

Mercer's investment approach to climate change

Mercer NZ

November 2021





Introduction

Mercer (N.Z.) Limited (Mercer NZ), is a leading provider of investment solutions including a comprehensive suite of multi-sector and single-sector funds catering for the investment needs of a wide range of investors. This climate change report sets out in more detail the climate-related commitments made in Mercer NZ's publicly available [Responsible Investment Policy](#) and the approach to managing climate-related financial risk as it relates to the Mercer Investment Trusts New Zealand, referred to throughout this document as the MITNZ. References to Mercer shall be construed to include Mercer LLC and/or its associated companies including Mercer (N.Z.) Limited.

Climate reporting in relation to Mercer NZ's operations is captured within Marsh McLennan, Mercer NZ's parent entity, reporting globally, which includes, for example, carbon emissions reporting to CDP annually.¹

Climate change has been part of Mercer's global investment beliefs since 2014. Mercer believes that climate change poses a systemic risk, with risks and opportunities driven by two key sources of change:

1. The physical damages expected from an increase in average global temperatures.
2. The associated transition to a low-carbon economy.

Since 2016, the policy has stated that "limiting global average temperature increases this century to 'well below 2°C', as per the 2015 Paris Agreement, is aligned with the best economic outcome for long-term diversified investors and Mercer will seek to increasingly align portfolios with that objective where this is also consistent with meeting stated investment objectives."

In July 2021, Mercer NZ committed to achieving **net zero absolute portfolio carbon emissions² by 2050 for the MITNZ**. To achieve this, Mercer NZ expects to reduce absolute portfolio carbon emissions by 45 per cent from 2020 baseline levels by 2030. The commitment is consistent with targeting a 1.5 degree Celsius limit on global temperature increases and the Paris Agreement's ambitions.

These decisions are informed by Mercer's 2020 climate transition advice framework and Analytics for Climate Transition (ACT) tool; 2015 and 2019 *Investing in a Time of Climate Change reports*³; as well as 2011 research on climate change and its implications for strategic asset allocation.

The 'TCFD' framework

Mercer NZ's climate-related disclosure, outlined in the following pages, is aligned with the Financial Stability Board's Task Force on Climate-related Financial Disclosures (the TCFD) framework, which has become the industry standard globally. In addition, Mercer NZ will implement obligations under the Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act 2021 in relation to climate related disclosures and statements in New Zealand.

Figure 1: TCFD Framework



¹ Formerly called the Carbon Disclosure Project, this non-government entity tracks company disclosure on carbon emissions, forestry and water metrics.

² Defined as: absolute carbon emissions per \$M of FUM, Scope 1&2 emissions for the Mercer Investment Trusts New Zealand in aggregate.

³ <https://www.mercer.com/our-thinking/wealth/responsible-investment.html>

Governance

Oversight of climate-related risks and opportunities

Board level

The Mercer NZ Board has determined that climate change is an explicit topic for its agenda at least annually. Board members are educated on climate-related risks and opportunities and how these may influence decisions in relation to risk management, strategy setting, implementation and monitoring. This will include an Annual Environmental, Social and Corporate Governance (ESG) report containing a climate portfolio assessment for each of the managed investment options of the MITNZ. This has included carbon footprinting relative to benchmark for equities for many years, and has now evolved to include a whole of portfolio climate transition risk assessment using multiple climate metrics such as carbon emissions, transition capacity and green exposure analysis. The Board has also reviewed both climate scenario analysis modelling results and a climate transition plan, which led to the net zero by 2050 commitment being approved at the June 2021 meeting.

Management level

The New Zealand Chief Investment Officer (CIO), is responsible for ensuring climate change is appropriately incorporated within the MITNZ investment strategy and implementation program, and is actively supported by the investments team in execution across all key areas of decision making i.e. within strategy; portfolio construction; manager selection, appointment and monitoring; as well as the sustainable investment program. A dedicated Pacific Sustainable Investment Manager actively supports this, working closely with members of the investments team and reporting to the Pacific CIO. The Sustainable Investment Manager and analysts within the investment team also work closely with the sustainable investment consulting team to perform a range of climate-related research, collaboration, engagement, and reporting responsibilities.

Global team

The NZ CIO has the leadership and support of the Pacific and Global CIOs, who also reinforce the growing importance of capturing climate change considerations and monitoring for developments within investment decisions in global CIO meetings and governance committees. This includes the Global ESG Integration Committee, formed in 2018, and represented by Mercer investment and consulting teams in the Pacific, Europe and North America.

