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RESEARCH PERSPECTIVES



FOREWORD



Robert Howie Matt Reckamp

Welcome to our first issue of *Research Perspectives* for 2014. Once again, we think we've assembled a solid set of articles from across our manager research boutiques. These articles are related to the theme of looking for investment opportunities in a low-growth world. In this environment, we think that equities still matter and that there is a case to be made for being more dynamic, for example, in response to the changing face of debt finance.

With that in mind, we open by highlighting a research paper on the benefits of long-term equity investment. The second article discusses how private debt (that is, non-

bank financing) investments are possibly moving from being opportunistic to playing more of a strategic role in a diversified portfolio. We've also included a piece on accessing differentiating segments of the evolving infrastructure markets, including as debt providers. A somewhat longer article that makes a case for continued investment in emerging markets rounds out our lineup of investment-oriented pieces. We close with a Q&A with Deb Clarke discussing her new role as global head of Investment Research.

As always, we hope you find *Research Perspectives* informative and timely. Please contact us if you have any questions or comments.

Robert Howie
Matt Reckamp

ABOUT THE EDITORS

Robert is a principal and European head of the Alternatives Boutique, a unit within Mercer's Investments business. Located in London, he leads manager research and generation of intellectual capital for alternative assets in Europe, spanning liquid hedge fund strategies to private market strategies such as infrastructure and private equity. Additionally, he advises institutional investors on the use of alternative assets, including manager selections and portfolio construction.

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Sarika Goel, CFA

LONG-TERM EQUITY INVESTMENT — HIGHLIGHTS OF OUR RESEARCH PAPER

Mercer recently produced a white paper titled “Long-term Equity Investment,” which outlined some of the benefits and constraints of equity strategies that employ a long-term investment approach. According to the World Economic Forum, this is defined as “investing with the expectation of holding an asset for an indefinite period of time by an investor with the capability to do so.”¹ This research is timely given a growing body of literature on issues related to the breakdown of long-term relationships along the investment chain.² With this backdrop in mind, we set out to test whether a long-term mindset on the part of investors leads to better relative returns. We also examined other, more qualitative arguments supporting — and the perceived constraints of adhering to — long-term investing. Although our analysis was not conclusive, we will continue to explore aspects of long-term investing.

INVESTMENT PERFORMANCE ANALYSIS

We used the Global Equity Core, EAFE, and US Large Cap Core universes as proxies for the broader market in analyzing whether investment strategies with long-term investment horizons had a performance advantage over those with shorter-term investment horizons. Using information from Mercer’s Global Investment Management Database, we focused on strategies in these three universes that had returns and expected turnover data available for the trailing 10-year period, ending December 31, 2012. This reduced the opportunity set from approximately 1,800 strategies to close to 500 across the three universes.

We then categorized the three universes into strategies with low, medium, and high expected turnover, defined as less than 40%, 40%–100%, and greater than 100% turnover per annum, respectively. The majority (90%) of these strategies across all three universes expect turnover to be less than 100% per annum (with approximately 10% expecting turnover greater than 100% per annum). The percentage of managers represented by each turnover approach — low, medium, and high — was fairly consistent across the three universes, as shown in Figure 1.

“This research is timely given a growing body of literature on issues related to the breakdown of long-term relationships along the investment chain.”

¹ World Economic Forum. *The Future of Long-term Investing*, 2011.

² See a recent research paper by Mercer consultants, “Behaving Like an Owner: Plugging Leakages in the Investment Chain,” available at <http://utpjournals.metapress.com/content/x68675178j796p02/fulltext.pdf>, accessed 18 February, 2014.

continued

FIGURE 1

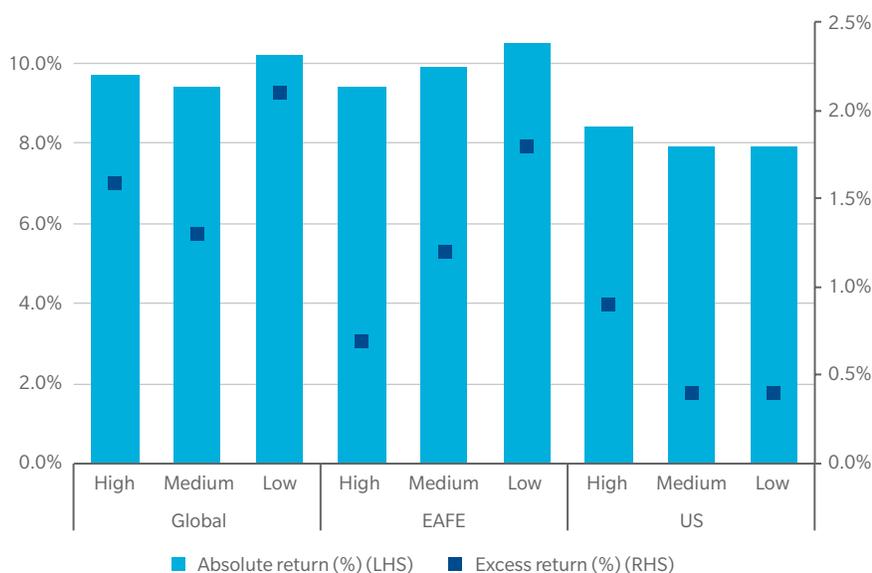
Opportunity Set by Geographic Region

| Turnover | US | | Global | | EAFA | |
|------------------------|--------------------|-------------------------------|--------------------|-------------------------------|--------------------|-------------------------------|
| | Number of managers | Percentage of opportunity set | Number of managers | Percentage of opportunity set | Number of managers | Percentage of opportunity set |
| Low (<40% p.a.) | 69 | 45% | 59 | 35% | 73 | 42% |
| Medium (40%–100% p.a.) | 71 | 46% | 86 | 52% | 88 | 51% |
| High (>100% p.a.) | 14 | 9% | 22 | 13% | 12 | 7% |
| Total | 154 | 100% | 167 | 100% | 173 | 100% |

Figure 2 below summarizes the results of our analysis. We acknowledge that our study is limited to one 10-year period, due to the difficulties of gathering a more exhaustive data set. Nonetheless, the results of our analysis show that there is no strong relationship between expected turnover levels and relative performance. The Global and EAFA results provide some support for the hypothesis that long-term horizon strategies may provide superior long-term performance, but the US results do not support this conclusion. We also note that, across the three approaches, the magnitude of the differences in relative performance does not appear to be significant.

