

Altius Sustainable Bond Fund

Fund Update 31 August 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 August 2023

	1 mth %	3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	7 yrs % p.a.	Since inception % p.a.
Gross total return	0.71	0.59	4.84	(0.15)	1.20	1.49	2.23
Net total return	0.67	0.47	4.33	(0.69)	0.59	0.85	1.58
Benchmark	0.54	0.15	2.61	(0.88)	0.90	1.08	1.72
Excess to benchmark	0.13	0.32	1.72	0.19	(0.31)	(0.23)	(0.14)

Inception date for performance calculations is 21 November 2014.

Gross total returns are calculated before fees and expenses and assume the reinvestment of distributions. Past performance is not a reliable indicator of future performance.

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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 Net total return.

Portfolio Performance and Activity

August was a tale of two halves for the domestic bond market. The month started with a relentless move higher in global yields before stabilizing mid-August and recovering most of the losses into month's end. Intra month both Australian and US 10-year yields reached a cycle high of 4.32% and 4.36% respectively. While there was no single catalyst behind the selloff, the events that generated the most headlines included the US downgrade by Fitch from AAA to AA+, increased focus on the US budget deficit and funding requirements and a growing scepticism that the US Federal Reserve would commence an easing cycle in the second half of 2024. Domestic markets outperformed both US and European markets with the domestic Treasury indices generating a return of 0.60% while the US and European treasuries generated a return of -0.30% respectively. Domestically the interest rate curve steepened 8 basis points over August with 3-year bond yields falling to 3.73% while 10-year bond were largely unchanged at 4.03%. Duration was increased over the month as interest rates touched our targeted levels. At the end of the month, the duration stood at 3.77 years after starting at 3.43 years.

The Reserve Bank of Australia (RBA) held the cash rate steady in August at 4.10% for the second month in a row. The RBA highlighted that rates had been increased by 4% since May 2022 and that "higher rates are working to establish a more sustainable balance between supply and demand in the economy" Overall the statement was slightly dovish with the RBA noting the economy had slowed, inflation had peaked but still too high and employment conditions had eased. The dovish tone laid the foundations for domestic rates to outperform offshore markets as evidence grew that the RBA is extremely close to the end of the tightening cycle.

Following the RBA meeting came the release of the Statement of

Monetary Policy. As largely anticipated the economic forecasts were largely similar to the last release. Gross Domestic Product (GDP) was revised slightly lower with household consumption largely explaining the move. Importantly, inflation forecasts continued to move lower with inflation expected to return to the RBA target band of 2% to 3% by late 2024/early 2025. The inflation narrative continued to evolve with the risks shifting from the upside to more mixed with cross currents. The statement also noted that policy was and will remain restrictive given policy lags.

Locally, economic data was on the softer side of market expectations in August. While labour markets remain strong there are early signs of a softening labour market. Employment fell 14k in August to take the unemployment rate to 3.8%. Leading indicators such as vacancies and softer employment in business surveys highlighted we are past peak tightness with early signs of loosening. The much anticipated Q2 wages data rose by 0.8% taking the annual number to 3.6%, below consensus forecasts. Closing out August was the monthly inflation point which fell to 4.9% from 5.4%. Overall, the data provides the RBA additional time to assess the lag effects of monetary tightening.

In the US we had the release of the July Federal Open Market Committee (FOMC) minutes which remained hawkish. The minutes showed most participants continue to see upside risk to inflation which could require further tightening, but there was uncertainty about the lags of policy with some officials seeing downside risks even though the economy had been resilient. The minutes highlighted the increased importance of data over the coming months to provide clarity on the direction of inflation and policy. Following the release US 10-year yields reached 4.32%, a level not seen since 2008. The most surprising data release over August was the JOLTS report on August 30. The report showed job openings declined to 8.8m vs. consensus of 9.5m while the quit rate fell 6.7%, near 2019 level. The report supported the growing

view that the US rates would remain on hold at the next meeting.

Renewed concerns for European economies were a key driver of lower yields post-mid-August. The flash Performance of Manufacturing Index's (PMI's) for August was the key driver. The Euro composite PMI fell back to 47, which was worse than expected and the lowest reading since 2020. Likewise, the UK number fell back to 47.9, which was the first contraction since January. China was a constant negative throughout August with the property sector being the dominant driver. July property numbers cratered with absolute levels of sales and new sales falling a further 4% and 15% which meant Year on Year (YoY) numbers declined by another 15.5% and 25.9% respectively. The weakness in the property sector saw multiple policy announcements late in August to try and stabilise the market. Outside of the property sector economic activity remained very weak. This was highlighted through retail sales which fell to 2.5% YoY in July from 3.1% YoY in June with all components weak.

