Altius Sustainable Bond Fund

Fund Update
30 September 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 30 September 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	(0.79)	0.22	(6.08)	(2.06)	(0.06)	0.75	1.10
Benchmark	(0.59)	(0.08)	(5.50)	(1.50)	0.81	1.16	1.51
Excess to benchmark	(0.20)	0.30	(0.58)	(0.56)	(0.87)	(0.41)	(0.41)

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

September rounded out a quarter of extreme volatility with declines experienced across the majority of major asset markets. Multiple events were responsible for market declines including higher than expected inflation in the US, massive energy shock in Europe, very hawkish central bank commentary and the UK governments mini-budget in late September. Domestically, three-year bonds traded between 3.07% and 3.93% while 10 years bonds traded between 3.51% and 4.18% before finishing at 3.67% and 3.92% respectively. US bonds underperformed the local market with 10 years bonds finishing 0.65% higher at 3.83%. Portfolio duration started the month at 3.87 years before being reduced to 2.60 years towards the middle of September. As markets recommenced the push higher in yield, we gradually reintroduced duration to finish the month at 3.40 years.

In many respects, what alarmed markets most over September were how central banks become more explicit about how far there were willing to take policy into restrictive territory, even as signs of slowing growth emerged. This was particularly the case with the US Federal Reserve following through on its hawkish rhetoric to deliver a third 0.75% tightening, taking the cash rate to 3.25%. Furthermore, the median dots (Fed rate expectations) favored a further 1.25% in 2022 and a cash rate of 4.6% by the end of 2023, even with forecasts of unemployment raising to 4.4% from 3.8%. This was a similar story across most central banks. The ECB commenced there tightening cycling in July with markets expecting a 0.25% hike, however with inflation rising they delivered a 0.50% in July following it up with an even larger 0.75% hike in September. Other notable policy moves included a 1% hike by the Riksbank, 0.50% by Bank of Canada, 0.75% by the Swiss National Bank and 0.50% by the Bank of England.

Domestically, the RBA delivered a further 0.50% tightening in cash rates taking the official level to 2.35%. The RBA noted it expected to raise rates further over the months ahead, but it is not on a pre-set path and that the timing of future interest rate increases would be guided by incoming data. This had a number of market commentors speculating that the RBA would move to 0.25% increases in the months ahead. Locally, data continued to print on the positive side with Q2 GDP coming in above expectations at 3.6%, employment remaining very strong with a further 58,000 full time jobs generated in August with the unemployment rate at a historical low of 3.5% and retail sales was above expectations at 0.60% after printing a very high 1.3% in July. Housing remains the key uncertainty with house prices continuing to fall and the rapid increase in the cash rates yet to fully feed through to the lenders.

Significant volatility emerged in the final days of September with the UK government announcing a mini-budget which included the biggest tax cuts in 50 years and a larger Government borrowing program. This resulted in an aggressive move higher in Gilts, with 2 years to 30 years lifting 1.75% in just 3 days and the pound falling to 1.03 versus the USD, a record low. These wild moves prompted an intervention by the Bank of England which saw the market retrace a large part of the sell-off.

Credit markets performed well in the first half of September before unwinding early gains to finish wider over the month. Interest rate volatility driven by central hawkish commentary and ongoing inflationary concerns were the key drivers of credit sentiment in September. Equity market weakness contributed to credit markets softening with S&P500 down 9.2% and the ASX200 was down 7.30%. US and European credit markets were the standout, underperforming over the month with both matching their 2022 highs, last seen in July. AUD credit was more resilient compared to global peers, supported by a lack of corporate supply and high investable all-in yields. Locally, banks were the weakest sector reflecting their high liquidity nature rather than any underlying credit fundamental concerns. Over the month senior bank three- and five-year spreads to swap widened 0.06% and 0.09% to finish at 0.70% and 0.99%, while bank subordinated debt fared worst with five years widening 0.13% to 2.42%. Corporate spreads were largely unchanged to slightly wider over the month with single A spreads finishing around 1.47%, 0.02% wider while the BBB sector closed at 1.96%, unchanged over the month. With third quarter earnings in the US fast approaching credit markets will remain cautious until companies provide their outlooks on the economy heading into year end. Primary markets were mixed in September with solid issuance volumes in the first half of the month before falling in line with the softer credit sentiment. Notable deals included a $900m ANZ seven-year subordinated deal at a margin of 2.60%, $400m Challenger Life five year subordinated deal at 3.55% and a AMP Bank five year subordinated deal at a margin of 4.65%.