FIGURE 2

Returns: January 1, 2003–December 31, 2012



continued

Although our study suggests that the relationship between expected turnover levels and relative performance is weak over the full period, we believe it is also important to understand the varying market styles that characterized this period before reaching a full conclusion. To accomplish this objective, we looked at the performance of style characteristics using data from Style Research. We note that over the 10-year period ending December 2012, value and quality factors outperformed the market while growth factors lagged, and momentum factors were generally neutral.

However, these conclusions, although instructive, could be too simplistic and might not fully explain what happened. A turbulent macroeconomic environment affected equity markets in a variety of ways over the past 10 calendar years. For example, from 2003 to 2007, high-turnover strategies generated a higher level of excess return versus that of their comparable low-turnover peer group. The exception was the EAFE universe. During this same period, value and momentum outperformed, while quality factors lagged. Although it is speculation, one potential explanation might be that global economies were expanding and access to credit was more accommodative. This may have favored managers that actively reallocated capital to new investment ideas.

In contrast, during the five-year period ending December 2012, the global financial crisis, eurozone debt panic, and the US debt-ceiling debacle of 2011 caused markets to oscillate from being willing to accept risk to shunning it. During this period, managers that employed a low-turnover investment approach tended to outperform. Alternatively, value and quality style factors outperformed, while momentum and growth factors lagged. Again, one might speculate that investors were better off remaining with managers that had conviction in their investment decisions and were not seeking to add alpha by continually turning over their portfolio.

BENEFITS AND CONSTRAINTS

In addition to performance, the paper highlights some benefits and constraints to investing with a long-term investment horizon. Some of the arguments supporting long-term investing include:

- Long-term investors are typically better placed to become more engaged with companies through ongoing dialogue, which has been shown to encourage company management to place more emphasis on long-term business strategy, thereby creating shareholder value.
- Investors with low-turnover approaches are able to take advantage of lower direct-trading costs.
- Investors with low-turnover strategies tend to exhibit better environmental, social, and governance characteristics compared with those with high-turnover strategies.

However, there are constraints to pursuing a long-term investment strategy; for example, increasing short-term pressure from all participants along the investment chain can result in a disproportionate focus on short-term performance. This pressure is reflected in, among other things, more frequent performance-reporting periods and can be manifested in the incentive structure of investment managers. For those investment management firms that base compensation on short-term performance metrics, investment decisions are more likely to be driven by the goal of delivering short-term performance.

“Long-term investors are typically better placed to become more engaged with companies through ongoing dialogue ... ”

continued

CONCLUSION

Although our study suggests that the relationship between expected turnover levels and relative performance is not strong, we will continue to explore other aspects of long-term investing and management engagement to ascertain the possible connections with creating shareholder value. Qualitatively, we think there are some advantages to investing with a long-term outlook (although this does not negate the merits of some investment approaches with shorter-term horizons). If clients wish to consider adding a long-term strategy, we have a number of highly rated, low-turnover strategies to consider.

Finally, the “Long-term Equity Investment” paper closes with some key questions that clients should consider addressing with their managers. A few are summarized below:

- Do your manager’s investment philosophy and process call for adopting a longer holding period?
- What alternative measures, beyond quarterly performance, are available to evaluate the manager against its objectives (that is, the operating performance of its portfolio companies) to move away from a short-term focus?
- Is there room for higher levels of engagement and active ownership such that the managers could better use their influence for positive corporate change?



ABOUT THE AUTHOR

Sarika is a member of the Global Responsible Investment team at Mercer, focusing on manager research. Her primary responsibility is researching ethical, environmental, and other responsible-investment-themed strategies in the listed equity space. She also works with other researchers across asset classes in assessing the extent to which fund managers incorporate environmental, social, and governance factors into their investment analysis. Sarika is based in London and she may be reached at sarika.goel@mercer.com.



Sanjay Mistry

PRIVATE DEBT MAKES ITS WAY INTO INSTITUTIONAL PORTFOLIOS

Over the years, the team at Mercer has been discussing the suitability of private debt with a range of institutional investors of all types and sizes across the globe. The discussion has featured a number of threads. First is that even those investors with misgivings cannot dismiss the attraction of this asset class, despite the number of different investment opportunities available. And second, the illiquidity of the asset class is arguably the most common barrier to investing. However, investors nevertheless recognize that risk-adjusted returns remain attractive relative to other credit strategies.

As the discussion progresses, the illiquidity concerns are rationally addressed, and one of the common questions from investors is, “How does an allocation to private debt fit into my current strategy?” It is around this question that we have seen some of the most disparate views, and changes in approach, from investors.

Around five years ago, many of the early private debt investors were allocating from an opportunistic or private equity bucket and targeting mid- to high-teen returns from their credit investments (largely focusing on mezzanine investments). Rolling forward to the current day, investors are now considering whether the investment might have a longer-term strategic, rather than a purely opportunistic, role. Although it will still take another generation of fund-raising to determine whether such a change is actually afoot, current indications point in that direction. Discussions we have held with a number of participants across the market also suggest that the European private debt market is set for longer-term structural change. The shift of investor private debt allocations from opportunistic to strategic has created a long-term source of non-bank debt financing that represents a structural shift in the European debt market.

“... investors are now considering whether the investment might have a longer-term strategic, rather than a purely opportunistic, role.”

