

# Policies, Politics and Portfolios

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## Policies, Politics and Portfolios

### MANAGING THE INVESTMENT IMPACT OF WORLD EVENTS

IT IS VIRTUALLY IMPOSSIBLE TO PICK UP A NEWSPAPER or click on a news site without confronting today's economic challenges. The headlines broadcast the latest updates on America's slowdown, the Eurozone's meltdown and fiscal downturns of all shapes and sizes. It's clear that politics and policymakers are influencing portfolios in unprecedented ways.

As a result of all this information, many investors are confused and anxious. For private investors, the challenges are even more complex. They must make critical investment and planning decisions within a regulatory and tax environment that continues to change. The question is, "Can investors move forward in the midst of all this volatility and uncertainty?" The answer is yes.

# The Choice Between Progress and Paralysis

AS HARD AS IT MAY BE FOR INVESTORS TO ACCEPT, unpredictability and constant change are here to stay. Adding to the uncertainty is the increased impact of world events on the markets. The U.S. elections and international policy decisions are further compounding the confusion.

Investors today are increasingly recognizing the strong connection between policy decisions—and indecisions—and economic and market behavior. They are also reacting accordingly. Not surprisingly, the bewildering landscape has left some investors paralyzed. Afraid to do the wrong thing, they do nothing at all.

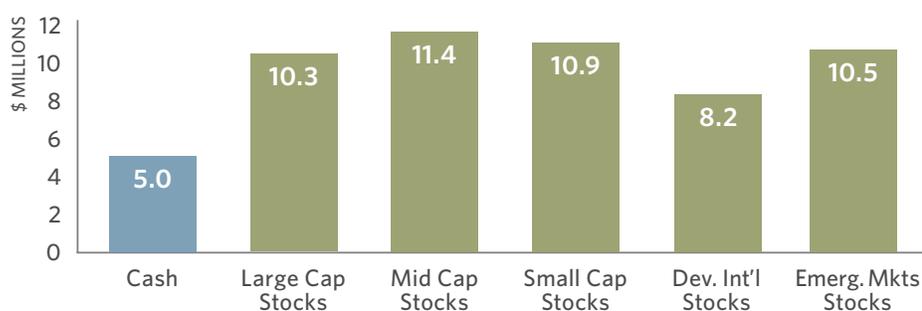
At first glance, it may seem sensible to wait for clarity or to hold off until things return to “normal.” However, lack of clarity and ongoing change are the new normal. While it may appear prudent to avoid making decisions until the fog clears, doing nothing actually is a decision—one with real, and potentially damaging, long-term consequences, particularly in today’s environment. Exhibit 1, for instance, illustrates some of the more recent investment gains that swept past investors who sat on the sidelines.

Exhibit 1

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## Opportunity Lost?

Growth \$5M Since March 2009 S&P 500 Market Bottom



Regardless of what lies ahead, there are steps investors can take to move forward. Doing so, however, requires a firm understanding of today’s realities and tomorrow’s potential changes. It is important to position yourself for both, considering not only the possible rewards but also the likely risks. In short, know what you know, know what you don’t know and plan around each.

It is also helpful to shift your perspective. Rather than seek opportunities in spite of the current environment, look for opportunities that exist because of the current environment. And leverage them while you can.

# Following the Leading Indicators

IT IS DIFFICULT ENOUGH TO ANTICIPATE THE PORTFOLIO IMPACT of world events in times of relative stability. It can seem almost impossible when policymakers are aggressively at odds and the politics of one region can easily cause tremors in another. Therefore, it is critical to recognize the leading indicators related to policy actions and politics and to remain aware of their potential influence on market events.

