Salt Sustainable Income Fund Fact Sheet – October 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 aims to provide a gross fixed quarterly income (after fees and expenses but before tax) in excess of bank deposit rates, along with a positive return on capital on a rolling three-year basis. Deposit rates are proxied by the NZ Bank Bill Index.

A Reference Portfolio is provided, medium-term outperformance of which is a secondary objective, consisting of the weighted sum of components.

The Fund targets a diversified mix of growth and defensive assets, with a focus on securities with strong Environmental, Social and Governance credentials & reliable income generation. The Fund's strategy is to invest in a quality asset mix with an aim to provide regular, sustainable income and a positive return on capital. At times the value of the fund will fluctuate in line with listed market developments, but the primary focus is enhanced income and thus, shorter-term variability or volatility is an expected feature.

Income is prioritized above capital gain in the fund, nevertheless, the allocation to both growth and yielding assets allows for both objectives to operate over the medium- and longer-term horizons.

Fund Facts at 31 October 2022

Benchmark	Bank deposit rates (BNZBIL Index)
Reference portfolio	SAA-weighted component benchmark indices' performance
Fund Assets	$43.27 million
Inception Date	19 June 2021
Portfolio Manager	Greg Fleming
Current distribution yield (cents per unit) / based on Unit Price of 1 November 2022	1.00 cents per unit per Quarter / 4.58% per annum

Unit Price at 31 October 2022

Application	0.8748
Redemption	0.8712

Investment Guidelines

Sector	Target	Range
New Zealand Fixed Interest	20%	0% – 40%
International Fixed Interest	15%	0% – 40%
Australasian Shares	30%	15% – 45%
Global Listed Property	15%	0% – 30%
Global Listed Infrastructure	15%	0% – 30%
Cash or cash equivalents	5%	0% – 20%

Fund Allocation at 31 October 2022

New Zealand Fixed Interest	0%
International Fixed Interest	19%
Australasian Shares	34%
Global Listed Property	27%
Global Listed Infrastructure	18%
Cash or cash equivalents	2%

Fund Performance to 31 October 2022

Period	Fund Return	Reference Portfolio Return
1 month	1.11%	0.86%
3 months	-5.45%	-5.23%
6 months	-7.03%	-5.94%
1 year	-11.10%	-11.07%
Since inception	-8.31%	-8.99%

Performance is after all fees and does not include imputation credits or PIE tax.
Past performance is not a reliable indicator of future performance and no representation or warranty, express or implied, is made regarding future performance.

Top Individual Holdings at 31 October 2022

Goodman Property Trust	Property for Industry
Kiwi Property Group	Argosy Property Trust
Precinct Properties	Auckland International Airport
Fisher & Paykel Healthcare	Stride Property & Investment Mgt
Spark NZ	Vital Healthcare Property Trust

Holdings stated as at 31.10.22, excludes cash and consolidated International Fixed Interest Fund component of the Sustainable Income Fund due to its large number of securities.

