

Perpetual Investments

PERPETUAL DIVERSIFIED REAL RETURN FUND - CLASS Z

31 July 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: \$741.3 million as at 30 June 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

TOTAL RETURNS % AS AT 31 JULY 2022

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)*	0.3	-2.1	-2.0	0.4	4.2	5.0	6.6	Perpetual Diversified Real Return Fund (Class W)	3.7	3.4
Perpetual Diversified Real Return Fund (Net)	0.3	-2.2	-2.1	0.0	3.6	-	4.4	Mercer Balanced Growth Median	10.6	7.7

FUND OBJECTIVE OUTCOME AS AT 31 JULY 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)	5.0	6.6
CPI plus 5%	7.79	7.36

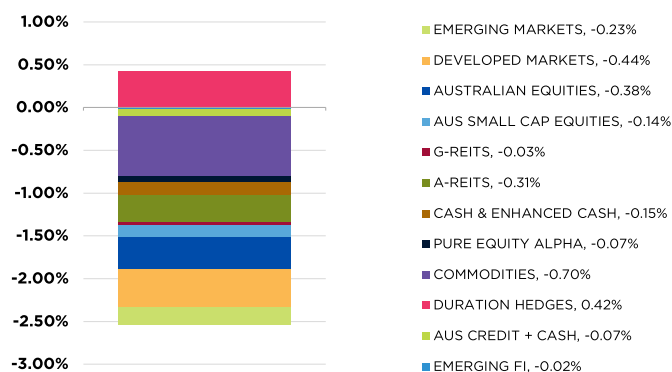
Past performance is not indicative of future performance.

^^ 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)



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.

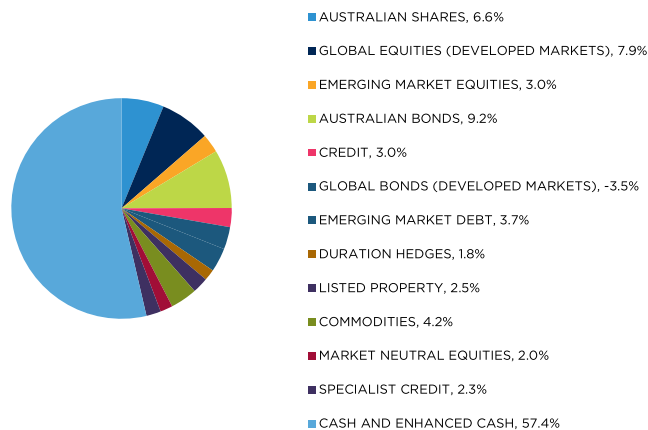
FEE OPTION

Class Z is the performance fee option.

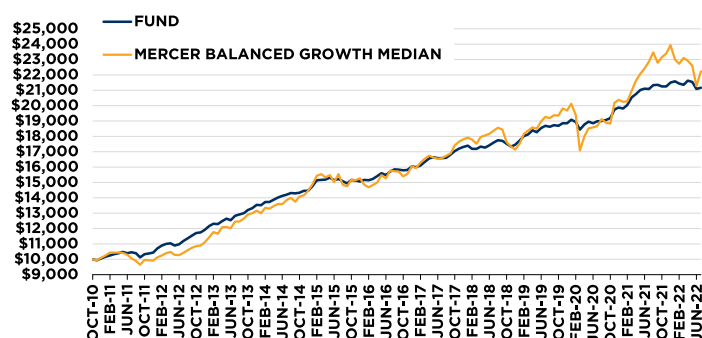
The maximum performance fee is 1%

The performance hurdle is 2.5%, the middle of the RBA target inflation rate

PORTFOLIO SECTORS



GROWTH OF \$10.000 SINCE INCEPTION



CHANGES IN ASSET ALLOCATION (%)

	3 MTHS	6 MTHS	1 YR
Australian Shares	-1.1	-1.1	-1.1
Global Equities (Developed Markets)	-0.4	-9.0	-10.7
Emerging Market Equities	0.3	0.0	-1.5
Frontier Market Equities	0.0	0.0	0.0
Australian Bonds	6.0	8.3	8.4
Credit	-3.1	-3.6	-3.6
Global Bonds (Developed Markets)	-3.5	-3.5	-3.5
Emerging Market Debt	0.0	-0.9	-0.5
Duration Hedges	5.9	6.6	5.1
Secured Private Debt	0.0	0.0	0.0
Unlisted Property	0.0	0.0	0.0
Listed Property	-1.0	-1.3	-1.3
Commodities	-1.4	1.3	1.4
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	0.3	0.1	0.1
Cash and Enhanced Cash	-2.0	3.2	7.2
Alternative Beta	0.0	0.0	0.0

FUND PERFORMANCE

The Diversified Real Return Fund returned 0.3% (gross) during July. Over the past year, the Fund has returned 0.4% (gross) and over the past 5 years the Fund has returned 5.0% (gross) per annum compared with the objective of 7.8% (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 7.4% (CPI plus 5%*).

It was a month of reversal from the trends in many markets over the first half of 2022. Accordingly, the Fund's positions in global and Australian equities were the most substantial contributors to return during the month. The Fund's equity put options gave back a portion of their recent gains as a result. Equity stock selection also gave back a portion of recent out-performance as growth sectors outperformed value.

The Fund's recently established duration exposure performed well as Australian long-term yields rallied strongly. The Fund's US Dollar (USD) exposure detracted marginally as the Australian Dollar (AUD) performed well. The Fund continues to maintain a significant allocation to cash, actively managed across a number of currencies which defended capital over the first half of 2022 as equity and fixed income markets fell significantly.

