Investing Plus

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

Happy New Year and welcome to the January 2012 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 the first of our three featured articles our in-house market strategists Tom Elliott and Dan Morris look back over an eventful and challenging year for investors. Tom and Dan review the performance of equity and bond markets, in a year dominated by worries over global growth and the eurozone sovereign debt crisis. They also provide a brief overview of what we can expect from global markets in the coming year.

Our second article summarises the findings of our recent European fixed income survey. In the survey we sought to 'take the pulse' of Europe's major fixed income investors, bringing together their opinions to build a comprehensive picture of current attitudes in Europe towards the asset class. Among other things we found that European institutions are allocating, on average, 56% of their portfolios to fixed income, twice their allocation to equity.

We also feature an article by Paul Sweeting, European Head, Strategy, on 'right-risking' for pension plans. As more and more pension plans have been seeking to hedge their liabilities, we look at the methods in which they might do this and what challenges a de-risking strategy can present. Paul also looks at some alternative solutions for how to manage risk within a pension plan.

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

Simon Chinnery
Executive Director, UK Institutional Business

J.P.Morgan
Asset Management

A review of 2011 and outlook for 2012

Dan Morris and Tom Elliott, Global strategists

> "The asset classes that appear to offer the best potential returns over the next year include higher yielding fixed income, such as emerging market debt, as generous coupons, falling risk aversion and appreciating currencies all argue for positive total returns."

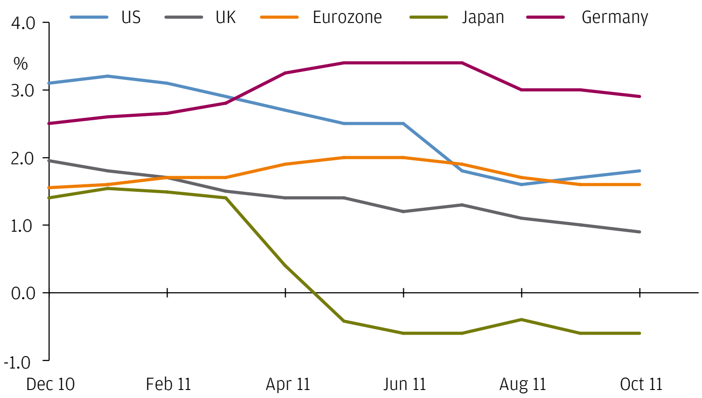
Investors have had a challenging year. With stubbornly high inflation to contend with in the eurozone, the UK and US, weak macroeconomic data and a rise in market volatility, achieving a real return on capital has been difficult. Many stock markets have suffered large falls, particularly in the eurozone and emerging markets, and yields have risen in many credit and government bond markets.

However, UK and US government bonds, surprisingly, have performed well, benefiting from an increasingly narrow definition of what constitutes a safe haven in the investment world. Far from falling in value due to worries that quantitative easing would result in runaway inflation, as some feared in January, many investors have favoured them because the UK and the US can print the money needed to repay debt, unlike the eurozone countries.

Driving the disappointing stock market returns have been weaker-than-expected economic data and a slow policy response to events in the eurozone. Global growth has been steadily revised down, from what were in any case modest initial projections (see Exhibit 1 below), while the eurozone debt crisis has got to such a level as to threaten the sustainability of the single currency. Across the Atlantic, in the US, still the world's largest economy and with one of the world's most flexible labour forces, we appear to have a serious structural - not cyclical - unemployment problem.

Furthermore, in March a tsunami and a subsequent nuclear power plant explosion severely disrupted output in Japan, the world's third largest economy. There were knock-on effects on supply chains around the world, particularly for the auto and technology sectors.

Exhibit 1 | The disappointing year...downgrades to 2011 GDP growth forecasts



Source: 2011 GDP estimates, Blue Chip, Bloomberg, J.P. Morgan Asset

These themes were the driving forces behind the fall in growth expectations seen in 2011, particularly in the second half of the year, which in turn led to a lowering of corporate earnings growth forecasts.

Behind many of the macroeconomic problems lies a weak banking sector in Europe and the US, which is still suffering from the after-effects of the collapse of Lehman Brothers in 2008, and is still struggling to rebuild balance sheets full of property-related and/or eurozone sovereign debt. The reluctance of European and US banks to lend has been a significant contributor to the disappointing growth after the initial recovery of 2009-10, with lending to small and medium sized companies (which provide the bulk of employment growth within the OECD) severely restricted.

