

the great

acceleration

Themes and
opportunities 2021

Investor insights



Executive summary

2020 has been an *annus horribilis*. In response to the global COVID-19 pandemic, policymakers have struggled to balance the competing priorities of safeguarding public health, the economy and personal freedoms. We are observing various important developments, the speed and magnitude of which have influenced our title choice for this paper.

These developments include:

- Increasingly wide-ranging policy measures
- Escalating dispersion within and between markets and economies
- Virtualization trending toward the mainstream
- A rapid rise in long-term planning for the environment, society and the corporate world

Many of these trends were with us before 2020, part of a pre-existing (and dizzying) acceleration that was contributing to “future shock.” They now represent an acceleration within an acceleration.



We’re in a **new world**, and it’s impacting policies globally. As the effectiveness of both stimulus and scientific measures is called into question, possible outcomes for markets have widened significantly. We see reasons for concern at the prospect for higher inflation over the medium term as policy distorts the economy and recommend investors consider buying unexpected inflation protection before it gets expensive. Historical returns and correlations become less-reliable indicators of the future in an artificial market environment, so we encourage investors to take a holistic, qualitative, scenario-based approach to risk. In a world of vying powers, where blocs solidify to replace the old norms of globalization, investors should consider targeted regional and specialist

mandates to supplement broader global mandates. To combat inflated asset markets and high dispersion, investors should consider opportunistic strategies, such as hedge funds and currency strategies.



We are in a period of **business as unusual**. As the likelihood of collateral impairment spooks the credit markets, we enter a period of markets as unusual, which promises opportunities in both public and private credit (for example, in fallen angels). We are now more accustomed to work as unusual, and so investors must reassess their real assets exposure. Investors have many options as we enter an age of engagement — review their investment managers’ diversity, review modern slavery exposures in their portfolios, and invest in strategies with high environmental, social and governance (ESG) ratings.



Investors looking to mitigate risk should **position for transition** by developing a total portfolio climate-transition plan, which reviews their portfolio holistically to assess its ability to weather the move to a sustainable future. They can then develop a path to a more robust alternative portfolio, one that manages the “gray” transition risks, targets more “green” investments and stewards the “in between.” Though the United Nations Sustainable Development Goals¹ (SDGs) have a broader purpose than informing investment decisions, they are a good framework for health-checking investments in the decade of delivery. We suggest investors consider SDG-aware investing, with a particular focus on SDG 7² as developments aimed at reducing the cost of production and storage of renewable energy accelerate, fueling the energy transition. We are seeing investor flows accelerating into sustainable funds (money talks, markets listen), marking a turning point in overall investor sentiment toward sustainability.

¹ United Nations. *Sustainable Development Goals*, 2015, available at www.un.org/sustainabledevelopment/sustainable-development-goals.

² SDG Compass. “SDG7: Ensure access to affordable, reliable, sustainable and modern energy for all,” 2015, available at www.sdgcompass.org/sdgs/sdg-7.

The great acceleration

The “great acceleration” started in the mid-20th century and continues now. Nonstop social and technological change has increased at a rate as exciting as it is bewildering. New gadgets and social norms invigorate and emancipate, but also contribute to cultural insecurity and intergenerational alienation. Out of this process come brave new existences and culture wars.

What we are now seeing is an acceleration within that acceleration. The COVID-19 pandemic triggered a period in which a precautionary lifestyle has been adopted, and as a result, there have been step changes in pre-existing socioeconomic trends. Many shifts, such as homeworking and the online entertainment boom, will recede somewhat as the public health threat diminishes, but many behavior changes are now embedded. Sustainability, for example, is here to stay. The pace of change is such that it pays to be aware of the possible future, and invest accordingly.

We have grouped these trends into three overarching themes that will affect investment decisions in 2021 and beyond: the new world, business as unusual and position for transition.

Themes and opportunities 2021 — The themes

The new world

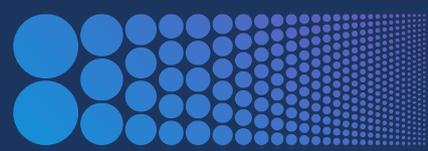
3



Policy distortions
The vying powers

4
6

Business as unusual



Markets as unusual
The age of engagement
Workplace as unusual

8

9
11
12

Position for transition

13



Money talks, markets listen
The energy transition
SDG-aware investing

14
16
16

The new world

The “new world” refers to ways in which our monetary and fiscal institutions are moving from the drawing board to full-scale trials of new techniques for ensuring economic stability and continuity; also to the way in which global allegiances and working relationships are being recast.



Policy is distorting the economy

Policy is currently warping the fabric of the economy as authorities experiment with monetary and fiscal stimulus in response to the COVID-19 crisis (see Figure 1). Interest rates have gone from “lower for longer” to “lower for very long.” This has come with a price for the privilege of holding government assets, which have changed from a risk-free return to return-free risk — though we acknowledge they may be held for regulatory reasons and by those worried about short-term deflation. In these strange, interventionist times, the “invisible hand” has been effectively furloughed as the cost of capital and therefore the value of risk assets are now largely policy-driven. A huge, unanswered question is what asset returns look like when the economy becomes so artificial.

