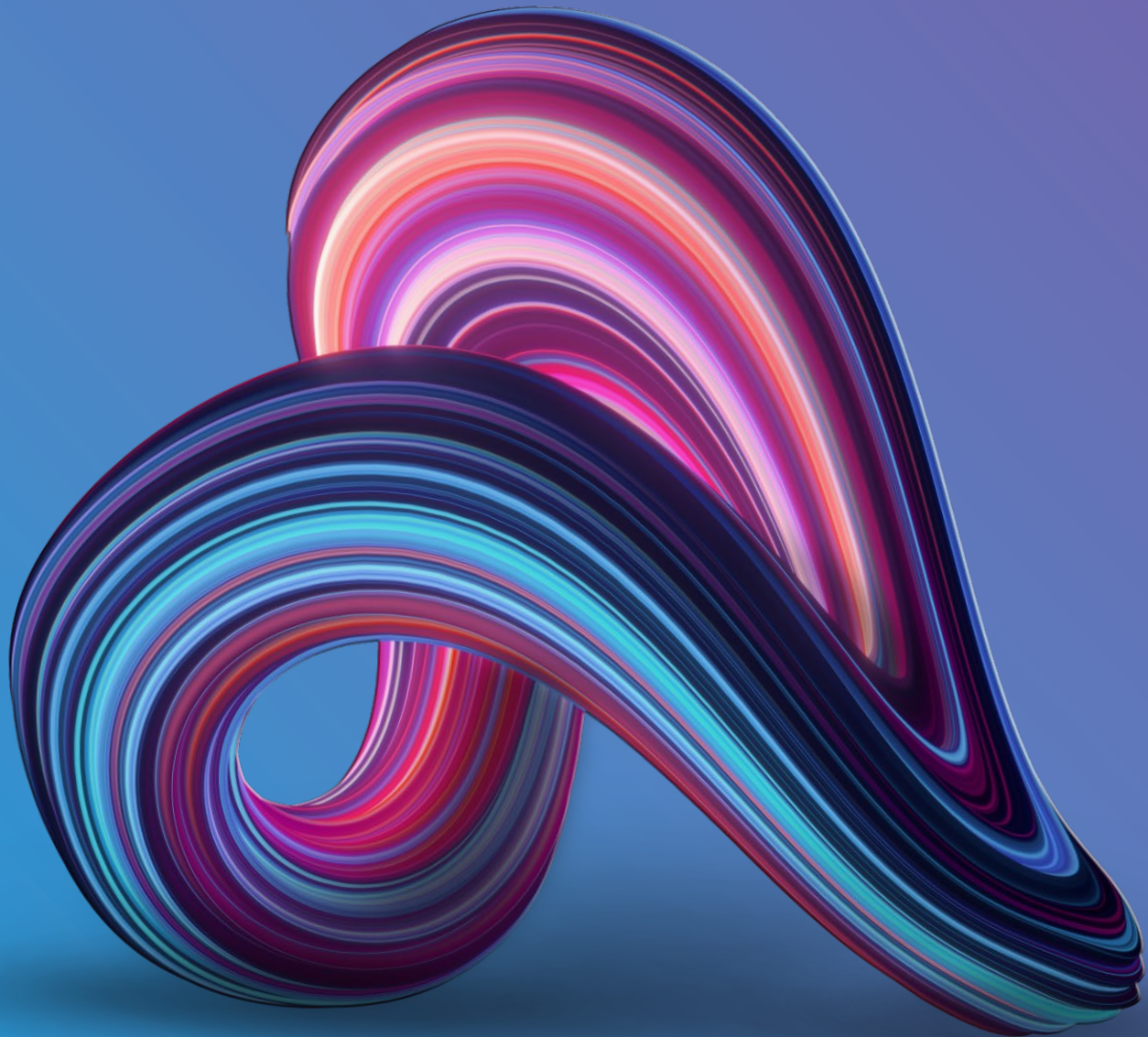


Themes and Opportunities 2022

Metamorphosis



Summary

Substantial and profound changes are rapidly reshaping the world as we know it, with significant implications for investors. This vibrant reimagining can be encapsulated in a single word: metamorphosis.

