DEVON FUNDS.

Quarterly Sustainability Report

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Interest Piece: Carbon Offsets -Friend or Foe?

Decarbonisation plans for many companies are supported by the use of offsets, particularly within industries which do not currently have low-emission technologies available to them.

This has been well supported by government responses to climate change, with the New Zealand Emissions Trading Scheme (ETS) and the Australian Safeguard Mechanism, both of which are highly relevant to our investment universe. While the idea of carbon offsetting is inherently appealing, it is certainly no replacement for absolute emission reductions and has come under scrutiny as a result. We provide a case study of the steel industry which demonstrates the challenges of decarbonising an industry without low-emission technology available, and a summary of the commonly discussed flaws with carbon credits and offsetting.

The New Zealand ETS is the government's primary tool to reduce greenhouse gas emissions, meet its obligations under the Paris Agreement, and achieve New Zealand's nationally determined target to reach net zero by 2050. The ETS requires businesses to measure and report on their greenhouse gas emissions and surrender one 'emissions unit' (an 'NZU') to the government for each tonne of emissions the business emits.

The number of NZU's available is limited by the government, in line with its emission reduction targets. Businesses who participate in the ETS can buy and sell units from each other and so the price reflects supply and demand in the scheme.

The Australian Safeguard Mechanism is a policy tool for reducing emissions at Australia's largest industrial facilities, which are classed as those which emit more than 100,000 tonnes of carbon dioxide equivalent (CO2-e) per year. The mechanism uses baselines for the emissions from facilities, and any emissions in excess of the baseline must be offset with Australian carbon credit units (ACCUs). The baselines will be artificially reduced on a trajectory consistent with achieving Australia's emission reduction targets of 43% below 2005 levels by 2030 and net zero by 2050.

Steel industry case study

Steel making is an energy and carbon intensive process. According to the IEA, the iron and steel sector is currently responsible for about 8% of global energy demand and 7% of energy sector CO2 emissions as it relies heavily on fossil fuel sources. However, steel as a relatively light but strong material is invaluable for construction and car industries. It will also be a vital part of the energy transition as it is a major component in wind turbines and other forms of renewable energy. Succinctly put by the IEA: "Steel needs energy and the energy system needs steel."

Efforts to decarbonise the steel making industry are still in their infancy. Blast furnaces are the dominant method for producing steel, and this technology is the biggest contributor to the emissions in steel making. An existing alternative is to use electric arc furnaces which use scrap steel or sponge iron (produced from the reduction of iron ore into iron) as their main input. Electric arc furnaces present two problems in the context of decarbonisation. Firstly, the source of electricity must be renewable. Secondly, there is not enough steel scrap to keep up with demand for new steel production.

BHP, a supplier of steelmaking raw materials, identify four primary steelmaking (iron ore based, rather than produced using scrap steel due to availability constraints) pathways that are most promising for decarbonising the industry. These are:

1. Modified Blast Furnace with carbon capture, utilisation and storage (CCUS)
2. Direct Reduced Iron with Electric Smelting Furnace
3. Direct Reduced Iron with Electric Arc Furnace
4. Electrochemical reduction by electrolysis

These pathways are heavily dependent on the development of technologies which would enable them. BHP has said, "Not all these developments will be successful and for those that are, local conditions will influence where, when, in what combination and to what extent they are adopted by steelmakers."

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Interest Piece: Continued

Given these immense challenges, and conversely the importance of steel across sectors and industries, the way in which the Australian Safeguard Mechanism affects the steel industry operationally and financially is yet to be seen. There are a litany of other considerations including the ACCUs themselves (availability and pricing), the effectiveness of the scheme, and the need for a carbon border adjustment mechanism (CBAM). As the Safeguard Mechanism has commenced as of 1 July 2023, in 2024 we will begin to see some of these unknowns play out.

Carbon Offset Flaws

Carbon credits that operate within the New Zealand ETS and Australian Safeguard Mechanism, as well as carbon credits generated for the global market have been subject to criticism. Simplistically, an individual or company can offset the emissions they are responsible for by purchasing a 'carbon credit' which represents the reduction, avoidance, or removal of carbon dioxide from an offset project. Below, we outline the commonly discussed flaws with carbon offsets.

