Pensions
A global perspective
As we continue to reflect on shifts we see in the marketplace, we recognize that certain client segments are going through unprecedented amounts of change. One client group that is faced with evolving requirements and diversified investment strategies is the global pensions space. The changes in this arena are driven by new regulatory policies and corporate finance requirements, and they are altering the way we — as a global service provider — support the pensions segment globally.

Highlighting a range of industry issues, opportunities and product solutions, this publication of Thought focuses on pensions, and provides a global perspective that we hope will continue to fuel dialogue across the United States, Europe and Asia-Pacific.

The pensions space affords a look at worldwide issues and gives us a chance to articulate many of the themes at the heart of JPMorgan’s mission as a service provider and as a firm overall. Our pensions clients, and all of our clients, expect an organization with our breadth and depth of global resources and expertise to offer a seamless and cohesive experience — based on trusted, integrated relationships.

Throughout this issue you will see a variety of views on the pensions landscape from a regulatory, financial infrastructure and strategic investment perspective. As we evaluate the issues facing this segment, you’ll also see articles by two of our WSS clients — Wellcome Trust and the YMCA Retirement Plan — that illustrate our consultative approach to really understanding the needs of our clients. Other articles highlight various products and services from across WSS, including transition management, private equity fund services, depositary receipts and securities lending. Additionally, we showcase the best of our thought leadership across other lines of business with articles contributed by the JPMorgan Investment Bank and by JPMorgan Asset and Wealth Management.

We will continue to demonstrate that a relationship with us means that our clients can leverage the expertise of JPMorgan — to help them explore the possibilities of how we can service all parts of the investment chain — across any instrument, any infrastructure and any global location.

We are including a feedback card in this issue and we encourage you to provide your “thoughts.” Your questions and comments are always welcome and can also be sent to thought.magazine@jpmorgan.com.

Mike Clark
AMIDST CHANGE AND TRANSITION

Over the last decade, an array of forces has converged to prompt a perfect storm of widespread changes to U.S. pension funds. Here’s how JPMorgan has met — and surpassed — the dynamic needs of this critical client segment.

Perhaps no other segment of American business and finance has undergone as sweeping a transformation of late as the U.S. pension arena. A high-octane confluence of population changes, an aging workforce, capital market volatility, increasingly integrated global markets and an onslaught of regulatory developments have placed the U.S. pension market in a state of flux.

Despite the requisite growing pains, the outlook remains favorable. The industry is poised for favorable growth, greater efficiency and a higher degree of transparency, benefiting plans and participants alike.

THE FUNDING CRUSADE: DRIVING CURRENT TRENDS

Most plan sponsors would agree that funding concerns are driving such accelerated change. In the early part of this decade, demographic developments, the imminent retirement of baby boomers, and falling equity-market values and bond yields synchronized to expose asset-liability mismatches in many U.S. pension funds. As trends shifted, regulators and legislators took note, and for good reason. The sheer size of pension-related assets indicates their potential influence over U.S. financial markets. In 2004 alone, U.S. pension and pension insurance assets constituted $13.4 trillion, representing approximately 115% of GDP.¹

“Funding concerns and their impact are the most talked about issues in the pension community,” says Ed Mollahan, Employee Benefit Investment executive. “Clients are asking: How do we fund our liabilities? What is the optimal way to manage our assets and liabilities? How do we manage to protect the corporation’s balance sheet from capital market volatility and deliver on the promises made to our retirees and current employees?”

Whether overblown or well-founded, funding concerns have fueled broad manifestations.

**Defined Benefit (DB) Plan Freezing:** With the exception of public pensions, defined benefit plan freezing has gained some momentum, due in part to a “contribution culture” that favors defined contribution structures. Another key factor: the market downturn earlier this decade that resulted in assets decreasing while liabilities grew at a faster clip. This “perfect storm” caused some otherwise healthy DB plans to enact a “hard freeze,” where the plan is closed entirely, or more commonly a “soft freeze,” by closing out new participants.

**Shifting of Responsibility:** A steady number of companies are adopting pension models that shift a greater portion of retirement responsibility and investment onto employees. “The advent of health savings accounts, high-deductible health plans and the like are symptomatic of increased employee responsibility through accelerated costs as well as more extensive benefit choices,” said Stephanie Skolnik, U.S. Fund Services product executive. “However, along with this shift, employers are looking to assist employees by providing lower cost investment options such as commingled funds and separate.”

**New Structures:** Another response to funding concerns is to morph existing plans into other forms or to converge plans. By some estimates, roughly 45% of all corporations offering retirement plans offer both a defined contribution (DC) and a DB option. In the aftermath of The Pension Protection Act of 2006 (PPA, 2006), hybrid plans have gained new recognition, since the legislation generally categorizes such plans on the same footing as plain vanilla DB structures. The proliferation of plan types has accelerated, as well, including cash balance plans, a hybrid of both DC and DB structures.

**Shifting Investment Strategy:** Once hailed as a conservative bastion of investment strategies, the U.S. pension field has responded nimbly to the market downturn of the early part of this decade. Sponsors of employee benefit plans are more focused on the asset-liability decision and the critical role of investment alpha on the health of its plans. Increasing allocations to hedge funds, private equity, broad scope mandates and real estate have been trending up for several years. At the same time, the volume of derivatives has skyrocketed, says Mollahan.

Plans are embracing nontraditional asset classes, from hedge funds to real estate assets to derivatives and private equity. Flexibility, funding and return expectations are the main drivers. Plan sponsors are more willing to go where there is alpha with an increasing percentage of the allocation.

The move toward greater utilization of alternative investments has caused client needs to evolve, said Mollahan. “Now, due to a higher degree of sophistication in terms of their investment strategies, plan needs have also ramped up from core administration of these assets to understanding the associated risks and virtually everything in between.”

**Leadership, Innovation and Service**

Skolnik believes serving the complex needs of U.S. pension clients requires focused discipline and a vision for the future. She notes that a high degree of innovation, with a constant focus on client service and sophisticated technology, is also critically important. (continued page 6)
How has the custody business changed over the years?
The custody business has evolved from a settlement and safekeeping business into a comprehensive investment support business.

How does JPMorgan achieve a differentiated level of service quality?
It is not enough to provide just asset settlement, dividend recordkeeping and corporate actions support. We have to understand what our clients are trying to accomplish to meet their business growth and efficiency objectives. We have to become part of our client’s back office. It is this real understanding of the institutional investor — across the front office and the entire securities servicing continuum — as well as the ability to execute upon this knowledge that is the true indicator of how good you are.

How is JPMorgan positioned to achieve this level of service?
We have people on staff who can think that way — technical specialists who can put ideas in motion — and we have the business know-how to leverage that intellectual capital to our broad base of clients.

What should clients expect from JPMorgan?
Clients should trust that we’ll be there for them and that we’ll respond with consistent, accurate support. We also have to demonstrate that we’ll be creative. And they should trust that we can take the capabilities, the information and the knowledge that we have and actually do something differently tomorrow than we did today. Critically, our clients have to see that we can present that important information in a way that is efficient from a reporting standpoint, and in a way that they need it. If we present our clients with the right data in the right way, then they can make better decisions.

**Michael Ravensbergen**, senior vice president, is the corporate pension, public pension and not-for-profit new sales and client management executive for JPMorgan’s Worldwide Securities Services business in North America. He has been working globally in this industry since 1997. Michael completed a three-year assignment as JPMorgan’s Asia business executive for Investor Services sales and client management — based in Hong Kong. Michael joined JPMorgan in 1990 as a senior relationship manager working with several large U.S. mutual fund clients. Prior to joining JPMorgan, he worked 10 years at Bankers Trust Company in several trust and securities management positions.
Clients are seeking **increased returns** in combination with **reduced risk**.

A complete offering includes:

- A comprehensive suite of fund servicing products for greater choice
- A full range of global short-term investment alternatives that provide transparent returns, diversification, varied duration and overall investment efficiency
- Ability to overlay services such as securities lending and FX, to maximize efficiency of each client’s portfolio
- Experienced staff dedicated to pension clients, linking the advantages of size and scope with personal service
- Highly sophisticated and state-of-the-art technology platforms, providing information to make and evaluate critical decisions
- Industry-leading experience and presence in a variety of return-enhancing strategies and products — including securities lending, FX, derivatives, transition management — offering greater flexibility, choice and customization for plans
- The proprietary VIEWS Portfolio Reporting system — a comprehensive, easy-to-use and customizable online platform, a secure single point of entry to accounting, custody, compliance and performance measurement
- The best asset servicing tools in the market for alternative investments, including hedge funds, private equities, derivatives and ETFs

**PRODUCT INNOVATION IS VITAL**

Providing solutions beyond the traditional is critical in serving pension clients, which demands greater innovation in product development. “In order to stay competitive, clients are seeking increased returns in combination with reduced risk, and they also must identify underperforming managers,” says Skolnik. JPMorgan’s Investment Analytics and Consulting presents an innovative, comprehensive solution to these needs.

JPMorgan’s Performance Analysis product provides security-level, multicurrency portfolio measurement, allowing clients to evaluate and compare the performance of accounts and composites against each other and against a wide array of benchmarks. “Plans need tools to measure the impact of portfolio manager changes and changes in asset allocation strategies on a fund’s risk and potential return, and this product is designed to address these needs,” says Skolnik.

Derivatives Exposure Analysis, another offering, exposes the impact of derivatives on asset allocation structures and currency exposure for a given plan. Still, JPMorgan’s efforts to foresee future client needs prevail. “We’re currently expanding this product to encompass an even more robust understanding around credit default swaps and swaptions,” notes Skolnik, referring to other products enjoying increasing appeal among plans.

The personal, tailored approach JPMorgan employs in serving clients ensures products are delivered through a consultative, interactive process, with individual attention to each client’s unique situation.

While client needs are distinct, one commonality underscores most plans. “There is a glut of information coming at plan sponsors, and it has become too expensive for individual clients to have in-house the expertise necessary to sort through data and evaluate and test portfolios,” says Michael Ravensbergen, head of sales and client management for pensions in North America.

Products like JPMorgan’s Marginal Risk Analysis tool directly address this need. Essentially a risk budgeting tool, it creates a forward-looking analysis of how specific changes in asset allocation or manager selection might impact total risk and relative risk versus a given benchmark.

Complexity is another driving force. Since some DB plans, for example, have over 50 different asset managers, clients need the ability to “slice and dice” performance data to evaluate managers, either individually or in aggregate, and “our products can meet this demand,” said Ravensbergen.

Overall, the goal is to help clients make more informed decisions regarding issues that impact their portfolios. In the ever-changing landscape that confronts plan sponsors on a daily basis, forward-looking products and services are the key to achieving incremental returns.

