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# RESEARCH PERSPECTIVES

## FOREWORD



Robert Howie   Matt Reckamp

As 2014 draws to a close, we welcome you back to our final issue of *Research Perspectives* for the year. We have articles covering the mainstream asset classes as well as alternatives, both liquid and illiquid.

We believe equities still matter to most investors, so we open with a short article on how our thinking has evolved regarding our preferred way to structure equity portfolios. Following this is the second part of a two-part paper on boutique investment firms and niche investment strategies (across multiple asset classes). We

then present a “postcard” from Singapore providing a succinct look at Asian bonds.

The second half of this issue focuses on alternative investments. At the liquid end, we have another postcard — this time from Geneva, and focusing on global macro hedge funds. Next, we look at illiquid investments and explore how investors can determine their tolerance for illiquidity — and, therefore, how they can size their allocations to the attractive opportunities in the illiquid space. We close with a Q&A with Jelle Beenen, global leader for Alternatives Research, who shares his views on alternative investments.

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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# EQUITY PORTFOLIO 2.0 — AN EVOLUTION IN PORTFOLIO CONSTRUCTION

Equities remain a critical component of most investors' return-seeking allocations; therefore, reviewing and improving equity portfolios remains an important activity for institutional investors. In 2010, we proposed a global equity construct built around four underlying components: a core invested in developed markets; meaningful allocations to smaller companies and emerging markets to reflect the return opportunities in these segments of the global universe; and an allocation to low-volatility (or defensive) equities, providing an offset to the higher-risk allocations and an improvement in risk-adjusted returns. We believe that this broad framework remains appropriate, but following a thorough review, we have recently published an update to this guidance — *Equity Portfolio 2.0* — which we outline in this article.

## WHAT'S NEW?

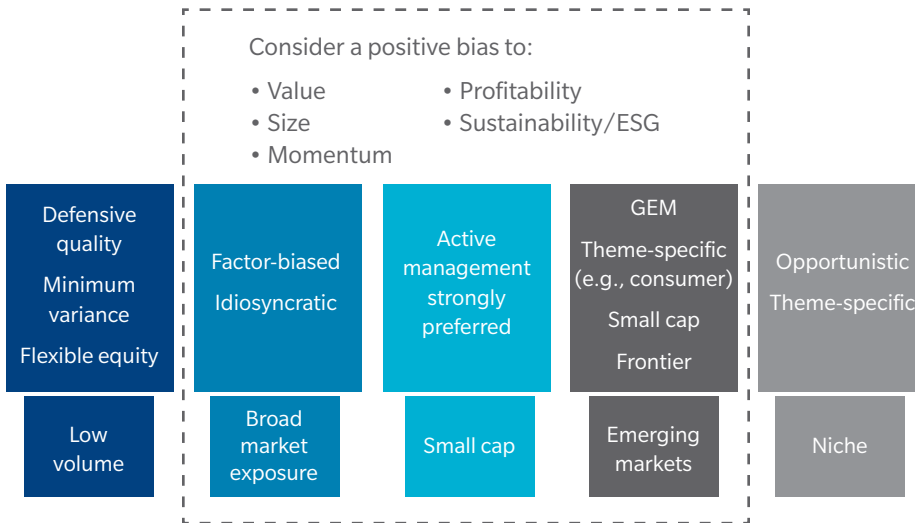
*Equity Portfolio 2.0* evolves our previous guidance in three important respects:

1. We recommend a more explicit focus on the “style factor” biases running through equity portfolios.
2. We recommend that investors incorporate a sustainability/environmental, social, and governance (ESG) focus within their equity portfolios.
3. We have introduced a fifth underlying component to the construct — the “niche” bucket — in order to capture opportunistic or theme-specific allocations that would not naturally sit within any of the other underlying portfolios.

*continued*

TABLE 1

## Equity Portfolio 2.0



In relation to the first point, investors should consider a positive bias toward a number of style factors (or return drivers). Specifically, we highlight value, size, momentum, low volatility, and profitability for potentially improving an investor’s long-term return profile. The rationale for identifying these factors as important and our thoughts on the different approaches to implementing these biases was set out in a previous article, “Building Equity Portfolios With Style.”

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TABLE 2

## 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

On the second point, Mercer believes that ESG risks and opportunities can have a material impact on long-term risk and return. As such, incorporating a sustainable investment view in equity portfolios is more likely to preserve and grow long-term capital. Such a view might be captured by utilizing strategies that score highly on Mercer’s ESG ratings (which now apply to both passive and active strategies).

Finally, the niche allocation could include theme-specific strategies (for example, those with a focus on sustainability or resource scarcity) or opportunistic strategies designed to exploit a specific market distortion (depending on market conditions at a given point in time). The focus would be to incorporate exposure to ideas that are not likely to be captured elsewhere in the portfolio and might offer asymmetric upside should the theme(s) or market opportunity become more widely accepted by market participants. In addition, investors might also consider concentrated strategies with a significant active ownership (voting and engagement) focus within this allocation, with the aim of introducing “engagement alpha” as a return driver into the equity portfolio. Investing in niche strategies and having an opportunistic allocation require a robust governance framework to enable the effective identification of such opportunities.

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## WHAT ACTION CAN I TAKE?

