

Top considerations for insurers in 2023

Introduction

The German economist Rudiger Dornbusch once said, “in economics, things take longer to happen than you think they will, and then they happen faster than you thought they could.” This represents well the compressed economic cycles experienced over the past few years and the recent upward shift in interest rates across the globe.

As 2022 comes to a close, insurance companies are facing significant price losses across their portfolios, particularly within long-duration fixed income. On the horizon are the risks of a global recession, peaking fundamentals, persistent inflation and energy crises, particularly in Europe.

On one hand, the increase in yields makes things simpler — insurers don't need to take the same level of risk to generate a reasonable level of income. On the other hand, the highly uncertain economic environment makes things more complicated. Although true across the globe, this is

particularly acute in Europe, which has experienced a series of tumultuous political and monetary events. In what asset classes are investors compensated for taking risk, and when is the appropriate time to pull the trigger? Does it make sense to realize losses in investment-grade fixed income to reallocate to higher return strategies? What sectors and exposures represent meaningful risk over the near term and should be avoided?

We've been preaching diversification and balanced risk for some time as risk premiums compressed and we entered the later stages of the business cycle. Now, more than ever, it's important for clients to revisit their assumptions around risk tolerance and the strategic alignment of their portfolios with capital and liquidity requirements. At the same time, they need to ensure a robust governance process exists to retain flexibility as opportunities emerge.

Over the past decade, insurance portfolios have experienced meaningful changes, including an increase in third-party outsourcing, continued diversification beyond core fixed income and allocations to private markets. These changes were driven in part by a secular decrease in interest rates and a need to maintain income. But they also represent insurers' desire to optimize the overall value derived from the investment program. We do not expect this trend to reverse.

Several macroeconomic topics — inflation, recession risk, and climate transition risk and opportunities — will be covered in Mercer's broader Themes and Opportunities for 2023. In this paper, we outline six key themes we believe insurance companies across the globe should focus on in the coming year. [Click the icon to navigate to the read more.](#)

1. The return of high-quality yield

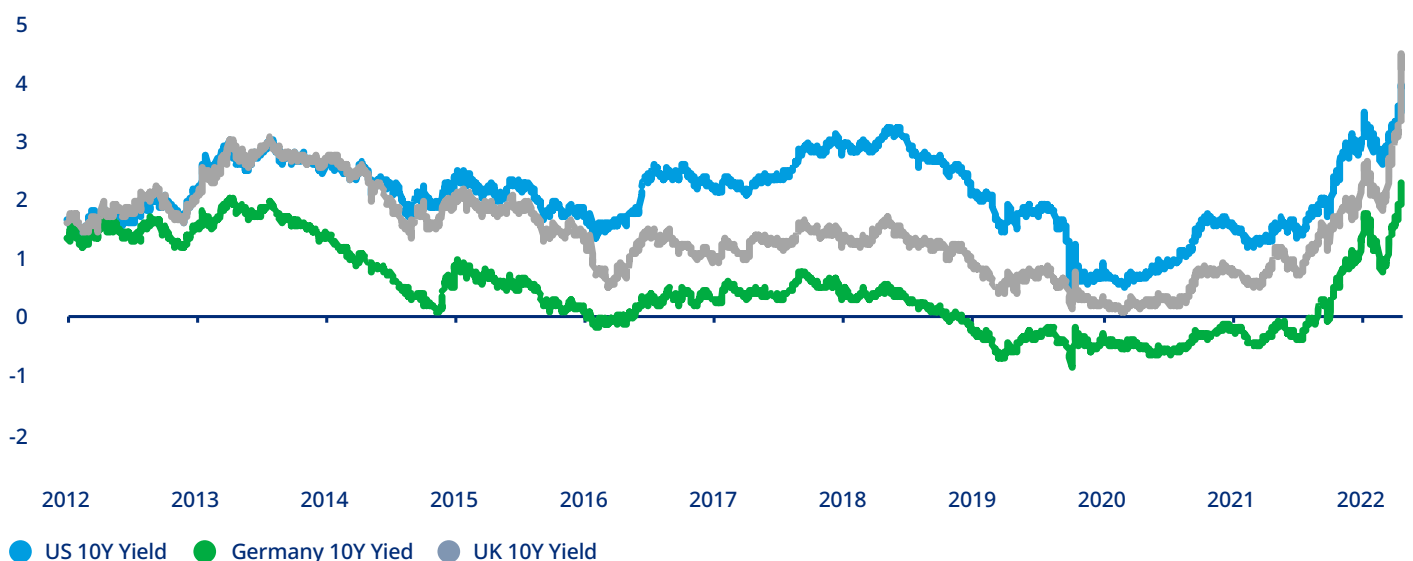
2022 has seen rapid changes across financial markets as central bank policy has shifted from easing to tightening as we exit the COVID-19 pandemic, the Russian invasion of Ukraine, and persistently high inflation. This has induced perhaps the greatest bear market in bonds as yields surged in tandem across the world. At the same time, fixed income spreads and equity valuations have repriced to account for the highly uncertain outlook going forward.

