2008 was a period of profound market dislocation as most asset classes suffered considerable declines. But equities—a central component in many U.S. portfolios—endured the brunt of the impact.

The aftermath has left many equity investors questioning what went wrong and wondering how to respond in both the near and long term. Should investors re-balance tactically to their original equity allocations, or perhaps step back and re-think their overall strategic allocations?

Against this backdrop, we tapped several Equity CIOs and investment professionals from across J.P. Morgan Asset Management to hear their insights on equity markets. All agree, with conviction, that what lies ahead is an enormous opportunity for equity investors to harvest attractive returns.

Q. Every money manager says now is a great time to invest in their particular asset class. So why should investors focus on equities per se?

Paul Quinsee: You can say all risk assets are cheap to some degree. But from the perspective of valuations and the potential for strong future returns, there is a truly compelling argument for investing in equities today. Looking back, equities didn’t just have a bad year in 2008, they’ve had a bad decade! But we now see an incredible opportunity to buy attractive, well-run U.S. companies generating free cash flow yields of 8% to 10%, or higher. The last period we saw such attractive valuations was in the 70s and early 80s.

Christopher Jones: Decimation spawns opportunity. The key point investors should focus on here is: What are future return expectations for equities?

Over the last 10-year period ending 12/31/08, equities have returned zero net dollars for investors. This has been the worst ten-year period dating back to the Great Depression. And if you go back 18 months, it’s been the worst return in 100 years! Historically, the best returns have been delivered following periods of crisis and fear. Going back just three decades, equities generated strong double-digit returns following the ‘87 market crash, the ‘91 recession, the Long Term Capital Management debacle and Asian crisis in ‘98, and then 9/11 in 2001.

Investors should remember that U.S. equities will eventually revert to the statistical mean because economic crises historically have been cyclical, not systemic. The fact that we had almost a 40% jump in just the last two months (as of 5/8/09) is clear evidence that equity markets anticipate a positive outlook. So it comes down to
what investors believe will happen in the economy and markets, and when some form of normalization will materialize, and be sustained.

JONATHAN SIMON: Looking at the value space, this is one of the best opportunities I’ve seen in terms of potential for long-term appreciation in my 21 years of investing in equities. Value stocks remain extremely depressed as they include financials and cyclicals—two of the hardest hit sectors during this market dislocation. This is where skilled active value managers can truly shine by identifying good quality names amidst the rubble. The financial names have enjoyed a dramatic recovery from the extremely low levels of early March, but still offer reasonable value.

BALA IYER: When analyzing companies from a discounted cash flow model perspective, stocks appear attractive today. But in order to truly realize value, you need a catalyst. The emerging catalysts that we are seeing are: a moderation in the rate of decline of the U.S. economy, restoration of banking sector profitability and stabilization of consumer spending.

The business models of many impaired companies have changed drastically... relying on our forward-looking fundamental research was critical in avoiding those names. —Nigel Emmett, Senior Client Portfolio Manager, International/Global Equity

Q. What about international and emerging market equities? Is there a compelling argument to invest there as well?

NIGEL EMMETT: Absolutely. Look at equity dividend yields vs. bond yields. The projected dividend yields on non-U.S. equities are higher than the yields on the respective foreign government bonds, in most instances. Although we expect additional dividend cuts down the road (which will drive yields down), dividend yields should remain very competitive compared to those of local government bonds.

RICHARD TITHERINGTON: Historically, emerging markets equities (EME) have been a volatile asset class. Looking back 20 years, the right time to buy EME was when they traded below 1.5 times book value. Investors were rewarded with good returns over the subsequent 3-5 years.

We are currently at 1.4 times book, clearly in buy territory. Aside from the EME credit crisis in the 90s, this approach to analyzing entry points has worked. Periods of caution have been when EME valuations traded above 2.5 times book. Also, although EME dropped further than in some developed countries, they recovered more strongly. From the lows of 10/27/08 through 3/31/09, the MSCI Emerging Markets Equity Index was up 27% while the MSCI World Index posted a 2% decline.