## Evaluating the U.S. Indicators

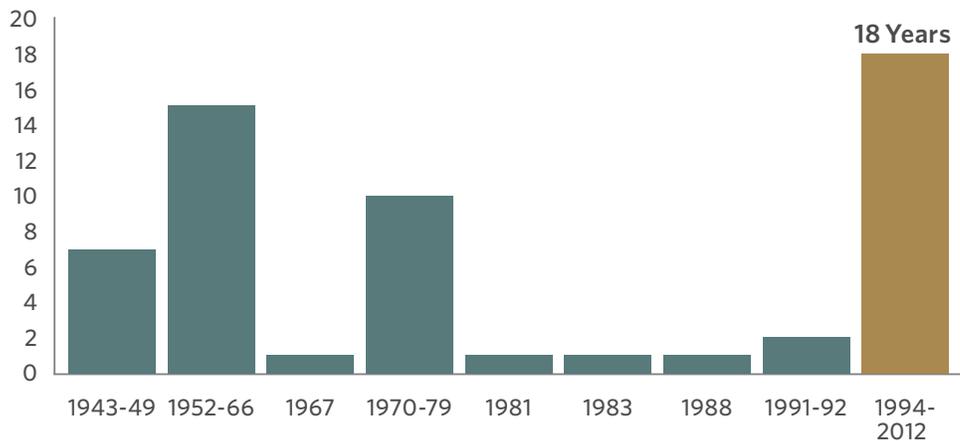
In the U.S., all eyes are on the short- and long-term consequences of the 2012 elections and the subsequent direction of U.S. policy. Among the key forces that need to be kept in sight are the future indicators for tax, spending, monetary policies and growth.

Regardless of the election's aftereffects, it appears inevitable that tax policies will change. Taxes in the U.S. have remained low for a historically long period—the longest since World War II (Exhibit 2). What's more, countless tax policies are due to expire in 2013 unless extensions are enacted (Exhibit 3). These facts, coupled with the country's current economic challenges, make tax changes and increases highly likely.

Exhibit 2

### A Tax Increase is Looming

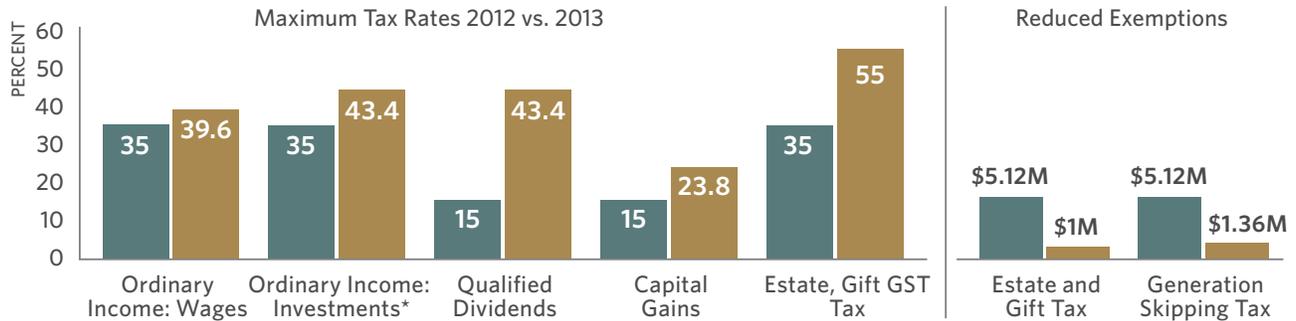
Longest Time Period without a Net Federal Tax Increase Since WWII



Source: StrategasRP.

Exhibit 3

**Steep Tax Increases on the Horizon?**



\*Excludes qualified dividends.

