CarbonFund

Carbon Fund Fact Sheet – Quarter ending 31 March 2024

Manager Profile

Salt Funds Management is a boutique investment management firm wholly owned by its employees. We are active managers. Our shared investment philosophy is centred on the belief that market inefficiencies exist that can be exploited over time to deliver superior risk-adjusted returns.

Further, the consideration of environmental, social and governance (ESG) factors is integral to the research we carry out. Salt analysts consider the potential for ESG factors to influence long term returns on invested capital (positively and negatively).

Investment Strategy

The Fund's aim is to provide investors with a total return exposure to the price of carbon credits. The Fund has the ability to buy carbon credits in emissions trading schemes in New Zealand and offshore.

The Fund gains its exposure to the price of carbon credits in the NZ ETS through purchasing and holding carbon credits on the NZ ETS. We may also use swaps or other derivatives to gain exposure to the NZ ETS.

The Fund will also have the ability to buy carbon credits in international emission trading schemes, as well as futures, swaps or other derivatives that provide exposure to international schemes. As a result, the Fund may also provide exposure to the price of carbon offshore.

The Fund is actively managed by us. This means we buy and sell carbon credits on emission trading schemes, or hold cash based on our own analysis and assessment of the market. This includes our assessment of the price of carbon credits relative to the demand and supply of carbon credits and other factors including technological advancements, politics, regulation, fuel prices and even global weather and climate change.

Fund Details

Fund Assets	$84 million
Inception Date	8 November 2018
Portfolio Manager	Paul Harrison
Total Fund Charges (p.a.)	0.96%
NZX Code	CO2

Who is involved?

Supervisor	The New Zealand Guardian Trust Company Limited
Administration Manager & Custodian	Apex Administration (NZ) Limited
Unit registrar	Link Market Services Limited
Investment Manager	Salt Funds Management Limited

Net Tangible Assets (NTA) Value on 31 March 2024

Application	1.7861

CO2 price on NZX Main Board on 31 March 2024

NZX Close	1.62

Investment Guidelines

The guidelines for the Carbon Fund are shown below:

Carbon credits	0% – 100%
Cash	0% – 100%

Target investment Mix

The target investment mix for the Carbon Fund is:

Carbon credits	98.00%
Cash	2.00%

Fund Allocation at 31 March 2024

NZ carbon credits	95.9%
Aus carbon credits	4.0%
Cash	0.1%

Fund Performance to 31 March 2024

Period	Fund Return
3 months	-11.72%
1 year	2.31%
2 years (p.a.)	-9.83%
3 years (p.a.)	10.76%
5 years (p.a.)	12.03%
Since inception (p.a.)	11.36%

Performance is based on NTA movement and is after all fees and 28% tax. Past performance is not a good indicator of future performance.

SALT INVESTMENT FUNDS LIMITED
Level 3, The Imperial Buildings, 44 Queen Street | PO Box 106-587, Auckland 1143
P: +64 9 967 7276 | E: info@carbonfund.co.nz | www.carbonfund.co.nz

Quarterly Fund Commentary

Dear Fellow Investor,

The NZ Unit (NZU) price drifted lower over the March quarter with all eyes on the first NZU Auction of the year on March 20. This was viewed as a key test of NZU demand as it was the final auction before the May 2024 surrender deadline for emitters.

With 3.525m NZUs available, the auction partially cleared, selling 2.974m NZUs at the floor price of $64.00, a small discount to the previous day's closing price in the secondary market. This partial clearance was the first such instance in the NZ Emissions Trading Scheme's (ETS) history. Some forestry owners looking to sell NZUs may have been waiting for the auction to "fail" in order to create a tighter market for those emitters yet to acquire enough units to meet their 2023 obligations. In addition, a group of market participants may not have realised that the auction could partially fill. Therefore, the expectation for the NZU price to rally as emitters scrambled to purchase NZUs on the back of a failed auction did not play out, with many traders caught long NZUs and the NZU price fell c18%.

The volume of bids submitted indicated that demand was subdued and that 2023 emissions offset obligations have largely been purchased (thanks largely to the frantic selling of forestry NZUs following the release of the Government's 2023 consultation options around the inclusion of forestry NZUs in the ETS). Emitters appear to be well supplied with NZUs for their 2023 and possibly 2024 obligations.

The Climate Change Commission (CCC) released their latest recommendations for the NZ ETS unit limits and price control settings for 2025-2029. Recommended future auction volumes aim to tighten the supply of NZUs available to be purchased by emitters and thereby reduce the sizeable NZU "surplus" that has been accumulated. Earlier auctions in 2021 and 2022 saw an extra 15.3m "cost containment reserve" NZUs sold; generous free unit allocations were made to industry; and there was a larger issue of forestry units in 2023 at the end of the 5 year mandatory emissions return (MER) period. The CCC recommendations contained an increased estimate of the surplus from c48m to c68m NZUs. This will require a significant reduction of NZUs available at auction over the next four years to absorb the surplus and tighten the market supply. These new settings are still aligned with the planned reduction of the NZU surplus to zero by 2030 and thereby adhering to current emissions budgets.

The Government has until September to announce whether it will take up the CCC recommendations on ETS auction volumes. Meanwhile, the market is pricing NZUs well below the $64 minimum price where the government will sell additional units at auction so it is unlikely that the June auction will see any NZUs sold. If there is no announcement on CCC recommendations before the September auction then that will also likely see no sales. The current secondary market price for NZUs would need to rise over 18% in order to reach the minimum auction price.

As we saw in 2023, when the potential auction supply of 15m NZU was not purchased, the market will simply fix the current oversupply by not purchasing NZUs at auction. If we get a replay of 2023 the market will have turned its back on the remaining 2024 supply of a further 11.1m NZUs.

The key piece of information the market is waiting for is the release of the number of NZUs held on the private register as at the 30th of June in order to gauge how many NZUs were surrendered to meet the emissions obligations over 2023 and therefore taken out of the stockpile of existing NZUs. In previous surrender periods (March vs June) we saw a large 23m reduction in the NZUs held in 2022, but a more modest 9.5m reduction in 2023. With no NZUs sold at auction in 2023 and only a partial clearance of the first auction of 2024, the market will be watching to see how big a reduction in NZUs held has occurred and whether the CCC has calculated the surplus versus future supply correctly.

The Manager had become concerned that the market did not realise the increasing potential of a partial clearance and that there could be a negative reaction to this. The Fund had been selling NZUs prior to the auction and had sold $7m of NZUs at an average price of c$70 over the prior months. In addition, the Fund continues to take advantage of the arbitrage opportunity produced by trading below its NTA value and has continued to buy back CO_2 units at a level implying a much cheaper NZU price. The NTA value of the Fund finished the quarter at $1.79, moving 11.7% lower, matching the decline in CO_2 units over the same period. The decline was largely due to the substantial decline in the NZU price on the back of the auction that saw the NZU finish the quarter at $58.35 down 15.6%.

Paul Harrison, BCA, MBA, CA