The coming years present an extraordinary challenge for policymakers and investors. Governments across many developed markets are trying to rein in multi-decade high budget deficits and debt-to-GDP ratios, their hands forced to a degree by credit-rating agencies (indeed, debt-related concerns pushed Standard & Poor’s to downgrade the U.S. long-term sovereign rating for the first time in history in August).

IN BRIEF

In this “low for long” rate environment, generating income remains a challenge for investors who need to maintain portfolio yields. However, certain market dynamics are creating opportunities to pick up yields across a range of asset classes.

• A recovering economy and low default rates make the risk/reward trade-offs for high yield debt and leveraged loans potentially attractive.
• Strong corporate balance sheets are creating equity income opportunities as companies look to increase dividends.
• As market volatility makes it more expensive and difficult to access traditional financing, investors can find higher yields in other fixed income sectors, such as mezzanine debt.
• Given the current recovery in property values, fundamentals and cash flow, real assets and REITs are generating attractive and stable yields with the potential for equity-like upside through measured growth in payouts.
Subsequent prospects for slower growth are pushing central banks to keep monetary policies easier for longer. In August, for example, the Federal Reserve suggested that the Fed funds rate would remain at near-zero levels at least until mid-2013, serving as an anchor for yields along the curve. At its two-day policy meeting in September, the Fed also announced “Operation Twist”—which includes plans to buy about $400 billion of Treasuries and sell shorter-dated bonds by June 2012—in an effort to push down longer-term yields (primarily as a way to help support the housing market).

Meanwhile, the Bank of England announced a new round of quantitative easing this fall in an attempt to stimulate the economy. The European Central Bank, while raising policy rates twice this year to 1.5%, now has turned a corner and seems inclined to maintain easy policy as peripheral Economic and Monetary Union (EMU) pressures build. Finally, Japan is expected to keep policy rates low for an extended period. Despite the faster-than-expected recovery from the tragic March earthquake and tsunami, broader growth trends remain lackluster, in part because government stimulus efforts are limited by the G-7’s largest debt-to-GDP ratios.

For investors, this developed world “new fiscal world order” means it will be increasingly difficult to find income. Consider U.S. and German 10-year yields—both were trading near record lows in early September. As of October 7, the developed world’s average policy interest rate stood at 80 basis points, nearly 260 basis points below the average in 2005–2007. We believe those yields could be biased lower over the coming 12 months, and even in two to three years, the average yields in developed markets are only likely to have recovered to current levels.

So what are investors who need income to do? In the following pages, we explore some income-generating strategies for investors.

Corporate Mezzanine Debt

The current market environment creates an attractive opportunity for corporate mezzanine debt—primarily subordinated debt used for leveraged acquisitions or refinancing of maturing obligations—and is driven by a number of distinct market trends:

- Large supply/demand imbalance for private, dedicated mezzanine capital: The addressable set of mezzanine opportunities is growing as private equity (PE) firms have significant uninvested capital. The top 25 PE firms, as defined by capital to be invested, have circa ~$130 billion of equity to invest over the next 3 to 4 years; we estimate this capital will require up to $400 billion of senior and subordinated debt financing to effect these leveraged buyouts (LBOs); mezzanine “dry powder” for deals more than $1 billion in size is estimated at $10 to $15 billion or less than ~3% of potential demand.

- Market volatility—driven by ongoing EU concerns, U.S. macro issues, risks to economic growth and unstable equity markets—is increasing the potential cost and reducing the predictability and availability of traditional, underwritten/syndicated financing.

- Large recent outflows from high yield and loan mutual funds are limiting banks’ visibility on the buyer base for syndicated high yield and loans, which is further impacting the cost and availability of traditional financing on commercially reasonable terms.

- Structural shifts in the financial landscape caused by established and pending regulatory action (Basel III, Volcker, Dodd-Frank) have resulted in a decreased appetite to risk “hung” loan or high yield commitments on bank balance sheets.

As a result of these factors, issuers will have less certainty and access to traditional syndicated credit markets and this, in turn, is driving strong deal flow and a positive pricing environment for mezzanine.

