Mercer

Change brings **opportunity**

Not for profit European investment survey 2021

welcome to brighter

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Executive summary

Welcome to our 2021 investment survey for European Not for profit investors (NFP). This is the first survey of its type from Mercer Europe, focused entirely on asset owners seeking profit with purpose. We look forward to delivering this survey on an annual basis and wish to thank those that participated this year.

Throughout the last decade, investors have enjoyed favourable market returns across virtually all asset classes, driven generally by buoyant equity markets and underpinned by ultra-accommodative monetary policy. The challenges of the last 10 years – trade wars, Brexit and the COVID19 pandemic, have only served as blips in the prevailing rise of investment markets. Against this background, most philanthropic investors have experienced strong returns during a period of subdued inflation.

We expect the decade ahead to be more challenging for investors, with returns more elusive and greater risk in markets then we have experienced in recent years. The 2020s have been dubbed the decade of delivery where unprecedented climate change policy must be delivered in a world of very low yields: we beleive the challenges for NFP investors to continue to grow on many fronts. Headwinds will be seen in the form of reduced incomes as governments, subscribers and donors continue to cut back their funding in order to reduce debt levels or divert spending. To fill the gap, all streams of revenue generation must work harder, including that from investment returns. In this low-rate environment, there will be less opportunity to reap the rewards of market returns.

The importance of genuine diversification, at both asset class and manager level, cannot be overstated in the years ahead. In hindsight, the 2010s were an "easy" investment environment, with rallying equity and bond markets driving strong returns as central banks suppressed volatility. NFP investors are well placed to allocate to less-constrained strategies and capitalise on market dislocations to enhance diversification. There may also be opportunities in strategies that have struggled to keep pace with broad market indices, such as value stocks, hedge funds, real assets and emerging markets, although ethical and responsible consideration may limit this exposure.

As the search for returns becomes more challenging, we expect accessing the illiquidity premium to be more important. This is reflected in a greater proportion of NFP investments being placed in private asset investments such as private equity and private debt. Our survey respondents indicated the growing importance of integrating the impacts of climate into decision making. Whilst many NFP investors have been at the forefront of acknowledging climate change and seeking to address it in their policy documents, efforts to address climate change within portfolios has progressed slowly. As consumers and other stakeholders demonstrate behavioural change to moderate their environmental impact, we expect that firms in any industry that fail to follow suit will find their social license to operate (and ultimately their revenues) increasingly under threat. We believe as NFP investors, we can quickly understand and address the environmental impact of NFP investments and drive change.

We encourage clients to undertake, where appropriate, a carbon-footprint analysis on investment portfolios as part of a broader assessment of exposure to climate policy risk, and then chart a course for alignment with global climate targets. Broadly speaking, those experiencing funding declines could benefit from reviewing their spending policies and investment objectives. In addition, universities for example may have to focus more attention on widening their base of philanthropic donors to better fund their spending programme. Despite these challenges, NFP investors should have confidence that their inherent advantages as investors – such as their long-term time horizon and smaller size – provide them with opportunities and flexibility that other investors may envy. Whilst the future is uncertain, we believe there is still opportunity in markets for investors to unearth ethically and sustainably aligned returns by investing with a strategic and long-term lens.

Amit Popat
Europe and IMETA Head of Not for profit

Paul Fleming
UK Head of Not for profit

Key findings of the survey

1. Market volatility and insufficient returns to meet objectives at centre of concerns

Whilst recent returns have been strong, the sharp bouts of volatility of early 2019 and 2020 have reminded investors of how finely balanced the global economy is positioned. Capital markets are very attuned to policy decisions and statements by central bankers and politicians. Global instability remains a concern for NFP investors in positioning their portfolios to keep delivering strong returns.

Over 43%

of respondents identified market volatility and insufficient returns to meet their objectives as one of the top 3 key risks their organisation will face over the next 12 months.

2. Seeking alternative sources of return– the move to private markets

62%

of respondents currently have no exposure to private markets; however, over

almost 40%

have expressed that they will increase their exposure to private markets or real assets as a tool to address a low income yield environment...

...demonstrating the increasing trend within the NFP industry to search for yield in new asset classes.

3. ESG remains ever important for NFPs

Despite a more challenging environment, NFPs remain resolute in their focus on ESG factors as part of their investments and governance.

48%

currently have a standalone sustainable/RI policy with another **40%** considering producing one in the next 12 months.

47%

currently allocate to low carbon investments with another **43%** planning to in the future.

46%

use ESG ratings to assess managers whilst **66%** exclude specific sectors in their portfolio.

Key recommendations overview

Reviewing your strategy in a low-rate environment

Following a decade of strong real returns, NFPs now face the challenges of "lower for longer" interest rates, market uncertainty and funding pressures. With the global economy and capital markets constantly evolving, we recommends all NFPs to review their investment objectives, strategic asset allocation and spending policies to ensure they remain aligned, and achievable, in the current environment. The current market and regulatory environment suggests that investment portfolios will need to "work harder" going forward.

