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Sustainable investing: The 3 things that matter most

Research & Insights

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Ausbil Investment
Management Limited
ABN 26 076 316 473
AFSL 229722
Level 27
225 George Street
Sydney NSW 2000
GPO Box 2525
Sydney NSW 2001
Phone 61 2 9259 0200

For investors focused on the future, sustainable investing is where ESG meets active investment management to generate sustainable alpha with lower relative risk. Nicholas Condoleon, Deputy Head of Equities, Australian Long Only and Måns Carlsson, OAM, Head of ESG, Co-Portfolio Manager Active Sustainable Equity – both portfolio managers for the Ausbil Active Sustainable Equity Fund - share the 3 things that matter most in sustainable investing.

Nicholas Condoleon
Deputy Head of Equities,
Australian Long Only,
Co-Portfolio Manager,
Ausbil Active Sustainable Equity

Måns Carlsson, OAM
Head of ESG,
Co-Portfolio Manager,
Ausbil Active Sustainable Equity

10-minute read

Key points

- Sustainable investing is not just an exciting idea, but an opportunity to match ESG (environment, social and governance) considerations with more sustainable investment outcomes.
- 3 things matter the most when investing sustainably: active ESG engagement, sustainability scoring and genuine integration.
- **Engagement**: Corporate engagement can help reduce risk and improve investment outcomes in an active sustainable investment strategy.
- **Scoring**: Ausbil applies proprietary industry, company and sustainability scoring as an empirical approach to capturing the fundamental ESG characteristics and behaviours of listed companies. Sustainability scores combine with exclusions for controversial activities to trim the index of company names that are unacceptable to our investment universe.
- **Integration**: Scoring and exclusions work together with our active, fundamental research to deliver sustainable alpha over the long term. We believe active sustainable investing offers superior long-term outcomes to passive approaches, especially when accounting for the full ESG risk spectrum and the benefits of dynamic active engagement.

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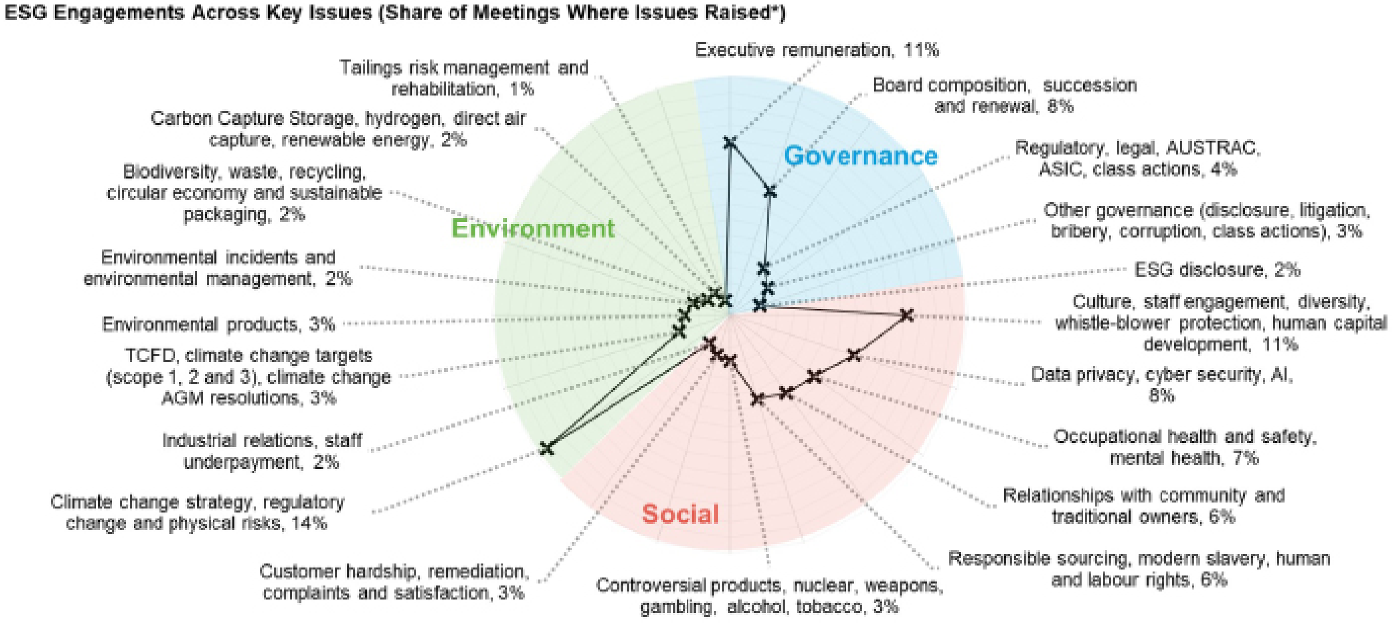
1. Dynamic active ESG engagement is at the heart of sustainable investing

At Ausbil, we are very careful to underscore sustainability with transparent and consistent advocacy and engagement across the spectrum of ESG issues. Ausbil engages with companies for three key reasons. We believe we can have a more positive impact on companies that are in dialogue with us. We want all companies to become more sustainable in their journey, and increase the universe of where we can invest. Finally, we need to understand the distribution of ESG behaviours and outcomes to form a full picture of both ends of the curve; those in which we would never invest, and those we believe are exemplary on a sustainability basis.

