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Ethical Leaders update

Mercer Investment Funds

Quarter ending 31 December 2024

A business of Marsh McLennan

Introduction

Welcome to the December 2024 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

Mercer (N.Z.) Limited is the manager of the Mercer Ethical Leaders Funds.

Sustainable Investment Policy

The Ethical Leaders Funds are governed by the Mercer NZ Sustainable Investment Policy and accompanying Mercer Socially Responsible exclusions list.

RIAA certification

All the Mercer Ethical Leaders Funds have been certified by the Responsible Investment Association of Australasia (RIAA), as of October 2023.

Mercer Ethical Leaders Funds name changes

The Mercer Ethical Leaders Funds will be changing their name during the next quarter as follows:

Current fund name	New fund name
Mercer Ethical Leaders Balanced Fund	Mercer Sustainable Balanced Fund
Mercer Ethical Leaders NZ Shares Fund	Mercer Responsible Trans-Tasman Shares Fund
Mercer Ethical Leaders Global Shares Fund	Mercer Responsible Global Shares Fund
Mercer Ethical Leaders Hedged Global Fixed Interest Index Fund	Mercer Responsible Hedged Global Fixed Interest Fund

The name changes are planned to be implemented on 28 February 2025, subject to the replacement Product Disclosure Statement with updated fund labels taking effect.

International engagement

The Schroders Quantitative Equity Products (QEP) investment team works in close collaboration with the Mercer Sustainable Investment team to facilitate its engagement activity. Schroders' engagement blueprint includes six priority engagement themes capturing issues relating to environmental (climate change, natural capital & biodiversity), social (human rights, human capital management, diversity & inclusion) and corporate governance.

Social issues continue to be an important area of focus, and Schroders engaged with several pharmaceutical companies on the blueprint themes of diversity & inclusion and human rights.

Recent communication with AstraZeneca is one example. The company is progressive in its approach to drug access which not only includes pricing initiatives but also diagnosis and healthcare infrastructure solutions. The company adopts a flexible pricing policy, recognising regional disparities in affordability while understanding the importance of diversity in clinical trials to further improve health access. AstraZeneca also highlighted the importance of their climate strategy and the engagement they conduct across their value chain to meet emissions targets and maximise resource use efficiency.

Engagement with Sanofi primarily focused on health security and governance. Sanofi's efforts in combating antimicrobial resistance (AMR) were discussed, with the company aiming for 100% compliance with the AMR Industry Alliance's Common Manufacturing Framework by 2025. They are also investing in the development of new antibiotics and therapies, with a significant portion of Research & Development (R&D) focused on World Health Organisation (WHO) priority pathogens. On governance, executive remuneration was covered given concerns over a lack of transparency, with improvements having subsequently been made in Sanofi's disclosures.

Engagement with GlaxoSmithKline (GSK) focused on access to medicines and diversity in their clinical trials. GSK confirmed access principles are considered throughout both R&D and product launch with patient access assessed alongside commercial returns. The company also noted their approach to partnering with external organisations for distribution to allow specific populations better access to medication.

During the quarter Schroders engaged with South Korean semi-conductor company SK Hynix on the topic of decarbonisation, with the focus on the company's progress towards setting more ambitious 2030 emission reduction targets. The company highlighted challenges in achieving an absolute reduction due to increased production capacity, but noted an improvement in emission intensity was achievable. They aim to increase renewable energy usage from 30% to 33% by 2030 due to the construction of a renewable electricity plant planned for completion by 2027.

Engagement also covered plans to expand the measurement of Scope 3 emissions, which are a significant contributor to the company's total emissions. Schroders will continue to monitor developments but see the progress so far as positive.

The stewardship process extends to a proactive voting programme. Schroders make considered use of voting rights and vote on all resolutions unless specifically restricted from doing so, with all voting carried out by Schroders' corporate governance specialists.