Corporate mezzanine debt offers substantial excess spread (~400–500 basis points) versus comparable liquid high yield names (see Exhibit 1 for a comparison of typical terms). This illiquidity premium results from providing certainty and long-term “buy and hold” financing to corporate borrowers. These premiums are highest when traditional sources of debt financing (i.e., banks) become harder and more expensive to access.

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Global Infrastructure Loans

Institutional investors have an opportunity to invest in mature infrastructure loans with low risk profiles and attractive yields. Infrastructure loans—which are loans originated primarily by project finance banks—are high quality, long-term, floating-rate assets that are senior secured by monopolies or assets with monopolistic characteristics.

While pension plans and insurance companies are increasingly seeking out long-term assets to match their liabilities, traditional banks are seeking to mitigate the capital requirements from Basel II and III on holding long-term loans. As a result, in today’s environment, undercapitalized bank balance sheets and increasingly stringent capital requirements for long-dated infrastructure loans have created an opportunity for fixed-income investors to purchase these loans at substantial discounts and attractive yields.

As shown in Exhibit 2, because of their historically low default rates and high recovery rates, the average five-year cumulative credit loss rate for infrastructure loans is 56 basis points, according to Moody’s and J.P. Morgan Asset Management (data as of February 28, 2011). By comparison, the average five-year cumulative credit loss rates for global corporate A-rated bonds and Baa securities are 49 and 119 basis points, respectively.

In addition, infrastructure credit generally improves over time as the asset performs and the associated debt declines.

Historically, infrastructure loans with 20- to 30-year terms have generally been priced at 100 to 150 basis points over LIBOR with quarterly or semi-annual interest and principal amortization payments. Recent capital rules for banks have widened credit spreads, which stabilized in 2010 closer to 300 basis points. As shown in Exhibit 3, current spreads for infrastructure debt are approximately equivalent to BB corporate debt, according to Barclays Capital, Dealogic and J.P. Morgan Asset Management estimates (data as of 1Q, 2011).

In our view, credit spreads, ranging from 200 to 300 basis points are sustainable over the medium term. Depending on the rate environment, swapping a 25-year loan priced at LIBOR plus 300 basis points may generate fixed interest rates...
between 5.70% and 5.90% on a senior secured loan with a duration of about 15 years, according to estimates from a leading third-party market maker (as of end of September).

In recent months, there have been a number of sales of infrastructure loan portfolios, primarily by undercapitalized European banks, at attractive discounts and spreads. Our discussions with banks suggest that while they wish to continue to service their clients by underwriting new infrastructure projects, they are also likely to divest portions of their loan portfolios—providing investors with continued opportunities to invest in mature loans in this sector.

Emerging Market Debt

Emerging market debt offers more attractive yields relative to U.S. and other developed market bonds. Issuing emerging market countries—which have stronger growth and fiscal dynamics—are showing signs of stability due to more established democracies, thriving commodity-based economies and stronger currency reserves.

Recent net inflows into emerging market debt reflect structural and cyclical shifts in emerging markets that have resulted in much stronger macroeconomic backdrops, both in absolute terms and also relative to their developed-market peers. Emerging markets are expected to outpace growth in developed markets. As shown in Exhibit 4A, emerging markets are expected to post average GDP growth of 5.5% in 2011, according to the International Monetary Fund’s World Economic Outlook, April 2011. This growth is increasingly being driven by domestic demand as emerging markets consumption now exceeds U.S. consumption. Emerging markets are also in a stronger fiscal position with an average 35% debt-to-GDP ratio versus 98% for developed markets (Exhibit 4B, IMF, April 2011).

Source: International Monetary Fund’s World Economic Outlook, April 2011. Data for 2011-2016 are forecasts. Forecasts are based on market conditions and subject to change without notice.
Dollar-denominated emerging market sovereign and corporate debt—which generally have investment-grade ratings—offer attractive yields of just over 6%, at durations of five to seven years (J.P. Morgan Asset Management, September 2011). We expect yields and spreads will gradually tighten over the medium to long term as investors reappraise the asset class (Exhibit 5). This combination of factors makes emerging market debt (EMD) an attractive investment alternative for fixed income investors looking for additional yield and diversification away from developed-market allocations and the dollar.

