THE LONG AND WINDING ROAD

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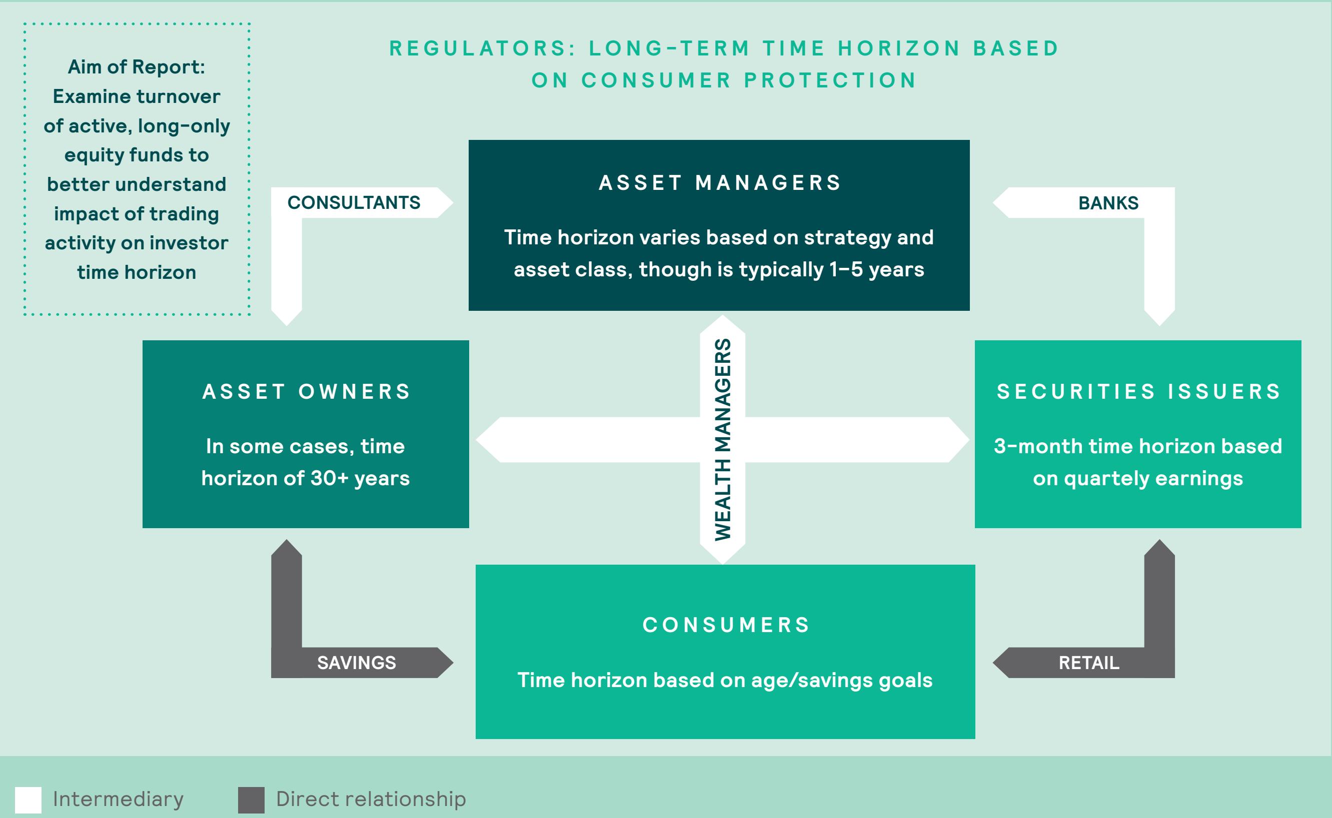
TRAGEDY OF THE HORIZON: TURNOVER LEVELS OF ACTIVE, LONG-ONLY EQUITY FUND MANAGERS

Mercer's report *The Long and Winding Road: How Long-Only Equity Managers Turn Over Their Portfolios Every 1.7 Years*[1] was produced as part of the "*Tragedy of the Horizon*" research,[2] which seeks to explore the potential for long-term suboptimal allocation of capital due to the finance sector's limited ability to capture long-term risks within short-term risk-assessment frameworks.

The report reveals that the turnover levels of active, long-only equity funds have decreased over time, but could be improved.

INVESTMENT MANAGEMENT 'VALUE CIRCLE'



[1] 2° Investing Initiative, Generation Foundation, Mercer. *The Long and Winding Road: How Long-Only Equity Managers Turn Over Their Portfolios Every 1.7 Years*, 2017, http://www.tragedyofthehorizon.com/The-Long-And-Winding-Road.pdf.

