Health Wealth Career

The Investment Landscape for Endowments, Foundations and Charitable Organisations

Tuesday 5th February 2019
RUPERT WATSON
Head of Asset Allocation

- Rupert is responsible for the asset allocation strategy of our discretionary mandates, both in terms of dynamic and strategic asset allocation.
- Rupert manages clients’ Growth Portfolios as well as the Mercer Diversified Growth Fund

HILL GASTON
Senior Investment Consultant

- Hill is responsible for advising institutional investors on sustainable investment strategies.
- Hill provides advice to a broad range of clients on integrating Environmental, Social and Corporate Governance (ESG) issues throughout their investment processes.

JAN-HEIN VAN DEN AKKER
Senior Portfolio Manager

- Jan-Hein is responsible for fund manager selection, monitoring and blending of all equity investment products.
- Jan-Hein also assists the Chief Investment Officer with the asset allocation and implementation process and product development

PAUL FLEMING
Head of Investment Solutions
UK Charities, Endowments and Foundations

- Paul is responsible for ensuring the full range investment options are made available to Mercers Not-For-Profit clients.
- Paul leads on structuring investment portfolios, creating the most efficient implementation of our strategic advice
A G E N D A

01 MARKET OUTLOOK
Outlook for 2019
How not-for-profits should be thinking about positioning their portfolio and asset allocation decisions

02 MERCER’S APPROACH TO SUSTAINABLE INVESTING
The reality and implementation of a responsible investment policy in action

03 KEY TAKEAWAYS
What are the next steps you can take for your not-for-profit organisation

04 Q&A
Ask our expert panel your questions.
MARKET OUTLOOK 2019

HOW NOT-FOR-PROFITS SHOULD BE THINKING ABOUT POSITIONING THEIR PORTFOLIO AND ASSET ALLOCATION DECISIONS
WEAKNESS SEEN OUTSIDE THE US

J.P. Morgan Growth Forecast Revision Indices

(FFIs); 1y ago = 100

- EM FRI
- Euro FRI
- US FRI

SOURCE: JP MORGAN
US UNEMPLOYMENT LOW AND GOING LOWER

SOURCE: GOLDMAN SACHS

* 3-month moving average. Vertical lines denote months in which jobless rate rose more than 0.35 percentage points above the preceding low. Gray shading indicates NBER recession.
** We use estimates of the structural rate from the Fed since 1960 and the CBO before 1960.
MATERIAL SLOWDOWN IN GERMANY PROBABLY TEMPORARY

SOURCE: BLOOMBERG
EUROZONE UNEMPLOYMENT BACK TO NORMAL

SOURCE: BLOOMBERG
WITH DEVELOPED WORLD UNEMPLOYMENT AT MULTI DECADE LOW, WAGES AT LAST GOING UP

Source: Goldman Sachs

Source: Haver Analytics, Goldman Sachs Global Investment Research
US INFLATION AT TARGET. EUROZONE SLOWLY RISING TOO.

SOURCE: BLOOMBERG, JP MORGAN
EM AND CHINA HAVE SLOWED SHARPLY AFTER STRONG 2017 AND START TO 2018

CHINESE GROWTH HAS SLOWED

SOURCE: GOLDMAN SACHS
WHILE FX CRISIS HIT ARGENTINA & TURKEY, NOW STABILISING

ARGENTINIAN PESO IN FREE FALL

<table>
<thead>
<tr>
<th>Currency</th>
<th>Price</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>ARS</td>
<td>37.6093</td>
<td>+0.0509</td>
</tr>
<tr>
<td>BGN</td>
<td>37.6043</td>
<td>37.6143</td>
</tr>
</tbody>
</table>

At 14:43: Op 37.7009 | Hi 37.7021 | Lo 37.5610 | Close 37.5583 | Value 01/28/19

SOURCE: BLOOMBERG
EM EQUITIES CHEAP & COULD OUTPERFORM MATERIALLY

EM May Have Put in a ‘Double Bottom’ Relative to DM, Similar to What Happened in 1999-2001

Relative Total Return, MSCI EM/DM
(Feb’87 = 0%)


