

# 2020 Vision: The Most Critical Decade<sup>SM</sup>

INTRODUCTION

2

THE CRITICAL CHALLENGES OF THIS DECADE

3

HOW TO SUCCEED IN THIS CRITICAL DECADE

7

INVESTMENT INNOVATION AND RIGOROUS DISCIPLINE

8

DYNAMIC, SEAMLESS PLANNING

21

A DIFFERENT QUALITY OF CLIENT-ADVISOR ENGAGEMENT

31

NAVIGATING THE CRITICAL DECADE WITH CONFIDENCE

39



BNY MELLON  
WEALTH MANAGEMENT

# 2020 Vision: The Most Critical Decade<sup>SM</sup>

OVERWHELMED BY THE FINANCIAL CRISIS and subsequent ongoing volatility, today's investors are looking toward the future with a view that is clouded by confusion and uncertainty. New courses of action are clearly necessary, but they must be plotted across terrain that has been fundamentally altered—in many cases forever.

A major shift has taken place, compelling investors to face and adapt to new realities. These fundamental changes have created unprecedented challenges—so many, in fact, that this decade will, in many ways, be the most critical ever.

One significant difference lies in the nature of growth itself. No longer fueled by debt and unbridled spending, growth is more heavily influenced by factors such as demand-driven exports and increasingly unpredictable consumer behavior. Consequently, growth will continue, but at a far slower rate than experienced over the past three decades. It will also be less predictable, harder to attain and more sporadic.

In addition, fiscal policy reactions and global headwinds are destined to exacerbate the situation. The cost of health care alone will place a significant burden on the economy. And who can predict the impact of financial reform and potentially higher taxes down the road on business development?

Amid these stark realities, investors are challenged to act effectively. Yet they are likely to feel less confident about taking any action at all. Long-held beliefs in the value of investing and the viability of the financial system have come crashing down, replaced by questions about whether investment plans are safe or even worthwhile.

It is easy to understand the current doubtful mindset. Investors are confronting a world where governments, economies, corporations and individuals are struggling to manage the complex and interconnected challenges the crisis has left in its wake.

Success is possible in this new world, but investors must first understand the environment they face and the magnitude of the changes occurring within it. Equally important, investment advisors must take a deep look at their own beliefs to determine which “truths” are enduring and which are extinct. Only when these questions have been answered can investors and advisors begin asking an important new question—what will it take to succeed moving forward?

# The Critical Challenges of This Decade

TO BETTER ADDRESS the complexity of the coming years, it is critical to understand the forces that are shaping the decade's challenges. Investors now face an environment of extremes, compounded by a complex, rapidly changing regulatory and planning landscape that can no longer be navigated using traditional plans and approaches. In addition, the path to recovery is difficult, cluttered with financial and psychological obstacles.

## Extreme Investing Environment

Market reactions today are faster, more intense and sometimes contradictory, confounding many time-tested investment models. As a result, investors are tackling the task of rebuilding their diminished portfolios in an increasingly volatile environment.

Consider the huge market fluctuations in 2009, illustrated in Exhibit 1. In February of that year, the six-month returns for both the S&P 500 and the developed international markets index were down approximately 40%. Six months later, they were up approximately 40%. Following a slight moderation in 2010, volatility again rose in 2011 with the S&P 500 gaining or losing more than 3% on more than 5% of trading days.

Exhibit 1

## An Investment Environment of Extremes



S&P 500 vs. MSCI EAFE Rolling 6-Month Total Returns

As of 12/31/11. Source: FactSet.

Daily market fluctuations are also becoming more extreme. On May 6, 2010, for example, the Dow Jones Industrial Average (DJIA) plummeted more than 1,100 points, only to rebound by more than 700 points by the day's end. The market's split-second reaction created a near-record tumble and recovery.

It is reasonable to expect periods of investment extremes to remain with us for the foreseeable future, if not permanently.

---

THE SIMPLE FACT IS THAT MANY INVESTORS  
NO LONGER TRUST THE FINANCIAL SYSTEM OR ITS PROVIDERS.  
THIS MUST BE ACKNOWLEDGED AND ADDRESSED.

---

### **A Challenging, Dynamic Landscape**

Market volatility and economic dynamics have caused a domino effect, driving policy changes and financial reform, which, in turn, are changing the rules that govern wealth planning. Consequently, investors must confront the reality that many traditional assumptions about planning are outdated, if not obsolete. In today's environment, where the path to success is narrower and more treacherous than ever, many existing plans are no longer valid, comprehensive or flexible enough to cope.

### **Multi-Dimensional Recovery Challenges**

Reconstructing a battered portfolio in the midst of these challenges will be difficult. Recovery is a necessary process after any financial crisis, but recovery from the 2008-2009 financial crisis must be significantly different because it involves two dimensions—psychological and financial.

Just when successful investing has become more difficult, investors have become far less trusting of their advisors and the financial system as a whole. According to Capgemini's 2009 World Wealth Report, 78% of surveyed high net worth individuals said they had lost trust in the financial system's regulatory bodies.<sup>1</sup> One year later, the 2010 report noted that 71% of those surveyed had yet to regain that trust.<sup>2</sup> And a 2009 Dow Jones study found that only 29% of wealthy clients felt that their advisor had performed well during the crisis.<sup>3</sup> The simple fact is that many investors no longer trust the financial system or its providers. This must be acknowledged and addressed in order to move forward.

<sup>1</sup>World Wealth Report 2009; Merrill Lynch, Pierce, Fenner & Smith Incorporated and Capgemini.

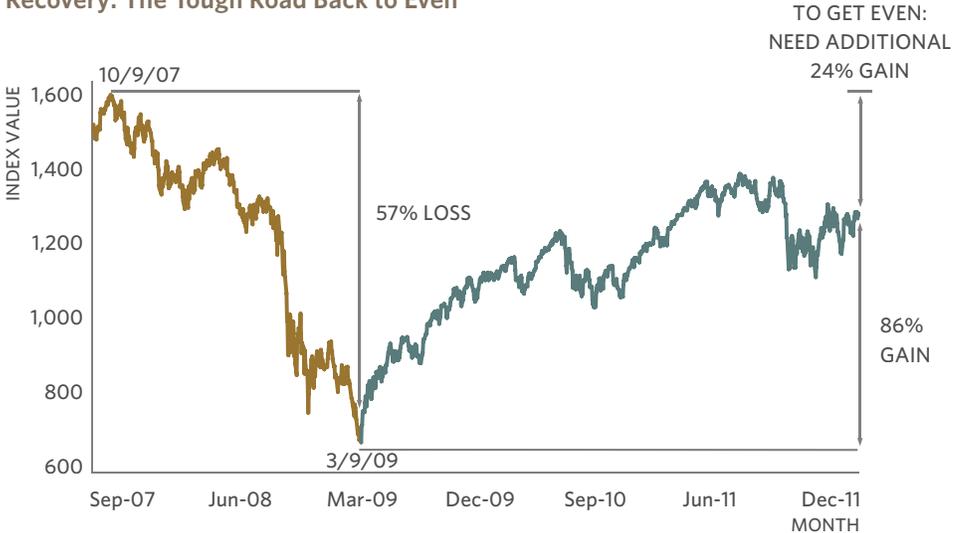
<sup>2</sup>World Wealth Report 2010; Merrill Lynch, Pierce, Fenner & Smith Incorporated and Capgemini.

<sup>3</sup>Wealth Management after the Crunch; Dow Jones and Company.

The second dimension of recovery is financial, and the market's performance tells the tale—the climb out of any trough takes far longer than the fall in. By the time the S&P bottomed out in March 2009, for instance, it had dropped 57%—a massive decline. By the end of 2011, the market had gained back 86%. However, this improvement belies the truth about the challenge that remains. As Exhibit 2 shows, it will take another 24% increase just to return to the pre-recession levels of October 2007.

Exhibit 2

**Recovery: The Tough Road Back to Even**



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

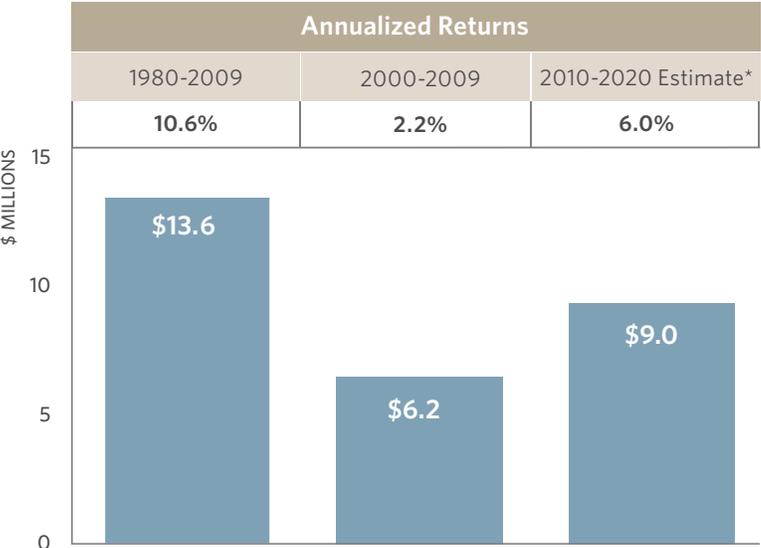
As of 12/31/11. Source: Bloomberg LP.

Once investors have accepted the psychological and financial challenges of recovery, they must establish realistic expectations about future returns, understanding what is reasonable and achievable in a slow-growth environment.

Exhibit 3 illustrates the impact of a diverse range of returns on the growth of a \$5 million portfolio. Average annual returns in the last two decades were clearly superior to those of the most recent decade alone, generating very different growth results. Investors should be prepared for the possibility that returns over the next 10 years may also remain lower than historical norms. For instance, if the balanced portfolio in Exhibit 3 were to return a 6% average annual rate of return over this decade, the outcome would be \$4.6 million less than historical averages.

Exhibit 3

**Projecting Expenses: Resetting Expectations**



Projected 10-Year Growth of \$5 Million 60/40 Portfolio

\*For illustration purposes only. Not a forecast.