**Global Equity Income**

In a world where the “income” part of fixed income is reduced, investors looking for sources of yield should consider equities for this purpose. Currently, equity income—which also offers potential capital appreciation—offers a more compelling yield than the 10-year Treasury.

Recently, the projected 12-month forward-looking yield for the MSCI World Index was 3.22%, as of September 30, up from 2.9% at the end of July, and higher than the 10-year Treasury yield. Companies’ ability to support their dividends from earnings is also strong. As shown in Exhibit 6, dividend payout ratios—the percentage of earnings paid to shareholders in dividends—is low (29.1%, MSCI World Index as of September 30, 2011), and consequently, the dividend cover—the earnings per share divided by the dividends per share—is high (3.44, MSCI World Index as of September 30, 2011).

Although equities involve more risk and near-term volatility, dividend payers tend to be larger, more stable companies with undervalued stock prices and solid financials. Dividend payouts have been historically stable, even in periods of earnings volatility (Exhibit 7).

Simply identifying high current dividends is not enough. Investors should focus on companies with attractive yields that also have the financial strength—sustainable cash flows, a strong product range, resilient margins and good balance sheets—to support their operations and maintain a solid dividend stream for shareholders in difficult times. Also, with
Generating Income in a Low-Yield Environment

well-managed, dividend-paying companies in high demand, investors should widen their investment scope to take advantage of dividend opportunities around the world and across a wide range of sectors to avoid concentrating their investments too narrowly.

Commercial Mortgage Loans

Commercial mortgage loans (CMLs)—high-quality loans that are secured by stable income-producing commercial properties that are well diversified by use, geography and borrower—offer compelling risk-adjusted returns of approximately 4% to 5%, according to estimates from J.P. Morgan Asset Management (as of the end of September, 2011). The relatively high yields are stable, paid current and call protected. CMLs also exhibit low correlations with other asset classes—offering investors portfolio diversification benefits.

Current valuations look attractive as property fundamentals and values—which experienced significant corrections—show signs of stabilization and recovery. Although commercial mortgage loan spreads have compressed, they remain at attractive levels (Exhibit 8). Moreover, the credit turmoil of 2008 and 2009 has resulted in lending standards that are more stringent today than historic norms. Finally, the recent market dislocation provides portfolio lenders such as J.P. Morgan Asset Management with significant opportunities over commercial mortgage-backed securities (CMBS) lenders that have largely constrained lending because of the market uncertainty.

Non-Agency Residential Mortgage-Backed Securities

The non-agency residential mortgage-backed securities (RMBS) market—bonds backed by pools of home loans that are not issued or guaranteed by government agencies—is extraordinarily diverse in its range of potential investments. Investors can find securities ranging from well-performing credit-enhanced bonds to bonds with extreme leverage. Meanwhile, since the majority of securities have been downgraded to below investment grade by at least one of the credit-rating agencies, these investments may be more appropriate for long-term investors willing to provide liquidity and ignore the variability in the rating agencies views.

Focusing on the more senior portion of the market—which reflects what used to be investment-grade debt at the time of issue but may have been subsequently downgraded—the expected average internal rate of return (IRR) can range from 5.75% to 9.00%, based on factors such as leverage, cash flow coverage, term, property type, location, loan structure and asset-specific characteristics.

Non-Agency Residential Mortgage-Backed Securities

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Source: J.P. Morgan Asset Management, Barclays Capital; data as of September 30, 2011.

* Spreads currently ranging between 200–300 basis points based on variables such as leverage, cash flow coverage, term, property type, location, loan structure and asset-specific characteristics.

EXHIBIT 7: DIVIDENDS ARE MUCH LESS VOLATILE THAN EARNINGS

Source: IBES, Datastream, European Equities, Credit Suisse.

