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2015 was a year to forget; 2016 will not be a year to forgive

Kerry Craig | JP Morgan Asset Management | 08 February 2016

Asset allocation is the key driver of returns in a portfolio and diversification is the bedrock of investing. However, neither of these factors supported investors in 2015. The year ended up being distinctly forgettable, not for a lack of memorable market events, but because there was little to differentiate the big traditional asset classes of fixed income and equities on a global scale. Any investor who followed the rules and allocated across a portfolio of equities and bonds wasn't rewarded in the way they should have been.

The global expansion will continue in 2016, but it will be another year of below trend growth. The muted economic backdrop, for Australia and the wider world, combined with relatively higher valuations mean that return expectations are lower across most asset classes. In effect, the efficient frontier has shifted lower, suggesting that investors should take less risk in portfolios.

In this new world of lower Sharpe ratios, where returns are lower relative to the risks taken, diversification remains crucial. The challenge for asset allocators is that in an environment of low returns and heightened market volatility traditional diversification strategies that are based on a mix of "safer" government bonds and equities may no longer be as effective as before.

Investors looking for opportunities to improve risk-adjusted returns in this environment may need to look at alternatives strategies and alternative asset classes, which offer the potential to access uncorrelated sources of return.

2015: SIMPLY FORGETTABLE

At the broadest level the performance of many markets in 2015 could at best be described as flat, wrapping up a forgettable year for returns. However, from a risk perspective, 2015 was anything but forgettable, with worries over Chinese growth, a dramatic slump in oil prices, the strengthening US dollar and increasing levels of credit in emerging economies all competing for investors' attention.

For a second successive year sluggish growth in emerging markets held back the global economy. With emerging market (EM) growth slowing and developed market (DM) growth holding steady, the growth gap or "growth alpha" between EM and DM economies continued to narrow over the course of 2015 (see Figure 1). The subdued aggregate growth for emerging economies has been largely the product of economic malaise in a number of key economies, including China, Brazil and Russia.

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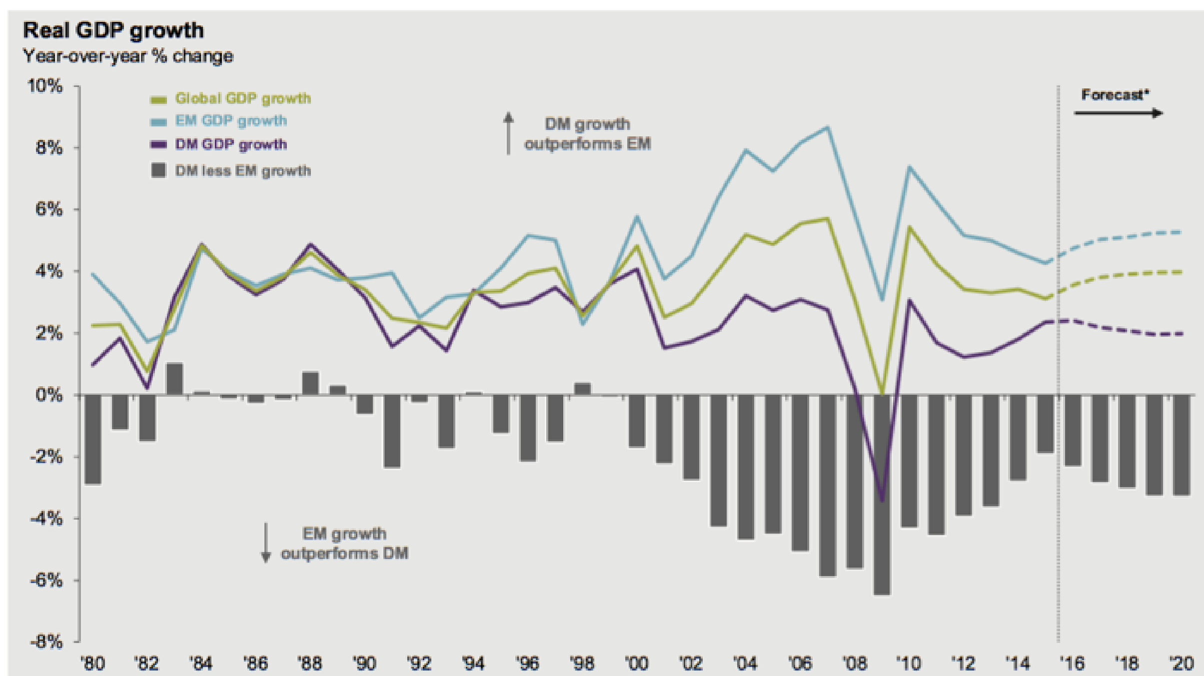
Figure 1: Developed and emerging market economic growth
The growth gap between emerging and developed markets narrowed as emerging market growth fell



Source: IMF World Economic Outlook October 2015 edition, FactSet, J.P. Morgan Asset Management. Data as of 31 January 2016.

China was a major source of market anxiety, as currency devaluations and a collapsing equity market raised serious questions over the 'real' pace of economic activity in the country. Attempts by the Chinese authorities to calm market nerves, first in August 2015 and again in January 2016, failed to have the desired effect. Instead, Chinese policy announcements were seen as a panicked reaction to an economy that was already weakening beyond the authorities' control.

The weakness in the emerging world is not limited to China. Brazilian authorities are struggling to remedy long-standing structural economic weaknesses, constrained by limited scope for manoeuvre through fiscal and monetary policy, and plagued with political scandal. Meanwhile, Russia's economy, like Brazil's, has been damaged by the sharp drop in commodity prices.

