EUROPEAN ASSET ALLOCATION SURVEY
2018

MAKE TOMORROW, TODAY

MERCER

CONTENTS

WELCOME	01	03
KEY FINDINGS	02	04
SURVEY PARTICIPANTS	03	05
ASSET ALLOCATION	04	06
INVESTMENT GOVERNANCE	05	09
DE-RISKING FOR UK DEFINED BENEFIT PLANS	06	12
RISK MANAGEMENT	07	14
EQUITY PORTFOLIOS	08	20
ALTERNATIVE INVESTMENTS	09	22
RESPONSIBLE INVESTMENT	10	27
ACKNOWLEDGEMENTS	11	30
IMPORTANT NOTICES	12	31

WELCOME

This year in our *European Asset Allocation Survey* we provide a comprehensive overview of investment strategy across the European pension industry and identify a number of emerging trends in the behaviour of institutional investors.

Following a year of strong equity market returns and exceptionally low volatility, 2018 has provided more of a return to normality, with market volatility picking up noticeably in early February. The goldilocks environment of 2017, with a broad-based upswing in global growth, has in 2018 had to contend with an escalation of trade tensions, a rising oil price and data disappointments in a range of economies.

Against this evolving backdrop, we have identified four key themes that we believe will be important for investors to consider when building portfolios in what remains a fragile and uncertain environment:

- **Transition from QE to QT.** After almost a decade of monetary stimulus, the world's major central banks are starting to gradually pull back, led by the US Federal Reserve. In response to low levels of unemployment and robust growth, the Fed is looking to gradually normalise its balance sheet over the coming years (referred to as quantitative tightening or QT). In November 2017, the Bank of England implemented its first rate hike since 2007, and the European Central Bank halved its rate of asset purchases in January 2018. The pace and scale of the shift from QE (quantitative easing) to QT will be critically important for markets going forward.

- **Preparing for late-cycle dynamics.** The later stages of a credit cycle typically present a challenging environment for investors, offering lower returns and greater risks than the early or mid-cycle periods. Although we expect the economic environment to remain supportive of corporate earnings growth during 2018, we believe that investors should start considering the ways in which they might prepare portfolios for the risks and opportunities that the late stage of this credit cycle might present.

- **Political fragmentation.** After 25 years of convergence towards the political centre across the developed world, politics since the financial crisis have become increasingly divergent, with populists from both the left and the right of the political spectrum making significant advances. Symptoms of political fragmentation have manifested in the Brexit vote, the election of Donald Trump, the Catalan bid for independence and the Italian general election. Investors are likely to face an environment of heightened political uncertainty for some time.

- **Stewardship in the 21st century.** As the finance industry seeks to rebuild trust following the financial crisis, institutional investors increasingly need to recognise the importance of their role in acting as good stewards of the capital entrusted to them. This requires investors to have a clear set of beliefs in relation to environmental, social and corporate governance (ESG) issues as well as recognising and managing systemic risks (such as climate change). An increasing number of investors will seek to reflect their values and promote the social good when investing their assets.

The results of our survey suggest that investors are concentrating on strategy more than ever, and we would encourage investors to focus on diversity and robustness in a world that is likely to exhibit lower returns and "fatter tails".

Phil Edwards
Global Director of Strategic Research

Matt Scott
Investment Consultant

Kate Brett
Investment Consultant

KEY FINDINGS

ENDGAME LOOMING FOR UK DB PLANS

In recent years we have seen a large increase in the number of UK defined benefit (DB) plans becoming cashflow negative (with outgo larger than their income). Around 56% of UK DB plans are already cashflow negative (a similar figure to last year), but we have seen a marked increase in the number of cashflow-positive schemes that are less than five years away from being cashflow negative (an increase from 43% to 49% of cashflow-positive plans). This finding is reinforced by the timeframes being targeted for de-risking strategies — the proportion of plans with a de-risking target of less than five years has almost doubled from 13% to 24% since last year's survey. The maturing of UK DB plans has led to a further reduction in equity exposures (from 29% to 25%), a gradual increase in liability hedge ratios, greater use of alternatives and an increasingly urgent search for income-generative assets.

INCREASED USE OF ILLIQUID AND COMPLEX CREDIT

The search for diversification seems more relevant than ever and has encouraged investors to seek alternatives to traditional equity and bond assets. Two beneficiaries of this trend from among the alternative asset classes have been secured finance and private debt strategies (both benefiting from the focus on income highlighted above). The proportion of plans allocating to private debt increased from 7% to 11% over the year, while secured finance strategies emerged from close to zero exposure last year to 3% of plans in this year's survey. We expect both areas to see further interest in the years ahead.

MORE PARTICIPANTS HEDGING EQUITY DOWNSIDE RISK

Equity option strategies gained in popularity over the year as schemes sought to manage their exposure to equity downside risk. Some 9% of respondents have implemented equity-option protection strategies, with a further 24% of plans having considered such approaches. By contrast, bespoke tail-risk hedge funds have remained a niche proposition. In this extended cycle, with stretched valuations across many asset classes, investors (especially those who are path-dependent or sensitive to volatility) are rightly thinking about approaches to managing their exposure to downside scenarios.

THE GRADUAL SHIFT FROM ACTIVE TO PASSIVE CONTINUES

The slow but perceptible shift from active to passive approaches (in both equity and bonds) has continued in this year's survey. Based on a consistent sample, the proportion of equity and bond assets managed passively has increased by 1% to 52% in equities and by 3% to 51% in bonds. This trend is likely to continue, with tailwinds including downward pressure on fees and costs, a desire to control the governance burden, and an increasing allocation of fee and governance budgets towards alternative assets (where credible passive options rarely exist).

CLIMATE CHANGE INCREASINGLY PERCEIVED AS AN INVESTMENT RISK

Although consideration of climate change has tended to be fairly low down on investor agendas, this year's survey results show a material jump in the number of investors considering the investment risks posed by climate change — from 5% last year to 17% this year. Regulatory nudges have likely played a role here, with the UK Pension Regulator, the EU Commission and the Financial Stability Board's Task Force on Climate-related Financial Disclosure (TCFD) all making statements encouraging investors to consider the physical and policy risks posed by climate change.

SURVEY PARTICIPANTS

Our 2018 survey gathered information on 912 institutional investors across 12 countries, reflecting total assets of around €1.1 trillion. The charts that follow show the composition of survey participants both by country and by size of plan assets. Please note that not all percentage charts in the survey sum to 100 due to the application of rounding.

Chart 1. Split of Total Survey Assets by Country

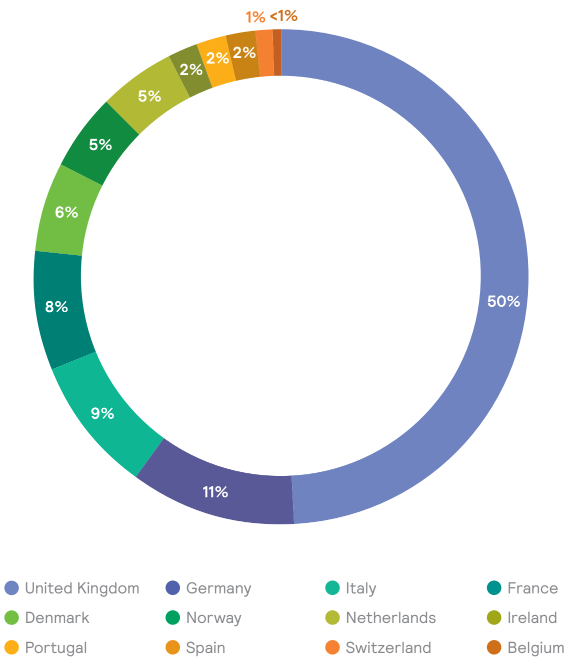


Chart 2. Split of Total Survey Participants by Plan Size

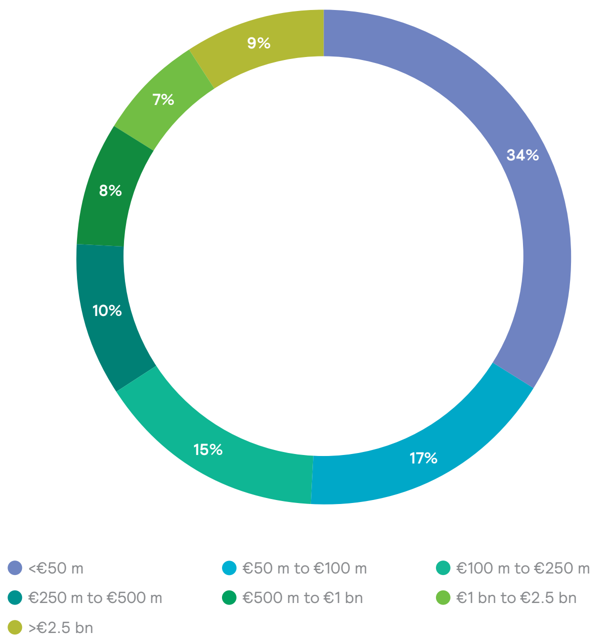
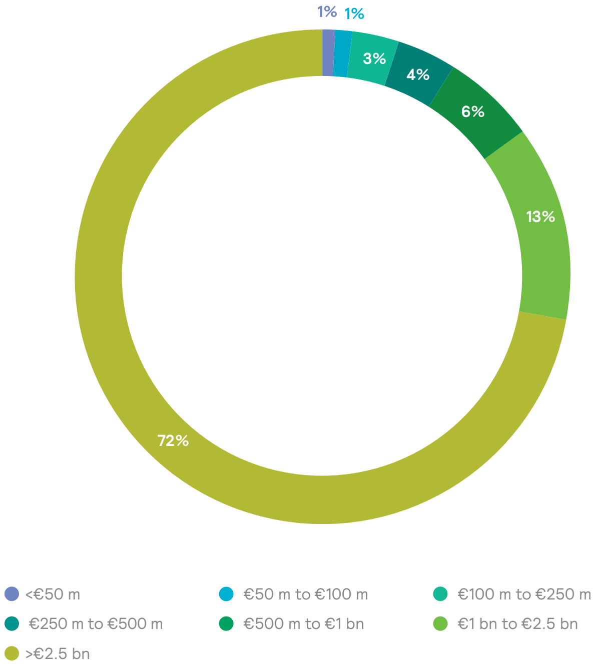


Chart 3. Split of Total Survey Assets by Plan Size



As in previous years, the largest group of survey participants was UK-based (see Chart 1). Just over half of the participants (by number) represent plans with assets under €100 million, whereas 16% had assets over €1 billion (see Chart 2). Although smaller in number, these larger plans continue to dominate the overall assets under review (see Chart 3).

Some year-on-year turnover among survey participants is inevitable, but a majority of the plans have remained part of the survey over time, allowing us to identify trends in asset allocation based on a robust core of data.

ASSET ALLOCATION

Charts 4 and 5 show the broad allocation of plan assets broken down by country for DB plans. Plans in Belgium continue to have the highest average equity weightings, whereas plans in Denmark and Germany (excluding German contractual trust arrangements, or CTAs) exhibit the lowest equity exposure. Since last year's survey, average equity allocations have ticked down slightly, offset by a corresponding rise in allocations to alternative assets (discussed further in Section 9), while bond allocations stayed at broadly the same level.

