Taking the long view

Strategies for long-term investors

June 2015

IN BRIEF

Long-term institutional investing, as practiced by the leading sovereign wealth funds, enjoys large strategic advantages and a decisive tactical edge over investing with a shorter time horizon:

• A long-term strategy allows for fundamental themes to fully develop.
• By taking positions with high potential payoffs despite possibly uncertain timing, the strategy both shapes the future and profits from it.
• Paradoxically perhaps, the long view, coupled with ample resources, can exploit tactical opportunities created by short-term investors under pressure to liquidate holdings due to margin calls and liquidity demands.
• More broadly, a long-term strategy stands to benefit from mispricings arising from errors in evaluation and elevated risk aversion.
• Finally, long-term investors’ ability to absorb the liquidity risk inherent in unlisted and illiquid assets can generate a premium return.

These advantages have rarely mattered more than now in a capital market environment of low yields, mounting volatility, unexciting global economic growth and subpar investment returns—nor have they diverged more from the prevailing transaction-oriented mentality. Yet today, as much as ever, long-term investors can (and should) access the full range of long-term non-public assets—value-added real estate, infrastructure, private equity and private debt—to diversify their holdings, mute the volatility of the public markets and earn steady and favorable risk-adjusted returns. Indeed, the contrast between transactional markets and the breadth of opportunity open to long-term strategies suggests that investors across the entire institutional spectrum—pension plans, insurers and endowments as well as sovereign wealth funds—should give the approach serious consideration.

The spike in stock turnover during the “dotcom rally” of the late 1990s has become the new floor

EXHIBIT 1: ANNUAL GLOBAL EQUITIES TURNOVER AS A PERCENTAGE OF TOTAL MARKET CAPITALIZATION


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Investors today inhabit an extraordinarily frenetic universe. Every year the entire market value of the world’s listed stocks changes hands (Exhibit 1, previous page). That’s in relatively normal times. During the recent financial crisis, global turnover more than doubled. The transactional mindset affects even so-called fixed assets. The average holding period for commercial real estate investments has come down by half in the last quarter century (Exhibit 2). What was once a decade-long commitment now lasts about five years.

The pervasive “short-termism” argues for the benefit of a contrarian perspective that places the passions of the moment in the context of a lengthy time horizon. It makes feasible strategies that the bulk of market participants simply cannot afford to pursue, in our view. It puts institutions in a unique position to capture liquidity premiums, pick up viable assets at distressed prices during market dislocations and access asset classes and investments closed to investors with more limited time horizons. In sum, sovereign wealth funds (SWFs), pension funds, insurers and endowments can take advantage of the long view required of them to generate long-term returns in excess of what the current investment environment would seem to provide.

THE INVESTING MARATHON

Time horizon, not portfolio size, sets long-term investors apart, to our way of thinking. They have the luxury of necessity. Institutions have long-dated liabilities that compel them to look beyond a single market cycle. A view that can see and plan past the ups and downs of the single cycle can adopt strategies designed to deliver returns consistently superior to those realized within a cycle. While many long-term opportunities, particularly in illiquid and non-public markets, are better suited to large pools of capital, the long-term mentality can apply across the investment spectrum.

Conventional wisdom ties market cycles to economic cycles, which, on average, last almost five years, according to the National Bureau of Economic Research, the recognized standards setter. One of the most successful institutional investors, Singapore’s sovereign wealth fund GIC, places market cycles in a similar time frame. Discussing its own investment practices, GIC states that “the minimum time horizon for performance measurement is five years.”

Paring down the definition of long-term investing still further not only dispenses with considerations of portfolio size, it also eliminates the time criterion. In the words of GIC, “it is actually not the time horizon that matters most, but rather… mindset and discipline.” The mindset implies two long-term prerequisites: first, that anticipated near term liquidity needs are a controlled and manageable proportion of total portfolio values; and second, that investors have not only the financial capacity to withstand the inevitable intra-cyclical drawdowns but also the political will and emotional aptitude.

