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Top investment considerations for financial intermediaries 2024

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Introduction

We have identified five issues that we believe financial intermediaries should consider for client portfolios in 2024.

1. Responding to the changed opportunity set
2. Integrating structural trends and addressing emerging risks
3. Accelerating capital deployment within a multi-sleeve private markets program
4. Targeting asymmetric alpha
5. Considering opportunities in credit

Our 2024 Themes and Opportunities paper calls the years ahead an "An Age of Agility." It highlights the fact that the next 12 months abound with unknowns, that it's essential to be wary of unrewarded risks and that everyone should keep in mind Alexander Pope's message that "only fools rush in where angels fear to tread."

The global investment landscape is undergoing a profound transformation. The once disinflationary effects of globalization are waning, and the world is leaning increasingly toward factionalization and friend shoring. Issues such as resource nationalism, the possibility of "greenflation" due to energy transitions and emerging inflationary pressures highlight this transformation. The past trend of reduced labor costs due to automation and outsourcing is being replaced by challenges that include rising commodity prices and the potentially negative implications of AI.

With higher interest rates and tighter financial conditions, the spotlight is on alternative capital sources, favoring private lenders. Moreover, as the global community becomes increasingly aware of growing environmental crises and nature-related risks, investment strategies are evolving. The recent framework from the Taskforce for Nature-related Disclosures (TNFD) hints at the dawn of regulatory changes in this space.

In this report, we look at a notable development — the flattening of the global efficient frontier. In this area, there have been changes in the expected returns for the risk taken on, which have significantly changed the outlook for several asset classes. We therefore set out the ways in which advisors and their clients can enhance their resilience and adaptability. We also look at how they can strategically shape and position their portfolios to flourish in this shifting investment environment.

We emphasize the importance of a strategic asset allocation review that incorporates structural trends and addresses emerging risks. Such reviews enable portfolios to stay focused on long-term goals amid the noise of short-term fluctuations. We also provide insights on accelerating capital deployment within a multi-sleeve private markets program — a way to target asymmetric alpha in a world of dispersion and dislocation. We also highlight the semiliquid, bidirectional and private markets opportunities available in the realm of credit.

1

Responding to the changed opportunity set

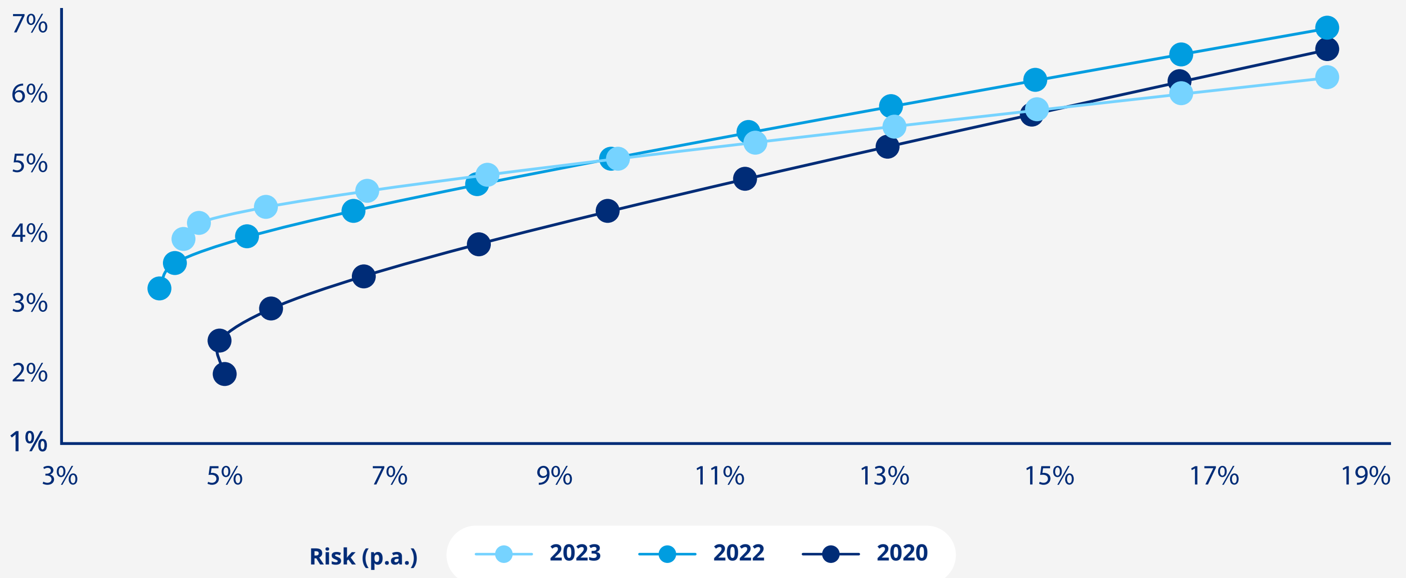
The global efficient frontier has been fundamentally reshaped by significant shifts in the financial landscape. These changes stem from a substantial increase in global bond yields resulting from an aggressive monetary-policy-tightening cycle coupled with a robust resurgence in global equity prices (which had hit a low in 2022). As a result of these dynamics, the front end of the efficient frontier has risen sharply, while the back end has experienced a decline (Figure 1). This shift carries several implications for portfolio construction:

Improved risk-return trade-off: In 2023's flatter frontiers, the incremental return for taking on more risk is smaller than in previous years. This shift represents an "efficiency gain," in that investors can achieve a given level of return with less risk, with implications for total portfolio construction.

Incentive to explore alternatives: There is an opportunity to further improve on portfolio efficiency through the introduction of alternative investments that look particularly attractive in this environment, such as private debt and hedge funds.

In light of these developments, we strongly recommend expediting a strategic asset allocation review. Such a review is essential to realign asset allocation with the evolving investment landscape as the substantial shift in underlying investment dynamics mandates a thorough reevaluation of medium- to long-term portfolio positioning.

Figure 1 | Global efficient frontier



Hypothetical performance,[1] based on Mercer capital market assumptions for global broad fixed income hedged and global equity all cap unhedged.

Source: Mercer. Data as of July 2023.

Considerations

- **Undertake a strategic asset allocation and portfolio governance review:** In response to the evolving investment landscape, we strongly recommend expediting a strategic asset allocation review. Such a review is essential to realign asset allocation with the evolving investment landscape as the substantial shift in underlying investment dynamics mandates a thorough reevaluation of medium- to long-term portfolio positioning.
- **Look beyond traditional fixed income:** Embracing the broader spectrum of fixed-income options becomes crucial in a higher-interest-rate environment. This spectrum encompasses semiliquid opportunities, such as opportunistic multi-asset credit, bidirectional hedge fund credit strategies and private markets credit opportunities.
- **Target asymmetric alpha:** Advisors should explore a diversified and dynamic collection of alternative risk-and-return alpha streams implemented by allocating to a multi-sleeve hedge fund program that incorporates dedicated convex strategies. Collectively, the allocation should complement a broader portfolio of traditional risks while also serving to dampen downside risks.
- **Reevaluate risk-profiling processes:** As strategic asset allocations of risk-rated portfolios are reviewed, clients' risk profiles will also need to be revisited.

2 Integrating structural trends and addressing emerging risks

The world has changed dramatically over the past decade, with significant shifts in areas such as inflation, interest rates, globalization, technology, resources, climate change and nature. All of these developments indicate a shift to a new regime within which investors must now operate.

We therefore recommend that advisors incorporate these structural trends and any emerging risks into their thinking as they construct their client portfolios. Our definition of structural trends and emerging risks encompasses long-lasting, multidimensional changes that can be classified into three distinct categories:

1. Regime change: One-off, persisting paradigm shifts in conditions, as in the shift in the efficient frontier (Figure 1). The increased opportunities for hedge funds from greater volatility, dispersion and dislocation are discussed in Section 4.

