

# Perpetual Investments

## PERPETUAL DIVERSIFIED REAL RETURN FUND - CLASS Z

31 August 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 AUGUST 2022

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)*	0.7	-1.1	-0.6	-0.1	4.6	5.1	6.6	Perpetual Diversified Real Return Fund (Class W)	3.7	3.4
Perpetual Diversified Real Return Fund (Net)	0.7	-1.2	-0.7	-0.4	4.0	-	4.5	Mercer Balanced Growth Median	10.6	7.7

### FUND OBJECTIVE OUTCOME AS AT 31 AUGUST 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)	5.1	6.6
CPI plus 5%	7.88	7.49

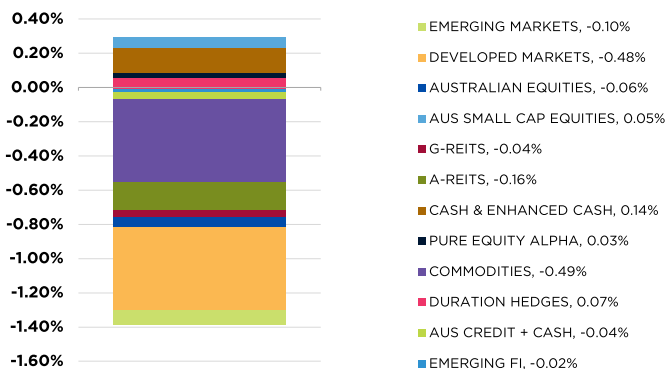
Past performance is not indicative of future performance.

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

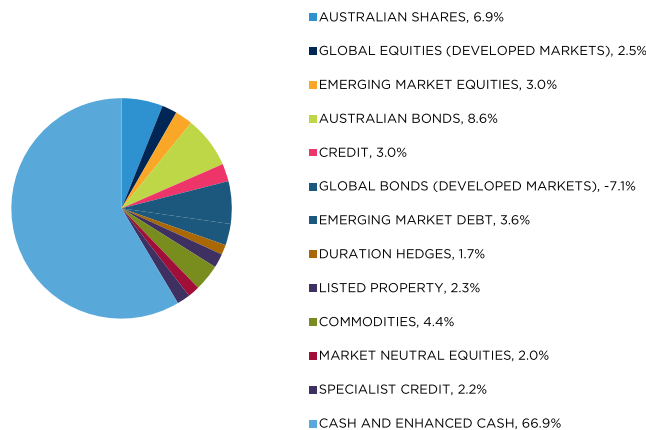
\* Volatility and Mercer Balanced Growth Median data is lagged by 1 month

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

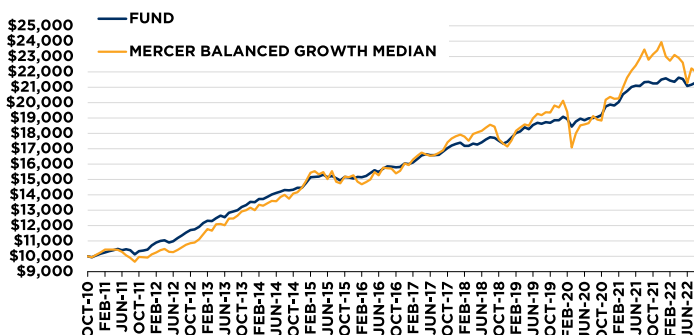
### CONTRIBUTION TO 3MTH PERFORMANCE (GROSS)



### PORTFOLIO SECTORS



### GROWTH OF \$10.000 SINCE INCEPTION



### CHANGES IN ASSET ALLOCATION (%)

	3 MTHS	6 MTHS	1 YR
Australian Shares	-0.7	-0.9	-0.8
Global Equities (Developed Markets)	-10.1	-8.8	-15.2
Emerging Market Equities	0.3	0.2	-1.7
Frontier Market Equities	0.0	0.0	0.0
Australian Bonds	5.6	7.8	7.9
Credit	-3.1	-3.6	-3.4
Global Bonds (Developed Markets)	-7.1	-7.1	-7.1
Emerging Market Debt	-0.1	-0.6	-0.5
Duration Hedges	1.8	6.4	6.2
Secured Private Debt	0.0	0.0	0.0
Unlisted Property	0.0	0.0	0.0
Listed Property	-0.9	-1.4	-1.7
Commodities	-0.9	1.4	1.6
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	0.0
Cash and Enhanced Cash	14.8	6.7	14.5
Alternative Beta	0.0	0.0	0.0

## FUND PERFORMANCE

The Diversified Real Return Fund returned 0.69% (gross) during August. Over the past year, the Fund has returned -0.16% (gross) and over the past 5 years the Fund has returned 5.10% (gross) per annum compared with the objective of 7.64% (CPI plus 5%\*) over rolling 5 years. Since inception (in 2010) the Fund has returned 6.59% (gross) per annum compared with the objective of 7.29% (CPI plus 5%\*).