Q. Describe how you have avoided the now apparent “value” traps, such as financials, in 2008?

NIGEL EMMETT: I think some of our competitors bought more of and/or held onto the wrong stocks in many cases in 2008, which proved to be disastrous. It’s extremely difficult to make up 500 to 1,000 basis points of underperformance without taking significantly more risk. What helped our international portfolios was underweighting some of the companies that experienced the most severe stock price declines.

Our key differentiator was a commitment to forward-looking analysis, where we concluded that the asset value of many names was severely and permanently impaired. While a significant number of these companies may have appeared attractively priced on paper, the key to relative success was questioning the “true” forward-looking earnings capability of the business model and balancing likely future profitability with the amount of potential risk.

PAUL QUINSEE: During a period of unprecedented market dislocation, valuations were a poor guide to stock selection, particularly in financials. Our Large Cap Core team exhibited strong results relative to our peers and the benchmark index primarily because we better understood the risks in those names. From our 23 years of experience in managing equities, we have learned when to take risks and when to avoid them. We were already familiar with the dangers of financial leverage: stocks may appear very cheap, but if they’re highly levered, and the market and economy suddenly shift, those companies’ stocks will pay a heavy price.

CHRISTOPHER JONES: Financials make up a much smaller percentage of the growth universe than they do in core or (particularly) value. So the performance challenges that many of our competitors faced in 2008 were in many cases more related to the economic crisis caused by the financial meltdown. For our team, our quality bias, together with the strength of our stock selection and risk management, allowed
us to pick the right names and underweight or avoid the losers for the most part.

More generally, successful growth investing involves a very different mindset from other parts of the market. Almost by definition, the universe of companies is more dynamic than average—both on the way up and the way down. When growth is expanding or accelerating, investors often underestimate how well and for how long a company can perform (think of Google). But when that growth starts to decelerate or is challenged competitively, investors should be very dispassionate and be prepared to sell. Many in our peer group did not recognize the changes that were taking place last year and doubled down, compounding their problems.

RICHARD TITHERINGTON: The key to outperformance of our Global Focused strategy over the past year against its benchmark and our peers has been disciplined stock selection—our core philosophy. Since we generally own higher quality, less cyclical names than the average EME strategy, we tend to underperform during the later stages of bull markets and outperform during periods of stress.

Q. How important was risk management in navigating through the market turmoil?

RICHARD TITHERINGTON: Proper risk management controls are critical when investing in emerging markets. In reaction to the beginning of the bear market (early 4Q08), we reviewed all of the portfolio holdings in our Global Focused strategy to ensure each passed our quality stress tests for financial risk, solvency risk and liquidity risk. As a result, we reduced our holdings from the higher end of our range to the lower end (from 75 to 60), essentially removing the names about which we had lower conviction: In other words, those that appeared to be more stressed in a tight credit environment such as property companies in China and the Middle East.

Furthermore, we seek to own companies that are not highly correlated with one another in order to maximize the number of independent bets in the portfolio.

CHRISTOPHER BLUM: Rigorous risk management is a critical tenet in effectively managing our behavioral equity strategies. Our portfolio construction process is subject to sector weight tolerances, turnover limits and a targeted number of stocks. A portfolio optimizer balances the above and attempts to maximize the portfolio’s expected “excess” return. The stock rankings determine expected excess return for each individual security for inputs to the optimizer. Based on these constraints, risk is automatically controlled so that human emotion doesn’t take over.

Yet another area that allows us to monitor risk is the qualitative component of our investment process. By leveraging our qualitative insights, we can better determine whether or not those stocks that screen as “cheap” are true bargains. It also helps us identify risks that might not be flagged by our models.

NIGEL EMMETT: For our active international strategies, we monitor risk mainly at the portfolio level. Everyone from the portfolio manager down to the analysts is thinking about not just what could go right but also what could go wrong, and sharing their ideas with one another.

Although our international portfolios avoided some of the big losers last year, there were a number of names that did well which we didn’t own. One such example was Japanese utilities—a sector that investors ran to for safety. We had felt that many companies within this area of the utility sector were already fully valued. And although we appreciate the sector’s defensive characteristics, we maintained our core investment principles and thus avoided these relatively expensive names.

