knowledgeable thoughtful ethical experienced interactive

summaries

the official newsletter of sigma investment counselors October 2006

Crucial Components

Case 1:
Couple A has $1 million in investments. All of their living expenses are covered by their pensions. They would like to **grow** their investments to leave to their children and grandchildren, and only draw on these investments in case of emergency.

Case 2:
Couple B has $1 million in investments. All of their living expenses are covered by their pensions. They would like to **preserve** their investments to leave to their children and grandchildren, and only draw on these investments in case of emergency.

These couples appear to have identical financial situations. And yet, the correct investment solution for each may be vastly different. This difference, captured in the asset allocation, will determine each portfolio's expected risk and return.

At Sigma Investment Counselors, we pride ourselves on our ability to craft custom financial solutions for our clients. In our April 2006 edition, we discussed the services our firm offers, including financial planning. More recently, our colleague Marisa Lenhard described the Sigma Wealth Management Tool that aids in financial plan construction. A key component of every financial plan is the asset allocation. This article will discuss the importance of asset allocation and the factors that we consider in its determination.

It would be easy at this time to toss this article aside. After all, asset allocation is the kind of discussion that causes many investors to yawn and fidget. What does it mean? Asset allocation is the breakdown of a portfolio into the different major asset classes available for investment. The major asset classes available may include equities, fixed income, cash, commodities, real estate, private equity and hedge funds. As an example, a portfolio that is half invested in stocks, and half in bonds, has a 50% equity and 50% fixed income asset allocation (50/50). A more aggressive asset allocation would be one that is tilted towards equities, while a more conservative allocation will be more heavily weighted in fixed income.

Why is this important? Asset allocation is the primary determining factor of long-term portfolio returns. As the financial academicians Brinson, Hood and Beebower reported in their landmark study[1], asset allocation accounts for approximately 95% of returns. Investment selection and timing account for the rest. Consider the following 3 sample portfolios:

Portfolio	Composition	Expected Annual Return	Expected Risk
Growth	100% Equities	10%	High
Balanced	50% Equities/ 50% Fixed Income	8%	Moderate
Income	100% Fixed Income	6%	Low

[1] "Determinants Of Portfolio Performance", Financial Analysts Journal, Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, July/August 1986, Vol. 42, No. 4: 39-44

summaries

If all other factors were equal, everyone would choose the 100% Equities portfolio and earn a higher expected annual return. However, all factors are not equal. A portfolio comprised of only equities will also be much more volatile than the Balanced or Income portfolios.

Obviously, determining the right asset allocation for each investment plan is crucial.

So, you may ask, what are the factors we consider when recommending an asset allocation?

First, what investment return does a client require or desire? While most people want to make as much money as possible, their circumstances may only require a lower return on their investments. This allows construction of a more conservative portfolio, like the Balanced or Income portfolios above.

Next, the investment time horizon is discussed. How long can funds remain invested before making withdrawals? The longer the time horizon, the more volatile assets such as equities can be employed to strive for higher returns. Thus, it is generally more appropriate to use a more aggressive asset allocation for an investor in the midst of their working years. For someone closer to retirement, a more conservative allocation may be warranted.

Another related factor is liquidity needs. An investor may generally have a long time horizon, but may need to make significant withdrawals in the nearer term, for instance to cover college expenses. In this case, the asset allocation may allow enough fixed income to cover the expected withdrawals.

Once these liquidity events have passed, the long-term asset allocation will again take hold.

Finally, the investor's risk tolerance is discussed. How well do you sleep at night during a bear market? Some people are risk averse, and uncomfortable with the volatility of equities. We have to consider this in our discussions, because we want our clients to stay invested according to the plan we develop. Because of its emotional and personal nature, risk tolerance may trump all other considerations.

We put these factors into the Sigma Wealth Management Tool, and then run simulations using different target asset allocations. Through this iterative approach, we establish the asset breakdown with the lowest risk that produces returns that meet the client's needs.

Returning to couples A & B at the beginning of this article, one might imagine that the first couple would end up with a Growth portfolio, and the second couple might end up with an Income portfolio. In most cases, our clients end up with a combination of equities, fixed income and cash that provides a balance of growth, security, and liquidity that meets their needs.

In closing, asset allocation is a crucial component of every investment plan. We work closely with our clients to jointly determine their appropriate asset allocation. If you have any questions about asset allocation, please contact your portfolio manager at Sigma Investment Counselors.

- Kenneth M. Bernard, CFA

The Economic and Market Environment

In Sum: The North Koreans detonated a nuclear warhead and the Dow Jones Industrial Average surged to a new high. The capital markets have priced in low-level geopolitical risks. Economic growth continues to plod along with an absence of meaningful inflationary pressures. The environment has proven healthy for common stock investors and benign for fixed income investors.

Geo-political: North Korea raised the stakes in its game of brinkmanship when it detonated a nuclear warhead in mid October. The United Nations Security Council reacted with characteristic indecisiveness, passing a sanctions program, only to then have various members signal that they would probably not enforce all of the provisions. Needless to say, the United States does not have the resources, nor the will, to act unilaterally to convince the North Koreans to alter course. Fortunately, the capital markets reacted in a muted fashion to the news of the detonation, showing that the potential for such an event as this was not unexpected by the markets.

Economic: Gross Domestic Product slowed in the US during the third quarter of 2006 versus prior periods. This was not unexpected given the tempering effects of rising energy prices and interest rates. Importantly, gold recently traded at just under $600 per ounce, a significant drop from over $700 per ounce in mid-year. In contrast, base metals such as tin, nickel, and zinc have strengthened on the notion that US economic growth would not decline precipitously. As indicators of potential inflationary pressures, gold has the better track record than industrial metals and therefore, one should conclude that surging inflation will not be a near term concern.

Monetary: Monetary policy makers around the globe are evaluating the effects of protracted, and concerted increases in interest rates. While economic growth in the US has moderated somewhat, geographies such as China continue to show zesty ebullience. The Chinese Central bank has attempted to nudge rates modestly higher, but they do not wish to see their currency appreciate because of the prospective negative consequences on exports.

Fiscal Policy: US Government receipts surged dramatically in fiscal 2006 notwithstanding the cut in tax rates. The increase in the government take came from higher payments by both individuals as well as corporations. As a result, the 2006 fiscal budget deficit as a percent of GDP was well within historical ranges at 2.5 percent. Deficits of this degree are manageable and would be well tolerated by global capital market participants.

Equity markets: Stock markets around the globe continued to firm through early October, punctuated by the Dow Jones Industrial Average breaking into new, all time high territory. The more widely accepted Standard and Poor's 500 Stock Index is still meaningfully below its all time high reached in 2000. Nonetheless, the tone has been encouraging for common stock investors.

Fixed income markets: Bond interest rates continue to be range bound across the maturity spectrum as inflationary signals continue to be mixed.

Robert M. Bilkie, Jr., CFA
As of October 18, 2006

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

The views in this publication are as of October 2006 and are for educational purposes only and do not represent any recommendation of any particular strategy and should not be considered investment advice. The information presented has been gathered from sources believed to be reliable. Keep in mind that each sector of the market entails risk. Statements concerning financial market outlook are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

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

26261 Evergreen • Suite 455 • Southfield, MI 48076 • tel (248) 223-0122 • fax (248) 223-0144 • www.sigmainvestments.com