



## Back to Basics A Conversation with our CIOs



**Phillip Maisano**  
**Chief Investment Strategist**  
**BNY Mellon Asset Management**

Last year a prominent financial service executive announced his company was exiting the investment banking business by saying “*I have had about all the fun I can stand.*” While the past few weeks may be causing some to approach the same conclusion about the financial markets, panicking is clearly the wrong answer for long-term investors.

At BNY Mellon Asset Management our multi-boutique model generates divergence of thought, presented by experts in their specific asset classes. We polled some of our CIOs and would like to share some of their current thinking with you. We believe we have identified some of the challenges and opportunities as they relate to those asset classes and how they may impact your portfolio.

### Global Equities

**Michael Ho, Ph.D.**  
**Chief Investment Officer**  
**Mellon Capital Management Corporation**

History has shown that periods of great equity market fear are the best of times to acquire stocks and the worst of times to buy safer assets such as U.S. Treasuries. Indeed, both popular valuation measures and our valuation work indicate that stocks are extremely attractive compared to sovereign bonds. According to our valuation models, the expected annual returns over the next 10 years for large-cap equity indices in G-10 countries range from 10% to 14%, depending on the country. Compared to today's G-10 sovereign bond yields ranging from 2% to 5% per annum, we believe large-cap equities are significantly undervalued by historical norms.

While only hindsight will determine if the rally on October 13th marked a bottom, that day's 11% jump in the MSCI World Index is an example of what investors waiting for confirmation may miss. Historical analysis demonstrates that turning points of stock markets typically start during recessions. This predictive nature of equity markets makes it hard to time bottoms. However, we believe that the valuations are extremely attractive, making equities a compelling asset class going forward.

**Jeff Munroe, CFA**  
**Chief Investment Officer**  
**Newton Investment Management Limited**

We consider there to be attractive opportunities in well-positioned businesses that offer good dividend potential. We are continuing to avoid exposure to the financial sector, particularly in the Western markets and businesses that we consider to have excessively high levels of gearing or face large near-term requirements for debts to be refinanced. 2009 may also create opportunities

***The current stock prices represent the buying opportunity of a generation.***

***In what is likely to remain a challenging financial environment, our focus is on high quality, well-financed businesses.***

in the corporate bond market as it becomes clearer that financial conditions are stabilizing. Generally we wish to avoid investing in areas that do not fit with our longer-term thematic views or in businesses where we do not understand how profits are generated.

**John Truschel, CFA**  
**Chief Investment Officer**  
**The Boston Company Asset Management, LLC**

***We believe the current fear-filled markets are creating opportunities for long-term investors to begin building equity allocations that will likely produce very attractive returns.***

We believe the financial crisis is reaching a crescendo with the early to mid-October declines, and that valuations have reached a level where real bargains are emerging. We have reached the capitulation stage where the enormous policy responses from Washington are likely to reverse the tide. It will take time for the real economy to heal and recover, but the equity markets should discount the recovery by six months or more.

In our balanced accounts, we have reduced cash and fixed income to our minimum levels and have reduced absolute return strategies to buy U.S. large cap and U.S. small caps. The “flight to safety” trend has made U.S. Treasuries overly expensive. We like the U.S. large cap space the most, although emerging market equities have been discounted enough that they are looking more attractive.

**Oliver Buckley**  
**Chief Executive Officer & Chief Investment Officer**  
**Franklin Portfolio Associates, LLC**

***In this environment, we expect that companies with strong balance sheets and higher quality earnings will outperform their peers.***

We see two basic scenarios emerging, depending on the effectiveness of government efforts to stabilize credit markets. In the first scenario, the credit crunch begins to ease somewhat in the near-term. This would allow U.S. companies access to capital at rates that are higher than before but not prohibitive. Recent government interventions have made this scenario more likely. If these efforts do prove successful, we would expect that investors will return to evaluating companies based on earnings and earnings prospects, as well as competitive positioning in the marketplace. Even so, we believe it prudent to expect the U.S. economy to contract over the next several quarters. There are clear signs that businesses, consumers, and state and local governments expect to reduce spending in the near-term. If the recession is mild, we expect U.S. equities to rebound over the next year or so; if it is more severe, the equity market recovery will take longer.

