Salt Sustainable Income Fund Fact Sheet – November 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 November 2022

Benchmark	Bank deposit rates (BNZBIL Index)
Reference portfolio	SAA-weighted component benchmark indices' performance
Fund Assets	$44.11 million
Inception Date	19 June 2021
Portfolio Manager	Greg Fleming
Current distribution yield (cents per unit) / based on Unit Price of 1 December 2022	1.00 cents per unit per Quarter / 4.52% per annum

Unit Price at 30 November 2022

Application	0.8848
Redemption	0.8811

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 November 2022

New Zealand Fixed Interest	0%
International Fixed Interest	19%
Australasian Shares	33%
Global Listed Property	28%
Global Listed Infrastructure	18%
Cash or cash equivalents	2%

Fund Performance to 30 November 2022

Period	Fund Return	Reference Portfolio Return
1 month	2.32%	2.24%
3 months	-2.75%	-2.23%
6 months	-2.15%	-1.97%
1 year	-7.45%	-8.21%
Since inception	-6.18%	-6.75%

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 November 2022

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

Holdings stated as at 30.11.22, excludes cash and consolidated International Fixed Interest Fund component of the Sustainable Income Fund due to its large number of securities.

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Market Commentary

- Equity markets continued their recovery from mid-October's lows with developed markets rising a healthy 7% and emerging markets up nearly 15% (both in USD).
- Despite further aggressive rate hikes from the US Federal Reserve and the Bank of England, who hiked their respective policy rates by 75bp, the Global Aggregate Bond Index rallied 4.7% (in USD) over the month as US inflation data printed below expectations. This was the first below expectations data print in four months, contributing to the view that the Fed would be able to slow the pace of rate hikes from December.
- In the United States, consumer spending continues to prove resilient, however there is a strong downtrend emerging in the housing market. Housing starts peaked at an annualised 1.8m in April but had fallen to 1.4m by October. Consumer spending continues to be supported by an equally resilient labour market, though signs of weakness are emerging there too as unemployment claims have risen and job openings have declined.
- In Europe higher energy prices continue to fuel new highs in consumer price increases. The October eurozone CPI came in at 10.6% but eased to 10.0% in November. At the same time, activity indicators improved over the month including consumer confidence, albeit from very low levels. The risk of Europe running out of gas this winter continues to diminish thanks to mild temperatures and soft demand. Storage is over 90% of capacity thanks to strong planning actions earlier.
- Policymakers in China have started a gradual easing of Covid controls and have stepped up efforts to vaccinate the elderly. The easing of controls includes a shortening of the quarantine period and taking secondary contacts out of scope for quarantine. But it has not all been positive news as some new restrictions were put in place towards the end of the month. Despite the setback, equity markets rallied on the back of hopes of an eventual end of the Covid-zero policy.
- Activity data in China was mostly weaker than expected over the month. Monetary policy was eased, and we expect there is more easing in the pipeline.
- Australian data remains mixed with the labour market continuing to show resilience. However, Australian retail sales suffered their first fall of 2022 in October as rising prices and higher interest rates finally seemed to have an impact on spending. The RBA has continued to hike at the reduced rate of 25bp per meeting, despite above-forecast Q3 inflation data.
- In New Zealand, the RBNZ delivered its largest ever interest rate increase of 75bps in November, taking the Official Cash Rate to 4.25%. Cementing the hawkishness even further was the admission the Bank had considered a 100bp hike. The projected terminal rate of the OCR was lifted from 4.1% to 5.5%, higher than was expected by the market. The New Zealand dollar has rallied 10% since its lows in early October, reflecting a combination of hawkish domestic monetary policy and the softer USD. This has offset some gains from the rally in unhedged international equities, after the opposite dynamic prevailed earlier in 2022.

Salt Sustainable Income Fund Commentary

The Sustainable Income Fund was aided in November by improving global asset values, rising by 2.32% (after fees.) The fund's 3-month return remained in negative territory, at -2.75% (net) as at 30 November. On the rolling six-month basis, the fund is recording a decline of -2.15% while since inception, the return was -6.18% (on an after fees basis.)

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 rebound in both global share and bond markets since October has assisted Income fund components back to positive short-term returns. As inflation shows signs of a definitive peak in the months ahead, we expect component asset classes to improve further.

November month saw asset prices in the long-resilient Global Listed Infrastructure sector continue to advance strongly, as investors' concerns about monetary policy abated to a degree. This led the Listed Infrastructure fund to make a strong positive monthly portfolio contribution of 1.1%, as the Sustainable Infrastructure underlying investment gained 6% (net of fees.) We believe the September quarter's downward re-pricing in Infrastructure assets mainly reflected the sharp spikes in bond yields at that time. Bonds are seen as competing assets for infrastructure. Bond yields have now moved downwards over the last two months, lifting sector returns. 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.

The Property funds, which provide a strong income yield to the Salt Sustainable Income Fund, experienced more modest capital returns in the November month. The Enhanced Property Fund contributed a flat return in the month while the Global Property Fund, added at a small initial weighting at the beginning of the quarter, contributed returns of 0.17% for the month. 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.

The Salt Sustainable Income Fund's exposures to New Zealand and Australian equities were positive in November, and those markets have recently been 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 equities have broadly been more resilient to international market weakness and rallied in October and November months. The NZ Dividend Appreciation Fund made a positive contribution of 0.65% in November month, building on its near-1% contribution over the prior month of October 2022.

Salt Sustainable Income Fund outlook

As the largest current individual Sustainable Income Fund component, the NZ Dividend Appreciation Fund's 1.9% monthly gain was of substantial benefit to the Sustainable Income Fund return. All the same, now that the Reserve Bank of New Zealand has indicated sustained interest rate rises ahead, we anticipate trimming the weighting to this fund within our Sustainable Income portfolio in the early New Year. A Neutral portfolio weighting is seen as more appropriate than the existing overweight holding, as better Income interest streams have become available within the Fixed Income universe than has been the case for a considerable period. This is also true, albeit to a lesser extent, for domestic property sector allocations.

Although the capital growth element built up in this fund in late 2021 has been reversed by the first nine months of 2022's negative market developments, the 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 sone quarters in the future and we expect a major beneficial capital growth impact of such will only become apparent from the last part of 2023.

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 19% versus 35% in the SAA. The bond allocation is likely to be lifted at the beginning of 2023, assuming yields and other factors remain supportive. The quantum of the additional bond investments should then close up the underweighting in this sleeve of the portfolio by around half.

The Global Fixed Interest fund component within the Income Fund has this year provided largely negative returns, justifying the underweighting that Fixed Interest holds currently with respect to its benchmark weighting. However, Global bonds outperformed their benchmark in November, contributing 0.37% for the month to the Sustainable Income Fund's total return.

The re-stated commitment from global central bankers to battling high inflation leans against periodic market expectations of a pivot to a more moderate tightening process. As a result, PIMCO continues to believe that a "soft landing" is increasingly off the table and their core view is for 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. 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.

For 2022 as a whole, 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 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 will be added to the Salt Sustainable Income Fund is close. 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

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