Investors looking to ensure that their equity portfolio remains fit for purpose should consider the following actions:

- Based on your objectives, risk tolerance, and investment beliefs, determine which return drivers you would want to have exposure to in your equity portfolio.
- Seek to understand the magnitude of any style biases running through your existing equity portfolio and consider the extent to which sustainability/ESG factors are reflected in the portfolio.
- Be aware of the range of strategies (from systematic to unconstrained active) available to help address any excessive concentrations or gaps in exposure following an analysis of your existing portfolio.
- Ensure that your governance arrangements allow you to monitor the nature and magnitude of the style, ESG, and other biases running through your portfolio over time.

We make use of both quantitative analytic tools and qualitative insight to help our clients address these issues. Your Mercer consultant would be happy to discuss how these ideas might be relevant to your portfolio.

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**Phil Edwards** is the European director of Strategic Research within Mercer's Investments business, with responsibility for developing intellectual capital on portfolio construction, asset class views, and key investment themes. Phil sits on the Global Strategic Research Committee, which has responsibility for driving Mercer's research agenda and bringing new ideas to Mercer's client base.

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Matt Reckamp  
(St. Louis)

# BOUTIQUE FIRMS AND NICHE STRATEGIES — PART TWO

This paper is the second in a two-part series discussing boutique investment firms and niche investment strategies. In the first installment, we set the scene by discussing what is meant by these terms and the various ways in which they might be identified or defined. We concluded by saying that Mercer embraces boutique firms and niche strategies, as well as larger firms and mainstream strategies. Each can have their place in a client's line-up. We now turn our attention to the risks that should be considered before investing in either a boutique firm or a niche strategy.

## RISKS AND CONSIDERATIONS

### Boutique Firms and Niche Strategies

Let's start with the higher-level discussion of boutique investment firms, as opposed to niche strategies, by first identifying the most commonly cited positive elements of a boutique relative to a larger organization. Keep in mind that that these arguments certainly don't pertain to every boutique firm, but they tend to be directionally correct and reflective of many such firms.

1. **OWNERSHIP AND ALIGNMENT.** Boutiques are generally owner-managed firms, meaning they have "skin in the game" and the long-term interests of investment decision-makers and clients are aligned. This alignment is enhanced when ownership is broadly dispersed among employees rather than just a few people and the firm's decision-makers are meaningfully invested alongside clients.
2. **FOCUS.** Many portfolio managers want to focus solely on managing money, without the potential distractions that may accompany a firm of more substantial size, while still participating in the resulting economics. Consequently, certain high-quality investment professionals may be attracted to the boutique structure, in which the day-to-day working circumstances are consistent with these preferences.
3. **ACCOUNTABILITY AND TIMELINESS.** Given that boutiques typically have fewer employees, and likewise fewer decision-makers, there is arguably less bureaucracy than in a larger firm. Research and decision-making (by analysts and portfolio managers) are likely to be more intertwined in a boutique, which

*continued*

can lead to a higher level of accountability, as contributors are more directly tied to the success of specific products. It is also reasonable to argue that with fewer key players, decisions can be reached in a more timely manner.

4. **DISECONOMIES OF SCALE.** Typically, boutique firms will be committed to a relatively lower level of assets across fewer strategies and are prepared to manage a smaller business. With a limited asset size, boutiques are less hampered by liquidity constraints and can better take full advantage of investment ideas. By avoiding a proliferation of offerings, boutiques can lessen the risk of split focus, dilution of ideas, and orphaned strategies. Finally, boutiques generally avoid the allegation of having an asset-gathering mentality (often viewed as a negative), given the perceived tradeoff between asset size and investment performance.
5. **ACCESS AND TRANSPARENCY.** From a manager research perspective, it is true that reviewing a boutique firm is more straightforward than it is for a conglomerate firm; it typically has fewer moving parts to understand. Moreover, the manager researcher is likely to have better access to, and develop better insights from interacting with, key decision-makers. Boutique firms also tend to be more willing to share proprietary information than firms with a more restrictive culture. All of these elements allow for the development of a deeper understanding than might be achievable with a firm of greater size and complexity.

Conversely, there are multiple potentially negative elements (that is, risks) to a boutique firm when compared to a larger organization. Here are some of the most common arguments.

1. **RESOURCES.** Smaller firms, by default, tend to have smaller budgets, which can lead to fewer and perhaps lesser resources in terms of the depth of research coverage and advanced technologies (for example, sophisticated trading systems). With more resources, larger firms can also have larger compliance functions, more robust infrastructures, and better segregation of operational duties. While having fewer resources may be appropriate for some processes, it can also mean a lack of sounding boards, differing perspectives, and relevant experiences from which to make more informed investment decisions.
2. **SUCCESSION PLANNING.** Compared to a larger firm, boutiques can be challenged when preparing for and executing an intergenerational change in leadership, in which a key person risk is more concentrated and ownership transfer is involved. Even when such a change is properly communicated and understood by the investment community, it can represent a major distraction over an extended period of time. This challenge is often cited as a reason for boutique firms selling their business to fund aggregators. Also, boutique firms tend to be more materially impacted (although larger firms are certainly not immune) by the unexpected departure of just one key individual. Alternately, larger firms may be better equipped to weather personnel storms, as the depth and breadth of the team are more pronounced.
3. **EXTERNAL NETWORKS AND ACCESS.** Outside contacts can be a differentiating element in terms of generating valuable investment ideas, and boutique firms may have to be more proactive and creative than larger firms in building networks. Also, large firms can use their size and reputation as an advantage in terms of

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gaining better access to management teams. They are also more likely to have access to external economic forecasts and industry specialists. These networks can help provide a more robust data set in framing investment decisions.

