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summaries

SIGMA INVESTMENT COUNSELORS

the official newsletter of sigma investment counselors September 2019

THE VALUE OF MIDWESTERN SENSIBILITIES

I began my career at a local bank in the commercial lending department. At the time, Texas and all of the "oil patch" was one of the hottest growth areas of the country. Texas Commerce was one of only two AAA-rated banks in the US. Texas' booming economy was in stark contrast to the rust belt economy of the Midwest. In a meeting with colleagues and a few lenders from this premiere Texas bank, I could see from their stares and the tone of their conversation how pathetic they thought our Midwest perspective was; so sheltered and unsophisticated. Our suggestion that oil prices might decline someday was just a function of our living in a struggling economy. The bank's business had been booming. They felt we should simply take them at their word with regard to the value of the oil and drilling companies they were representing. Thus, we'd be allowed the privilege of being part of a syndicate fortunate enough to lend to those companies. We declined.

Within eighteen months of that meeting, oil prices began to drop and Texans lost their jobs. Home values declined and foreclosures soared. In the end, the large Texas banks, including the AAA-rated bank, had all but collapsed and were forced to merge with other banks, mostly from New York. Dealing with these oil patch lenders was my first business opportunity to experience the value of Midwest sensibilities but it was certainly not the last.

In the investment business, there are many ways and many paths a firm can take to provide the proper products and services to address and satisfy client needs. However, there are few private investment firms that have stood the test of time the way Sigma has over the past 45+ years. Our Midwest perspective has much to do with this. Over the years, my colleagues and I have continually vetted investment ideas and vehicles that have come across the transom.

Our Midwest upbringing has taught us to be well-reasoned in our thought process, to examine all sides of an issue, and not simply take people at their word. We encourage others to ask questions, even if they may sound silly. In other words, our modus operandi is one of trust but verify. Our Midwest sensibility has instilled in us the need to think for ourselves, not to merely rely on the others for investment ideas.

Often this means playing devil's advocate. It means having the courage of one's convictions to stand still when everyone else is jumping on the band wagon. This can be difficult. The access to vast amounts of data now allows people to pitch new products with volumes of supporting data and back testing. When we see back testing, our antennas go up extra fast. So often, investment products work beautifully in the sterile laboratory world of back testing but the results rarely are replicated in the real world. One classic example is the use of back testing to demonstrate the success of market timing strategies. However, we have yet to see a market timing strategy that works!

We also have a bias against more "exotic" products such as hedge funds and illiquid limited partnerships that promise huge dividend streams from real estate or oil, etc. Aside from what we perceive to be less than optimal underlying fundamentals, our skepticism stems from two primary fronts: One, illiquidity, as there did not appear to be "anyway out." Sadly, many investors do not fully understand this risk until it is too late. They try to cash out of their investment and there is no market. The second is excessive fees, both upfront and/or ongoing throughout the lifespan of the investment product.

There is also the category of complex products that are often impossible to understand or diagram, which for us is a big warning sign. If we can't understand the investment structure or track the cash flow, we will not invest in it. This was the situation with the mortgage-backed security crisis that led us into the financial crisis in late '08. There were lenders to the mortgage lenders and then, lenders to those lenders and so on. Ultimately, no one really knew what entity was backing the credit or where the investment return was coming from. The memories of that time period remain painful.

We escaped this debacle by embracing the philosophy that fixed income investments are meant to provide certainty of principal and predictable cash flow. When we saw that mortgage-backed securities were providing above average yields, yields that appeared to be too good to be true, we chose to side-step these investments despite their high bond ratings. Our position was in the minority at the time but proved to be beneficial as time passed.

In more recent times, we are being presented opportunities to invest in venture capital and private equity investments. Previously, we were locked out of this marketplace given the large upfront investment minimums that catered to pension funds and other institutional accounts. Now, firms have found a way to market these products at much smaller price points. The analogy would be standing towards the end of the buffet line where the main dish is missing, the fresh lettuce is gone, and all of the tasty desserts have been taken. However, studies indicate that the returns from these investments are sub-optimal.

Midwest sensibilities can also mean jumping on the band wagon when everyone else is jumping off. In such cases, we seek to figure out if a market overreaction has left an opportunity. One good illustration of this was several years ago when a well-known municipal bond analyst made a very bearish call on the municipal bond market. Based on this call, investors sold their municipal bonds, driving down the price and driving up the yield. We felt the market had over reacted to this negative sentiment and we were able to take advantage of the weakness. Fears of Armageddon in the muni bond markets never materialized.

For us, having Midwest perspective is really the art of investigation combined with common sense and having courage of our convictions. Seeing something new does not always result in "no". Good examples of this is Sigma's early adoption of equity ETFs and more recently ibonds. To succeed in helping clients achieve long term investment goals, it is not only what the portfolio is invested in but also the mine fields that have been avoided along the way. My colleagues and I are proud of our Midwestern roots and how that has played in serving our clients' needs with regard to investments and the services we provide for them.

Denise M. Farkas, CFA
Chief Investment Officer

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

186 E. Main Street • Suite 200 • Northville, MI 48167 • tel (248) 223-0122 • fax (248) 223-0144 • www.sigmainvestments.com