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Ethical Leaders update

Mercer Investment Funds

Quarter ending 30 September 2024

A business of Marsh McLennan

Introduction

Welcome to the September 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 underlying investments were replaced with the Mercer Socially Responsible Balanced Portfolio within the Mercer Investment Trusts New Zealand. This change took effect on 6 August 2024.

The reason for this was 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 closed 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, and engagements were held with several consumer staples companies on the topic of deforestation.

With Kimberley Clark, understanding was sought on the company's strategy to manage forestry risks and plastics usage. The company confirmed that they have comprehensive practices in place. Specifically, they conduct forest & agricultural land refreshing practices and are already in compliance with the European Union's deforestation regulation (EUDR). This regulation applies to companies with exposure to certain commodities and requires them to demonstrate their products are not linked to forest degradation or illegal harvesting practices.

The company also highlighted their intent to set more ambitious environmental targets, improving their forest land and agricultural practices and their ongoing efforts to reduce their plastic footprint. Future discussions are planned into the topics of water use and timelines for TNFD (Taskforce on Nature-related Financial Disclosures) reporting.

In discussions with Procter & Gamble, the company explained their increased support for smallholder farmers in their efforts to increase yields while minimising the environmental impact to meet sustainable production standards. While the company acknowledges traceability challenges for palm oil production, they are working on satellite monitoring capabilities to improve their exposure.

Schroders also engaged with several pharmaceutical companies on a range of social and governance topics. This included engaging with Pfizer on their Access to Healthcare initiative and approach to Antimicrobial Resistance (AMR). Further details were requested on their progress in combating AMR and targets for 2025 following the company's commitment to limit the discharge of pharmaceutical ingredients into wastewater.

Concerns were also raised about the combined CEO/Chair role and the lengthy tenure of KPMG as auditor. Schroders are awaiting Pfizer's response but have encouraged them to re-evaluate their approach to better align with global best practice.

Another engagement was with Bristol-Myers Squibb on AMR, who highlighted their commitment to sustainable business practices and their Pharmaceutical Discharge Assessment Programme. This programme evaluates potential impacts of medicines on water ecosystems and human health. Furthermore, the company partners with the Pharmaceutical Supply Chain Initiative (PSCI) to implement supply chain best practices and reduce potential environmental impacts.

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 votes on all resolutions unless specifically restricted from doing so with, with corporate governance specialists carrying out all voting activities. In the third quarter, it voted at over 200 meetings on more than 2,000 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 engagements

Engagement with companies over the quarter was largely in the form of post result meetings with executives where sustainability issues were also discussed. The main topic covered was climate change, particularly given the new regulatory reports (climate-related disclosures) published from many of the companies.

Conversations on climate change centred on disclosure, with many companies noting the challenges involved in putting together their first reports compliant with new regulation. The Infratil Board Chair noted how it had been a costly and resource intensive exercise but would likely become more efficient as time goes on. Infratil remain committed to its science-based target that was recently established with the focus being on increasing its coverage of interim targets across its portfolio companies.

The power generator companies (Contact and Mercury) reported that the lack of rainfall over the past year has resulted in a greater reliance on fossil fuel generation and subsequently higher carbon emissions. While some of these factors were outside of the companies' control, Harbour queried how feasible emissions reduction targets are and if they would still be on track.

Expectations were mixed when it came to short term targets, but all companies engaged with were committed to long term targets with strategies in place to help achieve them, such as new renewable energy projects in the pipeline and/or the substitution of fossil fuels with low emitting fuels like biomass.

The Manager also queried companies on other sustainability topics such as health and safety, Te Ao Māori and customer hardship. It noted improving health and safety performance from company reports but asked Fletcher Building for further information on a fatality that had occurred.

Some companies, such as Mercury Energy, are developing strategies to strengthen Te Ao Māori, particularly managing relationships with iwi stakeholders, and supported by increased resourcing in this space.

Customer hardship has been another topical issue given cost of living pressures, with Mercury Energy noting collaborative initiatives with community agencies to help support these people where possible.

The Manager Harbour's industry engagement over the quarter was principally through their participation at the RIAA conference here in New Zealand. This involved contributing to two of the sessions, one on sustainability in the real estate sector and the other a workshop on stewardship in practice. The conference in general also gave some useful insights on the key issues facing investee companies in our region.