When we form a holistic view of a company against the spectrum of our ESG risks (Figure 1), we can then score and rank them on how they are today, and their momentum on ESG issues looking ahead. With a more complete picture like this, we can see which companies are not just generating sustainable earnings outcomes, but are also generating sustainable ESG outcomes. That sweet spot is where our sustainable investment strategy seeks to invest.

Figure 1: Ausbil covers a vast array of ESG risks in our engagement and scoring



Source: Ausbil for year ended 31 December 2024. *Share of meetings where this issue was raised. The sum of these percentages will exceed one hundred percent because multiple issues can be raised at meetings.

Q: How does Ausbil define sustainable investing?

A: For us, sustainable investing can bring together two worlds that help generate sustainable outcomes. These two worlds are sustainability in earnings and the ability to generate earnings growth; and ensuring that these earnings are also sustainable when challenged across the gamut of ESG considerations. In other words, we are governed not just by the pursuit of profit, but by profit that is also sustainable.

The Responsible Investment Association Australasia (RIAA) defines sustainable investment similarly as “a broad-based approach to investing which factors in people, society and the environment, along with financial performance, when making and managing investments.”[1] For us, ESG integration in our investment process also means better informed investment decisions and active ownership.

1. Source: RIAA. (2025, May 2). Responsible investment explained. Retrieved from https://www.responsibleinvestment.org/learn/what-is-ri

About Ausbil Investment Management

Ausbil is a leading Australian based investment manager. Established in April 1997, Ausbil’s core business is the management of Australian and global equities for major superannuation funds, institutional investors, master trust and retail clients. Ausbil is owned by its employees and New York Life Investment Management a wholly- owned subsidiary of New York Life Insurance Company. As at 30 April 2025, Ausbil manage over $19.2 billion in funds under management.

Q: What does a sustainable company look like?

A: Sustainable companies with high scores on ESG, which are leaders in their markets might sound few and far between, but in a deeply considered and researched sustainable investment strategy, these exemplars are there to be found. A great sustainable company is one where the owners and management have established a business model that goes beyond simply becoming a market leader in its segment, but reaches for true sustainability in design and execution. These are companies that 'pay it forward' for future generations, for their workforce, for society, for the environment, and for the future sustainability of the economy. These types of companies seem to find a nexus between being profitable and successful and leaving a legacy that is beneficial for society. There is no one industry, but rather many places where we find these companies.

From an ESG perspective, great sustainable companies demonstrate leadership in governance and board independence, sustainability practices and transparency, diversity and workplace flexibility, quality risk management and safety, information security and great staff engagement. We look for future income streams that are linked to strong and sustainable thematics, excellent management, a low and reducing environmental impact, controlled risks, low or improving carbon impact, and a long, sustainable business model.

Great sustainable companies also demonstrate a strong awareness and ownership of the social purpose and responsibility in their business, an area of growing importance. Finally, great companies are connected with, and tuned into, the environment in which they exist, the health and wellbeing of the global communities in which they operate, their impact on the environment now, and into the future.

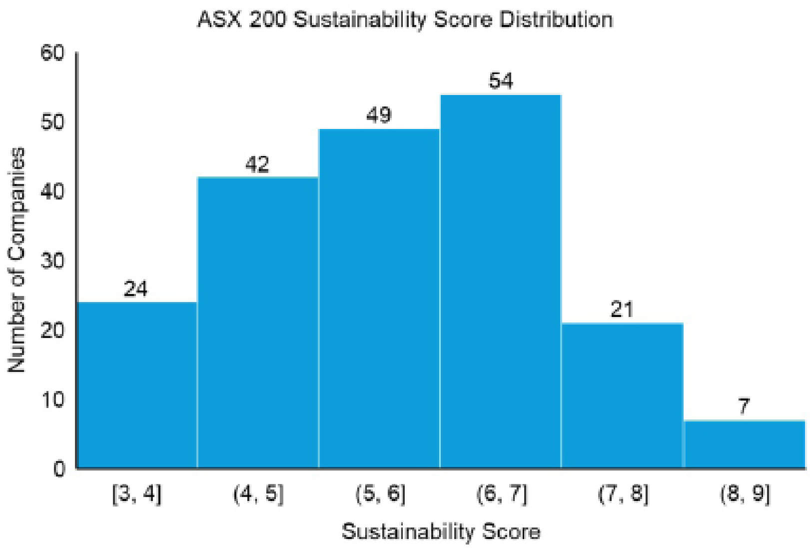
> "From an ESG perspective, great sustainable companies demonstrate leadership in governance and board independence, sustainability practices and transparency, diversity and workplace flexibility, quality risk management and safety, information security and great staff engagement"

2. Sustainability scoring

Q: Can you describe how you score sustainability at Ausbil?

A: We have designed a simple but dynamic scoring system that we have been implementing for almost a decade. We calculate a Sustainability Score by adding together two underlying scores, an Industry Score and a Company Score for each listed company in our coverage. Figure 2 gives a sense of how our Sustainability Scores are distributed, and the potential score ranges.

