Sigma Investment Counselors

Sigma Summaries

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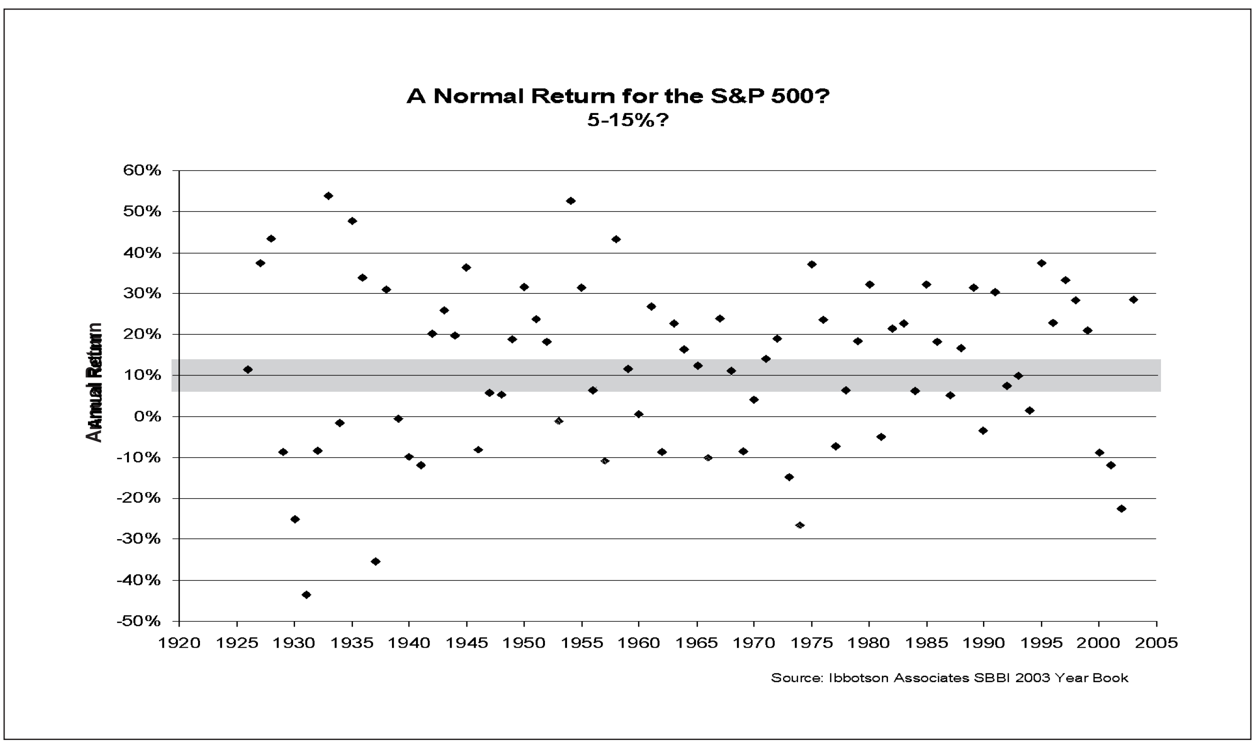
A Return to Normal

