Portfolio trends

Themes and observations from U.S. Portfolio Insights

4Q 2018

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PORTFOLIO INSIGHTS ANALYTICS

A personalized service designed to help advisors build stronger portfolios.

- Dedicated team with credentials including MBA, CFA® and CIMA® designations
- Thousands of advisor portfolios reviewed annually
- Portfolio consultations with thousands of advisors

IN BRIEF

- **Equities:** Advisors are maintaining an overweight in U.S. equities. U.S.-China trade tensions and weaker-than-expected economic data remain concerns.
- **Fixed income:** While we see a gradual shift toward higher quality core to mitigate the impact of stock market volatility and potential drawdowns, advisors are remaining diversified, with allocations to core complement and extended sectors, given the possibility of further rate hikes.
- **Multi-asset:** Moderate and conservative allocation strategies predominate as advisors look for a balanced approach in response to bouts of market volatility and trade tensions.
- **Alternatives:** While alternatives remain a small allocation in portfolios, certain styles are growing in popularity as advisors look for ways to reduce risk without adding interest rate sensitivity.
- Our equity alternatives case study shows how options-based equity investments can potentially provide protection in a downturn.

AN "ALTERNATIVE" APPROACH FOR MITIGATING THE IMPACT OF LATE-CYCLE VOLATILITY

Minimizing the impact of market volatility on client portfolios is the greatest concern for 60% of advisors, according to data captured through our Portfolio Insights (PI) service. This is not surprising, given the domestic, geopolitical and policy uncertainties surrounding markets in the late stage of this economic cycle.

Historically, advisors have positioned portfolios for uncertainty and a potential market downturn by simply increasing allocations to higher quality core fixed income. But with the Federal Reserve raising rates, advisors are searching for a different solution—an "alternative" approach to mitigating portfolio volatility.

WHAT TYPES OF ALTERNATIVES ARE GAINING POPULARITY, AND WHY?

Among the over 3,700 portfolios our PI team analyzed in 2018, less than one-third had an allocation to alternatives. However, our work with advisors indicates a keen interest in alternatives and, we believe, an opportunity to provide further education on different alternative styles and their portfolio implementation.

As we dig a little deeper into our data, a picture of the alternative styles that may best align with advisors' current needs begins to emerge. Strategies within two Morningstar Alternative categories,[1] Market Neutral and Options-based—typically used to manage equity beta exposure and as a buffer against market volatility—have gained relatively strong followings. They accounted for approximately 50% of the alternative assets held in portfolios submitted to our team in 2018, and also had the highest net inflows among Morningstar Alternative styles.

From our perspective, this is a clear indication that advisors are looking for much more defensive approaches to gaining equity-linked exposure. In each of these categories, the most widely used investment had a beta to the equity market of 0.5 or less.[2] Additionally, these investments have demonstrated an ability to provide positive total returns and significantly outperform traditional fixed income in rising rate environments.[3] These strategies are also relatively low cost, with an average net expense ratio of 0.81% vs. 1.98% for the Morningstar Alternative category as a whole.

DAMPENING PORTFOLIO VOLATILITY WITH EQUITY ALTERNATIVES

The final quarter of 2018, in which the S&P 500 had a -19.36% pullback, was quite painful for investors. We used this period in a case study illustrating how an allocation to alternatives may help reduce a portfolio's sensitivity to market volatility. Insights from our PI team and J.P. Morgan Global Alternatives' implementation framework guided our analysis.

Let's start by tackling the framework's three critical questions:

1. Which strategies should I invest in?

We chose U.S. Options-based equity strategies, since they are a favored style among advisors and can serve as efficient beta reducers.

2. From where should I fund my allocation?

Given the goal of reducing equity risk, we chose to fund the equity alternative by reducing traditional S&P 500 exposure.

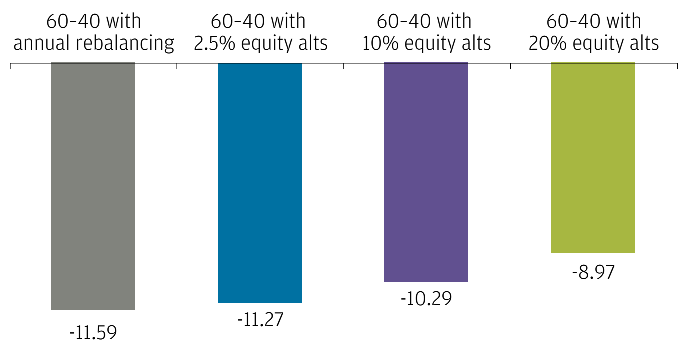
3. What would be the right allocation to alternatives within my portfolio?

This depends on the client's objectives and time horizon. We review multiple allocations to help understand each one's potential benefits.

EXHIBIT 1 shows the returns for four sample portfolios over Q4 2018, starting with a baseline 60-40 mix of stocks and bonds.

A 10% to 20% allocation to equity alternatives can lessen portfolio downturns in volatile markets

EXHIBIT 1: RETURNS FOR 60-40 PORTFOLIOS WITH DIFFERENT ALLOCATIONS TO EQUITY ALTERNATIVES,* FUNDED FROM A TRADITIONAL 60% EQUITY EXPOSURE (SEPTEMBER 21, 2018–DECEMBER 24, 2018)



Source: Morningstar, Standard and Poor's, J.P. Morgan Portfolio Insights Analytics; data as of December 24, 2018.

*Stocks and bonds are represented by the S&P 500 and Bloomberg Barclays U.S. Aggregate Bond index, respectively. The equity alternative used in these scenarios is the fund in the U.S. Options-based Morningstar style category with the highest net flows in 2018.