Figure 2: Distribution of Sustainability Scores for the ASX 200



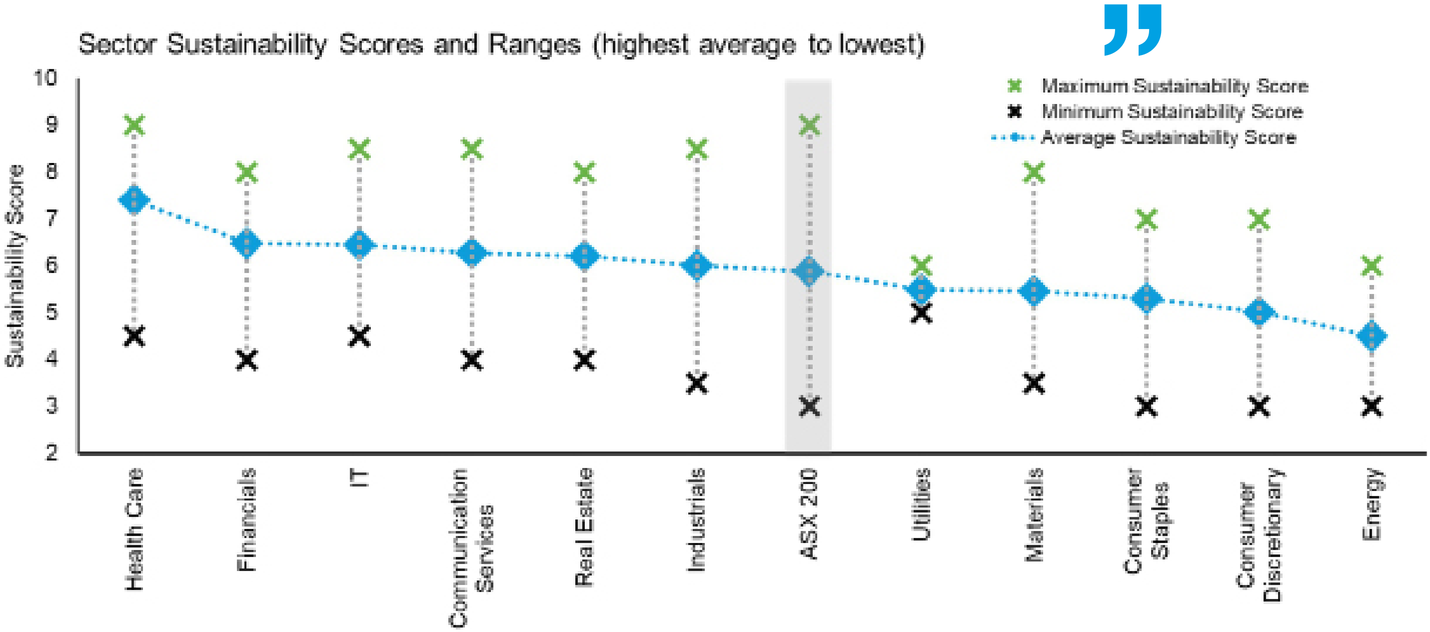
Element	Description
Index	S&P/ASX 200 Index
Companies scored	197/200*
Sustainability Score	• Ranges from 2 – 10 • Sum of Industry Score (1-5) and Company Score (1-5)
Excluded if:	1. company score of 1.5 or less, or 2. industry score of 1.5 or less, or 3. sustainability score of 4 or less, or 4. are explicitly on the excluded list due to material exposure to controversial activities regardless of sustainability, company or industry scores.

Source: Ausbil, 31 March 2025. *Some companies (3 currently) are yet to be initiated in our ESG coverage due to changes in the index.

Ausbil calculates a Sustainability Score for each company on which we initiate ESG coverage. The Sustainability Score is effectively the sum of two underlying scores for each company, the Industry Score and the Company Score. Industry Score measures how we assess a company's exposure to sustainability drivers, with a score of 1 denoting an industry that has the biggest sustainability challenges, and 5 being an industry that is contributing positively to sustainability drivers. Industries are diverse, and so are their scores (Figure 3). Company Score also has a range of 1 to 5, with 1 denoting a recalcitrant company often with major governance and ESG issues, and 5 denoting a company that is a global exemplar on all ESG issues. Thus, summing these scores to create the Sustainability Score gives a range of between 2 and 10.

> "Ausbil calculates a Sustainability Score for each company on which we initiate ESG coverage"

Figure 3: Sustainability scoring across key sectors shows diversity by industry



Source: Ausbil, 31 March 2025. MSCI Level 1 Sectors.

In order to calculate these scores, we have developed a comprehensive but standardised proprietary score card for each company that we maintain dynamically, particularly as we gather primary evidence from our extensive ESG engagement meetings with companies. From Figure 2, it is clear that the Sustainability Score distribution is skewed to the right, meaning that our overall scoring approach is not overly positive and more realistic, giving companies room to develop and improve on their ESG performance.

However, Figure 2 shows the scoring distribution for all companies we cover in the ASX 200, including the companies we exclude because of their exposure to controversial activities or because their Sustainability Score is not considered investment grade (Figure 4). Overall, from our ASX 200 coverage, we have excluded 49 names for the reasons shown in the pie chart, including 17% that are excluded because their Sustainability Score is not acceptable. What remains forms our sustainable investment universe.

