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# summaries

SIGMA INVESTMENT COUNSELORS

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# Scanning the Horizon in 2012

## The 50,000 Foot View: Our General Macroconomic Overlay for Portfolio Management

From as far back as the mid-to-late-1990s, a witches brew of easy monetary policies, limited supervision of the markets in general and banks in particular, poor legislation and non-existent credit standards for consumer lending created a boom of debt-fueled consumer and government spending. These pieces resulted in unsustainable levels of economic growth that reached a crescendo in 2007. As it all came to a crashing halt in late 2008 and early 2009, the contraction in economic activity seemed to overshoot on the downside. In other words, the country experienced a drop-off in economic activity that was unsustainably low for a nation of 330 million people. As we crawled out of the 2008-2009 recession the US had shifted to a new, lower plateau of economic activity. However, that shift provided a solid foundation from which the economy could begin to grow. Since mid-2009 economic activity in the US has continued to improve, albeit at a very low, 1-2% rate. This 1-2% rate is what we believe is a realistic and sustainable economic growth rate to expect from the US for several years to come.

Throughout 2011, Sigma's view was that the US was not slipping into another recession. To date, this has been correct. Although there is continued economic growth, it does not feel as comfortable as one might expect. This is due to a combination of high unemployment and reduced spending by both government and consumers as they focus more on reducing their levels of indebtedness. (This process is often referred to in the press as "deleveraging".) Despite the positive economic growth, consumers remain concerned about their jobs and the country as a whole. This is why we believe that the most probable forecast is for a low-growth environment to persist well into the New Year.

At the same time, we recognize that the US economy will rise and fall. Thus, while we anticipate a continuation of slow growth in the US, the further we move away from the last recession, the closer the next one becomes. As a result, it would not be all too surprising to see a mild slowdown sometime toward the end of 2012 or early 2013. The good news is, given the slow economic growth since 2009, the economy does not have nearly as far to fall. If there is a recession, it is likely to be moderate compared to the violent downturn of 2008-2009

## The 20,000 Foot View: Market Themes and Portfolio Strategies for 2012

As we head into the New Year there are several themes that will be critical for markets and investors. To begin, there is a need for clarity pertaining to the plan and path for the Euro currency and its member countries. At the time of this writing, the European situation remained as clear as mud for investors. Equity market volatility has been driven in large by the constant stream of news, both positive and negative, regarding developments in Europe.

When the Euro was conceived, it was puzzling to envision the establishment of a single currency without the development of a single fiscal authority. While parameters and standards were set for general financial integrity, there was no single point of enforcement for sound fiscal policies. That was left to each country. At the time, it was reasoned this would work in the absence of such an authority because the financial rewards of a single currency were so compelling that all of the member states would borrow, tax and spend appropriately.

Contrast this to the United States, where individual states not only share a single currency, but also abide by the rule of a single federal law and report to central fiscal and monetary policy bodies. After the Revolutionary War, the financial issues faced by the member states in the Union show several similarities to the Euro currency situation that member states face today. Alexander Hamilton believed the Union could not survive without a common currency and debt that was backed by all the states in concert. He continued to press for a single form of National debt. However, the northern states had significant debts piled up from the war while the South did not. Creating debt backed by all the states in the Union would require the citizenry of the southern states to assume equal responsibility for the debts of the North. Needless to say, the South was not interested. It was in the 11th hour when Hamilton was able to broker a deal that resulted in the establishment of a unified sovereign debt for the United States to which all citizens were responsible. The southern states agreed to this on the condition that the Nation's Capital would not be in the North (New York or Philadelphia) but instead in the South, Northern Virginia, or what is now known as Washington DC.

The success that the US has enjoyed since this agreement stems from the fact that all of the member states are accountable for the entire liability. They also abide by rules established by a common authority regarding fiscal, monetary, and taxing policies. The difference with the Euro is that there are 17 separate and distinct countries with their own rules of law and central authorities. This adds to the complications of the European situation. The development of a more integrated system to bind policy making and authoritative power will continue to evolve in a messy manner for some time. In effect, each country is being forced to cede some level of their sovereignty to a central authority. As the process continues, market volatility will persist as each twist and turn is traversed.

While the future of the Euro remains in a fragile state, we think continued forward progress and discussions are enough to keep the Euro and the European economy from falling over the precipice into the abyss. As long as Germany and France are willing to be engaged in talks, the Euro will remain largely intact, although the fate of some membership states remains unclear. Down the road we expect the Euro countries and the European Union to have a much more cohesive and unified approach to policy.

