HEALTH WEALTH CAREER

EUROPEAN ASSET ALLOCATION SURVEY 2015

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CONTENTS

01
WELCOME

In the *2015 European Asset Allocation Survey* we provide a comprehensive overview of investment strategy across the European pension industry and identify a number of emerging trends in the behaviour of institutional investors.

After 2014 surprised investors with a dramatic fall in long-dated bond yields and a halving of the oil price, 2015 has already provided investors with plenty of food for thought. In Europe, investors have had to consider the impact of the sudden and unexpected removal of the peg between the Swiss franc and the euro, the election of the Syriza party in Greece, and the commencement of quantitative easing by the European Central Bank.

The combination of low and even negative yields across a number of eurozone bond markets, modest risk premia, and rising volatility creates a challenging environment for investors. With relatively few attractively priced assets available, we believe that investors 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.

The future path of economies and markets remains highly uncertain and will likely be driven as much by politics as by economics. Against this backdrop, we have highlighted five key areas in which investors may wish to review portfolios[1]:

- Consider shifting the balance between "beta" and "alpha" to reflect reduced risk premia and the improving opportunity set for some active strategies.
- Seek to capitalise on a long time horizon within the asset allocation and manager selection decisions, and through an appropriate monitoring approach.
- 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 for the consideration of new ideas.
- Consider private markets, which 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.
- 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.

These themes are evident to varying degrees in this year's survey results and remain active subjects of discussion. We hope our findings make for interesting reading.

NATHAN BAKER
Principal

PHIL EDWARDS
European Director of Strategic Research

[1] These issues are discussed in more detail in our *2015 Themes and Opportunities* paper.

02
KEY FINDINGS

Pension Scheme De-Risking Remains a Dominant Trend in Mature Markets

Within most countries in the survey, average equity allocations increased marginally last year. Offsetting this, however, was the ongoing de-risking of defined benefit pension plans, particularly in the UK and Ireland, which leaves a visible footprint in our survey data. Across Europe as a whole, average plan equity weightings fell by two percentage points (from 34% to 32%). By and large this overall strategic reduction in equities is expected to continue.

In the UK specifically, de-risking frameworks are now in widespread use by DB plans, alongside other risk management approaches such as interest rate hedging and liability management programmes. With many more plans finding themselves cash-flow negative, it may be that asset strategies become increasingly "cash-flow driven" over time.

Low (or Negative) Yield Environment Shifts Attention to 'Alternatives'

For less-constrained investors, such as endowments and foundations, there are some signs that, in response to low bond yields, there has been a small switch from bonds into equities. However, at an aggregate level, we find little evidence of the "great rotation" (from bonds to equities) that had been predicted by many commentators. Instead, investor appetite has shifted towards alternatives, with a two percentage point increase in the average allocation (from 12% to 14% of plan assets)[2] at the overall European level. Growth-oriented fixed income strategies, such as multi-asset credit and private debt, saw the most significant increase in demand over the year.

'Alpha Budgets' Being Redeployed

The use of passive management within traditional equity and bond portfolios has increased, while average performance targets for alternative allocations, as well as the size of those allocations, have risen. This suggests that investors increasingly prefer to seek returns from manager skill (or "alpha") within alternatives mandates, while harvesting cheap "beta" in the core equity and bond portfolios. It is worth noting, however, that many of the largest investors continue to make significant use of active management across their entire portfolios, reflecting the generally greater governance budgets available to such investors.

Increasing Complexity Continues to Affect Governance Structures

A consistent theme emerging from this survey in recent years relates to investors' response to the increasing complexity of the investment landscape. We find that larger plans with greater resources are likely to make use of internal committees as a means of managing their investments, while investors across the spectrum are increasingly delegating some aspects of the investment decision-making process to a fiduciary manager.

Sustainability and Stewardship

Our survey points to an increasing focus on environmental, social, and governance (ESG) factors within the investment process, with only 35% of respondents not actively considering these factors (versus 48% in 2014). Although this is partly a reflection of reputational risk, we note that this year such factors are more firmly recognised as also having material financial impacts. Stakeholders address ESG factors at different levels, but notably as part of manager selection and monitoring. In doing so they rely partly on advisers to understand how their managers, be they active or passive, incorporate ESG factors in their investment process.

Notes:
- Charts in this report may not add up to 100% due to rounding, unless otherwise specified.
- Values provided in this survey are quoted in euros.
- Data provided in this survey were collected during January 2015.
- €1 billion equals €1,000 million.
- Averages shown in charts are not weighted by plan asset size unless stated otherwise.

[2] Includes asset classes and strategies outside of traditional equities, bonds and cash.

03
SURVEY PARTICIPANTS

Our 2015 survey gathered information on nearly 1,100 institutional investors across 14 countries. The information relates to total assets of more than €950 billion; an increase of around 10% on last year's survey. The charts below show the composition of survey participants both by country and size of plan assets.

As in previous years, the largest group of survey participants was UK-based (see Chart 1). Around half of the participants (by number) represent plans with assets of under €100 million, whereas 13% had assets over €1 billion (see Chart 2). Although smaller in number, these larger plans dominate the overall assets under review (see Chart 3).

Some year-on-year turnover among survey participants is inevitable, but the majority of plans have remained part of the survey over time, allowing us to identify trends in asset allocation based on a robust core set of data.

Chart 1: Split of Total Survey Assets by Country

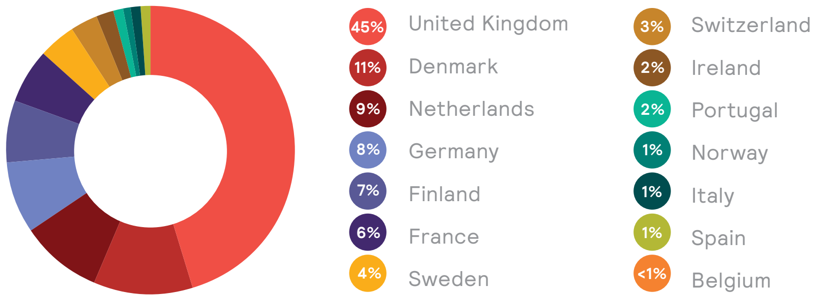


Chart 2: Split of Total Survey Participants by Plan Size

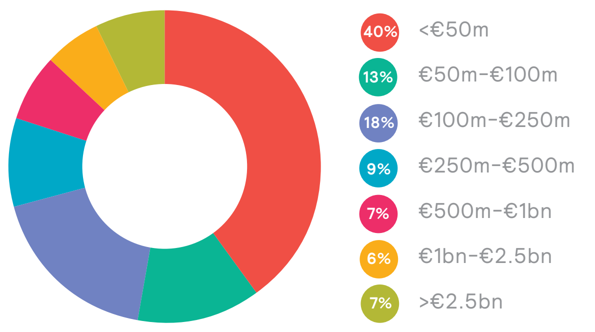
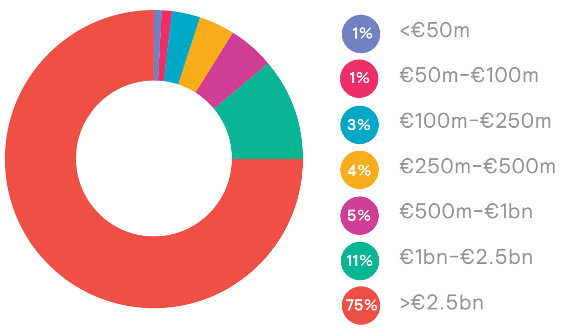


Chart 3: Split of Total Survey Assets by Plan Size



04
ASSET ALLOCATION

Chart 4: Broad Strategic Asset Allocation by Country

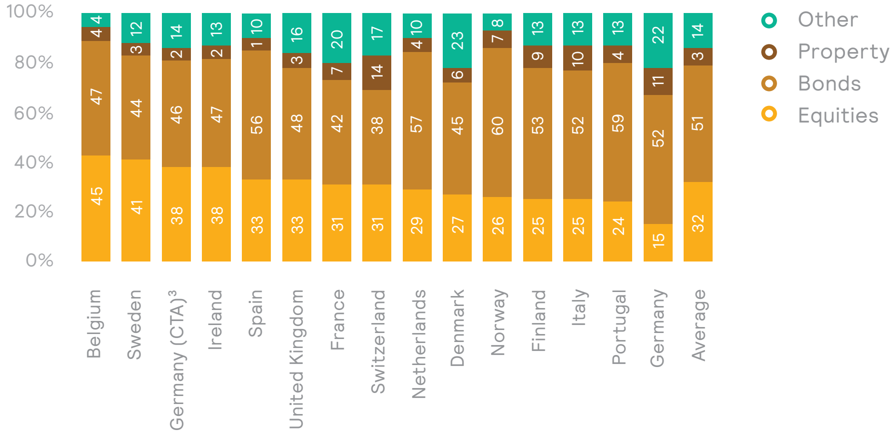


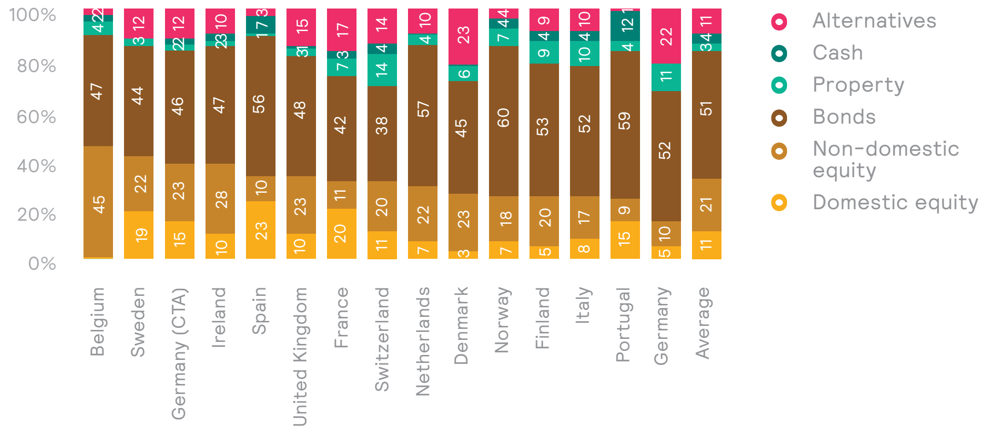
Chart 4 shows the broad allocation of plan assets broken down by country.

