HEALTH WEALTH CAREER

CURRENT TOPICS

MAY 2016

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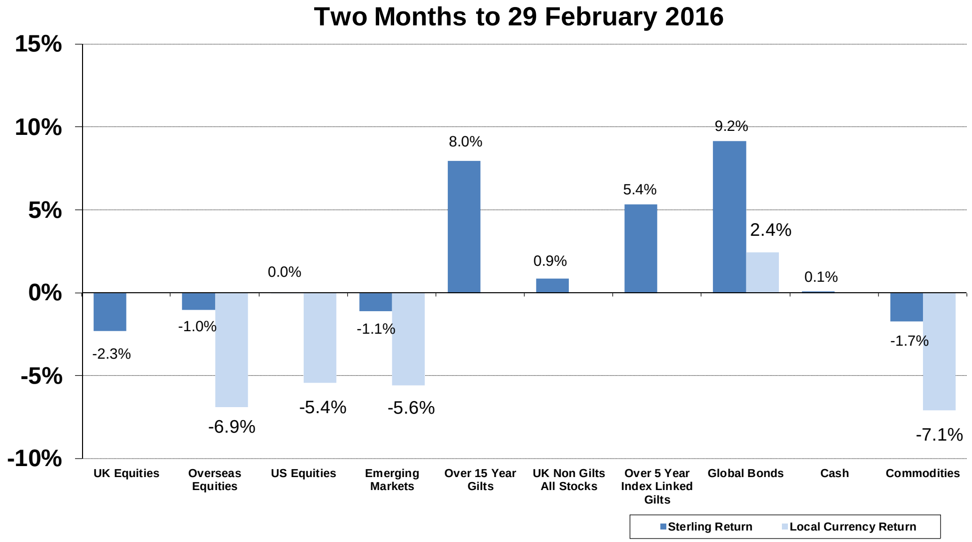
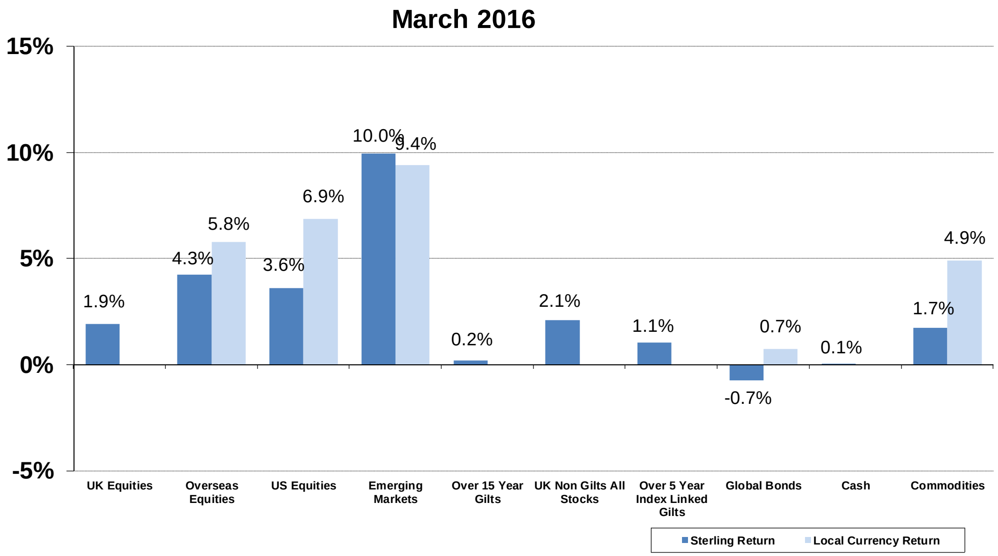
CONTENTS