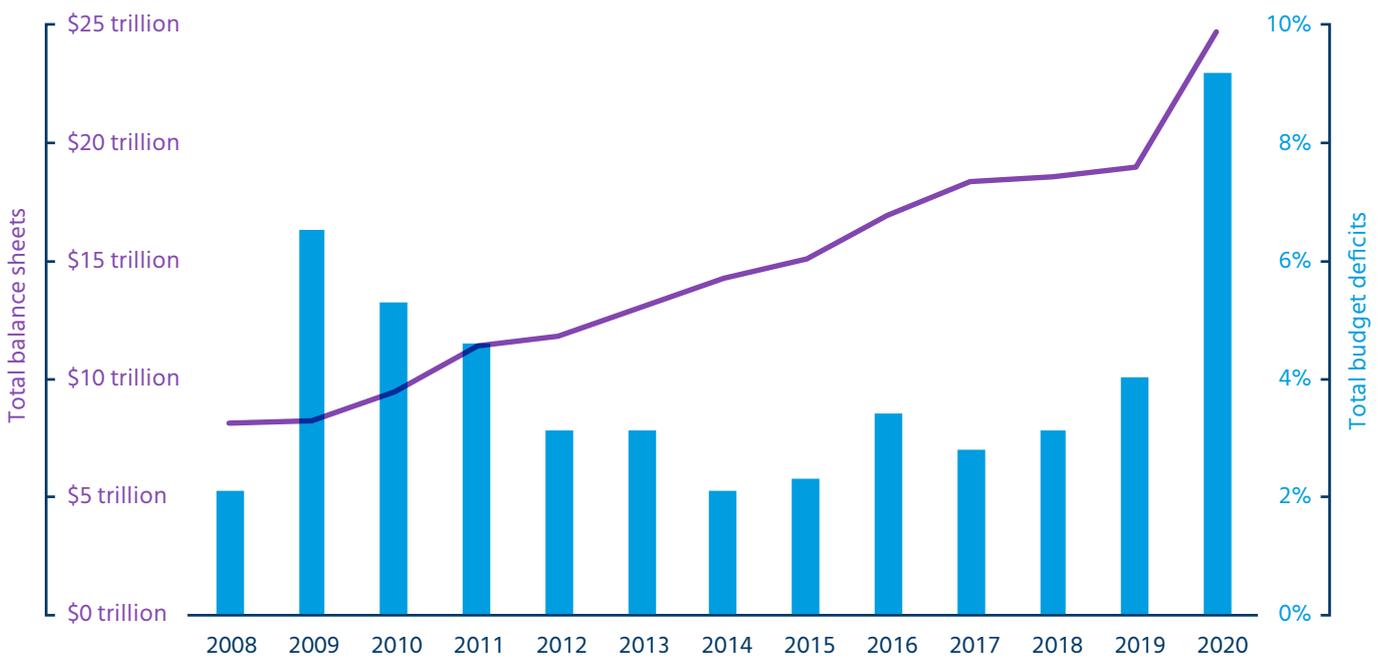


Our global economy's tattoo cannot easily be removed for years to come.



Bill Gross — investor, investment manager and philanthropist, known as the “Bond King,” September 2020

Figure 1. Unprecedented policy stimulus



Source: Bloomberg for central bank balances sheets. Haver Analytics, CEIC, Morgan Stanley Research forecasts for budget deficits. Total balance sheet figures represent data from the European Central Bank, the Bank of Japan and the People’s Bank of China. Total budget deficit figures represent the China, Eurozone, Japan and US government-headline budget deficits.

In these unnatural markets, where government and central banks act together, and the most influential participants in government debt markets are the borrowers themselves, what role do government bonds play? Government bonds now offer scant returns to maturity and as shock absorbers they appear significantly dilapidated (unless you believe yields can go significantly negative or a secular-deflation environment is worth hedging against). Governments benefit from the fact that many investors are forced participants, particularly those with liability-hedging requirements.

Emerging markets are now using the same chemistry set as their competitors in developed markets, but to a lesser degree. In these countries, bond-purchasing programs and deficit expansions increase risk.

For the time being, the dampening of consumption associated with large-scale unemployment, increased savings rates, high aggregate supply and the increasing impact of technology should keep inflation low (though the impairment of just-in-time supply chains is providing a short- to medium-term inflationary pressure). In our view, the various forces at play may lead to short-term disinflation, but we present a risk case for inflation over the medium term.

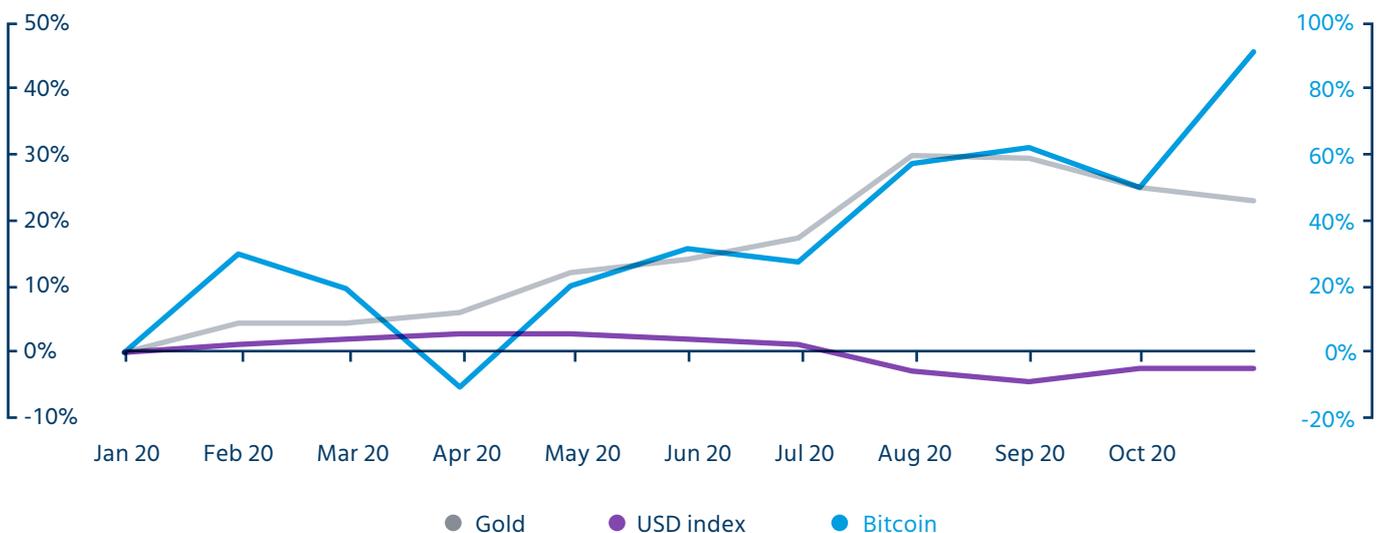
Inflation may be hard to avoid, and policymakers will likely welcome it because inflation is perceived as the easiest way for the economy to erode its debt burden. Central banks have already signaled that looser inflation targeting is acceptable.³

