Perpetual Investments

YEAR IN REVIEW

July 2016

Our team of investment specialists share their views on the past 12 months – how markets have performed and what it means for your investments with Perpetual.

MEETING THE CHANGING NEEDS OF INVESTORS

This is my first chance to write to Perpetual investors, and the first thing I want to do is to thank you for trusting us with your investments.

On the following pages the heads of our asset class teams look at the evolution of investment markets over the 2016 financial year and how we approached the challenges it posed.

It has been a tough year, but as I've come to know those at Perpetual who manage your money, I've been impressed with their rigorous and disciplined application of Perpetual's value and quality approach to investing. Sometimes, forgoing easy gains from sub-standard assets comes with short-term pain. But our history tells us that value and quality will pay off for our investors in the end. I have also been genuinely impressed with the fact that our investment teams put you – our clients – first, by doing all that we can to generate outstanding investment outcomes for you.

That discipline, the trust it has earned with clients, and the strength of the Perpetual brand are some of the key reasons why I joined the company. I've been investing clients' money for more than 30 years and have seen a lot of fads come and go. It means a great deal to me that I have joined a company that runs an Australian share fund celebrating 50 years of positive performance on behalf of its clients (our Industrial Share Fund), which you'll hear more about in the coming months.

Just as importantly, I see a great future with Perpetual because it's put a lot of work into meeting a wider range of investor needs. We believe the key features are:

- Global equity funds and shares that may give you access to the world's best businesses, and diversification away from Australian assets that may be overvalued as a result of the limited size of our market.
- Credit funds that offer you an alternative to cash and bonds – an increasingly important option in a low-yield world.
- Flexible multi-asset funds built to thrive in a low-growth world – with wide diversification, multi-faceted risk management, and a focus on actual returns for investors – not beating an inappropriate benchmark.

These developments matter because they address the real needs of investors today – income, diversification, consistency and capital protection. I'm looking forward to working with the investment team to build on these newer solutions, without ever losing sight of the values that have underpinned our success for clients over decades.

David Kiddie
Group Executive, Perpetual Investments

In 2016 we were honoured to be recognised as:

Winner of the Best of the Best 2016
Best Australian Share Fund, Money Magazine Awards

Winner of the Responsible Investments category
2016 Money Management/Lonsec Fund Manager of the Year Awards

Perpetual

FINANCIAL YEAR 2015/16 AT A GLANCE

0.56%

Return from the Australian sharemarket over the financial year

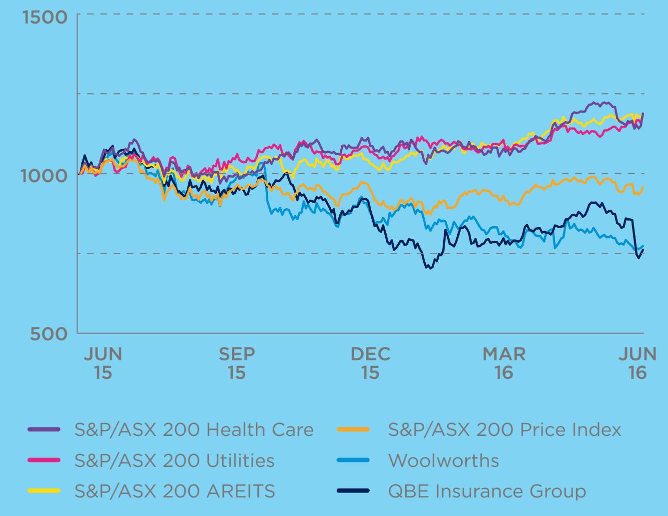
S&P/ASX 200 returned +0.56%. Broken down to a -4.13% price decline offset by +4.69% dividend income

AUSTRALIAN SHAREMARKET

The Australian sharemarket rose +0.6% in FY16 with a price decline of -4.1%, mostly offset by our high dividend income. Although lower, Australian shares outperformed most of our international peers in both price return (an average of -8.5%) and dividend (2.5%), even though our two major sectors, banks and resources, faced a more difficult trading environment. The two headwinds that have restrained returns over the year are elevated valuations and a more difficult earnings environment, which capped gains despite increased policy support from the government and the RBA.

During the financial year, there were two distinct periods of volatility in August/September 2015 and January/February 2016, which sparked larger-than-normal losses. However, central bank intervention stabilised the global backdrop and enabled markets to recover. On the macro front, Australian economic growth accelerated as the country continued to transition from the mining investment boom, with unemployment declining to a 3-year low of 5.7% and housing construction remaining upbeat given favourable interest rate settings.