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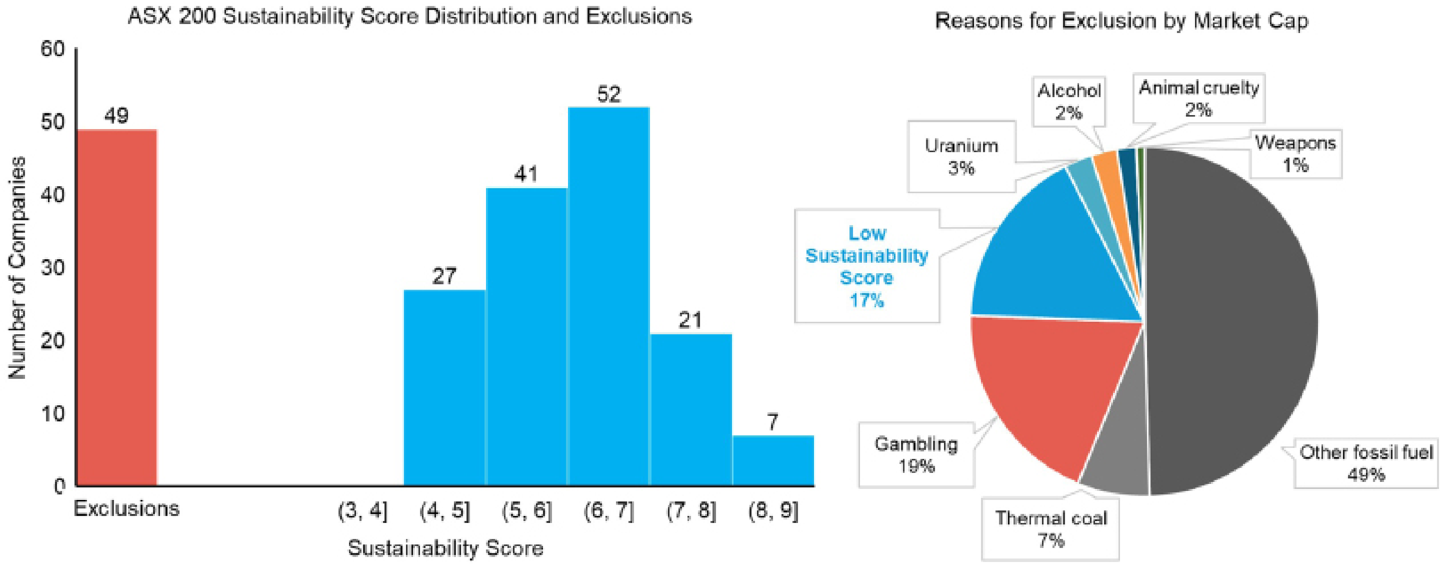
Figure 4: Sustainability score distribution after exclusions



Source: Ausbil, 31 March 2025. *Some companies (3 currently) are yet to be reviewed due to changes in the index.

The strategy's policy is to exclude companies from the benchmark if they demonstrate the following characteristics: a company score of 1.5 or less; or an industry score of 1.5 or less; or a sustainability score of 4 or less; or if they are explicitly on the excluded list due to material exposure to controversial activities regardless of sustainability, company or industry scores.

Exclusion due to poor Sustainability Score. Companies that have poor sustainability profiles in Ausbil's view are filtered and excluded from the investible universe. There are many factors that might contribute to Ausbil's view that a company has a poor sustainability profile, but examples include companies with poor employee safety and/or workplace practices and companies that Ausbil considers having significant, persistent and unresolved corporate governance issues, conflicts of interest in ownership and/or poor board structures.

Exclusion for controversial activity. Ausbil's Active Sustainable Equity strategy has codified a range of ESG exclusions in its investment policy. You can read our exclusions policy here: **Controversial Activity Exclusion Policy**. Effectively, companies with what we deem to be unacceptable exposure to the following areas are excluded: adult content and adult entertainment, alcohol, animal cruelty, controversial weapons and armaments, conventional weapons and armaments, fossil fuels, gambling, human rights violations, old-growth forest logging, predatory lending, and tobacco and tobacco-based products.

The strategy bases its controversial exclusions on a limit measured as a percentage contribution to earnings before interest and tax (EBIT). Most other sustainable investment strategies in the market base their limits on percentage contribution to gross revenue, which, for a given percentage limit, is a significantly larger tolerance than that used by the strategy.

The Sustainability Score gives us empirical data points that we can blend with qualitative fundamental ESG analysis to form a view on company sustainability, and on the momentum in their sustainability journey, whether it is improving or in decline. These two elements are then combined with our approach to finding earnings and earnings growth in our integration of ESG in a sustainable investment strategy.

