HOW TO BUILD A PORTFOLIO IN A WORLD OF LOW GROWTH AND HIGH VALUATIONS.

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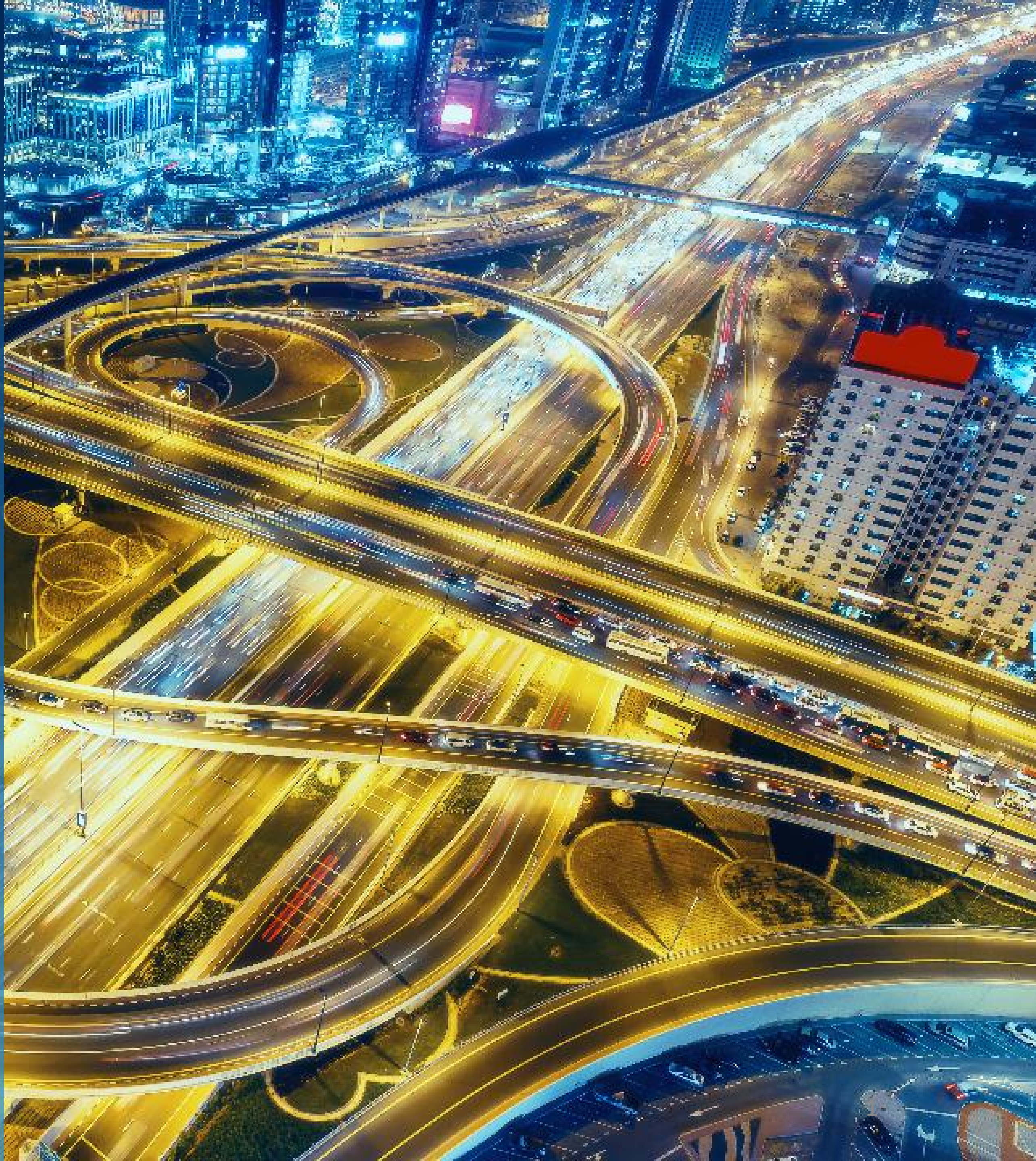
Head of Investment Strategy, Multi Asset

November 2020

Perpetual



HOW WE ARE THINKING ABOUT THE COVID DISLOCATION

FRAMEWORK:

1. Liquidity (resolved) – refinancing risk due to Covid-19
2. Solvency (ongoing) – balance sheet risk due to shape of the economic recovery (record corporate debt)
3. Long term impacts of policy response (unknowable) - e.g. inflation, lack of productivity and potential economic scarring

KEY ISSUES:

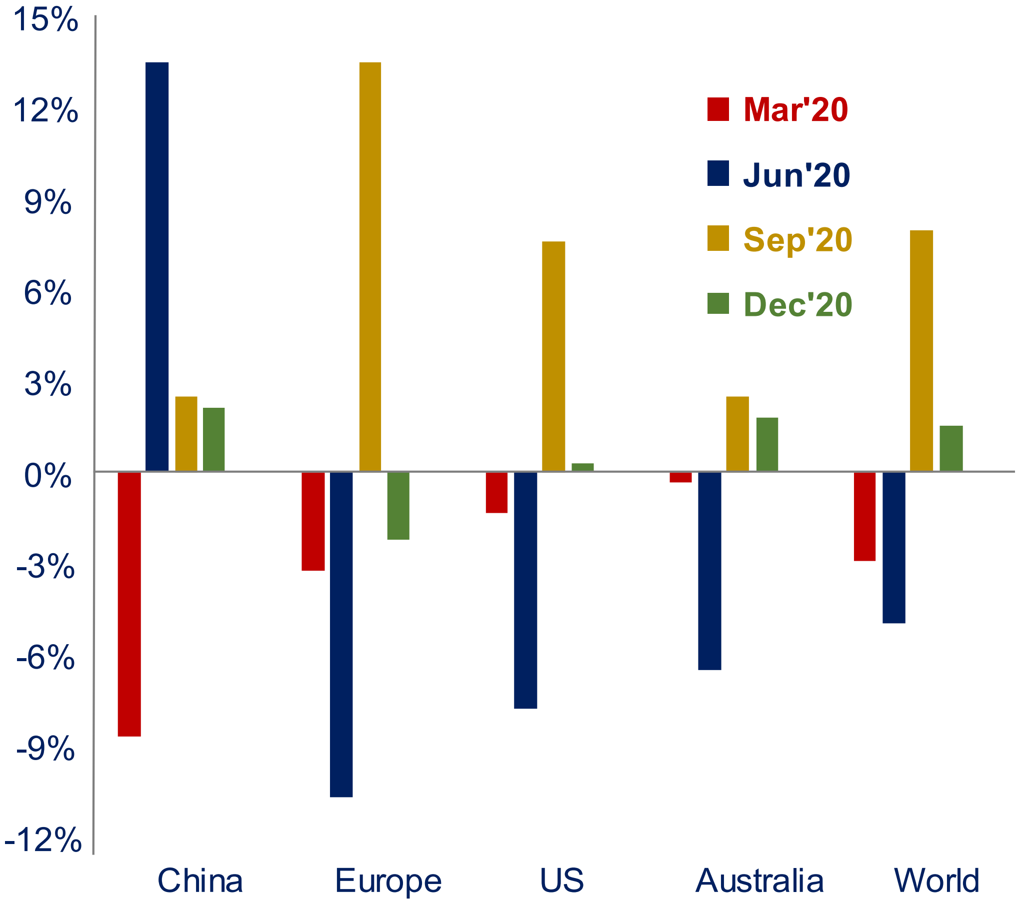
- Equities have less support from falling bond yields
- Central banks have less ammunition. Policy pendulum has swung to fiscal.
- Traditional portfolios have less diversification.
- Short-termism means equity sell offs could be brutal.

Investors have two choices – hope policy makers will continue to bailout markets, or take ownership and build a more robust portfolio

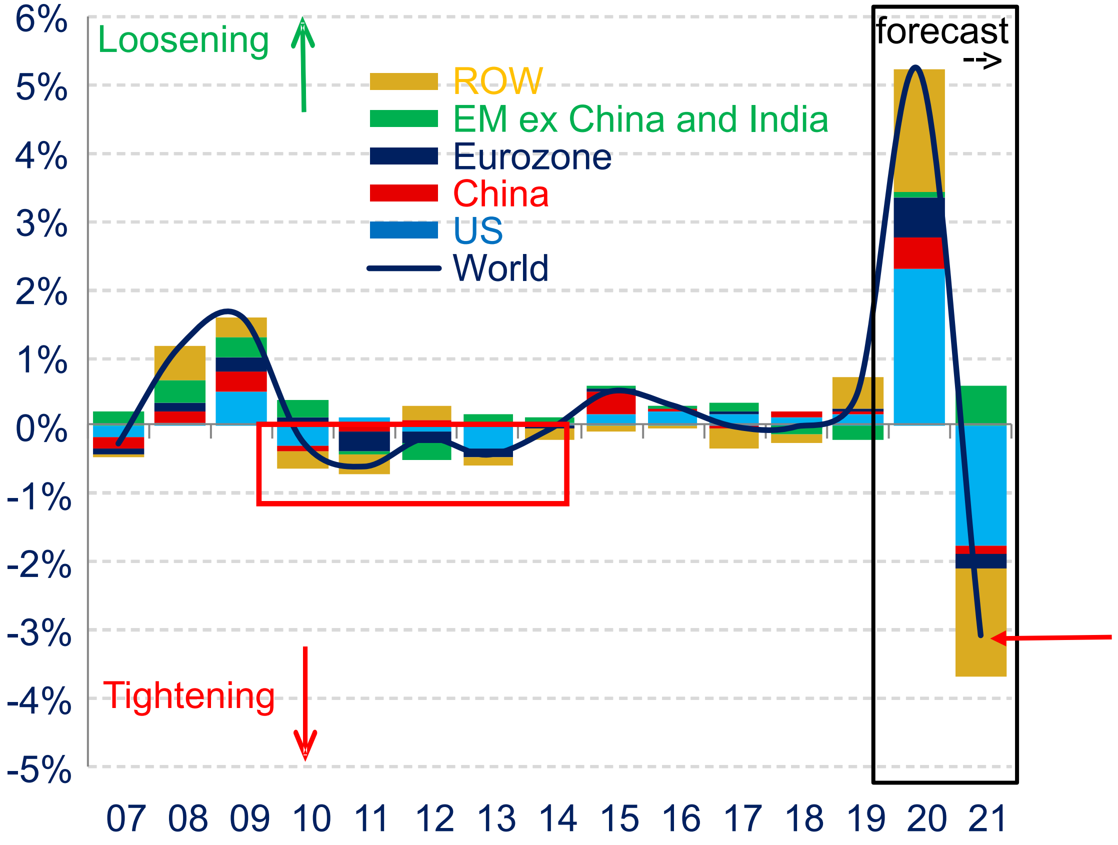
DON'T GET CARRIED AWAY WITH SEPTEMBER QUARTER GROWTH