DEFENSIVE AND GROWTH ARE IN DEMAND, BUT UNLOVED STOCKS OFFER OPPORTUNITY



Source: FactSet, as at 30 June 2016

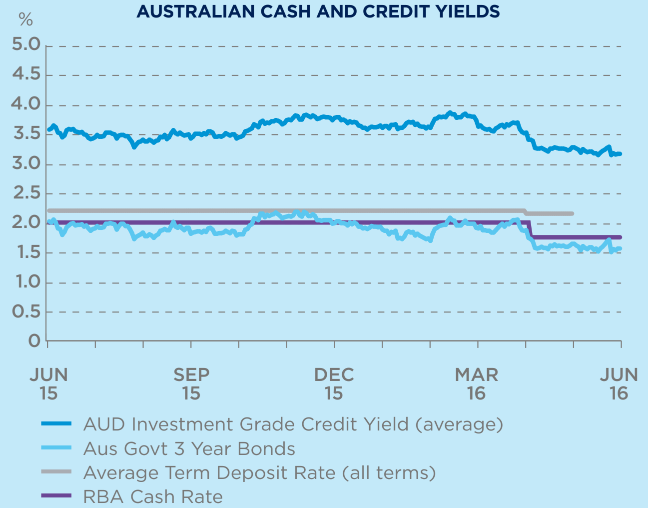
1.75%

The Reserve Bank of Australia cash rate (as at 30 June 2016)

INTEREST RATES

Despite numerous international headwinds the Australian economy has performed strongly over the past year, with growth of 3.1%, which is around double most of our G20 advanced economy peers. Despite this, the Reserve Bank of Australia cut the target cash rate to a fresh record low of 1.75% given concerns that both headline and core inflation is too far below their 2–3% target band, which is something that has been evident in international economies over the past five years. More importantly, the Bank seemingly believes that inflation is likely to remain at historically low levels for an extended period, which is good news for household budgets, but not for nominal earnings growth or the Federal Budget. Lower inflation also culminated in our 10-year bond yield trading below 2.0% for the first time ever, with the downward pressure amplified by falling global yields in response to a weaker international climate, central banks' asset purchase programs in Europe and Japan, and specific risk events, including Britain's referendum on EU membership.

AUSTRALIAN CASH AND CREDIT YIELDS



Source: FactSet, as at 30 June 2016

AUD $

High

78.12c

Low

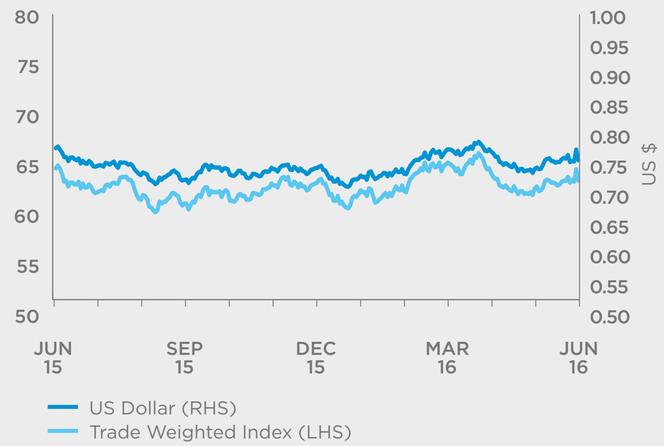
68.67c

Australian Dollar from 1 July 2015 to 30 June 2016

THE AUSTRALIAN DOLLAR

The Australian dollar declined for a second consecutive year. Despite several key headwinds the currency proved quite resilient as investors remained attracted to our relatively high yields, which helped offset the impact of a sustained reduction in commodity prices. Elsewhere, there appears to be more pressure on Australia's AAA credit rating (which has been a keystone to the currency's strength over the past six years), given Australia's growing debt burden, even though this stock of government debt remains modest relative to other major global economies. The positive and negative factors impacting the currency culminated in the Australian dollar depreciating modestly against most major international currencies, including the Yen, Euro and US dollar and appreciating slightly against the major Asian currencies, as a moderation in China's growth profile weighed heavily on commodity exposures.

AUSTRALIAN DOLLAR VS US DOLLAR AND TWI (INDEX,$)



Source: Reserve Bank of Australia, as at 30 June 2016

PERPETUAL VIEWPOINT

We asked Perpetual experts what's in store for the coming year and where they are seeing challenges and opportunities for investors in 2017.

Paul Skamvougeras

Head of Equities

The Australian market struggled to grow earnings in FY2016 because of the low-growth global environment. Falling commodity prices affected resources and energy shares, while Australia's banks suffered from higher funding costs and regulators' demands to hold more capital. Sectors selling to Chinese consumers did well along with those that typically outperform in a low-rate environment, including construction, real estate and infrastructure. Many investors are taking excessive risk holding heavily indebted income-generating stocks. Our strategy, as always, is to focus on quality companies with strong balance sheets and sustainable dividends. Our holding in fuel distributor Z Energy boosted performance as it delivered strong earnings and took further steps (via acquisition) to boost its share of the New Zealand petrol market. We have a significant stake in Woolworths because we feel the low buy-in price, new management team and business strategy make it a compelling medium-term value play.

Michael O'Dea

Head of Multi Asset

One of the big issues for investors is that many 'defensive' assets are expensive – for example, Japanese and German government bonds that are trading on negative yields. Investors are prepared to accept a negative return over the longer term in an attempt to avoid market risk in the short term. Very low interest rates have also seen investors pay more for 'defensive' equities such as consumer staple stocks and real estate investment trusts. However, it is important to consider the risks of paying too much for any investment, including those labelled defensive.

