Shifting sands, turning tides

Addressing investment regime change

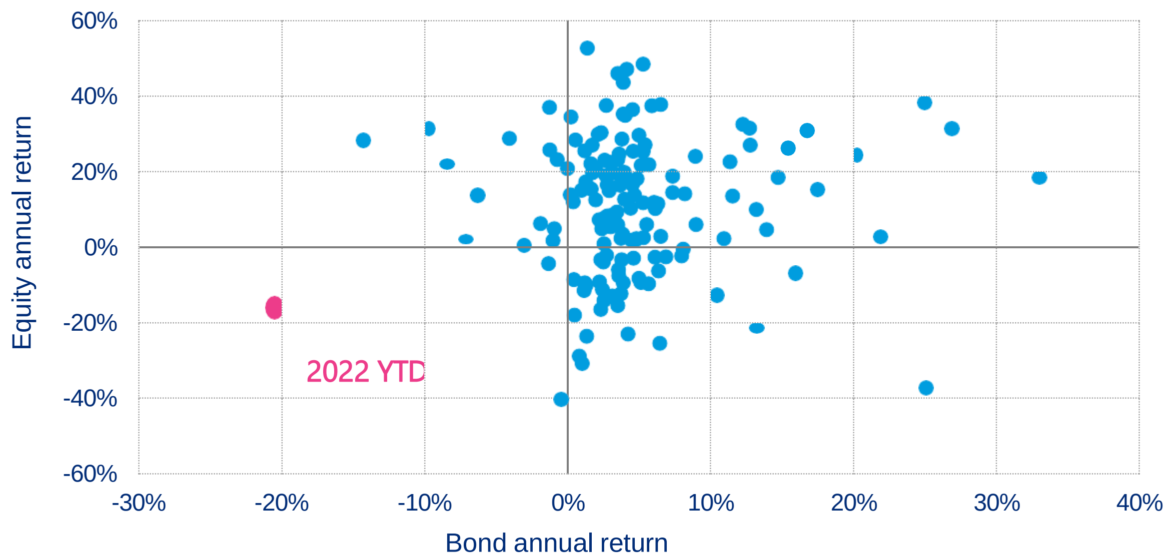
Contents

1. Everything everywhere all at once: the multiple regime changes of 2022 and beyond

With every New Year comes new hope. For most investors, the hope for next year will simply be that it is a lot better than this year. 2022 was a shock to the system.

The year kicked off with central banks nursing a hangover from COVID-induced over-stimulus. They were positioned a long way behind the curve on inflation and needed to catch up fast to rein it in. Inflationary pressures ramped up with the conflict in Ukraine and its impact on energy and food supply. The rate response was aggressive and the movements in yield curves seismic – in the UK, the rate rises, coupled with political misjudgment, led to the yield curve movements triggering a liquidity crisis. The result was that both equity and bond returns fell firmly into negative territory (see Figure 1).

Figure 1. 2022: standing out like a sore thumb among 150 years of returns



Source: Bloomberg, NBER, Jordà-Schularick-Taylor Macrohistory Database, Morgan Stanley Research; Note: Data to 1871. Bond return is long-maturity UST. Data as of December 9, 2022. © 2022 Morgan Stanley.

Real returns in most countries were far worse, of course, given high levels of inflation, driven by both cyclical and structural forces. The key objective of our annual Themes and Opportunities paper[1] was to identify structural trends and emerging risks. In papers of recent years, we have flagged underlying inflation pressures, the potential scenarios in which those pressures would emerge, the likely rate response and the risk that equities and bonds would become correlated on the downside in such an event.

The question now is whether, as cyclical inflation pressures subside, structural pressures will remain. Are today's conditions – to use the word of 2021 – simply "transitory", a short-term fallout of the shocks of recent years? Or has there been a more permanent shift in conditions, symptomatic of a regime change?

[1] Themes and opportunities 2023, Mercer, published in November 2022, available at https://www.mercer.ca/en/our-thinking/wealth/investor-themes-and-opportunities.html

In our view, 2022 did indeed represent a regime change. The shocks simply served to exacerbate underlying pressures and trigger a momentous shift in investing conditions across a number of areas. Some of these are directly related to the inflation story, others are not: real interest rates and discount rates; leverage and liquidity; valuations and correlations; and energy and climate transition.

All of these issues and more were considered by Mercer's Global Strategic Research Team in the development of our Themes and Opportunities 2023.[1] As a wrap up for 2022, we thought it would be interesting for each of us to look at a different aspect of this regime change that will impact the way we all invest in 2023 and beyond.

In the development of this paper, our Themes and Opportunities, and all of our research throughout the year, we recognize the contribution of the many exceptional asset managers and other industry experts we have had the pleasure of working with, and who influence, challenge and shape our views. All of our research and theirs can be found in the MercerInsight Community[2], a place you may want to visit *after* your well-earned break, in what will I am sure be a much calmer 2023!