1. Additionality Issues:

Carbon credits sold must represent an actual reduction that otherwise would not have occurred.

2. Permanence Concerns:

Offset projects that capture or reduce emissions may not be permanent. For example, a forest planted may be subject to deforestation or forest fires.

3. Verification and Monitoring Challenges:

It can be difficult to verify the emissions reductions claimed by offset projects.

4. Lack of Standardisation:

The lack of standardised methodologies for calculating emissions reductions risk inconsistencies in offset calculations and make it challenging to compare offset projects.

5. Social and Environmental Impacts:

Some carbon offset projects may cause unforeseen social and environmental impacts. For example, they may lead to displacement of local communities or negatively impact biodiversity.

6. Double Counting:

There is a risk of double counting emission reductions if the same offset is claimed by multiple parties.

7. Ethical and Moral Issues:

The question of whether it is ethical to allow businesses and individuals to continue emitting greenhouse gases by purchasing offsets rather than making direct emissions reductions is one of the key criticims of carbon offsets.

8. Market Volatility:

Fluctuating prices of offsets create uncertainties which can impact the financial viability of offset projects.

9. Limited Scope:

Carbon offsets focus primarily on reducing or capturing carbon dioxide emissions and may not address other pollutants or environmental issues.

It is therefore critical that these flaws are addressed to ensure carbon credits, and offsetting, have integrity. In the context of company decarbonisation pathways, it is important to keep in mind whether offsetting is allowing companies to operate "business as usual", with no real efforts to reduce absolute emissions. It is especially critical so that government schemes like the New Zealand ETS and Australian Safeguard Mechanism actually achieve the emissions reductions they intend to.

- Alice Jones, ESG Analyst

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Devon Sustainability Fund

ESG Metrics as of 31.12.23

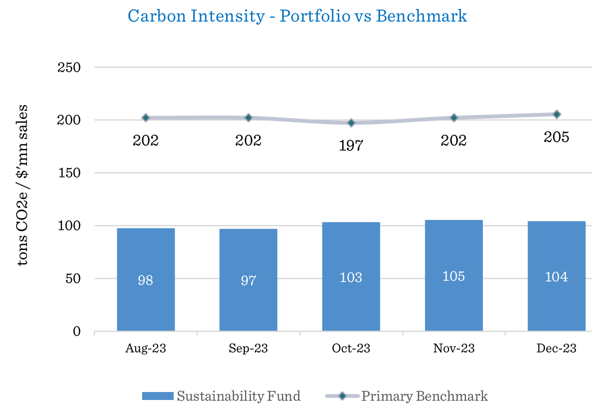
During the fourth quarter, the Devon Sustainability Fund achieved an AA MSCI ESG score.

The Devon Sustainability Fund has continued to perform well against its benchmark for carbon intensity, and its MSCI ESG rating.

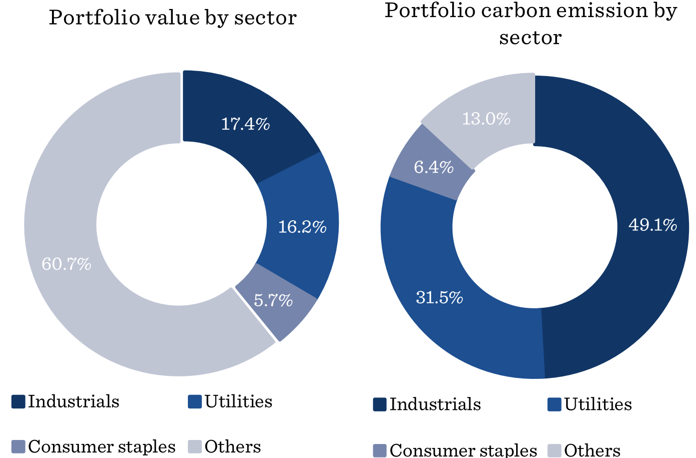
The Devon Sustainability Fund is characterised as a low carbon intensive portfolio. We monitor the companies held within the portfolio for their emission reduction plans.

The largest contributor to the Fund's carbon emissions is the Industrials sector which makes up 17.4% of the portfolio holdings but contributes 49.1% of portfolio carbon emissions.

