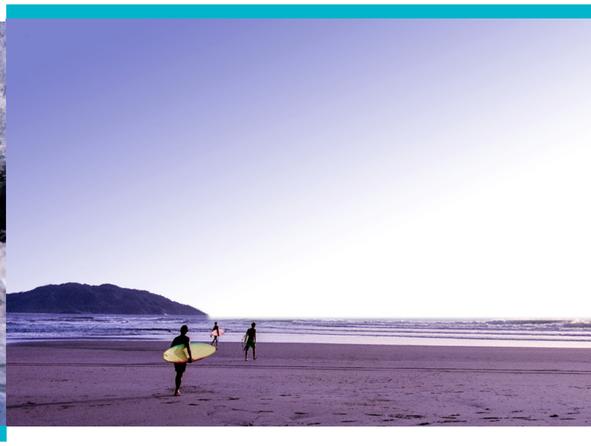


INSTITUTIONAL INVESTOR OUTLOOK FOR 2018

It's the end of the world as they know it.

And they feel fine.

Institutional investors are anticipating that a decade of low interest rates, low volatility and high investment returns may well be coming to an end in 2018. But just because they see dramatic change on the horizon doesn't mean they are ready to strike a more defensive pose. Instead, these professional investors see the potential for global growth to continue and nobody wants to be the first to leave the party before it ends.

As the outcome of dramatic change, institutional decision makers forecast higher levels of market volatility, greater dispersion of returns, and lower correlations for 2018. Three-quarters say it all adds up to an environment that favors active management. Survey results show they'll look to take advantage of growth opportunities around the world with tactical allocations in equities and put alternative investments to work for both yield replacements and enhanced return potential.

The institutional mindset

- Three-quarters say today's environment favors active management
- Three-quarters worry that a long period of low rates has created asset bubbles
- Six in ten believe rate increases will have a negative impact on performance

Active management, tactical allocations, and alternative investments

Given these factors, institutional decision makers foresee plenty of risk on the horizon: Geopolitical uncertainty and potential market spikes, inexplicable market growth and potential asset bubbles, and the specter of rising interest rates all factor into their outlook for 2018. While many anticipate that these factors may translate into an uptick in volatility, it appears that a large majority of institutions believe there is opportunity to be found in the fury.