2020 QUARTERLY GROWTH FOR US, EUROPE, CHINA, AUSTRALIA (%); GLOBAL FISCAL IMPULSE (% GDP)

THE GROWTH BOUNCE IN Q3 2020 WILL QUICKLY FLATTEN OUT



IN 2021 FISCAL POLICY WILL RECORD ITS LARGEST GROWTH DRAG IN 50 YEARS

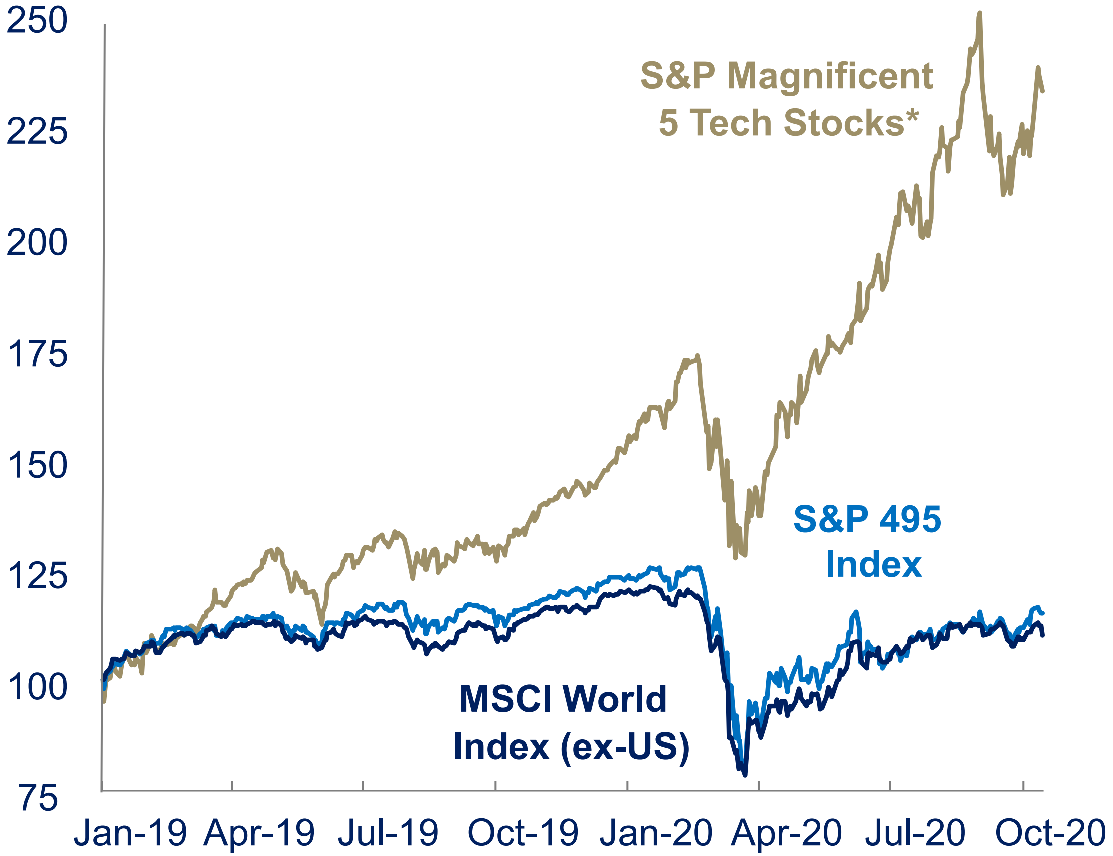


 Source: Perpetual Investments and UBS Australia Limited as at 8th November.

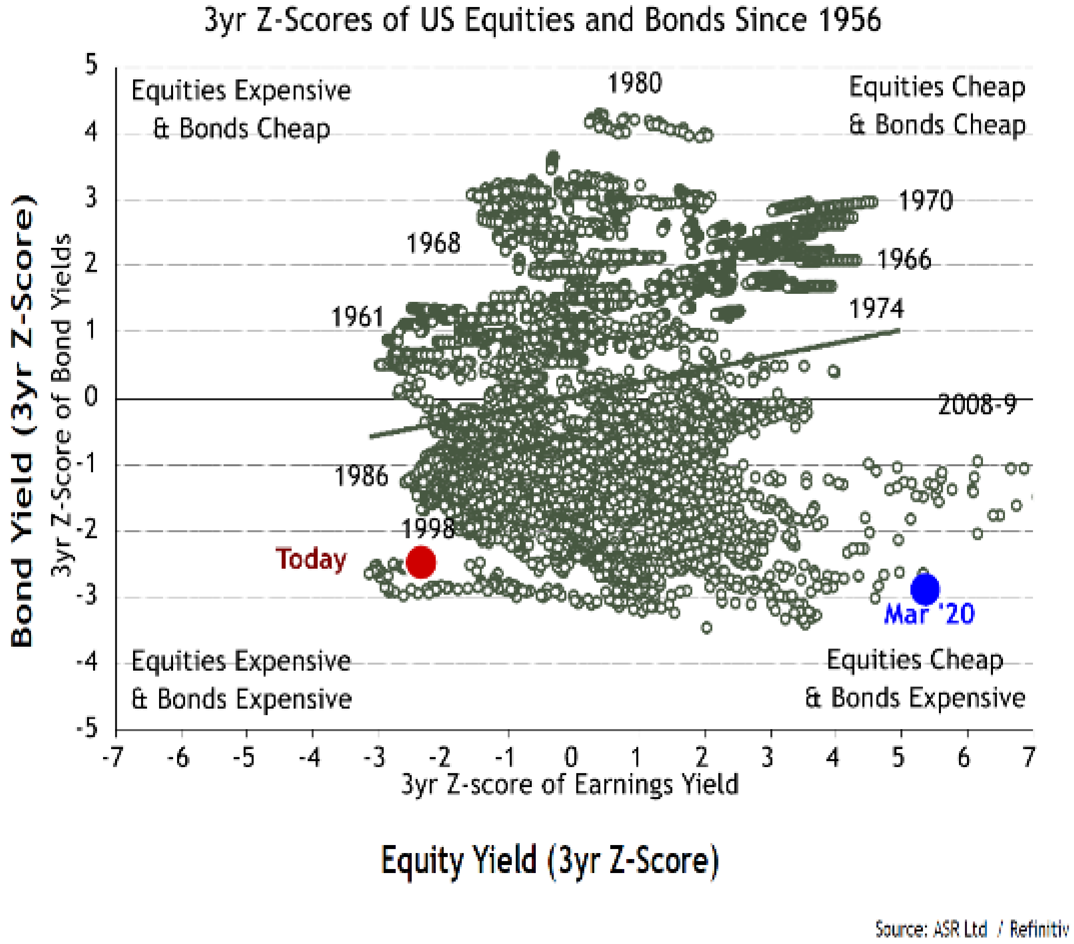
EQUITIES ARE EXPENSIVE, BUT WHAT ASSETS AREN'T?

US 5 TECH STOCKS, THE S&P495, AND WORLD EX-US INDEX, 3-YEAR Z-SCORE OF US EQUITIES AND DURATION

SHAREMARKETS ARE TWO PACED, BUT HAVE FACTORED IN A STRONG RECOVERY



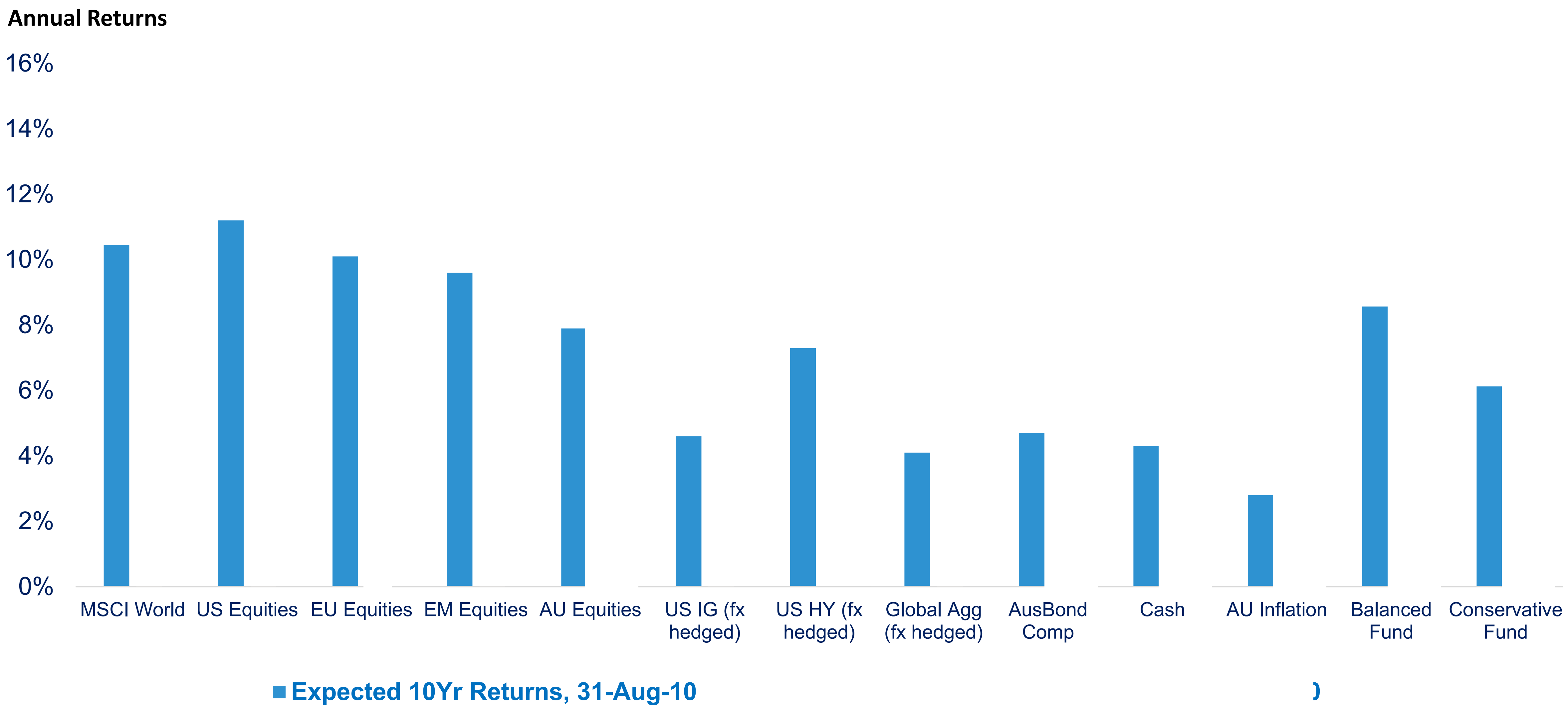
EQUITIES ARE EXPENSIVE, BUT BONDS ARE REALLY EXPENSIVE!



