

Altius Sustainable Bond Fund

Fund Update 31 March 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 March 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	1.32	3.14	1.32	(0.43)	0.58	1.04	1.54
Benchmark	1.73	2.71	1.26	(0.76)	1.15	1.43	1.81
Excess to benchmark	(0.41)	0.43	0.06	0.33	(0.57)	(0.39)	(0.27)

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

March was a volatile period for global markets, with the key driver being concerns of a contagion in the banking system both in the US and Europe. Given this backdrop, sovereign bond markets were very strong, driven by flight-to-quality trades. Australian 10-year government bond yields fell 0.55% to finish at 3.30% while US 10-year treasury yields fell 0.45% to finish at 3.47%. Particularly notable was the extreme volatility in bond yields with an implied volatility of Treasuries as given by the MOVE index reaching its highest since the Global Financial Crisis (GFC) and some of the largest daily ranges seen in years. Equity markets were more mixed, with the ASX 200 returning -1.11%, however, the S&P500 continued its strong run, returning 3.5% for the month. The fund started the month with 2.87 years of interest rate risk before increasing to 3.40 years in the first few days of the month. The fund took profit on this long-duration position as yields dropped precipitously on the back of global banking concerns. By month end, the fund had reduced its total duration to 1.84 years as, in our view, markets had become overextended.

The Reserve Bank of Australia (RBA) delivered an expected 0.25% cash rate increase, the 10th consecutive rise to official cash rates, to 3.60%. The statement was less hawkish than the previous given the change of narrative from "further increases in interest rates will be needed over the months ahead" to a more open-ended "further tightening of monetary policy will be needed" (no reference to time). Market pricing now suggests interest rates have peaked at 3.60% and will start to fall from here, with an implied cash rate of 3.25% in 12 months' time. Economic data locally continued to print relatively strongly with unemployment back to cycle lows at 3.5%, robust retail sales and Gross Domestic Product (GDP) data, and also inflation that is well above target, although the strength of the data took a back seat to the banking fears offshore.

Economic data in the US was also robust for the most part, with very solid employment figures and stubbornly high inflation at 6%

year-on-year (YoY) headline and 5.5% YoY core. Purchasing Manager's Index (PMIs) continued to show a softening in the manufacturing sector, however, services remained strong. Despite the global banking concerns, the Fed, European Central Bank (ECB) and Bank of England (BoE) all hiked rates during March, emphasizing the risks of inflation over financial stability. At the beginning of the month, the market was pricing the US Fed Funds rate to reach a peak of 5.4% by September before falling to 5.2% by Jan 2024, however, over the course of the month, the market took out the bulk of rate rises and priced a peak Fed Funds rate of 4.95%.

The strong positive momentum in credit markets was broken in March with spreads largely reversing the spread contraction over the last two months. Fears of a banking crisis offshore were ignited by the collapse of Silicon Valley Bank in the US and the forced merger of UBS and Credit Suisse. Spreads were wider across the board with financial spreads increasing by 21 basis points and industrial spreads out by 16 basis points. Despite this, there was a reasonable amount of primary financial issuance, with all four majors issuing into the market alongside several regional and offshore banks. Notable financial transactions included subordinated debt from NAB and CBA, and a large senior deal from ANZ, split across 3 and 5-year fixed and floating tranches at a risk margin of 0.83% and 1.06%. In addition, corporates returned to the market with Telstra, Toyota and Volkswagen all issuing into the local market across a mix of 3 and 5-year tenors.

Socially Responsible Investments in Focus

The Federal government with the support of the Independents and Greens successfully passed a bill to implement changes to the so-called Safeguard Mechanism, the most significant move yet toward a pathway to meet the ambitions contained in the Government's Climate Change Act (2022) of legislated, economy-wide emissions reduction targets of net greenhouse gas (GHG) emissions to 43% below 2005 levels by 2030 and net GHG emissions to zero by 2050.

