RESPONSIBLE INVESTING ESG INVESTMENT PHILOSOPHY

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CENTREPOINT
ALLIANCE

Contents

1. EXECUTIVE SUMMARY

In Australia, responsible investing has reached a critical moment, driven by the strengthening demand and interest for more substantial alignment to society's values, in addition to delivering strong investment returns. An ethically conscious investor's objective is to stop supporting businesses that engage in activities harmful to people, animals and the planet.

Over the last number of years, we have observed the unprecedented demand in responsible and ethical investing, both locally here in Australia and globally.

In this philosophy paper, we wish to outline how we at Centrepoint Research define the Environmental, Social, and Governance considerations of responsible investing or ESG as it is referred to. Making sure to take into consideration the various schools of thought in this space such as exclusionary strategies and impact strategies, as well as addressing other terminologies commonly used. We wish to also outline our process and approach with regards to our responsible investing model portfolios.

1.1.1 Responsible Investing Model Portfolios

The Centrepoint responsible investing model portfolios are designed to meet the same objective goals and time horizons as the existing active models with an ESG overlay. We do caution that our portfolios will not always meet specific client demands around ESG (based on their specific ESG requirements).

They are designed to identify the key objectives specific to each portfolio risk profile with the purpose of producing an outcome that aligns the client to their investment objectives and risk tolerance. The hope from the Centrepoint Research team, is that these models help to create meaningful and nuanced discussions between the adviser and their clients to provide a greater understanding of the client's needs and objectives. In addition to helping advisers meet clients ESG Investment goals. They are constructed with an awareness of risk, diversification, and current market dynamics by utilising market-aware Capital Market Assumptions (CMAs), Strategic Asset Allocation (SAA) and portfolio construction principles with a responsible and ethical investing overlay (where possible given specific asset classes, investment styles, hedging, and market conditions).

1.1.1.1 Considerations:

- It is important to be aware that each investment manager can define ESG in a very different way. It is essential to know that you can approach responsible investing through various lenses.
- We understand that not all responsible investing models may meet every clients ESG requirements, and as such, customisation may be required to fit the needs of specific client situations, needs, objectives, and specific ESG requirements.

2. DEFINING ESG

The environmental, social, and governance (ESG) are all a set of criteria that help constitute standards that an investor uses to analyse for a company's operations.

- The **Environmental** refers to how conscious a company/investment is towards their direct environment and towards nature.

- **Social** refers to how a company/investment manages its impact on people; this can encapsulate employees, suppliers, customers, and the communities it operates in.

- **Governance** focuses on the corporate structure of the company/investment; this includes leadership, internal controls, shareholder rights, executive pay, compliance with the law.

We observed over this time two schools of thought. The first came from early adopters to responsible and ethical investing focused on negative screens, while the second is more recent which focused on impact investing.

1. **Negative screening** (exclusionary strategies) – these strategies placed emphasis on removing from portfolios specific screens to fit to their defined integration of environmental, social, and governance (ESG) considerations,
2. **Impact investing** (directly targeting ESG causes for investment).

3. RESPONSIBLE INVESTING PHILOSOPHY OVERVIEW

The CPAL Research team philosophy on responsible and ethical investing stems from the idea of providing our clients a well-researched ESG portfolio that can be easily accessed and invested in. In Australia, responsible investing has reached a critical moment, driven by the strengthening demand and interest for more substantial alignment to society's values, in addition to delivering strong investment returns. Increasingly more engagement to environmental and social issues are driving not only the consumer landscape but also the investment landscape. There is now a growing sentiment of investors who want their investments and retirement savings invested responsibly. Research shows that 9 in 10 (89%) of Australians expect their superannuation or other investments to be invested responsibly and ethically and two thirds (67%) of Australians who do not currently invest in ethical companies, funds or superannuation funds would be most likely to consider doing so in the next 5 years, with 32% saying they would consider doing so in the next year[1].

There can be a great deal of confusion when navigating the ESG landscape. Terms such as sustainable investing, ESG investing, socially responsible investing (SRI), green investing, ethical investing, and impact investing are often used interchangeably. Responsible Investing should be holistic in its approach to investment analysis, where material factors, ESG factors and traditional financial factors are identified and assessed to form an investment decision[2].

ESG integration is defined as "the explicit and systematic inclusion of ESG factors in investment analysis and investment decisions."[3]

3.1 Exclusion Strategies

- **Exclusion Strategies** – this includes funds that negatively screen investments which are associated with specific sin industries. This includes such industries like tobacco, alcohol, weapons, pornography, gambling, animal testing, genetic engineering, deforestation, oil and gas, nuclear power, mining, and climate change (just to name a few).

