SALT

Salt Sustainable Income 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 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 30 September 2022

Benchmark	Bank deposit rates (BNZBIL Index)
Reference portfolio	SAA-weighted component benchmark indices' performance
Fund Assets	$43.11 million
Inception Date	19 June 2021
Portfolio Manager	Greg Fleming
Current yield to 31/10/22	4.00% per annum

Unit Price at 30 September 2022

Application	0.8651
Redemption	0.8616

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 30 September 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 30 September 2022

Period	Fund Return	Reference Portfolio Return
1 month	-6.00%	-5.19%
3 months	-2.19%	-2.12%
6 months	-10.12%	-8.60%
1 year	-12.27%	-11.97%
Since inception	-9.32%	-9.85%

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 30 September 2022

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

Holdings stated as at 30.09.22, excludes cash and consolidated International Fixed Interest Fund component of the Sustainable Income Fund due to its large number of securities.

Market Commentary

- After 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.
- 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.

Salt Sustainable Income Fund Commentary

The Sustainable Income Fund was hit in September by the fall in global asset values, declining by -6.00% (after fees.) The fund's 3-month return moved slipped into negative territory, by -2.19% as at 30 September. On the rolling six-month basis, the fund is recording a decline of -10.12% while since inception, the return was -9.32% (on an after fees basis.)

Given current market conditions, these performance results indicate the present sensitivity of particularly income-yielding asset types to sharply higher global interest rates. The 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.

September month saw asset prices in the long-resilient Global Listed Infrastructure sector succumb to the worse-than-anticipated international inflation outlook. This led the Listed Infrastructure fund to make the largest negative monthly contribution to the Sustainable Income Fund, at -1.9% and on a Quarterly basis, where Infrastructure detracted -1.3%. The sharp monthly drop in Listed Infrastructure, while in line with the broader Equity market return, removed a performance plank from the fund which had been holding up the capital value of the diversified portfolio for some time. We believe this 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 September month. 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.

Similarly, the Property funds which provide a strong income yield to the Salt Sustainable Income Fund experienced weak capital returns in the September month and quarter, also largely due to the move higher in international interest rates. The Enhanced Property Fund contributed a negative return of -1.7% in the month and -0.54% for the third quarter as a whole. The Global Property Fund, added at a small initial weighting at the beginning of the quarter, also provided a drag on returns of -0.4% for the month and -0.33% for the three-month period. This addition has nevertheless been useful to increase the Income Fund's range of sources of yield, and supports the maintenance of its distribution level to investors.

The Salt Sustainable Income Fund's exposures to New Zealand and Australian equities were less advantageous, but those markets have recently been moderately 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 and Australian equities have broadly been more resilient to international market declines though September. The NZ Dividend Appreciation Fund made a negative contribution of -1.4% in September month, but a small positive contribution of 0.62% for the third quarter.

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.

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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 later in Q4 2022, assuming yields and other factors remain supportive.

The Global Fixed Interest fund component within the Income Fund continues to provide negative returns, justifying the underweighting that Fixed Interest holds currently with respect to its benchmark weighting. Global bonds underperformed its benchmark in September, contributing -0.75% for the month and -0.58% for the quarter to the Sustainable Income Fund's total return

Hawkish comments from many central bankers subsequent to US Federal Reserve's Jackson Hole meeting and with more, higher than expected inflation prints, sent bond yields higher, contributing to another tough month for bond markets. The benchmark Bloomberg Barclays Global Aggregate Index dropped -3.5% in September month alone, bringing its one-year return to -12.3%. Persistently high inflation levels and continued aggressive central bank rate hikes, exacerbated by policy missteps in the UK, saw bond yields rocket higher, yield curves invert or pivot and credit spreads widen. 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 renewed commitment from central bankers to battling high inflation leaned against prior market expectations of a pivot to a more moderate tightening process. The Fed delivered a third straight hike of 75bps, ECB delivered a 75bps hike to tackle record inflation and the BoE hiked 50bps. We also saw noticeable hikes from the central banks of Switzerland, Norway, South Africa, Indonesia and the Philippines. Turning to the UK, which has been in the eye of the storm in the recent market sell-off, we saw the month start off with Liz Truss being named the new Prime Minister. Her Chancellor of Exchequer, quickly announced a 'mini budget' that ended up being anything but mini. His £45bn tax cut package, would be funded by raising additional debt, was received poorly by markets and led to a collapse in GBP – as well as a sharp sell-off in UK bonds. His plan included the biggest tax cuts in 50 years. In a move that was described by Larry Summers to be "a bit like an emerging market", extreme market moves followed and the Bank of England ultimately had to effectively restart QE to calm markets. It was merely days before QT was supposed to start. This was highly effective, with 30yr Gilt yields falling by some 105bps on the day – marking the largest decline since Bloomberg data became available some 30 years ago.

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. 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 to 5.4%. 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 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, 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 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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