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# summaries

SIGMA INVESTMENT COUNSELORS

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# Gravitating Back to Long Term Averages

Dateline: 12/13/13. Not so long ago the big weather concern was global warming. As I look out my office window the weather is sunny and bright and 16 degrees in Cleveland, Ohio. The six inches of snow with more on the way seems to be sending a signal that maybe we will have snow Christmas day. Over the past several months, weather patterns have shifted and brought colder weather morphing concerns from global warming into global climate change. While I have experienced "weather" for the past 54 years, I am certainly no expert on the subject. However, the thought crossed my mind that it is probably rare to have a "normal" weather year. Rather it seems the variations, even the extremes, are simply part of the way we arrive at long term averages, kind of like.... the markets.

Five years ago we experienced an equity market extreme (defined for this purpose of the discussion an extreme is a move of 30% +). As we approach the end of calendar 2013 it appears we have another year in which market performance (not market valuations) have reached an extreme. In the world of finance, variations, even extremes, are simply the path that takes us to long term averages otherwise known as the annualized return (the average annual return experienced by an investor over a given time period).

When comparing annualized returns for the extreme that led to a market bottom in March of 2009 versus the extreme that has led us to today, one quickly sees in any given year market returns can be dramatically different, yet longer term returns remain much closer together. As an example, the annualized return for the twelve month period ending 3/31/09 (market bottom) was a negative 38.04%, compared with a positive 30.30% for the current 12 month period (ending 11/30/13). A 60% variation in returns certainly illustrates how wide a swing can be in any given 12 month period!

However, as the time periods are extended, the variation in outcomes narrows significantly. Using those same end dates, 3/31/08 and 11/30/13, the variation in the annualized return over 20 years is much closer, 7.33% and 9.15% respectively. Reviewing the truly long term returns, for the period since 1926 forward, the returns are almost identical 9.31% versus 9.80%.

Two points to highlight: First, over longer periods of time the returns gravitate to the long term averages. This provides the underpinning of the case for the long term time horizon one must have to stay invested in equity markets.

Second is that the five year return is now well above "normal." We are not market timers. However, the above illustration provides some insights as we think about our expectations for 2014 and beyond. We continue to believe the underpinnings to the market remain intact for a long term secular bull market. Solid company fundamentals including seasoned management teams, strong balance sheets, solid cash flows and judicious investment of capital remain key

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characteristics of US companies. The energy industry, with all the new fields and discoveries (assuming that the energy can be accessed) is a long term benefit for economic growth, American jobs and American manufacturing. In addition, while not knocking anyone's socks off, economic growth remains in a slow but steady upward trend. Also, at the time of this writing the House of Representatives has passed a budget deal for the coming year, resolving concerns about immediate, automatic and indiscriminate budget cuts (sequestration). The strong markets have led to full valuations. However, in the context of the current interest rate environment we do not see the US markets as particularly overvalued or frothy.

Offsetting these positives are cross currents and little conviction on several economic issues by investors, and company managements. Growth in commercial and industrial bank lending remains stubbornly low, indicating either banks do not have the confidence to lend, company managements see too much uncertainty to invest in their businesses, or both. In addition, while Obamacare (Affordable Care Act) is the law of the land, there is great uncertainty as to how the implementation will impact government spending, company expenses and, perhaps most importantly, consumer wallets. The taxes to pay for Obamacare will also begin to be paid in 2014. We think this is part of the reason for the recent downturn in consumer confidence. In addition, as we move into 2014 it is clear we have moved into an environment where many of the regulatory bodies have the ability to create regulations with out legislative approval. Hence we expect the regulatory landscape will continue to be a burden on corporate America and more importantly small and mid size businesses. Regulatory issues will continue to add to company managements' reticence to make bigger capital commitments to their businesses.

While recent employment data appears to be improving, concerns remain as to the number of part time versus full time jobs being created as well as the number of people leaving the workforce rather than looking for work. As discussed in our last quarterly market update, as unemployed job seekers decide to stop looking for work, it shrinks the workforce. Therefore, the number of workers within that pool becomes a larger percentage of the overall pool possibly creating a false sense about the health of the employment rate.

