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Top considerations for financial intermediaries 2025

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Executive summary

In recent years, financial intermediaries have had to navigate an investment landscape transformed by the converging risks of high inflation, rising yields and market volatility. Between 2010 and 2020, inflation across the 38 OECD member countries hovered between 0% and 3%. By October 2022, aggregate inflation had surged to peak above 10.7%,[1] transforming global monetary policy and the risk and market backdrop for global portfolios. Since then, the trajectories of global interest rates and inflation have dominated the market narrative, with markets gauging the likelihood of central bankers successfully navigating a soft landing for the global economy.

Our annual Themes and Opportunities paper for 2025, Swing state, explores the evolving structural trends expected to shape portfolios over the next five years and beyond. The paper aims to support investors with long-term horizons, such as financial intermediaries and their clients, to evaluate strategic priorities across asset allocations. This year's paper underscores the importance of adaptable approaches to balance risk and opportunity. A focal point of the paper is rising concentration risk within global equity markets, where a narrow set of high-performing stocks dominates returns, potentially increasing vulnerability to market corrections. Paired with the complexities of a new macroeconomic regime — characterized by persistent inflationary pressures, elevated interest rates and a shifting geopolitical landscape — the potential for heightened volatility has grown. Swing state explores how these dynamics may challenge traditional investment models, highlighting the need for diversified, forward-looking strategies that can respond effectively to unpredictable market conditions and emerging structural shifts.

Following on from Swing state, this paper explores in more detail how financial intermediaries can potentially achieve their goals, and presents key considerations for investors seeking to diversify portfolios across asset classes, geographies, sectors and investment styles to better withstand higher-for-longer interest rates and an uncertain growth outlook.

We highlight key shifts that financial intermediaries should consider in their portfolio construction, from the blurring lines between private market strategies and the risks of market concentration to the total portfolio impacts of the trajectory of interest rates and inflation.

In today's environment, flexibility and diversification are crucial. Semi-liquid funds are providing a route into private markets for a broader set of wealth investors, whereas next-generation infrastructure investments align with long-term secular trends like the energy transition and digitalization. Hedge funds can be used to take advantage of market volatility, while active exchange-traded funds (ETFs) — which are revolutionizing active exposures across the wealth landscape — offer tactical liquidity and cost efficiency.

We believe emerging market (EM) equities remain attractive despite recent underperformance and view this dynamic market as an important strategic allocation as the global economy becomes increasingly "multipolar."

To effectively manage portfolios in this complex environment, the ongoing assessment of strategies and flexibility to recalibrate allocations will be the keys to success for financial intermediaries. By expanding their focus and embracing a more diversified, adaptable approach, financial intermediaries seek to help clients manage risks and seize opportunities in a volatile global economy.

We recommend considering the following five potential opportunities:

1. **Semi-liquid funds**
2. **Next-generation infrastructure**
3. **Hedge funds**
4. **Active ETFs**
5. **Listed EM equity**

01. The perils and promise of semi-liquid funds

Over the past few years, the private markets industry has sought innovative approaches to make its products more accessible to the broader wealth-management market. One approach has been to launch products that offer access to illiquid assets in open-ended funds with limited liquidity, typically 5% per quarter.[2] These funds are often referred to as "semi-liquid," a somewhat misleading name as they are mainly illiquid but have nonetheless proved popular, with rapid growth in both the number of new launches and asset classes covered. To manage liquidity, most semi-liquid funds maintain a cash and/or liquid asset buffer, which can constrain returns compared to closed-ended funds. However, their features continue to attract wealth managers and, increasingly, other types of institutional investors. Although these funds cater to clients that are unable or unwilling to invest in closed-ended funds without liquidity, they offer a range of other potential advantages:

- **Speed of deployment.** Semi-liquid funds offer the advantage of faster capital deployment compared to closed-ended funds. With monthly or quarterly subscriptions, capital is deployed almost immediately, mitigating the opportunity cost of waiting for the next fund raise and subsequent capital calls, which can take up to two or three years. By expediting capital deployment into underlying assets, clients have the potential to gain exposure quicker and generate additional returns. It's important to consider that semi-liquid funds typically have a limited allocation to lower-returning liquid assets, and this should be weighed against the opportunity cost of slow deployment in closed-ended funds.

