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SIGMA INVESTMENT COUNSELORS

the official newsletter of sigma investment counselors September 2011

As The World Turns

The 54 year-old soap opera "As the World Turns" aired its final episode about a year ago, or so we thought. It appears that the old story line has simply been replaced by an updated version with new characters. This story line focuses on the countries and governments who have been living beyond their means and now have to "pay the piper". Citizens of these countries are either up in arms over their local situation, forced to watch the childish antics of their leaders, or both. Sadly, the current version is not fiction. In reality, the truth is stranger than fiction; the story lines are infuriating and exasperating, and the main characters are equally as contentious as any villainous soap opera character. At the time of this writing, the Greek debt situation continues to oscillate between deal or no deal while German Prime Minister Angela Merkel's political life seems to be hanging by a thread. The thread becomes more frayed with each passing day as the Germans become more and more reluctant to support a Greek bailout. These opinions heightened after Greeks continued protesting against the proposed austerity plans. If Greece defaults (which has several different technical definitions), there is a reasonable possibility that the contagion spreads and other "Club Med" nations follow suit. This, in turn, could lead to the possible demise of the European Union currency (the Euro) and the European Union itself. China, in its effort to become more of a power player on the world stage, has become a key participant in the Euro situation. By offering their help, China is strongly suggesting they be recognized as a full-market economy; an option the World Trade Organization had not intended to consider until 2016.

On this side of the Atlantic, our own soap opera continues. After several divisive weeks debating the debt ceiling, Congress once again kicked the can down the road and instead of legislating has created yet another committee. The 12 Congressmen that make up the bipartisan committee have been tasked with devising a solution for the debt ceiling and ongoing budget issues. This is no small task, to say the least. More recently, President Obama has announced an additional $470 billion jobs bill to be paid for, in large, by higher taxes. The unemployed continue to suffer as none of these activities have much impact on job creation (evidenced by a stubbornly high unemployment rate). Furthermore, the business community remains hesitant to invest in an environment where there is no clarity in future regulation or taxation. Not only are businesses skeptical, but new regulations are forcing major changes in corporate behavior. Case in point, Bank of America released plans to reduce their workforce by 30,000 people as they pare back their consumer credit/debit unit in response to new pricing controls.

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If that were not enough, side plots in our soap opera have included various other issues. For instance, how the Arab Spring and new leaders in the Middle East will change the current environment, as well as how China's increasing presence on the world stage as an economic and military power will affect the balance of powers across the globe.

It is not our intent to make light of the situations that exist at home and around the world but we find the analogy appropriate. The difference is that the readers of this piece are among those who live real lives and are forced to make significant decisions in a very unsettled world. With all of the tension and political uncertainties around the globe, investors remain nervous and skittish as evidenced by the pick-up in volatility that we have seen throughout the second quarter.

We are hopeful that the systemic risks of the past few years will not be an unrelenting theme. However, the reality is that as the world turns there will always be investor concerns. Most people do not have the luxury of hoarding all their money in a mattress or locked in a vault; they need their investments to grow. This is where thoughtful investing comes into play. Thoughtful investing provides the opportunity to take actions in a portfolio against inflation, taxes and short term market conditions in order to maintain one's current standard of living now and in retirement. As investment managers our decision process must take into account changes in market dynamics as the environment changes. Current priorities include managing the tradeoffs between circumventing the latest crisis while maintaining appropriate diversification within the portfolio.

Sigma's outlook heading into 2011 revolved around the position that the best investment opportunities were in US equities. Specifically, large cap stocks where corporate balance sheets have continued to be as strong as they have been in 25 years. These companies have large cash reserves, low debt levels and dividend yields that are, in many cases, above 10-year Treasury yields. In our individual stock portfolios, Sigma has been particularly focused on companies that have demonstrated an ability to grow revenues. Companies with strong revenue growth in a weak economic environment can drive long-term improvement in profitability. This is commonly accomplished through real demand for their products, as opposed to implementing one-time improvements in profit margins simply by cutting costs. Throughout the year we have kept client portfolio weightings at the upper end of our target ranges for large cap domestic stocks. Consequently, international stocks (both developed and emerging markets), and small and mid cap stocks have remained at the low end of our ranges. Where appropriate, we have maintained client portfolio positions in gold and real estate as a hedge against inflation. We continue to believe world-wide emerging economies will continue to develop, thereby, driving global demand for these finite resources.

At present, more than 50% of the global equity markets are represented by companies that are domiciled outside of the US. In contrast, Sigma is dedicating just over 20% of client equity portfolios to non-US based equities. Our decision to underweight non-US equities and the recent instability in several international markets (primarily the Middle East and Europe), has resulted in Sigma's client equity portfolios being significantly less impacted by this year's turmoil in the global markets versus the broadest global indexes. For some context regarding the stability that large cap US equities have provided: the S&P 500 was down 4.9% year-to-date as of September 19, versus a 10.0% decline for the MSCI All World Equity Index.

Given the backdrop outlined above, going forward we expect that uncertain times will persist. As we write this missive the Federal Reserve Open Market Committee has a two-day meeting. Many market participants anticipate the outcome of which will be the announcement of some form of QE 3 (quantitative easing round three or what is now being called "Operation Twist"). "Operation Twist" would involve the Federal Reserve selling short term bonds that they currently hold and purchasing bonds with longer dated maturities. In theory, this should drive up prices on longer dated bonds, driving down yields on those bonds and stimulate demand for borrowing. Rates are already hovering near all time lows. In our view, the problem is not the price of money but rather the desire of businesses to borrow or invest in the current uncertain environment.

Contrary to political rhetoric, we continue to believe a majority of the issues being faced have no quick fix. The solution for the structural problems our country faces requires political leaders to find common ground, not a quick stimulus bill. They need to set clear and logical paths of fiscal reform that allow for the rebuilding and repair of economies over time. Ever the optimists, we believe that this will ultimately happen. Not because we have such great hope in the current leadership of the world economies, but rather because in most situations there comes a point at which "kicking the can" is no longer an option. Time is running out. As the clock winds down, leaders will be forced to find common ground.

Our best judgment is Greece will be bailed out but only after agreeing to deep reform. These reforms or political consequences will also serve to stop the concerns of contagion throughout the region. We expect the US will continue down a path of slow economic growth, not head into another recession. There will be pockets of the economy such as global industrial companies, technology companies and high-end consumer retailers which will continue to demonstrate growth opportunities while other major sectors, such as housing, continue to struggle. The overall unemployment rate will remain high acting as a drag on the economy. This high unemployment will continue until a more visible path provides the business community with confidence to invest their money in projects and people without concern for the unknown consequences regarding taxes and regulation. Importantly, businesses must also come to the conclusion that such taxes and regulation are not so onerous as to prevent their investments from being worth the risk.

In this economic environment, large cap domestic equities continue to offer the best values and opportunities. International developed and emerging markets still offer significant, long-term growth opportunities. The recent declines in those markets are beginning to offer compelling values for long-term investors. For now we remain cautious with our international exposure and have chosen to keep that exposure at the low end of our target ranges. However, as the story continues to unfold in the Middle East and Europe the opportunity for increased international investments may well present itself. Our expectation for the bond market continues to be seeing lackluster performance, at best, over the near and intermediate term. Current interest rates are near or at all-time lows. At some point, rates will begin to move up and bond prices will move down. Therefore, we continue (where possible) to invest in shorter maturity bonds in order to avoid being locked into low yielding bonds when rates do move upward.

As always we welcome your thoughts and comments.

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

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