MERCER

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RESEARCH PERSPECTIVES

FOREWORD

Robert Howie

Matt Reckamp

Welcome back to another issue of *Research Perspectives*, our second this year. This edition is packed with a particularly diverse set of articles, some with implications that stretch across Mercer's global research boutiques and some that are more asset class specific. We think we've included something for everyone.

We open with the first installment of a two-part paper on boutique investment firms and niche investment strategies (across multiple asset classes). Between this issue and the next, we will define the two terms and identify the relevant risks and considerations. The second article is specific to public equities and focuses on understanding and incorporating factor-based return drivers in a portfolio. The next two pieces are new additions to *Research Perspectives*. We call them "postcards" because they provide a succinct look into something very specific to the firm or its colleagues.

We've also included a piece making a case for hedge funds and another outlining the potential of residential real estate as a suitable investment. Another article provides a nice framework for understanding the nuances of the multi-asset strategy space. We close with a Q&A with Jane Ambachtsheer on the evolution and increasing importance of responsible investment.

As always, we hope that you will find *Research Perspectives* informative and timely. Please contact us if you have any questions or comments.

Robert Howie
Matt Reckamp

Robert is a principal located in London. He leads the manager research and generation of intellectual capital for alternative assets in Europe, focusing on hedge funds, insurance-linked securities, and multi-asset and other liquid alternative strategies. Additionally, he advises institutional investors on the use of alternative assets, including manager selections and portfolio construction.

Matt is a principal located in St. Louis, Missouri. He conducts research on private equity funds and private equity funds of funds as part of the Alternatives Boutique. Previously, he conducted research on US equity strategies for the Equity Boutique. Matt remains involved with client work with particular emphasis on US foundation and endowment clients.

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Matt Reckamp
(St. Louis)

BOUTIQUE FIRMS AND NICHE STRATEGIES

Mercer, with its 100+ manager researchers specializing by geography and asset class, has the opportunity and the breadth of access to identify interesting investment opportunities. We refer to many of them as niche strategies or boutique managers. But what do we mean by these terms and do they mean the same thing? We believe not. Moreover, are there unique considerations for investing in niche strategies or with boutique managers? We believe so.

Because of this topic's scope and importance, we plan to discuss it in two installments:

1. DEFINITIONS AND DELINEATIONS — This installment sets the stage by defining what we mean by boutique firms and niche strategies, which are often used interchangeably, and recognizing that there are many nuances to both, especially across asset classes.
2. RISKS, CONSIDERATIONS, AND EXAMPLES — The next installment will highlight the key issues to consider, including potential risks and rewards, when rating these investment options and/or placing money with them. We will also include an assortment of specific, albeit anonymous, examples of highly rated boutique firms/niche strategies across major asset classes.

DEFINITIONS AND DELINEATIONS

Boutique Firms and Niche Strategies

Merriam-Webster defines *boutique* as (1) a small fashionable shop, or (2) a small company that offers highly specialized services or products. Likewise, *niche* is defined (among other things) as (1) a place, employment, status, or activity for which a person or thing is best fitted, or (2) a specialized market. While these two terms are clearly not synonymous, they share certain commonalities, with the key words being *small* and *specialized*. Consequently, boutique and niche are often used interchangeably in an investment context. Moreover, because the terms investment manager and investment strategy are also used as substitutes, it is not difficult to see how the distinctions between a boutique firm and a niche strategy could become blurred. So let's provide some clarification.

continued

BOUTIQUE FIRMS

In our view, a boutique investment firm can best be characterized along the dimensions of size, time, focus, and ownership/culture. While there are no universal thresholds, boutique investment firms are smaller, have been in business for a shorter time, are typically focused on a singular investment approach, and are generally employee-owned. The term "emerging manager" is sometimes substituted as an alternative descriptor, but it mostly deals with dimensions of size and time. By smaller, we generally mean having lower levels of firmwide assets under management (AUM) or number of employees, compared to peers. For argument sake, let's say that materially less than $5 billion in firmwide AUM and/or less than 50 employees, is a good starting point for identifying a boutique firm. Firms that have been in business for less than five years or have a particularly entrepreneurial culture can also generally be considered boutiques.

Having a focused menu of investment strategies is a more subjective measure of "boutique-ness." For example, does an investment firm that offers three US equity strategies (such as small cap value, smid cap value, and mid cap value) managed by the same team using the same approach equate to one strategy or three? We would tend to think of these three strategies as having only one approach and believe that this is the appropriate level of demarcation. Alternatively, the lines of distinction can be drawn at the asset class level (that is, equities, fixed income, hedge strategies, etc.) or sub-asset class level (that is, US equities, non-US equities, emerging market equities), but these could inadvertently capture some firms that are more diversified than they appear on the surface.

Another interesting consideration is whether an affiliate of an aggregator holding company, whose business is building out a collection of subsidiary firms, is truly a boutique. We tend to consider these affiliates as boutiques, where applicable, despite being part of a larger organization, because they generally retain autonomy in terms of all investment and most business management matters.

A third, somewhat pragmatic way to identify a boutique firm is from the client perspective. If a client is not familiar with a given investment firm, depending on the collective industry knowledge of the client's agents, that firm could be considered a boutique. Those that have name recognition usually advertise, share a common name with a large banking organization, or are so entrenched that most institutional investors have some historical familiarity with them. However, we believe this definition of boutique is too broad and not particularly effective in truly identifying them.

Another reasonable way to identify a boutique firm is based on the notions of firm ownership and interest alignment. Boutique firms tend to be owned by the individuals most responsible for the management of the firm and its investment strategies. In fact, a partnership with broad employee ownership, compensation based on longer term performance results (with a deferred component), and significant personal co-investment in the firm's limited number of investment strategies seems to describe the preferred boutique alignment culture. Conversely, being owned by a financially strong parent company that provides an assortment of services (distribution, compliance, technology, etc.) in addition to managing the business, thereby limiting the distractions for investment professionals, as well as

> "While there are no universal thresholds, boutique investment firms are smaller, have been in business for a shorter time, are typically focused on a singular investment approach, and are generally employee-owned."

continued

having the financial resources to attract and retain high-caliber talent may represent the ideal structure for a non-boutique firm. Clearly, a case can be made that both types of organizations have positive elements.

Finally, because a boutique firm can be reasonably defined along different parameters, we would argue that it need not meet each of the criteria to be considered a boutique. For example, a firm that meets the ownership and interest alignment and focused investment approach criteria could be considered a boutique even if it has attracted a sizable level of assets. This would simply be a larger boutique.

NICHE STRATEGIES

So what makes an investment strategy specialized enough to be considered a niche strategy? The answer to this question is multidimensional. From a very broad perspective, a strategy may be considered niche if it only appeals to a very limited or specific audience. Liability-Driven Investing (LDI) or tax-free municipal bonds, for example, are most appropriate for very specific client types. Alternatively, a niche strategy may be one whose opportunity set cannot accommodate unlimited investment (such as micro-cap equities) or one where the opportunity is fleeting. The Public-Private Investment Program (PPIP), the US government's program to facilitate the investment in "toxic" real estate related assets on bank balance sheets after the financial crisis of 2008, is a good example. Strategies that are focused on one of many narrowly defined market segments may be most prevalent in the fixed income space, could also be considered niche. These might include nuanced strategies such as emerging Asia bonds, Treasury Inflation Protected Securities (TIPS), or ultra-long duration bonds. In each of these instances, almost any investment portfolios belonging to one of these specialized universes could be reflective of a niche strategy.

However, more mainstream universes (such as public equities) can also be fertile hunting grounds for niche strategies, based on a variety of metrics. Some of the most fundamental metrics allow for niche strategies to be found at either extreme — for example, particularly high or low beta strategies, highly concentrated or highly diversified portfolios, or those with extremely low or high levels of portfolio turnover. Moreover, some niche equity strategies only allow investments in a particular country, economic sector, or industry group. Some consider strategies driven by a quantitative investment process, socially responsible principles, or technical indicators to be niche strategies. Conversely, active extension strategies (that is, 130/30), those enhanced by option writing, or the use of convertibles or preferred securities may also be considered niche strategies. Needless to say, because of the multitude of ways to define them, niche strategies abound.

