Mercer

Top considerations for financial intermediaries in 2023

New beginnings

welcome to brighter

Executive summary

New beginnings

The past decade was one of the best on record for traditional 60/40 portfolios, but a sharp rise in macro-economic volatility caused this period of success to come to an abrupt halt. A combination of the pandemic, the resulting policy response and the Russia-Ukraine war helped fuel inflation to 40 year highs and brought a period of lower interest rates and steady growth to an end.

Now, investors must face the linked challenges of high inflation, rising yields and market volatility. To put this in perspective, inflation across all 38 members of the Organisation for Economic Co-operation and Development (OECD) between 2010 and 2020 (before the pandemic) ranged between 0% and 3%. As of writing this report, inflation is running at over 10%.[1]

This, combined with synchronized interest rate hikes (put in place by major central banks in response to inflation), risks triggering a global recession, notwithstanding some countries may already be in recession. Ironically, whether this economic contraction is mild or deep depends, at least in part, on the unpredictable path of inflation and further central bank responses.

In this report, we discuss regional monetary policy dispersion and look at how advisors and their clients can ensure portfolios are diversified both across and within asset classes, as well as by geography, sectors, factors, investment styles and non-traditional market betas. This diversification is vital as it will allow preparations to be made for a period of higher-for-longer interest rates, and an uncertain growth outlook.

We have identified six areas we believe financial intermediaries should consider for client portfolios in 2023. Click the icon to navigate to read more.

[1] OECD. "Consumer Prices, News Release," available at www.oecd.org/sdd/prices-ppp/consumer-prices-oecd-08-2022.pdf.

1. Navigating recession risks

~~Lower for longer~~ Higher for longer?

"Shorter, narrower and more direct," the message to the financial markets was clear: The Federal Reserve will not hesitate to act to return US inflation to target, and is prepared to accept a sustained period of slower growth and higher unemployment to achieve it. As the world's most powerful central bank leads the charge against inflation – swiftly followed by others around the world – a global recession may be on the way.

For advisers and their clients, geographical portfolio diversification is going to be vital as regional monetary policy dispersion will affect the direction of rates, currencies and market support. For example:

- Central banks in Latin America are much further ahead of their developed-market counterparts in this tightening cycle.
- European central banks, along with the Reserve Bank of Australia, have been slower to respond.
- The two major central banks in Asia, the People's Bank of China and the Bank of Japan, are likely to maintain and possibly expand accommodative monetary policy.

However, despite having control over monetary policy, which can help slow demand and reduce domestic inflationary pressure, central banks have little influence over global supply shocks, which can force prices up again.

As noted by the IMF,[2] this mismatch can create headwinds for investors. A risk of stagflation therefore remains.

As a result, we believe advisors and their clients should prepare to pivot from a decade of lower-for-longer interest rates to a prolonged period of higher interest rates. They should expect an uncertain growth outlook.

This means addressing a traditional 60/40 portfolio with some urgency, as total returns from both bonds and equities in the first nine months of 2022 saw investors lose money.[3]

Unlike the last decade, in which diversification beyond these two asset classes offered limited rewards, we believe expanding portfolios both across and within asset classes, as well as by geography, sectors, factors, investment styles and non-traditional market betas, will offer the most potential for positive outcomes.

This is even more likely if equities and bonds move in the same direction, as they have this year, which may become the norm in a more inflationary environment.

59% of respondents believe the biggest investment opportunity over the next three years is in diversifying portfolios away from traditional equities and bonds.

Source: Mercer 2022 Global Wealth Management Investment Survey.

[2] IMF. "Confronting a perfect storm," available at www.imf.org/en/Publications/fandd/issues/2022/06/confronting-a-perfect-long-storm-tharman-shanmugaratnam.
[3] Mercer's Periodic Table of Index Returns, as of 30 September 2022

Considerations

- **Stress test higher for longer:** Assess the performance of client portfolios under various macroeconomic scenarios, paying particular attention to the path of inflation and interest rates. Explore whether portfolios are prepared for structurally higher inflation, determine whether you have the right mix of inflation protection assets and identify methods for strengthening the growth-inflation relationship within multi-asset portfolios. We discuss the potential benefits of this approach on our Yield Point SM blog: Endurance and resilience – putting portfolios to the test.

- **Portfolio transparency and ESG data "Operational Alpha":** Advisors who have an accurate picture of portfolio positions and ESG reporting are likely better positioned to communicate with their clients in an effective manner. We address portfolio transparency and ESG data in more detail, as the sixth theme to consider in 2023.

- **Diversify, diversify, diversify:** Consider moving away from traditional equities and bonds by exploring dynamic fixed-income strategies such as multi-asset credit, alternative investments such as hedge funds, and private markets. Consider issues such as liquidity, complexity and suitability.

