Perpetual Investments
PERPETUAL DIVERSIFIED REAL RETURN FUND - CLASS W
30 September 2020

FUND FACTS

Investment objective: The Fund targets a pre-tax return of 5% per annum above inflation (before fees and taxes) over rolling five-year periods.
The Fund aims to provide investors with exposure to a balanced portfolio that is constructed with reference to risk premiums (risk contribution to the overall portfolio) rather than capital allocations

Inception date: October 2010
Size of fund: $548.1 million as at 30 September 2020
APIR: PER0556AU
Management Fee: 0.85% pa ^^Refer to PDS for Management Costs
Investment style: Diversified risk budgeting, active, value
Suggested minimum investment period: Five years or longer

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.

FEE OPTION

Class W is the standard fixed fee class

TOTAL RETURNS % AS AT 30 SEPTEMBER 2020

PERFORMANCE	1 MTH	3 MTHS	6 MTHS	1 YR	3 YRS PA	5 YRS PA	INCEPT PA
Perpetual Diversified Real Return Fund (Gross)	0.2	1.0	3.3	1.7	4.3	5.0	6.7
Perpetual Diversified Real Return Fund (Net)	0.2	0.8	2.9	0.8	3.4	4.1	5.8

VOLATILITY^	3 YRS PA	INCEPT PA
Perpetual Diversified Real Return Fund	3.4	3.3
Mercer Balanced Growth Median	9.8	7.5

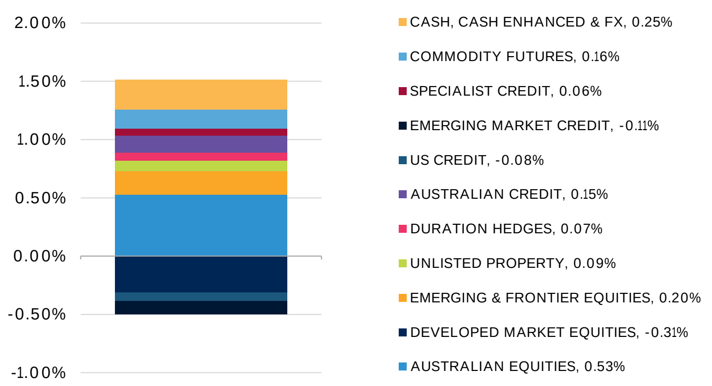
FUND OBJECTIVE OUTCOME AS AT 30 SEPTEMBER 2020

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

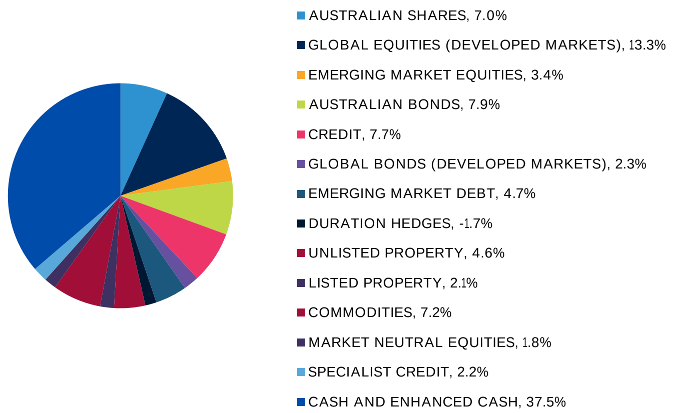
	5 YRS PA	INCEPT PA
Perpetual Diversified Real Return Fund (Gross)	5.0	6.7
CPI plus 5%	6.3	6.9

Past performance is not indicative of future performance.
^^ Information on Management Costs (including estimated indirect costs) is set out in the Fund's PDS
^ Volatility and Mercer Balanced Growth Median data is lagged by 1 month