While weaker demand from emerging economies, mainly China, has contributed to the decline in commodity prices, the real driver has been oversupply across not only oil but industrial metals. Oil prices fell last year as the Organization of the Petroleum Exporting Countries (OPEC) abandoned its output quotas and effectively stopped operating as a cartel.

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Meanwhile, iron ore output continues to rise as new production is brought online. On top of these supply issues, the stronger US dollar added to the downward pressure on commodity prices.

The strengthening of the US dollar was a key feature of 2015, driven higher by a divergence in interest rates between the US and other major economies. The US Federal Reserve's (Fed's) decision to finally move away from a zero interest rate policy and raise rates in December 2015 was in sharp contrast to further policy easing in Europe and Japan. Expectations for higher US interest rates have contributed to a 19% rise in the US dollar in real trade-weighted terms since the middle of 2014 (as of 31 January 2016).

A weaker economic outlook for China and falling commodity prices create clear challenges for the Australian economy, making the acute imbalance towards resources and China all the more apparent. Despite the trials facing the Australian economy, growth has surprised many forecasters as a booming housing market has created a stronger wealth effect and when combined with a more stable labour market, resulting rising levels of consumer confidence and stronger than anticipated household consumption. Business conditions also improved last year as the weaker Australian dollar helped lift foreign earnings and change to a more business friendly government was also viewed as a positive development (Figure 2).

Figure 2: Business conditions and consumer confidence indices
Both business and consumers found reasons to be more confident

Source: Westpac, Melbourne Institute, National Australia Bank, FactSet, J.P. Morgan Asset Management. Data as of 31 January 2016.

The weaker economic environment and the fall in commodity prices put downward pressure on markets. The ASX 200, with its outsized exposure to the financials and materials sectors, fell 2.1% for the calendar year in price terms and only entered positive territory when dividends are included. Meanwhile, sovereign bond yields were largely unchanged in the year. The 10-year Australian Treasury ended 2015 just eight basis points above where it

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started. However, this masks what was a volatile year for fixed income markets and yields on the 10-year bench mark swung from a low of 2.28% to a high of 3.15%.

The overall result was that 2015 generated disappointingly modest returns for local Australian investors. This disappointment was mirrored on the global stage. 2015 was the first year since 1978 that both the S&P 500 and the Barclays Aggregate Bond Index both gained only 1% or less.

2016: MORE OF THE SAME

Although 2016 will not be a re-run of 2015, it will likely share many of the same characteristics in terms of risks and less exciting returns. Although the aggressive sell-off in global risk assets over the first weeks of 2016 suggests that the pessimism towards the global economy and heightened risks have carried over from 2015, global growth should continue its trudge back towards trend in 2016, albeit with less momentum. Meanwhile, inflation in the developed world should head back towards central bank targets.

Markets should be well supported in this environment, but the moderate growth outlook for the year ahead does mean returns for traditional asset classes are likely to be unspectacular.

Developed economies will once again drive global growth as they move along the recovery path, but EM are still in repair as the overhangs from excessive leverage are unwound. Nevertheless, for all the ills in the emerging world, growth is still expected to increase in the coming years and the contagion to the developed world will be limited as the consumer carries the global economy.

Positive real wages in Europe and the U.S. will help to spur stronger household credit growth and boost private consumption (Figure 3). The improvement in these economies provides the foundation for a sustainable moderate global growth outlook. There are also three major regions where the cost of money is virtually zero, with the European Central Bank (ECB) and the Bank of Japan continuing with their quantitative easing programmes and the Fed on course for one of the most gradual rate hiking cycles in its history.

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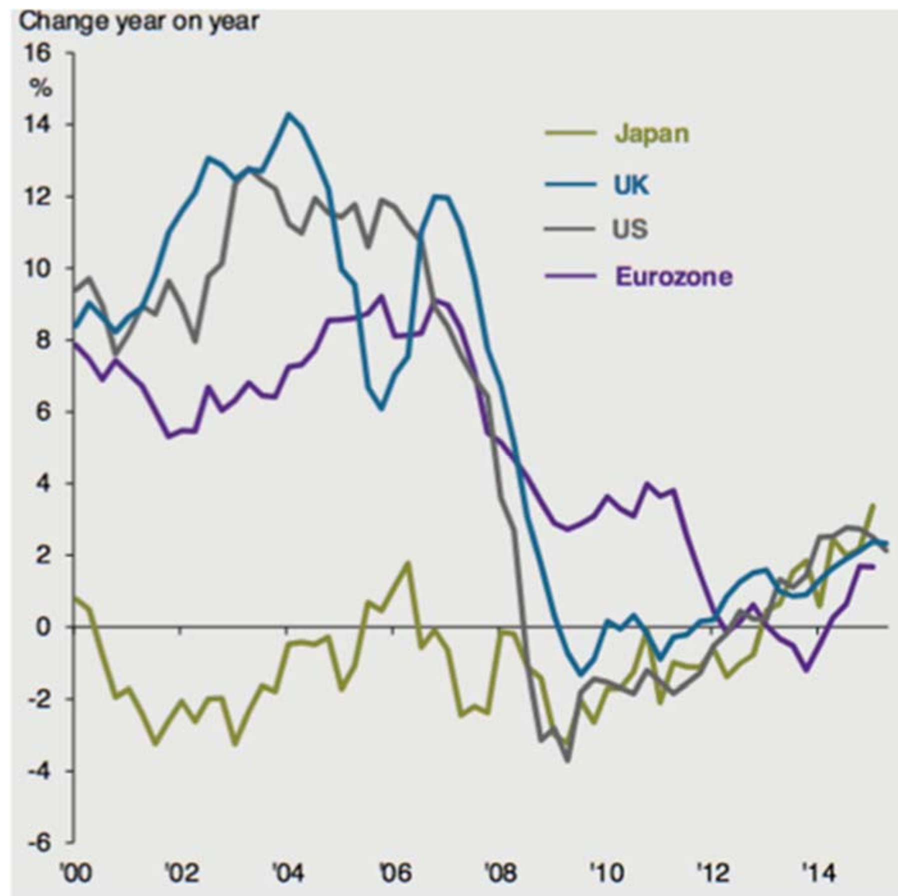
Figure 3: Household credit growth
The strength of the consumer will keep the global economy ticking over



Source: Haver Analytics, J.P. Morgan Asset Management. Data as of 31 January 2016.

