MERCER

TALENT • HEALTH • RETIREMENT • INVESTMENTS

VOL. 1, NO. 2 • OCTOBER 2013

RESEARCH PERSPECTIVES

FOREWORD

ROBERT HOWIE

MATT RECKAMP

In this issue of *Research Perspectives*, we continue to focus on finding investment opportunities in a world where economic conditions remain challenging in many respects. One way for investors to generate returns is to seek out more unusual and less-established investments. Our lead piece by Simon Fox explores what some would regard as esoteric investments. While some esoteric investments are already starting to become mainstream, some are relatively unknown by the majority of investors. Another strategy for seeking out returns is to find areas of the global economy that are showing more resilience and signs of growth. With that in mind, we explore two more straightforward opportunities based on the North American growth story in real estate and energy with contributions from Paul Kolevsohn and Harry Leggat. Within the fixed income space, the high-yield bond market is one that has experienced a period of excess returns; Martyn Simpson provides an update. We close by returning to another esoteric investment with a Q&A with Gareth Anderson on frontier market equity investing.

We hope you find this issue valuable. Please feel free to contact us for comments and questions.

Robert Howie
Matt Reckamp

ABOUT THE EDITORS

Robert is a principal and European head of the Alternatives Boutique, a unit within Mercer's Investments business. Located in London, he leads manager research and generation of intellectual capital for alternative assets in Europe, spanning liquid hedge fund strategies to private market strategies such as infrastructure and private equity. Additionally, he advises institutional investors on the use of alternative assets, including manager selections and portfolio construction.

Matt is a principal of the firm located in St. Louis, Missouri. He has a dual role at the firm, splitting time between conducting research on US equity strategies for the Equity Boutique and client-related work with a particular emphasis on foundation and endowment clients.

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MARSH & McLENNAN COMPANIES

ESOTERIC INVESTING

SIMON FOX

In a low-yield, low-growth world it becomes ever-more important for investors to seek alternative sources of return to enable them to generate the long-term growth they need to meet their future obligations — to their pensioners, charity, or university. While there are now a number of “mainstream” alternative asset classes (core property, established infrastructure, blue-chip hedge funds, etc.), the opportunity set is becoming ever broader, as managers become institutionalized and investors become more comfortable with less traditional investments.

The more “esoteric” investments available today are differentiated by being in new geographies, focused in new industries, and/or underpinned by new or hybrid instruments. While not everything esoteric will make a good investment, a number of strategies stand out as providing truly differentiated return sources and rewards that can compensate for the inherent risks of the unusual. Manager selection may be challenging and position sizing important, but opportunities in areas such as catastrophe insurance, global timberland, and private debt have become accepted esoteric investments. As we look forward, the esoteric opportunities for the future might include litigation finance, frontier market equity, impact investing, environmental credits, general partner stakes in hedge funds, and trade finance.

DISTILLING ESOTERIC INVESTMENTS FROM THE MAINSTREAM

In the 1970s, a radical new investment strategy — the index tracker — was launched by Vanguard. What was then seen to be a “pure alpha” investment strategy is now accepted as the underlying driver of the most mainstream of investments — equity beta. Since that point, the asset management industry has continued to innovate and academics and thought leaders have continued to help identify and define new categories of investment. Over the past five years in particular, new ideas have also been brought to the mainstream by the institutionalization of the alternatives industry.

As we look at the investment landscape today, investors can and do access a broader range of alternatives than they ever have done before. For the most sophisticated investors, this will stretch across real estate investments, direct hedge fund allocations, growth-orientated fixed-income mandates, infrastructure, and private equity strategies. For investors just starting out on the road to diversification, these core alternatives are the most logical first steps to take. But as we seek new and differentiated sources of returns, we believe there is value in

“As we look at the investment landscape today, investors can and do access a broader range of alternatives than they ever have done before.”

continued

sifting through the new strategies emerging to identify the opportunities that are available in today's esoteric investments. Indeed, esoteric opportunities strike us as providing some of the most differentiated sources of returns (for example, catastrophe risk) and best market opportunities (such as private debt) available to investors today.

To help provide a context for thinking about mainstream and esoteric investments, Table 1 provides a simplified categorization of different investment strategies by their underlying characteristics. Within this we have highlighted the asset classes that many of our clients now regard as accepted institutional investments, stemming from traditional domestic and global equity through to common alternative investments. Alongside these mainstream investments, we have then identified a mix of the more esoteric investments in today's marketplace.

TABLE 1

Overview of Mainstream and Esoteric Investments

	Mainstream	Geography	Industry	Instrument
Structure	Arbitrage strategies Event-driven hedge funds	Emerging-market hedge funds		Seeding General partner interest Volatility
Style	Long short equity Smart beta Global tactical asset allocation	Emerging-market currency	Sector specialists	Style premia
Income/ Production	Infrastructure Ground leases UK property	Timberland and agriculture	Shipping/aircraft Clean tech	Impact Mitigation/REDD
Credit/ Insurance	High-yield and emerging-market debt Global fixed Gilts and investment-grade credit		Trade finance Litigation finance	Commodities Private debt Catastrophe
Equity	Emerging-market equity Private equity Domestic and global equity	Frontier public equity	Venture capital Sector focused	

"… we believe there is value in sifting through the new strategies emerging to identify the opportunities that are available in today's esoteric investments."

As can be seen, some of these opportunities are differentiated by geography. Over the past few years, emerging-market equities, for example, have become an accepted part of many investors' equity allocations; frontier equities are the natural next step. In the core alternative asset classes, it is still the shift from developed markets to emerging markets that often represents the esoteric opportunity.

continued

Other esoteric investments stand out because of their focus on a particular industry or sector — the move from "core" infrastructure to focused opportunities in, say, the clean-tech space, or opportunities in shipping or aircraft leasing, for example.

