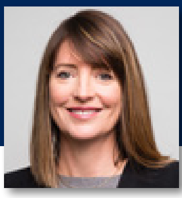
Annual Update 2021



Amanda Gillespie
Group Executive,
Perpetual Asset Management Australia

Thank you for trusting Perpetual to manage your money over what has been a tumultuous 12 months for both markets and the broader economy as we continue to manage the COVID-19 pandemic. The speed of market downturns in 2020 has been matched by the speed of the recovery in many countries, thanks to significant monetary and fiscal responses that have limited damage to the global economic system. As a result, 2021 has been characterised, so far, by resurgent economies, increasing investor optimism, and strongly performing equity markets. And while fixed income investors have had to contend with falling or historically low interest rates, there are still opportunities to generate meaningful returns above cash and term deposits. Upgraded forecasts from the International Monetary Fund (IMF) for Australian GDP growth have added to the positivity that looks set to continue. As we begin the new financial year, our investment teams are focused on delivering strong investment outcomes for clients and, as a business, we are looking forward to bringing a number of new investment solutions to market. During an incredibly busy time, it is great to see the efforts across the division and momentum building for FY22.

Market rally

While few investors would look back with any fondness on 23 March 2020 – the day the ASX hit its lowest point as the result of a sharp sell-off in response to COVID-induced lockdowns – the rate of recovery has been remarkable. Swift government and central bank action saw the market rally from these lows – a rally that continues to this day, with the S&P/ASX 200 Index recording a series of new highs in May and June.

This is a timely reminder of a key principle of successful investing: stay invested for your time horizon and don't react to short term market events! There have, of course, been some negative consequences, with low interest rates limiting prospective returns for government bonds and cash – a core portfolio holding for retirees. Persistent low yields and rapid economic growth have also reintroduced inflation risk.

Return to value

The past decade has seen growth stocks outperform value stocks on a relative basis, but the tide has well and truly turned over the past 6 to 12 months. Value's resurgence has been underpinned by a broad economic recovery, a flood of liquidity in most markets, high commodity prices and growing inflation concerns. This shift has seen unprofitable companies struggle to justify unprecedented valuations, while the global vaccine rollout and easing of lockdown measures has been good for sectors like Financials, Energy and Industrials. Perpetual continues to be a beneficiary of the rotation to value stocks. Our active management style also means we can take advantage of market volatility to position the portfolio in a way that is unavailable to index investors.

Strong performance

Perpetual Asset Management Australia has enjoyed a strong year delivering exceptional performance for clients across many of our investment strategies. Pleasingly, our Australian equities funds have seen a significant rebound in performance, supported by the return to value investing. Credit and fixed income funds have continued to perform well, delivering competitive returns in a continuing low return environment. Multi-Asset funds have also performed strongly, with the Perpetual Diversified Real Return Fund a standout. The Perpetual Global Share Fund and Perpetual Global Innovation Share Fund have also delivered strong outperformance over the year.

New investment solutions

The first half of FY21 was bookended by the acquisitions of US ESG investor Trillium Asset Management and US value manager Barrow Hanley. These are transformational milestones for Perpetual as we continue to build out our suite of world-class investment capabilities. Importantly, they have allowed us to bring new investment solutions to our clients with Barrow Hanley now managing the Perpetual Global Share Fund. The Trillium ESG Global Equity Fund and the Trillium Global Sustainable Opportunities Fund are open to Australian and New Zealand investors and complement our existing socially responsible capabilities, including the Ethical SRI Equity Fund and the Ethical SRI Credit Fund.

Conclusion

As we have seen over the last year, the COVID-19 pandemic and its impact on global markets remain unpredictable. In times like these, our active investment approach is best placed to add value for clients and pleasingly we have seen this play out in fund performance over the last year. Looking ahead, our investment teams continue to be focused on our clients and navigating the challenges and opportunities thrown up by the ongoing pandemic and global economic recovery.

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Investment Manager Viewpoint

Paul Skamvougeras
Head of Equities,
Portfolio Manager,
Perpetual Asset Management Australia

Australian Equities

The financial year marked a dramatic turnaround for Australian equities. Whilst massive stimulus in 2020 had prevented economies falling off a cliff, the shape and nature of recovery was still uncertain at the start of the new financial year with markets struggling for direction from July to October. The discovery of several highly effective vaccines for COVID-19 transformed sentiment from November onwards, however, as investors began to price in a 're-open trade' with much greater confidence. This cemented the nascent recovery in undervalued, pro cyclical stocks. A sharp spike in longer-dated bond yields also led to a sharp correction in some expensive growth stocks, although they remain at elevated levels.