4. **BUSINESS VIABILITY.** A boutique firm might find itself reliant on an individual investment strategy or asset class (or maybe even a few major clients) that, if out of favor for a period of time, can compromise the entire firm or, at the very least, prompt it to cut expenditures. Furthermore, from a financial perspective, boutique firms may be more likely to have debt finance burdens and narrower bottom lines, as reinvestment to support growth tends to be a financial priority. Consequently, ongoing viability is generally an area of focus and/or preoccupation for a boutique firm, especially in the absence of growth opportunities (or an advancing market environment).
5. **DISTRACTIONS.** Boutique firms have the freedom of full discretion for all business decisions, but that comes with the ultimate responsibilities of creating an appropriate culture of performance, providing proper incentives to attract and retain talent, remaining diligent on compliance issues, keeping current with technologies, and other critical business initiatives. So while boutique investment professionals may avoid the distractions that accompany large company life (for example, being part of time-consuming committees), they often wear multiple functional hats at a boutique which can be equally time consuming, even when certain functions are outsourced.

## NICHE STRATEGIES

Now let's turn our attention to niche strategies and consider some of their inherent risks. They can, in many ways, be viewed as the opposite of a passive investment in an S&P 500 or MSCI World Index fund. Such an investment, almost by definition, has a market beta, is diversified, has very low transaction costs and management fees, remains fully invested, and more or less delivers the performance of an underlying benchmark. Contrarily, niche strategies may not reflect a market beta, typically have higher management fees, offer differing levels of diversification, and can disappoint or delight the investor with differentiated returns. In short, niche strategies are littered with elements of risk (in this case, generally viewed from a tracking-error perspective) but also present opportunities that make them interesting and possibly worth pursuing to provide diversification with other strategies and/or increase alpha potential.

Some niche strategies are unproven. They may represent an opportunity in a relatively new asset class (for example, frontier market equities) or an innovative way to structure a portfolio in a long-standing asset class (for example, portfolios of exchange traded funds). Other niche strategies are unproven because it wasn't until some recent event (for example, bank deleveraging as a result of the financial crisis) that gave rise to the opportunity. This is arguably most prevalent in the hedge fund space, where specific disruptions often develop into the next event-driven trading opportunity — sometimes in previously esoteric market segments.

“Niche strategies are littered with elements of risk ... but also present opportunities that make them interesting and possibly worth pursuing ... ”

*continued*



Liquidity risk is present in many niche strategies. In some cases, the strategy's success hinges on capturing an illiquidity risk premium; in other cases, illiquidity is simply a structural cost of investing. Many alternative investments (for example, private equity or private real assets) may be considered niche strategies, at least in part, because of their liquidity profiles. Other alternative investments (such as hedge funds) have the ability to limit liquidity if deemed to be in the best interest of investors (usually during periods of stress). For this reason, they could also be considered niche investments. Liquidity risk can also arise from investing in a thinly traded market, as is the case with certain niche equity and fixed income segments.

Investments that are considered niche strategies because of a narrowly defined market segment (for example, an energy sector fund, a European high-yield credit strategy, or an Australian infrastructure fund) will likely cause a client to be invested differently than its peers. This can be negative if the selected segment underperforms the rest of the market as a whole. These types of investments, which may not necessarily be all-weather components of a portfolio, also carry an element of market-timing risk. A practical impediment to some of these more nuanced investments — that often reveals itself as performance risk — is the lack of a truly representative index for relevant comparison purposes.

Perhaps the most common risk inherent in niche strategies is active management risk. Active risk results from a variety of investment decisions that cause a portfolio to deviate, usually intentionally, from a benchmark. These might include an absolute return (as opposed to relative return) mindset, an opportunistic approach, the selection of a highly concentrated portfolio of best ideas, an explicit overweight or underweight in certain market segments (such as sector or industry, country or region, credit quality bucket), or the absence of any mandated index relative constraints (for example, tracking error limit or index constituent requirement). A high level of active share is often indicative of an equity portfolio with high conviction and high active management risk. With an actively managed portfolio, security selection can — and, in fact, is usually intended to — dominate its return profile. Obviously, this can work for or against a strategy in the short term, but over longer periods investment skill (or a lack thereof) should reveal itself for an actively managed niche strategy.

## CONCLUSION

Boutique firms and niche strategies, whose qualifying elements are diverse and multi-dimensional, have the potential to deliver superior returns and heightened diversification. However, they come with certain risks that are more acute than with larger firms and mainstream strategies. We recognize these tradeoffs and maintain the view that there are many ways to manage money successfully. While we evaluate the strengths and weaknesses of each individual firm/strategy on its own merits, we do believe that boutiques and niche strategies can provide clients, particularly those who are prepared to be early adopters of interesting strategies, with compelling long-term opportunities.

“Boutique firms and niche strategies, whose qualifying elements are diverse and multi-dimensional, have the potential to deliver superior returns and heightened diversification.”

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Mercer embraces investment boutiques and niche strategies alike. That is not to say that we shun larger firms or more mainstream investment strategies, but we recognize the potential benefits — and risks — inherent in utilizing a lesser-known investment manager or a nuanced investment strategy. Consequently, our universe of recommended firms and strategies is appropriately very diverse and populated with investment options of many hues.

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**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.

