

CHANGE FOR A DOLLAR

ANSWERS TO QUESTIONS NONPROFITS SHOULD CONSIDER IN THE FACE OF A STRENGTHENING DOLLAR

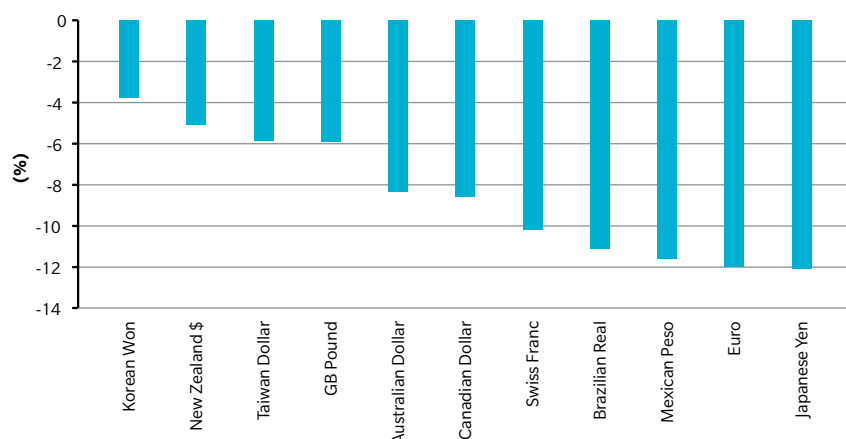
For most of the last 30 years, the US dollar has fallen in value against a broad basket of foreign currencies due to higher inflation and a persistent current account deficit. Since mid-2011, the dollar has appreciated against foreign currencies, a trend that accelerated in the second half of 2014. A strong dollar has broad economic and investment implications; a rising US dollar reduces the returns received by US investors for investments made in foreign currencies. Given the global nature of trade, a rising US dollar also reduces expectations around inflation as the prices for imported goods and services decline. As commodities like oil are traded primarily in US dollars, a strong dollar may also contribute marginally to the falling price of crude. Each of these factors leads to questions about how to position portfolios in this changing currency environment, and we address some of these questions in the following discussion.

Q: What has caused the US dollar to appreciate or strengthen versus foreign currencies?

A: The US economy has recovered more significantly than foreign economies since the Global Financial Crisis, driven in part by accommodative policies enacted by the US Federal Reserve System. (See Chart 1.) Now that the economy is on stronger footing, US policy is likely to grow tighter, raising the prospect of higher interest rates. US interest rates are already higher than in many developed countries, making the US a relatively more

Chart 1

2014 Performance of Foreign Currencies Versus the Dollar



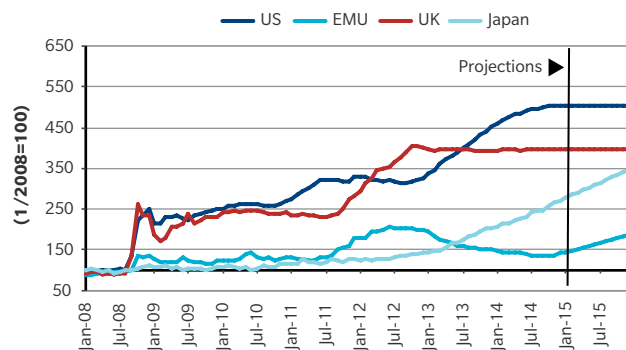
Source: Datastream, December 31, 2014.

attractive place to invest. Additionally, the eurozone and Japan are now embarking on US-style quantitative easing (QE) measures, which are designed to increase liquidity (that is, supply of currency) and drive down interest rates, thus making the euro and yen relatively less attractive. The increase in the supply of these currencies, coupled with reduced demand, causes their value to fall.

Q: How does Mercer see the future of the euro, the yen, and other currencies against the US dollar?