The Global CIO team is also informed by Mercer's investment governance structure and research committees charged with reviewing and setting guidance on Mercer intellectual capital development and 'house views'. This includes the Global Strategic Research Committee, which reviews all new climate-related research.

This research, led by Mercer's Global Sustainable Investment specialists together with senior actuaries/consultants, informs the strategic climate scenario modelling, climate transition advice framework and Analytics for Climate Transition (ACT) tool, together with asset class and industry sector priorities. Mercer has advised investors on all aspects of ESG and stewardship since 2004, with a focus on climate change for more than a decade.

Strategy

The modelled impacts under multiple climate scenarios

Investors often use scenario analysis to support strategic asset allocation and portfolio construction decisions as it helps to test portfolio resilience under multiple potential future outcomes. Mercer developed its own climate scenario modelling tool in 2015. This is documented in the 2015 Investing in a Time of Climate Change report, and updated in 2019 in the Sequel.

Mercer's climate scenario modelling takes a forward looking approach to supplement core asset allocation models, which rely primarily on historical data and thus fail to capture the investment impacts of the low-carbon economy transition and anticipated physical damages of climate change. The key benefit is the ability to prioritise climate-related risks and opportunities and the potential relative impacts under different climate scenarios to support strategic decision making on asset allocation and portfolio construction. This 'top down' scenario analysis can be combined with further insights from 'bottom up' tools that look at company level exposures to refine assessments within asset classes and sectors.

The Sequel sets out Mercer's latest climate scenario model for assessing the effects of both physical risks and transition risks on investment return expectations at a total portfolio, asset class and industry sector level. In the Sequel, Mercer separates out physical damages risk and transition risk into four risk factors. The model uses these risk factors for three climate change scenarios (2°C, 3°C, 4°C) over three timeframes (2030, 2050 and 2100).

Modelling results for the Diversified MITNZ

The Asset Allocation Committee (AAC), working with the CIO, includes climate scenario modelling as an input to setting investment strategy for the Mercer NZ multi-sector funds. The scenario modelling process helps to test current and potential portfolios with a 'climate lens', alongside other traditional considerations in the decision making process. This analysis was first undertaken in 2017, and updated in 2019.

The key finding was that the 2°C scenario was in investor best interests, as compared to the higher warming scenarios modelled.

High level results extracts are shown in Figures 2 and 3 from the 2019 review. In summary:

- Positive to flat return impacts are expected under a 2°C scenario over the next ten years.
- By 2050 and beyond, climate change becomes a drag on returns under all scenarios, acknowledging that current modelling approaches underestimate the true impact of physical damages, particularly in the higher warming scenarios (see the Sequel for more information).



Figure 2: Annualised Total Portfolio Returns by Climate Scenario

Mercer Portfolio Results		Mercer High Growth Fund	Mercer Balanced Fund	Mercer Conservative Fund
2°C	10 Years	≥ 10 basis points	> - 10 bps, < 10 basis points	> - 10 bps, < 10 basis points
	32 Years (ending 2050)	< - 10 basis points	> - 10 bps, < 10 basis points	> - 10 bps, < 10 basis points
	82 Years (ending 2100)	< - 10 basis points	> - 10 bps, < 10 basis points	> - 10 bps, < 10 basis points
3°C	10 Years	> - 10 bps, < 10 basis points	> - 10 bps, < 10 basis points	> - 10 bps, < 10 basis points
	32 Years (ending 2050)	> - 10 bps, < 10 basis points	> - 10 bps, < 10 basis points	> - 10 bps, < 10 basis points
	82 Years (ending 2100)	< - 10 basis points	> - 10 bps, < 10 basis points	> - 10 bps, < 10 basis points
4°C	10 Years	> - 10 bps, < 10 basis points	> - 10 bps, < 10 basis points	> - 10 bps, < 10 basis points
	32 Years (ending 2050)	< - 10 basis points	> - 10 bps, < 10 basis points	> - 10 bps, < 10 basis points
	82 Years (ending 2100)	< - 10 basis points	< - 10 basis points	> - 10 bps, < 10 basis points

All figures represent % per annum return impacts

■ ≤ - 10 basis points
 ■ > - 10 bps, < 10 basis points
 ■ ≥ 10 basis points

Stress testing analysis was also completed to consider changes in view on scenario probability, market awareness and physical damage impacts. This is because we don't believe future changes will be neat and gradual, but could come with sudden surprises where new information and market responses prompts more rapid change towards 2°C or 4°C from the current 3°C scenario trajectory. The figures below are a single point in time impact over less than 1 year, not annualised figures.