Many portfolios could be more resilient if their inflation protection went from none to some, and we suggest investors consider buying unexpected inflation protection before it gets too expensive. Investors who have the governance and implementation capacity to use derivatives could consider investing in a break-even inflation strategy that gives more direct exposure to changes in inflation expectations.

Monetary debasement can occur without inflation — roughly speaking, you can print more money, but if people spend less of it or goods and services become cheaper, you won't see inflation. However, even in this case, assets like gold and Bitcoin (competitive stores of value in a crisis) could increase in price because their supply inflates more slowly than the supply of government-backed currencies. Both assets were well supported for some time after the start of the last monetary crisis, with gold peaking in 2011 and Bitcoin gaining exponentially until 2018.

Some humility is also important as we enter terra incognita. Resilience matters — in the new world described here, reliance on traditional modeling and historical asset movements might be misplaced, and it is more important than ever to consider risk cases as well as the base case. Portfolio diversification remains as important as ever, and investors should take a holistic, qualitative, scenario-based approach to risk.

Figure 2. Debasement — gold, bitcoin price change and USD index



Source: Thomson Reuters Datastream, CoinMarketCap, Bloomberg

³ Note: This is no longer necessarily as effective because the duration of debt is much higher now than during the post-war era, the last time debt was inflated away. In addition, many government liabilities are inflation-linked — not only inflation-linked bonds but off-balance-sheet liabilities such as social security pensions.

The vying powers

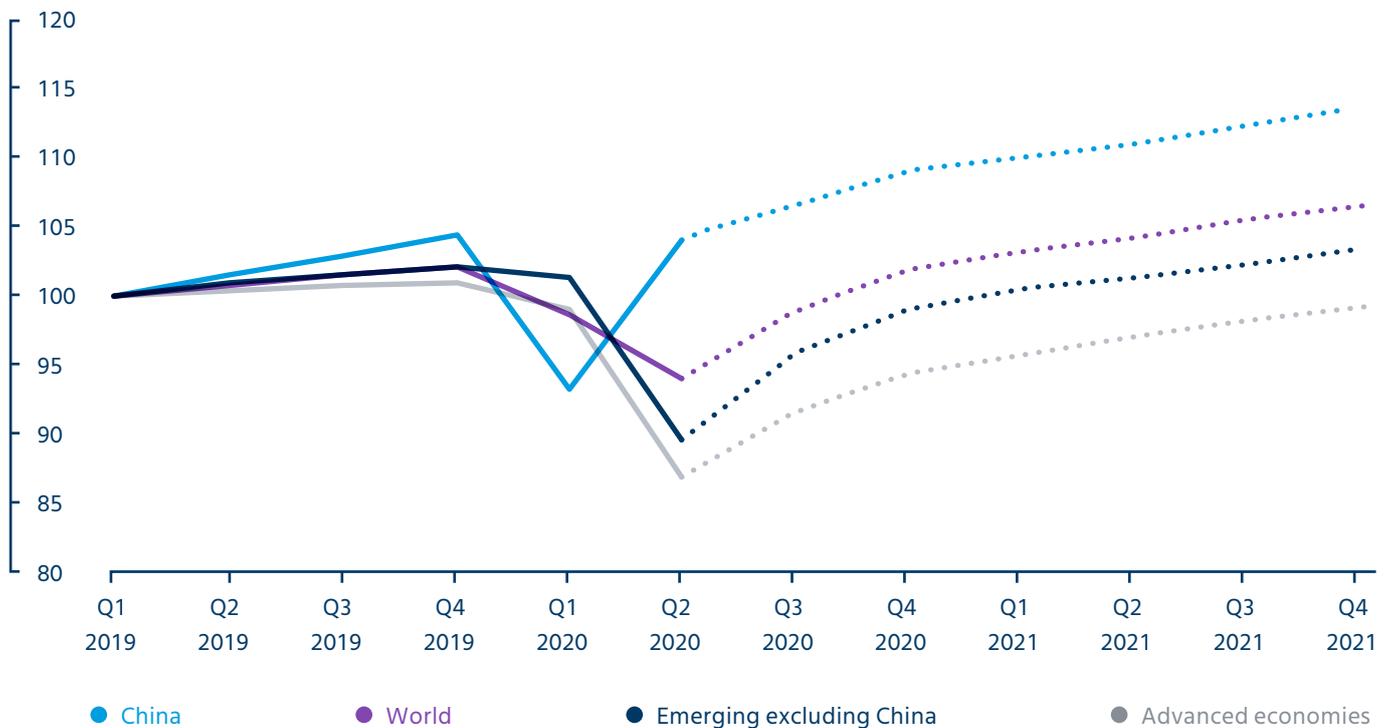
In an era when the world has split into vast power blocs and globalization is stalling, investors must consider regional exposures. “Chimerica” is likely to disband into China and America again as the blame game plays out, with resentment on both sides over trade, spheres of influence and the origins of COVID-19. China has proved relatively resilient, as evidenced by forecast positive GDP growth for 2020.

