

JPMorgan Hedged Equity Fund Class I JHEQX

Analysis

A solid, systematic option.

By Erol Alitovski 9/19/2019

JPMorgan Hedged Equity offers a straight-forward, systematic process that should provide investors a predictable stream of attractive risk-adjusted returns over the long term. An experienced management team and competitive fees solidify our confidence in the fund. It continues to earn a Morningstar Analyst Rating of Silver.

The fund strives to provide smoother equity returns by tempering downside and upside returns via a systematically implemented options strategy. At the start of every quarter, management purchases put options 5% below the S&P 500's value. To offset the cost of the put option, management first sells put options 20% out-of-the-money. This structure should generally protect the fund from quarterly losses in the 5%-20% range; if markets fall less than 5%, the fund should fall in line with the market, and if the market falls more than 20%, the fund should incur the same incremental losses beyond negative 5%. Selling the deep-out-of-the-money put only recoups some of the cost of the long put option position, so management also sells call options to make up the difference. The call options tend to be 3.5%-5% above the S&P 500's value at the start of the quarter, depending on the amount of income the fund needs to pay for the rest of the put option.

The systematic implementation removes elements of market-timing and increases the chances of the fund performing within expectations like in the fourth quarter of 2018 and the first quarter of 2019. In the former period, the fund's losses were limited to 5.4% compared with 13.5% for the S&P 500. During the following quarter, the S&P 500 rallied 13.7% and the fund gained 4.0%.

Hamilton Reiner has designed a robust strategy based on his long experience trading options. He is supported by co-portfolio manager Raffaele Zingone and a deep bench of 25 JPMorgan equity analysts charged with implementing the low-tracking-error equity portfolio the options are built

around. Fees are competitive, at 0.60% for its institutionally distributed shares, a discount to the 1.14% for the options-based Morningstar Category median for institutional shares.

Process Pillar: Positive

The fund's well-thought-out and systematic approach to trading options is repeatable and should produce predictable results. It earns a Positive Process rating.

Management aims to damp the volatility of its underlying equity portfolio by purchasing 5% out-of-the-money puts and selling 20% out-of-the-money puts to help pay for the cost of the purchased put option. This structure is designed to protect capital when markets sell off 5%-20% in a given quarter. Since the short option position is so far out of the money, management also sells a call option to cover the price of the long put position. The call options are usually sold 3.5%-5.5% out of the money, depending on the amount of income needed to cover the cost of the long put. If the S&P 500 price level surpasses the call option strike at the end of the quarter, upside returns will be capped at wherever the strike was set to start. The options trades are systematic, removing elements of market-timing, thus limiting the potential for unintended consequences that can arise when trading options more actively.

Management aims to generate a small level of alpha in the equity portfolio by slightly overweighting attractively priced stocks and slightly underweighting expensive stocks based on fundamental analysis. Since the constitution of the equity portfolio closely replicates the S&P 500, the use of the index options is not problematic from a hedging perspective.

The fund's core long equity portfolio should track the S&P 500 closely as it constrains tracking error to 1.5% annually. It aims to outperform that index by tweaking the individual stock exposure within a 1-percentage-point range, using a dividend discount model that ranks stocks from most attractive to least attractive based on forecast earnings and company-specific growth catalysts. The result-

Morningstar's Take

Morningstar Analyst Rating



Morningstar Pillars

Process	 Positive
Performance	 Positive
People	 Positive
Parent	 Positive
Price	 Positive

Morningstar Analyst Rating

Morningstar evaluates mutual funds based on five key pillars, which its analysts believe lead to funds that are more likely to outperform over the long term on a risk-adjusted basis.

Analyst Rating Spectrum

 Gold  Silver  Bronze **Neutral**  Negative

Fund Performance

	Total Return %	+/- Category
YTD	9.45	-1.09
2018	-0.71	4.80
2017	12.70	3.62
2016	9.58	4.13
2015	-1.43	-0.92

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ing portfolio holds around 200 stocks, including a long tail of more than 100 names that each take up less than 0.5% of assets. Management creates a well-diversified portfolio that mitigates risk associated with individual holdings. Sector weightings resemble the S&P 500 with very modest underweightings in real estate and consumer staples, and a small overweighting in consumer discretionary.