- **Minimizing deviation from target asset allocation.** For clients willing to commit to an illiquid fund structure, the inability to rebalance assets can lead to deviations from their target asset allocations. Semi-liquid funds address this concern by offering clients with a long time horizon the ability to manage their relative exposures more effectively. Additionally, these funds allow for the compounding of capital by reinvesting income over longer periods of time, further supporting the maintenance of a client's target asset allocation.

- **Reduced administrative burden and cost.** Holding traditional closed-ended funds can involve significant administrative burden and cost. This includes managing unpredictable capital calls and distributions as well as conducting new due diligence on each vintage. By contrast, semi-liquid funds simplify operations for advisors. Typically, there is a single subscription payment and potentially a single redemption payment, reducing administrative complexity and associated costs.

When effectively implemented, semi-liquid funds offer an attractive avenue for accessing private markets, providing greater flexibility and transparency. However, it's crucial to view any investment as part of a client's total portfolio. The optimal allocation to semi-liquid funds should be determined by considering the client's individual circumstances and needs.

Options to consider

1. **Understand nuances.** Prudence is essential when considering semi-liquid funds as a solution for liquidity. It's important to recognize that the "semi-liquid" label can be misleading if the underlying assets are illiquid and the funds offer limited liquidity. For example, open-ended real estate funds may experience "gating issues" that prohibit fund withdrawals. Implementing a pacing model is one method to prudently manage liquidity. Advisors should approach these funds with the same prudence they would apply to more illiquid allocations.

2. **Build robust portfolios.** Regardless of whether portfolio construction is implemented through closed-ended or semi-liquid funds, a robust approach is essential. This involves diversifying across different managers and strategies to optimize desired returns, diversification, liquidity and risk management.

3. **Work with the best of the best.** Advisors should strive to access the best managers[3], based on their proprietary ratings processes, through efficient structures while aiming to negotiate favorable fees.

4. **Master liquidity.** Effective liquidity management is essential. This can potentially be achieved through a limited allocation to cash and/or quickly realizable assets, utilizing a credit facility, or considering income and loan maturities for private credit and vintage diversification for private equity. Striking the right balance between liquidity and return is essential as the size of the liquidity sleeve may slightly impact overall performance.

02. Next-generation infrastructure

Infrastructure as an asset class has evolved significantly, moving beyond its traditional role of providing stable yields and inflation protection. Today, it serves as a versatile portfolio-construction tool, offering potentially less correlated yields and acting as a source of stable, inflation protected cashflows.

The asset class has expanded to include a broader range of assets, allowing for targeted customization of risk and return profiles across various strategies, including core, core-plus, value-add, and opportunistic. While these terms are not new, the types of assets within each category have expanded significantly. Notable additions include electric vehicle (EV) charging infrastructure in the opportunistic category, non-public-private partnership (non-PPP) social infrastructure and fiber investments within value-add, and hyperscale data centers classified with a core-plus risk level.

This evolution is not entirely new; renewable energy, once considered a nascent sector, has now become a core component of infrastructure portfolios. Rapidly evolving technologies and global megatrends — such as decarbonization and digitalization — are shaping the next frontier of investments. While some newer infrastructure assets may not exhibit all the hallmark characteristics of traditional infrastructure, they often retain intrinsic value, inflation protected cashflows, and lower correlation to public markets.

Investors in these segments may encounter greater returns but also face heightened risks. For example, data centers and cloud processing have yielded substantial rewards due to surging demand for computing power driven by advancements in artificial intelligence. However, rising electricity costs, supply chain inputs (such as high bandwidth memory and GPUs), and rising interest rates are risks that must be managed.

Next-generation infrastructure assets have the potential to deliver competitive returns compared to other private-market strategies while providing access to global megatrends and diversification for investors. As the infrastructure landscape continues to evolve, embracing these new opportunities will be crucial for long-term success.

