

Themes and opportunities 2023

Déjà new

From hindsight to foresight

Introduction

From hindsight to foresight

The last 12 months have seen significant upheaval in global markets, with a number of notable events having a profound impact on the world as we know it. Pandemic restrictions are now in the past as most of the world has decided to “live with Omicron,” but we still feel their fallout in the elevated debt burden and fragility of the “just in time” production model. At the same time, regional conflict has further exacerbated supply chain stresses and led to higher food and energy prices.

Elements of these experiences echo those of the 1970s — another period that started with the aftermath of a severe virus (influenza strain H3N2, “Hong Kong flu”) and conflict-induced shocks in the energy complex (Nixon’s support of Israel in the Yom Kippur War causing a swift and lasting retaliation from OPEC). Some parallels are concrete, whereas others are uncanny. Both pandemics led to the hospitalization of premiers called Johnson, and the series of Apollo missions at the time has now been replaced by a series of missions back to the moon named after Apollo’s sister Artemis.

Investors then, as now, faced the challenge of investing during a period of inflation, cold war and decoupling, which leaves us with a sense of *déjà vu*. Yet we are not in precisely the same place. The current challenge in prices is twinned with a wider sustainability crisis (accelerating physical damages from climate change and biodiversity on the brink). But we are in a better place to find solutions to the crisis, with many renewable technologies having gained the critical mass they did not have in the 1970s. Although the respective decades are not in identical situations, distinct parallels can be drawn. Combined with the increased potential for change, these parallels can best be encapsulated by the concept of *Déjà New*.

By constructing a series of themes that reflect the lessons from the past, combined with much needed foresight, we believe investors stand the best chance of long-term success. In the following pages, we explore these themes and how they can help shape investor decision-making in 2023 and beyond. All is not lost; today’s investors arguably have greater degrees of freedom to play with than did their 1970s counterparts.

Our three themes

“History doesn’t repeat itself, but it often rhymes.” – Mark Twain

The world is currently in flux across various fronts. A global economic slowdown amid monetary tightening precipitated a bear market, which was then exacerbated by a “summer of disasters,”¹ conflict, and polarization within and between countries. Governments around the world

are facing sizeable challenges in managing the levels of debt built up over the past decade and especially the past two years. Inflation has continued to balloon above central bank targets, causing sharp rises in interest rates. At the same time, the conflict between Russia and Ukraine compounded the already complex and geopolitically sensitive challenges of supply chains and led to steep spikes in energy prices, particularly in Europe.

We have translated these experiences and developments into three investment themes for investors for 2023 and beyond, combining lessons from the 1970s with foresight fit for our new situation:

¹ Megadrought in California, the appearance of “hunger stones” in Europe and extreme flooding in Pakistan were the worst in a series of disasters.

² Reporting bureaucracy and underinvestment in oil and gas have been the two main challenges to orthodoxy. In July, a group of 80 CFOs and 16 leading sustainability investors signed a constructive letter in response to proposed IFRS sustainability standards. Among other requests were to “recognize that reporting is a means to an end, not an end in itself.” See <https://www.accountingforsustainability.org/response-ifs-sustainability-disclosure-standards.html>.

1. History rhyme

The inflation playbook

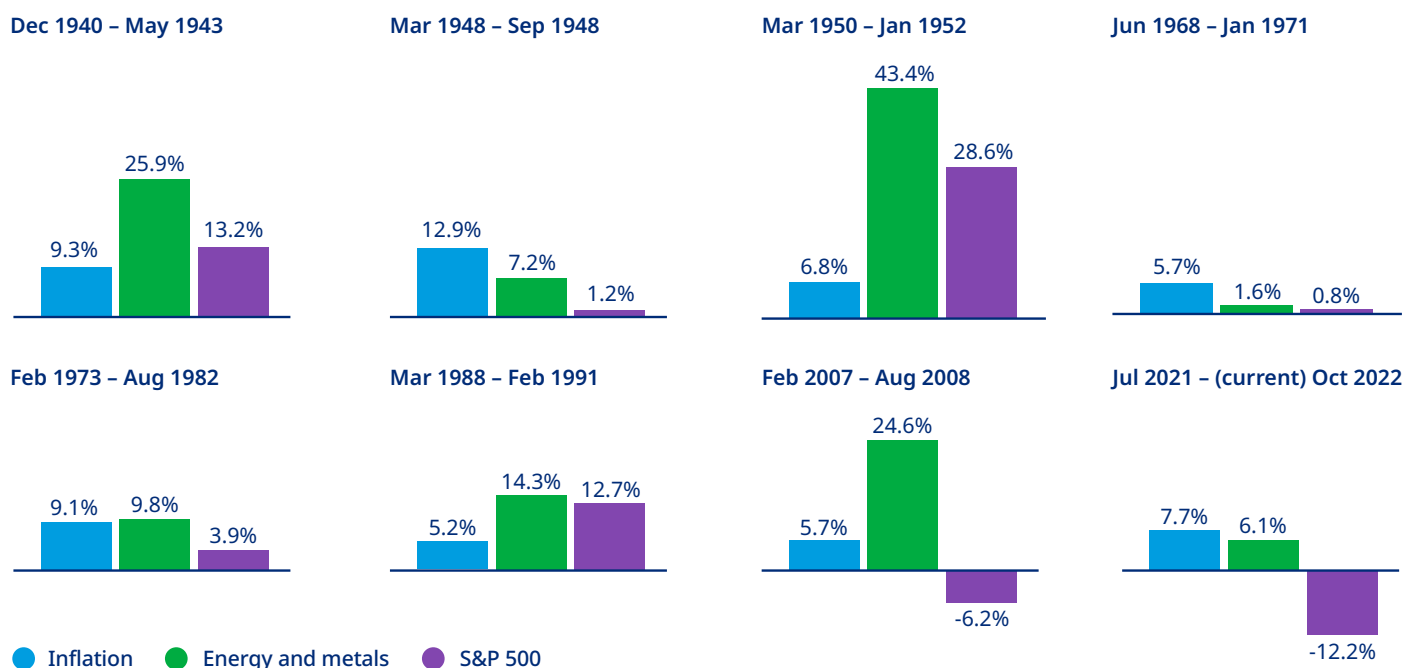
Inflation has been one of the driving themes and concerns for investors over the past 12 months. Even if many believe inflation is beginning to slow, it is unclear how long it will take to return to a level that resembles central bank targets. A number of factors suggest that the challenges of the current inflation bout are far from over and that inflation risk has increased in the long term:

- Globalization is likely slowing and moving toward factionalization.
- Policymakers may be tempted to keep interest rates lower than inflation to reduce the debt burden over time, at the risk of runaway inflation.
- Significant challenges exist with respect to energy infrastructure, security and electrification, particularly in Europe.
- Price increases as a result of higher wages (the so-called wage-price spiral) could continue, although union power has declined significantly since the 1970s.

