Perpetual Investments

THE CASE FOR REAL RETURN INVESTING

A PORTFOLIO THAT CAN ACCELERATE ON THE OPEN ROAD, CHANGE DIRECTION TO AVOID DELAYS OR BRAKE SAFELY.

For many, the primary goal of investing is to accumulate sufficient assets to fund a comfortable retirement – whether that's in five or 50 years' time. And whilst most investors expect there will be market corrections and fluctuations along the way, the severe downturn of the Global Financial Crisis caused many to question: How to best structure a portfolio to withstand extreme market stress?

Objective-based, or 'real return', investing is a style of investing that may be considered by those seeking to balance strong investment returns with an element of capital preservation.

WHAT ARE REAL RETURN FUNDS?

Real return funds are designed to provide investors with a higher certainty of achieving a real return objective with a lower level of risk and lower sensitivity to extreme market events.

HOW DO REAL RETURN FUNDS WORK?

Real return funds will all have different investment objectives, strategies and guidelines. Generally, they focus on providing investors with genuine diversification by investing in high-quality opportunities at reasonable prices with a specific return target. They're generally measured against the rate of inflation – for example, the rate of inflation plus 5% p.a.

In addition, most real return funds have a strong focus on preserving an investor's money and reducing the potential for loss. They sometimes achieve this through specialised asset management, dynamic asset allocation, or by investing in a broader investment universe – or a combination of all three.

This means that real return funds often have greater flexibility to adjust the portfolio's asset allocation in response to market conditions.

Importantly, real return funds can invest in a wide range of investments outside 'traditional' asset classes (such as shares, cash and bonds), to include unlisted property or infrastructure, commodities, specialist equities (like emerging or frontier markets), specialist credit, foreign currencies and derivatives.

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BUILT TO NAVIGATE CHANGE FOR INVESTORS

Free from the constraints of a fixed strategic asset allocation, real return funds with active asset allocation have grown exponentially in recent years. Between 2011 and 2016, real return funds more than quadrupled in size to almost $10 billion in assets[1], as investors have gained a greater appreciation of the ability of real return funds to "better adapt to an ever complex and dynamic investment landscape... [with] investment personnel granted freedom to adjust asset allocation on both a material and continuous basis in response to changing market conditions".[2]

BRIDGING THE GAP BETWEEN ASSET CLASSES AND INVESTMENT OPPORTUNITIES

A portfolio constructed solely of equities, fixed income, cash and property can limit a portfolio's possible sources of return. Real return funds, which often have a much broader set of allowable asset classes, are not as constrained. **Chart 1** below shows the typical asset class exposure of the Multi-Sector Market Index, whereas **Chart 2** shows the diversification of Perpetual's Diversified Real Return Fund.

CHART 1[3]
MULTI-SECTOR INDEX

CHART 1 KEY

- International Shares
- Australian Shares
- Australian Fixed Interest
- Cash
- International Fixed Interest
- Australian Listed Property
- International Listed Property

CHART 2[4]
PERPETUAL DIVERSIFIED REAL RETURN FUND

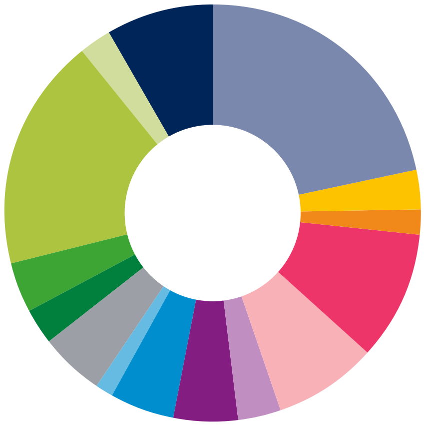


CHART 2 KEY

- Cash and Enhanced Cash (inc US duration hedges)
- Emerging Market Debt Local Currency
- Emerging Market Debt Hard Currency
- Bonds
- Credit
- Alternative Beta
- Market Neutral Equities
- Absolute Return Credit
- Syndicated Loans
- Property
- Commodities
- Emerging Market Equities
- Developed Market Equities
- Smaller Companies
- Australian Equities