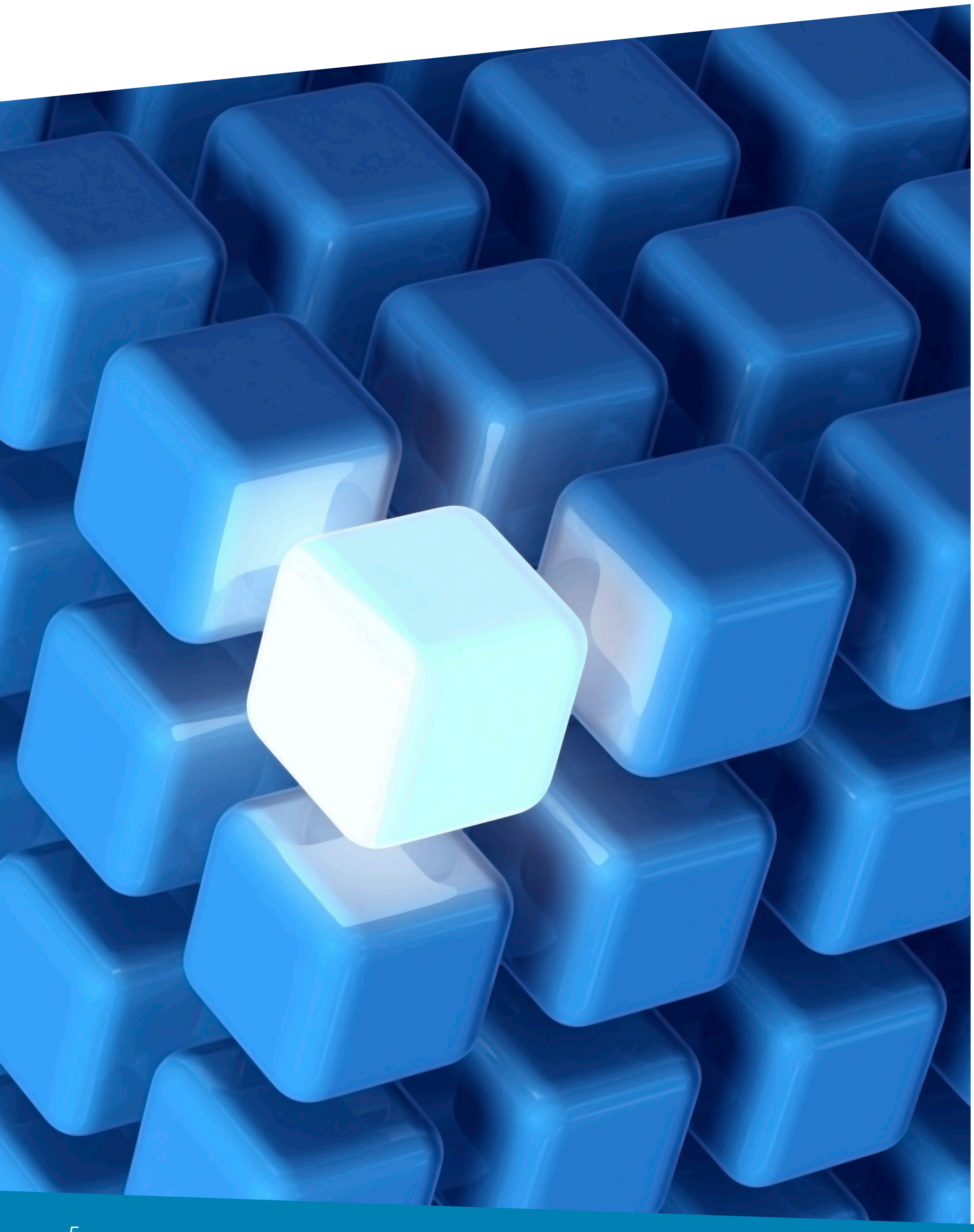
"Needless to say, because of the multitude of ways to define them, niche strategies abound."

continued

CONCLUSION

Boutique firms and niche strategies are certainly related concepts but do not necessarily have the same meaning. Nor is it the case that either term is governed by a universally agreed list of qualifying criteria. In fact, both can be identified in a variety of ways. Mercer recognizes this and actively pursues investment firms and strategies along many of these dimensions. We embrace boutique firms and niche strategies, but not necessarily to the detriment of larger firms or more mainstream strategies. In a future installment, we will focus our attention on the risks that should be considered before investing in either a boutique firm or a niche strategy, and provide examples of both niche strategies and boutique firms that we have discovered.

The second installment of this article will be published in the next issue of *Research Perspectives*.



Matt Reckamp is a principal located in St. Louis, Missouri. He conducts research on private equity funds and private equity funds of funds as part of the Alternatives Boutique. Previously, he conducted research on US equity strategies for the Equity Boutique. Matt remains involved with client work with particular emphasis on US foundation and endowment clients.

Michael Kinney
(London)

BUILDING EQUITY PORTFOLIOS WITH STYLE

Much has been written recently about "smart beta," "advanced beta," "intelligent indexing," and various other buzzwords — broad terms that are not always well-defined, Mercer believes that it is important to focus beyond these catchy titles, on the underlying drivers of return, and how this can help investors with constructing and monitoring their portfolios. We have been helping clients implement equity structures with explicit allocations to style factors for many years. This short paper serves as a primer on approaches to capturing a range of return drivers in global equity portfolios.

WHAT DRIVES EQUITY RETURNS?

The first step is to consider what it is that drives equity returns, and which of these factors investors should emphasize in portfolios.

There are many factors that can affect returns. Historically, investors think in terms of a top-down framework, such as one defined by geography, industry sector, or market capitalization. Of course, these factors can still affect returns — we saw that in 2013 when emerging market equities underperformed developed markets by almost 30%.[1] However, underlying these factors are further drivers of return, which may be powered by the behavioral biases of investors or compensation for risk.

TO WHICH RETURN DRIVERS SHOULD INVESTORS SEEK EXPOSURE?

The simple answer is that investors should seek exposure to those drivers of return that they believe will outperform (either in absolute or risk-adjusted terms) over the long term. So which drivers are likely to outperform? This is, of course, a vexed question, on which commentators, market practitioners, and academics will not always agree. At Mercer, we are wary of claims that certain return drivers are "academically proven" to outperform ("proven" is a dangerous word to use in the investment industry, particularly in relation to the future). Nevertheless, there is evidence — both empirical and economic rationale — that can be used to assess whether a given return driver is likely to outperform in the future. We do not include the full detail of that evidence in this paper, but Table 1 lists the key drivers that Mercer believes should be reflected in investors' equity portfolios.

continued

[1] Throughout 2013, the MSCI World Index returned 27.4% versus the MSCI Emerging Markets Index return of –2.3% (in USD terms).

TABLE 1

Key Drivers to Consider in Building an Equity Portfolio

Driver	What is it?	Rationale
Value	Bias toward cheap stocks on a measure of value, such as price to book or price to earnings.	Return enhancing due to (a) behavioral overextrapolation of earnings growth, (b) "distress" risk premium, and (c) the rebalancing effect.
Size	Bias toward companies with a smaller market capitalization.	Return enhancing due to (a) small company illiquidity and credit risk premia and (b) the rebalancing effect of selling stocks that have risen in price.
Momentum	Bias toward stocks that have recently performed well.	Return enhancing due to behavioral factors of (a) underreaction to company news, (b) overreaction to recent stock price performance, and (c) herding.
Low volatility	Bias toward stocks with historically low absolute variability of returns.	Risk-adjusted return enhancement due to (a) lottery effect whereby high-volatility stocks are systematically overpriced, (b) leverage aversion, and (c) tracking-error constraints causing systematic overpricing of high-volatility stocks (as not owning these disproportionately increases tracking error).
Profitability	Bias toward stocks with a strong measure of profitability, such as return on equity.	Return enhancing due to behavioral underestimation of the long-term sustainability of high-quality businesses.

Mercer has also undertaken an empirical analysis of these return drivers, building on the large body of academic work that already exists. Consistent with earlier work, we find that each of the drivers has a long record of strong performance, although the efficacy of each factor does vary. We also find that these drivers are, in general, good diversifiers to each other (that is, have typically exhibited low correlations), but that the characteristics of exposure to these factors have varied over time.

We should note that this empirical analysis is limited by the amount of data available, and is prone to "data mining" criticisms. The intuitive rationale for each driver is also subjective, so not all practitioners agree on the validity of each return driver. We recognize that not all clients are the same and that they too will have their own opinions on the validity of these return drivers. However, although there are other potential drivers of return, Mercer believes that investors should consider a positive bias toward the drivers of value, size, momentum, low volatility, and profitability.

HOW SHOULD INVESTORS BUILD THESE RETURN DRIVERS INTO THEIR PORTFOLIO STRUCTURES?

To achieve exposure to these return drivers investors can structure portfolios in many different ways. No single way is best and different investors will have different

continued

objectives and practical constraints leading to different approaches. Hence, when deciding on an investment structure, investors should consider the following:

- What are the fundamental beliefs of the investor? Do they include a belief in the value of active management?
- What is the available governance budget (time, commitment, expertise, and resources) to build, monitor, and maintain an investment structure?
- Do the investor's goals and risk constraints impose limitations on the type of structure that can be adopted?
- In particular, over what time horizon does the investor set and measure investment goals?
- Does the investor have fee constraints (particularly if a DC fund)?
- Does the size of the fund impose any further constraints? This could be because either the fund is too small to adopt a complex structure or so large that finding product capacity is difficult.

Having considered these issues and constraints, investors need to decide on a structure that works for them while achieving exposure to the desired return drivers. A spectrum of implementation approaches is shown in Table 2, and we use this to describe two possible approaches.

TABLE 2

A Spectrum of Implementation Approaches

	Traditional index tracking	Systematic strategies		Active strategies[2]	
	Market cap weighting	Factor weighting ("indices")	Optimized ("strategies")	Benchmark relative	Unconstrained
Value	N/A	Fundamentals weighted	Value factor indices	Fundamental value	Unconstrained active
				Core quant	
Size		Equal weighted	N/A	Fundamental small cap	
				Core quant	
Momentum		N/A	Momentum factor indices	Trend growth	
				Core quant	
Profitability		Quality weighted	Quality factor indices	Quality growth	
Low volatility		Risk weighted	Minimum variance indices	Minimum variance	
				Defensive quality	

[2] The table is a summary schematic only and does not show all the possible nuances. For example, some unconstrained active managers might have narrow exposures to certain return drivers.

1. SYSTEMATIC EXPOSURE TO RETURN DRIVERS

One approach is to use a combination of investment products that provide systematic exposure to the chosen drivers of return. These products (highlighted in blue in Table 2) are typically rules-based and are designed to specifically target one or more drivers. We can further subdivide these products into (a) factor-weighted indices and (b) optimized strategies. Factor-weighted indices are based on stock weightings other than market capitalization. Examples include weighting by fundamental measures (for example, economic or accounting) of company size to target value or risk-weighting to target low volatility. Optimized strategies are those that use quantitative mathematical algorithms to target the return drivers. An example is quantitative minimum variance indices, which target low-volatility exposure.