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# POSTCARDS ... FROM SINGAPORE

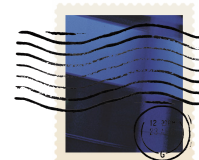


Asia has been a favored location for equity investors for many years, either as a standalone allocation or as part of a global emerging market equity allocation. However, the fixed income markets of the region have largely been a sleepy backwater that tended to miss the attention. Since the global financial crisis in 2008, this has changed and Asia has seen growth in both size and investor interest in the region's fixed income market. This was the backdrop to your intrepid researcher being transferred to Singapore in early 2012 to help ensure that Mercer would be at the forefront of covering this market.

The Asian bond market is dominated by local currency government debt that has grown steadily over the years. Unlike many other markets, where government debt has risen to precarious levels, the Asian economy has also been growing, so the debt-to-GDP ratio still looks very healthy in most countries. This is not the case in most developed markets, where rising government debt has unfortunately been coupled with low or stagnant GDP growth. Consequently, Asian bond markets look more attractive to foreign investors.

In addition to local-currency government debt, we have also seen explosive growth in the US dollar (USD) denominated corporate credit markets in Asia, with many companies in the region diversifying their funding by issuing bonds. Traditionally, Asia was a place where the vast majority of companies looked toward the banks to fund their activities. However, with many European banks cutting back in the region after 2008 and Asian banks having to shore up their capital adequacy, companies have looked to new funding sources. Having been reliant on bank lending meant that most companies had short-term loans that were dependent on bank extension. By issuing bonds, these companies secured more reliable longer-term financing, giving more flexibility to their balance sheets.

This led to rapid growth in the USD corporate credit market in Asia. From 2008 to 2014, it grew by well over 250%. At the



same time, this large issuance did not result in a wave of defaults in Asia because many companies simply replaced bank debt with bond financing and total leverage did not rise as much as the growth in the bond market would suggest. Even if a cyclical downturn were to occur, the secular trend of growing Asian bond markets looks set to continue.

No discussion of the Asian debt markets would be complete without mentioning the proverbial elephant, or in this case, the dragon in the room. China is now a very large bond market. Thus far, capital controls have largely stopped foreign investors from buying bonds in mainland China. It is estimated that only around 2% of the market is owned by foreigners. If China were included in the world government bond index, it would represent around 10% of the index. In 1997, there were no corporate bonds in China, and currently the onshore corporate bond market in China is larger than the US high-yield market.

How quickly the Chinese open the market to foreign investors is unknown, but that is presumed to be the ultimate end-game for the government. Already China is having a big impact in the USD corporate market, as Chinese companies are now the largest component in the Asian index. Although setbacks may develop along the way and the market has yet to mature, China will play an increasingly large role in the world bond markets.

Standalone Asian bond mandates may not suit all client portfolios, but Asia will likely still have an impact. Whether in a sovereign emerging debt mandate, an emerging credit mandate, or simply as an off-benchmark position in a broad mandate, many managers are buying into Asia. As China opens its doors to outside investors and Asian growth continues to outpace more developed markets, bond investors will no longer be able to ignore this region.

Martyn Simpson

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Martyn Simpson is a principal within Mercer's Manager Research team, which sits within Mercer's investment consulting business. Located in Singapore, he is primarily responsible for researching Asian fixed income strategies.

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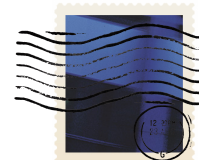
# POSTCARDS ... FROM GENEVA



I have come to Geneva for two very different meetings — one with a small manager that has a macro trading strategy and the other with a large established hedge fund that has many billions under management. I traveled yesterday so that I could have a full day for my meetings here.

Central Geneva is small enough to be walkable, so, armed with my map, I made my way across the river to my first meeting, pulling my red overnight case behind me. I didn't expect the roads to be quite as cobbled or such a steep hill but managed to find the place without too much trouble. Although the building itself looked quite functional, the offices were smartly furnished and clearly somewhere that you could invite wealthy clients.

My meeting took longer than expected because I spent time trying to understand the structure of the business before meeting with the trader who managed the strategy I was covering. He was very engaging and enthusiastic about describing the way he traded and his current views, although he didn't seem experienced with speaking to consultants and it took time to get specific answers to questions about how the strategy was managed. The track record is longer than five years and performance has been very strong, but it was only in response to a question about a particularly bad month that I discovered it had been co-managed for the first couple of years. I was told that the other trader had left after that very bad month. It also wasn't apparent that the trader didn't work in the Geneva office until I was taken on an office tour and asked where his assistant sat. So while it was quite an interesting meeting, it left me feeling I would need to do more digging before I could get comfortable recommending this manager to clients.



Then I got my map out again and went back over the river to my second meeting. At least it was downhill this time.

This meeting was held in a rather plain office block. Inside, once again, it was quite different and modern. The meeting was held on the top floor, with a view spanning over the rooftops. This manager is one that we have followed for some years and where a number of Mercer clients are invested. I had provided the business update by phone yesterday so I could concentrate on the three traders that I was meeting in person. They each have different trading mandates and also head specialist teams. We discussed how the teams are structured and how recent markets had impacted performance. They have found it difficult over the past few years to manage a strategy based on fundamental economic analysis, as prices have been dominated by central bank policy and quantitative easing. However, they expect that the increasingly divergent economic outlook will start to be reflected in markets and provide more opportunity to trade successfully. They are already seeing this come through in better recent performance. So all in all, I was reassured by the depth of research and the quality of insights, which I saw as supporting my positive view of the manager. If markets do start to focus on fundamentals again, I would expect clients to see improved results after a period of dull returns.

