Ethical Leaders update

Mercer Investment Funds

Quarter ending 30 September 2023

Introduction

Welcome to the September 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.

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 29 September 2023.

RIAA certification

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

International engagement

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 governance (corporate governance). Through the last quarter a range of engagements were carried out linked to these priority themes.

American pharmaceutical giants Merck and Johnson & Johnson (J&J) were both engaged with on several issues in the third quarter. A coalition of drugmakers, including Merck and J&J, have filed a lawsuit against the US government over negotiated pricing of drugs for the Medicare programme.

Access to medicines is an important social issue, and considering this litigation, Schroders focused on understanding each company's approach and communicated its expectation that drug pricing should demonstrate value for patients. In the case of Merck, the company has committed to not raise prices in the US beyond inflation and to continue to take a responsible approach to pricing, which was a positive but something which will be revisited in the future.

Schroders also took the opportunity to engage on climate change seeking an update on climate strategies. Merck continue to focus on upgrading their plants to meet their climate goals, and the company confirmed they have now committed to a long-term net-zero target. J&J confirmed that they have submitted new climate targets to SBTi for approval and are planning to start publishing sustainability reports in 2024. These were positive developments from both Merck and J&J.

Finally, both companies were asked for additional disclosure on waste and deforestation risk and the strategies they have in place to mitigate this. We await their responses.

Schroders' Sustainable Investment team also engaged with Japanese financial firm Sumitomo Mitsui Financial Group (SMFG). The focus was on the company's climate transition plan and their target setting. SMFG published a transition playbook earlier this year and have incorporated climate-risks into their risk appetite framework and now include financed emissions in their transition progress KPIs.

As well as working on their own transition plans, SMFG have been engaging with clients on the topic and have helped in developing transition strategies for specific clients. Further, SMFG work with the Glasgow Financial Alliance for Net-Zero (GFANZ) so play a role in supporting the transition to net-zero and banks' transition plans. They have set targets to be net-zero by 2030 covering scope 1&2 emissions and by 2050 when including scope 3. The company's transition plans and targets are all positive and show a continued commitment to climate change issues and decarbonisation.

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. As a firm, it voted at 90 meetings on more than 860 resolutions for companies held across the QEP desk in the third quarter of the year. Within these votes, around 12% were not with management. Votes against management were focused on compensation plans, the election of directors or auditor related.

New Zealand engagement

Engagements with companies over the quarter were predominantly governance focused due to contentious AGM proposals and investor roadshows conducted by company boards. However, these discussions often involved other sustainability issues as well, such as climate change and diversity.

A common theme discussed with board directors during the roadshow meetings was climate change and how the upcoming reporting regulation is influencing behaviour. Mercury noted the extensive internal resource that has been dedicated to improving climate disclosures which has been backed up by tangible action as well including a new science-based emissions reduction target. Serko mentioned progress in reporting its carbon data, although acknowledged challenges in measuring emissions further down the value chain (scope 3).

Industry engagement over the quarter was a combination of attending multiple ESG conferences and a group discussion with the regulator regarding climate disclosures. The conferences covered a range of sustainability issues in the case of RIAA's annual conference, while the other two were deep dive climate events from both New Zealand and Australian perspectives. A recurring trend observed from each of these conferences as well as the meeting with the FMA was the focus on mandatory climate disclosures – whether that be the implementation and enforcement in New Zealand or how reporting standards are developing in Australia.

Overall, there has been a shift in climate related engagements over the year from acute response plans in light of extreme weather events to a greater focus on long term transition plans and disclosure. This reflects the reporting regulation due to come into effect for most NZX listed companies next year that has been frequently mentioned in the latest round of sustainability reports as well as our conversations with boards and senior management.

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. Harbour will therefore closely scrutinise any contentious resolutions that arise and will engage companies where appropriate.

Economic summary

Market review

Despite a strong start in July, both equities and bonds ended the September quarter (Q3) on a down note, supporting the latter month's reputation for delivering 'seasonably weaker' returns.