Options to consider

1. **Diversify managers and investments across traditional and next-gen infrastructure.** Investors should consider a diversified approach that includes both traditional infrastructure assets and next-generation opportunities. This strategy can help mitigate risks associated with market volatility and sector-specific downturns while capitalizing on the growth potential of emerging technologies and trends, such as energy transition investments and digital infrastructure.

2. **Work with specialized GPs.** We suggest investing alongside specialized managers which have expertise in specific infrastructure sectors. These managers are better equipped to identify and manage attractive opportunities within more niche sectors.

3. **Flexible implementation options.** Investors should consider a variety of implementation vehicles to gain infrastructure exposure, including open-ended and closed-ended funds, co-investments, and secondary market opportunities. This flexibility allows for strategic allocation across different infrastructure assets while optimizing potential returns and managing exposure effectively.

4. **Adopt a long-term perspective with a focus on sustainability.** Investors should prioritize sustainability and resilience in their infrastructure investments. By focusing on assets that contribute to decarbonization and digitalization, investors can align their portfolios with global megatrends and regulatory shifts. This long-term perspective not only supports environmental goals but also positions investors to capitalize on the growing demand for sustainable infrastructure solutions, potentially leading to enhanced returns over time.

03. Are hedge funds suited to the current environment?

It's clear that global monetary policy is recalibrating as central bankers seek a return to normal, with a focus on objectives and mandates. Although the effects of unprecedented stimulus following the global financial crisis and COVID-19 pandemic were initially unclear, normalization of policy represents familiar territory — one that lacks free lunches, promotes free capital markets and capital allocation, enforces a real cost of capital, and better aligns with efficient frontier principles.

From an investment standpoint, the unknown pace and trajectory of the return to normal suggest a need to increase diversification in portfolios. The inclusion of hedge funds that provide absolute returns could help improve outcomes for investors currently concentrated in traditional assets. Hedge funds are well suited to the current environment due to their ability to capitalize on volatility or dislocations resulting from uncertainty. Furthermore, those absolute returns benefit from higher cash rates today due to the implicit and explicit cash components embedded in the return structure.

Policy continues to recalibrate. Markets and opportunities will adjust accordingly, and we encourage investors to review their asset allocation and investment playbooks for a more normalized market environment.

We believe a hedge fund mandate can serve as a fixed-income alternative, delivering risk reduction while preserving long-term capital appreciation. A well-constructed hedge fund allocation, built around the guiding principles set out below, represents one of the few areas with foreseeable tailwinds, unique diversification benefits and independence from the stock–bond correlation dynamics.

Guiding principles:

- **Seek mandates that balance both sides of the balance sheet and types of risk exposure taken.**
- **Opportunism is more effective when implemented through dynamic and flexible mandates as opposed to timing strategy allocation.**
- **Limit constraints within a tight risk management framework, emphasizing risk relative to reward.**
- **Embrace differentiated risk rather than duplicative risks/beta.**
- **Manager selection is the ultimate determinant of success.**
- **Benefits accrue to long-term partners that value relationships.**
- **Mistakes occur, and a margin for error is prudent.**
- **Tactical allocations are most effective in hedging and at the margins.**
- **Position size is the risk-management tool of last resort.**