I'm just on my way to airport now to catch my plane home, so I thought I would send a postcard.

Diane Miller

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**Dianne Miller** is a principal and member of the Manager Research team, which sits within Mercer's investment consulting business. Located in London, she is lead researcher for managed futures and also researches global macro, currency, UK equity, and UK small cap. Diane sits on the Global Macro and UK Ratings Review Committees.

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# ILLIQUID INVESTING



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We believe there is a place for illiquid assets within many institutional investors' portfolios, even in situations where this may not be immediately clear. In fact, a well-structured illiquid portfolio can help meet liquidity needs in the long term, as the cash flow from these assets (which are not reinvested) can be used to meet required obligations.

It is generally accepted that there is a potential return premium available for holding illiquid assets, and for investors who are able to tolerate illiquidity, harnessing this premium can enhance returns. In addition, many illiquid assets have a low correlation to equities and credit and can offer higher and more predictable cash yields.

A large number of institutional investors, including pension funds, insurers, and endowments, should, in principle, be well positioned to take advantage of the performance enhancement potential offered by illiquid assets due to the fact that they are typically long-term investors.

Many such investors recognize this fact but do not fully capture the portfolio benefits offered by illiquid assets, as they are unsure how much illiquidity they can afford to accommodate in their portfolios.

## WHAT IS LIQUIDITY?

Liquidity when selling an asset can be defined as the ability to trade an asset quickly while receiving a fair market value for the asset. Liquidity will vary across and within asset classes and is, mainly, a factor of the size of the secondary market for that asset and market sentiment. Generally, the larger, deeper, and more active the pool of secondary buyers and sellers, the greater the liquidity of the asset class. The less active and developed the secondary market, the less likely it is that the true fair market value of an asset will be received at any one point in time, due to higher than average transaction costs, low demand, or negative market sentiment.

It is generally accepted that privately traded assets tend to be less liquid than publicly traded assets.

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## DEFINING ILLIQUID ASSETS

Given the liquidity of asset classes is likely to change over time, it is impossible to categorize asset classes into those that are clearly and consistently liquid and those that are illiquid. However, asset classes sit on a liquidity spectrum, and it is possible to identify those that are relatively more liquid (for example, listed equity) than others (for example, private equity). Some funds clearly have a closed-ended structure, which means that an investor's assets will be tied up for the term of the investment. Opportunities may exist to sell these investments to others through the secondary market, but this is not guaranteed. Some of these funds may have lives of 10–15 years or longer. However, we would not expect liquidity restrictions to exceed 15 years for the vast majority of illiquid offerings in the market.

Generally, we believe that in order to benefit from an illiquidity premium, investors must consider asset classes with a multi-year holding period (at least five years, but ideally 10 or more). These include assets such as:

- Infrastructure debt/unlisted infrastructure equity.
- Private equity.
- Private debt.
- Certain real estate funds.
- Timberland, agriculture, and natural resources strategies.

## THE RATIONALE FOR ILLIQUID ASSETS

Investing in less-liquid assets offers the potential to harvest premia unavailable from more frequently traded investments of a similar risk profile, harness alternative sources of return, and achieve diversification away from traditional sources of market risk.

Many academic and institutional studies have attempted to quantify the size of the illiquidity premia. Existing estimates range from around 0.50%–0.75% for assets such as senior infrastructure debt to around 3% for assets further up the risk spectrum, such as private equity. Illiquid assets also provide exposure to other sources of growth that are not directly correlated with other drivers of returns within traditional asset classes.

For example, private equity managers typically invest in small and medium enterprises, which provide exposure to the size factor. Many managers base entry and exit points for investments on valuation multiples such as EV/EBITDA, and, as a result, they also provide consistent exposure to the value premium. Finally, private equity managers often fund part of their investment through bank borrowing, and when lending conditions unexpectedly improve (for example, due to central bank easing or financial innovation), managers are able to refinance their loans at more favorable terms and thereby leverage the total return to equity investors — this has been another source of excess returns historically. While we used private equity as one example, the broader message is that a carefully constructed portfolio of illiquid assets can significantly improve the risk/return profile of the total portfolio by adding exposure to risk factors that we expect to enhance returns over the long term. An important note is that we have developed tools (such as the Growth Portfolio Toolkit) that help investors analyze and understand the impact of these factors on their overall assets.

“Generally, we believe that in order to benefit from an illiquidity premium, investors must consider asset classes with a multi-year holding period.”

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Our research shows empirical and theoretical justification for the existence of illiquidity and other risk premia within private investments, such as infrastructure, private debt, real estate, and others. Both the prospective and realized sizes of these different premia vary over time, so being strategically diversified across them is the key to successful long-term investing.

The application of manager skill to the asset held is potentially significant for illiquid assets. For example, a property can be refurbished, updated, re-let on better terms, made more energy efficient, and so on. These are all sources of value added that are more readily accessible to the holder of such asset in an illiquid format.

Similarly, our research illustrates that the differential drivers of return associated with underlying assets in less-liquid investment sectors, such as infrastructure, private equity, and some areas of real estate, can deliver meaningful diversification benefits to a portfolio otherwise comprising more traditional financial risk assets.

