IN BRIEF

- Based on the J.P. Morgan Portfolio Insights team’s reviews of client portfolios and our strategists’ 2020 outlooks, we review the common portfolio trends and imbalances we are seeing.
- Advisors are constructing portfolios against the backdrop of a mixed macroeconomic picture: consumer strength and the lowest U.S. unemployment rate in half a century amid signs of softening in other data, including U.S. GDP, PMI and corporate earnings.
- Intentionally or not, many advisors’ portfolios have become more tilted or concentrated. Our Portfolio Insights team has seen an overweighting of growth style equities, underweighting international equities and, in bonds, insufficient duration and a potentially worrisome shift toward lower credit quality.
- We lay out a more balanced approach that plays both offense and defense to help advisors navigate the potential uncertainty ahead and achieve improved diversification.

THOUGHTFUL RISK MANAGEMENT BY BALANCING OFFENSIVE WITH DEFENSIVE

Marking the 12th year of the U.S. economic expansion, 2019 was a year of strong gains for equity and bond markets around the world. While we continue to see strength in the consumer, and the lowest U.S. unemployment rate in half a century, the data—including GDP, PMI and corporate earnings—are beginning to show signs of softening. Looking to 2020 in light of these macro factors, how should portfolios be tilted or concentrated? They shouldn’t be, we believe. Rather, portfolios should take (or move back toward) a balanced approach, playing both offense and defense to navigate the potential uncertainty ahead.

We have seen countervailing trends in our analysis of client portfolios (see box, “How We Get Our Data”): Advisors are shifting toward a more defensive stance in some ways, de-risking their portfolios by moving money from equities to fixed income. Yet in other ways they are playing offense—for example, by increasing their exposure to emerging market (EM) equities. We recommend finding a balance between these levers, one that acknowledges current higher valuations, the aging cycle and also our expectations that the markets still likely have further to go in 2020.

Based on what the J.P. Morgan Portfolio Insights team is seeing in client portfolios, and J.P. Morgan strategists’ 2020 outlooks, we detail here the imbalances we’ve seen and consider how advisors can become more risk conscious within each asset class, balancing offense and defense.
U.S. EQUITIES

Growth style overweight

As advisors have sought stronger returns in a world where earnings are coming down, many have edged toward overweighting growth style equities. We are seeing a heavy growth lean in our portfolio analytics: allocations to growth that are nearly 2.5 times higher than to the value style (EXHIBIT 1). With economic data less than strong, advisors we’ve worked with have (sometimes by design) leaned toward taking a little more exposure in one growth sector in particular—technology—and in some of the more cyclical sectors that have delivered better performance in recent years.

Portfolios analyzed allocated more than twice as much to growth than to value (47.5% vs. 19.7%), creating a lack of balance and diversification

EXHIBIT 1: ALLOCATIONS BY STYLE IN PORTFOLIOS ANALYZED USING J.P. MORGAN PORTFOLIO INSIGHTS ANALYTICS

<table>
<thead>
<tr>
<th></th>
<th>Value 19.7</th>
<th>Core 32.9</th>
<th>Growth 47.5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large</td>
<td>14.5</td>
<td>23.8</td>
<td>37.2</td>
</tr>
<tr>
<td>Mid</td>
<td>2.7</td>
<td>6.0</td>
<td>7.4</td>
</tr>
<tr>
<td>Small</td>
<td>2.5</td>
<td>3.1</td>
<td>2.9</td>
</tr>
</tbody>
</table>


One factor driving the growth lean is that some value-style fund managers are drifting, incorporating growth stocks into their funds, so investors and their advisors may not have the weightings that they think they do. Some of the best-performing large cap value funds, for example, are investing in Microsoft and Apple, saying, more or less, “There’s still value in them.” Meanwhile, growth managers are looking at the same companies and saying, effectively, “Well, there’s still growth ahead.” If both value and growth managers are investing in some of the same companies, portfolios may end up skewed toward higher concentrations and larger, unintended overweights. This may be the right decision for the funds’ managers, but not for an advisor who meant for her investments to be evenly allocated to value and growth.

Domestic overweight—although appetites are growing for emerging markets

Geographically, we are seeing that U.S. advisors have a strong home country bias. News media stories about trade tensions, Brexit and other geopolitical headwinds have made many people nervous about international markets, while at the same time clients have high expectations for S&P 500 returns. And even without geopolitical worries, the U.S. equity market has outperformed international equities by 8.5% annualized over the last decade, leading to a domestic overweight for anyone who hasn’t rebalanced. Still, advisors continue to regard international stocks with concern and lack conviction about why they should allocate a significant portion of their clients’ assets outside the U.S.

However, in the last couple of months, especially since trade tensions have taken a pause, we have seen a greater appetite for emerging market equities and believe that may continue into 2020—a U.S. presidential election year when many advisors believe trade tensions should stay contained. Investors seem to know that U.S. equities can’t continue climbing 30% every year, and they understand the demographic story unfolding in the emerging markets. J.P. Morgan’s 2020 Long-Term Capital Market Assumptions (LTCMAs) project that over the long run EM stocks can deliver the highest total annualized return of any market: 9.2% over 10 to 15 years, vs. about 5.6% for U.S. equities (EXHIBIT 2). We suggest incorporating more international equities (emerging and developed market) for another reason: They can serve as portfolio diversifiers.

