investing in the future

European Asset Allocation Insights 2020

welcome to brighter

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Welcome

Mercer's European Asset Allocation Insights 2020 provides a comprehensive overview of investment strategy across the European pension industry and identifies emerging trends in the behaviour of 927 institutional investors across 12 countries, reflecting total assets of over €1.1 trillion.

What has happened since last year's survey?

In 2019, the world witnessed very strong returns, with most equity markets posting strong double-digit returns (developed equities: 28.1%; emerging equities: 18.5%[1]). This was encouraged by an apparent reduction in fears that a trade war between the US and China would derail the global economy. Economic growth appeared strong globally by many measures.

Though investors were still wary of high asset valuations, the end of 2019 (into the start of 2020) was characterised by a strong appetite for risk assets, in an expansionary policy environment, with low interest rates and low inflation — the so-called "Goldilocks" environment for risk assets. The eventual derailment of the global economy by COVID-19 lockdown measures in March 2020 is something for which almost everyone was unprepared.

As we do every year, we collected the latest available data from our institutional clients during Q4 2019 and early Q1 2020 to analyse and release in mid-2020. However, we do not believe asset data will have changed drastically due to market events in the first half of 2020. We are seeing investors continue with the same long-term strategic decisions.

In the face of high asset valuations throughout 2019 and a strong decade of returns, particularly in equity markets, investors are continuing to focus on investment strategy. They are de-risking where possible, particularly out of equity market risk. They are also looking to increase liability matching where appropriate.

We have seen a significant increase in the proportion of investors considering climate-change risk and incorporating wider environmental, social and governance (ESG) considerations into their investment strategies. Though 2019 was a strong year for investment markets, it was also another damaging year for the planet's ecosystem. Few will forget the sheer scale of forest fires around the world, particularly in Australia, and the devastating ongoing drought in southern Africa.

[1] MSCI World Index Total Return (developed); MSCI Emerging Market Index Total Return (emerging). Local currency basis.

Key findings

Diversification away from traditional risks

Investors continue to diversify into less traditional sources of return. At the same time as respondents' average equity holding fell from 25% to 22% of their total portfolio, the proportion of investors allocating to growth fixed income, real assets and private equity increased.

	2019	2020	Change
Average equity holding	25%	22%	▼
Proportion investing in growth fixed income	37%	47%	▲
Proportion investing in real assets	49%	53%	▲
Proportion investing in private equity	8%	14%	▲

Within growth fixed income asset classes, all saw noticeable increases over the previous year in the proportion of total assets invested. Multi-asset credit rose from 16% to 22% of total assets invested, high yield from 10% to 21%, emerging market debt from 18% to 28%, absolute return from 16% to 21%, private debt from 11% to 16% and secured finance from 4% to 7%.

Continuing move to delegating governance

For the vast majority of plans (87%), strategic asset allocation decisions remain with the trustee or board of directors. A noticeable trend over the last few years, however, has been an increasing proportion of plans using third parties for later stages of the investment cycle (manager selection, ongoing monitoring, rebalancing decisions, etc.)

	2019	2020	Change
Do you delegate day-to-day investment issues to a third party?	29%	33%	▲
Do you delegate rebalancing decisions to a third party?	26%	30%	▲

Given the relatively low, but still important impact these decisions have on plan performance (compared with asset allocation decisions), we may explain this trend as a refocusing of governance away from these activities.

ESG: the new normal?

Investors have an increasing appetite to take into account ESG considerations, and our 2020 survey reflects this in a number of ways. The key reason for considering ESG risks remains the need to comply with regulation, accompanied by an increase in plans integrating ESG into their investment policy and developing a suite of related policies as a result.

	2019	2020	Change
Investors considering ESG	55%	89%	▲
Investors complying with regulation	56%	84%	▲
Plans integrating ESG into investment policy	68%	88%	▲
Plans developing a set of ESG beliefs	19%	55%	▲

Broadening equity portfolios

Although some investors are disinvesting from equities, many are seeking diversification within their equity portfolios by increasing allocation to emerging markets, small cap and low-volatility equities.

	2019	2020	Change
Emerging markets	34%	43%	▲
Small cap equities	12%	21%	▲
Low-volatility equities	7%	17%	▲

More investors are focusing on factor-aware strategies through balanced or targeted exposure to the factors underlying equity returns. Investors are also increasing currency hedging within equity portfolios, with 42% hedging over 60% of their foreign currency exposure in listed equity portfolios, compared to 26% in 2019.

Increased awareness of and desire for action on climate-change risk

In last year's survey, we expected an increase in investors considering the investment risk posed by climate change, following the release of Mercer's *Investing in a Time of Climate Change – the Sequel*[2] and increased engagement on this topic. This year's survey revealed a dramatic increase in the proportion of investors now considering this risk (54% versus 14% last year).

Deeper into the endgame for pension plans

As defined benefit pension plans move toward their end dates, the proportion of cash-flow negative plans continues to increase. Over half of cash-flow positive plans expect to become cash-flow negative within five years.

A large proportion (92%) of plans are still disinvesting assets to meet these cash flows. However, there has been an encouraging increase in the proportion of plans meeting cash flows in less costly and likely less risky ways, including distributing income or the more sophisticated approach of using income and principal repayments of debt instruments to match required cash flows.

	2019	2020	Change
Cash-flow negative plans	64%	66%	▲
Cash-flow positive plans predicted to be negative in 5 years	41%	53%	▲
Plans meeting cash flows with distributed income	48%	57%	▲
Plans using cash-flow matching approach to meet cash flows	9%	13%	▲

[2] Mercer. *Investing in a Time of Climate Change – the Sequel*, 2019, available at www.mercer.com/our-thinking/wealth/climate-change-the-sequel.html.

Survey participants

Figure 1. Split of total survey assets by country

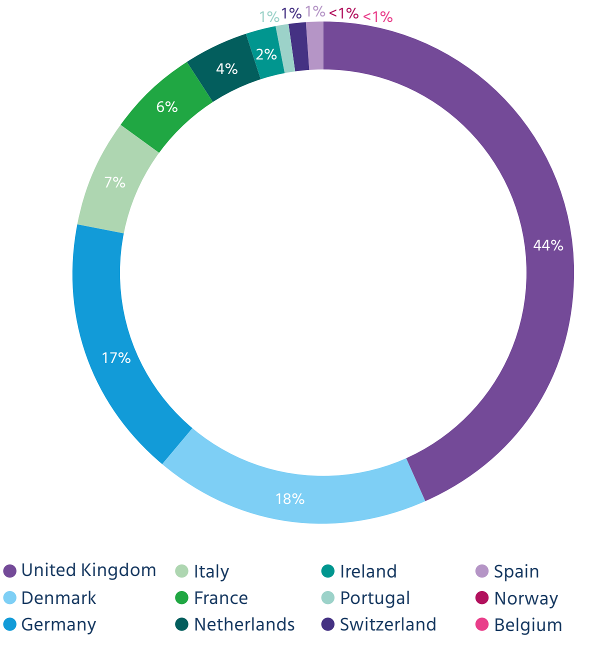


Figure 2. Split of total survey participants by plan size

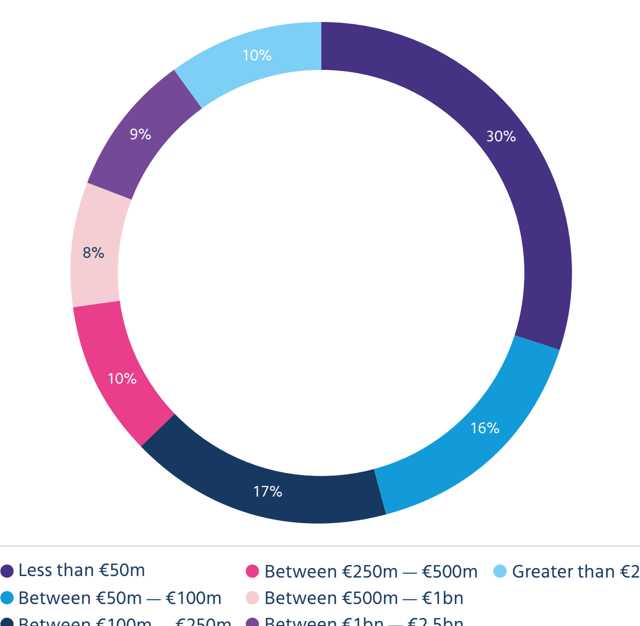
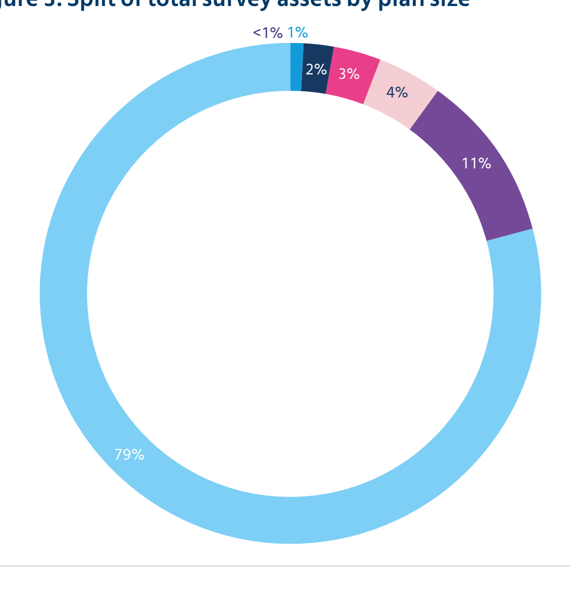


Figure 3. Split of total survey assets by plan size



Our 2020 survey gathered information from 927 institutional investors across 12 countries, reflecting total assets of over €1.1 trillion. Figure 1 shows the asset-weighted composition of survey participants by country. UK-based participants formed the largest group.

Just under half of the participants (by number) represent plans with assets under €100 million, whereas 19% had over €1 billion of assets (see Figure 2).

Although smaller in number, these larger plans dominate the overall assets under review (see Figure 3), which is why we have not asset-weighted many of our charts.

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

Asset allocation

Figure 4. Broad strategic asset allocation by country (%)

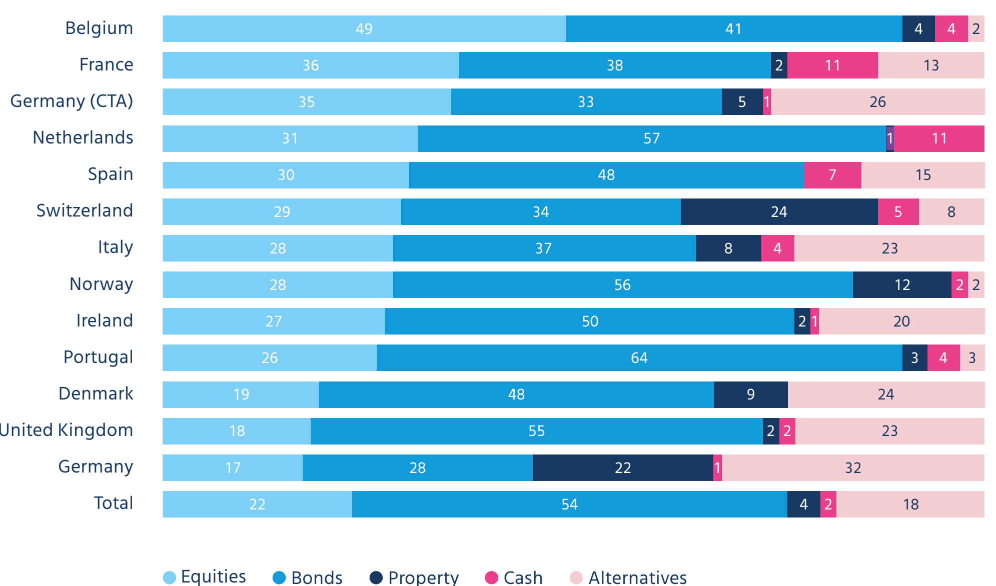


Figure 5. Other alternatives allocation

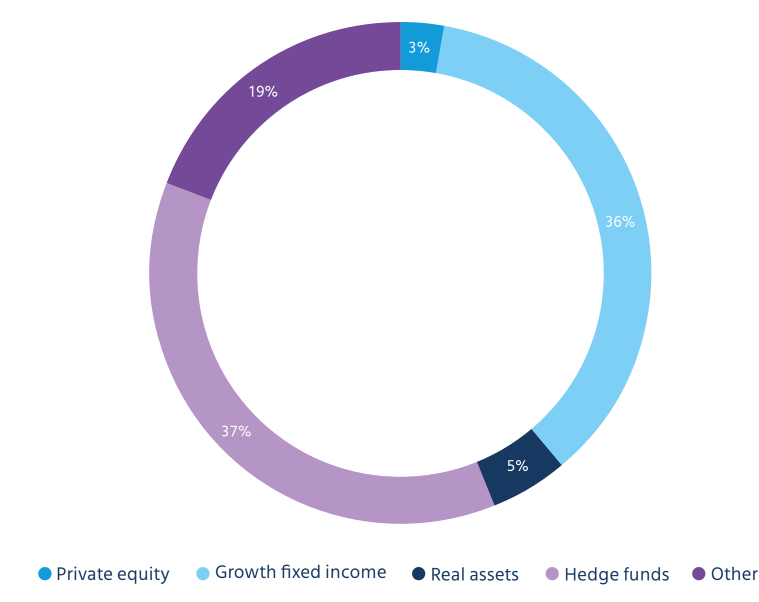


Figure 4 shows the broad allocation of plan assets by country for defined benefit (DB) plans. Plans in Belgium continue to have the highest average equity weightings, whereas plans in Denmark, Germany (excluding contractual trust arrangements, or CTAs) and the UK exhibit the lowest equity exposure. Continuing last year's trend, average equity allocations decreased from 25% to 22%, with average bond allocations remaining flat at 54%, while average allocations to cash and other alternatives increased from 18% to 21%, and property allocations increased from 3% to 4%.

