

Buckle up, it's going to be a bumpy ride

Institutional investors anticipate a year of dramatic change in 2017: A global wave of populism is upending conventional thinking about politics and economics. Central bank policies, which have driven investment performance for nearly a decade, are beginning to diverge. The U.S. Federal Reserve is likely to raise rates, while other central banks are challenged to scale their asset purchase programs.

Market volatility is the likely outcome as political, economic and monetary forces converge, according to the 500 decision makers included in our 2016 Global Survey of Institutional Investors.* Recognizing the role geopolitical events could play in the year ahead, we split our pool of respondents to reach 340 respondents prior to the U.S. presidential election and 160 after. In many cases, the results have had a significant effect on their outlook.

Active management and alternatives key to investment strategy

In anticipation of higher volatility and greater dispersion,¹ institutional investors have strong investment opinions. Decision makers say they will apply a one-two punch to portfolio construction by implementing actively managed strategies in pursuit of returns and alternative investments² in search of diversification.³

Looking ahead to the new year, institutions have clear preferences for both active management and alternatives:

- Almost three-quarters of institutional investors say the current market environment is more favorable to active management.
- Investment plans call for increased allocations to alternatives with decreased exposures to fixed-income.

Posing pointed questions to institutions about their opinions on risk, predictions on asset allocation, and views on market performance, our survey finds that institutions are ready to hit the reset button in order to address a more volatile market and uncertain landscape globally.

Economics and politics add up to volatility

After seven years marked by only sporadic bouts of volatility, economic and geopolitical forces are converging to make volatility the top risk concern for institutions in 2017.

On the economic front, central bank monetary policies have kept volatility artificially low for close to a decade, but it is now poised for a change, at least in the U.S., as the Federal Reserve looks to increase interest rates. Simply put: Volatility may actually be the byproduct of the market perception that central banks are no longer delivering the so-called Yellen/Bernanke “put option” on assets, in which accommodative monetary policy has resulted in the perception of downside protection for risk assets.

On the geopolitical side, the Brexit, a Trump presidency, and Italy's no vote on constitutional reforms are emblematic of the forces of change that could contribute to heightened volatility. But these events do not mark the end of geopolitical volatility; they are more likely just the start. Still to come are elections in France, Germany, and the Netherlands, where populist sentiments are running high,

* Survey sample included 500 institutional decision makers representing corporate pension plans, public pension plans, sovereign wealth funds, insurance companies, foundations and endowments. Geographic representation included respondents from Asia (62), Europe (208), Latin America (34), Middle East (35), United Kingdom (69), and North America (92).

¹ Dispersion refers to the variability of returns among individual indexes and stocks within each index.

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

and the outcomes of political upheaval in South Korea and Brazil, as well as Britain's plan for invoking Article 50; all add to uncertainty across the globe. While they see volatility as their top risk concern, institutional decision makers also see it as an opportunity for asset growth. With the likelihood of a policy-driven market shifting to one driven by earnings growth, institutional professionals are once again returning to active management in pursuit of returns.

Risk and Volatility Concerns

Top Risk Concerns for 2017	
Market volatility	50%
Geopolitical risk	43%
Interest rates	38%

Top Sources of Volatility for 2017	
Geopolitical events	65%
U.S. election	38%
Interest rates	37%

The shift is reflected in changes to what institutions see as their primary investment objectives for the year. As expected, the number one objective among institutions is achieving the highest risk-adjusted returns, but post-election the number who listed growth of capital as their primary objective increased by 9%, moving from 15% to 24%. At the same time the number citing capital preservation as their primary objective declined from 16% to just 8%.

A market for active management

Higher volatility is likely to lead to greater dispersion within equity markets, and institutions believe the tide is turning in favor of active management. Looking back at past performance, half say passive investments distort relative stock prices and risk-return tradeoffs. Almost three-quarters also say current market conditions are more favorable to active management. More than eight in ten institutions choose active management over passive for generating alpha, and three-quarters say they are willing to pay a higher fee for potential outperformance. Of course, all investing, whether actively or passively managed, is subject to risk, including risk of loss.

Long-term views on passive beginning to change

Over the longer term, institutions project they will be less reliant on passive investments than they previously believed.

Current portfolio projections show passive allocations have decreased by 3.3% in the past year. Institutions anticipate adding just 1% to current passive allocations over the next three years, a figure that's considerably less than the 7% they projected for the same time frame in 2015. This underscores the need to evaluate passive investments on both their merits and their limitations.

Institutions say they implement passive investments for two clear reasons: to manage fees and to avoid closet indexers among active managers. While both issues are important considerations, closet indexers have become a pervasive problem. Managers who charge an active fee for an investment strategy that mimics their benchmark challenge institutions' ability to maximize returns. Even though they say they are willing to pay a higher fee for potential outperformance, the institutional motto for 2017 is likely to be "get what you pay for."