	MSCI ESG Ratings	MSCI ESG Quality score	
Portfolio	AA	7.80	Portfolio Sustainability Fund
Benchmark	AA	7.41	Primary Benchmark 50:50 composite S&P/NZX50 Portfolio Index & S&P/ASX200G Index



Source: Devon Funds Management analysis, MSCI



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TAHITO Te Tai o Rehua Fund

ESG Metrics as of 31.12.23

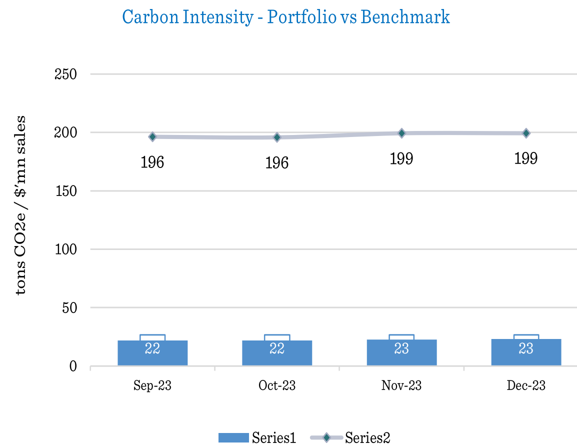
During the fourth quarter, the TAHITO Te Tai o Rehua Fund achieved an AA MSCI ESG score.

The TAHITO Te Tai o Rehua Fund continues to perform exceptionally well against its benchmark for carbon emissions.

TAHITO applies its own Te Kōwhiringa Tapu taxonomy. TAHITO apply these in Te Utu Panga or impact intention measures. These measures are in continuous development as society better understands and then measures the externalities and intangibles.

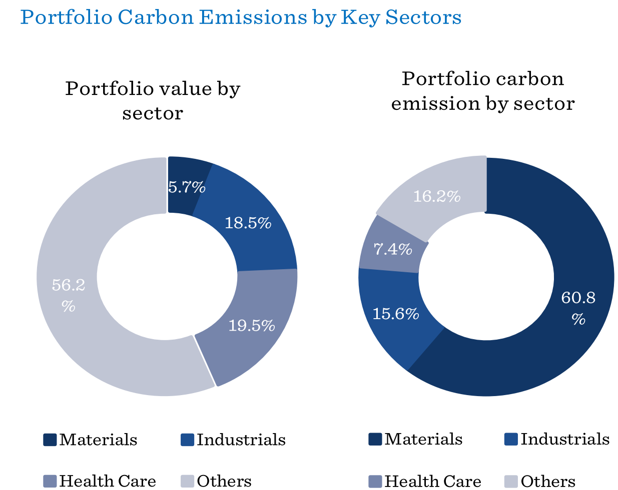
This quarter we have included an example of Technology One held within the TAHITO portfolio where *Te Pae o Ranginui: Zero Carbon, Zero contaminating emissions* has been applied. Decarbonisation targets, and emissions (Scope 1, 2 & 3) are all tracked as part of the reviewing and profiling of a company.

	MSCI ESG Ratings	MSCI ESG Quality score	
Portfolio	AA	8.14	Portfolio TAHITO Te Tai o Rehua Fund
Benchmark	AA	7.38	Primary Benchmark NZX50 Portfolio Index & ASX Accumulation 200 Index



Source: Devon Funds Management analysis, MSCI

Portfolio Carbon Emissions by Key Sectors



TechnologyOne Ltd	
Has achieved Carbon Netural (CO2 only, Y/N)	Y
Target date for carbon netural if N	Achieved
Has set target for Net zero scope 1,2 (Y/N)	Y
Target date for Net zero Scopes 1&2	Achieved
Has set target Carbon Net zero Scopes 1,2 &3 (Y/N)	Y
Target date for Net zero Scopes 1,2 & 3	Achieved

Scopes 1&2 Carbon Emissions - Key *	Reported
Scope 1+2 (metric tons) *	643
Scope 1+2 Intensity (t/USD million sales) *	2.7
Scope 3 Carbon Emissions - Key *	Estimation model
Scope 3 - Total metric tons (combined dataset) *	27,084
Scope 3 - Total Sales Intensity (combined dataset) *	114.4
Total GHG Emissions - metric tons (Scopes 1, 2 and 3) *	27,760