Figure 5 (new this year) shows a further split of assets within non-cash alternatives. The two largest allocations are growth fixed income (35.6%) and hedge funds (36.8%), both as percentages of the 18% total allocated to non-cash alternatives. (Note: these figures will differ from figures in Section 9 because they are percentages of total assets and not percentages of total clients reporting an alternatives allocation.)

Figure 6. Bond portfolio allocation by country (%)

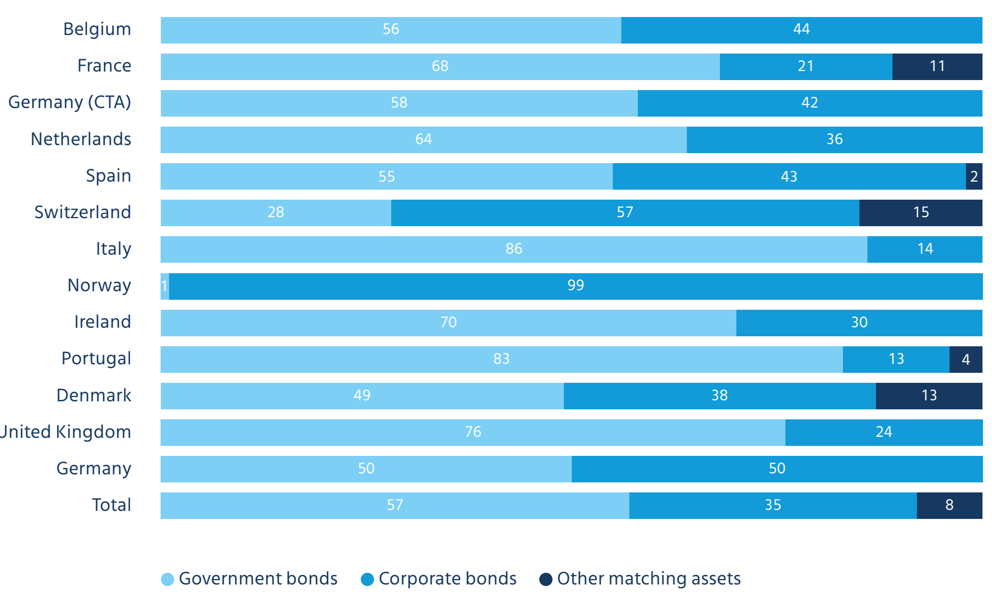
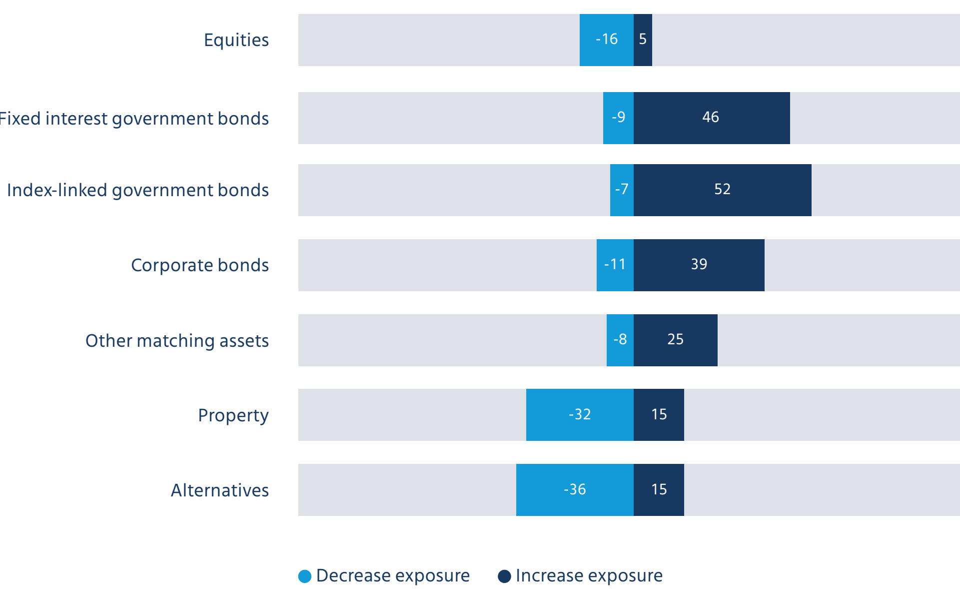


Figure 7. Percentage of plans expecting to change investment strategy

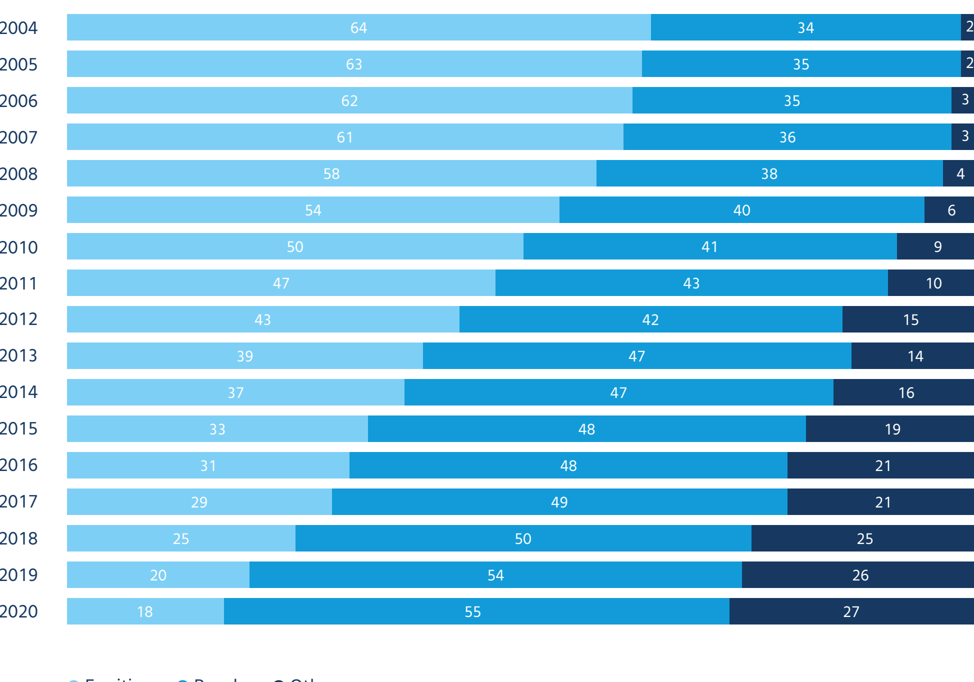


The composition of the average bond portfolio has changed very little over time; the make-up of individual plans' bond portfolios (see Figure 6) is heavily country-specific. Government bond allocations form the largest component, and the average corporate bond allocation represents around 35% of all bond holdings.

Figure 7 shows investors' forward-looking plans for allocating assets. The ongoing move of pension plan clients into their endgame, with desire for de-risking into bond assets (a better match for liability movements), means that the picture is largely unchanged from previous years. Most surveyed investors plan to increase exposure to bond assets while decreasing exposure to equity and other growth assets. A notable group of investors expect to disinvest from alternatives; when plans de-risk from their growth portfolios they often disinvest from mandates with disappointing returns, and in many cases this has been diversified growth funds and alternative risk premia funds. In the aftermath of COVID-19, plans may reconsider their investment strategies, but for those with longer time horizons, we suspect the expectations in Figure 7 will remain largely unchanged.

Figure 8 shows the change in overall allocations in the UK over the last 16 years. The equity allocation of UK participants fell again over 2019, with the average equity allocation reaching a new low of 18%. This has involved both a slight increase in bond allocations, but also a continued move into alternative investments — representing a desire to both match liabilities and cash flows and diversify return drivers away from those of traditional equity.

Figure 8. Changes in broad strategic asset allocation for UK plans (%)



Investment governance

Figure 9. Strategic asset allocation by plan size (%)

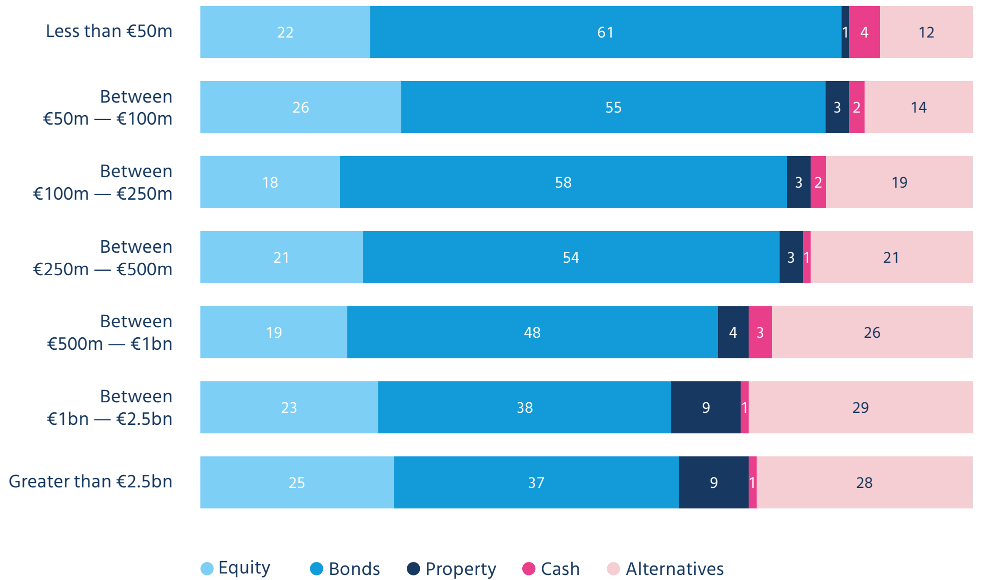
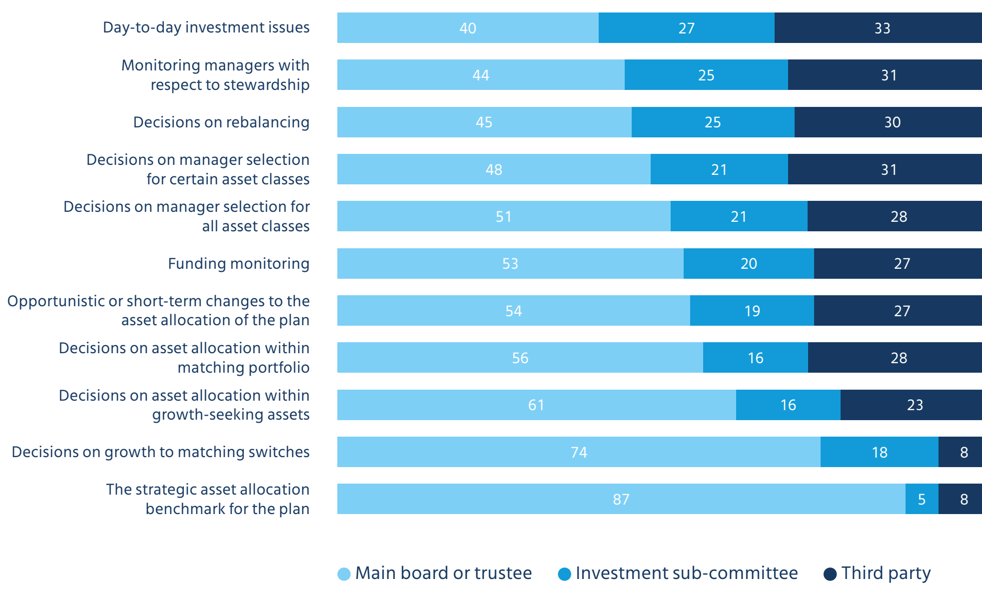


Figure 10. Breakdown of investment responsibilities (%)



Pension plan governance covers a range of topics, from the composition of the trustee group to the delegation of decisions to subgroups or third parties, to the complexity of investment arrangements and the number of ideas and opportunities considered. Our survey results highlight a clear link between plan size and the amount of time and resources devoted to considering investment issues.

Figure 9 illustrates how asset allocation varies with plan size. Although equity exposures do not appear to follow a clear pattern, alternatives allocation size and larger plan size are clearly correlated. These plans usually have higher governance ability and wider resources — and are likely to be large enough to access certain opportunities smaller plans might not. The largest plans, though holding less in bonds, often have higher interest-rate and inflation-hedge ratios than their bond allocations reflect, given their ability to leverage their portfolios to achieve a higher degree of liability matching. This often frees up assets for return-seeking portfolios.

