

JANUARY 2024 For institutional, professional and wholesale investors only

## COMBINING SUSTAINABILITY, CLIENT VALUES AND A 'SUFFICIENT INCOME FOR LIFE'

The Martin Currie Australia (MCA) Sustainable Income strategy invests in a diversified benchmark-unaware portfolio of high-quality companies that we have screened for client-driven ethical values, and which have been assessed using a proprietary approach for understanding sustainability and financial attributes.

The strategy aims to deliver a growing income stream, through:



**No binary choice between sustainability & client values, and returns** – Unique investment process that reflects sustainability and client ethical values, without compromising income objective of providing a 'sufficient income for life'



**Income-focused return profile** – Favouring high quality, highly franked dividend payers to reduce income shocks and grow income



**Benchmark unaware portfolio construction** – Combining proprietary multi-lensed research, **Shadow Carbon Cost & Sustainability** assessments and negative ethical screens with income-focused construction methodologies



**Fundamental active ownership** – Purposeful engagement with companies and client advocacy through proxy voting – influencing companies to make positive change




**Experienced stock pickers with long term track record** – Deep industry experience generating 'active insights'

Read more in the following document about how the MCA Sustainable Income strategy seeks to provide a 'sufficient income for life', without making investors choose between income returns, their values and Sustainability.

## Overview

**Investors don't want to have to choose between income, their values and Sustainability – and we believe they shouldn't have to.**

The MCA Sustainable Income strategy invests in companies that have first passed our client-driven ethical screens and have then been assessed using MCA's proprietary Active Ownership approach and ratings framework to have more favourable **Sustainability**  assessments for “**Sustainability Risk**”, “**Net Benefits**” & “**Sustainability Pathway**”, and “**Shadow Carbon Cost**”. This approach is premised on our philosophy that companies with these characteristics should prove to be more successful financially over time.

Furthermore, we have found that stocks that ‘pass the grade’ for traditional equity accumulation or Sustainability-focussed funds may not always be suitable for income portfolios. We focus on the high-quality companies that have solid earnings can sustain dividends, match rises in the cost of living and are likely to be less volatile than the wider equity market. These are attributes are key to providing what we like to call a ‘sufficient income for life’.


The development of the Sustainable Income strategy was a natural extension of MCA's investment philosophy. Sustainability inputs and assessments have been embedded directly into our investment process since 2009, the year we became signatories to the PRI. We also have over 10 years of experience in managing income-focussed strategies for retirees, charities, foundations and not-for-profit organisations.

We believe that by taking an Active Ownership approach, we can encourage greater transparency and gain further insight into the company's governance and their management of key ESG factors. We are very strong believers that Active Ownership should be undertaken directly by those making investment decisions rather than being outsourced. Responsibility lies directly with our experienced team of research analysts and portfolio managers.

Our experienced investment team identifies attractive income opportunities using a disciplined and repeatable investment approach based on proprietary research into **Valuation**, **Quality**, **Direction** and **Sustainable Dividend** lenses.

Our proprietary **Sustainability**  ratings, which include considerations of modern slavery and human rights risks, contribution to the UN Sustainable Development Goals and other relevant factors, are also a key component of our **Quality** assessments. We also undertake a proprietary **Shadow Carbon Cost** assessment to understand the sensitivity of stocks and portfolios to climate transition risk.

Portfolio construction for the MCA Sustainable Income strategy combines:

- our unique **Valuation**, **Quality**, **Direction** and **Sustainable Dividend** multi-lensed proprietary research,
- a tilt towards companies that have more favourable proprietary **Sustainability**  assessments;
- proprietary **Shadow Carbon Cost** assessments;
- negative screens based on client-specific ethical values; and
- bottom-up methodologies to maximise a **Sufficient Income for Life**.

This has resulted in a benchmark-unaware Australian equity portfolio that is constructed in a very different way to traditional equities, Sustainability-focused strategies and other income-focused approaches. We have also specifically designed the strategy to aim to extract the full benefit of franking credits and maximise after tax income for 0% tax payers.