- Trends in the pricing of consumer electronics and improvements in storage and processing power appear to have been flattening out, although AI and quantum computing could eventually pull prices down. (The “tech deflator” has been a long-term anchor for inflation.)

All of this points to the need to structure portfolios for inflation regime management, not just business cycle management, and it is here that elements of the lessons of the 1970s and other periods can be employed. The shift from building in “shock protection” (in response to short-term price movements) to assets targeting longer-term inflation-sensitive revenues may be a sensible rule of thumb for investors to consider. Natural resource stocks provide such revenues, and — despite the performance of underlying commodities — are still arguably underloved given underserved global energy and materials demand. Engaging with these firms to mitigate negative externalities is crucial, as is ensuring that appropriate supply levels are maintained to ensure a smooth and just transition.

Figure 1. Natural resource equity returns through periods of high US inflation



Source: GMO and Mercer; periods where US inflation was over 5% for longer than a year. “Inflation” and “energy and metals” are industry classifications, constructed by GMO. Data for energy and metals in the most recent period is from the MSCI ACWI Commodity Producers Index. All returns in USD.

In the 1970s, the issuance of inflation-linked bonds was mainly limited to emerging-markets, whereas the UK started issuing index-linked gilts in the 1980s, and the US Treasury started issuing Treasury Inflation Protected Securities (TIPS) in 1997. With real yields now positive in some major territories despite higher inflation and yield curves priced for inflation to fall back again, inflation-linked bonds may offer better protection than nominal bonds against persistent inflation.



‘What if?’ should be on all investors’ minds. In a world where potential outcomes are so dispersed, building a strategy around the central case could be particularly dangerous. Investors should prepare for the scenario where, even after inflation has come off its peak, it remains elevated for some time.

Nick White, Global Strategic Research Director



Key takeaways:

- Although market expectations are for inflation pressures to subside, various factors indicate that further inflation shocks are a threat for the foreseeable future.
- Natural resource equities could play a useful role as part of a broader inflation-regime-management positioning.
- The return of positive real yields increases the inflation-protection merits of inflation-linked bonds.



The end of “free money”

A general consensus is that the era of “free money” and ultra-loose central bank policy is at an end. The US Federal Reserve has acted on its plans to raise interest rates to reduce unacceptably high levels of inflation; indeed, the minutes from its September 2022 meeting emphasize that *“the cost of taking too little action to bring down inflation is likely to outweigh the cost of taking too much action.”*³ Similarly, firm policy approaches have been taken by other major central banks (the exceptions being China and Japan).

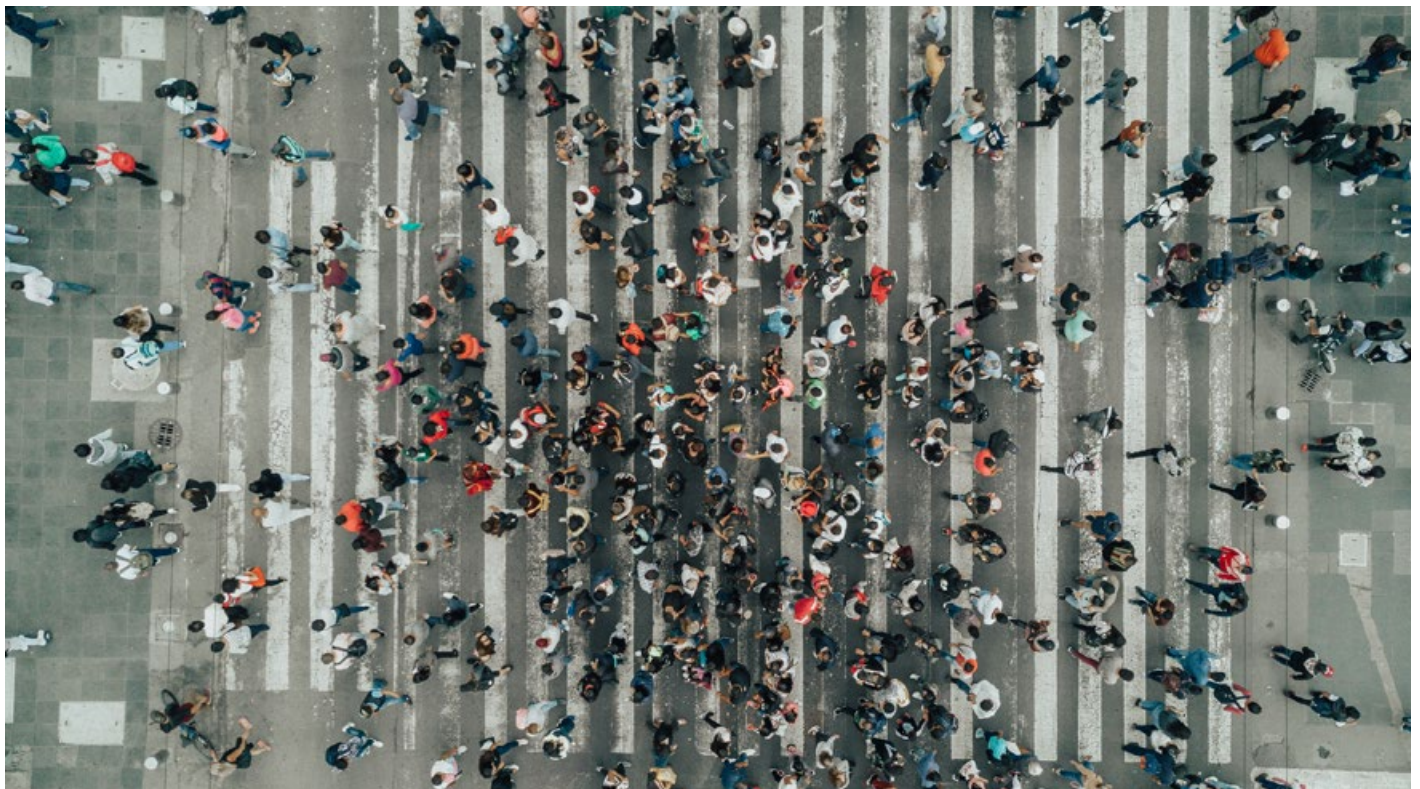
Despite this, even the rate rise in late 2022 leaves rates far below the Taylor Rule — a rule of thumb proposed by Stanford economist John Taylor in 1993 as to where we can expect central bank rates to be given current inflation and unemployment levels.⁴ Therefore, more tightening has been priced in across a number of asset classes, with real yields now higher in many cases than nominal yields were a year ago and high-yield debt assets now living up to their name.

