Annual update 2023

Amanda Gillespie

Chief Executive
Perpetual Asset Management Australia

Over the last 12 months, we have seen a continued shift away from the benign inflation and low interest rate environment which dominated investment markets for most of the last decade.

While inflation appears to have peaked, it has proved more persistent than some first thought and central bankers have continued to lift cash rates in response.

As financial conditions have tightened, we have also seen pockets of instability in the financial system, most notably resulting in Credit Suisse's forced merger with UBS in March, where governments and regulators moved quickly to prevent wider contagion in the banking sector.

Despite this, equity markets proved resilient, even in the face of potential risks around a global recession and credit market tightening.

While the market and economic outlook is always uncertain, it is in these kinds of conditions that the benefits of active, fundamental investment management can come to the fore.

Value for the long term

Over the last two years, value investing has returned to favour and markets are again starting to place greater focus on investment fundamentals, rather than narratives – conditions which suit the active approach of our investment teams.

In particular, our Australian Equities team has performed exceptionally strongly and we believe our investment process – with the four quality filters of conservative debt, sound management, recurring earnings and quality of business at its core – will be increasingly important, as cash flow and capital allocation take precedence in a rising rate world.

For Barrow Hanley, manager of the Barrow Hanley Global Share Fund, a bottom-up focus on a company's long-term prospects and fundamentals should also see it well positioned for what could be a longer value investing cycle. We have been offering Barrow Hanley's Global Equities capability in Australia since 2020 and we were pleased to also launch the Barrow Hanley Emerging Markets Fund during the year. This fund aims to provide investors with long-term capital growth from investing in emerging market shares.

Credit markets

The impact of contractionary global monetary policy was particularly evident in credit and fixed income markets, which have grappled with tightening financial conditions over the past year.

In March, we saw credit spreads impacted by concerns over the strength of the global banking system and liquidity pressures emerge in financial markets. While these pressures have eased somewhat, the outlook for credit markets continues to be challenging.

Despite this, our Credit funds performed well over the year – focusing on quality, defensively positioning portfolios while retaining capacity to take advantage of opportunities as they arise in the year ahead.

Award-winning investment capability

We were excited to see the Perpetual Diversified Real Return Fund, managed by our Multi-Asset team, named category winner at both the Lonsec awards and, for the fourth year in a row, at the Zenith awards.

This result is a testament to our Head of Multi-Asset, Michael O'Dea, and the Multi–Asset investment team and the outcomes they have been able to achieve for our clients.

More broadly, we were honoured that Perpetual Asset Management Australia was recognised as Fund Manager of the Year at both the Lonsec Fund Awards and, for the second consecutive year, at the Zenith Fund Awards. These awards are wonderful recognition of the strong investment culture and outstanding capabilities we have been able to deliver to clients and maintain through many market cycles.

Pendal acquisition

Lastly, you may have seen that Perpetual Limited acquired the Pendal Group earlier this year. This has brought together two investment management firms with a long and proud history of offering high-quality, active investment capabilities and delivering strong and consistent outcomes for clients.

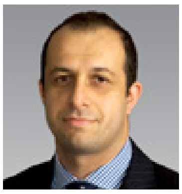
In Australia, we are now home to more than 70 investment professionals and are managing over $60b in assets. We are also part of a truly global asset management group, with leading active investment capabilities across the world and more than $200b in assets under management*.

As these businesses come together, the focus for our investment teams will, as always, be on investing for the long term, on behalf of our clients. In the year ahead, we look forward to continuing to provide you with world class active investment management capabilities and solutions in the Australian market.

*As at 31/03/23.

Perpetual

Australian Equities



Vince Pezzullo
Head of Australian Equities
Portfolio Manager
Perpetual Asset Management Australia

The S&P/ASX300 delivered a solid return of +14.40% over the year ended 30 June 2023. This came despite a succession of rate hikes by the Reserve Bank of Australia as central banks around the world rushed to unwind stimulatory monetary settings and battled to contain rising rates of consumer price inflation. Amongst the larger sectors Energy & Materials stocks led the charge in a year defined by the rising inflation challenge whilst expensive sectors like Consumer Staples suffered as rising rates negatively impacted their valuations.