Hamilton Reiner, who focuses on the options portion of the strategy, constructs a zero-cost option overlay at the beginning of each calendar quarter and resets at the end of the quarter. Call premiums received should improve with persistently high market volatility and higher interest rates, thus improving the fund's upside in such a market environment. However, in periods of serious market stress (such as Black Monday in 1987, where the S&P 500 dropped 23% in a single day), the short out-of-the-money put leg of the spread may expose the fund to additional losses. In more typical markets, this fund should produce competitive returns relative to peers.

Performance Pillar: + Positive

The fund's long-term performance has been in line with expectations and has stayed ahead of options-based peers, resulting in a Performance Positive rating.

Since its December 2013 inception, the fund has returned 6.9% annualized through August 2019, outperforming the options-based category by more than 3.6 percentage points annualized. Performance is equally impressive on a risk-adjusted basis: Its Sharpe ratio of 0.9 since inception outpaces the category norm of 0.3 and matches the S&P 500's. The strategy was able to further set itself apart from peers in 2018 when equity markets struggled in the fourth quarter. For the full year, the fund was mostly able to protect capital, suffering a loss of just 0.4% versus 6.8% for the category and 4.4% for the S&P 500.

In the fourth quarter of 2018, the underlying equity portfolio lost 13.9% but the long put option helped limit the fund's losses to 5.4%. The short put and

the short call options expired out of the money. In the following quarter, the strategy lagged the rallying equity market owing to the cap from selling call options. It gained 4.0% versus the S&P 500's 13.7%.

The underlying equity portfolio is another source of potential excess returns, although it did detract in 2018. Since the fund launched, it has been mildly additive, outperforming the S&P 500 by about 20 basis points annualized.

People Pillar: + Positive

Extensive experience in derivatives markets and access to JPMorgan's ample resources earn this fund a Positive People rating.

The core of the strategy is managed by a small team, but that is not particularly concerning as implementation is systematic and the strategy has access to the strong support team. Lead portfolio manager and strategy architect Hamilton Reiner joined the firm in 2009 and has extensive experience trading derivatives, with a career dating back over three decades. Prior to joining JPMorgan, Reiner held senior positions at Barclays Capital, Lehman Brothers, and Deutsche Bank, and he spent the first 10 years of his career at O'Connor and Associates, an options specialist firm.

Raffaele Zingone, the other named portfolio manager, joined the firm in 1991 and is responsible for the equity portfolio implementation. Zingone also manages other equity strategies including Bronze-rated JPMorgan U.S. Research Enhanced Equity JDEAX. He directs a deep bench of 25 equity analysts, who average 19 years of industry experience. The analysts specialize by sector and provide the stock-specific research for the underlying equity portfolio.

Reiner has more than \$1 million invested alongside investors, signaling a strong alignment of interest between management and shareholders. Zingone has between \$500,000 and \$1 million invested in the fund.

Parent Pillar: + Positive

J.P. Morgan Asset Management boasts long-tenured and strongly aligned portfolio managers who are supported by deep analytical resources. Competitive fees across the board also contribute to the firm's Positive Parent rating.

The firm's diverse lineup features many Morningstar Medalists across asset classes and regions. In February 2018, its U.S.-domiciled SmartRetirement target-date series was upgraded to a Morningstar Analyst Rating of Gold, befitting strong underlying resources and processes on both equity and fixed income. On U.S. equities, for instance, experienced managers draw on a core team of more than 20 career analysts, while on their cored fixed-income mandates, long-tenured managers are supported by more than 25 credit and securitized analysts based across Columbus, London, and New York. Managers' compensation factors in 10-year performance where applicable, which exceeds industry standards. Retention rates and managers' coinvestments alongside fund shareholders are above average, and succession planning is generally well handled.

Fees are regularly reviewed downward; funds tend to be cheaper relative to peers in the U.S. than abroad. The firm has refrained from trendy offerings and expanded its passive business recently. It has continued to rationalize its broad lineup otherwise, leading to some mergers and liquidations in Europe in particular.