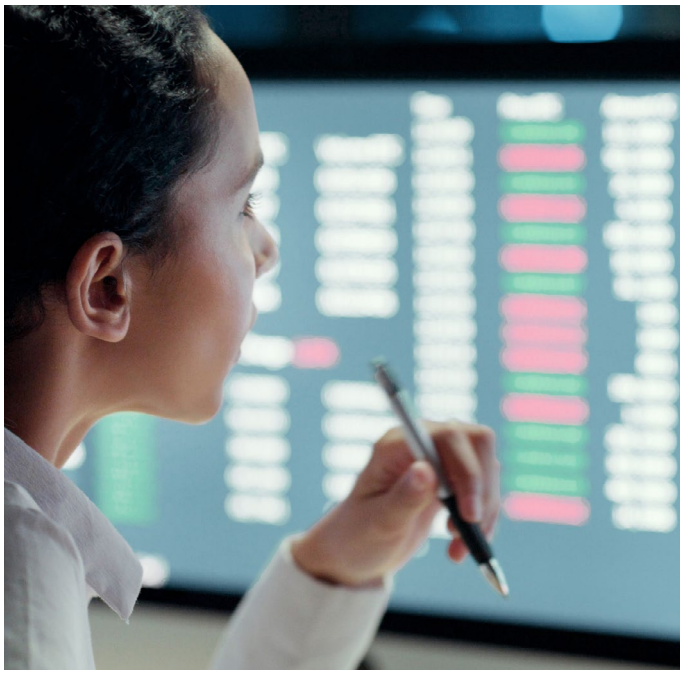
Options to consider

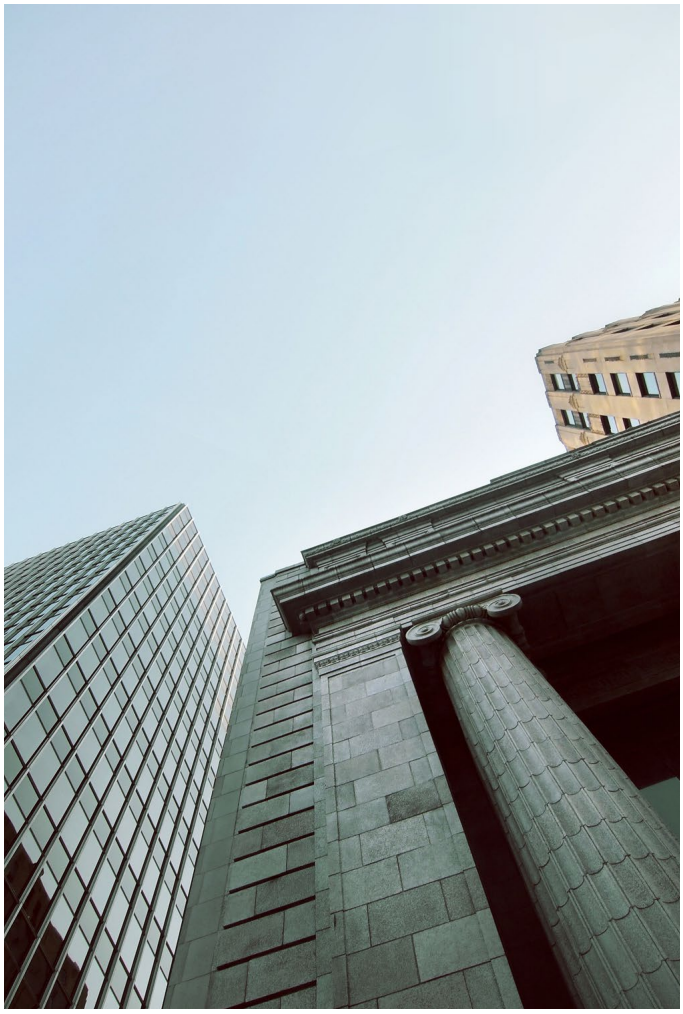
1. **Embrace multidimensional diversification.** Hedge funds offer access to a broad variety of disparate nontraditional risk-and-return opportunities. Investors should seek diversification across multiple dimensions within the hedge fund allocation itself — managers, strategies, risk exposures, risk profiles and regions. The key to success is building robustness and flexibility within manager allocations to help avoid the urge to time market opportunities and instead deliver all-weather capabilities that inherently and dynamically adjust to the opportunity set.

2. **Avoid self-imposed constraints.** In an effort to access the broadest set of alpha sources, investors should seek to fully optimize the unconstrained hedge fund toolkit. For investors with a long-term horizon and a moderate allocation size, focusing on net-of-fee results within a flexible liquidity profile has proven to deliver strong portfolio benefits over time without being an impediment to fee or liquidity budgets. Equally, added constraints have proven to severely impact results.

3. **Define the mandate.** It's critical to set clear objectives and expectations for a distinct and separate allocation. This should include an appreciation that different strategies play different roles, likely at different times. Measures of success or failure should consider both the role of individual strategies and/or managers in delivering on objectives over time as well as the sum of parts in the aggregate at points in time.