Source: Morningstar. Please see endnote 1 for additional information.

Despite this decade’s unusual challenges, recovery is possible, as is ultimate success. Trust in the system and its advisors can be rebuilt, although the process is likely to be a protracted one. And investors can adapt to new realities if they adapt their strategies as well. However, it is important to recognize that the risk of over- or underreacting to market and worldwide conditions has dramatically increased, as have the consequences of making the wrong move.

---

THE RISK OF OVER- OR UNDERREACTING HAS DRAMATICALLY INCREASED,  
AS HAVE THE CONSEQUENCES OF MAKING THE WRONG MOVE.

---

## Achieving 2020 Vision: How to Succeed in This Critical Decade

Given this decade's unique investment extremes, shifting economic and policy headwinds, and daunting challenges of recovery, investors and their advisors will need to embrace new approaches to protect and grow wealth. Success will depend on:

- INVESTMENT INNOVATION AND RIGOROUS DISCIPLINE
- DYNAMIC, SEAMLESS PLANNING
- A DIFFERENT QUALITY OF CLIENT-ADVISOR ENGAGEMENT

Success will also require a *change in thinking* as well as a *change in doing*. Investors will need to fully realize *why* these three factors are so critical to their success before they can determine what steps to adopt and implement.

# Investment Innovation and Rigorous Discipline

THE UNPREDICTABILITY AND VOLATILITY of this decade are mandating a new approach to investing—one that unites continual innovation with ongoing, rigorous discipline. In developing plans for this new world, investors and their advisors must be aware of several key trends:

## **Information Will Be Overabundant and Rapidly Changing.**

Investors can easily misinterpret information when they are bombarded with it all day, every day. Without the proper filters or insights, this information is meaningless at best and misleading at worst. Most individual investors lack the time and resources to sift through the daily deluge of often conflicting data to identify pertinent trends, conduct detailed research and make informed decisions.

## **Policy Changes and Economic Headwinds Will Be Unpredictable and Significant.**

Policy changes and economic headwinds will remain powerful influences throughout the critical decade. For example, rising taxes from government deficits may limit business expansion, or financial reform may constrain certain types of business and economic development. Consider also fiscal policy reform attempts, both domestically and worldwide, particularly in 2011, and the far-reaching impact of such actions or failures to act. The ability to react to these changes—or, better yet, to anticipate as many as possible—and incorporate them correctly in an investment strategy may mean the difference between success and failure.

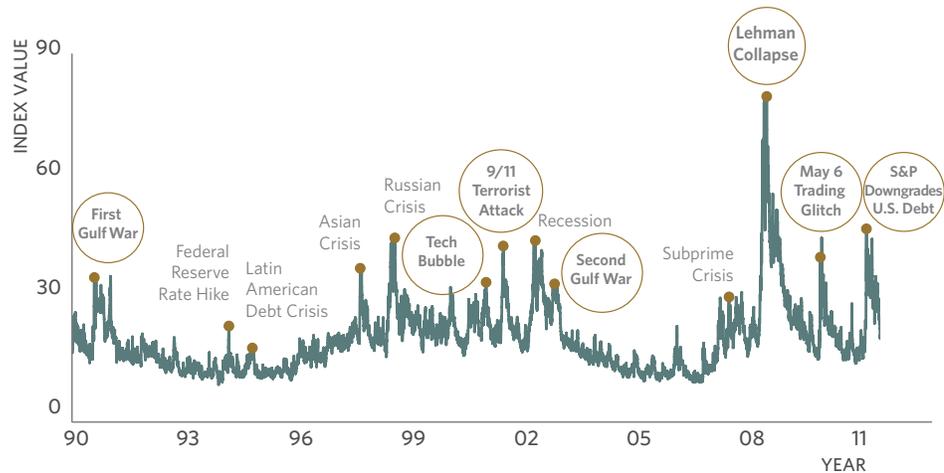
## **Hyper-Sensitized Market Reactions Will Amplify the Speed and Scale of Market Shifts.**

We have entered a new phase where overreactions to economic and global events are amplifying the scale and speed of market shifts. Navigating these extreme conditions will be important—and highly challenging.

Consider the performance of the Chicago Board of Options Exchange Volatility Index—the “fear index”—which charts the expectation of market volatility. As illustrated in Exhibit 4, the largest spike on the chart in the last two decades was caused by the collapse of Lehman Brothers in 2008, an event that dwarfed the spikes prompted by 9/11 or either Gulf War. Even the trading glitch on May 6, 2010, which resulted in a 1,100-point slide in the DJIA followed by a 700-point recovery, generated more fear than did the technology bubble burst of 2001.

Exhibit 4

**Hyper-Sensitized Market Reactions: The Fear Index**



Chicago Board of Options Exchange Volatility Index

As of 12/31/11. Sources: Bloomberg LP and BNY Mellon Wealth Management.

**Investor Behavior Will Drive Markets and Impact Personal Wealth.**

Knee-jerk reactions to market events and market volatility have always been wealth destroyers. But in this new era, when a quantitative trading model can cause an 1,100-point tumble in the Dow in one day, investor response can be catastrophic. More than ever, investment approaches must be designed to help investors cope rationally and without panic. Otherwise, investors risk compromising their wealth and further contributing to market volatility. With the likelihood of more causes for panic in the future, investors will need approaches that help keep their emotions under control—or at least keep them out of investment decisions.

**Asset Classes and Global Markets Will Continue to Behave Unpredictably.**

Asset classes and global markets are no longer performing according to historical norms. Therefore, strategies to deal with them must be new and different. For example, the basis of modern portfolio theory—that asset classes tend to act differently from each other—was far less true during the crisis of 2008-2009. In fact, even before the crisis, correlations had risen considerably, meaning that most asset classes had parallel—and, at the time, largely positive—performance patterns. Then, at the height of the crisis, massive investor panic caused most asset classes to collapse together.

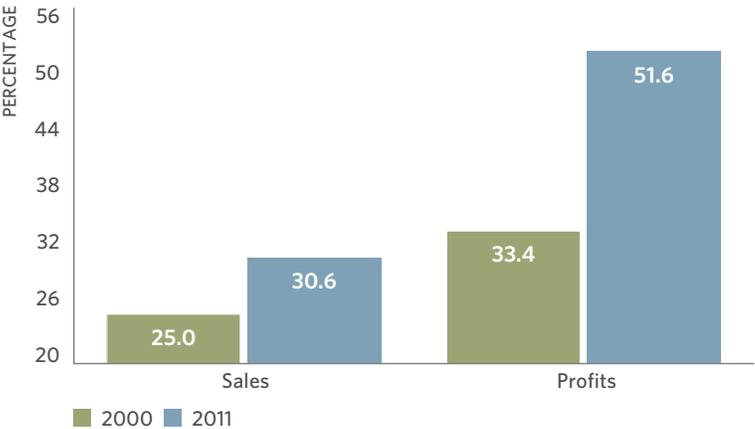
When an occasional period of high correlation—whether returns are good or bad—occurs, the benefit investors gain from diversification is marginalized. Even though asset class behavior is now returning to its previous norms, the definition of “normal” must be reconsidered. Occasional disconnects and odd performance patterns will continue to occur, mandating an even more modern portfolio theory to address the new “normal.”

The fact that markets worldwide have become increasingly interconnected must also be considered in any investment strategy. For instance, emerging markets made up 35% of world gross domestic product at the end of 2010; a decade ago, they accounted for only 22%. The balance has shifted from a U.S.-dominated global economy to one where regions and economies worldwide can affect investment success.

Moreover, the distinction between global and domestic markets has become increasingly blurred. Ten years ago, as Exhibit 5 shows, international sources accounted for 33% of total profits for S&P 500 companies reporting on earnings from global operations. Today that number is about 52%. In fact, the phrase “domestic equity” has become a misnomer; these companies and their stocks are no longer purely domestic at all. This truth requires that investors and investment strategists come to a new understanding of the characteristics of their holdings. This does not make asset class distinctions obsolete. It does, however, underline the importance of thinking about global influences and opportunities within an asset class, such as equities. Even if an individual is investing only domestically, it is important to understand how global economics and global events may impact U.S. market behavior and results.

Exhibit 5

**Globalization: What Is Domestic Equity?**



S&P 500 Percentage of Sales and Profits from Foreign Operations

Source: Ned Davis Research. Please see endnote 2 for additional information.

## THE DEMANDS OF INVESTMENT INNOVATION AND RIGOROUS DISCIPLINE

DESPITE ALL THESE CHALLENGES, investment success is attainable but much more challenging to achieve. It will require a combination of innovation and discipline characterized by five key elements:

### Keys to an Innovative and Disciplined Investment Strategy

- KNOWLEDGE RATHER THAN JUST INFORMATION
- DIVERSIFICATION REDEFINED
- ACCESS AND DUE DILIGENCE
- ACTUAL ASSET MANAGEMENT
- DISCIPLINE

#### **Investors Must Recognize the Difference between Knowledge and Information.**

Success in this critical decade will require deep knowledge and insights. The barrage of investment-related data, the erratic behavior of markets and the complexity of current challenges will require a greater level of market intelligence. Deep market insights and experience, as well as thorough knowledge and understanding of economic events and signals, have always been the foundation of effective investment strategies. Given the intricate dynamics of the new investment era, they will become even more important.

---

THE ABILITY TO ANTICIPATE AND ACT ON SHORT-TERM  
MARKET SWINGS OR DISCONNECTS  
WILL BE EXTREMELY VALUABLE.

