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SIGMA INVESTMENT COUNSELORS

the official newsletter of sigma investment counselors April 2014

First Quarter of 2014 is “In the Books”

In our December market update we suggested after a year of US equity returns approaching Nirvana, 2014 might prove to be the pause that refreshes. As the first quarter of 2014 came to a close the market seemed to follow our script, with the S&P 500 posting a 1.8% gain for the quarter. Developed markets outside the US as represented by the EAFE index were essentially flat in the quarter, up .7% after rising 22.7% in 2013. While it would be nice to think we have the crystal ball, the reality is predicting market direction over a short time frame is nothing more than luck (and we note there are still three quarters of 2014 yet to unfold). As we wrote in our first quarter letter to clients:

During the first quarter of 2014, four out of the five stock market indices that we closely track posted low single digit returns. Emerging markets bucked the trend but were down only 0.4%. In light of the extraordinary returns realized last year, conflicting economic data, bond tapering and heightened geo-political risks abroad, we are pleased with these results. We also believe that the recovery in equity prices following January’s downdraft reflects an underlying optimism by investors in our economic recovery and belief that equities, on the margin, offer a better risk/reward trade-off than cash or bonds.

Since the end of the first quarter US markets have been more treacherous. Relative to prior recoveries, economic growth (as defined by GDP – Gross Domestic Production) during this recovery has been persistently weak, overall around 2%. Back in early 2013 stocks remained undervalued, still on an upward trajectory from the dramatic under valuations of 2008/2009. In 2013, US equity performance incorporated a rising tide which lifted almost all boats. Today domestic equity markets overall are fully valued and the recent market activity reflects that sentiment. Despite the recent pull back, markets remain near all time highs. The next economic wave on the horizon is earnings season, which will be in full swing by the time this letter hits your inbox. In a 2% growth environment, a company growing sales 2% is fairly valued. The key to individual stock performance going forward will be less about overall market performance and more about a company’s individual characteristics with a particular focus on its ability to grow sales. In order to stand out as an attractive investment opportunity in today’s market, a company’s management team has to demonstrate their products are in demand and that they are able to improve their operations. The latter has been the focus of company managements for the last several years as companies have restructured and cut costs. While there is always room for improvement, much of the heavy lifting has been done. This is evidenced by the peak margins currently being experienced by US corporations; hence the focus will be on managements’ comments about revenue growth.

As we look forward through 2014 there are two additional issues we see on the horizon which will affect investor behavior. The first has to do with the

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Federal Reserve; the transition of leadership from Chairman Bernanke to Chairman Yellen and, the second, what the Fed tapering process will look like. To date, it does not appear there is a huge shift or material difference in the Fed's behavior under the new Chair. However the timing of the tapering and the size and magnitude of the program remains an uncertainty for investors. At present it seems our economy should be able to withstand some tapering without experiencing a decline in economic growth. If interest rates do rise due to economic growth there is a benefit to both fixed income and equity investors. Fixed income investors will be advantaged from higher levels of real income in the form of higher interest payments; equity investors will benefit from the stronger economic environment that is driving the rate increase. Conversely, rate increases due to inflation would be detrimental to both fixed income and equity investors as any growth in income or capital appreciation generated due to inflation will eat away and offset opportunity for growth in purchasing power.

The November elections are another issue investors will face in 2014. As election activities gain strength it has the potential to feel like choppy waters for investors. Political activities have had an increasing impact on investor behavior over the years. This is a direct result of Washington's inability to compromise. Lack of compromise has let issues fester rather than get resolved, leading to less middle ground and more extreme positions on both sides of the aisle. Consequently, when legislative changes are made they have been increasingly dramatic and have a large impact on various sectors of the economy, be it healthcare, energy or defense, to name a few. As we move towards November, labor issues (minimum wage), environmental issues, income inequality issues (tax code) as well as whether the current leadership will remain in the House of Representatives and the Senate, will weigh on investor sentiment. These are significant issues with significant implications for the nation. How much impact these issues will have on market behavior headed into the elections in part will be determined by the level of clarity about the election outcome as we head into the fall. Our assessment today is uncertainty will remain; the painful vitriolic activity that will likely also take place will compound the issues. This may lead to a volatile time for those market sectors at the heart of the fall election issues. While investors do hate uncertainty, the "silver lining" is that with uncertainty comes opportunity.