SOURCE: KKR
EM DEBT ALSO ATTRACTIVE

SOURCE: BLOOMBERG
BOND MARKET EXPECTING FED TO CUT NEXT YEAR. FED EXPECTS TO MOVE BEYOND 3%
GLOBAL DAA DASHBOARD
MAIN ASSET CLASSES 2019 Q1

LISTED EQUITIES

GROWTH FIXED INCOME

DEFENSIVE FIXED INCOME

CASH*

* In lieu of cash, investors might consider liquid alpha-oriented strategies with low sensitivity to equity, credit and duration.
MERCER’S APPROACH TO SUSTAINABLE INVESTING

THE REALITY AND IMPLEMENTATION OF A RESPONSIBLE INVESTMENT POLICY IN ACTION
ESG: RISK, RETURN AND REPUTATION
A BROADER PERSPECTIVE – AN ABILITY TO SUSTAIN

What is missing from current finance / investment processes? How might the future be different to the past?

WHAT IS ESG?
ESG issues which can be considered include:

ENVIRONMENTAL CONCERNS
- Climate Change
- Energy Efficiency
- Waste & Pollution
- Water & Resource Scarcity

SOCIAL CONCERNS
- Health & Safety
- Stakeholder Concerns
- Demographics
- Labour & Supply

CORPORATE GOVERNANCE CONCERNS
- Audit Quality
- Board Structure
- Remuneration
- Shareholder Rights

BOOK VALUE
MACRO RISKS INCLUDING CLIMATE CHANGE

Top 5 Global Risks - Likelihood

1. Extreme weather events
2. Failure of climate change mitigation and adaption
3. Natural disasters
4. Data fraud or theft
5. Cyber attacks

Top 5 Global Risks - Impact

1. Weapons of mass destruction
2. Failure of climate change mitigation and adaption
3. Extreme weather events
4. Water crisis
5. Natural disasters

The black circle represents the total portfolio, with the width of each asset class section representing the respective percentage weighting. Asset class sections expected to experience a reduction in returns will move towards the circle centre and those expected to experience additional returns will move outwards from the circle.
Significant increases in GHG emissions are raising average temperatures and changing the Earth’s climate.

**THE INVESTOR ZONE**

**THE CLIMATE ZONE**

<table>
<thead>
<tr>
<th>Risk Factors</th>
<th>Technology</th>
<th>Policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Physical Risks</td>
<td>Resource Availability</td>
<td>Impact</td>
</tr>
</tbody>
</table>

- **Transformation:** ‘Safe’ range for humans, but still meaningful damages
  - **2°C**
- **Coordination:** Not seen for 3 million years, highly disruptive damages
  - **3°C**
- **Fragmentation:** Not seen for tens of millions of years, severe damages
  - **4°C**
THREE REASONS FOR INVESTORS

WHY?

MERCER BELIEF STATEMENTS - SUSTAINABILITY

• **ESG factors** can have a material impact on long-term risk and return outcomes.

• **Climate change** poses a systemic risk given the low-carbon transition and physical impacts of different climate outcomes.

• **Stewardship (voting and engagement)** gives investors an opportunity to enhance the value of companies and markets.

• **Taking a broader and longer-term perspective on risk**, improves risk management and identifies new investment opportunities.

*We believe a sustainable investment approach - where investors consider ESG factors in risk, return and reputation decisions - is likely to deliver more sustainable outcomes.*
THE REGULATOR IS TELLING US SOMETHING
INVESTMENT DECISION MAKERS WITH DISCRETIONARY POWERS HAVE A FIDUCIARY DUTY TO THEIR BENEFICIARIES, WITH INTERPRETATION OF THESE DUTIES EVOLVING OVER TIME

THROUGH ‘COULD’ AND ‘SHOULD’ TO ‘MUST’

1992
Rio Earth Summit
UN Conference on Environment & Development

2000
UK Disclosure Regulation
- First pensions disclosure regulation

2000
UN Global Compact launched
- Ten sustainability principles

2005
Freshfields Report
- Legal opinion on ESG having financial impacts and ESG analysis was consistent with fiduciary duty, arguably required.

2006
UN Principles for Responsible Investment (PRI) launched
Six principles founded in environmental, social and corporate governance (ESG) factors having potential risk and return impacts

2008
Global financial crisis and subsequent tax payer funded banking bailout

2010
UK Stewardship Code
- Asset owner / manager systemic role as ‘stewards’
- Engaging with companies on good corporate governance;

2012
Kay Review
- Raised short-termism issues and fiduciary duty confusions as problems.

2014
UK Law Commission
“No impediment to trustees taking account of ESG factors where they are, or may be, financially material”.