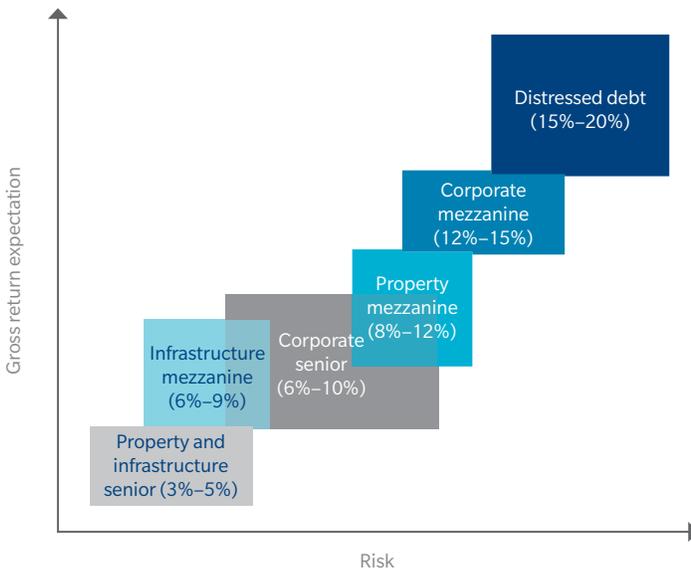
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EUROPEAN PRIVATE DEBT MARKET STRATEGIES

The other significant evolution is the emergence of a wider range of investment strategies in the European private debt market, as shown in Figure 1.

FIGURE 1

Risk and Expected Gross Returns in the Private Debt Market



Source: Mercer

Although the opportunistic mid-to-high-teen return-seeking funds still exist, a number of funds have been launched at the lower-risk and lower-return end of the spectrum. Here investors are looking for increased security as alternatives to publicly traded credit investments. Investments like senior real estate debt and senior infrastructure debt are two such examples for which pricing is in the range of LIBOR¹ + 2.0% to 4.5% p.a. Pricing in the core of the illiquid senior corporate debt market is higher (reflecting the higher risk) at LIBOR + 6.0% to 8.0% p.a. with total expected annual returns of 8% to 10% (gross of fees). The credit quality is typically below investment grade, the equivalent of BB and B-rated debt.

Certain strategies in the corporate senior debt market can be expected to generate even higher returns (say, 10% to 15% gross of fees), but it is important to note that the underlying risk levels are proportionately higher.

Some fixed-income-biased investors appear to be less comfortable with this higher-risk end of the market but, in contrast, investors with a return-seeking orientation often find this area more appealing.

GROWTH FIXED INCOME PORTFOLIOS

The wide range of strategies, risks, and expected returns available today is helping investors to construct robust private debt portfolios that can assist them in

“Certain strategies in the corporate senior debt market can be expected to generate even higher returns than senior infrastructure and real estate debt.”

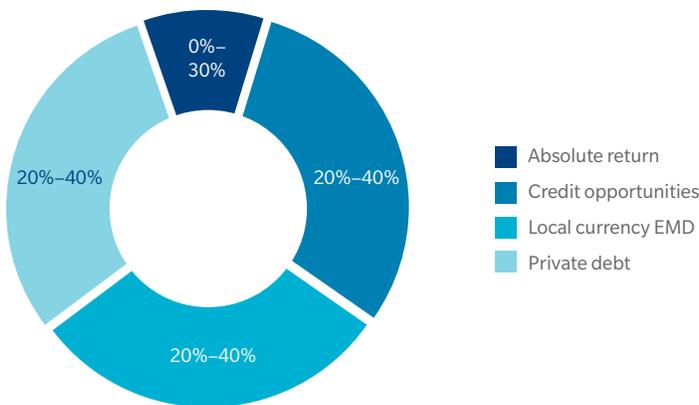
¹ LIBOR is the London Interbank Offered Rate, the main benchmark interest rates for banks lending to each other.

continued

meeting a diverse range of investment objectives. A prime example is building growth fixed income portfolios, for which we believe an allocation to private debt of around 20% to 40% of the portfolio can be supported, as shown in Figure 2. In this portfolio, we would expect private debt to sit alongside other credit assets such as multi-asset credit/credit opportunity, emerging market debt, and absolute return bonds. The premise is that we believe such portfolios should focus on generating returns from multiple sources, with the actual sizing for the private debt allocation varying by the extent to which private asset returns are being captured by those other credit assets.

FIGURE 2

Growth Fixed Income Portfolio



In summary, we believe that institutional investors are changing their attitude toward the European private debt market — moving away from an opportunistic approach to longer-term, more strategic allocations.

The range of strategies coming to market is also supporting this development, spanning lower and higher risk/return levels and thus enabling stronger portfolio construction as we hold the premise that investors, like those looking at growth fixed income, should focus on generating returns from multiple sources. Overall, with the European private debt market maturing and broadening into an asset class worthy of long-term strategic allocations, we believe the future of private debt continues to look bright.

ABOUT THE AUTHOR

Sanjay is a principal within Mercer's Alternative Boutique, part of the Investments business. As director of Private Debt, he is responsible for developing the boutique's intellectual capital and research coverage in this area. Sanjay also has responsibility for Mercer's European private equity coverage; he started covering the European private markets industry in 1999. He also sits on a number of advisory boards on behalf of Mercer clients. Sanjay is based in London and he may be reached at sanjay.mistry@mercer.com.



Amarik Ubhi, CFA

INFRASTRUCTURE: ALTERNATIVE ACCESS ROUTES

In the wake of the financial crisis, we have observed a reduced risk appetite — and increased focus on yield — across many investors considering a “real asset” allocation. In an infrastructure context, this has translated into a focus on lower-risk “core” style assets, which has resulted in some valuation pressures in certain segments of the market. Examples include operational, availability-based private finance initiative/public-private partnerships (PFI/PPP) projects (such as schools, hospitals, and government buildings) and utilities (such as water companies, electricity grids, and gas pipeline networks) in some regions. Monopolistic transportation assets viewed as “safe and stable” (such as key airports and some major ports) are also in demand in other parts of the world.

Even within this context, investors have become more selective since 2007. For example, investors now distinguish between northern and southern OECD Europe, and they have shown skepticism toward certain sectors that have demonstrated instances (however isolated and regionalized) of retroactive change in policy that have been detrimental to returns (such as in the renewable energy sector).