Unsurprisingly, by sector, the weakest stocks in global markets have been financials, followed by other economically-sensitive sectors such as industrials and materials. Meanwhile, defensive sectors outperformed, with relatively slight losses from sectors such as consumer staples and healthcare. The blue-chip stocks in these sectors benefited from relatively high dividend yields (backed up by strong balance sheets) and a growing exposure to emerging market consumer demand.

Emerging market equities fell in line with developed markets, despite much more robust economic growth. The reasons were twofold: first, tighter monetary policy in the emerging markets as central banks sought to bring down inflation; and second, downgrades to GDP growth forecasts on the back of weaker growth in developed economies. Since the autumn there has also been an increasing problem in obtaining trade finance from European and US banks, as they seek to sell-off assets in emerging economies in order to help rebuild their balance sheets.

2012 Outlook

The eurozone debt crisis will almost certainly continue to reverberate in 2012. Even if a definitive solution is soon found, Europe will suffer lower growth because the economic damage that has been done. After years of lax fiscal policies, the planned cuts in debt-to-GDP ratios means a fiscal contraction of EUR 150 billion in 2012, with more to follow in subsequent years. Growth will be fortunate to reach 0.5% and the reforms required to boost economic competitiveness will take years to bear fruit. The adjustment in the UK will be similar and with global growth weak the country cannot rely on exports to offset the domestic contraction.

Outside of Europe the outlook is a bit brighter. In the run-up to the US election, both fiscal and monetary policy is likely to stay expansionary. Investors remain indulgent about the country's level of indebtedness as the Treasury market is still unrivalled in its size and liquidity. Japan will continue its recovery from the 11 March earthquake. Elsewhere in Asia, growth will inevitably slow as trade with Europe drops, but GDP expansion will still outstrip all other regions. Latin America's commodity exports to China will continue and rising internal demand will benefit Brazil and Mexico.

Severe risk aversion thanks to the eurozone crisis means that traditional safe haven assets offer little potential return. Core sovereign debt yields are well below what expected nominal GDP growth rates would suggest is reasonable. With the US economy forecasted to expand by at least 4% over the next five quarters (again, in nominal terms), ten-year yields should be much higher than their current levels around 2% (quantitative easing explains part of this divergence). Gold, traditionally a hedge against inflation, is at risk because an escalation of the eurozone crisis would likely be deflationary, and a rising dollar due to a flight to quality would also hurt gold prices.

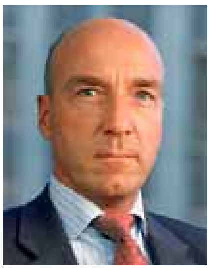
The asset classes that appear to offer the best potential returns over the next year include higher yielding fixed income, such as emerging market debt (both USD and local currency), as generous coupons, falling risk aversion and appreciating currencies all argue for positive total returns. Corporate high yield debt also looks attractive as companies generally have sufficient cash to make interest payments and current spreads suggest a much higher default rate than we think is likely. Equities should recover some of their losses from 2011 as the outlook in Europe improves and valuations are attractive, but earnings growth will be hard to come by, moderating gains. Stocks with better dividend yields should provide some additional cushion.

To keep up to date with the views and analysis on events across world financial markets from our Global Strategist, Dan Morris visit our Market Views section of our website on the following link http://www.jpmorganassetmanagement.co.uk/Institutional/CommentaryAndAnalysis/JPMorganMarketViews/

If you would also like to receive Dan's weekly Market Review and Outlook, please email chris.d.scicluna@jpmorgan.com

European views on fixed income: The J.P. Morgan Asset Management 2011 Fixed Income Survey

Simon Chinnery, Executive Director, UK Institutional Business



"In our J.P. Morgan Asset Management 2011 fixed income survey, we sought to build a comprehensive picture of current views in Europe towards on asset class that has long been the foundation of institutional investment. We conducted extensive research by online poll in May and June 2011, gathering the opinions of 166 institutional investors from across 15 European countries."

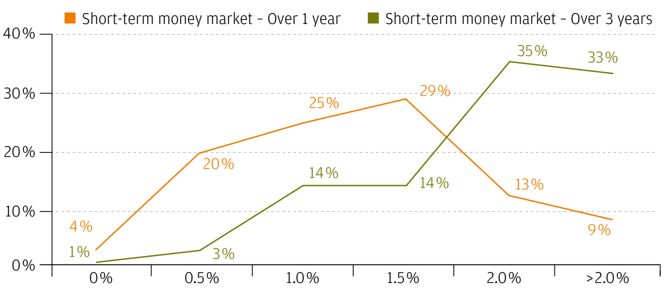
The survey assessed the returns that Europe's major fixed income investors expect to achieve from fixed income over the short and medium term; considered how much fixed income European institutions are holding - and plan to hold - given their return expectations; and, looked at the prime reasons for holding different types of fixed income and the investment approaches investors use. Plus we canvassed institutions regarding the biggest challenges they face in managing their fixed income assets.

