DIVERSIFIED REAL RETURN FUND

March 2018

TOTAL RETURNS % (AFTER FEES)

PERPETUAL	SIZE $M	1 MTH	3 MTHS	6 MTHS	1 YR	2 YRS PA	3 YRS PA	5 YRS PA	7 YRS PA
Wholesale Diversified Real Return Fund	387.36	0.01	-0.84	1.86	4.36	5.36	3.40	6.04	6.73
Benchmark*		0.00	0.00	0.63	1.45	1.79	1.63	1.83	1.89

* The Diversified Real Return Fund is constructed without reference to any benchmark. CPI is for comparison purposes only.

MARKET COMMENTARY

The March quarter was marked by a spike higher in volatility after an extraordinary period of record low or near record low volatility across all asset classes. The fundamental developments which contributed to the correction included:

- The continuation of very strong growth and modest increases in inflation caused a re-assessment of the outlook for monetary policy – particularly in the US.
- The pressure on monetary policy from strong growth and modestly higher inflation was exacerbated by the substantial easing of fiscal policy in the US in the past six months. The tax cuts enacted late last year was welcomed by the markets, but the passage of a massive spending bill in February adds further stimulus to an economy already growing well above trend. Moreover, the US economy is already at full employment and yet the budget deficit is projected to increase to more than 5% of GDP in the next couple of years.
- Finally, late in the quarter, the US administration announced tariff increases targeting a reduction in the trade deficit with China. We do not expect a trade war (as it is not in the economic interest of either the US or China) but if it were to occur it would start like this!

The upshot was that global stocks, which had a strong start to the year, rolled over to finish the quarter marginally lower. US equities had their first down quarter since late 2015. Australian equities under-performed notably, weighed down by the lack of growth in the two key sectors of financials and resources.

Global bond markets were under pressure led by the sell-off in US Treasuries, although Treasuries recovered some of the losses late in the quarter. And the US dollar continues to weaken against other major currencies as well as most emerging market currencies but strengthened marginally against the Australian dollar.

It appears that that the sweet spot of the cycle is over and the global economy and geo-politics will provide a more 'mixed' backdrop for global markets going forward. In particular:

- Economic growth has peaked (at least for the time being) and underlying profit growth is slowing quite sharply.
- The 'pro-market' policies that President Trump has talked about (tax cuts and deregulation) are largely done and priced in. The 'anti-market' protectionist policies are now being aired and the process is messy as various ambit claims are made on both sides.
- Central banks continue to gradually tighten policy and remove the support for equity, credit and bond markets coming from quantitative easing.
- Geo-politics will remain in focus with the leaders' summit between the US and North Korea alongside the Iran nuclear deal a key focus in coming months.

The economic cycle remains supportive and we still see a fair bit of 'runway' for risk assets to rally in 2018. But we are also mindful that we are investing in the late stages of this economic and market cycle and we remain wary about the prospects of a nasty bear market sometime in the next two to three years.

PORTFOLIO COMMENTARY

The Diversified Real Return Fund is constructed without reference to any benchmark. CPI is used for comparison purposes only.

The Fund retains its exposure to a diversified range of growth assets. Active management of equity exposures throughout the quarter resulted in a lower portfolio allocation to US equities, particularly during the episodes of heightened volatility in February and March. However, as time progressed, exposure to US equities was re-established, with the fall in markets viewed as a correction rather than being the initial stage of a broader sell off. Despite being the most expensive markets from a valuations perspective, the economic cycle favours continued out-performance of a selection of equity markets – most notably US equities. Elsewhere, ongoing weakness in the US dollar is assisting the performance of emerging market equities on a unhedged basis, but undermining the performance of European and Japanese equities on a hedged basis. Accordingly, the Fund's exposure to European and Japanese equities has been trimmed for the time being. That said, the Fund's exposure to growth assets remains diversified across asset classes and markets including:

- In equities: US value, Emerging Markets, Japan and Australia;
- In credit: US bank loans, Australian credit and Emerging Market debt;
- In property: Australian industrial property and listed property.

The major contributors to performance in the quarter were portfolio exposure to both emerging market debt and equity. Alongside this active management of currency and equity option positions was positive. The major detractors from performance were negative alpha from portfolio allocation to Australian equities alongside exposure to Japanese equity.

OUTLOOK

The economic outlook for 2018 remains upbeat. Global economic growth is expected to remain strong which should underpin another year of double digit profit growth, in turn supporting equity markets and other risk assets particularly in the first half of the year. Nonetheless, valuations remain expensive in many key markets – most notably in US equities (which make up more than half of global equity market capitalisation) and global bonds. We are investing in the late stages of this economic and market cycle and remain vigilant to deal with the prospects of a bear market, should a destabilisation in risk markets occur. The key risks to the market outlook remain as they were in 2017.

Against this backdrop, we retain a cautious approach to portfolio construction, but have added to risk seeking positions at the margin (particularly in Australian equities and emerging market equities). The Fund retains a diversified exposure to various equity, credit and unlisted markets. Cash weightings are high (although they have fallen somewhat recently) as most assets are expensive and this will limit medium term returns. As a counter balance to high cash weightings, relative value positions are elevated including exposure to equity alpha, foreign currency positioning (exposure to a range of foreign currencies in preference to the Australian dollar including the US dollar, Japanese Yen and Emerging Market currencies) and a systematic trend following strategy.