Under the second scenario, the credit crunch does not resolve for a significantly longer period. Although this seems less likely today, we believe any long-term planning should continue to include this possibility. In this case, solvency becomes a much more important determinant of share prices than earnings fundamentals. We would expect the rolling set of failures in financial services companies to begin to expand to industrial companies, with those that are more highly levered and dependent on short-term debt markets

more likely to fail. While we hope and expect the “modest downturn” scenario to unfold, we would adapt our outlook if signs emerge that the crisis is not moderating.

We are continuing to overweight companies that look attractive relative to their peers based on relative valuations and underlying business momentum. Within that group of companies, we are emphasizing those with lower leverage and higher quality of earnings. We expect these stock characteristics to be rewarded in either scenario.

## **Global Emerging Markets**

**Hugh Hunter, CFA**  
**Head of Global Emerging Markets**  
**WestLB Mellon Asset Management LLC**

Global emerging markets have undergone a period of extreme volatility - in the past two weeks we have experienced a 9 standard deviation daily decline and a 10 standard deviation daily rise. Fear and total risk aversion gripped investors in the face of credit market paralysis in the developed world, banking sector collapses or rescues, and the knock-on effect these forces will have on economies across the world will take time to become clearer.

Emerging markets will not be immune from a slowdown or recession in the developed world but, as a result of prudent economic policies and strong growth over the past five years, they should be partially insulated from recession in the developed world. Stock prices have fallen by 50% from their peak almost 12 months ago and although valuations now look very attractive, earnings downgrades will temper this to some extent. Risk-averse investors have exited the asset class and are unlikely to return in the short term, regardless of the fundamentals. We continue to believe that emerging economies will grow in 2009, albeit at a slower pace than before, and that the long term story for Emerging Markets remains intact. When some stability is restored to financial markets and the economic outlook for 2009 is clearer, this may provide the opportunity for a rebound in EM equities. Given the precipitous decline we have seen, this recovery could be sharp.

We are remaining defensive in our portfolios, looking at countries which offer value relative to growth, and companies which have solid business models and sustainable cash flows. We are cautious of countries and companies with high financing requirements as we anticipate credit availability will continue to be tight over the coming year. Countries with overvalued currencies are also at risk of devaluation, particularly where export growth is falling and current account balances are deteriorating

***Emerging markets should be partially insulated from recession in the developed world.***

## Global Emerging Markets - Asia

**Hugh Simon**  
**Chief Executive Officer**  
**Hamon Investment Group**

*There are attractive fundamentals in Asia, given strong economies and overall lower levels of corporate leverage.*

The ongoing deleveraging in financial markets and risk aversion in the global markets brings to the forefront the attractiveness of the Asian economies. In contrast to the highly leveraged western financial markets, we believe the Asian financial system is well-regulated and adequately capitalized. The regulators in the region have been proactive over the last few years in raising interest rates and reserve ratios to curb credit growth and rein in non-performing loans. The present market turmoil enables us to choose high quality businesses at very reasonable valuations.

We are paying careful attention to the balance sheet and cash flow of companies to evaluate whether they are securely positioned amid the deleveraging of the markets. We are currently avoiding countries with political uncertainty, such as Thailand and Malaysia.