2016 UPDATE AND BREXIT

2016 UPDATE AND BREXIT
WHAT DID WE OBSERVE?



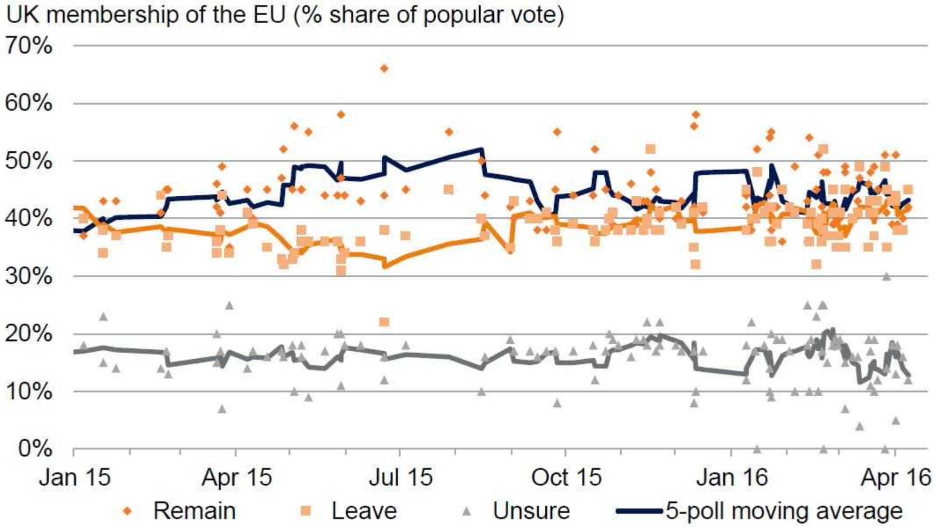
- Bond yields **fell sharply, continuing the trend of significant intra-month volatility.**
- Global equity markets generally declined, although returns were supported for unhedged UK investors by the depreciation of Sterling over the period (primarily a reaction to the announcement of the EU Referendum).
- **Credit spreads widened over the period,** reflecting the 'risk off' sentiment.
- Overall this was a weak period for most UK pension schemes in funding level terms.



- Over March 2016 we saw a **rebound in global equity markets,** led by Emerging Markets and the US.
- In addition, commodities rebounded after their year-long slump; by late-April 2016 the oil price had risen 55% from the multi-year low it reached in February.

Source: Thomson Reuters Datastream.

2016 UPDATE AND BREXIT
POLLING DATA



Source: ComRes, ICM, ORB, YouGov, BMG Research, Survation, Ipsos MORI Panelbase, Pew Research Centre, Norstat, Populus, TNS-BMRB, Opiniom, Greenberg Quinlan Rosner Research. Schroders Economics Group. Last survey conducted 10 April 2016.

Source: Oddschecker.com. Schroders Economics Group. 14 April 2016.

- Polling data remains too close to call as at mid-April 2016, with a significant proportion of voters still undecided.
- While polling data remains inconclusive, implied odds are suggesting a vote to 'Remain' is the more likely outcome, with a 'Brexit' having an implied probability of 33.8% as at 14 April 2016 (as demonstrated by the chart on the bottom left).
- As a reminder, given the prevailing uncertainty around the outcome we are recommending investors:
  - Consider dynamic trigger-based liability hedging frameworks to take advantage of market dislocation to hedge at attractive levels;
  - Consider the size of any UK bias within their equity portfolios;
  - Consider whether currency hedge ratios remain appropriate given the potential for heightened volatility, and for a depreciation of the Pound in the event of a 'Leave' vote;
  - Ensure that collateral positions within LDI mandates remain robust given the potential for gilt yields to spike in the event of a 'Leave' vote.

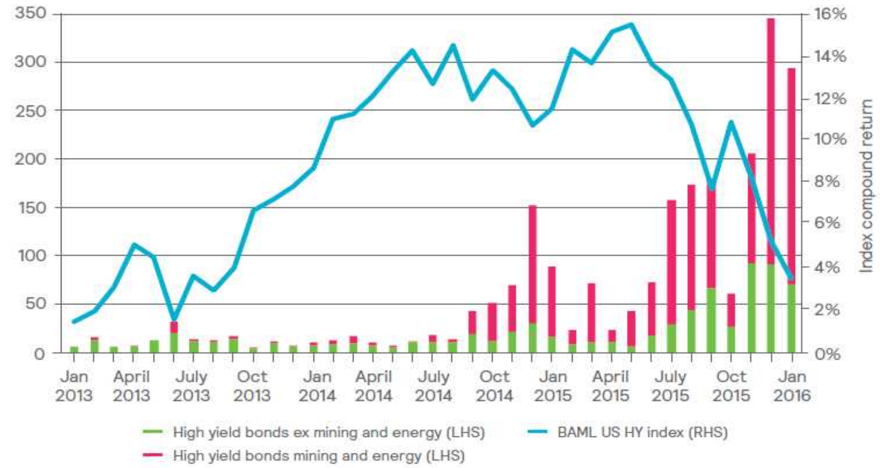
UPDATE ON HIGH YIELD AND DISTRESSED DEBT

