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summaries

SIGMA INVESTMENT COUNSELORS

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One World

Common stock portfolios managed by Sigma have taken on a more international "hue" during the past few years. We have increased our representation of domestic companies with world wide operations and introduced international exchange traded funds providing broad exposure to companies headquartered across the globe. While there are many reasons why we have embraced this strategy, there are two books that have either influenced or supported this decision to become more global in our investment management. These include *The World is Flat: A Brief History of the Twenty-First Century* by noted author Thomas Friedman and *The Post-American World* by noted author Fareed Zakaria. In both instances, the authors advance the theme of globalization.

Globalization covers a wide range of political, social, and economic trends. In its most literal sense, it can be defined as a transformation of local or regional phenomena into global ones, or a world where people act as one society regardless of their location. It is widely acknowledged that globalization has already created remarkable wealth for certain regions of the world and certain industries. But what is the next wave of globalization? How should one position investment portfolios to participate?

Friedman's work analyzes the current world marketplace through his own extensive travels and experiences. "Flat" to Friedman means connected. His book illustrates a view of the world where all competitors are on an even playing field, where political and geographical divisions (sovereignty) become irrelevant. In this flat world, distance is no longer measured by location, but by time. Friedman provides numerous examples where workers are able to provide services to customers 900 miles or more away. He cites an example where a customer ordering a burger in a drive-through at a McDonald's restaurant in Missouri will provide the request to a worker at a call center in Colorado Springs, who then sends the order back to Missouri in time for the meal to be ready at the pickup window.

He broadly suggests the factors that precipitated this "flattening" were the collapse of communism, the dot-com bubble resulting in overinvestment in fiber-optic telecommunications, and the subsequent out-sourcing of engineers enlisted to fix the perceived Y2K problem. This global market place was created starting with the fall of the Berlin Wall and advanced through technological innovations such as the Internet, Google, and mobile phones. As a result, the West is seen as losing much of its economic strong-hold on the world stage as products, services, and labor are often cheaper elsewhere.

As a U.S. consumer, this is good news as manufacturers can import goods at lower cost. On the other hand, as a U.S. producer, it becomes harder to compete with overseas enterprises. Externally, China and India are viewed as the most obvious winners in Friedman's flattening world, because they are benefitting the most. They can be seen as threats to developed countries. This also allows them to provide employment for hundreds of millions of their own people. Moreover, as these countries become more industrialized, their workers will demand more goods and services themselves, thereby strengthening their local economies.

Friedman suggests that companies willing to change and accept change are more likely to thrive than those that do not. He explores commoditization in a wide range of industries, where goods are the same and there is abundant supply. Companies in these industries are driven to be more creative and innovative in order to survive.

Friedman's message is that everyone needs to be prepared because the world isn't becoming flat, it is flat. Businesses, governments, and individuals who fail to recognize this trend will not be able to compete. To be successful, companies must find ways to differentiate themselves versus their competitors in the eyes of their customers and create superior goods or services for which they can charge a premium.

While there are many examples which help to prove this point, we can't help but reflect on the U.S. auto industry which is being forced to make gut-wrenching changes to its business model to survive and compete with its foreign rivals.

The World is Flat doesn't explore in depth the political factors of globalization. In fact, the suggestion is that political institutions should stand aside and not impede progress. As certain governments around the world have become more market friendly (China, the Baltic states, etc.), they have unleashed the energy of the private sector. It is difficult to place the order, the technological boom or the more market friendly policies, but there is reason to believe that each has helped the other to advance.

Zakaria's *Post-American World* explores the political aspects more extensively. He argues that a "post-American" world order is in the beginning stages. Zakaria writes that America remains the dominant military force, but "in every other dimension – industrial, financial, educational, social, cultural – the distribution of power is shifting, moving away from American dominance." His definition of a post-American world is "one defined and directed from many places and by many people."

Zakaria's book is not about the fall of America, but about the "rise of the rest." As globalization helps lift the economies of countries like China and India, they will become more powerful. Not ironically, Zakaria suggests that the impetus behind these emerging economies success lay in response to America's influence in suggesting free markets, democracy, and the application of technology.