---

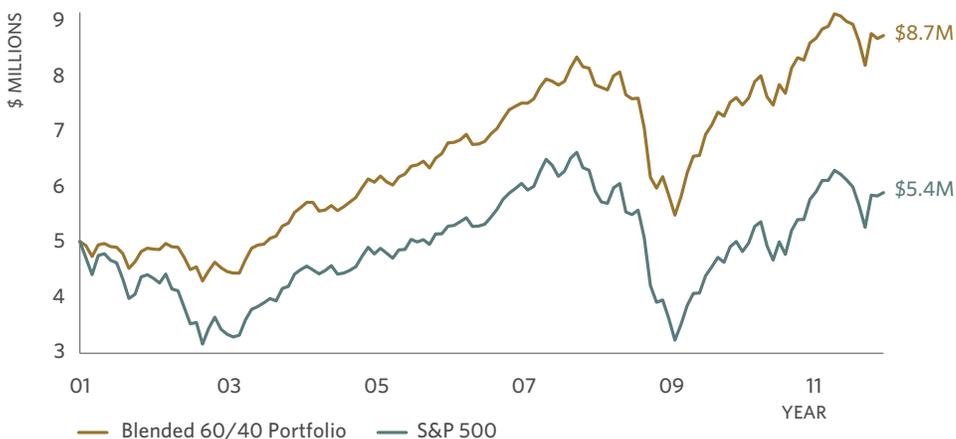
**Diversification Will Remain Important but Must Be Redefined.**

Diversification strategies must be more nimble and opportunistic than in the past. A long-term, dynamic approach to asset allocation should remain at the heart of any investment program. The value of such an approach, as illustrated in Exhibit 6, is still paramount. But an updated asset allocation approach requires something more—the ability to anticipate and act on market swings or short-term disconnects between and within asset classes. This flexibility will be extremely valuable in capturing opportunities and enabling defensive action.

*Exhibit 6*

---

**Value of Long-Term Asset Allocation**



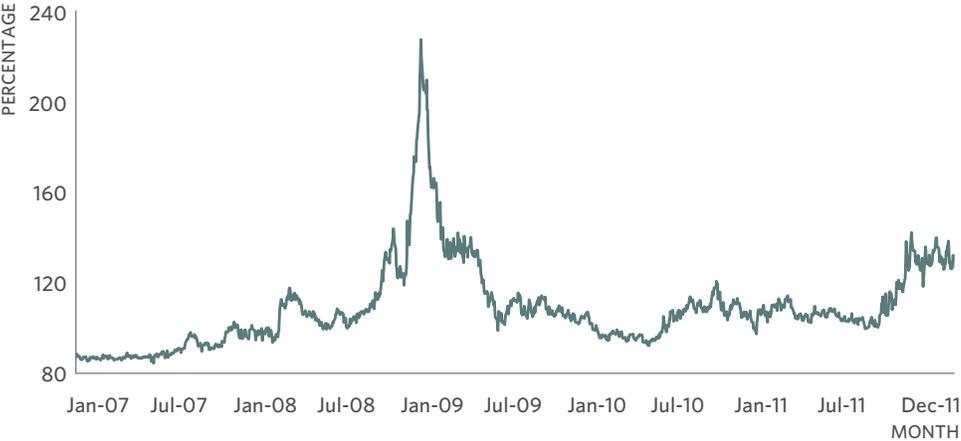
Growth of \$5 Million Portfolio, 1/1/01-12/31/11

Sources: Morningstar and BNY Mellon Wealth Management. Please see endnote 3 for additional information.

Consider the huge jump in yields on tax-free municipal bonds compared to U.S. Treasuries in late 2008 and early 2009, illustrated in Exhibit 7. Spurred in part by concerns about the solvency of municipal credit guarantors, a tremendous mispricing of municipal securities caused yields to reach historic highs relative to their taxable counterparts. This unusual opportunity may have been brief, but it was long enough for alert investment managers to take advantage of the historically low cost of municipals and the underperformance of certain credit structures and sectors to increase portfolio returns. Those who succeeded in this scenario had to act fast, rapidly sorting through the myriad issues affecting the municipal market and quickly identifying the mispriced securities. While the opportunity was short-lived, increased returns, particularly on an after-tax basis, garnered attractive rewards for the additional risk assumed.

Exhibit 7

**Muni Yields as a Percentage of Treasuries**



AAA 30-Year Municipal Bond Yields as a Percentage of 30-Year Treasury Yields

As of 12/31/11. Source: Bloomberg LP.

A more recent opportunity occurred in 2011 for dividend-paying stocks, due to several converging factors. First, the continued record interest rate lows caused dividend paying companies to be favored as alternative sources of income. Second, the 15% tax on dividends, vs. 39.6% on interest income for high earners, made these stocks a tax-efficient investment. Lastly, following several years of drastic cost-cutting measures, many corporations were rich in cash, prompting increased dividend payout rates, which typically helps lift share prices over time. While dividend-paying stocks are typically beneficial for several reasons—providing a stable income source, strong returns and protection in volatile environments, for instance—these factors unique to 2011 combined to make these stocks particularly advantageous.

Similar value opportunities and inefficiencies are likely to occur frequently going forward. In an environment where growth and profit may be harder to achieve and risk may not be fully recognized or understood, the ability to be opportunistic when possible and defensive when feasible will be not just important but also determinative.

---

**VALUE OPPORTUNITIES AND INEFFICIENCIES  
ARE LIKELY TO OCCUR FREQUENTLY GOING FORWARD.**

---

To make the most of diversification, investors should consider not only traditional views of asset classes but also the *purpose* of specific investments *within* an asset class. Recognizing the role certain investments may play in a total portfolio is key to addressing market challenges or pursuing a specific investment objective, such as capital appreciation. The ability to think beyond traditional asset allocation—to understand the part each investment plays in offsetting or exploiting economic or market events, as illustrated in Exhibit 8—will likely be invaluable in negotiating future headwinds.

Exhibit 8

---

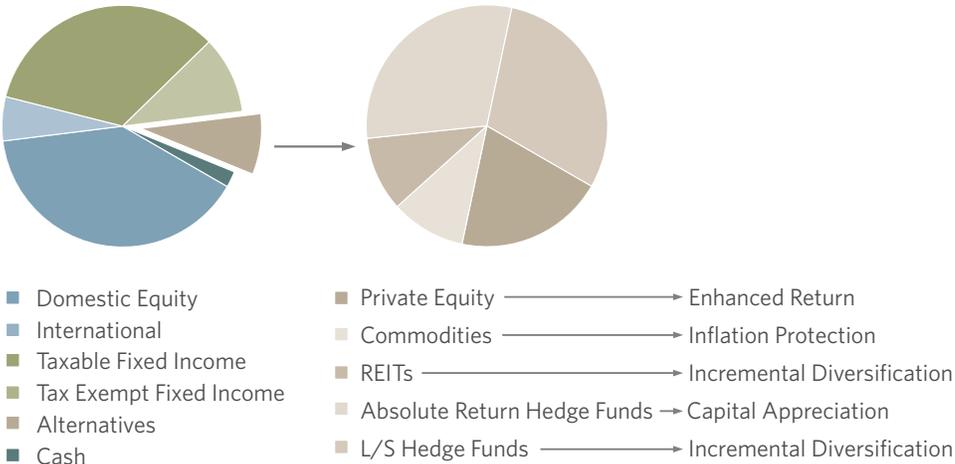
**Rethinking Traditional Asset Class Groupings: From Purpose to Solution**

	Purpose	Solution
PURPOSE-BASED INVESTMENT CATEGORIES	Preservation and Income	Investments to provide stability of principal value, liquidity and/or income ▪ Cash ▪ Core fixed income ▪ Structured products
	Inflation Protection	Investments to provide a hedge against inflation ▪ TIPS ▪ Commodities ▪ Real estate
	Capital Appreciation	Broad market investments that seek capital growth ▪ Domestic equity ▪ International equity ▪ Absolute return strategies
	Incremental Diversification	Investments for opportunistic diversification ▪ International fixed income ▪ Long/short strategies ▪ High yield ▪ REITs
	Enhanced Return	Focused/opportunistic investments for capital growth ▪ Value/growth equity styles ▪ 130/30 equity strategies ▪ Private equity

Take, for example, alternative investments. Often, investors make a single allocation to alternatives in pursuit of a diversified portfolio. Yet these investments comprise a broad range of sub-asset classes, as illustrated in Exhibit 9, each of which has unique attributes and can contribute to a portfolio in very different ways. Long/short hedge fund strategies can provide incremental diversification, due to their ability to profit in both rising and falling markets. Private equity may provide high relative returns, particularly in today's environment, but bring higher risk as well. Commodities, because their prices rise with increased demand for goods and services, can provide valuable inflation protection. Other alternatives can be helpful in generating income or preserving wealth.

Exhibit 9

**Application of Investment Purpose**



Considering the role of each diverse asset type within a portfolio can help investments perform better together in varying market conditions while ensuring alignment with a specific portfolio's goals.

### **Access to the Right Investment Resources, Due Diligence in Their Selection and Ongoing Oversight Will Be Imperative.**

Market insights and timely diversification ideas are pointless without the ability to quickly recognize opportunities and risks and act on them.

During the 2008-2009 financial crisis, the unraveling of complicated debt instruments made it clear that seemingly safe investments can carry huge risks buried deep within a complex structure. In addition, even the most traditional investment strategies can occasionally veer off course from their stated aims. Therefore, careful selection of investment solutions and rigorous, ongoing oversight are essential.

---

### **INVESTORS MUST KNOW WHAT THEY ARE ACTUALLY INVESTED IN AND BE CERTAIN THAT THESE INVESTMENTS REFLECT THE PHILOSOPHY AND STRATEGY INITIALLY AGREED UPON.**

---

The first step is to employ highly specific evaluation criteria, such as objectives, investment parameters, purchase and sale decision processes, and manager credentials. Subsequently, thorough due diligence must be implemented to determine how well the considered options meet the stated criteria and the investor's needs.

This due diligence must continue throughout the life of the investment. The ability to consistently and thoroughly view decision processes, actions and results is critical to maintaining oversight and ensuring that what was sold is actually what the investor is getting. This transparency is especially imperative today. Investors must know what they are actually invested in and be certain that these investments stay aligned with the philosophy and strategy they initially agreed upon.

### **ASSET CLASS OPPORTUNITIES OR OPPORTUNITIES WITHIN ASSET CLASSES?**

#### **An Important Distinction in Future Investment Strategy**

In this new investment era, when growth will be slow, markets highly volatile and historical investment models outdated, the ability to look beyond asset classes and their interrelationships will be key to success. While asset classes will still afford chances to capture longer-term misvaluations or diversify risk, further opportunities can and should be sought deeply *within* asset classes—e.g., anticipating and leveraging shorter-term divergences within specific segments of an asset class, rethinking asset class categories in global terms, or considering how a given sub-asset class or security type can fulfill a specific purpose.