Plans in Belgium and Sweden continue to have the highest average equity weightings, whereas (non-CTA) German plans exhibit the lowest equity exposure. Since last year's survey, average equity allocations have increased (slightly) in more countries than those experiencing falls — the major exceptions are Ireland and the UK, where average equity allocations fell by six percentage points and four percentage points, respectively.

The largest move in equity weightings was registered by German CTA plans, which are relatively unencumbered with regard to regulation of investment strategy, with an increase in the average equity allocation of seven percentage points.

Conversely, bond exposures reduced in most countries, and typically by more than the corresponding increase in equity allocations. As we see in Chart 5, which provides a more detailed breakdown, the gap was typically filled with real estate and alternatives, allocations to which increased in the majority of countries. Although plans in the UK and Ireland increased their allocations to bonds, this increase was less than the reduction in equities, so real estate and alternative allocations also increased in those countries. This is consistent with investors' expectations from last year's survey, with many plans having anticipated increasing alternative exposures in 2014. Average cash allocations also increased over the year, which may point to an increase in the perceived value of cash where it represents "dry powder" in an environment with relatively few compelling return opportunities.

Chart 5: Strategic Asset Allocation by Country

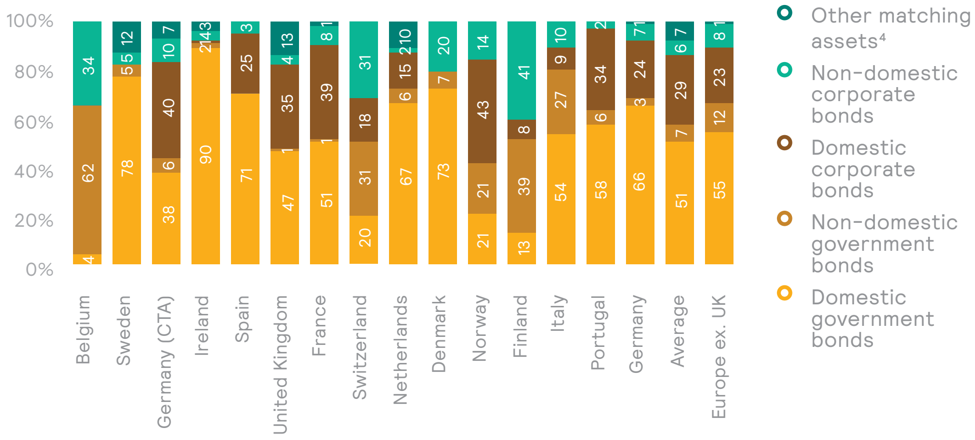


The proportion of equities invested outside the domestic market continues to vary considerably by country, but the reduction in the "domestic bias" continues — domestic exposure now represents 34% of the average plan's equity portfolio, down a further four percentage points from last year. We consider this effect by plan size in the governance section of the report.

³ We show data for German Contractual Trust Arrangements (CTAs) separately given their different regulatory treatment. A CTA is a special-purpose vehicle into which the sponsoring employer transfers assets (shares, including those of the sponsoring employer's parent company; bonds; cash; real estate; etc. — there are no restrictions on what assets can be transferred) for the sole purpose of securing the pension liabilities under a direct commitment scheme. Employee benefits remain ultimately secured by the employer.

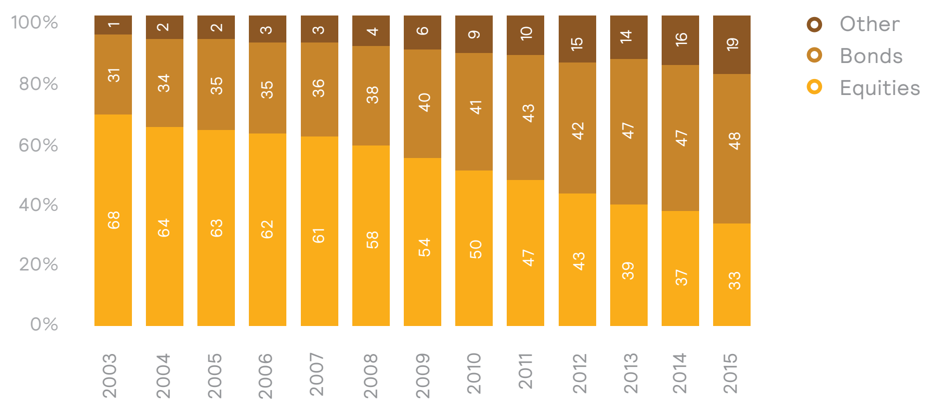
The make-up of plans' bond portfolios (see Chart 6) is heavily country-specific. Although the composition of the average portfolio is little changed compared with last year, more countries saw falling rather than increasing corporate bond exposure. Alongside the increased allocation to growth-oriented fixed income (discussed later in the report), this suggests that plans may be seeking higher-yielding credit exposures, perhaps due to investment-grade credit spreads remaining relatively low.

Chart 6: Bond Portfolio Allocation by Country



Although the average allocation to equities increased marginally in many countries, across Europe as a whole it fell due to the de-risking of UK pension plans in particular. Chart 7 shows the change in overall allocations in the UK over the last 12 years. The long-term reduction in equity exposure continued in 2014, with the average plan equity allocation falling to a new low of 33%. This largely corresponded with an increase in alternative assets rather than bonds, likely reflecting the continued fall in bond yields over the year. Consistent with the data, investors remain interested in allocating to relatively low-risk, cash-flow-generative assets offering a yield premium to government bonds in exchange for reduced liquidity (such as long-lease property or infrastructure debt).

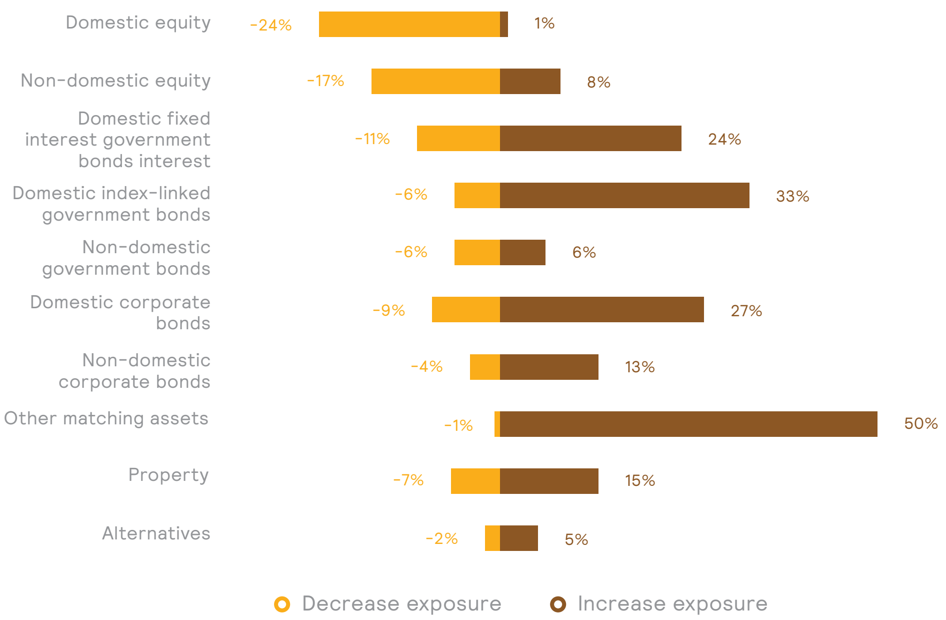
Chart 7: Changes in Broad Strategic Asset Allocation for UK Plans (2003-2015)



⁴ Other matching assets include derivative-based liability hedging strategies that typically form part of defensive portfolios.

Looking forward (see Chart 8), plans are, on the whole, expecting to reduce allocations to equities and increase bond exposures. This is likely to reflect the structural de-risking of certain segments of the respondents (such as closed and maturing UK DB pension plans). In line with this over-arching de-risking trend, it appears that the persistence of the low-yield environment is focusing investors' minds: there is a clear desire to increase allocations to "other matching assets", suggesting that investors expect to increase the size of liability-hedging strategies in order to manage liability-relative valuation risk. Meanwhile, the overall expectation of increasing allocations to real estate remains, perhaps implying that rising values have led to improved sentiment. Within real estate, investors appear increasingly comfortable with non-core strategies such as long-lease property, ground leases, and social housing, as well as higher-yielding value-add strategies.