Socially Responsible Investments in Focus

The Albanese Government's landmark Climate Change Bills passed the Senate last week, ensuring Australia's emissions reduction target of 43% by 2030 (from 2005 levels) and net zero emissions by 2050 will be enshrined in legislation. This provides the energy policy and investment certainty and brings it more in line with other developed countries. At the same time, the Government has also released a consultation paper on changes to the safeguard mechanism that it intends to introduce next July. It would involve new emissions baselines or limits for 215 major polluting facilities, that would be gradually reduced over time. Companies will have to either cut emissions or buy carbon credits to stay within their baseline.

ANZ provided an ESG briefing where it reiterated its commitment to a $50B sustainable finance target by 2025, of which approx. 60% had been completed earlier this year. ANZ said it is on track to set emission targets for 9 priority sectors (by 2024) and will announce targets for oil and gas, as well as the building products sectors by end-2022. Thermal coal mining is currently the only sector ANZ has pledged to stop financing. Adding to the task, Lending to oil and gas extraction increased from $5.9B to $6.4B in the 6 months to March. ANZ also said it is not keen to exit whole sectors based on emissions but would rather "skew capital towards those that have robust transition plans".

ANZ's top emitting customers belong to manufacturing (30%) and resources (20%) sectors, with 60% based in NZ and/or offshore. Most customers had not publicly disclosed plans to transition to net zero or were just starting to develop plans as of a year ago. Investors and analysts on the call pushed for more disclosures around customer conversations, specifically criteria used to assess plans, and consequences for lack of progress. The bank made no mention about scope 3 targets.

There is also currently no lending screen for new homes around physical risk, citing short term nature of lending portfolio (2-3 years). Finally, the bank acknowledged shareholder and investor pressure to improve biodiversity disclosures with Pollination Group engaged to refine its screening and engagement on biodiversity issues including participating in the TNFD forum.

The Science Based Targets initiative (SBTi) announced the launch of the Forest, Land and Agriculture (FLAG) Science Based Target Setting Guidance, providing a standard method for companies with material land-related emissions (20% or more) to set targets aligned with global climate goals.

Land-intensive sectors represent nearly a quarter of global GHG emissions – second only to the energy sector. A key requirement is for companies to commit to zero deforestation by 2025. Companies are also required to set near term (5–10 year) emission reduction targets in line with 1.5°C and long-term targets to reduce at least 74% of emissions by no later than 2050.

The SBTi guidance also noted a role for GHG removal, like soil carbon sequestration and improved forest management but clarified that nature-based carbon removals are not offsets and are not a substitute for deep emissions cuts.

Following the lead of the European Central Bank (ECB) and Bank of England (BoE), the US Federal Reserve Board announced it will launch a pilot climate risk study with six of US's largest banks, starting early next year and conclude by the end of 2023.

Against scenarios of climate, economic, and financial variables, the Fed will review the banks' analyses, engage on climate risk management capacity, and publish aggregate-level insights from the pilot.

Louisiana has announced that the state will divest around $800 million from BlackRock in response to the asset manager's sustainable invest approach. The decision follows action by other conservative states across the US with boycotts from Arkansas ($125 million), Utah ($100 million), and West Virginia ($20 million). A report, commissioned by the PRI, noted that global asset managers and banks are being forced to choose between ESG or fossil fuel energy strategies. Banks and pension funds that control assets in a state where investment laws are changing could also face legal liability risks.

Meanwhile, reinsurance giant Munich Re has announced that it will no longer finance or insure projects "exclusively covering the planning, financing, construction or operation of new oil and gas fields". From April 2023, the German-based insurer will also cease to make new direct investments in "pure-play" oil and gas.

Global Green, Social, Sustainability, and Sustainability-Linked (GSSS) bond issuance has surpassed $600 billion at the end of Q3 this year, although this is down 30% on last year reflecting worsening credit conditions and less Covid related spending. On the investor side, the ECB is expected to favour corporate bonds of companies that emit less carbon incorporating into security selection a scoring system which will be based on emission performance, goals and climate disclosures.

In the ongoing debate on green taxonomy, several environmental groups are legally challenging the inclusion of natural gas and nuclear power as eligible sustainable activities by the European Union. They have requested for an internal review and asked for a response within the next 22 weeks from the EU failing which they will be taking action reaching the court of justice of the EU.

Lastly, Altius is about to release its inaugural Impact report, the first of its kind for bond portfolios in Australia. The report covers measuring and tracking carbon within a portfolio and measuring against Benchmarks, comparing the carbon risk exposure of individual portfolio holdings and how to get bang for buck in portfolio construction as well as forward looking assessment of portfolios under accepted climate scenarios and the role of engagement with ESG issues and how advocacy can advance action on issues that matter most to investors/members. For access to the report please contact us through our website @altiusam.com

Outlook

Australian bond yields are expected to remain elevated with yields oscillating in a wide range around current levels, whilst international yields adjust higher.