Australian credit markets performed extremely well during August bucking the trend seen in offshore markets. The sell-off in yields throughout the first half of August and the concerns on China growth were the key drivers of credit in offshore markets. Over the month US credit widened roughly 0.05% to swap to finish at a margin of 1.40% while domestically Australian corporates contracted 0.04% to swap to finish at 1.01% and aggregate financials spreads fell 0.03% to 0.89%. After rallying 28 basis points (bps) in July, domestic Major bank Tier 2 tightened by just 2bps with 10NC5 securities finishing at 1.90%. With several global banks issuing subordinated debt in Australia in August investor took the opportunity to switch out of local Major bank debt post the strong performance in July.

Offshore, primary markets were very quiet in August reflecting a deterioration of investor sentiment. US primary markets saw the lowest supply since 2015 with just \$69 billion, with financials representing \$26bn and corporates \$43 billion. Locally, primary markets were more positive with roughly \$10.9 billion of issuance. With the reporting season completed we saw three of the Major banks issue multi-tranche deals totaling \$9.4 billion. Westpac was first to market issuing a \$2.25 billion 3-year deal at a risk margin of 0.75%. This was quickly followed by CBA issuing \$3.5 billion across 3 years and 5 years at margins of 0.75% and 0.95%. ANZ closed out the month issuing \$4.3bn on the 31st of 3 and 5 years at margins of 0.75% and 0.93%. Other notable transactions included \$600 million issued by Natwest Markets PLC for 5 years, \$400 million of TLAC 6NC5 debt issued by Mizuho Financial, \$750 million of 10NC5 subordinated debt by Lloyds Bank Plc and the only corporate transactions from NBN in green format issuing \$850 million for 5 years.

Reporting season wrapped up in August. Corporates (ex Australian Real Estate Investment Trusts (AREITs)) reported modestly credit negative – to – credit neutral results with outlooks guiding to tougher times ahead. Cost pressure was a big theme across all entities and is expected to persist in FY24, driven by inflation, labour market constraints, higher wages, domestic supply chain costs and elevated interest costs. Cash holdings of corporates have remained broadly the same as the prior year, as companies remain cautious in deploying cash amid an uncertain global economic outlook. Financial leverage as measured by debt/EBITDA improved modestly, but interest coverage ratios deteriorated with the sharp rise in the weighted average cost of debt.

Major banks reported a continued rise in 30+ and 90+, but they still remain at very low levels. CBA expects arrears to move higher as consumer spending and savings reduce, particularly for the <35-year cohort. More stress is seen in non-banks as arrears have

doubled or tripled those of major banks. Banks are particularly monitoring the impact of reduced discretionary spend on Small to Medium enterprise (SME) customers. Key sectors they are also closely watching include commercial property, entertainment, leisure & tourism, retail trade and construction.

AREITs reported credit-negative results with spikes in the cost of debt, sharp declines in profits and a rise in gearing due to asset devaluations. Office REITs were particularly hard hit by property write-downs of 5-11%, with more devaluations expected in FY24. Residential REITs in the affordable housing categories (MPC and lower-priced apartments) reported higher settlements as production timeframes improved with easing supply chain issues and better weather. FY24 settlements are expected to be driven by demand from net overseas migration. Development margins were still constrained by elevated input costs and limited price growth.

Socially Responsible Investments in Focus

The Australian government has agreed to settle a class action lawsuit for misleading investors due to poor disclosures around climate change risks in its sovereign bonds. The lawsuit called for a public declaration by the Government that investors were not made aware of the systemic risk brought about by climate change, which would impact both the value of the sovereign bonds as well as the Government's ability to pay back its debt.

The settlement comes amid growing concerns about the impact of climate change on the economy and highlights the importance of more disclosure and transparency around climate-related risks. Recently, Reserve Bank Australia (RBA) governor Michele Bullock said the growing uncertainty posed by climate change could make it harder for central banks to manage inflation. The Intergenerational Report released by the Federal Government also estimated Australia could face economic losses of \$423 billion in reduced productivity if global action fails to halt extreme climate change.

