

For professional investors only – not for public distribution



Delivering the best outcome for DC members

Six things you should know about Risk

Better insight + Better process = Better results

JPMorgan 
Asset Management

Six things you should know about risk

'Risk' is a term that few people want to associate with their pension. But risk is the fuel that drives investment returns. Anyone who wants to build a good retirement fund using the growth potential of shares and other assets must be willing to take some risk with their capital. Fortunately, DC pension schemes can now include investment options that allow risk to be diversified and managed more effectively than ever before.

In this DC Insight guide, we'll discuss six important issues about risk that every trustee needs to be aware of when supporting members in their investment choices

1. Risk can be relative or absolute

LIBOR (London InterBank Offered Rate) - the rate of interest at which banks lend to one another; often used as a benchmark when aiming to beat the return on cash.

Total return fund – an investment fund that aims to achieve positive returns over the medium to long term regardless of market movement, typically using the return on cash as its performance benchmark.

When most ordinary people talk about investment risk, they usually mean the danger of losing capital, full stop. Yet in the pension world, risk has long been talked about in 'relative' terms – the risk of performing worse than a particular benchmark. This benchmark might be a stock market index (eg the FTSE All-Share Index) or a peer group where the performance of a group of pension funds is combined to reflect the median return (eg CAPS).

As a result, what scheme members and investment professionals may class as low risk can be completely different. The professional may consider an index-tracking strategy is low risk because it won't underperform its benchmark. To a scheme member, however, a fund that tracks the ups and downs of the stock market is very high risk in absolute terms as it has the potential to lose them money whenever the market falls. Instead, their idea of low-risk may be a cash fund.

When talking about risk – whether with scheme members, consultants or other trustees – it is vital first of all to ascertain what type of risk is being discussed – the 'absolute' risk of simply losing money or the relative risk of performing worse than a particular benchmark.

Targeting absolute risk

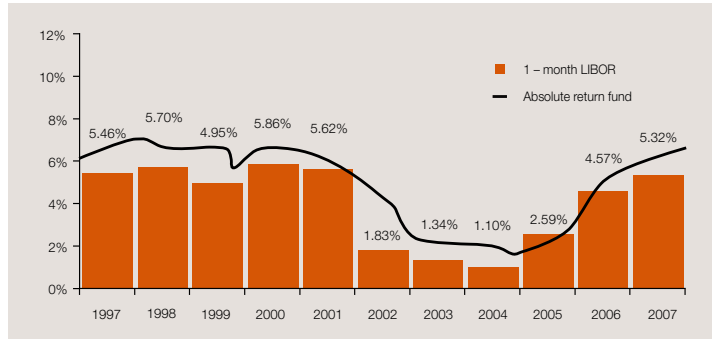
Until recently, the concept of relative risk dominated pension investing. However, more and more pension funds – especially in the DC market – are starting to focus on limiting absolute risk.

A number of 'absolute return' or 'total return' funds measure their performance against a cash benchmark – eg LIBOR – rather than a market index such as the FTSE All-Share. This means they can only claim to outperform their benchmark when they are delivering a positive return that beats the return on cash (see diagram below). In this way, the interests of scheme members (not losing money) and pension professionals (beating the benchmark) are much more closely aligned.

Action points

- Communicate the difference between absolute and relative risk to members;
- Consider offering 'absolute' or 'total' return investment options that aim to beat the return on cash rather than a stock market index;
- Make clear whether your scheme's risk ratings are absolute or relative.

Absolute funds aim for a consistently positive return above cash (eg LIBOR)



Source: JPMorgan Asset Management 31 August 2007

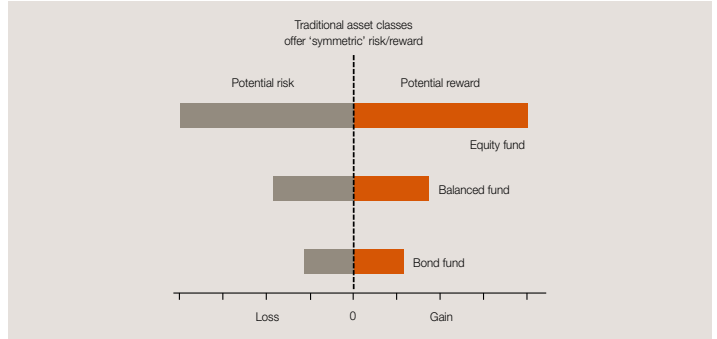
Note: In this guide, whenever we refer to risk, we will mean the absolute risk of losing capital, unless otherwise stated.

