Ethical Leaders update

Mercer Investment Funds

Quarter ending 30 June 2023

Introduction

Welcome to the June 2023 quarterly update for the Mercer Ethical Leaders Funds. In addition to quarterly fund commentary and performance updates, the objective of this report is to provide insights into, and promote a greater understanding of, sustainable investment. We also report on key engagements over the last quarter.

Manager of Ethical Leaders Funds

On 3 March 2023, Mercer (N.Z.) Limited (Mercer NZ) became the manager of Macquarie Asset Management Public Investments (NZ) Limited's retail and wholesale funds. The retail funds, including the Ethical Leaders funds, were renamed the Mercer Investment Funds to reflect the change of Manager but there were no material changes to the funds themselves.

Mercer Ethical Leaders Global Shares Fund update

During the quarter, there was a change of underlying investment manager and underlying investment for the Mercer Ethical Leaders Global Shares Fund. The underlying fund was replaced with the Mercer Socially Responsible Overseas Shares – Low Active Risk Fund, an actively managed fund which is currently used as a global equities allocation within Mercer's Socially Responsible Diversified Funds. Schroders Investment Management is the current investment manager appointed by Mercer to manage this fund.

In line with the change of investment manager and underlying investment, the benchmark for the Mercer Ethical Leaders Global Shares Fund changed from the MSCI All Country World Index to the MSCI World Index, effective 1 June 2023.

Note: Through their exposure to the Mercer Ethical Leaders Global Shares Fund, the change also impacted the Mercer Ethical Leaders Diversified Funds (Conservative, Balanced and Growth).

Sustainable Investment Policy

The change of investment manager for the Mercer Ethical Leaders Global Shares Fund brought forward the transition of the Mercer Ethical Leaders Funds to the Mercer NZ Sustainable Investment Policy and accompanying Mercer Socially Responsible exclusions list. This transition process was completed by 30 June 2023.

RIAA certification

Except for the Mercer Ethical Leaders Hedged Global Fixed Interest Index Fund, the Mercer Ethical Leaders Funds have been certified by the Responsible Investment Association of Australasia (RIAA).

International engagement

In the second quarter of 2023 Schroders' sustainable investment team conducted engagements on a range of areas, including on its engagement blueprint priorities of climate change, human capital management and deforestation.

Microsoft was engaged with on the topic of human capital management, specifically the rights of workers and customers, with three key recommendations proposed. The first was the importance of improved corporate governance and oversight of their algorithms and future developments in AI. Central to this was assessing the impact of these developing technologies on human rights. Implementing a formal human rights framework, which should be publicly available, would be beneficial to address this, along with information about the potential scope of the technology's human rights impact.

Secondly, Microsoft was asked to improve its user protection policies for LinkedIn and Skype, aligning this with their other applications such as Bing and Outlook where stronger protection policies already exist. Finally, it was requested users be given greater control of their personal data and how it is used, with user options clearly published. The Manager will continue the dialogue and monitor how the company addresses broader questions on AI and customer protection.

With engagements typically taking time to be implemented, Schroders re-engaged with Lloyds & NatWest on last year's climate engagement. With only balance sheet lending captured in Lloyds' financed emission disclosures, it was requested that this be expanded to include capital markets activity while also asking for net zero targets to include scope 3 with reduction targets being SBTi approved. While there was no real update on their progress, it was requested that commitments be included in their plans to help mitigate the risk of financed emissions increasing.

An update was sought on NatWest's transition plan and how they plan to deal with high emitting sectors, and again for this to capture both balance sheet lending and capital markets activity. NatWest confirmed that while high emitters do not have a separate policy or targets, their exposure to the oil and gas sector is small and financed emissions have already been reduced by 69% versus 2019 levels.

New Zealand engagement

Engagement with companies over the quarter was increasingly governance related given the growing number of AGMs and investor roadshows organised by company boards. ESG issues discussed included topics such as climate change, modern slavery, and sustainable finance.

Climate change conversations related to dealing with some of the acute impacts from extreme weather events like Cyclone Gabrielle earlier in the year, as well as the transition to decarbonisation strategies and the scaling up of clean technologies in the case of Contact Energy.