Underperforming peers in climate indicators or a slow progression in meeting emissions reduction targets may thus pose a risk to the country's AAA credit rating and cause investors to reassess their investments in its bonds. As noted in the following report, Altius see this as a positive step to improve investor understanding of risk and ultimately governance of the Australian economy. (<https://www.bloomberg.com/news/articles/2023-08-30/australia-agrees-to-acknowledge-climate-change-impact-on-bonds>)

The Australian Prudential Regulation Authority (APRA) has outlined new and developing risks impacting the global financial system and its priorities over the coming 4 years. Key risks to the banking industry include rising interest rates and high inflation; geopolitical instability, the growing threat of cyber-attacks and scams, cost-of-living pressures on customers; emergence of new digital competitors and the increased frequency of natural disasters.

Priority areas over the next 4 years include assessment of Climate-related financial risks and Improving superannuation transparency, addressing system-wide risks, and a focus on operational resilience with APRA noting "will act on breaches of cyber standards". (<https://www.apra.gov.au/news-and-publications/apra-responds-to-emerging-risks-2023-24-corporate-plan>).

The UN has issued a letter warning banks (including Goldman, Citi, BNP Paribas) that they may be in violation of international human rights law due to their financing of Saudi Aramco's plans to expand oil production, which is enabling the company's contribution to

climate change.

This is the first time the UN has warned the oil industry and their banks in relation to the human rights implications of climate change. The UN alleges the business plans of Aramco and the banks that provided financing to it "appear to be contrary to the goals, obligations and commitments under the Paris Agreement on climate change." The UN also said if banks are aware of a human rights issue, they should take reasonable steps to prevent or mitigate the impact including impacts resulting from climate change. (<https://www.ft.com/content/bacb921e-042c-44db-8291-84169a43473d>).

The European Commission has adopted rules governing the implementation of the Carbon Border Adjustment Mechanism (CBAM). The transitional phase starts on 1 Oct 23 and runs until the end of 2025, and the tax will be fully implemented from 1 Jan 2026. Products covered by the trial phase include electricity, hydrogen, fertilisers, and aluminium. It is expected that the Carbon Border Adjustment Mechanism (CBAM) will expand its scope to all products covered by the EU Emissions Trading System (EU ETS) when it is fully implemented.

The CBAM aims to prevent 'carbon leakage' and level the playing field between domestic and imported goods by placing a carbon price on certain imports based on their carbon footprint. EU importers of carbon-intensive goods will be required to purchase CBAM certificates to ensure it does not undercut local manufacturers by running operations outside of the EU's regulatory boundaries. The price of these certificates will be pegged to the EU ETS. Importers must calculate and report on embedded emissions released during the production process of such goods under the transitional methodology to the European Commission.

The move could result in a chain reaction for other countries to respond with similar schemes and/or develop stronger domestic carbon pricing mechanisms. For instance, Australia is commissioning a review to examine the feasibility of such a scheme alongside the Safeguard Mechanism reforms. It could also drive an increase in manufacturing and administrative costs, trade tensions between countries and changes in industrial supply chains. Corporates that are unable to rapidly decarbonise will see their goods lose international competitiveness. (https://taxation-customs.ec.europa.eu/news/commission-adopts-detailed-reporting-rules-carbon-border-adjustment-mechanisms-transitional-phase-2023-08-17_en)

The International Auditing and Assurance Standards Board (IAASB) announced the launch of the International Standard on Sustainability Assurance (ISSA) 5000, General Requirements for Sustainability Assurance Engagements. The standard was designed as a global baseline for sustainability assurance and will be adaptable to information prepared by any size entity. It is intended to boost trust and credibility in sustainability reporting. The standard will be made in alignment with existing sustainability reporting frameworks such as the Global Reporting Initiative (GRI), the International Organisation of Securities Commissions (IOSCO), TCFD and ISSB. Publication of the final standard is expected in 2024. (<https://www.iaasb.org/news-events/2023-08/iaasb-launches-public-consultation-landmark-proposed-global-sustainability-assurance-standard#:~:text=IAASB%20Launches%20Public%20Consultation%20on%20Landmark%20Proposed%20Global%20Sustainability%20Assurance%20Standard,-Proposed%20International%20Standard&text=The%20International%20Auditing%20and%20Assurance,Requirements%20for%20Sustainability%20Assurance%20Engagements>).

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 markets reacting to the uneven implications of downward shifts in activity countered by idiosyncratic inflation pulses and policy responses.

Central banks have largely completed rate rise cycles. Australia and the US now factor in one more rate rise at most. Some minor volatility is expected as markets consider the proximity of an easing cycle. We don't believe it to be nearby.