<p>Stress test #1</p> <p>Tested the potential return impact of a sudden shift to an increased likelihood of a 2°C and 80% market awareness (from a 20% base case).</p>	<p>Stress test #2</p> <p>Tested the potential return impact of a sudden shift to an increased likelihood of a 4°C scenario and 80% market awareness (from a 20% base case).</p>
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Figure 3: Total Portfolio Returns (Single Point in Time) for Two Stress Tests

Mercer Portfolio Results		Mercer High Growth Fund	Mercer Balanced Fund	Mercer Conservative Fund
2°C Stress Test	Return impact over <1 year	< - 2%	> - 2%, < 2%	> - 2%, < 2%
4°C Stress Test	Return impact over <1 year	< - 2%	< - 2%	> - 2%, < 2%

All figures represent % return impacts (not annualised).

■ ≤ - 2%
 ■ > - 2%, < 2%
 ■ ≥ 2%

Application in business scenario planning

We expect that the risk and return priorities by asset class under each scenario, particularly a 2°C scenario, will assist in future decisions on portfolio exposures and product development. In business planning these findings can be drawn upon in considering exposures in each asset class and industry sector and drive the risk management priorities.

Risk management

Identifying, assessing and managing climate-related risks

The 'top down' climate scenario modelling outlined above is the foundational framework used to assess the size and scope of potential climate-related return impacts and prioritise asset classes and industry sectors to minimise risks and maximise new opportunities.

In addition, Mercer has developed an Analytics for Climate Transition (ACT) tool, which provides a 'bottom up' company level perspective across asset classes on a 'well below 2°C' or transition scenario. This is the scenario that is now seen as increasingly possible. Momentum to achieve a <2°C scenario is growing, via government policy and regulation, supported by the Paris Agreement; technology tipping points and pricing shifts in the energy sector; along with consumer sentiment and company actions. It's also the scenario that presents the greatest short term risks and opportunities in different sectors over the next decade.

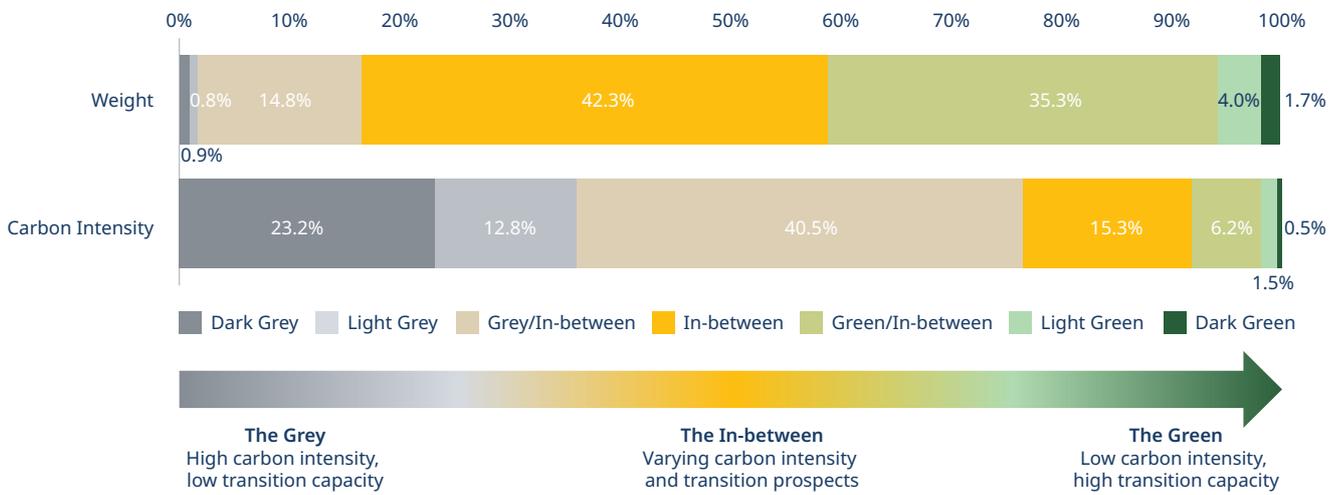
ACT draws on multiple third party metrics on company level emissions, transition capacity and green revenues, which Mercer has selected and weighted to provide a single transition capacity assessment for portfolios on a spectrum — going from 'grey', high-carbon and low-transition investments, to the 'green', those already low-/zero-carbon or are climate solutions, and the many companies in the middle, the 'in-between' with varying transition capacities.