“Providing clients with whatever they need to make those critical decisions — whether to comply with legislation or regulatory changes, increase returns or keep up with demographic shifts — is what it boils down to,” said Ravensbergen.
The Dallas-based Institutional Fund Accounting Services group (IFAS) takes Texas-size pride in its ability to meet the evolving needs of pension service clients in the United States — whether it’s same-day valuation, web-based access to fund manager reconciliation information or staying abreast of the latest regulatory issues.

The team provides accounting, financial and regulatory reporting services for endowments and foundations, public and corporate pensions, 401(k) plans and group trusts, servicing $850 billion in assets under management and over 4,800 accounts.

“Our accounting team in Dallas has worked hard to streamline the pension servicing process by reducing expenses, implementing procedures and controls to improve timeliness, and working closely with our innovative technology and accounting product teams,” said Brian Goldman, operations executive and head of IFAS.

One key innovation is same-day valuation, which enables clients to review their accounts on a daily, rather than monthly, basis. Clients can view accounting information on JPMorgan ACCESS, an online system that can also feed other data resources, such as daily investment analytics and consulting and daily compliance monitoring.

The Dallas team also pioneered a proprietary web-based fund manager reconciliation tool, which has enjoyed widespread adoption throughout the investment management community. Now, regardless of a firm’s internal technology, IFAS and investment managers are able to receive, integrate and reconcile holdings, market values and accruals using a standardized, consistent reconciliation format.

To assist clients with regulatory concerns, IFAS developed a comprehensive GASB 40 package that includes summary and detailed reporting for concentration of credit risk and foreign currency risk. Investment analytics and consulting clients can also receive reporting on the various methods of interest rate risk, and clients’ packages are customized to fit their reporting needs.
“Come for the mission, stay for the pension,” quips John Preis, chief executive of the YMCA Retirement Fund. As Preis point out, there is good reason to stay — after 32 years of service, a YMCA official can retire on upward of 80% of his or her final salary. By any standards, that’s impressive; by the brutal mathematics of today’s retirement paradigm, it’s exceptional.

How does the YMCA do this? First, the $4.9 billion fund performs exceptionally well, a function of a seasoned chief investment officer and investment committee that have consistently made smart investment decisions.

The fund’s international exposure is heavy (15% of the portfolio), as is its alternatives bucket (23%, split among hedge funds, real estate and private equity). “We have a tolerance for illiquid assets, and it’s served us well,” says Preis. As an example, the fund’s private equity portfolio, which is traced back to 1981, has an IRR since inception of 21.3%.

The net of these investment choices is a truly above-par performance record: A dollar invested by a YMCA Retirement Fund participant in January 2000 would have been worth $1.59 in January 2006; by comparison, a dollar invested in the Russell 3000 would been worth $1.42.

Preis took the job in 2000, when prospects were far from rosy — most of the assets were run in-house, performance was lagging, and the YMCA itself had barely survived a full-court press from the IRS, which was looking to strip away its church plan status. Preis, a YMCA lifer who had previously been CFO of the New York City YMCA, quickly turned things around, hiring new staff, moving to outside managers and reinvigorating benefits communications with employees.

Our uniqueness is that we are an ERISA-electing church plan.... From the participants’ perspectives, we are the best of both worlds.

Aside from investment performance, the architecture of the fund is also what sets it apart as a benefit. The $4.9 billion pool ($2.6 billion in a 401(a) fund, $1.0 billion future annuity reserve, $290 million in a 403(b), and $1.01 billion reserve for ancillary benefits and contingencies) is a true hybrid: a defined contribution plan with defined benefit attributes. It describes itself as a nonprofit, defined contribution, money purchase, church pension plan, and each year its 75,000 participants receive an interest credit on their balances. That credit can vary from year to year, but its effective lowest rate is set at 3%, even in the bleakest of years: in 2005 and 2006, participants saw their balances rise by 12% per annum. In the 85-year history of the plan, there has never been a single year when the balance went down.

Each YMCA itself has a choice as to how much of its employees’ wages it kicks into the retirement fund — 12%, 9.6% or 7.2% — and that obviously has an impact on the final replacement ratios. There are no lump-sum payouts; all payouts are annuitized. “That’s just that right thing to do,” says Preis. With all the attention now being paid to pension viability, the YMCA Retirement Fund is exceedingly proactive in its disclosure, ensuring that every participant can access everything about the fund’s status and its ongoing ability to meet its obligations. Indeed, the plan’s site, yretirement.org, is a model of clarity, with straightforward and transparent explanations of the A to Z of pension management — from explaining how asset allocation decisions are made to what a hedge fund is. “There is so much uncertainty out there about the status of pension funds that we feel we owe it to our participants to be completely transparent,” says Preis.

As a church plan, how can you ensure that you can meet a more complex commitment to employees?

Being a church plan creates a very interesting set of circumstances.

If you’re running a typical corporate 401(k) plan, when the person wants to annuitize the benefits they have to take their account balances to a bank or insurance company and convert it to an annuity. Obviously, that bank or insurance company is going to give them an interest rate that includes the profit they want to make for the annuitization.

A church plan self-annuitizes and tends to subsidize the annuity rate because that’s the benefit of doing it. You do it yourself and you’re only in business for your participants. Those are the main benefits of being a church plan.

Now, having said all that, our uniqueness is that we are an ERISA-electing church plan. From the participants’ perspectives, we are the best of both worlds. We comply with all the ERISA requirements and we are a church plan that self-annuitizes the benefits.

That results in the best of both worlds for all participants because they have the benefits of our compliance with all the ERISA regulations and they have the benefit of us acting as a church plan, self-annuitizing the benefits, meaning, end of day, our participants get a bigger monthly check.

Given this hybrid nature of your plan, how do you meet those complex challenges in terms of the provision of benefits provided to your participants?

We are unique as a plan in that we are a defined contribution plan during the accumulation phase when participants are working to advance the mission of the Y, but when they retire, we self-annuitize the benefits and pay them out — and we will pay retirees more than 12 checks a year if our performance is good in the market. At that point, during the payout phase, we function more like a defined benefits plan. Typically, with a defined contribution plan, the liabilities are at market value at the end of investing. But for us, because we’re paying the annuity out on the other side, we pay careful attention to the asset liability.

Another positive for our plan is that we only serve the YMCAs — and nothing but YMCAs. YMCAs are continuing to grow across the United States. They have continued to expand at a rate of about 7% over the last seven years and that encompasses both a boom and bust in the U.S. economy — and yet they continue to consistently grow and prosper. That means that our fund continues to be cash-flow positive. There’s more coming in each month — in the form of contributions, together with new business and interest — than there is going out to pay benefits. Consequently, our tolerance for illiquidity is quite high, and we are driving more of our assets towards what we consider to be alternatives in order to capture that advantage.

Do you think this model should be used by corporate or public funds?

I think it would be beneficial to an extent. It’s the best of both worlds, because it puts the burden of saving and careful planning about the future onto the individual. If investments go well, it provides the retirees with the account balance that’s entitled. We don’t have this kind of defined benefits formula. But, if we’re doing well and we’re being overfunded, the overfunded condition of the plan allows us to provide what the retiree calls an “extra check”.

The difference, though, is that we’re a standalone organization... we have nothing to do with YMCA USA or any individual Y in the United States. We are separately incorporated and separately governed.

From the participants’ perspective, that’s a good thing, because we are not subject to the economic condition of any employing YMCA as a separate and distinct entity. So if a person works for the Y for a career, and they work 10 years for the Y in Los Angeles, and five years for the Y in Detroit, and ten years for the Y in Bangor, Maine, and three years for the Y in Savannah, Georgia, their account is with us. So wherever that individual may go, we are their retirement fund.

How do you rely on your service providers to help you?

Well, any organization comes down to its people, and those people are going to decide if they want to help out, or listen, or concentrate, or deliver, or if they’re not. We have come across a bunch of people who always happen to have the JPMorgan logo branded on them and they deliver on that brand promise. It’s the same way when you’re dealing with a big law firm, or big accounting firm — it’s those two or three people who act as your client service representatives, that are the ones who deliver for you. That’s where the rubber meets the road. Our team represents JPMorgan with a tremendous amount of pride and tremendous effectiveness. And no one else can keep up with them. This just happens to be a group of people who are making it happen for us.

There are several things that the bank provides that we find value in and we take full advantage of. The lockbox product has helped streamlined our processing of incoming retirement contributions. And we use the JPMorgan ACCESS electronic portal to help us initiate ACH debits for clients to make electronic payments. Those products are just excellent for us as they provide effective, accurate, timely reporting, which helps us understand our financial position on a daily basis which is very important to us.
The Wellcome Trust, with $27 billion (£13.9 billion) in assets, is the world’s second-largest charitable foundation. Over the past 50 years, it has been able to increase its grant-giving by an average annual compound rate of 17%, equivalent to growth of over 2,500 times.

Like most endowments, we have our roots in private equity: Sir Henry Wellcome’s pharmaceutical company developed both a number of blockbuster drugs and a global marketing capability. In 1986, the company was floated and subsequently merged with Glaxo. The Trust sold down its shares over time and diversified into a broad range of real financial assets.

Liquidity constraints and the need to build an experienced investment team meant that the Trust initially focused on public market assets, but the portfolio moved into private equity, venture and emerging markets in the early 1990s, into real estate through an audacious acquisition in 1996 and into hedge funds in 1999. The equity market slump slowed the transition out of public markets, as the Trust rightly held on to equities for the subsequent recovery. However, by the end of the 2006 financial year, ‘alternative’ assets comprised 42% of our total portfolio.

The results have been impressive: charitable grants have risen from £20 million in 1985 to £540 million in 2006. The annual volatility of returns has fallen to around 10% and the charity is no longer exposed to a single company. Our 20-strong investment team continues to diversify the assets, most recently into active currency funds and direct investments in healthcare and financial services. In 2006, Wellcome became the first UK issuer of a £550 million listed AAA/Aaa charity bond.

In managing our portfolio, we try to make use of our competitive advantages as an investor: our time horizon, the absence of defined liabilities, our high tolerance for risk, our strong balance sheet and our brand.

Our investment culture is aligned with our charitable culture: we seek to partner with the best people who seek to make a significant difference in whatever field they operate. We have no strategic asset allocation — our only benchmark is to surpass our targeted 6% real annual return over the long term (and none of us is quite sure what the long term is). We share the view of Warren Buffett that “we do have a few advantages, perhaps the greatest being that we don’t have a strategic plan.” With respect to the master, however, we do not require our grant-making colleagues to spend money each year unless they can find worthwhile causes.
Our management is largely outsourced. At present, we have 232 managers. They manage their portfolios better than we do, so we encourage them to take more money from us when they are full of conviction — and to give it back when they are not. We select them on the basis of their people and their culture rather than their processes, philosophy or performance. We like to understand how they make money but not to be judgemental about the asset classes in which they invest. We do not have quarterly reviews.