Engagement included querying Scales' current practices with respect to modern slavery given the high-risk industry they operate in and found it would be reviewing its grievance mechanism and conducting a site inspection in the near future. The engagement with KMD Brands focused on sustainable finance and whether the company would disclose the targets that underpin the renewal of its sustainability linked loan facility to which it had committed.

Harbour's industry involvement over the quarter was primarily through hosting a responsible investing conference and attending other sustainability events. These events tended to focus on three key areas: positive impact, climate action and stewardship. Harbour's event showcased its approach to investing in impact generating companies as well as featuring perspectives from external managers and experts they collaborate with in the industry. The other events represented learning opportunities, particularly one on stewardship which provided insights on the UK experience.

Overall, engagement so far this year has continued to focus on climate issues, particularly on the aftermath of Cyclone Gabrielle. Through these engagements Harbour have developed a better understanding of each company's climate approach and will continue to monitor progress, especially in the upcoming August reporting season.

Climate change was also a central theme in industry events such as the Mindful Money conference where important new research highlighted the difference between companies contributing or detracting from the transition. Other ESG issues such as modern slavery and board composition will also remain key areas of emphasis going forward.

Economic summary

Market review

Global shares impressed in Q2 with the advance led by developed markets, notably the US, while emerging market stocks lagged behind. US debt ceiling negotiations and continued rumblings in the banking sector caused a bit of a stir. However, investors were largely unphased by this as hype surrounding artificial intelligence (AI) drove a rally in the information technology sector and, in particular, sent chipmakers higher.

Other leading catalysts were moderating inflation and the continued strength of the US economy, despite higher interest rates. The US economy expanded at a rate of 2% (annualised) in Q1 and headline inflation slowed to 4% year-on-year – it's lowest 12-month increase in over two years. Unemployment increased to 3.7% in May but the US labour market still remains historically tight, prompting the US Federal Reserve (the Fed) to address the need for further interest rate rises despite electing to pause at their latest June meeting.

Emerging market equities underperformed as concerns remained over China's economic recovery running out of steam. Eurozone share markets trended higher on the back of a strong performance from the information technology and financial sectors, while the Japanese market hit its highest level in 33 years amid expectations of corporate governance reforms and structural shifts in the Japanese macro-economy. Elsewhere, UK equities were a weaker proposition this quarter as an increase in core inflation, stronger-than-expected wage growth and jobs market numbers all weighed heavily on sentiment.

In fixed income, government bond yields generally rose (prices fell) as major central banks all continued to lift their benchmark interest rates during the quarter. UK and Australian government bonds saw the biggest decline as inflation remains particularly sticky in both economies. US debt was also negative, with a sharp increase in the two-year yield marking a further inversion of the US Treasury yield curve.

On the credit front, global high yield outperformed investment grade as more immediate recessionary fears rescinded amid a risk on environment. All things considered, most major asset classes closed out Q2 and the first half of the year in remarkably good fashion.

Market outlook

Looking back, there has been a lot to digest in the first half of the year: four US banks have failed; an impending US debt default was averted in what felt like the final hours; the geopolitical landscape remained ever so fragile; and central banks were relentless in their continued efforts to bring inflation back down to their target levels. And yet, the S&P 500 has produced a 15.9% gain through the first six months of the year – the tenth-best first half since 1951 and certainly a change in fortune from the first half of 2022 (the S&P 500's eighth-worst half since 1951).

Despite such a strong year-to-date performance, many will say that markets have simply looked through the challenges faced and do not appropriately reflect the true economic environment. So when looking beyond the headline returns, is all quite so well under the surface?

While developed market equities had a strong start to the year, the rally wasn't broad-based. US equities are currently exhibiting extremely narrow leadership with year-to-date performance being dominated by what Wall Street have now dubbed the 'magnificent seven' – a select group of megacap stocks which includes the likes of Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla.

The S&P 500 has surpassed all expectations and soared 15.9% year-to-date. However, excluding the performances of the magnificent seven, the S&P 500 would have returned a mere 3.8% in comparison. The excitement around AI has played a pivotal role, with stock prices soaring as much as 190% year-to-date for those companies poised to profit from the secular expansion of the AI market (such as Nvidia).