- **Dynamic strategies:** Implement investment strategies that take advantage of different regional economic policies. Compared to the western world, China is in a better position to employ counter-cyclical policies to buffer against slowing global growth (assuming an end to its zero-COVID-19 policy). We believe advisors and their clients need to be mindful of (and comfortable with) geopolitical and governance risks when investing in emerging markets.

Figure 1. Asset class and style returns

2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	YTD
US REITs **19.7%**	Small Cap Core Equity **38.8%**	US REITs **28.0%**	Private Equity All **10.1%**	Small Cap Core Equity **21.3%**	Emerging Market Equity **37.3%**	Private Equity All **19.2%**	Large Cap Core Equity **31.5%**	Private Equity All **29.9%**	Private Equity All **53.1%**	Commodity **13.6%**
Emerging Markets Equity **18.2%**	Mid Cap Core Equity **34.8%**	Private Equity All **15.1%**	US REITs **2.8%**	High Yield Bonds **17.1%**	Developed Intl Equity **25.0%**	Treasury Bonds **0.9%**	Mid Cap Core Equity **30.5%**	Small Cap Core Equity **20.0%**	US REITs **41.3%**	Hedge Fund of Funds **-5.9%**
Developed Intl Equity **17.3%**	Large Cap Core Equity **32.4%**	Large Cap Core Equity **13.7%**	Large Cap Core Equity **1.4%**	Mid Cap Core Equity **13.8%**	Global Equity **24.0%**	Aggregate Bonds **0.0%**	US REITs **28.7%**	Large Cap Core Equity **18.4%**	Large Cap Core Equity **28.7%**	Treasury Bonds **-13.1**
Mid Cap Core Equity **16.6%**	Global Equity **22.8%**	Mid Cap Core Equity **13.2%**	Blended 65/35 **1.3%**	Large Cap Core Equity **12.0%**	Large Cap Core Equity **21.8%**	High Yield Bonds **-2.1%**	Global Equity **26.6%**	Emerging Market Equity **18.3%**	Commodity **27.1%**	Aggregate Bonds **-14.6%**
Emerging Debt Local **16.8%**	Developed Intl Equity **22.8%**	Blended 65/35 **11.0%**	Treasury Bonds **0.8%**	Commodity **11.8%**	Mid Cap Core Equity **18.5%**	Blended 65/35 **-2.5%**	Small Cap Core Equity **25.5%**	Mid Cap Core Equity **17.1%**	Mid Cap Core Equity **22.6%**	High Yield Bonds **-14.7%**
Small Cap Core Equity **16.3%**	Private Equity All **22.0%**	Aggregate Bonds **6.0%**	Aggregate Bonds **0.6%**	Emerging Market Equity **11.2%**	Private Equity All **17.1%**	Hedge Fund of Funds **-2.6%**	Blended 65/35 **23.3%**	Global Equity **16.3%**	Global Equity **18.5%**	Emerging Debt Local **-18.6%**
Global Equity **16.1%**	Blended 65/35 **19.3%**	Treasury Bonds **5.0%**	Hedge Fund of Funds **-0.3%**	Emerging Debt Local **9.9%**	Blended 65/35 **15.4%**	US REITs **-4.0%**	Developed Intl Equity **22.0%**	Blended 65/35 **14.6%**	Blended 65/35 **15.9%**	Blended 65/35 **-20.1%**
Large Cap Core Equity **16.0%**	Hedge Fund of Funds **9.0%**	Small Cap Core Equity **4.9%**	Developed Intl Equity **-0.8%**	Private Equity All **9.2%**	Emerging Debt Local **15.2%**	Large Cap Core Equity **-4.4%**	Emerging Market Equity **18.4%**	Treasury Bonds **8.0%**	Small Cap Core Equity **14.8%**	Large Cap Core Equity **-23.9%**
High Yield Bonds **15.8%**	High Yield Bonds **7.5%**	Global Equity **4.2%**	Global Equity **-2.4%**	Blended 65/35 **8.8%**	Small Cap Core Equity **14.6%**	Emerging Debt Local **-6.2%**	High Yield Bonds **14.3%**	Developed Intl Equity **7.8%**	Developed Intl Equity **11.3%**	Mid Cap Core Equity **-24.3%**
Private Equity All **12.5%**	US REITs **2.9%**	Hedge Fund of Funds **3.4%**	Mid Cap Core Equity **-2.4%**	US REITs **8.6%**	US REITs **8.7%**	Mid Cap Core Equity **-9.1%**	Emerging Debt Local **13.5%**	Aggregate Bonds **7.5%**	Hedge Fund of Funds **5.7%**	Small Cap Core Equity **-25.1%**
Blended 65/35 **11.9%**	Aggregate Bonds **-2.0%**	High Yield Bonds **2.5%**	Small Cap Core Equity **-4.4%**	Global Equity **7.9%**	Hedge Fund of Funds **7.6%**	Global Equity **-9.4%**	Private Equity All **11.9%**	High Yield Bonds **7.1%**	High Yield Bonds **5.3%**	Global Equity **-25.6%**
Hedge Fund of Funds **4.8%**	Emerging Market Equity **-2.6%**	Emerging Market Equity **-2.2%**	High Yield Bonds **-4.5%**	Aggregate Bonds **2.7%**	High Yield Bonds **7.5%**	Small Cap Core Equity **-11.0%**	Aggregate Bonds **8.7%**	Hedge Fund of Funds **6.7%**	Aggregate Bonds **-1.5%**	Developed Intl Equity **-27.1%**
Aggregate Bonds **4.2%**	Treasury Bonds **-2.8%**	Developed Intl Equity **-4.9%**	Emerging Market Equity **-14.9%**	Treasury Bonds **1.0%**	Aggregate Bonds **3.5%**	Commodity **-11.3%**	Commodity **7.7%**	Emerging Debt Local **2.7%**	Treasury Bonds **-2.3%**	Emerging Market Equity **-27.2%**
Treasury Bonds **2.0%**	Emerging Debt Local **-9.0%**	Emerging Debt Local **-5.7%**	Emerging Debt Local **-14.9%**	Developed Intl Equity **1.0%**	Treasury Bonds **2.3%**	Developed Intl Equity **-13.8%**	Treasury Bonds **6.9%**	Commodity **-3.1%**	Emerging Market Equity **-2.5%**	US REITs **-27.9%**
Commodity **-1.1%**	Commodity **-9.5%**	Commodity **-17.0%**	Commodity **-24.7%**	Hedge Fund of Funds **0.5%**	Commodity **1.7%**	Emerging Market Equity **-14.6%**	Hedge Fund of Funds **6.2%**	US REITs **-5.1%**	Emerging Debt Local **-8.8%**	Private Equity All **N/A**

