Commodities update: October 2011
Webconference summary

This document represents our views as at October 2011 and may be subject to subsequent change

With Ian Henderson about to step back from lead fund management duties and hand over the reins to Neil Gregson, we take the opportunity to look at the commodities market and assess the outlook for the JPM Natural Resources Fund.

Ian Henderson hands over to Neil Gregson

After 20 years managing our natural resources portfolios, Ian Henderson is stepping away from day-to-day fund management duties and is handing over lead manager responsibilities to Neil Gregson from the end of January 2012. Ian will remain employed full time until March 2012 and then will move to a part time advisory role for a further 12 months.

Given Neil's long experience in the sector, and thanks to the support of Chris Korpan and Stuart Connell, we are confident that our Natural Resources Team is ideally placed to maintain Ian's success. The team boasts investors with direct industry experience at the corporate level as well as expert portfolio managers who can fully exploit the compelling long-term opportunities in the sector.

Fund performance – China is the key

In 2011 fund performance has suffered as investors have indiscriminately reduced risk in their portfolios on concerns over global growth – in particular on worries of a slowdown in China. As risk aversion has increased, investors have sold positions in the riskier sectors, including resources stocks.

We believe fears of a China hard landing are overdone. China continues to grow at a very fast pace and has a leadership that is committed to the country's continued rapid economic development. Having tightened monetary policy in recent years, Beijing is able to begin relaxing policy if growth is threatened, particularly now that inflation is easing.

Nevertheless, as a result of the selling pressure, many natural resources stocks have fallen irrespective of fundamentals and remain very cheap despite a recovery in recent weeks. We own several well managed smaller mining companies that are progressing strong projects that are now looking very undervalued. We believe if investors are prepared to stick with these stocks then they will be rewarded in the long term.

Commodity equities have been lagging commodity prices

Gold, copper, oil & gas and iron ore producers have all steadily underperformed the underlying commodity prices throughout 2011. As a result, valuations across commodity sectors have become very attractive on a long-term basis and there is considerable room for strong future performance as this discount closes.

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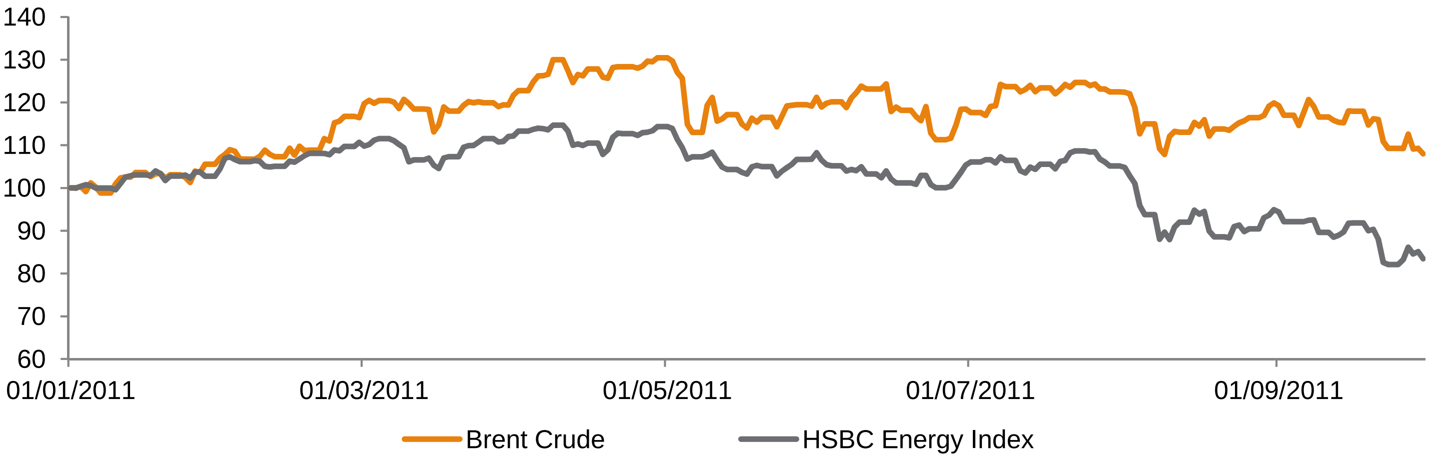
Energy

