

J.P. Morgan
Asset Management

MARKET PULSE

EUROPEAN EQUITY SURVEY

How institutional investors are
investing a year on from the credit crisis

J.P. Morgan

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Dr. Morgan

Foreword

Every market crisis heralds certain expectations - and the sharp market declines emanating from the credit crisis and ensuing global recession have been no different. As billions were wiped from the value of assets between the end of 2007 and mid-2009, many commentators have been ready to herald the end of the cult of equity, the start of a wholesale 'de-risking' and a general flight to quality.

Certainly, many of these responses were in evidence during the crisis - for example, in the billions that were taken out of hedge funds or poured into treasury bills. But as markets have settled, what now? Has the unprecedented combination of a global banking crisis, property slump and economic recession had any real and lasting impact on institutional investment thinking - or have investors swiftly reverted to business as normal?

The aim of this survey was to take the pulse of Europe's institutional investors a year on from the most severe leg of the credit crisis - the collapse of Lehman Brothers investment bank. This survey follows on from a similar analysis conducted by our colleagues in the US into institutional equity attitudes there in April/May 2009.

We wanted to find out how Europe's pension funds and other institutions feel about equity investing now that markets - and economies - have started to show signs of stabilising. What are their return expectations for the next five years? Have their long-term asset allocation principles changed in the wake of the credit crisis? Have there been any significant changes in the way they approach equity investment?

Given that European institutional assets are estimated to exceed EUR12 - 14,000 billion, the answers to these questions have major repercussions for everyone involved in investment markets. For institutional investors themselves, the opportunity to see how their peers are thinking and acting may be of value as they look to plot their future investment course amidst a fragile recovery.

On the following pages, we bring together the opinions of close to 200 European institutional investors - over 70% of whom have assets of more than EUR1 billion. In many cases we have been able to disaggregate results by country to show the diversity of thinking across Europe. Where appropriate we have compared these findings with those of our US counterparts to see how leading investors in the world's two biggest developed markets differ - or converge - in their investment approaches.

We thank every institution that took time to participate in the survey. We hope the findings are of interest and of real practical value to them and to anyone who has an interest in knowing how Europe's leading investors are thinking.

J.P. Morgan Asset Management, November 2009



Peter Schwicht
Head of Institutional Business Continental Europe



Peter Ball
Head of UK Institutional Business

Key findings

This report canvassed the activities, intentions and opinions of Europe's institutional investors in three areas – market expectations, asset allocation and rebalancing, investment approaches and strategy – to assess likely overall institutional investment trends within equity investment.

Market expectations

- While short-term expectations for European and global markets are mixed, markets are largely expected to deliver annualised returns of 5 – 10% three to five years out;
- Nordic investors appear the most bullish on European equity in the short term;
- Bond yields are generally expected to rise within the next three to five years;
- Most alternative asset classes are expected to hold steady or deliver increased returns over the next year – apart from real estate where investors are evenly divided between those who expect it will rise and those who expect further falls.

Asset allocation and rebalancing

- Over half of institutions say they have made or are considering making changes to the way they rebalance their portfolio in light of recent market turmoil;
- Volatility in the market is the biggest concern when rebalancing;
- Almost two-thirds (61.5%) of respondents have made no change to their target equity allocation (i.e. their original target vs. 12-month target at June 2009); 24.2% have increased their equity allocation, while 14.3% have reduced it;
- Current average target equity allocation is 29% for Europe-ex UK institutions and 56% for UK institutions.

Investment approaches and strategy

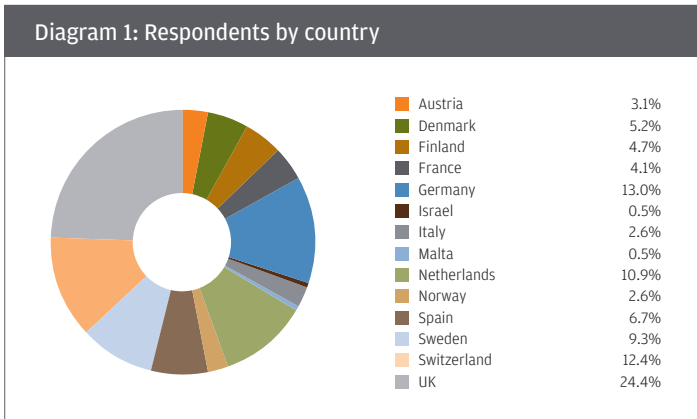
- European institutions have increased their preference for fundamental investment approaches over the past year – and this is most marked among large investors;
- Appetite for quantitative and 130/30 strategies has fallen strongly. Preference for short-selling has also fallen among a third of institutions, while a fifth have increased their interest in short-selling and market neutral investing;
- Large-cap and value stocks are expected to outperform by a greater number of respondents than small-cap and growth stocks over the next year;
- About a third of institutions have increased their interest in using passive/index-tracking approaches to get exposure to large-caps but also to Japan and emerging markets;
- Non-domestic markets are expected to outperform – with the exception of Japan; strongest regional performance is expected from emerging markets and Asia-Pacific.

About the survey

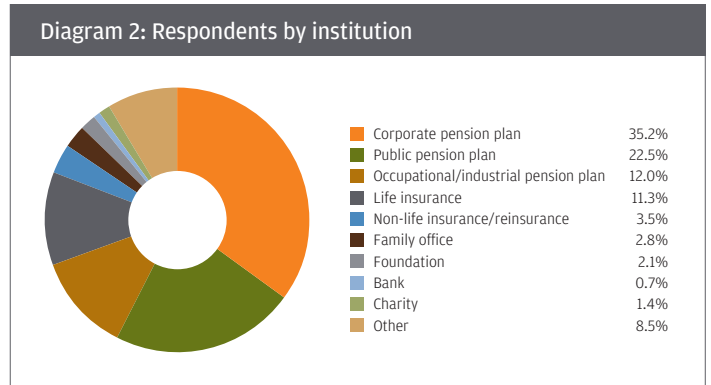
Our survey was conducted online in early August to mid-September 2009. In total, 194 European institutions from a universe of 781 participated in the survey - a 25% response rate.

Respondent profile

Respondents came from 14 European countries, with the UK, Switzerland and Germany providing the highest number of respondents. The majority (over 70%) of respondents were corporate, public or industry pension plans. Just under 15% of respondents were insurance companies. The remaining 15% included charities, foundations and family offices (see Diagram 2).

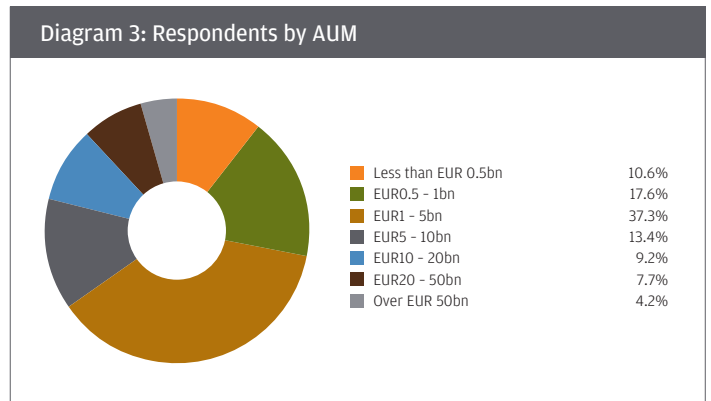


Base: 194



Base: 142

The survey canvassed the full spectrum of institution in terms of size, ranging from less than EUR500 million to over EUR50 billion. The biggest segment (37.3%) was made up of respondents with assets under management of between EUR1 billion and EUR5 billion.



Base: 142

Partial list of participants

J.P. Morgan Asset Management wishes to thank all 194 institutional investors who participated in our survey. The following participating institutions generously agreed to have their names listed in this report.

A Ahold Pensioenfonds

Allianz Investment Management

AMF

APK Pensionskasse AG

Associated British Foods plc

Aviva Spain

B Bedfordshire Pension Fund

Bernische Pensionskasse

Blue Sky Group

Bnl Pension fund

BP Investment Management Ltd

British Airways Pensions Investment Management Ltd

Buck Consultants

C Caisse de pensions de la République et Canton du Jura

Civil Aviation Authority Pension Scheme

Cnp Vida

Coal Pension Trustee Services Ltd

Concordia

CSM Pensioenfondsen

D Danish Pension Fund for Engineers

E East Riding Pension Fund

Electrical & Electronics Industries Benevolent Association

Electrolux

EnBW Energie Baden-Württemberg AG

F Fondaco Sgr

Fondazione Roma

G Gestiohna

Gjensidige Forsikring

Groupe Pasteur Mutualite

I Intesa Previdenza Sim

K Kalmar Läns Pensionskapitalförvaltning AB

KF Invest Förvaltning AB

M Meridian Investment Consultancy

Middlesea Valletta Life Assurance Co. Ltd.

Motorola Ltd

O OECD

P Pensionskasse Degussa

Pensionskasse der schweizerischen EDS-Gruppe

Pensionskasse Manor

Q Quantica Empresa de Asesoramiento Financiero Independiente, EAFI

R Royal Borough of Windsor & Maidenhead

Rural Pensiones

S Saab Pensionsstiftelse

Sanofi - Aventis S.A.

