

Altius Sustainable Bond Fund

Fund Update
31 May 2023

Altius Asset Management employs a diversified strategy to fixed interest funds management that aims to take advantage of the mispricing of bonds in all market conditions. The Altius Sustainable Bond Fund is an Australian fixed interest fund that invests in companies which conduct their business and apply capital responsibly, giving full consideration to a range of environmental, social and governance (ESG) issues.

Performance as at 31 May 2023

	1 mth %	3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	7 yrs % p.a.	Since inception % p.a.
Total return	(0.12)	1.72	3.72	(0.54)	0.55	0.88	1.56
Benchmark	(0.44)	1.52	2.25	(0.87)	1.05	1.27	1.75
Excess to benchmark	0.32	0.20	1.47	0.33	(0.50)	(0.39)	(0.19)

Inception date for performance calculations is 21 November 2014.

Total returns are calculated after fees and expenses and assume the reinvestment of distributions. Past performance is not a reliable indicator of future performance. Effective 1 July 2016, Benchmark is 50% Reserve Bank of Australia Cash Rate and 50% Bloomberg AusBond Composite 0+Yr Index and applied retrospectively for all periods. Excess to benchmark is calculated on Total return.

Portfolio Performance and Activity

May was an eventful month for markets with concerns early about further US regional bank issues, further interest rate tightening by the US Federal Reserve, European Central Bank (ECB) and the Reserve Bank of Australia (RBA), negotiations around the US debt ceiling and data that pointed to inflation being stickier than expected. Over the month bond yields pushed higher across the globe. Australian three- and ten-year rates finished 0.37% and 0.25% higher at 3.37% and 3.61% respectively, with similar moves being experienced in the US with the two- and ten-year yields closing the month at 4.40% and 3.65% respectively. The fund started the month with 2.25 years of interest rate duration before finishing the month with 3.09 years.

The month opened with the RBA increasing the cash rate by 0.25% to 3.85% after a brief pause in April, which was contrary to market and most economists' expectations. Forward guidance for further policy tightening was softened but the Board flagged upside risks around services inflation. This led to heightened volatility in bond markets as the short end of the yield curve initially sold off ~20bps on the decision, however, regained those losses a few days later. Adding to the volatility, there was a fresh round of US regional bank concerns with First Republic Bank being closed and JP Morgan acquiring most of the asset, which was the third regional bank collapse in 2 months. In addition to this, equity prices of several other regional banks in the US fell significantly, driven by concerns about deposit outflows. The key driver of rates for the remainder of the month was headlines around the US debt ceiling which caused nervousness amongst investors and bonds subsequently traded with a bias towards higher yields, led by the US.

Economic data locally printed on the soft side, with the unemployment rate backing away from cycle lows, albeit still at very low levels, and retail sales that were weaker than expected, however monthly inflation continued to print strongly at 6.8% vs. 6.4% expected. This was in contrast to global economic data which

printed broadly stronger with the US unemployment rate falling back to the lows of 3.4% and a stronger-than-expected inflation print with a core personal consumption expenditure (PCE) deflator of 4.7% vs. 4.6% expected. This robust data in the US made investors rethink the previous thesis that the Federal Reserve would need to cut rates later in the year.

Credit markets had a strong month, tightening roughly 10bps in both the financials and industrials index. This was despite a large amount of issuance which included a jumbo \$5.25 billion multi-tranche NAB senior unsecured deal split across fixed and floating 3- and 5-year tenors at a risk margin of 0.78% and 1.00%. Several other local banks also came to the market including ANZ, CBA, Bendigo and Adelaide, Suncorp Metway and a few other local branches of offshore banks such as UBS Australia, OCBC Sydney and Rabobank Australia, and these primary issues were absorbed very well by the market. In addition to financial issuance, there was also reasonable corporate issuance, with Paccar, NSW Electricity Networks, QIC and Ausnet Services all issuing into the domestic market.