In contrast, investments that are not brownfield with a lower operational risk profile and located in “stable” OECD countries are perceived by many investors as being too risky and having no role to play in a portfolio context. Investor demand for “quality” projects is compounded by three additional interacting factors:

- Given that such projects are typically cash-generating (and may have a degree of inflation-linkage), they have proven appealing to yield-hungry investors in an environment of low base rates and bond yields.
- Following the financial crisis, investors seeking to diversify their portfolios away from listed equity and fixed income market exposure have been increasingly looking at alternatives, such as infrastructure, to fill this role.
- As the alternatives asset class has become more accessible and less niche over time, it is proving more popular with both new investors (such as sovereign wealth funds) and existing investors (such as pension schemes) as allocations are established or increased.

“... investments that are not brownfield with a lower operational risk profile and located in ‘stable’ OECD countries are perceived by many investors as being too risky ...”

continued

These types of investments have an important role to play in most well-constructed infrastructure portfolios, if acquired at reasonable entry prices. However, we also believe that portfolios should be diversified across different revenue and return drivers. In addition, portfolios should be built out subject to a market overlay, which takes into account supply and demand factors over time in order to identify value.

We highlight two additional deployment options available to investors seeking to access traditional infrastructure projects (infrastructure debt and secondary interests in infrastructure funds), and two options for diversifying an existing infrastructure portfolio (greenfield infrastructure and emerging market infrastructure), for consideration below.

INFRASTRUCTURE DEBT: To date, most investors have focused on the (unlisted) equity of infrastructure assets rather than on the debt. In part, this is because of the shareholder control and upside potential offered by equity investment. However, investors seeking a lower risk exposure to the asset class, perhaps as an augmentation to a traditional fixed income portfolio, have found it difficult to access suitable opportunities in infrastructure debt in the past. Pre-financial crisis, this part of the market was dominated by banks and the debt capital markets, which would provide and then hold on to infrastructure debt over the longer term.

Historically, this left little room (or role) for other types of investors. However, the market has since evolved and now provides a real opportunity for other institutional participants as long-term debt providers. More stringent financial regulation enacted following the financial crisis (specifically, Basel III) has forced banks to improve their liquidity positions and reduce leverage. In practice, this has made it more difficult for banks to provide (long-term) infrastructure debt and more “costly” for banks to hold such debt on the balance sheet. Similarly, debt capital markets are also now a less reliable source of long-term finance for infrastructure projects than they were before the financial crisis.

Infrastructure debt can be attractive for inclusion in a portfolio for several reasons. Historically, infrastructure senior debt in particular has exhibited low default rates and high recovery rates when compared with other forms of lending.¹ Also, infrastructure debt can allow investors to capture a credit and illiquidity premium for lending to projects on a long-term basis. For some loans, it is also possible to capture a direct inflation linkage that mirrors the linkage inherent in underlying project earnings streams. In combination, this means that infrastructure debt can provide returns and cash flow profiles that are appealing on a risk-adjusted basis, for those investors with the ability to tolerate a degree of illiquidity in the lower-risk segments of their investment portfolios.

INFRASTRUCTURE SECONDARIES: Over the past eight years, more than 350 infrastructure funds have been raised on a primary basis, with aggregate capital commitments of nearly US\$250 billion.² Although still evolving, a secondary market for these funds has developed, growing from around US\$200 million in 2008 to nearly US\$2 billion in 2013 by volume of transactions completed.³ Secondaries can provide investors with an alternative way of accessing traditional infrastructure projects at potentially more attractive valuations, if approached on an opportunistic and well-informed basis.



Greenfield projects (top) are assets yet to be constructed, whereas brownfield investments (bottom) are established assets (albeit which are sometimes in need of improvement)

continued

¹ Moody's. *Default and Recovery Rates for Project Finance Bank Loans, 1983–2011*, February 2013.

² Q4 2013 Infrastructure Fundraising Report. Preqin, January 2014. https://www.preqin.com/docs/newsletters/inf/Preqin_Infrastructure_Spotlight_January_2014.pdf (Page 4).

³ Campbell Lutyens. January 2014.

Regulatory and structural change is expected to increase supply (specifically, the Volcker Rule and Solvency II). Banks and, potentially, some insurance companies could be forced to reduce (or dispose of) their private market investments to comply with the changes, including infrastructure. Also, some infrastructure managers previously owned by financial institutions are now seeking independence. This process is likely to prompt more (institutional) investors to exit funds in which there is now platform uncertainty.

Existing investor behavior is also evolving. Previously, sales may have been motivated by the need for liquidity and/or the mixed performance of certain investments. Now, some investors also consider exits more opportunistically for portfolio construction reasons and so forth.

GREENFIELD INFRASTRUCTURE: Most investors appear to be wary of investing in greenfield projects due to perceptions of construction and “ramp up” risk (that is, the risk associated with the initial uptake in usage of the asset by the relevant client base and with the commencement of physical operations themselves). Although these risks should not be ignored, they are, in fact, quite different in nature and, in our view, often poorly understood by investors. It is also important to note that not all greenfield projects contain both levels of risk in equal measure, and indeed, many new projects being pursued by private infrastructure investors contain a limited ramp-up risk profile (if any). Indeed, greenfield patronage-based projects (that is, those with exposure to volume and/or price risk) with a fully exposed ramp-up profile risk are now rare due to a marked shift in investor appetite away from this approach. By contrast, construction risk can be mitigated in a meaningful way when investors apply discipline in the types of projects considered for investment, work with experienced construction and operational partners, and ensure appropriate contractual protections are put in place upfront. There is a strong level of experience in this area across established managers and sponsors in the market.

Selective exposure to greenfield infrastructure should be of interest to investors as it can be an effective means of enhancing returns from the asset class. A well-observed “de-risking” premium can be earned by investing in projects at the construction stage and then exiting once projects are mature, cash-generative, and therefore more appealing to a wider group of (yield-hungry) investors. Currently, this is evident in certain sectors such as PFI/PPP projects and renewable energy. Similarly, there is a well-observed premium available to long-term, buy-and-hold investors prepared to invest at the construction phase of a project.