For most plans (87%), strategic asset allocation decisions remain with the trustee or board of directors. A noticeable trend over the last few years, however, has been an increasing number of plans using a third party for later stages of the investment cycle (manager selection, ongoing monitoring, rebalancing decisions, etc.). Given the lower (but still material) impact these decisions have on plan performance (compared with asset allocation decisions), this may reflect a refocusing of governance away from these activities.

Figure 11. Responsibility for day-to-day investment issues by plan size (%)

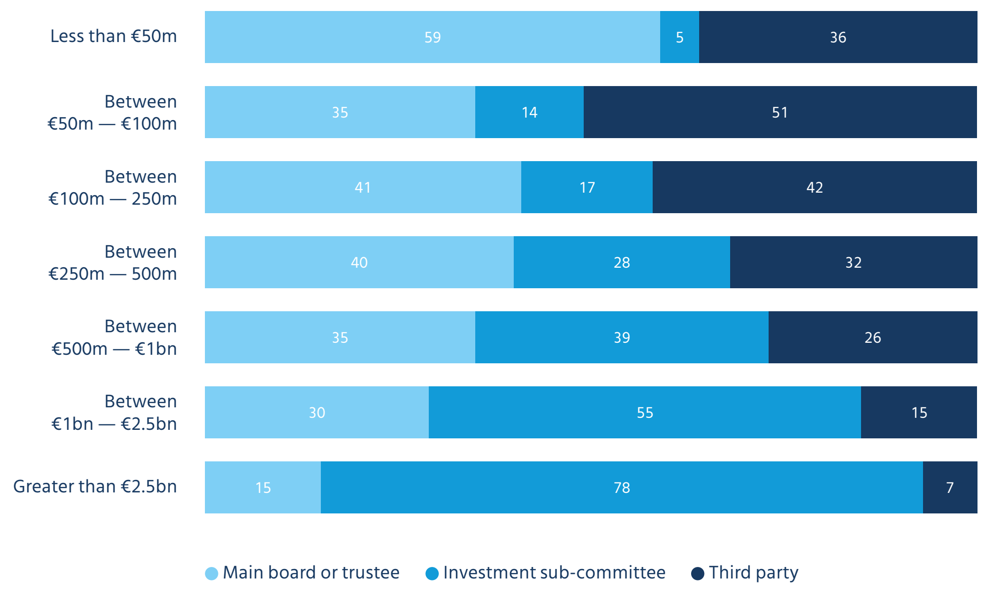


Figure 12. Average number of active mandates by plan size

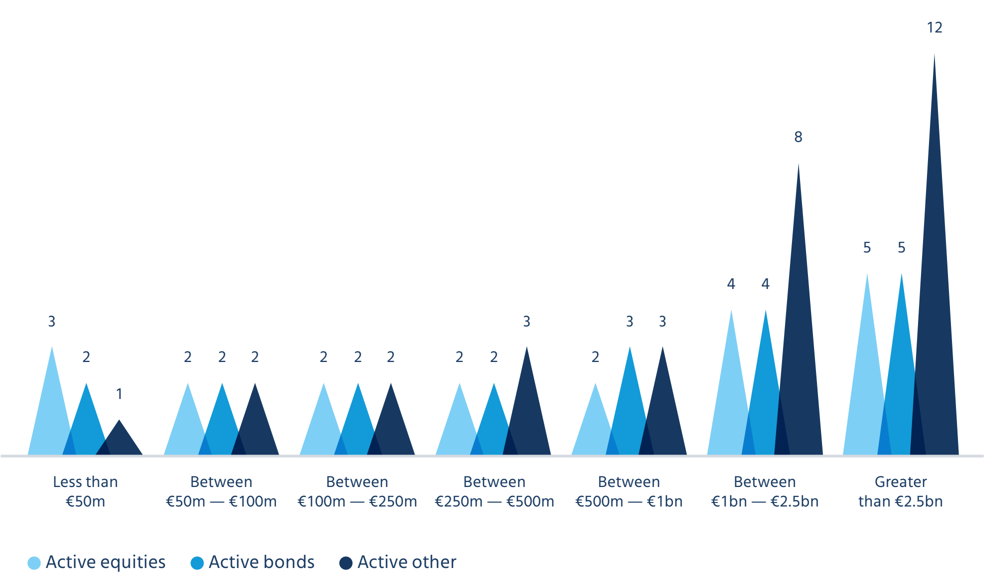


Figure 11 indicates that the nature of delegation is a function of plan size — larger plans are more likely to have an investment subcommittee, whereas smaller plans are more likely to appoint a third-party to act on their behalf.

Figure 12 shows that larger plans tend to use more active manager mandates. This is 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.

Figure 13. Proportion of equity and bond assets managed on a passive basis

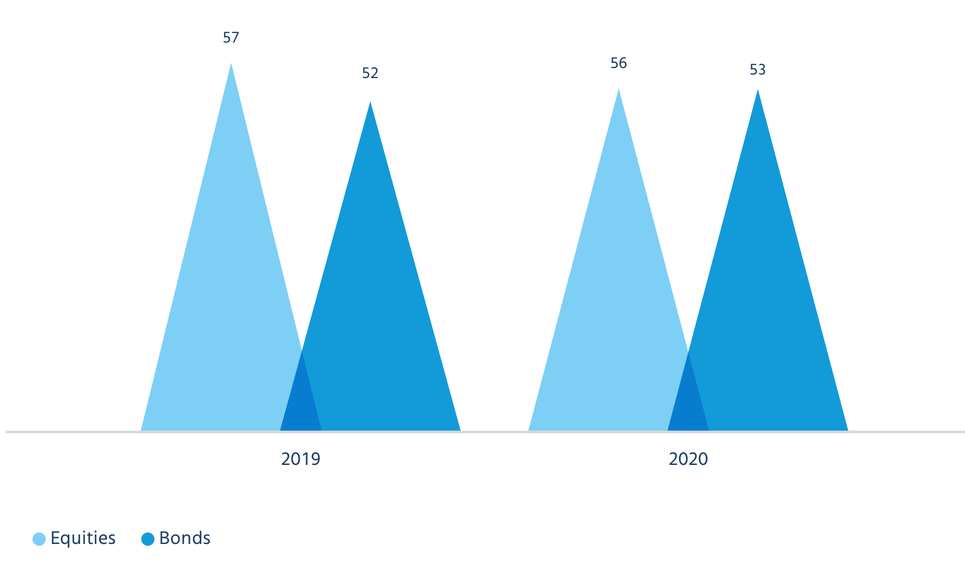


Figure 14. Proportion of equity and bond assets managed on a passive basis by plan size

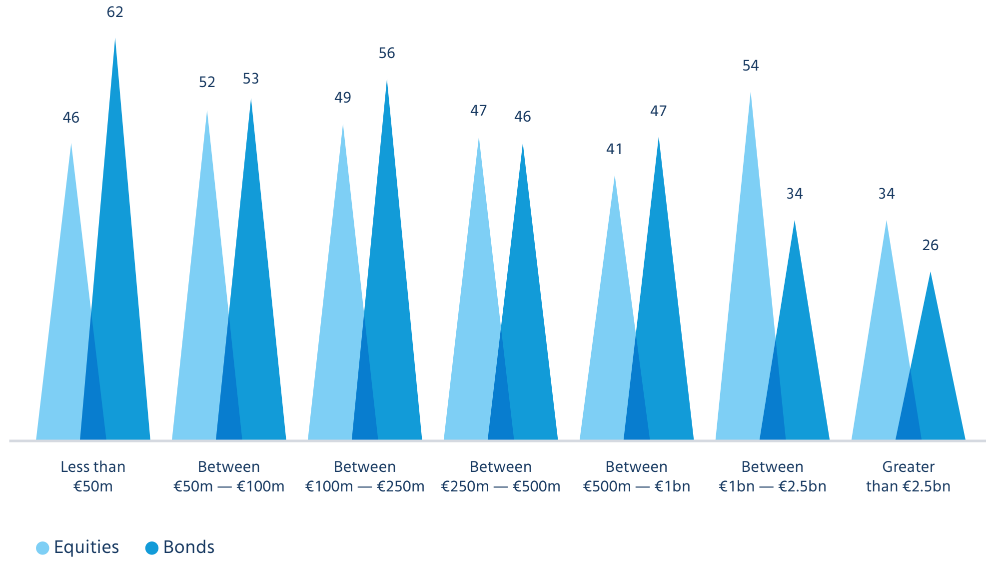
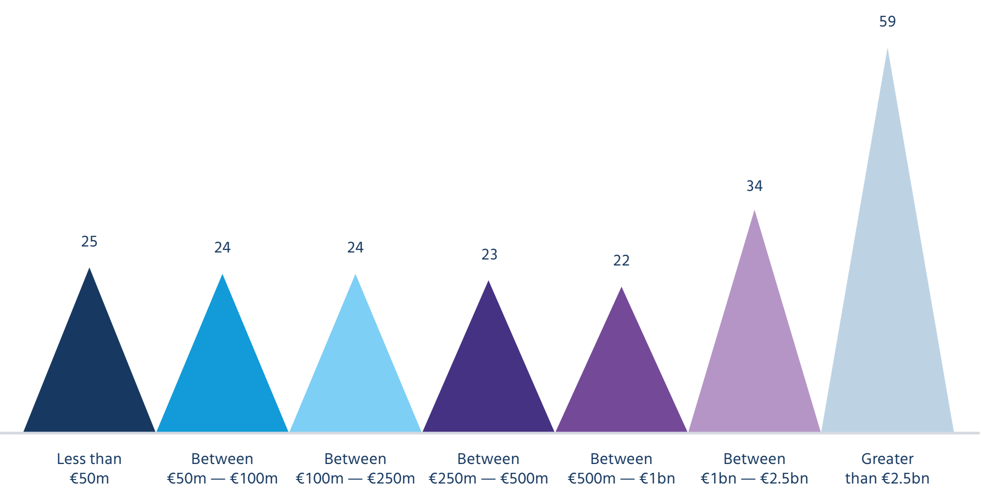


Figure 13 shows the extent to which plans use passive mandates for equities and bonds, using a like-for-like comparison of those plans featuring in the 2019 and 2020 datasets.[3] For a number of years, this chart has shown a steady increase in the proportion of passive allocations; however, the 2020 figures are largely the same as for 2019.

Figure 14 is also largely unchanged year on year, supporting the result that smaller investors are more likely to do so passively — perhaps due to greater fee sensitivity, lower ability to negotiate on fees or the lack of framework from which to effectively and regularly monitor the performance of active managers. For many smaller investors, it makes more sense to focus their governance budget on liability management, or matching cash flows, rather than spending time on high governance active management. These figures also only report active/passive basis on traditional bonds and equity; many investors focus their governance budget on alternatives asset classes where passive options rarely exist.

[3] We used only those plans present in both the 2019 and 2020 surveys and reporting figures for this question. We eliminated plans not in both survey years to remove noise and see the change more clearly. This is why the 2019 passive equity number is higher in this year's survey than last.

Figure 15. Proportion of plans carrying out operational due diligence by plan size



With typically more stringent operational governance requirements, larger plans also have a tendency to place a higher priority on reviewing providers' middle- and back-office functions, as shown by more prevalent operational due diligence (ODD) activities. Among plans over €2.5 billion in size, 59% of respondents carried out ODD reviews (see Figure 15). We also saw a slight increase in plans carrying out ODD across all sizes, potentially reflecting increased recognition of its value as part of the manager selection process.

Risk management

Over half (54%) of the average plan remains allocated to bonds. The bond portfolio acts as a diversifier for equity and alternative allocations while also hedging changes in liability valuations for liability-sensitive investors (such as pension plans). This is particularly important in regions that require regular updating of pension plan mark-to-market liability valuations (derived significantly by changes in the bond yield curve and, in some countries, inflation expectations). A large number of plans implement a liability-driven investment (LDI) approach that invests in bonds and/or bond derivatives with a specific match to the estimated present value of the plan's liabilities. This strategy attempts to reduce potential mismatch between the variation in liabilities and assets due to level changes, steepening/flattening or twists of the relevant yield curve.

Figure 16 shows that larger plans are more likely to have an LDI portfolio due to the relatively high governance requirement associated with such allocations and the challenges for smaller plans when implementing these strategies. Our results show that some of the largest surveyed plans were slightly less likely to use LDI, but this is because local government pension plans dominate these plan sizes. These plans have a longer timeframe, and a stronger covenant, than most plans.