Finally, we see esoteric investments emerging as a result of the availability of new instruments. Investors can buy stakes in hedge fund management companies, rather than invest in their funds; they can trade in derivatives to gain exposure to the volatility of markets, rather than their outright direction; and they can trade in catastrophe risk or carbon credits, for example.

This list is not exhaustive, nor, as highlighted above, would we expect it to be static. Today's esoteric investments may become tomorrow's mainstream (or fade away in failure). The classifications will also be somewhat in the eye of the beholder. Timberland may be considered mainstream by a US endowment, but it is a new asset class for the majority of European investors.

WHY ALLOCATE TO ESOTERIC INVESTMENTS?

While esoteric investments can be identified, this does not make them per se a good investment. Indeed, the nature of these strategies means that manager selection may be challenging and the appropriate position sizes might be small. This said, we believe that some of these strategies do stand out as providing a truly differentiated source of return, reducing an investor's reliance on traditional market betas to generate the long-term growth they need. Moreover, while the risks may inherently be higher when stepping out of the mainstream, their additional return potential can compensate investors accordingly.

SOME LEADING CANDIDATES TODAY

Over the past few years we have highlighted a number of esoteric strategies that we believe deserve consideration as part of a diversified growth portfolio of investments:

Catastrophe risk[1] — When investing in insurance-linked securities, such as catastrophe bonds, investors earn a premium unless a specified catastrophe (such as a hurricane in a particular region or an earthquake of a given magnitude, etc.) occurs. Through building a diversified portfolio of these investments, and given the attractive premiums that are available in a niche sector, we believe that investors can gain access to a valuable return stream that has limited correlation to the vagaries of the financial markets.

Private debt[2] — Private debt encompasses real estate debt, infrastructure debt, and corporate debt, as well as opportunistic credit. We first proposed private debt to clients in 2009 as an opportunity directly arisen from the financial crisis, given the shortage of financing available to companies. Five years later, as bank lending remains depressed and likely so for the near term, we are now seeing allocations to private debt moving from being opportunistic to becoming longer-term strategic allocations. Ultimately, we believe that those investors who have some appetite for illiquidity and are looking for attractive risk-adjusted returns should look no further than an investment into private debt — particularly in Europe.

continued

And others for the future …?

Renewable energy infrastructure | Esoteric rating: ★
From wind farms to solar panels, biomass, hydro, and distributed energy efficiency.

Frontier markets | Esoteric rating: ★★★
Equity investments in countries that are too small, illiquid, and less developed than the emerging markets.

Esoteric hedge fund strategies | Esoteric rating: ★★★
Including taking general partner stakes in hedge funds and seeding new managers.

Litigation finance | Esoteric rating: ★★★★
Provides funding for corporate court cases with payoff for success shared with investors.

Impact investing | Esoteric rating: ★★★★★
Earning a return in conjunction with a positive social and/or environmental impact.

REDD+ and mitigation banking | Esoteric rating: ★★★★★
Reduced emissions from deforestation and forest degradation (and similar strategies such as mitigation banking) earn "credits" for their environmental benefits. REDD+ is esoteric, mitigation banking more recognized.

[1] *Perspectives on Alternative Investments* (2012), Vol. 3, No.1.

[2] Mercer. "Private Debt Makes Its Way Into Institutional Portfolios" (2013).

Timberland and farmland[3] — Although US timberland is a recognized investment for many in North America, a globalizing marketplace has created investment opportunities in emerging markets such as Latin America, Eastern Europe, and Asia. Farmland represents another interesting natural resource opportunity, although it is less established at this time and we have therefore found it more challenging to identify high-quality managers in this space.

CONCLUSION

While not everything esoteric will make a good investment, a number of strategies stand out as providing truly differentiated return sources and rewards that can compensate for the inherent risks of the unusual. Manager selection may be challenging and position sizing important, but a number of more esoteric opportunities have become accepted institutional investments — including catastrophe insurance, private debt, and global timberland.

ABOUT THE AUTHOR

Simon is a principal within Mercer's Alternatives Boutique, part of the Investments business. As director of macro, currency, and commodity research, Simon is responsible for developing the Boutique's intellectual capital and research coverage in global macro hedge funds, currency, and commodity strategies. He also has broad input into less-liquid natural resource strategies, such as timberland and agriculture. Simon may be reached at simon.fox@mercer.com.

[3] *Perspectives on Alternative Investments* (2012), Vol. 2, No. 1.

THE US INDUSTRIAL REAL ESTATE OPPORTUNITY

PAUL
KOLEVSOHN

As a result of the global financial crisis, all major real estate property types (multifamily, retail, office, and industrial) realized significant deterioration in both capital-market and property-level fundamentals. In the US, these property types, excluding the multifamily sector, still have average valuations and property fundamentals below prerecession peaks. However, the industrial sector has emerged as the next sector poised to experience sustained growth as a result of improved economic conditions and property-level fundamentals. Market performance in the industrial sector is heavily influenced by a number of economic variables but is most closely correlated to Gross Domestic Product (GDP). As Figure 1 illustrates, growth of the US economy, as reflected by GDP, is closely tied to industrial space demand and market rents. The cyclical flow of domestic consumption and production supports manufacturing activity, housing production, and global trade — all of which depend on the industrial sector (that is, warehousing) for the transport and storage of goods.

During the second quarter of 2013, US GDP grew at an annual pace of 2.5%, which was more than double the pace registered for the prior three months. While economic headwinds may slow GDP growth during the second half of 2013, GDP is expected to stabilize around 3% over the next several years. As a result, industrial sector rental rates and space absorption will demonstrate meaningful improvements and should remain strong for the foreseeable future (Figure 1).

