Mercer

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Findings from the 2022 Global Not-for-Profit Investment Survey

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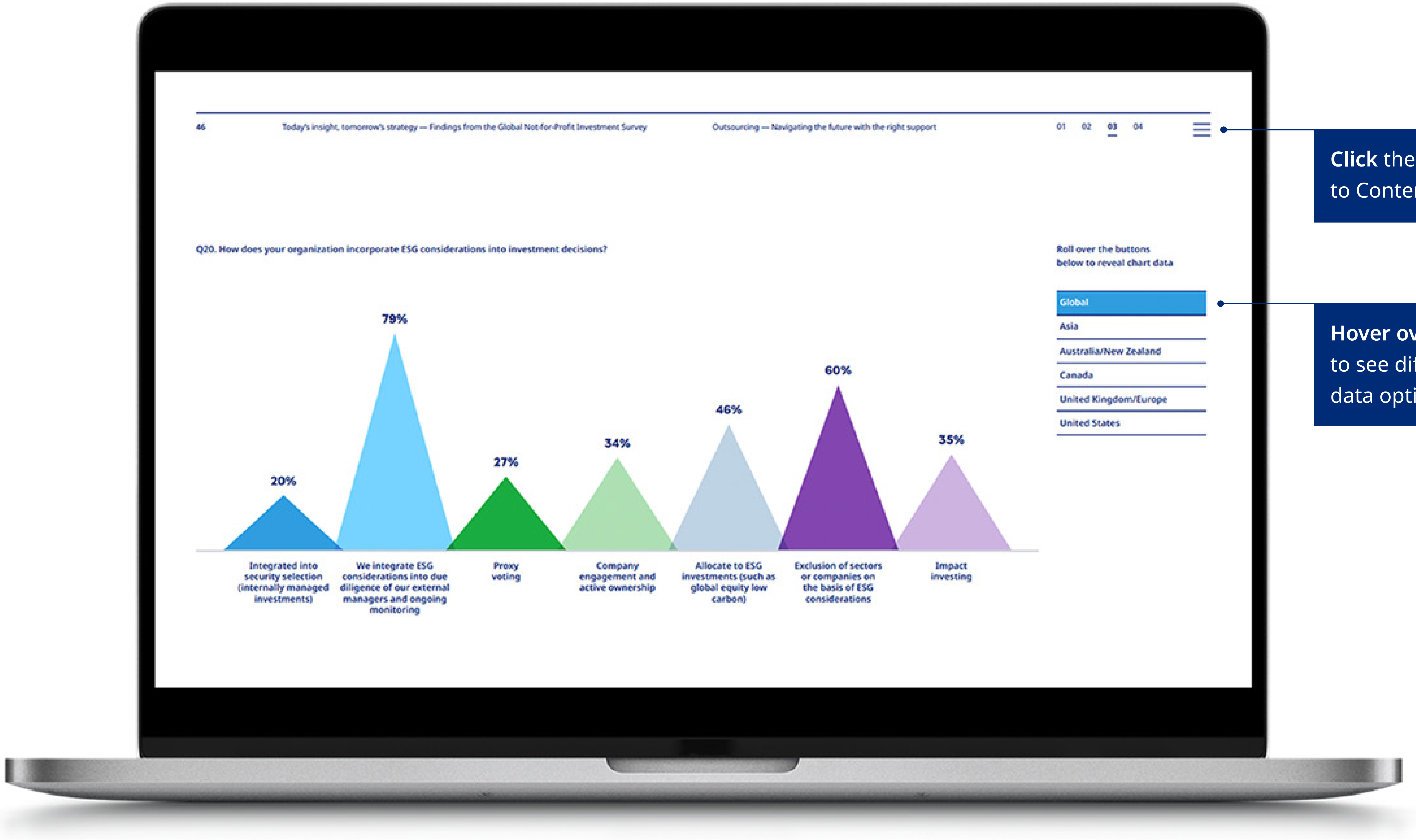

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Foreword

Surveys like these are incredibly valuable sources of information on what investors are really thinking about the most pressing issues of the day, so I was delighted to be asked to comment on Mercer's *2022 Global Not-for-Profit Investment Survey* findings and write this foreword.

Our organization, the Intentional Endowments Network, focuses on sustainability factors in the investment process, so I was particularly interested in this survey's findings about not-for-profits' attitudes to environmental, social and governance (ESG) issues.

What struck me most was the relatively low 9% of respondents that stated they adopt an ESG approach because they believe doing so will improve their risk-adjusted returns. There's clearly still skepticism about the investment performance benefits of incorporating ESG. We hear this skepticism in the broader market, but in our conversations as an ESG-focused network, we've found that most investors have seen and experienced the risk reduction and return enhancement benefits that smart ESG strategies can yield.

Several factors may be driving the notion that ESG is more about mission than investment performance. In recent months, ESG investing has faced new challenges. In the US, there has been a significant increase in political attacks on ESG investing in an attempt to drag it into the culture wars. With economies emerging from the pandemic and Russia's invasion of Ukraine, legacy energy stocks have outperformed recently after a decade of underperformance. And old, preconceived notions about ESG that aren't based on the data are likely also contributing factors. There is also wariness about greenwashing as more funds enter the market claiming to be sustainable. Although this is a natural part of a maturing market, greenwashing threatens to undermine the credibility and legitimacy of the whole concept of ESG, so it's good to see an increased emphasis on regulation and labelling globally.

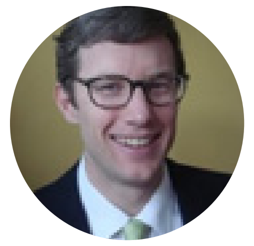
In this market, investors seem to be preparing to take on extra risk as they seek to compensate for lower expected returns. There is increased risk in the system against a backdrop of inflation, food shortages, social instability and political unrest. Everything is interconnected, and while investors rightly focus on these traditional macro risks, I fear the element of climate risk as an amplifier of these other risks may be underappreciated. In my opinion, investors need to consider not just risk linked to individual securities and their own portfolios but also system-level risk, such as climate change and inequality. These risks can't be avoided through security selection. Increasingly, investors must think about participating in collaborative shareholder engagement initiatives and work collectively with other investors to influence policy to address these risks.

We've seen a significant focus on net-zero portfolios, and that focus was also reflected in this survey's findings. From our perspective, this trend is only going to gather pace. We're spending a lot of time on net zero — how to define it, where to get the data and how to report on progress. The amount of data in private markets remains a particular challenge, but we're seeing the market respond, with more data providers coming online.

The *2022 Global Not-for-Profit Investment Survey* made clear investors' growing appetite for private markets, which I think is interesting from an ESG perspective. A topic that comes up frequently in our network's conversations is whether investors should divest from fossil fuel companies. One view suggests that doing so might lead these firms to turn to the private markets, where they're under less investor scrutiny, so their emissions might actually increase. I think the entry of more mission-driven institutions like we find in the not-for-profit sector will be important in increasing scrutiny of private companies.

The survey reveals a range of perspectives when it comes to investing in China. Some investors don't want to go near it as they say China is an adversarial country with a range of human rights issues, while others argue it's a developing country that's doing a lot of good things to pull people out of poverty. In our network, there's generally less focus on geopolitical factors because stakeholders can have legitimate divergent views, and, for long-term investors, the political dynamics in a region can change. But the risks and long-term trends associated with climate change and inequality are more straightforward.

Gaining a comprehensive understanding of ESG investment and all the associated terminology is still one of the biggest challenges for investors. In short, it's about explicitly and systematically considering ESG factors in the investment process to make better, more informed decisions. There's still a misconception among some that ESG is about negative screens and exclusions, although it's about far more than that now. It can be challenging to choose the right approach to ESG for your institution and find the right manager to help you reach your goals. The good news is there are plenty of companies, including Mercer, that can help you navigate the complexity and point you in the right direction.



Georges Dyer
Executive Director at Intentional Endowments Network

Key findings summary

Macro concerns reflected in the sentiment of the sector

59% cite low expected future returns as the biggest concern over the next three years.

39% are uncertain whether their portfolios are adequately positioned to withstand another extreme market downturn.

50% express that inflation concerns are weighing on their minds, stating that it will be their second-biggest challenge over the next three years.

Learn more →

Private markets — The big migration

65% of respondents see diversifying away from traditional asset classes as their greatest opportunity over the next three years.

78% of those investing in private markets say the main reason for investing is the search for better yields or enhanced investment returns.

61% of respondents intend to increase allocation to private equity in the next two years.

Learn more →

Outsourcing — Navigating the future with the right support

44% of respondents say their portfolios are more complex today than they were three years ago.

70% are getting external investment support for their portfolios.

61% cite a strong track record of performance as most important when selecting a third-party provider.

Learn more →

Sustainability — Closing the gap between ethics and investment returns

72% of respondents state an intention to increase or significantly increase their exposure to ESG-focused investments over the next 12 months.

39% of respondents believe they will have to make compromises, and, of that group, **57%** believe they will have to compromise on absolute return.

56% see climate change as an investment opportunity over the next three years — the second-greatest opportunity identified by respondents.

Learn more →

01 Macro concerns reflected in the sentiment of the sector

Action points

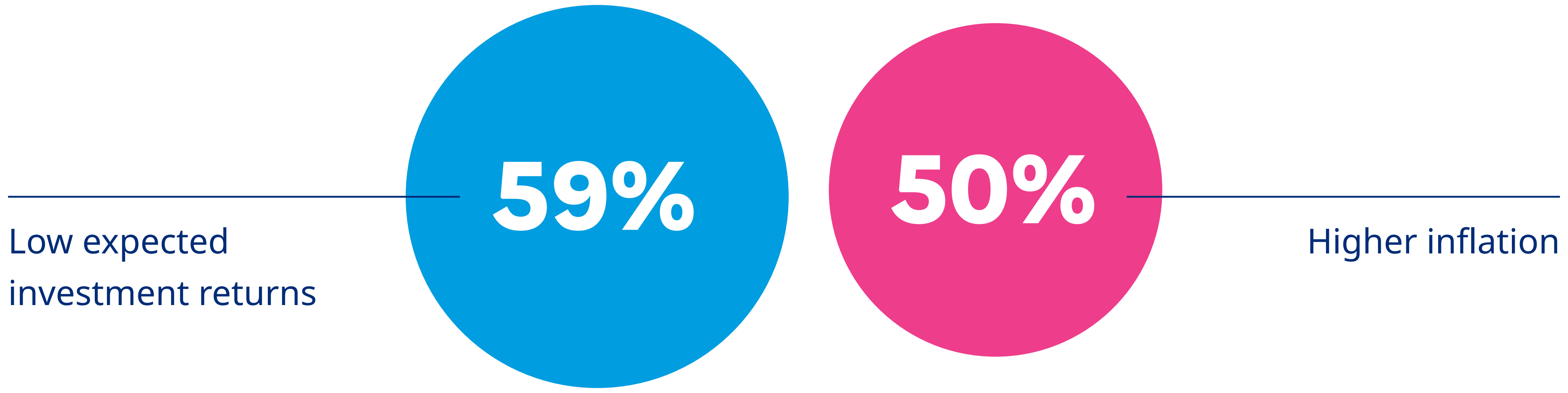
- Review how the assets in your portfolio are likely to perform in a period of sustained high inflation. Which asset classes offer protection against inflation?
- Consider assets likely to perform well in an environment of rising rates as central banks act to counter inflation.
- Consider diversifying beyond traditional developed-markets equities and bonds; that is, consider investing in private markets, infrastructure, real estate, commodities, hedge funds, risk premia, active concentrated strategies, inflation-linked bonds and emerging-markets assets.
- Review your liquidity needs to ensure you have enough liquidity to meet your cash flow requirements without being forced to sell assets at depressed levels.

Lower expected future returns leading investment challenge

The Not-for-Profit (NFP) Investor Survey was conducted at a pivotal moment for markets. The first months of 2022 saw the world shift from the disorientation of COVID-19 to the shock of a major conflict in Europe.

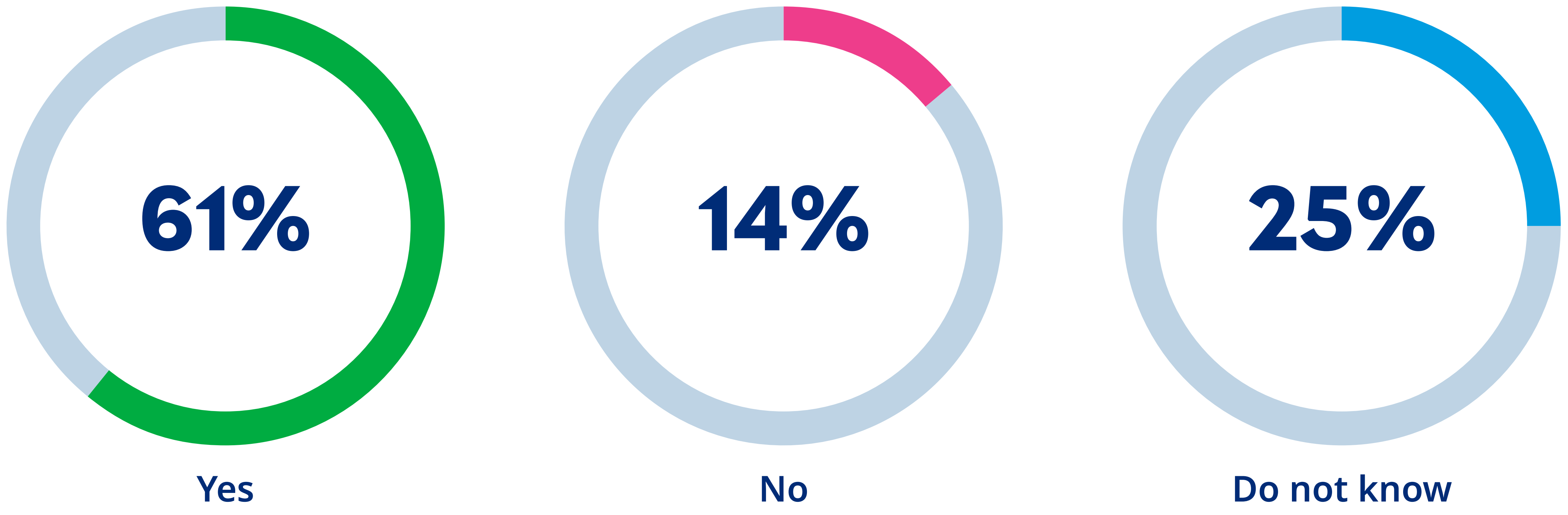
This survey captures a snapshot of a sector unsettled by the market environment, which is cautiously moving further up the risk spectrum as it seeks to address the challenges that lie ahead.

What are your organization’s two main investment challenges over the next three years?



As NFPs begin the process of reviewing the damage caused by the pandemic, nearly 40% of survey respondents either do not believe or are unsure whether their portfolios are well positioned to weather another extreme market downturn/volatility event.

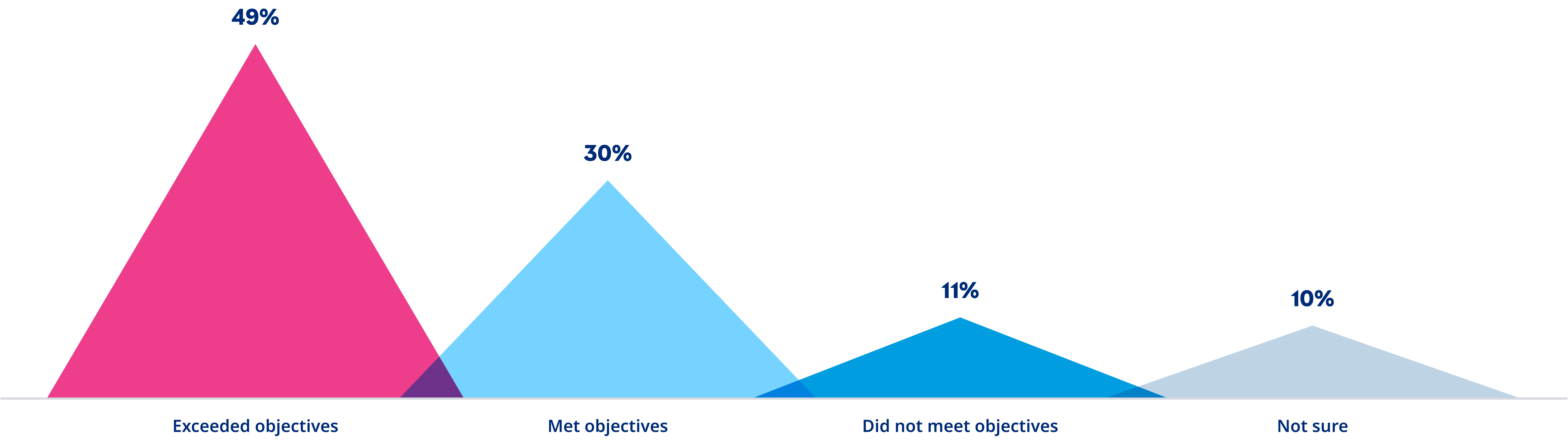
Do you feel your portfolio is well positioned for another extreme market downturn/volatility event?



Seeking to capture the period leading up to the sell-off of 2020 through the aftermath of the worst of the pandemic, we asked investors how their portfolios have performed over the past three years. Seventy-nine percent of respondents say their portfolios met or exceeded the investment objectives over the period. However, it is evident that the sector is now bracing itself for a less-rewarding period ahead, with 35% of survey respondents saying they either do not know whether their portfolios will meet the intended financial objectives over the next three years or don’t believe they will.

79% say their portfolios met or exceeded objectives over the past three years.

Did your portfolio meet its stated financial return objectives over the past three years?



