**ASX Code: AEF**

**22 November 2012**

# Chairman and Managing Director's Addresses to the Annual General Meeting

## Andre Morony – Chairman, Australian Ethical Investment Limited

Good evening everyone and welcome to the 2012 Annual General Meeting of Australian Ethical Investment.

Before we begin proceedings, I would like to acknowledge that we are here today on the land of the Wurundjeri people. The Wurundjeri people are the traditional custodians of this land of the Melbourne area and form part of the wider Aboriginal nation known as the Kulin Nation. We also pay our respects to the Elders of the Kulin Nation both past and present.

The 2012 financial year has been a very interesting one from an Australian Ethical perspective. As has been the case for the last few years the external environment has again been difficult and while I will come back to that shortly, I do not want to focus on it for too long. We cannot control what happens outside our walls and I would much rather we focus on the things we can control and on the many positive things that have happened within our company over the last little while.

Australian Ethical has gone through some significant changes in recent years and in many ways is unrecognizable from the company it was three or four years ago. As the global financial crisis descended upon us in 2008 we were a complacent, not very efficient, organisation with a factionalised board and a less than ideal workplace culture. Costs were sky-rocketing. For example over the three years to June 2009 costs rose by 50% and staff costs by over 60%. As well, the company continued to launch new products with little regard to whether those products would be profitable. The bloated cost structure meant that the company's profitability relied on high fees and in particular on high up-front fees. In short, we were a ship sailing in favourable winds but with a lot of ballast that made us completely unsuited to the weather conditions about to descend on us by way of the global financial crisis.

Phil Vernon will go through in more detail the transformation that has taken place in Australian Ethical since that time and in particular will talk about what has been achieved over the last year.

I want to emphasise though that there is one thing that has not changed inside our company and that is the way we go about investing our clients' money. Our commitment to our ethical charter is unwavering. We use the same ethical advisory team we always have and they analyse potential investee companies in the same way they always have. A senior manager from our ethical advisor recently commented that he has never seen Australian Ethical's commitment to the ethical charter as strong as it is today. We are the leaders in this space and we are proud of that. Our commitment to the ethical charter is inviolate.

More and more Australians are thinking about the world they live in and are concerned about some of the things they are seeing happening around them. They are concerned about the world they are bequeathing to their children. Our job is to make them realize that the financial clout given to them by their growing superannuation balances is the biggest weapon they have to help change that world.

For further information contact: Tom May, Company Secretary
**Phone** 02 6201 1988 **Email** tmay@australianethical.com.au **Fax** 02 6201 1987
**Web** www.australianethical.com.au/asx-announcements **Post** GPO Box 2435 Canberra ACT 2601

We don't need or want to change our ethical stance to grow our business. What we did need to do was to reduce our costs and enhance our service and products to make sure that when the current difficult financial head-winds abate, we are still around to take advantage of the underlying growing awareness of the benefits of socially responsible investment.

Our net profit after tax result last year was $402,000, down considerably from the previous year's $1.1 million. There were some one offs that boosted the previous year's result and held down this year's results and adjusting for these, underlying profit after tax was down 12% this year.

I would like to comment on two of those "one offs".

The first was the $210,000 write down of Australian Ethical's Canberra property. Unfortunately it seems that the property market is not fully valuing the environmental enhancements we made to our building at great expense some years ago. This is disappointing.

The second one off I wish to comment on is the $125,000 direct costs we incurred in respect of the campaign being run by a group of shareholders against the company. Without these costs underlying profit would have been flat last year. Not a bad result in a year where the Australian share market fell by over 10% with a consequent flow on to our funds under management and our revenues. I should also say that we have had a closer look at this $125,000 in costs and have realized that some of it should have been properly and legally borne by the people who called the Extraordinary General Meeting. We have taken steps to recover these costs on behalf of all shareholders.

I do not want to spend too much time talking about this campaign against the company that some shareholders are continuing to run, despite the vote against them at their Extraordinary General Meeting and their promise to respect shareholder wishes. The Board and Management of Australian Ethical would rather focus on driving the company forward.