AI euphoria aside, low stock market participation in year-to-date gains perhaps gives reason to pause when considering such an impressive headline return. That said, of the 21 other occasions since 1950 that the S&P 500 has been up at least 10% or more in the first half, 17 of those times it has gone on to rally further in the second. Though, one would question if the current landscape is fit for equities to push on and make that 18 times. For a start, growth remains soft but globally resilient. Yet, this doesn't necessarily mean that the outlook has improved.

Underlying drivers of this resilience can be attributed to three main factors: a growth boost from China's reopening, broad strength in consumer balance sheets and an assist from easing energy prices. Although all have played their part in providing a great lift thus far, the US economy is still expected to stall in the second half of 2023 and into 2024 as assistance from lower energy prices fades, consumer balance sheets are being depleted and banks continue to tighten their lending standards.

However, the slowdown is not uniform across regions as different economies are at varying stages of the business cycle. For some, the dreaded 'R' word has already become a reality, with the New Zealand economy entering a technical recession in Q1 (albeit by the barest of margins). In the near-term, it can be said that New Zealand faces more downside risk as many fixed-rate mortgages are set to rollover at much higher rates.

The outlook is more negative in the Eurozone and the UK as both economies remain overheated and constrained on the supply side. Both are showing signs of buckling due to tighter financial conditions, but the European Central Bank and Bank of England remain hawkish as tight labour markets remain a primary concern.

On the other hand, China's economy is currently sitting below optimal capacity and has room for growth. After a year of lockdowns, major internet and property sector reform, China has done well thus far in 2023 but momentum is showing signs of waning with a range of indicators from manufacturing activity to exports all losing steam in Q2. However, with headline inflation currently reported at 0% year-on-year, China should continue to benefit from ultra-loose monetary policy and continued fiscal stimulus as policymakers look to breathe some life back into their economic recovery.

While China is running extremely close to deflation, other large economies are still fighting inflation. That said, the battle has well and truly passed its infancy. Headline inflation rates have fallen from the very high levels seen at the end of 2022 and are expected to continue their descent over the remainder of 2023.

However, it would be naive to dismiss the fact that reducing inflation from approximately 5% to 2% will be not nearly be as easy and swift as the transition from 8% to 5%. Core levels of inflation (which strip out volatile items such as food and energy) still remain well above the 2% target set by central banks due to factors such as high rent and wage growth. Labour markets will need to weaken materially for wage growth to fall, but this will take time.

Central banks will be asking themselves if they've now done enough to sufficiently stabilise prices. We'll likely see more central banks take a moment to pause and assess heading into the second half of the year. Some have already got the ball rolling, with the Fed and the RBNZ leaving interest rates unchanged at their last meetings.

Others are expected to follow suit, albeit in stages, as inflation levels and other macroeconomic factors (such as unemployment rates) are slightly varied from economy to economy. In particular, the Bank of England has a tough road ahead with both core and headline inflation still quite elevated despite lifting its key interest rate from 0.1% to 4.5% since December 2021. The Bank of England was one of the first central banks to initiate what later became a fully-fledged global monetary tightening regime, though it looks as though they may also be one of the last to finish.

It's still a bit premature to generate a clear-cut view on how things will play out for the remainder of 2023. Financial markets have sailed through stormy conditions with relative ease thus far, but the waters remain choppy.

Diversified portfolio activity for the quarter

Looking forward we expect economic growth in the developed world to be weak well into 2024 as high interest rates work their way through the economy. Households and businesses strong balance sheets combined with pent up consumer demand have supported economic activity this year but this is expected to fade over time.

Inflation is set to fall further in most of the developed world on the back of base effects, lower commodity and rental prices and supply chain improvements. At a core level, however, we think inflation will remain above central banks' 2% targets well into 2024 as the tightness in labour markets keeps wage growth high. While inflation is above target in most of the developed world, it is expected to remain weak in China for some time.

Central banks in much of the developed world will likely welcome a prolonged period of weak economic growth to ease the labour market tightness and bring it back into balance. The People's Bank of China (PBoC) faces the opposite challenge as it tries to engineer strong growth to boost the labour and property markets following widespread weakness last year.