2. Risk and reward no longer need to be an equal trade-off

Long only – a fund that only buys stocks to make money when they rise in value – ie it does not use shorting techniques to make money when prices are falling.

In the past, risk and reward was a pretty even affair. If you wanted the potential to achieve a high return, you needed to take a high degree of risk with your capital. If you were only prepared to take a little risk then over the long term you could only expect a modest return.

The risk/return profile of conventional 'long-only' investment funds therefore looked like this:

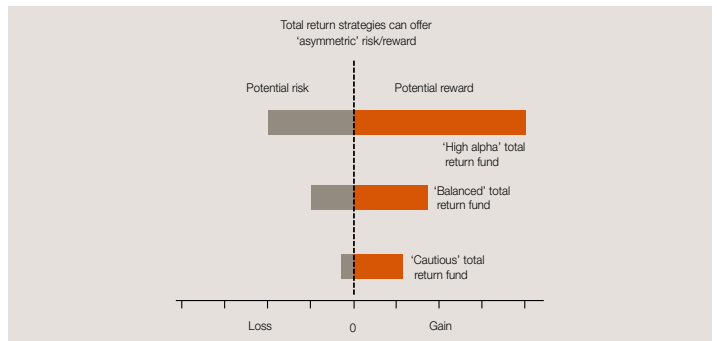


However, new investment approaches now mean that in some scenarios that the risk-reward trade-off no longer has to be equal. By using hedge fund techniques such as shorting (profiting by selling then buying back stocks that have fallen in value), investment funds have the potential to make money in falling markets as well as rising ones. Meanwhile tactical asset allocation that uses derivatives (rather than investing in the assets themselves) allows investment managers to swiftly alter their exposure to different asset classes – maximising exposure to those asset classes that are rising in value while reducing exposure to those in decline.

Techniques like these mean that fund managers now have the ability to be able to reduce downside risk without sacrificing upside potential. As a result, the risk-reward profile of the new breed of total return strategies can look more like this:

Action Points

- Ask consultants and fund managers about investment strategies that aim to deliver 'asymmetric' risk;
- Make clear to members that targeting higher returns must always involve accepting higher levels of risk – there is never a 'free lunch'.



Targeting higher returns still involves accepting a higher level of risk – but a level of risk that may be more acceptable to a greater number of DC scheme members.

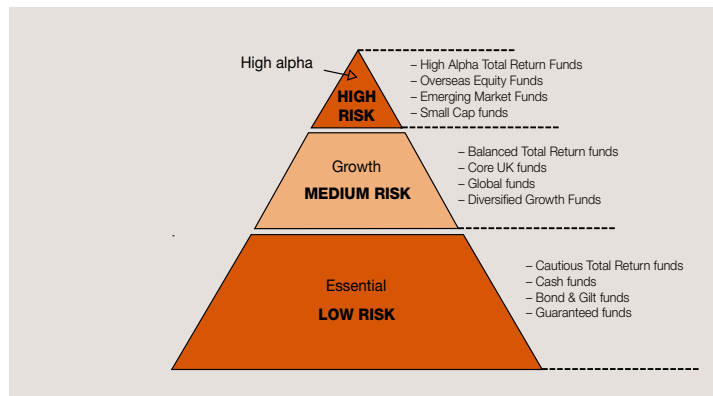
3. Different pension assets deserve different levels of risk

High alpha – investment strategies that aim to achieve a high level of outperformance against their benchmark – and therefore may involve higher-than-average levels of risk.

DC pension scheme options can range from low to high risk. It can be tempting for scheme members to focus on the lowest risk options if they are cautious about investing. But this means they miss out on the greater return potential that higher-risk investments can offer.

One way to encourage members to achieve a better balance of risk is to get them thinking about matching different levels of risk to different pension assets. For example, a member's pension pot could be divided to three components:

Structuring a DC pension pot



1. **'Essential Fund'** – This represents the bare minimum pension fund that the member feels they need at retirement. This can be assigned to low-risk funds that are likely to achieve modest returns without sharp losses.

Action Points

- Show members how they can mix and match funds with different risk profiles;
- Stress the importance of regular reviews to ensure the overall level of portfolio risk is appropriate.
- Ensure members have the flexibility to change their portfolio swiftly if the level of risk isn't right.

2. **'Growth Fund'** – This is the part of the pension pot which is to be used to drive growth in the pension fund. The member must be happy to take some risk with this portion in return for the potential to achieve attractive levels of growth over the longer term.

