PORTFOLIO INSIGHTS

Portfolio Trends

Themes and observations from U.S. Portfolio Insights

3Q 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: Allocation to U.S. equities has increased amid trade tensions and a rise in the U.S. dollar.**
- **Fixed income: Core fixed income remains prominent; advisors are also utilizing managers with low duration and a more flexible style.**
- **Multi-Asset: The conservative stance we observed in the beginning of 3Q has waned and a more moderate risk profile has regained dominance.**
- **Alternatives: Allocation within portfolios remains low and primarily focused on reducing equity beta.**
- **Advisors are gravitating toward highly ranked intermediate-term bond strategies. We caution that doing so may be doubling down on risk within other strategies. We encourage using a holistic approach to ensure that your bond holdings are adhering to their role within the portfolio.**

A CLOSER LOOK AT WHAT'S HAPPENING IN FIXED INCOME

Financial advisors have become concerned about potential equity market volatility affecting portfolios. Yet responding in the typical way, by leaning on high quality fixed income, isn't the straightforward decision it once was because of rising interest rates. Intermediate-term bonds, advisors know, introduce more interest rate sensitivity. As the J.P. Morgan Portfolio Insights team analyzed over 2,500 portfolios this year, we found advisors maintaining their allocation to fixed income but shifting styles to build more of an all-weather portfolio (see box: Asset Class Trends: 3Q 2018).

Although traditional, or "core," (higher quality, lower volatility) fixed income holdings remained a considerable portion of portfolios, advisors are also turning in significant numbers to flexible strategies and shorter duration investments. In this publication, we take a more in-depth look at these different styles and how they may be interacting with the traditional core allocation. Our goal is to ensure that advisors maintain the appropriate balance of rate sensitivity and portfolio ballast.

Certain kinds of fixed income investments tend to be less interest-rate sensitive. We refer to these portfolio components as "core complements" (which seek returns with little correlation to rates and can reduce portfolio volatility) or "extended sectors" (which increase income and the potential for returns). The team has observed the most momentum this year in core complements (Morningstar's Ultrashort and Nontraditional categories) with a 100% uptick in usage year over year.

J.P.Morgan
Asset Management

INVESTING MORE WITH HIGH-PERFORMING CORE MANAGERS—THE UNINTENDED CONSEQUENCES

We've also observed advisors gravitating toward highly ranked strategies in the Intermediate-Term Bond category—we are seeing these funds with 60% more frequency, relative to last year. We deem these high performers' style "core plus": generally high-quality core exposure but designed to enhance yield by venturing outside the U.S., adding high yield or by taking out-of-benchmark bets. The top three most-utilized active Intermediate-Term Bond funds we have observed within our service have, on average:

- 10.5% allocated to high yield
- 20% allocated to BBB-rated debt
- high correlation (0.64) to the S&P 500 during the global financial crisis of 2008

Let's take a deep dive into these intermediate-term managers with more flexibility, which tend to outperform those with higher-quality styles in rising rate environments. There is value in them. But they often come with a trade-off: Their potentially higher correlation to equity markets introduces a layer of risk that advisors may not be expecting from a core position. This risk may be exacerbated by the use of the core complements and extended sectors within a portfolio—precisely the type of investments for which our Portfolio Insights team has seen heightened demand during the past year. Traditional core, core complement and extended sectors all play important roles in helping investors build an all-weather fixed income portfolio, but paramount in doing so is ensuring the appropriate mix—or, to put it another way, knowing what you own.

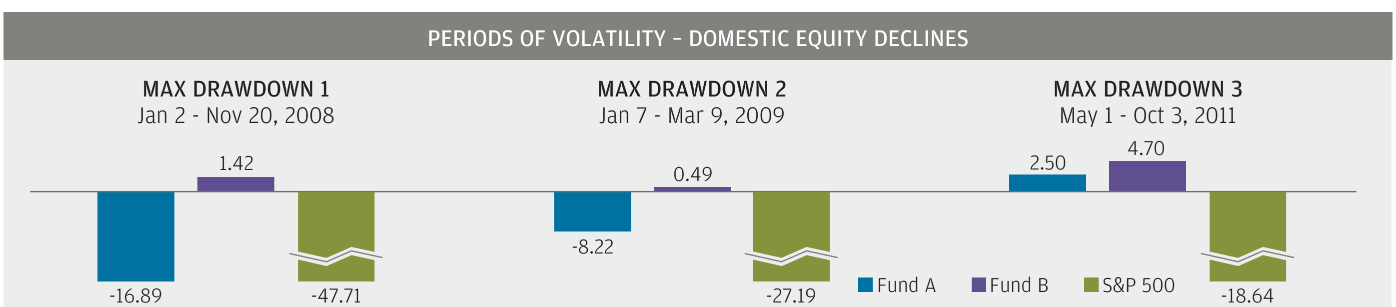
Building stronger portfolios requires a holistic approach, beyond only finding the best performers. Facing the likelihood of rising rates and the need to dampen potential equity volatility, advisors need to look beyond returns to consider correlations, as well as the role each investment is playing within its asset class and the portfolio as a whole.

EXHIBIT 1 shows two investments from Morningstar's Intermediate-Term Bond category: Fund A is the high performer with a strong total return, yet it is not a true diversifier to equity market risk, with its significant positive correlation to the S&P 500. Fund A also has a lower R^2 to the Bloomberg Barclays US Aggregate Bond Index (BBG Agg), so relative to Fund B, it is not behaving as a core holding. Fund B, however, excelled in diversification vs. equities. It is negatively correlated to the S&P 500 and its performance was consistently positive during equity market drawdowns.

