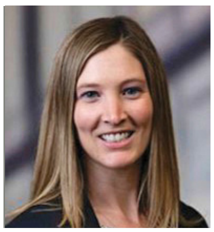
Portfolio trends

Themes and observations from U.S. Portfolio Insights

July 2020

AUTHORS



Heather Beamer, CIMA
Head of Portfolio Insights Specialists

Corey Hill, CFA
Portfolio Insights Specialist

IN BRIEF

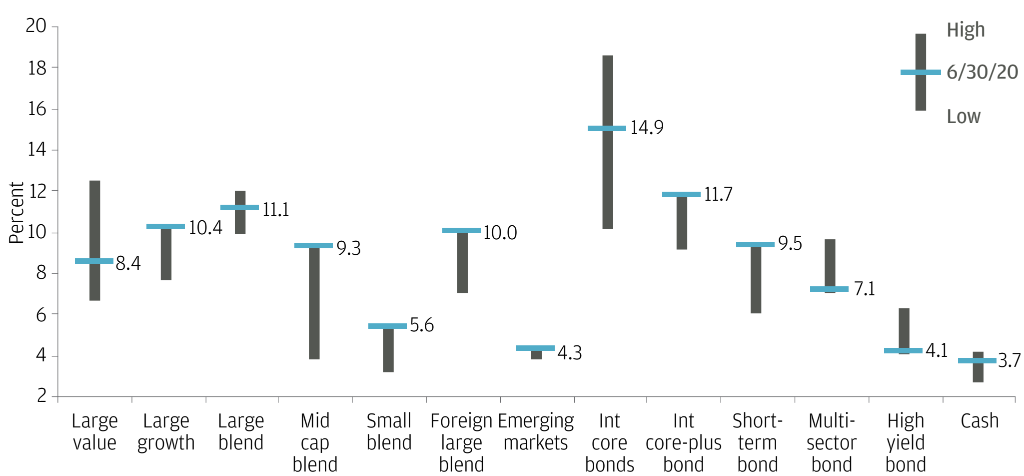
- In our Portfolio Insights Analytics team's review of thousands of client portfolios, we are seeing a lean toward equities with higher growth potential, such as U.S. large growth and small and mid cap equities (**EXHIBIT 1**).
- Within fixed income, the team has observed lower allocations to high yield bonds alongside larger allocations to higher quality bond categories, such as Intermediate Core, Core-Plus and Short-Term Bonds (Exhibit 1).
- As investors construct portfolios against the backdrop of the sharpest, and potentially briefest, recession on record, they appear to be mindfully balancing risk-taking in one area with a more cautious approach in others.

AMID SEISMIC CHANGES IN PORTFOLIOS, INVESTORS STRIVE TO BALANCE RISK AND REWARD

The second quarter saw swift corrective reactions after Q1's pandemic-triggered sell-off. Unprecedented stimulus around the globe—paired with slowing COVID-19 infections—helped the MSCI All Country World Index (ACWI) finish just 8.3% shy of its highs, its best quarter since 2009, after a historic Q1 sell-off that cost the index a third of its value.

Asset class trends (most utilized Morningstar categories)

EXHIBIT 1: HIGH, LOW AND AVERAGE ALLOCATIONS OBSERVED BY OUR TEAM (TRAILING 12 MOS.)



Source: Spectrum; data as of June 30, 2020. Bars represent the high and low allocations observed over the trailing 12-month period; dashes mark current average allocations as of June 30, 2020.

PORTFOLIO INSIGHTS ANALYTICS

A personalized service designed to help investors build stronger portfolios.

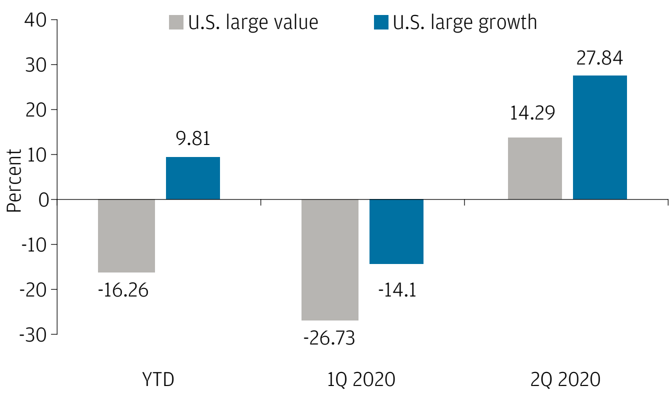
- Dedicated team with credentials including MBA, CFA® and CIMA® designations
- Thousands of investor portfolios reviewed annually
- Portfolio consultations with thousands of investors

