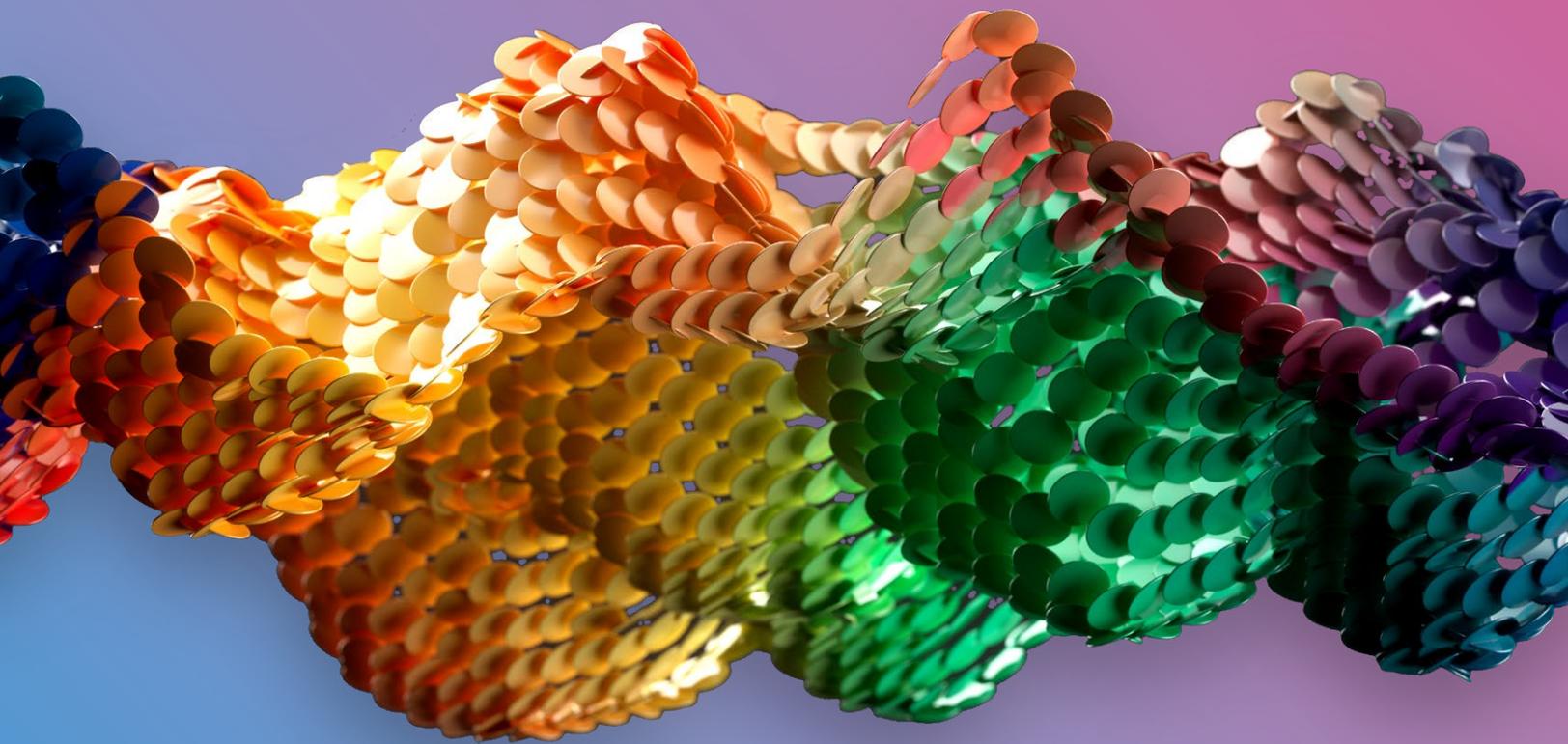


Top considerations for financial intermediaries in 2022



As the world slowly recovers from the shock of Covid-19, we are coming to terms with some fundamental shifts in the global investment landscape.

