



EUROPEAN ASSET ALLOCATION SURVEY 2019

CONTENTS

| | |
|--|---------|
| WELCOME | 01 / 04 |
| KEY FINDINGS | 02 / 05 |
| SURVEY PARTICIPANTS | 03 / 06 |
| ASSET ALLOCATION | 04 / 07 |
| INVESTMENT GOVERNANCE | 05 / 10 |
| RISK MANAGEMENT | 06 / 14 |
| DE-RISKING FOR UK DB PLANS | 07 / 19 |
| EQUITY PORTFOLIOS | 08 / 21 |
| ALTERNATIVE INVESTMENTS | 09 / 23 |
| SPONSOR COVENANT STRENGTH FOR UK SCHEMES | 10 / 28 |
| RESPONSIBLE INVESTMENT | 11 / 29 |
| ACKNOWLEDGMENTS | 12 / 35 |
| IMPORTANT NOTICES | 13 / 36 |

WELCOME

As in previous years, *Mercer's European Asset Allocation Survey* provides a comprehensive overview of investment strategy across the European pension industry and identifies emerging trends in the behaviour of institutional investors.

Many investors would like to forget 2018, as cash was one of the only assets to end the year with a positive return. As central banks around the world began to talk in less expansionary tones, and the 10-year anniversary of the Global Financial Crisis came and went, it is no surprise that many investors began to wonder how long the current expansion could continue. This nervousness, combined with historically high stock valuations, waning global economic growth, and trade tensions between the US and China, saw a sharp market downturn in December 2018.

Investors have been cautiously optimistic in 2019, given accommodative stances in China and the US and steady economic growth in both regions. As a result, many stock markets have posted their strongest start to the year since 2006, with the technology sector at the vanguard.

Against an ever-evolving backdrop, we have identified four key themes that we believe will be important for investors to consider when building portfolios in what remains a fragile and uncertain environment.

WHITE WATERS OF THE LATE CYCLE

We see mounting evidence of overextension of credit. Outstanding debt is increasing, while quality is decreasing. Covenants are deteriorating and speculative use of debt is becoming more evident. Meanwhile, we expect the continuing positive macroeconomic backdrop, pro-business policies and levels of business optimism to continue to assist the equity market in the near term. When these contrasting equity and bond market currents meet, there is scope for white water turbulence. Navigating such an environment will require investors to be alert, prepared and tenacious. Investors should examine and waterproof their fixed income portfolios. The return of inflation, thought to be long banished, is a further threat that investors cannot afford to ignore.

WINDS OF CHANGE IN MARKET PARTICIPATION

After the global financial crisis, central banks stepped in for traditional banks as the primary providers of liquidity. As they now try to rein in their market involvement (albeit in a stop-start manner), it is far from clear what the implications for liquidity will be and investors should be on alert for signs of stress. The increased involvement of institutional investors in private markets affects both public and private investors, and an increase in the number of investment strategies that sit somewhere between traditional active management and traditional passive management is likely to benefit many investors not suited to either extreme.

TECTONIC FRICTIONS IN THE GLOBAL WORLD ORDER

Our 2018 theme of political fragmentation continues to be relevant in 2019 (and beyond). It is now considered a credible possibility that the pace of globalisation may slow or even pause. Perhaps the most obvious example of the influence of politics on international trade is the state of trade relations between the United States and China. China's growth and, perhaps more important, its efforts at opening up capital markets raise some practical questions for investors about how to manage their exposure to the world's second largest economy. Although more turbulence in global politics is likely to continue to weigh on markets, it may present a more favourable investment environment for certain types of opportunistic strategies.

SUSTAINABILITY GATHERING MOMENTUM

We foresee a world where asset owners and investment managers incorporate sustainability as standard, moving from optical responses to a place where sustainability is integral to idea generation and risk management. Governments, regulators and beneficiaries are increasingly expecting those with responsibility for allocating capital to take a broader perspective of risk and return – albeit with strong regional variation to these expectations. Can the investment industry continue to invest without serious consideration of the way the world is changing demographically, socially, environmentally, technologically and politically? We recognise that the incorporation of sustainability considerations into portfolios involves the need for a longer time frame than that typically used for investment decision-making, but investors who take a longer-term view may uncover opportunities that are not currently priced in.

The results of our survey suggest that many investors are continuing to focus on investment strategy and are looking to de-risk where possible in a world where continued strong returns seem less probable and higher volatility/extreme events seem more likely.

KEY FINDINGS

CONTINUING MOVE TOWARDS DB ENDGAME

A common feature of our annual surveys is the continuing move of defined benefit (DB) plans into their end game. Strong equity returns in 2017 and rising yields in 2018 helped further this trend. A significantly higher proportion of plans this year were cash-flow negative (that is, when a plan has matured to the point that regular outgoings to meet liabilities exceed income from investment and contributions) at the time of the survey (64% in 2019 versus 56% in 2018). Although disinvesting assets still remains the most popular method, tailored cash-flow matching approaches that aim to reduce costs and risk saw a rise in consideration from 5% to 9% of cash-flow negative plans.

INCREASED LIABILITY HEDGING RATIOS FOR PLANS

Targets for interest and inflation rate hedge ratios have increased since last year — most notable is an increase in plans that are now targeting a hedge ratio of 90%+ of their funded liabilities (from 27% in 2018 to 41% in 2019). A rise in yields over 2018 may be the reason a number of plans have been implementing increased hedging on an opportunistic basis. The rise in hedge ratios targeted was more pronounced in plans that outsource hedging to a fiduciary manager.

INCREASED FOCUS ON SUSTAINABILITY

Around 55% of the survey respondents this year indicated that they consider environmental, social and corporate governance (ESG) risks in their schemes — a notable increase from 40% in 2018. We expect this trend to continue. Regulatory pressure was the most often cited reason for plans to consider ESG risks (56% cited this as a key driver). Stewardship — that is, voting and engagement — is increasingly on investor agendas as asset managers come under greater scrutiny to disclose how they undertake these activities. Around 28% of respondents consider proxy voting and engagement activities when selecting an investment manager.

CONTINUED SEARCH FOR DIVERSIFICATION

Investors have continued to look for ways to diversify their strategies away from equity exposure, following 10 years of strong equity returns, with the average equity holding falling from 28% last year to 25% this year. We find that investors have increased their allocations to real assets in the search for diversification (and cashflows). The number of plans with an allocation to real assets and hedge funds increased by 4% and 6%, respectively, over the year.

ONGOING GRADUAL SHIFT FROM ACTIVE TO PASSIVE

Although the amount of passively invested bond mandates has remained flat this year (at 52%), the slow shift in favour of passively managed equity mandates has continued, with the average proportion of plans' equity holding in passive increasing from 53% to 55% in 2019. The main driver of this trend — downward pressure on fees and costs — is likely to continue. Many investors are refocusing their governance budgets on liability risk considerations or towards alternative asset classes (where credible passive options rarely exist), both leading to increased utilisation of passive management for equity portfolios.

RISE OF FACTOR-AWARE INVESTING

A key evolution that has been occurring in the equity investment space is an increased investor focus on factor-aware investing. This involves investing with an explicit focus on exposure to different factors — for example, value, low volatility, profitability and momentum — that have historically driven equity returns above that of the broad equity market. The rise in investors using a single factor index strategy has increased from 12% to 19% over the year.

SURVEY PARTICIPANTS

Our 2019 survey gathered information from 876 institutional investors across 12 countries, reflecting total assets of around €1 trillion. The charts below show the composition of survey participants both by country and by size of plan assets.

Chart 1. Split of Total Survey Assets by Country

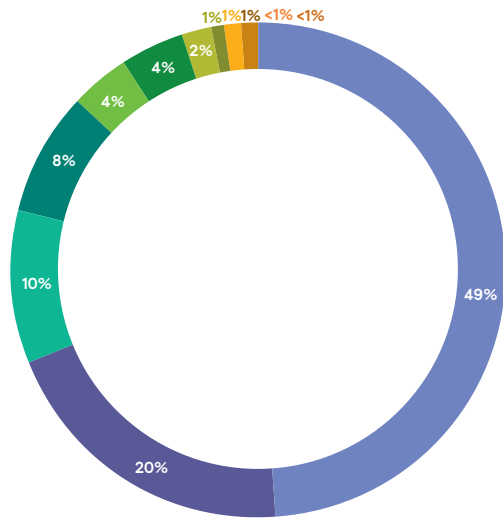


Chart 2. Split of Total Survey Participants by Plan Size

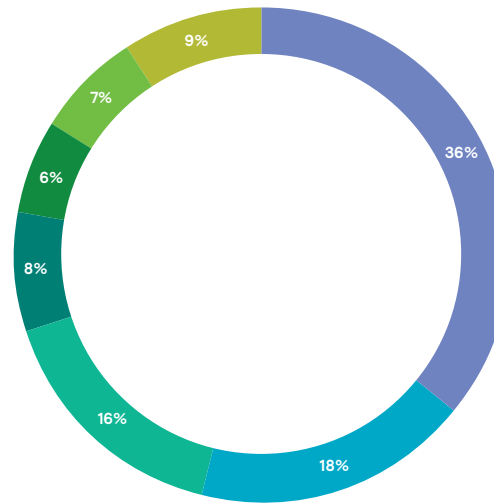
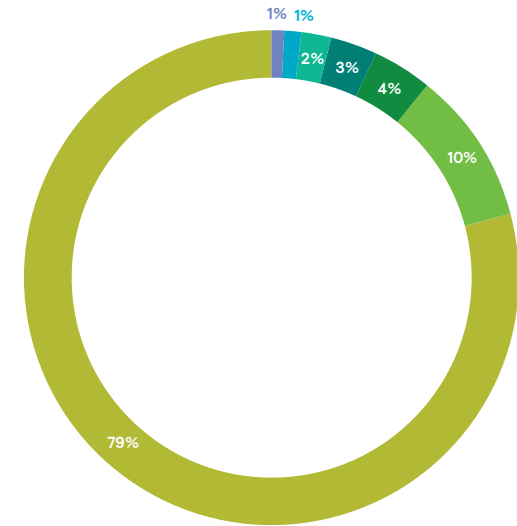


Chart 3. Split of Total Survey Assets by Plan Size



- United Kingdom
- Germany
- Denmark
- Italy
- <€50 m
- €50 m to €100 m
- €100 m to €250 m
- France
- Netherlands
- Portugal
- Ireland
- €250 m to €500 m
- €500 m to €1 bn
- €1 bn to €2.5 bn
- Spain
- Belgium
- Norway
- Switzerland
- >€2.5 bn

As in previous years, the largest group of survey participants were based in the UK (see Chart 1). Just over half of the participants (by number) represent plans with assets under €100 million, whereas 16% had assets over €1 billion (see Chart 2). Although smaller in number, these larger plans continue to dominate the overall assets under review (see Chart 3).

Some year-on-year turnover among survey participants is inevitable, but the majority of the plans have remained part of the survey over time, allowing us to identify trends in asset allocation based on a robust core of data.

ASSET ALLOCATION

Charts 4 and 5 show the broad allocation of plan assets, broken down by country, for DB plans. Plans in Belgium continue to have the highest average equity weightings, whereas plans in Denmark, Italy and Germany (excluding German contractual trust arrangements, or CTAs) exhibit the lowest equity exposure. Continuing the trend from last year, average equity allocations have ticked downward from 28% to 25% (seen further in Section 8), while average bond allocations have increased from 51% to 53%, and average alternatives allocations have increased from 17% to 18%.

Chart 4. Broad Strategic Asset Allocation by Country (%)

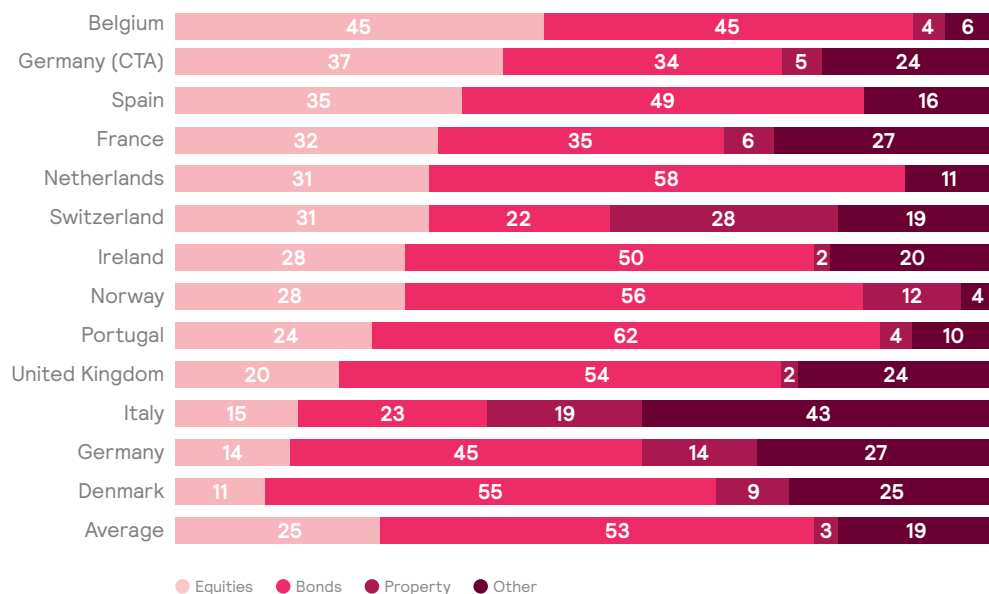
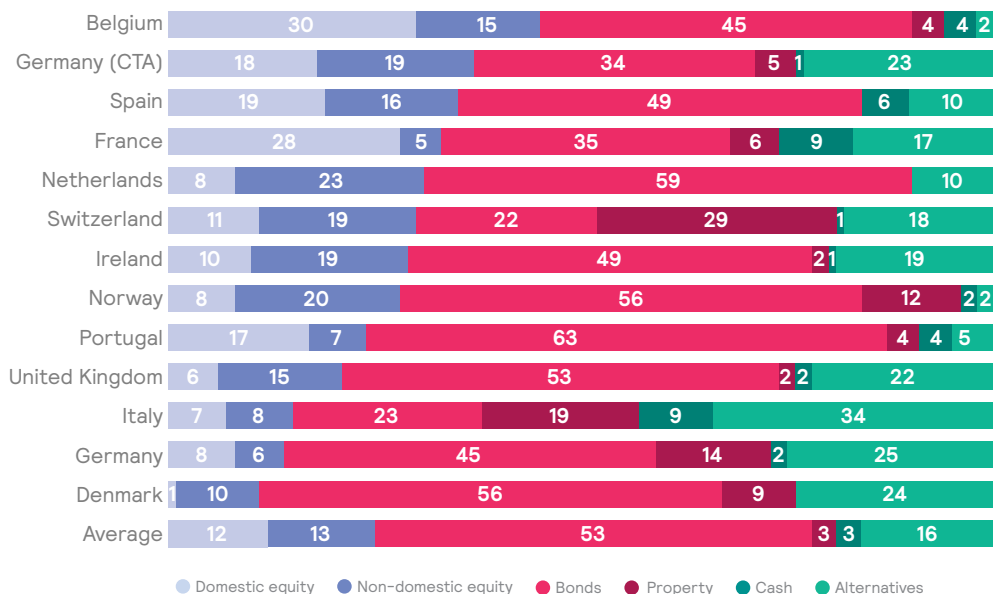


Chart 5. Strategic Asset Allocation by Country (%)



The proportion of equities invested outside the domestic market is defined as eurozone markets for those within the eurozone. Belgium is the country with the most pronounced bias to eurozone equities.

