Salt Sustainable Global Shares Fund Fact Sheet – September 2022

Manager Profile

Salt Funds Management is a boutique investment management firm wholly owned by its employees which specialises in actively seeking to maximise returns while managing the risks of the investment. Salt examines investments for their environmental and social impact as well as the quality of their governance.

Investment Strategy

The Fund's investment objective is to outperform (after fees and expenses but before tax) the MSCI World (Net) Index in New Zealand dollars on a rolling three-year basis. To achieve this, the Fund targets a portfolio of global companies with high total return potential and high Environmental, Social and Governance (ESG) factor scores.

The strategy seeks to provide attractive long-term returns with less long-term volatility than the broader market by reducing the risks associated with poor ESG outcomes. The Fund will seek to achieve its investment objective by investing primarily in global equity.

Fund Facts at 30 September 2022

Benchmark	MSCI World (Net) Index in NZD
Fund Assets	$51.12 million
Inception Date	12 July 2021
Underlying Manager	Morgan Stanley Investment Management

Unit Price at 30 September 2022

Application	0.9625
Redemption	0.9585

Investment Guidelines

The guidelines for the Sustainable Global Shares Fund are:

Global Equities	95% – 100%
Cash	0% – 5%

Target investment Mix

The target investment mix for the Salt Sustainable Global Shares Fund is:

Global equities	100%

Fund Allocation at 30 September 2022

Global equities	98%
Cash	2 %

Fund Performance to 30 September 2022

Period	Fund Return*	Benchmark Return
1 month	-1.93%	-1.69%
3 months	0.37%	3.12%
6 months	-2.65%	-3.32%
1 year	-4.21%	-1.99%
Since inception	-3.96%	-1.62%

Performance is after fees and tax, but not adjusted for imputation credits. Benchmark performance is gross. Past performance is not a guarantee of future results. Data as of 30 September 2022.

Fund ESG Scores	Portfolio	Index
Sustainable Global Shares	26T CO2 /$m	162T CO2 /$m
Portfolio Carbon Footprint:	14% of MSCI AC World Index*	

Source: MISM Quarterly Investment Report, 30.9.2022 & Trucost based on the Scope 1 & 2 carbon emissions per $1million of Portfolio companies' sales, and as weighted average carbon intensity (WACI). See p.4 for further ESG details.

Top 10 holdings	
Microsoft (US)	Thermo Fisher Scientific (US)
VISA (US)	Reckitt Benckiser (UK)
Danaher (US)	Becton Dickinson (US)
Accenture (US)	Intercontinental Exchange (US)
SAP (DE)	Baxter International (US)

Source: MSIM, data as at 30 September 2022. The Top 10 Holdings represented 46.3% of the total portfolio.

Market Review

- After a strong rally at the start of the quarter, equity and bond markets sold off sharply in August and September. In USD terms, developed market equities ended the quarter 6% lower while global bonds fell 7%.
- The rally in July was supported by markets starting to price in interest rate cuts by the Federal Reserve in 2023, suggesting an economic soft landing was likely. However, in August, the Fed along with other central banks renewed their commitment to prioritise returning inflation to target over supporting growth.
- The tough talk was followed up by aggressive action as the key global central banks raised interest rates over the quarter, by 1.5% (in the US) and 1.25% (in the eurozone). Guidance indicative of further hikes saw markets price in significantly higher terminal rates as the quarter progressed.
- Headline inflation moderated in many countries as last years' increases fell out of annual calculations and prices for key commodities fell, most notably oil. However, core inflation is proving to be more stubborn and remains well in excess of central banks targets, supporting indications of more tightening to come.

- The global growth outlook continues to weaken as central banks continue to hike and signal further interest rate increases to come. The odds of a "soft landing" are diminishing in several countries.

- Despite a technical recession over the first half of 2022, the US economy remains one of the more resilient. That is especially the case for the labour market where an unemployment rate of 3.7% and nominal wage growth in excess of 5% remain inconsistent with 2% inflation.

- The energy crisis continues to dominate the headlines in Europe as Russia halted all gas flows through the Nord Stream 1 pipeline in early September. Activity data continued to weaken over the quarter and recession now appears the most likely outcome. However, with inflation still stubbornly high, the ECB will continue to hike interest rates.

- Despite better economic data recently, the Chinese economy remains fragile as it confronts a number of headwinds including its zero-Covid policy, weather-related disruptions and weakness in the housing market. But given the benign inflation environment the PBoC has eased monetary policy further and the State Council has announced new fiscal measures to support the economy.

- Fiscal policy was the hot topic in the UK towards the end of the quarter. The announcement of significant unfunded tax cuts by the new Chancellor brought a severe negative reaction from markets and intervention from the Bank of England. The package has since been partially reversed.