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Market Commentary

- October month saw a moderate rebound in many markets, following the sharp corrections of the third quarter. Fixed Interest assets stabilized while equities made gains on corporate earnings.
- Despite a rough start to the month, developed market equities ended October 7% higher (in USD terms). It was a tough month for emerging markets which ended 3% lower, dragged down primarily by weakness in China.
- Bond yields continued to push higher, making new cyclical peaks of 4.2% in the US, 2.4% in Germany and 4.7% in New Zealand. Yields rallied into the close of the month.
- Inflation, central banks, recession risk and geopolitical tensions were all key foci over the month. Good news came in the form of a further reduction in supply chain constraints.
- The combination of high inflation and tight labour markets saw further aggressive action from central banks over the month. The European Central Bank hiked by 75bp, with the US Federal Reserve and the Bank of England widely expected to hike by similar amounts in early November. The Reserve Bank of New Zealand delivered a hawkish 50bp hike in the sense that the bank actively considered a larger 75bp hike.
- The interest rate outlook and rising geopolitical tensions saw the US dollar continue its inexorable rise. USD strength was most notable against the Japanese Yen and the Chinese renminbi, the currencies of the two central banks that continue to maintain an accommodative stance.
- The US economy showed signs of softening over the month, particularly in the housing market as higher mortgage rates started to bite. Flash PMIs were soft, with all forward-looking components weak. However, inflation came in stronger than expected and the labour market remains tight, keeping pressure on the FOMC. The Committee is expected to signal a slower pace of tightening into the end of the year, though the peak terminal rate remains uncertain.
- Europe announced further plans to address the energy crisis, including a proposed price cap and a common purchases system. Both should support the recent downside in energy prices. PMI data moved into recessionary territory. The ECB is continuing to prioritise inflation over growth and is expected to continue tightening, though probably at a slower pace than recently.
- Growth in China rebounded in the third quarter, though continued Covid lockdowns has seen a softening in the higher frequency activity data. Inflation remains low which we expect will lead to further interest rate cuts by the PBoC. As expected, President Xi was reappointed at 20th Party Congress.
- In Australia, activity data continues to slow. However, a higher-than-expected inflation print for the September quarter has challenged the recent decision by the RBA to reduce the pace of interest rate increases. The RBA hiked by only 25bp at its October meeting. Maintaining this slower pace risks needing to become more aggressive further down the track and causing a sharper economic downturn.
- Activity data continues to slow in New Zealand, while September quarter inflation came in stronger than expected. The HLFS report for the same period showed the labour market remains tight with very strong wage growth. Market pricing expects the RBNZ to lift its forecast terminal OCR rate at its 23 November meeting and deliver a 75bp hike.

Salt Sustainable Income Fund Commentary

The Sustainable Income Fund was aided in October by improving global asset values, rising by 1.11% (after fees.) The fund's 3-month return remained in negative territory, at -5.45% (net) as at 31 October. On the rolling six-month basis, the fund is recording a decline of -7.03% while since inception, the return was -8.31% (on an after fees basis.)

Given recent market conditions, these performance results indicate the present sensitivity of particularly income-yielding asset types to sharply higher global interest rates. Recently-weak global share and bond markets have in the short-term allowed only Cash a positive return, though this is likely to change once global monetary policy adjusts to a neutral level and inflation shows signs of a definitive peak in the months ahead.

October month saw asset prices in the long-resilient Global Listed Infrastructure sector recover part of its September drop. This led the Listed Infrastructure fund to make a positive monthly contribution of 0.56%. We believe the September quarter's re-pricing in Infrastructure assets mainly reflects the sharp spikes in bond yields, which are seen as competing assets for infrastructure and also, the influence of a dip in energy prices. In the medium-term, we do not think Infrastructure's distinctive qualities have changed and expect that as the international economy cools next year the assets' defensive and inflation-hedging qualities will come again to the fore.

The Property funds which provide a strong income yield to the Salt Sustainable Income Fund experienced different capital returns in the October month, also largely due to the adjustments to international interest rates. The Enhanced Property Fund contributed a negative return of -0.4% in the month while the Global Property Fund, added at a small initial weighting at the beginning of the quarter, was little changed in October, contributing returns of 0.1% for the month. This addition has been useful to increase the Income Fund's range of sources of yield and thus supports the enhancement of its distribution level to investors.

The Salt Sustainable Income Fund's exposures to New Zealand and Australian equities were positive in October, and those markets have recently been more resilient than their global counterparts. While earlier in 2022, domestic assets were not significant drivers of portfolio gain, they contributed via their superior dividend income yields. Recently, NZ equities have broadly been more resilient to international market weakness and rallied in October. The NZ Dividend Appreciation Fund made a positive contribution of 0.96% in October month, building on its 0.6% contribution in the September quarter as a whole.

Salt Sustainable Income Fund outlook

Although the capital growth element built up in this fund in late 2021 has been more-than reversed by 2022's negative market developments, the income level has been enhanced. We anticipate the capital growth aspect of the Fund to resume gradually once international conditions stabilize. As the primary objective of the Salt Sustainable Income Fund is to invest in quality sustainable yield payers, minimizing short-term capital price fluctuation is secondary. Market volatility allows us to acquire high quality and defensible dividend-paying assets for the Fund at better prices.