Nick White

Nick White, FIA
Global Strategic Research Director

[2] https://insightcommunity.mercer.com/dashboard

2. As cyclical inflation subsides, will structural inflation survive?

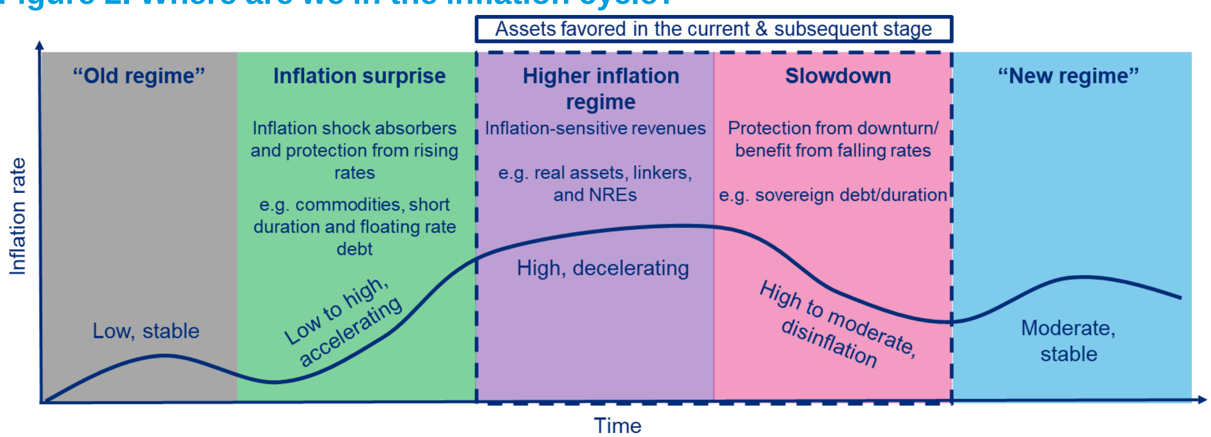
Inflation was clearly central to 2022's regime change. Multi-decade highs in inflation led to an aggressive monetary policy response, slowed down consumer spending and ended with almost all asset classes falling in absolute terms with the exceptions of energy, commodities and the US dollar.

We entered 2022 warning about higher inflation risk and positioning reference portfolios towards diversified inflation protection to make them robust in a number of scenarios, including the overheat scenario of central banks scrambling to rein in inflation. This was the scenario that actually materialized over 2022 to the detriment of markets. Now, even as there are tentative signs of cyclical inflation subsiding and the monetary tightening cycle approaching its peak, investors should remain on alert, as the regime has changed, especially in regards to inflation.

Indeed, it seems unlikely we will simply return to the stable, low inflation regime of the post-global financial crisis (GFC) world. We are seeing a slowing pace of globalization, a continued push for an energy transition, and the potential for renewed fiscal-monetary coordination. It is likely that as part of a new regime defined by greater economic fragility, we will see more regular inflationary shocks combined with inflation running modestly above central bank targets.

2022 has been the year of inflation surprise and rapidly rising yields, where shock absorbers such as commodities, which have a strong "inflation beta", have done remarkably well. Positioning portfolios for a new regime means a re-orientation of inflation protection towards longer-term assets with inflation-sensitive revenues, and a readiness to manage portfolios dynamically as both business cycles and inflation cycles evolve.

Figure 2. Where are we in the inflation cycle?



Source: Mercer

Chris Canstein, MSc, CFA, CAIA
Strategic Investment Research Specialist

3. The prerequisites of diversification have changed

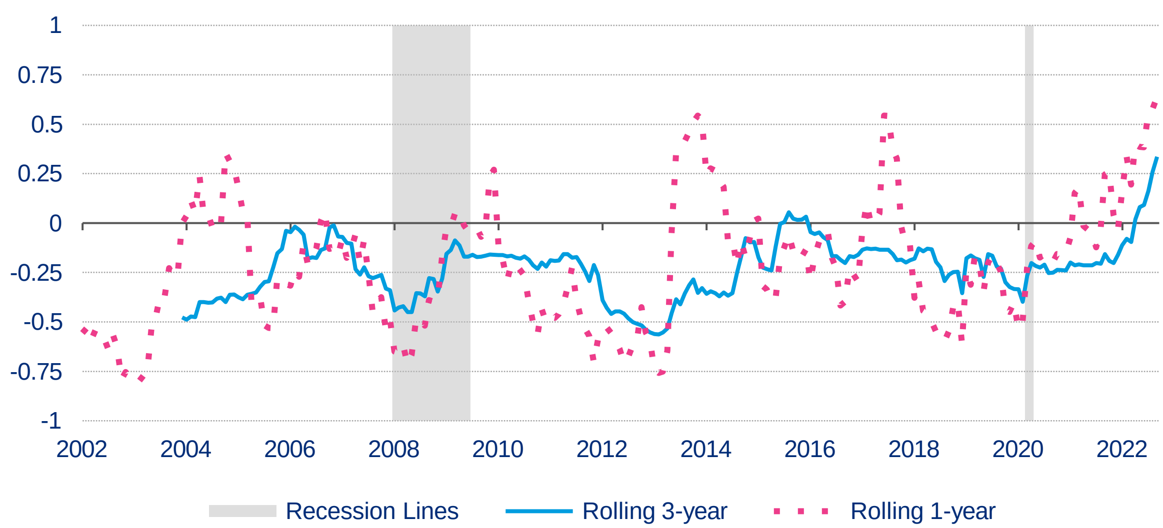
2022 was the first year in most investors' careers in which equities and bonds simultaneously produced negative returns.[3] This highlighted that correlation structures are both regime dependent and conditional, and gave investors a taste of what it would be like to invest in a very different regime for diversification.

The current regime is most likely defined by fragility (the constrained ability of authorities to cushion economies and markets), changes, and geopolitical "factionalization". The correlation relationships that portfolios have been built around for decades are likely to be unstable, if not outright unhelpful.

The past year saw high inflation lead to increasingly hawkish central bank policy and a general slowdown in growth. Investors, lulled into complacency by generally low inflation over the past three decades, had come to rely on equities and bonds being negatively or close to zero correlated. When equity markets fell in the past, central banks would cut rates to restart the economy, and this allowed bonds to serve as the ideal tool for diversification in risk-off markets.