This more granular and adaptive allocation approach will not only help investors navigate and mitigate unpredictable or potentially harmful events. It also should help leverage the opportunities that will unquestionably arise in the volatile and dynamic environment ahead.

### **Actually *Managing Assets* Is More Important than Ever.**

Due to the nature of the past—and future—changes in the financial world, professional, hands-on management has never been more important.

Managing assets is very different from recommending products or managers that have recently performed well. While investing in products based on a prior track record has never been a sure path to success, it is even more unlikely now. As market dynamics continue to change, so must investment approaches. That means records of past results will be even less relevant. If performance deteriorates, an investment distributor can simply sell other products with better histories, but investors cannot exchange poor results as easily. The risk is that this process of selling, or investing in, recent winners can continue indefinitely, ultimately diminishing wealth.

The circumstances presented by this next decade only emphasize the need for skilled, professional asset management. Rapid access to information and its correct interpretation will be increasingly critical. Smart and insightful securities selection—finding quality and value or identifying weaknesses—will be extremely important as economic and market events remain challenging. Complex asset class and investment interconnections will mandate careful oversight and coordination of decisions across a portfolio—and aggressive seeking of opportunities within asset classes as well. Transparency—a complete, total portfolio view of what is held, why it is held and how it could impact other investment decisions—is imperative. The ability to control and coordinate the timing and nature of tax consequences in investment actions will become increasingly critical as taxes rise, the return environment remains low and the concept of “total portfolio results” takes on new resonance.

---

INVESTING BASED ON PRIOR TRACK RECORDS HAS NEVER  
BEEN A SURE PATH TO SUCCESS AND IS EVEN LESS SO NOW.

---

These factors—information access and effectiveness of its use, experience and skill in securities selection, insights within and across asset classes, transparency in holdings and actions, and coordination and control of investment and tax impacts—are only fully possible if you are an asset manager.

Perhaps most important of all, asset management ensures accountability—an important quality that has been noticeably absent for many investors, leading to calamitous results. Asset managers have direct responsibility for understanding what is in a portfolio and knowing why it is there. As a result, investors can benefit from clear ownership and accounting for investment decisions by an informed, experienced and responsible party.

### **Investors Must Maintain the Discipline to Stick with Their Plans.**

Emotion rarely helps any decision process. Investing is no exception. Unfortunately, the ability to stay focused and committed to one's plan is typically the first thing that gets lost in tough times.

History has shown that investors who adhere to an investment strategy driven by long-term goals rather than short-term emotions come out ahead over time. While fidelity to long-term goals can be difficult during periods of near-term upheaval and disappointing returns, bumps experienced along the way should not steer investors toward unnecessary and unproductive detours.

---

### **EMOTION RARELY HELPS ANY DECISION PROCESS. INVESTING IS NO EXCEPTION.**

---

Investors are quick to react to negative news and tend to panic when things are at their worst. One need only look at the many investors who threw in the towel in the face of major declines in the S&P 500 in 2008 and early 2009. The problem with such responses is that investors are reacting to what has already happened—the bad news—and therefore missing out on any good news that might follow. Likewise, chasing good news—for example, buying into a fund because of strong recent outperformance—can be very risky.

Changing a strategy based on a reaction rather than a reason is always a bad idea, but it also is dangerous—and damaging—to “wait it out.” It is impossible to pinpoint when markets may improve or how long an upswing may last. Significant gains typically occur over relatively short periods, often in the initial months of a recovery. The average investor historically misses out on such opportunities. Failure to detect the beginning of an upswing can have devastating financial consequences. Sitting on the sidelines waiting for the “right” moment is, at best, an unreliable tactic and, at worst, a destructive strategy.

## THE IMPORTANCE OF CONVICTION

The first and most obvious step necessary for staying committed to a plan is to have confidence in it. Investors who take the time to understand themselves—including their needs and objectives—and have chosen sound managers and strategies that they understand and believe in are better able to trust their chosen path.

Conviction is one of the most important qualities in maintaining willpower and staying on course, even in the toughest times. Having clear information and consistently performing due diligence are the best ways to ensure it.

## TRUTHS: THE BEST OF OLD AND NEW

Take, for example, the bear market of 1973-1974, reflected in Exhibit 10. Consider an investor who did what is typical: pulled out of the market when things became too painful and then waited six months to return. With a \$5 million equity portfolio at the start, this investor lost out on \$1.07 million by being out of the market for those crucial six months. The decision to pull out in order to hold ground actually resulted in the investor losing ground instead. This pattern is remarkably consistent. Less than two years after the bottom of the 2007-2009 bear market, an investor in the same situation would have lost \$1.28 million merely by staying in cash for the first six months of the recovery.

Exhibit 10

### Discipline: Delay Is the Enemy



\$5M portfolio at start of bear market.

Cash proceeds are reinvested in S&P 500 six months after bear market end.

Performance calculated monthly. Returns for 2007-2009 bear market recovery as of 12/31/11.

Sources: FactSet and BNY Mellon Wealth Management.

While many of the traditional principles of investing should be revised to reflect new realities, other “old truths” endure and remain critical. The combination of these new and old principles will help shape a new era of investing—one that is informed by innovation and discipline, and positions investors to not only withstand the coming challenges but also to succeed in the days ahead.

### ENDURING TRUTHS

- Deep knowledge and market insights
- Long-term asset allocation perspective
- Thorough due diligence and oversight
- Expert, accountable asset management
- Disciplined adherence to investment principles and guidelines

### NEW TRUTHS

- Nimble, opportunistic allocation adjustments
- Deeper global insights and access
- Purpose-driven investment disciplines
- Access to and management of new opportunities

As evidenced by Exhibit 11, a significant recovery has occurred within the three years following every bear market since 1957. In fact, in most cases, bear market losses are more than recouped in the three years following a slump. Even missing the first month of a recovery can significantly reduce portfolio gains. In the case of the 2000-2002 bear market—the most recent with a full three-year history—absence during the first month would have cost more than 20 percentage points of a portfolio’s three-year gains.

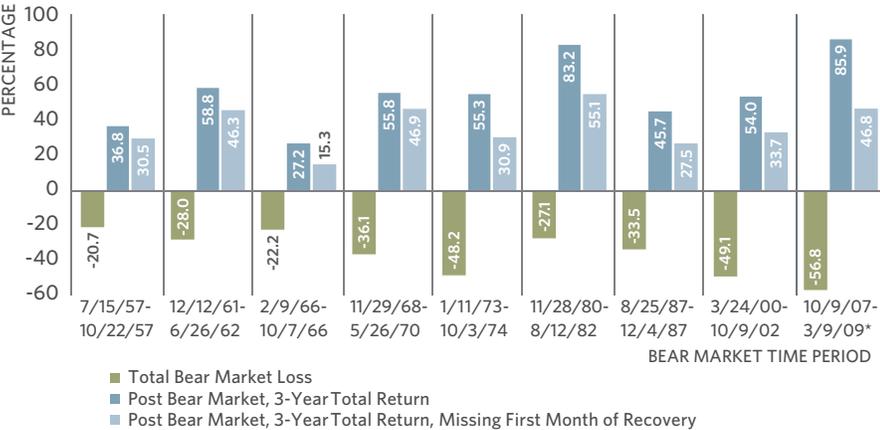
Volatility is frequently high in these periods, increasingly so as the market begins to bottom. However, this is not the time for an investor to join in the general panic. Investors with long-term time horizons should adhere to a disciplined investment strategy and remain invested in the market rather than sell out or attempt to “time” the bottom.

This adherence to a disciplined strategy will become even more essential in the critical years ahead, when traditional recovery periods may be longer or more erratic than ever before and upswings may feel more like up and downswings. The bottom line: No matter how painful the market or how tempting another strategy’s historical performance record, staying the course is usually the best choice. Doing so, of course, is the tough part and will be particularly difficult given the rocky road ahead.

The good news is that investors can take advantage of new methods of planning and new models of partnership with their advisors that make it easier to manage emotions, maintain discipline and stay on track when it is most critical to do so.

Exhibit 11

**Delay is the Enemy Again**



\*Returns for most recent bear market recovery are as of 12/31/11 and do not yet reflect full 3-year recovery.

Returns represent the S&P 500. A “bear market” is a period of at least two months in which stock prices decline by 20% or more. Source: Bloomberg LP.

# Dynamic, Seamless Planning

AS IF THE STRESSES OF THE MARKET environment are not daunting enough, a number of additional factors are challenging investors' ability to anticipate and plan for what lies ahead. As a result, a new mode of planning is required, one that takes several factors into account.

## **Most Plans Are Obsolete.**

When so much has changed, why haven't most plans? Even before the recent financial crisis, many plans, even those of the wealthiest, were unrealistic. The problem is now compounded by the combination of a transformed investment world, changing rules and higher costs. Consequently, many plans are not only obsolete but also incapable of meeting investors' most basic and important goals. At stake is whether people will have enough money to live on for the rest of their lives and/or to leave a legacy for future generations and philanthropic causes.

---

EVEN BEFORE THE RECENT FINANCIAL CRISIS, MANY PLANS,  
EVEN THOSE OF THE WEALTHIEST, WERE UNREALISTIC.

---

## **The Landscape Will Be More Complicated and Unclear.**

Investors face an environment of unprecedented complexity and change. Investment dynamics, tax policies, regulatory reform, fiscal policies and more—all are in flux and will profoundly affect planning, yet no one can say precisely how these changes will play out.

---

AFTER DECADES OF LOW OR DECLINING TAX RATES,  
THERE IS NOWHERE TO GO BUT UP.