Don't give up on diversification

Many investors are not expecting a repeat of the past 10 years' equity and bond returns. Many NFPs could benefit from greater diversification and bigger allocations to less-constrained strategies that are well placed to capitalise on either market dislocations or long-term structural trends. These opportunities can be found in both public and private markets. Alternative investments, such as unlisted property, infrastructure and private equity can help insulate against market volatility, rising geopolitical uncertainty and downside risks.

The importance of ESG continues to grow - position for climate change

The warning signs of climate change have been heeded and policy is now increasingly proactive. This will have implications for the way businesses are run and how asset owners invest. Policy needs to address issues from carbon emissions to physical impact mitigation and structural trends associated with climate change, such as water scarcity.

We recommend undertaking carbon-footprint analysis and charting a course for alignment with global climate targets. Determine whether your objective is to be "future aware" and protect against and capitalise on the transition to a lower-carbon world or to go further and influence the transition — that is, be a "future maker."

1. Reviewing your strategy in a low-rate environment

Global instability remains a concern for NFP investors in positioning their portfolios to keep delivering strong returns.

When considering the next 12 months, the biggest challenges keeping respondents "awake at night" centre on market volatility, followed by the ability to deliver sufficient returns to meet charitable objectives.

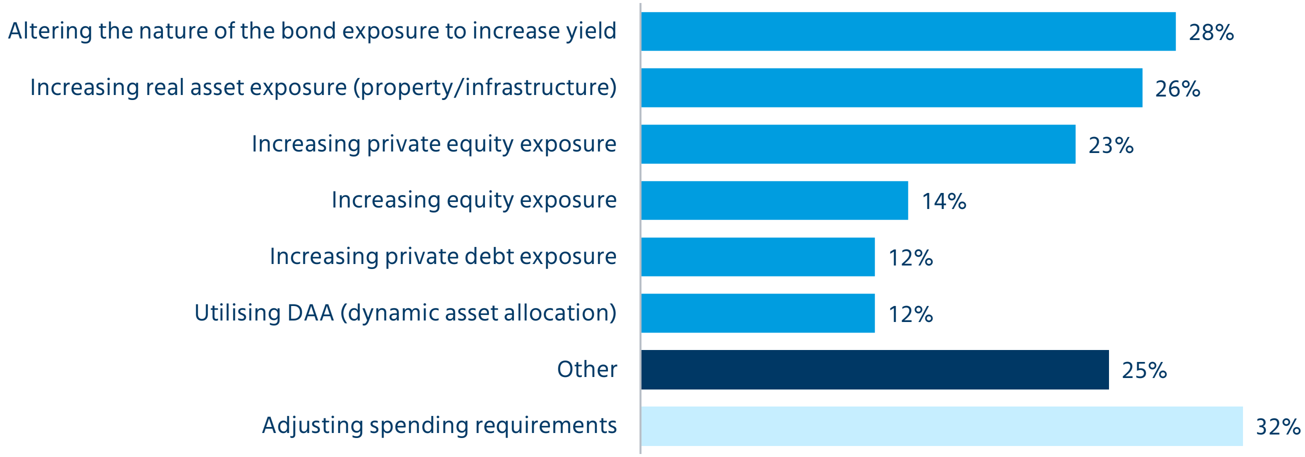
The current low yield environment is reflected in the respondents answers in actions with their asset allocations. The majority of respondents have implemented strategies to protect against downside equity volatility. These strategies include increasing diversification within and across asset classes geographically, dynamic asset allocation and increasing allocations to unlisted and defensive assets.

NFP investors highlighted stakeholder pressure as the third biggest challenge they see over the next 12 months, due to increasing pressure from their stakeholders to invest sustainably. We believe this makes communication and transparency ever more important.

Greatest risk or challenge over the next 12 months

1. Market volatility
2. Insufficient returns to meet objectives
3. Stakeholder pressure, for example ESG, contentious issues

Actions to a low income yield environment



As long term investors, NFPs tend to employ active management across the majority of their portfolios. However, there has been greater interest in investing in low carbon equity investments which coincides with the development of low carbon equity index funds.

The majority of NFPs have met or exceeded their objectives over the trailing 5 year period. Perhaps unsurprisingly given the very strong returns delivered by equity markets which tend to make up the majority of NFP portfolios.

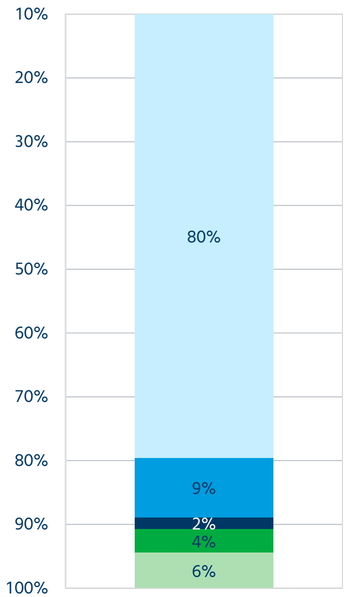
Moving forward, we expect the next 5 years to be much more challenging for performance, which is reflected in the fact that 64% of respondents ranked insufficient returns to meet objectives as one of their top 3 risks for the next 12 months. Our recent article “the income challenge” discusses this in more detail.

