Today, investors face more challenges than they have in a very long time. While market return expectations are increasingly less certain, the risk of not meeting investors’ objectives continues to rise.

Although the challenges themselves may not be new, their confluence is. Take longevity as an example. Longer life spans are not a new development, but when combined with a myriad of other driving forces, planning for a longer life can demand more assets than simply accounting for a few more years and the nominal adjustment in cost of today’s goods in tomorrow’s prices. Other known variables should include the cost of services which investors would expect to need more of post-retirement, such as healthcare, alternative housing and other age-related expenses, which have been growing relatively faster than headline inflation.

This is not to mention the challenges brought on by the financial markets. Once a relatively reliable source for growth and income to help meet objectives, the risk/reward balance offered by equity and fixed income markets has shifted over the past 20 years (See Chart 8, page 6), making it harder to create, follow and achieve financial plans. Furthermore, many investors are still recovering from the emotional and financial effects of the Global Financial Crisis and Great Recession and now have an increased aversion to uncertainty, volatility and risk.

Although the broad financial markets have bounced back over this time, the recovery has only partly remedied investor challenges. In fact, the risk of investors falling short of their objectives is still present. No matter the objectives, investors continue to turn to advisors in an environment marked by uneven economic growth, gradually rising interest rates, and increased uncertainty, which can lead to potentially harmful spikes of volatility.
INVESTING THROUGH CYCLICAL GROWTH, SECULAR HEADWINDS

Investors should take advantage of cyclical growth opportunities while being aware of the longer-term secular headwinds.

After nearly nine years, central banks globally, led by the U.S. Federal Reserve, are gradually starting to tighten monetary policy. The market is now looking to fiscal policy to carry the baton, which has given some investors confidence in the potential for a faster pace of economic growth going forward (see Chart 1: UM Confidence, NFIB Small Business Optimism).

While a potential return to more “normal” cyclical growth factors is encouraging, we believe investors should keep an eye on the secular headwinds weighing on the long-term growth trend of the economy. These headwinds are largely demographic in nature, including an aging population and its impact on employment, but also include the impact of extended periods of low productivity growth on real potential GDP and an increase in corporate and government debt. Investors should note that this trend has been in place since before both the Global Financial Crisis in 2008 and the tech bubble in 2000, and will likely continue to serve as an overhang to cyclical factors leading to more periods of uneven growth or even a drag on a robust expansion (see Chart 2: Secular Forces Weighing on U.S. Growth).

For advisors building portfolios, the challenge is how to take advantage of short-term cyclical growth opportunities while accounting for the longer-term secular trends. The rally in risk assets over the past nine years has most likely been a painful lesson for any investor who was either not invested, or under-invested, as they waited for signs of a more robust economic recovery. We believe the best approach advisors can take is to remain focused on the objectives of the portfolio first, identify the risks in achieving those objectives second, and then allocate capital accordingly.
THE RETURN OF UNENCUMBERED VOLATILITY?

In the past few years, financial markets have grown very accustomed to the central bank’s accommodative monetary policies globally.

Volatility, as measured by the CBOE Volatility Index (VIX), has hovered in a historically low range over the past eight years. Spikes, while infrequent over this time, have usually coincided with periods of economic or market uncertainty, but have often retraced quickly to the previously low range (see Chart 3: Economic Uncertainty and Market Volatility).

This subdued level of market volatility since the Great Recession has largely been attributed to the accommodative monetary policies of central banks globally and their “whatever it takes” attitude toward financial stability. Following this logic, with the U.S. Federal Reserve in the early stages of withdrawing accommodation, investors should be mindful of the possibility for more frequent and/or longer lasting—periods of higher volatility in the future, which can potentially lead to harmful drawdowns in a portfolio.

From an investment strategy perspective, there are three key points on volatility to consider. The first point is that not all volatility is negative. After all, volatility is one measure of risk, and without risk, there is no return. Building on that, the second point is that the level of volatility can be an important indicator of both the current, and the future, potential risk and return in the market. Over the past eight years, assuming volatility was artificially subdued by monetary policy, the level of volatility in the market likely gave investors a false sense of security of the true risk in the market or in their portfolios. The third point is that volatility is just one of the factors among many that needs to be accounted for when building a portfolio and should always be put in the context of the portfolio’s overall objectives.

