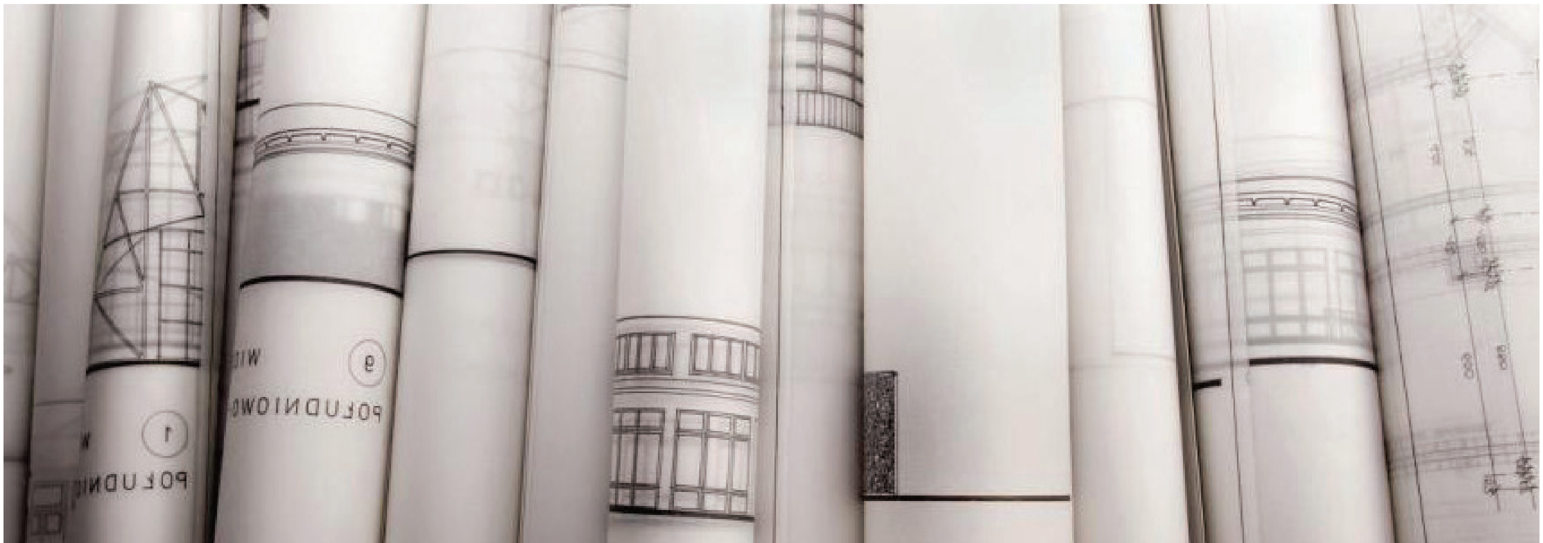


Public Eye

FALL 2014/WINTER 2015

News and views impacting public funds

CIO Corner:

Christopher Ailman, Chief Investment Officer of California State Teachers' Retirement System (CalSTRS), discusses the rewards of public fund leadership, the evolution of his organization's collaborative culture and the long-term funding plan recently approved by the California state legislature.

Q: What skills does someone need to be an effective CIO of a public plan, especially a large plan like CalSTRS—the second largest plan in the U.S., with a market value of $188.3 billion as of Aug 31st?

AILMAN: You have to be a very astute investor, but you also have to be a very good leader and manager of an investment management organization. When I was CIO of a smaller fund, I got to spend about two-thirds of my time doing investments and one-third on administration, leadership and management. Now that ratio has flipped. As CIO of a public fund in a big state, there's a constant challenge of outside pressures and influences. Rather than reflect that heat back on my staff, I choose to shield them from it, so that they can focus on investing.

Q: In June, the state legislature passed a long-term funding plan that largely reflects the changes that CalSTRS itself had proposed. How did this happen, and how do you feel about the final result?

AILMAN: The Board and our CEO, Jack Ehnes, have been working on our funding problem for over a decade. We didn't have the power to make the change. We had to present the problem and offer potential solutions. We had to encourage, cajole, and

J.P.Morgan
Asset Management

CIO Corner: A conversation with Christopher Ailman, CIO of California State Teachers' Retirement System (CalSTRS) *(continued)*

educate the decision makers. I really credit the California legislature, and I'm thrilled with the final outcome.