Schroders aims to vote on all resolutions unless specifically restricted from doing so with, with corporate governance specialists carrying out all voting activities. In the fourth quarter, it voted at over 200 meetings on over 1,500 resolutions for companies held across the QEP desk. Around 13% of votes were not with management and focused on compensation plans, the election of directors or were auditor related.

New Zealand engagement

Engagements with companies over the quarter were largely governance oriented given the prevalence of AGMs during the period, with some boards proactively conducting investor roadshows to field concerns and provide updates. Despite the governance emphasis, these discussions often involved other sustainability issues as well such as climate change.

The two recurring themes discussed in many engagements with board directors were board composition and climate change disclosure. On board composition, company chairpersons were particularly aware of managing the levels of tenure and independence across the board including their own succession planning. The importance of having an adequate level of independence was acknowledged but also recognising the need to balance this with the retention of valuable skills and experience on the board that can be shown through a skills matrix.

In terms of climate change disclosure, there was broad consensus over how costly and resource intensive the exercise has been to produce these reports and how it has detracted from other sustainability work.

Other sustainability issues covered during engagements included climate opportunities and green finance. In one case, we spoke with a technical expert at a power generation company (Contact Energy) to learn more about the potential for using deep or supercritical geothermal energy for the energy transition long term. On green finance, we engaged a company (Kiwi Property Group) with respect to its launch of a green bond to express our view that it's important that the assets are of a high (green) standard and how it is better to exceed the relatively lax criteria rather than be backed by a larger amount.

Industry engagement over the quarter largely focused on climate disclosures as well as stewardship and sustainable finance. On climate disclosures, Harbour Asset Management (Harbour) participated in the consultation from the External Reporting Board proposing changes to the regime, particularly the need to provide further time to comply with some of the difficult requirements under the regulation. Harbour was also involved in general industry advocacy on the topic through a course run by INFINZ as well as a sustainable investment event hosted by Otago University and NZ Super.

Regarding stewardship, Harbour participated in a webinar panel on voting practices as one of the key tools for promoting change as active shareholders. Sustainable finance has been another area that continues to progress, particularly with the new partnership between the Government and the Centre for Sustainable Finance. Harbour helped contribute to the development of the taxonomy project through its involvement with a new technical expert group established to oversee the strategic direction and framework of the taxonomy.

Overall, engagement over the year has been dominated by the first round of mandatory climate disclosures, with conversations centred on how companies have responded to the requirements and their thoughts about the effectiveness of the regime in general. Other issues covered during engagements included governance concerns, health and safety and customer hardship.

Going forward, climate disclosure is expected to be a key focus as companies turn to some of the more difficult reporting aspects such as transition plans that were optional to provide in the first year. More attention may also be paid to other emerging sustainability topics like the role of nature and biodiversity as well as the risks of generative artificial intelligence use.

Market environment

Economic review

International

There was notable market variation across regions and sectors in the final quarter of 2024. Global equities ended Q4 in the positive as a brief Trump-influenced rally in November pushed equities higher. But pessimism about the likelihood of rate cuts in 2025 applied some downward pressure in December.

In line with market expectations, central banks continued to cut interest rates over the quarter, the European and the US (Fed) central banks cutting rates by 50 bps and Canada cut 100 bps. The Fed noted that future interest rate cuts were likely to be gradual and dependent on inflation. The Bank of Japan left interest rates unchanged in the quarter at 0.25%, noting that Japan's economy had recovered moderately.

US CPI data was mostly unchanged in Q4 2024 with annual core inflation remaining at 3.3%. Rent and utility costs, a significant expense for households, have begun to ease, giving the Fed comfort to cut interest rates at their meeting.

The US employment rate increased slightly to 4.2% from 4.1% in Q3 2024. The US National Federation of Independent Business survey surged in Q4 2024, suggesting increased optimism following the US election for small businesses.

New Zealand

The Reserve Bank of New Zealand (RBNZ) delivered two consecutive Official Cash Rate (OCR) cuts during the quarter as the CPI (Consumer Price Index) and core inflation fell back within the target range. The official cash rate currently sits at 4.25%.