In our equity portfolios we have five core holdings including small, mid and large sized domestic stocks as well as international developed market and emerging market stocks. Over the past few years we have kept portfolio exposures to international markets at the low end of our exposure ranges as we have been concerned about the dynamics and growth for their economies. With regard to developed markets, barring a huge increase in energy prices from Russia, the European economy now appears to have worked through many of the issues that had been an anchor against European economic growth. Japan's recent policy changes are also focused on growing its economy.

Weakness in commodity prices and concerns about economic growth in China continue to pressure emerging markets. Growth in China will be an

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ongoing issue as the Chinese transition their economy from an export driven one, to an economy driven by internal demand. This will not be an easy transition and it will certainly result in a lower growth rate for China. However, at current levels, in aggregate, the emerging market valuations are compelling. Over the last year we have begun to slowly increase portfolio exposure to international markets. Further increases will require that valuations remain attractive and that we see information and data that support our thesis of better economies outside the US.

In addition to Fed tapering, inflation is a key issue for fixed income markets. While a surprise in 2014 could be higher than anticipated inflation, at this point in time we see little that gives us inflation concerns. Given our expectation for continued low economic growth, we expect intermediate term treasury bonds to continue to trade in a range of 2.5% to just over 3% for the balance of 2014. If we are wrong about this we think it will be due to stronger than anticipated economic growth as opposed to higher inflation.

Recent market activities include an increasing number of "investor activists" taking large positions in companies with the intent of unlocking values in the companies and hence, enhancing the share price. Given the increased frequency with which these events seem to be occurring, we wanted to provide our perspective.

Activists are particularly valuable in situations where shareholders have been ill served by board members who have either been asleep at the switch or, are consistently taking actions that favor management at the expense of the shareholders. In these cases strategic activists can be beneficial to both the shareholders and the long term prospects for the company. However, on many occasions activists are financial buyers, not strategic buyers. The presence of financial activists is often a troubling distraction to solid management teams. Financial activists, often larger institutional hedge funds, arrive on the scene with ideas of how to unlock value through selling off assets or returning cash on the balance sheet to shareholders though dividend payouts. Often these ideas of how to unlock value in the short term come at the expense of longer term strategies. If management does not take their advice the activists may turn to proxy fights to get their own representatives on the board, creating pressure and distractions for management teams. While good managements will ultimately win out on these battles it is usually at great cost to the company in management time and effort to say nothing of the legal fees that are incurred. We are not a fan of these types of shareholder activists. However, given the cash on company balance sheets these days and the quick buck that can be made once the general public finds out an activist investor has taken a position in the company, we expect to see continued activity by financial shareholder activists.

Finally, no market up date would be complete these days without mentioning the "Flash boys" story now being discussed and debated by both media and market participants. After the television show 60 Minutes interview with Michael Lewis, I wrote a blog (Selling books can be a tough business, dated 4.3. 14) expressing my view that his book does identify issues that are very disconcerting and must be addressed. Yet his conclusion that the market is

"rigged" for all investors is way off point. The issues he brings to light must be dealt with effectively. For me, one of the true crimes here is not just the "front running" (buying shares with advance knowledge that someone else will be shortly buying them) but also the challenges faced by the SEC to effectively do its job. Its resources are spread so thin that sometimes it appears to rely on detective work done by others in order to uncover bad actors in the public markets. As an investment professional at a firm that recognizes that ethics and transparency are the underpinnings to high functioning public markets and serving clients' best interests, I find it incredibly frustrating that such issues have to be brought to light by people trying to sell books. This results in sensationalism which unduly jades the general public's perspective about fair and transparent markets.

Switching gears, we are pleased to announce that Anthony (Tony) Basalla recently joined Sigma, joining me in our Cleveland office. Tony brings a wealth (pun intended!) of experience managing client portfolios and related needs, and will continue doing so for individual clients. You can read more about him at our recently enhanced and updated website, www.sigmainvestments.com.

We hope you find the new version of our website of value. We believe it is more vibrant, informative and easier to navigate. Streamlined and more "user friendly" we provide information about Sigma, the markets, a client login tab for specific account information, as well as reports and documents vaulted on our site. We would appreciate any feedback or suggestions you may have.

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