Altius Sustainable Bond Fund

Fund Update
30 September 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 30 September 2023

	1 mth %	3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	7 yrs % p.a.	Since inception % p.a.
Gross total return	(0.83)	0.48	4.75	(0.63)	0.97	1.30	2.11
Net total return	(0.87)	0.36	4.24	(1.16)	0.36	0.67	1.46
Benchmark	(0.60)	0.37	2.60	(1.25)	0.81	1.00	1.63
Excess to benchmark	(0.27)	(0.01)	1.64	0.09	(0.45)	(0.33)	(0.17)

Inception date for performance calculations is 21 November 2014.
Gross total returns are calculated before fees and expenses and assume the reinvestment of distributions. Past performance is not a reliable indicator of future performance.
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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 Net total return.

Portfolio Performance and Activity

The big story for September was the significant bond sell-off, which sent rates to multi year highs. Both Australian and US 10-year bond yield ended September around 0.50% higher at 4.50% and 4.57% respectively. Yield curves in both markets steepened with 3-year yields in Australia rising 0.36% to 4.08% and 0.19% for US 2-year yields. Reflecting the move higher in yields, the Australian Treasury 0+ index generated a negative 1.87% return over the month with credit markets performing better with the Australian Credit 0+ index generating a negative return of 0.57%. The fund underperformed over the month by 0.23%, driven by the overweight duration position held in the fund. At the end of September, the portfolio duration was 3.41 years.

Central banks played a key role in the sell-off, as investors started to believe rates would be held higher for longer with any easing cycle pushed out further into 2024. The main catalyst was the US Federal Reserve September meeting. While the cash rate was left unchanged at 5.30%, it was the change in officials cash rate expectations that took the market by surprise. The FOMC raised their median expectations for the cash rate in 2024 by 0.50%, suggesting there would be fewer cuts in policy in 2024. Markets quickly reflected this change with the timing of the first cut pushed out to Q3 2024 from Q2 2024.

Locally, rates markets took most of their lead from the global market. The RBA again left cash rates unchanged at 4.10% with the accompanying statement largely unchanged from the August release. The bank retained a slightly hawkish bias with "some further tightening of monetary policy may be required" to bring inflation back to the target with any future change to policy being driven by incoming data and global developments. Reflecting this bias, six-month forward cash rate expectations were anchored at around 4.15% until global developments pushed the market to price in one further tightening of policy by Q1 2024.

Locally, data was mixed in September. Early in the month saw GDP come in above expectation at 0.4% for Q2 and 2.1% y/y. The breakdown highlighted the strength remained the export and government sectors. The consumer sector remains weak with discretionary spending seeing the largest fall (0.5%) since the Q3 2021 lockdowns; while non-discretionary spending increased 0.5% driven by increased rents and energy costs. Consumer weakness was highlighted with the Westpac consumer confidence index, falling 2.9 points to 80.2, close to 12 months lows and a soft August retail sales of 0.2%, with annual growth slowing to just 1.5%. Employment printed better than expected with the unemployment rate holding steady at 3.7% with the participation rate rising to 67%. The month closed with the monthly CPI release, increasing to 5.2% yoy from 4.9% yoy with the increase driven by housing (rents), fuel and food.

Credit markets outperformed the risk-off sentiment seen with equity markets in September. Markets were buoyed by a strong technical backdrop, with US high grade credit funds seeing strong broad-based inflows, driven by high all-in yields, providing a solid foundation for outperformance. This was coupled with light supply in the US markets. A surprise over September was the strength of the US economy despite the higher yield environment. This strength was a core driver of the soft-landing narrative which was a further positive for credit market sentiment. Locally, financial spreads drifted a little wider with 3 year and 5 years Major bank margins closing 2 and 3bpts higher at 0.74% and 0.94% respectively. Bank subordinated debt had a far more volatile month with 10NC5 debt opening at a margin of 1.89% before widening to 2% in the second half of the month, before strong support entered the market to drive spreads back to their opening levels. The standout for the month was industrial credit with spreads contracting 5bpts to close at 1.30%.