Chart 4. Broad Strategic Asset Allocation by Country (%)

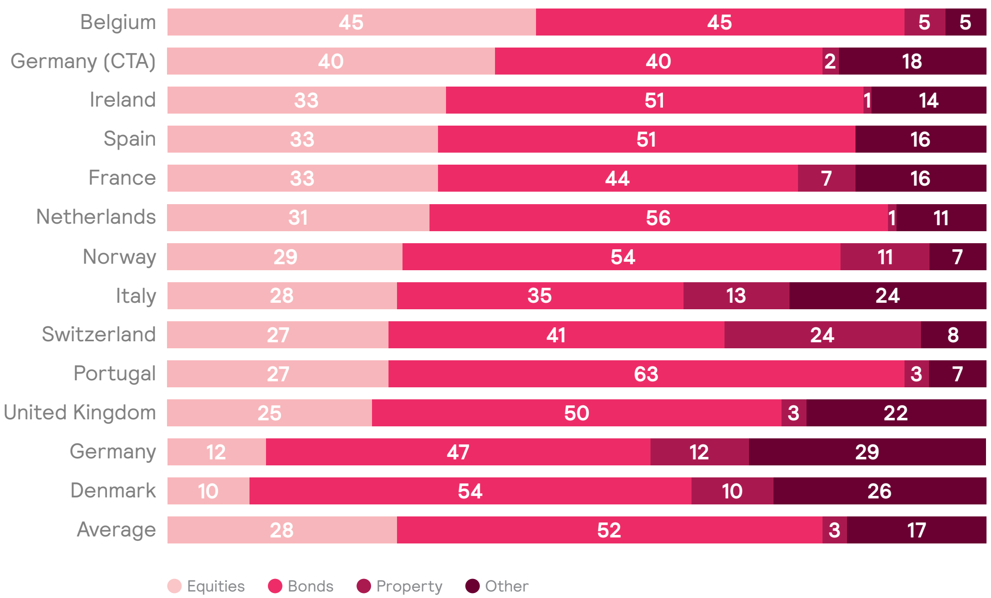
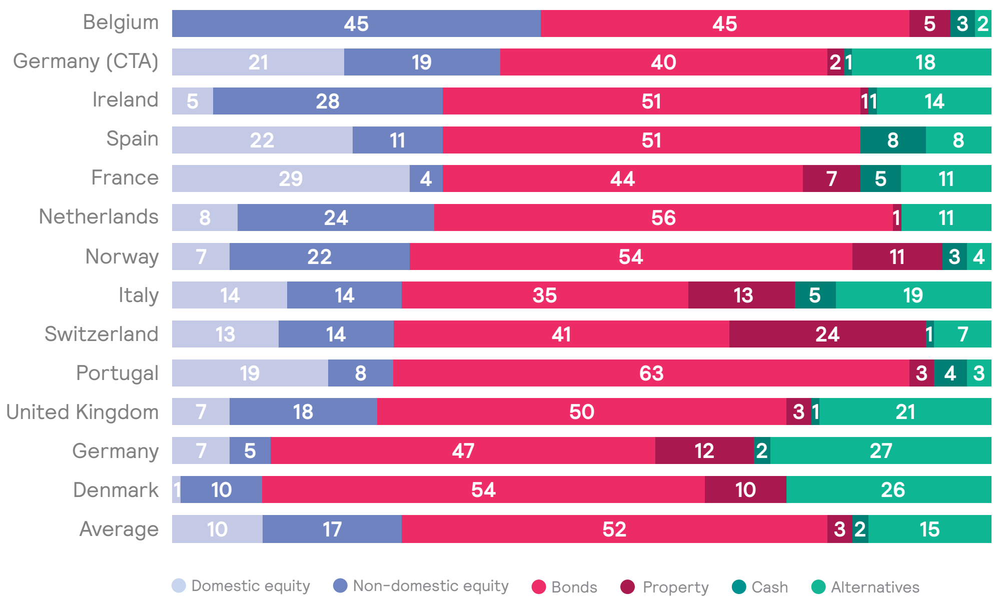


Chart 5. Strategic Asset Allocation by Country (%)



The proportion of equities invested outside the domestic market continues to vary considerably by country, but the overall "domestic bias" remains similar to last year, with domestic exposure (defined as eurozone markets for those within the eurozone) now representing around 37% of the average plan's equity portfolio. France had the most pronounced domestic bias, with many schemes surveyed having 100% of their equity portfolios invested domestically.

Since last year's survey, average equity allocations have ticked down slightly, offset by a corresponding rise in allocations to alternative assets.

Chart 6. Bond Portfolio Allocation by Country (%)

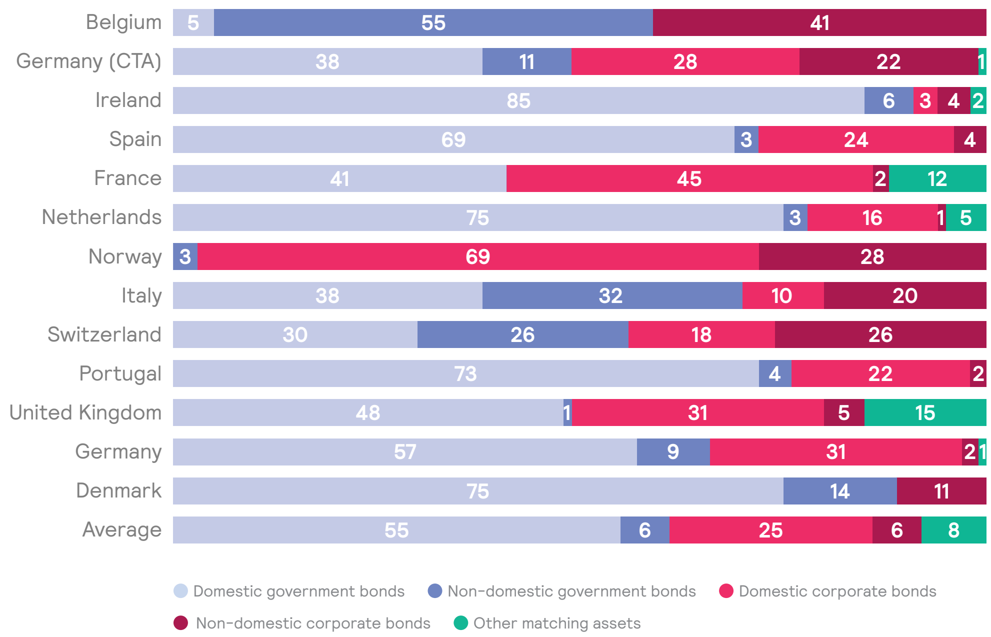
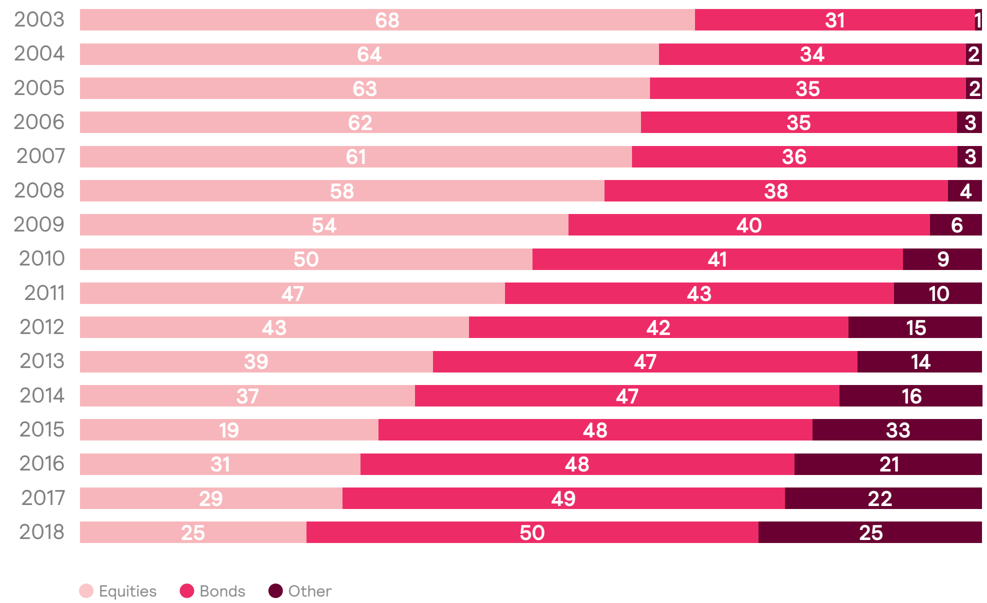


Chart 7. Changes in Broad Strategic Asset Allocation for UK Plans (2003–2018) (%)

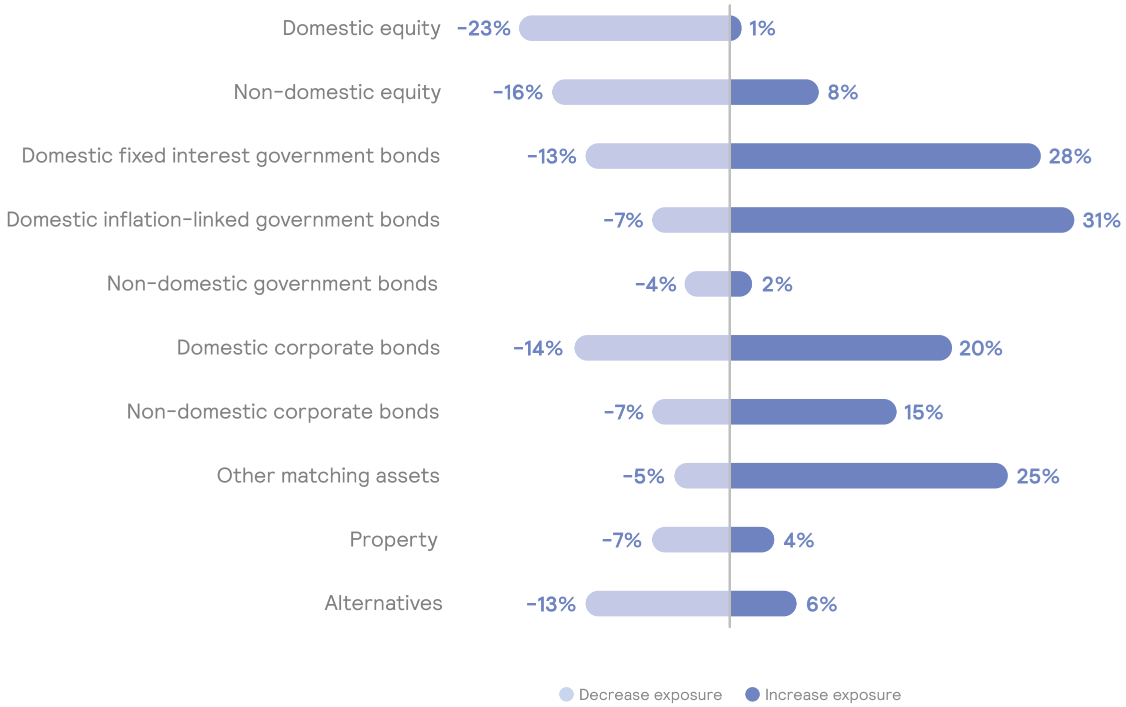


The make-up of plans' bond portfolios (see Chart 6) is heavily country-specific. The composition of the average portfolio changed little from last year, with government bond allocations forming the largest component and the average corporate bond allocation representing just over 30% of all bond holdings.

> *The long-term reduction in equity exposure continued in 2017, with the average plan equity allocation falling to a new low of 25%.*

Chart 7 shows the change in overall allocations in the UK over the last 15 years. The long-term reduction in equity exposure continued in 2017, with the average plan equity allocation falling to a new low of 25%. The fall in equity assets was largely matched by an increased allocation to alternatives as some schemes looked for diversification and banked gains from their equity portfolios.

Chart 8. Percentage of Plans Expecting to Change Investment Strategy



Looking forward (see Chart 8), plans are, on the whole, expecting to continue reducing allocations to equities and to increase exposure to domestic government bonds, corporate bonds and other matching assets. The trend from last year of plans expecting to reduce allocations to property continues. This may reflect the strong returns experienced in a number of markets in recent years as well as de-risking activity.

INVESTMENT GOVERNANCE

Pension plan governance covers a wide range of topics, from the composition of the trustee group to the way in which decisions are delegated to subgroups or third-party providers, to the complexity of the investment arrangements and the number of ideas and opportunities that are considered. Our survey results continue to highlight a clear link between the size of a plan and the amount of time and resources devoted to the consideration of investment issues.