AUSTRALIA: AN ECONOMY IN TRANSITION

The outlook for Australia will be heavily dependent on the condition of the global economy and international influences, such as the strength of the US dollar. But there will be heavy reverberations of 2015 and another year of underwhelming domestic economic performance should be expected. The Australian economy is moving through a multi-year transition away from resources and the continued unwinding of mining-led investment, and there is little to suggest that 2016 should be very much different as this transition progresses.

The Australian economy is finely balanced and still exposed to several shocks, both domestic and international. Business confidence needs to translate into increased investment outside of the mining sector, while a housing market that is slowing faster than anticipated could undermine the positive wealth effect and see one of the few areas of investment

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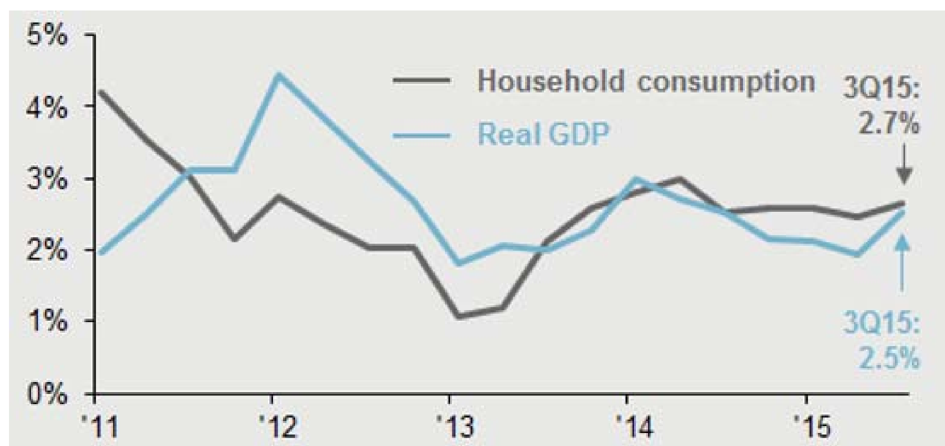
recede. Furthermore, there has been little apparent appetite for increased fiscal spending. However, just as in other developed countries consumption will become a key pillar of support.

The well documented decline in the terms of trade means that Australians are relatively worse off. Nevertheless, household consumption has risen steadily since 2013, when it slowed to 1% year-on-year, and was growing again at a 2.7% annual pace by the third quarter of 2015 (Figure 4). Real consumer spending should remain steady throughout 2016, driven by improving real income as inflation remains restrained even as wage growth is relatively weak. Furthermore, the savings rate remains elevated at 9.1% of disposable income, much higher than the 3.8% average between 1989 and 2008. The confidence and wealth effects that come from rising house prices will continue, albeit at a more moderate pace, should help with the willingness to spend.

Figure 4: Year-on-year change in household consumption
Australian households continue to spend at a steady pace



Source: ABS, FactSet, J.P. Morgan Asset Management. Data as at 31 January 2016.

This view is predicated on the continued stability in the labour market as more jobs are added in the services sectors and a cooling (rather than a collapse) in the housing market. House price appreciation has started to slow and the decline in auction rates suggests that the pace of appreciation has moved past its peak as macro-prudential policies take some of the sting out of the investor market, but housing activity is of a sufficient level to suggest a crash is not imminent (Figure 5).

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Figure 5: House prices and auction clearance rates
The housing market is cooling but unlikely to crash

Source: RPD Core Logic, J.P. Morgan Asset Management. Data as at 31 January 2016

The 19% fall in the Australian dollar on a trade weighted basis and its 32% fall against the US dollar since the start of 2013 aids competitiveness and diminishes fears of deflation in the economy as the price of imports rise (as at of 31 January 2016). The Reserve Bank of Australia (RBA) talked the economy up and the currency down throughout the second half of 2015. Further currency weakness is likely but will largely dictated by the direction or pace of appreciation of the US dollar.

A weaker currency will do some of the RBA's easing for it. Therefore, there is reason to believe that the RBA will want to defer on further rate cuts if possible. However, core inflation that is near the lower end of the RBA's target band, the risks to the global outlook and the knock on impacts to domestic economy warrant a downside bias to interest rates.

THE US: STEADY AS SHE GOES

Rising fears of a recession in the US have resulted in a lack of growth leadership for the global economy. While the risk of recession may have risen, as reflected in market pricing, there is little evidence of a sustained downturn in the economic data.

The improving labour market and falling fuel prices are boosting consumption, while the housing market is staging a late recovery. These factors should lead to slightly better economic growth in 2016 than in 2015. The economic expansion will be restricted, however, as the build-up of inventories in the second and third quarters of 2015 is unwound, capital spending in the energy sector continues to decline, and the stronger dollar hampers net

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exports. Nevertheless, on balance, there are more positives for the US economy than negatives.

Higher interest rates, while a source of market volatility, should not be too disruptive for the US economy as long as the tightening remains extremely gradual in nature. The conversation in 2016 will, therefore, move on from the frenzy around the first rate increase to tortuous analysis of the likely trajectory of rates from here.