Figure 16. Percentage of surveyed plans that have LDI portfolios (by size)

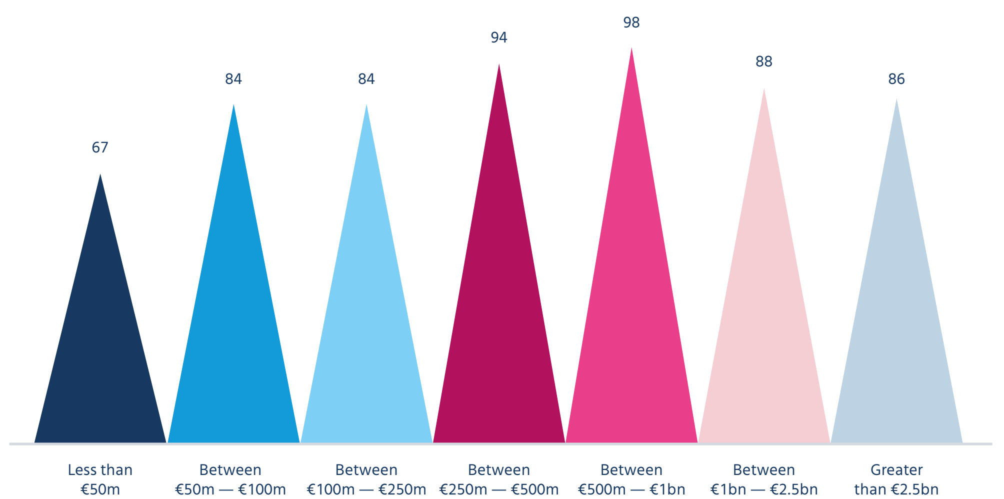


Figure 17. Interest rate and inflation hedging ratio as a percentage of assets

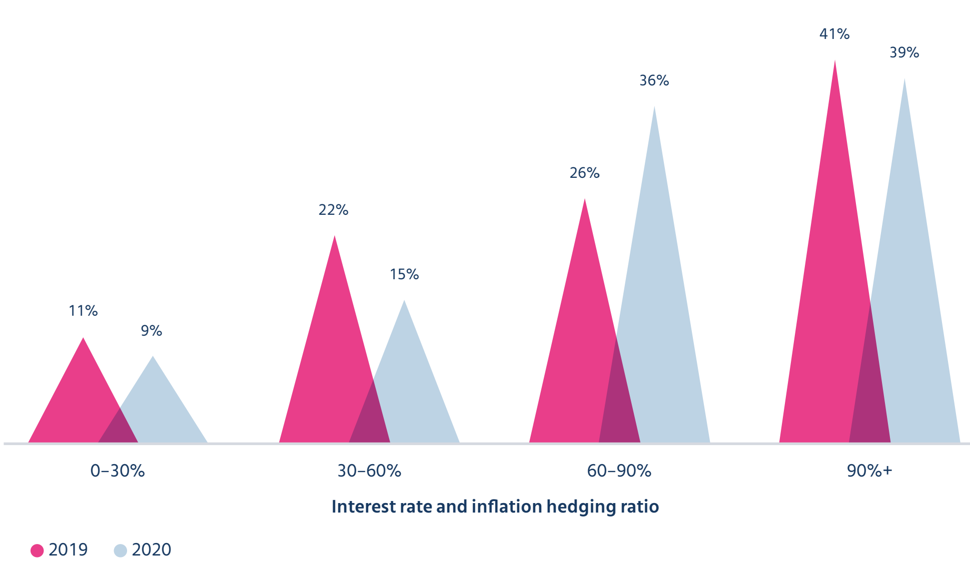


Figure 18. Vehicles used for liability hedging

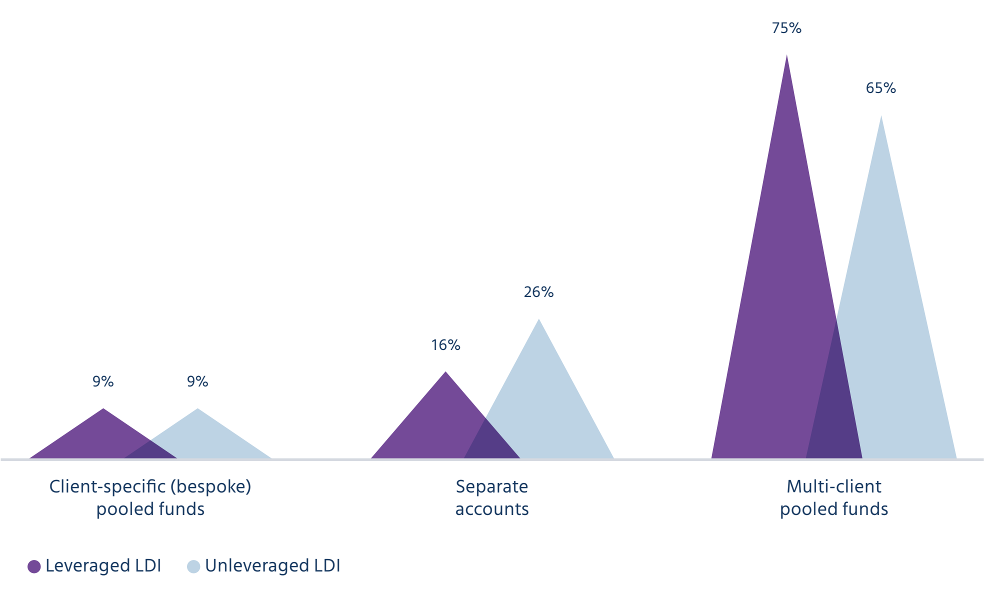
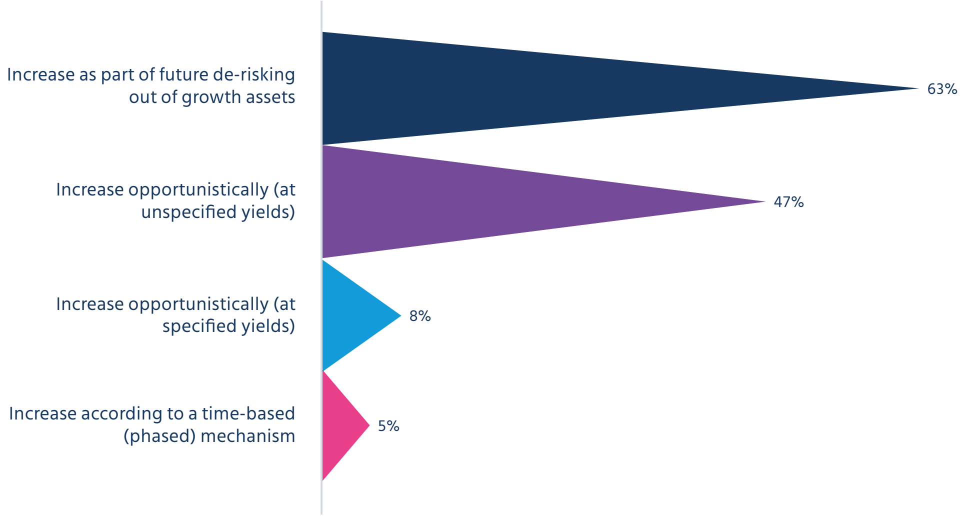


Figure 17 shows that investors again increased the level of hedging targeted this year, with many likely hitting funding level triggers in 2019 (due to strong asset performance relative to liabilities) that automatically increased hedging levels. The increase in hedging ratio is most pronounced in the 60%–90% bracket, with 36% of plans hedging at these levels versus 26% in 2019. The build-up of hedging portfolios has also evolved over the last decade to include a range of instruments beyond physical bonds. Government bond repos, interest rate swaps and inflation swaps remained the most-used financial tools.

Pooled vehicles remain the most popular means for implementing liability hedging (see Figure 18), as they offer a solution for smaller investors.

Figure 19. Methods for increasing liability hedging



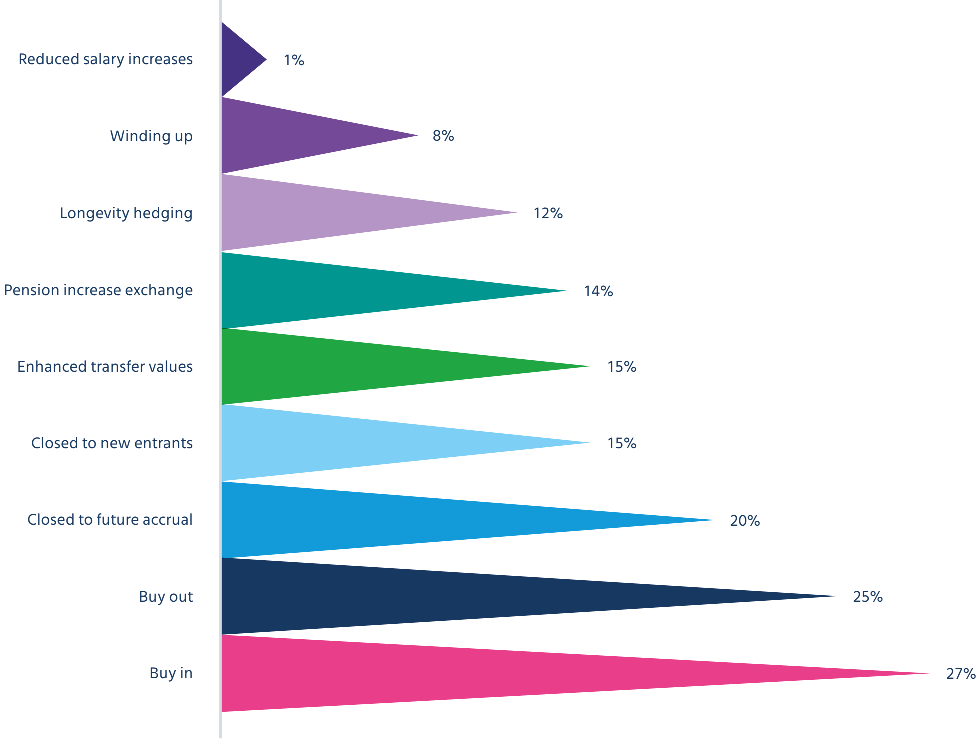
Note: The figures do not add to 100% since some plans are using more than one method for increasing their liability hedging ratio.

Though plans have, in general, already come a long way in increasing hedge ratios, we should also look at where they are aiming. Most plans (63%) expect hedging to increase by virtue of future de-risking out of growth assets; this is an increase compared to last year (51%). Almost half (47%) of plans also expect to opportunistically increase hedging, when bond yields increase to a level that makes bond prices more attractive. The use of specified-yield and time-based triggers have both fallen this year (from a combined 17% to 13%), potentially due to the increased flexibility plans will have by not specifying an exact yield at which to de-risk.

Beyond inflation and interest-rate hedging, plans have other ways to reduce risks associated with liabilities. Figure 20 shows the methods plans consider to try reducing the risk of not meeting their liability commitments, led by buy-in and buyout exercises.[4] The results again portray 2019 as a strong year for plan funding levels, with a noticeable increase in plans considering these methods — 27% and 25% of plans are considering buy-in and buyout, respectively (versus 22% and 19%, respectively, last year). However, COVID-19 may have delayed implementation of these exercises.

Other liability-risk-reduction methods can be grouped into "ways to curb future liability growth" (such as closing plans to new entrants or future accrual) or "approaches to managing existing liabilities" (such as enhanced transfer values, pension increase exchange exercises and reduced salary increases). The survey also shows a noticeable increase in the proportion of plans looking to engage in these exercises between 2019 and 2020, again perhaps indicating stronger funding positions and the corresponding higher sensitivity to uncertain liability risks.

Figure 20. Proportion of plans considering risk-management exercises over the last year



The figures do not add to 100% since some plans are undertaking more than one risk-management exercise.

[4] Buyout: when a pension plan pays a premium to an insurer and, in return, the insurer takes on all responsibility for paying the pensions for the plans insured members. This transfers all investment, inflation and longevity risks associated with the insured benefits to the insurer and would usually involve all of a plan's liabilities. Buy-in: a similar arrangement to a buyout, but instead of the insurer taking on responsibility for paying the members' pensions, the insurer makes these payments to the plan, which, in turn, pays the members. Plans more commonly do this with a partial subsection of the liabilities.