Chart 6. Bond Portfolio Allocation by Country (%)

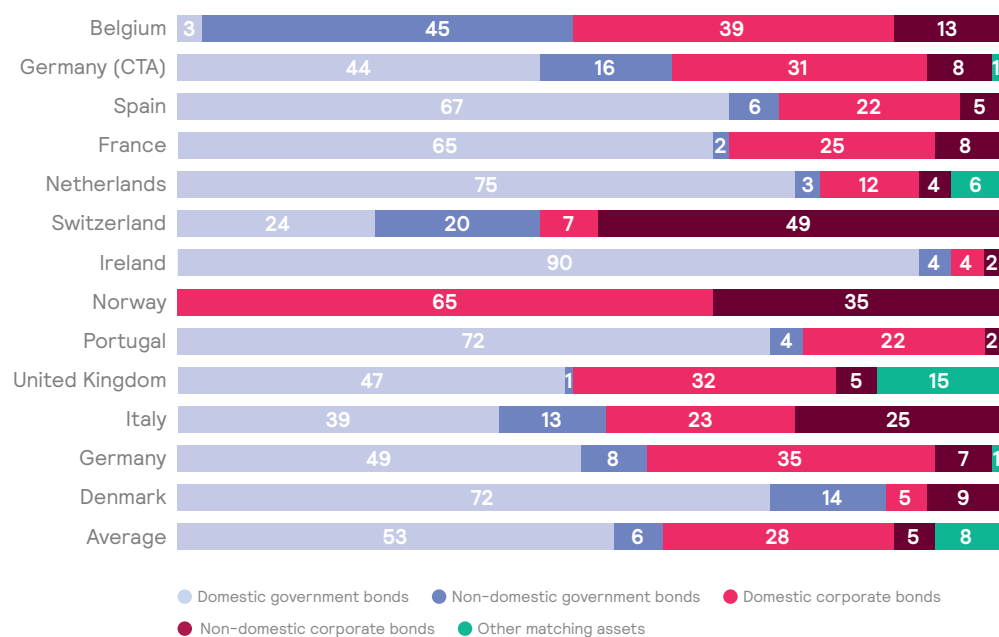
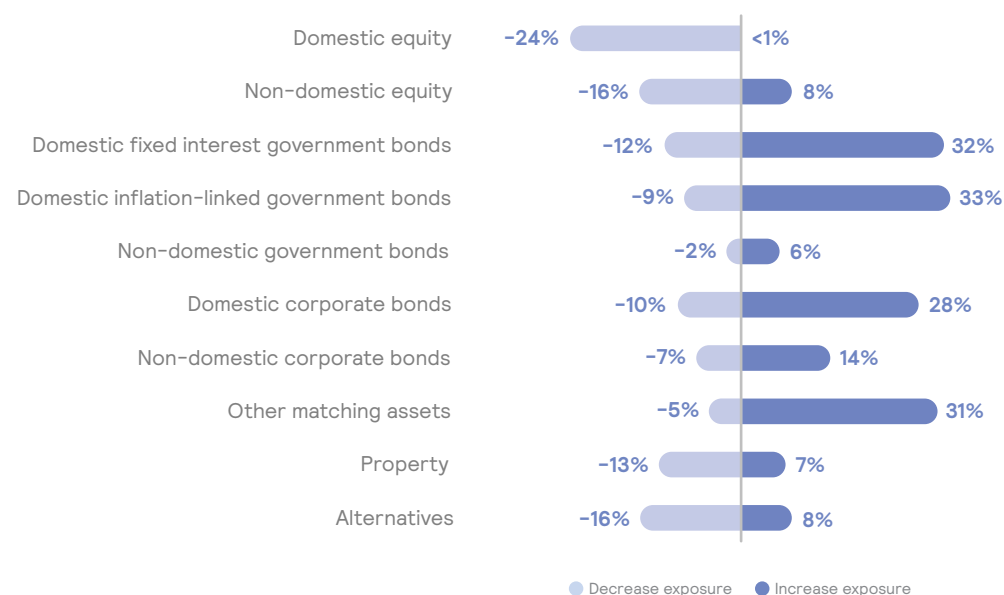


Chart 7. Percentage of Plans in the UK Expecting to Change Investment Strategy



The composition of the average bond portfolio has changed very little over the years, with the make-up of individual plans' bond portfolios (see Chart 6) being heavily country-specific. Government bond allocations form the largest component, with the average corporate bond allocation representing around 33% of all bond holdings.

Chart 7 shows investors' forward-looking plans. Largely, investors are planning to increase their exposures further to government bonds, corporate bonds and other matching assets, while moving away from growth assets. As the endgame approaches for a number of large pension schemes following a strong period of equity performance, this result is perhaps unsurprising. The trend from last year of investors planning to decrease exposure to property and other alternatives continued. This is also perhaps due to de-risking activity and the need for many schemes to move into more liquid assets.

Chart 8. Changes in Broad Strategic Asset Allocation for UK Plans (2003–2018) (%)

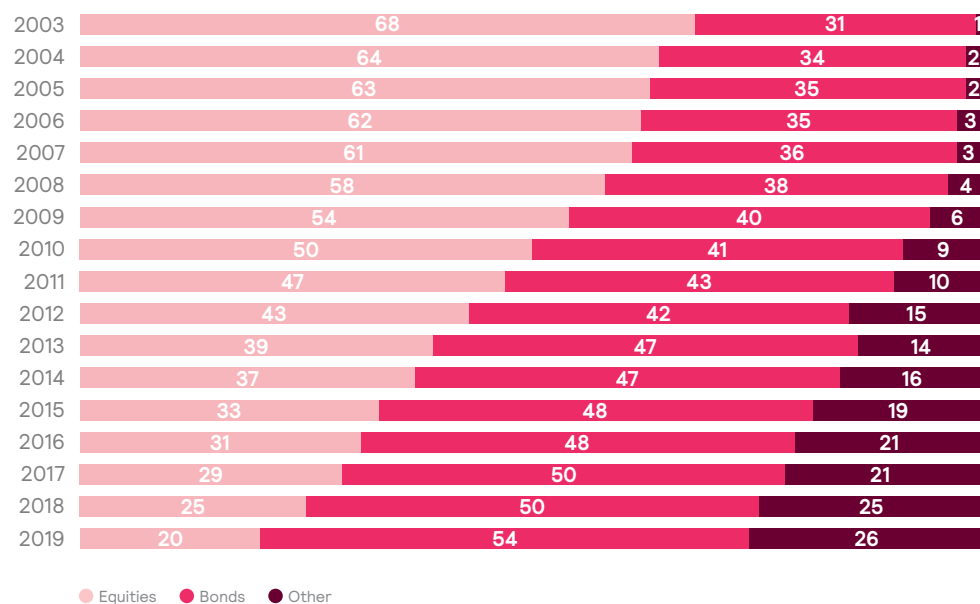


Chart 8 shows the change in overall allocations in the UK over the last 15 years. The trend of falling equity exposure in the UK continued in 2018, with the average equity allocation now reaching a new low of just over 20% (see Chart 5). This year, we have already seen allocations to alternative assets increase from 25% to 26%. However, the bulk of equity disinvestments involved moves into bond allocations, with the average bond holding rising from 50% to 54% since the last survey. This increase has been influenced by the increasing maturity of schemes and their higher focus on cash-flow and liability matching.

The trend of falling equity exposure in the UK continued in 2018, with the average equity allocation now reaching a new low of just over 20%.

INVESTMENT GOVERNANCE

Pension plan governance covers a wide range of topics, from the composition of the trustee group to the way in which decisions are delegated to subgroups or third-party providers, to the complexity of the investment arrangements and the number of ideas and opportunities that are considered. Our survey results continue to highlight a clear link between the size of a plan and the amount of time and resources devoted to the consideration of investment issues.

Chart 9. Strategic Asset Allocation by Plan Size (%)

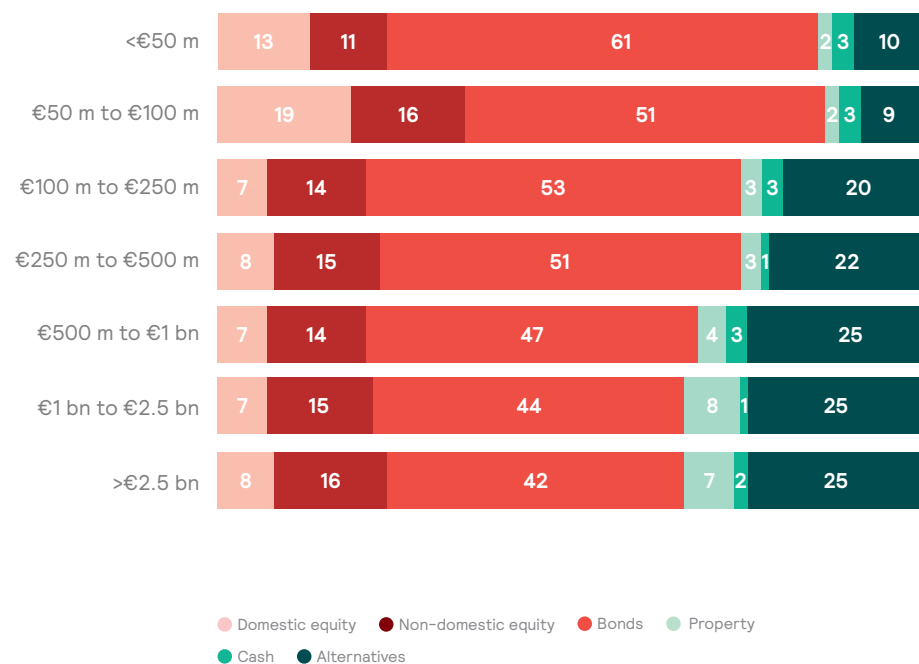


Chart 10. Breakdown of Responsibilities Around the Investment Cycle (%)

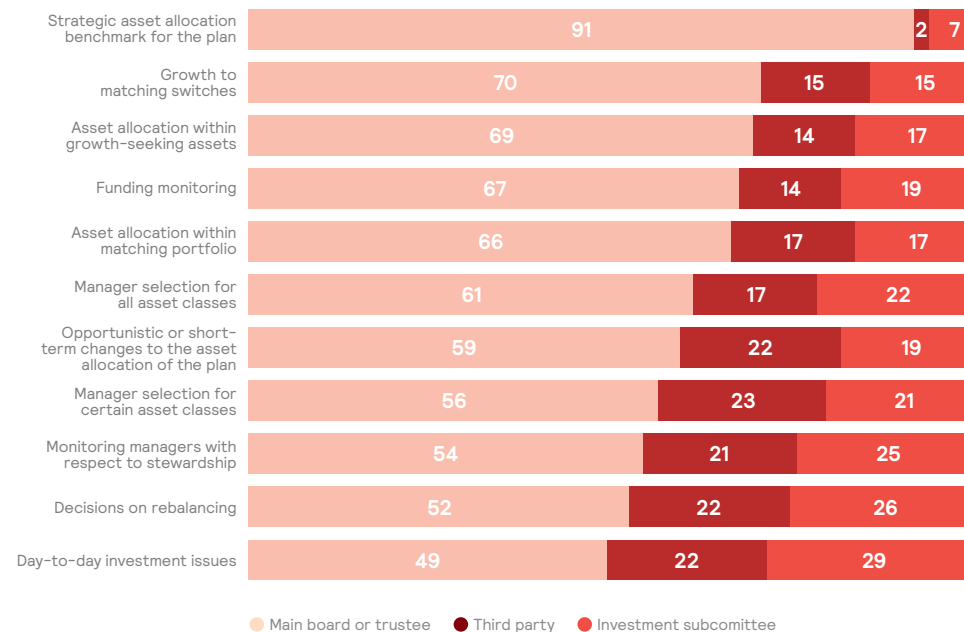


Chart 9 illustrates how asset allocation varies with plan size. Although equity exposures don't appear to obey a clear pattern, the average plan allocation to alternative assets – which can include complex and less liquid strategies – is higher for larger plans, which typically have greater resources. The largest plans, while holding less in bonds, often have higher interest rate and inflation hedge ratios than their bond allocations reflect, given their ability to leverage their portfolios to achieve a higher degree of liability matching; this often frees up assets to return-seeking portfolios.