Chart 9. Strategic Asset Allocation by Plan Size (%)

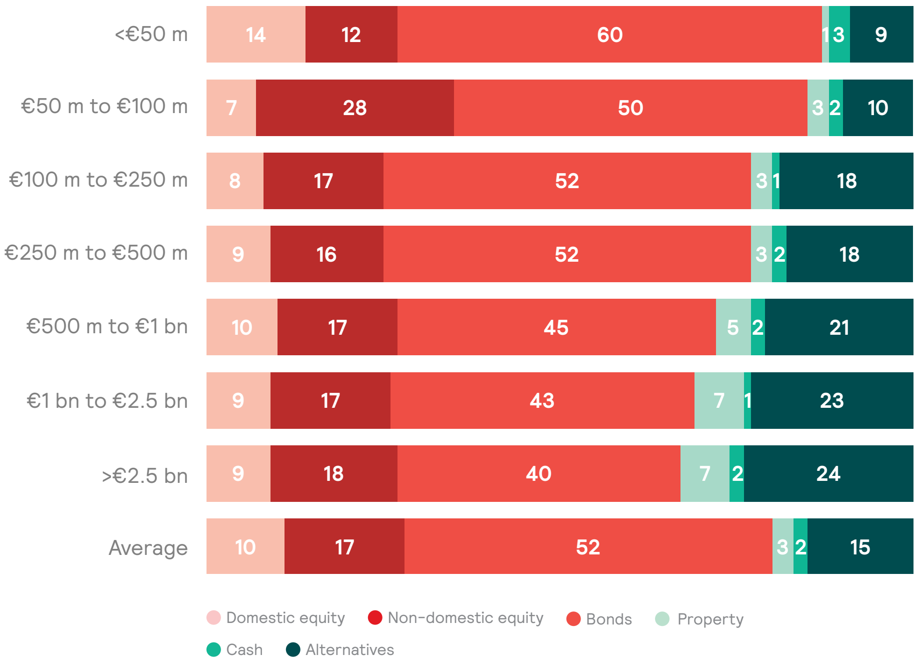


Chart 10. Breakdown of Responsibilities Around the Investment Cycle (%)

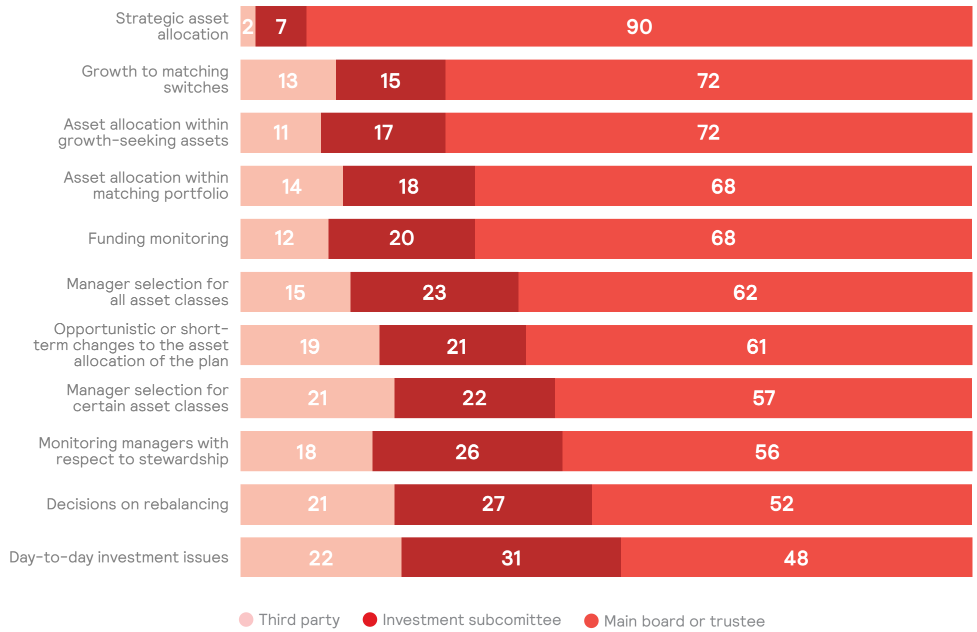


Chart 9 illustrates how asset allocation varies with plan size. Although equity exposures don't appear to obey a clear pattern, the average plan allocation to alternative assets — which can include complex and less liquid strategies — is higher for larger plans, which typically have greater resources. The largest plans, while holding less in bonds, often have higher interest rate and inflation hedge ratios than the bond allocations reflect, given their ability to leverage their portfolios to achieve a higher degree of liability matching; this often frees up assets to return-seeking portfolios.

The delegation of investment activities by plan participants (shown in Chart 10) remains similar to last year. Strategic asset allocation decisions continue to reside with the highest level of decision-making body, such as the plan trustee or board of directors, for the vast majority of plans (90%). Regular review of the investment strategy is increasingly recognised as best practice, with more than 64% of plans now reviewing their strategy at least once a year, an increase from last year.

Around 43% of plans delegate some degree of investment manager selection, either to an investment subcommittee or to a third party, whereas day-to-day decisions are delegated by over a half of survey participants. Chart 11 illustrates that the nature of any delegation is partly a function of plan size: smaller plans are more likely to appoint a fiduciary manager and larger plans are more likely to use an investment subcommittee.

Charts 12 and 13 consider the average number of active mandates by plan size and the extent to which passive mandates are used for equities and bonds (Chart 13 shows a like-for-like comparison using only those plans that were present in both the 2017 and 2018 datasets). Larger plans use a greater number of active managers, partly because they have the scale to diversify active manager portfolios (sometimes to neutralise unintentional factor/style/geographical biases and concentration risk) and to build bespoke portfolios of alternative assets.

The proportion of equity and bond assets managed on a passive basis has modestly increased over the year. Part of the reason for this is that underperforming mandates are often moved to passive management, as active manager monitoring is seen as a distraction for plans increasingly focusing on strategy-level risks and more complex strategies within the alternatives universe.