Q. What are some concerns that you are hearing from clients?

PAUL QUINSEE: In 4Q08, clients dealt with a number of emergencies in their portfolios that they normally never had to face—e.g., issues with money market funds, securities lending, prime broking. As credit stabilized, those issues were brought under control. Today, asset allocation is the prominent issue. Should clients aggressively invest in equities to rebalance back to their strategic equity targets, or should they reduce their portfolio’s equity weighting going forward? And if they decide to invest more in equity, where should that capital come from?

When clients find their portfolios so far away from their long-term norm, they begin to reflect on whether the world has shifted to a
new paradigm, and if so, how should they react to this change. That's really where the discussion is right now. When markets begin to normalize, we will begin to see clients rebuild their equity allocations with even greater emphasis on manager selection.

RICHARD TITHERINGTON: Some of our EME clients are questioning the sustainability of emerging markets and whether the talk of de-coupling from developed markets is dead. Our response has been that in the past, emerging markets lacked fiscal responsibility during previous downturns. However, today, emerging nations have significantly more fiscal firepower due to more stringent economic and monetary policies implemented during the boom years. Additionally, EME countries today appear to have widespread ability to run counter-cyclical fiscal stimulus in the face of the current global economic weakness.

We are also hearing that EME returns are highly correlated to commodities returns. These markets themselves are top-heavy in commodity names, but the underlying economics in a number of EME countries is more diversified than their stock markets would indicate. Brazil is a good example where the nation’s top two stocks are commodity names that make up 40% to 50% of the index. Yet commodities represent only 15% of the Brazilian economy. In reality, the direction of commodity prices is an indicator of where you need to be in the emerging world rather than the overall attractiveness of the emerging world itself: If commodity prices fall, it’s very positive for China; if commodity prices rise, it benefits Russia.

BALA IYER: The most common question I’m hearing from clients is around valuation signals. Specifically, when will the toolset for picking stocks work again? Unfortunately, it hasn’t for the majority of the last seven quarters dating back to the middle of 2007. I think this is why many quantitative managers have struggled over the last two years. However, the valuation signal has had a powerful rally since the recent market bottom of March 9. It remains to be seen if this trend is sustainable.

Q. What lessons have you learned over the past 12-18 months?

PAUL QUINSEE: I think we validated what we’ve been saying for years now: Don’t buy cheap stocks just because valuations say they’re cheap. This mantra allowed us to avoid the value trap that many (previously) successful managers fell victim to. Some of those financial names that imploded initially ranked high in our model. Still, Urmas Wompa, our analyst who has been covering financials for more than 25 years, acknowledged that he could not analyze/value some of these stocks because there was rising fear that the companies’ business models would be severely compromised following the collapse of easy credit.

Taking advice from Urmas, Tom Luddy, our Large Cap Core and 130/30 manager, decided that rather than buy some of these highly ranked financial names, he would instead move down the ranking scale and buy middle-ranked stocks instead. In normal times, we would avoid this strategy. But given elevated risk associated with cheap stocks, we decided to buy the more expensive names, which worked out in our favor.

RICHARD TITHERINGTON: It’s important to understand the drivers of the companies that our managers invest in. What we need to do is differentiate companies whose business model is driven by cheap credit during a boom in global risk-taking from those whose business model is driven by a sustainable competitive advantage. During the tail end of bull markets, you see investors emphasizing momentum over quality.

Looking back, we would have liked to eliminate some of the lower quality names sooner. But I believe the benefits of being long-term investors far outweigh the pitfalls over time. And that’s what the 15-year track record of our Global Focused strategy would suggest.

CHRISTOPHER BLUM: It’s more important than ever for managers to focus on each stage of their investment process. When we describe our behavioral investment process, we frame it in four parts: quantitative research, disciplined portfolio construction, qualitative overlay and value-added trading. In today’s volatile environment, overlooking any of these key components can lead to sub-optimal returns.
Q. We’ve all heard that passive managers tend to outperform active managers over the long term. What are your thoughts?

**PAUL QUINSEE:** The S&P 500 index has always been a respected competitor in the U.S. large cap space. During the few years leading up to last year’s market dislocation, even the most skilled active managers found it difficult to generate excess returns. Within that period, valuation spreads between cheap and expensive stocks were very tight, allowing little room for active managers to generate real alpha. But in 2008, and through the first quarter of 2009, the majority of active large cap core managers outperformed the S&P 500 index.