Given this major repricing of financial assets, it can be a tempting time to consider adding incremental risk to portfolios to take advantage of more attractive valuations. Although there are near-term opportunities in certain markets, at the time of writing this report in late 2022, we do not believe it is a prudent time to stretch risk levels to a meaningful degree. With a looming earnings recession,

volatile energy prices in Europe, supply chain constraints eroding margins, significant ongoing geopolitical risk, and persistent inflation, the risks appear tilted to the downside. There will be a time, however, when it makes sense to take advantage of depressed prices and we recommend insurers embed flexibility into their portfolio to capture those opportunities when they arise.

In the meantime, increased yields in developed market investment grade bonds may provide an attractive source of higher current income and return on a risk-adjusted basis. With lingering uncertainty that central banks can thread the needle by slowing growth without a recession, financial conditions could deteriorate further before they improve. As such, insurers should revisit their core fixed income portfolios, which represent the lions share of assets, and ensure they are making the most of opportunities within the asset class. We believe the best opportunities are typically found on the periphery of bond markets, and as such, insurers should examine their level of off-benchmark allocations in place, while ensuring the right managers and strategies are in place to identify those opportunities. This includes embedding more flexibility in certain mandates and focusing on managers who deliver a high degree of differentiated alpha over time.

Sovereign yields %



Source: Bloomberg, 28 September, 2022.



Loss harvesting

With the sharp increase in interest rates, some of our clients have been evaluating the payback period for realizing losses on fixed income and re-striking a higher long-term book yield. The implications vary by client based on earnings objectives, tax status and surplus volatility sensitivity. In some cases, this payback period has been estimated at less than two years. While primarily an accounting exercise, the decision of whether to change the risk profile of reinvested funds is another consideration.

Key takeaways

- High-quality fixed income yields appear attractive on a risk-adjusted basis.
- There remains significant downside risk to the global economy.
- Embed more flexibility into your core fixed income portfolio.
- Focus on high alpha-generating managers.

2. Convergence of public and private markets

One of the key structural themes in capital markets over the last decade has been the increased use of private markets to secure capital. This is readily evident in the growing proportion of companies staying private for longer and the resulting decrease in the relative supply of public equity markets.

This trend is also evident in debt markets and is driving the creation of large origination platforms, expanding beyond middle market lending to investment grade corporate and asset-backed financings. Many of these platforms are utilizing affiliated insurance company balance sheets as the engine to originate larger deals and supplant traditional banks.

The result is a wider range of tenors, collateral types, and risks available to investors, including Property & Casualty and Health insurers with shorter liability duration profiles. This was historically the playground of life insurers. Much of this growing supply is currently limited and can be difficult to access without meaningful scale or strategic partnerships, but we believe this trend will endure over time and the opportunity set will expand.

The decision to allocate to private investment grade markets is a function of an insurers' ability to accept liquidity risk. In our experience, most insurers reach their risk thresholds before they reach their liquidity thresholds. If the average risk asset position for a P&C insurer is 30% of the portfolio, there are opportunities to evaluate optimizing the remaining 70% that consists primarily of liquid investment grade bonds.

We recommend insurers view this liquidity tradeoff across their portfolio and evaluate opportunities through the available spread compared to publics, relative liquidity, and collateral exposure. When compared to the major public fixed income sectors, there are opportunities across each to trade liquidity for additional spread.

Example

Public opportunity set	Private opportunity set
Public corporates	Corporate private placements
Residential mortgage-backed securities	Residential whole loans
Commercial mortgage-backed securities	Direct commercial mortgage loans
Non-traditional asset-backed securities	Private asset-backed securities
Municipals	Infrastructure debt