A: Mercer believes the US dollar will continue to strengthen against most major currencies through 2015 and beyond. Relatively faster US growth and the potential for interest rate hikes by the US Federal Reserve System, coupled with QE programs in Europe and Japan that are longer-term in scope, suggest ongoing pressure on those currencies for an extended period. (See Chart 2.) Potential headwinds to the US dollar include expectations of higher inflation, a still-sizeable current account deficit, and a policy response, should the stronger dollar significantly impact US recovery.

Chart 2
Central Bank Balance Sheet Growth



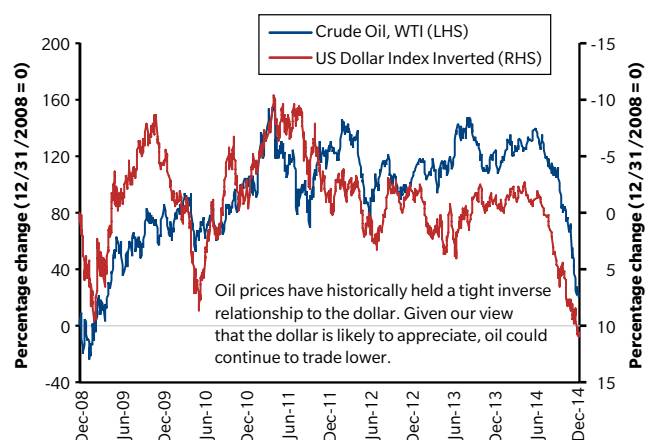
Source: Bloomberg, December 31, 2014.

Q: How does US dollar strength impact Mercer's view on non-US equity investments?

A: When considering valuations and near-term positive momentum, we continue to like non-US stocks as a meaningful allocation within client portfolios. The weaker currencies allow goods and services from businesses based in these countries to be priced more

competitively. (See Chart 3.) This strategy should lead to increasing corporate profits and coincident stock price increases. Non-US stocks have not performed as well as those in the US more recently, so we expect a marginal increase in corporate earnings will translate into better non-US stock returns.

Chart 3
Oil and US Dollar Since 2008



Source: Bloomberg, December 31, 2014.

The challenge to achieving those expected better returns is the currency translation. All else equal, a strengthening dollar reduces the returns for US investors, as it did significantly in 2014. Hedging some of the currency exposure in our non-US equity allocation can help reduce this potential impact. Because currency is a key component to long-term diversification — and because we don't have a crystal ball — we recommend hedging only a portion of the position, just in case things work out differently than expected.

Q: What other areas in our portfolio might be impacted by a strengthening US dollar?

A: When we invest unhedged in non-US securities, we are implicitly "short" the US dollar under the notion that we expect some risk of US dollar weakness versus other currencies. Portfolios can be short the dollar through other investments as well, such as natural resource stocks. All things equal, changes in the value of the dollar will negatively impact the price of global

commodities like oil that trade primarily in US dollars. Over the long term, we think the US dollar will remain in secular decline as demonstrated in Chart 4. However, shorter term, we expect continued dollar strength. Along with other factors, this could weigh on the short-term performance of natural resource investments, although we believe these instruments also offer diversification against unexpected inflation and geopolitical risk.

Chart 4
Trade-weighted Dollar Index: Major Currencies

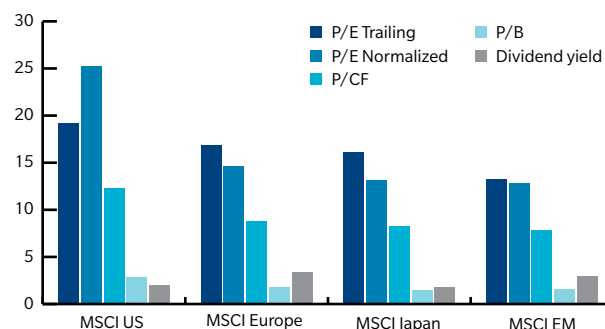


Source: Bloomberg, December 31, 2014.