### FACTORS TO CONSIDER WHEN ASSESSING TOLERANCE FOR ILLIQUID ASSETS

In order to understand an investors' tolerance for illiquidity, one needs to ask a range of questions — such as the following:

- What is the (net) liquidity profile of the investor as things stand, given known and projected sources and uses under a central case?
- What is the range of potential outcomes around this central case, and how likely are these to occur in practice?
- Is the investor contemplating structural changes in the foreseeable future that could give rise to meaningful liquidity requirements? (For example, bulk transfers in the context of a defined benefit pension fund.)
- How would this change in times of market stress?

### AN ANALYTICAL FRAMEWORK AND ILLUSTRATIVE EXAMPLE

Mercer has developed an analytical framework that seeks to examine an investor's tolerance for varying potential allocations to illiquid assets under a range of possible market outcomes. We illustrate this in what follows in the context of a hypothetical defined benefit pension fund. However, the broad framework can be adapted readily to accommodate other investor types.

#### Summary

Our approach centers around analyzing how an investor's asset allocation may change over time as a result of allocating to illiquid assets. This approach has been used on the premise that a key drawback for many investors of investing in illiquid asset classes is the likely distortion of the strategic asset allocation in years to come. Our conclusion is essentially that due to the expected cash flow from a well-structured illiquid portfolio, the relative size of the allocation to illiquid assets is expected to shrink over time if no new illiquid investments are made. However, critically, this depends on the proportion of the total return from illiquid assets that is delivered through yield (rather than capital growth) and the degree to which illiquid assets outperform (or otherwise) other asset classes over time.

“The application of manager skill to the asset held is potentially significant for illiquid assets.”

*continued*

We have made a number of assumptions in support of the analysis, which are available on request.

**Cashflow Analysis**

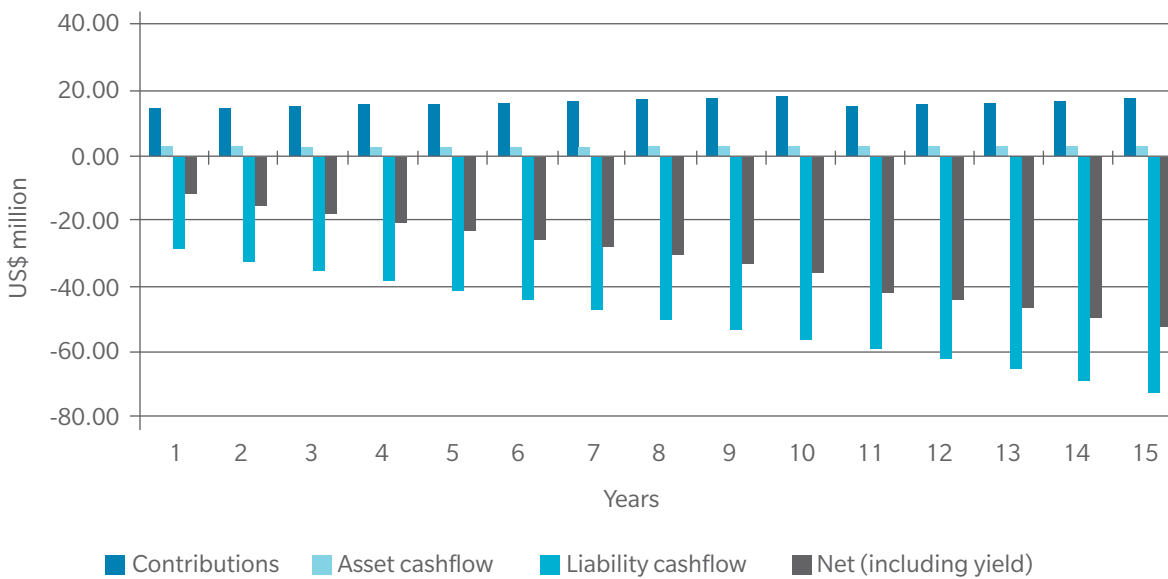
In determining the fund’s liquidity tolerance, the first step should be to realize the cash required to meet pension payments in the future. This can then be compared to the income expected from contributions and investment income.

Comparing these will help trustees understand whether a scheme is currently receiving more in income than it needs to pay out (it is “cashflow positive”) or whether the reverse is true (it is “cashflow negative”). While a scheme is cashflow positive, it can accept significant amounts of illiquidity, as there is no need to divest assets to meet payments. Understanding when a scheme changes from being cashflow positive to negative, and the factors that can drive this, is important. At that point, the trustees will need to sell assets on a regular basis to meet cashflow requirements, and it is important to ensure that there are sufficient liquid assets to facilitate this.

As shown below, our sample scheme is already cashflow negative.