Let me just say this. On the first of July this year Australians woke up to the first day of life under a carbon tax. I can't remember what the weather was like that day, but I do know that despite the dire warnings of some, the sky had not fallen in and there were no cobras or even a python to be seen on the streets of Australia.

Well, despite the dire warnings regularly sent out by our dissident shareholders, usually intermingled with highly personal and defamatory remarks about the company's Board and management, the sky is not falling in at Australian Ethical either.

- Our staff are happy and I refer everyone to the latest staff survey results which Phil Vernon will flesh out later;
- Our costs are not out of control. In the year just ended they were basically flat;
- Key management personnel compensation is not up 24% and no serious analyst would calculate the increase in compensation in the way the dissident shareholders have. In fact redundancy payments made to three of the dissident shareholders last year account for the bulk of the increase in key management personnel compensation. Adjusting for this and properly calculated, key management personnel compensation rose by about the same rate as average weekly earnings in Australia last year;
- Profits are not in a terminal slump. Our current half year results are on track for a more than 60% rise on the previous corresponding period; and
- We are not being deserted by our business partners. In contrast the changes we have made are being

welcomed by them. This is evidenced by the recent comments made by Lonsec, a key rating agency, who said and I quote,

"*Lonsec observes that the Board of the firm and senior management have made encouraging progress in improving the overall professionalism and investment culture over a number of years. This trend has continued in the past 12 months……pleasingly, these developments have been achieved without deviation from its commitment to provide responsible investment products"*

The recent award by SuperRatings of the Rising Star Award to our Superannuation fund recognizing improvements made to that fund's pricing and features is further testament to the fact that our business partners are embracing us, not deserting us.

Frankly the "chicken little" calls of the dissident shareholders are becoming ludicrous. Unfortunately they show no sign of stopping. The dissidents have already started lobbing in resolutions for the 2013, yes the 2013 AGM. They include the re-nomination of Director candidates being put up to this AGM. None of their nominations for this meeting or next year's have been accompanied by any biographical details for the candidates being nominated, which is why the papers for this meeting do not contain any. This is curious.

I would have thought, for example, that our shareholders would like to know that one of the people they are voting on as a potential director is a director of a company that has, and I quote from that company's web site

*"focused primarily upon the development of large, repeatable resource plays in the US where horizontal drilling, advance, massive fracture stimulation and enhanced recovery technologies have provided the means to economically develop and produce oil and natural gas from unconventional shale formations*"

It does appear that our company will have a second strike against its remuneration report this year. While I respect shareholders right to vote how they think fit, I note that the resolution about something as non-controversial as the appointment of our auditor has a vote against it of a similar magnitude to that of the remuneration report. The vote against the auditor is not about the auditor at all and neither is the vote against the remuneration report about remuneration. They are both very much just "spoiling' votes by people trying to obstruct the normal operations of the company. Our remuneration arrangements are not excessive. Directors have had no increase since 2008 and I doubt any employee would be paid above the median of comparable jobs in comparable companies.

Australian Ethical's corporate vision is to

*"promote a sea-change in community wide practice such that all investment will be undertaken with an ethical purpose as well as in pursuit of a competitive return for chosen risk".*

I find that vision inspiring and the Board of your company wants a company that is strong enough to carry out that vision. Underlying the tough cyclical external environment that we are currently in the middle of is a fantastic long term shift that will be very positive for ethical investment companies like us. More and more people are becoming socially and environmentally aware and shareholders of Australian Ethical should be proud that they own a company that has been in this space for 25 years. The company's best years are I believe still ahead of it.

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I will finish up by firstly welcoming our newest Board member Steve Gibbs who is submitting his name to your vote for the first time. Steve has a distinguished CV in the field of ethical investing and was personally invited by the then United Nations Secretary General to be a part of the Committee that established the United Nations Principles for Responsible investment. Secondly I want to thank the other Australian Ethical Board member submitting herself for election this year Justine Hickey. Justine is the longest serving AEI Board member and is also the long time Chair of our Investment Committee. Justine has announced that this will be her last term as an Australian Ethical Director. I urge you to support both Steve and Justine's nomination.

