

INVESTOR INSIGHTS SERIES

When. Not if.

Institutions prepare for the fallout of a market shift

Institutional investors have performed a masterful balancing act over the past decade: They've taken advantage of low rates, low volatility and low inflation to generate high investment returns. Along the way they've also navigated increased regulatory pressure, ballooning liabilities and growing exogenous risks in order to keep investment programs on track. But like watching the performer spinning plates on a stick, some may wonder how long they will be able to continue this admirable feat when markets change and how they will adjust in order to keep it all from coming to a crashing halt.

The risks are many. Institutional investors put geopolitics at the top of the list. But asset bubbles, interest rate increases, low yields and the potential for central banks to unwind quantitative easing are not far behind. Despite the challenges, respondents to the Natixis 2017 Global Survey of Institutional Investors¹ say they still have a few tricks up their sleeve to meet average long-term return assumptions of 7.2% in the year ahead.

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1 Natixis Investment Managers, Global Survey of Institutional Investors conducted by CoreData Research in September and October 2017. Survey included 500 institutional investors in 30 countries.

Factors that could negatively impact investment performance in 2018 (% who said negative impact)



Even as they consider a course of action to address future market turmoil, few are making radical defensive moves today. It would appear that many are keeping the plates spinning in order to wring as much return as possible out of the bull market run-up.

Their plans for addressing these critical factors comes down to three broad strategies: opportunistic calls for allocations to active management and alternative investments;² renewed emphasis on environmental, social and governance (ESG)³ and liability-driven investing (LDI) strategies to help manage risk; and a measured response to the regulatory and business challenges waiting in the wings.

Opportunity in the uncertainty

Since the global financial crisis investors have profited from a prolonged bull market. But it's been significantly different from other run-ups. Not only has it been one of the longest in history, but it's also been marked with abnormally low levels of volatility. Many analysts attribute the rampant asset price

growth witnessed in this time period to the combined effect of accommodative monetary policy and artificially low interest rates, rather than attractive company fundamentals and earnings growth.

Between January 1, 2007 and December 31, 2017, the S&P 500 generated 87% in total return for an average annual return of 5.89% – impressive returns for a period that began with a 35% loss in 2007 alone. Through it all, the VIX⁴ has declined to its all-time low of 9.14% on November 3, 2017. It is not surprising that in this same time, dispersion returns have been low and there has been a steady flow of assets to passive investments. Institutional investors see the potential for that formula to change, and interest rate hikes may be the catalyst that sets off a new reaction.

Institutional investors recognize that the run-up is not all positive. Three-quarters of those surveyed globally believe the same low rate environment that has helped propel market growth has also created asset bubbles for stocks (30%) and bonds (42%). The potential impact weighs so heavily that

Overinvestment in passive raises market concerns

Over the past decade, many believe stock market performance has been driven as much by artificially low interest rates as fundamentals. This has resulted in a rising tide that's lifted most boats. In its wake, market sentiment has sided with investments such as index funds and ETFs; so have investment flows.

Many wonder if this phenomenon has, in turn, created new market risks. Institutional investors worry that large asset flows into passive strategies have artificially suppressed market volatility. Logically, when volatility does return, its effect could be amplified, causing wilder market swings as investors attempt to unwind assets held in passive investments.

The problems with passive

- 59% say absence of volatility is cause for serious investor concern
- 59% of institutions say flows into passive strategies artificially suppress volatility
- 56% say passive investing distorts relative stock prices and risk-return trade-offs

Similarly, 63% of institutional investors say the growth of passive investing has increased systemic valuation risk. With markets rising on artificially low interest rates, rather than the real valuations of securities, an uptick in the use of index investment has amplified the momentum, adding to institutional concerns about asset bubbles in the year ahead.

² Alternative investments involve unique risks that may be different from those associated with traditional investments, including illiquidity and the potential for amplified losses or gains. Investors should fully understand the risks associated with any investment prior to investing.

³ ESG investing focuses on investments in companies that relate to certain sustainable development themes and demonstrate adherence to environmental, social and governance (ESG) practices, therefore the Fund's universe of investments may be reduced. It may sell a security when it could be disadvantageous to do so or forgo opportunities in certain companies, industries, sectors or countries. This could have a negative impact on performance depending on whether such investments are in or out of favor.

⁴ The VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options.

almost two-thirds of institutions cite asset bubbles as one of their top risk concerns.