With higher rates and cheaper equity and bond valuations, investors might be tempted to think there is a stronger

case for the traditional 60/40 portfolio; however, reliance on such a strategy is risky, particularly because equities and bonds may be positively correlated during an inflationary environment. Much uncertainty remains, and an important concern now should be the potential for monetary and fiscal policies that grate against each other. On one side, central banks are seeking to rein in inflation, whereas on the other side, governments are fueling inflation through fiscal expansion, seeking to mitigate real wage crunches, securing electoral support and/or seeking to fund transition-oriented infrastructure build-outs.

Key takeaways:

- We have reached the end of “free money.”
- Investors should be cautious about returning to traditional 60/40 portfolio construction just because assets are cheaper.
- There are notable risks that monetary and fiscal policies could clash, creating further challenges and uncertainty.



³ Burns D and Saphir A. “Fed Officials Worried More About Doing Too Little on Inflation Than Too Much,” Reuters, October 12, 2022, available at <https://www.reuters.com/markets/us/fed-officials-worried-about-ending-inflation-battle-prematurely-minutes-show-2022-10-12/>. See also <https://www.federalreserve.gov/monetarypolicy/fomcminutes20220921.htm>.

⁴ Bernanke BS. “The Taylor Rule: A Benchmark for Monetary Policy?” Brookings, April 28, 2015, available at <https://www.brookings.edu/blog/ben-bernanke/2015/04/28/the-taylor-rule-a-benchmark-for-monetary-policy/>.

Balance of power

The parallels with history — specifically the 1970s — can also be applied to current geopolitical and social dynamics. In 1973, US President Richard Nixon proposed providing military aid to Israel during the Yom Kippur War. The result was an Arab oil embargo that forced the Western world to economize for the subsequent decade. Admittedly, several positive developments came on the back of this, with the birth of many renewable technologies, energy-demand-reduction technologies and supporting policies to address the challenges posed by the embargo. Today, there are similarities to that dynamic, with the Russia-Ukraine conflict impacting supply chains and forcing Western countries to consider much-needed evolutions to energy provision and infrastructure.

Alongside this, we appear to be seeing a move away from globalization toward factionalization, with the current Russia-Ukraine conflict and reactions to it drawing dividing lines between nations and regions. This raises the question of whether we will see future conflicts, with a potential Taiwan conflict already a major concern, while score-settling may spread to other regions as hegemony is preoccupied and overstretched. More broadly, factionalization has implications for the powerful deflationary force that unconstrained globalization has had since the start of the century.

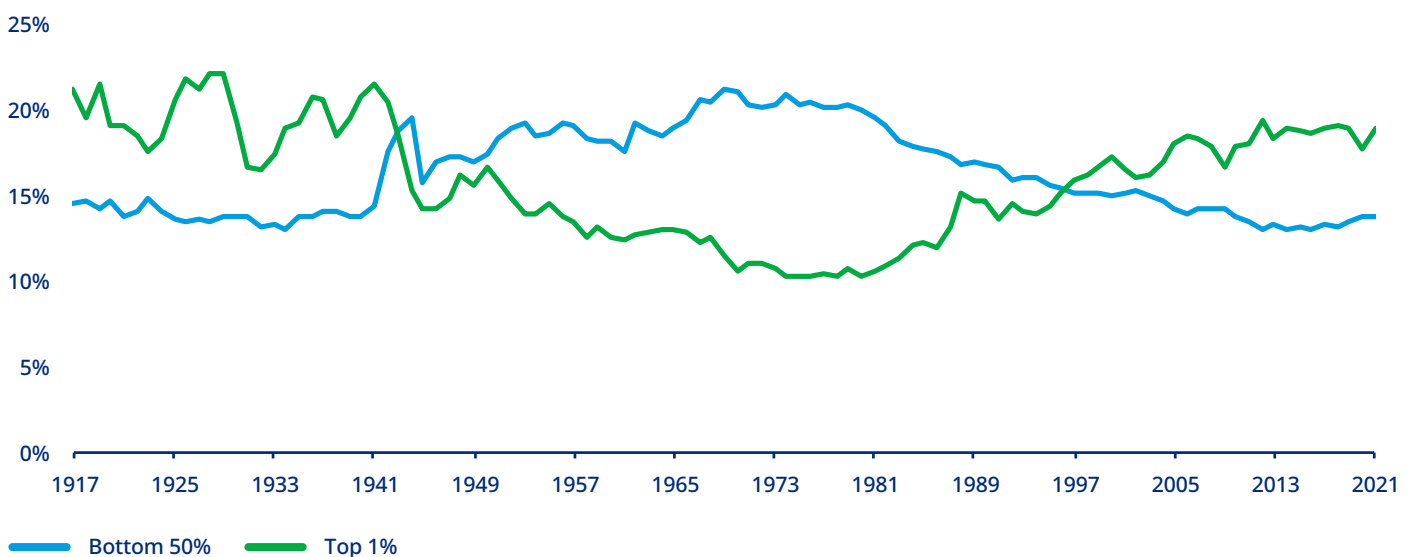
Other threats to the balance of power as we know it are the trends of dissatisfaction and inequality that we're seeing within society. Inequality is now at pre-World War II levels, with 14% of income flowing to the bottom 50% of society, while 19% goes to the top 1% (see Figure 2).

Global unhappiness (measured by Gallup's Negative Experience Index) has also been on the rise. These levels of dissatisfaction are potentially related to polarization over economic and cultural issues. At best, this polarization can increase the risk of unconstructive politics or novice governments and, at worst, increase the risk of internal and/or external conflict. With little immediate prospect of these trends being reversed, investors should be prepared for more volatility, driven by political and geopolitical events and more uncertainty in general.

