Tectonics: Shifting Investor Sentiment and the Implications for Hedge Fund Managers

J.P. Morgan – Prime Brokerage

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Published by J.P. Morgan – Prime Brokerage

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Introduction Letter

In the first quarter of 2010, J.P. Morgan's Capital Introduction Group completed its 7th annual Institutional Investor Survey. More than 300 of the world's leading institutional investors participated and their responses proved to be both thoughtful and provocative. Investors suggested that their attitudes toward hedge funds were changing in important ways. We were intrigued and decided to undertake a broader study of institutional investor sentiment. We drew upon the resources of J.P. Morgan's Prime Brokerage business, the analytical capabilities of the firm, and the additional insights that select institutional investors were able to provide. This report describes our analysis and findings.

Many investors we surveyed continue to deal with the overhang of the financial crisis. Many suffered substantial erosion of their capital bases, and nearly all of the investors we spoke with redeemed some portion of their hedge fund investments in 2009. But we found reasons to be optimistic as well. Respondents recognized that hedge fund managers delivered superior performance across the cycles in 2008 and 2009, and indicated in overwhelming numbers that they would allocate more capital to the segment in coming months. Most importantly, we found that the shifts in investor sentiment were beginning to drive a historic shift in the allocation of assets among hedge funds, one that we believe will fundamentally redefine the competitive landscape.

We hope that hedge fund managers and other market participants find it to be useful. And we welcome any comments you may have regarding the scope, structure and conclusions.

Best regards,

Louis Lebedin
Andrea Angelone

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Key Findings for 2010

The hedge fund asset base continues to be subjected to unprecedented forces. We expect to see net inflows in 2010, but also believe that the industry is in the early stages of a massive reallocation of existing capital.

- Hedge funds, in general, outperformed other investment managers during both the crisis and the rebound, driving total assets under management higher and making the segment more attractive to institutional investors.
- The hedge fund indices mask the difference in performance of their underlying funds. Some managers dramatically outperformed, while others dramatically underperformed – sometimes with catastrophic results.
- Our data suggests that there will be net inflows, but those flows will be modest. In all, 97% of respondents to our investor survey indicated that they intend to make new allocations to hedge funds in 2010, and 60% said that they intend to increase the size of their average allocation. Asset flows, however, remain at or below their historic averages.
- We think that the industry is in the early stages of a massive reallocation of capital, one that is occurring on a scale that could redefine the competitive landscape. The largest, most professionally operated funds, which already presided over more than 75% of industry assets before the crisis, are likely to emerge as clear winners.
- Performance matters above all else. Managers that underperformed were redeemed, or had their fees restructured, with the dominant reduction affecting the management fee.

Investors with whom we spoke remain profoundly cautious. They have become more assertive, moving capital toward overperforming funds and aggressively reorienting their underperforming managers.

- A total of 89% of investors surveyed reported that they redeemed at least one hedge fund investment in 2009, primarily for underperformance or concern over liquidity terms.
- In all, 80% of survey respondents said that a redemption request was suspended or gated at some point in 2009, a slight improvement over the 90% rate in 2008, but hardly an encouraging result.
- Nearly 70% of investors surveyed increased the frequency of due diligence in 2009 on managers and many will begin to perform diligence on co-investors.
- Overall, 55% of survey respondents stated that they had renegotiated terms with hedge fund managers in 2009, and a majority of the changes resulted in lower management fees.
- Only 14% of responding investors surveyed said they would accept lockups of more than 3 years, compared to 22% in 2008.
- North American investors responding to the survey generally seem comfortable with quarterly liquidity: 68% of our respondents indicated a willingness to invest in hedge funds with side pockets. However, institutional investors surveyed in Europe and Asia indicated that 45% and 57%, respectively, require monthly liquidity.

Established and professionally operated hedge funds are likely, in our view, to win a disproportionately large share of new and reallocated capital and the largest placements are likely to come from major institutions.

- The most important criteria for hedge fund selection cited by our survey respondents were the experience and pedigree of the managers, the type of strategy, track record, risk management acumen and lock-up provisions.

- In total, 52% of investors surveyed indicated that they would consider allocating to a fund with <$50 million in assets, and 71% indicated they would consider investing in a startup. However, respondents reported a preference for new funds launched within the operating framework of an established fund family, and/or by established managers.
- Among our respondents, average placement sizes for the largest institutions, such as pensions and investment managers, were typically in the $25 million to $100 million range in 2009. For smaller institutions and family offices, allocations were typically considerably smaller, often well below $25 million, particularly when allocating to new managers.
- Investors with the most experience appear to make larger average placements and take no more time to complete due diligence: the majority of placements by investors we surveyed with >7 years' experience in hedge funds are greater than $10 million.

Investors appear to have contradictory views about which strategies will succeed in 2010, and the sector could see considerable turbulence.

- The strategies that our survey universe said would garner the most interest were Event Driven, CTA/Managed Futures, LS Equity/Fundamental and Macro. However, there were indications that each will see significant decreases in allocation as well. For example, 22% of respondents indicated that they intend to increase their allocation to LS Equity/Fundamental managers in 2010, but 20% indicated that they intend to decrease.
- A slight majority of our respondents invested in North American strategies and managers. Allocations to European and Asian strategies appear likely to remain proportional to past years, but on a somewhat larger capital base than in 2009.
- Overall, 37% of investors surveyed indicated that they plan to invest in managed accounts, and 37% in UCITS. These figures are nearly double what investors indicated in 2009, but investors have yet to begin acting on these intentions in a meaningful way.

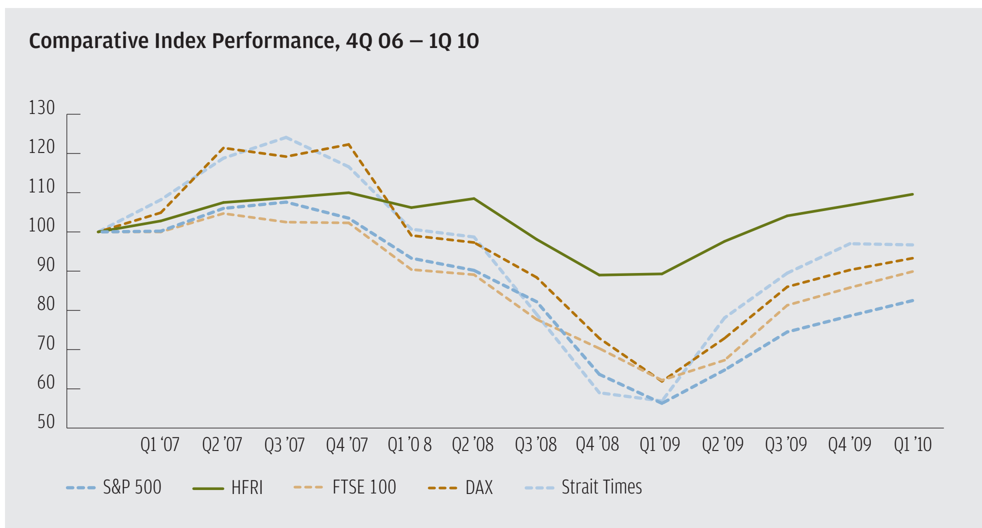
EXECUTIVE TAKEAWAY

The most important criteria for hedge fund selection cited by our respondents were the experience and pedigree of the managers, the type of strategy, track record, risk management acumen and lock-up provisions.

I. Stress Test: Forces at Work on Hedge Fund Assets

The crisis period of 2008 and early 2009 was a time of unprecedented challenges for investors. According to the McKinsey Global Institute, the total value of the world's financial assets fell by $16 trillion in 2008, the largest setback on record.[1] Positive returns of any kind were difficult to find; at times, even the safest investment platforms appeared to be breaking down. While major stock, bond and commodity markets came back to life during the second half of 2009, other major asset classes – such as real estate and sovereign debt – continued to decline and GDP growth remained anemic.

The hedge fund segment, in the aggregate, proved to be resilient. On average, hedge funds significantly outperformed other major classes of investment vehicle during both the sharp downturn in early 2009, and the rapid run-up that followed. As a class, hedge funds achieved those returns with significantly less portfolio volatility. For the twelve months leading up to the end of the first quarter of 2010, none of the strategies tracked by Hedge Fund Research had more volatility – defined as standard deviation of returns – than the S&P 500. In fact, 14 of the 25 strategies delivered returns that were comparable to or better than the S&P 500, with less than half the volatility of the S&P 500.



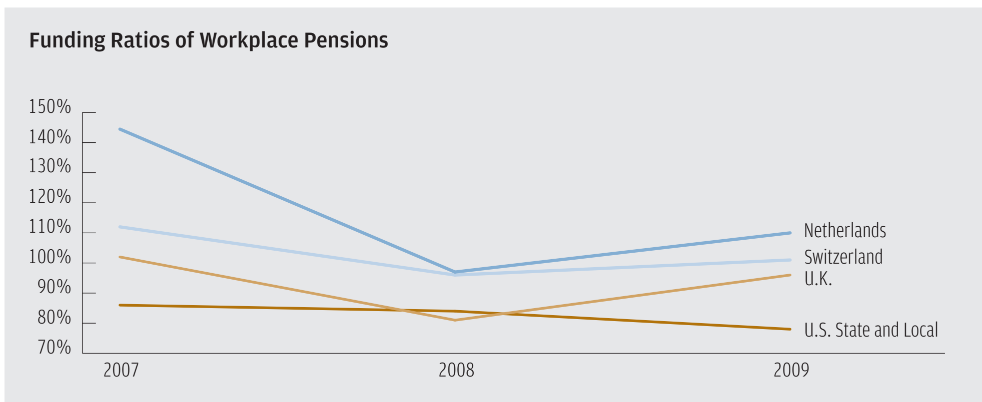
Note: Performance measure at quarter-end; sourced from index tear sheets.

Figure 1

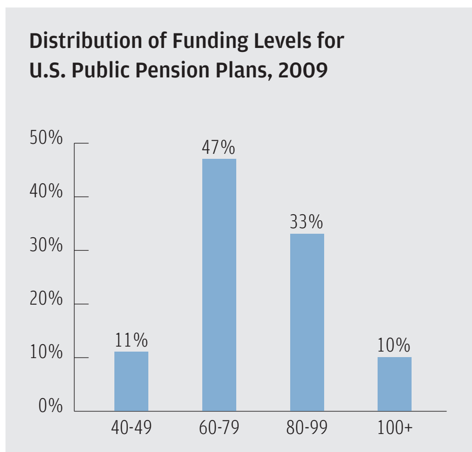
Manager selection has become a matter of singular importance to investors. It was reasonably easy to pick winning managers in the mid-2000s, and before the crisis, we consistently saw high demand for hedge fund products. The positive results in 2009, and less negative results in 2008, were disproportionately driven by the significant outperformance of a fairly small number of the largest, most professionally operated hedge funds. On the other hand, more than 2,000 hedge funds were liquidated in 2009, and many hundreds more felt compelled to suspend redemptions in order to protect their capital base. This differentiated performance will have important implications for 2010 and beyond, as investors reallocate existing capital to reward the managers that truly outperformed and accelerate the trend toward increased "institutionalization" of the hedge fund segment.