The Income Fund remained underweight in the Fixed Interest asset category throughout the 2022 YTD period. Fixed Interest assets are currently at just above half their Strategic Asset Allocation weighting, at 18% versus 35% in the SAA. The bond allocation is likely to be lifted by the close of 2022, assuming yields and other factors remain supportive.

The Global Fixed Interest fund component within the Income Fund has this year provided largely negative returns, justifying the underweighting that Fixed Interest holds currently with respect to its benchmark weighting. Global bonds underperformed its benchmark in October, contributing -0.06% for the month to the Sustainable Income Fund's total return

Persistently high inflation levels and continued aggressive central bank rate hikes, saw bond yields rocket higher, yield curves invert or pivot and credit spreads widen during the September quarter. The market, rather than looking for a "peak" in interest rates, became increasingly unsure as to how high official rates would need to go, with large daily rate fluctuations the norm. This trend is only showing tentative signs of abating as of early November and may re-assert itself, were inflation pressure to resume.

This renewed commitment from central bankers to battling high inflation leaned against prior market expectations of a pivot to a more moderate tightening process. As a result, PIMCO's latest Cyclical outlook has seen a deterioration in their growth outlook, PIMCO believes the "soft landing" is increasingly out of reach and now expects a shallow but prolonged recession. They expect headline inflation to fall but that core inflation will remain "sticky" and above target meaning official interest rates remain higher for longer. They see further downside risks for equity markets and remain cautious on credit despite improved credit margins but believe that potential returns in the bond market appear compelling at these higher yields and that bonds are now positioned to again be a genuine hedge for equities. However, the investment timeframe is the crucial consideration.

Accordingly, PIMCO are maintaining a cautious view towards both interest rates and corporate credit, with a focus on relative value positions and diversified alpha strategies. Within the broader risk exposures, they maintain tactical tilts that aim to provide benefits across a variety of scenarios given the increasingly volatile environment. The big unknown is how high Central Banks will have to take cash rates successfully curb inflation expectations.

The average credit rating of the Fund remains AA, slightly higher than benchmark, and rising yields and PIMCO's curve positioning has seen the Fund's total carry rise. The Fund has had no credit defaults and while we expect ongoing month to month volatility in returns, that ultimately Central Banks will be successful in constraining inflation and the Fund will continue to recover earlier "mark to market" losses through a combination of capital gains and higher running yields.

The bond components of the Salt Sustainable Income portfolio have dragged on bond valuation returns as interest rates rose; however, the yield received from those bond investments is also now higher and will support the Sustainable Income Fund's forward distribution path. This is characteristic of a transition period from a low- to a mid-level interest rate regime.

It is crucial to note that the Income level from equity dividends and bond coupons received into the fund has been commensurately rising through the recent period of market turbulence and remains well in excess of the Income Fund's distribution rate of 1.00 cents per unit per quarter (4 cents per unit per annum.) This trend exemplifies the incremental return of some "risk premia" into asset classes, though this has further to go.

The equity capital value components of the Income Fund have adjusted to weaker economies ahead, yet the Real Asset components of Infrastructure and Property are suited to an economically uncertain and inflation-prone period. Defensive merit should be re-asserted in coming quarters through continuing positive demand for these specific equity types, along with the sustainable dividend-payers in the broader Australasian market.

Given the rapid run-up in global bond yields, the point at which additional Fixed Income exposure will be added to the Salt Sustainable Income Fund is closer. Internationally, major central banks are now communicating the desirable course of carrying through several more meaningful interest rate increases, sufficient to anchor inflation expectations, and this does unnerve markets at times. While the resultant volatility requires fortitude from investors, the objective of securing an inflation-resilient income level now means that equity market fluctuations and corrections over short periods are inevitable. Over the medium-term, moderate capital gains in addition to income advantages are expected, and the Sustainable Income Fund is positioned to harvest them.

Greg Fleming, MA