Market Indicies - 10-year average return

- 18.0% **Private Equity All** Burgiss Private iQ All
- 11.7% **Large Cap Core Equity** S&P 500
- 10.3% **Mid Cap Core Equity** Russell Midcap
- 18.0% **Small Cap Core Equity** Russell 2000
- 7.3% **Global Equity** MSCI ACWI Net
- 7.2% **Blended 65/35** 65% S&P 500/35% Barc
- 7.0% **FTSE NAREIT Equity** US REITS
- 3.9% **High Yield Bonds** Bloomberg High Yield
- 3.7% **Developed Intl Equity** MSCI EAFE Net
- 3.6% **Hedge Fund of Funds** HFRI Fund of Funds
- 1.0% **Emerging Markets Equity** MSCI EMF Net
- 0.9% **Aggregate Bonds** Bloomberg Aggregate
- 0.5% **Treasury Bonds** Bloomberg Treasury
- 3.6% **Commodity** Bloomberg Commodity
- 1.0% **Emerging Debt Local** JP Morgan Emerging Market GBI-EM

Source: Mercer's Periodic Table of Index Returns, as of 30 September 2022

2. Capturing themes in private markets

Investors have traditionally turned to private markets to help enhance diversification and capture greater alpha potential. As investors are finding, this approach can also bring elements of innovative strategies, alongside access to a diverse range of opportunities to meet their clients' sustainability and environmental impact goals.

Our recent paper (*Raising your impact ambition*) takes a closer look at the practical implementation of the private markets approach.

The deep opportunity set that exists in private markets allows investors to diversify across a range of managers and strategies. The starting point for this approach is an effective portfolio construction process to identify themes and opportunities. It is also vital to apply a rigorous due diligence process to help ensure a balanced blend of strategies diversified across, geographies, sectors and vintage years.