The ongoing charm offensive, as the two superpowers race to extend their economic, cultural and geopolitical spheres of influence, is drawing dividing lines across the world. As co-operation disappears in the virtual world, a two-track system is developing, particularly in technology. The situation is exacerbated by the US taking potshots at Huawei, WeChat and TikTok, and by intellectual-capital appropriation by China. Investors should consider the ramifications of this trend and diversify appropriately.

While the US and China battle for supremacy, Europe remains an economic region to be reckoned with, despite internal divisions. This bloc is both a leader and a laggard — it is behind on tech (with some exceptions, such as Spotify), but leading in sustainability and regulation (notably data protection). This year, the European Union (EU) had its so-called Hamiltonian moment⁴ — the recovery fund of 750 billion euros is less remarkable for its size than for the fact that it was issued by the European Commission itself, and agreed in only five days.

The UK has only just started to forge new trading relationships in its own right. This is easier said than done, and bumps along the road are expected. Initially, distinguishing the effects of Brexit from the larger shock of COVID-19 will be difficult. Brexit is a process rather than an event and entails both opportunities and risks. Politically, the EU should enjoy medium-term stability as the wait-and-see begins for the Brexit experiment.

Figure 3. GDP forecasts to end of 2021



Source: International Monetary Fund estimates; GDP rebased at 100 for Q1 2019; dotted lines represent forecasts

⁴ A reference to the moment in the 18th century when the US consolidated state debt into federal debt.



We think investors should consider the merits of targeted regional and specialist mandates to supplement these broader global mandates.



In an uncertain environment, globally aware mandates remain a cornerstone of a diversified portfolio; however, we think investors should consider the merits of targeted regional and specialist mandates to supplement these broader global mandates.

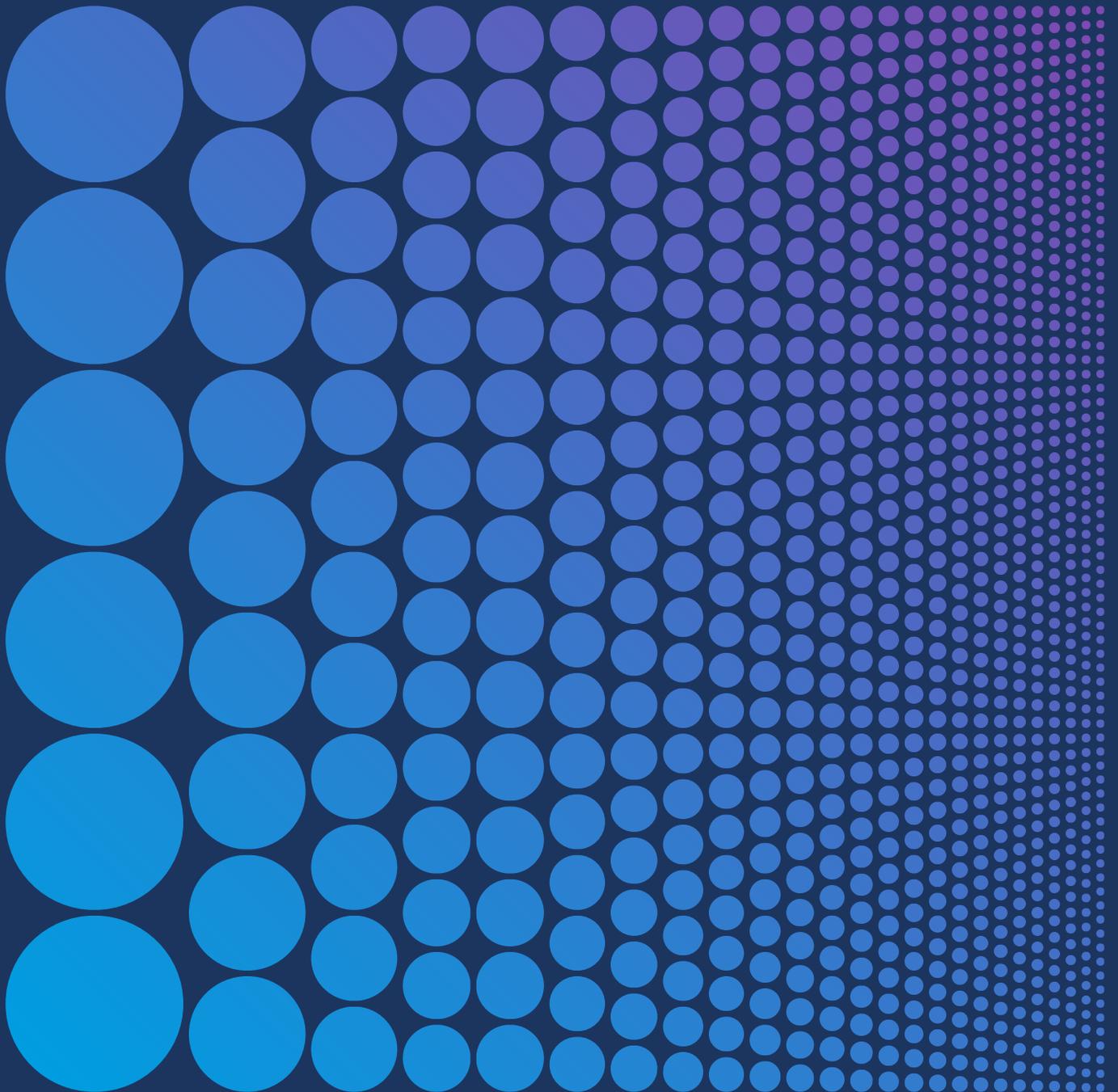
Although investors gain some underlying exposure to China's growth via developed market equities and other non-China assets, China's large and liquid domestic capital markets offer unparalleled access to a much wider spectrum of growth drivers. Against a backdrop of economic, geopolitical and technological regionalization, Chinese assets provide vital portfolio diversification and unique economic participation in the evolving new world. The high proportion of temperamental retail money in China's domestic market amplifies opportunities for professional investors to generate alpha. Some of the same features that make the market attractive also introduce risk, with the speculative and short-sighted behavior of many investors elevating volatility.

