Mercer

staying on course

Positioning your portfolio post covid

welcome to brighter

The new reality

Despite the rollercoaster ride the global economy took in 2020, investors would, in most cases, have been rewarded for doing nothing. After the initial crash, markets eventually moved ever higher, buoyed by unprecedented fiscal and monetary support, enabling most investors who had been paralyzed by inertia to end the year fairly well-compensated.

As we make our way through the relatively calmer stages of the pandemic, investors might think the same playbook will reward them again. We think this is unlikely to be the case, and inertia will no longer be their friend.

Despite the benign start to the year across capital and financial markets, the reality and fallout of the enormous stimulus packages needed to keep the global economy turning are already beginning to bite. In an environment where equity valuations in several areas already look expensive relative to their long-term averages and there is little upside in bonds against a low-rate backdrop, investing has become a whole lot harder.

We believe there are six key challenges non-profit investors will face in the short and medium term, and the inertia that handily shielded their portfolios will not come to their aid again. Inflation, changing and diverging market directions, and the way in which certain asset classes may behave in a new economic reality are going to be key considerations for investors in 2021. Combine that with the market realigning expectations of returns and volatility, and it is clear many portfolios will, at a minimum, need adjustments and, in many, cases significant repositioning.

At Mercer, we have identified both these challenges and potential solutions to help investors generate the returns they need to meet their objectives.

Challenge 1: Inflation finally awakens

Despite the quantitative easing spree central banks took to support markets during the financial crisis of 2008/09, inflation — in developed markets at least — has not been a major concern for most investors in the interim.

With inflation seldom reaching 2% in the UK, Europe and North America over the past decade, investors may have moved the measure ever further down their agendas. However, the volume of quantitative easing (QE) and other financial support offered around the world in the last 12 months has dwarfed the amount and speed of previous packages, and therefore markedly raised the prospect of inflation returning. Additionally, as much of these packages has been injected directly into the economy rather than via bank lending, there is a growing expectation that costs and prices will rise relatively quickly — as the global economy re-opens after the pandemic — and the potential distribution of support packages continues.

Figure 1 shows household excess savings by country at the end of 2020. Households have spent a lot less than normal over the last 12 months as most people (other than key workers) have been stuck at home. In addition, in the US, income has actually gone up because of huge transfers from the government.

In the US, excess household savings were $1.5 trillion at year end 2020 (Bloomberg) and will be closer to $2 trillion or more by the spring (and post-Biden package). That's 10% of GDP and may drive a huge surge in demand/GDP. These savings will drive GDP growth and determine relative GDP growth rates over the next few quarters.

