



CarbonFund

Carbon Fund Fact Sheet – Quarter ending 31 March 2023

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	\$81 million
Inception Date	8 November 2018
Portfolio Manager	Paul Harrison
Total Fund Charges (p.a.)	0.97%
NZX Code	CO2

Who is involved?

Supervisor	The New Zealand Guardian Trust Company Limited
Custodian	The New Zealand Guardian Trust Company Limited
Administration Manager	MMC Limited
Unit registrar	Link Market Services Limited
Investment Manager	Salt Funds Management Limited

Net Tangible Assets (NTA) Value on 31 March 2023

Application	1.7460
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CO2 price on NZX Main Board on 31 March 2023

NZX Close	1.77
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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 2023

NZ carbon credits	90.5%
Aus carbon credits	4.6%
Cash	4.9%

Fund Performance to 31 March 2023

Period	Fund Return
1 month	-12.93%
3 months	-20.76%
1 year	-20.53%
2 years (p.a.)	15.25%
3 years (p.a.)	22.31%
Since inception (p.a.)	13.52%

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

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Quarterly Fund Commentary

Dear Fellow Investor,

This quarter we focus on the NZU market, examining factors contributing to market weakness and stabilization, the impact of government policies and announcements, and the outlook for the future.

Market Weakness

The initial weakness in the NZU market appears to be due to the Government's willingness to largely ignore the advice of the Climate Change Commission in December last year, creating widespread uncertainty amongst market participants. With the Government appearing to weaken its commitment to an appreciating NZU price, the urgency for emitters to reduce emissions or purchase offsets was reduced and has led to a much lower level of demand for NZUs.

What did the Climate Change Commission recommend?

The Climate Change Commission report released publicly in April, doubled down on its prior advice and expressed to the Government that the ETS settings should be more ambitious in reducing emissions. The recommendations included reducing the amounts auctioned each year, introducing a disclosed minimum auction clearing price (starting at \$60 in 2023 and rising), and putting a much higher price on where the extra Cost Containment Reserve ("CCR") NZUs would be released into the auction (starting at \$171 in 2023). As the Commission explained in its report last year, the CCR has been particularly problematic, "While the cost containment reserve is intended to be used only rarely, it has been triggered three times in the last six auctions". This has led to 14 million tonnes of extra NZUs sold into the market that must be recouped in future years by lowering emission budgets. As a comparison, the entire amount of NZUs forecast by the Ministry for the Environment to be released into the ETS this year from Forestry is 15 million tonnes.

The Government chose to make only small cuts to the NZUs available at auction and modestly increased the CCR trigger prices (2023: \$80.64 2024: \$91.61, 2025: \$103.24, 2026: \$115.84, and 2027: \$129.97).

Other Factors

The expectation of continued strengthening in ETS settings would have encouraged many emitters to have built up their balances of NZUs. There were likely to have also been trading desks that held some extra units with this in mind too. With the sudden apparent swing away from this commitment by the Government, any additional NZUs held would have been purged. Even a flattish outlook for NZU pricing would have generated selling, as much higher interest rates have made it more expensive to hold NZU inventory. Furthermore, some forestry owners are selling NZUs into the market ahead of

receiving new allocations for 2023 year as well as 2017-2022 5yr allocations. These factors have led to a lack of buying and increased selling pressure, causing NZU prices to fall.

As a result of this lack of confidence and urgency, there was subdued bidding in the March 2023 NZU auction. Consequently, the Government "declined" to sell any NZUs as they could not clear all 4.75 million units above the "secret reserve price". The June 14th auction will now have 8.9 million NZUs to sell and has the very real potential to see the Government "decline" to sell any again. We are sure the government will be focused on the potential miss out on sale proceeds of over half a billion dollars!

Market Stabilization

Since the beginning of June, the NZU market has stabilised. Emitters who need to buy to make good on their 2022 emissions will need to buy over April/May in the secondary market, as the June auction is too late to meet their surrender obligations. If emitters are gambling on a low auction price in June, we could see the auction fail again with a large 8.9 million tonnes of NZUs available for sale.

The updated Climate Change Commission report was not kind to the Government for ignoring their advice last year and there is hope that the latest recommendations will gain more traction and confidence in the ETS can be restored. The National Party has publicly committed to the ETS and meeting the Paris commitments, while ACT has promoted an average based the carbon price of our trading partners. We do not favour outsourcing New Zealand policy settings to offshore. However, a simple average of the UK, European, Australian, Californian, and Chinese carbon pricing would currently result in a NZU price over NZ\$80 using this methodology.

Outlook

The NZU market has experienced weakness due to a lack of buying by emitters, selling pressure from forest owners, due largely to the shift in government policies and announcements. However, the market has stabilised since the beginning of April, and there is potential for longer-term gain despite the short-term pain. Decarbonization of New Zealand will likely stall with a carbon price in the \$50 or \$60 range. Anything below \$70 will have a chilling effect on capex, consumer behaviour, and sequestration. This makes the climate change mountain even steeper to climb and will potentially require higher prices in the future. The next key test will be the ETS auction in June.

Thank you for your interest in the Carbon Fund. We look forward to bringing you more developments in the New Zealand and International carbon markets in the future.



Paul Harrison, BCA, MBA, CA