Ethical Leaders update

Mercer Investment Funds

Quarter ending 30 June 2024

Introduction

Welcome to the June 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 of Ethical Leaders Funds

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

Sustainable Investment Policy

The Mercer 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 recertified by the Responsible Investment Association of Australasia (RIAA) as of October 2023.

Change to Mercer Ethical Leaders Balanced Fund

The Mercer Ethical Leaders Balanced Fund's current underlying investments are being replaced with the Mercer Socially Responsible Balanced Portfolio within the Mercer Investment Trusts New Zealand. This change will take effect from 6 August 2024.

The reason for this decision is to leverage Mercer's existing capability and benefit from greater economies of scale. By doing so, we aim to enhance the efficiency of the Fund's operations and improve its ability to deliver cost-effective returns.

Diversified fund closures

The Mercer Ethical Leaders Conservative Fund and Mercer Ethical Leaders Growth Fund will both close on 28 August 2024. This decision was made due to the small size of these funds, which makes them inefficient to operate and deliver cost-effective returns.

International engagements

The Schroders Quantitative Equity Products (QEP) investment team works in close collaboration with the 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.

Climate change and biodiversity continue to be key subjects of engagement, with several engagements focused on environmental topics conducted during the second quarter. Banks JP Morgan Chase & Toronto-Dominion Bank were both engaged with on their climate alignment practices. The engagement with JP Morgan Chase centred on the bank's green bond framework to understand how the proceeds from green bond issuance were being used. The Manager sought further information around their financed emissions framework, asking for more robust financed emissions disclosures and the methodology employed to set their new energy targets.

With regards to Toronto-Dominion Bank, the focus was on their climate strategy and transition readiness. The bank openly discussed their approach to assessing their transition readiness, highlighting the use of tools such as their Transition Plan Assessment Framework. They emphasised their commitment to delivering on their existing targets rather than extending them further.

It is pleasing to learn that climate risk is integrated into their credit assessment processes to identify potential transition risks in their lending book. Furthermore, the bank has increased its focus on utilising sustainability metrics in the remuneration policies for senior-level executives, including financed emissions targets.

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

Schroders, as a firm, votes on all resolutions unless specifically restricted from doing so with, with corporate governance specialists carrying out all voting activities. In the second quarter, it voted at over 800 meetings on almost 12,000 resolutions for companies held across the QEP desk. Approximately 15% of these votes were not in alignment with management. Votes against management were primarily focused on compensation plans, the election of directors, or auditor-related matters.

Schroders voted against ASML's remuneration proposal as the metrics used to set targets within the long-term incentive proposal were below expectations.

They also voted against AstraZeneca's proposed new director given the overboarding of the company's board presently. The nominee already sits on a number of external boards which could also impact their ability to appropriately carry out the role if elected.

New Zealand engagements

Over the quarter, engagement with companies increasingly focused on governance-related matters. This was due to the growing number of Annual General Meetings (AGMs) and investor roadshows organised by company boards. During these engagements, a range of Environmental, Social, and Governance (ESG) issues, including climate change, remuneration, and artificial intelligence, were discussed.

The governance-related engagements primarily centred around concerns regarding executive remuneration. In both cases, there were questions raised about the justification of bonus outcomes considering the companies' financial performance. However, the explanations provided were satisfactory from the Manager's perspective.

Another issue that was discussed, specifically in the case of Stride Property, was transparency on performance hurdles, namely the lack of transparency and justification for bonus outcomes. The Manager will continue to monitor this issue and advocate for improvement.

The Manager had discussions on other sustainability issues such as climate change and artificial intelligence during engagement with the Mercury Energy board as part of their investor roadshow. It was particularly insightful to learn about their experience with climate-related disclosures reporting and the resource burden and regulatory fatigue they encountered. This highlighted the challenges faced by companies with limited voluntary disclosure prior to the implementation of mandatory reporting requirements.

Artificial intelligence emerged as an interesting topic during these engagements, and it was encouraging to see it being discussed at the board level. It is anticipated that it will become more prevalent across the market in the future.

Industry engagement over the quarter primarily involved the Manager's continued participation in the technical advisory group for the development of a Green Taxonomy in New Zealand. This classification system aims to define activities that are sustainable and contribute to the country's environmental objectives while considering cultural and social considerations. Additionally, the RIAA conference in Australia provided valuable insights into the key issues facing investee companies in that region.