Traditional ideas relating to correlations between asset classes, and to the roles of asset classes in portfolios, are being challenged. Meanwhile, diversifying assets, such as private markets investments, have become more accessible to a wider range of investors. This has increased opportunities, but has also added complexity to the investment landscape and enhanced the need for specialized expertise in investment research.

Central banks around the world are grappling with the dilemma of inflation, which has re-emerged in the wake of the pandemic. While some inflation is expected during a recovery period, there is much debate as to how transitory this latest spike will be. This has raised the likelihood that inflation hedges will be more of a requirement in client portfolios.

China's rise as a global economic superpower was not thrown off course by the pandemic. Its influence in South-East Asia and beyond continues to grow. This should not be ignored by investors looking to build diversified portfolios.

Finally, important research and dire warnings from scientists and global organizations have focused investors' minds on the impacts of climate change on countries and their economies. Comprehensive action is needed to help ensure portfolios are protected against climate risks.

Advisors and their clients need to be adaptable to the challenges that lie ahead in the post-pandemic world.

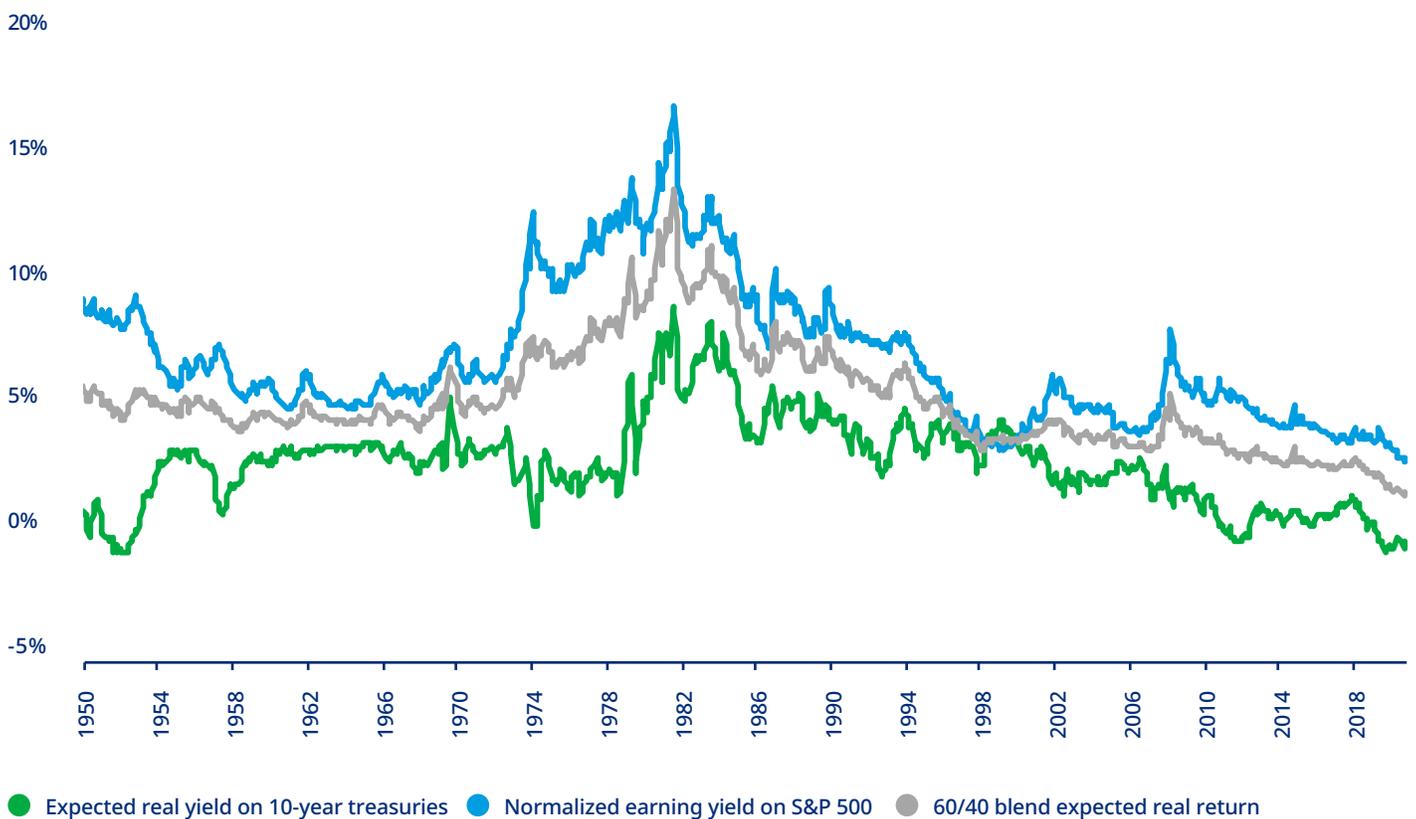
Mercer has identified five areas for advisors to consider — areas we believe are critical for long-term success.