Key takeaways

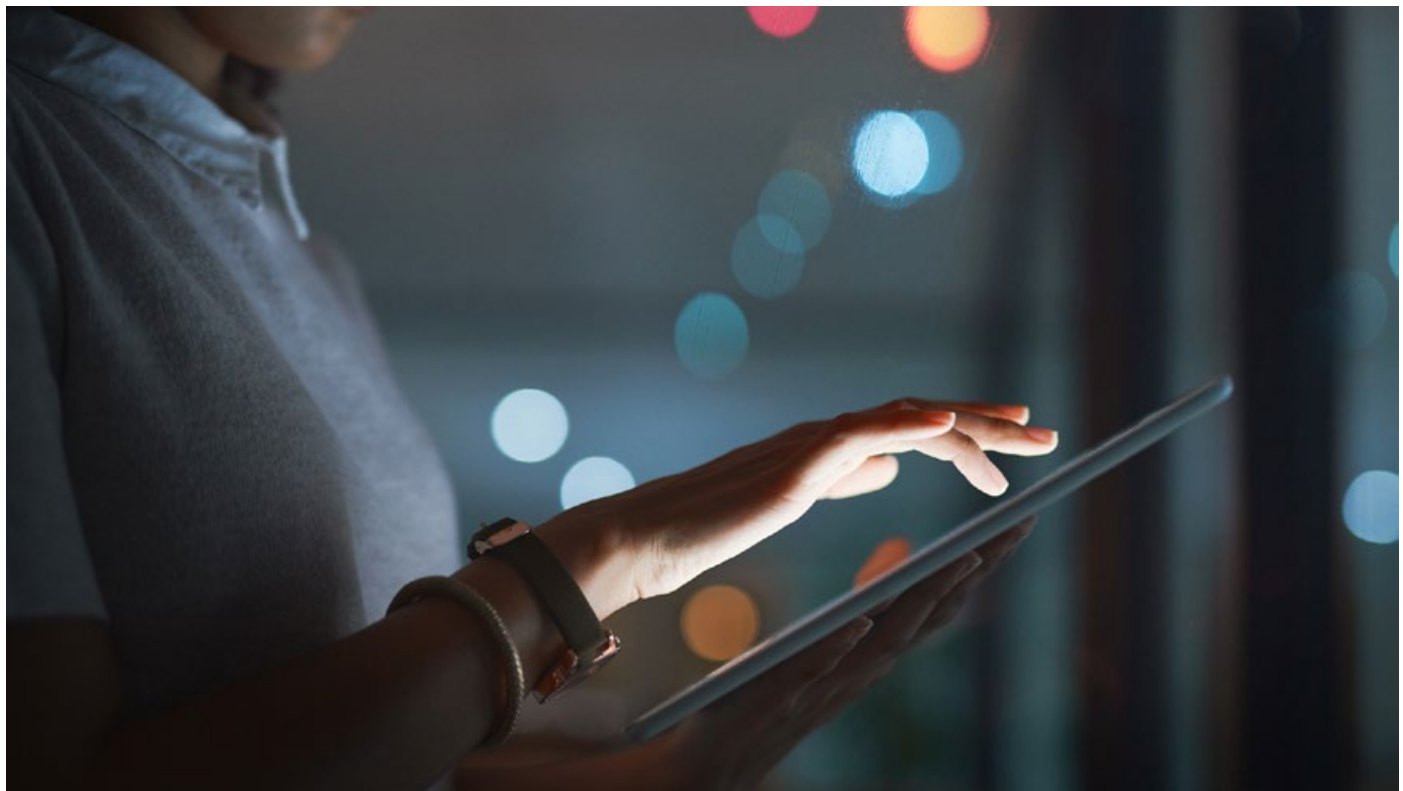
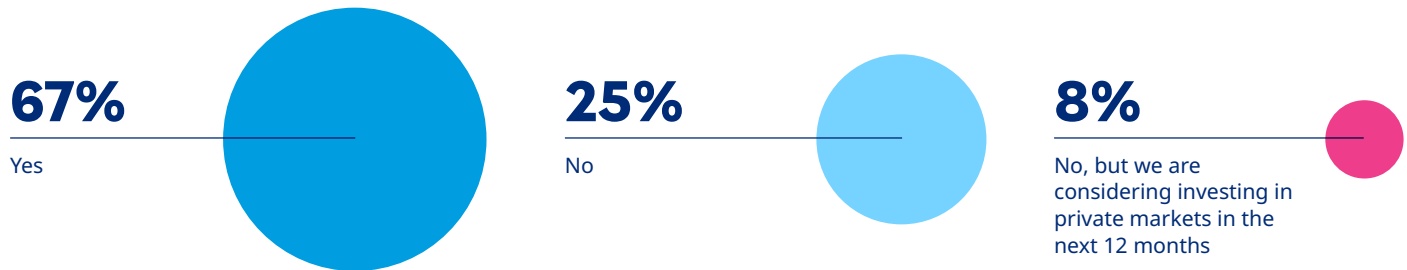
- There is a growing supply of investment grade private debt originations available to investors.
- Large asset management and insurance company partnerships are driving deal flow.
- Clients with excess liquidity should evaluate options to trade liquidity across major public fixed income sectors.

3. Continued growth in Alternatives

Insurers across various liabilities and size continue to allocate to Alternatives to improve returns and grow surplus.

