DIVERSIFIED REAL RETURN FUND CLASS W

June 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
Diversified Real Return Fund Class W	398.57	0.85	1.11	0.26	4.19	5.18	3.92	5.90	6.75
Benchmark*		N/A	0.00	0.45	1.72	1.82	1.56	1.84	1.83

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

MARKET COMMENTARY

Global economic growth continues to be strong (at a pace well above trend). Inflation is accelerating somewhat although it remains well below target in Europe and Japan and has only just got to target in the US, after a protracted period of below target inflation. This combination is supporting continued strong growth in company profits, although the growth rate has slowed from its peak (in an underlying sense after excluding the impact of corporate tax changes).

This backdrop is essentially benign for equity and credit markets and would be consistent with a continuation of the bull market in equities and credit alongside ongoing upward pressure on interest rates. Equity markets have, however, been very choppy in the first half of this year and lack a clear direction overall. Some of the reasons for this indifferent performance might include:

- ‘Quantitative tightening’: Total central bank asset purchases peaked late last year and these purchases are now falling significantly as the Fedstarts to reduce the size of their balance sheet; the ECB continues to ‘taper’ their purchases (expecting to diminish to zero by December 2018) and the BoJ’s yield curve control policy has been achieved with much lower purchases of assets than might have been expected. By the beginning of next year, global central banks in aggregate will be selling assets – a massive shift for markets to digest.
- The fear of a ‘trade war’ has increased markedly in recent months as the US President has announced tariff increases on a range of products in a (misguided) attempt to target the US trade deficit. The retaliation has been swift and the risk of a dramatic escalation has put investors on edge.
- The clamp down on the Chinese shadow banking system is welcome, but the resulting financial deleveraging could slow economic growth significantly in an economy which has become highly dependent on expanding credit to drive economic growth.

The outlook for markets is likely to be a battle between worsening liquidity (due to quantitative tightening) and expensive asset valuations on the one hand and a constructive economic cycle backdrop for growth assets on the other. The outlook for the economic cycle becomes more problematic in late 2019 onwards as the lagged impact of the Fed tightening cycle coincides with a neutral fiscal policy stance (as the tax cuts have at that point fully worked their way through the economy).

PORTFOLIO COMMENTARY

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The Fund retains exposure to a diversified range of growth assets. The main portfolio adjustment in the quarter was to reduce the exposure to emerging market (EM) equities. The recovery in the US dollar, combined with pockets of stress in some EM countries and concerns about the outlook for the Chinese economy (see below) weakened the outlook for EM. That said, the Fund's exposure to growth assets remains diversified across asset classes and markets. The Fund retains a high allocation to diversifying opportunities reflecting the combination of generally expensive valuations for growth assets (limiting return seeking opportunities and attractive relative value opportunities. 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 (following the spectacular demise of a product which systematically sold volatility), equity volatility has quickly fallen again making one to two month put options on the US equity market attractive. Accordingly, the Fund has re-established a position in these options. The Fund retains the existing long dated Australian dollar put versus the US dollar (in addition to the foreign currency positions outlined above). In addition, shorter dated Australian dollar put options against the US Dollar and the Japanese Yen were initiated. The Fund also has a position in Australian sovereign credit default swap which will protect the portfolio in the event of a repricing of this risk. The Fund has also re-established a modest duration position in Australian government bonds as it has become clearer that the Reserve Bank of Australia is a long way from tightening monetary policy.

Inflation pressures are finally beginning to stir, and we continue to expect some further modest increases in global inflation over coming quarters. The Fund has an exposure to a basket of energy and agricultural commodities which tend to perform well in a rising inflation environment. In addition, the Fund's vulnerability to higher interest rates is quite limited (due to very low exposure to global government bonds and interest rate sensitive growth assets). Other inflation hedges in the portfolio are indirect (from exposures in industrial property and equities).

The major contributors to performance in the quarter included exposures to developed market equities and alternative strategies. Perpetual's market neutral equity and global share funds added, where performance strength was underpinned by positive alpha from stock selection. Also positive for performance was the allocation to a trend following strategy alongside active currency management and exposure to industrial property which all delivered positive returns. The main detractors over the period were allocations to emerging market debt and equities, where a stronger US dollar (given the hawkish outlook for policy normalisation by the US Federal Reserve) depressed demand for emerging market assets.

OUTLOOK

The global economy continues to perform well, and company profits are growing which will provide ongoing support for equity and credit markets, but it is also putting upward pressure on interest rates. In addition, the liquidity backdrop for markets is becoming more challenging as central banks begin to wind back the extreme policy settings of recent years. Most assets are trading on the expensive side of fair value and are underpinned by record low interest rates. At this stage we continue to expect equity markets to resume their rally in 2018, but we are closely monitoring a range of risks highlighted above.

Against this backdrop, we retain a cautious approach to portfolio construction with continued high cash weightings. The Fund retains a diversified exposure to various equity, credit and unlisted markets. 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 and Japanese Yen) as well as a USDCNH call option and a systematic trend following strategy.

To take advantage of the re-emergence of very low volatility in equity markets, the Fund owns a put option on the US equity market and a long dated Australian dollar put versus the US dollar (in addition to the foreign currency positions outlined above). Finally, the Fund also has a position in Australian sovereign credit default swap which will protect the portfolio in the event of a repricing of this risk.