

Altius Sustainable Bond Fund

Fund Update 30 November 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 November 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	1.04	0.82	(3.76)	(1.62)	0.14	0.95	1.28
Benchmark	0.89	0.87	(3.40)	(1.09)	0.88	1.39	1.66
Excess to benchmark	0.15	(0.05)	(0.36)	(0.53)	(0.74)	(0.44)	(0.38)

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

As with the majority of 2022, markets remained squarely focused on inflation data and Central bank commentary. While volatility was lower than in previous months it remained above historical norms, with domestic three- and 10-year trading in a 0.50% and 0.62% range, respectively. Bonds were able to produce a solid return in November driven by downside surprises in the United States (US) and European inflation and speculation that Central banks are moving to a slower pace of tightening. Domestically three- and 10-year bonds finished 0.21% and 0.24% lower to finish at 3.13% and 3.52% respectively. While US 10-year bonds finished November 0.40% lower at 3.64%. After starting the month with 2.97 years of interest rate duration the fund moved from overweight to underweight position to finish the month at 2.24 years.

In terms of the interest rate drivers over the month, the US Consumer Price Index (CPI) miss was the biggest surprise. Markets expected core inflation to rise by 0.50% over the month, instead of only rising by 0.30%. In year-end terms, headline inflation fell to 7.7% from a peak of 9.1% in June. The miss reflected broader evidence that US inflation may have peaked with a deceleration in prices becoming more evident. Of note was the moderation in rents, a dramatic fall in health insurance costs and a broadening in declines of core products. That said, overall price pressures remained firm. The CPI release led investors to price in a growing chance that the US Federal Reserve would slow the pace of its tightening cycle at the December meeting.

As expected, the US Federal Reserve (FED) raised rates again by 0.75%, taking the cash rate to 4.00%. The FED hinted at dialling back in rate hikes by noting that future increases in the policy rate "will take into account the cumulative effect of tightening", however the hawkish tone remained. The FED also noted that since the last meeting the data suggested the terminal rate "will be higher than previously expected". This view was confirmed with the release of the November minutes which detailed it "may soon

be appropriate" to reduce the pace of rate increases, suggesting members are leaning towards a 0.50% move, down from 0.75% in December. While members noted that a downshift could be appropriate, many expected the terminal cash rate to peak at around 5.0 to 5.25%, meaning the cycle could be drawn out for longer. Other notable policy moves included the 0.75% tightening to 3.0% by the Bank of England and the step up in tightening by the Reserve Bank of New Zealand (RBNZ) from 0.50% to 0.75% to take the cash rate to 4.25%.

Locally, the RBA delivered a further 0.25% tightening to take the cash rate to 2.85%. The RBA has been a clear stand out compared to other Central banks with its more balanced view. As noted in the November minutes the domestic economy continues to grow solidly, labour markets remain tight, wages are picking up slowly and inflation remains too high. While the key uncertainty is how households will respond to tighter financial conditions given "policy operates with a lag". As such, the Members considered two options at the November meeting, either staying with a 0.25% move or reinstating a 0.50% increase. "Acknowledging the uncertainty, members did not rule out returning to larger increases if the situation warranted. Conversely, the Board is prepared to keep rates unchanged for a period while it assesses the state of the economy and the inflation outlook. Interest rates are not on a pre-set path". By the end of November, the market had the terminal cash rate peaking at 3.65% by October 2023.

The solid rally experienced in credit markets during the second half of October continued throughout November. Credit markets performed strongly post the lower-than-expected US CPI release as risk markets started to factor in the winding down of tightening cycles globally. By the end of November, US credit markets had retraced to a five-month low while local financial spreads recovered early month losses driven by large primary deals from NAB and Westpac to finish the month 0.10% tighter. An extremely volatile month for local subordinated debt following the APRA release of a letter titled "Expectations on Capital Calls". APRA did not say anything new, but it did restate that the economics of new

capital remained an important part of the deal approval process, meaning issuers need to justify replacing a low-spread deal with a new deal with a higher spread. The context of the letter was likely related to the pending Challenger Group and AMP bank calls. This saw margins move materially wider as the market began to speculate that securities with margins below current market levels would not get called, in turn creating extension risk. This resulted in short-dated subordinated debt widening by up to 1% and five years moving out 0.50% with market liquidity disappearing. Market relief emerged when APRA approved Challenger and AMP Bank to redeem the securities in question, resulting in a strong reversal.

