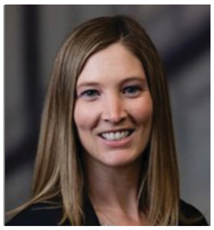
Portfolio trends

Themes and observations from U.S. Portfolio Insights

1Q 2019

AUTHORS



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IN BRIEF

- **Equities:** Continued lack of clarity surrounding trade tensions and Brexit have amplified advisors' historical overweight to U.S.-based equity.
- **Fixed income:** With the Federal Reserve's dovish pivot, and 4Q 2018 a fresh reminder of market volatility's impact, advisors have been shifting toward core fixed income.
- **Multi-asset:** Moderate asset allocation strategies remain dominant at a time when advisors see market upside yet are mindful of volatility.
- **Alternatives:** While options-based equity is still most popular, managed futures and market neutral strategies have gained traction as advisors seek diversifiers to traditional market risk.
- We consider metrics for assessing value-oriented investments, to help rebalance growth-heavy portfolios back toward neutral, since we believe good style diversification is crucial at a time of potentially higher market volatility.

ENSURING TRUE EQUITY DIVERSIFICATION IN LIGHT OF POTENTIALLY HIGHER VOLATILITY

The importance of diversification is a given. Over the past few years, though, a majority of advisors have failed to keep their equity portfolios truly diversified. Instead, they've allowed them to tilt meaningfully toward growth stocks. What to do about this overweight has been coming up more frequently in our conversations with advisors. Their top question: When is the best time to think about rebalancing, whether to neutral or perhaps toward value stocks, in preparation for increased volatility? Let's break down our answer.

First some background. The tilt toward growth is understandable because of how well it's worked. The growth style (buying stock in a company poised for fast growth) outperformed value (the philosophy of buying shares in companies with attractive relative valuations) by 5% annually for the last three years. Now, however, as the global economy shows signs of slowing and as market volatility picks up, diversification is imperative. And value stocks' valuation is more attractive, at two standard deviations below the historical average.[1] When value was this relatively cheap in the past, rebounds over the subsequent 12 months in the style provided an average absolute return of 15%.

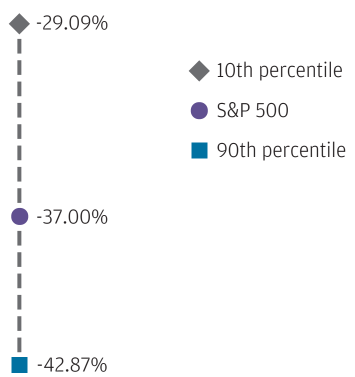
[1] Based on the spread between the median P/E (price-to-earnings) ratio of top quartile and bottom quartile value stocks. To rank stocks, our proprietary model uses a combination of book-to-price, earnings yield, dividend yield and cash flow yield.

J.P.Morgan
Asset Management

So what might an optimal balance between growth and value look like? First off, we want a value investment that can be bought for a lower price relative to history. But that's not enough. Its historical metrics should also suggest it has the potential to hold up during periods of increased market volatility. In the bear market of 2008, value investments saw a significant dispersion between top decile performers (which had a 29% drawdown) and the bottom decile. Indeed, those in the bottom decile, with a 42% drawdown, did far worse than the S&P 500 overall (**EXHIBIT 1**).

How, then, to dial back a portfolio toward neutral, to stay well diversified? In conversations with advisors, we often discuss the metrics we believe offer the most holistic picture, to help them choose a value-oriented strategy. Because performance dispersion is so great during periods of market stress, investment selection is more important than ever.

EXHIBIT 1: RETURN DISPERSION BETWEEN 10TH AND 90TH PERCENTILE OF U.S. LARGE VALUE FUNDS VS. THE S&P 500



Source: Morningstar, Standard & Poor's; data as of December 31, 2008. Represents average annual portfolio return dispersion between the 10th and 90th percentile in 2008 for the U.S. Large Cap Value Morningstar category, including mutual funds and ETFs. This information is shown for illustrative purposes only, does not reflect actual investment results, is not a guarantee of future results and is not a recommendation. The performance quoted is past performance and is not a guarantee of future results. Mutual funds are subject to certain market risks. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than original cost. Current performance may be higher or lower than the performance data shown.

METRICS TO UTILIZE WHEN EVALUATING VALUE INVESTMENTS FOR THE LATE CYCLE

Here are some of our favorites:

Sharpe ratio: We find this excellent performance metric is underutilized. It shows not just return but also how much risk was taken to achieve it. The balance of risk and return is crucial at this stage of the cycle, when every basis point of return is needed and risk reduction is top of mind.