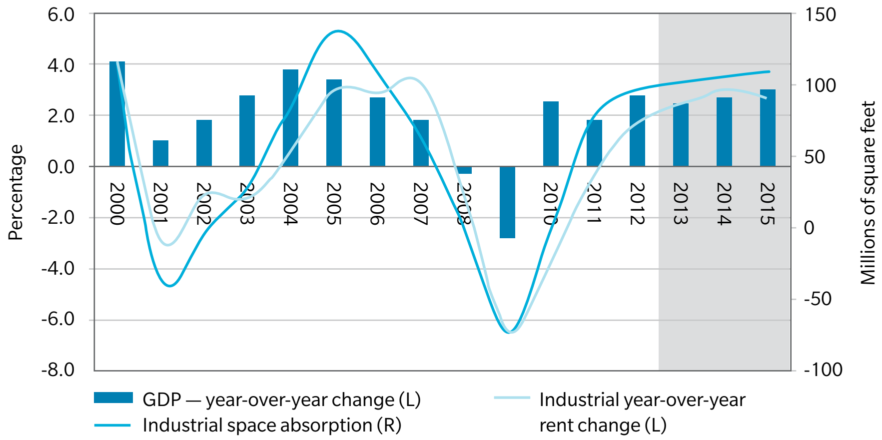
"While economic headwinds may slow GDP growth during the second half of 2013, GDP is expected to stabilize around 3% over the next several years."

While many components within GDP affect the industrial sector, this article focuses on two key areas: the surging housing market and e-commerce, both of which have and will continue to significantly impact the sector. Another positive trend for US industrial real estate is the recent data suggesting that offshore manufacturing may be returning to the US, which would cause an increase in domestic production and lead to positive absorption of industrial square footage. Finally, the above-mentioned variables combined with a generally improving economy have led to a surge in demand for industrial space (Figure 2), which is putting downward pressure on vacancy rates.

continued

FIGURE 1

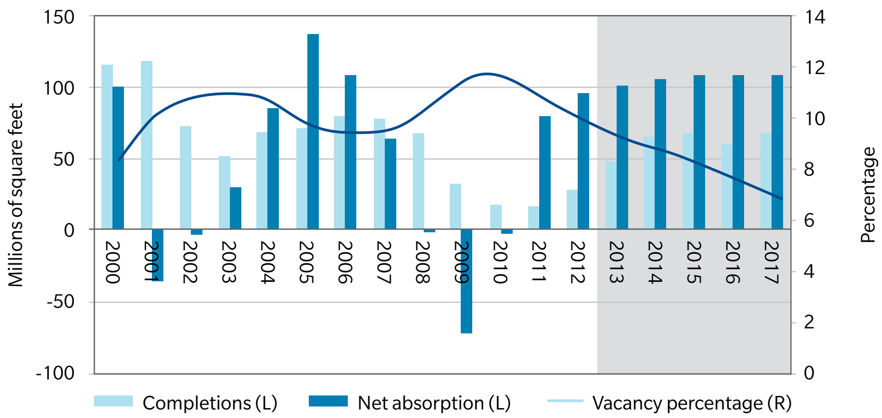
GDP and Industrial Fundamentals



Source: Bloomberg, Reis, Mercer

FIGURE 2

Industrial Supply and Demand



Source: Bloomberg, Reis, Mercer

IMPROVING THE SINGLE-FAMILY HOUSING MARKET

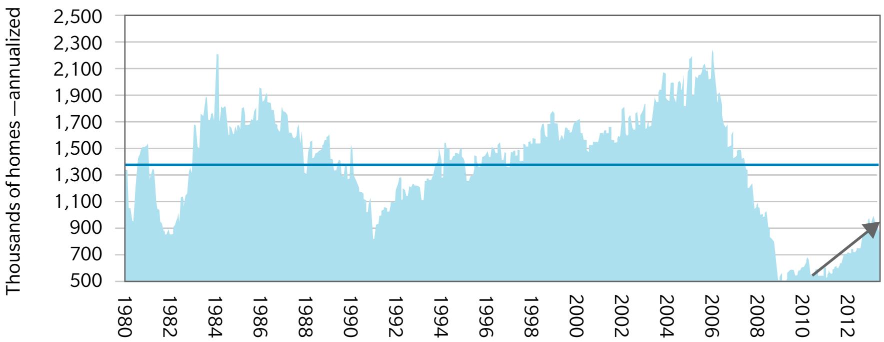
A significant portion of the investment component of US GDP is in residential real estate. In fact, during the second quarter of 2013, investments in housing accounted for nearly one-fifth of the economy's growth. A large part of this growth can be tied to the Fed's bond-buying program, which has reduced borrowing costs for home buyers and helped ignite a burgeoning recovery in the US housing market. The recovering housing market and new residential construction have played a significant part in the improving industrial space market. Demand for durable consumer goods, such as home appliances and building materials that must be stored in industrial sector warehouses, will continue to increase with the improving housing market. As Figure 3 illustrates, housing starts since the beginning of 2012 have grown by almost 25% and are still approximately 35% below long-term averages, implying that the pace of recovery could remain robust for several years.

