



Investing Plus

J.P. Morgan Asset Management's half-yearly newsletter for UK institutional clients.

Welcome to the Autumn 2009 issue of Investing Plus – our newsletter for UK institutional investors.

After the turmoil of last year, there has been a welcome return to positive sentiment in 2009 with many sectors and asset classes clawing back a great deal of the previous year's losses. Of course, the question posed by many investment professionals is 'Where to now?', and whether to participate in short-term gains or reposition portfolios for the longer haul – with a likely different and evolving environment.

We naturally advocate a diversified portfolio and a long-term strategy for all investors so it is perhaps appropriate this edition takes a look at three very different sources of potential return.

First, we look at the merits of property investing in Europe. Although indicators show the UK property market is perhaps showing signs of recovery, the pan-European market has not yet reached its nadir.

This gives investors the chance to take full advantage of any bounce when it comes. Macroeconomic conditions are also beginning to look more promising with both France and Germany emerging from recession – their growth forecasts for 2009 and 2010 having been considerably revised up. We look at the near-term uncertainties, while also exploring the long-term capital growth and diversification opportunities for property investing throughout the continent.

As emerging markets have sparked over the past six months global strategist David Shairp and investment director Edmund Brandt believe the asset class warrants a closer look. They discuss whether emerging markets have the ability to outperform further, and if so, what are the key drivers likely to propel this growth. By assessing the long-term case for emerging markets, including risk factors, they draw up regional preferences and suggest indicators to watch out for, so performance does not get ahead of fundamentals.

Finally, Bob Michele, CIO of our Global Fixed Income and Currency Group, shares his view on finding value in today's bond markets and explains how pension funds can best capitalise on these opportunities. He talks about the significant revaluation of asset prices – the extent of which has never been seen before. As a result of this volatility, he believes, global bond markets have been heavily oversold, creating significant opportunity for investors to buy fundamentally sound assets at very low prices. The key naturally, is to have the skill, the strong fundamental research and a disciplined investment process to identify and take advantage of these opportunities.

I hope you find this edition of Investing Plus relevant and interesting.

Peter Ball
Head of UK Institutional Business



Property investing: time to look to Europe? Pensions Insight

UK pension funds considering a move into property investing should keep a watchful eye on Europe. While the UK property market is already showing signs of recovery, the pan-European market has not yet bottomed, giving investors plenty of time to take full advantage of the upswing, when it comes.

There are several key reasons why we believe now is the right time for UK pension investors to consider the European property market. The first is the steady improvement in macroeconomic conditions, already witnessed in France and Germany, where growth forecasts for 2009 and 2010 have been revised upwards over the last three months, driven in part by China's strong rebound and the resulting anticipated rise in demand for goods and materials. The French economy was insulated from the worst effects of the credit crisis, and has enjoyed greater resiliency than the UK and Spain with lower levels of consumer debt and higher savings rates. Long term, property returns are driven by what is going on in the underlying economy. We are in a trough, but the lead indicators like GDP suggest we are climbing out.

Property market recovery will lag economic recovery, but a key determinant in identifying the time lag is how much space is available in any particular market. Because the supply of

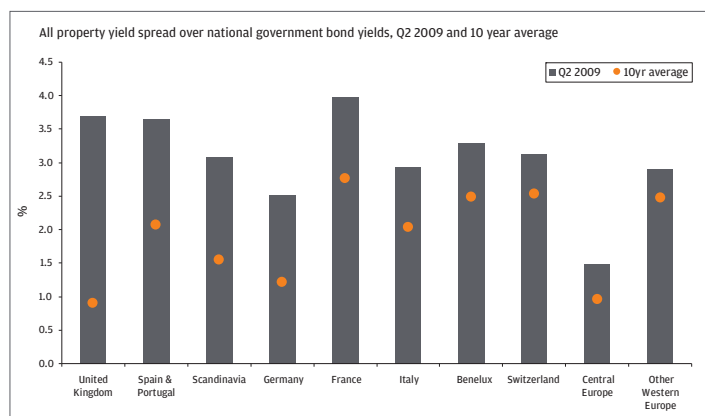
new space available has been lower than in previous cycles, we believe any improvement in occupier demand is likely to translate more quickly into rents and property performance. Current office vacancy in London, Paris and Frankfurt is significantly lower than it has been in the early 1990's. Depending on the market recovery in occupier markets could be between 6 months and 18 months from where we are today.