Chart 8: Percentage of Plans Expecting to Change Investment Strategy



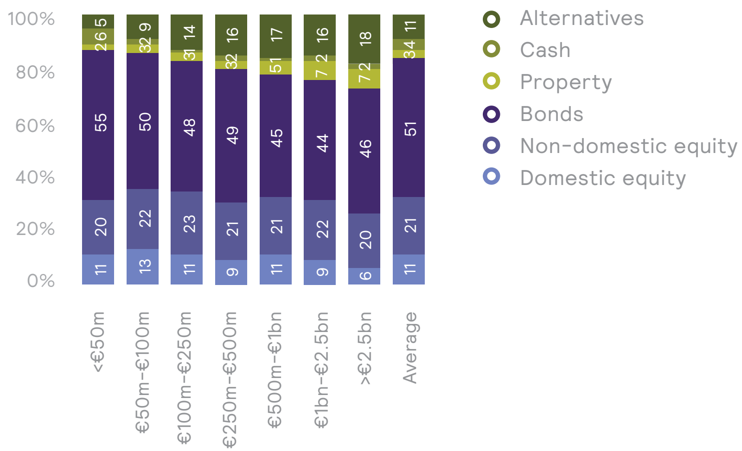
05
INVESTMENT GOVERNANCE

Pension plan governance covers a wide range of topics, from the composition of the trustee group to the way in which decisions are delegated to sub-groups or third-party providers, to the complexity of the investment arrangements and the number of ideas and opportunities that are considered.

Our survey results continue to highlight a clear link between the size of a plan and the amount of time and resources devoted to the consideration of investment issues. Reflecting the governance challenge facing plan trustees, we have seen an increased degree of delegation, especially by plans implementing some form of trigger-based de-risking strategy, but also by investors seeking to introduce a diversified exposure to a new asset class without overburdening their governance structure.

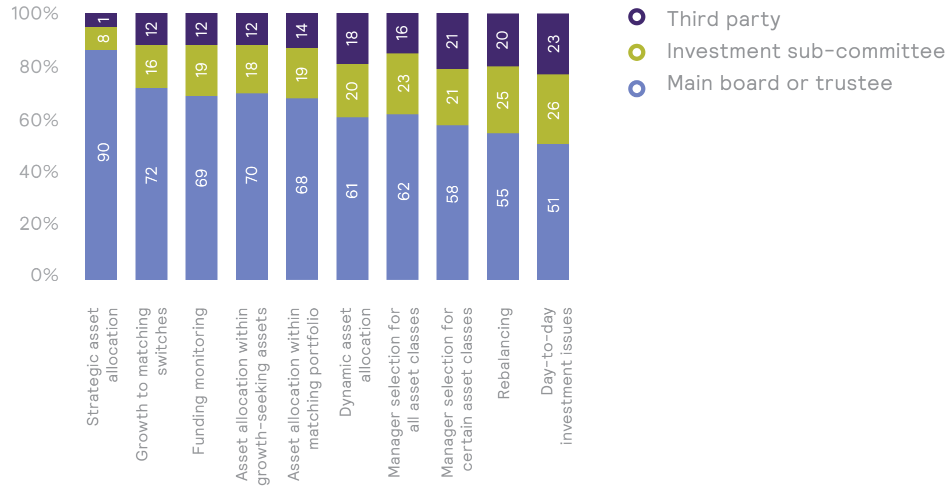
Chart 9 illustrates how asset allocation varies with plan size. Although equity exposures don't appear to obey a clear pattern, the average plan allocation to alternatives — which can include complex and less liquid strategies — is higher for larger plans, which typically have greater resources.

Chart 9: Strategic Asset Allocation by Plan Size



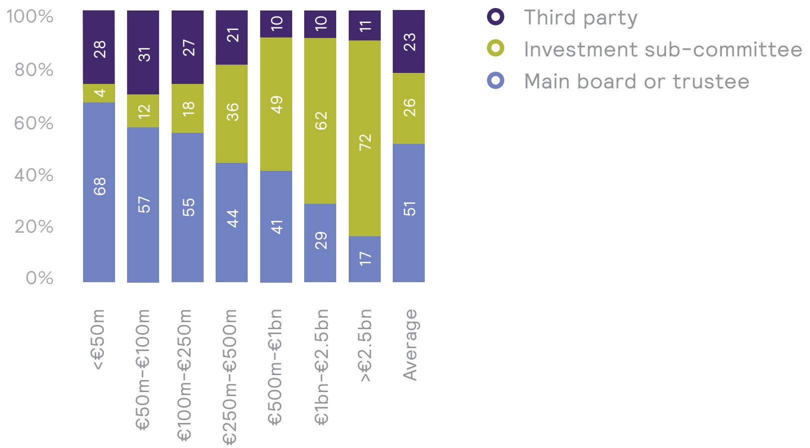
Strategic asset allocation decisions are typically seen as the most significant driver of investment performance and may therefore be expected to reside with the highest level of decision-making body, such as the plan trustee or board of directors. Chart 10, which shows the level at which various plan investment decisions are made, indicates that for 90% of plans this is the case. The average frequency of strategic asset allocation reviews continues to increase, with 58% of plans reviewing their strategy at least once per year (up from 55% in 2014).

Chart 10: Breakdown of Responsibilities Around the Investment Cycle



Investment decisions that are expected to have a smaller overall impact, such as allocation of underlying portfolios or investment manager selection, are more frequently delegated to an investment sub-committee or third-party "fiduciary" manager. Chart 11, which focuses on day-to-day investment issues, illustrates that the nature of any delegation is partly a function of plan size, with smaller plans being more likely to appoint a fiduciary manager and larger plans more likely to use an investment sub-committee.

Chart 11: Responsibility of Day-to-day Investment Issues by Plan Size



Charts 12–14 consider the average number of active mandates, the average outperformance target for such mandates, and the extent to which passive mandates are used, by plan size. There is a clear trend, whereby larger plans exhibit a greater use of active management and tend to invest with less-constrained (higher outperformance target) mandates, with a corresponding preference for passive mandates by smaller plans. Since last year, the overall use of passive mandates has increased for equities and bonds (by four and seven percentage points, respectively). Alongside this, however, we have seen average outperformance targets for alternatives increase. Taken together, these changes suggest that investors have been redeploying active management risk budgets (or "alpha budgets") towards alternatives portfolios.

Chart 12: Average Number of Active Mandates by Plan Size

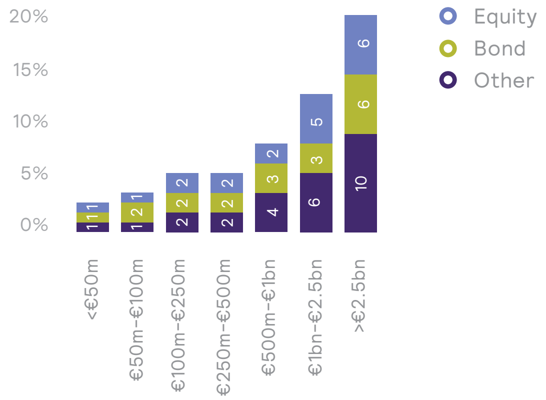


Chart 13: Average Active Manager Outperformance Targets by Plan Size

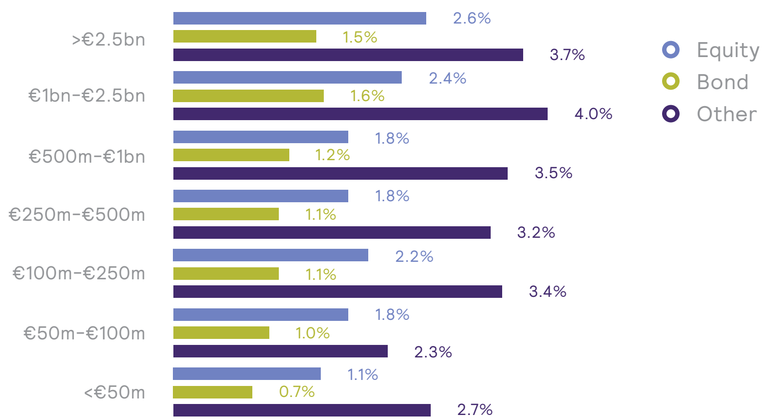
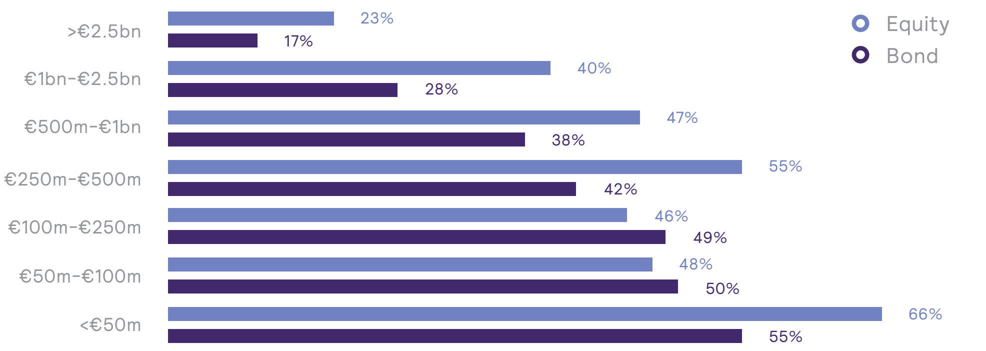


Chart 14: Proportion of Equity and Bond Assets Managed on a Passive Basis



As plans increase in size and the number of managers they appoint typically increases, so too do their operational requirements. For example, the likelihood of an investor appointing its own custodian increases with plan size (see Chart 15), not least to ensure a central point of record. Investor interest in providers' middle and back-office functions — assessed through the use of operational due diligence — also appears to be a higher priority for larger investors, with plans between €500 million and €2.5 billion making the greatest use of operational due diligence reviews (see Chart 16). Operational due diligence reviews tend to focus on investment managers' capabilities and credibility within their middle and back office functions, and have become a regular feature of many plans' investment process in recent years.

