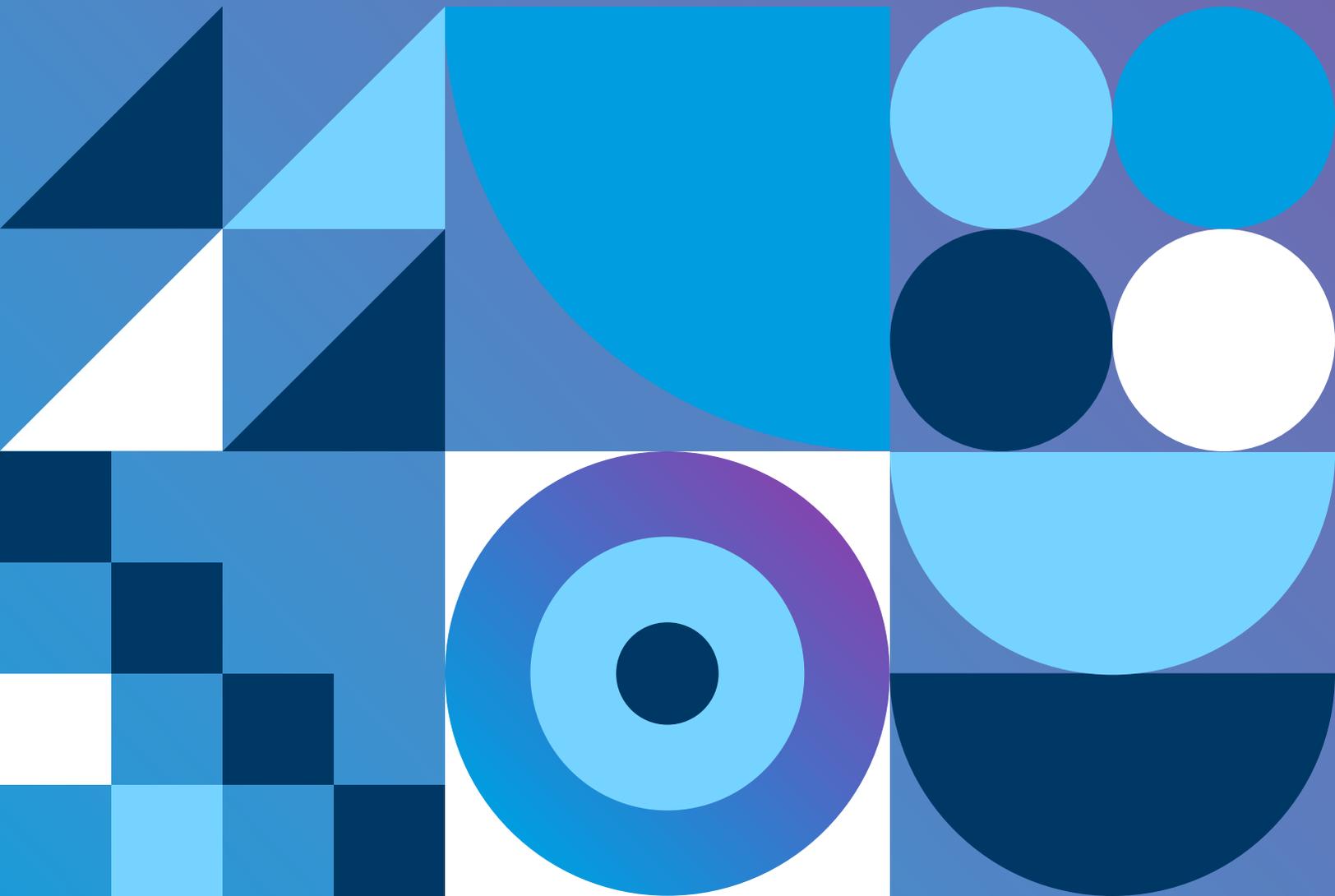


# How to be ready for investment opportunities

Global Investment Research



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# Capitalizing on investment opportunities — building the right mindset

Market volatility can be uncomfortable. However, in the uncertain depths of a market crisis, there can be emerging signals of investment opportunity, provided investors are looking for them and are positioned to capitalize on them. So far, in 2020, against the somber backdrop of a global pandemic, Mercer has alerted clients of investment opportunities in fixed income and gold while also encouraging investors to be pragmatic about rebalancing. Furthermore, we have emphasized that periods of volatility are likely to be favorable for strategies that allow asset managers a degree of freedom in deciding where to invest.

