1 Global investment outlook

A synchronized global upswing?
Prospects for worldwide economic growth have improved. While it’s not yet clear whether the momentum can be sustained, optimists are wondering aloud whether the world may be in store for the first coordinated expansion of its major economies in more than a decade.

5 Asset allocation

Hypothetical examples of reasonable portfolios for those who invest exclusively in traditional publicly traded stocks and bonds, as well as those whose investments include real estate, hedge funds and private equity.

6 Investing

Tactical asset allocation steps into the spotlight
With forecasts of continued high volatility and moderate returns from the stock market, opportunistic short-term tactics may take on new importance in portfolio strategies.

12 Planning

Split-dollar life insurance
With IRS rules now final and a January 1 regulatory deadline approaching, some policyholders face crucial decisions.

The material in “Global investment outlook” was developed by Morgan investment strategists who serve private clients. They are: Michael Cembalest, Christopher J. Wolfe and Anthony D. Werley of J.P. Morgan Securities Inc.; Stuart A. Schweitzer and Carey S. Miller of J.P. Morgan Chase Bank; and Gary A. Dugan of J.P. Morgan Fleming Asset Management (London) Limited. For more information, please call 212-464-1300.
Few investment principles deserve to be inscribed in stone. For eighteen years, “buy and hold” appeared to be a fundamental law of the investment universe. In fact, it was the law of the secular bull market – an approach well-suited to markets that were steadily rising.
When markets become more volatile and returns more subdued, an unwavering commitment to buy and hold investing can lead to increased risks and disappointing returns. In this kind of environment, a more flexible approach that incorporates shorter-term tactical moves may prove more beneficial to investors in terms of both enhancing a portfolio’s return potential and mitigating risk.

Anticipating a cyclical rather than secular upturn
JPMorgan Private Bank’s investment strategists have sharpened their focus on tactical asset allocation in anticipation of the market conditions they foresee over the next three to five years. While there has been mounting evidence of an upturn in the economy (see this issue’s “Global investment outlook”), a return to a multi-year, double-digit upward trend in the global equity markets does not appear likely.

Michael Cembalest, the Private Bank’s chief investment officer, sees a cyclical bull market ahead for stocks – not a secular one. Cyclical bull markets correspond to underlying economic cycles and generally last one to two years. Secular bull markets, like the one that encompassed most of the 1980s and 1990s, generally last five years or more and are driven by fundamental changes in long-term economic trends.

As Cembalest explains, the U.S. economy, for one, no longer has the benefit of the tailwinds that propelled it forward for two decades. He points out that declines in inflation, unemployment, interest rates and military spending, coupled with initially low equity valuation multiples, helped to produce one of the strongest secular uptrends in U.S. stock market history. “From the end of July 1982 through the end of March 2000, U.S. equity markets generated average returns of nearly 19% a year, with volatility of close to 18%,” Cembalest says. “We now see that period as an anomaly – one not likely to recur any time soon.”

Anthony Werley, the Private Bank’s global head of portfolio construction, concurs. “Based on JPMorgan’s current forecast, we are still expecting 15%-16% equity market volatility, but with returns averaging closer to 7.5%-8.5%.”

With the amount of risk per unit of return expected to be notably greater than over the last decade, many investors feel less sanguine about a buy and hold investment strategy – particularly those who suffered sizeable losses during the bear market. Werley points out, “With cyclical market upturns – unlike the secular bull run equity investors got used to during the 1990s – time does not necessarily heal all wounds. We try to help clients understand the risks in what’s likely to be a more challenging environment. We also want make sure they know that there is an expanded set of opportunities that may help to improve a portfolio’s overall risk/return profile.”

Tactical asset allocation defined
In simple terms, tactical asset allocation is designed to capture opportunities or limit risks arising from relatively short-term (generally, six- to 18-month) discrepancies in valuation or anticipated relative returns.

Tactical asset allocation is not new, although its value as a portfolio tool was largely overshadowed during the 1990s. Relatively recent developments in portfolio theory, coupled with the equity market’s downturn and the emergence of new and liquid investment instruments such as exchange traded funds, have focused greater attention on the growing importance of tactical asset allocation – particularly as a vehicle that may help capture excess return and manage risk during volatile, directionless markets.

Werley believes tactical asset allocation has a role to play in virtually any kind of market. But in periods when markets lack a strong overriding trend, tactical moves can be used to help boost returns or reduce risk at the margin. “When investment returns are in the single-digit rather than the double-digit range, investors tend to have greater appreciation for a series of tactical moves that can generate a 2% incremental portfolio return – or avert a 2% loss to their portfolio,” says Werley.

