

# Perpetual Investments

## PERPETUAL DIVERSIFIED REAL RETURN FUND - CLASS Z

31 December 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:** May 2018

**Size of Strategy:** \$697.5 million as at 31 December 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 DECEMBER 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	0.7	1.9	8.2	7.2	6.0	7.1	Perpetual Diversified Real Return Fund (Class W)	3.5	3.3
Perpetual Diversified Real Return Fund (Net)	1.1	0.6	1.7	7.3	6.4	-	5.6	Mercer Balanced Growth Median	10.0	7.5

### FUND OBJECTIVE OUTCOME AS AT 31 DECEMBER 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)	6.0	7.1
CPI plus 5%	7.06	7.20

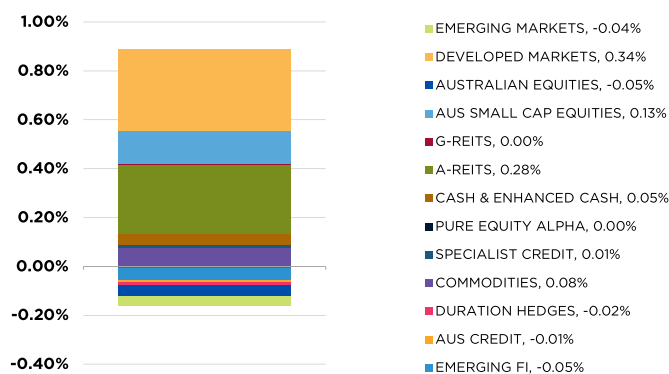
Past performance is not indicative of future performance.

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

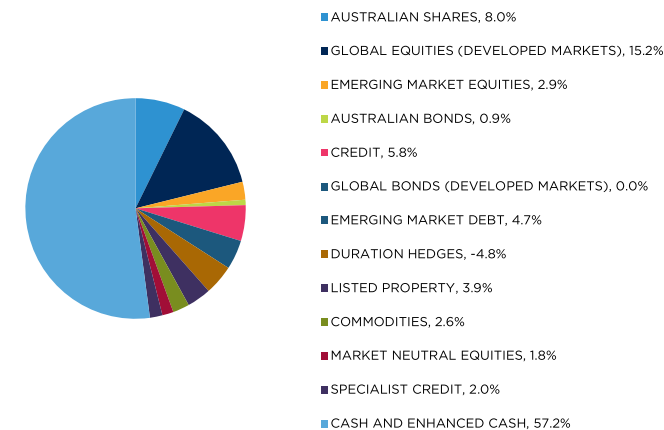
\* Volatility and Mercer Balanced Growth Median data is lagged by 1 month

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

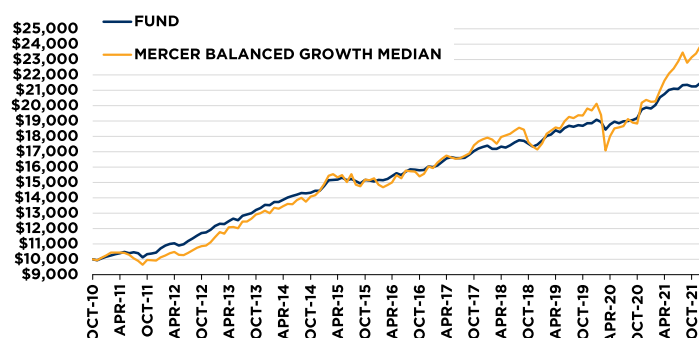
### CONTRIBUTION TO 3MTH PERFORMANCE (GROSS)



### PORTFOLIO SECTORS



### GROWTH OF \$10.000 SINCE INCEPTION



### CHANGES IN ASSET ALLOCATION (%)

	3 MTHS	6 MTHS	1 YR
Australian Shares	0.0	-2.7	-2.6
Global Equities (Developed Markets)	-3.7	-4.2	-0.8
Emerging Market Equities	-1.6	-4.4	-4.5
Frontier Market Equities	0.0	0.0	0.0
Australian Bonds	0.0	0.1	-7.2
Credit	-0.4	-1.0	-2.2
Global Bonds (Developed Markets)	0.0	0.0	-2.5
Emerging Market Debt	0.8	0.4	-0.1
Duration Hedges	-0.5	-1.6	-3.3
Secured Private Debt	0.0	0.0	0.0
Unlisted Property	0.0	0.0	-4.1
Listed Property	0.1	-0.1	1.9
Commodities	-0.1	-0.1	-1.0
Market Neutral Equities	-0.1	-0.1	-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	5.7	14.0	26.5
Alternative Beta	0.0	0.0	0.0

## FUND PERFORMANCE

The Diversified Real Return Fund returned 0.7% (gross) in the December quarter. Over the past year, the Fund has returned 8.2% (gross) and over the past 5 years the Fund has returned 6.0% (gross) per annum compared with the objective of 7.1% (CPI plus 5%\*) over rolling 5 years. Since inception (in 2010) the Fund has returned 7.1% (gross) per annum compared with the objective of 7.2% (CPI plus 5%\*).