EMERGING MARKET INFRASTRUCTURE: In a similar way to greenfield projects, emerging market infrastructure can allow investors to capture additional (and different) sources of return from the asset class. Energy demand, ongoing urbanization, and transportation bottlenecks are three of the long-term themes prevalent in many emerging markets that will require significant capital expenditure, estimated to be around US\$1 trillion per annum until 2030.⁴

It is important to note that such investments carry extra political, regulatory, and currency risks compared with traditional infrastructure projects more commonly sought by investors. As such, potential allocations must be appropriately sized within the context of a well-diversified portfolio and must be implemented via suitably qualified and positioned managers. However, investors should be aware that these risks can be managed effectively.

“Selective exposure to greenfield infrastructure should be of interest to investors as it can be an effective means of enhancing returns from the asset class.”

continued

⁴ Royal Bank of Scotland. *The Roots of Growth: Projecting EM infrastructure demand to 2030*, 2011.

CONCLUSION

In our view, traditional core-style infrastructure investments still have an important role to play in most portfolios established around the asset class. However, investors should also be flexible when building out portfolios and should recognize that the infrastructure market can be both cyclical and disparate in its pricing of risk across regions, sectors, and project types. In addition, investors should be mindful of the differing portfolio roles that varying types of infrastructure investment can perform. Finally, as with all private market assets, deploying to a robust and well-thought-out portfolio plan is also critical.

ABOUT THE AUTHOR

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REVISITING OUR STRATEGIC RATIONALE FOR INVESTING IN EMERGING MARKETS



Paul Cavalier



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Noel Collins

RECENT MARKET DEVELOPMENTS

Continuing the poor performance witnessed in 2013, emerging markets (EMs) weakened sharply and suddenly in the latter part of January 2014. In particular, the currencies of Argentina, Turkey, South Africa, and Russia came under strong selling pressure. The specific triggers for this were ongoing political concerns in Argentina — where central bank support for the peso was withdrawn, effectively devaluing the currency — and growing concerns over the possible vulnerability of the Chinese economy due to a domestic credit bubble. In the context of markets nervous about the implications of US Federal Reserve tapering, along with political unease in Ukraine, Turkey, and Thailand, the MSCI Emerging Market Equity Index fell 4% (in local currency terms) in three days, while the yield on the JPMorgan Local Currency Emerging Market Debt Index rose around 50bps to 7.25%. EMs continued to trade nervously heading into the end of January 2014, when a number of countries took action: The Turkish central bank raised interest rates by 450bps, India raised rates by 25bps, South Africa raised its key interest rate by 50bps, and Russia's central bank intervened directly in currency markets to support the ruble.

In a wider context, this nervousness in EMs follows a period of turbulence that began in May 2013. At that time, EMs suffered sharp falls triggered by initial comments from the Federal Reserve that hinted at a possible reduction (tapering) in the scale of its quantitative easing policy. Although not part of our original thesis, EMs had been seen as a beneficiary of quantitative easing, since the policy increased investor flows toward “growth” assets. The potential withdrawal of this liquidity left markets and investors questioning their investment theses. In this period, much of the weakness in EMs had manifested itself via the currency markets.

DOES THE STRATEGIC CASE STILL HOLD IN THE LIGHT OF RECENT EVENTS?

Higher Long-term Economic Growth Rates?

EM economies can be expected to achieve higher levels of economic growth than developed markets (DMs) will for a number of reasons. This is driven by a greater potential for productivity gains (due to infrastructure improvements and labor market

“EM economies can be expected to achieve higher levels of economic growth than developed markets will for a number of reasons.”

continued

up-skilling) and typically younger populations, leading to growth in the overall workforce. These factors are largely unaffected by recent events. However, EM growth is also positively influenced by other factors, such as relatively low levels of government debt and flexibility in fiscal and monetary policy, and these factors are more likely to be influenced by recent market developments. A clear example is Turkey's recent decision to raise interest rates sharply in order to protect its currency. All else being equal, such a move could have a negative influence on economic growth in the short term, even if it achieves its main aim of defending the currency. We do not believe this would necessarily have a significant effect on Turkey's long-term growth potential.

More generally, investors fear that market moves can have an adverse "vicious circle" impact on an EM economy, in that as portfolio flows reverse away from a country's bond and equity markets, the currency weakens. This pushes up inflation, which causes the central bank to raise interest rates, potentially leading to lower growth. This is especially the case in what the market has termed the "Fragile Five" (South Africa, Indonesia, India, Turkey, and Brazil), due to their reliance on imported commodities. Although we acknowledge that such a sequence of events is quite possible, we believe that the likelihood of such an outcome very much depends on a country's wider balance of payment flows and currency reserves. In particular, flows of foreign direct investment (FDI) into an EM economy are an important source of finance. Our view is that such capital flows (via FDI) are likely to continue, due to the productivity and demographic factors discussed above. It is also important to note that many EM countries have high levels of foreign exchange reserves, which gives them additional means of protecting their currencies in periods of weakness.

Generally Better Demographic Profiles?

Excluding conjecture on possible longer-term, second-order impacts (such as increased emigration if current events lead to recession), demographic profiles and the rise in workforce growth are unaffected by recent events.

Lower Levels of Government Indebtedness?

The starting point of relatively low debt levels remains unchanged, but it is fair to say that currency weakness generally increases the debt-servicing costs for EM economies (hard currency debt becomes more expensive, while local currency yields likely move higher). But the original point still stands: Countries can more easily withstand the impact of such moves when initial debt levels are low rather than when debt levels are high.

Higher Secular Productivity Gains Relative to Developed Countries?

Broadly speaking, the potential for productivity gains remains unaffected. It is possible to argue that certain funding inputs into productivity improvements (for example, training budgets, infrastructure spend) are, at the margin, somewhat less likely during periods of market stress. However, we feel that such a case is too subjective to change our initial opinion that the potential for productivity gains remains intact.

Portfolio Diversification?

Arguably, the nature of EM investment has become much more country-specific in the last 12 months or so, with market analysis increasingly distinguishing between categories of countries such as the Fragile Five, the "Edgy Eight,"¹ and "debtor countries/creditor countries." Although EM investment has always had a country-specific (and company-specific) discipline, recent events have highlighted the level of diversification inherent in EM portfolios.