3. **'High alpha fund'** – This element represents money that the member is willing to invest for the very long term and take the most risk with. Depending on what it is invested in, this portion has potential to achieve very strong performance over the very long term – but the member must be willing to accept that its value may fluctuate substantially in the meantime.

How much a member should allocate to each of these three elements is a very personal decision – there are no wrong or right answers. But the allocation between high, medium and low-risk investments should be regularly reviewed by the member to ensure it is still appropriate to their time of life, the size of their pension pot and the investment returns they hope to make by retirement.

4. Blending assets is key to reducing risk

Correlation – the extent to which different investments or markets move in line with one another/influence each other's performance.

Managed currency – an investment strategy that looks to profit from movements in the value of currencies.

Private equity – companies that are held in private hands rather than being publicly listed on the stock market.

'Don't put all your eggs in one basket' is a well-worn investment adage but it still holds true. By diversifying capital between different investments, there is likely to be less impact if one falls into difficulty. Falls in one investment may be offset by rises in another, which can help to 'smooth out' overall investment performance.

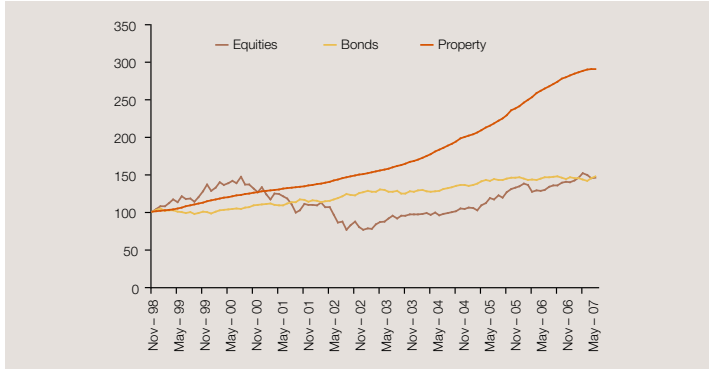
The challenge is finding investments that genuinely behave differently from one another. In the past, investing across different markets was an effective way to diversify risk. But today, globalization means that stock markets are increasingly 'correlated'. So, for example, when the US market has problems, others are likely to follow.

One answer is to diversify across different asset classes. For example, equities (shares), government bonds (eg gilts) and property are influenced by different factors and still tend to have low correlation with one another, as the graph over the page shows:

Action Points

- Ensure your DC fund range offers sufficient diversification across different asset classes.
- Watch out for rising correlation between your investment range – get a consultant to review your funds for you.
- Make sure the risks of any specialist/esoteric investment choices are clearly explained to members.

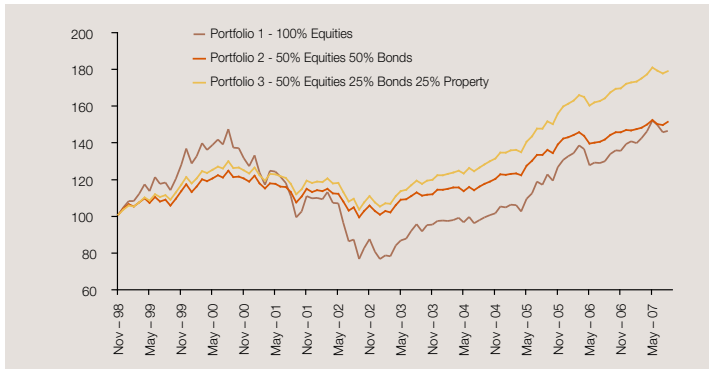
Equities, bonds and property 1998-2007



All returns in GBP. Shows the performance of market indices which do not include charges or fees so returns may be different from those received from an investment fund and are used here for illustration only. Equities – MSCI All Country World Gross; Bonds – FTSE-Actuaries Govt.Securities 5-15 year; Property – IPD All-Property index GBP
Source: JPMorgan Asset Management, figures are gross of fees. 31 August 2007.

You can see below how blending these uncorrelated investments can help to ‘smooth out’ overall performance – and improve returns. Portfolio 1 which holds only equities has experienced very sharp falls from time to time. Portfolio 2 holds both bonds and equities and, as a result, has seen far lower volatility. However, Portfolio 3, combining equities, bonds and property, has seen the smoothest performance and the highest overall returns.

The benefits of combining assets



Source: JPMorgan Asset Management Asset Management, figures are gross of fees. 31 August 2007.