The Bank of Japan's recent decision to reduce the artificial suppression of interest rates should be seen as a part of the expected volatility.

Australian inflation has peaked and we believe to be on a descending path. The goods sector is well advanced as global supply chains have eased.

Labour market conditions remain tight globally. The Australian wage response to date has seen wage claims lift appreciably, though not as high as inflation. This should mean inflation eases from a high level but over an elongated period of time.

The population surge is pressuring housing supply with rental inflation and energy costs likely to slow the decline.

Interest rate rises impact a much greater part of the economy due to borrower's preference for floating-rate mortgages. Higher cash rates have greater efficacy in Australia than in most other jurisdictions. Consumer demand is cooled at much lower interest rates.

A more patient approach to returning inflation to the target has been the Reserve Bank of Australia's (RBA's) preference given the intent to retain much of the hard-fought employment gains.

Given yields are at the time of writing toward the top end of the expected range, the expected excess return over cash underpins a long-duration position.

With an approximate midpoint in 10-year Australian sovereign bonds at 3.8%, the portfolio strategy is to actively manage duration settings; increasing or decreasing duration accordingly but with the benefit of attractive accrual.

Shorter-dated Australian Government Bond yields are at or slightly below the expected cash rate. This drives a strong preference for the superior income generated by higher-yielding high-grade credit.

Moreover, a measure of value that we find in the high-grade corporate market is related to the yield on the Australian Corporate Index is higher than the dividend yield of Australian stocks as defined by the ASX 200.

Market-implied recession probability, although likely to be more technical, is around 50%. Loss given default in a recession are more likely at lower credit ratings, thus we prefer high grade versus high yield credit.

The daily accrual of inflation-linked bonds has averaged considerably above the equivalent nominal sovereign bond, given headline inflation of around 6%. Shorter-dated inflation-linked bonds hedged with short-dated nominal bond futures isolate the excess inflation income accrual. The strategy is additionally intended to act as a hedge against inflation reaccelerating.

Sector Profile

Asset Class	Portfolio %	Benchmark %
Supranationals	9.80	4.06
Industrials	12.20	2.20
Financials	23.27	2.02
Asset Backed	10.13	0.00
Agencies	10.90	0.55
11AM	2.72	0.00
Cash at Bank	1.43	0.00
RBA Cash	0.00	50.00
Sovereigns	9.62	26.52
Semi Government	19.93	14.64

Ratings Exposure

Rating	Portfolio %	Benchmark %
A	12.86	1.25
AA	30.00	14.31
AAA	42.50	32.91
BBB	14.64	1.53
RBA Cash	0.00	50.00

Top 20 Issuers

Issuer	Portfolio %	Benchmark %
Government of Australia	9.01	26.52
New South Wales Treasury Corp.	8.67	3.90
National Housing Finance & Investment Corp.	7.36	0.06
Treasury Corporation of Victoria	5.03	4.07
Australia and New Zealand Banking Group Limited	4.15	0.17
Commonwealth Bank of Australia	3.74	0.17
KfW	3.07	0.60
Queensland Treasury Corp.	3.01	3.23
NAB 11AM A/C - Deposit Accounts	2.72	0.00
NBN Co Limited	2.49	0.13
Australian Capital Territory	1.75	0.28
Woolworths Group Limited	1.67	0.07
Airservices Australia	1.65	0.04
Wesfarmers Limited	1.57	0.03
BPCE	1.56	0.06
Suncorp-Metway Ltd.	1.55	0.07
National Australia Bank Limited	1.51	0.25
Kommunalbanken AS (Norway)	1.42	0.25
Suncorp Group Limited	1.42	0.02
Asian Development Bank	1.39	0.43

Portfolio Summary Statistics

	Portfolio	Benchmark
Yield to maturity (%)	4.34	4.15
Modified duration (years)	3.78	2.54

Fund snapshot

APIR code	AUS0071AU
Inception date	21 Nov 2014
Distribution frequency	Quarterly
Minimum initial investment	\$5,000
Fund size (net asset value)	\$195.97m
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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The Altius Sustainable Bond Fund won the Lonsec Innovation Award 2016, which recognises the major innovators and industry leaders who are shaping the future of Australia's wealth creation sector. The Lonsec Awards go beyond the pure quantitative, looking at the people behind the investment decisions, the rigour of the investment process and philosophy, and the new thought and innovations that create real value for investors.

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