Figure 21. Proportion of plans that are cash-flow negative

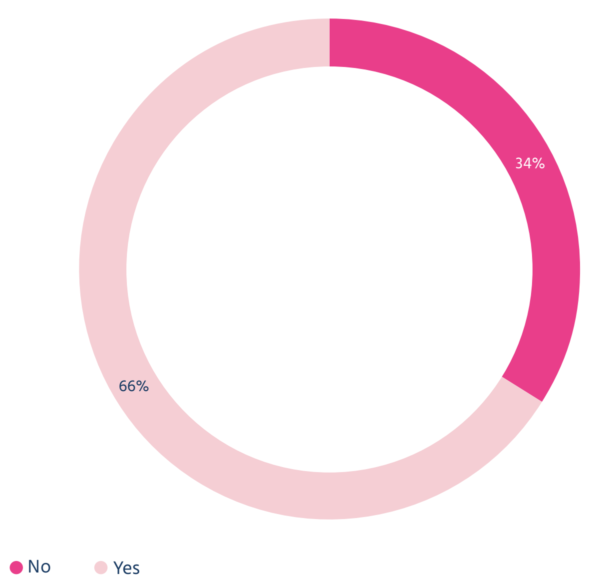


Figure 22. Expected time for cash-flow positive plans to become cash-flow negative

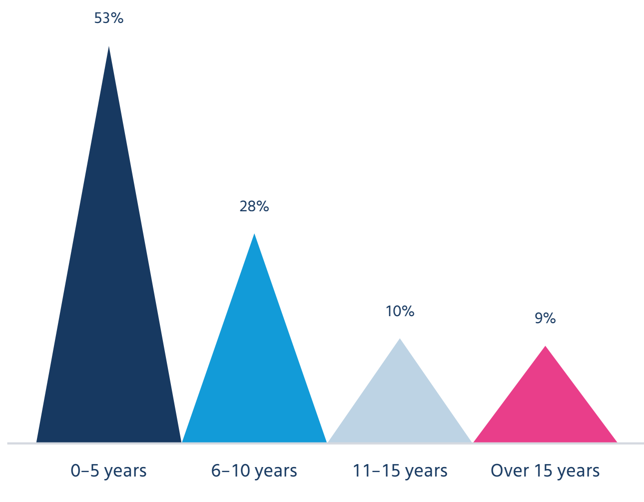
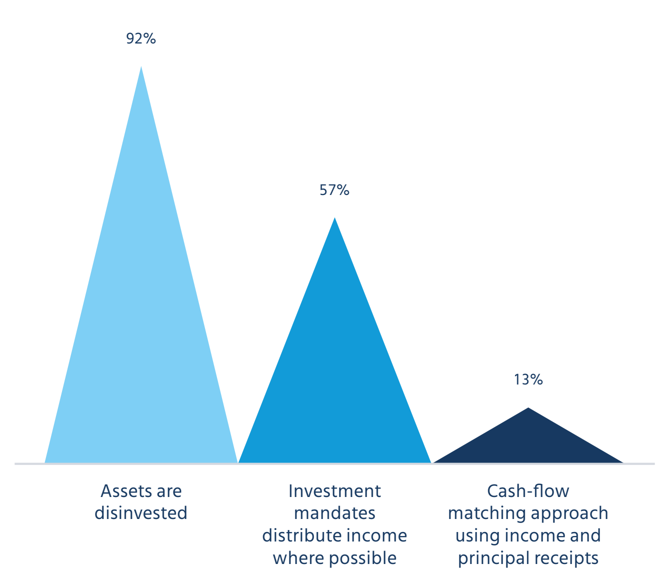


Figure 23. Methods of meeting cash-flow negative outgoings



Again in 2020, a higher proportion of plans have reported being cash-flow negative at the time of the survey (66%, versus 64% in 2019). Of the cash-flow positive plans, a higher proportion (82%) expect to become cash-flow negative within the next 10 years compared to the figure last year (72%).

Disinvesting assets remains the most common way to meet cash flows. However, we are seeing an increase in plans meeting cash flows in other ways, such as having assets distribute income or cash-flow matching to target income and principal repayments of debt instruments to match cash flows due. 57% and 13% of plans, respectively, reported using these methods (versus 48% and 9%, respectively, in 2019). We expect more and more plans will use a full cash-flow matching strategy as they move closer to their endgame.

Responsible investment

Figure 24. Does the plan consider ESG risks?

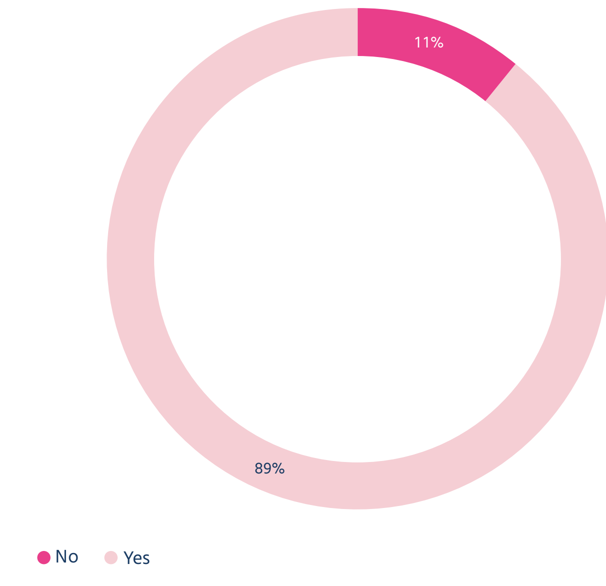
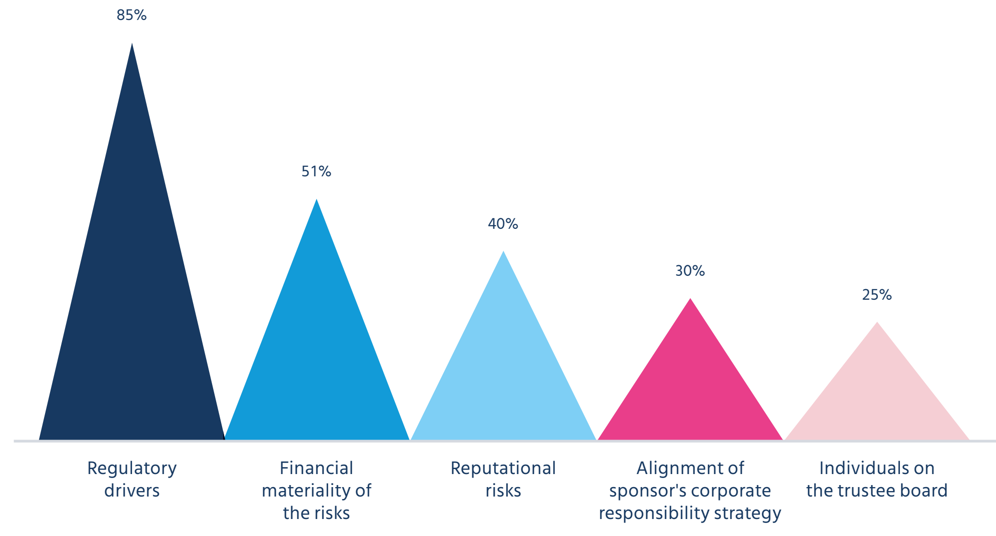


Figure 25. In your view, what are the key drivers behind the consideration of ESG risks?



Our analysis focuses on several elements, ranging from broad consideration of ESG risks in investment beliefs and policies to the specifics around climate change and introducing new elements regarding the social and environmental impact of investments. Our long-term view is that these factors will transition from being afterthoughts of a few investors to become something actively considered in investment strategy decisions. This has increased substantially over the years — in 2020, 89% of plans said they will consider ESG risks in 2020, compared to 55% in 2019, which supports our view.

The regulatory environment continues to drive consideration of ESG risks (see Figure 25), and various initiatives mean we expect this to continue into the future. The 2017 European Pensions Directive (IORP II) and the UK Department for Work and Pensions Investment Regulations both came into force in October 2019 and require pension funds to take ESG factors, including climate change, into account when making investment decisions, which will have had a significant impact on the figures reported.To enable long-term mindset changes, and real positive changes in any space, the change must happen because internal participants realise the value for themselves — rather than being told or forced to act by regulation.

We therefore view increased "yes" answers to other, less enforced reasons for considering ESG factors to be extremely positive; in particular, we have seen a large jump in those considering ESG risks due to recognised financial materiality (from 29% of respondents last year to 51% this year). We are also encouraged to see a large number of pension plans increasing their focus on ESG risks because sponsor companies are seeking alignment with new or existing corporate responsibility strategies.

Governance beliefs and policy — a large step in the right direction this year

The increase in ESG risk consideration has clearly been only the first step many investors took in 2019. We believe that incorporating responsible investment (RI) into an investment framework begins with developing a set of beliefs. The next step is translating these beliefs into policies, before incorporating into processes and portfolios.

Figure 26 highlights the degree to which plans have incorporated ESG into these beliefs. The number of plans that have explicitly created and formalised ESG beliefs has increased significantly, up from 19% last year to 55% this year.

As Mercer continues to run education and belief sessions, we expect more plans to gradually develop more RI-specific beliefs and incorporate ESG into dedicated RI policies and processes.

Stewardship increasingly on the agenda

Stewardship (that is, voting and engagement) is increasingly on investor agendas as asset managers come under greater scrutiny to disclose how they undertake these activities. The increase in investor-led collaborations on particular ESG issues (such as climate change and diversity) has helped bring greater awareness to the topic of stewardship. Figure 27 highlights how respondents undertake stewardship responsibilities within their plans.

Figure 26. Governance, beliefs and policy

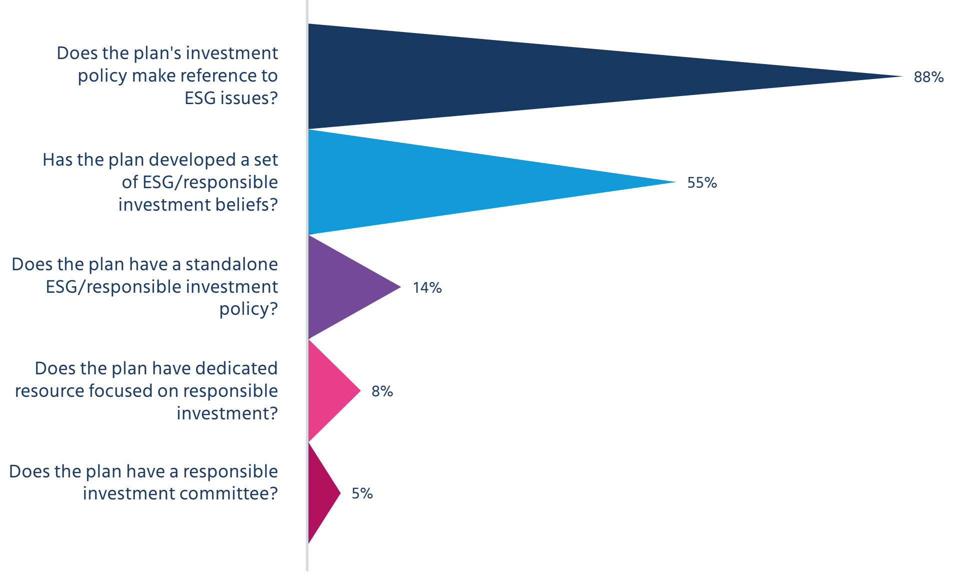
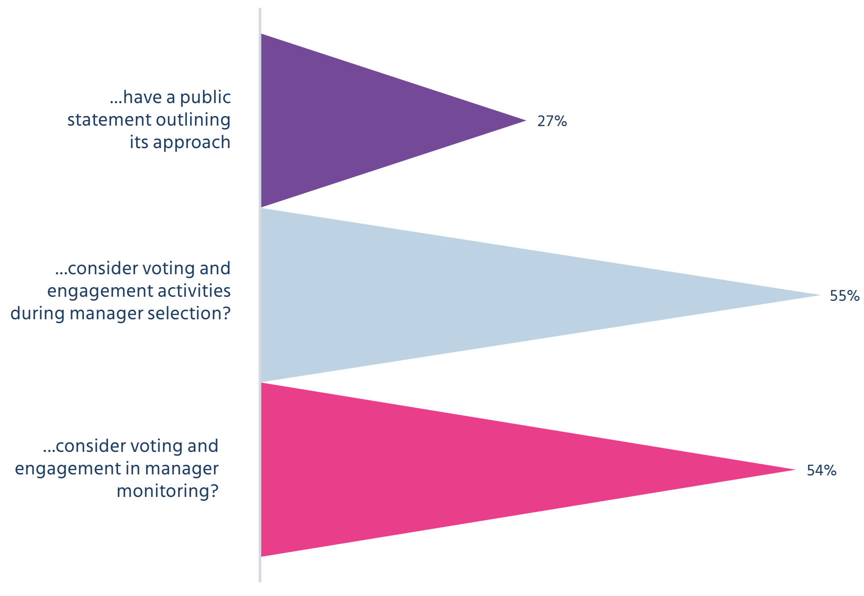


Figure 27. Active ownership and stewardship: does the plan ...?



For the first time, our survey reported over 50% of participants consider the voting and engagement aspects of investments at both the manager-selection and manager-monitoring stages of the investment process. Just over one in four investors report they have a public commitment to outlining an explicit approach to voting and engagement — an encouraging increase from just over one in ten last year. The revised UK Stewardship Code, which came into effect on 1 January 2020, was a major overhaul, and we expect it to encourage further focus on stewardship outcomes and ESG integration in future. The first reporting against the revised code is expected in March 2021.

Big year for climate change

In a year that saw activist Greta Thunberg, with others, organising global school strikes to raise climate change awareness and witnessed vast swathes of the world on fire (including Australia and the Amazon), it is not surprising that a growing number of investors are considering the investment risk of climate change. Over half of surveyed investors have considered this risk, up from only 14% last year. Another 7% plan to consider the risk within the next 12 months (see Figures 28 and 29).

Mercer published Investing in a *Time of Climate Change – the Sequel* during 2019, which highlights potential investment risks under different climate scenarios and risk factors.[5] The report finds that for nearly all asset classes, regions and timeframes, an increase of 2°C in global temperature leads to enhanced projected returns compared to a 3°C or 4°C increase.

We align our recommendations with those of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) and will continue to work with plans to undertake scenario analysis and adopt the TCFD recommendations into their frameworks. Mercer has been engaging more and more with plans in the months after publication of the sequel report on climate change, so we are pleased to see that investors are increasingly engaging with this topic. Our RI team has also been working on ways to decarbonise portfolios.