Price Pillar: + Positive

Fees compare very favorably with options-based peers across all share classes. This strategy earns a Positive Price rating.

Most of the assets are in the institutionally distributed share class; it charges 0.60% compared with 1.14% of the options-based category median, substantially undercutting many peers. Other share class costs vary but remain cheaper than the peer average.

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Notably, assets have grown exponentially over the past couple years to nearly \$5.8 billion as of August 2019, up from \$1.1 billion as of July 2017, but the liquid strategy should be able to absorb the growth without any problems.

JPMORGAN HEDGED EQUITY FUND - JHEQX

MORNINGSTAR RATING AS OF 8/31/19

Morningstar overall rating 5 stars, Class I; Options-based Category; 96 funds. Three-year rating 5 stars; 96 funds. Five-year rating 5 stars; 60 funds. Ten-year period not yet rated. Ratings reflect risk-adjusted performance. Overall Morningstar Rating™ for a fund is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics.

ANNUAL OPERATING EXPENSES (%)

	Gross expenses	Net expenses
I shares	0.63	0.60

The Fund's adviser and/or its affiliates have contractually agreed to waive fees and/or reimburse expenses to the extent Total Annual Fund Operating Expenses (excluding acquired fund fees and expenses, dividend and interest expenses related to short sales, interest, taxes, expenses related to litigation and potential litigation and extraordinary expenses) exceed 0.60% of the average daily net assets. The Fund may invest in one or more money market funds advised by the adviser or its affiliates (affiliated money market funds). The Fund's adviser has contractually agreed to waive fees and/or reimburse expenses in an amount sufficient to offset the fees and expenses of the affiliated money market funds incurred by the Fund because of the Fund's investment in such money market funds. This waiver is in effect through 10/31/2019, at which time the adviser and/or its affiliates will determine whether to renew or revise it. The difference between net and gross fees includes all applicable fee waivers and expense reimbursements.

TOP 10 HOLDINGS AS OF 8/31/19 (%)

Microsoft Corp.	5.3%
Apple, Inc.	4.0%
Amazon.com, Inc.	3.4%
Mastercard, Inc., Class A	1.9%
Alphabet, Inc., Class A	1.8%
Alphabet, Inc., Class C	1.7%
Berkshire Hathaway, Inc., Class B	1.6%
Comcast Corp., Class A	1.6%
Chevron Corp.	1.5%
Coca-Cola Co. (The)	1.5%
Total of top 10	24.3%

The top 10 holdings listed reflect only the Fund's long-term investments. Short-term investments are excluded. Holdings are subject to change. The holdings listed should not be considered recommendations to purchase or sell a particular security. Each individual security is calculated as a percentage of the aggregate market value of the securities held in the Fund and does not include the use of derivative positions, where applicable.

PERFORMANCE

(%) as of 6/30/19	1 year	3 years	5 years	Since inception (12/13/13)
I Shares at NAV	5.50	8.88	6.39	6.91
S&P 500 Index	10.42	14.19	10.71	11.80
ICE BofAML 3-Month US Treasury Bill Index	2.31	1.38	0.87	0.79
Lipper Alternative Long/Short Equity Funds Average	1.50	5.50	3.29	3.68

Performance quoted is past performance and is no guarantee of future results. Investment returns and principal value will fluctuate, so shares, when sold, may be worth more or less than original cost. Current performance may be higher or lower than returns shown. Call 1-800-480-4111 for most recent month-end performance.

Contact JPMorgan Distribution Services at 1-800-480-4111 for a fund prospectus. You can also visit us at www.jpmorganfunds.com. Investors should carefully consider the investment objectives and risks as well as charges and expenses of the mutual fund before investing. The prospectus contains this and other information about the mutual fund. Read the prospectus carefully before investing. Must be accompanied or preceded by a prospectus.

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Diversification does not guarantee investment returns and does not eliminate the risk of loss. Diversification among investment options and asset classes may help to reduce overall volatility.