Unlike the US market domestic supply was strong in September, with issuance dominated by financials. Over the month issuance exceeded 10bn. Macquarie Bank returned after a few years absent issuing 1.75bn for three years at a margin of 0.92%. Westpac was the only other domestic financial, issuing $2.4bn for five years at 0.93%. International financials dominated in September with deals from Toronto Dominion, Mizuho, RBC and Svenska Handelsbanken. All transactions were well supported with deals being oversubscribed and pricing being lowered during the book building process. Chorus Ltd, New Zealand's broadband provider was the only corporate transaction of the month. Chorus issued $300m for seven years at a margin of 1.73% with the deal receiving $1.3bn of interest and the margin being lowered from 1.80%.

Socially Responsible Investments in Focus

EU banking supervisors will likely be given new powers to assess bank climate transition plans as a component of the supervisory review and evaluation process (SREP), used by European financial regulators to set their capital levels (known as Pillar 2). This move would help to standardise best practices on climate and environmental risk management among banks or risk having to set aside larger amounts of capital to absorb potential losses. (Source: Responsible Investor). The EU will also stop companies advertising claims for carbon or climate neutral without proof of 'recognised excellent environmental performance'. Claims based on emissions offsetting and those with green labels that are not from approved sustainability schemes will be prohibited. This will add to the pressure on carbon offsetting schemes to improve the credibility and effectiveness of their carbon credits.

The final framework on nature-related risk management and disclosure has been released and although not mandatory at this stage, provides a guide to help market participants identify, assess, and disclose nature-related issues. They are consistent with the TCFD, ISSB and GRI standards and aligned to the requirement of Target 15 of the Global Biodiversity Framework for corporate reporting. Disclosures should be provided alongside financial statements as part of the same reporting package to provide decision useful information. guidance will be developed to provide specific additional guidance, with sectors with the most significant dependencies and impacts on nature to be prioritised. For example, banks will be required to map the location of each asset to understand how nature risks could impact their lending books or portfolios.

The EU Commission also announced an anti-subsidy investigation into Chinese electric vehicles that are purportedly "distorting" the EU market, a probe that could constitute one of the largest trade cases launched given the scale of the market. Member states, notably France, has demanded action against Chinese carmakers in Europe as concerns grow over the risk of major domestic carmakers losing their leadership. The action was also applauded to prevent a replay of what happened to its solar industry in the early 2010s when photovoltaic manufacturers undercut by cheap Chinese imports went into insolvency.

Locally, South Australia is on track to get 100% of its electricity from solar and wind by 2027, increasing the challenge to create sources of more demand in the middle of the day to soak up excess energy. Potential solutions are more battery storage, shift hot water services, new industrial demand and green hydrogen production.

QLD has become the first state to implement the Modern Homes standards under the new Construction Code 2022 (NCC 2022), with a phased approach to the National with implementation from 1 Oct 23 through to 1 May 25. New residential properties in QLD will thus be built to the national minimum standard, with tougher energy efficiency and accessibility standards as well as higher energy ratings for features such as ceiling fans or hot water systems. New buildings must meet a new minimum energy Nationwide House Energy Rating Scheme (NatHERS) star rating of seven out of 10, rather than six previously. The new code is expected to reduce emissions by 1.64 million tonnes and would assist in Australia reaching its goal of net zero by 2050.

AP Møller-Maersk, the container shipping giant, has set up a new company called C2X to produce green methanol close to the Suez Canal in Egypt, the port of Huelva in Spain, and the US, India, and Australia. The shipping industry remains almost entirely dependent on fossil fuels and accounts for about 3% of global greenhouse gas emissions, according to the OECD. Maersk has previously hit out at the oil industry for not producing cheap enough green fuel, leading to it founding C2X as shipping proves to be one of the hardest sectors worldwide to decarbonise. Critics of green methanol had pointed out the need for CO_2 to produce the e-fuel, to which Maersk responded that finding a "biological" and not fossil source of carbon was "very hard" and that C2X would probably need to get it via carbon capture projects.

Outlook

Australian inflation has peaked and on a descending path. Goods inflation has reduced significantly.

Labour market conditions remain tight. The Australian wage response to date has seen wage claims lift appreciably, though not as high as inflation. Population growth is pressuring housing supply. This should mean inflation eases from a high level, but over an elongated period of time.

While oil prices have eased after a recent surge, they do remain high, particularly in Australian dollar terms. In the short term this will lift headline inflation. Were the elevation of petrol and energy prices to be prolonged, a wage response would likely lead to cash rate increases from the RBA. The recent easing does however suggest the lift in costs to be temporary and insufficient to increase inflation expectations. The global rise in oil prices have additionally contributed to the "higher for longer" narrative in global bond markets.