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

MARKET COMMENTARY

Global economic growth has clearly slowed with the leading indicators suggesting more weakness is in store in the second half of this year. Together with hopes that inflation may have finally peaked, this has led to some recalibration of monetary policy tightening expectations with the peak in rates lower and sooner than previously priced. Following the deep losses over the first half of 2022, equity and bond markets were oversold and some of those losses were recouped as fears of a hard landing were replaced by hopes that the economy might still be on a narrow path to a soft landing.

- US equities (+9.2%) led global equities, rebounding sharply with the strongest month of performance since 2020. Falling bond yields and robust US technology company profits saw growth sectors (+12.0%) outperform value (+6.6%) in a reversal of the recent trend.
- Australian equities (+5.8%) underperformed global peers but still posted strong gains. Mining and energy stocks dragged as materials and oil prices fell while technology stocks performed well.
- Emerging market equities (+0.2%) underperformed, led by China (-9.3%) which plunged on slowing growth indicators, the zero covid policy and the worsening property crisis.
- Credit markets were relatively quiet with the exception of European spreads which narrowed following a dramatic selloff in June.
- US and Australian bond yields continued their late June rally. The Australian 10-year (-60bps) is more than 100bps down from the June peak while the US 10-year (-33bps) ended the month at its lowest level since early April.
- Commodity markets were mixed over the month with oil and materials (like iron ore and base metals) falling, while natural gas prices surged.

While there has been a reversal in many key markets since mid-June, we maintain our view of the key pressures currently weighing on the market outlook;

- expensive absolute valuations across just about all markets;
- the complete overhaul of the monetary policy outlook that has caused a nasty bear market in government bonds and much tighter liquidity conditions;
- a slowdown in economic and profit growth with recession risks elevated in the US, Europe and Asia; and
- growing geo-political risks in Europe due to the Russia/Ukraine war and in Asia reflecting a much more assertive China.

The US economy has slowed from the tearaway growth recorded over 2021. So much so that July saw the confirmation of a technical recession in the US with two successive quarters of marginally negative GDP growth. This only highlights the limitations of this recession guide as the labour market remains in rude health (at least for now) with the unemployment rate dropping by 0.4 p.p. over the first seven months of 2022 to 3.5% to be within 0.1p.p. of the lowest levels of the past 60 years.

To be clear, we remain very concerned about the outlook for economic growth and profits. The leading indicators suggest that recession risks remain very elevated as the Fed attempts to get inflation back under control. But monetary policy operates with long and variable lags and the tightening cycle has only been underway for six months.

Notwithstanding market optimism that the Fed tightening cycle may be completed earlier and at a significantly lower policy rate than previously thought, we remain of the view that the Fed has much more to do to get inflation back under control. As a result, tighter financial conditions will continue to be required, implying a combination of a stronger US dollar, higher bond yields and credit spreads and weaker equity markets.

While we highlight the actions of the Fed as the most crucial determinant of the market outlook, other major central banks have also embarked on aggressive tightening programs. The European Central Bank (ECB) surprised markets with a larger than expected rate increase in mid-July. The central bank's first policy rate increase in 11 years brought the deposit rate up 50bps to zero. The ECB had previously signalled it would be increasing rates in July and September to combat surging inflation. The ECB faces a very challenging predicament, and the risk of policy error is high as the bank attempts to tighten into a sharply slowing economy. This comes against a backdrop of a deepening energy crisis as the continent attempts to lessen its reliance on Russian LNG. At the same time, political risks were at the fore in Europe and the UK with the Prime Ministers in both Italy (Mario Draghi) and the UK (Boris Johnson) resigning during the month.

The Reserve Bank of Australia (RBA) also continued its aggressive tightening cycle, having increased the target cash rate by 175bps between the start of May and the 2nd of August. Inflation remains the key concern for the RBA with trimmed mean inflation – the RBA's preferred measure – rising to 4.9% yoy in the June quarter, remaining well outside the target range (of 2 to 3%). While surging inflation will provide little comfort to the

central bank, the print came in short of estimates and saw monetary policy tightening expectations wound back somewhat as a result. At the same time, the labour market is very tight with the unemployment rate falling to multi-decade lows of 3.5% and, as a result, wages growth is expected to accelerate adding to inflationary pressures.

The Chinese economy is at the centre of rising global economic growth concerns with the zero covid policy, the beleaguered property sector and slowing western demand for manufactured goods all weighing on the outlook. During the month, Chinese manufacturing purchasing manager indices (PMIs) fell below 50 reflecting weaker global growth and elevated input costs. Meanwhile, the property sector remains under huge pressure with the 'three red lines' policy restricting credit to the sector leading to halted construction projects, plummeting sales and mortgage strikes.

The global tightening of monetary policy that is underway, slowing economic and corporate profit growth and heightened geopolitical tension all continue to contribute to a very challenging outlook for financial markets. We remain cautious on the outlook for the second half of 2022.

CURRENT POSITIONING

Tightening financial conditions, very high inflation and slowing economic growth provide a fraught environment for investors to navigate. High equity valuations were only supported while bond yields stayed low as a result of extraordinarily easy monetary policy. Equity valuations have adjusted (although there could be more to come) but now profit expectations need to be substantially reduced.

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 slow the economy too sharply, 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 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. During the month, the Fund added a call spread on the VIX index which will payoff if US equity volatility increases again.

The fund also employs a range of portfolio protection strategies to defend capital. This includes US equity put options and 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 through the first half of 2022 have increased the attractiveness of government bonds in some markets. During the month, the Fund's US and Australian duration was further increased partially offset by the addition of a small short (negative) position in Japanese bonds.

The Fund also 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).

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 extremely extended in some parts of the equity market and bond yields remain under pressure. Financial market 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.

MORE INFORMATION

Adviser Services 1800 062 725

Investor Services 1800 022 033

Email investments@perpetual.com.au

www.perpetual.com.au

