

## INTRODUCING BOND RISK PREMIUMS

### THE IMPORTANCE OF BONDS

*The primary advantage a bond has over a stock is one of consistency in that the bond carries a lower level of expected risk.*

Bond investments are considered less risky because historically they have exhibited less volatility than stock investments. Essentially, a bond is a binding contract between a company or government agency and a bondholder where the bondholder becomes a creditor. The creditor is owed a regular fixed interest rate payment in addition to repayment of the principal on a pre-determined future date. In contrast, a stock represents part ownership in a company. Stock investments typically appreciate only if the company's earnings increase and offer no promise of steady payment — in fact, a company may elect not to pay any dividends to its shareholders.

When it comes to the construction of a well-diversified portfolio, bond investments are an integral component of all but the most aggressive portfolios. As an asset class, its primary responsibilities within a diversified portfolio are two-fold — namely the preservation of capital and the production of steady, consistent income. Toward those ends, academically validated research and time-tested financial modeling have continually shown that short-term and high quality bonds are best able to fulfill these objectives.

Additionally, bond investments provide any portfolio with the benefits of diversification and stabilization. Because these low-risk assets provide a solid foundation of consistency, you are able to implement a more aggressive approach to other asset class holdings elsewhere in your portfolio that are better apt to produce a maximized incremental return.

Bond investments also facilitate the portfolio rebalancing process. When a methodical and objective rebalancing rigor is applied and followed, the investor will sell stock holdings once they reach a high relative value in order to purchase bonds with the proceeds. Conversely, in keeping with an established investment strategy, the investor will also sell bonds to purchase stocks with low relative value in order to maintain the portfolio's optimized allocation weighting for its defined risk profile.

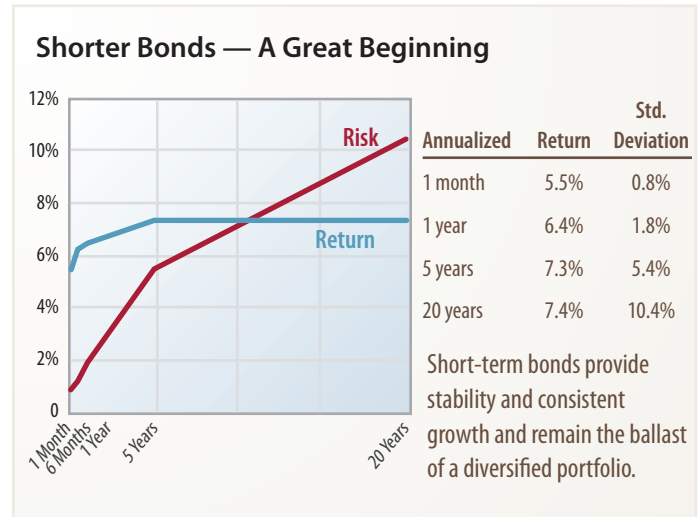


FIGURE 1 Historical Bond Yield Curve.

Source: B of A Merrill Lynch 1964-2010, Fama-French 1964-2010.

Naturally, longer-term bonds will produce a higher rate of return, as illustrated in FIGURE 1. However, it is very important to note that between the 5-year and 20-year bond, the return rate increases by a mere 0.1%, whereas the additional risk associated with the additional 15 years is essentially doubled. In this scenario, the potential for incremental return is nowhere near commensurate with the additional risk assumed.

### THE LATEST RESEARCH

The primary mandate of the Mercer Advisors Investment Committee is to continuously research, analyze and develop strategies to capture superior risk-adjusted returns for our clients. Current bond interest rates, both real and nominal, are at an unprecedented and historical low. Over the course of 2011 and within the context of uncertainty surrounding the sustainability of global economic recovery from the financial crisis of 2008–2009, the potential for a Greek sovereign debt default and the downgrade of U.S. government debt, the committee has identified two unique ways to capture additional return within the bond component of your portfolio. Now, in addition to the foundational stability and consistency provided by short-term, high quality bonds, essential to all but the most aggressive of portfolios, we are introducing a new strategy designed to generate additional potential bond returns for clients willing to take on additional risk.