Although the results in this section have illustrated the greater resources that are typically available to larger plans, the increasing use of fiduciary managers, particularly by smaller plans, may act to reduce the gap between the investment strategies adopted by large and small investors.

Chart 15: Proportion of Plans That Have Appointed Custodian by Plan Size

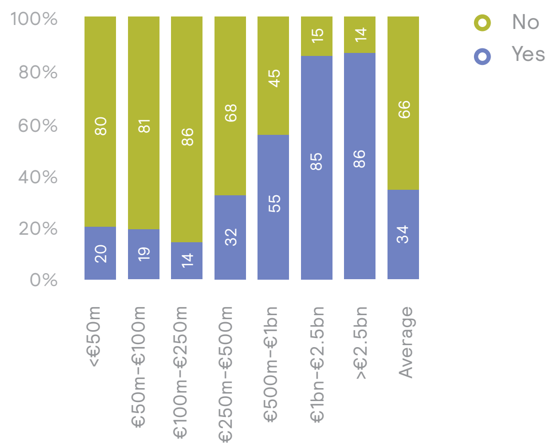
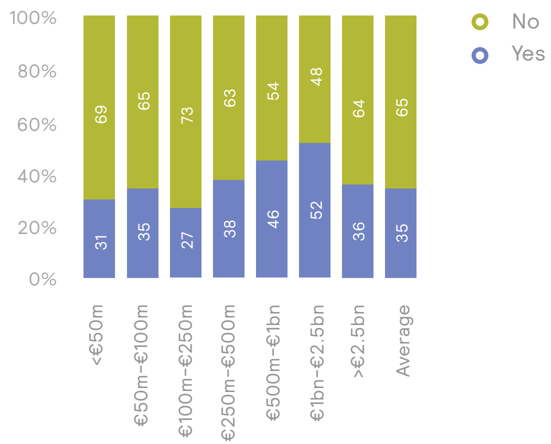


Chart 16: Proportion of Plans Carrying out Operational due Diligence by Plan Size



"Larger pension schemes typically have greater diversification across their asset base and investment managers. Fiduciary management is gaining traction as a way for schemes that don't have the governance budget or size to fully utilise the benefits of diversification across asset classes and investment managers. As a result, we expect the dispersion of results between large and small schemes to narrow over time. The burden of the most important investment decisions still rests with the board of trustees and the level of delegation to third parties, such as fiduciary managers, still remains limited. However, there is a growing recognition of the need to ensure the investment governance structure in place is reflective of the level of complexity within the asset portfolio and can act with the required speed. We expect that over time the use of third parties across all elements of the investment decision making process will increase significantly."

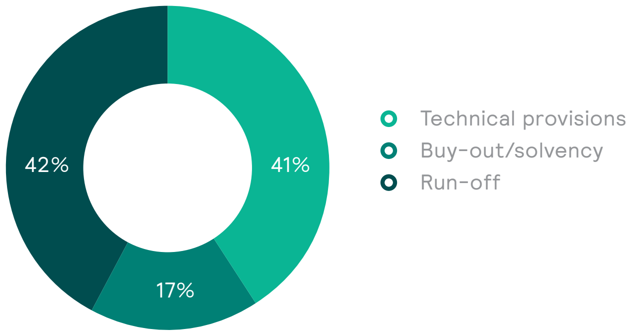
Ben Gunnee, UK Head of Fiduciary Management

"We expect that over time the use of third parties across all elements of the investment decision making process will increase significantly."

06
DE-RISKING FOR UK DEFINED BENEFIT PLANS

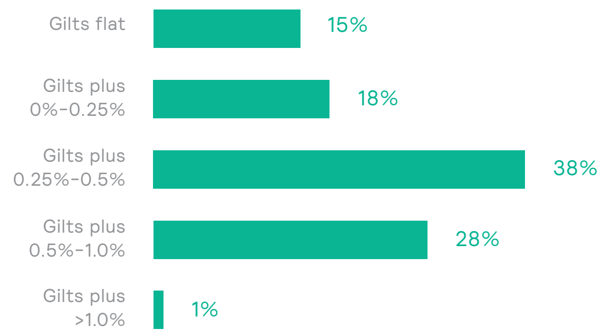
Charts 17a–f provide further colour on the de-risking of UK DB plans, which represent the largest single type of plan in the survey.

Chart 17a-e: De-risking Frameworks for UK DB Plans
17a: Long-term Funding Objective

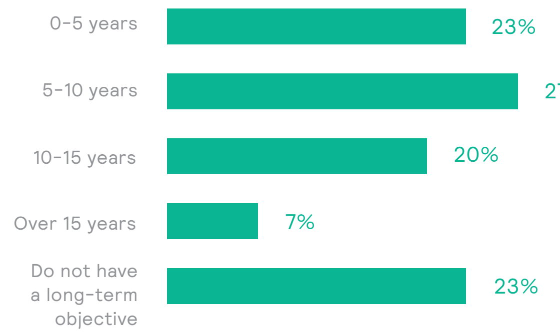


Nearly 60% of such plans have defined a specific long-term funding objective beyond their "technical provisions" liabilities.[5] The objective is typically either "buy-out" (the transfer of plan liabilities to an insurer) or, more frequently, "run-off".[6] In the latter case, the associated basis on which the liabilities are valued varies by plan, but usually reflects a modest premium above the risk-free rate (see Chart 17b).

17b: Run-off Basis

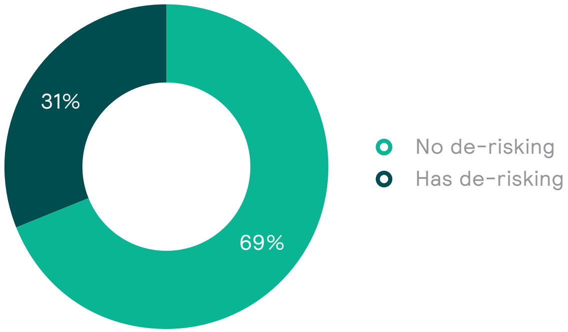


17c: Timeframe for De-risking

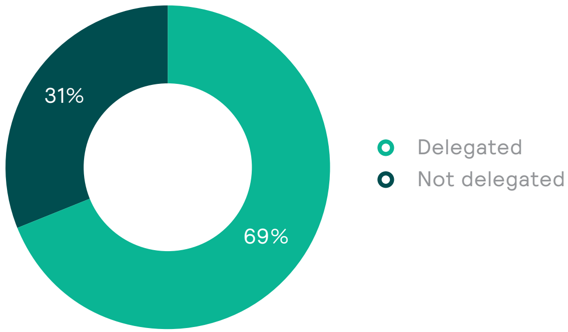


[5] Technical provisions refers to the value placed on plan liabilities by the scheme actuary under the assumption that the plan remains a going concern.
[6] A run-off objective refers to the situation where a closed plan continues to meet member benefit payments directly as the liabilities run off over time, rather than transferring them to an insurer. Usually some element of investment risk is retained. We note that some plans will set a low risk "run-off" target as an intermediate step on the path toward buy-out.

17d: Implementation of De-risking Basis

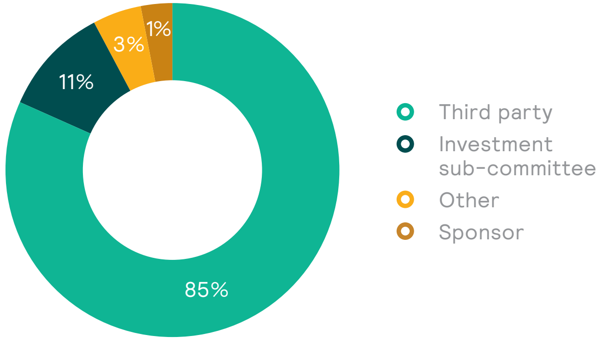


17e: Delegation of De-risking



Just over 30% of plans have put in place a de-risking framework to guide their journey towards their funding objective (see Chart 17d). The associated time frame for reaching full funding varies — not least due to the range of plan funding levels today — but most plans are aiming to achieve their objective within the next 15 years (see Chart 17c). The majority of plans with such a framework have delegated management to a fiduciary manager, who will typically monitor the plan's funding level and automatically de-risk the plan's portfolio in line with a set of pre-agreed funding level triggers (see Charts 17e and 17f).

17f: Who De-risking Is Delegated to



07
RISK MANAGEMENT

Across all countries surveyed, the largest component of the overall asset allocation for the average plan was the bond allocation. As well as acting as a diversifier to equity allocations, for many liability-relative investors the bond portfolio also seeks to “hedge”, to the desired extent, changes in the actuarial valuation of the liabilities. This liability-hedging role is particularly important in regions that require pension plans to update their funding plans regularly based on a mark-to-market valuation of the liabilities (which will be driven largely by changes in interest rates and, in some countries, inflation expectations).