Proponents of these approaches argue that the resultant factor exposures will achieve much, if not all, of the outperformance that can be achieved by traditional active managers. They further argue that these products typically have lower management fees. These systematic products and indices are sometimes referred to as "smart beta" products.

We do not believe that these systematic products are a "silver bullet." Although they can indeed provide investors with systematic exposure to specific return drivers at a relatively low fee (compared with typical active management fees), they do also present some challenges:

- The key drivers of outperformance may change in the future. A portfolio structure designed to gain exposure to the key drivers of the past may miss out on the key drivers of the future. A skilful active manager, on the other hand, may be more flexible in adapting to both tactical and structural changes in the market.
- When using traditional active managers, an investor delegates decisions on the return driver exposures (and the nature of their capture) to a fund manager. This is not the case when an investor decides upon a structure of systematic products. Although in both cases the investor retains a fiduciary duty, the function of factor selection is delegated in the former scenario but not necessarily in the latter. Investors should be aware when they have not delegated factor exposure decisions and make sure they have a clear understanding of the risks involved.
- In many cases, the evidence for the efficacy of these products is based on simulated returns and back-testing. Investors should remember that although life (and investment returns) can only be understood backward, it must be lived forward[3] — returns might not turn out as hoped for. Not all systematic products are created equal: some are, in our opinion, better than others and demonstrate greater efficacy of factor exposure.

However, despite these challenges, Mercer believes there may be a role for systematic products. For some years we have been advising clients to build equity portfolios with an explicit exposure to (among other things) low volatility, emerging markets, and size, and indeed some of our clients already use systematic products for the low-volatility element of their investment structures.

"For some years we have been advising clients to build equity portfolios with an explicit exposure to (among other things) low volatility, emerging markets, and size, and indeed some of our clients already use systematic products for the low-volatility element of their investment structures."

continued

[3] With apologies to the Danish philosopher Soren Kierkegaard (1813–1855).

2. ACTIVE MANAGEMENT

An alternative to using systematic products is to use one or more active managers in combination (highlighted in gray in Table 2).

Almost all active managers have a bias toward certain return drivers. We can think of each manager as having his or her own "return driver footprint." An investor can build an aggregate portfolio with exposure to the desired return drivers by putting together a structure of managers with the right combination of footprints.

At Mercer, we believe in the value of active management. Market inefficiencies arise for a variety of reasons, from behavioral biases and investor constraints to an excessive focus on the short term. The nature and magnitude of these inefficiencies vary significantly over time. Hence, we believe that skilful active managers can improve upon the risk/return characteristics of a market cap index or a systematic strategy designed to capture factor exposures.[4]

A well-diversified equity portfolio that is biased toward value, size, momentum, low volatility, and profitability can be assembled with high-quality, unconstrained active managers.

Some investors might wish to use a combination of active strategies alongside systematic products. A number of our clients already use a combination, with active systematic products often used to provide low volatility or value exposure. Systematic products can also be used in a "completion" role, whereby a tailored systematic product might be used to fill the gap between the aggregate footprint of an investor's selected managers and the investor's desired footprint.

> "A well-diversified equity portfolio that is biased toward value, size, momentum, low volatility, and profitability can be assembled with high-quality, unconstrained active managers."

MERCER'S RESEARCH OF SYSTEMATIC PRODUCTS

Mercer maintains research on a number of systematic products that target return drivers. For those products offered as an index, Mercer assesses these using our "Preferred Provider" methodology. This approach is applied to strategies for which the primary goal is to track an index, and it is the same approach used for assessing conventional market cap weighted index products.

For those products managed on an active systematic process, Mercer assesses products using our traditional rating process. Strategies are rated using the Mercer rating scale or A, B+, B, or C, which is an assessment of the likelihood of whether a strategy will outperform a benchmark over a market cycle.[5]

CONCLUSION

Investors should think carefully about the underlying drivers of return when designing equity portfolios. In particular, investors should understand the different drivers of return and decide upon those to which they wish to have exposure. Although there are many potential drivers and not all commentators agree, we believe that investors should consider a positive bias toward value, size, momentum, low volatility, and profitability.

There are many ways to implement an equity portfolio with targeted drivers of return. No single way is best, as different investors will have differing fundamental beliefs, goals, and constraints. One approach is to use a combination of systematic

continued

[4] We do note, however, that our confidence in the value of active management can vary according to market and style.

[5] For more details on this process, see *Guide to Mercer's Investment Strategy Research Ratings*, June 2013.

products that target drivers of return using a rules-based process. This approach has some merits, including typically lower management fees, but also presents some material challenges.

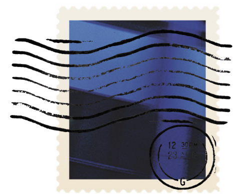
An alternative is to use a combination of traditional active managers, being careful to ensure that (a) the aggregated return driver footprint of these managers is consistent with the investor's targeted exposures and (b) the chosen managers are skilful and likely to achieve performance in excess of a benchmark and the relevant systematic factor exposure.

In the absence of any material fee or governance constraints, we believe that a diversified portfolio of active managers is a valid approach. We believe that skilled, active managers should be able to provide a more attractive risk/return trade-off on a net-of-fees (and costs) basis. However, the use of systematic products might provide a better fit with some investors' beliefs, governance arrangements, or fee constraints. In particular, they can be used in a completion role or to target specific characteristics.

Either way, our approach is straightforward. We incorporate factor analysis to ensure that when a client employs a manager, the client is getting what it expects and that it is paying appropriate fees for the expected alpha and not over-paying for simple factor capture.

Michael Kinney is a senior researcher within Mercer's Equity Boutique. Based in London, he is responsible for researching Japan equity, Asian equity, and some industry sector equity strategies managed in Europe. Michael works with a range of clients, advising on monitoring and selecting managers.

POSTCARDS
… FROM TORONTO



Earlier this year, Mercer's infrastructure team worked with a client considering its first direct infrastructure investment.

Infrastructure investing has some novel challenges compared to other asset classes. The investments are generally private and, when combined with their large scale and complexity, liquidity is limited. Once acquired, a capable and hands-on asset manager is required to effectively oversee the asset, whether it is an airport, power plant, or toll road.

Mercer was initially responsible for helping the client assess the manager's capabilities and track record as an infrastructure investor and asset manager. Additionally, the client would need Mercer to assess each investment opportunity prior to making a decision to invest. The client chose Mercer's infrastructure team in part due to the team members' diverse backgrounds, which includes individuals with both extensive experience advising on infrastructure fund investments and direct infrastructure investing experience. This combined skillset is relatively unique in the consulting industry and allowed us to meet both of the client's key needs: conducting an initial review of the manager and assessing each direct investment opportunity on an ongoing basis.

Over the course of 2013, Mercer's entire infrastructure team was involved in conducting due diligence on the manager on behalf of our client. This included assisting in the negotiation of the key terms for the investment with the manager. As part of this effort, Mercer organized a three day on-site due diligence session involving the majority of the Mercer's infrastructure group (traveling from the UK and Australia) and converging in North America.

In April of this year, we ramped up our due diligence on a potential investment presented by the manager. The opportunity was a large infrastructure asset located in North America, and as part of the due diligence, representatives from the client, as well as other investors with the manager, assembled in Toronto for due diligence sessions and numerous rounds of negotiations. Despite a tight time frame, a large volume of due diligence materials and highly complex negotiations, Mercer was able to assist the client in understanding the key investment features and risks and in negotiating a favorable investment agreement.

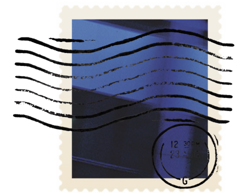
Given the deep pipeline of infrastructure opportunities we are seeing, and the increasing interest of large institutional investors in this segment, I'm sure it won't be long before we're called upon to help with the next direct infrastructure investment.

Regards,

Toby Buscombe

Toby Buscombe is Mercer's Global Head of Infrastructure, leading a team of specialists servicing major institutional investors around the world. He has over a decade of experience advising and representing large institutional clients (predominantly pension funds) in both an advisory and principal investor capacity.

POSTCARDS
… FROM HONG KONG



In early February 2014, Mercer provided an opportunity for me to relocate from Chicago to Hong Kong. Looking back, it is hard to believe that my family and I have now been here for over five months.

As a member of the Manager Research Equity Boutique since 2007, I have come to appreciate Mercer for its global reach, seeing that one of the benefits of being part of such a large organization is the diversity of experiences that one can pursue. Witnessing colleagues who made similar regional transitions sparked my curiosity for potentially working in another country. So in the spring of 2013, I expressed an interest in moving to Hong Kong, specifically to work with the manager research team covering Asian equity strategies.

Why Hong Kong? First, I was keen on broadening my experiences by covering another market. Given the dynamic growth potential of the Asian region, I viewed Hong Kong as a compelling yet practical city in which to get immersed. Second, the ability to be closer to extended family (in Taiwan) was an appealing factor. Third, my wife and I always had a desire to experience the vibrant Hong Kong lifestyle. Even with two young children, we thought it was an opportune time for us to step out of our comfort zone and meet a new set of challenges.

Thus far it has been a wonderful experience all round. Meeting with asset managers and collaborating with colleagues in Asia has given me a greater appreciation for the investment landscape and changing dynamics in the region. The team has been particularly helpful in getting me up to speed and making the adjustment process as smooth as possible. My family and I have used the weekends to explore the plethora of outdoor beauty and culture that Hong Kong has to offer, as well as to meet new people. Seeking out new and interesting local restaurants (our options seem to be endless) has been an ongoing adventure. Over the course of our time here, we also plan on taking a number of short trips to some of the nearby countries for quick getaways.

