Mercer

Our investment approach to climate change

Task Force on Climate-related Financial Disclosures 2022 Status Report

Mercer Investment Solutions Europe
April 2023

welcome to brighter

Contents

About this report

This report sets out in detail how Mercer Investment Solutions Europe intends to fulfil the climate-related commitments made in the publicly available **Sustainability Policy** and manage climate-related financial risks and opportunities for the Mercer Funds, our suite of managed investment schemes.

Mercer's approach and disclosure, outlined in the following pages, is consistent with the framework recommended by the Financial Stability Board's Task Force on Climate-related Financial Disclosures (the TCFD), which has become the industry standard globally. Disclosure consistent with the TCFD recommendations is encouraged for appointed investment managers.

Please note that climate reporting in relation to Mercer's operations is captured within Marsh McLennan, Mercer's parent entity, reporting globally, and includes, for example, annual carbon emissions reporting to the Carbon Disclosure Project.

Introduction

About Mercer Investment Solutions Europe (ISE)

Mercer Investment Solutions Europe (Mercer ISE[1]) is a leading provider of investment solutions, offering customised guidance on investment decisions, risk management and investment monitoring services to a broad range of institutional investors, including pension funds, insurance companies, endowments, foundations and other investors.

Mercer ISE does not invest in securities directly; it appoints and combines highly rated specialist sub-investment managers into funds (both multi-client and bespoke) and those funds into portfolios for certain clients. We provide a range of funds across equities, fixed income, passive solutions, alternatives and private markets.[2]

Our purpose is to support clients in setting, implementing and monitoring their investment strategies through our investment solutions to meet their goals and fiduciary responsibilities. Management of climate risks and opportunities plays a key role in this regard.

The TCFD framework

Mercer's approach and disclosure, outlined in the following pages, is consistent with the framework recommended by the TCFD.[3]

The TCFD recommendations are categorised into four key areas: governance, strategy, risk management, and metrics and targets.

Figure 1. TCFD framework

Governance
The organisation's governance around climate-related risks and opportunities

Strategy
The actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning

Risk management
The processes used by the organisation to identify, assess and manage climate-related risks

Metrics and targets
The metrics and targets used to assess and manage relevant climate-related risks and opportunities

Message from the CIO

Consideration of the impacts of climate change has been central to Mercer's global investment beliefs since 2014. Mercer believes climate change poses a systemic risk, with financial impacts driven by two key sources of change:

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

Each of these changes presents both risks and opportunities to investors. Mercer therefore considers the potential financial impacts at a diversified portfolio level, in portfolio construction within asset classes, and in investment manager selection and monitoring processes.

Mercer ISE has recognised climate change as a systemic risk in its Sustainability Policy since 2015. Since 2017, the Sustainability Policy has stated that "limiting global average temperature increases this century to 'well below 2°C', as per the 2015 Paris Agreement, is aligned with the best economic outcome for long-term diversified investors and that Mercer will seek to increasingly align portfolios with that objective where this is also consistent with meeting stated investment objectives".

In early 2021, Mercer announced its aim to achieve net-zero absolute portfolio carbon emissions by 2050 for UK, European and Asian clients with discretionary portfolios and for the majority of its multi-client, multi-asset funds domiciled in Ireland. To achieve this, Mercer set a 2030 target to reduce portfolio carbon emissions by 45% from 2019 baseline levels. We are pleased to share that we are on track to meet this target and look forward to making further progress via active stewardship efforts and, where necessary, adjusting strategic asset allocation.

Mercer's climate transition framework and regularly updated Analytics for Climate Transition (ACT) tool, the Ortec Finance ClimateMAPS research (updated every six months), Mercer's 2015 and 2019 *Investing in a Time of Climate Change* reports,[4] and our 2011 research on climate change and its implications for strategic asset allocation have all helped inform our decisions to date.

Mercer ISE continues to evolve its thinking and incorporation of climate-related risks and opportunities within its investment decision-making processes and across its portfolios. Over 2022, monitoring and portfolio considerations also benefited from:

- New climate **scenario analysis modelling**, with Mercer now collaborating with Ortec to deliver updated scenarios every six months while drawing on the same foundational models applied in 2019
- Enhancing the sustainability characteristics of a substantial portion of funds and solutions to further promote environmental characteristics in line with the Sustainable Finance Disclosure Regulations (SFDR)
- Actively monitoring and engaging with appointed managers on how climate considerations are incorporated into the investment process and across their engagement and voting activities with underlying companies and other relevant stakeholders
- New analysis exploring physical damages for listed assets, which is helping with risk prioritisation and identifying potential mitigation steps

We recognise that it is early in our decarbonisation journey as we aim to meet our 2030 targets while navigating short-term transition risk volatility, particularly in the current market environment. However, we are also mindful that carbon budget timelines are fast approaching. Applying multiple approaches across our well-diversified portfolios should support our commitments over different timeframes, but for true success, all players in the economic ecosystem will need to play their parts, and collaboration will only become more critical.

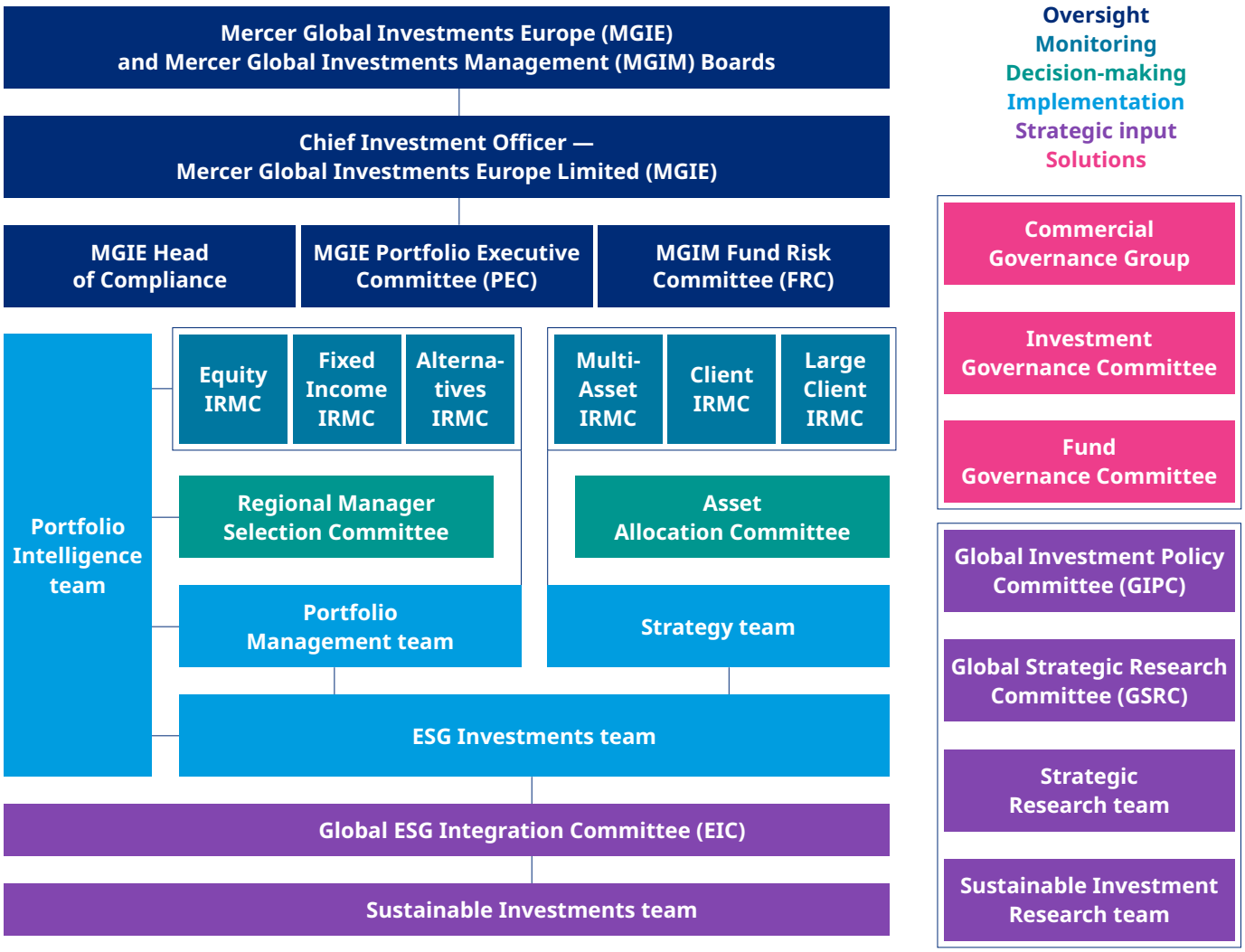
We trust that this report provides our investors and stakeholders with confidence that Mercer continues to thoughtfully incorporate climate-related financial risk and opportunity considerations into our investment processes and decision-making. We look forward to working together throughout 2023 to continue to chart the course.

David O'Sullivan
Chief Investment Officer
for Mercer Global investments Europe Ltd.

Governance

Mercer ISE has established a robust governance structure with responsibilities allocated at board and management levels with inputs and oversight by global team members and integration responsibilities across the business. Mercer has demonstrated experience in integrating sustainability considerations into investing practices and works rigorously to ensure Mercer ISE is delivering on its climate-related policies and commitments while meeting client investment objectives. By establishing good practices within our own business, we also encourage our appointed sub-investment managers to do the same.

Figure 2. Climate change governance structure



Boards

The Mercer ISE Boards — Mercer Global Investments Europe (MGIE) and Mercer Global Investment Management (MGIM) Boards, or "the Boards" — are responsible for ensuring effective governance of climate-related and broader sustainability risks and opportunities across the investment management process as highlighted in Mercer ISE's Sustainability Policy. More specifically, this includes overseeing the multi-client, multi-asset funds and discretionary client portfolios for which Mercer is targeting net-zero by 2050.

The Boards oversee Mercer ISE's approach by reviewing, at least annually, reporting from management, which is responsible for overseeing the integration of climate-related and broader sustainability risks and opportunities into the investment management process. Board members continue to develop their knowledge on climate-related risks and opportunities and how these may influence decisions concerning risk management, strategy setting, implementation and monitoring. These reviews include reporting that covers Mercer ISE's climate scenario analysis results, progress towards its climate targets, and climate-transition risk-assessment results using multiple climate metrics, such as carbon emissions, transition capacity and exposure to green revenues. Please see more within the Metrics and Targets section.

Management

Mercer Global Investments Europe Ltd Chief Investment Officer David O'Sullivan is responsible for ensuring climate-related risks and opportunities are appropriately incorporated into the investment management process for the Dublin-domiciled Mercer Funds. This is executed by setting clear expectations of, and providing clear direction to, those responsible for implementing climate-related considerations across the investment process.

The ESG Investments team works closely with Mercer's Sustainable Investment team in defining its approach to broader sustainability and climate-related risks and opportunities by translating Mercer's thought leadership and best practice into clear policies and processes for implementation into portfolios by various teams across the business. Mercer's dedicated Sustainable Investment team provides thought leadership and guidance to the ESG Investments team and the CIO on best practice around climate-related risks and opportunities.

These policies and processes, and their application across portfolios, are captured in Mercer ISE's Sustainability Policy, which is approved by the CIO and the Boards.

The ESG Investments team works closely with the various Portfolio Management, Strategy and Portfolio Intelligence teams on the ongoing management and implementation of climate-related risks and opportunities. The Portfolio Management team takes responsibility for ensuring climate and broader sustainability considerations are incorporated into Mercer's investment management strategies, while the Asset Allocation Committee ensures strategic and dynamic asset allocation decisions take climate-related risks and opportunities into account. The Strategy team is responsible for implementing those decisions. This team's mandate is to ensure climate and broader sustainability considerations are incorporated into the portfolio construction process of multi-asset funds and multi-asset portfolios. The building blocks are predominantly Mercer Funds, although third-party funds are used in some cases. The Portfolio Intelligence team supports each of these teams and decision-making committees with data and analytics related to climate factors.

The Portfolio Executive Committee (PEC), chaired by the CIO of MGIE, consists of senior members from the Portfolio Management and ESG Investments teams. The PEC oversees Mercer ISE's key regulatory responsibilities, including ratifying the Sustainability Policy.

The various MGIE Investment Risk Management Committees (IRMCs) and the MGIM's Fund Risk Committee provide quarterly monitoring of the relevant climate-related risk metrics. This includes tracking progress towards our net-zero commitment as well as other climate-related metrics aligned with sustainability characteristics we've committed to promoting and monitoring under the SFDR.