SAUL Trustee Co

Sinergia

Somerset County Council

Stadtwerke München GmbH

Statoil Kapitalforvaltning ASA

Stichting Pensioenfonds DHV

Stichting Pensioenfonds Elsevier Ondernemingen

Stiftelsen Åbo Akademi

Strathclyde Pension Fund

U Unisys (Schweiz) AG

V VeF Versicherungseinrichtung des Flugpersonals der Swissair

Victoria-Volksbanken Pensionskassen AG

Volvo Group UK

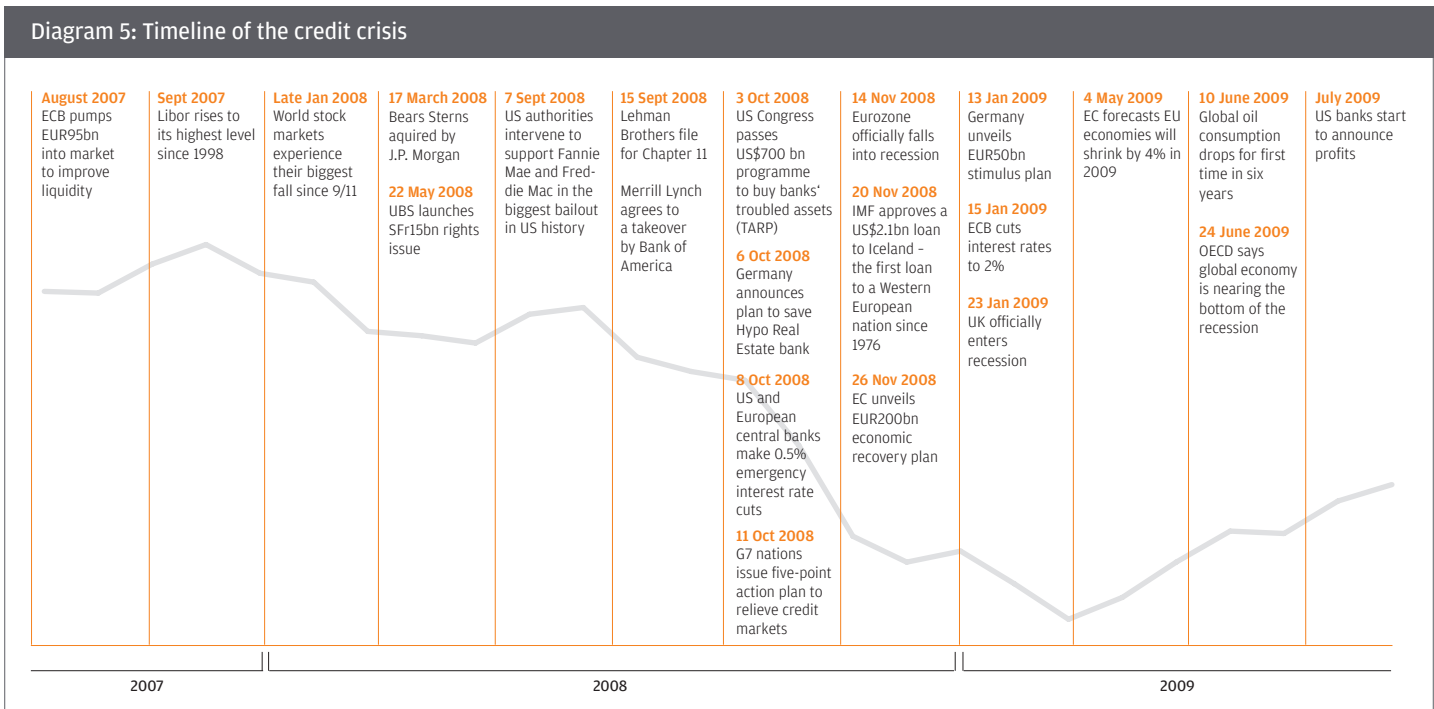
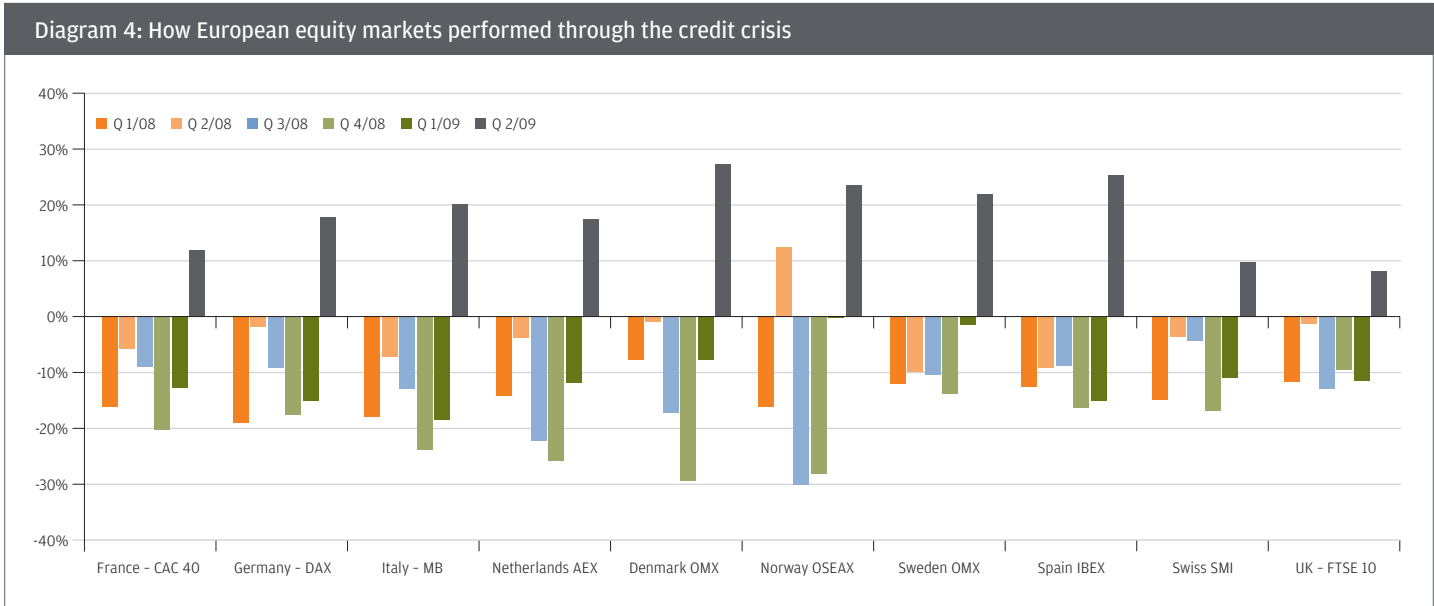
W Worcestershire County Council Pension Fund

Württembergische Versicherungen

Market background to the survey

This survey into attitudes towards equity investment was conducted among European institutional investors in August/September 2009. By this stage, European equity markets had experienced more than five months of reasonably steady gains, since equities hit their lowest point in the global credit crisis in March 2009 - and had broadly recovered to the levels just shy of mid-September 2008.

Although the roots of the credit crisis lie primarily in the US, European equity markets suffered in almost equal part. Over the 15 months to March 2009, the FTSE Eurofirst 300 Index of leading European companies saw its value more than halve from over 1,600 points to just above 700 points. However equity performance within individual markets varied widely throughout the crisis as Diagram 4 shows below.



Part One - Market challenges and expectations

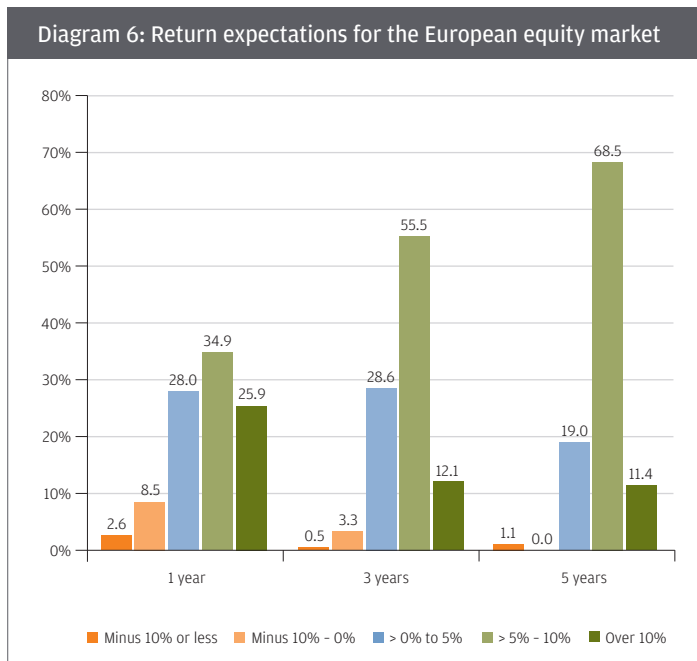
As global markets start to show signs of stabilisation, supported by data that some markets are emerging from recession we wanted Europe's institutional investors to disclose the return expectations on which they are basing investment decisions across equities, bonds and alternative assets.