1) Modernizing the 60/40 balanced portfolio

Following the global financial crisis, “traditional” balanced portfolios, made up of 60% equities and 40% fixed-income assets, outpaced more diversified portfolios. However, we believe that sustained low interest rates, inflationary pressures and high equity valuations will continue to reduce forward-looking return expectations for client portfolios. This means building forward looking analysis based on past stock/bond performance could be less conducive.

Given these challenges, advisors and their clients should consider adding investment exposure from outside the traditional framework, such as private equity, private debt and other diversifying alternatives strategies that add diversification. It should be recognized that including these asset classes can make portfolios more complex, and that it requires additional expertise in asset manager selection, portfolio management and overall due diligence.

Figure 1. Real expected returns on stocks and bonds



Source: S&P, Bloomberg, Mercer, as of September 2021

Considerations

Explore alternative investment strategies such as private equity and private debt. Over a market cycle, these can provide portfolios with additional sources of risk-adjusted returns.

Revisit clients' liquidity needs to identify appropriate levels of exposure to these alternative investment strategies, which are typically less liquid than traditional approaches.

Understand and discuss with clients the potential benefits and associated risks that alternative strategies may bring to a portfolio. Benefits may include increased returns. Risks may include lower liquidity, leverage, tax inefficiencies and higher fees.

Pursue the proper level of investment to help ensure that operational due diligence is incorporated within the manager research and selection process. This due diligence should be carried out by either a highly experienced internal team or by a trusted external firm.

