Mercer's equity guiding principles and what they mean for your portfolio

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No single portfolio represents the optimal solution for all equity investors. Each investor has a unique set of circumstances and beliefs that will generate similarly unique outcomes. However, at Mercer, we believe there are common considerations that all investors should take into account. We believe following a set of **guiding principles** can help investors design a robust portfolio structure that best meets their needs.

Following a principles-based framework enables investors to focus on decisions that can enhance risk-adjusted returns while allowing for varying levels of complexity, as well as different constraints and objectives. In this paper, we explore the rationale behind each of these principles, why we believe they are relevant for investors, and how they can be used to guide the investment decision-making process.

Principal 1: Invest broadly

The central reason investors allocate to listed equities is to reap the return from gaining exposure to the equity risk premium. Modern Portfolio Theory, as set out by Harry Markowitz in the 1950s, introduced the concept of systematic and unsystematic portfolio risks. Unsystematic risks, so the theory goes, can be diversified away by holding a broad portfolio of assets, leaving investors holding systematic, or market risk, while expecting to receive the equity risk premium in return. We believe these simple principles still hold true today.

However, although Modern Portfolio Theory would argue for owning the entire market portfolio, we believe this is both impractical and unsupported by empirical evidence.[1] As such, we believe investors should consider a number of practical considerations to help ensure portfolios are constructed with sufficient breadth (diversification):

- **Invest globally**: Design equity portfolios with exposure to a broad investment universe, while avoiding unnecessary concentration in single markets (which for many will be their home market). This does not imply that an investor should own all stocks listed on every exchange globally, but rather have broad exposures across a wide range of diversifying markets and sectors.
- **Seek exposure to underrepresented areas of the market**[2]**:** This means, at a minimum, an equity portfolio should have exposure to an opportunity set that encompasses global developed markets, global emerging markets (including China A-shares[3]) and small-cap equities.
- **Consider appropriate strategic weightings**: Though global market-cap-weighted indexes are a sensible starting point, they are dominated by large-cap developed markets, in particular the US market. Investors should assess the suitability of market-cap-weighted indexes when

[1] Fama EF, French KR. *"The Capital Asset Pricing Model"*. Journal of Economic Perspectives, Volume 18 Number 3 (2004), pp. 25–46.

[2] Relative to a standard reference benchmark (for example, MSCI World or Russell 1000)

[3] Mercer. "Investing in China," available at www.mercer.com/our-thinking/wealth/investing-in-china.html.

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determining the relative size of strategic allocations to different components of the equity market.

- **Consider allocating on a dynamic/opportunistic basis**: Investing broadly does not necessarily mean always owning everything at its strategic weighting. Instead, we encourage investors to consider including the flexibility to allow investing opportunistically or dynamically when market opportunities allow.
- **Rebalance**: Incorporating a structured rebalancing framework, implemented appropriately (with clear tolerances and triggers), can help maintain breadth, manage risk and provide an additional source of return.[4]

Principle 2: Invest sustainably

The ideas set out above, and the focus on ensuring diversification, help manage portfolio risks using traditional measures of risk and reward. However, it is equally important to consider risks and opportunities not captured in traditional risk frameworks, specifically climate transition[5] and environmental risks/opportunities, stewardship and governance factors, and the social considerations of investing. This view is reflected through one of Mercer's five core investment beliefs, specifically that investing sustainably is more likely to create and preserve long-term investment capital.[6]

Of particular note, Mercer believes **climate transition** is a key risk that investors should be managing in their portfolios regardless of their objectives. To this end, we believe investors should consider having a plan to help ensure their overall equity portfolio is positioned for climate transition. Equity strategies positioned for climate transition should satisfy one (or more) of the following criteria:

- Target sustainability themes[7]
- Have a high degree of environmental, social and governance (ESG) integration (that is, a Mercer ESG1 rating[8])
- Are stewarding a decarbonization pathway[7]

This does not mean all strategies need to meet this objective but, investors should aim to ensure that longer-duration strategies are actively positioned for climate transition. This includes all low-turnover approaches, such as most active, quality-focused equity strategies and passive exposure.

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[4] Mercer. 'Rebalancing in troubled markets,' available at www.mercer.com/our-thinking/wealth/rebalancing-in-troubled-markets.html.

[5] Mercer. 'From gray to green: Your path to portfolio transition,' available at www.mercer.com/our-thinking/wealth/investing-in-a-time-of-transition.html.

[6] Mercer. *Mercer investment beliefs*, 2018, available at www.mercer.com/our-thinking/wealth/mercer-investments-beliefs.html.

[7] Mercer. *Managing climate transition risk in equity portfolios*, 2021, available at https://insightcommunity.mercer.com/research/619ae4d35bad5c0020a5dfa4/Mercer_Mercer_s_approach_to_managing_Climate_Transition_risk_in_equity_portfolios

[8] Mercer. 'Mercer ESG ratings,' available at www.mercer.com/our-thinking/mercer-esg-ratings.html.

