The case for value in Europe

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IN BRIEF

- The value style has had a strong rebound since the summer of 2016. However, this pick up in value returns follows a decade of underperformance vs. growth. When considered over the long term, value's underperformance vs. growth is still significant.
- There are signs that the recent value revival may be the beginning of a more sustained rally. The dispersion in valuations between value and growth remains wide – a situation that has previously been a strong signal for future value outperformance. Also, value sectors are clear beneficiaries of a reflationary environment, while market-implied earnings growth rates still appear overly bearish for several value sectors.
- We believe that the Europe Strategic Value Fund is well placed to tap into any upturn in the performance of the value style. The fund provides investors with style purity regardless of market environment, and was in the top percentile of all offshore European equity funds the last time that the value style had a sustained period of outperformance (2000-2006). The fund has also outperformed the MSCI Europe Value index in 14 of 17 calendar years since inception.

AUTHORS

Ian Butler
Portfolio Manager

Michael Barakos
Portfolio Manager

Tom Buckingham
Portfolio Manager

THE CASE FOR THE VALUE STYLE

Introduction

Value investing has been advocated by investors as far back as Benjamin Graham and David Dodd in the 1930s. However, it was not until the 1970s that academics began to empirically examine the performance of value investing. In a prominent early paper, S. Basu[1] found that stocks with low price-to-earnings (P/E) ratios outperform high P/E stocks by an average of 10% per year.

Using data courtesy of Kenneth R French, we now have some 90 years of evidence in support of value investing. J.P. Morgan research from 2013[2] showed that since 1927, one dollar invested in the cheap portfolio (low price-to-book) would have grown to more than $3,200 compared to $515 for the expensive portfolio.

[1] S Basu, "Investment performance of common stocks in relation to their price-earnings ratios: A test of the efficient market hypothesis," The Journal of Finance Vol. 32, No.3 (June 1977); pp. 663-682.

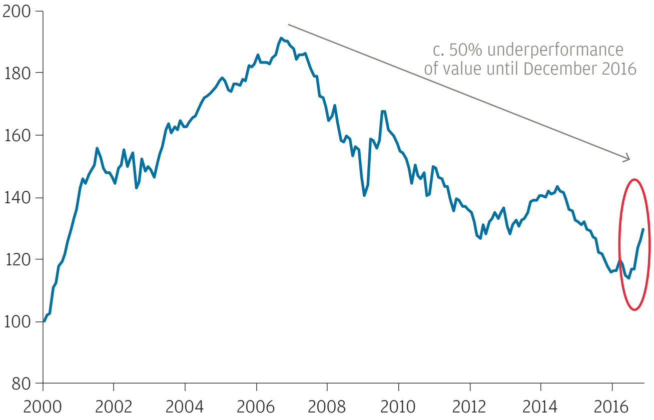
[2] J.P. Morgan research: Kenneth R. French, Dartmouth University, 2013.

But what is behind these returns to value investing? Lakonishok, Shleifer, and Vishny[3] find that value stocks are not fundamentally riskier than faster growing "glamour" stocks. Lakonishok et al. also find that the differences in the growth rates between glamour and value companies do not persist. In practice, the growth rates of value companies tend to improve as companies divest underperforming units, restructure operations, bring in new management, and emulate competitors.

We believe investors tend to be overly pessimistic about value companies, extrapolating earnings trends into the future, which in turn drives a wedge between price and fair value, creating buying opportunities. The important thing is to stick rigidly to a value style to benefit from the strategy's long-term performance potential, especially when it feels emotionally most uncomfortable (for example, in early 2000).

When considered over the long term, value's underperformance vs. growth is still significant

EXHIBIT 1: MSCI EUROPE VALUE VS. MSCI EUROPE GROWTH CUMULATIVE EXCESS RETURN



Source: Factset, MSCI, J.P. Morgan Asset Management; data from 31 January 2000 to 31 December 2016.

