

Perpetual Diversified Real Return Fund

Fund Performance as at 30 September 2021

Period	Gross [^]	Net [*]	Volatility
1 month	0.1%	0.0%	-
3 months	1.2%	1.0%	-
6 months	3.9%	3.5%	-
1 year p.a.	12.1%	11.1%	3.4%
3 years p.a.	6.4%	5.5%	3.7%
5 years p.a.	6.2%	5.3%	3.3%
Since Inception p.a. [#]	7.2%	6.3%	3.3%

Fund objective outcome as at 30 September 2021

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

	5 yrs. pa	Inception Pa
Perpetual Diversified Real Return Fund (Gross)	6.2	7.2
CPI Plus 5%	6.9	7.1

[^]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 1.2% (gross) in the September quarter. Over the past year, the Fund has returned 12.1% (gross) and over the past 5 years the Fund has returned 6.2% (gross) per annum, compared with the objective of 6.9% (CPI plus 5%*) over rolling 5 years. Since inception (in 2010), the Fund has returned 7.2% (gross) per annum compared with the objective of 7.1% (CPI plus 5%*).

Australian equity stock selection and listed property exposures contributed to performance during the quarter. Global equity exposures were more mixed. Developed market equities performed well through July and August before selling off in September. The Fund's emerging market equity exposure detracted from performance over the quarter as emerging markets – led by China – sold off. This was somewhat mitigated by stock selection as the Fund's emerging market

exposures remain underweight Chinese equities. Elsewhere, the Fund's style positioning contributed with exposure to UK equities and European banks contributing positively to performance.

Return-seeking asset classes

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

Overall, the Fund's equity exposure was reduced over the quarter. The Fund's return-seeking assets were significantly restructured late 2020 to increase focus on value and the economic cycle and reduce exposure to the US and the technology sector in particular. Early in the quarter, these relative value positions were selectively reduced. Exposure to emerging market equities and value specific indices were trimmed. A number of defensive positions limiting exposure to US equities were reduced. At the same time, the Fund entered a put option position on the Nasdaq in order to limit exposure to the US tech sector.

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 expensive valuations in equities and extremely low bond yields (even after increases early in the year and again in late September), diversifying opportunities remains a key focus. Despite trimming slightly over the quarter, the Fund retains exposure to cyclical sectors as well as attractive relative value opportunities in UK equities and European banks.

The Fund also retains:

- A range of FX exposures including the US dollar, British Pound 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. Over many years, these stocks have lagged the performance of growth stocks and low-quality value stocks. Historically, however, recovery from financial and economic shocks have been supportive for value stocks. The shift towards value sectors and stocks that began in late 2020 has benefitted the portfolio in the first half of 2021 and we expect this trend to continue as economic recovery continues and inflation and long-term yields rise.

Downside protection

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

While the economic outlook and liquidity conditions remain supportive for markets, we remain cognisant of a number of significant tail risks. The most likely catalyst for a correction remains an earlier-than-expected tightening by central banks and the evolving property debt crisis in China. We continue to manage these risks by limiting exposure to the most expensive parts of equity and credit markets. In addition, the Fund has a put option position in the US market (as well as the technology sector put option cited above). A call option on the USD versus the CNH has also been implemented to hedge the possibility that the debt crisis in China becomes more systemic.

Notwithstanding the rise in late September, bond yields remain extremely low and their ability to provide downside protection is compromised. As a result, the Fund maintains very low exposure to bonds. Instead, the Fund maintains its high cash allocation, providing downside protection without introducing interest rate risk.

INFLATION PROTECTION

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

Inflation risks continued to be a concern for investors over the quarter with transitory inflation effects persisting. As a result of the overwhelming monetary and fiscal policy response to the COVID-19 pandemic and subsequent explosive economic growth, the risk of a sustained increase in inflation has increased. 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 in the event that inflation has a persistent outbreak. The portfolio maintains a small allocation to a basket of commodities which historically perform well in inflationary environments.

Market Commentary

Financial markets largely marked time over the quarter as some of the key themes that have driven markets over the past 18 months are clearly changing. Developed market equities continued to rise through July and August (supported by very strong profit growth) before giving back those gains in September (as expectations of monetary policy tightening were bought forward and government bond yields moved higher). Emerging market equities continued to lag, weighed down by the under-performance of Chinese equities. Bond markets rallied in July but sold off again for the rest of the quarter to be largely unchanged. Currency markets remain quiet, but the US dollar was uniformly stronger and the \$A was the weakest of the major developed currencies.

In fact, the past six months has been marked by a period of transition for the global economy and financial markets:

- Global economic growth remains well above trend but has peaked and will slow significantly in the next year.
- Inflation has unexpectedly vaulted higher as very strong demand growth has collided with significant supply side disruptions.
- Profit growth has been stunning but, in the US, profit expectations for this year and next have levelled out.
- The highly contagious delta variant has led to yet another reassessment of the likely course of the pandemic.
- Global central banks have become significantly more hawkish with the US Federal Reserve (the Fed) bringing forward both the start and end date for 'tapering' quantitative easing (QE), the Bank of England is now expected to hike rates in coming months and the Reserve Bank of New Zealand, Norway's central bank (Norges Bank) and some emerging market central banks (in Latin America and Europe) have already hiked rates.

