knowledgeable thoughtful ethical experienced interactive

summaries

SIGMA INVESTMENT COUNSELORS

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Thoughtful Investing

Over the past year I have spent a significant amount of time with marketing professionals, graphic designers, and writers to update our marketing brochure, collateral materials, and website. Surveys were conducted in which we talked to both current and former clients and asked what they liked about us and what they didn't. Market positioning studies were done as well as analysis of our current materials. Approachable, knowledgeable, independent, proactive, experienced and personal was how clients, peers, and friends described Sigma. Working with this feedback, my challenge was to define what distinguishes us.

After much rumination, it was determined the unifying theme of our new collateral would be "thoughtful investing." This embodies our in-depth knowledge of our clients and their financial goals, as well as our approach to identifying creative solutions that meet their objectives. As part of this new undertaking, this newsletter has also been updated in both format and content.

Past *Sigma Summaries* have typically focused on one topic, and have varied between human interest stories and commentaries on investment topics. Going forward, each month we will feature, at a minimum, a summary of the economic and market environment. If appropriate, an investment related piece or a human interest piece, or both may be included. This is in response to readers' requests for increased investment content while keeping the personal nature of the newsletter. Most importantly, all content will remain written by the investment professionals at Sigma.

I'd love to hear what you think of our new format. Please don't hesitate to call or email me with feedback and suggestions. Also, check out the new look of our website at www.sigmainvestments.com, where you can find past issues of *Sigma Summaries*. Since inception in 1973, our *Sigma Summaries* have covered topics that our readers have hopefully found insightful, educational, and entertaining. We will strive to provide worthy content to keep you reading.

Marisa A. Lenhard, CFA

inside this issue

The Economic and Market Environment

In Sum: Despite geo-political tensions emanating from the Middle East, North Korea and South America, global economic growth continued unabated in 2005 as developed and emerging economies alike showed growth for the year. In the United States, growth was well balanced. The Federal Reserve Board continued to raise short term interest rates for most of the year to check potential inflation—particularly from rising energy prices—and longer term interest rates stabilized at about the same level as short rates. Widespread concern about the US budget deficit has Congress sensitized to this issue. Corporate profitability continued to improve broadly in 2005 but prices for most large company stocks proved range bound, while foreign, small and mid sized companies showed good price performance.

Geo-political: US troop withdrawal from Iraq will occur as soon it becomes evident that the Iraqi army can secure the country, according to the Bush Administration. Israel's Prime Minister, Ariel Sharon, has suffered a debilitating stroke, creating more uncertainty in Israeli/Palestinian relations. Iran recently announced a resumption of nuclear "research," an unsettling development North Korea continues to command nuclear attention, attempting to extract economic aid from the developed world. The South American continent bears watching with the leaders of Venezuela, Bolivia and Argentina making murmurings about adopting socialist policies. On balance, the geo-political environment appears to have deteriorated during the past twelve months with no apparent measurable economic impact.

Economic: China, India, and many Far East and eastern European nations are showing robust economic growth. Hurricanes Katrina and Rita devastated the gulf coast states in the US but did not materially affect the broad economy. The automobile industry is struggling, but construction activity has been buoyed the economy. In the fifth year or economic expansion, the US is progressing well with low unemployment and inflation.

Monetary: The Federal Reserve Board (Fed) has been raising short term interest rates for two years to keep inflation in check. Incoming Fed Chief Nominee Bernanke has indicated that he will continue the anti-inflation stance of the Greenspan Fed; however, recent Fed pronouncements indicate that interest rate increases may be coming to a close.

Fiscal Policy: Spending on Iraq and Hurricanes Katrina and Rita has stretched the resources of the federal government. Fortunately, the strong US economy in 2005 provided a boost to tax revenues. Fiscal spending restraint in 2006 and forward will be necessary, though.

Equity Markets: In 2003–2004 the equity markets showed broad price strength. However, 2005 proved to be a more subdued environment for large company share prices, while somewhat more dynamic for foreign, small and medium sized companies. Corporate earnings continued to advance broadly in 2005.

Fixed Income Markets: Rates paid on short and longer term bonds differ little at present. It would appear that either longer term interest rates are set to rise, or economic growth will slow, within the next several months. ■

Good Health and Prosperity

Over the past two decades there have been myriad investment "themes" spouted from the Wall Street seers. "Japan Inc." dominated in the early 1980s. The "peace dividend," following the collapse of the Berlin Wall in the late 1980s was that period's rage. Anything Internet was the craze in the late 1990s. The one constant theme echoed over and over again over the past twenty years though, has been the effect of the aging population. The chief notion of this demographic phenomenon is an aging population will consume an increasing quantity of health care services (demonstrated and known to be true) and will generate ever-increasing profits to the companies that make up the health care sector (not necessarily true).

Since its founding over thirty years ago, the investment professionals at Sigma have indeed spent considerable time researching health care stocks, and material client funds investing in these same stocks. Since it is our contention that health care investments will continue to occupy a significant portion of client portfolios, we felt it appropriate to devote this month's letter to a discussion of the factors that influence our decision-making as it pertains to health care stocks. Specifically, we will:

1. Talk about the different sectors that make up the health care industry
2. Discuss the broad factors that have impacted this sector in the last two decades
3. Articulate some of the factors that help us determine how we position individual investments in this segment of portfolios

Health Care Services Sector

The health care services sector encompasses some 14 industries available for investment. Some companies in these industries were formed in the middle of the 19th century (Pfizer, Inc.) while most saw their genesis in the late 1970s and early 1980s. Some, such as biotechnology and HMOs, only arrived on the scene within the last ten years. Companies primarily specializing in stem cell research, considered by many to be the leading edge of drug discovery, have only recently arrived as legitimate investments (www.stemcellresearchnews.com indicates that there are 27 public and 55 private companies engaged in stem cell research)!

