Altius Sustainable Bond Fund

Fund Update
28 February 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 28 February 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	(0.12)	1.26	(1.89)	(1.46)	0.27	0.90	1.40
Benchmark	(0.54)	0.05	(2.32)	(1.36)	0.90	1.18	1.62
Excess to benchmark	0.42	1.21	0.43	(0.10)	(0.63)	(0.28)	(0.22)

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

After a positive start to 2023, most risk markets reversed in February. Globally, bonds had a poor month with Australian Government 3- and 10-year yields rising 0.42% and 0.35% respectively to finish at 3.60% and 3.85%. This move led to the Australian Treasury index giving back over half its January gains to be down -1.63%, while US Treasuries were down -2.41%. Investors ramped up expectations of monetary tightening throughout February as pessimism grew about inflation. By the end of the month, the US market had removed the expectation of monetary easing in Q4 2023, leading to the terminal cash rate of 5.40% from 4.60%. This was a similar situation in the domestic market with the terminal cash rate moving from 3.78% to 4.31% by December 2023. The fund started the month with a short-duration position of 1.92 years before closing that position early in the second half of the month, adding value for the fund. By the end of the month, the fund held 2.87 years of duration, modestly long versus the benchmark.

The release of the US employment report on February 3rd set the tone for the month. The January release saw a very strong increase in non-farm payrolls of +517,000 resulting in the unemployment rate falling to 3.4%, a 53-year low. Of most concern was the average hourly earnings and hours worked. Both raised concerns that inflation could be more entrenched than previously anticipated. The strong release reaffirmed Fed Chair Powell's assertions the week prior that the labour market remained very tight. The same day saw the release of a strong non-manufacturing Institute of Supply Management (ISM), reversing the disappointing December number and supporting the new narrative of the "no landing" economic scenario where both inflation and growth remain strong and the Central bank needs to hike rates further to bring inflation down.

Inflation in the US showed few signs of easing with annual CPI printing at 6.4%, above expectation of 6.2%. This was a consistent theme across the globe in February. In Europe, January core Euro inflation hit a record high of 5.3%, with initial releases in France and Spain pointing to no easing of inflationary pressures in February. Like employment in the US, the Euro area also remained low at 6.6%, driving similar fears of inflation becoming more embedded. As expected, Central bank commentary post the inflation releases were hawkish in nature. This was highlighted by European Central Bank (ECB) Board member commentary, with one of the most senior ECB members Schnabel reiterating that a move into contractionary territory is required and the hurdle to step down the size of tightening was significant.

The Reserve Bank delivered a further 0.25% increase, taking the official cash rate to 3.35%. The statement that followed erred on the hawkish side with the Board's priority to return inflation to the target. Noting that "high inflation makes life difficult for people and damages the functioning of the economy" and if expectations became entrenched "it would be very costly to reduce later". What caught the market off guard was that the statement referenced "further increases in interest rates will be needed in the months ahead". Leading into the meeting most of the market expected one further tightening following the February increase. The change of language saw the terminal rate move 0.60% higher in February to finish at 4.31%.

Locally, data was mixed in February. The unemployment rate drifted higher to 3.7% following a loss of 11,500 jobs in January. Westpac Consumer confidence index was very weak, falling to 78.5, just above the COVID low. Cost of living pressures and high-interest rates continued to weigh heavily on consumers. The much-anticipated Wage Price Index gained 0.80% for the quarter taking annual wage growth to 3.3%, below expectations with the pace of growth being softer than expected. Anchored wages expectations remain key for the Reserve Bank of Australia's (RBA) policy. Rounding out the month was the stronger-than-expected retail sales release at 1.9%, leading to 7.5% growth over the year. While the number bounced after a large fall in December the trend continues to soften.