Q: For this new long-term funding plan, some suggested that an 80% funding target was a more realistic goal, but why did CalSTRS insist on a 100% target?

AILMAN: You wouldn't run a model on your 401(k), and say, "Well, I'm going to shoot for 80% of my goal and hope I win the lottery." You wouldn't want your pilot to estimate enough gas to get 80% of the way to your destination.

Q: CalSTRS posted impressive results for the most recent fiscal year and strong performance over the long term. What explains your success?

AILMAN: In our rebound since the financial crisis, one of the most important contributing factors to our success has been our overweight to U.S. equities. Credit goes to my team for having the guts to stay in the market.

Q: What is your approach to asset allocation?

AILMAN: We break this task into two segments. We have a long-term strategic asset allocation, which the Board revisits every three or four years. We're a giant ship. The Board sets the target on the horizon, and our job is to sail to it. Then we make subtle course corrections along the way. We're not trying to time the market with these tactical shifts. We're just trying to be smart in how we rebalance the fund.

Q: The plan currently targets 55% to global equity, 17% to fixed income and 13% each for private equity and real estate. Have those targets changed much in recent years?

AILMAN: They haven't significantly changed. We have had a slow, steady reduction in the amount of fixed income in the portfolio, from a high of 25% about a decade ago, down to the current target of 17%.

Q: How do you think about alternatives in your portfolio?

AILMAN: We've recognized that we might like more private equity and real estate in our portfolio, but we believe there are

PROFILE

Christopher Ailman
Chief Investment Officer, California State Teachers Retirement System (CalSTRS). 2000–present

Education:
BA: University of California, Santa Barbara

Personal Highlights:
Born: Northridge, CA (a "Valley Boy")
First job: Dean Witter Reynolds
Hobbies: Road cycling (500 miles per summer month), sailing, woodworking
Favorite movies: *Hunt for Red October, The Great Race, Monty Python and the Holy Grail, Rocket Man*
Favorite books: *The Bible, Lincoln on Leadership, A Salty Piece of Land* by Jimmy Buffett

limits in terms of dollar amounts. For example, I think a $30 billion private equity portfolio is about as much as we can sensibly put to work. Like others, we are looking more at other alternatives, growing infrastructure and inflation-sensitive assets.

Q: How does CalSTRS decide to invest in a sub-asset class for the first time?

AILMAN: In 2009, we created the Innovation Team. It's funny, when they recently made a Board presentation, we had them wear safety goggles and white lab coats. This was to emphasize the fact that they are like scientists in a lab, because they carefully explore potential new opportunities, looking for investments that might enhance our return without dramatically increasing our risk. This is a safe place to pilot test different, new investment strategies before introducing any of them in size to the rest of the fund. Some of our peers like to experiment, with $3-$5 billion stakes. I've heard them say, "Go big or go home." I don't buy into that.

Q: CalSTRS has been a strong advocate for corporate governance. How should institutional investors consider this subject?

AILMAN: Corporate governance is critical. Institutional investors should care about it, because they are long-term owners of a company. We advocate for a number of good governance practices that will help make for sustainable, successful businesses that we can be comfortable investing in for the very long term.

Q: CalSTRS is known for its culture of excellence, mutual respect and inclusion. What have you done to develop and foster this workplace environment?

AILMAN: Culture is a huge focus for me. CalSTRS' strong culture is something I inherited from Jack Ehnes and my predecessors, and it is something that I am very intent about fostering for the future. As I've studied money managers, it is clear that a consistent driver of alpha is the culture. We have seen management and organizational culture shifts result in loss of alpha. Our culture is collaborative, and it is fully adopted by the staff, not forced down from management and definitely not some hollow words on a plaque in the lobby. Besides our investment success, one other piece of evidence of the importance of our positive, inclusive culture is our low personnel turnover rate. Over the past 15 years, it has averaged just 4% a year, far below the average for a public plan.

Q: You're planning to team up with other pension plans to invest in infrastructure assets. Can you tell us about the consortium you're developing?