In 2022, this relationship reversed. Central bank hiking caused equity markets to roll over, but, unlike the past, they did not then cut rates – in fact, they just kept hiking. Inflation, which in past decades had been highly correlated with the business cycle, had become untethered from targets and central banks around the world were unwilling to risk a repeat of the 1970s. The net result was stock/bond correlations moving into positive territory at the exact time when we would normally hope bonds would cushion the portfolio.

Figure 3. Correlation between global equity and sovereign fixed income



Source: Refinitiv, Mercer. Data as of September 30, 2022. Recession lines indicate NBER recessions.

[3] MSCI World Index and Bloomberg Global Aggregate Bond Index. As at November 30, 2022.

So how do we believe this relationship will evolve as we move into 2023 and beyond? In short, it's complicated. Inflation, while linked to the business cycle, is driven by a number of idiosyncratic factors that could trigger future spikes, as well as secular drivers that could keep it modestly above central bank targets. Should these conditions leave markets more concerned about inflation upside, and the rate response needed to contain it, equities and bonds would remain positively correlated. The higher level of yields makes fixed income a more valid investment on a standalone basis, and creates some room for appreciation from any cuts central banks deliver to help power economies out of future recessions. However, we would not rely on it also offering diversification benefits from equities to the same degree, as rate cuts would likely boost equity markets at the same time.

What we have learned in 2022 is that to build robust portfolios, investors may need to find additional portfolio diversifiers. Stress testing and scenario analysis, as identified in the 2023 Themes and Opportunities, can help evaluate where portfolios might have diversification gaps and what portfolio adjustments or new allocations should be made.

Max Becker
Strategic Investment Research Analyst

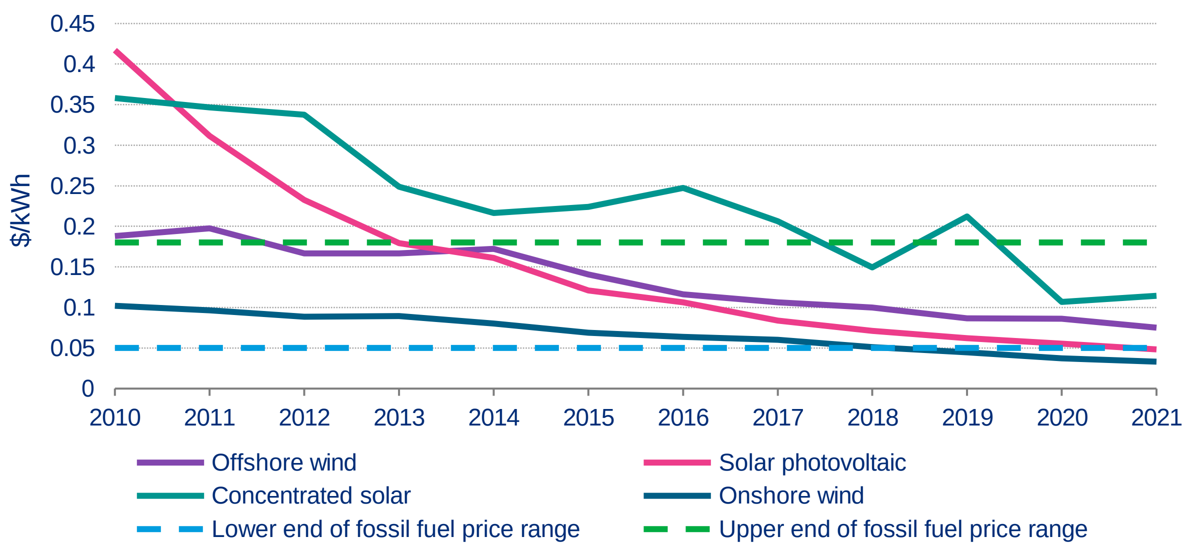
4. Energy enters a paradigm shift

This time last year it seemed inconceivable that Germany would sign a 15-year deal with Qatar for natural gas supply, and yet it has happened. Progress on emissions has been poor, with only the economic standstill provided by COVID having had a significant dampening impact so far. Scalable renewables' share of energy generation has grown from 5% to 10% of total supply in the last 10 years, but it must reach 45% by 2030 for the world to stick to a 2050 net-zero emissions trajectory.[4]

While we are all well aware of the consequences for Europe of the Western world's sanctions on Russia after its invasion of Ukraine, geopolitical frictions are not only a risk in traditional energy. Tensions between Europe and the United States on one side and China on the other are critical as China controls 85% of overall solar manufacturing capacity and 97% of polysilicon wafer production[5] (these wafers are the underlying component of the solar cell). Security and decentralization are becoming key components of energy planning for the future.

But there are reasons to be positive. The conflict in Ukraine has accelerated European plans to transition to renewables, and China has taken up the green gauntlet as it is forecasted to install almost a half of new renewable energy capacity in the next five years.[6] Whether the motivator is energy security, air pollution reduction, or cost effectiveness, renewable energy production looks set to boom. As Figure 4 shows, many renewable sources of energy are now cost competitive, with onshore wind and solar photovoltaic cheaper than fossil fuels.

Figure 4. Levelized cost of energy of selected technologies



Source: IRENA, 2022

Making use of cheap, renewable energy is not as easy as it might be. There can be intermittency problems (the wind is not always blowing nor the sun always shining), there is a need for infrastructure reform, and renewable component supply chains are not infallible. Energy

[4] See Transitioning between elements | Mercer. Hydropower excluded from calculation due to lesser scalability.