Chart 11. Responsibility for Day-to-Day Investment Issues by Plan Size

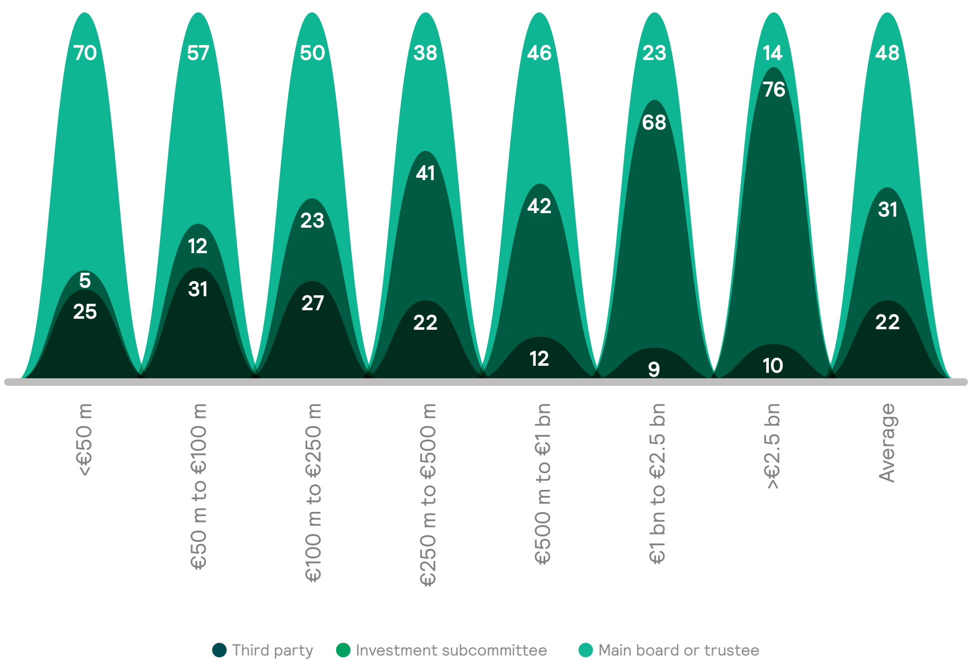


Chart 12. Average Number of Active Mandates by Plan Size

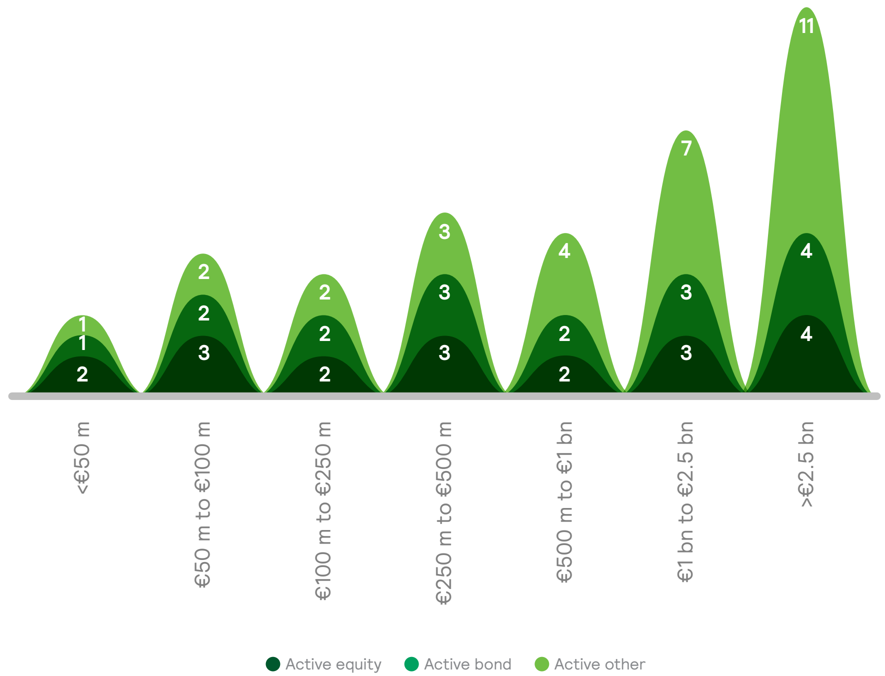


Chart 13. Proportion of Equity and Bond Assets Managed on a Passive Basis

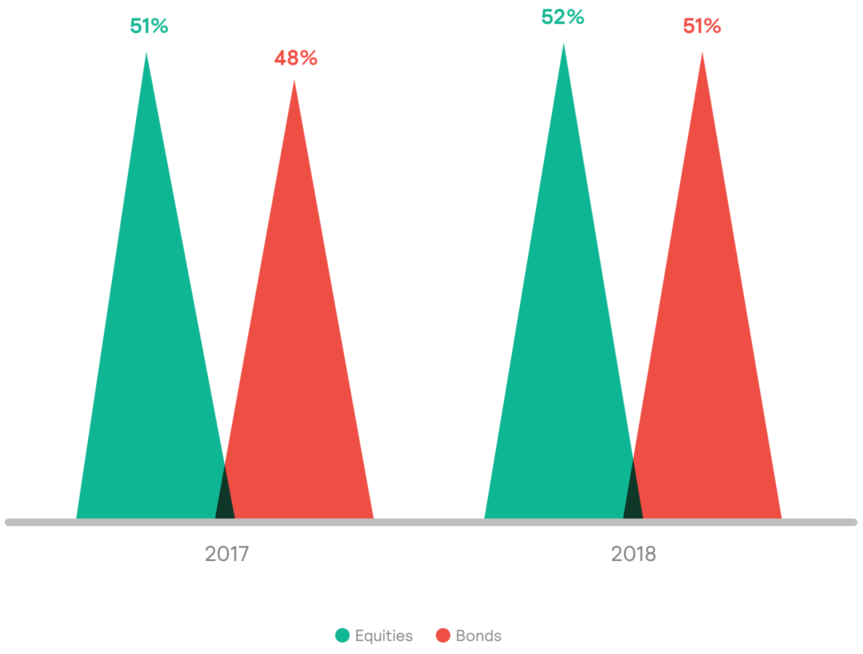
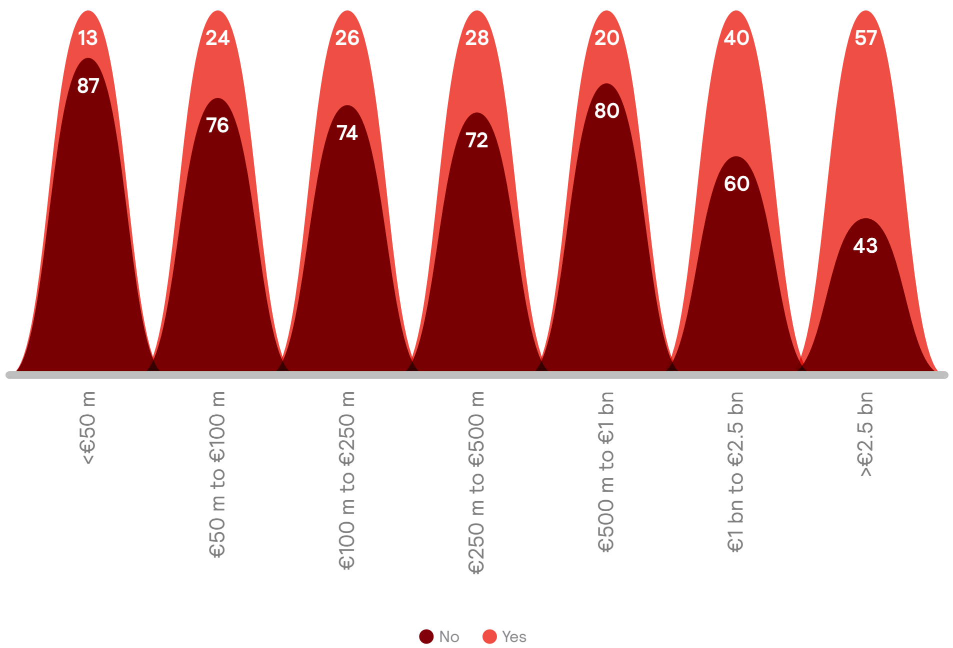


Chart 14. Proportion of Plans Carrying Out Operational Due Diligence by Plan Size (%)



As plans increase in size, the number of managers they appoint typically increases, leading to higher operational requirements. Investor interest in providers' middle- and back-office functions also appears to be a higher priority for larger investors, with plans over €1 billion in size making the greatest use of operational due diligence reviews (see Chart 14).

DE-RISKING FOR UK DEFINED BENEFIT PLANS

Charts 15a–15f provide further detail on the de-risking of UK DB plans, the largest single type of plan in the survey. The asset allocation of such plans is now commonly guided by a strategic "journey plan", in part because many plans have been closed (to new entrants and future accrual) in recent years. When, as is often the case, the plans are underfunded, a journey plan is designed to align the future investment strategy with the gradual recovery of the funding position.

Chart 15a. Long-term Funding Objective

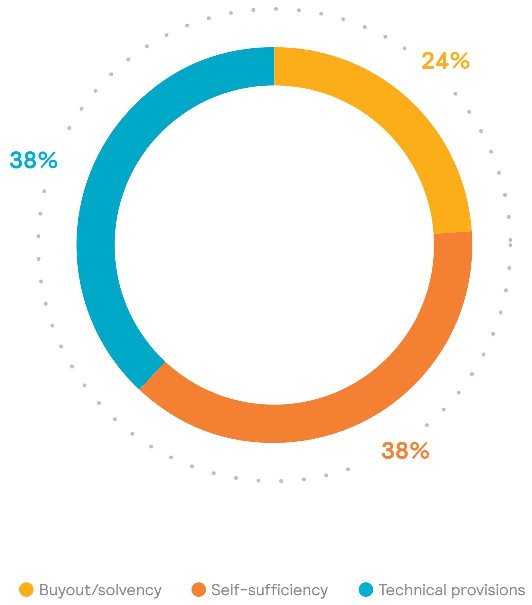


Chart 15b. Self-sufficiency Basis

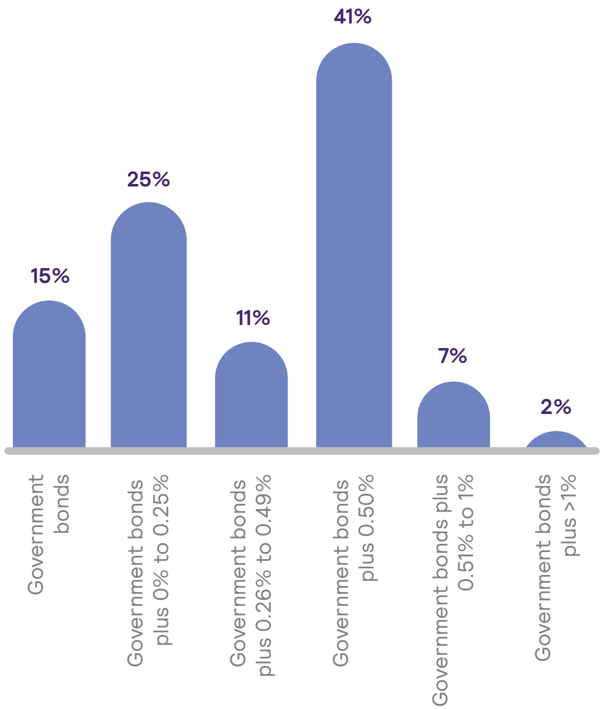


Chart 15c. Implementation of De-risking

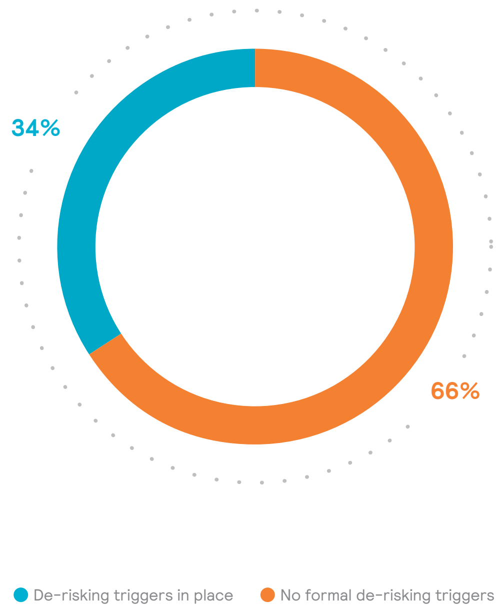


Chart 15d. Timeframe for De-risking

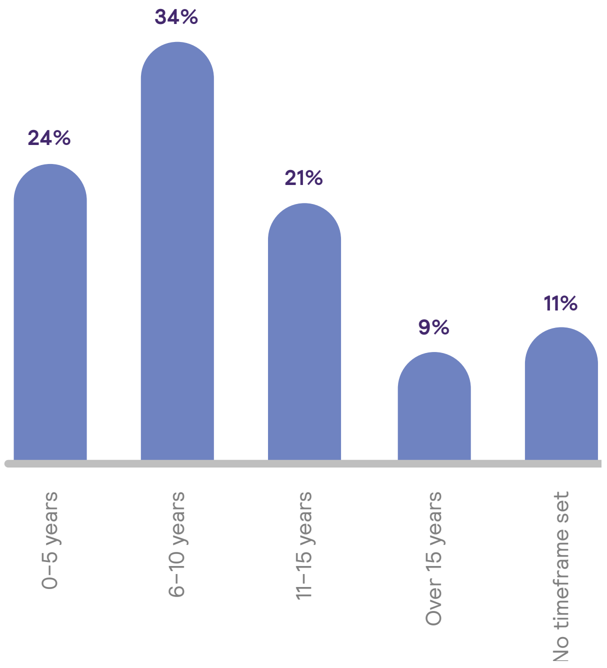


Chart 15e. Delegation of De-risking

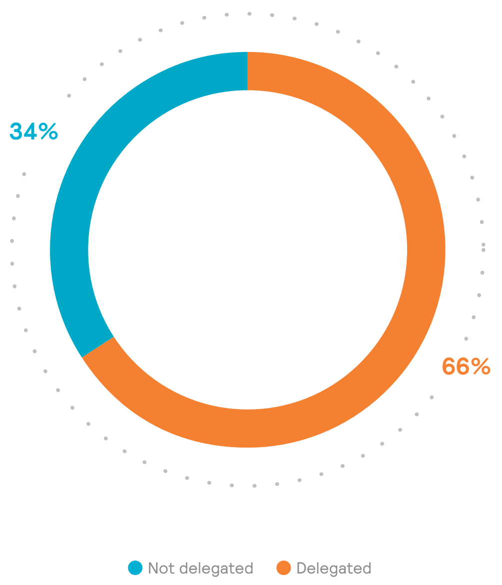
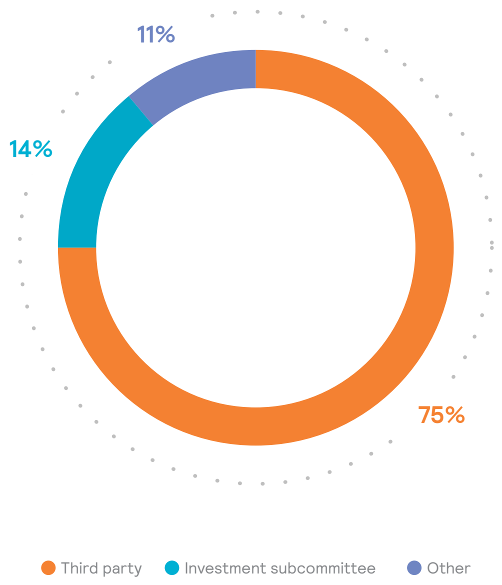


Chart 15f. Who De-risking Is Delegated to



The proportion of DB plans that have moved to having buyout as their long-term target has increased to 24% this year from 17% last year (see Chart 15a). This objective involves the transfer of plan liabilities to an insurer (a buyout). Where plans are targeting a “run-off” strategy (sometimes described as “self-sufficiency”), the associated basis on which the liabilities are valued varies by plan but usually reflects a modest premium above the risk-free rate (see Chart 15b).

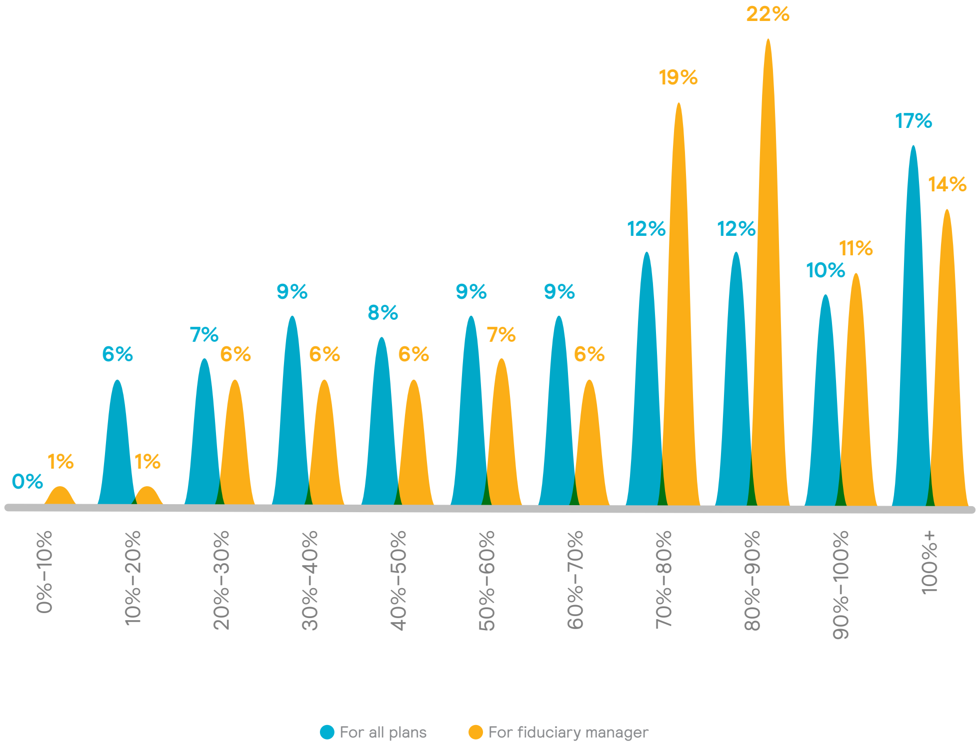
Over one-third of plans have put in place a de-risking framework to guide their journey towards their funding objectives (see Chart 15c). The associated timeframe for reaching full funding varies — not least due to the range of plan funding levels today — but most plans (c. 80%) are aiming to achieve their objectives within the next 15 years (see Chart 15d). Two-thirds of plans with such a framework have delegated implementation, the vast majority of whom have selected a third party such as a fiduciary manager, who will typically monitor the plan’s funding level and automatically de-risk the plan’s portfolio in line with a set of pre-agreed funding-level triggers (see Charts 15e and 15f).

