

Investing Plus

J.P. Morgan Asset Management's quarter newsletter for institutional clients

Welcome to the summer 2011 edition of Investing Plus - our newsletter for institutional investors, which aims to keep you up to date with the latest investment ideas and opinions from J.P. Morgan Asset Management's investment teams.

In this issue, diversified growth is in focus, as Simon Chinnery, Executive Director, UK Institutional Business, talks us through the compelling investment opportunity these strategies offer to pension plans. Simon discusses the objective of a diversified growth strategy, the drivers of returns in diversified growth portfolios and the considerations investors should make when looking to invest. Simon also presents our own product offering, the JPM Life Diversified Growth Fund.

Next up, Alex Christie from our Strategic Investment Advisory Group evaluates the role of emerging markets in a long-term portfolio. Over time emerging and developed markets have become increasingly less correlated, allowing investors to reap the benefits of differentiated sources of return.

Alex explains our proprietary analysis, which shows that a material allocation to emerging markets has the potential to boost returns and provide diversification benefits over the long term.

Developed world government bonds, for so long the staples of most bond portfolios, appear to offer little long-term value at current levels, under pressure from high inflation and rising interest rate expectations. In the third article, Nick Gartside, our international chief investment officer for global fixed income, suggests how investors can position themselves in this new bond world.

Finally, we highlight some exciting awards wins for J.P. Morgan Asset Management, which bear testament to our capabilities in

European equity research and alternative investment management.

As always, I hope you find this edition of Investing Plus relevant and interesting. If the topics discussed raise any questions, or if you would like information on any of our products and services, please do not hesitate to contact your usual J.P. Morgan representative.

For a full range of investment insights and market commentary, please visit the Commentary and Analysis section of our website:

www.jpmmorganassetmanagement.co.uk/institutional

Peter Ball

Head of UK Institutional Business

Diversified growth strategies: A compelling opportunity for all pension plans

Simon Chinnery, Executive Director, UK Institutional Business



Diversified growth funds enable pension plans to invest in a single portfolio of growth assets and alternatives, with the objective of producing attractive long-term capital growth while reducing the volatility of investing in riskier assets and maintaining a high level of liquidity.

The diversified growth sector

Diversified growth funds aim to achieve an attractive risk and liquidity profile by maintaining exposure to multiple asset classes, each with a low-to-medium correlation to one another over the long term.

Driven by their aim to produce higher long-term returns and reduce the volatility associated with equities diversified growth funds have continued to gain in popularity. However, the recent proliferation of diversified growth strategies has made picking the right manager more difficult, with different managers offering varying return targets, benchmarks and strategies.

Different approaches to diversified growth investing

Ostensibly there are three drivers of return within diversified growth portfolios: strategic asset allocation, tactical asset allocation, and investment approach/security selection. Although all diversified growth funds have similar objectives, individual managers may manage each of these return drivers differently.

Strategic asset allocation

A diversified growth fund's asset mix is usually determined by some kind of strategic asset allocation process, designed to reflect a fund manager's long-term view on risk assets.

Tactical asset allocation

Many diversified growth funds take tactical positions to allow them to dynamically increase short-term exposure to the most attractive asset classes while reducing exposure to asset classes where the investment case looks less compelling. Tactical asset allocation can vary widely in terms of the allocations to different asset classes and the concentration achieved, as well as the process used.

Investment approach/fund selection

Some funds use a passive management investment approach, while others are highly active; some use an internal fund of funds approach, while others use external funds.

The result of these differences in overall approach is a complex diversified growth sector providing a range of opportunities for pension plans. This complexity means that investors need to ensure they fully appreciate a fund's risk profile and style of management when selecting a diversified growth strategy. Pension plans therefore need to think carefully about the balance they want to achieve between volatility reduction and the ability to continue to grow their assets over the long term.

Strategy considerations

Cash plus isn't necessarily low risk

Investors looking for low risk funds should look for strategies that emphasise downside protection and aim for conservative annual returns. However, investors should note that some funds with a cash or inflation benchmark are actually able to take considerable equity risk and offer only limited downside protection.

Higher risk funds have a role to play

More aggressively positioned funds can participate more fully in the rise of global equity markets and other riskier asset classes, as they are likely to have higher exposure to risk assets. These funds can therefore be used by pension plans to complement or even replace their portfolio's existing growth assets.