2. Supercycles: Conditions driven by supply/demand imbalances that outlast multiple individual market cycles. Increasing protectionism, supply chain pressure and the needs of the long-term energy transition all skew inflation risks to the upside.

3. Megatrends: Multidecade transitions that are gradually but steadily materializing and have the potential to transform the global economy and society. Examples of megatrends include regulation on nature-related issues and the need for sustainable agriculture and energy transition (specifically, the next phase, addressing hard-to-abate sectors, such as aviation or shipping, and the role of critical minerals therein).

Wealth managers with long-term investment horizons should recognize these structural trends as potential sources of long-term investment returns as well as opportunities to preserve intergenerational wealth. In terms of opportunities, we recommend focusing on megatrends and supercycles, delegating microtrends and, most significantly, avoiding hype and any other noise.

Figure 2 | Risks and opportunities of structural trends

- Beware left-tail risks when correlations go to one
- Factor diversifiction over asset class diversification

- Be on the right side of history
- Position for regime changes and structural trends
- Accommodate right-tail opportunities

It is crucial to keep in mind that investing in structural trends requires patience and a long-term perspective. Investors should work to a minimum performance measurement timeframe of five years. While outperformance over global equities is expected, it is important to adjust expectations accordingly and not to focus on short-term horizons. To invest in structural trends, we recommend an active multimanager, multi-theme portfolio with selectively chosen themes.

Considerations

- **Beware of rose-tinted glasses:** Stay vigilant about biases that are rooted in past performance or based on romanticized narratives. Investors should not let history cloud their judgments. To effectively manage long-term opportunities, consider the risks associated with structural trends in the strategic asset allocation framework. Diversifying a structural trend portfolio across different futures and scenario testing can also help manage long-term risks.

- **Be smart about risk budgeting:** To enable a direct comparison with other investments, it is advisable to allocate a risk budget to structural trend investments. You should also assess multiple dimensions of risk at the total-portfolio level on a look-through basis. Don't frame your risk budget around relative returns and correlations.

- **Play the long game:** Strategic asset allocation is a marathon, not a sprint. Keeping your eyes on long-term goals and avoiding reacting to short-term underperformance is prudent for investors in uncertain markets.

- **Terminology matters:** Advisors should exercise caution when labeling investment strategies as "thematic." Such terms can carry emotional baggage and potentially deter any serious considerations. If the approach genuinely aligns with lasting structural trends, choose terminology that conveys a sense of their enduring nature.

- **Need for speed:** To add long-term portfolio resilience, advisors should proactively position clients toward emerging structural trends and opportunities. Use an active, multi-manager, multi-theme strategy to prepare against a divergence of futures.

3

Accelerating capital deployment within a multi-sleeve private markets program

Predicting individual GP capital drawdowns remains challenging due to fluctuating market conditions and deal-closure success rates.

For advisors venturing into private markets, it's vital to realize that commitment doesn't directly translate to exposure. Typically, investors set an annual capital deployment goal to private markets. This is often grounded in an investment-pacing model. Throughout the year, they partner with various fund managers to hit this allocation. But after committing, limited partners (LPs) relinquish control over when and how much capital gets called — this is a discretion held by the general partner (GP). It is important to remember that during times of high economic uncertainty, GPs call capital less quickly (we cover this topic in more detail in our research paper *Characterizing Capital Calls*).