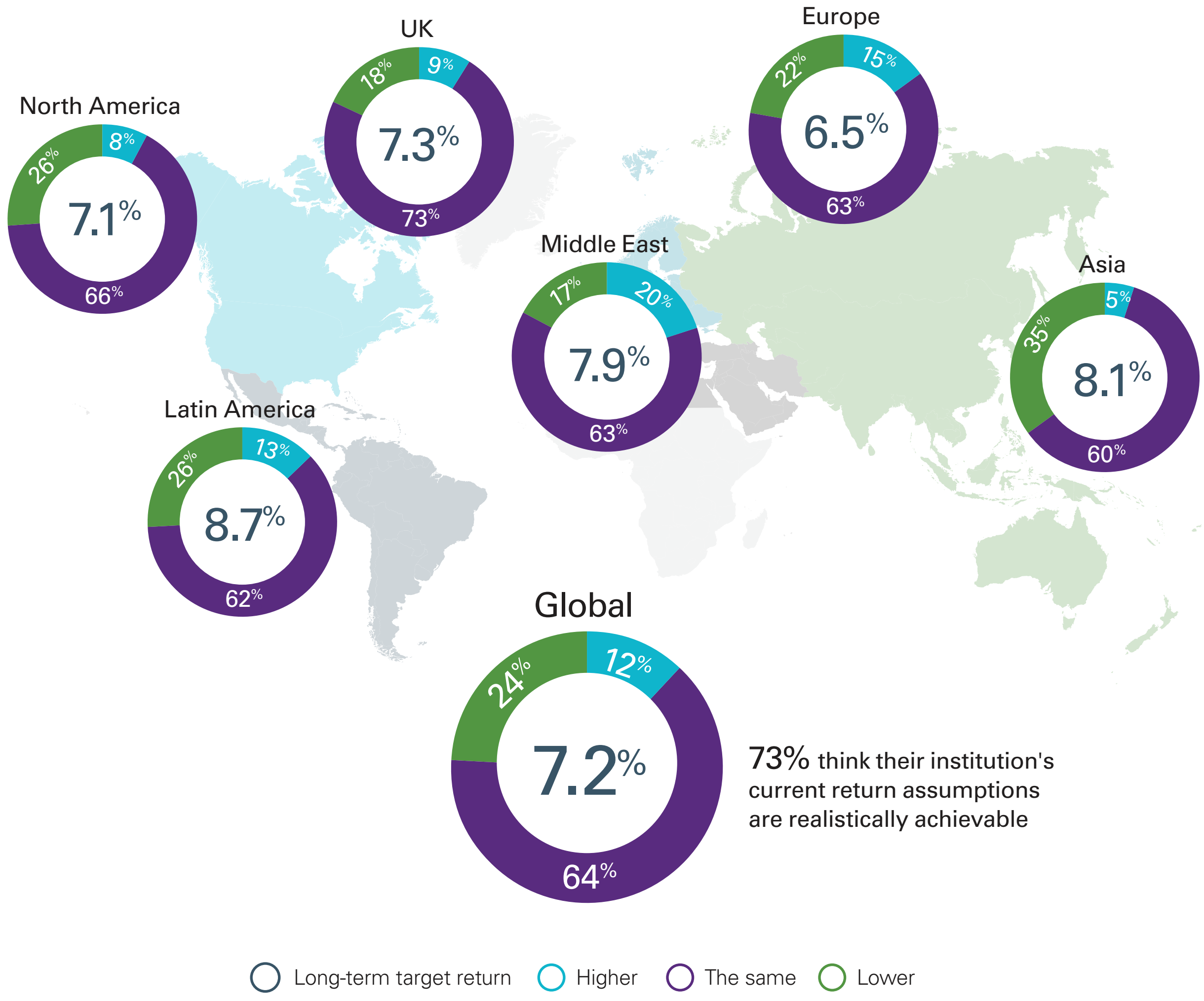
In order to be better positioned for a changing market, respondents in the 2017 Natixis Global Survey of Institutional Investors appear to be making adjustments to allocation plans rather than a wholesale shift in portfolio strategy.

Key investment trends include:

- **Active management:** Institutions demonstrate a clear preference of actively managed investments and continue to allocate the majority of assets to these strategies.
- **Regional diversification:** On the heels of double-digit returns for the S&P 500 in 2017, institutional investors are betting on Europe and Asia as growth drivers for 2018.
- **Alternative investments[1]:** Low yields have institutions looking for fixed income alternatives and in many cases focusing on the higher return potential of private markets.

While they may believe the constants of post-crisis markets will begin to shift in 2018, it appears that institutional investors are not worried about their world changing. The so-called smart money is moving forward with long-term plans.

Long-term targets and outlook for 2018



1 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.

Risk, returns, and realistic assumptions

Faced with what they believe to be more volatile markets, institutional investors are building investment plans with an average return assumption of 7.2%. Confidence in their ability to achieve these results remains high with 64% reporting that they anticipate no changes in their return assumptions over the next 12 months. Given that a majority of institutions anticipate increased volatility in equities (78%) and bonds (70%), it's no surprise that one-quarter of respondents believe they may actually reduce their expected returns in 2018. But it is surprising to see that one in eight institutions say they will actually increase return expectations in the year ahead.

Even though three-quarters of institutions believe their targets are realistically achievable, it should be noted that few think meeting these performance goals will be an easy task, as evidenced by the nine out of ten (92%) who say meeting long-term return assumptions is a challenge for their organization.

