ALTIUS ASSET MANAGEMENT | Australian Unity Real Wellbeing

Altius Sustainable Bond Fund

Fund Update
31 December 2022

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 December 2022

	1 mth %	3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	7 yrs % p.a.	Since inception % p.a.
Gross Return	(0.49)	1.21	(4.07)	(0.82)	0.70	1.51	1.88
Benchmark	(0.90)	0.55	(4.32)	(1.13)	0.73	1.22	1.53
Excess to benchmark	0.41	0.66	0.25	0.31	(0.03)	0.29	0.35

Inception date for performance calculations is 21 November 2014.
Gross Returns are calculated before 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 Gross Return.

Portfolio Performance and Activity

2022 will go down in living history as one of the worst years for global bond markets. With inflation hitting multi-decade highs and central banks embarking on the most aggressive tightening cycle in generations bond yields moved aggressively higher. After Australian three- and 10-year bond started the year at 0.91% and 1.67% they rose to finish at 3.50% and 4.05% respectively. This led to negative absolute returns in the three-to-five-year and seven-to-10-year Treasury index of -5.6% and -14.36%. In the United States (US), the Treasury index fell -12.5%, its worst annual result since 1973. Deutsche Bank reported that US 10-year Treasuries had their worst year on a total return basis since 1788. Sovereign returns in Europe and the United Kingdom (UK) were even worse, with the European sovereign index down -18.4% while UK gilts were down a whopping -25% amidst the political turmoil.

The month of December reflected the previous 11 months with markets remaining heavily focused on inflation, central banks tightening cycles and how the economy would respond in 2023. As expected, the key events in December included the release of the US Consumer Price Index (CPI), the US Federal Reserve and Reserve Bank of Australia (RBA) monetary policy decisions and the local employment and Gross Domestic Product (GDP) releases. Locally three- and 10-year bonds rose 0.33% and 0.52% respectively to finish at 3.50% and 4.05%. The portfolio entered December with 2.24 years of interest rate risk before being reduced to 1.92 years. This position was maintained throughout the month before being closed out in the last days of the year.

Following the release of a soft US CPI number in October, attention turned to the November release to confirm whether US inflation had moved past its peak. Like October, the release printed on the weaker side of expectations. Headline inflation moved down to 7.1%, the fifth consecutive month of slowing and well off the June peak of 9.1%, with energy seeing the largest fall, while housing was the largest monthly contributor. Core inflation fell to 6% from 6.3% after peaking at 6.6% in September. The release of the softer CPI print strengthened the case for the US Federal Reserve to step down the size of policy tightening at the December meeting.

As largely expected, the US Federal Reserve stepped down its tightening of policy to 0.50% from 0.75% in December. While the market had fully priced this outcome it was the accompanying policy statement and Chairman Powell's press conference that gathered the most attention. While noting the recent CPI had been welcome news and provided some confidence that it would head lower over 2023, he stopped short of declaring victory. Instead, the Chair continued to emphasize that rates needed to be higher and for a longer period, noting the "strong view on the Committee is that we need to stay there until we are confident that inflation is coming down in a sustained way and I think that will be some time". This view was also reflected in the Fed's policy assumptions that had the terminal cash rate rising to 5.1% up 0.50% from the September forecasts and with no easing of policy projected until 2024. These projections continued to push hard against the market's view that policy could be eased in late 2023.

Locally, the RBA increased cash rates by 0.25% to 3.10%, fully priced by the market. The RBA noted that inflation should peak by year-end at around 8% before falling over 2023-24 and that medium-term inflation expectations remained well anchored. Economic growth remained solid, and the labour force remained very tight, with unemployment at a 50-year low which is leading to a pick-up in wage growth. The evolution of the wages story will be a key determinant of policy over 2023. The final key takeaway from the RBA decision was that rates were expected to be increased further over the period ahead, "but it is not on a pre-set course". This was further elaborated on in the RBA minutes where the board discussed the arguments for a 0.50% or 0.25% tightening and no change to policy.

From a local interest rate policy perspective, the two key releases were the monthly employment numbers and the Q3 GDP release. Employment remained strong with an additional 64k full-time jobs generated, the participation rate returned to the recent highs of 66.8 and the unemployment rate remained at a 50-year low of

3.4%. With the continuation of a strong employment market, upward pressure on wage growth will remain in 2023. While the GDP figures were slightly below expectations at 5.9% YoY it was the inflation and wages components that generated the most interest. The broadest measure of consumer inflation (the household consumption indicator) had its highest quarterly reading since 1990 (outside of the GST introduction) of 2%, beating the previous quarterly increase of 1.5% and taking the annual rate to 6%. Wages picked up sharply with compensation per employee up 2.5% quarter on quarter (q/q) and 4.8% Year on Year (YoY), boosted by the increase in superannuation and by the minimum wage. Both these indicators will be keenly watched by the market in 2023 as the RBA gets closer to a pause in the tightening cycle.