[2] 2° Investing Initiative. *Tragedy of the Horizon*, 2016, http://www.tragedyofthehorizon.com.

HIDDEN COSTS

Portfolio turnover is used as a proxy for often difficult to ascertain portfolio transactions costs and taxes. Transaction cost types vary in their traceability and magnitude depending on the characteristics of a given investment strategy but often can be as significant in aggregate as investment management fees according to a survey of industry research.

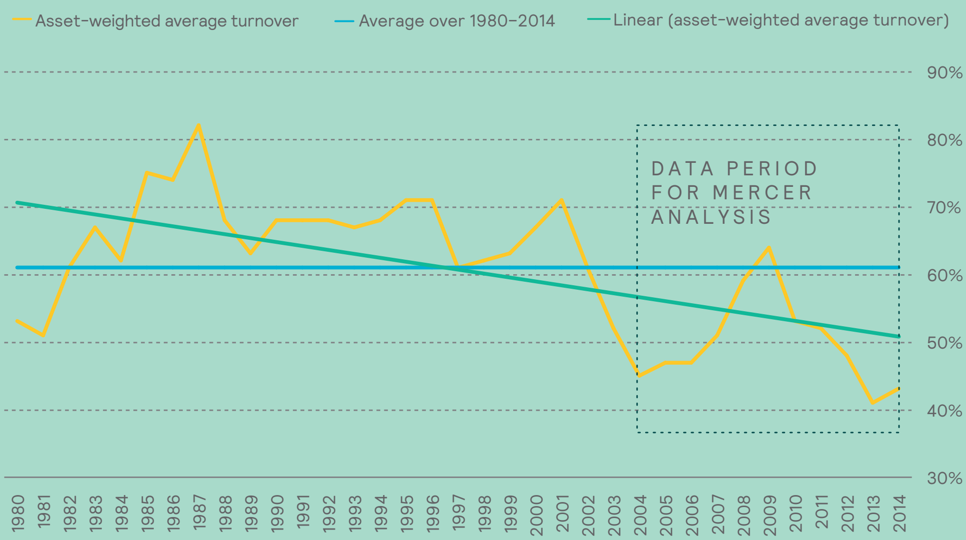
BROKERAGE COMMISSIONS

BID-ASK SPREADS

PRICE IMPACTS

TAXES

A SECULAR TREND



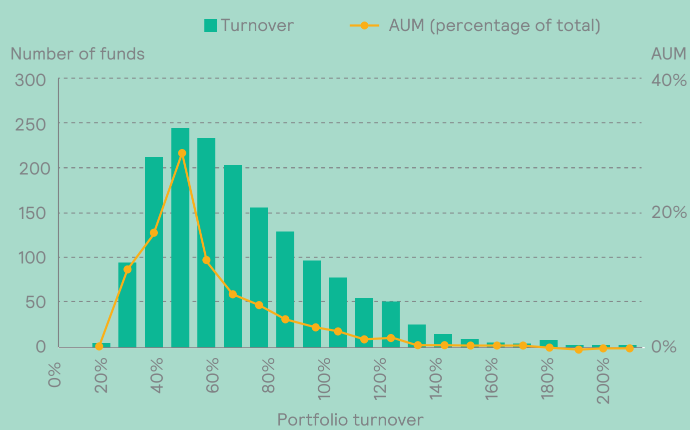
The portfolio turnover of professionally managed, long-only equity funds has been declining on average for decades despite rising overall stock market turnover during the same period.

Source: ICI Analysis, Mutual Funds Only, 2015

AVERAGE PORTFOLIO TURNOVER

- Analysis of over 1700 equity strategies with at least 3-years of recent consecutive data shows an average portfolio turnover rate of 58% (median of 51%).
- ~50% of strategies by count (~70% by AUM) have turnover <50%.
- ~80% of strategies by count (~70% by AUM) have turnover >30%.
- ~11% of strategies by count (~4% by AUM) have turnover >100%.