ACT is helping to identify where the highest carbon intensity risks lie, including the potential for stranded asset risk in the dark grey companies, and where emissions reductions can best be achieved by portfolio weight to still deliver on investment objectives. This company level analysis is helping to compare different portfolios and benchmarks within asset classes and compare asset class impacts to ensure Mercer's transition pathway adopts a thorough risk management approach to an economy wide and portfolio wide transition.





Transition assessment: Example diversified portfolio



Source: Mercer, with underlying metrics from MSCI ESG Research and ISS

Legal and Compliance representatives, together with the Sustainable Investment team, also keep up to date on regulatory developments in relation to climate change, with our current understanding that Mercer NZ's established frameworks and processes are well positioned to meet or exceed existing and anticipated regulatory requirements.

Integration into overall risk management processes

The following table outlines example actions to be taken as part of Mercer NZ's climate transition plan by asset class. This covers four implementation methods - Integration, Active Ownership, Investing in Solutions and Screening. The focus is on a genuine whole of economy and portfolio transition, not just emissions reduction.



Integration

- Optimised Strategic Asset Allocation (SAA) updates to contribute where possible to emissions reductions
- Optimised asset class emissions reductions informed by:
 - **Mercer's ACT results** by Fund and manager to prioritise highest emissions intensity and lowest weight impact
 - **Mercer's manager survey results**, those best positioned and that pose a risk
- Agreements made with appointed investment managers, based on materiality, for:
 - Transition management and emissions reductions
 - Physical damages management and risk reduction



Active Ownership

- Climate focused manager engagement
- Climate actively considered for voting and engagement across material holdings
- Participation in collaborative initiatives e.g. Investor Group on Climate Change, Climate Action 100+, CDP, Investor Statements to Governments



Investment in Solutions

- Increased allocation to low-carbon / sustainability-themed exposures through SAA optimisation and / or allocations within asset classes



Screening

- High carbon intensity exposures with low transition capacity (i.e. Dark Greys from ACT assessment) monitored to inform integration, manager engagement and active ownership steps

Reporting

Responsible Investment Policy; Climate Change Management Statement (this report); Annual Sustainable disclosure; Regular client / member communications and Board Reports

Metrics and targets

To assess and manage relevant climate-related risks and opportunities

Mercer NZ has undertaken a step by step process, supported by robust analysis, to manage climate transition risk and underpin the commitment to a net zero by 2050 target and expected portfolio emissions reductions by 45 per cent by 2030. This has informed our view that Mercer NZ can set this carbon reduction target and climate transition plan without altering investment objectives or expected risk/return profiles to deliver on both short and long-term investor and member outcomes.

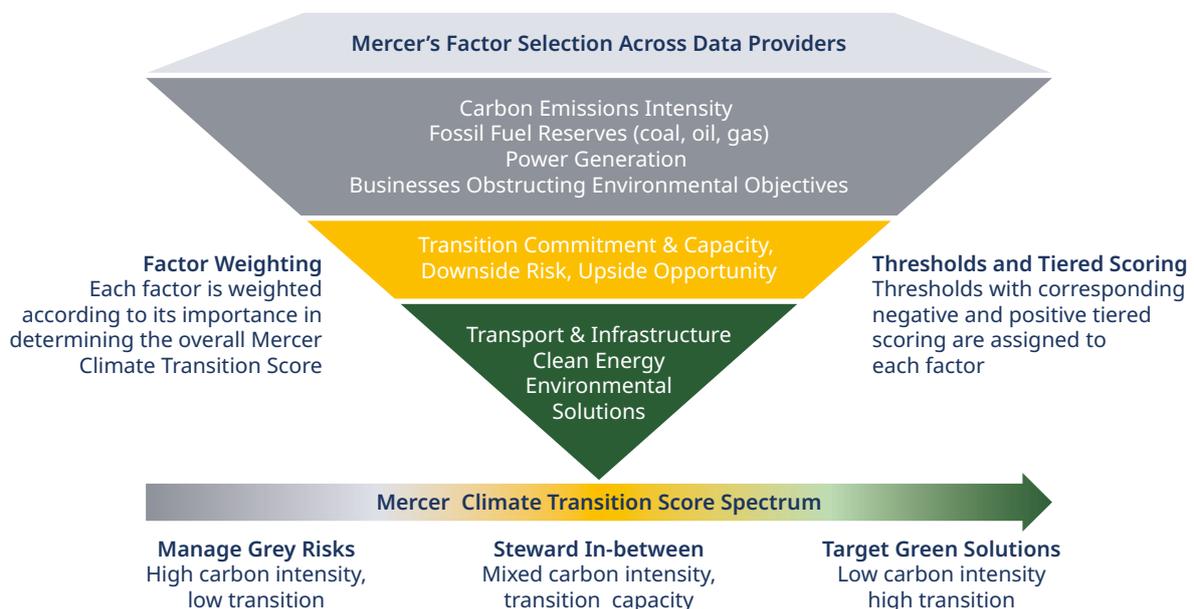


Carbon reduction targets are much like performance targets. They help to set expectations and provide goalposts to track and measure progress.