Where the risks lie

Despite a positive outlook on their ability to generate returns, these investors realize the task will be difficult if their greatest worries about risk are realized. Geopolitics top their list of risk concerns in 2018 with three-quarters (74%) of institutions saying this factor will have a negative impact on portfolio performance. Much as we saw on the heels of Brexit and the Trump upset in 2016, institutions have witnessed once seemingly improbable possibilities come to light in 2017. A nuclear-armed North Korea, investigations into Russian meddling in the US elections, populism, protectionism, and potential trade wars all factor into geopolitical risks. While none has resulted in market upheaval to date, it appears that institutions are more concerned about the question of when it will happen, rather than if it will happen at all.

77%

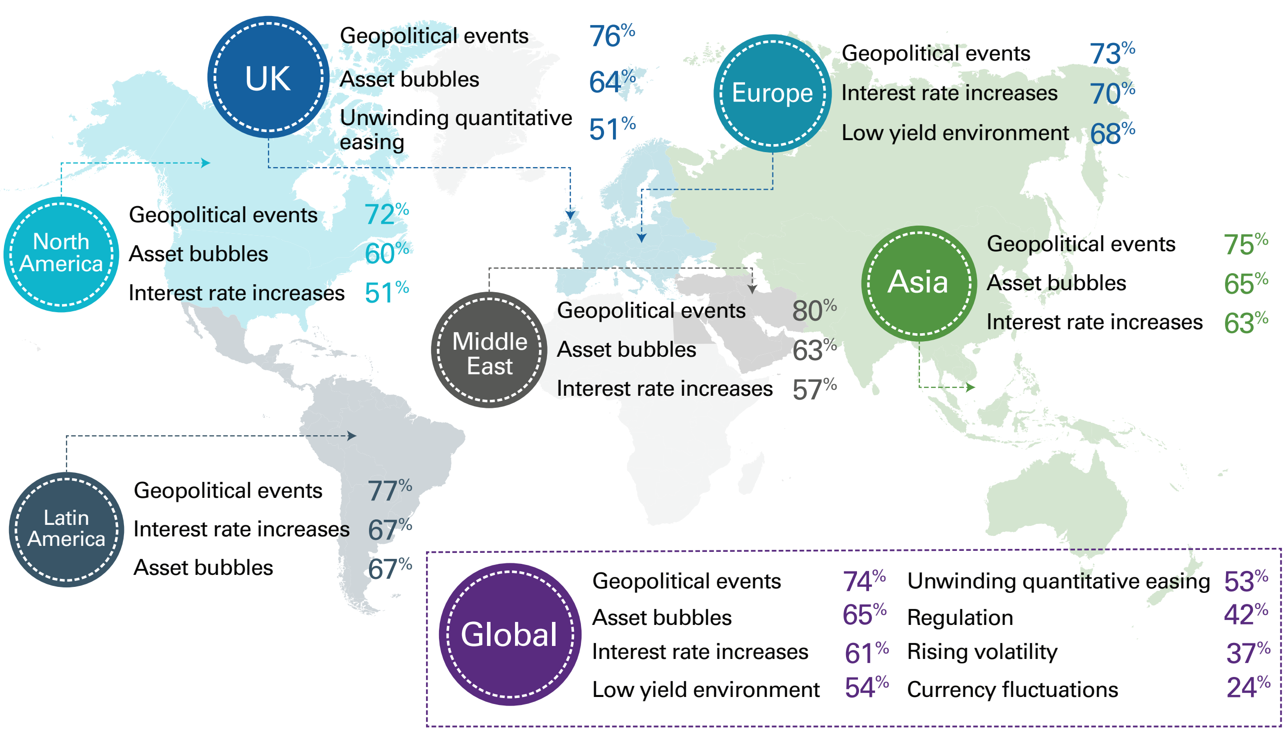
I am concerned a prolonged period of low rates has created asset bubbles.

