Investment Update

BNY MELLON
WEALTH MANAGEMENT

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Making the Grade

One of my favorite inspirational movies is *Dangerous Minds*, starring Michelle Pfeiffer. Based on a true story, Pfeiffer's character is an ex-marine who takes a teaching job at an inner-city school. After struggling to engage her students, she decides to get creative in order to motivate them. A successful technique she utilizes changes her students' perspectives—as she gives each student an A at the beginning of the semester, asking them only to keep the grade throughout the term. For these students, earning a grade from the bottom up had been daunting, but now her students began working hard to keep a grade they had been given. A shift in the starting point drastically changed their perspectives and enabled them to strive for success.

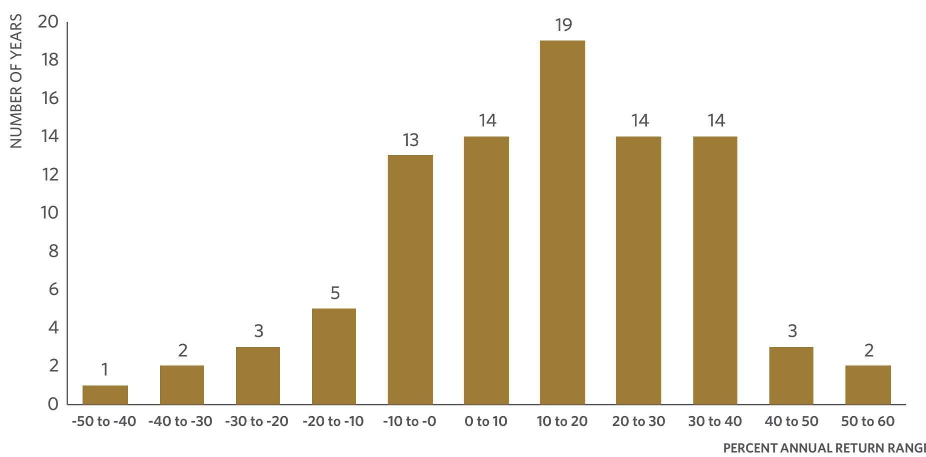
Markets Go Up and Down

Entry points also heavily influence perspectives in the investing world. An individual who invests in equities at a market bottom will see very different returns compared to an investor who enters in a late-stage bull market. For example, the investor who entered the stock market soon after the March 2009 low benefited from cheap valuations and went on to realize outsized equity returns. Meanwhile, the individual who entered the stock market a year ago has experienced more subdued returns amid much higher volatility.

An old, but true market adage asserts that markets exist in one of three states: They go up, they go down, or they bore you to death (sideways). With that said, if you had been fully invested in the stock market, as measured by the S&P 500 Index, you would have earned an average annual total return of about 10% from 1926 to 2015. Some investors may be under the false pretense that the equity portion of their portfolio will always earn 10% per year. That is wishful thinking. As Figure 1 shows, markets deliver annual returns between 0% and 20% only 37% of the time. In the remaining 63% of years, returns were either greater than 20% or negative. Depending on an investor's starting point, some earn more than the average, some earn less, while others may even lose money over the short term.

Figure 1—Equity Returns Over Time

S&P 500 Historical Annual Return Ranges 1926–2015



Average S&P 500 annual return 1926 to 2015: 11.95%
Source: Morningstar Direct

Lessons for the Class

Some investors may think that their investment portfolios aren't "making the grade" because they started investing at a point in the market cycle that has resulted in meager gains or even short-term losses. In volatile environments, a certain discipline is required to stick to an investment plan and avoid the temptation to exit the market. It can be difficult to resist the flight instinct in the midst of negative headlines and geopolitical uncertainty, but staying invested positions investors to capture the next market upswing.

Perhaps you are a new investor, or recently received a large cash inflow from the sale of a business or an inheritance. You may wonder if it just makes sense to keep the cash and wait out market volatility, but this strategy has several flaws.