[1] "Global Capital Markets: Entering A New Era," McKinsey Global Institute, September 2009

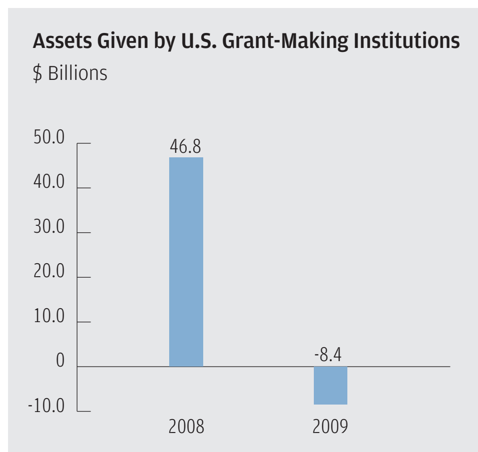
Many investors may need to generate substantial outperformance to recover eroded portfolio value. The Center for Retirement Research at Boston College estimates that at the end of 2009, state and local pensions in the United States were 22% underfunded – their lowest point in more than 10 years.[2] European pensions are considerably better funded, but still dramatically off their 2007 marks. Endowments and foundations faced similar challenges.[3] In the United States, for example, grant dollars fell more than 8% in 2009, and less than half of U.S. grant-making institutions indicated that they would increase giving in 2010. For many endowments and foundations, difficulties were compounded by the illiquidity of long-duration private equity investments and underperforming of 130/30, UCITS and portable alpha programs. Some fund of funds struggled to maintain an asset base substantial enough to support their business models. For some, breakup or merger was the only alternative.



Source: European Federation for Retirement Provision, Center for Retirement Research, Boston College. Figure 2



Source: Center for Retirement Research, Boston College. Figure 3

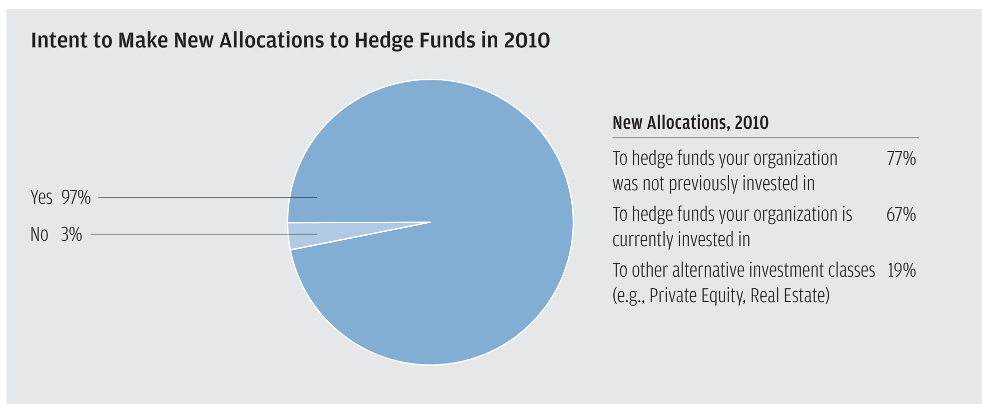


Source: The Foundation Center. Figure 4

Standard asset allocation programs appear unlikely to generate the year-over-year returns necessary to meet conservative targets set before the crisis, and offer little hope of making up for ground lost in 2008. Moreover, based on major index returns, some "long" strategies appeared to be even more susceptible to market shocks than hedge fund strategies, particularly when the highest quality hedge fund managers were added to an investor's portfolio.

[2] "The Funding of State and Local Pension: 2009-2013" Alicia Mundell, Jeanne-Pierre Aubry, Laura Quinby, Boston College, April 2010
[3] "Foundation Growth and Giving Estimates: Current Outlook," Steven Lawrence, Reina Mukai Foundation Center, 2010

These factors all suggest that institutional investors might be more inclined to invest in hedge funds over the course of 2010. And, in fact, 97% of our survey respondents indicated that they intend to make new allocations to hedge funds in 2010. More than two-thirds indicated that they intend to increase their allocation to managers in which they are currently invested, and 80% said they plan to increase their allocation to managers in which they are *not* currently invested. Hedge funds appear attractive even in comparison to other alternative investment classes, which can often combine the volatility and negative performance that sometimes characterize long investment strategies with the lack of liquidity and transparency that plagued many poorly performing hedge funds. Only 20% of responding investors surveyed indicated that they intend to allocate additional capital to private equity, real estate and other non-hedge fund alternatives.



Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 5

Survey respondents not only said that they would allocate more capital to the space; they also stated that the average size of an allocation is anticipated to increase significantly in 2010. More than 80% of our survey respondents indicated that they intend to increase their average allocation by more than $10 million in 2010. In 2009, more than half of our survey respondents stated that their average allocation would be less than $10 million.

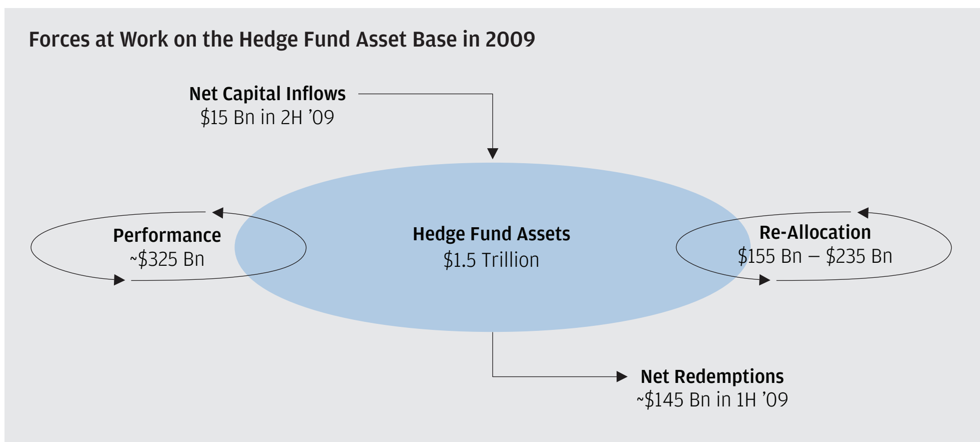
As we analyzed survey results within the context of emerging industry data, a picture began to develop of a hedge fund asset base subjected to four forces of significant magnitude.

- The first is performance, which in our experience has been quite uneven, even among managers within the same strategy. Those that outperformed in 2009 saw asset growth fueled primarily by appreciating investments. Only 18% of our survey respondents saw more than 75% of their hedge fund investments reaching their high water marks in 2009. Those that underperformed saw assets decline, sometimes catastrophically. In the aggregate, Hedge Fund Review estimates that performance propelled the asset base higher in 2009 by $325 billion.
- But the turbulence around the industry returns were considerable, increasing the magnitude of the second force at work: reallocation. If our survey is an indication, institutional investors have become far more aggressive about managing their hedge fund positions. Overall, 89% of our survey respondents redeemed some portion of their hedge fund investments in 2009. Many more indicated they would have redeemed but were still gated in the first quarter of 2010. These redemptions, when considered alongside the overwhelming investor interest reported by survey respondents in increasing allocations to managers, point to a meaningful reallocation of existing investor capital in 2010 that could likely restructure the hedge fund segment permanently. According to estimates cited by Bloomberg, more than 11% of industry assets were restricted by managers at the beginning of 2009.[4] Our survey responses strongly suggest that forced restrictions of this type are in place to prevent substantial redemptions

[4] "Hedge Funds Hold Investors 'Hostage' After Rebound," Saijel Kishan, Bloomberg, January 20, 2010

due to performance. Allowing for a limited number of net redemptions, the Bloomberg figures imply that at least $155 billion in hedge fund assets either have or will become available for reallocation. Our survey results suggest that the figure could be closer to $235 billion. These analyses do not include capital being reallocated by investors that is not locked up.

- The third and fourth forces at work are net flows of investor capital. HFR's measure of global net asset flows into hedge funds turned positive during the second half of 2009, with $13–$15 billion in new capital coming into the hedge fund segment in each of the quarters leading up to this writing. These figures are consistent with trailing 10-year averages, and we think portend solid but by no means monumental net inflows for 2010. Net outflows from the segment exceeded $145 billion in the first half of 2009, but were never more impactful on total assets under management by hedge funds than performance. Outflows, the weakest of the four forces, have also diminished in recent months; it appears that most redemptions are being put back to work as reallocations.



Source: J.P. Morgan Prime Brokerage. Figure 6

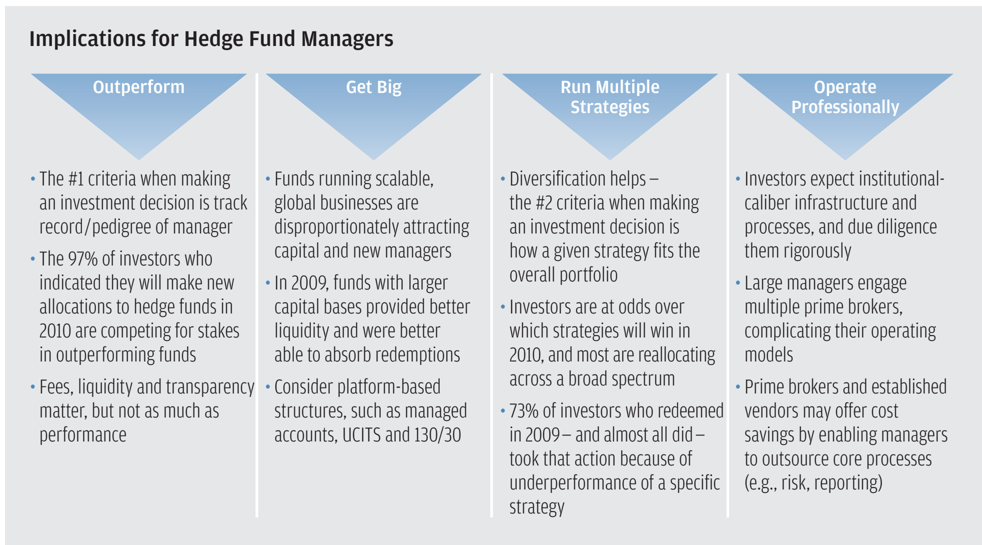
In all, we estimate that more than a third of the hedge fund asset base is likely in motion. What are the implications for hedge funds? One is that in hedge fund investing, size matters. We think capital reallocations and new inflows will disproportionately benefit the largest, most professionally managed funds. In the first quarter of 2010, for example, Hedge Fund Research reported that hedge funds managing more than $5 billion in assets saw net capital inflows of $15 billion, while the rest of the hedge fund industry saw net capital outflows of more than $1 billion. Our observation has been that even startup managers will need a substantial track record and are more likely to attract investments if they affiliate with an established platform. If it plays out, these trends could exacerbate the trend toward increased concentration of assets that was already underway but accelerated by organic growth in 2009 caused by outperformance. Hedge funds managing more than $1 billion in assets accounted for roughly 66% of total industry assets at the end of 2004.[5] By the middle of 2009, that figure had grown to the mid-70% range. We believe that by the end of 2010, the largest, most successful managers will be responsible for well over 80% of total assets. And what had been industry standard terms around liquidity, transparency and fees are already being altered. A total of 55% of our respondents renegotiated terms with at least some of their hedge fund managers. The overwhelming majority changed the management fee, further damaging the prospects for managers at underperforming funds – many of whom remain underwater and are suffering from capital flight.[6]

[5] HFR, Absolute Return, J.P. Morgan Analysis
[6] J.P. Morgan Capital Introduction Group, Institutional Investor Survey – 2010

Performance matters even more. The most fundamental requirement for outperformance is strong portfolio management; however, we believe that strong performance within a single investing style will only win incremental assets for a period of time. All strategies, no matter how well managed, may underperform the broader indices at some point. The key to winning consistently appears to be the ability to operate multiple strategies across multiple geographic regions, and to perform well relative to peers in down markets and positively when financial markets are in positive territory.

Fees matter, but not as much as performance. Institutional investors we surveyed have consistently reported over the years that they were comfortable with the relatively high fees charged by hedge funds if those funds delivered the kinds of risk-adjusted performance that the managers said they would. This is precisely how they behaved through the crisis period.

Although investors responding to our survey had concerns about transparency, liquidity and controls, these factors are subordinate to institutional investors' performance. Views on the relative importance of each of these characteristics varied somewhat by investor type and region. But what was very consistent across all investors surveyed was that, when performance suffered, investors either redeemed and reallocated, or renegotiated management fees, thereby reducing the damage to their own returns. Operating large, multi-strategy asset management companies with whom we work across disparate regions requires investment in the development of institutional-caliber operating processes and controls, and with size comes the ability to manage liquidity. Additionally, managers began to increasingly outsource core middle-office functions and technology to their prime brokers and vendors, thus realizing some savings in staff and direct expenses. So, many leading managers were able to satisfy investors without reducing fees.