"More generally, investors fear that market moves can have an adverse 'vicious circle' impact on an emerging market economy, in that as portfolio flows reverse away from a country's bond and equity markets, the currency weakens."

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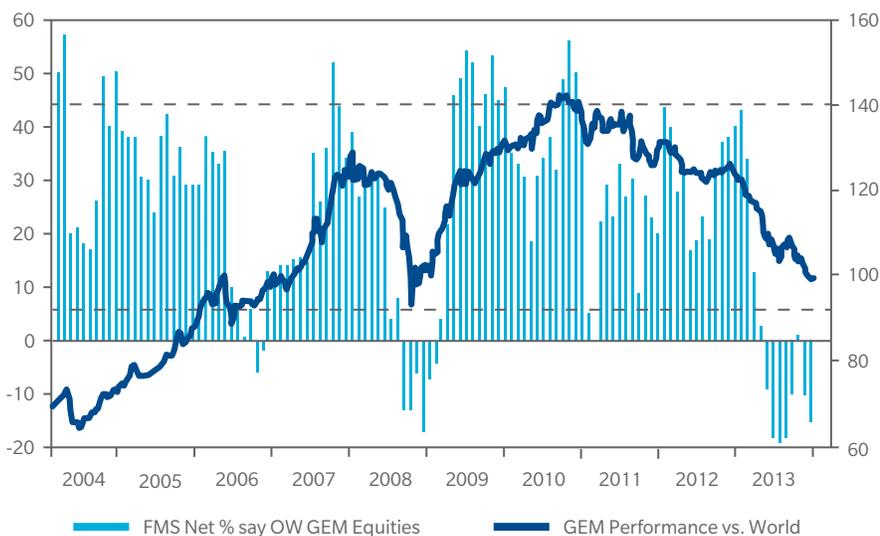
¹ The "Edgy Eight" countries, according to data processed by Schroders and the *Financial Times*, are South Africa, Turkey, Brazil, India, Indonesia, Hungary, Chile, and Poland. This is an expansion of the "Fragile Five" and broadly links vulnerability to current account and fiscal deficits.

EM benchmarks imply exposure to, and hence diversification across, a large number of countries and regions. However, one point to consider is that the most common emerging market debt (EMD) benchmark contains 40% in the Fragile Five countries. This factor does highlight our preference for an active management approach within EMs. Furthermore, correlations between EMs and DMs have been low in recent times; this enhances the portfolio diversification potential of EM securities in client portfolios.

In terms of portfolio positioning, the recent Bank of America Merrill Lynch Global Fund Manager survey also revealed that fund managers are already underweight EM equities, with net exposures significantly lower than the long-term average. Thus there is “capacity” for portfolios to diversify and allocate more capital to EM assets. The bars in Figure 1 below show the net percentage of survey respondents that are overweight EM equities. The current reading is -15%, meaning that there are more managers underweight the asset class than managers who are overweight the asset class. The black line shows the relative performance of EM equities versus DM equities.

FIGURE 1

Asset Allocation: Global Emerging Market Equities



Source: BAML Global Fund Manager Survey (January 2014)

Attractive Return Potential?

Yes, we believe so. In 2013, the MSCI World index (in USD terms) rose 27.4%, while the MSCI Emerging Market index (in USD terms) fell 2.3%. On this metric alone, we believe relative valuations look attractive. Although some areas in EM equity have become expensive, such as in the consumer staples and health care sectors, it is important to note that they comprise a relatively small portion of the overall market. In contrast, the more cyclical areas of EMs — such as energy, materials, and financials, which account for approximately 50% of the broader opportunity set — are trading well below their long-term average valuations. However, this is mainly

“Thus there is ‘capacity’ for portfolios to diversify and allocate more capital to emerging market assets.”

continued

due to the large weights in the high-risk markets of Russia, Brazil, and China. In valuation terms, price-to-book ratios for the MSCI Emerging Markets energy, materials, and financials sectors are trading substantially below their long-term averages. In addition, the 12-month forward price/earnings ratio of the MSCI World Index has risen to a postcrisis high of 14.9, whereas the ratio on the MSCI Emerging Markets Index is down to 10.1. This valuation difference is at its highest since June 2005. We believe that although there are short-term risks to our expectations, current valuations from an absolute perspective, and maybe more importantly from a relative perspective, make EM equities a strong investment opportunity over the longer term.

Meanwhile, local currency EM bonds offer a yield in the region of 7.25%. In addition, the yield spread between JPMorgan's Government Bond Index and its Emerging Market Global Diversified Index at the end of January stood at 525bps. The only time it traded at this level over the last 10 years was very briefly at the height of the financial crisis in 2008. We feel that this is an attractive level of valuation given the credit quality of EM sovereign issuers (70% of the index is rated investment grade). It should also be noted that the improving outlook for the global economy provides a positive backdrop for EMD, notwithstanding the market's more immediate focus on the importance of Chinese growth prospects for EM economies.

WHAT ARE THE RISKS?

As with all growth assets, there are a number of risks and uncertainties associated with EM investment. Idiosyncratic country risk will likely have a far higher bearing on market direction than it has had in the past few years. Furthermore, the policy uncertainties that exist at a global level, such as changes in US monetary policy, may result in continued volatility in EM assets for some time, and investors need to be aware of these factors.

- China is of extreme significance for many EMs, forming a large part of the equity index and acting as major source of demand for EM exports. As China continues its attempt to transition from investment-led to more balanced growth, investors' concern has grown over the rapid pace of debt expansion. Indeed, Chinese bank credit has increased from 100% of GDP to nearly 140% of GDP since the financial crisis. Many commentators have pointed out that this could lead to a potential credit bubble, and this risk will have to be monitored carefully. However, we do not see a catalyst for a crisis, as China does not need foreign capital inflows and the government has the capacity to recapitalize banks and support local governments if needed. Nevertheless, reducing debt growth will put downward pressure on economic growth over the short term.
- The election calendar for EMs is full in 2014, including in the Fragile Five countries, and this will undoubtedly contribute to volatility. Most of the recent movements in debt markets have focused on these five countries as their economies have experienced a widening of their trade deficit. These countries have found it harder to attract capital inflows, which has led to significant currency depreciation and interest rate increases. However, broadly speaking, current account deficits are smaller today than in the lead-up to the crisis in 1997/1998, and levels of external debt are lower. Additionally, many countries have amassed large currency reserves, which should act as a buffer in the event of a panic. Therefore, although it remains a major risk, a widespread crisis appears unlikely.
- Rising US bond yields (and eventually interest rates as well) are likely to represent a headwind for some emerging economies and markets over the next few years.