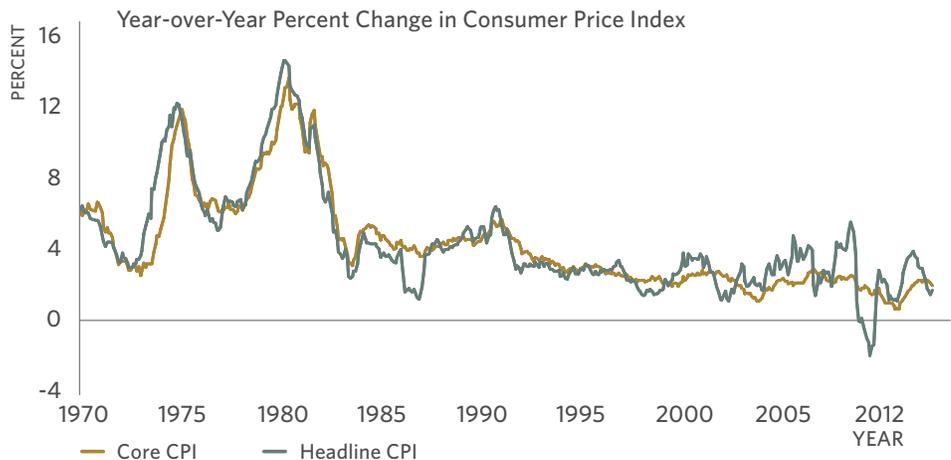
Tax policy changes, however, represent only half the tax story. The market’s reaction to those inevitable changes is equally significant. The response will depend on which taxes are changed, how they are changed and the context of the changes. For example, constructive progress in comparable areas of concern, such as spending, growth and the deficit, could greatly influence investors’ reactions to the reshaping of tax policies.

No matter what form these policy shifts may assume, they are certain to impact economic growth and market behavior, including certain asset classes and sectors. They will also greatly influence strategies for wealth transfer and planning.

In addition to taxes, it is essential to remain vigilant about the potential for future inflation. The U.S. has been experiencing low interest rates and accommodative monetary policy for quite some time. Similar prolonged periods have historically led to inflationary aftermaths. While inflationary pressures remain muted, as illustrated in Exhibit 4, investors need to be prepared for the possibility of future inflation and plan accordingly.

Exhibit 4

**Inflation Remains Contained...for Now?**



As of 8/31/12. Source: U.S. Bureau of Labor Statistics.

### The Indicators beyond U.S. Borders

Beyond U.S. borders, Europe’s unraveling debt crisis remains front and center, reinforcing the link between policies and portfolios all too painfully.

The Eurozone’s challenge consists of three interconnected components: a sovereign debt problem, a banking problem and a growth problem. Pull on any one of the Eurozone levers and the others are affected. Therefore, Europe’s political leaders must muster a strong enough policy response to address debt without sacrificing growth or exacerbating the banking issues. The steps these policymakers take, and the markets’ response to their actions, will have far-reaching consequences—on a country-by-country and investment-by-investment basis.

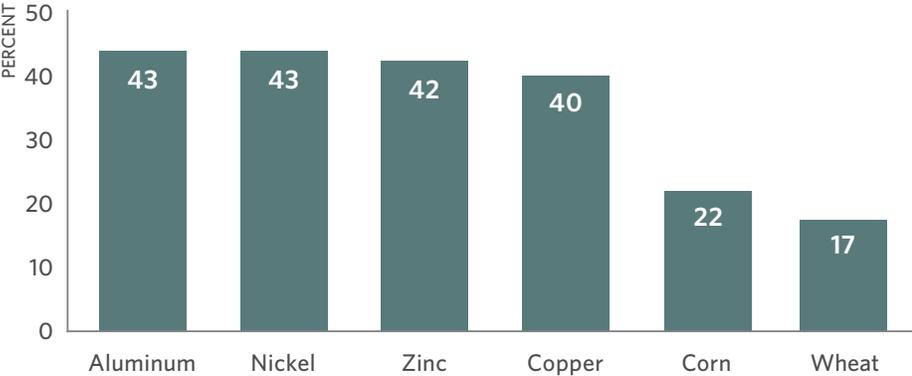
Meanwhile, economic growth in China has clearly decelerated. Because China is a massive consumer of commodities, its tepid growth could significantly impact commodity prices worldwide (Exhibit 5). It is unwise to underestimate the potential domino effect of China’s troubles on other nation’s economies. That said, however, China’s risks must be weighed in light of the controls its policy makers have at hand.