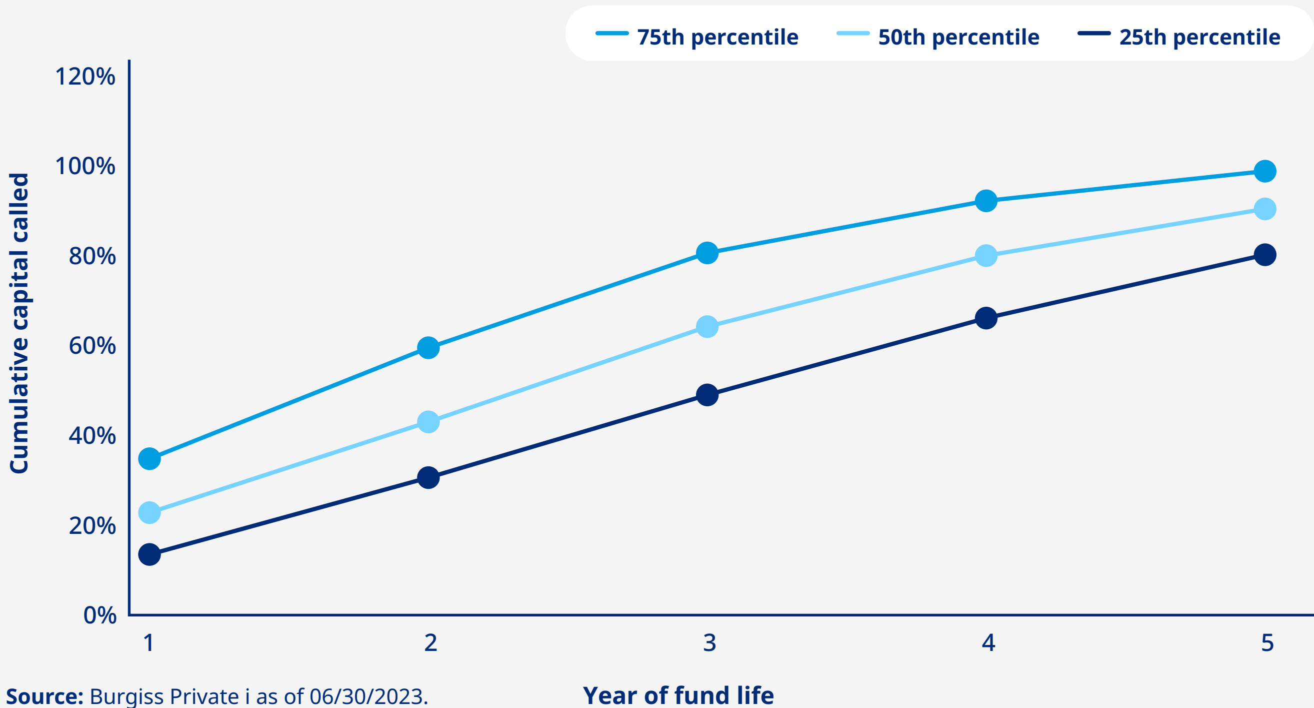
Notably, even three years post-commitment, capital calls can vary considerably. For instance, by the third year, a stark 32% difference exists between the 25th and 75th percentiles (see Figure 3 on the following page), which leaves LPs uncertain about their GP's exact position within that spread. The operation of private markets is therefore unlike that of many asset classes that allow swift capital deployment post-allocation.

Capital drawdowns fluctuate based on the fund manager's sector and strategy. Sectors such as early-stage venture capital and biotech typically make minimal starting investments and earmark significant capital for subsequent financing rounds of their chosen companies (if they prosper). If ventures don't pan out, this reserved capital redirects to other investments. Consequently, a manager might seem to be lagging in the pace of their investments since the reserved capital has not been called. The reality is that they could be leading, especially if they have a high "winner" count. This is a situation LPs can appreciate.

Even within a single sector, variances exist. For example, a buyout fund focused on add-on investments might reserve more capital than one emphasizing operational enhancement.

Predicting individual GP capital drawdowns remains challenging due to fluctuating market conditions and deal-closure success rates. However, given that most private market funds maintain compact portfolios (between 15 and 25 companies), a manager can swiftly shift from a lagging investment pace to a leading one if they seal more deals than anticipated. For more in-depth insights on this topic, see our research paper *Lags in Private Markets — Private Market Insights*.

Figure 3 | Called by year of fund life



Source: Burgiss Private i as of 06/30/2023.