Overall, engagement efforts this year have continued to focus on climate change, given the introduction of mandatory reporting standards. These efforts have been complemented by an increasing number of governance conversations, particularly regarding executive and director remuneration.

Looking ahead, the upcoming August company reporting season will serve as another catalyst for engagement, especially if any areas of concern are highlighted in the disclosures.

Economic summary

Market review

The second quarter of 2024 saw a continuation of the positive economic momentum from the first quarter. Equity markets experienced another period of growth, despite initial worries about an overheating US economy. However, as the quarter progressed, concerns eased and hopes for a soft landing resurfaced. Over in the Eurozone, the economy remained on a positive trajectory as the impact of the cost-of-living shock diminished.

While the worries about inflation at the end of Q1 turned out to be exaggerated in Q2, service sector inflation remained stubbornly high, exceeding the targets set by central banks. This caused expectations for rate cuts by Western central banks to decrease compared to projections from the beginning of the year. Despite this, most major asset classes ended the quarter in positive territory.

Developed market equities, as represented by the MSCI World index, achieved a positive total return of 3.0%. This performance was primarily driven by larger companies, while smaller cap stocks and real estate investment trusts (REITs), which are more sensitive to interest rates, faced challenges due to the anticipation of higher rates in the long term.

Fixed income investors generally experienced an underwhelming quarter with more muted gains. The Bloomberg Global Aggregate Bond Index (NZD hedged) was up just 0.1% over the quarter.

All in all, the second quarter of 2024 maintained the positive trend established in the first quarter, with risk assets generating favourable returns for investors.

Market outlook

For over a year, economists and investors have been fearful that elevated interest rates and tight monetary policies could tip the US economy into a recession, but the economy has shown remarkable strength. Higher incomes and low unemployment have supported consumer spending, and businesses have managed their costs and pricing to convert higher sales into profits.

Looking towards the latter half of 2024, there is confidence that the US economy is slowing, which should lead to further labour market loosening and, hence, lower inflation, allowing the Fed to cut interest rates. This creates an environment where risk assets should perform strongly.

However, investors should brace themselves for political risks as the US presidential election in November draws closer, with the potential for it to be a close and divisive race. President Biden's withdrawal from the 2024 election, endorsing Vice President Harris, has upended market expectations.

Bonds should continue to offer attractive absolute yields as long as policy rates remain above inflation. In the US, bond market pricing indicated an increased likelihood of a cut by the Fed at the September meeting. In the UK, bond markets strengthened their expectations of a cut on August 1 by the Bank of England (BoE) following a significant change in tone from the Monetary Policy Committee and inflation easing to 2% in May, which is in line with the BoE's target. However, some Committee members are not yet convinced that the drop in inflation is sustainable and want to see more data and evidence of diminishing inflation to make a firm decision.

Closer to home, household consumption is expected to remain weak as the labour market continues to weaken, while many mortgages are resetting to higher rates. With a weaker labour market, consumer confidence has fallen further to well below pre-Covid levels. Surveys also suggest that business conditions have further deteriorated, with more firms reducing investment and staff numbers due to weak domestic demand.

While the Government confirmed it will cut taxes from July as proposed in last year's election, offering some support to households, the net impact on the economy is likely to be small given that this will be offset by spending cuts.

Diversified portfolio activity for the quarter

Global growth has remained broadly resilient amid slowing disinflation and increased policy uncertainty. While energy and food price inflation are now almost back to pre-pandemic levels in many countries, services inflation are proving rather sticky in advanced economies. This may force major central banks to hold interest rates “higher for longer”, keeping borrowing costs elevated and putting upward pressure on the US dollar with a potential for spillovers to emerging markets.

Additionally, company valuations have risen to alarming levels. The US index’s cyclically adjusted price-earnings (cape) ratio is sitting at 36, near dotcom bubble and 2021 highs, both of which preceded crashes. Investors are also attaching exaggerated expectations on corporate earnings which could cause equity bull market to end abruptly should earnings disappoint.

We are also cognisant of debt sustainability concerns given the notable deterioration in public finances following the pandemic-era stimulus. With little appetite to tighten the fiscal stance, higher debt levels, larger deficits and lower nominal GDP levels could force market to take notice again, raising government bond yields and adding risks to global financial stability. Countries with limited fiscal space and higher debt burdens like France, Spain, Italy, the UK and Japan are also likely to face additional fiscal constraints in future downturns.

