EUROPEAN ASSET ALLOCATION SURVEY 2017

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CONTENTS

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.

After the political earthquakes of Brexit and the election of Donald Trump as US president in 2016, European elections in 2017 have so far delivered few surprises and the health of the European economy continues to improve. However, with uncertainty around the nature and timeframes of Brexit, a gradual withdrawal of extreme monetary policy support and escalating geopolitical tensions, investors continue to face an unpredictable environment. Despite this, equity markets have continued to rise in the early part of this year.

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

- **Fragmentation —** Growing nationalism and what some have dubbed “the death of liberal politics” are likely to remain prominent influences on the political landscape for some time. Indeed, parts of the developed world may be undergoing a political regime shift on a similar scale to that ushered in by Margaret Thatcher and Ronald Reagan in the early 1980s.

- **Shift from monetary to fiscal policy —** 2016 may have witnessed the high point of monetary stimulation, with policymakers increasingly recognising its limits and unintended consequences. At the same time, growing calls for fiscal stimulus have been supported by both mainstream economic voices and populist politicians. The speed and magnitude of any shift from monetary to fiscal stimulus could have important implications for investors in the years ahead, not least in relation to the potential build-up of inflationary pressures.

- **Capital abundance —** The sustained period of monetary stimulation by central banks – now in its ninth year – has created a challenging environment for investors. With real yields below zero in much of the developed world and most asset classes having experienced significant price inflation, generating annual real returns as high as 3%–4% is likely to be difficult over the next three to five years. Many investors will therefore need to consider less familiar asset classes and more flexible strategies in order to meet return objectives in the coming years.

- **Structural change —** Amid the shorter-term discussion of politics and economics, longer-term structural forces such as demographic trends, climate change and technological disruption could also have far-reaching, if less obvious, implications for investors. Identifying some of the broad market outcomes these structural forces could create will help investors manage risk and return over the long term.

The results of this year’s survey suggest that investors are concentrating on investment strategy more than ever, and we would encourage investors to also focus on diversity and robustness in an environment likely to exhibit lower returns and abrupt shifts away from the current low-volatility environment.

Phil Edwards,
Global Director of
Strategic Research

Matt Scott,
Investment Consultant

KEY FINDINGS

DE-RISKING REMAINS A DOMINANT FORCE

Equity allocations continued to fall over the course of 2016, with UK DB plans in particular taking opportunities to de-risk in the latter part of the year as equity markets and bond yields rose in tandem. Over the decade since the financial crisis emerged in 2007, UK plan equity allocations have more than halved from 61% to 29%. This trend looks set to continue, with survey participants indicating their intention to further cut equity allocations in the years ahead.

MORE THAN 50% OF UK DEFINED BENEFIT PLANS NOW CASHFLOW NEGATIVE

In recent years, we have seen a large increase in the number of UK DB plans becoming cashflow negative (that is, their outgo is larger than their income). This year's survey shows that, for the first time, more than half of UK DB plans were cashflow negative, which has fuelled interest in income-generative assets and cashflow-driven financing strategies. Such approaches involve tailoring the asset portfolio to more closely meet the projected liability cashflows while improving funding-level stability. Cashflow-negative plans are also more path-dependent than less mature plans, which is to say that they are less able to tolerate a substantial drawdown in asset values, due to the risk of crystallising losses in order to meet cash outgo.

LOW YIELDS ENCOURAGE A MOVE TOWARDS LESS LIQUID ASSETS

Following eight years of central bank largesse and low levels of business investment, the world is awash with financial capital seeking a home. The exceptional returns of the last eight years will not be repeated, and there is a scarcity of "easy beta" to be harvested. In an effort to maintain returns, some investors are seeking higher yields by investing in asset classes with liquidity and complexity premia such as private infrastructure and secured finance. This trend goes hand-in-hand with the need for income as an increasing number of UK DB schemes become cashflow negative.

RESURGENCE OF HEDGE FUNDS

There is a growing consensus that portfolios dominated by traditional beta (that is, equities, credit and government bonds) will offer a relatively unattractive risk/return trade-off on a forward-looking basis. Although hedge funds have faced a challenging post-crisis environment, with falling volatility and dispersion, institutional investors have not lost faith in this asset class. Indeed, this year's survey shows an increase in exposure to hedge funds as investors respond to the challenging environment for traditional beta.

SURVEY PARTICIPANTS

Our 2017 survey gathered information on a record 1,241 institutional investors across 13 countries, reflecting total assets of around €1.1 trillion. Charts 1–3 show the composition of survey participants both by country and size of plan assets.

Chart 1. Split of Total Survey Assets by Country

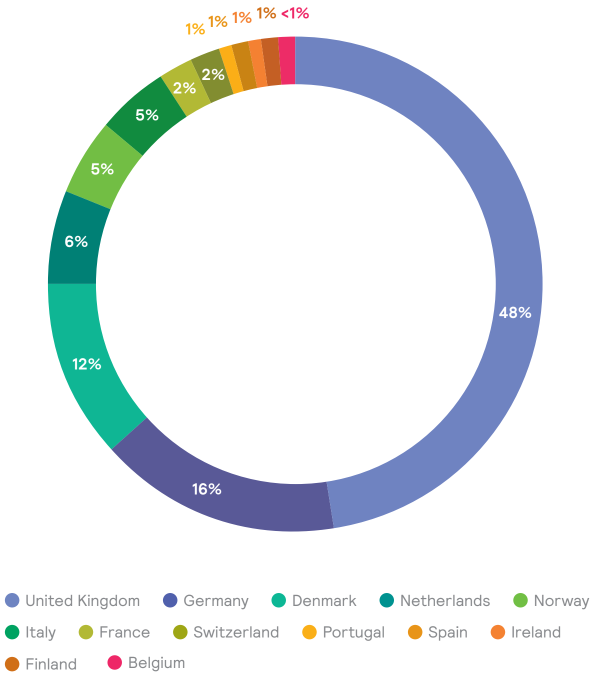


Chart 2. Split of Total Survey Participants by Plan Size

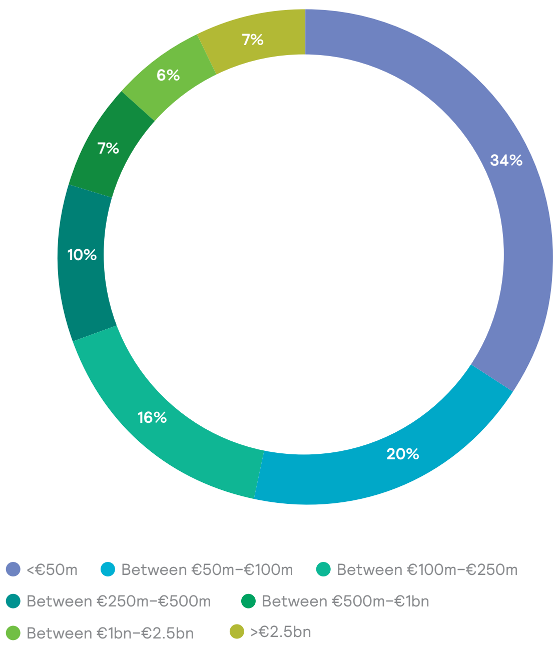
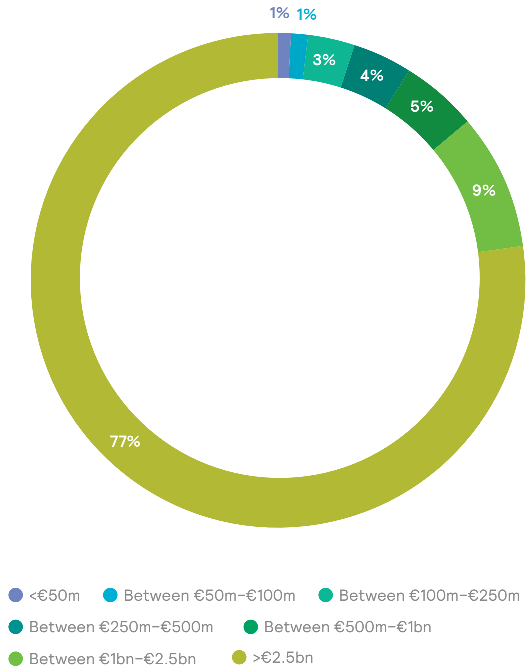


Chart 3. Split of Total Survey Assets by Plan Size



As in previous years, the largest group of survey participants was UK-based (see Chart 1). Around half of the participants (by number) represent plans with assets under €100 million, whereas 13% 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 the majority of 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 DB plan assets broken down by country. Plans in Belgium continue to have the highest average equity weightings, whereas plans in Denmark and Germany (excluding contractual trust agreements, or CTAs, which have less constraints on their asset allocations) 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, including property (discussed further in Section 9), while bond allocations stayed at broadly the same level.

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

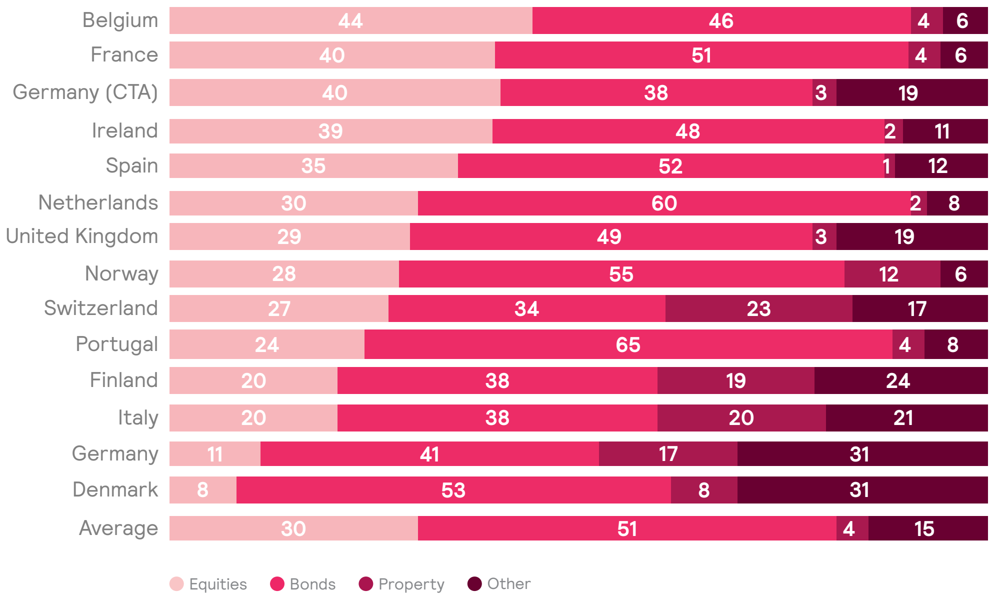
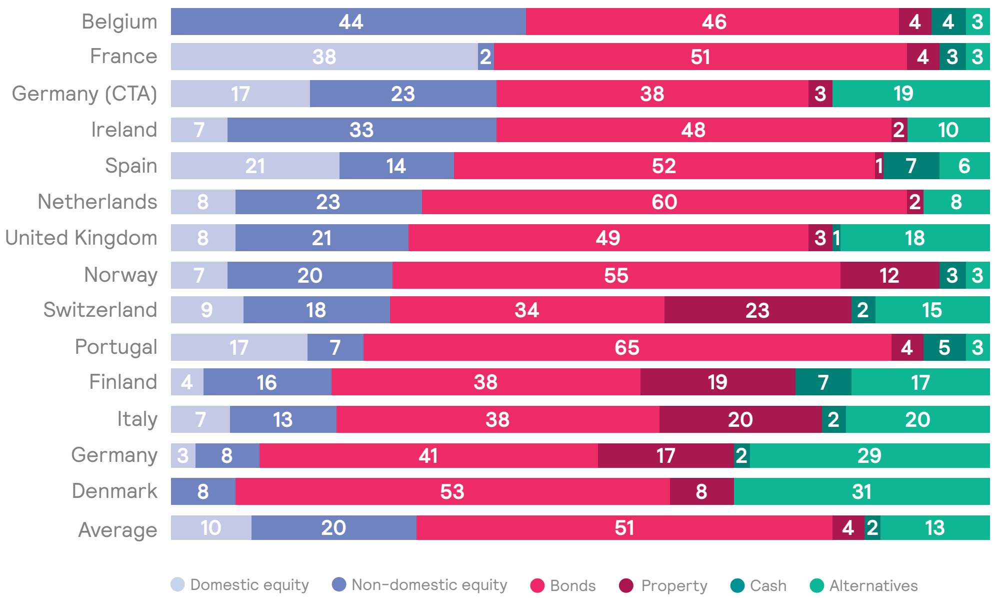