Socially Responsible Investments in Focus

Belatedly for vulnerable borrowers that have accumulated debt, they cannot afford, responsible lending obligations that currently apply to all credit providers will now also apply to the Buy Now Pay Later (BNPL) sector. The sector will be regulated under the Credit Act and companies must determine that products are suitable for their users and providers must also hold an Australian credit license. The legislation is likely to in part reflect the BNPL industry code of conduct, which introduced scalable lending checks, identity, and age verification.

Providers will need to comply with "design and distribution obligations" administered by the Australian Security and Investment Commission (ASIC) to ensure products are suitable for their target market and have internal and external dispute resolution in place, offer hardship provisions to struggling

customers and tougher rules will be imposed on marketing.

Regulating the BNPL sector will help protect. The move will also be credit positive for the financial system

(<https://www.abc.net.au/news/2023-05-21/buy-now-pay-later-regulations-credit-act-afterpay-zip-pay/102368810>).

Significant capital continues to be deployed toward climate change mitigation, accounting for 80% of all green bond proceeds in 2022. In contrast, sustainable management of natural resources and terrestrial/aquatic conservation accounts for around 13% given the difficulty in finding bankable projects at scale for benchmark-sized bonds.

A Moody's report has identified five sectors with around \$1.1 trillion in rated debt that has high exposure to both physical climate and natural capital risk and contends that standardised disclosure frameworks are critical to improving risk assessment, particularly noting that the risks can exacerbate each other. A disclosure framework is also important to help ease funding challenges to finance measures to address and mitigate these risks. The five sectors identified include mining, coal mining & coal terminals, integrated oil and gas, protein and agriculture, and environmental services and waste management.

Risks included reclamation and rehabilitation costs for mining companies, abandonment liabilities due to physical damage to ecosystems for oil and gas companies, as well as disrupted operations from extreme weather events for agriculture and protein companies. The report notes that Issuers with significant geographical diversification, or robust operational and financial risk management frameworks are better positioned to manage their risk exposure. However, even geographically diversified entities can still have operating concentrations in high-risk areas.

A report from Market Forces has found that Australia's major banks have been acting out of line with the credible pathways to achieve Paris climate goals. Over recent years the major banks had lent \$13.1 billion to the fossil fuel industry predominantly oil and gas but also including coal. In addition, corporate lending to companies with fossil fuel expansion plans is more than 3x the amount loaned directly to expansionary projects where direct lending restrictions apply. ANZ and NAB are Australia's climate laggards and have more than doubled CBA and WBC in terms of backing the fossil fuel industry (<https://www.marketforces.org.au/campaigns/banks/banking-climate-failure-2023/>).

Outlook

Australian bond yields are expected to oscillate in a reasonably wide range with the top end of that range currently observed. The range trading nature of bonds reflects variability in downward shifts in activity and an evolving but uneven effect of the tightening cycle on activity, inflation and policy measures.

The central bank cash rate tightening cycle amongst dollar bloc countries is not yet but very close to complete. Current market pricing largely reflects the peak in cash rates fairly, though forward implied cash rate cuts somewhat underestimate the need to retain a tight monetary policy.

The Reserve Bank of Australia has lagged other dollar bloc central banks due to a number of factors that include monetary policy efficacy of a floating interest rate regime (versus fixed), and a preference to retain the hard-fought employment gains by allowing inflation to return to target over a longer period of time.

Wage growth has picked up in response to the tight labour market and cumulative inflation. The very recent award wage case and

public sector wage claims (which had lagged private sector wages) reduced the preference of the RBA to remain as patient with the path of inflation as previously articulated. Prevention of a wage/price spiral by dampening wage expectations is the overriding RBA objective.

We believe cash rates will rise to 4.35%, with the significant risk of a further move to 4.60%.

During March, the offshore banking sector "crisis" drove markets to factor in a swift global hard landing and a central bank pivot away from inflation containment measures. At the time, we believed this to be overdone. And so, it proved. Importantly, it does reflect the cracks that tight financial conditions bring with increasing frequency – especially on sectors reliant on easy monetary settings. The reaction function of bond markets highlights the attractive defensive elements of bonds, in addition to the decade high in income accrual.

