

summaries



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A Higher Standard

Like many industries, the investment management business has undergone great changes in the past two decades. Much of this has been the result of the great technology revolution, but the increasing use of sophisticated tools and models, based upon the evolution of academic theory into practice, has been equally impacting. Effective investment management requires the synthesis of disparate information, wedded together on the basis of known relationships and historical experience. In order to elevate the professionalism of investment management, it has long been a central focus at Sigma that the investment professionals hone their management skills and the primary avenue for doing so has been the Chartered Financial Analyst (CFA) Program, administered by the CFA Institute in Charlottesville, Virginia. One of Sigma's newer CFA's, Marisa Lenhard, shares her experiences, and explains the benefits of the program for clients, in this month's Sigma Summaries.

—Bob Bilkie, CFA

When I first joined Sigma as an intern in college, I had no idea what the three letters CFA after some of the portfolio managers' names stood for. (The only CFA I had heard of was the Cat Fanciers Association!) I quickly discovered this CFA stood for Chartered Financial Analyst and was what the large framed certificate hanging on the walls in some of the portfolio managers' offices represented. I learned "famous" CFA charter holders include such industry luminaries as:

Abby Joseph Cohen, CFA – Chief Investment Strategist, Goldman Sachs

William H. Donaldson, CFA – Former Chair, SEC

John B. Neff, CFA – Author and Portfolio Manager, Wellington Management

William H. Miller, CFA – Portfolio Manager, Legg Mason Value Trust and Legg Mason Opportunity Trust, CEO of Legg Mason Funds Management, Inc.

It became clear that if I wanted a career managing portfolios my final exams in college were not going to be my last.

Upon joining Sigma full time, I began studying for the CFA Level 1 exam. There are three sequential, six-hour examinations that must be passed in order to be eligible to earn the credential. Each exam covers areas of finance, accounting, economics, statistics, portfolio theory, and ethics. Examples of questions include:

Describe one adjustment that Tobin's Q theory makes to address distortions in market value to book value relationships.

According to new classical economists, is financing a reduction in current taxes by government borrowing likely to result in an increase in aggregate demand, the real interest rate, both, or neither?

After spending more evenings and weekends than I would like to admit studying, I completed all three levels alongside the three years of work experience, and was awarded my charter in 2003.

I decided to volunteer and get involved in the CFA Society of Detroit to do what I could to increase

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awareness of the designation, enhance my own professional development, and help make our local society stronger. Last year I was elected to serve on the board, and this past May represented the CFA Society of Detroit at CFA Institute's annual meeting in Zurich, Switzerland.

The CFA is a globally recognized designation. There are currently 134 CFA Societies in 55 countries around the world. In Zurich, I was able to meet with people from all over the world including Australia, Hong Kong, Russia, Belgium, and Brazil. We were each there representing our local societies and the global investment community. We talked about what issues we faced in our local cities and chatted at dinner about inflation, energy prices, real estate prices and how they affected each of our client's investments.

I learned energy and real estate prices continue to be a concern all over the world, Sprungli is the best chocolate in Zurich, and the Europeans like Starbucks coffee almost as much as Americans like it. To paraphrase Thomas Friedman, I was constantly reminded how "flat" the world is.

In every market around the world, CFA Institute and its member societies believe investors come first. They believe "The interests of the investing client must always take precedence over the interests of investment professionals and their employers." CFA charterholders promise to maintain independence, act with integrity, and continuously strive to maintain and improve professional knowledge and competence.

The mission of the CFA Centre for Financial Market Integrity is to be a leading voice on issues of fairness, efficiency, and investor protection in global capital markets and to promote high standards of ethics,

integrity and professional excellence within the investment community. A recent example of the CFA Centre for Financial Market Integrity's advocacy in action is on the issue of Corporate Governance. CFA Institute released a corporate governance manual for investors, the first of its kind in the industry. This is a comprehensive guide to help assess companies' policies when it comes to issues such as executive pay and board independence.

Probably of most importance to Sigma clients is the Standards of Professional Conduct CFA charterholders and Sigma employees abide by. These standards of practice are a set of principles that define the professional conduct CFA Institute expects from its CFA candidates, CFA charterholders and members. They outline what constitutes fair and ethical business practices, and identify what clients should expect from any money manager anywhere in the world. The standards are presented below (lengthy, so read at your own risk!)

Marisa A. Lenhard, CFA

CFA Standards of Professional Conduct

I. PROFESSIONALISM

A. Knowledge of the Law. Members and Candidates must understand and comply with all applicable laws, rules, and regulations (including the CFA Institute Code of Ethics and Standards of Professional Conduct) of any government, regulatory organization, licensing agency, or professional association governing their professional activities. In the event of conflict, Members and Candidates must comply with the more strict law, rule, or regulation. Members and Candidates must not knowingly participate or assist in and must dissociate from any violation of such laws, rules, or regulations.