Economic activity in New Zealand remains subdued, with output below potential and inflationary pressures easing due to excess productive capacity and falling import prices. Employment growth is likely to remain weak until mid-2025.

During December, Statistics NZ announced that New Zealand was in a technical recession after gross domestic product (GDP) had fallen -1.0% during Q3 2024. This news came as 11 of the 16 industries contributing to GDP, experienced a decline in activity during the September quarter.

The most significant decreases were in manufacturing, business services and construction. Both goods-producing and service sectors also saw reductions, while primary industries experienced growth. Rental, hiring, real estate services and agriculture, recorded increases, with dairy farming driving the growth in agriculture.

Per capita GDP decreased at a slightly higher rate of -1.2%, marking the eighth consecutive decline in this metric.

Market outlook

International

We expect international economic growth to remain resilient but regionally divergent with the US experiencing a period of softer economic activity compared with other parts of the world. President Trump brings both upside and downside uncertainty to growth and inflation.

Central banks around the world are likely to continue to cut rates as inflation moderates but at a slower pace. The exception is Japan where interest rates are expected to rise as it emerges from a multi-decade deflation period. Japan is likely to continue to do well economically, driven by income growth and continued investment in capital expenditure.

We favour global listed property as fundamentals are broadly healthy, and valuations are attractive. We also favour Japanese shares due to the potential growth rebound and solid earnings growth.

New Zealand

Statistics released in December show the Q3 unemployment rate was 4.8%, which is a seasonally adjusted increase of 0.2% compared to Q2.

According to Statistics NZ, New Zealand's seasonally adjusted current account deficit decreased by $0.9 billion, bringing it down to $6.2 billion in Q3. Contributing to this decrease was fewer car imports and the absence of additional defence aircraft imports which were accounted for during the Q2 outcome.

Economic growth is anticipated to pick up again in Q4, fuelled by reduced borrowing costs that are likely to boost household spending.

Performance summary

Diversified

Mercer Ethical Leaders Balanced Fund

Underlying investment portfolio

The Mercer Ethical Leaders Balanced Fund invests into the Mercer Socially Responsible Balanced Portfolio within the Mercer Investment Trusts New Zealand.

Asset allocation

Sector weights (average)	Actual (%)	SAA (%)	Tilt (%)
Trans-Tasman shares	13.2	13.0	+0.2
Socially responsible overseas shares	11.7	22.1	-10.4
Socially responsible hedged overseas shares	18.3	16.9	+1.4
Overseas shares low risk	8.0	0.0	+8.0
Property	3.2	3.0	+0.2
Infrastructure	4.7	5.0	-0.3
Growth total	**59.1**	**60.0**	**-0.9**
Overseas sovereign bonds	10.8	11.0	-0.2
Socially responsible global credit	10.4	10.0	+0.4
Short term bonds	5.1	5.0	+0.1
NZ sovereign bonds	11.1	10.0	+1.1
Cash	3.5	4.0	-0.5
Defensive total	**40.9**	**40.0**	**+0.9**
Total	100.0	100.0	0.0

Fund performance

As at 31 December 2024

Ethical Leaders Balanced Fund	Quarter (%)	1 year (%)	3 years (%)
Fund return	1.98	12.12	3.29
Benchmark return	2.61	13.37	3.99
Value added	*-0.63*	*-1.25*	*-0.70*

Fund commentary

- The Mercer Ethical Leaders Balanced Fund produced positive returns in the December quarter but underperformed its benchmark. The Fund also underperformed over both one- and three-year periods. However, the Fund has outperformed its benchmark over five and seven years.
- The main contributors towards relative performance over the quarter was security selection in unlisted infrastructure and property and sovereign bonds, and the allocation to hedged and low risk overseas shares. Detractors included security selection in listed infrastructure, and the allocation to unhedged socially responsible overseas shares.
- Performance for the year reflects seven months (up to 31 July 2024) of the Fund's previous sector weights and returns, followed by five months (1 August to 31 December 2024) of the new underlying Mercer Socially Responsible Balanced Portfolio returns.
- Over the last 12 months, security selection in listed infrastructure and the allocation to socially responsible overseas shares detracted from relative performance. Security selection within unlisted property and infrastructure, NZ and global fixed interest, along with the allocation to index and low risk overseas shares, contributed positively.

