Altius Sustainable Bond Fund

Fund Update
31 January 2024

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 2024

	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	0.31	4.03	4.73	0.41	1.43	1.85	2.38
Net total return	0.27	3.90	4.22	(0.10)	0.83	1.22	1.73
Benchmark	0.28	3.50	3.26	(0.29)	1.01	1.52	1.87
Excess to benchmark	(0.01)	0.40	0.96	0.19	(0.18)	(0.30)	(0.14)

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

Bonds were under pressure for the first half of January, driven largely by strong offshore economic data, however, yields fell later in the month to finish roughly flat. Over the month of January, 3-year bond yields fell by 0.04% to finish at 3.57% and 10-year bond yields rose by 0.05% to finish at 4.01%. The fund finished the month with total duration of 2.68 years which represented a small overweight to benchmark.

The month of January did not have an RBA meeting so the cash rate was unchanged at 4.35%. Key local economic releases in January included retail sales, employment and inflation, and all printed on the weaker side. Retail sales, combining both Nov and Dec prints, was softer than expected, which pointed to the lagged effects of cash rate rises impacting the consumer. Employment data was also soft. Although the unemployment rate remained steady at 3.9%, the details of the report were weak with 65k jobs lost over the month, all skewed towards full-time jobs, and the participation rate stepped down from 67.2% to 66.8%. Finally, CPI data was released at the end of the month and showed inflation continuing to slow, at a faster rate than both market expectations and the RBA's own forecast. This gave further weight to the fact that the RBA was finished with its hiking cycle and the next move in cash rates would be lower. Market pricing for the terminal cash rate in Australia reflected this as almost another full cut was priced by the end of the year and bonds recovered towards the end of the month. Implied cash rates have now peaked here at 4.35% and are priced to be gradually falling throughout 2024 to end the year with 0.65% of cuts.

The economic data out of the US was relatively stronger compared to locally. First up was the employment data with a solid nonfarm payrolls report across the board showing a large uplift in jobs created at 216k, a better-than-expected average hourly earnings at 4.1% and an unemployment rate that remained steady at 3.7% against a forecast 3.8%. The other significant data point released was CPI which showed a rise in headline inflation from 3.1% last month to 3.4% YoY and a core inflation print of 3.9% YoY which was higher than expected. Although core inflation continued to slow, from 4% YoY last month, it is still substantially above the Fed's target and suggests an inflation rate that could linger higher for longer. GDP for Q4 2023 also printed to the upside at 3.3% vs. 2% expected, highlighting the resilience of the US economy. This economic backdrop does not seem consistent with a central bank needing to cut interest rates imminently and the risk is that rates will have to stay higher for longer which is not reflected in the market, with 1.25% of rate cuts priced in for 2024.

Credit markets globally were mixed during January. Risk sentiment was extremely strong with global equity indices finishing the month close to record highs. This largely flowed through to global credit where US IG and European IG markets had positive performance, with spreads in those markets tightening by a few basis points. The US high-yield market was a laggard, with spreads widening 20 bps. Despite the widening, high yield spreads are still well below the 5% average of the last 30 years and pricing a goldilocks outlook for the rest of 2024. Australian financials also lagged, with major bank spreads in Australia widening by 3bp and 5bp respectively for the 3-year and 5-year tenors. The underperformance of subordinated spreads was more acute, with 10NC5 lines widening by 17bps over the month, driven by a combined $4bn issuance in subordinated T2 lines by both ANZ and NAB which repriced secondary spreads. Portfolio risk was increased slightly over January with total spread risk of 1.54 years made up of 1.21 year of credit risk and 0.33 years of asset-backed risk.

Socially Responsible Investments in Focus

The Australian Federal Government's new draft legislation on mandatory climate-related financial disclosures come as a welcome development in the corporate reporting space. The proposed law, which will require companies to report on material climate-related risks and opportunities, metrics, and targets around scope 1, 2 and 3 emissions, as part of their general financial reporting, is an important step in addressing the need for high-quality, transparent and comparable climate-related data. This will allow companies to better consider the financial implications of climate risks and opportunities, facilitate investment decisions and actionable strategies that can drive deeper decarbonisation.