<https://www.abc.net.au/news/2023-03-28/safeguard-mechanism-climate-change-policy-explained/102151992>

Coming into effect from July 1, the mechanism is designed to compel Australia's 215 biggest polluters to reduce their emissions, with crossbench amendments securing a hard ceiling on actual gross emissions (not to exceed 1,233 million tonnes over the decade). The overall result is a 205 million tonnes cumulative emissions reduction by 2030 and 100 million tonnes by 2030 annual target. Crucially the hard cap overcomes the fundamental weakness in the initial proposal which would have allowed unfettered coal and gas expansion in Australia (Scope 1 and 2 emissions over a coal or gas project's life must now be formally considered in the context of the Environment Protection and Biodiversity Conservation (EPBC) Act, which governs approvals). So, while there is no prohibition on new fossil fuel projects, new projects need to adopt international best practice baselines for carbon dioxide. For new Liquefied Natural Gas (LNG) facilities, best practice means zero emissions. This restriction is expected to halt about 60 projects as they will not be able to fit into the pollution cap. In addition, the regulation directly addresses methane and nitrous oxide, due to their higher global warming impact, with the Climate Change Authority to review methane measurement, verification, and reporting.

Recognising concerns about the scale and integrity of carbon offsets there is also a requirement that any facility claiming more than 30% of reductions via carbon offsets explain its position. An outright limit on the use of carbon offsets was not included, given current technology has not made it viable for some industries like cement to meet their emission targets without the use of offset.

Responsible Investment Association Australasia (RIAA) notes that "the Safeguard Mechanism (SGM) legislation also establishes a credible and rising price on carbon, the key policy lever to drive an accelerated investment switch from polluting, extortionate and volatile fossil fuels to renewable energy and cleantech". This will create greater certainty by delivering "a policy architecture that will work in concert with the government's other climate, energy, and industry initiatives such as Rewiring the Nation, the National Reconstruction Fund, and the Capacity Investment Mechanism."

In overseas developments, UN members have agreed on a High Seas Treaty, highlighting increasing policy momentum to protect biodiversity. The agreement is to put in place protected marine areas to protect wildlife and biodiversity, which will help to achieve the global goal of protecting 30% of the world's international waters by 2030. At least 60 countries must adopt and ratify the treaty before it can take effect. The treaty will provide a legal framework for establishing these marine protected areas and share out the genetic resources of the high seas. The treaty will impose constraints on activities that take place in these marine protected areas and only occur if it does not damage marine life.

<https://climatechampions.unfccc.int/why-the-high-seas-treaty-is-a-breakthrough-for-the-ocean-and-the-planet/#:~:text=The%20new%20High%20Seas%20Treaty,benefits%20from%20marine%20genetic%20resources>

The Bank of England (BoE) has released a report on climate-related risks and the regulatory framework updating the Climate Change Adaptation Report (CCAR). The report sets out the BoE's latest findings on how climate change will impact financial firms it regulates, including consideration over whether banks and insurers are sufficiently capitalized for future climate-related losses, appropriate accounting for climate change, including

promoting the implementation of consistent and comparable disclosure standards for climate risks, including the International Sustainability Standards Board (ISSB).

<https://www.bankofengland.co.uk/prudential-regulation/publication/2023/report-on-climate-related-risks-and-the-regulatory-capital-frameworks>

Canada's financial regulator, the Office of the Superintendent of Financial Institutions (OSFI), issued its first prudential framework for banks and insurance companies to manage and disclose climate-related risks. The regulator did not mandate specific increases in capital buffers to deal with climate-related risks or assignment of higher risk factors and capital requirements to fossil-fuel lending and investments. Risk management recommendations centred on management accountability and compensation policies, and disclosure on climate risk plans, including metrics used to assess climate risk and targets/commitments by 2024. Scope 3 disclosures were deferred to end 2025.

<https://www.osfi-bsif.gc.ca/Eng/osfi-bsif/med/Pages/b15-nr.aspx>

Republican efforts to make investment management the latest area for a culture war have led President Biden to issue his first-ever veto, blocking a move to stop retirement fund managers from considering environmental and social concerns — or ESG — in their investments.

"There is extensive evidence showing that environmental, social, and governance factors can have a material impact on markets, industries, and businesses," Biden wrote in a message to the House accompanying his decision.

<https://www.vox.com/politics/2023/3/20/23643243/joe-biden-veto-esg-republicans-woke-capitalism>

Lastly for this month, reflecting trends globally the level of scrutiny on Australian organisations has ratcheted up with the Australian Securities and Investments Commission (ASIC's) legal action against a major superannuation fund for greenwashing and the Australian Competition and Consumer Commission (ACCC) announcing an investigation into several businesses about their environmental or sustainability claims.

Simon O'Connor, head of the Responsible Investment Association of Australasia (RIAA), says the ASIC case is a huge warning for the industry on both sides of the Tasman. "It's very clear what the regulators are focused on; they want to see absolute precision and no vagueness in terms of the language used because there is a risk of consumers being misled. "Where there's room for consumers to be misled, they will be very concerned, and they are going to protect consumers. This is a massive warning for managers and providers across our region."