2015
Paris Agreement

2016 - 2018
EU IORP II 2016
- Consider ESG incl. climate change and stranded asset in IPSs.

Global FSB Task Force on Climate-related Financial Disclosures (TCFD) 2017

UK DWP Regulates ESG into Trust based scheme SIs 2018

UK FCA consultation “evaluating ESG”, “climate change”, due Q1 2019


- Investor Duty
- Green Taxonomy
- Benchmarks
- Role of Institution (EIOPA, ESMA, EBA)
A SUSTAINABILITY FRAMEWORK
THE EVOLUTION AT MERCER

2004-2006
- RI consulting practices developed and new team formed
- Mercer advises UN on PRI development

2007-2010
- Launches ESG ratings platform for investment strategies
- Publishes many ESG materiality and education papers

2011-2013
- Climate Change and Strategic Asset Allocation report
- MMC launches Climate Change Task Force managed by Mercer
- Sustainable Opportunities private markets solution launched

2014-2015
- Investment beliefs formalised
- Sustainable Growth Framework
- Investing in a Time of Climate Change report
- ESG ratings for passive equity managers
- ESG ratings reach over 5,500 strategies
- Sustainable Investment Policies established for delegated solutions

2016-2019
- Sustainable Global Equity Fund launched and second Sustainable Opportunities closes
- Mercer represented on FSB Task Force on Climate-related Financial Disclosure
- Investment beliefs updated - strengthened
- Investing in a Time of Climate Change Sequel due for release
We believe a sustainable investment approach is more likely to create and preserve long-term investment capital.

**Sustainable Investment Policy** since 2015, updated November 2017:

1. **ESG** integration, aiming for highly rated strategies vs peers.
2. **Climate change** integration, that follows the recommendations of the FSB Task Force.
3. **Stewardship** monitoring, on voting and engagement activity and UK Stewardship Code.
4. **Taking a broader and longer-term perspective on risk**, including sustainability trends.
5. **Screening** or exclusions approach.

The process and responsibilities for policy execution is clearly documented.

There are four key strategies for portfolio implementation:

1. **Integration**
2. **Stewardship**
3. **Investment**
4. **Screening**
FROM THEORY TO PRACTICE
# Sustainability Framework

## Four Strategies for Implementation

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Description</th>
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</table>
| **Stewardship** | Annual Stewardship Monitoring report Review:  
- Policies using the UK Stewardship Code principles  
- Engagement priorities  
- Voting and engagement activity |
| **Integration** | ESG Ratings included in quarterly performance report  
- ESG Ratings review vs asset class peer group  
- Carbon foot-printing of equity portfolios  
- Climate scenario modelling  
- Climate-related financial disclosure |
| **Investment** | Sustainable Global Equity Fund included in the model growth portfolio 2016  
- Semi-annual reporting on the Sustainable Global Equity Fund  
- Sustainable opportunities Fund available within PIP V (Private Markets)  
- Sustainable index development |
| **Screening** | Exclusion framework for equities* and fixed income  
- Screening reviews for the Sustainable Global Equity Fund |

* Equities includes both active and passive equities however market cap weighted indices are excluded at this time.

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The UK Stewardship Code review is a firm level assessment, while the Voting and Engagement review is a strategy level assessment.

**Manager Engagement Topic Priorities**

- **Governance:** Executive compensation; Board independence; Corruption.
- **Environmental:** Climate change – disclosure and strategy; Pollution.
- **Social:** Supply chain (modern slavery); Human rights; Community relations.

Emerging themes from leading managers also include:

- Diversity & inclusion; Sustainable Development Goals; Cybersecurity; Antibiotic resistance; Opiods; Sugar; Carbon emissions & cryptocurrencies.

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Mercer’s ESG ratings have been undertaken by Mercer’s global manager research team since 2010, as part of the standard research process by strategy.

Rating represents our assessment of how ESG factors are included within a strategy’s process for: Idea Generation, Portfolio Construction, Implementation, & Business Management.