Overall, engagement following the company reporting season has continued to show climate disclosure as the key sustainability theme for the year. While there have been valid concerns of this coming at the detriment of other ESG considerations, Harbour continues to have conversations with companies on issues such as remuneration, health and safety and hardship.

Looking forward, the remainder of the year will see more attention paid to governance concerns as we enter the peak of the Australasian AGM season. The Manager will seek to scrutinise any contentious resolutions that arise and engage companies where appropriate.

Economic summary

Market review

Interest rate cuts were the talk-of-the-town during the third quarter as most major global economies began their easing cycles, including New Zealand, the US and major Eurozone players.

July was coined “the great rotation” for equities and jump-started a trend which continued throughout the quarter as markets turned their focus to small caps and value-style sectors, with funds starting to flow out of mega-caps and into interest rate sensitive asset classes. Such activity was influenced by a growing hope for an economic soft landing and underwhelming quarterly earnings reports from the "Magnificent 7" in July.

Japanese stocks dropped -4.9% following the Bank of Japan's July rate hike and comments from Governor Ueda suggesting more increases ahead, coinciding with a weak US labour market report. As interest rate differentials between the US and Japan decreased, the yen strengthened, leading to a rapid unwinding of carry trades that depended on low Japanese borrowing costs. Although a more positive tone from Bank of Japan officials helped mitigate some losses, the market still finished the third quarter down.

In contrast, European equity returns were modest, with MSCI UK and MSCI Europe gaining 3.4% and 2.1%, respectively (local currency), while the S&P 500 rose 5.9%, indicating a potential broadening of returns for equity investors.

Fixed income markets experienced a boost from the anticipation of lower interest rates, with the Bloomberg Global Aggregate Index (NZD Hedged) posting a return of 7.0% in the third quarter. Both government bonds and credit instruments generated strong returns, while emerging market debt surged by 6.1% during the quarter, positioning it near the top of the performance rankings for fixed income sectors year-to-date.

Market outlook

The immediate outlook for the global economy is starting to stabilise, yet several vulnerabilities persist. There are grounds for cautious optimism, particularly due to a steady decline in inflation rates and a move towards more relaxed monetary policies.

However, the ongoing slow pace of global growth, coupled with increased political instability, puts many nations at risk of economic disruptions, with current government debt hindering initiatives aimed at stimulating growth.

As a result, the key market outlook theme is the varying economic data coming out of influential, global economies. The varying growth paths observed in recent years has led to a disconnect between the US and the economic cycles in Europe and the UK. This suggests that Europe and the UK may continue their recovery even if the US manages a soft landing. Conversely, a recession in the US would likely have ripple effects globally, affecting trade and overall confidence.

Japan's economy is struggling, with weak GDP growth and household spending pressured by rising prices, though business confidence is improving. The Bank of Japan plans to raise interest rates further, while in China economic outlook is bleak due to unresolved property market issues, slowing credit growth, and low consumer confidence, with a meaningful recovery unlikely without government stimulus.

Locally, NZ CPI (Consumer Price Inflation) data is looking promising and back within the target range of 1-3%, leading to the RBNZ to cut the Official Cash Rate (OCR) by 50 bps on 9 October. Markets are now pricing in more aggressive cuts to follow.

NZ fixed income yields have remained stable recently, even as global rates rise, with 10-year NZ Government Bond yields trading below AUS government bonds for the first time in three years. Meanwhile, the US Treasury market is experiencing heightened implied volatility due to uncertainty surrounding the Fed's response to economic conditions and potential fiscal policy changes of the upcoming election. This election event will be watched closely in the coming weeks alongside the evolving geopolitical tensions in Europe and the Middle East.

Diversified portfolio activity for the quarter

Over the quarter as headline inflation continued to approach their targets, major central banks have started cutting rates with their focus shifting towards growth and unemployment. This has in turn reduced the likelihood of a global recession in favour of a soft landing and buoyed asset prices further.

With the direction unclear for further rate cuts, we expect to see a continued divergence in rate cutting across regions as some central banks push back against market expectation particularly where inflation remains above target.

In August, we saw brief market turmoil where the narrowing of the US-Japan interest rate differential following the unexpected rate hike by the Bank of Japan led to the strengthening of the yen and unwinding of the 'carry trade'. While the equity market sell off was short lived, it showed how shifting sentiment, and increased leverage can amplify market volatility and cause sharp and sudden declines in asset prices.