MARKET BACKGROUND OVER 2015 & 2016 YTD

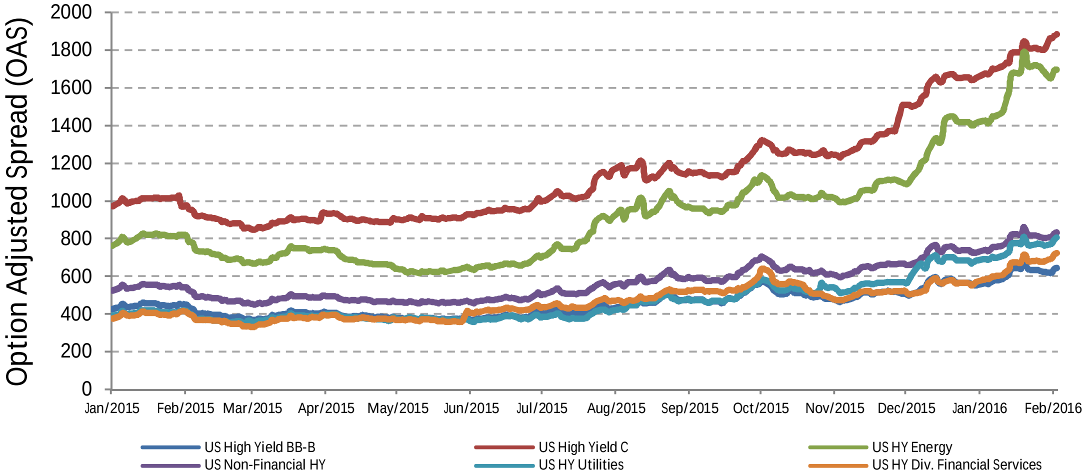
- 2015 was a year that most corporate credit investors would like to forget. Marked by **severe volatility, a deterioration in credit quality and market liquidity**, all US-based High Yield credit indices finished in negative territory, posting the worst annual returns since the 2008 crisis, while European High Yield also declined.

- Selling momentum was strong, and a second consecutive year of outflows from the asset class have left **spreads on the edge of pricing in a global recession**. The degree of the sell-off is captured by the chart on the right, which show the number of US High Yield credits that have experienced more than a 10% price loss in a month.

- Overall, the **Yield to Worst on US HYD is approximately 9%; the highest level since October 2011**, when markets sold off as a result of a 'risk off' environment caused by the Eurozone crisis.



Source: BlueBay Asset Management, BAML



Source: BAML

- Over the second half of 2015, the marked decline in market liquidity exacerbated the volatility in credit trading, leading to **dramatic swings in otherwise stable, liquid positions**. Weaker prices caused further selling, stop-losses were triggered and redemptions caused a degree of panic selling by retail investors (a sector that owns approximately 25% of the High Yield market).

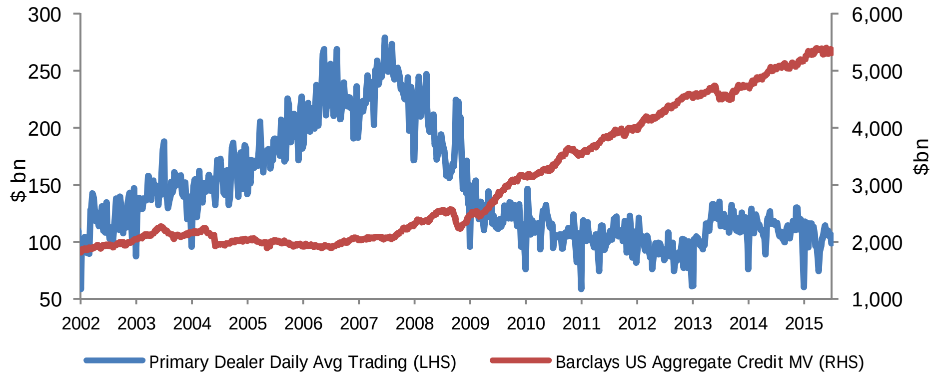
- However, the chart on the left demonstrates that **much of the poor performance of corporate credit in recent years has been due to losses in energy and commodity related issuers**, as weaker worldwide demand and excess supply sent oil and commodity prices down.