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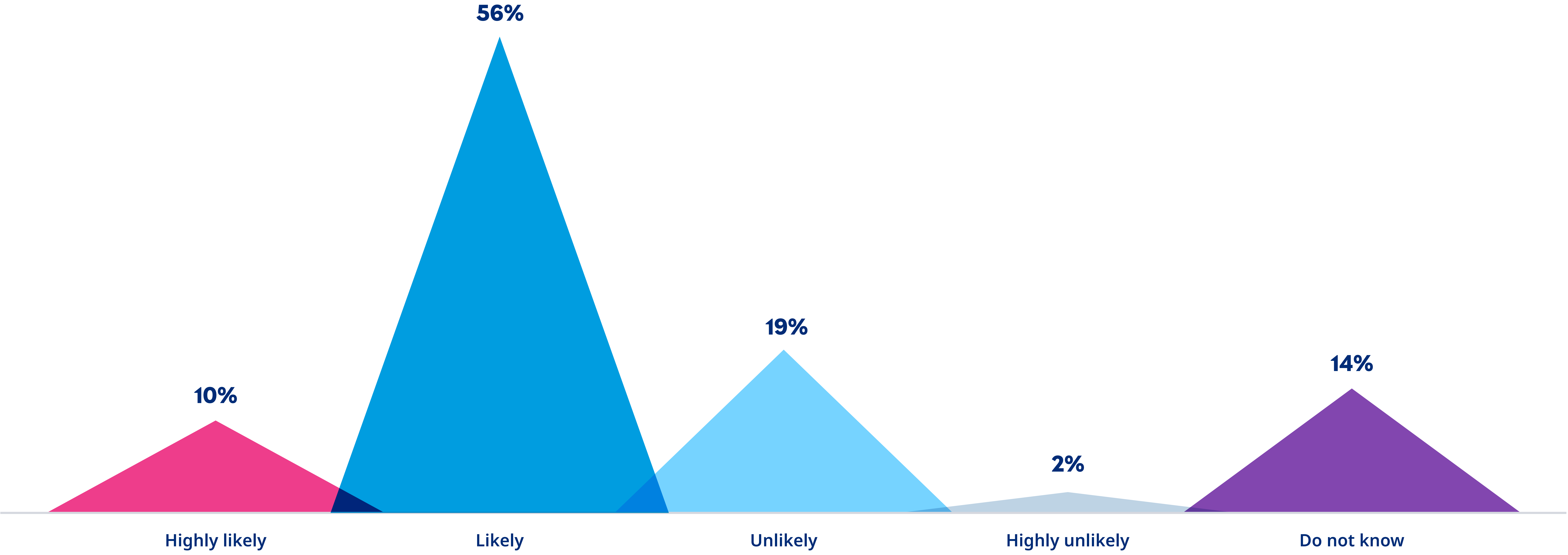
35% don't know whether their portfolios will meet the intended financial objectives over the next three years or don't believe they will.

What do you think is the likelihood that your investment portfolio will meet its stated financial return over the next three years?



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Getting to the source of the uncertainty

The survey uncovered residual uncertainty across the sector, the source of which predates Russia's invasion of Ukraine and even the pandemic.

When we asked participants what their main investment challenges were likely to be over the next two years, their responses overwhelmingly referenced macroeconomic and fundamentally long-term concerns. Largely unchanged from the results of Mercer's European NFP investment survey carried out in 2021,[1] lower expected investment returns, higher inflation and market volatility remain the leading challenges for the sector globally. When we look through a regional lens, the US cites low returns as the leading concern, whereas high inflation dominates concerns in Europe and the UK, and Asian respondents are concerned about market volatility. In Australia/New Zealand, investors see market volatility as their main challenge, followed equally by inflation concerns and low expected future returns.

> **We expect a 60/40 equity-bond portfolio to earn significantly less over the next decade than it has over the past 10 years. So now could be a good time for investors in such portfolios to rethink their asset allocations and add some much-needed resilience.**
>
> **Hooman Kaveh**, Global Chief Investment Officer

[1] Mercer. *2021 Not-for-Profit European Investment Survey*, available at https://www.mercer.com/our-thinking/wealth/2021-nfp-european-investment-survey.html.

What, in your view, are your organization's two main investment challenges over the next three years?

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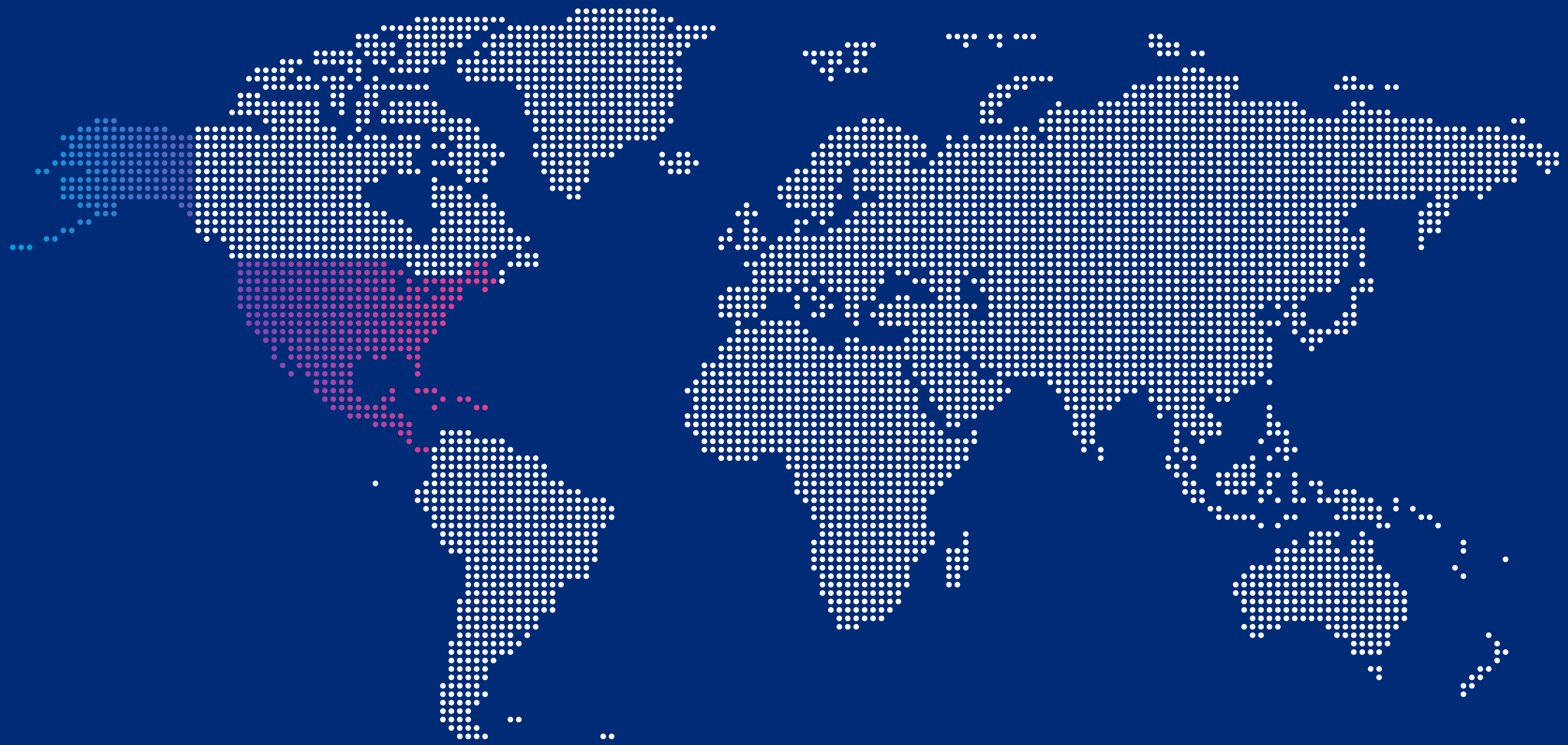
United States

77%
Low expected investment returns

47%
Market volatility

43%
Higher inflation



Spending policy

With low future expected returns, prolonged elevated inflation and market volatility weighing heavily on not for profits' minds, we were interested to explore how organizations were approaching the outlook for their spending policies.

When asked how organizations expect their spending rates to change over the next three years, 33% of respondents state they will increase current spending policy over the period. Despite uncertainty about the market, the rationale for increased spending is driven by willingness to put the strong returns of the past three years to work amid evidence of increased need across causes and within communities.

That said, strong past performance is unlikely to support increased spending over the long term, raising a question mark over whether — and how — increased commitments can be met in an environment of sustained low investment returns.

How is your organization's spending rate likely to change over the next three years?

Where there are challenges, there can be opportunities

The survey uncovered a clear, straight line between what the sector sees as its main challenges and what it sees as its biggest opportunities.

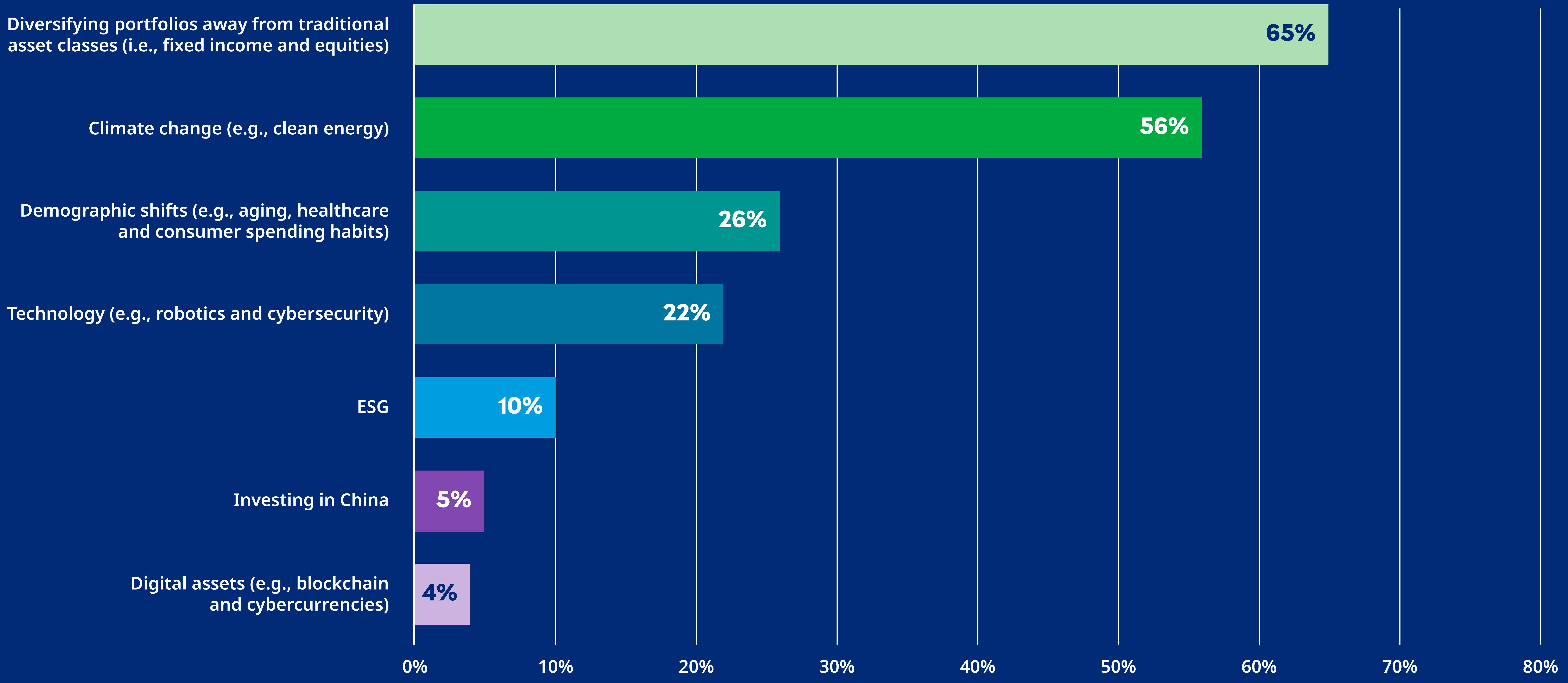
Amid concerns about low expected investment returns, 65% of survey respondents say diversifying away from traditional asset classes is their prime investment opportunity over the next three years.

Not far behind, 56% see climate change as their second-biggest investment opportunity over the next three years. Different opportunities were identified across some regions, with 69% of investors in the UK/Europe identifying climate change as their top opportunity and 59% identifying the diversification away from traditional asset classes as their second-biggest opportunity. Asia respondents identified demographic shifts as the biggest opportunity at 57%, with both climate change and diversification away from traditional asset classes tied at 43%.

As investors navigate the impacts of some significant macro challenges — global pandemic, war, inflation, supply chain and labor issues — a longer-term view on the mega-trends of climate change, inequality and threats to democracy will remain critical in setting investment policy.

Georges Dyer, Intentional Endowments Network

What, in your view, are your organization's two main investment opportunities over the next three years?



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While opportunities related to climate change also rank highly, it is noteworthy that two much-discussed topics — investing in China and cryptocurrency — are the two lowest-ranked opportunities for NFPs.

China: addressing the elephant in the room

The size and scale of China's domestic marketplace is arguably one of the nation's greatest economic achievements. From its middle-class explosion to the sweeping impact of digital transformation throughout its population and industries, China is entering a new era of investment opportunities — as is the global economy. There is money to be made by investing in China, but opening up the country's heavily regulated domestic assets to foreign investors requires a learning curve on both sides.

Alongside the issues of access and transparency, with investing in China, there are many challenges for investors with ESG objectives for their portfolios. Our survey has found that most NFPs are indeed considering ESG factors in their investment decisions, and this may be a key driver for the sector's continued reluctance to increase allocation to China independently of a wider emerging markets portfolio.

China still may have a long way to go on its ESG journey, particularly with regard to human rights of individuals. However, we do see meaningful progress being made in addressing its sustainability challenges and scaling up green finance efforts. Government regulation and social pressure regarding environmental protection, labor rights and food safety have driven this progress, and the increasing exposure of international investors to China A-shares is shining more light on these issues. The COVID-19 pandemic has shifted focus to the "S" (social) in ESG. Companies are facing scrutiny for their treatment of a wide range of stakeholders — not least, their employees — during this time.

Shying away from China and crypto, however, does not mean the sector is not open to opportunities. In their efforts to overcome their primary challenge of low expected investment returns, NFPs are venturing further along the risk spectrum in search of return, allocating away from traditional asset classes or reallocating to strategies that aim to provide higher returns but are higher on the risk spectrum.

The search for yield continues

The willingness to explore more risk is predominantly reflected in an increased allocation to private markets.

Funding for this increased allocation is likely to come from fixed income portfolios, where 30% of respondents plan to decrease their allocations to government bonds over the next two years and 26% of respondents intend to decrease their allocations to corporate bonds.

Within fixed income portfolios, the search for yield is also driving a reallocation of investors' risk budgets, reflected in the increased allocation to higher-yielding strategies. Of the respondents, 25% intend to increase allocations to high-yield and 16% intend to increase allocations to emerging markets.

While market volatility remains a key concern, we are seeing little movement out of cash.

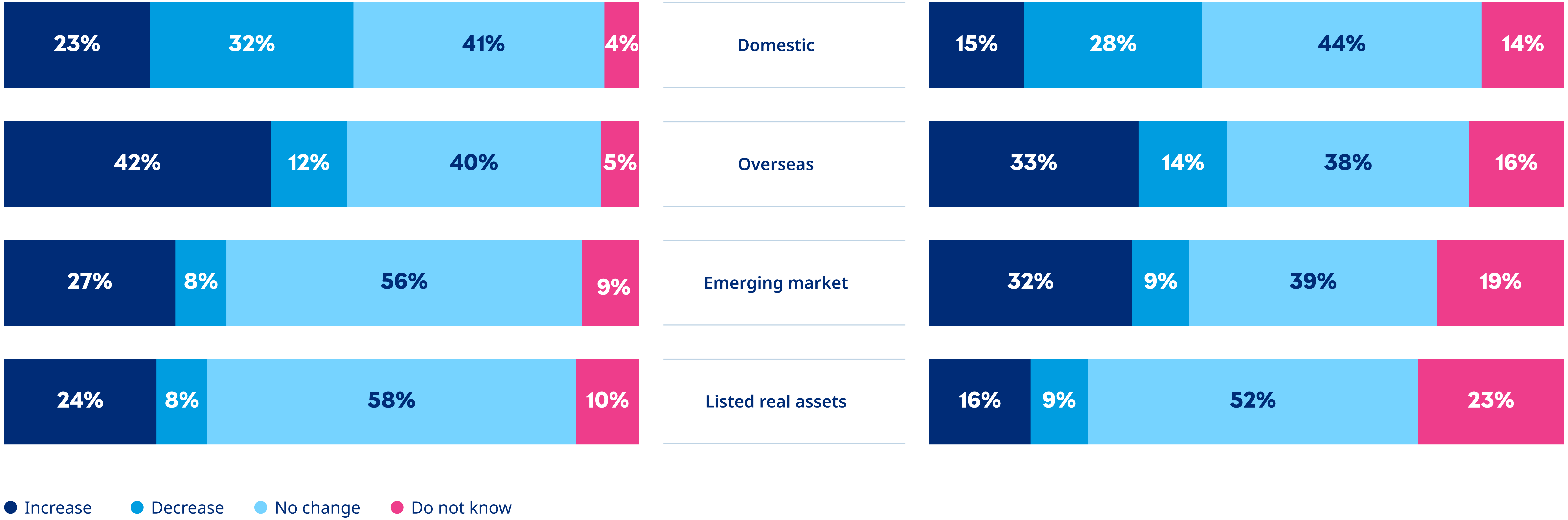
The 21% of investors that say they will reduce the level of cash in their portfolios is in contrast to the 12% who intend to increase their cash exposure over the next three years. Fifty-four percent of respondents intend to keep the existing level of cash in their portfolios unchanged.

Reflecting continued concerns around oncoming volatility in the market, the regional variation in portfolio positioning stood out most in the equities space, with US-based organizations being least likely to increase allocation to overseas markets. Only 15% of respondents in the US plan to increase their overseas equity allocations in the next three years. Perhaps reflecting the strong performance of US equities over recent years, investors in Europe/UK (34%), Asia (57%) and Australia/New Zealand (40%) all state their intention to increase allocation to overseas equities.

How has the asset allocation of your investment portfolio changed over the past three years?

Equities

How do you expect the asset allocation of your investment portfolio to change over the next two years?



