Salt Sustainable Income Fund Fact Sheet – August 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 August 2022

Benchmark	Bank deposit rates (BNZBIL Index)
Reference portfolio	SAA-weighted component benchmark indices' performance
Fund Assets	$45.98 million
Inception Date	19 June 2021
Portfolio Manager	Greg Fleming
Current yield to 31/10/22	4.00% per annum

Unit Price at 31 August 2022

Application	0.9203
Redemption	0.9116

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 August 2022

New Zealand Fixed Interest	0%
International Fixed Interest	18%
Australasian Shares	33%
Global Listed Property	29%
Global Listed Infrastructure	18%
Cash or cash equivalents	2%

Fund Performance to 31 August 2022

Period	Fund Return	Reference Portfolio Return
1 month	-0.52%	-0.89%
3 months	0.62%	0.27%
1 year	-7.88%	-8.01%
Since inception	-3.54%	-4.66%

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 August 2022

Goodman Property Trust	Property for Industry
Kiwi Property Group	Argosy Property Trust
Precinct Property	Stride Ppty & Stride Invest Mgmt
Fisher & Paykel Healthcare	Vital Healthcare Property Trust
Spark NZ	Auckland International Airport Ltd

Holdings stated as at 31.08.22, excludes cash and consolidated International Fixed Interest Fund component of the Sustainable Income Fund due to its large number of securities.

Market Commentary

After the significant market weakness experienced in both equities and bonds so far this year, which had paused in July month, August saw a resumption of nervousness across most key asset classes. Global interest rates erased most of their July rally, negatively impacting bond markets.

- After a brief respite in July, equity and bond markets were rattled again in August as central banks renewed their respective commitments to bring inflation under control, despite the growing risks to the outlook for economic activity.
- The level of nervousness about the outlook for global growth remains high. This is especially the case in Europe as concern over the security of energy supplies intensifies on the back of the ongoing conflict in Ukraine.
- In the United States GDP June quarter data recorded a second consecutive quarterly decline, meeting the definition of a technical recession. However, given the narrowness of the weakness and the strength of other data, particularly the labour market, this is unlikely to be classified as an economic recession.
- US headline inflation appears to be past its peak; however, core inflation will remain more difficult to get under control, especially as the labour market remains strong. This saw Federal Reserve Chair Powell deliver a hawkish commentary at the monetary policy symposium in Jackson Hole, keeping alive the prospect of ongoing interest rate hikes by the FOMC, including the possibility of a third consecutive 75bp hike at its September meeting.
- Eurozone second-quarter GDP surprised on the upside but revealed marked divergences in performance amongst member states. Several countries (Spain, Italy) continue to benefit from the post-Covid bounce in services activity while Germany, heavily reliant on gas imports from Russia, stalled.
- In China, the domestic economy continues to struggle as ongoing Covid disruptions have morphed into disruptive weather events. July activity data was weak, with the service sector also losing momentum over the month. The People's Bank of China eased monetary conditions further and the State Council announced new fiscal stimulus measures.
- The unemployment rate in Australia dropped sharply, to 3.5%. This helps justify the Reserve Bank of Australia's early September interest rate hike of 0.5% to 2.35% - the highest since 2014.
- Headline Consumer Price Index inflation for the second quarter in Australia rose by 6.1% y/y while the core rate came in at 4.6%. The Reserve Bank of Australia hiked a further 50bp in August, signalling more to come.
- The Reserve Bank of New Zealand remains ahead of the rest of the world in tightening monetary conditions. The RBNZ hiked 50bp in August to take the Official Cash Rate to 3.0%. We expect a further 50bp hike in October. However, with monetary conditions now tight and given the emerging weakness in some activity data, we are fast approaching the point at which the RBNZ's next move is not immediately obvious. There are increasing signs of a slowdown in growth in activity in the New Zealand economy.

Salt Sustainable Income Fund Commentary

The Sustainable Income Fund was slightly weaker in August, declining by -0.52% (after fees.) Given the positive July month's return of 4.59% (after fees), the fund's 3-month return moved just into positive territory, up to +0.62% as at 31 August. On the rolling six-month basis, the fund is still recording a decline of -2.91% while since inception, the return was -3.54% as at 31 August (on an after fees basis.) Given current market conditions, these performance results are quite resilient and show the benefits of fund diversification, notwithstanding the weak global share and bond markets.

