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summaries

SIGMA INVESTMENT COUNSELORS

the official newsletter of sigma investment counselors August 2011

Reassessing Risk

Historically, investors with an aversion to risk have had a propensity to invest in fixed income securities. Government bonds, CD's, municipal bonds and corporate bonds are favored by conservative investors for their low volatility, predictable cash flows and return of principal. In the past, finding high quality bonds that paid reasonable rates of interest was not all that difficult. A 5 percent targeted return from bonds without having to take on much risk was considered quite probable. Shopping for high quality bonds that pay a reasonable rate of interest today has become increasingly difficult.

While a 10-year U.S. Treasury bond paid over 15 percent in the early 1980's and a respectable 5 percent as recent as 2007, a 10-year U.S. Treasury bond in today's environment is yielding 2.3 percent. This trend of declining yields over more than a generation is depicted at the end of this piece.

As rates have stepped down, bonds have performed exceptionally well. This is because the total return on bonds is driven by interest payments, as well as the change in market value of the bond over time. In a declining interest rate environment, the market assigns a higher price to previously issued bonds that have higher interest payments. As long as rates keep declining, positive bond returns are sustainable. However, if interest rates rise, previously issued bonds with low interest payments (i.e. bonds being issued today) will become less attractive and their prices will fall.

With interest rates at all-time lows, a continuation of historical bond returns becomes mathematically impossible at a certain point, unless we see interest rates approach zero, or turn negative. To offer some perspective, negative interest rates would mean that lenders would pay interest to borrowers, which is possible but hard to imagine.

Interest rates have been pushed to all-time lows by the Federal Reserve's extremely loose monetary policy following the credit crisis of 2008 and 2009 in an attempt to jump-start the economy. Two rounds of quantitative easing (often referred to as QE1 and QE2), wherein the government purchased billions of dollars worth of bonds, have driven prices continually higher. In addition, worries of another recession have sent investors fleeing into the safest securities, including U.S. Treasuries, notwithstanding Standard & Poor's recent downgrade of U.S. government securities.

Even investment grade corporate bonds, which have offered investors more return for a little more risk in the past, are exhibiting painfully low yields. Corporations

have repaired their balance sheets materially over the last few years while hoarding cash and as a result are not as dependant on borrowed funds to run their businesses. As one might expect, this has caused the market rate of interest on corporate debt to fall right alongside government bond yields.

With fixed income securities having done so well and inflation still remaining subdued by global economic concerns, many investors continue to view bonds as being much safer than equities. This perception is further engrained into investor's minds after the roller coaster ride that equities have taken over the past 10-plus years.

However, in the current low-rate environment there could be a level of risk in the fixed income markets that is not being fully appreciated by investors. Going forward, the primary threat to the fixed income markets is interest rate risk. Bond investors need to realize that rates will eventually move higher, and when they do, bond returns will suffer.

Inflation is another risk associated with fixed income markets. Interest payments are fixed for most bonds and therefore do not increase with inflation. For those that like the certainty of cash flows and return of principal with bonds, the concern has less to do with whether or not one will get their money back, but how much that money will buy when it is paid back. Gradual inflation may not be shocking on a day-to-day basis, but it can be devastating over time to those who are not prepared or protected. One must consider the long-term effects of the Federal Reserve's recent actions, which may prove to be quite inflationary.

So what does this portend from a portfolio management perspective? We believe that it requires a true assessment of the relative risk between fixed income investments and equities. It must be noted, although it seems counterintuitive, that the risk of an asset class is usually the greatest after periods of prolonged strong performance, while risk is much lower after significant negative performance. In March of 2009 investors were shunning equities because they had been cut in half in less than two years. In reality, the actual risk of owning equities at those levels was quite low, notwithstanding the gut wrenching reaction that adding to equities at that point induced. This lower level of actual risk was borne out as the equity markets nearly doubled over the ensuing two years from their March 2009 lows.