The continued slide in the oil price and the ongoing economic ructions in China may alter the Fed's compass as both factors will have an impact on the outlook for inflation. The oil price was expected to have only a transitory impact on inflation, as even a stabilisation in prices would have created inflationary pressures due to the base effect. However, the continued drop in oil prices means the drag on headline inflation will last longer. Meanwhile, the devaluation of the Chinese yuan has effectively exported disinflationary pressures to the rest of the world.

The offsetting factor for inflation and the Fed will be the labour market. The faster-than-anticipated tightening of the labour market has not yet led to increasing wage pressures. The relationship between wages and the unemployment rate may not be linear and the upward pressure on wages as the unemployment rate falls from 5% to 4% is likely to be much stronger than when it fell from 6% to 5%. Business surveys from the National Federation of Independent Businesses (NFIB) already point to the difficulty companies are having in attracting workers with the correct skills. The risk is that eventually the tight supply of labour will drive up wages, creating more inflation than the Fed was expecting and leading to a faster pace of rate hikes.

THE EUROZONE: CYCLICAL IMPROVEMENT CONTINUES

The cyclical improvement in the eurozone continues, although the driver of growth has passed from the core economies of France and Germany to the southern economies of Italy and Spain, albeit off a very low base. Consumer and business confidence is at multi-year highs, the rate of unemployment is falling (although still above pre-crisis levels), the currency is low, austerity is no longer actively pursued and, most importantly, the ECB remains extremely supportive.

However, growth overall will not be much higher in 2016 than 2015, given the protracted progress on economic reform by each national government. The ECB's actions to drive inflation higher will only really be successful if accompanied by national level reform to correct long-run competitiveness issues. The labour market reforms that have been announced, such as the Macron Law in France or the reforms announced by the Renzi government in Italy, are steps in the right direction but the economic impact will be felt years, not months, from now (Figure 6).

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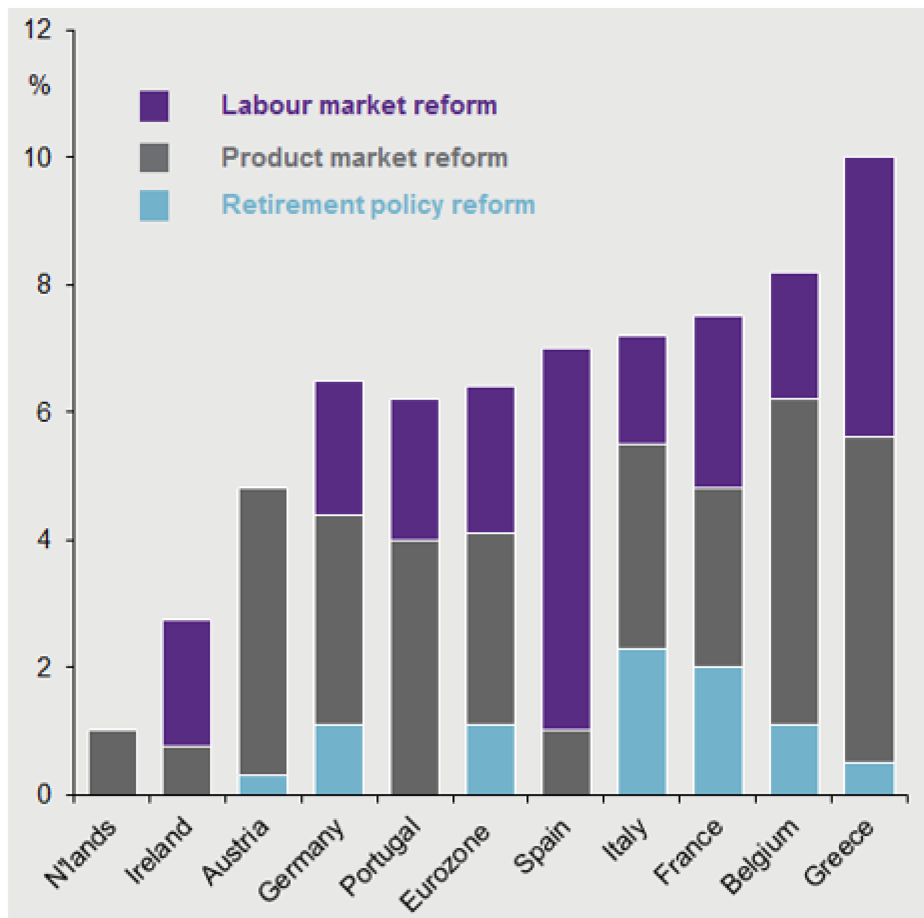
Figure 6: The potential impact on economic growth from eurozone reforms

Eurozone reforms are underway, but the impact is measured in years not months



Source: OECD J.P. Morgan Asset Management. Data as of 31 January 2016. *The size of each bar shows the effect on GDP of each policy simulated in isolation. The reform of retirement policies assumes that the ratio of working-life to life-expectancy converges towards that of Switzerland. Labour market reforms as assumed to gradually reduce the structural unemployment rate to 5% in all countries where it would otherwise be above this level. Product market reforms move each country's regulation gradually towards best practice.