The start to the financial year was turbulent. The S&P/ASX300 had fallen -8.97% in June 2022 as the scale of the shift from policymakers sunk in. The RBA had slashed the official cash rate to just 0.10% in 2020 and embraced Quantitative Easing as COVID raged. The RBA had also implied that rates would remain low until around 2024. The sudden reversal of this position in early 2022 was the catalyst for an outsized market reaction. Growth stocks briefly bounced back in July 2022 as market embraced a "bad news is good news" narrative driven by hope that imminent recession would necessitate policy easing. This proved premature however and central banks had to make up for widespread fears that they were raising too little too late given the booming economy.

The RBA raised rates by 50 bps at four successive meetings in June, July, August and September 2022. Value stocks performed particularly strongly in the second half of 2022 as the market began to focus on fundamental valuations in a normalising interest rate environment instead of growth and momentum narratives driven by years of policy stimulus. Early 2023 was a more nuanced environment though as markets rallied on the hope of central banks slowing down rate hikes, the market re-rating to higher levels in anticipation, and the prospect of a soft economic landing saving equities from a larger drawdown. The risks of a downturn in the economy and corporate earnings remains high. We continue to position our clients in good quality businesses trading at reasonable valuations which we think are well placed to weather any storm.

Global Equities

Brad Kinkelaar
Senior Managing Director
Portfolio Manager
Barrow Hanley

Over the past year, global markets saw multiple twists and turns, highs and lows, and changing leadership. However, there was much about the market that was similar to what we saw going into the global pandemic, especially in the second half of the year during which a handful of stocks reasserted leadership and drove the majority of the strong returns. After some of the fastest rate increases by central banks in the last 40 years to battle the highest inflation seen in the last 40 years, inflation finally appeared to peak and move lower. However, core inflation remains 'sticky', driven by a strong consumer. Despite this, markets reverted to exuberant levels on the assumption that central banks are likely to pause, if not begin to ease, in the near term – though Canada's and Australia's recent rate increases may prove the contrary.

The expectation of interest rate relief created a meaningful rotation to growth stocks, which in the year prior suffered their largest shortfall since the tech bubble burst. Increased interest in new Artificial Intelligence technology also added to the excitement. This created a very narrow market environment wherein only three sectors outpaced the broader market, creating challenges for active management and pushing the concentration in market cap-weighted indexes back toward all-time highs. In terms of trends, markets were driven not only by exuberance about large tech champions. Over the last year, continental Europe has been one of the better performing regions.

Higher inflation also challenged the US banking sector, particularly a few regional banks; however, the market treated all bank stocks similarly. We disagreed with this assessment and took the opportunity to add modestly to our bank holdings. We also added to emerging market-exposed banks/insurers during the period and added modestly to the Information Technology sector, while trimming holdings in Consumer Discretionary that had performed well. We believe these changes position us well for what we expect to be a temporary pause in value stock performance and think that, given the continued discount of value stocks relative to their growth peers, it is more a matter of when than if value will reassert its leadership.

Credit and Fixed Income

Michael Korber
Managing Director Credit & Fixed Income
Perpetual Asset Management Australia

Fixed income markets continue to grapple with the aggressive synchronised monetary policy tightening which caused havoc in fixed rate bonds throughout 2022. While bonds have recovered slightly, there remains significant uncertainty surrounding the path of monetary policy increasing the likelihood of further yield volatility. While low and 0 duration portfolios have substantially mitigated the impact of sharply rising rates, the earnings and macroeconomic outlook provide a difficult environment for credit investors. Meanwhile, the role of fixed income as a portfolio diversifier is changing. As bonds and equities become increasingly correlated in stressful conditions, actively managed credit offers portfolio diversification that is often difficult to replicate.

While risks are elevated, there are also a number of promising corollaries to the most aggressive tightening of financial conditions in decades. Most notably for credit focused and floating rate strategies, rising interest rates fuel increases in the coupons paid on floating rate assets, improving the income generated for investors. At the same time, higher rates and tightening financial conditions mean quality issuers come to market offering more attractive yields to take on their debt. These are the conditions where prudent active management can set up portfolios for success. While we expect to see more attractive opportunities, recession risks, earnings and credit downgrades mean that prudent management of credit, capital structure and sector risks is more crucial than ever.