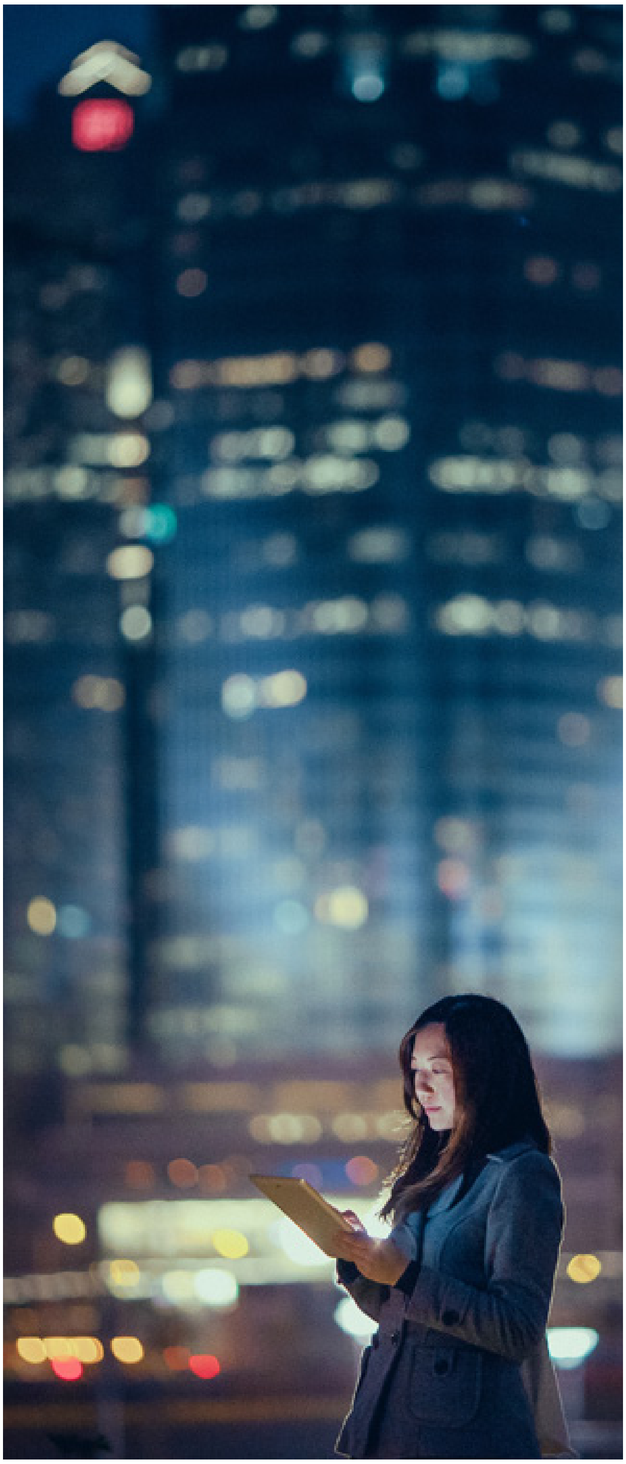
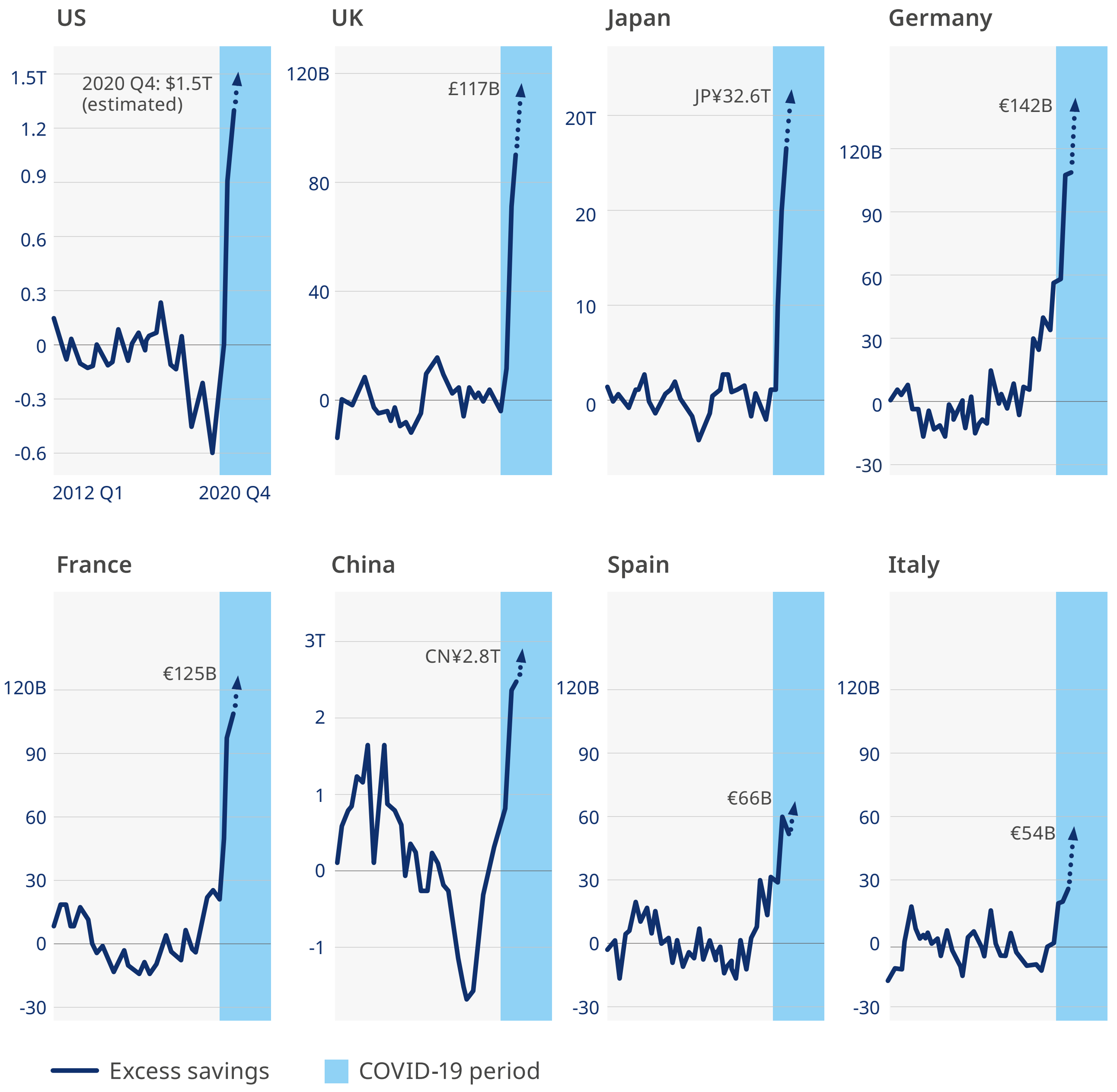


Figure 1. Savings to splurge



Source: Bloomberg

Lockdown barriers to spending combined with stimulus-boosted incomes have left consumers with significant pent-up savings. Although nothing can be certain, investors should be alert to the risk of inflation returning. The type and duration of inflation we see will be important to potential portfolio responses. We believe that the move higher in inflation will be a shorter-term phenomenon before moving back to longer-term trend, but we need to be mindful of the factors influencing inflation and be prepared to adjust as the situation develops.