An overlay to strategic asset allocation
From the standpoint of portfolio strategy, Morgan believes tactical moves are best implemented within the context of an investor’s strategic asset allocation: the long-range plan designed to help each individual achieve his or her overarching objectives.

Trisha Stewart, the Private Bank’s global head of strategic asset alloca-
How does a strategic framework influence tactical decisions? “The two have to be kept in perspective,” says Stewart, adding that it’s especially important that the tactical not overwhelm the strategic. “Anyone who’s ever plotted a sailing course will see the importance of this right away,” she explains. “Strategic allocation is the course line you lay down in the direction of your goal. You know from the outset that winds, currents, unanticipated events – positive or negative – will divert you from that path. Short-term tactical adjustments, ideally, will help to keep you on course. But these tactics work best if you never lose sight of your long-term objectives and the strategic allocation designed to get you there.”

Portfolio rebalancing
Tactical allocation opportunities regularly arise in conjunction with portfolio rebalancing. Following a period of strong relative performance, for example, international equities might constitute 10% of a portfolio that, according to its strategic asset allocation, should devote no more than 8% to this asset class. When should the position be sold down? If international equities appear poised for continued outperformance, an investor might well delay returning to the strategic benchmark. If the investor believes international equities are now overvalued, it might make better sense to immediately reduce the position to 8% of the portfolio – or, perhaps, to even less.

Jeffrey Shen, head of asset allocation research at JPMorgan Fleming Asset Management, points out that static, rule-based rebalancing often introduces unmanaged – and uncompensated – risks. He believes that a well-executed tactical asset allocation program can help to manage risks and perhaps provide opportunities to enhance return.

“A well-thought-out asset allocation can help to minimize risk,” Stewart says, “because different investment classes held in a portfolio tend to respond differently to market events. Without a strategic plan, investors may take on more risk than necessary and find it more difficult to reach their goals.”

For a more complete discussion, see “Asset allocation: an old tool gets a sharper edge,” Portfolio, April 2001.
Risk management need not be an add-on to tactical asset allocation strategies; rather, it should be the starting point of the investment process.

According to Werley, “The risk budget should create a heightened awareness of risk across each client’s entire portfolio.”

Of course, investment risk takes many forms, as Lex Zaharoff, head of the Private Bank’s Advice Lab points out. “Tactical investments, like all investments, to some degree or another, involve not just market risk (which reflects the volatility, return and correlations of a particular asset class), but also liquidity risk, manager selection risk, data quality risk, concentration risk and information risk. Tactical decisions also introduce the risk that you’ll get the timing wrong.” The risk budget is being designed to take all these forms of risk into account.

“Our point is not that one risk is better than another, but that each risk should be taken on explicitly,” Zaharoff says, “because investors need to evaluate the likelihood of earning an appropriate return for each risk they are taking.”

How will the risk budget fit in with tactical asset allocation? Think of it like this: If strategic allocation decisions revolve around the universe of investment assets cut into fairly large pieces, tactical allocation divides these into even finer slices. The risk budget helps to keep better account of how changes in the portfolio affect its risk profile.

Theoretically, tactical allocation can be employed to increase the number of less-correlated decisions that go into shaping a portfolio. This, then, raises the overall level of portfolio diversification and, thereby, reduces risk. In other words, focusing on a larger number of finer market sub-segments can, in itself, help create greater stability in a portfolio. (One example: screening for valuation or relative return discrepancies among not just small- and large-cap equities but also mid-cap stocks.)

Shen points out that tactical allocation strategies should derive further diversification benefits from the intrinsic nature of the decisionmaking process itself. “Tactical moves generally are driven by a top-down, macro approach, which is inherently different from the bottom-up micro investment processes used in stock picking. Therefore, the alpha (additional return above a benchmark) generated through tactical asset allocation should have a low correlation with the alpha resulting from micro risk-taking processes.”

Tax and cost considerations

One of the advantages of a buy-and-hold investment strategy, of course, is that it tends to minimize portfolio turnover and, hence,
the realization of capital gains. Insofar as tactical asset allocation means more active trading, it clearly has the potential to increase investors’ exposure to capital gains tax, as well as their transaction costs.

Morgan stresses the importance of tax-aware investing, particularly with private clients subject to U.S. taxes. Moreover, the Private Bank applies a proprietary tax-aware screen in many of the core strategic portfolios it manages to determine the likelihood prospective trades will still be attractive on an after-tax basis.