4. **Start at the end.** Allocators should avoid top-down views or rigid sub-strategy target allocations. The key to long-term success is to work backwards — identify top-tier, world-class managers that implement an investment strategy that conveys a competitive advantage highly likely to achieve future success. Populating a portfolio exclusively with managers of this ilk, while accumulating complementary, diversifying exposures, return drivers, approaches, styles, etc. is the path most likely to succeed.





04. Active ETFs: Unlock innovation

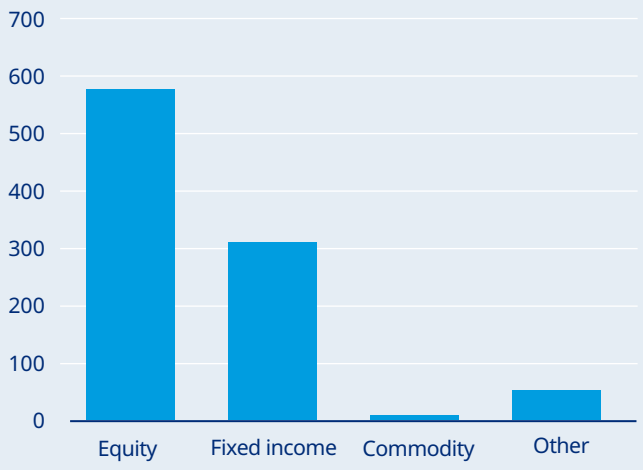
Active ETFs are revolutionizing the landscape of wealth management by seamlessly integrating the advantages of the ETF structure with active management strategies.[4] This innovative approach has propelled the active ETF market to unprecedented heights, surpassing the growth of the overall ETF market. In the past decade alone, the active ETF market has achieved an astounding compound annual growth rate (CAGR) of 51%,[5] outpacing the already impressive 24% CAGR for the broader ETF market. As of August 2024, global assets under management in active ETFs had soared to nearly US$950 billion,[6] with a wide array of 2,685 active ETFs now accessible to investors. This remarkable growth and availability highlight the immense potential and appeal of active ETFs[7] in today's investment landscape.

The growth in active ETFs in the US can be attributed to several factors. In addition to rising investor demand,[9] regulatory advancements, including the approval of nontransparent ETFs and the implementation of SEC Rule 6c-11, also known as "The ETF Rule," have simplified the process of launching and operating active ETFs. By contrast, the growth of active ETFs in Europe has been modest.

This slower pace can be attributed to a preference for lower-cost passive strategies and a complex regulatory environment that presents challenges for new product launches.[10]

These innovative investment vehicles present advisors with the chance to enhance client portfolio performance, diversify holdings, reduce management fees and improve portfolio liquidity compared to traditional mutual funds. Additionally, active ETFs offer the potential to exercise active stewardship and potentially enhance tax efficiency, depending on the jurisdiction.[11]

Figure 1. Actively Managed ETFs — global AUM by asset class, US$ billions



Source: Tracksight[8] as of 31 Aug, 2024.

Options to consider

1. **Manager risk.** The success of active ETFs is heavily reliant on the skills and decisions of the fund manager.

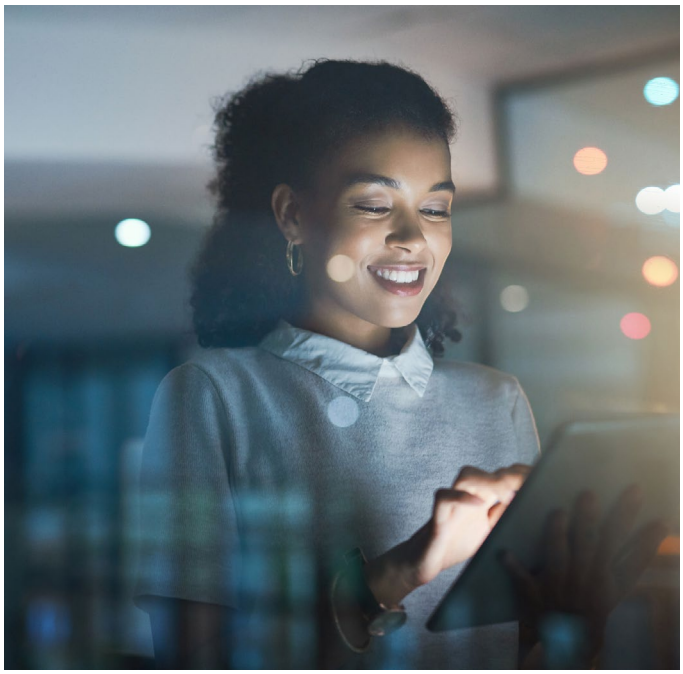
2. **Complexity.** Active ETFs can be more complex than passive ETFs, making it harder for some investors to understand the investment strategy and risks involved.

