MERCER

TALENT • HEALTH • RETIREMENT • INVESTMENTS

2015 THEMES AND OPPORTUNITIES

JANUARY 2015

MARSH & McLENNAN COMPANIES

Investors need to challenge existing beliefs and processes, introduce exposure to less familiar return drivers, and consider less-constrained mandates.

2015 looks set to mark the start of a shift away from synchronized monetary stimulation across the developed world toward increasingly divergent policies. This reflects a growing disparity between the improving economic performance of the US and the UK and weakness in the eurozone and Japan. Emerging economies face a diverse set of challenges — of particular importance will be China's attempts to rebalance its economy away from a reliance on investment spending toward a more consumption-oriented model.

The extreme monetary stimulus applied by central banks since the crisis has provided a strong tailwind for asset prices, thereby reducing yields, risk premia, and volatility across all major asset classes. Over the coming years, we expect to see increased volatility in markets and greater dispersion at the security level. In what is likely to be a challenging environment for generating returns, investors may need to challenge existing beliefs and processes, introduce exposure to less familiar return drivers, and consider less-constrained mandates in order to meet their objectives.

HOW IS THE INVESTMENT ENVIRONMENT CHANGING?

We would characterize the changing economic and market environment as follows:

Crisis Management (2009–2014)	Tentative Normalization (2015–2020 and beyond)
Huge monetary stimulus — synchronized policy: • Heightened risk premia. • Falling volatility (with bouts of stress). • Falling dispersion.	Uneven stimulus — divergent policy: • Reduced risk premia. • Higher volatility.[1] • Higher dispersion.
Dominance of monetary policy.	Gradual normalization of monetary policy. Greater focus on fiscal policy and structural reform.
Many cheap assets: buy beta.	Few cheap assets: tilt toward alpha and need to be more opportunistic.
Risks/concerns: • Focus on deficit reduction. • Uncertain impact of monetary stimulus. • Euro crisis. • The "fragile five."	Risks/concerns: • Focus on reducing overall debt burden. • Uncertain impact of monetary normalization. • The rise of nationalism and potential fall-out from geopolitics. • Chinese debts and reform program. • Inflating asset price bubbles and "crowded trades."

[1] It may be that in this environment, volatility stays relatively low on average but is punctuated by bouts of higher volatility and significant market moves due to reduced market liquidity.

THEMES AND OPPORTUNITIES

The consensus at the start of 2014 was positive on equities and the US dollar, based on an improving growth outlook, and negative on bonds, in anticipation of the end of quantitative easing. The major surprise of 2014 therefore was the significant decline in long-dated bond yields, with 30-year government bond yields falling by over 100 basis points in the UK and US since the start of the year.[2] The most likely explanations for the fall in yields are concerns around the strength of the developed world recovery, falling inflation, and changing expectations around the pace of monetary policy "normalization."

Given the fall in long-dated yields, one of the best-performing asset classes in 2014 was long-dated sovereign bonds. Equity and credit markets were mostly up for the year, with the US equity market posting the strongest returns of any major market. Private market assets also generally rose, while hedge funds provided returns (on average) in the low single digits.[3] Notwithstanding the market volatility in the fourth quarter, 2014 was a relatively benign (if not spectacular) year for investors in absolute terms, although many liability-relative investors (such as defined benefit pension plans) will have seen their funding positions deteriorate given the material fall in yields.[4]

The low level of yields available across a wide range of asset classes will make it challenging to generate a decent level of return with a high degree of confidence. This is not to say that financial assets are in a bubble and are set to fall; indeed, the supply and demand dynamics of financial markets (that is, the large and increasing monetary base seeking a home in yield-producing financial assets) suggest that markets *could* continue to rise for some time.

The current environment arguably offers relatively few attractively priced assets for the long-term investor. Institutional investors may therefore need to make use of a wider range of return drivers and embrace a broader perspective on risk management in order to meet their objectives. In this paper, we outline a number of ideas, under five broad headings, that we believe merit consideration in 2015.

In order to meet investment objectives, investors need to make use of a wider range of return drivers and embrace a broader perspective on risk management.

[2] Source: Thomson Reuters Datastream.

[3] It is worth noting that managed futures strategies did (in general) have a very strong year, with the Credit Suisse Hedge Managed Futures Index showing a return (in USD) of 16.4% over the 11 months to 30 November 2014. (Source: Thomson Reuters Datastream).

[4] Clearly, those investors with high liability hedge ratios coming into the year will have been much less affected by the fall in yields.

1. TILT PORTFOLIOS FROM BETA TO ALPHA

Given the exceptionally strong returns achieved across all major markets since the financial crisis, there is now a scarcity of "easy beta" to be harvested. We still believe that equities offer the prospect of reasonable returns over the medium term (in the mid to high single digits), but portfolios dominated by passive equity and bond exposure may fail to meet expectations given the low yields available across most bond markets.