For the vast majority of plans (91%), strategic asset allocation decisions continue to reside with the highest level of decision-making body, such as the plan trustee or board of directors. The breakdown of responsibilities has changed little over the year.

Chart 11. Responsibility (%) for Day-to-Day Investment Issues by Plan Size

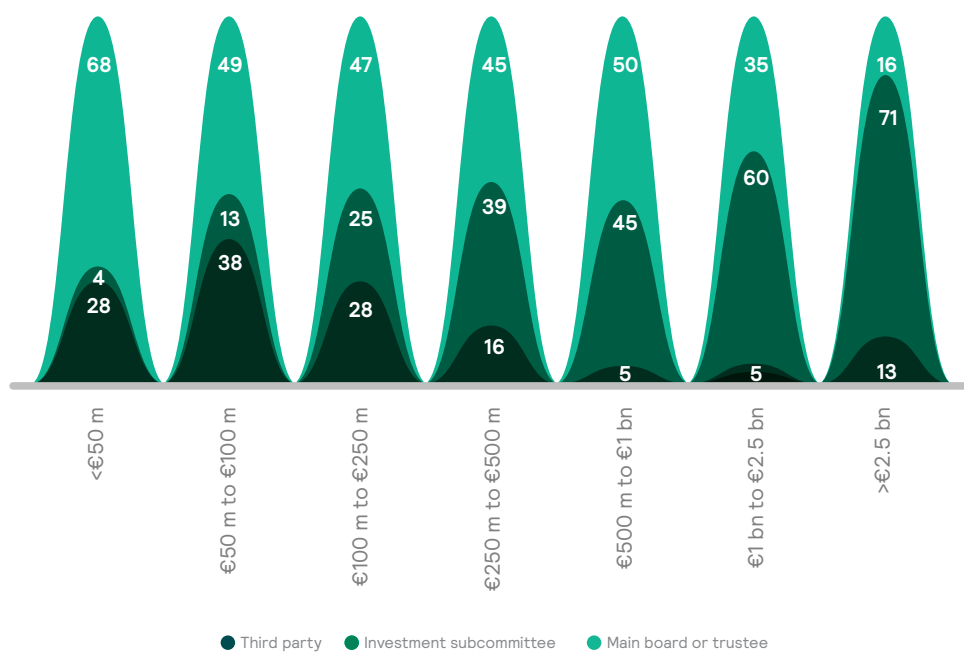
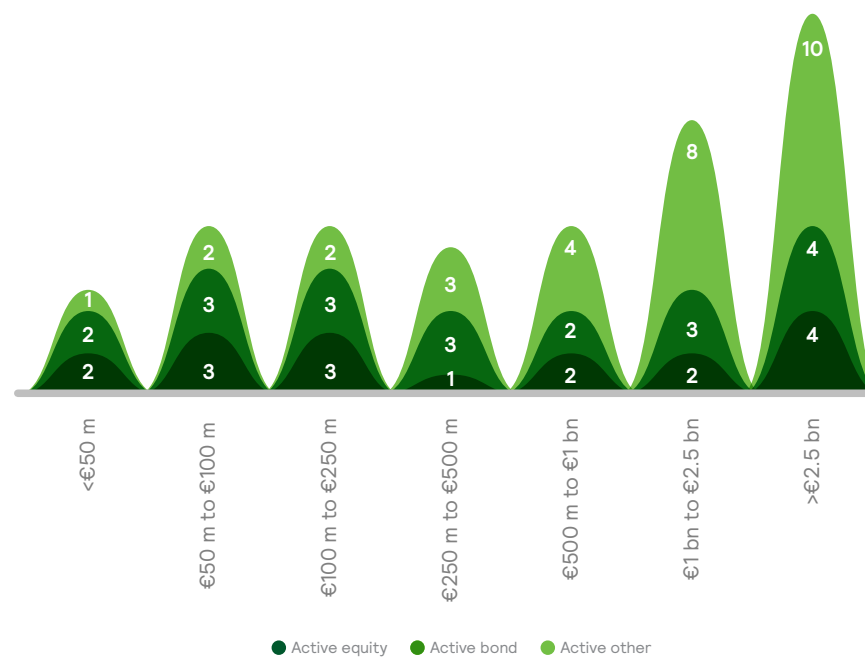


Chart 12. Average Number of Active Mandates by Plan Size



Around 39% of plans delegate some degree of investment manager selection, either to an investment subcommittee or to a third party, while day-to-day decisions are delegated by just over a half of survey participants. The results shown in Chart 11 indicate that the nature of delegation is a function of plan size — larger plans are more likely to have an investment subcommittee, whereas smaller plans are more likely to appoint a third-party manager.

Charts 12 and 13 delineate the average number of actively managed mandates by plan size and the extent to which passive mandates are used for equities and bonds (Chart 13 shows a like-for-like comparison using only those plans that were present in the 2018 and 2019 data sets).

Chart 12 shows that larger plans tend to use more active managers. This is partly because they have the scale to diversify active manager portfolios (sometimes to neutralise unintentional factor/style/geographical biases and concentration risk) and to build bespoke portfolios of alternative assets.

Chart 13. Annual Shift of Equity and Bond Assets Managed on a Passive Basis

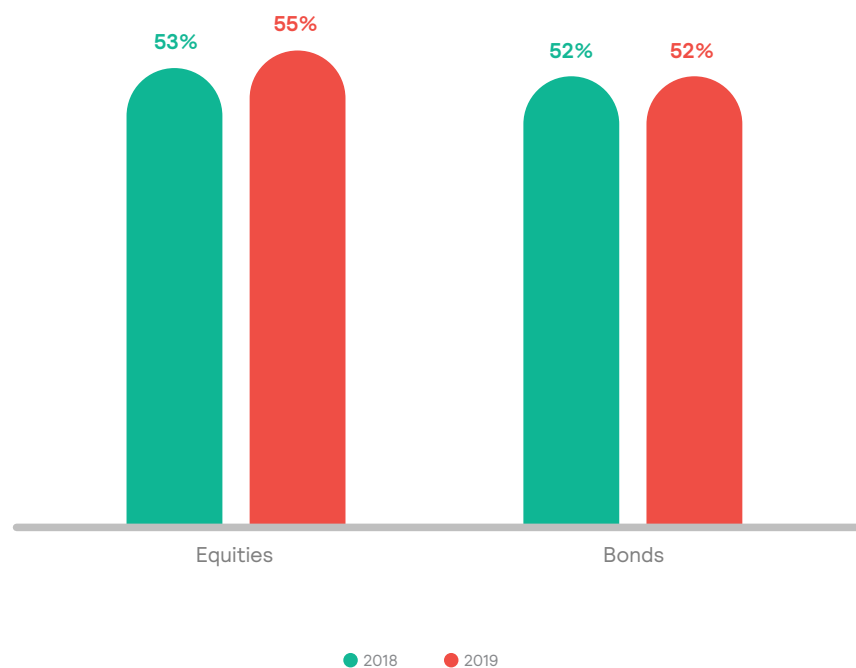


Chart 13 shows that the increase of passively managed equity assets has continued this year, with the average passively managed proportion increasing from 53% to 55%. The continued reasoning for this is a shift of governance focus to issues related to strategy and to other areas of growth, particularly in the alternatives universe. Underperforming equity mandates are often moved to passive management, following a loss of confidence in manager ability to deliver long-term outperformance.

Chart 14. Proportion of Equity and Bond Assets Managed on a Passive Basis

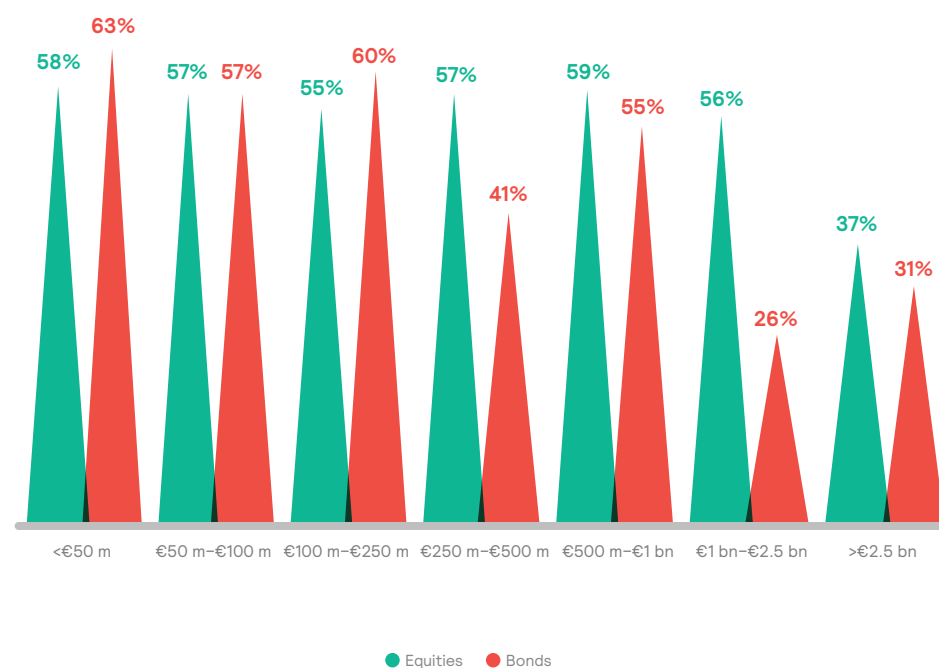
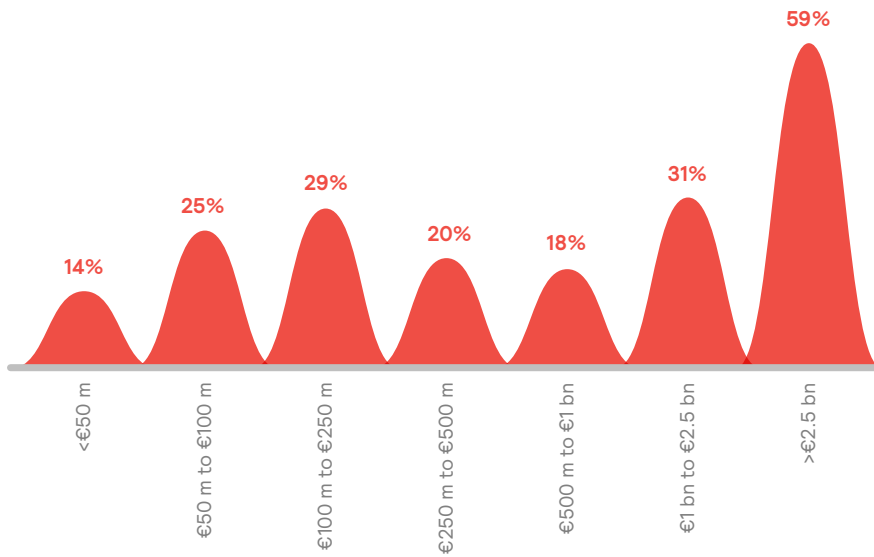


Chart 14 shows that smaller clients had a higher proportion of their assets invested passively. Reasons for this likely include the higher fee sensitivity of smaller clients, with less ability to negotiate attractive fees on active mandates. Many smaller investors are also refocusing their governance budgets on liability risk considerations or towards growth in alternative asset class areas (where credible passive options rarely exist). These can lead to increased utilisation of passive management for equity portfolios. At the other end of the scale, the largest investors appoint an average of 18 active managers, holding only around 37% and 31% of equities and bonds, respectively, in passive mandates.

Chart 15. Proportion of Plans Carrying Out Operational Due Diligence by Plan Size (%)



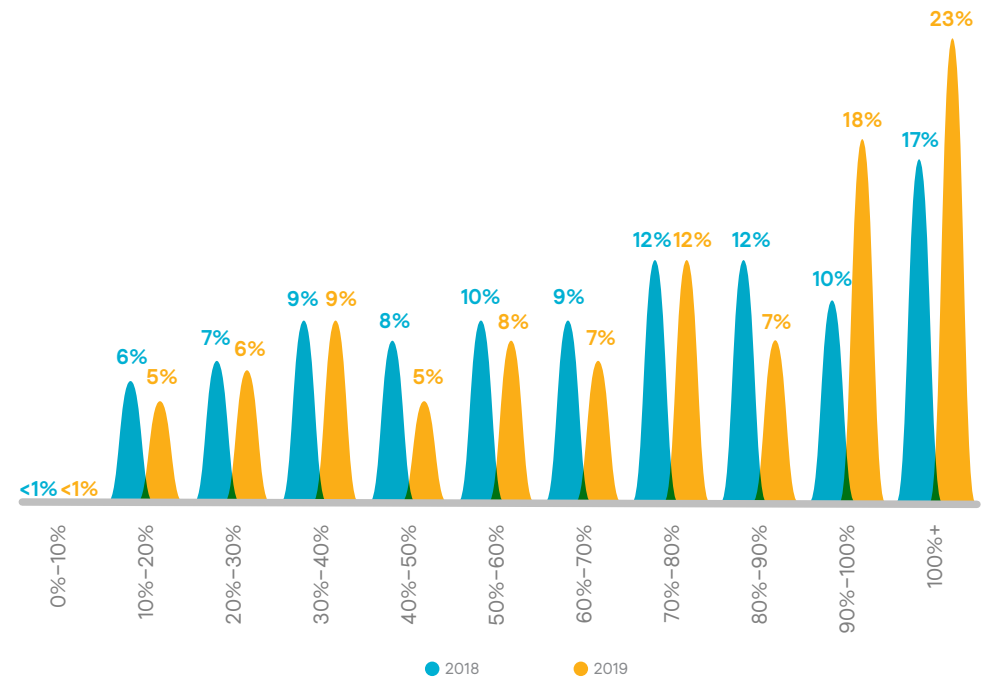
With higher operational governance requirements, larger plans also have a tendency to give higher priority to reviewing providers' middle and back office functions, as shown by the higher use of operational due diligence capabilities. Among plans over €2.5 billion in size, 59% carried out these reviews (See Chart 15).