[5] Source: International Energy Agency Executive summary – Solar PV Global Supply Chains – Analysis - IEA

[6] Source: International Energy Agency, Renewables 2022

production in the future must be diversified, and progress must be made on energy storage (electrochemical batteries as well as equivalents such as molten salt storage or cryogenic systems) and capacitance.

Looking beyond infrastructure, investors can position for the ongoing energy transition by looking at mining and the production of advanced materials. The MSCI ACWI Metals and Mining index has a price-earnings ratio of 7.1x as at 30 November 2022[7], less than half the parent index (17.2x for the MSCI ACWI). China comes into play again as it accounts for over 40% of the supply of vanadium, graphite, molybdenum, aluminum and lead, which are all crucial elements in the energy transition.[8] Investors will want to choose approaches that are not subject to the vagaries of international relations.

Energy has assumed an extra dimensionality in recent times. Whereas investors have in the past mainly focused on energy supply, they will now have to supplement this by focusing increasingly on efficiency, security, technology and materials. Transition-aware infrastructure and transition-aware natural resources approaches could benefit from the paradigm shift.

Matt Scott
Senior Strategic Investment Research Specialist

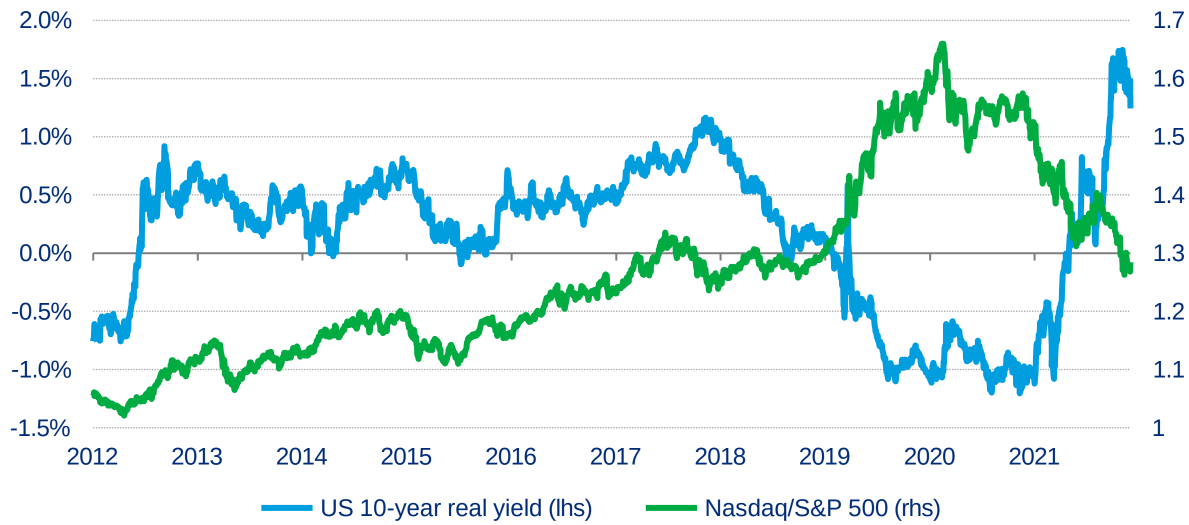
[7] Source: MSCI

[8] Source: IMF [Metals Demand From Energy Transition May Top Current Global Supply (imf.org)]

5. The end of free money and the effect on long-duration stocks

The era of free money came to an abrupt end in 2022, due to synchronized interest rate hikes by central banks around the globe in response to inflation. Nowhere had the benefits of free money been felt more acutely than in long-duration or growth equities. The dramatic rise in real yields hammered valuations of long-duration equities through the discount factor effect on present values, reversing many years of price-to-earnings multiple expansion since the global financial crisis (GFC). This led to the relative outperformance of value stocks, in particular those in the energy sector. Energy companies performed well as they traded like short-duration assets, with high up-front cash flows due to high oil prices, and low terminal values due to the long-term energy transition away from fossil fuel companies.[9] Figure 5 shows the spike in 10-year US real yields and the relative total return performance of the NASDAQ 100 versus the S&P 500.[10]

Figure 5. US real yields and relative equity duration performance



Source: Refinitiv, Bloomberg, Mercer. Data as of November 30, 2022.

We believe 2022 was not an anomaly for long-duration equities but the start of a fundamental regime shift, as the conditions of the previous decade are unlikely to repeat themselves over the short to medium term. A central bank pause or pivot in 2023 will likely be a necessary condition for all long-duration equities to stage a strong recovery, but by itself, it's unlikely to be sufficient, as the ability of central banks to run meaningfully negative real rates is likely to be constrained.[11]

Long-duration equities are now unlikely to re-rate and recover to previous market highs unless near-zero interest rates are seen again or earnings are finally able to support the investment thesis.

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[9] https://www.mfs.com/content/dam/mfs-enterprise/mfscom/insights/2022/october/pdfs/mfse_fly_1456331.pdf

[10] The NASDAQ 100 and S&P 500 are two of the most popular indexes in the US. We have used the two indexes to show the relative outperformance of long duration equities such as those in the NASDAQ 100 vs. a more representative and broader index of the S&P 500. The chart shows that as real yields fall, long duration assets outperform and vice versa.

[11] Due to persistent inflationary pressures, central banks are unlikely to be able to materially reduce nominal rates without dislodging inflation expectations.

We have seen lay-offs in the technology sector as CEOs are turning more attention to the bottom line than future moon shots.