EQUITIES

In our analysis of client portfolios, we're seeing a severe imbalance in style—the same massive lean toward growth we've seen before, but more so. And too many eggs in one basket may not bode well at this juncture. The average portfolio's overweight to growth-style stocks intensified in Q2 to the largest lean we've seen in the trailing 12 months. Large growth stocks significantly outperformed large value, a disparity that did shield imbalanced portfolios from the severe drawdown in March (**EXHIBIT 2**).

While a growth-style bias helped during the COVID-19 drawdown, we believe style parity makes more sense with a potential economic recovery on the horizon

EXHIBIT 2: YTD PERFORMANCE DISPERSION BETWEEN U.S. LARGE VALUE AND U.S. LARGE GROWTH STYLES



Source: J.P. Morgan Asset Management Portfolio Insights; data as of June 30, 2020.

Growth mainstays tech and health care proved resilient in the pandemic context, while value stocks faced difficulties: Financials were hit by low interest rates, and the energy sector was hurt by an oil price war and the lockdown's impact on travel.

But looking ahead, here's why a massive style lean could be a problem: Equity markets are in uncharted territory, with the outlook more opaque than in prior business cycles. Imbalanced portfolios could miss out on a rally in one style—or find themselves overexposed to a style downturn. Historically, value has tended to perform better in the beginning stages of an economic cycle. Meanwhile, tech companies, whose shares are up by as much as 50% in some cases, could find their earnings challenged, increasing the chances their shares will decline. As the second half gets underway, whether in recession or what our Multi-Asset Solutions analysts expect is early-stage recovery, we think more balanced diversification in equities makes sense. We advocate paring back a significant growth overweight and seeking more parity by giving equal portfolio weighting (one-third each) to value, core and growth stocks.

Other equities trends we've seen: a resurgence of interest in developed and emerging market international stocks—though investors still remain underweight, on average, vs. our Asset Allocation Views. (J.P. Morgan's multi-asset portfolios are overweight stocks, maintaining a positive view on U.S. stocks, with a greater focus on small caps, and entered Q3 keeping a positive tilt to European and emerging market equities.) As Europe begins to shape a cohesive policy response and major Asian economies appear to have made strong headway against the coronavirus, it's possible more portfolios we analyze may shift further toward international holdings.

Investors' appetite has also grown for mid and small caps, now at the highest allocations in the trailing 12 months. We believe it's a sign that investors are being careful about where they're taking risks. We are seeing sector-specific investments in portfolios 10 times more often than a year ago. Investors have moved into sectors with less structural sensitivity to the pandemic, or into those in which price fluctuations may have opened opportunities, including energy, consumer discretionary, health care and technology sector funds.

FIXED INCOME

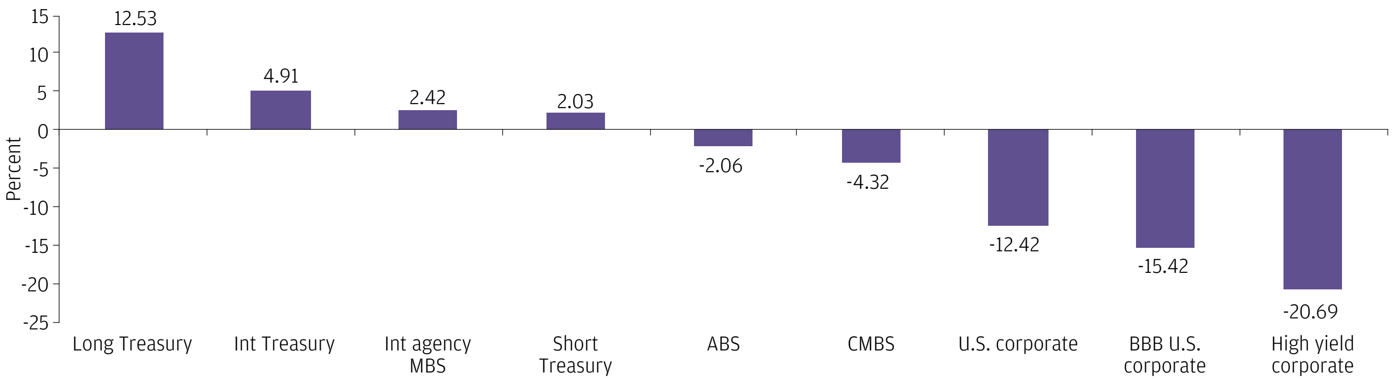
Average core fixed income allocations in the portfolios we analyzed staged a reversal. First, they fell to an eight-month low (to about 60% of portfolios before the COVID-19 sell-off). Then, as the pandemic ravaged equity markets, average core fixed income allocations ticked up to end Q2 at the highest level in about 18 months, about 70% of portfolios.