[1] RI – From Values to Riches Charting consumer attitudes and demand for responsible investing in Australia 2020
[2] CFA Guidance case study on ESG – PRI (Principles for Responsible Investment), January 2021
[3] PRI (Principles for Responsible Investment), January 2021

- The concerns with such exclusions in the portfolio means that specific managers would not invest in companies which may look to transition from sin industries or need guidance from active investors for guidance on their ESG footprint. This leads us to impact investing.

3.2 Impact Strategies

- **Impact investing** – this includes funds that look to generate positive returns while measuring an investment's environmental and social impact alongside its financial return. Funds in the category tend to be more active when voting and advising companies. They seek to positively reward firms which take a proactive approach to improving their ESG footprint.
  - The benefits of these types of strategies mean funds can attempt to keep firms accountable while improving companies who have traditionally been bad actors (to make a meaningful change we should be invested in these firms).

3.3 Philosophy Expectations

The Centrepoint Research team has taken the approach of integrating ESG in the investment process holistically using both exclusion and impact. Over the investment horizon, we expect the responsible model to have a different journey to that of a non-ESG model. However, we anticipate that over the long term, a client in either portfolio will achieve a broadly similar investment outcome. Our approach to responsible investing includes exclusion strategies, impact strategies, and non-ESG strategies (for diversification). ESG integration should not mean that an investor is prohibited from investing in specific sectors, countries, and companies, or that portfolio returns are sacrificed to perform ESG integration. By taking this approach, we hope to meet the client's investment objectives. A sound investment strategy will employ processes to analyse, systematise and exploit the investment opportunities that arise from shorter-term market dynamics. Asset prices are driven by both fundamentals and investor behaviour (and at times irrational biases in these).

4. HOW WE BUILD OUR RESPONSIBLE INVESTING MODEL

When looking at responsible and ethical investing, it is crucial to understand the approaches one can take to build a portfolio. As explained earlier one school of thought is via negative screening or exclusionary strategies as they are known by. These strategies exclude specific sectors, for example the exclusion of arms/munitions, alcohol, tobacco, energy, etc.

The second school of thought (still in its infancy) is impact investing. Impact investing aims to achieve specific beneficial environmental and social outcomes in addition to investment returns. The impact investments do vary in asset class and on an investment manger's definition. This type of approach endeavours to use investment capital for constructive outcomes to improve the environmental, social and governance in an investment they hold.

- To avoid confusion, we bucket thematic into the impact strategies (referring to them as impact). Both view financial performance as secondary to the investment's ESG theme or impact, ensuring that investments they hold have strong adherence to ESG.

The responsible model portfolio takes a holistic approach to responsible and ethical investing, focusing on both exclusionary and impact strategies (where possible) to create a portfolio which seeks to meet the ESG requirements of our clients.

At Centrepoint, portfolio diversification is key, for that purpose we will use non-ESG managers when we have no other alternative in that investment style or asset class to fill the gap needed in the portfolio. We will aim to have a portfolio which closely follows the SAA (strategic asset allocation), this is important since we do not wish to disadvantage clients entering the responsible investing model. Other reasons for divergence be to address hedging concerns or a lack of quality managers in the universe.

The Centrepoint Research team would also mention that some asset classes such as Property, Infrastructure, Cash and Diversified Alternatives will lack managers with an ESG focus. For this purpose, it is important not to exclude these asset classes, to avoid cyclicality in the portfolio. In the case for Alternatives, ESG is less of a direct concern due to the complexity of their investments, as they also provide other benefits to the portfolio.

5. BENEFITS AND RISKS TO RESPONSIBLE INVESTING

There are risks with all investment decisions, the Research team would like to address some of the specific risks associated to this space of ESG investing. What we have noticed over the years, is by excluding specific sectors and investments, clients may limit opportunities available to them, this is a common risk in responsible investing. We understand there are upsides to this during certain market environments, but this could also be detrimental. By have strong correlation characteristics between asset classes and via exclusion/impact strategies, we hope to address these common risks. Part of our portfolio construction looks to maintain a similar return and risk profile as laid out with our SAA.