Geopolitical risks dominated the third quarter particularly with the ongoing war in the middle east. The effect on financial markets has been arguably contained but we are cognisant that further escalation could lead to higher oil prices and higher inflation numbers.

Additionally, the uncertainty surrounding the upcoming US elections this year is likely to result in heightened volatility over the upcoming months particularly with recent polls showing contested elections. The prospect of a second Trump presidency is expected to be inflationary and increased tariffs by the US could see a renewed tit for tat trade wars as China and other US trading partners retaliate.

Finally, debt sustainability concerns could resurface with the notable deterioration in public finances and increased fiscal spending. With little appetite to tighten the fiscal stance, higher debt levels, larger deficits and lower nominal GDP levels could force markets to take notice, raising government bond yields as investor demand higher risk premia.

Overweight growth assets – overweight listed property/neutral global equities

In Q3 we neutralised our underweight to developed market equities, while retaining an overweight to global listed property. This was funded from cash, increasing the growth overweight within the funds.

Encouraged by the latest economic data, ongoing disinflation and moderation in economic activity we saw this as creating a favourable environment for equity prices and the outlook as a whole.

We believe the balance of factors driving equity prices has turned more positive with macro-fundamentals and earnings outlook outweighing the potential headwinds coming from expensive valuations and possibly less supportive technicals.

We also see the move to a more dovish monetary environment globally as being positive for risk assets and business prosperity.

Global Real Estate Investment Trusts (REITs) outperformed developed market equities in Q3. The rate sensitive sector was supported by the shift in monetary policy seen globally, as well as strong fundamentals and attractive valuations.

Overweight New Zealand fixed interest – underweight cash

We retained our overweight to New Zealand fixed interest in Q3. The position was implemented in Q3 2024 to add duration to the portfolios as yields spiked, driving the NZ 10-year above 5%.

The duration impact of this position delivered positively in Q3 as the RBNZ made their first cut in August. As at the end of September the NZ 10 year sat at 4.24%. This has come down sharply due to a repricing of interest rate expectations. We continue to monitor the position closely and will look to remove it if yields continue to fall.

Performance summary

Diversified

Mercer Ethical Leaders Balanced Fund

Underlying investment portfolio

During the quarter the Mercer Ethical Leaders Balanced Fund's underlying investments were replaced with the Mercer Socially Responsible Balanced Portfolio within the Mercer Investment Trusts New Zealand. This change took effect on 6 August 2024.

Asset allocation

Sector weights (average)	Actual (%)	SAA (%)	Tilt (%)
Australasian equities	13.9	14.0	-0.1
Global equities	19.4	19.0	+0.4
Global equities (hedged)	19.7	19.0	+0.7
Property	3.9	3.0	+0.9
Infrastructure	5.0	5.0	0.0
Growth total	**61.8**	**60.0**	**+1.8**
NZ fixed interest	10.9	10.0	+0.9
Global fixed interest	21.7	22.0	-0.3
Other fixed interest	2.9	3.0	-0.1
Cash	2.7	5.0	-2.3
Defensive total	**38.2**	**40.0**	**-1.8**
Total	100.0	100.0	0.0

Fund performance

As at 30 September 2024

Ethical Leaders Balanced Fund	Quarter (%)	1 year (%)	3 years (%)
Fund return	3.12	17.14	3.99
Benchmark return	5.06	17.87	4.27
Value added	*-1.94*	*-0.73*	*-0.28*

Fund commentary

- The Mercer Ethical Leaders Balanced Fund produced positive returns in the September 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.
- Performance for the quarter reflects one month (July) of the Fund's previous sector weights and returns, followed by two months (August and September) of the new underlying Mercer Socially Responsible Balanced Portfolio returns.
- The main contributors towards relative performance over the quarter was security selection in unlisted property and domestic fixed interest, and the allocation to overseas shares and listed property. Detractors included security selection in Trans-Tasman and overseas shares, and the allocation to hedged and low risk overseas shares.
- Over the last 12 months, security selection in global shares and global property and the allocation to NZ shares detracted from relative performance. Security selection within NZ equities and NZ bonds, along with the allocation to global shares and cash, contributed positively.