EXHIBIT 8: ALTHOUGH COMMERCIAL MORTGAGE LOAN SPREADS HAVE COMPRESSED, THEY REMAIN AT ATTRACTIVE LEVELS
Leveraged Loans

Leveraged loans (also known as bank loans) are loans made to businesses with generally below investment-grade credit ratings. The loans are typically senior instruments, secured by the debtor’s assets, and rank first in priority of payment in the capital structure, ahead of unsecured debt. As a result of their senior secured status, bank loans have historically had higher recovery rates and lower volatility relative to corporate high-yield bonds.

Leveraged loans typically offer higher yields than the Barclays Aggregate or Treasury yields and can also act as a hedge against longer-term inflation risks. Investors can gain protection from rising interest rates since the loans’ floating-rate coupons reset every three months or so—enabling yields to rise if short-term rates rise. In other words, investors may be able to avoid likely capital losses in a rising rate and inflationary environment.

While the events of the past several months have reduced concerns over inflation, with interest rates near historic lows, the potential capital loss from rising interest rates could be severe. A move in the 10-year U.S. Treasury from 1.9% to 5%, for example, will result in a 23.7% capital loss (Bloomberg, as of September 30, 2011). And today’s extraordinary monetary accommodation raises the risk of greater inflation tomorrow. Staying short, on the other hand, is not an attractive option for many investors either. Investing in short-duration two- or five-year U.S. Treasury notes, for example, will only yield 25 or 95 basis points, respectively (Bloomberg, as of September 30, 2011).

Meanwhile, the opportunity to earn higher yields in leveraged loans is even greater today, given the loans’ LIBOR “floors” (the income generated by leveraged loans has long been based on a spread over LIBOR, or the London Interbank Offered Rate). Given the historically low levels of LIBOR today, new loans often have LIBOR floors that pay the investor the spread plus the higher of the “floor” or LIBOR. LIBOR floors, for example, have recently ranged from 100 to 200 basis points, versus current 3-month LIBOR of 38 basis points, according to Bloomberg, as of September 30, 2011.

As shown in the Exhibit 9, loans are trading at a spread of LIBOR plus 702 basis points—a level that tends to occur only near the bottom of a deep recession, such as 2001-2002 or 2008. Meanwhile, in another sign of how attractively priced leveraged loans have become, the spread between loans and high yield debt is now only about 109 basis points; typically that spread has been 150 to 200 basis points.

At these levels, current spreads are implying an annual default rate of more than 12.4%4 over the next few years, a level we believe is highly unlikely. Default rates spiked to almost 11% in 20094 following the sudden and sharp recession and credit crisis, but declined to less than 1% today; most strategists and market participants expect default rates to remain low even with a slowing economy. In addition to high current yields, the decline in loan prices1 to an average of 90.35 provides capital appreciation opportunities to further enhance returns. As Exhibit 10 shows, we believe the potential returns on loans are even more attractive relative to the Barclays Aggregate’s lower yields than they were prior to the August Fed meeting.

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1 Using 420 basis points historical average spread of the Credit Suisse Leveraged Loan Index and assuming normal 3% average default rate and 70% recovery rate.
2 Credit Suisse Leveraged Loan Index, discount margin to maturity at September 30, 2011.
3 Source: Credit Suisse. As of September 30, 2011. Discount margin to maturity. Current average maturity for Credit Suisse Leveraged Loan Index is 4.37 years. Duration of Credit Suisse High Yield Index is 4.29 years.
4 S&P LCD
5 Credit Suisse Leveraged Loan Index, average price at September 30, 2011.
High Yield Bonds

The high yield market provided strong returns in 2009 and again in 2010. As a result of the recent market correction, the high yield debt market again offers an attractive and compelling risk/reward trade-off. Risk premiums have retraced beyond the long-term average, providing investors with attractive yields if they are willing to take on additional risk.