Return expectations

As Exhibit 1 shows, expectations for return from fixed income are moderately positive with the majority of investors expecting annual nominal returns of 0-4% over three years, which may translate to flat or negative real returns in an inflationary environment.

Within core fixed income, expectations are most positive for European investment-grade corporate bonds (from which 27% of respondents expect annual returns of 4-8% over three years), and least positive for US Treasuries. Non-core fixed income classes such as global high yield and emerging market debt are expected to deliver the strongest overall performance (over half of respondents are expecting annual returns of 5-15% from emerging markets over three years, for example) and are believed to offer the greatest potential for alpha (excess return) generation.

Exhibit 1 | Return expectations for short-term money markets



Q: What are your annualised return expectations?

Asset allocation

European institutions are allocating, on average, 56% of their portfolios to fixed income, twice their allocation to equity. While these average allocations show little planned change, a deeper drilldown shows that around 30% of respondents are looking to increase their fixed income exposure by the end of 2011, while 27% aim to reduce it, albeit mostly by 5% or less in both cases.

Reflecting their solvency requirements, life insurance companies hold the highest fixed income allocation at 74%, while public pension funds hold just 42% on average. There are also significant regional differences, with French institutions holding 70% of their portfolio in fixed income compared to 37% among UK/Irish respondents. However, we see no large-scale changes in these market asset allocations in the near future.

In terms of composition, institutions are typically holding 75% of their exposure in core European sovereign and investment grade debt, while 25% of exposure is allocated to non-core fixed income segments.

Objectives for fixed income

Portfolio allocations to fixed income are primarily driven by respondents' return expectations, followed by volatility concerns and liquidity requirements.

Within core European fixed income, investment grade corporate bonds are primarily used to deliver return while lower-yielding sovereign debt has a more operative function of liquidity and duration-matching.

Conversely, reflecting the return expectations noted above, global high yield and emerging market debt are sought-after as sources of total return and yield generation.

Management of fixed income

Two-thirds of European institutions manage their fixed income on a wholly active basis. However, there is a growing minority looking to manage core assets such as domestic government bonds passively, primarily using index funds. Where active management is used, there is a growing preference for total return rather than benchmark-aware strategies, using qualitative rather than quantitative investment approaches.

Derivatives are used for a blend of risk management and return generation. While in-house use of derivatives is limited, a third or more of investors are happy for their external managers to use currency forwards, futures and swaps, and one in four allow their external managers to use credit derivatives and options.

Portfolio duration

Half of European institutions have a fixed income portfolio duration of five to ten years, and a third of respondents maintain a duration of five years or less.

Two-thirds of respondents have no plans to alter their duration, which may reflect satisfaction with current portfolio weightings or lack of market/rate visibility.

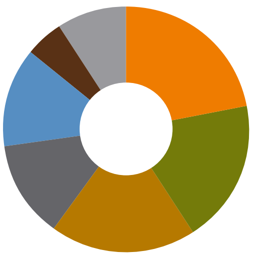
One in five institutions intends to lengthen duration, mostly by two years or less, while just one in seven intends to shorten it, typically by a year or so. Duration lengthening is being driven by a mix of regulatory, return and risk factors while those shortening duration are all doing so because of market expectations of higher rates.

Future challenges

Looking at the future challenges of managing fixed income, institutions are primarily worried about achieving the returns they need in the current low-rate environment. As Exhibit 2 shows, other major concerns are sovereign/political risk, effective means of managing portfolio risk and inflation/rising rates.

Sovereign default risk also means that many institutions feel impeded in their investment strategy, with a limited range of safe haven assets to move to. One investor sums up the uncertainty: 'Inflation/deflation, growth/no growth – it is difficult to be a long-term investor since the future is so unclear.'

Exhibit 2 | Biggest challenges for fixed income (open-ended response)



Q: What is the biggest challenge you face when you think about the performance of your fixed income investment portfolio?

An outlook on the asset class

Institutional investors are faced with an unprecedented convergence of factors affecting their fixed income strategies – including economic slowdown, inflationary pressures, low real returns and sovereign default risk.

It is therefore understandable that institutions appear to be making few major changes to their fixed income strategy. The lack of clarity in markets is also underlined by the fact that, of the 56% of investors who are looking to amend their fixed income exposure, there is a broadly equal split between those looking to decrease exposure and those looking to increase it.