"… housing starts since the beginning of 2012 have grown by almost 25% and are still approximately 35% below long-term averages …"

continued

FIGURE 3

Privately Owned US Housing Starts



Source: Bloomberg, Mercer

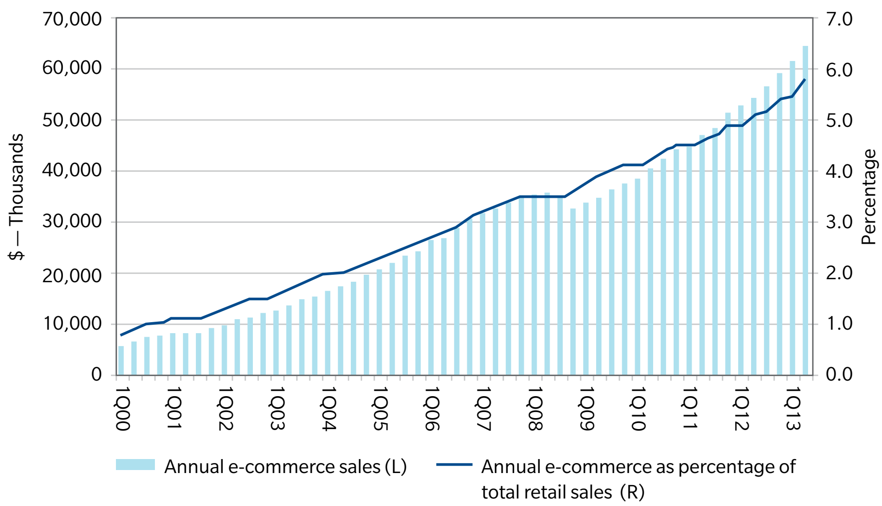
EFFECT OF E-COMMERCE ON INDUSTRIAL SPACE

Online shopping is becoming much more efficient and cost effective for the US consumer. In today's market, consumers have the ability to purchase virtually anything from any location, often with next-day delivery. As such, growth in internet retailing is having a substantial impact on warehouse properties. Since 2000, online sales have grown from $5.8 billion, or 0.8% of total retail sales, to $64.8 billion, or almost 6% of total retail sales (Figure 4).

"Since 2000, online sales have grown from $5.8 billion, or 0.8% of total retail sales, to $64.8 billion, or almost 6% of total retail sales."

FIGURE 4

Growth of E-Commerce



Source: Bloomberg, Reis, Mercer

This phenomenon has shifted a meaningful portion of retail activity from the physical store to warehouse and distribution centers. Accordingly, some major big-box retailers have begun altering their business model by reducing the size of their physical locations and increasing their regional warehouse and distribution

continued

centers. As online customers increasingly demand next-day or even same-day delivery of their purchases, retailers will have to continue to set up distribution centers closer to the customer. The industrial sector is reaping the benefits, at the expense of retail properties, of technology and the changing habits of the consumer.

OFFSHORING

Over the past three decades, the US has offshored a large percentage of its manufacturing jobs; however, there have been indications that companies are beginning to perceive domestic manufacturing as more profitable and efficient. Previously, the primary motivation for corporations to offshore manufacturing was substantially lower wages. However, over the past 15 years, oil prices have almost tripled, making cargo shipping costs substantially more expensive. Additionally, the expansion of domestic natural-gas production has reduced the cost of operating factories in the US. These factors are beginning to offset the wage savings experienced by offshoring. If sustained, they will serve as an additional catalyst for industrial space absorption and development in the US.

LACK OF NEW INDUSTRIAL DEVELOPMENT

National vacancy rates in the industrial sector reached a peak of 12% in 2009. As a result, the development of new square footage virtually disappeared and has not had a meaningful increase since that time. In contrast, since 2011 the demand for industrial space has surged, creating a supply and demand imbalance. In fact, at the end of 2013, industrial vacancy is projected to be down to approximately 9.4%, a 230-basis-point reduction in the four years since 2009. Over the next few years, tenant demand for new space is expected to almost double the pace of development, which will exert substantial downward pressure on vacancy and upward pressure on rental rates. As a result, the industrial rental rate is expected to increase by approximately 3% annually and the vacancy rate is projected to be 7.1% by 2017 (see Figure 2).

CONCLUSION

According to Reis,[1] between 2008 and 2011, rental rates in its 40+ US industrial markets declined by almost 9%. With two years of strong industrial space demand in 2010 and 2011, rental rate increases returned to the sector during 2012 for the first time since the start of the global financial crisis. Since the trough of the recession, fundamentals in industrial real estate have improved more than in all other property types, with the exception of the apartment sector. Further, the outlook for the industrial sector remains positive, with a number of domestic and global economic factors poised to provide tailwinds for future demand. The amount of new supply scheduled to be delivered to the national industrial market is projected at levels that will support the continued positive momentum of occupancy and rental rates, which bodes well for investing in industrial real estate over the next several years.

[1] Reis sources industrial property level data from more than 200 markets and submarkets across the United States. All multitenant and single tenant warehouse/distribution and R&D with at least 10,000 square feet across all markets are used for this report.

ABOUT THE AUTHOR

Paul is a senior consultant within the manager research division of Mercer and is located in Atlanta, Georgia in the US. His primary responsibilities include analysis, research, and due diligence of US real estate private equity investment strategies. In particular, he focuses on high-risk strategies utilizing both debt and equity structures. You may reach Paul at paul.kolevsohn@mercer.com.

HARRY
LEGGAT

AN ARGUMENT FOR INVESTING IN NORTH AMERICAN ENERGY

Based on a presentation by Harry Leggat at Mercer's Global Investment Forum in Boston, Massachusetts, June 13, 2013.

North American energy is an exciting investment opportunity that offers very attractive returns. In other words, it represents an attractive play on global growth and the expanding demand for energy.