While the market appears relatively calm about fiscal risk, the summer period is notorious for lower liquidity and outsized reactions to shocks. Last August, the US Treasury refunding announcement of surprisingly large issuance saw treasury yields rise from less than 4% to nearly 5% by the end of September.

Finally, the uncertainty with election outcomes this year could cause heightened volatility as most recently seen in the snap election in France. Bond markets are rightly concerned with the voters’ shift to right-wing parties whose policies are typically associated with increased government spending and further borrowing. Moreover, with the prospect of a second Trump presidency climbing following the recent debate, an introduction of further tariffs and a tit for tat response may lead to a global downturn.

Overweight growth assets – overweight listed property/underweight global equities

We have retained our underweight to global developed equities in Q2. Developed economies are showing considerable resilience in the face of tighter financial conditions.

While we have seen the timing of rate cuts pushed further out in the US to later this year, the European Central Bank and the Bank of Canada have both started cutting rates this quarter.

Despite global REITs underperforming developed equities over the first half of the year, we retain conviction in this pairing as a topping out in rates should support property valuations to a greater extent than the currently richly valued developed market in a declining rate environment.

Overweight New Zealand fixed interest – underweight cash

We retained our overweight to New Zealand fixed interest in Q2. The position was implemented in Q4 2024 to add duration to the portfolios as yields spiked, driving the NZ 10-year above 5%.

Given the current economic environment with declining inflation, increasing unemployment and weaker economic outlook, the RBNZ may look to cut policy rate later in 2024. We believe with the likely topping out of rates, an overweight duration position is still warranted. Cash is the desired funding position as any move downward in rates will support NZ fixed interest and provide headwinds to cash.

As we get more certainty around the timing and size of rate cuts, we expect yields to soften and the currently negative yield curve to flatten.

Performance summary

Diversified funds

Fund commentary

- The Macquarie Ethical Leaders Diversified Funds generated positive returns over the second quarter of 2024. The Mercer Ethical Leaders Conservative Fund returned 0.69% for the quarter and 7.16% over the last 12 months. The Mercer Ethical Leaders Balanced Fund returned 0.88% for the quarter and 10.98% over the past 12 months. The Macquarie Ethical Leaders Growth Fund returned 1.53% for the quarter and 14.64% over the last year.
- The Mercer Ethical Leaders Conservative, Balanced and Growth Funds all outperformed the benchmark over the quarter and 12 months period. All three Ethical Leaders Diversified Funds have outperformed over three years and longer.

Mercer Ethical Leaders Conservative Fund

Asset allocation

Sector	SAA (%)	DAA (%)	+/- (%)
Australasian equities	5.0	5.0	0.0
Global equities	13.0	13.0	0.0
Property	7.0	7.5	+0.5
Growth total	***25.0***	***25.5***	***+0.5***
NZ fixed interest	25.0	25.0	0.0
Global fixed interest	25.0	27.0	+2.0
Cash	25.0	22.5	-2.5
Defensive total	***75.0***	***74.5***	***-0.5***
Total	***100.0***	***100.0***	***0.0***

Fund performance

Ethical Leaders Conservative Fund	Quarter (%)	1 year (%)	3 years (%)
Fund return	0.69	7.16	1.21
Benchmark return	0.55	6.72	0.97
Value added	*+0.14*	*+0.43*	*+0.24*
From:			
Asset allocation	*-0.09*	*-0.24*	*-0.16*
Security selection	*+0.23*	*+0.67*	*+0.40*

Fund commentary

- The Ethical Leaders Conservative Fund produced a positive return in the June quarter. The Fund outperformed its benchmark over the quarter and outperformed over one and three year periods.
- The main contributors to relative performance were security selection within NZ shares, global shares and global bonds. This was partially offset by security selection within global property and allocation to NZ shares.
- Over the last 12 months, security selection in NZ shares, global shares, NZ bonds and global bonds contributed to relative performance along with an allocation to cash. This was offset by the allocation to NZ Shares, NZ bonds and global property.