Use of passive management

Passive management in bonds

Percentage of Organsations

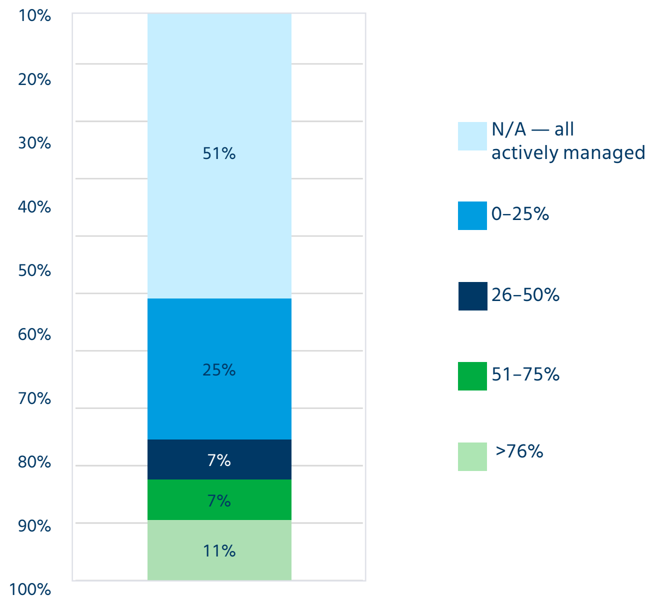
(N=54)



Passive management in equities

Percentage of Organsations

(N=57)



Performance of organisation’s fund relative to stated objectives over the trailing 5 period

53% Met objectives

17% Lagged objectives

29% Exceeded objectives

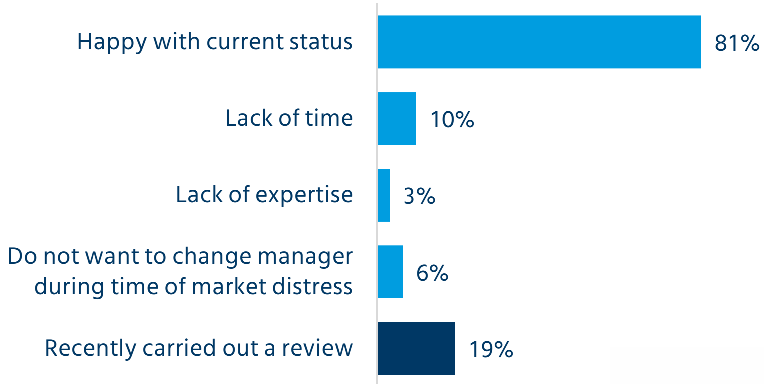
28% of respondents said they have not formally reviewed their investment manager(s) in the last 3 years, with 53% of these saying they also do not plan to in the next 12 months.

We recognise that 81% because are happy with their current status, however we believe trustees, as part of a robust governance structure, review their current investment manager(s) every 3 years.

Length of time since your organisation undertook a formal review of your investment manager arrangements

52%	21%	28%
Within the last 12 months	Between 1 and 3 years ago	More than 3 years ago

Reason for not planning to undertake a formal review of investment management arrangements over the next 12 months



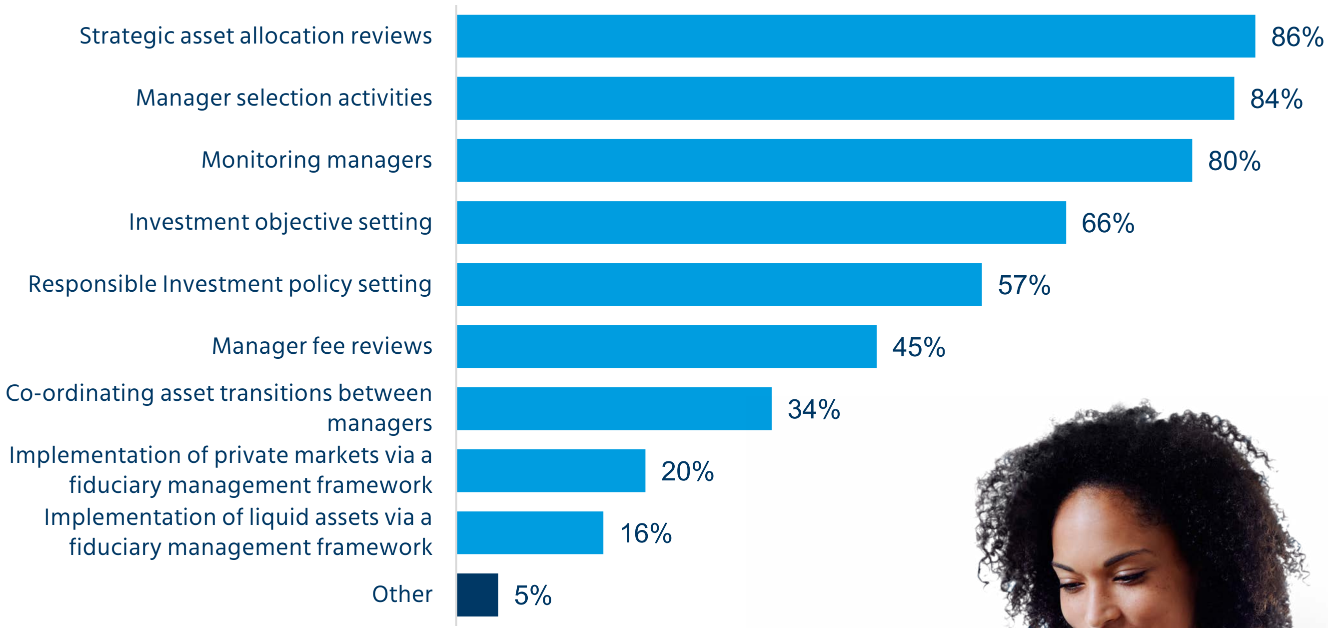
Planning to undertake a formal review of investment management arrangements over the next 12 months

