Fund update

Perpetual Diversified Real Return Fund

Fund Performance as at 30 June 2022

Period	Gross ^	Net *	Volatility
1 month	-2.1%	-2.2%	-
3 months	-1.3%	-1.5%	-
6 months	-1.9%	-2.4%	-
1 year p.a.	0.0%	-0.9%	-
3 years p.a.	4.4%	3.5%	3.7%
5 years p.a.	4.9%	4%	-
Since Inception p.a. #	6.6%	5.7%	3.4%

Fund objective outcome as at 30 June 2022

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

	5 yrs. pa	Inception Pa
Perpetual Diversified Real Return Fund (Gross)	4.9	6.6
CPI Plus 5%	7.5	7.3

^Historical performance has been adjusted to reflect the current fee. Past performance is not indicative of future performance.

* Over rolling 5-year periods, before tax and fees. Due to CPI data being released by the Australian Bureau of Statistics later in the month after quarter end, CPI figures reported are lagged by one month.

Numbers may not be whole due to rounding. Past performance is not indicative of future performance. Past performance information provided reflects the performance of the Portfolio and not any individual portfolio managed through an SMA provider. Returns will differ for an individual portfolio compared to the Portfolio depending on matters such as inception date, fees and brokerage costs payable, adherence to model portfolio weights, portfolio implementation timing and the fees payable to an SMA provider or financial advisor. The past performance information does not take into account any taxes that may be payable in connection with any returns or gains made from the Portfolio. Past performance is not indicative of future performance. Portfolio and Index return may not sum to Excess Return due to rounding.

#Inception date 19 October 2010

Fund Performance

The Diversified Real Return Fund returned -1.3% (gross) in the June quarter. Over the past year, the Fund has returned -0.1% (gross) and over the past 5 years the Fund has returned 4.9% (gross) per annum compared with the objective of 7.5% (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 7.3% (CPI plus 5%*).

The Fund's performance was resilient in the context of another strongly negative quarter for equity and fixed income markets. The elevated cash allocation, together with defensive strategies in equity and currency markets and long held bias towards value sectors and securities continued to mitigate the impact of falling equities, widening credit spreads and rising bond yields.

The Fund's equity allocation was the most significant detractor from return as major developed equity markets fell across the board. Stock selection within Australian and global equities was positive, offsetting a portion of the negative market return. The Fund's bias towards value and quality was rewarded as long-term bond yields rose and growth sectors and securities fell sharply. The Fund's S&P 500 put options were also significant contributors as the US underperformed all major equity markets. The Fund's allocation to Australian listed property detracted from performance as the Real Estate Investment Trust sector fell sharply over the quarter.

Foreign currency returns were strongly positive over the quarter as the US dollar (USD) appreciated against peers. A call option on the USD vs the Chinese Yuan (CNH) also contributed significantly to performance.

The Fund's commodity exposures detracted from performance as materials prices fell.

*All groups CPI measured and published by the ABS as at 31 March 2022

Return-seeking asset classes
Beginning of the Quarter: Low to Medium Allocation | End of the Quarter: Low Allocation

The current financial market outlook presents a challenge for generating attractive real returns with equity valuations still relatively high considering the inflation backdrop. Interest rates are still under considerable upward pressure and recession risks are rising. As a result, the Fund is taking a very cautious approach to return seeking assets. The fund's equity exposure was further reduced over the quarter with allocation to Australian, UK and European equities trimmed. Exposure to domestic credit was also reduced towards the end of the June quarter.

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;

Diversifying opportunities
Beginning of the Quarter: Medium Allocation | End of the Quarter: Medium Allocation

With equity valuations remaining stretched and the Fund's cautious positioning with regards to return seeking assets, diversifying opportunities remain a key focus.

The Fund 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. This positioning performed well throughout the recent rotation from growth towards value. This trend is expected to persist as central banks continue to tighten monetary policy and as economic and corporate profit growth slows.

Downside protection
Beginning of the Quarter: Medium Allocation | End of the Quarter: Medium Allocation

Despite recent selloffs, equity valuations remain quite elevated. They also face headwinds in the form of tightening financial conditions and slowing economic growth. We continue to manage these risks by limiting exposure to the most expensive parts of equity and credit markets.

Bond yields remain very low relative to historical levels and the Fund remains very selective in investing in fixed income and credit. The fund's exposure to Australian and US bonds was increased over the quarter in response to the back up in bond yields. Nonetheless, the Fund retains an elevated cash position which provides downside protection.

The Fund maintains some downside protection via put options on the S&P. The Fund also utilizes currency options to protect against 'tail risks'. The fund retains a call option on the USD versus the CNH to hedge the possibility China respond to their growing economic challenges by devaluing their currency as they did in 2015 and 2018. During the June quarter, a USDHKD call option was added as a low-cost downside protection position and a USDJPY put option providing a partial hedge against the USDCNH position.

INFLATION PROTECTION

Beginning of the Quarter: Low to Medium Allocation | End of the Quarter: Low to Medium Allocation

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 in response to persistently high inflation.

The portfolio also maintains a small allocation to a basket of commodities which historically perform well in inflationary environments. The Fund's commodity exposure is diversified across gold, softs, silver, palladium, platinum and copper.