Amid a constant drumbeat of market concerns, it's important to look beyond performance to know what you own and whether it's adhering to its role in the portfolio overall. Following this practice, in portfolio construction and investment selection, can help increase the likelihood that clients stay invested and achieve their financial goals.

EXHIBIT 1: COMPARISON, INTERMEDIATE-TERM BOND FUNDS DURING U.S. EQUITY MARKET DRAWDOWNS

	YTD / 1 Year		3 Year		5 Year		10 year			
TRAILING PEER GROUP RANKINGS	Total return	% rank	Total return	% rank	Total return	% rank	Total return	% rank	Corr. to S&P 500	R^2 to BBG Agg
Fund A	6.96	1	4.33	1	3.88	2	5.96	2	0.53	64
Fund B	3.81	48	2.25	47	2.01	52	4.30	43	-0.02	94



Source: Morningstar; data as of December 31, 2017. This information is shown for illustrative purposes only, does not reflect actual investment results, is not a guarantee of future results and it not a recommendation. R^2 is relative to Bloomberg Barclays US Agg Bond TR USD. Past performance is no guarantee of current and future results.

Past performance is not a guarantee of comparable future results. Total return assumes the reinvestment of income. Performance results are gross of investment management fees. The deduction of an advisory fee reduces an investor's return. Actual account performance will vary depending on individual portfolio security selection and the applicable fee schedule by share class.

R^2 reflects the percentage of a fund's movements that can be explained by movement in its benchmark.

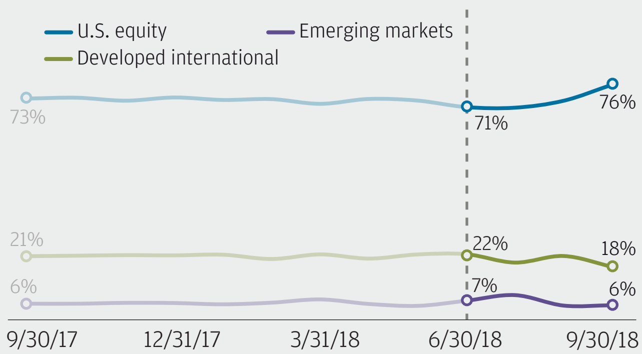
ASSET CLASS TRENDS: 3Q 2018

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.

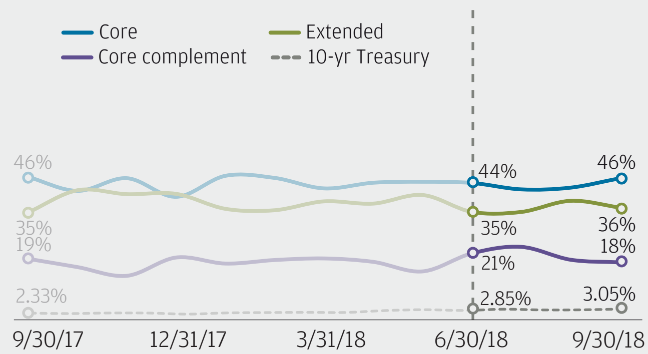
EQUITY

Advisors' overweighting of U.S. equity allocations has seen a resurgence. Short-term expectations have tapered for international equities, primarily driven by the strong U.S. dollar.



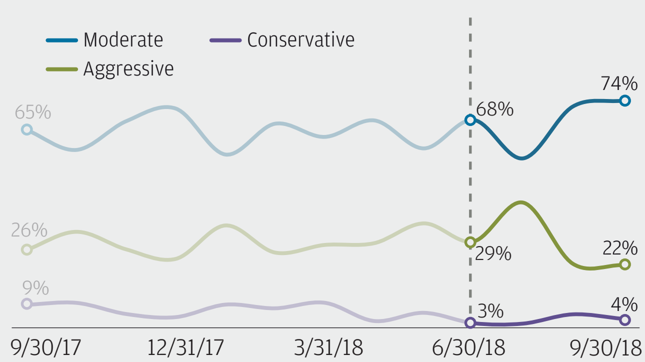
FIXED INCOME

Despite rising rates, advisors are maintaining significant exposure to higher-quality core due to fears of equity volatility. Sizeable allocations remain to core complement and extended sectors, due to the likelihood rates will continue to climb.



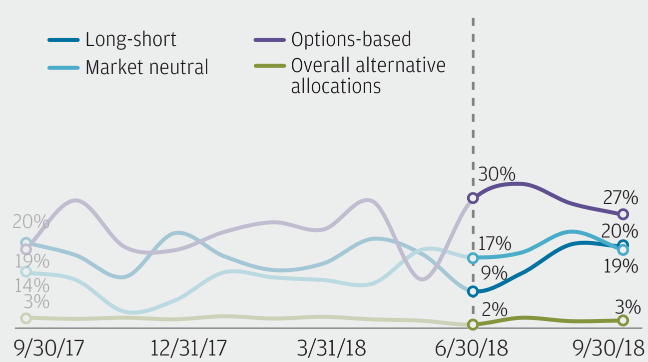
MULTI-ASSET

In early 3Q, advisors increased allocations to conservatively based products, partly in response to bouts of market volatility and trade tensions. However, the more familiar moderate risk profile returned to prominence by quarter end.



ALTERNATIVES

At about 3%, on average, alternatives continue to represent a small portion of overall portfolios. Options-based equity investments have been the primary driver of alternative exposure as investors search for instruments to help reduce beta.



Source: J.P. Morgan Asset Management. Data are as of September 30, 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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