## The following exhibits present examples of market dislocations or concepts that

### Global high-yield bonds



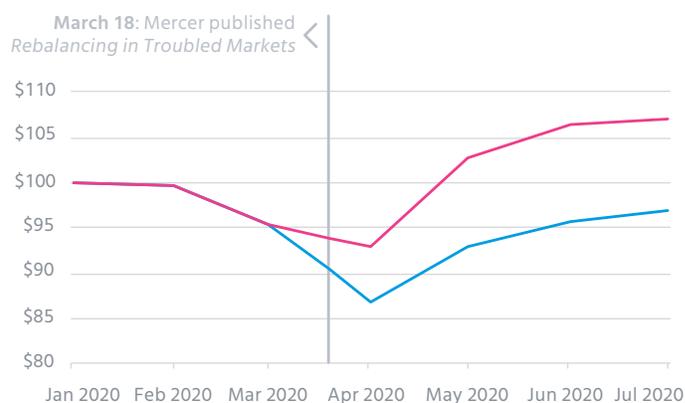
### Gold and gold equity returns in 2019 and 2020



### More volatile markets are expected to make fertile ground for less constrained investment strategies - CBOE VIX



### Regular rebalancing versus halfway rebalancing



Source: Thomson Reuters DataStream. Chart notes, clockwise from top-left:

1. Growth of \$100 for an investment in global high-yield bonds. Returns shown for the period January 1, 2020 to July 9, 2020 based on the total return index for the ICE BofA Global High Yield Bond Index hedged into US dollars, indexed = 100 as at January 1, 2020.
2. Growth of \$100 for an investment in gold bullion and gold equity. Returns shown for the period January 1, 2019 to July 9, 2020 based on the price index for a gold bullion troy ounce and the total return index for the FTSE Gold Mines Index. Returns are shown in US dollars.
3. Growth of \$100 for an investment in a mixed investment strategy (60% equity, 40% bonds). Returns shown for the period January 1, 2020 to June 30, 2020 based on the total return indexes for the MSCI All Countries World Index in US dollars (target allocation 60%) and the Bloomberg Barclays Global Aggregate Index, hedged into US dollars (target allocation 40%). Rebalancing at the end of each month assumed either (a) all the way to target allocation, or (b) halfway to target allocation.
4. CBOE VIX for the period January 1, 2020 to July 9, 2020.

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Opportunities such as these can be fleeting, which presents a challenge for investors: How can they balance the need for speed with the necessary caution? Investors also should think about the need for cash during a crisis if they want to capitalize on market dislocations. In other words, how do you invest opportunistically?

## Speed versus caution

**The recent COVID-19 market downturn illustrates how quickly markets can shift. In 23 days, the S&P 500 Index fell 30% — and then recouped 52% of those losses in the subsequent 23 days. Bond markets followed a similar pattern, with substantial ranges in valuations and high credit spread volatility. A nimble investor with perfect foresight could have reaped significant rewards. But dipping in and out of the market with less clairvoyant timing could have undone several years of diligently earned investment returns. Choosing the “right” investments is always easy in hindsight, but difficult in the moment.**

Even with perfect foresight, any delayed decision-making could have proved very costly for an opportunistic investor, given the speed of these movements. Acting quickly while making sure you remain focused on your long-term objectives is a balancing act.

Mercer believes there are ways to introduce agility — without compromising on the quality of investment governance — to support an opportunistic approach.



### Plan ahead

Some opportunities are cyclical, which means you can do much of the work of assessing the merits of these opportunities before the right moment to invest arises.



### Assign decision-making responsibilities, measure performance and set risk limits

Delegating responsibilities to a subcommittee, an investment manager or consultant can encourage agility in investment decision-making. However, like any active management decisions, there must be accountability, performance measurement and clear risk limits. We discuss the decision-making process in more detail on the next page.



### Look for efficiencies in execution and implementation procedures

Derivatives, for example, may be a helpful tool in enabling quick execution of short-term allocations at a very low cost. For example, defined benefit investors will already have collateralized exposures with a manager as part of their liability-hedging portfolio. This relationship can be leveraged for other synthetic exposures.