Source: J.P. Morgan Prime Brokerage.

Figure 7

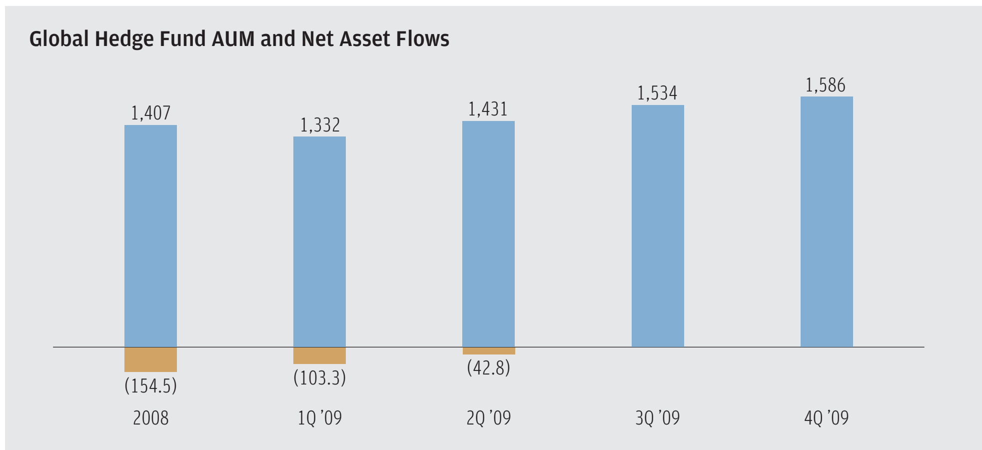
EXECUTIVE TAKEAWAY

The key to winning consistently appears to be the ability to operate multiple strategies across multiple geographic regions, and to perform well relative to peers in down markets and positively when financial markets are in positive territory.

II. Global Investment Flows

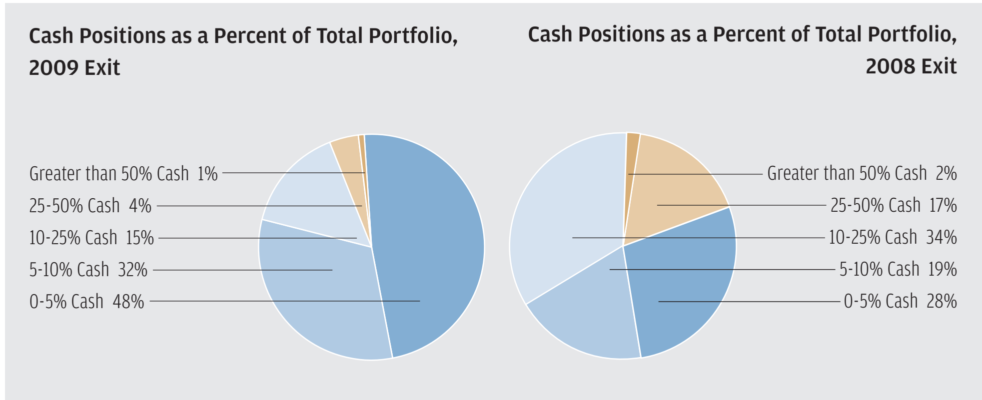
At the close of 2009, 80% of respondents reported that they had less than 10% of their portfolios in cash.

Some evidence of these shifts can be seen in the quarterly net asset flows reported by Hedge Fund Intelligence. According to HFI, more than $100 billion in AUM was pulled out of the hedge fund segment at the height of the crisis in 1Q 09. By 3Q 09, asset flows had turned positive, barely, with $1 billion in net inflows. It is clear however that investors are moving back into hedge funds slowly. In 4Q 09, net inflows were approximately $14 billion, roughly the level reported in 1Q 10. These volumes are in line with the $13–$14 billion average quarterly inflow that HFR recorded from 1998 through 2008. Additionallly, 80% of our survey respondents reported that less than 10% of their portfolios were in cash at the end of 2009. In December 2008, more than half of our respondents had over 10% of their portfolios in cash and nearly 20% of them had over half their assets in cash. This data suggests a positive trend and is consistent with investors' stated intention to allocate more to hedge fund strategies, but does not suggest that a surge of capital is entering the space. Further supporting this view are the responses from investors concerning high water marks. Despite solid double-digit trailing 12-month returns for most indices, only 18% of responding investors surveyed said that 75% or more of their hedge fund investments had reached their high water marks in 2009. Only 3% percent of respondents indicated that all of the hedge funds they were invested in had reached their high water marks.

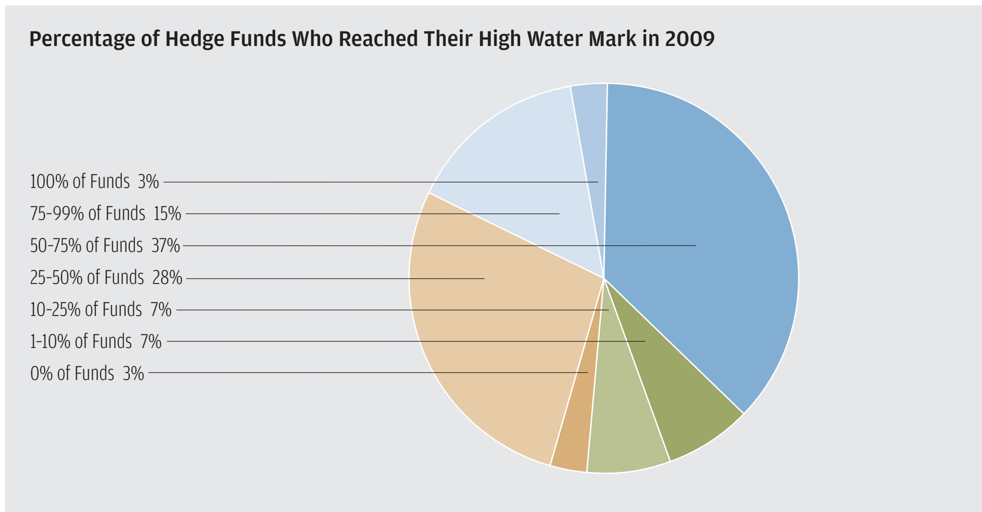


Source: HFR. Figure 8

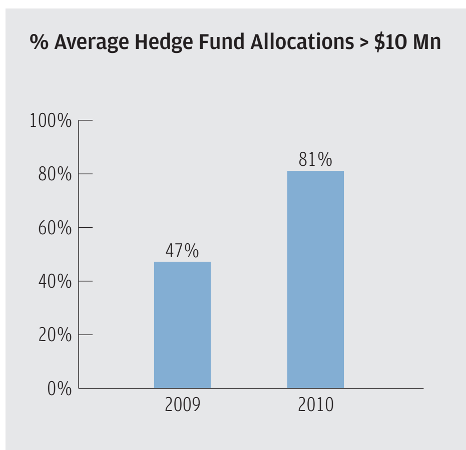
Based on our survey responses, the average size of an allocation could increase significantly in 2010. More than 80% of our respondents indicated that their average allocation will be more than $10 million in the coming year. In 2009, more than half stated that their average allocation would be less than $10 million. Pensions, endowments, foundations, insurers and wealth management companies all reported that the overwhelming majority of their allocations in 2010 will be $10 million or more. Fund of funds indicated that roughly half of their allocation would be more than $10 million. Other investors said that anywhere from two-thirds to three-quarters of their allocations would be less than $10 million.



Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 9

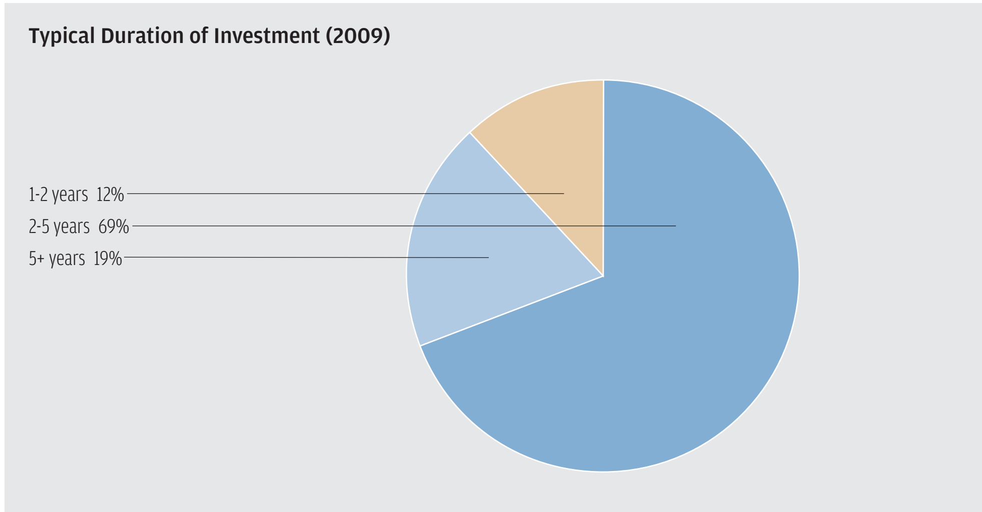


Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 10



Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 11

Survey responses indicated that investors overwhelmingly view their hedge fund stakes as medium- to long-term positions. Nearly 70% stated that they intend to hold their hedge fund investments for 2 to 5 years. Nearly 20% intended to hold them for more than 5 years. These responses suggest that institutional capital will likely continue to be rational and stable capital in the coming years.



Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010.

Figure 12

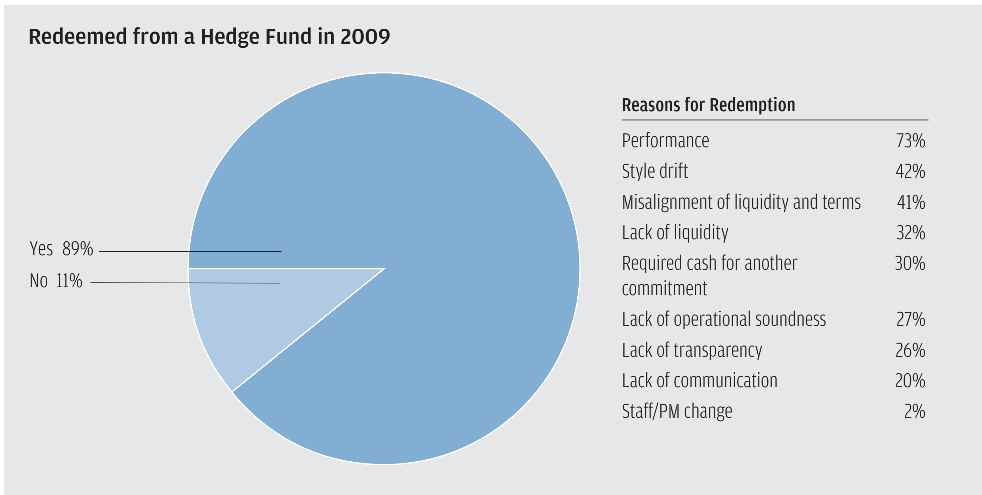
The number of years of hedge fund investing experience is related to average placement size. The majority of respondents with less than one year of experience investing in hedge funds reported their average allocation was $5 million or less, and none indicated that they would place more than $10 million. Responding investors with more than 7 years of hedge fund experience allocated more than $10 million as a typical investment, and 5% indicated that average allocations would be $100 million or greater. We believe it is possible that larger investors who have had positive experiences investing in hedge funds over the course of the last several years have seen the recent turnover among managers as an opportunity to increase their allocations, and could be driving these more substantial placements.