The draft legislation applies to all public and proprietary companies and start dates will be staggered. Reporting for those with revenues over $500 million or assets over $1 billion, with over 500 employees and asset owners with more than $5 billion in assets is expected to commence from 1 July 2024. Medium-sized companies (>$200 million revenue, with over 250 employees) and asset owners with >$500 million assets will be required to commence reporting from July 2026. Smaller companies (revenues >$50 million, over 100 employees or assets over $25 million) will commence reporting in July 2027.

https://ministers.treasury.gov.au/ministers/jim-chalmers-2022/media-releases/new-climate-reporting-reforms-stronger-financial-system

A report by the ECB and the European Systemic Risk Board (ESRB), has found that EU banks' lending to high-emitting sectors is around 75% higher than its equivalent share in economic activity. At the same time, around 60-80% of all mortgage lending in the Euro area is to high-emitting households.

The report also found that 75% of EU financial institution's loans and more than 30% of insurer investments in corporate bonds and equity are in sectors heavily reliant on at least one ecosystem service. These include services relating to surface & groundwater, mass stabilisation & erosion control, and flood & storm protection.

Furthermore, climate risk is not distributed evenly but concentrated in a subset of banks, which could lead to a 60% increase in lending portfolio losses in the event of a disorderly transition.

Climate shocks can lead to abrupt financial market repricing and the insurance protection gap across Euro area countries is noteworthy, with only 25% of average climate losses currently insured (and up to 95% of climate losses remaining uninsured in some countries). This is likely to worsen if climate shocks continue and can leave financial institutions and governments heavily exposed to climate losses.

The report proposes an additional capital requirement to strengthen the macroprudential framework, increase loss absorption capacity of banks, and influence the appeal of loans more exposed to climate risk. Specifically, it proposes to apply multiple rates to different risk buckets or different sectoral segmentations. It estimates that a one percentage increase in capital requirements could reduce credit growth by up to six percentage points.

https://www.ecb.europa.eu/press/pr/date/2023/html/ecb.pr231218_1~6b3bea9532.en.html

The Global Reporting Initiative (GRI) has launched "GRI 101: Biodiversity 2024", a major update to its Biodiversity Standard aimed to help companies disclose on most significant biodiversity impacts. The GRI collaborated with the TNFD, EFRAG, SBTN and WBA Nature Benchmark to support alignment between the reporting standards and systems.

The new reporting standard will set a new bar for transparency on biodiversity impacts. It will support detailed, location-specific reporting, both within an organisation's operations and throughout its supply chain, to help stakeholders identify, assess and manage the impacts on biodiversity.

GRI will pilot the use of the standard over the next 2 years with formal effect for reporting on 1 Jan 2026.

https://www.globalreporting.org/news/news-center/transparency-standard-to-inform-global-response-to-biodiversity-crisis/

The EU has adopted new legislation to phase out fluorinated gases and ozone-depleting substances. The rules are expected to eliminate 500 million tonnes of CO2-e emissions by 2050, in line with the Paris Agreement and roughly the combined annual emissions of France and Belgium.

The legislation targets fluorinated gases (F-gases) and ozone-depleting substances (OSDs) which are used in a range of industrial applications and found in appliances. An export ban will also ensure obsolete equipment containing such gases are not sold to countries outside the EU and incentives will be provided for climate-friendly alternatives.

Specific dates have been set out for the complete phase-out of the use of F-gases with at worst a 2035 target across all appliances. Strictly limited exemptions such as the use of OSDs as feedstock to produce other substances combined with a requirement to recover OSDs for destruction, recycling, or reclamation to cover sectors such as building materials (insulation foams), refrigeration, air conditioning and heat pump equipment, fire protection systems, and fire extinguishers, where technically and economically feasible.

https://climate.ec.europa.eu/eu-action/fluorinated-greenhouse-gases/eu-legislation-control-f-gases_en

Outlook

Global goods inflation has retreated but the tension between activity and employment data, and the trajectory of services inflation is expected to manifest in oscillating market reactions. The lags in the effect of interest rate adjustments, timing of data and of wage responses ensure a degree of volatility. The slow but non-linear fall in inflation biases yields lower though with reasonably wide ranges.

Unemployment is beginning to track higher, but still below 4%. We expect lower headline inflation and a less supply-constrained labour market to allow more modest wage growth compared to last year. The cumulative negative wage growth of the last three years likely sees wages react over a longer time horizon, rather than acutely.

Annual Australian inflation has now fallen from 7.8% at end 2022 to 3.7% at end 2023. Core inflation has eased from 5.1% to 4.2%. Inflation has fallen largely through goods disinflation with services inflation proving resilient.

Altius' expected flow-through of the reversal in the surge of global oil prices came to fruition. The disinflationary pulse from the 27% fall in Australian dollar terms saw the fall in transport costs flow through to the CPI.

Rent and other housing-related items are a key driver behind domestic inflation. The various government rental subsidies trimmed rent inflation to 0.9%.