Positive expectations for equity markets

Short-term expectations for European equity markets vary extensively - although longer-term views are generally positive. Eleven percent of respondents expect returns over the coming year (12 months to September 2010) to be negative; however more than one in four

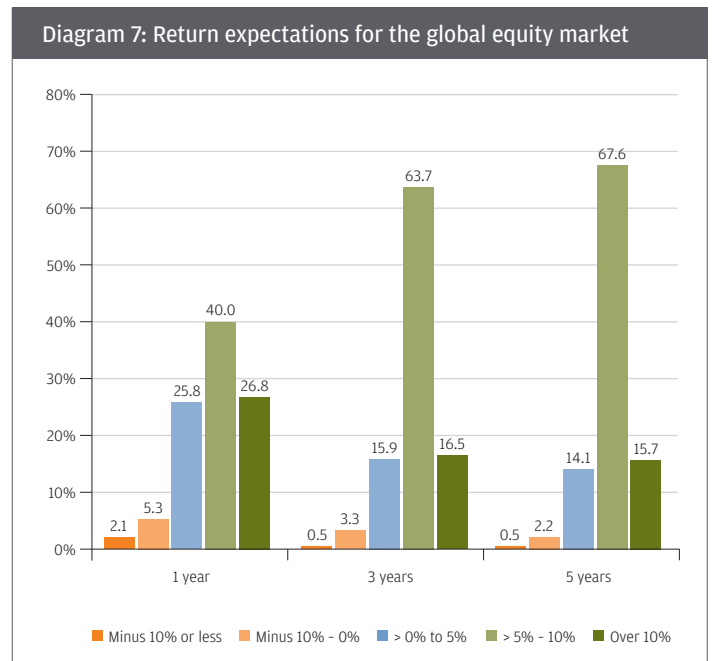
institutions (26%) expect a strong short-term recovery with expected returns exceeding 10%. Over three and five years, the majority of institutions are expecting returns to revert to historical norms of 5 - 10% a year.

Expectations for global markets are similar - although positive sentiment is marginally stronger, with over 80% of respondents expecting positive global returns of 5 - 10% or more a year over three to five years including a higher proportion anticipating annualised returns in excess of 10%. As we will see later on, this may be partly attributable to strong expectations for Asia-Pacific and emerging markets.



Base: 182-189

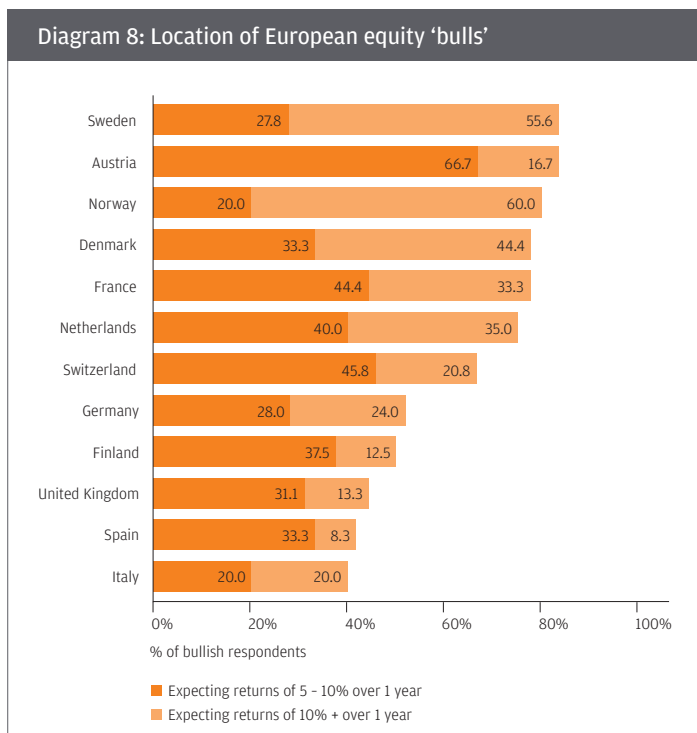
Q: What are your annualised return expectations for the European equity market (e.g. MSCI Europe)?



Base: 182-190+

Q: What are your annualised return expectations for the global equity market (e.g. MSCI World)?

When we break down return expectations by respondent market, we see a wide dispersal in short-term sentiment. Collectively, Nordic institutions (namely those in Sweden, Norway and Denmark) appear to be the most bullish about short-term recovery in European equity, with 44 - 60% expecting 1-year returns of more than 10%. The UK, Spain and Italy appear the most negative about the short-term outlook for the region (although the small Italian sample size must be taken into account here).

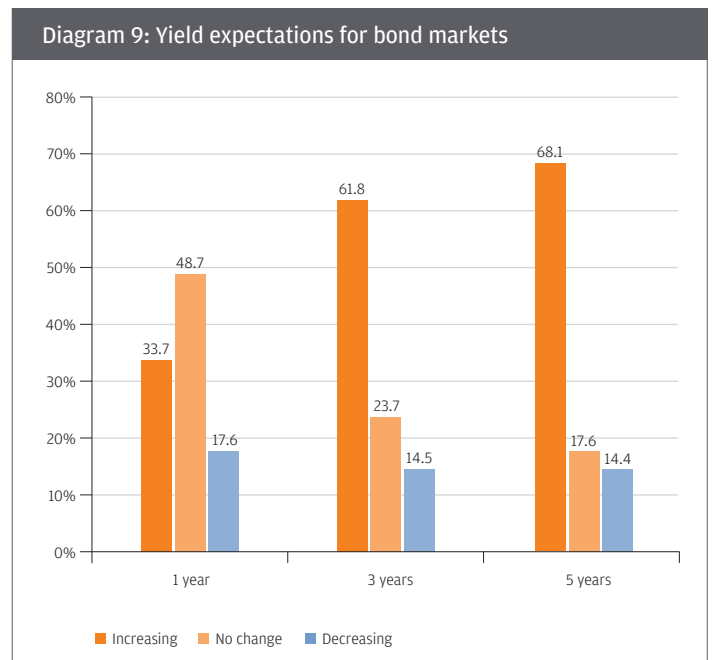


Base: 182-189

Certain country data should be considered directional only due to small sample size. Austria-4, Denmark-9, Finland-9, France-8, Germany-24, Italy-5, Netherlands-20, Norway-5, Spain-13, Sweden-18, Switzerland-20, UK-43

Bond yields expected to rise

As equity markets recover, bond markets are expected to fall back. Over the next year, around half of institutions (48.7%) expect no significant change in bond yields. Looking further out, over 60% expect bond yields to increase over three to five years - indicating expectations for a rising interest-rate/inflationary environment over the medium term.



Base: 186-187

Q: What are your annualised expectations for long-term bond yields?

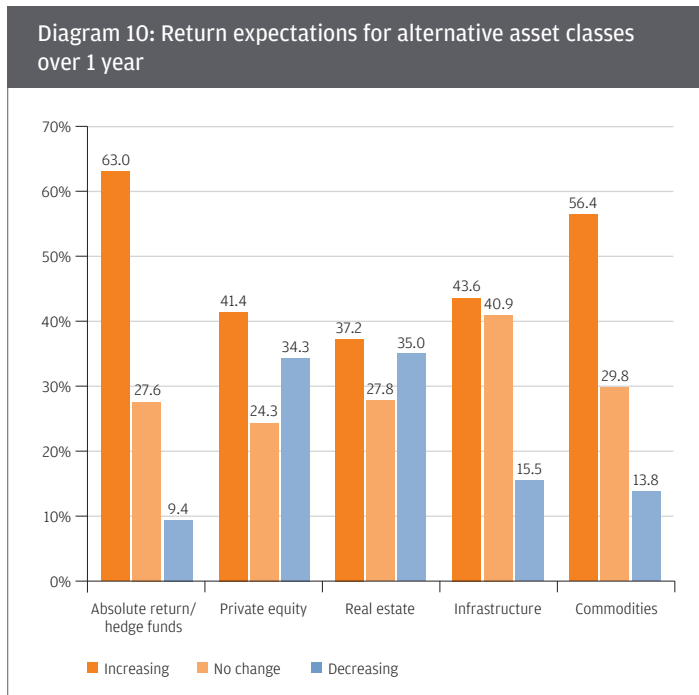
Comment

Expectations that bond yields will rise within the next three to five years should be welcome news for institutional investors required to discount their future liabilities using high-grade bond yields. As bond yields rise, funding positions improve. If this coincides with an improvement in equity performance - as our respondents suggest it will - then this suggests a relatively benign medium-term outlook for European pension schemes.