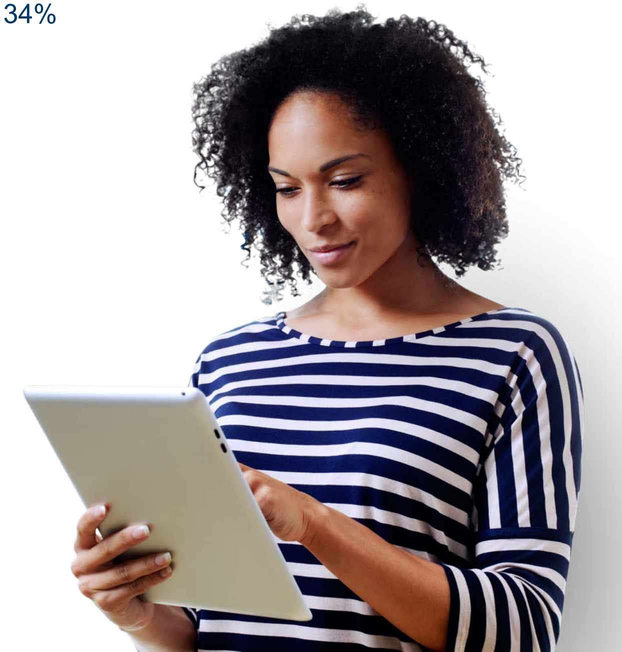
Over 75% of respondents take advice from a third party. The role of the advisor varies.

- Continue to see third parties' largest role is to conduct strategic asset allocation reviews for NFP investors – driving key decisions to align with financial objectives.
- Manager selection and monitoring are important areas – NFP investors continue to take advice to decipher between the best managers and holding them to account over the long term.

Capacity of advisor to assist the organisation

76% of organisations stated that they currently work with a third party investment consultant/advisor.



