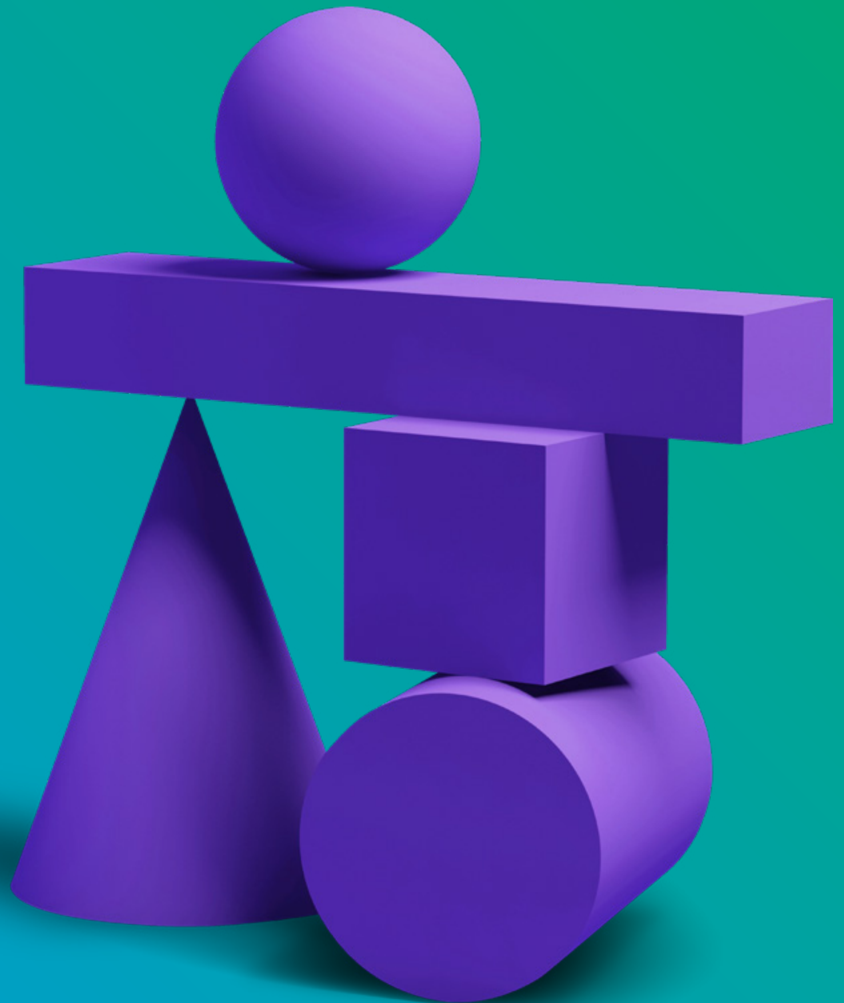
MERCER

navigating investments in a

new world

Pacific Endowments and foundations
2021 investment ideas



welcome to brighter

The COVID-19 pandemic has highlighted the urgency of addressing climate risk and societal disparities in 2020.

The resulting economic actions of governments, equity market volatility, persistently low interest rates and negative yields have challenged individuals, societies and investors.

Many philanthropic investors have seen an increased demand for grant-making and spending within an environment of lower expected future returns — in many cases, with little or no inflow of contributions.

In this paper, Mercer outlines the key areas of discussion we are having with our endowment and foundation (E&F) clients to ensure that they are prepared and can potentially capitalise on the opportunities created through the changing market landscape.

Reconsider the fundamentals

How long do you have?

The concept of intergenerational equity is often described as a tug-of-war between mission in perpetuity and satisfying current needs. But a seesaw might be the more appropriate description: in times of growth, investors look to the horizon and position their portfolio for strategic success over decades, but in times of market stress, investors focus on short-term mission spending. This provides an opportunity to stress test your strategic aims. **Can you get the spending you want from your portfolio? Should you move to a finite time horizon?**

Speed test your governance process

Institutionalise disciplined checks and balances

Driven by the pandemic, market volatility tested many governance structures. The most effective organisations learned lessons that helped to establish protocols for increased communication among all of the fiduciaries involved in the investment process: investment teams, committees, and Boards. Discussing and deciding which of these protocols to continue will help to ensure that constituents are better equipped to make decisions regarding the institution as a whole under both normal and stressed conditions.

Re-examine and document the most efficient and effective communication and engagement processes through the COVID-19 crisis. **Should you consider alternative/additional models to the current governance framework to ensure effective oversight and decision-making?**

Spend some now, save some for later

The swiftness and severity of the COVID-19 crisis left many mission-driven organisations with a need to make one-time special portfolio distributions or to accelerate or increase their normal spending.

