American economist Hyman Minsky famously said, “Stability leads to instability. The more stable things become and the longer things are stable, the more unstable they will be when a crisis hits.”

Given the subdued level of volatility in the financial markets over the past few years, investors might be getting a little too comfortable with the current “stable” environment. Broad market volatility has trended lower over the past 15 years (See Chart 1) and while it remains to be seen if this trend will continue, a number of factors point to a potential reversal, including uncertain and uneven economic growth, rising interest rates, and increasing geopolitical risk. Meanwhile, “left-tail risk” and portfolio volatility are on the rise as investors take on more risk in search of returns, which is pushing valuations to historically stretched levels.

For investors, it is critical to distinguish between broader financial market volatility and portfolio volatility. At the market level, subdued volatility can give investors a false sense of security and encourage them to take on more portfolio risk than they might have in the past. With the risk/return balance of many asset classes starting to look less favorable, one of the key questions investors must now ask themselves is whether they are efficiently allocating capital within their risk budget.

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1 Hyman Minsky, quote adapted from The Financial Instability Hypothesis, 1992.
Charts throughout are provided for illustrative purposes only and are not indicative of the past or future performance of any BNY Mellon product or service.
Market Volatility – Friend or Foe?

Market 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 2).

This subdued level of market volatility has largely been attributed to the extremely 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 normalizing policy, investors should be mindful of the possibility for more frequent and/or longer lasting periods of higher volatility in the future. Large spikes in volatility can lead to potentially harmful drawdowns in a portfolio, similar to what we saw during the Global Financial Crisis and Great Recession (See Chart 3).


From an investment strategy perspective, investors need to remember that not all market volatility is harmful. After all, volatility is one measure of risk, and without risk, there is generally no return. Investors also need to understand that volatility can affect portfolios differently depending on where an investor is on their investment time horizon.

During the “Accumulation Phase”, investors are contributing fresh capital to their portfolios on a regular basis, which allows them to not only take advantage of the power of compounding returns, but also allows them to add to positions on pullbacks in the market. Chart 4 shows the benefit of these two factors where an investor starts with $100,000, contributes $500 per month, and over a 17-year period accumulates roughly $400,000.

Conversely, in the “Decumulation Phase” (See Chart 5), such as in retirement, investors are now drawing funds out of their investment portfolios. While the portfolio is still taking advantage of compounding returns in positive markets, the principle that is compounding is growing smaller because an investor is drawing on the portfolio. In addition, during drawdown periods in the market, investors are selling in a falling market, which immediately realizes any losses. Chart 5 shows the impact on a portfolio when an investor is withdrawing $500 per month over the same period.
Subdued financial market volatility is not the only factor that has encouraged investors to take on more portfolio risk. The prospect of lower investment returns is also pushing investors out on the risk curve.

Looking deeper into portfolio volatility, we see that 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 securities in 1995, now requires investors to build more complex portfolios and assume more than three times more risk, with portfolios allocated less to bonds and more to equities and alternatives (See Chart 6).

Looking at this a different way, if investors wanted to maintain a consistent level of volatility in their portfolio, they would also need to diversify their investments. However, this diversification comes with a material impact to investment returns (See Chart 7).
Uncompensated Risk

In the current environment, with equity market valuations looking stretched and central banks globally starting to gradually normalize monetary policy, how can investors determine the level of uncompensated risk they are holding in their portfolios?

One of the most debated topics in the investing world is equity market valuations. The debate largely centers on how useful they are given the various ways it can be calculated and interpreted. Because of this, we believe valuations should be just one of factors investors consider when allocating capital.

One of the more common measures of stock market valuations is the price/earnings ratio.² This measure provides an indication as to whether the market is cheap or expensive relative to historical averages. While that is an important consideration when investing, we think what valuations tell us about potential future returns is the most important element.

In Chart 8, we compare the S&P 500 Cyclically Adjusted P/E (CAPE) ratio with the 10-year forward historical total return, adjusted for inflation, for the S&P 500. As the chart shows, periods of historically high CAPE P/E ratios have been followed by periods of relatively low returns.

The S&P CAPE as of March 31, 2017, was 29.02x, suggesting that future returns could be much lower than what we have experienced over the past few years.

With current valuations suggesting investors will not be compensated for the risk they are taking in equity markets, it is not surprising that the current market has been described as “the most hated bull market in history” by the financial media and market observers.

Given the current equity market landscape, many investors have turned to government bonds to help preserve their capital given the asset class’s defensive nature.