RISK MANAGEMENT

The largest component of the overall asset allocation for the average plan remains the bond allocation. As well as acting as a diversifier to equity allocations, for many liability-relative investors the bond portfolio also seeks to “hedge”, to the desired extent, changes in the actuarial valuation of the liabilities. This liability-hedging role is particularly important in regions that require pension plans to update their funding plans regularly based on a mark-to-market valuation of the liabilities (which will be driven to a significant degree by changes in bond yields and, in some countries, inflation expectations).

Chart 16 sets out the approximate level of interest rate hedging in place for participant plans. The wide range of hedge ratios observed (around an average of 69% across all plans, a year-on-year rise) in part reflects the spread of bond allocations within plan portfolios, but may also point to the wide range of views that exist around the likely path of interest rates and bond yields. We note that, for those plans that have delegated the design of their matching portfolio to a fiduciary manager, the associated hedge ratios are typically higher. This, in part, reflects the ability of a fiduciary manager to help investors overcome the complexity from a governance perspective associated with derivative-based liability hedging strategies. When liabilities have inflation linkages, plans have often adopted different hedge ratios for interest rates and inflation.

Chart 16. Interest Rate and Inflation Hedging Ratio as a Percentage of Funded Liability



Hedging portfolios have evolved over the last decade to include a range of instruments beyond physical bonds. Charts 17a–17e illustrate that those pension plans that use such instruments have become large players in the government bond repo markets, while interest rate and inflation swaps remain popular hedging instruments. Use of repo from survey participants with liability-driven investment (LDI) mandates was around 80%. As shown in Chart 18, the most popular means for implementing liability hedging is via pooled vehicles, offering a lower-governance alternative to separate accounts.

Chart 17a. Interest Rate Swaps

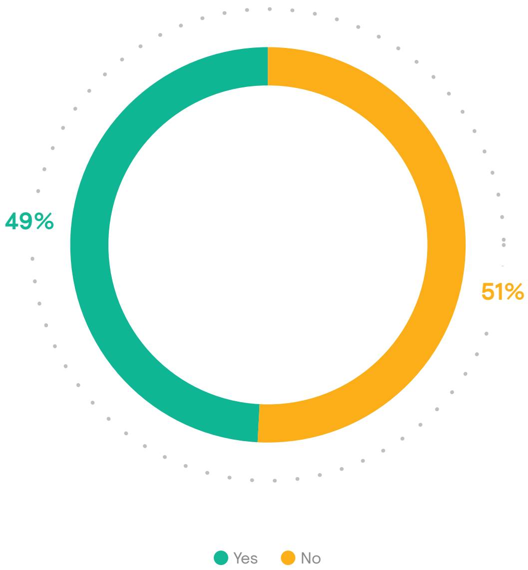


Chart 17b. Inflation Swaps

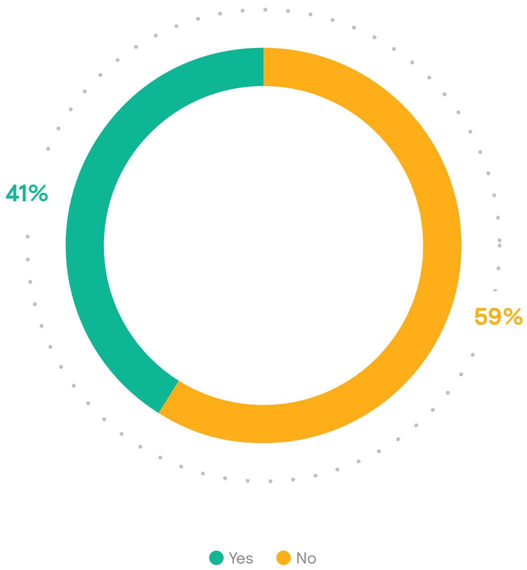


Chart 17c. Government Bonds Total Return Swap

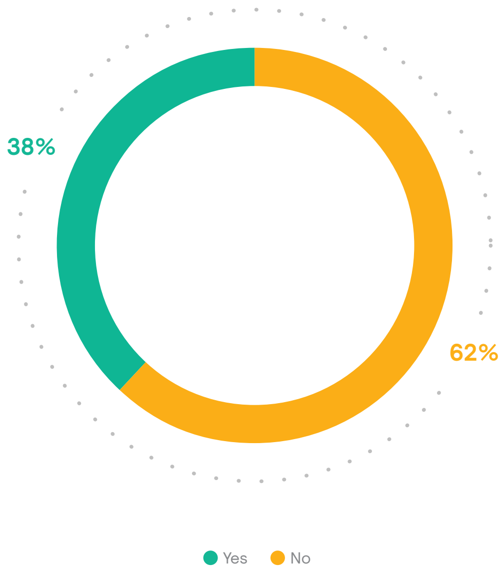


Chart 17d. Government Bond Repos

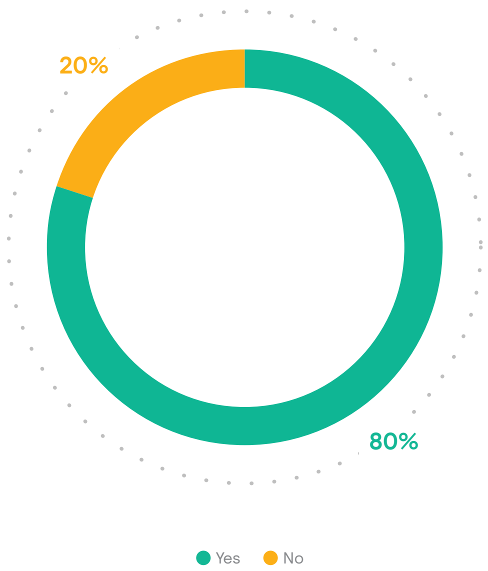


Chart 17e. Swaptions

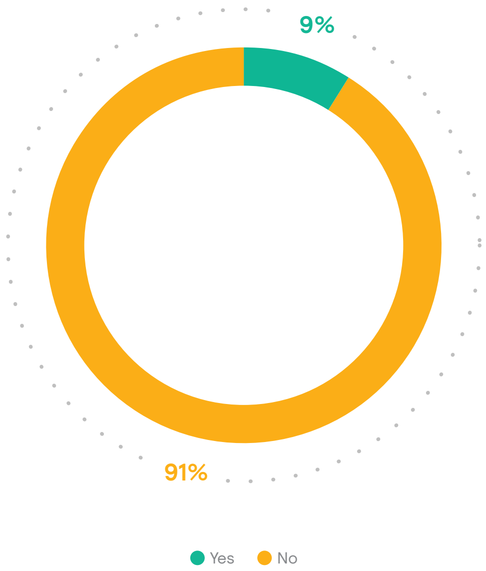
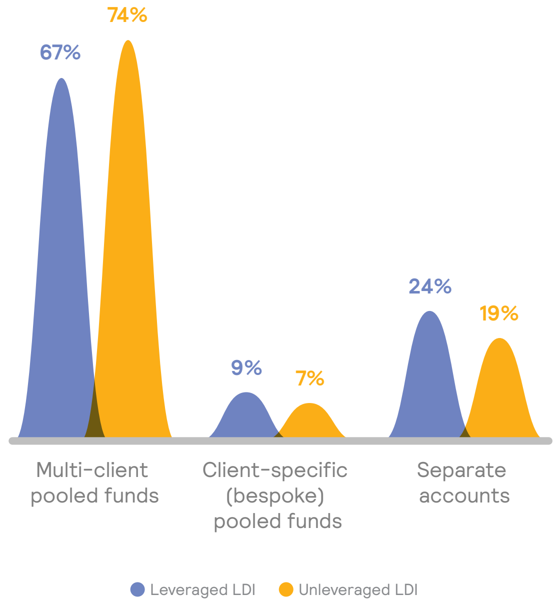


Chart 18. Vehicles Used for Liability Hedging



Looking at how plans expect to increase their liability hedge ratios from here, Chart 19 shows that plans commonly expect this to be a result of de-risking trades out of equities and into bonds. In 42% of cases, plans expect to increase their level of hedging opportunistically should bond yields increase. The use of phased or time-based approaches to increasing hedging remains relatively uncommon, and the percentage of plans employing such approaches decreased slightly last year to 8%.

Chart 19. Methods for Increasing Hedging

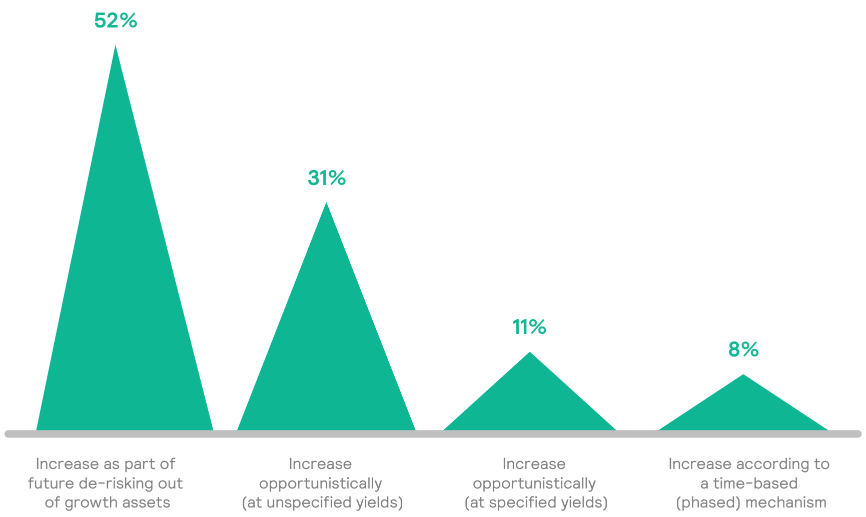


Chart 20. Proportion of Plans Considering Risk Management Exercises Over the Last Year

For those 11% of plans that have specified yields at which they are seeking to increase hedging, the average (long-term risk-free) yield at which they would start such an increase is 2.5%, and the yield at which they would be expecting to be fully hedged is 3.3%. Although these yields are higher than the associated sovereign yields at the time of the survey, such trigger-based approaches may benefit plans should increased volatility in the bond market provide temporary opportunities to “lock in” at higher yields.

Trigger-based approaches may benefit plans should increased volatility in the bond market provide temporary opportunities to “lock in” at higher yields.

