Tailoring risk/reward characteristics
A long/short hedged manager employs disproportionate long and short position ranges to dial up or dial down market risk. Long-bias strategies with 100% of portfolio assets held long may hold short positions anywhere between 1%-99%. Most strategies have specific range limits on how much of their portfolios can be shorted, based on their investment objectives. Higher shorting exposure results in increased hedging against market risk and relies more heavily on the manager’s stock selection skill. Conversely, more limited shorting exposure raises the impact of general market movements on portfolio returns. Varying short exposure within an approved range allows managers a level of flexibility to adjust to changing market conditions.

Potential for equity-like returns with less market volatility
Investors looking for attractive equity-like return opportunities but concerned about market risk may want to consider long/short hedged investment strategies. These professionally managed portfolios combine long and short positions to seek similar returns as the general stock market while seeking reduced levels of volatility and lower net market exposure.

Greater downside protection opportunities
Long/short hedged strategies use long and short positions to customize expected return and volatility potential. One of the primary differences between these portfolios and other long/short strategies is the percentage of assets held short in proportion to those held long. Portfolios that implement a long/short hedged strategy in an effort to reduce risk relative to the overall market while pursuing similar returns typically maintain a long bias, where long exposure is greater than short exposure. For example, a long/short hedged equity manager may invest 100% of portfolio assets long and 80% short. This would limit net market exposure to 20% and still partially participate in directional equity market returns, also referred to as “beta” [see Exhibit 1].

This net long exposure may help capture a portion of the positive stock performance when the market is moving upward, and portfolio short positions help lower market risk and offer protection during difficult equity periods. Consequently, many long/short hedged equity strategies are expected to deliver long-term returns competitive with the broader stock market but with standard deviations in the 5%-8% range, compared to the average 16% standard deviation experienced by the equity market during the last 15 years as measured by S&P 500 Index.

Exhibit 1: Long/short hedged strategies reduce market risk exposure

For illustrative purposes only.
How long/short hedged strategies work

Investment managers of actively managed equity strategies research the markets to develop outlooks on which stocks they think are likely to rise in value and which are likely to decline. Long-only managers apply this research by investing in the former and avoiding the latter. However, the only way a long-only framework can contribute to portfolio returns with an unattractive stock is by not owning it.

Employing a long/short hedged approach removes this long-only constraint and allows managers to implement select short positions in an effort to generate returns from stocks they dislike in addition to taking long positions in those they favor. These strategies can be thought of as equity hedged portfolios because they hedge exposure versus taking long-only positions. This expands their investment opportunity set and enables managers to act fully on both positive and negative stock views in order to reduce broad market risk exposure without introducing substantial limits to return potential.

To illustrate, consider a manager who has analyzed a group of stocks and ranked them into five categories, ranging from most attractive to least attractive based on investment potential. Long-only managers usually would be limited to the top quintiles, but long/short hedged managers have expanded flexibility to hedge against market movements and seek return from negative performance generated from stocks in the lower quintiles as well [see Exhibit 2].

### Exhibit 2: Expanding opportunity

**Potential long positions**

- Quintile 1
- Quintile 2
- Quintile 3
- Quintile 4
- Quintile 5

**Potential short positions**

- Quintile 1
- Quintile 2
- Quintile 3
- Quintile 4
- Quintile 5

- Initial opportunity set
- Expanded opportunity set

For illustrative purposes only.
Attractive upside potential while seeking downside protection

Long/short hedged strategies utilize short positions to offset much, but not all, of their long holdings to reduce exposure to market risk. The goal is to limit losses and protect assets during declining markets while still capturing much of the market’s upside potential. By maintaining net long exposure, these strategies seek to participate when the market moves upward, but their short positions help introduce some of the defensive characteristics associated with market neutral investing. In rising markets, long/short hedged strategies are typically expected to deliver slightly less upside potential than long-only portfolios and slightly more than market neutral investments. In difficult markets, they may outperform long-only portfolios with slightly less risk protection than market neutral strategies [see Exhibit 3].

**Exhibit 3: Participate in up markets and protect against market declines**
(hypothetical $100 investment)

<table>
<thead>
<tr>
<th>Rising market</th>
<th>Long-only</th>
<th>Long/short hedged</th>
<th>Market neutral</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Long-only</strong></td>
<td>$100</td>
<td>$100 (10% gain)</td>
<td>$100 (10% gain)</td>
</tr>
<tr>
<td><strong>Long/short hedged</strong></td>
<td>$100 (10% gain)</td>
<td>$110 (6% gain)</td>
<td>$110 (5% gain)</td>
</tr>
<tr>
<td><strong>Market neutral</strong></td>
<td>$100 (10% gain)</td>
<td>$110 (5% gain)</td>
<td>$110 (5% gain)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Declining market</th>
<th>Long-only</th>
<th>Long/short hedged</th>
<th>Market neutral</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Long-only</strong></td>
<td>$100 (10% loss)</td>
<td>$90 (10% loss)</td>
<td>$100 (10% loss)</td>
</tr>
<tr>
<td><strong>Long/short hedged</strong></td>
<td>$90 (10% loss)</td>
<td>$90 (6% loss)</td>
<td>$90 (5% loss)</td>
</tr>
<tr>
<td><strong>Market neutral</strong></td>
<td>$90 (10% loss)</td>
<td>$90 (5% gain)</td>
<td>$90 (5% gain)</td>
</tr>
</tbody>
</table>

For illustrative purposes only.
Shorts down refers to a depreciation in the price of the security resulting in a gain on the short position. For more information please see our Spotlight on: Short selling.
Skilled stock selection is key

When a portfolio utilizes short positions to hedge its long exposure, stock selection becomes a greater driving force behind performance. Success depends on selecting longs likely to appreciate more rapidly in rising markets and shorts likely to decline faster in falling markets. As a result, long/short hedged managers rely heavily on an intensive research effort to gather insights into stocks and generate sound investment ideas.

