

Q&A ON INCOME STRATEGIES

WHO NEEDS INCOME STRATEGIES AND WHY?

Many types of investors require income from their investments in order to meet financial obligations. This includes wealth management clients, endowments, foundations, healthcare organizations, insurance companies and, of course, retirement plans on behalf of their retiring members. Cash-flow requirements of these different types of investors can differ substantially, and it is critical that these are well understood before designing an income solution.



CAN YOU ADVISE ON A FRAMEWORK TO TAILOR A SOLUTION TO CLIENTS' OBJECTIVES?

The first stage is to fully understand the investor's income needs and risk profile. The following factors all feed into this process:

Time Horizon

Time horizon is a critical consideration, as it has implications for other factors, such as risk tolerance and inflation protection. A shorter-term income solution — say, for an individual transitioning to retirement and currently drawing up plans for how to invest — would be very different to that of a family office investing for perpetuity. It would be different again for a retiree funding for retirement — a period that is very likely long but ultimately finite (at least in 2019!).

Long time horizons facilitate investment in high-yielding illiquid assets, such as real estate and infrastructure. Depending on the tax environment, a long time horizon may also dilute the need for “pure” income, as opposed to distributions that also encapsulate sales and proceeds. Long-term solutions may therefore represent income-oriented growth funds rather than income funds per se.

Level of Income

The level of income required will have implications for the mix of assets held. In an environment of low bond yields and low credit spreads, it is hard to generate high levels of income without accepting higher levels of volatility — for instance, via dividend yield strategies — or lower levels of liquidity — by investing in real assets.

Inflation Protection

Investors looking for a long-term stream of income will typically require that the stream increases at least with inflation. A retiree needs inflation protection to protect against increases in his or her basket of goods (that is, “essentials”), but it is not so critical that the part of the pension allocated to “extras” (hobbies, travel, etc. — if funds allow) increases with

inflation over time. This is because retirees' spending needs change, particularly as they move from the more active, earlier stages of retirement toward the later, slower stages and become less focused on the extras. Inflation again becomes important for the retiree in the very late stages of life, when healthcare costs tend to increase.

Income Certainty

Many investors targeting income are looking for some form of predictability in their income stream. At one end of the spectrum, investors can invest in insurance products that guarantee certain levels of income (for a cost). Without insurance-backed guarantees, stable income can be engineered through products that incorporate broad diversification and dynamic management, and some of these strategies — often called managed payout strategies — can increase stability in their distributions by drawing on capital returns made in the “good years.” Even single asset-class exposures, such as real estate, can generate relatively stable levels of income over time.

Capital Stability

A key consideration is the extent to which capital preservation is required. For instance, an individual transitioning to retirement, who is looking to simply draw on income generated from retirement capital and leave the capital intact, may be quite sensitive to downturns as plans are developed for that capital base. Retiree surveys highlight a resistance to double-digit negative returns. Contrast this with a family office looking to invest its pool for multigenerational equity, and whose priorities are long-term real protection and decent growth, as opposed to capital stability.

Access to Capital

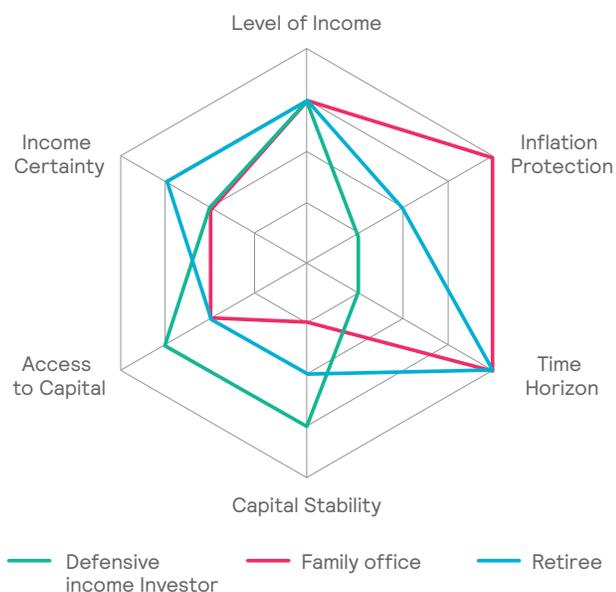
True long-term investors should not require high levels of access to capital and therefore should be open to strategies that incorporate illiquid investments. Retirees investing in guaranteed products, such as annuities, are typically giving up access to (at least some of) their capital.

A useful way of capturing the relative importance of the different objectives to the client is to graphically illustrate them via radar charts. Below we present some examples.