Hong Kong plays host to a very vibrant international community. Hence, when people say they are "settled" here, their meaning can be somewhat fleeting in a city so transient. At the same time, it is also what makes this place so exciting.

Best,

Jack Liu is a principal with Mercer's Investments business in Hong Kong. As a member of the Equity Boutique, he is responsible for researching Asia Pacific equity investment strategies, including regional and Asian single country equity strategies. He provides support and recommendations on investment managers to Mercer's Asia Pacific Equity Ratings Review Committee.

HEDGE FUNDS IN THE CURRENT ENVIRONMENT


Robert Howie
(London)


Dave McMillan
(St. Louis)

We believe that now is a good time to consider (or reconsider) hedge fund investing. The strategic case remains valid and many current factors are positive for hedge funds. This article explores the case for hedge funds with a focus on the current environment. We also offer some thoughts on choosing the best hedge funds and how to build robust portfolios.

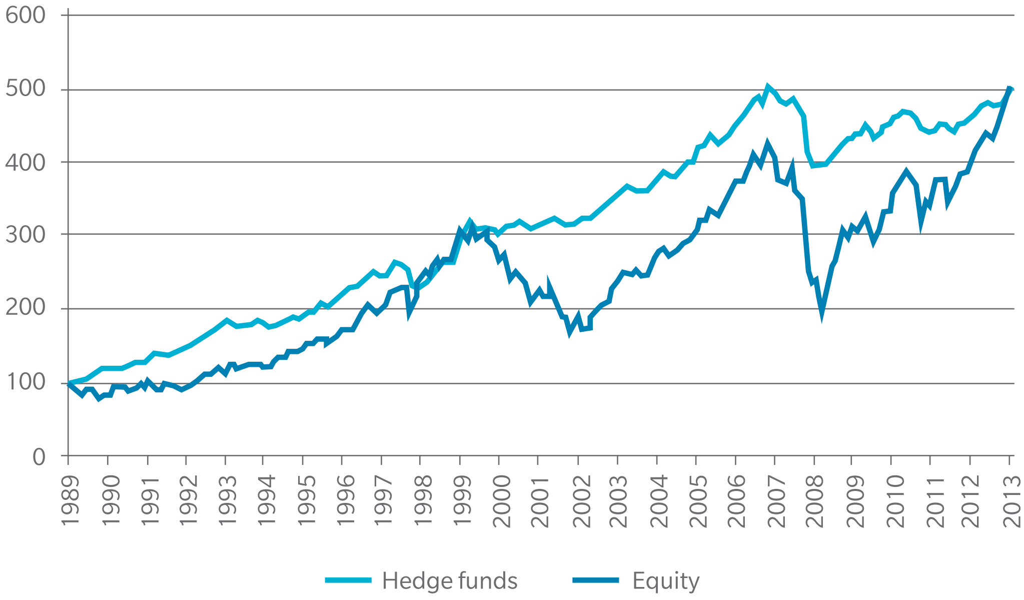
HEDGE FUNDS HAVE DELIVERED THE CLICHÉD "EQUITY-LIKE RETURNS WITH BOND-LIKE VOLATILITY"

Hedge funds can provide both long-term growth and diversification from other asset classes, and can generate these returns with less volatility than public equity markets. This can be achieved through exposure to various types of manager skill and nontraditional risks. Figure 1 on the next page shows the long-term performance of hedge funds compared to equities. We have used what we believe to be the most representative measure of hedge fund performance (the HFRI FOF: Diversified Index), which reflects the average professionally managed hedge fund portfolio and has the least amount of survivorship bias. The gross of fee MSCI World Index is shown for equities. The net of all fees return on hedge funds of 6.9% p.a. almost exactly matches the 7.0% p.a. from equities. By contrast, while equity volatility was 15.4% p.a. over the period, hedge fund volatility was 5.9%, compared with 5.5% achieved by the Barclays Aggregate Global Bond Index.

continued

FIGURE 1

Long-Term Performance of Hedge Funds Compared to Equities



Over shorter periods a well-designed portfolio of hedge funds is likely to “come in second place” relative to equities and bonds: lagging in strong bull equity markets and eclipsed by treasuries in times of crisis, even if they can protect capital better than equities do. However, always coming second, when the same asset class is not always coming first, means that the longer-term return profile can be very attractive and potentially result in outperformance over the long term (especially with robust portfolio construction and good manager selection).

Hedge funds have been able to deliver diversifying returns because they are afforded the flexibility to access different return drivers than those accessible through traditional long-only asset classes. This means that hedge funds can help share the burden of growth in investor portfolios. In investor portfolios that are often dominated by equity risk (and to a lesser extent credit risk), hedge funds can contribute by offering access to non-traditional return drivers such as bi-directional security selection and timely variability in beta exposure.

continued

THE CURRENT OPPORTUNITY SET FOR HEDGE FUNDS IS ATTRACTIVE

We see many positive factors for hedge funds including a robust opportunity set. The reward structure of hedge funds continues to attract the best investment talent and, on balance, we believe there are currently stronger tailwinds than headwinds for hedge fund strategies. Importantly, the opportunity cost of investing in hedge funds currently appears low. By this we mean that many traditional asset classes are either over- or fairly valued, so investors in hedge funds are less likely to miss strong bull markets in either equities or credit.

A key change has been a better environment for stock selection and long/short investing. We have seen lower intra stock correlation, a key measure that means security prices are better reflecting their own idiosyncrasies rather than moving in tandem with the market. This creates a favorable opportunity set for hedged security selection, especially when fundamentals are being rewarded and the economic environment is creating clear winners and losers.

Changes in the banking sector, notably bank deleveraging, are continuing to provide opportunities for hedge funds. Many hedge funds are providing liquidity to European banks, as these institutions are incentivized to dispose of non-core assets at prices that imply attractive forward-looking rates of return. The reduced competition from bank proprietary trading also has benefits for hedge funds. First, hedge funds are not competing with these banks for the same trades as they did in the past. Second, they are able to hire those very traders who previously worked at banks onto their staff.

Event-driven opportunities also abound. These range from restructurings to recapitalizations, to spin-offs, to mergers and acquisitions (M&A). It is worth noting that M&A volumes are currently in excess of the levels last seen in 2007.

For macro traders, monetary and fiscal intervention in markets has been a challenge in recent years especially when policymakers have had such a big impact on markets. But now, while macro risks remain, policymakers' actions are becoming increasingly differentiated as economies diverge, allowing more scope for different market responses. We believe this backdrop should allow skilled managers to profit from macro opportunities resulting from global imbalances.

> "Changes in the banking sector, notably bank deleveraging, are continuing to provide opportunities for hedge funds."

INVESTING IN HEDGE FUNDS – BUILDING PORTFOLIOS AND PICKING MANAGERS

We refer to "portfolios of hedge funds," rather than individual managers, as our core belief is that accessing this "asset class" is not unlike investing in equities — diversification within a hedge fund portfolio, by manager and strategy, is key to achieving the diversification benefits highlighted earlier. Furthermore, we believe:

- Hedge fund strategies should be rational and managers must have an identifiable edge.
- Hedge fund portfolios should be "hedged".

continued

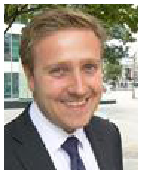
- No single hedge fund should represent a disproportionate share of the total portfolio.
- But there should be prudent concentration within an allocation.
- Liquidity terms should match the underlying investments.
- There is value in seeking exposure to more cyclical strategies via opportunistic multi-strategy funds.

Picking good hedge fund managers is hard. Quantitative analysis, including past performance, is not necessarily indicative of future results. This is especially true for hedge funds, as their nontraditional nature and general opacity can often mask underlying risks that lie dormant until realized in outsized losses. The hard work must start with detailed due diligence to select managers with an identifiable and repeatable edge.

A key part of hedge fund manager selection is forming an investment thesis on each hedge fund manager. This basis for selecting managers defines their unique role in the hedge fund portfolio and sets the tolerance for risk taking and performance expectations. Effectively defining the investment thesis for each manager is critical, as a break in the investment thesis should be the basis for termination. Successful hedge fund investing is predicated on skillful manager selection. From idea generation to implementation and business management, all elements of an investment strategy and hedge fund organization must continually be assessed and reassessed to ensure the investment thesis remains up-to-date.

Robert Howie is a principal located in London. He leads the manager research and generation of intellectual capital for alternative assets in Europe, focusing on hedge funds, insurance-linked securities, and multi-asset and other liquid alternative strategies. Additionally, he advises institutional investors on the use of alternative assets, including manager selections and portfolio construction.

Dave McMillan is a Partner with Mercer, directing the firm's hedge fund manager research effort globally. He serves on the firm's Alternative Investment Committee and the Hedge Fund Ratings Review Committee. In addition, he is the portfolio manager for several funds offered by Mercer Investment Management, Inc.



OPPORTUNITIES IN THE RESIDENTIAL REAL ESTATE SECTOR

Matthew Abbot
(London)

In countries such as Switzerland, Netherlands, Germany, and the US, institutional investment in the residential sector is well-established, and Mercer has been active in this area for many years. By contrast, institutional investment in markets such as the UK has been negligible.

However, the UK residential sector has recently received a lot of attention from the press, and over the last year or so this attention has moved away from the front pages of the Sunday papers to the institutional investment arena. It is starting to dominate agendas for many real estate investors. Since the Montague Review in 2012, the government has taken notice of the barriers to institutional investment in private rented homes. The sector is now receiving government support both in direct funding and through education.

