

Perpetual Investment Funds

PERPETUAL DIVERSIFIED REAL RETURN FUND - CLASS Z

31 October 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: \$800.0 million as at 30 September 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 OCTOBER 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)*	1.2	2.2	0.0	1.7	5.0	4.9	6.6	Perpetual Diversified Real Return Fund (Class W)	3.7	3.3
Perpetual Diversified Real Return Fund (Net)	1.2	2.1	-0.2	1.3	4.3	-	4.6	Mercer Balanced Growth Median	11.2	7.9

FUND OBJECTIVE OUTCOME AS AT 31 OCTOBER 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)	4.9	6.6
CPI plus 5%	8.13	7.62

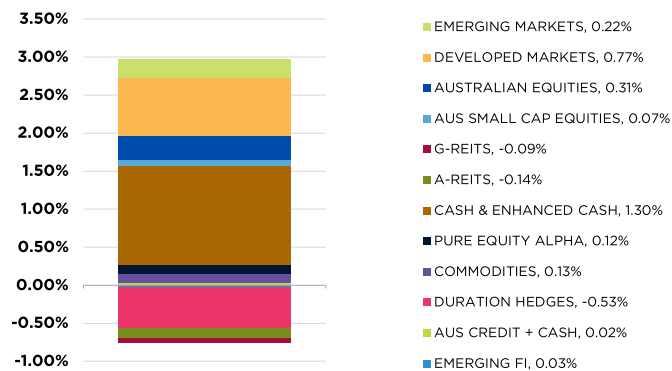
Past performance is not indicative of future performance.

^^ 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.

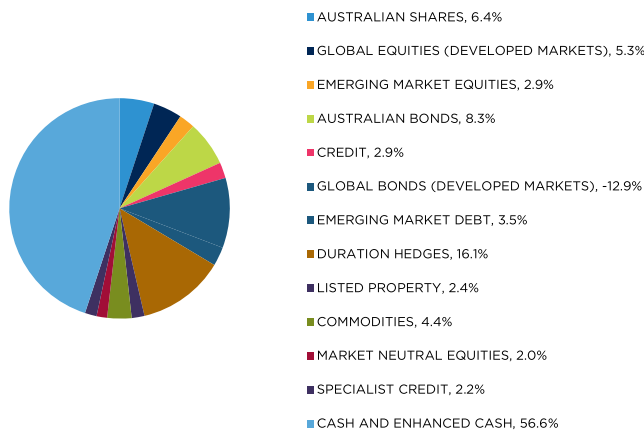
FEE OPTION

Class Z is the performance fee option.

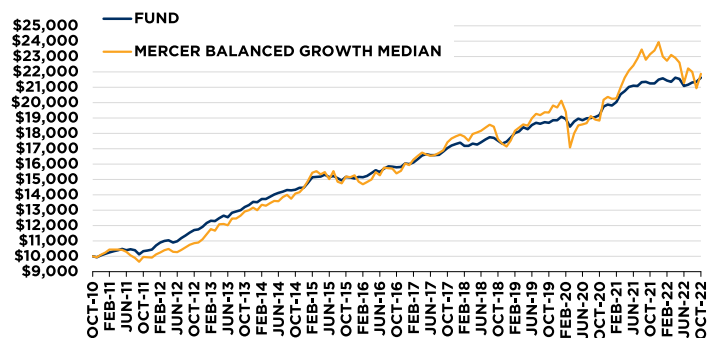
The maximum performance fee is 1%

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	-0.2	-1.4	-1.5
Global Equities (Developed Markets)	-2.6	-3.0	-10.6
Emerging Market Equities	0.0	0.3	-1.7
Frontier Market Equities	0.0	0.0	0.0
Australian Bonds	-0.8	5.2	7.5
Credit	-0.2	-3.2	-3.2
Global Bonds (Developed Markets)	-9.4	-12.9	-12.9
Emerging Market Debt	-0.3	-0.2	-0.1
Duration Hedges	14.3	20.3	20.2
Secured Private Debt	0.0	0.0	0.0
Unlisted Property	0.0	0.0	0.0
Listed Property	-0.1	-1.1	-1.4
Commodities	0.2	-1.2	1.8
Market Neutral Equities	0.0	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	-0.8	-2.8	1.8
Alternative Beta	0.0	0.0	0.0

FUND PERFORMANCE

The Diversified Real Return Fund returned 1.2% (gross) during October. Over the past year, the Fund has returned 1.7% (gross) and over the past 5 years the Fund has returned 4.9% (gross) per annum compared with the objective of 8.1% (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 7.6% (CPI plus 5%*).

The rally in global equities was constructive during October. The Fund's domestic and global equity exposure were the key contributors to return and global equity stock selection contributed to performance as value sectors and securities outperformed their growth peers with a number of US tech giants reporting underwhelming earnings. Conversely, the Fund's global equity put options detracted from return over the month given the strong rally across US and European shares.

Interestingly, the Fund's USDCNH call option performed well despite the People's Bank of China taking measures to slow the Yuan's depreciation in the lead up to October's Communist Party Congress. Elsewhere, the Fund's Australian listed real estate exposure performed well, with the sector regaining a portion of recent losses.

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

MARKET COMMENTARY

Global equity markets recovered in October as investors priced in a slower pace of central bank tightening.