5.1 Hypothetical performance:

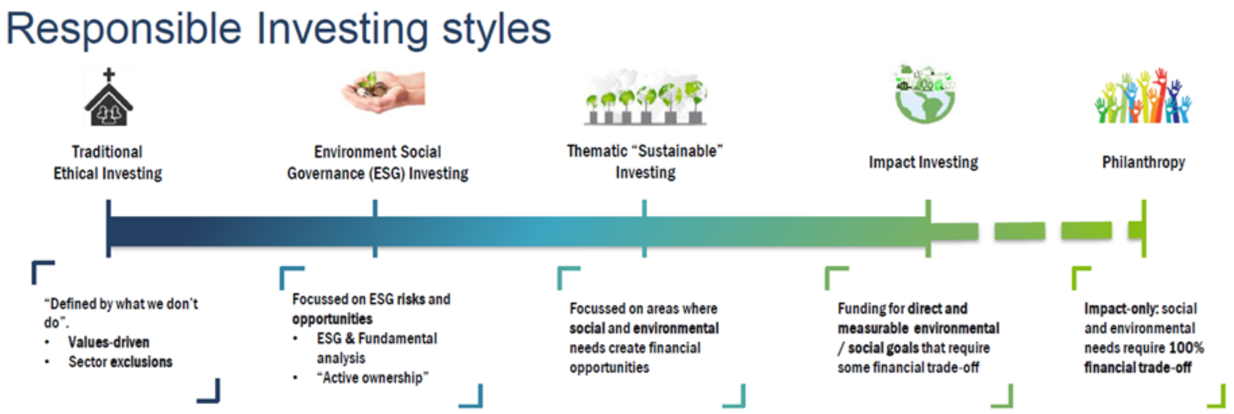
Performance may differ when compared to other portfolios. This can be dependent on cyclical factors that can arise. For example, in equities:

- A responsible investment manager may overweight growth companies due to their strong ESG scoring while underweight stocks with poor ESG scores (such as some value companies). In certain environments this may underperform as scenarios like “value” come into favour (currently dominated by energy and financial names).

The above is a possible scenario which explains the differences to returns a client might experience by incorporating these ESG qualities in their portfolio. Our expectation with the Responsible Investing Model Portfolio is that it will continue to hold the same objective goals, risk profiles, and time horizons as the existing active models, and as such expect the investment journey to be different from that of other portfolios with no ethical integration.

6. THE EVOLUTION OF ESG IN EQUITIES AND FIXED INCOME

The history and evolution of ESG in equities and fixed income originally developed from religious organisations which excluded so-called "sin" industries (e.g. gambling, tobacco and weaponry) and were value-driven. Over time this gave way to a broader focus on Environmental, Social, and Governance issues, while still encompassing a focus on excluding problematic actors to reduce the negative impact of portfolio holdings. The next transition was via thematic sustainable investing, which focused on areas where social and environmental needs created financial opportunities. The last transformation of the space was with the introduction of impact investing, which funded measurable environmental and social goals, this has also led to impact-only philanthropic causes which lay outside of this landscape.

