30 June 2018

AMP CAPITAL

RESPONSIBLE INVESTING UPDATE

Quarterly report

Welcome to the June 2018 quarterly report for the AMP Capital Responsible Investment Leaders Funds ('RIL 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 and responsible investment. We start by looking at AMP Capital's key responsible investment engagement themes.

ENGAGEMENT UPDATE

Over the June quarter, responsible finance remained in focus amid investigations by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. Our RIL managers, and AMP Capital, engaged with companies in an effort to understand the impact of the Royal Commission on businesses and customers. These meetings represented an opportunity to discuss company culture and how to rebuild trust with customers.

Climate change also remained a headline, with managers continuing to engage companies on the need to disclose climate change risk consistent with the guidelines outlined by the Taskforce for Climate-related Financial Disclosure (TCFD). In terms of environmental initiatives, RIL International Shares manager Stewart has been working on a plastics packaging round table in India, in an effort to identify ways in which the use of plastics in packaging can be reduced. This event brings together senior members of a number of Indian consumer companies along with representatives from the Institute of Sustainable Futures (Sydney), World Resources Institute (local NGO) and members of Stewart's Sustainable Funds Group investment team, and will not only benefit the environment but also the companies.

Other areas of engagement over the quarter included obesity and nutrition, human rights in supply chains, as well as corporate governance issues such as board composition and remuneration, as detailed below.

Climate change

The June quarter saw the kick-off of the Climate Action 100+ initiative, which is a global climate change engagement initiative designed to implement the investor commitment first set out in the Global Investor Statement on Climate Change in the months leading up to the adoption of the historic Paris Agreement in 2015. AMP Capital is a signatory of this Statement and is the lead engager with BHP Billiton and Wesfarmers. The BHP Billiton engagement is in conjunction with approximately seven international and six domestic investors and we had our first meeting with BHP in London in June. BHP has been one of the early adapters of the TCFD recommendations and many companies can learn from the lessons they learnt in undertaking scenario analysis. The kick-off meeting identified a number of areas for further engagement including greater transparency on the scenario analysis undertaken and the implications of climate change adaptation for BHP.

In addition to the Climate Action 100+ engagement, we continued our normal company engagement on TCFD. During the quarter we had meetings with Rio Tinto, Spark Infrastructure, Origin and Suncorp where we discussed TCFD disclosure.

In other climate change-related matters, Australian shares managers in the space, engaged with Lendlease Group on their sustainability practices. Positively, Lendlease shared their new sustainability approach which includes a focus on climate change with the goal of achieving net zero emissions by 2050. It also includes: achieving a circular economy and being efficient with resources, improvements in manufacturing, reducing waste; and biodiversity, with a focus on nature.

Our managers also engaged with Santos on better climate change disclosure in relation to fugitive emissions. In addition, they met with Macquarie Group to discuss their business model and how it relates to climate change and renewable energy, specifically the bank's acquisition of the Green Bank and risk management systems.

Obesity and nutrition

There were a number of developments in the obesity and nutrition space over the quarter. In May, Deakin University's Global Obesity Centre released their third report on obesity/nutrition in Australia, this time focusing on quick service restaurants. Similar to the two reports released in the first quarter on supermarkets and food and beverage manufacturers, the study focused on policies and commitments related to obesity prevention and nutrition.

The Access to Nutrition 2018 Global Index was also published in June, ranking the world's 22 largest food and beverage companies based on their contribution to addressing the challenges of overweight and obesity, and undernutrition. The key findings and recommendations will be used to assist AMP Capital's engagement activities with food and beverage companies to encourage better nutritional performance.

Finally, towards the end of the quarter the Australian Beverages Council announced a Coalition-backed commitment to reduce its sugar use by 20% by 2025.

Responsible finance

The focus this quarter has been on the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, with both Bennelong and the AMP Capital ESG Research team having engaged in dialogue with companies in these sectors.

National Australia Bank and Westpac were met with over the quarter to discuss responsible lending practices. Topics covered with NAB included consumer lending, with a focus on responsible lending as well as business lending, where they focussed on unfair contract terms. Management acknowledged the need to tighten credit controls, which they have been doing progressively over the last 18-24 months. With Westpac consumer lending was discussed with a focus on assessing applicants expense claims, the potential impact on customers as they move from interest only to principal and interest as well as the potential impact debt to income limits may have on customers.