These days, investment managers spend significant resources identifying assets that have low correlation with one another. As well as 'traditional' assets such as equities, bonds, domestic property and cash, these may include managed currency, private equity, hedge fund strategies, exotic bonds and global property.

Such highly specialist investments may not be suitable for DC scheme members to hold directly (particularly as some – such as property – can be highly illiquid). However some fund managers may offer them within a diversified growth fund – thereby giving pension scheme members access to exciting and uncorrelated asset classes that were once only available to professional investors.

5. Too little risk is as bad as too much

Real return – the investment return made over a period of time once inflation is taken into account.

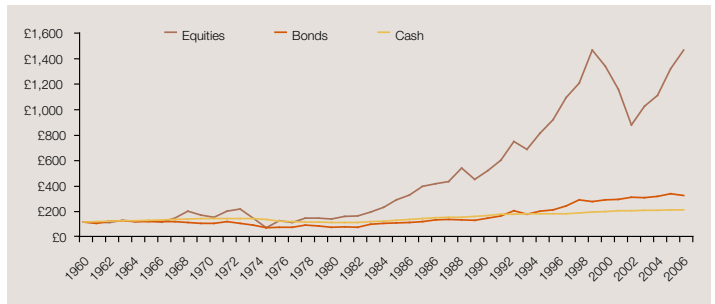
Inflation risk – the risk of capital losing its purchasing power due to the rising cost of living.

Market correction – falls in the stock market after a period of sustained rises that bring share prices to more reasonable valuations.

Erring on the side of caution can be a good thing in many circumstances. But it can be seriously detrimental when planning a long-term commitment such as a pension.

Historic data shows that anyone who has relied on low-risk investments such as cash deposits and gilts for their savings has severely fallen behind savers who have chosen to invest in equities – see graph below. In fact, cash-based deposits may virtually stand still in value over the long term once inflation is taken into account. In other words, investors stand to lose money in 'real terms' by taking too little investment risk.

The 'real' value of £100 invested 1960-2006



Source: Barclays Capital – Equity Gilt Study 2007

Action Points

- Communicate to members the long-term dangers of only holding low-risk investments.
- Show younger members that they potentially have a lot of time to ride out market falls.

Taking advantage of market falls

It's also important to remember that falls in the stock market can actually be good news. When stock markets fall, an investor is able to buy more shares with their money – thereby giving them a bigger pot from which to benefit when markets rise again. Professional investors often refer to falls or 'corrections' in the stock market as a buying opportunity.

When markets are volatile, regular monthly investors can even benefit from a phenomenon known as 'pound-cost averaging'. This means their monthly investment buys more shares or fund units when prices fall and fewer when prices rise. This means the average price they pay per share is lower than the actual average share price over the period they invest.

6. Time is the biggest factor when deciding the right level of risk

Excess return – the level of outperformance against a chosen benchmark.

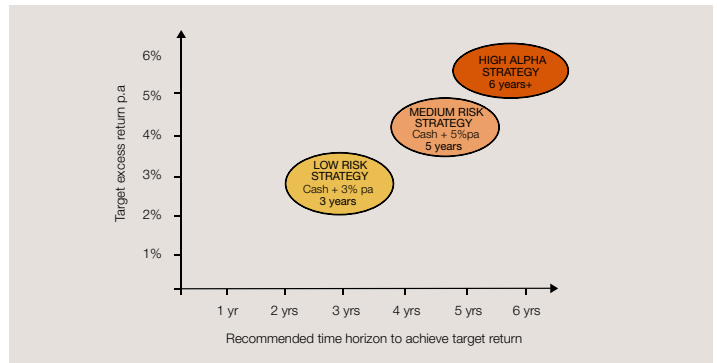
Investment markets can be volatile but historically, they have always tended to rise over time. Therefore the amount of risk a scheme member should take depends heavily on how much time they have until they need to call on their pension fund. The more time they have, the greater the opportunity to 'ride out' any falls in the value of their chosen investment funds.

As a broad rule of thumb, anyone who has more than 10 years before they need to call on their pension pot can afford to take a relatively high level of risk. Anyone with less than five years should take far less risk.

Time versus return

A big attraction of the new breed of total return funds is that they tend to give an explicit time period over which their target excess return is expected to be achieved. This can be very useful for scheme members as they can then see which funds are likely to be most appropriate for their stage of life.

