Sigma Investment Counselors

Sigma Summaries

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The Mirror Image

As the last year of the old millennium comes to a close, we are struck by the realization that some aspects of the markets in 2000 were almost a mirror image of 1999. All of the major stock market indices declined for the year and the Nasdaq significantly under performed the S&P 500. In 1999, the technology heavy Nasdaq Composite index appreciated a stunning 86% while the S & P 500 gained a healthy, but more modest 21%. In 2000, the Nasdaq recorded its worst loss ever, declining 39.3%, while the S &P 500 declined by a much lesser rate of 9.15%.

The fixed income market staged a complete reversal of its prior year pattern. In 1999, despite three interest rate hikes by the Fed, a stronger than expected domestic economy and global economic recovery kept the bond vigilantes increasingly nervous about the prospects of reaccelerating inflation, pushing interest rates higher all year. The long bond yield rose steadily throughout the year, starting at 5.08% in January and closing at 6.45% at year-end. In 2000, however, three more interest rate hikes, slowing economic growth both here and abroad, and benign inflation despite higher energy prices, convinced investors to bid up the long bond lowering the yield back to 5.1% by year-end.

Bonds clearly were the better investment versus stocks in 2000. This is the first time this has happened since 1990 which was also the last year the stock market provided negative returns. Earlier this year, we cautioned investors about unreasonably optimistic expectations for stock market returns. In June 2000, after the S&P 500 and the Nasdaq Composite had already fallen significantly from their peaks, many investors still seemed unconcerned from this major market shakeout. However, since 1980, there have been only two instances when the S&P 500 index showed calendar year declines, and the average annual compound return for the index from 1980 through 1999 has been 17.1%. This represents a very unusual period in stock market history.

As we noted in our June newsletter, we advise potential and current clients that it is reasonable to expect investments to be up every two out of three years. Looking forward, we would not be surprised if the stock market returned to this longer-term pattern.

Some investors have asked us if it would have been advisable to alter their asset allocations in view of the deteriorating economic and stock market outlook. Given the strength of the market and the apparent irrational exuberance priced into the market earlier this year, especially among "dot-com" startups, it seemed that weaker equity markets were inevitable. Our response to this question is that "market timing" does not work for long-term investors.

Market timing involves moving assets into and out of the stock market based on perceptions of where the market is headed. The difficulty in market timing is knowing "when to get out" and "when to get back in". In fact, history shows that market timing fails more often that it succeeds. Therefore, Sigma makes asset mix changes based on each client's financial obligations and liquidity needs rather than short-term changes in market expectations.

To further understand the difficulty in market timing, consider the following. For market timing to be successful, the timing of both the buy and sell decisions must be right and they have to be correct in every cycle. Unfortunately, the outlook for the market is rarely clear. Further, when broad stock price recoveries occur, they are often swift and provide significant returns. So even if investors are able to sell stocks at the right time, delays in getting back in the market can significantly affect returns. While extreme, the substantial decline in October of 1987 was immediately followed by a substantial rebound in equity prices. It would have been nearly impossible for investors to have timed this v-shaped rally and, in fact, for investors that stayed fully invested, their patience was well rewarded. Meaningful v-shaped rallies also occurred as recently as 1998 and 1999. Of course, for taxable investors, we also have to consider the value of selling stocks that have substantial capital gains.

What is the message from all this? While down markets can be unpleasant, we recognize that they are an inevitable part of investing. In addition, Sigma believes that the long-term trend of stock prices is upward and the upward trend over time will overcome the shorter-term unpredictable fluctuations. In the long run, stock prices track earnings in a fairly straightforward manner. Since successful companies have been able to offer positive earnings growth over time, stocks have been good long-term investments.

For most people, successful investing means making a multi-year commitment to stocks of successful companies selling at defensible valuations. As far as the current environment is concerned, we do not know how much more stock price declines there will be before the stock market lows are reached. We are confident, however, that ultimately markets work and the markets will force governments to make the right monetary, fiscal, and political decisions to enable continued prosperity.

At Sigma we attempt to assure that equity investors own reasonably priced shares in the strongest, most successful companies. Occasionally, some of our selections will be disappointing, as the fundamentals do not live up to our expectations. For the most part, though, we believe that our clients' portfolios are comprised of companies that will not only survive in today's economic environment, but will provide attractive returns over a reasonable holding period. As we have articulated often in the past (over the long-term) stocks provide the best returns versus bonds and marketable securities. Meeting our clients' long-term financial objectives outweighs the risks involved in the short-term volatility of the stock market.

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