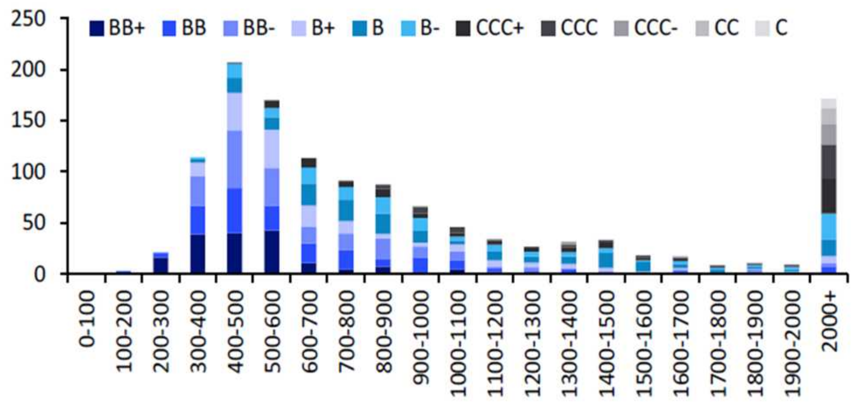
US High Yield spreads are on the edge of pricing in a global recession

KEY AREAS OF OPPORTUNITY & RISK

- Since the Global Financial Crisis, tighter regulations have discouraged banks from holding credit. **This has led to a significant reduction in market liquidity**. Without the banks there were often no willing buyers – this in turn exacerbated volatility, leading to dramatic swings in prices.
- The blue line in the chart on the right tracks primary dealer inventory over time, a good proxy for the presence of banks in the market. The significant reduction since the financial crisis presents an **opportunity for patient, long term investors with an illiquidity budget to step into the void left by the banks.**
- The extensive outflows from retail investors seen recently have led to more attractive valuations in the large cap space, which undoubtedly presents opportunities. However**, these issues will also be most volatile in the face of further market 'panic'.**

Primary Dealer daily average trading and outstanding Corporate Debt





Source: Deutsche Bank

- While the energy sector has driven losses, what is clear is that **stressed pricing is not just confined to energy**. What started off as turmoil in the energy sector has spilled over into non-commodity related areas, creating new opportunities in a range of industries including, for example, Telecom, Media, Retail and Healthcare.
- This leads to a broader question of whether **markets are experiencing 'contagion' from a concentrated weakness in certain sectors**. This dislocation between sentiment and fundamentals increases the likelihood of systematic asset mispricing, **and hence increases the opportunities available for active managers in this space**.
- Whilst the headline index spread for US HY stands in excess of 800bps (including energy/mining names), little more than 10% of the outstanding market notional trades within +/-100bps of the index average. We highlight this bifurcation in the USD HY market in the chart on the left. This further supports the **need for active management to capture opportunities**.

The new paradigm in market liquidity has exacerbated volatility, leading to dramatic swings in otherwise stable positions

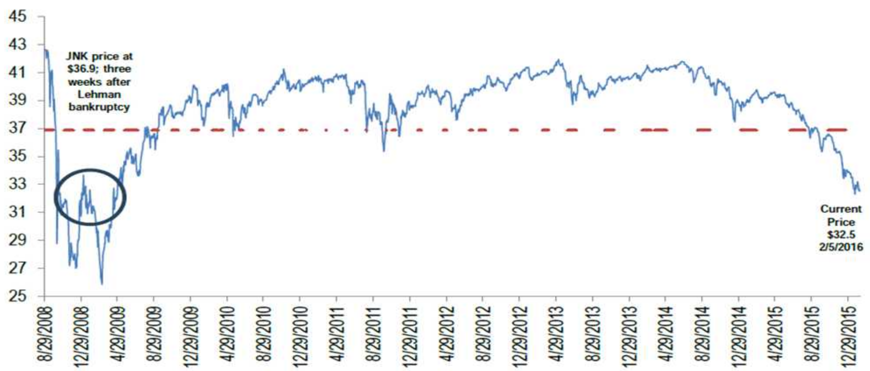
KEY AREAS OF OPPORTUNITY & RISK

- There are **clear signs that the credit cycle is maturing**. The peak of the credit cycle is characterised by, amongst other things, an increase in M&A activity; as the chart on the right shows this has been increasing significantly over the past year. Investors should therefore start preparing for the conditions and opportunities that present themselves at the later stages in the credit cycle.