Projections for Passive Decreasing

2016 Portfolio Projections		
	Active	Passive
2016	67.2%	32.8%
2019	65.9%	34.1%

2015 Portfolio Projections		
	Active	Passive
2015	64%	36%
2018	57%	43%

A word of caution for individual investors

While institutional investors have specific objectives for passive investments, they see potential problems for individual investors who have come to rely heavily on indexing.

- 75% say individuals are unaware of the risks of indexing.
- 75% say individuals have a false sense of security about indexing.

In essence, it's important to avoid transferring greater benefits from the index feature of market exposure at a lower cost. Index funds still leave investors exposed to market risks.

2017 Allocation Calls (%)

	2016	2017
Equities	33.8	35.5
Fixed-income	35.0	31.5
Alternatives	18.0	22.0
Real estate	7.4	6.2
Cash	5.1	4.5
Other	0.6	0.2

Alternatives for diversification

While they see an opportunity to pursue alpha, or returns above the benchmark, with actively managed strategies, institutions are also taking action to diversify portfolios with increased alternative allocations. Looking at a market that could be marked with a double-hit of increased volatility and rising interest rates (at least in the U.S.), institutions say they will dial back on fixed-income allocations, and two-thirds of institutional investors globally say it is essential to invest in alternatives in order to diversify portfolio risk.⁴

Increased allocations to alternatives

One reason for the shift in allocations is the current low-yield environment, which ranks as the top risk management concern for institutions. To better position portfolios, they are looking to increase diversification by implementing a range of strategies. Increasing alternative allocations (50%) is the most frequently cited approach, followed by diversifying by sector and geography (38%) and integrating absolute return strategies (36%).

Three-quarters of institutions believe investors may be taking on too much risk in the pursuit of yield. Based on their own allocation decisions, some may think they are guilty of the same behavior.

Confidence shaken by election surprise

U.S. election results have struck a blow to institutional confidence. Prior to the election, two-thirds of respondents expressed confidence in their organization's ability to handle the risks associated with investment performance. Among those surveyed after the election, only 53% had confidence in their abilities, a clear sign that the potential for policy changes and market volatility add a new twist to institutional plans.

As a result, some are resetting expectations for this volatile and uncertain time. Even though 70% of those surveyed say they are confident that their institution's current return expectations are achievable, half anticipate that their organization will decrease return assumptions in the next 12 months.

Winners, losers and also-rans

In light of their assumptions about markets in 2017, many institutional investors have clear convictions about where they believe the winners and losers will be. The results of the U.S. election and record run-ups in the U.S. markets continue to drive institutional outlook. Assessing their views on equities, fixed-income, and alternative investments, institutional assumptions show how they see the convergence of market volatility and potential rate increases playing out.

Equities

Prior to the U.S. presidential election, institutions had a clear view of emerging market equities delivering the biggest gains (43%), while anticipating U.S. stocks would underperform (46%). Conviction among those surveyed after the election softened, with just 31% calling for emerging markets to top equity markets and 31% calling for U.S. markets to falter.

Fixed-income

Low yields weigh heavily in institutional views on bond performance, with two-thirds projecting medium to long-term government bonds will disappoint in the year ahead. They also believe taking on greater risk in pursuit of yield will pay off with a call for riskier high-yield bonds to be the biggest gainers in the fixed-income realm. In the wake of an election that brought the self-proclaimed "King of Debt" to office, those favoring high-yield bonds as 2017's top performer increased by 8% from 51% to 59%.

Alternative investments

While they may be focused on delivering the highest risk-adjusted returns, they may be willing to take on more risk to generate results. Picking private equity as the top performer in the alternative space may be as much a condemnation of an overvalued public market as an endorsement of private opportunities. Conviction for private equity softened considerably, dropping from 35% to 25% in the two weeks following the election.

The most likely concern is the potential disincentive posed by dropping carried interest, which provides favorable tax treatment for the share of profits received by the general partners of a private equity or hedge fund, coupled with concerns over rising rates. This sentiment may likely change again as private equity experts have been named to Trump's cabinet and transition team.

The impact of rising rates on the prospects for real estate investments looms on the minds of institutions. Since it was split off from financials as its own S&P sector on September 19, real estate has been the worst-performing

⁴ Diversification does not guarantee a profit or protect against a loss.

sector (period represented is from 9/19/16 through 11/30/16). Institutions are not projecting better prospects for the sector, predicting it will be the biggest disappointment among alternative investments. While sentiment on real estate is consistent pre- and post-election, institutions held a more positive view on managed futures⁵ after November 8, a likely sign the professionals anticipate broader, long-term trends emerging from market dispersion.

Sector calls

In looking at sector performance, institutional investors are split on just what will result in a big gain or a big loss in 2017. Financials sit atop the projections for the biggest gainers but also rank second, behind utilities, as the biggest disappointment in the year ahead. The divergence of opinion indicates a clear philosophical split. Some have seen increased regulation and low profits as a signal that banks are poised to underperform. As a result, the price of many financial stocks has dropped. There is a second school of thought among institutions that low prices position financials to outperform. Negative perception for financials was cut in half post-election, a sign that promises of reduced regulation and rising interest rates and a steepening yield curve could drive earnings growth across the sector.

