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summaries

SIGMA INVESTMENT COUNSELORS

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Markets Have Had A Nice Run...

Is it time to take the gains off the table?

After markets have a good run we often receive questions about the strategy of taking gains off the table, going to cash and then reinvesting the cash after a market correction. The short answer: this is a description of market timing and we do not hold ourselves out as having a strategic and consistent capability to time the markets. Such scenarios require the ability to consistently be correct twice; calling both market tops and market bottoms. The intent of the suggested strategy is to protect profits and the portfolio's value by harvesting the profits and reinvesting those profits at more attractive price points. (Sell high, buy low.) However, we have yet to find any money manager (or anyone for that matter) who consistently calls the trades correctly both ways (getting out at the top and then going back in at the bottom). That doesn't mean no one has ever called the full trade correctly once or twice, but consistently enough to make it a long-term strategy ... nope. That is the short answer. Below is a more thorough explanation.

As indicated above, we believe timing markets is not a sound strategy. If anyone tells you they have the secret sauce we suggest you hold onto your wallet (or in this case your portfolio). At Sigma we have, however, designed the portfolio management process with an embedded focus on tactically rebalancing. This process addresses the concept of harvesting profits and making shifts in asset allocation levels as market conditions evolve. For each account we manage, we receive a daily upload of all transactions and holdings information from the various custodians. That data is typically loaded into our systems by 9:00 am each day. Once the data is in Sigma's system, portfolio managers have immediate access to internally developed reports which highlight the portfolio over or under weightings relative to the established targets and asset allocation ranges outlined in the client's Investment Policy Statement. We have built similar reports that provide information on specific holdings within the portfolio. These reports are reviewed and monitored by portfolio managers and various other members of our team on a regular basis. As a result, Sigma's portfolio monitoring process is focused on the concept of rebalancing. Opportunities to tactically take profits from winners as well as opportunities to add to underweighted positions are regularly considered by Sigma portfolio managers.

As noted above, often the question is why not take profits off the table and "go to cash with the winnings". First, to do this would require that profits from the winners be sold as opposed to letting winners run. Second, should just the winners be sold? Or should the selling be done pro-rata across the board? Or should there be some other type of profit taking strategy? As the sales are made the next question becomes: once the required cash buffer has been reached in the portfolio what should be done with all the excess cash that builds up? Should we keep the cash stashed on the sidelines waiting for a better entry point? Or should we take the cash out of the portfolio where it ultimately is going to sit in a cash account or more likely, get spent? If it is the latter then the portfolio is not being built up over time, instead it is being spent. Spending is fine if that was the intention. However, if the initial planning work done with the client had no plans to use the funds until a specified time (retirement, for example) the portfolio is now being spent well ahead of what was planned. The scenario forecasting work we do with clients assumes there is no significant spending over and above the assumptions provided by clients. Our models assume portfolio profits are reinvested back into the portfolio during both good and bad markets, not removed from the portfolio. If we were to redo scenarios to spend the profits it is unlikely most clients would be able to meet the long-term objectives for the portfolio (for example, living off of the portfolio in retirement).

Embedded in the question is also the suggestion to keep the cash and reinvest at a later date when the markets look "more attractive". Once profits are taken and the cash is sitting in the portfolio the question becomes: when do markets look more attractive? What if profits were taken and it turns out that was the wrong call or way too early? If the markets continue to rise, the portfolio misses the benefit of further upside. For example, if profits were taken at year-end 2012 after a 16%+ run for most equity markets and cash remains sitting in the portfolio, it is producing no return while the markets have moved ahead almost another 10%. If the market falls, the fear becomes the risk of reentry too soon. The risk of holding cash is significant as over time purchasing power is lost because neither the portfolio nor the investor is being protected from inflation. Unless we are in a deflationary environment, moving profits to cash over and above a stated cash buffer is not a safe strategy. The risks of excess cash in the portfolio are either the cash will get spent early or the purchasing power will wither away.

As we stress over and over, investing in equities is a long-term commitment. Over time the net result is positive, but to be successful requires remaining invested over time. Look no further than the long-term charts of the market. In any short span of time the markets go up or down but the trend over time is a strong upward sloping line. If one were invested over a long period of time it is impossible to have lost money in a market with a long-term upward trending line. So, how do people lose money in the markets if the line is up over time? Buying at the interim tops and selling at the interim bottoms…i.e. poor market timing.

While not a perfect analogy, all businesses go through the ups and downs. What would have happened if instead of having a steady plan for reinvestment of cash flows, management were to take out the profits (not reinvest the cash flow that made a profit) and then waited until a bad year to reinvest in the business? Not a likely strategy to lead to long-term success of achieving the financial goals set out for the portfolio. When market timing is contemplated, the investor truly believes that a "playing it safe" strategy is prudent. In my view, nothing could be further from the truth. While it may sound good in theory, the reality is quite different. If you are trying to time markets -- good luck executing.

At the time of this writing several of the domestic equity indices are reaching new all-time highs while the economy continues to limp along with moderate progress helped by low inflation rates. Given the policy of the Federal Reserve Board and other central banks around the world, we expect that investors will continually be forced into riskier assets in order to achieve the necessary returns to achieve their long-term goals. To that end, as 2013 has begun, we have started to see a slight shift from fixed income into equity securities. At this juncture in general, we believe the valuations for equities are still reasonable while the bond markets appear to be overvalued. As we have written in the past, we expect the confluence of these events to lead to equity markets poised for continued, albeit not unabated, positive performance. We continue to be concerned about the possibility of rising interest rates and, hence, continue to maintain bond portfolios with a heavy bias towards short- and intermediate-term maturities.

As always we look forward to discussions with clients on these issues and welcome and comments or questions you may have.

Denise M. Farkas, CFA

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As a reminder, 2013 is Sigma's 40th Anniversary year. In honor of this, each month our employees are sharing personal "Sigma Stories" with you. We hope you enjoy!

It Seems Just Like Yesterday…

It seems just like yesterday when I was sitting at my locker in Tiger Stadium and attempting to put together a road map for my life after baseball. It was 1988 and I still felt I had a few more years left to play. Truth be told, I always wanted to retire from the game versus the game telling me to go home! During each and every offseason, I attempted to do something that would further my chances of being attractive to an employer's standpoint. At one point, I felt that having a business degree and playing professional baseball would be attractive enough. But eventually I became unsatisfied with that! So I set out with a new game plan - I received my Securities License (Series 7), followed by my Insurance License, and finally my Real Estate License. This was all accomplished while working at EF Hutton, a Merrill Lynch and Roney and Company, during the offseason along with doing Triple Net Leases for a private group out of New York. Yet, after tackling and accomplishing all of this, I was still not happy with the path I was on.

Then, during the 1988 Tiger season, I received a letter from a Bob Bilkie. My first reaction, to the letter, was "who is this guy?" The letter stated that he had been following my career, knew of my background and would be interested in talking with me. My gut told me it was worth the time and effort to meet him. I knew after 20 minutes of us interviewing each other, I wanted to be a part of what Bob was starting to build. Bob said he would teach me the business if I would agree to be a part of his very small team. I started working for Bob during every offseason until I officially retired in 1992 and became a full time Sigma teammate! Looking back, that letter was a blessing. I can't think of a better place to work than Sigma. To be a part of Bob's vision and in some small way helping him achieve his goal (and mine) has been so rewarding.

In summary, I left a great organization and a great team, to be a part of another great team that will carry me further than my previous job. For that I am forever grateful to Bob and my current teammates.

By the way our team is now 15 members strong! Go Sigma!

David B. Bergman