For instance, China did not permit the leveraging the U.S. allowed and does not have the banking issues facing America and Europe. In addition, its currency resources are enormous. Even if China’s policy makers are slow to take action, they can enact stimulus policies and assume a more aggressive stance moving forward. These factors make it unlikely that China will experience a hard landing. Even still, the actions and reactions of this massive economy bear close watching.

Exhibit 5

### China’s Strong Demand for Commodities

Chinese Commodity Consumption as % of Global Consumption in 2011



As of 12/31/11. Source: Ned Davis Research.

# Distinct Challenges, Common Themes

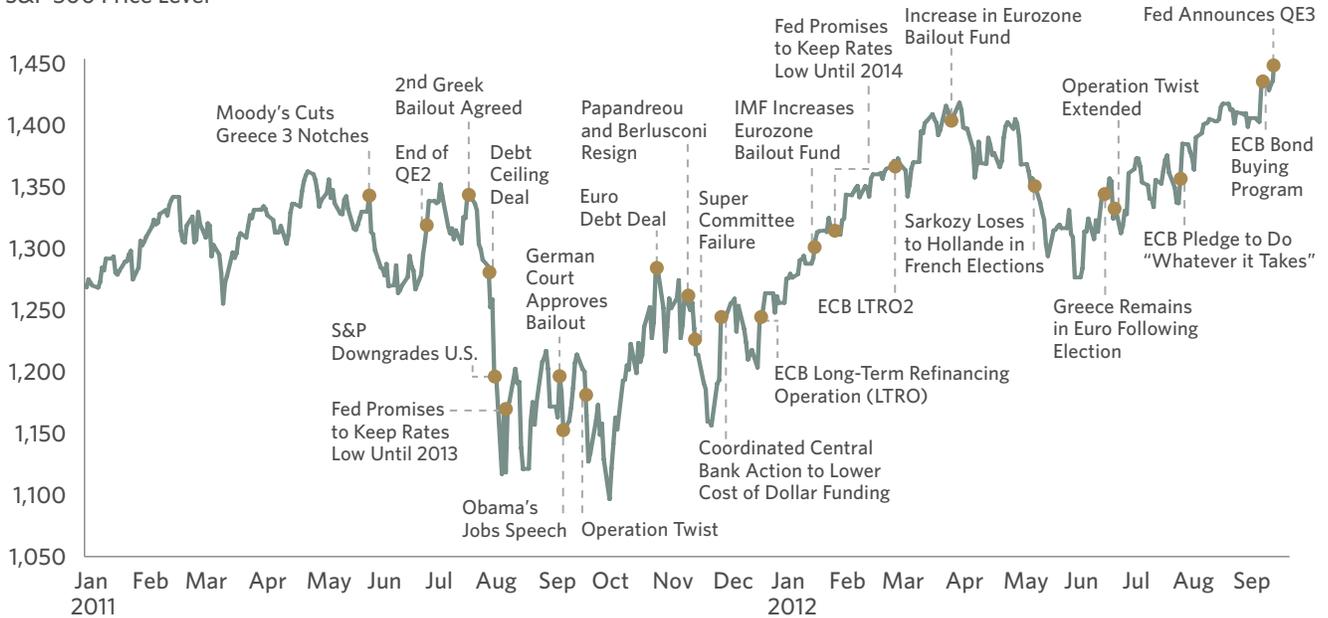
THE LINK BETWEEN POLITICS, POLICIES AND PORTFOLIOS IS NOT A NEW ONE. But forces such as globalization and the extraordinary speed at which information is now available have made the link shorter and tighter. In addition, investors are more aware of market and world events than ever before, quickly responding to changes, often in highly unpredictable ways. One need only glance at the recent mercurial performance of the S&P 500 to appreciate the firm coupling of the investment world and the world at large.

