# Investment Update

BNY MELLON
WEALTH MANAGEMENT

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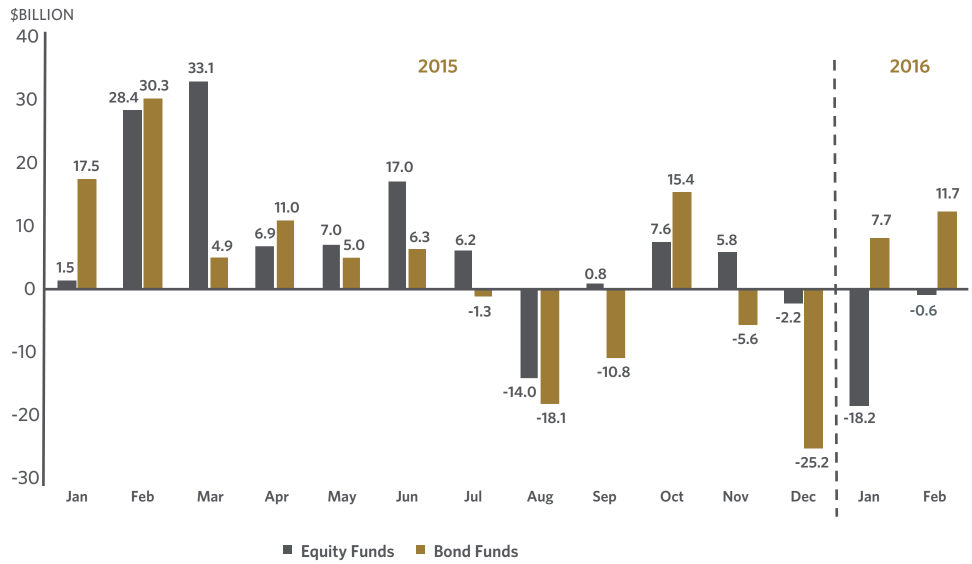
## Look Before You Leap

Do you know the story about the man who tries to catch the ferry? Believing he has missed the boat as it is pulling away from the dock, he leaps over a watery gap of four feet and lands awkwardly on the ferry's deck. Out of breath but relieved, he soon finds himself confused when the ferry's purser runs up to him and says "you fool, we're docking!" Like the fabled ferry, volatile markets also cause many to leap to decisions based on emotion, especially at what sometimes turns out to be a very important turning point.

**Figure 1—Net Mutual Fund and ETF Flows**

**Equities vs Bonds**




As of 2/29/16
Source: StrategasRP

Brought on by concerns about the strength of the global economy and extreme investor pessimism, the volatile start to 2016 drove many equity markets near or into bear market territory. A subsequent rally began mid-February from severely oversold conditions as it became clear that the U.S. was not headed for a recession. As is common during volatile market environments, investors were quick to react to negative headlines, feeding the tendency to panic when things seem at their worst. In investing, however, it is important to avoid making emotional decisions. Instead, one needs to examine the big picture and adhere to an investment strategy based on long-term goals that permits the flexibility to capture short-term market opportunities.

