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summaries

SIGMA INVESTMENT COUNSELORS

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Great Expectations

Stretching my mind back to those early high school days when Charles Dickens' classic *Great Expectations* was a must read for all English literature students, I remember the main character, Pip, as well as Miss Havisham and her adopted daughter Estella. Dickens' great work wove an interesting tale that led Pip through passages of his life and his expectations. Looking for a tie-in between *Great Expectations* and the psychological manic-depressive nature of stock market returns, I believe Pip's adventures have similarities with many investor's desire, hope and frustration in dealing with equity markets and their performance.

Thanks to Google and a website devoted to book notes, I discovered that a couple of Pip's expectations might be applicable to current performance expectations. First, when Pip receives news of his inheritance, he immediately notices a corresponding estrangement developing between himself and those people he most loves. Greater expectations, Pip realizes, mean he may no longer be content with the good things he already has. The second expectation involves Pip's first glimpse of London, its grimy streets and the dismal Barnard's Inn that disappoint him. It's his first indication that his expectations may be grander than the realties he'll find.

The themes I would like to address that apply to today's financial returns are "he may no longer be content with the good things he already has" and "it's his first indication that his expectations may be grander than the realties he'll find."

We investors are a peculiar bunch. Being human we have emotion. Emotion can be a great attribute, particularly when it motivates us to do great deeds. However, when emotion is brought into the investing arena it often produces poor decisions and lower returns. It is natural and understandable that investors get more excited and expect more from their portfolios as prices and account values increase. That excitement, we suggest, should be tempered by the history and knowledge that equity returns over long periods of time have produced positive returns of 6% to 8% per year with an additional 1% to 2% from dividend yields.

The following statistic drives home the point of historical stock market returns: The Dow Jones Industrial Average increased from 65.73 to 11,497.12 in the 20th century! No doubt about it, just looking at the numbers, it was a very big increase over 100 years. However, if we look at the same increase on a compound annual performance basis, the return was 5.3% according to the Berkshire Hathaway 2006 annual report. Of course that does not include dividends but it does illustrate the point. Several observations can be drawn from this data.

While 5.3% may not seem like a heady return, it is worth remembering that it does include a century of world wars, the great depression, the cold war, oil market crashes and recoveries as well as numerous recessions, good and bad administrations and even the Internet boom and bust. Of course, there have been many shorter periods of time when returns have been significantly higher and lower than this long-term return.

But, when investors think about returns, they should always be suspicious as to why the beginning and terminal years have been selected. If either year was aberrational, any calculation of growth will be distorted. In particular, a base year in which returns were poor can produce a breathtaking, but meaningless growth rate.

Stealing a paragraph from Berkshire Hathaway's recent annual report, Warren Buffett comments about this fundamental truth. "With unimportant exceptions, such as bankruptcies in which some of a company's losses are borne by creditors, the most owners in aggregate can earn between now and Judgment Day is what their businesses in aggregate earn. True, by buying and selling that is clever or lucky, investor A may take more than his share of the pie at the expense of investor B. And, yes, all investors feel richer when their stock soars. But an owner (investor) can exit only by having someone take his place. If one investor sells high, another must buy high. For owners as a whole, there is simply no magic - no shower of money from outer space - that will enable them to extract wealth from their companies beyond that created by the companies themselves."

We agree with Mr. Buffett's statement and think about it daily when we invest for our clients. It is hard not to get excited when equity returns rise above the long-term average because you feel better, stronger and wiser. Like Pip, whose new inheritance from Magwitch (remember him) elevates his expectations beyond reason, new market highs often elevate our expectation of future returns to unreasonable levels.

Another important point should be made. From our perspective, we remain positive regarding the global marketplace looking forward and believe there will be numerous opportunities for disciplined and thoughtful investing in the years to come. Valuations on a global basis remain moderate and do not suggest we are close to peak earnings. And, despite rising energy prices, the global economy continues to expand, producing millions of consumers particularly from the developing world that possess greater purchasing power.

As the global economy continues to integrate and an increasing number of countries adopt free-market capitalistic policies, it becomes less important where a company is domiciled and more important where a company competes. Moreover, US-based companies are becoming increasingly dependent on the global economy for growth.

This optimism about new investment opportunities presented by the global economy is not the only factor we consider important at this time. More and more companies are operating very efficiently, as evidenced by historically high profit margins. Profitability tends to be cyclical over time and there is risk that these margins will eventually decline. So, in contrast to the comment two paragraphs earlier, we have not seen peak earnings, but we may have seen peak profit margins.

Keeping our eyes on valuation and the growth potential for companies competing in this intriguing, complex world provides a worthy challenge for all equity investors. Considering rising interest rates, real estate prices coming back down to earth and commodity prices going to all-time highs, we believe our friend Pip would probably be thinking about becoming a commodity trader. We would suggest that Pip reconsider his instinct and continue to invest in a well-diversified equity portfolio that will likely be the best investment choice for the foreseeable future.

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Chief Investment Officer

The Economic and Market Environment

In Sum: Bolivia resurrected the centuries old debate on the virtues of capitalism versus socialism when it nationalized certain private energy assets last month. At present, this is not having any impact on global economic growth. The Fed continues to raise interest rates in a measured fashion while the federal deficit continues to shrink from surging tax revenues. Common stocks have produced solid gains for the year to date while bonds are just marking time.

Geo-political: "Morales in Warning to Energy Companies" was the lead headline in the May 12, 2006 issue of the Financial Times of London. Of course, the article references recent moves in Bolivia to nationalize the assets of foreign energy companies operating in that country. This should cause capitalists the world over to recoil in horror. While there is merit in wanting to eradicate poverty, nationalization historically has tended to have the opposite effect. While it seems unlikely that other countries will follow suit, this once unthinkable act in a modern global economic environment does hold lessons for investors who seek international investment exposure – buyer beware.

Economic: The global economic expansion continues to plod along with scant evidence of major imbalances. Even Italy registered a gain in growth for the first quarter of 2006, joining most other industrializing nations in contributing to the advance. Crude oil, gold and commodities in general are scoring significant price gains year to date, apparently due as much to investor demand as the demand from final consumers of those products. So far, the higher prices have not caused material increases in inflation.

Monetary: The Federal Reserve Board raised the federal funds rate to 5% in early May. Other central banks around the world have made similar moves as concern mounts over the potential for higher inflation. Measured moves are an appropriate course of action so as to balance the risks of inflation with the desire to see continued economic growth.

Fiscal Policy: According to the Congressional Budget Office, Monthly Budget Review, May 2006: "In the first seven months of fiscal year 2006, the federal government ran a deficit of $183 billion, CBO estimates, $53 billion less than for the same period last year. Robust growth in revenues and calendar-related shifts in the timing of certain payments account for much of that improvement. CBO now expects that the 2006 deficit will be significantly less than $350 billion, perhaps as low as $300 billion, assuming enactment of the pending supplemental appropriations and tax reconciliation legislation." Positive!

Equity markets: Equity prices showed solid gains for the first four plus months of the year. Most earnings reports for the first quarter were in line with expectations, or better than expected and this propelled stock prices. A pause in price appreciation would not be unprecedented – following the typical season pattern of summer doldrums.

Fixed income markets: Bonds have provided virtually no investment return for the year to date, as coupon income has been almost completely obliterated by price erosion.