merit planning East

Insights and Investment Solutions

Winter 2019

Welcome

In this edition of Insights and Investment Solutions magazine, learn about the latest market update on local and international markets.

We take a look at sustainable investing and how investors are increasingly interested in how a company makes money, not simply how much it makes.

Finally, we look into why diversity and inclusion is becoming a common focus for investors.

Until next time – happy reading.

Merit Planning East
Chris Burge
02 8076 6026
merit@meriteast.com.au
www.meriteast.com.au

Market update

Investors brace for another bout of market volatility as US-China relations take a turn for the worse, with a brewing tech cold war now on the agenda.

Equity markets lost steam over May breaking the start of 2019's four-month rally. Though, on a total return basis, the US S&P 500 was down -5.1%, the ASX 200 defied global momentum, rising 1.7% mostly supported by rising iron ore prices, and the Coalition's election win.

In latest US-China developments, President Trump has blacklisted Chinese tech firms deemed a national security threat, restricting the likes of Huawei and ZTE from doing business with American companies, following a breakdown of trade negotiations and a subsequent increase in tariffs. The move has aggravated China who has since signalled little interest in resuming talks with the US while retaliating with threats of their own.

The International Monetary Fund (IMF) has warned that the US-China trade war has already caused substantial damage, and that a failure to resolve differences alongside further escalation in other areas could dent business and financial market sentiment.

While the US Fed's patient approach towards monetary policy is believed to be appropriate for now, the Fed will be watching incoming economic and financial data closely to assess the case for a shift in monetary policy direction. A cut to interest rates could become a more attractive option if inflation continues to disappoint with annual core PCE, the Fed's preferred measure of inflation, having been reported to hold at 1.6%, below the Fed's 2% target.

Of some relief, the Eurozone economy was reported to have expanded by 0.4% in the March quarter. The past month's data has been positive, with the final reading for core consumer price inflation in April recording the firmest pace since mid-2015 at 1.3% year-on-year. Meanwhile, Italian political tensions heighten as the country's Deputy Prime Minister grows increasingly prepared to breach EU Budgetary guidance. On Brexit, the path remains clouded with uncertainty as Prime Minister May announced her resignation, following an attempt to push her many-times amended Brexit deal through parliament for a fourth time.

Domestically, the Reserve Bank has left the cash rate unchanged at 1.50%, but with unemployment having inched up to 5.2%, despite ongoing jobs growth, consensus is favouring up to 3 cuts in the cash rate over the next few months. In other news, the Coalition retained government having won the Australian Federal Election, against all expectations of a swing in favour to the Labor Party. The Morrison Government's victory served as a relief to the markets with the threat of Labor's policies targeting franking credit refunds and changes to negative gearing off the agenda.

Information current as at 3 June 2019.

Sustainable investing

There is no doubt that interest in responsible investments is growing.

Not only in Australia but globally, investors are increasingly interested in how a company makes its money, not simply how much it makes.

While some investors may focus on the longer-term viability of a company and its behaviour, others may hold particular values they want their investments to mirror. How these two strategies play out in the investments context can be different. We explore the rise of sustainable investing in more detail.

Changing investors' perception

Even at the highest level, investors are shifting from only looking at short-term returns to a broader focus on long-term value creation, including the impact a company is having on those around them.

In his 2017 letter to the CEOs of the companies his firm invests in – Blackrock CEO, Larry Fink, highlighted this exact issue noting that "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate".[1]

More and more investors are asking CEOs to focus not only on creating shareholder value, but also on long-term vision for the company, and, by extension, the impact it will have on society via investing sustainably.

It's not a new idea

Today, many investment managers, including BT, use environmental, social and corporate governance (known collectively as ESG) knowledge and data. It can help to inform the analysis of important areas including risk and innovation to engagement and voting practices.

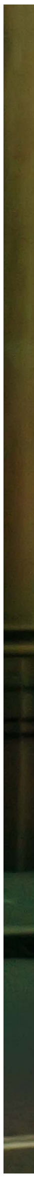
Examples may include a company's interaction with the environment, such as water and air pollution, social factors like employee diversity or safety standards, along with the company's governance structure, such as how the board is composed and compensation structures. This approach seeks to add value or manage risks through broader, more comprehensive investment analysis, decision-making and engagement with companies.

Investing opportunities

For investors, navigating the world of responsible investment can be complex. Terms like ethical, sustainable and impact investing are often used interchangeably by investors seeking to ensure that their money is invested in companies or funds that mirror their values and beliefs. In reality, these terms each relate to a specific type of responsible investing – depending on what the investment is trying to achieve.

Ethical investing verses sustainable investing

Arguably, the most well-known responsible investment strategy among investors is ethical investing. This strategy's primary purpose is to exclude certain industry sectors, companies, practices or even countries that meet specific criteria from a fund or portfolio, based largely on the client's preference not to be invested in these activities. Traditional ethical investment strategies seek to avoid issues like tobacco, weapons, gambling, and pornography, however, investors are increasingly interested in strategies that avoid sectors linked to climate change or abuse of human rights.