% Agree + Strongly agree

Bubble trouble

Beyond politics, nearly two-thirds of institutions (65%) see the potential for asset bubbles (where rapid price inflation far exceeds the fundamental value of the underlying asset) in both stocks and bonds. More than three-quarters (77%) believe that the prolonged period of low interest rates is the

Geopolitics top risk concerns

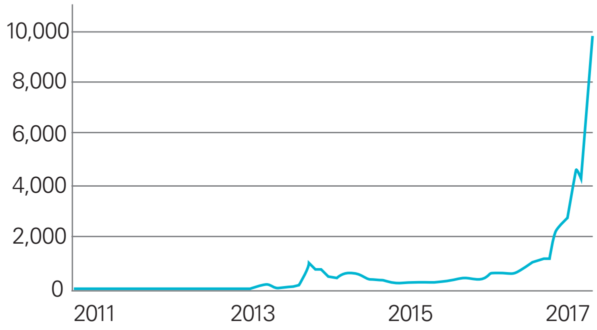


% Negative impact on investment performance of each response

The biggest bubble

Institutional investors may believe bubbles have formed in both the bond (42%) and stock (30%) markets, but concerns for these traditional assets pale in comparison to the 64% who say there's a bubble in Bitcoins. First introduced conceptually in a 2008 white paper penned under the alias of Satoshi Nakamoto, this cryptocurrency has soared almost 1000% to a dollar equivalent of nearly $10,000 in 2017. As if to confirm its bubble status, the currency jumped 11% on November 15, 2017 when digital payment specialist Square Inc. announced it would accept the currency as payment on its mobile system.

Bitcoin month end closing prices



Month end closing prices, and ending with month-to-date price on November 27, 2017.

projected cause of asset bubbles, and while they may be a concern, it is surprising to see that bubbles are not causing high levels of anxiety for all respondents. In fact, one-quarter of respondents believe asset price bubbles will have no impact on performance at all in 2018. But bubbles alone are not the only rate-driven concerns for institutions.

Rates pose double troubles

Institutional investors view rate concerns through two distinct lenses. First, after working under the reality of low rates for nearly a decade, six in ten institutions believe interest rate increases will pose performance risk in 2018. In essence, when rates finally go up, many are worried that the ensuing drop in value of current bond investments could upend portfolios built on traditional assumptions about fixed income. Despite the short-term risk management concerns, many may also be glad to see rates rise, which will help to reduce long-term liabilities.

It's likely that institutions will watch central bank policy developments across the globe carefully. In the US, leadership change at the Federal Reserve Bank in early 2018 is likely to draw the attention of these decision makers as they look to be assured that the Fed continues to telegraph interest rate moves. Globally, many will want to ensure that if the historic monetary policies constructed over the past decade are to be unwound it will be the result of slow and thoughtful action.

The speed at which rates increase will be of particular interest to institutions. With a 7.2% return assumption, a pop in inflation and particularly wage inflation may be

Equities and bonds could both be volatile in 2018

Equity volatility	78%
Bond volatility	70%
Dispersion (spread between security prices)	46%
Correlation (co-movement of security prices)	30%

% Rise expected

cause to revisit long-term performance goals. Further complicating the potential problem of a rate increase, this would be the first bear bond market that many of today's traders have ever seen.

Second, the current low rate environment presents another risk concern as institutions seek to generate the income needed to shore up long-term obligations. For many it has meant moving further out on the risk spectrum to pursue higher yields. With institutions reaching for lower-rated and riskier issuers to meet their objectives, it's no wonder that seven in ten believe institutions have taken on too much risk in pursuit of yield.

To better position portfolios for a potential rising rate environment, 31% of institutions say they will look to manage durations in their fixed income portfolios. Another quarter (23%) say they will increase their use of alternative investments as they seek out yield. Just under 10% (8.4%) of respondents say they are not taking steps to reposition their holdings.

Risks in the fallout

Risk concerns are not merely limited to interest rate policy. Even after a decade institutional investors see that the after effects of the financial crisis still pose significant risks. In the year ahead, more than half (53%) say the unwinding of quantitative easing and four in ten (42%) say new financial regulations also present significant performance risks.

Portfolio risks

Institutional investors are also acutely aware of the factors that present the most significant risks to a portfolio. Based on the potential performance challenges presented by the market, it's no surprise that in mapping out risk management concerns for 2018, institutional investors put interest rates at the top of the list. Adding pressure to portfolio decisions are concerns about spikes in asset price volatility, liquidity concerns, regulatory changes and inflation.