Key takeaways:

- There are clear parallels between the geopolitical tensions and resulting challenges of today and those of the 1970s.
- We appear to be entering an era in which globalization devolves into factionalization, with higher risk of conflict, further fueled by increasing social inequality and dissatisfaction.
- In this volatile environment, investors can benefit from scenario analysis and stress testing, extending to event-specific "fire drills."

Figure 2. Income inequality in the US



Source: World Inequality Database, Mercer. Data as of December 31, 2021.

2. Position for transition

In December 2021, the International Energy Forum (IEF) and IHS Markit published their *Oil and Gas Investment Outlook*, subtitled “Investment Crisis Threatens Energy Security.”⁵ This reported that investment in oil and gas was falling and was now insufficient to meet demand; the consequences, they warned, were price volatility and “adverse economic effects.” In July, Accounting for Sustainability (A4S) sent a letter to the International Sustainability Standards Board (ISSB) asking for various pragmatic changes to the IFRS Sustainability Disclosure Standards.⁶ This contained two statements, signed respectively by 80 CFOs and 16 leading sustainability-oriented investors, including the principle that we should “recognize that reporting is a means to an end, not an end in itself.”

In May, Stuart Kirk’s speech at the FT Live Moral Money Summit Europe conference acted as a lightning rod for

various criticisms of sustainability culture.⁷ The speech, although questionable in tone, in parts, highlighted some real challenges: the unintended consequences of the sustainability-reporting bureaucracy (index proliferation, lack of reporting standardization, box-ticking culture) and a focus on mitigation of climate risks at the expense of adaptation. In its omissions, it did, however, demonstrate an unwarranted complacency. The first half of 2022 already saw natural-disaster-related costs of US\$65bn⁸ (dominated by extreme weather events); at the same time, the world’s sixth mass extinction of species continues apace and is irreversible (once a species is gone, it’s gone).

We suggest investors stick to their principles on sustainability but ensure that efforts to “clean” portfolios are aligned with the need to “green the planet.” Engagement by asset owners and asset managers with companies will be key.



⁵ IEF-IHS Markit. *Investment Crisis Threatens Energy Security*, 2021, available at <https://www.ief.org/investment-report-2021>.

⁶ [Business and finance community respond to the proposed IFRS Sustainability Disclosure Standards \(accountingforsustainability.org\)](https://www.accountingforsustainability.org)

⁷ Stuart Kirk is the former Global Head of Research and Insights and Responsible Investing at HSBC Asset Management

⁸ Natural disaster review for first half of 2022 | Munich Re

Resource code

Continuing concern over climate change and the long-term future of the planet has become a major factor for investors and society. In May 2022, the World Meteorological Organization estimated a 50:50 chance of the annual average global temperature reaching 1.5°C above the preindustrial level for at least one of the next five years and a 93% likelihood of at least one year between 2022 and 2026 becoming the warmest on record.⁹ The UN Environment Programme (UNEP) report published in October 2022 provides a dramatic warning that we are on course to miss the 2030 1.5°C climate target and will do so unless there is an “urgent system-wide transformation.”¹⁰

Again, parallels can be drawn with the 1970s, which saw policies, technologies and opportunities to source new energy supplies and reduce demand. This was the era when Japanese car manufacturers penetrated the US car market with more fuel-efficient models than their American counterparts. Today, we appear to be in a far better place to embrace these new developments, with a sizeable toolkit at our disposal in comparison to the more limited capabilities of 50 years ago. Scalable renewable technologies represent around 12% of global power generation¹¹ and have gained enough traction that their

use can be further expanded in combination with storage capacity. UNEP has forecast that to keep below the 1.5°C by 2030 target, zero-carbon energy sources will have to reach a share of power generation of between 65% and 92%.¹²

But there is much to do. Electrification, the process of diversifying the energy mix and becoming less reliant on fossil fuels requires a tremendous amount of investment in metals. Rising price trends within commodities — which, according to the International Energy Agency (IEA), saw lithium and cobalt doubling in price and copper, nickel, and aluminum rising 25%–40% in 2021 — have continued and threaten to impact the cost and therefore adoption of clean energy technology.¹³ In some areas, a tangled commodity complex creates potential challenges for food production (owing to the reliance on natural gas for the production of fertilizers). At the same time, investment in conventional energy is equally needed to maintain current supplies and allow countries to shift their supply chains away from unreliable providers. Investors need to steer between the risks of oil and gas supply expansion creating larger stranded assets and the very real risk of phenomena such as a gas-to-coal substitution if gas prices remain elevated. Engagement with oil and gas majors is also vital to increase investment in the hydrogen economy and bio-refineries.¹⁴



⁹ World Meteorological Organization – WMO update: 50:50 chance of global temperature temporarily reaching 1.5°C threshold in next five years <https://public.wmo.int/en/media/press-release/wmo-update-5050-chance-of-global-temperature-temporarily-reaching-15c-threshold> (9 May 2022)

¹⁰ Emissions Gap Report 2022 (unep.org)

¹¹ Source, IEA and Mercer calculation, using 2020 data, excluding hydropower due to lesser scalability.

¹² <https://www.unep.org/resources/emissions-gap-report-2022> Emissions Gap Report 2022 (unep.org)

¹³ Tae-Yoon Kim – *Critical minerals threaten a decades-long trend of cost declines for clean energy technologies* <https://www.iea.org/commentaries/critical-minerals-threaten-a-decades-long-trend-of-cost-declines-for-clean-energy-technologies> (18 May 2022)

¹⁴ https://iea.blob.core.windows.net/assets/4315f4ed-5cb2-4264-b0ee-2054fd34c118/The_Oil_and_Gas_Industry_in_Energy_Transitions.pdf *The Oil and Gas Industry in Energy Transitions*. IEA 2020.