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Devon Global Sustainability Fund

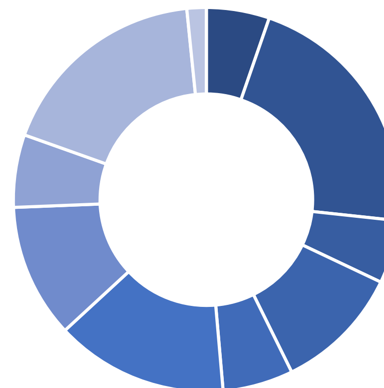
ESG Metrics as of 30.09.23*

Overall Portfolio CO_2 Emissions and Intensity as of 30 June 2023

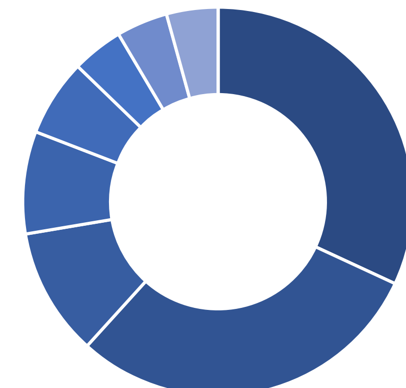
Carbon Footprint	Carbon Emissions	Total Carbon Emissions	Carbon Intensity	Weighted Average Carbon Intensity	Data Availability (Carbon Intensity)
Portfolio	12	12,693	49	46	100
Benchmark	52	55,063	149	139	99.9
	T CO_2e/$M Invested	T CO_2e		T CO_2e/$M Sales	% Market Value

Sectors	Market value	Contribution to portfolio emissions
Utilities	5.2%	15.0%
Information Technology	21.1%	14.0%
Materials	5.2%	5.0%
Consumer Discretionary	10.5%	4.0%
Real Estate	5.8%	3.0%
Industrials	14.2%	2.0%
Healthcare	11.1%	2.0%
Consumer Staples	6.0%	2.0%
Financials	17.6%	0.0%
Communication Services	1.6%	0.0%
Energy	0.0%	0.0%

Portfolio value by sector



Portfolio carbon emission by sector



*Metrics are as of the previous reporting period due to availability of information from the underlying fund manager Wellington Management Group

Source: MSCI | Benchmark: MSCI All Country World | Carbon Emissions: Emissions financed per $1 million invested in the mandate. This metric is calculated by summing the result of '% Enterprise value incl cash financed X Emissions' for each holding, and then dividing by the portfolio's total market value. | Total Carbon Emissions: Total emissions financed by the portfolio. This metric accounts for mandate size by summing the result of '% Enterprise value incl cash financed X Emissions' for each holding. | Carbon Intensity: Metric normalizes company's total emissions by output. This metric is calculated as total emissions financed by the portfolio (equivalent to Total Carbon Emissions metric) divided by total revenue financed by the portfolio (% Enterprise value incl cash owned X Revenue) for each holding. | Weighted Average Carbon Intensity (WACI): Proxy for carbon efficiency of portfolio construction when compared to benchmark. This metric is calculated as a weighted average of each holding's carbon intensity, using % market value in the portfolio. Each holding's carbon intensity normalizes its total emissions by output and is calculated as the company's total emissions divided by its revenue. | Data availability may be lower than Data Availability – Carbon Intensity for the two calculations of financed emissions (Carbon Emissions and Total Carbon Emissions). This is because the financed emissions metrics require availability of both carbon emissions and Enterprise Value including Cash for each holding.

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Devon Global Impact Bond Fund

ESG Metrics as of 30.09.23*

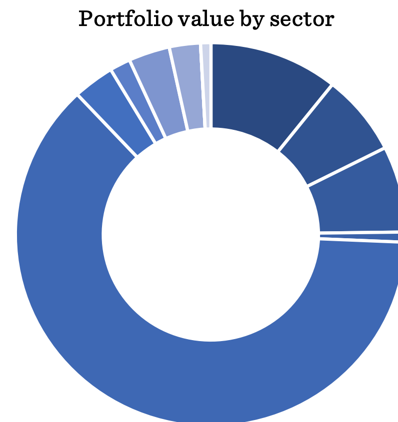
Overall Portfolio CO_2 Emissions and Intensity as of 30 June 2023