The debate about pension fund investment into 'alternative' assets reminds me of the quote by Max Planck: "a new scientific truth does not triumph by convincing its opponents and making them see the light, but rather because its opponents eventually die and a new generation grows up that is familiar with it." Our analysts cannot conceive of a portfolio without venture or hedge funds any more than they can believe that I did not have a PC when I started work.

Some years ago, I was charged with the responsibility of building up an Asian ex-Japan equity portfolio for the British Coal Pension Schemes. Tiananmen had just happened, the markets were small and illiquid and, in the tense period between the Iraqi invasion of Kuwait and the First Gulf War, buying meaningful numbers of shares in Asia was, to say the least, difficult. After almost a year, in October 1990, the big boss asked me how I was getting on. "£250 million," I told him proudly. "Excellent," he said. "That's almost as large as our Unilever holding."

Investing in alternatives requires the patience to accept that we are farmers, not hunters. After 15 years, our venture portfolio is over $1 billion and has returned more than 90% a year; however, we still have less money at work than we have with our largest long-only equity manager. Identifying and getting access to the best managers (and in venture, particularly, the second-best are to be avoided) is a long process. Even when one does, asset valuations have an annoying habit of being in the wrong place at the wrong time: I suspect that some of our best decisions in 2006 were to reject every infrastructure and commodity opportunity that was presented to us.

Our predecessors set the bar high: George Hitchings and Gertrude Elion rightfully won the Nobel Prize for the work which they did in discovering new drugs in the 1960s and 1970s, which transformed the financial fortunes of Wellcome as a private company. Sir Roger Gibbs' decision in the 1980s and 1990s to float Wellcome plc and to diversify into a broad range of financial assets provided the funds “to save medical research in the UK” (at least in the opinion of the Oxford Professor of Physiology, Denis Noble). Today, as with the managers of any long-term undertaking, we try to respond intelligently to the full range of opportunities to create long-term institutional success. For us, there are no 'alternative' assets.

Investing in alternatives requires the patience to accept that **we are farmers**, **not hunters**.
Investors seeking diversification and growth are increasingly eyeing international markets. The desire is natural: the MSCI EAFE Index, a broad group of international stocks, returned 27% last year, outperforming the strong returns of the S&P 500 by nearly 70%.

Consequently, international investments are an important component of any pension plan strategy. However, the desire to reach beyond traditional geographic borders to augment returns is balanced by the need to comply with several layers of regulations and reporting. Like any investor, pension plans must conform to the strict requirements — country, government and regulatory — necessary for foreign investments. Uniquely, however, pension plans must also observe limitations on direct investments that may be set by their own trustees.

Given these circumstances, how can pension plans benefit from international growth and increased globalization?

The ease and convenience of holding DRs is driving strong investor appetite for these securities.

Global Securities, Standard Practices
Fortunately, opportunities exist close to home. Depositary receipts, or DRs, are securities that represent ownership in foreign corporations. These dollar-denominated securities typically trade on the U.S. and/or European markets and settle in accordance with those market standards.

DRs allow pension plans to diversify overseas without associated currency and settlement risk, and remove additional custody and safekeeping charges. Pension plans increasingly use DRs to diversify their investments and venture into new markets. According to Claudine Cardillo-Rivot, global head of JPMorgan’s DR business, “The ease and convenience of holding DRs is driving strong investor appetite for these securities.”

Several of the largest pension plans, including TIAA-CREF, the New Jersey Division of Investment and the Teachers Retirement System of Texas, hold DRs in their portfolios, and the California Public Employees’ Retirement Systems (CalPERS), one of the world’s largest pension plans, recently amended its investment guidelines to include DRs. In fact, The Wall Street Journal noted that “investments in emerging markets now represent 3% of CalPERS’ portfolio,” and that percentage is expected to “multiply in the next five to 10 years.”

2007 marks the 80th American Depositary Receipt, created by JPMorgan for British retailer Selfridges in 1927.

This trend is not limited to the United States. One prominent U.K. pension plan manager has recently moved its overseas weighting to improve performance and returns. As trustees increasingly accept greater risks, DRs provide them with a safe alternative to invest in countries such as India and China.

The ABCs of DRs
As negotiable instruments that represent ownership of shares in a foreign company, the fundamental characteristics of DRs are attractive to global investors. DRs:

- Are quoted in U.S. dollars, with accessible, published price information that permits easy comparison with other investments. Dividends are paid in U.S. dollars.
- Follow the rules of the established markets in which they are listed, including trading hours and settlement practices.
- Provide salient information to investors, using required filings such as 20-F and F-6, and deliver ongoing shareholder information such as annual reports and corporate actions in English.
- Are subject to the disclosure and accounting requirements of the exchange on which they are listed.

1 13-F filings
Eliminate the need for costly global custody safekeeping charges.

Mitigate the transaction, settlement, risk and currency concerns that normally accompany cross-border investments.

Investors purchase or sell DRs just like any other listed security. Since new DRs can be created based on demand, the supply of available DRs is not limited by liquidity or trading volumes in the issuer’s home markets.

**Fair Comparison**
Foreign companies that meet the stringent requirements may list their DRs on a global exchange. This broadens their exposure to investors, who can assess these companies versus their global peers within a particular geography or sector. With common information and standard market practices, investors can easily and accurately compare two companies regardless of physical location, opening the doors to increased diversification and benefiting both issuer and investor.

**Explosive Growth**
As a result of this mutual interest, we have seen explosive growth in the DR market during the past few years.

- More than 1,800 companies from more than 75 countries have established DR programs.
- 72 of 124 DR programs created in 2006 — nearly two thirds — were listed on European exchanges.
- 460 DR programs are listed on U.S. exchanges.

Investor interest shows no sign of abating. During 2006, for example, the level of U.S. investment in foreign equities shot to an all-time high, exceeding $3.9 trillion and reflecting a record 19.1% portfolio allocation to non-U.S. securities.

DRs also enjoy robust liquidity, with record trading volumes in 2006 (up 22%, to 57 billion shares) and trading values of nearly $1.7 trillion (a 58% increase over 2005). Continued strong performance is expected during 2007.

**Market Expertise**
Since establishing the first depositary receipt program in 1927, JPMorgan has introduced the first DR programs from all major regions of the world. During 2006, JPMorgan handled the largest transaction ever in Latin America, and was named sole depositary bank for Russian oil and gas giant Rosneft’s record-breaking $6.4 billion global depositary receipt (GDR) offering.

Because of its local market expertise and global reach, JPMorgan is uniquely positioned to bring these companies to the global investor community. Today, JPMorgan sponsors more than 200 DR programs from companies in Europe, Latin America and Asia. In addition to its market-leading services for issuers and shareholders, JPMorgan’s dedicated liquidity solutions team delivers premier services to pension plans and other institutional investors who invest in JPMorgan-sponsored DRs. The liquidity team introduces issuers to investors, works to increase liquidity, helps large investors develop cost-effective solutions and is dedicated to meeting the unique needs of investors on the buy side.

According to Cardillo-Rivot, JPMorgan is the depositary for seven of the top 20 global DR programs. “These well-known, established companies are attractive options for pension plans seeking to expand their global exposure.” She expects these trends — deepening investor interest in foreign companies and the use of DRs to expand investment options — to continue.

**For more information about JPMorgan’s depositary services, please contact Kamal Pallan at 212-623-0122, or visit us at www.adr.com**
As pensions increasingly turn to alternative investments for higher returns, requirements for managing complex administrative challenges intensify.

Whether corporate or public, small or large, establishing and growing an alternatives program is a necessity for pension funds — not an option. Most pension funds already include private equity, real estate, hedge funds, real assets and other alternative investments in their portfolios. The dilemma is how to best manage the administrative burden of a portfolio of investments in limited partnerships (LPs) and other structures in alternatives.

It’s spring and while tax season rush is over, there’s no rest in sight. Now, senior managers look to their teams to provide information on 2006 performance for private equity investments: by vintage year, by strategy, by fund manager, for the last one, three, five years and since inception, and to top it off, they want to exclude funds A, B and C from the analysis. After a scramble to find the relevant spreadsheets, faxes, e-mails, usernames and passwords, and fund financial statements, it is clear that the answer is not going to come cheap.

In case this still doesn’t ring a bell, it’s important to understand what the administration of a portfolio of alternative investments involves:

- Performance analytics
- Capital call and distribution processing
- Underlying portfolio company monitoring
- Outstanding commitment monitoring
- Statement reconciliation
- Cash flow tracking and forecasting
- Document management (web-based)

Not that long ago, alternatives represented only a small portion of most pension portfolios. The administrative aspects were not that complicated, nor were the demands for transparency and quality reporting from investment professionals, senior management, auditors and regulators. Today’s challenges are different, and can include:

- Labor-intensive process of gathering and aggregating fund investment information that comes in different formats, mediums and time frames
- Limited technology and resources to evaluate portfolio performance and facilitate decision making and fund manager selection
- Administrative burden around capital call/distribution execution and capital commitment monitoring
- Pressure from auditors for greater portfolio transparency
JPMorgan Private Equity Fund Services Launches in EMEA and Australia

JPMorgan Private Equity Fund Services (PefS) has put a team on the ground in the U.K. better enabling it to serve the European and Middle Eastern markets. PEFS offers high-quality outsourced administration and banking services to private equity funds and institutional investors. As part of the group’s strategic expansion, Huw Jones has joined as head of PEFS’ London office.

Additionally, PEFS has launched its business in Australia and the Asia Pacific region. The PEFS team in Australia is run by Martin Archer, Head of Alternative Investment Services, Australia. He is joined by PEFS portfolio administration specialist, Amy Newlan, who recently relocated to Sydney from New York.

The right choice should allow a manager to focus on what is most important to the organization: achieving superior returns.

Larger portions of pension portfolios are allocated to alternatives, and the administration has only become more complicated. The options going forward are for managers to do it themselves or outsource. For those that do not choose to move forward on their own, the next question becomes “Who can I outsource this to?” Maybe the fund’s custodian would do it, or perhaps an investment advisor could take care of it. There’s no right or wrong answer. What’s clear is that Microsoft Excel and the part-time attention from an analyst or accountant will not be sufficient once it goes beyond administering 10 to 15 investments.

Some investment advisors or consultants might take on the portfolio administration work, albeit reluctantly, to win or retain the advisory mandate. Or, a fund’s existing custodian might be the obvious choice. “There are benefits to having a current custodian do the work on alternatives — such as integrated reporting across all asset classes, particularly if the custodian has the dedicated team, technology and expertise in the asset class,” says Cesar Estrada, head of product management for JPMorgan Private Equity Fund Services. “In either scenario, outsourcing to firms with established tenures and exposure to complex administrative challenges places the burden with the experts.”

To LP or not to LP is a question of the past. To outsource or not to outsource the administration of a portfolio of alternative investments is the question that deserves attention before a fund’s investment pace outgrows its infrastructure. “The right choice should allow a manager to focus on what is most important to the organization: achieving superior returns,” says Estrada.