New Zealand shares

Market review

Global equities faltered as 2024 came to an end, with a hawkish cut to official interest rates by the Fed and higher Government bond yields highlighting stretched investor confidence, which contributed to volatility in share markets.

Against the global trend the New Zealand S&P/NZX 50 benchmark had a slight gain, led up by the industrials (Auckland Airport), healthcare (Fisher & Paykel Healthcare) and consumer discretionary (Hallenstein Glasson) sectors.

Australia's S&P/ASX 200 benchmark dropped 3% in December, the worst monthly return of the year, dragged lower by the real estate, materials and information sectors. Overall, both the New Zealand and Australian share markets posted solid 11%+ returns in local currencies for 2024.

Mercer Ethical Leaders NZ Shares Fund

Fund performance

December 2024 quarter	%
Fund return	6.10
S&P/NZX 50 Gross Index with Imputation Credits	5.62
Relative performance	*0.48*

Fund manager

Harbour is the investment manager for the Mercer Ethical Leaders NZ Shares Fund.

Fund commentary

Fund performance was positive and ahead of the benchmark for the quarter. The Fund returned 6.10% over the quarter, outperforming its benchmark by 0.48%.

Over the quarter fund performance benefited from being overweight versus benchmark in outperformers Serko, Telix and Xero, and being underweight in underperformers Mercury and Fletcher Building. Underweighting of outperformer Auckland Airport, and overweighting of underperformers a2 milk, Pexa, James Hardie and Macquarie Group detracted from relative performance over the quarter.

After a strong rally, Harbour have topped up cash in the Australasian equity funds from low levels by reducing investment in selected companies. It will look to use pullbacks to invest in selected companies for potential better returns over the next 12 or more months.

Harbour's strategy remains to be patient, position for a range of scenarios and to be selective, focusing on quality growth. It continues to focus on companies delivering earnings per share growth, particularly where that earnings growth has the potential to be higher and last for longer than consensus expectations allow for.

The portfolio is overweight relative to the benchmark in investments with secular tailwinds in the defensive growth healthcare sector and the higher growth information technology sector. It continues to have a bias to quality, well-capitalised businesses that are well positioned to fund value adding growth opportunities, and remains underweight in the lower growth utilities, telecommunications, infrastructure and real estate sectors.

Global shares

Market review

Despite a shaky final quarter, global equities secured a second successive year of strong gains in 2024 amid a positive backdrop of a resilient US economy, robust earnings growth and central banks globally easing.

The key theme was the ongoing enthusiasm around artificial intelligence. This provided a strong tailwind to the big tech stocks which in turn led the overall market higher. The outsized performance of the Magnificent-7, most notably Nvidia, continued to have implications for market breadth, as over two thirds of the stocks in the S&P 500 underperformed.

It was a particularly difficult year for value focused investors who are unable to allocate to the big US stocks but according to MSCI's style indices, outside of the US market, value bettered growth.

Largely thanks to the strength of US equities (the MSCI US rose 24.6% in 2024 and now accounts for three-quarters of the MSCI World index), developed markets gained nearly 20% over the year (all figures shown in USD terms). The MSCI ACWI ex-US index posted a more modest increase of 5.5%, driven by Japan and the UK, as European stocks were flat. The MSCI Emerging Markets benchmark finished the year up 7.5% due to strength in Asia but was weighed down by a more challenging final quarter.

Donald Trump's win in the US presidential election negatively impacted sentiment outside the US due to concerns about the impact of potential tariffs. It also propelled the US dollar even higher. The dollar index gained 7.6% in the final quarter to a 25-month high which had a notable detrimental impact on the USD denominated returns of other markets.