**We believe that there are few peer strategies available in the market that address both income and the assessment of sustainability attributes in the way that the MCA Sustainable Income strategy can.**



### “A sufficient income for life”

- An **income stream** to support annual expenses
- **Income growth** for inflation protection
- **Capital growth** to manage longevity risk
- **Diversified growth** exposures (across a full asset allocation) to reduce income sequencing risk

## Proprietary multi-lensed investment process

The MCA Sustainable Income investment process starts with bottom-up fundamental research by our specialised industry analysts. The importance we place on proprietary research into long-term normalised earnings power, cashflow sustainability, business quality and risk, is reflected in the size, quality and experience of our investment team. Our analysts' independent insights are captured in a consistent manner via MCA's proprietary research lenses. This creates a common language for expressing our views on the risks and opportunities across the investment universe.



### Valuation

Fundamental insights into normalised earnings and risk to determine fair value



### Direction

- **Short-term Direction:**
  - Price momentum measures
  - Earnings revision measures
- **Long term Direction**
  - Capital deployment
  - ESG momentum
  - Profitability
  - MCA Growth



### Quality

Fundamental insights into:

- business strength
- management and governance quality
- **Sustainability** 

Quantitative risk rating based on:

- The MCA Analyst **Quality**
- Leverage
- Predicted beta
- Profitability



### Sustainable Dividend

Fundamental estimate of a company's ability to maintain payments to shareholders through different stages of the cash flow cycle

Our analysts and portfolio managers are also supported by the MCA research platform through access to:

- a deep 'Active Ownership toolkit', that includes ESG-specific tools that the team uses to uncover material ESG risks and opportunities within their bottom-up fundamental research;
- big picture analysis to identify changing economic and market conditions that drive factor performance;
- a peer review process that builds collaboration and consistency;
- investment process R&D into new or refined alpha and risk signals; and
- proprietary real-time cloud based analytics.

## Consideration of ESG factors in the investment process

ESG research is integrated deeply into MCA's multi-lensed research process and also our portfolio construction.

Our experience has demonstrated to us that ESG analysis, engagement and voting should be done by those making investment decisions rather than being outsourced as they are best positioned to develop an informed view of the ESG risks, opportunities and impacts that companies face or create. Therefore, this responsibility lies directly with our experienced team of research analysts and portfolio managers.

Drawing from our extensive experience, we've come to understand that engagement is an ongoing, iterative process that demands both patience and a persistent effort yielding results that unfolds over time. Our investment team's long-term experience with management engagements bolsters our ability to effectively affect company level changes. We have cultivated strong relationships and established open dialogues giving us the opportunity to express any areas of concern and encourage greater transparency on their management of these risks.



### Using engagement to influence companies to make positive change


Engagement is an important source of fundamental information that helps us improve our understanding and conviction in investee companies and their governance structures. It enables us to understand to what extent companies have identified material ESG risks and how they are managing these and also provides us with an opportunity to share best practice and improve corporate practice. Our practice is to engage not only with the management of companies, but also with a range of other stakeholders for each business such as competitors, customers, suppliers and government agencies.



### Promoting stewardship through proxy voting

Proxy voting at AGMs is a core element of our approach to active ownership. We believe it is our job as fiduciaries to make a stand where we see an issue as critical to a stock's performance in the long term. Annual General Meeting (AGM) season (typically October to December in Australia) is a critical time for us as investors to re-emphasise our stance regarding a board's progress on ESG matters and we engage with companies on contentious proposals.

By incorporating material and relevant ESG factors that we have uncovered through our bottom-up fundamental research, engagement and proxy voting activities directly into the **Quality** and **Valuation** lenses, the investment process specifically reflects how ESG factors can increase or reduce the risk of companies delivering the normalised earnings, cashflows that our analysts forecast.


- Where material to a company's ability to generate long-term returns, we factor the cost/benefits of ESG inaction or action directly into our **Valuation**.
- The materiality of ESG risk factors is reflected in our Management, Governance and **Sustainability**  ratings, which feed into our overall assessment of **Quality**. **Quality** is also used as a component in the stock-specific discount rates used in our **Valuation** model.

