

Investment Update



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What Now?

Under normal circumstances, a 50 percent rise in equities would cause most investors to take the profit and subsequently pare their position. In fact, based on average historical returns, a gain of this magnitude represents several years' worth of returns! However, normal is hardly an apt description of the investment environment over the last several years. The chart below illustrates the market's recovery to date. It serves as a painful reminder that more than a commensurate gain is needed to make up for losses. To erase a 60% loss, the market needs a 150% gain. Viewed in this light, the strong recovery, while welcome, may be considered an unmitigated positive only by those who did not suffer the previous decline.

Exhibit 1

S&P 500 Performance Since 10/9/07 Market High



Source: Bloomberg LP. As of 9/30/09.

Despite the recent strong rally, we do not advocate significant cutbacks in equity allocations for most investors. A reduction in equity exposure is recommended only for those investors who belatedly recognized that their portfolio allocation was riskier than their tolerance but maintained these positions through the March lows, in anticipation of prospective gains.

We have been surprised that no significant correction has occurred since the rally began in March. Instead, investors with cash on the sidelines and those skeptical of the markets' sustainability have been looking for an opportunity to enter the equity market on even small signs of pullback. A correction remains eminently possible — and should be expected as part of long-term investing. Given the clear signs of economic improvement, however, the odds of a substantive decline seem more remote.

Keeping Up with the (Dow) Joneses

Until recently, investment strategies emphasizing better quality, reasonably priced securities that were expected to have superior long-term performance fared somewhat worse than broad market indices. This occurred because those companies that were barely clinging to solvency during the economic downturn were priced in anticipation of failure. Pulled back from the brink and given a new lease on life by improving economic conditions, we are not surprised that these low quality stocks have been in the vanguard of the advance. A lower quality company can move from \$1 to \$3, but it likely still is a challenged company and may not make a good future investment. Fortunately, this trend has appeared to culminate and higher quality companies increasingly are participating in the rally. This bodes well for relative performance and increases the odds of a sustainable advance on stronger footing.

Reflecting vs. Anticipating

In many ways, the profile of this market advance has been consistent with those following many past waterfall declines. From the ashes of the darkest moments, when sentiment is bleak and recovery is a distant dream, frequently rise the fledglings of new bull markets. As with newborn birds, many challenges face them on their journey to flight. It can be difficult to imagine something so ungainly in its infancy ever attaining flight. Early stages of market advances are not dissimilar.

At the depths of the recession, as extreme pessimism and fear begins to give way to even small hints of improvement, fragile wings of hope grow and strengthen. This positive surprise is what nurtures the recovery. The unknown is what moves markets — in either direction.

One common element of waterfall declines is that clear signs of recovery are not always evident. Those that wait for stronger indicators risk missing substantial gains. In the past we have noted that, on average, the stock market turns up six months prior to an economic trough. Six months back would coincide with the S&P 500's March lows, so if our assessment is correct, we are now at the end of the recession.

While still in freefall during March, the market was not reacting to any evidence of a recovery. Instead, it was beginning the process of anticipating future recovery. When assets have been priced for a certain scenario (in this case, disaster and depression) and that outcome does not materialize (due to the Fed's efforts), investors are forced to reprice assets. Exhibit 2 shows that equity price increases have been fueled in large part by an increase in the forward P/E multiple. In plain English, this means that investors are anticipating that company earnings will improve as the economy begins to recover.

As we have witnessed, the initial anticipation phase of a market recovery can carry markets further than expected.

Exhibit 2 S&P 500 One-Year Forward Price/Earnings Ratio



Monthly data 7/31/1980 – 8/31/2009. Based on consensus operating EPS estimates for the next fiscal year, adjusted for fiscal year-end dates. Source: Ned Davis

However, if increased expectations are not eventually realized, markets can become overvalued — though we do not consider this to be the case. In fact, we believe that stocks have become fairly valued.

For several months, companies have beaten analysts' low earnings estimates. While better than expected earnings were largely fueled by cost cutting, we think companies will begin to see an improvement in sales. Although we expect a subdued recovery, an improvement in actual revenue growth likely will drive further stock gains. Those expecting the same phoenix-like ascension in equities since March most likely will be disappointed.

We project that 2010 will have modest economic growth with the possibility of better than expected profit growth, low inflation and a highly accommodative Federal Reserve. These elements together may provide the fuel to allow equity markets to further ascend. While many challenges remain, we do not think that most investors should reduce their equity exposure at this time.

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