Carbon Footprint	Carbon Emissions	Total Carbon Emissions	Carbon Intensity	Weighted Average Carbon Intensity	Data Availability (Carbon Intensity)
Portfolio	24	3,006	78	39	81
Benchmark	65	8,228	172	222	96
	T CO_2e/$M Invested	T CO_2e		T CO_2e/$M Sales	% Market Value

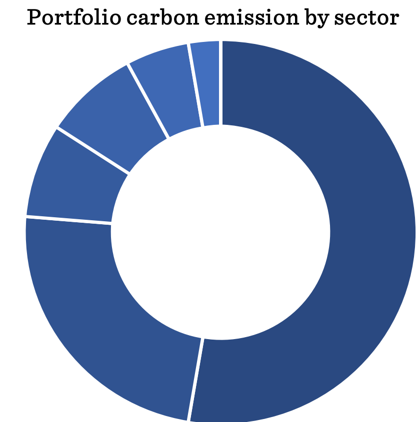
Sectors	Market value	Contribution to portfolio emissions
Utilities	2.5%	20.0%
Industrials	1.6%	9.0%
Communication Services	1.7%	3.0%
Materials	0.2%	3.0%
Financials	14.6%	2.0%
Consumer Discretionary	0.8%	1.0%
Real Estate	0.4%	0.0%
Healthcare	0.8%	0.0%
Information Technology	0.6%	0.0%
Not Classified	0.0%	0.0%
Energy	0.0%	0.0%
Consumer Staples	0.2%	0.0%

*Metrics are as of the previous reporting period due to availability of information from the underlying fund manager Wellington Management Group

Portfolio value by sector



Portfolio carbon emission by sector



Source: MSCI | Benchmark: Bloomberg Global Agg Hdg USD | Carbon Emissions: Emissions financed per $1 million invested in the mandate. This metric is calculated by summing the result of '% Enterprise value incl cash financed X Emissions' for each holding, and then dividing by the portfolio's total market value. Total Carbon Emissions: Total emissions financed by the portfolio. This metric accounts for mandate size by summing the result of '% Enterprise value incl cash financed X Emissions' for each holding. Carbon Intensity: Metric normalizes company's total emissions by output. This metric is calculated as total emissions financed by the portfolio (equivalent to Total Carbon Emissions metric) divided by total revenue financed by the portfolio (% Enterprise value incl cash owned X Revenue) for each holding. Weighted Average Carbon Intensity: Proxy for carbon efficiency of portfolio construction when compared to benchmark. This metric is calculated as a weighted average of each holding's carbon intensity, using % Market value in the portfolio. Each holding's carbon intensity normalizes its total emissions by output, and is calculated as the company's total emissions divided by its revenue. | Data availability may be lower than Data Availability – Carbon Intensity for the two calculations of financed emissions (Carbon Emissions and Total Carbon Emissions). This is because the financed emissions metrics require availability of both carbon emissions and Enterprise Value including Cash for each holding.

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Artesian Green and Sustainable Bond Fund (NZD)

ESG Metrics as of 31.12.23

The Artesian Green and Sustainable Bond Fund has contributed to the abatement of carbon emissions from 21,829** cars since inception*.

The Artesian Green and Sustainable Bond Fund (NZD) reports slightly differently on carbon metrics. If we reported carbon intensity, like we do for the other funds, this is done on an issuer basis, rather than the bond itself. Doing this risks overstating the carbon emissions of the fund, as many of the bonds held in the fund (especially green bonds) abate carbon.