---

**Taxes and Other Expenses Will Be Higher and More Unpredictable.**

If anything is certain in this context, it is uncertainty. For example, some tax rates are scheduled to increase after 2012, as seen in Exhibit 12, but if Congress chooses to act, the specifics could still change. Regardless, federal and state deficits make higher taxes an unfortunate reality. The extent of the increases is anyone's guess, but after decades of low or declining tax rates there is nowhere to go but up. Other expenses, including health care, living expenses and inflation, will also rise and remain hard to predict, further complicating an already challenging future.

*Exhibit 12*

---

**Future Expense Variables**

Tax	2011-2012	2013*	% Change 2012-2013
Ordinary Income	35%	43.4%	24%
Long-Term Capital Gain	15%	24%	59%
Qualified Dividend	15%	43.4%	189%

\*2013 rates assume Bush tax cuts expire as currently scheduled, plus an additional 3.8% surtax on net investment income for certain high income earners.  
Source: Internal Revenue Service.

## THE CHARACTERISTICS OF DYNAMIC, SEAMLESS PLANNING

WEALTH PLANNING TODAY must become a more comprehensive, integrated and evolving process. Three important elements can help investors revisit their plans and reposition them for the future. While they are straightforward to outline here, they are challenging to execute successfully. Getting them right, however, will be essential.

### Keys to Dynamic, Seamless Planning

- COMPLETE INCOME AND EXPENSE PROJECTIONS
- A FULL BALANCE SHEET VIEW
- A PLAN, AND A PLAN TO KEEP PLANNING

#### **Start with Complete, Realistic Income and Expense Projections.**

Higher costs, a constantly changing environment and the pressing need to adjust plans accordingly will necessitate regularly refreshed, comprehensive projections of future income, expenses and lifetime spending needs.

One common mistake in projecting future needs is to underestimate the amount required to avoid outliving one's money. Because people are living longer, they may require more funds than they expect in order to maintain their lifestyles in retirement. In addition, people often overestimate the future value of their investments, a risk that may be heightened in this decade.

In many plans, the lower return environment expected over the next 10 years has not been taken into account. Yet it will clearly have a dramatic effect on future net worth. In addition, future dollar values must be considered. The difference between what investors often envision as their future wealth and the actual future value after inflation can be extraordinary. Inflation over the past three decades, despite remaining fairly low on average, still took an immense toll on portfolio values in real terms.

---

ONE COMMON MISTAKE IN PROJECTING FUTURE NEEDS  
IS TO UNDERESTIMATE THE AMOUNT REQUIRED  
TO AVOID OUTLIVING ONE'S MONEY.

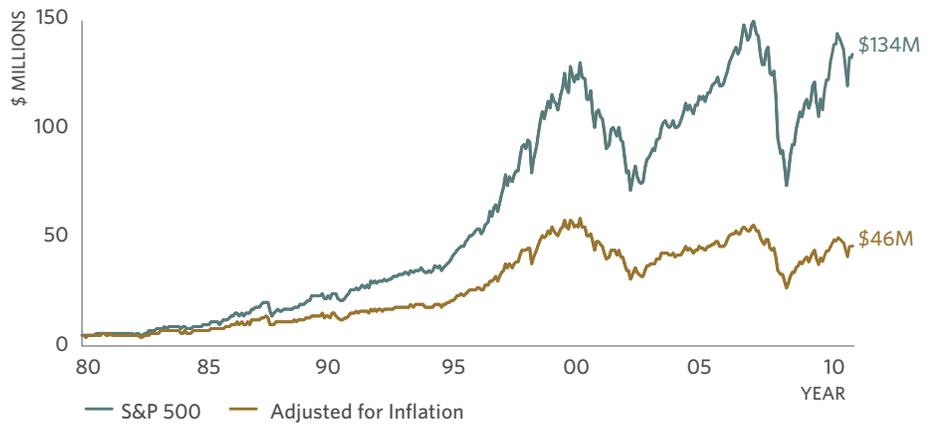
---

Take, for example, the \$5 million portfolio illustrated in Exhibit 13, for which the gap between nominal and real values amounted to \$85 million after 30 years. While U.S. inflation likely will remain muted in the near term, accounting for its long-term impact is paramount when planning for the future.

Exhibit 13

---

**Projecting Expenses: Inflation Erodes Value**



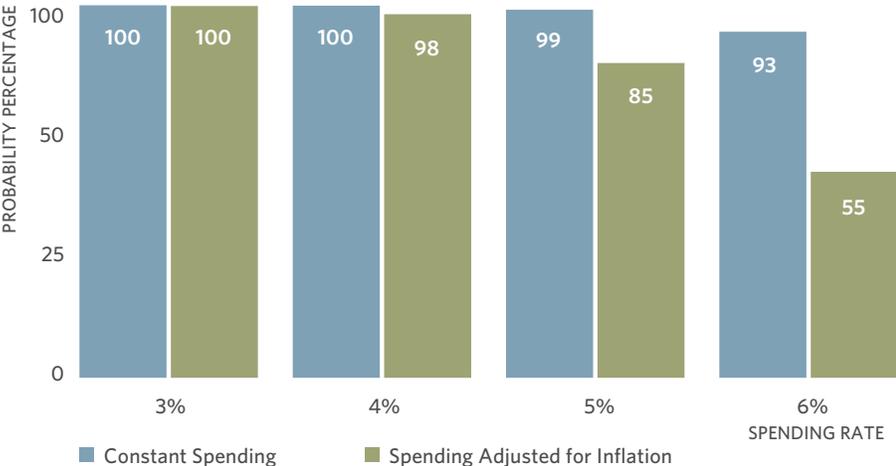
**Growth of \$5 Million**

As of 12/31/11. BNY Mellon Wealth Management calculations.  
Sources: Morningstar and U.S. Bureau of Labor Statistics.

Lastly, in estimating future net worth, quantifying how one’s real spending levels will erode wealth will be essential. Exhibit 14 illustrates the impact of annual spending in very meaningful terms. With and without inflation taken into account, this chart quantifies the probability of still having assets after 30 years of spending. Under this scenario, if a 50-year-old couple with \$5 million spent \$300,000 a year, increased each year to adjust for inflation, they would have a roughly one-half chance of still having funds at age 80.

Exhibit 14

**Spending: Opportunity vs. Risk**



Probability of Assets Greater than \$0 after 30 Years

Spending rate equals stated percentage based on inception value of \$5 million portfolio and increases at an assumed inflation rate of 2.5% per annum for the “Spending Adjusted for Inflation” data series. Asset allocation based on 60/40 portfolio, diversified across asset classes. Source: BNY Mellon Wealth Management. Please see endnote 4 for additional information.

While overestimating future asset values has always been an issue in planning, the risk is now greater, given future higher expenses. In fact, accurate cost projections and proper planning will continue to be very challenging in the face of rising taxes and uncertainty about health care and related costs. For example, estate expenses, already extremely high for the very wealthy and often the least considered, may present a formidable challenge, given the future trajectory of tax rates.

---

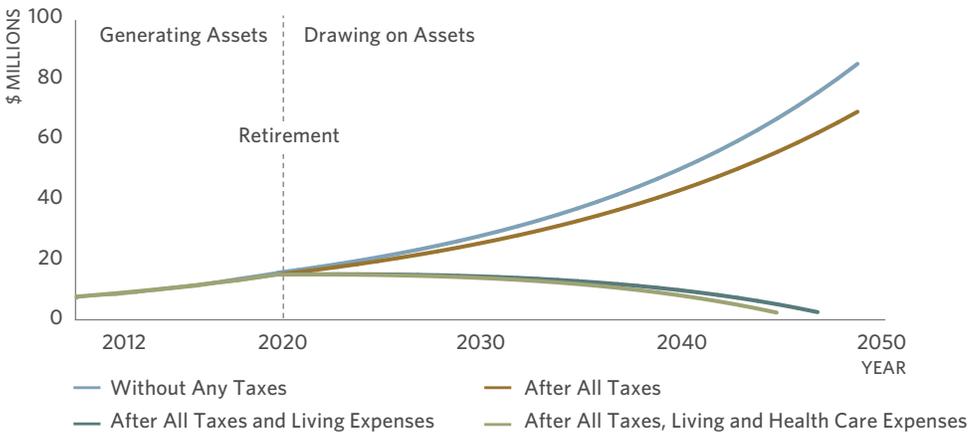
DESPITE THE ABSENCE OF TOTAL CLARITY, EXPENSE FORECASTS SHOULD BE MADE—AND THEN REMADE—AS CIRCUMSTANCES CHANGE.

---

Despite the absence of total clarity about these and other future concerns, expense forecasts should be made—and then remade—as circumstances change. Consider the 50-year-olds mentioned previously. They plan to retire in 2020 years and live on their savings. If their \$5 million portfolio were to simply grow, it would likely exceed \$60 million by the time they were in their mid 80s. But factor in taxes, annual living expenses, inflation and health care costs, and the picture looks much different. Under today’s tax scenario, the couple is likely to run out of money by age 86, as illustrated in Exhibit 15. If taxes go up as expected, the couple might run out several years sooner. With the proper foresight and planning, however, this couple can anticipate the potential gap and take steps to close it.

Exhibit 15

**Projecting Expenses**



**Portfolio Growth under 2012 Tax Policy**

Asset allocation based on a 50/50 portfolio, diversified across asset classes. Annual living expenses in retirement are 5% of the portfolio value, increased at an assumed inflation rate of 2.5% per annum. Annual health care costs in retirement are \$20,000 annually, increased at an assumed inflation rate of 6% per annum. Source: BNY Mellon Wealth Management. Please see endnote 5 for additional information.

Projecting expenses, and constantly revising projections as circumstances change over the next eight years, is only part of the story. Effective planning means knowing not only how much will be needed but also when it will be needed and where it will come from.

Taking into account all potential sources of income is key. Pensions, IRAs, 401(k)s, stock options and other income sources come in many forms, each with its own unique set of tax, transfer and timing considerations. By understanding each source's distinct characteristics and future changes that may govern its use, investors can more effectively optimize the role it may play in reducing the burden of higher taxes in the coming years. Quantifying the impact of major expenses, and then dynamically adjusting income and portfolio value projections and spending patterns accordingly, will help in meeting required payments and fulfilling future goals.