### Think ahead to the exit strategy

Considering how any opportunistic investment will be unwound is essential before investing.

# The cost of cash

**Allocations to time-sensitive market opportunities require funding. Typically, investors raise capital through some combination of rebalancing the portfolio, reducing invested amounts across all asset classes or deploying cash flows. However, in times of market stress, portfolios are likely to be affected by collateral and capital calls for various investment strategies. Raising cash may mean selling investments, potentially at a loss. Short-term liquidity commonly becomes the focus at these times, which can preclude investing in time-sensitive opportunities.**

Despite these challenges, there are ways investors can overcome these issues.



## Opportunistic investment sleeve

Creating a dedicated allocation to investment opportunities in the investment policy statement is a simple yet effective approach. It simplifies performance measurement. And the active, or opportunistic, risk is naturally limited by the size of this allocation. In some periods, this allocation may simply be a “dry powder” cash position. Of course, there is an opportunity cost of holding cash, so this approach requires committing to potentially forego returns in one period in the belief that the returns from deploying this cash in a future period will provide sufficient compensation.



## Rebalancing trades

An alternative approach could be used to apply the discipline of rebalancing from assets that have gained in value to raise capital for new investment opportunities.



## Develop a liquidity budget

Determine the specific amounts needed over a six- to 18-month time horizon. This will provide some operating certainty to any strategy.

# The need for agile execution

**Moving from opportunity to investment requires several steps, which can be time-consuming if many decision-makers are involved.**

The investment decision-making process



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Depending on the nature of the investment opportunity and governance process, it can typically take months for an investor to implement an investment idea. Timeliness is a critical factor to benefit from opportunistic ideas. So what can investors do to streamline the decision-making process?

- 1. Delegate decision-making power to a subgroup, such as an investment subcommittee (ISC).** This subgroup typically has a higher degree of investment expertise and a willingness to meet on a relatively frequent basis (and on an ad-hoc basis to address time-sensitive decisions). While creating an ISC is a relatively common practice, this subgroup should remain attentive to its purpose of being agile and responsive, and should avoid governance burdens that could become impediments to rapid decision-making when needed.
- 2. Delegate some of the decision-making power to a fiduciary manager.** This approach reduces some of the governance burdens. A fully implemented fiduciary plan is likely to offer the capture of new ideas as well as dynamic asset allocation.
- 3. Give investment managers more investment freedom.** Investment strategies with embedded flexibility to respond to changing market conditions, emerging trends or new ideas can also help you take advantage of shorter-term investment opportunities. However, the impact of ideas at the total portfolio level will be constrained by the size of the allocation to the manager. For low governance investors, hedge funds or multi-asset strategies (such as diversified growth funds or multi-asset credit) can be an effective way of introducing a degree of opportunistic investing.

A few means by which investors can make these actions successful:

- **Committee charter or terms of reference.** Establish clear guidelines and constraints at the outset. What are the objectives of the more opportunistic investment approach? And how much flexibility will be delegated to the ISC (or staff)? How frequently will the ISC meet, and how should you address opportunities that arise between meetings?
- **Portfolio structure.** Investors with (a) a strategic asset allocation that includes significant allocations to alternative asset classes (for instance, real assets, hedge funds, private equity/special situations, private debt) and (b) wider asset allocation ranges should be able to capitalize on new opportunities as they arise without altering the allocation, as most could be reasonably classified within one of the existing allocations. Additionally, managing the total level of active portfolio risk plays an important role.
- **Implementation.** From an operational perspective, well-defined responsibilities and process flows — such as signatory lists, delegated authority and well-established communication lines — are essential in ensuring you can implement decisions quickly and efficiently. Investors can take a number of approaches to implement investment opportunities.
- **Monitoring.** Agree upon measures of success (such as return and/or risk targets) at the outset, and review the impact of any opportunistic changes periodically. Measuring the success of external strategies can prove challenging, and appropriate benchmarks will vary from one approach to another. Investors should assess the impact of changes in asset allocation over time on a net-of-fees basis and ensure they have a good understanding of the flexibility and complexity of the strategy. Developing an effective monitoring process will require transparency.