 Source: Bloomberg and ASR as at 15th October 2020. * The Magnificent 5 are Microsoft, Apple, Facebook, Amazon and Google and the index is cap-weighted.

THE INVESTOR'S DILEMMA

EXPECTED AND ACTUAL RETURNS (2010-20) AND EXPECTED RETURNS IN NEXT TEN YEARS



Source: Perpetual Investment calculations and Bloomberg

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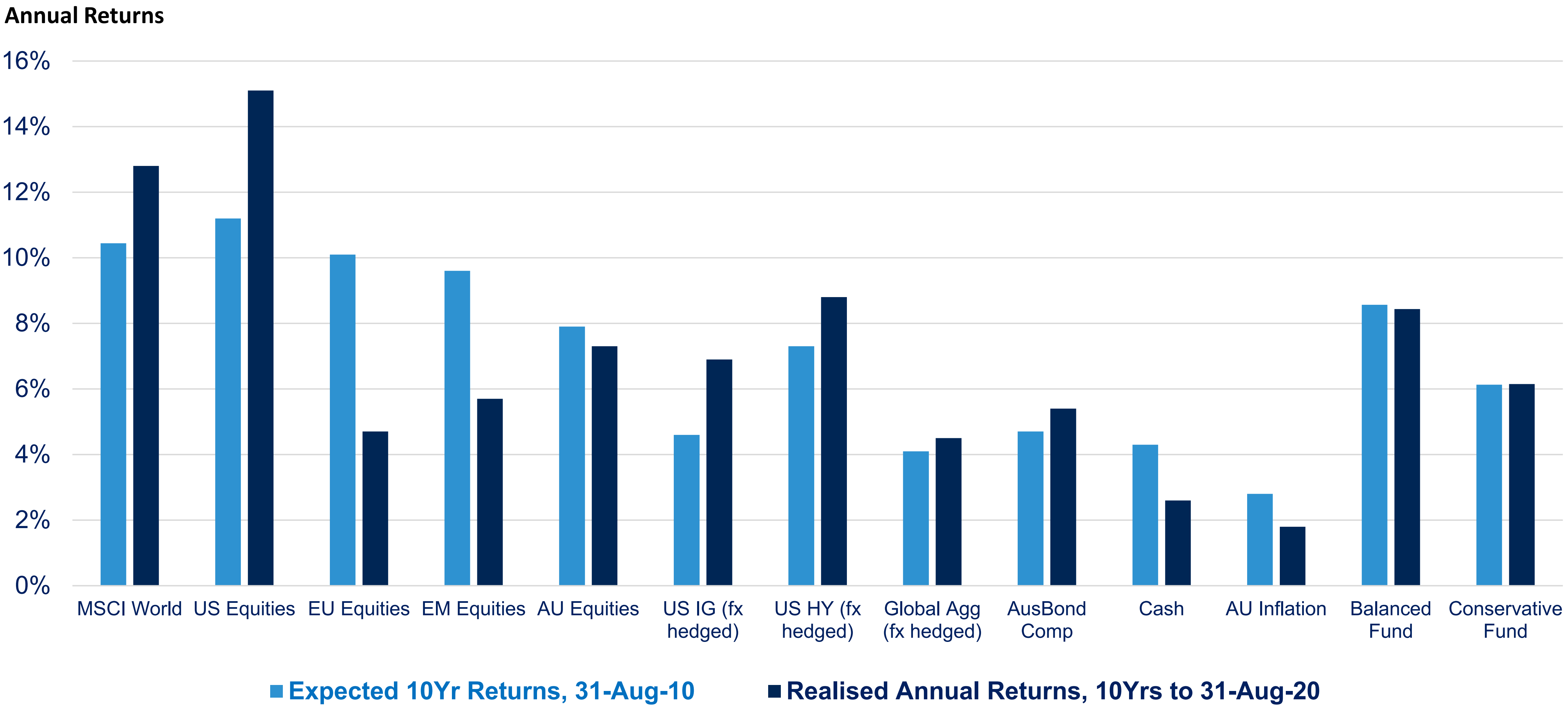

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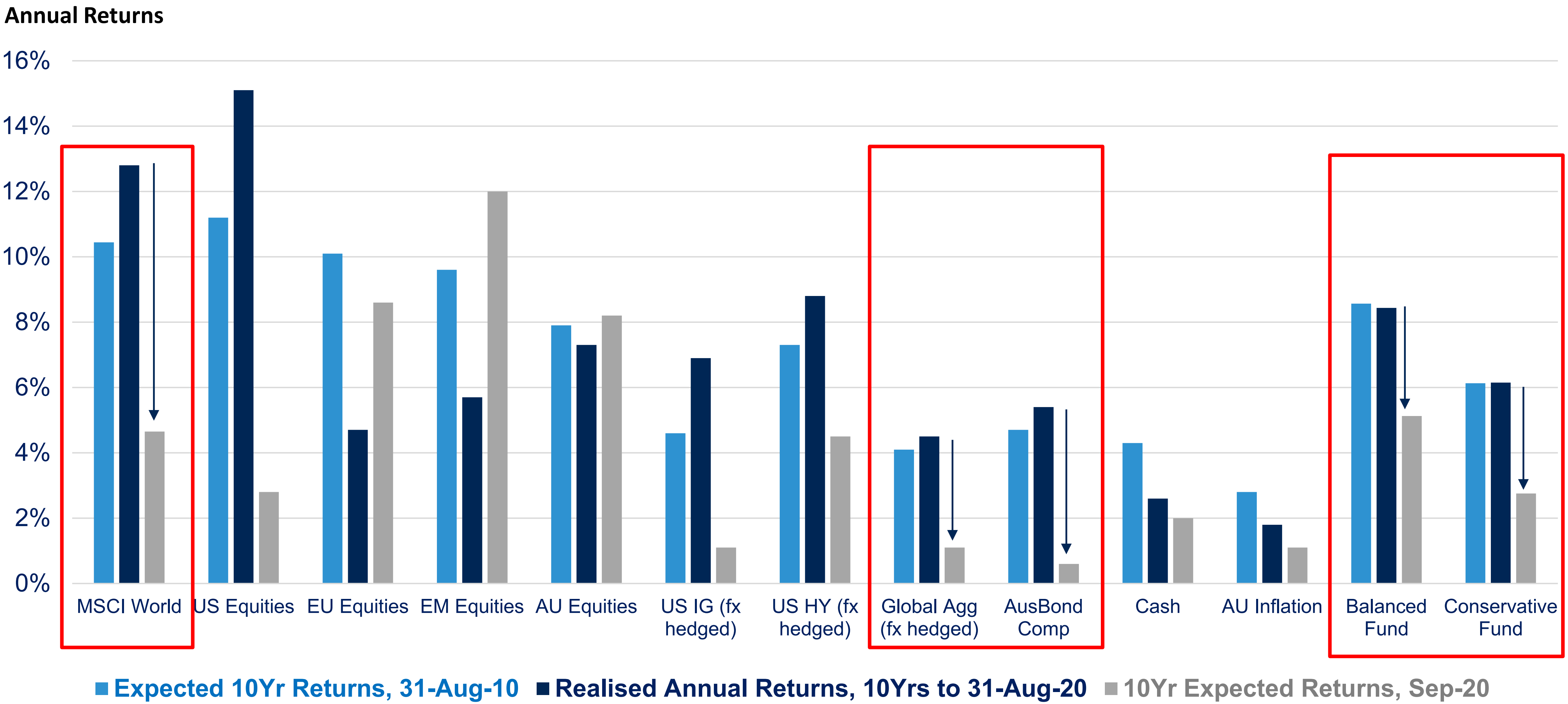


Source: Perpetual Investment calculations and Bloomberg

ALL PORTFOLIOS SHOULD BE BUILT AROUND 4 KEY INVESTMENT QUESTIONS

Inflation
What protects from inflation surprises over 5 year?

INFLATION PROTECTION

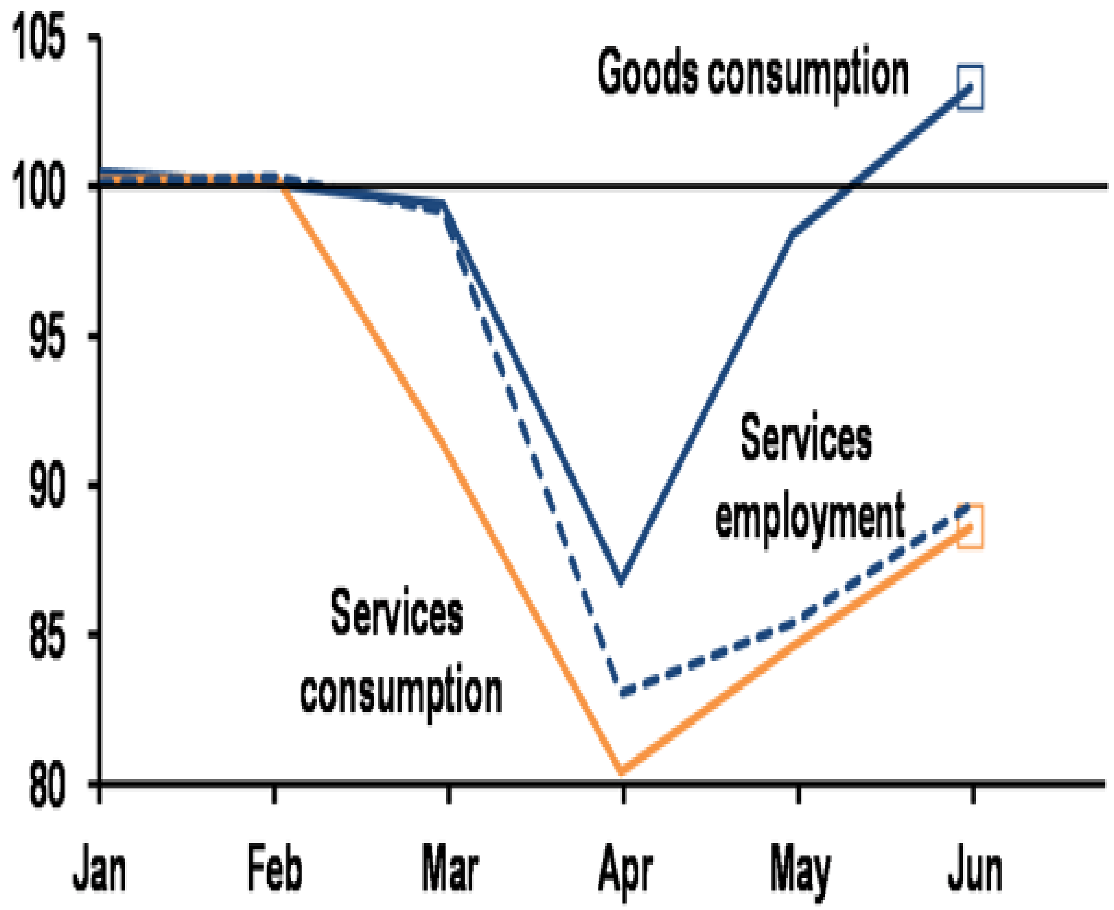
RETURN SEEKING

Return Seeking
What has a high probability of inflation + 5%?