The key component of return over the quarter was the Fund's global equity exposure. Global equities rallied despite an increasingly hawkish outlook by global central banks. The Fund's allocation to listed domestic property was also a significant contributor to return over the quarter as these stocks benefitted from the reopening following the September quarter lockdown. Stock selection in domestic and international equities detracted from returns over the quarter.

\*All groups CPI measured and published by the ABS as at September 2021

### 1. RETURN SEEKING ASSET CLASSES

Beginning of the Quarter: Medium Allocation

End of the Quarter: Low to Medium Allocation

The Fund's exposure to equities was reduced marginally by trimming exposure to emerging markets.

The Fund has exposure to a diversified range of growth assets across asset classes and markets including:

- In equities, global equities with a value style bias as well as exposure to emerging markets and Australian equities;
- Global and Australian listed property;
- Australian credit and emerging market debt;

### 2. DIVERSIFYING OPPORTUNITIES

Beginning of the Quarter: Medium Allocation

End of the Quarter: Medium Allocation

With expensive valuations in equities and extremely low bond yields (even after increases early in the year and again in late September), diversifying opportunities remains a key focus. Despite trimming slightly over the quarter, the Fund retains exposure to cyclical sectors as well as attractive relative value opportunities in UK equities and European banks.

The Fund also retains:

- A range of FX exposures including the US dollar and some emerging market currencies.
- 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. Over many years, these stocks have lagged the performance of 'growth' stocks and low-quality value stocks. Historically, however, recovery from financial and economic shocks have been supportive for quality value stocks. The combination of relatively stable long bond yields and robust earnings growth saw a recovery in growth stocks in the second half 2021. Nonetheless, stock selection benefitted the portfolio over 2021 and we expect this trend to continue as economic recovery continues and long-term yields rise.

### 3. DOWNSIDE PROTECTION

Beginning of the Quarter: Medium Allocation

End of the Quarter: Medium Allocation

Equity valuations are at record highs, fuelled by abundant liquidity and supportive fiscal policy. We expect these tailwinds to subside in the coming year as central banks tighten and governments seek to reduce budget deficits. We continue to manage these risks by limiting exposure to the most expensive parts of equity and credit markets.

Bonds yields remain extremely low and are compromised in their ability to offer downside protection. As a result, the Fund has no exposure to bonds. Instead, the Fund maintains its high cash allocation providing downside protection without introducing the risk of capital losses from rising bond yields.

The fund also retains a call option on the USD versus the CNH to hedge the possibility that the debt crisis in China results in the depreciation of the Yuan.

### 4. INFLATION PROTECTION

Beginning of the Quarter: Low to Medium Allocation

End of the Quarter: Low to Medium Allocation

Inflation concerns have persisted over the quarter with central banks abandoning the concept of 'transitory' inflation and taking steps to accelerate their tightening cycle. As a result of the overwhelming monetary and fiscal policy response to the COVID-19 pandemic and subsequent explosive economic growth, the risk of sustained inflation has increased. Direct inflation hedges are quite expensive at present, but the portfolio has a low (direct and indirect) sensitivity to higher interest rates which will assist its resilience as monetary policy is tightened. The portfolio also maintains a small allocation to a basket of commodities which historically perform well in inflationary environments.

## MARKET COMMENTARY

Global equity markets finished the year strongly, led by the US market which rallied to record highs capping another year of extremely strong performance. The US is ever more dominant in the global equity market (comprising 68% of the MSCI World index), reflecting sustained out-performance since the GFC. Accordingly, the rally in the US underpinned another record high in the MSCI World index in the final trading days of 2021. At the same time, the performance of other markets was mixed for the quarter:

- US stocks (+11.0%) led global equities, supported by robust earnings growth.
- European markets rose, led by France (+9.9%) ahead of the UK (+4.7%) and Germany (+4.1%).
- Asian markets under-performed significantly with falls in Japan (-2.1%), Korea (-3.0%) and Hong Kong (-4.7%).
- Meanwhile, Chinese equities (-6.2%) remain impacted by slowing growth, increasing regulatory intervention and the debt crisis in the property market.
- Australian equities (+2.1%) trailed global markets over the December quarter but managed small gains.

