From partying hard to doing the hard yards

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Market returns across most asset classes have been supercharged since the lows of March 2020, spurred by accommodative monetary policy, stimulatory fiscal policy and an improving

global economic outlook as the COVID vaccine rollout gathers pace. What has this all meant for Perpetual's Diversified Income Fund?

The COVID-induced market volatility played to our strengths as an active manager. In Perpetual's Diversified Income Fund, this active management included:

- Positioning the fund defensively (pre-COVID), by rotating out of BBB rated (bottom of the investment grade spectrum) securities into predominantly (over 50%) AAA rated (top of the investment grade spectrum) securities, the highest AAA exposure in the fund's 15-year history;
- Taking advantage of the repricing of risk post-COVID and using the large firepower available (from the high AAA exposure) to rotate back into BBB rated securities, which were now more attractively priced, including exposures to long-dated banks, financials and corporates; and
- Over the last 12 months, taking profit on many of these BBB rated exposures and returning the portfolio to a more defensive posture once again (by increasing the allocation to AAA rated securities) as credit spreads contracted to historical lows.

Our active management generated strong performance for investors in the Diversified Income Fund, with the fund achieving its highest rolling 12-month net returns (8.85% in March 2021) in almost a decade (since May 2011). This was a particularly strong result considering that the current RBA cash rate is just 0.10%, compared to 4.75% a decade ago when fund returns were last this strong. Consequently, fund distributions for FY21 were also the healthiest in seven years (since FY14) at just over 4%.

Whilst the credit fundamentals (low interest rates, an improving global economic outlook and strong technicals) remain supportive, many credit premiums are at historic lows (below pre-COVID levels and in some cases below pre-GFC levels), making it prudent to return the portfolio to a more defensive posture, albeit remaining fully invested. So, whilst investors have enjoyed partying hard with the supercharged returns of the last 12 months, we believe that return prospects for the coming year will be more modest. There still remains scope to generate returns commensurate with the fund's performance objective (bank bills plus 2% p.a. before fees). With a strong focus on investor outcomes, we believe the Diversified Income Fund has been a consistent and reliable performer through many market cycles, over the short, medium and long-term, comfortably exceeding its return objective over the last decade.

With credit yield premiums now at historic lows, the margin for error has reduced and investors will once again need to do the hard yards. In this environment, investors will need to be much more discerning and active management will be more important than ever to generate return whilst managing downside risk.

Perpetual's active management style positions us strongly to navigate this investment landscape.

Read the full newsletter.

Find out more about Perpetual's Diversified Income Fund.

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