Primary issuance was strong in November with Westpac and NAB both issuing large multi-tranche deals. Westpac issued \$1 billion of three years at a margin of 0.95% and \$1.750 billion of five years at 1.23% while NAB issued \$2.1 billion of three years at 0.92% and \$2.650 billion of five years at 1.20%. Of most interest was the issuance by Bank Australia and Transpower New Zealand, both issued in sustainable debt format. Bank Australia returned to the market with a sustainability bond that aligns strongly with the group's focus on responsible banking. Funding will be utilized for a combination of social and environmental lending, including social and affordable housing, specialist disability accommodation, green mortgages and commercial lending for green buildings. After launching its green finance program in May 2022, certified under the Climate Bond Standard, electricity transmission company Transpower New Zealand launched a six-year AUD green bond. Transpower plays a critical role in enabling New Zealand to deliver on its net zero commitments by supporting the moderation of the transmission grid required to scale up renewable sources of generation. Our funds participated in both transactions.

Socially Responsible Investments in Focus

This month was notable for COP27 in Egypt. The conference agreed to an historic Loss and Damage fund, but failed to find a final agreement committing to even a phase-down in fossil fuels.

As noted by BankTrack, Finance Day brought no new commitments from banks, while a UN High-Level Expert Group warned that businesses should not claim to be net zero while continuing to finance new fossil fuels. Agriculture and biodiversity protection were sidelined due to the upcoming convention on biological diversity in December where governments will negotiate a Global Biodiversity Framework. Similar to the wide-spread pressure for banks to disclose and manage down financed emissions, a focus on bank financing the expansion of industries that are driving biodiversity loss, such as meat and dairy, is going to be increasingly adopted by responsible investors.

The Climate Change Authority (CCA) in their advice contained in the first Annual Climate Change Statement to Parliament, recommends establishment of sector pathways to net zero emissions. The report entitled "First Annual Progress Report 2022: The baseline, global context and methodology", sets a baseline for the current status of climate policies and emissions reductions in Australia and articulates a framework by which the CCA will use to assess progress towards Australia's emissions reduction targets.

Sector pathways are important for investors as are critical in formulating decisions at a state and local industry level within the context of the overall long-term strategy for emissions reductions. This strategy sets expectations for when, how, and by how much, emissions should be reduced across different sectors of the economy, enabling investors to assess the impact of differential targets across sectors (and therefore the impact that may have on companies within those industries, and the financial position of

state governments with each having a greater or lesser exposure to the industries most challenged by the targets).

The Investor Group on Climate Change (IGCC) on behalf of its members' stated priorities, had specifically sort clarification on Sector by Sector targets and pathways. As noted by Erwin Jackson, IGCC Director of Policy, "Investors have the capital ready to fund climate solutions. A reliable picture of the risks and opportunities across all sectors of the economy will open the door for investors to allocate capital to these solutions with confidence."

Outlook

Inflation is in the process of peaking but is unlikely to recede quickly, implying Australian bond yields oscillate in a wide range around current levels, whilst international yields complete their adjustment higher. The range trading nature of bonds reflects the expected downward activity pressure due to already tightened financial settings countered by remaining sources of inflation.

The peak in goods inflation has likely occurred; helped by reduced shipping costs. Crude oil prices have fallen 35% from its mid year peak. Services inflation and other second order inflation pressures are more resilient. The strengthening of the Australian dollar has a disinflationary impact on imported inflation. Although oil prices have fallen 10% in the last month, in Australian dollar terms this is nearly a 15% fall. With a short lag, this element of the higher cost of living will abate.

A key determinant of the path of inflation is wages and rents. Further electricity price rises are expected during 2023. Rents, having lagged, will also reflect the tight rental market and higher mortgage (funding) costs. How wages respond to this is critical. To date, wages have, in a global context, been reasonably contained so far. Labour markets remain tight with unemployment at 50 year lows.

We believe the RBA's estimate of wage growth is too conservative. Measures of wage growth show 46% of the private sector saw an increase over the last quarter. The average rise was 4.3%. Wage inputs into national accounts point to a six month annualized rise in wages of 6.3%. We believe this to be the major source of inflation's resilience and the key threat to the RBA's policy guidance.