Currently, high yield bond spreads over similar duration Treasuries are averaging around 834 basis points, bringing total yields to more than 943 basis points, according to the J.P. Morgan Global High Yield Index (as of September 30, 2011). Such spread levels are implying default rates of 8% to 9%, compared with current default rates of about 1.2% (Exhibit 11).

At these levels, the market is pricing in a recession caused by declining corporate profits and deteriorating credit fundamentals. In particular, BB rated high yield investments offer attractive valuations versus investment-grade BBB debt. As Exhibit 12 shows, the spread difference between BBB and BB is currently about 340 basis points.

Unlike higher-quality issues, high yield bonds tend to be more sensitive to economic cycles than interest-rate movements. They generally perform well in an expanding economy marked by improving corporate finances and a declining default outlook. To date, for example, corporate balance sheets are strong, reported earnings are ahead of consensus estimates and firms are maintaining record levels of cash on their balance sheets.

But government austerity programs and weak consumer spending are still weighing on the economy—a factor that will likely keep a lid on Treasury yields for some time. Compared to government debt and investment-grade alternatives, the level of yield now available is much more attractive relative to the risk taken.

Global Real Assets

Global real assets are a natural next stopping point for investors in the current market environment. First, the various sub-sectors of the real assets world—such as private equity real estate, infrastructure and real estate investment trusts (REITs)—offer yields that are not only currently very competitive with other fixed-income alternatives (Exhibit 13), but also exhibit a long-term stability that should offer comfort to investors that these yields are sustainable contributors to both income generation and total returns. Secondly, while bonds pay out a fixed coupon over the duration of the bond itself, real assets offer a bond-like yield that can also grow in line with cash flow growth. Therefore, as a complement to bond holdings, real assets offer investors both a stable, competitive yield AND the potential for equity-like upside. In the context of a diversified portfolio, this optionality can benefit investors across various economic scenarios.
Private Equity Real Estate

As shown in Exhibit 14, direct investments in commercial real estate have historically demonstrated a consistent ability to generate attractive and stable yields for their investors. Many aspects of the property business lend themselves to yield generation. Tenants lease space with often multi-year contracts that lock in rates and may even allow for periodic increases in the rent over the life of the contract. While there is idiosyncratic risk associated with a single property investment—e.g., a large tenant suddenly goes bankrupt or a persistent decline in the attractiveness of a property’s neighborhood results in secular declines in market rental rates—a multi-property portfolio can largely diversify away such risk by owning multiple property types in different geographies, staggering lease renewals (i.e., thousands of leases across a portfolio will come up for renewal at different times ensuring that at no time is an exceedingly large percentage of the portfolio space at risk of going vacant), and renting to tenants in diverse industry sectors. The result is a portfolio that can be relied on to generate a relatively defensive stream of income across multiple economic backdrops.

Additionally, that yield can serve as a reliable base for mid- to long-term total returns by contributing solidly to price appreciation in up markets and offsetting price declines. Exhibit 15 demonstrates that, on average, over periods when annualized five-year price returns are negative, the income returns for both private real estate and REITs have been high enough over the same periods to offset those losses and generate positive total returns. Investors in the S&P 500 Index would have, however, experienced net losses. While the amounts do not seem large, note that $100 invested in direct real estate or REITs over the down periods would have increased, on average, to between $118 and $125 over a five-year period, while S&P 500 investors would have ended up with $94, according to J.P. Morgan Asset Management analysis. In a low-return world, that difference is significant. Finally, since the first quarter of 1978, private real estate has experienced unlevered cash flow growth of 2.7% (as of 2Q2011 as measured by National Council of Real Estate Investment Fiduciaries, or NCREIF). Theoretically, with a steady state payout ratio (i.e., the percentage of the cash flow that property managers pay out to investors as a dividend), these increases can be passed on to investors, serving both as a natural measure of appropriate price appreciation and a defense against rising inflation and interest rates.
Meanwhile, the current real estate lending environment—with a funding gap between first mortgages and the equity needed to recapitalize over-leveraged properties—is also creating opportunities to find higher yields in real estate mezzanine debt.