Oil & gas producers have held up better than most other commodity stocks this year, with energy prices lifted by the supply pressures associated with the Arab Spring. We believe oil prices have a strong floor at USD 80 per barrel for Brent Crude, above which higher cost production remains profitable. At current oil and gas price levels, we are finding many exciting opportunities, particularly in shale gas.

Brent Crude vs. HSBC Global Energy Index

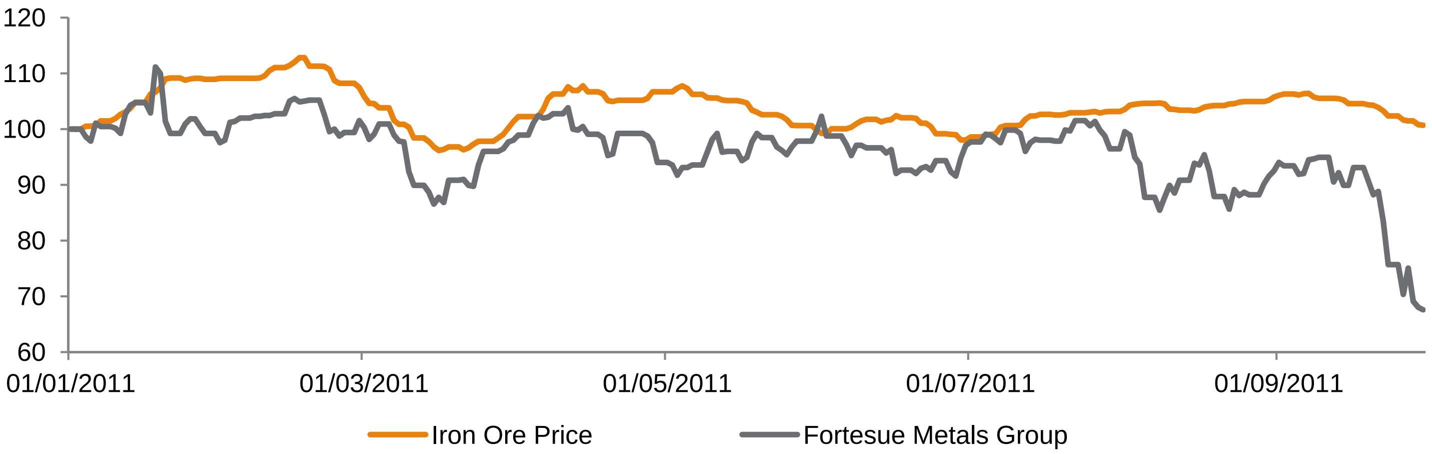


Source: Bloomberg as at 30 September 2011

Iron ore

Iron ore prices have fallen in recent weeks on concerns over Chinese demand. Major iron ore producers have seen sharp share price falls. We would expect share prices to begin to recover in anticipation of a recovery in iron ore prices towards the end of the year. Many iron ore projects are being delayed, hitting supplies and leading to higher margins for existing producers.