Global team of specialists

David has the support of the Regional CIO, Garvan McCarthy, and Global CIO, Hooman Kaveh, who ensure that climate-related considerations are captured and monitored for developments within investment decisions in regional and global CIO and governance committee meetings.

The Global ESG Integration Committee (EIC), formed in 2018, meets quarterly to coordinate Mercer Investment Solutions' global approach to investing more sustainably. The EIC oversees and coordinates the approach to integrating climate-related risks and opportunities within the regional Investment Solutions practices and ensures Mercer's best thinking on climate risks and opportunities is integrated into sustainability policies and practices, aiming for global consistency where possible. The Global EIC includes representatives from Mercer's Investment Solutions and Sustainable Investment teams in the Pacific, Europe and North America.

The Sustainable Investment team works closely with the various research groups. These groups provide strategic input through thought leadership and guidance on integrating climate-related risks and opportunities across asset classes as well as insights on sustainability-themed strategies (including climate, biodiversity and natural capital). The Global CIO group is also informed by Mercer's investment governance structure and research committees charged with reviewing and setting guidance on Mercer's intellectual capital development.

Mercer ISE colleagues

Mercer ISE provides ongoing employee training on sustainability-related risks and opportunities, including those related to climate. The ESG Investment team, working closely with the Sustainable Investment team, regularly provides training to the business on a variety of sustainability-related topics. The Sustainable Investment team also includes semi-annual updates on "current topics" for clients. Throughout 2023, Mercer's wider business streams will also be receiving additional ESG training, including training on climate-related topics, from a broader perspective.

Along with providing ongoing training, Mercer believes in encouraging a culture that promotes the consideration of sustainability factors across its broader business activities. Mercer ISE has adopted a remuneration policy consistent with promoting greater recognition of sustainability, including climate risks, across Mercer ISE's activities. To achieve this, sustainability goals are included in Mercer ISE's employee goals and objectives. All employees of Mercer ISE are expected to support the business in undertaking its activities in a responsible manner through the inclusion of sustainability considerations in their roles and decision-making processes. In particular, employees involved in investment decision-making activities are expected to implement the key principles embedded in Mercer's Sustainability Policy.

Strategy

Mercer ISE acknowledges the wider social and economic risks posed by climate change, and its greatest impact on the Mercer Funds is through investment risk. Client outcomes rely on investment returns. These are directly related to the value of the underlying assets that are increasingly subject to climate-related risks and opportunities — at different times and to different extents. In line with our climate scenarios and net-zero commitments, Mercer ISE defines time horizons for climate risks as short (five years), medium (20 years) and long-term (40 years).

We have identified and assessed the risks and opportunities across different transition and physical risk scenarios for our funds over the short, medium and long term using both top-down (climate scenario analysis) and bottom-up (transition assessment tool and physical damages assessment) approaches. The climate scenario analysis is discussed in this section, and the bottom-up analysis is discussed in the Risk Management section.

Our approach to managing climate-related risks and opportunities in our investment portfolios is summarised in three pillars:

Climate change integration

- **Strategic asset allocation (SAA)**: Mercer ISE's multi-asset funds are well diversified across asset classes, sectors and geographies to manage risks, including climate-related risks. We evaluate model portfolios under various scenarios and assumptions to help make more informed SAA decisions and help clients set the best portfolio mixes for their long-term strategic goals and objectives. This is important for avoiding silo decisions and ensuring alignment at a total-portfolio level.
- **Asset classes**: Risk exposures are evaluated for relevance and prioritisation through a specific asset-class lens, including regional and sector exposures.

Climate change stewardship

- **Mercer ISE manager engagement framework**: A core part of our stewardship approach centres on engaging with our appointed managers.
  - **Voting**: Although proxy voting responsibility is outsourced to equity managers, the ESG Investment team carefully examines the voting activity annually to ensure alignment with our commitments on climate transition and long-term value creation.
  - **Quarterly manager meetings**: During the Investment team's regular quarterly meetings with appointed managers, any material ESG issues are identified, and our expectations are discussed on an ongoing basis.

Climate change solutions

- **Selection and monitoring process**: For appointed and candidate managers, we consider exposure to climate solutions as one part of the portfolio construction decision. We also use the Mercer Manager Research team's ESG Ratings (see the Appendix for our methodology) and associated analysis to evaluate manager capabilities and practices.
- **Sustainability in solutions**: Mercer ISE's current view is that climate change risks are applicable, to varying degrees, across all asset classes. Initial activity has focused on listed equities, active and passive, and sustainability-themed private markets investments; however, all asset classes are being reviewed.

Climate change integration	Climate change stewardship	Climate change solutions
• **Appointed managers**: At the appointed-manager level, Mercer ISE's expectation is that climate-related risk assessment and risk reduction are integrated into each strategy's approach to investment decision-making and stewardship activities. Mercer works closely with its appointed managers to improve their ESG and climate change integration practices where required. • **Net-zero target alignment**: Our commitment to transitioning our multi-client multi-asset funds and reach net zero by 2050 is embedded throughout our strategic decisions, from policy to processes and portfolio implementation.	– **Annual manager engagement survey**: This survey provides useful insights on material ESG issues, with a section dedicated to understanding how our managers are assessing and addressing climate risks and opportunities. – **Manager engagement dashboards and trackers**: With inputs from the annual survey, trackers are used to identify goal-oriented engagement priorities and monitor engagement activities and outcomes to identify where escalations may be required. • **Collaborative initiatives**: Currently, Mercer ISE and/or Mercer globally is a supporter/signatory to the following climate-related initiatives: Institutional Investors Group on Climate Change (IIGCC), Task Force on Climate-related Financial Disclosures (TCFD), Climate Action 100+ (CA100+), Task Force on Nature-related Financial Disclosures (TNFD), Carbon Disclosure Project (CDP), Transition Pathway Initiative (TPI).	• **Climate transition benchmarks**: Our Sustainable Global Equity Passive Fund uses a Paris-Aligned Benchmark. Currently, Mercer ISE is exploring the potential impacts of switching passive funds to climate-aware benchmarks. • **SFDR**: We have implemented binding characteristics that promote positive environmental and social outcomes for the majority of our multi-client mainstream asset class solutions, and we will be disclosing under Article 8 of the SFDR for these approximately 50 funds. These commitments include benchmark-relative WACI[5] reductions, exclusions related to fossil fuel and the highest carbon-emitting activities, and an enhanced UN Global Compact engagement and escalation framework.

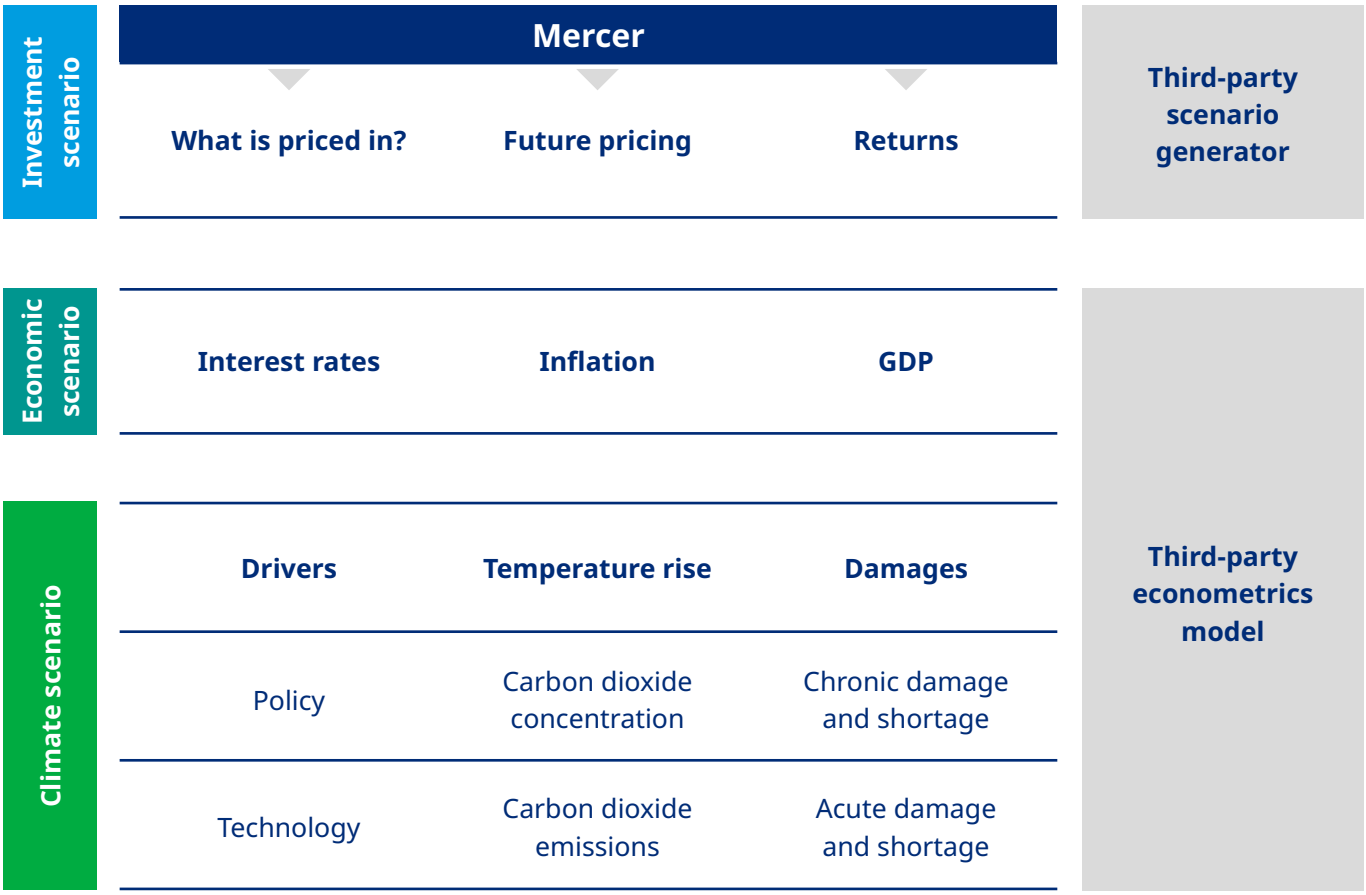
Mercer ISE is committed to investing more sustainably and prefers an integration- and engagement-based approach. We have recently implemented a number of climate-related exclusions across the majority of our multi-client equity and fixed-income solutions to reduce the funds' negative environmental impact and promote environmental characteristics to meet SFDR Article 8 disclosure requirements. For further details, please see relevant product disclosures on our dedicated sustainability website.

Climate scenario analysis: Potential impacts

Investors often use scenario analysis to support strategic asset allocation and portfolio construction decisions as it helps to test resilience under multiple potential future outcomes. Mercer's forward-looking climate change scenarios cover a range of policy assumptions, market responses and temperature outcomes.

Our climate change scenarios use the Cambridge Econometrics macro-econometric (non-equilibrium) model, delivered in partnership with Ortec Finance. Mercer ISE is aware of both the benefits and limitations of any modelling, and more detail is provided in the Appendix of this report. The key factors used in our model construction are summarised below:

Figure 3. Mercer's climate scenario construction model



Potential financial impacts are driven by two key sources of change: the physical damages expected to be caused by an increase in average global temperatures and the associated transition to a low-carbon economy. Figure 4 below demonstrates the potential risk factors associated with these key sources of change:

Figure 4. Risk factors

Transition

Technology	Opportunities from the low-carbon transition
Policy	Sudden asset repricing risk

Physical damages

Availability of natural resources (including biodiversity)	Sector performance divergence — energy, transport and agriculture most impacted
Chronic damage (including productivity)	Physical risks increasingly dominate over longer term
Acute damage (catastrophes)	

The climate change scenario analysis considers the transition and physical risks and the opportunities related to each scenario:

1. **Transition risks and opportunities**: This covers the potential financial and economic risks and opportunities from the transition to a low-carbon economy (that is, one that has a low or no reliance on fossil fuels) in areas such as technology and policy.

Risks include the possibility of sudden asset repricing events or increased costs associated with high-carbon activities and products. There are also opportunities that may come from the development of low-carbon technologies.

