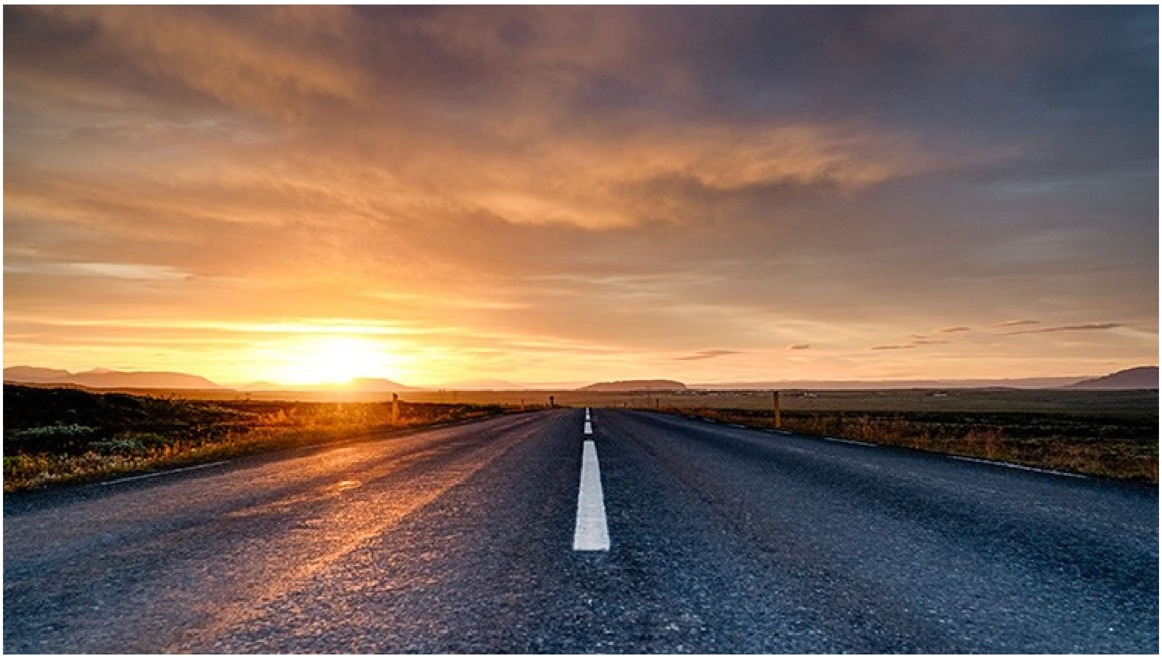
BUILT TO NAVIGATE CHANGE



PERPETUAL ASSET MANAGEMENT
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An all-terrain investment approach can help smooth an investment journey

Ten years ago, Australian share investors were in the midst of the global financial crisis (GFC). It arrived suddenly and unannounced, following halcyon days with four consecutive financial years of 20% plus returns. For many investors it was a car wreck, one which devastated their retirement plans and decimated the value of their investment portfolios. Yet fast forward to today, and what have we learned in the decade since?

Despite recent equity market highs and a bull market that brought us out of the GFC and hardly skipped a beat since, investors will have to accept potentially lower future returns and determine how to best diversify risk in their portfolios. The short-termism that dominates investor behaviour has led to Australians having a record high $91.5 billion deposited in cash, savings and bank accounts[1]. Unfortunately, ‘safety’ comes at a price. Cash is the lowest returning asset in history and bond yields are slowly increasing after years at record lows, reducing the bonds’ capital value.

Lower returns plus increased life expectancy equal the risk that investors outlive their retirement savings. This leads to a conundrum – investors want to avoid risk; however, they also want to accumulate sufficient assets to fund a desirable retirement. Rather than asking ‘*How do I avoid risk?*’, investors should focus on how competing risks can be managed.