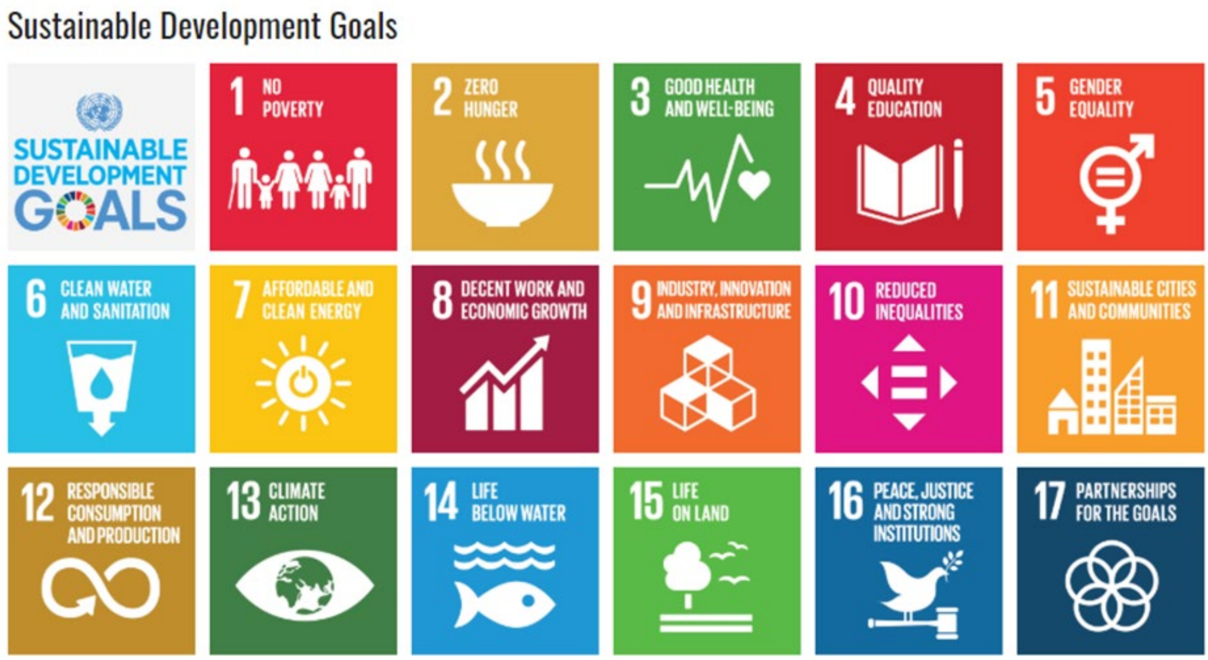


Source: Bridge Ventures, 2012

In equities, most investment managers continue to apply standard valuation methods to their investment decisions, with the added ESG overlay dependent on how they define their ESG approach. In fixed income there are more pronounced difficulties for asset managers including the inability to affect change due to bondholders not having the availability to vote. Bonds are also less liquid than equities, and green bonds have been found to be less susceptible to ESG factors as they tend to be issued with a focused ESG objective (the green bond debt can only be used on the specific ESG outcomes listed on issuance). Having said this though, there is now an emerging green bond market which could grow to surpass $1 trillion (USD) by the end of 2021[4]. As the market continues to grow, while providing more structure in scoring bonds on their ESG traits as well as creating further transparency. Green bonds are fixed-income instruments which help fund ESG initiatives.

ESG investing is quickly becoming another important risk measure for how we evaluate investments. Today, ESG investing is maturing to the point where it will continue to accelerate the transformation of the market in being aware of ESG outcomes. Providing a clear and transparent framework of conditions as governed by global rules outlined in the UN's Sustainable Development goals.

[4] Forbes Article – "Green bond Market will reach $1 Trillion with German New Issuance", Sep 2020



Source: United nations Principles for responsible investment - https://www.unpri.org/sdgs

