

# Investment Update



BNY MELLON  
WEALTH MANAGEMENT

January 2013

## Forward-looking Reflections

The month of January is appropriately named to honor the Roman god Janus, a two-headed deity who looked both into the past and into the future. As we enter 2013, let's look ahead as we always do in these *Updates*, but also reflect on the year that is now behind us.

## 2012: In Review

2012 will be remembered as the year of uncertainty. The Eurozone issues, the slowing in China, the presidential election and the never-ending talk of the fiscal cliff gave the market plenty to worry about. With all that as a backdrop, however, both equity and bond markets did quite well for the year, with the S&P up 16% and a bond market that actually saw rates move lower (and prices higher) to eke out a 4.2% gain, as measured by the Barclays Aggregate index. Rising interest rates and runaway inflation, which might have hampered markets, proved not to transpire in 2012.

Alternative investments, also known as diversifiers, meanwhile trailed the broad averages. This is to be expected. When broad market returns are strong, the alternatives asset class, which is in the portfolio to diversify it from risk, tends to trail. That is not to say one should abandon these investments. They play an important role in long-term portfolio results and can help to counteract the negative effects of other investments in varying market cycles.

## A Shadow of 2004

Many have said that 2012 was unprecedented. Investors generally felt a sense of helplessness, as headline events—both foreign and domestic—took center stage. It seemed the stock and bond markets cared little about fundamentals, and rather only about what was on the front page. Yet, from a historical market perspective, 2012 was eerily similar to 2004.

In both years, the economy was continuing to improve, but few noticed this overall strength because they were too concerned with major potential changes and the banter of what-if scenarios that painted a bleak picture of potential outcomes.

In 2004, when Bush won his second term, the market rallied into year end, gaining 10% in the last two months alone. The 2012 market was that in reverse, making its strongest move at the beginning of the year, with markets up over 10% in the first quarter, then stalling due to the looming election and related policy limbo, and rallying again into year-end as the cliff appeared manageable.

Even the Federal Reserve chairmen were singing from the same sheet of music in these two years. In 2004, Fed Chairman Alan Greenspan recommended that Congress cut spending on Social Security and Medicare instead of raising taxes. We heard similar comments from Chairman Bernanke in 2012, as he told the Federal Government to be fiscally responsible and warned that the economy might not be able to withstand the fiscal cliff plunge.

## Parallel Meanings

The similarities between 2004 and 2012 go on and on. But these parallels are not just academically interesting. They are important because they illustrate how markets have the ability to wrestle with extreme periods of uncertainty, and also how history can be a guide in anticipating—and preparing for—our future.

2004 was followed by nearly three years of strong equity markets, as the growing U.S. economy continued to gather strength. Housing was the main driver of that strength, and could well be again in the years ahead. Energy independence is yet another potential driver of economic growth at home. We will have to watch together to see how these drivers affect the markets in the years ahead. Looking back on 2004, and the years that followed, however, may provide a reflection of our potential future.

## The Power of Asset Allocation in 2012

Every once in a while the markets remind us of what is always the most important investment decision—asset allocation, at the most basic level. By this, I mean the decision of how to balance investments between cash, equities and bonds. In 2012, this most fundamental choice *actually determined* most of an investor's return.

For example, it appeared to matter little in 2012 if one invested in large or small cap, international or domestic, emerging market or developed stocks. All returns at this 'sub-asset class' level were similar. What mattered was how much you had invested in equities overall.

Investors with large cash positions were seriously and adversely impacted by their asset allocation decision. Even bonds—including high yield and emerging markets debt—provided some much-needed, additional income and capital appreciation.

Cash meanwhile continued to provide 0% yield, and again lost pace to inflation, which ran about 2% for 2012.

Bloomberg TV or CNBC rarely discuss asset allocation, but rather how to trade the close or what stocks will be hot. Markets such as 2012's remind us that the allocation decision influences results more than any other. For investors sitting in cash and worried about the headlines swirling around them, we see here—in black-and-white—the cost of improper, or delayed, diversification decisions. When asset allocation mistakes (including inaction) are made, the opportunity costs can be substantial.

### Where Top Down Meets Bottom Up

In reality, asset allocation or investment decisions overall were not simply important at the 'big picture' level, however. In 2012, the lack of sub-asset class differentiation in equities masked a very different story at the sector, industry and individual stock level. Within the S&P 500, for instance, financial stocks led, returning nearly 30%. Consumer discretionary stocks were next, returning 24%, while the energy and utility sectors lagged significantly, returning just 4.6% and 1.3% respectively. Individual stock returns within these sectors also varied widely, creating the potential for money managers to add value through good stock selection, making these decisions critical to an investor's end results.

In summary, 2012 illustrated the importance of both top-down and bottom-up thinking. Both proper asset allocation at the highest level, and surfacing opportunities at the deepest level, within specific sectors and securities, were the keys to success.

### Looking Forward

What do we see ahead as we begin 2013? Another muddle-through year, but that does not necessarily mean more of the same for all investors.

We believe the economy will grow between 2% and 2.5%, with most growth coming in the second half. Within the S&P 500, we see earnings growth of between 5% and 10%. As previously mentioned in many of our other communications, policy overhang, higher taxes, increasing government deficits and the need for financial reform may constrain certain types of businesses or even economic expansion. We see markets remaining volatile. In short, we expect more good cause for uncertainty—and, unfortunately, excuses for the average investor not to act, with potentially damaging consequences.

While, from a return standpoint, we believe more of the same is in order for 2013, we also have a bias to the upside regarding stocks. In uncertain and challenging times such as these, any positive news—whether progress in China, Europe, here at home, or elsewhere—can have a marked effect. Currently valuations are already reflecting a negative outlook, allowing the potential for markets to rally if they receive unexpectedly good news. The resilience shown by markets in 2012 should continue into 2013, as markets still possess the same characteristics and we remain in a part of the cycle where they discount too pessimistic a future.

From a bottom-up perspective, we continue to see opportunities in certain cyclical sectors, including materials and energy. We believe the potential strength of the U.S. economy is still not getting enough credit from the stock market, which still offers reasonable value and yield in companies tied to a strengthening economy.

### What Are You Waiting For?

Thus, 2013 looks to be a continuation of the work-in-progress market of 2012. While the world turns the page at year end, economics, in reality, work in much longer cycles than calendar years. So what will it take to move forward to the next stage?

As I have traveled around the country and had numerous conversations, I've found that many individuals are holding large positions in cash and fixed income as they seem to be waiting for some uncertainty to clear before investing in stocks.

My response is, "what are you waiting for?" In other words, what needs to transpire in order for you to move to your target allocation? Investing after markets have had substantial gains is simply missed opportunity. History shows that if you wait for comfort to come, markets are usually much higher. Beware of the cost of comfort!

I have written in prior *Updates* about the need to embrace uncertainty. Those that have been able to do so have been rewarded. I expect 2013 to continue to make this task difficult. As in 2012, however, difficult tasks have the potential to be financially rewarding.



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