Considering a potential reversal in the monetary policies that have buoyed markets and likely interest rate increases, institutional investors project market volatility will be on the rise, as will the dispersion of returns among securities. With the interest rate tailwind subsiding, three-quarters of institutional investors say the market favors active managers.

Active allocations continue to rise

Institutions may have come to this realization much sooner than the fall of 2017 when our survey was conducted, as it appears that they have been upping allocations to active investments for three years. When asked in 2015 how they thought portfolios would be allocated in 2018, institutions forecasted 43% of total assets to be invested in passive strategies. In reality passive allocations dropped to 32% by 2017 and institutions are projecting an increase of only 1% in the next three years. This allocation is substantiated by the 57% of institutions who believe active will outperform in the long run.

While a majority of institutional investors believe that passive investments offer an advantage in managing fees, they do not always place fees above performance. Three-quarters of institutions around the globe say they are willing to pay higher fees for potential outperformance. This may serve as an

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important example for those investors who focus only on low cost in their investment selection.

Institutions believe investors have other misconceptions about passive as well. Seven in ten say individual investors are unaware of the risks associated with passive investments. Three-quarters also say individuals have a false sense of security about passive investments.

Capitalizing on potential increased volatility with increased investment in active strategies is not the only allocation strategy in the institutional playbook. Many are turning to alternative investments as they look to diversify, manage mounting risks, and pursue returns. Faced with a low yield environment, many are also tapping alternatives as a replacement for traditional fixed income strategies.

Institutions continue to temper additional allocations to passive investments



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Top portfolio applications for alternative investments

Type	Diversification/ Lower correlation	Alpha generation	Risk/Volatility mitigation	Inflation hedge	Stable income	Other
Managed futures	37.4%	31.2%	46.4%	12.0%	4.8%	1.4%
Global macro	47.2%	42.2%	30.6%	10.4%	9.6%	1.6%
Hedged equity	28.2%	44.8%	45.4%	10.8%	10.6%	2.0%
Commodities	40.6%	16.2%	15.0%	55.6%	5.4%	1.8%
Private equity	32.6%	71.8%	13.6%	10.4%	9.6%	1.6%
Private debt	34.2%	36.2%	17.4%	12.8%	47.0%	1.0%
Infrastructure	40.2%	16.4%	22.2%	40.2%	54.6%	0.4%

Going off the traditional menu

Historically low interest rates have produced higher investment returns, but given a lack of dispersion and differentiation of security performance 60% of institutions believe traditional assets today are too highly correlated to provide distinctive sources of return. It's no wonder that nearly seven in ten say it is essential to invest in alternative investments in order to diversify portfolio risk. Nearly six in ten say investment in alternatives is necessary to outperform the broad market.

Institutions apply alternative investments to a wide range of portfolio objectives:

- **Diversification:** Institutional investors most commonly cite global macro strategies (47%), commodities (41%), and infrastructure (40%) investments as best for diversification; they also see private debt (34%) and private equity (33%) as useful in meeting this objective.
- **Fixed income replacement:** Top choices for providing a source of stable income that's critical to so many institutions include infrastructure (55%), real estate/REITs (54%) and private debt (47%) as their top choices.
- **Volatility management:** Projections for increased volatility in 2018 suggest the potential for increased allocations to managed futures and hedged equity, which they list as their top choices for risk and volatility mitigation. Respondents cite these as best suited to volatility management (46% and 45% respectively).
- **Alpha generation:** Traditional markets have generated attractive returns, but institutions see opportunity to outperform. Private equity is cited by 72% of respondents as their top choice among alternatives for generating alpha.⁵

More than one use for alternatives

Perhaps the most important takeaway from institutional views on alternatives is the portfolio utility that these investments can provide. Significant numbers of institutional investors see multiple applications for each alternative strategy, such as the 42% who say global macro and the 45% who say hedged equity are also effective choices for alpha generation.

While alternative investments can present a range of portfolio

risks, almost three-quarters of institutional investors say the potential returns of illiquid investments are worth the risk. But making the investment in these assets is not a simple proposition and decisions may not always be made for the best investment purpose.

Two-thirds among those surveyed report solvency and liquidity requirements have created a strong bias for shorter time horizons and highly liquid assets. If their ability to apply alternative allocations is limited by non-investment reasons, they must then add more strategies to their risk management toolbox. Stepped-up efforts for liability management and increased deployment of ESG strategies are two measures that are playing an increasingly important role in institutional strategy.