Investors cannot just think about the here and now; they must consider the issues most likely to drive future financial, social and political developments in a way that allows them to make the decisions needed to meet their objectives.

Through consideration of these key trends and challenges, we believe investors stand the best chance of long-term success. In the following pages, we discuss a number of different themes we believe investors should consider in their decision-making in 2022 and beyond.

Introduction

The world is in the midst of a revamp on various fronts. Monetary policy and thinking are being reshaped as inflation balloons beyond central bank targets, and policymakers grapple with the consequences of bloated balance sheets, inflated asset markets and disintegrating global supply chains. In parallel, regulators are increasingly active, with the unexpected announcement of a global minimum corporation tax of 15% and China imposing outright bans on cryptocurrency transactions and some areas of for-profit education.

We have also seen increased global coordination in the fight against climate change, with the US, China, India, Australia and Saudi Arabia all now also committing to net zero targets; and significant degrees of innovation and resulting disruption across a number of sectors, most notably healthcare (in the wake of the SARS-CoV-2 pandemic) and finance (where total asset value locked into the DeFi system has burst through the US\$100 billion mark).¹

To translate these and other developments into relevant themes for investors, we have identified three overarching themes which we believe will impact investment decisions in 2022 and beyond:

- **Changing of the guard:** Understanding the effects of the changing fortunes of economic players and ways of thinking that have held sway for a long time, including the evolving responsibilities of monetary policies; the prospect of an “Asian century”; the dramatic re-morphing of how finance is provided
- **Position for transition:** How investors should plan for the changes required to put us on a most sustainable path; the role of impact investing; the management of resources to facilitate the green transition; and the power that can be exercised through engagement
- **Modern diversification:** How portfolios should be reinvented to hit target returns while maintaining protection; the use of dynamic allocation between strategies and themes; and how to gain access to emergent innovators

¹ Source: DeFi Pulse, <https://defipulse.com/>

Changing of the guard

Policy pathways

Terms like monetary intervention and quantitative easing are now common parlance. A new one — Modern Monetary Theory — is quite different from others, however. Referring to continuing, coordinated monetary and fiscal stimulus, it reflects the precedence that jobs and growth have taken over austerity, with resulting economic and financial consequences.

The results of such largesse have been potent: Inflation has spiked, first in pandemic-impacted sectors due to supply chain issues and labor shortages, and later in sectors

turbocharged by stimulus and consumer spending from flush balance sheets. In parallel, the drivers of disinflation — particularly globalization and continuous technological improvement — that have been ever present over the last half century are being significantly challenged. Grudges in inter- and intra-national politics also continue to grate, with tribalism threatening to undermine the gains of globalization. As a result, though financial markets have seen stellar performance, investors should consider ensuring their portfolios are resilient to inflationary scenarios going forward.

Key takeaways

- **The use of commodities, gold, and sustainable natural resource equities can provide scenario-specific inflation protection for which many portfolios are currently unprepared.**
- **Longer-term exposure to real assets and select equity strategies can also be beneficial.**
- **Floating-rate assets, such as private debt and structured credit, can remove expensive duration risk and access more attractive spreads in light of bond market headwinds for investors who can tolerate some illiquidity.**