Cash produces near-zero returns and with inflation those returns could turn negative, both of which delay a portfolio in achieving return objectives. Instead, it is more prudent to take advantage of volatility by strategically deploying cash, particularly when the economic and fundamental backdrop is supportive of a bullish outlook on equities as we see in today's market environment. By investing a fixed amount on a regular basis, investors purchase more of a security (or index) when prices are low and less when prices are high. This process is called dollar-cost averaging and takes advantage of market weakness while reducing the risk associated with market timing.

"A" is for Asset Allocation

"Don't put all your eggs in one basket" is a phrase often referenced in investing. While the market has historically rewarded investors a premium for owning stocks over cash and bonds, it comes with a price tag—volatility. However, spreading risk across a number of different investments can help offset losses in any one investment and smooth out returns over time.

The right mix of asset classes will depend on both your wealth goals and an informed view of the current and expected market environment. Based on our expectations for growth, inflation, valuations and interest rates, we help position client portfolios to deliver a steady pattern of returns throughout a market cycle. If we compare our first chart with Figure 2, you will notice that a well-diversified portfolio designed to grow assets while generating a stream of income displays a more predictable pattern of returns with less volatility than a portfolio composed solely of stocks. Diversification becomes especially important in volatile times because it buffers portfolios against market swings and allows investors to maintain equity positions.

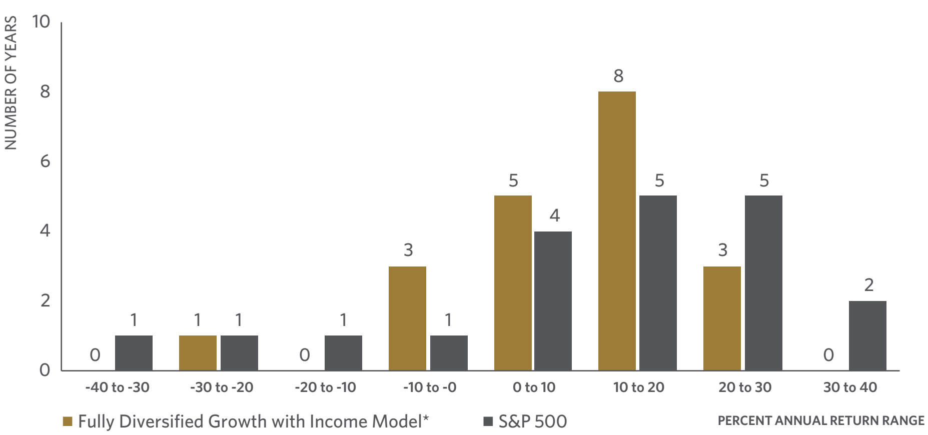
Investing can be challenging, especially in sideways markets where some investors may get discouraged by market volatility. Just as Michelle Pfeiffer helped her students succeed, we can do the same as your wealth manager by helping you achieve your goals throughout every part of the market cycle. Exercising patience and discipline, using volatility to your advantage, and developing a well-diversified portfolio will help you avoid the temptation to focus on short-term market movements and better position you to achieve long-term success.

Jeff Mortimer, CFA
Director of Investment Strategy

Figure 2—Value of Diversification

Historical Annual Return Ranges 1996–2015

Fully Diversified Growth with Income Model vs. S&P 500



BNY Mellon Wealth Management Fully Diversified Growth with Income model performance reflects a hypothetical model based on the asset allocation recommendations of BNY Mellon Wealth Management's Investment Strategy Committee. The performance of the model is not composed of actual client accounts, which may be materially different from that shown here. Past performance is no guarantee of future results. The investment process inception date is 1/1/96.

*Currently comprised of: 56.1% equities, 26.3% fixed income and 17.6% diversifiers.

Average annual return 1996–2015: BNY Mellon Wealth Management 7.77%; S&P 500 9.94%

Source: BNY Mellon Wealth Management and Morningstar Direct