

summaries



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Of vs. On - Not Just Semantics

Preservation of capital has always been a priority for investors. However, increasingly in today's environment, there has been a shift in retail investor sentiment and priorities. The focus and top priority has seemingly become a *return of money* (capital preservation) versus *return on money* (growth of assets). This perspective results in an investor psyche that has a short term orientation and runs contrary to the concept of investing (which by definition implies a longer-term time horizon).

Over the past several months in conversations with clients, Sigma Summaries, and blog posts, we have continued to outline the risks of a short term, *return of money*, method of investing. Given the tenuous environment we live in today the unseen risks of this seemingly "conservative" *return of money* approach are often overlooked. It is important to not only provide our best advice to clients but to also provide a counter balance to the 24/7 business and economic news from entities who thrive on a combination of sensationalism and "drama" to earn their keep.

In contrast to today's cautious environment, investor attitudes of just a few years ago threw caution to the wind, ignoring risk in their reckless pursuit of the highest possible (although not probable) returns. In late 2007 investors that were cautious on the markets, holding cash or bonds were thought to be foolish.

The hot tip at the cocktail party (when was that last time anyone heard that expression?) resulted in a call to make a trade before the market opened on the next trading day. These swings in sentiment to extreme levels are reinforced by the 24 hour news cycle and the financial news networks across the globe that amplify the issues of the day, injecting additional volatility to the markets. Overlaid on the barrage of information available to us are the changes in trading activity that have resulted in a market structure more prone to daily volatility. All of this - combined with a steady stream of news about unethical trading activities, reoccurring insider trading issues, trading mishaps such as the flash crash or the recent public offering fiasco with Facebook - has resulted in fabric worn thinner on what is already fragile investor confidence in the market system.

Preservation of capital (*return of money*) is seductive; it meets the needs of the investor psyche to feel safe and provides immediate gratification (no loss of principal). There is no question in our minds that such gratification will be short lived. Yes, equity markets are volatile, yes, Europe creates a drag for the global economy, yes, the rate of growth for China and its population of 1 billion people is slowing (to something that is still in the high single digits) and yes, there is a lot of uncertainty about the debt in developed countries (not the least of which is the United States). And yes,

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there are times when the playing field appears to not be level for the retail investor. When the situation appears to look the worst with no hope in sight the opportunities are the greatest in the equity markets. Conversely, when “things couldn’t be better,” what is the upside?

As we review investment opportunities we continue to believe the certainty of return of the initial investment and certainty of the income stream offered by bonds are deceptive. Investors who have structured their bond portfolios to provide the necessary cash flow from interest payments to meet their spending needs have been frustrated over the past 18 months. Bonds with high coupon payments are being called (redeemed early by the issuing company) at the first opportunity. Once the bond has been called, the cash flow from interest payments is reduced because in today’s environment the ability to reinvest the proceeds to produce the same income stream does not exist. In fact, in many cases an investor is lucky if he/she can replace 50% of that cash flow in today’s bond market. If they can, it is not without taking on a much higher degree of risk, either through a lower credit quality or, in some cases, a much longer time horizon. As risk increases, the certainty of the *return of money* investors are seeking declines.

Further, with bonds, the preservation of capital translates into a certainty that one will get their original investment back which is also not so certain these days. Fishing in today’s secondary bond markets requires the payment of huge premiums that will fade away as the bond approaches maturity. Additionally, as interest rates rise, bond prices fall. So unless the

bond is purchased at par and is held to maturity, the return of an investor’s original investment is not guaranteed. As a point of reference, if one looks back on the late 70’s, inflation was rampant and rates rose to very high levels. From 1971 to 1981 bond investors suffered several years of negative returns. In 1981, Paul Volker broke the back of inflation and the bond market was off to the races for a 30 year bull market run; bond yields (interest rates) dropped from the mid/high teens to today’s all-time lows (1.6% on a 10 year bond). That 30 year run provided abnormally high returns from bonds, creating an artificial safe haven for investors. Regardless of the abnormality, that safe haven is the only experience retail bond investors have known for the last 30 years. The returns were outsized for the level of risk being taken. That game is over.