How do you invest in this challenging world?

- Manage – rather than avoid – risk. The best way is to know what an investment is worth – its 'intrinsic value' – and pay significantly less.
- Have a fund structure that allows wide diversification. This gives you the ability to change your portfolio decisively when valuation opportunities – or new risks – present.

Michael Korber

Head of Credit

FY2016 saw increased volatility across credit markets. Despite challenging conditions into December 2015, our exposure to credit generated positive returns, benefiting from an increased investor appetite for yield. This put upward pressure on credit security prices. Subsequently, credit started to get expensive in early 2016, with these markets impacted by event risks, including US rate rises and weakness in the Chinese economy. Defensive positioning allowed us to capitalise on this market shift, capturing attractive risk-reward opportunities. Participation in overseas markets was particularly valuable over the year. Through stringent research and careful diversification across both domestic and offshore exposures, we were able to take advantage of securities offering superior income with less risk than many other assets.

Garry Laurence

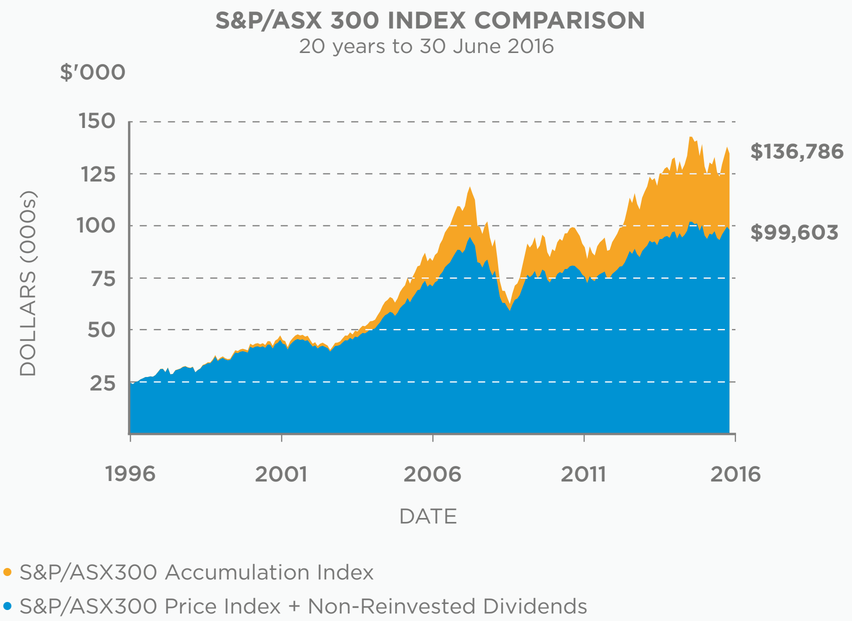
Global Equities Portfolio Manager

Global equity markets were volatile in FY2016, with falling oil prices and higher US interest rates. Weak economic growth tested business management in most regions. We managed this volatility by using weak periods to purchase quality undervalued companies and to sell into strength when valuation looked stretched. We also maintained high cash levels. Despite this challenging environment, the Fund identified some very attractive opportunities – US banks Bank of America and Wells Fargo have excellent retail businesses and will reap the benefits of a strengthening US economy. The share prices of two of our biggest technology holdings, Zhaopin (Chinese, recruitment) and EMC (US, data storage), were boosted by bids for their stock. Our holding in 21st Century Fox – a US media company that is a leading media player in the Asia region – gives us indirect exposure to the Indian economy, where growth is very strong.

WHAT COMPOUNDING COULD MEAN FOR YOU

The chart compares the performance of $25,000 invested in the S&P/ASX 300 over the past 20 years with dividends reinvested (the orange section) versus the same amount with dividends received, but not reinvested (the blue section).

As you can see, without dividends reinvested, the $25,000 grew to $99,603. But when dividends were reinvested, it compounded to $136,786, **an additional $37,183 – an increase of over 37%.**



Source: FactSet. Past performance is not indicative of future performance.

As billionaire investor Warren Buffet put it,

"My wealth has come from a combination of living in America, some lucky genes – and compound interest."

TO REINVEST OR NOT?

The decision whether or not to reinvest should be based on your personal circumstances. You may want to use the distribution income to pay for living expenses or other immediate needs. Alternatively, if you don't require the money in the short term, then harnessing the power of compound growth could be a beneficial long-term strategy for you. In addition, because reinvestments aren't subject to transaction costs (that is, buy spreads), this means that you receive more units than you would have if you had made a new investment at the same time.

Like any investment, reinvesting distributions is subject to investment risk, including the chance that the investment will not gain or retain its value. Talking to a financial adviser could help inform your decision.

HOW TO REINVEST YOUR DISTRIBUTIONS

Reinvesting your distributions is easy, and can be reversed at any time. Talk to your financial planner today or call us on 1800 022 033.

For more insights from Perpetual fund managers, visit **WWW.PERPETUAL.COM.AU/INSIGHTS**

MORE INFORMATION

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