New Zealand shares

Market review

Central bank policy recalibration (lower official rates), sector rotation (from banks to resources), and balance sheet recapitalisation (equity capital issuance by Auckland Airport and Fletcher Building) influenced the New Zealand and Australian share markets over the quarter.

The New Zealand share market delivered a solid positive return for the quarter. Financials (banks) was the best performing sector over the quarter while the communications sector was the worst.

Australian share market returns benefited from strength in the information technology, real estate and materials sectors over the quarter, offsetting weakness in the energy, utilities and healthcare sectors.

Ongoing cooling in inflation may contribute to further central bank recalibration (cuts) of official interest rates. In an environment where economic activity remains positive globally this should support equity returns.

Locally, the potential for an improvement in earnings forecasts as the New Zealand economy stabilises may support share market returns. While not the time the time to fight central bank rate cuts, there is potential for near-term market volatility to increase.

After a solid period of share market returns consensus market expectations for central bank rate cuts may prove too optimistic and geopolitics may reemerge, including a broadening of middle east expansion and US election uncertainty, to influence markets.

Mercer Ethical Leaders NZ Shares Fund

Fund performance

September 2024 quarter	%
Fund return	7.91
S&P/NZX 50 Gross Index with Imputation Credits	6.37
Relative performance	*1.54*

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 the benchmark for the quarter. The Fund returned 7.91% over the quarter, outperforming its benchmark by 1.54%.

The outperformance of the Fund over the quarter reflected being overweight in outperformers Summerset and ResMed, and being underweight underperformers Spark NZ, Auckland Airport and Meridian.

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 selectively overweight growth at a reasonable price (GARP) shares in the healthcare, information technology, financial services and materials sectors, given they offer the potential for compound growth. Businesses with productivity and efficiency 'self-help' programmes are favoured, particularly where business reengineering introduces technology that improves both revenue and cost structures.

Global shares

Market review

US shares advanced in the quarter, though sector performances were mixed. While utilities and real estate thrived, energy and information technology lagged.

Eurozone shares also gained, led by real estate, utilities and healthcare, as lower interest rates attracted investors.

UK equities rose following a Labour election win, boosting hopes for economic recovery and expectations of a Bank of England interest rate cut, which occurred in August.

The Japanese stock market experienced high volatility, peaking in July before correcting sharply due to weaker US economic data and the Bank of Japan's interest rate hike, which strengthened the yen against the US dollar.

Emerging market equities outperformed developed markets, rebounding strongly in September after initial volatility and a Bank of Japan rate hike. The MSCI World Index returned 4.7% in Q3, while the MSCI Emerging Markets Index returned 6.6%.

Mercer Ethical Leaders Global Shares Fund

Fund performance

September 2024 quarter	%
Fund return	2.40
MSCI World Index (69% hedged to NZD)	3.81
Relative performance	*-1.41*

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 underperformed during the third quarter. The strategy gave back a portion of the gains posted earlier in the year, with much of the impact seen in July. However, it remains well ahead of its benchmark over the year to date.

Notably, the July underperformance was not dominated by the reversal in fortunes for the big index stocks (where the portfolio is now broadly neutral). The Manager has been actively taking profits and trimming hot positions all year, particularly in technology. Instead, it was driven more by investors covering lower quality shorts.

The strategy was mainly impacted by a combination of avoiding low quality rate sensitive areas, which were buoyed by expectations of rate cuts, and holdings in higher quality companies which underperformed.

Performance for the rest of the quarter was largely flat despite the backdrop of market volatility which saw sharp swings in sentiment from the early August panic through to late September, when markets rallied following the Fed's pivot to rate cuts.

Outside of the big stocks, exposure to technology provided the greatest headwind as many areas previously in favour rolled over, most notably holdings within the hardware and semiconductor industries. Similarly, high quality defensives were a drag within health care and staples stocks.

The flip side of this was underexposure to interest rate sensitive areas (eg real estate sector and utilities) which rebounded due to a greater preference for bond proxies. Partially offsetting this, stock selection within higher quality industrials supported relative performance.

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

September 2024 quarter	%
Fund return	4.20
Bloomberg MSCI Global Aggregate SRI Select ex Fossil Fuels Index (100% Hedged to NZD)	4.36
Relative performance	*-0.16*

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 New Zealand dollar.

The Fund returned 4.20% over the September 2024 quarter, behind the benchmark return of 4.36%.

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Important information

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