Mercer NZ is an allocator of investment capital to many companies across the economy locally and globally. Mercer NZ believes that setting a public carbon reduction target, underpinned by a thoughtful climate transition plan focused on genuine economic transition, sends an important signal that should increase the probability of the 1.5°C scenario, or at least 'well below 2°C' eventuating.

Metrics monitoring

Mercer's ACT tool is key to the analysis and monitoring process. ACT draws on multiple third party metrics on company level emissions, transition capacity and green revenues, which Mercer has selected and weighted to provide a single transition capacity assessment for portfolios. A summary is provided below.



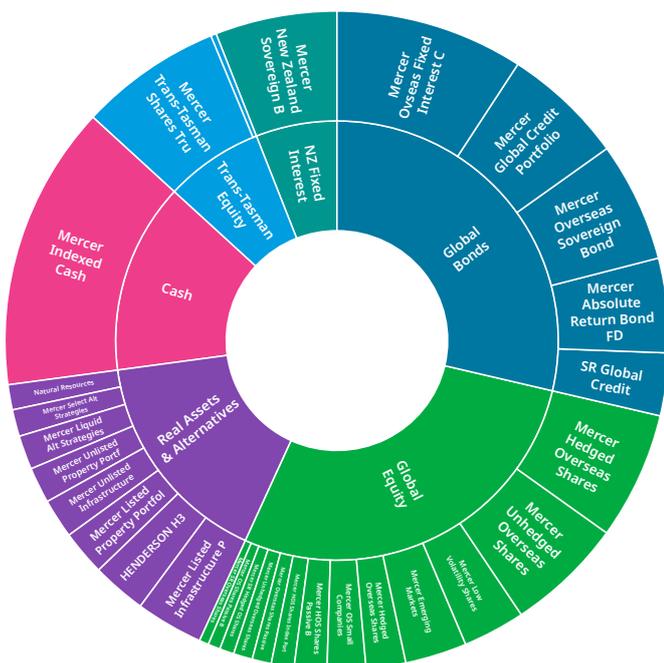


Mercer has calculated the baseline, taking a total portfolio perspective for:

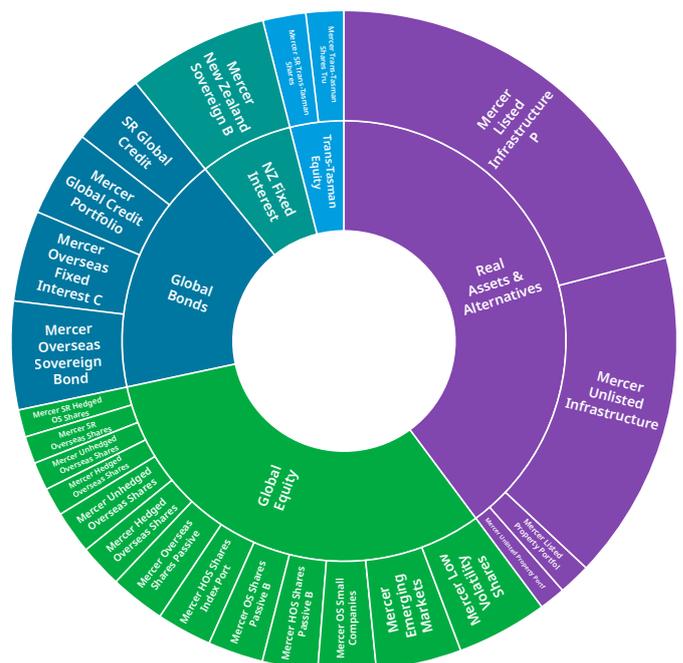
- Absolute and emissions intensity metrics
- Transition capacity and risk indicators
- Allocation to green solutions.

The metrics and assessment results aim to provide portfolio implementation insights that prioritise the greatest emissions intensity by asset allocation contributions. For instance, low portfolio weightings contributing to large carbon intensity profiles with low transition capacity can be observed (see illustrative example below).