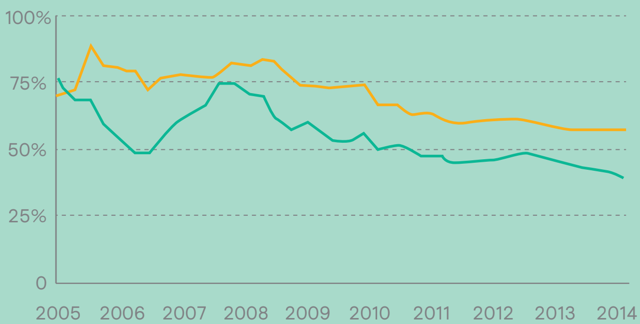
PORTFOLIO TURNOVER DISTRIBUTION BY FUND COUNT AND AUM PERCENTAGE



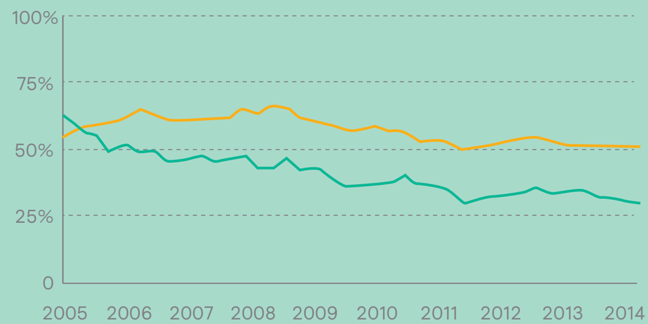
SRI VS NON-SRI

Sustainable and responsible investment (SRI) strategies exhibit systematically lower turnover than non-SRI strategies.

AVERAGE ANNUAL PORTFOLIO TURNOVER: SRI VERSUS NON-SRI STRATEGIES



AVERAGE ANNUAL NAME TURNOVER: SRI VERSUS NON-SRI STRATEGIES



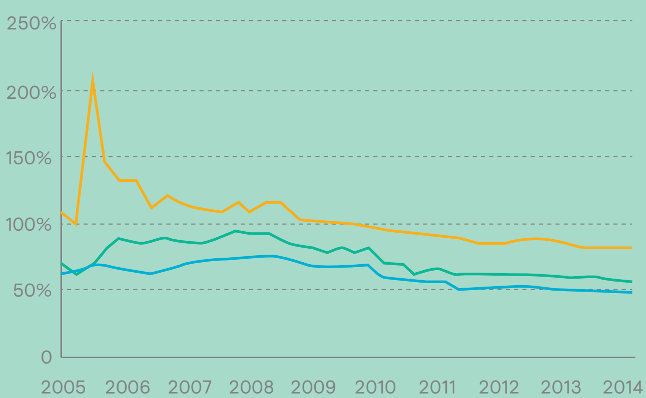
Non-SRI SRI

Source: *Mercer GIMD™*

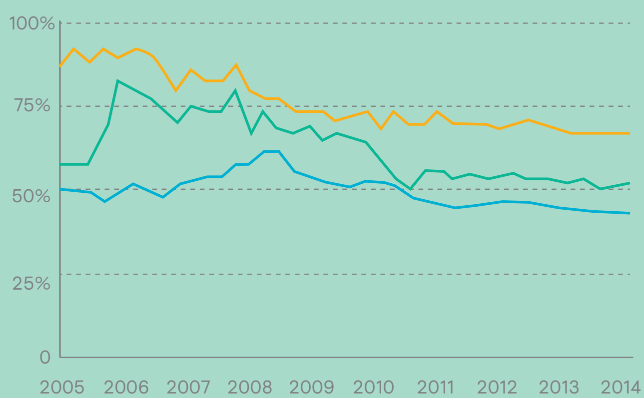
QUANTITATIVE VS FUNDAMENTAL

Quantitative strategies exhibit systematically higher turnover than fundamental strategies.

AVERAGE ANNUAL PORTFOLIO TURNOVER: QUANTITATIVE VERSUS FUNDAMENTAL



AVERAGE ANNUAL NAME TURNOVER: QUANTITATIVE VERSUS FUNDAMENTAL



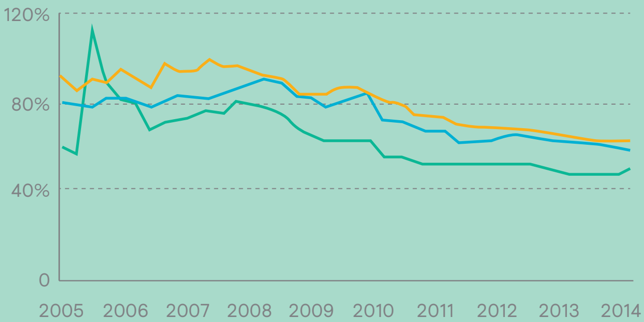
Fundamental Quantitative Blend

Source: Mercer GIMD™

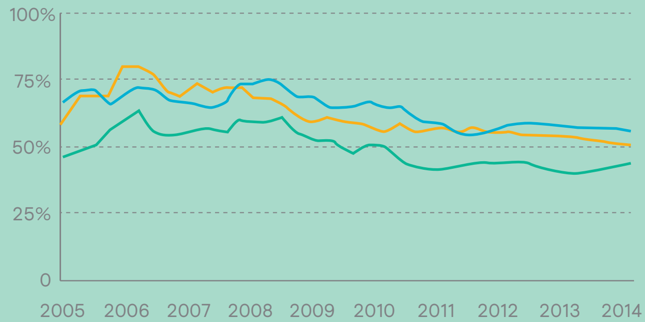
TURNOVER BY STYLE

Managers with value-oriented styles turn over their portfolios less often than those focused on growth.

