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The IPS: Non-Emotional Investing

In an emotionally charged financial environment influenced by around the clock media coverage that is quick to magnify a story with the smallest semblance of materiality, many investors' financial mindsets are in a constant state of flux. While much of our job at Sigma revolves around investment analysis and portfolio management, the past few years have highlighted the importance of managing emotions. Arguably one of the biggest destroyers of financial wealth is nervous energy. Emotions and investing have long been a toxic combination and successfully mastering the process of keeping them separate is an ongoing battle.

Investment decisions that are grounded in emotion are common because they tend to grant instant gratification. However, the temporary relief is often eclipsed by regret when the long-term impact of the decision is realized. Many investors were enticed by the stories of their peers who were sleeping well after having cashed out their portfolios before the height of the credit crisis in late 2008 and early 2009. However, the stories of an equally brilliant re-entry in March of 2009 have proven to be quite rare. The truth is that many of these investors did not have the foresight, fortitude, and nimbleness to get back into the markets. They have subsequently watched the S&P 500 index return 93% since March 9th, 2009. These are significant returns that can never be recouped by those who missed them.

The resulting question is how can one avoid emotionally fueled, irrational investment decisions? While emotions are ever-present, there are ways to mitigate their entry into the investment process. Whether you are a client of Sigma's, or have entrusted the management of your assets to someone else, the cornerstone of the portfolio management process should be your investment policy statement (IPS). The IPS is a document that outlines a client's objectives and constraints and describes the corresponding long-term strategy that is being employed by the manager. Further, the IPS is a solid first step toward keeping emotions out of the portfolio. At Sigma, we are surprised at the number of prospects who come to us uninformed and ill-equipped, having never been provided an IPS by their current manager.

Without an IPS in place, a critical line of defense against emotional investing is forgone. The IPS ensures that the manager has a clear understanding of the client's financial situation and is managing the portfolio accordingly. It provides a financial roadmap, specifying the asset allocation ranges being followed to obtain the client's required rate of return without violating their tolerance for risk. The client and manager alike are provided an enhanced level of clarity and mutual understanding by having a well thought out plan in writing. By agreeing on a long-term strategy at the onset of the relationship, the manger and client can avoid emotionally-driven changes and the lasting effects thereof.

To understand how the IPS affects the portfolio management process, consider a portfolio with a targeted equity allocation of 60% with a minimum allocation of 50%. If the actual portfolio weight falls below 50%, then per the IPS the manager should be gradually bringing the equities back toward a 60% representation in the portfolio. Likewise, that manager should be selling into strength if the portfolio starts to approach the maximum allowable equity allocation specified by the IPS. The key to this process is that it is non-emotional and the details are understood well in advance of emotionally charged market swings.

It is also imperative as a manager to truly understand the risk that a client is willing and able to take in order to obtain a desired rate of return. Many investors were fully invested in stocks in 2007 because they voiced to their manager a desire for a high rate of return. In the absence of all external factors, this could have been the correct strategy. However, if all of the relevant factors had been considered, a materially different strategy may have been employed. For example, did the manager consider the portfolio might be relied upon for income needs in a weak market? Was the client's ability to tolerate risk truly identified and agreed upon, thereby ensuring that the client would not be driven to sell out at the bottom of the market? Did the manager convey that in order to get higher returns over the long-term, an interim decline in stock values could be as high as 50%, and if so, could the client stomach that large of a decline? In the end, a portfolio positioned for long-term growth can only be successful if the investor has the resilience to withstand potentially drastic interim market swings.

The IPS is not set in stone and is meant to be flexible. As different facets of a client's financial life change, so too should the contents of the IPS. An investment policy that was once appropriate for a client may no longer be suitable due to a multitude of possible factors. For example, a number of Sigma clients were particularly unnerved by the most recent bear market. Rather than selling at the bottom, the IPS was updated with a lower risk tolerance, which resulted in a gradual reduction in portfolio risk as the market recovered. Importantly, these changes were well thought out and were slowly implemented as the opportunity to do so in a stronger market was presented. It should also be noted that in the absence of material changes in return objectives, risk tolerance, liquidity needs, time horizon, tax implication, or any other aspect of the client's plan, the IPS should be updated at least annually. This will ensure that the investment policy in place remains ideal for that client.

Lastly, the IPS affords clients a higher level of plan portability. In the event that a client changes managers, the IPS is transferable, giving the new manager a transparent summation of the client's investment objectives and constraints. The new manager is not left to deconstruct the portfolio, trying to make sense of the previous manager's work.

Prospective clients often come to Sigma asking for a second opinion, wondering whether or not they would have been better served as a client of ours throughout the recent crisis. Our first question is "do you have an IPS and if so, has your portfolio been managed in accordance with the document?" If the answer to both of these questions is 'yes', then there is greater reason to believe that the current manager has done a solid job of stewarding the portfolio, notwithstanding the general state of economic malaise. If the answer to either of these questions is no, then that prospect has the right to question the lack of communication and seemingly arbitrary nature of the portfolio's current structure.