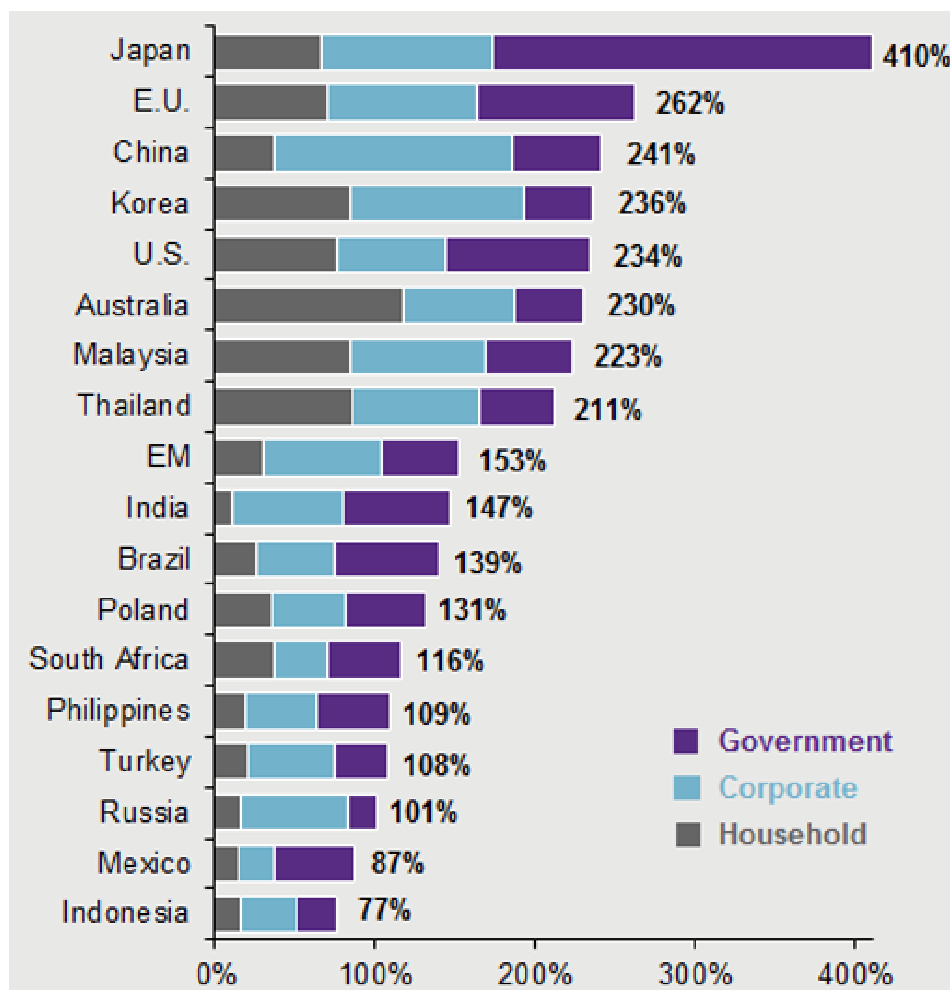
CHINA AND EMERGING MARKETS: FURTHER ADJUSTMENT NEEDED

Emerging market economies have completed another year of unwinding the excesses built up during the past decade's boom in growth and credit – however, the adjustment is far from finished.

China remains the biggest source of uncertainty for EM as the country's structural slowdown continues and the overcapacity adjustment in its manufacturing and industrial sectors continues. There is no escaping the fact that the Chinese economy is slowing, but this is very different to a collapse. The contraction so far has been centred in the manufacturing and industrial sectors, while services remain relatively healthy in comparison, which is an important factor considering the services sector accounts for more than half of the economy.

The sharp build-up in corporate debt from 115% of GDP in 2012 to nearly 160% in 2014 is a concern and has the potential to lead to trouble in the future – especially as officials grapple with the impossible trinity of free capital flows, independent monetary policy and a fixed exchange rate, which no country can control over the long run (Figure 7).

Figure 7: Total non-financial sector debt by country, % of GDP
The build-up in credit in China has been extreme but is no worse than some developed markets



Source: BIS, CEIC, Haver, UBS, J.P. Morgan Asset Management. Data as of 31 January 2016.

The overall level of debt (which includes borrowing from the corporate, household, and government sectors) stands at 240% of GDP, which is similar to levels in the US (234%) and Europe (262%). The lower share of China's overall debt held by the household and government sectors means that the Chinese government can take on more debt, just as the US and UK did after the financial crisis, if needed. For now, Chinese officials maintain enough policy flexibility – both monetary and fiscal – to manage the economy in the near term.

ASSET ALLOCATION IS ABOUT MEASURING AND MANAGING INVESTMENT RISK

Overall, the macroeconomic backdrop is supportive of risk assets, although uninspiring because of the still elevated risks and the excesses in the economy that impede growth. It's essential that investors have the right tools to navigate this new and challenging market environment.

There have been several years of strong returns for Australian and global equity markets since the financial crisis. The expectation of higher returns (and negative returns) can easily become imbedded in investors' psyche, but they shouldn't, as markets rarely move only in one direction for long.

The biggest determinant of market behaviour is the business cycle. Early in the business cycle markets are still depressed, valuations on risk assets more attractive and there is more upside to markets as corporates experience stronger revenues and earnings to support prices. However, the further along the business cycle the more modest the return expectations should be, as earnings growth may slow and valuations are not as attractive.

Later in the cycle, portfolio diversification becomes more important and there is less of a cushion for making the wrong investment decisions. This puts greater emphasis on the need for diversification of investment risk across a portfolio. Asset allocation, at its core, is about measuring and managing investment risk.

THE PAST AS A GUIDE TO ASSET CLASS PERFORMANCE

A basic balanced portfolio that allocates with a 60:40 split between equities and fixed income (shown as "port" in Figure 8) provides a return that usually ends up in the middle of the returns available from the major assets classes. Over a 15-year time horizon, the portfolio produced an annualised return of 7.5% with lower volatility than a simple 100% allocation to Australian equities. The portfolio also outranks cash, except in 2008 (the global financial crisis), 2011 (the eurozone sovereign debt crisis) and 2015 (worries over China and emerging markets).