The rewards of our approach have also seen in a number of event driven opportunities throughout the year where spiking volatility or dramatic shifts in yields or credit spreads have created a happy hunting ground for active managers. These have included APRA clarifying their guidelines on callable bonds, UK pension funds liquidating assets as bond yields spiked following the disastrous Truss government mini budget and most recently sharp selloffs in credit (most notably bank hybrids) following the collapses of Silicon Valley Bank and Credit Suisse. Our strategies aim to mitigate the downside of tail risks events such as these, while being able to take advantage of the relative value opportunities left in their wake.

Income remains the most substantial and predictable component of credit returns and provides a strong foundation from which to construct portfolios. Our strategies will continue to aim to generate robust income while carefully managing risks in an uncertain environment.

Multi Asset

Michael O'Dea
Head of Multi Asset
Perpetual Asset Management Australia

So far, the impact of this dramatic monetary policy tightening cycle (the most aggressive in decades) has been the collapse of a few US regional banks, crashes across speculative assets including cryptocurrencies and NFTs, rising bond yields and increased pressure on the prices of "long duration" assets.

For some time, we have been warning about the build-up of excesses in financial markets after such an extended period of extremely low interest rates. We expect to see more of these excesses wash out over time. Investor, corporate and household behaviour which may be justified when borrowing costs are extraordinarily low, need to be re-visited when interest rates rise by 4-5% in a year - but markets rarely adjust in a straight line.

While core inflation still sits at uncomfortably high levels, headline inflation has decelerated allowing central banks to pause or slow the pace of interest rate increases, and to assess the impact of rate increases on the economy and financial stability. Economic data has softened but not enough to mark a recession in the US and Australia and this creates a confusing and challenging time for investors. Until a recession is confirmed and reflected in much lower corporate profits, stock prices can continue to rally and diverge from weakening fundamentals. But fears of a much weaker economy in recent months have meant investors have rotated their portfolios towards stocks perceived to have better prospects in a slowing economy – notably large cap tech stocks (and especially those associated with Artificial Intelligence) - even though some of these stocks are trading on very high valuations.

To us, the best insurance against an uncertain future, is to not overpay for an investment. If a hard landing awaits, we do not believe the mega cap tech stocks or AI related stocks will be immune. Conversely, it is also important to consider what will do well if a recession is avoided. Under this scenario, cyclical stocks like banks, energy, materials, retailers, and transports are poised to perform well.

Our focus remains squarely on carefully managing risks on behalf of our investors, while retaining the capacity to take advantage of opportunities as they arise. Our disciplined investment approach, in depth research, patience, and a preparedness to be different will help our investors capitalise on this challenging environment.

Access our investment expertise

Through a range of Perpetual's ASX listed products

ASX:PIC

Perpetual Equity Investment Company Limited

Asset class: Australian equities

- Aims to provide investors with an income stream and long-term capital growth in excess of the S&P/ASX 300 Accumulation Index (Benchmark) over minimum 5-year investment periods.

ASX:GIVE

Perpetual ESG Australian Share Fund (Managed Fund)

Asset class: Australian equities / Responsible Investments

- Aims to provide long-term capital growth and regular income through investment predominantly in quality Australian shares that meet Perpetual's ESG and values-based criteria and to outperform the S&P/ASX 300 Accumulation Index (before fees and taxes) over rolling three-year periods.

ASX:GLOB

Barrow Hanley Global Share Fund (Managed Fund)

Asset class: Global equities

- Aims to provide investors with long-term capital growth through investment in quality global shares and to outperform the MSCI World Net Total Return Index (AUD) (before fees and taxes) over rolling three-year periods.

ASX:IDEA

Perpetual Global Innovation Share Fund (Managed Fund)

Asset class: Global equities

- Aims to provide investors with long-term capital growth through investment in global shares that are benefiting from changes in technology and innovation and to outperform the MSCI All Countries World Net Total Return Index (AUD) (before fees and taxes) over rolling three-year periods.

ASX:PCI

Perpetual Credit Income Trust

Asset class: Credit/fixed income

- Aims to provide investors with monthly income by investing in a diversified pool of credit and fixed income assets and to target a total return of RBA Cash Rate plus 3.25% per annum (net of fees) through the economic cycle*.

Find out more

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* This is a target only and may not be achieved.

Trust is earned.

Perpetual