SALT

Salt Sustainable Global Shares Fund Fact Sheet – May 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 31 May 2022

Benchmark	MSCI World (Net) Index in NZD
Fund Assets	$45.48 million
Inception Date	12 July 2021
Underlying Manager	Morgan Stanley Investment Management

Unit Price at 31 May 2022

Application	0.9801
Redemption	0.9761

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 31 May 2022

Global equities	98%
Cash	2 %

Fund Performance to 31 May 2022

Period	Fund Return*	Benchmark Return
1 month	-0.69%	-0.22%
3 months	-3.07%	-2.22%
6 months	-5.92%	-5.60%
Since inception	-2.19%	-0.60%

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 31 May 2022.

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

Source: MSIM, data as at 31 May 2022. The Top 10 Holdings represented 47.4% of the total portfolio.

Market Review

- Global equity markets ended May broadly flat, though it was a round-about journey getting there with significant intra-month volatility. Key macro risks remain at the forefront, including war in Ukraine, weak data out of China, and further tightening in monetary policy. Markets still lack a catalyst for a change in sentiment.

- Central banks continue to play catch-up with inflation, which is contributing to growing risks to growth, though those risks remain greater in Europe than the United States. Labour markets remain tight but negative real wage growth continues to squeeze household incomes.

- Margins are coming under pressure, especially for consumer-facing companies, with pricing power becoming an increasingly important factor in relative equity performance.

- In the United States the FOMC's 50bp hike in the Fed funds rate during the May month was well-signalled. Hawkish commentary from various FOMC participants and inflation data saw interest rate markets pricing in a series of larger hikes. In June, the Fed hiked 75bps, validating market expectations, with more to come.

- US headline inflation came in higher than expected at 8.6% y/y. Growth risks increased over the month which saw FOMC commentary becoming more hawkish.

- The war in Ukraine continues unabated with no sign and little hope of an imminent resolution. Positioning of both sides appears incompatible with a diplomatic solution.

- European consumer confidence improved in May, though remains low. Business confidence remains resilient. This will give the European Central Bank confidence in moving ahead with its "pre-announced" intentions to deliver a first interest rate increase in July, end asset purchases during the third quarter of the year and exit negative interest rates by the end of Q3 2022.

- In China, Shanghai remained in lockdown, though there were some easing of restrictions as the month progressed. The easing of restrictions is expected to gather pace over June. Credit growth eased over the month as banks became concerned about the deteriorating economic outlook, prompting an easing in a key mortgage rate by the People's Bank of China.

- The Reserve Bank of Australia raised interest rates for the first time this cycle at the May meeting, raising the cash rate 25bps. Labour market and activity trends during 2022 thus far suggest solid economic fundamentals amid building inflationary pressures. We expect ongoing interest rate increases and a step up to 50bp hikes was seen in the first meeting in June, to 0.85%.

- After some short-term softness in economic data and pullback in activity due to the Omicron variant, recent consumer and labour data indicate that the outlook for the New Zealand economy remains solid.

- The inflation outlook has heated up as well, which will keep the RBNZ on track for further rate hikes this year. We expect a 50bp hike in July, after which the RBNZ will likely slow the pace of rate hikes to 25bps for a terminal rate of 3.0-3.5%.

Global equity markets finished roughly flat for the month of May, with the MSCI World Index up just 0.1% in U.S. dollars (USD) for the month, and down 0.2% in local currency (-0.2% in NZD).

Surging inflation, tightening policy and impending recessions continued to weigh on market sentiment, although the prospect of easing lockdown measures in China did offer some relief. Looking at geographies, the U.S. (-0%) was marginally behind the overall index in the month. Euroland in particular was strong: Spain (+5% USD, +3% local) was among the month's top performers, while Italy (+3%, +2%), Germany (+3%, +1%) and France (+2%, +0%) all finished in the black. The performance pattern among other regions was more mixed. While Hong Kong (+3%, +3%), the UK (+2%, +1%) and Japan (+2%, +1%) all outperformed the index, Switzerland (-3%, -4%) and Singapore (-3%, -3%) lagged.

Turning to sectors, soaring oil and gas prices pushed Energy (+13%) higher yet again, the sector now up 46% since the start of the year and ahead 59% from one year ago. On balance, the more cyclical areas tended to do well in the month, with Financials (+3%), Communication Services (+1%) and Materials (+1%) all closing ahead of MSCI World. At the other end of the spectrum was the defensive Consumer Staples (-4%) sector which, in a reversal from last month, claimed its spot as the month's laggard. Consumer Discretionary (-4%) and Information Technology (-2%) were also weak, while Health Care (+0%) was flat.