Our team saw investors using their fixed income allocation for high quality portfolio ballast, resulting in the lowest average allocation to high yield bonds we have seen in 18 months. They also shied away from the more flexible, multi-sector, higher income-producing funds. While investors seemed willing to take some risk with their equities, they wanted fixed income for capital preservation.

We suspect the up-in-quality move is attributable to investors' disappointment with their bond funds' significant underperformance during the worst of March's drawdown period, when U.S. equities fell 33.5%. The five most frequently used bond funds among portfolios we analyzed were down 8%,

After experiencing underperformance this spring, investors are seeking capital preservation with their bond allocations

EXHIBIT 3: FIXED INCOME SECTORS' PERFORMANCE DURING COVID-19 DECLINE (2/19/2020–3/23/2020)



Source: Morningstar February 19, 2020–March 23, 2020. 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.

on average, during the period vs. the Bloomberg Barclays U.S. Aggregate Bond Index's loss of just 1%. A look at bond subsectors' performance helps explain the phenomenon (**EXHIBIT 3**). Some investors likely didn't know what their fixed income strategies actually held. As we've noted for some time, it's crucial to know what you own. In this context, we also stress that a more balanced approach to fixed income investing would have better served investors' portfolios.

What's ahead? Not surprisingly, many investors are asking our Portfolio Insights team whether fixed income can still act as a diversifier offering protection in a multi-asset portfolio, given bonds' reduced potency after years of performance and their currently expensive valuations. Investors have been asking us this since well before the pandemic; now they express more concern, since interest rates are expected to stay near zero for a few years, reducing bonds' traditional income cushion.

HOW WE GET OUR DATA

The Portfolio Insights team analyzes thousands of portfolios and conducts thousands of one-on-one consultative calls with investors annually. Our team of 18 specialists is focused exclusively on helping investors 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.

We note that in 2020 year-to-date, bonds have, in fact, delivered on their promise, and the Federal Reserve has stated that it can and is willing to provide even more support, as part of a massive, worldwide policy response that our Multi-Asset Solutions strategists say should shape the global economy for years to come. We expect that in the event of another market decline like March's—a possibility, as meaningful risks remain, along with the potential for lingering volatility—traditional fixed income should still play its role, as a short, sharp recession should give way to a new early-cycle phase.

ALTERNATIVES

Allocations to alternatives generally followed equity markets' major dip, ending Q2 little changed: They declined in February and March and rebounded sharply from April to June, returning to around January's levels. We might have expected a marked increase in the use of alternatives in a period of equity volatility. Why didn't that occur? In short, because too many of the major liquid alternatives categories didn't hold up well, due to many managers' underperformance. While some managers bucked the trend, such a broad dispersion among managers' performance accounts for the alternatives category's failure to provide the benefits investors were looking for.

The takeaway: Very mindful selection of the right alternatives strategy is crucial to portfolio performance because the divergence between the best and the worst can be attributed to manager selection. March reinforced a lesson we've noted before: Not every manager performs as expected. Having a sound manager selection process in place can help alleviate such unexpected results at a time when investors would most like alternatives to help.

Commodities also saw a resurgence of interest, based on portfolios analyzed through our tool—up 7x, year over year. Traditional safe haven assets like gold and precious metals ETFs constituted the majority of the increase, representing a classic fear signal. We find that, outside an inflation event, fixed income has historically provided better ballast.

REASSESSING IN A TIME OF CHANGE

The first half of 2020 saw more profound change in the economic and investing landscape than during any comparable period in modern history, complicating our ability to forecast clearly into the second half. That suggests investors should be reassessing their portfolios today, reexamining their allocations and how they have held up, to ensure they're properly positioned for the uncertainties ahead.

Our team does just that—and has understandably seen more client interest than ever before during the pandemic crisis period.

PI_PT_2H20 | 0903c02a82657531