The potential solutions

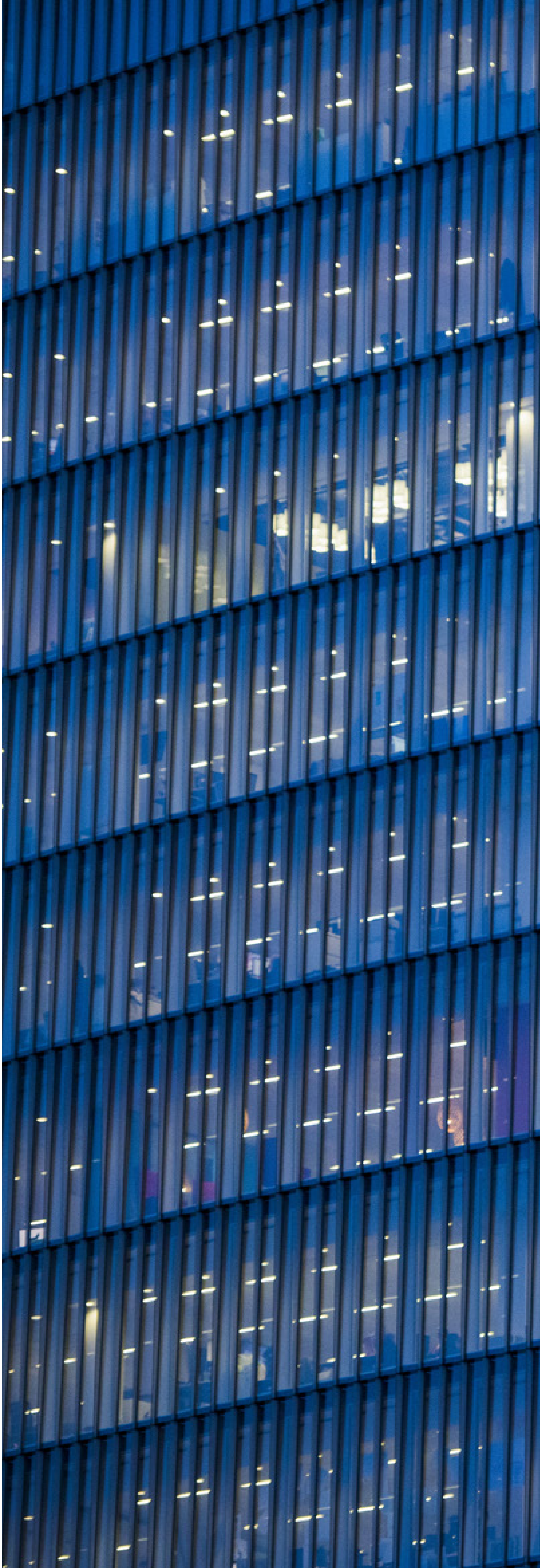
As inflation is one of investors' oldest foes, there is a wide range of solutions that can be used to combat it — the key factor is to think about solving it with nuance and innovation.

Aside from matching assets such as inflation-linked government bonds, which may be expensive and may ultimately fail to produce the absolute yield a not-for-profit investor needs, there are many other options.

Some **inflation-sensitive assets**, such as **core real estate** and **infrastructure**, may offer explicit contractual or implicit links to inflation. However, investors should not rely on implicit sensitivity continuing into the future: relationships and behaviors that were the norm in the past may no longer hold firm and true in a post pandemic environment. With uplifts baked into tenancies, revenue structures and lending arrangements, investors may benefit from both rental or interest payments that keep pace with inflation, along with a potential earning at the sale of the asset or redemption of the loan.

Equities, too, may hold the key to moving long-term returns upward, in line with inflation — but the effectiveness of equities in offsetting inflation will be driven largely by the type and duration of inflation. Equities, of course, also bear a greater relative risk of low or even negative returns in shorter periods of higher inflation. In an environment of modest and/or shorter-term inflationary spikes, companies may be able to pass along higher costs to consumers and maintain their earnings and margins. With extended or substantially higher short-term inflation, not only might earnings come under pressure, but the risk of higher interest rates is meaningful, given the valuations of many stocks around the world.

While most markets and major indices moved upward in 2020, support packages masked much of the complexities and differences between their constituents. In an inflation-pressured economy, it is important to understand how each company in an equity portfolio deals with this important (and potentially business-limiting) measure. Working with fund managers, investors can understand how successful specific companies have been at passing on inflationary cost pressures to consumers rather than eroding their own bottom line. There are many



possible data points to consider, including market share, how output prices have compared against the rate of inflation, sustainability of profit margins and investors' return on equity.

It is important to note that all equities do not act in the same way in an inflationary environment. Some will correlate positively with inflation such as firms involved in the production of raw goods and materials, but it is a gross simplification to suggest that all will do so consistently.

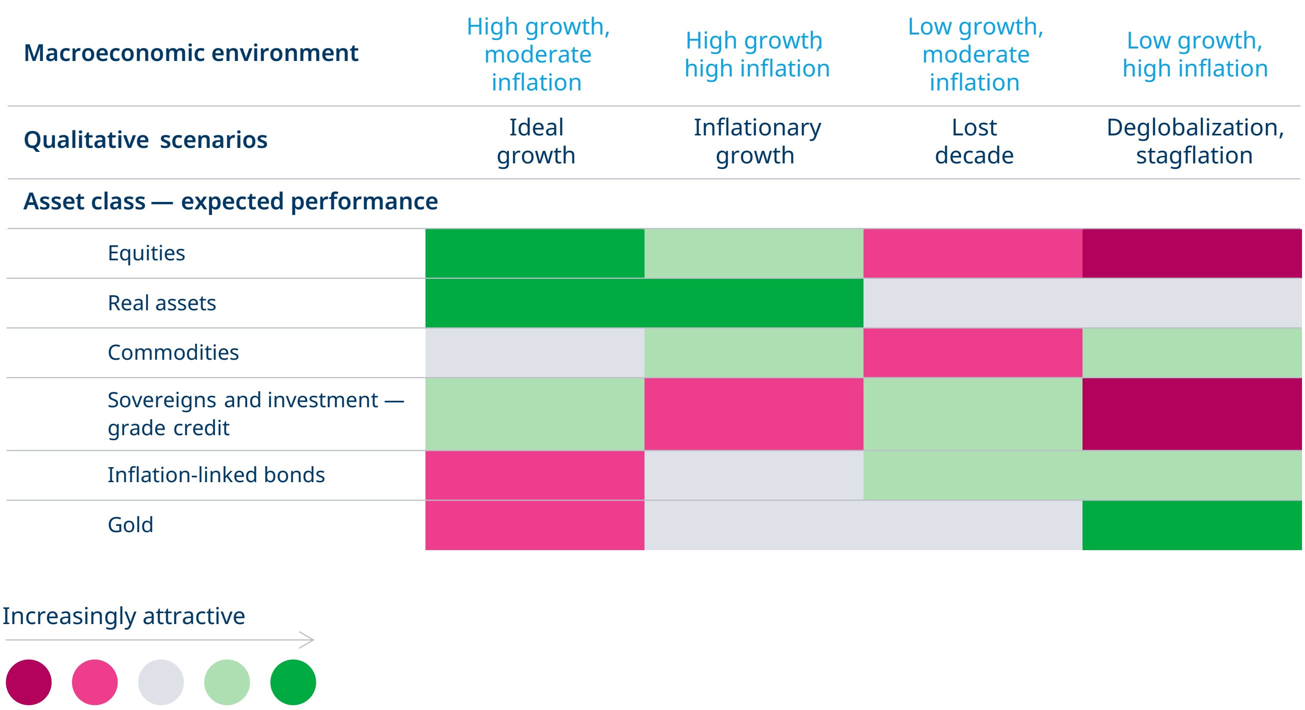
Companies — even within the same industries and sectors — need to be examined carefully by managers. Business models may wear down margins, while poor governance practices may cause even more serious issues.