RISK MANAGEMENT

Over half (53% – see Chart 4) of the average plan remains allocated to bonds. The bond portfolio acts as a diversifier for equity and alternative allocations while also hedging changes in liability valuations for liability-sensitive investors (such as pension plans). This is particularly important in regions that require regular updating of pension plan mark-to-market liability valuations (which are derived significantly by changes in the bond yield curve and, in some countries, inflation expectations).

Chart 16 shows the change in interest rate and inflation hedging ratios that plans had in place in the year since our last survey. Plans continue to look to hedge more of their funded liabilities (assets) – most apparent by the increase in plans that are now targeting a hedge ratio of 90%+ of their funded liabilities (27% in 2018 to 41% in 2019). The wide range of ratios displayed shows that there is no one-size-fits-all solution for hedging inflation and interest rate risk, with around a quarter of plans hedging less than 40%. The average hedge ratio of 76% across all plans is a further increase from last year (69%). This variation in part reflects the spread of bond allocations within plan portfolios but may also point to the wide range of views that exist around the likely path of interest rates and bond yields.

Chart 16. Interest Rate and Inflation Hedging Ratio as a Percentage of Funded Liability



Hedging portfolios have evolved over the last decade to include a range of instruments beyond physical bonds. Chart 17 illustrates that those pension plans that use such instruments have become large players in the government bond repo markets, while interest rate and inflation swaps remain popular hedging instruments. This year has seen a noticeable increase in plans reporting the use of interest rate swaps, inflation swaps and government bond total return swaps. Higher hedge ratios this year could be one reason for this, with plans making more use of swaps to manage shorter-term interest rate or inflation risks. Levels of repo use by survey participants with liability-driven investing (LDI) mandates remained similar this year at around 76%.

Chart 17. Plans Using Various Hedging Instruments

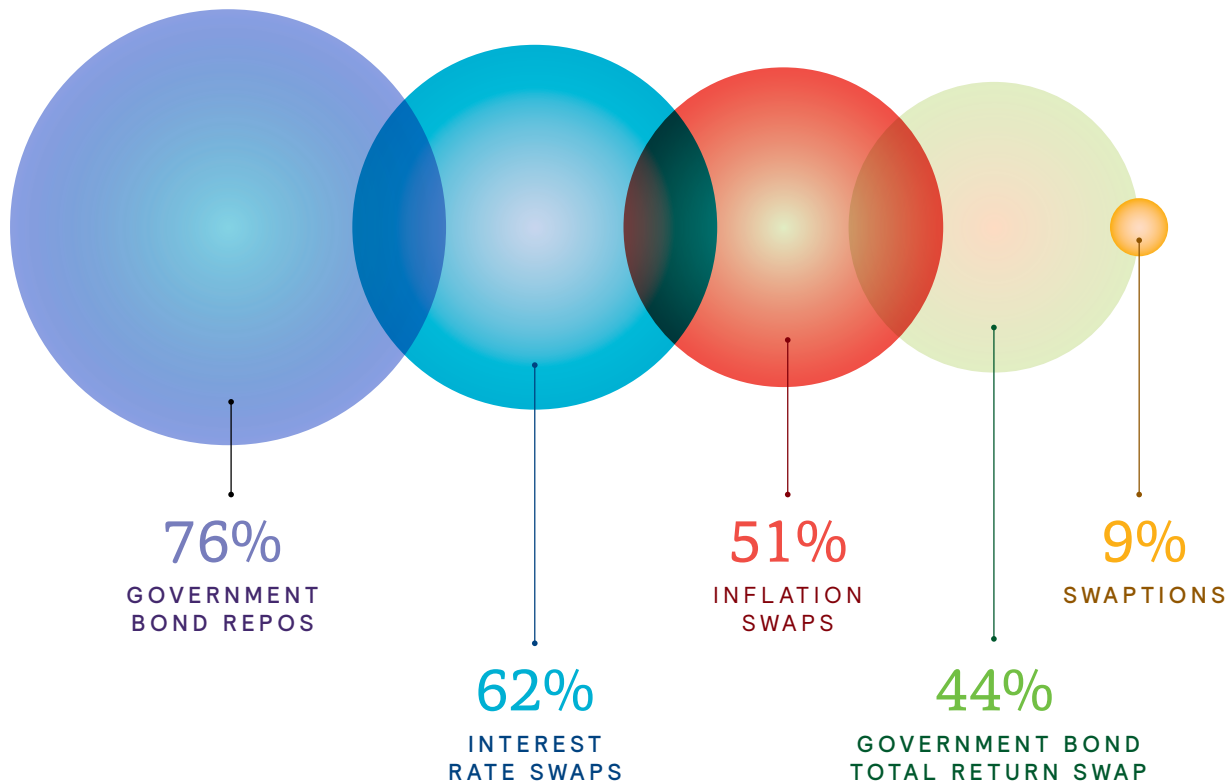
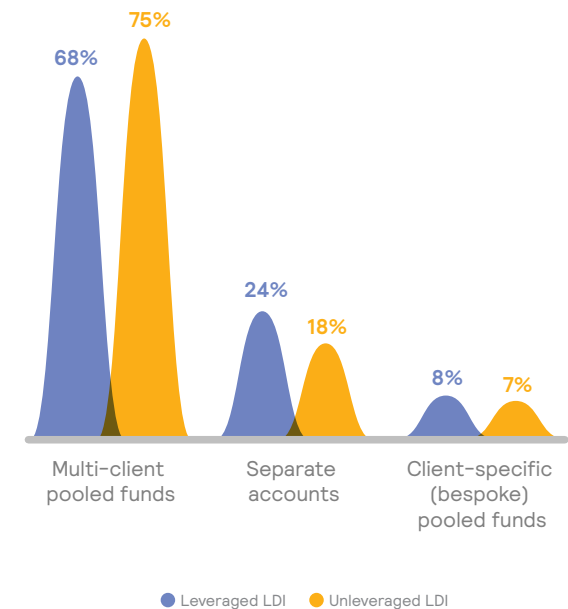
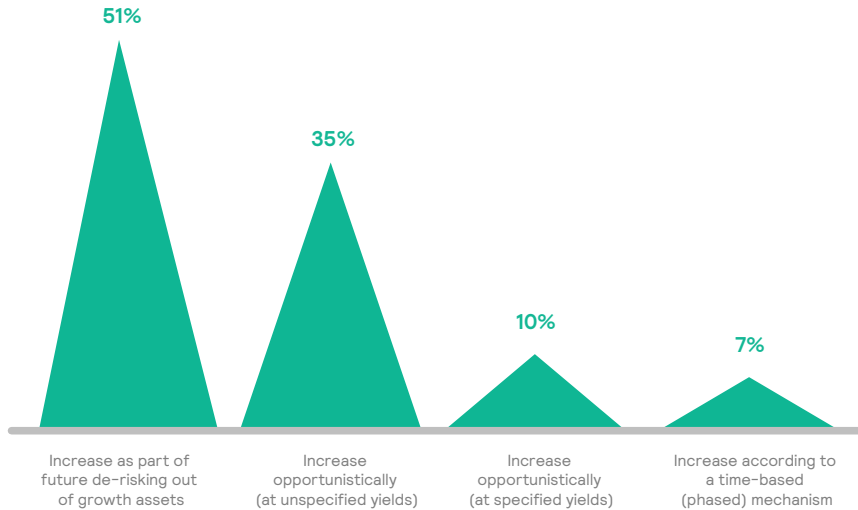


Chart 18. Vehicles Used for Liability Hedging



Pooled vehicles remain the most popular means for implementing liability hedging (see Chart 18), as they offer a solution to separate and smaller accounts without the size for separate mandates.

Chart 19. Methods for Increasing Hedging



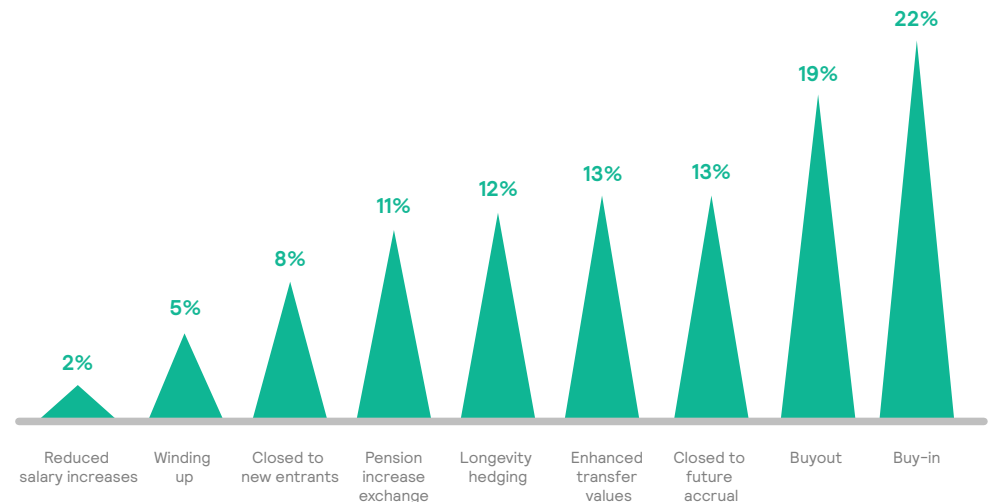
Looking at how plans expect to increase their liability hedge ratios from here, Chart 19 shows that plans commonly expect this to be a result of de-risking trades out of equities and into bonds. In 45% of cases, plans expect to increase their level of hedging opportunistically should bond yields increase. The use of phased or time-based approaches to increasing hedging is not used widely, with a further fall in the proportion using this method from 8% last year to 7% this year.

Only 10% of plans have specified triggers in place. These are yields at which they would increase their hedging. The first trigger in place is at a median of 2.3%, while the final trigger in place has a median yield of 3.1%. These have reduced since last year (from 2.5% and 3.3%, respectively). This ties in with the general appetite for further and sooner risk reduction in plans this year, following volatility in 2018. Yield trigger approaches can benefit plans should an increase in the volatility of the bond market provide opportunities to “lock-in” bond purchases at lower prices.

¹ A buyout is when a pension scheme pays a premium to an insurer and, in return, the insurer takes on all responsibility for paying the pensions for the scheme’s insured members. This transfers all investment, inflation and longevity risks associated with the insured benefits to the insurer and would usually involve all of a plan’s liabilities.

A buy-in is a similar arrangement to a buyout, but instead of the insurer taking on responsibility for paying the members’ pensions, the insurer makes these payments to the scheme, which, in turn, pays the members. This is more commonly done with a partial subsection of the liabilities.

Chart 20. Proportion of Plans Considering Risk Management Exercises Over the Last Year



The risk associated with plan liabilities can be managed/reduced in other ways beyond interest rate and inflation hedging. Chart 20 shows that the most common risk mitigation exercises being considered by investors are buy-in and buyout exercises.¹

Many of these exercises are commonly used to transfer liability risk to third parties, with the buy-in approach being considered most over the last year. Other liability risk reduction methods can be grouped into “ways to curb future liability growth”, such as closure of plans to new entrants or future accrual or “approaches to managing existing liabilities”, such as enhanced transfer values, pension increase exchange exercises and reduced salary increases. The proportion of plans looking to engage in these exercises was largely flat between 2017 and 2018.

Yield trigger approaches can benefit plans should an increase in the volatility of the bond market provide opportunities to “lock-in” bond purchases at lower prices.

Charts 21a–21c consider the degree to which plans are cash-flow negative. This year, a significantly higher proportion of plans were cash-flow negative at the time of the survey (64% versus 56% in 2018).

This issue is particularly stark in the UK, where 73% of plans were cash-flow negative (up from 66% in 2018).

Of the plans that are cash-flow positive, 72% expect to become cash-flow negative within the next 10 years. The most common way to meet cash flows is still disinvesting assets, while an increasing number of plans have asked their investment managers to distribute income (up from 43% last year to 48% this year). In addition, 9% of plans engage in cash-flow matching (up from 5% last year), where portfolios are designed to try to align income and principal receipts to liability cashflows. We continue to believe this approach will be more widely adopted as DB plans approach their endgame.