Market Commentary

Financial markets continued their torrid start to the year through the June quarter. Global equity markets fell sharply in April and June, contributing to the worst first half year for equity markets in 50 years. Rampant inflation, hawkish central policy and rising recession risks all contributed to falling equity markets and rising bond yields.

- US equities (-16.1%) fell dramatically over the quarter with sharp sell-offs in April and again in June. Growth stocks (-20.9%) significantly underperformed value (-12.2%).
- UK equities (-3.7%) continued to show resilience while continental markets were more mixed with Germany (-11.3%) and France (-8.9%) seeing larger declines.
- Australian equities (-11.9%) were impacted by reduced Chinese demand for materials and accelerated monetary tightening.
- Chinese equities (+4.6%) outperformed significantly, supported by the reopening of Shanghai. Chinese equities remain well below their 2021 highs following a dramatic selloff over the past 12 months.
- US 10-year bond yields peaked at just under 3.5% in June before rallying over the remaining two weeks of the quarter. Similarly, Australian 10-year yields rose to above 4% in June before falling back to 3.6%. The Bloomberg Global Aggregate Bond index remains on track for easily the worst year in its history.
- Energy prices eased somewhat in June but remain high, impacted by the war in Ukraine.
- Materials (like iron ore and base metals) remain at elevated prices but fell sharply over the quarter as a result of reduced Chinese demand.

We maintain our view of the key pressures currently weighing on financial markets;

- expensive absolute valuations across just about all markets;
- the complete overhaul of the monetary policy outlook that is driving a nasty bear market in government bonds and the prospect of much tighter liquidity conditions;
- a slowdown in economic and profit growth with recession risks increasing 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.

In our assessment, the most important of these influences has been the transformation of the monetary policy outlook in the US. The US Federal Reserve (the Fed) has begun to aggressively tighten monetary policy to curb inflation which has reached multi-decade highs. Tighter financial conditions mean a combination of a stronger US dollar, higher bond yields and credit spreads and weaker equity markets.

All of these things are happening, but the adjustment may have much further to go. For example:

- While US equities have fallen precipitously over the first six months of the year, they remain more than 15% above their pre-pandemic high.
- Despite normalising somewhat towards the end of the quarter, bond yields remain under pressure with the US 10-year breakeven rate (2.56%) less than half the current core inflation rate (6.0%).

The Fed has commenced a rapid tightening cycle with 1.5 percentage points worth of increases already this year. Nonetheless, inflation remains uncomfortably high. For the past 35 years, the Fed has been able to operate within a 'dovish' framework because inflation consistently surprised to the downside. At this stage it seems more likely that we have a long slog ahead in order to get inflation back down to 2% and the risk of a recession in the next two years has increased appreciably as a result.

Slowing economic growth and rising recession risks weighed on equity markets and other growth assets throughout the quarter. High inflation and rising interest rates were reflected in falling business and consumer sentiment. Purchasing manager indices continued to fall over the quarter with the latest US manufacturing survey reading the lowest in two years. At the same time, the fall in consumer sentiment has been precipitous. In the US, this has been reflected in reduced personal spending and a stagnant economy in the first half of 2022. Risks to economic growth are not unique to the US however, with increasing concerns across Europe and China.

Eurozone inflation reached a record high during the quarter as the ECB prepares to increase rates for the first time in 11 years and above zero for the first time since 2014. The war in Ukraine continues to intensify inflationary pressure as a result of Europe's dependence on Russian energy and increasing food security concerns. The increasing hawkishness of the ECB may not be enough to curb inflation and rapidly increasing interest rates sit uneasily with an already slowing economy.

China's economy remains extremely sensitive to the path of the virus, the beleaguered property sector and western demand for manufactured goods. Leading indicators showed recovery in May and June following the two-month lockdown in Shanghai. While the rebound has been quick, the Shanghai lockdown highlighted the risks of China's zero COVID policy. With low natural immunity and vaccination rates, the policy is likely to persist, and Chinese economic activity will remain extremely sensitive to outbreaks. Meanwhile, the property sector remains under huge stress reflecting the 'three red lines' policy restricting the flow of credit to this highly levered sector. Finally, the cushion provided by positive net exports in China may be eroded in the next year as Western demand growth slows and rotates away from good and towards services.

Of course, developments in China always have significant ramifications in Australia. While iron ore prices moderated over the quarter, they remain very high, contributing to the resilience of the Australian economy. The Reserve Bank of Australia (RBA) has commenced an aggressive tightening cycle with a pair of higher-than-expected rate rises during the quarter. Much will depend on the evolution of the inflation outlook. While high inflation remains a significant determinant of RBA policy, wage pressure – as yet – is less severe than in comparable developed markets.

Tightening monetary policy, slowing growth, disrupted supply chains and increasing geopolitical tension all contribute to a very challenging outlook for financial markets. Equity valuations have made some adjustment to the increase in interest rates, but profit expectations look too high and are likely to be the next shoe to drop. Meanwhile, bond yields are exposed to inflation risk and could still go significantly higher. Against this backdrop, the most exposed part of the market continue to be growth stocks, while value and quality could be expected to continue to be more resilient.

Current Positioning

Tightening financial conditions 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 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. 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 devaluing their currency. Despite increasing exposure to US and Australian bonds, the Fund's overall exposure to fixed income remains low.

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.

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

For more information

Adviser Services: **1800 062 725**

Email: **investments@perpetual.com.au**

www.perpetual.com.au

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