RISING LIFE EXPECTANCIES

To compound the complexities of this new environment, investors must also contend with more familiar challenges, such as demographics.

Rising life expectancies can impact investment planning options, such as seeking higher returns, investing for longer periods or making larger contributions in order to achieve desired income in retirement.

Furthermore, demographic trends point to more active lifestyles in retirement, potentially requiring a higher level of disposable income than that often prescribed for earlier generations.

**FOR EXAMPLE**

The average man turning 65 years old in 2010 can expect to live another 16.6 years in retirement — almost four years more than in 1970. Meanwhile, women can expect to live to almost 84 years of age, nearly 20 years beyond retirement age.

THE SEARCH FOR “TO THE RIGHT AND NARROW”

To illustrate the opposing forces investors now face, consider the normal distribution of investment returns in the years preceding the Global Financial Crisis (see Chart 5).

GDP growth was relatively strong and followed a more normal cycle; traditional monetary policy tools were sufficient to either stimulate or cool off the economy and left-tail risk was often confined to idiosyncratic events. Market performance was also comparatively consistent, where a 7% return could be generated with relatively low risk using portfolio strategies that were not required to be overly complex or diversified.

Today’s socioeconomic challenges, such as longer life spans and rising healthcare and education costs, should be prompting advisors to seek investment opportunities that offer the potential for higher and more consistent returns, or with less dispersion, and a lower probability of left-tail risk. In other words, investors should be driven to find strategies that push the distribution of returns “to the right and narrow” of normal, thus creating higher probabilities of investing success (see Chart 6).

However, the macroeconomic environment and financial market challenges are pushing the distribution of outcomes “left and flat,” meaning the likelihood for higher returns decreases while left-tail risk increases (see Chart 7). Those challenges include uneven economic growth, increased instances of volatility and inconsistent returns across asset classes.

Source: BNY Mellon. For illustrative purposes only.
Investment Considerations

We believe investors need to remain vigilant in this constantly evolving macroeconomic and investment environment, especially given the potential impact that sudden changes in market conditions can have on the risk and reward dynamic of certain asset classes.

One of the key challenges for advisors will be keeping clients invested in, and through, an environment where desired returns are likely to be accompanied by a higher degree of risk.

Risk and return dynamics have changed dramatically over the past two decades. To achieve a 7.5% annual return, which could have been accomplished with allocations to just U.S. fixed income markets in 1995, now requires investors to build more complex portfolios and assume higher levels of risk, with portfolios allocated less to bonds and more to equities and alternatives (see Chart 8).

While portfolio diversification has effectively been forced upon investors to strike the right balance, it is critical to understand the benefits and limitations that diversification brings.

How well clients understand the nature and sources of risk depends on many factors, including their experience through the Global Financial Crisis and Great Recession, personal values and overall investment knowledge. It is important for them to realize that risk involves not only the possibility of a large drawdown in a portfolio, but the real-life consequences such as running out of money during retirement.

<table>
<thead>
<tr>
<th>Asset Classes</th>
<th>1995</th>
<th>2005</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Fixed Income</td>
<td>100%</td>
<td>52%</td>
<td>12%</td>
</tr>
<tr>
<td>Non-U.S. Equity</td>
<td>4%</td>
<td>14%</td>
<td>13%</td>
</tr>
<tr>
<td>U.S. Large-Cap Equity</td>
<td>8%</td>
<td>6%</td>
<td>12%</td>
</tr>
<tr>
<td>U.S. Small-Cap Equity</td>
<td>1%</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>5%</td>
<td>33%</td>
<td>32%</td>
</tr>
<tr>
<td>Private Equity</td>
<td>1%</td>
<td>20%</td>
<td>22%</td>
</tr>
</tbody>
</table>

**Expected Return**: 7.5% 7.5% 7.5%

**Standard Deviation**: 6.0% 8.9% 17.2%

Hypothetical example only.

Source: Callan Associates, Callan Capital Market Projections. Chart does not show actual performance. Asset classes and allocations for 1995, 2005, and 2015 are Callan’s and based on their forward-looking capital market projections. Past performance is no guarantee of future results. “Risk” is represented by standard deviation, which is a statistical measure of volatility of an investment.
Here are a few investment considerations we think are critical for advisors to take into account when investing in the current environment.