Looking forward, we are conscious of the risks of more inflation than market consensus with many CEOs seeing rising cost pressures and labour market tightness. The massive scale of discretionary fiscal stimulus, especially emanating from the United States, could spark a much larger than expected boost to these inflation risks and prove difficult to remove even as full growth is restored. Output gaps are closing at record speed. With Australian GDP already recovered to pre-COVID levels, record levels of employment and business conditions reaching back to back record highs in recent months, any slack in the economy is being quickly absorbed and Australian and US central bankers could soon face the sort of tightening conditions normally associated with the booming later stage of the economic cycle.

All this bodes well for our investment style. Perpetual's Australian share funds have posted their strongest annual returns in many years as our quality and value approach to investing has proven itself. Despite some concerns in recent years that value investing was 'broken', we stuck by our proven investment process, which has once again delivered excellent results as it has in many previous market cycles. Whilst there is more to do, we are confident that Perpetual's funds are well positioned to steward our clients' capital through the coming months and years which should be favourable to our fundamental value investing philosophy and more challenging for riskier and expensive asset classes to navigate.

Brad Kinkelaar
Senior Managing Director,
Lead Portfolio Manager
Barrow Hanley Global Investors

Global Equities

After a tumultuous market environment leading up to the beginning of the year, global equity markets pushed well above pre-pandemic levels with the MSCI World Index up more than 90% since the bottom of the crisis and now trading at all-time highs. This recovery was well underway at the beginning of the year as central banks and governments around the world injected or planned to inject more than $30.8 trillion (USD) into global economies. Across regions, this represented a high of 70% of GDP in Japan and about 50% of GDP in Europe and the U.S.

Despite a lower amount of stimulus provided within emerging markets, for example China about 18%, and challenges containing COVID-19 in some major economies, emerging market stocks kept pace with developed peers. While there was little dispersion in performance across regions, excepting Japan, which was challenged both in its effort to effectively roll out a COVID-19 vaccine program and by the unexpected resignation in late 2020 of prime minister Shinzo Abe for health reasons.

Amid the pandemic sell-off, two areas of the market had meaningful dislocations. The first was in value stocks, which had underperformed their growth peers to a far greater degree than during the tech bubble of the late 90s and were trading at valuation levels not seen since that period. The second area was small- to mid-capitalization stocks which had also lagged large cap counterparts. Both were profitable areas to exploit, as value stocks have outpaced their growth peers over the last year with very strong performance since the end of August, while small cap stocks have outpaced their large cap peers by nearly 20% over the last year.

We are now seeing very strong economic data as PMIs are hitting all-time highs, employment and wages are increasing, there are record levels of savings, and we believe economies will continue to post good economic growth. This combined with moderate (but rising) levels of inflation, and modestly higher interest rates, should mean value stocks will continue to perform well and close the gap with their growth peers. Due to our bottom-up, fundamental process, our portfolio is well-positioned to take advantage of continued economic strength, as the names we hold are companies with good balance sheets that can manage through any further market turmoil.

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

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

Credit and Fixed Income

The 2021 financial year saw a sustained rally in credit spreads driven by promising economic and public health developments alongside an extraordinary level of fiscal and monetary support.

Over the second half of the year, the economic recovery from the COVID-19 pandemic proved explosive, albeit from a lowered base. Fuelling the remarkable growth story are the expansionary policy positions of governments and central banks keeping markets awash with liquidity. Governments continued to pump fiscal stimulus into their economies in order to close the output gap.

In the meantime, valuations have been supported throughout by extraordinary monetary policy conditions. Global interest rates were at or near zero throughout the year. Central bank balance sheets have also exploded at an unprecedented rate, led by the Fed's aggressive quantitative easing program. In Australia, the RBA has pursued its own unconventional monetary policy agenda with quantitative easing, yield curve control and the Term Funding Facility providing more liquidity to markets.