US markets underperformed both developed and emerging markets, as Value outperformed Growth, with a retreat among the 'magnificent seven' stocks who had provided the majority of the gains during the first half of the year. Negative market sentiment was driven by a 'higher-for-longer' rates narrative in an environment of weak economic growth. This was more pronounced in interest rate sensitive sectors, driving negative returns for fixed income and gold.

Advanced economies keep progressively readjusting the balance between supply and demand, leading to a gradual reduction in inflationary pressures. Although growth is slowing, it's at a more moderate pace than any declines in inflation.

US headline inflation (raw measure) moved higher mostly due to base effects, while core inflation (which removes key volatile commodities) continued to trend lower. Both inflation measures in the UK and Eurozone decreased as their respective central banks maintained their hawkish stances. This resulted in the status quo being maintained or rates being increased further, which put upwards pressure on yields.

Energy prices surged during the September quarter on the back of extended supply cuts by OPEC+ and Russia, resulting in large gains in West Texas Intermediate (WTI) crude oil. This resulted in the energy sector being the only one to deliver strong positive returns overall. The listed property sector underperformed equities by a large margin due to rate sensitivity and concerns surrounding the Chinese property debt crisis.

Closer to home, Australasian equities posted similarly weak returns with the NZX and ASX returns dominated by the negative impact of higher long-term government bond yields on equity valuations.

Market outlook

The global economy has remained resilient in Q3 driven by a strong consumer, an expanding services sector, elevated business spending and expansionary fiscal policies in some countries. These factors are likely to continue for now but may fade as we approach year-end and enter 2024. At that point, the effects of tightening bank lending standards and tight monetary policy may become more pronounced, leading to softer economic growth.

US economic activity over Q3 has been remarkably strong. Growth has continued to be supported by a number of factors, principally the ongoing drawdown of pent-up savings, robust private investment and expansionary fiscal policy. We expect these factors to fade in Q4 and beyond. Current expansionary fiscal policy should flip to become contractionary; the stock of savings is getting depleted and the long and variable lags from tight monetary policy continue to feed further into the economy. We remain in the soft-landing camp and expect a period of low growth rather than a sharp downturn argued by those in the hard landing camp.

In the Eurozone, economic activity has slowed over the quarter and will likely be flat in the third quarter. The manufacturing sector has continued to soften with the Purchasing Managers' Index (PMI) data now showing the sector to be at the lowest levels since the beginning of the global financial crisis (GFC). Looking forward, broadly speaking, we expect the bloc to slow less than the US because it was less overheated. Notably, in the Eurozone, the regional divergences are quite vast.

China continued to struggle in Q3 as consumption remained weak, youth unemployment soared and its property sector showed further signs of weakening. Policy makers have announced a number of stimulus measures aimed at boosting consumption, increasing business activity and reviving the housing sector. We do not believe enough pass-through has occurred yet and policy measures have so far been quite piecemeal.

We are beginning to see tentative signs of a slight rebound in economic activity as the most recent August activity data was better than most economists had expected. We think policymakers will do more to support the Chinese economy, especially given its very low inflation. After one of the most aggressive monetary policy tightening periods ever, central banks are now close to pausing to assess the impact with interest rates firmly in restrictive territory. However, they have continued to say more hikes are possible if inflation does not fall back to target.

At their September meeting, the Fed decided to keep rates unchanged. The accompanying forecasts from the Fed following the decision suggested the possibility of a final rate hike at the upcoming November meeting. The Fed Chair Jerome Powell has continued to reiterate that the Fed will do whatever it takes to bring inflation back in line with their 2% target. Given latest inflation and labour market dynamics, we think they are on hold but do not discount the possibility of one last hike.

Diversified portfolio activity for the quarter

We continue to expect economic growth in the developed world to moderate going forward 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 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 very 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 largely approached a turning point with the majority on hold as they assess the impact of past interest rate increases on economic activity. We think central banks will keep interest rates at a high level and maintain their hawkish stance until it is clear that wage growth and inflation are back at normal levels.