## Fixed Income

**Kent Wosepka, CFA**  
**Chief Investment Officer, Taxable Fixed Income**  
**Standish Mellon Asset Management Company LLC**

*In the realm of expected returns, the fixed income securities of strong credits and well-structured high quality asset- and mortgage-backed securities are more attractive than they have ever been.*

Liquidity in the bond market is very thin. Trading in anything other than Treasuries (and even to some extent, Treasuries) is very expensive. Markets for corporate, mortgage- or asset-backed securities, when they exist, have very wide bid/offers. Against this backdrop, we are adding fewer new securities to portfolios than might normally be the case. Historically wide yield spreads and the backing of the U.S. Treasury help make agency mortgage-backed securities attractive. In addition, the Treasury has initiated a program where they are in the market purchasing these securities. This provides a backstop to the bonds. We also think non-cyclical corporates that do not need to come to market are great bonds to own. Finally, very short maturity, amortizing asset-backed securities are excellent. These are high quality bonds with less than a year to final maturity that pay back a portion of principal every month, and have characteristics which make 100% principal repayment extremely likely. These asset-backed securities might be priced at a yield of 10% or more.

The riskiest bond positions today are those where the entity has a large amount of short term refinancing needs. With the new issuance market essentially shut down, a healthy credit can rapidly get sick if it cannot refinance upcoming bond maturities.

***Extreme illiquidity and lack of bank funding has created dramatic opportunities in bond markets.***

**Michael Ho, Ph.D.**  
**Chief Investment Officer**  
**Mellon Capital Management Corporation**

Franklin D. Roosevelt said that *“the only thing we have to fear is fear itself.”* This statement characterizes the current fixed-income market conditions world-wide. With the seizing up of bond markets and drying up of interbank lending, there are significant opportunities in the fixed-income markets. Aside from taking long positions in distressed fixed-income instruments, such as high-quality and paying asset-back securities, opportunities abound for investors willing to look for bargains in non-traditional spreads. For example, 2-year U.S. swap spreads are near the highest point of 150 bps per annum vs. a norm of 40 bps per annum since 1990, even though we believe there is very limited credit risk exposure due to collateral sweeps. Another example is in the dramatic fall of break-even inflation implied by real and nominal bonds in G-10 countries. A notable example is that Japanese break-even inflation has fallen from +50 bps per annum on June 30 this year to -1.8% as of October 15 this year. The current situation implies a decline in CPI of nearly 2% per annum for the next 10 years in Japan. Attractive relative value opportunities exist also on the credit spreads of various industrial companies. With a lack of rationality and reduction of arbitrage capital from banks and hedge funds, significant mis-valuations can be found in almost every corner of the fixed-income markets.

We cannot predict the timing of the turnaround in fixed-income markets. However, with confidence in global coordinated government actions announced so far, we believe fixed-income market liquidity should return. We expect TARP and other related programs will be implemented as soon as late October or early November. This, together with injection of bank capital, should put an end to the painful deleveraging process that has been pressuring asset prices world-wide. We believe that the fixed-income markets will still take time to adjust to government action, and this means that there are significant opportunities to generate returns from investor confusion about government policy.

## **Alternative Investments – Hedge Funds**

**Peter Noris, CFA**  
**Chief Investment Officer**  
**Ivy Asset Management Corp.**

***In 2009 we see returns coming from virtually all strategies in which we invest as the recent dislocations have created opportunities in almost every sector.***

While it can be argued that through most of 2008 hedge funds as a whole have been producing acceptable levels of alpha in relation to the broader markets, absolute returns have been less than expected, with September's results in particular reflecting the extreme investing environment. We should state up front our belief that hedge fund investing, as a concept, is not going away. That being said, we believe the hedge fund industry will certainly shrink meaningfully as we move toward the end of the year. We are now in a period of industry consolidation, where today's losers will be sorted out from

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tomorrow's winners. Importantly, we should also note that the closing and scaling back of many investment bank proprietary trading operations should also materially improve the opportunity set, as among biggest competitors for hedge fund returns over the last few years were banks that deployed multi-billion dollar, often leveraged proprietary trading strategies identical to that of many hedge funds. We have seen this phenomenon before, in 1998, when many hedge funds suffered in the aftermath of the Russian debt crises, especially in relation to equity markets, which had a very strong year. The hedge fund industry resized, and returns were robust for many years afterward. While the parallels with 1998 are not exact, we do see many similarities, albeit on a broader scale.