A significant increase in the number of Australian fixed mortgage borrowers will convert to floating – at rates 3.5-5% higher – over the next four to five months. This gives the Reserve Bank's monetary settings greater efficacy than most other economies; a more swift dampening effect. Greater than 75% of all mortgages will face higher rates. By contrast, the US 30 year fixed rate regime means existing mortgage holders, locked in near 3%, will have little impact. Only new financing needs will face higher rates.

The implication is that US cash rates will have to rise much further than Australian cash rates. A key risk is the US overtighten given the uneven efficacy of monetary policy.

Having achieved monetary settings that are restrictive, with the attendant lags in impact, central banks are articulating a slower pace of rate hikes. Some guidance to the expected peak in rates is being provided. For the most part, the implied market rates suggest rate rises until March 2023.

The incredible market volatility seen since November 2021 has been related to the enormous amount of "price insensitive buying" from central banks needing to be replaced by other sources of buying. Necessarily this is price sensitive, of which whilst central banks have been raising rates vigorously and to "yet to be defined" levels, buyers have retreated. More recently, the amount of

financing required has reduced with better budget positions. Moreover, with something of an endpoint in the tightening cycle being reflected in markets, the volatility has been reduced. This provides a much improve backdrop for non sovereign holdings.

Absent any further acceleration of inflation above 7.5%, we believe Australian cash rates peak in Q2 2023 at 3.6%. With an approximate midpoint in Sovereign long bonds at 3.7% . The portfolio strategy is to actively manage duration settings; increasing or decreasing duration accordingly, but with benefit of attractive accrual.

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%. That inflation remains high, even if below it's peak, leads to the indexation driving higher income accrual than the nominal equivalent. Moreover, should inflation become more acute, the value of the inflation linked bonds rise relative to the nominal bond overlay.

For the first time in over a decade, higher cash and bond rates have pushed the yields on many senior bank bonds higher than the dividend yields (ex-franking) on the same bank. The yield is already higher, but the income generated from the banks and other corporate bond programs will also lift given new bonds will be issued with higher coupons. This added to our constructive view on corporate risk.

Sector Profile

Asset Class	Portfolio %	Benchmark %
Australian Commonwealth Government	9.24	27.72
Supranationals	7.58	3.78
Industrials	13.14	2.28
Financials	22.26	1.85
Asset Backed	10.97	0.00
Agencies	10.64	0.44
11AM	2.84	0.00
Cash at Bank	1.73	0.00
RBA Cash	0.00	50.00
Semi Government	21.60	13.93

Ratings Exposure

Rating	Portfolio %	Benchmark %
A	15.10	1.37
AA	28.05	13.33
AAA	39.41	33.73
BBB	17.44	1.57
RBA Cash	0.00	50.00

Top 20 Issuers

Issuer	Portfolio %	Benchmark %
New South Wales Treasury Corp.	10.56	3.48
Government of Australia	8.58	27.72
National Housing Finance & Investment Corp.	7.56	0.06
Queensland Treasury Corp.	4.83	3.49
Australia and New Zealand Banking Group Limited	3.66	0.22
Commonwealth Bank of Australia	3.34	0.16
Treasury Corporation of Victoria	3.27	3.51
NBN Co. Ltd.	2.15	0.14
National Australia Bank Limited	1.99	0.22
Australian Capital Territory	1.77	0.29
Suncorp Group Limited	1.70	0.02
European Investment Bank	1.67	0.45
Airservices Australia	1.62	0.02
Woolworths Group Limited	1.59	0.07
BPCE SA	1.56	0.06
Wesfarmers Limited	1.55	0.03
REDS EHP Trust Series 2021-1	1.54	0.00
Kommunalbanken AS (Norway)	1.46	0.29
Suncorp-Metway Ltd.	1.30	0.05
GAIF Bond Issuer Pty Ltd.	1.15	0.03

Portfolio Summary Statistics

	Portfolio	Benchmark
Modified duration (years)	2.24	2.64
Yield to maturity (%)	4.54	1.84

Fund snapshot

APIR code	AUS0071AU
Inception date	21 Nov 2014
Distribution frequency	Quarterly
Minimum initial investment	\$5,000
Fund size (net asset value)	\$191.05m
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.



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