Renewed focus on risk management

Risks are wide and varied for institutional investors. Interest rates, volatility and geopolitics may be the most visible, but institutions are also looking more closely at their liabilities and exposure to ESG factors in order to help enhance risk controls.

As if to underscore the broad range of risks presented in today's uncertain markets, more than six in ten institutions say it's a challenge for their organization to gain a consolidated view of risks across their portfolio.

Despite finding that traditional asset classes are highly correlated in today's low yield environment, 84% of institutional investors still believe that diversification is an effective strategy for managing portfolio risks. In seeking to better control portfolio risk, eight in ten also find that risk budgeting is an effective tool. The budgeting process allows investment teams to examine the risk and return contributions of individual investments and optimize risk/return trade-offs by reallocating holdings.

Lower rates mean higher liabilities

Chief among the long-term risk concerns for institutional investors is longevity. Despite having access to sophisticated risk management tools and methodologies, a majority of institutions are challenged to manage longevity risk, including 78% of corporate pension plans, 76% of public pension plans

⁵ Alpha is a measure of the difference between a portfolio's actual returns and its expected performance, given its level of systematic market risk. A positive alpha indicates outperformance and negative alpha indicates underperformance relative to the portfolio's level of systematic risk.

and 85% of insurance firms. The ever-present pressure to manage liabilities has been exacerbated by the prolonged low rate environment.

Low rates may have helped boost returns by increasing the value of bond assets held in institutional portfolios, but at the same time low rates have also increased the future value of liabilities. In essence, this is the root of a funding crisis that has loomed over institutions during the past decade.

Prospects for an interest rate increase represent a bright spot on the horizon for many institutions. Even though a rate hike would reduce the present value of bond holdings, it would also decrease the present value of an institution's liabilities. The key challenge is to then strike an optimal balance of duration within fixed income portfolios. This is one of the reasons institutions cite managing duration as their top strategy for navigating a rising rate environment.

Getting the balance right is a critical component of institutional portfolio strategy with seven out of ten respondents reporting that their organization incorporates some form of asset liability management. But given the complex range of factors at play in determining and managing liabilities, it's no wonder that almost six in ten of those surveyed say asset liability matching is challenging for their organization. Adding to the challenge may be a lack of tools for managing liabilities. Six in ten say there is a lack of innovation within LDI solutions. To meet the need many are looking to private debt for an effective LDI solution.

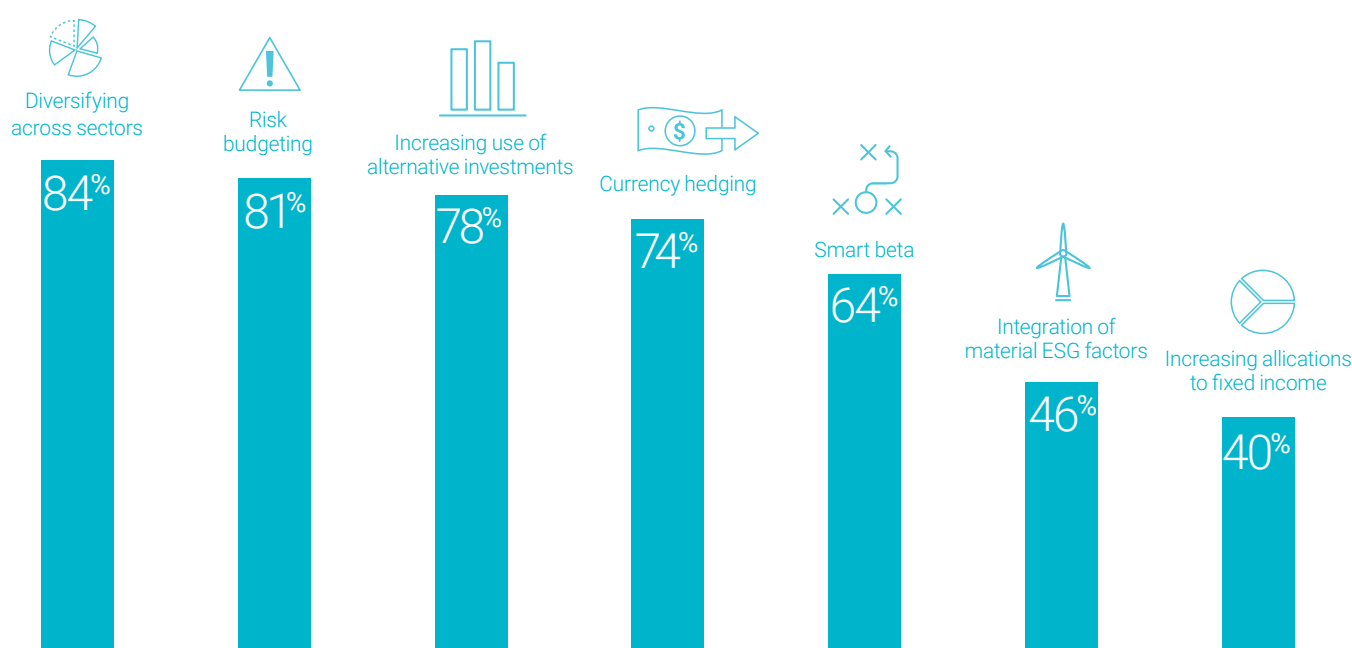
Despite the intense focus on implementing LDI strategies, not all are confident of the abilities of institutional investors to deliver. As a result, 60% believe that despite adopting LDI techniques, most organizations will fail to meet their long-term liabilities. For many (63%) the challenge is made all the more complicated by decision makers placing greater importance on achieving short-term performance results over meeting long-term liability matching objectives.

