

# Altius Sustainable Bond Fund

## Fund Update 30 June 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, having regard to a range of environmental, social and governance (ESG) issues.

### Performance as at 30 June 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        | (1.13)  | (3.03)   | (6.16) | (1.82)       | (0.01)       | 0.83         | 1.11                   |
| Benchmark           | (0.71)  | (1.87)   | (5.26) | (1.11)       | 0.85         | 1.37         | 1.57                   |
| Excess to benchmark | (0.42)  | (1.16)   | (0.90) | (0.71)       | (0.86)       | (0.54)       | (0.46)                 |

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

Risk off sentiment remained the overriding theme throughout June with all asset markets experiencing various levels of negative returns. Developed market equity returns ranged from -3% to -14% with the ASX 200 falling -8.9% while the AUD treasury index bonds were down -1.319% after being down -4.5% around the middle of the month. Even commodities markets have struggled after a strong start to the year with WTI falling 7.8%, posting the first monthly decline in 2022. After starting the month with 2.41 years of interest rate duration we progressively unwound the position to end the month at 2.80 years.

The main reason for the broad-based declines is the fact that recession risks have ramped up significantly over June. There are a number of reasons for the change in sentiment. The first being inflation has been far more persistent than central banks and markets have expected, thus leading to a more aggressive pace of tightening from central banks globally. As an example, the 12-month forward cash rate moved from 2.50% to 3.75% over the March quarter. This was after starting the year at just 0.90%. This was a common pattern across all developed markets with the effect of higher rates now starting to show up in real economic data.

A large worry for investors is that the speed and the cumulative effect of the rate moves globally will push global economies into recession. This is particularly the case for the US markets. Over June multiple forward economic indicators pointed to slower growth such as the University of Michigan sentiment indicators, retail sales and regional manufacturing surveys. Other market specific recessionary indicators like the yield curve are hovering near inversion territory which is regarded as an early sign of a future recession.

Closer to home the RBA surprised the market by increasing rates by 0.50%, as the markets were split between a 0.25% or 0.40% rise. Off the back of the move markets moved aggressively higher, at one point the forward cash rate rose to 4.50% before easing back to 3.75%, as globally recessionary fears grew. The RBA cited the significant increase in inflation and the need to remove the extraordinary monetary support provided through the pandemic as the key drivers. The RBA also noted the resilience of domestic growth and the strength of the labour markets which should provide some buffer against future cash rate increases.

Locally, key economic releases included Q1 GDP which came in at 0.80%, leading to solid annual growth of 3.3%. Unemployment fell to 3.8% with 69k full time jobs created. Like the US economy, customer and business sentiment surveys were weaker as interest rate increases led to uncertainty. The Westpac consumer confidence index fell 4.5% after falling 5.6% in May while the NAB business surveys saw conditions and confidence fall. Also, the CoreLogic house price index for June fell -0.8%, highlighting the effects of interest rate increases on consumer sentiment.

Credit market stability late in May came to a screeching halt in June with spreads resuming the March high. While AUD credit is around YTD wides, the performance through June was more stable than global peers; with US and European investment grade underperforming by 2.7% and 3.6% respectively and US high yield falling 7.1%. This compared to the AUD credit index being down 1.38%. Liquidity remains a concern for credit markets as central banks undertake quantitative tightening and investors' concerns about the economic outlook impact both the primary and secondary markets. Locally, corporate credit was most challenged with cash spreads widening between 0.10%–0.25% while the credit derivative index widened 0.30%. Domestic bank spreads were mixed in June. Senior unsecured risk found pockets of support with spreads largely unchanged over the month, with 3 years at 0.85% and 5 years at 1.05%. Bank Tier 2 debt was again under significant pressure with spreads out another 0.20%. This was the sixth month in a row that spreads have widened between 0.15%–0.25%. Over the course of 2022, five-year bank subordinated debt spreads have widened 1.25% to 2.50%, significantly underperforming global relative pricing.

Some concerns are starting to emerge for the non-bank and non-conforming RMBS market. Price indications for the new RedZed non-confirming transaction were at a spread of 1.70% for the AAA tranche vs the recently priced Resimac transaction at 1.40%. Also, with many non-bank RMBS transactions having very short seasoning, a reliance on securitization as a funding source and a softening in house prices, the market is starting to factor in these additional risks associated with these issuers.