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Specifically, in the case of passive-index-tracking exposures, we suggest investors consider tracking a climate-transition benchmark.[9]

We believe investors that invest sustainably, by positioning for opportunities and/or by managing the risks outlined above, put themselves in a strong position to build more robust equity portfolios that generate superior outcomes.[10]

Principle 3: Invest actively where appropriate

The role of active management in equity portfolios elicits views that are often highly polarized and emotive. While it has the potential to add value to some degree in most areas of the market, it may not always be the most appropriate option. Consequently, in many equity markets, investors considering active management need to be confident they can capture its benefits. We advise investors to consider the following points when assessing the potential benefits/costs of active management.

- We believe investors should meet the "conditions for success" to maximize the chances of being rewarded for active management. This requires (1) a governance process that is fit to oversee manager appointments and terminations, (2) a clear strategy and process for identifying best in class active asset managers, and (3) a time horizon and ability to tolerate underperformance that reflects the historical outcomes of the asset class.
- The return to active management is not equal across markets or at all points in time. Different markets exhibit varying levels of potential for alpha generation, and we encourage investors to prioritize active management in areas most likely to add value. We also encourage investors to consider specialist active managers in markets that have been shown to reward specialist knowledge, such as emerging markets, onshore China (A-shares) and small-cap equities.
- The role of management fees and other costs is a key determinant of the return an investor receives. Considering the appropriate fee to pay for active management should inform the decision on whether to invest actively or passively. Mercer has developed a framework that considers three key questions when determining what a suitable fee for active management may be in each market segment:
  - What is a realistic expected return from active management?
  - What is a fair share of the expected excess returns?
  - What are the costs of a passive alternative?

  For more information on this framework, see Mercer's publication: *Investment Manager Fees: Expanding the Framework*.[11]

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[9] We also suggest investors with a material allocation to systematic (quantitative) strategies consider approaches that are either actively positioned for climate transition or that use a climate-transition benchmark.

[10] Mercer. "The ABC of ESG," available at www.mercer.com/our-thinking/wealth/the-abc-of-esg.html.

[11] Mercer. *Investment manager fees: Expanding the framework*, 2018, available at www.mercer.com/content/dam/mercer/attachments/private/nurture-cycle/gl-2018-wealth-investment-manager-fees-expanding-the-framework-mercer.pdf.

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- Investors have a number of different ways to gain exposure to equity markets (passively managed indexes, targeted systematic approaches or traditional active strategies). In our view, the most appropriate solution should reflect each investor's own beliefs, objectives and constraints. However, we also believe certain return drivers are best accessed using forward-looking, judgmental approaches rather than systematic strategies (either active or passive). For example, while quality may be captured through a style-based index, or as a component of a systematic multi-factor process, we believe the benefits are most likely to be reaped in a low-turnover active approach where judgement can be used to assess the sustainability of a company's underlying business model.[12]

Principle 4: Invest in diversifying return drivers

Mercer believes it is possible to deliver better risk-adjusted returns than a broad market-cap-weighted index. In our view, this is best achieved by investing in strategies with underlying return drivers that have academic and empirical support and are diversifying when combined in a portfolio setting.

Allocate to active quality

Where possible, we believe equity portfolios should be constructed around a meaningful allocation to actively managed, quality-focused equity strategies (active quality).[13]

From a Mercer standpoint we define "*quality*" strategies as having:

- Persistent exposure to companies that display higher than average profitability (e.g. ROE, ROA or ROIC)

In addition **"active quality"** refers to **actively managed** equity strategies that:

- Employ a long-term investment horizon
- Have sustainability embedded in their investment approach
- Are positioned for climate transition

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[12] Mercer. *Building portfolios on the solid foundation of active quality*, 2021, available at https://insightcommunity.mercer.com/research/619ae6375bad5c0020a5dfa5/Mercer_Building_equity_portfolios_on_the_solid_foundation_of_active_quality

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While quality as a return driver has academic and empirical support[13], there are a number of additional reasons we believe active quality belongs at the heart of an equity portfolio:

- Our analysis suggests active quality strategies exhibit a less episodic performance pattern than strategies with exposure to other return drivers. Combined with the low correlation with other return drivers, this suggests a meaningful allocation to active quality strategies should also help ensure a smoother return profile at the overall equity portfolio level.[14]
- Sustainability and the importance of a long-term time horizon have been cornerstones of Mercer's investment beliefs for many years,[15] and both feature prominently in most active quality strategies. Consequently, we believe a meaningful allocation to actively managed, quality-focused strategies that embed these principles (both sustainability and a long-term investment horizon) increases the probability that an investor's overall equity portfolio delivers market-beating risk-adjusted performance – over both a market cycle and the long term.