III. Attitude Adjustment: Institutional Investors and the Hedge Fund Segment

Despite the numerous secular trends that favor hedge funds, investors appear to remain profoundly cautious. The performance and behavior of hedge fund managers varied widely throughout the crisis period, and most institutional investors in our survey universe experienced a meaningful amount of dislocation. Many, in fact, report that they are still experiencing significant dislocation. In 2010, respondents indicate due diligence will be more intense, terms will be more actively negotiated and liquidity and transparency will be a priority.

Nearly 90% of those institutional investors surveyed reported that they redeemed from at least one hedge fund investment in 2009. Every type of investor surveyed redeemed at roughly the same rate. Performance was cited as a principal reason for redemption by nearly 75% of responding investors. Liquidity issues were also prominent. Many investors responding to our survey who allocated to funds in the 2004-2007 period had to compete for some opportunities to make placements, and felt that market forces drove them to make illiquid investments without enabling them to be sufficiently compensated for their liquidity risk. Style drift and operational issues were cited as well. But what is striking is the overwhelming degree to which performance drove investors' decisions around redemption. Performance was more than twice as likely to be cited as a factor in a decision to redeem as lack of liquidity, roughly three times as likely as operational soundness or lack of transparency, and many times as likely as critical staff changes.

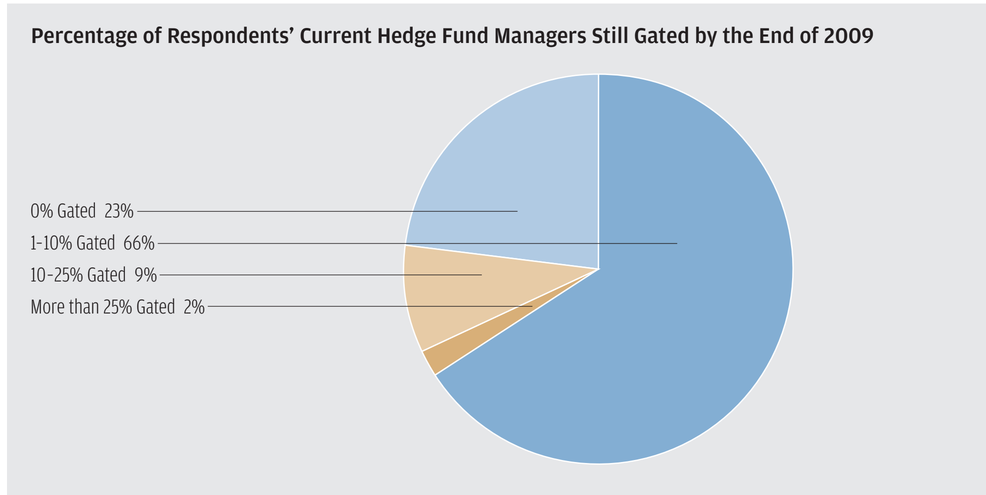
Redeemed from a Hedge Fund in 2009



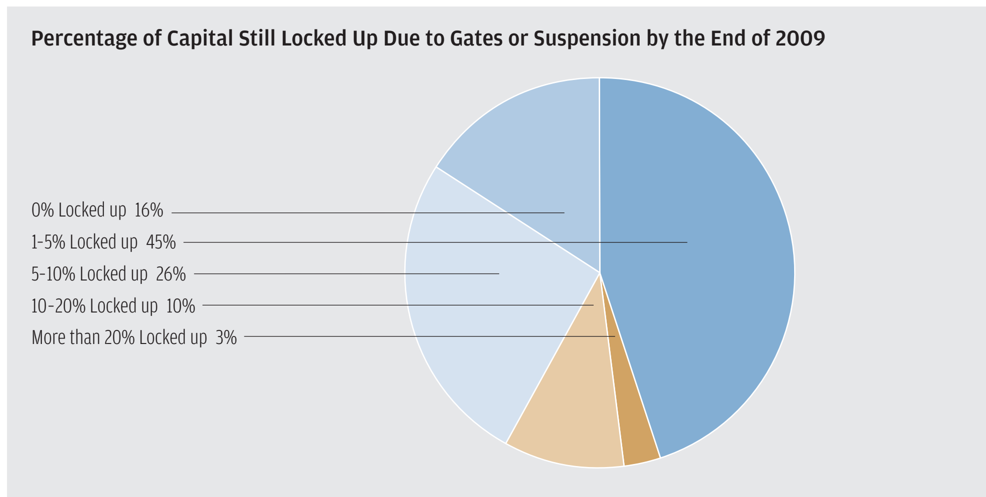
Reasons for Redemption	
Performance	73%
Style drift	42%
Misalignment of liquidity and terms	41%
Lack of liquidity	32%
Required cash for another commitment	30%
Lack of operational soundness	27%
Lack of transparency	26%
Lack of communication	20%
Staff/PM change	2%

Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 13

More than 75% of investors surveyed said that some of their hedge fund managers suspended or gated redemptions in 2009, and nearly 85% of investors exited 2009 with a portion of their capital locked up due to manager gates or suspensions. For 39% of respondents, more than 5% of their capital was still locked up by managers at the time of the survey.

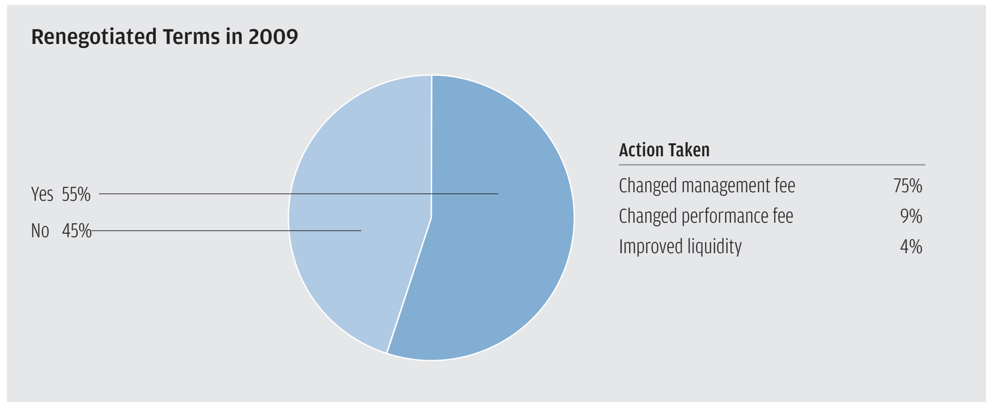


Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 14



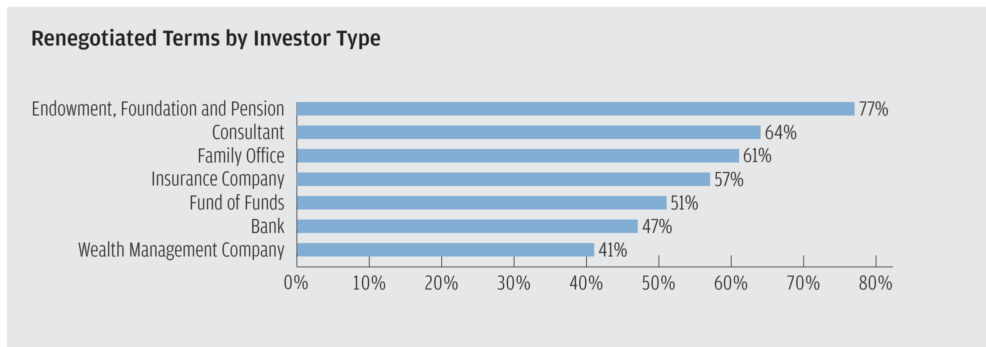
Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 15

The primacy of performance was also evident in responding investors' increasingly aggressive approach to management fees. A total of 55% of survey respondents reported that they renegotiated the terms of one or more of their hedge fund investments. The overwhelming majority of successful renegotiations resulted in reduced management fees, though investors typically agreed to a longer lockup. Our respondents felt that in many cases they overpaid in order to buy into a manager during a period when investor demand was quite high. Such investors appear to have taken this opportunity to reprice manager talent, perhaps a healthy trend over the long run. In 2009, however, this repricing often added additional stress to already struggling managers. In our view, if hedge fund managers met or exceeded their targets, investors were comfortable compensating them.



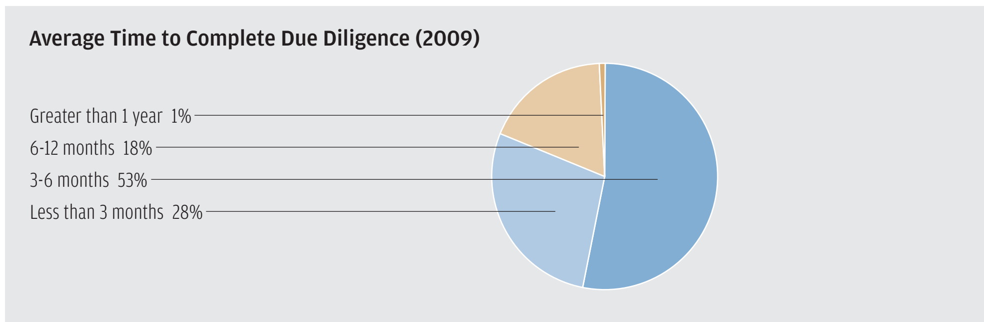
Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 16

Some investors were far more likely, or able, to renegotiate terms than others. The overwhelming majority of responding endowments, fund of funds, foundations and pensions surveyed renegotiated terms, more than any other surveyed investor class. This, again, reflects the fact that many of these large institutions made long-duration investments during the pre-crisis run-up and were, in their view, being insufficiently compensated for illiquidity. Family offices and consultants surveyed also were very active in renegotiating terms.



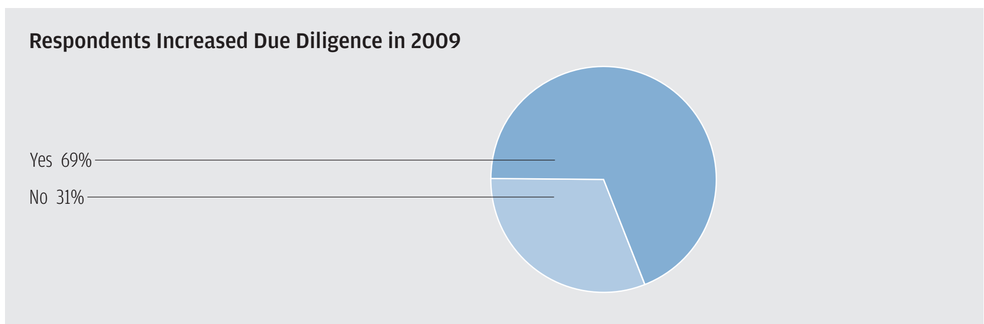
Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 17

With so many investors experiencing both unexpectedly poor performance and unanticipated liquidity issues, it is not surprising that they have begun to increase the duration and expand the focus of their due diligence. The majority of investors responding reported taking three to six months to complete due diligence, though timing varied considerably by situation. This was up slightly from what we measured in the pre-crisis markets of 2006. However, managers indicated that they also increased the frequency of due diligence efforts, and family offices and consultants have been particularly active in seeking out new investment opportunities. The combined effect has been to increase the total number of due diligence events significantly, something that we have seen manifested in the surging volumes of due diligence questionnaires. The size of the investment appeared to have little effect on the duration of due diligence. In general, hedge fund managers worked just as hard to win a $5 million commitment as they did to win a $100 million one. The type of investor did not materially impact due diligence duration.



