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PWM

PROFESSIONAL WEALTH MANAGEMENT

SOLUTIONS FOR EUROPEAN DISTRIBUTORS

STAY ON THE DEFENSIVE SIDE

In order to keep their investment goals on track and to limit risk, investors with cash-heavy portfolios need to rework their asset allocations. Here are some strategies they could put to use

Investors with large cash positions should evaluate whether their current portfolio will provide them with the long-term capital appreciation and cash flow necessary to support their long-term investment objectives.

Cash positions are at record levels, having grown to €20bn at the end of January 2003* from €11bn in 2001. Investors surely will be feeling the pain of three straight years of equity losses and consequent investment skittishness.

Those who continue to hold large cash balances should look for defensive opportunities, which will enable them to re-align their asset allocation to match longer-term investment objectives.

REBALANCING

Investors with large cash positions and risk allocations well below their strategic long-term equity allocation may be jeopardising long-term purchasing power by placing an emphasis purely on capital preservation. Consider a €5m 100 per cent cash portfolio with a 4.25 per cent expected yield. In 10 years, this portfolio is forecast to have a value of €7.58m**.

A balanced portfolio (5 per cent cash, 45 per cent fixed income, 50 per cent equities), however, is forecast to grow to €9.98m** in 10 years. Considering this potential difference in performance it is advisable that investors consider allocating a portion of their portfolio to equities to help maintain future purchasing power, after accounting for inflation.

The asset allocation process must be dynamic — on one hand, the strategic asset allocation enables investors to achieve long-term goals, while on the other, tactical recommendations enable investors to respond to changing market conditions.

Deciding when to invest: Markets move quickly and timing has generally been viewed as counter-productive to long-term growth. Those investors who invested in the DJ Euro Stoxx from January 1987 to the present have earned 147 per cent on their invested capital, while those who may have timed the market and missed the 15 best months are left with a portfolio down more than 40 per cent over this same 16-year period (see graph over).

Averaging into the market: While moving from cash to a balanced portfolio over a five-year period may reduce near-term volatility, it may also reduce the portfolio's potential long-term value. Averaging into a strategic allocation over a five-year period significantly reduces the likely range of wealth values in the near term at some cost to the most probable wealth values by year 10. For investors uncomfortable with deploying all their excess cash at once, we would recommend phasing into markets over the next six to 12 months.

REDUCING RISK

In the first few weeks of 2003, equity markets have been driven down by uncertainty, whether it relates to events in Iraq or the prospects for economic growth.

We have reached a stage in the UK where, for the first time in a generation, equities, bonds and cash yield about the same. It therefore seems right to consider moving back into equities for long-term growth, while at the same time limiting risk.

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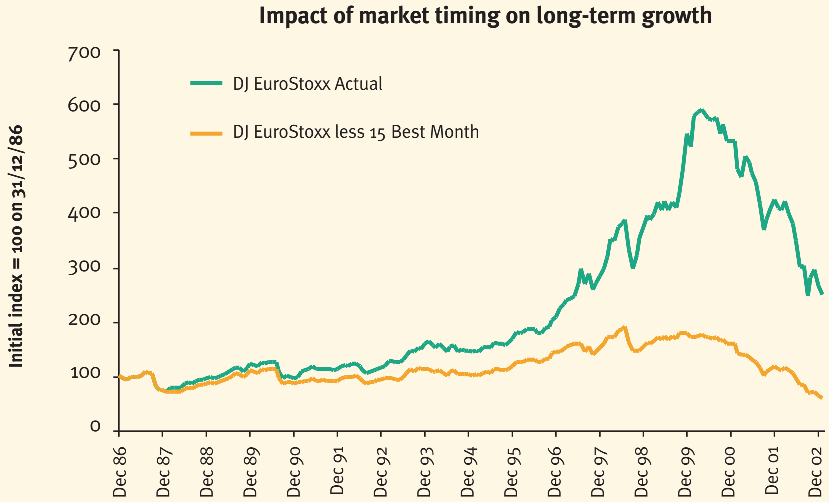

Source: JPMorgan Private Bank

● **Use derivative strategies to enhance return potential and contain risk in range-bound markets:** Given our view of modest single-digit returns over the near term, investors can sell off the upside above an annualised return of more than 7 to 8 per cent and use the proceeds to either purchase portfolio protection or to purchase additional exposure to the markets, thereby leveraging the returns within a range.

Fully capital protected investments: Investors seeking high levels of capital protection can also participate in the upside of the equity markets. Low levels of interest rates and high market volatility, however, result in low participation in the potential upside appreciation of the markets for one to two-year capital-guaranteed notes. If a three to five year investment fits within the parameters of the investor's asset allocation and objectives, these longer-term notes maximise the participation rate by benefiting from an upward sloping yield curve and lower levels of long term equity market volatility.

Purchase portfolio insurance within a range: Investors who believe there may be further contraction in the market may want to purchase protection for near-term investments. By purchasing a zone of protection, rather than insuring all the way to zero, investors participate in a higher percentage of market appreciation.

Leverage returns within a range to express a modestly bullish view on market: Investors can leverage their returns within a range by selling away their exposure above a specified level, while maintaining full downside exposure to the equity markets. For example, if the EuroStoxx 50 were to appreciate 5 per cent, the investor would receive up to a 15 per cent return. Above a return of 11.5 per cent, the investors' return is capped at 34.5 per cent. Swapping from long equities into this strategy enables investors to capitalise from a modestly bullish view, without changing their downside exposure to the markets.

● **Focus on value-tilt investing:** Investors can create a defensive portfolio through their security selection process. Investors should look for securities trading at low valuations relative to their peers and the market (using price/earnings and price/sales ratios). Companies with improving free cash flow have additional capital for reinvestment, higher dividends and share buy-backs. With lower return expectations for equities, securities which offer high dividends as a percentage of the total return may also attract investors with low risk tolerance. Value strategies only trail growth strategies by a small amount in "up" markets, while they outperform substantially in "down" markets. This suggests a positive trade-off given all the uncertainties facing us in 2003.

● **Use hedge funds-of-funds to diversify a portfolio's market risk:** Expanding the investment universe can help diversify the types of risk in a portfolio and, for a given level of risk, increase potential return. Hedge funds can increase a portfolio's diversification while potentially increasing returns. These investments are absolute return-oriented investments with a low correlation to traditional cash markets. Manager selection is a significant driver of performance and risk, with dispersion of returns amongst managers being much wider than traditional asset classes. A multi-manager approach can mitigate fund-specific manager risk by reducing dispersion of results. Hedge funds may not be appropriate for all investors, as they are less liquid and less transparent than the cash markets.

The key to successful investing in this market is diversification, both across asset classes and investment vehicles. Balancing a strategic asset allocation with tactical solutions will enable investors to achieve long-term goals while maintaining an ability to select investments which optimise current market conditions.

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* AAA-rated euro-denominated offshore funds registered to the International Money Market Funds Association

** Most probable wealth value: the range in and around the 50th percentile. The "50th percentile" indicates the middle wealth value of the entire range of probably wealth values. All portfolio values are pre-tax.