Alternative Investment Portfolio Administration is offered by JPMorgan Private Equity Fund Services to institutional investors including public and corporate pensions, endowments and foundations, insurance companies, family offices, fund of funds and investment companies in North America, Europe, the Middle East, Australia and Asia.

For more information, please contact Cesar Estrada at 1-212-552-5955 or jpm_pefs@jpmorgan.com, or view our product tour at www.jpmorgan.com/pefs
From the Desk of Rick Lazio

2007 pension outlook

Rick Lazio, a former four-term Congressman representing New York, is executive vice president for Government Relations and Public Policy at JPMorgan Chase. As the only member of Congress to sit on both the Commerce and Banking Committees, Rick was an important voice in the debate over Gramm-Leach-Bliley, which was the most dramatic modernization of the U.S. financial supervisory and regulatory system since the Great Depression of the 1930s. Rick provides strategic political and regulatory insight and advice to JPMorgan Chase and its clients worldwide, and also sits on the firm’s Executive Committee.

Next year, the first of 76 million baby boomers born between 1946 and 1964 will become eligible for Social Security in the United States. As the largest generation in the United States makes its way into their sixties, retirement security is becoming a larger and more vexing issue, and drawing greater legislative and regulatory scrutiny.

Individuals near retirement are rightly concerned about their financial position, while policymakers are focused on sustaining pension systems and ensuring the viability and vitality of defined benefit and defined contribution pension programs. The U.S. Social Security program and the U.K. Pension Service are supplemented with employer-sponsored defined benefit and contribution plans.

Promoting policies that strengthen and expand defined benefit and contribution plans is a key objective of JPMorgan. Over the last several years, JPMorgan has brought its unique perspective to pension debates in the United States and Europe. As a central player in the international pension space that touches plan sponsors, pension funds, and beneficiaries, the firm has helped provide policymakers the background and context essential to making sound policy. We look forward to remaining engaged as policymakers grapple with the issues outlined below.

U.S. Pension Policy

In the United States, defined benefit plans have been in sustained decline, and recent vulnerability in the airline, steel and auto industries has exacerbated that trend. Prompted by these problems, Congress passed the Pension Protection Act of 2006 to amend the public insurance fund rules that guarantee benefits under defined benefit plans, and strengthen participation in defined contribution [e.g., 401(k)] plans. To those ends, premiums paid to the Pension Benefit Guaranty Corporation were increased and funding of defined benefit plans was accelerated. 401(k) plan sponsors have been authorized to provide automatic enrollment of employees with contribution escalation, and have been given a fiduciary safe harbor for designating default investment options within their defined contribution plans.

The regulations being drafted by the U.S. Department of Labor (DOL) governing permissible default investments have become a contest in lobbying might. In September, the Department proposed regulations that would discourage employers from putting all their employees’ money into stable value funds and money market funds. It said default options needed to offer a mix of investments, usually including stocks, and the proposed rule...
emphasized three types of appropriate default choices: balanced funds, which typically have an unchanging mix of stocks and bonds; life-cycle funds, which have evolving asset allocations based on age; and a diversified portfolio of funds managed by an outside adviser.

While last year’s bill addressed many of the pension issues on the Congressional agenda, Congress continues to scrutinize various aspects of defined contribution plans — specifically, 401(k) fee structures and disclosure. Spurring Congress to action was a November 2006 Government Accountability Office study that recommended improved 401(k) fee disclosure legislation and urged the DOL to respond. The DOL is currently working on several ways to improve fee disclosure and hopes to publish a final regulation in the next several months.

In early March, Congress heard from witnesses who suggested that 401(k) fees are typically between 3% and 5%, when witnesses suggested they should be no more than 1.5%. “That is 1.5% to 3.5% more than is reasonably necessary,” said one of the witnesses. “A remarkable amount of assets that could have been available for retirement has leaked out of that fund,” said U.S. Rep. George Miller, D-Calif., “You have a lot of people dipping into other people’s money”.

To the extent Congress legislates on this topic, greater disclosure of fees — with a focus on plain English — is likely to be required. However, there is some concern within Congress that financially unsophisticated 401(k) participants not be “overloaded with information”.

**U.K. Pension Policy**

Compared with 2006, 2007 is likely to be a year of relatively little change in pension policy in the United States. In the United Kingdom, however, pension policy continues to generate controversy and new proposals. The broadly supported recommendations made by the Turner Commission in 2005 have prompted vigorous debate and two *White Papers* from the government. To implement the first *White Paper*, the government has proposed legislation that would raise the retirement age (more quickly than proposed by the Turner Commission), make the state pension more generous by restoring the link to wages severed by the Thatcher government, and create a mandatory National Pension Savings Scheme (NPSS) that requires employer and employee contributions. The bill is well advanced in the House of Commons and is likely to be agreed prior to the end of Parliament in the fall.

The second *White Paper*, issued in December 2006, largely addresses the implementation of the NPSS, and legislation is likely to be announced in the Queen’s Speech in November 2007. While there is substantial agreement between Labour and Conservatives, the role of the private sector in managing NPSS assets has emerged as a central point of contention. Essentially, the government would like to provide private investment managers less discretion in their management of NPSS funds than the Conservatives would. Ultimately, this issue will be resolved and legislation is likely to be passed sometime in 2008.

Pension policy is a difficult political issue. It addresses a topic over which most voters have considerable anxiety; there is little immediate positive effect from “reform;” and it implicates some of society’s most vulnerable members. Political leaders in both the United States and the United Kingdom want their recent reforms to stand the test of time. If recent history is any guide, they may be disappointed. The cresting of the aging wave, uncertain public finances and investment volatility are almost assured to create new political imperatives that must be acknowledged. The future starts now.

1, 2  *MarketWatch*, March 8, 2007

Retirement security is becoming a **larger and more vexing issue**, and drawing greater legislative and regulatory scrutiny.
JPMorgan's new design for online products will introduce a new look and feel, a portal dashboard and new navigational elements that facilitate improved interaction with the underlying application data.

This spring, JPMorgan ACCESS debuts its new portal interface. This redesign is part of a broader program to provide a best-in-class online experience with a cleaner and more modern color palette and more intuitive navigation.

**Transaction Initiation**

**Portal Integration**
Transaction information directly available from the Portal Dashboard.

**Efficient Summarization**
Trades are summarized by type, stage in the trade life cycle, with full drill down capability into underlying details.

**Rapid Entry**
Entering trades now required significantly less clicks and keystrokes.
We want to provide our customers with more than just a great set of tools.

“We have a very powerful set of online products, but we want to provide our customers with more than just a great set of tools,” said Robin Smith, head of Client Access Product Management for Worldwide Securities Services.

The product redesign program:

- began with an examination of how JPMorgan designs and builds client-facing technology to focus on how clients use JPMorgan tools in their workflow
- will allow users who are running daily reports to have immediate access to those reports when they log in
- will allow users who are interested in exceptions only to have those items highlighted on their home page
- uses client input to drive the entire design process from start to finish

JPMorgan plans to redesign applications and integrate them into the JPMorgan ACCESS portal starting in the second half of 2007.
An aging population. Capital markets volatility. Regulatory changes. These and other dynamics have resulted in funding concerns in the pension industry, leading plan sponsors worldwide to look more critically at the return on assets in all parts of their portfolios. Against this backdrop, cash — while representing a relatively small portion of a pension portfolio — has emerged as a strategic asset. And custodians are increasingly being asked for solutions for investing short-term cash assets, including residual cash from trading.

“JPMorgan Chase has responded to the evolving needs of plan sponsors by offering a complete array of short-term cash investment alternatives — both globally and regionally,” says Sarah Jones, head of Treasury & Securities Services (TSS) Liquidity and Investment Products group. “These solutions provide clients with a host of benefits, including transparent returns, diversification, liquidity and overall investment efficiency.”

The U.S.: A Wide Array of ERISA-Qualified Funds
In the U.S., banks are in a unique position to serve plan sponsors. They are the only financial institutions allowed to offer dedicated commingled funds for the sole purpose of investing retirement plan assets under the Employee Retirement Income Security Act (ERISA) of 1974, as amended.

ERISA-qualified, short-term collective funds offer a number of advantages: Typically, they are lower cost than comparable money market mutual funds and have a longer weighted average maturity. Among the full range of investment alternatives that JPMorgan
We expect our custody clients to have greater needs for investing cash. We are poised to meet those needs.

Chase offers its custody clients an investment sweep into short-term collective funds for ERISA plans. They are are managed by JPMorgan Asset Management, the world’s largest provider of institutional money market funds.

“We have the capabilities to meet the specific needs of plan sponsors,” says Christopher Martin, Client Solutions for TSS Liquidity and Investment Products, Western Hemisphere. “Of any bank, we understand that we have one of the widest arrays of commingled funds dedicated to the ERISA market — five funds, with total assets of around $8 billion to $10 billion. While the vast majority of plan sponsors choose to invest in our suite of ERISA-qualified employee benefit funds, a number choose to invest in alternative vehicles including JPMorgan money market funds.”

Europe: Beyond Interest-Bearing DDAs

In Europe, plan sponsors are considering investment alternatives other than interest-bearing DDAs to get greater returns on cash under custody.

JPMorgan Chase gives its custody clients several options for investing in a diversified offshore liquidity fund managed by JPMorgan Asset Management: a straight automated sweep from a single DDA; physical cash concentration of several DDAs prior to the sweep, to maximize the amount being invested; and notional pooling, which achieves the benefits of cash concentration without commingling funds. Says Tristan Attenborough, head of TSS Liquidity and Investment Products, EMEA, “Not all custodians have an asset management company as we do. Our JPMorgan liquidity fund offers a very competitive yield and may be a differentiator for our clients.”

Clients in Europe can also choose to sweep cash balances — in sterling, euros or U.S. dollars — into third-party time deposits across a diversified range of counterparties through Cash Trade Execution (CTE). Noting that the competition does not offer a similar capability, Attenborough says, “CTE is a preferred investment alternative for clients with strict guidelines for spreading counterparty risk — especially in markets such as Germany, where regulations prohibit investment managers from having more than 20 percent of assets including cash with any one counterparty.”

Asia: Growing Investment Needs

In Asia, the ratio of cash to total assets under custody tends to be smaller and plan sponsors across the board generally invest their residual cash in interest-bearing DDAs. As in other regions, they are showing increased sensitivity both to the rate of return on cash as well as to ensuring investment diversification.

“One area where we’re seeing a lot of pension fund activity is Australia,” says Tom Schickler, head of TSS Liquidity and Investment Products, Asia Pacific. Though the cash to assets under custody ratio is a bit less than 1 percent, total pension fund assets are growing because of regulatory changes — by $50 billion to $60 billion a year, according the Association of Superannuation Funds of Australia.