Finally I wish to thank our company secretary Tom May for the efforts he has put in for your company this year despite challenges that no employee should have to go through in a life-time let alone a year.

**Phil Vernon, Managing Director, Australian Ethical Investment Limited**

Thank you Andre

As Andre said over the past few years we have been on a journey to improve our operations, our products and our services.

Why was this necessary?

It was necessary for two reasons:

1) Firstly, the company wasn't reaching its full potential even in boom times. Why do I say that? Based on recent research 2.3m people (11%) want to invest ethically with 1m (8%) willing to do so even if it meant compromising investment returns, fees and other factors. This is supported by the fact that 1.2m people voted Green at the last Federal election. We have 18,000 members. Somewhere in between that 18,000 and at least the 1.2m and even the 2.3m is our full potential.

Why aren't all these people our clients?

   a. One is reach – they either aren't aware of us or don't have access to us.
   b. The other is that they might like what we do ethically but there is some other reason they don't invest.

This research plus our own feedback from clients said:

   a. For those that knew us we were most trusted on ethics but not on the other factors – investment returns, fees, features etc.
   b. High fees has been a large factor in people leaving but also other features

2) The world has changed fundamentally and if we didn't change we ran the risk of going out of business. It's that simple. To illustrate the impact on Australian Ethical, I use two simple examples:

   a. Our revenues are largely based on funds under management which are largely dependent on the market. The ASX All Ordinaries Index is 21% lower today than before the onset of the global financial crisis representing a drop in revenues of some $1.6m.
   b. We were heavily reliant on upfront fees of some $1m. These sorts of fees were dropped by most other fund managers years ago but were also soon to be legislated away.

This totals $2.6m. At our maximum in the boom times they were only ever as high as 1.8m. The year before I arrived our profits were only 1.2m.

It's for these reasons that we needed to change. We needed to work out how we could be bigger and reach those other 1m people and, quite simply, we needed to become more effective and more efficient.

Our journey to correct this has taken the following path:

- Get the basics right - client service, operations, right skills
- Get our products right – features and pricing
- Increase our reach – branding review, sales and awareness raising

Last year I talked of improvements we'd made in respect of areas of client service and our operations. This year our main focus has been on improving our products whilst also continuing to improve our operations and client service in two very important areas.

**Product improvements**

This year we have made a number of improvements to fees and features of some key products.

*Cash trust (formerly the Income Trust)*

One outcome of the global financial crisis is that people are taking their money out of the share market (and share based managed funds) and putting in "safe havens" such as term deposits until the turmoil abated and our clients are no different. We wanted our Income Trust to be that vehicle but feedback from clients was that it was too expensive and its portfolio was too risky.

We have subsequently reduced its fees and restructured its portfolio to be more attractive with the aim of capturing some of that money and encouraging clients to stay with us.

*Smaller Companies Trust*

The Smaller Companies Trust is our flagship investment fund with a strong investment performance track record returning 9.5% pa over 10 years some 3.4% above its benchmark. In the past 12 months it has returned 21% some 7% above its benchmark.

This fund has significant appeal to a much wider audience particularly through the broader Adviser market. But there were fundamental issues preventing it from getting proper traction in that market. These were:

- It was a mix of Australian equities and International equities. More particularly the international equities component was detracting from the performance of the trust. Feedback from Advisers was that they preferred it to be Australian equities only. We listened to this and divested the international component
- Its wholesale fees were high by market standards. By the time Advisers added their fees on top it was unattractive to them
- We didn't have a proper wholesale unit. Whilst this may sound like a legal technicality it was significant. Our products were retail products with complicated rebate structures which Advisers and platforms hate. We fixed that.

*Larger Companies Trust*

We made the same improvements to the Larger Companies Trust as the Smaller Companies Trust other than the portfolio changes – that is we reduced the fees and introduced a wholesale unit. It remains a mix of Australian and International shares.

*Superannuation Fund*

Our superannuation fund is our most important product. It has most of the funds under management and generates most of our profits. It is critical that we constantly ensure that it is attractive with pricing and features that clients expect.