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Alternative assets to rise or hold steady over coming year

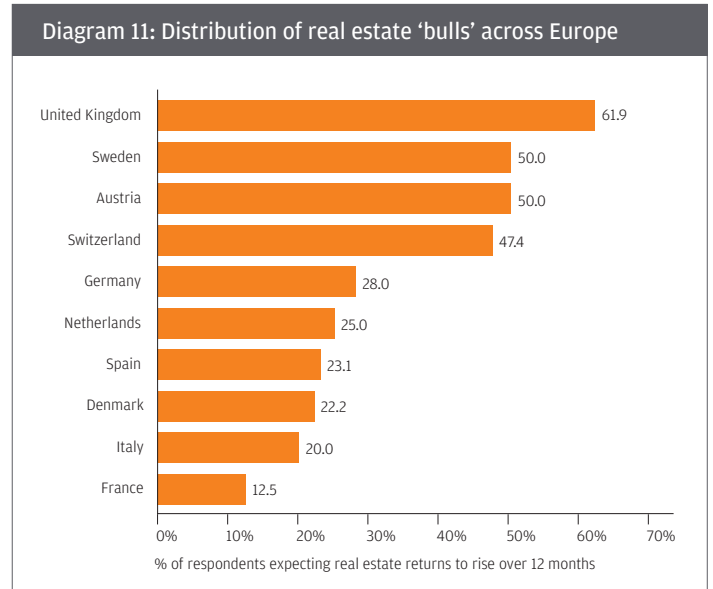
In the alternative investment space, the majority of investors expect all key asset classes to maintain or increase their value over 12 months. Institutions appear most bullish about absolute return/hedge funds and commodities. Expectations for real estate and private equity are more divided. Although the real estate bulls still marginally outweigh the bears, with 37% expecting returns to increase over the next 12 months compared to 35% who expect them to fall, sentiment appears more negative for real estate – see Diagram 10 below.



Base: 181

Q: Where do you see annualised returns going over the next 12 months for the following alternative asset classes?

When we disaggregate real estate responses by market, we see how positive expectations for property are distributed across Europe (see Diagram 11). In the UK, almost two-thirds of respondents expect real estate returns to rise over the 12 months to September 2010 – perhaps indicating hopes that domestic property declines have hit bottom. It is notable that in Spain (which alongside the UK has experienced the harshest property slump in Europe) fewer than one in four respondents expect recovery over the coming year.

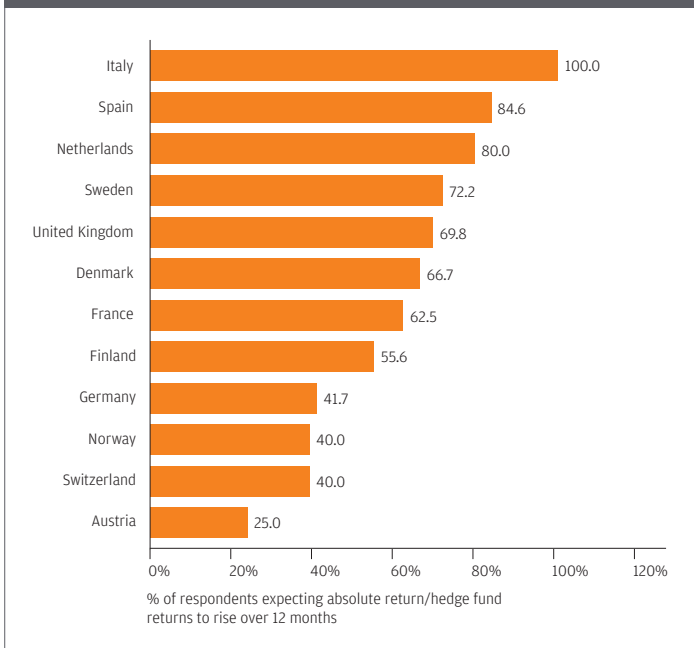


Base: 181

Certain country data should be considered directional only due to small sample size. Austria-4, Denmark-9, Finland-9, France-8, Germany-24, Italy-5, Netherlands-20, Norway-5, Spain-13, Sweden-18, Switzerland-20, UK-43

Given that absolute return/hedge funds generated the most prevalent positive sentiment among alternative asset classes, we thought it would also be interesting to see whether this positive outlook is distributed evenly across Europe (see Diagram 12). Again, we see that views diverge significantly – although in most markets 40% or more of investors expect annualised returns from hedge funds to rise over the coming year.

Diagram 12: Distribution of absolute-return/hedge fund 'bulls' across Europe



Base: 181

Certain country data should be considered directional only due to small sample size. Base= 181, Austria-4, Denmark-9, Finland- France-8, Germany-24, Italy-5, Netherlands-20, Norway-5, Spain-13, Sweden-18, Switzerland-20, UK-43, Other-3

Comment

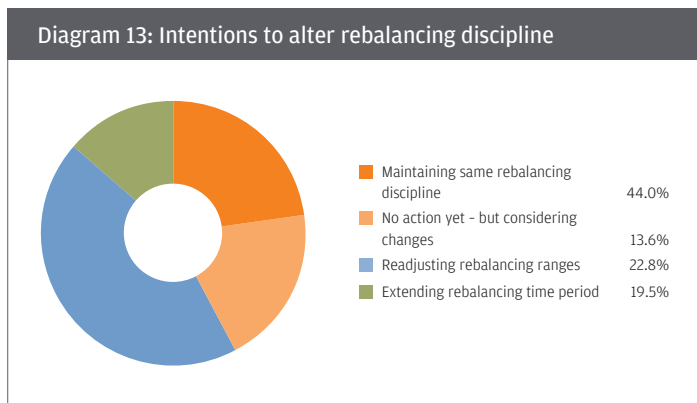
The strong expectations for alternative and real asset classes appear to be translating into significant portfolio exposure. European institutions are now allocating 13 - 14% of their portfolio to these asset classes. For Europe-ex UK investors, this is almost equivalent to half their allocation to equity (see Diagram 18, page 14), a sign that alternatives are becoming a mainstream asset class.

Part Two – Asset allocation and rebalancing

We asked institutions to tell us how recent market events have impacted how they allocate their portfolio and their policy towards rebalancing portfolios to bring them back to target allocations

Investment frameworks are being reviewed

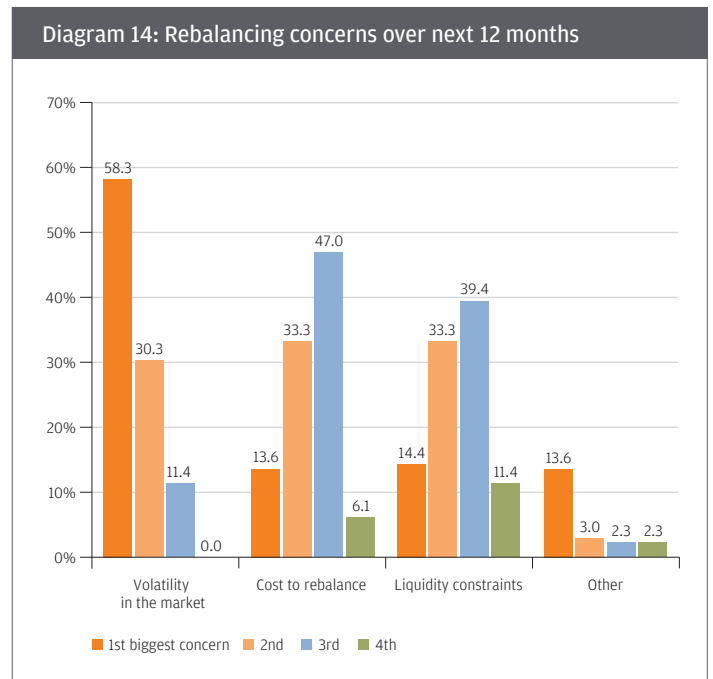
Recent market events appear to have encouraged institutions to review their asset allocation approaches. Over half (56%) of institutions said they had or were thinking about making changes to the way they look to rebalance their portfolio. Around a fifth (22.8%) said they had readjusted their investment ranges while a similar proportion (19.6%) said they were extending the time period taken to rebalance a portfolio back to its target allocation.



Base 184:

Q: Has the market turmoil over the last 12 months changed the way you rebalance your equity portfolio?

However, institutions appear to have significant concerns about adjusting their investment framework - primarily in terms of the impact of market volatility on portfolio valuations. This may suggest more institutions may look to review their rebalancing discipline when market stability is more assured.



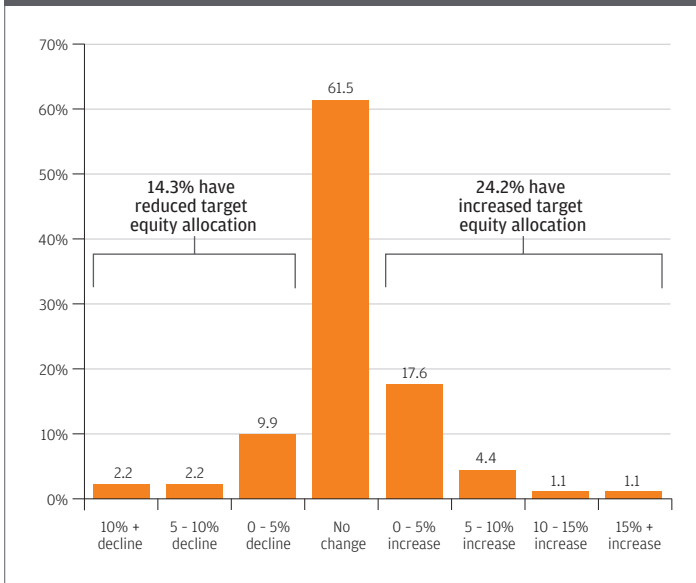
Base: 132

'Other' includes: valuations, risk, regulatory environment, the economy, accounting issues, and asset-liability matching

Q: Please rank in order of most important to least important, your concerns when rebalancing your total equity portfolio over the next 12 months.