This does not suggest that America's role in this dynamic global system is diminished, but instead changed. Zakaria suggests America becomes a "global broker" shifting from unilaterally setting policy to "setting the agenda, defining the issues and mobilizing coalitions."

Taking these two works together, it becomes evident that indeed the world is changing, and this has to influence the manner in which investment portfolios are positioned. While an

American consumer is going to discharge most obligations in U.S. dollars, the investment portfolio should not be comprised only of dollar-denominated investments, particularly when economic growth and consumption patterns appear to be so much greater overseas.

Investing overseas, however, does introduce additional risks and challenges into the equation. For example, currency fluctuations can have a dramatic impact on the rate of return of a non-U.S. dollar denominated investment, irrespective of the return of that investment in its host currency. Geo-political risks, lack of corporate governance, and inconsistent accounting standards, to name a few, can also heavily impact the investment results of a security, irrespective of the underlying fundamentals.

For these reasons, we prefer to invest overseas through the use of well-diversified mutual funds. Particularly, we have chosen lower cost, exchange traded index funds. We have historically shied away from country-specific funds, preferring regional funds where some of these risks can be better controlled.

Clients may also have noticed that we recently introduced the EAFE index as a companion benchmark to the S&P 500 index in our quarterly reports. This inclusion reflects our growing conviction that a well-diversified portfolio should be constructed with a global perspective.

As always, we invite our readers to contact us at any time to discuss this concept of globalization in greater detail.

The Economic and Market Environment

In Sum: Common stock prices around the globe rebounded smartly from the mid March 2009 lows. Government bond yields have increased (prices have moved lower) while corporate bond yields have declined (prices going higher) during the past several weeks. The Obama State Department introduced a more conciliatory tone towards those countries whose relationship with the United States deteriorated in recent years. In some locales (Cuba) this appears to be meeting with some success while elsewhere (Iran), not much appears to have changed. The passage of time will determine whether this diplomacy is working towards resolving conflicts more constructively. Global economies appear to be stabilizing following dramatic declines in the last half of 2008 and early 2009. Fiscal and Monetary policy continue to be focused on supporting such stabilization.

Geo-political: The Obama administration foreign policy team has deployed a general tone of conciliation to regimes long considered foes (Venezuela, Iran, Syria, Cuba) in an attempt to improve relations. Success can only be judged by subsequent developments over the next several months. In an ominous sign, however, North Korea recently launched a missile with an unknown payload, in defiance (again) of recently negotiated agreements not to do so.

Economic: In our February 2009 commentary, we noted that "While this economic contraction may be prolonged and painful, we do not believe we are entering a period such as the Great

Depression." A statistical review of such varied economic indicators including US Industrial Production, Retail Sales, Consumer Confidence, and Existing Home Sales seem to bear this out. Outside of the US, the outlook in China, Australia and the United Kingdom, to name a few, shows similar signs of stabilization. It is too early to suggest that all economic risks are abating, but so far the outlook is more promising.

Monetary: Interest rates in most developed and developing countries are quite low as dictated by their central banks. Commodity prices such as copper and crude oil have begun to move higher giving signals of potential inflation. Central bankers appear to prefer the task of calming inflation in the future versus battling current deflationary (falling prices) forces.

Fiscal Policy: The American Recovery and Reinvestment Act of 2009 was passed by the US Congress and signed into law by President Obama on February 17, 2009. This bill provides for $787 billion of new spending. The US Congress also approved a $3.4 trillion budget for fiscal 2010. Enough said.

Equity markets: Global equity prices have rebounded smartly from the lows of March, 2009. Considerable debate exists as to whether this rally is sustainable or merely a pause before a renewed decline. Valuations on common stocks generally appear attractive, and in the face of what appears to be an improving economic outlook with favorable implications for corporate profitability, we would suggest a constructive longer term outlook.

Fixed income markets: Interest rates on longer dated US government issued debt have begun to rise, suggesting both concerns over financing the federal deficit as well as concerns over the above noted inflation concerns. As risk appetites have improved, the difference in interest rates for US government debt versus corporate debt has begun to narrow.