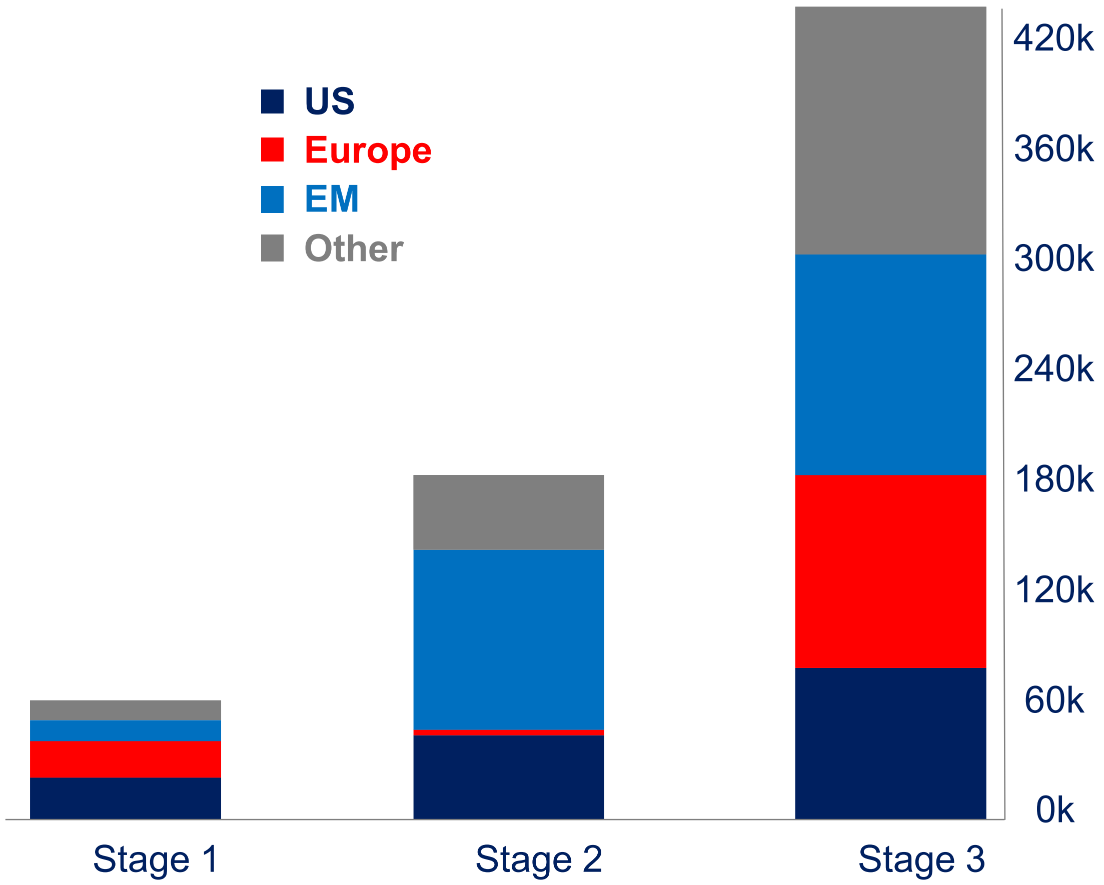
REASONS FOR CAUTION 1: A NARROW RECOVERY AND UNFAVOURABLE SEASONALITY

2020 ECONOMIC OUTPUT: GOODS VS SERVICES; COV-19 CASES BY REGION

SERVICES BASED ACTIVITY REMAINS DEPRESSED



… AND THERE IS A STRONG CORRELATION BETWEEN TEMPERATURE AND COV-19 CASES



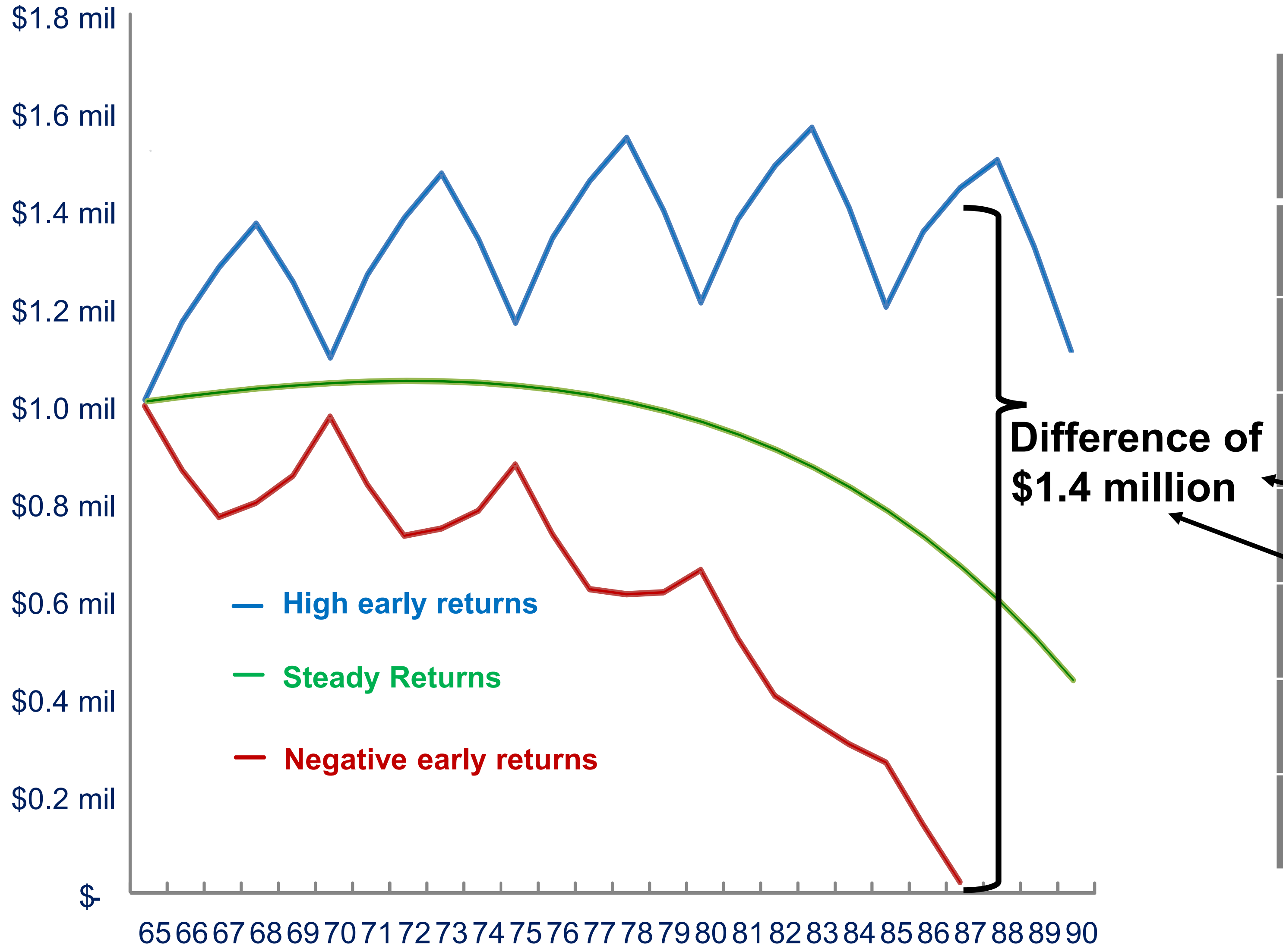
9. Source: JPMorgan and Bloomberg as at 16th October 2020.

REASON FOR CAUTION 2: LOWER AND MORE VOLATILE RETURNS AHEAD

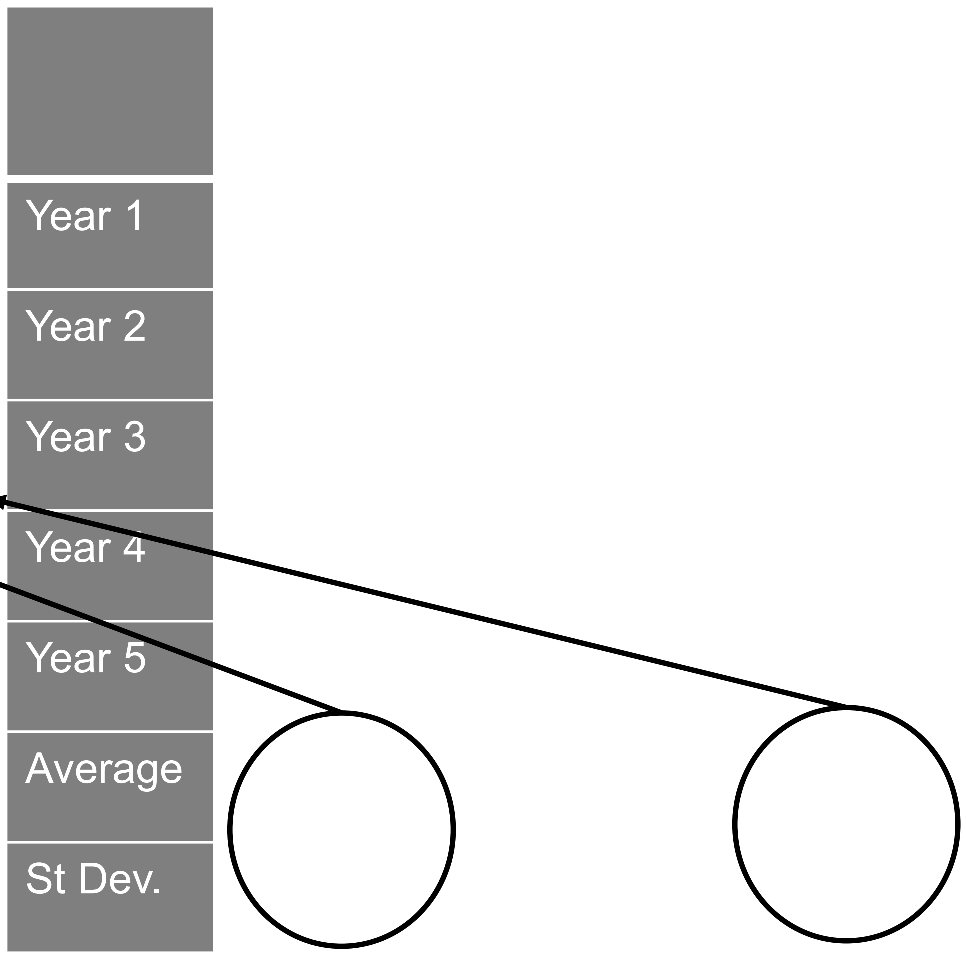
JAPANESE SHAREMARKET RETURN SINCE 2000 (INDEX)

A KEY PROBLEM FOR RETIREES: SEQUENCING RISK

PORTFOLIO VALUE OF THREE RETIREES WITH $1 MILLION AND THE SAME RETURN ($)



In retirement, the order of returns is what matters



Source: Perpetual Investments as at 1st September 2020.