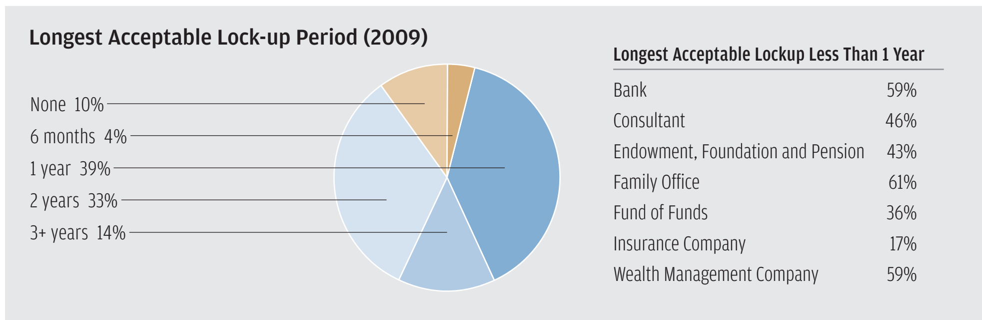
Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 18

Nearly 70% of our survey respondents said that they increased the intensity of their due diligence in 2009. And, in response to liquidity issues experienced during the crisis period, 57% of respondents indicated that they expected to increase due diligence performed on the other investors with whom they may co-invest. Based on survey responses, fund of funds and family offices were more likely than other types of investors surveyed to have increased time spent on due diligence in 2009.



Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 19

Investor concerns about liquidity began to manifest themselves in increased pressure to reduce lock-up periods. In 2009, 54% of responding investors surveyed said that they would not accept a lockup of more than one year's duration, and 10% stated that they would not invest in a fund with lockups at all. These responses are up slightly from 2008, but significantly from pre-crisis levels. Respondents' views on lockups varied considerably by type. Endowments, pensions, foundations and family offices responding in 2009 were relatively willing to accept lockups of more than one year. In fact, roughly a quarter of these investors indicated that they would agree to lockups of three years or more under certain circumstances. Banks, consultants, wealth managers and especially fund of funds stated that they were far less willing to be locked up for more than one year; 35% of banks said that they would be unwilling to accept any lockup at all.



Longest Acceptable Lockup Less Than 1 Year	
Bank	59%
Consultant	46%
Endowment, Foundation and Pension	43%
Family Office	61%
Fund of Funds	36%
Insurance Company	17%
Wealth Management Company	59%

Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 20

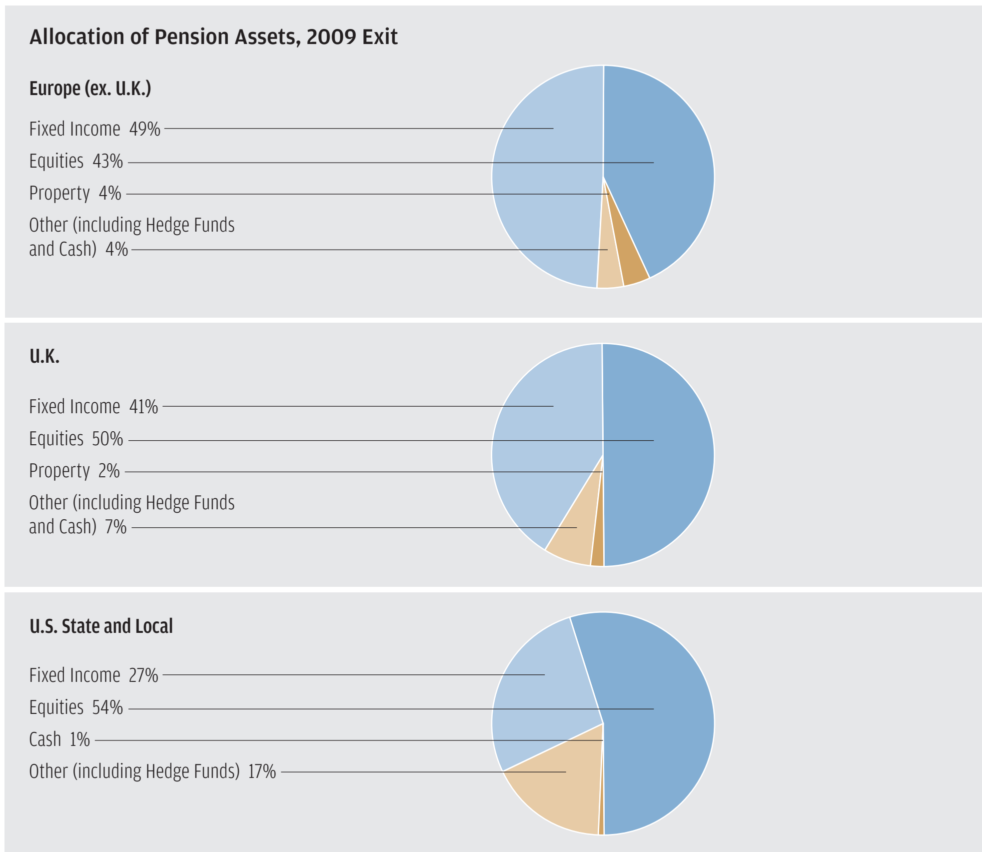
Investor shock over the magnitude and length of the bear market is something that we believe will be unlikely to recede anytime soon. Investor liquidity requirements varied little by type. When viewed from a regional perspective, however, significant divergence can be seen. North American responding investors were far more willing to accept less frequent liquidity than their counterparts in other regions. The majority of North American investors surveyed required quarterly liquidity, and 26% indicated a willingness to accept liquidity semi-annually, annually or expressed no preference. North American investors may believe that overly frequent liquidity would impair investment returns. They were interested in transparency and wanted to understand what their positions and exposures were in significant detail. As long as managers provided them with transparency, respondents were generally comfortable holding a position with a view toward long-term absolute returns. More generally, we found that North American investors tend to view the role of their hedge fund positions somewhat differently than investors from other regions. For respondents in North America, hedge funds tend to be one component of a long-duration "alternative" allocation. According to the Towers Watson survey, U.S. pensions exited 2009 with 82% of their assets allocated to inexpensive and liquid long-only fixed income and equities programs, 17% allocated to alternatives (including hedge funds, real estate and private equity), and approximately 1% in cash.[7]

Respondents from other regions tended to construct far more liquid portfolios, and they were far more insistent about frequent liquidity in their hedge fund investments. European pensions, for example, exited

EXECUTIVE TAKEAWAY

Investor shock over the magnitude and length of the bear market is something that we believe will be unlikely to recede anytime soon.

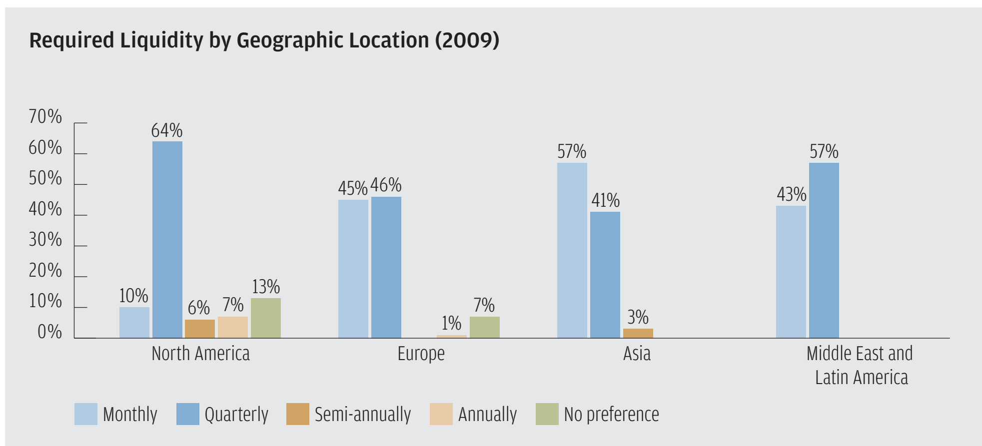
[7] Towers Watson: 2010 Global Pension Asset Study, January 2010



Source: 'Annual Report' European Federation for Retirement Provision, April 2010. Figure 21

2009 with more than 96% of their capital invested in something other than alternatives. According to our survey in Europe, 91% of investors required liquidity at least quarterly. In Asia, that figure rose to 98%, and in Latin America and the Middle East it was 100%. Outside of North America, more investors use fund of fund platforms and have the need to manage heightened asset/liability mismatch risk. Additionally, the fallout from the Madoff scandal has been particularly impactful outside of the United States. Proposed regulatory changes are likely to only increase this push for liquidity.

More than a third of our respondents said that they intended to invest in managed accounts in 2010. This is double the number that expressed interest in these structures in 2008, and consistent with our experience



Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 22

at J.P. Morgan, where we observed significant allocations being made to managed accounts across most of 2009. And while we think that the assets allocated to managed account structures will continue to grow – the advantages from the investor's perspective can be compelling – the volume of activity has slowed dramatically in recent quarters. Our view is that managed accounts face significant headwinds, and that asset growth will be less fulsome than the headline numbers in this year's survey may suggest. In recent quarters, managers we work with report that investors have been deterred by the complexity involved in setting up the accounts, particularly for smaller allocations and for strategies involving various investment instruments, such as listed derivatives, OTC derivatives and foreign exchange. And some types of account structures bring risk up into the investors' pools of assets that would not be present in a more standard hedge fund allocation. However, we believe the principal reason is that because managed account structures impose considerable operational burdens on managers, they are increasingly unlikely to operate the platforms for allocations of less than $100 million. More than 70% of our respondents who intend to invest in managed accounts in 2010 indicated that they planned to invest less than $50 million, and few managers or investors appear willing to move across that gap. Approximately 15% of investors surveyed who stated that they plan to allocate to managed accounts in 2010, representing 5% of the total pool of respondents, will allocate more than $100 million to the structure. Our view is that this figure offers a more realistic picture of what asset growth in managed accounts will look like going forward. In 2010, we expect to see a reasonably small number of large, sophisticated investors placing blocks of well over $100 million into a modest number of accounts managed by the largest hedge funds that have the operational sophistication to work through the complexities that the structure introduces. And, in fact, we have seen some large financial institutions attract investor interest in recent months by offering well-structured managed account platforms as "plug and play" solutions.

Investment in Managed Accounts (by typical investment size)

	2008	2010
$1-25 MM	31	57
$25-50 MM	11	17
$50-100 MM	8	14
Greater than $100MM	2	16
Total	52	104

Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 23

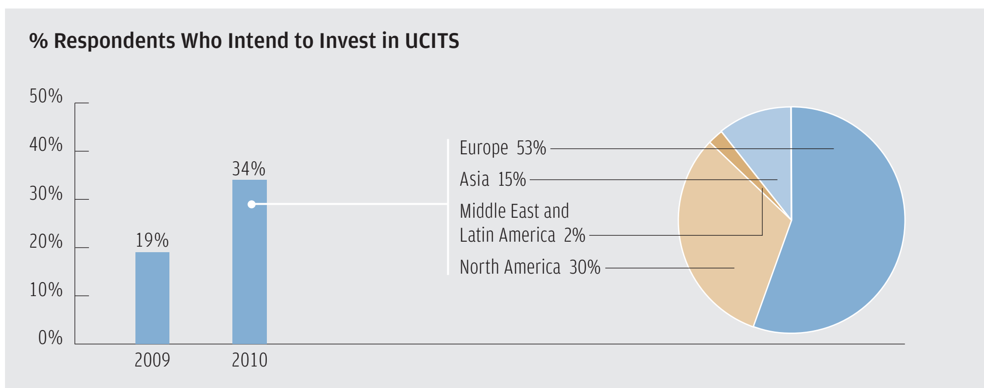
One third of investors reported that they intended to invest in UCITS products this year, up from 19% in 2009. Interest from European investors surveyed was quite strong, as the frequent liquidity and high mutual-fund-like transparency are well suited to the general approach most European investors appear to take to the hedge fund segment. European respondents were not the only interested parties; a significant percentage of Asian investors responding indicated they were interested in the product, as were a third of prospective UCITS investors surveyed in North America. The UCITS platform has, of course, been enormously successful from an asset-gathering perspective. A total of $6.9 trillion of assets was managed in UCITS at the end of March 2010.[8] Only a small percentage of those assets, however, are invested in hedge fund strategies. The research team at Strategic Insight estimates that only $40 billion of the nearly $200 billion of "alternative UCITS" assets are managed by hedge funds.[9] And the performance of UCITS products appears to be less attractive than direct hedge fund investing.