Considerations

- **Strategic blueprint:** Craft a resilient long-term portfolio strategy. Meeting risk and return goals while accommodating unique scenarios can help things sail smoothly, even during economic downturns.
- **Employ a quality pacing plan:** Due to the long-term nature of private markets, we believe it is important to employ a quality cash-flow pacing model. This should allow for the testing of assumptions and for the determination of sensitivities. It will enable managers to anticipate liquidity needs and offset potential challenges, especially for newly established programs.
- **Vehicle consideration:** Private market vehicles have evolved over the years, with some GPs now offering evergreen structures that can deploy capital immediately and reduce the J-curve effect. Additionally, interval fund structures have also seen considerable growth. These can reduce the complexities associated with pacing in closed-end fund structures.
- **Liquidity lifeline:** Bridge the gap between commitment and deployment by ensuring liquidity for unpredictable capital calls. Newer programs may struggle more, whereas mature ones can balance calls with distributions. Stay agile during periods of high deal flows in order to manage liquidity adeptly. Consider allocations to secondaries and co-investments that offer benefits such as mitigation of the J-curve effect, reduction of “blind pool” risk, increased diversification and accelerated exposure buildup.

- **Develop a robust manager-selection process:** Manager selection in private markets is critical. Elite managers recognize potential pitfalls and strategize to diminish their effects. For instance, many elite managers have deep experience across various market cycles and have developed toolsets that allow them to generate attractive returns even in poor markets.

- **Balance discipline with adaptability:** In tough times, seize the chance to partner with top-tier managers that have previously been out of reach. This could improve the lag between allocation and exposure while also improving the quality of the investor's portfolio.

- **Establish strong communication with managers:** Engage proactively with private market managers. Although they aren't bound by public disclosure norms, many are open to sharing insights, helping you gauge portfolio prospects more accurately.

4

Targeting asymmetric alpha

Allocators may want to consider dedicated and tactical exposure to hedging strategies across equity, credit and volatility.

In this evolving investment landscape, our recommended approach for advisors is to pursue a diversified and dynamic collection of alternative risk-and-return alpha streams. This could be done by allocating to a hedge fund program and incorporating a mix of hedge fund strategies. Collectively, the allocation should complement a broader portfolio of traditional risks while serving to dampen downside risks. Given our view of current market and geopolitical risks, investors may want to consider adding dedicated convexity as part of their hedge fund programs (or in addition to them) in an effort to build in further asymmetry.

We firmly believe that global monetary policy has entered a new regime — one where the easy-financing punchbowl has been removed and the return potential for traditional risk assets now looks less favorable. This has ushered in a renewed focus on portfolio resilience. We expect sustained, broad-based volatility and dispersion. This will occur across asset classes, markets, regions, inflation and currencies. It will allow for long/short investing and hedges to deliver positive benefits. We are more confident than ever that this will result in a multi-year opportunity set for unconstrained hedge funds. As a result, maintaining allocations should continue to serve investors well. For investors who currently lack an allocation, now may prove a timely entry point into alternative diversification that fills the void between public and private opportunities. This is likely to provide improved benefits in a variety of hedge fund strategies, such as increased diversification, inflation protection and downside mitigation. Importantly, our target remains cash +3%–4% for a well-balanced hedge fund portfolio. Looking ahead, this suggests a 7% to 9% return, which we think will be quite attractive for portfolios.

Additionally, allocators may want to consider dedicated and tactical exposure to hedging strategies across equity, credit and volatility. This will provide added tail protection by seeking to balance premium/costs with convexity and liquidity. Executed effectively, such an allocation could serve to deliver high convexity when it is needed most and a source of liquidity for tactical deployment. Lacking any meaningful dislocation event, the allocation may produce a slight drag on performance; therefore, allocators need to consider sizing.

Moreover, in some scenarios, a standalone hedging strategy could be considered to bolster the overall protection of the total portfolio. In such an approach, it must be recognized that the allocation size that is considered beneficial for a hedge fund program may prove inadequate for the total portfolio.