Chart 5. Strategic Asset Allocation by Country (%)



These broad trends are not reflected in each underlying country. Although overall the allocation to bonds was static, it is notable that in Germany, where long-dated sovereign yields have been around and (at times) below zero, bond allocations actually fell substantially.

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 now representing around 35% of the average plan's equity portfolio. Whereas a bias towards eurozone equities will have been supportive of returns during 2015, the opposite was true in 2016. France had the most pronounced domestic bias, with several survey schemes having all their equities invested in the eurozone.

Chart 6. Bond Portfolio Allocation by Country

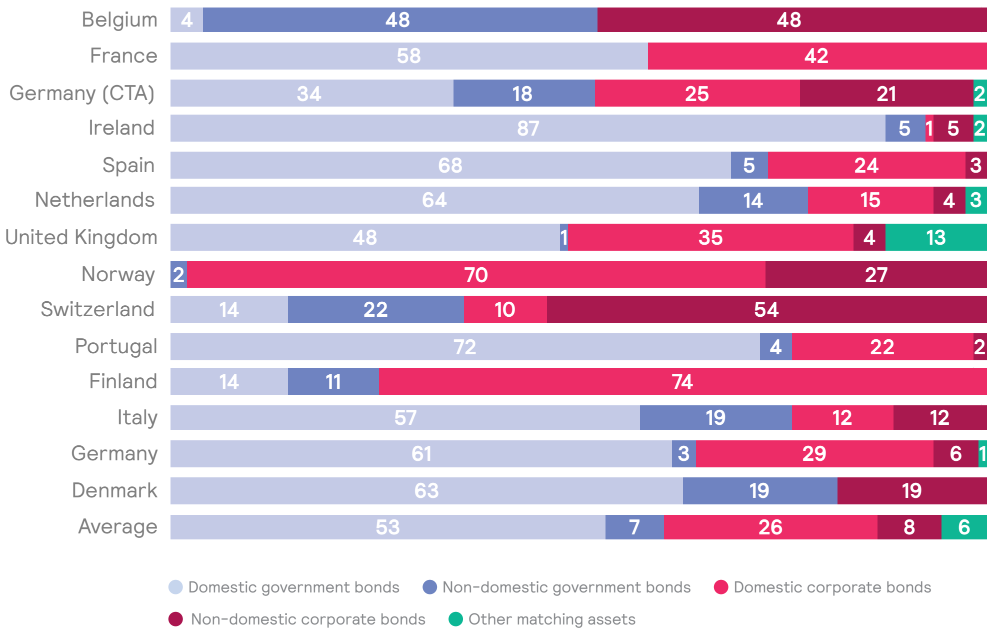
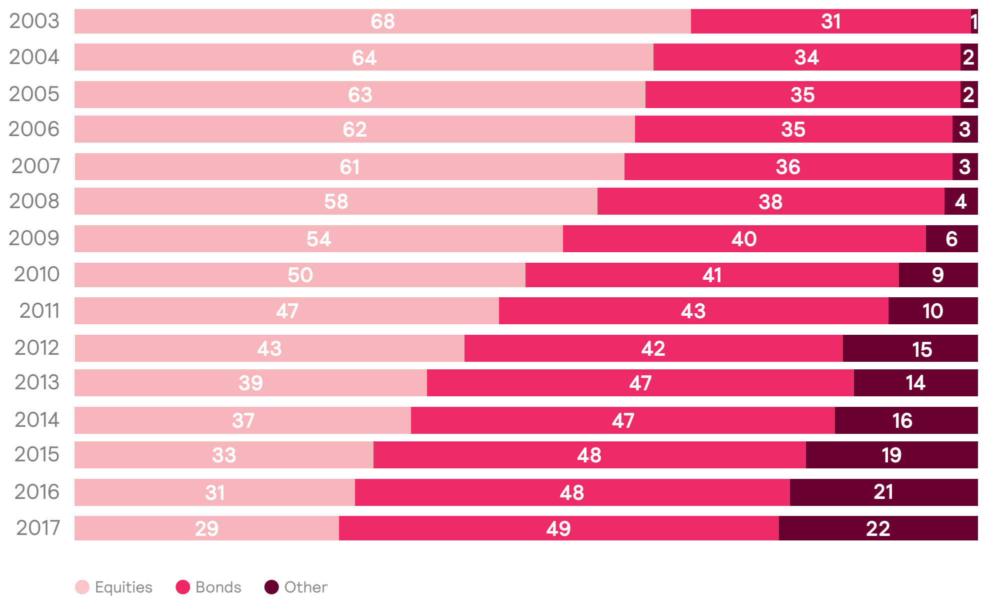


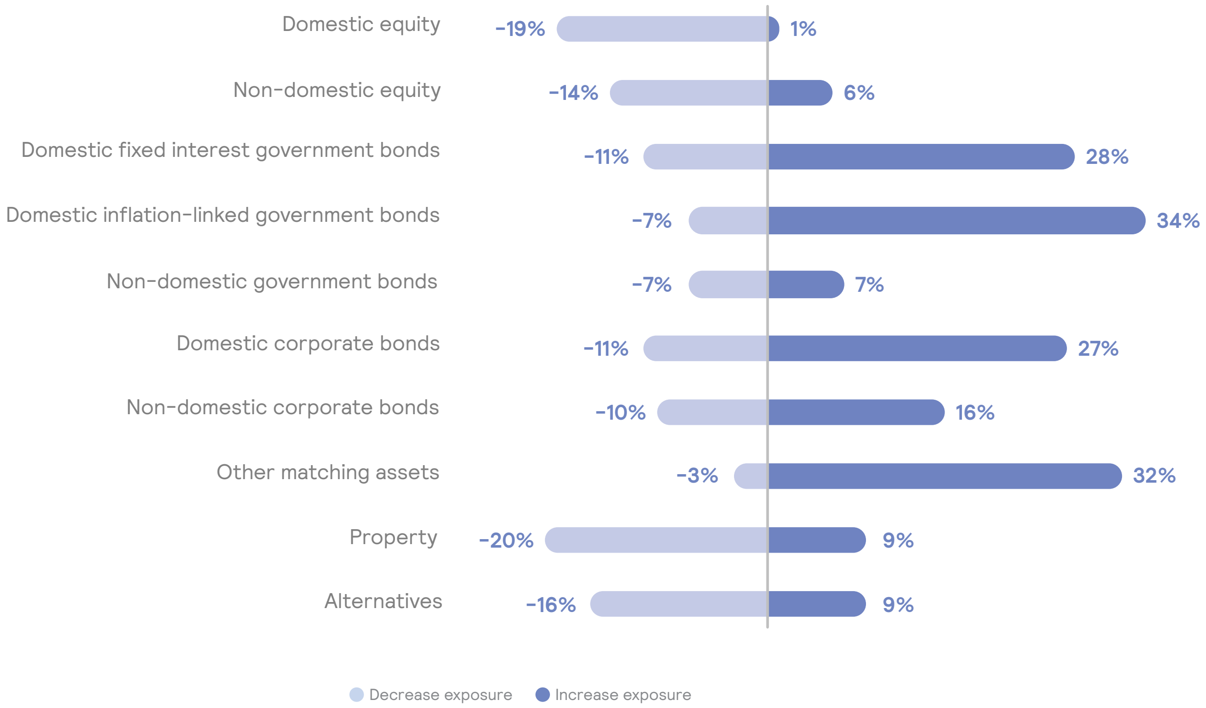
Chart 7. Changes in Broad Strategic Asset Allocation for UK plans (2003–2017)



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

Chart 7 shows the change in overall allocations in the UK over the last 14 years. The long-term reduction in equity exposure continued in 2016, with the average plan equity allocation falling to a new low of 29%. The fall in equity assets was offset by a slight increase in bond and alternative allocations.

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 (primarily LDI strategies). The trend from last year of plans expecting to reduce allocations to alternatives (in particular, property) continues. In the case of property, this may reflect the strong returns experienced in a number of markets in recent years. At a more granular level, the main asset classes expected to see inflows are private debt, secured finance and infrastructure.