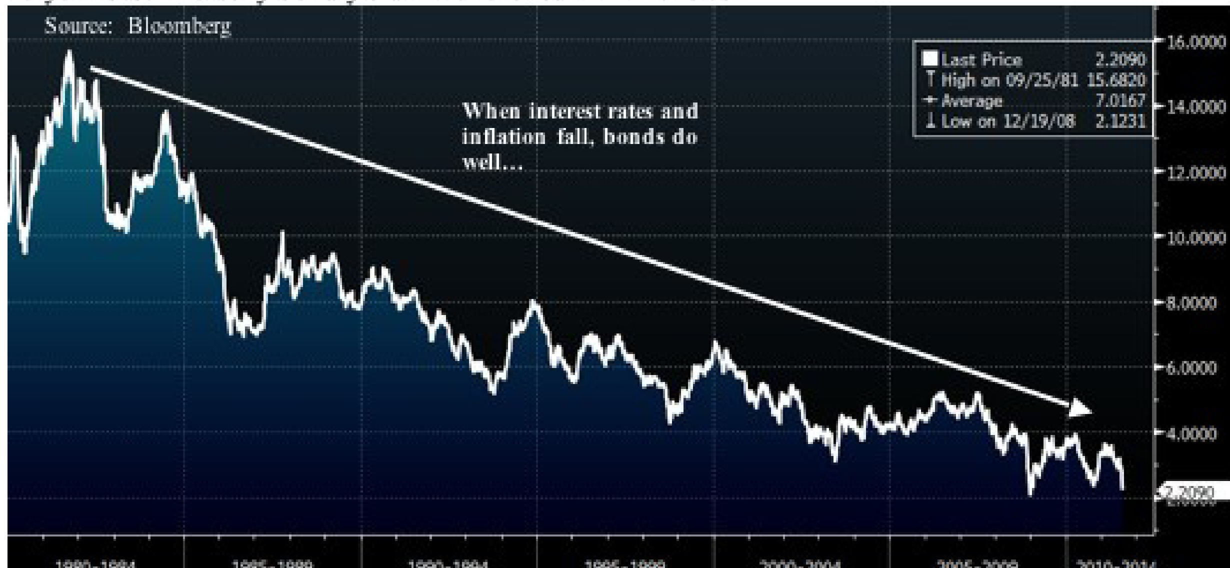
Today we believe that the actual risk of owning bonds may be higher than the perceived risk, because the perceptions of many bond investors have been molded in the past by an asset class that has treated them quite well, rather than by looking forward. Our internal discussions of late have centered on whether dividend-paying stocks of large multinational corporations may in fact be "safer" today for the long-term viability of a diversified portfolio than high quality bonds when allocation changes are being made at the margin. That is not to say that bonds do not serve an important role for many client portfolios. However, in today's environment, there are an increasing number of

blue-chip stocks that offer higher yields than one can achieve with quality bonds. Considering this in conjunction with the recent rapid pullback in equity prices, this may be an opportune time to favor higher yielding stocks when rebalancing one's portfolio.

In fact, for those clients where it has been deemed appropriate, we recently started using an exchange traded fund of large, multinational, dividend-paying companies as a way to supplement portfolio income. This fund has a current dividend yield of roughly 3 percent. Not only is the ongoing dividend stream greater than many high-quality fixed income securities, but the dividends have preferential tax treatment and the underlying companies are likely to increase dividends steadily over time. This will help combat the negative effects of inflation. On the other hand, fixed income securities often lack this attribute (i.e. interest payments are fixed).

For those who are fully reliant on a fixed stream of income and have enough assets to produce that income with ultra safe and low-yielding bonds, then an all fixed income approach may still be in order. However, as we are talking to clients, we think that it is imperative to understand that even though the risk associated with investing in bonds has been minimal for a prolonged period of time, future risk must be assessed in the context of looking forward, rather than by simply relying on past performance.

10-year U.S. Treasury bond yield have reached all-time lows



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Market Outlook

At the time of this writing, markets remain volatile as questions continue with regard to the solvency of several European banks and how the European Union ultimately deals with this crisis. As for the United States, recent data has come in stronger than expected, most notably the jobs data with initial unemployment claims dipping below 400,000 for the first time in four months. While the probability of a recession has increased in the past few weeks, we continue to believe that as we look forward we are in a slow growth environment as opposed to a recessionary one. Further, as we have commented in letters to clients and on our blog, uncertainty brings volatility and with volatility, opportunities arise. We continue to make changes in the portfolios based on our assessment of the financial markets.

Internal Recognition

We are please to announce that Denise Farkas, CFA, has been awarded The Chartered Financial Analyst (CFA) Institute's prestigious Special Service Award. With over 100,000 members worldwide, CFA is dedicated to promoting the highest educational, ethical and professional standards in the investment industry. Denise has been in involved as a volunteer for over 15 years, having served in several capacities as a member of the Institute's Board of Governors and its Executive Committee. Most recently she has been involved with content oversight for the CFA program and exams, with developing the Institutes' positions on various market issues, and advocating those issues to regulators and legislators across the globe. Please join us in congratulating Denise on this award.

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Please remember to contact Sigma Investment Counselors if there are any changes in your financial situation or investment objectives

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