The Total Return Reward/Time trade-off

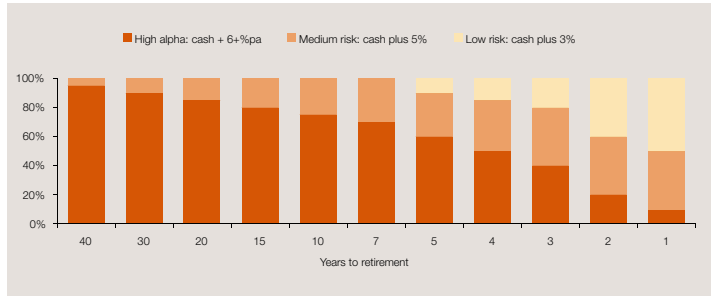


This also makes these funds highly practical as a lifestyling option. By automatically moving a scheme member's pension pot from high alpha to low-risk total return strategies, the level of risk can be carefully calibrated in line with the time left until retirement – see graph below.

Action Points

- Offer investment options that fit to different member time horizons.
- Consider offering a blend of total return funds as a lifestyling option to older members.
- Encourage members to review their pension funds regularly to ensure they fit with their time horizon.

‘Lifestyling’ in the run-up to retirement

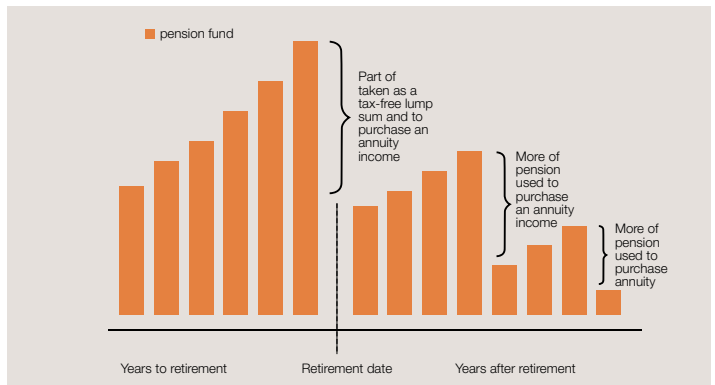


Looking beyond retirement

It’s important that members think about their time horizon and risk not simply in terms of the date they intend to retire. Longer life expectancy means that retirement can last 15, 20 years or more. Increasingly members therefore need to consider how their pension pot can maintain its real value beyond their retirement date.

For example, while some of a pension fund may be used immediately on retirement to buy an annuity income, the rest of it could continue to remain invested – perhaps to be called on to purchase further annuity arrangements after retirement. The key point is that the risk profile of an investment must be appropriate to the time remaining until the capital will actually be used.

Retaining growth potential – before and after retirement



Last Word

Risk is a personal choice

In this guide, we've aimed to give some pointers as to how members of DC pension schemes can achieve a suitable level of risk while taking full advantage of the different investment opportunities to build a healthy pension fund.

But ultimately, risk is a very personal issue and members should only take risks with which they are really comfortable. Be sure your scheme offers sufficient investment choice for every member to achieve their preferred level of risk.

How we can help

JPMorgan Asset Management is part of one of the world's largest financial services organisations. As such we have significant experience and expertise in traditional, total return and hedge fund management.

We firmly believe that the newer types of product will continue to sit alongside more established offerings for many years to come. Your clients are unique and each demands a bespoke suite of products blended to meet their personal requirements. Whatever the exact mix we're confident in our ability to offer a range of funds that fit the bill.

For more information please contact your usual JPMorgan Asset Management representative or visit us at www.jpmorganassetmanagement.co.uk/institutional



JPMorgan Asset Management
Finsbury Dials
20 Finsbury Street
London EC2Y 9AQ

www.jpmmorganassetmanagement.co.uk/institutional

For professional investors only – not for onward distribution. Past performance is not a guide to the future. The value of investments and the income from them may fall as well as rise and investors may not get the full amount invested. Investments in emerging markets may involve a higher element of risk due to political and economic instability and underdeveloped markets and systems. The opinions and views expressed here are those held by JPMorgan Asset Management as at October 2007, which are subject to change and are not to be taken as or construed as investment advice. Issued by JPMorgan Asset Management Marketing Limited, authorised and regulated by the Financial Services Authority. Investment is subject to documentation (Prospectus, Simplified Prospectus and Terms and Conditions), copies of which can be obtained free of charge from JPMorgan Asset Management Marketing Limited, Registered in England No. 288553, 125 London Wall, London EC2Y 5AJ.

8807976

10/07