While European issues dominated the news and markets for much of 2011 there are other important dynamics that will be of interest in 2012. Corporate balance sheets for large capitalization companies in the United States remain strong and flush with cash. In aggregate, corporate returns on investment remain near all time highs (10%) and significantly above the average cost of capital (6%). Despite the positive returns that corporations could earn by reinvesting in their businesses, corporate cash levels remain at or near all time highs. This is an indication of the concern and hesitation businesses have about investing capital when the rules of the game are unknown (tax rates, regulations, healthcare, etc.) We expect this issue will remain unclear for much of 2012 and the uncertainty will impact market activity as investors try to gauge the direction of the fall elections. Following the November 2012 election, we expect to have a better sense of what the rules will be going forward. With better clarity on the rules of engagement, we are hopeful that corporations will open up their coffers and deploy much of this surplus liquidity.

Thus, there will continue to be a unique and compelling case for US equities, particularly larger companies with solid balance sheets, good business models, and dividend yields at or above Treasury rates. Human nature leads us to extrapolate the future based on experiences of our recent past. For the past 12 years, bonds have had outsized total returns while equity returns have been less compelling. As a result of these more recent experiences, many investors have become more comfortable today investing in bonds to achieve their long-term goals as opposed to stocks. However, where the capacity for additional risk can be tolerated in a portfolio, it will be important to consider a basket of high-quality, dividend-paying stocks in lieu of bonds.

Our reasoning for this recommendation is two-fold. For the past 30 years, investors have experienced an environment where bonds provided certainty of ongoing cash flow and a return of principal. In 2008, the return of principal concept was challenged outright as previously high quality credits defaulted. Now, with rates continuing to hover at or near all time lows, certainty of income is being challenged as there is an increasing volume of bonds issued in the past with higher coupon rates that are being repaid early. Corporations that can refinance at lower rates are doing so across the board. Focusing solely on income to achieve cash flow needs will prove frustrating to bond investors in this environment. Moreover, as interest rates begin to rise, bond prices may fall. Thus, investors should be focusing on total return, not simply current yield. In such an environment, high quality equities offer an alternative that provides both a competitive source of income and the opportunity not only for capital appreciation but also for increased levels of income as dividends are raised in the future.

## The View From 10 Feet: Portfolio Tactics and Investments Selection

Growth is not a commodity in today's investment environment. Growth is precious and scarce. In individual equity accounts, Sigma's focus is on high quality companies that have demonstrated strong demand for their products and services as evidenced by their ability to grow earnings through higher revenues. Increased earnings through revenue growth, as opposed to cutting expenses, is an important distinction as it pertains to the sustainability of a profitable entity.

Growth of the middle classes in developing countries continues to provide opportunities for emerging market investments. However, given the ongoing uncertainties in international markets, Sigma seeks to capture a portion of these opportunities through the foreign operations of large US companies. Nonetheless, it remains important to have direct exposure to these markets by way of local corporations as well. Therefore, we invest directly in developed and emerging international markets through low-cost index funds. Given our predilection for US markets at this time our international exposures remain at the lower end of our targeted ranges.

Piggybacking on the concept of targeting the growth in developing countries, we believe scarce resourcebased assets may increase in value as emerging and frontier economies continue to grow and demand such commodities. While cash flows from such holdings may be minimal (i.e. commodity stocks do not typically pay dividends), we believe these investments offer the opportunity for attractive price appreciation.

Our desire is to remove the noise in the market place and concentrate on the fundamentals. However, living in a world of instantaneous news dissemination, complex financial products, and sophisticated traders means information travels fast and can have an impact on any given investment on any given day. Moreover, the media will often sensationalize the news with the facts of the events getting blown out of proportion. As a result, we have greater market volatility than ever before. As this is a planet with seven billion people, there will always be something happening somewhere. Unfortunately, this higher volatility is now structurally embedded in the markets.

The uncertainty of US politics will also weigh heavily on domestic market behavior in 2012. Presently, both the Democrats and Republicans are spewing rhetoric that is very extreme and partisan. Once a nominee for the Republican Party is determined, both candidates will "move to the middle" in an attempt to capture the independent swing vote of the electorate. The 2012 election will determine whether the country continues on the more socialist path set by President Obama or a path that returns us to a more free market nation. There is a lot at stake for the American people and for the markets. There will be winners and losers under each scenario and the market behavior will seek to anticipate the outcome.

Denise M. Farkas, CFA

At this time of year, we take time to reflect on the privilege that we have to serve as investment counsel for clients. We value the relationships we have and never take for granted the trust our clients have placed in our firm. For this reason, we think it is important and valuable to lay out the signposts that will affect our portfolio management decisions in the coming year. As we meet with our clients and friends with whom we share this letter, we welcome your perspective and insights on these issues.

***Warm wishes to all for a wonderful holiday season and all the best for 2012!***

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