Long-term underperformance of value vs. growth

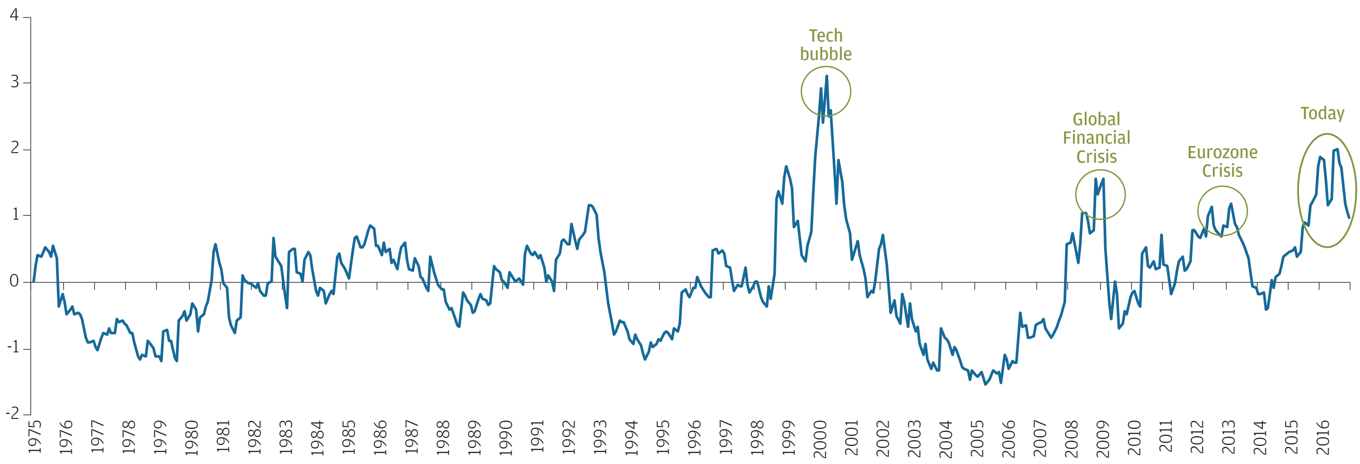
The last value cycle lasted from 2000 to late 2006 following the bursting of the technology bubble. In fact, this was the most powerful value rally since the Great Depression of the 1930s. However, this value outperformance of the early 2000s was followed by a near decade-long period of value underperformance (other than a short, sharp rally in 2009) until the summer of 2016.

As **Exhibit 1** shows, even after the strong recent rebound, the MSCI Europe Value index has underperformed the MSCI Europe Growth index by approximately 50% in the decade to the end of December 2016. The most recent outperformance of value appears modest when considered in a longer-term context.

In addition, it is important to note that since the beginning of 1975 the average duration of value outperformance relative to growth (using the MSCI Europe style indices as proxies) is approximately 28 months—with value's longest period of outperformance lasting 80 months. The current rally has lasted six months so far, which would suggest this recent value revival may be just the beginning of a more sustained rally, especially when put in the context of a 10-year value bear market.

Relative valuations signal a potential opportunity for value investors

EXHIBIT 2: RELATIVE VALUATION OF MSCI EUROPE VALUE VS. MSCI EUROPE GROWTH



Source: MSCI, J.P. Morgan Asset Management; data from January 1975 to December 2016. The relative valuation is based on the price-to-book ratio and dividend yield of the Europe Value index compared to the Europe Growth index normalised for comparison.

[3] Josef Lakonishok, Andrei Shleifer, Robert W Vishny, "Contrarian investment, extrapolation, and risk," The Journal of Finance, Vol. 49, Issue 5 (December 1994); pp. 1547-1578

Value spreads look attractive at current levels

The underperformance of the value style has in turn caused the relative valuation between the MSCI Europe Value index and the MSCI Europe Growth index to widen significantly. As **Exhibit 2** shows, although the relative valuation of the value index has come in from its widest point (in the summer of 2016), value stocks are still trading at a discount to growth stocks that was last seen at the extremes of the eurozone crisis.