Long-term investing, in the minds of the SWFs who are its leading practitioners, has another defining attribute. Long-term investors don’t merely hold or “bet on” an investment; they participate in it. The European Commission has defined long-term capital as capital that is patient, engaged and productive. Patient capital tends to adopt non-cyclical strategies; it looks past market momentum to asset fundamentals. Engaged capital encourages active stakeholders and better corporate governance. Productive capital emphasizes macroeconomic growth—through long-duration infrastructure projects and new ventures with disruptive, paradigm-shifting potential, for example. It tends to avoid currently favorable “trades.”

1 J.P. Morgan’s Long Term Capital Market Return Assumptions extends horizons even further. The 2015 edition of our Assumptions explains, “We have therefore chosen a time horizon of two economic cycles, or a period of 10 to 15 years, as an appropriate time frame over which secular trend factors and issues can reasonably be expected to play out and be more fully reflected in the financial market returns.”

2 Lim Chow Kiat “GIC’s Long-Term View.” Perspectives on the Long Term (Focusing Capital on the Long Term), 2014.

TAKING THE LONG VIEW

THE CONTRARIAN WAY

Those qualities of patience and productive engagement also (not coincidentally) define the contrarian vision essential to effective long-term investing. The long-term investor is looking for opportunities that the markets, distracted by day-to-day noise, routinely overlook. The payoff for a successful contrarian position takes time; the market will recognize its value only slowly. It will also tend to be outsize, incorporating premia for illiquidity and first-mover effects on top of the normal risk premium.

The search for contrarian opportunities inevitably involves the broad themes that will shape the civilization’s future: urbanization, climate change mitigation, sustainable agriculture, globalizing capital markets and the growth of a worldwide middle class, among others. The fundamentals underpinning such themes ultimately seem as favorable as the timetable for their returns seems vague. Long-term investors’ willingness to wait for the fundamentals to assert themselves sets their discipline apart. Like all strategic investors, they are seeking to maximize risk-adjusted returns—the ratio of an investment’s return minus the risk-free rate of return divided by the standard deviation of the investment’s return. They differ from the ordinary investor in their willingness to tolerate a higher denominator (and greater volatility) over a longer period until a higher numerator (and greater absolute return) materializes.

SIRENS OF THE SHORT TERM

Ironically, most of the risks in long-term investing come from the approach itself. It demands formidable discipline, not only from the professionals in charge but from stakeholders as well. The expansive time horizon of the ideal long-term investor shrinks by many magnitudes under real-world pressures. The U.S. stock market in recent years provides a painful demonstration of the hazards to superior long-term results. The S&P 500 has grown a hundred times over since 1970. Along the way, it muddled through a lost decade from the beginning of 2000 to the end of 2009 with a negative return (-0.3% nominal, -3.0% real, accounting for ground lost to inflation). It may be technically appropriate to attribute such chronic market dips to transient volatility, but they can be very hard for even the most patient investor to endure.

A second risk is the obverse of the first. It is no doubt easier psychologically to be a follower, after an investment’s initial returns have demonstrated proof of concept, than a leader, but it is also likely to be less lucrative. The Lost Decade’s long slog set the stage for a powerful rally. The index has tripled in value off its March 9, 2009, bottom. Surging stock valuations over the last three years, which have shot above historical averages, propelled much of the gain. So, if investors didn’t have the foresight and fortitude to ride out the bottom, they had a very short window to get in before the law (or at least the probability) of diminishing returns at the market’s top limited their prospects.

A similar pattern may be unfolding in prime real estate, an asset class whose yields compared with those in fixed income have made it a magnet for sovereign wealth fund investment. SWF allocations to real estate expanded sevenfold between 2010 and 2014, much of it underwriting the acquisition of “brand-name” properties like the Chrysler Building and

ACTIVELY MANAGING THE LONG TERM

Our emphasis on the long term should not obscure a critical distinction. Long-term investing is not the same as buy-and-hold investing—it does not automatically equate to long holding periods. Rather, it creates optionality. Long-term investors may hold an investment only as long as prospects justify it. Singapore’s GIC, to cite that prominent example again, will exit an investment “if values converge quickly,” in its words. The New Zealand Superannuation Fund, another sovereign wealth investor with an outstanding track record, has stated that it will rotate out of a strategic holding if it identifies an opportunity that offers the prospect of a better risk-adjusted return.