So how is this review of rebalancing translating into asset allocation? We asked institutions to compare their target 12-month equity allocation as at June 2009 with their original target - see Diagram 15. Of those 102 institutions that were able to provide data, we see that almost two-thirds (61.5%) have made no change to their target equity allocation. However around one in four (24.2%) has actually chosen to increase its equity allocation - almost double the number that has decreased target equity exposure.

Diagram 15: Changes to equity allocation targets (Original target vs. 12-month target as at June 2009)



Base: 102

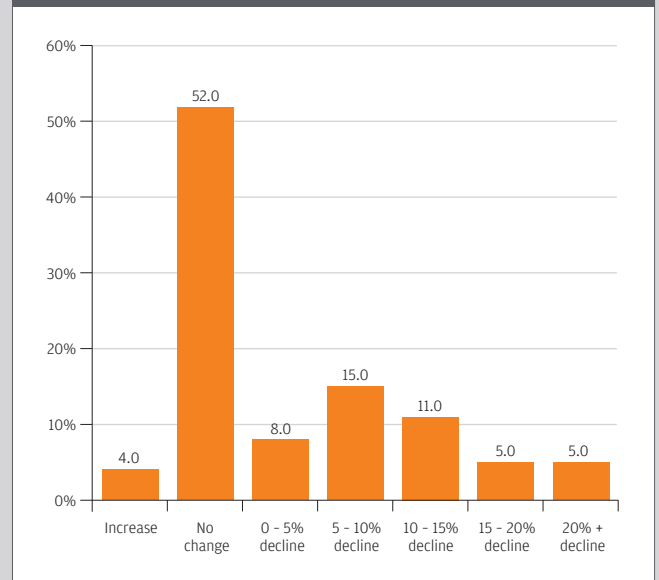
Diagram 17, overleaf, gives further insight into these trends by plotting the average equity exposure of three groups of respondents: 9.9% that have decreased their equity allocation by up to 5%; the 17.6% that have increased exposure by up to 5% and the 61.5% that have made no change to their equity target.

The US experience

In our US equivalent of this survey, conducted in April/May 2009, the majority planned no change to their equity allocation. However, only 4% of US institutions were planning to increase their equity exposure - compared to over 24% of European investors. At the same time, more than a fifth of US respondents (21%) were planning to reduce their equity allocation by more than 10% - see Diagram 16 below.

Again - as in Europe - this may be because institutions that are choosing to decrease allocations or keep them the same, already have a high exposure to the asset class. On average, US institutions had an original target allocation of 54% to equities - far higher than most European institutions, except for the UK.

Diagram 16: Changes to original and target equity allocation among US institutions (Original target vs. 12-month target as at June 2009)

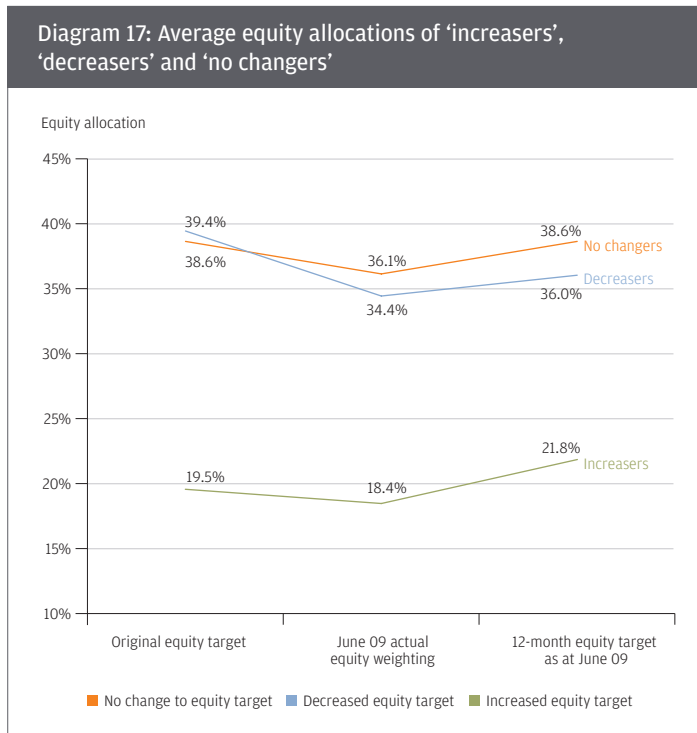


Base: 265



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This diagram reveals that the average equity allocation of institutions that are choosing to increase their target exposure has tended to be significantly lower than that of investors that are choosing to decrease exposure or make no change. On average, those increasing their equity exposure had an original target exposure of 19.5% compared to 39.4% for those who have chosen to reduce target exposure.



Note: this diagram does not include the 11% of respondents who indicated an equity increase or decrease of more than +/-5%.

Overall portfolio asset allocations

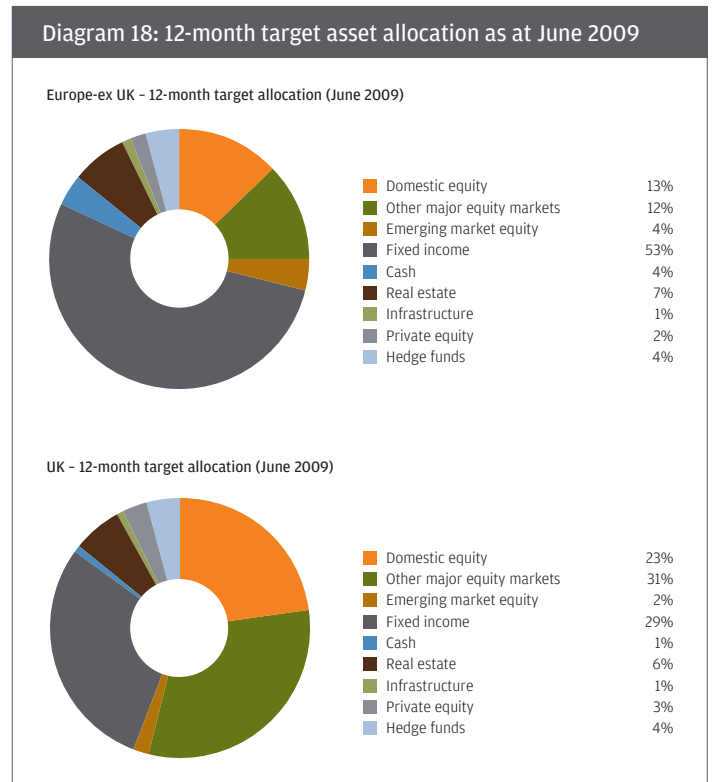
We then wanted to put these equity decisions in context of an institutional investor's whole investment portfolio. Given that UK institutions tend to have higher equity exposure, we have assessed the portfolio allocations of UK and Europe-ex UK investors separately.

Europe-ex UK

European institutions outside of the UK generally remain highly conservative in their portfolio strategy. Only 29% of their target asset allocation is held in equities, while 57% is allocated to fixed income and cash. Fourteen percent is allocated to alternative assets, of which real estate is the biggest weighting. There was negligible change in the original target portfolio allocations and the target for the 12 months from June 2009 - see table, right.

UK

UK average target allocation is distinctly different from the rest of Europe, with 56% held in equities and 30% in fixed income and cash. Alternative assets account for 14% of the average target allocation. The most significant reweighting between the original target and the 12-month target thereafter was 4% coming out of equity and 3% going into fixed income - see table, right.



Base: Europe-ex UK - 83; UK - 19

Note: this diagram does not include the 11% of respondents who indicated an equity increase or decrease of more than +/-5%.

