Following three tumultuous years of returns across asset classes, the asset allocation decision is crucial in helping investors rebuild their portfolios to meet their future savings goals. In this paper we will focus on two asset classes — equities and bonds — to try and provide some perspective for those making an allocation decision. Looking at the historical global returns of these asset classes offers valuable insight into how returns may be constituted in the future. This will not only give us direction on why we currently favor equities, but also direct us to what we believe are attractive equity security types. We will finally talk about why these security types can be best accessed through an active stock selection approach.

Our broad views are:
- The twenty-six year rally in bonds appears to be over
- Equity returns will be driven by different dynamics than in the previous multiple expansion driven upswings
- Active stock pickers are poised to do better than passive strategies
- A global approach allows active stock pickers a broader opportunity

**Asset Allocation — Historical Analysis**

Before deciding how to allocate for the future we need to look to the past. We shall examine both past short-term and long-term allocations.

Investors that allocated money to equities in the low volatility period prior to 2007 did a complete reversal in 2008. There were record withdrawals from equity mutual funds and into cash alternatives. As equity markets rebounded in 2009, investors reallocated much more heavily out of cash into fixed income than into equities, on a relative basis. Bond funds saw $398 billion net inflows in 2009, a record that was easily double the next closest full year of $135 billion in 2002.\(^1\) The perceived relative stability of bonds perhaps was viewed as a more attractive way for many investors to dip back in risk assets.
We use mutual fund assets as a proxy for the retail investors’ asset allocation to financial assets (Exhibit 1).

**Exhibit 1  U.S. Mutual Fund Assets (as a % of total assets)**

Historical Bond Returns

Global real (or inflation-adjusted) bond returns have been dramatically high over their long-term average since the start of the 1980s. When looking at global bond returns we are looking at long-term sovereign debt from 17 countries in the aggregate, as a proxy. The recipe for such outsized returns is to have high and falling interest rates for a sustained time, which is exactly what we’ve had. The 10-year U.S. Treasury Bond hit a high of over 15.8% in 1981. By the end of the third quarter of 2009 the rate was just over 3.3% (Exhibit 8). We are certainly no longer in a period of high and falling interest rates. The mix of return attributes of bonds — capital appreciation and income — has historically been more highly weighted to income and income reinvestment (over 80%) than capital appreciation. So, in the near term, returns from bonds will be even more dependent on the income than in the past twenty-eight years. However, with rates below 4.0% in the United States on long-term government debt, we believe total returns will have a very hard time coming anywhere close to the returns of the last twenty-eight years. In fact we feel the prospect for real bond returns in the near future may take on a “yield-minus” constitution.

Exhibit 2

<table>
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<tr>
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<th>1900-2008 (%)</th>
<th>1950-2008 (%)</th>
<th>1950s (%)</th>
<th>1960s (%)</th>
<th>1970s (%)</th>
<th>1980s (%)</th>
<th>1990s (%)</th>
<th>2000-2008 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global real bond returns</td>
<td>1.8</td>
<td>3.5</td>
<td>-0.4</td>
<td>0.7</td>
<td>1.5</td>
<td>6.5</td>
<td>6.7</td>
<td>6.6</td>
</tr>
<tr>
<td>U.S. real bond returns</td>
<td>2.1</td>
<td>2.4</td>
<td>-2.2</td>
<td>-1.0</td>
<td>-1.7</td>
<td>7.2</td>
<td>5.7</td>
<td>7.8</td>
</tr>
</tbody>
</table>

Source: Credit Suisse/London Business School “Global Investment Returns Yearbook 2009”

*Performance is historical and not indicative of future results. “Real” returns reflect inflation-adjusted returns.*

The other interesting factor on real bond returns is the low to negative returns we have seen in other past periods (Exhibit 2). The U.S. had three straight
decades of negative annualized real returns from bonds. The 1960s and 1970s were not too much better globally, albeit positive.