Transition to an economy with lower carbon emissions, and ultimately net-zero emissions, is already underway. This is evidenced by the disruption in major sectors, such as energy and utilities in the first instance, and increasingly in other sectors like transport and the built environment. These technology- and economy-driven changes are emerging in an iterative way, reflecting the growing global policy ambitions of governments, companies and investors. Such developments increase the likelihood of a lower warming scenario and the near-term risks and opportunities this scenario presents.

2. **Physical risks and opportunities**: The higher the level of future global temperature increases, the greater the physical risks will be in terms of frequency and magnitude. Physical risks cover:
   - Availability of natural resources (water, food, materials, biodiversity loss)
   - Chronic damage (longer-term shifts in climate patterns causing sea-level rises or heat waves)
   - Acute damage (major catastrophes from storms, wildfires, droughts and floods)

In shorter timeframes, transition risk tends to dominate, whereas, over longer timeframes, physical risk will be the key driver of climate impacts. The physical damages and losses are largely expected to emerge in the medium to longer term and require increasing prioritisation given emerging evidence for climate-related hazards developing sooner than anticipated in multiple regions. These present the greatest risk where the physical assets of a company are critical to their financial outcomes; for example, an office building, a network of factories or a timber plantation.[6] A key strength of our scenario modelling is that it allows for climate impacts to be "priced in" before they happen. This reflects likely market dynamics and means climate impacts are more likely to fit within investment timeframes.

Mercer focuses on the following three core scenarios:

- **A rapid transition**: Average temperature increase of 1.5°C by 2100. Sudden divestments across multiple securities in 2025 to align portfolios to the Paris Agreement goals that have disruptive effects on financial markets, with sudden repricing followed by stranded assets and a sentiment shock. Following this shock, there is a partial recovery.
- **An orderly transition**: Average temperature increase of less than 2.0°C by 2100. Political and social organisations act quickly and predictably to implement the recommendations of the Paris Agreement to limit global warming to well below 2°C. Transition impacts occur but are relatively muted across the broad market.
- **A failed transition**: Average temperature increase above 4°C by 2100. The world fails to coordinate a transition to a low-carbon economy, and global warming exceeds pre-industrial levels by 4°C by 2100. Physical climate impacts cause large reductions in economic productivity and increasing impacts from extreme weather events. These are reflected in repricing events in the late 2020s and late 2030s.

Our scenarios are 40-year projections, representing the likely time horizons over which client portfolios will be invested to and through retirement. However, we have focused this analysis on short-, medium- and long-term timeframes of five, 20 and 40 years.

Summary of scenario analysis results for Mercer portfolios

We have undertaken climate change scenario analysis on the strategic asset allocation of Mercer ISE's key portfolios to assess the potential implications under the three scenarios outlined above. The analysis was conducted on the Model Growth Portfolio (primarily active funds) and the Mercer Multi Asset Growth Fund (primarily passive funds). The climate change scenario analysis is based on the strategic asset allocation of each portfolio as of 31 December 2021 and uses asset-class assumptions rather than being based on fund-holding data, as is the case with the reported metrics. Due to the long-term nature of the climate change scenario analysis, we assess the impact of climate change scenarios against our strategic asset allocation given the time horizons, as opposed to including the shorter-term dynamic asset allocation overlay.

Climate return impacts

Overall, lower warming scenarios, ideally achieved through an orderly transition, are in the best interest of the strategies. However, short-term transition risks are linked with the rapid (disorderly) transition associated with limiting warming to 1.5°C, largely due to policy drivers.

Outputs are shown in the table below for the additional climate impact on returns expected annually, relative to the baseline,[7] for the Model Growth Portfolio and the Mercer Multi Asset Growth Fund.

	Model Growth Portfolio Annualised additional expected return impact (% p.a.)	Mercer Multi Asset Growth Fund Annualised additional expected return impact (% p.a.)
Rapid transition		
Impact at five years	-1.3%	-1.6%
Impact at 20 years	-0.2%	-0.3%
Impact at 40 years	-0.1%	-0.1%
Orderly transition		
Impact at five years	-0.4%	-0.4%
Impact at 20 years	-0.1%	-0.1%
Impact at 40 years	-0.2%	-0.2%
Failed transition		
Impact at five years	0.3%	0.4%
Impact at 20 years	-1.0%	-1.0%
Impact at 40 years	-0.7%	-0.8%

Although the effects on returns are muted on an annualised basis, they are quite significant on a cumulative basis over the longer term, as shown in Figures 5 and 6 below. Note that asset values on the Y-axis are simply for illustrative purposes.

Figure 5. Model Growth Portfolio

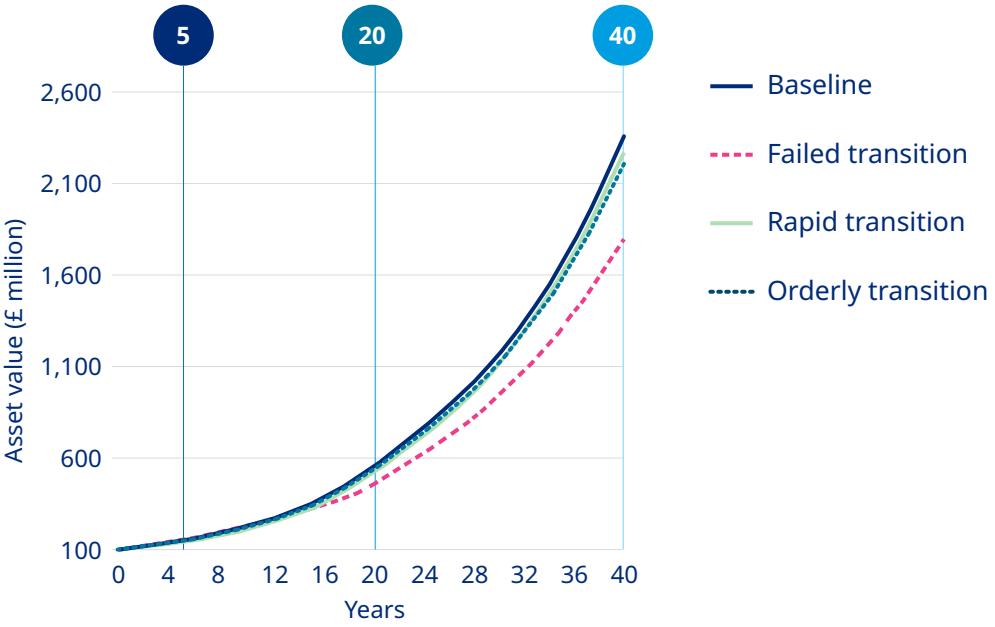
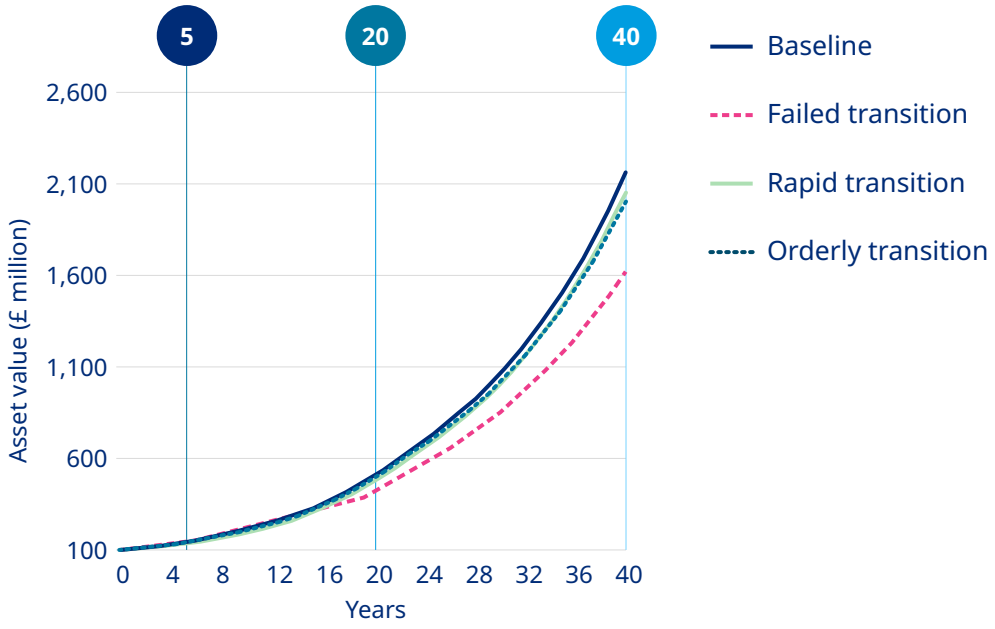


Figure 6. Mercer Multi Asset Growth Fund



Time horizon	Model Growth Portfolio	Mercer Multi Asset Growth Fund
Short term (five years)	Over the short term, transition risk dominates, and the market shock in the rapid transition causes a cumulative climate impact of -6% in the portfolio's value at year five (compared to the baseline). This is driven by the shock impacting the economy and investment markets, causing losses in equity and growth assets in particular. The timing of any shock or recovery is uncertain.	Similarly, transition risk dominates, and the market shock in the rapid transition causes a cumulative climate impact of -7% in the portfolio's value at year five (compared to the baseline). The Mercer Multi Asset Growth Fund is marginally more affected due to differences in asset allocation, such as a slightly higher allocation to infrastructure assets and a slightly lower allocation to sustainable assets. Regional differences also play a role as this fund has higher allocations to the US and emerging markets.
Medium term (20 years)	The impact of the shocks under the failed transition due to physical risks begins to become material. The failed and rapid transitions show a cumulative loss impact of -17% and -5%, respectively, over 20 years for the portfolio.	The failed and rapid transitions show a cumulative loss impact of -18% and -6%, respectively, over 20 years for the Fund.
Long term (40 years)	Over the long term, the failed transition, largely due to physical impacts, is the worst-case scenario, potentially reducing the cumulative value of the portfolio by 24%.	Over the long term, the failed transition, largely due to physical impacts, is the worst-case scenario, potentially reducing the cumulative value of the Fund by 25%.

For more detailed climate scenario analysis, please refer to the Technical Appendix.

The **key findings** from our analysis support four conclusions that Mercer ISE has already embedded in our approach to climate change:

- An orderly transition is imperative. Long-term investors should collectively try to bring about an orderly transition, limiting global warming to well below 2°C, aligned with their fiduciary duty to seek the best return within risk, liquidity and complexity constraints.
- Sector exposure is key. Climate exposure varies greatly by sector. Portfolios with exposures to the coal, fossil fuel, and oil and gas sectors do not perform well in the orderly and rapid-transition scenarios. Low-carbon electricity and renewables are the two sectors likely to outperform under rapid and orderly transitions. Mercer ISE is already evaluating exposure to these sectors on a regular basis. We continue to engage with our investment managers to limit exposure in SFDR Article 8 strategies to the thermal coal and oil and gas sectors and focus on investee companies with the most credible transition plans.
- Regional analysis is important to understand physical risks over the long term. Under the failed-transition scenario, China, Japan and emerging markets are the most exposed to physical risks, whereas Canada is the least exposed. Mercer ISE continues to monitor regional concentration risk in the portfolios from a transition and physical risk perspective.
- Beware of future pricing shocks. Longer-term impacts, including transition and physical risks, could impact portfolios before they occur. For example, allocations to emerging markets and developed Asia are materially exposed to physical risks under a failed-transition scenario over the medium to longer term. Although the exact timing of these shocks is unknown, consideration is important to risk analysis. Thus, Mercer ISE is integrating climate data into periodic portfolio analysis and introducing more climate-resilient options into portfolios in an effort to plan ahead for potential shocks.

Scenario analysis remains an important reminder that isolating a preferred scenario does not mean it will definitely eventuate. Complex system changes lie ahead that are a challenge to model accurately because we expect they are unlikely to be linear or neat. We also appreciate that investors have a role to play but do not have complete control over government policies or company decisions.

Risk management

The process for identifying and assessing climate risks includes "top down" and "bottom up" approaches, as explained earlier. The top-down climate scenario analysis outlined in the Strategy section is the foundational framework used to assess the size and scope of potential climate-related return impacts and prioritise asset classes and industry sectors to minimise risks and maximise new opportunities. This is complemented by the bottom-up company- and asset-level analysis — to date, primarily focused on transition risks but increasingly recognising the need to include physical damages for risk management purposes. We discuss this analysis further below.

Both the top-down and bottom-up approaches capture all asset classes except for derivatives, although we are mindful of emerging industry developments in this space.

