# WHAT ARE REAL RETURNS AND HOW DO THEY WORK?

**PERPETUAL INVESTMENTS**
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For most people, the primary goal of investing is to accumulate sufficient assets to fund a comfortable retirement – whether that's in five or 50 years' time.

And while most investors expect there to be market corrections and fluctuations along the way, the severe downturn earlier this year and before that the Global Financial Crisis (GFC) raised an important question – how to best structure a portfolio to withstand extreme market stress?

Of course, the GFC felt like a once in a lifetime event. Fast forward more than a decade and in the words of Yogi Berra 'it feels like déjà vu all over again':

- The worst global pandemic since the Spanish flu 100 years ago.
- The worst global recession since the great depression in the 1930s.
- Policy interest rates around zero in most developed countries including Australia.
- Fiscal policy support for the global economy is unprecedented in its size and scope.
- A stunning fall in stock markets in late February and March 2020 has been followed by an incredible bounce led by the technology sector with company valuations close to all time highs.

Understandably the talk has turned to the 'lower return, higher volatility' investment environment. Defensive assets like government bonds are trading at the lowest yields ever by some considerable margin. At these yield levels we must question whether bonds can they play their usual role in portfolios. Term deposits are also generating extremely low returns which are unlikely to keep pace with inflation.

In part due to the very low interest rates on offer, share prices are now at valuations that have been exceeded only twice before – once prior to the Great Depression and once during the tech bubble in the late 1990s.

While we're not predicting the next market correction, high valuations do create a problem – where to next? When you think about the future returns that can be expected from overvalued assets, the potential upside is lower.

A combination of lower returns and higher volatility often means investors have two choices:

1. either take on extra risk to achieve the same return,
2. or reduce their return expectations.

This is not an ideal choice for most investors, particularly those close to retirement.

### Enter the real return fund

Real return funds focus on outcome orientated objectives; they're designed to provide investors with a higher certainty of achieving a real return objective with a lower level of risk and lower sensitivity to extreme market events. In other words, a real return fund is designed to enable investors to maintain their investment goals and not have to choose between taking on more risk or accepting lower returns.

Real return funds are particularly useful for investors seeking to balance investment returns with downside risk.

**A real return fund can accelerate on the open road, change direction to avoid delays, or brake safely.**

### How do real return funds work?

Real return funds will all have different investment objectives, strategies and guidelines. Generally, they focus on providing investors with genuine diversification by investing in high quality opportunities at reasonable prices with a specific return target.

Many investors have encountered diversified funds – they're very common in the superannuation environment. Like those traditional diversified funds, real return funds invest across a range of asset classes and investment strategies. However, that's where the similarities end. Points of difference include:

1. Real return funds have very specific investment return targets, which are generally measured against the rate of inflation (CPI) – for example, CPI plus 5% per annum over rolling five-year periods.
2. Most real return funds have a strong focus on preserving an investor's money and reducing the potential for loss. This is sometimes achieved through specialised asset management, dynamic asset allocation, or by investing in a broader investment universe – or a combination of all three.
   This means that real return funds often have greater flexibility to adjust the portfolio's asset allocation in response to market conditions and to reduce or remove asset classes which have poor expected returns.

3. Real return funds can invest in a wide range of investments outside 'traditional' asset classes; this may include unlisted property or infrastructure, commodities, specialist equities (like emerging or frontier markets), specialist credit, foreign currencies and derivatives.

So, for an investor looking for steady performance, lower volatility and reduced downside risk, real return funds are worth investigating. As with all fund types, there will be differences between real return funds offered by different investment managers and they carry different levels of risk. It's important to understand the investment approach taken by each, and the depth of experience and expertise of the investment team managing the fund.

**Find out more about the performance, strategy and holdings of Perpetual's Diversified Real Return Fund.**