Against this backdrop, we expect financial market volatility will remain present 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

Since March, economic indicators have turned over, highlighting a greater likelihood of a soft or mild recession. Considering that, we reduced our overweight position to NZ equities at the start of August as an allocation to this relatively defensive asset class is no longer warranted.

We have retained our underweight to global equities given the inherent uncertainty and less favourable outlook for developed market equities.

The overweight to global listed property is based off discounted valuations and market cycle timing. Historically, global REITs have outperformed broad equities following the topping out of a rate rising cycle. There are signs that this environment is what we are entering in to currently. Additionally, we believe this recent decline in global REITs was overdone, with strong companies being pulled down with the weak. We view this as a good opportunity to pick up exposure to quality companies at discounted valuations.

Overweight New Zealand fixed interest, underweight cash

We are overweight New Zealand fixed interest as the recent sell-off has brought yields into a reasonably attractive territory to increase our duration in the portfolio. We are underweight cash as a funding source for this position.

Bond yields have sold off sharply and are now at close to their highest in decades. While we think central banks are a long way from cutting interest rates, valuations are reasonably attractive. Soft economic growth and data prints should lead to softer inflation over time followed by an easing cycle from central banks.

Performance summary

Diversified funds

Fund commentary

The Macquarie Ethical Leaders Diversified Funds generated negative returns over the third quarter of 2023. Global markets declined over the quarter having rallied the first half of the year. Higher interest rates, weaker global demand and tighter financial conditions have weighed on investor sentiment despite most developed market central banks pausing their rate hikes.

The Macquarie Ethical Leaders Conservative Fund returned -1.45% for the quarter and 4.23% over the last 12 months. The Ethical Leaders Balanced Fund returned -2.3% for the quarter and 7.7% over the past 12 months. The Macquarie Ethical Leaders Growth Fund returned -2.6% for the quarter and 11.12% over the last year.

The Ethical Leaders Balanced and Growth Funds have outperformed their benchmarks over the quarter while the Conservative Fund marginally underperformed. All Ethical Leaders Diversified funds have outperformed over three years and longer.

Mercer Ethical Leaders Conservative Fund

Asset allocation

Sector	SAA (%)	DAA (%)	+/- (%)
Australian equities	5.0	5.0	0.0
Global equities	13.0	13.0	-0.5
Property	7.0	7.0	+0.5
Growth total	25.0	25.0	0.0
NZ fixed interest	25.0	25.0	0.0
Global fixed interest	25.0	27.0	+2.0
Cash	25.0	23.0	-2.0
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	-1.45	4.23	0.22
Benchmark return	-1.43	4.20	-0.30
Value added	-0.02	+0.03	+0.53
From:			
Security selection	+0.10	-0.05	+0.41
Asset allocation	+0.01	+0.04	+0.24

Fund commentary

The Ethical Leaders Conservative Fund produced negative returns in the September quarter. It underperformed the benchmark over the quarter but outperformed over one year.

The main contributors to relative performance included security selection within NZ equities and global property while allocation to global equities slightly detracted.

Over the last 12 months, security selection in global equities and Australian equities detracted from relative performance. This was offset by security selection in New Zealand equities and the allocation to global bonds, global equities and cash.

Mercer Ethical Leaders Balanced Fund

Asset allocation

Sector	SAA (%)	DAA (%)	+/- (%)
Australian equities	20.0	20.0	0.0
Global equities	35.0	34.0	-1.0
Property	10.0	11.0	+1.0
Growth total	65.0	65.0	0.0
NZ fixed interest	12.5	13.5	+1.0
Global fixed interest	12.5	12.5	0.0
Cash	10.0	9.0	-1.0
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	-2.60	11.12	7.33
Benchmark return	-2.83	11.61	6.23
Value added	+0.23	-0.49	+1.10
From:			
Security selection	+0.28	-0.59	+0.54
Asset allocation	-0.04	-0.28	+0.08

Fund commentary

The Ethical Leaders Balanced Fund produced negative returns in the September quarter. It outperformed the benchmark over the quarter but has underperformed over one year.