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Figure 8: Asset class returns over the last 15 years
Diversification works in the long run, but allocations may have to change

																15-years '01 - '15	
2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	4Q15	Ann.	Vol.
Aus. Equity 10.4%	Global FI 16.5%	EM equity 46.7%	REITS 28.0%	EM equity 35.8%	EM equity 28.8%	EM equity 33.6%	Aus. FI 14.9%	EM equity 62.8%	REITS 28.8%	Aus. FI 11.4%	REITS 26.7%	DM equity 29.9%	REITS 32.0%	REITS 11.5%	REITS 7.3%	EM equity 10.2%	EM equity 18.1%
EM equity 7.9%	Aus. FI 8.8%	DM equity 25.8%	Aus. Equity 28.0%	REITS 32.9%	REITS 27.3%	Aus. Equity 16.1%	Cash 7.6%	Aus. Equity 37.0%	EM equity 14.4%	Global FI 5.6%	Aus. Equity 20.3%	Aus. Equity 20.2%	DM equity 10.6%	DM equity 2.7%	Aus. Equity 6.5%	REITS 8.2%	REITS 17.0%
Aus. FI 5.5%	Cash 4.8%	REITS 17.1%	EM equity 16.4%	Aus. Equity 22.8%	Aus. Equity 24.2%	Global FI 9.5%	Global FI 4.8%	REITS 34.0%	DM equity 11.0%	Cash 5.0%	EM equity 17.4%	Port. 10.3%	Aus. FI 9.8%	Aus. FI 2.6%	DM equity 6.3%	Aus. Equity 7.9%	DM equity 14.5%
Cash 5.3%	Port. -3.8%	Port. 16.2%	Port. 16.1%	Port. 16.3%	DM equity 15.9%	Port. 8.7%	Port. -19.8%	DM equity 26.1%	Port. 8.7%	Port. -1.2%	DM equity 16.2%	EM equity 3.8%	Port. 9.4%	Aus. Equity 2.6%	Port. 3.3%	Port. 7.5%	Aus. Equity 13.1%
Port. 3.3%	EM equity -7.1%	Aus. Equity 14.6%	DM equity 11.5%	DM equity 16.1%	Port. 15.8%	Cash 6.8%	DM equity -38.4%	Port. 24.2%	Aus. FI 6.0%	REITS -2.7%	Port. 14.5%	Cash 2.9%	Aus. Equity 5.6%	Cash 2.3%	EM equity 1.6%	Aus. FI 6.1%	Port. 10.3%
REITS 2.9%	Aus. Equity -8.8%	Global FI 12.5%	Global FI 9.3%	Aus. FI 5.8%	Global FI 6.6%	DM equity 4.9%	Aus. Equity -38.4%	Global FI 6.9%	Global FI 5.5%	DM equity -4.7%	Aus. FI 7.7%	Aus. FI 2.0%	EM equity 5.6%	Port. 2.1%	Cash 0.5%	Cash 4.8%	Global FI 5.7%
Global FI 1.6%	REITS -13.5%	Cash 4.9%	Aus. FI 7.0%	Cash 5.7%	Cash 6.0%	Aus. FI 3.5%	REITS -45.0%	Cash 3.5%	Cash 4.7%	Aus. Equity -10.5%	Global FI 4.3%	REITS -0.1%	Cash 2.7%	Global FI -3.2%	Aus. FI -0.2%	Global FI 4.8%	Aus. FI 2.9%
DM equity -14.2%	DM equity -24.0%	Aus. FI 3.0%	Cash 5.6%	Global FI -4.5%	Aus. FI 3.1%	REITS -16.1%	EM equity -45.7%	Aus. FI 1.7%	Aus. Equity 1.6%	EM equity -12.5%	Cash 4.0%	Global FI -2.6%	Global FI 0.6%	EM equity -5.4%	Global FI -0.9%	DM equity 4.1%	Cash 0.4%

Sources: Bloomberg, MSCI, Standard & Poor's, J.P. Morgan Securities, FTSE, FactSet, J.P. Morgan Asset Management. Annualised return (Ann.) and volatility (Vol.) covers the period 2001 to 2015. EM equity: MSCI Emerging Markets; Aus. FI: Bloomberg AusBond Composite (0+Y); Global FI: Barclays Global Aggregate; DM equity: MSCI World ex-Australia; Aus. equity: ASX 200 Index; REITs: FTSE EPRA/NAREIT Developed; Cash: Bloomberg AusBond Bank Bill Index. Port. is hypothetical portfolio (for illustration purposes only and shouldn't be taken as a recommendation): 15% DM equities; 10% EM equities; 25% Australian equities; 25% Australian FI; 10% Global FI; 5% Cash and 10% REITs. Returns are unhedged in currency reported by the index. Data as of 31 December 2015.

