

# Altius Sustainable Bond Fund

## Fund Update 31 January 2023

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 2023

	1 mth %	3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	7 yrs % p.a.	Since inception % p.a.
Total return	1.92	2.44	(2.14)	(1.29)	0.35	1.03	1.42
Benchmark	1.51	1.49	(2.38)	(1.03)	1.05	1.34	1.70
Excess to benchmark	0.41	0.95	0.24	(0.26)	(0.70)	(0.31)	(0.28)

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

January was a strong start for global markets with investors buoyed by several good news stories. A decline in gas prices of 24% saw several economists remove a European recession from their outlooks. The continued reopening of China meant investor sentiment turned positive on the Chinese economic outlook, but residual concerns did surface about the inflationary impact on the global economy. The ASX 200 returned 6.22% while the S&P500 had its strongest start since 2019 returning 6.3%. Sovereign bond markets were equally as strong with Australian 10-year Treasury yields falling 0.54% to finish at 3.32% with the Treasury index generating 2.93%, while United States (US) treasuries fell 0.37% to finish at 3.50%. With markets continuing to range trade over January the fund's duration largely reflected these moves. The fund started the month with 2.38 years of interest rate risk before being increasing to 3.70 years by the middle of the month. As yields pushed higher in the final week of January, we took the opportunity to reintroduce our underweight position. At the end of January, the fund held 1.90 years of interest rate risk.

With the Reserve Bank of Australia (RBA) not meeting in January, attention turned to the data that would set the screen for the February meeting. The release of a weaker-than-expected employment figure pushed rates to their intra-month low with the three-year bond falling to 2.97%. Full-time employment disappointed markets by printing negative 12,000, well below the consensus of plus 22,000, leading to a small uptick in the unemployment rate to 3.5% from 3.4%. The move lower in rates was short-lived following the release of the much-anticipated inflation report. Inflation surprised to the upside with headline at 8.4% Year on Year (YoY), well above expectations of 7.7%. Inflation momentum continued to build domestically in Q4 with 75% of the basket annualizing above the top of the RBA's band. Of greater concern was the increase reflected domestically driven inflationary pressures which are more relevant for the RBA's policy setting. The higher inflation number pushed against some speculation that the RBA could pause at their February meeting and instead locking in a

further 0.25% hike and a terminal cash rate of 3.75% by July 2023.

Much of the strength in global bond markets was driven by softer economic data in the US and the growing speculation that the Federal Reserve (Fed) might be nearing the end of the tightening cycle. This view accelerated with the release of weak ISM services and manufacturing indices which fell into contractionary territory at 49.6 and 48.4 respectively and soft retail sales and industrial production numbers. US inflation data further supported the market's view that we were past the peak inflation. Core inflation (excluding food and energy) gained 0.3% in December putting the annual rate at 5.7%, well below the peak of 6.6% in September 2022. While trending in the right direction, services sector inflation remains persistent. Shelter costs remain a significant contributor although evidence in hand from the Zillow index indicates that new rents have peaked. Overall, the theme was that goods inflation is solved but services inflation will evolve over 2023. By the end of the month, the market expected the US Fed funds rate to reach 4.9% by July before falling to 4.40% by the end of 2023. This was in stark contrast to the Federal Reserve forecasts of a cash rate of 5.25% and no rate cuts expected until 2024.

A strong start to the year for credit markets with spreads contracting across both the financial and industrial sectors. The positive technical backdrop was the dominant theme across the month with investors becoming more comfortable with the economic outlook, coupled with limited supply, saw investors drive risk spreads lower. Over the month financial spreads contracted on average 8 basis points but industrials spreads were the standout contracting around 18 basis points. The introduction of Australian issuers into the JACI Index (JP Morgan Asian Credit) also provided additional support for credit markets. Corporate were again absent from primary markets, a theme that played out across 2022. 2022 only saw around \$6.5 billion of new issuance, well down on the \$22bn in 2021, with 2023 likely to be a carbon copy of 2022. Financial supply was strong with the combination of general refinance and Term Funding Facility (TFF) rolls driving issuance. Major banks completed \$19 billion of funding with the

majority being issued into offshore markets. Locally, the Commonwealth Bank of Australia (CBA) issued a jumbo 3 and 5-year fixed and floating transaction at a risk margin of 0.90% and 1.15% respectively. Other notable transactions included the Bendigo Bank and Bank of Queensland 4-year deals and a Teacher Mutual tap of their 2025 line. Investments were made in CBA, Bendigo and Teachers Mutual. The market environment for bank subordinated debt also got a boost in January with Westpac confirming it had received approval from APRA to call its February 28/23 Tier 2 deal. The approval from APRA removed future risk for Tier 2 callable debt markets.