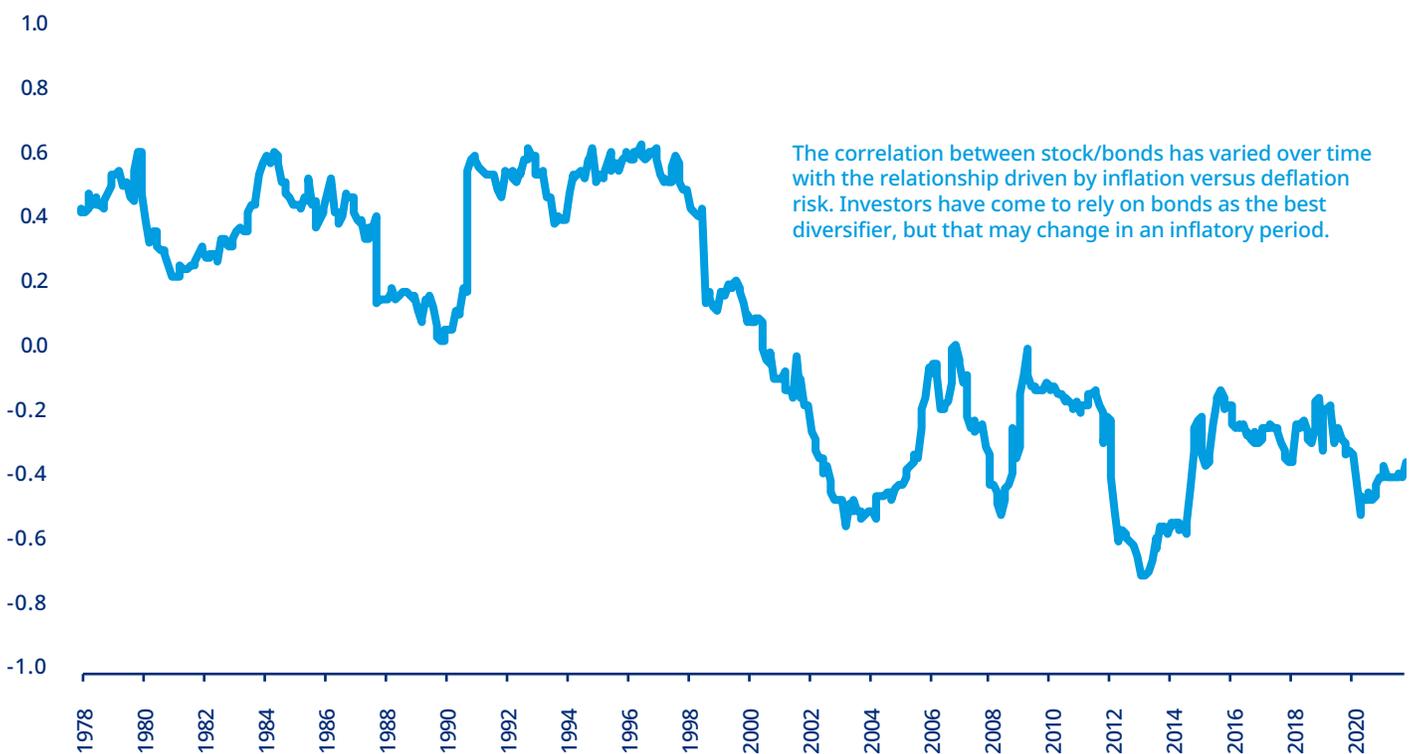


2) Fixed income breakdown: Correlation challenges and risk management

With global inflation on the rise, the possibility of higher interest rates is becoming more likely. Client portfolios may therefore be challenged if the historical diversification benefits of fixed-income allocations no longer hold true. Higher inflation and rising interest rates may have a negative impact on both equity and fixed-income

portfolios. The past few years have seen many investors sacrificing investment quality while seeking higher-yielding instruments. Moving forward, advisors need to be more mindful of the hidden risks involved in seeking yield, and should focus on the future role that fixed-income allocations could play in client portfolios.

Figure 2. Rolling 36-month correlation of stock and bonds



Source: Datastream, as of September 2021

Considerations

Establish a clear understanding of the role of fixed-income assets in client portfolios. Are they included for risk-reduction or income-generation purposes?

Consider whether the diversification benefits of holding fixed-income assets, particularly US Treasuries, still hold true under an inflationary scenario in which interest rates are rising.

Help to ensure that clients are aware of — and comfortable with — the risk involved in moving allocations to higher yielding but lower quality investments. Ask whether such a position is worth the potential loss risk if credit markets deteriorate.

Examine the suitability of other sources of income and yield. Consider distressed credit, taxable municipal bonds, preferred equities, real estate, including non-traded Real Estate Investment Trusts (REITs), high yield bonds and emerging market debt.

