Altius Sustainable Bond Fund

Fund Update
31 January 2022

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 January 2022

	1 mth %	3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	7 yrs % p.a.	Since inception % p.a.
Total return	(0.58)	0.64	(2.25)	0.69	1.30	1.62	1.93
Benchmark	(0.51)	0.58	(1.65)	1.41	1.97	2.00	2.28
Excess to benchmark	(0.07)	0.06	(0.60)	(0.72)	(0.67)	(0.38)	(0.35)

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

The big theme over January was the hawkish pivot by several central banks in response to increasing inflationary pressures. The US Federal Reserve (FED) was at the forefront with investors rapidly bringing forward rate hike expectations. Over January the US market went from pricing in three hikes over the coming 12 months to five. Further to this a number of participants started to speculate the first-rate move would be 0.50% compared to consensus of 0.25%. The domestic market took its lead from global movements with three and ten-year yields jumping 0.40% and 0.22% respectively to finish the month at 1. 31% and 1.90%.The fund started the month with 2.77 years of interest rate duration before closing out the month at 1.62 years.

With no Reserve Bank of Australia (RBA) meeting in January markets began to speculate that the RBA would follow the Federal Reserve by signalling the commencement of a tightening cycle earlier than expected. This was reflected through the steepening of the implied cash rate curve which saw 12-month expectations move from 0.80% to 1.15%. The aggressive market adjustment was highlighted when the release of the very high inflation print only resulted in a small repricing of cash rate expectations.

The release of Q4 inflation surprised to the upside with a quarterly number of 1.3% leading to 3.5% year on year. Apart from the Q3-20 print of 1.6%, which was heavily distorted by the end of subsidies, this was the highest number since 2012. The drivers of inflation were largely as anticipated, but the size of the move was larger than expected. Transport was the largest contributor reflecting the strong uplift in fuel costs followed by housing amid shortages of material and labour. Coupled with the stellar employment number in December it was expected the RBA would revise higher it's macro forecasts in its State of Monetary Policy due for release early February.

As largely expected, the US Federal Reserve officially announced a stop of its QE program from March 22 and points to four tightening's of policy in 2022. Powell noted in the post meeting press conference "the committee is of the mind to raise the federal funds rate at the March meeting assuming that conditions are appropriate for doing so". The FED also released the principles and plans for balance sheet reduction which provided broad elements of how and when the FED would unwind its balance sheet.

Semi Governments significantly underperformed Government bonds over January. Much of the underperformance was attributed to the expected ending of the RBA bond buying program and lower demand for high quality liquid assets (HQLA) from banks. This saw markets speculating who the marginal buyer of Semi government bonds would be going forward. As a result, ten-year semi spreads to bond widened out to pre-pandemic levels.

Domestic credit remained resilient though January against a backdrop of weaker global equity and credit markets. Five-year senior bank spreads widened 0.03% to 0.68% while regional banks pushed 0.05% to around 0.85%, while the equivalent US financial spread widened roughly 0.15%. Adding to the pressure on spreads in the US market was the high level of primary supply in the first half of January and Q4 earnings season which weighed heavily on the finance sector. Locally, primary markets were equally as strong however the return of major bank issuance after being largely absent was a welcomed development for investors. CBA was first to market printing $3.1bn of a five-year fixed/floating transaction at a margin of 0.70%. The deal saw one of the largest books in history for the local market with $4.9bn of interest. We saw value in this transaction with an investment made in the floating rate tranche. This was quickly followed by Westpac with a $1.9bn five-year deal at a margin of 0.70%. As Westpac remains on our excluded list no investment was made. Other key transactions of note included the Suncorp five year at a margin of 0.78% and Rabobank five-years at 0.73%. Primary issuance was concentrated in the first three weeks of January, with a total of $13bn of new deals, while softening investor sentiment in the final week saw no new deals.

A solid start to 2022 for issuance in the sustainable finance space although it all came from the Supranational sector. Close to $3bn was raised with deals from European Investment Bank, Asian Development Bank (ADB) and Dutch Public sector bank BNG. ADB issued both a five- and ten-year health bond with the proceeds focused on health issues in Asia and the Pacific. Project areas include mental and child health, communicable disease prevention and control, pandemic and emerging diseases and strengthening health system and service. BNG Bank returned to the market issuing a 10.5-year sustainability bond with the proceeds linked to the Dutch Social Housing Associations. Investments were made in both the ADB and BNG Banks deals.

Socially Responsible Investments in Focus

Sustainable finance boomed last year reflecting increasing pressure from investors, policy makers and regulators in the lead up to and post COP26. Globally, finance identified as sustainable more than doubled to USD1.64 trillion and according to the latest data from Bloomberg New Energy Finance, the total global sustainable debt market now exceeds USD$4 trillion. On the flip-side, a study by the Sierra Club and the Center for American Progress, shows that eight of the biggest U.S. banks and 10 of its largest asset managers combined to finance activity directly contributing about 2 billion tons of carbon dioxide emissions, vying with Russia as a force in enabling carbon emissions.

In a case of when clean is not green, Renew Economy has noted that "with the looming closure of Victoria's emissions-intensive brown coal fired power stations, some – including the federal government – believe the growing demand for hydrogen could serve as an alternative use for Victoria's brown coal deposits". Fossil fuel-fired hydrogen accompanied by offsets and/or carbon capture is often referred to as clean, but studies have found that hydrogen produced from gas – even with carbon capture – was significantly worse for the climate than burning coal or gas directly, due to the significant extra energy required for processes to produce hydrogen and power carbon capture and storage.