So is the residential estate sector a minefield of uncertainty and policy risk, or do the risk/return benefits outweigh such factors? Matthew Abbott considers the pros and cons of the sector from an institutional perspective and compares this sector to other more established markets.

INTRODUCTION TO THE UK MARKET

The UK residential market has, for the last 40 or 50 years, comprised mostly private owner-occupied housing or social housing, with a relatively small proportion of privately rented housing. Of this, the majority of landlords have been small-scale buy-to-let operators, many of whom own only one unit. Thus the market is currently very fragmented.

However, since the global financial crisis and the associated reduction in availability of credit this trend is changing, and the proportion of the population who live in privately rented accommodation has been increasing significantly over the last 5 to 10 years. Government and investors have been paying more attention to the private rented sector ("PRS"). The UK has a housing shortage, and PRS may be one of the key solutions to this problem. The demographic trend of rapid urbanization is fuelling this demand further; certain regions now have such a shortage of and high demand for housing that owning a property is becoming impossible for many.

Over the last six to nine months, we have seen a significant increase in the number of institutions looking to launch products in this sector. The UK government has also been taking steps to increase the supply of PRS housing (through the Build-to-

continued

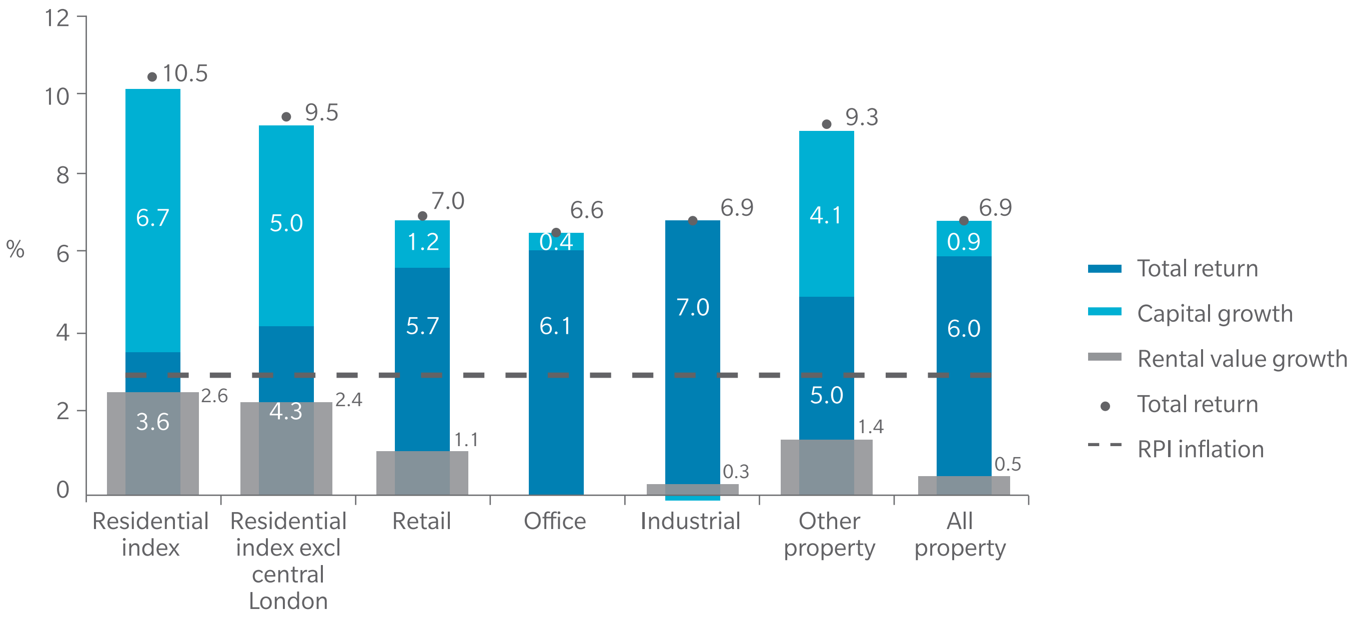
Rent Funding Scheme) and to educate and inform investors (through the PRS Taskforce). In response to a clearly growing market, Mercer is now undertaking significant research into the PRS market in the UK.

RISK AND RETURN

Although data is very piecemeal and difficult to get on a countrywide basis, Investment Property Databank (IPD) has recently launched a residential index covering PRS. Figure 1 shows the return over the last 13 years (annualized) from the residential index compared to the commercial real estate indices, which IPD also measures. The 13-year period seems reasonable as it reflects a full commercial market cycle, although we are conscious that the assets represented in the data are not necessarily the most appropriate type for the current environment, as they are generally confined to central London and do not include a great deal of modern, purpose-built stock, given the infancy of this end of the market.

FIGURE 1

UK Private Rented Sector Returns Relative to Commercial Sectors



Source: IPD All property index

continued

The return delivered by PRS over this period is clearly compelling. However, there are a number of health warnings behind these return levels (not just including the limitations of the data itself) which need to be explored in order to ascertain whether the risks associated with this asset class are commensurate with the level of return one can expect to achieve. These include (but are certainly not limited to):

- Low income return relative to commercial real estate and a consequent reliance on consistent long-term capital growth to make up an attractive total return.
- Different risk profile relative to commercial sectors due to different return drivers.
- Greater vulnerability to changes in government policy.
- Differences in lease structure.

Our initial view is that PRS offers a lower risk profile than commercial real estate, and because of this, the expected returns should also be lower. This is based on fundamental supply and demand characteristics, which have resulted in a less volatile return profile and lower long-term vacancy rate when compared to the commercial sectors. The sector should also be less cyclical than many commercial sectors and may even offer contra-cyclical benefits. It is certainly true that the sector offers diversification benefits relative to commercial, as shown in Table 1.

TABLE 1

Correlation of Mainstream Commercial Sectors Relative to Residential PRS

	All Commercial	Retail	Office	Industrial	Residential
All Commercial	1				
Retail	0.98	1			
Office	0.95	0.87	1		
Industrial	0.99	0.96	0.95	1	
Residential	0.64	0.60	0.66	0.66	1

Source: IPD

RENTAL GROWTH

Although income yields are low (due in large part to high management costs), the sector appears to offer good inflation protection. Also although leases are short, occupancy data suggests that tenants stay for far longer than the accepted standard 12 months they initially sign up for. Figure 2 shows the inflation protection shown by rental growth, which is particularly strong when compared to inflation as measured by CPI. It is also significantly more pronounced than commercial real estate.

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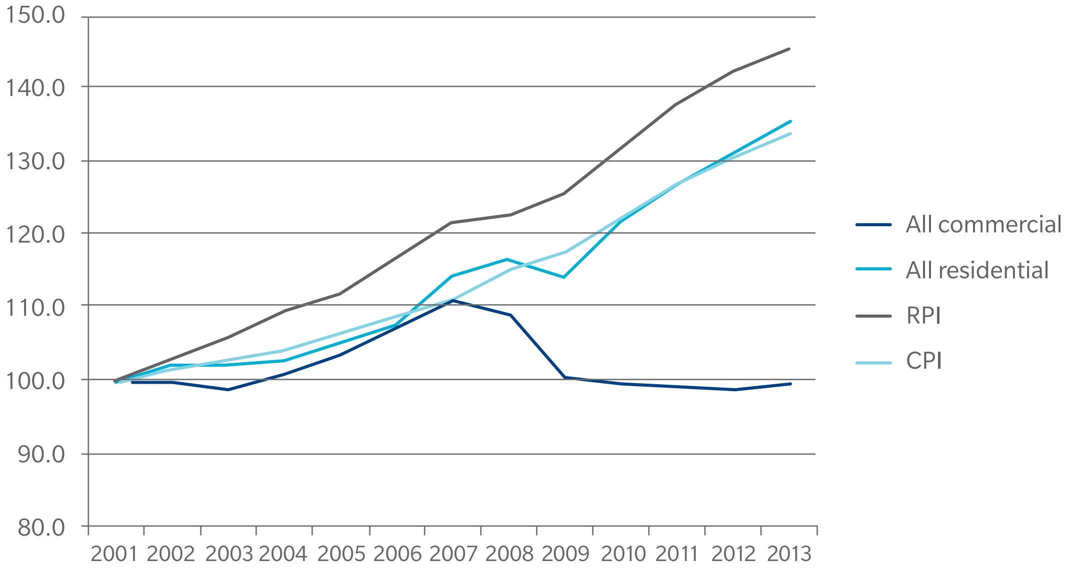
FIGURE 2

Rental Growth of Residential and Commercial Real Estate Relative to Inflation



The introduction of some sort of rent control may not actually be as much of a bad thing as certain generations recall — areas of the US and the majority of Germany operate such regimes and it does not cause the market to malfunction. The old school of thought is that rent controls would inhibit supply and cause problems in the upkeep of assets. This is understandable but is a legacy of previous governments, with different political agendas. However, in a low interest rate environment, the presence of modest but steadily (and predictably) increasing income is attractive for many pension funds. While legislating for rent controls would undoubtedly cause some unease, longer leases with predefined rental increases could work well for pension funds.