For example, in September 2012, when the European Central Bank announced its bond buying program and the U.S. government committed to a third round of easing, the markets responded quickly and positively. The MSCI EAFE benchmark rallied nearly 2% and the U.S. markets increased by about 1.5% following the Fed's announcement of another bond buying program and the extension of low short-term interest rates (Exhibit 6).

Exhibit 6

## Domestic and International Events Impact Markets

S&P 500 Price Level



As of 9/13/12. Sources: StrategasRP, and FactSet and BNY Mellon Wealth Management.

While the issues facing U.S. and global policy makers are often highly distinct, a number of common themes have emerged. All have long-term implications for investors.

**Policy makers are getting it.** Time will tell whether the decisions and deeds of policy makers are effective, but at least there is a more realistic recognition of the issues and the urgent need for action. While some policy makers were initially sluggish in their response, many central banks have demonstrated newfound determination to actively address clearly identified problems with more comprehensive solutions.

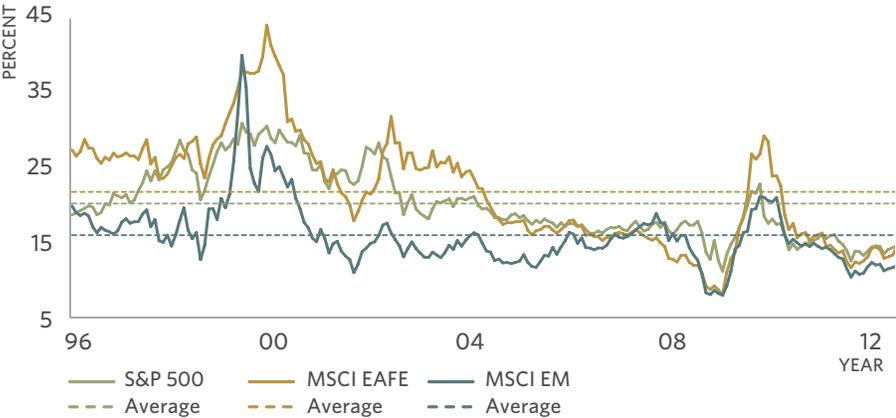
**Investors are accepting new realities.** Much like policymakers, investors are also realizing the severity and lasting implications of our new environment. This was not the case a few years ago. Many investors were slow to understand and accept the scope and persistence of the new challenges, unaware of the crippling impact on their fundamental short- and long-term financial goals.

Ironically, investors today not only recognize the gravity of the new realities but are virtually wed to them. They perceive the current challenges as permanent. Assuming the situation will never change, they act—or don't act—accordingly, placing their portfolios and their futures at risk. Yet nothing is constant. Change will come and most investors are not ready.

**New, favorable valuations are presenting opportunities.** Shifting politics and policies are creating areas of favorable valuations around the world, particularly within certain industries, regions and asset types. This presents a real opportunity for the deliberate and thoughtful investor (Exhibit 7). For example, valuations on domestic and international equities are below their historic averages, presenting considerable upside potential for active managers able to uncover fundamentally sound investment possibilities.

Exhibit 7

**Historically Attractive Valuations: Price/Earnings Ratio for Major World Markets**



As of 8/31/12. Source: Bloomberg L.P.

# Portfolio Implications: MOVING THROUGH THE FOG OF UNCERTAINTY

SO WHAT SHOULD YOU DO TO OPTIMIZE YOUR INVESTMENTS amidst ongoing policy and political turbulence? Avoid letting the fog of uncertainty block your view of the future. Instead, peer through the fog to discern the true opportunities and risks—and act accordingly. Here are a few key recommendations:

## **Seek The Bright Spots, Even When Things Look Dark.**

Although market and asset class correlations have been abnormally high, growth is not the same worldwide. Even when global markets all seem to be behaving in the same way, the key is to look deeply—by country and by sector—to find the true bright spots, regardless of the clouds of gray.