### Socially Responsible Investments in Focus

In further steps to improve capital market confidence in financial and sustainability reporting, the International Sustainability Standards Board (ISSB) has moved to enhance connectivity between Environmental, Social and Corporate Governance (ESG) concepts and financial disclosures by explicitly articulating the relationship between sustainability matters and financial value creation. As part of that, ISSB has clarified the definition of "sustainability" as: "the ability for a company to sustainably maintain resources and relationships with and manage its dependencies and impacts within its whole business ecosystem over the short, medium and long term."

The ISSB said that referring to this articulation of the value creation process, a company will be better placed to explain to its investors how it is working sustainably within its business ecosystem—addressing the impacts, risks and opportunities that can affect its performance and prospects—to ultimately deliver financial value for investors. It also provides important context for companies when making materiality assessments. <https://www.ifrs.org/news-and-events/news/2022/12/issb-describes-the-concept-of-sustainability/>

In January, the Fed published instructions for its first climate scenario analysis (CSA), which will help banks identify potential risks and promote the integration of climate risk into their enterprise risk management practices. The pilot CSA comprised two separate and independent modules: a physical risk module and a transition risk module. Climate scenarios used are informed and adapted from the Intergovernmental Panel on Climate Change (IPCC) and Network for Greening the Financial System (NGFS). The CSA will improve transparency around understanding banks' exposure to climate risk, the potential magnitude of climate-related financial losses and what controls are in place to mitigate or address them. The exercise will be exploratory at this stage and will have no bank capital or supervisory implications for now.

The effect of these scenarios on relevant credit exposures will be a focus with the physical risk module estimating the impact on residential real estate and commercial real estate (CRE) loan portfolios over a one-year horizon in 2023. The transition risk module will focus on estimating the effect of specific scenarios on corporate loan and CRE loan portfolios over a 10-year horizon. <https://www.federalreserve.gov/publications/climate-scenario-analysis-exercise-instructions.htm>

Energy and Climate Minister Chris Bowen released a position paper on reforms to the safeguard mechanism covering Australia's largest polluting businesses which account for 28% of Australia's total emissions - mainly in the oil, gas, mining, and manufacturing sectors. These businesses will need to cut emissions by almost 5% per annum over the next 7 years. This is intended to deliver 205 million tonnes of carbon abatement between 2023 and 2030 and is vital in helping Australia meet its

43% reduction target by 2030 and net zero by 2050.

With a target start date of 1 July, the safeguard mechanism will apply to facilities that exceed 100,000 tonnes of CO<sub>2</sub>-e emissions annually. Under the reforms, The Government has announced \$600 million in funding from the \$1.9 billion Powering the Regions Fund to support trade-exposed businesses and regions with the transition.

Baselines for each of the covered facilities will be based on emissions intensity, rather than actual emissions. Baselines will be site-specific initially and then move towards industry average benchmarks or industry baseline by 2030. However, a 'reserve' has been proposed to set aside emissions allowable for new high-emitting projects. The reserve will be built into baseline decline rates for other facilities, requiring them to be higher to make room for emissions from new entrants. This is likely to be problematic given widespread agreement that new or expanded coal, oil or gas developments are consistent with global warming close to a 1.5-degree threshold.

Companies may purchase and surrender carbon credits where they cannot avoid emissions. The Government is also proposing to establish a second set of credits to operate alongside Australian carbon credit units (ACCUs), called Safeguard Mechanism Credits (SMCs). Ongoing questions remain about the integrity of carbon credits, meaning increased scrutiny of genuine emissions reductions and verifiable carbon credits. <https://minister.dcceew.gov.au/bowen/media-releases/next-steps-safeguard-australian-industry-and-regions-net-zero-global-economy>

### Outlook

Australian bond yields are expected to oscillate in a wide range, with current yields toward the lower end of that range. The range trading nature of bonds reflects the expected downward activity pressure due to already tightened financial settings countered by remaining but changing sources of inflation.

Three major sources of inflation are in different parts of the cycle.

Having led global inflation higher, goods inflation is experiencing a disinflationary pulse. Oil prices are 40% off their highs. Supply chain bottlenecks have been corrected sufficiently to drive freight costs to close to pre-pandemic levels. The Australian dollar is 10% above its October lows.

Rental inflation is still rising in Australia, though has peaked in other major economies. A tight Australian rental market is under further upward cost pressures from borders reopening, historical under construction and higher mortgage rates.

Non-rental services inflation, accounting for a little over half of the economy, is proving persistent and threatening in some jurisdictions. This is driven by wages and other service costs. Australia's "rolling" wage negotiation system points to many agreements yet to be negotiated for the uplift in the cost of living.