AILMAN: In the U.S., infrastructure has typically been financed by municipal debt. That's an excellent way to build an asset, but it doesn't work so well to maintain the asset. A lot of wonderful infrastructure in this country is crumbling. Pension funds represent long-term, patient capital and these are long-term stable assets. This is a nice match of our capital needs and what society needs. Many of the infrastructure funds are closed-ended with artificially short investment horizons for such investments. We want to find partners to invest in well-managed infrastructure over a much longer investment horizon, because our plan's liabilities keep extending. Here's an example. When a CalSTRS retiree turns 100, we send out a birthday card. We average close to 30 of these a month. California teachers for some reason have healthier lifestyles and longer lives.

Q: What changes might we see in pension management in the next few years?

AILMAN: I think that in the next five years more plan sponsors will be paying attention to long-term sustainability issues. It will be an interesting challenge, because I don't think it's in the current scope of most investment officers. We are one of the few funds that currently talks openly about ESG (environmental, social and governance).

Q: Personally, what gives you the greatest satisfaction in your job?

AILMAN: The two things that give me the greatest satisfaction in my job are my tremendous staff and our important mission. Loyalty to the staff, up and down the organization, has kept me here. There's also something very special about working for teachers to safeguard their retirement. My sister is a 30-year veteran teacher, and I have two sisters-in-law who are teachers. My daughter is finishing her Master's degree in education and will become a teacher. Teachers have a true calling, not just a career. They make sacrifices to ensure a better future for our children and for all of us, and they're dependent on us to do a good job to secure their retirement years. We know we've got to perform and perform well.

U.S. expansion: Room to run

By Michael Hood, Global Markets Strategist

Although GDP reportedly contracted in the first quarter of 2014, the U.S. economy appears to be transitioning to a pace of growth that is somewhat faster than the one that characterized the first several years of the current expansion. With the 4.6% second quarter number, GDP growth averaged 2.6% in the year to mid-2014, even with the stumble at the turn of the year. That rate compares with 2.1% on average in the previous four years. We expect that healthy private sector balance sheets, less contractionary fiscal policy and a more favorable international backdrop will enable growth to run at roughly a 3% clip during the next few quarters, even as the Federal Reserve begins tightening monetary policy.

Given that the expansion began in mid-2009 and thus has passed the five-year mark, is the cycle nearing its end? In our view, the U.S. economy still possesses considerable room to run, with the risk of a recession in the near term fairly low. Cycles have grown longer over time, and a five-year expansion no longer looks aged. The particular characteristics of the current expansion also suggest that the economy is not yet bumping into constraints. Sluggish growth after a deep recession means that the level of economic activity is not significantly above its pre-recession peak. The credit cycle has barely gotten underway. And interest-sensitive spending, particularly residential construction and household purchases of durable goods, looks low by long-term standards. The unemployment rate has fallen rapidly, but broader measures

U.S. expansion: Room to run

(continued)

of labor market conditions still point to remaining spare capacity. Admittedly, the drivers of expansions and recessions remain poorly understood, and a downturn in the forecast horizon cannot be ruled out, but few obvious warning signs are apparent at the moment.

While the economy has not yet begun to overheat, the Fed will likely begin raising policy interest rates in mid-2015. The FOMC has made progress toward achieving both parts of its mandate, with the labor market gradually healing and deflation risk receding. Short-term interest rates at zero look increasingly inappropriate for an economy well on the way to normalization. Although bond yields jumped in 2013 when the Fed hinted at reducing its asset purchase program, ultimately the “tapering” process has played out with little damage to the economy. Fed policymakers likely believe that growth can withstand somewhat higher rates as well.

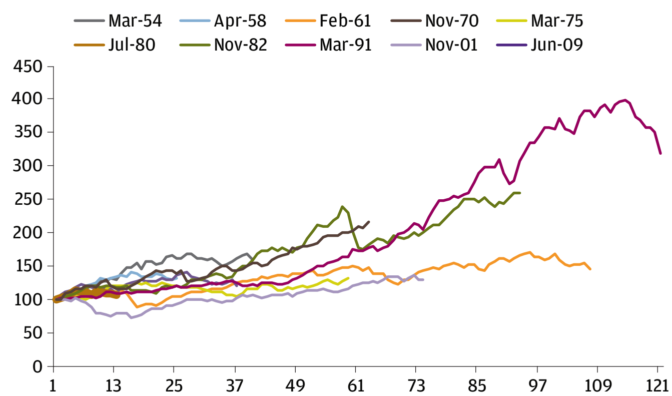
If the U.S. economy indeed remains in the middle phase of the current expansion, equity markets likely can move higher over time. In the past, U.S. equity prices have tended to drift upward throughout expansions, falling only when the economy enters recession or is very close to the brink of a downturn (**Exhibit 1**). Current valuations do not suggest elevated returns on stocks in the next few years, but significant and lasting corrections have occurred only infrequently outside of recession. By contrast, credit spreads seem to bottom earlier in expansions, likely because of transitions in corporate behavior. In the first few years of each cycle, companies take creditor-friendly actions, later shifting toward more shareholder-supportive activity (such as mergers and acquisitions). Spreads currently stand not far above the troughs reached in previous cycles, and that evolution of corporate behavior appears to be underway. Spreads thus probably enjoy only limited room for tightening from here.