Developed world central banks have signalled they will continue to raise interest rates in the near term. However, we think most will shortly go on hold as they assess the impact of past interest rates increases on economic activity. Central banks are expected to keep interest rates at a high level, until it is clear that wage growth and inflation are back at normal levels. In contrast, China is expected to keep monetary policy loose for a prolonged period.

Against this backdrop, we expect that financial market volatility will remain and that in this environment, investors are best to maintain a longer-term focus and a well-diversified portfolio.

The Ethical Leaders Diversified Funds remain well diversified.

Neutral equities – overweight listed property/underweight global equities (post quarter end)

Within the portfolio, we neutralised the +1% overweight to Trans-Tasman Shares and allocated this to listed property, taking the position to +1%.

The Trans-Tasman overweight position was placed earlier in the year when the likelihood of a hard landing outcome looked likely. This position was of a defensive nature as we believed the non-cyclical parts of the New Zealand market would outperform global equities under this scenario.

Since March, economic indicators have turned over, highlighting a greater likelihood of a soft or mild recession. Given this, the Trans-Tasman shares overweight was reduced to neutral.

The overweight to global listed property is based off discounted valuations and market cycle timing.

Global REITs have sold off over the past year, returning -5.2% to June as opposed to global equities which has returned 18.2% in local currency. We believe this sell off has been overdone, with strong companies being pulled down with the weak. We see this as a good opportunity to pick up exposure to quality companies at discounted valuations.

Historically, Global REITs have outperformed broad equities following the topping out of a rate rising cycle. There are signs that this is the environment we are entering into currently.

Neutral bonds – neutral global bonds and cash

Labour markets in general remain robust, with the US labour market being particularly tight. Inflation also remains sticky with the US experiencing a shift in inflationary pressures from goods to services, most notably from rent inflation.

Although we may see some further tightening of monetary policy, the peak of policy rates is now visible as the Fed and markets focus on slowing growth and headline inflation. In addition, our base case assumption is that a soft landing is more likely than what is currently being priced by the market.

On that basis, we neutralised our modest underweight to global bonds versus cash in May. Global bond yields have risen over the quarter, making for a more attractive point to close the position

Performance summary

Diversified funds

Fund commentary

The Macquarie Ethical Leaders Diversified Funds generated positive returns over the second quarter of 2023. Global markets moved higher during the quarter as slowing inflation, the pause in the Federal Reserve's hiking cycle, an agreement on the debt ceiling and enthusiasm over artificial intelligence supported investor optimism. Volatility remained relatively subdued throughout the quarter, despite issues in the banking sector and difficult negotiations over the debt ceiling.

The Macquarie Ethical Leaders Conservative Fund returned 1.1% for the quarter and 3.2% over the last 12 months. The Ethical Leaders Balanced Fund returned 2.6% for the quarter and 7.0% over the past 12 months. The Macquarie Ethical Leaders Growth Fund returned 3.7% for the quarter and 10.2% over the last year.

The Ethical Leaders Diversified Funds have underperformed their benchmark over the quarter but have outperformed over three years and longer.

Mercer Ethical Leaders Conservative Fund

Asset allocation

Sector	SAA (%)	DAA (%)	+/- (%)
Australian equities	5.0	5.5	+0.5
Global equities	13.0	12.5	-0.5
Property	7.0	7.0	0.0
Growth total	***25.0***	***25.0***	***0.0***
NZ fixed interest	25.0	25.0	0.0
Global fixed interest	25.0	24.0	-1.0
Cash	25.0	26.0	+1.0
Defensive total	***75.0***	***75.0***	***0.0***
Total	***100.0***	***100.0***	***0.0***

Fund performance

Ethical Leaders Conservative Fund	Quarter (%)	1 year (%)	3 years (%)
Fund return	1.06	3.16	1.33
Benchmark return	1.22	3.38	0.75
Value added	*-0.15*	*-0.22*	*+0.58*
From:			
Security selection	-0.17	-0.23	+0.44
Asset allocation	0.00	-0.13	+0.23

Fund commentary

The Ethical Leaders Conservative Fund produced positive returns in the June quarter. It underperformed the benchmark over the quarter but outperformed for three years and longer. The main detractor towards relative performance over the quarter was security selection within global equities and New Zealand bonds. Contributors included security selection within NZ and Australian shares.