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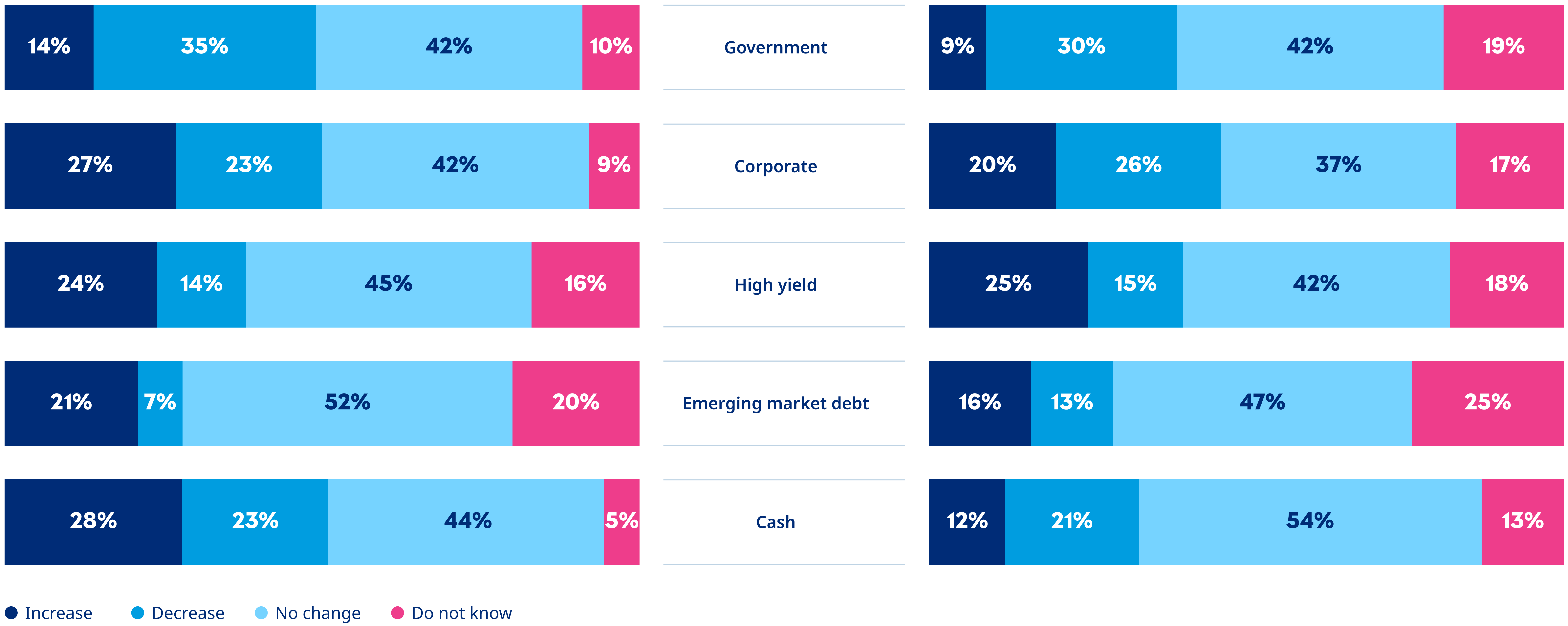
How has the asset allocation of your investment portfolio changed over the past three years?

Fixed income

How do you expect the asset allocation of your investment portfolio to change over the next two years?



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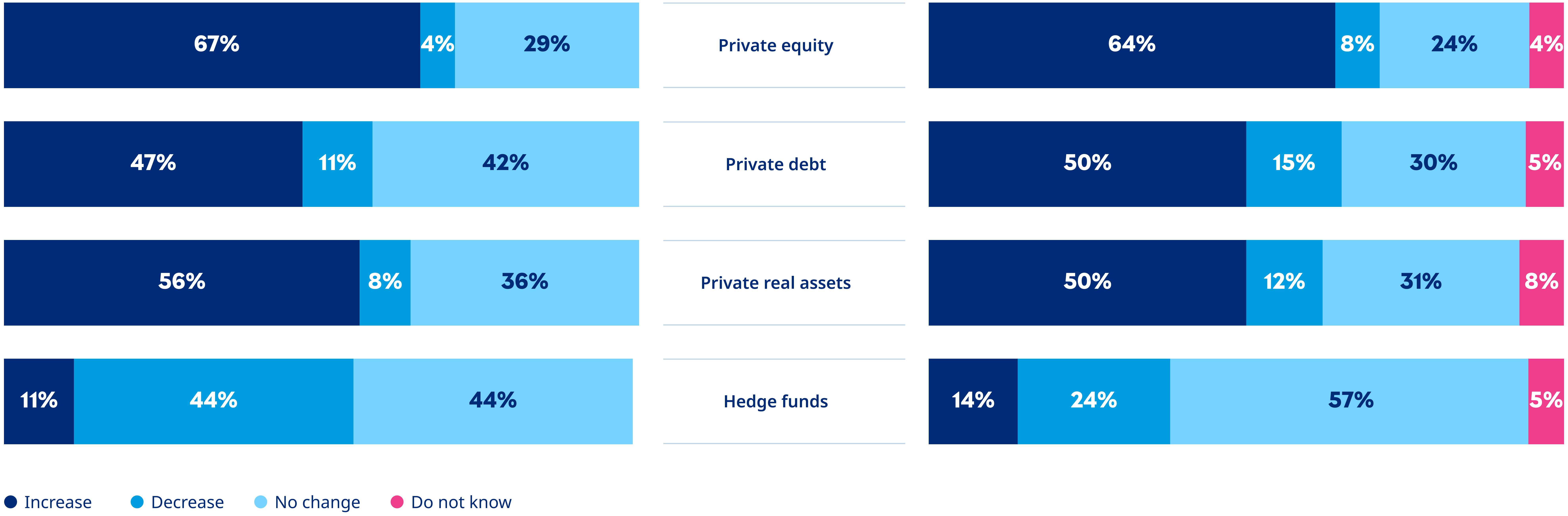
How has the asset allocation of your investment portfolio changed over the past three years?

Alternatives

How do you expect the asset allocation of your investment portfolio to change over the next two years?



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Time to look beyond the 60/40 portfolio?

Against a backdrop of ever-falling interest rates, the past 10 years have seen most asset classes provide impressive returns.

In fact, it's been among the best decades ever for the traditional 60/40 equity-bond portfolio, which means many investors adopting such allocations have been able to sit back and enjoy the ride.

But with inflation picking up — and proving longer-lasting than had been expected — central banks in many regions are now hiking rates. This makes risky assets less attractive because the return they need to achieve to outperform current rates becomes higher.

The upshot is that we expect a 60/40 equity-bond portfolio to earn significantly less over the next decade than it has over the past 10 years. So now could be a good time for investors in such portfolios to rethink their asset allocations and add some much-needed resilience.

We believe part of the answer lies in exploring **other types of asset classes and strategies**. These can include private assets — particularly those that can act as a hedge against inflation, such as infrastructure and real estate. This is because their income streams tend to rise in line with inflation. Liquid alternatives, such as hedge funds, will also have a role to play.

From the results of this year's survey, we see that not-for-profit investors point to similar concerns, with 59% citing low expected future returns as their biggest challenge over the next three years. However, with 65% identifying diversification away from traditional asset classes as their biggest opportunity over a similar timeframe, it appears this shift has begun for many.

Regional diversification could also be important. Although we generally prefer to let specialist asset managers make regional allocation decisions, an allocation to China could significantly boost a balanced portfolio's diversification as China is currently easing monetary policy at a time when the rest of the world is tightening. Due to the specific characteristics of the Chinese economy and financial markets, we believe active management is especially important, along with **using asset managers with a focus on stewardship and engagement**. Meanwhile, investing in frontier markets — the next generation of emerging markets — could provide some much-needed extra return potential.

Inflation has **implications within asset classes**. For fixed income, for example, longer-duration bonds have performed best in recent years. But with interest rates rising, different strategies are likely to come to the fore. Shorter-duration bonds now look more attractive, and absolute-return fixed-income strategies, which typically start from a zero-duration position, could also be interesting options. Within credit, active managers may choose to invest in high-quality firms with strong balance sheets. These firms should be able to weather any economic downturn and continue to pay their coupons. Private debt, which involves lending money directly to corporations, also tends to have low duration, so this could be another attractive investment in a rising-interest environment.

Now could be a good time to look to **active management**. With markets rising strongly over the past decade, passive exposure was all that was needed to take part in the gains. But in the coming years, active specialist asset managers may have a bigger role to play by eking out extra returns and navigating what looks set to be a more challenging environment.

ESG and the transition to a net-zero-carbon economy will continue to gain prominence over the coming years as the global community seeks to reduce its reliance on carbon. This will have significant implications for investment portfolios. And it's important to remember that the road toward net zero isn't about imposing restrictions on portfolios or doing the right thing — it's going to lead to better portfolio risk management as well as potentially attractive investment opportunities. But active management will be needed to navigate this changing landscape.

Diversification, diversification, diversification!

In summary, we believe **diversification** will be hugely important over the next decade as the various asset classes, sectors and regions are likely to face different challenges at different times. The challenge of diversifying, of course, is complexity. Bringing in an outside expert to help navigate a more complex and challenging investment environment could provide big benefits.

Hooman Kaveh
Global Chief Investment Officer

02 Private markets: The big migration

Action points

- Decide what you’re trying to achieve and what you need your allocation to private markets to do for your portfolio.
- As part of the liquidity assessment, where you have the capacity, consider allocating to less liquid strategies.
- Consider aligning your investments with your institution’s mission.
- Use experts to identify asset classes, develop a clear commitment plan and ensure appropriate sizing.

63% of respondents are either investing in private markets or plan to in the next 12 months.

In an acceleration of the trend we saw unfolding in last year's European investment survey, NFPs are bolstering their allocations to private markets, with only 37% of respondents saying they have no private markets exposure in 2022.

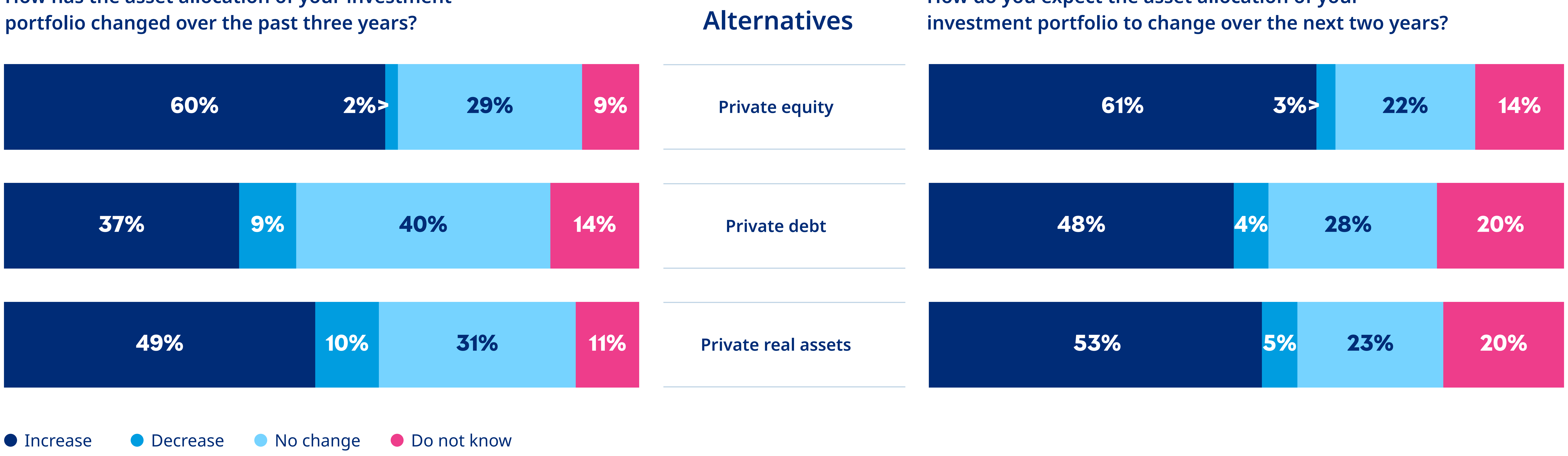
Over the next two years, 61% of survey respondents intend to increase allocation to private equity, 53% intend to increase allocation to private real assets and 48% to private debt.

As an Investment Committee, we chose to allocate to private markets in order to improve the overall risk/return profile of our investments, as well as access sustainability themes that are not readily available within public markets (such as early-stage technology companies and renewable infrastructure).

Richard Williams, Finance Director, Diocese of Rochester

How has the asset allocation of your investment portfolio changed over the past three years?

How do you expect the asset allocation of your investment portfolio to change over the next two years?



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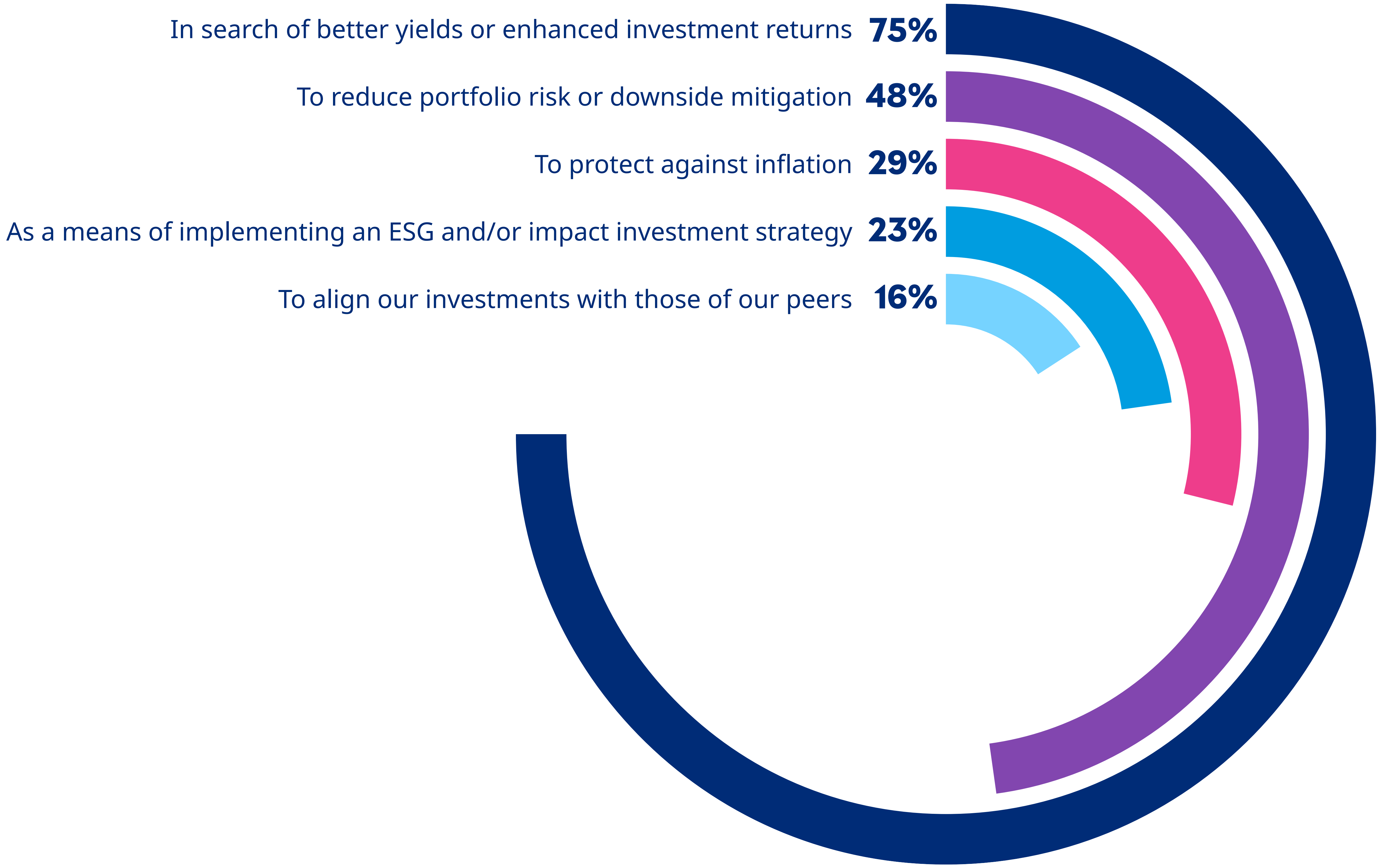
The hunt for better investment returns is the main driver for investing in private markets.

The search for better yields or enhanced investment returns is cited as the top reason (75%) for investing in private markets, followed by reduced portfolio risk or downside mitigation (48% of respondents). Interestingly, this sentiment is consistent across all regions except UK/Europe, where 45% identify a means of implementing ESG and/or impact investing as their second-most important reason for investing in private markets.

What are the two main reasons your organization is invested in private markets?



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Assessing the side effects of going private

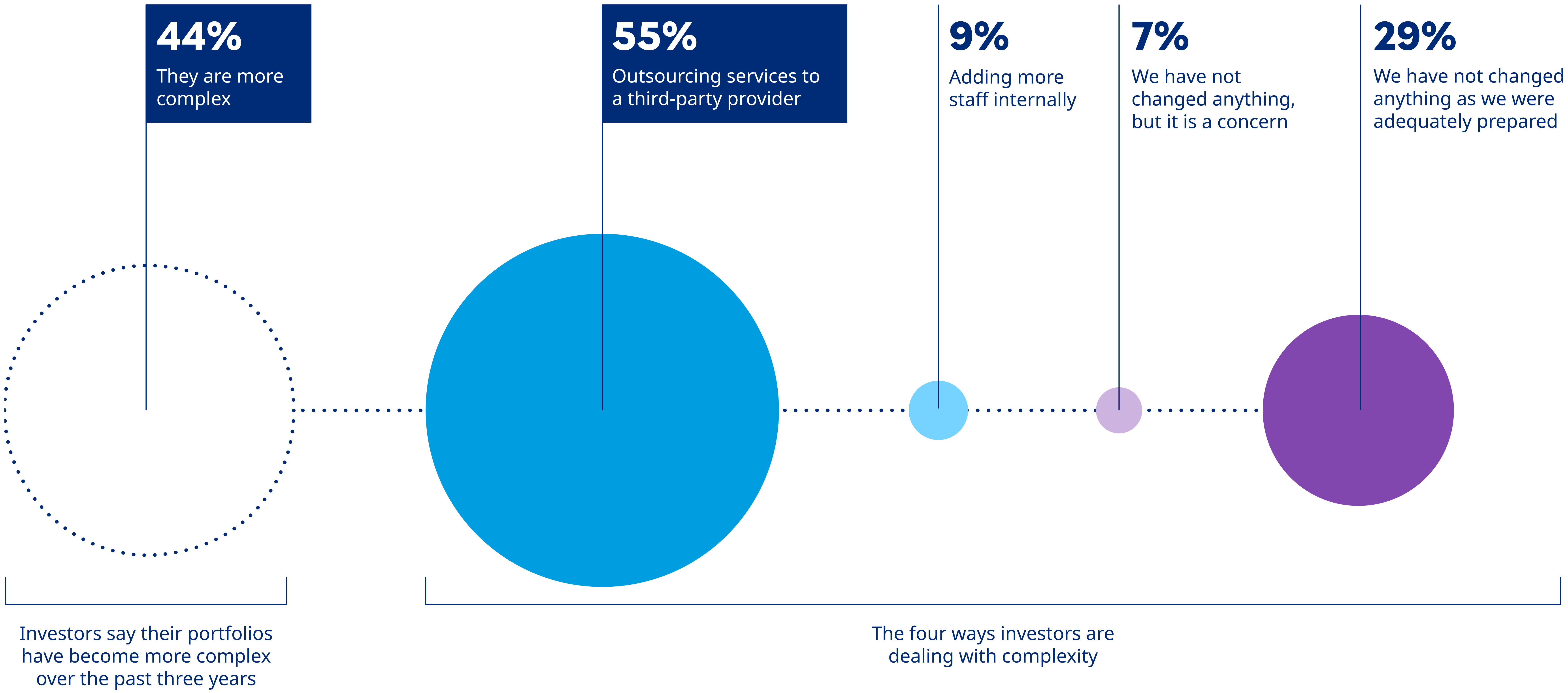
Although the search for enhanced investment returns is the main driver of NFP investors' shift toward private markets, the desire to reduce portfolio risk and protect against inflation are also cited as leading factors in the decision.

