Investment Update

BNY MELLON
WEALTH MANAGEMENT

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Our Family Motto

The expression "if you can't dream it, you can't do it" carries a lot of weight in the Mortimer household. I have taught my children this expression to emphasize the need to be goal-oriented in order to be successful. In other words, having a long range plan, or forecast, will allow you to make better, more appropriate decisions in the short run and help set you up for future success.

BNY Mellon also recognizes the importance of having a time-tested forecasting process at the heart of our investment guidance. Each year a group of senior investment professionals from different businesses across the firm, including Wealth Management, peer into the future and develop a set of asset class return and volatility assumptions for the next decade. These capital market assumptions (CMAs) are informed by a rigorous process that combines quantitative and qualitative analyses of longer-term variables that may influence returns of different asset classes across the capital markets. My belief has always been that none of us are as smart as all of us, and this annual gathering allows experts with different backgrounds to develop a common set of forecasts that fulfills a key role in advising clients.

A Closer Look

Let's take a deeper dive into the process. We begin by defining two key themes that underlie our CMAs: demographics and inflation.

The global population is aging, which has many economic implications, including declining labor force participation, limited productivity growth and slow economic activity. We also expect to see a shift in the balance of capital from borrowers to savers, which will keep government bond yields low as investor demand for income remains strong. Although we expect bond yields to rise at a moderate pace from historically low levels, inflationary pressures should remain muted over the next decade.

After establishing our opinion on these two variables, our network of global asset class and investment specialists then utilizes a building block approach to develop assumptions for each asset class.

Let me give you an example of how we apply this rigorous process in developing assumptions for the total capitalization of U.S. equities. We break down long-term returns on equities into three components: inflation, earnings per share (EPS) growth and dividend yield (including stock buybacks). By estimating each of these variables independently and adding them together, we can develop a forecast for the annualized return of U.S. equities over the next decade. Currently, we estimate that inflation will run at 2% per year on average. Our estimate of real EPS growth, which is usually very closely tied to overall GDP, is 2.1%. Dividend yield (including buybacks) is expected to average 2.7% per year over this time period. The combination of these variables equates to our return estimate for U.S. stocks of 6.8% per year on average for the next 10 years.

But we're not quite done. The last variable we must consider is valuation. For this part of the exercise we compare current price-to-earnings multiples (P/Es) to historic P/Es. History illustrates that buying stocks when P/Es are below historical averages has led to outsized gains, while buying stocks when P/Es are above average has led to undersized gains. Currently, P/Es are slightly above historical averages, and as such we downwardly adjust our equity return estimate by 0.5% per year to account for this slight overvaluation. Consistent with our expectation for more moderate equity returns this year, we believe U.S. stocks as a whole will return 6.3% per year on average for the next decade. Within U.S. equities, our estimated returns are: 6.2% for large cap, 6.7% for mid cap and 7.1% for small cap.

We do this same type of analysis for fixed income and alternative asset classes, but use different variables as building blocks. For fixed income, the building blocks include inflation, term premiums (the extra yield investors demand to hold a longer maturity bond), as well as changes in credit spreads, default rates and currency. We expect fixed income returns will be modest amid rising interest rates; however, higher-yielding sectors that are less sensitive to rising interest rates should be among the best performers. For alternatives, we consider the Sharpe ratio (a measure of risk-adjusted return), risk-free rates, liquidity premium and projected alpha generation. Overall, we believe expected returns for alternative asset classes will generally be in line with publicly traded markets on a risk-adjusted basis.

We also look at the variability of returns, or standard deviation of each asset class. By considering both expected return and standard deviation together, we can understand the risk/reward trade-off of each asset class and allocate assets appropriately along the risk spectrum. In order to estimate our views, we use history as a guide. We have found that using the geometric average of standard deviations from the past 20 years is a good estimate of what the standard deviation will be going forward for the next 10 years. Figure 1 illustrates the 10-year expected returns and standard deviations of the key asset classes Wealth Management uses in asset allocation guidance.

Figure 1—Capital Market Assumptions

Equities	Expected Return	Standard Deviation
Large Cap	6.2%	15.7%
Mid Cap	6.7%	17.9%
Small Cap	7.1%	20.7%
International	6.0%	17.7%
International Small Cap	6.1%	19.3%
Emerging Markets	8.5%	23.7%
Private Equity	10.5%	21.6%
Private Real Estate	8.0%	7.0%

Bonds	Expected Return	Standard Deviation
Taxable Bonds	2.6%	3.3%
Tax-Exempt Bonds	2.7%	3.7%
High Yield	4.7%	9.4%
Emerging Market Debt	5.1%	10.1%

Diversifiers	Expected Return	Standard Deviation
Long/Short Hedge	5.2%	8.8%
Absolute Return	4.1%	5.6%
Managed Futures	4.1%	8.4%
Commodities	2.0%	16.3%
Global Real Estate	6.4%	20.1%

As of January 31, 2017.
Source: BNY Mellon Wealth Management

CMAs in Wealth Management

CMAs are one key input to the development of the asset allocation recommendations of the Investment Strategy Committee (ISC), which I chair. CMAs provide a "goal-oriented," long-term outlook and anchor our risk/return views of each asset class over a 10-year horizon. Nevertheless, global markets move in cycles, warranting the consideration of shorter time horizons when developing the appropriate mix of asset classes for a stated objective. The ISC makes recommendations on a 12- to 18-month outlook, and therefore considers current market conditions as well as forward-looking views of variables such as the economy, inflation, corporate earnings and interest rates.

Because our process applies to multiple time horizons, we carefully consider how our outlooks across these horizons converge or diverge. Often, our 12- to 18-month view dovetails nicely with our longer-term CMAs. But this is not always the case, and for good reason. Consider the 10-year CMA for emerging markets equity. Over the next decade, we believe emerging markets will return 8.5% per year on average. Although the longer-term return expectations are attractive, we currently recommend an underweight to this asset class in our portfolios. Emerging markets are facing near-term headwinds, such as large levels of Chinese debt, the potential for protectionism under a Trump administration and a rising dollar. As these headwinds begin to fade, you can expect us to incrementally raise our exposure to emerging markets, as we did in March, in order to move closer to our longer-term expectations.

The Long and Short of Investing

As I have taught my children, staying focused on your ultimate goal should make it easier to make smart decisions in the short run. Investing is no different. Over my 30 years of investment experience, I have learned that decisions are best made when considering multiple time horizons. At BNY Mellon Wealth Management, a 12- to 18-month view anchored by longer-term CMAs and informed by near-term events allows the ISC to make the best possible recommendations. In the end, we believe this framework helps investors navigate dynamic market cycles, allowing them to achieve their wealth objectives.

Jeff Mortimer, CFA
Director of Investment Strategy