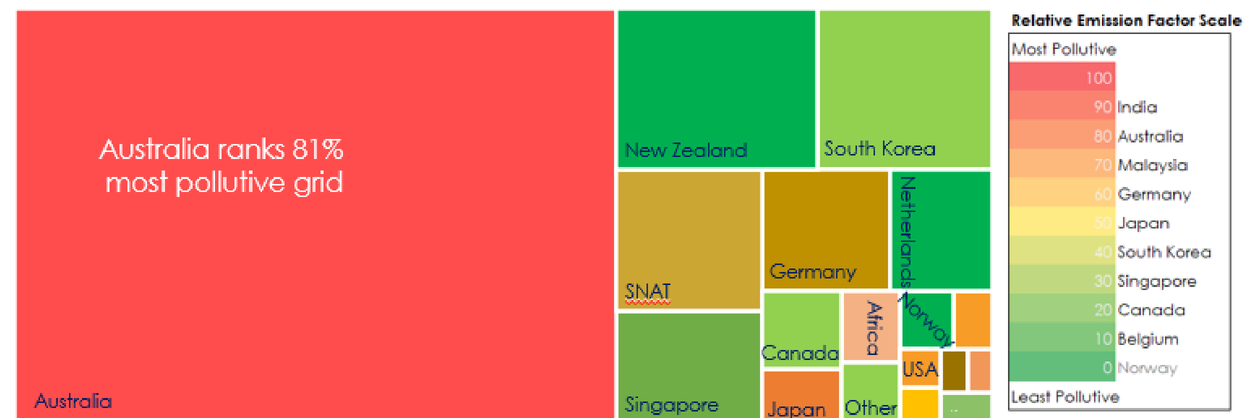
In addition, we have included an Allocation of Funds Heatmap. This shows which countries the Fund is allocating capital, to improve the global green economy. The Relative Emission Factor Scale shows how dirty the energy grid of each country is. It is a normalised scale of the baseline emission factor for electricity generation across 43 major countries - how much gCO2e/kWh is emitted. In essence, the more green capital investors can channel to higher pollutive countries, the higher the impact per dollar.

	Fund
December's estimated carbon abatement	1,733 tCO2e*
Since inception estimated carbon abatement[1]	46,566 tCO2e*
% of Fund used in this estimation	40%

Equivalent to 21,829 cars** off the road for a year, since fund inception*.

One of the primary goals for the Fund is to report regularly on the impact that the bonds we have invested in are having on the environment. As issuers report their use of proceeds achievements, we update our records. We expect this should also lead to a continual increase in the 40% of the Fund used to calculate the carbon abatement.

*Please note the data shown is for the AUD unit class since inception. The NZD unit class launched on 19 June 2023
**As per the ABS's latest Survey of Motor Vehicle Use (link as of 20 Mar'19), Passenger Vehicles in Australia on average travelled 12,600km a year in 2018. As per NTC's latest emission intensity paper (link; as of Jun'20). Passenger Vehicles in Australia on average had an emission intensity of 169g/km in 2019 (or 169.8g/km in 2018). As a result, we defined the carbon footprint of an average passenger vehicle in Australia as 2.14t CO2e per year being [(169g/km x 12,600km) / 1,000,000].



Source: Artesian, EIB; Relative Emission Factor is measured across 43 countries/regions; Oct 2022

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Engagement Devon Sustainability Fund

The Devon Sustainability Fund has frequent engagements with companies held within the portfolio. This quarter the highlight was with Medibank.

The Devon Sustainability Fund aims to generate capital growth over the long term by investing in those New Zealand and Australian listed companies that exhibit sustainable characteristics and which demonstrate credible strategies to improve their outcomes with respect to Environmental, Social and Governance (ESG) factors.

Engagement spotlight

In November 2022 one of the most significant data breaches in Australia to date targeted Medibank, an ASX listed health insurer. The breach covered 9.7 million current and former customers, with the information exposed including service provider names and the codes associated with diagnosis and procedures. This had a material impact on the share price, Medibank shares plummeted and wiped out $1.8 billion in market capitalisation on the day. This in some respects set the precedent for heightened cyber security measures for all businesses.

During the quarter we met with Medibank to discuss this cyber crime issue and the corrective actions they have taken in its aftermath. In what is becoming best practice, Medibank have decided that they will only keep the absolute minimum data that they need. Historically, the more data a company had on their customers and clients had been an advantage. However, the risk of holding this data and having it vulnerable to cybercrime has made it more of a liability. Medibank have also decided to isolate as much data as possible, so sensitive information that is not regularly utilised will be stored offline so it cannot be breached.

Fortunately, in the November 2022 case they had a bespoke IT system in place which meant the data which was stolen couldn't be easily reconstructed. In addition, Medibank believe the cybercrime event was more of a blackmail exercise than anything more sinister. Nevertheless, it demonstrates the need for heightened vigilance and examples of best practice can be applied to all companies who hold sensitive data.