Inflation is a central theme for our funds as we recognise that inflation expectations lag experience and can be stubborn to reset once imbedded into wage outcomes. Transitory inflation is generally not an issue as employers and employees look through disruption. However, many are noting that extreme weather events tied to climate change are also contributing to inflation by impacting crop yields, disrupting energy supplies, and crippling transportation lines. Economists say that this reality will only worsen as the planet warms.

Outlook

The global economy continues to recover, albeit unevenly. Already high energy prices have continued to surge. Tight product markets have lifted goods inflation. Services inflation has been slower to rise but strengthening labour markets is placing upward pressure on core inflation.

The US Federal Reserve (Fed) ceased characterising inflation pressures as transitory in late November. Since that date, there has been an evolution among most central banks that emergency settings are no longer appropriate. The two key channels of emergency settings have been Bond purchase programs and near zero cash rates.

The US Federal Reserve has announced its purchase program will halt. Moreover, the Fed Balance sheet will be allowed to shrink. Subject to caps, maturities and coupons will not be reinvested back into bonds. The ending of asset purchase programs finishing places upward pressure on bond yields.

We had anticipated the Reserve Bank of Australia (RBA) would cease asset purchases at the February meeting. The market implication of this will continue to play out over the coming year, given the absence of the RBA, who has been the standout buyer of bonds over the last year.

Faced with ultra-low domestic interest rates, European investors have been a key buyer of Australian bonds. With the European Central Bank announcing an end to the Pandemic Asset Purchase Program, the likely implication is a lift in key European bond yields thus reducing the attractiveness of Australian bonds for European investor. Coupled with the now absent RBA, Australian nominal bond yields will be biased to rise further.

New Zealand, Canada and the UK have commenced cash rate cycle. The US is widely anticipated to commence rate rises at the March meeting. Within dollar bloc, Australia has been the laggard, but the transmission mechanism of a lower Australian dollar increases inflationary pressures, and thus likelihood of RBA action. To date, the profile of anticipated cash rate hikes has curtailed the implied inflation rate. The Australian market has factored in four rate rises by end of 2022, with an implied peak cash rate of 2.4% in 2024.

We are underweight longer dated bonds as net bond supply (the amount of bonds issued by the government less bought by the RBA) is set to rise. Over the course of the second half of 2021, the Australian Office of Financial Management (AOFM) have issued on behalf of the government, $45billion of their full year target of $105bn. There remains $60bn of sovereign issuance for the current financial year to do. With the RBA ceasing all bond purchases in early February, there is an increased burden on private sector purchasers.

We remain significantly overweight in our exposure to an inflation linked strategy. The implied inflation rate of approximately 2.2% is somewhat at odds with the cash rate profile. Inflation at 2.2% is at the lower end of the RBA target range. It would not ordinarily be high enough for the RBA to be tightening. Core inflation is currently tracking at 2.6% and headline 3.5% with pressure to rise further as food and energy costs continue to rise. This is reflected in the anticipated cash rate hikes. The inflation linked strategy seeks to benefit from higher inflation - particularly headline - increasing the capital of real yield bonds, while an overlay hedges against weakening nominal bond prices (rising yields).

Sector Profile

Asset Class	Portfolio %	Benchmark %
Australian Commonwealth Government	10.68	28.44
Semi-Government	18.29	13.28
Supranationals	13.92	4.63
Industrials	14.21	2.21
Financials	17.70	1.29
Asset Backed	10.66	0.00
Money Market	0.00	0.00
Agencies	11.43	0.15
11am	1.16	0.00
Cash at Bank	1.96	0.00
RBA Cash	0.00	50.00

Ratings Exposure

Rating	Portfolio %	Benchmark %
AAA	49.27	33.05
AA+ to AA-	31.77	14.37
A+ to A-	10.30	1.41
BBB+ to BBB-	8.67	1.17
RBA Cash	0.00	50.00

Top 20 Issuers

Issuer	Portfolio %	Benchmark %
National Housing Fin Invt	10.79	0.06
Australian Government	10.70	27.03
New South Wales Treasury Corp	8.40	3.38
Commonwealth Bank Aust	4.38	0.07
Queensland Treasury Corp	3.65	3.12
Treasury Corp Victoria	3.47	2.99
Kommunalbanken As	2.20	0.25
ANZ Banking Group	2.18	0.13
European Investment Bank	2.07	0.44
Landwirtsch. Rentenbank	1.77	0.40
Asian Development Bank	1.75	0.36
BNG Bank Nv	1.67	0.31
Inter-American Devel Bk	1.63	0.32
Woolworths Group Ltd	1.61	0.06
Aust Capital Territory	1.46	0.25
Wesfarmers Ltd	1.42	0.02
Bank Of Queensland Ltd	1.29	0.01
Intl Bk Recon & Develop	1.20	0.31
OCBC (Sydney)	1.19	0.00
Royal Bank Of Canada (Syd)	1.17	0.01

Portfolio Summary Statistics

	Portfolio	Benchmark
Yield to maturity (%)	1.67	0.83
Modified duration (years)	1.62	2.88

Fund snapshot

APIR code	AUS0071AU
Inception date	21 Nov 2014
Distribution frequency	Quarterly
Minimum initial investment	$5,000
Fund size (net asset value)	$259.58m
Management fee*	0.57% p.a. Note: from 1 July 2021 this will reduce to 0.37% p.a.
Buy/Sell spread	0.00%/0.10%
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.

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Ratings / Awards

Investment Grade Lonsec Research

Zenith APPROVED

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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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