As globalization falters and economists speculate on how individual countries will do under the LUV framework,⁵ dispersion undoubtedly increases, and opportunistic strategies, such as hedge funds and currency strategies, may benefit. Dispersion is clearly not limited to differences in outcomes between countries. In "Business as unusual," we explore dispersion further.

⁵ L, U or V-shaped recovery: That is, none, long or quick.

Business as unusual

“**Business as unusual**” refers to more granular trends within financial and commercial marketplaces, and within social movements, where the way of the world has changed forever.



Markets as unusual

Dispersion in markets and between sub-asset classes is currently wide. The earnings gap between stock market winners and losers has widened sharply over the past five years, particularly in relation to technology. Five stocks have carried the entire US market in 2020, and, astonishingly, these technology/technology-enabled firms account for just under a quarter of US market capitalization.⁶ The dispersion in cumulative return over the past 10 years between technology and energy (the worst-performing sector) is 479%.⁷ Tech companies and their expertise were an invaluable part of the COVID-19 response, enabling remote working and online shopping from the safety of home. These stocks are, however, priced somewhere between “fair weather” and “perfection,” and though they offer great potential for further growth, they come with substantial risk.

Within fixed income, an uncertain outlook calls for a more flexible approach. Accommodative fiscal and monetary policies have driven a strong recovery in spreads post-March, but the possibility of a renewed spike in COVID-19 cases is clouding the outlook. Magnifying this uncertainty is the potential weakening of policymaker appetite for further accommodative measures, as could be the case in the US with a new, divided government.

Facing this uncertain environment is a more structurally fragile market. For example:

- The concentration of BBB-rated bonds in investment grade corporate indexes has risen from one-third in 2007 to almost half today (see Figure 4). Additionally, the market value of BBB-rated bonds is now 2.5 times the market value of the high-yield market (see Figure 5), meaning any significant downgrade wave would be difficult for smaller, high-yield investors to absorb.
- The leveraged-loan market is twice the size it was in 2008 and the vast majority is now covenant-lite.⁸



Everything depends on how long it lasts, but if this goes on for a long time, it's certainly going to be the mother of all financial crises.



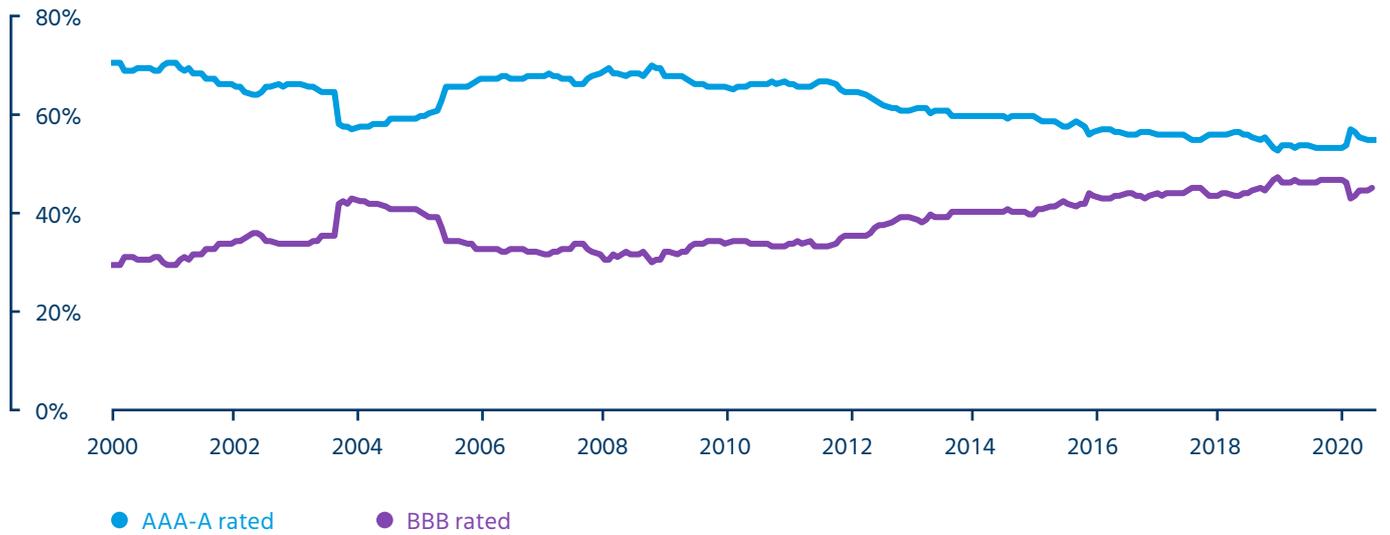
Kenneth S. Rogoff, Thomas D. Cabot Professor of Public Policy and Professor of Economics, Harvard University, April 2020.

⁶ Thomson Reuters Datastream data to September 30, 2020: Total weight of Apple, Microsoft, Amazon, Facebook and Alphabet in the S&P 500 was 22.6%.

⁷ Thomson Reuters Datastream: Differences between the total returns of the FTSE AW Developed: Industry: Technology and FTSE AW Developed: Industry: Oil & Gas indexes for 10 years to September 30, 2020 in USD.

⁸ Source: Reuters, *Leveraged loan market size doubles in 10 years, private credit explodes*, December 23, 2019.