INVESTMENT GOVERNANCE

Pension plan governance covers a wide range of topics, from the composition of the trustee group and the way in which decisions are delegated to sub-groups 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

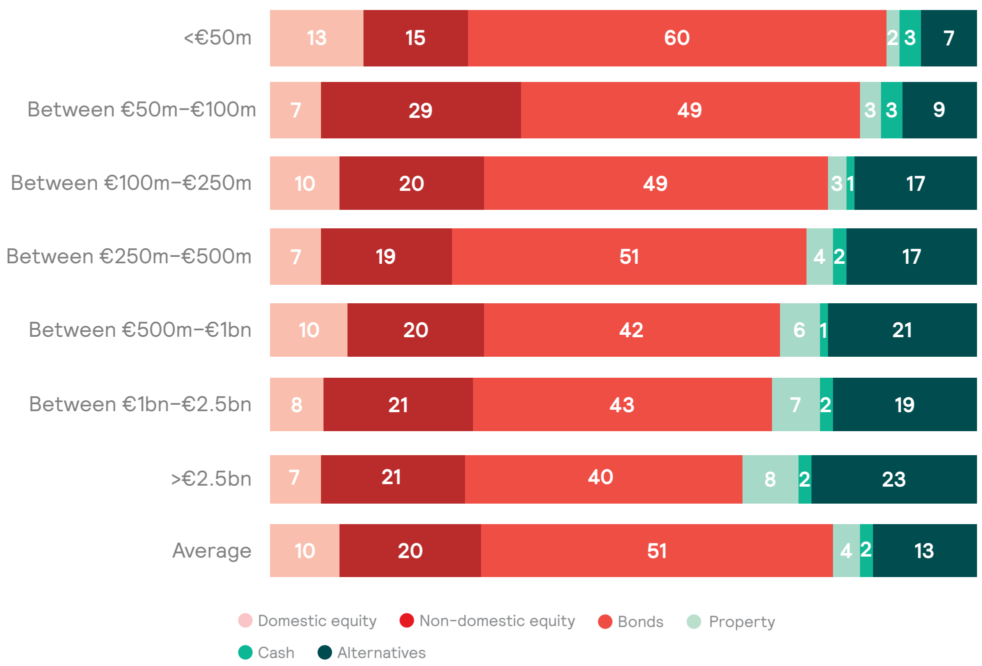


Chart 10. Breakdown of Responsibilities around the Investment Cycle

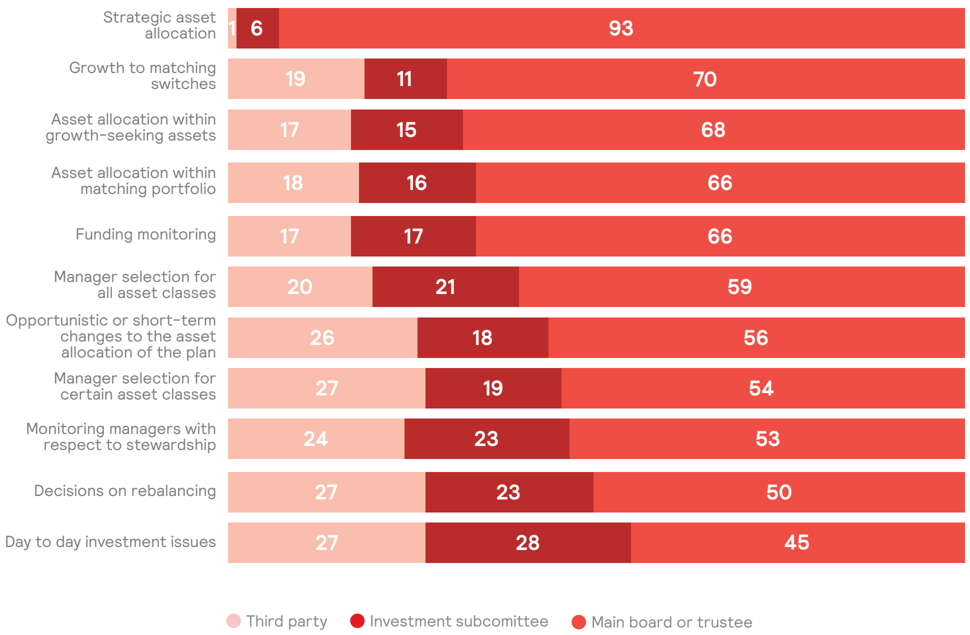


Chart 9 illustrates how asset allocation varies with plan size. Although equity exposures don't appear to obey a clear pattern, the average plan allocation to alternative assets — which can include complex and less-liquid strategies — is much higher for larger plans, which typically have greater resources.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

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 (93%). Regular review of the investment strategy is increasingly recognised as best practice, with more than 60% of plans now reviewing their strategy at least once a year, an increase from last year.

Forty-six percent of plans delegate some degree of investment manager selection, either to an investment subcommittee or 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 12–14 consider the average number of active mandates by plan size and the extent to which passive mandates are used for equities and bonds. Larger plans use more 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 increased slightly over the year. This has been driven by industry-wide forces, including pressure on fees and a shift towards passive by those investors that experience a sustained period of underperformance from their active managers. We note that although passive bond strategies are more likely to be employed by smaller plans, there is less of a clear trend (by size of investor) in equities.

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

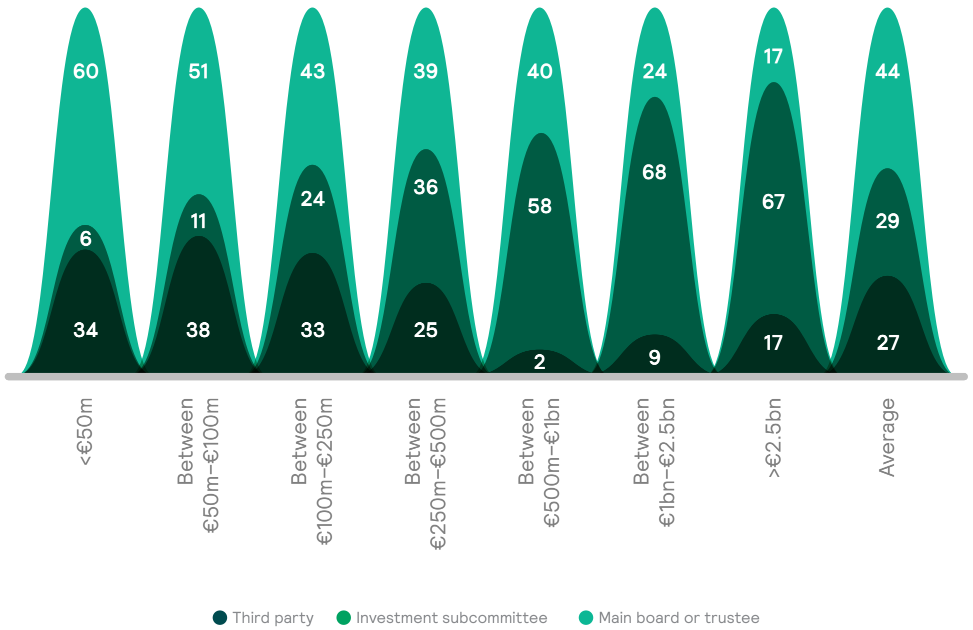


Chart 12. Average Number of Active Mandates by Plan Size

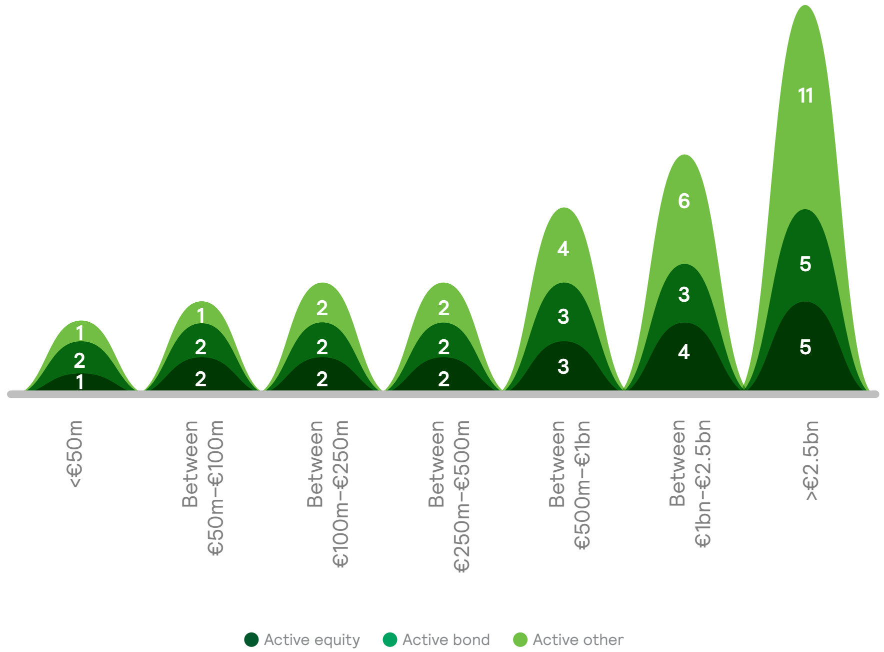


Chart 13. Proportion of Equity and Bond Assets Managed on a Passive Basis, Annual Shift

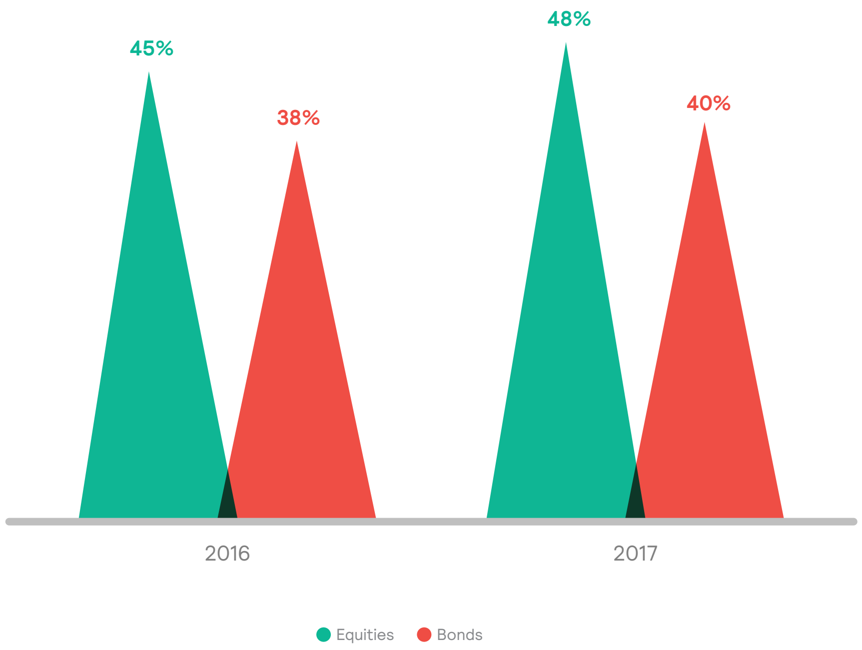


Chart 14. Proportion of Equity and Bond Assets Managed on a Passive Basis, by Plan Size