Credit continued its strong start to 2023 with spreads contracting further over February. Over the month both the Bloomberg financial and industrial indices fell 0.10% to finish the month at margins of 0.83% and 0.96% respectively. The positive technical backdrop remains a key driver for credit and with little corporate supply expected over 2023 investors scrambled to invest inflow and maturities. Financial issuance remains the notable standout with pre-funding for TFF repayments, business as usual funding and ongoing Australian Prudential Regulation Authority (APRA) Tier 2 (T2) capital requirements leading to consistent primary issuance. February was a standout month for bank T2 performance. APRA's announcement that approval had been provided to Westpac to recall its T2 transaction on its call date removed any market residual concerns about call risk. This led to a return to the T2 market by the major banks, with deals from ANZ, Suncorp and NAB. A significant development was the first public 10-year T2 deal by an Australian bank in the local market. ANZ issued $1 billion of 15NC10 at a margin of 2.80% with $1.5 billion of interest. The transaction performed exceptionally well with the spread contracting 0.60% in the first week of trading. A key driver of performance was the all-in rate of 6. 73% which drove interest for the Private Banking community. Suncorp issued $250 million of a T2 deal with a book of $1.2 billion, with pricing being reduced by 0.20% through the book-building process. Finally, NAB launched a 10NC5 T2 deal on the last of the month at a margin of 2.30%.

Outside of the T2 market, it was a very busy month for financial issuance with deals from international banks, DBS, Sumitomo Mitsui and MUFG Bank, all receiving strong support. On the sustainable debt front, Bank Australia returned to the market with $225 million of a 4 years sustainability bond at a margin of 1.55%. As with the transaction they bought in 2022, funds will be predominately used for green property lending and affordable and social housing. Bank Australia remains one of our preferred banks with a strong focus on climate and social outcomes.

Socially Responsible Investments in Focus

In a new angle for environmental legal action, activist groups have sued BNP Paribas for providing financial services to oil and gas companies, as well as meat producers deforesting the Amazon. BNP Paribas has made commitments on net-zero by 2050 and zero deforestation in their production and supply chains by 2025, the lawsuits allege improper due diligence in providing around $55 billion of financing to loans to oil and gas companies like BP, Chevron, ExxonMobil and Shell between 2016 and 2022. BNP Paribas is also charged with continuing to fund companies like Marfrig, a meat producer that purchases cattle from illegally deforested land and fails to monitor indirect beef suppliers. The bank will be sued for failing to conduct proper sustainability due diligence in its financing, thereby fuelling the deforestation of the Amazon rainforest and contributing to global methane emissions.

https://news.mongabay.com/2023/03/deforestation-lawsuits-take-aim-at-french-bank-bnp-paribas/

With carbon offsets in the spotlight, carbon credit certifier Verra has been accused of overstating the climate impact of some forest projects, with a suggestion they are "phantom credits". One project, NIHT Inc's rainforest carbon credits in Papua New Guinea, was exposed as completely ineffective as deforestation was still occurring while carbon accounting numbers were being "fudged". Locals involved in the project failed to receive fair payment for the use of the land and promised benefits such as housing, school, church, and health facilities were never delivered. The investigations further raise fears about the integrity of the voluntary carbon markets, prompting calls for more scrutiny by regulators. Somewhat unhelpfully, while seeking more responses from Verra, Australia's government stakeholder in the Climate Active program is encouraging members to do their own due diligence on individual carbon projects.

https://www.theguardian.com/environment/2023/jan/18/revealed-forest-carbon-offsets-biggest-provider-worthless-verra-aoe

https://www.abc.net.au/news/2023-02-14/carbon-credits-projects-papua-new-guinea-logging-four-corners/101936714

A study of major asset managers running more than $77 trillion conducted by ShareAction, a UK-based NFP organization, found "serious gaps in their responsible investment policies and practices". ShareAction noted "As managers of tens of trillions of dollars, and investors in the biggest companies from many industries, their decisions have a vast impact all over the world. They should be considering their effects on our climate, the ecosystems providing our life-support systems, and human wellbeing worldwide." ShareAction also noted some of the biggest managers sat near the bottom "managers with the greatest influence are coming worst in class". The highest ranking overall amongst larger managers was Netherlands-based Robeco, which received a 'AA' rating, with other European managers also faring well. Eleven companies were awarded an 'E', the lowest score. These included Vanguard, Fidelity Investments, and Mellon Investments.

https://m.bankingexchange.com/recent-articles/item/9583-asset-managers-falling-short-on-esg-report

Outlook

Australian bond yields are expected to oscillate in a wide range, with current yields toward the upper 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. Inflation has proven to be as resilient as expected.