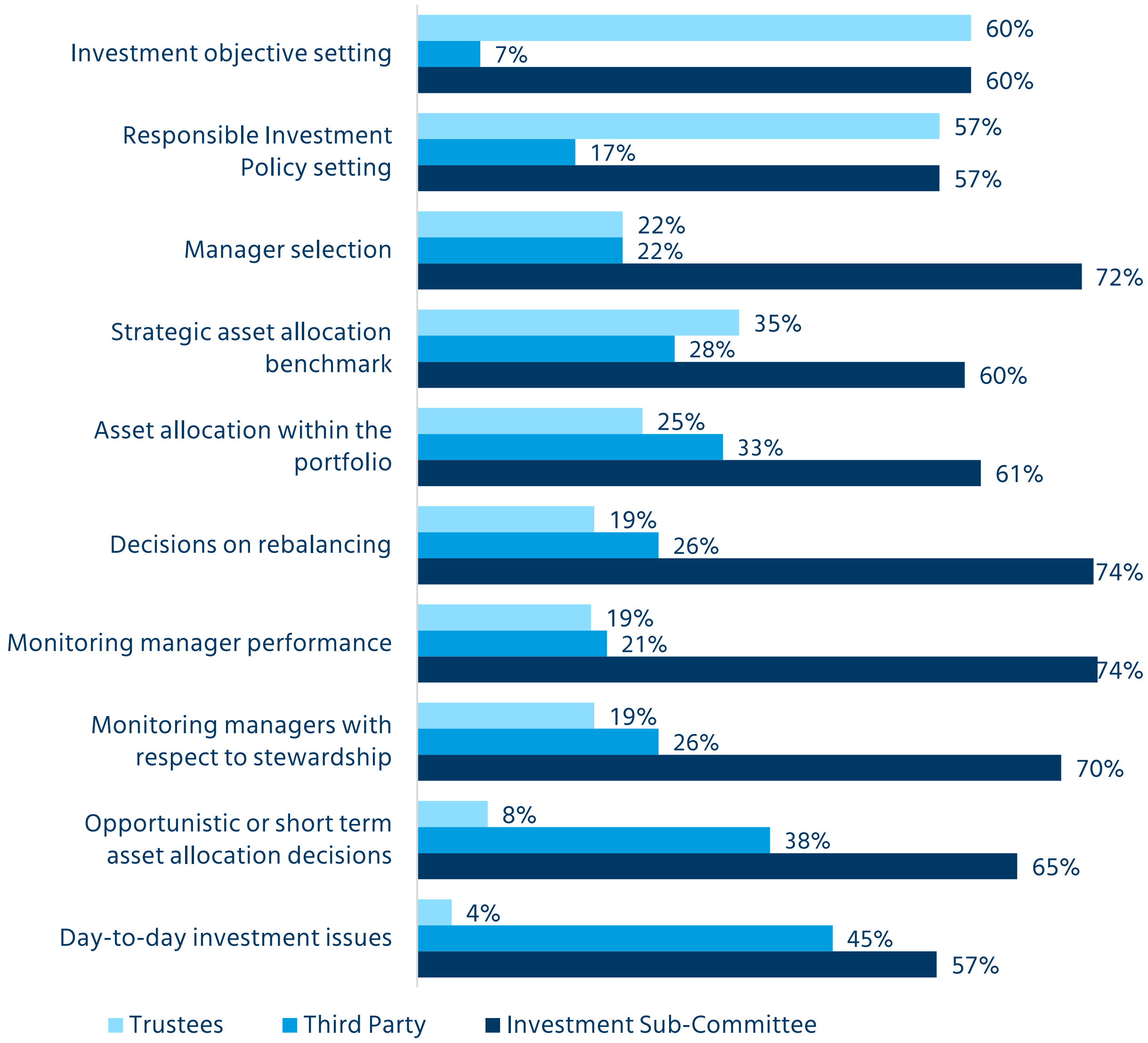


Majority of NFPs now use a separate investment sub-committee to take care of key tasks. This allows for more focused meetings and decision making with appropriate levels of expertise.

Importantly a majority of main trustee boards are responsible for long term objective setting and take ownership on responsible investment policy setting.

Heavy lifting of day to day investment issues are increasingly delegated to a third party allowing trustees to focus on strategic decision making and fulfilling their organistaion philanthropic mission.

Breakdown of activities around the investment cycle and responsibility by governing body



2. Don’t give up on diversification

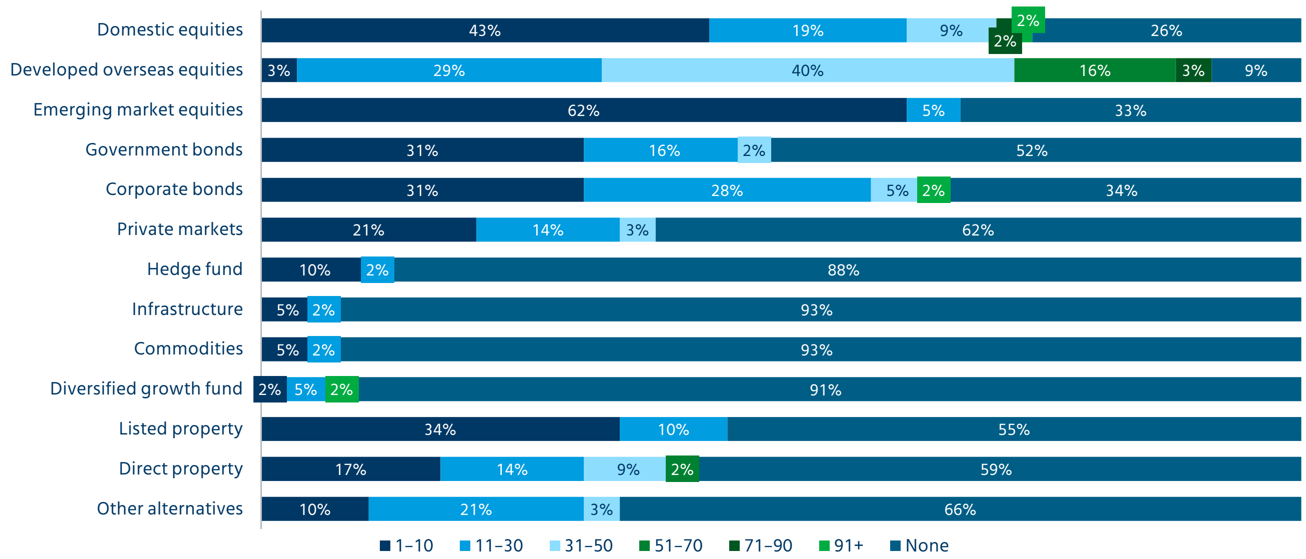
With nearly a quarter of NFP's indicating they only use one investment manager, we would suggest reviewing this arrangement. In addition to having diversification across asset classes and funds within these asset classes, we believe NFPs should also look to diversify by investment manager.

Strategic asset allocation remains an active and dynamic process throughout the sector. Despite maintaining a long-term focus, many NFPs undertake annual strategic reviews to ensure they are responding to the investment environment.