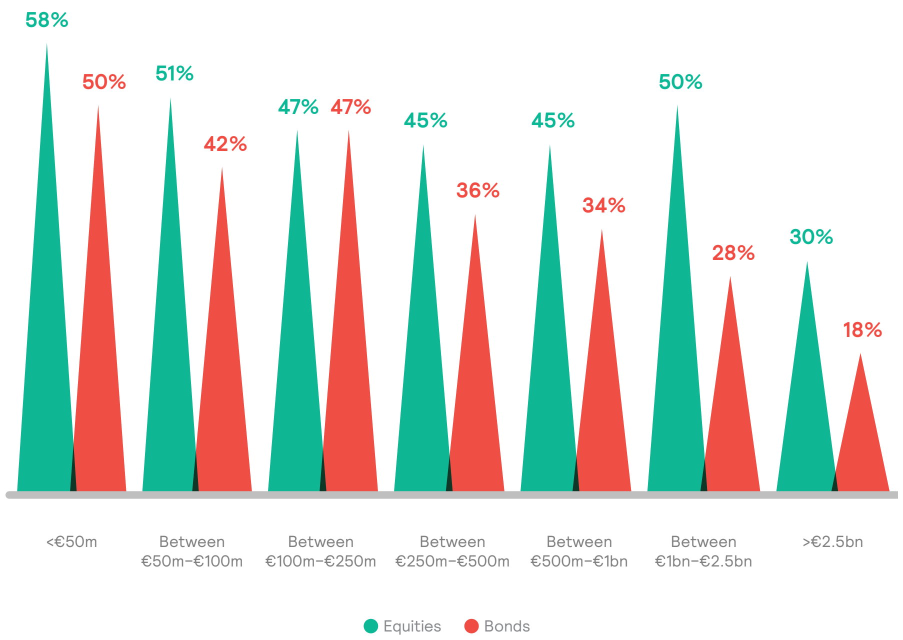
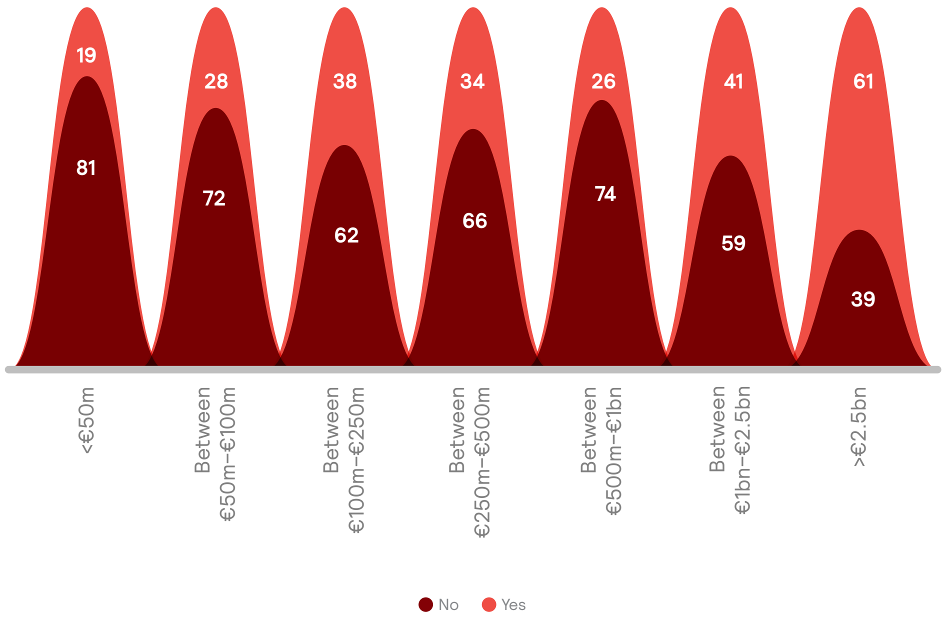


Chart 15. Proportion of Plans Carrying out Operational Due Diligence by Plan Size



As plans increase in size, the number of managers they appoint typically increases, leading to higher operational requirements. It is therefore no surprise that investor interest in providers' middle- and back-office functions appears to be a correspondingly higher priority for larger investors, with plans between €1 billion and €2.5 billion making the greatest use of operational due diligence reviews (see Chart 15).

DE-RISKING FOR UK DEFINED BENEFIT PLANS

Charts 16a–16f provide further detail on the de-risking of UK DB plans, the largest single type of plan in the survey. The 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 16a. Long-term Funding Objective

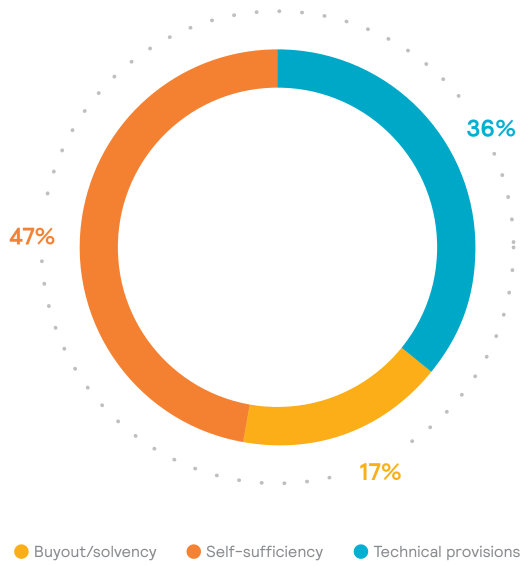


Chart 16b. Self-sufficiency Basis

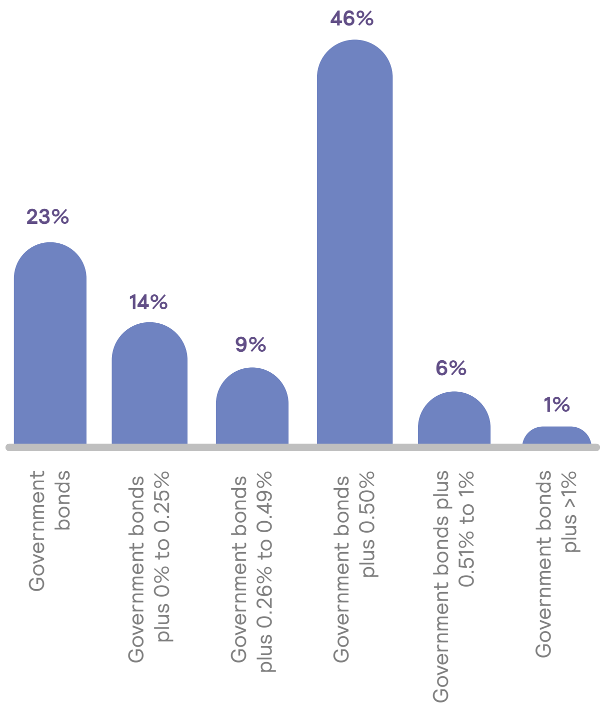


Chart 16c. Implementation of De-risking

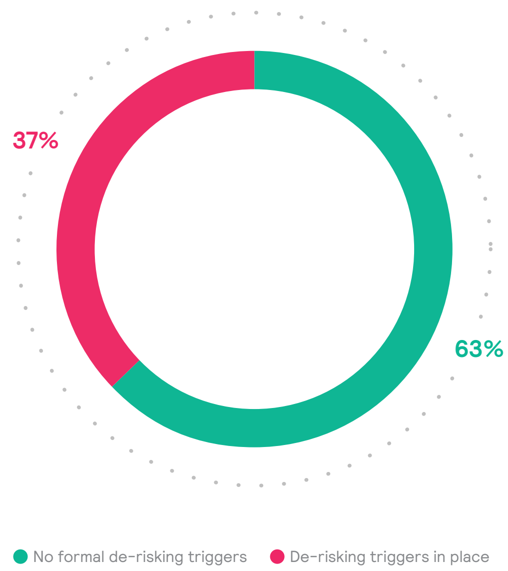


Chart 16d. Timeframe for De-risking

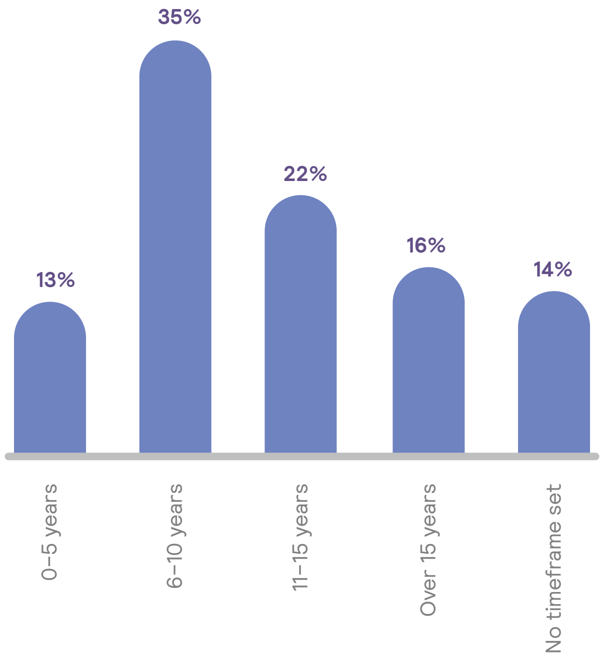


Chart 16e. Delegation of De-risking

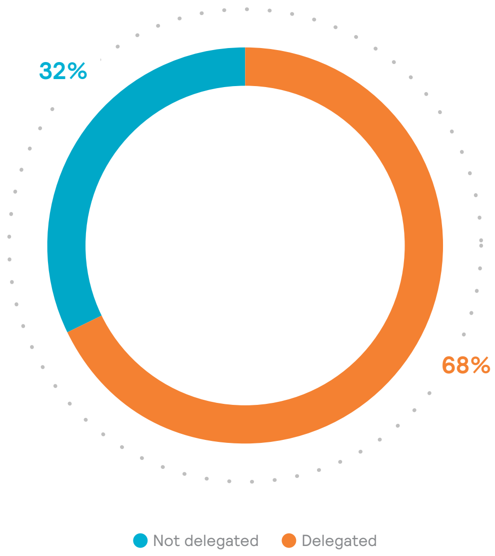
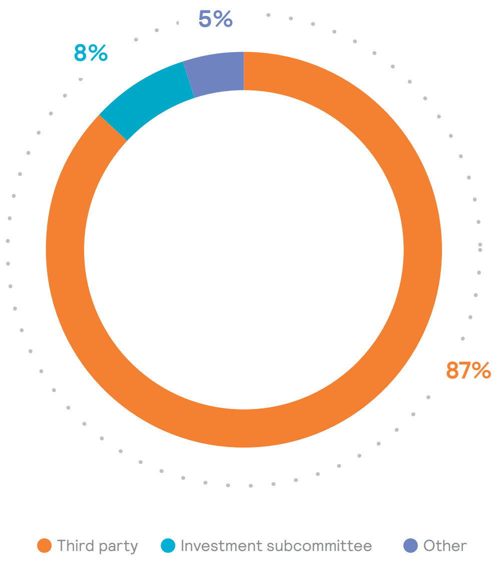


Chart 16f. Who De-risking Is Delegated to



The proportion of DB plans that have defined a specific long-term funding objective (beyond their "technical provisions" liabilities) has increased to 64% this year (see Chart 16a). This objective is typically either the transfer of plan liabilities to an insurer (a buyout) or, more frequently, a "self-sufficiency" strategy. In the latter case, 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 16b).