Conceptually, the approach resembles buy-and-maintain strategies, a dynamic variation of buy and hold that many insurance companies employ. A buy-and-maintain strategy will dispose of long-term holdings if the holdings no longer seem able to meet their investment objectives. For instance, an insurer may liquidate an investment-grade position in the event of a downgrade.*

* For a fuller discussion of buy and maintain, see “Buy and Maintain: A ‘smarter’ approach to credit portfolio management,” Investment Insights, J.P. Morgan (September 2014).
Investors can earn more yield on long-term investment-grade debt in many prime locations than on core real estate today.

EXHIBIT 3: CORE REAL ESTATE YIELDS AND SPREADS OVER RISK-FREE RATES*

<table>
<thead>
<tr>
<th>Prime office net yield</th>
<th>Local risk-free**</th>
<th>Spread</th>
<th>Current local investment-grade yield†</th>
</tr>
</thead>
<tbody>
<tr>
<td>Melbourne</td>
<td>6.6%</td>
<td>2.5</td>
<td>4.1</td>
</tr>
<tr>
<td>Auckland</td>
<td>7.3%</td>
<td>3.3</td>
<td>4.0</td>
</tr>
<tr>
<td>Sydney</td>
<td>6.1%</td>
<td>2.5</td>
<td>3.6</td>
</tr>
<tr>
<td>Tokyo</td>
<td>4.9%</td>
<td>2.9</td>
<td>2.5</td>
</tr>
<tr>
<td>Seoul</td>
<td>3.2%</td>
<td>2.3</td>
<td>1.7</td>
</tr>
<tr>
<td>Singapore</td>
<td>3.9%</td>
<td>2.3</td>
<td>3.1</td>
</tr>
<tr>
<td>Taipei</td>
<td>3.0%</td>
<td>1.6</td>
<td>1.4</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>3.0%</td>
<td>1.6</td>
<td>1.4</td>
</tr>
<tr>
<td>Paris</td>
<td>3.8%</td>
<td>0.6</td>
<td>3.2</td>
</tr>
<tr>
<td>London</td>
<td>3.8%</td>
<td>1.8</td>
<td>2.0</td>
</tr>
<tr>
<td>San Francisco</td>
<td>3.7%</td>
<td>2.1</td>
<td>1.6</td>
</tr>
<tr>
<td>New York</td>
<td>3.3%</td>
<td>2.1</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Source: J.P. Morgan Asset Management; data as of January 2015.

*Percentages may not add up due to rounding.

**Yield on 10-year sovereign debt

†Current yields are local average weekly investment grade corporate bond yield to worst (for Australasian cities, except Tokyo, current yield is Asia, ex Japan, corporate bond yield) January-May 2015, source: Barclays Point.

See disclosure on last page for additional notes regarding this exhibit.

Rockefeller Center in New York City and Canary Wharf and the Shard in London. The flood of investment has compressed the yield spread between risk-free assets and prime properties to the point where the income from prime properties in some markets has fallen below that from investment-grade corporate bonds (EXHIBIT 3). Prime properties in New York, Hong Kong and Taipei yield less today than local investment-grade bonds. With 60% of SWF real estate portfolios concentrated in prime properties and SWF allocations to the asset class below their targets, we think it only reasonable to anticipate further spread compression and lower returns.

THE TIME FOR LONG TERM IS NOW

With its unique access to illiquidity and first-mover premia and its ability to exploit mispricings created by liquidity squeezes and market overreaction, the long-term approach expands the investment opportunity set. EXHIBIT 4 gives an idea of how much this expanded opportunity set might add to future risk-adjusted returns, according to our long-term capital market return assumptions. The lower curve depicts the efficient frontier for a conventional allocation consisting of public equities (represented by the S&P 500) and fixed income.
(represented by the Barclays U.S. Aggregate Bond Index).
The upper curve shows the impact on the frontier of adding illiquid assets with high expected returns, such as global infrastructure, U.S. value-added real estate and U.S. private equity. Global infrastructure pushes the existing return potential up higher and to the left toward less volatility. Value-added real estate and private equity both extend the return potential.