REASON FOR CAUTION 3: US FISCAL POLICY

- Joe Biden will be the 46th US President, but:
  - The GOP looks to have maintained control of the Senate; and
  - The GOP picked up seats in the House;
  - Biden can't claim to have a mandate.

PRESIDENT		U.S. SENATE		U.S. HOUSE	
Biden/Harris	Trump/Pence	Democrats	Republicans	Democrats	Republicans
306	232	48*(+1)	50(-1)	221(-8)	209(+9)

- Two opposing effects on growth;
  - Positives – Biden is unlikely to pursue growth-sapping reforms;
  - Negatives - the GOP is likely to dump Trump's populist agenda; and
  - The 2021 fiscal drag is likely to be large.

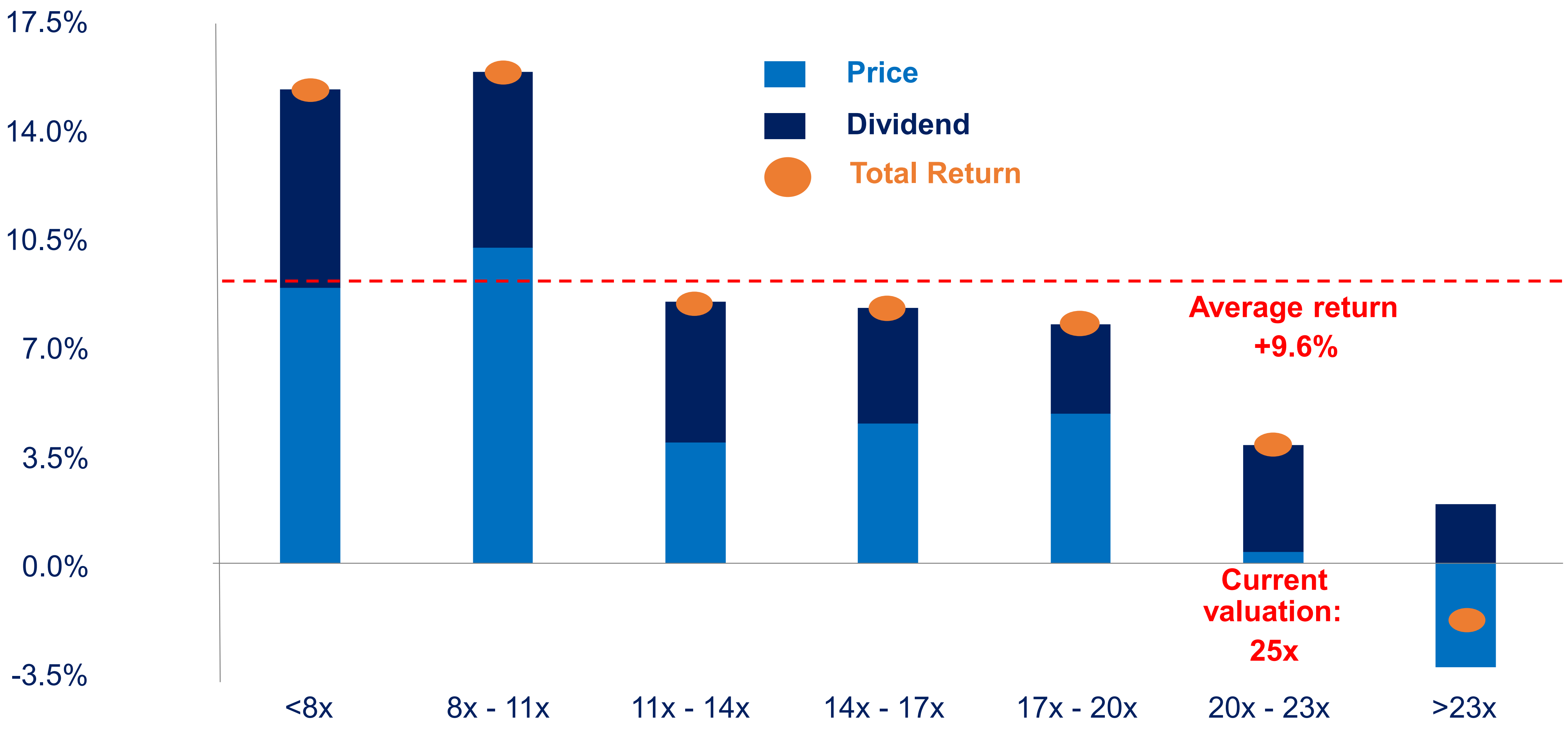
- What offsetting forces are there?
  - The Fed doesn't have the tools to lift growth or inflation; and
  - The US Dollar and bond yields are unlikely to move materially.

A split US Government has delivered the highest average return, but none of the data points have been in the midst of a pandemic.

Source: RealClearPolitics as at 9th November 2020.

REASONS FOR CAUTION 4: RICHLY PRICED MARKETS

MSCI WORLD 12-MF PE RATIO AND EPS ESTIMATES; US SHAREMARKET PE RATIO AND 5-YEAR RETURN (X, %)

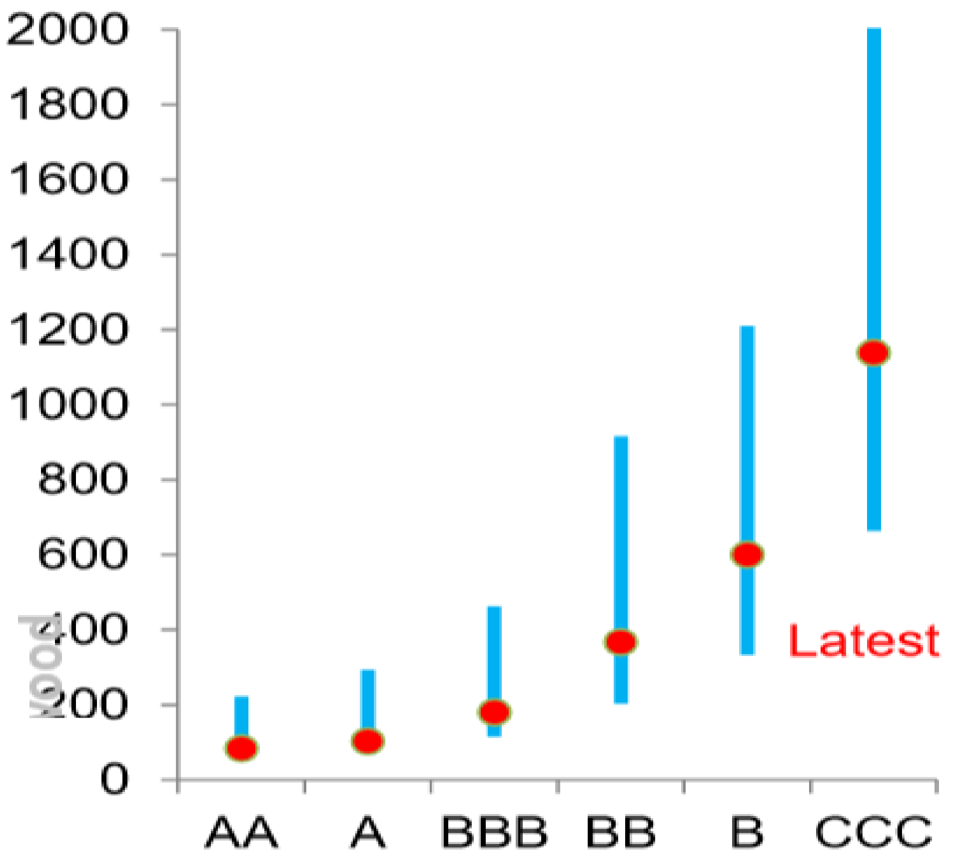


13. Source: UBS Australia limited as at 8th November 2020.

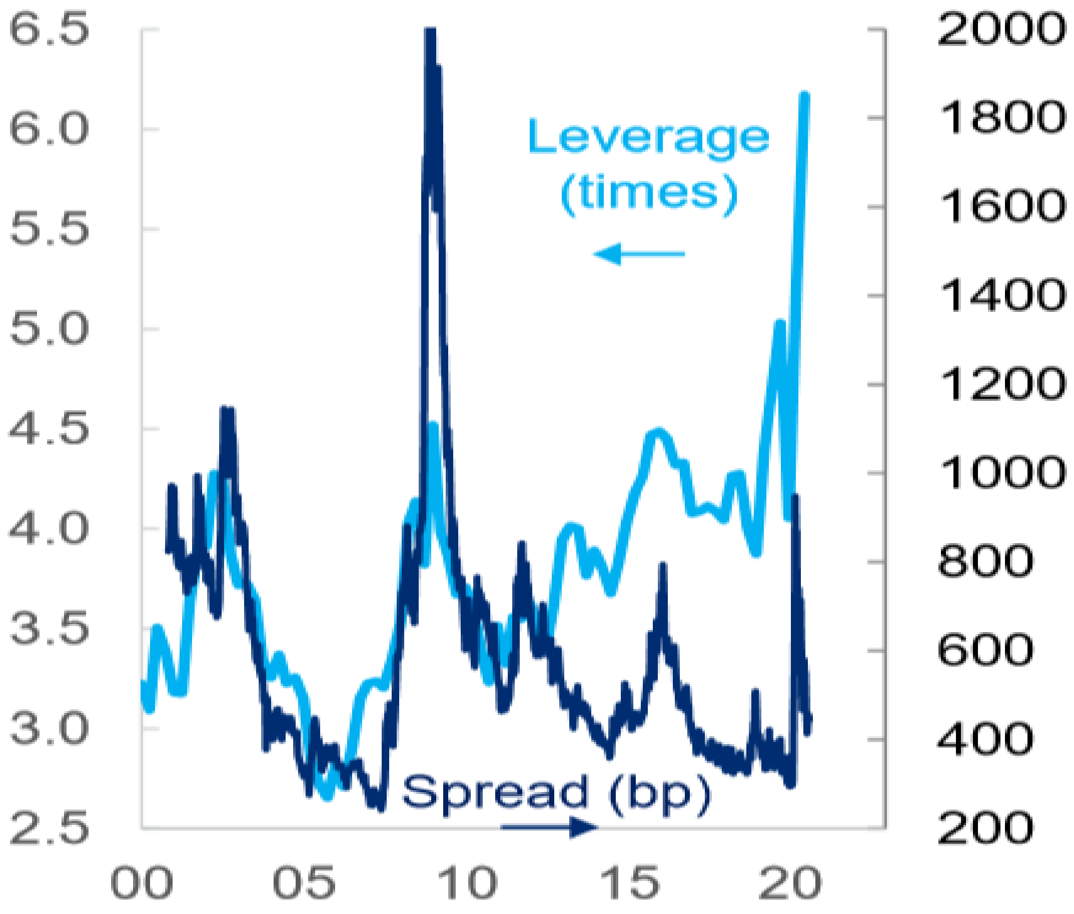
REASONS FOR CAUTION 5: THE BIG PICTURE DOESN'T TELL THE RIGHT STORY

SPREAD BY CREDIT RATING (BPTS); US HIGH YIELD SPREAD (EX-ENERGY) VS CORPORATE LEVERAGE (BPTS, X)

LOW QUALITY CREDIT SPREADS MAKE SENSE RELATIVE TO THEIR HIGH QUALITY PEERS…



… BUT THEY DON'T MAKE SENSE RELATIVE TO THE 7-YEAR LEVERAGE BUILD-UP



 Source: Citigroup at 8th September 2020.

