

Perpetual Diversified Real Return Fund

Fund Performance as at 30 June 2021

Period	Gross [^]	Net [*]	Volatility
1 month	0.4%	0.3%	-
3 months	2.7%	2.5%	-
6 months	6.1%	5.7%	-
1 year p.a.	11.9%	10.9%	3.3%
3 years p.a.	6.6%	5.7%	3.7%
5 years p.a.	6.4%	5.5%	3.3%
Since Inception p.a. [#]	7.2%	6.3%	3.3%

Fund objective outcome as at 30 June 2021

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

	5 yrs pa	Inception Pa
Perpetual Diversified Real Return Fund (Gross)	6.4	7.2
CPI Plus 5%	7.0	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 2.7% (gross) in the June quarter. Over the past year, the Fund has returned 11.9% (gross) and over the past five years the Fund has returned 6.4% (gross) per annum compared with the objective of 7.0% (CPI plus 5%*) over rolling five years. Since inception (in 2010), the Fund has returned 7.2% (gross) per annum compared with the objective of 7.1% (CPI plus 5%*).

Once again, the main contributor to performance was the Fund's global and Australian equity allocations. The value bias within equity allocations detracted marginally from performance (following a very strong contribution over the previous quarter), reflecting the stabilisation in government bond markets. The fund's foreign currency positioning added to performance with the Australian dollar falling against the USD and emerging market currencies late in the quarter.

Return-seeking asset classes

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

The Fund's return-seeking assets were significantly restructured late last year to increase focus on value and the economic cycle and reduce exposure to the US and the technology sector in particular. In the process, the defensiveness of the Fund's equity allocation has been increased significantly.

The Fund has exposure to a diversified range of growth assets across both 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,
- US investment grade credit, 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 the increase in the first quarter of 2021), diversifying opportunities remains a key focus. The Fund retains its increased 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, Sterling 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 economies' recover and inflation and long-term yields rise.

Downside protection

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

The improved economic and public health outlook has fuelled equity markets and many sectors now appear expensive, while some are extremely expensive. Equity volatility continues to subside as the investor's memory of the shock early last year recedes. At the same time, the economic outlook is favourable and liquidity conditions remain very supportive. It is difficult to identify the catalyst for a correction although as usual there are plenty of risk scenarios, including: an earlier tightening by central banks than is currently contemplated; vaccine impotency against new strains of the virus; and an unusually unsettled geo-political back drop. For the time being, our focus remains on embedding greater defensiveness in the Fund's growth investments by further reducing the exposure to the most expensive parts of the equity and credit markets.

The Fund's government bond position has been further reduced in light of the inflation surprise in the past quarter and the expectation of continued very strong growth. As a result, the Fund's already high cash allocation has been further increased.

INFLATION PROTECTION

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

We have been arguing that the overwhelming monetary and fiscal policy response to the COVID-19 pandemic has introduced some modest long-term inflation risks. These risks were highlighted by inflation data in the June quarter that well exceeded expectations. Investors appear to subscribe to the Fed's narrative that these pressures are transitory. Nonetheless, 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 larger outbreak. The portfolio maintains a small allocation to a basket of commodities that historically perform well in inflationary environments.

Market Commentary

As expected, the global economy is rebounding very strongly in 2021, led by the US in the first half and likely to be followed by Europe and emerging market economies (excluding China) in the second half as lockdowns and other social mobility restrictions ease.

Global growth was very strong in the first half and is expected to accelerate in the second half of 2021 as the vaccination roll-out continues apace, releasing pent up demand by reopening economies in the developed world. Growth is expected to slow in 2022 as fiscal policy becomes a drag and pent up demand is satisfied.

As a result, profit estimates for this year and next continue to be revised up, so much so that 2022 earnings per share in the US are expected to be almost a third higher than in 2019.

There are, however, some more problematic developments for the market outlook:

- Inflation in the US has been much higher than expected in recent months. These misses have been attributed to 'transitory factors' caused by supply side bottlenecks, most notably in used cars (as a spill-over from excess demand for new cars) as well as sporting goods, furniture and appliances. A lot hinges on this assessment as monetary policy settings are so extreme – our own view is that core inflation will subside from recent levels back towards 2% next year as some of these 'one-offs' reverse. With growth estimates expected to be well above potential growth, however, average core inflation will likely be somewhat higher than we previously estimated.
- The emergence of the highly contagious Delta variant has wreaked havoc in India, become the dominant strain in the UK and is growing rapidly elsewhere. The growth in cases in the UK has happened despite a population with a high level of natural immunity and vaccinations. On the more encouraging side, there are some indications that the vaccine is working to significantly reduce the risk of severe disease.
- The outlook for Australia is especially delicately poised given the combination of a highly contagious variant and very low levels of vaccination and natural immunity. The economy has recovered very well but the second half of 2021 is going to be difficult to navigate if the virus becomes established in the most populous states.