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Engagement TAHITO Te Tai o Rehua Fund

Putting Environment and People before Profit: The TAHITO Te Tai o Rehua Fund is a values-led ethical and sustainable Australasian equities fund for investors who want competitive market returns but equally would like to see their capital applied to a high ethical standard and in investments that are making a positive social and environmental impact.

The TAHITO Te Tai o Rehua Fund provides a holistic accountability on wellbeing using ethical and sustainable screens derived from Māori indigenous values. Māori values and ethics place people and the environment in high priority. This thinking is derived from the ancestral Māori worldview, which can be described as a holistic socio-ecological system that centres on the connection and interrelationship of all things. The process is call 'Te Kōwhiringa Tapu' which translates to 'Careful Selection'.

Engagement spotlight

TAHITO actively promotes its principles through proxy voting. This is used as a tool to advocate for changes related to diversity and equity. This quarter we demonstrate this in practice through the Stockland Corporation AGM proxy votes.

Stockland has low female representation on the Board, with three directors out of nine. TAHITO believes Stockland should have taken the opportunity to increase the number of female directors. The TAHITO Te Tai o Rehua Fund voted for the re-election of Kate McKenzie and abstained from the re-election of Tom Pockett and Andrew Stevens.

Stockland has an extremely high wage ratio of 65.7 to 1. Based upon TAHITO's equity principle, The TAHITO Te Tai o Rehua voted against the remuneration report and against the issuance of performance rights to the Managing Director.

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Engagement Devon Global Sustainability Fund

During the second quarter of 2023, Wellington Management Group (the underlying fund manager of our Global Sustainability Fund) had 30 engagements with names held in the portfolio on a broad range of ESG topics.

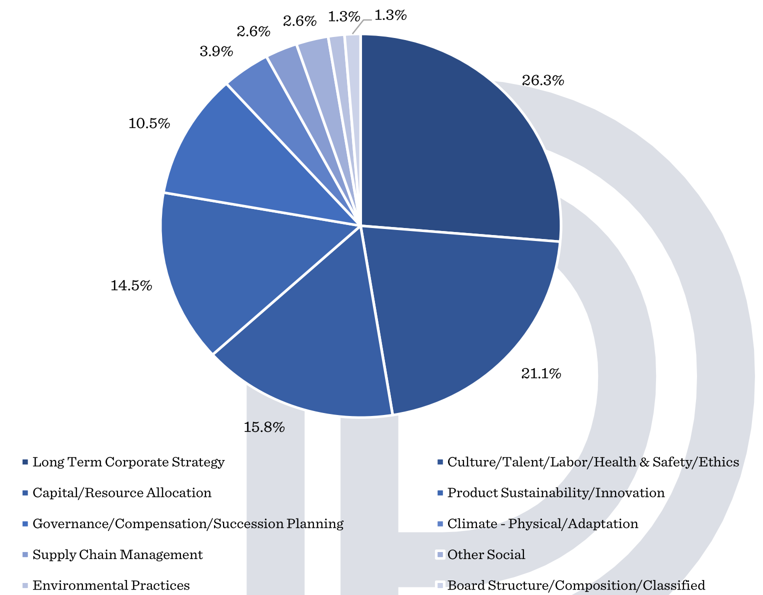
This Fund aims to generate long term total returns by investing in a selective portfolio of global companies that generate high return on capital relative to their peers, and whose management teams and board's display exemplary stewardship to sustain those returns over time.

Engagement spotlight

Wellington had the opportunity to meet with the lead independent director at pharmaceutical company Merck & Co. Merck's board successfully oversaw an important leadership transition in the CEO and in the President of Merck Research Laboratories over the last two and a half years.

With a strong C-suite in place, the board is now set for further refreshment and hopes to bring in greater European, regulatory, and early-stage tech expertise. During Wellington's engagement, they sought to better understand the boards stance and support on the current lawsuit challenging drug pricing negotiations under the Inflation Reduction Act. Merck argues that they are defending their ability to drive future drug discovery and balance this with the pressures for affordability and access to medicines, which they are strongly committed to upholding. Their concern is that the new legislation tilts the balance too far in favour of access. It empowers the government to fix prices unilaterally without consideration of drug discovery economics and could impair Merck's ability to invest long term in drug discovery. The board is very focused on strong capital allocation to help fill the revenue gap that is anticipated as Keytruda goes off patent over 2028 to 2032. This is an area of discipline where the board has strong confidence that Rob Davis as CEO excels.