**A Total Balance Sheet View Will Be Extremely Important.**

Although concern about growing, accumulating and preserving wealth in the face of rising taxes and other expenses is warranted, the liability side of the balance sheet should also be considered. Debt can actually be an asset when it comes to planning, particularly in a low-interest or higher-tax environment.

Financially successful people generally prefer to avoid significant debt and live within their means. However, this can be taken too far. In fact, constructive use of debt can help enhance a portfolio and further long-term objectives.

---

DEBT CAN ACTUALLY BE AN ASSET  
IN PLANNING, PARTICULARLY IN A LOW-INTEREST  
OR HIGHER-TAX ENVIRONMENT.

---

For example, an individual who incurs a significant expense, such as a major tax bill, a divorce settlement or an estate tax bill, might be inclined to pay the debt immediately. However, under certain circumstances, the wiser move may be to borrow the required funds. This would preclude having to liquidate part of a portfolio, pay capital gains on the sale and diminish the portfolio's return potential.

Another use of credit is as investment leverage; for example, borrowing to enhance overall net worth with a new home, investment property or vacation home. When funds can be borrowed at a lower interest rate than the projected or potential return on an investment, or when the debt can offer benefits such as a mortgage's tax deductibility, use of credit can make sense.

Asset liquidation involves costs that are not obvious, such as potential tax consequences, an imbalance in a portfolio's asset allocation or the potential loss of future growth through compound returns. The effective use of credit can unlock the value of assets to meet liquidity needs without disrupting a long-term investment plan. While it can be emotionally difficult for some investors to accept, judicious—not excessive—use of debt can positively contribute to a wealth strategy.

**Plan, and Plan to Keep on Planning.**

Increasingly, wealth planning is like a giant jigsaw puzzle where the pieces keep changing shape. Yet many investors try to address the changing pieces of their financial lives—banking, investing, retirement, taxes, estate planning, etc.—as though they don't need to fit together. The result is that many plans are not well integrated or able to address a vastly altered set of circumstances.

To meet the complex, interconnected challenges of the next decade, wealthy individuals in particular will need well-integrated, well-coordinated plans. These plans should incorporate every aspect of wealth strategy and clearly indicate how individual components work together.

---

WEALTH PLANNING IS LIKE A GIANT JIGSAW PUZZLE  
WHERE THE PIECES KEEP CHANGING SHAPE.

---

Moreover, plans must be built and managed with the expectation that they will need to adapt and adjust continually. In the context of many changing variables, agility will be crucial to effective wealth planning. As reflected in Exhibit 16, planning opportunities may shift quickly as legislative or other changes occur. With so much yet to be determined, a tendency toward inertia is understandable. However, one of the keys to success in changing times is being informed, nimble and prepared to act.

Exhibit 16

**The New Nimble: Examples of Timely Planning Opportunities**

Opportunities and Planning Techniques	Actions for Consideration*
Asset Location	Weigh the difference in capital gains vs. ordinary income tax rates under changing tax law, and assess the effects on different asset classes <ul style="list-style-type: none"> <li>• Place tax-inefficient assets in tax-deferred accounts</li> <li>• Shift long-term growth assets to taxable accounts</li> </ul>
Current Low Interest Rates	Transfer wealth to children and grandchildren <ul style="list-style-type: none"> <li>• IRS-required interest rates (\$7520/Applicable Federal Rate (AFR)) at historic lows</li> </ul>
Proposed Legislation	Monitor current legislation for potential changes, such as: <ul style="list-style-type: none"> <li>• Further changes in income tax rates and estate tax provisions</li> <li>• Taxation of part or all of the “carried interest” of hedge fund managers as ordinary income rather than capital gain</li> </ul>
Restrictions on Grantor Retained Annuity Trusts	Transfer assets to family members before proposed legislation makes GRATs less favorable <ul style="list-style-type: none"> <li>• Take advantage of short-term and zeroed-out GRATs</li> </ul>
Roth IRA Conversions	Consider converting traditional IRA to Roth IRA before income tax rates increase
Increase in Tax Rate on Qualified Dividends after 2012	Consider new asset classes no longer burdened by less favorable tax rate than investments paying qualified dividends
Increased Estate and Generation-Skipping Transfer Taxes	Consult counsel about transferring wealth to children and grandchildren before scheduled tax law changes in 2013 <ul style="list-style-type: none"> <li>• Benefit from higher exemptions and lower tax rates for gifts, estates and generation skipping</li> <li>• May avoid incurring generation-skipping tax</li> </ul>
Valuation Discounts	Transfer business interests to family for non-tax (i.e., business or personal) purposes <ul style="list-style-type: none"> <li>• Consider reorganizing legal structure of assets into partnership or limited liability company and transferring partial interests in new entity</li> </ul>

\*Provided for illustrative purposes only. Planning opportunities should be considered in the context of each individual's unique situation, in consultation with a legal or tax professional.

As advisors work to implement investors' plans, they must also recognize the important roles other specialists can play. Managing wealth is a complex business, and it benefits greatly from the effective collaboration of experts. Wealth managers, accountants, attorneys, insurance professionals, business valuation consultants or other experts cannot do well by their clients if they do not collaborate and communicate openly with each another. The ideal is for all to work together with one common goal—each client's long-term success.

---

### ONE OF THE GREATEST RISKS IN THIS ENVIRONMENT IS TO WAIT FOR TOTAL CLARITY TO ACT.

---

Finally, having an effective plan will mean making the commitment to stick with it. This will require that investors and their advisors have the necessary resources and discipline to do so. Personal circumstances, market conditions, available resources, investment opportunities, and tax and regulatory frameworks will change constantly over the course of the next decade. For this reason, an effective plan will be one that is regularly revisited, adjusted and enhanced. This does not suggest that a plan should not exist or be followed diligently. One of the greatest risks in this environment is to wait for total clarity in order to act. Instead, it will be critical to actively manage plans with discipline while staying on top of any potential changes and proactively recognizing when a strategy shift may be warranted.

### PREPARING CHILDREN FOR THE MONEY, NOT JUST MONEY FOR THE CHILDREN.

Through the recent financial crisis, people have come to realize how easy it is to lose the wealth they have accumulated, giving rise to concern that history could repeat itself in successive generations. The crisis also served to sharpen the recognition among many that the legacy one leaves should be about more than just money. For both of these reasons, the concept of preparing the children for the money, not just the money for the children, has assumed renewed importance in the planning process.

By involving younger generations in family wealth decisions at an early age, parents can take the mystery out of talking about money and encourage financial maturity. With the increasing complexity of the financial markets, a comfort level with investing and wealth planning—and a clear understanding of the keys to success—can help the next generation work effectively with advisors to receive, preserve and grow the family wealth.

Discussing and agreeing on a family mission statement, which spells out shared values and details how the family's wealth should be used to further its legacy, can be invaluable in fostering a common vision and ensuring that the family's assets last long beyond the wealth creator's lifetime. Philanthropy also can play an important role, allowing the family to incorporate its personal values into wealth planning. Parents can involve even young children, emphasizing the importance of charitable giving rather than simply making and spending money. Given the expectation that financial growth will be more difficult to attain, the balance between doing well and doing good can be that much more powerful in ensuring a lasting legacy of values as well as assets.

# A Different Quality of Client-Advisor Engagement

INVESTORS TODAY ARE CAUTIOUS AND DOUBTFUL, questioning not only the individuals who advise them but also the financial system as a whole. Yet the challenges of the market environment and the crosscurrents ahead will make the right investment help—including sound ideas, dynamic strategies and effective plan implementation—more important than ever. Therefore, a new and different quality of client-advisor engagement is necessary. To serve investors well in this decade, this approach must reflect a number of key facts.

## **Fraud and Conflict Have Broken Trust.**

The market collapse of 2008-2009 was remarkable not only for the extent of wealth destruction but for the financial industry's role in the wreckage. Many investors felt their trust and loyalty were exploited—most obviously by outright scams but also by firms and individuals who failed to put their clients' interests first. As a result, many investors were left questioning the safety of the financial system itself, along with the credibility and integrity of its advisors.

Moreover, the erratic path of the markets toward recovery in 2010 and 2011 demonstrates that many investors continue to be skeptical—despite financial reforms and introduced consumer protections—and that it will take time for them to regain their trust.

## **Miscommunication Created Disconnects between Expectations and Outcomes.**

Amplifying the problem of broken trust, many investors realized too late that they did not fully comprehend the risks inherent in their chosen investment plans and strategies. Jargon-filled communication by many in the financial industry contributed to losses that clients never saw coming.

## **Emotional Reactions Destroyed Wealth.**

Human emotion is consistently one of the biggest causes of investment failure. Unfortunately, the more alarming the news, the more likely many investors will be swayed by their fears. The sheer scale of market losses in this recent crisis compounded the damage caused by investors' tendency to panic—and react—at precisely the worst time.

## DEFINING THE NEW CLIENT-ADVISOR ENGAGEMENT MODEL

THE FACT THAT TRUST, COMMUNICATION AND EMOTIONS are at the heart of these challenges might suggest that hard and fast solutions would be difficult to define. Yet investors and their advisors can directly control their mutual destinies by committing to three rules that can help guide their interactions.

### Keys to a Different Quality of Client-Advisor Engagement

- PARTNERSHIP AND PERSONAL RESPONSIBILITY
- CLEAR COMMUNICATION
- OBJECTIVE-DRIVEN INVESTING

#### **Partnership and Personal Responsibility Are Imperative.**

Effective partnerships require mutual accountability, with investors and their advisors sharing responsibility for achieving success. Advisors and clients alike will be most successful in this decade through closer involvement and a greater regard for the contributions each can make to the relationship. Simply stated, they must recognize that enhanced engagement can lead to better results over time.

To begin, investors must know what they want to accomplish with their wealth and make sure their advisors do as well. Plans must embody each investor's personal views, concerns, values and principles. Investors must also take responsibility for understanding the strategies their advisors recommend. In fact, although investment and wealth management techniques can be complex, they should be fundamentally understandable and logical. If the ideas and practices an advisor is applying do not make sense to the investor, there is a good chance that they do not make sense *for* the investor.