B. Independence and Objectivity. Members and Candidates must use reasonable care and judgment to achieve and maintain independence and objectivity in their professional activities. Members and Candidates must not offer, solicit, or accept any gift, benefit, compensation, or consideration that reasonably could be expected to compromise their own or another's independence and objectivity.

C. Misrepresentation. Members and Candidates must not knowingly make

any misrepresentations relating to investment analysis, recommendations, actions, or other professional activities.

D. Misconduct. Members and Candidates must not engage in any professional conduct involving dishonesty, fraud, or deceit or commit any act that reflects adversely on their professional reputation, integrity, or competence.

II. INTEGRITY OF CAPITAL MARKETS

A. Material Nonpublic Information. Members and Candidates who possess material nonpublic information that could affect the value of an investment must not act or cause others to act on the information.

B. Market Manipulation. Members and Candidates must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

III. DUTIES TO CLIENTS

A. Loyalty, Prudence, and Care. Members and Candidates have a duty of loyalty to their clients and must act with reasonable care and exercise prudent judgment. Members and Candidates must act for the benefit of their clients and place their clients' interests before their employer's or their own interests. In relationships with clients, Members and Candidates must determine applicable fiduciary duty and must comply with such duty to persons and interests to whom it is owed.

B. Fair Dealing. Members and Candidates must deal fairly and objectively with all clients when providing investment analysis, making investment recommendations, taking investment action, or engaging in other professional activities.

C. Suitability.

1. When Members and Candidates are in an advisory relationship with a client, they must: **a.** Make a reasonable inquiry into a client's or prospective clients' investment experience, risk and return objectives, and financial constraints prior to making any investment recommendation or taking investment action and must reassess and update this information regularly. **b.** Determine that an investment is suitable to the client's financial situation and consistent with the client's written objectives, mandates, and constraints before making an investment recommendation or taking investment action. **c.** Judge the suitability of investments in the context of the client's total portfolio. 2. When Members and Candidates are responsible for managing a portfolio to a specific mandate, strategy, or style, they must only make investment recommendations or take investment actions that are consistent with the stated objectives and constraints of the portfolio.

D. Performance Presentation. When communicating investment performance information, Members or Candidates must make reasonable efforts to ensure that it is fair, accurate, and complete.

E. Preservation of Confidentiality. Members and Candidates must keep information about current, former, and prospective clients confidential unless: 1. The information concerns illegal activities on the part of the client or prospective client. 2. Disclosure is required by law. 3. The client or prospective client permits disclosure of the information.

IV. DUTIES TO EMPLOYERS

A. Loyalty. In matters related to their employment, Members and Candidates must act for the benefit of their employer and not deprive their employer of the advantage of their skills and abilities, divulge confidential information, or otherwise cause harm to their employer.

B. Additional Compensation Arrangements. Members and Candidates must not accept gifts, benefits, compensation, or consideration that

competes with, or might reasonably be expected to create a conflict of interest with, their employer's interest unless they obtain written consent from all parties involved.

C. Responsibilities of Supervisors. Members and Candidates must make reasonable efforts to detect and prevent violations of applicable laws, rules, regulations, and the Code and Standards by anyone subject to their supervision or authority.

V. INVESTMENT ANALYSIS, RECOMMENDATIONS, AND ACTION

A. Diligence and Reasonable Basis. Members and Candidates must: 1. Exercise diligence, independence, and thoroughness in analyzing investments, making investment recommendations, and taking investment actions. 2. Have a reasonable and adequate basis, supported by appropriate research and investigation, for any investment analysis, recommendation, or action.

B. Communication with Clients and Prospective Clients.

Members and Candidates must: 1. Disclose to clients and prospective clients the basic format and general principles of the investment processes used to analyze investments, select securities, and construct portfolios and must promptly disclose any changes that might materially affect those processes. 2. Use reasonable judgment in identifying which factors are important to their investment analyses, recommendations, or actions and include those factors in communications with clients and prospective clients. 3. Distinguish between fact and opinion in the presentation of investment analysis and recommendations.

C. Record Retention. Members and Candidates must develop and maintain appropriate records to support their investment analysis, recommendations, actions, and other investment-related communications with clients and prospective clients.

VI. CONFLICTS OF INTEREST

A. Disclosure of Conflicts. Members and Candidates must make full and fair disclosure of all matters that could reasonably be expected to impair their independence and objectivity or interfere with respective duties to their clients, prospective clients, and employer. Members and Candidates must ensure that such disclosures are prominent, are delivered in plain language, and communicate the relevant information effectively.