Our product offering: The JPM Life Diversified Growth Fund

The JPM Life Diversified Growth Fund follows an active growth-oriented strategy and provides pension plans with access to a wide range of asset classes, including alternatives, through one simple, cost-effective, pooled solution. The fund benefits from:

- An attractive risk-return profile
Seeks equity-like returns at two thirds the volatility of global equity markets.
- Exposure to a wide range of growth asset classes
Including equities, extended fixed income, absolute return, commodities, private equity and property.

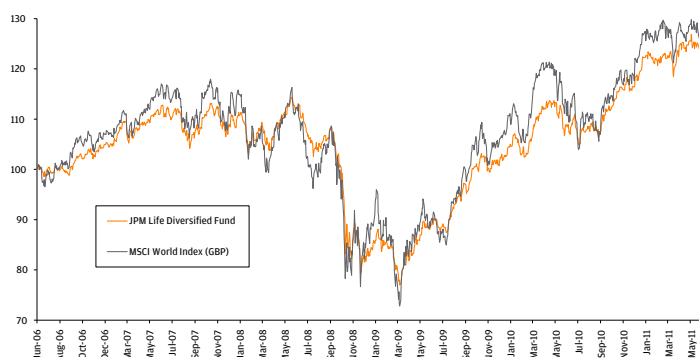


- A rigorous and disciplined investment process
Driven by asset allocation (strategic and tactical) and individual fund selection.
- A transparent approach
The fund's customised benchmark represents its strategic asset allocation and allows trustees to evaluate a fund manager's performance over the short term, while aiming for long-term growth in line with equities.

The fund has a blend of growth assets in its strategic asset allocation designed to achieve long-term growth with reduced volatility. The fund will move tactically across asset classes and will invest in different underlying investment processes and strategies as market conditions dictate.

A strong performance record with reduced volatility

The success of this highly diversified and flexible investment strategy is proven by the fund's performance record. Since inception* (in sterling terms) the fund is up 4.6% on an annualised basis compared to the 5.7% annualised gain recorded by the MSCI World Index, but volatility has been just 11.4% compared to 18.8% for the global equity market.



*Inception date 30/06/06, performance to 31 May 2011

Focus on growth assets

The fundamental building blocks of the JPM Life Diversified Growth Fund are global equities, private equity, commodities, high yield/extended fixed income, property and absolute return (including infrastructure).

Each of these growth asset classes and their strategic weights has been chosen based on the long-term risk/return assumptions of the J.P. Morgan Global Multi-Asset Group (GMAG), incorporating the views of

our Strategic Investment Advisory Group (SIAG), an experienced team of specialists in asset allocation, pension finance and risk management.

We believe our strategic allocation provides a balanced mix between long-term return expectations, liquidity and risk, with a primary focus on growth.

The flexibility to boost returns

A key aspect of the fund's success is its ability to move actively between different asset classes to reflect the short and medium-term views of GMAG. The experienced Global Strategy Team within GMAG uses both qualitative assessment and a quantitative model-driven process to generate investment views for different asset classes.

These allocation decisions within asset classes reflect our risk appetite, our views on which type of strategies will work in the prevailing market environment and provide another important source of alpha.

Fund of funds approach

The fund's allocation to each asset class is achieved through a fund of funds approach, which allows the fund to select individual strategies that offer the most appropriate mix at a particular point in the market cycle.

The majority of funds (approximately 80%) are selected internally from J.P. Morgan Asset Management's broad product palette, providing a higher level of access to portfolio management teams and fund data than is available from external funds.

JPM Life Diversified Growth Fund also has the flexibility to use external funds. We particularly use investment trusts, which can be a good way to gain access to illiquid asset classes as they offer tradable closed-ended investment vehicles. The fund can also use exchange-traded funds.

The perfect balance: Strong long-term returns with low volatility

We believe the strategy is attractive as a standalone investment for pension plans looking for higher long-term returns with a lower volatility than their equity holdings. The fund can also suit those investors looking for exposure to alternatives within a liquid structure and for those who might be looking to diversify their diversified growth exposure.