Nuance and selection are key for sustainable, long-term equity allocation for investors who have objectives to meet, suggesting perhaps an improved environment for active strategies.

Alternatives to listed and conventional investment options may also provide inflation-proof solutions for investors. From commodities to gold to international currencies, investors could consider other stores of wealth that can keep pace with the eroding qualities of inflation. The advantage here is that in this space, there is a constant stream of invention.

While the **digital currency landscape** is still in its infancy, we believe investors need to be thinking along new and innovative lines about how their portfolios will evolve. This means investigating and asking their fund managers about developments within electronic assets along with advancements within the facilitating technology itself. They may seem a long way off now, but they could provide long-term inflation-linked investment opportunities.

Figure 2. Asset returns by economic environment — over the medium term



The challenge: Sell-off in equity markets

As vaccines are rolled out and new treatments emerge, global leaders want economies to emerge from lockdown and return to pre-Covid norms — and this will have a knock-on effect on financial markets.

Governments and central banks are likely to withdraw the support that kept businesses and economies afloat during the pandemic, albeit at a gentle pace, given debt levels have reached (if not exceeded) wartime levels. Markets are therefore unlikely to grow as fast as they have in recent years, as the flow of liquidity slows and the reality of a "new normal" tempers positive sentiment.

Additionally, as noted previously, should inflation run ahead of expectations, global central banks may need to walk back their previous views of lower interest rates for longer, which we believe puts pressure on stock prices due to generally rich valuations.

As for investors with typically significant holdings in equities, now is a good time for global endowments and foundations to reassess their equity portfolios.

The potential solutions

After years of considerable gains, the recovery from the pandemic could be a suitable time to consider taking profits and rebalance portfolios. We believe that investors need to approach this assessment from both a **top-down** and **bottom-up** perspective to fully appreciate what they wish to keep and what needs to be discarded.

From a **whole-portfolio standpoint**, high public equity allocations to seek greater long-term returns may represent greater risk for non-profits, given the likely limited upside from stocks that have become increasingly expensive over the past decade.

Re-evaluating the public equity mix may have value to positioning for the next leg of the cycle.

From a **bottom-up** perspective, investors may need to revisit allocations to stocks that have led markets higher in recent years. After years of outperformance, the conditions that have helped propel capital-light, high-growth companies — ultra-low interest rates and excess liquidity — might be coming to an end, which could signal a change in market direction.

Equally, stocks that were catapulted into the spotlight in the atypical social and professional environment are unlikely to be able to maintain their market-beating performance from an already elevated position.

Importantly, too, a post-pandemic regulatory regime, which is taking an increased focus on environmental, social and governance (ESG) factors, could cause difficulties for the winning stocks of recent years. Not-for-profit institutions (NFPs) and their managers need to be aware of the broad swathe of non-financial reporting rules companies must follow — and be alert to how the results of this could sway investor favor.

Happily, within the equity universe, there are a swathe of alternatives for NFPs to consider. This could include an allocation to stocks in sectors and countries that may benefit from the reopening theme, including those exposed to the "real" economy, valuations of which have fallen to generationally low levels. These include small cap stocks with more of a domestic focus as well as stocks in emerging markets that are well placed to benefit from economies reopening throughout 2021 and 2022.