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

Over the last 12 months, security selection in global and Australian equities and the allocation to Australian shares detracted from relative performance. Security selection within NZ equities, along with the allocation to global bonds and cash, contributed positively.

Mercer Ethical Leaders Growth Fund

Asset allocation

Sector	SAA (%)	DAA (%)	+/- (%)
Australian equities	22.5	22.5	0.0
Global equities	57.5	56.0	-1.5
Property	10.0	11.5	+1.5
Growth total	90.0	90.0	0.0
NZ fixed interest	2.5	3.0	+0.5
Global fixed interest	2.5	2.5	0.0
Cash	5.0	4.5	-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	-2.60	11.12	7.33
Benchmark return	-2.83	11.61	6.23
Value added	+0.23	-0.49	+1.10
From:			
Security selection	+0.28	-0.59	+1.10
Asset allocation	-0.04	-0.28	+0.18

Fund commentary

The Ethical Leaders Growth Fund produced negative returns in the September quarter. It outperformed the benchmark over the quarter but has underperformed over one year.

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

Over the last 12 months, security selection in global and Australian equities and the allocation to Australian equities detracted from relative performance. Security selection and the allocation to NZ equities contributed positively.

New Zealand shares

Market review

New Zealand and Australian share market returns over the quarter were dominated by the negative impact of higher long-term government bond yields on valuations. Higher bond yields increase the return required by investors to put their funds into shares.

Factors influencing the sharp increase in bond yields included signalling from central banks that official cash rates need to stay higher for longer to offset sticky inflation, the increasing US Government budget deficit requiring increased bond issuance to fund it, and oil prices increasing from below US$70/barrel in June to above US$90 by late September.

The size and pace of the interest rate moves have been significant. 10-year maturity US government bond yields increased from 3.84% at the end of June to 4.6% at end of September – the last time US bond yields were this high was 16 years ago in October 2007.

Ten-year New Zealand government bond yields have increased from 4.6% at the end of June to 5.3% at the end of September – the last time NZ bond yields were this high was in May 2011. And 10-year Australian government bond yields have increased from 4.0% at the end of June to 4.5% at the end of September – the last time Australian bond yields were this high was in October 2011.

Share markets don't react well to rapid, sharp increases in interest rates. Often higher interest rates are associated with higher economic activity which is offset by higher earnings. But the latest increase in bond yields happened at a point where earnings growth prospects remain constrained with cyclical businesses giving back much of their recent pricing power.

New Zealand share market weakness reflected the negative impact of higher bond yields on the valuation of future cashflows for more interest rate sensitive shares (bond proxies including Spark, Meridian and Chorus). It also reflected the impact of disruption risk, including industry (including Fisher & Paykel Healthcare, Ebos and a2 Milk) and regulatory (including Sky City) change.

Economic recession risk (including Ryman and Freightways) and risk around potential changes to New Zealand tax treatment (Precinct and Stride Property) also impacted.

Mercer Ethical Leaders NZ Shares Fund

Fund performance

September 2023 quarter	%
Fund return	-3.93
S&P/NZX 50 Gross Index with Imputation Credits	-4.82
Relative performance	*0.89*

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 over the quarter. The Fund returned -3.9% over the quarter, outperforming its benchmark by 0.9%.

Higher long-term interest rates rattled capital markets over the quarter. Industry disruption, economic recession risk and potential Government policy changes also influenced returns.

The New Zealand share market was led down by the healthcare, industrials and consumer staples sectors. However, the financial, energy and information technology sectors generated positive returns over the quarter. The Australian market also fell over the quarter with healthcare, consumer staples and IT underperforming, and energy, consumer discretionary and financials outperforming.

Over the quarter relative portfolio performance was enhanced by being underweight relative to benchmark weight in underperformer a2 Milk. Overweighting of outperformers Summerset, Serko, Goodman Group, and Pacific Edge provided a boost during the quarter.