Persistent low yields and rapid economic growth have reintroduced inflation risk. In February, long terms yields rose dramatically on inflation fears, impacting fixed income portfolios and increasing discount rates. Perpetual's credit and fixed income strategies are either predominantly floating rate or heavily leveraged towards corporate credit and remain well positioned to perform through an environment of higher inflation and rising rates.

Credit spreads remain tight, having plunged below their pre-COVID lows during the year. In a low yield environment, the premium paid for prudently taking on credit risk is essential to building a portfolio that can generate a competitive yield. Despite full valuations, the outlook for corporate credit is positive. Market demand for Australian Dollar issuance remains strong and alongside the strong economic outlook is expected to support spreads. Credit risks have also subsided somewhat with a raft of ratings upgrades and robust earnings results over the past year.

In a context of low interest rates and tight credit spreads, active portfolio management is essential to defending capital and generating yield. While performance has been unambiguously strong and the outlook is promising, the team maintains its selective approach to investing, seeking out attractive relative value opportunities from quality issuers.

Multi Asset

The global pandemic drove wild swings in the real economy over the past 18 months – the worst recession since the Depression in early 2020 was followed by a boom in the global economy in 2021.

An overwhelming policy response by governments and central banks around the world, combined with the success of various vaccines, has underpinned the economic recovery. Moreover, there is growing confidence in the sustainability of the rebound in growth given macroeconomic policy remains extremely supportive and the vaccine roll-out continues apace.

The anticipation of this recovery has been very favourable for stocks (and other so-called growth assets) as the economic recovery is underpinning a snap back in corporate earnings – particularly in the sectors most affected by the lockdowns. As a result, markets have, thus far, been able to 'look through' second and third waves of the virus and a few troublesome variants.

Despite the bold macroeconomic policy response from governments and central banks, there have been some negative consequences. For example, the lowest interest rates ever are limiting prospective returns for government bonds and cash – a core portfolio holding of conservative investors, including retirees. The performance of government bond markets may be challenged further if some emerging pockets of inflationary pressure continue to build.

In managing this challenge, we have again been guided by our value philosophy, which has served us well over many decades. The market dislocations caused by the pandemic has helped us to do this as there are some outstanding 'value' investment opportunities. When the vaccine trials were successful in late 2020, a booming global economy in 2021 became a central case and provided a great opportunity to invest in some sectors and markets affected by the lockdowns, including the UK, Europe and emerging markets.

In addition, late last year, the multi asset portfolios were restructured further to reduce our clients' exposure to very expensive 'growth' stocks (including parts of the US technology sector). This has resulted in strong absolute and relative performance for our clients' portfolios and positions these portfolios to be resilient if interest rates continue to rise.

Investing Matters

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New funds available

With almost 20 years of providing ethical fund options to investors, Perpetual is pleased to advise you that we have recently added to our Ethical, Social and Governance (ESG) capabilities with the launch of three new products. ESG funds are those that use Ethical, Social and Governance screens as part of their investment process. The **Perpetual Ethical SRI Fund** was one of the first socially responsible funds launched in Australia in 2002 and has a history of strong performance. Our recent acquisitions of Trillium Asset Management and Barrow Hanley have allowed us to further build on the depth and scale of our ESG offerings.

Of the new offerings, the **Trillium ESG Global Equity Fund** is an actively managed, diversified portfolio of global equities that provides the potential for long-term capital growth by investing in companies that are leaders in managing ESG risks and opportunities. This fund has a comparable investment strategy to an existing Trillium fund, of the same name, offered to United States residents for more than 20 years.

The **Trillium Global Sustainable Opportunities Fund** is actively managed with a concentrated high conviction, sustainability-themed strategy that invests in companies positioned to thrive during the ongoing transition to a more sustainable economy. This fund invests in companies contributing to three core sustainability themes through their core business: climate solutions; economic empowerment; and healthy living.

We also recently launched the **Perpetual ESG Real Return Fund**, a Multi-Asset offering that invests in a diversified portfolio including Australian and global shares, fixed income and credit assets, selected based on a range of sustainable, ethical and financial criteria. This is a great example of being able to leverage the capabilities of both our Australian and international businesses to deliver a unique and relevant product to market. The fund is managed with a similar approach to the Diversified Real Return Fund (DRRF), but with additional ESG screening that utilises Perpetual's and Trillium's ESG expertise.

▶ For further information, please visit: www.perpetual.com.au/investments

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