U.S. and Global REITs

REITs are publicly traded companies that own, manage and often develop commercial property. REITs and real estate operating companies are now trading in country markets across the globe offering investors a market capitalization of $784 billion (FTSE EPRA/NAREIT Global Index as of September 30, 2011). Evidence suggests that over time, REITs’ investment performance more closely tracks that of real estate than the equity market. Exhibit 16 demonstrates that at least in one aspect, REITs are very similar to private real estate funds. Since inception of the NAREIT U.S. Equity REITs index in 1972, and over the last 10 years through September 30, 2011, REIT dividend yields (measured as an income return) made up about 60%-70% of REITs’ annualized total return performance, generating stable income returns of between 5.5% and 8%.

REITs’ cash flows can also, as with private real estate, grow over time as rents and property revenue increase. Currently, REIT investors likely face a period of potentially strong dividend growth. Two things are working for investors on this front. First, per Exhibit 17, Global REIT dividend coverage ratios (cash flow/dividend payouts) are as high as they have ever been. In fact, if REITs were to raise dividend payouts to pull this ratio back to long-term averages, dividends could grow by just over 15%, without any increase in cash flow. Secondly, after seeing cash flow decreases over 2008–2010, REITs are in a period of recovery. As an example, U.S. REIT dividend yields grew between 4.3% and 5.5% on an annualized basis in the late 1990s and in the mid 2000s, both recovery periods after property bear markets.

Infrastructure

Infrastructure assets are natural monopolies that provide essential services. Natural monopolies have limited competition: for example, it does not make economical sense to construct two or more power lines, natural gas or water lines to serve a single household. Similarly, it does not make economical sense to construct a second airport or a close and parallel toll road unless the first one has congestion issues. Essential services also create stable demand: Price and income elasticities for the services that regulated utilities provide are very low. Water or gas bills are mostly correlated with weather than anything else. Demand for transportation services, though more income elastic, is also relatively stable as long as economic activity prevails.
Mature infrastructure assets exhibit relatively stable cash flow growth trends. Exhibit 18 demonstrates two main points empirically: First, cash flows for mature infrastructure assets grew faster than CPI in the OECD economies over the past 25 years. The rates and tariffs they charge mostly have automatic inflation adjustments (in the case of utilities) or are directly indexed to inflation (in the case of transportation assets). The second point is that infrastructure cash flows exhibited very small income elasticities and mostly continued to grow during recessionary periods. Consequently, the asset class offers a high and growing yield to investors.

Summary

Against the backdrop of a low growth, low interest rate climate, securing a high and stable income going forward is proving to be a difficult quandary for investors. The good news is that there are ample opportunities and strategies across a rich and developing spectrum of assets from fixed income and equities to real assets and REITs.

For more information about income opportunities in today’s low interest rate environment, contact your J.P. Morgan client advisor or visit www.jpmorgan.com/institutional.


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Generating Income in a Low-Yield Environment

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Real estate and infrastructure investing may be subject to a higher degree of market risk because of concentration in a specific industry, sector or geographical sector. Real estate and infrastructure investing may be subject to risks including, but not limited to, declines in the value of real estate, risks related to general and economic conditions, changes in the value of the underlying property owned by the trust and defaults by borrower.

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Although certain Loans are secured by collateral, an investment could experience delays or limitations in realizing on such collateral or have its interest subordinated to other indebtedness of the obligor. Loans are vulnerable to market sentiment such that economic conditions or other events may reduce the demand for Loans and cause their value to decline rapidly and unpredictably. Loans that are deemed to be liquid at the time of purchase may become illiquid. No active trading market may exist for some of the Loans and certain Loans may be subject to restrictions on resale. The inability to dispose of Loans in a timely fashion could result in losses. Typically, Loans are not registered securities and are not listed on any national securities exchange. Consequently, there may be less public information available.

The value of real estate securities in general, and REITs in particular, are subject to the same risks as direct investments in real estate and mortgages, and their value will depend on the value of the underlying properties or the underlying loans or interests.

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