In this new macro and market regime in which higher inflation, higher real yields, and market volatility are all intertwined, reassessing active manager selection will be key. Managers implementing a "growth at any price" strategy are expected to be continually tested, while managers implementing strategies which are more sensitive to valuation look better positioned. These more valuation-sensitive strategies have lower equity duration risk by design than long duration hyper-growth stock strategies. The new regime will likely inject more idiosyncratic risk into stocks, put a premium on selection versus naively loading up on growth beta, and see earnings growth and resilience take precedence over multiple contraction. The age of the stock picker may be back!

Steven Keshishoghli, CFA
Senior Wealth Management Research & Strategic Investment Research Specialist

6. Eyes on risk management

The multitude of regime shifts currently underway has led to a renewed focus on risk management. Years of cheap money have come to an end as financial conditions have tightened. Markets will shift and the risks rewarded in the recent past will likely not persist. New policy rules and a different economic cycle suggest the need to gain a fresh perspective on risk factors ahead.

Market air pockets	The withdrawal of central bank liquidity can create air pockets in markets, especially where leverage is involved. We witnessed one such event in the rapid spike in gilt yields catalyzed by the UK's "mini-budget" on September 23. This caused a sharp decline in the notional value of associated interest rate derivatives, requiring massive collateral calls on UK DB pension funds. The scale of the collateral requirements triggered UK pension funds to rapidly liquidate assets as they scrambled to find the necessary cash to support these collateral calls. While the Bank of England temporarily stepped in to calm the market, the limits of fiscal policy without the support of monetary policy were made clear.
Vehicle liquidity mismatch	Mounting withdrawals at Blackstone Real Estate Income Trust, Blackstone Private Credit Fund, and Starwood's non-traded REIT, Starwood Real Estate Income Trust, exposed the vulnerability of funds with a mismatch in vehicle and underlying asset liquidity. Unlike publicly traded REITs and BDCs[12], these private open-ended, semi-liquid funds lack permanent capital, are leveraged, and are invested in private markets where "marked" valuations lag valuations in the publicly traded markets. Rising redemption requests tend to bring about more redemption requests as investors scramble to get in early to the redemption queue.
Shifting marginal buyers	The pull-back in central bank liquidity has altered the marginal buyer. An example of this is US agency mortgage-backed securities (MBS). Trading volumes declined in 2022 and yield spreads over US Treasuries rose. With the marginal buyer shifting from central banks to levered participants, like mortgage REITs, agency MBS became more volatile than in the past few decades.[13] Beyond areas of direct intervention, the broader market has pushed the proverbial Fed put further out of the money due to the ongoing battle with inflation.
Tenuous exit plans in private markets	Exit activity has fallen below its short- and long-term trends. Liquidity from public listings has completely dried up, while sales to financial sponsors have continued to take up a greater share of overall exits. The illiquidity issues and lack of mark-to-market pricing likely will contribute to a difficult fundraising environment in the coming quarters.[14]

Beyond these more structural shifts in conditions resulting from the regime shift we are experiencing, there are a number of other examples of liquidity stress in markets today: the leveraged loan market, which has been the primary source of buyout debt, has softened rapidly, and is at its lowest level

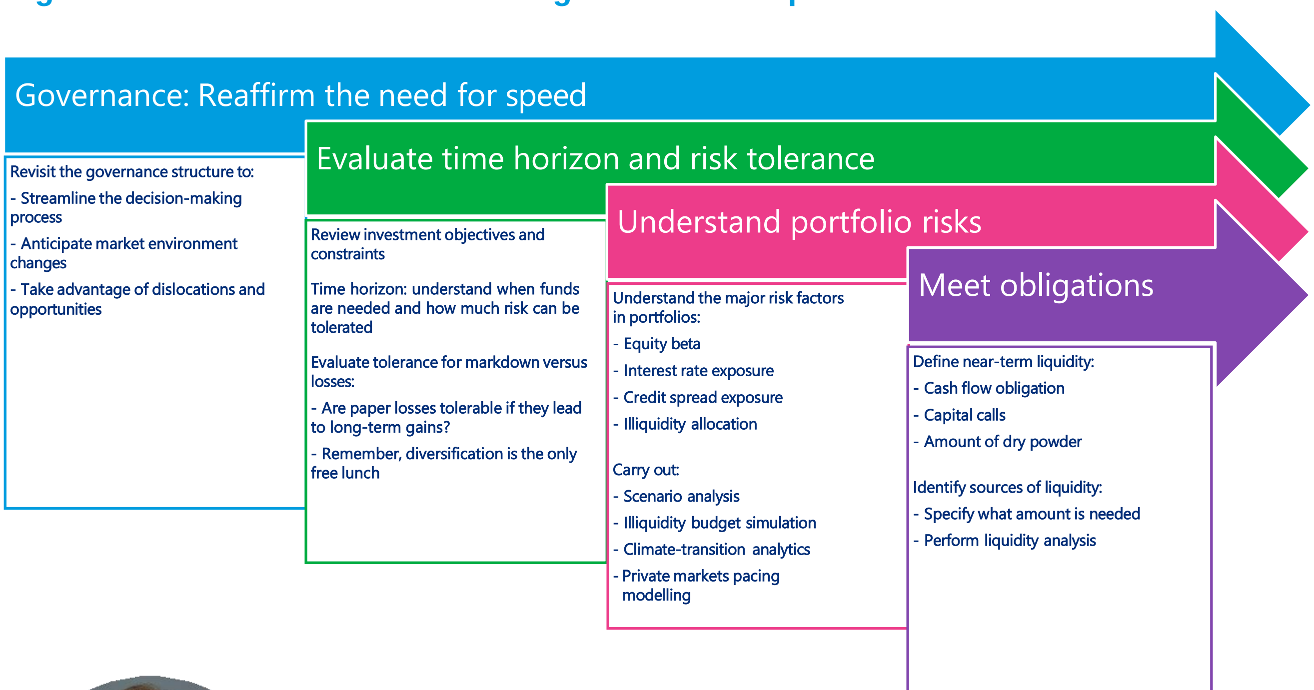
[12] Business development company (BDC) is an investment firm that typically invests in small and medium-sized companies to help them grow.
[13] Markets swayed by inflation and growth prospects (bis.org)
[14] Q4 2022 Quantitative Perspectives: When the Tide Goes Out (pitchbook.com)

