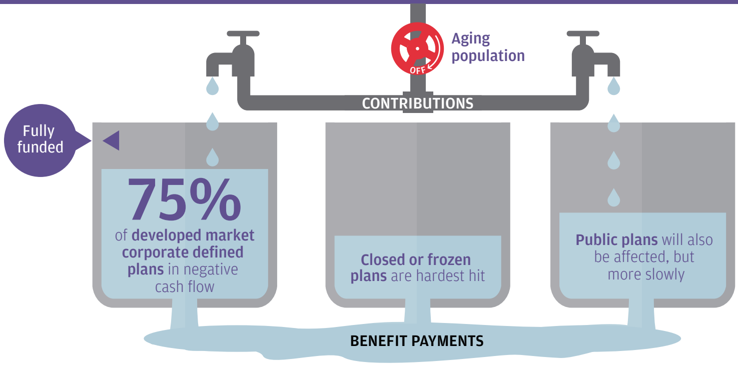
PENSION INVESTMENT STRATEGY IN AN AGE OF UNDERFUNDING AND LOW RETURNS

1 MATURING, UNDERFUNDED PENSION FUNDS FACE A GROWING CASH FLOW PROBLEM

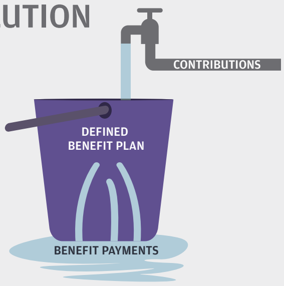
In today's low return environment, many developed market pension plans are underfunded and face growing pressure from negative cash flow as they mature.



2 FOUR CHALLENGES COMPLICATE THE SEARCH FOR A SOLUTION

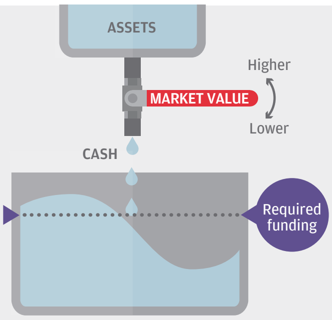
The "leaky bucket" effect

As more cash flows out of underfunded plans than comes in, funding levels are dragged ever downwards, requiring increasing returns to maintain funded status without additional contributions.



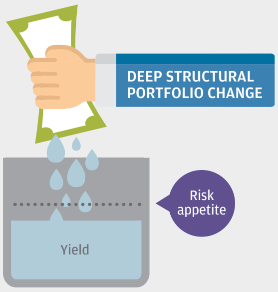
Forced selling

Where funds are forced to sell assets to service cash flows, exposure to market ups and downs amplifies funding level volatility to potentially intolerable levels.



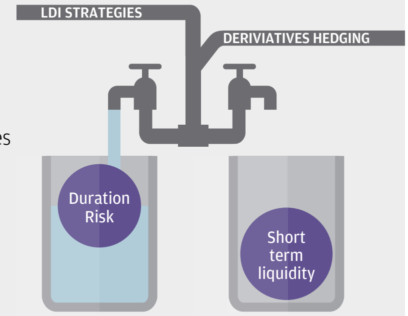
The liquidity squeeze

Although modest liquidity squeezes can be managed with small shifts in existing investment strategies, a tighter squeeze needs a deeper structural rethink to deliver the required yield within risk appetite.



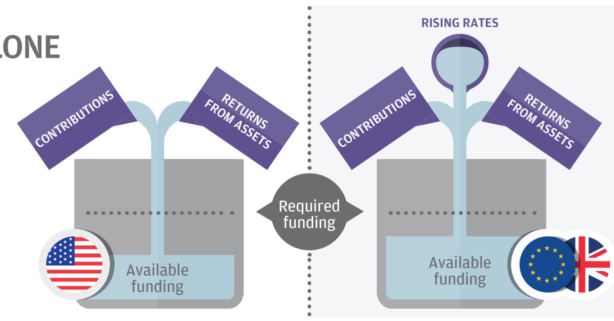
Managing duration AND liquidity risk

Common pension investment strategies can struggle to meet the requirement to manage both short-term liquidity and duration (interest rate) risk, and instead may exacerbate the negative cash flow problem.



3 RISING INTEREST RATES ALONE ARE NOT THE ANSWER

In the United States, as our expected rise in rates is already priced into bond yields and pension liability discount rates, corporate plans will have to look to asset returns and contributions to repair future funding levels.



Although higher yields from rising rates will contribute more to repairing funding levels in the U.K. and Europe, they will not be enough to close the gap.

4 HOW WILL PENSION FUND MANAGERS RESPOND?

At first, we expect funds to seek income-generative assets to maximize income. Higher yielding, stable cash flow assets will be increasingly attractive, particularly those offering long-term capital growth potential.

However, we believe limited appetite for the risk associated with higher yielding assets will ultimately lead to a gradual shift towards 'buy and maintain' strategies.

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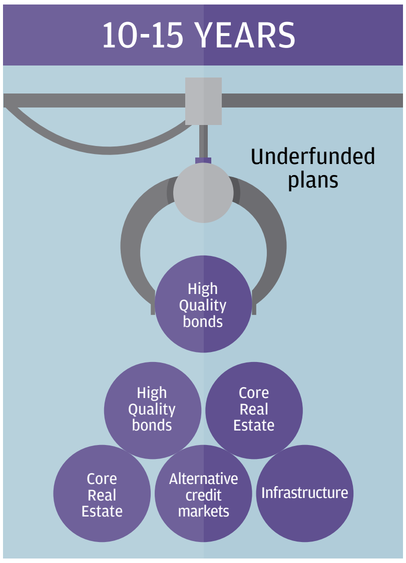
5 WE EXPECT CREDIT MARKETS TO BENEFIT OVER THE NEXT 10-15 YEARS.

We believe this gradual shift to buy and maintain style credit portfolios will sustain demand for high quality bonds over the next 10-15 years.

Core real estate, infrastructure and alternative credit markets will also continue to attract investment from underfunded plans over the immediate and longer term.



NEXT STEPS

For more information, contact your J.P. Morgan representative.

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