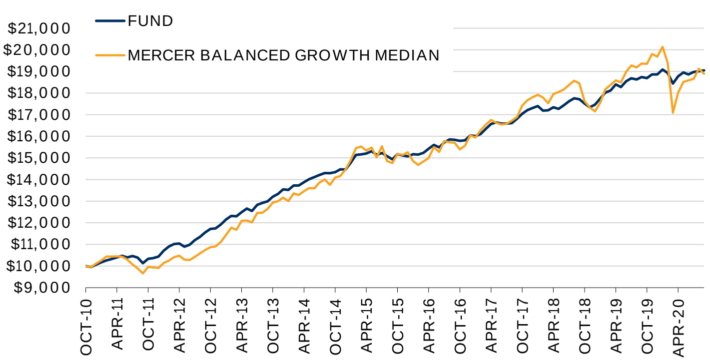
CONTRIBUTION TO 3MTH PERFORMANCE (GROSS)



PORTFOLIO SECTORS



GROWTH OF $10,000 SINCE INCEPTION



CHANGES IN ASSET ALLOCATION (%)

	3 MTHS	6 MTHS	1 YR
Australian Shares	-1.3	-2.2	-0.1
Global Equities (Developed Markets)	1.8	1.5	-0.3
Emerging Market Equities	0.1	0.3	0.5
Frontier Market Equities	0.0	0.0	0.0
Australian Bonds	-0.2	-0.5	3.0
Credit	-0.1	-0.2	0.1
Global Bonds (Developed Markets)	0.0	-0.4	2.3
Emerging Market Debt	0.4	0.1	-0.1
Duration Hedges	-0.4	-0.7	-18.2
Secured Private Debt	0.0	0.0	0.0
Unlisted Property	-0.3	-0.4	-0.1
Listed Property	-0.1	-1.1	2.1
Commodities	-0.1	-0.5	4.2
Market Neutral Equities	-0.1	-0.1	-5.5
Infrastructure Debt	0.0	0.0	0.0
Other Investments	0.0	0.0	0.0
Specialist Credit	-0.1	-0.2	-0.2
Cash and Enhanced Cash	0.4	4.3	15.6
Alternative Beta	0.0	0.0	-3.2

FUND PERFORMANCE

The Diversified Real Return Fund returned 1.0% (gross) in the September quarter. Over the past year the Fund has returned 1.7 % (gross) and over the past 5 years the Fund has returned 5.0% (gross) per annum compared with the objective of 6.3% (CPI plus 5%*) over rolling 5 years. Since inception (in 2010) the Fund has returned 6.7% (gross) per annum compared with the objective of 6.9% (CPI plus 5%*).

The key drivers of return over the quarter were equity exposures as equity markets continued their recovery through July and August before selling off in September. Australian equity stock selection contributed to performance as value and quality biases outperformed through the rally and subsequent selloff. The Fund's allocation to gold also added to performance as gold posted record highs in July and August before giving back some of those gains in September.

The main detractor over the quarter was the fund's US dollar exposure. The portfolio's value bias and stock selection in global equities detracted from performance over the quarter.

*All groups CPI measured and published by the ABS as at 30 June 2020

1. RETURN SEEKING ASSET CLASSES

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

Equity allocations remain conservative as valuations continue to look expensive against a challenging economic backdrop.

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 Australia;
- US investment grade credit, Australian credit and emerging market debt;
- Australian industrial property as well as global and Australian listed property.

2. DIVERSIFYING OPPORTUNITIES

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

With expensive valuations in equities and persistent low yields, diversified sources of return are crucial to accessing uncorrelated absolute returns.

The Fund retains:

- A range of FX exposures including the US dollar, Yen and some emerging market currencies.
- Stock selection alpha (through Australian Share Fund, Australian Small Cap Fund and Global Share Fund). The equity holdings are concentrated in high quality 'value' companies. 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. We remain of the view that investments in undervalued companies with strong balance sheets should out-perform in the years ahead.