We also see some interesting trends emerging: active external management is being used extensively – and increasingly – for high-alpha fixed income segments; but perhaps in a bid to manage costs in a low-return environment, a growing minority of investors are looking to passive and/or in-house management to run their domestic/European sovereign bond exposure. We also see a strong interest in European investment-grade corporate debt as a potential safe (or at least lower-risk) haven that can deliver strong returns.

While Europe continues to offer many high grade fixed income opportunities, institutions are now faced with exceptional challenges in managing fixed income in line with their risk limitations and their liability requirements.

With the notion of risk in fixed income being redefined, we believe that institutions will need to review their use of fixed income, and the core and non-core assets they choose to hold, if they are to achieve their long-term return objectives.

If you'd like a copy of the full survey report, please email chris.d.scicluna@jpmorgan.com*, or download it at* www.jpmorganassetmanagement.co.uk/institutional

Risky business: The importance of taking the right amount of risk in pension portfolios

Paul Sweeting, European Head, Strategy Group.

"More and more firms are seeking to remove risk from their pension plans. Some sponsors are de-risking in order to make members' benefits more secure as the economic environment remains uncertain. Other plan sponsors seek to hedge their liabilities through tax arbitrage opportunities, simultaneously reducing risk in their pension plans and increasing corporate levels of leverage."

However, de-risking strategies can actually end up increasing overall risks, reducing security for members by reducing the expected rate of return, and by increasing the pension plan's exposure to the firm's profitability, losing the benefit of diversified returns.
Rather than attempting to remove risk, we argue that trustees should seek to simply reduce risk in their plans to a point at which it is cost effective to do so, while remaining in line with the risk appetite of the plan.

De-risk versus right risk

As a result of escalating costs and increasing regulation, de-risking is seen as the ultimate aim for defined benefit pension plans. In extreme cases, the term 'de-risking' is taken to mean cashflow matching by designing a portfolio of fixed income securities, sometimes supplemented by swaps, so that the income received exactly matches the pensions payable. The more common result of a de-risking strategy is a portfolio of fixed income securities and derivatives that is used to mitigate the nominal and real interest rate risk present in pension plans.

However, de-risking is both difficult to achieve and often can produce undesirable results. Instead pension plans should look to right risk their portfolios, hedging interest rate and inflation risks to the extent that it is cost-effective to do so, while maintaining exposure to risks that hold the prospect of commensurate rewards, such as those available from equities, at a level in line with the risk appetite of the firm and the plan.

The reasons against de-risking

- Tax arbitrage:

  One of the main reasons pension plans de-risk is tax arbitrage. There is no tax advantage to any particular asset allocation in a pension plan, but it is advantageous to fund a company with debt rather than equity as coupon payments from a firm to its bondholders are tax-deductible. It seems to make sense therefore under a tax arbitrage plan to have the pension plan invested fully in bonds, while the firm's leverage is increased through a debt-funded share buy-back.

  Although the approach works in theory, there are issues in practice. It is impossible for a corporation to borrow at a risk-free rate of interest, therefore if the cost of borrowing is too high, the tax arbitrage disappears. Similarly, with debt issuance, if the cost of borrowing multiplied by the corporate tax rate is less than the credit spread, the arbitrage does not exist.

  Another issue with tax arbitrage is the assumption that equities in the pension fund behave exactly like the firm's own equity – the former will in fact be much more diversified. Adopting a tax arbitrage plan means accepting that the firm's shareholders will have a more concentrated exposure to the firm's underlying profitability, thus increasing the risk of insolvency.

- Member security:

  The method for de-risking also poses potential problems. If the capital structure of the firm is left unchanged, moving to a lower risk strategy in the pension plan – for example, from equities to bonds – will typically have a higher cost for the firm. If the cost is too high it might drive the firm into insolvency, which could well devastate members.

- Hedging longevity:

  As longevity has increased, the duration of liabilities has extended, making them more volatile. Falling interest rates have also meant that the impact of longevity improvements has been more keenly felt. Additional mark-to-market legislation has added not only to the cost of providing pensions, but to their volatility as well.

  Annuitisation is an option to hedge longevity risk, but it can incur a significant risk premium and the capacity of insurers to take on more longevity risk could well be reduced through regulatory requirements such as Solvency II in Europe. As a result, it makes sense for pension plans to hold onto their assets and liabilities – and not to try and match them completely with risk-free assets.

The advantages of right-risking

- Illiquidity:

  The recent liquidity crisis must make even sponsors with high credit ratings question the wisdom of issuing debt or even using cash to fill deficits – particularly since the current financial climate may make borrowing difficult for all firms over the next few years.