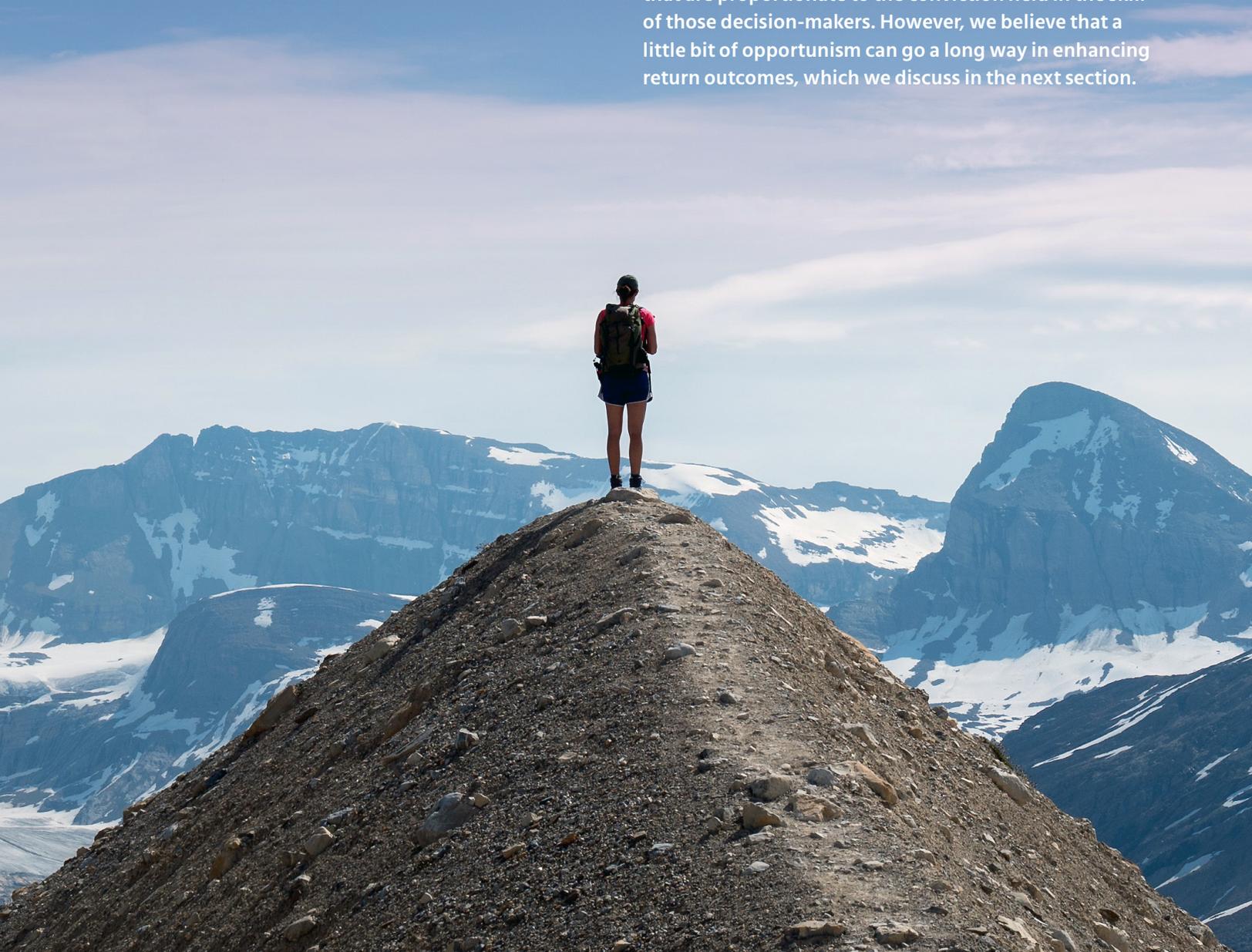
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# The dark side of opportunism

Opportunistic investing aims to improve investment returns. However, this approach is not a given. The potential risk can be substantial if the program has not been soundly designed. Experience shows that trading across asset classes is high risk because the deviations in performance between two asset classes can be extreme. Additionally, market dislocations and valuation mispricing can persist over long periods. The risks are also heightened if investors are forced to sell their position to cut their losses or because of liquidity issues.