As a result, the combination of **Quality** and **Valuation** adjustments can tilt our assessment of fair value on these stocks, and ESG factors can directly impact the size of an individual security position in a portfolio, or our decision to invest in, or divest from these stocks.

For further information on our embedded ESG process, please refer to our Active Ownership brochure on our [website](#).



# Focus on sustainability for higher conviction

**Sustainability**  is a key component of our **Quality** research lens. We outline the key components of each of our proprietary Sustainability insights below, which are complemented with external quantitative data sources to provide a holistic view of sustainability.



## Sustainability

**Sustainability risk:**  
Assessment of common Sustainability risk factors faced by a company and its industry

**Net Sustainability Benefit:**  
Assessment of a company’s overall impact on society

**Sustainability Pathway:**  
Assessment of the level of company management understanding and integration of current Sustainability issues



## MCA's fundamental assessment

- Common sustainability risk factors and their mitigation
- Material issue identification

- Net benefits and harms to society
- Governance Assessment
- UN SDG target contribution



## External quantitative data

- MSCI E&S
- Ownership Matters Governance
- MSCI Controversies
- Change in MSCI E&S
- Change in Ownership Matters Governance



## Capturing the impact of carbon

We have also developed a proprietary **Carbon Value at Risk (VaR) tool** to assess the sensitivity of each stock and the portfolio to climate transition risk.

Our tool looks at how a company's valuation could be impacted by applying a **Shadow Carbon Cost**, and this helps us to identify stocks that will either benefit or have a minimal impact on their earnings from the energy transition.

We base our assessments on a carbon cost assumption of A\$80. The rationale is that this price is where there would be an economic incentive for energy companies to switch from coal to gas, and it is also similar to the European carbon price (i.e., the most liquid market).

Importantly, our analysis takes Scope 1, 2 and 3 carbon emissions into consideration. Scope 1 and 2 emissions can be mitigated by investment in new technologies to replace and reduce existing assets that contain high carbon emissions, but it is Scope 3 emissions, which capture downstream value-chain activities, which we believe better reflect a company's strategic risk with regards to carbon. Our model supports the purchase of carbon offsets to reduce the net emissions where when no viable alternatives exist.



### Shadow carbon cost assessment

- Based on Scope 1, 2 and 3 carbon emissions
- Carbon cost of A\$80/t CO<sub>2</sub>-e
- Evaluation of transition path towards a low carbon world
- Ability of a company to pass carbon costs through to customers

## Negative ethical screens

We actively screen out companies that do not meet the strategy's ethical investment criteria to ensure the portfolio does not invest in securities with excluded business activities. Should an investment cease to be consistent with these screens, we would divest as soon as reasonably practicable and in the best interests of investors.

The criteria for determining our ethical screens has been drawn from working with third-party vendors, charities and foundations on their investment requirements. The criteria for the screens are expected to be static in nature; however, they can be adjusted over time to fit with market norms and market demand, and also client specific requirements.

The screens consist of the following criteria:

- Companies with revenues related to any one of the following activities that represent more than 5% of the company's total revenue, or revenues from a combination of any of the following activities that represent more than 10% of the company's total revenue:
  - Alcohol
  - Adult entertainment
  - Tobacco
  - Fur
  - Gambling
  - Genetically modified crops
  - Nuclear power
- Companies with revenues related to any one of the following activities that represent more than 5% of the company's total revenue, or revenues from a combination of any of the following activities that represent more than 10% of the company's total revenue:
  - mining, extraction, refinement, transportation, distribution, and power generation
    - from thermal coal
    - from conventional & unconventional oil and gas
- Companies directly involved in:
  - the production of controversial weapons
  - the manufacture of tobacco products
- Companies that do not meet MCA's assessment of Modern Slavery (including child labour)
- Companies that, in the opinion of Martin Currie Australia are not operating in accordance with widely accepted international norms and principles, including the:
  - Universal Declaration of Human Rights
  - International Labour Organisation (ILO) Declaration on Fundamental Principles and Rights at Work
  - United Nations Global Compact
  - United Nations policy on trafficking in humans
  - the OECD Guidelines for Multinational Enterprises