For their part, advisors must acknowledge that successful strategies depend on a thorough understanding of their clients and on direct, reciprocal communication. Advisors should be just as accountable for these qualities as for the ultimate strategies they implement on their clients' behalf.

---

IF AN ADVISOR'S IDEAS AND PRACTICES DO NOT MAKE SENSE *TO* THE INVESTOR, THERE IS A GOOD CHANCE THAT THEY DO NOT MAKE SENSE *FOR* THE INVESTOR.

---

Additionally, investors will need to adopt sound strategies rather than apply individual tactics that may (or may not) have worked for others. They should do the homework necessary to make informed decisions, relying on hard data as opposed to testimonials, gut reactions or cocktail party conversation. Ultimately, they must listen to their instincts but also undertake the requisite due diligence, keeping in mind that if it sounds too good to be true, it probably is.

Finally, investors entering a relationship with a financial advisor should seek ample transparency. They should know what they hold and why, and have information that confirms it is what they signed up for. The same rule applies for advisors—if they do not have a clear view of what their clients are invested in and why, they cannot adequately protect against countless risks.

Full transparency should also play a role in how investors pay for advice. Investors should understand the net value of the advice they receive after all management fees and incremental charges for transactions, mutual fund costs and bond spreads, for instance, are taken into account. This is particularly true when future expenses are liable to rise, returns are expected to be more modest and trust will need to be earned. Because compensation can drive behavior, investors will want to ensure that they are paying for what serves their best interests (satisfaction or portfolio growth) versus their advisor's bottom line (product sales and transactions). Ultimately, clients will be well served by knowing what they are paying for and by reaffirming that it's what they want.

---

FULL TRANSPARENCY SHOULD  
PLAY A ROLE IN HOW INVESTORS  
PAY FOR ADVICE.

---

Investors should think carefully about the kind of professional help they want and need. Although the criteria for selecting an advisor will be unique to each investor, the general qualities reflected below are worth weighing in assessing an advisor's suitability.

### Credentials

- Financial strength?
- Wealth management history and experience?
- Wealth management an important business?
- Quality and tenure of professionals?

### Strategy and Advice

- Understandable and credible philosophies and processes?
- Proven, relevant track record?
- Tax-conscious strategies?
- Accountability for decisions?
- Coordination with other advisors?
- Full balance sheet view?

### Relationship Quality

- Asks right questions?
- Answers all questions?
- Understands and cares about each client?
- Clear accountability for client success?
- Quality of communications—clear, honest and relevant?
- Proactive communication and advice?
- Clear client focus? (e.g., no sales, revenue, investment research or other responsibilities)

### Oversight and Control

- Transparency of decisions, holdings and actions?
- Due diligence quality and consistency?
- Asset protection and insurance coverage?
- Internal and external oversight and measures?
- Reporting capabilities and standards?

### Resources

- Sufficient for current and future needs?
- Customizable for each client?
- Consistent investments in technology and tools?

### Values

- Proven client satisfaction and retention success?
- Compensation aligned with clients' interests?

All of this depends on clients being open and direct about communicating with their advisors, and advisors communicating clearly, concisely and consistently in turn. No client should ever think a question is too basic to ask. In fact, an advisor's inability or unwillingness to answer a question should be a clear warning signal. In the end, communication skills and honesty are just as important as technical skill, as is a willingness to partner with a client to arrive at the right solutions.

### **Clients and Advisors Must Speak the Same Language—Literally.**

Jargon must be eliminated. No matter how often it is used, it never provides clients with the insights they need to make educated decisions. Terms like *standard deviation*, *alpha*, *beta*, *dispersion*, *mean reversion* and *Sharpe ratio* may have their place, but not in client communication.

In a study published following the 2008-2009 crisis, 40% of high net worth individuals described themselves as less risk tolerant than they had been the year before.<sup>4</sup> Yet it is hard to say whether the respondents became more conservative or never really understood the risk of their previous strategies.

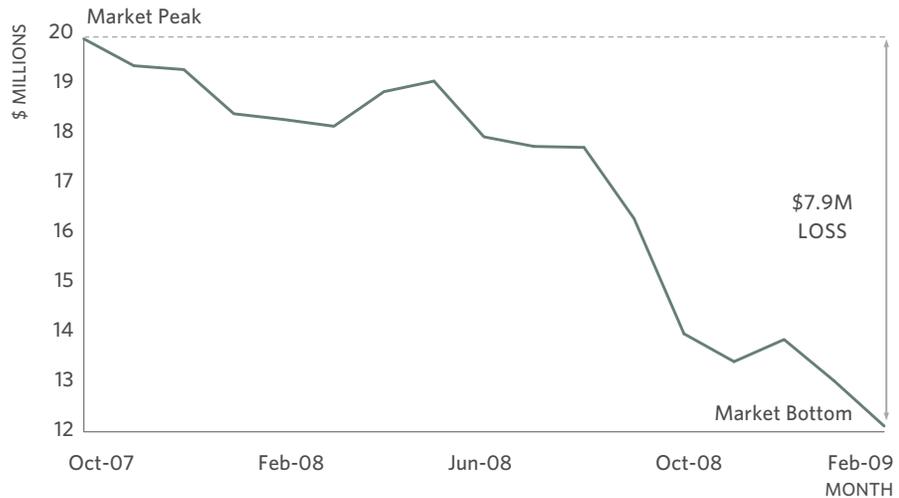
For example, an investor with a \$20 million portfolio in 2007 might have felt comfortable with a 70% equity and 30% fixed income asset allocation described as “moderately aggressive” by his advisor. In reviewing the allocation, the investor probably focused on the 7% average return the advisor projected rather than on the 10% standard deviation or the nuances of “kurtosis” and “fat-tail risk” that may have also been mentioned.

In reality, the benign-sounding 10% standard deviation meant that the investor could expect returns of between -3% and 17% about two-thirds of the time. The investor probably did not focus on the remaining one-third, but might have if his advisor had used plain language. After all, a 1% chance of something bad happening in any given month means that it is likely to happen about once every eight years. In this case, something bad did happen. By March 2009, at the bottom of the financial crisis, the \$20 million portfolio would have dwindled to \$12.1, as illustrated in Exhibit 17, and the investor would have gained a much clearer understanding of the risks involved in a “moderately aggressive” strategy.

<sup>4</sup>2000-2009 Phoenix Wealth Survey.

---

### Steep Decline in Balanced Portfolio



Decline of \$20 Million 70/30 Portfolio, 10/31/07-2/28/09

Footnote: Asset allocation based on a 70/30 portfolio, diversified across asset classes.

Sources: Morningstar and BNY Mellon Wealth Management. Please see endnote 6 for additional information.

Without clear communication and mutual understanding between advisors and their clients, emotions are apt to overpower rational thinking to disastrous effect—often when reasoning matters most. This was made clear by the events of 2008 to 2009. In part because of the extreme volatility and in part because of lost trust, investors' fears caused far more damage to their portfolios than they might otherwise have suffered. Yet, in these times, markets are going to frighten even the hardest investors. For this reason, investors need an approach that will help them:

- Understand proposed strategies better, to ensure they do not commit to something that will not suit them when times get tough
- Maintain discipline and stick with their strategies in any market environment

---

## INVESTORS' FEARS CAUSED FAR MORE DAMAGE TO THEIR PORTFOLIOS THAN THEY MIGHT OTHERWISE HAVE SUFFERED.

---

The solution to how investors and their advisors can both communicate more clearly and mitigate the harmful impact of emotion—enabling a strategy that is best suited to the client's goals and preferences and most likely to be followed—lies in objective-driven investing.

### **The Value of Objective-Driven Investing.**

“Will I have enough money to live on?” “Will I have enough to achieve my goals?”

As sophisticated as wealth planning can be, these basic questions are frequently asked of advisors by even their wealthiest clients—and are always the most important. Objective-driven investing is designed to directly address these questions by assigning the right strategies to the right assets, helping to ensure that the answer to these questions is yes and that clients remain confident in their plans.

In principle, objective-driven investing is very simple—it directly matches investment strategies to each client’s ultimate goals, including both lifetime spending and wealth transfer. Why is it becoming an increasingly powerful tool today?

---

OBJECTIVE-DRIVEN INVESTING GREATLY INCREASES THE ODDS  
THAT INVESTORS WILL UNDERSTAND THEIR STRATEGIES,  
STAY THE COURSE AND AVOID LASTING DAMAGE.

---

Consider the experience of the investor in the previous example. Rather than accepting the “moderately aggressive” income mix with 10% standard deviation, suppose he had an in-depth discussion with his advisor about the amount of money he would need to live on for the rest of his life. Then suppose he told the advisor he intended to transfer the remainder of his assets to his children or to personal causes. Taking the client’s objectives into account, the advisor might have allocated the dollars for the client’s lifetime spending to a conservative portfolio of “lifestyle investments” and invested the “wealth transfer” assets in riskier securities that could potentially offer a higher return over the long run. During the 2008-2009 market crisis, the highly conservative “lifestyle portfolio” assets would have declined modestly, but not enough to alter the client’s future plans. The “wealth transfer” assets would have been sizably impacted when the market hit bottom, but there would be adequate time for them to recover and grow to meet their longer-term objective.

How would this investor react to these events? Would he be more likely to remain confident in his separate and distinct strategies, knowing he is safeguarding his “lifestyle” money? Likewise, would he understand that his wealth transfer portfolio will recover and perhaps even thrive over the long run, assuming he remains invested? While human behavior is never entirely predictable, an increasing number of investment professionals believe that objective-driven investing greatly increases the odds that investors will understand their strategies, stay the course and avoid lasting damage.

In the prior example, the outcome of the objective-driven, two-strategy approach might not have been dramatically different from that of a traditional consolidated portfolio strategy. But, assuming the investor understood that his objective-driven approach was designed to protect the assets needed for his long-term security, he would have felt more confident in his plan. Even in the worst of times, he would have been more inclined to stay the course—something that makes a major difference in achieving long-term investment goals.