The quarter closed a strong calendar year for global equities (which were up by 25% in local currency terms), with the standout performer being the US (+29%) while China (-22%) and Hong Kong (-14%) under-performed dramatically.

As a result of the overwhelming monetary and fiscal policy response globally to the emergence of COVID-19, the pandemic has turned out to be 'very good' for markets and valuations of most assets are extremely extended. Medium to long term (5 to 10 year) returns from these valuation starting points in equities have consistently been poor thereby contributing to our very cautious outlook.

Adding to our caution, the December quarter saw a dramatic shift in central bank rhetoric led by the US Federal Reserve (the Fed) as a result of persistent high inflation. For some months, we have been highlighting the very difficult balancing act faced by the Fed as it tries to unwind extreme policy settings in the face of a slowing economy and inflation that is more than double the target. During the quarter, the Fed retired the 'transitory' moniker for the recent spike higher in inflation and began the process of reducing asset purchases before announcing an acceleration in the 'taper' in December. The Fed's quantitative easing program will likely be completed in March this year, to be followed by 3 or 4 hikes in the policy rate over the remainder of the year, but the uncertainty regarding this forecast is very high.

The European Central Bank (ECB) has also shifted its rhetoric on inflation to reflect persistent high inflation outcomes. They now plan to phase out asset purchases by March 2022. Moreover, the Bank of England became the first major central bank to raise policy rates in December with a 0.15% increase. And the Reserve Bank of Australia abandoned its yield curve control program in November, but they insist that increases in the policy rate in 2022 remain unlikely.

Central bank supported liquidity and artificially low interest rates have been a crucial component of increasing asset valuations over recent years. Even though US short-dated government bonds sold off significantly in the quarter due to the recalibration of monetary policy expectations, the US 10-year bond yield was stable at a yield of just 1.5%. It is worth emphasising that bond yields have never been lower than in the past two years. If rates move significantly higher from present levels, it may be a significant challenge for equity valuations which are already at extremes on just about all metrics -- except relative to interest rates.

Meanwhile, the identification of omicron as a variant of concern in late November has been a salutary reminder that the acute phase of the pandemic is not yet in the rear-view mirror. The faster spread and reduced virulence of omicron -- combined with much higher vaccination rates in many key developed economies may limit the impact on the global economy. Nonetheless, the impact on supply chains is still very significant due to the number of workers furloughed by the virus.

The spread of the omicron variant will continue to be closely scrutinised in the weeks and months ahead. The path of the virus is also crucial to the deliberations of the Fed and other central banks. Even though omicron is clearly negative for economic growth, the implications for policy are uncertain as it will also boost supply-side inflation, increasing the risk of a permanent shift higher in inflation expectations.

The impact of new COVID variants on emerging markets is less opaque. Chinese economic activity remains very sensitive to the path of the virus as the authorities zero tolerance for COVID leaves the economy particularly vulnerable to lockdowns. Chinese growth has slowed significantly and while policy is starting to be eased, the property sector remains under enormous pressure as the 'three red lines' policy continues to restrict the flow of credit to a heavily levered sector.

Despite record case numbers, the impact of Omicron on Australian markets has been minimal. So far, Australian inflation remains subdued (relative to global peers) and the RBA maintains that policy rate increases remain far off. This has contributed to the weakness of the \$A over the past year. Slower global growth and tightening liquidity, suggest the USD and other foreign currencies may continue to be a worthwhile hedge against weaker equity markets.

## CURRENT POSITIONING

In the next year, some of the extreme macroeconomic policies will be unwound. The omicron variant has heightened uncertainty about the end of the pandemic which may have delayed any tightening of monetary policy. But the Fed is losing patience after a string of poor inflation outcomes. This carries clear risks for financial markets.

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. We have been cautious about the outlook for some major parts of the investment universe for some time including:

- credit markets – which offer very little compensation for the risk of default.
- government bonds – where yields are negative after allowing for inflation.

The Fund has low or no exposure to these assets.

The Fund's equity exposures remain relatively 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 retains a 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 substantial risk allocation to diversifying opportunities (including equity alpha and currency positions). In addition, a USDCNH call option position has been implemented at low cost with an asymmetric pay off should authorities in China respond to the evolving property sector crisis by devaluing their currency.

There is also significant optionality in holding cash. This is an extreme environment for the economy and for markets. Valuations are extremely extended in some parts of the equity market and bond yields have never been lower than in the past two years. Financial markets history is replete with dire warnings about the risks of investing when valuations are as extended as they are now. 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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