Chart 18: Interest Rate and Inflation Hedging Ratio as a Percentage of Funded Liability

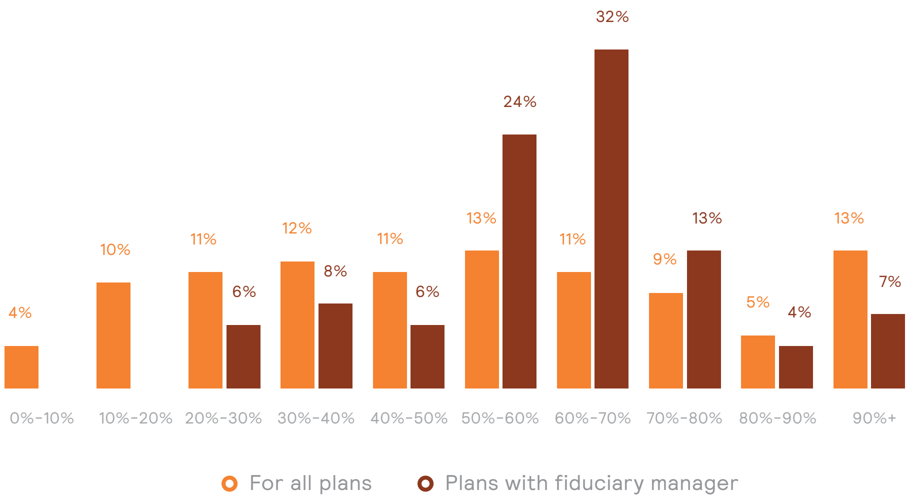
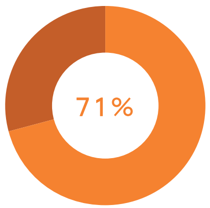


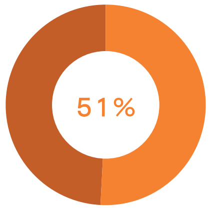
Chart 18 sets out the approximate level of interest rate hedging in place for participant plans. The wide range of hedge ratios observed (around an average of 55% across all plans) in part reflects the spread of bond allocations within plan portfolios, but may also point to the wide range of views that exist around the likely path of interest rates. It is notable that, for those plans that have delegated the design of their matching portfolio to a fiduciary manager, the associated hedge ratios are typically higher, in part reflecting the ability of a fiduciary manager to help investors overcome the complexity associated with derivative-based liability hedging strategies. Where liabilities have inflation linkage, plans in some cases have adopted different hedge ratios for interest rates and inflation.

Chart 19a-e: Derivative Instruments Used to Hedge Interest Rate and Inflation Risk (Where Applicable)

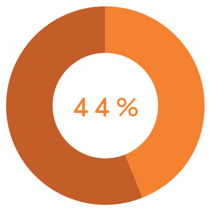
19a: Government Bond Repos



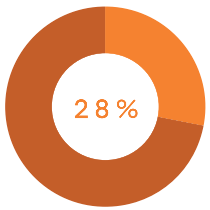
19b: Interest Rate Swaps



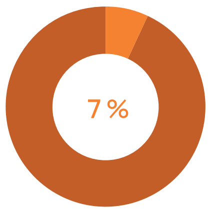
19c: Inflation Swaps



19d: Government Bond Total Return Swaps



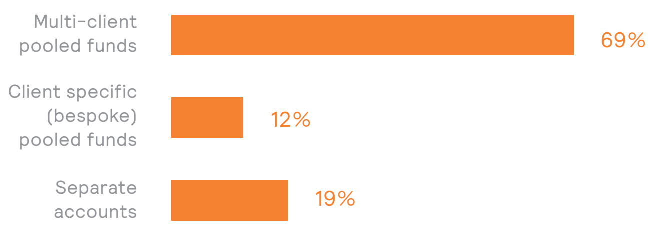
19e: Swaptions



Yes
No

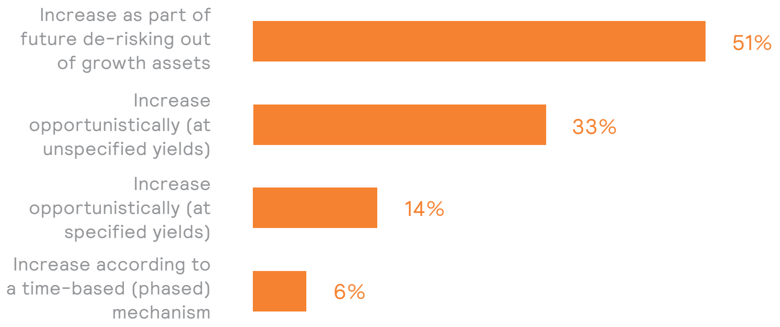
Hedging portfolios have evolved over the last decade to include a range of instruments beyond physical bonds. Charts 19a–e illustrate that those pension plans that use such instruments have become increasingly large players in the government bond repo markets, while interest rate and inflation swaps remain popular hedging instruments. Compared to last year, the relative use of repo over swaps appears to have increased, perhaps as a result of the ongoing yield premium available on long-dated government bonds relative to equivalent swaps. As shown in Chart 20, the most popular means to implementing liability hedging is via pooled vehicles, offering a lower governance alternative to separate accounts.

Chart 20: Vehicles Used for Liability Hedging



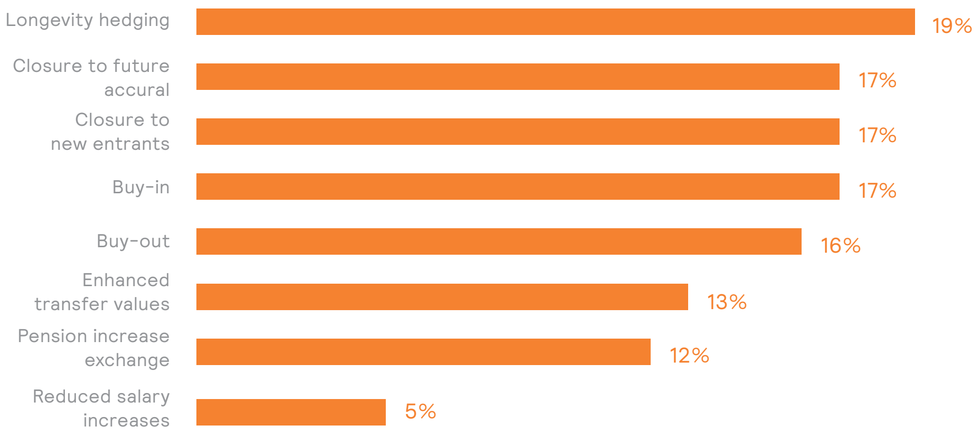
Looking at how plans expect to increase their liability hedge ratios from here, Chart 21 shows that this is commonly expected to be a result of de-risking trades out of equities and into bonds. Nearly half of plans expect to increase their level of hedging should bond yields increase — although only 30% of such plans have set specific "yield triggers". The use of phased or time-based approaches to increasing hedging remains relatively uncommon.

Chart 21: Methods for Increasing Hedging



Liability risk management goes far beyond interest rate and inflation hedging, and plans have considered a variety of liability management approaches over 2014, as shown in Chart 22. These can be grouped into "ways to curb future liability growth", such as closure of plans to new entrants or future accrual; "approaches to managing existing liabilities", such as enhanced transfer values, pension increase exchange exercises, and reduced salary increases; and the "transfer of liability risks to another party" through longevity hedging, buy-ins, or buy-outs. All of these options appear to have been explored by more plans over this survey year than last. The most commonly considered option in 2014 was longevity hedging, which was considered by nearly 20% of plans. This is typically brought about through a longevity swap that, when added to an interest rate and inflation hedging programme, can be seen as an alternative to buy-in or buy-out, often at lower cost. Historically, longevity hedging has only been used by larger plans, but there are now options for smaller plans as well, which may explain some of the increased interest.

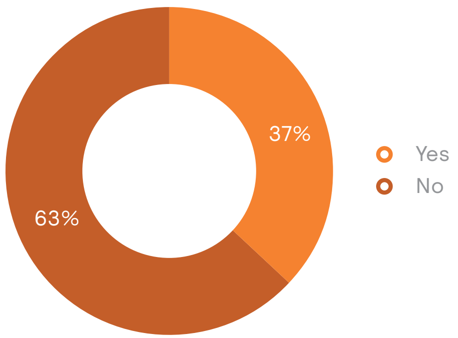
Chart 22: Proportion of Plans Considering Risk Management Excercises Over the Last Year



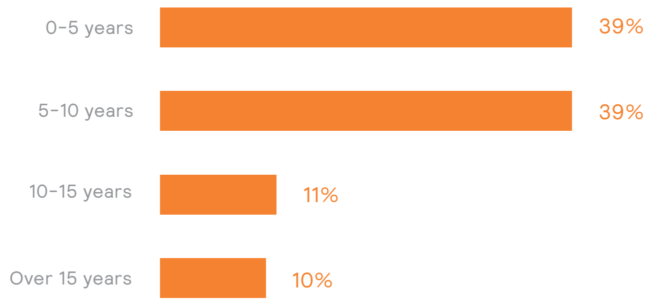
Charts 23a–c consider the degree to which plans are cash-flow negative; that is, when a plan has matured to the point that regular outgo to meet liabilities exceeds income from investment and contributions. Nearly 40% of plans surveyed are currently cash-flow negative and, of those that are not, nearly 80% are expected to become so over the next 10 years. In seeking to meet net cash outgo, most plans disinvest assets, but nearly 30% have instructed their investment managers to distribute income where possible (to reduce the transaction costs associated with disinvestment). A small number of plans (3%) have adopted a cash-flow matching approach, whereby portfolios are designed such that their income and principal receipts are aligned with liability cash-flow requirements.