The return difference between long and short holdings is known as the “spread.” Because these strategies rely less on general market movements, long/short hedged portfolios are largely dependent on this spread as their main source of return, and it is critical to select a manager with a history of delivering positive spreads while limiting downside market risk throughout various economic climates.

Evaluating long/short hedged managers

Not all long/short hedged strategies are the same. It takes a skilled manager with a proven process to realize the potential benefits of this investment approach. Here are some qualities to consider when selecting a long/short hedged portfolio.

- **Extensive research capabilities:** A long/short hedged investment process is only as good as the information it uncovers. How does the manager gather insights into stocks? Computer models? Analysts out in the field? A combination of both? Does the investment team conduct its own research or use third parties? How many stocks do they cover?

- **Proven stock ranking process:** How are stocks evaluated and ranked? What criteria are used to decide which stocks to buy long, sell short or avoid altogether? How long has the process been in place? Can the manager demonstrate a track record of accurately identifying over- and under-performers?

- **Manager experience and expertise:** Who are the managers? How long have they been with the fund and the firm? How do they use stock research and rankings to construct a long/short hedged portfolio? Are they experienced with short selling? Are you confident in their stock-picking abilities?

- **Solid performance history:** What is the strategy’s objective? How has it performed versus its benchmark in up and down markets? How do returns compare to other long/short hedged portfolios?

- **Rigorous risk management:** How much risk does a strategy assume to achieve its returns? Are risks concentrated in a small number of stocks? How does management address the unique risks of shorting? What do they do, for example, if a shorted stock unexpectedly rises in price?

- **Companywide experience with shorting:** How long has the firm as a whole been shorting stocks? Are they equipped to handle the extra legal, accounting, reporting and trading functions? Do they have relationships with third-party firms needed to execute short sales?

Adding a long/short hedged strategy to a diversified portfolio

<table>
<thead>
<tr>
<th>Investment role</th>
<th>Who may benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Establish strong portfolio foundation</td>
<td>Investors who want to add equity exposure but are apprehensive about market volatility</td>
</tr>
<tr>
<td>Replace long-only funds</td>
<td>Investors who already own stock funds and want to reduce risk</td>
</tr>
<tr>
<td>Fund IRAs, 401(k)s and other tax-advantaged accounts</td>
<td>Investors who do not want to incur current year taxes on frequent trading typical of long/short hedged strategies</td>
</tr>
</tbody>
</table>
Long/short hedged investing with J.P. Morgan

J.P. Morgan Asset Management offers a range of long/short strategies, including a long/short hedged portfolio. As one of the world’s largest, most respected financial institutions, with over a century of experience and $1.2 trillion in assets under management*, J.P. Morgan provides investment insights, capabilities and solutions few firms can match.

- Nearly 300 career research analysts globally, averaging 14 years of experience, offering extensive coverage of stocks across all market capitalizations
- Time-tested stock ranking process offering a 25-year history of consistent, repeatable results [see Exhibit 4]
- Experienced, disciplined fund managers drawing on decades of stock investment and portfolio construction expertise
- Long-term track records across market cycles
- Over 20 years of organizational experience with shorting strategies, leveraging significant investment in infrastructure, technology and personnel, as well as long-standing relationships with multiple prime brokers
- A strong emphasis on risk management
  - Broad diversification with limits on portfolio holdings and sector exposure
  - Careful liquidity monitoring
  - Monitor volatility on an on-going basis
  - Testing the impact of potential trades under various market scenarios

*As of 9/30/10

Exhibit 4: J.P. Morgan’s time-tested stock ranking process dates back to 1986

As demonstrated below, our higher-ranked stocks have consistently outperformed the market while lower-ranked stocks underperformed.

Performance of our rankings vs. S&P 500 over the last 25 years

From 1/1/86 - 12/31/2011

Source: J.P. Morgan Asset Management.
Chart shows performance of quintiles (as determined by J.P. Morgan research universe) versus the S&P 500 Index, with quintiles rebalancing monthly. Quintile performance represents the annualized returns of quintiles vs. the annualized return of the S&P 500 over the full time period. Quintile performance results have certain inherent limitations. Unlike an actual performance record, quintile results do not represent actual trading, liquidity constraints, fee schedules and transaction costs. No representation is being made that any portfolio will or is likely to achieve profits or losses similar to those shown. Past performance is not indicative of future results.
JPMorgan Research Equity Long/Short Fund

Share class/Ticker: A JLSAX  S JLSSX

- Pursues repeatable returns primarily from stock selection, not market exposure
- Well-suited for more conservative investors looking to reduce risks and ease back into stocks

For more information, please visit www.jpmorganfunds.com

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There is no guarantee that the use of long and short positions will succeed in limiting an investment portfolio’s exposure to domestic stock market movements, capitalization, sector-swings or other risk factors. Investment in a portfolio involved in long and short selling may have higher portfolio turnover rates. This will likely result in additional tax consequences. Short selling involves certain risks, including additional costs associated with covering short positions and a possibility of unlimited loss on certain short sales positions. Derivatives investments may be riskier than other types of investments because they may be more sensitive to changes in economic or market conditions than other types of investments and could result in losses that significantly exceed the original investment. Many derivatives create leverage thereby causing an investment portfolio to be more volatile than it would be if it had not used derivatives.

Past performance is not indicative of comparable future results. Diversification does not guarantee investment returns and does not eliminate the risk of market loss.

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