FLEXIBILITY ACROSS THE RANGE

The traditional approach to diversification has been to allocate certain ranges to growth and defensive style assets. Typically, the growth component has been dominated by Australian and global equities, accounting for 50–60% of the portfolio. However, despite being just over half of the typical allocation, equities are the single largest source of risk, accounting for 85–95% of total portfolio risk.[5]

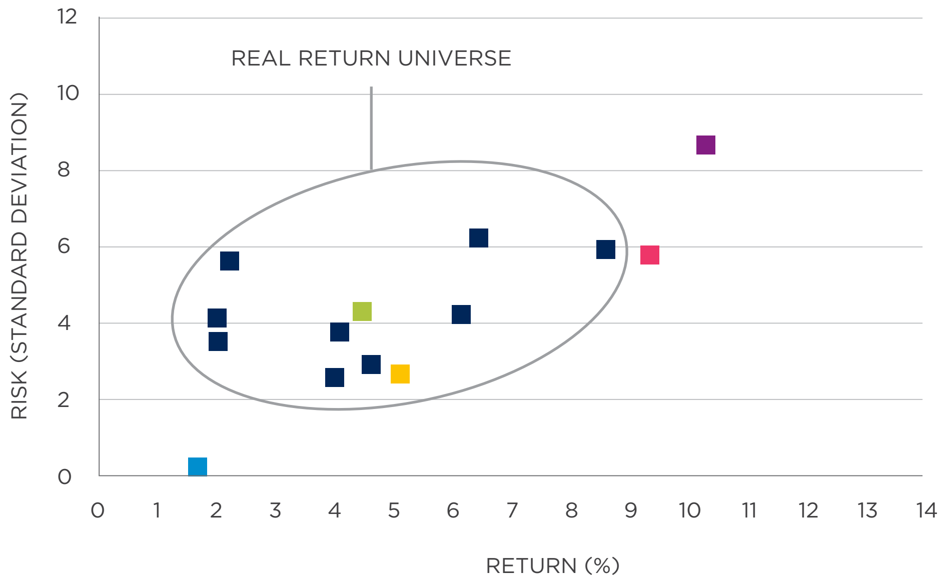
That being said, generally, investors who have the time to ride out market vagaries, have historically been well-rewarded for taking on the risk.

For investors without the luxury of time to recoup their losses, however, a more intelligent approach to diversification is needed.

Over the past three years to 31 December 2019, real return funds have provided an average net return of 4.49%, compared with the Australian share market return of 10.33% (S&P/ASX 300 Index). What is important for investors to be aware of is that real return funds have managed to do so at less than half the level of risk, with an average of 4.24% risk versus 8.59% for Australian shares, as shown in **Chart 3.**

1 Source: Morningstar Research, "Objectives-Based Investing – The Australian Landscape", June 2016.
2 Source: Zenith Multi Sector Report, 2014.
3 Chart 1 - Morningstar Multi-Sector Growth Index, Data as at 31 August 2019.
4 Chart 2 - Perpetual, Data as at 31 August 2019.
5 Source: Morningstar Multi-Sector Growth Index and Barra.

CHART 3 – RISK AND RETURN PROFILE OF REAL RETURN FUNDS VERSUS OTHER INVESTMENTS[6]



- Real Return Funds
- Real Return Universe Average
- Cash (Bloomberg AusBond Bank Bill Index)
- Fixed Income (Bloomberg AusBond Composite Index)
- Australian sharemarket (S&P/ASX 300 Index)
- Morningstar Multi Sector Growth Index

> Over the past three years to 31 December 2019, Real Return Funds have achieved solid investment returns but with significantly lower levels of risk compared to the Australian sharemarket.