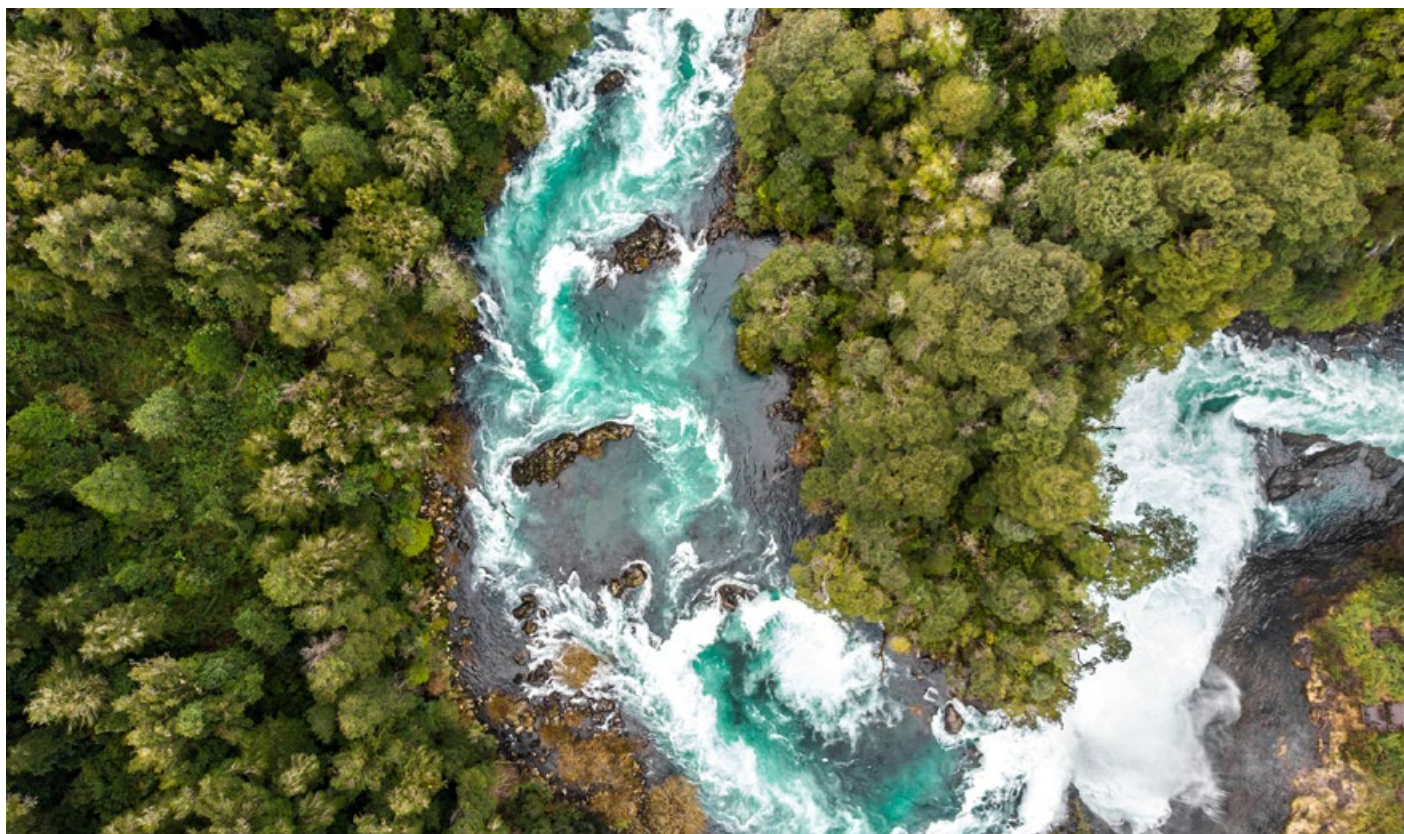
Critical to the transition are metal-mining stocks, a sector that clearly has its own environmental issues. Investor engagement is crucial here to secure attractive returns and to ensure the necessary progress for the benefit of society. Mines should convert their operations to run on renewables, and proper tailings-ponds management and reclamation should be encouraged, as should equitable sharing of rewards with personnel and local communities. We need to rethink the acceptability of our major technology firms relying on mineral sources that are out of sight and out of mind. We also need to end the doublethink in which battery technology development is considered sustainable but battery contents are considered unsustainable.

“Resource Code” is a theme we introduced into our 2022 Themes and Opportunities. While we did not foresee the catalyst (the conflict in Ukraine), we did perceive material threats to, and an imbalance in, the overall resource complex. Holistically, we see this as including both natural resources, such as energy and minerals, and natural capital, such as biodiversity, soil and air. Biodiversity is a key underappreciated resource that we consider in our Age of Engagement section below. We perceive and welcome an emerging universe of funds that take a broader

perspective of resources that span the whole spectrum, and we also welcome the development of specialist funds; for instance, the metals/renewables thematic.

Key takeaways:

- The world is in a much better place today to address some of the key challenges we face, with a much wider range of tools than was the case during similar experiences in the 1970s. For instance, energy transition funds are available that should benefit from regulatory tailwinds and shifts in demand, and there are opportunities in environmental funds.
- Often overlooked by investors, mining stocks are crucial to the transition and offer an element of inflation protection, in particular, for greenflation.
- Engagement approaches taken by investors are necessary for future developments in this space.

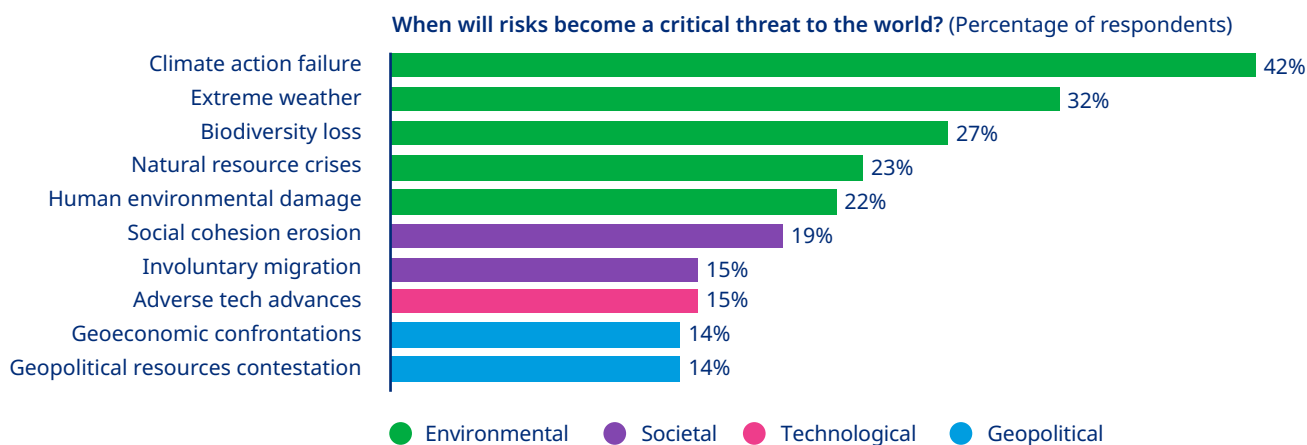


The age of engagement

In our *Metamorphosis* paper,¹⁵ we noted that engagement levels had returned with renewed vigor. This appears to have continued apace through 2022 — studies show the number of proposals that went to a vote at Russell 3000 companies increased by 25% (indicating both an increase in the number of proposals filed and the number of no action requests granted by the SEC).¹⁶

