Perpetual Investments
PERPETUAL DIVERSIFIED REAL RETURN
31 December 2018

FUND FACTS

Investment objective: Targets a pre-tax return of 5% per annum above inflation, before fees and taxes, over rolling five-year periods.
Aims to provide investors with exposure to a balanced portfolio that is constructed with reference to risk premiums (risk contribution to overall portfolio) rather than capital allocations.
Management Fee: 1.88% pa*
Suggested minimum investment period: Five years or longer
*Refer to PDS for Management Costs.

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.

TOTAL RETURNS % (AFTER FEES) AS AT 31 DECEMBER 2018

PERFORMANCE	APIR	1 MTH	3 MTHS	6 MTHS	1 YR	3 YRS PA	5 YRS PA	7 YRS PA	10 YRS PA
Perp. WealthFocus Allocated Pension	PER0741AU	0.3	-2.1	-0.9	-0.9	2.9	-	-	-
Perp. WealthFocus Investment Advantage	PER0739AU	0.3	-2.1	-1.0	-1.2	2.9	-	-	-
Perp. WealthFocus Super	PER0742AU	0.3	-1.9	-0.8	-0.9	2.9	-	-	-

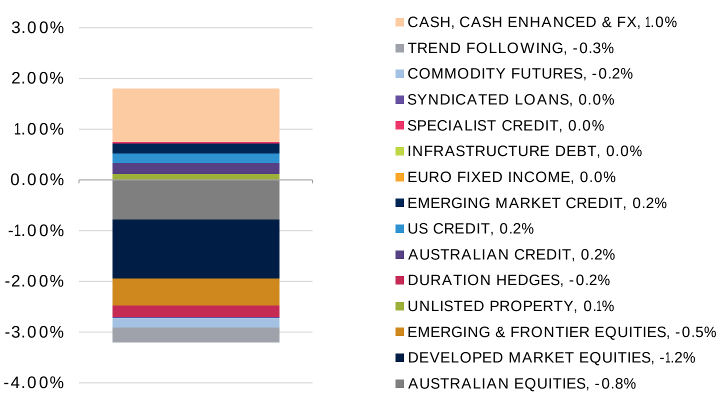
FUND OBJECTIVE OUTCOME AS AT 31 DECEMBER 2018

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

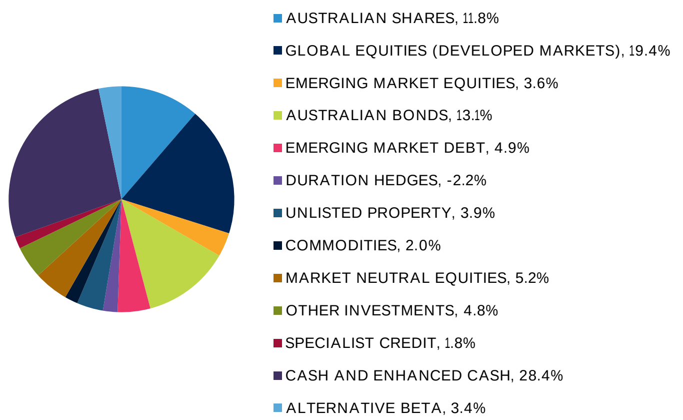
	5 YRS PA	INCEPT PA
Perpetual Diversified Real Return Fund (Gross)	5.2	7.0
CPI plus 5%	6.8	7.2

Past performance is not indicative of future performance.
^^ Information on Management Costs (including estimated indirect costs) is set out in the Fund's PDS

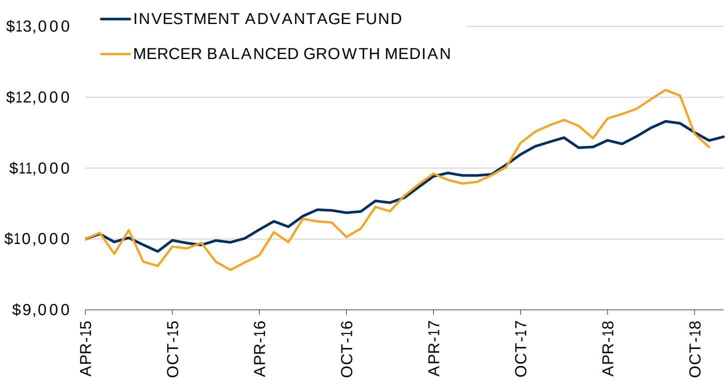
CONTRIBUTION TO 3MTH PERFORMANCE (GROSS)



PORTFOLIO SECTORS



GROWTH OF $10.000 SINCE INCEPTION



CHANGES IN ASSET ALLOCATION (%)