ESG exposures come into focus

Not all risks are presented by the vagaries of macroeconomics and investment market dynamics. Beyond the familiar challenges of interest rate hikes, currency fluctuations, and market valuations lie the potential business risks that companies can face when posed environmental, social, and governance crises that can all too often impact stock prices.

Institutional investors have borne witness to the impact of these events at numerous companies in recent years and watched as stock values declined right along with corporate reputations. More and more institutions are integrating non-financial factors such as social, environmental and governance issues into standard investment analysis and manager selection processes. But not only do institutions today find that this approach can help them steer clear of potential problems, it can also help them navigate a path to potential profits.

Effective strategies for managing risk



ESG becoming an important tool for institutions as they look to manage risk and enhance returns



ESG analysis is providing a greater role in institutional strategy. Among those surveyed, 44% say they consider ESG factors to be as important to their investment analysis as financial factors. About the same number (43%) say these factors are an important part of their manager selection process.

This is a significant change from motivations cited in past institutional surveys. A year ago, respondents to the 2016 Natixis Global Survey of Institutional Investors⁶ cited their reason for deploying ESG strategies was the mandate prescribed within their organizations' investment policy statement. A year later in our 2017 Natixis survey, institutions now say their rationale for implementing ESG strategies are:

1. Proactively aligning investment strategy with organizational values (47%)
2. Minimizing headline risk (41%) (a 21% increase over 2016)
3. Mandated by investment policy (32%)

More than a risk management protocol

The approach is quickly becoming an important tool for investment managers looking to manage risk and most importantly, enhance return potential. While 56% agree ESG mitigates risks (such as loss of assets due to lawsuits, social discord or environmental harm), a larger number (59%) believe there is alpha to be found in ESG. Their convictions about the efficacy of this approach are strong, and 61% of institutional investors believe incorporating ESG into investment strategy will become a standard practice within the next five years.

This greater acceptance may not be limited to investment analysis, and could become a more significant part of how institutions act as large shareholders in large organizations. One test of commitment to ESG principles is how these decision makers vote when presented with ESG-related proxy issues. When asked if they expect their firm will vote in favor of these issues in 2018, 43% say it will happen more often and 41% say levels will stay the same. Only 2% see their firm dialing back in their support of ESG and remarkably, only 14% say this is not applicable to their firm.

Acceptance of ESG is growing, but ESG may still need clearer definition. Institutions are split on ESG and how to best approach it. Some (36%) limit it to the use of negative and exclusionary screening that was the hallmark of socially responsible investing strategies. Some (21%) see it in positive terms through impact investing. Only a small number (15%) see the full potential of ESG today and consider it thematic investing around global themes such as climate change and technology innovation. The right answer to this question may be "all of the above."

Business challenges

In today's highly regulated environment, managing the money is only one part of the equation in the implementation of institutional strategy. Decision makers must also be cognizant of the impact that tighter regulatory controls will have on their activities and be ready to pursue specialized investment talent when needed to help deliver on investment expectations.

A clearing regulatory picture

On January 2, 2018, the second phase of the European Union's Markets in Financial Instrument Directive or MiFID II went into effect, marking the latest phase of tightening regulatory controls on markets and investors. While focused on ensuring greater structure in markets and increased transparency, particularly among banks and brokerages, the new regulations are emblematic of the regulatory pressure that all parts of the financial services sector have felt in the decade following the Global Financial Crisis.