Engagement has become increasingly common parlance in the ESG lexicon, with investors recognizing the power their vote has to influence change and drive progress, particularly in regard to some of the perceived critical issues facing the world today. In terms of these perceptions, we note that the top five risks identified in the World Economic Forum's *Global Risks Report 2022* were all environmental.

Figure 3. The five most menacing threats over a 5-10 year horizon threats are all environmental



Source: World Economic Forum - Global Risks Report 2022.

The Stockholm Resiliency Centre of Stockholm University publishes a risk gauge relating to nine planetary boundaries affected by human activity. If we stay within these boundaries, we can continue to thrive. It is notable that the biodiversity boundary is already in the red zone (even more significantly advanced than climate risk), and new analysis in 2022 suggests that the related water boundary has also been breached.¹⁷ Why is this important? As naturalist Sir David Attenborough put it, “Every breath of air we take, every mouthful of food that we take, comes from the natural world. And if we damage the natural world, we damage ourselves.”

COP15 is taking place at the end of 2022 in Montréal, with many hoping for a “Paris Agreement”-style outcome to the conference. Investors should prepare themselves for the release of the Taskforce for Nature-Related Financial

Disclosures in September 2023, which will provide a framework for financial reporting to mirror its sister reporting framework on climate change.

When looking to reflect these concerns in portfolios, investors can find it tricky to locate suitable biodiversity-themed investments. For example, only a few utility stocks meet a definition of having a substantial amount of biodiversity-solutions-related revenue. For institutional investors, the approach in listed equities is likely to revolve around engagement with firms to limit the damage they do to biodiversity; for example, encouraging manufacturers to use more sustainable packaging solutions. Private markets can give investors wider clout by investing in early-stage firms with an impact orientation and a purer solutions implementation.

¹⁵ Mercer. Themes and Opportunities 2022 — *Metamorphosis*, available at https://insightcommunity.mercer.com/research/619c3f9e5bad5c0020a5e622/Mercer_Themes_and_Opportunities_2022.

¹⁶ PwC. *Boardroom Recap: The 2022 Proxy Season*, available at <https://www.pwc.com/us/en/services/governance-insights-center/library/2022-proxy-season-review.html>.

More broadly, companies that do not consider their social and environmental impact may see their valuations come under pressure over time, whether through gradually diminishing investor support or more sharply following adverse news or reputational damage. There will also be expectations for investors to engage with these companies on a variety of fronts. Investors pursuing non-financial objectives will therefore need to develop their own engagement principles over time and, more importantly, ensure these principles can be translated into tangible goals that can be measured objectively and in a sophisticated way, whether by assessing carbon emissions, Sustainable Development Goals (SDG) scores or improvements in ESG ratings.

Key takeaways:

- Engagement activities continue to increase as the world faces a number of critical challenges. Investors should ensure their engagement principles result in tangible objectives.
- Valuations for laggard firms are expected to be impacted over time.
- Private markets can give investors wider clout by investing in early-stage firms with an impact orientation.

Sustainability investors have focussed on quality growth investments in a decade which, until recently, rewarded such an approach. Upstream stocks tend to be messier and to have more of a value bias; engaging in this area is key for the transition, and investors should not be afraid to get their hands “dirty”.

Matt Scott, Senior Strategic Investment Research Specialist



Mother necessity

“Necessity is the mother of invention.” – Plato

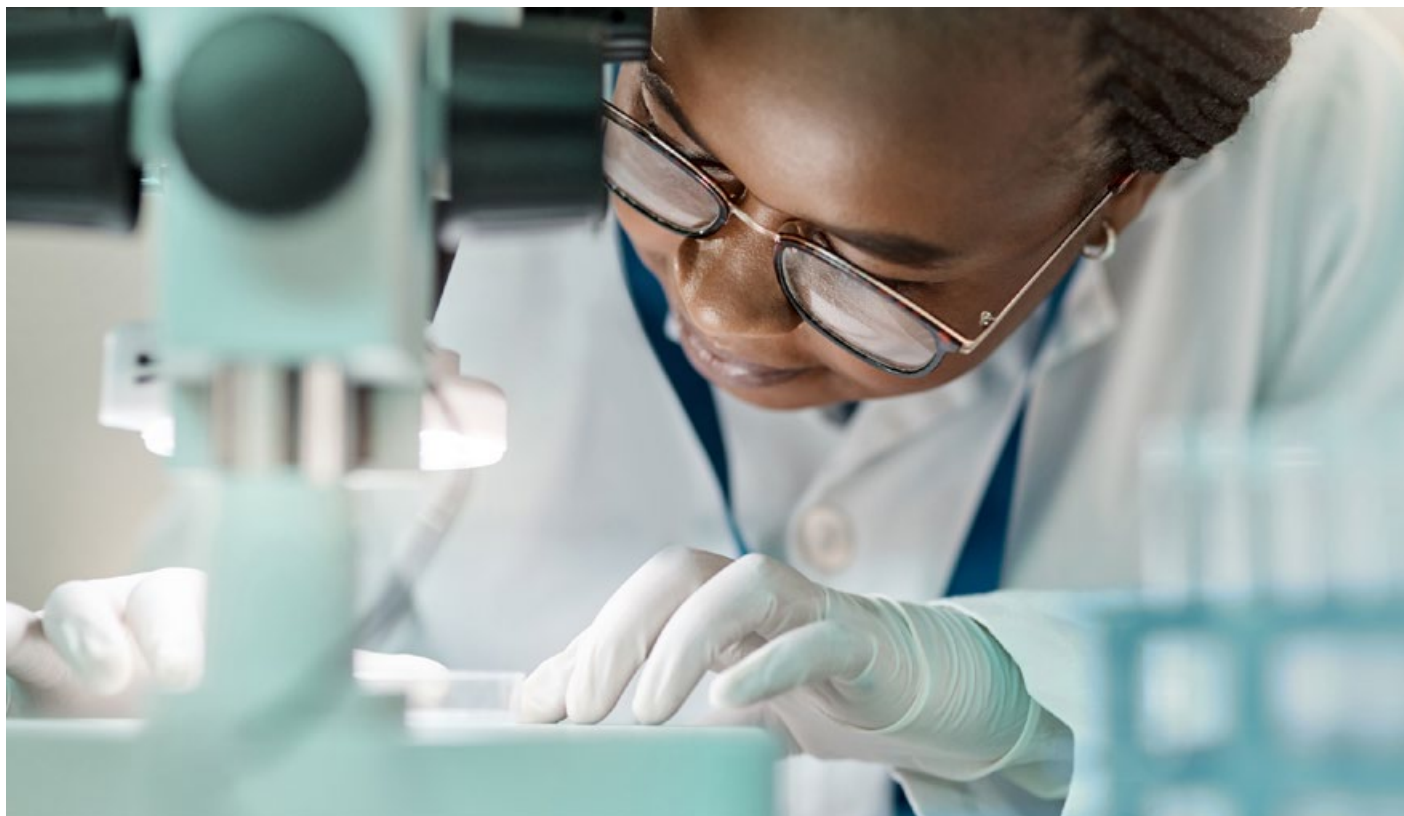
It is difficult to identify a time in human history when we needed innovation more to drive us forward. Problems such as climate change, energy supply disruptions, ailing infrastructure and polarization — among others — require practical solutions that constitute opportunities. Upward pressure on commodity prices and greenflation are a major impetus for innovation going forward, as industry continually strives for more cost-effective clean technologies. The world may be on the brink of an all-encompassing connectivity, where the internet of things, augmented reality, AI and biotechnology all start to join up and become more than the sum of their parts: this is the so-called “Fourth Industrial Revolution.”¹⁸