WHERE DOES A REAL RETURN FUND FIT IN A BALANCED PORTFOLIO?

Markets are volatile and the complexity of constructing diversified portfolios is increasing. Investors need to explore new solutions without taking on more risk than they can afford.

There are three main ways investors can incorporate a real return fund into their portfolio:

STABLE CORE

Real return funds are generally well-suited to investors seeking a more regular profile of returns and protection from volatility. Having a stable core of one or more real return managers allows investors to take carefully considered risk with other potentially higher returning and higher risk satellite portfolios.

SHOCK ABSORBER

Many investors could benefit from incorporating active asset allocation as a way to diversify their portfolio's sources of return. Real return funds can help otherwise static portfolios shift underlying equity and fixed income exposures in favour of the most attractive opportunities at any one time.

DIVERSIFYING ALTERNATIVE

Real return funds could be used as a substitute for existing investments, and could be funded from either an alternative allocation, or for example, funded from 5% of an investor's existing allocation to equities and 5% from bonds. The greater investment breadth and active asset allocation of a real return fund can improve the diversification of equity and bond-dominated portfolios by providing access to asset classes that may be difficult for investors to hold directly.

6 Chart 3 – Source: Lonsec, Zenith, Morningstar and Perpetual, three year data to 31 December 2019. Compares S&P/ASX 300 Index, Bloomberg AusBond Bank Bill Index and Bloomberg AusBond Composite Index data versus median net return over 3 year periods for Morningstar Real Return fund universe. Past performance is not indicative of future performance.

REASONS TO CONSIDER INVESTING IN REAL RETURN FUNDS

The right investments at the right time

Investing is a full-time job. To ensure you're holding the right investments at the right time requires expertise, discipline and skill. Real return funds aren't 'set and forget'. They don't decide on a set allocation of asset classes to hold; rather they constantly modify the investments they're holding in response to changing market conditions to ensure an appropriate level of return for the risk taken on.

Access a wider range of assets

To maximise your portfolio diversification, having access to the widest range of asset classes is preferable, and this is where real return funds can be beneficial.

Many investors find it difficult to access the types of investments that 'fall between the cracks' of more defined asset classes like cash, shares and bonds. Investments such as emerging market debt and commodities, for example, can be accessed in a real return fund.

Lower volatility means more regular returns

Real return funds actively target a certain level of return, while seeking to minimise the amount of risk that an investor takes on.

By investing across a wider range of assets, real return strategies are generally less reliant on any single source of return.

Managing portfolios in a more holistic and flexible way, where the mix of exposures can respond quickly to changing market conditions, may assist in providing a more regular profile of returns for investors.

Protection against inflation

Because inflation erodes your purchasing power and your real investment returns, it's important that your investments provide protection against inflation over time.

Real return funds are generally constructed from the bottom up, with the single-minded premise of delivering an investment objective above the rate of inflation – for example, CPI + 5% p.a.

Managing complexity while still providing transparency, liquidity, control and flexibility

Holding a diverse mix of investments in your portfolio can be beneficial, but the complexity associated with it may outweigh the benefits. This is when managing the investments within a single fund can remove the investing uncertainty.

And because real return funds are structured as managed funds, investors have:

- **Transparency** – see daily what you're invested in and what your investment is worth
- **Liquidity** – top up or reduce your investment at any time
- **Flexibility** – combine them with other investments or funds, and
- **Control** – choose who manages your money.

However, all investments carry risk and different strategies may carry different levels of risk. The relevant product disclosure statement or offering document for a fund should be considered before deciding whether to acquire or hold units in that fund. Your financial adviser can assist you in determining whether a fund is suited to your financial needs.

For more information about the benefits that real return investing can offer, talk to your financial adviser. You can find out about the Perpetual Diversified Real Return Fund on our website www.perpetual.com.au/realreturn

MORE INFORMATION

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