Whenever a tactical move under consideration involves low-basis assets, tax-awareness has a critical part to play in decisionmaking, as well. As Werley acknowledges, “There’s no question that portfolio turnover can increase taxes and transaction costs. But it can also reduce risk and enhance returns. It’s important to evaluate carefully whether the potential benefits of a trade are likely to outweigh its added costs.”

**The years ahead**

History offers few parallels to today’s post-bubble investment environment.

“The worst of the bear market is likely behind us,” Cembalest believes. “Balance sheets are being repaired, and excess capacity is slowly being absorbed. We believe we’ve been through the most severe part of the adjustment, and at this juncture, another collapse in stock market valuations seems to us highly unlikely. But, the situation will continue to be volatile as the market responds to mixed news of strong consumer spending without job growth. We don’t expect another strong downward market – nor do we expect to go back to another period of consistently double-digit returns.”

Acknowledging that history has proven the stock market to be anything but predictable, Werley believes the U.S. equity markets may go through a period similar to the late 1970s. “After the market bounced back from a significant decline, the period from 1976-1978 was marked by a volatile saw-tooth pattern without any overall trend. A look at other similar historical periods suggests that during years without a clear market trend, investors who adopted even a modestly tactical approach might have significantly added value in the portfolio, if only through a reduction of risk.”

“In such an environment,” says Cembalest, “investors can maintain consistent allocations and absorb volatile market conditions. Or they can try to identify themes and benefit from the volatility by positioning portfolios accordingly. For private clients, we almost always favor the latter approach when we feel we have an advantage in identifying the catalysts for a change.”

“We cannot know with any certainty, of course, what the markets are going to do,” Werley adds. “We have a point of view that guides us, but the market never unfolds precisely as anyone’s strategic forecast would have it unfold. Given this, we see tactical asset allocation as a tool that can add a degree of openness and agility to the investment process. We can hope to be somewhat prescient with our forecasts. But even more important, we need to stay closely attuned to what is actually occurring in the markets. Ideally, investors will want to stay flexible enough to take advantage of the short-term opportunities and have access to investment professionals who can help them identify which ones make sense for their particular portfolio.”

We see tactical asset allocation as a tool that can add a degree of openness and agility to the investment process.
Taking advantage of short-term discrepancies
EXAMPLES FROM THE TACTICAL ASSET ALLOCATION TOOLBOX

Even in environments without a discernable trend, certain market segments may significantly outperform others. Depending on an investor’s position, these discrepancies may represent either elevated risks or attractive opportunities. Anthony Werley, JPMorgan Private Bank’s global head of portfolio construction, notes that in every one of the last 20 years – with the sole exception of 2002 – at least one segment of the U.S. equity market registered a gain. “In 2000, we had a precipitous decline in the overall market. During that year, the S&P 500 Index dropped 9.1%. But, in fact, if you parsed the large-cap equity performance data more finely, large-cap growth stocks that year (as measured by the S&P 500/BARRA Growth Index) fell roughly 22%, while large-cap value stocks (as reflected by the S&P 500/BARRA Value Index) appreciated just over 6%.”

Tactical asset allocation centers on identifying and taking advantage of these periods of relative outperformance. Sometimes they can be predicted from discrepancies in valuation: At any given moment, for example, growth stocks may be substantially overvalued in comparison to value stocks. Sometimes, relative outperformance can be anticipated on the basis of economic trends that favor one market segment over another; a period of renewed economic growth, for example, may be more positive for small-cap stocks than for large.

JPMorgan Private Bank investment strategists continuously screen the investment markets for such opportunities. Often a tactical move will involve a relatively modest shift in allocation within an asset class; other tactical plays require a more deliberate shift between asset classes to take advantage of a perceived trend or theme. Tactical asset allocation may also employ structured investments specifically designed to reflect a particular market view. Here, in brief, are a few examples of the Private Bank’s tactical thinking.

Growth versus value equities now
Growth and value stocks tend to be somewhat countercyclical to one another. Over any given one-year period, one of these styles is likely to outpace the other. Christopher Wolfe, the Private Bank’s chief equity strategist believes investors currently may want to favor stocks that benefit most when economic growth accelerates and when market liquidity conditions are high – conditions present today. Two prime examples: small-cap and growth-oriented stocks. Moreover, this view is supported by the fact that growth stocks are currently “cheap” relative to value stocks. Wolfe notes that “in a cyclical upswing, you want exposure to companies that seem most likely to capture the impending growth in both revenues and market liquidity. Historically, this has meant favoring small-cap stocks and growth at the expense of value. However, at some point in this upswing, growth companies will overshoot and thus become expensive. We’re not there yet in this cycle. But the relationships between growth and value and between large- and small-cap stocks are among those we closely monitor as part of our tactical allocation process.”