Legal and Compliance representatives, together with the Sustainable Investment team, also keep up to date on regulatory and industry developments in relation to climate change.

Climate transition assessment

To help achieve alignment with the Paris Agreement targets on our multi-client, multi-asset portfolios, Mercer measures portfolio-level climate metrics, has set net-zero-aligned targets to reduce carbon emissions and has created a transition plan setting out how these reductions can be achieved. Our approach supports the following key principles[8]:

- Transition plans should focus on actions that reduce real-world carbon emissions; that is, decarbonisation. This is best achieved as active owners, focusing on company-level decarbonisation targets, the actions of appointed fund managers and the policy environment within which we are investing.
- Portfolio decarbonisation via exclusions/tilting/optimising based solely on historical emissions, and not transition capacity, is unlikely to directly impact real-world emissions and, therefore, is not our preferred approach. Strategy-level stewardship and ESG integration will likely result in underweighting or selling, but when led by asset managers in ways specific to each strategy, it has a greater likelihood of leading to a more desirable outcome than investor-led exclusion or divestment rules.

Mercer ISE's decision to target net-zero absolute portfolio carbon emissions by 2050[9] is supported by insights gained from Mercer's Analytics for Climate Transition (ACT) tool and advice framework. The ACT tool provides a bottom-up company-level perspective across asset classes on a "well-below 2˚C" or transition scenario. Details of the methodology and framework are outlined in Appendix B.

This assessment has helped to identify where the highest carbon-intensity risks lie, including the potential for stranded asset risk in the "dark grey" companies, and where emissions reductions can best be achieved by portfolio weight and still deliver on investment objectives. This company-level categorisation helps to compare different portfolios and benchmarks within asset classes and compare asset-class impacts to adopt a thorough risk-management approach to an economy-wide and portfolio-wide transition. Key outputs from our analysis on our Model Growth Portfolio and the Mercer Multi Asset Growth Fund are provided under the Metrics and Targets section.

Physical damages assessment

Physical risks translate into business risk and, therefore, investment risk as damage and disruption of business operations and supply chains impact company revenues and, ultimately, valuations. Although transition risks dominate in the short term, it is increasingly important that Mercer ISE has the ability to assess potential exposure across our funds, identify potential risk priorities and engage with appointed managers on potential risk-reduction options.

Mercer utilises a third-party data provider's methodology to help assess and report on potential physical damages risks for listed assets. This includes perils such as extreme temperatures, extreme precipitation, coastal flooding, fluvial flooding, tropical cyclones and wildfires. Coastal flooding and tropical cyclones are modelled in much greater detail given their historical focus within the insurance industry.

The modelled impacts, expressed as a percentage of a company's market value, reflect the downside potential associated with risks from physical damages to a business's assets. They are modelled bottom up at an asset level and are based on the asset's geographical and structural characteristics, including supply chains.

The insights provide country and sector risk lenses for indices and portfolios.

Investment in climate solutions assessment

Increasing allocation to low-carbon and sustainability-themed exposures is part of Mercer's Climate Transition Plan. This can be achieved through SAA optimisation and/or allocations within asset classes. Such allocations are expected to reduce downside risk associated with the transition to a low-carbon economy and capture the anticipated positive performance of those companies that will directly benefit from the transition and their contribution to it.

Mercer has developed an assessment approach for listed assets, utilising third-party data, that assesses the UN Sustainable Development Goals (SDG) revenue alignment. The analysis identifies companies whose revenues are aligned to the SDGs, including those most related to climate change risk and opportunity, such as:

- Affordable & Clean Energy
- Climate Action
- Industry, Innovation & Infrastructure

Taking action to manage risks

The following table outlines example actions to be taken as part of Mercer's Climate Transition Plan by asset class. This covers three implementation methods — integration, stewardship and investing in solutions. The focus is on a genuine entire-economy and portfolio transition, not just emissions reduction.

	Integration (risk reduction)	Stewardship (transition support)	Investment (solutions)
Key actions	• **SAA**: Ensure SAA reviews incorporate net-zero and climate-related considerations. • **Asset classes**: Continue to strengthen climate-related considerations by asset class, drawing on Mercer ISE's Manager Engagement Framework and ACT analysis on transition capacity. • **Sector and data developments**: Ensure the sector focus goes beyond energy/utilities and addresses other high-emitting sectors, such as materials and agriculture and emerging solutions, with an emphasis on the circular economy and ending deforestation. • **Stranded-asset screening**: Maintain additional screening for exposure to fossil fuel producers and reserves.	• **Monitoring and engaging with appointed managers**: Continue to consider climate risks in voting and engagement across the Mercer Funds. • **Transition capacity**: Communicate to managers and clients our focus on the highest-emitting, lowest-ACT-transition-capacity companies, drawing on the Climate Action 100+ (including "Just Transition") benchmark report and regular briefings. • **Collaboration**: Continue to engage and collaborate in investor groups; for example, Investor Group on Climate Change, Climate Action 100+, CDP, Investor Statements to Governments.	• **Focusing on solutions**: Increase allocations to high-transition-capacity companies via low-carbon/ sustainability-themed exposures. • **Defining green solutions and avoiding greenwashing**: Conduct further work on defining the allocation to green solutions and ensuring consistency with regulatory frameworks and industry standards. • **Third-generation benchmarks**: Where appropriate, consider climate-transition benchmarks focused on supporting an economy-wide transition rather than an exclusions-based approach.

In addition to the above, as a last resort, Mercer ISE will consider the exclusion of companies based on their contributions to carbon emissions. Limited exclusions, focused on some of the most environmentally damaging sectors, have already been implemented in the majority of our multi-client equity and fixed-income solutions that disclose under Article 8 of the SFDR. We will regularly review the broadening of emissions-based exclusions . Mercer ISE also has an Exclusions Framework, established in 2018, which supports our decision-making process globally and is applied on a regional basis.

Integration of climate into our overall risk management process

Mercer ISE adopts the Enterprise Risk Management (ERM) Framework across all group functions to support Mercer ISE's risk management objectives and policies. The ERM Framework establishes the governance arrangements and the principles of how risk is to be identified, assessed, managed, monitored and reported. The ERM Framework provides a basis that supports the realisation of strategy in a sustainable way, within limitations set out in the risk appetite statement. Sustainability risk, including climate risk, forms part of this framework. A sustainability materiality assessment methodology is applied to current risk registers to identify ESG risks in Mercer ISE's risk environment.

Risks are regularly assessed as part of the ERM process and particularly through the periodic risk register process and presentations by risk owners to the Executive Risk Committee (ERC), which is chaired by the MGIE chief operations officer (COO) and meets on a monthly basis. The ERC assists the Board Risk Committee (BRC), a sub-committee of the Board, and the Board in its responsibilities to ensure risks are appropriately identified, assessed and managed.

Mercer ISE's strategy is to integrate ESG risks into governance structures, establishing clear working procedures and responsibilities for business lines, internal control functions, the relevant committee(s) and management body, with a view to ensuring a sound and comprehensive approach to the incorporation of ESG risks into business strategy, business processes and risk management.

Risk and Compliance, as the second line of control, has embedded sustainability in its monitoring framework and provides oversight of the various sustainability-related commitments made by Mercer ISE within its Sustainability Policy. This includes commitments addressing climate risks. The team conducts an annual review of controls in place to ensure sustainability and climate-related policy commitments are carried out, with a summary of findings provided to the BRC.

Metrics and targets

This section discusses climate metrics and targets for Mercer ISE's core portfolios, where the majority of our clients' assets are invested — in particular, the Model Growth Portfolio for the Mercer Multi Asset Growth Fund. The climate-related metrics help Mercer ISE understand fund exposures and opportunities and identify areas for further risk management, including appointed manager portfolio monitoring and informing stewardship priorities.

Mercer ISE recognises that the availability of accurate data for some asset classes is an industry-wide issue. We encourage appointed managers, and the underlying companies in which they invest, to improve their climate (and carbon) reporting as quickly as possible. In the interim, we apply a pro-rata approach to funds where there are holdings with no data coverage, effectively assigning the holdings an average of the companies that do have data within that fund. This is in line with statutory guidance and ensures we do not assign a "zero" to a holding and artificially improve our climate metrics. This approach is used for the following climate metrics noted on the next page: Absolute Emissions, Carbon Footprint, Weighted Average Carbon Intensity, Implied Temperature Rise and Climate Value at Risk.

Mercer ISE reports on the following key metrics, which we believe to be credible and easy-to-understand measures that have been derived through a transparent methodology and are useful in decision-making.

Absolute Emissions — This represents each company's reported or estimated greenhouse gas emissions, where available (includes Scope 1 and Scope 2 emissions). At a fund level, it represents the total greenhouse gas emissions attributable to the fund. Scope 1 emissions are those from sources owned or controlled by the company (e.g., direct combustion of fuel from vehicles), whereas Scope 2 emissions are those caused by the generation of energy purchased by the company. Mercer ISE will continue to work with data providers and investment managers to obtain Scope 3 data.

Carbon Footprint — This measures the carbon emissions (in metric tons) per million US dollars invested. This is the TCFD's recommended metric for measuring carbon emission intensity.

Weighted-Average Carbon Intensity (WACI) — This is an alternative carbon-emission-intensity metric and measures the carbon emissions (in metric tons) generated per million US dollars of sales. For sovereign assets, this is normalised by gross domestic product (GDP) rather than sales.

Implied Temperature Rise — This analyses the warming scenario with which the investment is aligned. Implied Temperature Rise is a forward-looking metric that helps infer the degree of portfolio alignment with the goals of the Paris Agreement (i.e., limiting global warming to well below 2°C). Mercer ISE recognises that very few companies are currently aligned with net-zero pathways but that this will change as companies transition their business models.

Climate Value at Risk — This demonstrates the expected return contribution from changes arising in a 1.5°C scenario out to 2100. It is designed to provide a forward-looking and returns-based valuation assessment to measure climate-related risks and opportunities in an investment portfolio across top-down risks and opportunities (transition and physical exposures) and bottom-up risks and opportunities (policy/economic impacts and technology/company-specifics).

Data Quality — This measures the share of the portfolio held for which climate-related metrics of an acceptable quality have been obtained. The share of the portfolio on which high-quality climate-related disclosures are taking place is a good indication of the integration of climate risk and opportunity in asset owner and asset manager decision-making.

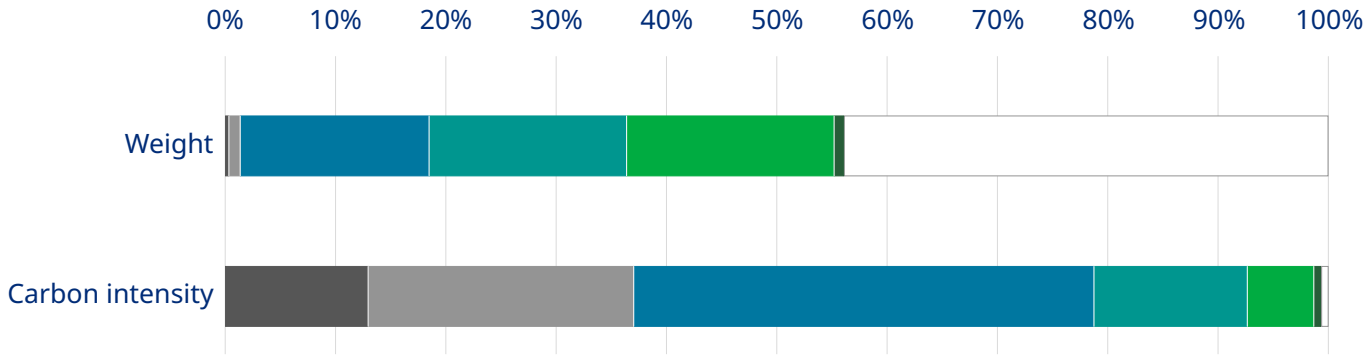
We disclose these metrics for the building block strategies of the Model Growth Portfolio and the Mercer Multi Asset Growth Fund in the Technical Appendix. The methodologies for these metrics are also disclosed in the Appendix. Mercer ISE is working towards additional product- and entity-level disclosures required under the SFDR, which cover a full suite of sustainability-related metrics, including those relating to climate change. These will be disclosed from mid-2023.

Transition capacity

In addition to the metrics tracked and assessed above, we focus on understanding the transition capacity of Mercer's solutions, captured through Mercer's Analytics for Climate Transition tool. As discussed earlier, the ACT tool aggregates multiple climate-related metrics to provide a forward-looking view of transition capacity on a spectrum. Although this tool is not a single metric that can be monitored over time, it is proving very beneficial for looking forward and assessing potential stranded-asset risk and identifying the most appropriate priorities for future emissions reductions.