Federal Reserve tapering will continue to be an issue for investors as well. This is a great experiment and the American people are the guinea pigs. No one knows what the unwinding of the Federal Reserve balance sheet will look like. In addition, the change at the helm of the Federal Reserve from Ben Bernanke to Janet Yellen is another unknown with which investors will have to get comfortable. Regardless, the concept of returning to long term averages with regard to interest rates will be a theme in the bond markets in 2014. While rates have moved significantly on a percentage basis over the past year they still remain well below their long term averages. We expect rates will continue to have an upward bias in 2014, putting some pressure on the equity markets.

Finally, there are a host of political issues which will affect the landscape as we roll into the 2014 elections. Without being too cynical, we think the budget deal passed in the House was a positive beneficiary of the upcoming election cycle, neither side wants to be viewed as the party which shut down the government. While the deal does not address the longer term structural issues of debt and tax reform, it is nice to see a budget after a four year hiatus. More importantly it may portend a more conciliatory tone in Congress as both sides position themselves for mid term elections (hope springs eternal!). However, we think the overall lack of long term strategy to address the structural issues in the federal budget (long term deficit spending and debt reduction) will continue to frustrate investors.

All of these issues, combined with the strength of the markets over the past 18 months, provide some challenges for continued above average returns in the domestic equity markets in 2014. This does not necessarily mean negative returns or the return of a bear market (20% or greater decline). A return in the mid single digits would take the annualized average return back towards that long term number of 9%. However, 2014 may prove to be the year of the "pause that refreshes."

For sure, investors will have to be more selective as there will be no rising tide to lift all boats. In short, we continue to believe that the US equity markets remain in a secular bull market. However, we have been rebalancing portfolios, taking advantage of the gains created this year. The old adage applies here: bulls make money, bears make money and pigs get slaughtered.

International markets have underperformed dramatically. Through November, developed markets – excluding the US - are up 19% while emerging markets are down 2%. However, we are starting to see global growth reemerge. As non reserve currency countries (the dollar is the largest, some would argue the only, reserve currency) begin to grow we will see their currencies gain strength against the dollar. This is starting to happen with the Euro.

Indications of healthier near term global economic growth, combined with the significant underperformance of international markets signals to us that international investments are somewhat more compelling from a valuation standpoint relative to the US and as a result we have begun to raise our international exposure slightly in equity portfolios.

As the year comes to a close we at Sigma are thankful for our good fortune. We never take for granted the trust clients have placed in our ability to provide the advice and counsel necessary for them to achieve their long term investment and wealth planning needs. We wish everyone a wonderful holiday season and a very happy and healthy New Year.

Denise Farkas, CFA
Chief Investment Officer

*As we mentioned in our January newsletter, 2013 is Sigma's 40th Anniversary year. In honor of this, our employees are sharing personal "Sigma Stories" with you each month. We hope you enjoy!*

## One Week Quickly Turned into Seventeen Years!

I was only supposed to stay a week to help answer the phones, and almost seventeen years later I'm happy to say I'm still working at Sigma. I was a college student home for the summer, when Sigma brought me in as a temp. Since then, it's the only place I've worked. When I decided last year to relocate to Florida, I knew leaving my friends and family in Michigan would be tough enough. I couldn't imagine also leaving my job. I was fortunate that Bob Bilkie and my fellow portfolio managers were supportive of my dream to open an office for Sigma in Orlando. My move to a new state and building a business and life in Florida has been much easier than I ever expected because of Sigma's investment in technology and the continued support of my coworkers. Even though most days I'm working across the country from my colleagues, it often feels like we are in the same room. I'm lucky to have found such a wonderful company when I was young, and I look forward to a long future with them!

Marisa A. Lenhard, CFA

I hope you have enjoyed the personal profiles and getting to know my colleagues (and me) better. Ours is a "people business" and our team treats everyone in the Sigma extended family with courtesy, dignity and respect – exactly the way they want to be treated. I know this because I get emails, notes and phone calls of praise for our people. Trust me when I say this – there is not a person here for whom you would not enjoy sitting down, spending time and having a cup of coffee.

The feelings are mutual too. Many of our clients become long term friends and attend our weddings, birthday parties, bar/bat mitzvahs, etc.

We are blessed; truly blessed.

On behalf of everyone here at Sigma, I wish you the happiest of holidays.

Bob Bilkie, CFA





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