Mercer Ethical Leaders Balanced Fund

Asset allocation

Sector	SAA (%)	DAA (%)	+/- (%)
Australasian equities	20.0	20.0	0.0
Global equities	35.0	34.5	-0.5
Property	10.0	11.0	+1.0
Growth total	***65.0***	***65.5***	***+0.5***
NZ fixed interest	12.5	13.5	+1.0
Global fixed interest	12.5	12.5	0.0
Cash	10.0	8.5	-1.5
Defensive total	***35.0***	***34.5***	***-0.5***
Total	***100.0***	***100.0***	***0.0***

Fund performance

Ethical Leaders Balanced Fund	Quarter (%)	1 year (%)	3 years (%)
Fund return	0.88	10.98	3.28
Benchmark return	0.26	9.37	2.69
Value added	*+0.62*	*+1.61*	*+0.59*
From:			
Asset allocation	*0.00*	*+0.15*	*+0.02*
Security selection	*+0.62*	*+1.46*	*+0.61*

Fund commentary

- The Ethical Leaders Balanced Fund produced positive returns in the June quarter. The Fund outperformed its benchmark over the quarter and outperformed over one and three year periods.
- The main contributor towards relative performance over the quarter was security selection in NZ shares and global shares. Detractors included security selection in global property and the allocation to NZ shares and cash.
- Over the last 12 months, security selection in global property and the allocation to NZ shares detracted from relative performance. Security selection within NZ equities, global shares and global bonds, along with the allocation to global shares and global bonds, contributed positively.

Mercer Ethical Leaders Growth Fund

Asset allocation

Sector	SAA (%)	DAA (%)	+/- (%)
Australasian equities	22.5	22.5	0.0
Global equities	57.5	56.5	-1.0
Property	10.0	11.5	+1.5
Growth total	***90.0***	***90.5***	***+0.5***
NZ fixed interest	2.5	3.0	+0.5
Global fixed interest	2.5	2.5	0.0
Cash	5.0	4.0	-1.0
Defensive total	***10.0***	***9.5***	***-0.5***
Total	***100.0***	***100.0***	***0.0***

Fund performance

Ethical Leaders Growth Fund	Quarter (%)	1 year (%)	3 years (%)
Fund return	1.53	14.64	5.24
Benchmark return	0.58	12.91	4.68
Value added	*+0.95*	*+1.73*	*+0.56*
From:			
Asset allocation	*+0.10%*	*-0.06%*	*-0.18%*
Security selection	*+0.85%*	*+1.79%*	*+0.74%*

Fund commentary

- The Ethical Leaders Growth Fund produced positive returns in the June quarter. The Fund outperformed the benchmark over the quarter and outperformed over one and three year periods.
- The main contributor towards relative performance over the quarter was security selection in NZ shares and global shares. Detractors included the allocation to NZ shares, fixed interest and cash.
- Over the last 12 months, security selection in global property and the allocation to NZ shares and cash detracted from relative performance. Security selection in NZ and global shares and the allocation to global shares and property contributed positively.

New Zealand shares

Market review

The New Zealand share market rose over the June quarter and ended the quarter up 12.7% from its 12-month low on 30 October 2023. New Zealand 10-year Government bond yields fell by 0.16% over the June, boosting the attractiveness of shares and contributing to the better returns.

The Australian market benefited from positive earnings revisions, while less hawkish Reserve Bank of Australia comments saw Australian 10-year Government bond yields fall by 0.17% over June. M&A activity also supported returns.

The S&P/NZX 50 benchmark indices rally over June included broad market participation, with most shares making a positive contribution. This may reflect investors anticipating a move by the Reserve Bank of New Zealand to start easing interest rates and moving to a more neutral monetary policy stance which is more supportive for share market returns, with the New Zealand economy in recession and inflation rates continuing to fall.

Strength in a2 Milk, Fisher & Paykel Healthcare, Infratil, Contact Energy and Meridian led the New Zealand share market up over the quarter. Weakness in Ryman, Fletcher Building, Auckland Airport, Spark NZ and Kathmandu held the market back over the quarter.

The best performing New Zealand shares during the quarter included a2 Milk, Gentrack, Hallenstein Glasson, Vista and Sky City. The worst performers over the quarter included Kathmandu, Ryman, Oceania, Tourism Holdings and Fletcher Building.

The Australian market also benefited from positive earnings revisions, while ongoing M&A activity (including the proposed takeover of Virgin Money and several smaller market capitalisation shares) boosted returns. Bank sector share buyback programmes supported the sector, while choppy commodity prices contributed to volatility in resource sector returns.

Earnings revisions over the past three months remained slightly negative. Australian company profit updates contributed to increasing return dispersion between shares during the period.

Over the quarter, strength in the information technology (IT), property and consumer discretionary sectors drove the Australian market higher, while weakness in the materials (mainly resource shares), communications services and consumers staples sectors dragged on overall market returns.