A recent insurance survey conducted by Mercer found that 67% of respondents currently invest in private markets, and 8% who do not currently invest in private markets plan to in the next 12 months (see Figure 1). Sustained growth in this area is unsurprising coming off the back of a decade of low-interest rates and the creation of more capital-efficient structures for US insurers. As a result, Alternatives have become a vital part of insurance companies' investment strategy.

Figure 1. Does your organization invest in private markets?



Within Alternatives, private debt continues to be the most utilized asset class for insurance companies. Over 50% of respondents to our survey stated they plan to increase their allocation to private debt over the next 12 months (Figure 2). We continue to believe this asset class provides benefits to insurance companies in the form of enhanced income and strong structural protection, particularly as the environment shifts to one that is more lender-friendly. As the asset class has grown, so have the various strategies available to investors. While middle market lending continues to be a core allocation, insurers are increasingly allocating to specialty finance, structured credit, and credit opportunities funds to generate additional returns and diversification. One key trend we expect to grow over the coming years is the use of evergreen funds within private debt, allowing clients to maintain their exposure more efficiently than the usual commitment cycle. In addition to a more stable net asset value exposure, these structures can also offer potentially lower fees.

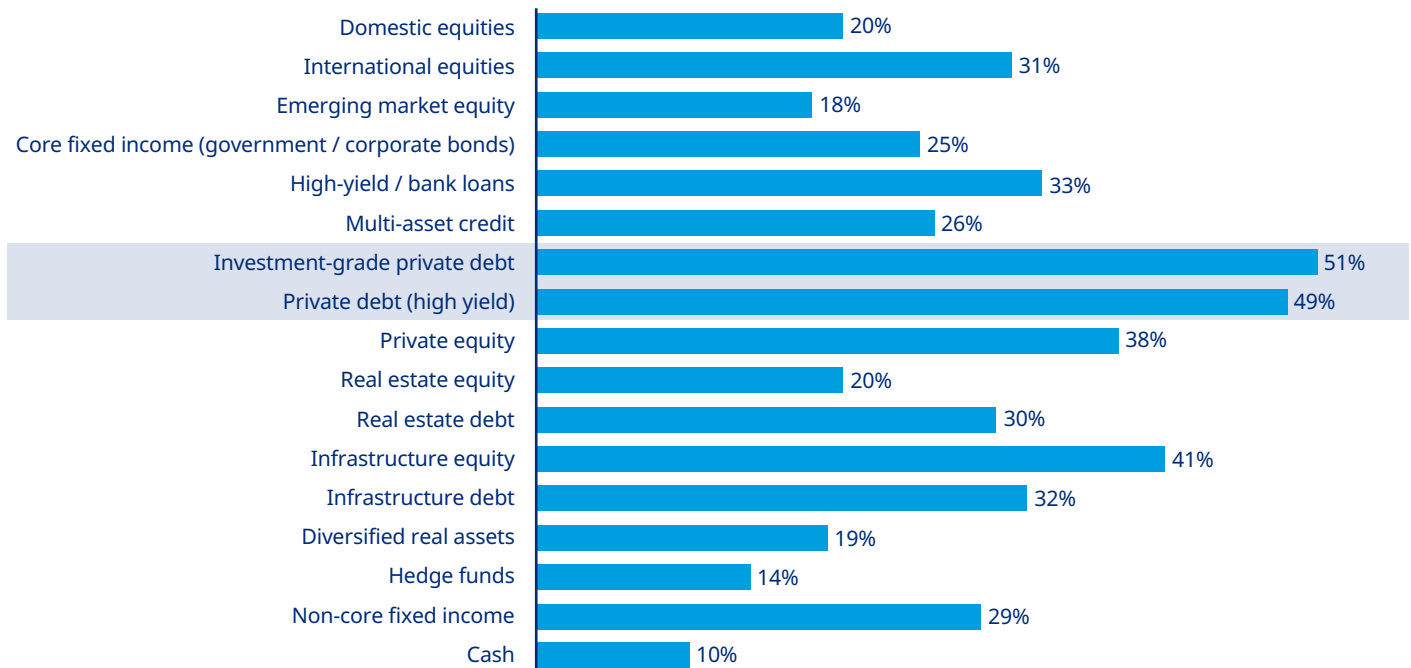
While we believe allocations to private debt will continue to increase, insurers also plan to increase exposure to other alternative asset classes over time. The most notable Alternatives cited by respondents in our survey included

infrastructure, private equity, and real estate. These assets can provide meaningful benefits to insurers challenged by elevated market volatility, inflationary pressures, and rising interest rates – the three primary investment challenges over the next 12 months cited by respondents in the survey.