Engagements by topic



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Engagement Devon Global Impact Bond Fund

During the third quarter of 2023, Wellington Management Group (the underlying fund manager of our Global Impact Bond Fund) had five engagements on ESG topics.

This Fund aims to deliver long-term total returns in excess of the index by investing in a diverse portfolio of global bonds. The Fund seeks to invest primarily in debt issued by companies that are addressing the world's environmental and social problems.

Engagement spotlight

Wellington Funds Management ("Wellington") releases an annual Impact Report for the Global Impact Bond Fund. In our last quarterly update, we provided an engagement highlight from this report and have provided another below. This highlight is a positive 'Governance' engagement they had during 2022.

Wellington engaged with a US health insurer, due to ongoing concerns relating to executive compensation, board composition, and structure. Their engagement included supporting an activist investor who was questioning excessive tenure of board members. Wellington sent a letter to the board and had a follow-up conversation, during which they encouraged management to replace entrenched directors with directors whose qualifications include managed care and CEO experience.

In response to combined pressure from the activist investor and the Wellington team's engagement, five new members joined the board.

In their introductory meetings with the new directors, they were pleased to find evidence of an evolving board culture, including the addition of age limits and consideration of revisions to the executive compensation plan. The issuer also expressed greater openness to shareholder input, calling a special meeting at which management initiated proposals to declassify the board, permit shareholders to call a special meeting, and act by written consent. These measures received strong shareholder support. Management also acknowledged that its executive compensation plan had been above market norms for a prolonged period and asked the Compensation Committee to revise the plan over the next several years. Wellington have subsequently upgraded the issuer's fundamental ESG rating, reflecting their confidence in its ability to manage financially material ESG factors. They will continue to monitor and engage with the management team on its plans to evolve governance and compensation.

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Engagement Artesian Green and Sustainable Bond Fund (NZD)

Artesian seeks to actively engage with companies and issuers in exploring ways to align their business strategy, and operating policies with best practice international standards and ESG frameworks, as well as engaging within the wider industry.

The Artesian Green & Sustainable Bond Fund (NZD) is managed by Artesian Corporate Bond Pty Ltd ("Artesian"). The strategy for the Fund is to invest in a diversified portfolio of Australian and international bonds labelled as Green, Social or Sustainable Bonds that have been screened in accordance with Artesian's screening processes.

Engagement spotlight

A significant part of Artesian's engagement program involves speaking with numerous bond issuers about issuing labelled (green, social and sustainable) bonds in the AUD market. Artesian are actively trying to grow the size and add to the diversification of the AUD market. To that end, Artesian met with Emirates National Bank of Dubai (ENBD) in November 2023 to discuss their inaugural green bond issue they completed in USD in October 2023. Artesian were keen to understand ENBD's ESG credentials and were pleased to learn the following;

- ENBD has been proactively involved as a partner in COP28, supporting clients across sustainable finance and ESG awareness.
- ENBD have been supporting female leadership in 2023, which has increased from 15% in 2022.
- ENDB launched carbon trading and is the first UAE bank to introduce carbon trading to offer carbon emission offsetting solutions to their customers.
- The use of proceeds (UOP) for the labelled bond issues would be allocated to green assets which includes green buildings, renewable energy, clean transportation, pollution prevention, energy efficiency and wastewater management.
- In their loan book, lending to oil, gas mining and quarrying is less than 0.5%. In Dubai the larger sectors of their economy are focused on logistics, transportation, and financial services as compared to Abu Dhabi which is a leading generator of carbon emissions.
- Sustainalytics has reduced their rating from high risk to medium risk.
- ENBD has recently hired a new Chief Sustainability Officer, who has a background in sustainability consulting with one of the big consultants to strengthen their ESG reporting, develop their framework and implement ESG overseas.

Whilst there is still more work to be done, Artesian were pleasantly surprised and look forward to continuing our research on the company should they decide to issue a labelled bond in the AUD market.

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