However, these traditional “safe-haven” assets might not be as “safe” today as investors might expect. Accommodative monetary policy pushed interest rates to exceptionally low levels, and even into negative territory in some regions. At the same time, the embedded interest rate risk in certain fixed income markets, as measured by duration, has increased (see Chart 9).

During this time, investors were forced to take on additional duration risk in their search for yield. This wasn’t a huge concern given central banks were keeping rates low and there was very little risk that rates would rise quickly.

However, now that central banks are starting to normalize monetary policy, investors will now need to re-evaluate whether the yield they are pulling is worth this increased risk, especially in an investment allocation that is typically considered a portfolio’s risk anchor.

² Price/earnings ratio is calculated as the price of an equity security divided by the earnings of the security.
²² Shiller P/E is calculated as the price of the S&P 500 divided by the average of 10 years earnings, adjusted for inflation.
Investment Considerations

Volatility is just one of the many factors that needs to be considered when allocating a risk budget and should always be put in the context of the portfolio’s overall objectives.

One of the first lines of defense in mitigating portfolio risk is to maximize the benefits of diversification by using the dispersive correlations of asset classes to their favor to lower overall volatility.

In addition, investors need to be mindful of the limitations of diversification as well. First, diversification cannot assure a profit or protect against loss. Second, cross-asset class correlations increased materially during the global financial crisis. While they have retreated since the acute levels of 2007 and 2008, they continue to remain elevated and have yet to settle closer to their lower historical norms (See Chart 10). These relatively high correlations are increasing portfolio risks at a time where investors are dependent on lower correlations the most.

![Chart 10: Correlations Before, During and Since the Global Financial Crisis]


CONSIDER ACTIVE MANAGEMENT

Active strategies that focus on fundamental research and have the flexibility to look across and within geographies, sectors and asset classes have the ability to invest in the highest-quality opportunities while side stepping lower-quality, higher-risk investments. These strategies have the potential to deliver attractive risk-adjusted returns and to help dampen volatility so a portfolio has the potential to grow over time and help investors meet long-term objectives.
THINK OUTSIDE THE STYLE BOX

Identify which risks can cause the most damage in a portfolio and ensure they are managed accordingly. Investors should consider active strategies that have time-tested, low-correlated returns to other asset classes to help manage financial market volatility when it spikes. Alternative, multi-asset strategies that have allocation flexibility and focus on capital growth and preservation can potentially help protect against large drawdowns.

“BARBELL” APPROACH

A “barbell” approach to investing which utilizes strategies that seek to capitalize on return potential on one side and capital preservation in the case of an unexpected correction on the other can be a helpful strategy investors can utilize to mitigate portfolio volatility and protect against uncompensated risk.

Conclusion

Investors need to be able to distinguish between broad financial market volatility and portfolio volatility. Given the level of uncertainty around a number of market drivers, including economic growth and monetary policy, investors need to be prepared for spikes in volatility in both the financial markets and their portfolios. With the risk and return balance for many asset classes becoming less favorable, investors will need to allocate to their risk budget in a more focused way.
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RISKS

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. Equities are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees. There is no guarantee that dividend-paying companies will continue to pay, or increase, their dividend. Investing in foreign denominated and/or domiciled securities involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries.

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 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. 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. Chicago Board Options Exchange, CBOE SKEW Index is a global, strike independent measure of the slope of the implied volatility curve that increases as this curve tends to steepen. CBOE Volatility Index (VIX) is a popular measure of the implied volatility of S&P 500 index options. Correlation measures the degree to which the performance of a given asset class moves in relation to another, on a scale of –1 to 1. Negative 1 indicates a perfectly inverse relationship, 0 indicates no relationship, and 1 indicates a perfectly positive relationship. The Economic Uncertainty Index is a GDP-weighted average of national EPU indices for 16 countries: Australia, Brazil, Canada, China, France, Germany, India, Ireland, Italy, Japan, Russia, South Korea, Spain, the United Kingdom, and the United States. Each national EPU index reflects the relative frequency of own-country newspaper articles that contain a trio of terms pertaining to the economy (E), policy (P) and uncertainty (U). The FTSE EPRA/NAREIT Developed Index is designed to track the performance of listed real estate companies and REITs worldwide. 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. MSCI World is a stock market index of 1,643 'world' stocks. It is maintained by MSCI Inc., formerly Morgan Stanley Capital International, and is used as a common benchmark for 'world' or 'global' stock funds. The index includes a collection of stocks of all the developed markets in the world, as defined by MSCI. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The Russell 3000 Composite 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. The widely tracked S&P GSCI® is recognized as a leading measure of general price movements and inflation in the world economy. The index — representing market beta — is world-production weighted. Indexes are unmanaged and one cannot invest in an index.

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