## THE EVOLUTION OF BOND RISK PREMIUMS

Remember that risk and return are related — they are fundamentally linked. Beyond intuition, this is an academically validated and scientifically supported fact. In order to gain access to greater opportunity (return), one must be willing to assume some additional risk in order to reap the greater reward. In both stock and bond markets, investors are paid over time for the additional risk they are willing to take. This incremental return is known as a **risk premium**. By strategically tilting a portfolio toward select risk premium asset classes, returns can be optimized for any defined risk tolerance level.

YOU **MEASURE OPPORTUNITY**  
WITH THE SAME **YARDSTICK**  
THAT **MEASURES RISK**.  
THEY GO TOGETHER.

—Earl Nightingale

From our research, we have identified two appropriate and time-tested bond

investments that can provide potential risk premium benefits to our clients.

One bond investment remains short-term but includes lower quality investment-grade bonds. The other extends average maturity to include medium-term bonds yet maintains the highest level of credit quality. Both are low-cost institutional funds of the caliber and superiority you have come to expect from Mercer Advisors.

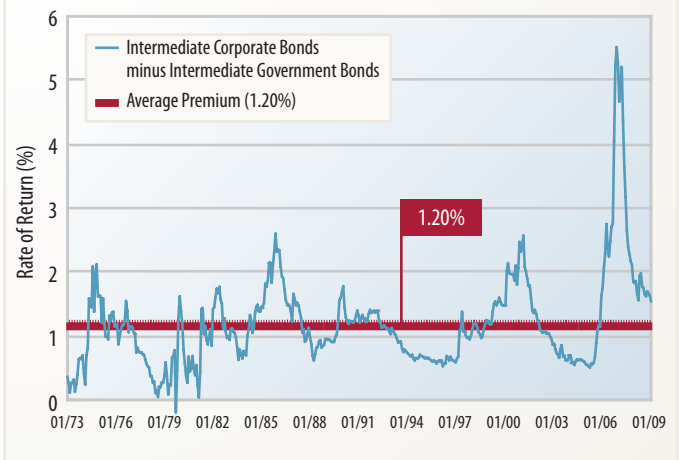
As your investment fiduciary, we conducted exhaustive due diligence to identify the best performing and highest quality institutional fixed income managers with whom to entrust the implementation of our bond risk premium strategy.

### Expanded Credit Quality Premium

The first bond risk premium broadens our perspective on the credit quality of a bond as well as its underlying ability to generate incremental return.

**FIGURE 2** illustrates intermediate-term corporate bond performance relative to intermediate-term government bonds. By holding the term steady (using only medium-term bonds) it is possible to analyze credit quality performance over time. The blue line tracks the out-performance rate of intermediate corporate bonds of lower credit quality as compared to intermediate government bonds. As indicated by the red line, the lower credit quality bonds paid, on average, a 1.20% premium over the government bonds between January 1973 and January 2009.

### Credit Quality Premium



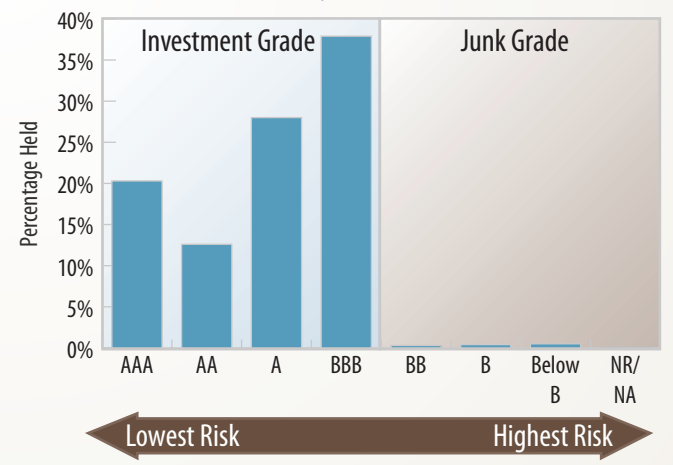
**FIGURE 2** Intermediate Corporate Bond Performance.

Source: Barclays Capital Intermediate Indices.

In order to access this potential for incremental return, we have hired a long-standing, comprehensive financial services firm that mirrors our disciplined and research-driven approach to investment strategy to target this credit quality risk premium for our clients. **Baird Advisors**, founded in 1919 in Milwaukee, Wisconsin, has a total of \$75 billion in assets under management (AUM) with a dedicated team of experts who manage more than \$15.5 billion in fixed income assets alone<sup>1</sup>.