Opportunities may also be attractively priced because of their complexity or operational risk. In a volatile environment, there may be pressure to take shortcuts in due diligence or underestimate the depth of knowledge required to assess complex investments.

That's why Mercer stresses the importance of accountability for decision-makers, measuring the performance impact of allocation decisions, and enforcing strict limits on the size of opportunistic trades that are proportionate to the conviction held in the skill of those decision-makers. However, we believe that a little bit of opportunism can go a long way in enhancing return outcomes, which we discuss in the next section.



# How to play opportunities

Applying an opportunistic mindset may deliver enhanced return outcomes with the right governance approach. The following case studies<sup>1</sup> illustrate how clients could potentially benefit from market dislocations.

## Case study High-yield allocation

### Key concepts

- Planning ahead
- Speed versus caution
- More meetings to improve readiness
- Swift decision-making process

Mercer's approach to growth portfolio construction is to target an "equity-like" return with lower volatility. Implicit in this approach is the harvesting of long-term risk premia (such as equity or credit). This can lead to periods of heightened market volatility, as we witnessed in recent months. But the process works over the longer term if you hold your resolve, remaining true to long-term asset allocation principles paired with opportunistic dynamic asset allocation.

- Dynamic asset allocation activity in our Growth Portfolios delivered approximately 65 bps of DAA value-add over H1 2020.
- As market conditions proved volatile, the Asset Allocation Committee increased the cadence of meetings to stand ready to capture market opportunities.
- Most notably, we took advantage of dislocations in high-yield and investment-grade markets — both major contributors to DAA value-add.
- Strength in conviction also allowed for swift action and appropriate position sizing.

## Case study Harnessing rebalancing range discretion

### Key concepts

- Planning ahead
- Efficiencies in execution
- Implementation procedures
- Rebalancing trade

Due to our preparedness and our investment in technology, Mercer was able to rebalance efficiently during unprecedented volatility with 10 times the normal trading volumes. Our technology allows us to set parameters, rules and generate trades, of which 96% are processed straight through our system. However, in cases of heightened market volatility, as experienced during COVID-19, we stepped in to cancel 3,500 automatically generated trades in order to eliminate unnecessary trading and transaction costs. We have built systems and rules so that in certain market conditions, the investment team can intervene and make decisions in our clients' best interests:

- Process in place to consider trading decisions daily
- Canceled rebalancing trades due to market reversals on several occasions
- Widened rebalancing ranges and rebalanced halfway to target to ensure efficient execution and implementation
- Eliminated unnecessary trading and transaction costs

<sup>1</sup> Each case study is an illustration of Mercer's capabilities provided to one client. Client results will vary, and there can be no guarantee of similar results.

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# Summary

**The challenging outlook for generating returns amid volatile equity markets and low interest rates means that producing a targeted return in the future may require investors to embrace a greater degree of opportunism. There are several approaches to introducing an opportunistic component into the investment strategy. These approaches involve reducing constraints on investment strategies or investment decision-makers while establishing efficient governance processes.**

Arguably, the most critical condition for success in opportunistic investing is adopting the right mindset. In many cases, there must be a willingness to invest in relatively untested assets or strategies with limited historical evidence. Given elevated volatility during periods of market stress, thoughtful, timely and smart execution is key to capturing the full potential of opportunistic investing. Some opportunities will surface in traditional asset classes (for example, investment-grade and high-yield credit in early 2009 and 2020). But for opportunities that arise in previously unexploited areas of the market (such as niche or exotic strategies), a degree of delegation to more experienced investors may be helpful.



# Reshaping the future.

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With more than 70 years of experience, we provide trusted advice and solutions by understanding data and applying it with a human touch. We drive change by turning ideas into action, positioning our clients, colleagues, and communities for the future.

## How We Can Help

Continuously rethinking purpose and priorities drives HR transformation. Shaping the future of work requires improved strategies around investment and retirement, health and wellness benefits, talent and communications. We believe in the value of investing in the future to build resilience for your business and your employees.

Investments and retirement require sophisticated solutions. We approach these with a big picture view that prioritizes long term financial wellness. We offer research and advice on assessing risk and designing benefits programs while keeping in mind the need to optimize throughout changing times.

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