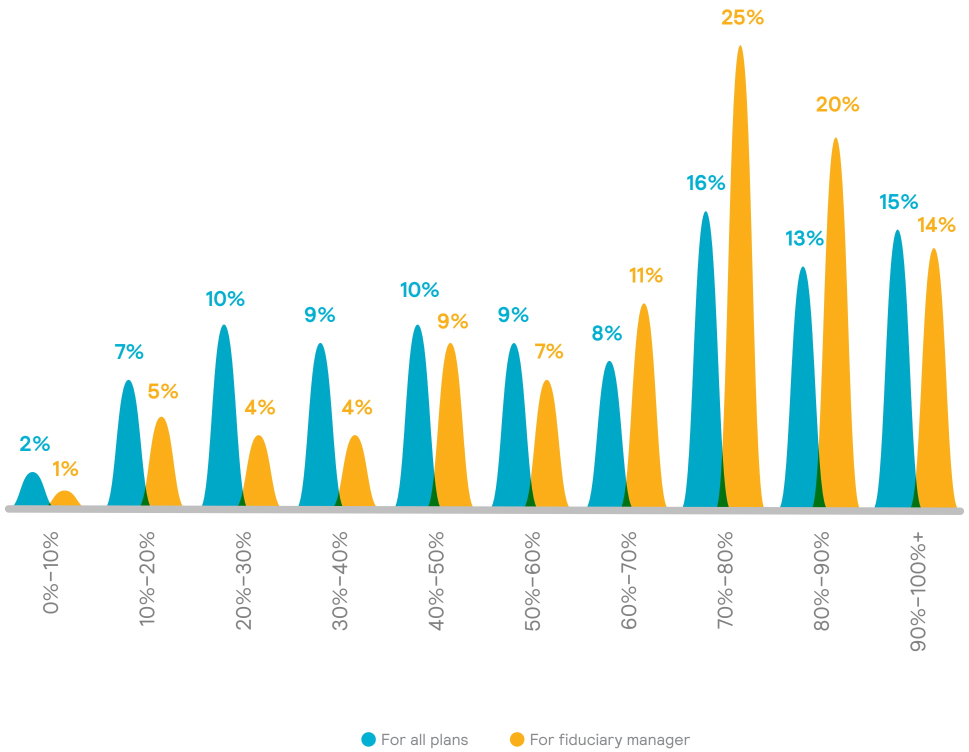
Almost 40% of surveyed plans have put in place a de-risking framework to guide their journey towards their funding objectives (see Chart 16c). The associated timeframe for reaching full funding varies — not least due to the range of plan funding levels today — but most plans (around 70%) are aiming to achieve their objective within the next 15 years (see Chart 16d). 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 16e and 16f).

RISK MANAGEMENT

The largest component of 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" 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 17 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 63% 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 17. 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 18a–18e 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 LDI mandates increased to just shy of 90%. Although repo remains attractive in pricing terms relative to swaps, this is not a new development.

One of the challenges to the use of repo has been regulation, making it less attractive to banks and therefore raising the prospect of market dry-up. However, some investors may have had this reservation quashed by non-bank counterparties coming online. As shown in Chart 19, the most popular means for implementing liability hedging is via pooled vehicles, offering a lower-governance alternative to separate accounts.

Chart 18a. Interest Rate Swaps

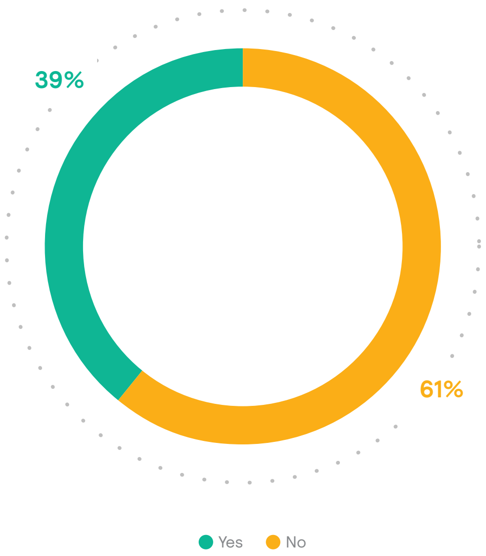


Chart 18b. Inflation Swaps

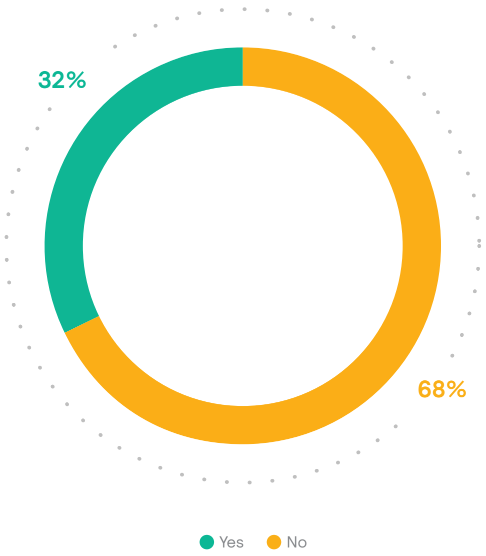


Chart 18c. Government Bonds Total Return Swap

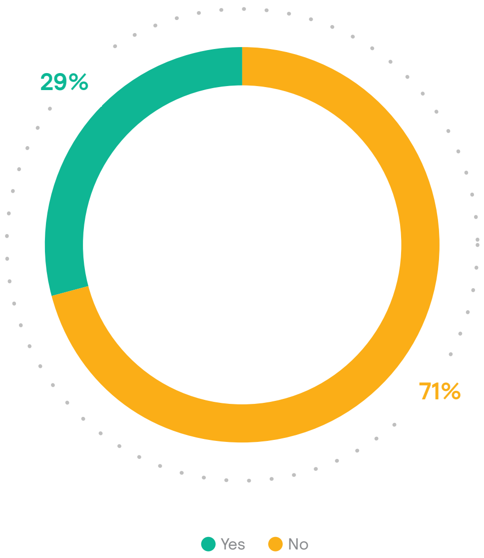


Chart 18d. Government Bond Repos

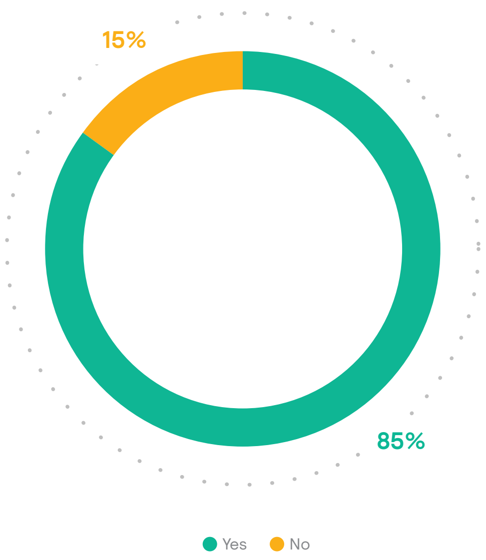


Chart 18e. Swaptions

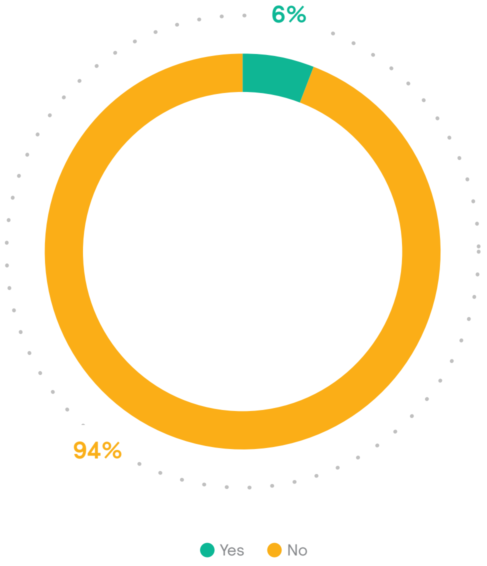
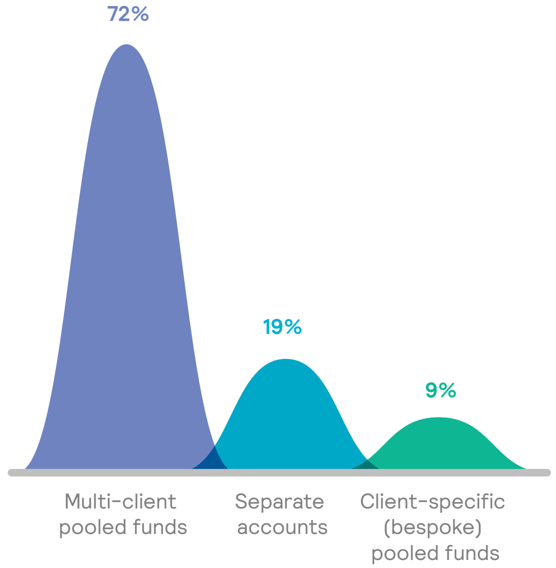


Chart 19. Vehicles Used for Liability Hedging



Looking at how plans expect to increase their liability-hedge ratios from here, Chart 20 shows that plans commonly expect this to be a result of de-risking trades out of equities and into bonds. In 44% of cases, plans expect to increase their level of hedging should bond yields increase, up from 42% last year. The use of phased or time-based approaches to increasing hedging remains relatively uncommon.

Chart 20. Methods for Increasing Hedging

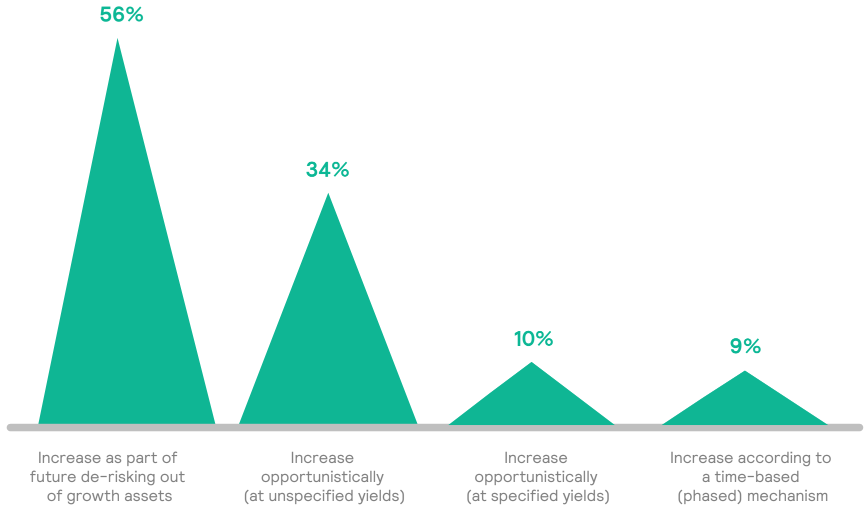
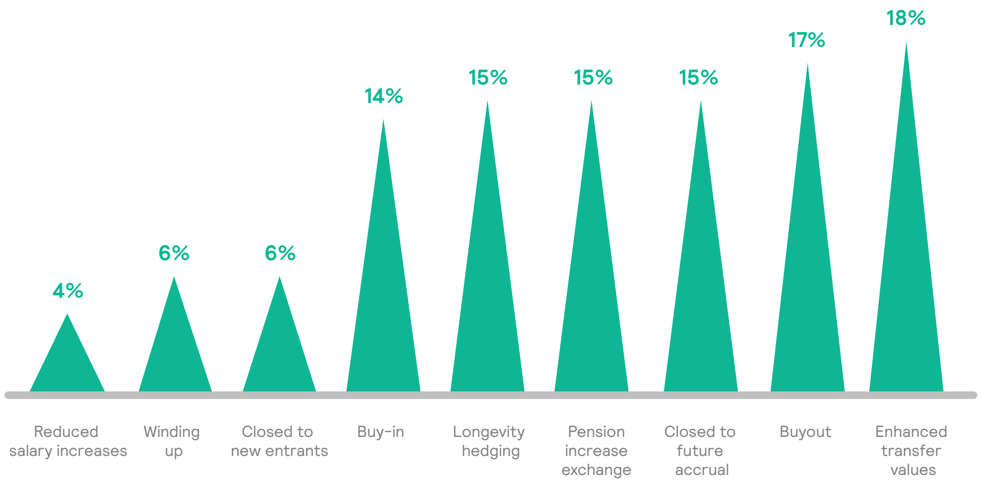


Chart 21. Proportion of Plans Considering Risk Management Exercises over the Last Year



For 10% 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 2.8%, and the yield at which they would expect to be fully hedged is 3.7%. Although these yields are considerably higher than the associated sovereign bond 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.