- One such opportunity is that weaker lending standards typically lay the ground for a period of **higher default rates and opportunities for distressed debt investors.**

- In such periods, idiosyncratic risk is highlighted and dispersion in performance among credits is more likely. Once again, this supports the case for allocating to managers that are **willing to adjust their market exposure dynamically over time. This includes managers that are willing to hold cash as 'dry powder' to deploy in stressed market conditions.**

Source: Bloomberg



Source: Beach Point, Bloomberg

- The risk of a period of weak global growth has increased. However, the chart on the left shows that the JNK (High Yield ETF) was at a lower price in February than it was 3 weeks post-Lehman. **This further points to the likelihood of attractive opportunities for a skilled manager to exploit.**

- **Geopolitical risk** remains, not least a looming referendum on EU membership in the UK on 23 June. The impact of a potential Brexit is uncertain, but whether Britain leaves the EU or not, the only certainty in the short term is the increased market volatility globally as the referendum approaches.

There is a strong case for allocating to managers what are willing to adjust their market exposure dynamically over time

IMPLEMENTATION CONSIDERATIONS

- We believe there are opportunities in the High Yield space at present for active management through careful stock selection and dynamic asset allocation. As the credit cycle continues to mature, we believed that stressed and distressed credit could offer investors a rare opportunity to generate attractive returns in today's low (or negative) yield environment. However, **there is not a 'one size fits all' solution.**

- Investors will need to consider how they access the opportunity set, taking into account their return objectives, time horizon and threshold for short term losses.

- Strategies targeting credit opportunities vary significantly in their return objectives and liquidity terms. The following are broad strategies that may be worthy of consideration:

  - **Multi-Asset Credit:** these strategies are towards the lower end of the risk/return spectrum, but can provide diversified exposure to credit markets including high yield and distressed debt.
  - **Long-only "credit opportunities" funds:** these strategies could be thought of as higher up the risk/return spectrum, with less liquidity than traditional multi-asset credit funds.
  - **Credit-oriented hedge funds:** These strategies have the flexibility to invest on both the long and short side, and as such are likely to be less exposed to the "beta" of the opportunity in credit markets, with a higher reliance on manager alpha.
  - **Private Markets vehicles:** Distressed Debt funds will often form part of a diversified private markets portfolio, will typically sit at the higher end of the risk/return spectrum, and will tend to offer the least liquidity to the end investor.

A variety of implementation approaches are available, depending on risk and return objectives and constraints

HOW TO BE A MORE OPPORTUNISTIC INVESTOR

BACKGROUND: WHAT IS OPPORTUNISTIC INVESTING?

- The relatively stable investment environment of 2013 to mid-2015 has since given way to a period of market volatility. We expect to see more such disruptions over the coming years as investors react (and overreact) to ongoing macroeconomic uncertainty.

- Meanwhile, low interest rates and historically rich equity valuations present a challenging investment environment and a scarcity of cheap 'beta'. As such, generating a targeted return in future may require a greater degree of opportunism on behalf of investors.

- We believe investors should consider how they can behave more dynamically to changes in market conditions, whilst managing the challenges associated with speed of response and the governance burden. Ultimately the goal of introducing more dynamism is to add value (absolute or risk-adjusted) relative to a long term strategic asset allocation.

- There are a number of approaches that investors can take, which are set out on the next slide. Arguably, regardless of the implementation approach the most important condition for success is adopting the right mindset; in particular a willingness to exploit opportunities that arise in previously untapped segments of the market.

An opportunistic approach to investing can take advantage of market volatility and mis-pricings to generate alpha

IMPLEMENTATION APPROACHES (1)

Floating Asset Allocation

What is it?

Floating Asset Allocation replicates the DAA framework but with a more fluid asset allocation strategy with fewer constraints.