The AMP Capital ESG Research team met with a number of financial and non-financial companies over the quarter, seeking to understand the impact of the Royal Commission on businesses and customers. This was a great opportunity to discuss company culture, and how to rebuild trust with customers. The team will continue to monitor the Royal Commission over the coming months and keep dialogue open with the companies involved.

Human rights in supply chains

In June, the Turnbull government introduced a Modern Slavery Bill into Federal Parliament that will require Australia's largest businesses to publish annual statements on the steps they are taking to address modern slavery in their supply chains and operations, covering human rights risks such as human trafficking, child labour, and other forms of forced labour.

Our RIL Managers have been engaging with companies from all sectors about the impact the legislation will have on their business. Notably, Breville were engaging with us on how they are dealing with the proposed reporting requirement, while one of the managers meeting with BlueScope Steel Limited involved a discussion on modern slavery and how the company is mapping out and risk assessing for human rights in the supply chain.

In terms of industry engagement on the matter, Ausbil also provided stakeholder input into the proposed Modern Slavery Act at a roundtable event organised by the Department of Home Affairs.

Corporate governance

Over the June quarter, our managers continued to meet with the boards and management of companies held in the RIL range of funds. As the ultimate owners of companies, shareholders can exert influence through the directors that represent them, by asking the right questions, lodging considered votes, and by holding directors and management to account for their performance.

Board composition continues to be one of the most important corporate governance issues for shareholders and the RIL managers remain focused on this issue. For example, RIL International Share manager Investec met with NICE Systems Ltd to discuss their concerns on remuneration and committee composition. Investec also met with Polymetal for a general update on governance and sustainability, and are of the view that the company is on the right track with regard to board composition.

In regards to remuneration, remuneration reports should facilitate a clear understanding of the company's remuneration policy, providing evidence that the policy is both fair and reasonable, and is aligned with shareholder interests. In the past, AMP Capital's ESG Research team has expressed concern with regard to excessive termination payments (both actual and potential) that were made to some departing senior executives – particularly as actual payments often bore little resemblance to previously agreed limits. Pleasingly, this has become less of an issue.

ESG REPORTING AND INTEGRATION

Kathmandu (KMD)

We focus on Kathmandu this quarter, a company that was widely commended following the publication of a report suggesting that it ranks as one of the most ethical of companies in Australasia operating in the fashion industry. Unfortunately, a capital raise carried out recently was less impressive, as we discuss below.

2018 Ethical Fashion Report

The 2018 Ethical Fashion Guide, the fifth such report produced by Baptist World Aid Australia and Tearfund New Zealand was released during the quarter. This annual survey has gained particular prominence since the 2013 collapse of the Rana Plaza Building just outside of Dhaka in Bangladesh which claimed the lives of 1,134 garment workers and injured thousands more. The disaster focused the minds of consumers, companies, investors and governments around the world on the plight of workers in the fashion industry.

The report essentially examines labour rights management systems (LRMS) and grades 114 companies in the fashion industry from A to F, on the strength of their systems to mitigate against the risks of forced labour, child labour and exploitation in their supply chains (with practices here assessed at three stages: raw materials, input production and final stages production).

Kathmandu was one of 18 companies to receive an 'A' grade, the first time the company has received such a grade and a steady improvement on the 'B+' grade achieved in 2017. The median grade in the report was 'C+'.

We describe below in broad terms what a good LRMS looks like and highlight the areas where KMD was commended by the report's authors. Effective LRMS are seen as critical to addressing the risks outlined above. The optimal LRMS involves the following:

High quality relationships with suppliers and detailed knowledge of the supply chain – ideally from farm to factory. If companies don't know (or don't care) who their suppliers are, then there's virtually no way of ensuring that the workers who make their products aren't being exploited. There are three tiers of the supply chain that the report authors focus on:

> Tier 1 (final stage manufacturing suppliers). For the majority of companies, it is at this stage of the supply chain that they have the strongest relationships and most control. Thanks to this strong visibility, the worst forms of exploitation, forced labour and child labour are now less prevalent than in the past in the actual manufacturing of garments.