Chart 21a. Proportion of Plans That Are Cashflow Negative

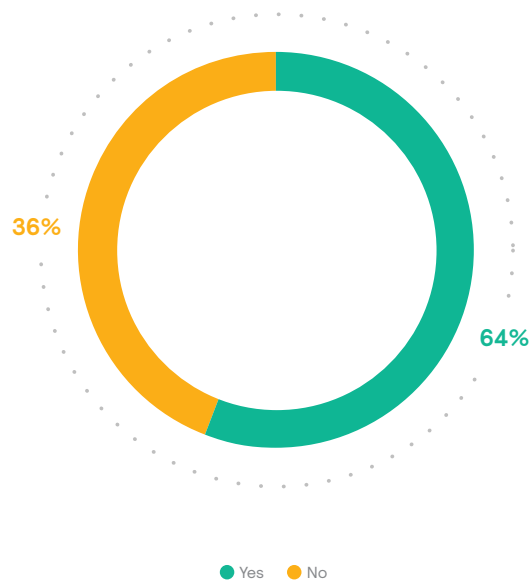


Chart 21b. Expected Time for Cash-Flow-Positive Plans to Become Cashflow Negative

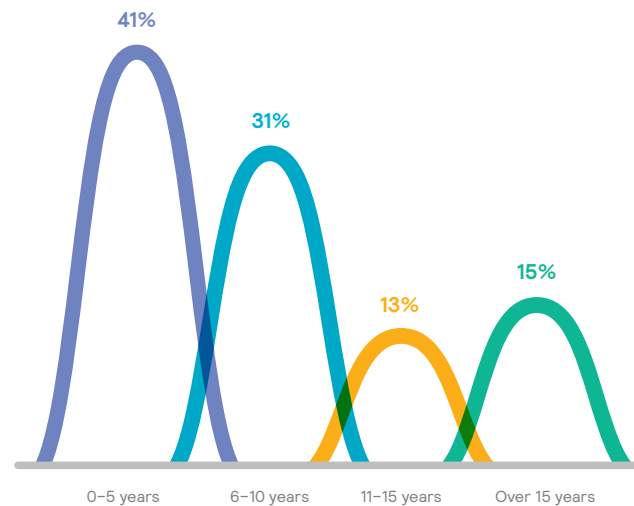
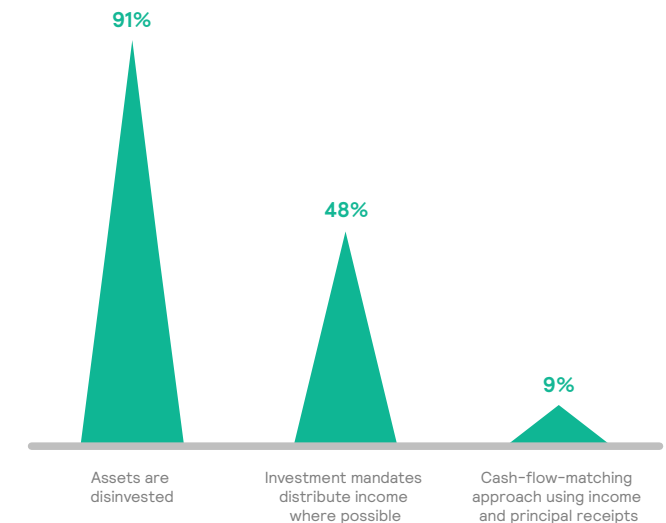


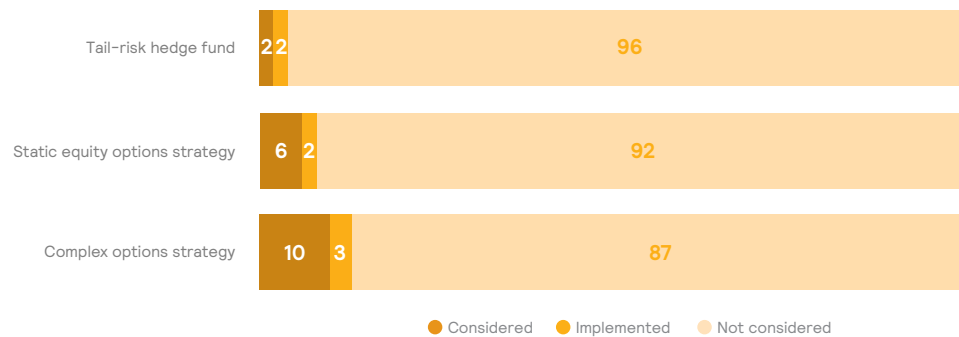
Chart 21c. Methods of Meeting Cash-Flow-Negative Outgoings



This year, a significantly higher proportion of plans were cash-flow negative at the time of the survey (64% versus 56% in 2018). Of the plans that are cash-flow positive, 72% expect to become cash-flow negative within the next 10 years.

Chart 22 shows the range of strategies that plans have considered in order to manage equity risk. The number of plans considering the implementation of equity option protection strategies was noticeably lower this year, which may be expected given the reduction in overall equity holdings. Plans are divesting from equities instead of implementing equity protection. Only around 5% of investors implemented either a static or a complex option protection strategy over the year, as these strategies tend to be used by investors with higher governance budgets.

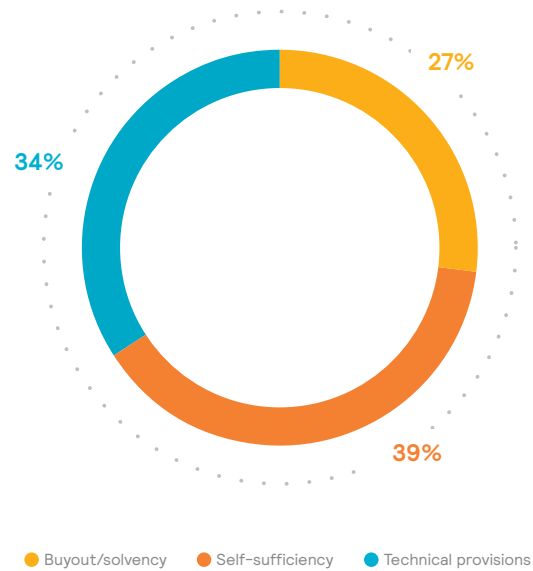
Chart 22. Managing Equity Risk (%)



DE-RISKING FOR UK DB PLANS

Charts 23a–23f provide further detail on the de-risking of UK DB plans – the largest single type of plan in the survey. The allocation of such plans is now commonly guided by a strategic “journey plan”, in part because many plans have been closed (to new entrants and future accrual) in recent years. When, as is often the case, a plan is underfunded, a journey plan is designed to align the future investment strategy with the gradual recovery of the funding position.

Chart 23a. Long-term Funding Objective



The proportion of DB plans that have moved to having buyout as their long-term target has increased to 27% this year from 24% last year (see Chart 23a). Where plans are targeting a “run-off” strategy (sometimes described as “self-sufficiency”), the associated basis on which the liabilities are valued varies by plan but usually reflects a modest premium above the risk-free rate (see Chart 23b). The most common premium in the plans surveyed was 0.5% above appropriate government bonds in 2019.

Chart 23b. Self-Sufficiency Basis

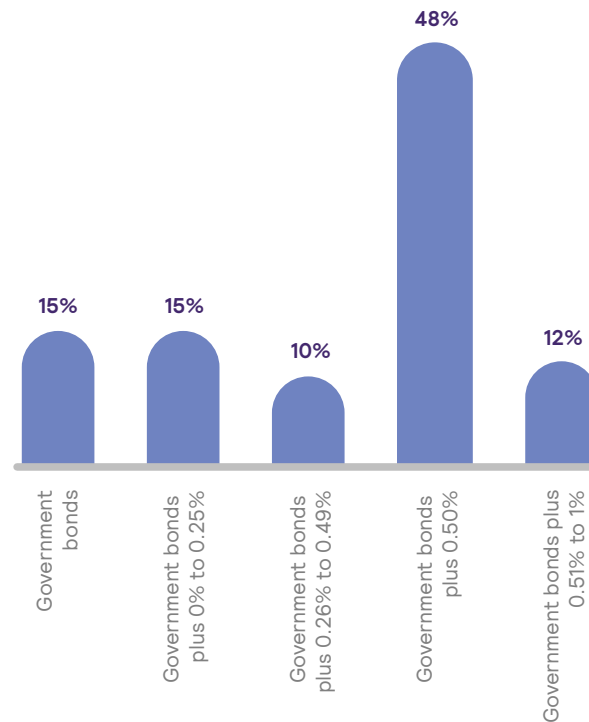


Chart 23c. Implementation of De-risking

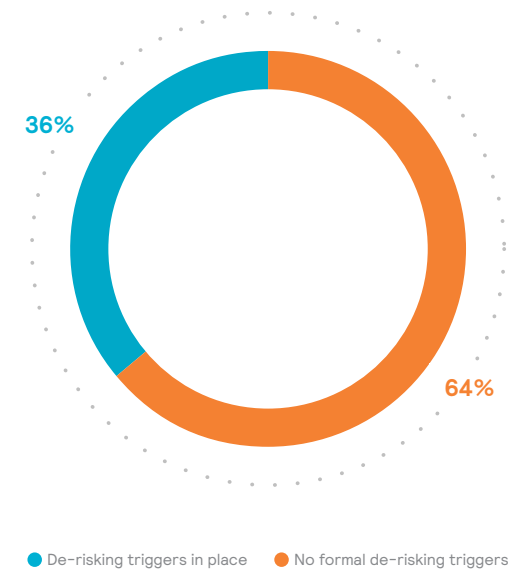
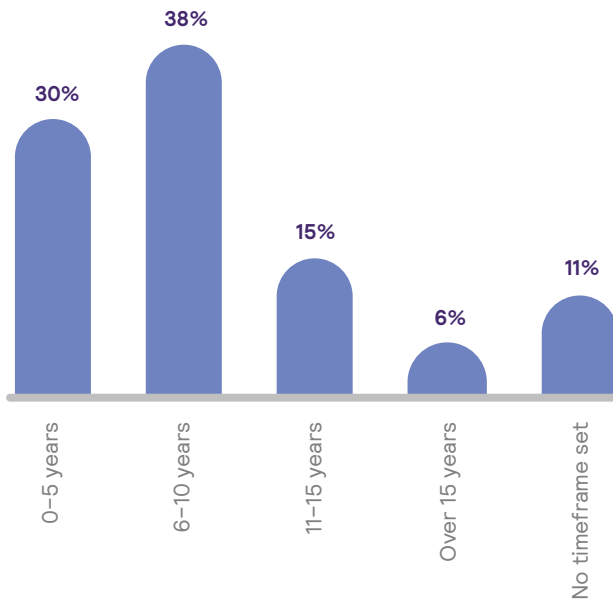


Chart 23d. Timeframe for De-risking



The number of plans that have put in place a de-risking trigger strategy has increased by from 34% last year to 36% this year (see Chart 23c). The number of plans that are looking to de-risk within the next 10 years has also increased since last year, potentially as a result of the increased volatility in 2018 and increasing bond yields leading to improved funding positions. Most plans (c.83%) are aiming to de-risk within the next 15 years (see Chart 23d).

Chart 23e. Delegation of De-risking

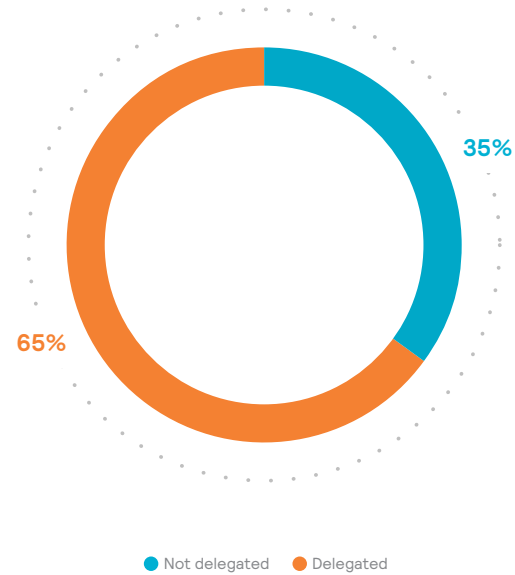
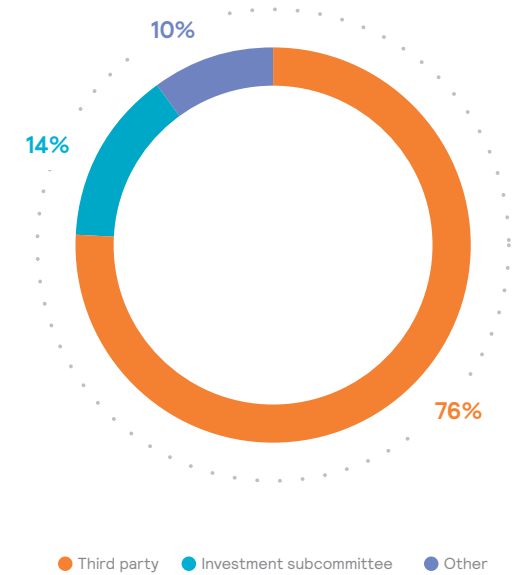


Chart 23f. Who De-risking Is Delegated to



Around two-thirds of plans with such a framework have delegated implementation, the vast majority of whom have selected a third party such as a fiduciary manager, who will typically monitor the plan's funding level and automatically de-risk the plan's portfolio in line with a set of pre-agreed funding level triggers (see Charts 23e and 23f).

EQUITY PORTFOLIOS

Charts 24–27 consider equity portfolios by underlying allocation, currency exposure and capture of style factors. Equity allocations are typically smaller than they were a decade ago. However, the construction of equity portfolios has evolved in an increasingly thoughtful manner, with reductions in domestic bias and with the gradual acceptance of emerging markets as a material component of the overall equity universe. Although the proportion of plans with a low volatility equity mandate fell this year, these mandates are still present — providing a defensive component to an equity portfolio.

The reduction in plan equity allocations in 2018 continued, following higher volatility in equities and as the equity bull market approached its 10-year anniversary.