The Asian Century

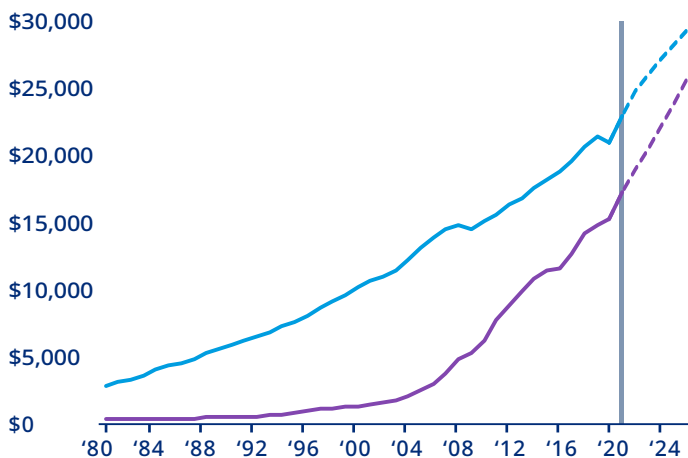
While the United States will continue to be a dominant player, China will rival it on the world stage by the end of 2030.² This is just one part of a regional transformation that will unfold over the coming years. An Asian Century is upon us, fuelled by a spectrum of structural forces: demographics, urbanization, innovation, technology adoption, domestic consumption growth, and intra-regional trade integration. Quite simply, this is one of the most transformative themes unfolding over the next few decades.

Actively managed, unconstrained emerging markets allocations can provide access to the prospective Asian Century. But while emerging market equity benchmarks have high exposure to Asia, a heavy bias to China offshore shares means weightings to onshore shares are almost inconsequential. Dedicated China allocations are therefore required,³ which also may offer strong potential for manager outperformance and enhanced diversification.

Active management of China allocations is particularly important given the speed of change, China’s economy is undergoing a profound transition, recently evidenced by surges in regulatory activity.

Opportunities also abound elsewhere, with high Chinese labor costs forcing basic good manufacturing to more competitive countries to create a Southeast Asian powerhouse. India, another rising consumer market, should also benefit from favorable demographic trends. Immense intra-Asia trade flows are forming large consumer and producer hubs, with East Asia benefiting particularly from trade spillovers due to a high degree of integration. These trends mean there is a lot to be constructive about, though investors should be aware of the potential for automation to stymie a centralized manufacturing base in Southeast Asia and create more of a “pass the parcel” effect between markets.

Figure 1. China’s economic trajectory (current prices GDP in US\$ billions)



Source: IMF.

Key takeaways

- Actively managed, unconstrained EM public equity allocations can provide investors with exposure to the Asian Century trend, but could be enhanced through the inclusion of dedicated China allocations to benefit from onshore opportunities. EM ex-China mandates can then be used in combination with All Share China mandates to access India and smaller ASEAN markets.
- Asian private equity exposure can complement portfolios by providing exposure to areas less accessible via public markets, including early-stage technology.

² CEBR forecast 2028 as the catch-up date. World Economic League Table 2021. <https://cebr.com/wp-content/uploads/2020/12/WELT-2021-final-23.12.pdf>

³ <https://www.mercer.com/our-thinking/wealth/investing-in-china.html>

The future of finance

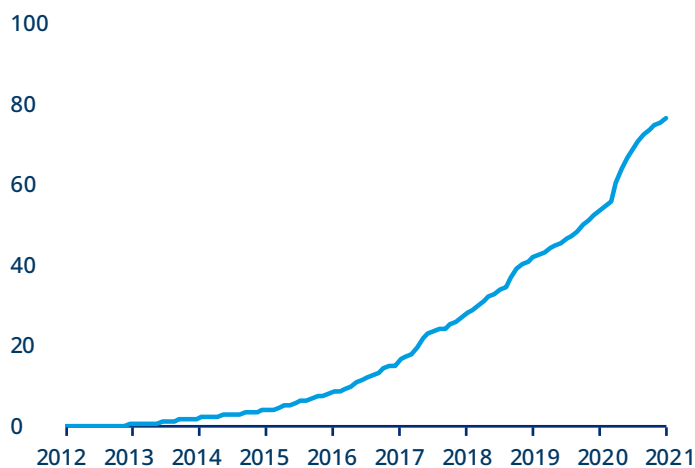
Originally arising from the ashes of the global financial crisis, decentralized cryptocurrencies are in good health, despite much naysaying over the years. While most are incredibly volatile, the adoption rate has been steady, reflected in the smooth increase in the number of digital wallets. New price records have been broken in the second half of 2021, with the rise of the financial services system for cryptocurrencies — known as decentralized finance (DeFi) — providing a sign of maturity.