The role of emerging markets in a long-term portfolio

Alex Christie, Strategic Investment Advisory Group



Over the past decade, returns from emerging market equities and debt have compensated investors well for the higher volatility that investment in these asset classes entails. Yet many institutional investors' portfolios remain significantly underweight, with UK institutions targeting an allocation to emerging market equities of 2%¹. This compares to a market cap weighting for emerging market equities of 13.7% in the MSCI All Countries World Index, and to a contribution to global GDP growth of 47% from emerging markets in 2010.

Emerging economies account for more than 70% of the world's population and a steadily larger proportion of GDP. Fundamental shifts in inflation, tighter monetary policy and a rise in demand for commodities translate into different sources of risk and return for investors. Our analysis shows that emerging markets are decoupling from developed markets, leading to significant diversification benefits for investors.

The decoupling factor

Before the financial crisis, the theory that emerging markets were decoupling from developed markets was gaining currency. However, the spike in correlation at the height of the crisis appeared to belie this view, resulting in a loss of confidence in the diversification benefits of emerging markets. Yet our quantitative analysis suggests that investors may have written off the decoupling theory too easily.

Unconditional decoupling is undoubtedly extremely difficult to observe between regions, especially during periods of financial stress. There is evidence of decoupling between emerging and developed *economies*, since even in the turmoil of mid-2007 to mid-2009 emerging market GDP growth was consistently higher, exceeding developed economies' growth

by an average of 5%. But economic decoupling didn't necessarily translate into financial market decoupling. In the early days of the financial crisis, emerging market equities appeared somewhat impervious to movements in developed markets, but as the crisis deepened they succumbed, and fell much further than developed market equities.

However, while correlation analysis is useful in discerning short-term trends, it can disguise underlying long-term linkages that may exist, dissipate or vary between time series. We have therefore carried out an econometric measure of co-movement called co-integration analysis, which not only reveals what correlation sometimes hides, but also gauges whether two variables share a long-term, stable relationship.

Our analysis appears to corroborate the argument that emerging and global equity markets recouple during extreme global market events. The markets moved into recoupling territory in the aftermath of the Russian default crisis of 1998, as well as during the financial crisis. Barring extreme market distortions, however, there is little evidence of consistent longer-term price co-movement. In other words, there is evidence of a long-term decoupling of emerging and developed equity markets, especially in 'normal' market cycles. Co-movement analysis for emerging and developed market debt tells a similar story.

¹"European Equity Survey—How institutional investors are investing a year on from the credit crisis," J.P. Morgan Asset Management—Market Pulse, December 2009. The figure of 2% is likely to underestimate UK investors' exposure to EM as many schemes include their EM holdings in global equity portfolios.

The diverging economic drivers of emerging and developed market assets therefore do result in portfolio diversification benefits overall - an important reason to support a strategic allocation to emerging markets in a long-term portfolio.

The value added by emerging markets

The benefits that emerging market equities and debt bring to a portfolio are confirmed by our proprietary Non-Normal Market Return Model, which we employ to analyse downside risk. In addition to considering standard

deviation, which assumes a normal distribution of returns and does not measure the potential severity of negative outcomes, our model employs conditional value at risk (CVaR95), defined as the average real portfolio loss (or gain) relative to the starting portfolio in the worst five percent of scenarios, based on 10,000 scenarios.

Exhibit 1 summarises the main results of our analysis. In the first column, labelled 'current', we show the risk and return characteristics of a hypothetical starting portfolio.