> Tier 2 (fabric suppliers). Deeper into the supply chain, where there is less visibility, risks are greater. However, an increasing number of companies are identifying their suppliers beyond the first tier.

> Tier 3 (raw material suppliers). Knowledge of raw materials suppliers (third tier, usually cotton farms) appears to be improving markedly. This improved knowledge has, in most cases, been coupled with improved systems to address exploitation. When Baptist World Aid Australia began this research in 2013, most companies argued that tracing back to the farm was outside their scope of control and responsibility. At the time, raw materials tracing was largely restricted to Fairtrade companies. Now close to half of companies surveyed are seeking to trace their cotton suppliers, with many collaborating through the Better Cotton Initiative (BCI) to do so. BCI is a multi-stakeholder initiative that works with brands, NGOs, farms, and cotton-traders to improve social and environmental protections and increase farm yields. All Fairtrade companies excel at cotton-tracing and ensuring that robust systems are in place to protect workers in their cotton fields. Kathmandu was commended as a stand out performer when it comes to tracing raw materials. By using a combination of BCI and Fairtrade cotton, Kathmandu has traced three quarters of its cotton supply and, through The Responsible Down Standard, has traced 100% of its down supply.

- Transparency in relation to the identity of suppliers. Transparency demonstrates a company's willingness to be accountable to consumers, civil society, and workers; and makes it easier for these groups to collaborate to ensure the rights of workers are upheld. One significant element of transparency is the publication of a list of suppliers that includes their business names and addresses. Around one third of companies surveyed publish their supplier lists, including Kathmandu.
- Worker remuneration/representation. A high quality LRMS should be able to demonstrate that workers have an avenue to collectively agitate for their rights and that living wages are being paid in at least the final stage of the manufacturing process. A living wage is defined as one that is sufficient for workers to be able to afford the basics (food, water, healthcare, clothing, electricity, and education) for themselves and their dependants. Living wages also mean that parents earn enough to send their children to school, rather than to factories. This would mean that, where such wages are paid, the likelihood of other forms of exploitation, such as forced labour and child labour, fall dramatically. Given the importance of wages to workers, being able to demonstrate that workers are receiving a living wage, is one of the most telling signs that a corporate labour rights system is genuinely responsive to the needs of workers. Kathmandu ranks relatively highly in this regard, in that the company developed a living wage methodology and calculated a living wage for each region that it operates in as well as published a commitment to pay living wages within a reasonable time frame.
- Gender policies. Women represent about 80% of global garment workers. Best practice for companies operating in the global fashion industry should include specific policies on gender, and strategies to mitigate discrimination and ill treatment of women in the supply chain. At present, just over one fifth of companies had a robust gender policy and strategy, while a further 16% received partial credit. In most cases these companies had a policy but no clear strategy for implementation.

Benchmarking environmental performance

Baptist World Aid Australia has initiated an assessment of companies' efforts to mitigate their environmental impact. The authors asked questions that looked at impacts on climate, chemical management practices, water usage, use of sustainable fibres, provision of take back and repair programmes, and whether companies have completed an environmental impact assessment. While assessments of environmental systems did not impact the grades awarded to companies in this year's report, it is anticipated that they will form a part of the grading system in future reports.

Preliminary research demonstrated a significant correlation between the strongest labour rights performers and strong environmental systems. While large global firms (in most instances) had some environmental systems in place, firms headquartered in Australia and New Zealand are largely trailing behind their international counterparts.

Oboz acquisition and equity raising

While it is gratifying to note the rigour with which Kathmandu manages its environmental and social responsibilities, other aspects of its governance procedures have been less impressive in recent times.

Kathmandu announced at the end of the previous quarter the acquisition of Oboz Footwear for US$60 million (with scope for an additional earn out of US$15 million). Oboz designs, sources and sells footwear for backpacking, hiking, travel, winter and general outdoor wear. The product is distributed directly to North American outdoor retail chains, speciality outdoor retailers, limited online sellers, shoe stores and sporting goods retailers.