since mid-2020; liquidity from public listings has completely dried up; a heightened awareness of counterparty risk has seen CDS[15] prices increasing; and there have been multi-billion dollar failures in the crypto industry.[16]

The effects of the end of free money and the withdrawal of liquidity are clearly being felt. Liquidity management has always been a key tenet of any governance process, but the radically different conditions over the last year have clearly tested investors. The regime shift is such that investors should expect and prepare for more shocks along the way.

Governance processes adopted by an organization need to be built around the circumstances of that organization and the way to prepare for potential risks depends on the investor's individual objectives and investment horizon. The specific tools available to address those stresses also vary as markets evolve. The following framework can help to plan ahead.

Figure 6. Governance and risk management roadmap



Ursula Niederberger, CEFA, CAIA
Senior Strategic Investment Research Specialist and Head of Operations

[15] Credit default swaps

[16] Full time for FTX - A perspective on the ongoing "Crypto Winter" – Mercer November 2022 https://insightcommunity.mercer.com/research/637eafed48a5d30021db16cb/Mercer_Full_time_for_FTX_A_perspective_on_the_ongoing_Crypto_Winter

7. Shifting perspectives on ESG

Events in 2021-22 had many implications for the way investors approach ESG and particularly climate risk, especially as management of climate risk came into conflict with efforts to manage other portfolio risks.

Inflation risk (see topic 1)	Assets such as commodity-related strategies and infrastructure, which are expected to provide inflation protection through a higher inflation regime, are often associated with higher emissions at this point in time.
Environmental risk	Mining is clearly associated with environmental risks and higher emissions, but the infrastructure and transport build out needed to deliver climate transition requires vast volumes of "green metals".
Social risks	Western sanctions on Russia in response to its invasion of Ukraine meant discussions of energy security trumped energy transition for many politicians. There were calls to invest in "friendly" oil and gas, sectors which had been underinvested in over the years.
Downside risk	The positive correlation between equities and bonds confirmed the need for alternative sources of defensiveness, such as gold, which outperformed both equities and bonds through the market downturn. Gold is associated with environmental issues and often considered like mining for emissions measurement purposes (even though emissions generated from securely holding gold in a vault are negligible compared to those from uses of other metals, and it is a highly recyclable asset).

Even in a world where climate-transition risk was the only risk to manage, the environment highlighted process issues for investors to be aware of.

- Investors looking at weighted average carbon intensity (WACI) portfolio statistics may have seen their WACI rise simply because the market weight of energy and materials increased at the expense of cleaner sectors like technology. In other words, the WACI rose because of the "WA", not the "CI".[17]
- A portfolio intended to have enhanced sustainability criteria, such as delivering low-carbon statistics, may have incorporated sector biases away from the strongest performing sectors of 2022, which would have impacted performance considerably in 2022.

All of these issues led to investors thinking about climate and ESG concerns in a more pragmatic manner than in the past. There is a broader recognition of the need to consider climate risk as well as other ESG factors within a total portfolio risk management framework rather than as an overlay. In doing so, we believe investors should consider the principles set out in Figure 7.

[17] This increase in emissions intensity was despite no overall increase in *absolute* scope 1 and 2 emissions. Instead, it was primarily due to changes in market value weights of different sectors – increases in energy and materials vs cleaner sectors such as technology. https://www.msci.com/www/blog-posts/are-emissions-rising-or-falling/03250417569#:~:text=Rising%20emission%20intensities%20without%20a,as%20the%20exhibit%20below%20shows.

Figure 7. Incorporating climate risk into a broader risk management framework

Approach climate risk at the total portfolio level …

Consider climate risk like other risks, for example downside risk. Consider the potential to offset exposure to higher emissions investments with increasing investment in transition-aligned assets.

… but prioritize real economy decarbonization over portfolio decarbonization

Decarbonization is ultimately affected company by company, industry by industry, not by portfolio adjustments. Engagement is critical in delivering this.

Employ long-term oriented, transition-aware strategies, particularly in higher emissions areas

For instance, truly transition-aware infrastructure and natural resource equity strategies balance energy and resource needs of today with those of the future.

Rather than adjusting for low portfolio emissions today, focus on lowering future company/asset emissions

Recognize the merits of strategies like green metal miners, which exhibit higher emissions today but which contribute to lowering of emissions tomorrow.

Consider implementing a transition pathway as a transition "highway"

Transition pathways act as a discipline for monitoring emissions progress. Implementing pathways as "highways" with slow and fast emission reduction lanes enables dynamism and **decarbonization at the right price**.

Monitor emissions progress as you would monitor active managers

Performance, both good and bad, must be understood: underperformance is not itself a reason to sell; only unexplained, severe or extended underperformance is a reason for action.