Credit continued to perform well during December, in a move that has been supported by increasing evidence of a slowing in inflation, a stepping down globally in the size of policy tightening and better-performing equity markets. The move into the Christmas period saw primary activity significantly slow adding to the positive technical backdrop. While senior bank spreads were unchanged over the month with three and five years closing at a margin of 0.79% and 1.01% respectively, it was bank-subordinated debt that was the stand-out performer. Risk spreads on Major bank subordinated debt contracted from 0.24% to 2.29% well off the high of 2.90% seen in October. On the corporate front spreads contracted between 0.03% to 0.06% over the month with the strongest performance coming from sectors with regulated cash flows such as utilities while Real Estate Investment Trusts (REITs) were towards the bottom of the corporate market performance in December.

Socially Responsible Investments in Focus

December was a big month for sustainable finance in Australia with the Government releasing a consultation paper on the development of an Australian climate risk disclosure framework. The framework will be consistent with internationally comparable disclosure, and it's expected that reporting will be mandatory for large entities, being phased in over time. The consultation period is open until 17th February 2023. Additionally, the Government has tasked Treasury with developing a comprehensive sustainable finance strategy which will include "a range of measures to improve transparency, deepen Australia's green finance markets, and seize opportunities presented by surging global momentum in sustainable finance". Importantly the strategy will include the development of Australian taxonomy which will support the development of the sustainable finance market and assist in reducing greenwashing and strengthening Environmental, Social and Corporate Governance (ESG) labelling of financial products. The development of this strategy aligns with the progress already made with the legislation of Australia's net zero commitment by 2050 and the updated nationally determined contributions (NDC) targets of a 43% reduction of carbon emissions by 2030.

The Government announcement was followed by the release of the Australian Sustainable Finance Institutes (ASFI) framing paper "Designing Australia's Sustainable Finance Taxonomy". The document provides design consideration including the key principles, purpose, objectives, sectorial prioritization, governance and timelines for the development of an Australian Taxonomy. Post the consultation period ASFI will commence work on the governance structure, expected to be completed in mid-2023 and then move on to the technical screening criteria for the priority sectors. This is expected to run until mid-2025. While climate change adaptation was deemed highly important, climate change mitigation was seen as the most pressing concern. A lack of clear and credible guidance on the type of activities that are aligned with the government's Net Zero Commitments only hinders Australia's climate progress. Post completion of the taxonomy, financial institutions will be able to identify economic activities that address key environmental and social objectives, such as alignment to the Paris Agreement, biodiversity risks and opportunities and key Government climate objectives. The taxonomy will also provide local regulators with the option of incorporating sustainable finance into prudential standards, allow a strengthening of sustainable labelling standards for financial products and assist in addressing greenwashing.

The UN Biodiversity Conference (COP 15) was held in December and the unveiling of the Kunming-Montreal Global Biodiversity Framework has been held out as biodiversity's Paris Agreement moment. Parties agreed to the landmark agreement to guide global action on biodiversity through 2030. The proposed Global Biodiversity Framework (GBF) consists of four key goals to protect nature and 23 targets. Goal A includes substantially increasing the area of natural ecosystems by 2050, halting of human-induced extinction of critically endangered species and reducing the extinction rate of all species tenfold by 2050. Goal B: Biodiversity is sustainably used and managed and ecosystem functions and services are valued, maintained and enhanced with ecosystems in decline being restored. Goal C: Monetary and non-monetary fair sharing of genetic resources, digital sequencing of genetic information and of traditional knowledge as it relates to genetic resources and Goal D: Implementation, including financial, technical, and scientific resources needed to implement the framework with particular focus on the least developed countries. Among the key targets agreed upon included the following (https://www.cbd.int/article/cop15-cbd-press-release-final-19dec2022)

- Effective conservation and management of at least 30 per cent of the world's land, coastal areas and oceans. Currently, 17 per cent of land and 10 per cent of marine areas are under protection.
- Restoration of at least 30 per cent of degraded terrestrial, inland waters and coastal and marine ecosystems.
- Reduce to near zero the loss of areas of high biodiversity importance and high ecological integrity.
- Halving global food waste.
- Phasing out or reforming subsidies that harm biodiversity by at least $500 billion per year, while scaling up positive incentives for biodiversity conservation and sustainable use.
- Mobilizing at least $200 billion per year from public and private sources for biodiversity-related funding.
- Raising international financial flows from developed to developing countries to at least US$ 30 billion per year by 2030.
- Requiring transnational companies and financial institutions to monitor, assess, and transparently disclose risks and impacts on biodiversity through their operations, portfolios, supply and value chains.