Up/down capture: This metric illustrates how much market gain (upside participation) a fund achieved and—maybe more critically today—how much of the decline or downside. The ratios are rendered as percentages to show the portion of the broad market gain/loss the investment captured. If it historically provided 120% upside capture vs. its benchmark, for example, that suggests it may outperform when the market is rising. Typically, that comes with a trade-off—more than 100% of the up capture often comes with more than 100% of the down capture, too. In searching for strategies to help dampen volatility, we prefer investments with down capture ratios under 100%.

Batting average: We like batting average because consistency of returns matters. A batting average effectively shows the steadiness of an investment's performance—how often it met, or beat, the applicable benchmark. A strategy with a five-year batting average of 55% kept pace with, or exceeded, its benchmark in 33 of the past 60 months (55% of the time).

STYLE DIVERSIFICATION IS PARAMOUNT

The value vs. growth debate will continue. And trying to perfectly time a portfolio rebalancing may be a futile exercise. We believe, however, that style diversification is paramount to performance, and that now may be an opportune moment to rebalance back to neutral. Using these metrics to assess value-oriented strategies can help ensure you fully understand your investments, increasing the likelihood of achieving your clients' financial goals.

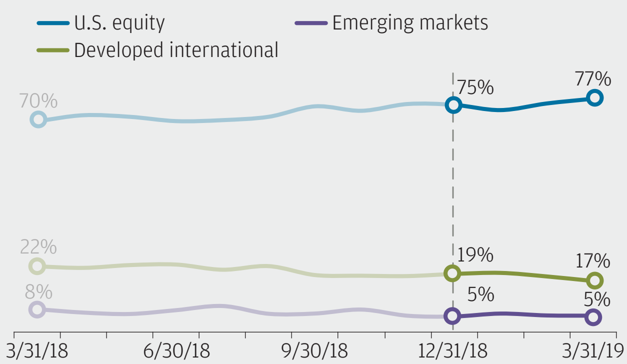
ASSET CLASS TRENDS: 1Q 2019

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.

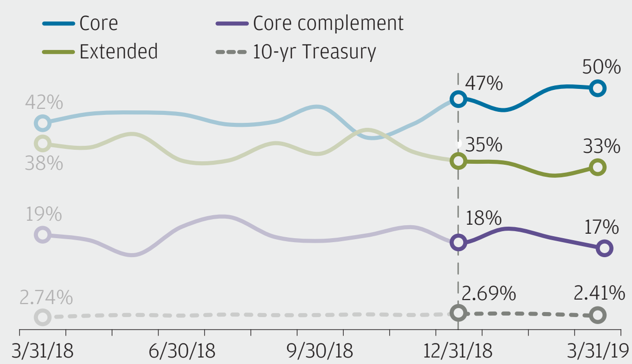
EQUITY

Continued lack of clarity surrounding trade tensions and Brexit have amplified advisors' historical overweight to U.S.-based equity.



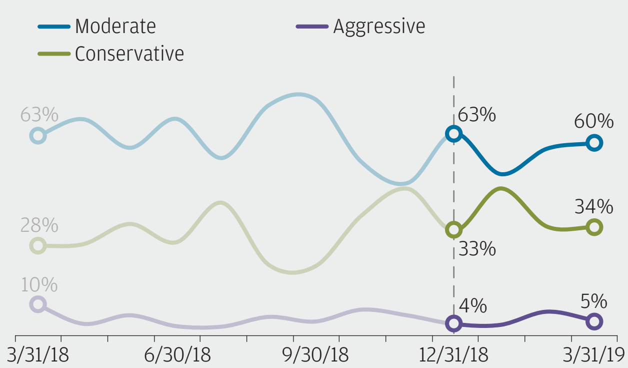
FIXED INCOME

With the Federal Reserve softening its interest rate policy language and 4Q 2018 a fresh reminder of market volatility's impact, advisors have taken the opportunity to shift toward core fixed income.



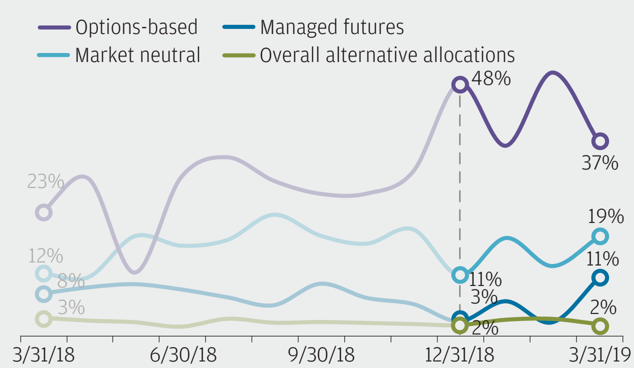
MULTI-ASSET

Moderate asset allocation strategies remain the dominant approach at a time when advisors see market upside yet are mindful of volatility.



ALTERNATIVES

While options-based equity continues to have a prominent role, managed futures and market neutral strategies have gained traction as advisors search for diversifiers to traditional market risk.



Source: J.P. Morgan Asset Management; data are as of March 31, 2019. 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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