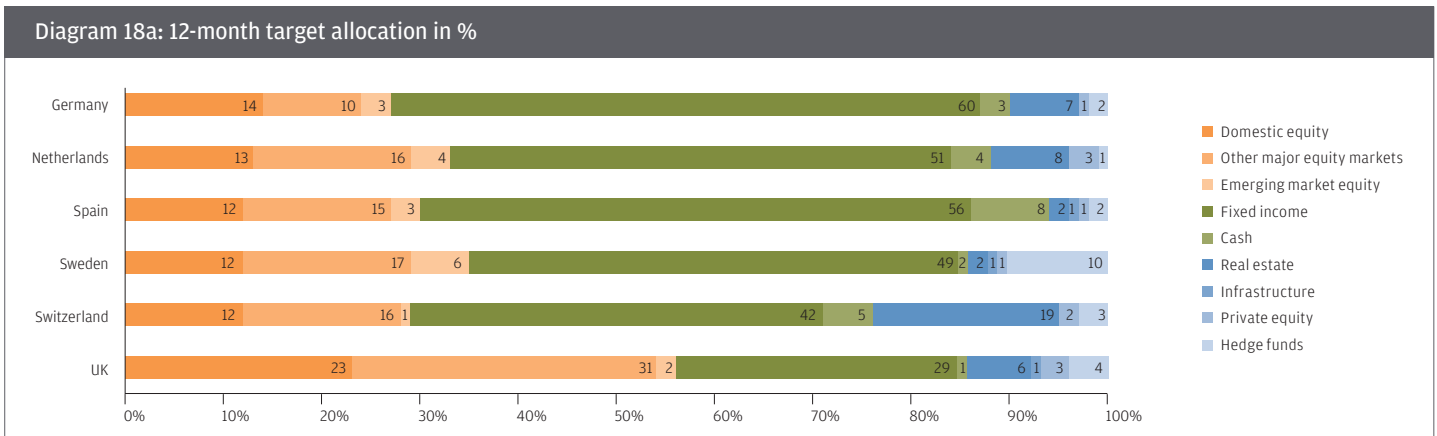
Changes in target portfolio allocations				
Europe-ex UK Base: 83	Original target	12-month target as at June 2009	Difference	Overall target asset allocation as at June 2009
Domestic equity	13%	13%		Equity: 29%
Other major equity markets	12%	12%		
Emerging market equity	3%	4%	+1%	
Fixed income	54%	53%	-1%	Bonds & cash: 57%
Cash	5%	4%	-1%	
Real estate	7%	7%		Alternatives: 14%
Infrastructure	0%	1%		
Private equity	2%	2%		
Hedge funds	4%	4%		

United Kingdom Base: 19	Original target	12-month target as at June 2009	Difference	Overall target asset allocation as at June 2009
Domestic equity	25%	23%	-2%	Equity: 56%
Other major equity markets	33%	31%	-2%	
Emerging market equity	2%	2%		
Fixed income	26%	29%	+3%	Bonds & cash: 30%
Cash	1%	1%		
Real estate	6%	6%		Alternatives: 14%
Infrastructure	1%	1%		
Private equity	3%	3%		
Hedge funds	3%	4%	+1%	

Diagram 18a gives us further detail on asset allocation by institutions within selected European markets. It must be stressed that respondent bases for some of these markets are very small so this data should be viewed only as directional. However, it does reveal further the wide diversity in asset allocation among Europe's institutional investors. Once again, we see just how much more UK investors are likely to

allocate to equities than their overseas counterparts. But we also see that Swiss respondents are by far the largest allocators to real estate, while Swedish institutions have substantially higher exposure to hedge funds than anyone else.

The most risk-averse institutions appear to be in Germany and Spain with total bond and cash allocations of 63% and 64% respectively.



Base = Germany - 16; Netherlands - 8; Spain - 10; Sweden - 10; Switzerland - 12; UK - 19

Part Three - Investment approaches and strategy

Alongside the issue of where institutions intend to invest lies the issue of how they intend to access markets and their preferred strategies for achieving performance.

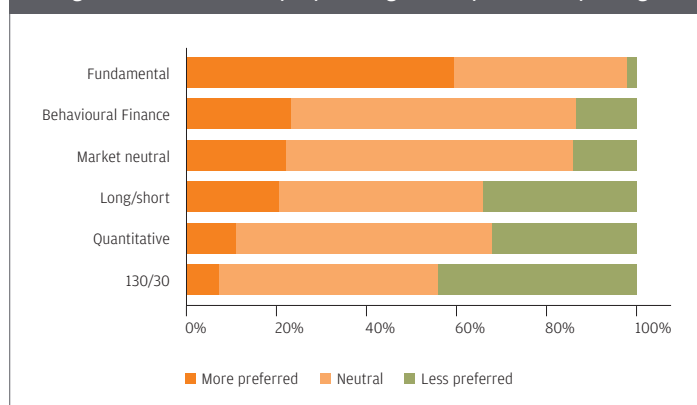
Preferred approaches to equity investing

Compared to a year ago, there has been a significant shift in preference from quantitative to qualitative investment. Almost 60% of institutions said that their preference for a fundamental approach to equity investment (i.e. where stocks and markets are appraised on their underlying attributes) has increased over the past year - see Diagram 19.

Conversely, a more quantitative approach has become less favoured. Likewise, 130/30 strategies, which aim to use the proceeds from short-selling to buy stock in order to give overall position that is 130% long and 30%, short, also appear to have fallen sharply from favour.

In fact, over a third of respondents (34.1%) say their preference for long-short strategies has fallen compared to a year ago. However it is also worth noting that over a fifth of institutions say they are now more interested in long/short and market neutral strategies than a year ago - suggesting there is still strong institutional interest in using straightforward short-selling tactics to counter market volatility.

Diagram 19: Preferred equity strategies compared to a year ago

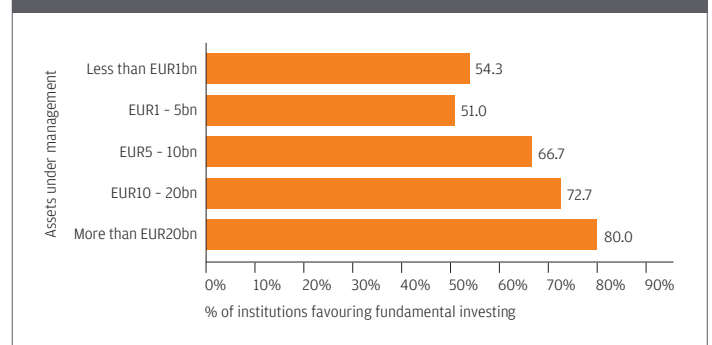


Base: 125-128

Q: For each of the following equity strategies, please rate your preference today versus one year ago

The larger an institution is, the more likely it has increased its preference for fundamental investing compared to a year ago - as Diagram 20 shows on the right.

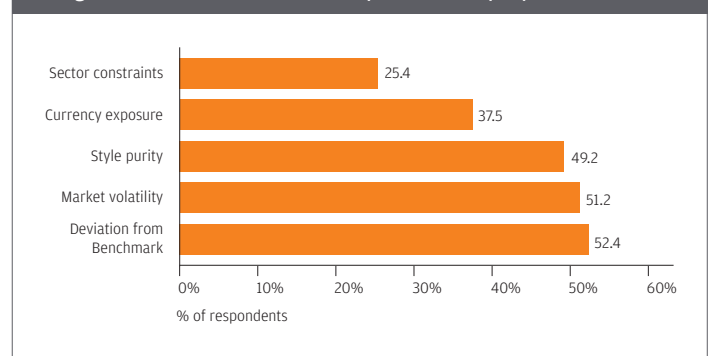
Diagram 20: Increased preference for fundamental investing compared to a year ago, by size of institution



Base: 128

Institutions also want clarity as to what they are investing in. Style purity is seen as a key factor in controlling the risks of equity investing by half of respondents. More than half of institutions also put a strong focus on relative risk and how far their strategy deviates from their chosen benchmark.

Diagram 21: Factors ranked as important in equity risk control



Base: 126-129

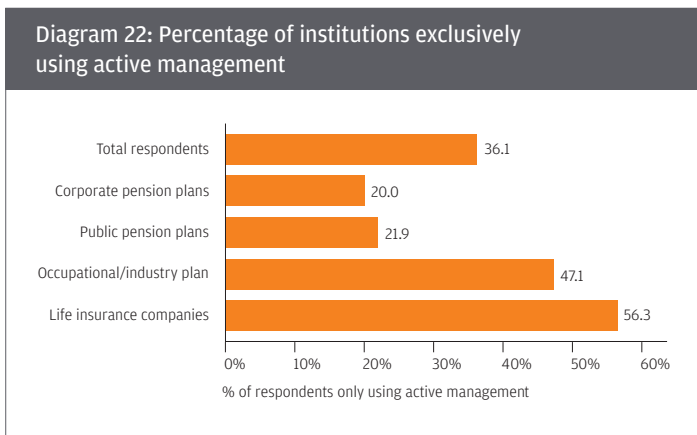
Q: Please indicate the importance you place on the following influences on equity risk control

Comment

The emphasis on fundamental equity analysis may also reflect heightened concerns about companies' financial strength in the wake of the credit crisis. Given the collapse of major names in sectors including financial and autos, the standing of even the most blue-chip stocks has been put into question. As it seems no company is now 'too big to fail' - institutions need to know more than ever exactly what they are investing in.