Factors Impacting the Health Care Services Sector

In many developed countries (excluding the United States and a handful of others), nationalized health care has rationed services and regulated prices. Therefore, most companies operating in the health care sector have found that they can earn the bulk of their profits in the US.

The dominant, overriding factor influencing health care spending in the United States for the past four decades has been the third party payer system. Negotiated labor contracts made this benefit a stable of most labor agreements. Government agencies, principally Medicare and Medicaid, parallel this system.

It is easy to predict what happens to prices and costs when the consumer of the good or service is not the one paying for it—they skyrocket. When the population of workers in the US was young on average, and consuming relatively inconsequential amounts of health care services, there was not a problem. Today, it is a problem and concerns all participants—consumers, health care companies, health care providers and payers. Sensitivity to cost pressures has begun to precipitate changes in benefits covered under collective bargaining contracts, Medicare/Medicaid reimbursement rates, and health insurance policy coverage—mainly in the form of premium sharing, higher co-pays and higher deductibles.

Regulatory activities, principally at the Food and Drug Administration (FDA), have also proven challenging to the sector. For the past several years, the FDA has become more stringent in their requests for test data from companies that are evaluating new compounds, and this stringency has only intensified with the well publicized problems associated with Merck's recently recalled, FDA approved painkiller, Vioxx.

Litigation has also impacted the health care industry. Product failures, medical malpractice lawsuits against physicians and hospitals, and class action suits launched against publicly traded companies have forced virtually all providers to change the way that they do business.

The cumulative effect of these factors, as well as a host of other smaller issues, have forced all companies in the industry to examine their practices and adapt to a radically, and rapidly, changed environment. Some companies have profited immensely from these changes (HMOs and generic drug manufacturers) while others have suffered dramatically.

So, how should an investor position their health care portfolio?

Positioning Portfolios

Before launching into a discussion of current portfolio positioning, a bit of history is in order. From an investment standpoint, Sigma has generally invested only in health care companies that have solid balance sheets, generate strong returns on capital and are proven innovators. This means that we typically do not invest in start-ups, or companies that are unprofitable. As a result, while we will miss the periodic hot health care IPO, it also means that we generally dodge the myriad disasters.

During the 1970s, 1980s and 1990s the drug/pharmaceutical companies tended to most consistently exhibit the characteristics described above. As a result, the pharmaceutical companies dominated our investment portfolios. However, a major sea change took place in the early 1990s. Pharmaceutical companies were weak stock performers for the most part as investors preoccupied themselves with concerns over price

Good Health and Prosperity continued

controls on prescription drugs. Companies in other health care industries began to come of age, and it became apparent that diversification for Sigma portfolios was in order.

As a result, in the decade ended 2005, Sigma's client portfolios were materially altered in order to garner exposure to companies in the biotechnology, medical device, hospital, diagnostic and generic drug industries.

These investments were selected (and future investments will be selected) for further analysis based upon two primary criteria: 1. Our determination that the companies under review could sustain their growth in sales and earnings or 2. Our conviction that a turnaround was underway at a company that previously had been struggling. From a screening perspective, we were, and are, attuned to companies that provide solutions to the health care challenges described above.

As an example, it has been well documented that pharmaceutical spending represents a significant proportion of overall health care spending on a global basis. While we believe firmly that the lifeblood of any pharmaceutical company is its new product pipeline, born of research and development spending that can only be funded with profits, we recognized that the pricing environment for this industry had become challenging. One obvious solution was generic drugs.

Unfortunately, for most of its short history, the generic drug industry has been characterized as one with a host of players that rarely could sustain prosperity. However, through our internal research process we became familiar with a company that seemed to betray that reputation—Teva Pharmaceuticals. At the time we became interested in the company in early 2005, the valuation looked compelling, and the earnings history was also impressive. We elected to invest in this company on behalf of many of our clients.

Quest Diagnostics was another company that caught our attention in early 2004, for similar reasons to Teva and for which we purchased the stock for many clients. We noted that many health insurers were bemoaning the fact that some of the costliest procedures that they were paying for would have been much less costly if the problem had been diagnosed earlier. Clearly Quest, as the largest provider of medical testing services in the United States, was in a position to benefit if physicians began ordering more tests for early detection. While the surge in preventive diagnostic tests has not yet materialized as we expected, illegal substance detection testing for employers has led to increased testing. This, in conjunction with more gene based testing (which carries much higher profit margins for Quest) resulted in the company achieving our earnings expectations. Quest's low cost model has also allowed the company to win market share from smaller labs. We still expect preventive diagnostic tests to increase over time, leading to further sales and earnings gains.

Finally, we recognize that the patient Electronic Medical Record will come to fruition within the next decade—embraced by hospitals, physician practices and clinics. There is widespread agreement by the medical consulting community (but fewer physicians) that information technology (IT) expenditures will increase efficiency in the clinical setting while also improving medical outcomes.

There are ways to invest directly in the health care IT sector via companies such as Cerner Corp, but the stock prices for many of these companies seem to excessively value future sales and earnings. Nonetheless, some larger companies that we have invested in, such as IBM, General Electric and 3M, do have material resources devoted to facilitating a computerization of the clinical setting.

Summary

The challenge to investing in the health care industry is one in which the investment professional has to be keenly aware of the constantly changing health care environment, and also be sensitive to the impact on a company's sales and earnings. We believe that by maintaining a dedicated research effort focused on this industry, and by employing rigorous analytical valuation techniques, we will be able to capitalize on opportunities. ■

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