While few investors were able to navigate the recent bear market and subsequent recovery unscathed, those that had a well thought out investment policy in writing in advance of the downturn were better equipped against taking evasive action purely on the basis of emotional distress.

Christopher W. Frayne

The Economic and Market Environment

Sigma has been fortunate to see its client base grow during the past two years (and, the capacity to handle the needs of an enlarged client base has been expanded even more). For those new clients, this segment of the monthly newsletter is designed to inform as to how the investment professionals managing their assets view the investing environment.

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Close study and observation of the ever changing factors that impact the pricing of stocks and bonds, coupled with broad and deep experience in the investment arena, lead to judgments on how to optimally position portfolios. The purchase or sale of an asset (unless tax driven or that which results from a contribution or withdrawal from the portfolio) is always a direct reflection of a change in said factors.

In Sum: Geo-politics may be the center of focus in 2011 while continued economic growth is becoming an entrenched expectation. This will probably lead central banks to cautiously modulate their growth spurring actions, and seems certain to prompt lawmakers to rein in theirs. Common stock prices continued to move irregularly higher last year while bond prices on longer dated maturities weakened towards the end of 2010. Municipal bond prices of issuers facing financial difficulties declined more significantly.

Geo-political: The global balance of political power is shifting. China is resurging, the US is recovering, Europe (ex. Germany) is reeling, Russia is regaining, North Korea is reneging, Iran is rebelling, Venezuela is regressing and Brazil is rocking. These regions and regimes, and negotiations by and between them, bear close watching in 2011. China, Russia and the US have pivotal elections in 2012, and foreign relations (trade and military cooperation) will prove important.

Economic: It appears evident that the global economy is well on the road to recovery without a depression style relapse (as Sigma suggested last summer). With the exception of US housing, most other measures of economic activity are improving. Outside of the US, and with few exceptions (principally in Europe), similar signs are emerging. While there are still economic risks (debt defaults), most of these appear manageable. Two broad trends are also emerging. The first, on a micro level, is that entitlements and public sector benefits across the globe are poised to be restructured (again, it was suggested in these pages last summer that this would soon become necessary). The second is that the United States will represent a diminishing percentage of future global economic activity (but this is not a negative).
Monetary: The Federal Reserve Board, led by Ben Bernanke, is almost becoming a household word. A YouTube cartoon (humorous and largely accurate) chronicling the machinations of the Fed during the past two years, has been one of the most viewed videos in the world. The public is informed and watching. Deflation fighting moves have dominated, led by the current thrust called Quantitative Easing 2 (watch the video). As the economy expands, this program will probably be wound down.

Fiscal Policy: Fiscal rectitude is the mantra of most newly elected members of the political class, from Washington DC to the states. The stimulus measures embarked upon following the economic crisis have been viewed by many as ineffective. The contrasting approach to be pursued going forward will be closely monitored for signs of success.

Equity Markets: Common stock prices the world over continued to recover from the lows touched in 2009, with broad indexes generating percentage gains in the mid teens in 2010. A pause in 2011 following two strong years would not be unusual.

Fixed Income Markets: Sigma has been suggesting for several months that interest rates would begin to rise from their abnormally low levels, and during the past several months, this has been the case. Historically, inflation in developed countries has averaged about 3% and debt issued by sound countries carried yield premiums of about 2 percentage points, meaning a central tendency interest rate on government debt would be 5%-6%. Municipal bonds are an asset class unto themselves, and the spending policies of many states and cities have alarmed municipal bond investors, leading to more dramatic price declines for those issues deemed to have exceedingly poor credit prospects.

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Estate Planning Update

In December, 2010, President Obama signed into law the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010." Had this bill not been passed, temporary tax relief originally granted by President Bush in 2001 and 2003 would have expired and income tax rates would have risen. Now, individual taxpayers will benefit from this tax relief for two more years. Another provision of the bill provides for a one year reduction in Social Security taxes such that individual taxpayers will only have to pay 4.2% in payroll taxes versus the standard rate of 6.2%.

Among the many other provisions of the bill, there were also very significant changes regarding present-day gift taxation, generation-skipping transfer taxes and estate taxation upon death. For example, large taxable estates can now transfer up to $5 million per spouse to beneficiaries before having to pay estate tax, with the maximum estate tax rate pegged at 35%. Had this bill not been passed, the estate tax exemption would have reverted back to $1 million, with a 55% top bracket. Moreover, high net worth individuals can gift up to $5 million before death without having to pay a gift tax. The old rule only allowed individuals to make present day gifts up to $1 million before a gift tax was imposed. Unfortunately, these rules only apply for 2011 and 2012.

For individuals with large taxable estates, there may be a two year window in which to consider a number of sophisticated estate planning strategies to exploit these higher exemption amounts and lower tax rates. While Sigma is not in a position to provide estate planning advice, we can make referrals to estate planning attorneys who we believe are well-qualified to offer such advice. At the very least, we encourage all high net worth individuals to be aware of the changes in the recently passed bill and not miss an opportunity to reduce one's tax liability, be it now or in the future.

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