

# Investment Update



BNY MELLON  
WEALTH MANAGEMENT

March 2011

## The True Nature of Risk

The science of risk measurement has advanced considerably over the past few years. Measurement alone, however, is not sufficient to manage investment portfolios — as many investors woefully witnessed during the financial crisis. In fact, the 08-09 crisis and its aftermath provides a good example of how an over-reliance on methodologies can be detrimental in managing one's portfolio.

Leading up to the crisis, investors had become increasingly secure in their ability to predict risk. Unfortunately, this confidence became overconfidence, and overconfidence leads to mistakes. The fundamental reality is that risk equals uncertainty — the future is unknowable.

Of course, we should be diligent in analyzing how future developments may pan out and, in turn, how these possibilities should impact our portfolio positioning. Based on this work and insight, we then should make proactive changes. But we must never forget that we do not have perfect foresight. We cannot know exactly what actually will transpire.

As we have mentioned in past *Updates*, we are confident that economic growth is improving. The earnings outlook, especially for large cap U.S. equities, appears favorable, and, despite the

recent rise in Treasury bond yields, further increases are likely. Does this mean we should solely allocate to large cap stocks? We don't think so. Although large cap stocks may end up being a top performing asset class, many aspects in the near future are causing great uncertainty. Several issues that contributed to the recent crisis still lurk beneath the surface.

## The Looming Deficit

Massive policy intervention and support has turned the tide of the crisis but, in many ways, this only transferred risk from the private to the public sector. While the European sovereign debt situation rightfully continues to command attention, the U.S. also has seen a massive increase in public debt obligation. The currently proposed U.S. fiscal budget does not adequately address the growing and unsustainable deficits. Therefore, growth assumptions about the economy, wages and inflation could be called into question.

While the growing deficit likely will not interfere with cyclical economic growth in the next few years, it looms as a significant longer term hurdle if not addressed. We are not confident that any substantial near-term progress on this important issue will be made. However, it cannot be ignored for too long. At some not-too-distant-point, markets will demand and enforce discipline via much higher rates — as we have seen in other markets. A rate hike is far from the preferred way to address the problem and would be far more painful than any self-imposed steps. We will elaborate on this issue in next month's *Update*.

## A Disparity in Global Growth

Globally, the three-speed recovery — with rapid growth in emerging markets, modest growth in the U.S. and lower levels of growth in other developed countries — is unsustainable. If a fast-growing economy mirrors the monetary policy of an economy recovering from a crisis, imbalances are inevitable. This disparity is manifested in the food inflation problems that a number of emerging economies are experiencing and the resulting unrest this issue is causing. When "refreshing" my Spanish for an upcoming trip to Honduras, I was reminded of the Spanish proverb, "Lo que separa la civilización de la anarquía son solo siete comidas." (Translation: "Civilization and anarchy are only seven meals apart.")

While we do not think all of these issues will have unfavorable outcomes, to think one could definitively predict the future would be foolhardy. For this reason, we continue to believe that the right kind of diversification is essential, despite our relative optimism on equities.

### What's in a Name?

Over recent years, we have both broadened and deepened our portfolio tool kit to include more asset classes and more capabilities within asset classes. I was reminded of these enhancements during a discussion that I had with a long-time client who I have known for more than 15 years, and who has been our client for much longer than that. We were reminiscing about the days when portfolios were simpler, days when we talked about individual stocks and bonds rather than asset classes.

The topic shifted to our client's current allocation, and she asked me about one of her holdings. "What is this thing, and why is it in my portfolio?" she asked, referring to an element of our diversification in what once was considered a less traditional asset class.

Depending on a client's portfolio size, risk tolerance and ability to hold less liquid securities, this question could apply to a fairly broad range of holdings. Regardless, it is an essential question to ask — and answer — for several reasons.

First, recent events hopefully have illustrated for investors the importance of knowing what their portfolio actually consists of, rather than what they assume it includes. Often, an investment's name bears little semblance to what it actually is. Also, the question goes to the heart of understanding the role an investor expects an asset or asset class to play in a portfolio. The financial crisis was a reminder that blind, or naïve, diversification is of little value. Such an approach can lead an investor to overcrowded, overpriced or illiquid investments that cannot be sold if the need arises. Illiquidity is fine if one understands it, plans around it and is compensated for the risk. Too often, though, this was not the case.

### True Diversification

To us, true diversification means evaluating the intended purpose of an asset class or other type of investment and assessing the degree to which it can help add return or mitigate, or hedge, risk. Considering the investment purpose of a current or potential asset class or strategy helps in understanding the benefit it may have. Is the purpose inflation protection, enhanced return, diversification that decreases correlation? Or is it a hedge against so called "tail risks" — extreme events with low probability but large consequences?

Viewed in this light, diversification can help an investor better understand why an investment may make sense in the context of a forward-looking view of his or her portfolio. Just mixing a bunch of stuff together and hoping for the best is not the type of diversification that likely will prove helpful. This method too easily can lead to paths previously trodden to the wrong destination.



Christopher Sheldon  
Director of Investment Strategy