Conversely, we believe that opportunities for skilled and flexible active managers are likely to improve as economic and policy divergence combines to create more volatility and dispersion in markets. Returns from manager skill (or "alpha") might therefore become an increasingly important return driver for investors in the next three to five years.

It is important to recognize that active management can take many forms, and a given market environment will create headwinds and tailwinds for different strategies. It is difficult to predict with a high degree of confidence which strategies will enjoy the most favorable conditions in the next few years, but we highlight the following areas for consideration:

- An increasingly divergent policy landscape, with the likelihood of rate rises in the US and further stimulus in Europe and Japan, together with the possibility of competitive currency debasement ("currency wars"), may create opportunities for macro hedge fund strategies.

- Rising stock level dispersion and lower stock correlations could provide long/short and unconstrained long-only equity investors with more attractive opportunities.

- Continued merger and acquisition activity (supported by above-average CEO confidence, cheap borrowing, and high levels of balance sheet cash) should be positive for event-driven strategies, and a deteriorating credit environment in Europe (should economic conditions remain weak) could create a more fertile environment for distressed debt investors.

- Low yields and credit spreads, significantly reduced liquidity in credit markets, and large retail inflows into credit-based exchange-traded funds mean that the risks to "traditional" index-focused bond strategies may have increased. We believe that flexible mandates with fewer constraints are more likely to prosper in this environment. In particular, we think that absolute return bond and multi-asset credit strategies offer material benefits compared with more traditional approaches to bond investing, accepting that the nature of a given investor's liability profile will also have an impact on the appropriateness of different approaches.

Given the large volume of assets[5] chasing a limited set of opportunities, investors will need to be selective — manager selection will be critical in identifying strategies capable of providing a diversifying and sustainable source of return.

---

[5] Hedge fund industry capital reached $2.8 trillion as of 30 September 2014. (Source: HFR third-quarter press release)

Finally, we continue to suggest that investors build equity portfolios with exposure to a diverse mix of style factors — specifically, they should consider a positive bias toward value, size, momentum, low volatility, and profitability.[6] However, investors should be wary of signs of over-enthusiasm in this area — an increasing volume of assets pursuing simple factor-biased strategies (comparable to the early quantitative equity strategies developed in the 1990s and early 2000s) may reduce the rewards available to such approaches. Thoughtful implementation of any factor biases alongside the pursuit of "idiosyncratic alpha," which describes the returns available to investors from insights into company performance not driven by widely understood factors, is likely to be well-rewarded for investors with the governance and decision-making discipline to select and monitor a portfolio of unconstrained managers.

2. THINK LONG TERM

Keynes highlighted the difficulty in adopting a genuinely long-term investment horizon in his 1936 work, *The General Theory of Employment, Interest, and Money*, stating that "investment based on genuine long-term expectation is so difficult today as to be scarcely practicable." Many would say the same today.

A long-term approach is unlikely to be a realistic goal for all investors, in part for the reasons identified by Keynes (that is, a behavioral preference for short-term results and career risk[7]) but also because many investors (such as closed defined benefit pension plans) have a reducing time horizon. However, a governance structure, philosophy, and decision-making process designed to encourage long-term decision-making may confer material advantages not available to many market participants.

Specifically, we believe that investors with a longer time horizon can consider action on three fronts:

- First, at the asset class level, genuinely long-term investors should seek to harvest opportunities available only to investors with a long time horizon — investments that require a long holding period or lock-up will be considered only by a subset of all investors. Illiquidity budgeting is a sensible first step in assessing an investor's tolerance for illiquidity. Long-term investors should also consider sustainability issues and the potential impact of secular trends (such as technology and demographic changes) that could have a dramatic impact on a range of assets.

[6] For further detail on this subject, see "Building Equity Portfolios With Style," Mercer, July 2014.

[7] Keynes noted in Chapter 12 of *The General Theory* that "there is a peculiar zest in making money quickly, and remoter gains are discounted by the average man at a very high rate" and it is "[long-term investors] who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks."

- Second, at the asset manager level, investors should consider strategies that behave more like owners of the businesses in which they invest. Managers running concentrated portfolios, built without any reference to a benchmark, are likely to be less prone to unhelpful short-term behaviors driven by benchmark-relative measures (such as tracking error) and are more likely to be able to engage effectively with portfolio holdings.

- Finally, at the investor level, more thoughtful monitoring of asset managers should be designed to reflect the nature of the underlying strategy and encourage a constructive dialogue between the asset owner and the asset manager. Monitoring information should focus on measures that are tailored to the strategy and appropriately reflect the manager's time horizon.