From an ESG perspective, the business appears a good fit, with a brand ethos said to be built around sustainability and environmental friendliness (for example, one tree is planted for every pair of shoes sold). However, Salt were relatively agnostic as to the merits of the deal from a financial perspective, and unimpressed with the way the deal was funded.

Kathmandu, advised by Goldman Sachs NZ, launched a fully underwritten institutional placement to raise $40 million via the issue of 18.5 million new shares, as well as a share purchase plan that raised $10 million. The new shares were priced at a sizeable (10%) discount to the closing price of the shares on the day before the deal was announced. In total 23,148,030 new shares were issued, representing more than 11% of the existing capital base prior to the transaction.

In Salt's view, issuing this amount of new equity, at a sizeable discount to the prevailing share price, creates an ethical duty on the part of the Board and its advisers to ensure that the pre-emption rights of existing shareholders are not disregarded. However, the Board and its advisors chose to materially under-allocate shares in the placement to various existing shareholders, relative to their pro-rata 'rights', in favour of new investors who essentially entered the share register at a discount, diluting existing holders in the process.

Salt made its views on this allocation process very clear to Kathmandu management, the Board and their advisors.

DIVERSIFIED FUNDS

Market review

- Volatility came off its first quarter highs but remained persistently elevated throughout the June quarter. Geopolitical developments continued to unsettle investors especially the prospect of a trade war between the US and China, and Italy's new populist government. Despite the political uncertainty, developed equity markets rebounded from their first quarter dip as the macroeconomic backdrop remained relatively supportive and the US economy maintained its upward momentum. In this environment, global developed markets closed the second quarter up 3.6%, led higher by the European region which gained 4.1% over the period. US equities returned 3.4% and the Asia Pacific region 2.3%. Meanwhile, trade concerns and a strong US dollar weighed on emerging markets with the MSCI Emerging Markets Index ending the quarter 3.5% in the red.
- Australasian equity markets were the standout performers over the past three months and led developed markets over the quarter. The S&P/NZX 50 Index rose 7.5%, lifting the return for the first half of the year to 6.5%, while the Australian equity market recovered sharply in the June quarter finishing 7.6% higher. In New Zealand, equity market returns saw strong double digit returns from many large cap stocks such as Fletcher Building, Spark, Ryman Healthcare and Fisher & Paykel Healthcare. In part, these returns reflect an up-weight of New Zealand in global equity indices, forcing passive global investors to increase their exposure. Tegel's share price rallied after receiving a takeover offer while a2 Milk's share price came off its highs and was one of the largest detractors in the index. On the other side of the Tasman, the Australian equity market had its best quarterly return for three years.

- Global listed real estate rallied over the June quarter, outperforming the broader global equity market. Listed property was pushed higher as interest rates outside the US declined, as the trade war intensified and political concerns remained a consistent disruption. Closer to home, the New Zealand listed property sector recovered from a weak first quarter to end up 5.9% over the past three months. Transactional activity dominated the domestic listed property market over the quarter, with Precinct Properties selling half its stake in the ANZ Centre in Auckland and Goodman Property divesting its 51% interest in the VXV portfolio.
- Global bonds delivered a relatively flat return over the second quarter in New Zealand dollar hedged terms. Markets were characterised by volatility mainly driven by political events and the prospect of an escalating global trade war. In the US, the Federal Reserve raised interest rates again to a 1.75-2.00% range, remaining on its planned trajectory despite the uncertainty caused by the current antagonistic global trade environment. The US 10-year Treasury yield broke the psychologically important 3% level for a period before pulling back towards the end of the quarter.
- The Reserve Bank of New Zealand (RBNZ) had two policy meetings during the second quarter. The first, in May, was the new Governor Adrian Orr's first opportunity to deliver policy under the new Policy Targets Agreement. The RBNZ left the Official Cash Rate (OCR) unchanged and maintained a consistent message with prior statements. The forecast track for the OCR showed the RBNZ anticipating the first interest hike in late 2019. On 28 June the RBNZ again left the OCR unchanged as expected. However, the statement came across slightly more dovish than the market anticipated. Over the quarter the 90-day bank bill rate increased by four basis points finishing the quarter at 2.00%. The higher rates reflect some tightening in the short-term funding market in New Zealand mirroring moves seen in Australia.