Diversification continues to be an important investment principle. We do observe that NFPs continue to utilise their tax exempt status, and perhaps (in the case of UK investors), by holding higher levels of domestic shares relative to other institutional investor types.

24% of respondents employ only a single investment manager

Current % proportion of total assets

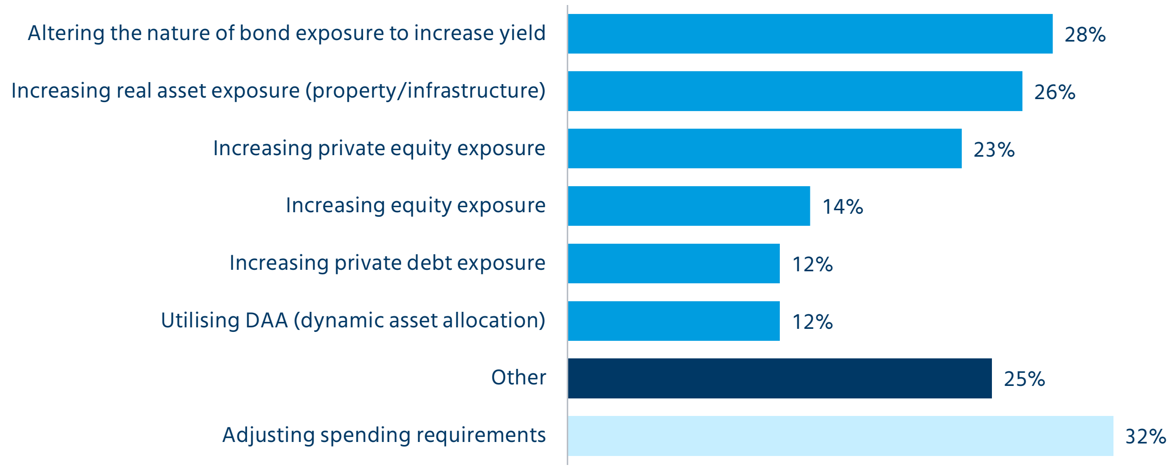


26% of respondents

said they will be looking to increase their portfolio exposure to real assets in an attempt to boost returns from the current and expected continued low yield environment.

35% said they will turn to allocations within private equity or private debt to boost returns.

Which actions will be implemented as a likely response to a low-income yield environment



3. The importance of ESG continues to grow - position for climate change

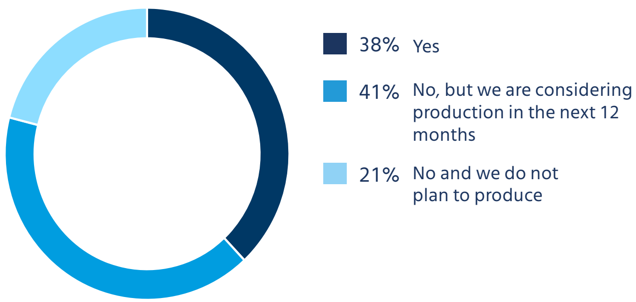
Climate crisis focus

The climate crisis is an increasing focus.

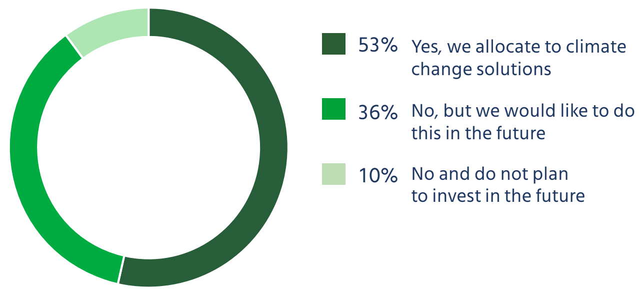
80%

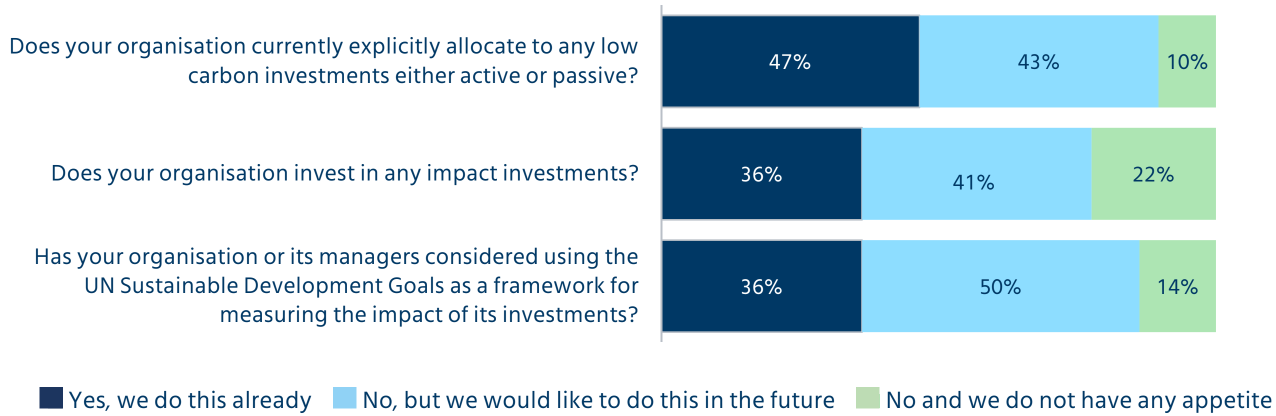
of respondents either have a climate policy or are considering introducing one in 2021. Further, almost half of respondents allocate to low carbon investments and of those who to don’t, a large majority would like to add this in the future.