**CONSIDER ACTIVE OVER PASSIVE**

Today’s market landscape represents fertile ground for active managers. An environment with wide dispersion of investment returns both within and across asset classes represents one of the times when active management can and should outperform passive indexing, especially on a risk-adjusted basis.

Fundamental security selection of active managers may aid in identifying higher-quality investment opportunities while avoiding lower-quality, riskier securities versus a passively managed index fund that uniformly invests across the quality spectrum.

To illustrate, consider that 70% of the MSCI EAFE Index is made up of companies based in countries with sub-2.2% growth. Given this anemic economic growth, digging deeper into company fundamentals is critical to finding the best opportunities. Active managers take the time to parse through a company’s business model to understand where the true risks lie, and may be able to better diversify on a country and regional level than purely passive strategies.

U.S. investors also tend to be confined by a “home country bias,” meaning they overweight their portfolios in domestic asset classes at the expense of broader diversification. This means investors could be missing out on geographic regions and sectors with higher relative growth prospects, including pockets of opportunity within emerging markets.

**CHART 9**

**SOME OF THE BEST-PERFORMING FIXED INCOME MARKETS HAVE HISTORICALLY BEEN FOUND OUTSIDE THE U.S.**

**Performance Results Have Varied From Country to Country**


*Past performance is no guarantee of future results.* This example is for illustrative purposes only. It is intended to illustrate the changing country leadership in terms of bond market performance over time, the divergence in performance from year to year, and the potential benefits of a diversified investment approach. It is not intended to promote investment in any single country or market. Returns from emerging market countries have been historically more volatile than those of the U.S. and other developed countries. Investors cannot invest directly in any index. Actual results will vary.
CONSIDER ACTIVE OVER PASSIVE (continued)

In addition, sector dispersion across equity and fixed-income markets tends to be fairly broad. In Chart 10, we can see how investors in passive funds might enjoy the mean return across any time period (marked by the gray diamond), but this means limiting the opportunity set and all the higher returns above the mean. As a passive investor, you’re buying the whole index, which can include the good and the bad, and limit potential investment returns.

Investment Consideration
Consider active managers that have the flexibility to look across and within regions, sectors and asset classes to find the highest-quality opportunities while sidestepping lower-quality, higher-risk investments (and in the case of fixed income, negative-yielding bonds). For clients looking for asymmetric risk, alternative strategies can help protect a portfolio against downside losses versus their passive counterparts.

Source: Annualized return data from Morningstar as of March 31, 2017. Time period shown is January 1, 2000 to December 31, 2016. Past performance is no guarantee of future results.
THE BENEFITS (AND LIMITATIONS) OF DIVERSIFICATION

Given the opposing forces in play, investors must be more vigilant about the risks in the markets and in their portfolios. More specifically, because risk is the primary driver of return, they need to ensure they are taking the “right” type of risk based on their objectives. That is, investors must have the knowledge and experience to determine whether a perceived risk has the potential to deliver portfolio returns or the potential to cause a meaningful drawdown.

One of the primary goals of diversification is to reduce risk, and history shows that portfolios allocated across low-correlated assets have indeed been less volatile over long periods. However, diversification tends to be least effective when it is most needed. Because correlations between many asset classes typically spike during times of crisis, even well-diversified portfolios may be unable to avoid large portfolio drawdowns triggered by a broad market sell-off.

Stated another way, diversification can help protect a portfolio from falling behind in the long term, but not necessarily from extreme risk in the short term. During the Global Financial Crisis, for example, correlations to the S&P 500 increased among major asset classes, with the exception of alternatives (see Chart 11). As those correlations increased, the cushioning effects of diversification decreased. When constructing an investment portfolio, it’s important to know not only how different asset classes perform in different environments, but perhaps more importantly, how they may behave relative to one another.

Investment Consideration

Consider strategies that have proven, low-correlated returns in periods of heightened volatility and during bear markets. Global fixed income strategies can help dampen volatility, while funds that hedge currency exposure can help smooth out the return path. Municipal bonds can offer diversification benefits while delivering relatively consistent returns in volatile markets. Alternative, multi-asset strategies that focus on asset allocation flexibility and capital preservation can protect against drawdowns.

CHART 11
DIVERSIFICATION CAN BE LEAST EFFECTIVE WHEN MOST NEEDED
Major Asset Class Correlations to S&P 500 Index

THINK OUTSIDE THE STYLE BOX

The economic and investment landscapes are going through a transitional phase which is likely to bring higher volatility going forward. Given the limitations of diversification over the short run, what can advisors do to position their clients’ portfolios?