These actions had meaningful short-term benefits, but we believe the key to preserving intergenerational equity is discipline around these short-term actions. Intergenerational equity is not meaningfully affected if additional spending has a limited duration. **Have you considered revising your spending policy? Should you have specific protocols for "crisis response" spending? How will such interventions impact long term prospects?**

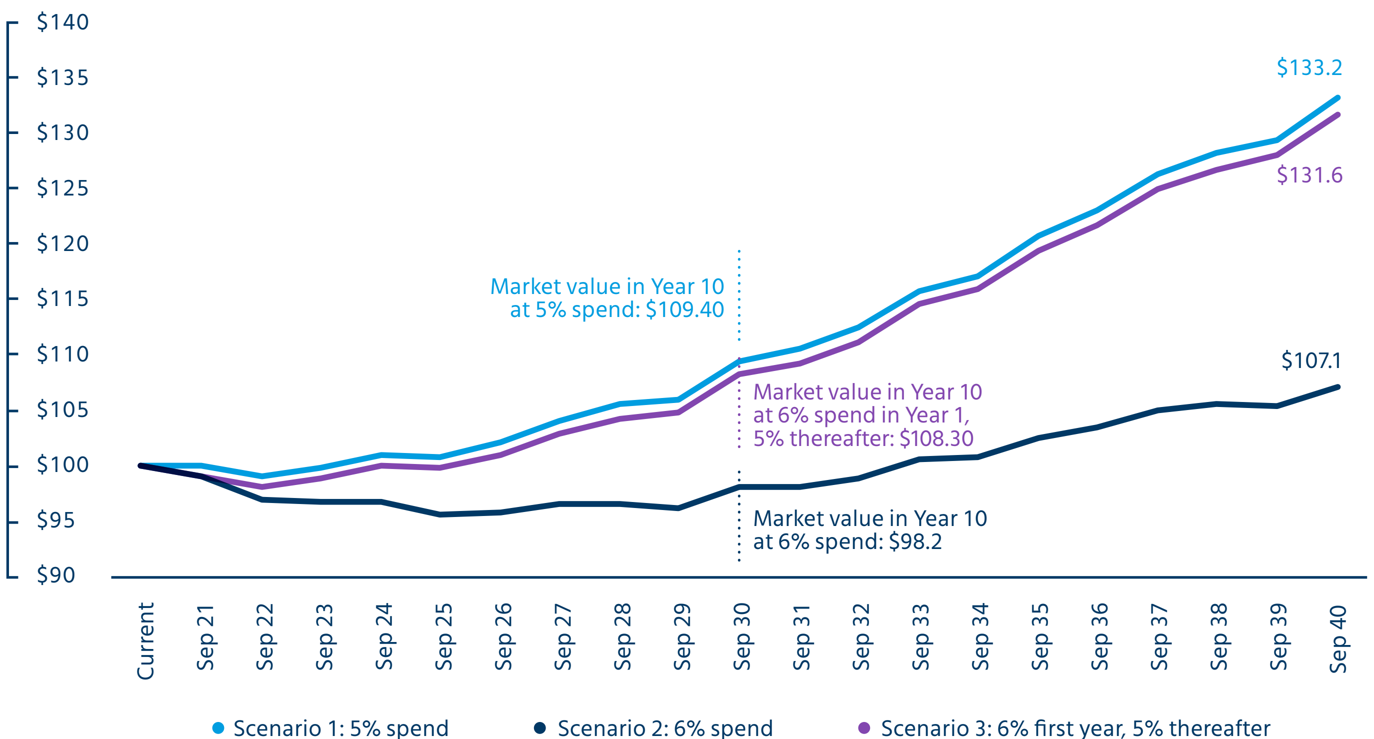
A one-year increase in spending from 5% to 6% that reverts back to 5% in subsequent years only has a 1% impact on the 10-year portfolio value.

Take a detailed look (See Figure 1) at whether or not the effect of the pandemic on your institution will be temporary or permanent and revisit endowment dependence, portfolio risk, and asset allocation accordingly.

Manager selection

Invariably there are winners and losers in times of extreme market volatility. Effective monitoring and measurement of investment managers will determine which ones have performed in line with expectations and which ones have missed the mark. Have the investment manager(s) done what you have asked of them? **Examining, reviewing and monitoring manager performance and ensuring appropriate diversification will help ensure the best chance of optimal outcomes.**

Figure 1. Hypothetical $100 million portfolio — Impact of changes on spend rate



Source: Mercer. (For illustrative purposes only.)

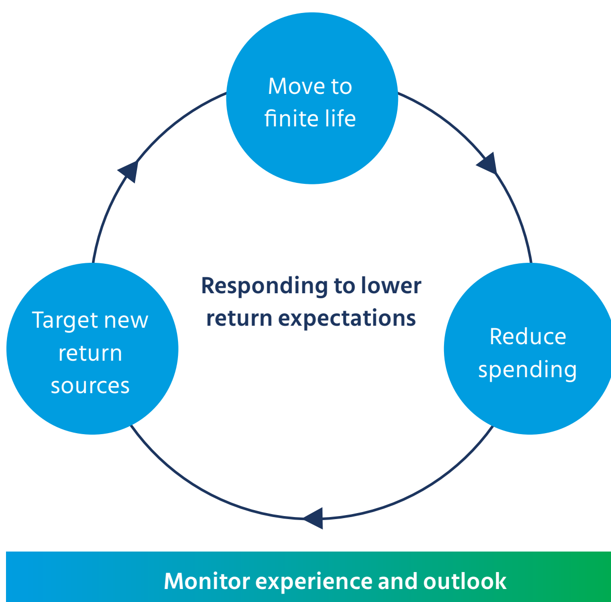
Asset class considerations

Returns will be harder to earn

In the new world, reliance on traditional modelling and historical asset movements might be misplaced. It is important to consider different scenarios as well as base cases. **Embracing ideas like capitalising on your ability to invest in less liquid strategies, such as private markets**, could provide the additional boost in return that you require for your long-term success. These ideas are often considered higher risk and complex; however, within the right governance structure could potentially enhance your portfolio. We suggest balancing these strategies with a lower-risk but higher-quality fixed income portfolio.