Policy/statement in place to address climate change issues for investments



Investment in any assets to address climate change





27%

of NFP organisations who currently assess the progress of ESG and climate change have already committed to reducing their carbon footprint over time. Based on our experience of helping investors to develop these policies, we expect this proportion to increase in future surveys.

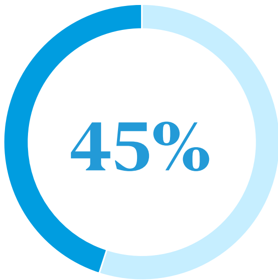
46%

use ESG manager ratings to assess manager progress

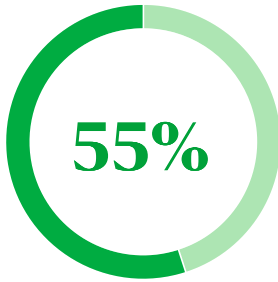
55%

are not currently assessing the progress of ESG and climate change, however 66% of these are considering implementing.

Does your organisation assess progress of ESG and climate change within their portfolio?



Yes



No

Of those who said their organisation does assess ESG and climate change within their portfolio

23%	27%	4%	46%	0%
Restrict investment in certain sectors (e.g. fossil fuels)	Commit to reduce their carbon footprint over time	Undertake scenario modeling on climate change	Use ESG manager ratings to assess manager progress	Yes, we undertake transition planning

Of those who said their organisation does not assess progress of ESG and climate change within their portfolio

66%	34%
Are considering implementing	Are not considering implementing

NFP organisations remain resolute in their focus on ESG factors as part of their investments and governance and face stakeholder pressure on numerous contentious issues.

Our survey continues to highlight the trend of increasing importance of ESG to NFP organisations.

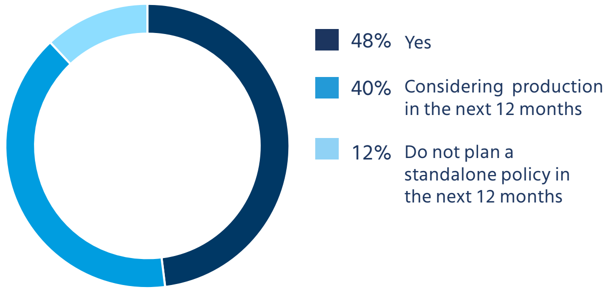
Over 88%

of respondents either have or plan to produce a standalone Sustainable Investment Policy, with 96% of those who have a policy plan to make it public, or plan to.

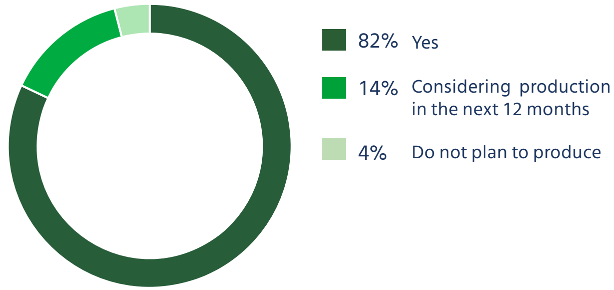
The key driver for considering ESG is the alignment with the organisations' mission – this was acknowledged by 74% of respondents. Reputational risks were also referenced by almost 50% of respondents.

52% identified it as the 3rd" greatest risk or challenge over the next 12 months

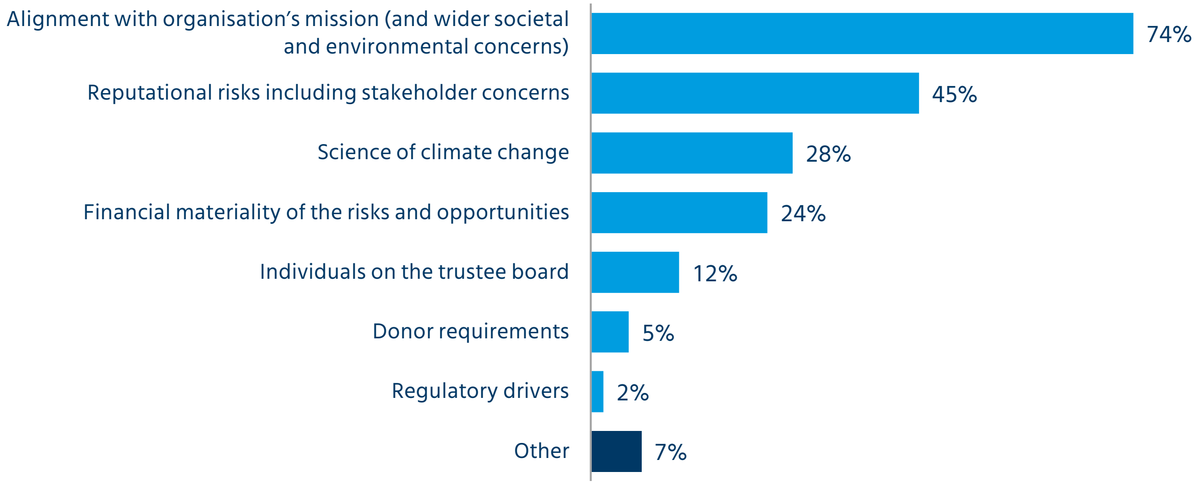
48% have a standalone sustainable investment policy