Driven by a demographic story, expectations are for EM stocks to deliver the highest 10- to 15-year returns of any market

EXHIBIT 2: U.S. LARGE CAP, DEVELOPED MARKET INTERNATIONAL AND EMERGING MARKET EQUITIES, HISTORICAL VS. EXPECTED RETURNS


Expected risk and returns are based on J.P. Morgan’s 2020 Long-Term Capital Market Assumptions (LTCMAs), which provide risk and return expectations over a 10- to 15-year horizon for more than 50 asset and strategy classes.
**FIXED INCOME**

Fixed income put in a strong performance in 2019 and had the largest net flows in the investment industry, in a year in which 10-year Treasury yields started at 2.68% and moved steadily downward. We have seen advisors reallocating money from equities into fixed income—a sign of de-risking that reflects their desire to offset equity positions with a more conservative fixed income stance amid growing concern about an aging economic expansion. However, because yields are at historical lows, advisors are gravitating to more flexible fixed income styles to boost income and return potential. These include intermediate core-plus and multisector bond managers that take a little more risk, seeking a little more return and yield. We find several imbalances cropping up as a result:

**A continued tilt toward short to intermediate portfolio duration**

This was an overriding trend in 2019. Average portfolio duration started 2019 at just 2.5 years but finished the year slightly above four years’ duration (from our vantage point, still a little short). We would encourage pushing duration closer to five years to balance a portfolio’s equity sensitivity.

**A tilt toward lower quality, with implications for downside protection**

This is the other trend advisors should be aware of: Even intermediate-term bond managers are tilting toward lower quality, nontraditional bonds in a reach for yield (EXHIBIT 3). If fixed income is your client’s capital preservation asset class, you’ll want to know if that tilt in holdings is occurring. Some intermediate-term bond managers tilting toward lower quality (and shorter duration) could get caught off-sides if equity markets turn down significantly.

The vast majority of advisors whose portfolios we’ve analyzed are investing with active managers that can be tactical and flexible. But we don’t tend to see the proper level of due diligence. Advisors should—but don’t always—understand the objective of the funds they are investing in, how they’re really managed, the credit quality of their assets and the implications of their holdings’ potential correlations under conditions of volatility. Managers can’t necessarily flip from below investment grade to AAA as the next downturn hits. The key takeaway is to know what you own and understand the trade-offs among return, income, flexibility and diversification.

**HOW WE GET OUR DATA**

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.

---

**EXHIBIT 3: GROWING BBB EXPOSURE OF 2019’S MOST UTILIZED INTERMEDIATE CORE AND CORE-PLUS BOND FUNDS**

<table>
<thead>
<tr>
<th>Year</th>
<th>Core</th>
<th>Core-plus</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>10.5</td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td>12.8</td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>13.5</td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td>14.4</td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td>15.0</td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td>15.5</td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>15.0</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>14.4</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>13.0</td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td>12.8</td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td>12.0</td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td>10.5</td>
<td></td>
</tr>
<tr>
<td>2019</td>
<td>10.0</td>
<td></td>
</tr>
</tbody>
</table>

ALTERNATIVES

Equity alternatives fulfill an appetite for risk reduction

Compared with traditional asset classes, which did very well in 2019—the S&P 500 up about 30%, fixed income up about 12%—alternatives have underperformed, with mere single-digit returns. Advisors tend to prefer asset classes that are performing well, so their adoption of alternatives has been very low. But there’s an exception: Options-based strategies have been adopted because their primary purpose is risk reduction for portfolios that have taken on additional risk, whether through growth stocks or emerging markets (to cite two common examples). Options-based strategies fit the bill for risk reduction and have found some favor because they are designed to provide an added layer of protection that can help a portfolio play defense.

PORTFOLIO CONSTRUCTION TO BRIDGE THE GAP BETWEEN EXPECTATIONS AND LIKELY RETURNS

In recent years, the combination of low volatility, few significant market sell-offs and the longest expansion on record has allowed someone investing in a diversified, balanced portfolio to generate about a 10% return. And yet most investment professionals—advisors, broker-dealers, asset managers—believe very, very strongly that such returns will not continue to be achievable over the next 10 years, a view our LTCMAs reinforce. The likely outcome is a significant gap between client expectations and the reality of what they’re likely to face. Playing both offense and defense, and being thoughtful about investment selection (whether active or passive), will be important to bridging that gap.

We suggest advisors follow the ABCs of investment selection (EXHIBIT 4A):

- **Alpha**: Are you delivering better results than your benchmark or an equivalent passive ETF?
- **Batting average**: Are your investments consistently outperforming?
- **Capture ratios**: Are your investments focused on balancing risk to both capture the upside and minimize the downside?

Our case studies suggest that advisors who use the ABCs to evaluate investments for their clients’ portfolios will more likely than not deliver a better client experience and help bridge the gap between client expectations and reality (EXHIBIT 4B).

