

# Altius Sustainable Bond Fund

## Fund Update 31 October 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 October 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	0.57	(1.33)	(3.86)	(1.84)	(0.06)	0.79	1.16
Benchmark	0.57	(1.22)	(3.25)	(1.24)	0.80	1.21	1.57
Excess to benchmark	0.00	(0.11)	(0.61)	(0.60)	(0.86)	(0.42)	(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

October proved to be a strong month for financial markets after a terrible third quarter. The key behind the recovery was the speculation that Central banks were starting to step down the size of their tightening moves following a period of aggressive action. The improvement in global asset markets was also supported by a significant fall in the European natural gas price and a stabilization in the UK market following the arrival of a new government. Equities were a standout over the month with the ASX 200 up 3.4%, the S&P 500 up 8.1% and European markets up between 5% to 9%. Globally, bond market performance was mixed with Australian three and 10-year bond closing the month 0.28% and 0.13% lower at 3.39% and 3.79% respectively, while US two- and 10-year yields closed higher at 4.49% and 4.05%, both 0.22% higher over the month. Once again, the size of the monthly change masked the continued volatility in markets with the Australian 10 year having a 0.68% range while the US 10-year range was 0.78%. The portfolio started the month with interest rate duration of 3.25 years, before taking advantage of the rally in yields, to lower duration to 2.60 years, in the first week of October. Duration remained largely unchanged until the last week of the month. With a large move higher in yields the portfolio duration was increased to around 3 years, which is where it closed out the month.

Two things dominated the markets' attention in October, Central bank commentary and action and inflation data. The month opened on the back of hopes that the US Federal Reserve and other central banks might start to slow the pace of tightening after the turmoil that closed out September. That narrative got further support when the RBA surprised the market by deciding to tighten by 0.25% instead of the expected 0.50%, taking the cash rate to 2.6%. The Governor had warned of the possible change at the Anika Foundation speech and the minutes from the September meeting confirmed that the board had considered two options for the size of the September rate move. The RBA was clear to acknowledge both the magnitude and pace of tightening over recent months but confirmed further tightening would "likely be

required over the period ahead." The other narrative that was evident, was that policy works with a lag and it's too early to determine the impact of higher mortgage rates on the household sector.

Locally, Q3 inflation was released on October 25th, both the headline and the trimmed mean (RBA's preferred measure) surprised to the upside. Headline inflation pushed to 7.3%, above consensus expectations of 7%, while the trimmed mean hit a series high of 6.1%, above the RBA end of 2022 forecast. The details of the release provided no bright spots with inflation increases being broad based. The most significant contributors to the rise included new dwellings up 3.2% q/q, gas prices up 10.9% and furniture up 6.6%. Food was also up 3.2% with higher wages, transportation cost and weather impacts pushing prices higher. The high inflation number saw the market speculate that the RBA would have to re-instate a 0.50% rate move at its November meeting, this however proved to be incorrect.

Turning to the offshore markets. US Federal Reserve officials again pushed against market speculation of a possible pivot in policy. Fed Speaker Kashkari stated "if we don't see progress in underlying inflation, or core, I don't see why we would stop at 4.5% or 4.75%." This hawkish sentiment saw the terminal cash rate reach 5%. The economic data also served to undermine the pivot story, particularly the stronger than expected inflation release, with annual inflation printing at 8.2%, above expectations of 8.1%. In the last week of the month, WSJ's Nick Timiraos, printed an article suggesting that although a 0.75% hike would be delivered at the November meeting, officials were also likely to discuss "whether and how to signal plans to approve a smaller increase in December" This again saw the market re-engage with the pivot story. Adding to this sentiment was a number of dovish comments at the ECB press conference following their 0.75% hike on October 27th and the decision by the Bank of Canada to move to 0.50% hikes from 0.75%.

As with previous months credit spreads were again driven by elevated inflation concerns and aggressive central bank tightening.

Mid way through October credit default swap spreads hit YTD wide's before experiencing a rapid turn around to finish well inside their opening levels. Locally, credit markets drifted wider from the beginning of the month before accelerating into the last week. This was particularly the case with financial spreads. After being in earnings blackout, ANZ launched a multi tranching three and five-year deal. With pricing in offshore markets expensive, ANZ offered a healthy concession of around 0.07% for the three year and 0.13% for the five-year. The concession drove a \$6 billion order book with ANZ printing \$4.75 billion across the tranches. This transaction resulted in a significant repricing of the secondary curves by 0.06%. CBA took advantage of being the only major bank not being in an earnings blackout with the announcement of a subordinated Tier 2 (T2) deal. The most surprising aspect of the deal was the \$2 billion size, the largest T2 on record. In-order to generate this amount of interest a very high 0.50% concession was paid; this transaction also repriced the secondary market. Outside of these transactions we saw a number of covered bond deals with Suncorp completing \$750m for 3 years and Canadian banks BNS and Bank of Montreal printing \$1 billion and \$700 million 3 years, respectively. Other deals of note included Teachers Mutual 3-year senior and Rabo Bank subordinated deal. While there remains uncertainty about the future direction of credit due to the economic outlook, we believe current spread compensates for the probability of default. As such we added credit during the month with investments in the primary deals of ANZ, CBA and Teachers Mutual.

### Socially Responsible Investments in Focus

Australia has signed up to the Global Methane Pledge a "non-binding" ambition to cut methane emissions by 30%. Methane is 24% of Australia's emissions (world's 11th biggest emitter), with around half coming from the agriculture sector. \$3 billion of the Govt's \$15 billion national reconstruction fund will focus on efforts to reduce agricultural methane and other clean tech initiatives. The focus will not just be agriculture, with other major methane sources in energy, resources, and waste sectors also to be addressed.