Innovation is the key to such change. The entrepreneurial spirit to create, innovate, improve and solve challenging problems seems to flourish in cyclical down markets. Venture capital fuels the flames of innovation and disruptive technologies that change the world and make it a better place. Energy transition has been one beneficiary from this trend with analysis showing a record amount of North American private capital flowing into this area in 2021.

In this context, private markets appear an evident beneficiary of the push for greater innovation across a range of sectors, including renewables, energy efficiency, healthcare and waste management.

Key takeaways:

- Increased innovation is required to turn the world’s challenges into opportunities.
- Private markets can play a significant role in supporting innovation, creating opportunities for investors.



¹⁸ World Economic Forum. “Fourth Industrial Revolution,” available at <https://www.weforum.org/focus/fourth-industrial-revolution>.

3. Degrees of freedom

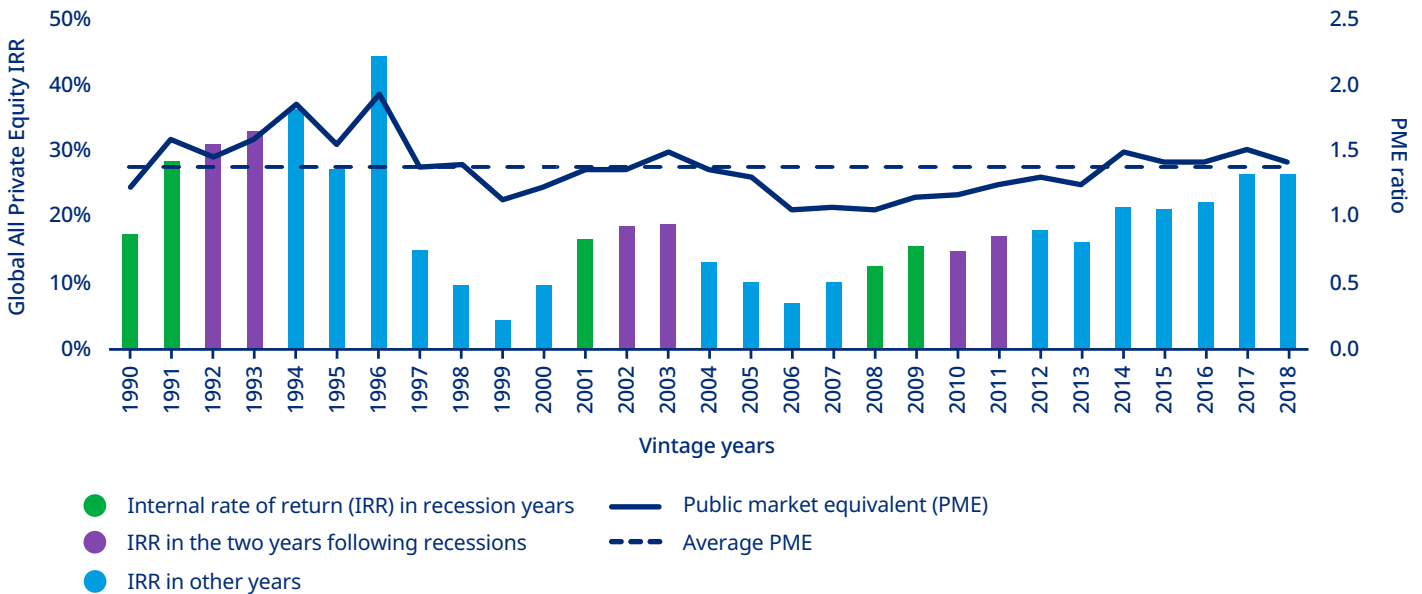
Investors today arguably have many more tools at their disposal than their predecessors ever did in the 1970s. For example, the hedge fund industry as we know it today hardly existed in 1970, with only around US\$300m in assets under management¹⁹ (US\$5.1trn today²⁰), following some teething problems and faltering first steps toward institutionalization in the 1960s. Private markets were also off-limits to most institutional investors, with the ERISA regulations prohibiting private equity investments in the US until 1978. Investors today enjoy the ability to create sophisticated and well-diversified programs in both arenas and with sufficient governance budget, can also potentially take advantage of short-lived opportunities as they arise; for example, by adding secondaries and co-investments to a private markets portfolio.