Today, despite the recent rally in equity markets, our large cap core managers continue to see tremendous opportunities in terms of depressed, yet attractive, stocks that they believe will recover. Further risks remain, so we need to be cautious and selective. As the world begins to normalize, we believe we are strongly positioned to beat the S&P 500 again.

**CHRISTOPHER JONES:** In general, active growth managers have held their own relative to their benchmarks, with the median large cap growth manager outperforming the Russell 1000 Growth index over the ten-year period ending 12/31/08.

That said, active management in the large-cap space has changed considerably in the last five years. The market has been demanding more differentiated, higher return, higher tracking error products, so the dispersion of returns between managers and their benchmark indices has been rising. There was greater appetite for return, but with it, increased risk taking. What resulted was a number of managers getting burned in 2008; their investment process did not pass the market’s “stress test.” Many of them may never recover from the deep hole they have dug for themselves. We believe the managers who have prevailed are those with a consistent, replicable and robust investment process in place.

**RICHARD TITHERINGTON:** Emerging markets are the least efficient markets globally, offering incredible opportunity for skilled managers and analysts to uncover alpha in various regions, countries and frontiers. That’s why the median active EME manager has outperformed the MSCI Emerging Markets Index over a ten-year period ending 12/31/08. “Feet on the ground” in every key region is critical to identifying new opportunities as well as avoiding traps.

**NIGEL EMMETT:** This passive versus active debate is a common misperception in the international space. Overall, the median manager—both international and global—has done a good job adding alpha. You’re in an environment now where manager skill is the key driver of alpha—more so than in years past—as the gap between winners and losers has widened. Fundamental insight should leave a skilled active manager well-positioned for the future.

“**To have confidence in your manager you have to (a) know they have done well in the past, (b) understand how they delivered that performance and (c) have confidence they will continue to deliver that performance in the future.**”

—Paul Quinsee, CIO, U.S. Large Cap Core

Q. Where do you see the best opportunities playing out?

**JONATHAN SIMON:** We expect further volatility in the near term. However, investors buying equities at today’s levels may be rewarded perhaps two to three years down the road.

Value, in particular, appears extremely attractive. Despite the release of some optimistic economic data recently, we anticipate the economy will remain sluggish for quite some time. So, it’s important to be selective when choosing companies that will generate growth and do well in a challenging economic environment. Traditional defensive sectors such as healthcare and consumer staples should perform well even after the initial recovery phase has played out.

**PAUL QUINSEE:** We’ve begun to take on more risk in our portfolios, gradually shifting from defense to offense as we’re seeing value essentially across every industry group except financials. At the moment, we’re underweight financials as they continue to be leveraged and government involvement remains uncertain. However, there are some pockets of opportunity in select investment banks. Technology is attractive as well, and should be one of the primary beneficiaries once the economy picks up. These stocks typically have great balance sheets, global diversification, and short product cycles. We are also selectively looking at levered companies but are mindful of associated risks.
**CHRISTOPHER JONES:** In the large cap space, there are two themes we are focusing on. The first involves companies with some degree of economic sensitivity that have had their valuations suppressed by the macro environment, but where their competitive positions have actually been strengthened by the demise of weaker competitors. Parts of the consumer and technology space fit that bill, as do a number of financials. The second is higher traditional growth stories where the secular trends are accelerating—broadband and wireless communications applications leap to mind in this case. Growth will be increasingly priced at a premium as the economy recovers and risk premiums coming in should add to the multiples the best companies will command.

In small cap, the carnage in the market has created some phenomenal opportunities for us to buy great franchises at very attractive prices. As usual, the broader story with small cap is simple and unchanged: Clients want focused active managers where alpha is driven by deep research and sharp individual stock selection.

**Q. What keeps you up at night?**

**NIGEL EMMETT:** The uncertainty of the economic environment produces restless sleep for institutional investors, portfolio managers and analysts alike. What’s really different this time around is the lack of clarity in the near-term outlook for earnings. The pace of change is much faster than what we have ever experienced before.

**PAUL QUINSEE:** We are dealing with an unprecedented economic environment. The scale of the problems around the world is of major concern to investors. But experience tells us that the time of maximum pain is also the time of maximum opportunity. You have a situation where there’s tremendous uncertainty, where spreads between cheap and expensive stocks are very wide.