82% of respondents say their policy is public and outlines their organisation's approach to ESG



Key driver behind consideration of sustainability/ESG risks



Stakeholder engagement is also a hot topic with almost 50% of organisations undertaking stewardship activities and a further 25% considering introducing them in 2021.

2/3

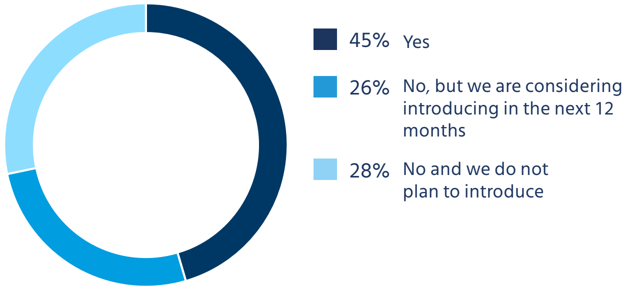
of respondents use exclusions within their investment portfolio. Tobacco and controversial weapons are the most common exclusions with climate focused exclusions becoming more common.

NFPs remain resolute in their focus on ESG factors as part of their investments and governance.

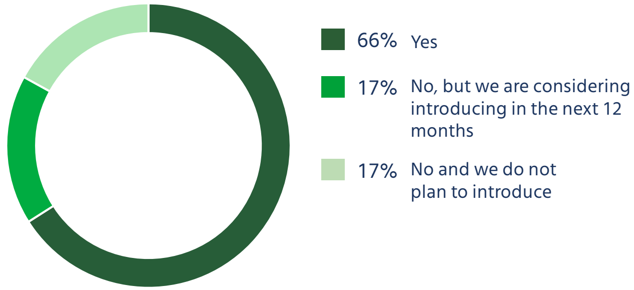
> We advise actively directing investments towards positive ESG assets and asset classes, rather than considering divestment as the only option.

The impact of climate change on investment portfolios is an area of increased focus.

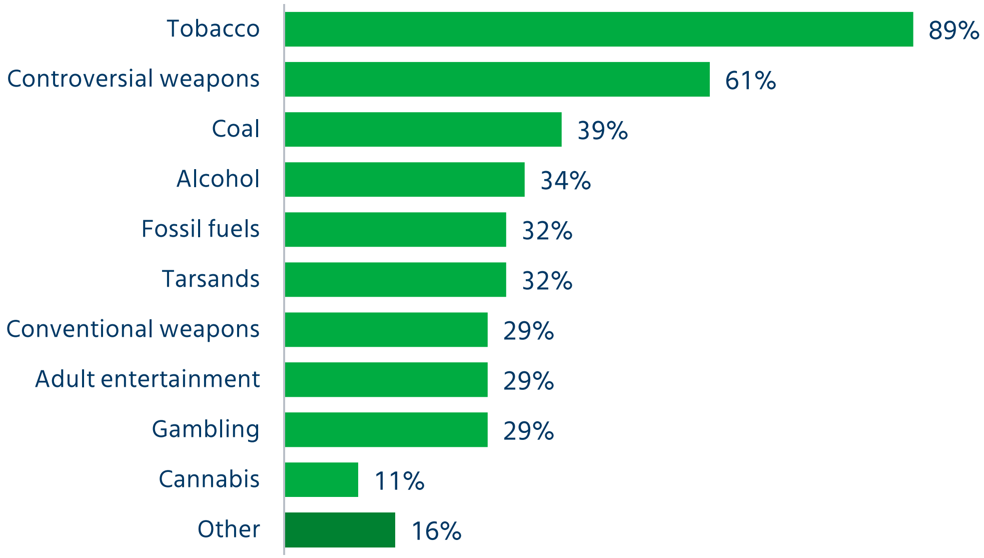
Undertake stewardship activities in support of ESG integration



Exclude any sectors within your investment portfolio



Does your organisation explicitly exclude sectors?



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About this survey

Mercer conducted a survey on NFP sector. The goal of this survey is to provide insights into trends and challenges that are shaping the not-for-profit industry, helping to equip organisation to face these challenges and positioned to capture opportunities.

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Organizations Participating in the Survey

November-December 2020

Data Effective Date

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