Chart 24. Total Equity Split

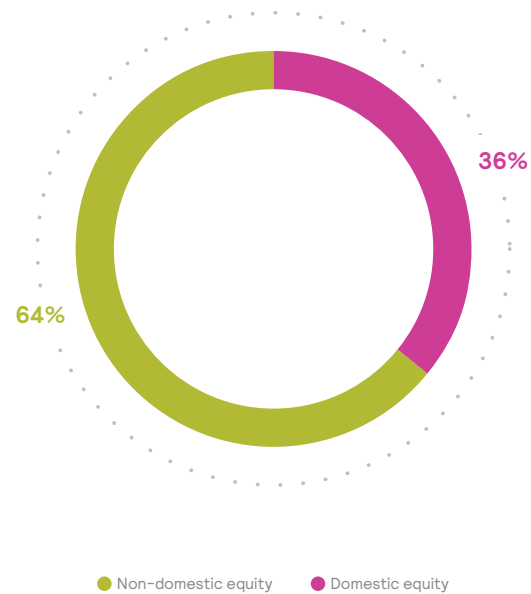


Chart 25. Strategic Allocation to Selected Equity Strategies (%)

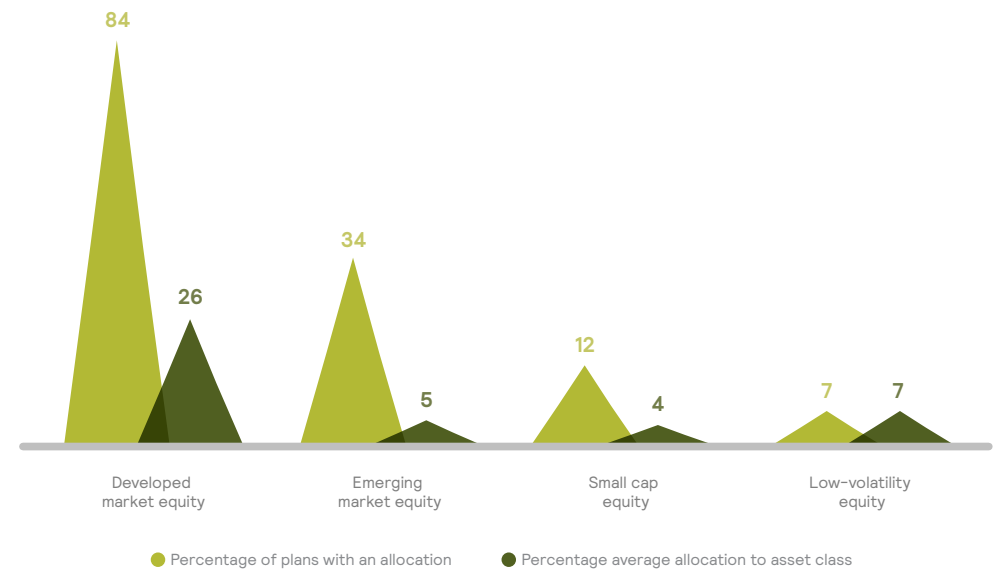
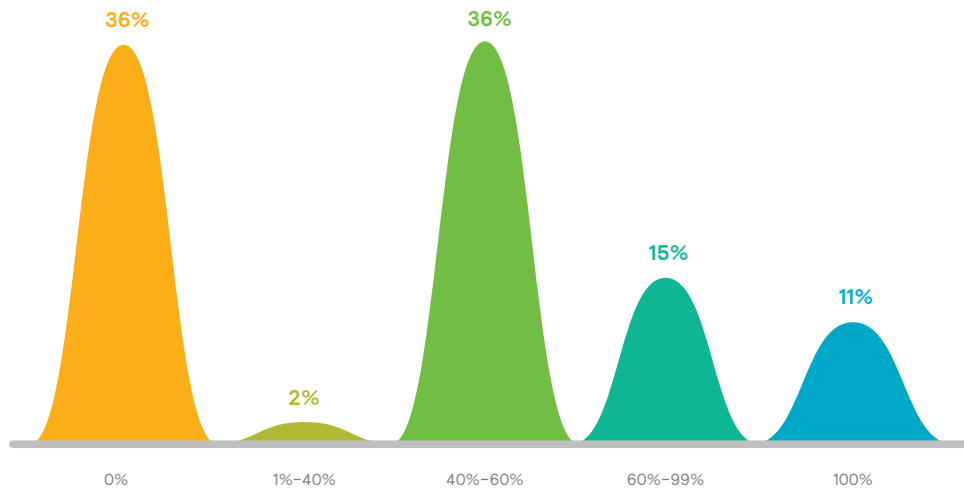


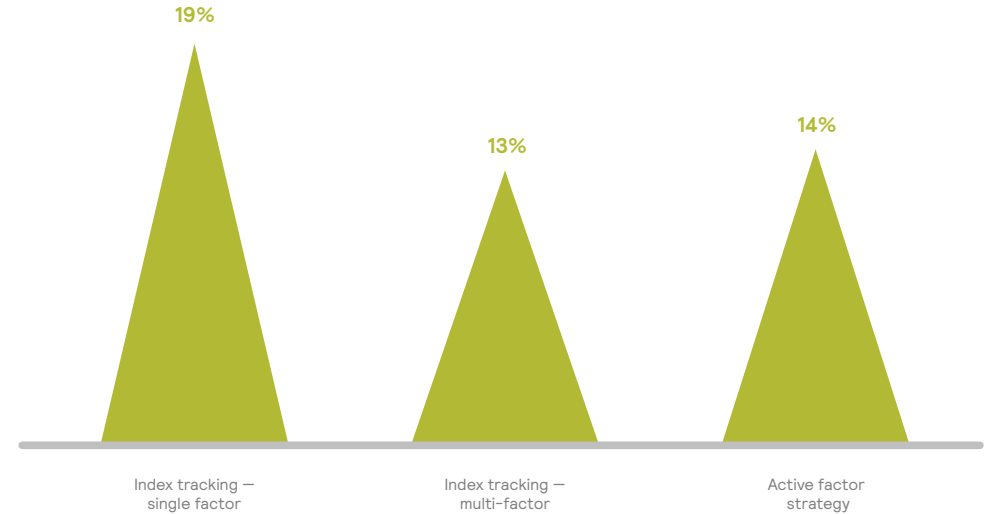
Chart 26. Target Currency Hedge Ratios for Equity Portfolios



Non-domestic exposures clearly bring foreign-exchange risk, and of the plans that have a formal currency-hedging policy, the majority hedge around 50% of the risk. However, a similar proportion of plans hedge none of their exchange-rate risk, which may reflect scepticism about the value of currency hedging or a belief that the values of currencies are essentially mean reverting. Often, hedge ratios are determined partially by the availability of currency-hedged share classes in pooled funds. We expect to see a reasonably wide variance in currency hedge levels, as these are often determined by the idiosyncratic risk profiles of each investor.

Among equity investors, we have seen an increased focus on factor-aware investing – or investing with an explicit focus on exposure to different factors (for example, value, low volatility, profitability and momentum) that have historically driven equity returns above that of the broad equity market.

Chart 27. Explicit Capture of Style Factors Within the Equity Portfolio



This year has seen a noticeable rise in plans that have an explicit factor exposure in their equity investment approach. The most common approach is still for investors to use an index-tracking single-factor approach, typically using a value-biased index. It is worth noting, however, that many investors will have implicit biases to various style factors via traditional active managers.

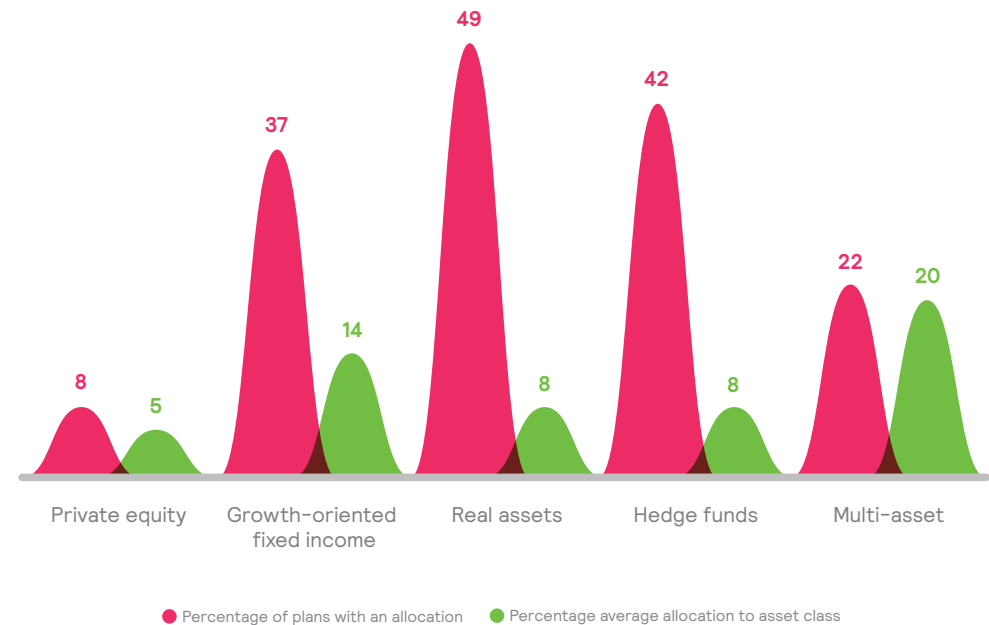
ALTERNATIVE INVESTMENTS

The use of alternatives continues to increase among investors, and this section considers the nature of underlying alternative investment strategies that plans are employing. Charts 28a and 28b consider five broad buckets:

- Private equity, both via fund of funds and direct investment
- Growth-oriented fixed income, which considers fixed income assets and strategies expected to generate returns in excess of government bonds and investment-grade credit
- Real assets, for which the return is expected to come largely from the yield on a physical asset with some degree of inflation exposure, such as real estate, infrastructure and natural resources
- Hedge funds, both via direct hedge fund exposures and through funds of hedge funds
- Multi-asset, which mainly relates to core, idiosyncratic and risk parity strategies

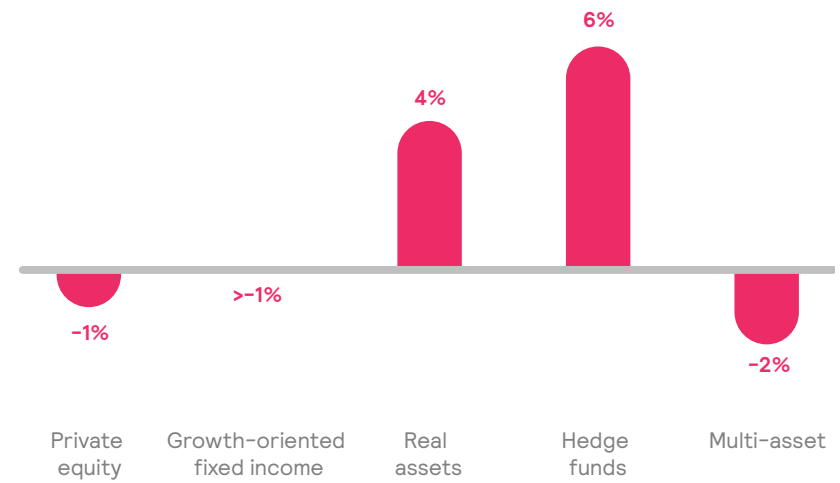
Chart 28a highlights that hedge funds, real assets and growth-oriented fixed income remain the most popular forms of alternative assets. The average size of allocation varies between 5% and 20% of total plan assets, with multi-asset strategies seeing by far the largest average allocations. This may be expected given that core multi-asset strategies in particular can be used as a “one-stop shop” for governance and fee-constrained investors seeking a diversified and relatively liquid growth allocation.

Chart 28a. By Type of Asset Classes (%)



The number of plans holding real asset or hedge fund mandates has increased this year (by 4% and 6%, respectively), while multi-asset mandates saw a c.2% fall in popularity. This is shown in Chart 28b. These increases highlight a potential hunt for returns by plans outside of traditional equity markets, with a mind for diversifying return drivers in wider portfolios.

Chart 28b. Year-on-Year Change in Allocation



Charts 29–33 consider plans’ allocations within each of the alternative asset categories identified. Growth-oriented fixed income allocations continue to be dominated by emerging-market debt, high yield, absolute return bond funds and multi-asset credit. Relative to last year, the main change is the increase in the percentage of plans allocating to secured finance strategies (an increase in proportion of investors using this strategy and in allocation size).