Valuation spreads suggest positive returns from value

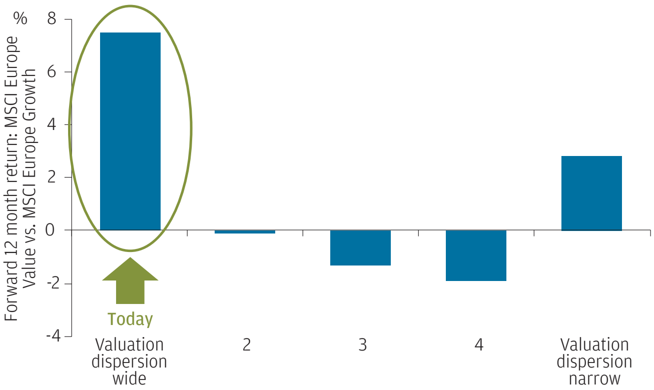
One of the best predictors of future returns to the value style is the valuation spread (which measures the difference in valuation between the value and growth indices).

Exhibit 3 shows the expected forward 12-month return of the MSCI Europe Value index relative to the MSCI Europe Growth index, conditional on the relative valuation of the two indices. Expected returns are highest when the valuation dispersion is widest.

Driven by the underperformance of the value style in recent years, valuation dispersion is still in the widest quintile compared to history. This wide dispersion in valuations would suggest a positive outlook for the performance of the value style on a 12-month forward looking basis.

Wide valuation spreads may predict stronger performance ahead for value stocks

EXHIBIT 3: FORWARD PERFORMANCE OF MSCI EUROPE VALUE VS. GROWTH INDICES CONDITIONAL ON RELATIVE VALUATION



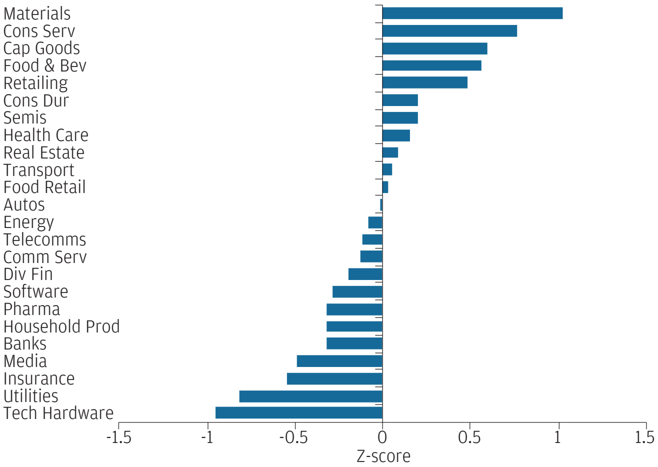
Source: MSCI, J.P. Morgan Asset Management. The chart shows the forward 12-month return of the value index relative to the growth index conditional on the relative valuation from 30 November 1984 to 31 December 2016. The quintiles are based on an expanding window with an initial 10 year period. Forecasts, projections and other forward looking statements are based upon current beliefs and expectations. They are for illustrative purposes only and serve as an indication of what may occur. Given the inherent uncertainties and risks associated with forecasts, projections and other forward statements, actual events, results or performance may differ materially from those reflected or contemplated.

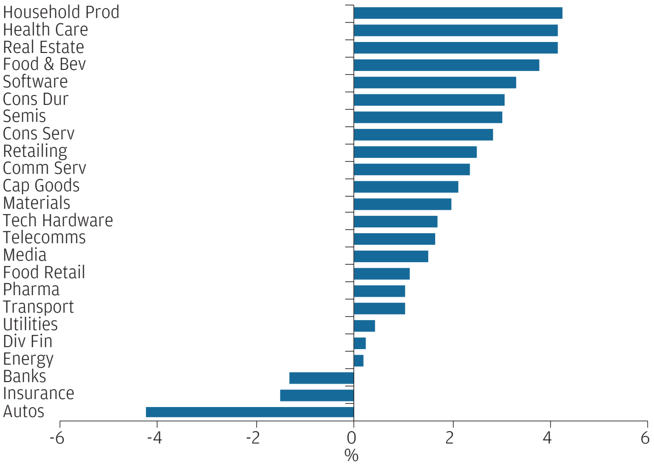
Market-implied earnings growth rates appear overly bearish for value sectors