Due to our emphasis on [Sustainability](#), [Quality](#) and [Sustainable Dividends](#), very few stocks in our investment universe that pass the grade for our traditional Equity Income portfolios are excluded by the Ethical and ESG Impact screens. This reflects our belief that our 'sufficient income for life' focus is already complementary to the income needs of an sustainability-focussed investor.





## Portfolio construction strategies to maximise a 'sufficient income for life'

In line with our belief that not all equities are created equally, we set out to build our Sustainable Income portfolios from the bottom up, and employ unique benchmark-unaware methodologies which seek to maximise a 'sufficient income for life' for our clients. This results in a portfolio that looks very different to both traditional equities and other income-focused approaches.

We outline some of the key characteristics below.



### 1. Resilient dividends

When a company pays a very high dividend that cannot be sustained, and then ends up cutting it, it can create an income shock to the dollar income level of the portfolio as a whole. And if sold out automatically after the yield fell, it can also result in an impaired capital value despite maintaining a steady headline yield.

In portfolio construction we place great importance on a stock's **Sustainable Dividend**, rather than a current or consensus dividend.

As part of their fundamental research, our team of analysts assesses each company's dividend paying power by analysing free cash flow generation through different stages of the economic cycle and explicitly modelling a two-year bear case scenario, i.e., can a dividend be paid in 8 out of the next 10 years, rather than the 'worst case' dividend, because that is always going to simply be zero for every company. The advantage of our 8/10 approach is it allows us to consider a significant downside scenario for each company and what level of dividend they can pay in a crisis.

Our downside scenario analysis also includes higher interest rates and inflation; our process therefore has a strong preference for owning stocks that can deliver on our income growth objectives even in a rising interest rate environment.


By investing in stocks with the most attractive **Sustainable Dividends**, the dividend component of a stock's total return is more stable, thus providing lower income volatility and more certainty in the dollar income amount no matter what the capital gains or losses may be for a stock.





## 2. A focus on Quality

High Quality companies tend to generate high free cash flows, which in turn generate attractive **Sustainable Dividends** as discussed above. Payout ratios alone are not a good indicator of sustainability, and our analysts fundamentally assess the free cash flow generation of companies through different stages of the economic cycle and look through any financial engineering that may artificially boost headline or near-term dividends.

As part of their stock research, our analysts assess each company's **Quality**. We deeply understand that ESG factors can lead to an increased or reduced risk of companies delivering the normalised earnings that our analysts have forecast. These factors are reflected by the way **Sustainability**  is an important part of our overall assessment of **Quality**.

We use a 1-5 scale, with lowest quality 5 rated stocks excluded completely from the investable universe. We have found that screening out stocks with lower quality and skewing towards higher quality stocks results in a portfolio that has naturally less volatile income than the market, i.e., less income shocks when a dividend that cannot be sustained ends up being cut.



## 3. Maximising franking credits

While it is often said there is no free lunch in finance, franking credits for Australian retirees could be considered a free lunch as the market values franking at a tax rate above the retirees 0% rate.

We recognise the value of franking credits within our investment process. As such, we seek to maximise the after-tax income for 0% taxpayers by actively selecting companies that both have a high rate of franking, and pay sustainable dividends.

The MCA investment process formally values franking credits and penalises unfranked dividends in the **Valuation** process, and therefore franking is a driver of every investment decision. We also avoid wash sales to protect franking credits and our pre-trade compliance flags any security that we are about to sell within 45 days of purchase, so that we can avoid loss of franking credits under the 45-day rule.

Global equities, on the other hand, incur withholding taxes, and thus miss out on the franking credit free lunch.

This differentiated source of return is also important because it allows more of the returns to come from a more stable income source than uncertain capital growth.