Figure 4. Market value of US corporate debt by rating



Source: Thomson Reuters Datastream

Figure 5. Multiple of BBB vs high-yield bonds outstanding (US market)



Source: Thomson Reuters Datastream



Investors who struggled to capitalize on dislocations in Q1 2020 should “speed test” their governance process in readiness for the next speed bump.

While a renewed, severe stress in these markets is not our base case, easy spread gains may well be behind us. Dynamic, active strategies such as absolute return, unconstrained, and multi-asset credit are well positioned to navigate around potential pitfalls and seize market opportunities, such as fallen angels. We also expect opportunities to develop within the private debt space.

The main issue here is the “blink and it’s gone” problem. Policy intervention has meant assets have not stayed cheap for long, and investors need to be quick to make gains. If this practice continues, waiting for the next board meeting before signing off on opportunistic investments is unlikely to be the optimal strategy. Investors who struggled to capitalize on dislocations in Q1 2020 should “speed test” their governance process in readiness for the next speed bump. Often when markets trend sharply down, the recovery point is lower than at the beginning. If it had not been for technology-related stocks, the global equity market as a whole would not have been as resilient.

Rebalancing programs could be useful in this market environment. In flat but oscillating markets, rebalancing is beneficial from a returns perspective alone; for the long term, it helps to maintain a desired risk exposure.

Investors can make gains through dynamic, responsive governance processes or delegation to nimble strategies, or both. Going private deserves consideration — due to their concentrated ownership structure and dedicated capital, private market investment managers are well placed to respond quickly to opportunities and challenges.



The age of engagement

A growing number of investors care more than ever about where their money is invested and that the companies they invest with are working toward a sustainable future. 2019 saw strong flows into sustainable funds, and those flows have accelerated in 2020, starkly contrasted by net outflows in the rest of the fund market. In our view, investing in strategies with high ESG ratings is the broadest way to improve portfolio sustainability; however, engaged investors can choose from lots of other actions.

Investors are recognizing the “power of control”: investing where asset owners have a say is more and more important in an era of transition, and one in which investors are increasingly seeking to make an impact. Private market strategies in particular offer that “control.”

Firms still need much encouragement to embrace diversity and inclusion practices that encourage staff retention and enhance decision-making. This is particularly true of the investment industry, where woman-led strategies are still rare and only around 12% of key decision-maker roles are filled by women.⁹ Investing with managers and into businesses with diverse ownership represents an opportunity, especially because businesses with diverse boards have a higher tendency toward outperformance.¹⁰

Wealth and income inequality have also come to the fore during 2020 as, in aggregate, workers on low incomes experienced the largest falls in income (even if mitigated by fiscal support) and those on high incomes remained relatively unaffected. It’s possible that economic inequality may depress aggregate demand, reduce growth and cause political unrest.

An extreme form of inequality is represented by modern slavery, which can take many forms and can go undetected in complex global outsourcing structures. Investors should assess their exposure to modern slavery, and many are increasingly required to do so by regulation.

As investor engagement rises, technology firms face increasing scrutiny over their ESG risk. Some technology firms now use dual share classes, which reduces accountability to common shareholders. Their use of personal data and creative tax avoidance are brewing large legal, political and business risks, while some firms face persistent bad press over their labor conditions and employee relations. The perception is that large technology firms are reactive rather than proactive on these issues, essentially responding to headlines. The issues are now too big to ignore. Tech-market dominance increases regulatory risk and could lead to the disruption of profitable business models if hit with an antitrust hammer.

⁹ MercerInsight™.

¹⁰ Hunt V, Prince S, Dixon-Fyle S, Yee L. “Delivering through diversity,” McKinsey, 2018, available at www.mckinsey.com/~media/mckinsey/business%20functions/organization/our%20insights/delivering%20through%20diversity/delivering-through-diversity_full-report.ashx.



Work as unusual

The flight to sanctuary during the pandemic has caused queasiness in the approximately \$27.5 trillion global commercial property market.¹¹ Many companies have realized the cost savings to be made by having employees work from home. Prime, adaptive and green property should continue to perform, as well as properties where contagion is less of an issue (for example, data centers and storage facilities). For some malls and hotels, COVID-19 could be the last straw, as a customer drought continues indefinitely. Although the ability to maintain a lease is important, some firms are also eyeing up lease end-dates or break clauses and reducing their real estate footprint. The losses from unrenewed leases will be gradual, as a maturity ladder of leases ends. As physical location becomes less relevant, we could see a new phenomenon of white-collar “rustbelts” in downtown city areas. Companies also know that working from home indefinitely could affect collaboration, creativity and team-building – humans are social animals after all, people need people. We will likely see some elasticity to the changes in real estate usage during the COVID-19 crisis, but we do not predict a snap back to the pre-pandemic position.