Include exposure to other diversifying return drivers

In our view, additional, diversifying return drivers should also be captured in an investor's equity portfolio, notably **value**[16] **and momentum**. Although they can be expected to have a 'lumpier' and more episodic return pattern than quality, value and momentum are expected to add value over the long term. Both have long-standing economic, academic and empirical support[17] and, importantly, provide diversifying exposure to active quality.

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[13] Bouchaud JP, Ciliberti S, Landier A, et al. "The excess returns of 'quality' stocks: A behavioral anomaly". *Journal of Investment Strategies*, DOI:10.21314/JOIS.2016.078 (2016). Fama E F, French KR. "A five-factor asset pricing model,". *Journal of Financial Economics*, Volume 116 Issue 1 (2015), pp. 1–22.

[14] This is because active quality strategies provide exposure to well-managed businesses that provide investors with a more stable, predictable return stream through the cycle. Please see: *Building portfolios on the solid foundation of active quality*, 2021, available at https://insightcommunity.mercer.com/research/619ae6375bad5c0020a5dfa5/Mercer_Building_equity_portfolios_on_the_solid_foundation_of_active_quality

[15] Mercer. *Mercer investment beliefs*, 2018, available at www.mercer.com/our-thinking/wealth/mercer-investments-beliefs.html.

[16] Mercer. "Is there still a case for value?" available at www.mercer.com/our-thinking/wealth/is-there-still-a-case-for-value.html.

[17] **Value**: Fama EF, French KR. "Common risk factors in the returns on stocks and bonds," *Journal of Financial Economics*, Volume 33 Issue 1 (1993), pp. 3–56.

Momentum:

Levy R, "Relative Strength as a Criterion for Investment Selection "*The Journal of Finance* Volume 22 Issue 4 (1967), pp. 595-610

Grinblatt M and Titman S "Mutual fund performance: an analysis of quarterly portfolio holdings," *Journal of Business* Volume 62 Issue 3 (1989), pp. 393-416.

Jegadeesh N and Titman S, "Returns to buying winners and selling losers: implications for stock market efficiency," *The Journal of Finance,* Volume 48 Issue 1 (1993), pp. 65-91

Chan, K. C., Jegadeesh, N. and Lakonishok, J., 1996, "Momentum Strategies," *The Journal of Finance*, Volume 51 Issue 5 (1996), pp. 1681-1713.

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Consider incorporating specialist exposures

Equity investors should also consider the role of diversification over the long term. A focus on short-term correlations between strategies may mask divergence that results from underlying, longer-term economic and structural drivers. These may be broad-based (such as sustainable investment opportunities and technology) or narrower, more niche themes (such as healthcare and water). Such focus can provide exposure to structural growth drivers not necessarily captured in a portfolio oriented toward quality, value and momentum. As a result, they can also play an important role in improving the risk–return profile of an investor's overall equity portfolio.

For investors who have a desire to explicitly manage the volatility of their equity portfolio, an allocation to **low volatility** offers appealing diversification benefits and also helps to reduce the absolute level of risk (standard deviation) at the overall portfolio level.

Investors should be mindful that some specialist investment approaches may produce a less reliable return stream, and we caution against them dominating an overall equity portfolio. However, investors should also recognize that specialist equity exposures may also be held for the role they play at the total portfolio level, where alternatives might not be available for all investors. Examples include listed infrastructure, Real Estate Investment Trusts (REITs) and gold equities.

A note on portfolio construction

Using a principles-based framework to build robust equity portfolios can result in many different structures depending on an investor's objectives and constraints. Although there is no one-size fits all solution, we believe all investors should consider the following when constructing portfolios:

- No one active manager should dominate total portfolio risk
- While there may be intended and persistent style biases (for example, value, momentum, quality), no one style exposure should dominate active risk. However, in the structure outlined here, we might expect quality/profitability metrics (for example, ROA, ROE) to be more prominent.
- Unintended active risks that are not rewarded (for example, geographic, sector, currency) should be minimized.
- Known macro risks should be managed at the portfolio level (for example, climate transition or inflation).

Investors can look to assess total portfolio exposures in a number of ways (for example, holdings-based style analysis, risk decomposition, regression analysis and money-weighted exposure). We caution against using the output from any one of these tools, or focusing on any one metric, in isolation to draw firm conclusions. Rather, we advise using a holistic and multifaceted approach to assess – and manage – total portfolio-level exposures and risk.

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Conclusion

Mercer's equity guiding principles framework is designed to provide investors with a backdrop for considering investment decisions at the overall portfolio level. It is not necessarily applicable to assessing individual segments of the equity market in isolation.[18]

The framework is a flexible structure, designed to help investors focus on the critical decisions that need to be made in order to enhance risk-adjusted returns while accommodating varying levels of complexity, constraints and objectives.

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[18] For example, niche areas of the market might not have viable passive solutions. In addition, it may not be possible to construct a portfolio with exposure to specific return drivers in areas of the market that have a narrow opportunity set.

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