It begins with the four primary factors of production: land, labor, capital, and entrepreneurship. Land includes natural resources both above and below the ground. As economist David Stern wrote: "All production involves the transformation or movement of matter in some way. All economic processes must therefore require energy, so energy is an essential factor of production."[1] In other words, the global economy cannot grow without energy. Global population and income growth are key drivers for energy demand. The world population is forecast to grow by 1.3 billion by 2030. Global GDP is expected to roughly double in the same period. As a result, over the next 20 to 30 years, energy demand is forecast to expand by 35% or more. Low and medium-income economies outside the Organisation for Economic Co-operation and Development (OECD) are expected to account for 90% of new energy demand, so this strategy is also potentially an indirect play on emerging markets.

"… over the next 20 to 30 years, energy demand is forecast to expand by 35% or more."

Most energy is basically from fossil fuels — and while it is true that they are going to lose share to other sources of energy, fossil fuels will continue to represent more than 80% of total global energy consumption and the dynamics for oil and gas are very strong. Together, they are projected to dominate all the other sources and represent more than 50% of total global consumption. Natural gas consumption is projected to grow by more than 45% by 2030, and it is also going to gain share primarily as a substitute for coal in power generation. Oil consumption is projected to grow by more than 15%. Renewables are exciting and are growing share at the fastest rate compared to all the other energy sources, but renewables are forecast to remain a minority of total consumption for some time.

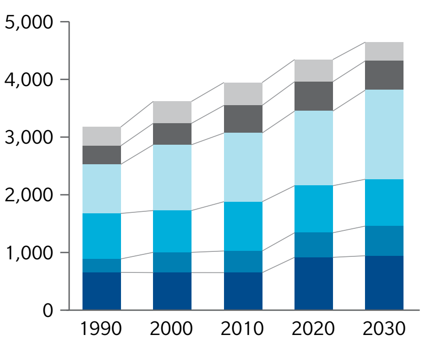
With all this growing demand, production has to expand in order to satisfy it. Oil production is expected to increase 18% by 2030, with most of that growth expected to come from North America. In fact, North American production is projected to grow faster than any other region in the world in the next 20 years. US oil production notched record growth of 14% just last year. Natural gas production is forecast to increase 49% by 2030, with North American production increasing 32%.

[1] Stern DI, Cleveland CJ. *Energy and Economic Growth*, March 2004.

continued

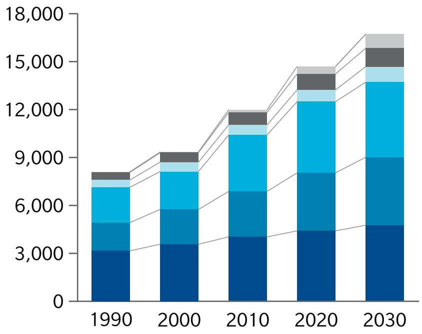
North America Continues to Be a Leading Oil and Gas Producer

Projected Global Oil Production



Source: Bloomberg, Mercer

Projected Global Natural Gas Production



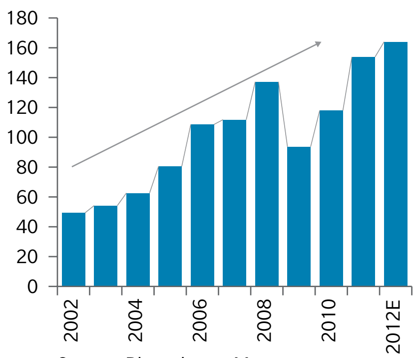
Source: Bloomberg, Mercer

North. America | South and Central America | Europe and Eurasia | Middle East | Africa | Asia Pacific

Increasing production requires significant capital investment. The International Energy Agency (IEA) estimates that roughly $20 trillion will be required for new oil and gas investments over the next 25 years. That is about $750 billion a year. This is a really big opportunity. Last year, more than $160 billion was invested in US oil and gas alone. These capital requirements are going to create substantial opportunity for private equity investors. In fact, private-equity investors are already major players in the energy sector. Last year, more than $16 billion was invested in US oil and gas companies. That is second only to the major public oil and gas companies in this country. Private equity investors have been opportunistic buyers of conventional assets from the large majors and publics who have been raising capital to develop their large shale-play portfolios. There are also ample exit opportunities, including sales to Master Limited Partnerships, who seem to always have an appetite for buying, and to other strategic buyers.

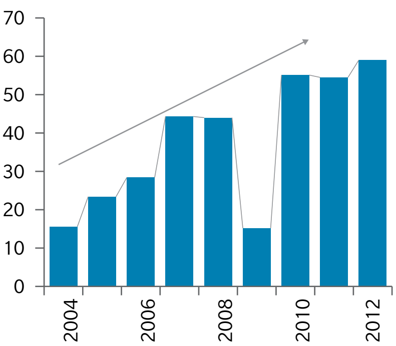
Capital Requirements for North American Oil and Gas Are Enormous

North American Upstream Capital Spending



Source: Bloomberg, Mercer

US Upstream Acquisition and Divestiture Transactions



Source: Bloomberg, Mercer

continued

Why private equity rather than public equity? The answer is pretty simple. Everybody knows that public equities have exposures to significant market volatility. Operating outside the scrutiny of public markets, private equity investors can take a patient long-term view, as opposed to managing to public-equity analysts' short-term earnings expectations. Private equity represents an efficient way of investing in smaller operations that are not burdened with heavy capital structures or legacy costs. Additionally, private equity offers an attractive structure that has good alignment of interests and fewer agency conflicts. However, to capture these benefits, investors have to forego some short-term liquidity, but the returns have been worth it.

Performance in this area has been pretty good. In the past 15 years, median internal rates of returns were 10%–15%; top-quartile returns have been in the mid-20% range. Given population-growth trends and the dependence on energy for that growth, the return potential is not likely to diminish. This is also a sector that offers plenty of choices for investors. The North America energy private equity sector is well developed with numerous established managers. Investors should have no problem developing high-quality, diversified portfolios.