Figure 28. Has the plan considered the investment risk posed by climate change?

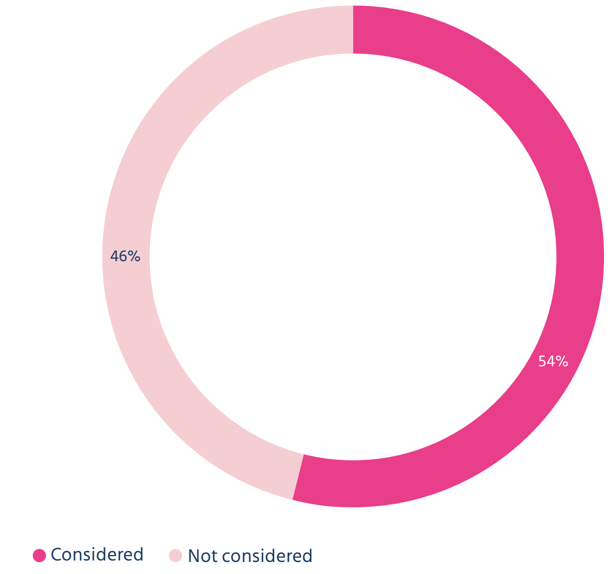
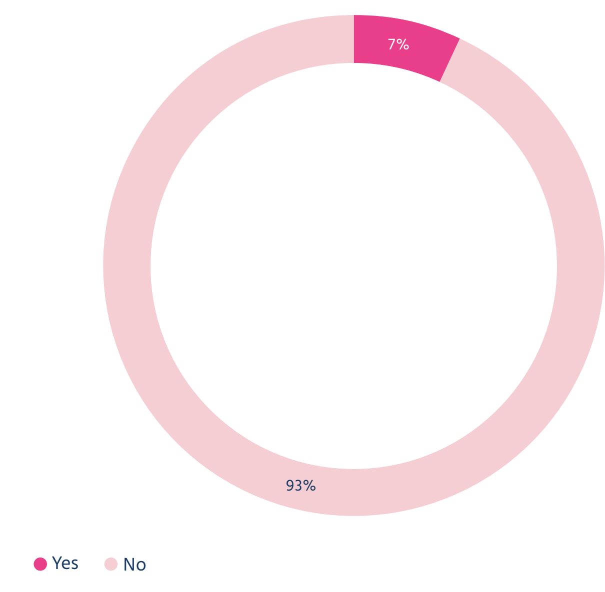


Figure 29. If no, is the plan planning to consider this within the next 12 months?



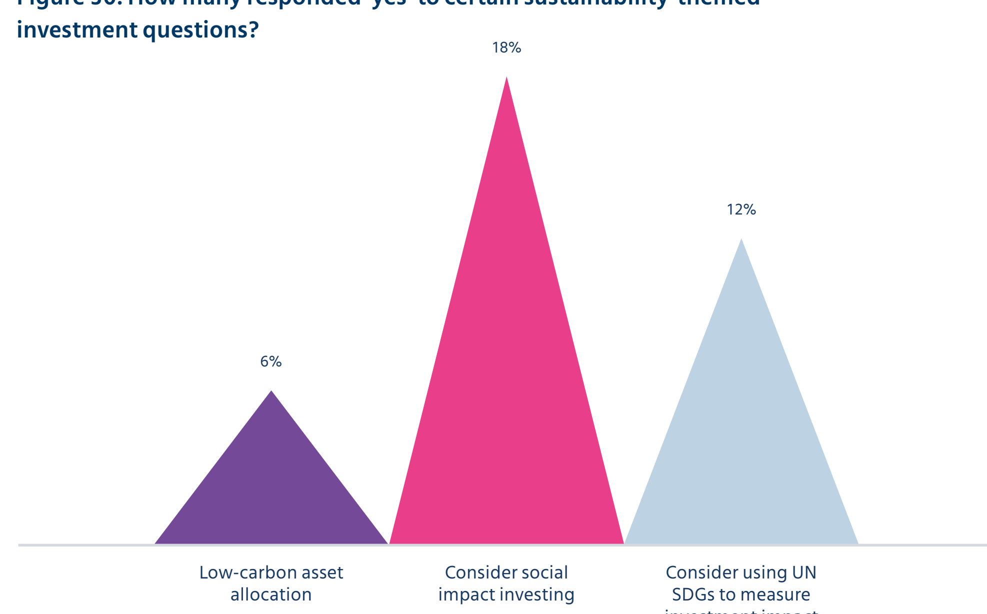
[5] Mercer. Investing in a Time of Climate Change – the Sequel, 2019.

Allocating to sustainability-themed investments

The opportunities for sustainability-themed investments range from broad sustainability and impact-themed solutions to dedicated low-carbon strategies. Asset managers are creating and launching investment strategies that target opportunities to address one or more of the United Nation's Sustainable Development Goals (SDGs),[6] as well as strategies aligned to a 2°C (or below) economy. In addition, asset owners are developing frameworks aligned to the SDGs to report on these targeted investments.

- Approximately 6% of plans allocate some assets to low-carbon solutions (where exposure to fossil fuels is minimal), down from 8% last year; however, this year's larger sample size could have influenced this.
- Nearly 1 in 5 respondents consider broader social-impact investing (that is, investing with a clear focus on the environmental and social impact of a company in the portfolio).
- As the opportunity set grows, we expect plans to continue allocating to low-carbon and sustainability-themed/social-impact investment strategies over the next few years across a range of asset classes.
- More than 1 in 10 plans have considered the UN's SDGs as a framework for impact measurement, up from just 2% last year, highlighting growing recognition of the SDGs as a useful framework for measuring impact. We expect to see this number grow noticeably in the next few years.

Figure 30. How many responded 'yes' to certain sustainability-themed investment questions?



[6] United Nations. "About the Sustainable Development Goals," available at https://www.un.org/sustainabledevelopment/sustainable-development-goals.

Equity portfolios

Figure 31. Strategic allocation to selected equity strategies

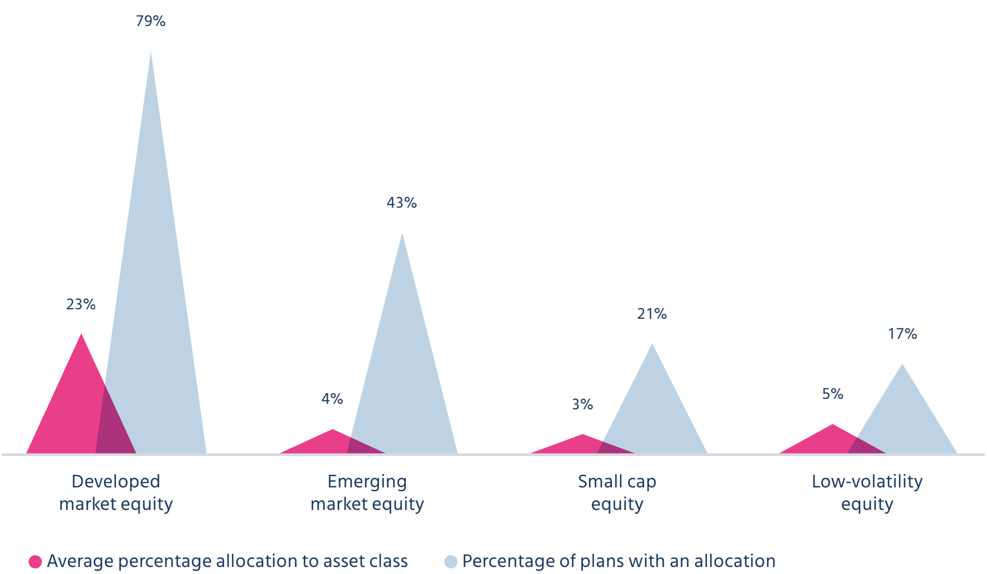
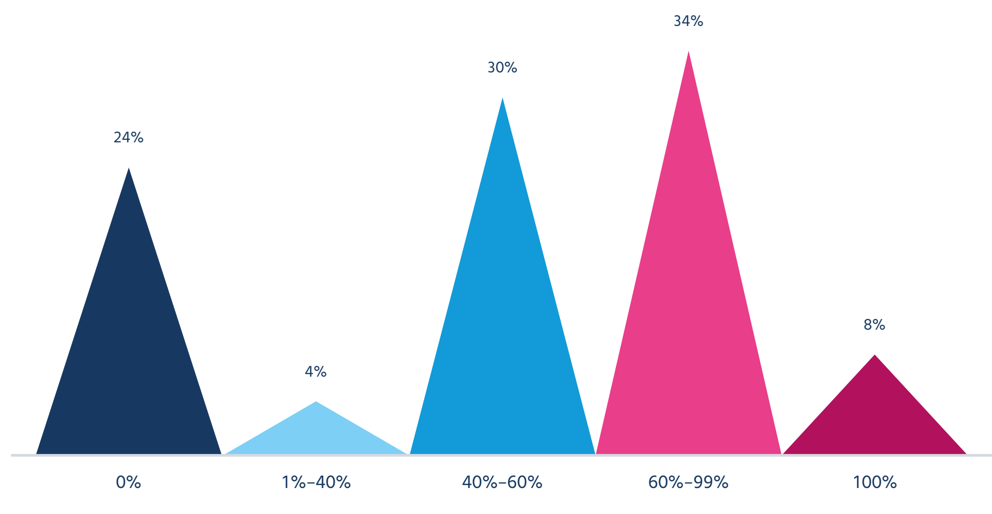


Figure 32. Target currency hedge ratios for equity portfolios



Figures 31 to 33 consider equity portfolios by underlying allocation, currency exposure and capture of style factors. The proportion of total assets allocated to equities has reduced over the years we have run this survey, but the construction of equity portfolios has kept evolving thoughtfully, with increased diversification across geographies and factors, and the steady adoption of emerging markets and small cap stocks as a key part of a broad equity portfolio.

The 2020 survey results again support this, showing a reduction in the average allocation of plan assets made to developed market equities (from 26% to 23%) and an increase in the number of plans with allocations to emerging markets (from 34% to 43%), small cap (12% to 21%) and low-volatility stocks (7% to 17%). High equity valuations in 2019 and a desire to diversify could explain the significant increase in figures this year, as plans continued to de-risk.

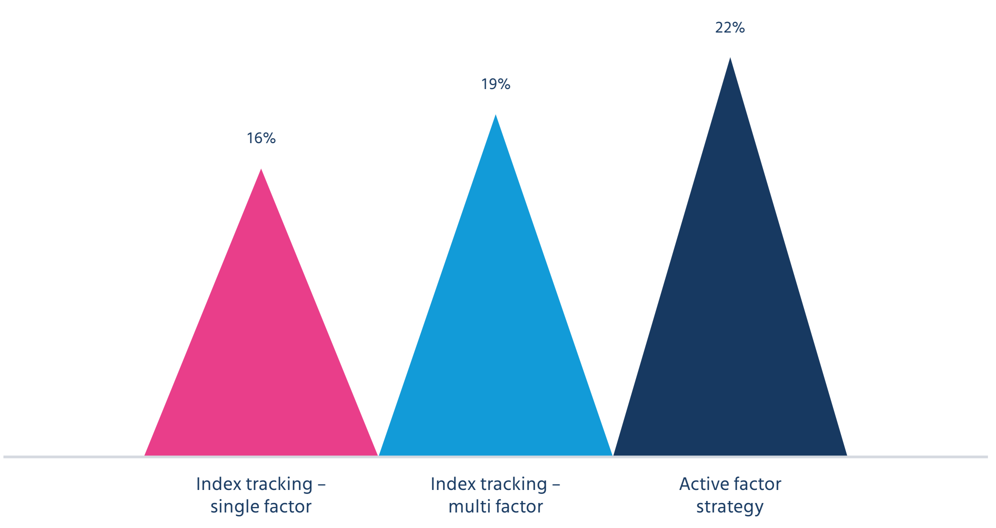
Investment in equities priced in non-domestic currencies comes with foreign exchange risk as returns may be reduced by adverse currency movements. One increasingly common story is investors hedging this risk, particularly in light of a strengthening US dollar against other major currencies and heightened currency volatility caused by “Brexit”. The 2020 figures show a marked increase in the proportion of investors currency hedging over 60% of their overseas equity exposure (42% in 2020 to 26% in 2019).

The number of investors with no currency hedging in place whatsoever has also reduced (from 36% to 24%), but this remains a sizeable proportion of investors. Currency hedging can be a divisive issue — many investors believe that currencies are mean-reverting, and some believe that currencies in developing countries will, over time, strengthen against those in developed countries, adding to investment returns. The ability to hedge an equity portfolio also depends on the availability of currency-hedged share classes. All of which means we expect a wide variation in levels of currency hedging.

Among equity investors, we continue to see an increased focus on factor-aware investing — or investing with an explicit focus on exposure to different factors (for example, value, low volatility, profitability and momentum) that drive equity returns above that of the broad equity market.