	3 MTHS	6 MTHS	1 YR
Australian Shares	1.5	1.2	-3.5
Global Equities (Developed Markets)	0.5	2.2	4.1
Emerging Market Equities	-0.7	-0.9	-3.8
Frontier Market Equities	0.0	0.0	0.0
Australian Bonds	0.9	6.3	11.5
Global Bonds (Developed Markets)	0.0	0.0	0.0
Emerging Market Debt	0.0	-0.1	0.2
Duration Hedges	8.2	0.1	-0.4
Secured Private Debt	0.0	0.0	0.0
Unlisted Property	0.0	1.2	1.1
Listed Property	0.0	0.0	-0.9
Commodities	-0.2	-0.1	2.0
Market Neutral Equities	0.1	-0.1	0.0
Infrastructure Debt	0.0	0.0	0.0
Other Investments	0.0	-0.1	-0.4
Specialist Credit	-2.5	-2.5	-2.8
Cash and Enhanced Cash	-7.8	-7.2	-6.5
Alternative Beta	0.0	0.0	-0.4

FUND PERFORMANCE

The Diversified Real Return Fund returned -1.4% (gross) in the December quarter. Over the past year the Fund has returned 0.9% (gross) and over the past 5 years the Fund has returned 5.2% (gross) per annum compared with the objective of 6.8% (CPI plus 5%) over rolling 5 years.

In a quarter where major equity markets in the US, Europe and Asia were down by between 10 and 15% and credit markets were also much weaker, the Fund's defensive qualities were highlighted by several factors:

- Optionality in the portfolio (in equities and FX) added significantly to portfolio performance as volatility increased and key downside protection positions moved to be 'in the money';
- High cash weightings – cash returns may be low, but it has been an out-performing asset class in the past year. In addition, a position in Australian fixed income was built up over the course of the year which added to performance in the December quarter;
- A position in unlisted industrial property continues to perform very strongly;
- The bias towards value in global equities added to performance; and
- A significant exposure to the US dollar also added value.

*All groups CPI measured and published by the ABS as at 30 September 2018

1. RETURN SEEKING ASSET CLASSES

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

The Fund retains exposure to a diversified range of growth assets, but the overall allocation has been trimmed – particularly in US equities and US bank loans. The Fund's residual exposure to growth assets remains diversified across asset classes and markets including:

- In equities, global equities with a value style bias as well as exposure to US value, emerging markets and Australia;
- In credit, US bank loans, Australian credit and emerging market debt;
- In property, Australian industrial property.

2. DIVERSIFYING OPPORTUNITIES

Beginning of the Quarter: High Allocation
End of the Quarter: Medium to High Allocation

The Fund's exposure to diversifying opportunities has been trimmed somewhat, but remains elevated reflecting the combination of generally expensive valuations for growth assets (limiting the opportunities in return seeking) and attractive relative value opportunities. The Fund has:

- A range of FX exposures including the US dollar, Yen and some emerging market currencies. We continue to view a lower Australian dollar ($A) as likely as the Chinese economy slows and the Australian housing market continues to moderate but have taken some profits on the US dollar position.
- Stock selection alpha (through Perpetual's Pure Equity Alpha Fund, Australian Share Fund, Australian Small Cap Fund and the Global Share Fund). The equity holdings are concentrated in high quality 'value' companies. At this mature stage of the economic and market cycle, these stocks have lagged the performance of 'growth' stocks and low quality value stocks, but in the medium term (3 to 5 years) they are expected to out-perform handsomely.
- A strategy which aims to extract value from trends in markets.
- The Fund's position in a fixed income spread strategy that is long Australian 10 year bonds against US 10 year Treasuries has been closed to take profits.

3. DOWNSIDE PROTECTION

Beginning of the Quarter: Medium Allocation
End of the Quarter: Medium to High Allocation

A feature of this cycle has been the cheapness of options across asset classes as investors continue to search for any yield pick-up in an extraordinarily low interest rate environment. Even after the surge in equity volatility in February 2018 (following the spectacular demise of a product which systematically sold volatility), equity volatility quickly fell again and short dated put options continue to provide attractive insurance against a significant market correction. We have taken profits on this position but the Fund retains a reduced exposure to these options at the end of the December quarter.

In addition, the weakness of the $A has allowed the strike price on the Fund's position in a (previously long dated) Australian dollar put versus the US dollar to be rolled down twice. This locks in a profit, while maintaining participation in any further $A weakness. Moreover, the position has been added to as it continues to provide attractive downside protection in the portfolio notwithstanding the fall in the $A over the course of this year.

The Fund has a position in Australian sovereign credit default swap which will protect the portfolio in the event of a repricing of this risk. And the Fund has established a position in Australian government bonds as it has become clearer that the Reserve Bank of Australia is a long way from tightening monetary policy and may even ease policy in 2019.