Outlook

Australian bond yields are expected to oscillate in a wide range, with current yields toward the bottom end of that range. The range trading nature of bonds reflects the expected downward activity pressure due to already tightened financial settings countered by persistent services inflation and central bank efforts to prevent a wage and inflation spiral.

The central bank cash rate tightening cycle amongst dollar bloc countries is not yet but very close to completion. The offshore banking sector "crisis" drove markets to factor in a swift global hard landing and a central bank pivot away from inflation containment measures. We believe this to be overdone.

Australia's variable rate mortgage regime means monetary policy

efficacy allows a lower cash rate peak than other countries. The more gradual path taken by the Reserve Bank of Australia (RBA) also reflects an intent not to lose much of the employment gains of recent years. We believe cash rates will rise to 3.85%, versus above 5% in the US and New Zealand. Australian inflation is nearly double target.

Although having peaked, the Australian system lags and the rolling wage bargaining structure suggests inflation to remain above target until at least late 2024. Therefore, cash rate reductions – particularly in Australia – are unlikely before year-end.

Importantly for global long-dated interest rates, Japanese monetary settings are likely to be modified when the new Bank of Japan Governor takes charge. Over the last decade, ultra-low bond yields and negative cash rates led Japanese funds to sell \$1.6 trillion worth of local bonds to buy overseas assets; mostly bonds. It is reasonable to expect that higher domestic rates associated with yield curve control modification will flow through to global rates.

The financial ructions of the last month did bring into sharp focus the impact of tightened financial conditions on incredibly fragmented banking markets. The swift liquidity response by the Fed and European Central Bank (ECB) stabilised financial systems to allow the continued pursuit of the inflation objectives, but the need for banking consolidation action and deposit stability among regional banks was laid bare.

The easing of inflation since late 2022 has been driven by the goods sector. Non-housing services inflation has been far stickier, in a sense responding to earlier non-services inflation. Freight costs have fallen to pre-pandemic levels. Oil prices are back to pre-Ukraine invasion levels.

Baseline effects will mean this disinflation source will (mechanically) ease. Moreover, oil may marginally add to headline inflation as the Organization of the Petroleum Exporting Countries (OPEC+) announced significant production cuts. The bounce in oil prices may have further upside given the Chinese economy is reopening from hard lockdown. Aviation fuel demand alone has doubled in the last two months.

For Australia, the labour force remains tight with unemployment at 50-year lows. Real wages have fallen over the last two years by a nearly cumulative 7%. Historically, such large, accumulated falls in real wages have led to a clawback via a wage response. In the 1970s wages responded in the third year of the OPEC-inspired inflation surge.

The rapid increase in population may remove some elements of skill shortages. However, sharp population growth will add to rental inflation. It typically takes five years for a housing supply response to population surges. Higher mortgage rates are being passed through to causing "rental stress".

Energy prices are expected to rise by 15% over the next year. This is not a function of increasing demand, but rather supply constraints. According to the RBA, "supply-side factors cannot be a reason to tolerate higher inflation on an ongoing basis. Dealing with supply-side issues will be harder, not easier if inflation stays high for too long.

With an approximate midpoint in 10-year Australian sovereign 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.

The pricing of interest rate cuts as soon as at the August meeting is premature. Indeed, we believe there to be another 25 basis point

rate rise likely after the April Consumer Price Index (CPI) data.

The daily accrual of inflation-linked bonds is more than twice that of the equivalent nominal sovereign bond, given headline inflation of around 8% and 10-year nominal bonds of around 3.2% (at the time of writing).

Additionally, the portfolio's inflation strategy is actively managed. The current "Break-Even" Inflation mid-point is 2.45%. We foresee adding to the inflation exposure when the 10-year breakeven falls to around 2.2%

The greater certainty surrounding peak central bank cash rates and peak inflation allows market volatility to fall. The strong link between volatility and credit spreads provides a tailwind for high-grade credit and semi-government holdings relative to sovereigns. The mid-month offshore banking issues shifted the margin of high-grade non-sovereign to more attractive levels. There is a distinction with high yield, however, given the increasing likelihood of loss given default in a recession.

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 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.