- In New Zealand second quarter GDP data came in stronger than expected, though the underlying detail was soft as consumer spending dropped sharply. The RBNZ raised the Official Cash rate 100bps over the quarter to 3.0% and flagged a terminal rate of 4.1% at the August Monetary Policy Statement.

- Over the fourth quarter of the year, growth conditions will continue to deteriorate as central banks continue to tighten with terminal rate likely to be met in late 2022 or early 2023.

Portfolio Review

- In September, the Portfolio returned -1.93%, slightly behind the MSCI World Net Index which returned -1.69%. The Portfolio underperformed for the third quarter (Q3), returning +0.37% (after fees) versus +3.12% for the index, measured on the gross basis.

- The month saw positive sector allocation, but negative stock selection. For sector allocation, the hit from the Information Technology overweight was outweighed by the benefit from the Portfolio's position in the defensive Health Care sector. Negative stock selection was driven by weakness in Health Care, which was partly down to our sector-level overweight in Life Sciences and Equipment rather than the Biotechnology and Pharmaceuticals sub-sectors, which were stronger in the month, as has been the case for the year as a whole. Consumer Staples was also a notable detractor. Information Technology, while stronger, was insufficient to compensate.

  For Q3 overall, the Portfolio's underperformance was also mainly due to stock selection. Most of the negative stock selection was attributable to underperformance in Health Care, Financials and Consumer Staples, although Consumer Discretionary, Information Technology and Industrials were also all notably weak. Sector allocation was also slightly negative. The Communication Services underweight did help; however, this was cancelled out by our underweight position in Consumer Discretionary and lack of exposure to Energy – the strongest performing sectors in the third quarter as a whole.

  - For the Third Quarter, the largest absolute contributors were Danaher (+52 bps), ADP (+32 bps), Amphenol (+23 bps), Intercontinental Exchange (+19 bps) and PayPal (+16bps).

  - The largest absolute detractors were AIA (-29 bps), Stanley Black & Decker (-28 bps), Baxter International (-25 bps), IQVIA (-19 bps) and TSMC (-17 bps).

Portfolio Outlook

Nine months in to 2022, and the MSCI World Index has fallen by more than a fifth in local currency terms, not helped in recent days by the Russian annexation of four provinces of Ukraine and the currency and bond crises in the UK. Remarkably, the year's fall has still been all down to de-rating, rather than any drop in forward earnings, which are actually up 3% this year, boosted by the boom in Energy profits. The market's earnings have edged down a little in the last quarter (off 2%), but this is a US dollar number, and thus easily explainable by the currency's continuing strength, which reduces earnings earned in weaker currencies. Margins remain very close to the all-time record levels recorded earlier in the year.

The market's earnings numbers are clearly not anticipating a significant slowdown, let alone a serious recession, with forward earnings expected to rise over 5% over the next year, despite the dollar headwind, and only Materials, affected by recent falls in metals prices, facing an earnings fall. The classic cyclical Industrials sector's earnings are expected to outperform the overall market over the next year, up 8%, while double digit growth is anticipated for Consumer Discretionary stocks in local currency terms.

The fall in the market multiple does suggest more wariness about future prospects than the earnings estimates do, with the MSCI World Index forward multiple dropping from 19x at the start of the year to sub-14x at the end of September. However, the new level is only 3% below the 2003-2019 average, with the c.20x multiples of 2020-21 looking like the outlier. The defensive sectors have outperformed, as Consumer Staples, Health Care and Utilities have 'only' dropped 14-17% this year, but the worst performing sectors, Information Technology, Communication Services and Consumer Discretionary, all off over 30%, were the most expensive at the start of the year, rather than the most cyclical, as growthier multiples have contracted most.

In this environment, the Portfolio has not shown its historic relative lack of downside participation, falling roughly in line with the market. The de-rating has been only marginally less severe than that of the market, with the multiple of forward earnings dropping 27% as against 29% for the market.

The bias towards defensive sectors mitigated the de-rating, but the Portfolio's exposure to more expensive sub-sectors, Software & Services within Information Technology and Life Sciences & Equipment within Health Care, largely cancelled that out.

We value pricing power – the ability to pass on costs to consumers – and recurring revenue – the propensity toward repeat purchases – either due to long-term contracts or consumers' force of habit, supported by brands. The combination of the two 'superpowers' means that both margins and revenues are robust in a downturn, supporting profits.

However, at the moment, pricing power seems fairly universal given all the supply shortages, not least in staff, which have fed into inflation, shrinkflation and the dreaded skimpflation (the deterioration in services we have all suffered), meaning that fundamental cross-cycle pricing power does not provide an edge at the moment. The situation is arguably worse for recurring revenue. Long-term contracts prevent providers from exploiting high spot prices and can also cause short-term problems in passing on inflationary cost rises, at least until the contracts expire, when pricing power allows the company to catch up.