For example, the clouds over Europe may be masking the fact that certain fundamentally sound companies are exhibiting notable growth potential. Emerging markets also are presenting valuation opportunities—not across the board, but in select countries with higher growth, lower inflation and easing monetary policies. There also are opportunities forming along the U.S. front, such as those presented by large companies with multi-national reach and emerging markets exposure.

## **Protect Your Portfolio Against Future Inflation.**

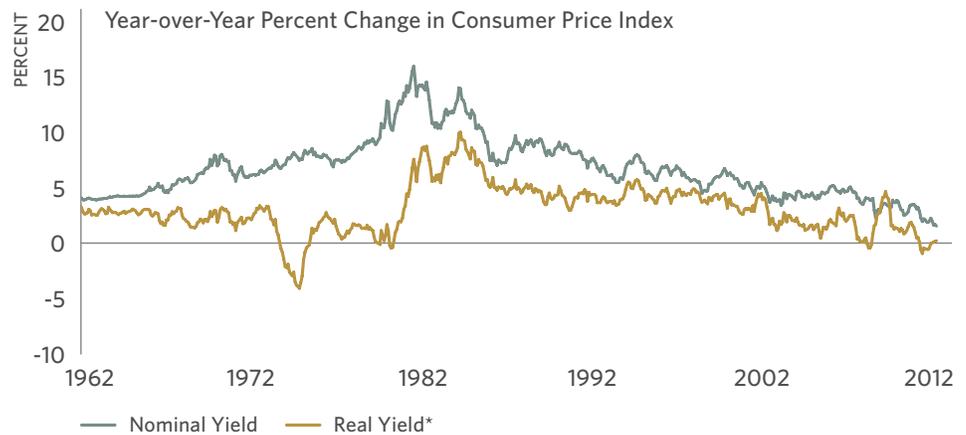
While inflation may not be a near-term threat, it is not likely to remain a slumbering giant forever. Yet, most investors' portfolio strategies are ill prepared for the awakening. In fact, many are unknowingly structured to compound the damaging effect of inflation on core objectives.

It is no secret that you should consider investments that protect your portfolio from the damaging effects of inflation. But it is equally important to understand how inflation could impact income-producing instruments, such as bonds and cash.

For instance, an investment such as a money market fund not only runs the risk of low yield, but also declines in purchasing power as the inflation rate increases. The same holds true for bonds. You may hold a low-yield bond until maturity to protect your principal, yet you will be buying less with those dollars if the bond matures after inflation (Exhibit 8).

## Exhibit 8

### Real Yields Near Zero



As of 7/31/12. Sources: Federal Reserve System, FactSet.

\*10-Year U.S. Treasury Yield minus annual percent change in Personal Consumption Expenditures Price Index.

### Understand Why Safety Isn't Always Safe.

In times of market tumult, it is unsurprising that investors flock to safety. But what was safe yesterday may not be safe today. In many cases, historically sound sources of income are no longer as reliable as they once were; investors are paying too high a premium for a diminished yield. As an alternative, investors should consider diversifying their income sources into less traditional areas such as emerging markets debt.

In fact, a general lack of diversification is another potential danger of rushing toward safety. It is not uncommon for a strategy driven by “security” to lead to a portfolio overweighted with investments that appear to be safe, but are actually creating a harmful lack of diversification or exposure to risks that are not immediately evident. While diversification is an essential tactic in almost any investment environment, it is particularly prudent when grappling with a capricious market.

### Seize The Day Before The Sun Sets.

Windows of opportunity open and close—often very quickly. When examining the impact of policies and politics, you need to not only recognize what is happening, but also think about what has not happened yet—and act before the windows are shut and locked.

Take, as an example, today's gifting and wealth planning opportunities, a number of which are presented in Exhibit 9. Fiscal policy, low interest rates, low taxes and relatively low valuations have created a perfect storm of opportunity for planning. For instance, historic interest rate lows have produced an ideal climate for intra-family loans and gifting strategies such as GRATs.