As the Fed moves closer to tightening, increased divergence characterizes global monetary policy stances, which have been almost uniformly accommodative until recently. The European Central Bank recently eased and may do more in coming months, and the Bank of Japan seems likely to pursue expansionary policy indefinitely. The Bank of England, by contrast, may raise rates before the Fed. As central banks pursue these various courses, short-term interest rate differentials are likely to move much more than in the past several years.

With the Fed among the more hawkish central banks, a rising rate differential in favor of the U.S. will likely produce steady, sustained appreciation pressure on the dollar. Already in the past few months, the dollar has begun to strengthen, and this trend may continue for another year or two. As a result, U.S.-based investors likely need to mark down their expected near-term returns on unhedged international assets.

S&P 500 in business cycle expansions (first month of cycle = 100)

EXHIBIT 1: U.S. EQUITY PRICES HAVE TENDED TO DRIFT UPWARD THROUGHOUT EXPANSIONS, FALLING ONLY WHEN THE ECONOMY ENTERS RECESSION OR IS ON THE BRINK OF A DOWNTURN



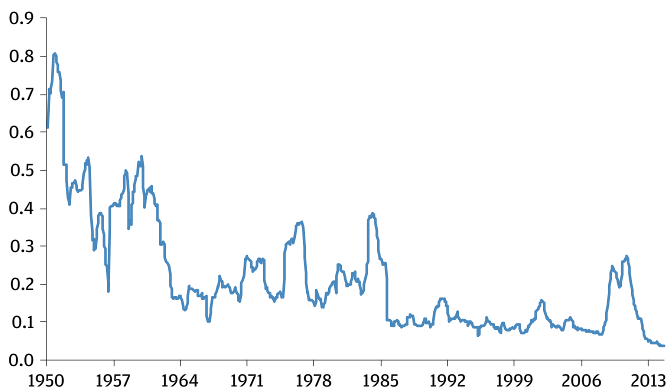
Source: J.P. Morgan Asset Management, J.P. Morgan Securities, Bloomberg; data through August 2014. X-axis scale is months.

Volatility, both implied and realized, has fallen to low levels this year. Rather than signaling investor complacency, though, this calm appears to reflect the economy’s cyclical position. Volatility dropped similarly in the mid-1990s and mid-2000s. Moreover, low market volatility likely owes a great deal to unusually limited economic volatility. Although growth has disappointed, it has been running at a quite steady pace by long-term standards. The standard deviation of monthly payroll changes, for example, has declined to a record low (**Exhibit 2**, next page). Meanwhile, oil price volatility has also collapsed, thanks to the easing of supply constraints, in turn preventing geopolitical risk from transmitting into sustained market nervousness.

The risk to this generally benign atmosphere likely centers on the labor market, in particular the possibility that less slack exists in this area than currently believed. If labor supply growth, which has been extremely muted in recent years, does not accelerate at some point, the economy may reach its neutral rate of unemployment fairly soon. If a sharp acceleration in wage inflation resulted, the Fed might tighten monetary policy more aggressively, perhaps bringing the expansion to an earlier-than-expected finish. Wage inflation has recently shown signs of moving higher, but gradually and from a low starting point. Measures of wage pressure will take center stage in coming quarters as markets gauge risks to the continuation of the current business cycle.