Current property pricing reflects the capital market shocks, which has created a recession leading to reduced occupier demand. In turn, rents have fallen significantly, particularly in office properties, where the peak to trough fall in headline rents in the City of London have fallen from c. £65 per square foot and seems to have bottomed out at under £45 per square foot before incentives. So why the cause for optimism? And headlines like the one in the Financial Times yesterday (October 6, 2009) that "Lenders flood back to property".



The answer lies in the second reason for considering property - namely the strong yield advantage offered by property over gilts. At the peak of the market, property yields were down to around 4% or under for prime property in Europe's best capital cities. Today, however, investors are able to obtain a yield between 5.5% and 6% from relatively low-risk core property investments - properties in prime locations, occupied by high quality tenants on long leases. With interest rates around the globe at or near record lows, spreads over bond yields are far above their ten year average (see chart). These factors are tempting investors back into the market.

Today's property yields look attractive compared to long-term average



Source: DTZ Research; J.P. Morgan Asset Management

Compelling long-term growth potential

The long-term case for property investing is also persuasive. As many pension investors know, property can provide compelling long-term capital growth opportunities and has frequently performed differently from other asset classes, thus providing a degree of portfolio diversification.

The moderate volatility of property returns and its historic low correlation with other asset classes can also be attributed in large part to the fixed and regular rental income (between rent reviews), which can give property investments bond-like investment characteristics. The property market also reacts more slowly to economic change, which makes property returns less likely than equities to be subject to substantial variations over any 12-month period. This moderate level of volatility of returns means the asset class can help pension funds better match assets with long-term liabilities.

Property also offers two sources of return, adding to its appeal as an investment in all market conditions. When property markets are rising, investors choose property for capital appreciation, while in more difficult market conditions property becomes attractive as a source of yield.

Don't follow the crowd

So where should investors look for value? Instead of following the crowd into the UK market, investors may benefit from a pan-European approach. As we've seen, the economic recovery looks increasingly sustainable, particularly in the heart of Europe. While there may be some near-term headwinds, we are confident that the property market will ultimately follow the economy into recovery.

Once the recovery is underway, investors in European property funds can further benefit from the diversification provided by exposure to differently performing economies. However, to profit from the best opportunities, it is, of course, important to find the right manager. Pension investors should look for well diversified pan-European property funds run by managers with the experience and resources to differentiate between European markets and seek out the most attractive property investments.

Emerging Markets

The outperformance of emerging markets over the past six months has put the asset class firmly at the forefront of investors' minds once again. David Shairp, global strategist, and Edmund Brandt, investment director, discuss the long-term case for emerging markets, the risks that investors should bear in mind and the factors that may drive emerging market GDP and earnings growth in the coming years.



Edmund Brandt
Managing Director
Investment Director

Edmund Brandt, managing director, has been the investment director for pooled funds domiciled in Europe since 2004. He was previously a senior portfolio manager with the Japan Portfolio Group. He joined in 1989 as a portfolio manager before transferring to the Global Fixed Income Group. He then relocated to Asia in 1993, as an investment analyst and later a head of research at Jardine Fleming Securities, before re-joining the Japan Portfolio Group in London in 1998. He obtained a B.A. in modern history from Hatfield College, Durham. Edmund is a CFA Charter-holder. He is also an Associate of the UK Society of Investment Professionals.



David Shairp
Managing Director
Global Strategist

David Shairp, managing director, is a senior strategist responsible for communicating J.P. Morgan Asset Management's global economic and asset allocation strategy and is based in London. He is a member of the Global Strategy Team, responsible for deciding asset allocation for the Global Multi-Asset Group's balanced portfolios. An employee since 2004, David previously worked at BNP Paribas as a strategist, chief economist and head of research. Before this he worked at BZW Asia as regional research director and strategist, and previously held roles at UBS Phillips & Drew, James Capel & Co and Caspian Securities. David obtained a BA in Economics from the University of Exeter and an MSc (management) Sloan Masters programme from London Business School.