However, this transition is not without challenges, and investors in the asset class have noted an increase in the complexity of their portfolios as a result. Nearly half of respondents state that their portfolios are more complex today than they were three years ago. In response to this, 55% of organizations are outsourcing services to third-party providers to help them navigate this complexity.

Other reasons for not investing in private markets include the perception that fees are too high as well as an inability to tolerate the required levels of illiquidity.

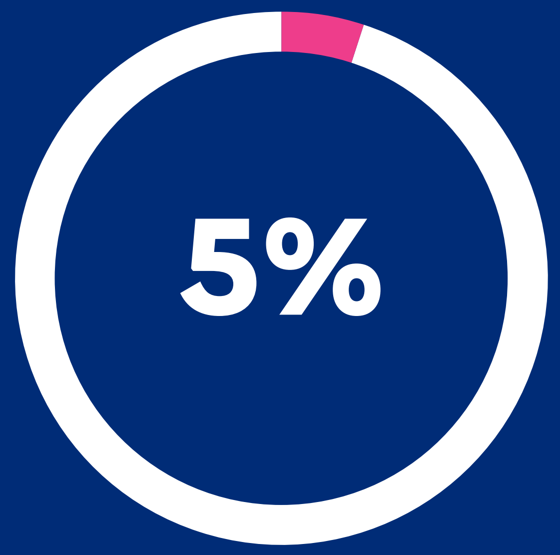
Has the complexity of your investments changed in the past three years?

How are you dealing with the more complex range of investments added to your portfolio in the past three years?

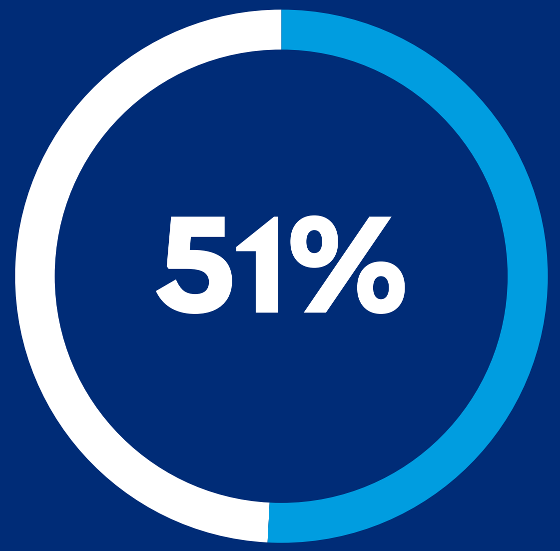


Overall, NFPs with portfolios of more than US$1 billion are more likely to be invested in — or to be planning to invest in — private markets (86%) relative to NFPs with portfolios of below US$250 million (40%). This is not surprising considering a lack of resources to assess investment opportunities is ranked as the leading reason organizations are not invested in private markets. Regionally, the highest proportion of respondents with private markets exposure are in Canada, where 86% are invested in the asset class, whereas Australia and New Zealand hold the lowest exposure, at 43% of respondents. In Europe, 47% of respondents have private markets exposure.

What are the three main reasons your organization is not invested in private markets?



of organizations with US$1 billion+ portfolios have no exposure to private markets



of organizations with US$100 million to US$250 million have no exposure to private markets

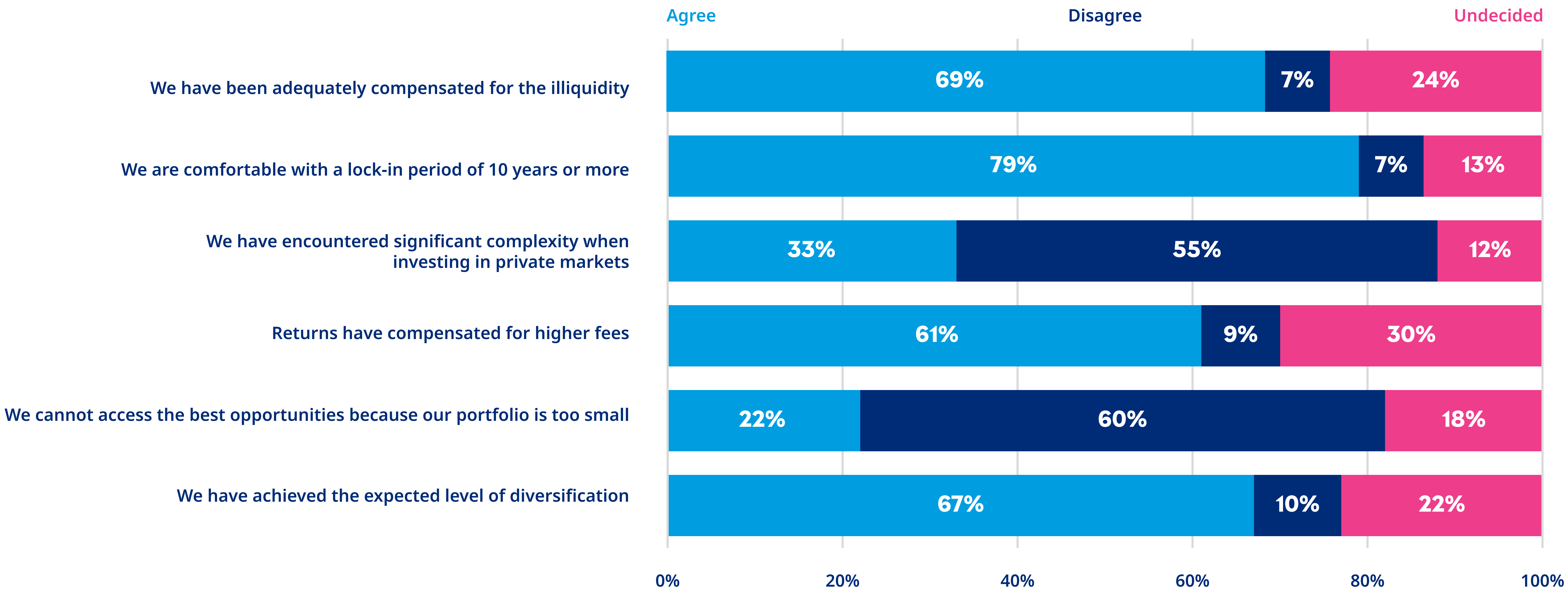
74% of organizations that are not invested in private markets have not sought help to address their concerns.

Interestingly, the concerns driving some participants' lack of exposure to private markets are not borne out by the experience of those that are invested.

The survey uncovered a largely positive investment experience among NFPs with private markets portfolios. **Despite 43% of non-private markets investors citing concerns about high fees as a reason for not being invested, only 9% of those that are invested believe returns have not compensated for the higher fees.** A lack of internal resources to assess investment opportunities is also given as a reason for not investing in private markets.

The most positive investment experience is among private equity investors, where 67% of respondents say their positions in the sub-asset class met the investment return objectives over the past three years. This was followed by real estate and then infrastructure.

Do you agree or disagree with the following statements in relation to your private markets investments?



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All respondents

US$250 million or less

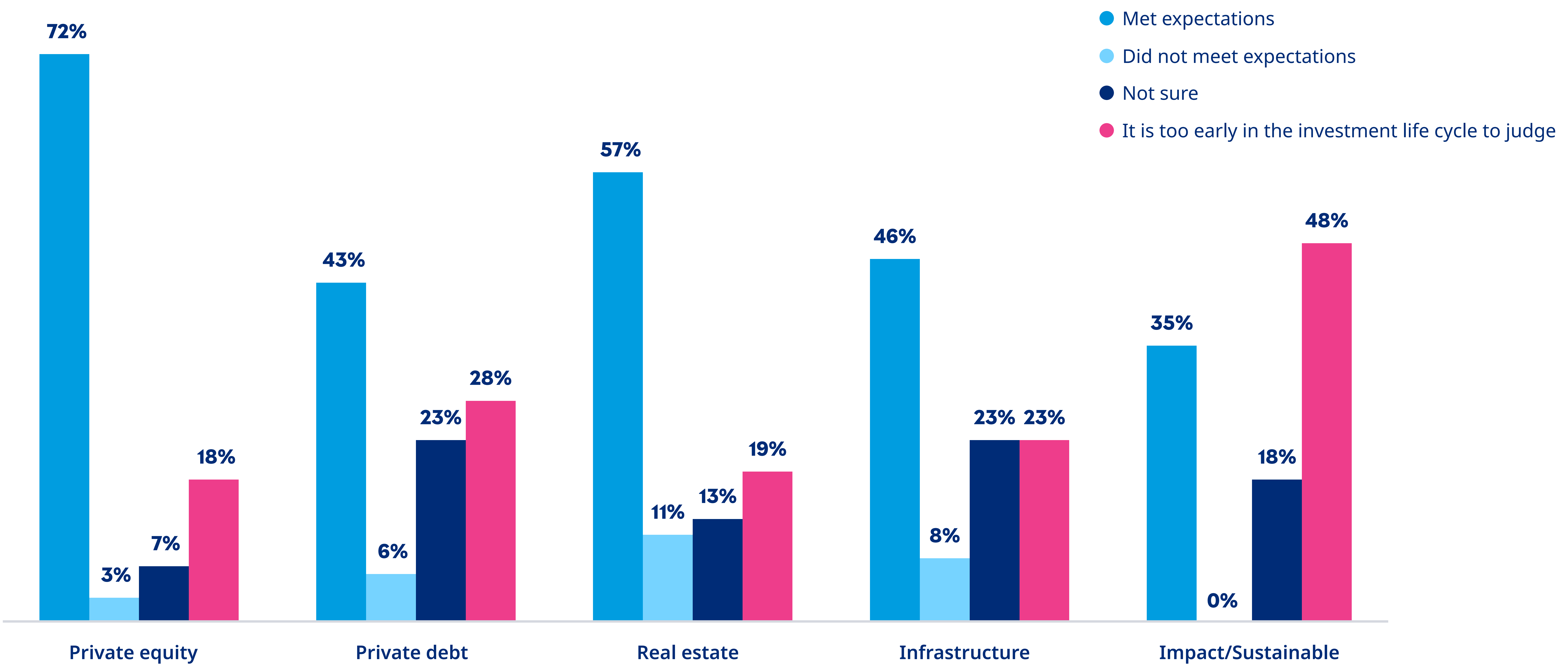
US$250 million to US$1 billion

US$1 billion+

Encouragingly, both investors with smaller portfolios and those with more than US$1 billion to invest report an equally positive experience with private markets investing. Seventy percent of organizations with portfolios of less than US$250 million believe they have been adequately compensated for the illiquidity of their private markets investments.

One particularly interesting finding is that nearly a quarter of respondents are already using private markets as a means of implementing an impact or ESG investment strategy. As this remains a relatively new approach for private markets investors, the majority of respondents are still early-stage investors in the cycle, with 48% of respondents saying they need more time to judge how these investments have performed. In the next section, we delve deeper into the NFP sector's approach, experience and outlook on ESG investing.

Have your private markets investments met their financial return objectives over the past three years?



Your outcome from your hedge fund portfolio will be based on the managers you choose to invest with and the risks they take and the risks they seek to avoid.

Dave McMillan, Global Chief Investment Officer, Hedge Funds

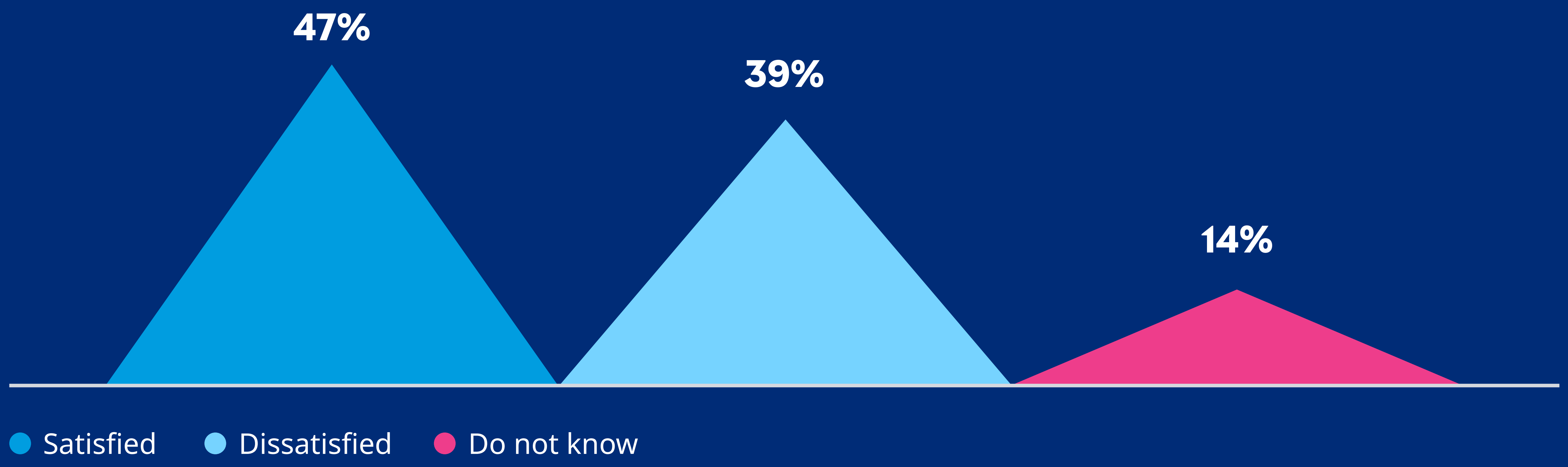
Hedge funds — The comeback kid?

Hedge funds remain a polarizing part of the market; however, 23% intend to increase their exposure to the asset class over the next three years, with only 11% looking to potentially decrease their allocations. The primary reason given for investing is for downside protection (43%), with diversification of returns following (35%) and, finally, excess return opportunities (22%).

Among those who are already invested in the asset class, 47% are satisfied with the return they received, 63% are satisfied with the level of diversification it delivered and 67% are satisfied with the liquidity.

We asked those that are not invested in hedge funds what they think needs to change in order to attract them back into the asset class. Improved returns and better transparency are the most cited changes investors want to see.

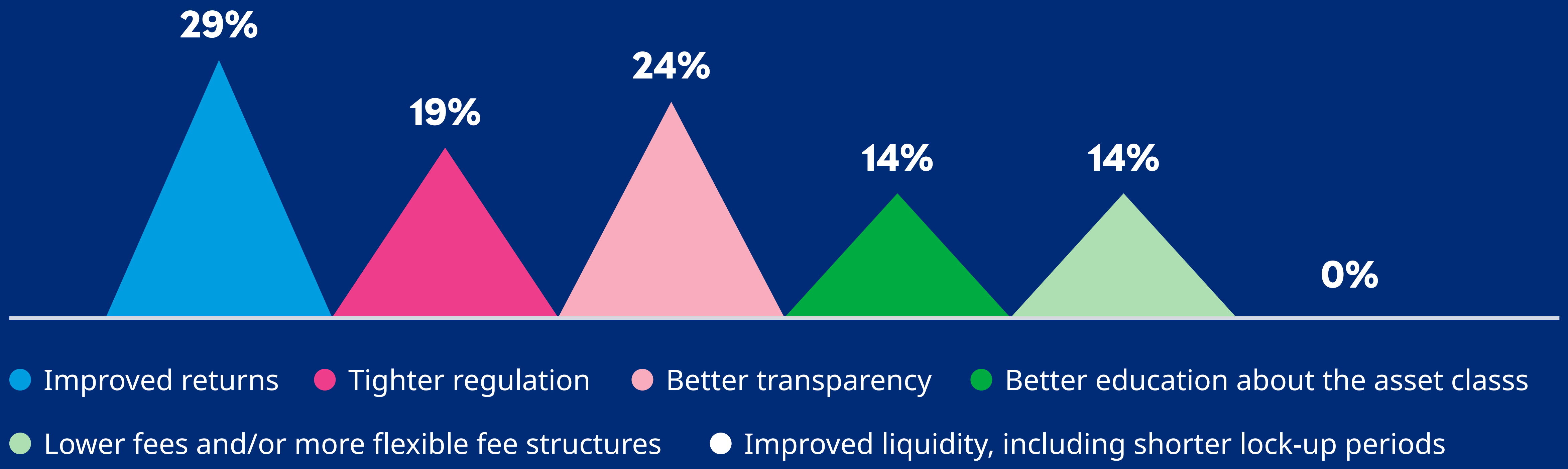
How satisfied are you with the following outcomes of your hedge fund investments?



Roll over the buttons below to reveal chart data

- Return
- Liquidity
- Diversification
- Fees
- Transparency
- Downside protection

If your organization does not invest in hedge funds, what do you think needs to change about the hedge funds sector in order for you to consider investing in the asset class?



Roll over the buttons below to reveal chart data

- 1st objective
- 2nd objective
- 3rd objective
- 4th objective
- 5th objective
- 6th objective

Private markets becoming a portfolio mainstay

The results of our survey are consistent with what we've been seeing over the past decade — investors are increasing their allocations to private markets.

In the US not-for-profit space, what used to be a 10% weight within a broad portfolio has grown to 15% or, in some cases, even as much as 25% — and that's just private equity, without even taking private real assets into account.

Of course, investors have to fund these increases from somewhere, and a previous trend was doing so by reducing exposure to hedge funds, which hadn't been producing expected returns. However, this trend now seems to be reversing as hedge fund performance has picked up and as investors look for asset classes with a low correlation to equities because of significant uncertainty about equities' return prospects. Investors have also been switching out of natural resources, which had not provided attractive risk-adjusted returns since around 2012 and have only begun to do so this year.

Private equity used to be seen as cutting edge, but it has become much more mainstream. That said, investors are becoming more adventurous in how they access the asset class. When they had small allocations, they tended to invest in their home countries and stuck to things like buyouts, but as their allocations have grown, they have increasingly entered more complex areas, such as venture capital, Asia, secondary investments and coinvestments. Many have needed external help to understand the issues specific to these areas and gain access to the best opportunities.

With inflation sharply up, investors are becoming more interested in real assets, such as core infrastructure, which provides steady yields that are positively correlated with inflation. Private debt is popular for the same reasons. Investors remain interested in real estate, but they don't want to own retail or offices. With people working from home and buying from Amazon, investors want to own warehouses and data centers instead, which are not among the traditional sectors covered by core real estate. And there are new opportunities. One example is a fund that is building studio space for independent content producers that need somewhere to make content for Netflix and the like. So investors are moving into different areas, but they still want the same attributes — assets that provide a degree of protection from inflation and add some alpha to their portfolios.