China Import Iron Ore vs. Fortescue Metals Group



Source: Bloomberg as at 30 September 2011

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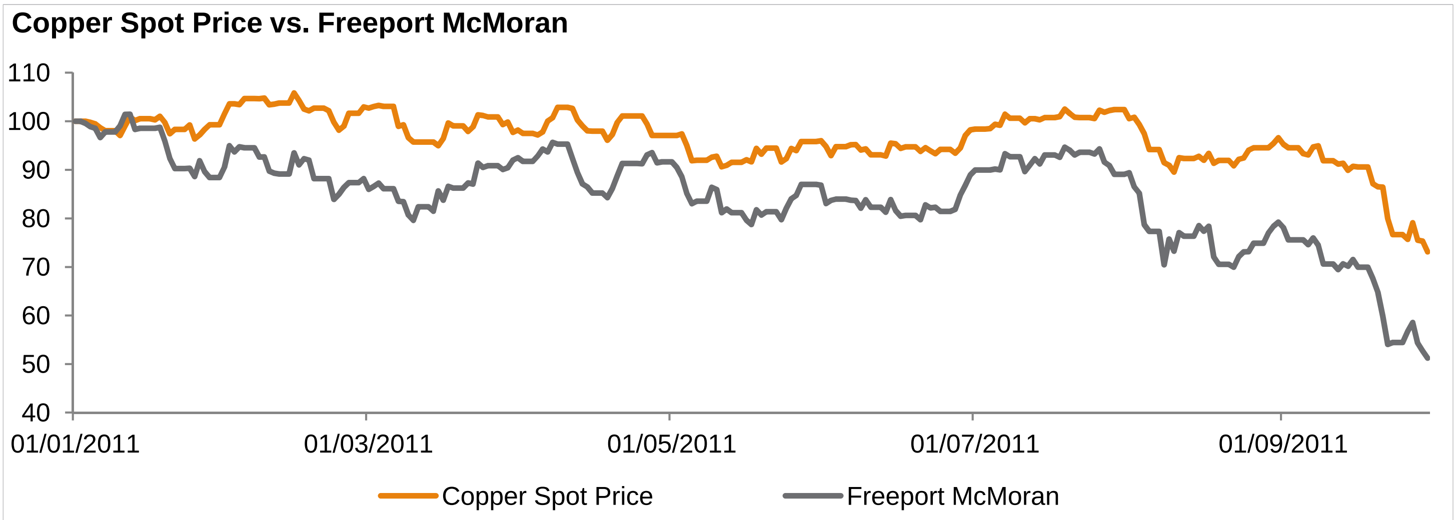
Copper

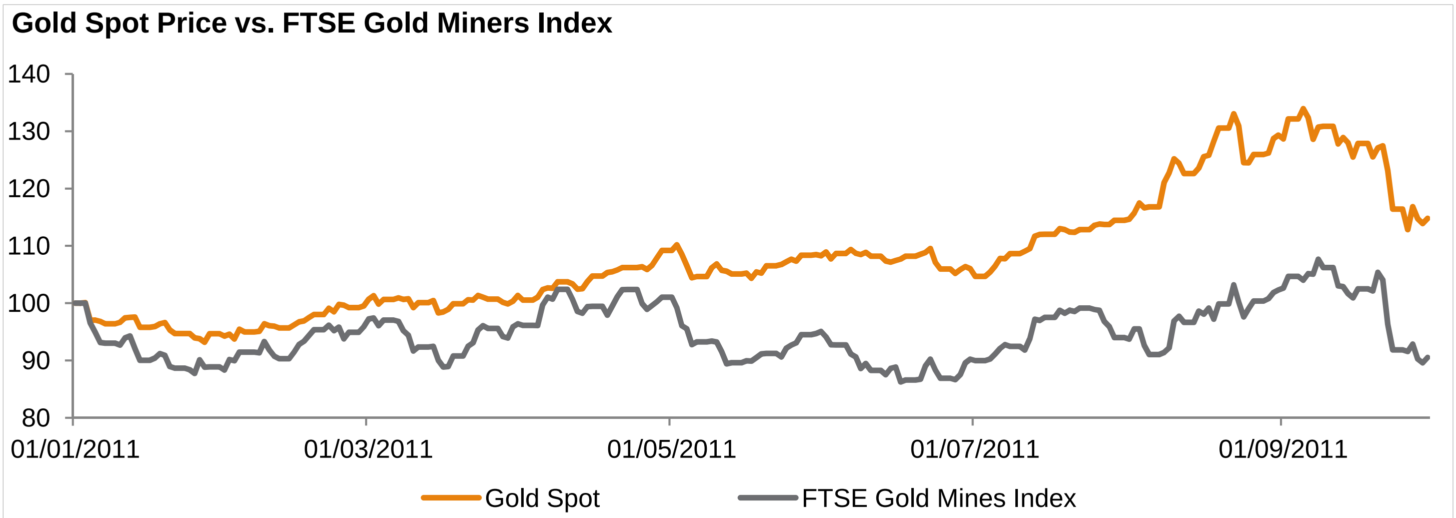
Copper prices have suffered a significant correction since the summer, down from USD 4 per pound to USD 3. Fundamentally, copper prices remain well supported given supply constraints and strong demand from China, and we would expect copper share prices to recover to reflect future demand. Chinese buyers in particularly tend to be opportunistic when prices fall. They have been destocking through the year and we would expect them to begin buying again soon. At the same time, the copper market remains tight – most of the major producers are still missing their production targets.