The graphics below illustrate the climate transition assessment of the Model Growth Portfolio and the Mercer Multi Asset Growth Fund.

Figure 7. Model Growth Portfolio by weight and carbon intensity



The grey

High carbon intensity, low transition capacity

The in-between

Varying carbon intensity and transition prospects

The green

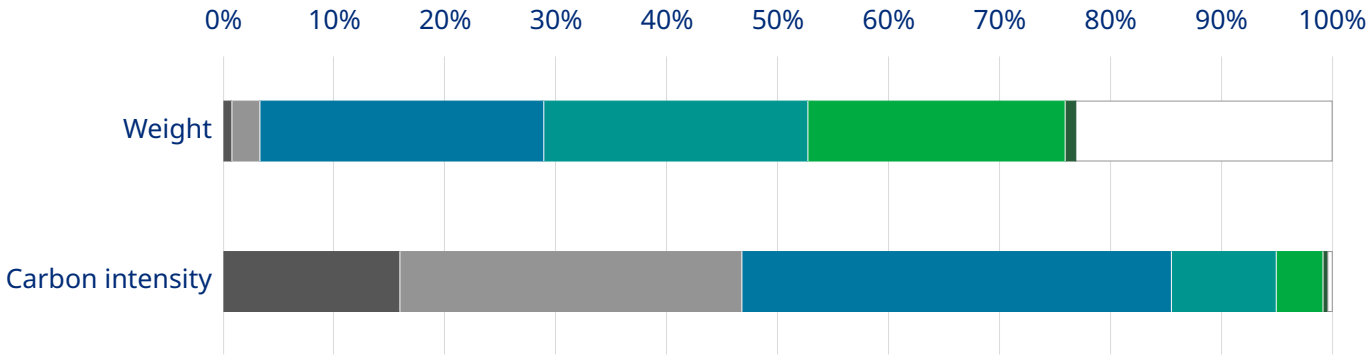
Low carbon intensity, high transition capacity

What is immediately evident from comparing the two bar charts is that the approximately 1% of holdings in dark grey and light grey assets have an outsized (37%) contribution to total portfolio WACI, driven mainly by holdings in the listed infrastructure and emerging markets debt and equity strategies.

On the green end of the spectrum, the values by weight and intensity are largely the same (approximately 1%) as investment opportunities in high-transition-capacity companies are only beginning to increase. The majority of the dark green exposures are held in the sustainable global equity strategy, with light green exposures seen more widely across emerging markets equity, listed infrastructure and REITs strategies. There are no grey holdings, dark or light, in the sustainable global equity or REITs strategies.

Notably, a significant portion of the green exposures outside of the sustainable global equity strategy come from the strategies driving the grey exposures (emerging markets equity and listed infrastructure), evidencing the barbell-like nature of climate-risk integration and transition preparedness of holdings within these asset classes.

Figure 8. Mercer Multi Asset Growth Fund by weight and carbon intensity



The Mercer Multi Asset Growth Fund implements predominantly passive strategies, and passive implementation does not have the active underweight to grey assets as seen in the Model Growth Portfolio's underlying, predominantly active strategies. Therefore, grey holdings have an even larger share of the Mercer Multi Asset Growth Fund WACI (approximately 47%), driven by just 3% of assets that are almost entirely held in the passive emerging markets equity and passive global listed infrastructure strategies. There are no grey holdings in the short-duration bonds or passive REITs strategies and <0.5% in the passive sustainable global equity and passive UK strategies (due to their broad market nature).

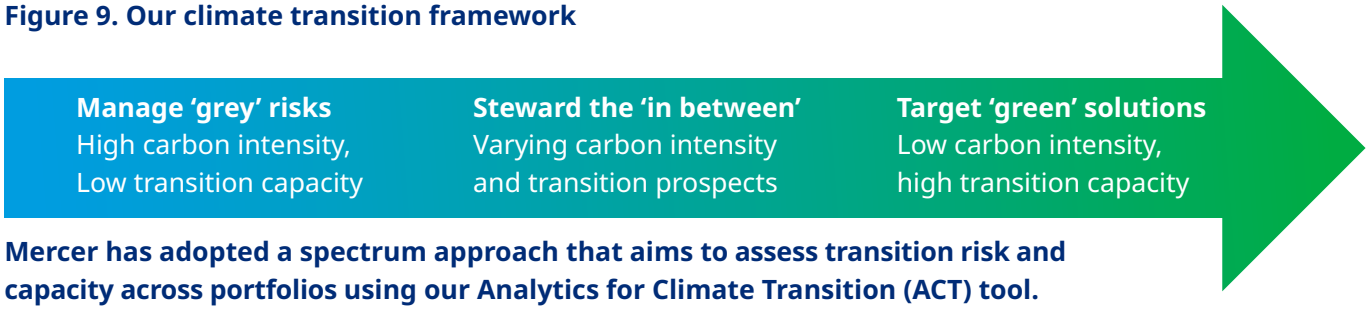
Green exposures are concentrated largely in the passive emerging markets equity strategy, with supporting contributions from passive sustainable global equity, passive global listed infrastructure and passive REITs.

We are in the process of restructuring both the active and passive global listed infrastructure strategies to integrate an increased exposure to strategies investing in climate and other sustainability-related solutions. During 2022, we introduced certain carbon- and/or fossil-fuel-activity-based exclusions to the majority of the building-block strategies and set emissions-reduction targets relative to benchmarks for active equity strategies (as mentioned previously in this report). We are confident these changes will better position our clients for the transition to net-zero portfolio carbon emissions, which will be evidenced in our next iteration of ACT analysis on the portfolios available in next year's report.

Targets: Our path to net zero

Mercer ISE has undertaken a step-by-step process, supported by robust analysis and a transition plan, to manage climate transition risk and underpin the target of net-zero portfolio emissions by 2050, with an expected portfolio emissions reduction of 45% by 2030 for some of its strategies. We are committed to doing this without altering investment objectives or expected risk/return profiles to deliver on both short- and long-term investor and member outcomes.

Figure 9. Our climate transition framework



Mercer has adopted a spectrum approach that aims to assess transition risk and capacity across portfolios using our Analytics for Climate Transition (ACT) tool.

1. Calculate the baseline

2. Analyse possibilities

3. Set measurable goals

4. Implement the plan

Integration

- Incorporate analysis into strategy and portfolio decisions
- Optimise SAA and seek asset class alignment
- Monitor market pricing*

Active ownership

- Engage with companies and utilise voting rights to influence disclosure and practices aligned with 2030 and 2050 ambitions, including via collaborative initiatives

Investment

- Allocate to low-carbon/ sustainability-themed solutions
- Monitor technology developments and pricing*

Screening

- Screen to monitor high-carbon exposures with low transition capacity

Report and disclose consistent with the TCFD framework

* "Decarbonisation at the right price" (DARP) is a term used to describe this market-aware approach to transition objectives.

Carbon-reduction targets are much like performance targets. They help to set expectations and provide goalposts to track and measure progress. Mercer is an allocator of investment capital to many companies across the economy, locally and globally. Mercer believes setting a public carbon-reduction target, underpinned by a thoughtful climate transition plan focused on genuine economic transition, sends an important signal that should support an increase in the probability of a 1.5ºC scenario, or at least a "well-below 2ºC" scenario, by 2100.

To meet our targets, Mercer ISE will use the following key levers:

- Strategic asset allocation and portfolio construction decisions to allocate to solutions in line with our climate goals and consistent with our fiduciary responsibilities
- Asset-class approach to implementation; for example, for selecting strategies and mandating guidelines that consider our climate goal alignment and other risk and return factors
- Stewardship, voting and engagement tools to ultimately target transition within company business models
- Allocation to sustainable infrastructure to support the energy transition that underpins significant parts of the whole economy

Mercer ISE is working closely with our appointed managers to identify and manage a staged emissions-reduction plan, oversee fund allocations to climate solutions and steward an increase in transition capacity across the funds. Progress on reductions will be monitored and reported to clients annually. These targets are also fully embedded within all governance, risk management, and strategy processes and communicated to relevant partners and third parties.

Carbon-reduction target

In early 2021, Mercer set its net-zero target for absolute portfolio carbon emissions by 2050 for its discretionary solutions and multi-asset, multi-client funds. To achieve this, Mercer expects to reduce portfolio carbon emissions by 45% by 2030 from 2019 baseline levels. We have not made our 2025 target public yet, but we intend to revisit this once we have rolling three-year data and increase transparency ahead of the 2025 midpoint to 2030.

At the time, the target was consistent with a 1.5ºC limit on global temperature increases and the Paris Agreement's ambitions, recognising that greater, quicker reductions may be required to maintain that alignment status.

Stewardship target

Mercer has been increasingly engaging with its appointed managers on their integration of climate risks and opportunities since climate change was added as a core sustainability belief in its Sustainability Policy. Mercer's announced target to achieve net-zero absolute portfolio carbon emissions by 2050,[10] along with the reclassification of a number of funds to further promote environmental characteristics,[11] has also led to and been the result of numerous engagements with appointed managers. Furthermore, Mercer's *Annual ESG & Stewardship Survey for Managers* engages appointed managers on their approaches to integrating climate considerations into their investment processes. The most recent survey further aimed to capture the connected roles that natural capital and biodiversity play within climate considerations.

To set meaningful stewardship targets, we are building on our existing engagement approach with managers and our expectation for companies to be assessed as net-zero aligned or with a net-zero pathway awaiting assessment, particularly for the highest emitters. Mercer's ACT analysis and transition capacity categorisation will be used in conjunction with a focus on the percentage of companies in the portfolio with assessed science-based net-zero targets. For private market exposures, disclosure is expected to be the initial stewardship focus. Together, these priorities will provide the framework to conduct goal-oriented engagements and set specific 2030 and 2040 targets in the near future.

Climate-solutions target

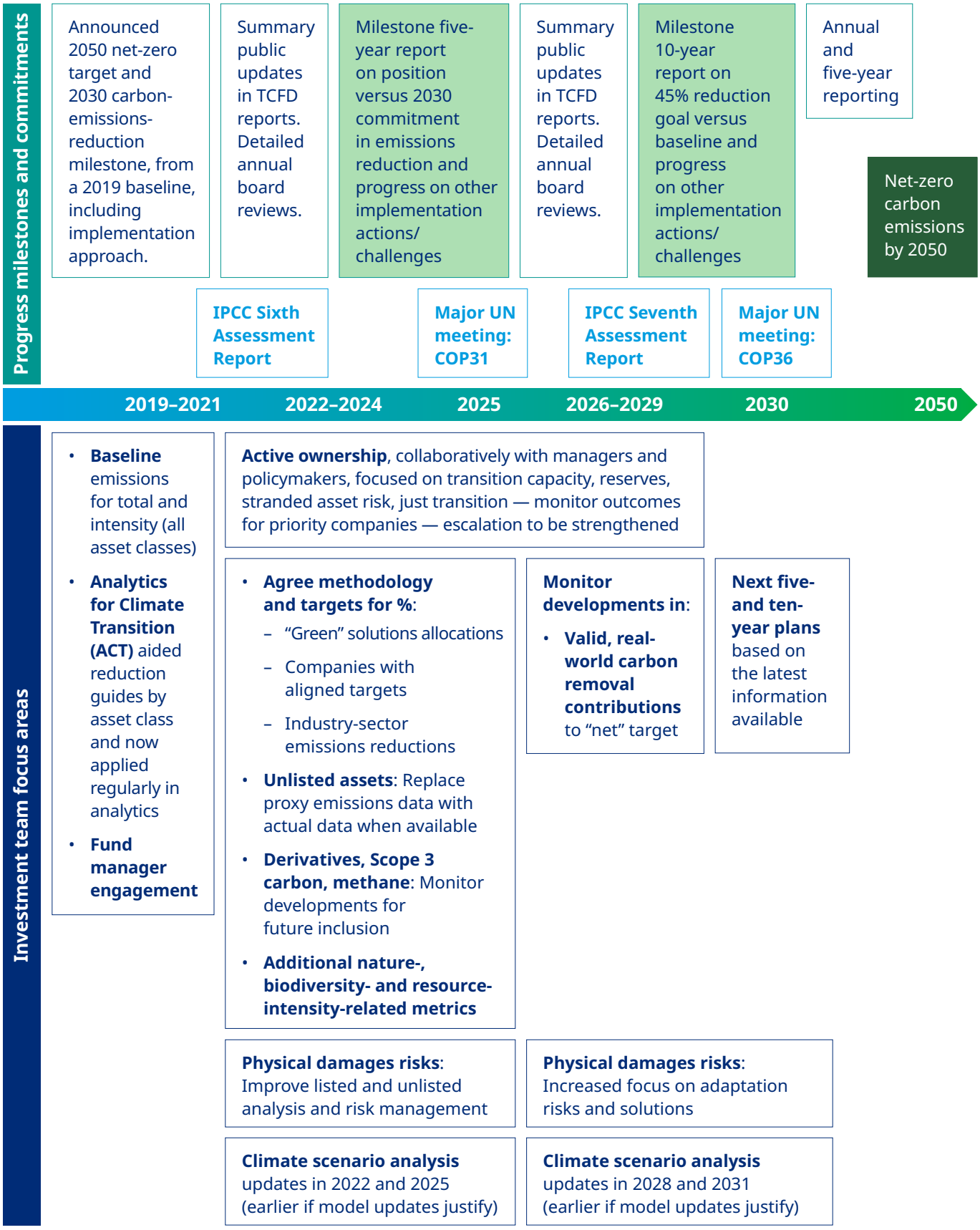
Mercer has considered but not set a climate-solutions target. We know that as of September 2022, our exposures to environmental impact solutions[12] are approximately 4% in the Model Growth Portfolio and approximately 5% for the Mercer Multi Asset Growth Fund.