3. DOWNSIDE PROTECTION

Beginning of the Quarter: Medium Allocation

End of the Quarter: Medium Allocation

While this stage of a bear market is typically characterised by a reduction in portfolio protection, equity markets have bounced back significantly and remain out of step with corporate earnings and economic growth. As such, downside protection was maintained through the quarter.

The Fund maintains some optionality in global and domestic equities to offer downside protection. The Fund maintains a position in Australian sovereign credit default swap which will protect the portfolio in the event of a repricing of this risk.

4. INFLATION PROTECTION

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

Inflation has remained below central bank targets across developed economies in recent years and the recent crisis further contributes to this. The overwhelming monetary policy response, however, has reintroduced some modest long-term inflation risks. The combination of supply chain disruption and extremely easy monetary and fiscal policies may ultimately prove inflationary. As such the portfolio has maintained its exposure to gold alongside an existing very small allocation to a basket of commodities which historically perform well in inflationary environments.

MARKET COMMENTARY

The recovery in equity and credit markets continued through the quarter before faltering in early September.

- US equities continue to out-perform strongly led by the technology sector. In fact, the S&P 500 (+8.9% for the quarter) surpassed its February record high during August;
- European markets were mixed, the UK (-4.0%), France (-2.0%) retreated slightly while Germany (3.7%) rose despite trailing the global average;
- Asian markets were also mixed with Japan (+4.7%), Korea (+10.4%) and Taiwan (+10.4%) continuing to rally while Hong Kong (-2.6%) was weaker;
- The ASX 200 (-0.4%) under-performed as the renewed Victorian lockdown weighed on the economic outlook;
- Investment grade and high yield corporate credit spreads tightened further both domestically and offshore;
- Global bond yields were pretty much unchanged over the quarter at close to the record low yields that have been established this year;
- A weaker US dollar was a key feature over the quarter which was reflected in higher commodity prices (including gold and iron ore) and a continued rally in the $A.

Throughout the quarter, global equity returns were dominated by the performance of the US tech giants (Facebook, Apple, Alphabet, Amazon, Netflix and Microsoft). By the end of August, the influence of the US technology sector had driven global price to earnings ratios to their highest level since the tech boom of the early 2000s. The divergence in performance between industries that are supported by stay at home policies (technology, telecommunications) and traditional cyclical industries remained stark. Similarly, the early September selloff was led by the US tech sector.

The low representation of tech stocks in Australia combined with the deterioration in the economic outlook due to the Victorian lockdown weighed on the performance of the Australian equity market.

Despite fears in July and August that the daily case counts in Victoria could skyrocket, the lockdown has proven effective and the state is on the path to reopening. The impact on economic growth is expected to be significant, however, as Victoria represents one quarter of the national economy. June quarter GDP figures released in the first week of September confirmed Australia is in recession with the 7% fall in GDP representing the largest contraction since the 1930s. Expansionary fiscal policy remains crucial in supporting the economy as the Reserve Bank of Australia (like all global central banks) has little monetary policy ammunition left to utilise.

The US continued to struggle to contain the virus throughout the September quarter. The rate of new infections remains stubbornly high and the spread of the virus remains geographically diverse and incredibly politically divisive. Offsetting these concerns were the resilience of the healthcare system and promising vaccine developments.

With rates at their effective lower bound and the Federal Reserve's balance sheet massively expanded, fiscal policy is of vital importance to economic recovery. The negotiation of a further fiscal stimulus bill remains crucial. Negotiations stalled during the September quarter and the outcome appears to have become contingent on the upcoming presidential and congressional elections. While savings from the last round of stimulus may give a temporary cushion, a resolution is likely needed to lessen the risk of a "double dip" scenario for markets.

While US economic growth indicators have rebounded strongly, the level of activity remains well short of pre-COVID levels and are reliant on continued fiscal support. Corporate earnings are also severely impacted. Second quarter results outperformed expectations, but posted the largest year on year decline since 2009 with similar expectations for Q3.