1. https://www.blackrock.com/corporate/investorrelations/2017-larry-fink-ceo-letter

Sustainable investing, in contrast, is a type of responsible investing that considers ESG issues in an investment, alongside standard financial measures when assessing a company's performance. This might include how a company approaches employee relations, executive remuneration and anti-money laundering legislation.

Sustainable investing also lends itself to longer-term investment horizons and strategies. If more investors use a sustainable strategy in their investment decision-making, more and more companies will be encouraged to behave sustainably and address ESG concerns and opportunities in their business.

Impact investing is a rapidly developing field

You may also have heard about the rapidly developing field of impact investing. Impact investments preference the social or environmental purpose of an investment over or alongside its financial results. Whilst there are currently few opportunities to access impact investments for most retail investors, many people are attracted to the idea of investments that aim to deliver a positive outcome as an alternative, or complement to traditional philanthropic funding.

Should diversity matter to investors?

Diversity and inclusion is becoming a common focus for investors.

Why?

Research continues to show that a diverse and inclusive workforce not only offers improved decision-making, it also affects a company's bottom-line.[1]

In fact, companies in the top 25 per cent for gender diversity on their executive teams are 21 per cent more likely to outperform companies in the bottom 25 per cent in terms of profitability. Those in the top-quartile for ethnic and cultural diversity are also 33 per cent more likely to have industry-leading profitability compared to the bottom quartile.[1]

In this article, we'll examine the opportunities for investing in companies that support diversity and why organisations like BT are advocating for it as part of their sustainable investing approach.

The opportunities for diversity

While diversity and inclusion has been predominately recognised as an important part of corporate social responsibility, there's now evidence to show that it's actually an integral part in driving profitability.

And it makes perfect sense.

A collective team of people from culturally diverse backgrounds might actually alter the behaviour of a group's social majority in ways that lead to improved and more accurate group thinking.[1] It also helps to remove potential bias that can otherwise blind the team from making the best decisions.

Companies that support gender diversity: potential profitability

Gender diversity in particular, has gained significant attention in Australia as a result of initiatives like the 30% Club which aims to achieve 30 per cent women on ASX200 boards. From December 2018, female representation on ASX200 boards reached 29.7 per cent, up from 19.4 per cent when the initiative was first launched in 2015.[2]

Importance of gender diversity in leadership

But it's not just about having more gender diversity – it's about where these employees are positioned within the company.

Gender diversity in management positions has been found to impact profitability more than previously thought. Data collected between December 2016 and November 20171 indicates that companies in the top 25 per cent for gender diversity on their executive teams were 21 per cent (originally thought to be 15 per cent) more likely to experience higher financial performance than the bottom quartile.

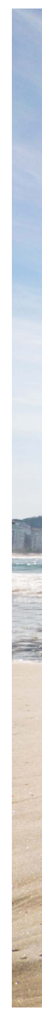
It gets better.

Large organisations with at least one female board member also demonstrate higher return on equity and higher net income growth than those that do not have any women on the board.[3]

So, the drive to have more women in positions where strategic decisions are being made, is no longer a nice-to-have, it's a must-have.

Companies that support ethnic and cultural diversity: potential profitability

Further evidence of a significant correlation between diversity and performance can be seen at the board of directors' level where more ethically and culturally diverse companies are 33 per cent more likely to see higher profitability than the bottom quartile.[1]



Companies that don't support diversity: the impact

Companies at the other end of the spectrum, with low diversity in management and executive roles, may be penalised by their lack of gender, ethnic and cultural representation.

In fact, companies in the bottom 25 per cent for both gender and ethnic/cultural diversity were 29 per cent less likely to achieve above-average profitability.[1]

What does this all mean?

Organisations like BT, have for some time, been advocating to have a robust approach to diversity and inclusion. When BT invests on behalf of its customers (including super members), workforce diversity is one of the key issues that it considers as part of its sustainable investment approach.

Part of this approach is an ongoing dialogue with directors and senior management of invested companies to encourage positive change in areas like diversity.

So, the case for diversity is no longer just about social progression - it can in fact deliver long-term sustainable performance.

In summary

Considering how a company embraces inclusion and diversity may help make better investment decisions, especially given this research shows a correlation between diversity and performance.

1 McKinsey & Company: https://www.mckinsey.com/business-functions/organization/our-insights/delivering-through-diversity

2 Harvard Business Review: ttps://hbr.org/2016/11/why-diverse-teams-are-smarter

3 Australian Institute of Company Directors: https://aicd.companydirectors.com.au/advocacy/board-diversity/gender-diversity-on-asx200-boards-hit-all-time-high

Merit Planning East P 02 8076 6026 W www.meriteast.com.au