> "Companies that have poor sustainability profiles in Ausbil's view are filtered and excluded from the investible universe"

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3. Genuine ESG integration in the sustainable investment process

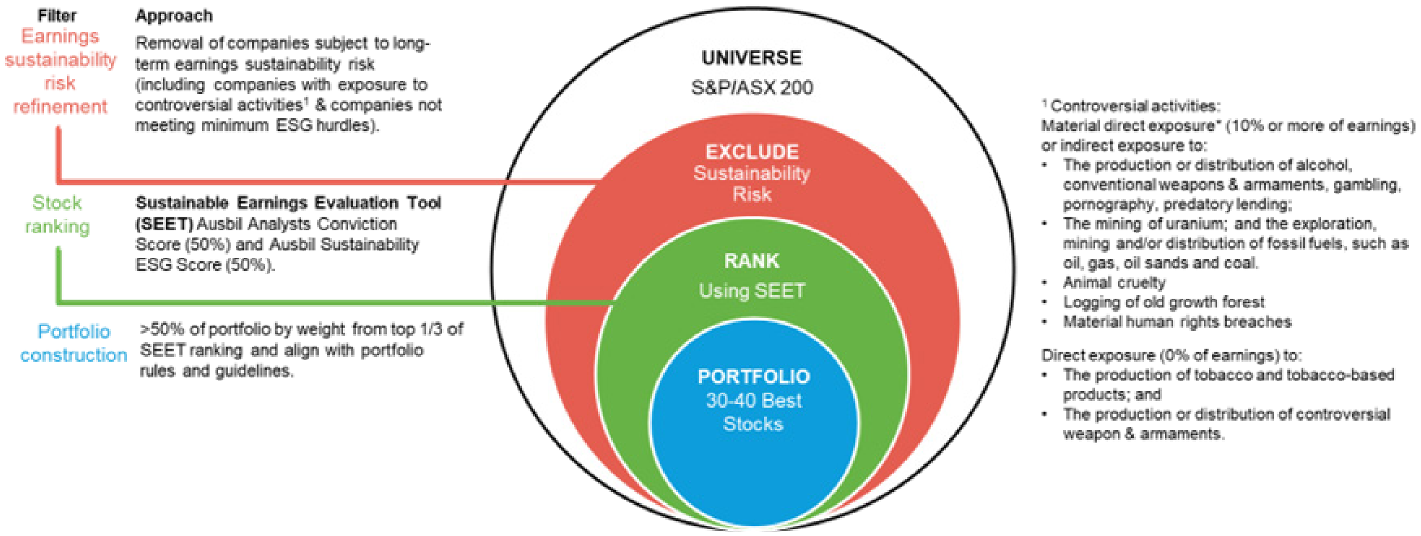
Q: How do you integrate scoring into your investment approach?

A: In our sustainable investing, ESG is integral to how we decide on investments, what we avoid, and in the ongoing re-evaluation process for portfolio companies. We believe that the inclusion of ESG in the investment process, supported by well-founded ESG research and engagement, can improve our ability to identify mispriced stocks, assess a company's earnings sustainability and, ultimately, lead to better-informed investment decisions.

While a lot of qualitative research and engagement is undertaken on ESG issues, scoring on ESG with the Sustainability Score provides an empirical approach to quantifying ESG quality and momentum over time for companies. With more quantitative and systematic scoring, we can complement our top-down macro bottom-up fundamental investment process with the integration of scoring. This is achieved through a proprietary tool we use called SEET (Sustainable Earnings Evaluation Tool). Figure 5 illustrates how we apply ESG scoring and SEET to narrow the index into what we evaluate to be a sustainable investment universe.

> "ESG is integral to how we decide on investments, what we avoid, and in the ongoing re-evaluation process for portfolio companies"

Figure 5: Placing sustainability and ESG at the heart of the investment process



Source: Ausbil, 31 March 2025. *Material direct exposure is defined as 10% or more of earnings from one or a combination of the above controversial activities. In addition, companies that do not meet minimum score(s) from Ausbil's ESG team are also filtered and removed from the investable universe. This controversial activities exclusion screening only applies to the Ausbil Active Sustainable Equity strategy.

Sustainability Scores and exclusions provide the first steps in refining the sustainable universe. Ausbil takes the investment universe, the S&P/ASX 200, and removes companies subject to long-term earnings sustainability risk, including companies with exposure to controversial activities and companies not meeting minimum ESG hurdles. As shown in Figure 3, as at 31 March 2025, this excluded 49 companies from the ASX 200 universe, 17% of which were excluded on the basis of low Sustainability Scores, and 83% which were excluded on exposure to controversial activities. Excluding 3 names Ausbil was yet to initiate for ESG coverage, this leaves 148 companies in the investment universe.

Sustainability Scores then combine with fundamental conviction to provide the second step. Using the SEET system, Ausbil combines Sustainability Scores with our fundamental equity analysts' Conviction Scores with equal weighting, in order to rank the remaining 148 companies in order of sustainability. SEET effectively ranks the remaining companies on how sustainable they are and by how constructive Ausbil is on their earnings growth outlook.

Sustainable portfolio construction. It is from the SEET ranked companies that Ausbil selects a sustainable portfolio. Under our investment approach, at least 50% of the sustainable portfolio by market-cap must come from the top third (33%) of the companies ranked in SEET. Of 148 companies or so that pass exclusion and scoring, a portfolio of 30 to 40 stocks is selected with names that the data and our research shows to be the most sustainable on ESG and earnings growth measures.