Q. How bullish or bearish are you on the strategic (three to five year) outlook for emerging markets?

We are positive on the strategic outlook for emerging markets. The world economy undoubtedly remains under pressure as banks continue to rehabilitate themselves, and there are still question marks over the pace of recovery in the US and European economies. However, this is a developed market crisis. Emerging markets are not facing the same problems, and therefore we believe their growth rates will be higher and probably more sustainable.

China, for example, is capable of growing in real terms by about 8% per annum. In comparison, the US economy has tended to grow at around 3% per annum and may struggle to maintain growth at that level over the next few years. This story of superior growth potential is repeated across the emerging world.

The key drivers of emerging market growth are higher levels of productivity and demographics. Urbanisation is fuelling a demand for infrastructure in many emerging market countries, and the improved financial stability in emerging markets means governments now have the ability to meet this demand. This is in marked contrast to many western governments, who are facing severe budgetary pressure. Meanwhile, rising incomes and burgeoning middle classes mean emerging markets offer substantial "catch-up" potential with western economies, supporting domestic consumption growth.

Q. GDP growth alone does not produce investor returns. How will this economic growth story feed through into earnings growth?

That's a very important point. Investors are of course interested in return on equity, rather than in GDP growth alone. On this point too, though, we're positive. Returns on equity in the emerging world have converged to European and US levels and may have even held up slightly better amid the declines of 2008 and 2009.

Q. The traditional earnings cycle for emerging markets is driven either by commodities or by exports. Given that exports - particularly to the US and Europe - may remain muted for some time, what is going to drive emerging market earnings?

Emerging markets rely on very open global markets, with free flows of capital and trade. Given the size of the shock from the financial crisis, it's perhaps not surprising that we've seen some bumps along the way, including fears of a return to protectionism, but our sense is that the forces of globalisation will remain intact. Meanwhile, a number of emerging market currencies are undervalued at present, which should also be supportive for exports. Furthermore, while export demand from developed markets may remain muted for some time, the urbanisation and infrastructure themes should support demand within emerging markets. This should be particularly positive for commodity-producing countries, and may support commodity prices at a higher level than we have seen in the past. With all this in mind, we expect to see returns on equity remaining at healthy levels.

Q. What about the short term? Over the year to date, emerging markets have had a very strong run, significantly outperforming developed markets. Are valuations beginning to look overstretched?

In the near term, we may see emerging markets take a pause for breath. The asset class has seen very strong inflows in the first half of the year, which is cause for some short-term caution, and relative valuations compared with developed markets are getting high. These are both reasons to think that there may be a break in the current strong run.

However, provided investors have an investment horizon of 12 months or longer, emerging markets are still presenting good opportunities. In terms of price to book ratios, emerging markets are currently only slightly above their long-term averages. Similarly, our own composite valuation index has just crept marginally above the long-run average, which dates back to the mid 90s. So valuations have a way to go before they look excessive. Developed markets still look very undervalued historically, so in relative terms emerging markets may look a little expensive, but in absolute terms valuations still look comfortable to us.

Q. You mentioned that the emerging markets trade has become somewhat crowded recently. Do you still think there is room for emerging markets to outperform, if they are able to generate a premium in earnings growth?

Yes, we've seen an initial wave into equities this year, and global fund managers appear to have been looking to get the biggest bang for their buck, hence the preference for emerging markets and some of the Asian markets. The US and European markets have largely been ignored, and now we're at a point where we may see global investors increasing their overall equity allocation, but taking down beta (equity risk). That could favour the developed markets at the expense of emerging markets, and may result in the pause for breath that we've mentioned.

However, anecdotally, many fund managers are still sitting on more cash than they would like, and there could be a further phase of inflows as we begin to see earnings delivery from emerging markets, rather than the earnings promise which has attracted investors over the last few months.