Whenever you’ve done well, you want to be mindful of the numbers that come next. We need to remain forward-looking, searching for opportunities that will reward us most in the recovery, but always being mindful of risk. Although we believe the U.S. government’s fiscal stimulus should provide a spark to the weakened American economy, we remain conscious of the dark scenarios that could make things worse than they are today.

**Over the past decade, investors were searching for equity-like returns but in much more complex structures often involving leverage, illiquidity, lock-up periods, limited or no transparency and no real-time valuations of assets.**

—Paul Quinsee, CIO, U.S. Large Cap Core

**Q. Any parting words for investors?**

**CHRISTOPHER JONES:** Investment performance is obviously front and center in the eyes of clients. But the core issue is how that investment performance is generated. As a result of several manager blow-ups in 2008, I think you’ll see institutional investors placing greater emphasis on the clarity of a manager’s investment process.

We are big believers in staying very focused and accountable. That means keeping our portfolio managers and analysts focused on their sole objective and not adding to their responsibilities by allowing them to manage or cover other strategies or sectors. For instance, you can’t expand an analyst’s coverage from 50 to 100 names without impacting quality. Our analysts know exactly how they get paid and what their job is.

We believe equities have unfairly sold off compared to some of the more illiquid investments on the alternative side as well as on the fixed income side since many investors have used their equity sleeves as ATMs. Regardless, if the economy picks up, equities are positioned to be the leaders in the market recovery.

**PAUL QUINSEE:** Over the past decade, investors were searching for equity-like returns but in much more complex structures often involving leverage, illiquidity, lock-up periods, limited or no transparency and no real-time valuations of assets. Investors should ask themselves: Is there a need for these limitations and uncertainties in illiquid investments when you can invest in equities? Stocks are a very liquid, transparent asset class with historically depressed valuations; one that allows for daily pricing and risk that can be easily quantified; one that has been out of favor for a decade and is positioned, in our opinion, for a strong recovery. These are compelling arguments to reignite the romance with equities again.
**RICHARD TITHERINGTON:** The market correction has pushed virtually all absolute valuations of EME back into constructive territory. EME valuations are cheap across the board and consistent with strong positive returns if history is any guide. Similar absolute valuations have usually proven to be good strategic entry points.

By and large, the emerging markets banking sector (except Eastern Europe) has avoided the whole U.S. subprime debacle as most of these banking companies were prohibited from owning U.S. subprime debt. So, in essence, the main issue is global liquidity, rather than toxicity for EME. What you are seeing is an economic decoupling from the developed world (in that we don’t anticipate the emerging world will fall into a recession) but what you won’t see is a financial decoupling.

**JONATHAN SIMON:** “Back to basics” is the recurring theme in equities today. We’ve always maintained this core tenet in the way we manage money. Our focus in the value space has always been on companies that exhibit strong business franchises with good management and solid finances. We look for a culture where the management team uses their company’s balance sheet to create long-term intrinsic value on a per share basis, rather than one that is incentivized by short-term rewards of cash bonuses and stock options.

As a result of this approach, we may underperform in the short term. But our experience and discipline, which comes with more than 21 years of investing in equities, should reward investors over the longer term.

“We look for a culture where the management team uses its company’s balance sheet and cash flow to create long-term intrinsic value on a per share basis rather than one that is incentivized by short-term, rewards of cash bonuses and stock option gains.”

—Jonathan Simon, CIO, U.S. Value

**NIGEL EMMETT:** These days as the operating environment and, consequently, corporate earnings remain unclear, we continue to place greater emphasis on quality management, sustainability of the business model and the ability of management to generate attractive returns over the business cycle.

International equities should provide the potential for attractive returns going forward. We believe active managers are well-positioned to add alpha, particularly in an environment where the markets may not have truly differentiated between the long-term winners and losers.

**BALA IYER:** I believe we have the foundation in place for a sustainable bull market. The market rally back in October 2008 failed because the economy continued to worsen, corporate profits continued to decrease, banks profits continued to decline and the housing market continued its accelerated slide. Today, we are seeing some gradual stabilization on all these fronts. But even in bull markets, we should expect a number of corrections along the way.
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