We broadly expect the opportunities to continue to grow and this number to increase. However, there is more knowledge to be gained on the emerging definitions and consistency with the EU's SFDR and Taxonomy Regulation before specific targets can be set.

Next steps

The timeline below illustrates Mercer ISE's key priorities over the short, medium and long term. As the industry and our clients' needs evolve, we will continue to advance our roadmap and frameworks. We look forward to working with all our clients and stakeholders as this develops.

Figure 10. A roadmap to 2025 and 2030



Technical appendix

Climate-related metrics

Below, we show the climate-related metrics for the building-block funds used to build our client portfolios, including the Model Growth Portfolio and the Mercer Multi Asset Growth Fund.

Fund	AUM (US$ million)	WACI (sales)	Carbon footprint	Absolute emissions	WACI (GDP)	Implied temperature rise	Climate VaR
Equity							
MGI Global Equity Fund	4,224	75	31	130,641	-	2.5	-8.1
Data quality							
Mercer Fundamental Indexation Global Equity UCITS CCF	1,000	93	57	57,013	-	2.7	-11.7
Data quality							
Mercer Sustainable Global Equity Fund	2,161	68	17	37,348	-	2.1	-2.9
Data quality							
Mercer Low-Volatility Equity Fund	1,635	79	32	51,752	627	2.3	-10.9
Data quality							
MGI Eurozone Equity Fund	809	156	97	78,234	-	2.9	-13.4
Data quality							
MGI UK Equity Fund	467	78	29	13,433	-	2.1	-12.6
Data quality							

Reported Estimated Not reported Sovereign assets N/A (incl. cash and derivatives)

Fund	AUM (US$ million)	WACI (sales)	Carbon footprint	Absolute emissions	WACI (GDP)	Implied temperature rise	Climate VaR
Mercer Global Small Cap Equity Fund	1,266	101	79	100,659	-	2.8	-8.2
Data quality	43%	52%	4%	0%	2%		
MGI Emerging Markets Equity Fund	1,766	160	70	124,300	-	3.3	-14.6
Data quality	65%	30%	4%	0%	2%		
Mercer Global Listed Infrastructure Fund	833	928	169	141,116	-	3,7	-19.6
Data quality	83%	13%	1%	0%	3%		
Mercer Passive Global Equity Fund	3,645	129	42	153,190	-	2.7	-7,9
Data quality	83%	15%	0%	0%	1%		
Mercer Passive Sustainable Global Equity UCITS CCF	3,250	40	14	44,780	-	2.1	-4.6
Data quality	89%	10%	0%	0%	1%		
Mercer Passive Low-Volatility Equity UCITS CCF	2,109	268	54	114,265	-	2.1	-12.1
Data quality	78%	22%	0%	0%	0%		

Reported Estimated Not reported Sovereign assets N/A (incl. cash and derivatives)

Fund	AUM (US$ million)	WACI (sales)	Carbon footprint	Absolute emissions	WACI (GDP)	Implied temperature rise	Climate VaR
Mercer Passive Global Small Cap Equity UCITS CCF	2,199	154	80	176,038	-	2.9	-9.9
Data quality	37%		57%	3%	0%	3%	
Mercer Passive Emerging Markets Equity Fund	4,130	311	135	558,365	295	3.7	-16.4
Data quality	63%		28%	1%	3%	5%	
Mercer Passive Global Listed Infrastructure UCITS CCF	2,083	1198	241	502,717	-	3.7	-23.6
Data quality	84%		16%	1%	0%	0%	
Mercer Passive Global REITS UCITS CCF	2,637	99	8	20,718	-	1.8	-61
Data quality	60%		39%	0%	0%	0%	
Mercer Passive Global Equity CCF	2,081	126	41	85,731	-	2.7	-7.7
Data quality	81.2%		15.2%	0.2%	0%	3.5%	
Fixed income							
Mercer Global Buy & Maintain Credit Fund	1,469	299	70	103,131	-	2.9	-14.3
Data quality	75%		16%	5%	1%	4%	

Reported Estimated Not reported Sovereign assets N/A (incl. cash and derivatives)

Fund	AUM (US$ million)	WACI (sales)	Carbon footprint	Absolute emissions	WACI (GDP)	Implied temperature rise	Climate VaR
MGI Global Bond Fund	392	435	143	56,016	404	3.2	-15.5
Data quality	10%	3%	1%	80%	6%		
Mercer UK Credit Fund	261	159	66	17,095	198	2.6	-13.8
Data quality	52%	18%	8%	16%	5%		
MGI Emerging Markets Debt Fund	935	575	348	325,792	891	-4.2	-36.7
Data quality	1%	1%	0%	91%	6%		
Mercer Emerging Market Debt — Hard Currency Fund	478	1372	377	180,211	1014	4.7	-43.6
Data quality	11%	7%	8%	68%	5%		
Mercer Multi Asset Credit Fund	5,067	258	129	656,048	288	3.2	-19.2
Data quality	13%	13%	55%	0%	19%		
Mercer Absolute Return Fixed-Income Fund	4,439	109	49	216,473	498	2.9	-8.1
Data quality	20%	7%	8%	36%	29%		
Mercer Tailored Credit Fund 1	9,489	258	79	746,908	180	2.3	-16.2
Data quality	65%	22%	7%	1%	5%		

Reported Estimated Not reported Sovereign assets N/A (incl. cash and derivatives)

Fund	AUM (US$ million)	WACI (sales)	Carbon footprint	Absolute emissions	WACI (GDP)	Implied temperature rise	Climate VaR
Mercer Global High-Yield Bond Fund	1,474	430	250	368,061	295	4.0	-23.6
Data quality	35%	31%	26%	4%	4%		
Mercer Short-Duration Global Bond Fund 1	1,892	74	26	49,184	266	2.3	-8.5
Data quality	78%	13%	3%	5%	2%		
Mercer Short-Duration Global Bond Fund 2	851	32	8	6,895	163	2.7	-6.2
Data quality	21%	9%	9%	49%	11%		
Mercer Short-Duration Bond Fund 3	312	86	51	15,915	372	2.7	-11.0
Data quality	47%	12%	5%	33%	2%		
Mercer Passive Global High-Yield Bond Fund	3,832	209	111	426,891	-	3.4	-18.4
Data quality	47%	34%	16%	2%	0%		
Schroder Secured Finance	595	1	0	123	295	1.4	-1.5
Data quality	0%	1.7%	1.2%	4.6%	92.5%		

Reported Estimated Not reported Sovereign assets N/A (incl. cash and derivatives)

Progress against our net-zero target

We have made positive progress towards reducing our total-portfolio-level carbon metrics versus baseline levels. During 2022, we added additional data sources to our tracking of carbon intensities to provide a better estimate of previously un-modelled exposures in the portfolios. This has improved the accuracy of historic climate metrics, which we have now restated and included in this year's report.

Weighted-Average Carbon Intensity (WACI) is the most widely used metric to assess carbon risk for portfolios and make comparisons across assets. WACI is the measure of portfolio exposure to companies' carbon emissions, measured by emissions (tCO2e) per million US dollars of revenue.

As of 31 December 2021, the Model Growth Portfolio has reduced its WACI slightly when compared to December 2019, but is **off track** to meet Mercer's internal, interim 2025 target to be aligned with the recommended IPCC 1.5°C pathway to net zero by 2050. The Mercer Multi Asset Growth Fund has reduced its WACI by a much greater magnitude versus its December 2019 baseline level and is **well ahead** of the recommended IPCC 1.5°C pathway to net zero by 2050.

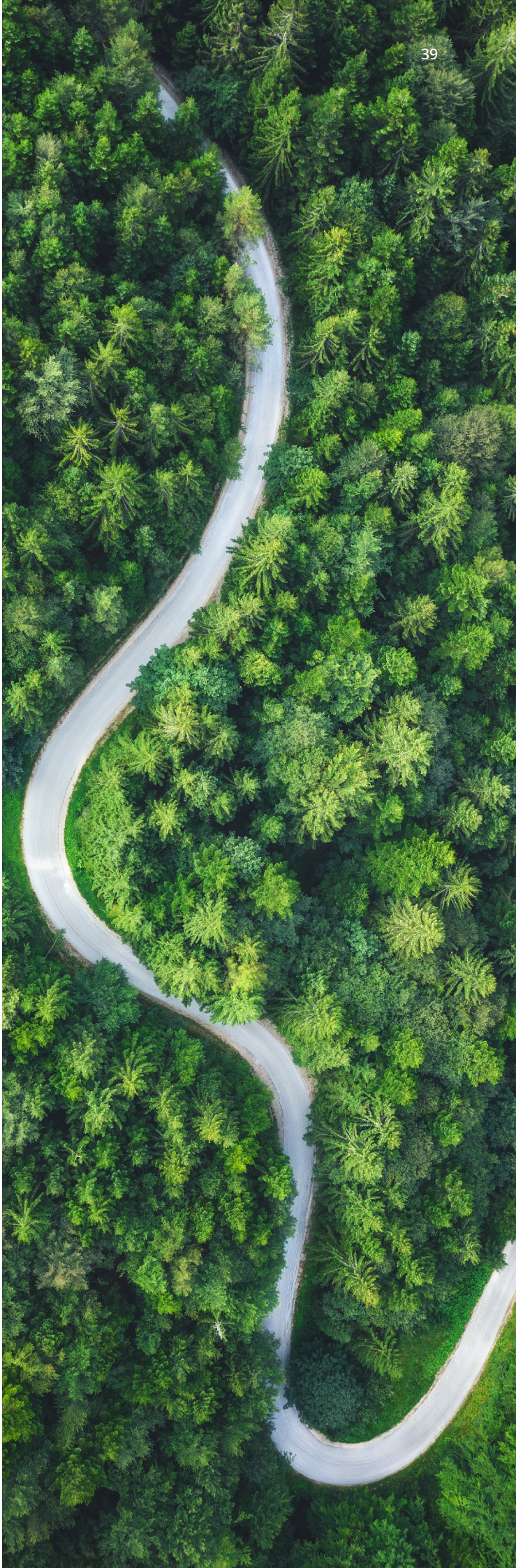
Before we made our net-zero commitment, the Model Growth Portfolio had already made meaningful strides towards integrating climate risks and reducing carbon emissions within the portfolio, resulting in a much lower baseline versus the Mercer Multi Asset Growth Fund. We have since made significant changes to most of the underlying building-block funds across both portfolios, particularly those with the highest emitters and lowest transition capacities (grey assets). These changes aim to enhance the funds' environmental and social characteristics in line with EU SFDR Article 8 disclosure requirements, better positioning them for the upcoming transition to a low-carbon economy and further enabling progress towards our net-zero target.

We look forward to reporting further progress and engaging with our managers on the future pathway towards our net-zero target.