“... the improving outlook for the global economy provides a positive backdrop for emerging market debt ...”

continued

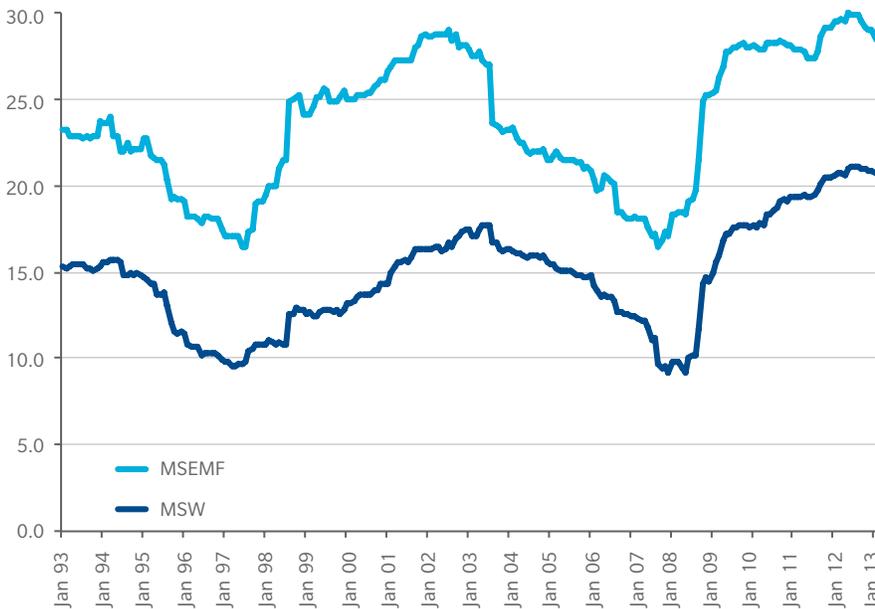
However, if the pace of US rate increases is as moderate as we expect, this should relieve some pressure.

- Rising wage costs in most emerging economies relative to developed economies have made EMs less competitive, while their higher share of world trade makes further gains more difficult. As a result, it is important that EM economies seek to improve their competitiveness through structural reforms.
- Additionally, in deficit countries, rising inflation due to higher import prices has put central banks in a difficult position. Soft growth requires lower interest rates, while higher inflation requires higher interest rates. Central banks of deficit countries have generally responded by raising interest rates, while hoping that recently depreciated domestic currencies would remain relatively weak and boost exports. There have been signs of a pick-up in export growth in some countries, although consumption remains soft. We expect the ongoing pick-up in the developed world to lead to stronger EM export growth.
- On a trade-weighted basis, the US dollar advanced 4.5% in 2013 — another contributing factor that led to declines in EM currencies, especially those that are commodity-sensitive. If this trend continues, it could place further pressure on commodity-sensitive currencies and impact inflation expectations. Although the risk remains, a lot of this news appears to be discounted in the price.

Recent volatility does serve to highlight the risks of investing in EM assets. Figure 2 below highlights how volatile EM equities have been in comparison with their developed peers, and we have no reason to believe that this relationship is likely to change meaningfully in the short to medium term.

FIGURE 2

MSCI Emerging Markets and MSCI World Index



Source: Mercer MPA

“We expect the ongoing pick-up in the developed world to lead to stronger emerging market export growth.”

continued

WHAT ACTIONS SHOULD INVESTORS CONSIDER?

We believe that investors' growth portfolios should have a broad and diversified exposure to different asset classes, covering both DMs and EMs. We also believe that investors should assess their strategic asset allocation in the context of their longer-term return and risk objectives, without being unduly swayed by shorter-term market volatility.

Equities

For equity portfolios, a natural reference point for sizing the EM allocation is its market capitalization, which currently stands at around 11% of the global equity universe. For investors who are significantly underweight the market cap exposure, we recommend that those with the risk tolerance to withstand the volatility associated with EMs consider increasing their allocation toward the market cap weight. Although our medium-to-long-term view remains positive, given the potential short-term risks to EMs discussed above, we would suggest phasing such an increase in allocation over the next six to 12 months in order to mitigate timing risk.

Where the current allocation to EMs is at or around the market cap weight, we would suggest that the appropriateness of any action will depend on investor specifics. For investors with a low to moderate risk tolerance who intend to reduce equity risk over the next five to 10 years, it may be appropriate to retain the current position. Rebalancing the EM allocation should be considered if it has fallen materially below the target level.

Investors with a higher risk tolerance and a relatively long time horizon might consider increasing their EM allocation to reflect the favorable medium-term outlook and the fact that recent performance has left EMs at attractive valuation levels (in both absolute and relative terms). A phased approach could be adopted, using any short-term underperformance as an opportunity to increase exposure. We continue to suggest that an allocation to EMs of around 20% could be accommodated within an equity portfolio that is balanced in terms of risk by an allocation to low-volatility equities, and diversified into smaller companies (around a core invested in DMs).

Fixed Income

We are of the view that local currency EMD plays a valuable role in growth portfolios, particularly since the prevailing yield on EMD is broadly in line with what many investors would consider to be a reasonable long-term rate of return for growth assets. This being so, an allocation to EMD will likely improve portfolio diversification by broadening the range of return drivers away from equities. We view the recent increase in yields and currency weakness as an opportunity for investment in this asset class. However, we do note the risks mentioned above could well lead to more pain in the short term.

We continue to favor local currency debt over hard currencies on the grounds of better issuer quality, higher yield, and the potential for currency appreciation over the long term. However, we recognize that hard currency debt can also be attractive in its own right, and its lower volatility characteristic may appeal to some investors. This means that blended products (with both hard and local currency) may also have an increasingly significant role to play.