Asset allocation



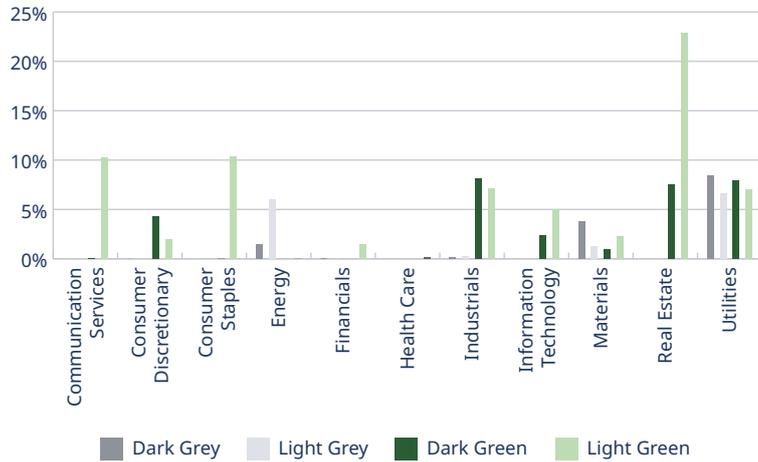
Carbon intensity



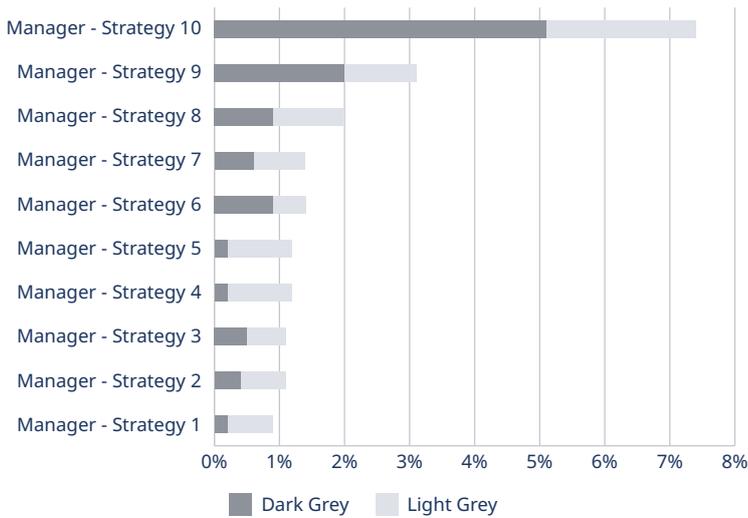
Source: Mercer, with underlying metrics from MSCI ESG Research and ISS

The portfolio risk assessment using the ACT tool enables monitoring at an asset class, sector, investment manager and company level to provide multiple portfolio perspectives with a consistent approach across asset classes to aid in ongoing integration, active ownership and investment allocation decisions. The following examples have been sourced from Mercer Australia Investments Limited.

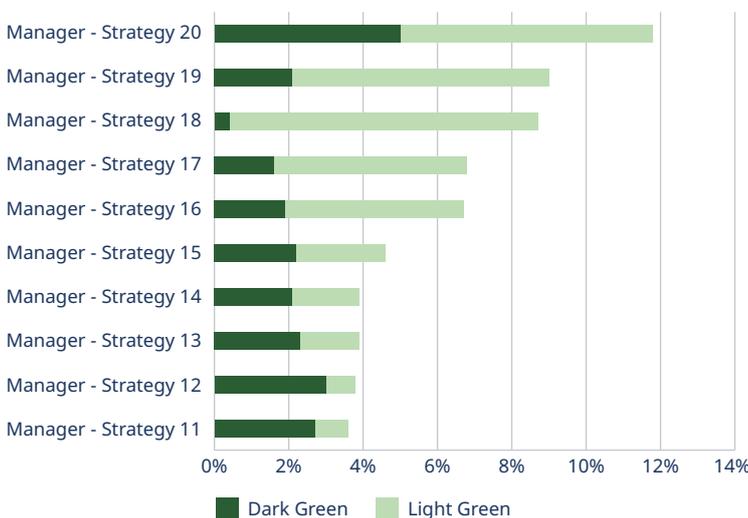
'Grey' & 'Green' assets by sector



Manager allocations to 'Grey' assets



Manager allocations to 'Green' assets



Source: Mercer, with underlying metrics from MSCI ESG Research and ISS



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