[8] "Trends in the European Investment Fund Industry in the First Quarter of 2010," Bernard Delbecque, The European Fund and Asset Management Association, June 2010

[9] "Exotic to Mainstream: The Growth of Alternative Mutual Funds in the U.S. and Europe" White Paper SEI and Strategic Insight, May 2010

From the manager's perspective, the UCITS structure may present significant challenges. Managers can only employ them in strategies that are highly liquid and sufficiently robust to withstand constant changes in asset base. This may provide a convenience to investors, but has the effect of forcing the manager out of positions that can deliver illiquidity premiums that can materially impact performance. In UCITS funds, most managers have to diversify their counterparties, and provide a level of reporting that goes well beyond anything they have had to provide in the past. And they must provide these services to a much larger number of much smaller investors than they have had to manage before. The firm operating the distribution platform collects fees that cannot, normally, be passed through to the investor. And the relative success of Long Only Strategies within the UCITS framework is likely to place additional downward pressures on fees in 2010.

Our expectation for 2010 is that UCITS will increasingly be used by both newer investors looking to dip their toes into the hedge fund segment, and more experienced investors who cannot, or do not want to, make multi-$100 million allocations to managed accounts. UCITS currently only account for around 2%–3% of global hedge fund assets; so we expect sharp growth off of a very small base. For large, established managers, running strategies out of a UCITS structure may be an accretive source of asset gathering on the margins of core business lines. Looking beyond 2010, there is a possibility that the advent of UCITS will erode hedge fund managers' fees for the more liquid strategies and cannibalize core business. Overall, we expect that UCITS are likely to remain an important, but clearly secondary, offering.



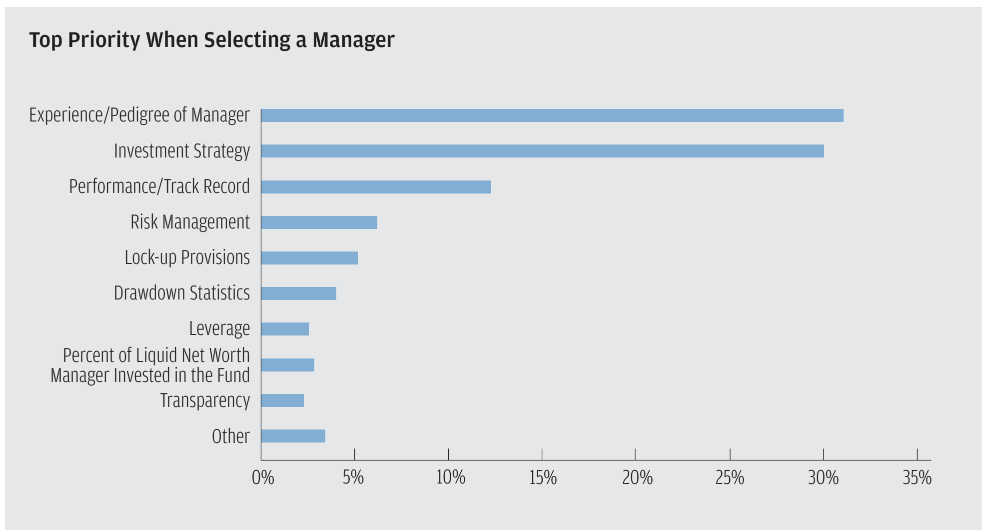
Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 24

EXECUTIVE TAKEAWAY

Our expectation for 2010 is that UCITS will increasingly be used by both newer investors looking to dip their toes into the hedge fund segment, and more experienced investors who cannot, or do not want to, make multi-$100 million allocations to managed accounts.

IV. Investor Sentiment: What Characteristics Make Managers Attractive?

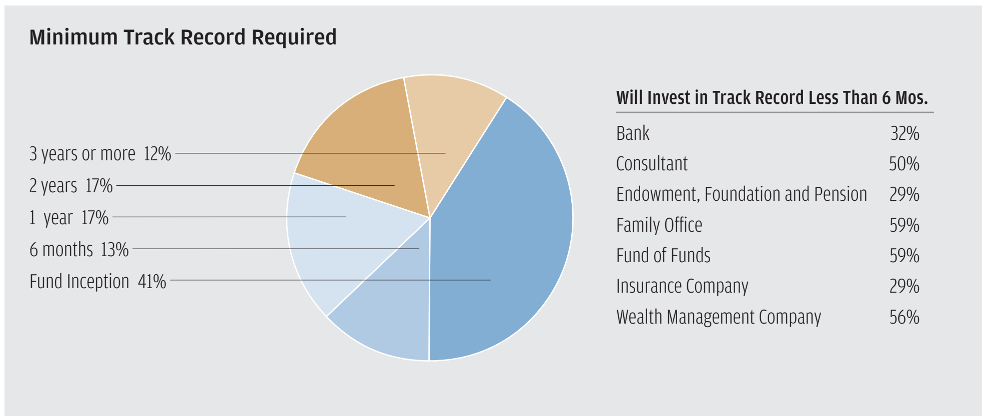
As in previous years, investors surveyed said that a manager's experience, pedigree and performance are primary considerations when selecting a fund to invest in. Manager selection matters: in 2009, industry performance data show that it mattered a great deal. The type of strategy also figured prominently, which seems quite sensible given that the respondents were institutional investors charged with the construction of diverse portfolios.



Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 25

Respondents cited risk management and transparency as important, but rarely the top criteria in manager selection. In follow-on conversations with investors surveyed, we were told that this was partly due to the fact that many managers had improved risk and reporting systems in the past year. A number of investors surveyed also stated that those were very important factors in their selection, just not the *most* important; risk management consistently scored high as a second or third priority with all investor types. Given investors' heightened focus on liquidity, it was somewhat surprising to see the relatively low ranking of lock-up provisions as a selection criterion. In fact, lock-up provisions ranked fairly low as a second or third priority as well. In follow-up conversations with investors surveyed, we concluded that this is attributable to the prevailing view that manager selection and strategy selection are paramount. If they are both done well, then the recent experience of investors surveyed suggests that liquidity will not become much of a concern as the issues regarding asset-liability mismatches have been addressed by the investor and manager. It does appear, therefore, that liquidity is a major consideration in manager selection, just not the principal one. Investors surveyed reported that they tend to focus first on the factors that are most likely to drive returns through their portfolios.

Consistent with the reported emphasis on selecting managers with outstanding pedigrees and performance histories, more than half of investors surveyed indicated they will not consider investing in managers with less than a year's track record. Those investors surveyed who did express a willingness to consider investing in funds with less than 6 months of operating history, however, appear to have primarily reserved their allocations for established managers who were operating new platforms, often as part of a larger, institutionally-managed hedge fund complex. Family offices, fund of funds and consultants surveyed were the investor types that reported the most willingness to invest in managers with a shorter track record; 35%-60% of these respondents indicated that they would consider investing from a fund's inception.



Will Invest in Track Record Less Than 6 Mos.	
Bank	32%
Consultant	50%
Endowment, Foundation and Pension	29%
Family Office	59%
Fund of Funds	59%
Insurance Company	29%
Wealth Management Company	56%

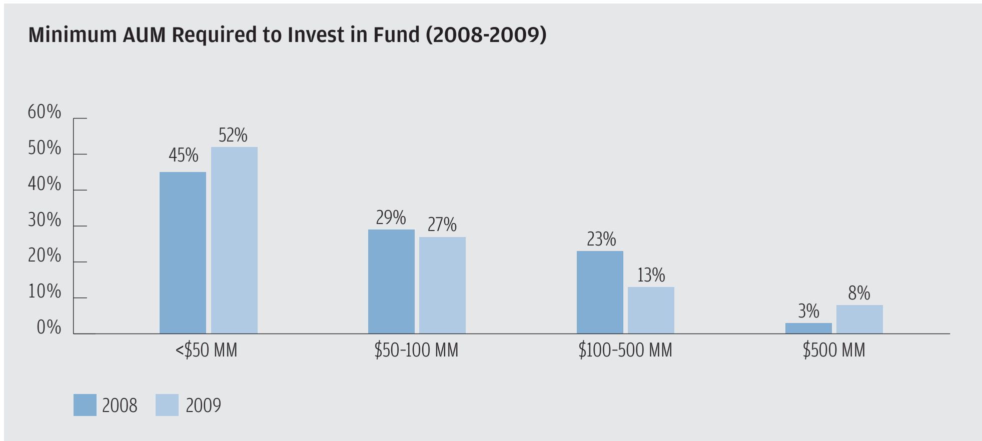
Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010.

Figure 26

Respondents were somewhat more willing in 2009 to lower the minimum AUM requirement, with 52% saying that they would consider investing in funds with less $50 million in AUM, and 79% saying that they would consider investing in funds with less than $100 million in AUM. Respondents, again, stressed that manager pedigree, track record and other factors would determine the attractiveness of a smaller fund. We believe most placements in smaller funds were being made in new vehicles run by established managers; if the manager was part of a larger, high quality fund family, then all the better. Respondents' willingness to consider smaller funds did, however, vary significantly by investor type. Between 70% and 88% of funds of funds, family offices and consultants surveyed indicated they would be willing to invest in a fund with less than $100 million in AUM.

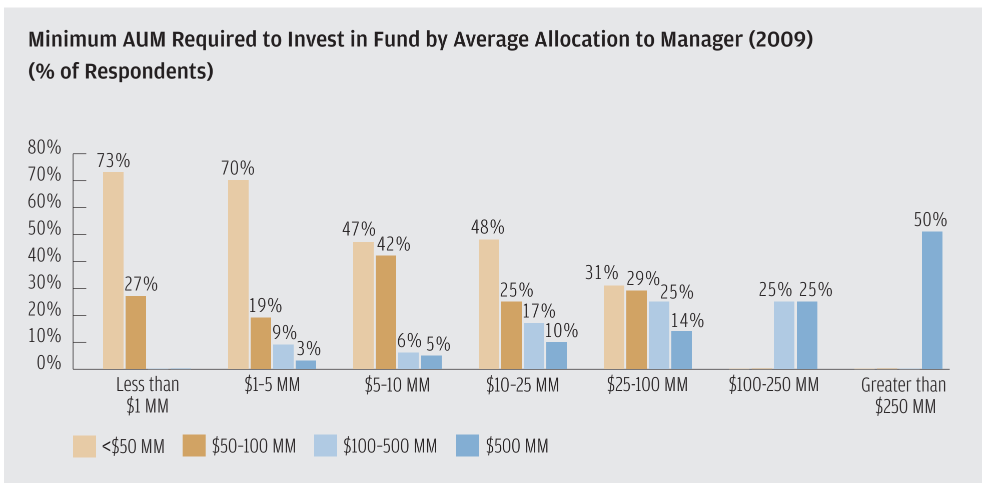
EXECUTIVE TAKEAWAY

Consistent with the reported emphasis on selecting managers with outstanding pedigrees and performance histories, more than half of investors surveyed indicated they will not consider investing in managers with less than a year's track record.