BARRIERS TO ENTRY AND LESSONS FROM ABROAD

There are barriers to the success of PRS as an asset class. As well as the risks listed above, pension funds remain concerned about reputational damage. In addition, achieving institutional scale can be difficult. Both of these aspects are being addressed to some degree by the managers in the market. Investment houses are in some instances creating separate businesses to manage the tenants and remove some of the reputational risk. Many are also teaming up with house builders in order to develop stock that is suitable for the PRS marketplace. However, the buoyancy of the residential owner-occupier market means that there is less incentive for house builders to build PRS stock when compared to building units to sell individually. But certain changes would nudge house builders toward developing PRS — for example, changes to planning regimes and changes to the economic backdrop.

continued

When assessing whether the UK PRS can start to attract meaningful institutional capital, it is worth looking to other countries. Switzerland and the Netherlands lead the way in this regard, with institutional portfolios including almost 50% in the residential sector. Residential has also long been an accepted institutional asset class in Germany, and Mercer has been active in this area for many years:

- The German residential market has some distinctly different characteristics, most notably a historical lack of aspiration from the general population to own one's home. This has underpinned a buoyant and well-established PRS market. But this trend is changing, and the demand from individuals looking to purchase their rented accommodation has risen out of a period where house prices have been relatively flat for a long time and disposable income has increased (notwithstanding the global financial crisis). Because of this and low interest rates, many occupiers are now looking to invest in their accommodation instead of renting it.
- Germany has a shortage of housing. Construction has been well below requirements for a long time, and new homes will need to be built in order to meet inherent demand, in much the same way as in the UK. As with any investment, a shortage of supply and a high level of demand underpins what should be strong performance.

However, these countries have some clear differences from the UK. Return expectations are generally lower and the historic aspiration of the population to own their own home is just not there to the degree it is in the UK. It is therefore interesting to consider the US residential (or "multi-family") market. The US has a similar level of owner-occupation to the UK, but the privately rented sector has become a mainstream asset class. The main benchmarks include a weighting to the sector and "balanced" US property funds invest meaningfully in the sector:

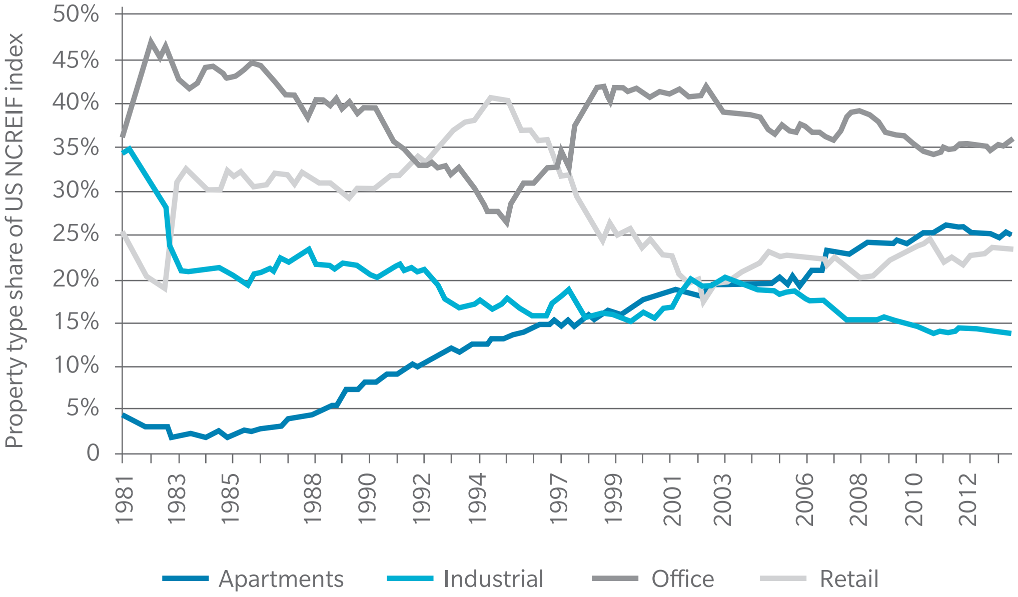
- In the US, residential has grown as an institutional asset class since the mid-80s (see Figure 3), and it is now an accepted sector of the institutional marketplace. The country has developed a strong "build to rent" model and has managed to embrace the benefits that can come as a result of having an efficient blueprint. The UK can learn from this and the Urban Land Institute has already taken note, publishing guidance on the design of such assets.

"The US has a similar level of owner-occupation to the UK, but the privately rented sector has become a mainstream asset class."

continued

FIGURE 3

US Allocations to the Rented Residential Sector



Source: NCREIF. Data to fourth quarter, 2013.

- Over the past few years, occupancy levels within this property sector in the US have been approaching record levels, while development of new inventory has been below the long-term average. Although development of these units has increased significantly over the last two years, the prolonged lack of new supply and demand drivers bode well for the sector. Additionally, like in the UK (as a result of the global financial crisis and the Mortgage Market Review), tighter lending requirements in the US are preventing many from qualifying to purchase houses, forcing these tenants into the rental market. The current supply and demand characteristics appear positive.
- Even with the emergence of increased supply risk in this sector, we still believe that positive fundamentals will continue for several years, presenting a window of opportunity to selectively develop new apartment inventory over the short term in attractive markets and also renovate and add value to existing aging apartments over the long term. However, investors should be aware that the strong appreciation realized over the last few years is likely behind us.

CONCLUSION

Clients of Mercer have been investing in the residential sector in the US and Germany for many years. These markets are well-established and, although they offer significantly different risk/return profiles, institutional demand is clearly there.

continued

The UK has lagged these markets. Many institutions worked hard to exit the sector in the 70s and 80s due to inhibitive rent controls and government interference. However, since the abolition of rent controls and signs that different government leaders share some common ground on the matter, interest has gradually increased. Most recently, the tangible impact seen from Sir Adrian Montague's review of the sector in 2012 has been encouraging. Although government policy is seen as a greater risk in this sector than in commercial sectors, there are signs that it is becoming more predictable.

Our initial work on UK PRS suggests that the sector could potentially be a suitable investment. It clearly offers diversification benefits relative to commercial sectors and, although the scope for value-added activity is lower (for the time being), the sector should offer good levels of inflation protection. The fundamental demographics of the UK population suggest that the supply/demand characteristics are favorable.

Matthew Abbot is a Senior Real Estate Researcher in the European Real Estate Boutique within the Investments business. Matthew is involved in the research of real estate investment managers across Europe, covering all investment styles. Matthew is also part of Mercer's Dynamic Asset Allocation group and assists clients with strategic real estate advice. He is part of industry bodies and sits on Committees with the Investment Property Forum and the Association of Real Estate Funds.

Simon Fox
(London)

THE MULTIPLE FLAVORS OF MULTI-ASSET STRATEGIES

Loved by many, reviled by some, multi-asset strategies are undeniably a key feature of today's investment landscape. These products have seen a surge in popularity over recent years. Liquidity, simplicity, and relatively low fees have made them attractive components of defined contribution pension schemes as well as appealing to smaller institutional investors where governance issues are a key consideration. Some strategies have also found favor from larger institutional investors, particularly where they can demonstrate a diversification benefit within the broader asset mix.[1]

While investors appear to have rekindled their desire for multi-asset strategies, product providers have also been looking to both innovate and move into new markets. Today Mercer tracks over 400 strategies within its multi-asset universe. The old labeling of "balanced" in the US and Asia and "diversified growth fund" in the UK is becoming redundant. Moreover, the range of strategies available to investors is increasing — for example, pushing the boundary between traditional and hedge fund investments in the liquid alternatives space, as well as providing access to specific risk factors, such as inflation.

As we stand back and look at the universe of managers, we believe that it is important to clearly identify the sources of risk and return in these products, as well as the potential role that they could play in an investment portfolio. To this end, we bucket the various products into four broad categories, as set out in Table 1.

continued

[1] They have also been used as liquidity buffers within a broader alternative or growth portfolio, helping investors meet short-term cash-flow requirements while providing exposure to a broad mix of more traditional growth assets.

TABLE 1

Categories of Multi-Asset Strategies

Core	• The key drivers of return will be from exposure to traditional market betas and, as such, they will generally show a positive correlation with, in particular, equity market movements. • Will typically hold a core of direct stock and bond exposures (including via in-house and/or third-party funds) rather than derivatives-based exposures. • Includes funds with a formal equity: bond benchmark (e.g. 60% equity; 40% bonds) as well as those that show a consistent exposure to markets as an implicit part of their process.
Risk parity	• Making use of leverage, these strategies provide a diversified exposure to traditional betas by equally risk weighting asset classes (e.g. equities, bonds, commodities) or risk factors (e.g. inflation.). • Some strategies may also include alternative risk premia or employ tactical asset allocation overlays to improve risk-adjusted returns.
Idiosyncratic	• Although the funds will have some traditional market exposure, more active and non-directional exposures will also be significant components and returns are expected to be more “absolute return” in nature. • Will generally be less correlated with traditional risk factors and asset classes than Core funds. • Derivatives will often be used to implement ideas.
Diversified inflation	• Invest in a blend of liquid real assets (growth assets) and defensive, inflation sensitive bonds. In some cases currencies are also used as an expected inflation hedge. • Portfolio characteristics will typically be dominated by a strategic asset allocation, although many managers also seek to add value through a degree of dynamic asset allocation

Because they are focused on earning returns from traditional asset classes (traditional market beta), Core strategies are likely to be suitable investment options for investors who need a low governance, all-in-one solution (for example, defined contribution clients). These products typically have a formal market benchmark (such as 60% equity, 40% bonds) or an implicit one, driven by long-term strategic asset allocation assumptions in the manager’s investment process. To a lesser extent, managers may also look to add value through, for example, exotic credit exposures (such as high yield bonds or emerging market debt) and many also have allocations to alternative investment funds (such as listed property or hedge funds).