Having led global inflation higher, goods inflation is experiencing a disinflationary pulse. Oil prices are 40% off their lows. Supply chain bottlenecks have 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 due to historical under construction higher mortgage rates are being passed through too.

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%. Public sector wages are the laggard. Wage inputs into national accounts show total compensation rose 9.8% in year-on-year terms. Considering Inflation is at 7.8%, real compensation expanded at 2%.

Closed borders have contained labour market supply and played some role in dampening potential demand for accommodation, noting the demand for separate dwellings lifted with COVID. However, this situation could change with borders reopening and the population rising. We are watching for increases in housing demand but also signs that wage negotiations – particularly in industries that draw on international labour sources – may slow. The impacts of these are opposing but not necessarily offsetting. The timing will be critical.

Real household disposable income is the weakest since the 1990s recession. The cost of living rises and the rise in mortgage rates are behind this. The peak in the reset of low fixed rate mortgages to current (higher) rates is occurring over the next four months.

Actual mortgage repayments are increased with a lag. Coupled with the fact that cash rates are still increasing, these adjustments have more bite in the coming months.

Current market pricing implies the Reserve Bank of Australia (RBA) will lift cash rates four more times to around 4.35%. We see value at these yields. Moreover, it is far from certain the RBA will deliver on all of these rises. 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.

Our inflation strategy is a key position within our funds. 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 3.85% (at the time of writing). Additionally, the portfolio's inflation strategy is actively managed. The current "Break-Even" Inflation mid-point is 2.45%, with increases in the inflation exposure when the 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. The strong link between volatility and credit spreads provides a tailwind for high-grade credit and semi-government holdings relative to sovereigns. 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 %
Supranationals	7.87	3.85
Industrials	13.33	2.15
Financials	24.23	1.91
Asset Backed	10.59	0.00
Agencies	10.57	0.54
11AM	2.47	0.00
Cash at Bank	0.26	0.00
RBA Cash	0.00	50.00
Semi Government	21.46	13.97
Sovereigns	9.22	27.58

Ratings Exposure

Rating	Portfolio %	Benchmark %
A	14.60	1.31
AA	28.35	13.48
AAA	39.34	33.73
BBB	17.70	1.48
RBA Cash	0.00	50.00

Top 20 Issuers

Issuer	Portfolio %	Benchmark %
New South Wales Treasury Corp.	10.50	3.57
Government of Australia	8.58	27.58
National Housing Finance & Investment Corp.	7.44	0.06
Queensland Treasury Corp.	4.80	3.36
Commonwealth Bank of Australia	4.44	0.20
Treasury Corporation of Victoria	3.25	3.68
Australia and New Zealand Banking Group Limited	2.92	0.19
NAB 11AM A/C - Deposit Accounts	2.47	0.00
NBN Co. Ltd.	2.18	0.13
National Australia Bank Limited	2.00	0.23
KfW	1.87	0.53
Australian Capital Territory	1.76	0.28
Suncorp Group Limited	1.71	0.02
Airservices Australia	1.67	0.05
Woolworths Group Limited	1.61	0.07
BPCE SA	1.58	0.06
Wesfarmers Limited	1.57	0.03
REDS EHP Trust Series 2021-1	1.55	0.00
Kommunalbanken AS (Norway)	1.46	0.31
Suncorp-Metway Ltd.	1.31	0.06

Portfolio Summary Statistics

	Portfolio	Benchmark
Yield to maturity (%)	4.99	2.02
Modified duration (years)	2.75	2.56

Fund snapshot

APIR code	AUS0071AU
Inception date	21 Nov 2014
Distribution frequency	Quarterly
Minimum initial investment	$5,000
Fund size (net asset value)	$191.40m
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

Contact us

australianunity.com.au/wealth

australianunitywealth@unitregistry.com.au

Investor Services

T 1300 997 774 F 1300 856 685

Adviser Services

T 1300 997 774 F 1300 856 685