Figure 4 | A fruitful environment for hedge funds

Considerations

- **Explore alpha benefits:** Diversification has not been well rewarded during the post-global financial crisis (GFC) era. This is because global policy induced a risk-on environment of unprecedented proportions. Recent policy reversals have meant that it is easier for absolute-return-oriented cash-plus mandates to deliver in that respect. Not only can this approach serve as a complement to portfolios, it might actually be critical for meeting objectives.
- **Risk diversification:** Investors should ensure their hedge fund program is optimized with the right blend of risk and return drivers and nimble mandates for this new environment. Broad, global, generalist mandates may serve to ensure flexibility, which will help you navigate uncertain markets.
- **Risk-relative position-sizing:** It is possible to manage risk effectively by limiting exposure to any single underlying hedge fund and by sizing inversely to risk profile. This should deliver a robust program that allows mistakes to be contained.
- **Consider convexity:** Both implicit and explicit hedging strategies that offer convexity during market stress might benefit hedge fund allocations and enhance broader portfolios.
- **Stay opportunistic:** Manager access is a key determinant of investor outcomes. The improved and broad-based opportunity set of the evolving investment landscape may provide opportunities to add to or upgrade allocations to top-tier managers that have previously been hard to access.

5

Considering opportunities in credit

We recommend that advisors explore the comprehensive range of opportunistic credit offerings available.

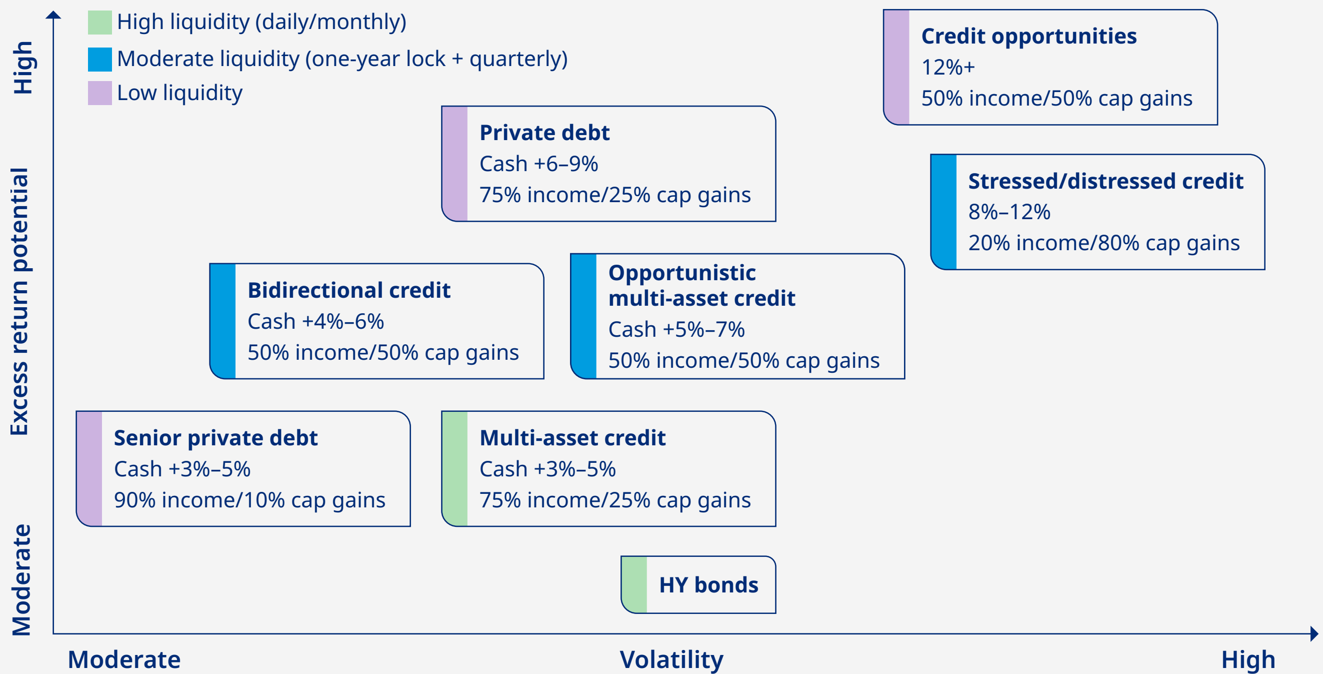
Credit investing is back in the spotlight due to rising yields, the negative impact of higher interest rates on the economy and a dwindling supply of capital. This situation has created a prime environment for significant credit divergence, offering opportunities for experienced capital providers. In light of these developments, we recommend that advisors explore the comprehensive range of opportunistic credit offerings available. These offerings include everything from semiliquid private credit, such as opportunistic multi-asset credit, to bidirectional credit and private market credit opportunities. These strategies are tailored to capitalize on market dislocations caused by factors like inflation, escalating interest rates and overall market volatility.