Over the last 12 months, security selection in global equities and Australian equities detracted from relative performance while overweight positions to global bonds and shares partially offset that.

Mercer Ethical Leaders Balanced Fund

Asset allocation

Sector	SAA (%)	DAA (%)	+/- (%)
Australian equities	20.0	21.0	+1.0
Global equities	35.0	34.0	-1.0
Property	10.0	10.0	0.0
Growth total	***65.0***	***65.0***	***0.0***
NZ fixed interest	12.5	12.5	0.0
Global fixed interest	12.5	12.0	-0.5
Cash	10.0	10.5	+0.5
Defensive total	***35.0***	***35.0***	***0.0***
Total	***100.0***	***100.0***	***0.0***

Fund performance

Ethical Leaders Balanced Fund	Quarter (%)	1 year (%)	3 years (%)
Fund return	2.57	6.98	6.04
Benchmark return	2.84	8.15	5.22
Value added	*-0.27*	*-1.16*	*+0.82*
From:			
Security selection	-0.31	-1.19	+0.77
Asset allocation	+0.04	-0.38	+0.18

Fund commentary

The Ethical Leaders Balanced Fund produced positive returns in the June quarter. It underperformed the benchmark over the quarter but has outperformed over three years and longer.

The main detractor towards relative performance over the quarter was security selection within global equities. Contributors included an overweight position in Australian shares and security selection within NZ and Australian shares.

Over the last 12 months, security selection in global and Australian equities and an overweight to global property detracted from relative performance. Allocation to NZ bonds and security selection within NZ equities and bonds contributed positively.

Mercer Ethical Leaders Growth Fund

Asset allocation

Sector	SAA (%)	DAA (%)	+/- (%)
Australian equities	22.5	24.0	+1.5
Global equities	57.5	56.0	-1.5
Property	10.0	10.0	0.0
Growth total	***90.0***	***90.0***	***0.0***
NZ fixed interest	2.5	2.5	0.0
Global fixed interest	2.5	2.0	-0.5
Cash	5.0	5.5	+0.5
Defensive total	***10.0***	***10.0***	***0.0***
Total	***100.0***	***100.0***	***0.0***

Fund performance

Ethical Leaders Growth Fund	Quarter (%)	1 year (%)	3 years (%)
Fund return	3.65	10.24	9.71
Benchmark return	4.55	12.09	8.73
Value added	-0.89	-1.85	0.98
From:			
Security selection	-0.85	-1.70	+0.98
Asset allocation	0.00	-0.42	+0.18

Fund commentary

The Ethical Leaders Growth Fund produced positive returns in the June quarter. It underperformed the benchmark over the quarter but has outperformed over three years and longer.

The main detractor towards relative performance over the quarter was security selection within global equities. Contributors included security selection and overweight positions to NZ and Australian shares.

Over the last 12 months, security selection in global and Australian equities and an overweight to global property detracted from relative performance. Overweight position to NZ equities and global bonds contributed positively.

New Zealand shares

Market review

The big driver of equity markets over the quarter was the unwind of debt market crunch concerns with the US banking system stabilising, and a strong performance by technology shares that benefit from an accelerating increase in the uptake of artificial intelligence and machine learning.

The New Zealand equity market was led up by positive returns from the information technology sector (positive updates from Vista and Serko), the real estate sector (Precinct and Goodman Property up on lower interest rates), utilities (positive monthly generation data from Meridian and Contact Energy, well supported capital raise from Infratil), selected health care shares (F&P Healthcare, positive news flow for Ryman and Summerset) and selected industrials (better-than-expected updates from Fletcher Building and Mainfreight).

Share price underperformance reflecting company specific news from Pacific Edge (tests not covered by US CMS funding), Ebos (contract loss), Freightways (earnings downgrades on cost and volume headwinds), and a2 (further weakness in Chinese infant formula demand) detracted from the New Zealand market's performance.

