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summaries

SIGMA INVESTMENT COUNSELORS

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A Look Forward

At Sigma, our investment viewpoint is ever evolving as we are barraged with new data and information daily. Setting aside time to reassess and more deeply analyze perspective is a worthwhile exercise. To that end, our investment staff recently spent time on an "off-site" retreat sharing thoughts and opinions and engaging in an extended dialogue. The intended result was to come away with an enhanced investment process and a more fully developed and vetted outlook on the economy and financial markets. In the comments below we share some of our thoughts from that dialogue, including our outlook for 2011, key challenges and opportunities investors face as we enter the new year.

Surveying the financial market and economic landscapes as we approach the end of 2010, it is as if we are observing a story of "One City with Two Tales." Companies that were able to survive the mayhem of 2008 and 2009 are in many cases thriving, as evidenced by the strong recovery in corporate profits and balance sheets. In contrast, the average consumer has not exhibited anywhere near the same voracious bounce back. The recovery in corporate earnings has been the catalyst for much of the strength in equity markets over the past two years. The market rebound has restored some level of faith and confidence in the underlying thesis for equity investing. Those who stayed the course during the most difficult of times have benefitted as portfolios have increased significantly since March of 2009.

While some companies have been able to grow sales, much of the corporate profit increases have resulted from burdening the back of Main Street through extensive restructuring programs, which is often code for layoffs. Observing the data on unemployment, job growth, and consumer confidence, the recovery seen in corporate America and the equity markets across the globe seems almost nonexistent on Main Street. For any economic recovery to be sustainable the environment on Main Street must improve and corporations must start to reinvest their profits. While it helps in the short-term we cannot rely on government spending to carry the economy over the long haul.

Despite high levels of unemployment, which tend to be deflationary by nature, we have been in the camp that price deflation is a low probability event. Rather, we believe that higher levels of inflation are not a matter of if but when. Until quite recently, the concept of deflation was part of the daily lexicon.

A healthy fear of deflation, a very heavy hand of the Federal Reserve's accommodative policy, combined with investors adding to bond mutual funds while draining funds from equity mutual funds led to record low yields. The recent announcement of a second phase of quantitative easing (QE2) by the Federal Reserve and the pending compromise on the extension of the Bush Administration income tax rates (at the time of this writing the agreement between the President

and Republicans was just announced) have resulted in what we expect will be the beginning of continued upward interest rate pressure. The yield on the 10 year treasury bond has moved up from 2.6% to just over 3.2% in the past week. Despite this move we continue to view treasury bonds as expensive – meaning we think their prices may continue to soften. At current prices we prefer the investment grade corporate bond market where balance sheets are strong and earnings continue to add to financial stability of the borrowing entity versus the yield on a 10 year treasury bond with a government balance sheet saddled with debt.

After several years of outsized returns in the bond market it is likely that fixed income portfolios will experience cross currents in 2011. A slow and steady continuation of economic growth will put upward pressure on interest rates. Higher levels of available interest income within bond portfolios will be tempered by the decline in bond prices as rates continue to rise. In the current low interest rate environment, we have not reached for yield, but rather have continued to maintain high credit quality and shorter maturities in our portfolios than might exist in a more normal rate environment. Our current bias for shorter maturities is being driven by our expectation of inflation and higher rates in the not too distant future. As interest rates rise, prices of higher coupon (lower quality) debt with longer dated maturities are more sensitive to interest rate changes. This simply means that these prices fluctuate more readily than shorter term, higher quality issues. While a rising rate environment will result in lower prices on all existing bonds, reaching for yield will have become a more costly strategy in a rising rate environment.

The municipal bond market will also prove challenging in 2011. This market has always been considered safe with low default levels over time. However, accounting rules in this arena are less stringent than in the corporate world which means that not all liabilities (some pension expenses) have been carried on the balance sheets until recently. Given the large portion of revenues municipalities' receive from real estate taxes and local businesses as well as cut backs in assistance from the federal government, we became very selective in our municipal bond purchases in early 2008. We anticipate the possibility for some defaults and restructuring of bond terms in this market over the next few years as municipalities fail to meet all of their obligations. Further, we think it is possible we may see policy at the federal level tested as some states, such as California, turn to the federal government for bailout assistance of some sort.

The flood of cash the Federal Reserve has put into the system since mid 2008 has been massive and led us to add inflation hedges (such as gold and real estate) in portfolios. Commodities remain inflation hedges too, as well as a way to participate in the growth of emerging and frontier markets. Gold provides the added benefit of a safe haven or store of value in uncertain times. We believe such investments continue to deserve consideration in portfolios.

The key to economies and equity markets, both foreign and domestic, continues to be the consumer. In developed markets this is likely to remain a challenge as slow economic growth will keep unemployment high both in the United States and other mature economies. That said, the recent income tax agreement

between President Obama and Republicans (assuming it passes) provides more certainty about tax law in the United States, at least for the next two years. With a clearer understanding of tax consequences for both consumers and corporations alike, we are optimistic that from the lower plateau from which we now operate, stronger growth will have ample opportunity to prevail. We are hopeful that the $2 trillion of cash on corporate balance sheets will begin to get reinvested into the economy. One of the "surprises" for 2011 may be that the resolution on income taxes will cause both large corporations as well as smaller businesses to feel comfortable hiring new employees with a resulting lower unemployment rate than the 9+% generally anticipated by economists. This would lead to a healthier consumer and stronger underlying growth in the US economy.

Another opportunity for growth is in the emerging markets' consumer sector. As the middle class in these countries emerge, they gain disposable income and move from purchasers of basic needs to consumers of a broader array of household items and even some durable goods. US multinational companies are well positioned to take advantage of this growth.

As the outlook for consumer spending strengthens, conditions on Main Street are likely to improve over the coming year. This combined with continued growth in developing markets provides the underpinning for an expectation of continued investment flows into the equity markets. This does not mean a rising tide will lift all boats. Following the common stock market bottom of 2009, the sharp move up was broadly shared across the majority of stocks. By contrast, in 2010, those companies that have demonstrated an ability to grow their revenues have been the top performers. As we move into 2011, the challenge will be to find those companies able to sustain their revenue growth and at the same time demonstrate the ability to improve their returns on reinvested capital.

Our one hesitation for 2011 is that the general consensus for investment returns is fairly optimistic. We have learned over time that the consensus tends not to be accurate. What could go wrong? The outbreak of war in either Asia or the Middle East, increased taxes in the US, the unraveling of the Euro, a trade war between the US and China, or developed countries defaulting on their debt, would each singularly create market turmoil. However, at this juncture we believe the trends and underpinning of the economy point to what will prove to be a year of positive returns in the equity markets for 2011.

We hope 2011 proves to be a wonderful year for all clients and friends of Sigma and their families. We know that we have plenty of worthy competitors in the investment advisory industry and appreciate that our clients have entrusted us to steward their assets. We value our relationships and the opportunity to provide investment services to our clients and look forward to servicing our relationships in the coming year and beyond.

Best wishes for a wonderful holiday season and a happy & healthy 2011.

Denise M. Farkas, CFA

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