Perpetual

DIVERSIFIED REAL RETURN FUND

December 2017

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	371.83	0.48	2.73	3.92	6.98	6.25	5.27	6.84	7.24
Benchmark*		0.41	1.86	3.30	6.91	6.63	6.61	6.90	7.17

* Australian CPI plus 5%

MARKET COMMENTARY

The December quarter was notable for a continuation of trends that were in place for all of 2017. Global growth picked up at the start of the year and remained strong for the rest of the year. Inflation was remarkably quiescent, even though it increased somewhat in the second half of the year from the very low readings early in 2017. This provided a good backdrop for global profit growth.

The global economy appears to have reached 'escape velocity' having finally thrown off the shackles of the global financial crisis. Growth is strong and synchronised while business investment is accelerating after years in the doldrums. This optimism has been further underpinned late in the quarter by the passage of corporate and personal income tax cuts in the US.

Just as importantly, the outlook for the global economy in 2018 is for another year of low inflation and strong growth while the key identifiable risks to global growth remaining benign (at least for now). In particular:

- The conflict between the US and North Korea over North Korea's nuclear weapons program has not escalated, although it remains unresolved;
- The trade war rhetoric from the US President has been largely absent lately as he seeks the cooperation of the Chinese in dealing with North Korea;
- The extremely tentative normalisation of monetary policy by global central banks has been well telegraphed and implemented without incident; and
- The heavily indebted Chinese economy appears to be transitioning smoothly to a more sustainable growth model.

The upshot was strong performance by equities and other growth assets over the year and incredibly low volatility across all asset markets. For example in the US, equity volatility over the year was the second lowest on record (the lowest was in 1964).

In the December quarter, the best performing equity market was Japan, while Europe lagged as performance was hurt by the strength of the Euro earlier in the year. The Australian market finished the year strongly, but still significantly lagged the performance of global equities over the year. Global bond markets were essentially becalmed in the December quarter as they were for the year – stuck at record low yields. The Australian dollar was flat to slightly weaker against the major currencies.

PORTFOLIO COMMENTARY

The Diversified Real Return Fund outperformed its benchmark during the quarter.

The global economy is performing well which will continue to provide support for equity and credit markets, but it will also put upward pressure on interest rates. Most assets are trading on the expensive side of fair value and are underpinned by record low interest rates. A further rally is likely in 2018, but we are closely monitoring the impact of the major changes in central bank policies expected over the next year.

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, Indian Rupee and the Swedish Krona) and a new investment in a strategy designed to follow trends in a systematic fashion.

To take advantage of the very low prevailing volatility, the Fund has a put 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.

OUTLOOK

The outlook in 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 and appropriately positioned to deal with the prospects of a nasty bear market, should a destabilisation in risk markets occur. The key risks to the market outlook remain as they were in 2017. In particular, we would highlight the evolution of central bank policy as a critical risk this year. Another year of strong growth will likely see central banks move more aggressively to normalise policy. This creates clear risks for the market outlook. This is not to downplay the other risks highlighted above.

Against this backdrop, we retain a cautious approach to portfolio construction. The Fund retains a diversified exposure to various equity, credit and unlisted markets. But cash weightings are high as most assets are on the expensive side of fair value (particularly if interest rates normalise) and that will limit medium term returns. As a counter balance to high cash weightings, relative value positions are elevated.