With apologies to Keynes, long-term investors may need to be willing to risk failing unconventionally in order to succeed.

3. MAXIMIZE YOUR 'RETURN ON GOVERNANCE'

Investors with more effective decision-making processes are likely to generate better long-term returns. In an environment in which compelling return opportunities are relatively few and far between, investors may be well-rewarded for undertaking a critical self-assessment of their internal operations in order to ensure that there is a clear connection between their beliefs, decision-making processes, and investment strategy.

Questions to consider include:

- Do you have a clearly articulated set of investment beliefs? Do these beliefs play an active role in all key investment decisions?

- Do your objectives and risk management processes remain appropriate to the economic and market environment in which we are operating? Are your objectives realistic?

- Does your board/committee strike a sensible balance between discussion of investment strategy issues and manager/performance issues?

- Does your governance structure enable quick decision-making? (An ability to take action in a relatively short timeframe will be a pre-requisite for some investment opportunities.)

There is no one "right" governance structure, and investors should try to design an approach that best fits their objectives and beliefs. However, investors should acknowledge that some investment opportunities will be available only to the most proactive and flexible of investors. In particular, private market investments often have a limited window of opportunity, requiring investors to take decisions and undertake the necessary due diligence within a fixed timescale. A subcommittee/working group approach is a popular means of managing the workload that would otherwise sit with an overburdened trustee board that meets less frequently.

Investors that lack the internal resources required to support such a structure will need to either accept that some opportunities will not be investable for them or consider delegating some elements of the decision-making process.[8] Delegation could mean using flexible multi-asset managers (whereby those managers essentially undertake some dynamic asset allocation decisions on the investor's behalf) or using fiduciary approaches that carry out manager due diligence and selection on an investor's behalf.

4. PROVIDE CAPITAL WHERE IT IS SCARCE

As a general principle, providing capital to areas of the market where it is scarce should serve investors well. The challenge in today's environment is that very few markets are suffering from a scarcity of capital. Quantitative easing has injected a wave of liquidity into markets, either directly or through what central banks refer to as the portfolio rebalance channel,[9] and much of this liquidity has been absorbed by listed bond and equity markets. Although an increasing volume of assets has been put to work in the private markets in recent years, we believe that the opportunity set in private markets is relatively attractive when compared with the listed markets (especially in the debt markets).

We first highlighted the opportunity in European private debt in early 2010, when there was a clear funding gap and a compelling return opportunity due to bank deleveraging. The opportunity set in private debt has changed over the past five years (in particular, the opportunity is now more concentrated in senior and uni-tranche deals as opposed to mezzanine finance), but we continue to believe that these markets offer an opportunity to generate attractive risk-adjusted returns.

When considering opportunities in private markets, investors need to not only assess the relative attractiveness of different parts of the market but also consider how these assets might fit within their wider strategy. A clear articulation of the objectives of any allocation and a program based approach to deployment should drive the portfolio construction process, as opposed to a reactive strategy that considers new opportunities depending on who is fundraising at any one point in time. Investors that want to build a material long-term allocation to private market assets will therefore need to spend some time at the outset developing an understanding of the investment characteristics of the asset class(es) in question, a clear and realistic view of what the allocation is intended to achieve, key filtering and selection criteria, and how the allocation will be maintained and managed over time in a risk-controlled manner.

---

[8] See further discussion in "How to Be More Opportunistic," Mercer, August 2013.

[9] The portfolio rebalance channel refers to the idea that central bank asset purchases push up the price (and reduce the yield) of those assets purchased, thus incentivizing investors to rebalance portfolios into other asset classes.

5. SEEK INEXPENSIVE DEFENSIVES

While the US appears to be enjoying a surge in growth,[10] the global economic recovery remains fragile and the long-term effects of the still-high debt levels and experimental monetary policy are not obvious. At the same time, many investors have moved up the risk spectrum to satisfy a need for yield and banks now provide much less of a liquidity buffer to markets.[11] With a significant volume of assets chasing a dwindling opportunity set, there is an increased likelihood of crowded trades and, as a result, a heightened risk of market dislocations arising from time to time. The large market moves in October 2014 provided a useful example of what a sudden unwinding of crowded trades can look like.

Against this backdrop, investors should place a higher-than-usual premium on diversification and, to the extent possible, incorporate exposure to assets/strategies that might provide some protection against tail events without sacrificing too much in return (what we might call "inexpensive defensives").

Investors looking to incorporate some degree of defensiveness into portfolios could consider the following approaches:

- Safe-haven sovereign debt offers protection against a deflationary recession. Government debt clearly offers very little in terms of forward-looking return, but this "deflation insurance" aspect might justify a higher allocation than would otherwise be the case.