Within private equity, one area we like at present is continuation funds. That's not to say that the entire universe of continuation funds is attractive, but we believe the best ones have the potential to offer the opportunity to invest in high-quality companies with strong operational momentum run by well-aligned general partners — often with lower fees than an investor would have paid in the underlying fund. We think this is an enormous opportunity, but it's vital to invest with high-quality managers. Outsourcing or seeking help from an external specialist can help you find the best managers in what can be a difficult market to navigate. If you can align yourself with the right vehicle, I believe continuation funds hold huge potential.

We've seen a growing trend in clients outsourcing or looking for support from external parties to build and implement their private markets portfolios, even among investors that have been involved in the asset class for years. When they move into niche areas in which they may not have the necessary expertise or contacts, it just makes sense to seek external support, and it can also save a lot of time. In the US, there's still a culture of building up your own staff that comes out of the endowment model. But by outsourcing, you can have the resources you need overnight rather than building them up internally over time, and many investors see this as much better value for money.

Finally, for investors looking to make an impact, certain funds can enable them to target areas that may be aligned with their organizations, whether through financial inclusion or funding the energy transition. It's good to remember that by investing in private markets, you can help make the world a better place.

Michael Forestner
Global Co-Chief Investment Officer, Private Markets

03 Outsourcing: Navigating the future with the right support

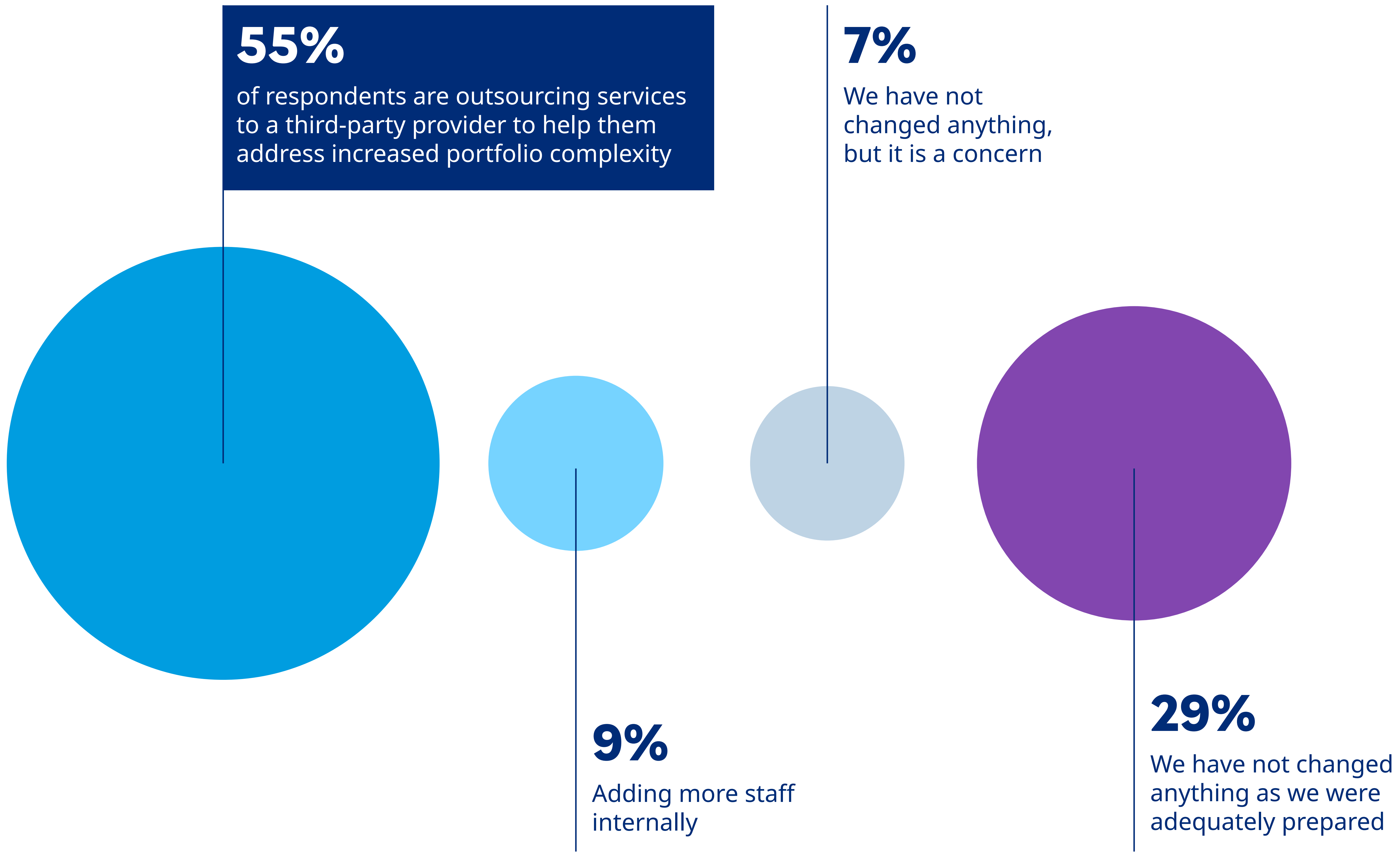
Action points

- Engage external help to supplement in-house resources and expertise.
- Consider additional governance models (outsourcing, extension of staff, etc.) to help ensure effective sourcing, assessment and execution, all of which complement in-house skills.
- Review your program regularly to make sure it remains appropriate and aligned with your objectives.
- Regularly review your provider to help ensure that it's best placed to meet your changing needs.

As the NFP sector continues its march toward a more ESG-focused investment future, the market landscape underneath it continues to evolve. Diminishing returns from the traditional asset classes are pushing investors further along the risk spectrum and into new asset classes, and NFPs have begun to follow suit.

To support this mass evolution of its portfolios, the sector is increasingly enlisting the help of third-party providers. Fifty-five percent of respondents to our survey say they are specifically using external expertise to help them navigate the complexity of private markets investing. Overall, 26% of respondents are working directly with fund managers, whereas the other 70% are getting external investment support.

How are you dealing with the more complex range of investments added to your portfolio in the past three years?



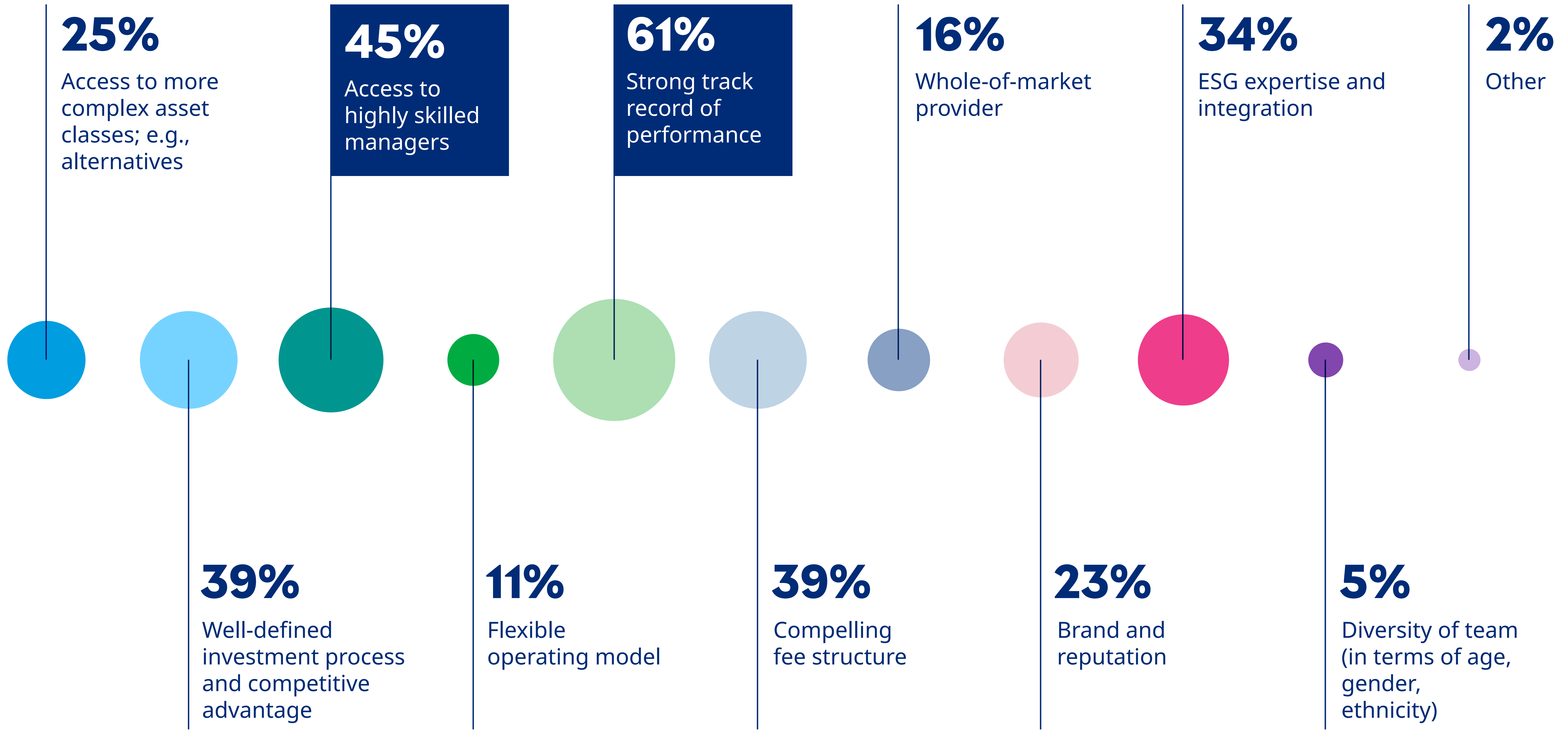
Alongside this finding, 30% of those that are already working with outsourced chief investment officers (OCIO)/implemented consulting are using them to help implement a private markets strategy. The majority of respondents (80%) say they are using OCIO/implemented consulting services for reporting and administration, along with strategic asset allocation reviews (77%) and activities related to manager selection and monitoring (75% and 73%, respectively).

When selecting a third-party provider, track record and access to skilled managers are the most-cited selection criteria.

Outsourcing the implementation of our portfolio has helped our investment committee keep its focus on the key strategic drivers of performance and lowered the administrative burden on the University's staff.

Steve Fusi, Advancement Committee Chair, Wentworth Institute of Technology

Which three of the following options are most important to you when selecting a third-party provider?



No. of responses 44
Some organizations indicate more than one answer; therefore, the total exceeds 100%.

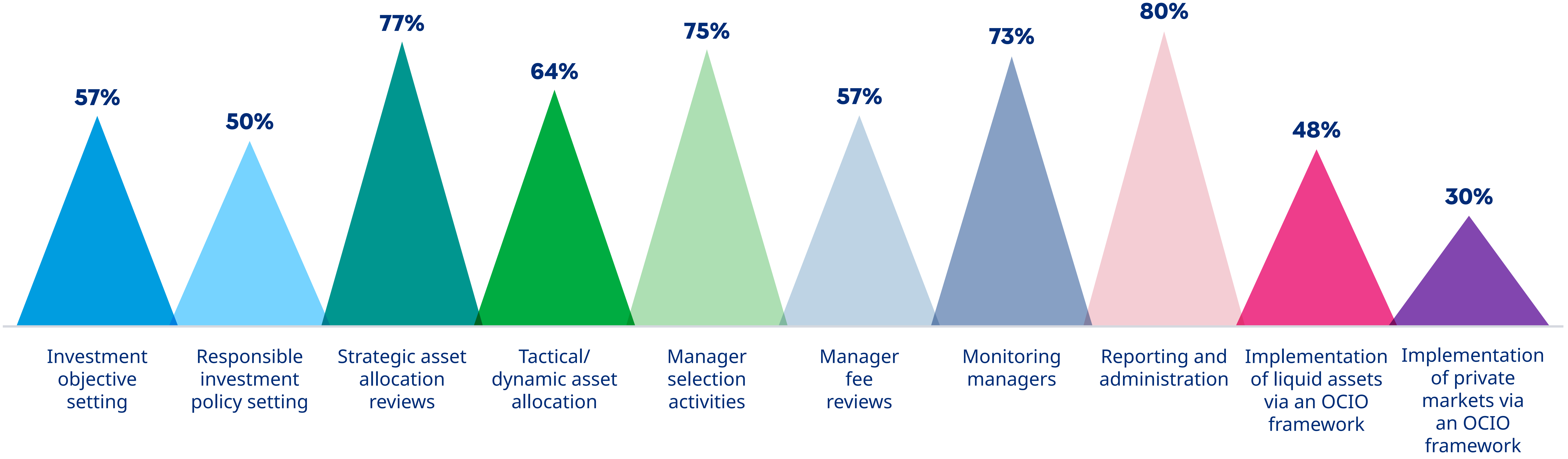
Our survey shows that reporting and administration, strategic asset allocation reviews, and manager selection are among the most outsourced tasks.

We believe a major benefit of the OCIO model is that it frees up more time for investment committees to discuss ESG and mission-aligned investing. It's encouraging to see ESG expertise receiving a high level of importance as it can support financial performance. Watch for the diversity option to grow in importance.

Georges Dyer, Intentional Endowments Network

If you are already working with an OCIO*/third-party provider, please select the tasks they assist you with.

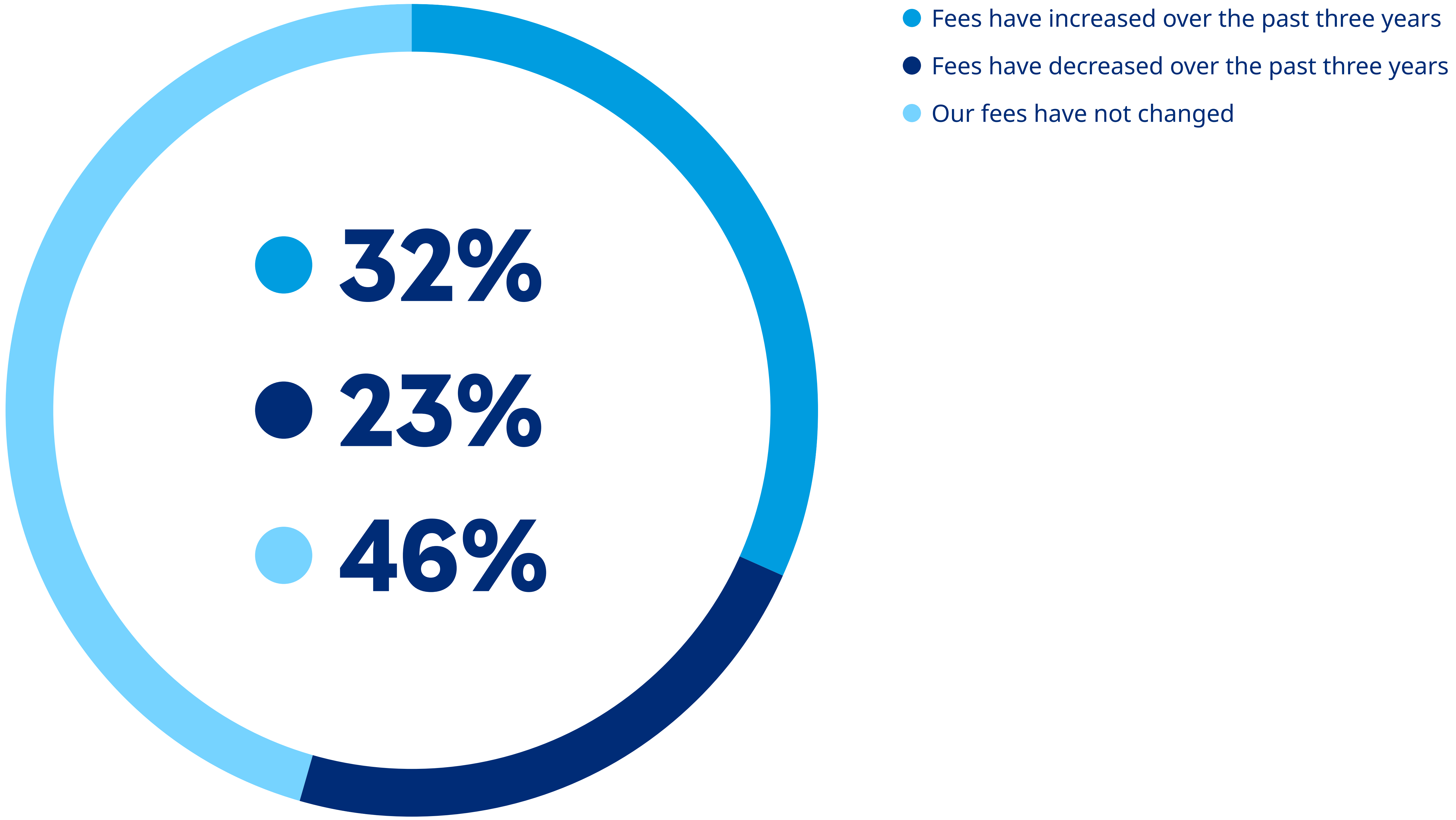
70% of respondents are getting some degree of external support to manage their investment portfolios



* Outsourced chief investment officer, also known as delegated solutions, fiduciary management and implemented consulting.

Against this backdrop, 46% of respondents say the amount of fees they pay has not changed relative to their investments, and 23% say their fees have actually decreased. This suggests that the sector is working with external providers in an efficient manner and wisely selecting the tasks it outsources to experts.

Which statement best describes your organization's stance on investment management fees relative to invested assets?*



*** Investment management fees covers your total portfolio fees paid to investment managers as defined above and fees you pay to a third party; i.e, consultant or OCIO provider.**

Outsourcing momentum continues to grow

Not for profits have had to deal with a huge increase in complexity since the global financial crisis.

For example, they've diversified their range of investments in response to the crisis, increasing portfolio robustness but also complexity. Whereas not for profits had traditionally invested in developed-markets equities and government bonds, in recent years, they've broadened their scope to include assets such as high-yield debt, emerging fixed income, emerging equities and small caps.

More recently, they've had additional issues to contend with — such as the inclusion of private markets as a new source of potential higher return and diversification, the increased urgency to achieve net zero and wider ESG requirements, and a sharp increase in market volatility as well as inflationary pressures and increasing interest rates. Forty-four percent of the respondents to our survey say their portfolios are now more complex than just three years ago. Exploring new asset classes and strategies can help manage these pressures; however, with this comes additional challenges. Education is key when looking at adding new strategies and asset classes to portfolios, ensuring they are integrated with consideration for broader portfolio construction requirements, getting access to the right managers, ongoing oversight and reporting, and ensuring all this is achieved in a cost-efficient framework.