U.S. employment, standard deviation of monthly % change (two-year window)

EXHIBIT 2: AMID LIMITED ECONOMIC VOLATILITY, THE STANDARD DEVIATION OF MONTHLY PAYROLL CHANGES HAS DECLINED TO A RECORD LOW



Source: J. P. Morgan Asset Management, J.P. Morgan Securities; data through August 2014

Alternative beta: Redefining αlpha and βeta

By Soheil Galal, Managing Director, Investment Management Solutions—Global Multi-Asset Group and Rafael Silveira, Portfolio Strategist, Global Strategy

Alternative beta (alt beta) strategies have opened a new avenue for accessing the investment characteristics for which hedge funds are highly valued. Alt beta strategies provide ready access to uncorrelated returns that can help improve portfolio diversification, risk-return efficiency and volatility management—without the high fees, lock-ups and limited transparency often associated with hedge funds.[1]

A passive, rules-based approach gives alt beta strategies the ability to provide liquid, low-cost and transparent access to the "beta" component of hedge fund returns (that is, the portion attributable to systematic factors associated with hedge fund investing) vs. the "alpha" component (attributable to idiosyncratic manager skill). As a result, these strategies can be a valuable complement to portfolios for investors that want to:

- access investment characteristics previously available only via hedge funds
- expand an existing hedge fund allocation or improve its fee, liquidity and transparency profile
- establish hedge fund exposure while they conduct manager due diligence to initiate or enhance a hedge fund program
- supplement fixed income allocations—to gain diversification benefits without the interest rate sensitivity of bonds in a rising rate environment
- gain new perspective on the performance of active, alpha-generating hedge fund strategies by comparing them with alternative beta benchmarks

The morphing of alpha into beta

Initially, returns from active investment management were attributed almost entirely to security selection—that is, to manager skill (or alpha). Over time, in both the traditional and alternative spaces, more and more of that "alpha" is being redefined as "beta." Through rules-based "beta strategies" these underlying drivers of market returns are becoming more readily "investable."

That is extremely important for investors because it means more ways to access and combine the different components of traditional and alternative returns, more opportunity to optimize management fee expenditures and new, more objective benchmarks for assessing manager-generated returns.

[1] As the term implies, alternative beta strategies are not restricted to strategies designed to provide exposure to the beta portion of hedge fund returns. This paper, however, focuses on hedge-fund-related strategies, currently the most prevalent form.

Alternative beta: Redefining αlpha and βeta *(continued)*

A short history of beta investing helps put alternative beta developments in context:

- In 1975, John Bogle launched the first mutual fund designed to track a *capitalization-weighted index*—creating an investable format for accessing *traditional market beta as represented by cap-weighted indices*.

- Less than two decades later, academic research began to identify other systematic risks, behavioral anomalies and structural inefficiencies driving equity returns, such as value, size, momentum and low volatility; another slice of alpha was being redefined as beta.[2] More recent research has indicated that cap-weighted approaches may not be the most risk-efficient way to gain exposure to these systematic drivers of equity market returns.[3,4]

  This enhanced understanding has led to the introduction of a variety of *strategic (or "smart") beta strategies—non-market-cap-weighted approaches* designed to provide investors with a more risk/reward-aligned exposure to the risks associated with traditional, long-only equity investing. Strategies may include equal-weighting the stocks in an index or weighting the stocks based on exposures to factors such as value, size, momentum and volatility.

- *Alternative beta (alt beta) strategies* extend the concept of beta investing from long-only traditional assets (i.e., equities and bonds) to long-short investing in traditional and alternative assets. These strategies are designed to build exposure, for example, to hedge fund-related risk factors by following specified rules and investing in individual securities. Alt beta strategies include a variety of hedge fund styles, such as equity long/short, global macro, merger arbitrage and convertible bond arbitrage (see sidebar).

[2] Among the most familiar multi-factor models is the Fama-French three-factor model, which includes the market, size and value factors. Eugene F. Fama and Kenneth R. French, "The cross-section of expected stock returns," The Journal of Finance, Vol 47, Issue 2 (1992); Fama and French, "Common risk factors in the returns on stocks and bonds," The Journal of Financial Economics. Vol 33, Issue 1 (1993).

[3] Andrew Clare, Nick Motson and Steve Thomas, An Evaluation of Alternative Equity Indices—Part 1: Heuristic and Optimised Weighting Schemes (March 30, 2013). Available at Social Science Research Network (SSRN): http:// ssrn.com/ abstract=2242028 or http://dx.doi.org/10.2139/ssrn.2242028.