Public ownership of (renewable) energy resources is being proposed in Victoria with a revived State Electricity Commission which was privatized in the 90's to become an active energy market participant. If re-elected the new SEC could become a state-run retailer, a partner for a like-minded retailer or remain solely in the wholesale generation market.

Renewable targets will be lifted to 65% of generation by 2030 (up from 50%) and 95% by 2035. An initial investment of \$1 billion will deliver 4.5GW of publicly owned clean generation replacing the capacity of coal-fired Loy Yang A power station which is set to close in 2035. Emissions reduction targets have also been improved with net zero a target for 2045 – five years ahead of previous commitments and matching the ACT.

Further clarification on the pathway to climate disclosure has been given by the International Sustainability Standards Board (ISSB) confirming Scope 3 GHG emissions will be included in global sustainability-related disclosure standards. These global sustainability standards will be published as early as possible in 2023.

Relief provisions will be provided to companies applying the Scope 3 requirements and could include giving companies more time to provide Scope 3 disclosures and working with jurisdictions on so-called 'safe harbour' provisions.

NAB is looking to incentivize home loan customers toward sustainability standards that will indirectly help the bank reduce

their Scope 3 financed emissions and ultimately improve credit worthiness. Eligible home loan customers will enjoy lower variable rates for homes that meet a NatHERS 7-star rating or a Green Building Council of Australia Green Star rating. While in the UK Lloyds banking Group pledged it will no longer support the direct financing of new greenfield oil and gas developments unless they can be shown to be part of a "credible" transition plans. However, the bank also delayed plans to have no clients who operate UK coal-fired power stations by end-2022. Plans to stop financing for coal power stations is on pause following the UK government's request to keep some thermal stations online until 2023 to ensure energy supply this winter.

### Outlook

Altius expect inflation to accelerate a little further, with peak inflation during the fourth quarter at approximately 8% in year-on-year terms, before easing gradually.

Cash rate increases by the Reserve Bank of Australia have unique efficacy. The 2.75% increase in cash rates since May, are being felt at the same time as Australian mortgages are reverting almost universally to variable. The implication being virtually all home borrowers are now or soon will be paying substantially higher rates that are squeezing discretionary spending.

Internationally, fixed rate mortgage rate regimes imply existing mortgages are locked in at the low rates seen during the ultra-low rate environment of a year ago. It is new lending that faces higher rates, meaning offshore central banks have to lift interest rates further than Australia – particularly given the higher inflation backdrop overseas.

We expect global bond yields to oscillate in a wide range around current levels. US yield curve inversion is as extreme as any time since 1981, indicating that financial conditions are restrictive. That curve inversion has been observed for six months leads to the conclusion this will dampen activity sufficiently for the US Federal reserve to slow rate rise.

The combination of lower inflation and expected lower peak in cash rates imply that Australian bond yields will outperform global peers. Longer dated bond yields may have already peaked. Absent any further acceleration of inflation above 7.5% to 8%, we believe Australian cash rates peak in Q2 2023 at 3.6%. This is 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.

For the first time in over a decade, higher cash, bond rates and credit spreads, have pushed the yields on many senior bank bonds higher than the dividend yields on the same bank. This speaks to the two elements we seek from the role of bonds within a portfolio. First, the higher yield lifts income generated given bank and other corporate bond programs increase the coupons on new fixed rate bonds, and floating rate coupons reset at higher levels. Second, the higher interest rates allow bonds to provide improved defensive properties versus growth assets.

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	8.48	28.22
Supranationals	9.83	3.73
Industrials	14.57	2.25
Financials	22.07	1.78
Asset Backed	11.42	0.00
Agencies	9.00	0.43
11AM	3.30	0.00
Cash at Bank	0.24	0.00
RBA Cash	0.00	50.00
Semi Government	21.09	13.58

## Ratings Exposure

Rating	Portfolio %	Benchmark %
A	16.43	1.39
AA	28.16	12.94
AAA	39.59	34.15
BBB	15.82	1.52
RBA Cash	0.00	50.00

## Top 20 Issuers

Issuer	Portfolio %	Benchmark %
New South Wales Treasury Corp.	9.38	3.39
Government of Australia	8.48	28.22
National Housing Fin & Invest Corp.	7.39	0.06
Queensland Treasury Corp.	4.78	3.43
Treasury Corporation of Victoria	4.00	3.36
ANZ Banking Group	3.70	0.17
Commonwealth Bank of Australia	3.33	0.16
European Investment Bank	2.88	0.45
GAIF Bond Issuer Pty Ltd.	2.34	0.03
NBN Co. Ltd.	2.15	0.13
National Australia Bank Limited	2.02	0.21
BNG Bank N.V.	1.77	0.30
Australian Capital Territory	1.77	0.29
Suncorp Group Limited	1.72	0.02
Kommunalbanken AS (Norway)	1.61	0.28
Woolworths Group Limited	1.60	0.07
BPCE SA	1.56	0.06
REDS EHP Trust Series 2021-1	1.56	0.00
Wesfarmers Limited	1.53	0.03
Suncorp-Metway Ltd.	1.31	0.04

## Portfolio Summary Statistics

	Portfolio	Benchmark
Yield to maturity (%)	4.98	1.94
Modified duration (years)	2.98	2.59

## Fund snapshot

APIR code	AUS0071AU
Inception date	21 Nov 2014
Distribution frequency	Quarterly
Minimum initial investment	\$5,000
Fund size (net asset value)	\$189.31m
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](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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