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summaries

SIGMA INVESTMENT COUNSELORS

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Performance

January is typically a time of evaluation, reflection and fresh starts. This is also true in the wealth management industry. The evaluation and reflection revolves largely around the exercise of determining if client investment objectives were met. Much of this is dependent upon investment performance and fortunately, 2014 proved to be another year of solid returns in client portfolios. Nonetheless, my colleagues and I at Sigma spend no short amount of time on this topic.

We try to be as self-critical as possible in an effort to make sure clients' assets are invested in as optimal a fashion as possible. We typically commence by comparing client portfolios to benchmark indexes (Standard & Poor's 500 Stock Index, MSCI EAFE, etc.).

The selection of a benchmark(s) is critically important. Early in my career, the Dow Jones Industrial Average was THE benchmark. The reason – it was widely known, widely followed, and well accepted as the barometer of stock market performance.

As the industry evolved, practitioners and academics alike realized the weakness of the Dow Jones Industrial Average – It is comprised of only 30 stocks so it is not representative of the broader market. Relative positions in the "portfolio" are a function of the price of the stock. Hence, a company that was priced at $100 per share would comprise ten times the weight of a stock priced at $10. No investment professional worth his or her salt would ever assemble a portfolio using these criteria because the critical objective – adequate diversity – would not be met. So what to do?

The Standard & Poor's 500 Stock Index provides a good solution as it is well known and widely followed. Unlike the 30 stocks in the Dow, the composition of the S&P 500 consists of 500 very large and established companies headquartered in the United States, providing a much better barometer of stock market performance. This addresses the issue of diversification. Importantly, unlike the DOW, a company's weight in the index is not based on its stock price but rather on its total worth – or market capitalization, making it much easier to construct/invest in the index.

In the 1980's and 1990's, many investors felt that high quality, domestic large companies were all that were required to comprise a well diversified stock portfolio. As large cap stocks performed poorly in the late 1990's/early 2000's, interest was piqued in the smaller and mid-sized companies, particularly those in the technology and bio-technology sectors. The result was investors quick realization that exposure to these sectors was not only warranted but dampened portfolio volatility when large domestic stocks performed poorly. International investments and investments in companies in emerging economies also quickly spilled onto the scene.

At that time the whiz kids in top business schools built mathematical models centered on the notion of correlation/non-correlation. (Time out! Think of it this way. When oil prices go down, the prices of oil stocks go down but the prices of the stocks of airlines companies – whose primary cost is fuel - go up. These sectors are said to be nearly perfectly non-correlated. Put together in a portfolio, these two serve to dampen the swings in the value of the portfolio). This led to the ability to quantify the benefits of diversification and guide the development of optimized portfolios.

Then, the natural next question arose. If the portfolio is comprised of large, mid-sized, small, and international companies, does it make sense to judge the portfolio against an index that only includes large domestic companies? Probably not.

Client portfolios at Sigma are typically comprised of all of the aforementioned investment groupings (as well as alternative investments such as real estate investment trusts and gold ETF's). This is why Sigma reports a handful of benchmark indexes in its reports to clients which makes for a better assessment and interpretation of client investment results. In a year like 2014 when the Standard & Poor's 500 stock index proved the leader in investment performance, it is easy to forget the benefits of diversification. What is important to remember is that over extended time periods – 5 to 10 years – each of the aforementioned investment groupings tend to see performance that closely migrates to a common number like 10% per year (large companies, a little less, smaller companies, a little more). We call this the "average annual compound return." Having a diversified portfolio that is made up of several of these different asset classes will result in lower overall volatility (swings in portfolio value) over time while achieving the desired long term returns.

As part of the "fresh starts" typically associated with the New Year we continue with our own internal evaluation of results. We dissect our "winners and losers" in an attempt to fully understand what we got right and what we got wrong. In those instances where an investment performed poorly, we reassess to determine whether a change is warranted (this part of the process is continuous and not just conducted at the beginning of the year).

We, and most clients, are focused on absolute annual returns versus relative returns as the former is what determines whether they will be able to maintain their way of life. But, we do want to make sure that we are providing as much value as possible and this is one facet of our service.

In closing, we invite friends and clients to contact us if they would like to discuss performance more fully.

For those friends who are clients of other investment managers, we would be pleased to provide an analysis of their investment performance if a "second opinion" is desired.

Before closing, my colleagues and I wish to extend a Happy New Year to all.

Robert M. Bilkie, Jr., CFA
President

27777 Franklin Road • Suite 1100 • Southfield, MI 48034 • tel (248) 223-0122 • fax (248) 223-0144 • www.sigmainvestments.com