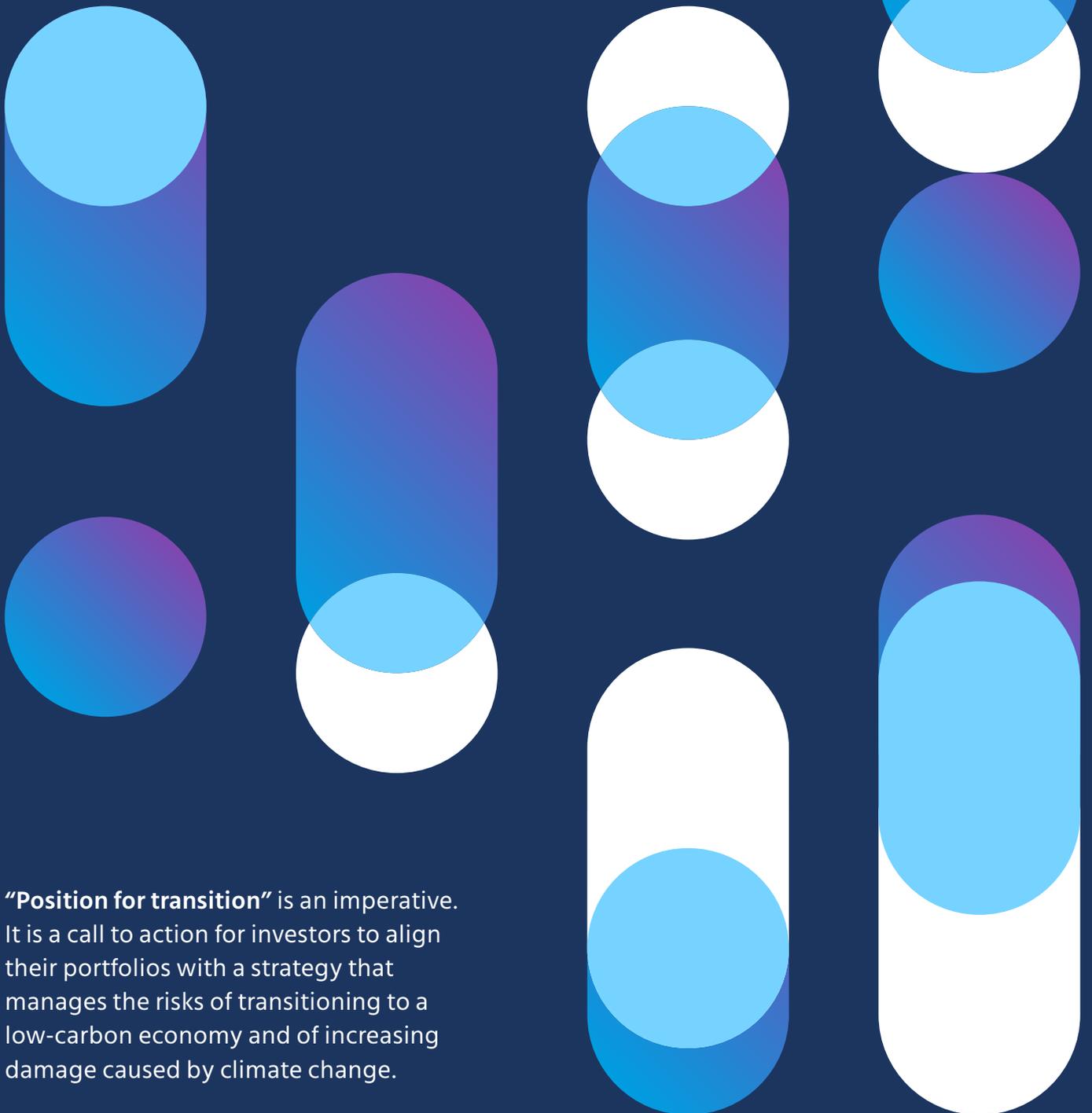
In the current environment, we expect structural trends and sectoral discrepancies resulting from the pandemic to drive future performance in real estate. We believe that investors need to reassess their real assets exposure. The addition of well-diversified, selective, value-driven strategies can potentially enhance the quality of portfolios. Value-add real estate may include specialist funds and niche property sectors; for example, self-storage, senior housing and elder care, medical office, lab space, and data centers. Investors can also examine opportunistic investments, which may involve exposure to development or redevelopment activities, complex distressed situations, a higher level of exposure to operating risks (for example, the hospitality segment), operational complexities or emerging market risks.¹²

Many companies must now “virtualize” or die, and do so in a way that manages the increased cyber-risk that comes with it. For example, home Wi-Fi protocols are generally easier to breach or untrained workers may transfer materials to more vulnerable personal devices, so cyber protection becomes increasingly important.

¹¹ CBRE. “London is world’s most liquid real estate market,” October 19, 2017, available at www.news.cbre.co.uk/london-is-worlds-most-liquid-real-estate-market.

¹² Mercer. “International non-core real estate,” October 28, 2020, available at www.mercer.com/our-thinking/wealth/international-non-core-real-estate.html.

Position for transition



“Position for transition” is an imperative. It is a call to action for investors to align their portfolios with a strategy that manages the risks of transitioning to a low-carbon economy and of increasing damage caused by climate change.



The pandemic represents a rare but narrow window of opportunity to reflect, reimagine and reset our world.



Klaus Schwab, Founder and Executive Chairman, World Economic Forum, June 2020.

Money talks, markets listen

The move toward a sustainable future experienced a shot in the arm in 2020 as investor money poured into the sustainable fund industry. Further proof that 2020 has had some good moments was the unexpected September announcement from President Xi that China is aiming for carbon neutrality by 2060.¹³

Figure 6. Sustainable fund flows accelerating



Source: Morningstar. European fund flows converted from EUR to USD using prevailing quarter-end exchange rates sourced from Thomson Reuters Datastream

¹³ McGrath M. "Climate change: China aims for "carbon neutrality by 2060," BBC News, September 22, 2020, available at www.bbc.com/news/science-environment-54256826.