Q. Do you have any regional preferences?

With some of the Asian markets, notably India, up 70% (USD) over the year to date, a short-term correction may be warranted. However, over a two to three year horizon, Asia is still showing the greatest strength and the greatest potential for robust earnings. China remains in focus, and we can expect to see investors veering from worrying about China overheating to worrying about China going into recession, but our research suggests that China can continue to produce GDP growth at the 8% level and to translate that into consistent strong earnings growth. Brazil and the rest of Latin America, in that order, also look attractive.

The emerging European region has had a more difficult time, with a lot of negative newsflow, but it's important to remember that there's a price for everything. What investors need to look for is the point at which the region's macro problems are factored into valuations. At that point, there may be money to be made.

Q. What are the key risks to the positive case for emerging markets?

Emerging markets remain very much a cyclical story, and there will always be times to buy, times to sell and times to exercise caution. The next one to two years look like a very promising period for the asset class, but investors should note that a certain amount of optimism is already priced in. If earnings deliver, we can expect emerging markets - particularly the BRIC countries (Brazil, Russia, India, China) - to continue to perform well. However, if earnings disappoint, it could hit those markets, and probably the whole of the asset class, hard.

Another point to note is that interest rates are currently at extreme lows across the globe. We've had a period of rapid interest rate easing and liquidity generation, which is always good for emerging markets, but this can't continue forever. Few commentators expect emerging market interest rates to go up in the next six months - the emerging world doesn't want to see its currencies strengthen against the major global currencies - but any sign of a tightening bias may cause nervousness. While India may see interest rates rise during 2010, China is the most likely place for us to see some form of policy tightening - an increase in bank reserve requirements, for example, or restrictions in bank lending - and if investors panic about this, broader emerging markets are likely to see prices fall.

Tightening in developed markets, and particularly in the US, would also be a cause for concern. However, the Federal Reserve (Fed) has signalled that it is unlikely to depart from its current policy stance in the near term. The risks to the US economy are diminishing, as the Fed has acknowledged, but it remains a long way from wanting to withdraw its accommodative policies, and that could be the story well into 2010. From that point of view, we therefore remain in a window of opportunity for emerging markets.

Q. What are the indicators that investors should watch to ensure that emerging market performance does not get ahead of the fundamentals?

The first key factor to watch is, of course, valuations, which we've discussed already. The second is the business cycle. Over the next three to five years we can expect to see emerging markets gradually weaning themselves from their reliance on global markets, but the world business cycle will remain a vital driver. Therefore, if we see the OECD leading indicator start to turn down, that may be a warning sign for emerging markets. The third factor would be if the whole world falls in love with emerging markets at the same time and it becomes a severely overcrowded trade. As we've discussed, there has been some concern about overcrowding recently, but the other two indicators (valuations and the business cycle) look supportive, which suggests to us that emerging markets have further to run.

At a glance

- Emerging markets look set to outperform developed markets in what could be a subdued period for the global economy.
- Fund flows into emerging markets have been quite heavy and in the short term we may see the asset class take a pause for breath.
- Over the next one to two years we believe we will be in the right stage of the business cycle for emerging markets to perform well, providing earnings growth does not disappoint.

Uncovering value in fixed income

The recent credit crisis has had tremendous impact on all sectors of the fixed income markets. As Chief Investment Officer of J.P. Morgan Asset Management's Global Fixed Income and Currency Group, Bob Michele shares his view on finding value in today's bond markets and explains how pension funds can best capitalise on these opportunities.

Q. How should pension funds approach fixed income in the current market environment?

Bob Michele: The last two years have seen high volatility in the global bond markets as the credit crunch and the global financial crisis sparked a significant revaluation of asset prices - the extent of which had never been seen before. As a result of this volatility, parts of the global bond markets have become heavily oversold, creating significant opportunity for investors to search for and buy fundamentally sound assets at very low prices.