Perhaps the most significant surprise has been the spike higher in US inflation. The Fed's preferred measure of core inflation is the highest it has been in nearly 30 years. The key contributing factor to the initial surge was supply chain disruption affecting the production of components like semiconductors. More recently, European inflation has surprised on the upside, while natural gas prices have doubled, reflecting a structurally tight market caused by years of under investment in energy production. The natural gas spike specifically has additional, associated economic risk as in a worse-case scenario (a colder than usual Northern winter) the industrial economy might be affected by forced black-outs. This risk bears close scrutiny in the months ahead.

We are also particularly focussed on the specific risks to the outlook for the two largest global economies, the US and China. In the US, the Fed is in a very uncomfortable position. The US economy is growing very strongly but is set to slow significantly in the next year. At the same time, 'transient' inflationary pressures are now proving to be longer lasting, while monetary policy settings remain extremely accommodative. As a result, they are bringing forward the taper to start later

this year and finish by mid-2022. They will be tightening monetary policy at a time when the impulse from fiscal policy is very contractionary, and the economy is slowing back to trend. Moreover, when the taper finishes, policy rates will still be zero with inflation well above target and the labour market back close to full employment.

China faces a completely different set of challenges. The Chinese economy is estimated to have marginally contracted in the September quarter – a very unusual occurrence caused by mobility restrictions to control the delta variant and a slowdown in the property sector. COVID restrictions have been eased, but the structural challenges faced by the economy remain intense. In particular, the highly leveraged property sector is under enormous stress, symbolised by the travails of the second largest property developer, Evergrande, as they are forced to de-lever. The real estate sector is enormous in China (representing close to 30% of GDP by some estimates) and the second-round effects on growth by a contraction in activity are significant.

In Australia, the impact of the slowdown in the Chinese property sector has been notable as it has caused a collapse in iron ore prices – admittedly from extraordinary, record-high levels. In addition, the lockdowns in NSW, Victoria and the ACT caused a significant fall in activity in the September quarter. The belated success of the vaccination rollout should ensure these economies safely reopen in coming weeks. In the meantime, the Reserve Bank of Australia (RBA) has underscored they plan to keep policy extremely stimulative. Moreover, fiscal policy is sure to provide further support in the lead up to the Federal election due next year. As a result, we expect a solid rebound in growth late this year and in 2022, but there are clearly substantial medium-term structural challenges facing the Australian economy including transitioning to a low carbon economy, over-reliance on high population growth via immigration, housing affordability and a broken relationship with our biggest trading partner, China.

The outlook for markets overall is heavily contingent on the bond market outlook. Fixed income investors gave the Fed the benefit of the doubt earlier this year when inflation surprised on the upside. But if they lose confidence in the Fed, it will be problematic for the bond market with flow-on implications for all assets – including growth stocks, which have disproportionately benefitted from the multi-decade trend to lower interest rates. It appears likely that the upward pressure on bond yields will continue.

The combination of lower economic growth, higher inflation and tighter monetary policy suggests a more challenging fundamental backdrop for equity markets and other growth assets. Equity markets have been on a tear for 18 months – particularly the US market which has more than doubled from the lows of March 2020. The US market is now trading at an all-time record high, more than one third higher than the previous record in early 2020. As a result, valuations are very extended on all metrics EXCEPT relative to interest rates. We are cautious on the market outlook as the mix of growth and inflation becomes more problematic and the anchor provided for extreme valuations by record low bond yields is at risk of being unmoored.

Current Positioning

In the next year, some of the extreme macroeconomic policies will be unwound in the US (and globally) as the impact of the pandemic recedes and the economy recovers. This carries clear risks for financial markets.

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. We have been cautious about the outlook for some major parts of the investment universe for some time including:

- the US equity market (which on some measures is the most expensive it has ever been) and specifically the technology sector.
- credit markets – very little compensation for the risk of default.
- government bonds – yields are negative after allowing for inflation.

The Fund has low or no exposure to these assets. Equity holdings are concentrated in value stocks and markets where medium-term return prospects are reasonable. This adds to the defensive characteristics of the portfolio, particularly in a rising interest rate environment.

In the past quarter, the Fund's overall equity weight was further reduced both directly and by reintroducing put option protection for both the US market and the US technology sector. In addition, a USDCNH call option position has been implemented at low cost with an asymmetric pay off in the event that the authorities in China respond to the evolving property sector crisis by devaluing their currency.

The Fund also retains a 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 substantial risk allocation to diversifying opportunities (including equity alpha and currency positions).

There is also significant optionality in holding cash. This is an extreme environment for the economy and for markets. Valuations are extremely extended in some parts of the equity market and bond yields have never been lower than in the past year. Financial markets 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

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The product disclosure statement (PDS) for the Perpetual Diversified Real Return Fund (Class W), issued by PIML, should be considered before deciding whether to acquire or hold units in the fund. The PDS and Target Market Determination can be obtained by calling 1800 022 033 or visiting our website www.perpetual.com.au.

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