One method is to take a risk-based approach to portfolio construction and allocation, which means addressing risk first and returns second. Instead of simply allocating assets across style boxes, think about the sources of risk in your clients’ portfolios and even their willingness to assume those risks.

Questions to keep in the forefront include:
- What are my clients trying to accomplish?
- What are the risks in each market?
- How will the portfolio’s investment allocations likely respond?
- Is the potential for return worth the risk?

Investment Consideration
Consider strategies that map directly to client objectives and challenges. Active equity strategies that rely on fundamental research to identify quality opportunities can help a portfolio grow over time and help investors meet long-term goals. For income seekers, consider strategies that balance the growth of both principal and income while preserving capital, and not just the highest-yielding assets. Active fixed income strategies that take advantage of opportunities both locally and abroad can provide consistent risk-adjusted returns and also help to dampen volatility. The right alternative strategy can help portfolios stay on track by helping to protect against drawdown risk.
Conclusion

Investors and advisors are facing more challenges today than they have in a long time. While the challenges themselves are likely familiar, the confluence of them is something that many advisors may not have had to address all at once prior to the Global Financial Crisis. Socio-economic factors, such as demographics, longevity and the rising cost of living, are pushing investors to seek higher and more consistent returns than in the past. Meanwhile, working against investors are the cross-currents of cyclical and secular forces in the economy, which has led to greater uncertainty and volatility around growth, risk and investment returns.

Given these opposing forces, advisors will likely need to take a fresh approach to portfolio construction, diversification and risk management. We believe the best approach advisors can take is to remain focused on the objectives of the client’s portfolio first, identify the risks in achieving those objectives second, and then allocate capital accordingly.
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**RISKS**

All investments contain risk and may lose value. Equities are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees. Small and midsized company stocks tend to be more volatile and less liquid than larger company stocks as these companies are less established and have more volatile earnings histories. Bonds are subject to interest-rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines.

**INDEX DEFINITIONS**

The BAML High Yield Master Index II is a market capitalization-weighted index of all domestic and Yankee high-yield bonds. Issues included in the index have maturities of at least one year and have a credit rating lower than BBB-Baa3, but are not in default. Bloomberg Barclays Global Aggregate Index represents the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities. Bloomberg Barclays U.S. Aggregate Index represents the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities. Indices are unmanaged and one cannot invest in an index. The Bloomberg Barclays U.S. Credit Index measures the performance of investment grade corporate debt and agency bonds that are dollar-denominated and have a remaining maturity of greater than one year. The Cambridge Associates LLC U.S. Private Equity is an end-to-end calculation based on data compiled from 1,206 U.S. private equity funds (buyout, growth equity, private equity energy and mezzanine funds), including fully liquidated partnerships, formed between 1986 and 2014. The FTSE EPRA/NAREIT Developed Index is designed to track the performance of listed real estate companies and REITs worldwide. By making the index constituents free-float adjusted, liquidity size and revenue screened, the series is suitable for use as the basis for investment products, such as derivatives and exchange-traded funds (ETFs). The HFRI Monthly Indices (“HFRI”) are a series of benchmarks designed to reflect hedge fund industry performance by constructing composites of constituent funds, as reported by the hedge fund managers listed within HFR Database. Indices are unmanaged and one cannot invest in an index. The Morgan Stanley Capital International Emerging Markets (MSCI EM) Index is a widely accepted unmanaged total return index of emerging stock market performance. The Morgan Stanley Capital International Europe, Australasia, Far East (MSCI EAFE) Index is a widely accepted unmanaged total return index of foreign stock market performance. The Russell 1000<sup>®</sup> Index measures the performance of the 1,000 largest companies in the Russell 3000<sup>®</sup> Index. The Russell Midcap<sup>®</sup> Index measures the performance of the 800 smallest companies in the Russell 1000<sup>®</sup> Index. The Russell 2000<sup>®</sup> Index measures the performance of the 2,000 smallest companies in the Russell 3000<sup>®</sup> Index. S&P 500 is one of the most commonly used benchmarks for the overall U.S. stock market, and is an index that tracks the performance of the largest 500 U.S. companies. It is not possible to invest directly in an unmanaged index.

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