Liability risk management encompasses a range of strategies beyond interest rate and inflation hedging, and plans considered a variety of liability management approaches over 2017, as shown in Chart 20. These can be grouped into “ways to curb future liability growth”, such as closure of plans to new entrants or future accrual; “approaches to managing existing liabilities”, such as enhanced transfer values, pension increase exchange exercises and reduced salary increases; and the “transfer of liability risks to another party” through longevity hedging, buy-ins or buyouts.

Charts 21a–21c consider the degree to which plans are cashflow negative — that is, when a plan has matured to the point that regular outgo to meet liabilities exceeds income from investment and contributions. In all, 56% of plans surveyed are currently cashflow negative and, of those that are not, 83% are expected to become so over the next 10 years. In seeking to meet net cash outgo, most plans disinvest assets and 43% have instructed their investment managers to distribute income when possible (to reduce the transaction costs associated with disinvestment), up from 29% last year. A small number of plans (5%) have adopted a cashflow-matching approach, whereby portfolios are designed such that their income and principal receipts are aligned with liability cashflow requirements. We expect portfolios to become increasingly "cashflow driven" over time as DB plans continue to close and mature.

Chart 21a. Proportion of Plans That Are Cashflow Negative

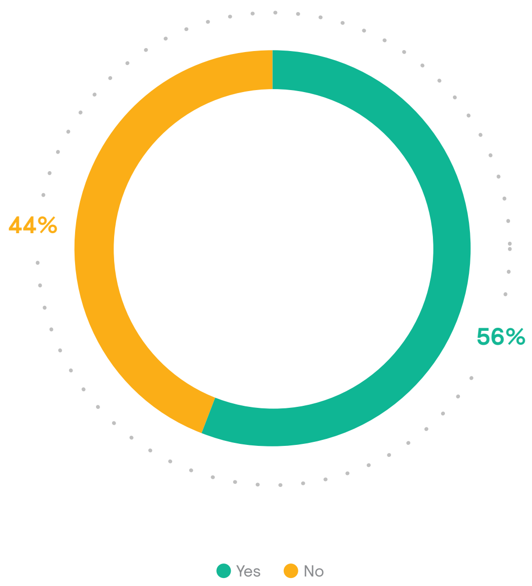


Chart 21b. Expected Time for Cashflow-Positive Plans to Become Cashflow Negative

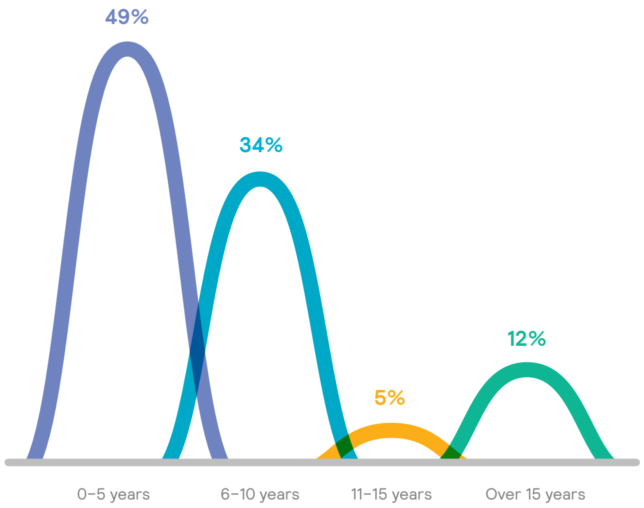
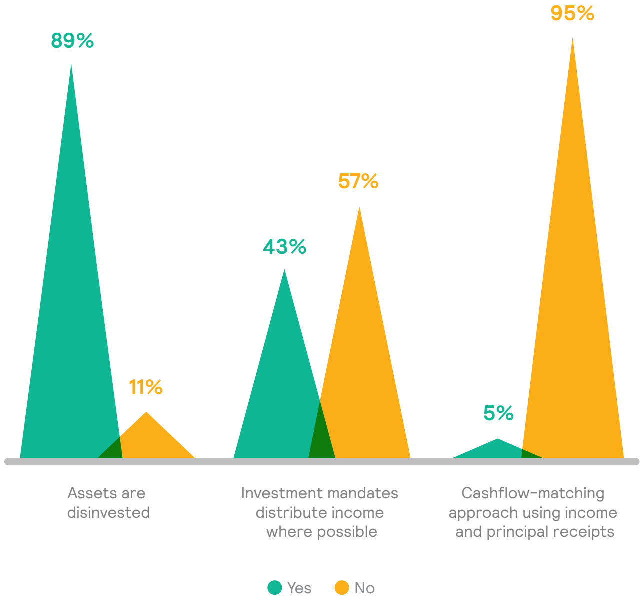


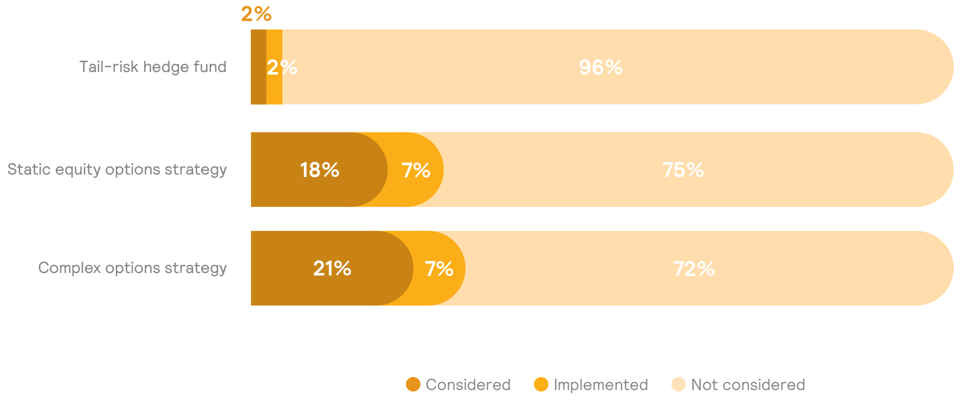
Chart 21c. Methods of Meeting Cashflow-Negative Outgoings



56% of plans surveyed are currently cashflow negative and, of those that are not, 83% are expected to become so over the next 10 years.

Chart 22 shows the range of strategies plans have considered to manage equity risk. Although many plans have weighed the use of derivatives, relatively few have implemented it. Very few plans have looked at tail-risk hedge funds, while those that have looked at derivative strategies have tended to design something more bespoke. Overall, 9% of plans implemented either static or complex options strategies or a mixture, while 24% considered using them.

Chart 22. Managing Equity Risk



EQUITY PORTFOLIOS

Charts 23–26 consider equity portfolios by plan size, underlying allocation, currency exposure and capture of style factors. Although equity allocations are typically smaller than they were a decade ago, we have seen plans construct equity portfolios in an increasingly thoughtful manner. This has included not only a reduction in domestic bias, particularly by larger plans, but also the gradual acceptance of emerging markets as a material component of the overall equity universe. Low-volatility equities provide a defensive component to an equity portfolio and are often seen as an offset to higher-risk exposures, such as emerging markets and small cap stocks.

Chart 23. Total Equity Split

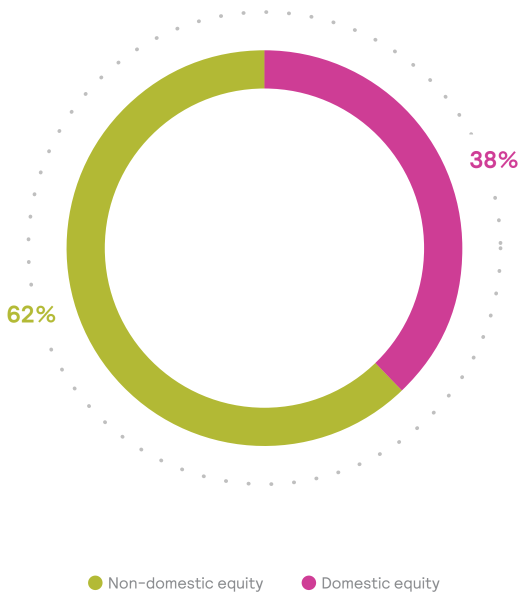


Chart 24. Strategic Allocation to Selected Equity Strategies (%)

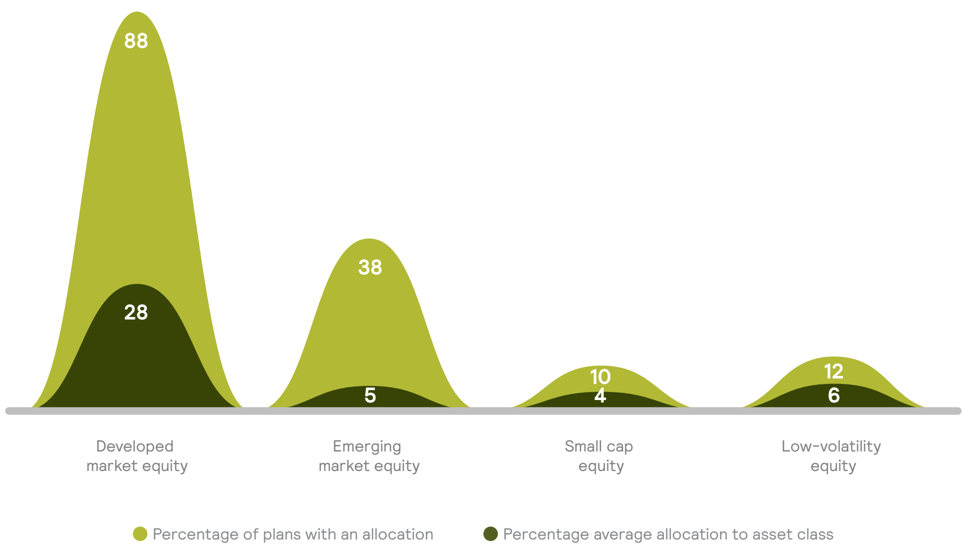


Chart 25. Target-Currency Hedge Ratios for Equity Portfolios

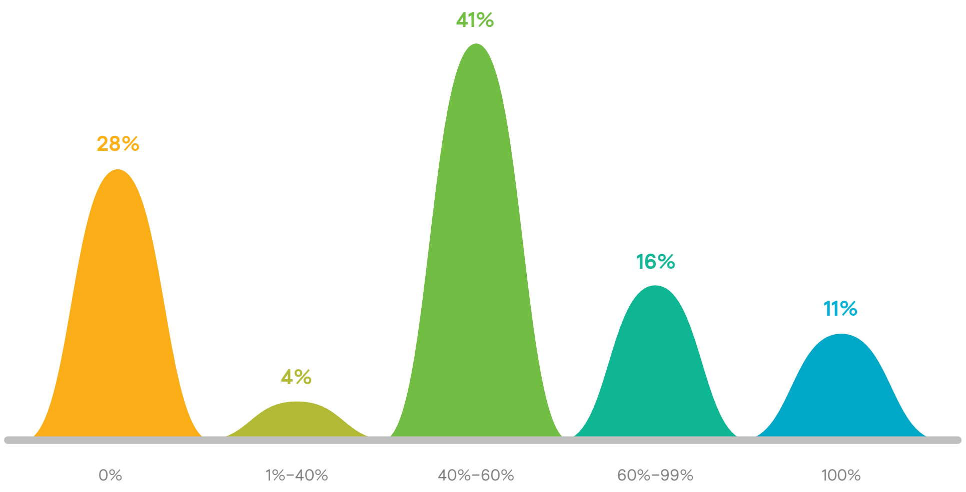
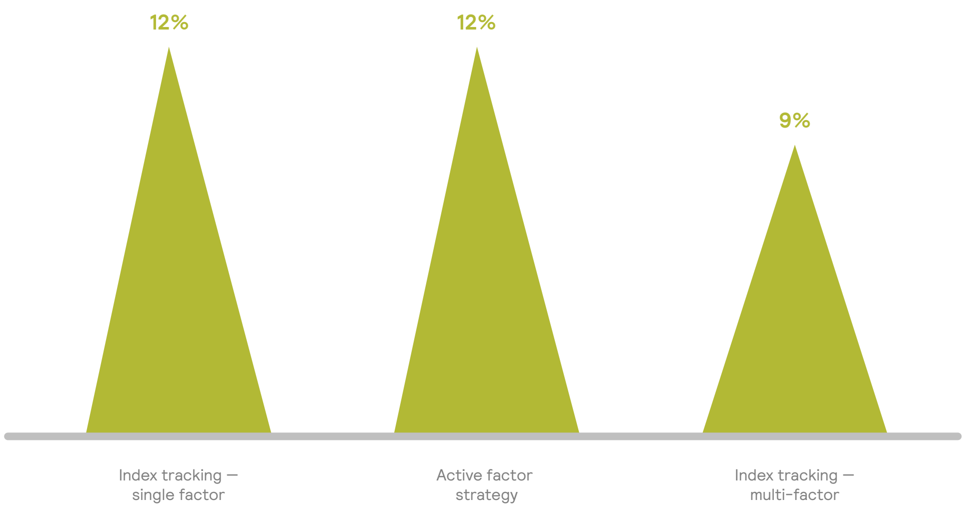