The most recent five-year records of eight large sovereign wealth funds, quintessential long-term investors, give an idea of the lift alternative assets have provided in the environment coming out of the financial crisis (EXHIBIT 5). The median allocation to alternatives among the eight funds amounted to 18.5% of the total portfolio. Returns for the funds with above-median allocations beat the conventional 60/40 benchmark allocation return by 551 basis points and beat the returns of the below-median funds by 316 basis points annually. The top four performers among the eight SWFs, with alternatives allocations ranging from 16% to more than 35% with a mean of 26%, beat the benchmark by an average of 671 basis points.

Alternative allocations have boosted SWF performance coming out of the financial crisis

**EXHIBIT 5: FIVE-YEAR ANNUALIZED RETURN AND ALTERNATIVE ALLOCATIONS, BASED ON MOST RECENTLY PUBLISHED REPORT**

<table>
<thead>
<tr>
<th>Allocation to illiquid strategies (%)</th>
<th>5-year annualized return (%)</th>
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</thead>
<tbody>
<tr>
<td>A</td>
<td>5</td>
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<tr>
<td>B</td>
<td>10</td>
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<tr>
<td>C</td>
<td>15</td>
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<td>D</td>
<td>20</td>
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<td>25</td>
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<td>F</td>
<td>30</td>
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<td>G</td>
<td>35</td>
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<td>H</td>
<td>40</td>
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**60/40 portfolio annualized return**

<table>
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<th>Allocation to illiquid strategies (%)</th>
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<td>G</td>
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<td>H</td>
<td>40</td>
</tr>
</tbody>
</table>

Source: Latest available (as of June 2015) reported five-year annualized returns from the websites of this selection of eight notable sovereign wealth funds. 60/40 portfolio represents annualized return between 2009 and 2014 of a hypothetical portfolio consisting of 60% MSCI ACWI Equity Index and 40% Barclays Global Aggregate Index; data from Bloomberg.


**ILLIQUID GEMS**

Long-term potential today looks to us to skew toward real assets. Infrastructure, shipping and comparatively overlooked value-added real estate properties all offer high current yields and appreciation potential on top of a liquidity premium. Like prime real estate, they have historically provided a measure of protection against the ravages of high inflation (EXHIBIT 6). Like public equities, they figure to grow as the global economy grows. Nevertheless, they diversify portfolios with low and even negative correlations to public investments.

Direct real estate and infrastructure investments performed best in the most recent U.S. high-inflation environment


Another attractive aspect of the real asset class is the fact that it has room left for first-mover advantage. While real estate’s spread over risk-free assets has shrunken in prime locations in the U.S. and east Asia, as well as in London, the spread remains attractive in other geographies, as Exhibit 3 shows. Value-added real estate—industrial properties and retail projects such as shopping malls—offers comparable prospects. Although spreads between risk-free assets and core properties have varied, the spread from core to value-added has been consistent (EXHIBIT 7, next page).
Since 2006, the annual yield premium of value-added real estate over core has consistently exceeded 500 basis points.

EXHIBIT 7: ANNUAL YIELDS U.S. CORE VS. VALUE-ADDED COMMERCIAL REAL ESTATE

Source: J.P. Morgan Global Real Assets.

Infrastructures, one of the most promising asset classes, according to our long-term assumptions, shares this potential. Our assumptions call for it to generate a Sharpe ratio of 0.42 over the next 10 to 15 years vs. 0.34 for both U.S. large cap equities and international equities. Yet while SWF allocations to infrastructure have been increasing (EXHIBIT 8), the Organisation for Economic Co-operation and Development in a discussion note published in 2011 observed that “in principle, institutional investors should be natural investors in infrastructure and venture, but allocations are generally low,” noting at the time that less than 1% of the world’s pension funds had invested directly in infrastructure.