More on the MSCI data underpinning our physical damages analysis

MSCI ESG research models physical risk impacts to 2035 via:

1. Statistical extrapolation of historical weather patterns for chronic climate risks
2. Physical risk modelling for acute climate developments
   - The modelled impacts, expressed as a percentage of a company's market value, reflect the downside potential associated with risks from physical damages on a business's assets.
   - The perils covered in the modelling include extreme temperatures, extreme precipitation, coastal flooding, fluvial flooding, tropical cyclones and wildfires.
   - Coastal flooding and tropical cyclones are modelled in much greater detail since there is a better understanding of these risks that have historically been a focus of the insurance industry.
   - Through its proprietary Asset Location Database, MSCI models these impacts at an asset level based on the asset's geographical and structural characteristics. This makes the physical risk assessment effectively "bottom up" in nature.



Appendix A. Climate Scenario Model

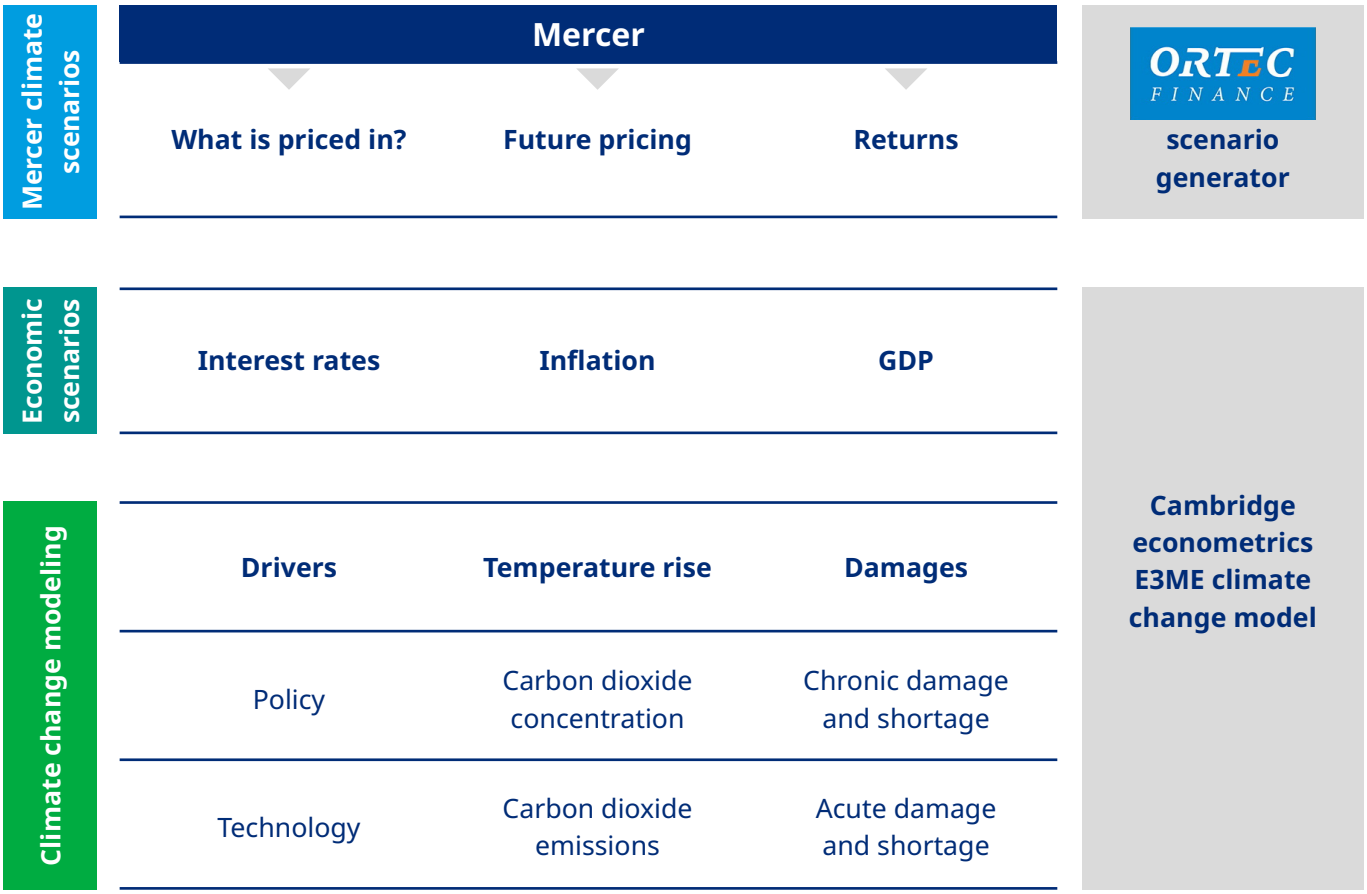
Mercer has partnered with Ortec Finance and Cambridge Econometrics to develop climate scenarios grounded in the latest climate and economic research and give practical insights.

Mercer's climate scenarios are developed by building the investment modelling on top of the economic impacts of different climate change scenarios within the E3ME climate model.

Each climate scenario covers a specific level of warming driven by levels of carbon dioxide (CO_2) and other greenhouse gases (GHG). These levels are determined by the policies enacted and the technological developments. The impacts of warming are shown in the physical damages. E3ME maps this to economic impacts, and Ortec's scenario generator maps the economic impacts to investment return impacts by making assumptions on what is currently priced in and how future pricing shocks will occur.

Mercer's scenarios include our own views on what is priced in and are built on Mercer's climate-aware capital market assumptions.

Figure 11. Mercer scenarios



The Mercer/Ortec scenarios are built upon the Network for Greening the Financial System (NGFS) scenarios, with the key differentiating factor being the forward pricing-in stress tests.

1. Scenario stress testing is embedded in the Mercer/Ortec scenarios, whereas the NGFS scenarios don't incorporate this.
2. The pricing-in shocks are captured before the actual risk event; for example, the physical damages risk is now assumed to be priced in within current investor timeframes rather than, say, in 2100.
3. The baseline is the 3ºC scenario, based on what is priced in today and reflecting current policies.

Modelling assumptions

	Rapid transition	Orderly transition	Failed transition
Summary	Sudden divestments in 2025 to align portfolios to the Paris Agreement goals have disruptive effects on financial markets, with sudden repricing followed by stranded assets and a sentiment shock.	Political and social organisations act quickly and predictably to implement the recommendations of the Paris Agreement to limit global warming to below 2°C.	The world fails to meet the Paris Agreement goals, and global warming reaches 4.3°C above pre-industrial levels by 2100. Physical climate impacts cause large reductions in economic productivity and increasing impacts from extreme weather events.
Cumulative emissions	416 GtCO2 (2020–2100) most closely corresponding to the "lowest emissions" IPCC pathway: SSP1-RCP1.9	810 GtCO2 (2019–2020) most closely corresponding to the "low emissions" IPCC pathway: SSP1-RCP2.6	5,127 GtCO2 (2020–2100) most closely corresponding to the "high emissions" IPCC pathway: SSP3-RCP7.0
Temperature change	Average temperature increase of 1.5°C by 2100	Average temperature increase of 1.8°C by 2100	Average temperature increase of >4°C by 2100

	Rapid transition	Orderly transition	Failed transition
Key policy and tech assumptions	An ambitious policy regime is pursued to encourage greater decarbonisation of the electricity sector and to reduce emissions across all sectors of the economy. There are higher carbon prices, a larger investment in energy efficiency and a faster phase-out of coal-fired power generation under a "rapid" transition.		Existing policy regimes are maintained with the same level of ambition.
Financial climate modelling	Pricing-in of transition and physical risks of the coming 40 years occurs within one year in 2025. As a result of this aggressive market correction, a confidence shock to the financial system takes place in the same year.	Pricing-in of transition and physical risks until 2050 takes place over the first four years.	Physical risks are priced in two different periods: 2026–2030 (risks of first 40 years) and 2036–2040 (risks of 40–80 years).
Physical risk impact on GDP	Physical risks are regionally differentiated, consider variation in expected temperature increase per region and increase dramatically with rising average global temperatures. Physical risks build up from: • Gradual physical impacts associated with rising temperatures (agricultural, labour and industrial productivity losses) • Economic impacts from climate-related extreme weather events Current modelling does not capture environmental tipping points or knock-on effects (for example, migration and conflict).		
Physical risk impact on inflation	Gradual physical impact (supply shocks) on inflation included through damages to agriculture and change in food prices. The total impact on a Global CPI Index is +2% in 2100.	No explicit modelling of physical risk impact on inflation (supply-side shocks). The impact on inflation follows the historical relationship between GDP and CPI.	Severe gradual physical impact (supply shocks) on inflation included through damages to agriculture and change in food prices. The total impact on a Global CPI Index is +15% in 2100.

Climate scenario-modelling limitations:

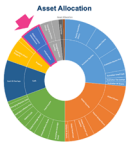
1. The further into the future you go, the less reliable any quantitative modelling will be.
2. Looking at average asset-class returns over multidecade timeframes invariably leads to small impacts. The results are potentially significantly underestimated.
3. There is a reasonable likelihood that physical impacts are grossly underestimated. Feedback loops or “tipping points”, such as permafrost melting, are challenging to model, particularly around the timing of such an event and the speed at which it could accelerate.
4. Financial stability and insurance “breakdown” is not modelled. A systemic failure may be caused by either an “uninsurable” 4ºC physical environment or due to the scale of mitigation and adaption required to avoid material warming of the planet.
5. Most adaptation costs and social factors are not priced into the models. These include population health and climate-related migration.

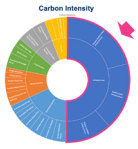
Appendix B. Analytics for Climate Transition methodology

Mercer has developed a proprietary Analytics for Climate Transition (ACT) tool, which provides a bottom-up company-level perspective across asset classes on transition capacity. A transition scenario, Rapid or Orderly, is increasingly possible, given the developments already evidenced in many areas. There is growing momentum to achieve a well-below 2°C scenario (with 1.5°C the science-based objective) via government policy and regulation (supported by the Paris Agreement) and technology tipping points and pricing shifts in the energy sector, along with consumer sentiment and company actions. It's also the scenario that presents the most significant short-term risks and opportunities in different sectors over the next decade.

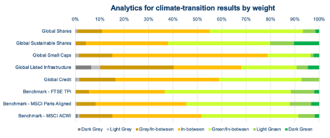
Figure 12. Overview of the transition plan based on Analytics for Climate Transition (ACT)

1. Calculate the baseline





2. Analyse possibilities



3. Set measurable goals

Determine a pathway suitable for your portfolio, and set net-zero targets with confidence.

Milestone expectations are set for each asset class through a phased approach.

4. Implement the plan

Integration

- **Incorporate** analysis into strategy and portfolio decisions.
- **Monitor** market pricing.

Active ownership

- **Engage** with companies, including via collaborative initiatives.
- **Utilise** voting rights.

Investment

- **Allocate** to low-carbon/sustainability solutions.
- **Monitor** developments and pricing.