We believe diversifying their assets was the right thing to do. However, it has put a lot of pressure on governance, oversight and operational day-to-day management in addition to, in some cases, increasing costs.

Many investors have responded by reviewing their governance. They've told us they feel overwhelmed by the range of issues they need to consider and the time it takes to deal with them. The result? A dramatic increase in outsourcing. In fact, 70% of respondents say they're getting some degree of external support to manage their investment portfolios more broadly, and 55% have sought direct help from an external provider due to increased complexity around their investments.

Outsourcing can provide some big benefits

It can help investors achieve tasks more quickly and in a more cost-effective manner. By delegating some of their day-to-day operational management, they have more time to focus on what's most important to their organizations, such as philanthropic mission or making investment decisions at a strategic level. Outsourcing can involve delegating everything, but it certainly doesn't need to — clients can pick and choose which of their activities they wish to outsource based on their individual requirements. What's more, an external specialist works as an extension of your team, so you don't need to make expensive internal hires to manage the increased complexity.

ESG investing is hugely important to the not-for-profit sector. There are many different ways of integrating ESG factors into your investments, and if you're aiming for a net-zero portfolio, you face a momentous task. You need to set plans, measure progress and gain access to high-quality data. Outsourcing can help on this difficult journey.

Rather than just representing an additional layer of fees, thanks to their buying power, external experts can actually help you reduce overall costs. This is particularly important for smaller not-for-profit entities that may not find it easy to access the best managers or new asset classes — and may struggle to afford them even if they can.

Outsourcing isn't for everyone. Some entities feel they have the internal capabilities to carry on doing everything themselves, and that may well be the right answer for them. But our research shows that many clients who had already outsourced have been able to face the growing number of challenges without a significant impact on their resources.

Those that have reviewed their governance arrangements have found the changes they've made to be very positive.

With the challenges and opportunities outlined by our clients, we believe governance, effective execution and monitoring are critical to successful outcomes. We work closely with our clients to amplify their in-house expertise through the full continuation of engagement models; that is, traditional consulting, extension of staff and a fully outsourced model.

Michael Dempsey
Global Leader, Investment Solutions and OCIO Services

04 Sustainability: Closing the gap between ethics and investment returns

Action points

- Develop a clear responsible investing policy for all your organization’s stakeholders. It should cover issues such as mission alignment; diversity, equity and inclusion; and climate risk.
- Establish clear processes to integrate ESG considerations into your investments, whether through manager selection, investing in thematic strategies, negative screens, impact strategies or net zero.
- If you want to make a positive impact, move beyond exclusions toward thematic or impact strategies with measurable stewardship and engagement outcomes.
- Use data to hold your investment managers accountable for their own sustainability commitments.
- Increase transparency, and share policies with potential donors and other stakeholders.

Eighty-seven percent of survey participants are currently incorporating ESG into their investment decisions or plan to begin doing so in the next 12 months.

When asked whether they plan to change their exposure to ESG-focused investments over the next two years, 72% of respondents state an intention to increase or significantly increase their exposure to ESG-related investments, with only 1% of respondents planning to decrease such exposures. However, although the sector's commitment to ESG is strong across the board, the rationale for incorporating ESG into investment decisions remains nuanced.

It is no longer tenable for a charitable organization not to incorporate ESG considerations into its decision-making.

Survey respondent

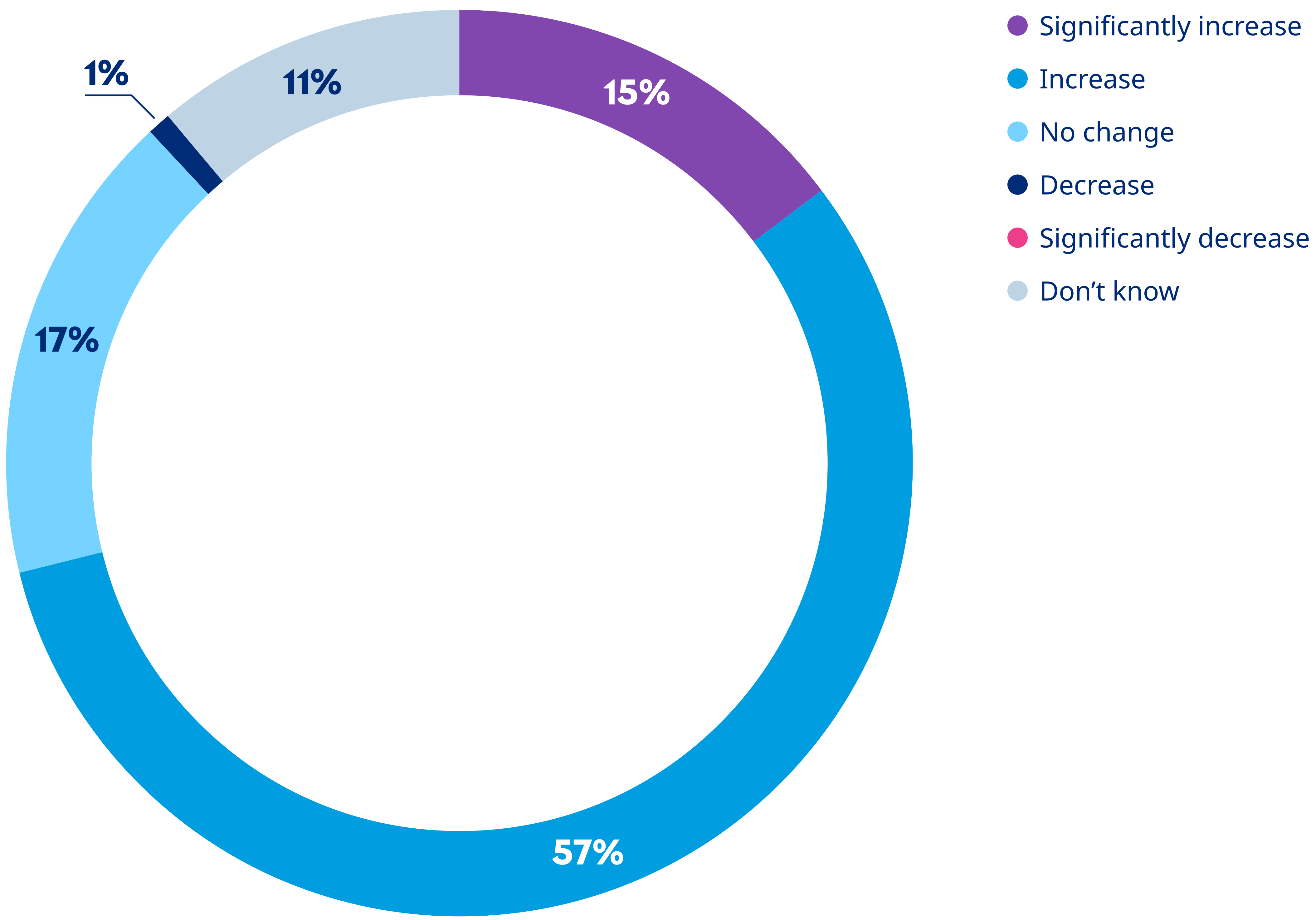
Does your organization incorporate ESG considerations into its investment decision-making?

Roll over the buttons below to reveal chart data

- Global
- Asia
- Australia/New Zealand
- Canada
- United Kingdom/Europe
- United States

72% of respondents are planning to increase their exposure to ESG investments in the next two years.

How is your organization's exposure to ESG investments likely to change in the next two years?



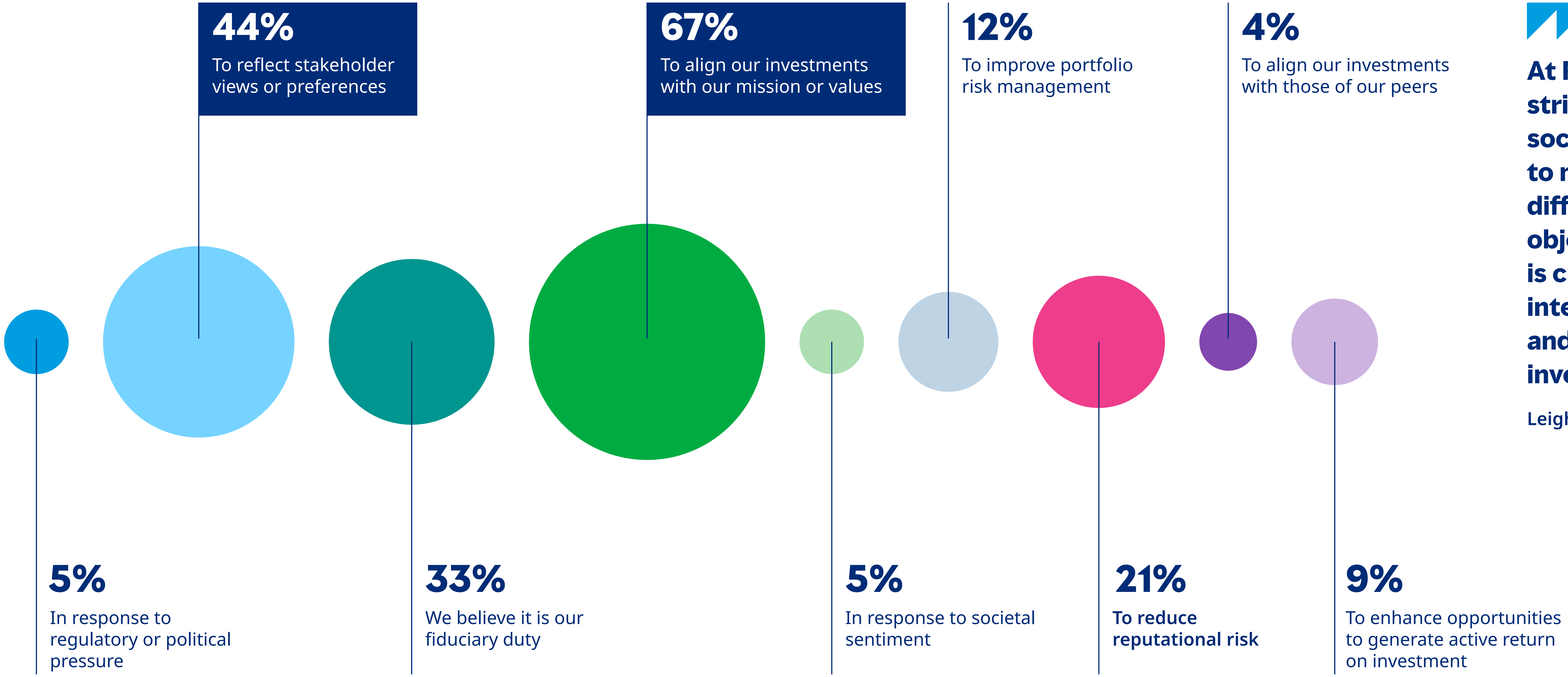
Incorporating ESG into our investment framework just makes sense. It helps focus on factors that underpin sustainable long-term performance.

The Presbyterian Church Property Trustees, New Zealand

When asked why they are incorporating ESG into their investment decision-making, the largest proportion of respondents cite aligning their portfolios with their organizations' missions and values.

Interestingly, only 9% of respondents believe strengthening their exposure to ESG investments will enhance opportunities to generate active return on investments. Only 12% believe it will improve portfolio risk management.

What are the top two factors driving your organization's decision to consider ESG in its investments?



At Rātā Foundation, our purpose is to strive for an equitable and sustainable society, and we do that in partnership, to make a meaningful and positive difference. Aligning our investment objectives to our values and purpose is crucial, and we are proud to be integrating environmental, social and governance factors into all our investment decisions.

Leighton Evans, Chief Executive, Rātā Foundation

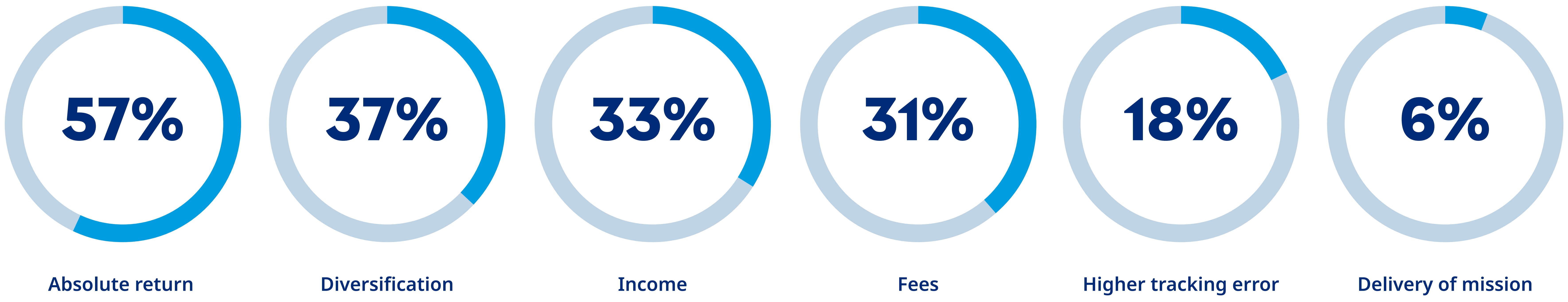
This finding suggests that the industry sees ESG investing predominantly as a vehicle through which they may "do the right thing" and have yet to be convinced of the financial return benefits of the approach. A similar sentiment arose when we asked whether participants believe they will have to compromise in order to meet their ESG investment objectives. Thirty-nine percent of respondents believe they will have to make compromises, and, of that group, 57% believe they will have to compromise on absolute return. Interestingly, compromising on diversification, income and fees were all a close second place at between 31% and 37%.

Do you believe your organization will have to compromise on any of the following in order meet its ESG investment objectives?

Roll over the buttons below to reveal chart data

- All respondents
- US$250 million or less
- US$250 million to US$1 billion
- US$1 billion+

Do you believe your organization will have to compromise on any of the following in order meet its ESG investment objectives?



This concern is further reflected in the rationale given by the respondents not incorporating ESG into investment decisions: 57% believe that doing so would hamper their ability to deliver on their prime fiduciary duty, which is to maximize financial returns.

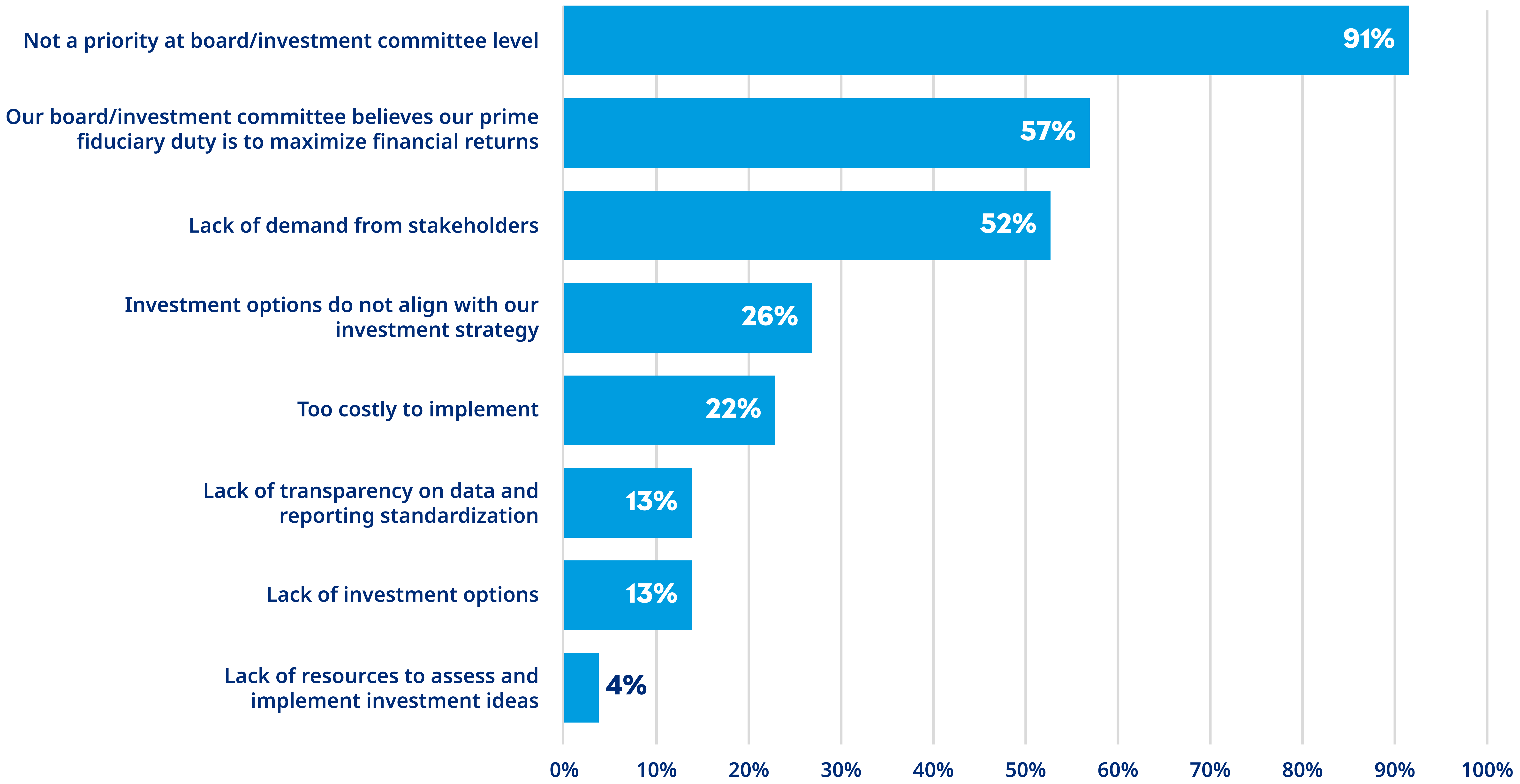
Interestingly, when considered from the point of view of portfolio size, the survey data show that organizations with portfolios of US$1 billion or more are most concerned about compromises on absolute return when investing in ESG, whereas organizations with portfolios of US$250 million or below are more likely to be concerned about higher fees related to the approach.

In the first signs of a trend that emerged across this section of the survey, US respondents are the least likely to be invested in ESG, citing a lack of drive at board level and/or among stakeholders.

Today, a holistic approach to creating positive social impact incorporates a wide range of ESG strategies and impact investments, alongside philanthropy. Our approach is informed by our foundation's core beliefs and our community's needs.

Beth Sirull, President and CEO, Jewish Community Foundation of San Diego

What are the top three reasons your organization does not currently integrate, or plan to integrate, ESG considerations into its investment decisions?