The Baird Advisors fund selected by Mercer Advisors is comprised of 98.8% investment-grade quality bonds. As illustrated in **FIGURE 3**, nearly all of the Baird Short-term Bond Institutional Fund (BSBIX) holdings range from between a lowest risk to medium risk ranking.

### Baird Fund Credit Quality Distribution

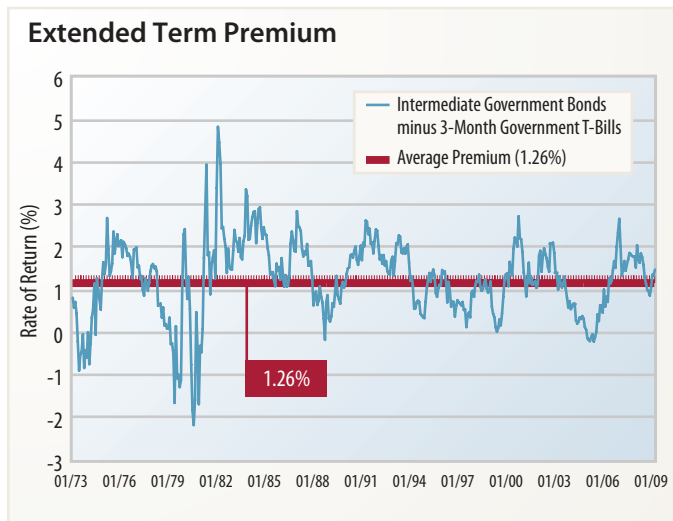


**FIGURE 3** Baird Short-term Bond Institutional Fund Allocation.

Source: Morningstar, September 2011.

## Extended Term Premium

The second bond premium maintains the highest of credit quality but includes extended medium-term investments.



**FIGURE 4** Extended Term Government Bond Performance.

Source: Index data from Barclays Capital. Treasury data from Federal Reserve Economic Data.

**FIGURE 4** illustrates bond performance over the same 35-year timeframe, this time with the credit quality held constant while bond term is extended. By holding credit quality stable (using only high quality government bonds) it is possible to measure bond term performance over time. In this exhibit, the blue line represents the rate at which intermediate-term government bonds outperform the 3-month government T-Bill. As evidenced by the red line, the expanded term government bonds paid, on average, a 1.26% premium over the T-Bill between January 1973 and January 2009.

We chose the extended term risk premium strategy managed by a prominent institutional investment management firm whose bond investment objective is to achieve a high level of total return consistent with the preservation of capital. **Reams Asset Management** was founded in 1981 and operates as the Fixed Income Division of **Scout Investments** with a total of \$10.3 billion in AUM<sup>2</sup> for institutional investors. We have hired Scout Investments' Fixed Income Division to target this extended term risk premium for our client portfolios.

## Implementing Bond Risk Premiums

Going forward, bond allocations within Mercer Advisors' Asset Optimization<sup>®</sup> portfolios will include an appropriate weighting of each of the bond funds outlined in **TABLE 1**. The core strategy will continue to be comprised of short-term, high-quality bonds and allocated more heavily in portfolios with very short time horizons or those holding capital earmarked for a specific use (ex: college tuition, down payment) within a short timeframe. A portfolio's bond risk premiums will be allocated in alignment with its overall risk/return profile, using the same criteria as was applied to determine the appropriate level of stock risk premiums.

At one end of the investment spectrum, the more conservative a portfolio's overall design, the less its bond allocation will be adjusted to include a bond risk premium strategy. Portfolios containing stock allocations of 40% or less are considered to be conservative. In keeping with the low risk tolerance profile of these conservative portfolios, a greater percentage of their overall bond allocation (60% or more) will remain within the core strategy fund. Using