FIGURE 1

## Cashflow Analysis for Sample Scheme



*continued*

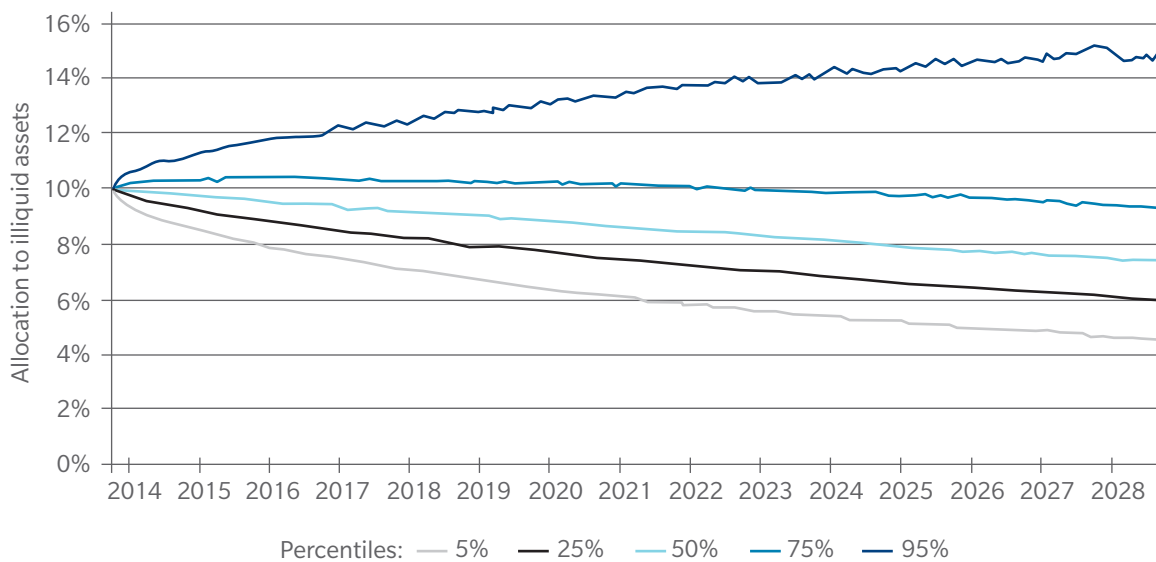


### Changing Allocation

The next chart shows the range of outcomes for the asset allocation over a 15-year timeframe for our sample scheme (starting with an initial allocation of 10% to illiquid assets). The light blue line shows the “expected” allocation to illiquid assets, whereas the dark blue line sets out the likely allocation in a 5% worst outcome (that is, when all other asset classes perform poorly relative to illiquid assets in the scheme). This helps to understand how large an allocation to illiquid assets could become.

FIGURE 2

## Asset Allocation Outcomes (Over 15 Years) for Sample Scheme



Notably, there is a clear downward trend for the expected allocation to illiquid assets, even taking into account the disinvestments needed from the liquid asset classes to meet future pension payments. This is due to the fact that a large proportion of the return achieved from the illiquid asset classes assumed in our analysis is paid out over time in the form of distributions. Clearly this will depend on the nature of the illiquid assets investments, but it should be possible for most schemes to design a portfolio that provides a meaningful cash yield.

Even in the worst 1% of outcomes (which are not shown in the chart), the final allocation to illiquid assets is about 28%, a sizeable but still manageable proportion of the total for many such schemes. This suggests that, even in extreme downside scenarios, the allocation to illiquid assets is still unlikely to grow to an unacceptable level if sized appropriately at the outset. We believe this scheme should therefore be comfortable with a 10% starting allocation to illiquid assets. In fact, depending on the trustees’ attitude toward illiquidity, a higher allocation could potentially be tolerated in this example.

*continued*

## CONCLUSION

A large number of institutional investors are inherently long-term investors who should be well placed to take advantage of the illiquidity premium and other portfolio enhancement potential inherent in illiquid assets. However, many investors are unsure how much illiquidity they can afford to take.

Using our analytical framework and tools, Mercer can assist investors in assessing their tolerance for illiquid assets. Our work to date in this area has shown that there is often greater scope to accommodate illiquid asset classes than may first be assumed by many such investors.



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**Toby Buscombe** is Mercer's global head of Infrastructure. He leads a team of specialists servicing major institutional investors around the world.

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Jelle Beenen  
(Amsterdam)

# Q&A WITH JELLE BEENEN

**Q: What was the attraction of accepting the role of global head of Alternatives Research?**

A: The global character of the role was quite appealing. In this role I feel the attractions of Mercer as an international firm more than in my previous role as business leader for the Benelux. I am working with all markets and regions and many client segments: defined benefit pension funds, defined contribution plans, endowments and foundations, fiduciary clients, wealth management clients, and subscribers to our Global Investment Manager Database (GIMD™). Focusing on alternative investments is also an attractive feature. It feels like coming back. Before I joined Mercer, I was head of Alternatives for a very large pension fund in the Netherlands, PGGM. Last but not least, it is an honor to lead a diversified group of about 45 very talented specialists spread over all regions.

**Q: What role do alternatives play in portfolios?**

A: The past decade has seen significant changes in asset allocation, particularly for pension funds. There has been a strong trend to diversify and move away from traditional public equities and bonds into alternatives. The key driver has been the desire to create portfolios with better risk/return profiles by exploiting the potential of alternative strategies.

The term “alternatives” entails a wide spectrum of investments that vary greatly in character, from liquid hedge funds employing short-term, high-frequency trading to long-term illiquid investments, such as, for instance, a sustainable energy infrastructure project. The wide range of alternative investments forces an investor to think harder about what they really want to achieve with their particular investment portfolios. For some, alternatives will provide much needed diversification; for others they deliver long-term return enhancement; and still for others, alternatives help to get exposure to a certain theme (like sustainability or inflation).

What alternative investments have in common, though, is the ability to provide investors with exposure to other risk factors and return drivers than equities and bonds. Alternatives provide investors the potential to customize their portfolio more to their own specific needs and preferences. Typically, equities and bonds are the main engines of a portfolio, but the alternatives allocation gives a portfolio a personal, unique signature.