Despite being "country zero" of the Covid-19 pandemic, **China** was able to contain the virus comparatively well and saw its economy grow by almost 2% in 2020. Economic growth of 7.9% p.a. is projected for 2021.[1]

With China still the standout performer in emerging market portfolios, we believe it might also be time for investors to consider a **standalone allocation** as with a focus on technology and environmental solutions, it is in line to become the world's largest economy in 2028.[2]

[1] *IMF Executive Board Concludes 2020 Article IV Consultation with the People's Republic of China*

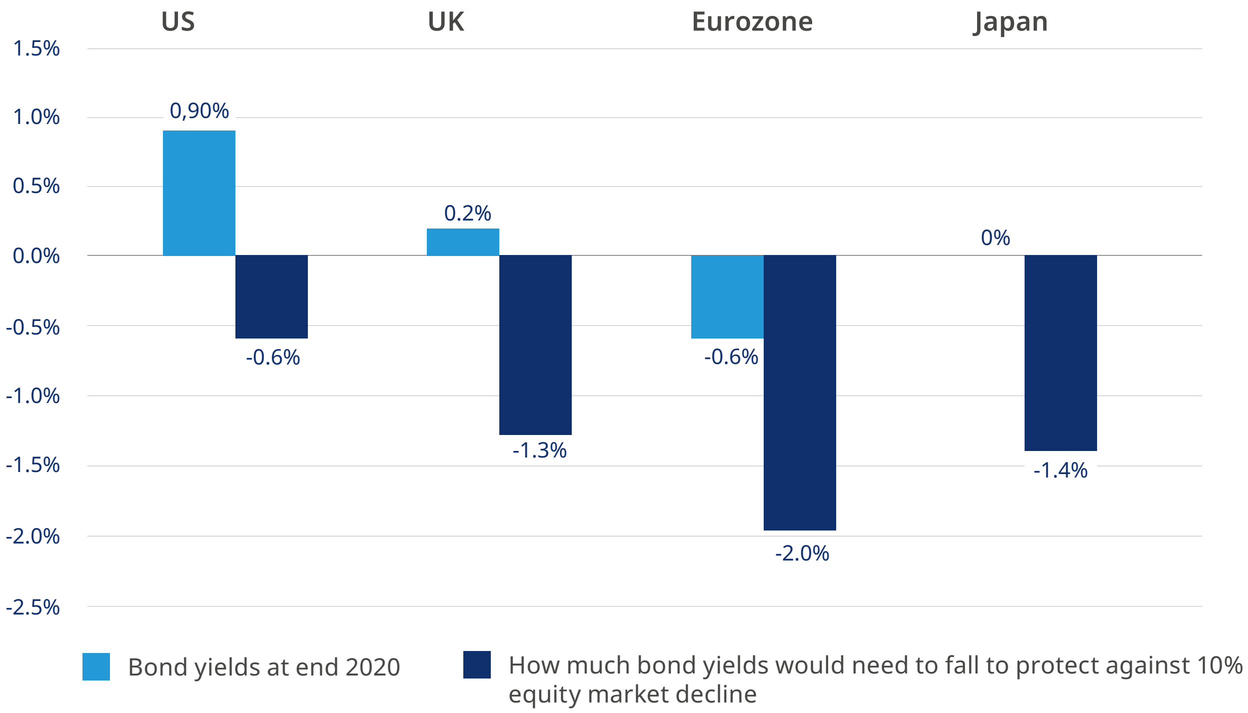
[2] *World Economic League Table*

The challenge: Fixed income no longer a safe haven

While fixed income has historically been the go-to asset class for investors when the outlook for equities seems challenged, NFPs looking to increase their bond exposure should choose carefully.

Traditional safe-haven assets — government bonds — are unlikely to give the same portfolio protection as in previous down markets given current yields. Years of QE and low interest rates, followed by huge levels of borrowing, more QE and even lower interest rates, have clouded the outlook for this non-profit staple. In some cases, this phenomenon has also removed the protective diversification historically it offered, with German bunds and Japanese government bonds losing money in February and March 2020.

Figure 3. Will bonds still be able to protect my portfolio against equity market declines?



Even moving up the risk scale a little, we believe is little prospect for stellar returns. While well over 50% of investment-grade credit is now rated BBB — the lowest investment grade credit rating — the return pick-up this group of corporate bonds offers over government-issued debt is lower in 2021 than before the pandemic hit. Credit spreads are close to record lows even as corporate indebtedness has reached record highs and we believe NFPs are no longer adequately compensated for default risk.

Government support may have backstopped the market, but although these packages can offer liquidity, they cannot offer permanent solvency. As support is weaned off, we expect the level of defaults to pick up quite significantly.

The potential solutions

Investors will have to look to more nuanced, alternative areas of the fixed income market for attractive yields and opportunities. Instruments such as **Collateralized Loan Obligations, Contingent Convertible bonds (CoCos)**, **areas of risk transfer credit** and **private markets** with yields in excess of 4% with strong downside protection, are looking increasingly attractive.

