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summaries

SIGMA INVESTMENT COUNSELORS

the official newsletter of sigma investment counselors March 2020

ALL THINGS MUST PASS

Even though it's the shortest month of the year, this past February felt like it took a lifetime to play out. The month began with a chaotic start to the Democratic primary season with confusion on the results of the Iowa Democratic caucus. Next was the acquittal of President Trump in only the 3rd impeachment trial of a U.S. president in our history. The New Hampshire Democratic primary saw Senator Bernie Sanders win in a close race followed by a dominant victory in the Nevada Democratic caucus. The S&P 500 hit all-time highs in the middle of February only to finish the month down -8.23% in a market correction due to concerns about the impact on the economy from the Coronavirus. Needless to say that it's been a volatile month in both the financial markets and our political landscape, but what does it mean for us as investors going forward? What actions should investors be taking?

For those of you asking this question, I'd advise that you stick with your long-term plan. Financial planning is a marathon, rather than a sprint. By utilizing the financial tools we have available and taking a knowledge-backed approach, we can avoid risks made from short-term emotional reactions. The most important tools we have at our disposal are financial models, asset allocation, and investment policy statements.

Financial models allow us to test varying assumptions and consider a wide range of possibilities in the context of your financial plan. For those of you that are retired or are getting close to retirement age, this means we can take your financial plan and see what would happen to it if you went through a large equity market decline early in your plan. We can also stress test your plan using asset returns that are lower than historical averages to test viability. In addition to using lower than average historical returns, we also model out inflation expectations that are higher than current levels to further stress test your plan. Using financial models, the current equity market correction we are in and future equity market corrections are planned for.

Another tenet of the financial planning process is asset allocation. Asset allocation is a function of your risk tolerance and your investment time horizon. Risk tolerance is determined by your willingness and ability to tolerate investment risk. Once these data points are factored in, an allocation to equities and fixed income is agreed upon. The riskier equity component of your portfolio is designed to capture equity market growth and protect against the long-term effects on inflation, while your fixed income portion is designed to generate current income and buffer against equity market volatility. This fixed income component is especially important in times where you have equity market corrections or recessions because you are able to sell fixed income assets to cover spending needs as opposed to liquidating equity assets at depressed price levels.

For example, say you have a $1 million investment portfolio that is allocated to 50% equities and 50% fixed income. At the beginning of each year,

186 E. Main Street • Suite 200 • Northville, MI 48167 • tel (248) 223-0122 • fax (248) 223-0144 • www.sigmainvestments.com

you withdraw $40k to fund your retirement and supplement your social security benefits. You go through the entire year and are ready to make your annual withdrawal but you notice that your equities went down -30% and your bonds returned 2%. What do you do? Based on these numbers you would sell bonds and here is why. First, while your equity assets are going through a drawdown, you wouldn't want to sell them at a loss and turn this paper loss into a real loss. Second, after a 2% return on bonds, your bond portfolio would have a value of approximately $510,000. Your bond allocation could support almost 13 years of spending needs without ever touching your equity assets. Since WWII, equity recessions have lasted 14.5 months on average and take 2 years on average to recover. With 13 years of spending needs in your bonds, you will have more than enough time to let your equity assets recover. Finally, another important aspect to remember is that even when equity prices are depressed, you will still be receiving interest income from your fixed income assets and dividend income from your equity investments.

The final component of your financial plan is your Investment Policy Statement (IPS). The IPS is a written document that outlines the mechanics of your financial plan and dictates how your assets are being managed. This document gets updated at a minimum on an annual basis and will get updated anytime a material change takes place. While this document is helpful for us when we manage your assets, its foremost benefit is for you, the client. The purpose of this document is for you to have a written plan that can be referenced during periods of market stress and to know the exact reasoning behind your financial plan.

While we advocate for our clients to stick to their plans and keep a long term focus, Sigma Investment Counselors will take advantage of market weakness in various ways. If Roth conversions are in your plan, we will take advantage of the market weakness to either lower the taxes due on your conversion or by converting over more shares. We will also implement tax loss harvesting for those of you with taxable accounts to lower your tax liability for this year and for future years. For those that are invested in our common stock portfolio, we will use the current weakness to find attractive investments for inclusion in our individual stock portfolio.

Ultimately, the Coronavirus will continue to have an impact on US and global economic activity. Further political uncertainty will also add to the volatility in the financial markets. However, our financial planning takes into account these types of scenarios and we have ways to manage this risk. Just like you, we also don't like to see the value of our equity assets go down but we know that this is temporary and won't last forever. Success in financial planning isn't measured in months or even a year, but rather over decades. Keep your focus on your long term goals and the short term noise will fade away.

Paul Warholak

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