The New Zealand equity market has the potential to claw back some performance relative to global equity market returns with the Reserve Bank of New Zealand pausing its official interest rate increase cycle.

While equity markets have strengthened off their 2022 lows, there is potential for equity markets to grind higher. Under invested investors (institutional investors have below long run average exposure in equities), positive seasonality and current low expectations into the upcoming earnings season set-up markets for a slow grind higher.

But full valuations and earnings uncertainty mean it's difficult to project the gains of the first six months onto the second half of the year. There is a gap between economic lead indicators and earnings forecasts for some sectors and companies which may impact on performance of parts of the equity market. A weakening labour market, reduced Government fiscal support and tightish credit markets may slow discretionary spend/capital investment exposed parts of the economy. The pending New Zealand general election has the potential to increase uncertainty, with businesses and consumers stepping back until the electoral 'dust' has settled.

Mercer Ethical Leaders NZ Shares Fund

Fund performance

June 2023 quarter	%
Fund return	1.59
S&P/NZX 50 Gross Index with Imputation Credits	0.37
Relative performance	*+1.22*

Fund manager

Harbour Asset Management (Harbour) is the investment manager for the Mercer Ethical Leaders NZ Shares Fund.

Fund commentary

Fund performance was positive and ahead of its benchmark over the quarter. The Fund returned 1.6% over the quarter, outperforming its benchmark by 1.2%.

Over the quarter portfolio performance was enhanced by overweight investment in outperformers Xero, Serko, Ryman and Telix which provided positive updates, and underweight investment in underperformer a2 milk on falling Chinese infant formula demand.

Weakness in Pacific Edge, IDP Education, and Ramsay on negative updates, and being underweight outperformers Fletcher Building and Arvida detracted from portfolio returns over the quarter.

The Manager continues to focus on appropriately valued investments that benefit secular tailwinds, including technology dispersion, decarbonisation, and demographic changes. The recent rally in AI related investments highlights secular trends take time to be reflected in returns and require a degree of patience to navigate periods of under-performance. But when they do get momentum, they can be powerful economic forces. There is also a bias to quality, well-capitalised businesses that are less vulnerable to a tightening in financial conditions.

The portfolio continues to maintain a mix of investments in enduring growth stocks, including quality defensive growth stocks in the healthcare sector that can sustain and grow returns through a period of slower cyclical economic activity, and selected cyclical growth stocks, including financial stocks that have pricing power to deliver higher earnings in a period of higher inflation and increasing interest rates. It also includes stocks that benefit from secular trends such as demographic change, digitisation, industry disruption, decarbonisation (greenablers) and de-globalisation.

Global shares

Market review

Within global equity markets, big growth names which fell sharply last year have now turned to being the driving force behind this year's increase (so far). Growth stocks were up 12.8% on the quarter and an astonishing 31.2% year-to-date. Developed market equities, represented by the MSCI World, were up by 7.1% (local currency) and 9.1% in New Zealand dollar terms.

At a high-level, further progress on the disinflation front and the global economy's apparent resistance to tighter financial conditions remain the main protagonists for equities moving higher. The breakout in demand for AI has also played a significant part (particularly in the US), with some of the country's largest technology stocks posting spectacular gains as a result.

From a regional perspective, Japanese equities have been one of the best performing equity markets, both for the quarter (15.6%) and the year-to-date (23.8%) in local currency terms. Investor appetite is resurfacing as the Japanese economy looks to be moving away from the deflationary stagnation of the last few decades.

Furthermore, continued weakness in the yen has helped support Japanese stocks, many of which earn a significant portion of their profits abroad. Outside of Japan and the US, equity market returns were more muted – the MSCI Europe and Emerging Markets were up 1.8% and 1.7% respectively, while the MSCI UK was down -0.6% (all in local currency terms).

Mercer Ethical Leaders Global Shares Fund

Fund performance

June 2023 quarter	%
Fund return	4.76
MSCI World Index (69% hedged to NZD)	7.51
Relative performance	*-2.75*

Fund manager

The Mercer Ethical Leaders Global Shares Fund invests into the Mercer Socially Responsible Overseas Shares – Low Active Risk Fund. Schroders Investment Management is the current investment manager of this fund.