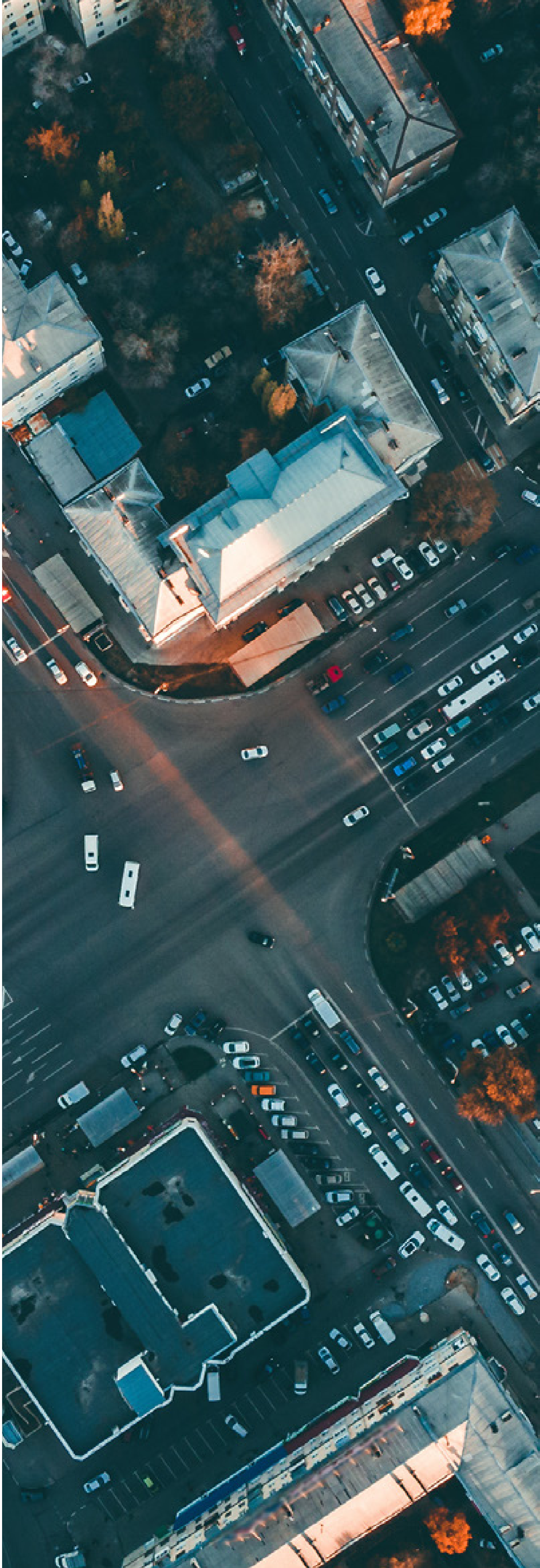
Yet these assets are not easily accessible to every investor, and NFPs may have to consider a more tactical approach. Investing through specialist **multi-asset credit funds** or **private debt vehicles** may meet their allocation needs and also help diversify their holdings across sectors, industries and regions to spread risk budgets effectively.

We believe investors would benefit from an **additional layer of diversification** by allocating across a range of high-quality managers with experience in these specialist fields.

For all investors allocating to fixed income, it is important to recognize that default rates are almost certain to rise, despite the extensive government and central bank support. However, we believe this is already generating a genuinely exciting investment opportunity in **dislocated** and **distressed credit** for investors to support companies that have the ability to survive defaults and recover strongly from company re-organizations and asset restructurings post bankruptcy. Our recent paper, *Opportunity Knocks: Opening the Door to Private Credit*, outlines the opportunities and challenges to be aware of in this strategy.

We have noted a growing number of innovative **private market solutions** that have overcome much of the timing risk associated with these opportunities, making this sub-asset class more appealing to institutional investors.

Finally, **absolute return, lower-beta hedge fund strategies** can be a valuable component in not-for-profit portfolios to provide diversification and additional potential for return. With a better-than-bonds return target but objective for bond-like volatility, absolute return strategies may be a valuable component to risk-dampening allocations in a low rate environment.



The challenge: Permanently changed real estate landscape

In a world of stubbornly low interest rates and government bonds yielding close to, or even less than, 0.1% p.a., there is a firm place for real assets in a non-profit portfolio. But investors should note that the Covid-19 pandemic has meaningfully changed the real estate landscape, with previously preferred assets falling out of favor.

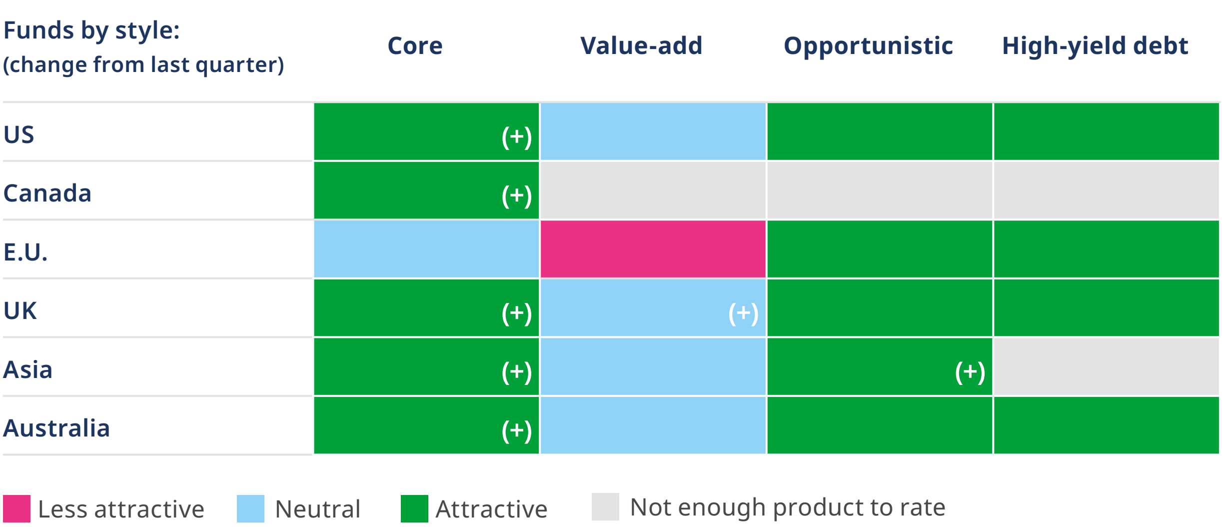
Thanks to changed shopping patterns and working practices — and companies realizing smaller overhead costs — retail and office sectors look less of an approved choice for investors, while logistics centers and supporting infrastructure have become more popular.