2016 projections: close but no cigar

Our 2016 outlook report noted that it appeared that institutional investors were “all in on equities” given that their predictions for the top three performers were global equities, U.S. equities, and emerging market equities. It turns out that U.S. equities may have been the biggest surprise to last year’s respondents as the asset class outperformed global equities by 3.58% as of November 30, 2016. Making the surprise even greater was the record run of market losses for the U.S. market to start 2016.

Even with strong results in U.S. equities, institutions would have done better had they upped allocations to what they predicted would be the worst-performing asset class: commodities.⁶ The Bloomberg Commodities Index registered a 13% gain through the end of November. Emerging market debt, their number two pick for the biggest disappointment, delivered a respectable 4.46% return for the same time period. Only 8% of respondents accurately projected that global real estate would be the biggest disappointment as the MSCI ACWI/Equity REITs Index racked up the worst rate of return (-0.33%) among their asset class choices.

How 2016 Projections Fared (as of 11/30/2016)

Projected gainers for 2016

Global Equities	5.87%
MSCI ACWI NR – LCL	
U.S. Equities	9.45%
S&P 500 Total Return	
Emerging Market Equities	8.49%
MSCI EM NR – LCL	

Projected disappointments for 2016

Commodities	13%
Bloomberg Commodities Index	
Emerging Market Fixed-Income	4.45%
Barclays EM Local Currency Government Index	
Global Fixed-Income	2.72%
Barclays Global Aggregate Bond Index (USD)	

Past performance is no guarantee of, and not indicative of, future results.

Depending on which currency you invested in, global bonds produced widely different results. While U.S. dollar returns were 2.72%, those invested in British sterling benefited from the Brexit and a weakening pound, garnering returns of 19.60%. On the other hand, a slightly stronger yen delivered a loss of -2.82% for yen-based investors. Results like this give one more reason why institutions are wary of the impact that geopolitical events may have on markets in the year ahead.

Strapping in

On the heels of a tumultuous political year, institutional investors believe that geopolitical volatility will translate into market volatility for investors in 2017. As a result, we see that institutions are taking steps not only to cushion the blow, but also to potentially prosper in the new year.

Navigating the volatility will mean resetting investment priorities and revisiting investment strategy. Institutional investors will look to active management to capitalize on newly found dispersion in pursuit of returns, and turn to alternative investments to diversify portfolios and manage risk in advance of interest rate movement. All in pursuit of the key objective of generating high risk-adjusted returns.

⁵ Managed futures specialists follow systematic investment approaches based on trend-following strategies. They focus on identifying price momentum across a broad range of markets, including equities, fixed-income, currencies and commodities. Portfolio decisions are generally implemented using futures and forward contracts. Also, managed futures strategies have the flexibility to buy long or sell short across these global markets. This may create the potential to profit whether the assets in which they invest are rising or falling. However, it is important to understand that because of this tendency to follow a divergent path, managed futures have failed to keep up with stocks in some rising markets.

⁶ Commodity trading involves substantial risk of loss.

PROGRAM OVERVIEW

About the Durable Portfolio Construction® Research Center

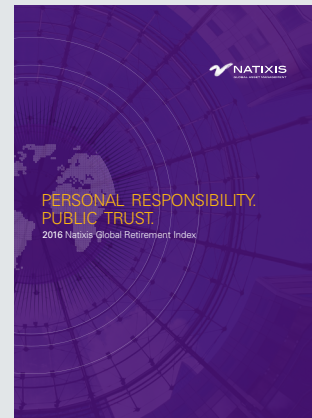
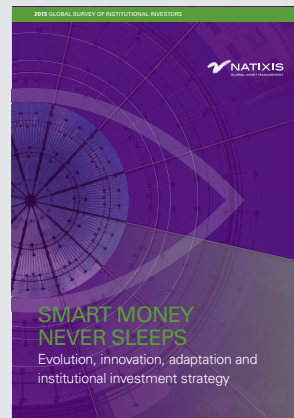
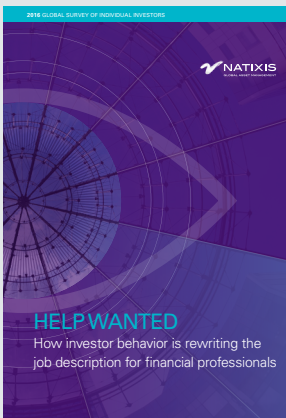
Investing can be complicated: Event risk is greater and more frequent. Volatility is persistent despite market gains. And investment products are more complex. These factors and others weigh on the psyche of investors and shape their attitudes and perceptions, which ultimately influence their investment decisions. Through the Durable Portfolio Construction Research Center, Natixis Global Asset Management 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 advisors 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 7,100 investors in 22 countries.
- **Global Survey of Financial Advisors** – reaches out to 2,550 advisors in 15 countries.
- **Global Survey of Institutional Investors** – reaches out to over 600 institutional investors in 29 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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