Outlook

We retain a cautiously optimistic outlook for markets. We are still cautious regarding the more expensive asset classes and market sectors, and are unsurprised that markets outside the US are finding it difficult to shake off their sideways trend. The willingness of investors to switch into debt securities at times of turmoil has clearly diminished this year, and cash has been preferred as the safe-haven asset to hold immediately following market shocks.

We continue to expect low returns from bonds as monetary policy continues to normalise and yields remain low. The key question for 2018 is how long the upward growth momentum can last. Geopolitical shocks from US Trade and Defence policy are a growing risk. We are yet to observe many of the usual signals of excess that presage a significant down turn in economic activity and equity markets. However, we feel the second half of 2018 will be volatile overall.

Fund commentary

- The AMP Capital Responsible Investment Leaders Funds produced positive returns over the second quarter of 2018.
- The AMP Capital Responsible Investment Leaders Balanced Fund returned 3.49% for the quarter and 9.87% over the past 12 months. The AMP Capital Responsible Investment Leaders Growth Fund returned 4.66% for the quarter and 13.32% over the past 12 months. The Conservative fund returned 1.73% for the quarter and 5.21% over the past 12 months.

AMP Capital Responsible Investment Leaders Conservative Fund

SECTOR	DAA TARGET %	SAA BENCHMARK %	DEVIATION %
Cash	31.0	25.0	6.0
NZ bonds	22.0	25.0	-3.0
Global bonds	22.0	25.0	-3.0
NZ equities	2.5	2.5	
Australian equities	2.5	2.5	
Global equities	13.0	13.0	
Property	7.0	7.0	
Foreign currency	4.0	4.0	

Fund performance

AMP CAPITAL RESPONSIBLE INVESTMENT LEADERS CONSERVATIVE FUND		QUARTER %	1 YEAR %	3 YEARS %
	Fund return	1.73	5.21	4.83
	Benchmark return	1.89	5.22	4.46
	Value added	-0.16	-0.01	0.38
From	Asset allocation	-0.01	-0.23	0.12
	Security selection	-0.15	0.22	0.26

- The overall added value for the RIL Conservative Fund was marginally negative for the quarter. Over the period US interest rates remained firm while equity markets were less volatile. The interest-rate sensitive property and infrastructure sectors rebounded. Australasian shares were also strong and the NZ dollar weakened. Given this environment, the asset allocation position that positively contributed over the quarter was the underweight position to bonds, although this was offset by a corollary overweighting of cash. The main drag on performance from security selection over the quarter were in global and NZ shares and global property.

AMP Capital Responsible Investment Leaders Balanced Fund

SECTOR	DAA TARGET %	SAA BENCHMARK %	DEVIATION %
Cash	16.0	10.0	6.0
NZ bonds	12.0	15.0	-3.0
Global bonds	12.0	15.0	-3.0
NZ equities	7.5	7.5	
Australian equities	7.5	7.5	
Global equities	35.0	35.0	
Property	10.0	10.0	
Foreign currency	14.0	11.0	3.0

Fund performance

AMP CAPITAL RESPONSIBLE INVESTMENT LEADERS BALANCED FUND		QUARTER %	1 YEAR %	3 YEARS %
	Fund return	3.49	9.87	9.57
	Benchmark return	3.73	9.49	9.20
	Value added	-0.24	0.38	0.37
From	Asset allocation	0.14	0.21	0.26
	Security selection	-0.38	0.17	0.11

- The overall added value for the RIL Balanced Fund was negative for the quarter. Over the period US interest rates remained firm while equity markets were less volatile. The interest-rate sensitive property and infrastructure sectors rebounded. Australasian shares were also strong and the NZ dollar weakened. Given this environment, the asset allocation position that positively contributed over the quarter was the underweight position to bonds, although this was offset by a corollary overweighting of cash. The main drag on performance from security selection over the quarter were in global and NZ shares and global property.