“For investors who are significantly underweight the market cap exposure, we recommend that those with the risk tolerance to withstand the volatility associated with emerging markets consider increasing their allocation toward the market cap weight.”

continued

We would recommend that investors who have yet to allocate capital to EMD should consider this asset class as part of their growth portfolio. Given the current volatility and potential for further currency declines in the near term, it might be wise to adopt a phased approach.

For those clients currently invested in the asset class, we would advise that they remain invested. The short-term economic prospects have weakened, but this should be kept in perspective — growth remains healthy in absolute terms, even as some economies struggle with imbalances. Current yields look attractive from both an absolute and a relative basis, and further weakness could lead to opportunities to add to existing positions.

CONCLUSION

Emerging markets are a volatile asset class by their very nature, and we have experienced significant negative years before, such as 1994 and 1998. In both cases, markets ultimately recovered and subsequently provided strong returns, and we believe that the current situation will result in the same outcome. As we have touched on in this paper, there is a diverse range of risks and challenges facing EM economies in the current environment, and active management is essential for portfolios so they can be appropriately constructed to reflect the manner in which different countries address these challenges. The silver lining is that the current upheavals could provide the impetus for reforms to boost long-term growth potential, which are often hard to make when times are good.

ABOUT THE AUTHORS

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Deb Clarke

Q&A WITH DEB CLARKE

DELIVERING VALUE BY HARNESSING STRATEGIC AND MANAGER RESEARCH

Q: How long have you been at Mercer and what did you do before joining the firm?

A: I joined Mercer in November 2005 from Watson Wyatt, where I served as a senior investment consultant and researched Asian and emerging market equity managers. Before that I was an equity fund manager for 20 years, my last position being head of Equities for Friends, Ivory & Sime in 2003.

Q: In September 2013, you were promoted from head of the Equity Boutique to global head of Investment Research. What does your new position entail?

A: This position effectively expands what I have already been doing as head of the Equity Boutique to other areas of research. I am now responsible for leading all Mercer's intellectual capital across strategic and manager research in all asset classes, including global asset allocation processes.

Q: What appealed to you most when you first considered taking the role as global head of Investment Research?

A: I was keen to broaden my responsibilities and be able to influence the development of our strategic and manager research, and to foster the link between the two. These are interesting times in financial markets and, more than ever, it is important to be cohesive in our delivery of advice to clients and to identify the most appropriate way to implement our best ideas for all clients.

Q: What do you miss most about your previous position?

A: The equity team has a strong, global culture, which I believe I have contributed to, so I will miss that. However, the other boutiques have strong cultures and I look forward to working with them more closely. Our global strength across the manager research team more broadly gives me enormous pride, and I believe it will strengthen as we work even more closely with the strategic research team.

Q: Have you been able to identify the biggest challenges in your new role?

A: It is still early days, but I want to be able to harness all the research we have and ensure that our clients' portfolios continue to proactively benefit from our best thinking as it evolves.

Q: One of your first decisions was to appoint Nick Sykes to a newly created position as director of Manager Research. What is your vision for this new position?

A: Nick will be spending a considerable amount of time with the Manager Research team. His responsibilities will include ensuring our research efforts retain their edge, that our best manager ideas are reflected in client portfolios, and that we have strong governance around the manager research process — across boutiques and across regions. He has a depth of experience with large clients and has been instrumental in developing our strategic research. He will be a strong advocate for manager research and contribute to how we evolve over time.

Q: Tell us about the other organizational changes you have made so far.

A: We recently put a new governance structure in place around our investment research pertaining to the prioritization, generation, and delivery of our global intellectual capital. This is designed to streamline the creation of strategic research and ensure that what we produce is “end to end,” from concept to client implementation. We have some new faces involved in the process, and over time I look forward to introducing them to a broader audience.

Q: In terms of strategic research themes, where do you see Mercer going in 2014?

A: Opportunities, which typically present themselves at times of market stress, are not as obvious at this point of the cycle as they may have been in the past. As such, some of the current opportunities are more “niche” or specialized in nature — these can be considered for those clients with sufficient governance budgets. More broadly, we believe clients need to be nimble, as the path to longer-term economic recovery, and the associated market response, is not likely to be a straight line. Opportunities are likely to present themselves for those investors who are prepared to respond dynamically to bouts of economic and market volatility. At the same time, we continue to believe in the importance of incorporating a diversifying mix of return drivers in a growth portfolio. Lastly, there is a compelling argument to be made that investors may be able to capture a return premium by actively engaging in building long-term portfolios that are consistent with mega sustainability trends, such as climate change and resource scarcity, amongst others.

Deb Clarke is Mercer’s global head of Investment Research, which includes responsibility for manager research and strategic research. Based in London, Deb manages a group of more than 100 asset class specialists across alternatives, fixed income, equities, and real estate. She also oversees the Strategic Asset Allocation, Dynamic Asset Allocation, Strategic Research, and Responsible Investing teams. These teams work together to support our full range of client solutions, from advisory to fiduciary management.

ABOUT MERCER'S RESEARCH BOUTIQUES

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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- Structure of fixed income allocations.
- Research on fixed income investment trends and opportunities.
- Due diligence on managers and strategies.
- Advice on portfolio structuring.
- Performance reporting.
- Assistance with fee and mandate negotiation.
- Ongoing due diligence of investment managers and client portfolios.

For more information, contact Paul Cavalier (London) at +44 20 7178 7314 or paul.cavalier@mercer.com

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- Due diligence on managers and strategies.
- Structure of equity allocations.
- Research on equity investment trends and opportunities.
- Advice on portfolio structuring.
- Performance reporting.
- Due diligence and assistance with fee and mandate negotiation.
- Ongoing monitoring of investment managers and client portfolios, including regular updates on performance.

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- Research on real estate investment trends and opportunities.
- Due diligence on managers and strategies.
- Performance reporting.
- Due diligence and assistance with fee and mandate negotiation.
- Ongoing monitoring of investment managers and client portfolios.

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