Exhibit 1 | Impact of EME and EMD on a portfolio's risk and return profile

	1	2	3	4	5	6	7
Asset Allocation	Current	5% EME	10% EME	5% EMD	10% EMD	5% and 5%	10% and 10%
UK Cash	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
UK Gilts - Index-Linked	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
UK Gilts - FTSE Govt All Stocks	5.0%	5.0%	5.0%	5.0%	0.0%	5.0%	0.0%
World Government Bonds (hed)	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Emerging Markets Debt	0.0%	0.0%	0.0%	5.0%	10.0%	5.0%	10.0%
US High Yield Bonds	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
UK Agg Corporate	10.0%	10.0%	10.0%	5.0%	5.0%	5.0%	5.0%
Fixed Income	30.0%	30.0%	30.0%	30.0%	35.0%	30.0%	30.0%
UK Equity	30.0%	25.0%	20.0%	30.0%	30.0%	25.0%	20.0%
AC World ex-UK Equity	35.0%	35.0%	35.0%	35.0%	35.0%	35.0%	35.0%
Emerging Markets Equity	0.0%	5.0%	10.0%	0.0%	0.0%	5.0%	10.0%
Equity	65.0%	65.0%	65.0%	65.0%	60.0%	65.0%	65.0%
UK direct real estate	5.0%	5.0%	5.0%	5.0%	5.0%	0.0%	0.0%
Alternatives	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Total Portfolio	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Expected Arithmetic Return	7.6%	7.7%	7.8%	7.7%	7.9%	7.8%	8.2%
(improvement)	NA	1.9%	3.7%	1.9%	4.4%	3.7%	8.1%
Expected Volatility	10.6%	10.9%	11.2%	10.8%	11.1%	11.1%	11.8%
(improvement)	NA	2.8%	6.0%	2.2%	5.3%	5.1%	11.5%
CVaR95 in non-normal framework	£286	£291	£298	£283	£286	£288	£299
% change in CVAR95	NA	1.71%	4.09%	-1.12%	-0.03%	0.80%	4.48%
Return per Unit of CVaR	0.159	0.161	0.162	0.166	0.171	0.168	0.173
CVaR95 in mean variance framework	£238	£244	£252	£238	£242	£245	£257

Source: J.P. Morgan Asset Management. For illustrative purposes only

The following columns show what happens when emerging market equities and emerging market debt are included in the portfolio. Column 2 shows that when 5% of the portfolio is taken from UK equities and allocated to emerging market equities, the portfolio's expected return rises by 1.9% while the potential loss rises also by 1.71%. The return per unit of risk, however, improves from 0.159 to 0.161. As the allocation to emerging market equities increases to 10%, the portfolio's return per unit of risk rises to 0.162.

Columns 4 and 5 show the impact of a 5% and 10% allocation to emerging market debt, taken from UK Gilts and UK corporate bonds. The portfolio's expected return rises by 1.9% and 4.4% respectively, while the potential loss falls by 1.12% and 0.03%.

In all four cases, therefore, the inclusion of emerging markets - whether equities or bonds - in a portfolio tends to increase efficiency.

In columns 6 and 7, we extended this analysis and measured the impact of investing in both emerging market equities and emerging market debt in varying proportions. Our analysis illustrates that the simultaneous allocation to emerging market equities and emerging market debt increases the return per unit of risk relative to the starting portfolio. The largest improvement to the return per unit of risk in this hypothetical setup is in the

case of a 10% allocation to both emerging market equities and emerging market debt.

It is important to note that the improvement in the return per unit of risk is sensitive to the return assumptions used in the model, and to which assets are replaced with emerging market assets. Beyond a certain allocation threshold, the increase in return per unit of risk begins to diminish - a result not unique to emerging market assets. With these caveats in mind, though, we can conclude that the return per unit of risk can potentially increase when emerging market equity and debt are added to a portfolio.

Conclusion

As financial markets have stabilised after the financial crisis, emerging and developed markets have again begun to decouple, affording investors the opportunity to reap the benefits of higher expected emerging market GDP growth and differentiated sources of return. Our analysis demonstrates the value in having a defined core allocation to emerging market assets, suggesting that a material allocation to emerging market equities and debt as part of a multi-asset portfolio has the potential to boost returns and provide diversification benefits over the long term.

Strategic bond investing: Solutions for a new bond world

Nick Gartside, Chief Investment Officer, Global Fixed Income



The bond world has been turned upside down. Developed world government bonds appear to offer little long-term value at current levels, under pressure from high inflation and rising interest rate expectations. In contrast, emerging market debt and high yield bonds are increasingly the driving force behind bond returns.

Stagflation and rising interest rates present challenges for bond investors

For developed market government bond investors, the past few years of weak economic growth and low interest rates have been positive for returns. However, there are now two major risks to this benign backdrop. First, stagflation is set to undermine bond returns. Stagflation's combination of weak growth and high inflation presents one of the worst possible scenarios for bond investors, as it erodes the future value of a bond's fixed cashflows.