These two items contributed to the Reserve Bank not lifting cash rates. They are unlikely to be repeated in the coming quarter with goods disinflation finding some resistance, thus pushing back on the quantum of cash rate cuts implied in the market by year end.

Global oil prices have stabilized at prices slightly higher than December's prices,

Rental subsidies expire over the coming quarter. Without the subsidies, rents would have lifted 2.2%. New (almost uniformly higher) rents are captured in the next CPI calculation.

The Red Sea conflicts have increased freight rates by about 25%. Insurance costs have lifted to a little less than 1% of hull costs (normally 0.1% to 0.2%), since December. Those containers that travel Asia-Europe via Sothern Africa now take an extra two weeks with higher fuel costs.

The more flexible US economy has seen inflation fall to 3.4%, despite considerable fiscal expansion. Both core and headline are tracking at around 3.2% on a six-month annualised basis.

Fed Governor Powell articulated that the Fed won't wait until inflation reaches 2% before easing interest rates. Cash rates at 5.37% and inflation at 2% leave real cash rates as tight as any time over the last 30 years. The US appears closer to trimming of cash rates whereby cash rates can be reduced but keep monetary settings slightly restrictive. The one hundred basis points fall in long-dated US Treasuries has already meaningfully eased monetary conditions.

The range on Australian long-dated bonds is expected to oscillate around a midpoint in 10-year Australian sovereign bonds of 4.0% with the expected evolution of inflation to allow long bonds to move lower to around 3.75%.

We expect the implied cash rate to remain unchanged over the first half of the year, but following the commencement of a US easing and the lags in the RBA reaction function to the clarifying inflation backdrop, rate cuts are a possibility late in the third quarter.

The portfolio strategy is to actively manage duration settings; incrementally increasing duration above 4.0% or decreasing duration accordingly.

With cash rates above 4% over much of the immediate investment horizon, there is a significant benefit of attractive accrual across the yield curve and capital gains from roll down on fixed-rate corporate bonds.

The portfolio has a strong preference for the superior income generated by higher-yielding high-grade credit. Non-cyclical consumer and financials, including senior and subordinated securities, we believe to be the standout.

A further measure of value that we find in the high-grade corporate market is related to the yield on the Australian Corporate Index being higher than the dividend yield of Australian stocks as defined by the ASX 200. To illustrate at the time of writing, the CBA dividend yield is around 3.8%. By comparison, the higher-ranking CBA (10-year) subordinated bond yields above 6%.

Sector Profile

Asset Class	Portfolio %	Benchmark %
Supranationals	9.27	3.98
Industrials	14.24	2.22
Financials	31.49	2.16
Asset Backed	10.37	0.00
Agencies	6.39	0.52
11AM	5.05	0.00
Cash at Bank	0.05	0.00
RBA Cash	0.00	50.00
Semi Government	22.25	15.02
Sovereigns	0.90	26.10

Ratings Exposure

Rating	Portfolio %	Benchmark %
A	14.41	1.33
AA	38.75	15.30
AAA	24.57	31.92
BBB	22.27	1.45
RBA Cash	0.00	50.00

Top 20 Issuers

Issuer	Portfolio %	Benchmark %
New South Wales Treasury Corp.	10.70	4.20
Treasury Corporation of Victoria	5.50	4.23
Australia and New Zealand Banking Group Limited	4.98	0.20
Westpac Banking Corporation	4.02	0.25
NAB 11AM A/C - Deposit Accounts	3.90	0.00
Commonwealth Bank of Australia	3.76	0.21
Queensland Treasury Corp.	3.61	3.29
KfW	3.29	0.62
National Australia Bank Limited	2.93	0.27
NBN Co Limited	2.81	0.15
Housing Australia	2.40	0.08
Suncorp-Metway Ltd.	2.23	0.08
Airservices Australia	1.87	0.04
Woolworths Group Limited	1.86	0.08
BPCE Societe anonyme a directoire et conseil de surveillance	1.80	0.07
Wesfarmers Limited	1.80	0.03
International Bank for Reconstruction & Development	1.76	0.38
Kommunalbanken AS (Norway)	1.60	0.23
APOLLO Series 2023-1 Trust	1.50	0.00
Macquarie Bank Limited	1.48	0.05

Portfolio Summary Statistics

	Portfolio	Benchmark
Yield to maturity (%)	5.26	4.23
Modified duration (years)	2.68	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)	$173.24m
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.

CERTIFIED BY RIAA

Ratings / Awards

Investment Grade Lonsec Research

Zenith APPROVED

2016 Innovation Winner Lonsec

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