Liability risk management encompasses a range of strategies beyond interest rate and inflation hedging, and plans considered a variety of liability management approaches over 2016, as shown in Chart 21. 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 22a–22c 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, 55% of plans surveyed are currently cashflow negative (up from 42% last year) and, of those that are not, nearly 85% are expected to become so over the next 10 years. In seeking to meet net cash outgo, most plans disinvest assets, but 29% have instructed their investment managers to distribute income when possible (to reduce the transaction costs associated with disinvestment). A small number of plans (4%) 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 22a. Proportion of Plans that Are Cashflow Negative

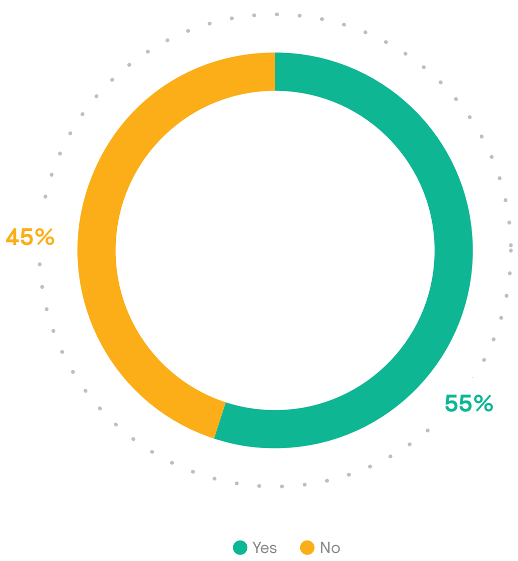


Chart 22b. Expected Time for Cashflow-positive Plans to Become Cashflow Negative

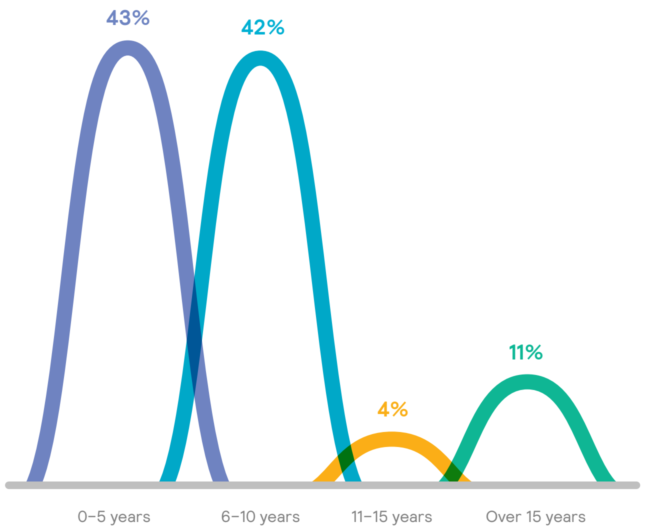
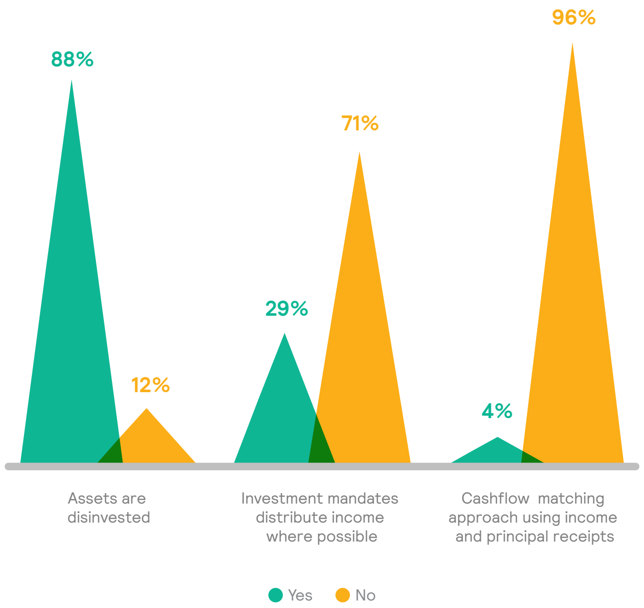


Chart 22c. Methods of Meeting Cashflow-negative Outgoings



"The popularity of cashflow matching is clearly set to grow over time and we are already seeing an upswell in interest in the cashflow-driven financing approach. In our view, focusing on income-generation provides much greater certainty of return over the long term than more traditional approaches, while also reducing the path dependency of outcomes."

Adam Lane, Senior Strategic Solutions Group Consultant, Mercer

Chart 23 shows the range of strategies that plans have considered to manage equity risk. Although many plans have weighed up the use of derivatives, relatively few have implemented them, with more traction coming from the use of low-volatility equities (either strategies aiming for a "minimum variance" approach by portfolio optimisation, or investing in stocks with a high-quality exposure).

Chart 24 shows that although sovereign yields remain at very low levels, this has not stopped plans increasing their exposure. Two-thirds of participants have increased bond holdings or interest rate exposure over the last year.

Chart 23. Managing Equity Risk

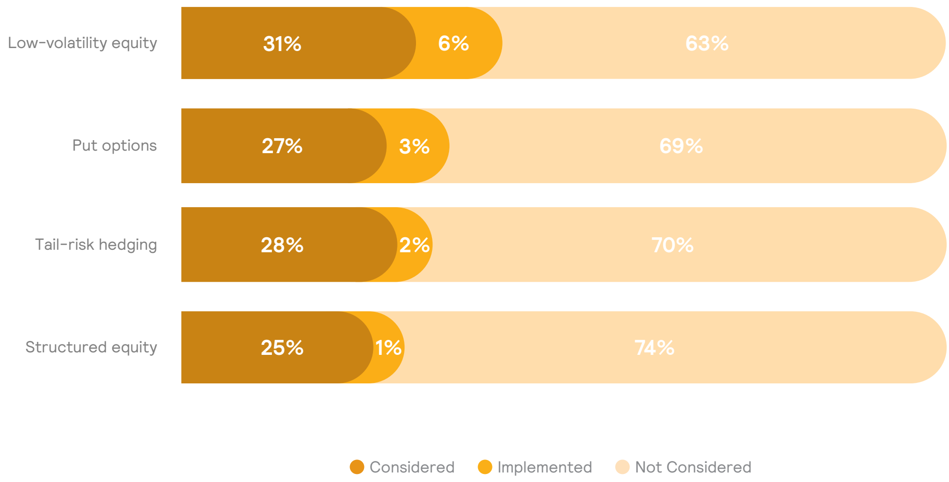
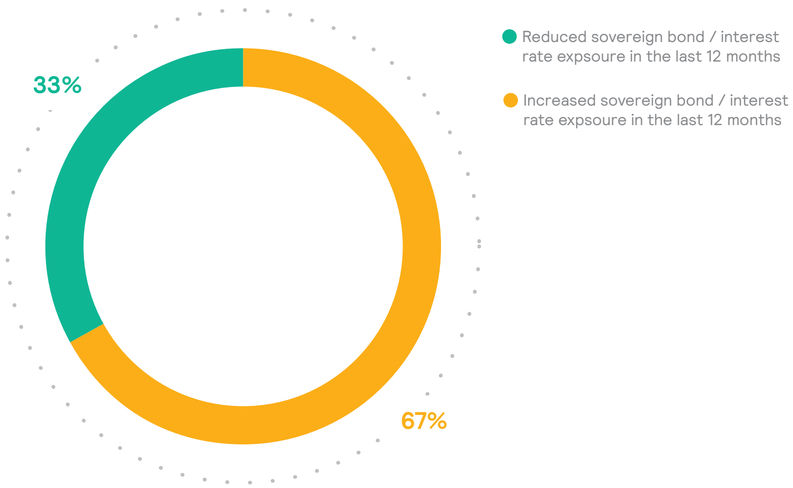


Chart 24. Response to the Low-yield Environment



EQUITY PORTFOLIOS

Charts 25–27 consider equity portfolios by plan size, underlying allocation and currency exposure. Although equity allocations are smaller than they were a decade ago, we have seen plans construct equity portfolios in an increasingly thoughtful manner. This has not only included 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 25. Total Equity Split

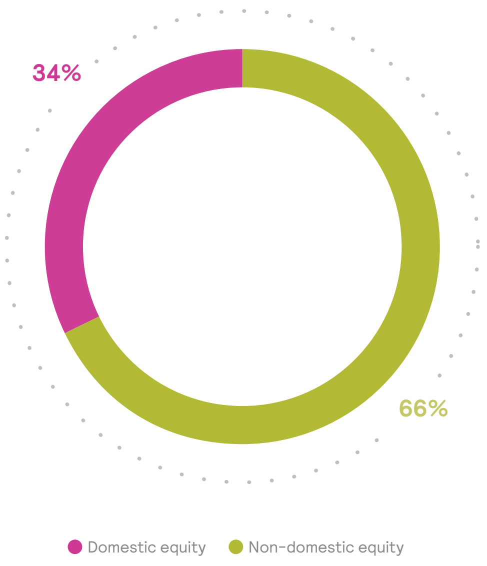


Chart 26. Strategic Allocation to Selected Equity Strategies

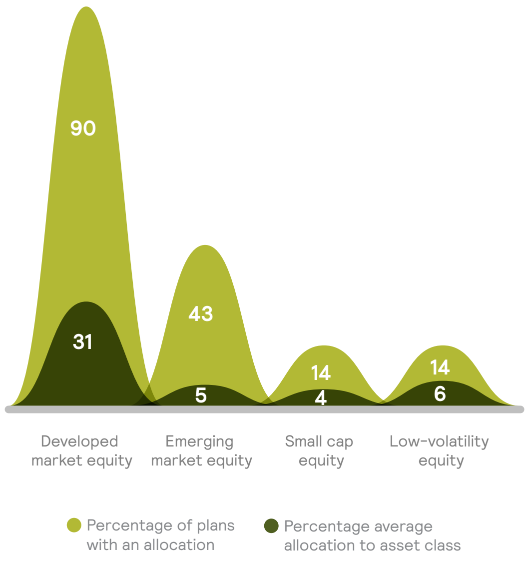
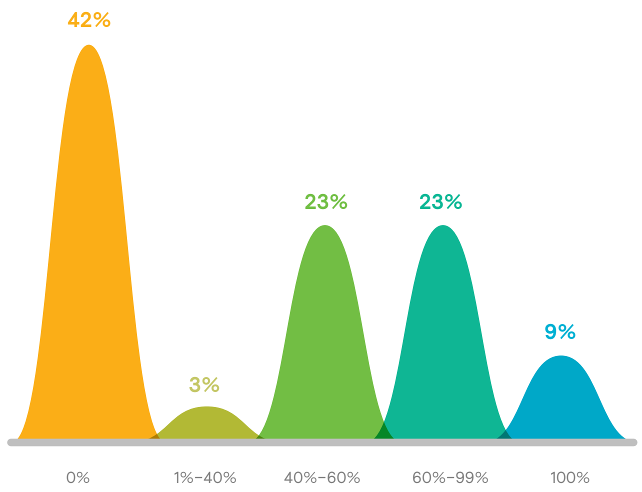