Chart 26. Explicit Capture of Style Factors Within the Equity Portfolio



Non-domestic exposures clearly bring foreign-exchange risk, and of the plans that have a formal currency-hedging policy, the majority hedge at least 40% of the risk. However, a material proportion of plans hedge none of their exchange-rate risk, which may reflect scepticism about the value or currency hedging, or a belief that the values of currencies are essentially mean reverting (this is often the case over the short term, but rarely over the long term). Currency hedging also varies with plan size: our survey results suggest the average currency hedge ratio for the largest plans is 10% higher than that of the smallest plans. The gap has reduced markedly this year, as around a quarter of the smallest plans who had 0% hedge last year had put in place some currency hedging over 2017.

Participants with active equity management are likely to have a wide range of exposure to different style factors (drivers of returns above that of the broad equity market) — for example, value, low volatility, profitability and momentum. This year, we asked participants to detail whether they had explicit exposure to these factors within their equity portfolio. Use of explicit factor exposure is still modest; one of the most common approaches is to use a value-biased index. It is worth noting, however, that many investors will have implicit biases to various style factors via traditional active managers.

Our survey results suggest the average currency hedge ratio for the largest plans is 10% higher than that of the smallest plans.

ALTERNATIVE INVESTMENTS

The use of alternatives continues to increase among plan participants, and this section considers the nature of underlying alternative investment strategies that plans are employing. Charts 27a and 27b consider five broad buckets:

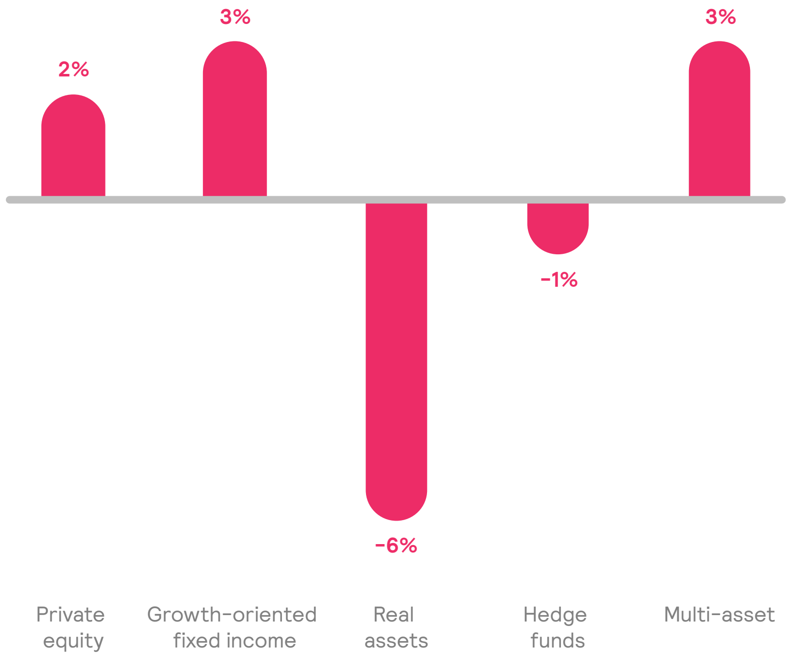
- Private equity, via both fund of funds and direct investment
- Growth-oriented fixed income, which considers fixed income assets and strategies expected to generate returns in excess of government bonds and investment-grade credit
- Real assets, for which the return is expected to come largely from the yield on a physical asset with some degree of inflation exposure, such as real estate, infrastructure and natural resources
- Hedge funds, both via direct hedge fund exposures and through funds of hedge funds
- Multi-asset, which mainly relates to diversified growth funds, diversified beta funds and risk parity (accepting that these strategies are not mutually exclusive)

Chart 27a shows that hedge funds, real assets and growth-oriented fixed income remain the most popular forms of alternative asset. The average size of allocation varies between 4% and 19% of total plan assets, with multi-asset strategies seeing by far the largest average allocations. This may be expected, given that such strategies are often seen as a "one-stop shop" for governance and fee-constrained investors seeking a diversified and relatively liquid portfolio.

Chart 27a. Strategic Allocation to Alternative Asset Classes (%)

Chart 27b exhibits the changes in the proportions of plans with an allocation to each category compared to last year's survey, with allocations to real assets and hedge funds decreasing and allocations to growth-oriented fixed income, private equity and multi-asset strategies all rising. The increases to fixed income assets reflect schemes becoming more aware of their cashflow requirements, with the decrease to real assets coming from a general trend towards de-risking and a taking of profits in property portfolios.

Chart 27b. Year-on-Year Change in Allocation



Charts 28–32 consider plans' allocations within each of the alternative asset categories identified. Growth-oriented fixed income allocations continue to be dominated by emerging market debt, high yield, absolute return bond funds and multi-asset credit. Relative to last year, the main changes are the increase in the percentage of plans allocating to private debt and secured finance strategies.

Chart 28. Strategic Allocation to Private Equity (%)

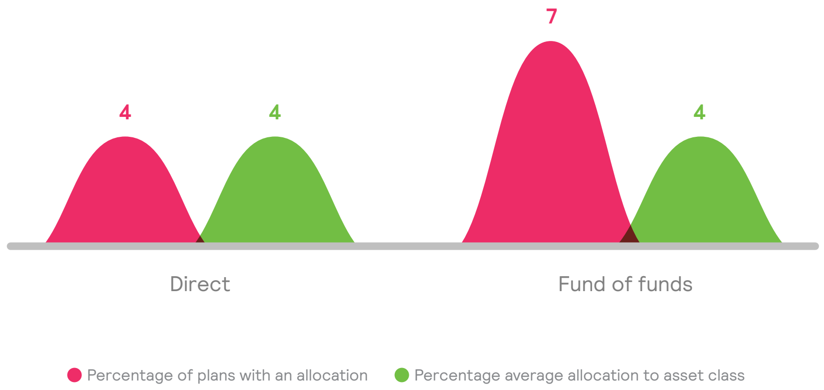


Chart 29. Strategic Allocation to Growth-Oriented Fixed Income (%)

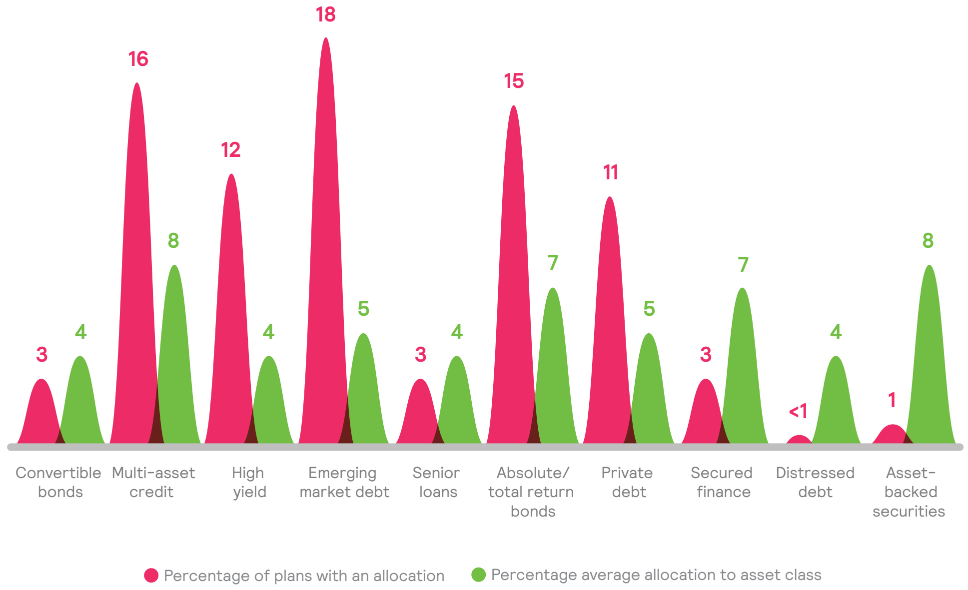


Chart 30. Strategic Allocation to Real Assets (%)

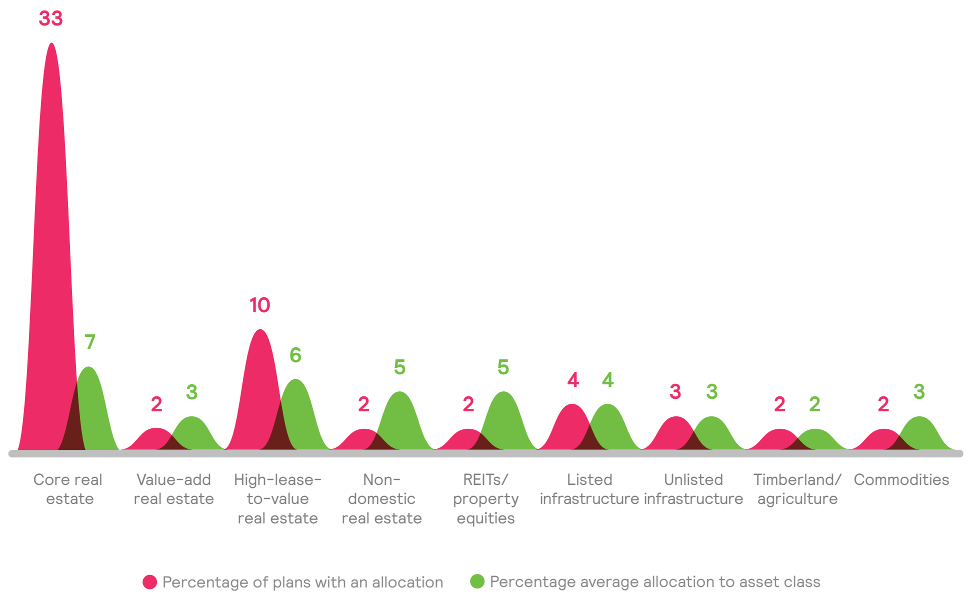
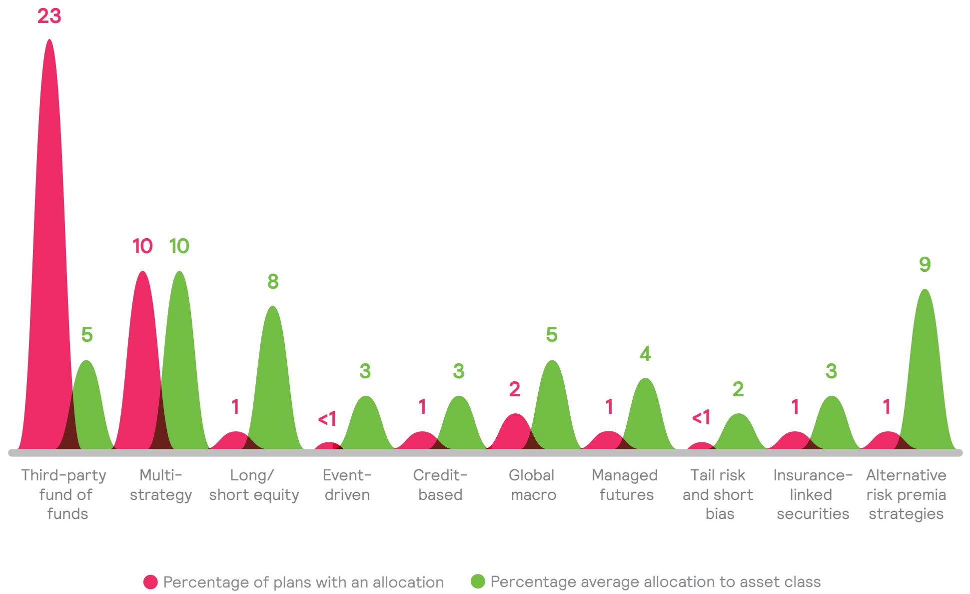