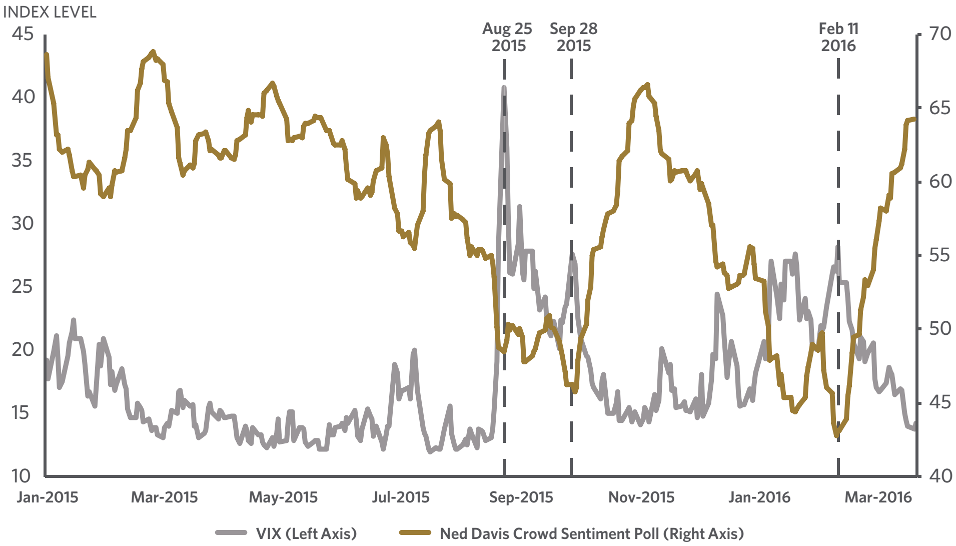
## Money Follows Fear

Bull market corrections are common, with those not associated with recessions happening every 2 1/2 years on average. This recent growth scare and resulting selloff took investors on a wild ride that led many to leap to the conclusion that the U.S. economy was destined for a recession. Many investors, however, were misinterpreting the signals. They abandoned stocks and moved to safe-haven investments on fears of weaker-than-expected global economic growth. Exhibit 1 shows this pattern of investors running from poorly performing equities on what turned out to be the August 2015 low. That pattern repeated itself in both January and February of 2016, as more than $18.8 billion came out of equity mutual funds and exchange traded funds, and $19.4 billion moved into bonds during this most recent turndown.

Exhibit 2 looks at this same issue utilizing sentiment data. The CBOE Volatility Index (VIX), often referred to as a gauge of investor fear, is a measure of implied market volatility. It spiked in August and again in the first two months of 2016. This pattern of extreme sentiment can also be seen in the Ned Davis Research crowd sentiment poll, which asks investors if they are bullish or bearish and typically reaches extremes at market turning points. Not surprisingly, both these indicators are used by professionals for their contrary signals. In other words, when everyone is bearish, it is a better time to be a buyer than a seller, as most sellers have already left the market.

## Figure 2—Investor Sentiment Contrary to Volatility

**CBOE Market Volatility Index (VIX) vs. Ned Davis Crowd Sentiment Poll**




As of 3/22/16
Source: StrategasRP

These flow patterns repeat themselves through time because many investors misread economic signals. At BNY Mellon Wealth Management, we meet frequently to assess global events and analyze economic data. We concluded that slower growth in China would not pull the U.S. economy into a recession. Instead, we believed this was more of a soft patch and that better-than-expected economic data would follow. Furthermore, the Fed recently lowered its expectations to raise rates in 2016 from four to two, which is more in line with what we and the market anticipate. Even commodities, and oil in particular, have rallied as the weakening of the U.S. dollar and hopes of a production freeze have served to steady prices.

## A Selloff Followed By Recovery: Now What?

I often get asked whether it is right to stay the course when the markets get bumpy. My answer is that staying disciplined and adhering to your investment plan is the right course of action if the underlying reasons for a selloff are unsupported by market and economic data, and you have taken the time to plan in advance of volatility. We predicted subdued returns and heightened volatility in 2015 and proactively positioned client portfolios for this market backdrop. We have a slight overweight to equities offset by a slight overweight to diversifiers (or those investments that don't move in the same general direction as stocks or bonds). If we see even greater equity weakness without a corresponding deterioration in economic fundamentals, you might even see us begin to buy in order to take advantage of oversold conditions. Just as we took steps to protect portfolios in advance of the downturn, we continue to seek opportunities that can help clients achieve their long-term goals.

## A Plan for Future Volatility

Just as we advised clients not to overreact during the January/February selloff, which had all the bad news already priced in, investors should not change their investment strategy just because the skies look clearer. We continue to expect that slow global growth, divergent but largely accommodative monetary policy, and low inflation will be supportive of equities moving eventually higher. While many of the risks that dominated the first few months of the year have somewhat subsided, we are not yet safely ashore. Volatility will likely remain a prevalent theme throughout the year with issues such as Brexit (a possible exit of the U.K. from the European Union), continued weakness in corporate earnings, political uncertainty and geopolitical tensions all adding a source of uncertainty.

Although it is easy for many investors to lose sight of proper investment discipline, usually because of emotion, it is imperative to set a course of action in advance. After all, market volatility presents opportunities to either make mistakes, or take advantage of the mistakes of others. In the end, discipline can help investors look before they leap.

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