Relative valuations appear to suggest an attractive outlook for the value style. **Exhibit 4** shows the market implied long-term earnings growth rates by sector and the relative valuation if you apply this growth rate using a dividend discount model. The chart shows that for a number of sectors the market is pricing in negative implied long-term earnings growth.

Earnings growth expectations may be too pessimistic for several value sectors

EXHIBIT 4: EUROPEAN INDUSTRY VALUATIONS AND IMPLIED ANNUAL GROWTH RATES





Source: Morgan Stanley, MSCI, J.P. Morgan Asset Management. Relative valuation chart (left hand side), data as of 31 December 2016. Valuations are a composite based on price-to-book ratios, price-to-earnings ratios and dividend yields, and are relative to each industry group's 20-year history. Market implied earnings per share (EPS) growth rates chart (right hand side), data as of 6 January 2017. Implied growth rates are for the next 10 years using a two-stage Gordon Growth Model assuming financial year three as the base year.

In many cases, earnings expectations are pessimistic. For example, the market's earnings growth expectations imply a 4% earnings decline per year for the next 10 years for autos, a 2% earnings decline per year for the next 10 years for insurance, and a 1% earnings decline per year for the next 10 year for banks.

Value tends to be a beneficiary of inflation

It is also worthwhile considering the macroeconomic regime change that currently appears to be taking place.

Over the last five years, as both interest rates and inflation have fallen, it has been the high duration bond proxy assets that have outperformed. This sustained outperformance means that these stocks are now trading near historical extremes. However, we appear to be reaching the end of a 30-year bull market in bonds as inflation expectations begin to rise and interest rates increase from near-zero levels.

Historically the value style has outperformed in periods of rising inflation and we believe that this relationship remains valid today. At a style level, value stocks are lower duration assets compared to growth stocks, which have a valuation that is more sensitive to cash flows further in the future. As the yield curve steepens the cash flows of growth stocks will be more heavily discounted and therefore value stocks should be expected to outperform.

THE CASE FOR JPMORGAN FUNDS - EUROPE STRATEGIC VALUE FUND

Introduction

The JPMorgan Funds—Europe Strategic Value Fund aims to invest in the most attractively valued stocks in the market, ensuring that each stock selected is fundamentally sound through further analysis of its quality and momentum characteristics.

We apply a consistent and disciplined approach to research and identify these characteristics across a universe of approximately 1,800 pan-European stocks.

A disciplined investment process ensures style purity

To identify attractively valued stocks we focus on the cheapest 30% of the market based primarily on a combination of the price-to-earnings (P/E) ratio and free cash flow yield. To ensure the companies we invest in are fundamentally sound we look to avoid those companies that are very low quality and have poor momentum. These stocks are deemed value traps, i.e. are cheap for a good reason.

We define poor quality as those companies that are not profitable, have unsustainable earnings and have a management team with poor capital discipline. We seek to avoid companies whose profit growth and margins are not sustainable. We expect management to be prudent with shareholder funds and are wary of companies that have a track record of issuing shares to make acquisitions, rather than financing growth through internally generated cash flow.