[4] Clare, Motson and Thomas, *An Evaluation of Alternative Equity Indices—Part 2: Fundamental Weighting Schemes* (March 30, 2013). Available at SSRN: http:// ssrn.com/abstract=2242034 or http://dx.doi.org/10.2139/ ssrn.2242034.

HEDGE FUND STYLES AND ALTERNATIVE BETA FACTORS

Alternative beta comes in multiple flavors that typically have low correlation to one another.

- **Equity long-short invests in top-ranked stocks while shorting bottom-ranked stocks from a global developed market universe, capturing momentum, value, size and quality factors.**
- **Global macro seeks some of the liquid and systematic risk premia captured by macro hedge funds, including term premium, fixed income carry, commodity roll yield, commodity momentum, foreign exchange (FX) carry and FX momentum factors.**
- **Merger arbitage focuses on the deal risk premium factored into the price of the merger target stock until the deal is completed.**
- **Convertible bond arbitrage focuses on the illiquidity and small cap premia available in the convertible bond market by capturing the underpricing of the embedded optionality.**

Source: J.P. Morgan

Constructing alternative beta exposures

Alternative beta strategies build exposures to the beta portion of hedge fund returns from the bottom up. A strategy for capturing the "deal risk premium" in merger arbitrage (the return for taking on the risk that a deal will not be completed, post-announcement) is an instructive example. While a skilled hedge fund manager may be able to add alpha by carefully analyzing and selecting the most profitable deals, the systematic deal risk premium can be captured through a more passive, rules-based strategy—namely, going long the target (acquiree) stock while shorting the acquirer stock, across all announced deals, within defined parameters.

The deal risk premium in this trade fits the definition of "systematic (beta) risk." The risk premium persists because many investors holding the target firm's stock are more comfortable with selling their positions to lock in immediate post-announcement gains than with holding the stock for a chance to gain a little bit more while being exposed to the risk of the deal failing. This is a logical risk-return trade-off for an individual investor. However, given the nature of these deals and the advantages of diversification, taking on the deal risk premium across all deals should over the long term result in a net gain.

This is just one example of how investors can gain access to hedge fund style premia without paying the 2-and-20 fees often associated with actively managed hedge funds—and establish an objective benchmark for assessing the alpha-generation capabilities of hedge fund managers. What's more, capturing the different hedge fund style betas in a diversified portfolio has the potential to offer highly risk/return-efficient access to these risk premia.

For more on alternative beta investing, including J.P. Morgan's clarifying definitions of the often confusing array of terms associated with beta investing innovations, see our recent *INSIGHTS* entitled: "Alternative beta: Redefining αlpha and βeta" or contact your J.P. Morgan representative.

Alternative investments: Striking the balance between growth and liquidity

Alternative investments—hedge funds, real estate, private equity and infrastructure—have attracted a great deal of attention in the public pension community and a growing share of its assets. The average public plan has increased the relative weight of alternatives in its portfolio two-and-a-half times in the last 10 years, from 10% to 25%.[1] NCPERS joined with J.P. Morgan this year to understand how this important trend is shaping plan sponsor investment strategies. A 2014 joint survey of a broad cross-section of public funds confirmed the growing appreciation of alternatives' high return potential. It also confirmed an awareness and acceptance of their principal risks. Only a small minority of respondents considered exiting illiquid allocations in 2008-09. Over 90% stayed the course through the financial crisis, despite temporary dislocations.

This is not to say that the respondents wouldn't welcome a more liquid form of alternative investing. The survey identified considerable interest in strategies, such as hedge fund replication and alternative beta, that feature daily liquidity while aiming for an alternative-like return profile

While the survey showed that public funds have enthusiastically adopted alternatives, it also showed that they have been slow to recognize the broader portfolio implications. Without a rigorous rebalancing policy, a plan could find itself short of liquidity for current obligations, despite superior returns, with the bulk of its assets tied up in highly illiquid investments. Yet while three-quarters of the NCPERs/J.P. Morgan survey respondents said they were considering an increase in their alternative investments allocations in the coming three years, two-thirds reported that they rebalanced informally "a couple of times a year" or less.

How much liquidity does your plan really need?