A market for active management

While institutions project higher levels of volatility in the year ahead, and see the risks associated with it, many may not perceive volatility in and of itself in a wholly negative light. With greater volatility, these professional investors also project higher dispersions and lower correlations, which is likely contributing to institutional confidence in active management. High levels of conviction in active

Where institutions see an advantage for active management

	Active	Passive
Generating risk-adjusted returns	✓	
Generating stable income	✓	
Taking advantage of short-term market movements	✓	
Downside protection	✓	
Exposure to non-correlated asset classes	✓	
ESG integration	✓	
Access to emerging market opportunities	✓	
Minimizing management fees		✓

The ability of an actively managed investment to achieve its objectives will depend on the effectiveness of the portfolio manager. There is no assurance that the investment process will consistently lead to successful investing.

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.

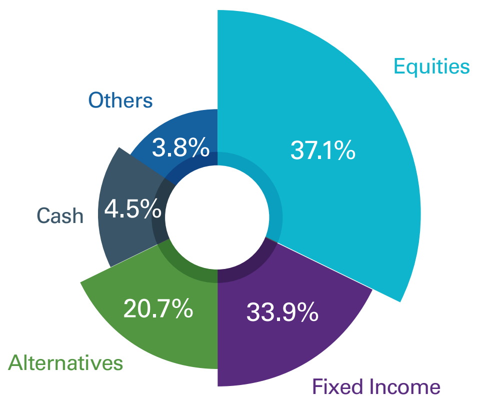
The problems with passive

- 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.

Institutions continue to temper additional allocations to passive investments[3]

2017 institutional portfolio allocations



management are all the more remarkable when three-quarters of respondents say alpha[2] has been difficult to find as markets have become more efficient. As a result, 76% of institutions say the market environment will be favorable to active management.

Institutional decision makers give active management the nod to fill a wide number of investment objectives that become increasingly important in volatile times. Almost three-quarters (73%) say active management is better at providing downside protection. Seven in ten (69%) also prefer active investments for taking advantage of short-term market movements. The same number (69%) believe that active is better suited to the ultimate goal for many investors: delivering better risk-adjusted returns.

These investors also prefer active for a number of portfolio functions that feature prominently in investment plans for 2018. Institutional investors believe active is better suited to providing exposure to non-correlated asset classes (74%), accessing emerging market opportunities (75%), generating stable income (58%), and implementing environmental, social and governance (ESG) strategies (68%).

Institutions only give the edge to passive for one factor: managing fees. Even at that, these professional investors do not confuse a lower cost investment with one that offers greater value. In fact, three-quarters of institutional investors say they are willing to pay a higher fee for strategies that can deliver outperformance.

Institutional sentiment toward active management is not mere lip service. Over the past three years we have seen a significant decline in institutional projections for the use of passive strategies.[3] Respondents in our 2015 Global Survey of Institutional Investors estimated a 7% increase in passive allocations over a three-year period, taking active down to under 60% of total holdings by the year 2018.

Instead, institutions have actually increased allocations to actively managed investments since 2015 to just over two-

2 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.

3 Natixis Investment Managers, Global Survey of Institutional Investors conducted by CoreData Research, October 2015. Survey included 660 institutional investors in 29 countries. 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.

thirds of their overall portfolio (68%). As an indication of their view on how long the market may favor active management, they anticipate only moderate adjustments over the next three years.

Allocation calls bet on risk

Last year, we noted that institutions anticipated increased volatility in 2017, but based on their allocation calls, they were actually doubling down on risk rather than running from it. For 2018 it appears that despite risk concerns that run from geopolitics to interest rate hikes to increased market volatility, institutional investors are willing to let it ride. Allocations appear to be more aligned with seeking to maximize return potential rather than minimizing perceived risks.

Institutions appear to be using regional allocation calls in equities in pursuit of the best opportunities. In fixed income, they appear to be weeding out bought assets, while alternative investments are getting the call to address a persistent low yield environment and enhance return potential by turning to the private markets.