To be clear, bonds have an important role in a portfolio and are a very important part of a long-term investment strategy. However, at current prices bonds are expensive relative to other asset classes and at current prices do not provide the inflation protection necessary for investors to preserve their purchasing power. While the timing is difficult to predict, we do expect rates to move higher and therefore bond prices to move lower. This creates an environment where there is a high likelihood over the next several years there will be times when the total return on bonds will be negative, disappointing investors whose intent was to seek *return of principal*.

So if the bond magic is gone what are other opportunities for those seeking the *return on principal*? Cash will preserve principal but in the current rate environment there is no return for someone holding

cash. If there is any inflation, holding cash means trading the certainty of principal for the loss of purchasing power. Proper and appropriate cash levels are an important part of one's financial plan. However, it does not constitute a long-term strategy. Furthermore, timing the markets, when to be "in" and when to be "out", is fraught with peril and for a variety of reasons we have articulated many times has never proven to be a sound investment strategy.

This leaves investors seeking *return of principal* with few alternatives such as CDs under \$100,000 (backed by the government guarantee) or money market funds. For an investor with a large portfolio investing in a portfolio of CDs fully covered by US Government FDIC insurance (right now \$100,000 for taxable accounts and \$250,000 for IRAs through 12/31/13) requires holding many CDs at various banks across the country. It requires a great deal of effort and is an inefficient vehicle for those depending on a monthly cash flow. With regard to money funds, as we saw in 2008, those funds could "break the buck". In addition as broadly covered in the press, there is pending legislation that, while still unclear, might require investors to take on more risk during times of panic by requiring the money funds to withhold 10% of the funds for a 30 day period.

In short, there is no strategy that guarantees an investor a *return of money*. This leaves other asset classes which provide *return on principal* and have a longer term focus. This includes many different asset classes such as real estate, commodities and equities. We continue to believe that real estate and commodities are assets of interest and have a place in client portfolios.

However, equities are the key piece, providing needed diversification to a portfolio. More importantly, from our valuation perspective, equities provide the most opportunity for both a *return of money* and a *return on money* at this moment in time. Certainly there are issues that give equity investors pause. The equity markets continued their march upwards throughout the first quarter of 2012 with many indices and individual stocks approaching their previous all-time highs. Since then, the market has staged a pull-back in prices accompanied with greater price volatility, resulting in an onslaught of conversations in the media where market experts discuss the merits of investors stepping to the sidelines

The fundamental underpinnings of the stock market rest on the idea that the increased risk an investor assumes when buying equities will be rewarded by long-term appreciation. Certainly, the investment experience in equities over the past several years weighs heavy on investor emotions. We cannot be assured the market will not take another dive like the 2008 experience. There are always issues that concern the markets. Today it is Europe. On a global basis, suffice it to say, the political situations and the behaviors of legislators and regulators provide little confidence. (One might question, however, if this issue is really anything new.) Yet, there are several reasons to be optimistic.

In particular, large capitalization domestic companies are in much better shape today than in 2008. There are many large US companies that have strong revenue growth, improving returns on investment, low debt levels, solid dividends that have been

local independent personal accessible
interactive creative local independent personal
knowledgeable thoughtful ethical experienced

increased on a regular basis and are leaders in their industries/products/services. These companies are currently selling at attractive valuations, many with dividend yields above the 10 year US Treasury Bond. Furthermore, unlike bonds where cash flow is locked in at the time the bond is issued, equities provide an opportunity for increased cash flow as companies raise their dividends. In short they are companies with solid track records where management has demonstrated good stewardship of the assets over the years. As we noted not too long ago in our blog titled “Almost Even”, and contrary to some seemingly popular thought, the market is not akin to a casino where walking away “almost even” would, in most cases, be a godsend. The stock market is made up of real companies with real assets producing real products for real people. Thus, investing in common stocks should be accompanied by a thoughtful, diligent and disciplined process. While companies may stumble from time to time, most companies that make it to the public markets have established businesses. Some

may grow faster than others, some may suffer at the hands of bad management or corrupt managers, and some may have products that become obsolete, but most grow quite nicely over time.

In sum, a *return of money* strategy implies ignoring stocks and reinvesting in less risky assets. Today, those alternatives (cash or shorter-term bonds) offer little, if any, return. When inflation kicks in (some would argue that it already has), holding a market basket of low-yielding securities as a long-term investment strategy makes even less sense. It is human nature to be emotional but emotional investing is the road to ruin when trying to build a portfolio for the long-term.

As always we look forward to your comments and perspective.

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