Salt Sustainable Income Fund Fact Sheet – February 2023

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 28 February 2023

Benchmark	Bank deposit rates (BNZBIL Index)
Reference portfolio	SAA-weighted component benchmark indices' performance
Fund Assets	$43.91 million
Inception Date	19 June 2021
Portfolio Manager	Greg Fleming
Current distribution yield (cents per unit) / based on Unit Price of 1 February 2023	1.00 cents per unit per Quarter / 4.45% per annum

Unit Price at 28 February 2023

Application	0.8802
Redemption	0.8766

Investment Guidelines

Sector	Target	Range
Global Fixed Interest	35%	0% – 60%
Australasian Shares	30%	15% – 45%
Global Listed Property	15%	0% – 35%
Global Listed Infrastructure	15%	0% – 35%
Cash or cash equivalents	5%	0% – 20%

See "Salt Statement of Investment Policy and Objectives, 30 June 2022" for further information.

Fund Allocation at 28 February 2023

Global Fixed Interest	27%
Australasian Shares	30%
Global Listed Property	23%
Global Listed Infrastructure	18%
Cash or cash equivalents	2%
Asset allocation to Fixed Interest + Cash	**29%**

Fund Performance to 28 February 2023

Period	Fund Return (after fees)	Gross Reference Portfolio Return
1 month	-0.78%	-1.87%
3 months	0.61%	0.04%
6 months	-2.15%	-1.64%
1 year	-5.00%	-5.45%
Since inception	-5.61%	-6.30%

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. Reference Portfolio return is gross.

Top Individual Holdings at 28 February 2023

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

Holdings stated as at 28.02.2023, excludes cash and consolidated International Fixed Interest Fund component of the Sustainable Income Fund due to its large number of securities.

Market Commentary

February month saw yet another flip in sentiment, this time into a cautious mood after the strong returns in January which opened 2023. Equity markets around the world declined modestly during the month, led by a -2.4% dip in the US S&P 500 Index. However, the -4.1% monthly drop in the NZD/USD exchange rate insulated unhedged NZ investors from the slippage in the US market. Elsewhere, there was a wide range of market returns among global regions, with the MSCI Europe Index gaining 1.4% in local currency terms, while the MSCI Emerging Market Index declined -4.6% bring its 2023 year-to-date returns down to 1.6%.

- After a strong start to the year, resilient economic data caused markets to give some of those gains back in February. The stronger data indicated central banks have more work to do and that rate cuts are far from imminent. Developed market equities were 2.4% lower (in USD) over the month, while the global aggregate bond index was 3.3% (USD) lower.
- Central banks in the US, the UK, Europe, Australia and New Zealand all delivered on expected rate hikes over the course of the month and all, with varying degrees of nuance, signalled they weren't done yet as inflation remains too high.
- In the US the January jobs report was much stronger than expected, retail sales surprised the upside, and while the monthly CPI print saw annual inflation fall, the result was stronger than expected. This followed Fed Chair Powell's comments earlier in the month that the process of disinflation still has some way to go and that further rate hikes are likely needed.
- In Europe, falling energy prices contributed to a further decline in headline inflation. However, resilient core inflation remains the key focus for ECB President Lagarde who, at the same time as raising rates 50bp in February, expressed her intent to deliver another 50bp hike in March.
- In China, the end of Covid-zero and the swift re-opening of the economy is feeding strong rebound in growth. As we have seen in other countries, the significant amount of excess savings accumulated during the lockdown will fuel consumption spending in the period ahead. Despite this, Chinese stocks were lower over the month on escalating geo-political tensions.
- In Australia, the release of the minutes of the RBA's February meeting confirmed its hawkish tilt, indicating they had considered a more aggressive tightening at that meeting. This was followed by weaker than expected labour market data suggesting the unemployment rate may have troughed. While this was a weaker print than expected, likely continued wage pressure means this is unlikely to alter the RBA's hawkish shift.
- In New Zealand, cyclone Gabrielle caused considerable devastation on the east coast of the North Island. Early indications are the repair bill to rebuild communities and infrastructure will be in the order of NZ$13 billion. It's early days and we expect more detail in the coming weeks.
- At its February meeting the RBNZ remained resolute in raising the OCR a further 50bp. The Bank said they would "look through" the near-term impacts of the cyclone on activity and inflation but expect both to be impacted to the upside over the medium-term as the rebuild gets underway.