4. INFLATION PROTECTION

Beginning of the Quarter: Low Allocation
End of the Quarter: Low Allocation

Inflation pressures were beginning to stir at the start of the quarter, but had fizzled out by the end of the quarter due to the dramatic fall in oil prices from their peak in early October. This will help to keep inflation well contained in 2019. Nonetheless, the Fund retains a small exposure to a basket of energy and agricultural commodities which tend to perform well in a rising inflation environment. Other inflation hedges in the portfolio are indirect (from exposures in industrial property and equities).

MARKET COMMENTARY

Global equity markets corrected sharply in the December quarter to the point where more than half of global equity markets were in a bear market (having declined more than 20% from their recent peak). Credit markets have also weakened notably and liquidity in these markets has become extremely poor. A number of factors coalesced to force a reassessment of the outlook. In particular:

- Notwithstanding signs of weaker growth, the tightening bias of US monetary policy which has prevailed since late 2016 continued, with the US Federal Reserve (the Fed) raising its policy rate in December.
- The liquidity backdrop for markets has changed profoundly over the past year – from massive expansion a year ago to marginal contraction now. By early 2019, only the Bank of Japan's QE program is in place and it has been scaled back substantially under its "Yield Curve Control" policy. The European Central Bank's (ECB) program has stopped and the Fed is 'on autopilot' in selling assets to gradually reduce its balance sheet.
- The global economic expansion is slowing as the US economy moves past the peak fiscal stimulus and Chinese economic growth continues to moderate due to its deleveraging policies.
- Oil prices fell dramatically in the quarter which, as usual, is a double edged sword – it provides some relief for consumers and businesses that are energy users, but it might also be an indicator of weakness in the global economy and it causes intense pressure on energy related companies in equity and debt markets.
- The uncertainty created by the trade war between China and the US (notwithstanding some more positive rhetoric from President Trump recently) and the growing strategic rivalry between these super-powers continues to hang over the markets
- Finally, in Australia, house prices in Sydney and Melbourne are finally falling which is a very good thing for housing affordability but the second round effects on consumption spending and the economy could be significant.

As a result of these developments, global profit growth is expected to slow sharply in 2019 (and could even be negative) and recession risks in the next two years have increased significantly in our judgement.

Policy makers are showing some limited signs of responding to the deterioration in the growth outlook in 2019. The Chinese authorities continue to ease policy in an attempt to revive growth, but it appears a more dramatic intervention (like the fiscal easing in 2016) will ultimately be required. This means President Xi would have to back away from his policies to clean up the shadow banking system – a step he has been unwilling to take (so far).

The Fed is likely to be on hold for some time as the sell-off in equity and credit markets late last year tightened financial conditions significantly (similar to the correction in late 2015 and early 2016 which caused the Fed to go on hold for 12 months). Moreover, a slowdown in growth is already underway and inflation will fall below target again (due to lower oil prices) in the next six months.

In Australia, the Reserve Bank (RBA) has long maintained that the next move in rates is likely to be up. Now it looks more likely to be down as the growth outlook becomes more uncertain and inflation remains at or below the bottom of the target band. The Federal election in the first half of the year will no doubt further complicate the outlook.

Notwithstanding these signs of adjustments by global central banks, the tightening in the liquidity of financial markets caused by the change in global central banks' balance sheet policy is likely to continue.

We remain cautious about the market outlook. A correction of the magnitude we have seen in the December quarter is usually enough to create the conditions for a renewed bull market if the global economy has a soft landing. At the same time, the economic outlook has clearly deteriorated and the risk of recession in the next two years has increased notably. Finally, as we have been observing for some time, the economic and market cycle are very mature and the market performance in the December quarter increases the risk that this very long bull market is over. Accordingly, leading indicators for the global economy will be more than usually important in the months ahead.

CURRENT POSITIONING

The Fund's defensive strategies kicked in during the December quarter and added significantly to performance. These positions were managed actively over the quarter as the risk reward proposition changed. Profits were taken by rolling strike prices on bought option positions in equity and currency markets or by reducing or removing some other positions (including credit protection strategies in US high yield and Australian investment grade credit).

By the end of the quarter, the portfolio was still positioned defensively, but much less so than during height of the sell-off during October and December.

The portfolio retains strong defensive qualities reflecting the value and quality bias in equity allocations; a position in Australian sovereign credit default swap which will protect the portfolio in the event of a continued repricing of this risk; and a (reduced) position in US equity put options. Finally, the duration of the portfolio has also been increased in the past quarter.

Relative value positions have been reduced at the margin as we took profits on the overweight in Australian 10 year bonds versus US 10 year bonds. However, the Fund retains significant foreign exchange exposure with a position in the USD (although this has been significantly reduced), core emerging market currencies (such as Chinese Yuan, Korean Won and Taiwanese dollar) and the Japanese Yen as well as smaller positions in the Euro and Sterling.

MORE INFORMATION

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