Providing financial services to holders of cryptocurrencies, it has seen a huge rise in interest, with assets controlled by the system surpassing the US\$100 billion mark in 2021.⁴ Given its largely autonomous nature, this parallel financial service system, which is native to the internet, has the potential for numerous efficiency improvements relative to the traditional banking system.

Inevitably, greater pickup had resulted in greater scrutiny, with sustainability proving a particular problem. Cryptocurrencies will need to make energy efficiency savings of magnitude to be viable long term, an aim of so-called proof-of-stake protocols,⁵ which are currently in a test phase.

Although we do not recommend strategic allocations to cryptoassets themselves, given their largely unregulated nature, there may be merit in a so-called “pick and shovel” play, where investments are made in areas that benefit from serving the sector. Fintech firms, for example, are particularly concerned with the potential profits of disintermediating the banking system. While evolution and disintermediation in the financial system is nothing new, the changes happening today have a different, more democratic, character, with banks no longer acting as the sole arbiters of finance.

Figure 2. Blockchain wallets worldwide (millions)



Source: Statista. Data as of September 13, 2021.

Key takeaways

- **Allocations to private equity, specifically specialist venture capital firms investing in fintech platforms, can potentially allow investors to potentially benefit from exposure to disruptive technological developments.**
- **Private debt and hedge fund platforms can also offer access to new loans coming from fintech platforms.**
- **Investment grade private debt funds aim to compete large, high-quality corporate and commercial real estate loans away from banks with the promise of quicker, more flexible execution while reaping a spread to public markets.**

⁴ Source: DeFi Pulse, <https://defipulse.com/>

⁵ Actors on the network prove their good intentions by staking their assets in what is essentially an escrow account. Staking protocols could replace the extremely energy-intensive proof-of-work protocols, such as those that are used to generate the Bitcoin blockchain.

Inequality street

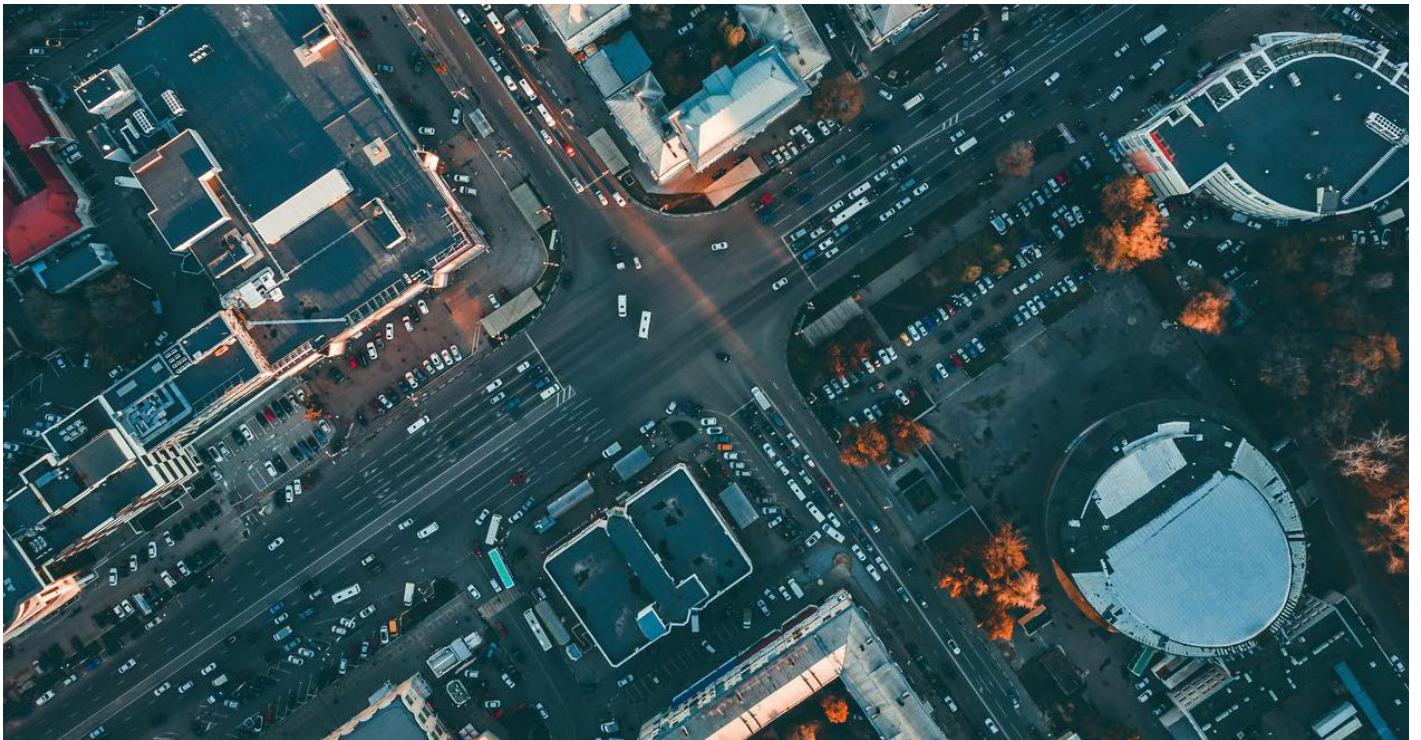
Despite being an impediment due to its effects on productivity and in stifling talent, inequality has been gradually rising over the past 50 years in many economies.