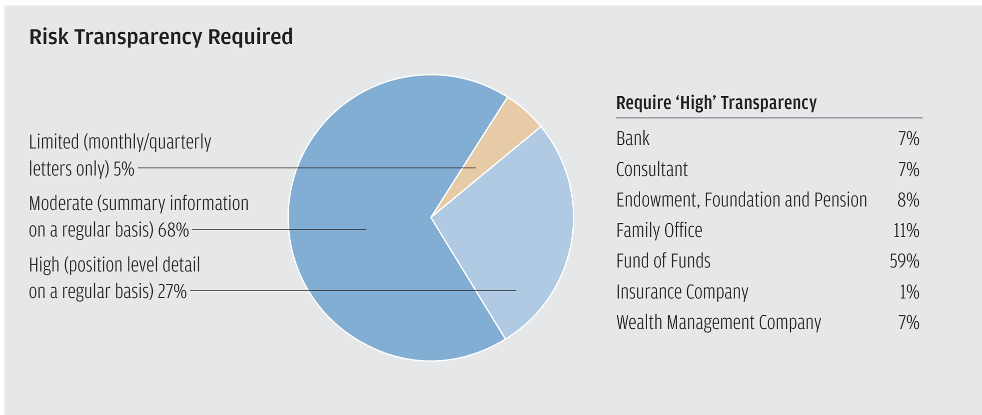
Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 27

Many respondents also indicated a willingness to be the lead investor in a fund if the opportunity appears to be sufficiently attractive. Nearly half reported that they would place $5 million to $25 million in a fund of less than $50 million in AUM, and 31% indicated that they would consider taking a majority stake. These figures were driven primarily by interest from fund of funds, consultants and family offices. A similar willingness to invest aggressively in the right opportunity was in evidence at the larger end of the spectrum. A quarter of investors surveyed indicated that they would be willing to take a majority stake in a $100 million to $500 million fund, and half of those respondents making average allocations greater than $250 million indicated they would consider making a placement of that size in a fund as small as $500 million.



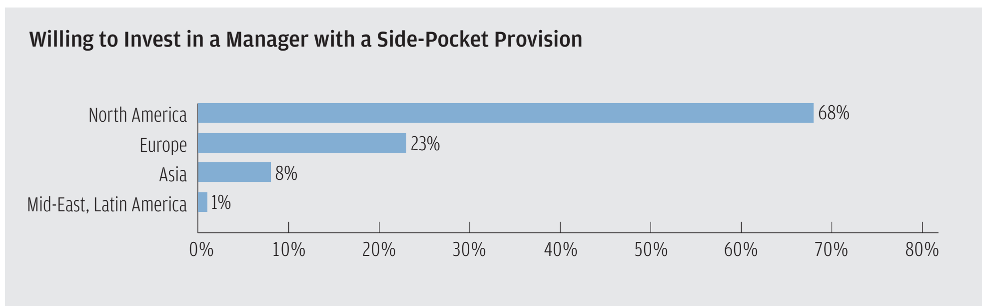
Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 28

Respondents generally showed a requirement for "moderate" (i.e., summary information on a regular basis) transparency around a manager's risk, and fully 95% said that they required moderate or high levels of transparency. This is consistent with responses from last year, and may provide further support to the notion that monthly or quarterly letters to investors alone may no longer suffice. Almost all of the 27% of investors who reported requiring position level detail on a regular basis were fund of funds. This appears to be primarily attributable to the need for these types of investors to manage the risk of asset/liability mismatch.



Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 29

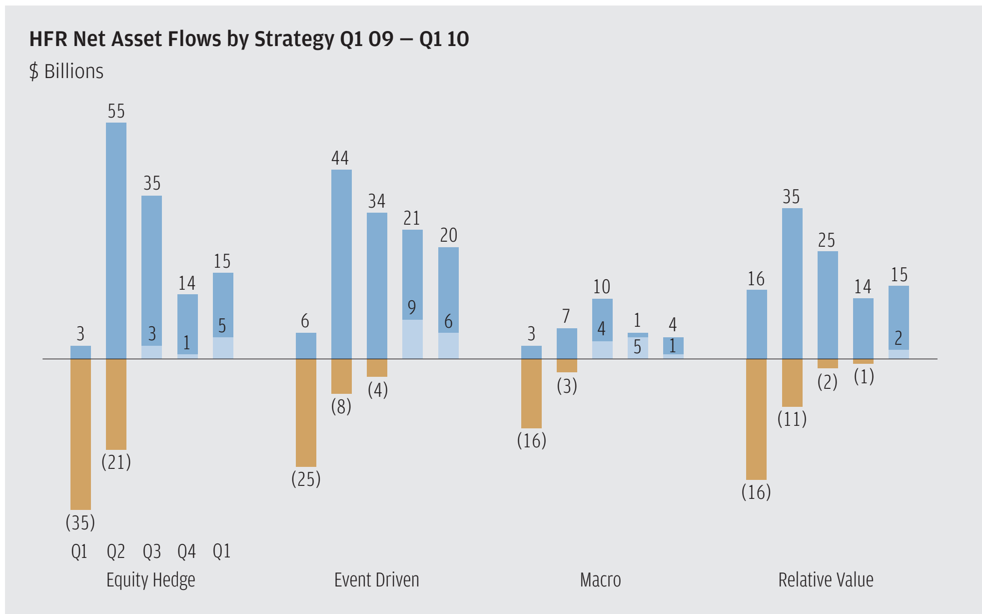
By a substantial margin, most North American investors surveyed said that they were comfortable investing in managers that employed side-pocket provisions. In general, certain strategies require stable capital, and improvements in risk and reporting systems have made it easier for investors to understand what is happening with their positions in even the more illiquid asset classes. The view outside of North America was quite different. Only 23% of European investors surveyed would be willing to invest in a fund with side pockets. Asian, Middle Eastern and Latin American investors surveyed were considerably less willing than that.



Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 30

V. Investor Sentiment: Which Strategies Will Win Assets in 2010?

Global net asset flows have turned moderately positive, and are now roughly in line with the trailing 10-year average of $13 billion to $14 billion per quarter. Event Driven and Equity Hedge strategies have attracted the most investor interest in recent quarters.



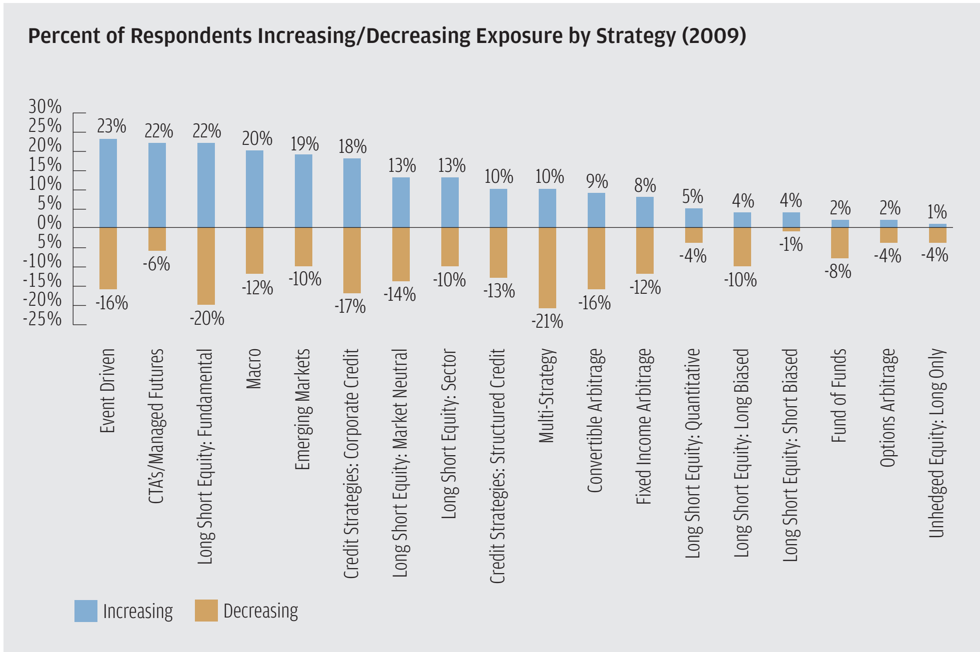
Source: HFR.

Figure 31

However, predicting which strategies will win the lion's share of investor assets in 2010 is difficult. All of the strategies that respondents cited as attractive were also marked by others for decreased allocations. Nearly a quarter of investors responding reported that they intend to increase their exposure to Event Driven strategies, making it the leading choice of respondents for 2010. However, 16% stated that they would decrease exposure to those same strategies. The same was true for a number of other strategies: 22% indicated that they would be increasing their investment in Long/Short Equity funds, while 20% reported that they planned to reduce their exposure. Although 18% indicated that they would be increasing their exposure to Corporate Credit strategies, 17% said that they would be decreasing. We believe decisions will be based more on the quality of individual managers, and that most portfolio activity will be generated by reallocating existing investment capital, particularly early in 2010.

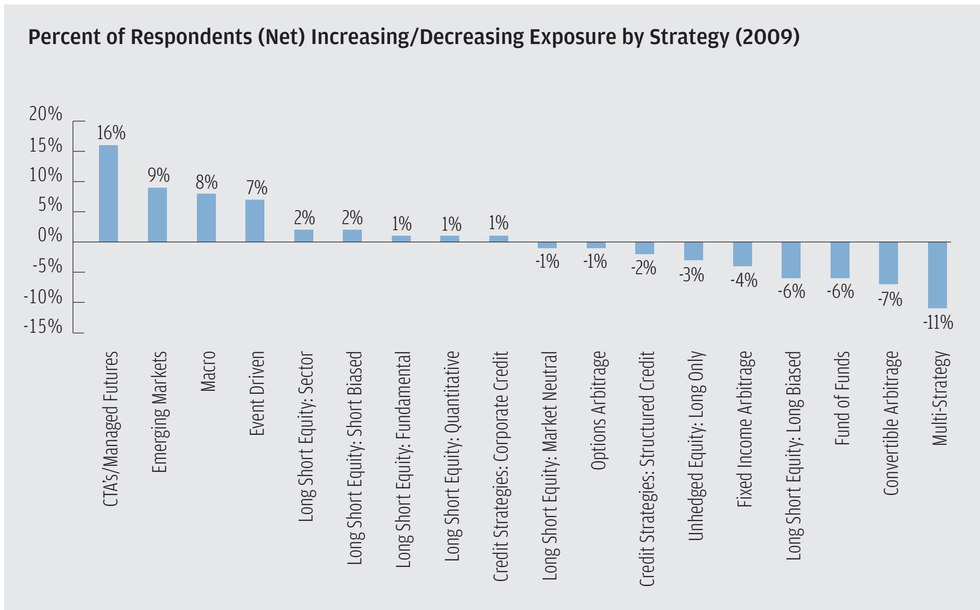
EXECUTIVE TAKEAWAY

Predicting which strategies will win the lion's share of investor assets in 2010 is difficult.



Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010.

Figure 32

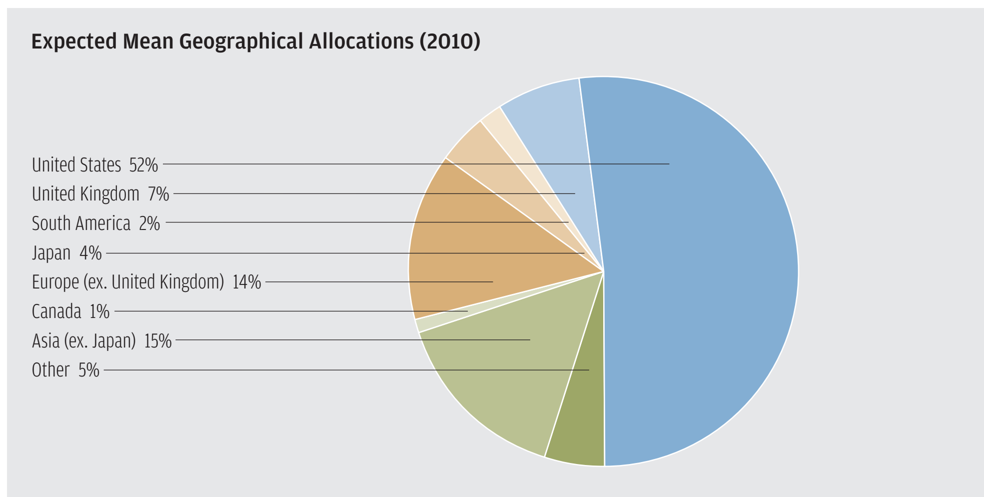


Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010.