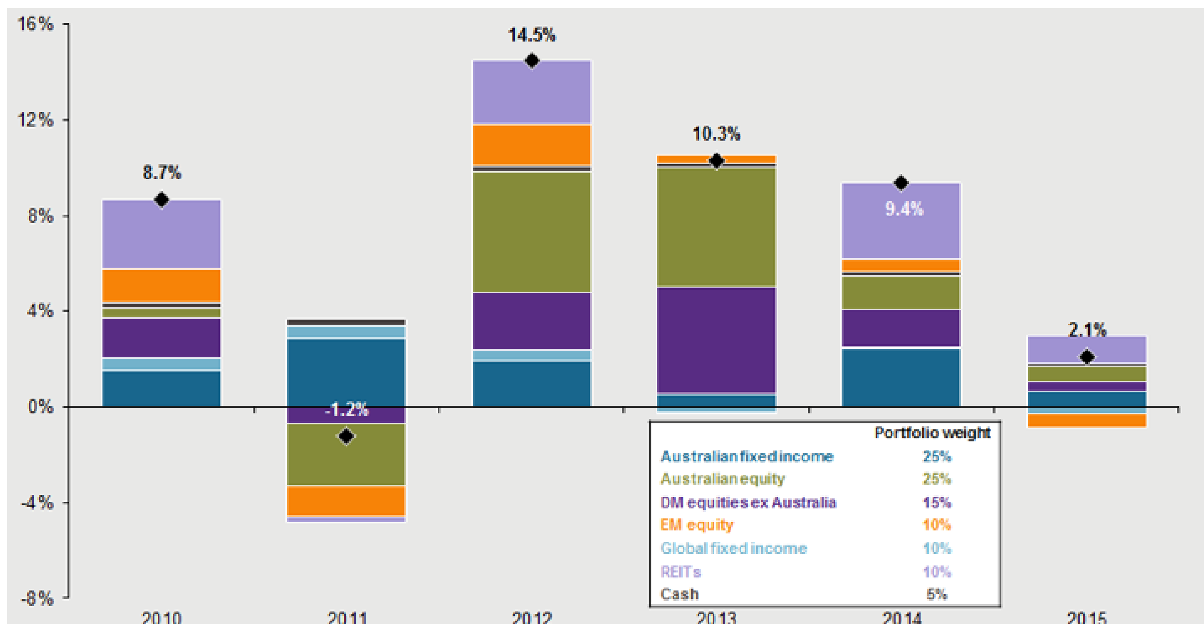
While this rather simplistic portfolio has been able to deliver what could be considered a healthy risk-return balance and has outperformed cash in the long run, the portfolio faces some shortcomings. These have become more prevalent in the last few years, with this hypothetical portfolio producing lower returns each year since 2012.

The portfolio is rebalanced each calendar year to keep the weightings within each asset class constant. Rebalancing a portfolio ensures that risk is evenly distributed and the defensive or protective elements provide sufficient cover. Rebalancing itself is a difficult thing for many investors to undertake, as it often means selling what has done the best and buying more of what has performed the worst.

As the allocation to each asset within the portfolio has remained static, some of the allocation that drove performance in the earlier years has now become a detractor.

To illustrate the contribution from individual asset classes to the hypothetical portfolio, Figure 9 shows the returns in proportion to their portfolio weight between 2010 and 2015. The return from Australian equities has declined since 2013, as the market has become increasingly expensive, while Australian fixed income has delivered varying but positive returns. However, perhaps the most notable change is the narrowing in the range of return that occurred in 2015 compared to previous years.

Figure 9: Return contribution, total returns in local currency
The contribution to portfolio performance has varied over time



Source: Bloomberg, MSCI, Standard & Poor's, J.P. Morgan Securities, FTSE, FactSet, J.P. Morgan Asset Management. EM equity: MSCI Emerging Markets; Australian fixed income: Bloomberg AusBond Composite (0+Y); Global fixed income: Barclays Global Aggregate; DM equities ex Australia: MSCI World ex-Australia; Australian equity: ASX 200 Index; REITs: FTSE EPRA/NAREIT Developed; Cash: Bloomberg AusBond Bank Bill Index. Returns are unhedged in currency reported by the index. Data as of 31 December 2015.

Aggressive easing by central banks globally has driven yields on sovereign bonds to record lows, forcing prices higher. Today, instead of generating a return from both the appreciation in the price of the bond and the coupon, the main source of future return is likely to be from

the coupon alone. Nonetheless, defensive assets, such as sovereign bonds, are a very necessary addition to any diversified portfolio.

The last few years have been challenging for EM equities. As mentioned, a strong US dollar has been a prevalent headwind, and is likely to continue to present challenges for emerging economies for some time to come. However, low commodity prices and a weak earnings outlook have completed the trifecta of downside risks for emerging equities.

A lot of the bad news may be in the price and therefore may also be reflected in the multi-year valuation at the broad index level. But valuation may not be enough. For investor sentiment towards EM equities to turn positive, one or more of the following three scenarios would be required: first, the dollar would have to stabilise; second, commodity prices will need to stop falling; and, third the Chinese authorities would need to once again regain an air of control over China's markets and economy. At some point, these factors will once again point in the right direction, but there is little visibility on when this will be.

A MORE DYNAMIC ASSET ALLOCATION APPROACH

With the prospects for higher market volatility in 2016, diversification is a crucial element in maintaining portfolio returns. It will be difficult to achieve the same risk-reward balance by maintaining the same asset allocation and asset weights as in prior years.

Return expectations are expected to shift down in future, reflecting weaker growth and higher valuations across asset classes (Figure 10). Investors will need to carefully think through asset allocation decisions to achieve the returns that they will need to meet their specific goals.[1]