Domestic versus international equities in the months ahead
Although the world’s major equity markets have recently tended to move in concert, various regional stock markets may also diverge from one another. Gary Dugan, global markets strategist for Europe, the Middle East and Africa, believes that in the current environment, European equities are definitely worth watching. The dollar’s sharp setback has highlighted structural problems in the U.S. economy and enhanced the attractiveness of overseas investments, particularly for U.S. investors,” he says. While European equities for more than a decade have been highly correlated with the U.S. market, Dugan expects these correlations to decline. Meanwhile, European equities are, by some measures, 20% to 30% cheaper than U.S. stocks. “At present, given uncertainty over how French and German reform agendas will play out, risks still outweigh potential benefits. But U.S. investors might want to position themselves to step in quickly if the opportunity presents itself,” Dugan says.

Value from short-term fixed income tactics
The fixed income markets regularly provide tactical opportunities. Early this year, 5-year U.S. Treasuries were yielding around 2.75%. The Private Bank’s investment team, anticipating that bond yields would rise, recommended that investors reduce the average duration of their bond portfolios to 2.5 years from 5 years. Anton Pil, the Private Bank’s global fixed income strategist explains: “For a 50-basis-point back-up in yield, this move would mean sacrificing about 0.2% of current income to avoid a principal loss of roughly 2.5%. Many investors regarded this as a favorable tradeoff.”
Split-dollar life insurance

With new IRS rules and a January 1, 2004 regulatory deadline, policyholders may face critical decisions.

Split-dollar life insurance arrangements have come into focus because of recent IRS activity and last year’s enactment of the Sarbanes-Oxley Act prohibiting corporate loans to certain senior executives. The new IRS regulations, finalized on September 11, call for a more rigorous definition of key terms and will likely alter the amount of compensation an executive must report.

These arrangements – in which two parties share the costs and benefits of a life insurance policy – are used as intra-family wealth transfer vehicles, but they are most common in the employer-employee context.

Historically, in accordance with rulings issued by the IRS, an employer would retain only the value of the premiums it had paid while the executive received all other rights under the policy, including the underlying cash value and the right to designate the policy beneficiaries. This practice came to be known as an “equity split-dollar arrangement” because the executive enjoyed any underlying cash value over the paid premiums. It provided executives with tax-efficient compensation because the amounts included as reportable income for the executive were relatively small (current life insurance protection) while the benefits, in the form of a paid-up insurance policy, could be substantial.

New regulations
To capture the economic benefit of this arrangement more adequately, the IRS has issued new regulations that were finalized in September. Very generally, the rules offer two mutually exclusive methods of treatment for split-dollar arrangements:

- A loan by the employer to the employee for the amount of the premiums, or
- A taxable economic benefit to the executive equal to the cost of the insurance plus the net cash value available to the executive.

In addition, the IRS has provided guidance for valuing current life insurance protection.

Where the executive is the owner of a policy under a collateral assignment arrangement, the loan treatment would apply (i.e., the employer would be deemed to have lent money to the executive, who would pay the policy premium). If the loan does not provide for sufficient interest, interest is imputed at the applicable federal rate as additional compensation to the executive.

Alternatively, where the employer owns the policy and endorses it over to the executive, the economic benefit treatment would apply. The executive would be taxed on the value of the economic benefit received in the taxable year, which would include the cost of any current life insurance protection, the amount of policy cash value accessible to the executive and the value of any other economic benefits provided to the executive.

Impact on executives
Executives in split-dollar arrangements have some decisions to make in light of the new IRS regulations and the enactment of the Sarbanes-Oxley Act. The new rules will apply only to arrangements entered into or materially modified after September 17, 2003. Under an additional IRS notice, existing policyholders may elect, prior to January 1, 2004, to repay the company for past premiums, take the premiums as a bonus or terminate the split-dollar arrangement.

The proposals present several complexities and, because there can be a significant amount of money at stake in a split-dollar arrangement, they have the potential to alter dramatically the amount of compensation executives must report. JPMorgan Private Bank wealth advisors can work with you to gather information pertaining to your split-dollar arrangement and discuss the implications of the new IRS regulations and the Sarbanes-Oxley Act with you and your professional advisors. While we do not provide tax or legal advice, your attorney or accountant can advise you on the implications and appropriateness of a specific strategy in light of your own circumstances.
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