While advisors have been shifting from active to passive over the last decade, we believe now is a time to be more thoughtful than ever about these decisions and to have specific processes in place to help identify and pick better-performing strategies. Passive could be the right fit for certain allocations, but as fiduciaries, advisors must perform proper due diligence to make sure. This late in the cycle, advisors should check that they know what their investments are capable of—what they’ve done historically and how they are built right now, to ensure that they can meet the expectations they were hired for.

A is for alpha: A case study suggests using the ABCs could improve portfolio results

EXHIBIT 4A: EVALUATING EQUITY INVESTMENTS

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ALPHA/EXCESS</strong></td>
<td><strong>BATTING AVERAGE</strong></td>
<td><strong>CAPTURE RATIOS</strong></td>
</tr>
<tr>
<td>Reflects a fund’s total return above or below a benchmark</td>
<td>Measures the manager’s ability to meet or beat the benchmark consistently</td>
<td>Percentage of the benchmark’s return that was captured in rising and falling markets</td>
</tr>
</tbody>
</table>

EXHIBIT 4B: BRIDGING THE GAP BY APPLYING THE ABCs

Source: J.P. Morgan Asset Management Spectrum from July 1, 2005–December 31, 2019. The two portfolios have the exact same asset allocation breakdown as represented by the J.P. Morgan Multi-Asset Solutions model 60/40 benchmark. 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. For illustrative purposes only. Past performance is not indicative of future results.
ASSET CLASS TRENDS

The graph below indicates the asset class trends observed throughout 2019 by the Portfolio Insights team. The asset classes are represented by the most utilized Morningstar categories. The bars represent the high and low allocations observed in 2019; the dash marks the current average allocations as of December 31, 2019.

- Style-wise, the team observed a move toward neutral. While allocations to value and growth declined, blend moved higher.
- Advisors utilized lower market cap strategies (such as mid cap blend) to play offense.
- Advisors began to deploy fixed income investments in a more defensive way, lowering allocations to high yield and core-plus bonds while increasing core and short-term bond investments.
- Allocations to cash in 2019 reached their highest level at year-end.

Source: J.P. Morgan Asset Management Spectrum; data as of December 31, 2019. Numbers may not sum to 100% due to rounding or omission of sub-asset classes. For illustrative purposes only.
This document is a general communication being provided for informational purposes only. It is educational in nature and not designed to be taken as advice or a recommendation for any specific investment product, strategy, plan feature or other purpose in any jurisdiction, nor is it a commitment from J.P. Morgan Asset Management or any of its subsidiaries to participate in any of the transactions mentioned herein. Any examples used are generic, hypothetical and for illustration purposes only. This material does not contain sufficient information to support an investment decision and it should not be relied upon by you in evaluating the merits of investing in any securities or products. In addition, users should make an independent assessment of the legal, regulatory, tax, credit, and accounting implications and determine, together with their own professional advisers, if any investment mentioned herein is believed to be suitable to their personal goals. Investors should ensure that they obtain all available relevant information before making any investment. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is considered to be accurate at the time of production, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. It should be noted that investment involves risks, the value of investments and the income from them may fluctuate in accordance with market conditions and taxation agreements and investors may not get back the full amount invested. Both past performance and yields are not reliable indicators of current and future results.

J.P. Morgan Asset Management is the brand for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide.

This communication is issued by the following entities: in the United Kingdom by JPMorgan Asset Management (UK) Limited, which is authorized and regulated by the Financial Conduct Authority; in other European jurisdictions by JPMorgan Asset Management (Europe) S.a.r.l.; in Hong Kong by JPMorgan Asset Management (Asia Pacific) Limited, or JPMorgan Funds (Asia) Limited, or JPMorgan Asset Management Real Assets (Asia) Limited; in Singapore by JPMorgan Asset Management (Singapore) Limited (Co. Reg. No. 197601566K), this advertisement or publication has not been reviewed by the Monetary Authority of Singapore; in Taiwan by JPMorgan Asset Management (Taiwan) Limited; in Japan by JPMorgan Asset Management (Japan) Limited which is a member of the Investment Trusts Association, Japan, the Japan Investment Advisers Association, Type II Financial Instruments Firms Association and the Japan Securities Dealers Association and is regulated by the Financial Services Agency (registration number “Kanto Local Finance Bureau (Financial Instruments Firm) No. 330”); in Australia to wholesale clients only as defined in section 761A and 761G of the Corporations Act 2001 (Cth) by JPMorgan Asset Management (Australia) Limited (ABN 55143832080) (AFSL 376919); in Brazil by Banco J.P. Morgan S.A.; in Canada for institutional clients’ use only by JPMorgan Asset Management (Canada) Inc., and in the United States by J.P. Morgan Institutional Investments, Inc., member of FINRA; J.P. Morgan Investment Management, Inc. or J.P. Morgan Alternative Asset Management, Inc.

In APAC, distribution is for Hong Kong, Taiwan, Japan and Singapore. For all other markets in APAC, to intended recipients only.

Copyright 2020 JPMorgan Chase & Co. All rights reserved.