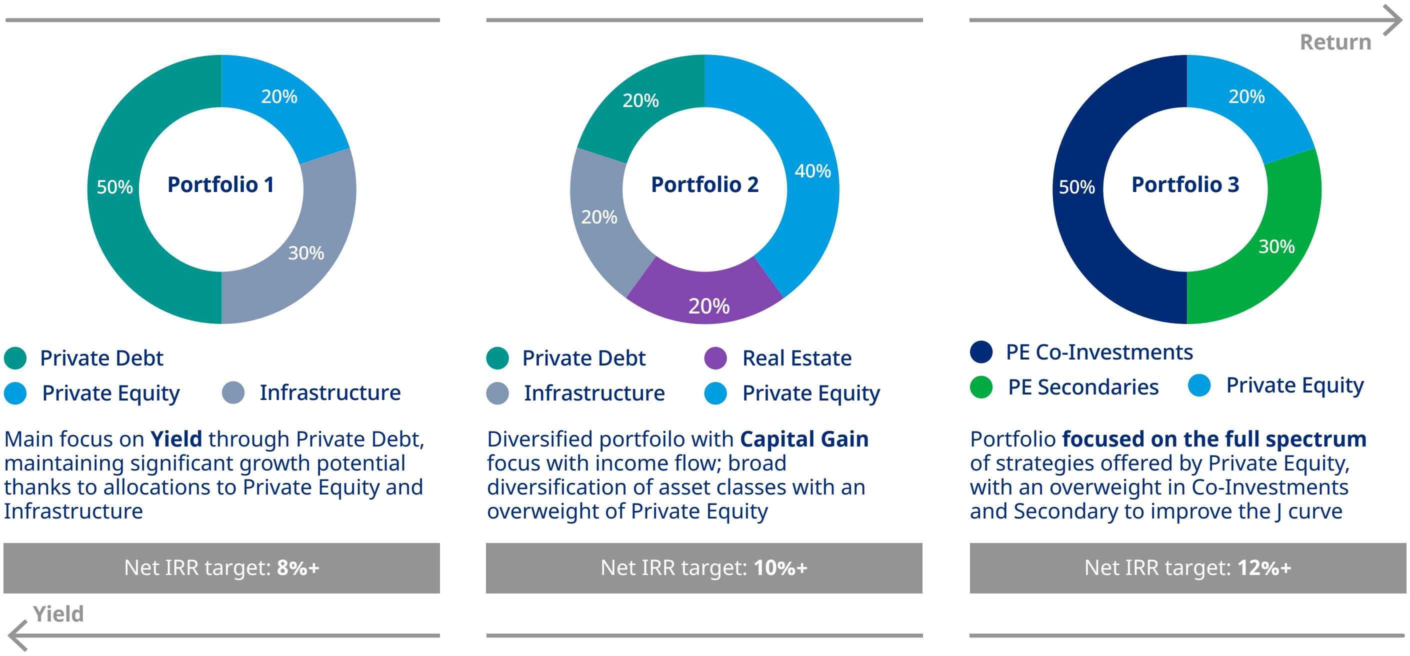
73% of respondents are either currently invested or are considering investing in illiquid assets over the next 12 months.

Source: Mercer 2022 Global Wealth Management Investment Survey.

In order to target different return profiles and objectives, investors typically allocate to a range of private market asset classes.

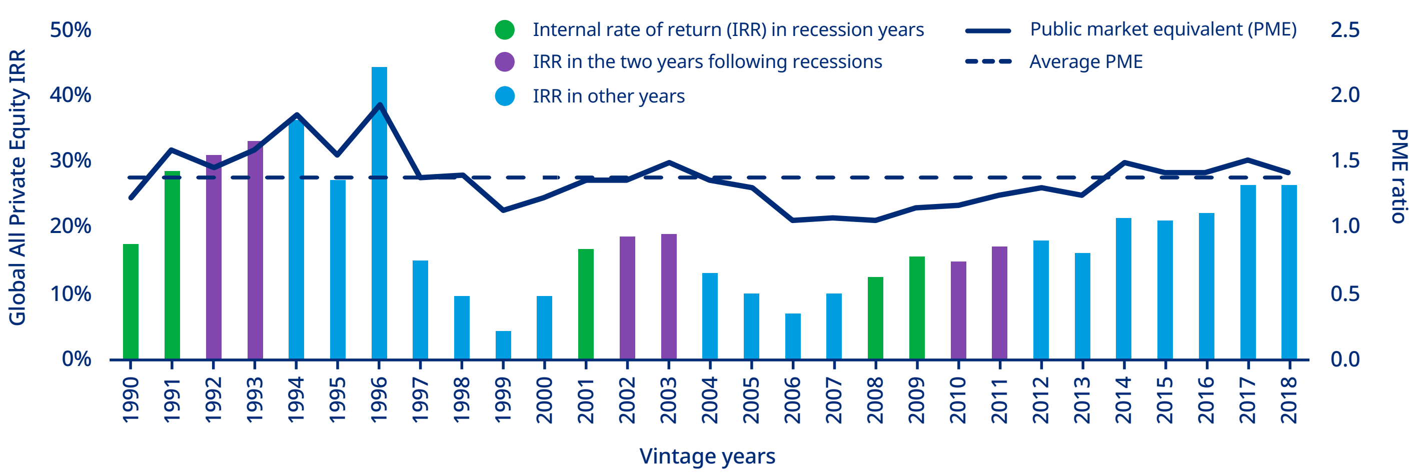
Figure 2 demonstrates the potential outcome of blending various private market strategies.

Figure 2: Illustrative multi-sleeve private markets program



Private market vintages raised during recessionary periods or downturns have historically seen strong long-term returns. As private market strategies deploy capital over time (usually years), they can exploit the drop in asset pricing that is typically seen during recessions. Figure 3 shows how private equity funds have performed during both the dot.com bubble (2001-2003) and the great financial crisis (2007-2009).