B. Priority of Transactions. Investment transactions for clients and employers must have priority over investment transactions in which a Member or Candidate is the beneficial owner.

C. Referral Fees. Members and Candidates must disclose to their employer, clients, and prospective clients, as appropriate, any compensation, consideration, or benefit received from, or paid to, others for the recommendation of products or services.

VII. RESPONSIBILITIES AS A CFA INSTITUTE MEMBER OR CFA CANDIDATE

A. Conduct as Members and Candidates in the CFA Program. Members and Candidates must not engage in any conduct that compromises the reputation or integrity of CFA Institute or the CFA designation or the integrity, validity, or security of the CFA examinations.

B. Reference to CFA Institute, the CFA designation, and the CFA Program. When referring to CFA Institute, CFA Institute membership, the CFA designation, or candidacy in the CFA Program, Members and Candidates must not misrepresent or exaggerate the meaning or implications of membership in CFA Institute, holding the CFA designation, or candidacy in the CFA Program.

The Economic and Market Environment

In Sum: As geo-political tensions remain high in the Middle East, the positive valuation aspects of an investment environment that has exhibited heightened volatility throughout the second quarter may be easy to overlook. Those countries that once lagged in terms of broad and diverse economic expansion are continuing to pursue the implementation of their own complex industrial infrastructure in an attempt to perpetuate progress. Fiscal and monetary policy are more constructive, and financial asset prices appear to offer compelling values.

Geo-political: A thick cloud of pessimism enveloped most of the industrialized world during the month of July and early August. Uncertainty on many geographic fronts - North Korea, Iran, Syria, Iraq, Venezuela, Bolivia and Cuba, as well as the still simmering and pensive ceasefire between Israeli and Hezbollah forces in Lebanon have all weighed heavily on the minds of investors. This heightened concern raised the risk premium – the extra return investors expect because of the higher perceived risk – in mid summer with the attendant effect of pushing financial asset prices down. Continuing strife will keep pressure on prices – and any sense of improvement will foment a more constructive outlook.

Economic: Consumer sentiment the world over has continued to waver beneath the weight of rising global energy prices. Amid the turmoil in the Middle East, BP PLC announced a shuttering of operations in Alaska to repair pipelines, and the specter of the impending American hurricane season raised its head, all causing consumers to fret over the financial pressures of higher energy prices. If energy prices continue to fluctuate with an upward bias, many businesses affected may ease their own financial pain by passing their heightened production costs onto the consumer. Indeed, higher energy prices, along with a softening in the US housing market has caused the average American to feel less wealthy, as the University of Michigan Index of Consumer Sentiment came in at 78.7 in early August from 84.7 in late July, down significantly from an index reading of 96.5 one year earlier.

Monetary: The Federal Reserve Board held constant the fed funds rates at their August meeting, ending a two-year streak of 17 consecutive rate hikes as GDP estimates, employment rates, and the housing market all have showed signs of softening. However, the Fed has left the door open for future rate hikes, as inflation has not altogether subsided. The conduct of monetary policy is now entering a critical phase given the current condition of the business cycle, as the Fed must decide whether the economy has slowed too much or not enough. Similar pauses in rate hikes were witnessed in February of 1995 and in May of 2000, with the first of such instances resulting in a period of slow growth followed by five additional years of economic expansion and the latter resulting in an economic recession.

Fiscal Policy: The federal budget deficit amounted to \$33.2 billion for the month of July 2006, which compares favorably to the \$53.4 billion dollar mark of one year earlier. According to the Congressional Budget Office, the full year deficit is projected at \$260 billion versus \$318 billion for the 2005 fiscal year. The welcomed improvement is largely due to surging tax receipts.

Equity Markets: With the second quarter of 2006 bringing with it a wave of weakness in global equity markets, it is understandable that many investors feel uneasy about the present market situation. However, notwithstanding this weakness, it is useful to note that as of the end of the second quarter 2006, the Standard & Poor's 500 Stock Index was trading at 15.2 times earnings (a measure of valuation), compared to 28.4 times earnings at March 27, 2000 (the last market peak) and 23.6 times earnings at October 9, 2002 (the recent market low). Given the current level of interest rates, and a fed that has gone into a pause mode, this valuation metric appears promising.

Fixed Income Markets: As the Fed has ended its streak of 17 consecutive rate hikes and inflation fears have abated somewhat, the total return on fixed income investment should approximate coupon yields over the near term.

As of August 18, 2006

The views in this publication are as of August 2006 and are for informational purposes only and do not represent any recommendation of any particular security or strategy and should not be considered investment advice. The publication is prepared for educational purposes and the information presented has been gathered from sources believed to be reliable.

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