AMP Capital Responsible Investment Leaders Growth Fund

SECTOR	DAA TARGET %	SAA BENCHMARK %	DEVIATION %
Cash	9.0	5.0	4.0
NZ bonds	0.5	2.5	-2.0
Global bonds	0.5	2.5	-2.0
NZ equities	11.25	11.25	
Australian equities	11.25	11.25	
Global equities	57.5	57.5	
Property	10.0	10.0	
Foreign currency	18.0	18.0	

Fund performance

AMP CAPITAL RESPONSIBLE INVESTMENT LEADERS GROWTH FUND		QUARTER %	1 YEAR %	3 YEARS %
	Fund return	4.66	13.32	13.95
	Benchmark return	5.21	13.25	13.76
	Value added	-0.55	0.07	0.19
From	Asset allocation	0.01	-0.14	0.17
	Security selection	-0.56	0.21	0.02

- The overall added value for the RIL Growth Fund was negative for the quarter. Over the period US interest rates remained firm while equity markets were less volatile. The interest-rate sensitive property and infrastructure sectors rebounded. Australasian shares were also strong and the NZ dollar weakened. Given this environment, the asset allocation position that positively contributed over the quarter was the underweight position to bonds, although this was offset by a corollary overweighting of cash. The main drag on performance from security selection over the quarter were in global and NZ shares and global property.

Diversified portfolio activity for the quarter

Overweight cash, underweight international fixed interest, underweight New Zealand fixed interest

We maintained our allocation to fixed income securities, with underweights compared to the benchmarks for both global and domestic bonds. US Treasury yields are now closer to their estimated fair value and investor's willingness to switch into debt securities at times of turmoil has clearly diminished this year with cash being preferred as the safe-haven asset to hold immediately following market shocks. We also retained our overweight position in cash.

Neutral global equities

During the quarter, we retained our position in global developed markets and emerging markets at their neutral weights. World share markets have spent much of 2018 in an uncertain mode, with corrective down-moves followed by unconvincing and fragile partial rebounds. Because the markets remain supported by underlying economic and corporate health, we still see the recent flat market direction a consolidation rather than an enduring market peak. When compared to bonds, global equity markets outside the US are not at extreme valuations, nevertheless they are fully-priced on a prospective earnings basis. This makes equities more susceptible to a correction as the US Federal Reserve raises the policy interest rate and escalating trade hostilities impact the investment landscape.

Neutral Australian equities, neutral New Zealand equities

We maintained our neutral position in New Zealand equities during the quarter. We also held the Australian weight at neutral, leaving an overall benchmark position to Australasian equities.

Neutral listed property

During the quarter, we kept our global and Australasian listed real estate exposure in line with the benchmark. Global listed real estate securities rebounded and outperformed the broader equity market over the second quarter of 2018, as the asset class recovered an unduly negative reaction in the first quarter to a normalization of monetary policy. The listed real estate sector is looking fairly valued, and gradually rising interest rates should cap returns from the sector near-term. However, the extended 'lower than average' real yield environment should provide some support over the longer term.

Overweight foreign currency

We maintained the overweight foreign currency position over the quarter. The relative interest rate differentials are not expected to support the New Zealand dollar and the Reserve Bank of New Zealand is unlikely to lift domestic interest rates until late 2019. This contrasts with the outlook for interest rates in the US which is for continuing gradual hikes.

GLOBAL EQUITIES

Market review

Despite a number of global concerns for investors throughout the June quarter, most markets climbed the 'wall of worries' to rise strongly. The MSCI World ex Australia Net Index finished the period higher by 3.4% in local currency terms.

Concerns included negative US rhetoric towards Europe with the threat of tariffs on automotive imports, ongoing US/China counter-retaliatory tariff threats, and early inflationary concerns in the US. There were also currency concerns in emerging markets as the US dollar rose, and subsequent concerns around the increasing real debt levels of many emerging market companies which hold their debt in US dollars. The MSCI Emerging Markets total return index was consequently down by 3.5%. China's market particularly suffered amid the US trade skirmishes, ending the period down by 10.6%.

Meanwhile, the US S&P 500 total return index ended the period up 3.4%, as companies continue to grow their earnings and economic growth remains strong. The UK's FTSE 100 total return index was extremely strong and reached record-highs in the June quarter, up 9.6% as the Sterling fell (leading to a significant increase in earnings for many UK-based international businesses), commodity prices rose and the Bank of England remained a little less hawkish than expected. (All figures quoted in local currency terms.)