This year has seen a noticeable rise in plans with an explicit factor exposure in their equity investment approach. The most common tactic is no longer to use a single-factor index-tracking approach; 22% of investors use an active manager with an active factor approach within their equity portfolio (14% in 2019). However, many investors will have implicit biases to various style factors via traditional active managers.

Figure 33. Explicit capture of style factors within the equity portfolio



Alternative investments

Investors' use of alternatives continues to increase, and this section considers the nature of plans' underlying alternative investment strategies. Figures 34 and 35 consider these broad categories:

- Private equity: both via fund of funds and direct investment
- Growth-oriented fixed income: considers fixed-income assets and strategies expected to generate returns in excess of government bonds and investment-grade credit
- Real assets: 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: mainly relates to core, idiosyncratic and risk-parity strategies

Figure 34 highlights 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 by far. This is perhaps unsurprising, because governance and fee-constrained investors seeking a diversified and relatively liquid growth allocation might rely on one multi-asset solution to achieve their risk and return objectives.

Figure 34. Strategic allocation to alternative asset classes

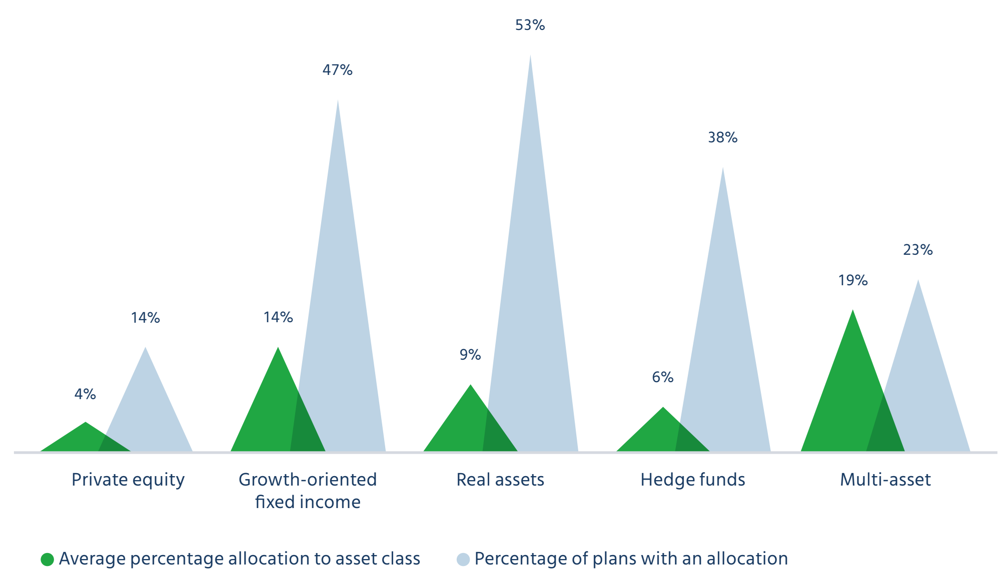


Figure 35. Year-on-year change in allocation

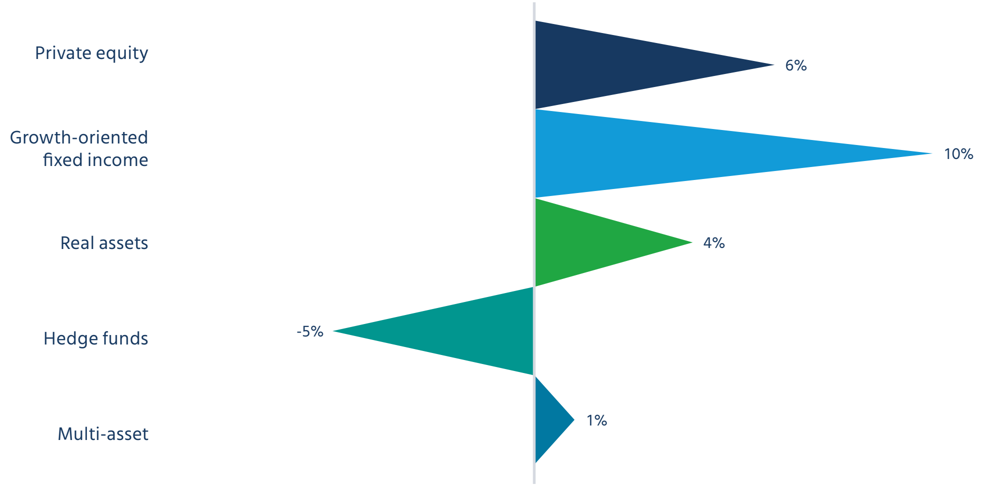


Figure 36. Strategic allocation to private equity

Figure 35 shows the changes since the 2019 survey. Most noticeably, the number of investors with an allocation to non-traditional growth asset classes (private equity, real assets and growth fixed income) has increased, while the number of investors reporting an allocation to hedge funds has reduced. Over the last decade, hedge funds have tended to fall out of favour, as they have struggled to justify their relatively high fees and lower liquidity. These changes highlight that, where investors might have diversified from traditional betas (equity, credit) via hedge funds, they now see an increased offering in other non-traditional asset classes.

Figure 36 shows the proportion of plans reporting a private equity allocation, either directly invested or via a fund of funds. In both cases, the proportion reported has increased since 2019, with a further 3% of plans reporting a direct private equity allocation and a further 3% reporting a fund of funds allocation. The average proportion of assets invested in both cases has reduced only marginally since last year. This is likely due to the number of new investors entering new private equity agreements — it will take a number of years for them to build up exposure.

Figure 37. Strategic allocation to growth-oriented fixed income

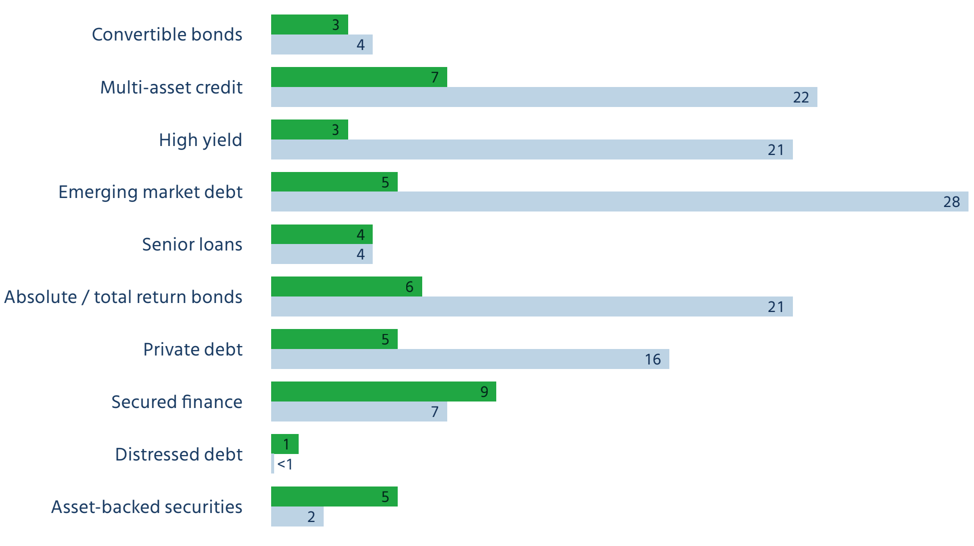


Figure 38. Strategic allocation to real assets

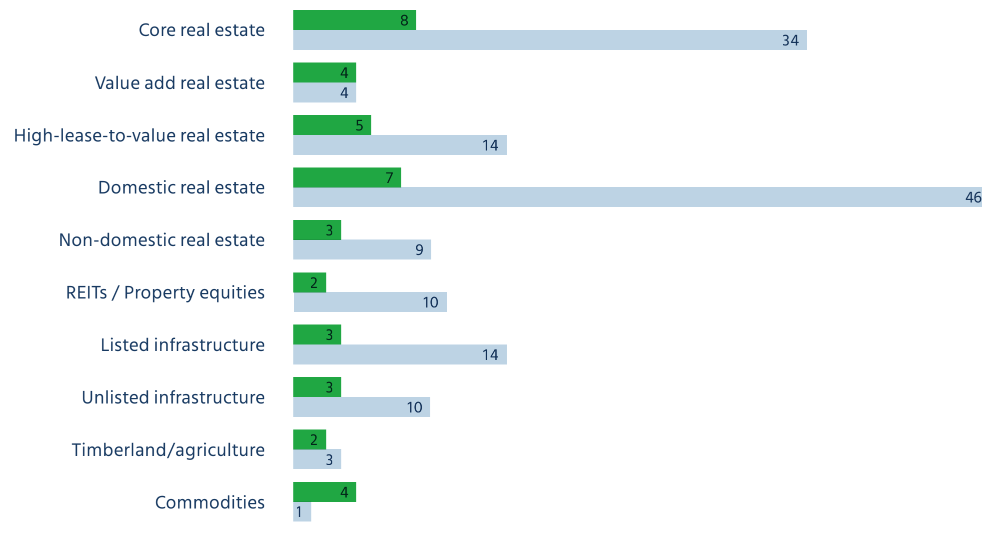
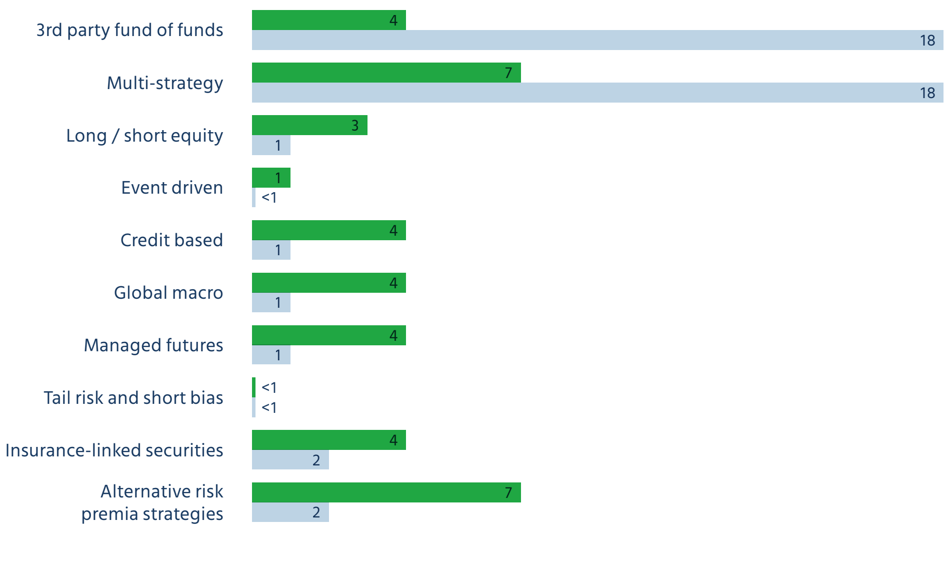


Figure 37 shows the proportion of plans with various growth fixed-income allocations, alongside the average portfolio allocation these plans report. Growth fixed income has offered investors wide diversification benefits against traditional asset classes, and continues to see appetite from investors, particularly given the level of valuations reached in 2019. The following asset classes all saw noticeable increases in investors reporting an allocation:

- Multi-asset credit (16% in 2019 to 22% in 2020)
- High yield (10% to 21%)
- Emerging market debt (18% to 28%)
- Absolute return (16% to 21%)
- Private debt (11% to 16%)
- Secured finance (4% to 7%)

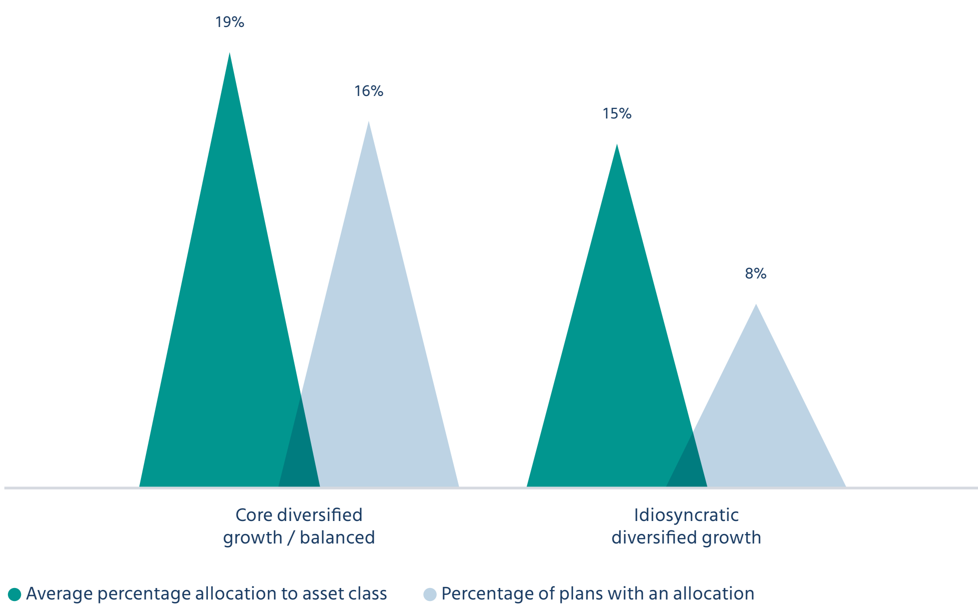
Figure 38 shows core and domestic real estate continue to dominate the real asset landscape. However, this year's survey revealed a reduction in the proportion of plans reporting a core real estate allocation and a corresponding increase in the proportion of plans reporting a more diversified range of real asset exposure, in high-lease-to-value real estate, non-domestic real estate, listed/unlisted infrastructure and timberland/agriculture. Some of these asset classes are becoming popular thanks to longer-term real return drivers and strong, stable cash flows.