Advantages?

Less anchored to the SAA than the DAA approach, and isn't limited to a fixed infrequent review period. Therefore it can adapt more quickly as the market and economic environment change.

Disadvantages?

This approach requires a stronger governance framework given the lack of constraints. In addition, it becomes more difficult to attribute performance between long term thinking and shorter term dynamic/market views.

Dynamic Asset Allocation

What is it?

A DAA approach usually supplements a longer term strategic asset allocation (SAA). It usually involves establishing medium term (1-3 year) views on major asset classes and tilting the allocation accordingly.

Advantages?

Governance hurdles to implementing Dynamic Asset Allocation (DAA) tilts are relatively low. DAA incorporates current market conditions and expected returns, while retaining the long term Strategic Asset Allocation (SAA) as the base. The medium term nature of DAA views is such that a quarterly meeting cycle is usually sufficient.

Disadvantages?

As the SAA remains the 'anchor' this approach tends to not be flexible enough to accommodate a full exit from an asset class that has become unattractive unless the SAA is altered.

Opportunistic Investing

What is it?

Opportunistic investing is a more flexible approach to tactical investing than DAA, as it isn't necessarily constrained by asset classes and manager or strategies in the existing portfolio

Advantages?

Opportunistic investments can be illiquid, which broadens the opportunity set and allows investors to monetise long time horizons.

Disadvantages?

Additional governance. Responsibility for opportunistic investing can be delegated to in-house teams or sub-committees, but the impact of these changes should be monitored on a periodic basis.

A combination of the above approaches may be appropriate **dependent on governance constraints**. Responsibility can be delegated to an **in-house investment team, sub-committee or external investment manager.**

IMPLEMENTATION APPROACHES (2)

Broader Investment Mandates

- Giving managers more flexibility through broader investment mandates should introduce more dynamism, and Mercer generally recommend broad over narrow investment mandates.
- An example of this would be substituting a High Yield Debt strategy for Multi-Asset Credit (“MAC”),which would expand the opportunity set significantly, increasing the manager’s ability to act opportunistically.

Idiosyncratic Multi-Asset Strategies

- Idiosyncratic Multi-Asset Strategies place heavy emphasis on tactical/dynamic asset allocation (albeit with a long bias) and idiosyncratic trade ideas. As such, they are suitable for diversifying a traditional stock/bond portfolio and tend to provide good ‘bang for your buck’ when seeking opportunistic allocations.
- Key considerations are the sizing of any allocation to such strategies, as well as the degree of flexibility inherent in the approach.

Hedge Funds

- The term ‘hedge fund’ covers a disparate collection of investment strategies, but their investment mandates and structures tend to give them far more flexibility than traditional, long only investments.
- For example, global macro funds seek to capture cross-asset class opportunities, including positions in interest rates, credit, equities and currencies.
- Investors with a material allocation to hedge funds will tend to have more opportunistic investing embedded in their approach than those without.

Using external investment managers to invest more opportunistically should offer **greater flexibility and responsiveness and a streamlined implementation of new ideas**

SMALL CAPS: TOO BIG TO IGNORE

BACKGROUND

Mercer's advice on constructing equity portfolios has evolved over the past few years to incorporate the importance of incorporating the following 'style factors'; value, size, momentum, low volatility, and profitability.

As part of that analysis, we proposed allocations with suggested exposure ranges that would produce a similar level of volatility to a global market-cap weighted portfolio but with a higher return.

An allocation to Small Cap equities of c. 15% would be a crucial component of our recommended portfolio, which is set out in the table on the right. However, there is evidence that investors have limited Small Cap exposure, often citing reasons including:

- A fee differential of c. 10-50 basis points over Large Cap equities;
- Potentially lower liquidity, and higher trading costs

Component	Allocation (%)	Range (%)
Broad Market Equities	50	30-60
Emerging Markets	10	0-25
Smaller Companies	15	0-25
Low Volatility	20	10-30
Niche (Opportunistic/Theme-Specific)	5	0-10