Source: Bloomberg as at 30 September 2011

Gold

The gold price has benefited from the global macroeconomic uncertainty, surging to record nominal highs. Given weakening currencies and worries over inflation and low interest rates, we don't see any reason why gold prices won't remain strong. However, gold equities have underperformed for much of this year and have only just re-linked to gold prices. We believe gold shares are cheap versus gold prices and offer a lot of value at current levels. We are finding many exciting investment opportunities at the junior end of the market. Junior companies identify the best deposits and can be highly profitable for investors, particularly if they attract attention from the larger producers.



Source: Bloomberg as at 30 September 2011

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Valuations are cheap and finances are strong

The natural resources sector as a whole is attractively valued, both in absolute terms and relative to historical levels. For example, Rio Tinto's market capitalisation only equals its expected cash flows from its operations over the next four years.

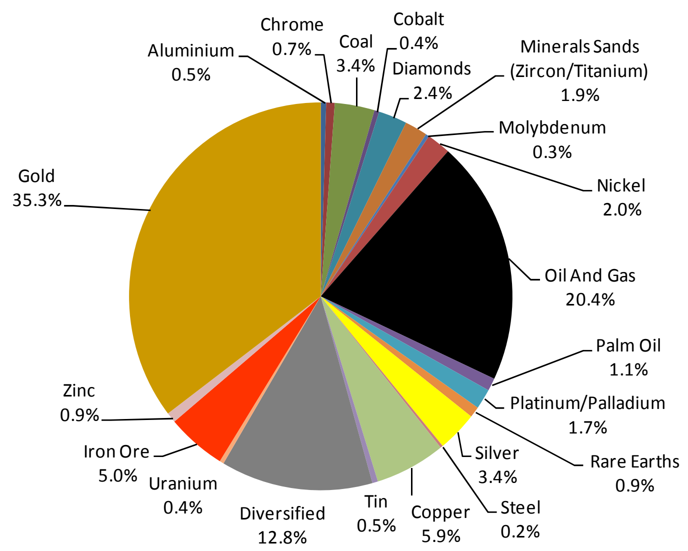
Meanwhile, contrary to the 2008 global financial crisis when many natural resources companies carried a lot of leverage on their balance sheets, finances in the sector are now much stronger. We do not envisage that companies will suffer any financial stress even in the unlikely event that commodity prices fall by another 20-30%.