Fund commentary

The Mercer Ethical Leaders Global Shares Fund returned 4.76% over the quarter, underperforming the benchmark by -2.75%.

During the quarter the AMP Ethical Leaders International Share Fund, into which the Mercer Ethical Leaders Global Shares Fund invested, closed and was replaced with the Mercer Socially Responsible Overseas Shares – Low Active Risk Fund managed by Schroders Investment management. The transition to Schroders took place beginning 25 May and completed late June.

As discussed on page 2, during the quarter there was a change of underlying investment manager and underlying investment for the Mercer Ethical Leaders Global Shares Fund and a new benchmark index was introduced. The following commentary relates to the new Schroders strategy and describes how over the full quarter this new strategy outperformed the new index the MSCI World Index. The Mercer Ethical Leaders Global Shares Fund was only invested in this new strategy for part of the quarter.

As markets continued their advance, our increased exposure to stocks exhibiting structural growth and reasonable valuations continued to be beneficial. More specifically, stock selection within technology and communications was strong, as overweight positions in both US application software and online media were again supportive as they were buoyed by the broad-based technology rally driven by AI optimism. Our continued aversion to the low quality and overindebted real estate & utilities sectors further aided relative returns. Similarly, avoiding weakness in financials (particularly insurers) provided a further boost to relative performance.

Partially offsetting this, positioning within discretionary areas (autos and hotels and leisure) detracted, as did those positions in favoured companies with more stable characteristics. In particular, a larger than index weight to pharmaceuticals, home products and drink manufacturers detracted as defensive areas were overlooked.

Global fixed interest

Market review

Government bond yields generally increased as central banks continued their fight against inflation. However, some adjusted their stance as the speed of which price levels are coming down appear to be diverging at a regional level.

In Q2, the Fed put rate rises on hold after one preceding 25 bps increase in May, although, didn't rule further hikes out completely as they look to give themselves time to assess the still-developing effects of previous increases in interest rates. The Bank of England hiked by a larger-than-expected 50 bps in June as inflation remains extremely persistent (leading many to price in an even higher terminal rate of 6%).

Against this backdrop, the JP Morgan Global Aggregate Bond Index (NZD Hedged) fell -0.6%. The US 10-year yield ended the quarter at 3.81% (up 34 bps). UK Gilts suffered much worse as the UK 10-year yield was up a full percentage point and ended the quarter at 4.39%. Italian government bonds have been one of the better performers this year – benefiting from their higher starting yields.

In the credit space, high yield outperformed investment grade credit as more speculative assets gained traction amid a risk on environment. By and large, global bonds marginally increased despite weakness in sovereign debt, with the Bloomberg Barclays Global Aggregate Index (NZD hedged) up 0.1%.

Mercer Ethical Leaders Hedged Global Fixed Interest Index Fund

Fund performance

June 2023 quarter	%
Fund return	-0.16
Bloomberg Barclays MSCI Global Aggregate SRI Select ex Fossil Fuels Index (100% Hedged to NZD)	-0.18
Relative performance	*-0.02*

Fund commentary

The Fund is a passively managed international fixed interest portfolio that is designed to track the return of the Bloomberg Barclays MSCI Global Aggregate SRI Select ex Fossil Fuels Index, fully hedged to the New Zealand dollar.

The Fund returned -0.16% over the June 2023 quarter, slightly ahead of the benchmark return of -0.18%.

Important information

The New Zealand Guardian Trust Company Limited (NZGT) is the Supervisor of the Mercer Investment Funds under the Financial Markets Conduct Act 2013 (FMC Act). Investors should be aware that the value of an investment in any of the Mercer Investment Funds may rise and fall from time to time and that neither NZGT nor Mercer (N.Z.) Limited (Mercer) guarantees the investment performance, earnings or return of capital invested in any of the Mercer Investment Funds. The various investment options in the Mercer Investment Funds are issued by Mercer (N.Z.) Limited. Product Disclosure Statements are available on the Mercer website www.multimanager.mercer.co.nz.

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