Financial markets are continuing to run hard with the upbeat growth and profits story, while largely ignoring the risks created by recent higher inflation prints and the emergence of the Delta variant. In fact, there are very few signs of distress in financial markets as equity, credit and commodity markets all continue an amazing run of performance, which began in the depths of despair at the onset of the COVID-19 crisis in March last year. This is best illustrated by:

- Global equity markets continue to perform very strongly, at first led by growth stocks in 2020 (particularly the technology sector) as the US 10-year rate fell under 1%. Value stocks have taken over so far this year, but the technology behemoths (Amazon, Google, Apple, Microsoft and Facebook) are still trading at or close to record highs.
- Commodity markets are very buoyant: iron ore prices are at record highs; copper prices are around the record highs of 10 years ago; and oil prices have recovered strongly after trading at negative prices in April last year.

- Credit spreads are very tight. For example, the spread on US high yield (or 'junk') debt is less than 3%. Moreover, benchmark government bond yields subsided somewhat in the June quarter, notwithstanding the spike in US inflation. As a result, government bond yields are still remarkably low with 10-year bonds in the major markets ranging from -0.17% in Germany to 0.05% in Japan and 1.5% in the US and Australia. And the value of negative yielding debt in the Barclays Global Aggregate Index (an index of global government and corporate investment grade debt) is still USD14trillion or 20% of the index.
- Currency markets have been marked by a weaker USD in 2020, but volatility in these markets is near 20-year lows.

Perhaps one sign of distress in markets is a major correction in Bitcoin in the June quarter (of 41%). Even after this correction, however, Bitcoin is still up nearly 280% from a year ago!

How do we make sense of these ebullient markets for risky assets like equities and commodities at the same time as the increase in bond yields has been quite limited? In our view, the answer is liquidity. Central banks went to 'tilt' monetary policy settings when the coronavirus hit early last year with zero (or negative) policy rates in all major economies, supported by massive quantitative easing (QE) programs. While the global economic recovery is now well established, there has been very little change so far in the guidance for monetary policy from the key central banks (the US Federal Reserve, the European Central Bank and the Bank of Japan). The strongest year of economic growth in many decades and a series of upside inflation surprises sits awkwardly with current policy settings.

In our judgement, this is why the bond market has been able to stabilise and the secular bull market in bonds over the past four decades remains very much intact. Indeed, interest rates are not far above their lowest levels ever (reached last year) underpinning eye-watering valuations in many key markets (like US equities). As the stimulus is inevitably wound back, we expect a more difficult backdrop for markets and particularly for those investments where the valuation is most sensitive to the level of interest rates.

It is difficult to be precise about the timing of such a major change. As usual one central bank, the US Federal Reserve (the Fed), will dominate the narrative. For now, we are in a holding pattern awaiting more inflation data, developments on the Delta variant and central bank policy decisions.

Current Positioning

The extraordinary monetary and fiscal policy response to the COVID-19 crisis has been very successful in minimising the damage of a massive shock to the global economy. It has also had profound implications for portfolio construction. In particular, the role of bonds in portfolios as long-term interest rates remain at extraordinarily low levels, supported by zero cash rates and aggressive quantitative easing. A key feature of portfolio construction for the past four decades has been the diversification benefit of owning bonds (with bonds rallying when equities are in bear markets). This time, bonds appear vulnerable and could continue to be the cause of a significant rotation within equity markets.

Our focus remains on investments that can generate CPI plus 5% per annum over a five-year horizon. Against this backdrop, we remain cautious about the outlook for some major parts of the investment universe, including:

- the US 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.

At the same time, there are many attractive investments in the long-neglected 'value' parts of the equity market. These investments have several desirable features including significant upside as economies re-open, resilience in a rising interest rate environment, and defensive characteristics in the event of a general correction in equity markets.

The Fund's overall risk level is at the high end of its recent range, reflecting the risk allocated to the various equity markets that are attractively valued as well as diversifying opportunities (including equity alpha and FX positions).

The Fund also retains a significant 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 by a substantial risk allocation to diversifying opportunities (including equity alpha and currency positions) and has also been used to back call options on equity markets.

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 can be obtained by calling 1800 022 033 or visiting our website www.perpetual.com.au.

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