Salt Sustainable Income Fund Commentary

The Sustainable Income Fund slipped in February, reflecting weaker returns in both the equity and fixed interest components of the portfolio, moving lower by 0.78% (after fees.) The fund's 3-month return remained positive, at 0.61% (net) as at 28 February which was 0.6% ahead of its reference portfolio three-month return. On the rolling six-month basis, the fund is recording a decline of -2.1%, while annually, the fund return is lower by -5.00% (after fees,) 0.45% above the SAA return, while since inception, the fund's return was -5.6% (on an after fees basis) which was 0.6% ahead of reference index return.

Given recent market conditions, these performance results indicate the present sensitivity of particularly income-yielding asset types to sharp moves in global interest rates. The consolidation in both global share and bond markets since recent market lows in October has assisted Income fund components back to stable short-term returns. As inflation shows signs of a definitive peak in the months ahead, we expect component asset classes to improve further, as has occurred in 2023 to date. However, volatility across markets is ever-present and sentiment remains fragile.

February month saw asset prices in most markets decline. The long-resilient Global Listed Infrastructure sector stalled in the face of rising bond yields and the Listed Infrastructure fund made a negative individual contribution to February month Income Fund returns of -0.62%. 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 remain at the fore, in a slowing economy.

The Property funds, which provide a strong income yield to the Salt Sustainable Income Fund, experienced varying fortunes in February. The Enhanced Property Fund contributed a +0.41% return for the month while the Global Property Fund contributed a return of -0.11%. 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.

Bonds are seen as competing assets for Real Assets, due to yield and stability with longer-duration underlying exposures. Bond yields have now consolidated, and rising interest rates last month led to a negative contribution from the Global Bond fund component, of -0.32%.

The Salt Sustainable Income Fund's exposures to New Zealand and Australian equities were neutral in capital growth terms, though they contributed via their superior dividend income yields. The NZ Dividend Appreciation Fund made a small negative contribution of -0.05% in the February month, following its strong January return.

Salt Sustainable Income Fund outlook

2022 was a watershed for traditional Fixed Interest, with bonds and bond-heavy Income funds experiencing unprecedented price weakness. Mark-to-market capital declines compounded by negative after-inflation returns from bond coupons. We believe bond yields have now adjusted upwards enough, to lower our underweight bond positions within the Sustainable Income Fund.

As the Reserve Bank of New Zealand continues to lift the Official Cash Rate and inflation is persisting, domestic yields and discount rates are likely to stay elevated. We lower our overweight position in the NZ Dividend Appreciation Fund to Neutral and trim our overweight position in the Enhanced Property Fund (whilst still remaining overweight.)

With higher yields now prevailing, the Fund’s income level has been enhanced. We anticipate the longer-term capital growth strategies within the Sustainable Income Fund to resume performance gradually, as international conditions stabilize. However, there could easily be a recessionary period to traverse en route to that outcome. The phase of interest rate reductions from central banks is still some quarters into the future and we expect a major beneficial capital growth impact of such will only become apparent from the last part of 2023 or even early 2024.

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 period, which helped protect returns during the most severe bond market weakness seen in decades. However, the size of this underweight was being halved in February 2023 (from -16% to -8% compared to the Reference Portfolio weighting.) The quantum of the additional bond investments closes up the underweighting in this sleeve of the portfolio, while still maintain an underweight bias. Bonds, as a share of the Sustainable Income Fund, are now lifted to 27% of the portfolio, compared to a 35% neutral allocation. A smaller-scale upward adjustment to Bond holdings is likely in Q2 2023.

Additionally, the Global Bonds exposure was switched into the Salt Sustainable Global Fixed Income Opportunities Fund, managed by our investment partner Morgan Stanley Investment Management. This enhances the sustainability credentials of our Diversified Funds significantly, given their weightings to Global bonds.

The silver lining in the bond repricing is that the yield received from bond investments is also now higher and supports the Sustainable Income Fund’s forward distribution path. This is characteristic of a transition into 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 in the year 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 absolute level and degree of differentiation amongst global bond yields, the point at which additional Fixed Income exposure should be incrementally added to the Salt Sustainable Income Fund has now arrived. Internationally, major central banks are now communicating the desirable course of carrying through several additional 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