As the crisis recedes further into the rearview mirror, the unknowns are becoming the knowns and institutional decision makers are feeling more comfortable that their organizations can adapt. Complying with new regulations remains to be a top challenge, but a smaller number of institutions are feeling the pressure. Eight in ten respondents in the 2015 Natixis Institutional Survey⁷ found regulations challenging; in 2017, that number had dropped to 68%. A 12% decline over two years may suggest that greater clarity on regulation translates into greater confidence, but it should be noted that two-thirds of respondents find it to be a challenge.

Institutions say complying with new regulations is challenging, but pressure is decreasing



⁶ Natixis Investment Managers, Global Survey of Institutional Investors conducted by CoreData Research in October and November 2016. Survey included 500 institutional investors in 31 countries.

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In some cases, particularly in the US, regulatory uncertainty may be replaced by political uncertainty as the Trump administration's pro-business stance may change the rules of the game yet again. Institutions may be watching the retail world's reaction to delayed implementation of the US Department of Labor's Fiduciary Standard. Where the industry had been prepared to implement new standards a year ago, players must now take a wait and see attitude to determine how the regulations will be implemented – if at all.

Navigating a new regulatory environment may complicate the business of managing institutional portfolios, but traversing a growing array of assets and investment vehicles magnifies the complexity of their job. To help simplify the problem many institutions are outsourcing.

In 2017, 44% of institutions report outsourcing at least some portion of their investment management function. The decision to outsource is increasingly aimed at gaining access to specialist capabilities. About half of institutions (49%) cite this as their motive, where about one-third said they were looking for this outside talent in 2016. Another 22% say they outsource in order to achieve better risk-adjusted returns, a statement which may underscore what's at stake when turning to outside managers.

The decision to outsource or not is not an all-or-nothing proposition. Those who outsource are handing off 41% of assets to outside managers, leaving the majority of assets to be run by in-house teams. Only 3% of those surveyed say they outsource 100% of assets.

Ready for the when

Institutional investors continue to perform a masterful feat of portfolio management. Even as they anticipate the potential for rising rates and rising volatility, they are making the most of what they can earn in today's market, while planning wisely for a significant market shift. Clearly it's a case of determining when markets may turn, not if.

PROGRAM OVERVIEW

About the Natixis Center for Investor Insight

Investing can be complicated: Event risk is greater and more frequent. Volatility is persistent despite market gains. And investment products are more complex. These factors and others weigh on the psyche of investors and shape their attitudes and perceptions, which ultimately influence their investment decisions. The Center for Investor Insight conducts research with investors around the globe to gain an understanding of their feelings about risk, their attitudes toward the markets and their perceptions of investing.

Research agenda

Our annual research program offers insights into the perceptions and motivations of individuals, institutions and financial professionals around the globe and looks at financial, economic and public policy factors that shape retirement globally with:

- Global Survey of Individual Investors – reaches out to 8,300 investors in 26 countries.
- Global Survey of Financial Professionals – reaches out to 2,550 professionals in 15 countries.
- Global Survey of Institutional Investors – reaches out to 500 institutional investors in 30 countries.
- Natixis Global Retirement Index – provides insight into the environment for retirees globally based on 18 economic, regulatory and health factors.

The end result is a comprehensive look into the minds of investors – and the challenges they face as they pursue long-term investment goals.

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Diversification does not guarantee a profit or protect against a loss.

The S&P 500® Index is a widely recognized measure of U.S. stock market performance. It is an unmanaged index of 500 common stocks chosen for market size, liquidity, and industry group representation, among other factors. It also measures the performance of the large-cap segment of the U.S. equities market.

Real estate investing may be subject to risks including but not limited to declines in the value of real estate, risks related to general economic conditions, changes in the value of the underlying property owned by the trust and defaults by borrowers.

Commodity-related investments, including derivatives, may be affected by a number of factors including commodity prices, world events, import controls, and economic conditions and therefore may involve substantial risk of loss.

Volatility management techniques may result in periods of loss and underperformance, may limit the Fund's ability to participate in rising markets and may increase transaction costs.

Duration risk measures a bond's price sensitivity to interest rate changes. Bond funds and individual bonds with a longer duration (a measure of the expected life of a security) tend to be more sensitive to changes in interest rates, usually making them more volatile than securities with shorter durations.

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