Although simple in principle, objective-driven investing can be complex in its application. The discovery process typically begins with straightforward questions, such as, “How much will you need to live comfortably for the rest of your life?” and “How much do you want to be able to leave your family?” But the process to arrive at the right answers is quite extensive. Further specificity about each goal—and what these words mean to the investor, both personally and quantitatively—is needed. Is the lifestyle portion of the investor’s portfolio intended purely to preserve wealth or to generate an ongoing income stream? Or is a combination of the two required? What special expenditures—a vacation home or other expenses—are contemplated? Is early gifting to children, versus at death, preferred? Do the future beneficiaries have assets of their own that should be considered in aligning strategies?

*Exhibit 18*

**Defining Goals and What They Really Mean**

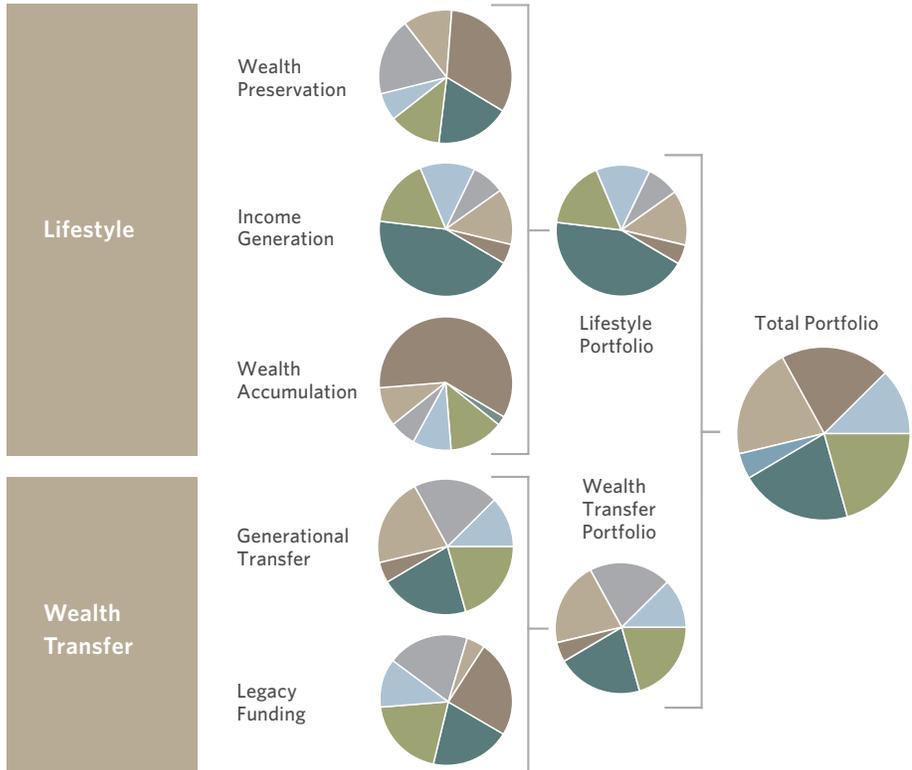
Lifestyle	<p><b>Wealth Preservation</b> Provide principal protection, stability, liquidity and consistent income generation</p> <p><b>Income Generation</b> Provide high levels of current income, modest principal growth and inflation protection</p> <p><b>Wealth Accumulation</b> Provide capital growth/growth of principal</p>
Wealth Transfer	<p><b>Generational Transfer</b> Provide growth of principal for current and subsequent generations</p> <p><b>Legacy Funding</b> Sustain portfolio assets and income across generations in perpetuity</p>

Based on this discussion, explicit portfolio goals, such as those reflected in Exhibit 18, can be identified, and work can begin on aligning assets and strategies to meet them. In doing so, the ability to accurately identify and forecast future costs and spending needs, and to address these within a tax-efficient portfolio, referenced earlier with regard to “Dynamic, Seamless Planning,” becomes critical. Also integral to success are the many behind-the-scenes strategies and resources—such as dynamic allocations, investment choices, oversight and management—discussed in “Investment Innovation and Rigorous Discipline.” Selecting from various portfolio goals and allocations, as reflected in Exhibit 19, the appropriate dual-portfolio strategy can then be developed—a strategy that is as unique to each client as are his or her circumstances and objectives.

While objective-driven investing is a complex process, the end result can be profoundly valuable. By being more explicit about clients’ true goals and the way strategies match up against them, advisors can better validate their advice and actions, and clients can remain confident that their strategies are right for them—in any market environment.

Exhibit 19

**Objective-Driven Investing**



# Navigating the Critical Decade with Confidence

AT FIRST GLANCE, some aspects of investment and wealth planning in this critical decade may look as if they have been torn from an old playbook. For instance, it will still be necessary to identify long-term goals, diversify investments and address spending and wealth transfer needs.

Yet today's approach must differ because the landscape itself has changed—and will continue to change—in unprecedented ways. Investors must build upon a foundation of enduring truths while incorporating new ideas and actions that reflect three pivotal new concepts.

## Keys to Achieving 2020 Vision

- INVESTMENT INNOVATION AND RIGOROUS DISCIPLINE
- DYNAMIC, SEAMLESS PLANNING
- A DIFFERENT QUALITY OF CLIENT-ADVISOR ENGAGEMENT

In investing, innovation must be combined with discipline to more effectively identify and leverage opportunities within the decade's challenging environment. By adhering to a structured yet nimble approach, investors will be better able to anticipate and optimize market opportunities—across and within asset classes, within and beyond borders—while defending against risk.

In addition, a seamless, dynamic approach to planning will help investors deal with mercurial influences such as taxes, inflation, health care costs, liabilities and personal concerns. With the right resources and mindset, successful planning will be possible over this decade and beyond, but only if projections are realistic, views remain broad and plans never stop adapting.

Finally, a new quality of client-advisor engagement is mandatory. A true working partnership, it will allow all parties to effectively address issues of trust and communication while precisely defining and delivering upon future goals. Investors and their advisors will have a clearer idea of where they are heading and a greater understanding of how they are getting there.

In a decade that is already proving to be challenging, these three principles will be key to the fulfillment of long-term objectives for wealth accumulation, protection, spending and transfer—not to mention vital to a much-needed peace of mind. Together, they can facilitate the journey through an ever-changing landscape and ensure that when investors and investment professionals look toward tomorrow, they do so with 2020 vision.

## Endnotes

### **Endnote 1** *Exhibit 3, Projecting Expenses: Resetting Expectations*

Portfolio is static blend of 60% S&P 500 Index and 40% Barclays Capital U.S. Aggregate Bond Index. Source: Morningstar. Calculations and estimated 2010-2020 returns by BNY Mellon Wealth Management.

### **Endnote 2** *Exhibit 5, Globalization: What Is Domestic Equity?*

Data includes only companies that report foreign profits. Companies with negative pre-tax income are excluded from calculation. Source: Ned Davis Research.

### **Endnote 3** *Exhibit 6, Value of Long-term Asset Allocation*

Blended 60/40 portfolio comprises 35% U.S. large cap equity (S&P 500), 6% U.S. mid cap equity (S&P MidCap 400), 3% U.S. small cap equity (S&P SmallCap 600), 8% developed international equity (MSCI EAFE), 8% emerging markets equity (MSCI EMF) and 40% taxable fixed income (Barclays Capital U.S. Aggregate Bond Index).

### **Endnote 4** *Exhibit 14, Spending: Opportunity vs. Risk*

Scenario is based on a 60/40 portfolio comprising 21.1% U.S. large cap equity, 2.4% U.S. mid cap equity, 1.7% U.S. small cap equity, 8% developed international equity, 9% emerging markets equity, 29.1% taxable fixed income, 3.9% high yield fixed income, 3.1% absolute return strategies, 7.3% long/short strategies, 7.5% private equity, 2.0% real estate, 1.2% commodities and 3.7% managed futures. Annual return assumptions for the 60/40 portfolio are approximately 7.1% pre tax.

### **Endnote 5** *Exhibit 15, Projecting Expenses*

The husband and wife are each 52 years old in 2012. While working (through 2019), they contribute \$125,000 annually to their initial \$5 million portfolio established in 2010. They plan to retire at age 60 (in 2020). The couple's blended 50/50 portfolio comprises 27% U.S. large cap equity, 5.3% U.S. mid cap equity, 3.2% U.S. small cap equity, 6.5% developed international equity, 7.5% emerging markets equity, 41.6% tax-exempt fixed income, 2% high yield fixed income, 2% emerging markets debt, 1% commodities and 3.9% managed futures. The illustration in exhibit 15 is based on a linear growth projection based on annual return assumptions of approximately 6.3% pre tax and 5.5% after tax.

2012 tax policy assumes 35% federal income tax, 15% long-term capital gains tax, 15% dividends tax and 5.3% state income tax.

### **Endnote 6** *Exhibit 17, Steep Decline in Balanced Portfolio*

Blended 70/30 portfolio comprises 40% large cap equity (S&P 500), 7% mid cap equity (S&P MidCap 400), 3% small cap equity (S&P 600 SmallCap), 10% developed international equity (MSCI EAFE), 10% emerging markets equity (MSCI EMF) and 30% taxable fixed income (Barclays Capital U.S. Aggregate Bond Index).

2020 Vision: The Most Critical Decade is a service mark owned by The Bank of New York Mellon Corporation.

The information provided is for illustrative/educational purposes only. All investment strategies referenced in this material come with investment risks, including loss of value and/or loss of anticipated income. Past performance does not guarantee future results. This material is not intended to constitute legal, tax, investment or financial advice. Effort has been made to ensure that the material presented herein is accurate at the time of publication. However, this material is not intended to be a full and exhaustive explanation of the law in any area or of all of the tax, investment or financial options available. The information discussed herein may not be applicable to or appropriate for every investor and should be used only after consultation with professionals who have reviewed your specific situation.

Pursuant to IRS Circular 230, we inform you that any tax information contained in this communication is not intended as tax advice and is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

©2012 The Bank of New York Mellon Corporation. All rights reserved.



**BNY MELLON**  
WEALTH MANAGEMENT

For additional information, please visit  
[bnymellonwealthmanagement.com](http://bnymellonwealthmanagement.com)