Fund positioning – well diversified with a bias to gold

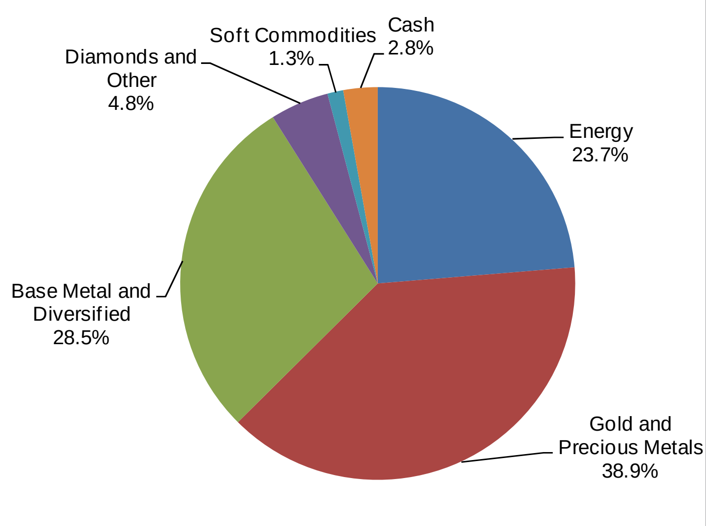
The fund is well diversified by region and commodity. We have made no large changes to asset allocation within the fund over the last few months and remain long-term investors focused on long-term returns.

Within the portfolio, we are long gold & precious metals with nearly 40% exposure in the portfolio, as we believe cheaply valued gold and silver producers offer good value as they catch up with surging gold and silver prices.

Commodity (%)



Sub-Sector (%)



Source: J.P. Morgan Asset Management as at 30 Sept 2011. Please note, allocations are subject to change at the discretion of the Portfolio manager without notice.

We have been underweight energy all year due to caution over the oil price amid rising inventories in the US. Current portfolio exposure stands at around 25%. However, we are finding some good opportunities in the sector through producers in Kurdistan and off the west coast of Africa. We also like shale gas producers and have some exposure to uranium.

In base metals, we believe copper is the well supported from a supply-demand point of view. It has the lowest level of inventories of all commodities traded on the London Metals Exchange, while Chinese production has not kept up with demand despite recent increases. Equally, the bulk commodities are attractive, providing some immunity from short term financial market volatility, and are well represented in the diversified producers (eg Xstrata for coal, Rio Tinto for iron ore). Base metals and diversified exposure is just below 30%.

Fundamental shifts in global demand are lifting the natural resources sector

Short-term market conditions have been challenging and the natural resources sector has been highly volatile, but we still firmly believe that we are in the middle of a 20-year commodities bull market. Companies continue to find it difficult to increase supply to match the incremental demand from the emerging world. China and India and other developing nations will continue to urbanise and industrialise despite debt issues in the eurozone.

The implications for the natural resources sector are only just being seen, as supply-demand imbalances intensify and lead to higher commodity prices and much stronger profits for commodity producers. These conditions look set to continue, driving a natural resources supercycle that could last for many more years to come.

Ian Henderson, *managing director*, is a portfolio manager in the Global Equities Team, based in London, and is responsible for specialist mandates. An employee since 1991, he was previously responsible for international portfolios and currently manages JPMorgan's Natural Resources Funds. Prior to joining the company, Ian spent nine years as director and chief investment officer at Wardley Investment Services International Limited. Prior to this Ian served five years as an international portfolio manager involved in business development in London and New York for Morgan Grenfell & Co. Ian began his career spending five years as an accountant with Peat Marwick Mitchell & Co. Ian holds an MA, LLB in Scots Law and Politics from Edinburgh University. ACA and FCA.

Neil Gregson, *managing director*, is a portfolio manager in the Global Equities Team based in London, and is a member of the team responsible for global natural resources mandates. Neil joined the team in September 2010 from CQS Asset Management where he was a Senior Portfolio Manager and Head of the Long-Only Business, with particular focus on the natural resources sector. Prior to this, Neil was the head of Emerging Markets at Credit Suisse Asset Management where he managed gold and resource equity funds. Neil began his career holding various positions at mining and resource companies, including a role as a mining investment analyst at South African company Gold Fields. He is a qualified mining engineer and holds a BSc in Mining Engineering from Nottingham University.

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