Given the growth in the Australian pension fund market and the increasing wealth of countries throughout the region, says Schickler, “we expect our custody clients to have greater needs for investing cash. Leveraging JPMorgan Chase’s liquidity and investment capabilities around the globe, we are poised to meet those needs.”

Solutions that Span the Globe

Jones concludes, “JPMorgan Chase is one of the few institutions with the global capabilities to provide plan sponsors with short-term investment solutions for residual cash no matter were the assets are.”
Q&A with Conrad Kozak

How have you evolved JPMorgan’s product capabilities and delivery tools to address the sophisticated investment strategies of pension funds in the current market?

The common thread between our past experiences and endeavours and our current model is our focus on the customer rather than the process or the product. Our extensive experience in fund services and as one of the largest global custodians lends itself to understanding the needs of our pension fund clients worldwide.

The nature of the business is changing as focus moves from the core custody offering toward the other valuable services provided around that primary offering. Now, we see our clients are increasingly asking what we can do in addition to the custody and directed trustee product offering.

On the one hand, this means increasing emphasis on reporting, performance measurement, participant record keeping, compliance and various other analytical functions. On the other hand, this includes the specialised products that make a difference to fund managers, including securities lending and transition management. Technology-differentiated tools and a cohesive technology architecture allowing clients to easily navigate, track inquiries and customize reports are also critically important to our pension fund clients. Going forward, I think it will be through the strength of the overall asset servicing activities that firms can offer that will differentiate the top service providers.

What are the key challenges facing global securities services providers today and how are you working to address them?

In particular, I see a couple of challenges facing providers today. The first involves continuing to develop innovative products to keep up with the speed at which the market is developing. The second is the ability to make the entire range of service capabilities easily available and clearly communicated to clients. Service providers today are faced with an increasingly complex set of requirements as the market continues to evolve. It is a constant challenge to keep up with the new instruments, new techniques, new risk management requirements and new demands in terms of client outsourcing — derivatives servicing being an example in each case. This is a challenge to which any business in a vibrant industry has to adjust successfully.

In recent years there has been a lot more interest in alternative asset classes. How important will servicing these emerging assets become to pension funds and to the industry overall?

Pension funds are sophisticated players in the market who are continually looking to expand their performance and outperform their liabilities through the use of evolving investment techniques. They are considering questions such as, “How heavily should we get into derivatives?” and “Should we be investing in leveraged loans or private equity?” All of the questions they, and we, are asking are about the best place to find alpha.
Pension fund managers have been talking about the ‘alternative’ areas like derivatives, private equity and real estate for years, but in the last 12 months these activities have become more mainstream. In the current market environment, the ability to process derivatives and to account for the increased amount of hedge funds and private equity funds within a pension fund’s investment portfolio is rapidly becoming essential. As such, we are investing a significant amount of time and effort in developing our capabilities to not only process derivatives, but also to provide the accounting for these alternative instruments really well — whether it is for derivatives, leveraged loans, hedge fund or private equity fund investments. As this adjacent space continues to evolve, I don’t think the current industry as a whole is at the level where many providers are providing these broad-based services extremely well. Therefore, there’s an enormous opportunity for players like us to combine a really broad range of asset servicing capabilities with the ability to execute them incredibly well.

In particular, what growing interest and use of derivatives are you seeing — by which client types — and how are you building out your service offering in lock-step?

We are seeing a significant growth in the use of derivatives by our current client base. The derivatives services we provide clients include valuation, transaction management and accounting services. Today our derivatives client base is broad, including pension funds and asset managers beginning to employ a variety of trading strategies such as liability-driven investments, absolute return and high alpha strategies to maximize returns and remain competitive.

Is it important to clients that WSS is part of a larger financial services firm? What does the broader firm bring to the table for clients?

For our clients, a relationship with us means they’ll have the opportunity to benefit from the broad expertise of JPMorgan Chase overall — including the talent of our people firmwide, our market-making and financial engineering skills, our commercial banking strength and more.

The challenge for us involves how well we leverage our own firm — to make the resources of our entire global JPMorgan platform available to our clients in a relevant and cohesive manner. The key in this effort is ease of use — whether we are talking about our processing services, clearance and trading, FX or cash management capabilities. And the real challenge is to provide the introduction to and the delivery of these various products and services from across the firm in a way the client can access them quickly and smoothly. We aim to help our clients explore the possibilities of how we can provide the most complete set of portfolio servicing solutions.
Q&A with Kevin Carter

Head of JPMorgan’s IB pension advisory group for Europe, the Middle East and Africa

There has been a lot of talk about pension fund buyouts, but we haven’t seen very many. Why not?

Let’s take a step back and look at the current dynamics of the pensions industry. As has been widely publicised, pension funds are suffering from deficits. In the UK, for example, the pensions regulator has estimated that 99% of final salary plans are running deficits totalling about £440 billion, using the same calculation buyout funds would use.

Because the liability calculation used by buyout companies is more conservative than that used to estimate liabilities for accounting purposes, the deficit for a pension plan being acquired by one of these companies is higher than it would be if the plan stayed put. For example, using the deficit calculation based on the accounting standard FRS17, against which corporations are required to report, the total deficit would be “only” £88.5 billion.

So while two pension funds may have similar membership profiles, the one that has been acquired by a life company in a buyout will be more costly to fund?

Yes, at least on paper. It is this “paper” deficit that makes buyouts of an entire scheme expensive. £440 billion is a lot of money, and that’s why the take-up has been slow, even though the potential buyers have raised money and are ready to do deals.

What needs to happen in order for more buyouts to occur?

There is pent-up demand from companies that are interested in removing the pension liabilities from their books, so there have been lots of active discussions between pension trustees and the buyout funds. These discussions so far have been part of an education process for trustees to understand what needs to change for that £440 billion figure to come down, which would make buyouts a more viable proposition.

For that to happen, this type of transaction needs to be viewed by the company sponsor as a risk management decision, and a judgment needs to be made about whether shareholders would be happy to see those liabilities move off of the company’s balance sheet. Until that mindset shifts, we may continue to see smaller buyouts, but not any big transactions. That said, I do think the shift in thinking is beginning. The question is, how long will it take?

Once that mindset changes, do you think we’ll see a flood of buyouts?

Not right away. It would help accelerate the pace of buyouts if trustees would think about their pension fund members by status — pensioners, deferred members and active members. Then, a pension fund would be able to consider buying out the piece that is associated only with the pensioners, which is both a clear legacy liability and one that is the cheapest to buy out, because it has the shortest duration and tightest buyout pricing. Those liabilities can also be matched to long bonds reasonably well. I think the buyout market won’t gain momentum until a large pension plan slices up its liabilities this way and looks at each group individually, and then effects a buyout of its pensioner liabilities. Once one large fund does this, it will encourage others who
are considering the move to follow. I think this scenario makes the most sense for
the pension plan as well as for a potential buyout fund, and I would expect to see the
buyout of the pensioner slice of a significant fund at some point this year.

What are the benefits for a company to sell off some, or all, of its pension fund?
In the last few years, pension deficits have been highlighted as a result of accounting
regulations, so this issue has come to the fore. Corporate sponsors of pension plans
typically aren’t in the pensions or investment business, so this has become a big
distraction and a potential drag on the finances of a number of otherwise financially
healthy companies. If a large company sold off some of its pension plan, as in the
scenario we just discussed, it would be less likely to close off its plan to new mem-
bers or to reduce the options available to employees. In addition, management and
resources can be refocused on the true business of the company.

What are the benefits, or potential issues, for members of a plan that has been bought
out by an insurance company?
Insurance companies that do pension buyouts are closely regulated and have to main-
tain adequate capital to ensure the obligations they have taken on can be met. Therefore,
members of a plan bought out by a registered insurer can feel very confident that the
pension promise they received whilst in employment will be honoured in retirement.

The greying of the population is often talked about, so presumably that is affecting
the pensions industry?
You’re right. While actuaries spend a lot of time looking at the longevity of the popula-
tion, it’s still a fledgling issue for the capital markets, which is where solutions can be
created to help pension plans manage longer life spans of their members. JPMorgan
has taken steps to address the disparity of focus between the capital markets and
actuaries by launching its LifeMetrics Index, the only international index designed to
benchmark and trade longevity risk.

Apart from selling a pension plan, what other options do trustees have to manage
increased liabilities?
A buyout is only one solution to the increase in pension deficits. Other tools available
to trustees to help them manage a deficit include liability-driven investments, risk
management solutions, contingent funding solutions, constant portfolio protection
insurance, transition management, equity risk management solutions and longevity
management. Advisors to pension funds, and investment banks, are actively discuss-
ing these tools with pension fund trustees. ☀️☀️
JPMorgan’s dedicated operations and technology centre in Bournemouth celebrates its 21st birthday this year. In 1986, when the site was developed, the firm was one of the first to move its operational functions outside of a major financial city centre. The very first business line to move there was Global Custody, with one hundred people dedicated to trade settlement and asset servicing. Now Worldwide Securities Services has 1,750 employees based in Bournemouth.

In fact, over the past 21 years the Bournemouth facility really has come of age, and has developed from a UK to a European — and now, a global — hub and JPMorgan’s own full-fledged in-house business park. The facility supports operations activities in more than 90 markets worldwide, and is linked via terrestrial and satellite networks to the firm’s branches around the globe, as well as to the clearing houses in all the major financial centres, including New York, Milan, Frankfurt, Paris, Hong Kong, Tokyo and London. It is the global processing hub for the firm’s foreign exchange and global custody activities, the European operations centre for cash management and euro clearing, as well as home to the firm’s investment banking operations teams. Bournemouth’s state-of-the-art data centre provides production services across all time zones, 24 hours a day, 365 days a year.

In total, 5,000 people — equivalent to over one third of all JPMorgan staff in the EMEA region — work in this purpose-built, high-specification and, according to The Economist, “most innovative” building.

Pension fund clients are concerned with risk mitigation, regulatory demands and the continuing search for increased alpha. For them, the scale of investment in our Bournemouth facility is key to our supporting their ever-changing business requirements. Processing the full range of instrument types, including alternative investments, accessing accurate and timely data, and offering a stable operating platform with globally linked and scaleable technology are all fundamental to the service we provide to our clients.

Bournemouth is a large town and tourist destination, situated on the south coast of England. With a population of 164,000, it is the largest settlement in the county of Dorset. It is notable as the home of the Bournemouth Symphony Orchestra, Bournemouth University and the Bournemouth International Centre, as well as seven miles of beautiful sandy beaches and a traditional Victorian pier. The town is also home to a number of large financial companies, including, of course, JPMorgan.
The subject of pensions is never far from anyone’s agenda these days; politicians wrestle endlessly with the subject, and while everyone is keen to do the right thing, solutions have been elusive. The UK is far from alone in having a looming pensions crisis; across vast swathes of the developed world, the aging population threatens the cozy economic prosperity so long taken for granted. In contrast to most of the rest of Europe, the UK at least does have a pensions industry. Most European countries have, at best, embryonic pensions and have very little by way of a pensions culture.