Active vs. passive management

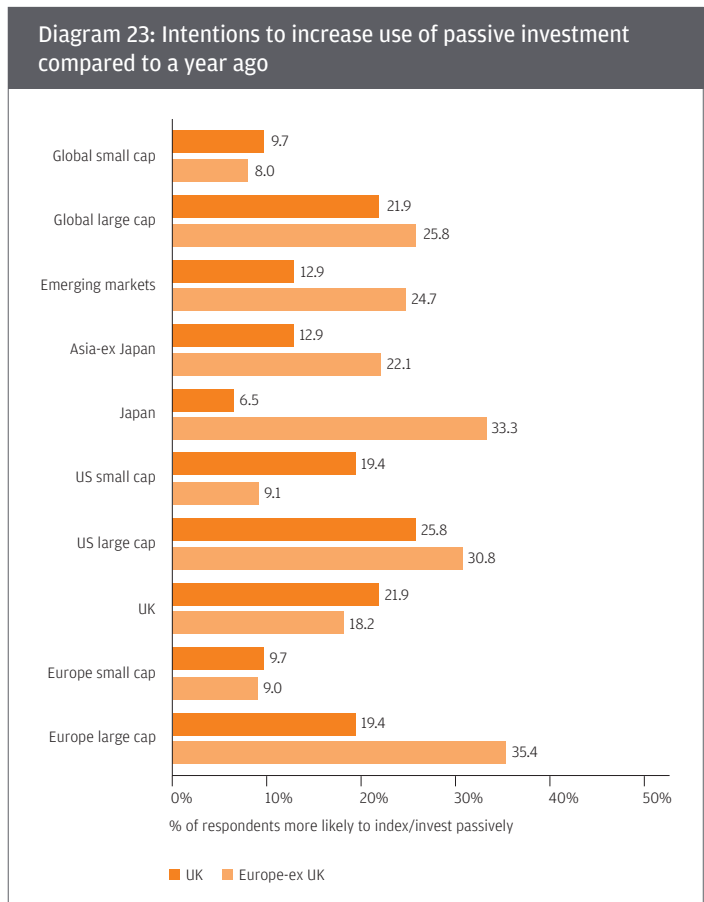
Just under two-thirds of institutions use passive management for some of their assets, while a third solely uses active management. More than half (56.3%) of life insurance funds use active management exclusively, as do 47% of occupational/industry pension plans.



Base: 142-144
Corporate Pension-50, Public Pension-32, Occupational/Industry Pension-17, Life-Insurance-16

Where passive investment is used, three-quarters of investors (73.9%) used index funds to gain exposure, while a third (35.9%) use exchange traded funds. Just under a third use futures contracts.

We asked respondents if there are any markets in which they are more likely to invest passively than they would have done a year ago. First it is apparent that Europe-ex UK institutions are more likely to use passive investment than their UK counterparts. Second, institutions are more likely to use indexing for large-cap exposure with a preference for actively managing small-cap portfolios. UK institutions appear less likely to increase their use of indexing for asian and emerging markets. However a third of Europe-ex UK institutions say they are now more likely to use indexing to invest in Japan and a quarter is more likely to use index-tracking for emerging markets.

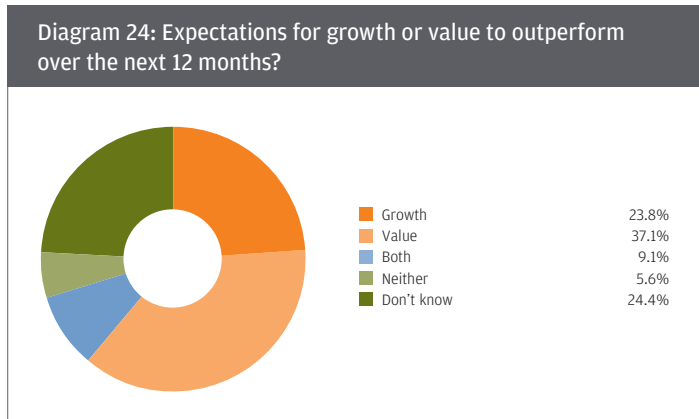


Base: Europe-ex UK - 86-96; UK 31-32
Q: Please indicate whether you are more or less likely to invest passively/index track in the following categories compared to a year ago

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Growth investing vs. value investing

In terms of investment style, over a third (37.1%) of European institutions expect a value investment approach (i.e. investing in stocks that are undervalued by the market) to outperform the market over the 12 months to September 2010. Conversely, 23.8% expect a growth approach (i.e. investing in stocks already experiencing strong price/earnings momentum) to outperform.



Base: 143
Q: Do you expect growth or value to outperform over the next 12 months?

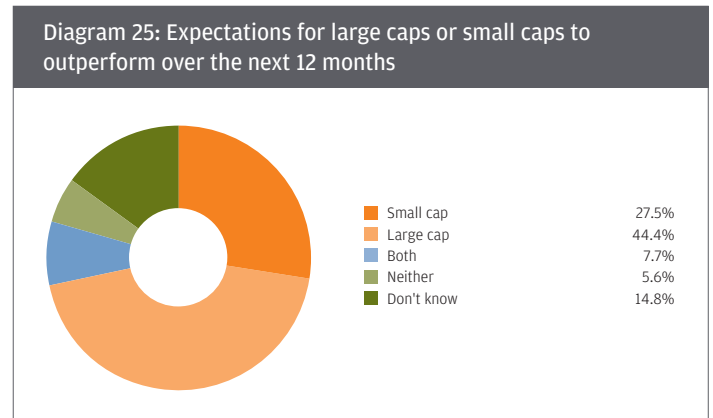
Comment

It is interesting that one in four (24%) of European institutions have no position on whether growth or value are likely to outperform over the 12 months to September 2010, while a further 9.1% are expecting both to perform well. However, at the same time, half of institutions say that style purity in a portfolio is essential to risk control (see Diagram 21, page 16). This suggests that around a third of institutions would welcome 'barbell' style strategies that can give them clear allocations to both growth and value opportunities. The high proportion of 'Don't knows' may also indicate that many European institutions put fairly low priority on the issue of whether to take a growth or value position.

However, generally European institutions are aligned with US investors, where 46% of institutions expect value to outperform compared to 36% favouring growth.

Large cap vs. small cap

Institutions seem to be more confident as to what size of company will outperform - with 44% expecting large-cap stocks to take the lead over the next year, while just over a quarter (27.5%) expect smaller companies to outperform.



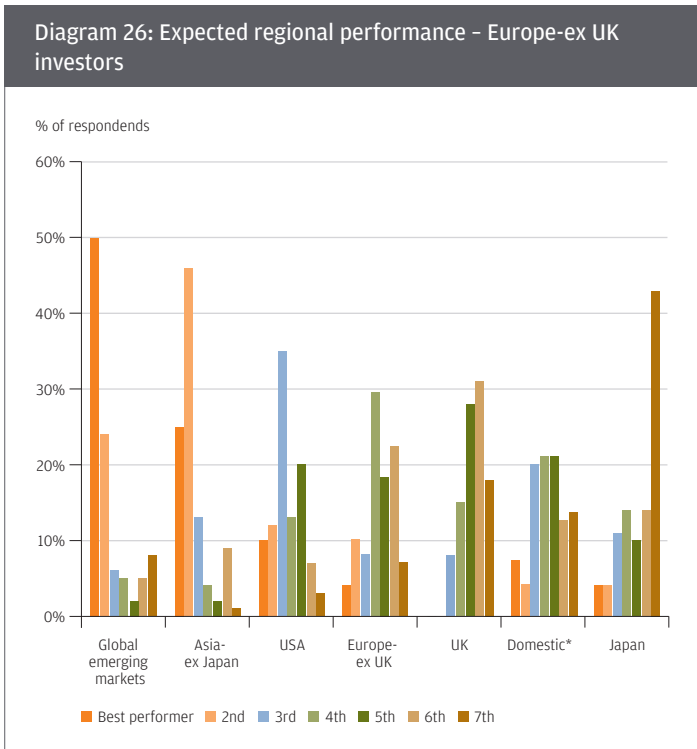
Base: 142
Q: Do you expect small-cap or large-cap stocks to outperform over the next 12 months?

Comment

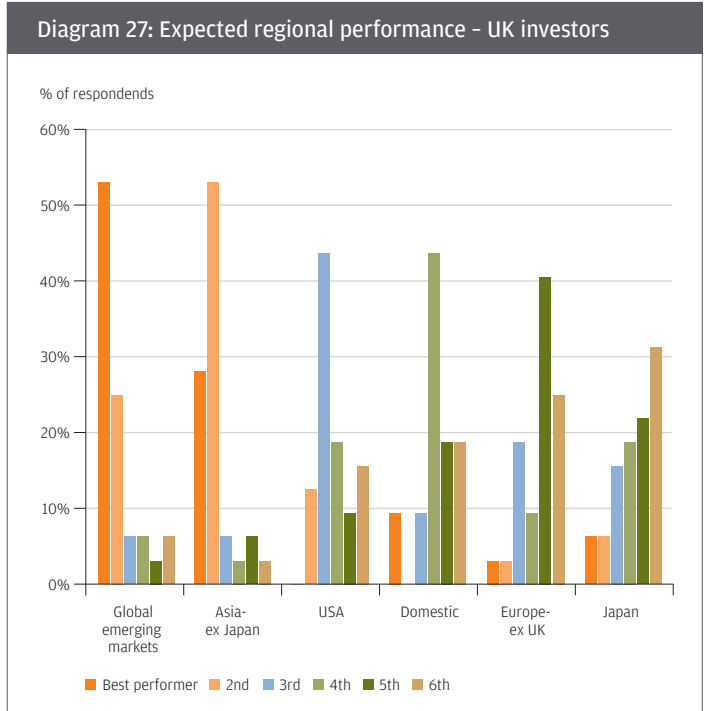
The fact that more institutions expect large caps to outperform suggests the next year is not expected to be a conventional market recovery. Traditionally, in the early stages of economic recovery, small caps tend to rebound strongly. These findings suggest institutions anticipate a prolonged 'flight to quality' in equity markets.