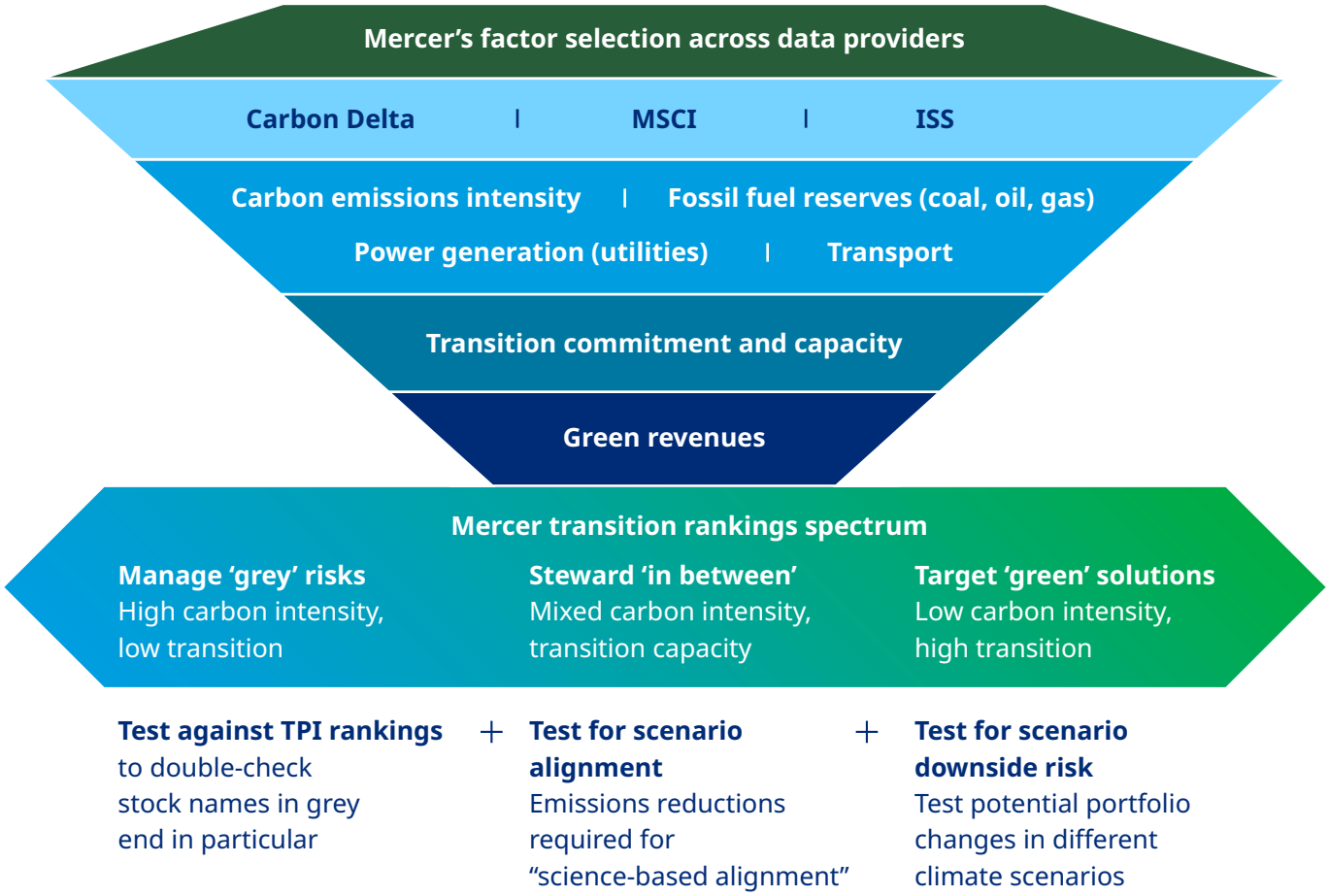
Screening

- **Monitor** high-carbon exposures where there is low transition capacity.

Report and disclose

ACT draws on multiple third-party metrics on company-level emissions and reserves, transition commitments and green revenues, and other UN SDG indicators. Mercer has selected and weighted the metrics to provide a single transition capacity assessment, categorising companies and, therefore, strategies and portfolios on a spectrum, going from "grey" — high-carbon and low-transition investments — to "green" — those that are already low/zero carbon or are climate solutions — and the many companies "in between", with varying transition capacities.

Figure 13.



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

The portfolio risk assessment using the ACT tool enables monitoring at an asset-class, sector, investment-manager and company level to provide multiple portfolio perspectives with a consistent approach across asset classes to aid in ongoing integration, active ownership and investment allocation decisions.

Appendix C. Metrics methodology

Data sources

Climate-related metrics utilised by Mercer have been sourced from MSCI ESG using stock list data provided by the investment managers and/or our custodian.

Scope of emissions

Only Scope 1 and 2 emissions data have been included in this report, except where noted. This means that for some companies, the assessment of their carbon footprints could be considered an understatement. Scope 3 emissions are currently excluded because Scope 3 disclosure remains insufficient to use reliably at present. This is being actively monitored, and we intend to include this data as disclosure improves. Scope 1, 2 and 3 emissions are as defined by the GHG protocol.

Data coverage

Data coverage refers to the proportion of an asset in which the various climate-related metric data are available. There are gaps in the data as:

- Some publicly listed companies do not publish climate-related data or provide poor-quality data. This is relevant to public equity and corporate bonds. Obtaining data for emerging market equity can also be difficult due to general disclosure and transparency challenges.
- Many private companies do not currently produce climate-related data, and coverage for private markets, such as private equity and private debt, will be low or zero for mature funds.
- Sovereigns, or governments, may not publish climate-related data in the public domain. This is a particular challenge for emerging-market debt.
- Short-term instruments, such as secured finance assets, have limited data available due to the short-term nature of the individual assets.
- For the long-dated property portfolio, the occupiers of the buildings in the portfolio have full operational control, and there are no Scope 1 or 2 emissions associated with the investments. The asset managers are looking to improve the collection of Scope 3 emissions data — this includes occupier activities where they have direct utility-supplier contracts.

Metrics in this report use a pro-rata approach to scale up each climate metric in order to present the data as if full coverage were available for each asset. This assumes that the part of an investment fund that does not have data available has the same investment characteristics (for example, same sector or geography) as the part where there are data.

Metrics calculations methodology

Emissions-based	**Weighted-Average Carbon Intensity (WACI)** (corporate assets only)	$\Sigma \frac{\text{\$ investment}}{\text{\$ portfolio value}} \times \frac{\text{Scope 1 and 2 emissions}}{\text{\$ million of issuer's sales}}$
	GDP-based WACI (sovereign debt assets only)	$\Sigma \frac{\text{\$ investment}}{\text{\$ portfolio value}} \times \frac{\text{Total GHG emissions of country}}{\text{GDP of country}}$
	Absolute Emissions	$\Sigma \frac{\text{\$ investment}}{\text{\$ issuer's EVIC}} \times \text{Scope 1 and 2 emissions}$
	Carbon Footprint	$\Sigma \frac{\left[\frac{\text{\$ investment}}{\text{\$ issuer's EVIC}} \times \text{Scope 1 and 2 emissions}\right]}{\text{\$ portfolio value (\$ million)}}$
Portfolio alignment	**Implied Temperature Rise**	The metric projects emissions forward for each company to assess how closely aligned it is with the Paris Agreement objective of 2°C of warming by 2100, taking into account the company's emissions, commitments and momentum. This is then aggregated to the fund and portfolio levels. Methodologies for this metric may vary by data provider. For the purposes of this analysis, the data provider is MSCI. Further methodology details can be viewed on the MSCI website.
Non-emissions-based	**Data quality**	Percentage of portfolio that has reported data, estimated data, verified data and no available data.
	Climate Value at Risk	This demonstrates the expected return contribution from changes arising in a 1.5°C scenario out to 2100. It is designed to provide a forward-looking and returns-based valuation assessment to measure climate-related risks and opportunities in an investment portfolio across top-down risks and opportunities (transition and physical exposures) and bottom-up risks and opportunities (policy/economic impacts and technology/company-specifics).

Appendix D. References for further reading

Mercer's thought leadership on climate change and net zero

Investing in a Time of Climate Change reports

In 2011, in partnership with a number of our institutional investment clients, Mercer published its first global research report on climate change and its implications for strategic asset allocation. In June 2015, we released a major update, *Investing in a Time of Climate Change* ("the 2015 Report"), another client collaboration. In 2019, we published *Investing in a Time of Climate Change — The Sequel* ("the Sequel").

The Sequel documents Mercer's former climate scenario model for assessing the effects of both climate-related physical damages (physical risks) and the transition to a low-carbon economy (transition risks) on investment return expectations. The Sequel modelled three climate change scenarios: a 2°C, 3°C and 4°C average warming increase from pre-industrial levels, over three timeframes — 2030, 2050 and 2100. Further, the Sequel focuses on the "why, how and what" for investors, providing practical advice, including peer case studies.

Mercer's advice on net-zero implementation

In December 2022, Mercer published a paper outlining our approach to advising clients on net-zero target-setting and implementation.

Mercer believes it is in all investors' best interests to keep global warming to 1.5°C. To help achieve this objective, we advise that investors measure their portfolio-level carbon emissions, set net-zero-aligned targets to reduce those emissions and create a transition plan that sets out how to achieve those reductions. In setting these targets, we believe investors should consider the following:

- To achieve decarbonisation, investors should aim to ensure their net-zero commitments focus not just on portfolio construction but also on actions that reduce real-world emissions.
- Reducing portfolio-level carbon exposure using exclusions, divestment or portfolio construction techniques, and based solely on historical emissions, is unlikely to impact real-world carbon emissions.
- Active stewardship plays a more vital role than simply divesting. It demands a clear engagement, voting and measurement programme focusing on forward-looking measures aimed at transition and net-zero commitments at a company level.
- To achieve a real-world impact on carbon emissions, we advise asset owners to work with asset managers that are stewarding the climate transition through robust engagement programmes that focus on influencing companies' transition strategies.

The third generation of climate indices

Initial climate index development focused solely on reducing carbon intensity through exclusion. Later developments added a green revenues or solutions component to the index construction. However, transition is the third important element where investors must also assess companies' abilities and commitments to transition to a low-carbon economy. Enter the third generation of climate indices, an approach that positions for transition, not just by penalising the laggards of today (that is, companies with high carbon risks) but rewarding the winners of tomorrow (that is, companies producing "green" revenues) and the many companies "in between" (demonstrating that they have the potential to transition).

This paper provides more information on the evolution of climate indexation.

Nature is next

Nature considerations are rising to prominence, and the link between nature and investors' climate strategies is becoming clearer. This paper examines this evolution and what it means for investors, in particular:

- The rise of nature as a theme, reaching a critical point in its significance to financial markets. Its position can be likened to that of climate change before the development of the Paris Agreement. The 2020s will be a decisive decade for the recognition of nature as a key issue for the public, political, business and investment communities. Climate change and nature are inextricably linked — investors will not be able to achieve climate-related commitments without considering the role of nature in their investment portfolios.
- The market developments for nature/biodiversity over the next 12 months, including the final recommendations from the Task Force on Nature-related Financial Disclosures (TNFD) and likely regulatory developments. These trends are expected to lead to nature and biodiversity considerations becoming increasingly financially material to asset valuations.
- Actions that asset owners can take today on nature, which can position investment portfolios positively for upcoming market developments as well as supporting the future of all life on this planet.

Additional readings from the industry

- Intergovernmental Panel on Climate Change (IPCC) — link to latest reports (https://www.ipcc.ch/reports/) plus link to the *2018 Special Report on Global Warming of 1.5°C* (https://www.ipcc.ch/sr15/)
- International Energy Agency (IEA) Paris Agreement Scenario — link to *2021 Net Zero by 2050* report (https://www.iea.org/reports/net-zero-by-2050)
- Carbon Tracker — link to the CAT Thermometer (https://climateactiontracker.org/global/cat-thermometer/)
- Investor Agenda — Accelerating action for a net-zero emissions economy link (https://theinvestoragenda.org/)
- Climate Action 100+ — link to 2021 *Net Zero Company Benchmark* report (https://www.climateaction100.org/net-zero-company-benchmark/)

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Ortec Finance

Mercer has entered into a global agreement with Ortec Finance regarding the use of their climate scenarios.

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3 The Financial Stability Board is an international body established by the G20 that monitors and makes recommendations about the global financial system. The TCFD's purpose was to develop recommendations for more effective climate-related disclosures that could in turn be used, in part, to promote more informed investment decisions. The initial recommendations were released in 2017.

4 Mercer. "Sustainable Investment", available at https://www.mercer.com/our-thinking/wealth/sustainable-investment.html.

5 Weighted Average Carbon Intensity; for definition of metrics, see Appendix C.

6 For companies with a direct link between physical infrastructure and financial performance, there is limited scope for significant risk mitigation.

7 At a market level, transition risks are reasonably priced in. However, longer-term physical risks are more likely to be mispriced. Transition risks remain at sector level and at the market level due to the potential for more extreme transition scenarios to occur. We express this view by modelling scenarios relative to a climate-aware baseline.

8 Mercer's approach to net-zero target-setting and implementation is described in this Net Zero Implementation Paper.

9 This commitment is for UK, European and Asian clients with discretionary portfolios and for the majority of Mercer's multi-client, multi-asset funds domiciled in Ireland. To achieve this, Mercer ISE plans to reduce portfolio-relative carbon emissions by at least 45% from 2019 baseline levels by 2030.

10 For UK, European and Asian clients with discretionary portfolios and for the majority of its multi-client, multi-asset Mercer funds domiciled in Ireland. To achieve this, Mercer set an expectation to reduce portfolio carbon emissions by 45% from 2019 baseline levels by 2030.

11 In line with Article 8 classification under the EU Sustainable Finance Disclosure Regulations (SFDR).

12 Defined by MSCI as the percentage of revenue that companies derive from the five environmental themes of Alternative Energy, Energy Efficiency, Green Building, Sustainable Water and Pollution Prevention.

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