SALT

Salt Sustainable Global Shares Fund Fact Sheet – June2022

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 30 June 2022

Benchmark	MSCI World (Net) Index in NZD
Fund Assets	$44.53 million
Inception Date	12 July 2021
Underlying Manager	Morgan Stanley Investment Management

Unit Price at 30 June 2022

Application	0.9590
Redemption	0.9550

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 June 2022

Global equities	98%
Cash	2 %

Fund Performance to 30 June 2022

Period	Fund Return*	Benchmark Return
1 month	-2.16%	-4.37%
3 months	-3.01%	-6.24%
6 months	-13.14%	-12.46%
Since inception	-4.31%	-4.94%

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 30 June 2022.

Fund ESG Scores	Portfolio	Index
Sustainable Global Shares	27T CO_2 /$m	150T CO_2 /$m
Portfolio Carbon Footprint:	18% of MSCI World Index*	

Source: MISM Quarterly Investment Report, 30.6.2022 & Trucost based on the Scope 1 & 2 carbon emissions per $1million of Portfolio companies' sales, and as weighted average carbon intensity (WACI). See p.4 for further ESG details.

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

Source: MSIM, data as at 30 June 2022. The Top 10 Holdings represented 47.4% of the total portfolio.

Market Review

It has been a tough June quarter for markets following what was already a difficult March quarter. This marks the worst first half of the year for developed market equities in 50 years. To make matters worse, bond prices have also fallen significantly, failing to give investors the protection they usually seek from this asset class.

- 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 an increasingly important factor in relative equity performance.
- In the US the Federal Reserve has signalled its clear intention to tame inflation by signalling interest rates will need to rise to 3.8%. Despite unemployment being low and wages increasing, consumer confidence has slumped, contributing to recession concerns. The Fed believes the unemployment rate will need to rise to just above 4% (currently 3.6%) to meet its inflation

mandate. US headline inflation came in higher than expected at 9.1% y/y in June.

- Consumer confidence has also slumped in Europe, though the biggest recession risk is the reduction in gas supplies from Russia. Prices have risen sharply, and some form of rationing may have to be implemented. This prospect is already having a negative impact on business confidence.
- The Chinese authorities continue to adopt a Covid-zero strategy, though there has been some easing in quarantine restrictions. With lockdown restrictions easing in some regions, recent economic data has improved. We expect the authorities will continue to back away from Covid-zero, most likely following the Communist Party National Congress later in the year.

Central Banks' shift in tone to a more inflation-adverse stance, combined with the Ukraine crisis, and energy / food cost spikes, has challenged investor sentiment throughout much of 2022 so far. It appears unlikely that such factors darkening the global growth outlook for the present will clear quickly, and sentiment depends on robustness of corporate earnings and a moderation in cost pressures.

After a mediocre rally in May, global equity markets continued to plummet in June, with the MSCI World Index finishing down 8.7% in U.S. dollars (USD) for the month (-7.8% in local currency and - 4.4% in NZD), with every sector in the red – and five of the 11 sectors with double digit drawdowns. Perhaps unsurprisingly, the fall saw defensive plays hold up better, with **Health Care** (-3%) and **Consumer Staples** (-3%) leading in the month. At the other end of the spectrum, recessionary fears took their largest toll on the more cyclical **Materials** (-16%) and **Energy** (-15%) sectors. The other sectors were more tightly bunched, all closing within 2% of the index. Turning to geographies, the U.S. was just ahead of the overall World index (-8%) in the month, meaning other major markets tended to be behind.

June Quarter compounded market weakness from March

Q2 overall was another difficult quarter for markets, with the MSCI World Index finishing down 16.2% in USD (-14.3% in local currency and -6.24% in NZD). The index is now down more than 20% YTD in USD, and down 18% in local currency. As in the month, defensive areas held up better: the Portfolio's key defensive positions in **Consumer Staples** (-6%) and **Health Care** (-7%), while down on the quarter, were ahead of the overall index, as was Utilities (-7%).

Weakness in the month left **Energy** (-5%) down for the quarter, though the sector is still up 24% for the year – the only sector with positive YTD performance. Meanwhile, the growth-tilted and high multiple Consumer Discretionary (-24%) and Information Technology (-22%) sectors were, as in previous months, among the worst performers, both now down 30% for the year.

The regional performance pattern was more mixed. As in the month, Hong Kong (-1% local currency) was the standout performer, while the UK -3%) and Switzerland (-11%) also finished ahead. Japan's loose monetary policy continued to put downward pressure on the yen, leaving the market down 15% in USD, but only -4% in local currency, while the U.S. (-17%) was just behind MSCI World Index.

Germany (-13% local) currency and Italy (-12%) were both towards the bottom of the pile given their nations' exposure to Russian gas, while Spain (3%) and France (-9%) were stronger, with more domestic energy.