Chart 27. Target-currency Hedge Ratios for Equity Portfolios



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 large proportion of plans hedge none of their exchange-rate risk, which may reflect scepticism about the value of currency hedging, or a belief that the 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 hedge ratio for the largest plans is 18% 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 28a and 28b consider five broad buckets:

- Private equity, both via 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 sensitivity, 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 largely relates to diversified growth funds, diversified beta funds and risk parity (accepting that these strategies are not mutually exclusive)

Chart 28a. Allocation by Type of Asset Class

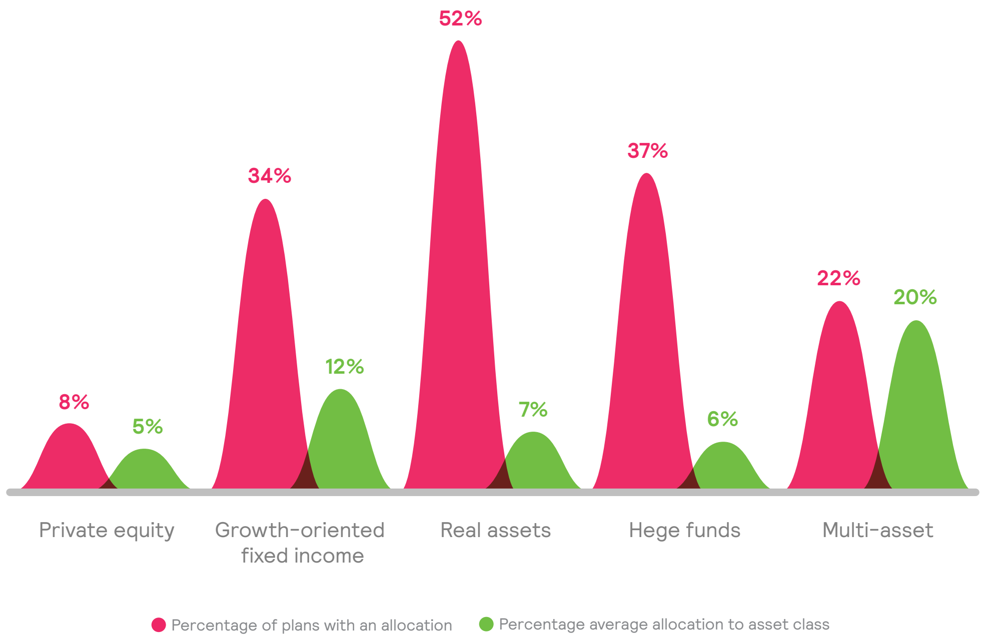
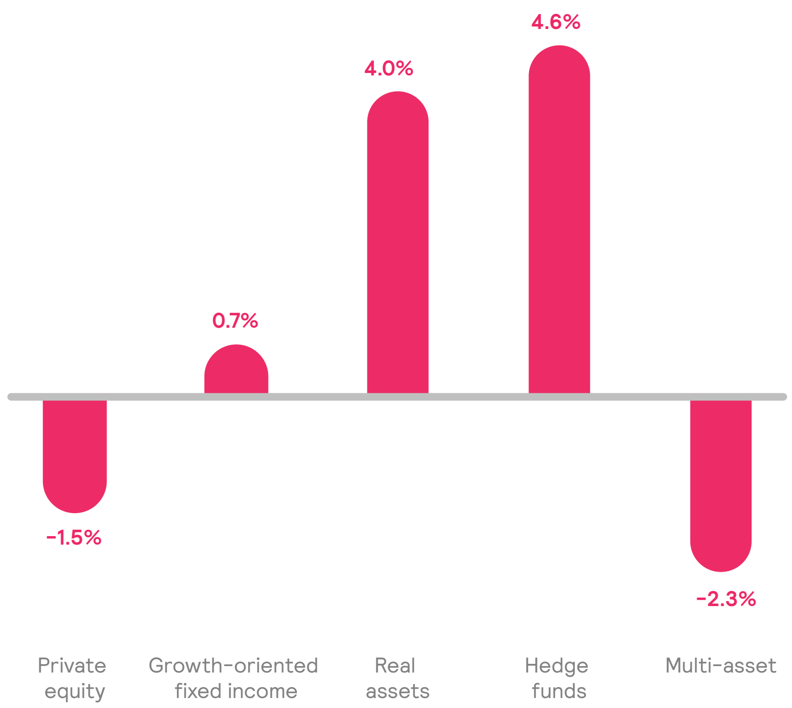


Chart 28a shows that hedge funds, real assets and growth-oriented fixed income remain the most popular forms of alternative assets. The average size of allocation varies between 5% and 20% of total plan assets, with multi-asset strategies seeing the largest average allocations. This may be expected given 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 28b exhibits the changes in the proportion of plans with an allocation to each category compared to last year's survey, with allocations to multi-asset strategies and private equity decreasing and allocations to hedge funds, real assets and growth-oriented fixed income all rising. The increases to growth fixed income and real assets reflect the fact that schemes are becoming more aware of their cashflow requirements, with the decrease to private equity coming from a general trend towards de-risking and an increase in hedge funds consistent with an environment where returns from traditional market betas will be hard to find.

Chart 28b. Year-on-year Change in Allocation



Charts 29–33 consider plans' allocations within each of the alternative asset categories. Growth-oriented fixed income allocations continue to be dominated by emerging market debt, high yield and multi-asset credit. Relative to last year, the main change is that the percentage of plans allocating to high yield has decreased, whereas the percentage of plans allocating to absolute return bonds has increased. We have also introduced "secured finance" as a new sub-strategy within this universe. Such strategies will invest in a range of liquid and less-liquid credits (including ABS, loans and senior private debt), targeting a return around cash +2%–3% p.a. A small number of plans have already allocated to this area, and we expect allocations to increase over the course of 2017.

Chart 29. Strategic Allocation to Private Equity

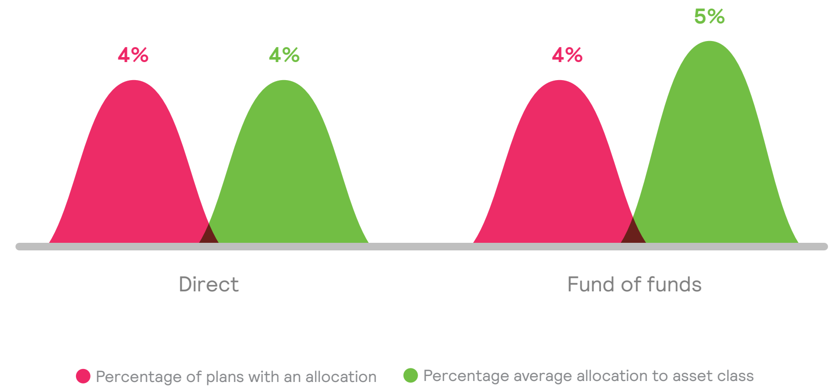


Chart 30. Strategic Allocation to Growth-oriented Fixed Income

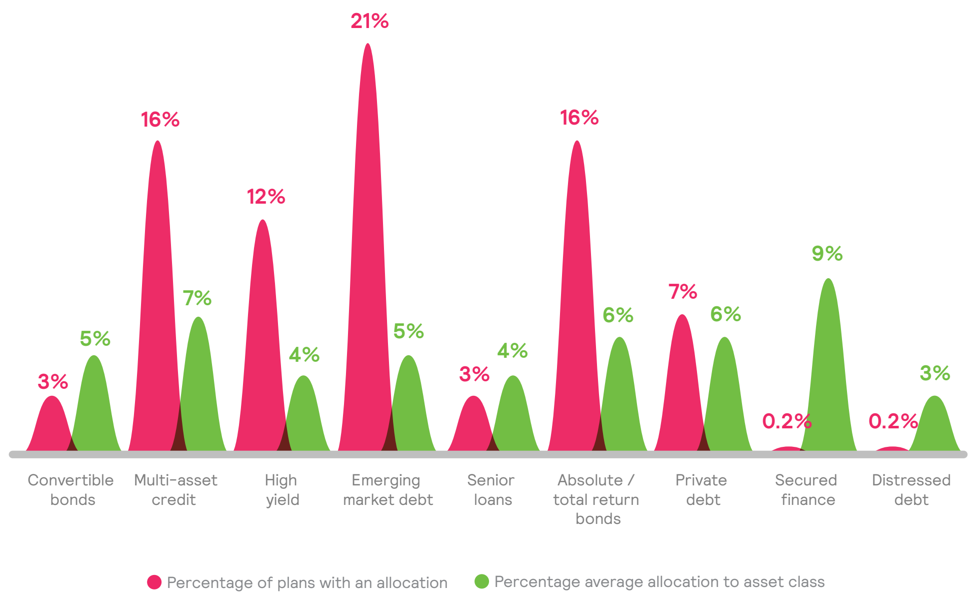


Chart 31. Strategic Allocation to Real Assets

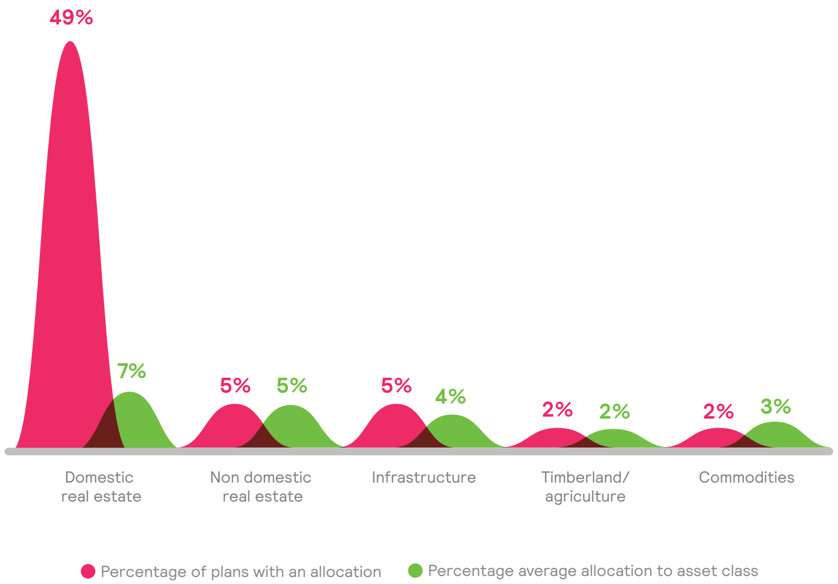
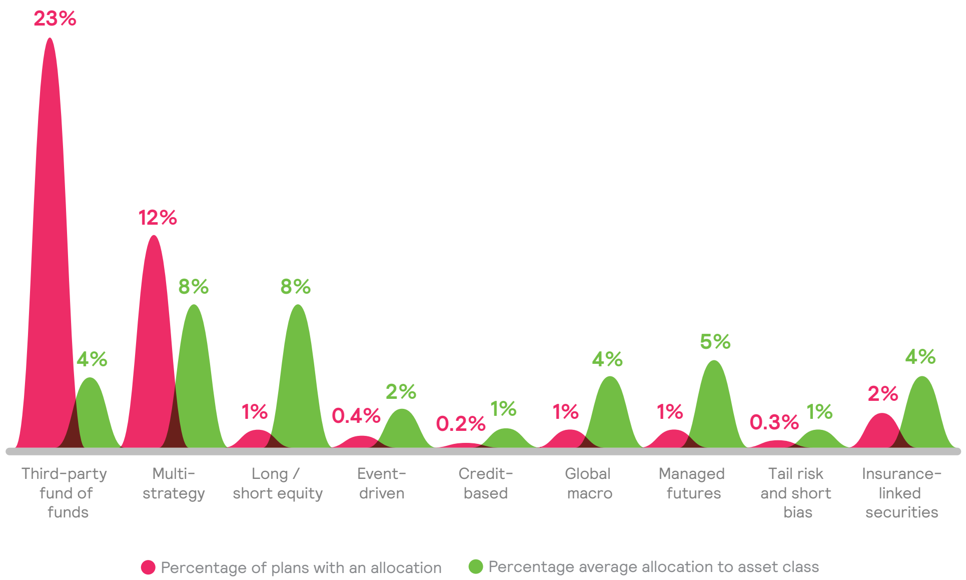


Chart 32. Strategic Allocation to Hedge Funds



"Over recent years, hedge funds have generated positive but muted returns, particularly when compared to traditional equity and fixed-income asset classes. The current outlook for traditional asset classes, however, appears more challenging, and hedge funds, with their absolute-return focus, offer an attractive proposition on a relative-value basis. In addition, we expect higher volatility and lower correlations across markets going forward, which should provide attractive opportunities for active management in general, and hedge funds in particular."