Chart 23a–c: Net Cash-flow Position

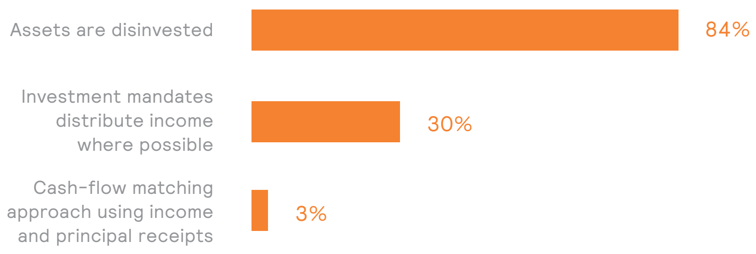
23a: Proportion of Plans That Are Cashflow Negative



23b: Expected Time for Cash-flow Positive Plans to Become Cash-flow Negative



23c: Methods of Meeting Cash-flow Negative Outgoings



Understanding and addressing liability risks is central to meeting an objective of managing overall funding level volatility for DB plans, and we expect the focus on the associated risk management techniques to ratchet up as plans mature. But it is also interesting to consider how this objective may evolve over time, as schemes become increasingly cash-flow negative and better funded. Although cash-flow matching techniques are likely to remain relatively rare in the short term, it may be that portfolios become increasingly "cash-flow driven" over time as their need for derivative-based overlays reduces.

"As DB pension plans mature, trustees and sponsors are focusing increasingly on the endgame. It is, therefore, right that these investors have taken significant steps to manage their risks in a strategic manner. Risk management is more urgent now — because the pain that the European pensions industry has felt on the downside in recent years has been more intense than the thrill that they have experienced on the upside. Due to the range of risk management tools available, trustees and sponsors can reduce or remove risks in their DB pension plans' assets and liabilities very effectively — at times, at very little cost. We also expect the European pensions industry to increase its investments in cash-flow matching strategies as its plans become more mature and cash-flow negative in the near future."

Norbert Fullerton, Partner, Financial Strategy Group

"Investors have taken significant steps to manage their risks in a strategic manner."

08
EQUITY PORTFOLIOS

Charts 24 to 26 consider plan equity portfolios by plan size, underlying allocation, and currency exposure. Although equity allocations are smaller than they were a decade ago, we have seen plans construct equity portfolios in an increasingly thoughtful manner. This has not only included a reduction in the domestic bias, particularly by larger plans, but also the gradual acceptance of emerging markets as a material component of the overall equity universe. Today, nearly 60% of plans have an allocation to emerging markets. For those that do have an allocation, the average allocation of 5% at a plan level works out to be around 11% of the average equity portfolio; roughly in line with the market capitalisation weight.

Non-domestic exposures clearly bring foreign exchange risk, and where plans have a formal currency hedge policy, the majority hedge at least 40% of this risk. Further equity portfolio components typically include defensive, or “low volatility”, equity strategies, as well as dedicated small cap strategies, each of which is employed by around 1 in 6 plans surveyed.

Chart 24: Total Equity Split by Plan Size

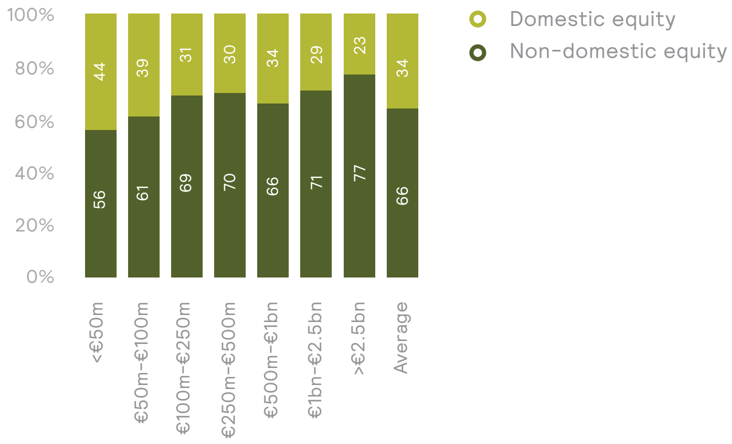


Chart 25: Strategic Allocation to Selected Equity Strategies

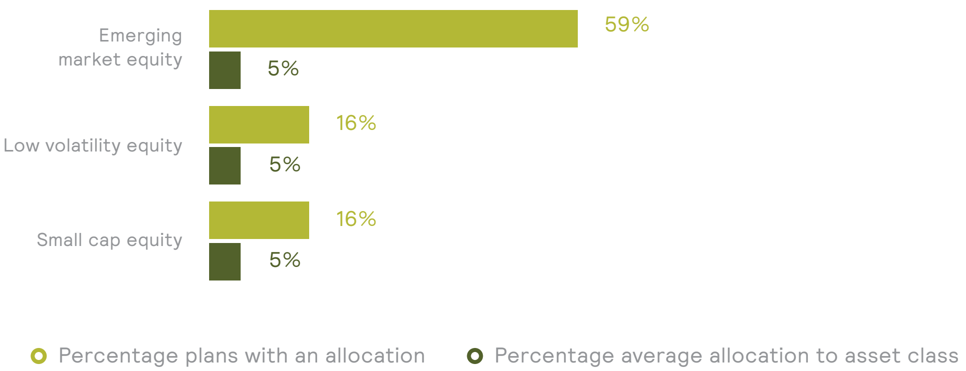
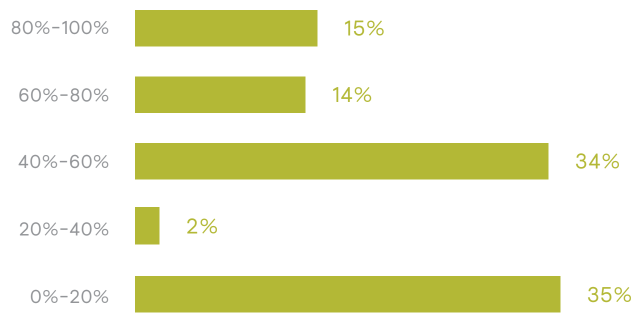


Chart 26: Target Currency Hedge Ratios for Equity Portfolios



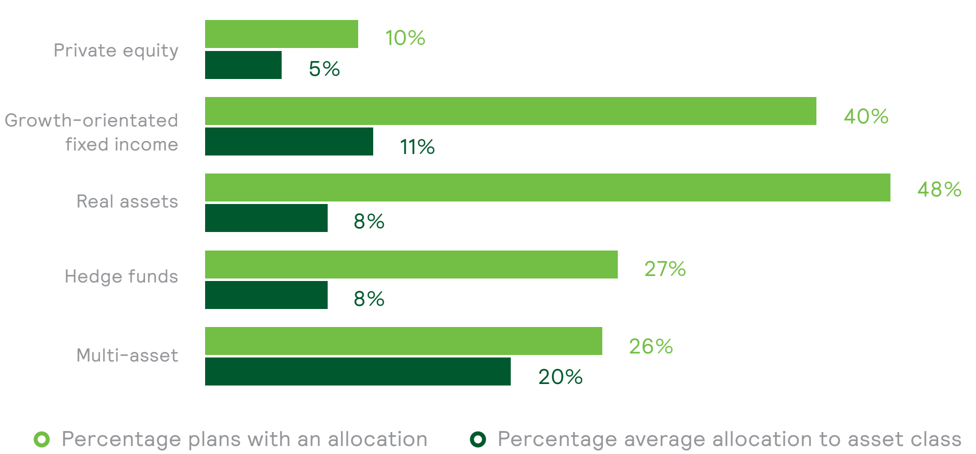
09
ALTERNATIVE INVESTMENTS

With the use of "alternatives" increasing among plan participants, this section considers the nature of the underlying alternative investment strategies being employed. Charts 27a-c consider five broad buckets:

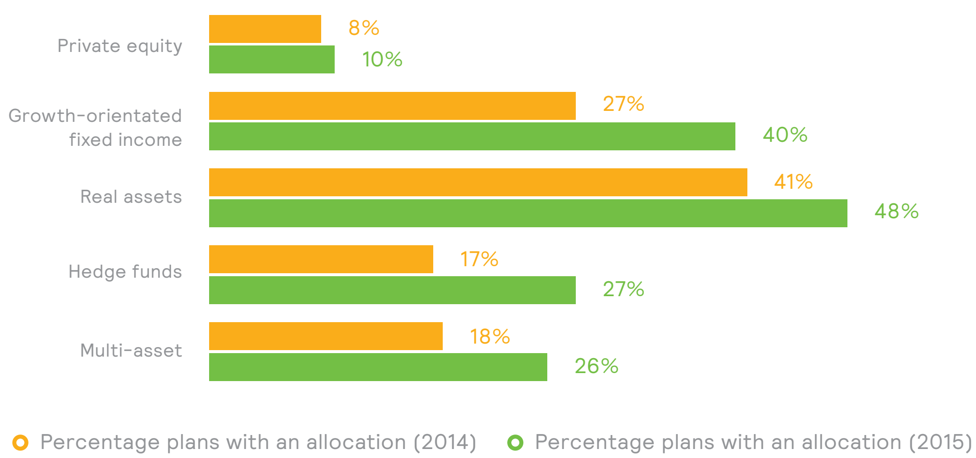
- Private equity, both via fund of funds and direct investment in private equity funds.
- Growth-oriented fixed income, which considers fixed income assets and strategies expected to generate returns in excess of government bonds and investment grade credit.
- Real assets, where the return is expected to come largely from the yield on a physical asset with some degree of inflation exposure, such as real estate, infrastructure, and natural resources.
- Hedge funds, both via direct hedge fund exposures and through fund of hedge funds.
- Multi-asset, which largely relates to diversified growth funds, diversified beta funds, and risk parity (accepting that these strategy types are not mutually exclusive).