Type	CORE STRATEGY		BOND RISK PREMIUMS			
	Short-term, High Quality		Short-term, Lower Quality		Medium-term, High Quality	
Fund	DFA 2-Year Global		Baird Short-term Bond Institutional		Scout Core Bond Institutional	
Fund Symbol	DFGFX		BSBIX		SCCIX	
	Actual Return	Std. Dev. (Risk)	Actual Return	Std. Dev. (Risk)	Actual Return	Std. Dev. (Risk)
YTD (as of 08/31/11)	0.89%	0.28%	1.79%	1.19%	6.16%	2.08%
1 Year	1.05%	0.31%	2.23%	1.17%	6.02%	2.32%
3 Year	2.25%	0.86%	3.57%	2.56%	10.72%	10.28%
5 Year	3.11%	0.77%	4.01%	2.17%	8.61%	8.14%
7 Year	2.91%	0.79%	3.55%	1.94%	7.00%	7.05%

**TABLE 1** Expanded Bond Product Offerings.

Source: Morningstar, 2011.

the 40% stock/60% bond portfolio as an example, its bond allocation would be revised minimally — 75% would remain in the core strategy fund; the other 25% would be invested appropriately between the two bond risk premium funds.

At the other end of the investment spectrum, the more aggressive a portfolio is in its overall design, the greater its weighting toward bond risk premiums will be within its small allocation of bond assets. For example, portfolios containing stock allocations of 90% or more are aggressive in their composition. These portfolios' bond allocation (10% or less) will be weighted much more significantly in the risk premium funds than in the core strategy fund, in keeping with the higher level of risk tolerance associated with an aggressive portfolio.

Any investment portfolio designed by Mercer Advisors will include a strategically calculated weighting formula in order to ensure optimization of its risk-adjusted returns. Based upon each client's defined risk tolerance level, the bond risk premium allocation within his/her portfolio will contain either a Standard risk premium tilt or a Strong risk premium tilt (a slightly more aggressive approach).

FIGURE 5 illustrates the weighting options for these new bond risk premium tilts, Standard and Strong, using the bond allocation within our 60/40 Asset Optimization portfolio as an example.

### CONCLUSION

*Mercer Advisors remains steadfast in its philosophy regarding the vital importance of the presence of short-term, high quality bonds within all but the most aggressive of portfolios.*

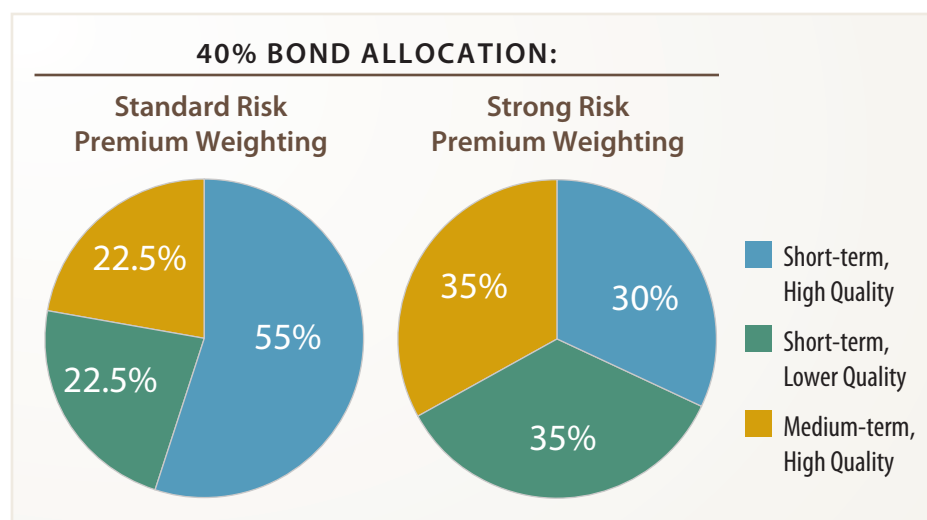


FIGURE 5 Bond Risk Premium Allocation Options for Mercer Advisors 60/40 Portfolio.

Source: Mercer Advisors Investment Committee.

What the addition of stock risk premiums such as small, value and Momentum has been able to offer as incremental stock return, these new bond risk premium strategies can provide for your bond assets' rate of return.

As investment science and academically validated investment theory continue to evolve and expand, Mercer Advisors will remain at the forefront of cutting-edge discovery. We are wholly committed to providing you with the best products, techniques

and strategies available in order to maximize return and minimize risk within your investment portfolios.

<sup>1</sup>As of July 31, 2011.

<sup>2</sup>As of March 31, 2011.