Limited credit activity occurred in the portfolio over June. We continue to maintain a cautious view toward credit with a preference to maintain existing holdings instead of adding. Our moderate overweight, particularly our corporate and bank subordinated holdings have been a negative contributor to performance in June. We will wait for signs of increased stability and liquidity before taking additional risk within the fund.

### Socially Responsible Investments in Focus

Australia is getting litigious on climate – ranking second globally behind United States. Grantham Research Institute note that while climate litigation to date has been against governments and corporations, there is an emerging trend for action targeting individuals, such as company directors. Over-reliance on unproven technologies like carbon capture and storage are also in cross-hairs with 'green washing' strategies likely to become a target for lawsuits.

The Federal Government now has a new emissions reduction target of 43% below 2005 levels by 2030 (26–28% previously). Importantly, progress against the target will be monitored and adjustments can be made, consistent with achieving net-zero emissions by 2050. In addition, the government will invest A\$20 billion to accelerate the decarbonisation of the electricity grid, boost job training, embed initiatives to electrify transport and provide up to A\$3 billion in a national fund supporting renewables manufacturing and low-emissions technologies. The role of carbon credits is about to become critical in Australia's planning as the "safeguard mechanism" requiring greenhouse gas producers to keep emissions below a baseline level is toughened by introducing declining emissions baselines with offsets required for shortfalls. A review into the integrity of the carbon credit market has been announced together with restoration of the policy advisory role of the Climate Change Authority. Greater climate risk disclosure requirements are also on the way as research has found that only a third of corporates' net zero pledges even fulfill bare minimum standards of reporting emissions reduction goals. The report found that many companies with net-zero targets have set no interim emissions goals before 2050 and only half include strategy detail. Nearly 40% of the companies intend to use offsets, increasing to 60% among companies with net-zero targets for 2030 or earlier and only 38% account for Scope 3 emissions, often unverified.

Despite its increasing profile, Hydrogen's integration into the global energy mix is not happening fast enough to meet the Paris Agreement's climate targets. Hydrogen – particularly its grey and blue forms derived from natural gas – is controversial in the energy transition, but the report concludes it will have a major role to play in decarbonising industries that cannot readily shift to electrification.

Blue hydrogen as a substitute for coal and natural gas in processes such as iron and steel production will have short-term success (30% of hydrogen production in 2030) but green hydrogen needs much greater renewable energy capacity and the lower cost structure provided by scale. Estimates are green hydrogen will account for 72% of hydrogen production by 2050.

### Outlook

Our bond market outlook is that bond yields are in the process of peaking, but this will unfold over an extended period with significant volatility over shorter time frames. Markets are oscillating between nascent inflation pressures and central banks fighting inflation with sufficient vigour to significantly slow economies and overachieve the inflation containment objective.

We believe that in broad terms, the running yield and accruals of sovereign bonds are already attractive. We expect "market noise" as bond yields and other asset classes vacillate between overly optimistic or pessimistic interest rate outlook. The process of central bank balance sheet reduction combined with increasing cash rates has lifted market uncertainty that has resulted in higher volatility and "trading ranges".

For bonds to weaken meaningfully from here, inflation would need to keep accelerating to even higher levels. Some of the initial drivers of inflation are likely peaking during the second half of the year because they are hard to repeat. Second order sources of inflation are emerging leaving inflation moderating somewhat but remaining elevated for a period longer than the market is currently pricing.

We believe that the ability for the Reserve Bank to lift cash rates to the market implied peak rate of 3.75% is unlikely. Given household debt has risen to around 115% of GDP, changes in Australian official interest rates extremely effective; particularly compared the fixed rate regimes used internationally. A cash rate above 2.5% is the equivalent of the tight monetary conditions last seen in 2008. Moreover, a significant proportion of fixed rate mortgage borrowings revert to floating before year end. This increases the sensitivity of households to cash rate rises; Consequently, shorter dated fixed bonds have attraction.