Sector Profile

Asset Class	Portfolio %	Benchmark %
Supranationals	8.17	3.87
Industrials	13.65	2.09
Financials	22.00	1.90
Asset Backed	10.12	0.00
Agencies	11.04	0.53
11AM	0.98	0.00
Cash at Bank	0.88	0.00
RBA Cash	0.00	50.00
Sovereigns	10.24	27.52
Semi Government	22.92	14.10

Ratings Exposure

Rating	Portfolio %	Benchmark %
A	15.53	1.28
AA	28.15	13.63
AAA	40.79	33.68
BBB	15.54	1.42
RBA Cash	0.00	50.00

Top 20 Issuers

Issuer	Portfolio %	Benchmark %
New South Wales Treasury Corp.	10.96	3.64
Government of Australia	9.56	27.52
National Housing Finance & Investment Corp.	7.79	0.06
Queensland Treasury Corp.	5.50	3.36
Commonwealth Bank of Australia	3.41	0.20
Treasury Corporation of Victoria	3.40	3.73
Australia and New Zealand Banking Group Limited	2.96	0.18
NBN Co. Ltd.	2.24	0.13
National Australia Bank Limited	2.02	0.21
KfW	1.93	0.50
Australian Capital Territory	1.84	0.32
Airservices Australia	1.74	0.05
Suncorp Group Limited	1.73	0.02
Woolworths Group Limited	1.65	0.07
Wesfarmers Limited	1.63	0.03
BPCE SA	1.57	0.06
Kommunalbanken AS (Norway)	1.50	0.30
Suncorp-Metway Ltd.	1.32	0.06
REDS EHP Trust Series 2021-1	1.28	0.00
European Investment Bank	1.24	0.48



Ratings / Awards



Portfolio Summary Statistics

	Portfolio	Benchmark
Yield to maturity (%)	4.03	1.76
Modified duration (years)	1.81	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)	\$192.30m
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.

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

Important Information

Units in the Altius Sustainable Bond Fund are issued by Australian Unity Funds Management Limited ABN 60 071 497 115, AFS Licence No. 234454 as responsible entity of the fund. The information in this document is general information only and is not based on the objectives, financial situation or needs of any particular investor. In deciding whether to acquire, hold or dispose of the product you should obtain a copy of the current Product Disclosure Statement (PDS), Additional Information Document (AID) and Target Market Determination (TMD) and consider whether the product is appropriate for you. Copies are available at www.australianunity.com.au/wealth or by calling us on 1300 997 774 or +61 3 9616 8687 (if calling from overseas). Past performance is not a reliable indicator of future performance. This document is updated monthly and is current at the time of publishing. We may change the investment characteristics of the fund at any time. This information is intended for recipients in Australia only. Not to be reproduced without permission.

Bloomberg Finance L.P. and its affiliates (collectively, "Bloomberg") do not approve or endorse this material and disclaim all liability for any loss or damage of any kind arising out of the use of all or any part of this material.

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. The Responsible Investment Certification program does not constitute financial product advice. Neither the Certification symbol nor RIAA recommends to any person any financial product is a suitable investment or that returns are guaranteed. RIAA does not hold an Australian Financial Service License.

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.

The Zenith Investment Partners ("Zenith") Australian Financial Services License No. 226872 rating (assigned June 2021) referred to in this document is limited to "General Advice" (s766B Corporations Act 2001) for Wholesale clients only. This advice has been prepared without taking into account the objectives, financial situation or needs of any individual and is subject to change at any time without prior notice. It is not a specific recommendation to purchase, sell or hold the relevant product(s). Investors should seek independent financial advice before making an investment decision and should consider the appropriateness of this advice in light of their own objectives, financial situation and needs. Investors should obtain a copy of and consider the PDS or offer document before making any decision and refer to the full Zenith Product Assessment available on the Zenith website. Past performance is not an indication of future performance. Zenith usually charges the product issuer, fund manager or related party to conduct Product Assessments. Full details regarding Zenith's methodology, ratings definitions and regulatory compliance are available on our Product Assessments and at: <http://www.zenithpartners.com.au/RegulatoryGuidelines>

The rating issued 08/2021 is published by Lonsec Research Pty Ltd ABN 11 151 658 561 AFSL 421 445 (Lonsec). Ratings are general advice only, and have been prepared without taking account of your objectives, financial situation or needs. Consider your personal circumstances, read the product disclosure statement and seek independent financial advice before investing. The rating is not a recommendation to purchase, sell or hold any product. Past performance information is not indicative of future performance. Ratings are subject to change without notice and Lonsec assumes no obligation to update. Lonsec uses objective criteria and receives a fee from the Fund Manager. Visit lonsec.com.au for ratings information and to access the full report. © 2021 Lonsec. All rights reserved.