As the year ended, global equities became more volatile. US equities initially reacted positively to Republican control of congress amid hopes their policies will support growth via tax cuts and reduce regulation. However, this was followed by a correction in December after the US Federal Reserve indicated that sticky inflation reduced their scope to cut rates much further.

Conversely, European and UK equities fell over the quarter driven by fears of recession and tighter fiscal policies respectively, as well as currency weakness. Japanese shares gained in local currency terms in the fourth quarter amid strong gains for financial stocks, but this was fully offset by a 9% fall in the yen.

Mercer Ethical Leaders Global Shares Fund

Fund performance

December 2024 quarter	%
Fund return	5.36
MSCI World Index (69% hedged to NZD)	5.40
Relative performance	*-0.04*

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 slightly underperformed during the fourth quarter. However, following on the back of a solid 2023, the portfolio outperformed its benchmark again in 2024, driven by strong stock selection from a variety of areas.

A key positive contributor over the year was good stock selection within US technology, particularly positioning within hardware and semis. Positioning in better value cyclicals was a highlight in the second half of the year.

In the final quarter, maintaining a balance between more affordable stocks and areas of higher structural growth was rewarded as the strategy finished the year on a firmer footing despite the more turbulent backdrop.

A mix of both quality cyclicals (industrials – defence & aero) and attractive areas of structural growth (Japanese semis) supported performance in the fourth quarter. Avoiding lower quality materials on the back of weaker commodity prices also contributed to relative performance.

Detractors were limited, but a lower than index exposure to utilities (fossil fuel utilities) was costly as the sector continued to perform well given the perceived increase in power demand from data centres.

Schroders Investment Management remained diligent in profit taking during 2024 while taking advantage of wide performance dispersion to purchase or top up compelling options higher up the quality spectrum. Gains were taken across technology, consumer discretionary and communications services where performance was strong.

During the final quarter, Schroders exploited end-of-year volatility by shoring up allocations to the highest quality financials, industrials and technology names and continued to reduce positioning across health care and select staples. This was led in part by profit taking and M&A activity and partly risk-reduction to reflect declining quality in pharmaceuticals.

The strategy starts 2025 with a broad and diversified global exposure. Technology is the largest overweight, focused on stocks demonstrating stronger growth characteristics alongside palatable valuations within application software, hardware and IT services.

The strategy remains discerning in financials due to balance sheet considerations, with holdings mainly in insurers and high-quality diversified banks. In industrials, the strategy is selective but favours manufacturing and business services. Regionally, exposure remains consistent with an overweight to North America which still represents the best quality opportunities versus other developed markets. The UK, and Europe remain a source of funding as their fundamentals are less compelling and are potentially declining, while a modest exposure to emerging markets is retained, primarily in Asian technology and communications.

Global fixed interest

Market review

Fixed income market performance was relatively flat. International government bonds produced negative returns over the quarter (-1.2% Bloomberg Global Agg Hedged). Yields climbed after the Fed noted further interest rate cuts will be made cautiously and be dependent on inflation.

Many central banks around the world cut interest rates in December and are likely to continue at a more gradual pace, except in Japan where rates are expected to rise as it emerges from a period of deflation.

Bond yields across the US treasury curve increased during the quarter, initially reacting to Trump's election victory and the Fed's hawkish comments.

In Europe, while sovereign bond yields rose, the European Central Bank's interest rate cuts and concerns over inflation led to mixed market reactions.

Mercer Ethical Leaders Hedged Global Fixed Interest Index Fund

Fund performance

December 2024 quarter	**%**
Fund return	-1.51
Bloomberg MSCI Global Aggregate SRI Select ex Fossil Fuels Index (100% hedged to NZD)	-1.65
Relative performance	*0.13*

Fund commentary

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

The Fund returned -1.51% over the December 2024 quarter, ahead of the benchmark return of -1.65%.

Mercer

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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