With a base case of future policies more balanced toward labor, but not outright destructive toward capital, assets tied to the success of the real economy and Main Street could be relatively better than financial assets.

Investors also need to be aware of the potential implications of policy outcomes in different regions or sectors. Certain sectors, such as technology, run the risk of regulatory action due to perceived impacts in social cohesiveness, something that has already happened in China and is being threatened in the US and Europe. Multinational companies may suffer due to increased risk of trade wars, as politicians look for rallying cries that suit the masses.

Key takeaways

- **Proper diversification across regions, sections and market caps we believe is an opportunity to make your portfolio robust to the risk of society potentially transitioning toward a more inclusive economic model.**



Position for transition

The gray, the green and the in-between

Assets in a portfolio exist in a spectrum. “Gray” assets have high emissions and transition risk and so are only viable as long-term sustainable investments if clear and actionable transition plans are in place. In contrast, “green” assets have low/zero emissions and low transition risk, with the greenest actually actively aiding emissions reductions.

The majority of assets are “in between,” exhibiting moderate transition risk that needs managing through emissions reduction plans, and all moving at different speeds in putting those plans into action. Like any major trend, climate transition won’t happen in a straight line, and neither will price recognition. Investors need flexibility in their strategic climate transition plans to decarbonize at the right price. China is a good case in point: It has made its carbon-neutral pledge, which will involve massive investments and massive opportunities. Policy details are currently being drafted for

this multidecade initiative, and we believe early investors are likely to reap the greatest returns.

The concerns for investors on whether to buy, sell or hold assets relate to the potential existence of an ESG bubble and whether assets are being “greenwashed” rather than truly green. The former may mean sound assets are not purchased; the latter that regressive assets are maintained or added to. The idea of an ESG bubble is, however, potentially overstated, with an MSCI study⁷ showing that high-ESG rated companies have outperformed mostly due to growth in earnings, with the top tercile of highly rated firms seeing a slight multiple contraction. Greenwashing concerns can also be avoided simply by being specific in sustainability requirements, which can also ensure avoidance of backward justifying.

“**Today’s IPCC Working Group 1 Report is a code red for humanity. The alarm bells are deafening, and the evidence is irrefutable: Greenhouse gas emissions from fossil fuel burning and deforestation are choking our planet and putting billions of people at immediate risk. Global heating is affecting every region on Earth, with many of the changes becoming irreversible.**”

António Guterres,
Secretary General of the United Nations⁶

Key takeaways

- Climate change is a global, multi-industry problem and therefore requires a total portfolio response, utilizing sustainably oriented strategies in both the public and private markets.
- Investors can now develop total portfolio climate transition plans, establishing targets for total portfolio emission reductions and for each asset class based on exposures and capacity for adaptation.
- Tackling the whole sustainability issue holistically might be overwhelming for some investors; sustainability can be addressed in stages depending on individual requirements.