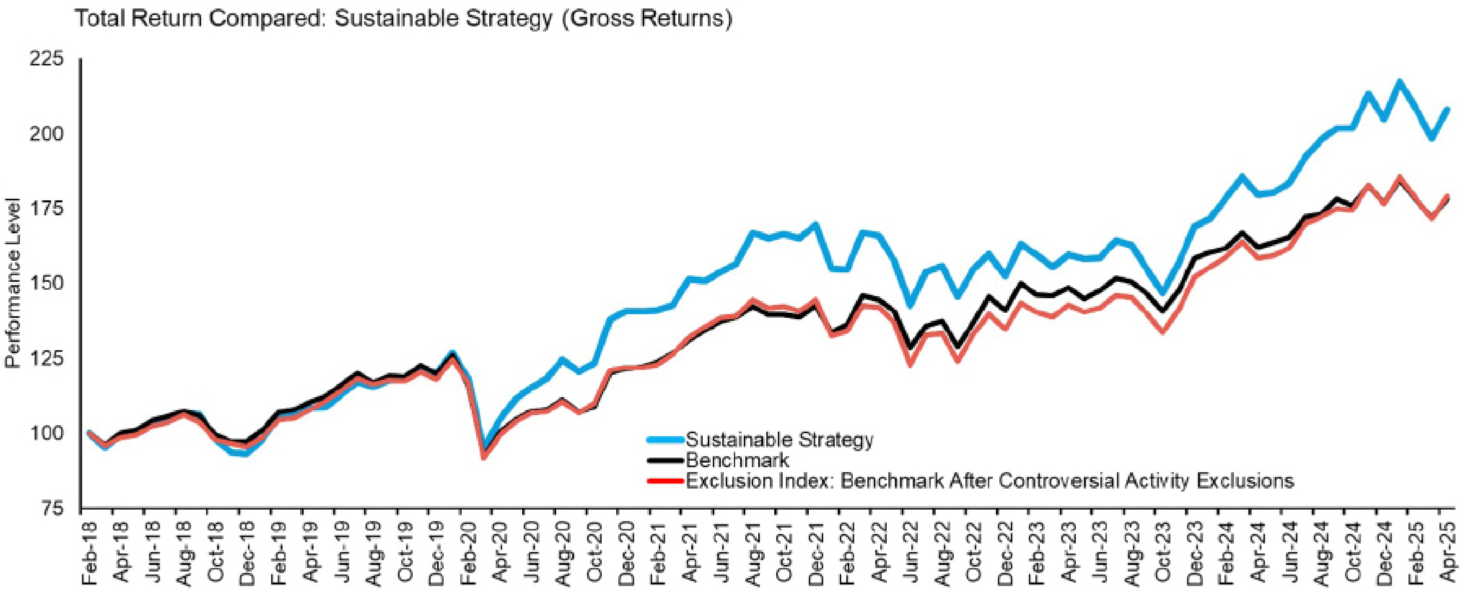
> "Ausbil takes the investment universe, the S&P/ASX 200, and removes companies subject to long-term earnings sustainability risk, including companies with exposure to controversial activities and companies not meeting minimum ESG hurdles"

Questions on performance and sustainability

Q: How does sustainable investing perform?

A: What has become apparent in the research on ESG and sustainable returns is that in our experience investing for sustainable returns with an ESG approach does not sacrifice returns, and may indeed enhance both the risk and return sides of the investment coin. We have seen this play out in our sustainable investment portfolio, and that a sustainable approach reduces investment risks in a material way. Figure 6 illustrates the excess returns the Ausbil Active Sustainable Equity strategy has been able to generate since inception compared to its benchmark (S&P/ASX 200 Accumulation Index).

Figure 6: Sustainable performance and the impact of exclusions (gross of fees)

