Investment Update

BNY MELLON
WEALTH MANAGEMENT

June 2014

The Second Half Playbook

I'm on the road all the time, talking with investors from Philadelphia to San Francisco, from Dallas to Chicago. It has given me a great opportunity to hear directly from people across the country about their experiences in the markets during the past five years of the recovery. As a lifelong student of investing and markets, I have found these conversations a fascinating and invaluable experience in how investors behaved from the depths of a crisis of cataclysmic proportion to a bull market that has shown remarkable resilience.

There was the college professor from the Midwest who liquidated his IRA in 2008 and still hasn't put his cash back in the market. The kindly grandfather from New York who was thrilled with his U.S. equity gains in 2013 and wants to let his winners run. The couple from California who wondered what the Federal Reserve's policies would mean for their bond income. The entrepreneur from the Southeast who wanted to sell his business but was worried about moving from business owner to investor in the current challenging environment.

Their investment experiences have all been as unique as their lives and aspirations. Along the way, I discovered some universal truths: One, investors who focused, stuck to a plan and listened to good advice survived and thrived. Two, those investors who didn't focus were left behind and have been trying to catch up ever since.

As we move through a transitioning investment landscape with an aging bull market, a strengthening economy and normalizing interest rates, most investors are understandably wondering what will come next. To help investors stay on the right path in this changing environment, we offer a playbook for the second half of 2014. There are three key "plays" that can determine the extent to which an investor will achieve success in 2014 and beyond.

Play #1: Embrace Change

A changing market offers opportunity, and investors need to be ready to capitalize on it. Play #1 in the Second Half Playbook is for investors to embrace change and use it to their advantage. By "rethinking" ahead, investors should review old mindsets and let go of assumptions about what is normal. They will need to look for opportunities in different places and employ new strategies, focusing on data and fact-based insights.

Perhaps one of the biggest changes in the market in the second half of 2014 is the Federal Reserve's decision to end quantitative easing. The Fed has reduced from $85 billion to $45 billion its monthly asset purchases to help jump-start the economy. While the Fed remains accommodative, its change in direction will continue to impact the market. For example, stocks moved sharply lower when a Fed official from Philadelphia suggested rates would have to rise soon. A few days later, markets soared when Fed minutes suggested policymakers see no signs of inflation. Investors need to be ready for ups and downs along the way.

The Fed's actions no doubt will also help to spur global growth and help the economy complete its recovery from the Great Recession of 2007-2009. In this environment, we remain constructive on global stocks. The accommodative Fed, low inflation and improving growth prospects have created a positive backdrop for steady, yet modest returns in equities for 2014.

Play #2: Get More Active

We are exiting the rising tide environment of broad market gains that we saw in 2013, and today's market will have clear winners and losers. Finding these potential winners will take rigorous investment discipline and analysis to identify good investments from poor ones. Security selection, also known as good old-fashioned stock and bond picking, has returned to the forefront. Most importantly, investing with "intent" means getting active at every level of a portfolio. This means making dynamic asset allocation shifts as markets change, all the while taking into consideration tax efficiency and strategy drift.

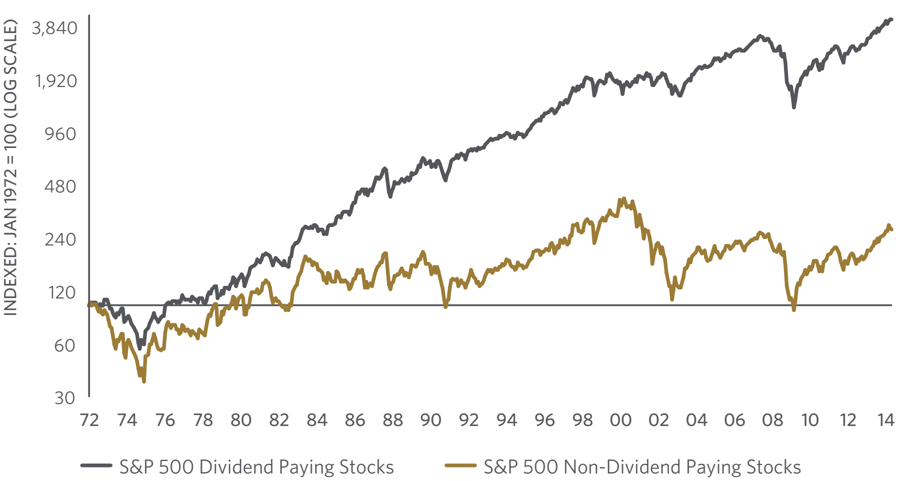
One great way for investors to get more active in the second half of 2014 is to think more carefully about their bond allocations. Over the long term, investors will need to position their portfolios for the end of a 30-year bull market in bonds that was marked by historically low yields. While Fed policy will lead to the eventual normalization of interest rates, rates have actually fallen in the first part of 2014. The Barclays Aggregate Bond Index is up 3.8% year-to-date as of May 31, not far behind the 4.9% return of the S&P 500 Index. The Barclays Municipal Bond Index is up 5.9% during the same time period. It is a reminder that bonds always have a place in a portfolio as a source of income and capital appreciation potential. In these volatile times, with rates moving up and down, a skilled investment manager can find opportunity through rigorous security selection.

Play #3: Take a 360 View

While investors need to look to the future to meet their long-term goals, they also need to see the changes that are happening today and all around them. A 360 view should include a holistic plan that can adapt to the changing landscape. The "set it and forget it" plan that may have worked decades ago is no longer valid in today's world.

For example, many investors have not adjusted their strategy to reflect legislative and regulatory changes. In 2013, new tax legislation took effect that resulted in increases on many sources of income. Given the persistently low bond yields we've seen in 2014, investors will need to revisit their income needs for today and years from now.

Exhibit 1—Dividend-Paying Stocks Have Historically Led the Way

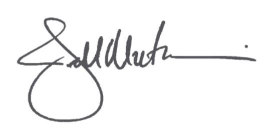


Source: Ned Davis Research. Total returns since January 1972. As of 4/30/14.

As outlined in Exhibit 1, dividend-paying stocks offer a reliable source of income, with the added bonus of the potential for capital appreciation. Over time, dividend-paying stocks have significantly outperformed non-dividend payers. In addition, companies that pay dividends typically have better business models and strong balance sheets. Thus, they perform well during difficult or uncertain markets. Defensive stocks within sectors including utilities, telecoms and consumer staples typically pay higher dividends.

Conclusion: Survival of the Focused

Embrace change, get more active and take a 360 view are three important "plays" in our Second Half Playbook for 2014 and beyond. They are also the cornerstones of how BNY Mellon Wealth Management defines investment focus. We will be talking more, in the coming months, about how investors can remain focused in today's transitioning investment landscape. Stay tuned.



Jeff Mortimer, CFA
Director of Investment Strategy