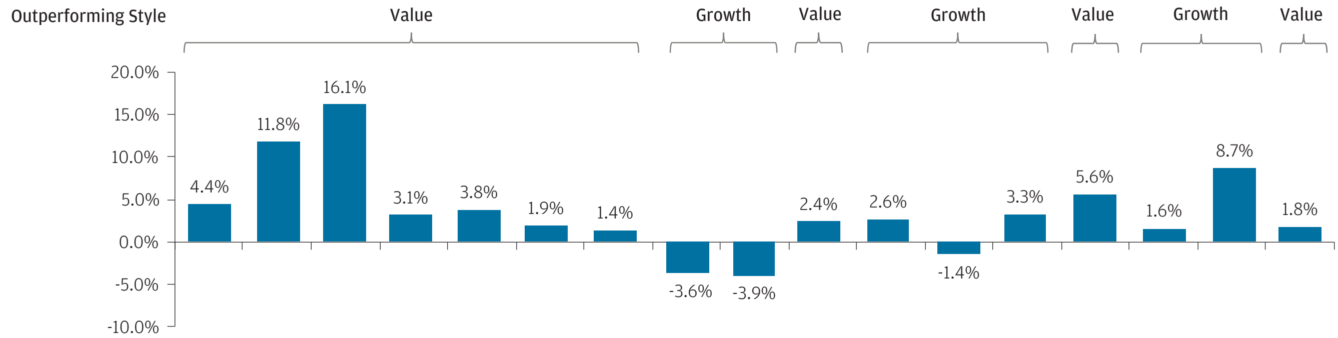
We also try to avoid those stocks with the weakest share price and earnings momentum. Stocks that have performed well over the last 12 months tend to continue to perform well and conversely stocks that have performed poorly tend to continue to underperform. When examining earnings momentum, our decision making isn't impacted by what a sell side analyst's recommendation is for any given company, but we do analyse the direction of underlying forecasts in detail. Strong downward revisions are often an indicator that a stock will underperform as analysts typically under react and don't fully incorporate the new information into their forecasts. Hence, there will often be further downward revisions along the road.

Consistent performance and significant outperformance when value style in fashion

As **Exhibit 5** shows, the fund's returns have been very consistent, having outperformed the MSCI Europe Value Index in 14 of 17 calendar years since inception despite the value style having underperformed growth since 2007. The only three calendar years that the fund has underperformed have all been years in which the growth style has outperformed value, and were therefore difficult periods for a pure value fund to outperform.

The fund has outperformed in 14 of 17 calendar years since inception

EXHIBIT 5: EUROPE STRATEGIC VALUE FUND EXCESS RETURNS VS. MSCI EUROPE VALUE NET INDEX TO DECEMBER 2016



	2000*	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Fund (%)	18.6	-0.7	-19.5	25.1	20.1	30.7	24.0	-5.9	-48.6	36.6	6.9	-10.8	20.2	28.2	7.3	9.4	9.28
MSCI Europe Value Index (%)	13.6	-11.2	-30.7	21.3	15.8	28.2	22.3	-2.4	-46.5	33.5	4.1	-9.5	16.4	21.4	5.6	0.7	7.41

Source: J.P. Morgan Asset Management; data as of 31 December 2016. Fund=JPMorgan Funds—Europe Strategic Value A (acc) - EUR Fund. Performance calculated on a NAV to NAV basis, gross of fees in EUR excluding ongoing charges and any entry and exit fees, with any income (net) reinvested. Excess return calculated geometrically, in euros. From launch on 14 February 2000 to 1 June 2008 the official benchmark of the fund was FTSE Europe Index. On 1 June 2008 the benchmark was changed to MSCI Europe Value Index. Gross fund returns are calculated from net returns by applying the fund total expense ratio (TER) which includes operating & administrative expenses (O&A). The O&A fees are accrued at the maximum rate, according to what is stated in the fund prospectus. Where the O&A fees incurred are actually lower than the accrual, this would lead to a minor overstatement of gross returns. Net returns are not impacted. Past performance is not necessarily a reliable indicator for current and future performance. *From 14 February to 31 December 2000.

The fund was launched in February 2000 during a period that was dominated by the growth style, with little interest in value. However, five years later the fund was in the top percentile of all 192 offshore European equity funds, having returned +41% over the period vs. the median fund's -34% return (source: Morningstar, European offshore equity universe, five years to 28 February 2005).