Portfolio performance was negatively impacted by weakness in growth shares Mainfreight and CSL during the quarter. Underweighting of outperformers Heartland, Air New Zealand (nil investment) and Skellerup detracted from relative performance over the quarter.

Harbour's strategy remains to position for a range of scenarios and to be selective. They continue to favour investments with structural tailwinds that are less dependent on strong economic activity, and see technology dispersion, decarbonisation and demographic changes as supporting company earnings.

The portfolio is positioned to favour businesses with productivity and efficiency 'self-help' programmes, particularly where business reengineering introduces technology that improve both revenue and cost structures. There continues to be a bias to quality, well-capitalised businesses that are less vulnerable to a tightening in financial conditions.

Global shares

Market review

Global equities delivered negative returns in Q3 as the market positioned itself for rates to remain elevated for longer. The S&P 500 ended the quarter down -3.3% (in local currency terms). Driving this was the cooling of the “magnificent seven” following their major rally which occurred during the first half of the year.

Emerging markets outperformed developed markets, but still delivered negative returns on an absolute basis. Emerging market central banks are ahead of the curve, having hiked interest rates earlier than developed market central banks. With disinflation firmly underway some are in a position to begin cutting rates – something many developed market counterparts are not in a position to do. Loosening monetary policy should create a decent tailwind for emerging markets going forward.

Mercer Ethical Leaders Global Shares Fund

Fund performance

September 2023 quarter	%
Fund return	-2.11
MSCI World Index (69% hedged to NZD)	-2.18
Relative performance	*0.07*

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 -2.11% over the quarter, outperforming the MSCI World index and adding to gains posted earlier in the year.

Markets consolidated over the period in light of persistent, albeit declining, inflationary trends and a hawkish Fed outlook in September. At a high level, the diversified exposure to both cheaper and higher quality segments was beneficial as market breadth increased during the quarter, recovering off lows earlier in the year.

Against this backdrop, contributions were broad based across sectors and regions, though higher quality holdings across preferred healthcare and consumer discretionary industries were the key driver.

Within this, globally diversified pharmaceutical holdings were key contributors, with select names also benefitting from promising weight-loss drug trial results. Elsewhere, autos and global hotel & leisure stocks, two areas added to during 2023, provided an additional tailwind as they moved higher amid a falling market.

There were few detractors that significantly impacted relative performance in Q3, although the avoidance of energy detracted over the quarter, given its strong performance. Exposure to defensives, trading at affordable valuations and offering stability within the strategy, was another headwind. In particular, exposure to home products and food manufacturing dragged as holdings failed to provide a hedge with markets reverting. Positions in semis gave back some of their gains from the first half of the year.

Global fixed interest

Market review

Many central banks continued to raise rates during Q3. The sharp rise in global interest rates has mainly been driven by expectations of policy rates remaining elevated for the foreseeable future, high government budget deficits and rising energy prices.

The Bank of England (BoE) raised its base rate 50 bps to 5% in July, then again by 25 bps in August to conclude at 5.25%. The BoE sighted signs of slowing inflation as the reason to leave the rate unchanged in September.

The European Central Bank delivered rate hikes as well, increasing 25 bps in August and again in September to end the quarter with an official cash rate of 4%. However, the US Federal Reserve made only one change in July, increasing its range 25 bps to 5.25-5.50%.

Global government bond yields peaked in September before slightly retreating at the end of the quarter which was led by the US 10-year yield rising by almost 75 basis points over the course of the quarter to its highest level since 2007%.

Mercer Ethical Leaders Hedged Global Fixed Interest Index Fund

Fund performance

September 2023 quarter	**%**
Fund return	-2.05
Bloomberg Barclays MSCI Global Aggregate SRI Select ex Fossil Fuels Index (100% Hedged to NZD)	-2.11
Relative performance	*0.06*

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 -2.05% over the September 2023 quarter, slightly ahead of the benchmark return of -2.11%.

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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