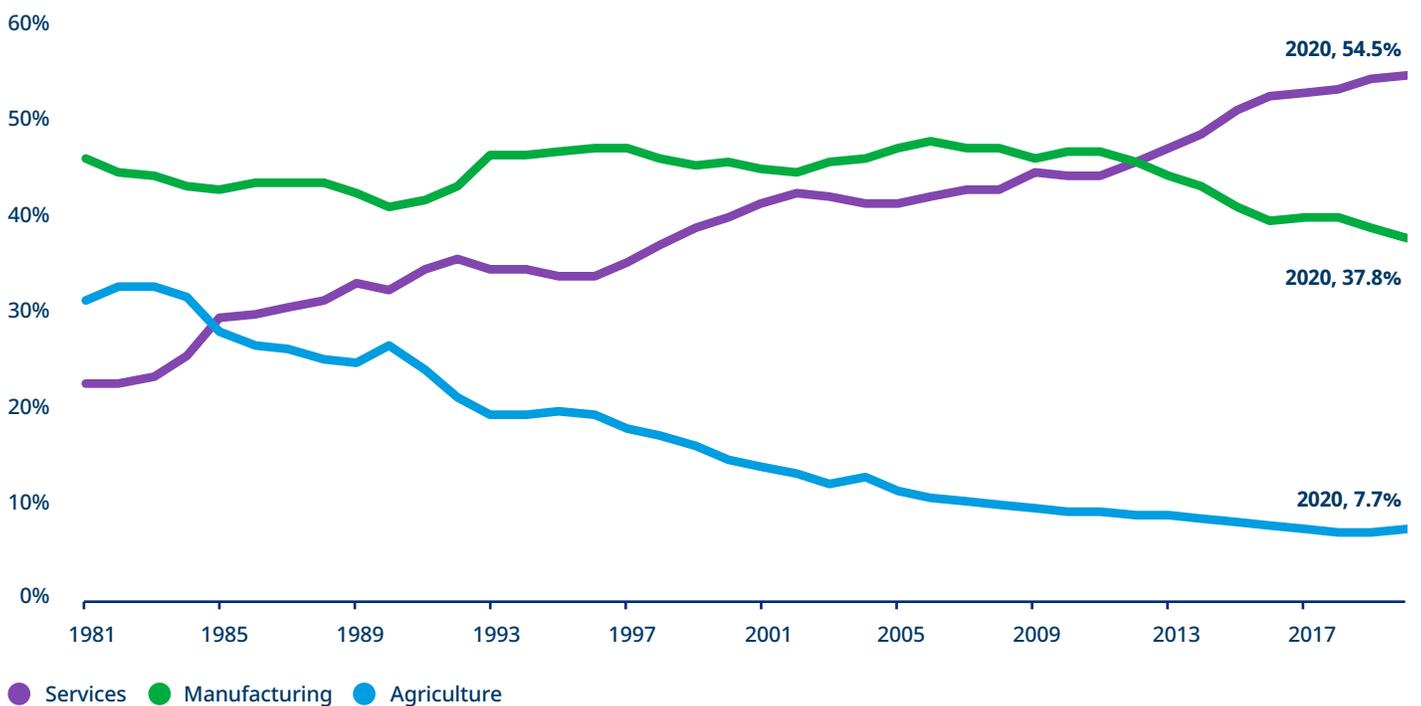


3) Emerging markets: Time for a dedicated China allocation?¹

China's rapidly diversifying and consumption-led economy is significantly under-represented in standard indices and in many investors' portfolios, including those with a broad allocation to emerging markets. For historical reasons, headline exposure to China in emerging market equity indices is heavily tilted toward offshore Chinese equities. This overlooks the fact that the future dynamics of China's

economy will be increasingly reflected in its onshore equity market (commonly referred to as China A-shares). China presents investors with a range of compelling opportunities. Given its scale and growing global influence, we believe it warrants dedicated strategic, risk-aware allocations in well-diversified portfolios.

Figure 3. Shift in drivers of China's GDP



Source: Bloomberg. Data as of the end December 2020.