Of course, identifying these opportunities, while avoiding the risks, will take considerably more skill than in the past. Strong fundamental research and a disciplined investment process are vital in uncovering value in today's market. As I believe asset prices will continue to recover over the coming months and years, pension schemes should move to capture these opportunities by meaningfully adding risk back to their bond portfolios today.

Q. So where do the best opportunities currently lie?

Bob Michele: We expect global economic growth and inflation to remain low as the financial system heals and companies repair their balance sheets. Under such an outlook, government yields should remain low thereby highlighting compelling opportunities in other parts of the global bond markets. In particular, three areas stand out: securitised debt, high yield corporate bonds, and emerging market debt.

The securitised debt markets remain cheap following the collapse in home prices. Despite this distress and the resulting increase in defaulted securities, these assets should further recover as home prices begin to stabilise. In particular, parts of the residential non-agency mortgage-backed securities market offer good value. Of course, intense credit research is needed to find those assets in the non-agency market that will perform and avoid those that will default. Much of the work we do involves stressing each transaction at the individual loan level under different scenarios of housing recession and depression. Most securitisations will 'break' under our scenarios, but we do manage to find many that remain stable and will return full principal.

Although having narrowed substantially this year, high yield spreads over Treasuries remain well above their long-term average. At these still distressed levels, high yield valuations do not reflect what we believe to be a more stable outlook for the global economy whereby deleveraging will be

the primary focus of borrowers. Companies have already become far more fiscally prudent as they have cut dividends, suspended share buy-backs and reduced expenses to the bare minimum. As long as their focus is on their balance sheets rather than accelerating earnings growth, credit spreads should halve from where they currently are over the next year. Our credit team is focussed on finding those issuers that remain committed to their balance sheet and can withstand a prolonged period of little or no economic growth and inflation.

Finally, I continue to find good opportunities in emerging market debt, particularly in Latin America and Asia where local debt and currency markets have only moderately recovered. For example, while Mexico has cut interest rates substantially as inflation expectations have moderated, bond yields remain relatively high. One of the key attractions of local market Asian or Latin American sovereign bonds is the currency. As deficits have ballooned in the UK and US, sterling and the dollar could come under pressure. The currencies that would benefit the most are in the emerging markets where expanding current account surpluses signal the need for appreciation.

Q. Is there still value in investment grade corporate bonds?

Bob Michele: Investment grade corporate bond markets performed very strongly earlier in the year, leaving valuations looking less attractive. After a quiet summer, I expect these markets to continue to trade sideways, further highlighting that better relative opportunity to add risk exists in the securitised, high yield and emerging debt markets.

Nevertheless, we remain constructive on the sector over the long term. Our credit analysts are tasked with scoring the investment grade credit market and, at the moment, all scorecards are marked positive-to-neutral. Financials, in particular, offer the biggest opportunities, given the wide spreads relative to industrials and utilities. I expect financial spreads to continue to narrow and eventually converge with other sectors.

Q. Given the risks associated with credit markets, how can pension schemes best capitalise on the opportunities you've identified?

Bob Michele: I believe that unconstrained 'best ideas' funds, taking a dynamic approach to sector allocation, are a particularly good way to capitalise on the broad opportunities that currently exist in global bond markets.

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Robert Michele, managing director, is the Global Chief Investment Officer within J.P. Morgan Asset Management's Global Fixed Income and Currency Group. In this role, he is responsible for overseeing the activities of our New York and London fixed income investment teams. Prior to joining the firm in 2008, Bob was at Schroder Investment Management for ten years, most recently serving as the global head of fixed income. He also previously served as the head of Schroder's U.S. Fixed Income Group, based in New York.

Bob Michele Managing Director
Global Chief Investment Officer
Global Fixed Income and Currency Group

Because many UK pension schemes have traditionally invested predominantly in the sterling bond markets, trustees would need to extend mandates to allow schemes to invest in non-sterling bonds to adequately capture today's opportunities.

Of course, mitigating risk is a key concern for many pension scheme managers today. To mitigate this risk, choosing experienced fund managers with disciplined investment processes and large research resources is vital.