#### 4. Avoiding over concentration

When you look at portfolio construction through an income lens, minimising the concentration risk within equity benchmarks (especially within the ASX) is more important than benchmark-relative alpha and tracking error measures.

We use a non-benchmark portfolio construction approach to limit security and sector concentration risk, and we believe this helps to ensure a more stable income stream and avoid income shocks in any one stock.

We promote diversification by focusing on a low absolute concentration of security and sector weights. We limit individual securities to a maximum 6% of the portfolio, meaning the portfolio's total yield is not dominated by any one security. We also limit the portfolio to a maximum of 25% in any one economic sector. These limits mean that the portfolio is structurally underweight the Top-20 ASX stocks, one of the most concentrated markets in the world. From a sector view, the index is dominated by banks and metals & mining sectors, which are typically volatile dividends.

Due to the concentrated nature of the Australian market, typically Australian benchmarks are not actually a very good mirror of the effect that Australian inflation has on long-term income requirements. Therefore, we have structured our portfolios to have better diversification across the domestic economy, in sectors such as consumer, financials and real assets, and this means that they have income growth more correlated to income needs.



#### 5. Avoiding capital impairments

Finally, we believe that an important way to improve or maintain capital growth is to not do anything unnecessary that could impair capital.

- Strategies that use derivatives to provide income enhancements or capital protection are in fact potentially detrimental to capital growth, and thus income growth, as the cost is borne from capital.
- Strategies that automatically sell stocks because of an income shock, such as rules based high yield ETFs, can result in an impaired capital value despite maintaining a steady headline yield.
- High turnover strategies also are more likely to impair capital due to excessive trading as they are turning capital to income by constantly moving to the next dividend paying stock.

Our income strategies do not use derivatives, are fully active, and are designed to be low turnover. We also seek a significant spread between the **Valuation** and **Sustainable Dividend** signal of securities we are trading to provide a buffer to ensure that trading is necessary.



## A balanced portfolio with sustainability-adjusted expected income returns

Our proprietary **Valuation**, **Quality**, **Direction** and **Sustainable Dividend** research outputs are combined with our proprietary **Sustainability**  assessments and **Shadow Carbon Cost** to help quantify our sustainability-adjusted expected income returns.

The portfolio construction process facilitates tilting of the portfolio towards companies with good Sustainability characteristics and low shadow carbon costs while maximising expected returns. Stocks with unsustainable business practice, poor quality, high risk of sustainability issues, or poor future sustainability outcomes, are penalised through this process.

In deriving and quantifying the sustainability-adjusted expected income expected return, fundamental proprietary signals make up a larger portion of the weight. Portfolio construction is fundamentally thus driven. Target bet guide sizes for the portfolio are risk adjusted based on the sustainability-adjusted expected income return forecast, market cap, liquidity and a blended risk measure.

Final stock selection is augmented by Portfolio Manager judgment, and takes into consideration the impact of any changes on the portfolio's style skyline and risk characteristics. This ensures the portfolio has a low carbon footprint and attractive sustainability and financial attributes relative to the market.

## The MCA investment team

The MCA Sustainable Income strategy is managed by Reece Birtles, Chief Investment Officer & Portfolio Manager, and Will Baylis, Portfolio Manager. Reece Birtles has ultimate management responsibility for the Ethical Income strategy.



**Reece Birtles**  
Chief Investment Officer  
& Portfolio Manager



**Will Baylis**  
Portfolio Manager

The Sustainable Income investment process draws on a wide range of proprietary fundamental and quantitative research metrics, and the strategy benefits from the close collaboration of the well-resourced and experienced MCA investment team.