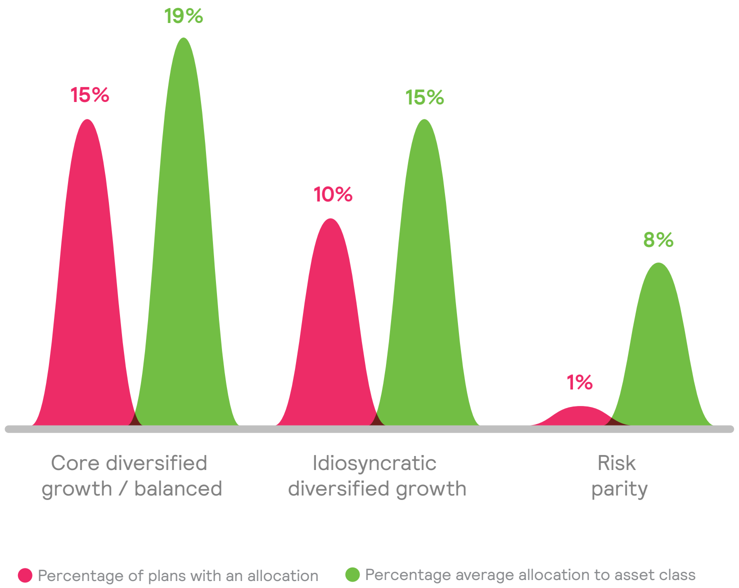
Deb Wardle, Alternatives Portfolio Manager, Mercer

Real-asset allocations remain dominated by real estate, with the overall increase in real estate exposure relative to last year driven by increasing allocations to domestic property. Much of this increase in exposure in UK plans has been via long-lease and ground-lease investments as opposed to the more growth-oriented “core” property mandates.

Fund of hedge funds remain the most common means of hedge fund exposure. We would expect this to continue as investors carry on spending and increasing the portion of 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 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 the current low-return environment, we expect investors to express a preference for idiosyncratic over “beta-heavy” core strategies.

Chart 33. Strategic Allocation to Multi-asset Funds



RESPONSIBLE INVESTMENT

As in previous years, we have focused our survey on the drivers behind environmental, social and corporate governance (ESG) integration, as well as on two key areas of focus within responsible investment: investor stewardship and active ownership rights; and the investment risks and opportunities posed by climate change.

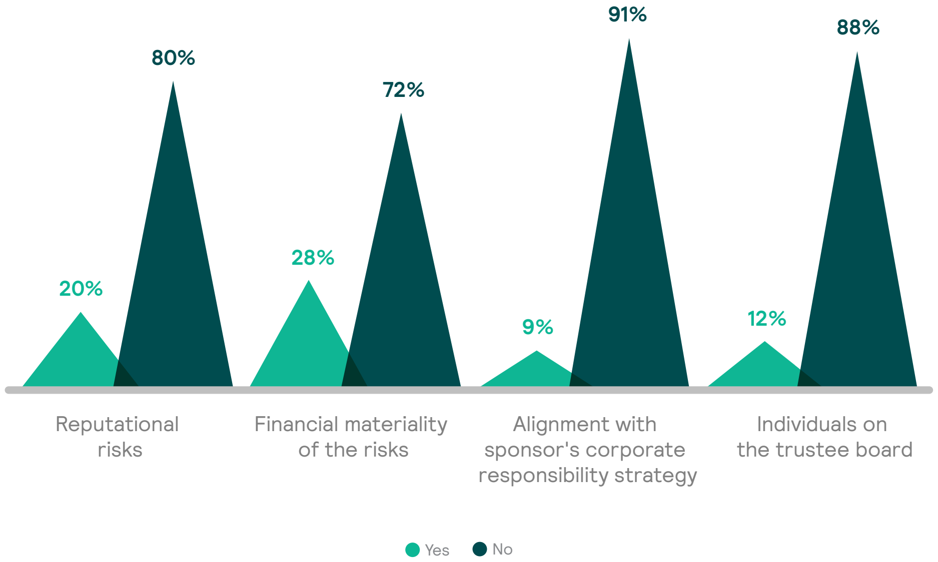
ESG INTEGRATION: STRONG INCREASE IN RESPONDENTS IDENTIFYING FINANCIAL MATERIALITY AS THE KEY DRIVER BEHIND ESG RISKS

We surveyed participants about the drivers behind the decision to integrate ESG issues into their investment processes. We note that the options are not exclusive; some asset owners are motivated by a combination of reasons.

Although there has been an increase across all four categories, the financial materiality of ESG risks remains the key driver behind integration. The number of respondents identifying financial materiality as the key driver behind ESG risks increased strongly: this year, 28% of respondents cited financial materiality as the main driver to integrating ESG issues, compared to 20% of respondents last year. Next on the list is reputational risk, cited by 20% of respondents this year, up from 16% last year.

The continued increasing recognition that ESG risks may be financially material is a positive development for the market and regulators. Asset owners cannot afford to dismiss ESG risks as non-financial, and the consideration of ESG issues is consistent with fiduciary duty. Reputational risk continues to be an important driver of the consideration of ESG risks; public scrutiny is increasingly apparent, with growing expectations for transparency and disclosure, driven by the prominence of social media. We expect reputational risk to continue to be a key driver in future years.

Chart 34. Key Drivers of the Consideration of ESG Risks



"The sharp increase in asset owners citing financial materiality as the driver behind considering ESG risks is a positive development for the market. Asset owners simply cannot afford to dismiss ESG risks as non-financial. Regulators are increasingly clear that asset owners should be considering all risks that may be financially material, including ESG-related risks and long-term risks, such as climate change."

Kate Brett, Senior Responsible Investment Consultant, Mercer

Typically, around 20% of asset owners integrate ESG risks into their investment beliefs and policies, with 22% of those surveyed having a standalone responsible investment (RI) policy.

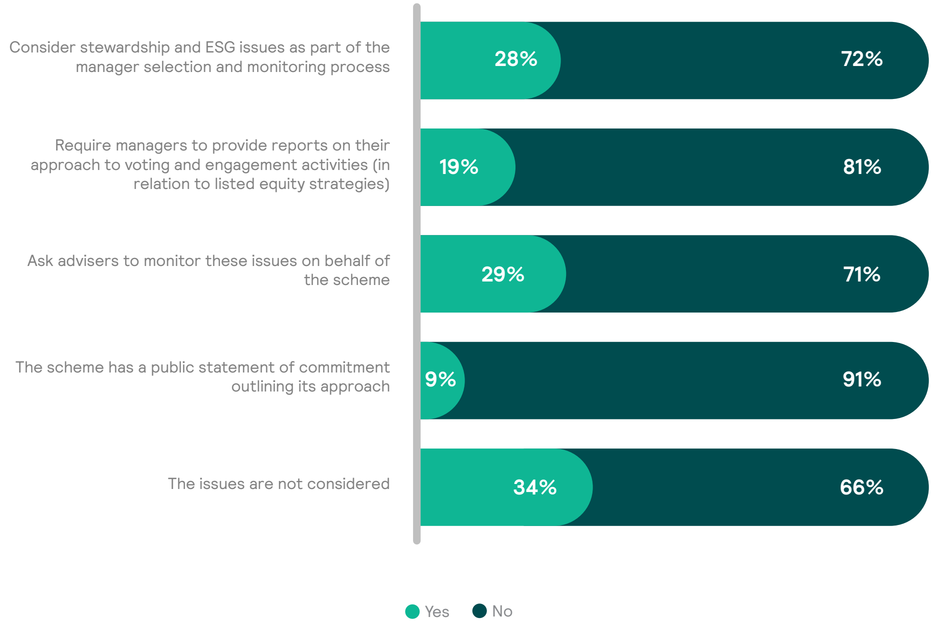
INVESTOR STEWARDSHIP AND ACTIVE OWNERSHIP

As in previous surveys, we asked participants how they act as active owners (exercising voting rights in pursuit of good corporate governance) to meet their stewardship obligations.

The profile of results shows an improvement on last year with 28% of asset owners considering ESG and stewardship as part of the manager selection and monitoring process (up from 24% in 2016) and 29% of asset owners requesting that their adviser monitors stewardship issues on their behalf (up from 20% last year).

Expectations for disclosure have also increased strongly, with 9% of asset owners reporting on their stewardship activities publicly (up from 6% last year). We continue to anticipate growth in public reporting by asset owners.

Chart 35. Stewardship and Consideration of ESG Issues



CLIMATE CHANGE: AN INVESTMENT ISSUE NOT TO BE IGNORED

The Paris Agreement, which came into force in November 2016, set an ambitious target to keep global warming well below 2˚C above pre-Industrial levels, with a stretch target of 1.5˚C. The agreement provided a clear signal for the direction of climate-related policy. We believe that considering the potential financial impacts of climate change on their portfolios is increasingly important for investors, and we continue to identify investment opportunities related to the growth in industries associated with the shift to a low-carbon economy.

Last year, we found that only 4% of respondents had considered the investment risks posed by climate change, whereas this year we saw a slight increase to 5%. This growth is encouraging, but given the scale of the potential effects, we hope this number will substantially increase in the coming years as investors recognise the financial materiality of the risks posed by climate change. We will continue to monitor progress on this important topic and expect the recommendations from the Financial Stability Board Task Force on Climate-related Financial Disclosure[1] (TCFD), due to be released later this year, to focus attention on the materiality of climate-related risks and opportunities.

[1] The TCFD provides recommendations to asset owners, investment managers and companies. Its recommendations are due to be released later this year.

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Should you have any questions about the survey, please contact Phil Edwards: phil.edwards@mercer.com

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