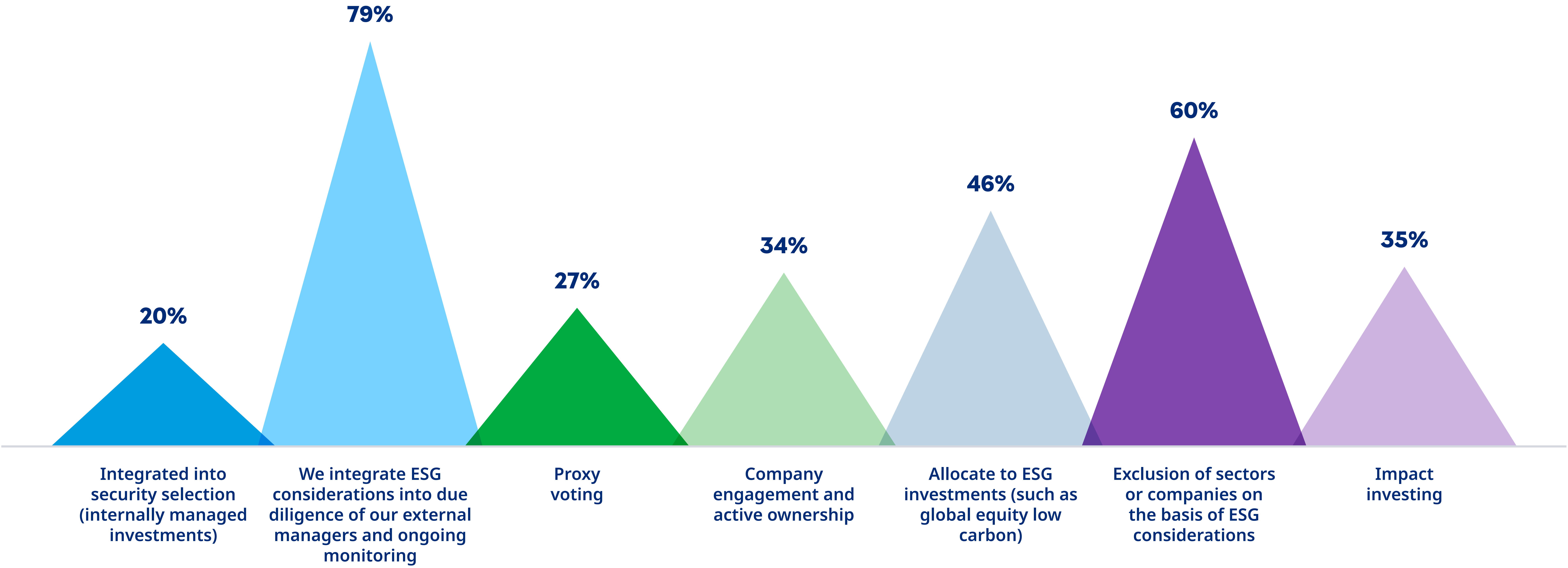


Among investors that do consider ESG in investment decisions, mission alignment is, as stated, the most commonly cited driver. ESG considerations are largely being applied at the manager-selection level, with 79% of respondents saying they integrate ESG analysis into external manager due diligence and ongoing monitoring. Although this suggests that inclusion — rather than exclusion — is the foundation of ESG investment selection, the survey shows that 60% of investors continue to choose exclusion over engagement as part of an overall ESG strategy. Tobacco, weapons and alcohol are among the industries called out for exclusion by respondents.

While most respondents focused on integrating ESG considerations into external manager selection, excluding companies or sectors was also a strong focus. We believe a more comprehensive approach should include shareholder engagement and thematic investing.

Georges Dyer, Intentional Endowments Network

How does your organization incorporate ESG considerations into investment decisions?



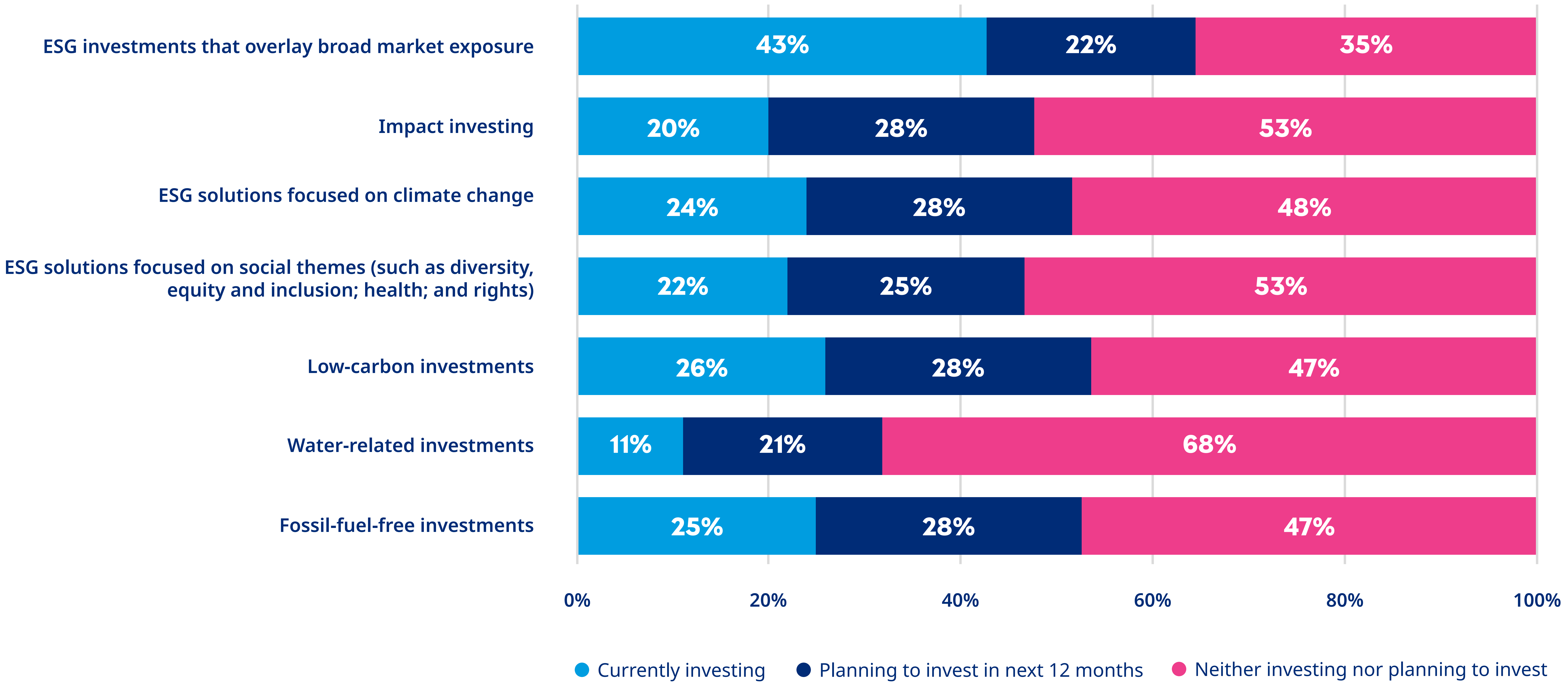
Roll over the buttons below to reveal chart data

- Global
- Asia
- Australia/New Zealand
- Canada
- United Kingdom/Europe
- United States

The survey also helped us develop a clearer picture of the ESG themes to which investors are most committed. Sixty-five percent are gaining exposure — or planning to over the next 12 months — via ESG investments that overlay broad market exposure; this is followed by low-carbon (54%), fossil-fuel-free (53%) and climate-change-related (52%) investments. Of the options presented, water-related investments are the least prioritized among investors, with 11% currently having exposure to the theme. However, 21% of respondents are looking to allocate to water-related investments over the next 12 months. This finding is in line with wider evidence that Mercer has gathered suggesting that investors are not considering the impact of their investments on water. Despite intensifying concerns about water scarcity globally, as a theme, it is — at present — rarely factored into such decisions.[2]

On one of our recent podcasts, "Making Waves, a Spotlight on Water Scarcity," we discussed why we believe water, essential to life on earth, is not more central to investors' decision-making.

Is your organization currently investing in any of the below, or planning to invest, in the next 12 months?



We believe that water-related scenarios and water risks and opportunities need to be elevated. As you know, they are very much part of climate change investing as well.

Helga Birgden, Global Head of Sustainable Investing

[2] Mercer. "Making Waves: A Spotlight on Water Scarcity," *Critical Thinking, Critical Issues*, 2022, available on Apple Podcasts at https://podcasts.apple.com/ie/podcast/making-waves-a-spotlight-on-water-scarcity/id1555223857?i=1000558162219.

56% identified climate change (clean energy) as the second biggest investment opportunity by respondents over the next 3 years.

The survey uncovered compelling regional variations, with the US significantly more likely (93%) to use impact investing as a means of delivering its ESG investment objectives. This is relative to 25% in Europe/UK and 33% in both Asia and Canada.

Amid their strong commitment to investing in funds that support the global drive toward net zero, we discovered the green shoots of signs that NFPs are themselves entering the net-zero conversation from an organizational point of view. Fourteen percent of respondents have set net-zero targets for their organizations, and a further 23% intend to set a target over the next 12 months.

> *37% of respondents have set net-zero targets for their organizations or intend to over the next 12 months*

The macro environment is the number-one threat. If countries don't meet their national targets, there is no chance that the investment markets will achieve net zero on their own.

Survey respondent

Europe is leading the way, with 44% either having set or planning to set a net-zero target, followed by Australia/NZ, with 40%.

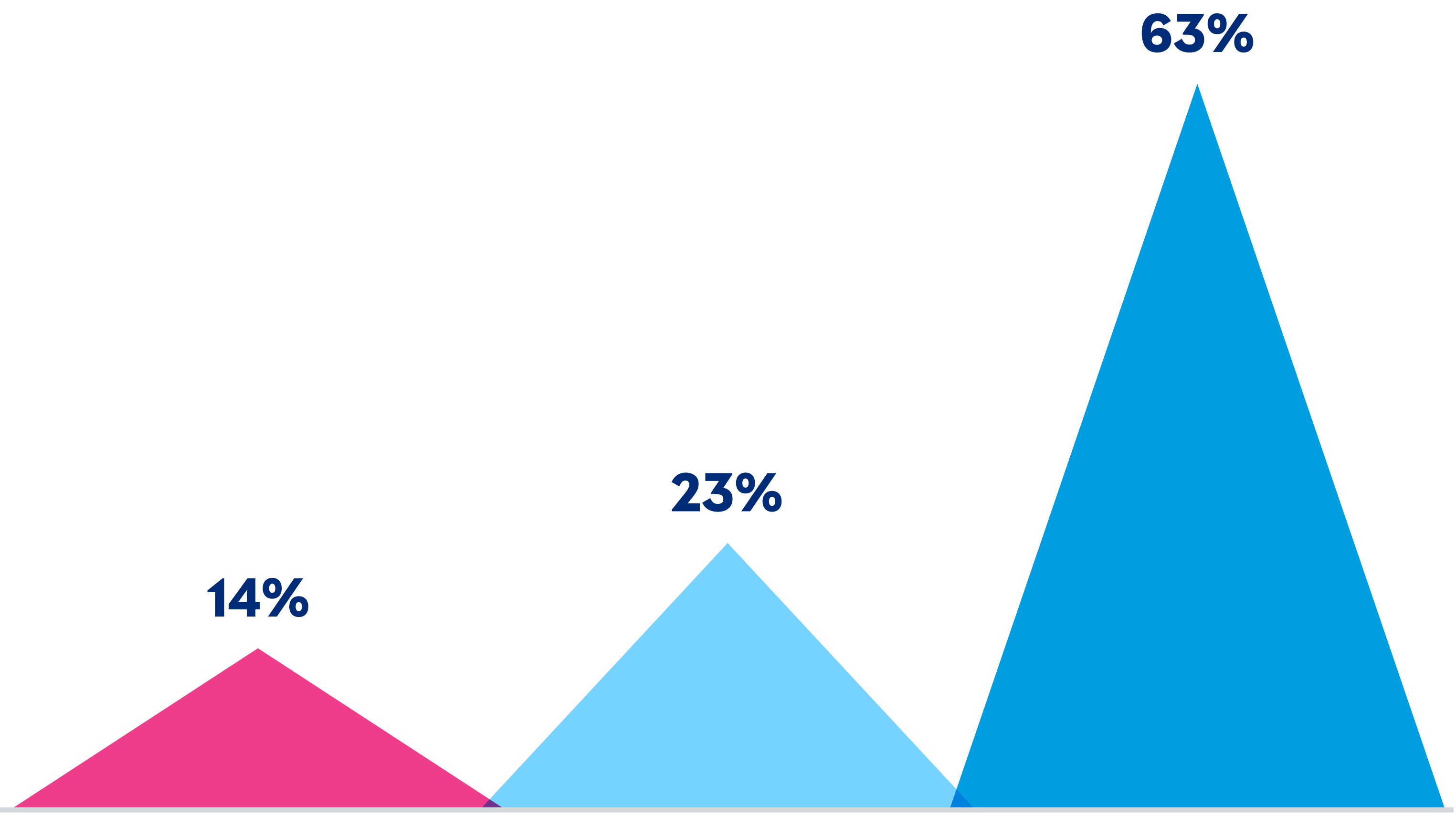
Organizations with portfolios of more than US$1 billion are more likely to have set a net-zero target (35% of respondents versus 11% of respondents with portfolios of US$250 million or less).

Across all organizations, the most-cited reason for not setting a net-zero target is a lack of leadership on the matter from the organization's board.

While we recognized that there were challenges associated with setting a 'net-zero target' (e.g., data and uncertainty of future investment opportunities), we felt as a university that we should be at the forefront of tackling the climate crisis, and being mindful of our role in transitioning to a low-carbon economy is a key part of this. We intend to work closely with our managers and advisors as we set out to achieve our ambitious interim and long-term targets in the years to come.

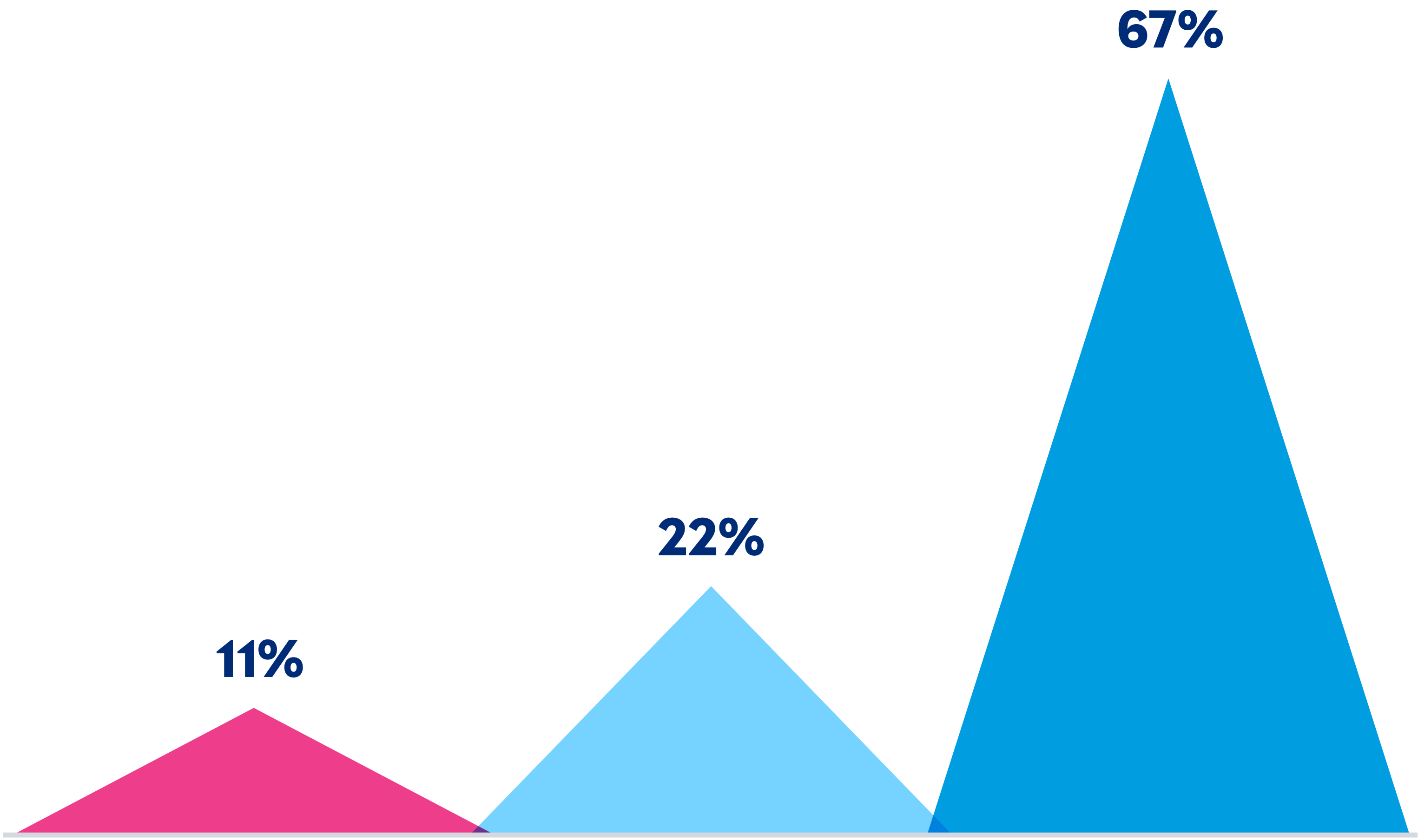
Professor Nalin Thakkar, Vice-President, The University of Manchester

In relation to your investment portfolio, have you set a net-zero target or do you plan to in the next 12 months?



Roll over the buttons below to reveal chart data by region size

- Global
- Asia
- Australia/New Zealand
- Canada
- United Kingdom/Europe
- United States



Roll over the buttons below to reveal chart data by portfolio size

- US$250 million or less
- US$250 million to US$1 billion
- US$1 billion+

37% of respondents have either set or plan to set a net-zero target in the next 12 months.