J.P. Morgan took the findings as a springboard for research into the question of how to balance current liquidity against the future growth of plan assets. The firm's strategists modeled returns over the next two decades for a typical plan (in this case the average of assets, asset allocation, funded status and cash flow of the 241 funds reporting in NCPERS' 2013 survey). Rather than the conventional back-testing approach, the strategists based their analysis on J.P. Morgan's proprietary long-term capital market return assumptions and performed a Monte Carlo simulation generating 10,000 statistically possible ending asset values. The study arrived at four important conclusions:

- Contrary to reports predicting the doom of public pensions, the threat of insolvency does not seem to apply to the typical public plan in the next few decades. The probable growth in assets, plus expected contributions, would nearly cover all plan benefits and expenses.
- Even on a worst case basis, the lowest 5% of all statistically possible outcomes, the likelihood of insolvency is remote. As a practical matter, it is nearly impossible, since plan sponsors would have ample time to take remedial action.
- A liquidity squeeze—defined as a circumstance in which a plan would lack the liquidity to cover two years of projected benefits and expenses—while insignificant in the first ten years of simulations, rises steadily over the second ten years to a cumulative probability of 18% in the worst case scenario, when investment returns decline from the median 6.6% level to 2.6%
- Over a long time horizon, according to our return assumptions, a portfolio with a total allocation to alternatives of 35% would optimize the portfolio trade-off in the median scenario. The superior long-term return compensates for the short-term liquidity given up below that level; above it, it doesn't.

[1] *Pensions & Investments* database, September 30, 2013.

Alternative investments: Striking the balance between growth and liquidity *(continued)*

The modeling suggests an approach; it doesn't provide the answer. It applied to only a single hypothetical portfolio and equal-weighted the factors used to calculate investment utility. Subsequent trials that weighted one of the factors more heavily at the expense of the other two—return, for instance, at the expense of volatility and liquidity—to reflect a plan sponsor's preferences or a plan's funded status, came up with different answers. So target alternatives allocations will change according to sponsor input, but our modeling does point the way to a quantitative means of assessing portfolio liquidity preferences and attaining the desired balance between alternative and traditional assets.

Quadrimestre views: Many roads lead to U.S. large cap equities

Risk allocation: Long stocks, but not short bonds

Conventional wisdom would translate a constructive stance on the U.S. economy to a positive view on stocks and a negative view on duration. While stocks look attractive, the outlook for duration is not particularly negative. Improving economic and EPS growth, low financing costs, and above average equity risk premia all point to a supportive environment for stocks.

Meanwhile, the typical hazards for bond investors of inflation, extended positioning, and exuberant global growth expectations are palpably absent. Add to the mix the backdrop of loose global policy and high demand for riskless assets as new financial regulations come into play, and it is hard to take an especially negative view on duration. Simply put, this is not a "great rotation" world, but a "persistent diversification" world.

U.S. equities: An overweight in U.S. large cap equities forms the core of our equity positioning

The U.S. is the clear growth leader in the world economy—so much so, that it leads us to put aside the old equity strategist adage "if you're bullish on the U.S. economy, be overweight any equity market but the U.S." This was based on the logic that the U.S. equity market traditionally was the high-quality defensive, low-beta market. The much higher degree of certainty surrounding the U.S. outlook outweighs this.

On the U.S. yield curve: Flatter, but now led from the front

With short-end rates likely to rise as the Fed starts to normalize policy, but back-end rates compressed by loose policy outside the U.S., continued flattening of the yield curve is likely. In addition, equities should return to high single digits and credit remains attractive as a carry trade. While some expect a higher U.S. dollar and anticipate a modest tightening of Fed language as the FOMC paves the way to higher short-end rates, this does not necessarily translate to meaningfully higher volatility in most asset classes.

Policy and growth divergence

The U.S. is moving from reliance on stimulus to a self-sustaining phase, and as the business cycle matures, monetary tightening will be justified. The same cannot perhaps be said of Europe (ex. UK) and Japan, both of which will likely rely on stimulus for a while yet; and many emerging markets face an uncomfortable period of adjustment relating to the recent rapid build-up in debt.

Upside and downside risks

Of course, there are risks to this view—a policy error, or weaker than anticipated consumption in the U.S. could cause an episode of de-risking. By contrast, a rapid acceleration of growth could trigger an inflationary end game. Nevertheless, light positioning in many asset classes plus a general tone of caution among many investors balances these tail risks. On balance, while the longer-run structural uncertainties persist, the recovery will likely gain pace; in turn creating a positive backdrop for risky assets.