We have seen record amounts of investor assets flowing toward bonds over the past year. Whether the assets are moving there for stability, income, or capital appreciation opportunities, investors should be aware that the stability or returns that they have become accustomed to in the recent past may not be replicable in the future.

Historical Equity Returns

Real returns from equities have outpaced real bond returns over the long term. Global equity returns here are measured by the returns of the same 17 countries as the global bond returns. Much like the rally in bond returns that started in the 1980s, equities experienced outsized real returns through the eighties and nineties (Exhibit 3). The performance of equities over the past decade shows the lack of predictability in equity returns. Without interest rates as a pricing mechanism, as with bonds, equity returns have proven to be more volatile.

Exhibit 3

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<th>1900-2008 (%)</th>
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<td>Global real equity returns</td>
<td>5.2</td>
<td>6.7</td>
<td>18.0</td>
<td>5.4</td>
<td>0.6</td>
<td>13.4</td>
<td>7.9</td>
<td>-4.4</td>
</tr>
<tr>
<td>U.S. real equity returns</td>
<td>6.0</td>
<td>6.7</td>
<td>15.7</td>
<td>5.6</td>
<td>-0.7</td>
<td>11.0</td>
<td>14.2</td>
<td>-5.4</td>
</tr>
</tbody>
</table>

Source: Credit Suisse/London Business School “Global Investment Returns Yearbook 2009”
Performance is historical and not indicative of future results. “Real” returns reflect inflation-adjusted returns.

Equity returns, much like with bonds, are made up of capital appreciation and income. Exhibit 4 looks at the historical make-up of these two components — the income compounding effect represents returns attributed to dividends. The trend on how the structure of equity returns has changed over time is noticeable. The income component of these returns has decreased every decade since the 1970s, despite being the more stable part of equity returns. The capital appreciation portion can come in the form of multiple expansion or earnings growth, but realized by investor demand. It has been multiple expansion that drove most of the returns in equities in the prior two decades (Exhibit 5). Inflation adjusted earnings growth during this same time period was sluggish. We are now in a period where earnings are low, dividends are low, but multiples are still high versus long-term averages.

Exhibit 4

<table>
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<th>1900-2008 (%)</th>
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<td>-4.4</td>
</tr>
<tr>
<td>Real equity capital gains</td>
<td>1.0</td>
<td>3.3</td>
<td>12.8</td>
<td>1.9</td>
<td>-3.3</td>
<td>9.6</td>
<td>5.6</td>
<td>-6.3</td>
</tr>
<tr>
<td>Income compounding effect</td>
<td>4.2</td>
<td>3.4</td>
<td>5.2</td>
<td>3.5</td>
<td>3.9</td>
<td>3.8</td>
<td>2.3</td>
<td>1.9</td>
</tr>
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Source: Credit Suisse/London Business School “Global Investment Returns Yearbook 2009”
Performance is historical and not indicative of future results. “Real” returns reflect inflation-adjusted returns.
Implications on the Next Wave of Equity Returns

We believe the earnings growth and income will be a more important contributor to equity returns over the next cycle. Any multiple expansion will help drive returns further, but relying on that to help investors meet savings goals is fraught with the hazard of uncertainty.

Performance is historical and not indicative of future results. Actual performance will be greater or less than any historical index or category average. S&P 500 Composite Index is an unmanaged index of 500 widely held common stocks that measures overall stock market performance. Dividend and earnings data before 1926 are from Cowles and Associates (Common Stock Indexes, 2nd ed. [Bloomington, Ind.: Principia Press, 1939]), interpolated from annual data. Investors cannot invest directly in any index. Price-to-earnings is the ratio of the market price of a firm's common stock to its trailing 12 months’ earnings per share.
In a market devoid of long trend multiple expansion, finding, analyzing and investing in companies that are able to grow their earnings becomes of paramount importance in order to generate returns. Companies that are able to internally generate cash and know how to deploy it are generally better positioned to grow their earnings and pay dividends. They are better positioned to preserve and grow investor assets in various economic environments as well. We believe this is a market suited for an active stock picker as there will be diversity among individual company returns.