Current tax rules also are favoring retirement planning and total return strategies. A good illustration of this can be found in Roth IRA conversions, where the transferred funds are taxed at very low rates.

In addition, the recent \$5 million estate-tax exemption and \$5 million lifetime gift-tax exclusion are providing a rare opportunity to shift significant assets from an estate in a tax-free manner. Now is also a good time to take advantage of low interest loans for large purchases, rather than dilute the long-term potential of your investments.

But these opportunities come with an expiration date. At any point, they may be legislated away or evolve into something less favorable. Take advantage of them while you can.

*Exhibit 9*

**The New Nimble: Examples of Timely Planning Opportunities**

Opportunities and Planning Techniques	Actions for Consideration*
Asset Location	Weigh the difference in capital gains vs. ordinary income tax rates under changing tax law, and assess the effects on different asset classes <ul style="list-style-type: none"> <li>Place tax-inefficient assets in tax-deferred accounts</li> <li>Shift long-term growth assets to taxable accounts</li> </ul>
Current Low Interest Rates	Transfer wealth to children and grandchildren <ul style="list-style-type: none"> <li>IRS-required interest rates (\$7520/Applicable Federal Rate (AFR)) at historic lows</li> </ul>
Proposed Legislation	Monitor current legislation for potential changes, such as: <ul style="list-style-type: none"> <li>Further changes in income tax rates and estate tax provisions</li> <li>Taxation of part or all of the “carried interest” of hedge fund managers as ordinary income rather than capital gain</li> </ul>
Restrictions on Grantor Retained Annuity Trusts	Transfer assets to family members before proposed legislation makes GRATs less favorable <ul style="list-style-type: none"> <li>Take advantage of short-term and zeroed-out GRATs</li> </ul>
Roth IRA Conversions	Consider converting traditional IRA to Roth IRA before income tax rates increase
Increase in Tax Rate on Qualified Dividends after 2012	Consider new asset classes no longer burdened by less favorable tax rate than investments paying qualified dividends
Increased Estate and Generation-Skipping Transfer Taxes	Consult counsel about transferring wealth to children and grandchildren before scheduled tax law changes in 2013 <ul style="list-style-type: none"> <li>Benefit from higher exemptions and lower tax rates for gifts, estates and generation skipping</li> <li>May avoid incurring generation-skipping tax</li> </ul>
Valuation Discounts	Transfer business interests to family for non-tax (i.e., business or personal) purposes <ul style="list-style-type: none"> <li>Consider reorganizing legal structure of assets into partnership or limited liability company and transferring partial interests in new entity</li> </ul>

\*Provided for illustrative purposes only. Planning opportunities should be considered in the context of each individual’s unique situation, in consultation with a legal or tax professional.

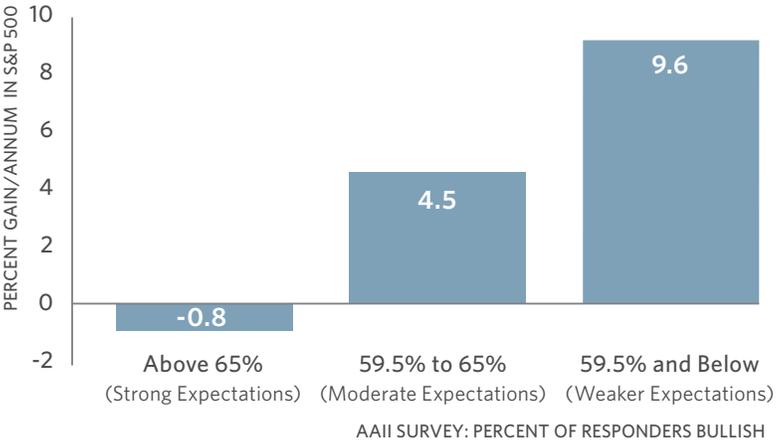
**Think About The Future. Period.**

Historical performance is historical. So is yesterday’s news. Yet for many investors, yesterday’s events are overpowering today’s realities, coloring investors’ perceptions and reactions in various shades of black. That’s a major risk. Some people have become so used to a negative mindset that they don’t believe things will change. Yet change is inevitable. It’s important to accept it—and prepare for it.