However, illiquidity may also be turned to a plan's advantage. Defined benefit pension funds are one of the only investors that are in a position to benefit from the illiquidity premium available from investments such as private equity holdings, infrastructure investments and direct real estate that are lumpy – that is, their large unit size makes them difficult and expensive to buy and sell. It is reasonable to expect that the price of such investments will be reduced to reflect cost and inconvenience. As such, they should be particularly attractive to investors with a very large volume of assets and a very long time horizon.

- Capital flexibility:
  To adjust corporate leverage is not free of cost. To issue or redeem bonds or shares is not in itself particularly expensive in terms of trading costs, but when the capital structure of a firm is changed, the price of the firm's securities will be affected. The price of shares will rise as they are bought back, and the cost of borrowing may also increase.

  If the pension plan is regarded as being part of the capital structure of the company, there is merit in maintaining pension plan asset allocation to alter the capital structure rather than de-risking completely. Changing the capital structure directly may involve trading in a significant proportion of a firm's capital, which can move the market, whereas buying and selling securities in a plan, where each security is likely to form only a small fraction of the total market capitalisation, will have a negligible impact on the firm's own stock price.

The smart approach to risk

The argument has been whether to keep return-producing assets or to try to exactly hedge liabilities. A plan should probably include a little of each of these aims. Return-producing assets can add value for a fund and its sponsoring company, while liability matching, although impossible to achieve an exact match, can hedge against interest rate risks.

A combination of smart diversification in the return-producing assets with appropriate interest rate hedging on the fixed income side could be thought of as right risking a portfolio, to get the most out of it for a given risk tolerance in the context of all of the risks faced by the plan and the firm. It is this, rather than de-risking, that should be the aim of pension funds.

Right-Risking Summit

Wednesday 22 February, London

Find out how to Right-Risk your scheme at our next conference, held in association with Pensions Age.

To register your attendance please email **chris.d.scicluna@jpmorgan.com** or visit **www.pensionsage.com/rightrisking**

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.

January

19 Emerging Markets Strategy

26 Fixed Income Corporate Credit

February

14 Income Opportunity

16 Fixed Income – Strategic Bond

23 Europe Equity Strategy

March

15 Fixed Income EMD

20 Income Opportunity

22 Highbridge Diversified Commodities

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

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Right-Risking Summit:

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strategies for uncertain times

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The cost of providing pensions and the risks they pose have caused many schemes to consider de-risking. But how robust are the rationales behind re-risking, what are the costs and is it possible to completely de-risk anyway? Rather than de-risking, trustees should be right-risking - removing the risks that don't benefit them, but choosing the appropriate level of rewarded risk for their pension schemes. Find out how to right-risk your scheme at this year's institutional conference in association with J.P. Morgan Asset Management.

This free event is only open to pension funds, sponsoring employers, consultants, independent trustees, pensions lawyers and actuaries and is free to attend.

Wednesday 22 February 2012, JP Morgan Conference Facilities,10 Aldermanbury, London, EC2V 7RF

FREE FOR PENSION FUNDS & CONSULTANTS

Speakers include:

Nicholas Gartside, Managing Director, J.P. Morgan Asset Management

Global Fixed Income: a portfolio hedge or a source of return?

Fixed income has traditionally been used as a hedge for liabilities. Increasingly it will be used as a source of and driver of portfolio returns. Even in a world of low interest rates and low growth global fixed income returns are likely to positively surprise investors. The real question is: 'what sort of fixed income?' Government, corporate, high yield, emerging market debt? In a trendless world portfolio managers are going to have to allocate more dynamically between the different fixed income sectors to meet client demands and aspirations and to provide investment solutions.

Louise Kooy-Henckel, Executive Director, J.P. Morgan Asset Management

Global Equity Investing: Is your investment held hostage by a benchmark?

Pension Funds often assume their global equity investment is actively managed, but in reality many are being held hostage by a benchmark. What are the risks inherent with using an index and is there a way of overcoming these shortcomings? Is there a better way of investing in global equities? Unconstrained investing can set your portfolio free.

Paul Sweeting, Managing Director, J.P. Morgan Asset Management

Theories behind de-risking:

This session will explore the theories that encourage schemes to de-risk. Does de-risking deliver the savings that it promises particularly given the current state of fixed interest markets? We will also examine the argument that actively encourages taking some risk in a pension scheme, as well as explaining why de-risking may not actually be possible.

HOW TO BOOK:

Spaces are limited so please book early to avoid disappointment.
Please complete the overleaf booking form to register for your free place, or apply online at: **www.pensionsage.com/rightrisking**

For further booking details please contact:

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Cancellation policy: Substitutions can be made at any time, for no extra charge. Due to security at the venue, we will need to be informed of the new delegate name at least 3 days prior to the event.