We still regard pricing power and recurring revenues as superpowers, key for compounding, the ability to grow earnings in both good times and tough times. This is crucial as we worry that the current good times for corporates may well turn into tough times in the next few quarters, with any slowdown or recession threatening the record corporate margins, as the current excess demand turns into a potential excess supply. We are less worried about the Portfolio's earnings vulnerability, as the two superpowers should again provide protection, as seen by the resilience of earnings in COVID, when the Portfolio's earnings fell by 7% versus 21% for the index. History suggests that a fall in the market's earnings has been accompanied by Portfolio outperformance alongside the resilient earnings.

The quality of the Portfolio is reflected in a significant premium, at least in earnings terms, with the Portfolio trading on a 18.5x forward multiple, a 35% premium to the index. However, the far higher return on capital of our intangible-asset driven compounders means that cash conversion is far stronger, cutting the premium to only 14% in free cash flow terms, the better measure since it is cash not earnings that is reinvested or returned to shareholders. This is for companies that are expected to grow faster, with consensus expecting 10% annual earnings growth over the next two years as against the market's 6%, but more importantly robustness of those earnings in the case of a downturn – the earnings implicit in the multiples are far more likely to actually be delivered for the Portfolio than the index as a whole, as the two superpowers provide earnings protection.

High quality is by its nature less exposed to potential adverse events. We cannot influence or even predict the macroeconomic or political or regulatory environment, but we can aim to ensure that the stocks we hold are the most robust we can find… and that the managements who run the companies that we select are more likely anticipating, mitigating, and managing resiliently through adversity.

We believe that markets have yet to fully reflect the phalanx of issues that will make the going tougher for companies from here, and that longer term all companies are likely to face greater structural cost pressures which may well pressure their earnings. As such, and as we have been signalling for some time, earnings resilience and pricing power are likely to become ever more significant assets.

With our portfolios' primary skew to quality defensive sectors, it gives us some comfort going forward that the portfolios' earnings are likely to hold up better than the market as a whole and that investors who choose active management will be vindicated.

Portfolio Activity

We initiated a position in Adobe during the quarter. Its main business, Creative Cloud, around 80% of profits, is a subscription business with 90%+ retention rates and is the industry standard. While growth appears to be slowing, it is still able to compound at a very attractive rate while offering a reasonable valuation, particularly after the share price fall triggered by the Figma acquisition, which gave us the opportunity to increase the position.

There were no final sales in the quarter. Given the sharp compression in the valuation of the growthier and more expensive names this year, we continued the process of adding to some of these names, for instance Steris and Microsoft, using the proceeds of reducing some of the names that have proved more resilient, such as Reckitt Benckiser, Abbott Laboratories and Medtronic.

Greg Fleming

Greg Fleming, MA

Sustainability metrics provided to Salt by MSIM

As of 30.9. 2022, the Portfolio's carbon footprint is 86% lower than the MSCI AC World Index's and 84% lower than the MSCI World's.

Engagement

- We engaged on 94% of our holdings across all strategies – far above the industry average of 19%* for asset managers.
- 62% of meetings with at least one vote against management
- 29% of votes on say-on-pay proposals against management
- 143 of 280 engagement meetings included discussions on ESG topics. Below are some examples.

1. Board composition, executive compensation, and sustainability governance – beverage company.

The challenge: A board composed entirely of Europeans, reservations about LTIP structure and lack of measurable ESG KPIs in pay plan.

The action: We continued to raise the issue of board diversity, the firm's hiring process and executive compensation structure.
The outcome: Encouraged to see the appointment of a female board member of Indian heritage with business experience from Asia, LTIP now 100% performance-based shares and new ESG-related targets to hold management accountable.

2. Find, Fix, Prevent – biodiversity, circular economy, supply chain management – food processing and retail conglomerate.

The challenge: Complex supply chains can create low visibility and direct control over labour conditions; water usage also a challenge.

The action: We revisited how they monitor labour conditions at suppliers' factories and pressed for more ambitious water use reduction targets.
The outcome: Confirmed our view that the company's sustainability plan is one of the most detailed and transparent in the industry. We will continue to encourage more action on garment recycling and water use.

3. You can't manage what you can't measure – decarbonisation, climate change and executive compensation - consumer credit reporting company.

The challenge: Despite strong progress on their carbon emissions reduction journey, only 34% of electricity is from renewable sources.

The action: We engaged to better understand emissions across the value chain and sought evidence they are on track with targets. We also pressed for E and S KPIs in compensation calculations.
The outcome: They acknowledged our engagement was the most in-depth meeting on decarbonisation they had experienced and were receptive to our suggestions. They outlined proposed solutions to increase renewable energy sourcing in US and EM and supplier engagement to reduce Scope 3 emissions.

* A recent report by the United Nations-supported Principles for Responsible Investment (PRI) suggests the industry average for corporate engagement is just 19% of holdings.