With hindsight, the year 2000 was the perfect time to invest in the value style, and the fund's performance in the following five years shows that it has the potential to outperform significantly when the value style works. As further evidence of the fund's ability to outperform when value is in fashion, in the latest value rally in the second half of 2016 it outperformed the MSCI Europe Value index by more than 350 basis points (bps) and the broad market (MSCI Europe index) by more than 1000bps—placing the fund comfortably in the top quartile of the Morningstar Europe Large-Cap Value sector over the second half of 2016.

The fund has also performed well vs. its peers for several years. The fund is top quartile over one year, three years and five years (to end of December 2016, Morningstar Europe Large-cap Value peer group).

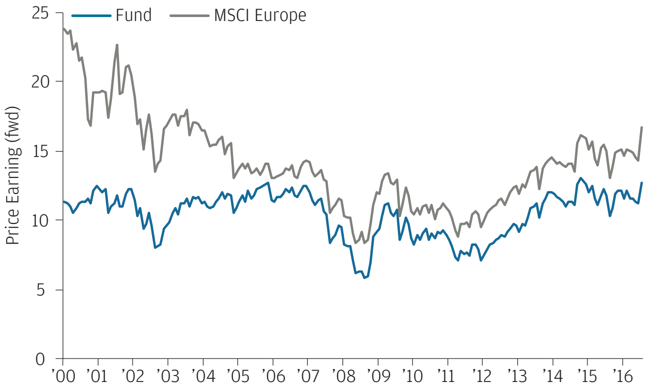
Style purity regardless of market environment

Clients should be reassured that regardless of the market environment, or which style is currently outperforming, the fund will always maintain its pure value style exposure, as evidenced by its portfolio characteristics over the past 17 years.

Exhibit 6 shows the weighted average P/E of the Europe Strategic Value Fund and the MSCI Europe index since 2000. Over this time, the fund has consistently maintained a healthy valuation discount to the broad market and this style purity sets it apart from its competitors—many of whom have, in recent years, tended to drift away from the value style as it has underperformed. In fact, we believe that our Europe Strategic Value Fund is one of the only pure value funds left in the market.

The Europe Strategic Value Fund has always maintained a valuation discount to the market

EXHIBIT 6: PRICE-TO-EARNINGS RATIO FOR EUROPE STRATEGIC VALUE FUND AND MSCI EUROPE INDEX

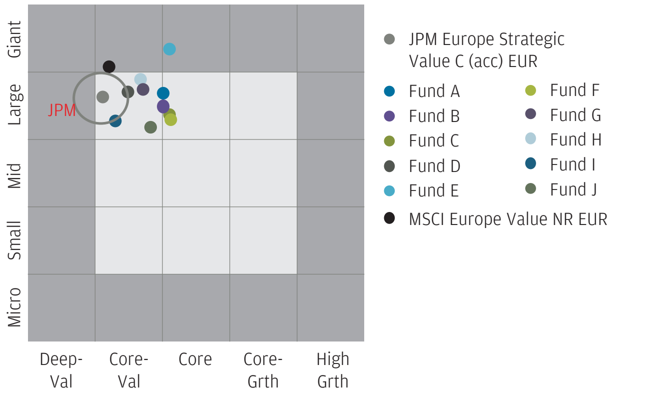


Source: J.P. Morgan Asset Management; data from 30 June 2000 to 31 December 2016. For illustrative purposes only. Fund=JPMorgan Funds–Europe Strategic Value Fund. The forward price-to-earnings (P/E) ratio is the average of the fund and the MSCI Europe Value Index respectively and has been calculated by weighting the forward P/E of stocks in the fund and index by their weight in the fund or index. These numbers are IBES estimates.

Exhibit 7 shows a holdings-based analysis of the 10 largest funds in the Europe Large-Cap Value peer group (as at end of December 2016). The Europe Strategic Value Fund is the deepest value fund of the group and the only fund that has more value than the MSCI Europe Value index. A number of other funds in the peer group are positioned more as core funds.