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Inflation
What protects from inflation surprises over 5 year?

Return Seeking
What has a high probability of inflation + 5%?

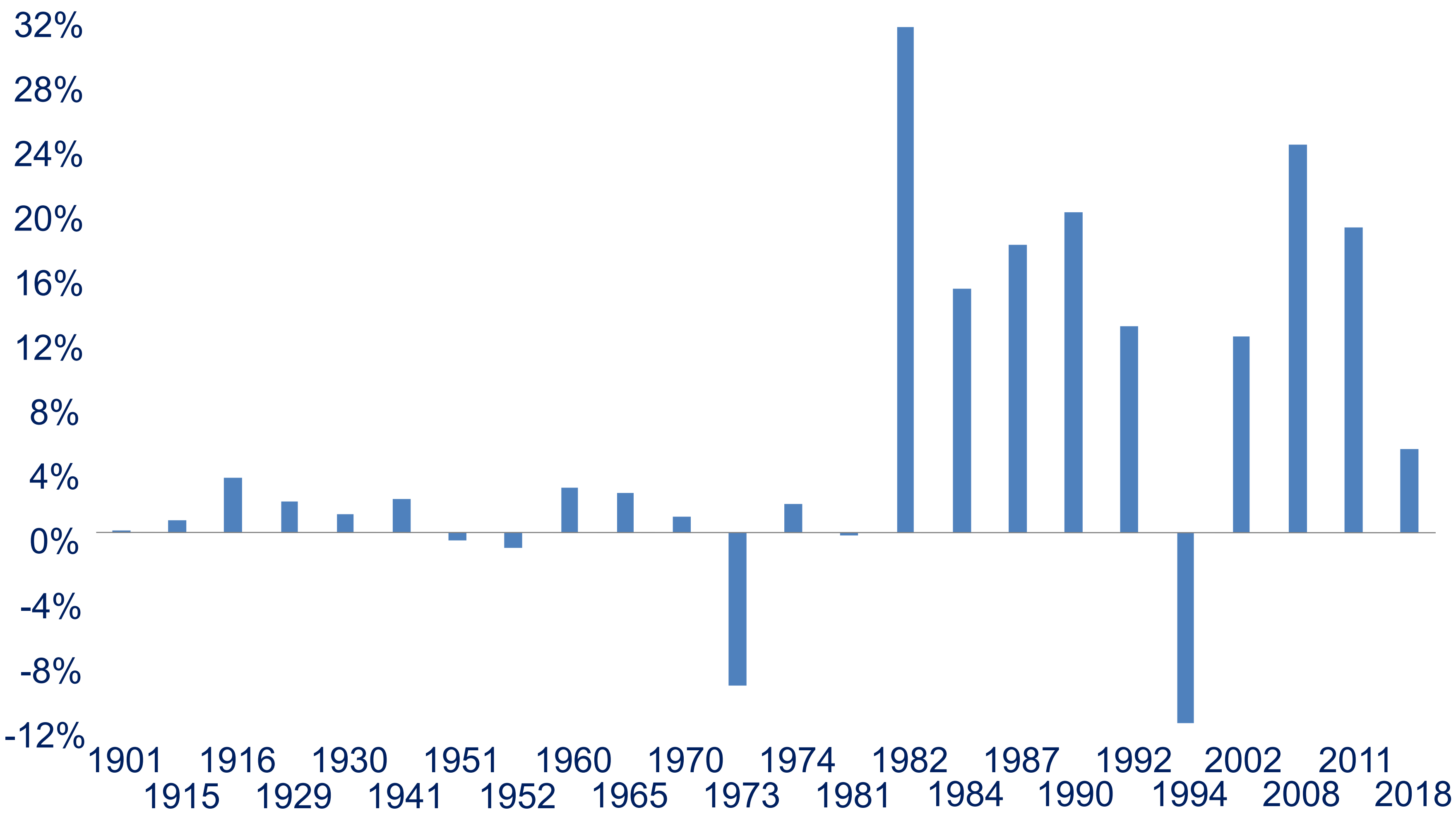
INFLATION PROTECTION	RETURN SEEKING	Returns
DOWNSIDE PROTECTION	DIVERSIFYING OPPORTUNITIES	Risk reduction

Downside Protection
What protects the portfolio in times of market stress?

Diversifying Opportunities
Are there uncorrelated return opportunities?

REASONS FOR CAUTION 6: THE DIVERSIFICATION FROM BONDS WON'T BE REPEATED

RETURN FROM AUSTRALIAN DURATION IN YEARS WITH NEGATIVE EQUITY RETURNS



Source: Perpetual Investments, Bloomberg

TODAY INVESTORS NEED A MORE COMPREHENSIVE PORTFOLIO DEFENCE

Government Bonds

- Very low nominal yields (& negative real yields) vulnerable to inflation
- Large fiscal deficits supported by central banks with low cash rates, quantitative easing and yield curve control policies.

USD

- Fed has been more active than the RBA
- Australia has a current account surplus
- Interest rate differentials are insignificant

Volatility/Options

- Volatility still high, making options more expensive
- Some put spreads offer reasonable risk/reward

Idiosyncratic

- HKD is trading at the high end of the range
- Hong Kong is in recession, is facing second wave of infections, and focal point of US and China tensions

Value/Quality

- If the economic recovery is weak, we could move from the liquidity to insolvency stage. High quality companies are likely to do well.
- Alternatively, the rotation into value could be violent

Gold

- Hedge for weaker USD
- Very low real yields
- Gold could potentially do well in both a deflationary and inflationary environment

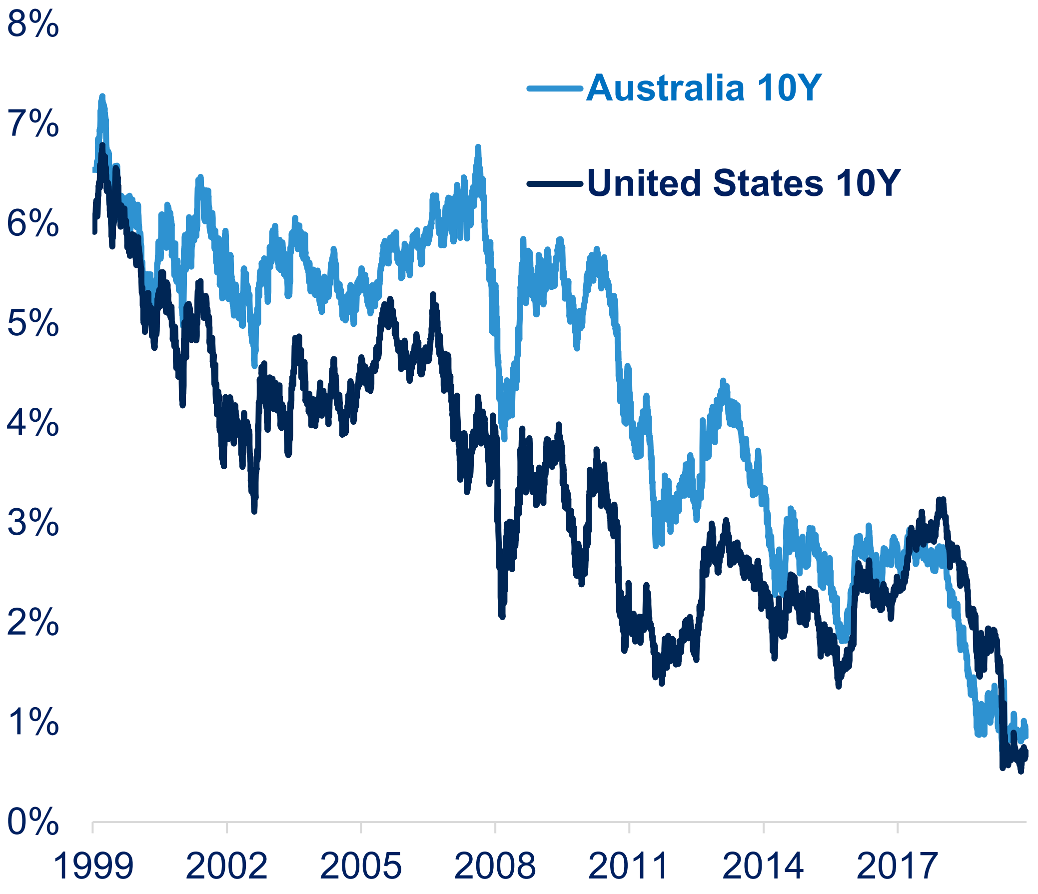
Low Allocation to Beta

- The simplest and most effective strategy is to maintain a low allocation to equities