Institutional projections for asset allocation changes

EQUITIES

INCREASE		DECREASE	
European Equities	33%	US Equities	36%
Emerging Market Equities	27%	European Equities	17%
Asia-Pacific Equities	22%	Asia-Pacific Equities	17%
US Equities	11%	Emerging Market Equities	15%

FIXED INCOME

INCREASE		DECREASE	
Emerging Market Debt	24%	High Yield Corporate Debt	33%
Securitized Debt (Mortgage-backed bonds, etc.)	20%	Government Related (sovereign debt, Treasury, etc.)	26%
Investment Grade Corporate Debt	19%	Investment Grade Corporate Debt	20%
Government Related (sovereign debt, Treasury, etc.)	16%	Securitized Debt (Mortgage-backed bonds, etc.)	18%
High Yield Corporate Debt	14%	Emerging Market Debt	12%
Green Bonds	7%	Green Bonds	3%

ALTERNATIVES

INCREASE		DECREASE	
Private Equity	39%	Hedge Fund Strategies	15%
Private Debt	36%	Private Equity	14%
Real Estate/REITs	33%	Commodities	10%
Infrastructure	33%	Infrastructure	9%
Hedge Fund Strategies	18%	Real Estate/REITs	9%
Commodities	13%	Private Debt	6%

Maintaining balance

Current allocations present a relatively well-balanced portfolio for institutional investors. The largest allocations (37%) in the average portfolio presented by respondents go to equities. This is followed with a 34% allocation to fixed income. What may be most telling in current allocations is the 21% of assets invested in alternatives.

In 2018, institutions are indicating that they will make slight adjustments within asset classes, rather than any major allocation shifts between asset classes. In equities, this means a regional focus on growth opportunities.

Equities: looking regionally for opportunities

Institutional investors who anticipated volatility in equity markets in 2017 were pleasantly surprised: The upheaval anticipated in November 2016 has not materialized by November of 2017, and many of those doubled down on equities were rewarded handsomely with double digit returns in the US, Europe and emerging markets. Asked to make a similar forecast one year later, institutions are making slight adjustments to equity allocations to capture opportunities for asset growth.

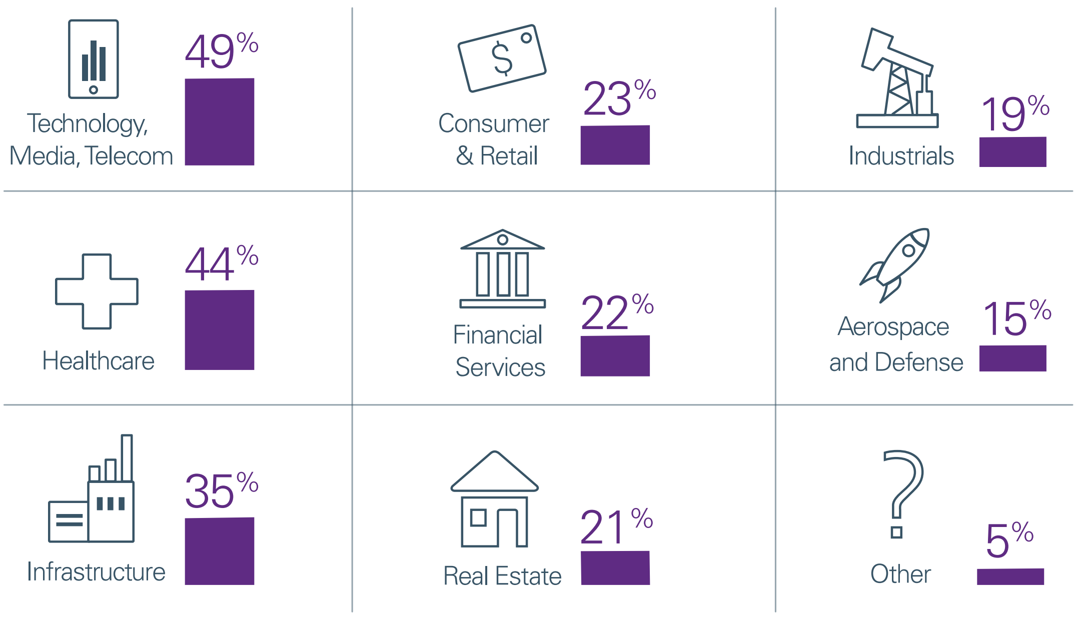
Institutions are generally maintaining overall equity allocations, but some are making regional bets to pursue higher returns. About half plan no changes to allocations to US (50%), European (47%), Asia Pacific (52%), and emerging market equities (48%). The numbers actually become most interesting when the same predictions are offered by the 12% of institutions who anticipate that their return assumptions will increase in the year ahead. These bulls demonstrate clear preferences for where they will search out return potential.

