

# Investing Plus

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

Welcome to the autumn 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.

The market has been extremely volatile since our last edition. The eurozone sovereign debt crisis has deepened and the health of the global economy also came into question. Against this uncertain backdrop, we feature three articles that can help investors position their portfolios to protect assets in times of market turbulence and grow assets when the market advances.

First, Paul Sweeting, European head of J.P. Morgan Asset Management's Strategy Group, looks at different methods of diversification that can benefit any long-term investment strategy. Paul proposes four questions a pension investor can ask their investment provider to understand how well their portfolio is positioned to cope in periods of market turbulence.

We also feature an article from Pascal Bougiatiotis of J.P. Morgan Alternative Asset Management (JPMAAM), discussing how investors can use tail hedging strategies to help protect their assets in uncertain times. Pascal also introduces JPMAAM's approach of constructing a diversified hedge portfolio with different payouts – a unique strategy that offers a number of advantages to investors.

In our last article of this edition, George Iwanicki, Macro Strategist for the Emerging Markets Equities Team, discusses the sources and implication of risk compression in emerging markets. George explains why emerging market assets, including equities, bonds and currencies, have sold off in recent months and suggests that still strong fundamentals and more attractive

valuations may represent a window of opportunity for investors.

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

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

[www.jpmorganassetmanagement.co.uk/institutional](http://www.jpmorganassetmanagement.co.uk/institutional)

**Simon Chinnery**

Executive Director, UK Institutional Business

# The world is risky, markets are uncertain: Four questions to ask your investment committee

Paul Sweeting, European Head, Strategy Group

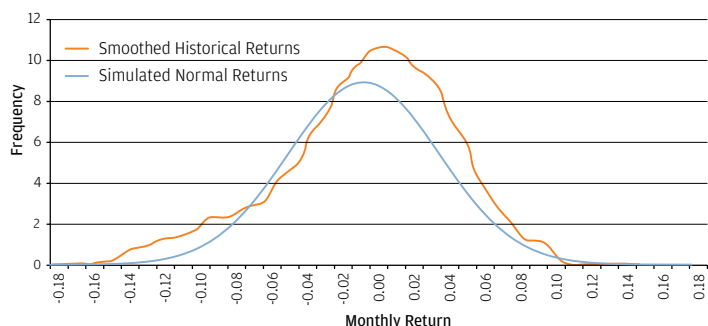


It is to be expected that the guardians of our pension funds should be working hard to identify and understand all of the risks embedded in investment portfolios. Perhaps they should also be looking for risks they can take advantage of to generate good risk-adjusted returns. To ensure that your pension fund is well-positioned for today's challenging markets, we outline four questions you should ask your investment committee.

## Question 1: Is our portfolio as diversified as we think it is?

Today's pension investors are fully aware of the benefits of diversification in mitigating risk. However, as the heavy losses at the height of the financial crisis demonstrated, portfolios are not always as well protected as investors may anticipate and the risk of extreme negative returns in many asset classes is higher than it may appear. This is, in part, because conventional asset allocation frameworks assume that returns are normally distributed, when actually, large negative returns have occurred with a significantly higher frequency than is assumed by the normal distribution (see Chart 1). This means that extreme losses such as those seen in 2002 and 2008 happen more frequently and with greater magnitude than traditional ways of measuring portfolio risk may imply.