Chart 29. Strategic Allocation to Private Equity (%)

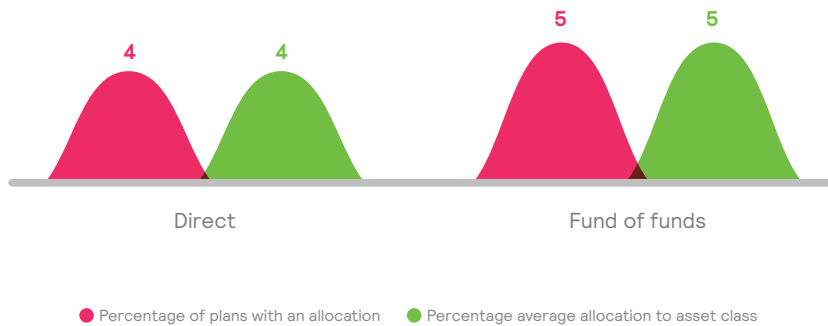


Chart 30. Strategic Allocation to Growth-Oriented Fixed Income (%)

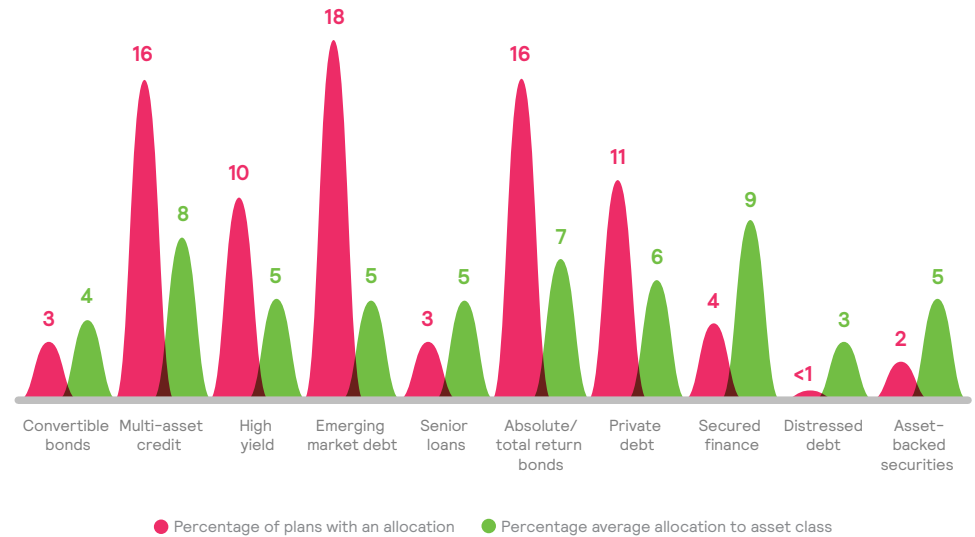


Chart 31. Strategic Allocation to Real Assets (%)

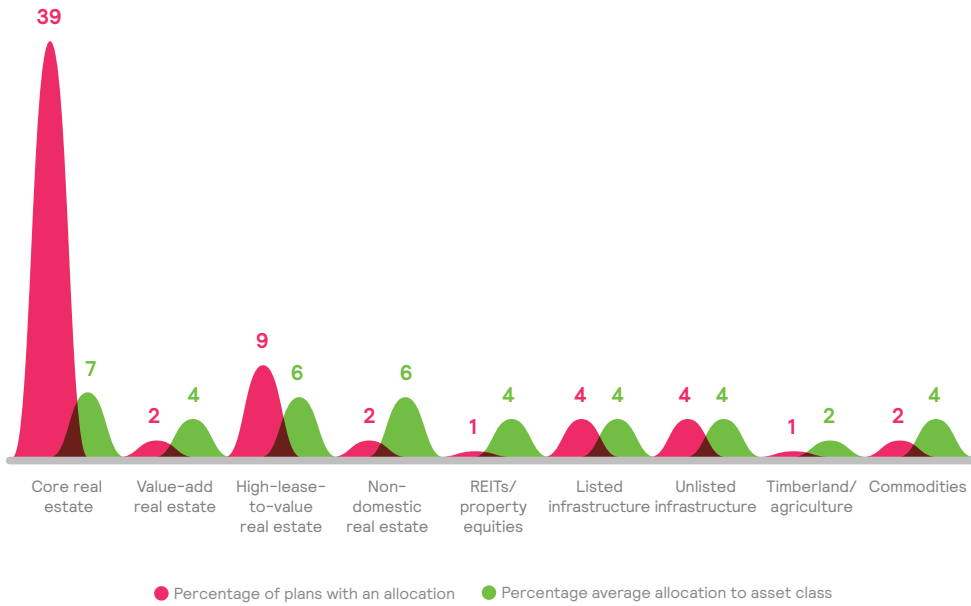
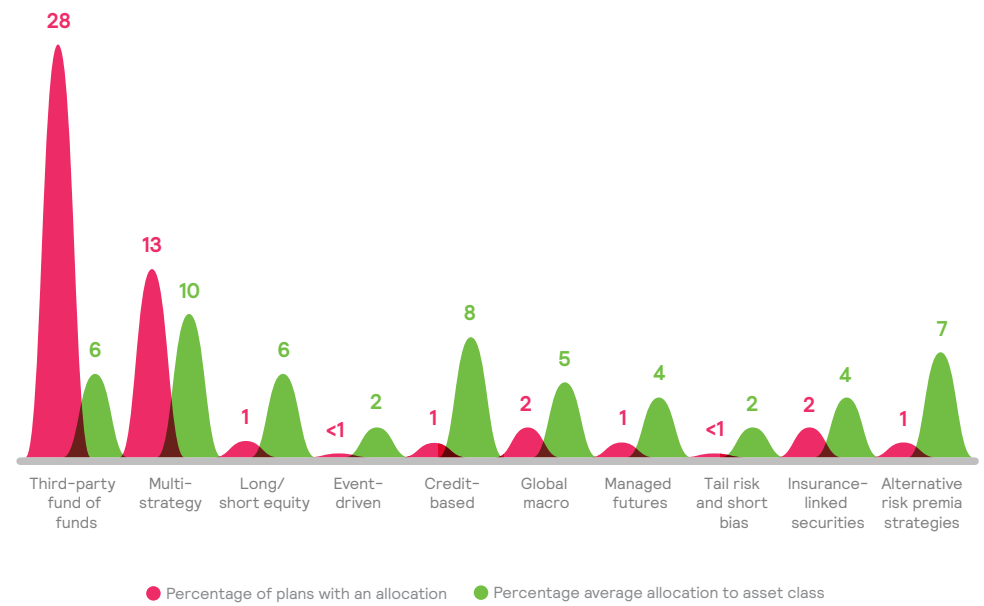


Chart 32. Strategic Allocation to Hedge Funds (%)



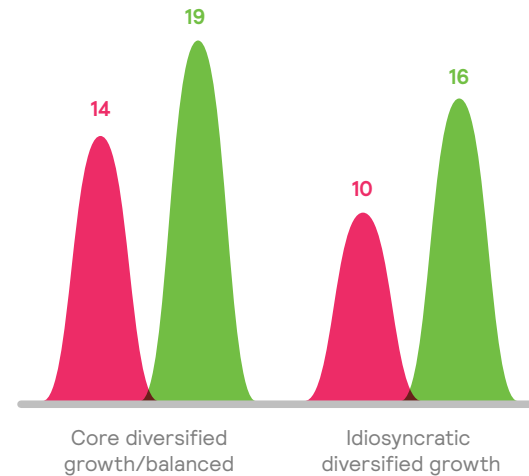
Real asset allocations remain dominated by core domestic real estate. The proportion of plans that have an allocation to core domestic real estate also increased this year (from 33% to 39%), as plans searched for diversifying sources of return. High lease-to-value property strategies still remain the second most popular form of real asset, due to their long-dated inflation-linked cash flows which share similarities with liability cashflows for some pension plans.

The increase in allocations to hedge funds has largely been through third-party funds of funds or multi-strategy hedge funds. These approaches may have higher fees, but they can provide lower-governance investors exposure to a number of hedge fund strategies through one vehicle while allowing investors to focus their governance budget on higher-level strategic decisions.

The most popular multi-asset strategies can be broken down into “core” funds (which are expected to rely largely on market returns — or “beta” — to achieve growth over time) and “idiosyncratic” funds (which place a greater emphasis on tactical asset allocation and specific trade ideas to create a portfolio less reliant on market returns). Where investors expect lower prospective returns for traditional beta, we would expect investors to express a preference for idiosyncratic strategies. Plans have a preference for “core” funds, although the percentage of plans that have an allocation to these strategies has fallen from 16% to 14% over the year.

The number of plans with allocations to multi-asset approaches has fallen this year, in part because of the poor performance of a number of well-known strategies.

Chart 33. Core vs. Idiosyncratic Diversified Growth Fund



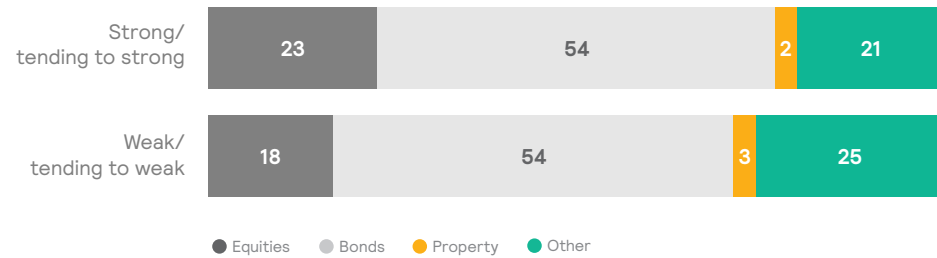
● Percentage of plans with an allocation ● Percentage average allocation to asset class

SPONSOR COVENANT STRENGTH FOR UK SCHEMES

This year’s survey also asked UK plans to provide information about the strength of plan covenants. Where a plan is supported by a larger organisation or business (for example, a DB pension plan being supported by its sponsoring company), the covenant describes its legal obligation and financial ability to support the plan now and in the future. The strength of the covenant can impact the plan’s ability to take on risk, with stronger covenants being associated with a greater willingness and ability to lend support to plans.

The results, as expected, show a higher allocation to equities for plans that have a covenant described as “strong” or “tending to strong” – with an average of 23% in equities, compared to 18% for plans that have covenants described as “weak” or “tending to weak”. All plans have similar weightings to property and bond assets, while those in the weaker covenant bucket have a 4% higher average allocation to other investments.

Chart 34. Broad Strategic Asset Allocation Covenant Strength (%)



RESPONSIBLE INVESTMENT

Sustainability is gathering momentum (this is one of Mercer's key themes of 2019), and we continue to see a spotlight on asset owners implementing a range of responsible investment (RI) approaches in their investment decisions.

As in previous years, our most recent survey focused on several elements, ranging from broad consideration of ESG in investment beliefs and policies to the specifics around climate change and introducing new elements around the social and environmental impact of investments.

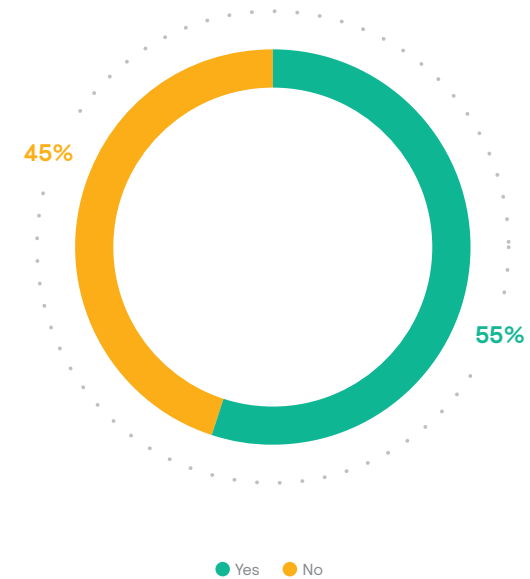
The regulatory landscape continues to drive a significant amount of the initiatives that pension schemes are undertaking. Chart 35 shows that 55% of the survey respondents consider ESG risks in their schemes, a notable increase from 40% in 2018. We expect this trend to continue.

REGULATORY ENVIRONMENT CONTINUES TO DRIVE CONSIDERATION OF ESG RISKS

The key drivers leading survey participants to consider ESG issues have not changed, and we continue to see the regulatory environment as the primary driver. This strengthened over 2018, with the UK's Department for Work and Pensions (DWP) introducing regulations on how trustees should take into account financially material ESG considerations and, more specifically, climate change in their investment decisions.

Beyond regulations, we are pleased to see the significant jump in the number of survey participants responding "yes" to the range of other drivers listed in Chart 36. We note that the options in our question are not exclusive, with some asset owners citing a combination of drivers.

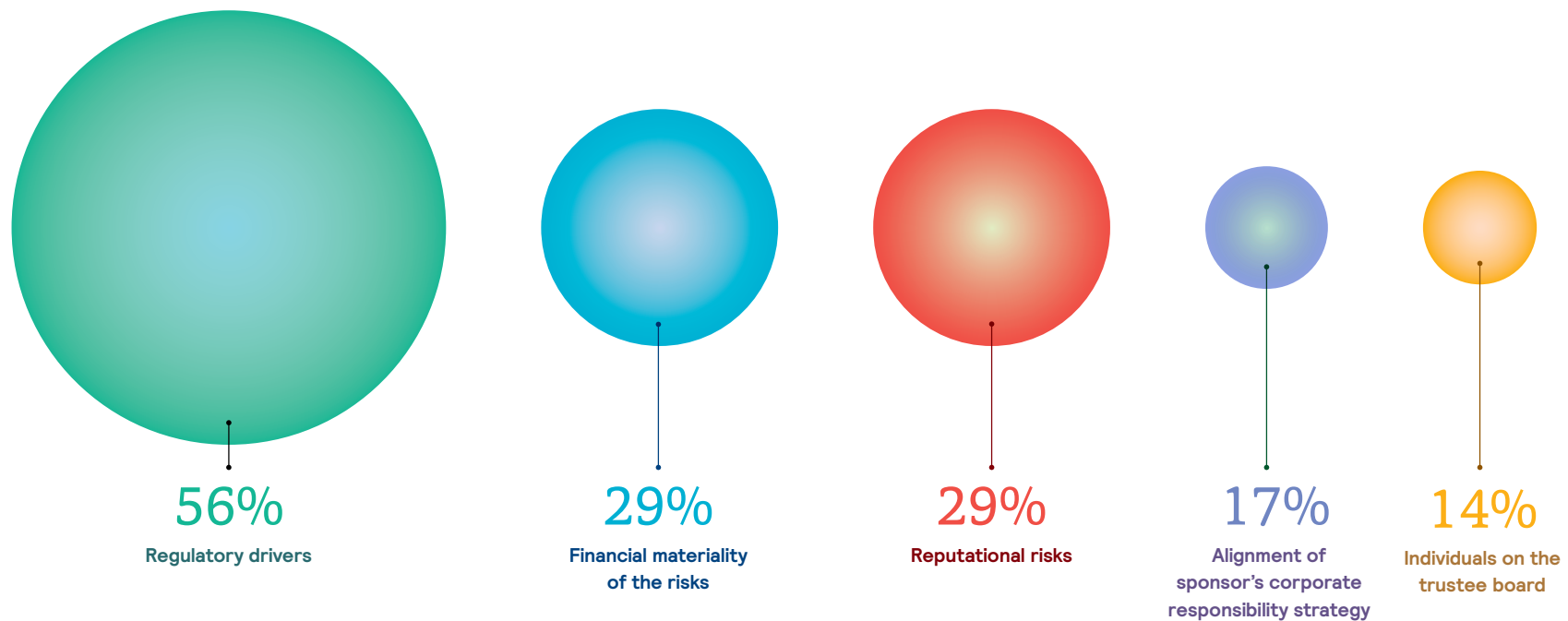
Chart 35. Does the Scheme Consider ESG Risks?