RISK SUMMARY: The following risks could cause the fund to lose money or perform more poorly than other investments. For more complete risk information, see the prospectus.

Hedged Equity Fund: Investments in derivatives may be riskier than other types of investments. They may be more sensitive to changes in economic or market conditions than other types of investments. Many derivatives create leverage, which could lead to greater volatility and losses that significantly exceed the original investment. The prices of equity securities are sensitive to a wide range of factors, from economic to company-specific news, and can fluctuate rapidly and unpredictably, causing an investment to decrease in value. Positions in equity options can reduce equity market risk, but can limit the opportunity to profit from an increase in the market value of stocks in exchange for upfront cash at the time of selling the call option. Unusual market conditions or the lack of a ready market for any particular option at a specific time may reduce the effectiveness of option strategies and could result in losses. Utilizing a strategy with a diversified equity portfolio and derivatives, with a Put/Spread Collar options overlay, may not provide greater market protection than other equity investments nor reduce volatility to the desired extent, as unusual market conditions or the lack of a ready option market could result in losses. Derivatives expose the Fund to risks of mispricing or improper valuation and the Fund may not realize intended benefits due to underperformance. When used for hedging, the change in value of a derivative may not correlate as expected with the risk being hedged.

U.S. Research Enhanced Equity Fund: The prices of equity securities are sensitive to a wide range of factors, from economic to company-specific news, and can fluctuate rapidly and unpredictably, causing an investment to decrease in value.

TARGET DATE FUNDS:

The JPMorgan SmartRetirement Funds are target date funds with the target date being the approximate date when investors plan to start withdrawing their money. Generally, the asset allocation of each Fund will change on an annual basis with the asset allocation becoming more conservative as the Fund nears the target retirement date. The principal value of the Fund(s) is not guaranteed at any time, including at the target date.

INDEXES:

The **S&P 500 Index** is an unmanaged index generally representative of the performance of large companies in the U.S. stock market. Index levels are in total return USD.

ICE BofAML 3-Month US Treasury Bill Index is comprised of a single issue purchased at the beginning of the month and held for a full month. The index is rebalanced monthly and the issue selected is the outstanding Treasury Bill that matures closest to, but not beyond 3 months from the rebalancing date.

The performance of the **Lipper Alternative Long/Short Equity Funds Average** includes expenses associated with a mutual fund, such as investment management fees. These expenses are not identical to the expenses charged by the Fund.

Total return assumes reinvestment of dividends and capital gains distributions and reflects the deduction of any sales charges, where applicable. Performance may reflect the waiver of a portion of the Fund's advisory or administrative fees and/or reimbursement of certain expenses for certain periods since the inception date. If fees had not been waived and/or certain expenses were not reimbursed, performance would have been less favorable.

There can be no assurance that the professionals currently employed by J.P. Morgan Asset Management will continue to be employed by J.P. Morgan Asset Management or that the past performance or success of any such professional serves as an indicator of such professional's future performance or success.

MORNINGSTAR DISCLOSURE:

The Morningstar Analyst Rating is not a credit or risk rating. It is a subjective evaluation performed by the manager research analysts of Morningstar. Morningstar evaluates funds based on five key pillars, which are process, performance, people, parent, and price. Analysts use this five pillar evaluation to determine how they believe funds are likely to perform over the long term on a risk-adjusted basis. They consider quantitative and qualitative factors in their research, and the weighting of each pillar may vary. The Analyst Rating scale is Gold, Silver, Bronze, Neutral, Negative. A Morningstar Analyst Rating of Gold, Silver, or Bronze reflect an Analyst's conviction in a fund's prospects for outperformance. Analyst Ratings are continuously monitored and reevaluated at least every 14 months.

For more detailed information about Morningstar's Analyst Rating, including its methodology, please go to <http://corporate1.morningstar.com/AnalystRating/>

The Morningstar Analyst Rating should not be used as the sole basis in evaluating a mutual fund. Morningstar Analyst Ratings involve unknown risks and uncertainties which may cause Morningstar's expectations not to occur or to differ significantly from what we expected.

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