¹ Mercer's China hub <https://www.mercer.com/our-thinking/wealth/investing-in-china.html>

Considerations

Evaluate the potential benefits and risks of a dedicated China allocation, and identify its appropriateness for client portfolios.

Seek high-conviction investment managers. Ask them to consider different approaches to implementing a broader China allocation in client portfolios (such as top-up or carve out).

Educate clients on the differences between offshore and onshore market exposure to China.

When adding an allocation to China A-shares, consider enhanced due diligence on both the choice of investment products and on the decisions made by asset managers.

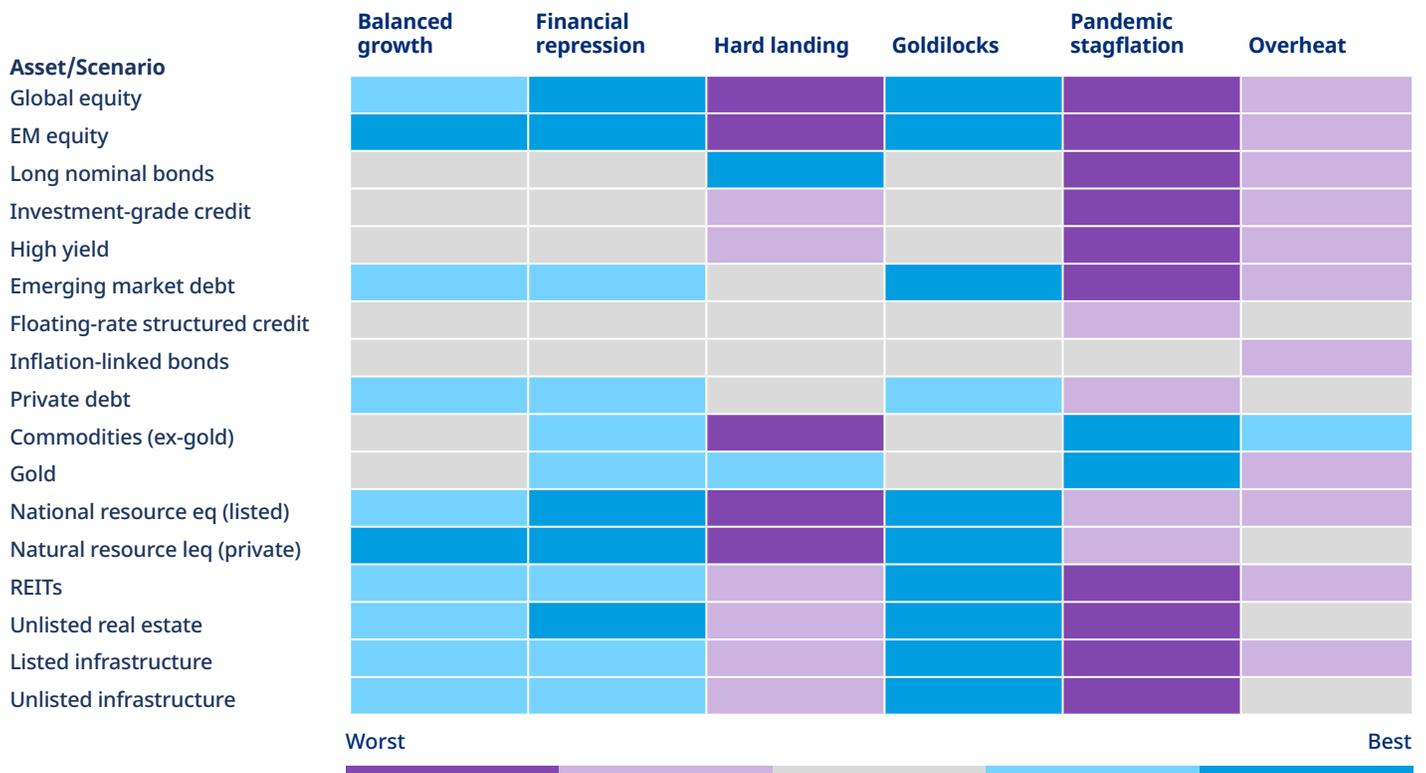


4) Preparing for higher inflation²

For the first time in a generation, investors need to seriously consider the impact of inflation. It has been on a gradual downward trend for almost 30 years — but this cannot last forever. Although some disinflationary pressures remain, several factors have shifted in the past 18 months: There has been a slowdown in globalization due to the Covid-19 pandemic, a change that has been coupled with large government spending programs and with central banks loosening their price-stability targets. It is not known whether 2021’s inflation surge is transitory. However, compared to the pre-pandemic period, the risk of

structurally higher inflation, and a more volatile inflationary environment, has increased. While the Federal Reserve, and other major central banks, believe the current rise in inflation is transitory and that inflation will fall back to normal levels, historically inflation has been difficult to predict. Moreover, the range of potential inflation scenarios in the future has increased. Given these factors, we believe scenario analysis that takes the risk of higher inflation into account is vital, as it can provide investors with crucial insight into the impact of inflation on various portfolio constructs.

Figure 4 – Asset class heat map



Economic scenario description