The volatility in markets is a function of the tension between central bank inflation fighting settings, including the unwinding of balance sheet inventory, and the likelihood of a hard landing should central banks over tighten. The speed of the tightening and the lagged nature of economic data create elevated uncertainty over the intervening period.

Although some of the initial drivers of inflation, such as freight costs have likely peaked, over coming quarters the second order sources of inflation will remain elevated before easing.

In considering the inflation profile, we believe there is a lot of this expectation already factored into markets.

Market expectations are that the US Federal Reserve will lift cash rates from their current levels of approximately 3% to 4.5% by February 2023.

Australian interest rate markets factor in a peak cash rate of 4.1% by May 2023. Long dated bond yields have lifted in line with US long dated yields, despite lower inflation expectations. However, much of the recent lift in Australian yields has been associated with a recalibration of European – particularly UK bond yields.

Absent any further acceleration of inflation above 7.5%, we believe Australian cash rates peak in Q2 2023 at 3.6% - below current implied rates. With an approximate midpoint in Sovereign long bonds at 3.8% to 4.0%, the portfolio strategy is to actively manage duration settings, increasing or decreasing duration accordingly, but with benefit of attractive accrual.

European inflation, is somewhat unique, given it has been driven by acute gas shortages, resulting in inflation of around 10%. UK inflation has lifted for similar reasons, leading the Bank of England down a more appropriately aggressive path. However, the unfunded fiscal stimulus announced by the UK government caused market dislocation. Long dated bonds soared, taking many largely unrelated markets with it to some degree.

The onset of the northern winter likely results in rationing. The most acute drought in 500 years is contributing to food price inflation. Wage pressures are significant given the indexed nature of wage negotiations. Growth will suffer further.

Australian inflation is lower than most developed nations. Annual headline inflation is expected to peak at 7.5% in December quarter, with underlying anticipated to peak at around 5.5%. A key difference between international central banks activity is related to wages.

Although we believe the RBA's estimate of wage growth too conservative. most wage negotiations are resulting in rises above 3%. More importantly, the rolling three-year nature of enterprise and public sector wage negotiation means the wage and labour costs changes are dampened.

The portfolio retains an inflation hedging strategy by actively managing a holding of inflation linked bonds. The current "Break-Even" Inflation mid-point is a little less than 2.4%. Should inflation become, more acute or chronic in nature, the value of the inflation linked bonds rise relative to the nominal bond overlay. The higher inflation lifts the accrued income appreciably in inflation linked bonds.

Sector Profile

Asset Class	Portfolio %	Benchmark %
Australian Commonwealth Government	10.60	28.07
Supranationals	10.31	3.76
Industrials	14.85	2.22
Financials	19.89	1.78
Asset Backed	11.71	0.00
Agencies	8.93	0.40
11AM	3.74	0.00
Cash at Bank	0.92	0.00
RBA Cash	0.00	50.00
Semi Government	19.05	13.78

Ratings Exposure

Rating	Portfolio %	Benchmark %
A	15.85	1.34
AA	26.83	13.04
AAA	41.29	34.10
BBB	16.03	1.52
RBA Cash	0.00	50.00

Top 20 Issuers

Issuer	Portfolio %	Benchmark %
Government of Australia	10.60	28.07
National Housing Finance & Investment Corp.	7.33	0.06
New South Wales Treasury Corp.	7.08	3.38
Queensland Treasury Corp.	4.75	3.41
Treasury Corporation of Victoria	4.32	3.49
Commonwealth Bank of Australia	3.49	0.16
Australia and New Zealand Banking Group Limited	2.92	0.17
European Investment Bank	2.85	0.44
GAIF Bond Issuer Pty Ltd.	2.33	0.02
NBN Co. Ltd.	2.17	0.10
National Australia Bank Limited	2.03	0.21
BNG Bank N.V.	1.78	0.30
Australian Capital Territory	1.75	0.29
Woolworths Group Limited	1.61	0.07
Kommunalbanken AS (Norway)	1.60	0.28
BPCE SA	1.57	0.04
REDS EHP Trust Series 2021-1	1.55	0.00
Wesfarmers Limited	1.52	0.03
Suncorp-Metway Ltd.	1.31	0.04
Suncorp Group Limited	1.19	0.02

Portfolio Summary Statistics

	Portfolio	Benchmark
Modified duration (years)	3.21	2.60
Yield to maturity (%)	4.85	2.00

Fund snapshot

APIR code	AUS0071AU
Inception date	21 Nov 2014
Distribution frequency	Quarterly
Minimum initial investment	$5,000
Fund size (net asset value)	$189.55m
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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