More than half of respondents reported that regulatory drivers were one key reason for schemes to consider ESG. This is up from approximately 34% in 2018. The 2017 European Pensions Directive, IORP II, and the UK DWP's Investment Regulations, which come into force in October 2019, require pension funds to take ESG factors, including climate change, into account when making investment decisions.

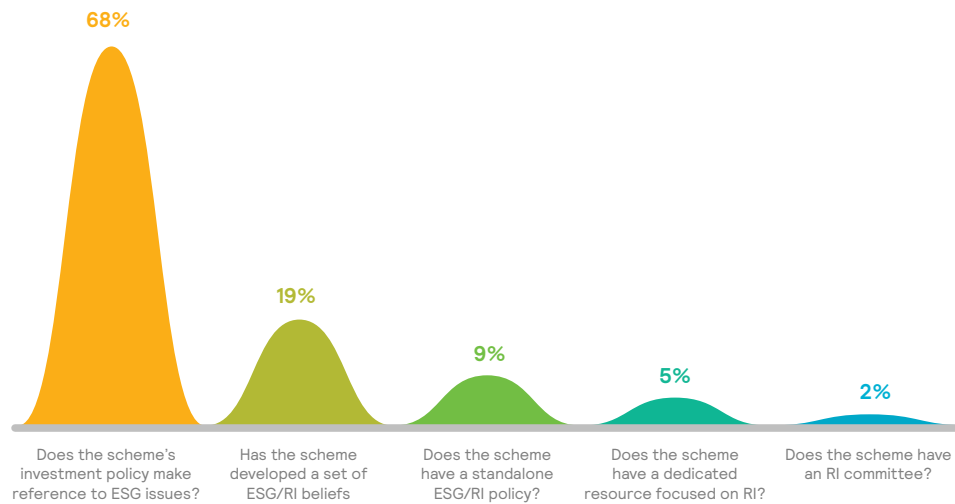
Furthermore, just under 30% of participants cited either financial materiality or reputational risks as key drivers, up from around 25% and 18% in 2018, respectively. As data increasingly show the relative positive link between better ESG management and improved corporate performance, we are not entirely surprised to see these jumps in figures.

Chart 36. Key Drivers Behind the Consideration of ESG Risks



More than half of respondents reported that regulatory drivers were one key reason for schemes to consider ESG. This is up from approximately 34% in 2018.

Chart 37. Governance, Beliefs and Policy

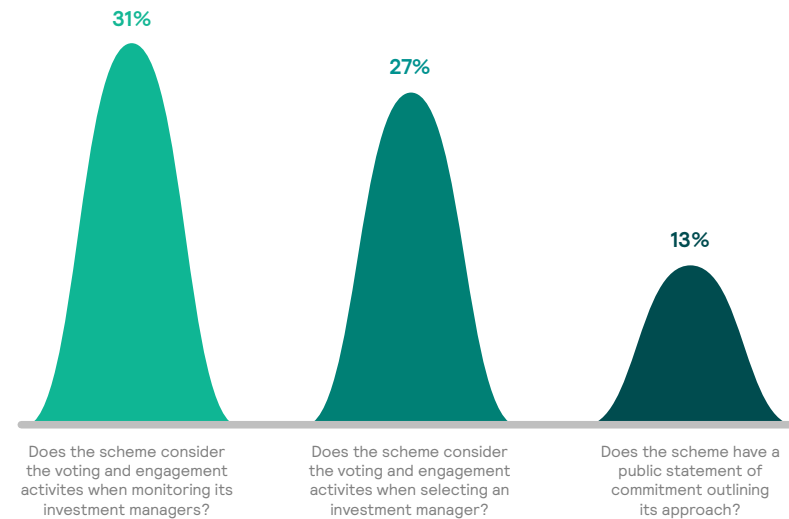


GOVERNANCE BELIEFS AND POLICY – SLOW STEPS IN THE RIGHT DIRECTION

Mercer believes that incorporating RI into an investment framework begins with the development of a set of beliefs, which then translate into policies and are then incorporated into processes and portfolios. New to the survey this year, we asked respondents to highlight where they are positioned in this journey on governance, beliefs and policies. Chart 37 highlights the degree to which schemes have incorporated ESG into these beliefs.

Although over two-thirds of respondents make reference to ESG issues in their investment policies, less than one-fifth have developed a formal set of RI beliefs, and less than one-tenth have developed a separate RI policy. Having said that, regulatory initiatives set up by the DWP highlight that setting up an RI policy is only the first step to take. As Mercer continues to undertake education and belief sessions, we anticipate that schemes will gradually move into developing more RI-specific beliefs and incorporating ESG into dedicated RI policies and processes.

Chart 38. Active Ownership and Stewardship



STEWARDSHIP INCREASINGLY ON THE AGENDA

Stewardship – that is, voting and engagement – is increasingly on investor agendas as asset managers come under greater scrutiny to disclose how they undertake these activities. The increase in investor-led collaborative engagements on particular ESG issues (such as climate change and diversity) has helped bring greater awareness to this topic. Chart 38 highlights some aspects in which respondents undertake their stewardship responsibilities within their schemes.

Just under one-third of respondents noted that they monitor the stewardship activities of their underlying managers. Approximately 27% of schemes are starting to consider stewardship in the selection of investment managers; however, public commitment regarding a scheme's approach to stewardship is less common, with only 13% having a public statement in place.

CLIMATE CHANGE: GROWING CONSIDERATION BY ASSET OWNERS

Mercer’s recent publication of *Investing in a Time of Climate Change – the Sequel* advances on the first study in 2015, highlighting potential investment risks under different climate scenarios and risk factors. The paper finds that for nearly all asset classes, regions and timeframes, a scenario of 2°C global temperature increases leads to enhanced projected returns versus 3°C or 4°C increases – and therefore a better outcome for investors. Our recommendations are aligned with those of the Financial Stability Board’s Task Force on Climate-related Financial Disclosures (TCFD), and we will continue to work with schemes on undertaking scenario analysis and adopting the TCFD recommendations into their frameworks.

Chart 39a. Has the Scheme Considered the Investment Risk Posed by Climate Change?

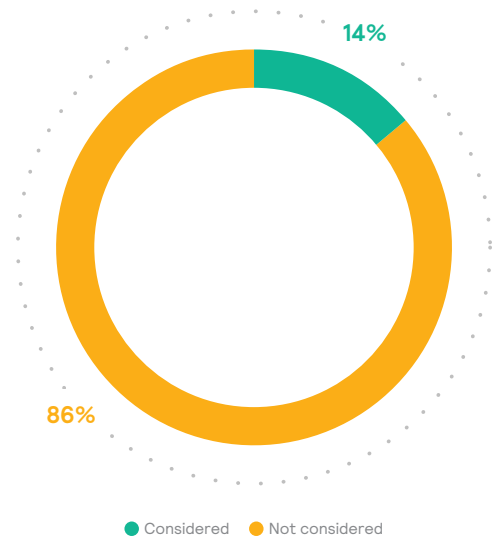
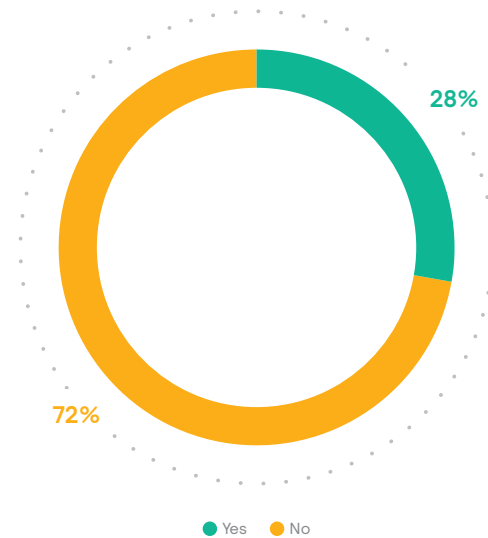


Chart 39a shows that approximately 14% of respondents in 2019 said they consider investment risks posed by climate change, compared to 17% of respondents in 2018. Although it is disappointing to see this decline, Mercer has been increasingly engaging with schemes over the last few months following the publication of the sequel paper on climate change. We expect the number of schemes considering this to increase over the next year.

Furthermore, we are pleased to see that, among the schemes that currently do not consider investment risks related to climate change, 28% are planning to consider this within the next 12 months (Chart 39b).

Chart 39b. If No, Is the Scheme Planning to Consider This Within the Next 12 Months?



ALLOCATING TO SUSTAINABILITY-THEMED INVESTMENTS

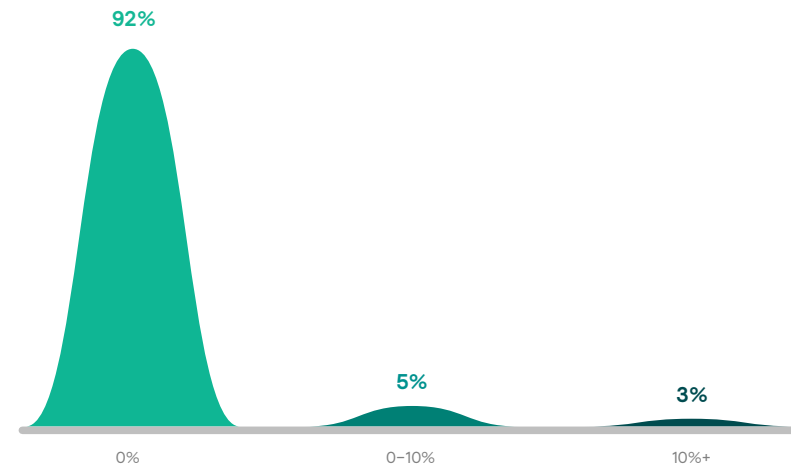
The opportunities for sustainability-themed investments range from broad sustainability and impact-themed solutions to dedicated low-carbon strategies. Significant developments have occurred within the asset management industry as asset managers create and launch investment strategies that specifically target opportunities to actively address one or more of the United Nation's Sustainable Development Goals (SDGs).² In addition, asset owners are focusing on developing frameworks aligned to the sustainable development goals to report on these targeted investments.

LOW CARBON AND IMPACT SOLUTIONS

In this year's survey, we asked schemes about the extent to which they have allocated their assets to low carbon and impact-themed investment solutions.

Approximately 8% of schemes have allocated some of their assets to low carbon solutions (where the exposure to fossil fuels is minimal), with only 3% having an allocation of 10% or more to this theme (Chart 40).

Chart 40. Allocation to Low Carbon Assets (Percentage of Plans)



² <https://www.un.org/sustainabledevelopment/sustainable-development-goals>

Similarly, as Chart 41 shows, 10% of respondents said they have considered broader social impact investing (that is, investing with a clear focus on the environmental and social impact of a company in the portfolio). Given the drivers highlighted above, as the opportunity set grows, we expect schemes to continue allocating to low carbon and sustainability-themed/social impact investment strategies over the next few years across a range of asset classes.

Chart 41. Has the Scheme Considered Social Impact Investing?

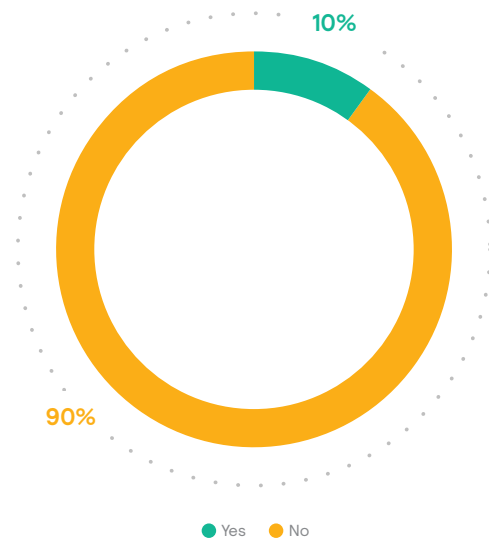
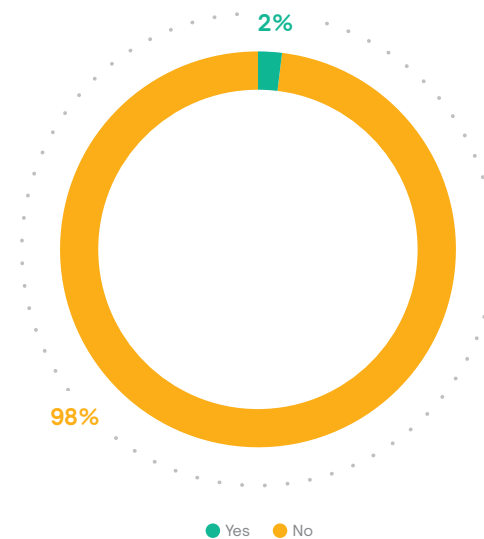


Chart 42 shows that only 2% are using the SDGs as a framework for impact measurement. This is not entirely surprising, given the lack of standardisation for impact measurement. However, the SDGs are a useful and increasingly common framework for measuring impact. As concrete measures are developed, we expect to see an increase in uptake for this tool.

Chart 42. Has the Scheme Considered Using the UN SDGs as a Framework for Measuring the Impact of Its Investments





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