Figure 3. 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.

Perhaps due to recent public market volatility, growth in private markets looks strong. It is estimated that private equity assets under management will grow by 16% per annum until 2025 (to $10 trillion), with private debt expected to grow by 11% p.a.[4] Similarly, we believe strong asset growth is expected in infrastructure equity and real estate, as they often offer protection against inflation.

[4] Preqin. *The Future of Alternatives 2025*, December 2020.

Considerations

- **Inflation playbook:** Private-markets debt may have various built-in inflation hedges if persistent price increases become a longer-term trend, and their structures are often less impacted by inflation. A sector-specific focus on issuers and organisations with a track record should serve advisors and clients well.

- **Climate transition:** The escalation of the Russian/Ukraine war has intensified the debate around how to balance energy security with long-term sustainability goals. Investors in private markets have a more direct connection with holdings than they would with publicly listed assets, and therefore may be more able to influence how these holdings are managed. Coupled with a long-term investment horizon, this will potentially attract new capital to these companies and helps drive the transition to a more sustainable path.

- **Modern diversification (going beyond beta):** Private markets can potentially offer access to innovative investment opportunities[5], while sidestepping much of the volatility that stops listed companies from trying to implement change. Moreover, as concentration increases within public markets, the potential for outperformance over the long term may lie in private companies and in assets where innovation and a strong focus on objectives can be rewarded.

- **Access and implementation:** Technology platforms can address the dual challenges of access for all clients and the administration of capital calls. Additionally, a growing range of semi-liquid, interval and continuation funds provide some liquidity for investors. Open-ended solutions in real estate, infrastructure equity and private debt are also beginning to offer investors some liquidity.

- **Portfolio construction:** Within private markets, there are relatively long investment periods and significant dispersion of returns. Detailed manager due diligence is therefore critical, as is allocating over various vintages.

- **Illiquidity:** It is imperative advisors and clients are comfortable with illiquidity or explore opportunities that facilitate greater liquidity to match their investment portfolio constraints and requirements.

[5] Mercer cannot guarantee access to opportunities. Access is at the discretion of the investment manager.

3. A hedge fund renaissance

The macroeconomic environment of the last decade challenged hedge funds to outperform, causing them to lag behind listed equities. To keep pace, hedge fund managers would have had to increase their risk-taking through leverage, directionality or beta (or a combination of all three). This would not have provided investors with the diversification qualities they expect from such strategies.

To access a more in-depth discussion on this topic, conducted with our global CIO for hedge funds, listen to our **critical thinking, critical issues** podcast: ***Hedge funds: the comeback kid?***

Interestingly, our recent global survey of wealth managers showed that among those already invested in hedge funds, **76% are satisfied with the level of diversification and 73% are satisfied with liquidity.**

We believe that investment returns from traditional equity and fixed income assets will be much lower over the coming years than they have been in the last decade. As a result, an allocation to hedge funds should be considered. Unlike long-only funds, and being benchmark-agnostic, these strategies often deploy a wide range of risk management and diversification tools or alpha-seeking options during periods of high macroeconomic volatility. However, it should be noted that these tools can carry a higher fee than traditional equity and bond strategies, and can offer reduced liquidity.

Hedge fund allocations can be structured to serve a variety of roles within a portfolio, potentially offering a return profile of cash plus 3% to 4% per annum over a full market cycle.

Manager selection is the key determinant of a successful hedge fund investment experience, with portfolio construction running it at close second — as we outlined in our recent paper *Managing a Hedge Fund Allocation: What is the recipe for success?*

24% of wealth managers intend to increase their exposure to hedge funds over the next 12 months predominately for potential downside protection and diversification.

Source: Mercer 2022 Global Wealth Management Investment Survey.