- US equities (8.1%) rallied strongly as less hawkish dovish monetary policy speculation. At the same time, disappointing earnings in the US tech sector contributed to value sectors substantially outperforming growth.
- Australian equities (6.0%) rebounded underpinned by a smaller than expected policy tightening by the RBA.
- Another sharp decline for Chinese equities (-16.4%) saw emerging markets (-2.6%) significantly underperform developed markets (7.2%).
- European equities (9.1%) surged, with strong performance for Germany (9.4%) and France (8.75%). UK equities (3.0%) trailed developed markets as the recent unfunded fiscal expansion was unwound and the Bank of England temporarily ceased its tightening cycle to offer monetary support.
- The US 10-year bond yield (+28bps) continued to rise, ending the month above 4% for the first time since 2008 with the YoY rise the steepest since 1984. Elsewhere, bond yields were mixed with Australian 10-year yields falling as the RBA slowed its monetary tightening during October.
- Commodities were also mixed with energy commodities rising amid OPEC production cuts whereas materials including Iron Ore (-6%) fell on soft Chinese demand.

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

- Even though equity valuations have improved this year, they still remain above levels which are attractive, given the weakening earnings backdrop across most regions.
- Inflation and the tightening of the monetary policy 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 have contributed a moderation in profit growth and this is expected to continue.
- 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) continues to face a challenging task to bring inflation under control while minimising the economic impact of monetary tightening. During October, there was renewed speculation that the central bank would pivot from the historically aggressive rate of tightening in order to engineer a soft landing. Despite the positive market reaction to the possibility of peak inflation, the path back to the Fed's target level remains long with inflation continuing to rise above market and central bank expectations. While goods prices have moderated somewhat, services sector inflation remains well entrenched given extremely tight labour markets with unemployment in many key economies running at 50-yr lows. At the same time, leading recession indicators continue to mount with the US 2Y10Y yield now inverted for over 4 months, and the 3M10Y curve also inverted which has been an extremely reliable indicator of recession within 12-months.

Thus far, central bank rhetoric and rate increases have had a more immediate impact on financial market valuations than on employment and demand given the long and variable lags of policy. Indeed, lagging US economic indicators remain resilient including the September quarter GDP which rebounded solidly (+0.6% q/q) following two consecutive negative quarters. While consumer spending showed resilience amid a very tight labour market and a falling savings ratio, the impact of higher interest rates has been very noticeable in housing. During the month there was a modest easing in wage inflation indicators with the latest average hourly earnings and employment cost index data softening.

We remain concerned about the outlook for economic growth and profits. US earnings results released thus far have exceeded downgraded market expectations. This primarily reflects the surge in energy sector profits given higher crude oil prices, but outside this small sector US Q3 earnings growth was a rather weak -5.2% year on year which is the lowest rate since the outbreak of the pandemic. At present, revenue growth is still quite strong, but cost pressures are rising sharply, and this before the impact of the Fed's interest rate begin to impact activity and corporate bottom lines. More importantly, financial conditions are set to tighten further in the months ahead as the Fed accelerates the reduction of its balance sheet by selling US Treasuries and some mortgage-backed securities, which will place upward pressure on corporate financing costs and the US Dollar. The combination of tightening financial conditions and slowing or negative growth also highlights the risk of zombie companies (heavily leveraged unprofitable firms that have only survived due to the incredibly low interest rates over the past decade) being exposed given their weak operating models.

While the actions of the Fed remain the most crucial determinant of the market outlook, other major central banks are grappling with similar – and sometimes far more dire – circumstances. The ECB faces a challenging backdrop of double-digit inflation, an energy crisis and a sharply slowing

economy. During the month, the ECB increased rates by another 75bps to 1.5% to combat both record high inflation and ease pressure in the labour market where regional unemployment fell to a fresh record low of 6.6%. Meanwhile, the Bank of England engaged in contemporaneous monetary policy tightening (raising interest rates) and easing (purchasing bonds as a buyer of last resort) to stabilise the bond market which was in turmoil following the Truss government's September mini budget which risked placing the country on a worsening debt trajectory.

Elsewhere, the RBA's path to a soft landing remained more viable than the US or Europe as they lowered the pace of recent policy monthly tightening from 0.5% to 0.25% despite a higher-than-expected 3rd quarter CPI result. The RBA has a more potent mechanism to address household spending given highly leveraged household balance sheets and the majority of local mortgages being at variable rates which are highly sensitive to changes in the RBA's overnight cash rate. At the same time, the economy looks quite solid at present and stands to benefit from the negative rate differential with the US resulting in a lower Australian Dollar.

CURRENT POSITIONING

Rising interest rates, tightening financial conditions, 40-yr highs in inflation and slowing economic growth are a challenging environment for investors to navigate. High equity valuations were only supported by bond yields staying low as long as inflation was contained. Equity valuations have adjusted (although there could be more to come), but now profit expectations need to be lowered to more closely align with the economic backdrop.

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 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 including 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 sharp selloff in bonds and the rising recession risks throughout 2022 have increased the attractiveness of government bonds in some markets relative to post-pandemic levels. The Fund maintains a modest exposure to US and Australian duration. During the month, the Fund added a quarter of a year of US duration at the 2-year tenure taking advantage of the value offered by the sustained flattening and subsequent inversion of the US yield curve.

The Fund also 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). This cash allocation is held across a broad range of currencies including a significant US Dollar allocation which performed very well during the quarter.

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