A risk consideration is the prospect of modification in Japanese monetary settings. Inflation is around 4%. Cash rates are below zero, 10-year Japanese bonds are pinned at 0.5% and policy is too easy. The degree of intervention over the last decade has driven Japanese investors into higher-yielding international bond markets. Japanese investors own approximately 10% of the Australian sovereign market. Although we do not expect significant selling of Australian bonds, it is reasonable to expect that higher Japanese rates associated with yield curve control modification may have spillover. Our view of this would be that it adds to the attraction of Australian bonds.

With an approximate midpoint in 10-year Australian sovereign bonds at 3.7%, the portfolio strategy is to actively manage duration settings; increasing or decreasing duration accordingly but with the benefit of attractive accrual.

The pricing of a further one-and-a-half interest rate hike is largely factored into markets. We retain an underweight in short-medium-dated sovereign bonds, given they are largely below cash securities. Instead, we hold an overweight to high-grade corporates that offer superior income accrual to cash. We distinguish between high-grade and high-yield credit, however. The increasing likelihood of loss given default in a recession impacts high yield more readily.

The greater certainty surrounding peak central bank cash rates and peak inflation reduces market volatility. The strong link between volatility and credit spreads provides a tailwind for our overweight to high grade credit and semi-government holdings relative to sovereigns.

Sector Profile

Asset Class	Portfolio %	Benchmark %
Supranationals	7.61	3.92
Industrials	13.24	2.16
Financials	20.13	2.01
Asset Backed	10.61	0.00
Agencies	11.27	0.53
11AM	5.31	0.00
Cash at Bank	0.14	0.00
RBA Cash	0.00	50.00
Sovereigns	9.84	26.85
Semi Government	21.87	14.53

Ratings Exposure

Rating	Portfolio %	Benchmark %
A	12.91	1.25
AA	33.76	14.25
AAA	40.11	33.06
BBB	13.22	1.43
RBA Cash	0.00	50.00

Top 20 Issuers

Issuer	Portfolio %	Benchmark %
New South Wales Treasury Corp.	10.55	3.75
Government of Australia	9.20	26.85
National Housing Finance & Investment Corp.	7.67	0.06
NAB 11AM A/C - Deposit Accounts	5.31	0.00
Queensland Treasury Corp.	5.06	3.52
Treasury Corporation of Victoria	3.28	3.88
Australia and New Zealand Banking Group Limited	2.89	0.20
Commonwealth Bank of Australia	2.84	0.19
NBN Co. Ltd.	2.17	0.13
National Australia Bank Limited	1.92	0.22
Australian Capital Territory	1.79	0.28
Suncorp Group Limited	1.71	0.02
Airservices Australia	1.67	0.04
Wesfarmers Limited	1.59	0.03
KfW	1.59	0.51
Woolworths Group Limited	1.59	0.07
BPCE SA	1.57	0.06
Kommunalbanken AS (Norway)	1.46	0.25
APOLLO Series 2023-1 Trust	1.31	0.00
Suncorp-Metway Ltd.	1.31	0.06

Portfolio Summary Statistics

	Portfolio	Benchmark
Yield to maturity (%)	3.93	3.86
Modified duration (years)	3.07	2.63

Fund snapshot

APIR code	AUS0071AU
Inception date	21 Nov 2014
Distribution frequency	Quarterly
Minimum initial investment	\$5,000
Fund size (net asset value)	\$194.26m
Management fee*	0.37% p.a.
Buy/Sell spread	0.05%/0.05%
Advice fee	Available

*Refer to the Fund's Product Disclosure Statement for more details on the Fund's management costs which also include recoverable expenses and indirect costs. Total management costs may vary.

RIAA - Certified Responsible Investment

The Altius Sustainable Bond Fund has been certified by RIAA. According to the strict operational and disclosure practices required under the Responsible Investment Certification Program. See www.responsibleinvestment.org for details.



Ratings / Awards



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