- **Opportunistic multi-asset credit:** This could be a good strategic choice for investment mandates with a medium-term investment horizon that are willing to accept lower liquidity for potentially higher returns. Typically, they feature an open-ended structure with a one-year hard lock and some gating provisions thereafter. They will incorporate some private markets exposure; however, their primary focus remains on public markets, necessitating tolerance for mark-to-market volatility. Within a portfolio context, these strategies serve to balance income and total return within a growth-fixed income portfolio.

- **Unconstrained credit:** As part of a hedge fund program, these strategies focus on idiosyncratic alpha and provide access to nontraditional risks — spread, arbitrage, relative value, complexity, variable beta and alpha shorting. Higher-for-longer rates should provide volatility and dislocations as balance sheets respond to this new environment and set up both long and short opportunities. Higher and tighter financing terms should lead to more stressed/distressed credit opportunities. We expect that the expansion of credit and lending over recent years will slow. This will likely lead to forced asset transfers as downgrades and stress increase.

- **Private market credit opportunities:** These represent a potentially attractive option for investment mandates that have a strong appetite for illiquid investments and which require illiquidity risk to be rewarded by the potential for substantial returns. It is especially beneficial for those aiming to augment an established multi-sleeve private markets program. These strategies adopt a drawdown fund structure with extended lock-up periods and represent comprehensive dislocation opportunities. Within a portfolio context, these strategies focus on bolstering income within an alternative fixed-income allocation.

Figure 5 | **Spectrum of public to private opportunistic credit offerings: Varying risk, return and liquidity profiles**



Considerations

- **Access alternative credit alpha:** Investors should consider opportunistic multi-asset credit when seeking higher yields and income compared to traditional, more liquid credit options. Tapping into privately originated yield and complexity premiums while enhancing your existing public and private credit allocations could maintain some rebalancing liquidity and flexibility, all while gaining the ability to allocate credit strategically. This could elevate a portfolio's total return potential and boost efficiency by diversifying the sources of credit spread, which will reduce reliance on equity risk premiums.

- **Build an all-inclusive credit portfolio as part of a well-balanced hedge fund program:** This might be done through the utilization of bidirectional credit strategies, which are characterized by their semiliquid, unconstrained and agnostic nature. The strategic objective should be to actively seek alpha opportunities while concurrently providing liquidity to potential sellers. This strategy is designed to be adaptable across the credit cycle, capitalizing on a wide and intricate range of opportunities that benefit from active management. We recommend accessing these opportunities through both nimble generalists and specialists for maximum effectiveness.