Central banks have largely completed their rate rise cycles. Real cash rates point to restrictive settings, but rate cuts are unlikely over the medium term. The recent and considerable lift in term interest rates among nations with a fixed rate regime is a substantial tightening in financial conditions. Credit creation and money supply will be tempered. The prospect on a "soft landing" definitionally becomes incrementally more challenged.

Australia has a floating rate regime. The lift in official cash rates has impacted nearly 75% of all mortgages – not just new ones. By contrast despite mortgage rates rising by more than 4% in the US, the average interest paid on existing mortgages has only risen 0.08% Given higher rate only effect new borrowings, there are lagged effects in the US versus more immediate effects in Australia. New US housing activity slows while general consumer activity remains resilient and business lending moderates.

The superior efficacy of Australian cash rate rises accounts for Australia's lower cash rate of 4.1% versus 5% to 5.5% in most other dollar bloc peers. Australia's long dated interest rates, however, are higher than most global peers. 10-year swap rates are around 4.85%. This is 0.75% above cash and 0.20% above the equivalent US and UK yields. The impact of the global recalibration in long term rates suggests something of an overextension in Australia compared to peers.

Largely driven by offshore markets, the range on Australian long dated bonds has shifted higher. with an approximate midpoint in 10 year Australian sovereign bonds around 4.5%, the portfolio strategy is to actively manage duration settings; increasing or decreasing duration accordingly, but with benefit of attractive accrual. Over time, there is likely an increasing importance of duration as an insurance policy.

Shorter dated Australian Government Bond yields are only at or slightly above the expected cash rate. The portfolio has strong preference for the superior income generated by higher yielding high grade credit.

A measure of value that we find in the high grade corporate market is related to the yield on the Australian Corporate Index is higher than the dividend yield of Australian stocks as defined by the ASX 200.

The tightening of financial conditions offshore does two things. They place more pressure on banking systems. The second effect is to slow the economy where cash rate rises have less efficacy, contributing to softer economic conditions and falling inflation. For this reason, the defensive elements of duration have an increasing role to play as a hedge against the attendant threat to risk assets

Sector Profile

Asset Class	Portfolio %	Benchmark %
Supranationals	9.80	4.09
Industrials	12.51	2.17
Financials	24.01	2.03
Asset Backed	9.91	0.00
Agencies	10.27	0.53
11AM	3.18	0.00
Cash at Bank	1.50	0.00
RBA Cash	0.00	50.00
Semi Government	19.29	14.86
Sovereigns	9.52	26.32

Ratings Exposure

Rating	Portfolio %	Benchmark %
A	12.67	1.20
AA	32.08	14.91
AAA	39.83	32.44
BBB	15.41	1.45
RBA Cash	0.00	50.00

Top 20 Issuers

Issuer	Portfolio %	Benchmark %
Government of Australia	8.93	26.32
New South Wales Treasury Corp.	8.58	4.02
National Housing Finance & Investment Corp.	6.74	0.06
Treasury Corporation of Victoria	4.69	4.17
Australia and New Zealand Banking Group Limited	4.18	0.17
Commonwealth Bank of Australia	3.75	0.23
NAB 11AM A/C - Deposit Accounts	3.18	0.00
KfW	3.05	0.62
Queensland Treasury Corp.	2.85	3.26
NBN Co Limited	2.49	0.16
Australian Capital Territory	1.73	0.28
Woolworths Group Limited	1.65	0.07
Airservices Australia	1.64	0.04
Suncorp-Metway Ltd.	1.56	0.07
Wesfarmers Limited	1.56	0.03
BPCE	1.55	0.06
National Australia Bank Limited	1.52	0.24
Kommunalbanken AS (Norway)	1.44	0.23
Asian Development Bank	1.41	0.41
APOLLO Series 2023-1 Trust	1.32	0.00

Portfolio Summary Statistics

	Portfolio	Benchmark
Yield to maturity (%)	4.50	4.31
Modified duration (years)	3.37	2.49

Fund snapshot

APIR code	AUS0071AU
Inception date	21 Nov 2014
Distribution frequency	Quarterly
Minimum initial investment	$5,000
Fund size (net asset value)	$194.94m
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

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