With inflationary pressures building, interest rates are also expected to rise gradually back to more normal levels over the coming years from their current record lows. This is also generally bad news for bond investors, leading to higher yields and falling bond prices.

On the face of it, the outlook does not look favourable for developed bond markets, which are confronted by high headline inflation and the prospect of rising interest rates. Fortunately, the global fixed income markets are broad and diverse. The key in this new bond world is to focus on the best opportunities, and to ignore the rest.

Focus on the best, ignore the rest

In the current stagflationary environment cash deposits, developed world government bonds and index linked securities no longer offer the best return potential. Record-low interest rates and rising inflation have meant the real interest rate available for cash deposits in the US, UK and eurozone is negative. As interest rates begin to rise any gains from the inflation protection element of an index-linked bond are likely to be offset by capital losses. Meanwhile, government bonds offer little value at current yield levels.

In this new bond world investors need to look at opportunities in investment grade credit, high yield and emerging markets. High yield bonds for example boast strong fundamental valuations and offer an attractive coupon, which gives good inflation protection. Also, as company default rates are falling there is the opportunity for bigger capital gains. Improving credit quality also provides good support for investment grade corporate bonds, which currently boast many attractive stock specific opportunities.

Emerging markets look increasingly appealing. Credit metrics are much more attractive in the emerging world than the developed world as lower debt-to-GDP levels and higher economic growth rates mean they have the resources to repay lenders.

A flexible, strategic bond allocation is key

To capitalise on the opportunities presented by today's complex global bond markets investors need to replace rigid bond benchmarks with cash and take a strategic view across global bond markets and sectors. By allocating flexibly, investors can position themselves wherever the greatest opportunities lie in this new bond world.

Investment tips for the new bond world:

1. **High yield** - as high yield is strongly correlated to equities any correction in equity markets may provide a buying opportunity.
2. **Investment grade** - investors should look to access the sector using a manager with strong credit analyst resources that is able to hunt out value and mitigate against default risk.
3. **Emerging markets** - as emerging markets face rising inflationary pressures, investors need to look closely at real yields to see if they are being compensated to take on inflation risk.

Awards recognition for J.P. Morgan Asset Management

J.P. Morgan Asset Management is committed to excellence across the investment spectrum. In the past quarter, this dedication to providing our clients with the highest quality products earned us accolades in two prestigious industry awards. Our European equity research capabilities were recognised in the Thomson Reuters Extel Survey, where we won top rankings for best buy-side firm and best individual buy-side analyst. And in the European Pension Awards, our expertise in alternative asset classes saw us named Alternative Investment Manager of the Year.

Another winning year in the Thomson Reuters Extel Survey

The Thomson Reuters Extel Survey is an annual survey in which the investment community assesses the leading Pan-European financial companies and professionals. This year, our European Research-Driven Process team swept the board. For a second straight year, J.P. Morgan Asset Management was voted Leading Pan-European Fund Management Firm. Furthermore, we were ranked top buy-side firm in 23 of the 33 sectors covered by the survey.

In addition, for the fifth year running, an analyst from our Research-Driven Process team was named the Leading Pan-European Fund Management Individual overall. Out of 3,952 buy-side individuals, Asif Jeevanjee took top honours this year. Last year's winner, Peter Lawrence, was placed second this year, with Peter Edwards, Francesco Sedati and Steven Ho completing an impressive J.P. Morgan Asset Management presence in the top ten.

Jorg Mitterer, who heads the European analyst team, said: "The continued recognition the team has received in the Thomson Reuters Extel Survey is testament to the hard work and insight of all our analysts. These awards underscore our commitment to supporting our funds with the highest quality fundamental research."

Best in field in alternative investment management

The European Pension Awards recognise excellence and innovation in European pension provision. In the 2011 awards, J.P. Morgan Asset Management was named Alternative Investment Manager of the Year, testament to our expertise and commitment to supporting our clients in this complex investment field.

The award is judged by a panel of experts from across the European pension sphere. In the alternatives category, the judges were looking for leadership in the provision of hedge funds, hedge funds of funds, private equity funds, commodities and other alternative investment classes. The winning manager was required to have proved itself the best of the best in the field, and to have demonstrated a strong commitment to the European pensions market with its product offerings.