**Chart 1 | Observed and Simulated Monthly Returns on the MSCI Index (in EUR) from 31 December 1999 to 31 July 2011**



Source: Datastream

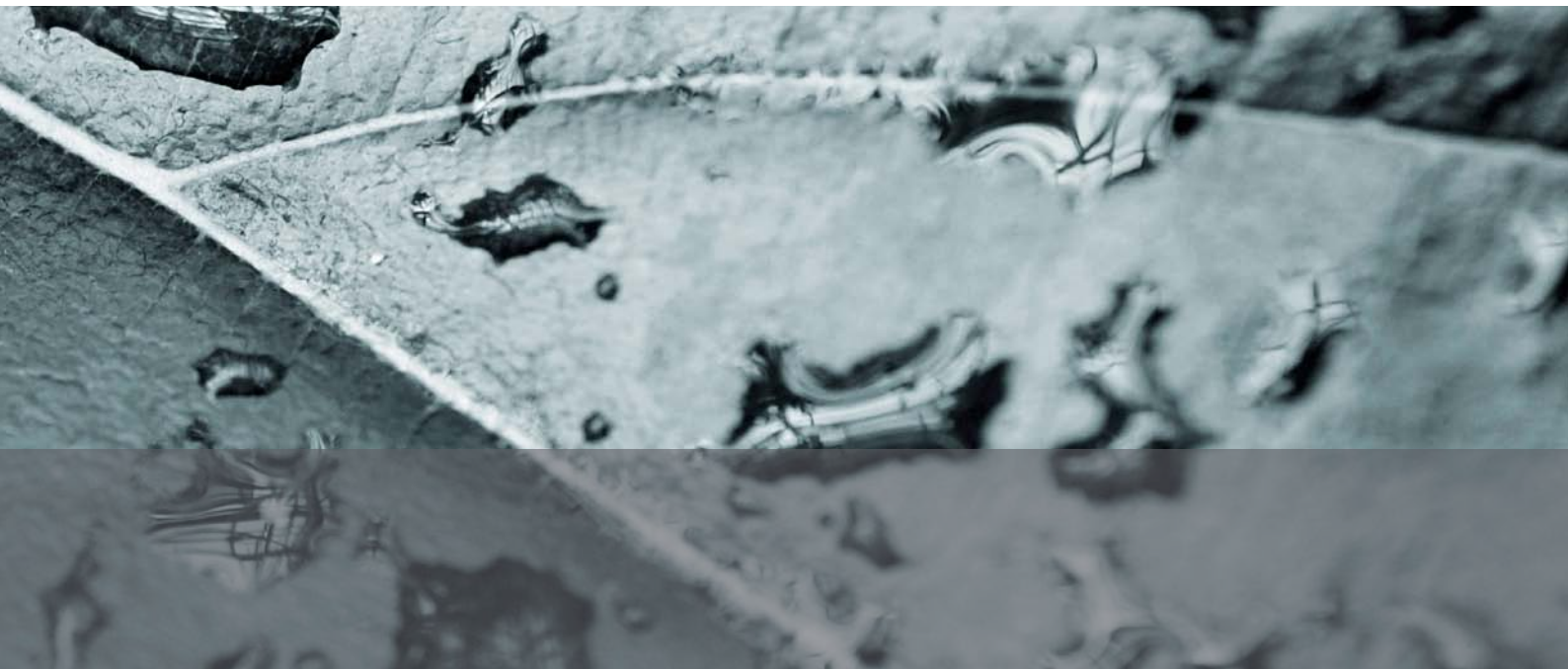
Another important factor for investment committees to bear in mind is the fact that correlations between risky asset classes tend to increase in periods of market stress. This increase in correlations happens because investors are susceptible to bouts of panic. As a result, they may sell all risk assets - not just those immediately affected by the crisis - as they scramble for safe havens.

As such, measuring the relationship between asset classes using only correlations does not provide the full picture. More accurate techniques, such as a method known as copula theory, can be used to understand the relationship between asset class returns more completely. The best way to deal with the issue, however, is to ensure that assets are truly diversified.

Within each broad asset class, it's important to ensure that returns come from as wide a range of sources as possible. For example, in equities this means considering not just global developed market equities but also emerging market equities. However, it is also important to look more widely at the sources of return. The economic drivers of equity returns also influence the credit component of corporate bond returns, while, in contrast, the drivers of returns from real estate and commodities are related, but do not necessarily operate in the same direction, so offer greater protection.

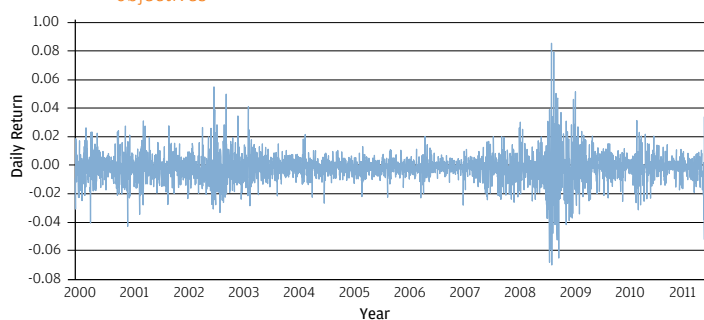
## Question 2. Are we thinking strategically, tactically or both?

The high levels of volatility in the market may make it tempting for pension fund investment committees to feel like they need to do something. In fact, we would argue that in all market conditions there is much greater merit in focusing on the long-term broad asset allocation - the strategic allocation - rather than on a short-term tactical approach.



There are two reasons why it is important to follow strategic objectives rather than trying to make significant changes now. First, while it is difficult to predict the direction in which markets will move on a day-to-day basis, it is easier to predict levels of volatility. In particular, large market movements on one day are likely to be followed by further large market movements in subsequent days - in other words, volatility clusters (See Chart 2).