Taken together, the peak of inflation is behind us but will remain elevated whilst wages and rental inflation sources remain present. Tight labour markets underpin the possibility of a wage spiral that ensures central banks maintain or tighten financial conditions further.

The labour force remains tight. 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 annualised rise in wages of 6.3%. We believe this to be the major source of inflation's resilience and the key threat to the Reserve Bank of Australia's (RBA) policy guidance. The competing

forces around inflation underpin a range trading environment.

A significant increase in the number of Australian fixed mortgage borrowers are presently converting to floating – at rates 3.5-5% higher. The peak will be 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.

The Bank of Japan has largely exported its' monetary policy settings for more than a decade. Their ultra-low (for the most part negative) interest rate settings have resulted in Japanese investors buying enormous amounts of higher-yielding international bonds. The rise in the "global floor" in interest rates via the allowance for Yield Curve Control at a higher yield allows other yields to trade higher.

The Bank of Japan's tightening of monetary policy via yield curve control is unlikely to be complete whilst inflation is around 4%, suggesting higher 10-year yields in Japan.

Dollar bloc bond markets are advanced in their tightening cycle. The softening of activity data has led the market, factoring in a peak in cash rates during the first half of 2023, with an easing cycle commencing swiftly after. Perversely, the rally in US long-dated bonds since December has the effect of a considerable easing in financial conditions. This may lead the US Federal Reserve to have to tighten further.

Absent any extension to what we believe to be the peak in Australian inflation, Australian cash rates likely peak in Q2 2023 at 3.85%. 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 the benefit of attractive accrual.

A key strategy in the fund remains our investment inflation-linked bond. The daily accrual of inflation-linked bonds is approximately twice that of the equivalent nominal sovereign bond, given headline inflation of around 8% and ten-year nominal bonds of around 3.55% (at the time of writing). Additionally, the portfolio's inflation strategy is actively managed. The current "Break-Even" Inflation mid-point is 2.4%, with increases in the inflation exposure when 10-year breakeven fall to around 2.2%.

The greater certainty surrounding peak central bank cash rates and peak inflation has allowed market volatility to meaningfully reduce as more "price sensitive buyers are drawn to the market to offset the effects of central bank balance sheet reduction. The strong link between volatility and credit spreads provides a tailwind for high-grade credit and semi-government holdings relative to sovereigns, supporting our modest overweight to these sectors. There is a distinction with high yield, however, given the increasing likelihood of loss given default in a recession.

## Sector Profile

Asset Class	Portfolio %	Benchmark %
Australian Commonwealth Government	9.37	27.83
Supranationals	7.23	3.68
Industrials	13.46	2.20
Financials	23.70	1.88
Asset Backed	10.46	0.00
Agencies	10.76	0.47
11AM	1.88	0.00
Cash at Bank	1.19	0.00
RBA Cash	0.00	50.00
Semi Government	21.93	13.93

## Ratings Exposure

Rating	Portfolio %	Benchmark %
BBB	17.74	1.52
RBA Cash	0.00	50.00
A	14.80	1.33
AA	28.59	13.41
AAA	38.88	33.74

## Top 20 Issuers

Issuer	Portfolio %	Benchmark %
New South Wales Treasury Corp.	10.77	3.54
Government of Australia	8.71	27.83
National Housing Finance & Investment Corp.	7.59	0.06
Queensland Treasury Corp.	4.93	3.40
Commonwealth Bank of Australia	4.42	0.16
Australia and New Zealand Banking Group Limited	3.74	0.19
Treasury Corporation of Victoria	3.29	3.62
NBN Co. Ltd.	2.20	0.13
National Australia Bank Limited	2.00	0.25
NAB 11AM A/C - Deposit Accounts	1.88	0.00
Australian Capital Territory	1.77	0.28
Suncorp Group Limited	1.70	0.02
Airservices Australia	1.68	0.05
Woolworths Group Limited	1.64	0.07
Wesfarmers Limited	1.59	0.03
BPCE SA	1.56	0.06
REDS EHP Trust Series 2021-1	1.54	0.00
Kommunalbanken AS (Norway)	1.50	0.29
Suncorp-Metway Ltd.	1.30	0.06
GAIF Bond Issuer Pty Ltd.	1.18	0.02

### Portfolio Summary Statistics

	Portfolio	Benchmark
Yield to maturity (%)	4.44	1.85
Modified duration (years)	1.96	2.60

### Fund snapshot

APIR code	AUS0071AU
Inception date	21 Nov 2014
Distribution frequency	Quarterly
Minimum initial investment	\$5,000
Fund size (net asset value)	\$192.63m
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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