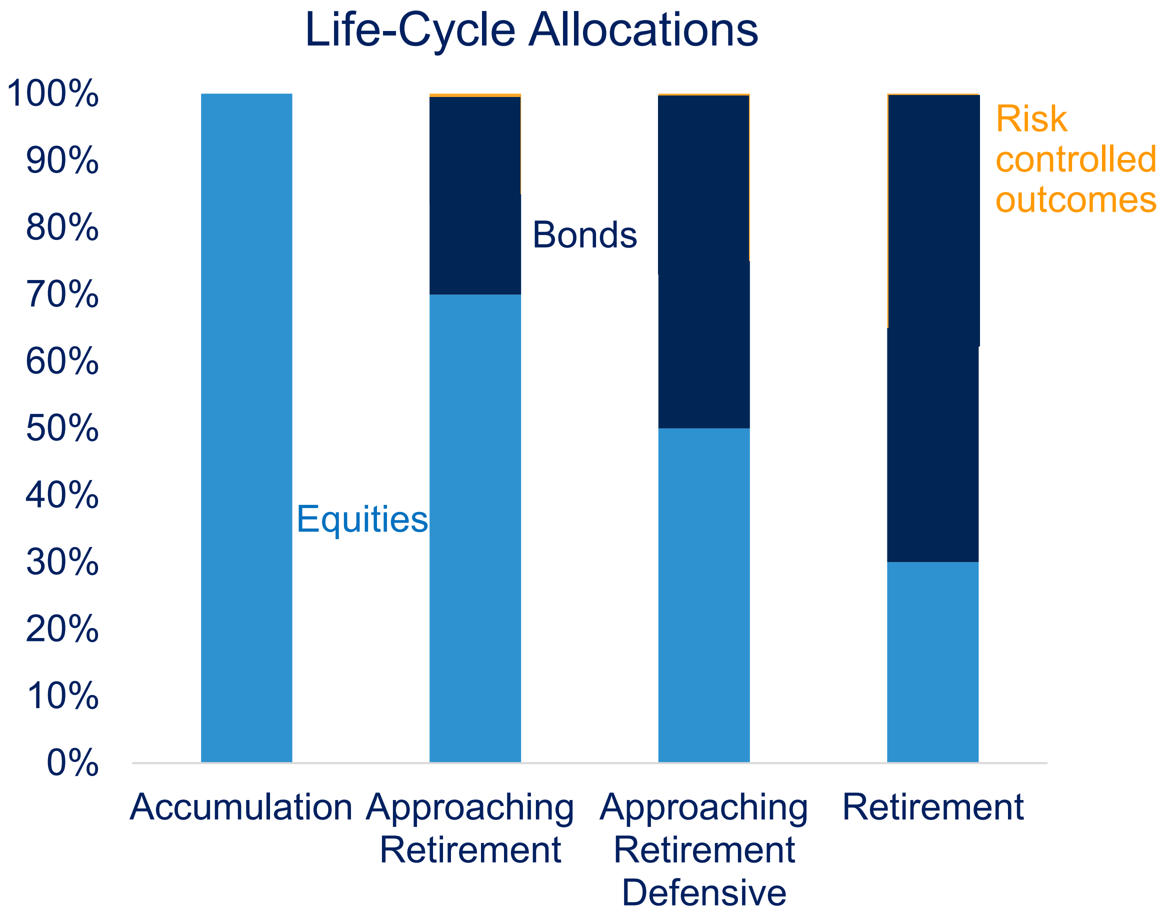
MEETING THE CHALLENGE FOR RETIREES AND CONSERVATIVE INVESTORS

10-YR BOND YIELDS: AUSTRALIA AND US (%); LIFE CYCLE-BASED ASSET ALLOCATION (%)

LOW YIELDS MEAN LOW INCOME AND LOWER DIVERSIFICATION

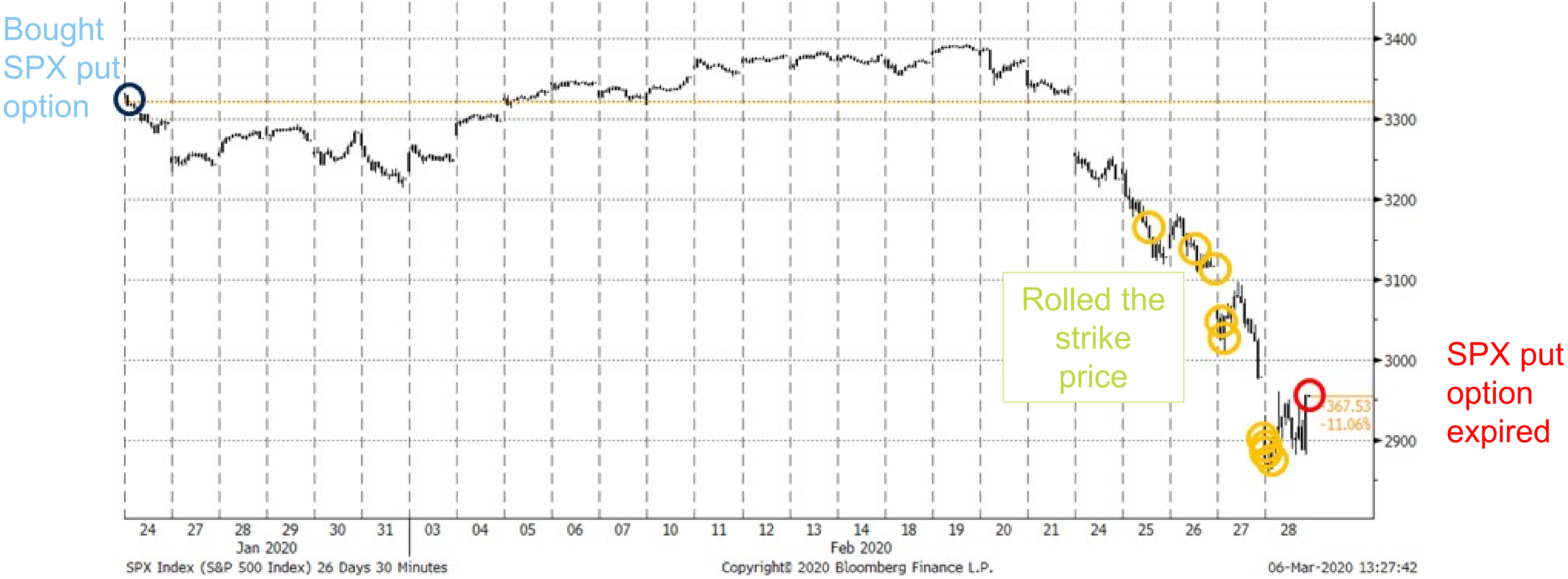


WE NEED A NEW APPROACH TO PORTFOLIO CONSTRUCTION FOR CONSERVATIVE INVESTORS



 Source: Perpetual Investments, Bloomberg

FEBRUARY 28 PUT OPTION



Source: Perpetual Investments, Bloomberg

ADDED TO THE GOLD POSITION ON ‘LIQUIDITY RUSH’ WEAKNESS

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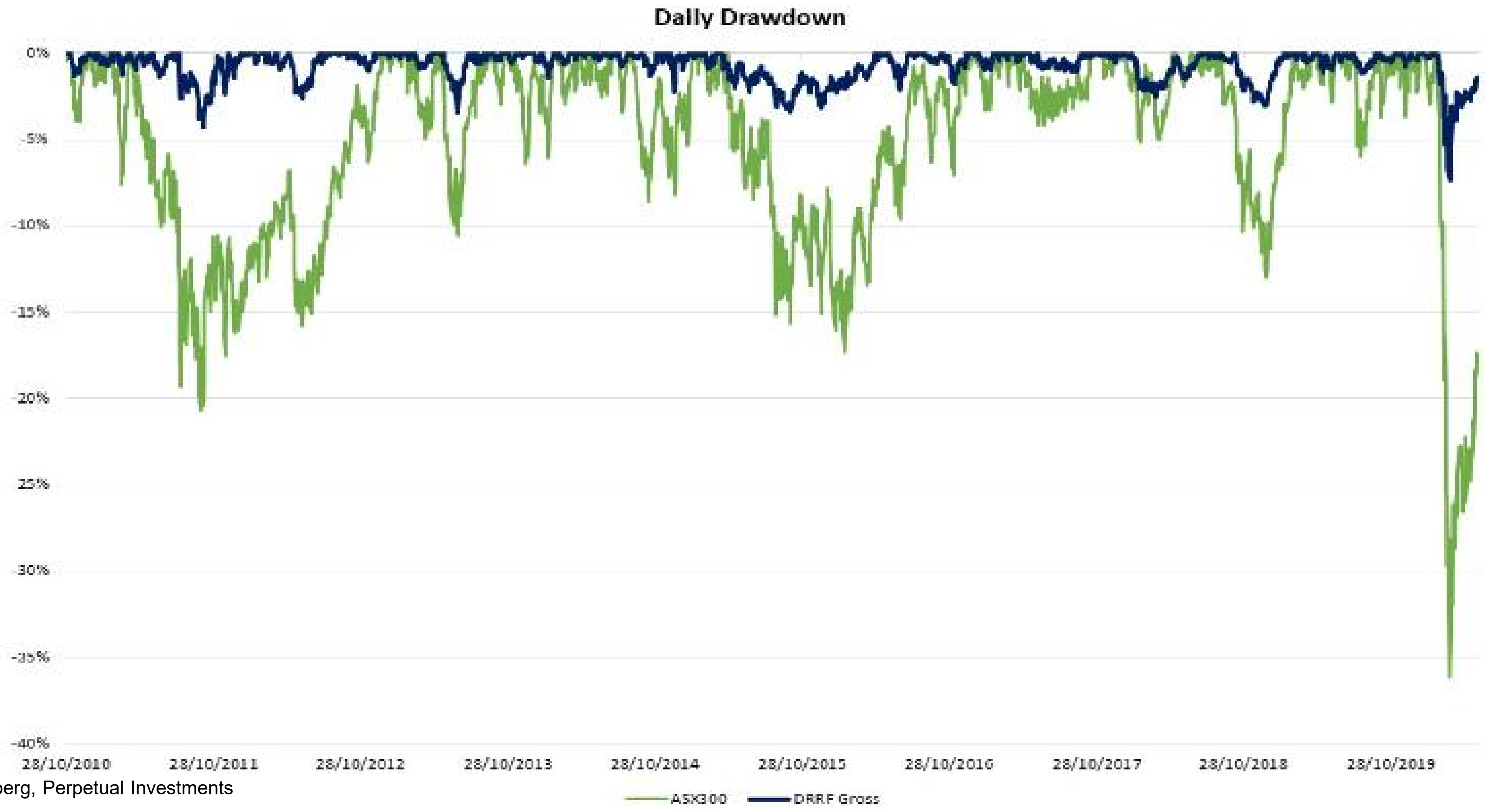
Switched to physical in May when the cost to roll futures increased to >4%pa