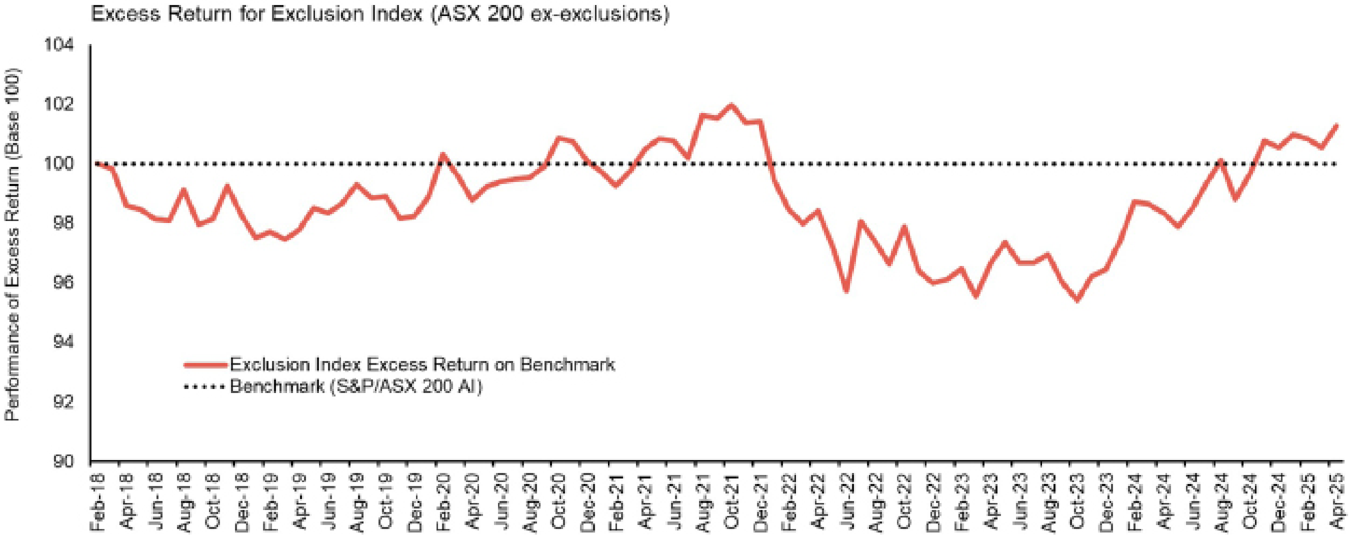


Source: Ausbil, FactSet, 30 April 2025. Sustainable Strategy is the performance of the Ausbil Active Sustainable Equity Fund (gross of Fees) since inception in February 2018. The gross of fees data is being used for illustrative purposes only. See later in paper for a net of fees return table. Benchmark is the S&P/ASX 200 Accumulation Index. Benchmark with Exclusions is the S&P/ASX 200 Accumulation Index less excluded companies based on Ausbil's controversial activities exclusion policy. Past performance is not an indicator of future performance.

Q: What is the impact of the scoring and controversial activity exclusions?

A: Interestingly, the impact of excluding companies is mixed. If you look at passive approaches to sustainable investing that exclude companies as their methodology, the result may not be that much different to the outcome of the benchmark. Figure 7 illustrates the cumulative excess return (return less the benchmark return) for the Exclusion Index (the benchmark S&P/ASX 200 Accumulation Index without the companies Ausbil has identified as exposed to controversial activities).

Figure 7: Performance of the exclusion index

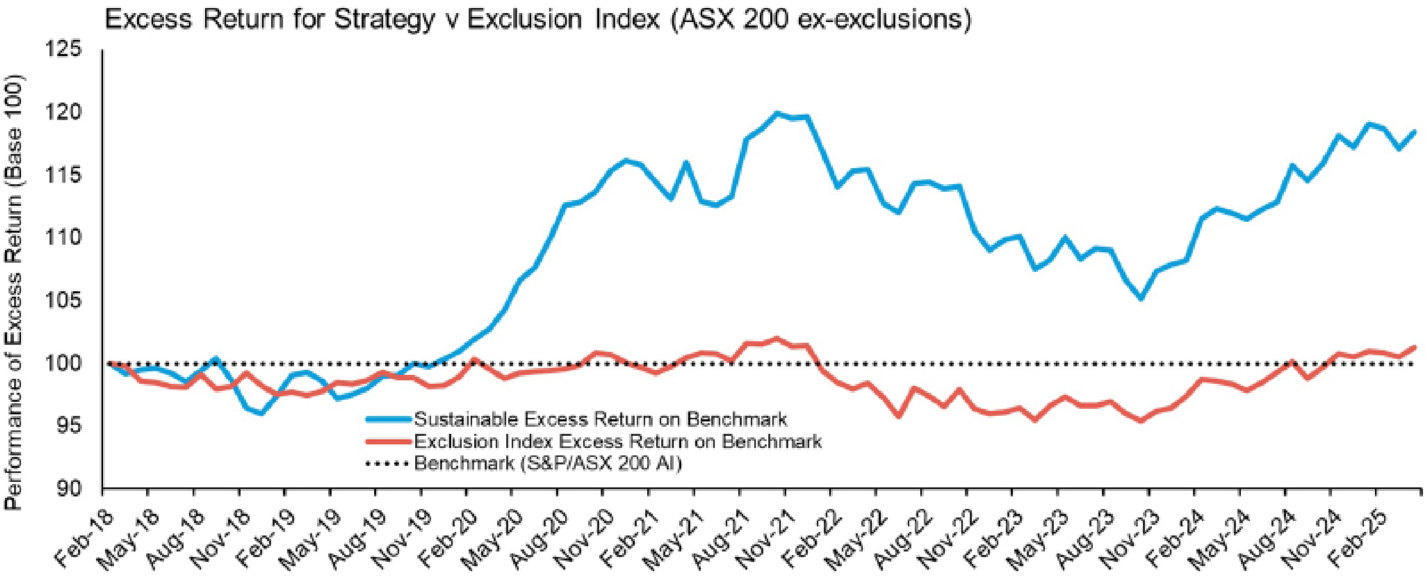


Source: Ausbil, FactSet, 30 April 2025. Benchmark is the S&P/ASX 200 Accumulation Index. Benchmark with Exclusions is the S&P/ASX 200 Accumulation Index less excluded companies based on the Ausbil Active Sustainable Equity strategy's controversial activities exclusion policy.

Across the series in Figure 7, tracking performance since the inception date of the Ausbil Active Sustainable Equity strategy, the Exclusion Index shows extended periods of underperformance compared to the benchmark. Relatively passive approaches such as exclusions do not make the most of the available alpha tools, as can an active investment approach that takes full advantage of the ESG intelligence that comes from dynamic active engagement with companies. In terms of comparing the excess return performance of an active sustainable equity approach against the performance that comes simply from just exclusions, we have seen a significant difference across the life of the Fund (Figure 8).