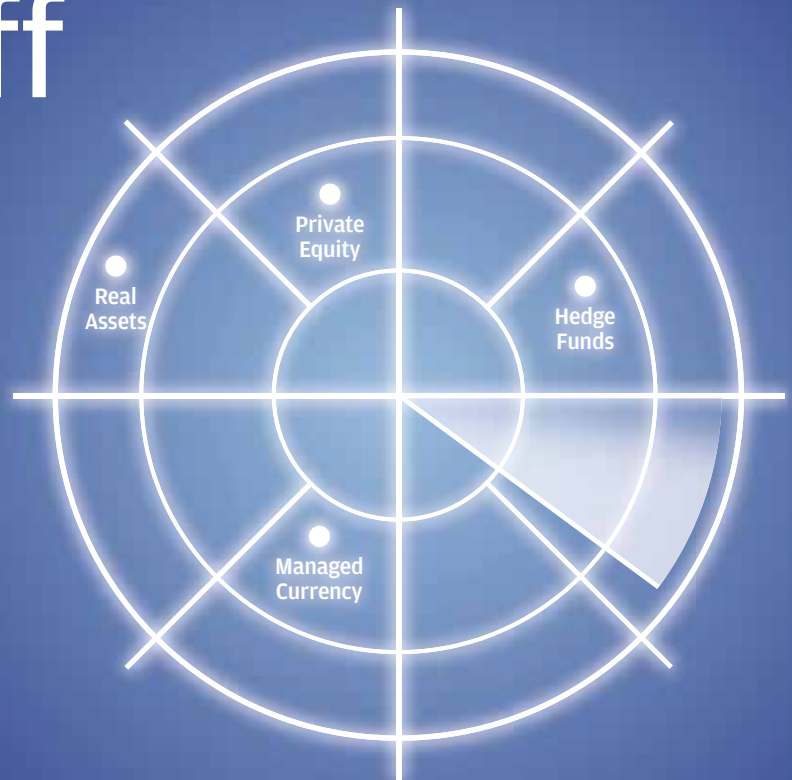
J.P. Morgan Asset Management's award entry highlighted our product innovation across the alternative investment spectrum, as well as our emphasis on client education and our involvement in industry consultations aimed at improving the provision of alternative products to pension investors.



Karen Robertson, who collected the award on behalf of J.P. Morgan Asset Management, said: 'We aim to provide pension plans with an alternative investment offering that surpasses their expectations, backed by exceptional client service. We are delighted that our achievements in this field have been recognised with this prestigious award.'



We believe in having a radar for investments that are off the radar.



Providing new opportunities in Alternative Investments.

From hedge funds to real assets, our specialist teams have the experience, knowledge, insight and tools to pinpoint alternative investments with the potential to perform.

What's more, as the popularity of alternative investments has grown, so has our range. This means we can offer a large number of compelling alternative investment solutions

to help pension schemes achieve a greater level of portfolio diversification.

To find out more, visit us online where you'll discover a breadth of insights, white papers and research documents designed to help you select the best alternative solutions to suit your needs.

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IMPORTANT INFORMATION

The value of investments and the income from them may fall as well as rise and investors may not get back the full amount invested. Investing in alternative assets involves higher risks than traditional investments and investors should consult a professional adviser prior to investing. Alternative investments have higher fees than traditional investments, may not be tax efficient and they may also be highly leveraged and engage in speculative investment techniques, which can magnify the potential for investment loss or gain. The information provided is for use by professional investors only and not for public distribution. The opinions expressed are those held by J.P. Morgan Asset Management at the time of publication and are subject to change. This material should not be considered by the recipient as a recommendation relating to the acquisition or disposal of investments. This material does not contain sufficient information to support an investment decision and investors should ensure that they obtain all available relevant information before making any investment. This advertisement is only directed to persons believed by JPMorgan Asset Management (UK) Limited to be investment professionals as defined in Article 19 of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, high net worth companies, unincorporated associations and other persons as defined in Article 49 of that Order and to others to whom it can lawfully be distributed or given, inside the United Kingdom. Issued in the UK by JPMorgan Asset Management Marketing Limited which is authorised and regulated in the UK by the Financial Services Authority. Registered in England No. 288553. Registered address: 125 London Wall, London EC2Y 5AJ.