One major part of the UK’s problem lies in its history: pensions have developed over an extended period, and the state’s role has changed over time. Continuous tinkering has resulted in pensions becoming overcomplicated — a key factor that mitigates against people saving adequately for retirement. The industry has been beset with problems, and twinned with scandals over mis-selling and the collapse of a leading mutual, the 21st century presented stock market conditions that undermined the bedrock that was the UK’s defined benefit pension regime.

Defined benefit arrangements, extremely attractive to employees, have been in decline in the UK for many years. While there were 12.2 million active members of defined benefit schemes in 1967, this had fallen to 9.8 million by 2004, and over 50% of the latter are in the public sector.

Government after government in the UK has sought to find ways to encourage additional saving to ensure that the state’s future obligations are minimized; these have included the Stakeholder Scheme, introduced in April 2001, which met with limited success.

By 2004, 56% of the private sector workforce had no pension provision other than that mandated by the state.

The household savings rate in the UK has been falling since the mid-1990s and the Bank of England’s view is that the relatively benign (low) interest rate environment explains a significant part of this decline. So a key policy objective, namely to keep inflation in check, appears to have had the unintended consequence of reducing the UK’s household savings rate. Of course, the picture is much more complex than that; but suffice it to say that governments are rattled by the demographic shift that is well underway, and solving the problem requires radical measures. It was in this spirit that the UK government set out to simplify the personal pensions regime (a major plank of this simplification was achieved on ‘A’ Day last year). In December 2002, it established a Pensions Commission under Lord Turner to report on the evolution of the UK’s pension system and to propose a new policy
framework to ensure future sustainability and fairness. The Commission made its final recommendations\(^3\) in November 2005, and this was followed by a Department for Work and Pensions (DWP) White Paper\(^4\) in May 2006. The legislative program is now underway to establish the new policy framework.

One of the most eye-catching details of the Turner proposals was that, finally, an element of savings compulsion was being proposed. This is politically sensitive and, of course, would have a significantly greater impact on lower-income households. Nonetheless, many commentators believe that without an element of compulsion, the strain on the public system will continue to grow, and that individualizing an element of hitherto state provision will lead to a greater level of personal responsibility.

What is in fact being proposed is a type of ‘soft’ compulsion via autoenrollment; employees will be able to opt out but, the presumption is that inertia together with greater awareness of the need for savings will have the desired effect. The DWP believes that eventually the new scheme will attract between 5 and 8 million of the estimated 10 million eligible employees. Arrangements will be made to open the scheme to the self-employed and those not working for a variety of reasons, and it is estimated that this may add another million members.

The Pensions Bill currently going through Parliament has a number of elements, but the key one that will be of interest to providers in the financial services space is the establishment of a delivery authority for the new National Pension Savings Scheme (NPSS). There is much to be done to get the new system underway, but the timeline is not hugely stretching. The DWP envisions the new arrangements to have the following key components:

**Governance**

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<tr>
<th>Autoenrollment</th>
<th>Information and Education</th>
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<tr>
<td>Colleague Reconciliation and Central Function</td>
<td>Fund Management</td>
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<tr>
<td>Regulation and Compliance</td>
<td>Account Administration</td>
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The financial services industry, which has contributed to shaping the new policies, will have much to gain by remaining engaged in the development. The economics of the new scheme will be much scrutinized; the DWP (and Turner before that) believed the scheme needed to be low-cost, but in the private sector. Whether all the objectives can be met is debatable. In addition, it will be important to weigh the macroeconomic outcome. There is evidence that compulsion (as in Australia) does not necessarily raise the household savings rate, and it may be that political maneuvering will mandate some further softening of the soft compulsion approach — for example, by exempting certain very-low-income workers or specific categories. However, the momentum established thus far in this area is commendable, and it would be a pity if the universality of the proposals were to be diluted.

**UK Pensions**

The UK government is on track to deliver a pensions framework fit for the 21st century, and we in financial services should be able to play a major role, whether as investment managers, custodians or administrators.

*Sheenagh Gordon-Hart is the head of Research & Industry Affairs for Worldwide Securities Services in Europe, Middle East and Africa.*

2. Since their introduction, 2.7 million Stakeholder Pensions have been sold.
4. This ABI estimate contrasts with the estimate of the Pensions Commission that some 9 million may be undersaving, some severely so.
Client Focus is Key

While many alternative investment strategies have gained popularity in recent years within the pension community, lending, in particular, has enjoyed growing appeal for a number of key reasons. First, lending per se represents a way to enable an existing portfolio of assets to operate as efficiently as possible, regardless of the composition of those assets. “Whether a client has a portfolio of mainly fixed income securities or equities, those assets can potentially be lent and incremental income derived,” explains Wilson.

Second, the lending arena itself has strived to keep pace with a rapidly changing environment to meet the dynamic and unique needs of pension clients. “Lending has undergone a subtle but significant change in the past decade,” explains Wilson. As pension plans have adopted lending activities as a core, rather than as a ‘peripheral’, strategy when it comes to maximizing a portfolio’s performance, lending agents such as JPMorgan have adapted their lending programs to become more flexible and responsive to plans’ needs.

Specifically, Wilson says that many current JPMorgan pension clients that might have viewed lending warily in the past now embrace it, due in part to JPMorgan’s ability to customize lending agreements and program guidelines to meet each client’s needs and risk preferences. “Risk is a big concern among pension clients, when it comes to lending,” notes Wilson, “but since these risks are easily quantifiable and can be addressed through program guidelines and well-defined risk parameters, most plans can be offered a program that mitigates risk effectively, while achieving an attractive return.” Wilson adds that through JPMorgan’s client-focused approach to both lending and reinvestment of cash collateral, now more than ever, a client can set its own tolerance for risk, and establish a lending program around the unique risk/reward profile that it is seeking to obtain.

Overall, client focus appears to be the deciding factor for many plans. “Pension clients want a lending agent to recognize and respond to their individual concerns,” says Wilson. “This entails listening to clients carefully to help assure goals are clear, risk tolerance levels are comfortable for the client, and that various avenues to incremental income are explored.”

Client focus also contributed to the development and deployment of VIEWS, JPMorgan’s best-in-class reporting application. “JPMorgan’s significant investment in state of the art technology is translating into valuable client benefits,” states Wilson, “providing in-depth information from a wide breadth of standard choices, accessed quickly and easily, enabling pension fund clients to get information they need as frequently as they want to view it.” Clients can now review 25 standard reports and seven Quick Queries, which include real-time transaction reports, a month-to-date earnings report capability, as well as performance reports and a multicurrency reporting capability.

Wilson says that the growing appeal of lending among plans is really no mystery. “A well managed securities lending program that is built around a client’s specific risk/reward goals can generate extra return for a plan with minimal additional risk,” he says. “There are few asset managers in the global arena who can or who would want to overlook the opportunities lending presents in terms of a competitive edge.”

It used to be that the very mention of pension funds called to mind institutions that would eschew virtually any investment strategy or tactic beyond those deemed most conservative. Within recent years, however, this has changed. Promoted in part by the market downturn of the early 2000s, low interest rates, heightened market volatility and increasing regulatory scrutiny with regard to pension funding levels, many pension funds have embraced securities lending as a viable, profitable option for adding value and generating incremental returns.

The reason is simple. “The incremental revenue that can be derived from a properly structured lending program can help push a fund into a higher quartile,” says Paul Wilson, global head of Securities Lending & Execution Products sales and client management. “This can prove to be critical in light of the increasingly competitive backdrop against which most plans are balancing growing liabilities, challenging market conditions and a tougher regulatory landscape. Indeed, many pension plans have now taken the management of their securities lending activities to the next level, managing them as a discrete alpha-generating asset class.”
European pension funds continue to look at many challenges, whether from regulation, volatility in equity markets or acceptance of more sophisticated solutions.

With birth rates across Europe having been on a downward trend for about a century, and with longevity increasing, the pressing issue of retirement funding is one element of the demographic challenge that is creeping inexorably to the top of the agenda in public, political, corporate and financial industry circles.

As a result, the creative tension between trustee and company is as palpable as ever, while there is also a profound sense of common purpose, as positive steps are taken collectively to improve the health of pension funds and slowly embrace new investment techniques.

Pension funds have been looking at increasingly complex investment strategies and viewed the process around these decisions as having many moving parts. In this arrangement, a good, well-organised custodian has an important role to play. Furthermore, the current climate would suggest we will have much more of the same, only with renewed intensity, during 2007.

The role of JPMorgan Worldwide Securities Services is changing, too, as the firm finds itself becoming much more a partner to the pensions industry, much more than solely a recognised and respected custodian and 'guardian' of those pensionable assets.

This parity in the relationship is coming about as much to the current thinking from trustees and advisors as to the need to look seriously at alternative investment services. At the same time, there is an expectation from the pension funds that JPMorgan will deliver timely and accurate independent valuations, as well as performance measurement data that is tailored to their individual investment arrangements.

New asset classes such as hedge funds, private equity and derivatives present a real opportunity for custodians like JPMorgan, because new methods and approaches are required. Questions are arising from pension trustees as well as the fund managers who manage their assets. These questions include:

- Where do you go to get a reliable valuation if there is no regular, or regulated, market to refer to?
- What is the impact on a portfolio of some of these new asset classes?
- How will the portfolio behave and what are the yardsticks used to measure performance if benchmarks have gone out of the window?

Several trends continue to point to rapid future growth in pension assets. The alignment of rising longevity and low real bond yields means a larger pot of money needs to be accumulated to finance an assumed retirement income than was previously believed to be the case.

In some European countries like the UK, the trend toward early retirement has ended abruptly and the focus is very firmly on later retirement and the need for individuals to save more. Occupational pensions will continue to play their part in these new savings patterns for a long time to come.

It is this changing face of pensions that is giving custodians like JPMorgan a tremendous opportunity to step forward as a genuine partner to trustees in the challenges that lie ahead in getting the investment mix right.

Benjie Fraser is head of European pensions and charities for JPMorgan Worldwide Securities Services.
More and more pension funds are relying on transition managers to help them implement decisions and custody fees, are gone. It is now widely accepted that implicit costs, such as market impact and opportunity cost, exist within transitions and can be significant if not managed correctly. Selecting the appropriate transition manager is a key part of efficient transition implementation.

A large number of firms have entered the transition management arena in recent years, and all of them share the core objective of preserving asset value when implementing changes to their client’s investment structure. Unfortunately, this is often where the commonality ends. Since the levels of capability and experience differ widely among providers, selection of the best transition manager can be a difficult task.