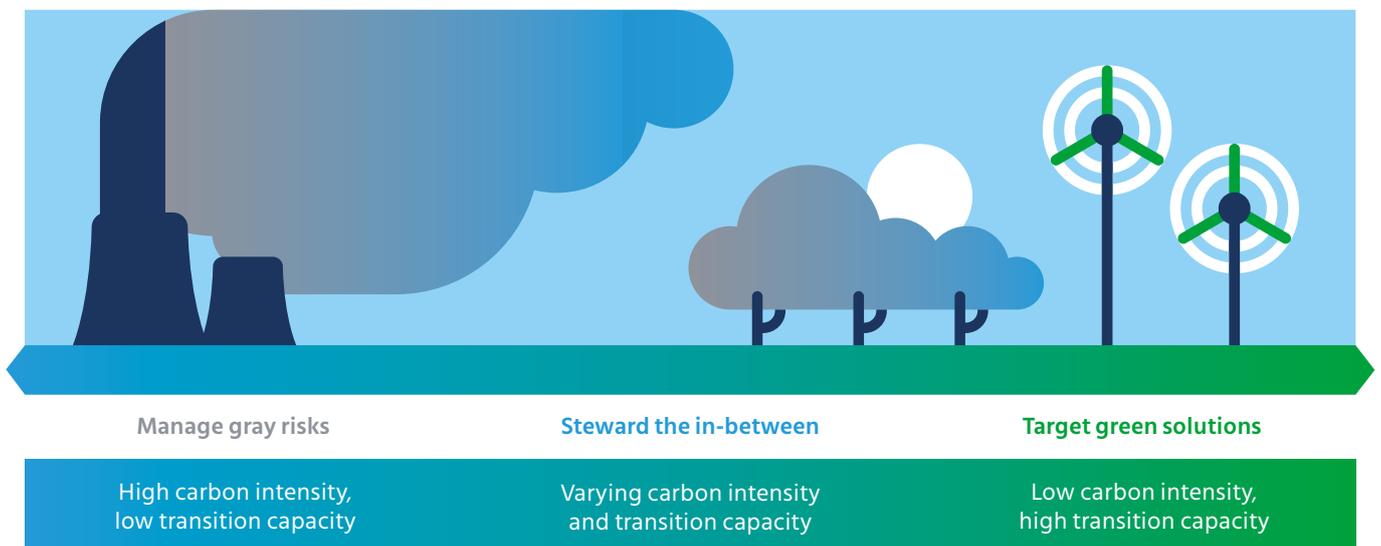
Alleviating climate change means we need to reach “net-zero” emissions. According to the Intergovernmental Panel on Climate Change (IPCC), greenhouse emissions need to reduce by 45% (from 2010 levels) by 2030 and to net-zero by 2050 to have a 50% chance of limiting temperature increases to +1.5°C above pre-industrial averages by 2100.¹⁴ Investors face a broad range of climate-related portfolio risks over this period — for example, regulatory, transition, physical and reputational risks — so they will need a total climate-transition plan.

Asset-owner commitment to climate transition is building: the UN Race to Zero Campaign of net-zero initiatives accounts for 995 businesses, 38 investors and 5,050 universities, covering approximately 25% of global CO₂ emissions and greater than 50% of global gross domestic product.¹⁵

Climate change is a global, multi-industry problem and, as such, requires a total portfolio response. Investors should assess their exposures to the “gray,” the “green,” and the “in between.” Gray assets have high emissions and high-transition risk; green assets have low/zero emissions and low-transition risk, and in between is just that.

Markets are starting to recognize climate risks in pricing. Investors should not be caught off guard by carbon-heavy portfolios being affected by market, technological or regulatory changes. This means investors should not wait any longer to act, and should exercise DARP — decarbonization at the right price. Like any major trend, climate transition will not travel in a straight line, and nor will price recognition — investors should build flexibility into their strategic climate-transition plans.

Figure 7. Mercer’s transition-risk ranking spectrum



¹⁴ IPCC. “Summary for policymakers of IPCC special report on global warming of 1.5°C approved by governments,” October 8, 2018, www.ipcc.ch/2018/10/08/summary-for-policymakers-of-ipcc-special-report-on-global-warming-of-1-5c-approved-by-governments.

¹⁵ United Nations Framework Convention on Climate Change. “Race to Zero Campaign,” available at <https://unfccc.int/climate-action/race-to-zero-campaign>.



The energy transition is well underway

The costs of solar and wind power have fallen far quicker than expected, such that, in many regions, new solar is now competitive with existing coal power generation (on an operating costs basis). As the transition continues, investors should watch for tipping points:

- Intermittency remains an issue with wind and solar
- Energy blackouts undermine support for the energy transition
- Widespread energy storage capacity could usher in a new age of power generation, and costs are already falling in this area

A “great electrification” is needed — energy transition requires a wholesale shift in power usage, not just power generation. The move from internal combustion engines to electric vehicles is just one part of a much broader transition needed across industry.

SDG-aware investing

As investors embrace sustainability and investigate ways to make an impact, they inevitably look for a framework through which to approach it. The United Nations’ 17 Sustainable Development Goals (SDGs) are a good guide. The SDGs address an audience beyond the investment community, including policymakers and the public, and focus on global society’s concerns; for example, justice and alleviation of poverty. We consider them a good framework to overlay investor portfolios. If a portfolio does not meet the needs of the world over the long term, it likely has significant pockets of risk, ranging from shareholder activism to obsolescence. If an investor can categorize portfolio investments as meeting various sub-goals within the framework, their portfolio becomes more future-proofed. We therefore suggest investors consider SDG-aware investing.

Investing to align with the SDGs is best done with a broad range of solutions. The following are examples of opportunities Mercer targets through sustainability-linked strategies, both public and private, but these can also be targeted individually.

- Renewable energy — SDG 7 (affordable and clean energy)
- Recyclers — SDG 12 (responsible consumption and production)
- Real estate — SDG 11 (sustainable cities and communities)
- Waste and water management — SDG 6 (clean water and sanitation)
- Climate-transition indexes¹⁶ — SDG 13 (climate action)
- Sustainable natural resources (timber/agriculture) — SDG 15 (life on land)

¹⁶ Mercer. “Moving to 3G: The third generation of climate indexes,” October 19, 2020, available at www.mercer.com/our-thinking/wealth/moving-to-3G.html.

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Please see the following link for information on indexes: <http://www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2020-investment-management-index-definitions-mercer.pdf>.

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