SWFs are investing in real estate and infrastructure at the expense of public and private equities.

EXHIBIT 8: PROPORTION OF SOVEREIGN WEALTH FUNDS INVESTING IN EACH ASSET CLASS, 2013 VS. 2015 (% OF TOTAL)

Source: Preqin; data as of May 2015.

THE PATIENT OPPORTUNITY SET

A vast market is thriving away from the public exchanges. The private equity universe is 25 times the size of its public counterpart, according to one estimate. Yet it has far fewer investors, in part because success in private equity demands more patience and skill than it does in the public markets. To get to the payoff of going public, a new private venture must undertake an intensive period of research and development, create a viable corporate structure and prove its proposition in extensive test marketing. An established business undergoing a leveraged buyout typically must proceed through stages of financial restructuring—and in turnaround situations, it will have to pass through a period of management restructuring as well.

The hallmark of private investment—the J-curve—maps out this time factor: a stream of outflows in the form of capital calls almost always precedes the first returns. Recent private equity trends have prolonged the curve. Ventures are staying private longer, generating more of their ultimate value for their non-public investors before seeking an exchange listing (EXHIBIT 9, next page). The trend has had a twofold effect on the private equity market. It has delayed the early investors’ ultimate payoff even as it has exponentially increased it. At the same time, the trend has fostered the growth of liquid secondary markets where limited partners can sell their interest prior to the initial public offering end state.

Source: Preqin; data as of May 2015.

5 J.P. Morgan Private Equity Group.
THE BUMPS ALONG THE INFRASTRUCTURE ROAD

The risks inherent in infrastructure help explain at once their lush returns and the reluctance of many investors to pursue them. Successful infrastructure investing calls for a deep understanding of local political and business dynamics, layered over an informed view of regional and global economic cycles. The high level of specialist knowledge required may explain why actual returns vary so much, as indicated by a comparison of median and mean results on a simple non-time-weighted basis—the multiple of invested capital. In an analysis of infrastructure returns between 1971 and 2009, the spread between the mean multiple, at 2.69X, and the median (the multiple in the middle of the entire sample), at 1.69X, indicates exceptional dispersion, with a few very large positive results distorting the average.

The dynamics of private investment help explain this dispersion. Unlike the mean-reverting bias that dominates public investment, the advantages of the best private investment managers tend to persist. Past performance is a better predictor of future results than in the public markets. The most successful investors go on to gain experience over many market cycles, and their track record earns them a first look at the most attractive deals.

IPOs are staying private for longer to realize more value when they finally go public

EXHIBIT 9: AVERAGE AGE OF ENTERPRISE AND AVERAGE MARKET VALUATION AT IPO, 2000-2014

As in infrastructure investing, the wide range of financial and managerial skills called for in private equity investing makes for a wide dispersion of returns. In fact, our long-term return assumptions forecast a somewhat lower risk-adjusted return for the median private equity investor than for publicly traded large cap stocks as a whole. After accounting for the dispersion characteristic of the asset class, however, the outlook for the top managers projects much higher (EXHIBIT 10, next page).

THE OTHER PRIVATE UNIVERSE

With the reregulation in the wake of the financial crisis, a market in private debt has grown to dimensions comparable to its private equity equivalent. The new Basel III regulations could eventually triple the amount of capital that banks must hold against their loan portfolios. To meet this requirement, we expect some of them to reduce their loan books, creating distortions and opportunities in the marketplace, especially in Europe where bank lending predominates, accounting for 86% of all corporate borrowing as against 29% in the U.S.7

In the U.S., provisions of the Dodd-Frank Act, which restrict proprietary trading by banks, have had the effect of drastically reducing dealer inventories. The lower inventories have in turn drastically reduced market liquidity. Investors able to withstand the mark-to-market volatility, which would most likely occur, should thus be in a position to provide liquidity and acquire solid loans beaten down by oversupply and unsteady demand. The tight market should also make it easier to write covenants in loan agreements that will secure buyers’ interests.