A negative perspective is not only a barrier to investment success but also a path to potential destruction. History shows that investor sentiment and market performance are often at odds, as conveyed in Exhibit 10. Extremely pessimistic investors often miss out on significant opportunities. Rather than anchor your mindset in the past, be ready for what’s ahead and keep your sights set on tomorrow.

Exhibit 10

**Investor Sentiment vs. S&P 500 Gains**



**Separate Truth From Trend.**

Today’s investment environment can be tiring and confusing, but it is a mistake to avoid planning and acting. It is also unwise to fall prey to the daily headlines and overreact. While it may be hard to see things clearly in today’s climate, it is critical to not let the frenzy overpower the facts. Successful investing depends on ignoring distracting noise and focusing on what is important.

**Be Adaptive, Not Reactive.**

Discipline is crucial to any successful investment strategy. But you also need to adapt—not only to changes in politics and policies but also to new investment opportunities that may arise. That means tapping today’s potential before it disappears and staying nimble enough for tomorrow’s surprises.

# Acting in The Face of The Unknown

IT IS UNDENIABLY HARD TO MAKE A LONG-TERM INVESTMENT DECISION in an environment of unknowns. But doing nothing *is* an investment decision. And it's a bad one. By not making a decision, you impact your ability to meet your objectives.

Even in the face of uncertainty, the key is to act. Uncertainty can be as big a drag on the economy as the policy decisions and political forces mentioned earlier—maybe even bigger.

What's more, if you sit and wait before taking action, your investment strategy quickly becomes outdated. Each day of delay is a day you fall further behind—until opportunity is eventually out of reach.

Instead, you should determine what you want to accomplish with your investments and develop a strategic plan that aligns with your goals. Once your plan is in place, it is critical to maintain a consistent approach, while remaining ready for change. More than anything, you must believe in your plan, even as your faith gets shaken—and it *will* be put to the test.

The coming days will continue to be volatile. Issues like the Eurozone crisis and U.S. debt will not be solved overnight. Politics and policies will never stop shaping our world and influencing investors' portfolios. Consequently, it is more important than ever for an investor to partner with an advisor who has a deep understanding of world events and their potential portfolio impact.

No one knows the future, but everyone can prepare for it. Investors who look ahead with the help of a knowledgeable, experienced advisor are likely to find that they are not only ready for tomorrow, but able to move toward it with confidence.

## Endnotes

### **Endnote 1** *Exhibit 1, Opportunity Lost?*

Cash: 90 Day U.S. T Bills; Large Cap Stocks: S&P 500 Index; Mid Cap Stocks: S&P MidCap 400 Index; Small Cap Stocks: Russell 2000 Index; Developed International Stocks: MSCI EAFE (Net); Emerging Markets Stocks: MSCI EMF. Source: Morningstar.

### **Endnote 2** *Exhibit 3, Steep Tax Increases on the Horizon?*

The 2013 rates reflect the expiration of the Bush tax cuts and the 3.8% Medicare tax on net investment income for certain high income taxpayers as well as the additional Medicare payroll tax on employees. The rates summarized above do not take into consideration the increase in the marginal tax rates for higher income taxpayers due to the loss of the personal exemption, the loss of some itemized deduction and the deduction for self-employment tax.

### **Endnote 3** *Exhibit 10, Investor Sentiment vs. S&P 500 Gains*

Chart shows percent gain per annum in S&P 500 based on the percentage of investors believing the market will appreciate in next six months. The chart illustrates that a market top is often the point of maximum optimism and a market bottom is the point of maximum pessimism. Based on data 8/7/87 to 9/14/12. Sources: American Association of Individual Investors and Ned Davis Research.

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