We have dedicated sector teams globally covering government bonds, investment grade corporate bonds, mortgage and asset-backed securities, high yield bonds, and emerging markets debt. Moreover, our fixed income team can tap into the full global resources of J.P. Morgan, including our equity analysts (who can provide a different perspective on corporate fundamentals), our real estate team, our investment bank and our commercial bank.

I have long said that the strength of an investment process depends on the quality of the research inputs and the strength of the team making investment decisions. Particularly when analysing credit markets, a strong team of credit analysts are a necessity in identifying value in today's bond markets. That's why I've been adding resources to our credit, emerging markets and securitised debt teams.

Q. What is your main message to UK pension schemes?

Bob Michele: The revaluation of credit over the last two years has provided significant opportunity for fixed income investors, with many areas of the fixed income universe offering value. Now is the time for UK pension schemes to explore them. Those opportunities are global, but will not last for long.

Complacency is not an option. Considerable risk still remains in bond markets and further volatility could lie ahead as the global economy struggles to recover. Fixed income managers that think globally, have invested in strong fundamental research capabilities and run disciplined investment processes will prevail in identifying value in these challenging market conditions.

For further information on this article or anything else featured in the Autumn 2009 newsletter, please contact your usual J.P. Morgan Asset Management representative.

www.jpmorganassetmanagement.co.uk/institutional

Catch up

Catch up on the latest research and insights from J.P. Morgan Asset Management

We are continually striving to provide you with the most topical and up to date research and insight pieces to keep you up to date with current investment trends and developments. The latest pieces added to the J.P. Morgan Asset Management website include:

Lessons from the credit crisis ►

In this paper, we revisit the benefits of diversification to alternatives in light of the current credit crisis.

Pillars of a New Paradigm, Emerging Asia Infrastructure ►

In this insight, we explore infrastructure investment in emerging Asia and the challenges facing global investors in a new investment paradigm.

Global Convertible Bonds – an update, July 2009 ►

Having seen a recent rebound in convertible bonds, when is the time to invest and is there still value in the asset class?

"The new world order": Reasons to invest in Asia ►

As the MSCI AC Asia Index bounces, we examine some key reasons to look at the Far East.

To download these and other research and insight pieces, please visit:

<http://www.jpmorganassetmanagement.co.uk/Institutional/CommentaryAndAnalysis>

Catch up with J.P. Morgan Asset Management

If at anytime you would like to meet with anybody at J.P. Morgan Asset Management, please contact your usual J.P. Morgan Asset Management representative. Alternatively, we will be exhibiting at the NAPF Annual Conference, 14-16 October 2009 which will be held at Manchester Central and the Professional Pensions Show, 18-19 November which will be held at the ExCeL Centre in London, Docklands. We look forward to welcoming you to our stand at both events where representatives from J.P. Morgan will be happy to discuss with you some of our recent product innovations and explain how they can help meet your investment goals.

George Ochs of our Global Real Assets team will be speaking at The 9th Annual UK & Irish Pensions and Investing Summit on 2nd November. J.P. Morgan Asset Management are Gold Sponsors of the event which is being held at the Burlington Hotel, Dublin.

We are also sponsors of the SPS Annual Bond Investment Strategies for Pension Funds conference where again we will also be taking a speaking slot. This conference will take place on 14 January 2010 at Le Meridien Picadilly, London.

If you would like to attend any of the above exhibitions or conferences, please contact your usual J.P. Morgan Asset Representative or Chris Scicluna at chris.d.scicluna@jpmorgan.com or on 020 7742 9334.

Investment dead ends



Alternative investments



New routes for today's markets

In today's markets, it can seem like there's nowhere to turn to achieve the blend of return and risk that your organisation requires. The range of alternative investments from J.P. Morgan Asset Management could open up a host of possibilities and help you rebalance your portfolio.

By introducing new sources of uncorrelated performance, you could enhance the risk-return profile of your strategy - with the choice of either individual strategies or as bundled products such as our Diversified Growth Fund. With proven expertise across all key alternative asset classes, see how our investment teams can help steer your investment strategy in the right direction.

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