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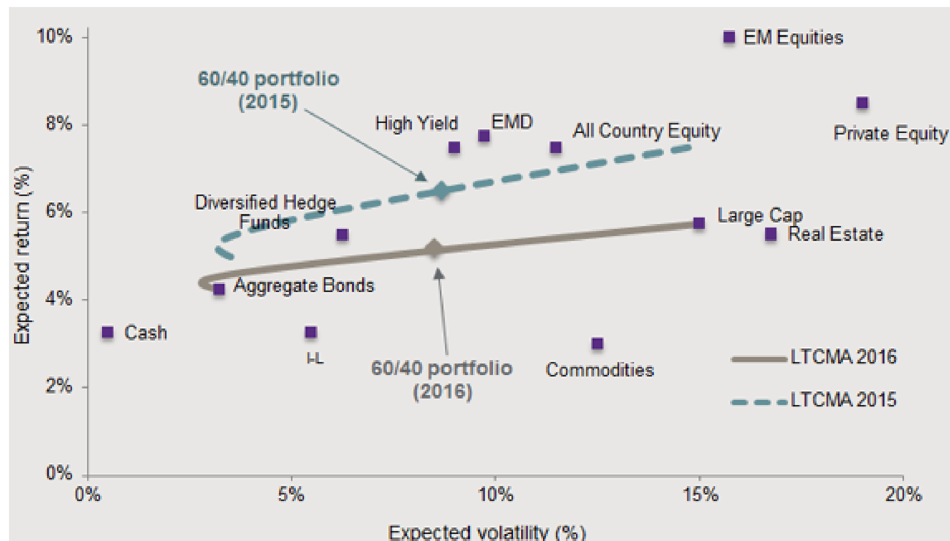
Figure 10: Efficient frontiers and 60:40 portfolios in Australian dollars
The efficient frontier has moved down



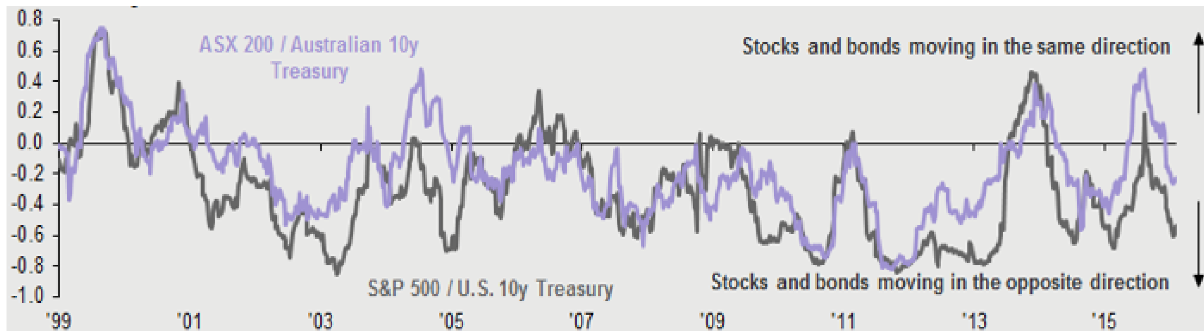
Source: J.P. Morgan Asset Management. Data as at 30 September 2015. Note: This is a projection used for illustrative purposes only and does not represent investment in any particular. References to future returns are not promises or even estimates of actual returns you may experience. Past performance is not guarantee of future results. It is not possible to directly invest in an index.

The more robust growth underpinning advanced economies should make developed market equities a better source of returns within any equity allocation, especially when compared to the rich valuations in government bonds. However, while the returns on sovereign bonds are expected to be lower, the relatively low level of volatility that they offer remains a valuable attribute in asset allocation.

Crucially, the static asset allocation of prior years should not be expected to deliver a consistently higher return. It is important to recognise that the benefits of diversification will change depending on market conditions and time frame.

History shows us that over long time periods, bond and equity returns should move in opposite directions or be uncorrelated. It is that negative correlation that allows for the effective implementation of simple diversification strategies that mix bonds and equities. But in times of heightened market stress, which is the time when investors need diversification the most, the correlation of diversifying assets can temporarily deviate from longer-term trends and the uncorrelated can become correlated (Figure 11).

Figure 11: Correlations of equities and bonds, six-month rolling correlations
Correlations between broad asset classes can temporarily deviate from historical norms



Source: Standard & Poor's, Tullet Prebon, FactSet, J.P. Morgan Asset Management. Data as of 31 January 2016. .

INVESTMENT IMPLICATIONS: BEWARE OF BETA AND CONSIDER ALTERNATIVES

High returns are good, but stable returns are more desirable. Investment principles teach us that slightly lower but less volatile returns are preferred to high but unpredictable gains. As the likely returns available from traditional assets diminish, investors should focus even more on achieving returns without volatile swings in portfolio performance.

Investors should retain a modest overweight to riskier assets as the global economy continues to gradually improve. However, it's important to acknowledge the risks to markets in the later stages of the business cycle.

With volatility increasing, investors should consider the size of their broad market, or beta, exposure. Lowering beta may be the best way to reduce volatility concerns.

From the perspective of portfolio construction, investors should remain disciplined in maintaining a well-diversified portfolio across a range of asset classes. However, a rise in market volatility could temporarily upset the traditional correlation between fixed income and equities, reducing the effectiveness of conventional diversification. Because of this effect, portfolio allocations should not only include traditional asset classes, but also alternative strategies.

Hedge fund style strategies, for example, have the capacity to make money in different market environments by taking advantage of return opportunities that have low or negative correlations with each other. However, manager selection can be crucial in determining the performance of allocations to alternatives.

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Multi-asset hedge fund style strategies with a "go-anywhere" approach benefit from this wider tool kit and also from the opportunity to invest in more asset classes than traditional funds. These unconstrained strategies can express their positive, negative or relative market and macroeconomic views across equity, bond, currency and commodity markets.

Therefore, while diversification remains the bedrock of asset allocation, a more dynamic allocation may help provide investors with a better risk-reward trade-off than prior years given the modest global economic backdrop.

ENDNOTES

1. 2016 Long-term capital market assumptions, J.P. Morgan Asset Management.

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Kerry Craig is Global Market Strategist with JP Morgan Asset Management. Based in Melbourne, Kerry is responsible for communicating the latest market and economic views from JP Morgan's Global Market Insights Strategy Team. Prior to joining J.P. Morgan, Kerry worked in the UK pensions industry and also held several economic research positions in the New Zealand government.