Mercer Ethical Leaders NZ Shares Fund

Fund performance

June 2024 quarter	%
Fund return	-0.93
S&P/NZX 50 Gross Index with Imputation Credits	-3.13
Relative performance	*2.19*

Fund manager

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

Fund commentary

Fund performance was negative but ahead of its benchmark for the quarter. The Fund returned -0.93% over the quarter, outperforming its benchmark by 2.19%.

The New Zealand share market fell over the quarter reflecting a combination of earnings forecast downgrades, weak domestic economic data, and the digestion of a large capital raise by Infratil. Weakness in industrials, communication services, and real estate contributed to the fall in the NZ share market. The Australian share market also fell over the quarter reflecting weakness in the real estate, energy and materials sectors.

The outperformance of the Fund over the quarter reflected being overweight in structural growth outperformers Telix, Infratil and CSL, as well as having nil investment in Sky City and underweight investment in Fletcher Building which both underperformed.

While mixed, the global economic framework remains broadly positive for share market returns with lead economic indicators suggesting solid but not spectacular global growth for the coming year and inflation continuing to slow.

The disinflationary trend means some central banks, including the Reserve Bank of New Zealand, may be moving towards less restrictive monetary policy, but stubborn inflation means others such as the Reserve Bank of Australia may maintain restrictive settings for longer. This macro backdrop may be constructive for equity returns but capital markets may continue to walk the tightrope of disinflation and growth.

Investor positioning globally is fully invested with limited allowance for risk, which may prove reasonable if earnings growth continues to beat expectations. Locally, investors have a low level of investment in NZ shares relative to their long run targets. Geopolitical risk, including the US Federal, French and UK general elections, may contribute to an increase in policy uncertainty for investors.

Harbour's strategy is to position for a range of scenarios and to be selective. They continue to see the secular tailwinds of digitisation, disruption, de carbonisation, and demographic changes as supporting company earnings.

The portfolio is selectively overweight growth at a reasonable price (GARP) shares in the healthcare, information technology, financial services and materials sectors. It also favours businesses with productivity and efficiency 'self-help' programmes, particularly where business reengineering introduces technology that improves both revenue and cost structures.

Mercer Ethical Leaders Global Shares Fund

Fund performance

June 2024 quarter	%
Fund return	2.81
MSCI World Index (69% hedged to NZD)	2.40
Relative performance	*0.41*

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 outperformed during the second quarter, building on earlier gains made in the year. During this period, the market showed narrow leadership, particularly in areas with high earnings potential. Despite this, large cap US stocks performed strongly, although market breadth decreased significantly.

Despite the lack of broad stock participation, the strategy’s balanced approach, which focuses on value and quality, remained robust. By avoiding weaker areas and prioritising affordable quality, the Fund achieved positive relative performance.

The Fund's positioning in healthcare and consumer discretionary sectors was beneficial. Avoiding underperforming health equipment and providers, and holding higher quality pharmaceutical stocks, contributed to positive performance. Similarly, not investing in weaker automakers and retailers, while holding positions in online retail, had a positive impact. Positioning in the US technology sector also contributed to overall gains.

However, there were detractors as stock selection within the financials and industrials sectors had a negative impact. The Fund's preferred names in insurers and payments, as well as its holdings in US manufacturers and construction-related industries, lagged.

Global fixed interest

Market review

Global bonds (NZD hedged) ended the quarter in positive territory, albeit by a narrow margin of 0.1%.

The quarter began with a disappointing start for global bond markets as concerns about US inflation prompted investors to reconsider the timing of interest rate cuts. However, as the quarter progressed, the market environment became more favourable due to softer labour market conditions and encouraging inflation news.

Global central bank action was plentiful with the European Central Bank, Bank of Canada, and Swiss National Bank all implementing interest rate cuts. In contrast, the US Federal Reserve and Bank of England adopted a more cautious approach and chose to maintain interest rates at their current levels.

Mercer Ethical Leaders Hedged Global Fixed Interest Index Fund

Fund performance

June 2024 quarter	**%**
Fund return	-0.06
Bloomberg Barclays MSCI Global Aggregate SRI Select ex Fossil Fuels Index (100% Hedged to NZD)	-0.16
Relative performance	*0.10*

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 -0.06% over the June 2024 quarter, ahead of the benchmark return of -0.16%.

Important information

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