Risk parity strategies take a slightly different approach to seeking growth from traditional asset classes. By accepting the use of leverage, these products can make more use of lower-returning risk premia, such as duration and inflation, in order to create a risk balanced portfolio. We have sympathy with the concept of risk parity in asset allocation, although we note that the use of leverage is often less attractive for those investors with governance constraints, while the typical emphasis on traditional beta reduces the appeal to those clients looking for a diversifier to existing market-focused investment portfolios.

Idiosyncratic strategies may also make use of leverage, although their distinguishing feature versus other multi-asset funds is a greater emphasis on tactical asset allocation and idiosyncratic trade ideas to create a portfolio that is less

continued

reliant on traditional market returns. While these strategies should provide more downside protection when equity markets fall, they also risk lagging strong bull markets during which their more alpha-driven trade ideas are unlikely to deliver as much return. Ultimately, however, they can provide greater diversification to a traditional asset mix than the other multi-asset strategies.[2]

Last, but not least, we have the Diversified Inflation strategies. These are products that explicitly focus their portfolio on liquid real assets (listed property, commodity futures, and other inflation sensitive growth assets), balanced with investments in inflation sensitive bonds. In the US market these strategies are designed primarily for defined contribution plans and, in particular, for plan participants close to or in retirement. As such, many are conservative strategies with substantial bond allocations. These strategies can fall across the core-idiosyncratic continuum.

1. ILLUSTRATING MANAGER BIASES — FROM CORE TO IDIOSYNCRATIC

We can illustrate the differences between managers that we would consider core from those that are more idiosyncratic (more exotic), by plotting the strength of bias toward different factors. The radar charts on the next page provide examples of two of our highly rated managers — one we regard as being core; the other more idiosyncratic. The closer a marker is to the outside of the chart, the more significant is the bias.[3]

Typical biases in a core product (Figure 1) are to traditional (equity and credit) beta and a reliance on a strategic asset allocation mix. Idiosyncratic strategies (Figure 2), in contrast, seek material return contributions from specific (idiosyncratic) trades — such as active currency positions, bottom-up security selection, or particular macro trades — as well as from tactical or dynamic asset allocation.

continued

[2] We note that, although multi-asset, these strategies do not provide full access to the broad range of diversifying growth strategies that can be accessed by institutional investors, for example, through a specialist portfolio of hedge funds or private markets investments; while we believe that they can fulfil a valuable role, they should not be seen as a complete solution, particularly by larger investors.

[3] The strength of bias is qualitatively assessed by Mercer as part of our manager research activities. The instruments and drivers of return will vary over time — these charts are no more than an illustration of Mercer's own view of these strategies, all else equal.

FIGURE 1

Illustration of Biases in Core Product

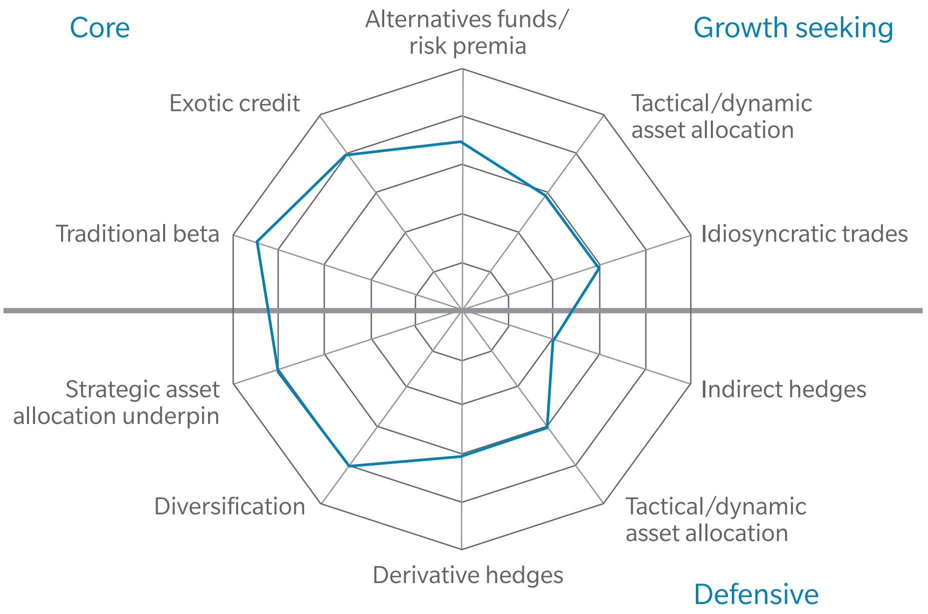
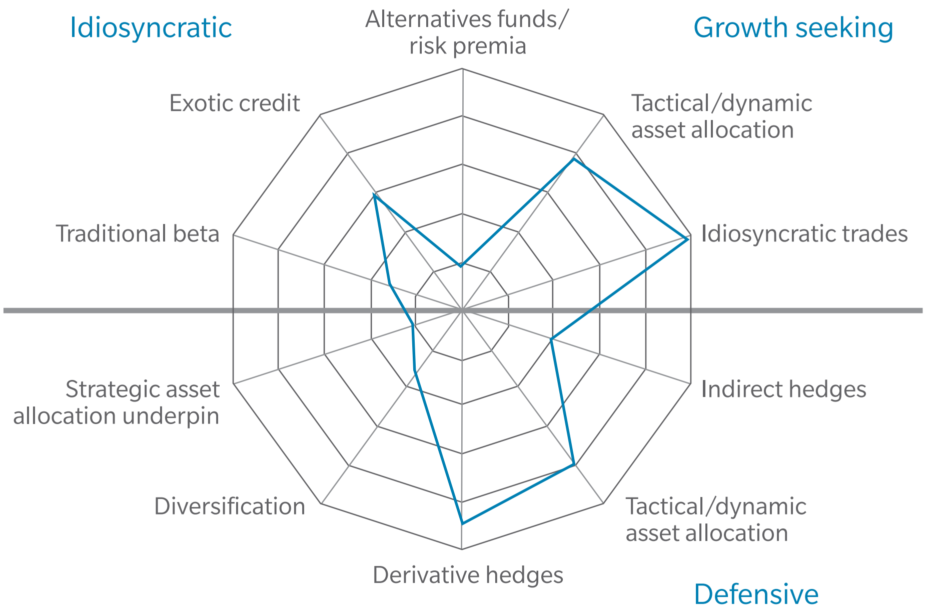


FIGURE 2

Illustration of Biases in Idiosyncratic Strategies



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The strength of bias is qualitatively assessed by Mercer as part of our manager research activities — we believe that this is an important step in identifying the right strategies for a given investor's needs. (See addendum below for more details about these radar charts.)

CONCLUSION

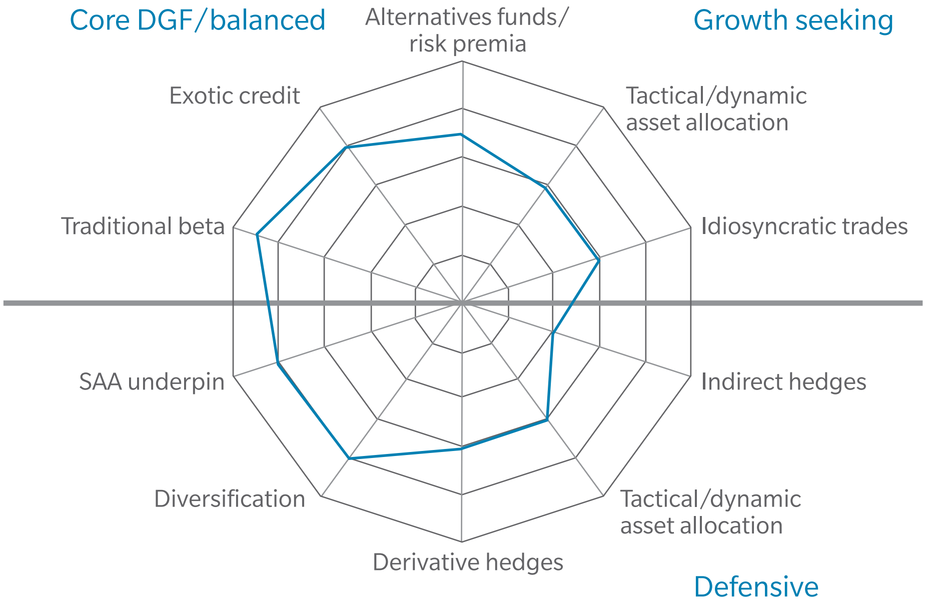
Multi-asset strategies continue to gain popularity and we believe that this will continue — with respect to both core products (including diversified inflation strategies), which can help add balance to small investment plans or defined contribution schemes, and more idiosyncratic investments, which can provide greater diversification (albeit with greater use of non-traditional return sources). Through our specialist manager research we believe that we can identify the most compelling opportunities across this range of approaches — we will continue to work closely with clients to identify the most suitable strategy (or strategies) to meet their specific investment needs.

ADDENDUM – MORE DETAILS IN THE FACTORS SHOWN IN THE RADAR CHARTS

The radar chart (Figure 3) below shows the biases (qualitatively assessed by Mercer) for one of our highly rated Core Diversified Growth/Global Balanced strategies when it comes to (1) seeking growth and (2) introducing more defensive characteristics. The closer a marker is to the outside of the chart, the more significant the bias.