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7 By contrast, bond issuance makes up 46% of the corporate debt market in the U.S. and only 10% in Europe. The balance consists of direct lending in both geographies. (From Jan Schildbach and Claudius Wenszel, Bank performance in the US and Europe: an ocean apart. Deutsche Bank, 2013.)
In illiquid asset classes, manager selection has decisively determined results

EXHIBIT 10: DISPERSION OF MANAGER RETURN ACROSS ASSET CLASSES BETWEEN 2009 AND 2014


*J.P. Morgan Long-term Capital Market Return Assumptions, projections of median annual returns over a 10- to 15-year time horizon.

THE SOUNDEST STRATEGY... AND THE MOST DIFFICULT

Over a sufficiently long time horizon, the odds favor the success of many investments. As time horizons shrink, market factors increasingly enter into target return calculations. Bid prices may rise so high that assets may not realize the desired gain over any reasonable time frame. By contrast, assets overlooked in the rush of conventional investors to capture a current fashion—or to sidestep a current dislocation—may stand to reap all the premia on offer: risk, liquidity, lock-up, first mover, distress and so on.

Such assets come with challenges of their own, however. Since the financial crisis, the emphasis on mark-to-market valuation in accounting and regulation has raised the price of patience, for pension funds especially. And even as long-term investors must look past transient volatility to a distant time horizon, they need to remain sensitive to the near-term opportunity—when a flood tide of enthusiasm lifts the value of their positions to their price target, or simply when another opportunity comes along that will improve the calculus of risk and reward in their portfolios overall.

Perhaps the gravest threat to the long-term strategy may arise from the shortsightedness of stakeholders who stand to benefit most. “Mark-to-peer pressure” can undermine the rationale for the soundest contrarian investment, especially in the early years of staking out a first-mover advantage when shorter-term investors are posting better results than investors poised strategically at the base of a J-curve. This threat is pervasive and it spotlights an aspect of the discipline no long-term investor can afford to ignore. Thorough education, plus open, frank and frequent dialogue with stakeholders, is essential to staying the frequently arduous course that leads to superior returns.
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EXHIBIT 3: For the best available global comparison, Sydney office is represented by Sydney CBD (1998-1Q 2015); Melbourne office is represented by Melbourne CBD (1998-1Q 2015); Tokyo office is represented by the Central 5 wards (1996-1Q 2015); Singapore office is represented by the Raffles area (1998-1Q 2015); Hong Kong office is represented by Central (1996-1Q 2015); Seoul office is represented by the CBD, Yeouido and Gangnam business district (2001-1Q 2015); Taipei office includes Xinyi (2001-1Q 2015); Paris office is represented by the Paris Île-de-France area (2003-2014); and London office is represented by London Central (2003-2014); San Francisco office is represented by all submarkets (2004-2014); and New York is represented office by Midtown (2001-1Q 2015).

Yields for Australia office are defined as the ratio of the net passing income deducting incentives (if any) and the sale price or estimated value; yields for Tokyo, Hong Kong and Singapore offices are defined as the ratio of the sale price or estimated value (net of transaction costs) and the current income being paid under the market-effective rent (assuming full occupancy and deducting operating expenses and incentives, if any); yields for the U.S. offices are defined as the ratio of the net operating income and its capital cost (i.e., the original purchase price); yields for European offices are based on the ratio of net market rental income (net of tax and any other expenses) and the gross market value (including transaction costs).

Asia Pacific office yield data are sourced from Jones Lang LaSalle REIS as of 1Q 2015, with the exception of Auckland, which is as of 4Q 2014; San Francisco prime office yield data are sourced from Real Capital Analytics as of 4Q 2014; New York prime office yield data are sourced from Jones Lang LaSalle REIS as of Q1 2015; European prime office yield data are sourced from CBRE as of 1Q 2014; risk-free rates for all countries are based on 10-year bond yield extracted via DataStream as of 1Q 2015.

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