Outlook

Although economic fundamentals remain broadly positive for stocks, the potential for a US initiated trade war has created increased volatility and uncertainty. Despite the elevated volatility, unless a trade war or other serious geopolitical situation eventuates we still expect shares to trend higher over the longer term, helped by the synchronised pickup in global economic activity data and the flow-through to growth and corporate earnings.

The greatest near-term pressure is likely to come from political uncertainty in the Eurozone. Volatility is likely to remain high in the short-term due to US political noise and a more aggressive Federal Reserve. Global shares appear to be valued reasonably, particularly relative to fixed interest markets, and we expect solid global growth, good corporate earnings and easy monetary conditions will be likely to provide support for shares into the medium term.

Responsible Investment Leaders Global Shares Fund

Fund performance

AS AT 30 JUNE 2018	QUARTER %	1 YEAR %	3 YEARS %	5 YEARS %
Fund return	3.71	14.95	7.70	12.24
Benchmark return	4.29	14.25	9.40	12.61
Value added	-1.19	0.70	-1.30	-0.37

Fund commentary

The Responsible Investment Leaders (RIL) International Share Fund produced a strong absolute return in the June quarter, though underperformed the benchmark over the period. Lazard and RIL Emerging Markets Fund outperformed their respective benchmarks, while Investec underperformed.

Lazard's developed market strategy was again the strongest outperformer. CSL made one of the largest contributions to their portfolio, as the global biotech's stock rose further. The business maintains its international market dominance, which Lazard believes justifies its high valuation. Australian/US currency movements also significantly assisted positive sentiment towards the stock. Other stocks in the portfolio, such as Equinor and Total, benefited from higher oil prices. Equinor has a number of fields coming on line in the next few years that should improve their free cash flow and Total's shares rose on the back of a significant stock buyback.

Investec delivered a positive absolute return albeit while underperforming its benchmark. Technology sector holdings have recently been significant contributors. Storage infrastructure provider, NetApp rose strongly after beating earnings expectations in late May. Sector peer VMware has also been rising of late after announcing a 14% increase in year-on-year sales, ahead of consensus expectations.

The Fund's overweight to emerging markets was negative for the period as they underperformed developed markets. Emerging markets continued to fall amid fears of currency outflows to the US and concerns around US protectionist policies. Both of the Fund's underlying managers outperformed the index over the period.

Investec's emerging markets portfolio has recently been held back by stocks such as WH Group, a Chinese pork producer, which fell on concerns around the US trade tariffs, and Beijing Capital International Airport, which fell after regulatory change was announced that is likely to result in a loss of around 25% of ongoing revenue. CFS's emerging markets portfolio bucked the broader market's trend and was positive in absolute terms. Over the quarter they initiated a new position in Mexican personal-care product company, Kimberly-Clark de México, which they believe to be a high quality business exhibiting sound fundamentals, including a cash return on invested capital of over 30% per annum, 15% free cash-flow margins, high quality management and dominant branding.

Fund managers as at 30 June 2018

RESPONSIBLE INVESTMENT LEADERS GLOBAL SHARES FUND	FUND WEIGHT %	STYLE
Lazard Asset Management	45.9	Core/quantitative
Investec – RIL International Share	40.4	Bottom up '4 factor'
Investec – Emerging Markets	7.6	Bottom up '4 factor'
CFS Emerging Markets	6.1	Benchmark un-aware
Total	100	

NEW ZEALAND EQUITIES

Market review

The New Zealand S&P/NZX 50 Gross (including Imputation Credits) Index posted a strong result in June to round out another strong quarter of returns. The most significant moves over the quarter include Synlait Milk surging following a strong but one-off driven result, Fletcher Building following an equity raising to restore its balance sheet, Kathmandu after a strong trading update which belied tepid retail conditions. Notable decliners included Comvita, which warned on soft honey season and announced a potential bidder has walked away and A2 Milk which posted a somewhat disappointing trading update. The NZD was 6.5% weaker against the USD and 3% weaker against the AUD.