⁶ The full statement available here: “Secretary-General’s Statement on the IPCC Working Group 1 Report on the Physical Science Basis of the Sixth Assessment | United Nations Secretary-General.”

⁷ “Is ESG Investing a Price Bubble? Probably Not.”, MSCI.

The age of engagement

Engagement levels have returned with renewed vigor in the run-up to COP26 following a “COVID pause,” with 86 new firms committing to net-zero goals by 2040, and examples of activism increasing, such as that of a hedge fund securing pro-sustainability board seats in an oil major via just a 0.02% holding.

However, a broader frontier of engagement can include a range of other items, with much more needed than voting proxies on listed equities alone. This includes scrutinizing diversity, equity and inclusion policies of asset managers; and checking with beneficiaries on how they want to see their assets managed (often they are keener on sustainability than their fiduciaries assume, but too rarely are they asked their opinion).

What we have seen over the past year as a result of the pandemic is that COVID has fundamentally altered work patterns, often to the detriment of diverse employees. Firms therefore need to be encouraged to embrace DEI practices which encourage staff retention and build good decision-making.

In fact, diversity of talent should be a particular focus for firms, with companies with diverse management teams exhibiting EBIT margins 9% higher than those with below average diversity, and a significantly higher percentage of innovation revenue (45% versus 26% for less diverse firms).⁸

Key takeaways

- **Much work is still required on DEI, particularly in the financial industry. More diverse teams can generate robust diversity of thought, which can lead to stronger, risk-adjusted returns by reducing groupthink.**
- **Engagement is now about more than voting proxies on listed equities: Bondholders can also influence decision-making.**

⁸ Source: Boston Consulting Group, <https://www.bcg.com/publications/2018/how-diverse-leadership-teams-boost-innovation>.

Implement with intent

Meaning matters: People want to make money, but also want to make a difference. Data suggests that purpose-driven companies have 40% higher levels of workforce retention than their competitors,⁹ indicating that making an impact (which is often assumed to be nonfinancial in nature) can, in fact, have ties to the intangibles that make enterprises work.

Impact investments are made with an explicit intention and objective to deliver positive, meaningful, and measurable social and/or environmental outcomes in underserved areas, alongside a financial return. Most investors report

that the impact investments they made have performed in line with their financial expectations.¹⁰ However, there are instances where certain impact investors may wish to willingly sacrifice returns in order to generate a specific type of impact. The impact financing gap over the next decade is substantial, with the UN Conference on Trade and Development estimating that US\$5 trillion–US\$7 is required by 2030 to meet the Sustainable Development Goals.¹¹ This includes investment in areas such as biodiversity, an area currently on the brink as a tremendous species decline threatens food security and increases our contact with disease.

Key takeaways

- **Private markets, particularly venture capital, offer the capacity for a substantial level of control over enterprises and therefore the potential to make the greatest impact.**
- **Providing finance to impact projects via sustainable bonds is a direct way to invest in change.**

⁹ Source: Deloitte DI_2020 Global Marketing Trends.pdf (deloitte.com).

¹⁰ Source: GIIN, 2020 Annual Impact Investor Survey. 68% report in line performance, 20% report outperformance, and 12% report underperformance versus expectations. What You Need to Know about Impact Investing | The GIIN.