"The North America energy private equity sector is well developed with numerous established managers."

With regard to regulation and environmental concerns, increased regulation, particularly in hydraulic fracturing or, more popularly, fracking, may, in fact, be a good thing — it will, after all, make the production process safer and more ecologically sound (generating power from gas produces significantly less carbon than from coal). But there is no ignoring the other side of the argument, which is that fracking is leading to energy independence for our country, creating more affordable fuel prices, and displacing coal in power generation, which is a good thing for the environment. Even if fracking spreads to other regions in the world and thereby results in a dramatic rise in supply, oil prices need not be where they are — around $100 a barrel, or even $60 a barrel — to be economically attractive. One of the reasons North America is an attractive place to invest is because it is a technological leader. It is where fracking was developed. It is where the fracking services infrastructure is established. If you want a play in that area, this is the place to be.

In conclusion, North American oil and gas private equity is very attractive because energy represents a fundamental economic factor that touches virtually every part of the global economy. The demand dynamics for oil and gas are very strong, and there are few, if any, reliable substitutes. Notwithstanding that renewables are exciting and are growing share at the fastest rate compared to all the other energy sources, oil and gas are expected to be the major sources of energy and represent more than half of global consumption for the foreseeable future. That's one of the more attractive aspects of this strategy. It is truly a global market, and North America will remain a dominant producer and one of the safest places in the world to invest. Investors can capture premium returns without taking excessive risk.

ABOUT THE AUTHOR

Harry is a principal in the Alternatives Boutique and has been researching private market investments since 2001. Prior to joining Mercer/Hammond Associates in 2007, Harry spent three years as vice president of Asset Consulting Group, Inc., where he was responsible for directing research and due diligence activities on private equity and real-assets investment strategies. You may reach Harry at harry.leggat@mercer.com.

MARTYN
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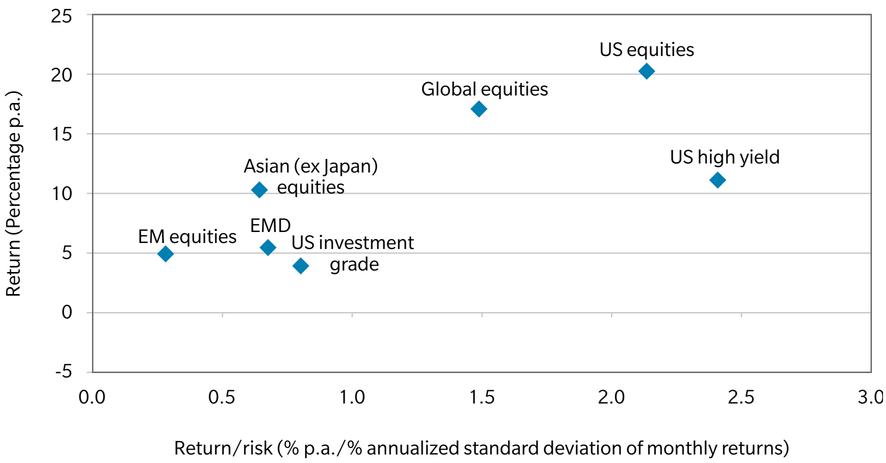
UPDATE ON THE HIGH-YIELD BOND MARKET

In January 2012, Mercer suggested that it was an opportune time for investors to make a strategic allocation to high-yield bonds because they had historically provided excellent risk/return characteristics, help diversify the source of returns in the growth portfolio, and have a defensive but cyclical nature. At the time, we believed that wide spread levels made high yield attractive for a tactical allocation.

RECENT PERFORMANCE OF HIGH-YIELD BONDS

Since then, high-yield bonds have enjoyed robust performance, although there has been a small sell off more recently. Below, we charted the performance of a number of major asset classes over the 18-month period ended June 30, 2013, showing the return they produced plotted against the return for every unit of risk taken, as measured by standard deviation.

Return vs. Return/Risk (Dec 31, 2011, to June 30, 2013)



Source: Thomson Reuters Datastream (indices used: MSCI EM, MSCI World, MSCI AC Asia ex Japan, S&P 500, Barclays Capital US Aggregate Government, Barclays Capital US Corporate Investment Grade, Bank of America ML US High Yield Master II, JPM EMBI Global Diversified)

continued

Although high-yield bonds were only the third-best performer, behind US equities and global equities, the asset class still returned an annualized 11.2%. More impressively, it was the best performer in terms of return for risk taken. The lower absolute level of volatility, relative to broad equities, is something we would expect to see over the longer term.

Of course, the recent impressive performance of high-yield bonds does not mean that future performance will be equally impressive. In fact, we now believe that returns from the asset class over the next couple of years could be muted, and we would be very surprised to see recent performance repeated in the near term. The main reason for this is that spreads have tightened dramatically over the period of observation. The Merrill Lynch Global High Yield index started 2012 with a spread of 807 basis points, and by mid-year 2013 this had fallen to 554 basis points, essentially driving the performance of high-yield bonds.

CURRENT ECONOMIC CYCLE

High-yield bonds are a cyclical asset class that tends to perform better than equities in the early stages of the business cycle. As companies enter and go through a recession, they tend to focus on reducing their debts (deleveraging) to help ensure survival. During this debt-reduction phase, credit generally outperforms equities. Once the economy recovers, profits start to grow faster than debt. While this period is good for credit, it is also good for equities. Then during the next phase, debt starts to grow faster as companies look to improve equity holder returns with the help of additional leverage. This causes credit to underperform as equity holders see enhanced returns, while the risk to debt holders increases. We suspect that we are currently somewhere near the end of the debt-reduction period.