The potential solutions: Look ahead to what you need

How investors can access this traditional institutional portfolio favorite to meet their objectives is changing too, with the financing of property development or refurbishment through real estate debt, rather than equity, looking increasingly appropriate.

An allocation to real estate debt can offer several attractive features. Investors are paid attractive rates for providing debt capital, rates which can reach up to 6%, with contractually secured income and preference rights often accompanied by defined downside (typically, a 30–40% loan-to-value buffer).

Figure 4. Relative attractiveness in global real estate



The above table presents a simplified outlook of risk-adjusted returns for new investors with a non-constrained risk budget over a 3 to 5 year investment horizon. **An 'unattractive' position therefore does not imply an advice to liquidate existing investments**. The table presents the views of Mercer at the time of writing this report, which are for illustrative and educational purposes only.

Best value: The distress created by the COVID-19 crisis is expected to lead to opportunities. We have experienced an increase in the number of funds being raised with an opportunistic risk profile and think that the timing is particularly good for special situations funds, which have flexibility in providing capital solutions, to be in the market today. In a similar vain, real estate debt funds providing higher tranches of (mezzanine) debt see strong opportunities and attractive returns due to traditional lenders having become more cautious.

Worst value: The economic recovery has shifted outwards during the last quarter, with GDP growth in the first half of 2021 likely to stable at best. This uncertainty around the timing of the recovery is impacting our view on value-add funds, particularly in Europe. While these general economic conditions also affect capital growth in core funds, we now take a neutral view to this style in all parts of the global real estate market. Valuations may not have fully corrected just yet, but since our preferred core funds have allocation queues and it may take several quarters for capital to be drawn, we therefore recommend allocating capital today.

Within each debt investment, managers often have the ability to include documentation provisions to better protect their investments, including ongoing covenant triggers and mechanisms to mitigate downside risk in the event of business plans underperforming. For investors aligning with certain **social investment criteria**, these allocations provide **liquidity** to a market where banks have pulled back from or out of circulation completely.

Additionally, there are other equity and debt opportunities in environmental, social and governance areas that can enhance a non-profit's alignment with these factors. From social housing to vertical farming and energy efficiency, across real estate and infrastructure, there is a burgeoning and booming landscape of opportunity.

Many of these real estate assets can also help protect portfolios against the eroding effects of inflation, but we believe selectivity is important. Not-for-profits can work with their advisors and managers to understand which sectors and opportunities are likely to offer better protection against inflation, with the focus here on underlying revenue/income structures and seeking explicit inflation linkage, where possible.

How investors approach **infrastructure**, too, will also impact outcomes and portfolio success. An allocation to listed infrastructure product may offer a governance-friendly solution, but it is likely to exhibit very similar behavior to wider equity markets and suffer comparable levels of volatility. That said, listed sustainable infrastructure could offer strong capital returns, especially sectors which have come under considerable distress during the global lockdown.

Private infrastructure can offer robust cashflows and an illiquidity premium over public assets but can also present implementation hurdles for non-profit investors, which we highlight in our paper: *Private Infrastructure: Navigating a Path Towards Long-term Opportunities*. Allocating to open-ended strategies or through a delegated solution could well help investors access this promising area of real asset investment, which could contribute meaningfully toward achieving return objectives.

However, there are important aspects to consider in this sector. Investors need to pay attention to underlying revenue structures, exposure to different regulatory operating environments and how thoroughly ESG and sustainability journey plans are integrated into company management and the underlying assets themselves.

The challenge: Lower returns and higher volatility

The remarkable bounce-back in capital markets — which, in some cases, has stretched beyond where economic indicators suggest is sustainable — has significantly dampened future returns. Essentially, the price paid for an asset matters hugely to the return it makes: Overpay for an asset and it will struggle to make enough for it to be worth an investor's while.

In addition, there are other factors at play that are likely to change the face of financial markets in future — and non-profit investors need to be keenly aware of these.

Volatility has returned to markets in significant and often inexplicable bouts. While volatility is an integral part of capital markets, this time — for the moment at least — there are different triggers. The liquidity that has been injected into markets since April 2020 is a contributing factor, as it has whipped up some valuation frenzies. This has partially led to the increased participation of retail investors in even mature markets via ETFs and direct trading, which has fueled the significant market movements — and we think this is likely to persist in the short-to-medium term as household savings remain at elevated levels across much of the globe.

The potential solutions: Dare to be different

To realistically achieve a return of inflation + 3% and 5% a year, which is a common return target for NFPs, investment committees may need to look beyond their traditional portfolio allocations to consider asset classes and strategies that can help them achieve their objectives in the medium to long term.

Increasing allocations to private markets, and in particular, early-stage venture capital investments, may add to portfolio returns if investors are prudent in their selection. These investments can identify true disruptors to multiple industries that may eventually grow into household names.