*continued*

I strongly believe it is important for every investor to consider alternatives — it raises awareness. Even if you end up not allocating to alternatives, the exercise will make you more aware of the character of your portfolio and to what extent that matches your aims and philosophy.

**Q: What is your view on some high-profile investors who have eliminated hedge funds from their asset allocations?**

A: As explained in the previous answer, an investor-specific analysis is important, as different alternatives provide very different features. The appropriate asset allocation is a client-specific decision, based on the specific circumstances of each, to achieve the optimal mix of asset classes to maximize the risk/reward trade-off of the total portfolio. In Mercer's view, a thoughtfully implemented hedge fund program can play a role in maximizing a portfolio's risk-adjusted return. However, given their semi-liquid nature, complexity, and general opacity, hedge funds are not suitable for all investors. Furthermore, as hedge funds are not an asset class, per se, performance will be dictated by manager selection — as well as the risks one chooses to accept and those one seeks to avoid. Our experience has been that a prudently constructed hedge fund program, designed to diversify and complement the risks that dominate the traditional portfolio, has been accretive to risk-adjusted performance over market cycles, net of all fees.

If it turns out that an alternatives allocation is not “fitting,” one should reconsider. In one recent situation, a high-profile investor decided not to allocate to hedge funds any more, for certain specific reasons — one being the investor's very large asset size. That this move triggered some much smaller investors to do the same doesn't seem to make much sense. Investors have to look at their situation and make their own decisions.

**Q: So what about liquid alternatives — for example, daily-dealing mutual funds?**

A: The liquid alternatives market is growing rapidly. We have some institutional investors and a growing client base focused on individual investors (including wealth management and defined contribution pension plans) who are forced to consider strategies in this space. While our preference would always be for clients to make use of the broadest possible universe of hedge funds, for some this is not a practical option.

Investors need to be aware that, by selecting managers from within the liquid alternatives universe, they may be constraining themselves in terms of manager talent, missing out on the hedge fund illiquidity premia and also leaving themselves vulnerable to higher costs. Nevertheless, we believe that we can recommend many interesting hedge fund strategies for investors that need to allocate in this way. Constraints trigger innovation and new products are developed. We are expanding our coverage in this area. We recently created specific strategy groups in our GIMD database specifically for investors looking at liquid alternatives.

“In Mercer's view, a thoughtfully implemented hedge fund program can play a role in maximizing a portfolio's risk-adjusted return.”

*continued*

**Q: At the other end of the spectrum, what are the attractions of illiquid private market strategies?**

A: For investors who can tolerate illiquidity, we believe that some private market strategies have compelling attributes. They profit from the fact that not all investors can tolerate illiquidity. In our view, many of our clients can afford more illiquidity in their portfolio than they currently have. Obviously, liquidity is an important risk management consideration, but being 100% liquid is not necessarily the optimal portfolio.

Private equity strategies — such as buyouts, venture capital, and distressed debt — can improve returns relative to public markets and provide access to new sources of alpha. In addition, dislocations and a reduction in bank lending have created a compelling opportunity in private debt for corporate, real estate, and infrastructure assets. Real assets such as real estate, natural resources, and infrastructure can provide diversification and generate income, and some are inflation-sensitive exposure.

We expect growth in illiquid investments for the coming years, driven by the search for return in a low-return environment and a reconsidering of liquidity policies. We are very excited about our acquisition of private markets specialist Strategic Capital Management in Zurich, which will help us cater to this growth.

**Q: And what about multi-asset solutions?**

A: Multi-asset strategies have seen a surge in popularity in recent years. Liquidity, simplicity, and relatively low fees have made them attractive components of defined contribution pension plans. They are also appealing to smaller institutional investors, for whom 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.

These advantages come at a cost, however, and manager concentration is one of them. Another important one is the extent to which the multi-asset strategy caters to the investor's specific needs. The suitability of any one type of fund will depend on its objectives, constraints, and the manager's approach (as well as its capability and skill in implementing the strategy). Manager selection is very important in this space.

**Q: Finally, how should investors think about key person risk?**

A: Some individuals can be very important within an asset management organization, in terms of skill, culture, and business management. If such a key person were to leave the organization, this would impact the organization. In the end, most people can be replaced, but it can be a painful process. As an investor, you don't want to be the potential victim of that process, and you should be

“We expect growth in illiquid investments for the coming years, driven by the search for return in a low-return environment and reconsidering of liquidity policies.”

*continued*

Q&A WITH JELLE BEENEN *continued*

prepared to redeem, if necessary.

In our research process, we always look at key person risk and succession processes. For alternatives, this is even more important than in the traditional asset classes, because many alternative asset managers are relatively small organizations and skill-dependent.

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**Jelle Beenen** is Mercer's global head of Alternatives Research, responsible for strategic research and manager research in the area of alternative investments. He was the Investments business leader for the Benelux from 2010 to 2014. Before moving to the financial industry in 1997, Jelle worked as a mathematical physicist at Imperial College in London.

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Each boutique is staffed with professionals with research and consulting capabilities; conducts forward-looking, institutional-quality research on investment management products; and works closely with both internal and external clients on manager structuring and selection projects.

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- Due diligence on managers and strategies.
- Advice on portfolio structuring and development of portfolio pacing plans.
- Assistance with fee and mandate negotiation.
- Ongoing monitoring of investment managers and portfolios.

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- Performance reporting.
- Assistance with fee and mandate negotiation.
- Ongoing due diligence of investment managers and client portfolios.

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- Research on real estate investment trends and opportunities.
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