The investment environment in 2019 and beyond will become increasingly challenging across a number of asset classes. Equity markets are overvalued, and, as global interest rates fell to historical lows, traditionally defensive assets such as fixed income, property and infrastructure have also become overvalued; as a result, these assets may lose their defensive attributes and become inherently risky. For investors, this means re-examining the role of asset classes within portfolios.

If investors do not take on the right amount of risk and have the optimal asset allocation today to generate the level of returns required to fund their retirement, they may need to:

1. Spend less today to save more for retirement
2. Retire later
3. Accept a lower standard of retirement living
4. Invest in riskier assets to hopefully boost returns, with the prospect of negative short term returns.

Very few investors would find these options appealing. At Perpetual Investments, we believe there is an alternative.

AN ALL-TERRAIN INVESTMENT VEHICLE

Warren Buffet once famously stated "*Be fearful when others are greedy and only greedy when others are fearful*." Fear and greed are powerful emotions that push markets to extremes.

For over 20 years, Perpetual Investments has employed an active approach to asset allocation to manage risk and enhance returns. Our Multi Asset team adopts a precision engineered approach; one that is agile and nimble and, importantly, packed with safety features to overcome the irrationality that can dominate thinking during periods of extreme market stress. This approach is built to navigate change and combat a challenging return environment.

We call this the three layers of defence:

1. **Value and Quality**
   Buying any asset at the right price increases the probability of a successful investment outcome. Real performance and a smooth investment journey are underpinned by our disciplined approach to identifying high-quality, attractively valued investment opportunities, irrespective of the security or asset class. We believe that protecting investor portfolios means not only avoiding poor quality investments, but also, by not being tempted to overpay by following the herd.

2. **Intelligent diversification**
   Intelligent diversification focuses on examining underlying return drivers and ensuring diversity among assets to identify distinctly unrelated investment opportunities. It's also about flexibility and being able to quickly adapt to change as markets shift course.

   Some asset classes that appear diversified from the outside may share underlying risk drivers. For example, commodities is an asset class often used as a source of diversification. However, many Australian investors have significant exposure to hard commodities, such as iron ore, via their equity holdings or superannuation fund by, for example, holding shares in BHP Billiton or Rio.

   At times when Perpetual identifies value in this asset class, rather than simply investing in the whole commodity market, we have instead tailored a basket of soft commodities, such as cotton, wheat, or sugar, which complements investors' existing portfolios and avoids 'double up', therefore ensuring *genuine* diversification.

   An intelligently diversified portfolio can adapt to change quickly, accelerate when the market moves or adjust to changing conditions with the freedom to take on a more dynamic and agile approach.

3. **Explicit portfolio protection**
   Minimising risk can be achieved, in part, by a breadth of investments and balance of risks in a portfolio. Our focus is on smoothing the investment journey and using portfolio construction expertise to act as a shock absorber to help preserve capital should the market suddenly fall.

   One way to protect on the downside is to explicitly manage valuation risk – that is, avoid investment in expensive asset classes in the first place. However, this approach can lead to large cash investments when valuations are unattractive, so is insufficient as a stand-alone strategy.

At Perpetual, we not only tactically increase exposure to fixed income and hold cash when appropriate, we may also implement explicit portfolio protection. This can be as simple as:

- reducing exposure to more volatile shares in an overvalued equity market
- deploying put options to prevent large peak-to-trough losses for our investors.

Looking ahead, investors will have to balance the demographic reality of a longer life expectancy with the reality of markedly lower investment returns. One thing is certain – by avoiding risk assets entirely, investors are reinforcing the reality of low returns, which can negatively impact their retirement plans. As such, Perpetual's Multi Asset team believes it is important for investors to not only own risk, but to manage it carefully. Risk management is vital, risk avoidance is damaging.

Navigating the future investment environment will be challenging. Adopting an active, dynamic and risk aware investment portfolio is one way to help ensure investors are best equipped to deal with, and potentially benefit from, this unpredictability.

1. APRA Monthly Banking Statistics, 30 September 2018