Our survey also asked respondents without private allocations the main reasons their organization has not invested in private markets. The top reasons included 1) a lack of resources to assess the investment opportunity (63%), 2) the investment instruments are too complex (44%), 3) the inability to adequately review operational due diligence factors (38%), and 4) the inability to tolerate the level of illiquidity (38%). Mercer has increasingly been engaging with insurers to help address these challenges and properly align the level of illiquidity and risk in client portfolios.

While the pace of Alternatives growth may slow amid current market volatility and higher investment grade yields, we believe allocations to these asset classes will continue to be an integral driver of portfolio returns and diversification over time. Please see our 2023 Alternatives Outlook for more information.

Figure 2. How do you expect asset allocation to change over the next 12 months?



Source: 2022 Mercer Global Client Survey

Update on capital-efficient funds

A key trend we have commented on in previous years has been the development of more capital-efficient vehicles for insurance companies, primarily within the United States. The objective of these structures includes regulatory or rating agency capital improvement, as well as operational and accounting efficiency versus owning the securities directly. The predominant structure available today is rated notes, which are increasingly adopting attributes of traditional collateralized loan obligations. There are many complexities to this topic, including emerging regulatory proposals, and Mercer has been at the forefront of evaluating the various structures and tracking the details of products coming to market. As a result, we will be releasing additional research in the coming year to help clients continue to monitor developments.

Figure 4: Hypothetical regulatory capital charge illustration (US life insurer example)

Fund Ratings Regulatory Capital Charge

The illustration provides a comparison of the regulatory capital charge difference between an unrated \$100 million fund and a \$100 million fund with a rated note

The comparison below shows that the indicative rated fund offers regulatory capital charge savings of 71.2% and \$21.4 million

Hypothetical Regulatory Capital Charge Illustration

Structure	% of investment	Rating	NAIC Code	Regulatory Capital Charge	Asset Valuation Reserve
Not rated	100%	Not Rated	NAIC 6	30%	\$30,000,000
Rated Note					
Senior Notes	75%	BBB	NAIC 2.B	1.5%	\$1,140,000
Equity	25%	Not Rated	NAIC 6	30%	\$7,500,000
				8.6%	\$8,640,000
Potential Regulatory Capital Charge Savings				71.2%	\$21,360,000

Key takeaways

- We expect insurance companies to continue to allocate to Alternatives, in particular private debt.
- Clients cite resource allocation, complexity, and ability to conduct proper due diligence as challenges in implementing private markets.
- Private debt remains a core allocation, but should evolve to be more diversified and opportunistic.

4. Evolving governance models

Insurer investment portfolios have undoubtedly become more complex. Underlying this was a decade of financial repression and falling interest rates, but also a desire to generate more value and alignment with the investment portfolio and broader objective of growing enterprise value of the company.

As a result, the level of sophistication and oversight required to manage portfolios has increased over time. This has resulted in challenges regarding lack of resources, implementation and operational complexities. As a result, we have seen increased adoption of new governance models and portfolio delegation to improve implementation and return outcomes over time.

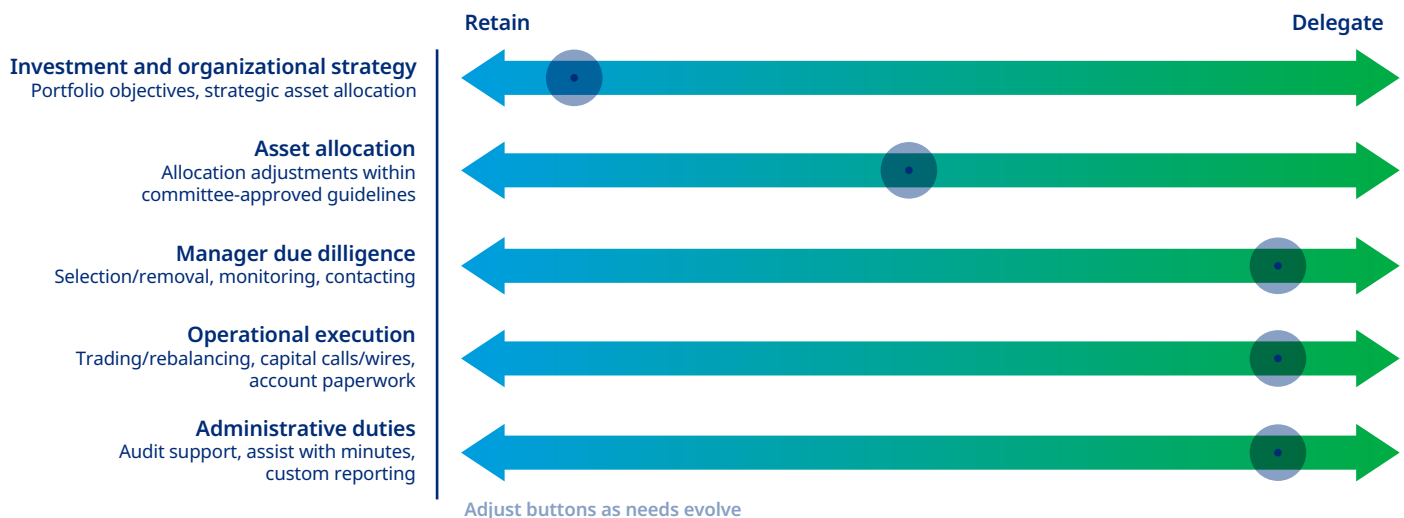
One of the key decision factors is the ability of an insurer’s governing body – typically an investment or finance committee – to balance strategic decisions with efficient implementation and management of the portfolio.