### Deep industry expertise generating best ideas

- MCA team of 17 led by Chief Investment Officer Reece Birtles
- Average tenure of 14 years, average industry experience of 22 years - across a variety of industry backgrounds<sup>1</sup>
- Additional insights from broader Martin Currie global investment floor



### A learning culture and growth mindset

- Investment expertise and rigour gained through peer review
- Key focus on continuous development and improvement
- Team culture, built on coaching and mentoring



### Highest standard of professional conduct

- Living the values of investing to improve lives through the responsible management of our own business



### Passion for investment excellence and focus on risk management

- Consistent investment philosophy and process applied to an extensive range of investment products
- Tailored investment options aligned to client needs
- Sophisticated, interactive risk analysis
- Robust risk culture

<sup>1</sup>As of 31 December 2023.

## Key facts

Launch date	8 December 2015
Performance objective	The strategy aims to provide an after-tax yield above the S&P/ASX 200 Index yield and to provide an income stream growth above inflation
Benchmark	No formal benchmark
Investable universe	Australian listed securities / all-cap / companies that pass the ethical criteria
Number of securities	Typically 40
Security limits	Absolute 6%
Sector limits	Absolute 25%
Exclusions	See page 7
Portfolio turnover	Typically 25% p.a.
Tracking error	We do not target tracking error, but total risk outcome is typically 90% of the market
How to access	Segregated mandate Martin Currie Sustainable Income Fund (An Australian Unit Trust)

The characteristics shown are guidelines only and are not hard risks limits.

## Industry recognition

Signatory of:



Since 2009

### Latest PRI Rating<sup>1</sup>



Policy governance  
and strategy



Confidence  
building measures



Direct – Listed equity  
– Active fundamental

**Top quartile**

Ranking vs peers  
across all three pillars<sup>2</sup>



Holder of highest Morningstar  
Sustainability Rating<sup>TM3</sup>

<sup>1</sup>Source: Martin Currie and PRI 2022. Ratings relate to the period 1 January 2022 – 31 December 2022.

Martin Currie has been awarded the highest possible rating from the Principles of Responsible Investment (PRI), with a five-star rating across all categories relevant to its investment activities. A copy of the PRI's assessment and transparency report are available on our [website](#).

<sup>2</sup>Policy governance and strategy: 95%; Direct – Listed equity – Active fundamental: 100%; Confidence building measures: 100%

<sup>3</sup>Sustainability Score and Sustainability Rating as of 30 November 2023. Data shown for the Martin Currie Ethical Values with Income Fund. Sustainalytics provides company-level analysis used in the calculation of Morningstar's Sustainability Score. Based on 99% of AUM. Data is based on long positions only.

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# About Martin Currie Australia



A leading innovator of **Australian Equity, Real Asset and Multi-Asset strategies**



Specialist investment manager  
of **Franklin Resources Inc.**



40+ years in  
**Australian equities**



World class  
**ESG credentials\***



**Tailored investment options**  
aligned to client needs



17 member team of  
**specialist investment analysts**



A\$6 billion in  
**Australian equities**

Source: Martin Currie, as at 31 December 2023.

\*For further information on our market leading ESG credentials please refer to full details on our website:  
[www.martincurrie.com/our-story/our-stewardship-approach](http://www.martincurrie.com/our-story/our-stewardship-approach)



## Important information

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### **Past performance is not a guide to future returns.**

The distribution of specific products is restricted in certain jurisdictions, investors should be aware of these restrictions before requesting further specific information.

The views expressed are opinions of the portfolio managers as of the date of this document and are subject to change based on market and other conditions and may differ from other portfolio managers or of the firm as a whole. These opinions are not intended to be a forecast of future events, research, a guarantee of future results or investment advice.

The analysis of Environmental, Social and Governance (ESG) factors forms an important part of the investment process and helps inform investment decisions. The strategy/ies do not necessarily target particular sustainability outcomes.

### **Risk warnings – Investors should also be aware of the following risk factors which may be applicable to the strategy shown in this document.**

- Investing in foreign markets introduces a risk where adverse movements in currency exchange rates could result in a decrease in the value of your investment.
- This strategy may hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the strategy's value than if it held a larger number of investments.
- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.
- Income strategy charges are deducted from capital. Because of this, the level of income may be higher but the growth potential of the capital value of the investment may be reduced.

### **For wholesale investors in Australia:**

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