Portfolio Review

In June, the Portfolio returned -2.16%, 2.21% ahead of the benchmark MSCI World Net Index which returned -4.37%. The Portfolio outperformed by 3.38% for the second quarter (Q2), returning -2.96% versus -6.24% for the index, but remains roughly in line with the index for the year to date (YTD), having returned -12.81% versus -12.46%. Since inception, the Fund has outperformed the benchmark by 1.11%.

In June month, stock selection and sector allocation were both positive. Sector allocation was the bigger driver of outperformance, where the drag from the Information Technology overweight was more than offset by the benefits from the Portfolio's **defensive position in Health Care** and the **lack of Energy and Materials** names which, under pressure from recessionary fears, underperformed in the month. In terms of stock selection, strong performance in IT and Financials outweighed underperformance in Health Care.

For Q2 overall, both stock selection and sector allocation were positive. As was also true for June month, outperformance in Information Technology drove stock selection, with Consumer Staples also doing well, offsetting the drag from underperformance in Health Care. The Portfolio's overweight to Health Care and underweight to Consumer Discretionary were the main positives for sector allocation, and the overweight to **Consumer Staples** also proved beneficial in the quarter, counteracting the drag from the lack of exposure to Energy and Utilities as well as the hit from the Information Technology overweight.

The largest positive contributors to absolute performance during the Quarter were Reckitt Benckiser (+50 basis points [bps]), AIA (+30 bps), Becton Dickinson (+22 bps), Proctor & Gamble (+15 bps) and Coca-Cola (+14 bps). Consumer Staples and Health Care showed defensive merit. The largest detractors were Intercontinental Exchange (-68 bps), Microsoft (-45 bps), Alphabet (-39 bps) TSMC (-34bp) and Accenture (-32 bps) reflecting the price adjustments across the technology sector.

Portfolio Outlook

The equity markets have had a terrible first half of 2022, with the MSCI World Index down over 20% in USD, the worst start to the year in over 50 years. The bizarre element is that the fall has all been down to multiple de-rating, as earnings have not yet been hit. The earnings estimates for 2022 and 2023 are both up slightly, meaning that the 12 months forward earnings number is up 5% this year as it benefits from the increasing weight of the higher 2023 estimates as H2 2022 runs on. The derating is arguably less bizarre given the extreme multiple at the start of the year, which at 19.3x forward earnings was 36% above the average between 2003 and 2019, the 17-year period between the bursting of the tech bubble and the pandemic – during which the multiple never even reached 17 times. The
derating has taken the multiple down to 14.6x, only 3% above the 2003-19 average. This has clearly reduced the multiple risk from here, shifting our concern to the prospects for earnings.

There are plenty of grounds to be anxious about earnings, even if inflation helps revenue growth, at least in nominal terms. The major threat in the short term is the prospect of an economic slowdown or recession. Central banks are attempting to counter inflation by dampening demand through higher rates. They are hoping to calibrate their rate rises to achieve a soft landing, and economic forecasts seem to think that this is achievable, with the OECD predicting 1- 2% growth

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for the USA and the Euro area for 2023, with inflation falling and unemployment only rising marginally.

What is clear is that there are no signs of any risk of downturn in the current earnings numbers, given the continued robustness of the estimates. The potential risk to actual earnings is raised further by the current record level of margins, with the MSCI World Index forward EBIT1 margin edging up further to 16.7% this year, as against a 13.3% average and a 15.2% peak in the 2003-19 period.

It seems that the excess demand is allowing companies to pass on even more than the rise in their input costs, be it through inflation (raising prices), 'shrinkflation' (reducing product sizes) or 'skimpflation' (trimming the level of services).

Any end to shortages, or worse still a shift to excess supply, could end this phase of generalised pricing power, with more commoditised companies suffering, while genuine pricing power holds up better.

In the longer term, there could be further pressures on earnings, be they from rises in interest costs, the need to build more resilient supply chains, companies paying for the negative externalities they create, and even potentially from higher corporate tax rates as governments look to repair their finances.

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 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. Six 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.

Given the many 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.

Portfolio Activity

We initiated a position in PayPal during Q2. The stock had fallen by over 70% from its peak with the slowing in revenue growth slowed as shoppers returned to bricks-and-mortar stores as the pandemic eased, reducing their dependence on online spending. Our view is that the franchise remains intact, centred around the PayPal brand that consumers associate with ease and security of paying online. Consumers are significantly more likely to transact when a business accepts PayPal, meaning that merchants are still willing to pay up for the PayPal check-out button.

In addition, we continued to build positions in some of the stocks initiated in Q1, Equifax, Atlas Copco and IQVIA, and to add to some of the growthier names in the Portfolio that had been hit hard in the derating, along with Intercontinental Exchange which had also been weak. These buys were partly funded by cutting the holdings in Automatic Data Processing and Medtronic, which had both also held up relatively well.

Greg Fleming, MA

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Sustainability metrics provided to Salt by Morgan Stanley Investment Management

As of 30 June 2022, the Portfolio's carbon footprint is 84% 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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