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summaries

the official newsletter of sigma investment counselors December 2012

On Your Marks, Get Set...

Generally the December *Sigma Summaries* serves as an opportunity to review the markets over the past year and provide our outlook for the year ahead. This year we will skip much of the review and instead share with you some of our thoughts about the underlying fundamental market dynamics as we move forward into 2013 and beyond. We will share with you how the policy and regulatory landscape impacts our thinking, judgment and approach in advising clients.

The November election results removed any uncertainties about the strategic direction of our nation for the next several years with regard to the policy and regulatory activities initiated since the November election of 2008. Those initiatives will now move more quickly and create a large footprint and foundation on which future policies, regulations and related activities will be built. The size of this footprint will profoundly affect our lives, the lives of our children and generations to come in ways we cannot yet imagine.

Our comments surrounding the budget/fiscal cliff are brief. At the time of this writing (12/12/12) negotiations drag on in Washington. The election set strategic direction for the country. While very important, the budget debate in Washington is tactical; it will eventually provide the detail on how the strategy is to be accomplished. The decisions made (or not made) as a result of those negotiations are critically important to this country. However, at this point we cannot add anything new to the barrage of commentary that continues 24/7 and, at least for today, we choose not to critique the way sausage is made in Washington DC.

As advisors and stewards of clients' monies, it is incumbent upon us to be thoughtful and deliberate in our judgments about markets and asset classes. Such judgments are at the core of the value that any advisor brings to client relationships and ultimately, sets apart one advisor from another. Election results and policy initiatives directly inform and impact our judgments and also the way in which we view markets, counsel clients, manage portfolios and allocate assets. Formation of such judgments is an ongoing and fluid exercise.

We set aside the time to think and debate the issues which most profoundly affect our judgment and hence our advice and portfolio management activities for clients. Our recent discussions about the range of investment return opportunities that equity markets might provide over the next 3-5 years have been quite lively.

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The affirmation that this past election is a directive for more government involvement in people's lives as well as in business operations is clear. This results in a significant change in the landscape when evaluating new projects and requires businesses to grapple with an array of issues. Business owners and managers must now determine how to best operate taking into consideration the changing healthcare policy for employees, an uncertain tax environment and what is sure to be a heavier regulatory environment. In a recent Sigma blog, I noted, from a macro perspective, that once the rules of the game are known, "follow the money" is a pretty good way to predict human behavior (and an excellent way to explain human behavior). Certainly this macro view is very applicable to the financial markets. A good illustration of this is the recent spate of corporate merger/acquisition activities and the dividend announcements we have seen from companies in an effort to reward shareholders before tax rates increase next year.

As businesses assess their options, we as investment practitioners have several concerns about the ability of business to earn the same level of returns from their operations. The incentive to reinvest capital seems to have been reduced significantly. This prospective restriction of invested capital ultimately restrains economic growth. In addition, the demographics of an aging population means a slowing of growth in the US labor force as aging baby boomers retire. Given that capital formation and labor force growth are key drivers for an economy we are concerned about the ability of the US to grow for any sustained period of time above the 2- 2.5% range. In addition, we are sanguine about longer term growth opportunities in several other developed areas around the world (not the least of which is Europe) for similar reasons. The ability to foster economic growth directly affects the expected investment returns for all asset classes. It is not reasonable to assume historic rates of return for the equity asset classes if economic growth remains low. This, in turn, affects the financial planning and asset allocation work we do with clients to determine the probabilities of success in achieving financial goals. We continue to debate this internally. And as we review financial plans and objectives with clients we will include scenarios which incorporate a lower-return environment.

As we look into 2013 we feel there is opportunity for continued growth, even if modest by historic standards. We do not anticipate a recession. Once businesses and individuals understand their tax and regulatory environment they can act accordingly and that should free up some resources for capital investment and hiring. This will provide investment opportunities within the equity markets.

For fixed income, we expect that the Fed will be true to their word and keep rates low for the foreseeable future. Returns in fixed income markets will continue to prove difficult. If rates stay low, interest payments will remain depressed and reinvestment opportunities for maturing bonds

will be limited. On the other hand, if interest rates tick up, bond investors may find an even more difficult environment, as the prices of their bonds will fall in response. Further, with all of the money that the Fed has forced into the market over the last several years, the risk of future inflation must be considered. Inflation is very hard to combat for those who rely on fixed interest payments from their bond portfolios.

One potential step toward protecting bond portfolios from future inflation (especially for those who are not willing to increase exposure to the equity markets) is through the use of treasury inflation protected securities (TIPS). While TIPS do not seem to be materially undervalued like they were in late 2008 and early 2009, the opportunity for appreciation due to changes in consumer price levels may still provide added diversification for bond portfolios that would otherwise not fare well in an inflationary environment.

As always we welcome your comments and look forward to our discussions with you in the coming months. All of us at Sigma wish you and your families a very happy holiday season and a happy, healthy and prosperous New Year.

Happy Holidays!

Denise M. Farkas, CFA

It is with sadness that we acknowledge the recent death of our friend and former colleague, John Cooper, CFA. In 1996, Sigma Investment Counselors purchased his investment management company, Cooper Van Dyke Associates which was formed through the partnership of John and his wife Marion Van Dyke Cooper, CFA. John had long and distinguished careers in both the construction and investment management industries. He was also past president of CFA Society of Detroit. He will be remembered for his wit, perpetual smile and sunny disposition.

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