The Europe Strategic Value Fund stands out from its peers as a deep value portfolio

EXHIBIT 7: MORNINGSTAR HOLDINGS-BASED STYLE MAP OF THE LARGEST FUNDS IN VALUE PEER GROUP



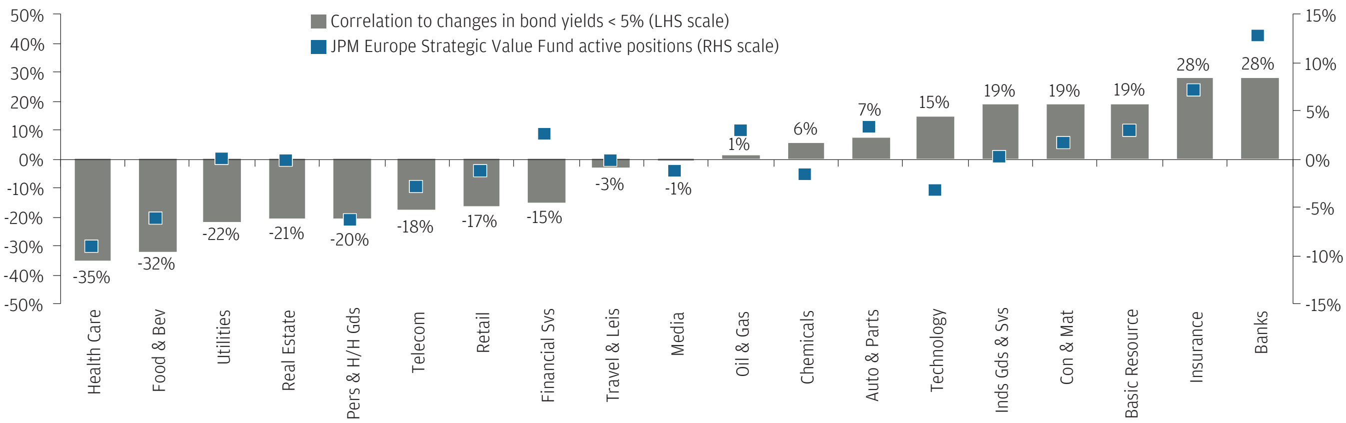
Source: Morningstar; data as of 31st December 2016 Based on the 10 largest funds in the Morningstar Europe Value Universe.

Positioned to benefit if the reflationary environment continues

The value style tends to outperform in periods where inflation expectations are rising and hence bond yields are increasing. **Exhibit 8** shows the correlation of European sectors to changes in bond yields as well as the fund's positioning vs. the MSCI Europe Index. The fund is clearly overweight those sectors that are positively correlated with changes in bond yields (banks, insurance and basic resources) and underweight those that have a negative correlation (healthcare, food & beverages, and personal & household goods). If the current reflationary environment continues, the fund should continue to benefit.

Europe Strategic Value Fund has exposure to sectors that will benefit from a reflationary environment

EXHIBIT 8: PORTFOLIO EXPOSURE TO RISING YIELDS



Source: UBS Securities LLC, J.P. Morgan Asset Management; data as of 31 December 2016. The fund is an actively managed portfolio. Holdings, sector weights, allocations and leverage—as applicable—are subject to change at the discretion of the investment manager without notice. Pas performance is not necessarily a reliable indicator for current and future performance.

INVESTMENT IMPLICATIONS

Although the value style has underperformed growth over the last 10 years, it has started to perform strongly since the summer of 2016. Despite this recent rebound, value stocks still look attractive relative to growth, with historically wide valuation dispersion suggesting that the value rally could be set to continue. Earnings growth expectations for value sectors may also be overly pessimistic.

Investors looking to gain exposure to the value style should look for funds with the proven ability, and disciplined process necessary, to maintain style purity through changing market conditions. The JPMorgan Funds–Europe Strategic Value Fund has a consistent track record and has produced significant outperformance when the value style is in fashion.

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