Balanced Growth: Economic growth and inflation moderate, consistent with consensus forecast.
Financial Repression: Strong growth and inflation, supported long term by low central bank rates, designed to reduce debt
Hard Landing: Growth slows sharply, as fiscal stimulus is reined in; deflation risk rises
Goldilocks: Robust growth, driven by productivity gains, which also keeps inflation low
Pandemic Stagflation: Pandemic stress re-emerges. Growth slows, but supply chains drive inflation.

Source: Mercer. Expected returns are hypothetical average returns of economic asset classes derived using Mercer's Capital Markets Assumptions. There can be no assurance that these returns can be achieved. Actual returns are likely to vary. Please see Important notices for further information on return expectations. Data as of June 30, 2021.

² Mercer's inflation hub. Available at: <https://www.mercer.com/our-thinking/wealth/inflation.html#hubs>

Considerations

Explore how client portfolios — particularly those with significant weighting towards equities and bonds — might perform in an environment with persistently high and volatile inflation.

Consider allocations to inflation-linked assets (e.g. some areas of infrastructure and real estate). These can act as an effective hedge against inflation and should perform better in scenarios where there is long-term inflation.

Investigate the suitability of other hedging assets, such as commodity-oriented strategies and gold. These may prove valuable additions to portfolios, as they can help in scenarios where there is stagflation.

Analyze potential exposures to floating-rate fixed-income assets. These may help in scenarios in which inflation is met with an aggressive rate response. They should also help protect against duration risk.

Seek to ensure portfolios are suitably balanced across a range of diversifying strategies. Use a blend of approaches that provide broad inflation protection across a number of different scenarios. This can be implemented internally or by buying in solutions (look for off-the-shelf inflation products designed to increase agility across sections).