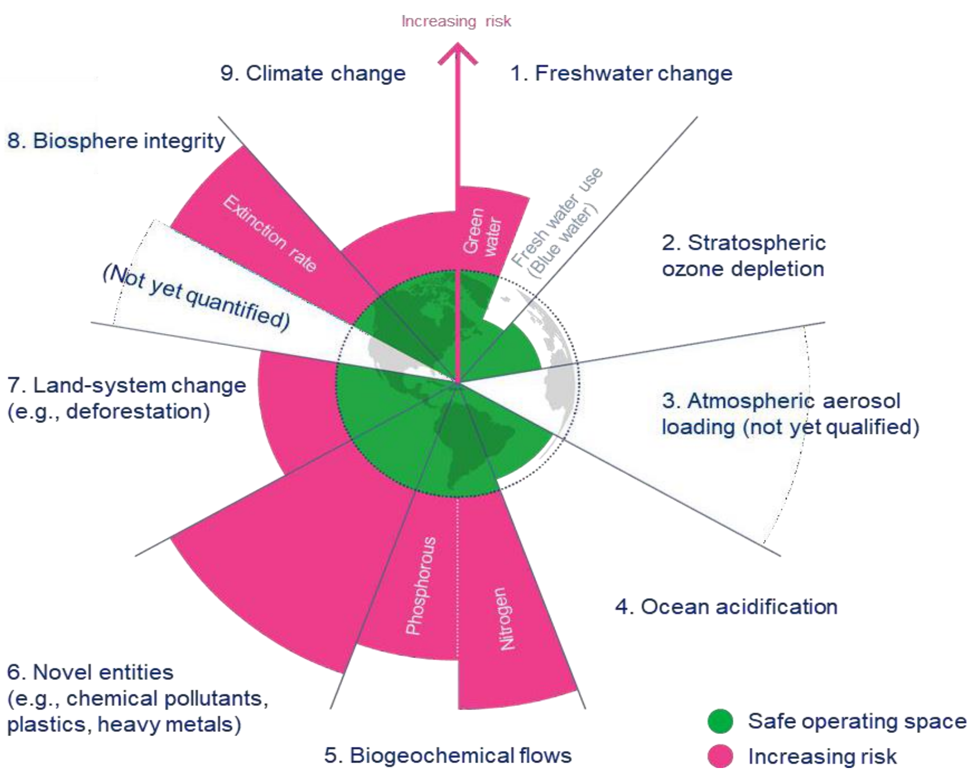
Nick White, FIA
Global Strategic Research Director

8. The next regime change: biodiversity and TNFD

Nature is likely to become one of the prominent ESG themes for investors and financial markets in the next few years. The natural world is the basis of our existence on this planet: nature underpins all life on Earth and we cannot exist without well-functioning natural ecosystems. However, since more than half of global GDP depends on nature[18] and human activity has already threatened one million species with extinction,[19] biodiversity loss poses significant systemic threats. In short, thinking solely about climate will not be enough.

The Stockholm Resilience Centre has highlighted the growing peril that nature faces by introducing the concept of planetary boundaries. These are quantifiable boundaries that can be used to measure and monitor the health of natural ecosystems. Going beyond these limits threatens life on earth; unfortunately, six of the nine boundaries already exceed their safe operating limits.

Figure 8. The planetary boundaries 2022



Source: The Stockholm Resilience Centre

Nature and biodiversity are intrinsically linked to climate change. Preserving the diversity of plant and animal life and the integrity of ecosystems is one of the most effective ways to remove carbon from the atmosphere and combat climate change. Conversely, increasing global temperatures will result in the extinction of species and reduction in biodiversity.

[18] Business for Nature Coalition, 2021, available at https://www.businessfornature.org

[19] IPBES. The Global Assessment Report on Biodiversity and Ecosystem Services, 2019, available at https://ipbes.net/sites/default/files/2020-02/ipbes_global_assessment_report_summary_for_policymakers_en.pdf

Regulation in this area is already starting to gather pace. The Kunming-Montreal Global Biodiversity Framework has just been signed as part of COP15. This agreement includes targets to protect at least 30% of the planet for nature by the end of the decade, reform at least $500bn annually of environmentally-damaging subsidies and restore at least 30% of the planet's degraded terrestrial, inland water, coastal and marine ecosystems. The agreed framework is expected to align financial flows with "nature positivity", which will likely lead to nature-based solutions becoming a larger investment opportunity set. A number of other industry initiatives are in place, a notable one being the framework on nature that is expected to be published by the Taskforce on Nature-related Financial Disclosures (TNFD) in September 2023. We believe that this framework will help the financial community to assess the impacts it has on nature. The TNFD's disclosure recommendations may also become a statutory requirement in some countries as certain governments (notably the UK[20]) have indicated they may enact legislation in this area.

Due to the intersections between nature and climate change, investors are starting to include nature positivity within climate objectives. We believe that, due to the various market developments that will happen over the next year, nature and biodiversity considerations may well become increasingly financially material to asset valuations. Preparing ahead of time could put investors in a position to take advantage of these market changes as they occur.

The opportunity set for investment strategies focused on natural capital and biodiversity is relatively new but growing rapidly. For institutional investors, the approach in public market allocations is likely to be focused on engagement with firms to limit the damage they do to biodiversity. Private market natural capital solutions often allow a purer focus (compared with public markets) on investing to support nature restoration and regeneration of biodiversity. Natural capital funds are often characterized by other attractive financial characteristics such as an element of inflation protection as well as diversification benefits when combined with equity and fixed income allocations.

