrial property allocation was liquidated. Capitalisation rates in the industrial property space have fallen significantly and the opportunity was taken to dispose of assets at a healthy premium. At the same time, allocations to listed Australian and Global REITs were selectively increased.**

The Fund retains a significant cash allocation. This is an extreme environment for the economy and for markets. Valuations are extremely extended in some parts of the equity market and interest rates have never been lower. Financial markets history is replete with dire warnings about the risks of investing when valuations are as extended as they are now. Even though there is a significant opportunity cost in holding cash, our focus remains on investments that can generate CPI plus 5% per annum over a five-year horizon. At the moment, that is a narrow part of the investment universe – **concentrated in the long neglected ‘value’ parts of the market. 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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