5) The curation of sustainable investment solutions

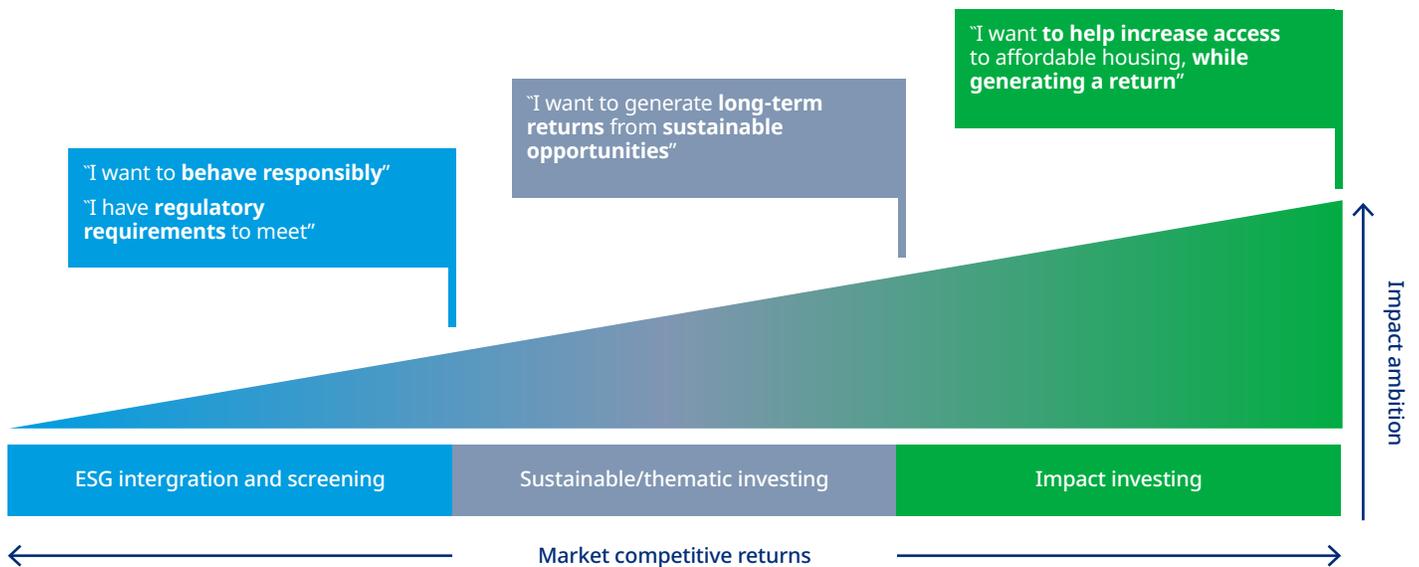
In recent years, demand for sustainable investment products has increased dramatically. This has been driven by a variety of regulatory and societal pressures. Environmental concerns and diversity, equity and inclusion (DEI) issues have become critical topics that are influencing corporate agendas. This means investors now have a wide range of new risks and opportunities to factor into their portfolio allocations.

The increasing significance of environmental, social and governance (ESG) factors means that the next decade may be a transformational period, as these criteria influence and change the world. Product manufacturers have already

responded with the rapid launch or restructuring of a vast range of ESG funds. This acceleration in supply presents investors with an additional challenge: distinguishing between products that genuinely integrate sustainable investing principles, and those that only demonstrate a superficial support.

Building sustainable investing policies at a firm level is important. Such policies can provide financial intermediaries with more robust governance frameworks, which can then help them make decisions on sustainable allocations. Flexible investment approaches can bring additional sources of return and help achieve better client outcomes.

Figure 5 – Spectrum of ESG, sustainability/thematic and impact investing



Source: Mercer, for illustrative purposes

Considerations

Establish firm-level sustainable investing beliefs to strengthen governance frameworks, differentiate intermediaries from competitors, and help guide clients into well-designed investment solutions.

Provide investors with an opportunity to enhance the value of companies and markets. This will help foster strong stewardship practices and realize long-term stakeholder value.

Take a broad, long-term perspective regarding investment analysis and decisions. This should include measuring carbon footprints and analyzing climate change scenarios and transition capacity. This can help to improve risk management and to identify new investment opportunities.

Commit to sustainable investment education and training for advisors. This could help them to establish a sustainable investing approach with their clients.

Research asset classes and strategies that showcase the potential performance-driven benefits of both companies and asset managers that adopt a sustainable investment approach. Research should include impact themes such as renewable energy, water and social housing.

Understand key implementation challenges and work to overcome them, so that you can action portfolio management decisions. Challenges may include data coverage, technology and reporting. They may also include perceptions of a lack of high-quality, sustainability-themed investment products.



Contact us

We welcome feedback and dialog with you and your organization as you plan for the upcoming year. Please reach out to your consultant or to any of our colleagues below.

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