Outlook

The European Central Bank and Bank of Japan have a significant impact on global markets Their ultra-low (for the most part negative) interest rate settings have provided a downward force bias to most interest rate markets for the past decade.

The overdue European Central Bank (ECB) announcement of

Quantitative Tightening and somewhat unexpected decision by the Bank of Japan to allow a 25 basis point rise in their yield curve control point have lifted long-dated bond yields. The rise in the "global floor" in interest rates has allowed other yields to trade higher; thus tightening financial conditions in the US and other economies with longer date fixed-rate lending regimes.

Dollar bloc bond markets are advanced in their tightening cycle, with the likelihood of peak cash rates being realized during the first half of 2023.

Australian bond yields are expected to oscillate in a wide range, with current yields (attractive) toward the top 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 falling rapidly as supply chain bottlenecks resolve and softer demand is observed, and supply overhang is emerging. Oil prices are 35% below their peak. Rental inflation is still rising in Australia, though has peaked in other major economies. 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 services costs.

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.

Australian implied cash rate expectations are fairly priced, as two forces compete.

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 annualized 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's) policy guidance.

A significant increase in the number of Australian fixed mortgage borrowers will convert to floating – at rates 3.5-5% higher – 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.

We expect the peak in Australian headline inflation to be delivered in this month's Consumer Price Index (CPI) release. Absent any extension to this peak, we believe Australian cash rates peak in Q2 2023 at 3.6%. 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.

The portfolio retains an inflation hedging strategy by actively managing a holding of inflation-linked bonds. The current "Break-Even" Inflation mid-point is 2.4%. That inflation is expected to remain elevated, though below its peak, determines that the indexation drives income accrual higher than the nominal equivalent; noting that nominal yields are also attractive at the top end of the range. Moreover, should inflation become more acute, the value of the inflation-linked bonds rise relative to the nominal bond overlay.

Sector Profile

Asset Class	Portfolio %	Benchmark %
Australian Commonwealth Government	9.14	27.65
Supranationals	7.66	3.84
Industrials	13.26	2.21
Financials	22.37	1.93
Asset Backed	10.90	0.00
Agencies	10.47	0.47
11AM	3.59	0.00
Cash at Bank	1.27	0.00
RBA Cash	0.00	50.00
Semi Government	21.34	13.91

Ratings Exposure

Rating	Portfolio %	Benchmark %
A	14.70	1.35
AA	28.61	13.40
AAA	39.17	33.75
BBB	17.53	1.50
RBA Cash	0.00	50.00

Maturity Profile

Term	Portfolio %	Benchmark %
0 - 1 Year	7.87	53.36
1 - 3 Years	30.14	11.18
3 - 5 Years	12.81	10.00
5 - 7 Year	14.61	8.35
7+ Years	34.56	17.10

Top 20 Issuers

Issuer	Portfolio %	Benchmark %
New South Wales Treasury Corp.	10.46	3.51
Government of Australia	8.48	27.65
National Housing Finance & Investment Corp.	7.37	0.06
Queensland Treasury Corp.	4.80	3.42
Australia and New Zealand Banking Group Limited	3.75	0.21
NAB 11AM A/C - Deposit Accounts	3.59	0.00
Commonwealth Bank of Australia	3.40	0.16
Treasury Corporation of Victoria	3.18	3.58
NBN Co. Ltd.	2.18	0.13
National Australia Bank Limited	2.03	0.25
Australian Capital Territory	1.75	0.28
Suncorp Group Limited	1.74	0.02
European Investment Bank	1.69	0.46
Airservices Australia	1.63	0.05
Woolworths Group Limited	1.62	0.07
BPCE SA	1.58	0.06
REDS EHP Trust Series 2021-1	1.57	0.00
Wesfarmers Limited	1.54	0.03
Kommunalbanken AS (Norway)	1.47	0.30
Suncorp-Metway Ltd.	1.32	0.05

Portfolio Summary Statistics

	Portfolio	Benchmark
Yield to maturity (%)	5.06	2.04
Modified duration (years)	2.37	2.59

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

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