The quarterly committee cycle, lack of internal resources, and varying levels of investment expertise, often result in challenges in properly optimizing the investment program.

For some clients, this means evaluating the decision-making process within their organization and developing a set of strategic investment policy targets, ranges, and pre-approved asset classes that properly balance the alignment of strategic risk with the ability to execute on more tactical opportunities, manager, or strategy changes. More and more, we see investment committees set the high-level strategic asset allocation decisions in the portfolio, but delegate the implementation to staff or their advisors. This requires a robust risk-setting process and a higher level of communication and reporting on changes in the implementation strategy over time.

We believe that for smaller and mid-size insurers, in particular, there are opportunities to improve portfolio outcomes by creating a more flexible approach that leverages the collective expertise and skills of their organization and their advisors. This process begins with a discussion around the levers of decision making best held internally versus those delegated to improve implementation and execution. This is ultimately driven by each organization's governance structure, internal resources, and portfolio objectives.

Figure 5. Flexible decision-making approaches



Source: Mercer, for illustrative purposes only

Key takeaways

- Insurance company portfolios are becoming more complex.
- Challenges for clients include lack of internal resources, implementation efficiency, and operational complexity.
- Insurers should identify the right governance model and decision-making process for their company to optimize their internal expertise and resources and capabilities of external partners.
- Evaluate opportunities to improve the implementation of portfolio strategy through various types of delegation.

5. Pace of regulatory and rating agency changes

Across the globe we are seeing significant activity from regulators and rating agencies regarding insurance investments and it is increasingly important for clients to stay abreast of the implications for their portfolios. Given the complexities of these changes, it is difficult to capture all the relevant points in a short commentary, but we have outlined below some of the key issues emerging across various regions and rating frameworks. Our global team of insurance consultants are available to discuss these trends in more detail.

IFRS¹ 9 and IFRS 17

The temporary exemption from applying IFRS 9 will expire for reporting periods starting on or after January 1, 2023, meaning all insurers reporting under IFRS will be brought into scope. Assets will be classified as amortized cost, fair value through other comprehensive income (FVOCI) or fair value through profit or loss (FVTPL). Business Model and Solely Payments of Principal and Interest (SPPI) tests apply. Assets that do not pass the SPPI test must be classified as FVTPL and investments in funds are likely to go through FVTPL. Implications vary by insurer, with some seeking to make greater use of separately managed accounts to achieve the desired accounting treatment, with others simply choosing to make greater use of the FVTPL classification.

US NAIC² principles-based bond definition

In March 2022, the NAIC approved the exposure draft of a revised principles-based definition of a bond. Key developments included the additional inclusion of a broader range of assets under review, the removal of stapling restrictions, and the treatment of rated feeder fund structures. The proposal seeks to prioritize substance over form by considering factors such as the existence of contractual principal and interest payments. The outcome of this work will be a framework around what will be accepted as a “bond” and therefore eligible for favorable capital treatment and reporting on Schedule D – Part 1. The objective is to reduce capital arbitrage and improve transparency in statutory filings going forward, including separating bonds into two separate schedules. We expect this process to take some time, with the project slated to conclude and go into effect in 2025 at the earliest.

US NAIC Structured Securities Review (CLOs)

During the Summer National Meeting, the NAIC discussed proposals regarding potential risk-based capital treatment changes to CLOs, building off of previous reviews of SSAP 43R. The proposals included addressing concerns over the capital charge reduction of holding a securitization versus the underlying securities directly and the potential for an expanded set of risk-based capital (RBC) factors for NAIC 6 tranches. The NAIC plans to target broadly syndicated bank loan CLOs for initial modeling and will likely move to examine the implications for private structures such as rated notes, collateralized fund obligations, and private structured asset backed securities. The implication is that RBC charges may be higher in the future and the determination of the risk charge may be set by the NAIC through a set of new stress scenarios. This timing is anticipated to be no earlier than December 2023, with year-end 2024 more likely. A broader theme tied to this review is the overall private letter rating process, which has seen significant growth from insurers over the last several years, and the desire on behalf of the NAIC to have more control over the capital charge outcome for various securities.