At the most basic level, every customer expects a transition manager to minimize cost and manage risk. However, this is only part of the transition manager’s role. Transition managers should be transparent to the organization, while shouldering much of the administrative burden. Additionally, they must deliver on a timely basis — maintaining confidentiality and always avoiding conflict.

Delivering a successful transition and meeting client expectations require the close coordination of a number of different disciplines, including analytics, execution, fund management and operations. The quantity and quality of dedicated transition management resources vary widely among providers, so when selecting a transition manager, companies will benefit from asking transition managers about their capabilities in each of the following areas:

- **Pretrade analysis** — How is the process conducted? Are proprietary systems used?
- **Execution** — Does the transition manager have access to multiple sources of liquidity? How is efficient execution achieved? How will execution be measured in post-trade reporting?
- **Risk** — Which risks will the transition manager be managing? What is their approach to risk management?
- **Project management** — What project skills does the transition manager possess? What key steps will be taken to reduce operational risk and ensure the transition is delivered in a timely manner?
- **Confidentiality and conflict** — How is the team structured? How is the flow of information controlled? Do team members have any responsibilities outside of transition management?

Transitions are becoming increasingly complex, and the delivery of a cost-efficient transition requires a combination of skilled resources and a wide range of capabilities. Not all transition managers provide the full range of capabilities for all transitions; but by asking key questions of transition manager candidates, it is possible for pension funds and consultants to short-list transition managers and make informed decisions regarding the selection of the appropriate transition manager for their needs.

*For further information about JPMorgan Transition Management services, please contact your relationship or sales manager.*
When to Engage the Transition Manager

Ideally, the transition manager is engaged as soon as the customer knows what changes it plans to implement, including the identity of the new investment managers, if any. A long lead time to implementation gives all parties more time to plan and will lead to a smoother and comparatively seamless transition. Once the transition manager has signed confidentiality agreements, most fund managers are prepared to provide wish lists so a detailed cost estimate can be conducted. All planning can be carried out so implementation can be effected promptly after the investment management agreements are signed.

What to Expect from Your Transition Manager

A transition manager should:

- Reconcile at key stages throughout the transition
- Accurately construct the target portfolio’s market exposure
- Preserve asset value and minimize costs
- Control risk
- Execute in a timely manner
- Maintain confidentiality
- Provide comprehensive post trade reporting and evaluation

All of this should be supported by a detailed project plan and continuous communication.

By using a transition manager, trustees are better placed to represent to their members that they have understood the costs and risks of the transition, and have taken action to manage and control them.

Why transition management is best described as the project management and execution of structural changes of the assets within pension plans in an efficient, cost-effective and risk-managed way. These structural changes can be driven by asset manager changes or larger reorganization following asset liability studies. Rather than deciding these changes to a plan’s asset mix, transition management helps to control risk and reduce the costs of these transactions by coordinating amongst all parties, designing and implementing trading strategies based on pretrade cost estimates, and producing thorough post-trade analysis that includes actual performance relative to predicted costs.

What are the Costs Involved in a Transition?

Any trading event incurs cost, which can be broken down into explicit costs and implicit costs. Explicit costs are the ones known at the outset: commission, taxes and fees. These costs generally comprise only a small component of total cost. Typically generating a much greater proportion of costs are the implicit costs, which include market movements, spreads and market impact.

Why Use a Transition Manager?

A transition manager eases the administrative burden, thus reducing operational risk; helps design a well-thought-out trading strategy, thus reducing market- and security-specific risk; and can also lower the overall cost of the event.

Alternatives to using a transition manager can be subject to increased risk and cost, as follows:

- **Cash funding** — In this scenario, the legacy manager would be instructed to sell all assets with the resulting cash being handed over to the incoming manager. Doing so misses any in-kind opportunities to migrate assets in common. This also introduces risk, as the fund would have no market exposure during this cash period.

- **Incoming manager as transition manager** — Here, the legacy assets would be delivered to the target manager. The target manager would then trade into a portfolio at the desired pace. While assets required by the target are retained in this scenario, the target manager is given a “performance holiday” until the transition is complete. As the target manager’s primary function is to manage the portfolio, and not manage transitions, it is likely the trade would last longer and introduce more risk than if the trade were executed by a dedicated transition manager. The fund manager’s commission rates may be higher than those of a transition manager, increasing costs. Finally, this option relies on the legacy manager providing the asset list, or the intellectual capital, to the target manager, as opposed to an independent transition manager.

- **Pension plan as transition manager** — It is possible for the plan’s internal investment team to perform the transition itself. The operational burden, risk management and trading requirements are all tasks transition managers handle on a daily basis. The associated increased workloads and requirements for specialized expertise may not be something the pension plan is comfortable providing itself.
The Significant Transformation of China’s Capital Markets

China has recently transformed its capital markets probably more than any other country in the world through a series of new regulations and, most notably, the nontradable shares reform. Its exchanges in Shanghai and Shenzhen are seeing considerable changes as they upgrade their systems and prepare for trading in more innovative products. Shanghai Stock Exchange (SSE) has developed the New Generation Trading System (NGTS), which aims to support trading of more products, improve efficiency and manage risks. The new system will increase trading capacity by 100%. NGTS has introduced the Participant Business Unit (PBU), a trading organizing pattern widely adopted by the global exchanges. With an extended capacity, the new system is capable of executing 63 million trades per day, with a peak capacity of 20,000 transactions per second.

NGTS will act as a trading platform for multimarket, cross-country trading and integration of the cash and derivatives market.

The A-share market is often criticized as being volatile with a high 20x price/earnings but with low trading value and refinancing ability. Both the Shanghai and Shenzhen stock exchanges launched a number of new products in order to diversify investment and financing channels. In 2005, they developed covered warrants in addition to bonds, open-end and closed-end funds, and exchange-traded funds.

In 2006, securities were allowed to start margin trading, permitting more investment from retail investors. In addition, the Shenzhen-Shanghai index is expected to be launched in the near future to give a more representative idea of share performance.

The nontradable share reforms were probably the most important steps taken by the authorities to improve market efficiency and maximize value for investors. The aim is to convert nontradable state-owned shares, making up 70% of the market capitalization, into tradable shares that can be held by retail investors.

Slower than Expected Qualified Domestic Institutional Investor (QDII) Program Results

China’s QDII program provides an important gateway to offshore investment opportunities, but a dramatic rush in support of the scheme is unlikely, as investors consider whether its benefits outweigh those gained by keeping holdings in China, where the renminbi is strengthening.

It’s still early for the QDII program, but its initial progress provides insight into the appetite of Chinese investors, even if they have a limited choice of investment products. At present, most QDII products are offering modest returns as the market, regulators and potential investors come to grips with the concept. With limited returns, together with currency translation risk, the new products may not match potential gains from investments in renminbi.

The issue of currency appreciation remains, as converting renminbi to invest in foreign currency-denominated products might fail if any gains are wiped out by a rise in the local currency. China revalued its currency by 2.1% on July 21, 2005, to 8.11 renminbi to the U.S. dollar. Since then, it has risen about 3.5%. The steady rise is expected to continue, supported by calls from both inside and outside China for a faster appreciation.

Overall, the China Banking Regulatory Commission has now granted QDII status to eight Chinese lenders, enabling them to invest funds overseas on behalf of their clients. Six of them — Industrial and Commercial Bank of China (ICBC), Bank of China (BoC), Bank of Communications, China Construction Bank and the mainland branches of HSBC and Bank of East Asia — have been granted a combined quota of USD 8.8 billion. The products now being offered are generally restricted to bonds and money market instruments. Higher-risk and higher-return products are unavailable at present, partly because the regulators fear a sudden outflow of funds from the country. Their various products, which generally require a minimum subscription of CNY 50,000 (USD 6,290), offer terms ranging from six months to a year and returns that could stretch from 3% to 12%.

However, for holders of foreign currency in China, investing in QDII products could prove a useful means of getting more out of their cash as they automatically avoid the risk inherent in subscribing to QDII products with renminbi. The products offered by HSBC, Citibank and Bank of East Asia — the only foreign banks to have received QDII approval so far — are only available in U.S. dollars, as overseas banks are not allowed to provide renminbi banking services to mainland citizens.

As the program develops, a broader array of products will be offered, with all QDII-approved institutions stating they plan to continue issuing investment products for clients, albeit at a slow pace.
Vietnam: The Next Economic powerhouse?

Highlights:

- Vietnam joined the World Trade Organization on January 11, 2007
- The World Bank ranked Vietnam 22nd most competitive economy in the world
- Boasts a competitive labor force, as well as abundant natural resources
- Vietnam’s stock market to experience a mini-boom in 2007
- There are still risks associated with doing business in Vietnam

Vietnam has emerged from the shadow of India and China, and is now seen as the next Asian economic powerhouse. In January 2007, Vietnam joined the World Trade Organization, and while the country still has much work left to do, its future as an economic powerhouse in the Association of Southeast Asian Nations (ASEAN) seems fully assured.

In addition to a competitive labor force and abundant natural resources that include oil and gas, Vietnam’s new government unleashed a blizzard of reforms in 2006. These included significant streamlining of foreign investment rules and creating greater transparency and flexibility in doing business in the country. Many bankers and analysts believe the country has the potential to scale even greater heights as it opens up its economy and welcomes more foreign investment.

These are especially exciting times for Vietnam’s stock market. While only a few dozen issues have been listed, a mini-boom is in the making. The volume of transactions is rapidly scaling up, and this will soon draw more investors to the market. At the rate companies are currently entering the market, stock market capitalization could grow to USD 6 billion to USD 7 billion in 2007.

Meanwhile, fundraising activity among asset managers has picked up, and they are expected to raise USD 2 billion this year for investing in Vietnamese shares.

Apprehensions Remain

While business is booming and foreign institutions are refocusing on Vietnam, the country’s shift from a centrally planned economy to a market economy has not been easy. The risks of doing business in Vietnam are still high. The country’s privatization effort, for instance, hasn’t been as fast as initially expected. Its legal infrastructure and internal corruption are also systemic issues for this developing economy; and while none of these constraints is unique to Vietnam, they do pose potential hindrances to the success of the country’s economic future.
Since the passage of ERISA over 30 years ago, defined benefit pension plans have grown to become the largest assets and liabilities of many U.S. corporations. (At end of third quarter 2006, total corporate pension assets reached $2.1 trillion.) But, in spite of their size, under SFAS 87 (Employers’ Accounting for Pensions, December 1985), pension plans were generally considered an off-balance sheet item. In addition, SFAS 87’s rules for calculating pension expense included the use of expected rather than actual return on plan assets and extensive use of smoothing and amortization techniques that hid the true risks to the plan sponsor of offering a defined benefit plan.