While a traditional 60-40 allocation can help a portfolio weather equity drawdowns, adding alternatives may further mitigate losses. An illustrative portfolio with a 2.5% allocation to equity alternatives (the average for the portfolios the PI team analyzed in 2018) had a -11.27% return, a slight improvement vs. a -11.59% return for the traditional 60-40 mix. From our perspective, an allocation of 10% to 20% is needed to meaningfully impact portfolio results. For example, the sample portfolio with an allocation of 20% to equity alternatives would have experienced only 77% of the traditional portfolio's loss during the most recent equity drawdown.

Investing is unpredictable, and the end of this economic cycle is in sight. The more you can diversify your client portfolios by using differentiated strategies that lower overall portfolio risk, the better positioned they will be to weather the volatility of uncertain markets.

[1] The Morningstar Alternative category includes Options-based, Long-Short Equity, Multi-Alternative, Market Neutral and Managed Futures styles.

[2] Beta compared with the S&P 500 over the three-year period ended December 31, 2018.

[3] Rising rate environments: April 3, 2015 to June 10, 2015, July 8, 2016 to December 16, 2016, September 8, 2017 to May 17, 2018.

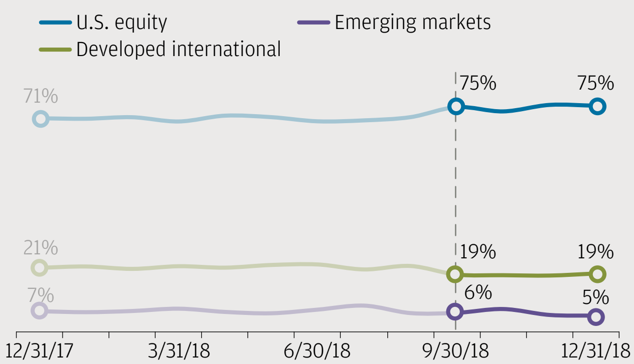
ASSET CLASS TRENDS: 4Q 2018

The Portfolio Insights Analytics service analyzes thousands of portfolios and conducts thousands of one-on-one consultative calls with advisors annually. Our team of over 20 specialists is focused exclusively on helping advisors with asset allocation decisions, investment selection and portfolio implementation. Through its interactions, the team gleans valuable insights and meets every quarter to review and assess these themes and trends, and their potential portfolio implications.

The graphs below indicate the trend the team is seeing in selected key sub-asset class allocations, in percentage terms, within their respective broad asset classes.

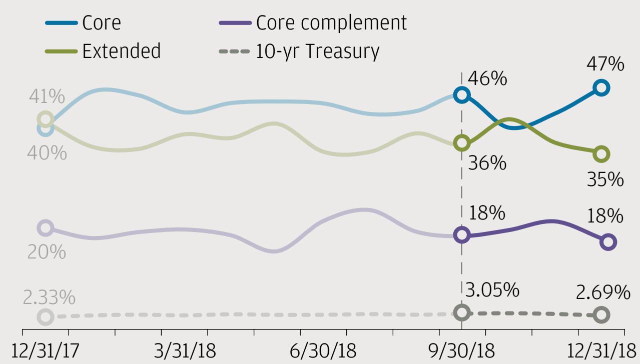
EQUITY

Advisors are maintaining an overweight in U.S. equity allocations. Trade tension between the U.S. and China remains a concern, along with weaker-than-expected economic data.



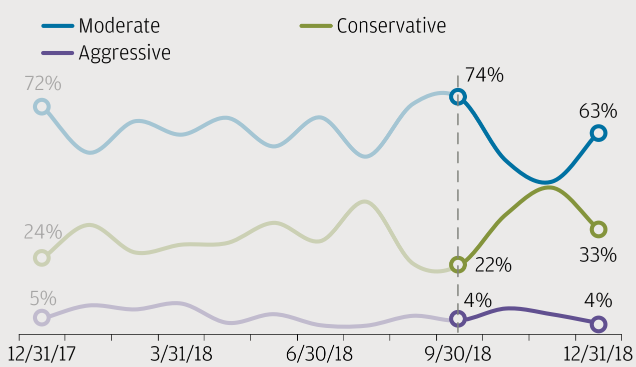
FIXED INCOME

Facing increased stock market volatility and potential draw-downs, advisors are gradually moving toward higher quality core but remain diversified, with allocations to core complement and extended sectors, due to the possibility of further rate hikes.



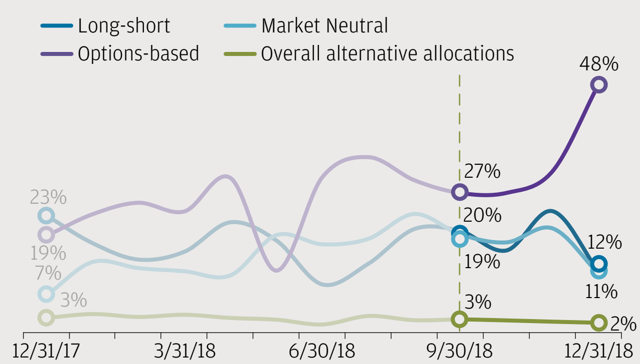
MULTI-ASSET

Moderate and conservative allocation strategies dominate the category as advisors seek a balanced approach in response to bouts of market volatility and trade tensions.



ALTERNATIVES

Advisors seeking to reduce risk without adding interest rate sensitivity are turning to equity alternatives and, in particular, to Options-based equity strategies that have the potential to provide downside protection.



Source: J.P. Morgan Asset Management; data are as of December 31, 2018. Numbers may not sum to 100% due to rounding or omission of sub-asset classes. For illustrative purposes only.

NEXT STEPS

For more information, contact your J.P. Morgan representative.

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