A Global Approach

Global equity investing works especially well for the active stock picker. It affords the investor greater opportunity for economic and industrial diversification through access to some of the best companies that the world has to offer, without the pressure of searching increasingly concentrated domestic markets.

Many of the world’s leading companies, such as Microsoft, Roche, and Honda, are international businesses generating significant revenue outside their home market. Among the world’s largest companies today, there are fewer headquartered in the U.S. compared to a decade ago. The rise of capitalism has led to increasingly consumer-oriented societies around the world and has helped raise the standard of living for many worldwide. As a result, the global economy has become less dependent on U.S. consumption. The baton of growth has been passed on and emerging markets are now driving the world economy. The GDP of emerging economies now constitutes about 30% of the world’s output. The world’s leading companies span a range of industries from energy to healthcare. Combining U.S. and non-U.S. securities expands potential investment opportunities — providing access to an ever-widening investment universe and delivering the possibility of better long-term real return prospects for the long-term investor.

The increasing globalization of today’s investment universe argues for an approach that evaluates companies on a global basis rather than regional or country-specific measures. In a world market economy, portfolio construction should not be limited by regional barriers or rigid market weightings. Active stock picking can exploit inefficiencies, especially across global markets. An integrated global approach provides the ability to invest opportunistically among regions, countries and sectors to take advantage of the most attractive valuations and prospects for growth. Contrast this to the process of moving money between separately managed U.S. and international mandates, which typically takes precious time and effort to change an asset allocation decision. A truly global approach views the world as a single global universe of opportunities, providing exposure to U.S., non-U.S., developed and emerging markets across market capitalizations.

Put simply, investing globally allows an investment manager to select what it believes are the best companies in the world for the portfolios it manages, irrespective of their geographic domicile.

1 Source: Strategic Insight
3 Source: Credit Suisse/London Business School “Global Investment Returns Yearbook 2009”
The 17 countries used in the calculations are US, Canada, Belgium, France, Germany, Ireland, Italy, the Netherlands, Spain, UK, Denmark, Norway, Sweden, Switzerland, Japan, Australia and South Africa.
Walter Scott is a global equity investment manager serving institutional investors around the world. The firm is based in Edinburgh where it was established in 1983.

*Investors should consider the investment objectives, risks, charges and expenses of a mutual fund carefully before investing.*

*Mutual fund investors should contact their financial advisors to obtain a prospectus that contains this and other information about a Dreyfus fund, and should read it carefully before investing. For more information, visit [Dreyfus.com](http://Dreyfus.com).*

*Retirement plan investors should call BNY Mellon Asset Management Retirement & Sub-Advisory Services at 1-800-992-5560 to obtain a prospectus that contains this and other information about a fund and should read it carefully before investing.*

Comments discussed herein are provided as a general overview and should not be considered investment advice or predictive of any future market performance. Views are current as of the date of this communication and are subject to change rapidly as economic and market conditions dictate. Statements and opinions expressed in this article are those of the authors and do not necessarily represent the views of Dreyfus or their primary employer.

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**MAIN RISKS**

Equity funds are subject generally to market, market sector, market liquidity, issuer, and investment style risks, among other factors, to varying degrees. These risks are more fully described in the fund’s prospectus.

Bond funds are subject generally to interest rate, credit, liquidity, prepayment and extension, derivative and market risks, to varying degrees, all of which are more fully described in the fund’s prospectus. Generally, all other factors being equal, bond prices move in the opposite direction of interest rate changes.

Investing internationally involves special risks, including changes in currency exchange rates, political, economic and social instability, a lack of comprehensive company information, differing auditing and legal standards and less market liquidity. These risks may be increased in less developed emerging markets.

*Asset allocation and diversification cannot assure a profit or protect against loss.*