Chart 27a-c: Strategic Allocation to Alternative Asset Classes

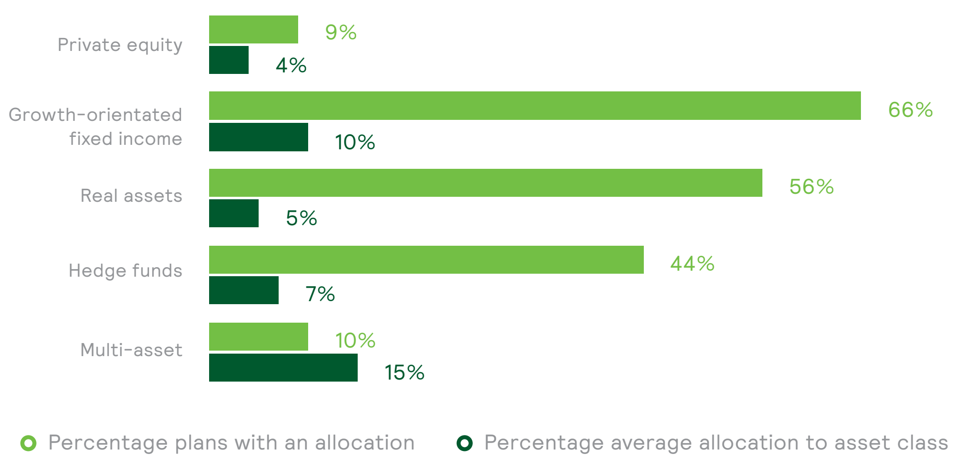
27a: By Type Of Asset Classes



27b: Change Since 2014



27c: For Plans Employing a Fiduciary Manager



Although the most popular areas for investment are growth-oriented fixed income (used by 40% of plans) and real assets (48% of plans), Chart 27b illustrates that more plans are allocating to each underlying category than in last year's survey. The average size of allocation varies between 5% and 20% of total plan assets, with multi-asset strategies seeing the largest average allocations. This may be expected given that such strategies are often seen as a more dynamic means of capturing traditional market exposures and as a "one-stop shop" for governance and fee-constrained investors seeking a diversified and relatively liquid portfolio. Chart 27c considers only the subset of plans using a fiduciary manager and shows an increased tendency for such plans to be invested in growth-oriented fixed income, real assets, and hedge funds, alongside a lower tendency for the use of multi-asset funds.

Charts 28–32 consider plans' allocations within each of the alternative asset categories identified. Relative to last year, we have seen particular increases in the proportion of plans investing in multi-asset credit and private debt. The proportion of plans invested in hedge funds has also increased materially, although this growth has predominantly been associated with fund of hedge funds (including fiduciary and "traditional" fund of funds) and multi-strategy funds.

Real asset allocations remain dominated by real estate. In spite of ongoing interest in infrastructure, take-up has not increased as significantly as other alternatives, which may be due to a degree of "undersupply", both of assets and investor-friendly institutional funds. Private equity remains the least commonly used asset class, perhaps due to its relatively high level of risk and illiquidity, combined with the increased governance required in managing closed-end investment programmes. It is therefore typically used mainly by larger plans.

The most popular flavour of multi-asset strategy remains diversified growth funds (DGFs), which can themselves be broken down into "core" funds (expected to rely on market returns to achieve growth over time) and "idiosyncratic" funds (which place a greater emphasis on tactical asset allocation and specific trade ideas to create a portfolio less reliant on market returns). Given their more balanced risk profile and reliance on traditional market beta, it is unsurprising that allocations to the former tend to be larger as a percentage of plan assets.

Further detail on investor behaviour in these areas can be found in Mercer's **2014 Manager Search Trends** report.