¹¹ <https://sdgimpact.undp.org/fact.pdf>

Resource code

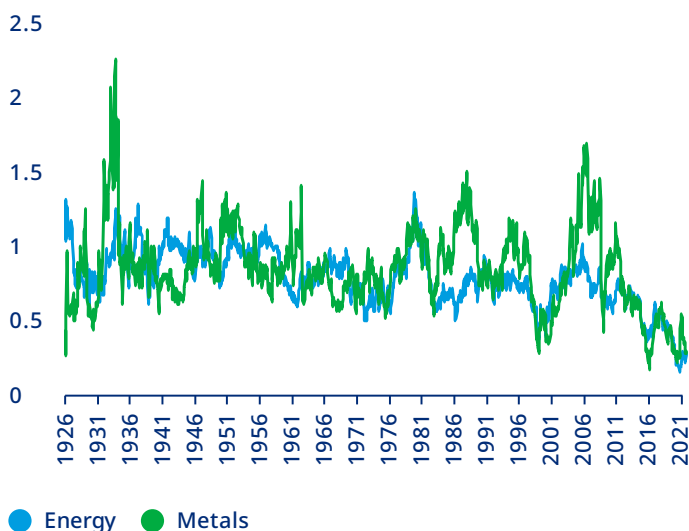
Carbon emissions have understandably been a key focus for attention to avoid or diminish the climate crisis. However, a wider lens is needed to sustainably service the food, water, housing, labor and transport needs of almost eight billion people. Biodiversity, adequate freshwater supplies and topsoil management are needed for food security; minerals for electric vehicles; and energy from sources such as nuclear and gas, given the intermittency of renewables. Put simply, a resource transition is needed, not simply an energy transition.

While emission reduction efforts focus on energy and transport, agriculture and land use — which account for around a quarter of emissions — are not being given sufficient attention. Global topsoil levels have halved in the past 150 years,¹² coinciding with dramatic insect (as vital pollinators) loss¹³ and an increase in the frequency of droughts. Innovation is needed to bring farming into the 21st century globally.

In other areas, vast amounts of metals are needed for a sustainable, electrified economy. It is estimated that the six major metals will see a two- to sixfold increase in demand over the 21st century.¹⁴ Although vital for the transition, it is possible that “portfolio cleaning” — that is, indiscriminately excluding high-emissions firms from portfolios — may have led to the sector being mispriced and underinvested in, as valuations versus the wider equity market are at historic lows just as demand spikes. Exposures in this area also have the potential to offer some inflation protection over the longer term as resources are a key component of inflation.

A key part of the solution to the resource code is the circular economy, where recycling is emphasized. For example, compared to primary aluminum, recycled aluminum emissions are 95% lower.¹⁵ Aluminum production on its own accounts for 2% of global emissions,¹⁶ and so recycling just aluminum would produce a significant emissions reduction. As carbon taxes increase, metal recycling enterprises will likely become more profitable.

Figure 3. Valuation of energy and metals companies relative to the S&P 500



Source: Statista. Data as of September 13, 2021.

Key takeaways

- Investors must think about the practical aspects of reaching net-zero emissions goals — a broader resource transition is needed.
- Areas such as biodiversity and responsible agriculture are critical to meeting long-term sustainability goals, but so are those metals which are needed to power the “great electrification.”

¹² Source: WWF, <https://www.worldwildlife.org/threats/soil-erosion-and-degradation>.

¹³ Hallmann CA, Sorg M, Jongejans E, Siepel H, Hofland N, Schwan H, et al. More than 75% percent decline over 27 years in total flying insect biomass in protected areas. PLoS One. 2017 Oct 18; 12(10).

¹⁴ “Major metals demand, supply, and environmental impacts to 2100: A critical review”. Resources, Conservation and Recycling. Volume 164, January 2021, 105107. Takuma Watari, Keisuke Nansai, Kenichi Nakajima.

¹⁵ “Life-cycle analysis of energy consumption and GHG emissions of aluminium production in China”. Energy Procedia 158 (2019) 3937–3943. Tianduo Peng, Xunmin Ou, Xiaoyu Yan, Gehua Wang.