During 2006, however, pensions became a larger and more prominent source of risk to many corporations. New funding and accounting regulations — The Pension Protection Act of 2006 (PPA), and SFAS 158 (Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans, September 2006) — call for new valuation methods that will increase liabilities by as much as 15%, raise sponsors’ funding requirements for those liabilities from 90% to 100%, and require companies to consolidate the net funded status of their plans on the balance sheets, with corresponding changes in shareholder equity.

Purists may continue to think their pension plans will operate as a long-term investment, independent of corporate influence. However, by adding the pension plan to the corporate balance sheet, unfavorable changes in a plan’s funded status will affect the risk profile of the corporation, and therefore its credit standing, access to the capital markets, and cost of capital. As a result of the increased transparency of pension risk — in particular, interest rate risk from mismatched assets and liabilities, and the risk of large strategic investment allocations to equities — pension plans will surely receive greater attention from chief executives, chief financial officers, corporate risk managers and boards of directors. We fear a rude awakening, as corporate managements see the full implications of the new accounting requirements on shareholder equity, and the new funding regulations on cash flow. SFAS 158 and the Pension Protection Act may be intended to bring stability to the pension system through more transparent reporting and stronger funding, but with these new dimensions of cost and risk, senior management will place pension plans in competition with core businesses for risk and resource allocations. These new, more transparent regulations could mean the end of many defined benefit plans, unless chief financial officers, treasurers and pension chief investment officers can implement more effective means of managing their plans’ risk exposures.

To measure the impact of pension plans on overall corporate risk, and develop asset allocations that fit the new risk context, we have developed a holistic pension risk framework that links corporate CFOs’ notions of risk with pension allocations advocated by chief investment officers. The first component of the framework is a set of three metrics, based on corporate finance concepts, that estimate the effect of defined benefit plans on corporate shareholder equity, cash flow, and earnings, represented by “shareholder equity at risk” (SHE@R), “corporate cash flow at risk” (CF@R), and “earnings at risk” (E@R) in the chart at right.

1 Federal Reserve Bank, Flow of Fund Accounts of the U.S., December 2006
2 JPMorgan Asset Management, Strategic Investment Advisory Group
These metrics quantify (for a given pension portfolio allocation) the charges or credits to shareholder equity, cash flow and earnings attributable to the impact on pension assets and liabilities of changes in the financial markets. With these measures, CIOs and CFOs have a way to jointly determine how much risk the pension plan should present to the corporation and to match the risk profile of the plan’s asset allocation to the company’s available risk capacity.

The second component of our framework is a “Broadly Diversified Investment Portfolio,” or BDIP — a novel method for setting asset allocation. BDIP takes into account interactions between plan assets and liabilities, but also draws on our “at risk” measures to fine tune the plan’s assets and liabilities to the risks of the consolidated corporation.

The ideas behind the framework are illustrated in the chart above. In essence, our new pension metrics measure the risk in the assets and liabilities of a pension plan, while the BDIP solves for an asset allocation that both generates the return needed in the plan, and matches the risk levels senior management seeks. In the return dimension, to reduce the traditional reliance on public equities, BDIP encompasses a broad range of beta and alpha sources for the plan’s investable universe, including: private equity, real estate, hedge funds, timber, commodities, infrastructure, oil and gas, and portable alpha programs, as well as traditional active management in strategies where managers can demonstrate skill.

We believe that within the next five years — especially after Phase Two of the FASB’s accounting rule changes is issued — the typical final pay pension plan will look radically different from the traditional 70% stock, 30% bond model, and invest between 25% and 35% of its assets in non-traditional asset classes. Cash balance plans will have even higher allocations, representing up to 50% of plan assets.

The framework we propose is not a one-size-fits-all solution. It will benefit companies differently, depending on plan assets, liabilities and surplus relative to profits and shareholder equity, firms’ cost of capital and access to funds, and firms’ views on interest rates and hedging risks. But with a consistent framework that speaks to the goals of both the pension plan and the corporation, sponsors can manage their plans to ensure benefit security for participants, and at the same time enhance value to shareholders. Chief executives, CFOs and chief investment officers can measure and align the pension plan’s interest rate and equity risks to the corporation’s risk tolerance with one corporate finance-based model.

Senior managers have a responsibility to manage risk and enhance value for their shareholders, but also have a significant obligation under ERISA to protect the security of participants’ benefits. Our framework addresses these goals simultaneously. First, measurement and management of pension risks will strengthen the corporation, better enabling the sponsor to honor its future funding obligations. Second, a Broadly Diversified Investment Portfolio (BDIP) should lead to a more efficient asset allocation for the plan, often earning the same or higher return at lower risk. The end result is greater security for participants and greater value for shareholders.
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in Commodities
by Ruy M. Ribeiro, Jan Loeys and John Normand

This extract was taken from "Momentum in Commodities," Investment Strategies No. 25, published September 19, 2006

Investors have heavily invested in commodities over the past few years, and have earned excellent returns. But the recent fall in commodity prices and signs they may be in a bubble are raising demand for less directional ways to be involved in the asset class (See Loeys and Panigirtzoglou, “Are Alternatives the Next Bubble? Momentum in Commodities,” September 8, 2006). We show that a dynamic trading strategy based on momentum in commodities is very profitable, robust and little correlated to the overall direction of commodity prices.

A simple momentum strategy, invests in the top performing individual commodity indices over the past year and shorts the bottom performers with monthly rebalancing. It delivers an excess return of 12.2% with volatility of 13.6% since 1991, producing a Sharpe ratio that matches the one delivered by hedge funds. In comparison, the commodity asset class, represented by GSCI, the most popular index in the market, has delivered only 2.9% in excess returns over cash with higher volatility, 18.6% since 1991.

This simple momentum strategy has value as an outright “alpha” strategy that exploits the market inefficiency of momentum. The chart shows it is uncorrelated to the overall commodities market and outperforms a pure long-only investment in commodities. The strategy can also be used as an enhancement to pure index exposures to the commodity asset class, but its low correlation to the direction of prices implies it should not be seen as a substitute to such “beta” exposures.

The reasons for momentum in commodities come from basic economic forces. They can explain why we should see momentum in aggregate and individual commodities in both absolute and relative terms.

In most markets, momentum can be simply explained by behavioural biases that create autocorrelation in prices. In the case of commodities, there are reasons for momentum that come also from demand and supply conditions that move only slowly over time. Demand and supply also suffer persistent shocks that can last for years as analyzed in the commodity cycle literature.

We test many additional strategies, besides this simple one, that capture different types of momentum using tradable commodities indices. We also introduce a number of refinements to ameliorate the almost inevitable negative effect of turning points without penalizing the profitability of the strategy.

This analysis also shows that the profitability is not dependent on a particular choice of indices/futures, time period, strategy rules, roll assumptions and other possible variations of the basic strategies.

Momentum is pervasive in commodities and has multiple manifestations. It shows up in two different dimensions. Momentum can be present at the individual commodity level and at the aggregate level. And it can show up in outright returns (versus cash) and in relative returns versus other assets.

We find that all these momentum strategies provide positive and significant alphas, but relative momentum (one commodity vs. another) is more profitable than absolute (individual commodities vs. cash) and aggregate momentum (aggregate commodity basket vs. cash). Moreover, combinations of these rules can deliver even better performance.

Ruy M Ribeiro, Jan Loeys and John Normand are JPMorgan’s Global Market Strategists.

For more information or questions, please contact Eileen Liu or Judy Diamant at (212) 834-4441.
Exploiting Momentum in Commodities
The recent fall in commodity prices and warning signs of a bubble in the commodities market led to an increasing demand for less directional ways to get exposure in this asset class. In a recent Investment Strategies paper summarized in this edition, our researchers developed a dynamic trading strategy that aims to generate “alpha” by exploiting the market inefficiency of momentum in the commodities market. Backtested since 1991, a simple momentum strategy that invests in the top performing individual commodity indices over the past year and shorts the bottom performers with monthly rebalancing, delivers an excess return of 8% to 10% p.a. with a volatility of 10% to 12% p.a. This momentum strategy had negligible correlation to the overall commodities market and outperformed a pure long-only investment in commodities. They analyzed variations of the momentum strategy and introduced refinements to reduce the almost inevitable negative effect of turning points on the profitability of the strategy. To implement the momentum strategies discussed here, JPMorgan has launched a family of structured products named Commodity-IGAR.

**Product Innovation**

- The JPMorgan Commodity-IGAR indices use a momentum-based algorithm to maximize the performance of an investment in a selection of the GSCI® commodity excess return sub-indices (‘Investment Universe’).
- The **Commodity-IGAR** (Bloomberg: CMDTYER Index) monthly rebalancing algorithm consists of selecting up to 12 of the best performing sub-indices which have positive 12-month returns and pass a performance Consistency Test.
- The **Commodity-IGAR Long/Short** version (Bloomberg: CMDTLSER Index) benefits from negative performance of sub-indices by enabling a short overlay on the long-only strategy using the same algorithm, potentially shorting up to 12 worst performing sub-indices in addition to long positions.
- A further refinement is the **Commodity-IGAR Conditional Long/Short** (Bloomberg: CMDTYCER Index) that behaves as a long-only portfolio in case of consistent bull market, and as a long/short portfolio otherwise, using the same algorithm as above for selecting the relevant sub-indices.
- Indices were launched in September 2006; strategies have been backtested since January 1991.
Structured Products on the Commodity-IGAR Indices

- Exposure to the JPMorgan Commodity-IGAR Indices is available in structured formats in terms of currency, wrapper and structured payout.

- **Direct Access Structures** include Excess Return Swaps and Pass-Through Certificates in non-levered format; **Levered Exposure** is available through Dynamic Leverage Certificates.

- **Capital Protected Structures** include Spi, which is an OTC replication of the CPPI (Constant Proportion Portfolio Insurance) strategy, as well as TARN Spi that combines an Spi with target redemption note features.

For more information or questions, please contact Eileen Liu or Judy Diamant at (212) 834-4441.
JPMorgan Chase & Co. (NYSE: JPM) is a leading global financial services firm with assets of $1.4 trillion and operations in more than 50 countries. The firm is a leader in investment banking, financial services for consumers and businesses, financial transaction processing, asset and wealth management, and private equity. A component of the Dow Jones Industrial Average, JPMorgan Chase & Co. has its corporate headquarters in New York and its U.S. retail financial services and commercial banking headquarters in Chicago. Under the JPMorgan, Chase and Bank One brands, the firm serves millions of consumers in the United States and many of the world’s most prominent corporate, institutional and government clients. Information about the firm is available at jpmorganchase.com.
Big-business muscle, small-business service.

As a leader in global securities services, JPMorgan is passionate about serving your needs through our unwavering focus on service delivery, robust technology and innovative products.

Our investment in client service excellence allows us to deliver unmatched stability in securities servicing in an ever-changing marketplace, positioning us to be the best global service provider for you.

Expertise and commitment are the hallmarks of our people. Use our superior service delivery to enhance your efficiency and mitigate risk.

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