The recovery in European markets slowed through the September quarter. While the infection curve had been flattened in the June quarter, a second wave of infections is well underway. This will inevitably be a drag on the economy.

One encouraging development is that the European Union have agreed on the establishment of a shared recovery fund. The fund would facilitate fiscal transfers between member states funded by pooled debt. This represents a critical step towards fiscal union in Europe. Structural issues in Europe have long been exacerbated by the European Union's currency union without a corresponding fiscal union. This is a step in the right direction, even though much more will ultimately need to be done to underpin a sustainable pan European economic recovery.

Economic recovery continued in China led by a surge in industrial production with the virus apparently under control. While the relationship between Beijing and Washington remains fraught, the semi-annual review of the phase one trade deal passed with both sides recommitting to the deal. In stark contrast, in other key emerging markets like India and Brazil, the virus remains rampant, and it is very difficult to see how it comes back under control in a sustainable fashion in the absence of a vaccine.

The current market conditions and outlook are balanced between two massive and opposing forces – on the one hand the deep global recession that emerged in March and, on the other, the massive fiscal and monetary intervention that followed. The impact of the intervention has been very supportive for asset markets, but cannot be as successful in addressing underlying growth concerns in the absence of a vaccine. In terms of the outlook, in our judgement there are three potential scenarios that investors must navigate.

- The 'Zombie' scenario represents a continuation of the current conditions. Extended stimulus with no decisive resolution to the public health crisis would continue to be supportive for equities. Many 'zombie' companies will survive on life support as monetary and fiscal policies work against the natural order of capitalism. This scenario would likely favour growth sectors as interest rates remain anchored at extremely low levels.
- The 'Recovery' scenario is contingent on a vaccine leading to the resolution of the COVID-19 public health crisis. Under the recovery scenario, fiscal and monetary support would be extended to close the output gap in the economy. This would be supportive for equities. Government bond yields may rise in spite of central bank support as risk appetites increase. This scenario would also likely see a rotation from expensive growth stocks into value stocks.
- The 'Double Dip' scenario would result from another downside shock occurring. The failure of a vaccine to emerge in the next 12 months and the early reduction in government or central bank support are the most pressing risks. Increasing geo-political tensions between the US and China as well as other unforeseen shocks may also result in a double dip.

CURRENT POSITIONING

The outlook for markets is likely to reflect one of the three scenarios outlined above based on the path of the virus and the continuation of fiscal and monetary support. The Fund is constructed to benefit from, or be resilient to, each of these potential outcomes.

- In the 'Zombie' scenario, the Fund will continue to maintain some participation in the market rally although the underlying value bias of our strategy will likely not be rewarded.
- In the 'Recovery' scenario, the Fund would likely generate strong absolute and relative returns. Low exposure to government bonds – especially in comparison to typical conservative multi asset fund models – will likely protect the Fund from an increase in yields that is expected in the recovery scenario. The Fund's value bias would also be expected to perform well in these conditions.
- In a Double Dip scenario, the Fund will protect capital despite some potential losses. The Fund is defensively positioned and maintains robust downside protection. A double dip scenario may provide future opportunities that the Fund is well positioned to exploit when valuations become more attractive.

Overall, the portfolio retains strong defensive qualities to mitigate against various risks including:

- Value and quality bias in the equity allocations; a position in Australian sovereign credit default swap; and some exposure to US and Australian bonds.
- Optionality in currency exposures through an Australian dollar put option (versus the Japanese yen).
- Allocations to gold and Australian industrial property which offer resilience to financial and inflationary shocks.
- Finally, the Fund has a significant cash position and substantial foreign exchange exposure with a position in the US dollar, core emerging market currencies (such as the Chinese Yuan, Korean Won and Taiwanese dollar) and the Japanese Yen.

These and other portfolio hedges have been retained at this stage based on a combination of their intrinsic investment merit as well as consideration of the cost of carrying them to help to protect the portfolio through the deep global recession which began in March.

MORE INFORMATION

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