- Cash does not typically form a material part of institutional investors' portfolios, and in the current environment it offers the prospect of a gradual erosion of purchasing power. However, in an environment of shrinking risk premia, the opportunity cost of holding some cash is reduced, while the option value of having some "dry powder" to deploy in stressed market conditions is greater.

- More direct approaches to managing downside risk include option strategies and tail-hedging funds. Such strategies are arguably relatively attractive when implied volatility is low. However, explicit tail-hedging strategies are likely to be appropriate only for sophisticated investors able to evaluate the trade-offs between cost, complexity, and the payoff profile.

- For investors wishing to reduce risk within the confines of their existing growth allocations, "soft tail hedges" could include low volatility equities, managed futures, or US dollar exposure. While low volatility equities should be expected to fall in value in an equity market sell-off, they are likely to fall less than other equity holdings.[12] Returns from managed futures can vary

---

[10] US GDP growth over the six months to 30 September 2014 was the strongest six-month growth figure since mid-2003. (Source: BlackRock)

[11] For example, the volume of trade in US investment-grade corporate bonds as a proportion of outstanding debt has fallen from over 120% in 2005 to just over 70% in 2014. (Source: BlackRock. "Corporate Bond Market Structure: The Time for Reform Is Now," September 2014)

[12] For further discussion of low volatility strategies, see "Investing in Low Volatility Equities," Mercer, September 2014.

significantly from one manager to the next, but as a group such strategies have historically performed well in falling markets. And some unhedged US dollar exposure (via the overseas equity holdings of non-US investors) may also be helpful in crisis conditions.[13]

Aside from specific strategies to control downside risk, scenario and stress test analyses can be helpful in identifying the outcomes that will place the greatest strain on an investor's ability to meet their objectives. A better understanding of the most painful environment for a given investor will help inform a discussion of the options outlined in this paper, as well as supporting any wider discussion with key stakeholders.

CONCLUSION

The exceptional performance of many asset classes over the past six years has, almost by definition, reduced the prospects for future returns while increasing risks to the downside. The future path of economies and markets remains highly uncertain and will likely be driven as much by politics as by economics.

In this environment, investors may wish to review their portfolios in five key areas:

1. Consider shifting the balance between "beta" and "alpha" to reflect reduced risk premia and the improving opportunity set for some active strategies.

2. Seek to capitalize on a long time horizon at the asset class, asset manager, and the investor levels.

3. Review decision-making processes to ensure that the governance structure does not act as a drag on returns by slowing implementation or allocating insufficient time to the consideration of new ideas.

4. Private markets may offer a richer opportunity set than many listed markets given that much of the central bank stimulus has been absorbed by the listed bond and equity markets.

5. Given the fragility of the economic recovery and the reduced liquidity in many markets, diversification and effective "hedges" may be particularly valuable in the current environment.

Investor-specific beliefs, objectives, and constraints will ultimately determine the appropriate actions. We look forward to engaging with investors to help develop strategies that can deliver against objectives while being robust in a range of different outcomes.

The evolving economic environment and the exceptional performance of many markets over the last six years underscores the need to take a fresh look at portfolios in 2015.

[13] Conversely, US investors may wish to consider increasing their currency hedge ratio on overseas assets.

Our "The Global Economy: 2015 Outlook and Beyond" paper highlights additional research. Please call your consultant at Mercer.

IMPORTANT NOTICES

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold, or otherwise provided, in whole or in part, to any other person or entity without Mercer's prior written permission.

The findings, ratings, and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes, or capital markets discussed. Past performance does not guarantee future results. Mercer's ratings do not constitute individualized investment advice.

This does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances.

Information contained herein has been obtained from a range of third-party sources. Although the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential, or incidental damages) for any error, omission, or inaccuracy in the data supplied by any third party.

This does not constitute an offer or a solicitation of an offer to buy or sell securities, commodities, and/or any other financial instruments or products or constitute a solicitation on behalf of any of the investment managers, their affiliates, products, or strategies that Mercer may evaluate or recommend.

For further information, please contact
your local Mercer office or visit our website at:
www.mercer.com

Argentina	Indonesia	Saudi Arabia
Australia	Ireland	Singapore
Austria	Italy	South Africa
Belgium	Japan	South Korea
Brazil	Mainland China	Spain
Canada	Malaysia	Sweden
Chile	Mexico	Switzerland
Colombia	Netherlands	Taiwan
Denmark	New Zealand	Thailand
Finland	Norway	Turkey
France	Peru	United Arab Emirates
Germany	Philippines	United Kingdom
Hong Kong	Poland	United States
India	Portugal	Venezuela

Copyright 2015 Mercer LLC. All rights reserved.

13853A-IC