Private eye on the case

Private markets have become a major focus in recent times, with asset owners increasingly cognizant of the ability of the space to drive innovation and meet the needs of changing economies. Their popularity has been reflected in global asset flows, with fundraising rebounding from the pandemic turbulence of 2020 to reach a record of almost US\$1.2trn in 2021, a year-on-year increase of nearly 20%.²¹

Private markets' product offerings have also reflected this increased demand and popularity, with a significant evolution in fund availability and portfolio design to provide investors with access to a broad range of opportunities (including secondary, open-ended, evergreen and continuation funds).²²

Figure 4. Relative outperformance of global private equity and performance during and after recessions



Source: Burgiss Private I (June 2022). The PME ratio is calculated using MSCI World Total Return Index. Vintage years not shown post 2018 since they are not fully matured yet.

¹⁹ Rappaport A. "A Short History of Hedge Funds," CFO, March 27, 2007, available at <https://www.cfo.com/banking-capital-markets/2007/03/a-short-history-of-hedge-funds/>.

²⁰ Statista, as of June 2022, available at <https://www.statista.com/topics/5064/hedge-funds/>.

A key attribute of private markets is the way they have become highly responsive to the needs of the global marketplace while also providing access to patient capital that allows innovative businesses to take a long-term view on growth. Investors can benefit from this, utilizing exposure to private markets to gain access to a greater portion of the global economy than is possible via public markets. This is particularly pertinent in the current environment as economic growth becomes more challenging to come by and in our view will likely be increasingly driven by the private markets space.

Committing to private equity during recession years and near-subsequent years has typically been rewarding for investors that maintained their commitment pacing (see Figure 4).



Tech has had a year to forget but we should remember that periods such as now have often constituted "creative destruction". Today could seed the next round of great venture capital ideas.

Joanne Holden, Head of Global Investment Research



Key takeaways:

- Exposure to private markets can provide investors with access to greater portions of the global economy than public markets alone. Private markets' role in driving innovation to meet the needs of changing economies can provide attractive opportunities for investors.
- Portfolio design and product developments have evolved significantly to meet investor needs. Investors have a broad range of opportunities, including secondary, open-ended, evergreen and continuation funds.
- Investors should maintain their commitment pacing. Committing to private equity during recession years and near subsequent years has historically rewarded investors.



Operational alpha

A confluence of major events — the COVID-19 pandemic, leading to inflation and supply chain challenges, followed by an energy shock — has disrupted the bull run of the last decade. How this ultimately plays out in the long term remains to be seen; however, we have already seen the return of market volatility (with the VIX Volatility Index in

2020 reaching its highest level since the global financial crisis and remaining elevated in 2022). As a further guide for what investors can expect, history shows us that prior downturns, including the “tech bubble” and the global financial crisis, were persistent, with long periods required to recover losses in major equity market downturns.

Figure 5. Days to recover losses in prior major downturns in equity markets



Source: Refinitiv, Mercer. Index used to proxy equity returns is S&P 500. Data as of October 28, 2022.

Becoming a provider of liquidity in stressed or dislocated situations is an important instance of operational alpha. The ability to pivot toward credit dislocation funds, special situations and distressed debt at opportune points in the cycle can be rewarding. We believe opportunistic credit strategies are well placed to capitalize in such circumstances.

Investment committees should review whether their frameworks allow them to react to dislocations and also consider the merits of specialist multi-asset managers or hedge fund strategies that are inherently dynamic.

Key takeaways:

- Becoming a provider of liquidity in stressed or dislocated situations is an important instance of operational alpha. We believe opportunistic credit strategies are well placed to capitalize in such circumstances.
- Enhancements to governance models will be needed to meet long-term investment goals while reacting to short-lived opportunities.
- Investors should consider the merits of specialist multi-asset managers or hedge fund strategies that are inherently dynamic.

Dynamic diversification

Harry Markowitz, the originator of Modern Portfolio Theory, famously said, “Diversification is the only free lunch” in investing.²³ It is a philosophy that has been embraced by many investors for a long time.

With markets operating differently than we’ve been used to over the past decade, many investors will no doubt be giving thought to how they approach diversification within the context of portfolio construction. Because relationships between asset classes may not be as predictable and stable as investors have been accustomed to, they should look at ways of diversifying more dynamically to both ensure sufficient diversification within their portfolios and access to the necessary sources of alpha; this can be achieved at the committee level given sufficient governance resource, or by utilizing mandates with discretion to be dynamic. A key risk to consider is that the inflationary regime may persist for some time. In such an environment, equities and bonds are likely to be positively correlated, and bonds may therefore provide scant protection and this could be a reason to consider real assets and alpha sources, amongst other levers.

Historically, hedge funds have played an important role in this respect, and exposure to macro and trend strategies may be beneficial during inflationary periods. But it’s important to ensure that the strategies being employed are sufficiently flexible to capitalize on the opportunities that arise within markets. These strategies have no real linkage to inflation but can often manage to catch trends when markets are in transition. No single hedge fund strategy is a silver bullet, so these should be part of a well-diversified hedge fund portfolio.

Downside protection strategies have tested the mettle of many an investor. Typically, such strategies utilize put options on equities, which, like insurance policies, come with a recurring cost. For behavioral reasons, many investors call time on these mandates before they have ever triggered. This is a very difficult skillset to master; for instance, the ability to monetize gains. Another challenge is to control the cost, either by judicious security selection or by utilizing liquid hedge fund strategies with modest target returns, which are fairly robust to market circumstance.



²³ Markowitz H. “Portfolio Selection,” *The Journal of Finance*, 1952.

We believe such downside/defensive strategies should typically be used as a complement to a growth portfolio of hedge funds. This provides the additional potential benefits of optionality (when the downside portfolio pays out, you can invest in distressed growth opportunities) and rebalancing. Today, with traditional assets cheaper and offering stronger forward-looking returns, albeit with a wide range of outcomes, investors can “barbell” higher allocations to those assets with such a specialist downside-risk mitigation strategy.

Key takeaways:

- In a very different market environment, investors should consider the best approach to diversification to meet their risk/return goals; for instance, incorporating a specialist downside-risk mitigation strategy.
- Macro and trend hedge fund strategies (as part of a diversified hedge fund portfolio) may be beneficial in an inflationary period — not due to any specific inflation linking but rather to capitalize on the transitional nature of markets.



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