Considerations

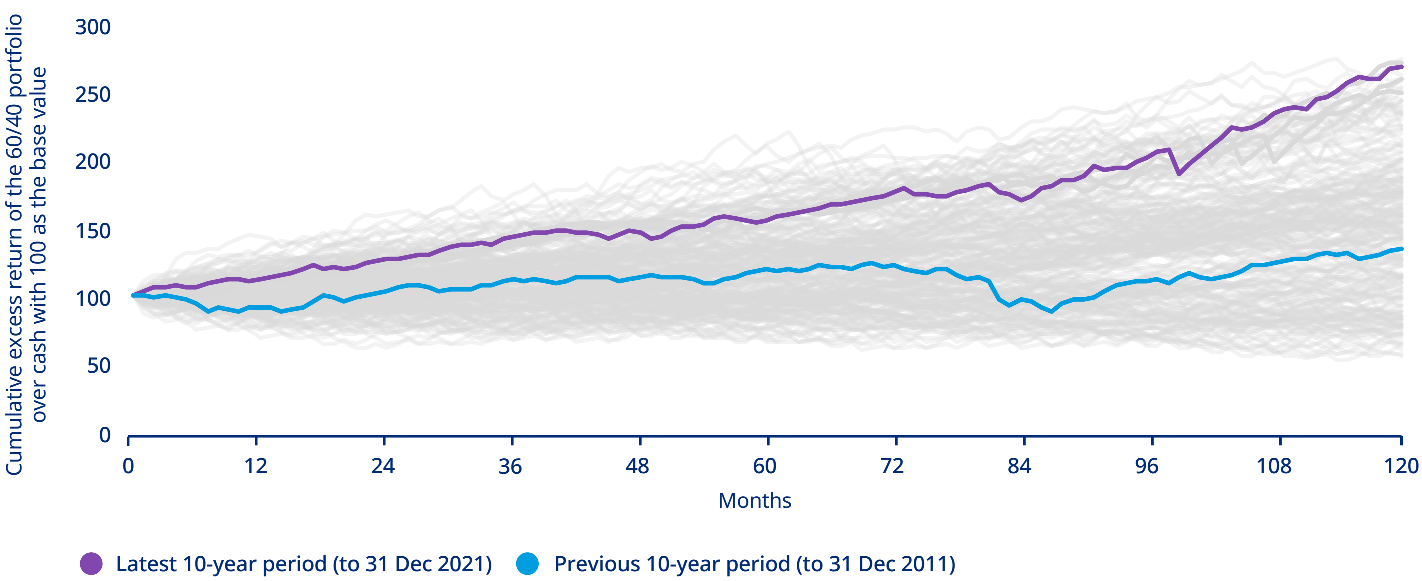
- **Alternative sources of return:** Hedge funds utilize a wide variety of trading strategies, implemented to various risk tolerances, to isolate a collection of alternative risks. Examples of these "hedge fund return drivers" are bi-directional security selection, deal risk premium, complexity premium, liquidity/time horizon premium, spread risk premium, variable beta and macro trends/changes.

- **Determine the role:** Hedge fund allocations can be structured to meet various needs within a portfolio, ranging from risk reduction to return enhancement. They also provide opportunities for portable alpha and portfolio hedging. Determine the main objective of your hedge fund allocation and build your diversified portfolio of managers around this.

- **Recognize the risk:** Implementation risk is high for hedge funds as there is no passive alternative. Due to relatively lower redemption opportunities and long advance-notice requirements, they are also a poor source of rebalancing capital. As a result, we believe it is best to establish a strategic, long-term allocation that can be carried during strong equity markets.

- **Complexity and liquidity:** Many hedge fund strategies are complex, and client education is vital. In addition, hedge funds have higher fees and protracted redemption periods. Focus on manager selection and portfolio construction, as we believe these are the key determinants of a successful hedge fund investment experience.

Figure 4: 10-year excess return of a 60/40 portfolio
(From beginning of quarters September 1954 – December 2021)



Excess return is on a portfolio of 60% stocks (as represented by the S&P 500) and 40% bonds (as represented by the 10-Year US Treasury) over cash (as represented by the Fed Funds rate). DATA SOURCES: Stocks & bonds data: Robert J. Shiller (Data Used in "Irrational Exuberance" Princeton University Press, 2000, 2005, 2015, updated) (http://www.econ.yale.edu/~shiller/data.htm). Cash data: Board of Governors of the Federal Reserve System (US) via FRED.
This chart is for information and illustrative purposes only; performance is hypothetical. It shows the nominal performance above cash for a 60/40 portfolio over all 10-year periods since 1954 (i.e., 1954-1963, 1955-1964....2011-2020) – **the grey lines**. Observations are overlapping with start dates set one quarter apart. The **purple line** highlights the recent decade (2011-2020), which was within the top quartile of all 10 year periods since 1954, while the **blue line** highlights the previous decade (2001-2010), which was close to the lowest quartile.

Note: This chart uses S&P 500 data from Professor Shiller's website in order to go back to 1954, whereas the S&P 500 TR was launched in 1989. Shiller does not use conventional closing prices but monthly averages and interpolated dividends, so Shiller's data will not line up with the more conventionally calculated S&P 500 TR. "S&P 500 TR" refers to S&P 500 Carry Adjusted Total Return Index, which measures the performance of a strategy representing a total return swap on the S&P 500® with gross dividends reinvested. There are inherent limitations of the hypothetical portfolio as the investment selections have been selected with the benefit of hindsight based on actual historical data, does not represent actual trading, assumes that asset allocations would not have changed over time and in response to market conditions. Actual results could differ materially. Past performance is no guarantee of future results. Investing in securities products involves risk, including possible loss of principal as the value of investments fluctuates.

