

Investment Update



BNY MELLON
WEALTH MANAGEMENT

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After a treacherous start in 2009, asset returns improved considerably as the year unfolded. Other than longer maturity Treasuries, which had a rocky year, fixed income returns were strong and equity returns across the board were even more impressive. Investors don't yet appear poised to abandon caution and jump back into markets with both feet. Still, as we look ahead, we believe some portfolio positioning considerations may merit investors' attention.

Lucky Penny

As 2009 progressed and equities and fixed income investments regained their footing, many investors looked askance at the few pennies they received for a month's worth of interest. Understandably disappointed with returns on cash, investors moved out of money market funds at an increasing pace. Searching for higher yields, most cash was shifted into bond funds. Very little of this money found its way into equity funds, as investors remained uncomfortable with the perceived risk.

One dilemma investors face in 2010 is that, while cash currently has almost no yield, if rates rise too much investors may stand to lose more than they gain by reaching too far for yield. We think it makes sense to move to maturities that are longer than one year to take advantage of the steeper yield curve (where longer term maturities have higher rates than shorter term maturities). However, we also recognize that interest rates have the potential to rise as 2010 progresses.

December may have offered a portent for bond investors in 2010. As investors contemplated the possibility that the economy could continue to recover in 2010 and that the Fed may have overstayed its welcome by offering very low rates, interest rates rose and longer term Treasury bond prices moved considerably lower. This episode illustrates the potential risk in seeking higher yields by reaching too far out on the maturity spectrum. Those seeking higher rates in longer term bonds would be advised to consider the potential impact of higher rates on the price of these bonds. While the cost of remaining in cash is high, if investors move too far afield in their search for yield they risk losing

more in principal than they could gain in incremental yield. We do not expect rates to skyrocket, but we do think they will trend higher. For this reason, investors should avoid securities with overly long maturities. We are recommending a shorter than average maturity profile for fixed income and holding only a minimum of cash beyond what may be needed for account-specific purposes. Unless the cash is needed, investors may benefit from considering short duration bonds instead.

Hedge is Not a Four Letter Word

While hedge funds had positive returns last year, in most cases they lagged far behind equity indices. On the heels of losses incurred in late 2008 and early 2009, the perception of inferior returns caused many investors to become

disenchanted with hedge funds, and many high net worth investors reduced or liquidated holdings. Those moves could prove costly in 2010.

While even high quality, well diversified long/short equity hedge funds declined in 2008 and early 2009, they held up far better than long-only equity alternatives during the same period. As the market recovery ensued, many hedge fund managers were caught with too much cash as they sought to raise funds to meet redemption requests in then illiquid markets. At that same time, many hedge fund managers were initially skeptical about the prospects for recovery and had expressed this in their portfolio positions. Also, by their nature, most long/short funds underperform in dynamic market conditions such as those experienced after the first quarter of last year. The average fund has nowhere close to 100% long exposure to equity markets and typically is closer to 50%/50%. Finally, most managers attempt to exploit their skill in buying stocks in what they think are better companies while selling those stocks of companies they judge inferior. For talented managers, this often enhances their relative return. However, in the early stages of the strong rally last year, the weakest companies that were generally in poor financial condition did the best, as they got a new lease on life when the economy began to stabilize. While these weaker companies would not be expected to outperform over the long run, their short term relative performance made it difficult for those managers who focus on quality to add value.

Despite relative performance lags in 2009, we continue to believe that, in 2010, maintaining or even adding hedge fund exposure will be appropriate for most clients. We expect broad

equity advances are likely to be more muted than those experienced in much of 2009. Also, we expect volatility, which fell considerably as last year progressed, to increase in 2010. The first part of the year may be more volatile as investors reposition portfolios after 2009's large gains. Ongoing tensions about the shape and vigor of economic recovery likely will continue. Questions about the appropriateness of the Fed's interest rate policy and the timing of its exit strategies away from financial assistance may also add uncertainty. Throw in concerns about the dollar, inflation, the deficit, rising taxes and high unemployment, just to name a few, and it is not hard to see how volatility could increase. Periods of moderate return with higher-than-average volatility often are when hedge fund managers shine.

We think it would be a mistake for investors to forgo hedged equity exposure in favor of long-only equities, even if market events do not unfold as we expect. Our expectation for more modest market gains is based on greatly improved profit growth in 2010 for many companies. Some of this already has been discounted into current prices. As the year progresses, we also believe that investors increasingly will become convinced that the U.S. economy is transitioning to an expansionary phase, not just recovering. This most definitely is not priced into markets and whether we truly are moving in that direction can certainly be vigorously debated. If our expectations for continued, though more modest, growth do not pan out, or if some of the

concerns noted above move to the forefront, it is possible that investors will place increased value on the downside protection of hedged equity strategies.



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