Fixed income: Managing risk exposures

Given competing concerns about navigating the current low-yield environment and preparing for potential interest rate increases, institutional investors are focused on credit quality in their fixed income portfolios. When asked where they anticipate making portfolio changes, more than half report they plan no changes to holdings in investment grade corporate debts (56%) and government bonds (51%). Just over 40% say they plan no change to their investments in securitized debt such as mortgage-backed bonds.

While a majority believes that institutions have taken on too much risk in pursuit of yield, it appears that they are not reducing risk exposures as much as replacing one risky asset with another. Following a run up high yield corporate bonds over the past two years, it's no surprise that one-third of institutions anticipate reducing their exposures to what many may consider to be an overbought asset. But many could be simply shifting their riskier allocations from high yield to emerging market debt. One-quarter of institutions anticipate increasing allocations to these bonds, indicating hopes for this market to satisfy their hunger for yield.

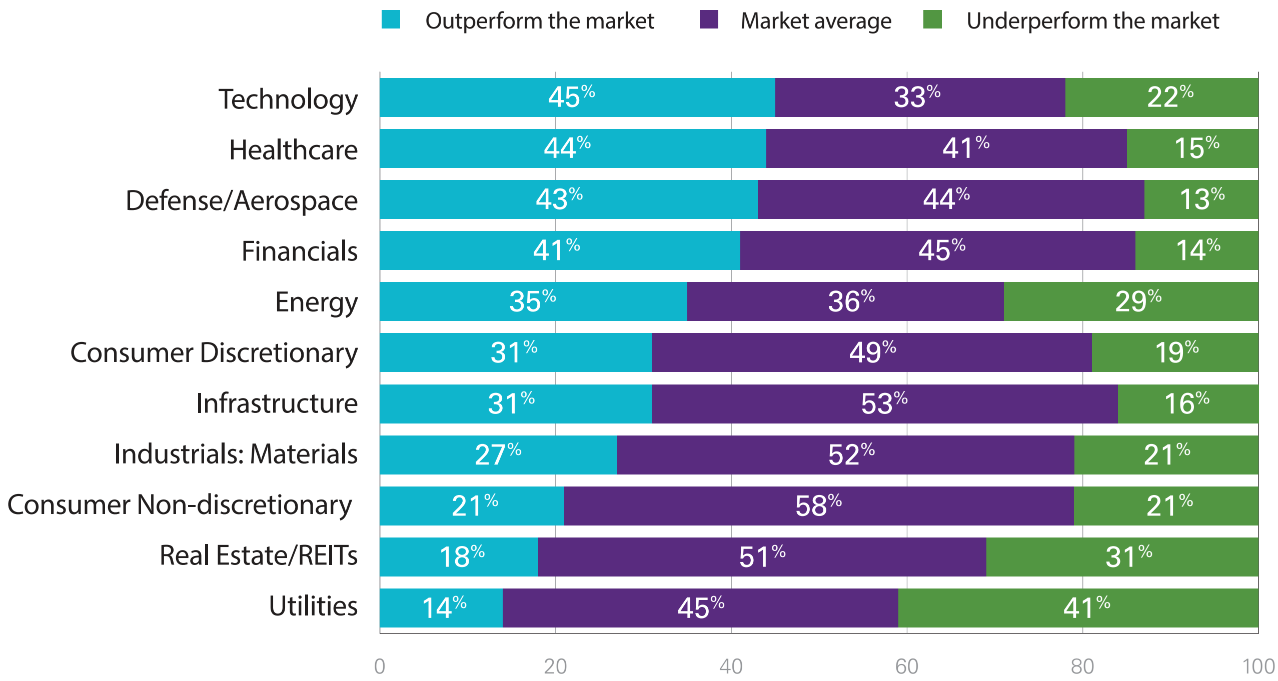
Institutional sector picks for private equity