4. Adopting a pragmatic approach to net zero

At a time when developed countries are making a herculean effort to reduce carbon emissions, there have been not one, but two global supply shocks that have complicated an already complex energy transition. The COVID-19 pandemic and Russia's invasion of Ukraine have increased the vulnerability and sensitivity of the world's energy systems.

In the US, capacity and storage have been an issue, while Europe's overreliance on Russian gas and oil has been underlined. In China, soaring summer temperatures have hampered hydroelectric power generation. Additionally, besides these geopolitical, industrial and climate change-related challenges, there has also been the issue of changing investor behavior.

There has been a trend among some investors to remove fossil fuel stocks from portfolios and to purchase clean energy stocks. This has led to some companies redirecting cap-ex into alternative energy solutions, rather than finding and supplying more fossil fuels. This is intended to help develop long-term solutions, but has exacerbated an already delicate energy situation. It has also caused some active managers to underperform this year due to a systematic underweighting of resource stocks. In addition, it has contributed to a greater tracking error.

A pragmatic approach to the challenge of countries and industries reaching net-zero emissions should be considered, focusing on the integration of environmental, social and governance (ESG) issues and engagement. An investment process shaped in response to climate-related risks and opportunities would reflect this approach. They should also be prepared for future periods of energy-driven inflation and slower economic growth. Our latest paper (*Advancing the transition: Seeking to mitigate risk and drive adaptation beyond COP27)* details practical solutions to address four challenges related to climate investing. It shares the industry global best practices of large asset owners, which have been captured using our new Climate Benchmark tool, Analytics for Climate Transition 'ACT'.

82% of wealth managers said that client demand for ESG products has increased over the past 12 months. The main driver for this demand was societal sentiment.

Source: Mercer 2022 Global Wealth Management Investment Survey.

Considerations

- **Explore effective engagement:** Seek out investment managers who engage companies actively and effectively. Focus on the quality, rather than the quantity, of engagement. There are two ways to influence portfolio companies to lower real-world carbon emissions:
  - Engage with investment managers on areas of high-stranded asset risk, as this is a key tool to help ensure that portfolios are managing short-medium-term investment risk properly.
  - Ensure investment managers engage with their investee companies to set concrete and verified science-based targets.
- **Look to a better future:** Plan for the changes that need to happen to place the world on a more sustainable path. Impact investing and the management of resources will help facilitate the required green transition. Do not be discouraged by short-term transition difficulties.
- **Make great plans:** Create a transition roadmap to help navigate the complex interrelated challenges of decarbonizing the global economy. Use the roadmap to break the challenge into applicable investor steps that address clients' unique objectives.
- **Form a good data habit:** Integrate client climate reporting across asset classes and as part of investment manager monitoring. This will enable advisers and their clients to track portfolio progress against transition roadmaps and climate commitments.

5. Proliferation of alternative products

Technology is changing wealth management, and this paradigm shift is already accelerating the transformation of advisor service and operating models. This has enabled the democratization of the sector and allowed advisors to expand their reach down from ultra-high-net-worth individuals to the affluent to the mass-affluent. This transformation is positive for advisors seeking to increase revenue and access a larger client pool.

We have also noticed an accelerating trend relating to the proliferation of alternative products, especially in the area of private markets, sustainable investments and digital assets. Various retail and accredited solutions are being developed and sold to financial intermediaries. These include active exchange traded funds (ETFs), interval funds, tender offer funds, business development companies (BDCs), closed-end funds (CEFs) and public non-traded real estate investment trusts (REITs). These products have been created to meet the increase in the number of advisor platforms that cater for alternative investments, and also to address the rising demand for liquidity, lower fees and enhanced transparency.

Private markets had been relatively inaccessible to wealth managers due to a range of factors, including high investment minimums, complex cash flow administration and suitability concerns. Developments in fund structures, platforms and regulations have helped to enable advisors to overcome these barriers. For instance, technology-enabled investment platforms allow advisors to access private markets for a lower minimum investment, and simplify the administration of cash flow (capital calls and distributions) and suitability procedures.

Since the advent of these new investment structures, it has become increasingly easy for smaller clients to purchase complex products that were previously only available to large, qualified clients. In addition to enhancing portfolio returns, accessing non-traditional asset classes can be beneficial to portfolio diversification and can help in the transition away from the traditional 60/40 portfolio model. It is important, however, for advisors and their clients to properly understand the risks involved with all these techniques, strategies and asset classes.

Considerations

- **Look before you leap:** Advisors should be alert to the proliferation of alternative products now available to clients. Illiquid products are increasingly being offered in lower minimum accounts and retail accounts, and it is important to remain vigilant.