Figure 39. Strategic allocation to hedge funds



Only multi-strategy and alternative risk premia strategies saw a slight increase in the proportion of plans reporting an allocation, compared to last year's findings, which may be due to the strongly diversified nature of these two strategies across various return drivers. Multi-strategy approaches, in particular, may have higher fees, but they can provide lower-governance investors exposure to various fund strategies through one vehicle while allowing them to focus their governance budget on higher-level strategic decisions. All other asset classes saw a reduction in investor appetite over the year.

Figure 40. Core versus idiosyncratic diversified growth funds



Within multi-asset strategies, we saw a slight increase this year in investors with an allocation to a "core" fund (which we expect to rely largely on market returns — or "beta" — to achieve growth over time). We saw a corresponding reduction in those reporting an allocation to an "idiosyncratic" fund (which place a greater emphasis on tactical asset allocation and specific trade ideas to create a portfolio less reliant on market returns). This shows stronger investor preference for "core" funds, possibly following a number of years of poor performance by idiosyncratic funds as traditional betas have seen strong returns.

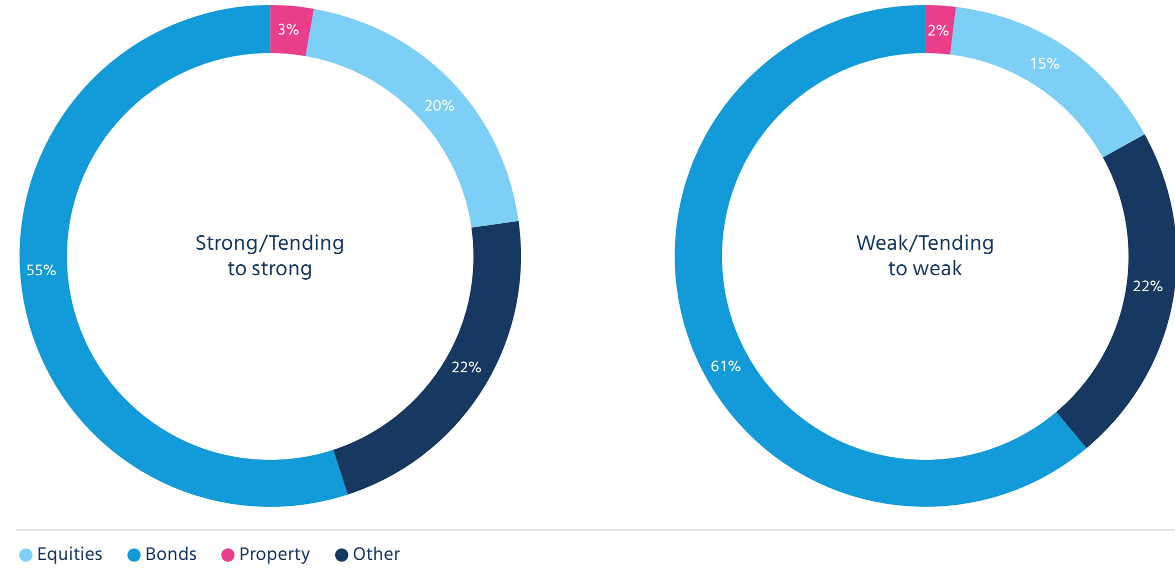
Sponsor covenant strength for UK plans

This year's survey asked participants to report the strength of plan covenants. When a large organisation or business supports a plan, the covenant describes its legal obligation and financial ability to support the plan now and in the future. The strength of the covenant thus influences the plan's ability to take on risk, with stronger covenants associated with a greater willingness and ability to lend support to plans.

The results — largely unchanged from last year — show a larger allocation to equities for plans with a covenant described as "strong" or "tending to strong" with an average of 20% in equities, compared to 15% for plans with covenants described as "weak" or "tending to weak". Of note this year, while stronger-covenant plans saw no change in bond allocations, weaker-covenant plans increased their bond allocation from 54% to 61% on average, which may reflect more opportunistic de-risking of plans (while stronger-covenant plans might remain focused on long-term returns).

Covenants of many plans will have deteriorated with the COVID-19 fallout, particularly with sponsors in the transportation, hospitality or natural resources sectors, among others. Depending on the resilience of the global economic and healthcare systems, we may see an impact on these numbers next year. Two technical elements could dampen this: some plans may only review their covenant position on a triennial basis, whereas others may disappear from the survey via insolvency.

Figure 41. Average strategic asset allocation for plans with different covenant strength



De-risking for UK DB plans

Figure 42. Long-term funding objectives

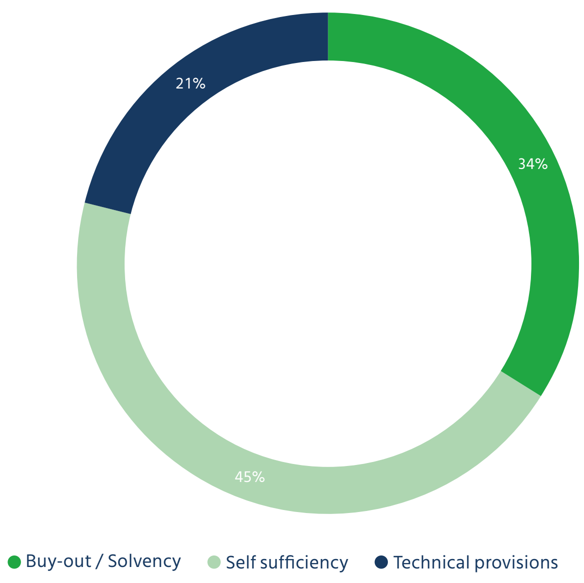


Figure 43. Self-sufficiency basis

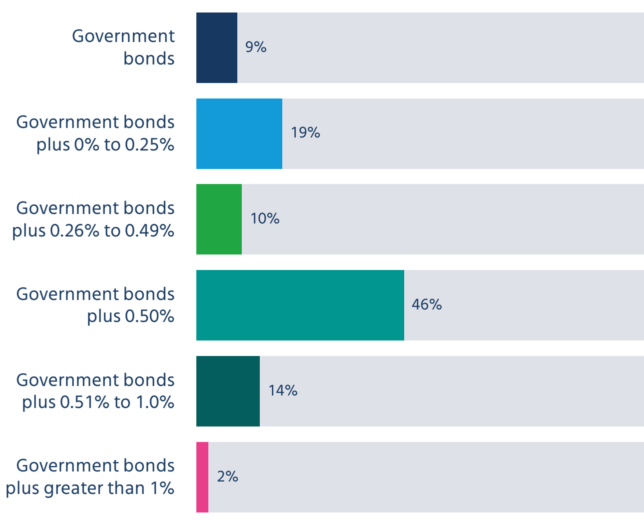
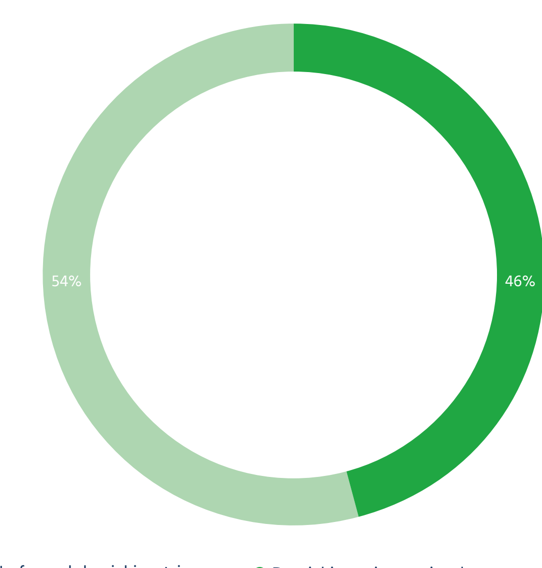


Figure 44. Implementation of de-risking



The final six charts provide further detail on the ongoing de-risking of UK DB plans the survey has revealed over a number of years — 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 closed (to new entrants and future accrual) in recent years. When, as is often the case, a plan is underfunded, a journey plan is designed to align future investment strategy with the gradual recovery of the funding position.

The number of DB plans that have moved to having buyout/ solvency as their long-term target has increased this year, from 27% to 34%. We would expect to see this movement after a strong 2019 for growth assets relative to liabilities. This level of funding is the most prudent/highest, as it means targeting a level of overfunding that accounts for the premium an insurer will charge to assume all of the pension plan liabilities.

When plans target a "run off" strategy (sometimes called "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 Figure 43). The most common premium in the plans surveyed was 0.5%, similar to last year.

We have seen a strong increase in the number of plans that have formal de-risking triggers in place, with 46% of plans having them (versus 36% last year). This is a result of plans emphasising de-risking as they enter the final stages of their journey.

Figure 45. Timeframe of de-risking

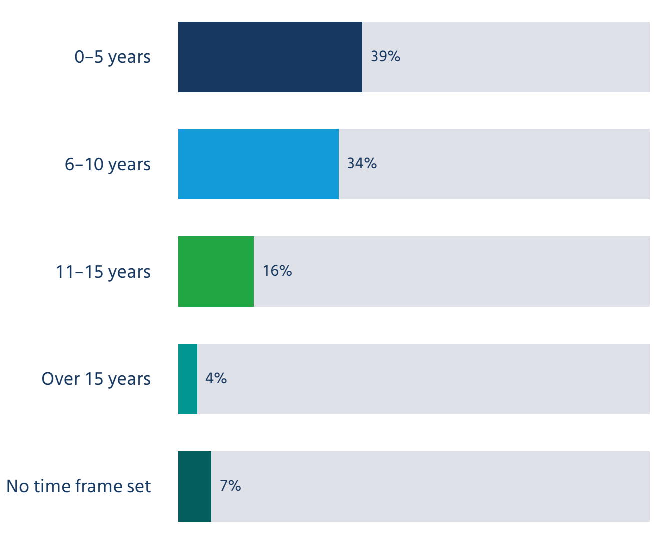


Figure 46. Delegation of de-risking implementation

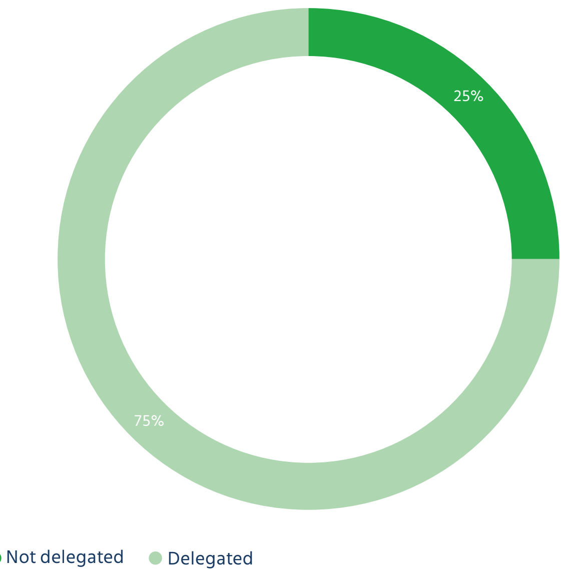
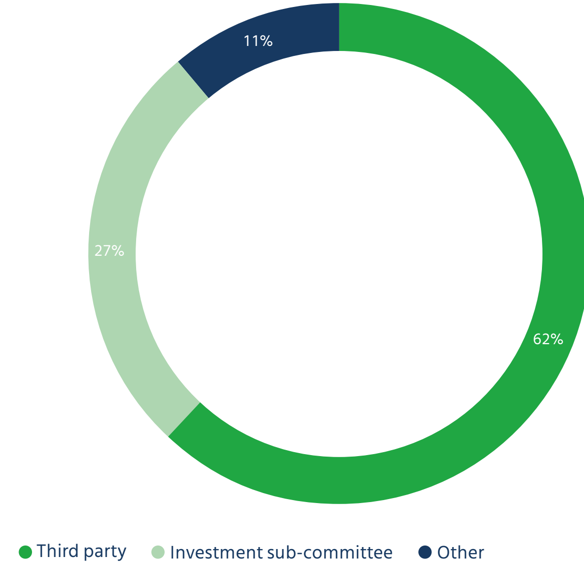


Figure 47. To whom is de-risking delegated?



The number of plans looking to de-risk in the next 10 years also increased again this year, likely due to the strong year for growth assets in 2019. Only 11% of plans have no timeframe for de-risking or a timeframe longer than 15 years, a decrease from 17% last year.

The number of plans delegating their de-risking has increased again, from around two-thirds of plans last year to three-quarters this year. Around 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 its portfolio in line with a set of pre-agreed funding-level triggers.

Acknowledgements

Matt Scott
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