3. **Both have a role to play.** Active ETFs and passive ETFs should be viewed as complementary components in portfolio construction. Active ETFs retain some of the advantages of transparency and trading flexibility provided by the ETF structure without compromising on the potential for generating alpha.

4. **Targeting asset allocation.** ETFs allow investors to access niche markets and quickly adjust their asset allocation based on market conditions or changing investment strategies. This flexibility is particularly advantageous for making tactical shifts in asset allocation, enabling investors to capitalize on short-term opportunities or manage risk effectively.

5. **Tax efficiency.** Many advisors in the US have utilized ETFs over recent years to access lower fees and potentially increase tax efficiency in managing capital gains relative to mutual funds. These potential tax benefits have grown more popular in recent years, with more mutual funds offering an ETF share class as a potential tax-efficient strategy for managing capital gains.

6. **Due diligence.** Understand that active ETF strategies are still relatively new, particularly in Europe, so not all investors have experience with the active ETF due-diligence process.



05. Don't give up on emerging market equities

Over the 10-year period from September 30, 2014, to September 30, 2024, emerging market equities have underperformed developed market equities by approximately 6% per annum in USD terms.[12] As a result, many investors have reevaluated their perspectives on emerging markets, particularly regarding China. Despite this relative underperformance, we remain supportive of an allocation to emerging markets and recommend an actively managed investment strategy aligned with the MSCI ACWI IMI.

EM equity returns have historically exhibited higher volatility and cyclical patterns compared to developed markets, with periods of both outperformance and underperformance. In the context of a developing "multipolar" world, a strategic allocation to emerging markets is essential. EM-domiciled companies tend to have more direct exposure to their domestic economies, often competing with multinational corporations. As the world becomes increasingly factionalized, certain markets may become less accessible to Western multinationals. Despite geopolitical and governance risks, emerging markets can offer opportunities for diversification and alpha generation.

Enhanced portfolio diversification

By accessing economies with a vast range of growth drivers and varying approaches to fiscal and monetary policy, advisors can expand the breadth and depth of their clients' equity universes. Currently, correlations between emerging markets and developed markets are below 1, which can partly offset higher volatility at the overall portfolio level.

However, we anticipate some convergence over time as foreign participation in emerging markets increases. Despite this, we firmly believe that the diversification benefits of investing in emerging markets are likely to persist.

Alpha potential

The relative inefficiency of emerging markets compared to developed markets creates a favorable environment for active managers. In our Global Emerging Market Equity universe, the median EM manager has a track record of generating excess returns of 1%–2% per year. This performance surpasses that of global equities, which typically achieve less than 1% in excess returns. Past performance aside, we believe emerging markets will continue to be one of the most promising opportunity sets in terms of future alpha generation.

What about China?

China is seen as an important part of the EM opportunity set, with among the greatest alpha potential, but there are structural risks that inform a preference for maintaining strategic exposure in line with the MSCI ACWI IMI weight rather than an overweight position. These risks include the real estate debt overhang, geopolitical disagreements, potential conflict with Taiwan and trade restrictions. Although some advisors may want to exclude China from their client portfolios, this could create tracking errors and opportunity costs. However, if advisors choose to exclude China, they should maintain exposure to other emerging markets through an EM ex-China mandate and adjust the equity benchmark accordingly to avoid excessive tracking error.