Outlook

Global equity markets have generally struggled for direction during the first half of 2018. The New Zealand and Australian markets have been unaffected by deteriorating regional sentiment, logging strong first half returns. This suggests that markets are still being driven by local factors and are awaiting a major global trend shift.

New Zealand equities have been the champion among developed markets, with world-leading gains in 2018 even as the business confidence outlook has consistently deteriorated. While GDP growth should be somewhat stronger in the second half of this year, the domestic share market could be affected disproportionately in the event of the negative (rising) interest rate scenario prevailing offshore.

The market is very expensive on traditional measures and has been seen as a suitable destination for global yield-seeking investors. Cuts to the dividends paid by major New Zealand corporations would only risk re-enforcing the signal that critical fundamentals are changing, and so NZ equities are unlikely to continue outperforming their international counterparts over the next three years.

Responsible Investment Leaders NZ Shares Fund

Fund performance

AS AT 30 JUNE 2018	QUARTER %	1 YEAR %	3 YEARS %	5 YEARS %
Fund return	6.57	16.99	17.00	17.55
Benchmark return	7.68	18.87	17.42	16.48
Value added	-1.11	-1.88	-0.42	1.07

Fund commentary

The Fund moderately lagged a powerful surge in the market in the June quarter, rising by 6.7% compared to the remarkable 7.7% recorded by the Index. The one year forward PE ratio for the New Zealand market now appears extremely extended at a record 25.0x. Earnings forecasts are not rising, bond yields are relatively steady and the domestic business confidence outlook is at its weakest level in some years.

In common with markets globally, much of the strength in New Zealand appears to have been driven by 'price momentum' and 'growth' as factors which have ridden rough-shod over other factors such as 'valuation', 'quality' and 'dividend yield'. For example, the MSIC Australia Growth Index has outperformed Value by 24% over the past year.

The largest headwind for the Fund was a modest holding in AMP Limited, which came under enormous pressure following the revelations at the Australian Royal Commission Enquiry. In Salt's view, the share price decline is out of all proportion to the direct issues themselves and a robust response led by the highly respected new Chairman, David Murray, could potentially see a retrieval of some of the enormous gap that has opened up to our assessment of fair value. Other overweights which weighed on returns included a small holding in the bladder cancer diagnostics company, Pacific Edge Biotechnology, which is yet to seal long awaited deals with Kaiser and/or Medicare, and Tower which continues to make strong progress in re-setting its core business but this was obscured by an unusually difficult period of storm activity.

Underweights which dragged on returns were led by Ryman Healthcare which rose sharply post what we considered a mediocre result. Bulls appeared to focus on the sharp rise in Net Tangible Assets (NTA) from long-term house price assumptions being lifted, which seemed odd when property prices have now peaked. The manager is concerned at the lack of free cashflow generation, early timing of sales recognition, the large multiple of NTA and the leveraged risks to an equity-light model from weakening house prices and housing turnover.

The second notable laggard was the zero-weight in Synlait Milk which is very much flavour of the month among a raft of bubbly Australian/New Zealand food export stocks. Synlait delivered a strong result in late March but this was due to surprisingly high gross margins thanks to volatile seasonality and commodity related factors that are unlikely to be repeated. Synlait's forward PE of 27x is quite extraordinary for a toll processor which is not a brand-owner. Other headwinds came from zero-weights in several high multiple growth names, with the largest such drag being Mainfreight.

The largest positive was having no holding in CBL Corporation, which was removed from the Index at a zero valuation. The Fund never owned CBL despite superficially attractive metrics given concerns regarding the background of the business and the risks around very long-tail policies that appeared to be written at aggressive pricing. Other helpful non-holdings included Fonterra, Ebos and Sky City. Positively contributing overweights included Vista which rose sharply along with other high multiple growth companies, Tilt Renewables and Evolve Education whose result was at the top end of guidance that had earlier been downgraded.

Cash levels rose slightly from 3.4% to 6.1% given the market strength. Weakness was used to add to Mercury and small new positions were purchased in Mainfreight and Pushpay, the latter in a discounted sell-down. Strength was used to lighten Auckland Airport, Contact Energy, NZ Refining, NZX and Z Energy.

The Fund's proprietary measured ESG score of 68.2 compared to 66.6 for the market.

CONTACT DETAILS

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