Source: Perpetual Investments, Bloomberg

THE 4 QUADRANTS SEES DRAWDOWNS WHICH ARE FEWER, SHORTER AND SHALLOWER
… AND THIS CAN HELP TURN RISK INTO OPPORTUNITY



Source: Bloomberg, Perpetual Investments

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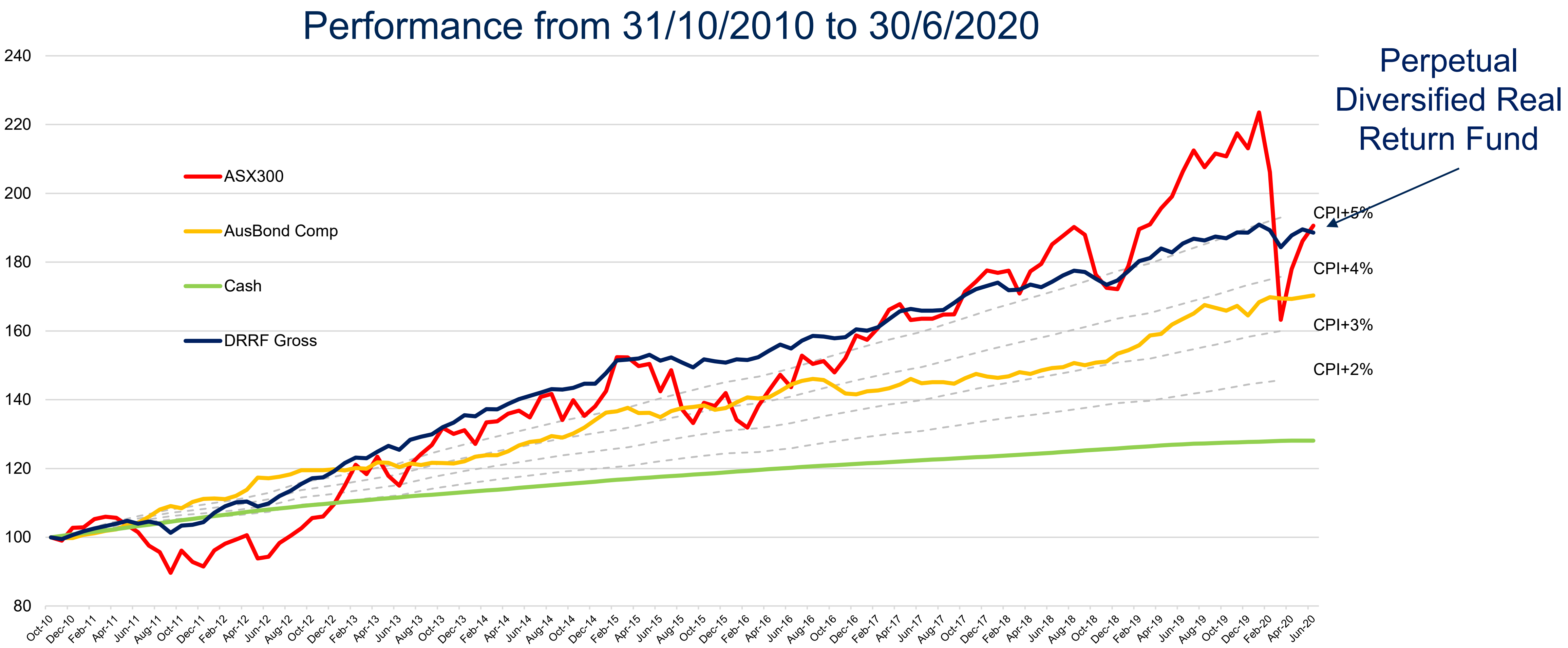
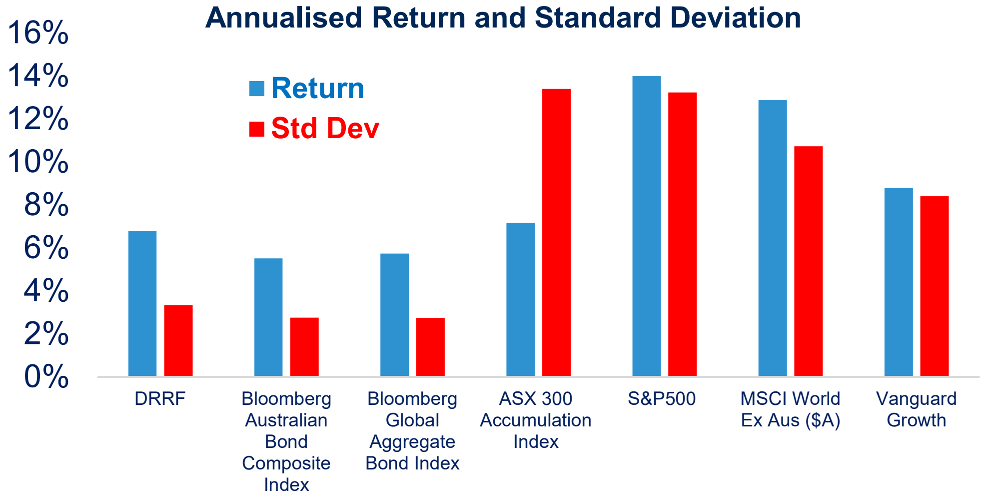
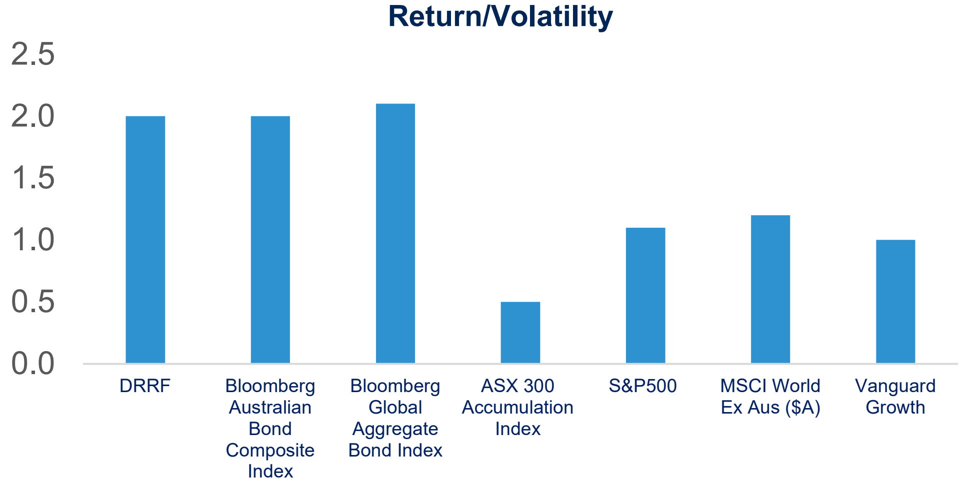
RISK MANAGEMENT DOES NOT NEED NOT BE AT THE EXPENSE OF RETURNS
PERPETUAL'S DIVERSIFIED REAL RETURN FUND VS ASSET RETURNS

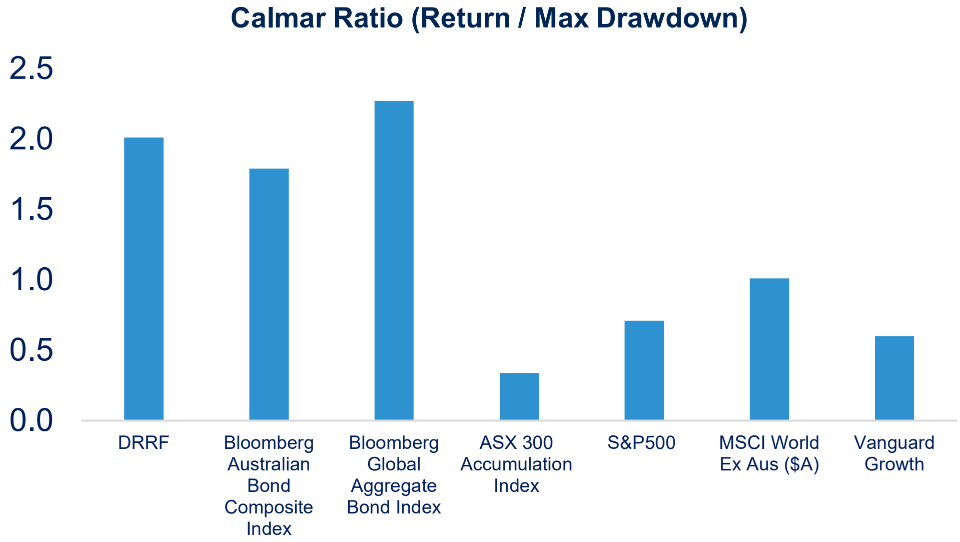


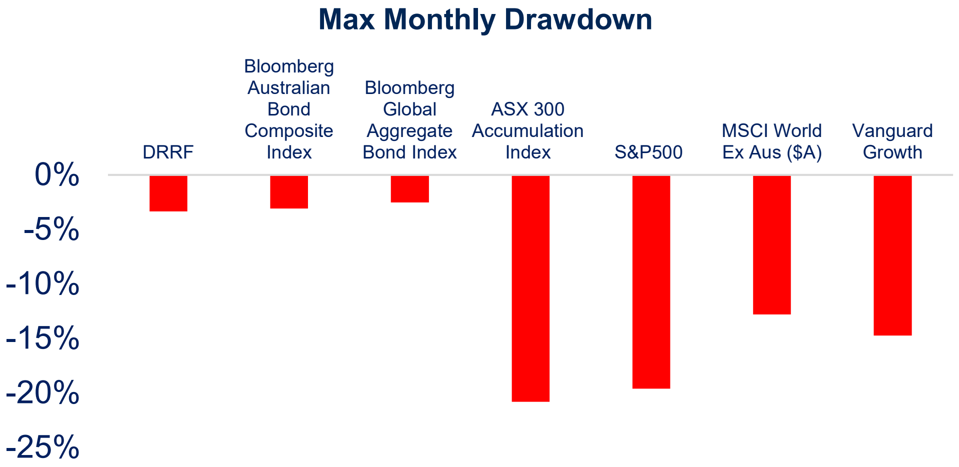
Source: Bloomberg and Perpetual Investments

RETURNS (GROSS OF FEES) AND RISK MEASURES
SINCE INCEPTION 31 OCTOBER 2010 TO 31 AUGUST 2020









 Source: Bloomberg and Perpetual Investments as at 13th October 2020.

SOME FINAL WORDS

- Our medium-term cycle framework is unchanged:
  - there is too much debt in the world;
  - the forces of secular stagnation are intensifying;
  - with rates at zero, monetary policy can only manage downside risks;
  - fiscal policy needs to be supported by debt monetisation;
  - Cov-19 will leave lasting damage; and
  - inflation remains elusive, but policy makers are determined.
- Market expectations in some areas is too optimistic:
  - a vaccine with modest fiscal expansion means a subdued cycle;
  - equity markets EPS expectations assume a fast return to normal; and
  - credit market prices do not reflect the revenue outlook and debt build-up.
- Investors face a dilemma in 2021:
  - The environment is one of lower returns, higher risk and reduced protection from bonds:
    - the only way to manage this challenge is through better asset allocation;
    - investors should only hold risk when its likely to be rewarded; and
    - investors need to realign costs with returns, without sacrificing diversification.

Fiduciaries have two choices – hope policy makers will continue to bailout markets, or take ownership and build a more robust portfolio