Options to consider

1. **Unlock alpha and diversification.** Emerging markets offer a rich opportunity set that may become harder to access for global companies domiciled in Western countries. The region has among the highest alpha potential within publicly traded equities, and different economic cycles and return drivers can add diversification benefits to a global equity portfolio.

2. **Active management is essential.** We firmly believe that emerging markets should be part of a well-diversified equity portfolio, in line with market-cap-weighted benchmarks, to seize the opportunities while being mindful of the risks. Active management is essential to make full use of the alpha opportunities while mitigating these risks, which cannot be entirely eliminated.

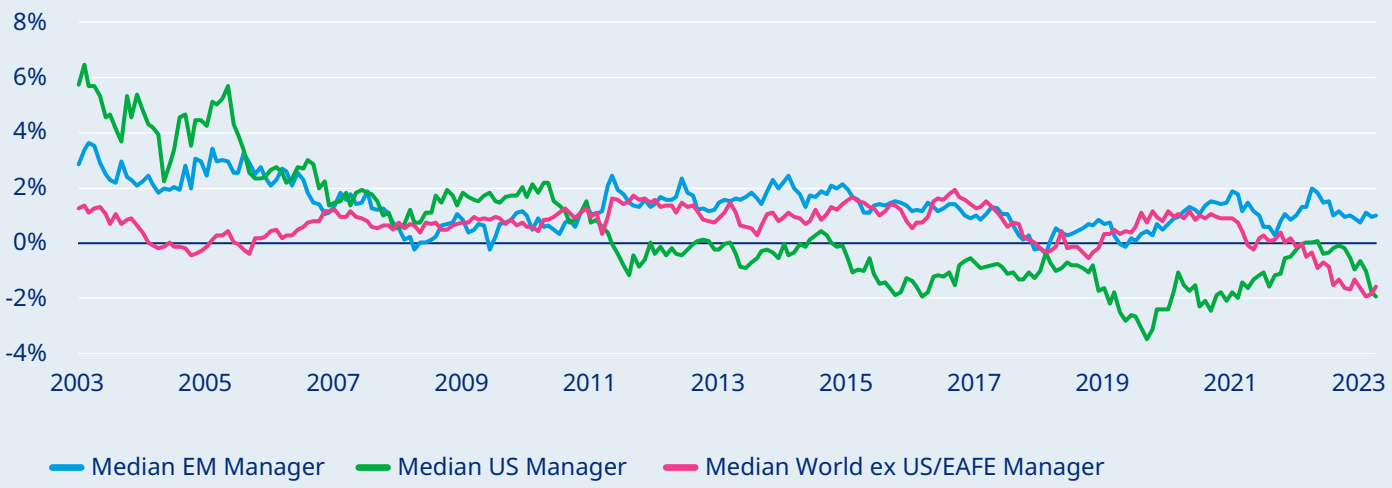
3. **Don't ignore the risks.** On the other hand, there are important risk considerations, such as:

   a. Property rights and corporate governance in emerging markets generally exhibit weaker standards compared to developed markets.

   b. Foreign investors in emerging markets may also be subject to rules that can change abruptly and without much notice.

   c. Emerging markets can be significantly impacted in certain geopolitical scenarios, potentially resulting in the implementation of capital controls, sanctions or investment bans at short notice. A recent example of this was the situation in Russia in 2022.

Figure 2. EM vs. US vs. DM ex US equity alpha – rolling 3-year excess return



Source: MercerInsight®. USD monthly excess returns. Gross of fees. Median EM manager vs. MSCI EM (emerging market equity universe). Median US manager vs. MSCI USA (US all cap equity universe). Median World ex US manager vs. MSCI World ex US (Global ex US equity universe data as of March 31, 2024. Fees will vary across strategies and clients and need to be estimated at the individual client level.

Appendix

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Endnotes

1 OECD (2024) consumer price indices (CPIs, HICPs), COICOP 1999.
2 Mercer. "Considerations for Semi-Liquid Private Debt," available at https://www.mercer.com/insights/investments/alternative-investments/considerations-for-semi-liquid-private-debt/.
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12 "MSCI Emerging Markets Index (USD)."

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