Chart 28: Strategic Allocation to Private Equity

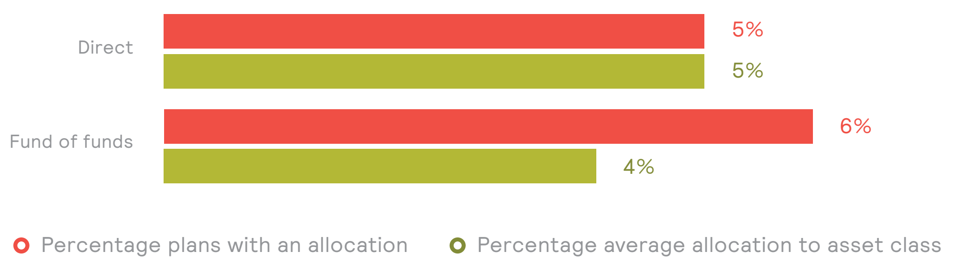


Chart 29: Strategic Allocation to Growth-oriented Fixed Income

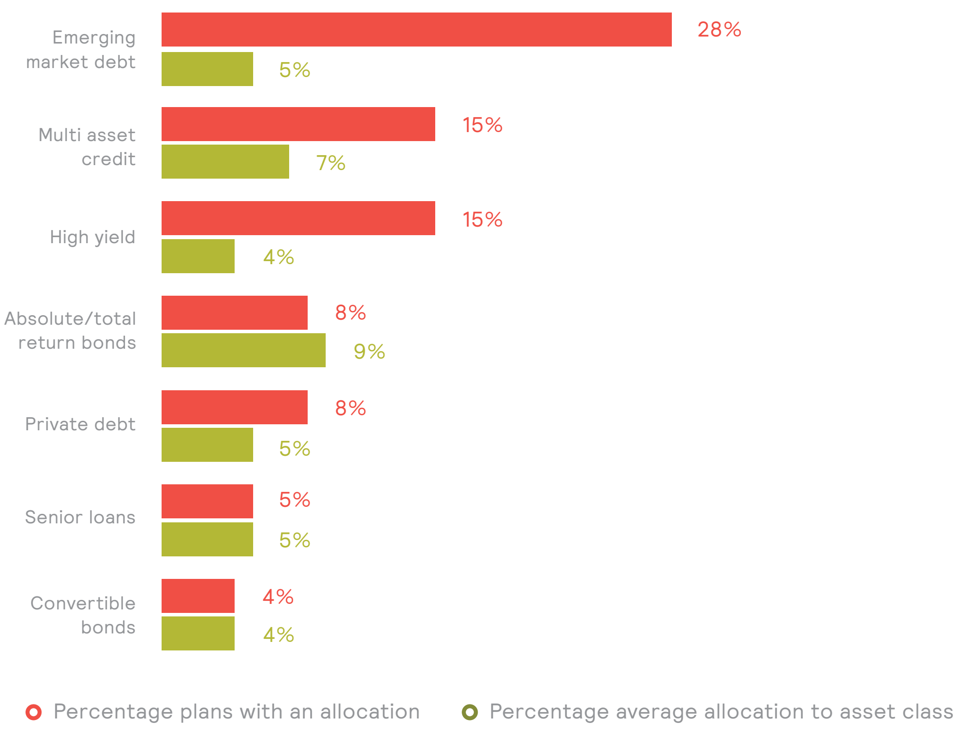


Chart 30: Strategic Allocation to Real Assets

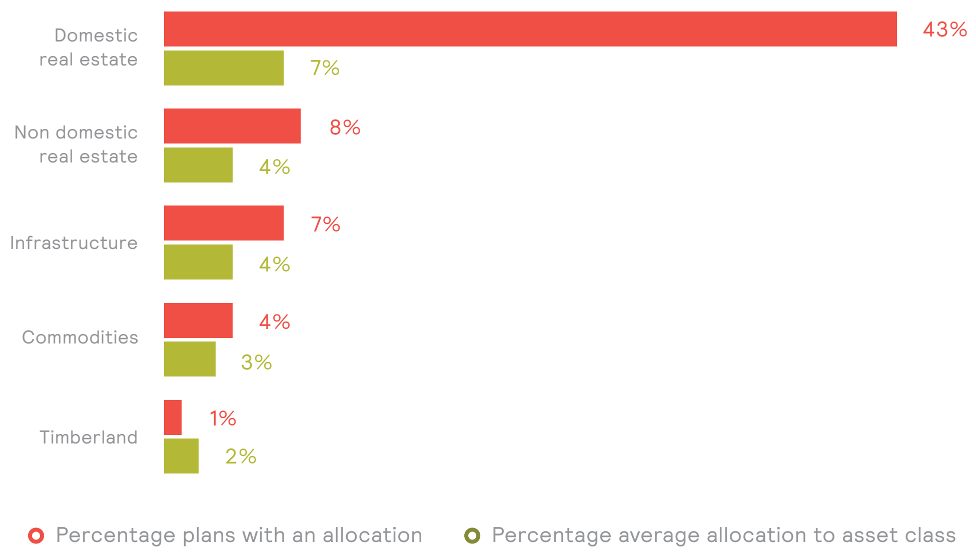


Chart 31: Strategic Allocation to Hedge Funds

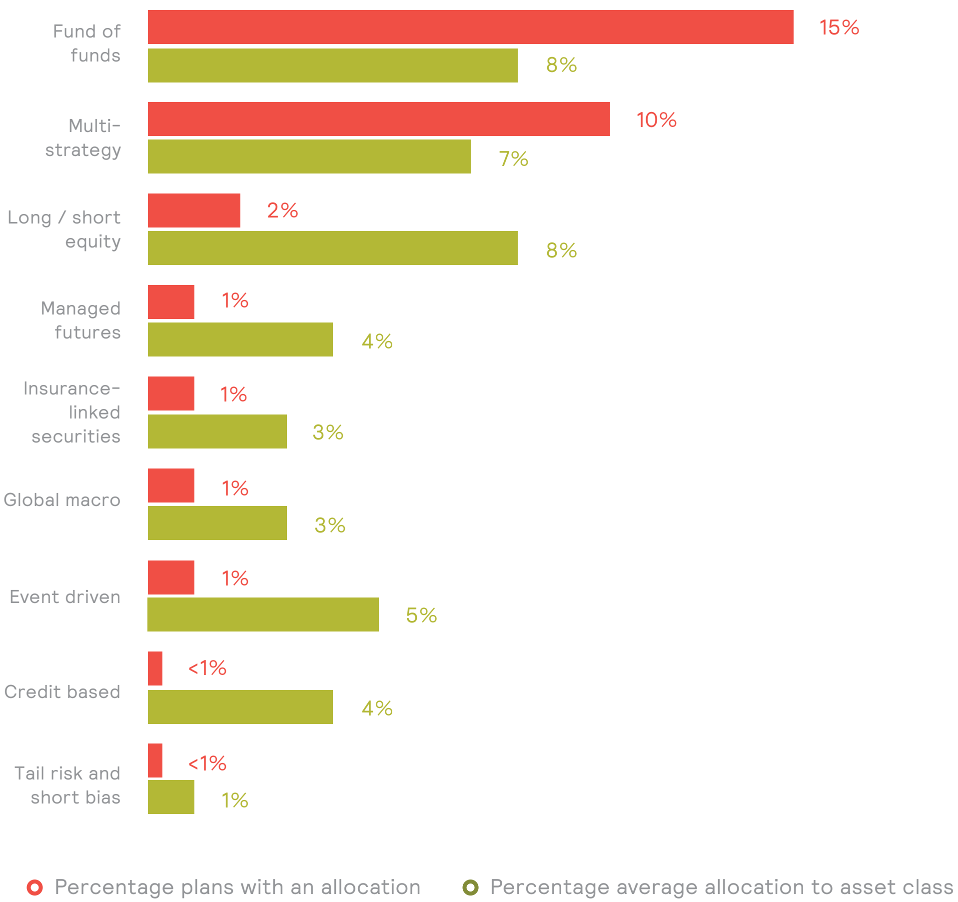
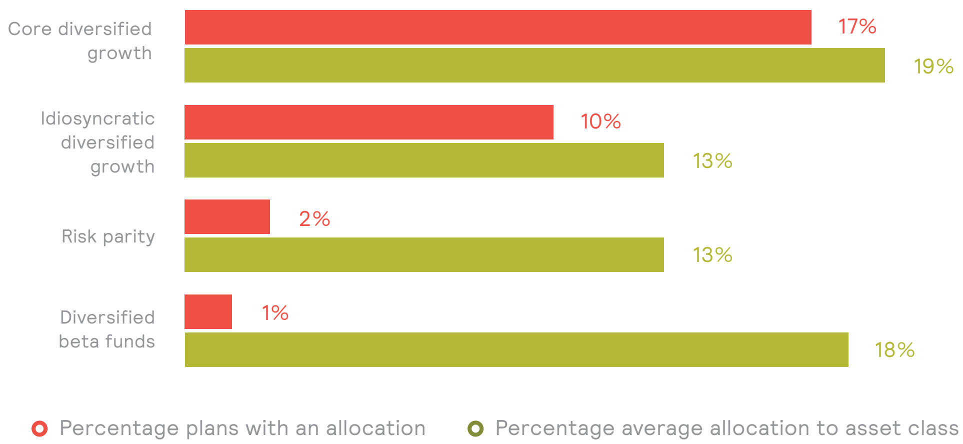


Chart 32: Strategic Allocation to Multi-asset



"Not much has changed in the area of private equity investing. Most clients with portfolios continue to allocate new capital according to well-established plans. Middle-market strategies tend to be the most popular, along with compelling teams in the venture capital sector. Exposures to life science strategies have been well rewarded and continue to garner interest. The high valuations in buyouts are leading some clients to seek out alternative exposures in the form of absolute return oriented or lower risk special situations strategies. In contrast, the growth fixed income allocations to private debt have seen a marked increase in popularity over the last few years. The continued attractive spread of private debt strategies to public fixed-income equivalents is driving such allocations. The addition of lower-risk private debt strategies to client matching portfolios has unleashed significant new demand for senior private debt exposure."

Michael Forestner, Global Co-CIO of Private Markets Group

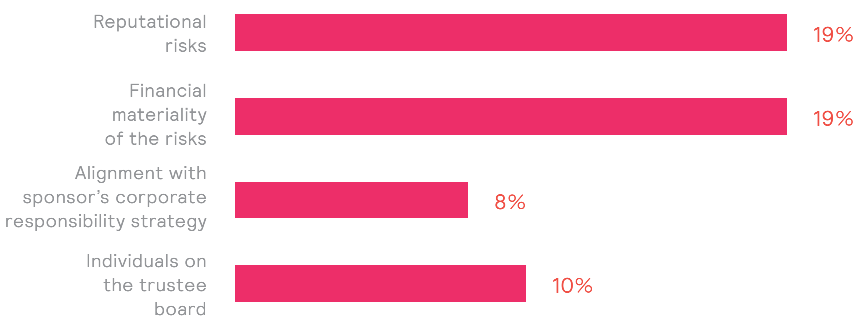
"The continued attractive spread of private debt strategies to public fixed-income equivalents is driving increased allocations."

10
RESPONSIBLE INVESTMENT

Mercer continues to focus on assisting investors in understanding environmental, social, and corporate governance (ESG) issues as both a source of risk and of opportunity for investors. This year, we have focused our survey on the drivers behind ESG integration as well as on two important areas within responsible investment: investor stewardship and active ownership rights, and climate change.

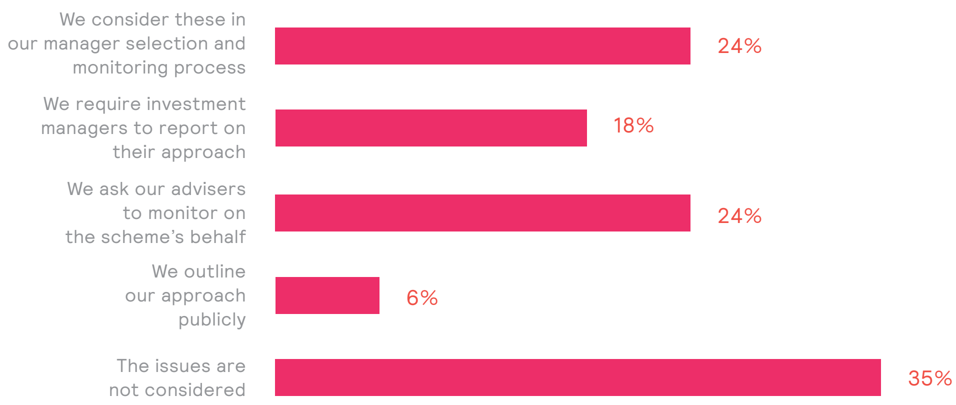
Reputational risks and the financial materiality of ESG risks are the key drivers behind integration (see Chart 33). Seeing financial materiality recognised as a key driver is a positive development. Historically, responsible investment has often been confused with ethical investment and many have incorrectly assumed that the motivation for considering ESG risks has been non-financial. Reputational risk continues to be important to asset owners and, in an age of increasing public scrutiny across social media, we expect this to remain the case. Linking to reputational risk is the desire of some corporate sponsors to align the exposure of their pension plan assets with their public commitments to sustainability. The survey also highlights that the influence of particular individuals on the trustee board can be a driver.

Chart 33: Key Drivers Behind the Consideration of ESG Risks



As in previous surveys, we asked our survey participants how they operate as active owners (exercising voting rights in pursuit of good corporate governance) to meet their stewardship obligations (see Chart 34). We are encouraged to see a strong drop in the number of respondents that do not consider stewardship and ESG issues — although 35% of respondents still do not consider these issues, this is a fall from 48% last year. We expect this number to continue to fall in future years as it becomes increasingly unacceptable to ignore ESG risks. Asset owners increasingly expect their advisers to monitor stewardship issues on their behalf, with 24% of respondents adopting this approach (compared to 16% of respondents in 2014).

Chart 34: Stewardship and Consideration of ESG Issues



Mercer continues to identify investment opportunities related to the growth in industries most directly affected by sustainability issues, with climate change a key focus. Over the last year, Mercer has been updating its 2011 study on the strategic investment implications of climate change and the results will be released in June 2015. This year is critical from a climate change policy perspective, and investors are increasingly under pressure from both policy makers and the public, most conspicuously as the target of fossil fuel divestment campaigns.

This year, we surveyed participants on whether they had considered the investment risks posed by climate change and found that only 3% of respondents had considered these risks. In our view, this highlights the need for a better understanding among investors of the financial implications of climate change. We will continue to monitor how investors are considering the risks and opportunities posed by climate change in future surveys.

"Financial materiality and reputational risk are driving an increasing number of asset owners to consider the integration of ESG issues, particularly when selecting and monitoring investment managers. The sharp drop in the number of respondents that do not consider stewardship and ESG issues is very encouraging. However, over a third of those surveyed do not consider these issues at all – we would expect this number to continue to fall in future years as it becomes increasingly unacceptable to ignore financially material ESG risks."

Kate Brett, Senior Responsible Investment Specialist

"The sharp drop in the number of respondents that do not consider stewardship and ESG issues is very encouraging."

11 ACKNOWLEDGEMENTS

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