Key contributors to performance were the USD (outright and through call options against the CNH and AUD), equity alpha and put options on the US and European markets, which completely offset the detraction to performance from global equities. The Fund's modest bond holdings, accumulated at the tail end of the sell-off in the first half of 2022, detracted from performance while REITs, gold and metals were a minor drag on performance.

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

## MARKET COMMENTARY

Ultimately, the rally in global equity and bond markets since mid-June could not be sustained in the face of hawkish central bank rhetoric and elevated global recession risk. Notwithstanding indications that inflation has peaked in the goods sector, it is still way too high and there remains a long way to go for central banks to get it back under control.

- US equities (-4.1%) fell sharply over the final two weeks of the month after continuing to rally over the first half of August.
- Australian equities (+1.2%) outperformed its global peers, supported by robust corporate profit results.
- Emerging market equities (+1.3%) outperformed, notwithstanding China's ongoing issues with Covid and the worsening property crisis.
- European equities (-5.1%) fell as the energy crisis intensified, while UK equities (-1.1%) were more resilient.
- Developed market bond yields rose substantially as monetary policy expectations were recalibrated yet again. Benchmark 10-year yields in the US rose by 49 bps, Australia by 54bps and the UK rose by 93 bps to a new 8-year high.
- Commodities were broadly lower over the month. Oil fell back below US\$100 while materials also fell on easing demand and higher inventories.

We maintain our view of the key pressures currently weighing on the market outlook.

- Even though equity valuations have improved this year, they remain expensive on just about all metrics.
- the transformation of the monetary policy outlook has caused a nasty bear market in government bonds and much tighter liquidity conditions.
- a slowdown in economic growth with elevated recession risks in the US and Asia and acute recession risk in Europe contributing to a likely sharp slowdown in profit growth.
- growing geo-political risks in Europe due to the Russia/Ukraine war and in Asia reflecting a much more assertive China and heightened tensions over Taiwan's future.

The US Federal Reserve (the Fed) has a very challenging task to bring inflation under control while avoiding recession. The US yield curve (between the 2 and 10 year) has now been inverted for two months which has been a reliable leading indicator of recession in the past. Economic growth has already stalled in the first half of 2022, but the labour market remains very tight with the unemployment rate in striking distance of 60-year lows.

The problem for the Fed is that inflation is so high they must take risks with economic growth to get it back down again. As a result, recent market hopes that the Fed's terminal rate might be lower and come sooner were punctured by comments from Fed Chair Jerome Powell at the annual Jackson Hole Economic symposium. Powell warned of "some pain" while recommitting to the aggressive monetary policy tightening that roiled markets in the first half of 2022. Powell's comments addressed the possibility of easing in the medium term stating: "restoring price stability will likely require maintaining a restrictive policy stance for some time," and that "the historical record cautions strongly against prematurely loosening policy". Equities sold off sharply following the address. Bonds were less impacted with yields already having risen over the first three weeks of the month. Alongside rising rates, financial conditions are set for further tightening in the months ahead as the Fed accelerates the reduction of its balance sheet by selling treasuries and credit securities.

We are yet to see the full impact of the Fed's aggressive tightening regime play out as monetary policy operates with long and variable lags and the tightening cycle has only been underway for six months. In the meantime, profit expectations in the US are too high with 8% growth expected this year and next. By contrast, we expect much weaker outcomes including the prospect of significant falls next year.

While we highlight the actions of the Fed as the most crucial determinant of the market outlook, other major central banks have followed the Fed's lead to embark on aggressive tightening programs. Voting members of the European Central Bank (ECB) have openly floated the idea of a 75bps interest rate increase and futures markets have priced a sharper pace of tightening. Meanwhile, the likelihood of a deep European recession continues to increase against a backdrop of an ongoing energy crisis. The ECB faces a diabolical predicament, and the risk of policy error is high as the bank wrestles with the prospect of double-digit inflation, an energy crisis and a sharply slowing economy.

The Reserve Bank of Australia (RBA) also continued its aggressive tightening cycle, having increased the target cash rate by 175bps since the start of May. The 50bps increase in the target cash rate in early August precipitated a selloff in Australian long term bond yields. The RBA may have to do less than the Fed as inflation and wages growth are lower and there is greater household sensitivity to policy rates reflecting highly leveraged households and the prevalence of variable rate mortgages. While the Australian economy looks robust thus far, the RBA also has a delicate balance to maintain. Inflation remains elevated and labour conditions are very tight, but forward indicators suggest slowing growth.

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 market outlook. We remain very 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 are very 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 employs a range of portfolio protection strategies to defend capital. During the month, the Fund added put options on US and European equities. The Fund also maintains 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 People's Bank of China cut policy rates during August while the Fed continues its aggressive tightening which saw the USDCNH call option perform well.

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. The Fund maintains a modest exposure to US and Australian duration. During the month, the Fund's short (negative) Japanese bond exposure was increased. The Fund maintains exposure to small parcel of metals and soft commodities which offer inflation protection.

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.

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## MORE INFORMATION

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