INVESTMENT TIMING

So how confident can we be that investors will not experience negative returns investing in high-yield bonds today? One way is to look at the level of portfolio defaults required to leave an investor with only a return of initial capital after a certain period. The default rate required to bring about a breakeven investment could be considered the "margin of safety" that an investor has. To represent this in terms of valuation, we believe that spreads of 600 bps and higher represent a decent entry point to the market. Based on conservative assumptions, but recognizing that today's high-yield market is dramatically different than the market from 20 years ago (in terms of size, liquidity, issuers, etc.), at that spread level it would require a default record, over the next five years, worse than at any period in history to lose money. We consider this a large margin of safety for investors. If markets turned out more benign, then an investor could reasonably be expected to profit in this period. With a default rate of 4.2% (the average default rate over the period 1980–2010), an investor could reasonably expect an annualized return over the five-year period of 3.9%. Although this does not sound like a particularly high return, when we consider that 10-year government bond yields in the UK, Germany, and the US are all below 3.0%, we believe that 3.9% is an acceptable return in the current market.

"... we believe that spreads of 600 bps and higher represent a decent entry point to the market."

continued

We looked back over the past 20 years to find the worst-possible entry point to invest in the high-yield market. This would have been on May 28, 2007, when the high-yield index had a record-low spread of 233 basis points. It was also just before the credit crunch started to impact markets. However, over the next five years, an investor entering the market at that point would have made a return of 7.1% per annum. If, instead, the investor had sold out at the worst possible point, in November 2008, the loss would have been 35.5% on the initial investment. It is probably fair to add that, during such periods of market stress, all risk assets would suffer and, historically, high yield has held up much better than equities at such times.

EFFECT OF RISING GOVERNMENT BOND YIELDS

So far, we have largely concentrated on spreads in the high-yield market. However, the total yield on a high-yield bond is made up of a component that represents the current government bond yield and the spread that is then added on top. It is widely believed that government bond yields are going to rise over the next few years and may do so considerably from current low levels. At the end of June, the total yield to maturity on the Merrill Lynch Global High Yield Index was 7%. This was made up of a spread of 554 bps and a government bond yield equivalent of 146 bps. In the past, a rising government bond yield had little effect on the high-yield market, as the increase in the government bond yield would have been small in comparison to the total yield in the market. In the current market, however, a 1% increase in government bond yields will have a significant impact on the market because of lower overall yields. How much of an impact rising yields will have is governed by the speed of the rise. A dramatic rise in yields over a short period would result in large losses for bond holders. A slow rise over time would result in muted returns for bond holders but no overall losses.

> "In the current market ... a 1% increase in government bond yields will have a significant impact on the market because of lower overall yields."

HIGH YIELD AS PART OF A BROADER FIXED-INCOME MANDATE

We published a paper titled "Constructing a Growth Fixed Income Portfolio," which examines a number of ways of combining different fixed-income assets to create a growth portfolio. In all of these portfolios, high-yield bonds play a part. The allocation to high-yield bonds can be achieved either by a direct allocation or through access to a multi-asset credit fund. This gives clients two ways of entering the market.

If clients choose to invest directly, as this paper has pointed out, they may wish to wait for a more opportune moment to invest, when spreads are higher or when government bond yields have risen further. This would mean that they could delay implementing a full fixed-income growth portfolio or allocate to other asset classes temporarily and increase the high-yield allocation over time as markets present better opportunities.

Of course, decisions like this one normally require a high level of governance. For those clients who may be uncomfortable with making such a decision independently, a multi-asset credit fund may be a good option. In this approach, a manager will invest across a number of credit asset classes and will be tasked with making the asset-allocation call between them. In this way, the manager will be responsible for identifying appropriate entry and exit levels for high yield while using other credits to achieve returns and to try to reduce volatility.

ABOUT THE AUTHOR

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GARETH ANDERSON

Q&A WITH GARETH ANDERSON: FRONTIER MARKETS

Q: What is a frontier market?

A: There is no clear-cut definition for what constitutes a frontier market, with asset managers, index providers, and other entities such as the World Bank all having slightly different interpretations for the term. Despite a lack of consistency in the application of this term, it is generally accepted that the term frontier market denotes a country with low income per capita and relatively undeveloped capital markets when compared to its emerging- and developed counterparts.

"… it is generally accepted that the term frontier market denotes a country with low income per capita and relatively undeveloped capital markets when compared to its emerging- and developed counterparts."

When considering the frontier markets definition from an investment — as opposed to economic — standpoint, the definitions used by index providers are the obvious starting point. Index providers tend to focus on the nature of a country's capital markets as the key determinant in deciding whether a country is eligible for inclusion in one of their frontier-markets indices. For example, Standard & Poor's (S&P) criteria for inclusion in its broad frontier markets universe includes market capitalization of the local equity market, trading volume (liquidity) of the local equity market, and the extent to which the local equity market is representative of the domestic economy. Income per capita is used by S&P only as an input for determining whether a country meets the hurdle for developed market status. In contrast, the World Bank's definition of a frontier market is determined principally by a country's income per capita.

Q: What is the attraction of frontier markets equity as an asset class?

A: Frontier market equities provide access to some of the fastest-growing economies in the world. Because income per capita is very low in many of these countries, the potential exists for growth to continue at rapid rates for a number of years as income levels initially begin to approach emerging-market, and thereafter developed-market, levels. This long-term growth tailwind is underpinned by an additional structural growth driver in that many frontier markets have very attractive population dynamics. This is in stark contrast to many of the developed and some of their emerging-market peers, such as Japan and China, which generally have rapidly aging populations. Provided the listed equity securities of companies operating in frontier markets have a strong link to their local economy, and are therefore able to capture this economic growth tailwind, the long-term investment case is attractive.