FIGURE 3

Biases in Core Diversified/Global Balanced Strategies



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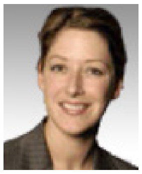
Growth seeking approaches can be defined as: Traditional Beta (for example, to what extent is the long-term exposure to equity seen as a core component of long-term returns); similarly for Exotic Credit, including the use of emerging market debt, high yield, and convertibles for example. Alternative Funds/Risk Premia include fund investments (or similar) to hedge funds, real assets (commodities, property, infrastructure, etc.) and other alternative asset classes. Idiosyncratic Trades include specific active currency positions, bottom-up security selection, or specific macro trades. Tactical/Dynamic Asset Allocation refers to the use of tactical/dynamic changes in the broad asset allocation to drive the portfolio performance.

Defensive approaches reflect the manager's bias to different techniques to help manage the "risk" in the strategy — what they fall back on in periods of challenge. For many, the underpin to their investments (and what they might seek solace in during shorter-term periods of absolute loss) is a strategic asset allocation (a Strategic Asset Allocation (SAA) underpin) — either an explicit beta benchmark or a long-term strategic asset mix (formal or informal).

In addition, the charts highlight the manager's focus on Diversification across asset classes or specific trades and the use of Derivative Hedges (for example, option overlays to protect the portfolio). The use of Indirect Hedges in portfolio construction includes (typically) long positions to balance the portfolio (for example, the use of gold in portfolios post 2008). Finally Tactical/Dynamic Asset Allocation is considered for its potential to protect the portfolio, as well as to seek out growth opportunities.

Simon Fox is a Principal within Mercer's Alternatives Boutique, part of the Investments business. As Director of Macro, Currency and Commodity Research, Simon is responsible for developing the Boutique's intellectual capital and research coverage in global macro hedge funds, currency, and commodity strategies. He also has broad input into less liquid natural resource strategies, such as timberland and agriculture. Simon serves on a number of Mercer's Ratings Review Committees, including as Chair of the Macro committee and member of the third party fund of fund committee. He is also a member of Mercer's Alternatives Investment Committee, responsible for the oversight of Mercer's fiduciary investment portfolios in the alternatives space.



Jane Ambachtsheer
(Toronto)

Q&A WITH JANE AMBACHTSHEER

THE EVOLUTION OF RESPONSIBLE INVESTMENT

Ten years ago, Mercer established a team of consultants focused exclusively on providing advice on responsible investment to investment fiduciaries and practitioners. Jane Ambachtsheer, a partner in Mercer's Investments business and an adjunct professor at the University of Toronto, has led this global team since its inception. Ambachtsheer, who in 2006 also served as a consultant to the United Nations in developing the UN Principles for Responsible Investment, reflects on the past decade of growth and change in the area of responsible investment.

Q: Responsible investment has evolved substantially over the past 10 years. Tell us about its development and future outlook?

A: Responsible investment has undergone a remarkable evolution over the past decade and especially the past five years, and has become a priority issue for many mainstream investors worldwide. At Mercer, we view responsible investment as building on traditional investing with an extra layer of due diligence that incorporates environmental, social, and corporate governance (ESG) factors. For the majority of the organizations we work with, their first priority is to maximize risk-adjusted returns. Our work is to consider how ESG issues can contribute to stronger companies, more aware fund managers, and ultimately, more satisfied investors.

"Responsible investment isn't about changing the world; it's about understanding how the world is changing and how companies will be affected."

Q: Some have confused responsible investment with ethical investing. What exactly is, and is not, considered responsible investment?

A: Responsible investment isn't quite the same as ethical investing, which focuses more on aligning investors' social objectives with their investment portfolios. Often, this involves avoiding investments in companies connected to perhaps alcohol, tobacco, or gambling, while possibly overallocating to companies with similar ethical guidelines as the investor.

For mainstream investors, responsible investment represents an overarching approach to investing that considers a wide range of ESG issues that are expected to impact a company, and hence capital market performance, over the long term. These factors may include population growth and demographic

continued

changes, such as consumption patterns; health and longevity issues; natural resource constraints, including water, fossil fuels, and climate change; and evolving public sentiment about and regulatory approaches to environmental and social issues. Table 1 below highlights several broad ESG-related areas of consideration.

For most of our clients, responsible investment isn't about changing the world; it's about understanding how the world is changing and how companies will be affected. It's about understanding where future growth will come from and having access to it. It's about a company's, an investment manager's, or investment committee's role as a steward of capital to make sure all is being done to create efficient companies and capital markets — both prerequisites to delivering long-term retirement security to beneficiaries.

TABLE 1

Responsible Investment Brings Additional Elements to Consider in Decision-Making

Environmental	Social	Governance
Climate change and greenhouse gas emissions	Health and safety	Accounting and audit quality
Energy efficiency	Population/consumption	Board structure
Resource scarcity	Stakeholder relations/ reputation	Remuneration
Pollution	Supply chains	Shareholder rights
Water availability	Working conditions	Transparency

Q: Why should organizations care about responsible investing?

A: A fund manager can improve the resilience of a portfolio by identifying and managing financial risks from governance failures, policy and regulation, and environmental and social trends. A significant number of studies support the belief that the quality of a company's governance practices positively correlates with market-based outperformance and a strong link between poor corporate governance and underperforming companies.[1] A growing body of research suggests a positive correlation between firms with higher ESG ratings and better returns on equity, cash flow, and dividend growth. Further, studies have shown that if done effectively, shareholder activism can create shareholder value.[2] Although these factors won't matter in every case, or to the same degree, they can have an impact. But there's more to RI than playing defense; there's increasing opportunity for growth investing as ESG factors become even more of a catalyst for global growth.

continued

[1] Deutsche Bank. *Sustainable Investing — Establishing Long-Term Value and Performance*, 2012.
Hermes. *ESG investing: Does it just make you feel good, or is it actually good for your portfolio?* 2014.
GMI Ratings. *GMI Ratings Research Findings: For the 10-year Period Ended August 31, 2012, a Portfolio of Companies with Top-decile AGR Ratings Would Have Outperformed the Lowest-decile Portfolio by 54%*, 2012.

[2] Bebchuk L, Brav A, and Jiang W. "The Long-term Effects of Hedge Fund Activism," available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2291577, accessed 29 April 2014.

The truth is that current consumption and production patterns are exceeding the ability of natural capital systems to provide resources to power the world's needs. This is putting pressure on businesses. At the same time, there's a lot more utilization of social media to focus on environmental stresses, and businesses are facing reputation risks for being out of line with current social expectations. Businesses and societies face a joint challenge to do "more with less," and more than 90% of the world's 250 largest global listed companies now issue sustainability reports. Some commentators say we are undergoing a resource and efficiency revolution; others call it the low-carbon industrial revolution. Major change is afoot, and there will inevitably be winners and losers. Our focus is on the investment implications of this.

The global investment industry's collaborative response has been the UN-backed Principles for Responsible Investment, which represent the first set of globally consistent, widely supported principles for the investment community around integrating ESG factors. The principles have come a long way since Mercer and a small group of investors joined as founding signatories in 2006; today, they are supported by more than 1,200 investors globally, representing US$34 trillion in assets.[3]

Q: What questions do you hear most from clients about responsible investing?

A: Generally, our clients have a responsibility to secure the greatest financial returns while balancing risk; therefore, the first question is always about whether adding an ESG perspective supports this aim. Our view is that it can, in three ways: by better managing risk, identifying investment opportunities, and supporting engagement with investee companies.

Q: How can investors incorporate responsible investment principles into their investment approach?

A: Integrating ESG considerations into your investment approach should be an evolution, not a revolution. It must be accomplished over time, with buy-in from all stakeholders. The first step with most investment committees is to hold an education and beliefs workshop. In these sessions, committees explore the economic and social trends that are making ESG factors more relevant to company and investment performance, and explore academic and practitioner evidence. It's not about completely changing an investment approach; it's about widening the lens to focus on protecting a portfolio against relevant risks and enhancing opportunities by opening access to growth. After the session, investors generally develop their own investment beliefs that reflect areas of joint consensus, ranging from the relationship between ESG and fiduciary duty, to the importance of corporate governance, and materiality of environmental and social issues to company performance.

Each investor's approach will be unique and should reflect its priorities based on stakeholders, regulators, investment structure, and available resources. For example, a recent trend is for corporate plan sponsors to look at how they can align their pension investment strategy with their corporate approach to sustainability.

continued

"Integrating ESG considerations into your investment approach should be an evolution, not a revolution."

[3] See www.unpri.org for information on the Principles for Responsible Investment.

Once a common understanding has been established and reflected in investment beliefs, an investor's processes and portfolio can then be aligned to reflect these beliefs. A first step is to review how well existing managers incorporate ESG factors and active ownership principles into their strategies. Mercer has more than 5,000 ESG ratings that reflect how well a range of traditional investment strategies incorporate ESG. Clients use these ratings to monitor existing managers and as an input to selecting new managers.

Another step is to consider the opportunity side of ESG, which means looking at sustainability-themed managers that look to exploit the transition toward a more efficient, low-carbon economy. We hold these strategies to the same in-depth, forward-looking research process as all our strategies.

Q: Any closing thoughts?

A: There are many internal and external drivers pushing investors to consider their approach to responsible investment. Though an organization shouldn't make a revolutionary change to its investment approach, a failure to consider ESG factors could put it on the wrong side of this evolution in investing.

Jane Ambachtsheer is a Partner at Mercer Investments and leads the Global Responsible Investment business, which she established in 2004. Jane advises a range of investors in North America, Europe and Asia Pacific on integrating environmental, social and governance (ESG) factors into the investment process. Jane played an instrumental role in the development of the United Nations-backed Principles for Responsible Investment (PRI) as the consultant to the United Nations responsible for coordinating the development of the Principles. She is based in Toronto.

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