Q: With the dollar strengthening, is there really value in diversifying outside the US?

A: We continue to believe in global diversification, and believe it is difficult — if not impossible — for most investors to consistently make large-market calls of the type that would suggest moving completely out of international in favor of US investments. Additionally, we believe stock prices outside the US already reflect much of the “bad news” associated with places like Europe and Japan and appear to be trading at attractive valuations. (See Chart 5.) Although the economic story may be challenging, investor returns that are differentiated from the crowd are characterized by engaging those investments before they become favorites of the market. So despite our belief that there are some headwinds for US investors investing overseas, we believe the opportunities still represent good long-term return potential and diversification benefits relative to a US-only portfolio.

Chart 5
Global Valuations

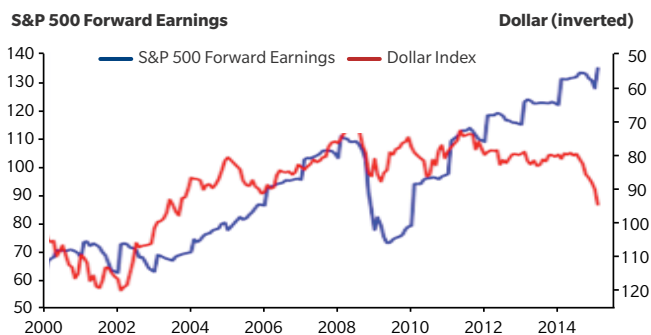


Sources: MSCI, Bloomberg, Datastream, Mercer, December 31, 2014.

Q: Given that many large companies in the US are multinational, when it comes to the sale of their goods and services, isn't the impact of a stronger dollar a headwind for their continued success, as well as the export segment of the US economy in general? If so, does this affect asset allocation recommendations?

A: Yes, a strong dollar is likely to be a headwind for US-based multinationals that generate a portion of their sales and earnings outside the US, although many multinationals may hedge some or all of their currency exposure to reduce the impact of a stronger dollar. US exports of goods and services account for about 14% of GDP, whereas the companies included in the S&P 500 receive around 40% of their sales from overseas operations. (See Chart 6.)

Chart 6
S&P 500 Forward Earnings vs. Dollar Index



Sources: Bloomberg, S&P, December 31, 2014.

In general, a strong dollar has been coupled with weaker earnings in the past. However, since the dollar reversed its downward trend in 2011, the historical relationship between currency appreciation and earnings estimates has decoupled, indicating that stronger domestic growth and subdued inflation have largely offset concerns of market participants over the negative effects on the export industry. Going forward, however, we believe the drag from the dollar will make it more difficult to grow earnings. Not only will US companies face a direct hit from currency conversion, they must also compete with foreign companies that will have lower cost structures due to weaker currencies.

Given the overall macro environment and valuations, Mercer believes US large-cap stock positions (which would include multinationals) should be near or below the global market capitalization weight. Quality stocks, of which many are multinationals, have modestly better valuations and appealing defensive characteristics that continue to support modest overweight positions.

Q: Since small-cap stocks tend to be domestic-only in nature, are they in a relatively stronger position than large companies? If so, does this affect asset allocation recommendations?

A: Small caps have smaller direct sales exposure to foreign markets and so should feel less of an impact from changes in currency values — an advantage in a stronger dollar environment. Faster domestic growth would also seem to favor small caps on a relative basis. However, small caps still appear fairly expensive relative to large caps. Additionally, small caps could be more vulnerable to tighter credit conditions and higher interest rates, or might struggle due to the volatility associated with rate hikes. As such, we would continue to recommend an underweight to small caps. As we look forward, if small caps continue to underperform and become more attractively valued, we would tilt the portfolio in that direction once again.

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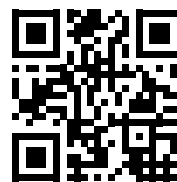
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