We made a number of significant improvements to our fund during the year:

- we reviewed our insurance arrangements and will be introducing improved features from March next year including cheaper rates, automatic D&TPD cover, Income Protection and transfer in arrangements
- we undertook a comprehensive review of superannuation administration arrangements and will be moving our administration to Russell Investments also from March next year which will provide better service and lower administration costs to members
- most critically we removed the upfront fees from 1 July 2012. Through a series of other fees and expense changes – increasing our member fee, increasing our reimbursements to that which we're legally entitled but for which we had previously ignored, lowering our management fee – we were able to remove the fees with minimal impact on shareholders and leaving the fund with a much more commercial and market standard package of fees and charges.
- we will be introducing Limited Advice for clients from March next year via our arrangements with Russell. This is an important benefit to clients who have made the decision to be with our fund but simply want certain specific advice either about which investment options may be right for them, advice regarding transition to retirement or similar specific advice without taking into account their full personal circumstances
- we are also working on – as are most providers – our MySuper product which we expect to be available by mid next year

These have all been significant changes to our superannuation fund and we were extremely pleased to receive the Rising Star award from SuperRatings recently in recognition of all of our efforts to improve the product. This was significant. The award was not just the best ethical fund. It was awarded from a pool across the market. It is consistent with what we want which is for our clients to not just be satisfied that they get the best ethics, best investment performance but also best practice products and services.

*Advocacy Fund*

We will also be making changes to our Climate Advocacy Fund. This has three aspects to it:

- We will be broadening its mandate to non-climate related issues. Whilst climate change is one of the biggest risks the planet faces, there are many more issues of concern to us that we wish to advocate on. We actively engage with companies as part of our normal investment process. Areas in which we have taken stands include tobacco, coal seam gas and bank disclosure of exposure to illegal forestry. We wish our Advocacy Fund clients to participate in that.
- The fund has operated in a way that allows us to unilaterally put resolutions to companies on issues of concern. The structure underlying this is complex and requires Australian Ethical to actually fund the purchase of the shares on its own balance sheet and incur the brokerage costs. This has led to large expenses and potential investment losses that are unsustainable. Effectively shareholders are subsidizing fund investors. We will be dismantling the nominee structure.
- We will be changing the investment structure away from investing in an index fund to an ethically screened fund. This fund will buy stocks in companies with which we wish to advocate against but will only remain invested whilst the engagement is active. We had a lot of feedback from investors concerned about investing in "bad companies" with which we may never actively engage. The new arrangements will be much more consistent with our ethical charter.

**Improving our reach – brand review, sales and marketing initiatives**

I'd like to now talk about our sales and marketing activities:

*Branding*

We have recently conducted a refresh of our brand and supporting material based on our research. This had the following key elements:

- It is an evolution, not a revolution
- It is aimed at making our approach to ethics more accessible and understandable
- It is aimed at raising the importance of financial aspects – investment performance, financial security, peace of mind
- It lifts the social aspects of what we do

*Direct marketing*

We continue to market our services through similar activities as before but with some refinements:

- Sponsorship and support at sustainable, environmental and ethical trade fairs
- Continued support of that area of the media with an increased emphasis on the financial press
- More bespoke advertising
- Increased use of social media
- Increased emphasis on online communication and ease of access
- Client seminars

*Advisers*

We continue to better service the Adviser channel and make our products and services attractive to that channel.

This has been a vexed subject at Australian Ethical for many years. This company appeared for many years to have almost a philosophical objection to Advisers and the Advice industry and everything that supported it.

Whilst the structure of the industry has a lot of issues with it in the past – and this is exactly what the recent legislative reforms are aimed at correcting – the fact is that many of our clients want and need Advice. We often have clients save with us for many years only to see an Adviser who is either unfamiliar with our products, sees that they are not rated by the rating agency they use or are not accessible through the platform they use. The client will then reluctantly leave us.