% who say sector will be most attractive for private equity investment in the next 12 months (select up to three)

4 The additional expected return associated with securities that are not as liquid.

Sector outlook: Tech, healthcare, and industrials to outperform



Alternative investments: Private markets

Generating yield continues to be a key challenge, and upping risk exposures within traditional fixed income holdings provides one avenue to enhance results; institutions are also turning to alternative investments as bond replacements. Looking at potential moves within these non-correlated assets, one-third of institutions are planning to increase allocations to real estate holdings, while less than 10% say they plan to decrease real estate investments in the next 12 months.

Similarly, 36% of institutions say they will increase investments in private debt in the next year with only 6% reporting they will decrease current allocations. Institutions also find private equity investments attractive in the year ahead as 39% say they plan to increase allocations to these holdings. Increased allocations to the private markets indicate that institutions are willing to harvest the illiquidity premium[4] at a time when returns may be hard to come by with traditional assets. Most frequently, respondents cite technology, media and telecom as their top sector for private equity in 2018, followed by healthcare and infrastructure.

Cash

Of all portfolio calls for 2018 cash may be the one that provides the strongest confirmation of institutional confidence. Two-thirds of respondents say they anticipate no changes to their cash holdings, indicating that despite their concerns about both political and market volatility and interest rate changes, they are not backing down from their pursuit of returns of 7.2%.

Sector picks indicate opportunity in market risks

The sector preferences of institutional investors shed light on where they think exposure to market risks could be rewarded. Even though institutional investors cite geopolitical events as the top market risk in 2018, many are also finding that political uncertainty could lead to gains. Under the specter of a nuclear North Korea, a power shakeup in Saudi Arabia, and chilling relations between the US and Russia, 43% of respondents believe that the defense and aerospace industrials sector will outperform the broad market in 2018.

Institutional investors also find opportunity in broad demographic trends shaping the world. Given the realities of an aging global population, 44% of institutions see the medical and care needs of these individuals and say they believe the healthcare sector will provide outperformance next year as well. Financials (41%) and energy (35%) are also seen as sectors with the potential to outperform in 2018.

Most striking on the downside is the 41% of institutions who believe utilities will underperform in the year ahead. This is likely a view that this overleveraged and overvalued sector is more likely to feel the sting of potential interest rate hikes than others. In short, institutions may question the cost at which they can derive higher yields from utilities.

Is it really the end? The middle? Or just the beginning?

Institutional investors see the potential for significant change in 2018. Low interest rates could break a decade-long stalemate and begin to rise, putting significant pressure on investors who have stretched too far out along the risk spectrum to generate yield. Market volatility could return to markets that have been relatively calm for most of the past decade, exposing overvalued stocks that may have been artificially bolstered by low rates. Carefully placed portfolio bets could be upset by the wildcard of geopolitical events, leaving investors exposed to unanticipated risk.

But even facing the prospect of significant change, many institutional investors do not anticipate wholesale strategy changes. They are sticking by allocation plans and making only moderate adjustments. They are relying on active management to seek alpha in the turbulence. And they are looking to alternative investments to generate yields needed to meet long-term obligations. Their portfolio plans for 2018 look very much like their plans for 2017 and they feel fine

PROGRAM OVERVIEW

About the Natixis Center for Investor Insight

Investing can be complicated: Event risk is greater and more frequent. The potential for volatility is always present 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 Center for Investor Insight, Natixis Investment Managers 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 31 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.

> To learn more:
Visit: durableportfolios.com/understanding-investors

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.

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