A **defensive income** investor, with a low tolerance for downside risk and illiquidity

A **family office** requiring income for perpetuity, that increases with inflation

A **retiree** requiring income for the rest of his or her life, with typically “balanced” risk aversion (not growth)



LOW BOND YIELDS MEAN MORE TRADITIONAL INCOME PORTFOLIOS MAY NOT SUPPORT ONGOING INCOME NEEDS. WHAT ARE THE ALTERNATIVE INVESTMENT OPTIONS FOR INVESTORS?

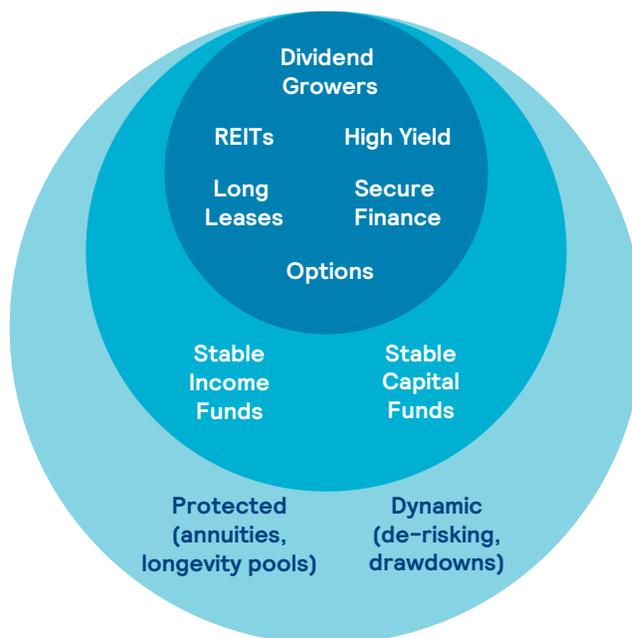
Investors can choose from a myriad of strategies, ranging from single asset-class strategies to more diversified multi-asset class strategies, to sophisticated bespoke solutions.

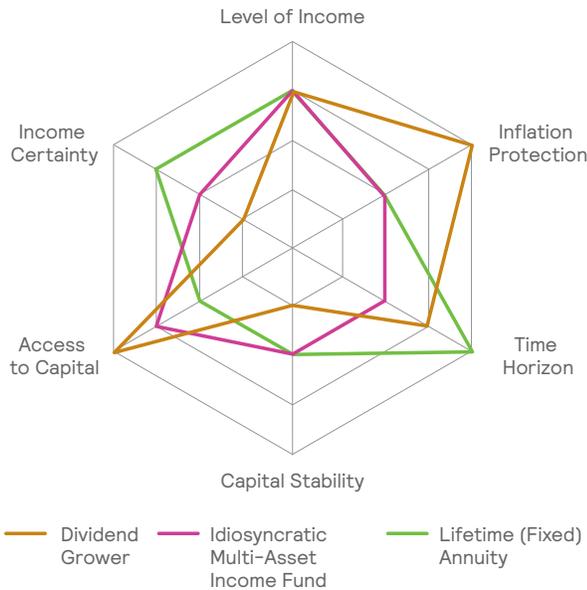
In this low bond yield environment, many income-oriented investors have focused on high-yielding equity, including real estate investment trusts (REITs). We believe such investors should be targeting high-quality “dividend growers” for predictable dividend growth.

Investors with a tolerance for illiquidity would benefit from expanding into higher-yielding areas, such as real assets and secure finance strategies.

Multi-asset income strategies are more efficient options for income-oriented investors. They are typically outcome-oriented in design, whether to deliver stable capital or, in the case of dynamic managed payout strategies, stable income. A developing universe of idiosyncratic multi-asset income funds looks to balance these objectives, tapping into income sources such as preferred stock and options.

In many cases, the right solution is a bespoke tailored solution. This may be a mix of investment and insurance strategies to blend return potential with guarantees (for example, via a deferred annuity) or a longer-term, dynamic service offering (for example, to manage retiree drawdowns).





We present radar charts for strategies that we referred to earlier. Differences are clear, as are their uses.