Portfolio Review

In May, the Fund returned -0.69% (after fees,) 0.47% behind the MSCI World Index which returned -0.22%. The May underperformance was due to sector allocation. The lag to benchmark arising from the lack of Energy stocks and the Information Technology overweight more than outweighed the smaller benefit from the Consumer Discretionary sector underweight.

Stock selection, on the other hand, was positive, as strong performance by Health Care and selected Information Technology names more than made up for weakness in Financials.

The largest positive contributors to absolute performance during the month were Baxter International (+27 basis points [bps]), Danaher (+21 bps), Abbot Laboratories (+12 bps), Becton Dickinson (+10 bps) and AIA (+10 bps).
The largest detractors were Intercontinental Exchange (-38 bps), Proctor & Gamble (-22 bps), Microsoft (-16 bps), Medtronic (-14 bps) and Accenture (-13 bps).

Portfolio Outlook

Potential for demand destruction is a risk, as consumers' real incomes are hit by inflation. Central banks face a tough policy-making challenge controlling inflation without causing a recession. So far, company earnings forecasts are proving largely immune to these fears. MSCI World Index's 12-month forward earnings estimates are up 6% so far this year, as companies enjoy the inflationary impact on revenues, without taking margin pain, as yet. Indeed, EBIT margins remain at extremely elevated levels, approaching 17% for MSCI World, as against the pre-pandemic peak of 15% and the 20-year average of 13.4%.

These stretched margins must be under threat, either from the inflation itself, or any slowdown caused by central bank attempts to tackle inflation. One key to navigating this environment as an investor is to focus on companies with robust fundamentals that enjoy pricing power, the ability to pass on input costs, be they stuff or staff, to consumers.

Staples companies that sell products we need can even increase prices in this tough environment. Companies such as Reckitt Benckiser have been reporting that their strong portfolio of brands has allowed for "responsible price action", an increase in pricing of 5% in the first quarter across its business. This contrasts with the fortunes of general retailers (which we don't own), which have suffered the mistake of increasing their inventory of home equipment at a time when a post-pandemic consumer is shifting towards leisure and services outside the home.
Mission critical software on subscription models also enjoys fortress-like pricing power and recurring revenues, as Microsoft proved with its announced price increases for commercial products which took effect 1 March 2022. Typically, such announcements are softened with reference to innovative improvements, for example new AI tools or enhanced security being included in the price.
Payments companies such as Visa, which take a clip of every dollar in a rising inflation environment, gaining revenue without having to increase prices, are often overlooked inflation plays – never mind that they have been able to effect increases in merchant fees.
Within MedTech and life sciences, product mix matters, and some categories like nutrition are easier to effect price increases than more commoditized areas. Medical and scientific supplies companies enjoy some protection as hospitals and scientists will continue to prize

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reliability and quality, raising switching costs. This is particularly the case where the products and services provided are a small part of the customers' cost base.

We started the year very worried about both earnings and multiples. Five months of derating has eased our fears on multiples, though they are not yet low, as they are still at the top end of their 2003-19 range. At least they are no longer a very concerning 20% above that historical range.

By contrast with price multiples, our concerns about earnings have continued to rise, along with the earnings themselves, aggravated by the growing risks to the stretched margins from either inflation or a downturn. Given the risks to earnings, it may be a particularly good time to own compounders, (companies that can grow their earnings steadily across economic cycles) because their pricing power and recurring revenue make their earnings resilient in tough times.
The team's focus on valuation risk over the last few years has contributed to the portfolio's relatively low free cash flow premium relative to the index. Moving on to the earnings risk, **pricing power is one of the key characteristics we look for in our stock selection process**. The companies' intangible assets, be they brands or networks, should allow them to pass on rising input costs to their customers, protecting margins. In addition, in the case where government actions against inflation cause an economic slowdown, or even a recession, recurring revenue, another factor we focus on, should protect the portfolio's earnings just as it did in 2008-9 and in early 2020.

Whatever the pace of change in 2022, efforts to create a sustainable future is a game that's played out in decades, not months. As the transition takes place, we believe companies with a strong awareness are more likely to stay on top of their game and deliver long-term returns for clients. As bottom-up stock pickers, we're determined to keep seeking better outcomes, to learn and improve our offering to you, and to keep pressing for progress from the world's best companies.

Greg Fleming, MA

Sustainability metrics provided by Morgan Stanley Investment Management

As of 31 May 2022, the Portfolio's carbon footprint is 85% lower than the MSCI AC World Index's and 82% 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

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

The challenge: A board composed entirely of white 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.

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