7. ESG SCREENING AND MANAGER SELECTION

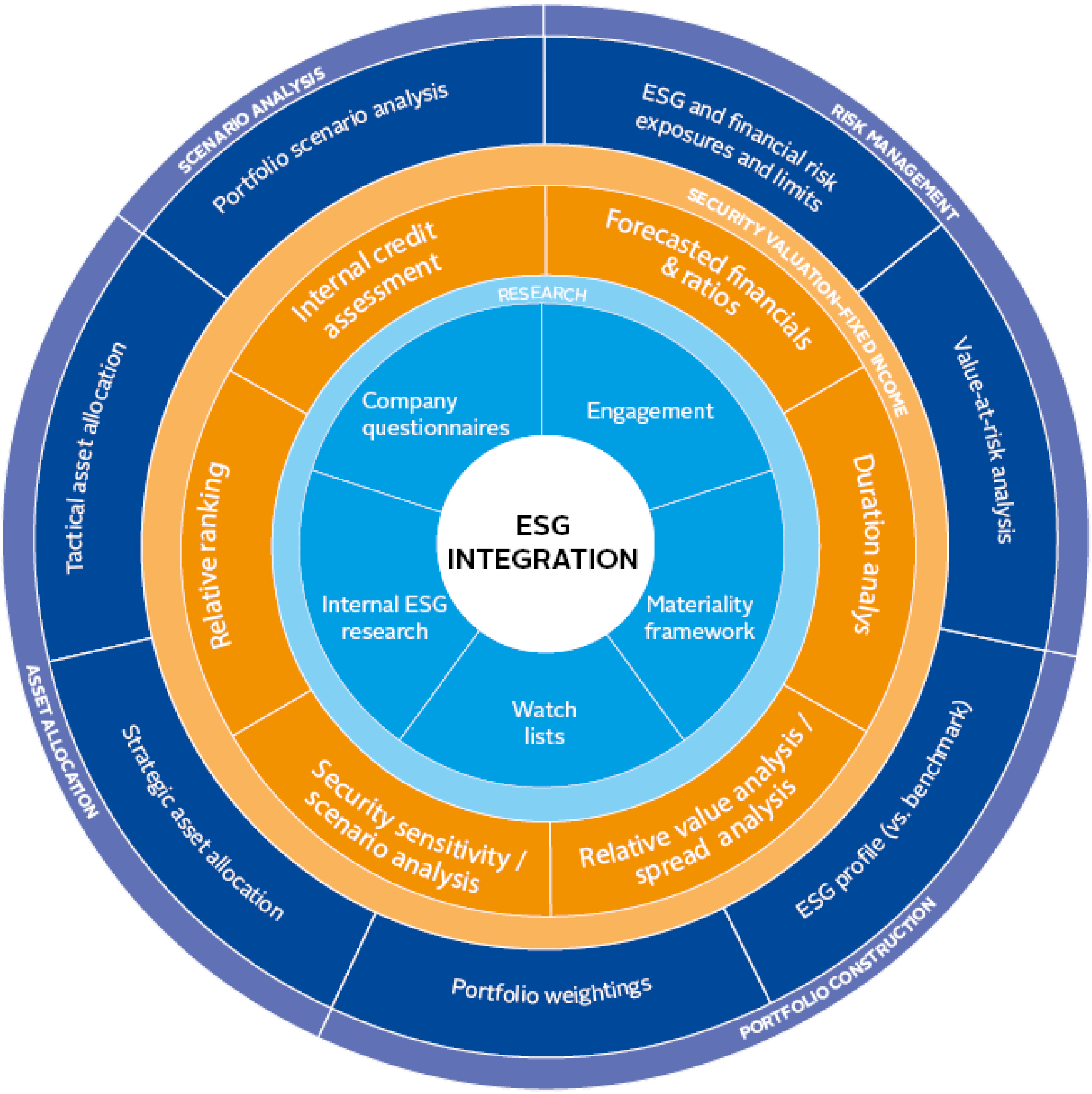
The Centrepoint Research team applies a multi-manager approach to the construction of the Responsible Investing Model Portfolios. This is based on the notion that portfolio returns can be enhanced through considered and skilful selection of investment managers whose processes enable them to outperform the benchmark return of their respective asset classes over different market conditions.

The Centrepoint Research team will continue to follow the existing process employed when selecting managers and building its portfolio with the added ESG integration which includes how the managers conduct their:

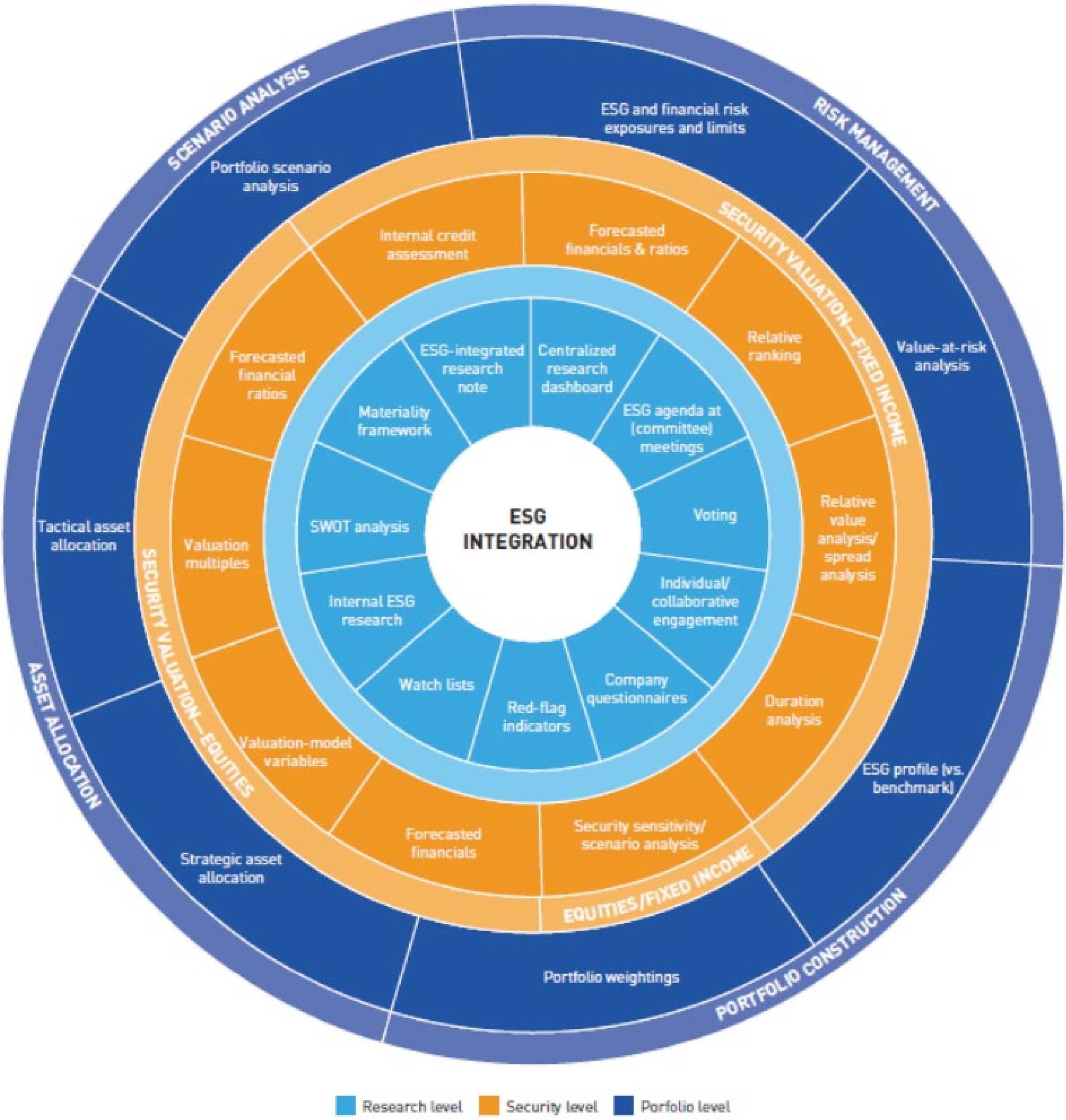
- ESG scoring and approach
- Active engagement (voting) – including collaborative investor engagement
- Industries screened
- ESG profile and history
- ESG agenda when meeting with investment teams
- SWOT analysis on ESG factors
- ESG integrated research notes