U.S. economic growth is expected to be above-trend, while growth in Europe and Japan remains weak. Quantitative easing has introduced uncertainties, which may eventually constrain potential growth; but this fragility is most apparent today in emerging markets, where the unwinding of rapid credit expansion could weigh on EM assets in the next 12 months.

Active allocation views

KEY: Max negative ■ ■ ■ | Neutral ■ | Max positive ■ ■ ■

Asset class		Opportunity set	Δ	Negative		Positive	Rationale
Main asset classes		Equities/Bonds	↑	□□□	□	■■□	Rebounding U.S. growth, more international policy should be supportive for risk assets.
Main asset classes		Duration	↑	□□□	■	□□□	International growth lagging U.S. and stimulus from BoJ and ECB keeps demand for long-duration riskless assets relatively high.
Main asset classes		Credit	↑	□□□	□	■□□	Attractive from a carry perspective, reasonable entry point to credit markets after summer correction, default risk remains low.
Main asset classes		Commodities		□□■	□	□□□	Oversupply in some commodities and falling EM demand lead to a poor outlook. Rising U.S. oil supply offsets risk of price spike.
Regional preferences by asset class	Equities	U.S.	↑	□□□	□	■■□	U.S. leads global growth and we have the most confidence in the U.S. outlook for 2015. Flattening curve supports U.S. large caps.
Regional preferences by asset class	Equities	Europe ex-UK	↑	□□□	□	■□□	ECB stimulus likely a game changer. EPS revisions should follow weakening of EUR.
Regional preferences by asset class	Equities	UK	↓↓	□■■	□	□□□	Fully valued defensive market with political risks high ahead of the general election in 1H15.
Regional preferences by asset class	Equities	Japan		□□□	□	■□□	Rebounding EPS momentum, even without further JPY weakness. Asset allocation shifts and possibly more BoJ action to come.
Regional preferences by asset class	Equities	Pacific ex-Japan		□□□	■	□□□	Reduction of policy tail risks in China is set against longer-term concerns remaining over the unwinding of credit cycle.
Regional preferences by asset class	Equities	Emerging markets		□□□	■	□□□	Stabilization and attractive valuations offset by structural concerns, economic dislocations and prospect of stronger USD.
Regional preferences by asset class	Fixed income	U.S. bonds	↑	□□□	■	□□□	Relative valuation to other G4 bond markets modestly attractive, no sign of inflation risk in U.S. just yet, expect flatter U.S. curve.
Regional preferences by asset class	Fixed income	Euro, *core*	↓	□□□	■	□□□	Bund yields have already substantially compressed, ECB stimulus creates preference for periphery.
Regional preferences by asset class	Fixed income	Euro, *periphery*		□□□	□	■□□	ECB stimulus puts pressure on peripheral bond yields, convergence trade in play with TLTRO locking front-end rates for 4 years.
Regional preferences by asset class	Fixed income	UK bonds	↑	□□□	□	■□□	Relative valuation to other G4 bond markets attractive, UK growth fully priced in data, impact of BoE hikes probably overstated.
Regional preferences by asset class	Fixed income	Other DM bonds	↓	□□□	■	□□□	JGBs unattractive on relative real yield basis, despite BoJ buying program. Australian bonds at fair value.
Regional preferences by asset class	Fixed income	Investment grade	↑	□□□	■	□□□	Remains an attractive carry asset, very low default rates; corporate balance sheet strength may make parts of IG quasi-riskless.
Regional preferences by asset class	Fixed income	U.S. high yield		□□□	□	■□□	Attractive carry in low rate environment. Good entry point after the summer correction. Default rate should remain very low.
Regional preferences by asset class	Fixed income	EMD	↑↑	□□□	□	■□□	Pockets of macro stimulus coming through, reasonable sovereign debt dynamics and economic stabilization supportive.

Source: J.P. Morgan Asset Management IMS-GMAG. These asset class views apply to an intermediate-term horizon (that is, six months to three years). Arrows indicate a positive (↑) or negative (↓) change in view since the prior *Quadrimestre* meeting. This summary of individual asset class views shows and strength of conviction, but is independent of portfolio construction considerations so should not be construed as recommended allocations. This product of the GIM Solutions-GMAG *Quadrimestre* is distinct from the asset allocation summary in our *Monthly Investment Outlook*.

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