Investment Update

BNY MELLON
WEALTH MANAGEMENT

February 2017

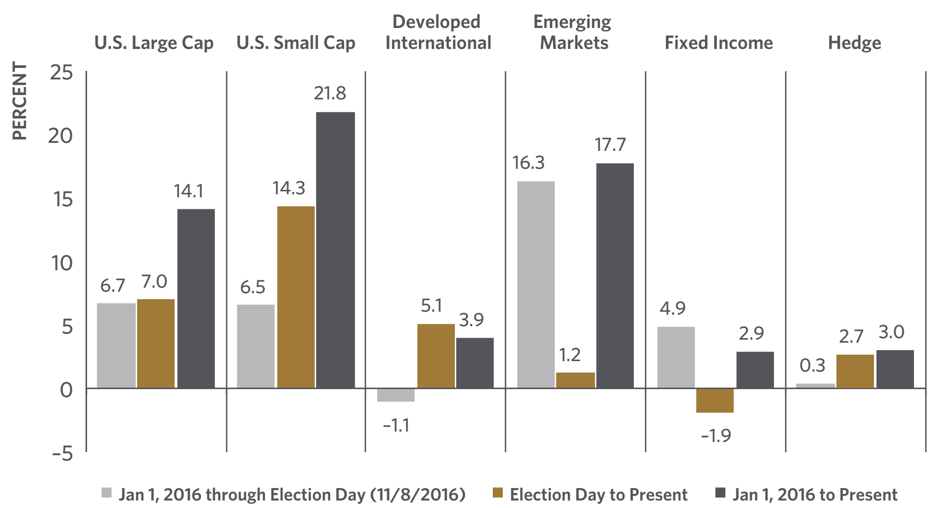
Eyes on the Prize

At a recent holiday family gathering, we organized a Yankee Swap. You know the game, each person brings a gift, throws it into a pile, numbers are drawn and the picking begins. The rules of the game are simple: open a gift of your choosing from the pile and then either keep that gift or exchange it for one that has already been opened by another family member. As luck would have it, I drew a high number and knew that my chances of finishing the game with a gift I cherished were excellent. Everything was going according to plan as I opened my gift and exchanged it for my favorite. I now had the gift that I wanted with only two people left to play. Needless to say, I was elated and my hopes were high. All hope was dashed, however, when the last person opened a gag gift and then turned to me to swap.

This holiday game always reminds me of the emotions associated with investing in the market. Often investors focus on short-term performance and trending headlines rather than keeping longer-term portfolio goals in perspective. We saw this occur last year, when domestic equities rallied after Donald Trump won the presidential election and many indices reached new highs. But, headlines only tell half the story, as illustrated in Figure 1. Other asset classes have struggled since the election, such as emerging markets, which were hurt on a relative basis by a rising dollar and fears of U.S. protectionism. Bonds, hurt by rising rates, also posted negative returns following the election. Even alternative investments lagged long-only strategies. Investors who focused on the post-election equity rally were likely disappointed with the more modest annual returns posted by their diversified investment portfolios.

Figure 1—Market Performance around the Election

As of January 31, 2017



As of January 31, 2017.
Indices used: Large Cap: S&P 500 Total Return Index; Small Cap: Russell 2000; Developed International: MSCI EAFE (Net); Emerging Markets: MSCI EMF; Fixed Income: Barclays U.S. Aggregate Bond Index; Hedge: HFRX Global Hedge Index.
Sources: Morningstar. **Past performance is not indicative of future performance**.

At first, this might seem like an argument in favor of ditching diversification for a 100% equity portfolio. Don't be deceived by these short-term trends. It is very risky to own just one asset class for precisely the reasons we saw during the post-election rally. Asset classes perform differently under various market conditions and cycles, playing unique roles in portfolios. At BNY Mellon Wealth Management, we recommend broadly diversified portfolios with allocation weights informed by our forward-looking market expectations and aligned with our clients' wealth goals. Let's drill down into those asset classes that lagged behind domestic equities during the post-election rally, taking a closer look at why they remain in client portfolios and our strategic positioning.

Fixed Income

Bonds serve to buffer equity volatility and also provide a steady stream of income, two functions that will remain critical even within a rising rate environment. Although there will be some principal erosion as rates rise moderately over the next 12 to 18 months, this may be offset by income. We also recommend diversifying within fixed income among sectors and credit quality to favor higher yielding securities. From a total portfolio perspective, we continue to favor equities over bonds. But by maintaining an underweight exposure to bonds we can take advantage of these income benefits and counterbalance global equity market volatility.

Emerging Markets

We remain significantly underweight to emerging markets, but continue to like the long-term prospects of this asset class, supported by positive demographic trends and faster GDP growth potential than developed markets. We continue to be wary in the near term, however, because emerging markets are more vulnerable to a strengthening U.S. dollar. Dollar-denominated emerging markets debt becomes more difficult to pay back for countries with weaker currencies, burdening developing economies that must borrow to support future growth. In addition, the Trump administration's protectionist policies position emerging markets at the tip of the spear when it comes to tariffs, border taxes and immigration laws. Despite attractive valuations, we will maintain our underweight until we see a more positive catalyst.

Diversifiers

Our allocation to diversifiers encompasses a broad range of asset classes with very different characteristics. We currently have a slight overweight to this group, particularly to managed futures and absolute return. These two categories hedge fixed income and equity positions as they exhibit low correlation to both traditional asset classes and help to mitigate volatility. So although these investments trailed long-only equity since the election, their positive returns were relatively attractive when compared to the negative returns delivered by fixed income. While rising rates adversely affect fixed income returns, managed futures and absolute return strategies tend to perform well.

Stay Focused

Our portfolio positioning ahead of the U.S. election favored those asset classes that went on to perform well, while underweighting many asset classes that have since struggled. Specifically, we were overweight to domestic stocks, neutral on international stocks, and had a significant underweight to emerging markets. Immediately following President Trump's surprise victory, we made the strategic decision to overweight small and mid cap equities, drawing out of our underweight to bonds. While others were calling to reduce risk exposure, we did the opposite. Our underweight to bonds, while favoring higher yielding sectors, and overweight to diversifiers also helped protect portfolios amid expectations for rising rates. All of these active decisions have been made within the context of our 12- to 18-month strategic outlook, which means we are positioning portfolios for the long term instead of reacting to current headlines.

I may have felt some brief disappointment about my final Yankee Swap gift, but I didn't let this distract me from enjoying precious time with my family and friends. Similarly, anyone comparing diversified portfolio returns to domestic equity performance since the election may be disappointed, but this initial discouragement is misplaced. Instead, investors should remember the value of diversification and have confidence in our active allocation recommendations. By taking this approach, investors can keep their eyes on the real prize of achieving their long-term wealth goals.

Jeff Mortimer, CFA
Director of Investment Strategy