While nature may be a nascent investing theme, it is expected to be a massive area for investors going forward, both for the impact on portfolios and the impact of portfolios on the planet. We urge investors to keep abreast of market developments and, where possible, to be proactive in integrating nature and biodiversity into their portfolios. If you would like to read more on this topic, please check out the white paper which my esteemed colleagues have written, available on MercerInsight Community.[21]

John Elmore-Jones, FIA
Senior Strategic Investment Research Specialist

[20] UK Government, "Update to Green Finance Strategy: call for evidence," (2022)

[21] Nature alert - the next major environmental, social and governance (ESG) theme. Available at https://insightcommunity.mercer.com/research/638e8bb28ea0e2002136c5bf/Mercer_Nature_alert_the_next_major_environmental_social_and_governance_ESG_theme_1

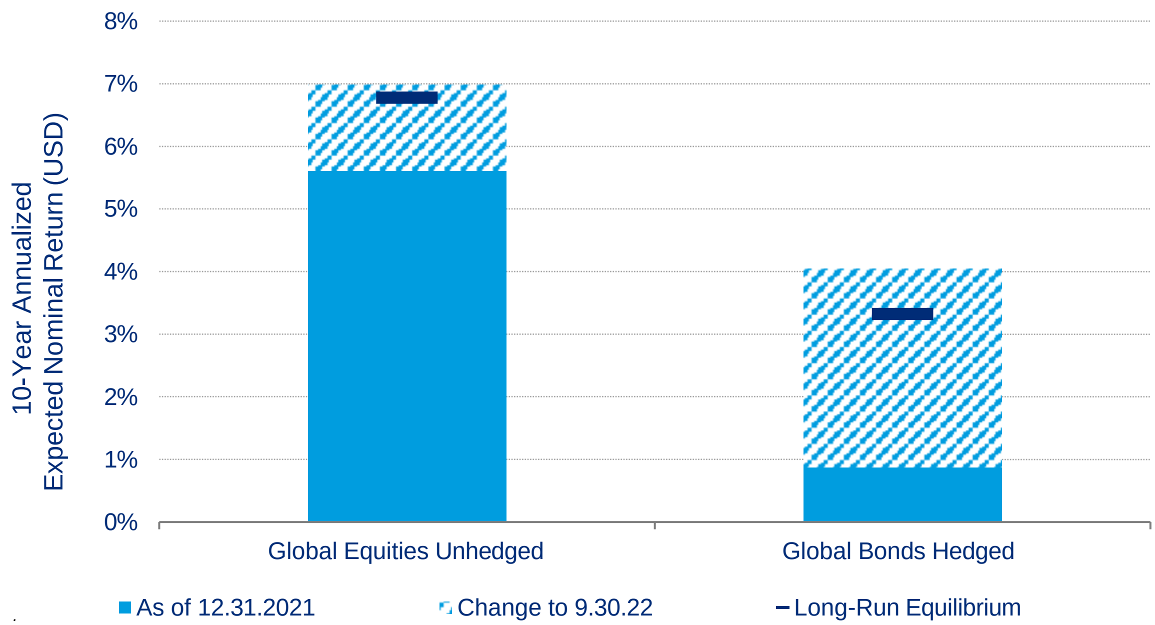
9. A subtle silver lining

The preceding sections have walked us through just some of the ways regime change is impacting the world we live in today. Many of those changes will challenge us in 2023 and beyond both as investors and global citizens.

The consequence of markets adjusting to these regime changes, principally inflation, has been a challenging 2022. In the face of persistent inflation, central banks have been forced to unwind the financial repression of the post-global financial crisis (GFC) and COVID era that had substantially boosted market valuation. The resulting reset of discount rates led to a sea of red in equities and bonds not witnessed in over a century, as we saw in Figure 1 in the introduction.

However, within that sea of red, we now see green shoots, not just in positioning for the new regimes, but also in more basic elements of investing such as interest rates. What had been offering miniscule returns to many investors since the advent of quantitative easing, has suddenly become attractive. Real rates in the United States, in particular, are now meaningfully positive. This has boosted not only sovereign bonds but all forms of fixed income, from global short-duration investment grade corporates at around 5% yield-to-worst to global high yield at 9%. Capital market assumptions (see Figure 9) for equity and other asset class returns have also increased, though not to the same extent.

Figure 9. Mercer's capital market assumptions



Source: Bloomberg, Refinitiv, Mercer calculations. Data as of September 30, 2022.

From a portfolio construction perspective, the reset in valuations has reopened some segments of investments that investors had passed over in recent years as being unattractive. The yields on offer in fixed income, especially in an environment fraught with uncertainty and regime changes as we have laid out previously, will appeal to many investors. As we have shown in our most recent global reference portfolios, future portfolios will be better able to utilize fixed income along with other diversifiers to build a robust portfolio for what we believe will be a period challenged by regime changes.

Nathan Struemph
Senior Strategic Investment Research Specialist

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Portfolio expectations are forward looking and reflective of Mercer's capital market assumptions, as defined by asset class and incorporating return, standard deviation, and correlations. Our process for setting asset class expected returns begins with developing an estimate of the long term normal level of economic growth and inflation. From these two key assumptions, we develop an estimate for corporate earnings growth and the natural level of interest rates. From these values, we can then determine the expected long term return of the core asset classes, equity and government bonds. We combine current valuations with our expectations for long term normal valuations and incorporate a reversion to normal valuations over a period of up to five years. Volatility and correlation assumptions are based more directly on historical experience except in cases in which the market environment has clearly changed. Manager impact on performance is not incorporated into expectations. The views expressed are provided for discussion purposes and do not provide any assurance or guarantee of future returns.

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December 2022