Making our products accessible to the Adviser market:

- Accesses many clients we may not otherwise access; and
- Retains clients we may otherwise lose

*Superannuation Employers*

Our superannuation product is our primary product. It is critical to the growth of this company that we

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service employers well. The inflows into our superannuation product are extremely strong and % come from employers. There is a whole sector of green employers for which we should be the default fund. We continue to commit focus and resources to this sector including:

- Adam Kirk joining us last year with specific experience in corporate superannuation
- More client service resources specifically dedicated to servicing employers

**Continuing to get the basics right – further improvements to service levels and operations**

We finalized the Garradin (our portfolio administration system) implementation project and surrounding process improvements and were able to meet service standards that we had never met before. To state it more specifically from 1 January 2012 we completed our distribution within 2 working days and were back up to date with our daily unit pricing within a day after that. Previously it would take us some 3 to 4 weeks. Consequently we had a very poor reputation amongst Advisers and platforms.

**Reduced costs**

As we progressively reduce our fees to be more attractive and competitive we need to become more efficient otherwise we will simply go out of business. As Andre pointed out, the costs of the company had increased significantly in previous years. 50 people managing $600m was far too high by any industry benchmark. We have reduced our staff numbers over the past few years from 50 to 38. Whilst some of this was done, unfortunately, through redundancies, wherever possible, we achieved it through natural attrition. That is, as vacancies arose, where possible, we did not replace the role. [6.8] positions were reduced in this way.

I point out that, whilst our head count has reduced by more than 20% our costs will not reduce by the same amount in the near term for a number of reasons:

- Staff costs are a significant but not the only cost
- We have progressively been getting our people up to market salaries. In particular our investment team which were below market. This has its impact on average salary costs.
- Some positions have temporarily been filled by contractors and consultants as we bring in specific expertise to get us through process improvement projects. It has been this approach that allowed to finally meet our service standards
- Some of the staff costs that have reduced are charged to the funds not the company and so will show up as lower costs to the funds

**Staff morale**

In order to achieve what we want to achieve it is critical that we have a highly motivated and committed workforce. To guide us in our efforts in providing the right environment we conduct regular staff surveys. Historically this was done bi-annually. Last year we committed to do it annually.

One of the reasons we conduct staff surveys is to get an objective measure of the feeling of staff as a whole. At any time in any organization there will always be individuals who are unhappy. Sometimes they can be the loudest or command the most attention for whatever reason. It's important to have a dispassionate, objective process that cuts through that noise and gives us a correct picture.

We have recently received the results of this year's survey and I'm very pleased to report that it has shown a significant improvement over last year's results which were, in turn a significant improvement over the previous survey conducted in 2009.

Particular areas of improvement were:

- Job satisfaction (increased to 100% up from 97%)
- Satisfaction with communication (74% up from 63%)
- Learning and development opportunities (78% up from 54%)
- Confidence in the board (77% up from 59%); and
- Confidence in the management team (81% up from 66%).

The results can be viewed in more detail in our Employee Status Report which was released to the ASX on Friday and can be downloaded from our website.

We're very pleased with the results particularly after a year of significant change.

**Conclusion**

Australian Ethical is a very special company that occupies a unique place in the Australian financial services landscape. We are the highest conviction ethical investment manager in the country and offer a genuine ability for people to align their savings and investment needs. We are uniquely placed to service the growing concern that people have for the future of our planet and society and a growing desire amongst the general populace to behave, consume and invest in a more ethically and responsible way.

This has been a significant year for Australian Ethical and we have achieved a lot in extremely challenging circumstances – the market conditions, regulatory uncertainty and change not to mention the distraction of the shareholder action.

It's been a year which has been about setting ourselves up for the future and creating a business that offers our clients:

- Highest conviction to ethics
- Competitive long term investment performance
- Best practise products and services
- Supported by a motivated and committed team

...and ultimately a business that is here for the long term.

I'd like to finish by re-emphasising four key milestones from the past year:

- The award by SuperRatings recognizing the improvements we have made to our superannuation fund
- The continued support by Lonsec recognizing the steady improvements made to our investment processes and team
- The staff survey which demonstrates that staff are behind us and supportive of the direction we are taking the company
- The fact that we have gotten over the hurdle of removing the upfront fees whilst looking forward to healthy profits

Each of these underline that we are on the right track for a successful future.

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