¹ International Financial Reporting Standards.

² National Association of Insurance Commissioners.

S&P Capital Adequacy Model

In late 2021, S&P announced a proposed update to its rating methodology for investments held by insurance companies by applying more punitive capital charges for certain securities not rated directly by S&P. After receiving significant pressure from the industry, including a warning letter from the Justice Department over potential anti-trust issues, S&P withdrew its proposal during 2022 and noted it intends to provide a revised proposal for comment. The future of this proposal may have an impact on the capital charge for various securities within S&P's rating framework.

UK and EU Solvency II reform

UK Solvency II reform approach has diverged from that of the European Union (EU) due to Brexit. The UK Treasury published a consultation in April covering Risk Margin reduction, reform of the Fundamental Spread used in the Matching Adjustment calculation, and a general reduction in regulations. The Prudential Regulatory Authority, which regulates insurers, published its own consultation on the same day, covering reforms to the Risk Margin and Fundamental Spread specifically, which would mainly affect Life insurers. The Risk Margin reforms (broadly similar to EU proposals) are estimated to reduce capital requirements by 60-70% for long-term life insurers, while Fundamental Spread reforms would reduce the benefit of the Matching Adjustment. These proposals have been met with mixed reactions from the insurance industry, and at present it is still to be determined how the reform will move forward.

In the EU, Solvency II reform continues, with the European Council having published its position on updated rules for insurers in June, following the proposals made by the Commission to the European Council last year³.

AASB⁴ 17 and Revised Capital and Reporting Frameworks

In Australia, the capital framework applying to life and general insurers (LAGIC), and the associated reporting framework, have been revised to reflect the introduction of new accounting standards (AASB 17). Concurrently, new capital and reporting standards for private health insurers have also been introduced. These changes increase alignment across insurance sectors, integrate applicable accounting and capital regimes, while also serving to increase the financial resilience of private health insurers. From an investments perspective, the impact is likely greatest for private health insurers with an increased focus on the level of investment risk taken, given its more granular and stringent assessment under the new capital standards.

These are some of the major regulatory and rating agencies challenges on the horizon. With the current pace of changes, it is increasingly important for clients to understand the various proposals under consideration and the potential impact. These are a complex set of topics with various implications and, in some cases, a set of uncertain outcomes. Mercer is available to support insurance clients in understanding how best to prepare for these future changes.



³ Mercer. Solvency 2.5. A €90 billion reboot?, available at <https://www.mercer.com/content/dam/mercer/attachments/global/Solvency%20II.pdf>.

⁴ Australian Accounting Standards Board.

Key takeaways

- The pace of regulatory and rating agency changes is increasing rapidly across the globe.
- It is critical to understand the implications of these changes for investment strategy.
- Engage with advisors to prepare for and position portfolios for potential future changes.

6. Sustainable investment

Sustainable investment – whether concerning environmental, social, and governance (ESG) factors in decision-making, impact investment opportunities, or related considerations — continues to be a key issue across our insurance client base.

Activity has remained higher across our clients in Europe, the UK, and Australia, but we have seen a meaningful increase in evaluation and engagement by U.S. insurers. For some insurers this is driven by a desire to be a leader in their industry, while others are preparing to respond to a higher level of disclosure requirements by rating agencies and regulators.

Most clients begin this journey by clarifying their corporate objectives around sustainability, ESG, and climate risk, both in terms of positioning for opportunities and mitigating potential risks. As an example, in 2022 we helped one of our publicly traded U.S. clients assess their general account investments in the context of their existing corporate ESG commitments in order to identify key areas of concern and measurement, including carbon metrics and Sustainable Development Goal (SDG) alignment. This evaluation included a security-level measurement of exposure to ESG risks, including oil and gas and tobacco exposures, as well as carbon emissions and a pathway to achieve net-zero greenhouse gas emissions at the portfolio, asset class, and sector levels. Climate scenario analysis is another emerging area of focus for our clients, in which investors seek to assess the impact of potential future climate warming scenarios across transition and physical risks.

Not surprisingly, many insurers are interested to know what their peers are doing on these issues. In this respect, we have been working with our clients to understand how their practices compare to those of other insurance companies, including conducting in-depth analyses of insurers' positioning regarding ESG practices for their general account investments. We have developed a proprietary framework to support clients in this exercise in order to benchmark their practices and take steps to keep up with industry standards.