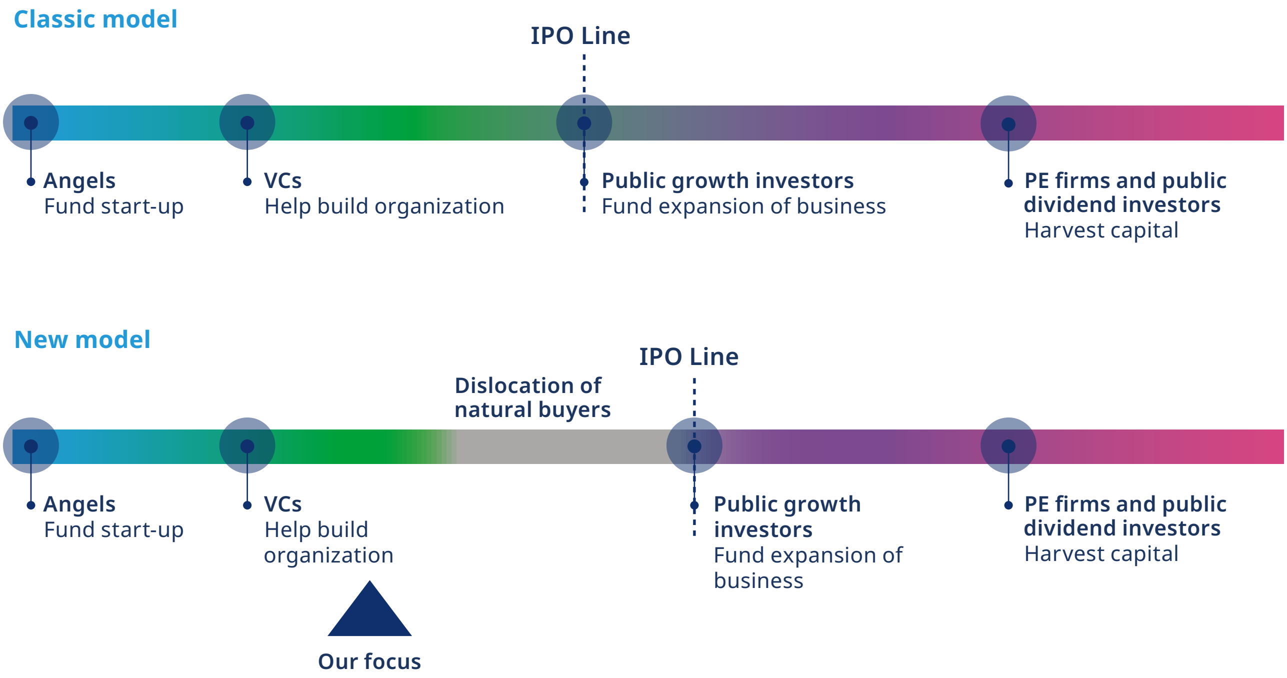
In recent years, a wide range of traditionally publicly listed equity managers have been spotting the opportunity and growth potential this area of private market offers, giving investors more choice of strategy and approach.

Increasingly important for many investors is the impact their allocations have on the wider world — and it is in this area of investment where they can make significant difference as we discuss in our recent paper, *The Power of Change: The What, Why and How of Creating a Diverse Private Markets Portfolio.*

By investing early in the development of dynamic and ambitious start-up companies, non-profits can be part of the stakeholder group that helps shape their approach to ESG. Not only is this beneficial to the sustainability of the company — the majority of start-ups fail[3] — but it also enables non-profits to align their investments with their own ESG targets.

[3] *How Many Startups Fail and Why?*

Figure 5. Classic model of a company's lifecycle versus new model of earlier investment



Source: Baillie Gifford

The challenge: Di“worse”ification

Investors are often told that diversification is the key to their success — but this hand can be overplayed.

In early 2020, many portfolios that were meant to be diversified turned out to be all moving in the same way at the same time. This is what we call di“worse”ification, and it can be more harmful to a portfolio than it may first appear.

With a portfolio that does not truly offer a diverse approach to investment, NFPs may find they are neither as protected against downside risk as they may think, nor as well positioned to capture the raft of opportunities that are created in markets every day. This was certainly the case when a liquidity squeeze took place in February and March 2020, and supposedly uncorrelated assets all moved in the same direction.

The potential solutions: Think differently

Investors have always needed to think about and look far into the future to fully gauge where their portfolios should be positioned, but in 2021 — and amid a pandemic — that need is even more acute.

Decisions made today will have long-reaching impacts, well into the life of a NFP and its portfolio. This means investors really have to reassess how they analyze, manage and exploit risk, and how they assess the underlying drivers of returns in their portfolio.

It is important to accept that the investment landscape has changed, and historic safe-haven assets are unlikely to protect portfolios from losses in future — and in some cases may even incur them. As noted above, this was the case for German and Japanese government bonds as the pandemic really hit in the first quarter of 2020. Now, more than ever, past performance is no indication of what will happen in future, so existing allocations and relationships need testing. We believe it is time to assess the protection and return potential from current alternative mandates and weigh up whether they are value for money. True protection may be available only for those willing to think differently about risk and how to protect against it.

The good news for smaller and mid-sized NFPs is that investment innovation has meant that capital efficient smart solutions are available to help. These solutions involve purchasing direct protection strategies using “smart” replication techniques and employing leverage to provide broad protection with a small pot of capital — effective insurance in a client friendly manner.

We suggest all NFPs stress-test their portfolios to see how assets perform under different conditions and scenarios so that they can be comfortable capital preservation will be provided when it’s needed the most.

Conclusion

The future is never certain, even without the complication of the aftershocks of a pandemic, so it is vital for NFPs to assess their current asset allocation and positions. Lightning rarely strikes twice — especially when the weather conditions change — and if inertia helped either protect or even boost portfolios last year, it is unlikely to do so again.

There are certainly challenges ahead, but many potential solutions, too. Now is the time to be bold with decisions and plan for a long-term investment portfolio that does not rely on inactivity and good fortune to produce the results you need.

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