Domestic vs. international exposure

In terms of other regions, there appears to be very clear opinion as to which global markets will perform well or poorly over the next 12 months. Fifty percent of respondents in Europe-ex UK expect global emerging markets to deliver the strongest one-year performance with a further 24% predicting it to be the second-best performer. Asia-ex Japan was ranked second by 46% (and first by a further 25%). Europe's performance is expected to be middling. However, Japan is clearly expected to be the worst performer with over half of respondents ranking it 6th or 7th.



Base: 95-100
 * Domestic = Eurozone if you are based in Eurozone country.
 Q: Please rank the following equity markets in order of expected performance



Base: 32
 Q: Please rank the following equity markets in order of expected performance

Comment

Clearly, global emerging markets and Asia-ex Japan are expected to be the drivers behind global equity recovery over the next year, while European/domestic equity returns are expected broadly to be average or below average (although as we have seen European returns are still expected to be reasonably positive - see Diagram 6, page 08). Bullish expectations for global emerging markets have translated to an overall increase in allocation of 1% to this asset class among Europe-ex UK institutions (see Diagram 18, page 14). However, it will be interesting to see if more is allocated to these markets if and when institutions regain their risk appetite.

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Biggest challenges for European institutions

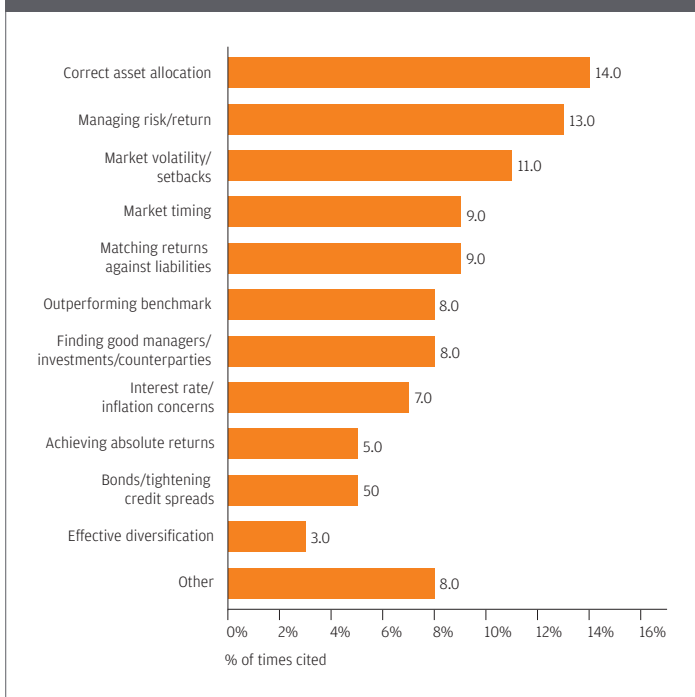
Lastly in our survey, we asked institutions an open question, asking them to say what they expect their biggest challenge to be in managing their equity portfolio from this point onward.

Diagram 28 below shows the chief areas of concern mentioned. These comments underline the value that institutions place on skilful asset allocation and market timing. There is also strong concern over how returns can be matched against liabilities suggesting a strong market for specific asset-liability matching (ALM) solutions. Another prevalent theme was how institutions could achieve required returns within a given risk budget in the face of continued market volatility.

Comment

It is noticeable how much more importance was placed on asset allocation than selection of investments - suggesting it is the overall split between equities, bonds and alternatives that is considered the greater driver of performance than the investments within those asset classes.

Diagram 28: Biggest challenges in managing equity portfolios



Base: Challenges identified by 87 respondents

'Other' includes: Cost to sponsor (1), Keeping clients focused on long term (1)

Explaining performance to trustees (1) Governance/regulation (2) Currency movements (2)

Q: What is the biggest challenge you face when you think about the performance of your equity portfolio?

Conclusion

At the time of writing, in late October 2009, equities have seen seven months of gains taking markets back to their levels immediately after the Lehman Brothers collapse in mid-September 2008.

In the US, the Dow Jones broke the psychologically significant 10,000 mark for the first time in a year on the back of forecast-beating corporate earnings reports (primarily from the banking sector), improved economic data and heightened investor optimism about the global economic outlook. Likewise in the UK, the FTSE 100 has tentatively breached 5,000 - again for the first time in 12 months - and in Germany the DAX is making progress towards 6,000 points.

Of course, many factors could blow this market recovery off course - as institutional investors will be keenly aware. So in the face of this tentative recovery what has changed, if anything, in terms of how Europe's institutional investors are managing their assets? The key conclusions we would draw from the findings of our survey are as follows:

Equity allocations remain stable

The idea that institutional investors may have fled from equities is unfounded. Our findings certainly confirm that institutions have or are considering changes to their rebalancing discipline in the wake of the credit crisis. But 61% of European institutions have made no change to their target equity allocation. Of those who are making changes, the majority are actually looking to increase their allocations to equities rather than decrease it.

Two points do need to be made here: the reason why many Europeans are happy to maintain or increase their target equity exposure stable is partly because it is relatively low. Europe-ex UK institutions have, on average 29% of their portfolio allocated to equities, while 53% is in fixed income.

Conversely, in European markets where equity exposure is higher, there are signs of a small 'de-risking' taking place (this was also the case in our US survey where 44% of institutions were looking to decrease exposure). In the UK, for example, the average equity allocation is 56% and institutions are, on average looking, to reduce that by 4% and put 3% in fixed income. This may sound like a modest adjustment - but given that EUR1,770 billion is estimated to be held in UK institutional portfolios (source: Watson Wyatt), it presents a potential shift in assets of around EUR70 billion.

Clarity and focus on fundamentals now preferred

Although portfolio allocations are remaining broadly the same, the processes by which institutions are looking to achieve exposure and generate performance may certainly be shifting. Most evident from our findings is a preference for fundamental investing where companies are appraised on attributes such as quality of earnings, products and management - and a shift away from more quantitative approaches. This trend is most evident among the very largest investors - with 80% of institutions managing assets over EUR20 billion saying they now prefer a fundamental approach.

Likewise, investors are looking for style purity and clarity regarding the level of benchmark deviation - they want to know exactly what they are investing in. Finally, skilful asset allocation and market timing are seen as key to delivering results.

Shorting strategies are less popular but still have a role

Although our research suggests a large-scale preference for back to basics investing, institutions are not necessarily eschewing more advanced risk management techniques completely. Certainly, around a third of institutions say their preference for long-short investing has fallen over the past year - suggesting greater interest in 'vanilla' long-only approaches. But shorting techniques are not completely out of favour: a further one in five institutions says that they have greater preference for market neutral and long-short equity strategies than they did a year ago. On top of this, hedge funds and absolute return strategies ranked highest as the alternative asset class most expected to post a recovery in returns over the next year.

Investors need to be convinced of alpha opportunities

On the whole active investment management is still preferred with around half of life insurers and industry pension plans using it exclusively. But active asset managers still need to be mindful: there appears to be small but strong interest among institutions in exploring index-tracking/passive approaches for markets that are not necessarily associated with this approach.



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A big surprise in our survey was the level of interest among Europe-ex UK investors in using passive approaches to get exposure in Japan - although respondents expect this to be the world's worst-performing market over the next year. This suggests work needs to be done by asset managers to convince investors of the long-term alpha generation opportunities that exist in these markets - and the benefits of active management in both achieving outperformance and controlling downside market risk.

Global returns expected revert to historic norms

There appears to be little sign that institutions believe there has been a paradigmatic shift in how stock markets behave. Over the medium term (3 - 5 years), most expect global and European markets to revert to their historic average with returns of 5 - 10% a year - another reason why target asset allocation has remained so stable.

Emerging markets and Asia-ex Japan are by far and away expected to deliver the strongest performance over the next year - which probably explains why global markets are expected to outperform European markets over the next one to five years.

Alternatives still expected to perform strongly

For all of the alternative asset classes we asked about, except real estate, the percentage of institutions expecting a rise in return outstripped those expecting a decline, with the strongest return expectations given for absolute return/hedge funds, commodities and infrastructure. This is a bullish outlook and is reflected in reasonable levels of allocation to these asset classes (13 - 14% of an institutional portfolio).

No 'United States of Europe'

Finally, our findings show that Europe is a long way off from being a heterogeneous investment region. We have generally focused on overall opinion across the region. However, individual countries still differ hugely in their outlook for performance and how and where they want to invest. Asset managers and others servicing European institutional investors must be fully aware of these differences in preference and opinion, and be able to accommodate them.

Last word

There is little evidence that events over the past two years have deterred European institutional investors from equity investing in any significant way. The greater changes are likely to be in how institutions look to achieve equity returns and the investment approaches they will seek out among their chosen investment managers. Simplicity and transparency are the order of the day. Skillful asset allocation and market timing are seen as paramount to achieving performance as market volatility and inflation/interest-rate uncertainty persist.

These are clear but demanding requirements. Those investing on behalf of Europe's institutions will have little place to hide - but the strongest asset managers with proven process and performance should be the beneficiaries.

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