¹⁶ <https://www.greenbiz.com/article/why-addressing-aluminum-industrys-carbon-footprint-key-climate-action>

Modern diversification

Beyond beta

While the past decade has been one of the best on record for the traditional 60/40 portfolio, all good things come to an end. With bond yields and spreads near all-time lows and cyclically adjusted PE ratios higher than anytime other than the run-up to the TMT crash, traditional beta exposures are priced for perfection in an uncertain world.

Investors may therefore struggle to achieve portfolio objectives if they rely solely on long-term beta exposures.

In a diversification context, fixed income will struggle to offer its past benefits during periods of sub-par economic or equity performance, with such low starting yields and the risk of higher yields from rising inflation.

More dynamic portfolio exposure management will be needed, and this may require changes to governance and/or mandates; for instance, via more alpha-centric approaches, or targeted long-term specialist or thematic exposures.

Key takeaways

- **Investors may no longer be able to rely on traditional beta exposures alone to secure accustomed returns.**
- **Diversification is critical, but must be multifaceted and dynamic, as the complementarity of equity and bond portfolios may no longer be reliable.**
- **Active management and the use of long-term strategic holdings can help meet investment goals.**

The protection conundrum

As we reach the latter stages of a 40-year fixed income bull market, we have seen an incredible limbo dance in yields, resulting in the once-improbable phenomenon of over a trillion dollars invested in negatively yielding corporate bonds, and a normalization of paying for the privilege of lending to governments.

The level of portfolio protection from high-quality debt instruments that generations of investors have relied on is no longer there. Investors need more tools in the toolkit. Gold and some currencies can protect well, but are subject to idiosyncratic risks and are noncontractual; their protective capacities are essentially market conventions or rules of thumb. Contractual approaches to protection, specifically

options on equity indices or on market volatility could also be warranted today, though these can raise issues over the cost of carry (spend on option premiums), which generates a drag on returns in persistently buoyant markets.

Given the need to manage a range of exposures dynamically, there is a role for hedge fund strategies, including macro managers, which may be better equipped at managing through a transitional period. Furthermore, given the potential for higher correlation between equities and bonds, reducing exposure to traditional beta in favor of strategies that are expected to generate returns regardless of market direction has merit.

Key takeaways

- **The effectiveness of duration — for years the dominant and powerful risk protection strategy for most investors — cannot be relied upon going forward.**
- **The different styles of downside - protection-oriented strategies each have some risk scenarios where they work and some where they don't. A mixed approach to portfolio protection can be beneficial, albeit highly governance intensive.**
- **Increasing exposure to strategies like hedge funds, which can provide returns regardless of market direction, could have merit.**

Accessing innovation

Innovation is occurring on multiple fronts, in areas already referenced, such as climate change solutions, and fintech, but also adaptive robotics, automation of manufacturing, applications of artificial intelligence and many others. One area of particular interest is healthcare. The necessity of coping with the pandemic proved to be the mother of much scientific invention and technology adoption (e-medicine being one example). The process of fully applying these advances will continue for years.

An unfolding genomics-led revolution is making individualized medicine more likely as costs of genomic sequencing¹⁷ continue to come down by orders of magnitude, creating greater certainty as to whether a

certain drug will be efficacious at treating particular patients and whether they will suffer side effects. These technologies will continue to bear fruits for decades, making healthcare more than a fad investment as populations age and are subject to ever-more-complex healthcare demands.

With some types of innovation happening at early stages in company lifecycles, considering private market investments (including venture capital) could bear fruit. One example is the emergence of ultra-high-pedigree “hybrid funds” offered by several top public/private equity investors, which are skewed toward mid-to-later rounds of growth equity and offer a more liquid profile versus traditional venture capital.

Key takeaways

- **The massive drop in the cost of solar energy production over the past decade is testament to the power of innovation. These trends must continue to support climate transition imperatives.**
- **Recent pandemic experiences have accelerated technological development, creating attractive investment opportunities. In particular, healthcare shows exciting long-term opportunities due to a range of innovations.**
- **Private markets exposure, including exposure via hybrid funds, can provide access to innovation in early-stage companies.**

¹⁷ Genomic sequencing refers to the process of obtaining a complete genetic map of an individual.

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