Dividend Grower

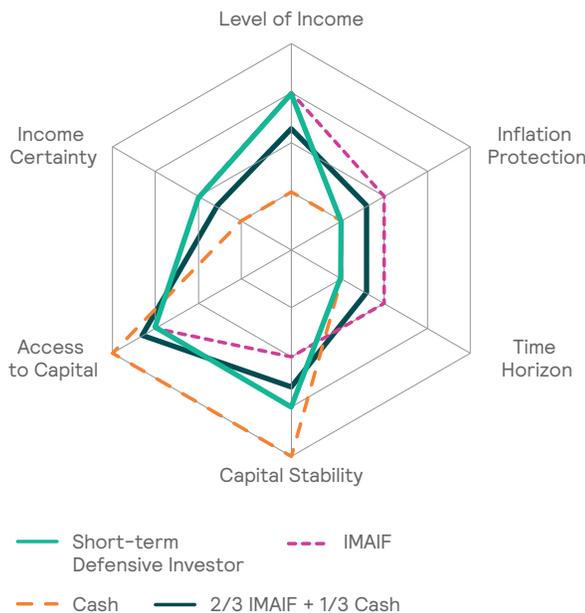
Idiosyncratic Multi-Asset Income Fund

Lifetime (Fixed) Annuity

HOW DO WE MATCH SOLUTIONS WITH INVESTORS' NEEDS?

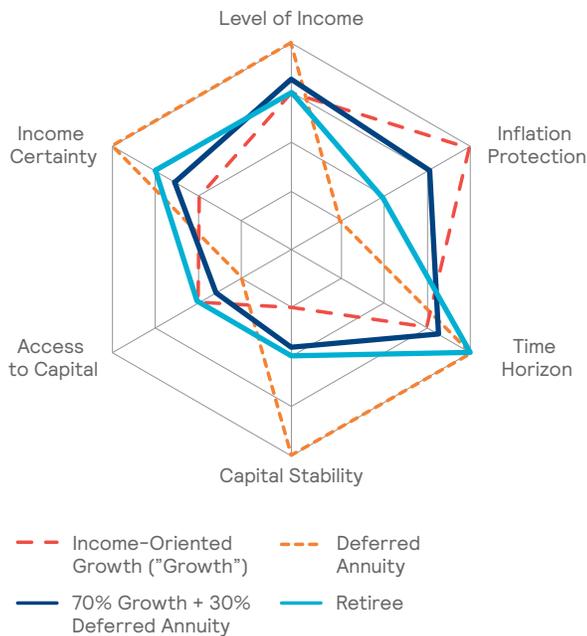
Once an investor's objectives have been fully analyzed and understood, we can match those objectives to characteristics of the various strategies and solutions available. We return to the investors outlined earlier and overlay individual strategies, as well as combinations thereof, to arrive at solutions that broadly match their characteristics.

Defensive income investor

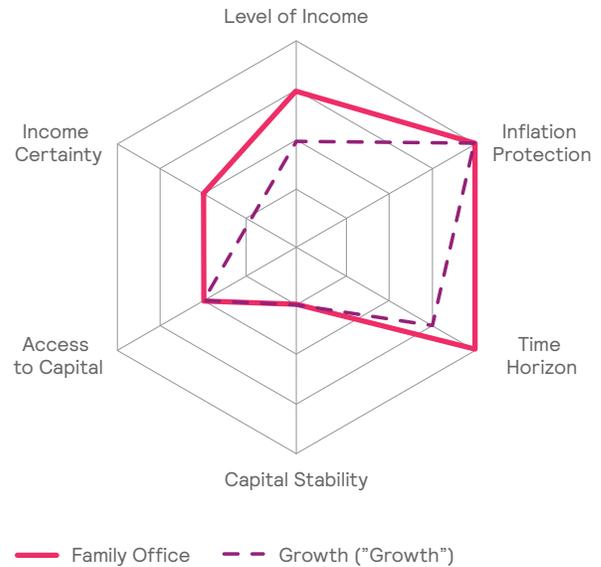


For the short-term defensive investor, an Idiosyncratic Multi-Asset Income Fund (IMAIF) is a good starting point, as it offers a diversified source of income while managing downside risk. Here, we assume that the investor is more risk averse, and by simply blending the IMAIF with some cash, we arrive at a reasonable solution.

Retiree



Family office



The retiree is looking for income over a very long time horizon (retirement), which could be achieved via a growth fund that is oriented toward income. However, this will not provide the level of certainty required nor meet the retiree's lower (balanced) risk tolerance. By insuring the long end with a deferred annuity, the retiree is able to invest in a strategy that aligns to the desired risk tolerance.

A diversified growth fund may be sufficient for this family office, assuming it has the risk appetite, and especially when tax environments often favor capital gains over income. Tax aside, the office could increase income orientation through introduction of dividend growers and/or real assets. In practice, some endowments split their investments between a growth fund and a shorter-term income pool to help manage liabilities.

We are clearly making generalizations in all these examples, and they should be seen simply as illustrations of the process in action. Every investor has unique income needs, and the devil is in the detail when designing a bespoke solution. However, by applying this practical process and drawing on our broad and deep manager knowledge, we can create income solutions that are truly tailored to investors' needs.

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