AVERAGE ANNUAL PORTFOLIO TURNOVER: VALUE VERSUS GROWTH



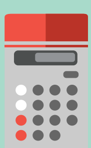
AVERAGE ANNUAL NAME TURNOVER: VALUE VERSUS GROWTH



Growth Neutral Value

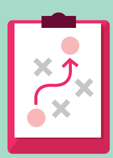
Source: Mercer GIMD™

KEY FINDINGS FROM INVESTMENT MANAGER INTERVIEWS



MANAGER ATTENTION TO TRADING COSTS IN INVESTMENT PROCESSES VARIES

Trading and impact costs are typically monitored quarterly and are an active consideration in portfolio construction for most surveyed managers (however, one manager said transaction costs had no effect on decision-making and another monitored transaction costs monthly).

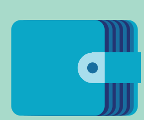


SHORT-TERM PERFORMANCE PRESSURE CAN RESULT IN SUB-OPTIMAL DECISIONS

Clients' fixation on short-term performance and general aversion to short-term volatility can result in poor decisions. One surveyed manager altered the portfolio-construction process to invest beyond the "top picks" to diminish shorter-term volatility.

TURNOVER IS REGULARLY IGNORED DURING FUND DUE DILIGENCE

Questions from clients and consultants about time horizons are standard, but turnover is often ignored. Due diligence is instead often preoccupied with shorter-term performance — some managers say this implies a need to spend more time cultivating client relationships.



BUY-SIDE RESEARCH INSULATED FROM SELL-SIDE SHORT-TERMISM

Most surveyed managers conduct their own research with little reliance on sell-side research. Others believe an uneven focus on the short-term (e.g. <1 year) by traders and sell-side analysts creates inefficiencies and opportunities for patient investors with longer time horizons.

RECOMMENDATIONS FOR INVESTORS

Both short- and long-term investment practices have potential roles to play in a diverse portfolio, though the overall equity marketplace seems skewed toward shorter-term behavior. While many of the managers we interviewed did not believe changes or interventions were necessary to promote greater long-term orientation in equity markets, we believe there are many potential drawbacks to short-termism which need to be better understood; the same holds for the potential benefits of long-termism. To this end we recommend the following:

RECOMMENDATIONS

ASSET OWNERS

Investment beliefs: be explicit about time horizon in investment beliefs

Ensure manager monitoring procedures look beyond short-term price performance:

- Compare actual performance against hypothetical "buy and hold" performance
- Develop a process to cross-check manager behavior against expectations
- Ask for more detail regarding frictional transaction costs

ASSET MANAGERS

Be explicit about time horizon and how this will affect decision-making, employee compensation, etc.

Review turnover and management of transaction costs in depth with clients during discussions on performance

REGULATORS

Consider broadening fund disclosure requirements to better cover transaction costs

ABOUT THE AUTHORS

Richard Dell is the global head of Mercer's Equity Boutique, a unit within Mercer's Wealth business responsible for equity manager research and selection. Since joining Mercer in 2008, Richard has focused on researching equity strategies across a range of universes and geographies. He took over as head of the Equity Boutique in 2013 and, in addition to leading the equity manager research process, has been responsible for evolving Mercer's advice on implementing equity portfolios including the development of ESG and sustainability-related considerations.

Alex Bernhardt is a principal and the head of Responsible Investment (RI) for Mercer in the US. He is a noted expert in catastrophe, weather and financial risk management. In his role as US RI leader, Alex drives innovation in environmental, social and governance (ESG) risk assessment for investors of all types and sizes, with a focus on climate change. Alex was a core contributor to Mercer's 2015 report *Investing in a Time of Climate Change*, and has served as a contributor or (co-)lead on several other large-scale strategic research projects at Mercer. He regularly works with institutional investors on a range of issues from education on sustainable investment to portfolio risk assessment and construction exercises incorporating ESG considerations.