WHY INVEST IN A REAL RETURN FUND?

PERPETUAL INVESTMENTS

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Free from the constraints of a fixed strategic asset allocation, real return funds with active asset allocation have grown exponentially in recent years. In the first article of this series, we examined what makes a real return fund and how it works. This article considers why a real return fund makes sense in a diversified portfolio.

The importance of a 'real' return fund

Real return funds can "better adapt to an ever complex and dynamic investment landscape… [with] investment personnel granted freedom to adjust asset allocation on both a material and continuous basis in response to changing market conditions."[1]

This adaptability enables real return funds to deliver a specified return with smaller drawdowns.

Or, in other words, provide a 'smoother ride' to an agreed objective; a ride with less volatility along the way and an eye on capital preservation. After all, the common objective of all investors is to make money and, ideally, not lose it!

A specified return objective – such as the inflation rate (CPI) plus 5% per annum over a rolling five year period – is important to investors, particularly retirees on a fixed income. Having a specified return objective and knowing the investment manager is continually adjusting the asset allocation to achieve the objective, helps investors plan.

Protection against inflation

Equally as important is the notion of an inflation-adjusted outcome. This 'real' return, which is not simply measured against a benchmark, means that investment returns will not only outpace inflation, they'll provide a reasonable level of return above inflation and grow the purchasing power of each dollar invested.

Because inflation erodes the purchasing power of each dollar, and your real investment returns, it's important that your investments provide protection against inflation over time.

Real return funds are generally constructed from the bottom up, with the single-minded premise of delivering an investment objective above the rate of inflation.

Diversifying the source of risk

Real return funds actively target a certain level of return, while seeking to minimise the amount of risk an investor takes on. By investing across a wider range of assets, real return strategies are generally less reliant on any single source of return.

Managing portfolios in a more holistic and flexible way, where the mix of exposures can respond quickly to changing market conditions, may assist in reducing the uncertainty of investment outcomes over the investment horizon.

Managing drawdowns

Every investment exposes you to some type of risk and some investments are exposed to more risks than others. A drawdown occurs when an asset class or investment falls in value. The main risk investors want to minimise is the risk of permanent capital loss. This risk is particularly acute for investors that are close to or in retirement as they are potentially forced to draw down on their reduced balance to fund their living costs. Depending on the severity of the drawdown and whether it occurs early or late in retirement this can increase the risk of running out of money even if the underlying strategy is otherwise appropriate. Its therefore essential to minimise drawdowns.

As illustrated in figure one, a loss of just 10% requires an 11% gain to recoup that loss…a 30% loss requires a 43% gain – just to get back to square one, let alone to deliver a positive return. The greater the drawdown, the greater the gain needed to recoup the loss.

Figure one: Market drawdowns and gains needed to recoup losses

Loss	Gain needed to recoup loss
10%	11%
15%	18%
20%	25%
30%	43%
40%	67%
50%	100%

The right investments at the right time

Investing is a full-time job. To ensure you're holding the right investments at the right time requires expertise, discipline and skill. Real return funds aren't 'set and forget'. They don't decide on a set allocation of asset classes to hold; rather they constantly modify the investments they're holding in response to changing market conditions to ensure an appropriate level of return for the risk taken on.

Bridging the gap between investment classes and opportunity

A portfolio constructed solely of equities, fixed income, cash and property can limit a portfolio's potential sources of return. Real return funds, which often have a much broader set of allowable asset classes, are not as constrained.

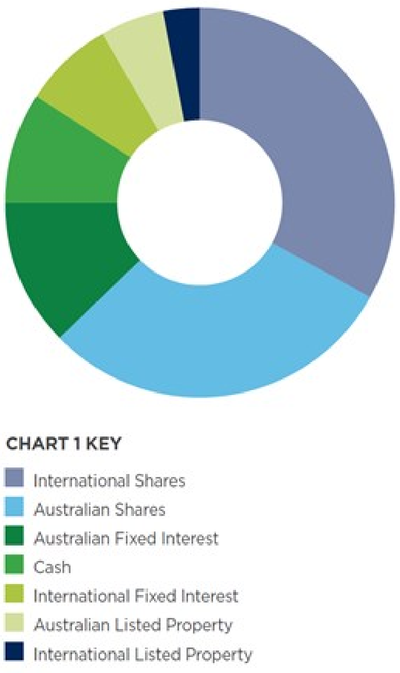
Many investors find it difficult to access the types of investments that 'fall between the cracks' of more defined asset classes like cash, shares and bonds. Investments such as emerging market debt and commodities, for example, can be accessed in a real return fund.

Having access to a more diverse range of investments enhances the potential for diversification of return and risk.

To illustrate the difference between a diversified fund and a real return fund, figures two and three provide a snapshot of asset class exposure. Figure two illustrates the typical asset class exposure of the Multi-Sector Market Index, whereas figure three shows the diversification of Perpetual's Diversified Real Return Fund.

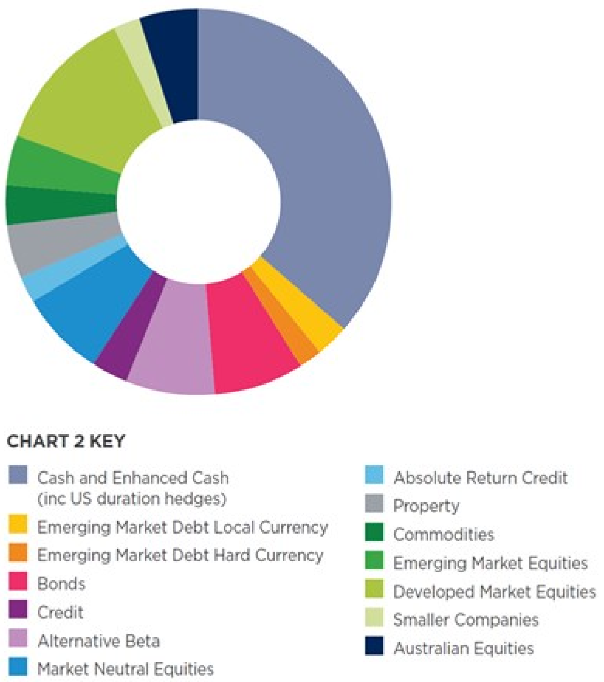
Figure two: Multi-Sector Growth Index

MULTI-SECTOR INDEX



Source: Morningstar Multi-Sector Growth Index, Data as at 20 February 2020.

Figure three: Perpetual Diversified Real Return Fund



Perpetual, Data as at 29 February 2020.

As one would expect Perpetual's Diversified Real Return Fund delivered a much smoother performance profile through the market turmoil earlier this year.

Holding a diverse mix of investments in your portfolio can be beneficial, but the complexity associated with it may outweigh the benefits. This is when managing the investments within a single fund can help remove uncertainty.

And because real return funds are structured as managed funds, you have the transparency to what you're invested, the liquidity to top up or reduce your investment at any time and the flexibility to combine a real return fund with other investments or funds.

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

1. Source: Zenith Multi Sector Report, 2014