Q: What risks are associated with investing in frontier markets equity?

A: Although the upside potential associated with investing in frontier markets is appealing, a number of risks are involved, including:

- **Liquidity** — Because frontier market stocks are much less liquid than those in developed or emerging markets, transaction costs, both explicit and implicit (market impact), are very high. Investors should take account of this, especially if they are considering appointing a high-turnover strategy. The low level of liquidity in frontier markets also increases the risk that investors face a delay in the return of capital, especially in periods of market stress. This is reflected in the fact that asset managers tend to have gating provisions in place to help mitigate the risk that they become forced sellers. A number of managers also impose lock-up periods on investments.
- **Corporate governance** — The ownership structures of many frontier market companies can result in minority investors being marginalized at the expense of other stakeholders. Assessing company management teams, knowing what motivates them, and understanding their history are essential in helping to protect against this risk.
- **Inflation** — Economies in the early stages of development will often experience volatile and persistently high inflation. Due to the difficulty and expense involved with hedging currency risk in frontier markets, inflation may erode returns to developed-world investors via currency weakness.
- **Political risk** — A lack of well-developed institutions and legislation protecting private property rights increases the risk of corruption. This, in turn, increases the possibility of capital being expropriated, or companies and their assets being nationalized.

Q: Is there a case for having a local market presence when investing in frontier markets?

A: The initial answer to the question seems obvious: Yes. The potential to gain an information advantage in frontier markets from having analysts/portfolio managers located in the region is clearly more evident than in developed or emerging-market countries. Frontier market companies are less well researched by the global investment community than their developed and emerging counterparts, and trading volume tends tend to be dominated by local investors. These factors ultimately result in frontier markets being less efficient. Analysts/portfolio managers that speak the language, know the culture, are able to build relationships with key decision-makers in local institutions, and are able to wander off the beaten path in the search of new ideas are better placed to identify information asymmetries and use this knowledge to generate alpha.

"Given the liquidity constraints associated with investing in frontier markets, capacity is an issue."

A number of issues must be considered, however, before one can make the assertion that this is the best method for researching frontier markets companies. Given the liquidity constraints associated with investing in frontier markets, capacity is an issue. This makes it challenging (if not impossible) at present for an asset manager to build a scalable product in this space that would enable the deployment of a large, dedicated frontier markets team consisting of investment professionals spread across the globe. Even if this is possible, facilitating communication between team members across different time zones is more challenging than it is for a team based in one location.

Within the research team at Mercer, we do not believe in a one-size-fits-all approach. In our view, there are positives as well as shortcomings associated with any approach a manager takes when structuring a research team. The willingness to travel, an understanding of cultural diversity, and the ability to speak different languages are elements we believe are beneficial for any international investment team, particularly individuals managing emerging- and frontier markets strategies.

Q: What is the best way for investors to access frontier markets equity?

A: We believe that an active unconstrained investment approach that limits exposure to the Middle Eastern Gulf Co-Operation Council (GCC) countries is likely to maximize the chances that attractive absolute returns can be achieved over the long term. There are good reasons for this.

- As discussed earlier, frontier markets can be considered a less-inefficient asset class than either developed or emerging markets. This considerably increases the potential for experienced, skilled active managers to generate alpha in this market.
- Given it is the economic-growth story that underpins the case for investing in frontier markets, it makes sense for investors to focus their attention on those countries where there is a higher chance of this growth potential being realized. Due to the methodology used by the major index providers for constructing market-cap weighted indices, many countries that are deemed developed on the basis of economic output are actually classified as frontier markets due to the undeveloped nature of their capital markets. This is highlighted by the inclusion of the GCC countries — Bahrain, Kuwait, Oman, Qatar, and United Arab Emirates — in the broad frontier market indices of both MSCI and S&P (S&P also includes Saudi Arabia in its frontier markets index). This is despite the fact that each of these countries produces GDP per capita in excess of $20,000. Given the high level of per capita income generated in the GCC countries, it seems less likely that they will be able to achieve and sustain the high future-growth rates that might be possible among lower-income frontier countries. Consequently, we would question the merit of a standalone investment in frontier markets that includes an allocation to the GCC. Interestingly, it does seem that the index providers are aware of this issue, and it is worth noting that both MSCI and S&P offer frontier markets indices that exclude the GCC countries.

Q: What other issues should investors consider before making an allocation to frontier markets equity?

A. On a market capitalization basis, frontier markets constitute only a very small proportion of the investable equity market on a global basis. For example, the market cap of the MSCI Frontier Markets Index represents less than 0.4% of MSCI ACWI. Consequently, prospective investors need to ask themselves whether they believe an allocation to frontier markets on a standalone basis can have a meaningful impact on the return (and risk) profile of their overall equity portfolio. They also need to consider whether they have the governance budget to appoint and monitor an additional specialist manager (or managers) specifically for this asset class. Investors that have neither the appetite nor governance budget to justify a separate allocation to frontier markets, but are seeking exposure to the asset class, could consider appointing an emerging-markets manager that actively invests in these markets or takes positions on an opportunistic basis.

Investors in standalone frontier market strategies should bear in mind a few key points. This is a long-term opportunity that should be reflected in the time horizon for this type of investment. Given the less-liquid nature of many listed frontier markets stocks, the promise of daily liquidity should be treated with caution. Investment teams with a genuinely long-term investment perspective are likely to enforce some form of lock-up or require an extended notice period for redemptions. In the majority of cases, we believe this is a prudent measure that should help protect clients.

This is a relatively new market for many developed-market-based asset managers; consequently, the depth of the active manager universe is relatively limited. Despite this, we have identified a small number of investment teams that we believe have the skill and experience to generate attractive returns for investors in this market.

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