Also, remaining nimble and being prepared to be opportunistic could help to boost long-term expected returns. Consider your ability to react to risks and take opportunities during the crisis. **A review of governance may allow greater opportunism in future.**

Focus manager selection where it is most rewarded, and simplify investments in asset classes which offer lower potential "added value-to-effort" ratios.



Inflation protection

Is short-term disinflation hiding longer-term inflation risk this time around?

In the aftermath of the Global Financial Crisis (GFC), quantitative easing (QE) activity inflated asset prices. During the current crisis, central banks and governments have responded by significantly increasing the money in circulation. The GFC saw credit destruction (disinflationary) whereas the COVID-19 crisis is currently seeing credit creation. Austerity measures are therefore unlikely.

Worries of monetary debasement are demonstrated by a rise in gold prices and dollar weakness. Impairment of just-in-time supply chains is an inflationary pressure.

Inflation is policy – it provides the easiest way for central banks to erode debt levels. Looser inflation targeting is already on the horizon. **Real-return-focussed investors should consider looking for inflation sensitive assets, including property and infrastructure.**

Revisit the role of fixed income

With global bond yields at historic lows and central banks indicating that they will aim to keep yields low, **the outlook for absolute returns from investment-grade fixed income over the next decade is subdued.** We believe that the "best" use of any defensive fixed income allocation should be to generate positive returns in a negative equity market. This also means investors should consider diversifying risk-reduction assets into other low-beta alternative investments, such as defensive hedge funds.

Responsible investing in a changing economy

Position for transition

Position for transition is **a call to action, asking investors to align their portfolios with a transition to a low-carbon economy.** This call to action is an imperative since we believe the increasing impact of the climate crisis makes policy response inevitable. Positioning for transition can help to protect against risks associated with transition and potentially enhance return by identifying emerging opportunities.

The pandemic represents a rare but narrow window of opportunity to reflect, reimagine and reset our world.

Klaus Schwab, Founder and Executive Chairman, World Economic Forum, June 2020

Decade of delivery

Climate-change alleviation will require reaching net-zero emissions. The Intergovernmental Panel on Climate Change (IPCC) states greenhouse emissions need to be reduced by 45% (from 2010 levels) by 2030, and to net-zero by 2050 to have a 50% chance of limiting temperature increases to +1.5°C above pre-industrial averages by 2100.[1] Investors face a broad swathe of climate-related portfolio risks over this period, for example regulatory, transition, physical and reputational risks, and this **necessitates a total climate-transition plan to help mitigate these risks.**

Asset-owner commitment to climate transition is building. The United Nations Framework Convention on Climate Change's Race to Zero Campaign of net-zero initiatives accounts for 995 businesses, 38 investors, 5,050 universities, covering approximately 25% of global CO_2 emissions and greater than 50% of global gross domestic product.

The age of engagement

A growing number of investors care more than ever about where their money is invested and whether the companies they invest in are working towards a sustainable, inclusive future. Following strong flows into sustainable funds in 2019, flows have accelerated in 2020 – a stark juxtaposition with net outflows in the rest of the fund market. In our view, **investing in strategies with high ESG ratings** is potentially the most effective way to improve portfolio sustainability.

Investors are recognising the power of control. Investing where you, as an asset owner, have a say, is becoming even more important in an era of transition and one where investors are increasingly seeking to make an impact. **Private market strategies in particular offer impact potential.**

Strive to meet the SDGs

As investors embrace sustainability, and investigate ways to make an impact, they inevitably look for a framework for approaching it, and the United Nations' 17 Sustainable Development Goals (SDGs) are quite instructive in this regard. The SDGs address an audience wider than the investment community, including policymakers and the public, and address global concerns over a wide range of areas, such as justice and poverty alleviation.

Although, in our view, these goals are not the best foundation for building an investment strategy, we consider them a good alternative lens to view investor portfolios through. If a portfolio is not meeting the needs of the world over the long-term, it is likely to bear significant pockets of risk, ranging from shareholder activism to obsolescence. If an investor can categorise portfolio investments as meeting various sub-goals within the framework, their portfolio moves towards a more future-proofed reality. **We therefore suggest investors consider SDG-aware investing.**

[1] IPCC. *Summary for Policymakers of IPCC Special Report on Global Warming of 1.5°C approved by governments*, 2018, available at https://www.ipcc.ch/2018/10/08/summary-for-policymakers-of-ipcc-special-report-on-global-warming-of-1-5c-approved-by-governments/.

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