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summaries

SIGMA INVESTMENT COUNSELORS

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Optics and the Challenges of Separating News from Noise

Most clients do not have the luxury of avoiding investment risk and still achieving their long term goals. Therefore, as financial advisors, one of our primary functions is as a risk manager, managing (as opposed to avoiding) portfolio risks.

There are a few conceptual pieces that make up the risk management equation. First is the science of working with clients to design a portfolio with an optimal chance of achieving their long term financial goals. We work with clients to determine their specific long term needs and constraints while at the same time trying to accurately calibrate their ability to tolerate portfolio volatility (risk).

We use many rigorous tools to develop and monitor our risk management processes for clients. These tools represent the skeletal foundation on which we build and monitor portfolios. As is true with most advice and counsel, it is the collective experiences and judgement of the people using the tools which ultimately determines the results. In this case the results include each client's risk profile, asset allocation, investment policy statement and investment portfolio.

The second part of the risk management equation is the art of assessing the risks that exist in the economy and markets. This assessment is an ongoing process. We continuously monitor, analyze and evaluate the changing risks to which the portfolio is exposed at any given point in time. In the current environment, information about a strong and growing economy is often overshadowed by the constant combination of polarized politics and seemingly daily crises created by a combination of tweets and commentary by the press. The latter creates a sense of chaos and the optics that the US economy (and possibly the world economy) is "falling off the rails" and that war (either nuclear or trade—or both) is imminent.

In tumultuous times the idea of risk avoidance can be tempting to investors. Put simply, risk avoidance is selling equities and instead holding cash or investing in US government securities. This is nothing more than market timing, a consistently failed strategy. As we have discussed in past Sigma Summaries and blogs, market timing requires the investor to consistently and correctly time the sales at market tops and purchases at or near market bottoms. It is extremely rare that anyone makes both sides of the call correctly, even once. Furthermore, we have yet to discover or see any investment process that has been correct more than once, let alone on a consistent basis over time.

Once an investor starts down the risk avoidance path, human emotion and ego create complications. For example, what if the sale of equities proves to be wrong because the equities are sold and yet the market continues to climb (example: November 2016)? It is highly unlikely that the investor will admit the call was wrong or step back in at higher prices. On the downside, the fear is that the market will continue to decline (March of 2009). When is it the right time to step back in? Allowing emotions to replace a disciplined investment approach is a sure recipe for failure to achieving long term financial goals.

The current state of seemingly constant chaos (besides being exhausting) creates a sense of turmoil and pending danger. All the while the economy has continued to chug along, gaining strength. One must not be tempted to avoid risk. Instead the challenge is to separate the politics and headlines of the day from factual observations about the markets and the economy and invest accordingly. Sometimes the lines can be very blurred. If one is very passionate about political views, or focused on the daily noise, it will cloud perceptions about the economy and obscure lines between politics and how a given action will affect the economy and markets.

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As an investment committee we spend much of our time in our daily briefings and weekly Investment Committee meetings discussing and debating what comes across the transom to discern the news from the noise. We do our best to separate current emotions of the day vs. data and useful information. This focus allows us to develop a cohesive mosaic about the underlying economic conditions that are driving both stock and bond markets. Below are some of our collective thoughts regarding the positives and negatives in today's chaotic environment.

There are a lot of constructive developments that provide reasons for us to continue to be optimistic about the economic environment. The United States economy continues to demonstrate improving growth off of a very solid foundation. This has been borne out in earnings reports over the last several quarters as well as the continued strength in consumer confidence. Corporate balance sheets remain strong. We are still in the early stages of understanding the long term benefits that will flow from corporate tax reform and deregulation.

In addition, global economies are improving.

For these reasons, equites remains the asset of choice for investment. That said, after several years of painfully low rates for fixed income investors, bond valuations are beginning to improve.

There are risks as well. Political uncertainty and geopolitical tensions remain in the headlines; trade negotiations raise concerns about protectionism; equity market volatility has increased back to more normal levels versus the lack of volatility in 2017; the rise in interest rates gives the equity markets some pause; corporate balance sheets are in good shape, however, government debt levels continue to climb; finally the combination of tightening labor markets and the lack of reinvestment over the last several years has led to shortages of both labor and resources, fanning inflation fears.

We do not take any of these concerns lightly. Yet, as we continue to focus on separating the news from the noise we view the probabilities of these issues derailing the economy and leading to recession and the end of the bull market as far out weighted by the positive trends that are often overlooked in day to day news reports.

In closing, I want to thank my colleagues on Sigma's Investment Committee for their continuous and thoughtful dialogue. It is through this ongoing process that we are able separate the news from the noise, provide thoughtful comments on the economy and the markets and most importantly, mange the risks inherent in client investment portfolios.

As always we welcome your questions and comments.

Denise Farkas, CFA
Chief Investment Officer

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