Carbon Fund Fact Sheet – Quarter ending 30 September 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	$90 million
Inception Date	8 November 2018
Portfolio Manager	Paul Harrison
Total Fund Charges (p.a.)	0.96%
NZX Code	CO2

Who is involved?

Supervisor	NZ Guardian Trust Company Ltd.
Administrator	Apex Administration (NZ) Ltd.
Custodian	Apex Administration (NZ) Ltd.
Registrar	Link Market Services Ltd.
Investment Manager	Salt Funds Management Ltd.

Net Tangible Assets (NTA) Value on 30 September 2024

Application	1.8998

CO2 price on NZX Main Board on 30 September 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 30 September 2024

NZ carbon credits	76.69%
Carbon Fund	18.58%
Aus carbon credits	3.98%
Cash	0.75%

Fund Performance to 30 September 2024

Period	Fund Return
3 months	16.02%
1 year	-5.22%
2 years (p.a.)	-8.95%
3 years (p.a.)	-1.50%
5 years (p.a.)	13.45%
Since inception (p.a.)	11.03%

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

Quarterly Fund Commentary

Dear Fellow Investor,

The September quarter brought some welcome news for the NZ Emissions Trading Scheme (ETS) in August with the NZ Government accepting the Climate Change Commission's (CCC) latest recommendations on ETS settings. Climate Change Minister Simon Watts announced that settings had been adjusted to restore confidence in the ETS and allow the market to function as intended. Current price control settings and cost containment reserve (CCR) volumes remained unchanged but were extended to 2029. Consistent with these recommendations, the unit limit settings were adjusted to address the oversupply of NZUs already on issue. Total units available through auction between 2025 and 2029 were cut by 53% to 21 million.

Naturally, the market took this as a positive signal, and the NZU price rallied towards the current minimum auction floor price of $64 in the days following the announcement. This change contrasts with the miscalculations of 2022, when the Government rejected the CCC recommendations, completely undermining the efficacy of the ETS and creating a surge of volatility in the NZU price.

With a September auction that failed to clear, the pressure is on the December auction as the last opportunity for emitters to obtain substantial volumes of NZUs at $64 ahead of the May surrender period in 2025. As it stands, with NZUs trading just below $64 in the secondary market, the possibility of at least some NZUs being sold at auction becomes a real possibility. A full clearance is less likely given the sheer volume that needs to be bid for with over 11 million units available in the December auction.

Any unsold auction units the 2024 year are not carried over, and with the updated ETS auction volume settings allowing for only 6 million auction units at a floor price of $68 across 2025, there is a potential for a much tighter NZU market going into next year.

Expectations of NZU supply from forest owners in the longer term remains under pressure. The Government has announced it will make changes to the regulations covering plantation forestry to include exotic carbon forests and to enable local authorities to control the location and scale of plantation and exotic afforestation. Forest owners over 2024 had already significantly scaled back their rate of plantings due to the uncertainty surrounding the ETS. In addition, forestry registered in the ETS was grappling with a Labour-implemented scheme imposing annual fees proportional to the size of their planted land registered within the ETS. These fees are meant to cover the operational and administration costs of running the forestry ETS register, with the initial fee set at $30.25/ha. However, in response to the backlash against these fees, the new Government cancelled the 2023/24 charge and has announced a consultation which proposes to adjust this fee down to $14.90/ha for the 2024/25 period.

Another development in the September quarter was the release of the inaugural emissions reduction monitoring report for NZ by the CCC. Such reports will now be released annually with the aim of tracking the adequacy and implementation of the current emissions reduction plan, and progress against both emissions budgets and the 2050 emissions target.

The report showed that gross emissions have declined relative to a 2019 baseline, however current policies in place make it increasingly uncertain as to whether NZ will meet its second and third emissions budgets. The agriculture and transport sectors are most at risk of not delivering against emissions reduction targets, however the Government is confident that it's technology-led approach including certain policy initiatives will keep NZ on track. As part of this solution, the Government maintains that the ETS will continue to be the primary tool in reducing net emissions.

The Net Asset Value (NAV) of the Fund finished the quarter at $1.88 (from $1.60), moving 17.5% higher. This reflected the 24.0% increase in the NZU price to $62.60 (from $50.50) and the 5.8% in Australian units (ACCUs) from A$34.25 to A$36.25 over the September quarter. The NZX traded CO_2 price increased to $1.62 (up 19.1%) over the same period. As long as the opportunity remains, the Fund continues to take advantage of the arbitrage created by CO_2 units trading on the NZX at below their NTA value and has continued to sell NZUs in order to buy back CO_2 units at a level implying a much cheaper NZU price.

As discussed earlier, the key event to watch is the outcome of the December ETS auction. A partial clearance is possible, but it remains to be seen how much underlying demand exists. Emitters may already have covered a significant proportion of their 2024 surrender liabilities already and it will come down to a funding decision as how hedged they want to be. They may instead wait until the 2025 auctions to hedge their 2025 obligations.

Paul Harrison, BCA, MBA, CA