Chart 31. Strategic Allocation to Hedge Funds (%)

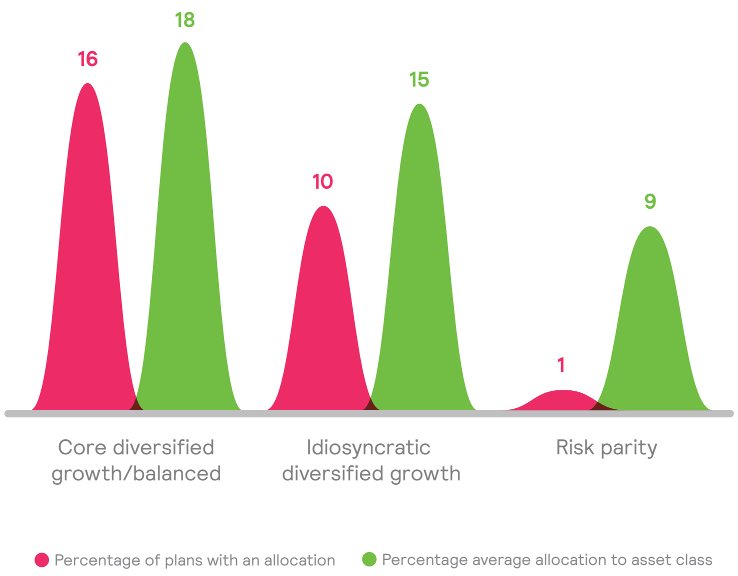


Real asset allocations remain dominated by core domestic real estate. This year, we have provided more granularity on the differing strategies that investors are accessing in the area of real estate — this illustrates the importance of high lease-to-value property strategies to plans seeking long-dated inflation-sensitive cashflows.

Fund of hedge funds remain the most common means of hedge fund exposure. We would expect this to continue as investors focus their governance budget on higher-level strategic considerations.

Turning to multi-asset funds, the most popular vehicles remain diversified growth funds, which can themselves be broken down into "core" funds (which are expected to largely rely on market returns to achieve growth over time) and "idiosyncratic" funds (which place a greater emphasis on tactical asset allocation and specific trade ideas to create a portfolio less reliant on market returns). In what is likely to be a low-return environment looking forward, we expect investors to express a preference for idiosyncratic over "beta heavy" core strategies, but note that idiosyncratic strategies are more dependent on manager skill and therefore demand a degree of manager diversification.

Chart 32. Strategic Allocation to Multi-asset Funds (%)



RESPONSIBLE INVESTMENT

One of our strategic investment themes for 2018 is Stewardship in the 21st Century, highlighting the importance of understanding ESG issues as a source of both risk and opportunity.

In this year's survey, we have continued to focus on some of the key aspects of successful ESG integration, including the drivers behind ESG integration as well as considering in more detail one of the issues we believe should be foremost for investors: the potential impact of climate change on investor outcomes.

The key theme that emerges from the results of the survey is the importance of the changing regulatory environment across Europe. At present, 40% of asset owners surveyed consider ESG risks.

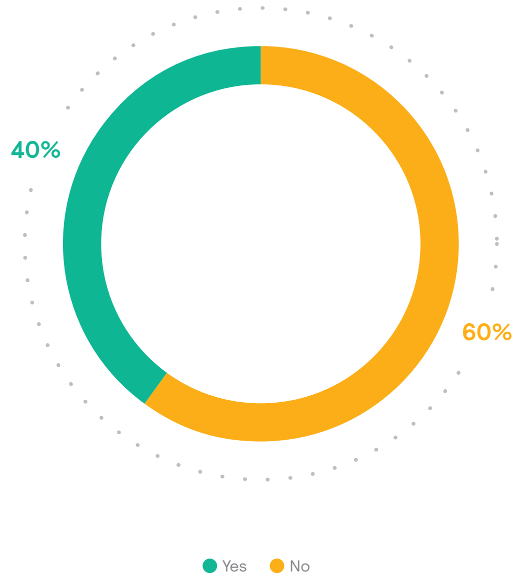
One perhaps surprising finding from the survey was the small number of asset owner signatories to the Principles for Responsible Investment (PRI), widely seen as the leading industry initiative on responsible investment. Only 3% of respondents are signatories to the PRI. As a founding signatory to the PRI, Mercer will continue to encourage its clients to support and participate in such industry initiatives, given the importance of investor collaboration. However, the survey highlights that from an asset-owner perspective, there is still a long way to go before ESG integration is considered mainstream.

We expect the changing regulatory environment to increase demand and expectations from asset owners for ESG integration.

REGULATORY DRIVERS CITED AS THE KEY DRIVER BEHIND THE CONSIDERATION OF ESG RISKS

Once again, we surveyed participants on the drivers behind the decision to integrate ESG issues into their investment processes. We note that the options in our question are not exclusive, with some asset owners motivated by a combination of reasons.

Chart 33. Does the Scheme Consider ESG Risks?



We found that regulatory drivers are the key motivator for plans to consider ESG issues — with 34% of participants citing this as the key driver for integration. This is perhaps not surprising, given the regulatory changes over the last 12–18 months, including strengthened guidance from the UK's Pensions Regulator as well as the recent EU Commission action plan on financing sustainable growth.[1]

Second to regulatory drivers, the financial materiality of ESG risks was cited by 25% of survey respondents as a key driver. The increased recognition across the market that ESG issues may be financially material and, therefore, that considering these issues is consistent with fiduciary duty, remains key to successful ESG integration. With regulatory guidance increasingly clarifying this consistency, we believe some of the former myths that have plagued the successful integration of ESG into mainstream investment processes over the last decade are closer to being dispelled. In time, we believe the opposite will become the standard market position — that is, not considering ESG risks will be seen as a breach of fiduciary duty.

Chart 34. Key Drivers Behind the Consideration of ESG Risks

[1] In August 2017, The Pensions Regulator issued revised guidance to trustees of DB schemes.

EU Commission action plan on financing sustainable growth: in late 2016, the EU Commission appointed a High-Level Expert Group (HLEG) on sustainable finance Chaired by Christian Thimann, Member of the Executive Committee AXA Group, to work on a sustainable finance strategy vision for the EU. The HLEG published its eight recommendations and two imperatives in early 2018. The Action Plan drew insight from the group's recommendations. A separate action was already taken by the EU when IORP II Directive in January 2017 brought trustees of occupational pension schemes under a legal obligation to build ESG factors into decision-making and state how their fund investment policies take ESG factors into account. The Directive will be transposed into Member State legal frameworks by January 2019.

CLIMATE CHANGE: GROWING CONSIDERATION BY ASSET OWNERS

The year-on-year growth in the number of asset owners considering the investment risks and opportunities posed by climate change is welcome — from the very low 5% last year to a much improved 17% in 2018.

Again, we believe regulatory drivers have been an important factor here as investors have digested the numerous industry reports highlighting the issues posed by climate change to the financial industry as a whole as well as the recommendations of the Financial Stability Board's TCFD, which were released in summer 2017.

The TCFD was formed in 2016 following The Paris Agreement, which came into force in November 2016, and set an ambitious target to keep warming well below 2˚C, with a stretched target of 1.5˚C. As we get closer to 2020, when emissions need to have peaked to be in line with meeting this 2˚C target, we expect policymakers to once again reiterate the commitments of The Paris Agreement and the clear signal it provides investors as to the direction of future climate-related policy.

The value of the financial industry-led approach of the TCFD is highlighted by the finding from our survey that over two-thirds of those clients that have considered climate change risks have also considered the findings of the TCFD. We expect that the TCFD framework and its recommendations to asset owners, investment managers and companies will continue to drive financial market participants to be increasingly cognisant of the transition risks posed by the shift to a low-carbon economy as well as the potential impacts of the physical damages being factored into investment decisions.

Mercer continues to focus on climate change and will be publishing an update to the 2015 study report, *Investing in a Time of Climate Change*, later this year. The sequel to this work will once again highlight the investment risks and opportunities posed under different climate change scenarios, including a 2˚C scenario, aligned with the recommendations of the TCFD. We expect to see continued growth in both the number of asset owners considering climate change as well as the adoption of the recommendations of the TCFD in the coming years.

Chart 35a. Proportion of Schemes Considering the Investment Risk Posed by Climate Change

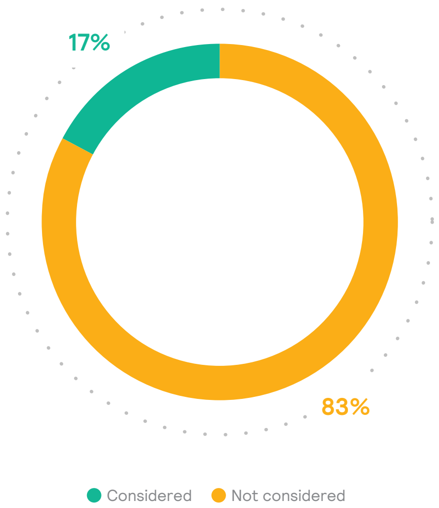
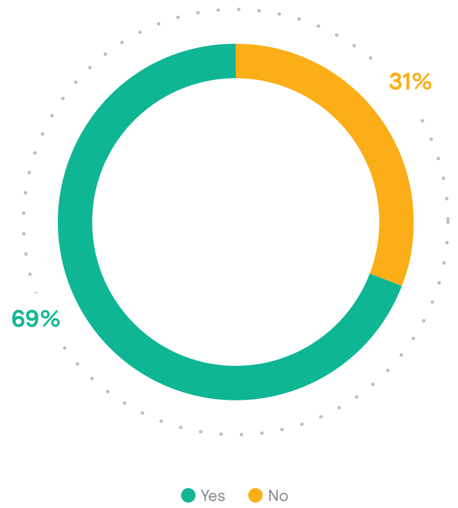


Chart 35b. When Considered, Has the Scheme Considered the Recommendations to Asset Owners of the TCFD?



ACKNOWLEDGEMENTS

Kate Brett, Senior Responsible Investment Consultant

Paul Devlin, Creative Producer

Phil Edwards, Global Director of Strategic Research

Sanish Mistry, Investment Analyst

Matt Scott, Strategic Research Associate

Amy Short, Senior Marketing Specialist

Steffen Zwink, Marketing Consultant

Should you have any questions about the survey, please contact Matt Scott at matt.scott@mercer.com

IMPORTANT NOTICES

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

Proprietary and Confidential

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity without Mercer's prior written permission.

Opinions — Not Guarantees

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed. Past performance does not guarantee future results. Mercer's ratings do not constitute individualised investment advice.

Not Investment Advice

This does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances.

Information Obtained From Third Parties

Information contained herein has been obtained from a range of third-party sources. While the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages) for any error, omission or inaccuracy in the data supplied by any third party.

For Mercer's conflicts of interest disclosures, contact your Mercer representative or see www.mercer.com/conflictsofinterest.