The RBA and notably the US Federal Reserve have recently commenced Quantitative Tightening. The periodic issuance of bonds requires an increase in private sector sovereign purchases. The Federal Reserve has recently implemented a large but increasing cap on the amount of bond maturity run off. This places an upward bias on sovereign yields as supply needs to be digested by price sensitive buyers.

An increasing source of private sector demand we believe will come from cross asset class allocations. Government bonds are resuming their role of risk mitigators in diversified investment portfolios. This is better news for investors who, for most of the first half of this year, felt that there was nowhere to hide.

A key insurance strategy within the portfolio relates to inflation. The running yield of the inflation-linked bonds, given the high CPI outcomes, is more than 4% higher than the equivalent nominal bond. The current implied market-implied inflation rate is 2.20%. Importantly, the return of inflation references headline inflation. For the moment, headline inflation is higher than the RBA trimmed mean, for which the midpoint of the Reserve Bank target inflation is 2.5%. Capital gains accrue if the inflation rate expected by the market rises from its current level.

## Sector Profile

| Asset Class                        | Portfolio % | Benchmark % |
|------------------------------------|-------------|-------------|
| Australian Commonwealth Government | 9.38        | 28.23       |
| Supnationals                       | 10.29       | 3.91        |
| Industrials                        | 13.06       | 2.34        |
| Financials                         | 18.17       | 1.59        |
| Asset Backed                       | 11.38       | 0.00        |
| Agencies                           | 12.71       | 0.41        |
| 11AM                               | 1.83        | 0.00        |
| Cash at Bank                       | 4.49        | 0.00        |
| RBA Cash                           | 0.00        | 50.00       |
| Semi Government                    | 18.67       | 13.51       |

## Ratings Exposure

| Rating   | Portfolio % | Benchmark % |
|----------|-------------|-------------|
| A        | 17.39       | 1.40        |
| AA       | 25.17       | 12.72       |
| AAA      | 42.83       | 34.34       |
| BBB      | 14.61       | 1.53        |
| RBA Cash | 0.00        | 50.00       |

## Top 20 Issuers

| Issuer  | Portfolio % | Benchmark % |
|---|-------------|-------------|
| National Housing Finance & Investment Corp.     | 10.51       | 0.06        |
| Government of Australia                         | 9.38        | 28.23       |
| New South Wales Treasury Corp.                  | 8.99        | 3.13        |
| Queensland Treasury Corp.                       | 3.33        | 3.71        |
| Treasury Corporation of Victoria                | 3.32        | 3.19        |
| Commonwealth Bank of Australia                  | 2.90        | 0.09        |
| Australia and New Zealand Banking Group Limited | 2.68        | 0.17        |
| European Investment Bank                        | 2.08        | 0.50        |
| NBN Co. Ltd.                                    | 1.95        | 0.10        |
| Societe Generale Sydney Branch                  | 1.71        | 0.00        |
| BNG Bank N.V.                                   | 1.62        | 0.30        |
| Bank of Queensland Limited                      | 1.59        | 0.02        |
| Woolworths Group Limited                        | 1.54        | 0.07        |
| Kommunalbanken AS (Norway)                      | 1.54        | 0.30        |
| Australian Capital Territory                    | 1.53        | 0.28        |
| Mirvac Group Finance Ltd.                       | 1.40        | 0.02        |
| Wesfarmers Limited                              | 1.37        | 0.03        |
| REDS EHP Trust Series 2021-1                    | 1.35        | 0.00        |
| Dexus Finance Pty Ltd.                          | 1.29        | 0.03        |
| Inter-American Investment Corp.                 | 1.22        | 0.01        |

### Portfolio Summary Statistics

|                           | Portfolio | Benchmark |
|---------------------------|-----------|-----------|
| Modified duration (years) | 2.78      | 2.61      |
| Yield to maturity (%)     | 4.36      | 1.78      |

### Fund snapshot

|                             |             |
|-----------------------------|-------------|
| APIR code                   | AUS0071AU   |
| Inception date              | 21 Nov 2014 |
| Distribution frequency      | Quarterly   |
| Minimum initial investment  | \$5,000     |
| Fund size (net asset value) | \$218.34m   |
| Management fee*             | 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](http://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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