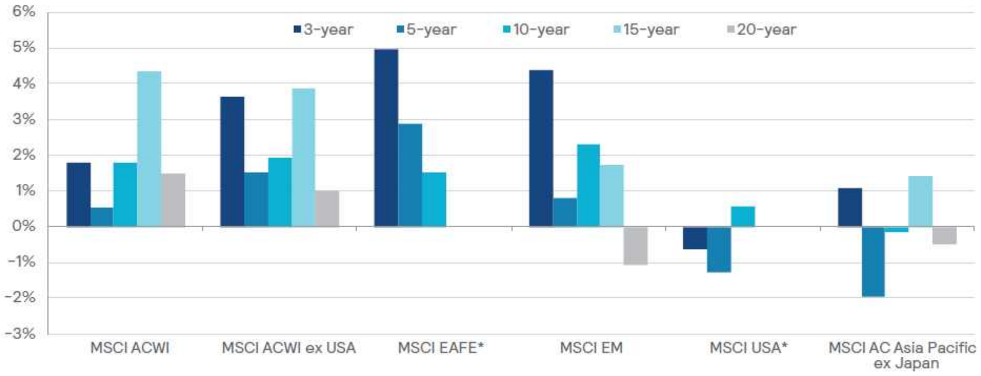
Source: Mercer

We believe that the benefits of Small Cap investing outweigh the negatives, and that investors should reconsider their exposure to this asset class, bearing in mind the potential for superior risk-adjusted returns and potentially some diversification benefits.

Underweighting of Small Caps represents a substantial active management decision, with likely opportunity costs

SMALL CAP: A FERTILE SOURCE OF ALPHA

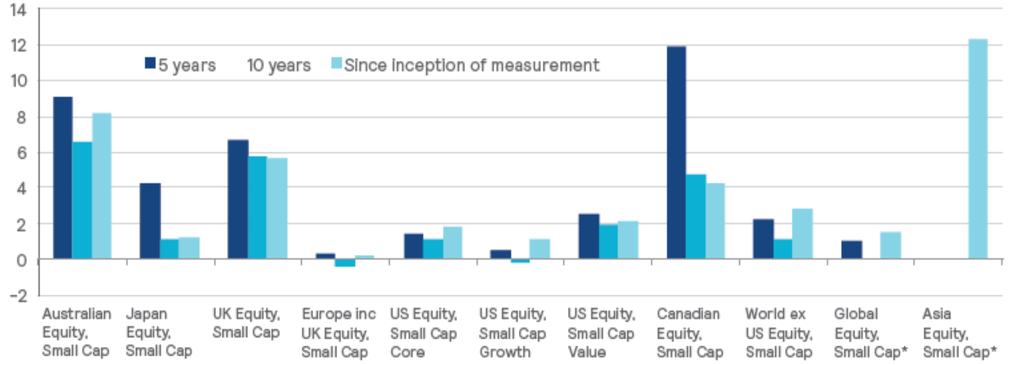
Outperformance of broader index



Source: Mercer as at end-September 2015. Performance is Gross of Fees.

* 10 Year data unavailable for "Global Equity, Small Cap" as measurement started in 2010. 5/10 Year data unavailable for "Asia Equity, Small Cap" as measurement started in 2014

Contribution from Active Management



Source: Mercer as at end-September 2015. Performance is Gross of Fees.

* 10 Year data unavailable for "Global Equity, Small Cap" as measurement started in 2010. 5/10 Year data unavailable for "Asia Equity, Small Cap" as measurement started in 2014

Academic and mainstream industry thinking has frequently pointed to the existence of a size-related or small-cap premium. This has broadly been backed up by performance over longer time periods, as the above chart highlights by looking at the difference between Small and Large/Mid Cap performance in different regions.

However, we would be cautious of proposing Small Cap equities as a 'free lunch' in beta terms. Instead, we believe investors should consider allocating to the asset class because of the potential for skilled active managers to generate consistent excess returns, as well as diversification benefits (e.g. notable disparity in sector weightings versus Large Cap).

We believe that Small Cap represent one of the most inefficient segments of the equity investment universe. This is demonstrated by the performance of our 'A rated' strategies in each universe, as demonstrated by the table above.

Pricing inefficiencies in the asset class may stem from a number of causes, including low research coverage, less competition and high cross-sectional volatility.

We do not think it is unreasonable to expect annualised excess returns of between 100 and 250 basis points from active management over the long term.

We believe the scope for excess returns outweigh the negatives associated with illiquidity and higher fees

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