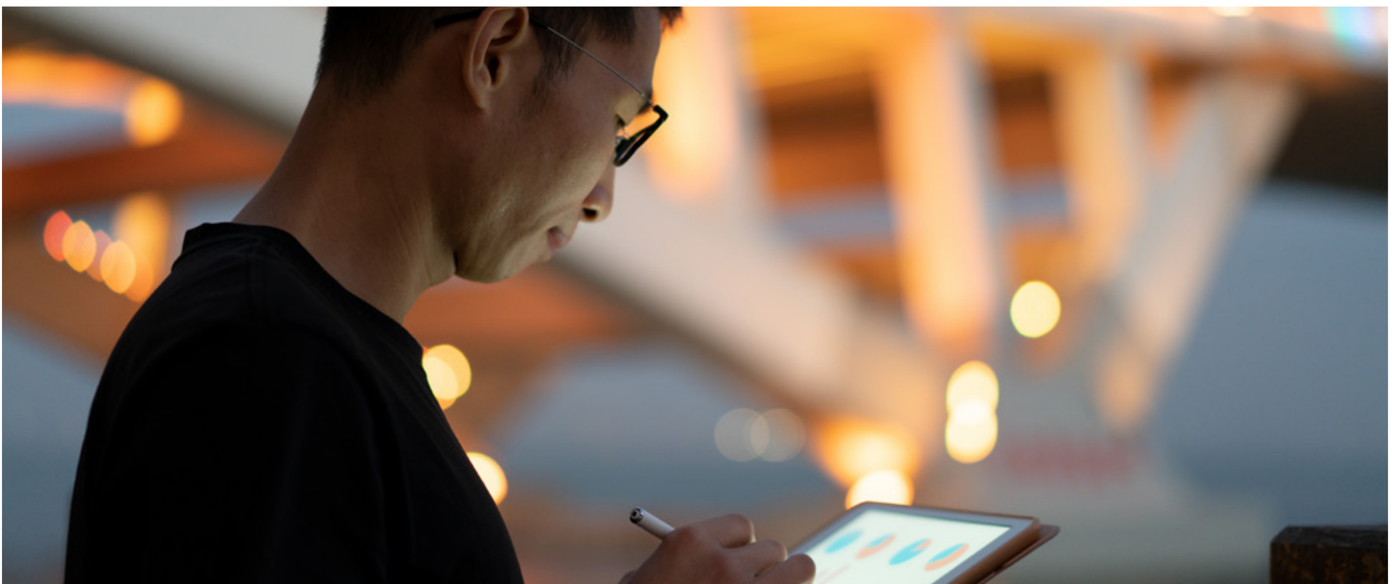
- **Capture the full illiquidity premium:** Explore private market credit opportunities in funds and co-investments, aiming for returns in the mid- to high teens that encompass both income and capital gains. These opportunities arise from a convergence of factors such as inflation, central bank tightening and slowing growth. To best capture this potential, employ a diversified approach, and pay close attention to manager selection.

Conclusion

The insights presented in this report are essential for guiding advisors and their clients through the upcoming year. We acknowledge that some of the subjects covered may be unfamiliar. To delve deeper into these topics or any of the other aspects discussed, get in touch with your local Mercer specialist. Mercer provides a comprehensive range of services, encompassing cutting-edge tools, investment guidance and customized portfolio solutions, all designed to align with the distinct requirements of advisors and their clients.

Additional reading sources

- Themes and opportunities 2024
- Five ways to prepare for a polycrisis
- The investment playbook for single family offices — Part 1: Taking a view
- The investment playbook for single family offices — Part 2: assets and allocations
- The investment playbook for single family offices — Part 3: considering the future



Contact us

For further information, please visit www.mercer.com/solutions, email us at mercerinvestmentsolutions@mercer.com or reach out to one of our specialists.

Amit Popat
Global Head of
Financial Intermediaries
+44 7789 030712
amit.popat@mercer.com

Robert Ansari
IMETA
+971 50 2204626
robert.ansari@mercer.com

Luke Fitzgerald
Australia
+61 4 1240 2722
luke.fitzgerald@mercer.com

Robert Ronneberger
Asia
+852 9255 0126
robert.ronneberger@mercer.com

Greg Sommer
US
+1 312 203 1538
greg.sommer@mercer.com

Conor Power
Europe
+353 1 411 8336
conor.power@mercer.com

Endnotes

1 Graph and analysis are hypothetical and not meant to guarantee any returns. This hypothetical performance is only indicative of the flatter frontier. This is not related to Mercer products or services and is meant to represent research to support our analysis. This graph does not contain investment, financial, legal, tax, or any other advice and should not be relied upon for this purpose. The data shown are not tailored to your particular personal and/or financial situation.

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