The current environment overwhelmingly favors the stronger, more experienced firms, those with business stability, institutional infrastructure, seasoned investors, and broad investment expertise. In 2009 we see returns coming from virtually all strategies in which we invest as the recent dislocations have created opportunities in almost every sector. In the very near term, we continue to see opportunities in macro-oriented and systematic trading, where market trends have been successfully exploited by a class of managers that are largely profitable year to date. On the event driven side, merger arbitrage also has begun to offer profitable spreads, even on cash deals where the risk of a breakage is almost immaterial in relation to the annualized return.

## **Alternative Investments – Real Estate**

**Todd Briddell, CFA**  
**Chief Investment Officer**  
**Urdang Securities Management, Inc.**

***We believe a defensive investment focus is required, with an emphasis on companies with low-leverage, cycle-tested management teams, high-quality real estate assets, and limited exposure to new development.***

While the current financial crisis is troubling, we remain committed to our belief that a strategic allocation to global real estate securities should provide an enhancement to most investment portfolios in terms of both absolute return and portfolio diversification. However, we believe that there will be no near-term catalyst for real estate values to rise until there is a recovery in confidence and a contraction of the “fear premium” for financial assets. Hence, we believe a defensive investment focus is required, with an emphasis on companies with low-leverage, cycle-tested management teams, high-quality real estate assets, and limited exposure to new development. We also believe that companies with a “war chest” of capital and prudent strategies to acquire high-yielding properties from distressed owners at substantial discounts to replacement cost should outperform.

In the current market, we are avoiding companies that have strong external financing needs. This would include real estate securities characterized by significant development pipelines, near-term debt maturities, funds management business models, and over levered “stories” with risk of debt covenant issues.

## Alternative Investments – Commodities

**Robin Wehbe, CFA**  
**Vice President**  
**The Boston Company Asset Management**

Commodity prices have fallen due to weakening demand, not an increase in supply, which for many commodities, such as copper, has been diminishing for the past several decades. Even if producers were still willing to commit capital today, bringing on new capacity is a major undertaking that takes time, with a number of logistical impediments.

*Prices have fallen due to weakening demand, not an increase in supply...if demand growth returns before the turn of the decade we envision a very bullish scenario for commodities.*

Our longer-term case for commodities must be made with full understanding that the global economy has entered a cooling phase. Clearly, if demand remains anemic through 2010, returns on commodities-linked investments are likely to suffer, and investors will have larger problems as well. However, if demand grows before the turn of the decade we envision a very bullish scenario for commodities. It is not likely that supply will be ready, nor will inventories be there to restrain price acceleration, which could resume the same trajectory we have seen over the past few years.

In the current environment, we believe in focusing on firms that are linked to commodities with tight fundamentals (like copper or potash) and have low-cost structures. But caution is certainly warranted. We would recommend a modest allocation to such investments, while increasing the size of the positions as the first signs of economic recovery begin to appear.

## Where and when will this end?

**Phillip Maisano**  
**Chief Investment Strategist**  
**BNY Mellon Asset Management**

While there is no consensus as to when and how this market crisis will end, everyone does agree however, it will end. What began as a credit “event” related to sub-prime mortgages issued since 2004 has exploded into a full blown “crisis of confidence” in all securities and the entire financial system. This crisis will end, as all prior crises have ended, when value buyers show up and start buying. This could be and has been both on the strategic buyers front (M&A and share repurchases) and on the financial buyer front (U.S. Government and private equity). These crises also come to an end when fiscal and monetary policy and other policy responses become significant enough to reverse the tide. Confidence will be slow to return but we believe the steps being taken by multiple government agencies will ultimately work and will provide liquidity to the market. It will then be back to basics, a common theme our CIOs are using in their investment approaches today.

*When confidence returns, it will be back to basics, a common theme our CIOs are using in their investment approaches today.*



BNY MELLON  
ASSET MANAGEMENT

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