**Chart 2 | Volatility provides a warning against deviation from strategic objectives**



Source: Datastream

We are currently experiencing a period of volatility clusters - in other words, there is greater volatility around the price at which you trade. A large change in asset allocation at this point could turn out to be the best decision that your investment committee ever made. It could just as easily prove to be the most costly.

The second reason not to make dramatic changes now is that a long-term investment strategy gets a pension fund from where it is to where it wants to be. It should therefore not be torn up in times of market volatility. This is not to say that a strategic allocation should be immune to significant market events. However, any amendments should be changes to the long-term strategy.

### Question 3. Are there some risks that we can take advantage of?

Given the current volatile markets and the lack of return in traditional asset classes, pension funds have strong incentives to look for other sources of return - in particular, sources that are more stable than and less correlated to equities, and with the potential to yield higher returns.

Many asset classes offer a reward for giving up liquidity. If you invest in an asset that can take time and money to liquidate, then the cost of the asset will often be lower to compensate for this fact.

For many types of investors, liquidity is an important factor - they need to know that they can realise their investment quickly should it prove necessary. Pension investors, however, have very long-term investment horizons. As a result, they are able to take advantage of the illiquidity premium offered by alternative asset classes such as infrastructure, real estate and private equity, accessing both higher potential returns and low correlations with traditional assets, and thereby improving portfolio diversification.

### Question 4. What should our immediate focus be?

Pension funds may have rushed to reconsider their asset allocations in the spectacular market falls of early August, but the real message of the current uncertain period is to avoid hasty action, focus on long-term goals, and make sure that the strategic allocation of your pension fund insulates it as well as possible from periods of volatility. What investment committees can do instead is ensure that they are well prepared for periods of market stress - this means making sure that the portfolio is truly diversified.

# Tail hedging solutions for uncertain times

Pascal Bougiatiotis, J.P. Morgan Alternative Asset Management



“Tail risk is the risk that a large move in a portfolio is greater than what is implied by traditional risk management theories.”

A number of recent market events (the credit crisis, Japan's earthquake, eurozone debt fears), have highlighted the costly impact that improbable events can have on investors' portfolios. As a result, we have recently witnessed increased demand for protection and a profusion of tail-hedging products - created to protect against downward market moves.

These products may present challenges to potential investors looking to build a hedging programme. We believe that investors should carefully understand the risk factors when they try to hedge their portfolios and consider the merits of such tail hedging techniques, taking into account considerations such as cost, timing/possibility of monetisation and possible crowding effects in tail hedges.

## Rationale for tail hedging and considerations

It is important for investors to understand the different risk factors embedded in their portfolios and the sensitivity of portfolios to different risks, such as equity, credit and rates. The traditional approach of purchasing put options on indices to protect against the occurrence of a dramatic event has some important limitations. Today there are an increasing number of investors, spooked by the global financial crisis in 2008-2009, who have flocked to options as a way to hedge the tail. This has created high demand for puts, resulting in steady price increases.

It is important for investors to understand the different characteristics of different hedging techniques available to them - such as attachment points, convexity and negative carry. Attachment points are the level at which protection starts kicking in. For example, options have different strike prices implying different levels of protection.

The convexity of a hedge is also a crucial concept for investors to grasp. Protection can either be linear or convex. In a linear protection scenario, if the market is up 10% you could reasonably expect your hedge to lose 10% and if the market is down 10% you can reasonably expect your hedge to be positive by approximately 10%. In a convex tail hedging strategy you can expect your hedge to be increasingly effective as the market sells off. For example, a selloff of 10% could generate a return of 60% and a selloff of 15% could generate a return of 150%.

Negative carry is another important consideration for investors. This is the cost associated with hedging techniques. For example, option based strategies have a negative carry which represents the time-decay of the option.

Investors should also bear in mind basis risk before engaging in a hedging programme. Basis risk is the risk of a hedge not working - the risk that offsetting investments in a hedging strategy will not experience equal price changes in opposite directions from each other. This imperfect correlation between the two investments creates the potential for excess gains or losses in a hedging strategy, thus adding risk to the position.

The alpha component of a hedging strategy is another important factor to take into account. Some hedging strategies (such as buying and selling options opportunistically and monetising these options) can offer alpha and have the potential to outperform naïve index replication.