"Interestingly, the impact of excluding companies is mixed. If you look at passive approaches to sustainable investing that exclude companies as their methodology, the result may not be that much different to the outcome of the benchmark"

Figure 8: Comparing active alpha to exclusions on performance (gross of fees)



Source: Ausbil, FactSet, 30 April 2025. Sustainable excess return is the performance of the Ausbil Active Sustainable Equity Fund (gross of Fees) since inception in February 2018. Benchmark is the S&P/ASX 200 Accumulation Index. Benchmark with Exclusions is the S&P/ASX 200 Accumulation Index less excluded companies based on Ausbil's controversial activities exclusion policy. Past performance is not an indicator of future performance.

From Figure 8, we can see that compound excess returns from the Ausbil Active Sustainable Equity strategy steadily advance over time from full active management, with the simple exclusion policy hugging close to the index on compound excess returns.

We think that ESG helps perfect a long-term investment approach as it helps us make investment decisions that look at a kaleidoscope of depleting and terminal risks to a business model that both traditional analysis and simplistic exclusion strategies usually miss. Genuine active engagement means maintaining an ongoing conversation with all companies in the potential investment universe, even when they currently have un-investable ESG scores.

The theory is one thing, but experience is another. Since establishing Ausbil's active sustainable equity strategy, the application of deep ESG research has significantly improved the risk-adjusted performance of our sustainable portfolios. We have seen this in examples of controversies and value-depletive companies we have avoided due to ESG research, and also in the avoidance of unforeseen risks that can be identified by an ESG approach, but are hard to quantify.

"Since establishing Ausbil's active sustainable equity strategy, the application of deep ESG research has significantly improved the risk-adjusted performance of our sustainable portfolios"

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Q: How has the Ausbil Active Sustainable Equity Fund performed?

Ausbil's Active Sustainable Equity Fund has generated a net long-term performance since inception of +10.9% per annum (after fees), outperforming the benchmark (S&P/ASX 200 Accumulation Index) by +2.6% pa since 31 January 2018 on a net basis (Table 1).

Performance to 30 April 2025	Active Sustainable Equity %	S&P/ASX 200 Accum %	Out/under performance %	Proxy Bench^ %	Value Added %
1 month	4.7	3.6	+1.1	4.3	+0.4
3 months	-4.3	-3.7	-0.6	-3.4	-0.9
6 months	3.2	1.2	+1.9	2.7	+0.4
1 year	15.8	9.8	+6.1	12.9	+2.9
2 years pa*	14.1	9.4	+4.7	11.9	+2.2
3 years pa*	7.8	7.2	+0.7	8.0	-0.2
4 years pa*	8.2	7.9	+0.3	7.9	+0.3
5 years pa*	14.8	12.1	+2.6	12.5	+2.2
7 years pa*	11.1	8.6	+2.5	8.9	+2.2
Since inception pa* Date: 31 January 2018	10.9	8.3	+2.6	8.5	+2.4

Source: Ausbil. *Annualised return. ^ Proxy benchmark S&P/ASX200 Accumulation Index ex exclusions. The strategy currently excludes material investments in controversial activities such as uranium, thermal coal, gambling, alcohol, tobacco, weapons and armaments, and pornography. From 1 Jan 2021, this exclusion list was strengthened to include investing in exploration, mining and/or the distribution of fossil fuels, including oil, gas, oil sands and coal, animal cruelty, logging of old growth forest, predatory lending and material human rights breaches. Past performance is not a reliable indicator of future performance.

"Another is the future of health for an ageing population, and medical and pharmaceutical developments that further humankind"

The outlook for sustainable investing

There is a multiplicity of sustainable themes in which to invest. Some include renewable and transition energies; energy transport and storage; batteries and EVs; and the electrification of things. Another is the future of health for an ageing population, and medical and pharmaceutical developments that further humankind. Another area of interest is in companies with zero-carbon plans and carbon-positive business models. Waste management and conversion, and the recycling industry is another area. The building of sustainable infrastructure (energy, communications, transport, utilities and technology), and building sustainable communities in real estate also offer interesting options. Investment in companies that excel at treating people well, and are exemplars on ESG measures in their industries is another area of opportunity. Artificial intelligence, cybersecurity, privacy, access to technology, data, electronic storage and the internet-of-things is also offering options. Of course, from a macro and bottom-up fundamental perspective, these themes are not always in favour, but as long-term themes, they offer investors the potential for long-term growth.

We believe that the market is rich with sustainable investment opportunities. The time is also right as complex but unstoppable global change is seeing the world's governments and companies drive towards achieving sustainability goals. We see a rich vein of opportunities across the market, and with our deep proprietary ESG research and engagement, we can identify the most exciting names for our strategy.

In ESG, there has not been a more exciting time than today. While we have been doing this for many years, in the past, companies often grudgingly incorporated ESG and sustainability in their disclosures. With the convergence of investor demand for change, a world hungry for more sustainability outcomes, and events like the energy shock making sectors like renewable energy critical to national security, we think it will not be long until sustainable strategies start to dominate the portfolios of astute investors.

More information

For more information on Ausbil's Active Sustainable Equity Fund visit **www.ausbil.com.au**.

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