

# Investment Update



November 2011

## Why Bother?

Candles flicker and give the dining room a soft glow. The roast, just out of the oven and resting on the cutting board, infuses the kitchen with its aroma. Steam rises from a basket of fresh bread. Everything is perfect, just as you had foreseen it, as you eagerly await your loved ones for a surprise “family night” dinner. The garage door rises, the front door bursts open... and it all falls apart amid the din of bickering over some trivial slight, stomping up the stairs and slamming bedroom doors. The warm feelings and flowing conversation you had envisioned are not to be this evening, and that expensive roast is relegated to sandwiches hastily made and consumed between the week’s practices, meets and recitals.

Perhaps it is an occupational hazard of being an investment strategist, but sometimes when the future does not cooperate with the forecast, it can be profoundly disappointing and cause one to ask “Why bother?”

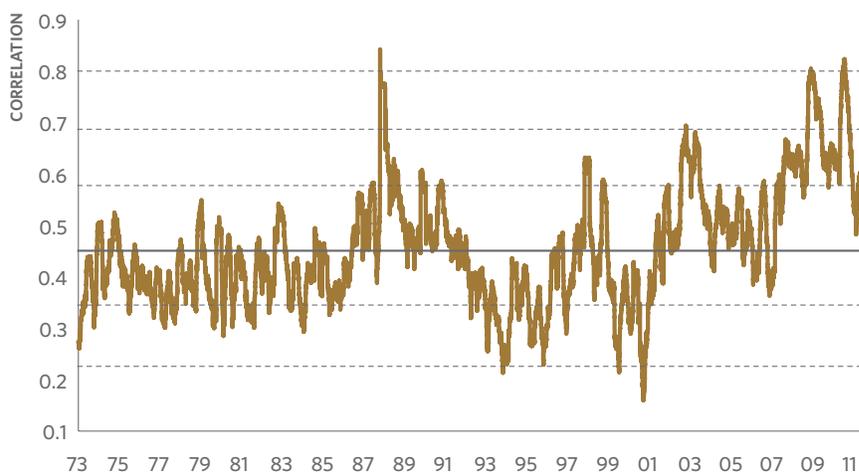
Why bother with analysis, projections and disciplined investment processes? What’s the point of diversification and long-term thinking when all the market is concerned with is the news of the day?

Investors must surely have felt this during the third quarter as macro worries drove volatility across asset classes and nothing else seemed to matter. Fears of recession rose to such a degree that commentators

were using words like inevitable, imminent, unavoidable and already here. The U.S. debt ceiling drama, including the rating downgrade and flirtation with default, and the ongoing European debt saga combined to destroy investor, business and consumer sentiment — despite the fact that relatively little happened that was unexpected in either case. The resulting volatility and extremely high correlations (the degree to which markets or asset classes move in tandem, as illustrated in Exhibit 1) made for a very challenging quarter.

## Exhibit 1 — Correlations Spike as Market Responds to Macro Uncertainty

Median 63-Day Correlation of S&P 500 Stocks to the S&P 500 Index



Daily data 1/1/1973 – 10/14/2011. Source: Ned Davis Research.

While we expected volatility this year and recognize that correlations often rise during periods of market stress, we were somewhat taken aback by the speed and breadth of the shift in trend. Looking at underlying economic data, it was not at all clear to us that the odds of recession were as high as those assigned by the markets. At the time, however, it truly did not matter. A portfolio with any degree of cyclical exposure to economic growth or participation in riskier asset classes suffered badly as investors began to panic. The macro environment overwhelmed any focus on fundamental factors and the safety trade bolstered Treasury bonds, pushing yields down to levels not seen in decades and at least temporarily strengthening the U.S. dollar.

Considering these extreme reactions and the conditions that propagated them, it would be understandable for investors to be thinking “Why bother?” Then along came October.

## Never Mind!

The nadir of the market is often the zenith of gloom-and-doom commentary. By the end of the third quarter, many equity markets had reached or were near the point generally considered a bear market, and the headlines were ominous and menacing. At times like this, it can be very difficult to resist the temptation to panic and throw in the towel.

But while we recognize the need to be nimble in implementing investment solutions, we do not advocate trying to time markets over such short intervals. Events early in this fourth quarter demonstrate why. As October dawned, economic releases undermined the prevalent view that recession was imminent. Despite very negative sentiment, consumers and businesses continued to spend — not at robust levels, but at levels far better than had been feared. Investors either began to tune out U.S. political noise or they sensed a modest shift in a more positive direction. In Europe, we finally saw the outline of an actual plan to deal with the debt and market contagion. It was not an ideal plan with full details and complete certainty about how it would be funded, but it was something concrete and directionally helpful. Given how markets were positioned, with valuations and sentiment at such extreme lows, the result in October was one of the strongest monthly market rallies in many years.

We do not think investors are likely to be completely comforted by this bounce. After all, it too is a manifestation of the ongoing volatility, though at least in an upward direction and partially based on better underlying data. Nor do we believe that the October bounce means we've moved past economic turmoil and uncertainty. The European debt crisis continues to evolve — eventually the focus will shift from Greece to other troubled debtor nations including Spain and Italy — and the debt-reduction deadline for the U.S. congressional super committee is drawing near.

But to have made significant portfolio moves because of the dire third-quarter headlines would have risked missing the October rebound.

## Setting the Table for What's to Come

In such volatile times, the odds may be stacked against shorter-term market forecasts. At the same time, forecasting is better than the alternative. Without planning and projections, we are doomed to be surprised.

The other way to avoid being unpleasantly surprised — in this case by being on the sidelines during market moves such as those we saw in October — is carefully crafting a long-term strategy and having the discipline to stick with it.

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Pinpointing when markets will improve or how long an upswing will last has always been difficult. What's more, significant market gains often occur over relatively short periods, making it easy for market-timing investors to miss out.

Looking ahead, we think it would be a mistake to assume that diversification based on economic and market fundamentals will fare as poorly over time as it has recently. While we do not in any way think volatility is behind us, we do believe that eventually longer-term equity investors will be attracted by several factors. These include low equity valuations in some areas, the cushion of current equity risk premiums, high cash positions and low dividend payout ratios, and, hopefully, gradually improving economic conditions. As these factors become more visible, fundamentals should matter more.

This return to fundamentals will happen slowly, however. As macro conditions continue to dominate headlines, volatility and correlations likely will remain higher than investors would prefer. But while diversification strategies may not always perform as expected over shorter periods, we will continue to seek out investments that may behave differently over time than other holdings in a portfolio and that may serve to capture opportunities created by inevitable market inefficiencies. We believe this disciplined and active approach to diversification will ultimately benefit investors and demonstrate why it is even more important to "bother" in times of market duress.



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