The capital efficiency of a hedging technique is another key consideration for investors. Hedging strategies such as short selling are capital intensive, meaning investors have to deploy GBP 100 to get GBP 100 of notional exposure. Option related strategies, on the other hand, are more capital



efficient due to the implicit leverage embedded in option contracts. The more capital efficient a strategy, the less capital needs to be deployed to reach a certain level of notional exposure or protection. This reduces the cash drag on the portfolio, enabling capital to be deployed more effectively towards other, potentially higher yielding investments.

#### Our approach to active portfolio hedging

Passive tail hedging alternatives (which are transparent, but limited in scope) are available, but our approach to portfolio hedging places a premium on active strategies which:

**Utilise asset class specialists.** We believe it is generally in an investor's interest to outsource the construction of optimal hedges to experts specific to each asset class. For example, within the option arbitrage bucket we have carried out due diligence on and selected managers who have over a decade of experience not just in trading equity options, but in specifically crafting positive convex tail positions through equity options.

**Focus primarily upon equity (but also credit) sensitivity.** We tend to employ specialists who have proven experience in shorting stocks and credit managers who have a long and demonstrable experience in shorting credit. We avoid generic hedging strategies and prefer to employ managers who have expertise in their own field.

**Offer convex, including out-of-the money hedges.** We believe that combining convex and linear hedging programmes offers an attractive payout for our investors. Convex payout profiles tend to offer greater capital efficiency and protection in severe tail events, while linear hedging strategies smooth out the distribution of returns.

**Minimise basis and counterparty risk.** To minimise basis risk (i.e. the risk of a hedge failing) we have a specialised team which analyses and understands the financing arrangements of the managers with whom we invest. In today's environment of declining liquidity and rising volatility, it is particularly important for hedge fund managers to obtain financing from the strongest counterparties.

**Constant focus on capital efficiency.** Capital efficiency is often overlooked by investors. However, highly capital efficient strategies like convex and option related strategies decrease the opportunity cost of hedge allocation and enable capital to be deployed to other, higher return asset classes/ investments.

#### A solution for uncertain times

Tail hedge products are becoming increasingly popular as they lend themselves well to uncertain macroeconomic environments. At J.P. Morgan Asset Management we believe our approach of constructing a diversified hedge portfolio with different payouts is unique and offers investors a number of advantages. Our focus on capital efficient hedging techniques means that less capital is needed to achieve a given level of protection, allowing investors to seek higher performing investments and help significantly protect capital in market dislocations.

This strategy may also allow investors to take advantage of undervalued assets or hold assets that have dislocated, rather than selling them in an unfavourable market. Finally, we can help construct a client's tail hedging programme that is geared towards specific risk factors and work with them to define their most appropriate downside protection strategy.

# Risk asset compression in the broad Emerging Markets space – Sources and Implications

George Iwanicki, Macro Strategist for the Emerging Markets Equities Team



“ We remain constructive on EM fundamentals and believe the window for either accumulating or adding EM equity has now been opened. ”

## Sources

The past several trading sessions have seen sharp declines in commodity prices, widening of Credit Default Swap (CDS) spreads even in Asia, and abrupt pullbacks in several Emerging Markets (EM) currencies - not to mention additional weakness in EM equities alongside the corrections in Europe and the US.

While it may be that this broadening weakness is simply a reflection of deepening global recession fears in the developed world spreading to the EM world, we suspect that the primary source of broadening risk asset weakness to the EM space is reflective of deepening liquidity pressures emanating from the unresolved sovereign debt problems in Europe and the resulting pressures on the European financial sector.

It is striking to us that even precious metals - both traditionally and over the past few years typical 'safe havens' that find a bid when global uncertainty rises - have corrected rather than rallied during this most recent 'risk-off' episode. This suggests broad financial deleveraging and/or liquidity pressures rather than traditional recession fears as the culprit. Of course, 2008 does remind that such an episode, left unchecked, can in its own right feedback on real economies and motivate global recession. Hence the need for policy action remains, possibly including a demonstration from the ECB or the Fed to serve as liquidity provider of last resort rather than the recent mere promises to do so.

## Implications

We continue to believe that EM fundamentals remain broadly sound, and hence do not view the developments in markets as signalling broad-based EM vulnerabilities. Having said that, developments to date reveal both risks and opportunities within the asset class.

