SIGMA INVESTMENT COUNSELORS

Sigma Summaries

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Long-Term Investment Themes

Periodically, we are asked about our investment process, and how we ultimately arrive at the decision to invest in a stock for our clients. Given the very volatile behavior of the securities markets, and the grinding bear market, we felt it appropriate to devote this issue of Sigma Summaries to an articulation of our process. Our decisions are first and foremost based on our philosophy of long-term investing.

Our initial step is fairly straightforward; we identify key trends in each sector of the economy as the foundation of our investment strategy. These economic sectors are broadly captured and defined by industry consultant Standard & Poor's as Energy (oil, natural gas), Materials (chemicals, cement, aluminum), Industrials (airlines, machinery, business services), Consumer Discretionary (restaurants, housing), Consumer Staples (food, beverages), Health Care (drugs, hospitals, medical devices), Financial Services (banks, brokerage firms, insurance companies), Information Technology (computers, software, networking equipment), Telecommunication Services (phone, wireless and network services), and Utilities (electricity, natural gas pipelines).

We have identified the following themes as those having the greatest influence on our portfolio sector weightings: the Information Revolution, the Aging of Populations Within All the Developed Countries, the Consumer Emphasis on Value, Globalization, Commodity Over-Capacity, and Global Competition in the Manufacturing Sector.

These themes were included in the introduction to the January 1999 edition of our Sigma Summaries. Almost by definition, long-term investment themes do not change frequently. Though the S & P 500 Index has been on a volatile ride since then, rising 25% only to fall 40% from its high and then climbing back to within 7% of the January 1999 starting point, the major themes have not changed. It is our strong belief that if we invest in high quality companies that participate in these long-term themes at reasonable valuation levels, investment returns will allow our clients to achieve their financial objectives.

Besides the themes mentioned three years ago, recent events as well as changes in our economy have brought three other themes to the forefront: Energy Supplies, Government Defense Spending, and Outsourcing. Though it may be too early to truly call these major trend changes, it does seem logical that our dependence on foreign oil, particularly in the Middle East, is a problem our country will address in the coming years. Also, though it is possible that defense spending will not rise, spending directed towards increased intelligence and surveillance will. Lastly, the increasingly competitive economy is forcing companies to outsource non-core functions such as human resource management or information technology in order to focus on their core competencies.

After determining the major themes that guide our investment process, we look at which sectors of the economy are affected by these trends both negatively and positively. For example, we think there is a 0x27Commodity Over-Capacity0x27 problem, and therefore, we have de-emphasized the Materials sector.

Conversely, we believe that the 0x27Aging of Populations Within All the Developed Countries0x27 trend is strong and sustainable and therefore, we 0x27over weight0x27 the Health Care sector as older people generally use more prescription drugs. Similarly, we have emphasized the Finance sector in portfolios as the baby boomers begin to plan for retirement. It is important to recognize that this theme does not make the entire Health Care and Financial Services sectors attractive. A company that specializes in aspirin, for example, when there are currently many substitute products such as acetaminophen and ibuprofen widely available, may not be a terrific investment.

Investment pundits have labeled the process described so far as a 0x27top-down0x27 approach. This is an accurate assessment. Indeed, after the top-down analysis is complete, we look at 0x27bottom-up0x27 fundamentals. The characteristics we consider important for the companies that we invest in are: strong management, attractive business model (the company makes money), diverse customer base, multiple products, an adequate marketing, research and development, and internal technology budget, strong balance sheet (low debt levels), and positive free cash flow (cash after capital expenditures and acquisitions). Thus, we look for strong, seasoned companies in sectors of the economy that have favorable long-term trends. When we find one of these companies, we discuss its merits at our weekly investment meeting and, if warranted, add it to our universe list of investment candidates.

Identifying a universe of stocks suitable for purchase is only half the battle. Next, we focus on valuation and how a particular investment fits into our diversified portfolio. From a valuation perspective, there are multiple strategies that we employ, based on the type of stock we are analyzing. In general, however, we look at how a stock has traded historically as well as how it has traded relative to its peer group and the broader stock market. Valuation statistics that we often review include price to earnings, price to sales, and price to cash flow ratios. We focus on dividend yield, earnings and cash flow, growth potential, and financial capability to manage growth. From this we determine a valuation range for the stock. If the price of the stock is in the lower end of its valuation range, we will purchase shares for our clients.

In future Sigma Summaries, we will discuss these long-term trends in greater detail and review some of the companies in the sectors with favorable trends.

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