Figure 33

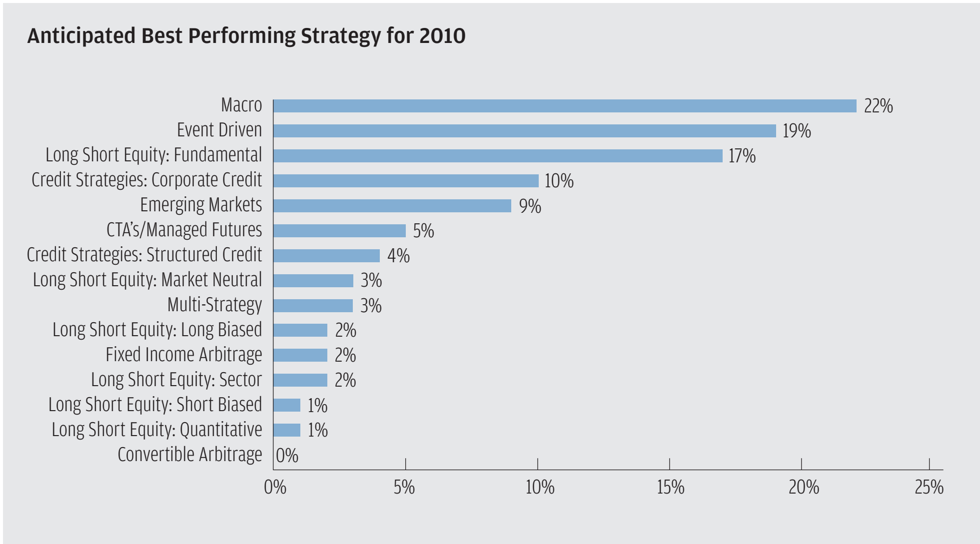
The intended geographic allocation of assets has been fairly stable over the past several years, and we saw little change in this year's results, according to respondents. Strategies focused on U.S. underlying securities should garner a little more than 50% of assets in 2010. These results indicate the United States seems slightly more attractive than in pre-crisis years, Europe slightly less so. Asia ex-Japan experienced a high growth rate off a low asset base for several years in the middle of the decade. The sharp decline in hedge fund assets seen in late 2008 appears to be reversing somewhat, and investors indicated an intention to allocate the same 15% to that region that they did, on average, in 2009. The location of a manager appeared to be of significantly less concern to investors than performance and liquidity terms. We found no particular preference for funds that manage regionally-focused underlying assets out of the region. From the investor's perspective, a manager focused on Asia could manage money just as effectively from New York or London as from Hong Kong or Singapore. To the extent that local presence does help drive performance, investors generally expressed heightened interest in established funds that operated globally within a strong control framework.

Expected Mean Geographical Allocations (2010)

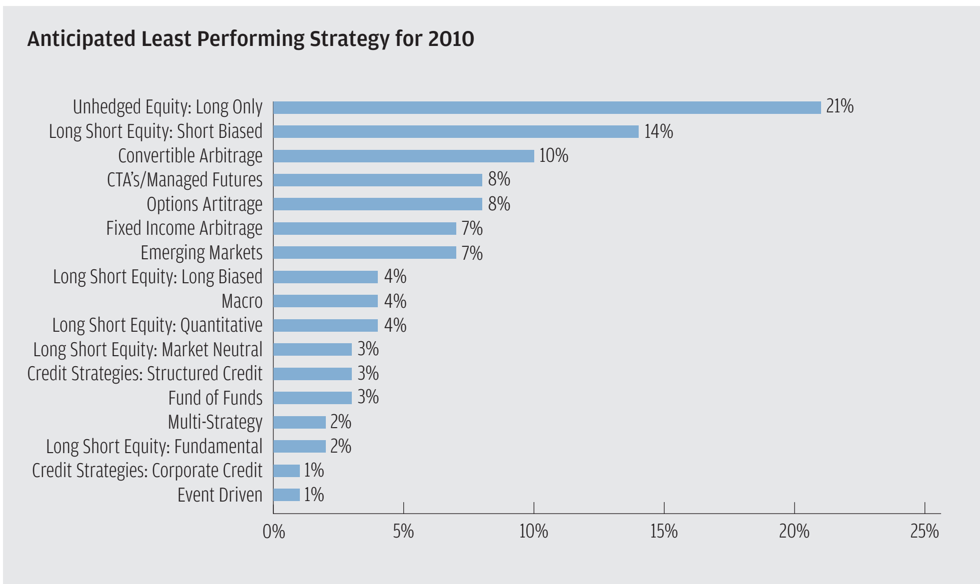


Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 34

Investors surveyed indicated they expect Macro, Event Driven and Long/Short Equity strategies to outperform other strategies in 2010. Among investors surveyed, Macro strategies were a clear winner on performance in 2009, but did not rank as highly when investors were asked where they expected to increase exposures. While 20% of respondents indicated that they planned to increase their Macro exposure in 2010, 12% indicated that they planned to decrease. We believe this is primarily driven by investor concern that in an environment where markets are being constantly roiled by liquidity and banking crises in opaque instruments, and governments in a number of major market centers are considering sweeping regulatory changes, the more generalist strategies are more likely to surprise to the downside. There was little doubt which strategies would perform the poorest in 2010: Long/Short, and Equity Short Biased. The bias against Long Only was directly attributable to the lack of downside protection that long strategies provided during the crisis, and can be seen as a broader endorsement of the hedge fund segment. The lack of enthusiasm for Short strategies partly reflected a muted optimism about the overall direction of markets in 2010, and partly a general antipathy seen every year. Investors surveyed also predicted limited prospects for Convertible Arbitrage strategies, and had divergent views on others, including Managed Futures, Credit and Emerging Markets.



Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 35



Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 36

Conclusions

This has been a turbulent period for hedge funds and their investors. With markets under extreme duress for much of the last two years, hedge funds proved to be resilient. As a class, they generally declined less during the crisis and profited more consistently during the rebound than other types of investment vehicles. We think it likely that investors and managers are in store for more turbulence in 2010, but there is also reason for optimism. Investors are seeking to rebuild eroded capital bases in a challenging macroeconomic, regulatory and geopolitical environment. The leading hedge funds stand out as one of the few classes of asset managers that offer investors a consistent and reasonably strong track record. Not surprisingly, most of the survey universe indicated a strong interest in allocating more capital to the leading hedge funds.

We believe this investor behavior is driving a set of tectonic shifts in the competitive landscape of the hedge fund segment. The performance of individual funds varied widely and the experience of investors was quite uneven. The relatively small number of hedge funds that have outperformed is garnering a steadily increasing share of global assets as their positions appreciate relatively faster than those of their competitors. Investors have become more assertive, moving capital deliberately toward overperforming funds and aggressively reorienting, or ending, their relationships with those that underperformed. We believe these actions have triggered a colossal reallocation of investor capital toward precisely the funds that were already taking a greater share of assets through organic growth due to performance. Net capital inflows to the hedge fund segment, which have returned to historically average levels in recent quarters, are also being directed at those managers that outperformed.

The implications for managers are clear. Performance matters above all else. In addition to superb investment management skills, the managers that continue to win investor assets have demonstrated the ability to operate multiple complex strategies across time zones and at significant scale. Alternative structures, such as UCITS, managed accounts and mutual fund strategies, may help attract additional investors but are unlikely to outpace core investment products. We believe that these trends will result in a hedge fund segment that is concentrated, with well over 80% of global assets managed by the top 2%–4% of the manager universe. By focusing capital allocations on the largest, most professionally operated funds, investors are also driving up the aggregate quality and hardiness of the hedge fund segment. We think that hedge funds will exit 2010 considerably stronger, and more influential than they were when they exited 2007 and entered the crisis.

EXECUTIVE TAKEAWAY

The implications for managers are clear.

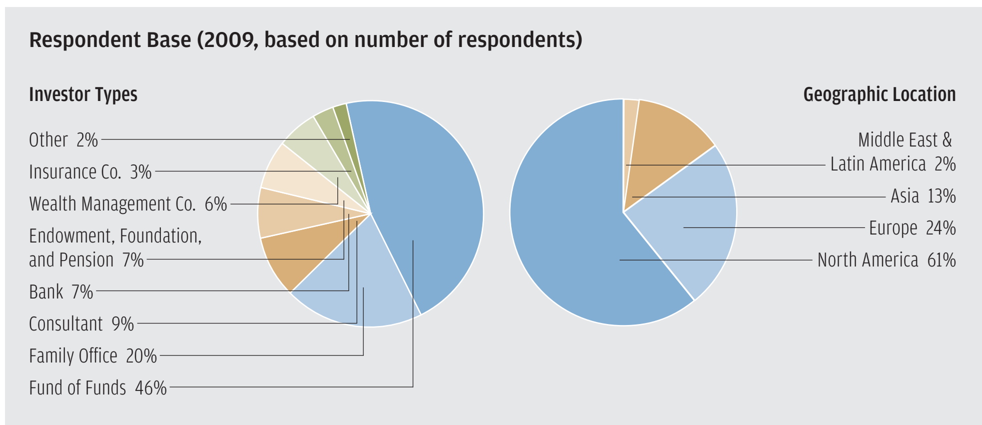
Performance matters above all else.

Overview of the J.P. Morgan Institutional Investor Survey

This year's survey was conducted over the course of the first quarter of 2010. Participants were selected to ensure that the results would proportionally represent the full spectrum of investor perspectives. When constructing the respondent universe, we focused on investor quality and demographics (i.e., investor type, location and years of experience). Our goal was to facilitate the assembly of a forum for a balanced group of thought leaders. We were fortunate to be able to involve many of the world's leading institutions in this effort. At the time of the survey, the respondents managed $2.4 trillion in assets globally, and had placed more than $0.5 trillion into the hedge fund segment. This figure represented roughly a third of all assets under management by hedge funds.

The respondents were geographically diverse, with 24% coming from Europe, 13% from Asia and 61% from Canada and the United States. This distribution is a reasonably accurate reflection of the institutional investor community as a whole. Geographic segmentation proved to be important in evaluating the survey's results, as investors in different regions expressed divergent views on a number of important topics.

Respondent Base (2009, based on number of respondents)

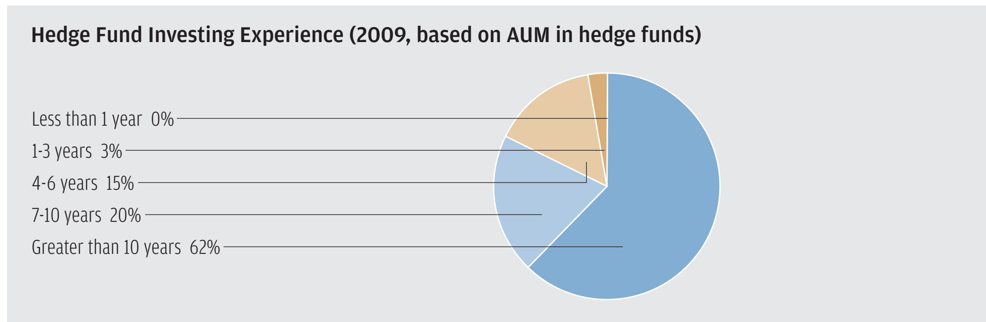


Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010.

Figure 37

Survey participants also represent a mix of levels of experience in, and exposure to, hedge fund investing. The majority reported more than 10 years of experience investing in hedge funds, and 82% of respondent assets invested in hedge funds were controlled by investors who reported at least 7 years of experience in the space. We included a significant number of investors who were newer to hedge funds. These respondents were identified using the same quality and demographic screens as the more experienced investors, who had placed the lion's share of the capital into hedge funds at the time of the survey.

The perspectives of the newcomers proved to be important, as they represent the largest source of potential capital inflows and often had views that differed from those of more experienced investors on several important points. Nearly 30% of respondents represented they had more than $1 billion invested in hedge funds at the time of the survey. The remaining 70% consists of investors from the spectrum of placement sizes and includes responses from several high quality investors with very little, but high potential, exposure to hedge funds.



Source: J.P. Morgan Capital Introduction Group, Institutional Investor Survey—2010. Figure 38

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