1. EM equity has now been pushed down to valuation levels that, whatever the origin motivating the decline, have traditionally represented strong buying opportunities for strategic investors. Calling bottoms is extraordinarily difficult; but identifying windows to top up allocations if more feasible, and Price/Book values of 1.5x or below represent that for EM equities. Recent price action has pushed valuations to roughly this level. We continue to believe that downward estimate revisions (in the wake of August GDP consensus estimate reductions for US and EU) will provide a momentum 'headwind' for global equity markets over the next couple of months but we are sufficiently impressed with cheap valuations that the window for topping up allocations has opened.
2. Commodities and commodity exporter currencies - we have long been skeptics on seeing another super cycle in commodities and the associated terms-of-trade boost to commodity exporter currencies. However, we have argued that the 'big reversal' of the past decade's super cycle requires one of two things to occur: either global recession or an extended USD rally. The latter still looks unlikely given the Fed's recent elaboration that 'extended period' means the next two years, the former is still not our base case even if US and Euro zone slip back into technical recession (i.e. modest negative GDP rather than the modest positive growth of recent quarters). Having said that, several of the commodity exporter currencies where we have long detected



overvaluation have begun to correct; those that also benefited from carry trades have suffered the sharpest reversals (more evidence of deleveraging). Most notable is the Brazilian Real, which has long appeared to be the richest of EM currencies by our estimates. While we defer to our FX colleagues for views on near-term direction, the magnitude of the currency headwind to long-term returns for several emerging markets has been reduced by the most recent leg of risk reduction.

3. Credit risks - We can identify instances where macro risk is evidenced by either relatively high sovereign debt/GDP (Hungary, India) or currency-mismatched private debt (CHF mortgages in Hungary, the subject of recent heterodox policy there), but we still view credit risks within the asset class as largely selective rather than systemic. Even in those instances where private credit growth boomed in response to 2008-9 stimulus (China as the biggest example), we believe that the duration of rapid credit expansion was insufficient to imply a coming credit bust that debilitates growth. Again while we defer to our EMD colleagues on specific views we are more inclined to view the widening in credit spreads within EM as largely reflective of global liquidity or risk concerns rather than a systemic credit risk within the asset class only now becoming recognized.

In sum, rather than be troubled by the broadening in correction across EM equities, currencies and credit, we remain constructive on EM fundamentals and believe the window for either accumulating or adding EM equity has now been opened by cheaper valuations alongside more fairly valued currencies.

## Upcoming webconferences

Please find below a schedule of our upcoming webconferences, allowing you to listen to the views of our investors and put your questions to them.

### November 2011

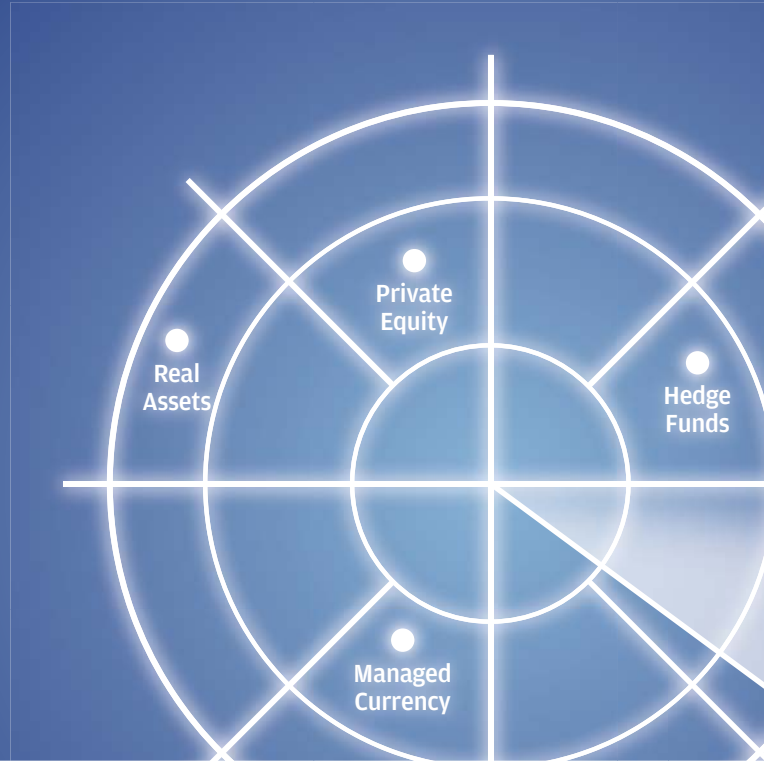
- 8 Fixed Income - Income Opportunity
- 17 Highbridge STEEP
- 24 Fixed Income - Strategic Bond
- 29 Fixed Income - EM Debt

### December 2011

- 6 Fixed Income - Income Opportunity

For more information on our upcoming webconferences or to access previous debates, please visit [www.jpmorganassetmanagement.co.uk/institutional](http://www.jpmorganassetmanagement.co.uk/institutional) or contact your usual J.P. Morgan Asset Management representative.

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