Investment Update

BNY MELLON
WEALTH MANAGEMENT

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Finding the Comfort in Uncomfortable

Market volatility has returned in 2014, and U.S. stocks are struggling to regain their momentum. Most indexes are down slightly for the year, following a robust 2013 in which many risk assets grinded upward, shaking off whatever bad news crossed their paths. If 2013 was a year in which the rising tide benefited all stocks, 2014 will be the year defined by individual names standing out from the crowd.

It's never comfortable when the markets are in a transition phase. Investment ideas that once worked may no longer be delivering positive results. Volatility spikes can exacerbate the uncertainty and confusion, rattling even the most steadfast investors. Portfolios generate lower, or sometimes negative, total returns. Yet a changing market environment is one that should be embraced because it can offer new opportunities that may otherwise go overlooked. We expect to see more volatility in 2014 and a far different market environment. Ultimately, however, we continue to see a positive year for the markets against a strengthening economic backdrop.

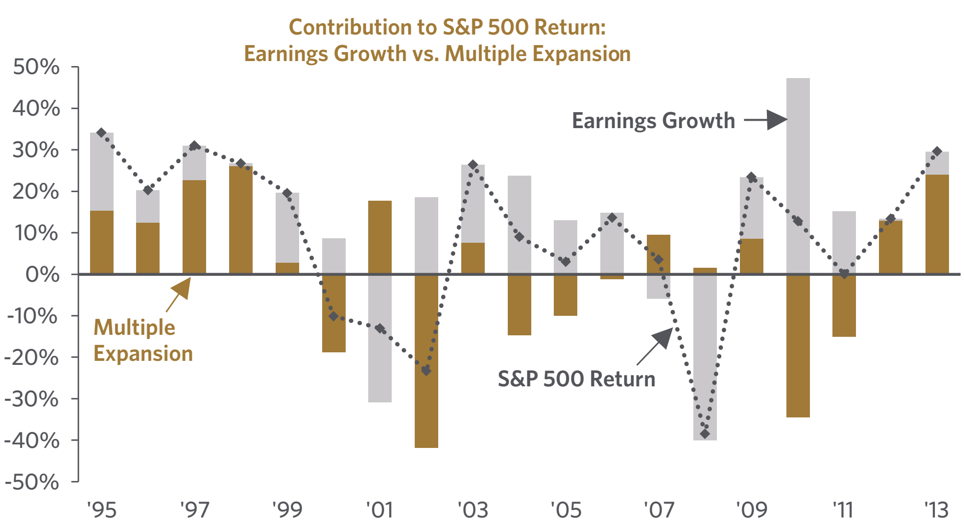
Bottom Up: Earnings Will Drive the Market

Some of our own money managers within BNY Wealth Management comment that stocks have reacted with more volatility when they surprise the Street (both good and bad). Moves of 15% to 20% in one direction or the other on the date of earnings announcements are not uncommon. As markets reach fair value, a condition we believe holds now, individual companies no longer benefit from a rising tide (when markets are undervalued), and thus must "earn their keep" on a company-by-company basis.

This leads to a much more volatile earnings season. Expect more of this type of volatility going forward, as even stocks within the same sector are beginning to act differently, depending on their growth prospects. Now is the time, even from a bottom-up perspective, that stocks must earn their valuations.

Exhibit 1 looks at the returns of the S&P 500 Index by calendar year. It breaks these returns into two components: multiple expansion and earnings growth. The combination of these two result in the total return for the year. In many years, such as in 2009, markets are driven by both variables, with earnings growth being slightly stronger in that year. In other years, 2013 included, returns were driven mostly by multiple expansion. Last year's returns took place within a backdrop of a modestly growing economy, low inflation and rising real yields. P/Es tend to rise in such a backdrop and they did, significantly.We believe that earnings growth will be the dominant driver of the market's returns for 2014.

Exhibit 1—Earnings Will Drive the Markets in 2014



Source: Strategas RP.

While 2014's economy should be better than 2013's, P/Es have already expanded. This most likely is due to the stock market having already discounted most of 2014's growth in 2013. Therefore, earnings must meet or exceed expectations in 2014 in order for markets to move higher. It should be a year much like 2006, with earnings propelling the market higher, and P/E expansion playing only a supporting role. The late 1990s of ever expanding P/Es is not expected this time around. The Internet was changing valuation metrics back then, as investors were willing to pay up for promise and future growth. We don't see any of that froth forming in today's environment. This puts greater pressure on individual company results. As such, a "show me the money" mentality will be the order of the day.

Most importantly, investors should understand that more modest returns tend to happen when earnings are driving market direction. We expect this more modest pattern will hold in 2014. Outsized returns, such as those of 2013, tend to take place in markets where P/E expansion has played a major role in the market's upswing. While we have written before that expanding P/Es will continue to drive this market higher over time, we see limited expansion transpiring in 2014.

The January Indicator

You will be hearing, probably relentlessly, the adage "As goes January, so goes the year." Statistically, this belief proves true 73% of the time (please remember that the statistic has an advantage because January's return is included in the year's return). While we won't rule out the possibility of a negative year for stocks, we still believe the path of least resistance remains up for the markets, as growth prospects continues to improve in the developed world. So, although we expect a positive year for stocks, returns will not come close to matching 2013's stellar numbers.

An Action Plan for 2014

Moderate your return expectations. While 30% returns are always welcome, they should not be counted on or expected in one's planning process. Mean reversion is a powerful force in market returns, meaning that the 10% long-term average usually acts like a magnet, pulling (average) returns toward it over time.

Rebalance

Resist the temptation to add to the winners of 2013. Instead, look to rebalance your portfolio by selling some of your winners and moving that cash into asset classes that may have underperformed the strong returns delivered in the U.S. in 2013. International stocks, especially in developed markets, offer an attractive rebalancing opportunity.

Use Alternative Strategies

Managers who utilize long/short strategies are able to take advantage of markets that post modest returns. As correlations among stocks drop, the ability to both go long and sell short those stocks expected to underperform provides two opportunities to add alpha. With strong tailwinds, such as those which existed in 2013, this type of investment often trails its long-only brethren. With more modest returns projected, long/short managers once again have a chance to move to the head of the pack.

Don't Forget Dividends

Historically, dividends have accounted for roughly half of the stock market's return. When returns are more modest, the dividend of the stock plays a more meaningful role in a stock's total return. For this reason, investors should pay particular attention to those companies that don't just offer higher current yield, but to those companies that have the ability to grow their dividends over time.

Use Options

Another way to add income to a portfolio is to write covered calls on some stock positions. Although this strategy sacrifices upside potential for current income, it can be very useful when markets are expected to offer only modest upside. The covered call writer is thus less likely to have the stock "called away" (if it moves above strike price), providing the ability to keep all of the premium and retain the stock for future call writing or sale.

Conclusion

A good active manager knows how to adapt to a changing market environment. I am fond of saying that "once you think you've found all the answers to the market, the market then goes and changes all the questions." The market is constantly changing, and it is imperative to change with it. We must effectively anticipate what will be asked of us as investors in 2014, and then create a portfolio that is up to the challenge. In 2014, this means having a portfolio with a healthy dose of mandates that won't rely on the same type of strong tailwinds seen in 2013. This year, a portfolio should instead depend on a manager's ability to weather bouts of volatility and pick winning investments.

Jeff Mortimer, CFA
Director of Investment Strategy