The three-month period from June to August was one in which the Salt Sustainable Income Fund's exposures to New Zealand and Australian equities were advantageous, for example. While for earlier in 2022, domestic assets were not significant drivers of portfolio gain, they contributed via their superior dividend income yields. Recently, NZ and Australian equities have broadly been more resilient to international market weakness than previously. Australian shares overall gained 1.2% (in AUD terms) for the month, while NZ equities moved up by 0.9% in August. The Australian economy in particular has shown considerable momentum in the first half of 2022, necessitating recent policy interest rate increases from the Reserve Bank of Australia (RBA) to combat price pressures.

As has been the recent pattern, slightly more robust returns were contributed by Equity Asset classes. However, there was considerable dispersion in returns from different equity sectors. In August month, sharply rising global interest rates hurt performance from the Listed Real Asset components of Global Property (which contributed -0.18%) and Global Infrastructure (contributing -0.32%.) In contrast, the Australasian assets held in the Salt Dividend Appreciation Fund and the Salt Enhanced Property Fund helped limit the extent of the August market declines for the Salt Sustainable Income Fund to -0.5%. The NZ Dividend Appreciation Fund was the key positive contributor with a 0.45% impact. Unsurprisingly, the dominant negative impact on the Fund's August performance was the Global Fixed Interest component, which detracted by -0.4% overall.

At the end of June, we introduced the Salt Sustainable Global Property Fund into the Income Fund's holding set at a weight of 3.5% due to much better valuations in Global Real Estate given the sharp international asset re-pricing this year. The dividend yield on the sector has now risen to a sufficient level to warrant inclusion in the Sustainable Income Fund, and further internationalises the underlying holdings, adding diversification. The primary purpose of the inclusion is to provide an additional yield source for distribution to investors, with capital growth a medium-term objective.

Although the capital growth element built up in this fund in late 2021 has been reversed by 2022's 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 somewhat during Q4 2022, assuming yields and other factors remain supportive.

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The Global Fixed Interest fund component within the Income Fund underperformed its benchmark in August. Hawkish comments from central bankers around the US Federal Reserve's Jackson Hole meeting towards month end sent bond yields higher, contributing to a tough month for bond markets. This renewed commitment from central bankers to battling high inflation leaned against prior market expectations of a pivot to a more moderate tightening process.

Underweight positioning to US duration, especially at the 1-5yr and 10yr+ parts of the curve, as yields rose, contributed to alpha. As did, underweight German and UK duration positions, as the curve shifted upwards.

Increasing yields meant our overweight duration positions in Danish and Swiss bonds detracted value, after solidly gaining last month, as did our positioning in emerging market bonds.

PIMCO continues to maintain a cautious view towards both interest rates and corporate credit, still focusing on relative value positions and diversified alpha strategies. The Global Fixed Income Fund's duration was unchanged in August with absolute duration currently 6.1 years vs. 6.9 years for the benchmark, the underweights predominantly in the 3-5 year and the 10 year+ sections of the yield curve. PIMCO continues to prefer 5-10 year maturities that appear to be more fairly priced. PIMCO is generally underweight duration in most regions, particularly the UK and core Europe although maintains an overweight to non-core Europe which offers a yield premium while still benefiting from ECB support. The Fund also maintains an underweight exposure to Japan and a slight overweight to the Australia / NZ region and remains underweight corporate credit generally, targeting financials and non-cyclicals.

US Federal Reserve "tapering" expectations see PIMCO remaining underweight the agency and semi-government sectors, but now having a small overweight exposure to the mortgage sector, slightly preferring non-agency mortgages. Securitised assets remain PIMCO's preferred way to take spread exposure offering greater default protection in the current environment. Currency strategies remain largely tactical or target portfolio diversification. We are underweight the US and core Eurozone, predominantly versus non-EMU Europe and Australia/NZ. We maintain a material underweight position in Emerging Markets currencies. The Global Fixed Interest Fund continues to have a small allocation to inflation-linked bonds. Securitised assets remain PIMCO's preferred way to take spread exposure offering greater default protection in the current environment. In geographical tilts, the Fixed Interest fund is underweighting the US and core Eurozone, predominantly in favour of non-EMU Europe and Australia/NZ.

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 in excess of the Income Fund's distribution rate of 4.0% p.a. 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, but 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 may be added to the Salt Sustainable Income Fund is coming 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

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