- **Education, education, education:** Focus on educating advisors and clients about these new structures. It is essential that both are fully aware of the opportunities and risks associated with them.

- **Buyer beware:** The caveat emptor principle applies more than ever when considering alternative investments. Fund structures, terms, liquidities and the underlying portfolio of investments should be fully understood by advisors.

- **Know your client:** Ensure that the investment is suitable. The end client's liquidity and risk profile must be carefully considered before investing.

- **Stay in the loop:** Adopt a perpetual approach to investment and operational due diligence. Apply greater scrutiny to non-institutionally managed funds and illiquid products held by lower high-net-worth individuals, mass-affluent and retail clients.

- **All funds are not created equal:** Some asset classes fit better in certain structures. Also, be aware that these new products are not identical to those they attempt to emulate. For example, daily dealing liquid alternative funds are not the same as traditional multi-strategy hedge funds.

6. Portfolio transparency and data “Operational Alpha”

A trend emerging within Europe is that in times of heightened market volatility, advisors must be able to communicate with clients using reliable and up-to-date portfolio information and have in place a robust and dynamic governance framework. We believe advisors who have an accurate picture of portfolio positions are more likely to be in a position to demonstrate ‘operational alpha’, and be ready to capture opportunistic investments, as and when they arise. A thorough portfolio analysis, for example, would provide an indication if allocating to credit dislocation funds during a market downturn would be appropriate.

A reliable source to obtain data on underlying positions should provide security-level information to determine whether they are behaving as expected at fund, asset class and overall portfolio level.

For advisors who work with multiple investment managers and sources of data this can be challenging. A significant amount of time can be spent aggregating data from multiple sources. This can limit the time available for the actual analysis of the underlying portfolio and make timely decisions.

Additionally, regulators and clients are seeking enhanced transparency on ESG issues to demonstrate compliance with policies, regulations and marketing collateral. We believe that having this transparency and insight fundamentally improves the investment process, client interactions and outcomes. This is particularly true for those advisors who utilize multiple managers within their portfolios and who deal with situations in which underlying positioning is relatively opaque.

78% of wealth managers said improving the client experience is their leading business priority over the next two years.

Source: Mercer 2022 Global Wealth Management Investment Survey.

Considerations

- **Know your strengths:** Review your look-through capabilities in relation to your portfolios. Does your investment team have a reliable and accurate picture of how portfolios are positioned at a security level?

- **Are you wasting time?** Determine if your team spends too much time on the aggregation of information across portfolios. In particular, are they spending a disproportionate amount of time on these activities and not on core competencies such as investment decision making and meeting with clients?

- **Who's monitoring your managers?** Check if underlying portfolios are regularly monitored. Are you aware if a manager's tracking error is too low or if they drifted from their prescribed investment style? What do you do if two managers who are supposed to be uncorrelated suddenly take similar positions? Reflect whether an additional layer of monitoring would enhance your risk management framework.

- **Show what you know:** Develop a framework that can demonstrate your ESG commitments and the value these add for your clients. Advisors who are in a position to do this are more likely to excel in client acquisition within an ESG-conscious market.

Conclusions

Growing geopolitical risks and tightening financial conditions mean that wealth managers face an increasingly challenging investment outlook. The key areas we have addressed in this report will help advisors and their clients to navigate the year ahead. We understand that some of the topics covered may be relatively new. If you would like to discuss these or any of the other considerations, please reach out to your local Mercer advisor. Mercer offers a spectrum of services that include innovative tools, investment advice and portfolio solutions, all of which can be tailored to suit the specific needs of wealth managers and financial intermediaries.

Additional reading resources

Mercer 2022 Global Wealth Management Survey

Themes and Opportunities 2023 - déjà new

Private markets themes and opportunities - inflation playbook

Private markets themes and opportunities - positioning for transition

Private markets themes and opportunities - modern diversification

Managing a hedge fund allocation - what is the recipe for success?

Systematic macro hedge funds: trending into a new regime

Advancing the the transition - seeking to mitigate risk and drive adaptation

Advancing transition potential: global asset manager survey results

If you would like to discuss the findings within this report in more detail or how we may be able to support your organization, please contact your local wealth management representative.

Alternatively, visit https://www.mercer.com/wealthmanagement for more information on how we work with financial intermediaries.

Amit Popat
Europe and IMETA

+44 7789 030712
amit.popat@mercer.com

Gregg Sommer
US

+1 312 203 1538
gregg.sommer@mercer.com

Luke Fitzgerald
Australia

+61 4 1240 2722
luke.fitzgerald@mercer.com

Yaser Z. AbuShaban
United Arab Emirates

+971 56 5248696
yaser.abushaban@mercer.com

Cara Williams
Global

+44 7789 030669
cara.williams@mercer.com

Janet Li
Asia

+852 6117 2997
janet.li@mercer.com

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