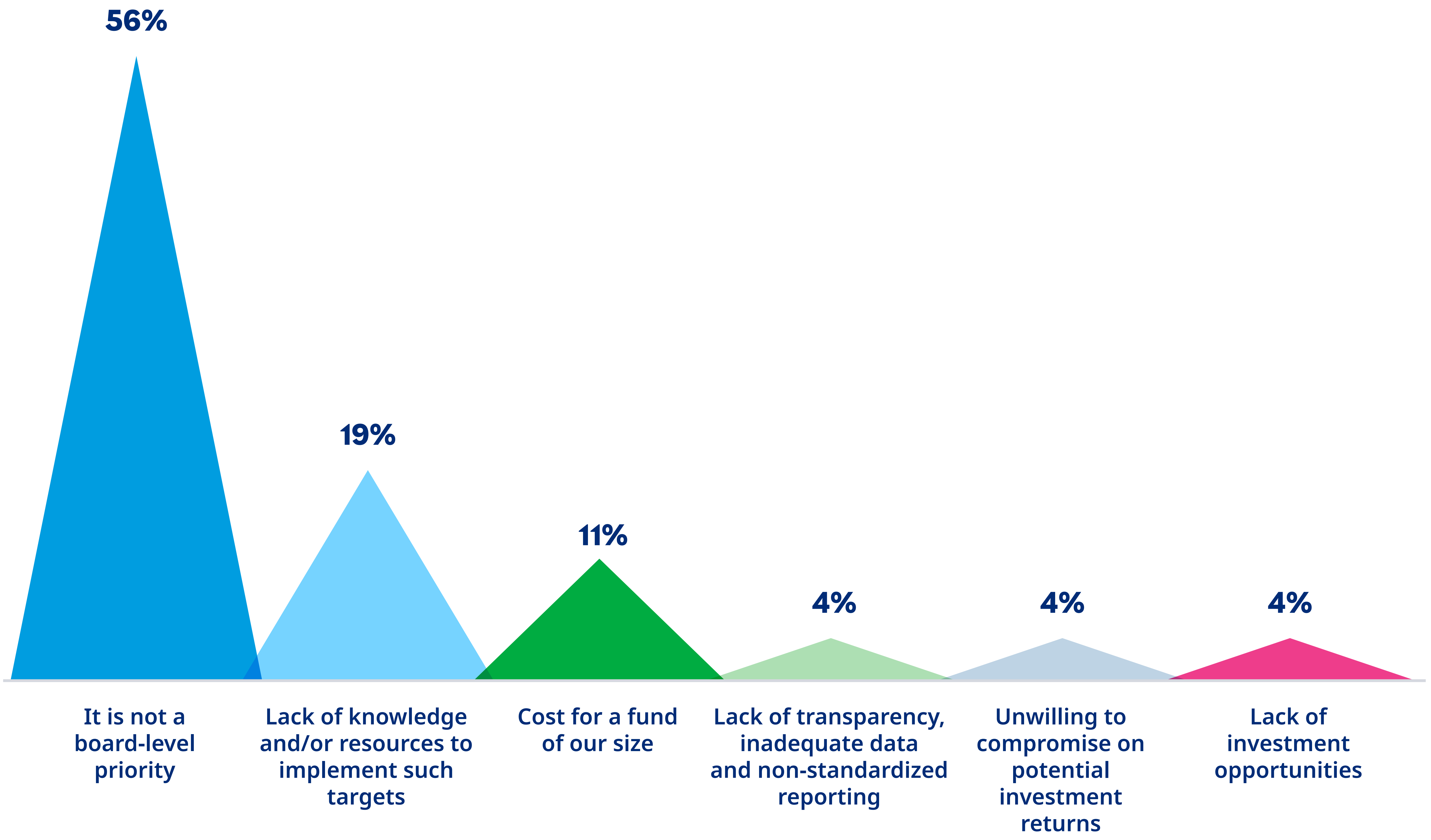
56% cite a lack of board-level priority for not setting a net-zero target.

This is followed by concerns surrounding a lack of implementation knowledge and data to monitor and report progress. These same concerns surrounding implementation and reporting arose among both organizations that have set a net-zero target and those that have not.

Setting targets is easy. Measuring progress and communicating is difficult!

Survey respondent

What is the primary reason you have not set, and are not planning to set, a net-zero target?

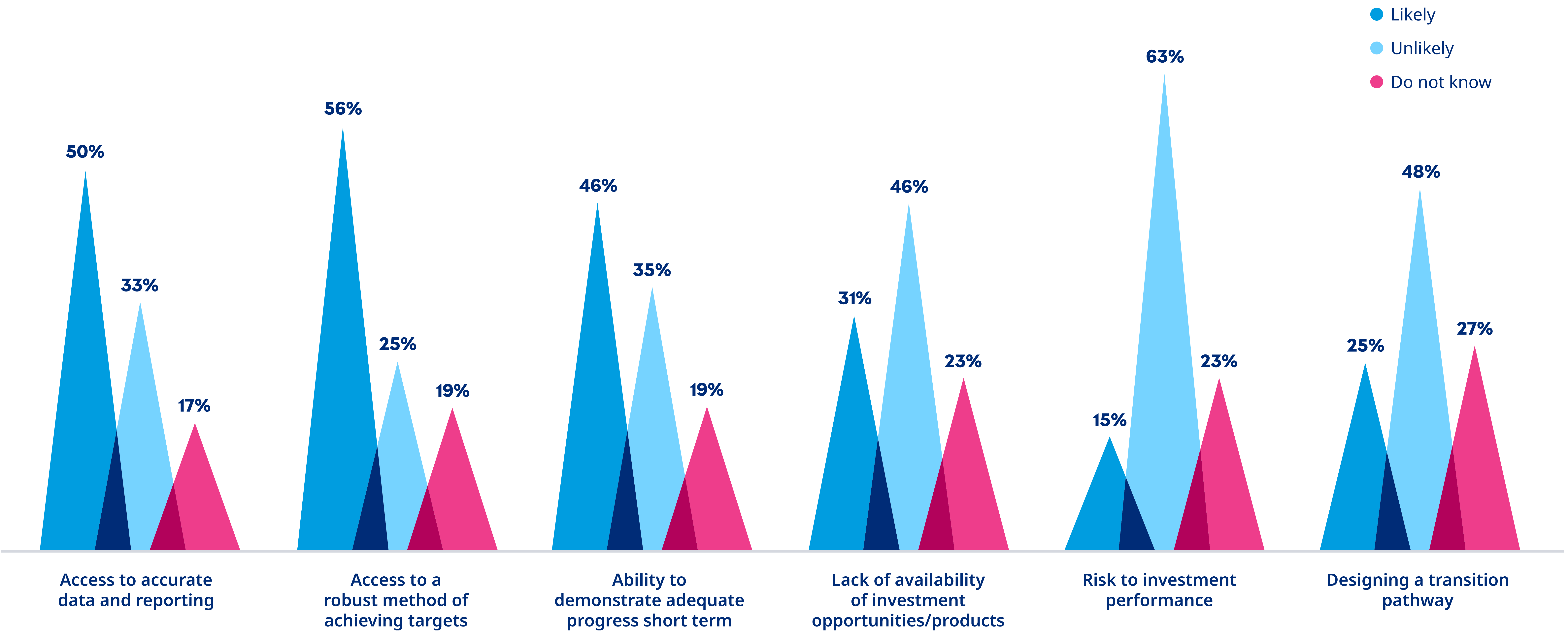


Roll over the buttons below to reveal chart data

- Global
- Asia
- Australia/New Zealand
- Canada
- United Kingdom/Europe
- United States

Access to a robust method of achieving net-zero targets is the main threat perceived by not for profits.

Which of the following external factors are most likely or unlikely to threaten your organization's ability to meet its net-zero target?



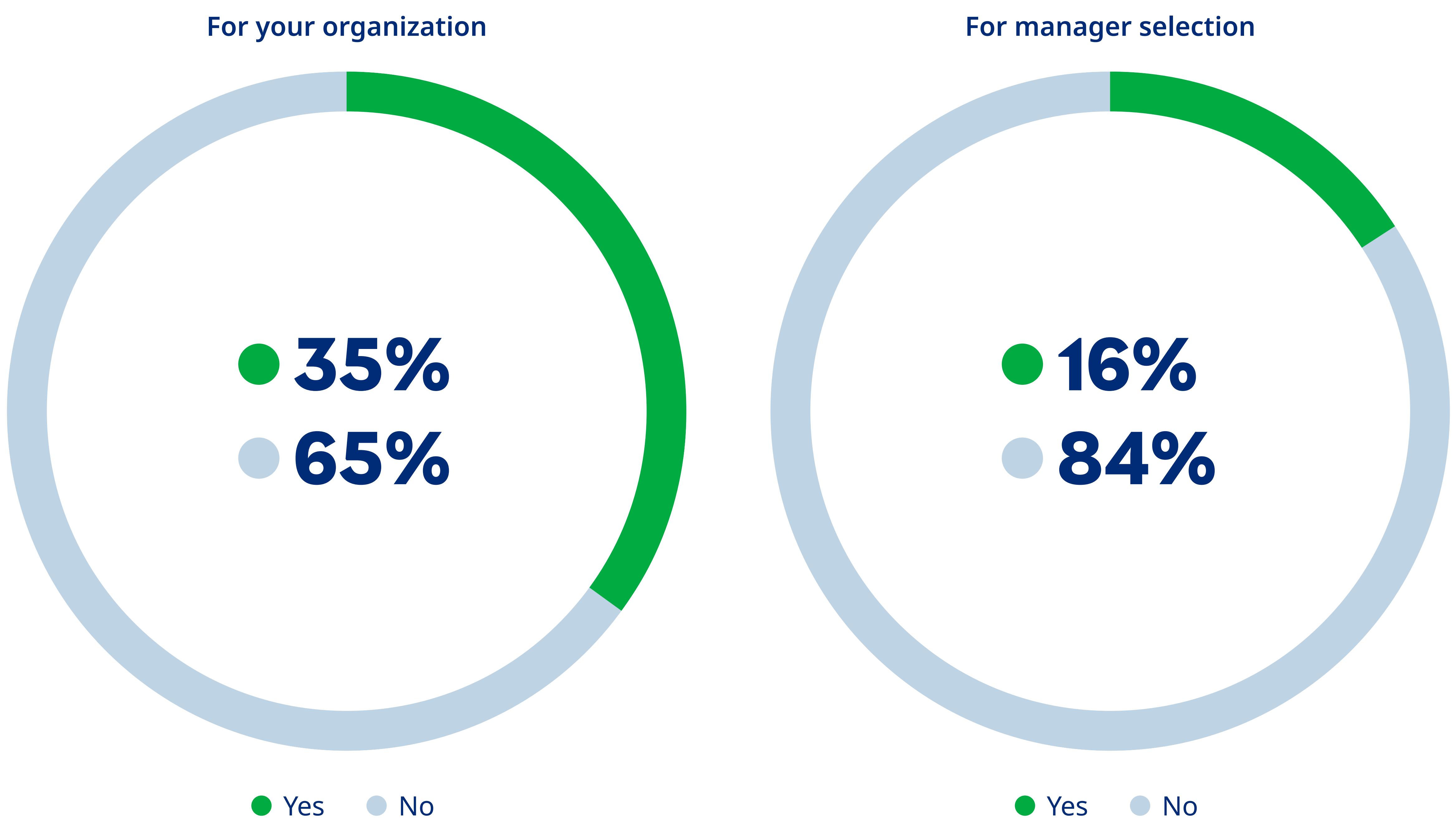
Diversity, equity and inclusion (DEI)

DEI has become an increasingly important topic for society and markets, and the theme is beginning to manifest in clear targets for NFPs. With many survey participants citing the existence of a DEI policy within their organizations, 37% have gone as far as setting a target either for their organizations or for their third-party investment managers.

Among those that have set a target, their reasons for doing so are largely driven by ethics rather than a recognition of the performance benefits of diverse teams. This finding reinforces what appears to be a widespread inclination to see social and other ESG issues for their ethical rather than their financial return benefits. For those organizations that have not set a target, the decision was driven by a lack of board-level leadership.

From a regional perspective — as with other areas of the ESG space — the US lags the other regions surveyed, with 70% of respondents not having set DEI targets for their organizations, relative to 59% in Europe/UK.

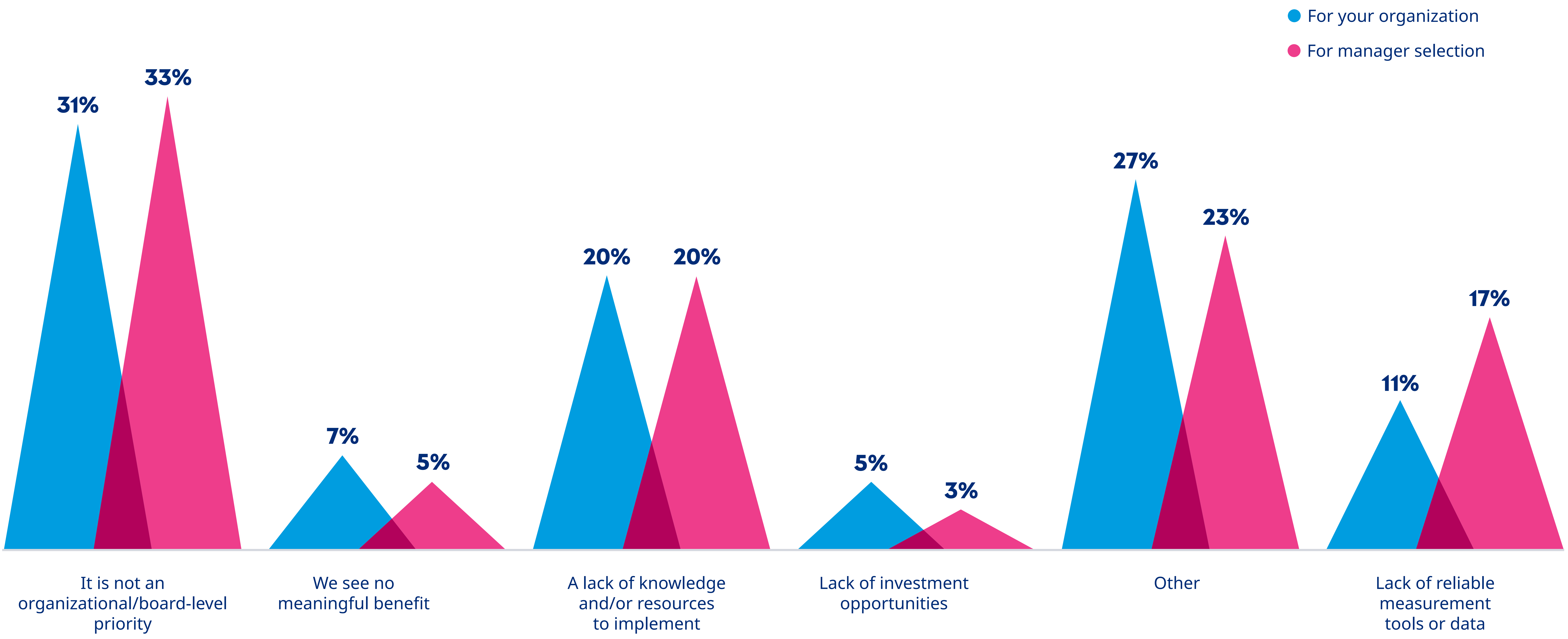
Have you set diversity, equity and inclusion (DEI) targets for your manager selection and your organization?



Roll over the buttons below to reveal chart data

- Global
- Asia
- Australia/New Zealand
- Canada
- United Kingdom/Europe
- United States

What is the primary reason your organization has not set DEI targets?



The evolution of sustainable investing

Given the nature and mission of many not for profits, it's perhaps unsurprising to see that relatively few respondents to our survey cite generating returns as one of their main reasons for considering ESG issues.

There has been a major evolution in how investors have approached ESG over the years. It started out with negative exclusions on a few ethical topics before moving on to ESG integration and recognition that ESG issues can affect risk and return. Integrating ESG, originally for financial reasons, is now largely a "hygiene" factor. Consequently, we see a trend toward investing in sustainability themes, such as low carbon and gender equality, for the return opportunities. But because we're now facing multiple, systemic environmental and social issues, the focus today is shifting toward how capital allocations can also have a positive impact. Taking this approach is beneficial for the reputations of not for profits because it's what their stakeholders increasingly expect.

Interestingly, when asked about where they intend to focus their investments over the coming year, survey respondents are fairly equally split among impact, climate and social themes. Until now, investors have tended to focus mainly on the "E" of ESG — in part, because companies saw it as the most pressing concern but also because it's simply easier to invest in and measure progress — but the social focus is definitely gaining momentum.

Only 14% of respondents have set a net-zero target for their portfolios, but it's encouraging to see that another 23% plan to do so over the next 12 months. Investors making net-zero commitments need to be able to back them up and demonstrate how they're being implemented. One of the biggest reasons we hear for not making a commitment is that the data just isn't there to be able to do so. The survey findings reinforce this — 50% of respondents say poor access to accurate data is likely to threaten their ability to achieve net zero.

We recognize that moving toward net zero isn't a straight line and data can be weak, particularly for asset classes such as private markets. However, the data shouldn't be an excuse. Given the urgency of the issue, much can still be achieved by allocating to managers that are investing in climate solutions and getting involved as active owners to urge companies to improve their transition practices. We don't recommend that investors simply sell their holdings with high emissions and say their portfolios are on the road to net zero as a result. That's just passing the buck and making no emissions difference in the real world.

Investments to help mitigate climate change remain paramount, but the reality is that investors will also need to turn their attention to adapting to climate change. In other words, they need to consider the physical effects of climate change on their holdings' operations and how real assets are prepared for extreme weather events. It will also be important to recognize the effects on people in that process. Active ownership and investment in adaptation solutions is likely to continue to be an area of increasing focus.

Although we did not cover it in this report, there's an increasing focus among the investment community on biodiversity. There's growing recognition that in addition to acting to support the climate, investors need to act to minimize pollution and preserve the world's oceans, forests and all kinds of other natural habitats. That's because biodiversity is crucial to the air we breathe, the food we eat and the water we drink, and if we lose biodiversity, we won't have a stable climate. This theme is one to watch.

Jillian Reid
Partner, Sustainable Investment

About this survey

This survey, conducted by Mercer, involved 133 not-for-profit (NFP) organizations in 20 countries. The aim of the exercise was to understand participants' investment sentiment, positioning, performance expectations and priorities over the medium and long term.

The survey also sought to identify what investment outcomes the industry values most and how much risk it is willing to take to achieve them. Views were gathered from a varied cross-section of NFPs, including both Mercer clients and non-clients. The range of organizational types that participated in the survey included private foundations or charities, community or public foundations, healthcare organizations, faith-based organizations, indigenous corporations, and educational organizations. Participants' investment assets ranged from US$100 million or less to US$1 billion or more.

The survey was completed online by respondents in the first quarter of 2022.

Survey parameters:

133	20	06
Participants	Countries	Regions*

Mercer sought to vary participants across the following categories:

- Organizational type
- Investment portfolio size
- Geography

* Regions: Asia, Australia/New Zealand, UK/Europe, South America, US.

Contact us

If you would like to discuss the findings within this report in more detail or how we may be able to support your not-for-profit organization, please feel free to contact your local not-for-profit representative. Alternatively, visit www.mercer.com/notforprofit or email us at mercerinvestmentsolutions@mercer.com.

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