Regardless of internal motivations to evaluate sustainable investment approaches, external pressure is mounting for insurers. Within the U.S., the Treasury (via the Federal Insurance Office) is seeking comment on a proposal to collect historical and current data on climate-related risks from P&C insurers. While limited in scope at the moment, we anticipate that the FIO will build on this proposal to begin collecting data on insurers' investment-related activities. These inquiries are likely to align broadly with the guidance from the Task Force on Climate-Related Financial Disclosure (TCFD), a global industry-developed disclosure framework that regulators are increasingly adopting.

New reporting rules are emerging in this area as well, such as the UK FCA climate-related disclosure rules under PS 21/24, which began to apply in January 2022, as well as the need to respond to other climate-related disclosures such as the NAIC Climate Risk Disclosure Survey and the New York Department of Financial Services (NY DFS) requests. The NY DFS issued guidance on November 15, 2021 outlining expectations related to insurers' management of financial risks from climate change. By August 15, 2022, the NYDFS expected insurers to have in place board oversight of climate-related risks and to articulate their plans regarding how climate risks will be considered and managed through the existing enterprise risk management function and risk management processes (i.e. enterprise risk reports, ORSA summary reports, and escalation to senior management). In addition, NYDFS sought insurer disclosure of how their organizational structure will establish or incorporate roles and responsibilities relating to climate. Future expectations NYDFS outlined include that insurers will engage with the TCFD and other initiatives, while developing relevant governance structures, policies, processes and reporting to support these efforts.

In Australia and New Zealand, regulators continue to play a role in highlighting climate change risk. In Australia, APRA⁵ has released a regulatory guide (Prudential Practice Guide 226), which sets regulatory expectations on the way insurers address climate risk, while in New Zealand, government legislation has been introduced requiring mandatory climate-related disclosures for large insurers (those with greater than NZ \$1 billion in total assets or annual premium income greater than NZ \$250 million).

To summarize – we expect to see momentum continue to accelerate and drive insurers' actions with regards to sustainable investment and ESG.

⁵ Australian Prudential Regulation Authority.

Key takeaways

- Sustainable investment is a key consideration for insurers across the globe.
- Regulatory and rating agency engagement is increasing in meaningful ways.
- Be prepared to communicate and report on your approach to sustainability to internal and external constituents.
- Evaluate both risk and opportunities resulting from climate transition.

Conclusion

As we enter another new year, the pace and scale of change remains a constant challenge as insurers grapple with the risk of recession, interest rates, an energy crisis and geopolitical upheaval. Against this, they are contending with a challenging business environment characterised by volatile pricing across core business lines, such as property casualty, cyber and health – in fact according to the Marsh Global Insurance Index, the third quarter of 2022 was the twentieth consecutive quarter in which composite pricing rose. Similarly, life insurers continue to face a demanding competitive environment, with business models constantly evolving.

Insurers must of course manage the asset pools backing their liabilities. From an investment strategy perspective there are also challenges. While rising yields can be helpful on a forward looking basis, for those on a mark-to-market model, the impact on their existing asset pool has been significant. This will no doubt have a heavy influence on how insurers – as asset owners – respond to the environment we anticipate for 2023 and beyond.

Insurers are actively revisiting their investment strategies, with a focus on building resilience into their asset pools to generate the income they need while preserving capital and stabilizing the balance sheet. Well-informed asset allocation that captures opportunities as they arise (which inevitably they will) continues to underpin capital-efficient portfolios that should be diversified across asset classes – both public and private – and this remains the focus for many insurers.

Mercer has a long heritage of advising insurance clients on navigating difficult business cycles and market environments. Our expertise and independent perspective places us in a unique position to help. For further information or an informal discussion, please contact us.

Additional resources

[Mercer 2022 Insurance Survey](#)

[Themes & Opportunities 2023 - Déjà New](#)

[Top considerations for alternatives in 2023](#)

[Private markets themes and opportunities - inflation playbook](#)

[Private markets themes and opportunities - Positioning for transition](#)

[Private markets themes and opportunities - modern diversification](#)

[Advancing the the transition - seeking to mitigate risk and drive adaptation](#)

[Advancing transition potential: Global asset manager survey results](#)

[Yield PointSM blog series](#)

[Critical thinking, critical issuesSM podcast series](#)

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Colin Tipping
Global Head
Insurance Solutions

+44 7789 030520
colin.tipping@mercer.com



Gregory Halagan
Co-Head of Insurance
US

+1 651 408 5746
gregory.halagan@mercer.com



Chris Tschida
Co-Head of Insurance
US

+1 612 642 8727
christopher.tschida@mercer.com



Denis Walsh
Head of Insurance
Australia

+61 4 1483 9094
denis.walsh@mercer.com

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