Importantly we continue to select a mix that will, in our view, meet SAA targets in terms of appropriate expected returns and risks. Please be aware that whilst we aim to have a responsible investing model that is aligned on most platforms (as a paper model), sometimes this may not be possible due to platform implementation issues and investment menu constraints. We hope to address this with a managed account SMA.

The below pie charts highlight how you can integrate ESG into the investment process for both Fixed income and Equities.



Source: CFA Guidance case study on ESG – Fixed Income



Source: CFA Guidance case study on ESG – Equities

8. CONCLUSION

The Responsible Investing Model Portfolios have been developed with a strong investment philosophy, portfolio construction and manager selection to:

Achieve real and meaningful diversification, increase the likelihood of achieving client objectives with a focus on risk, while improving the probability of meeting investment objectives, while maintaining the suitability of models across different client risk profiles and risk tolerances.

9. QUESTION AND ANSWER.

Common questions that come up with Responsible Investing (ESG)

Question: Is it possible to create a sustainable portfolio without giving away returns?

Answer: If you do not reduce the universe by too much, you will not need to give away returns. At a portfolio level, tracking error is the most significant risk that needs to be addressed when choosing investments. What we mean by this is if the portfolio hypothetically screened out banks/mining and had no significant banks or mining exposure, the portfolio would have performed well by not having exposure to those industries over the last year (where banks and miners disappointed). The concern in the portfolio is if hypothetically that scenario is reversed, therefore we wish to address cyclical concerns like this when building the model. Again, this example is only a hypothetical, but it is important that investors be aware of where underlying risks can occur.

ESG investing can have both positive and negative risk factors, that is why the CPAL Research approach is to set a holistic investment opportunity set to include a mix of strategies (exclusionary and impact).

Question: The question that must be asked is whether sustainable investments offer a return premium to non-ESG investments?

Answer: In short ESG investments will tend to offer lower overall risk by placing a strong emphasis on governance, due to the managers reliance on strong governance as a screen. The critical component set by strategies which employ ESG integration is to lower risk while enhancing investment returns. ESG strategies seek to uncover hidden dangers that may remain undiscovered without the analysis of ESG information and trends. These strategies also search for investment opportunities to enhance returns. If we use automotive companies as an example for analysing future risks, we could conclude that if that automotive company transitions to car electrification, other automotive companies who do not transition may see their forecasted revenue decrease over time, increasing their overall risk.

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