ESG 1 = highest possible rating and ESG 4 = lowest possible rating

- ESG1: Leader in the integration of ESG factors and active ownership into core processes
- ESG2: Less advanced than ESG1 but with moderate integration of ESG factors and active ownership
- ESG3: Limited progress with ESG integration and active ownership, albeit with signs of potential improvement
- ESG4: Little or no integration of ESG factors and active ownership into core processes and no strong indication of future change

Used in different ways:
- As a screen for highly rated strategies e.g. only ESG2 and above
- As a differentiator in monitoring questions and selection processes
Over 4,500 strategies rated currently – ratings began in 2008.

Less than 17% achieve an ESG1 or ESG2.

ESG ratings for passive equity introduced in 2014.

* Other includes multi-asset, private debt, natural resources.

**Analysis as at June 2018.
INTEGRATION
CARBON FOOTPRINT ANALYSIS

Reviewed 9 equity funds. **7 funds (78%)** have a lower carbon intensity than their benchmarks.

**Portfolio’s Weighted Average Carbon Intensity (WACI),**
calculated as the sum of (scope 1 & 2) tCO2 emissions / US$ revenue

*Note: Listed Infrastructure on secondary axis on RHS — same units (i.e. tones Co2/$m Sales).*

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INVESTMENT
NEW SOLUTIONS – NEW OPPORTUNITIES

RENEWABLE AND ALTERNATIVE ENERGY
Solar, wind, wave, biofuels, and geothermal technology

ENERGY EFFICIENCY
Storage plus power network, industry, building, and transport efficiency

WATER INFRASTRUCTURE AND TECHNOLOGIES
Irrigation, storage, treatment, drainage and flood protection

POLLUTION CONTROL
Pollution control solutions and environmental testing

WASTE MANAGEMENT AND TECHNOLOGIES
Recycling processing, hazardous and general waste management

HEALTH AND SOCIAL SERVICES
Positive impacts for social development and poverty or aging population

SUSTAINABLE CONSUMER GOODS
Meeting shifting consumer demands in sourcing and technology

RESPONSIBLE FINANCE
Supporting role for real economy
Sustainability themed exposures are recommended within listed global equity, private equity, and real assets (infrastructure and natural resources).
**EXCLUSIONS**
**MANAGING RISK, RETURN AND REPUTATION**

<table>
<thead>
<tr>
<th></th>
<th><strong>Risk/Return</strong></th>
<th><strong>Reputation</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Past</td>
<td>What would have been the financial impact?</td>
<td>What has been the reputation impact so far of owning the product/activity?</td>
</tr>
<tr>
<td>Present</td>
<td>What are the costs to implement an exclusion?</td>
<td>What are the fiduciary ramifications of excluding?</td>
</tr>
<tr>
<td>Future</td>
<td>Is the product/activity likely to outperform or underperform long term?</td>
<td>Are reputational concerns likely to increase or not? Is engagement likely to be effective?</td>
</tr>
</tbody>
</table>

**ANNUALIZED RETURNS ON THE S&P 500**
**1989 - 2017**

- 9.44% Health Care
- 9.54% IT
- 9.56% S&P 500
- 9.66% Discretionaries
- 9.71% Materials
- 9.74% Financials

Source: GMO, S&P
S U S T A I N A B I L I T Y F R A M E W O R K
FOUR STRATEGIES FOR IMPLEMENTATION

**Integration**
Include ESG factors in investment analysis/decisions to assess materiality

**Stewardship**
Actively engage with companies failing to address ESG risks through voting and engagement

**Investment**
Allocate to sustain themes/impact investments, e.g. renewable energy, water, social housing

**Exclusions**
Screen out sectors or companies deemed irresponsible or misaligned with values

**AIM:** Financial objectives + risk management improvement

**AIM:** Financial objectives + financial system improvement

**AIM:** Financial objectives + positive social + environmental impact

**AIM:** Align with values/reputation/risk management or longer term financial expectations
KEY TAKEAWAYS
QUESTIONS?

Please type your questions in the Q&A section of the toolbar and we will do our best to answer as many questions as we have time for.

To submit a question go to the floating panel at the bottom of your screen, click the circle which contains the three dots and select Q&A. Please make sure you send questions to "all panelists."
KE Y C O N T A C T

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