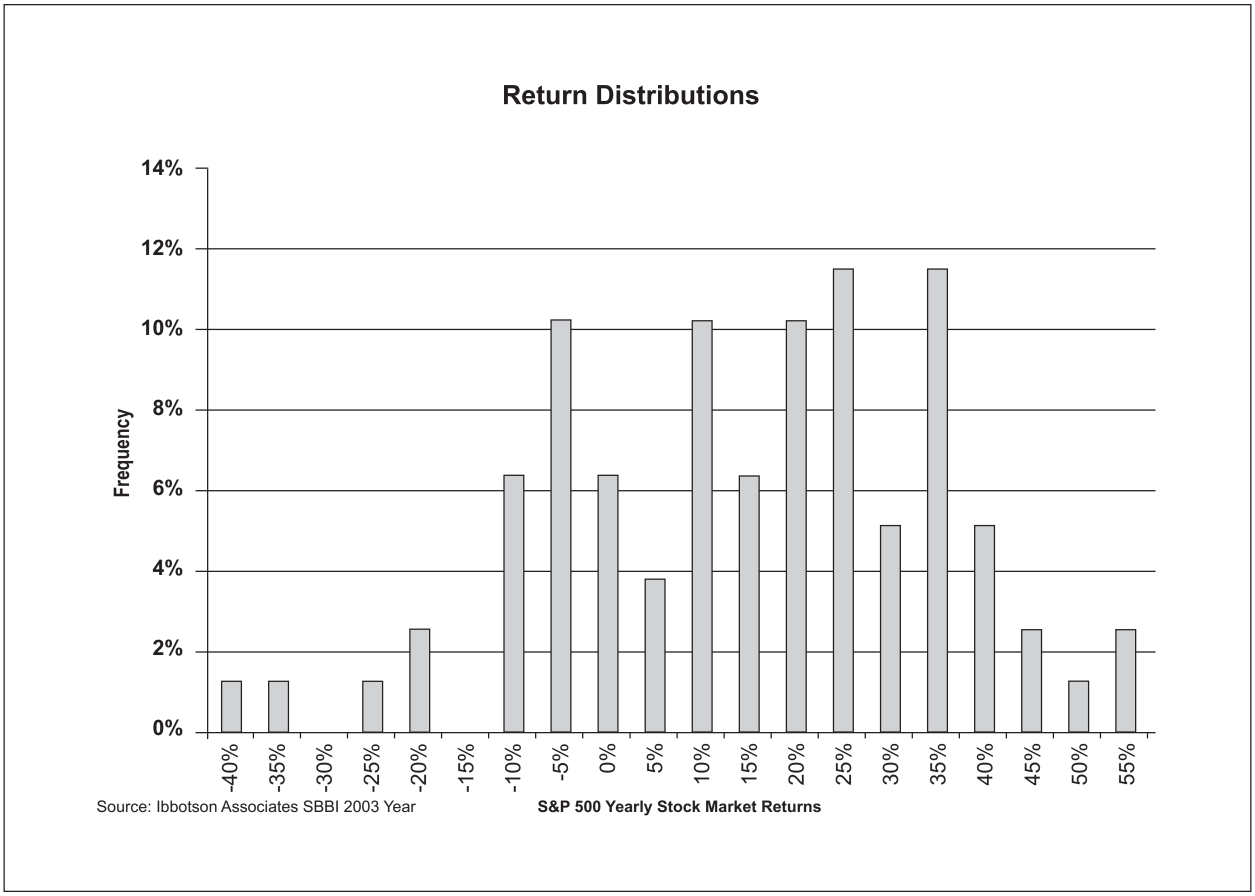
My brother recently went to see his company's 401-K consultant. He was telling me that this expert told him that his account was appropriately allocated for a return to normal markets. I asked my brother what this expert considered "normal". He replied that a stock market return between 8%-12% for the year would be considered "normal". Something bothered me about that statement. I began to wonder if I have been suffering from the Chinese curse to "live in interesting times," because I only vaguely remember the last time the market had a return in that range. I decided to take a look at some historical numbers, because I didn't want the recent past to color my judgment going forward.

In 1993, the market did indeed return 10.0% for the year. However, the last time the market had a return within that range prior to 1993 was 1968. Apparently, we've all been afflicted by the Chinese curse. Volatility in the markets is the norm, not the exception. The following chart shows what the stock market returns have been for each year starting in 1926. The shaded band is a slightly larger range than my brother's expert consultant used (5% -15%). Even still, not many dots fall within this band. In fact, the returns appear very random from year to year. The last ten years of "abnormal" returns do not stand out at all.

Another way to view the same data is to show the frequency with which you might expect a certain range of returns. The following graph shows incremental 5% ranges of returns starting with the –40% to –35% range and going all the way up to the 50% to 55% range. If the market's future is anything like its past 77 years, then it is just as likely to earn anywhere in the -5% to 35% range.



26261 Evergreen • Suite 455 • Southfield, Michigan 48076 • (248) 223-0122 • Fax (248) 223-0144

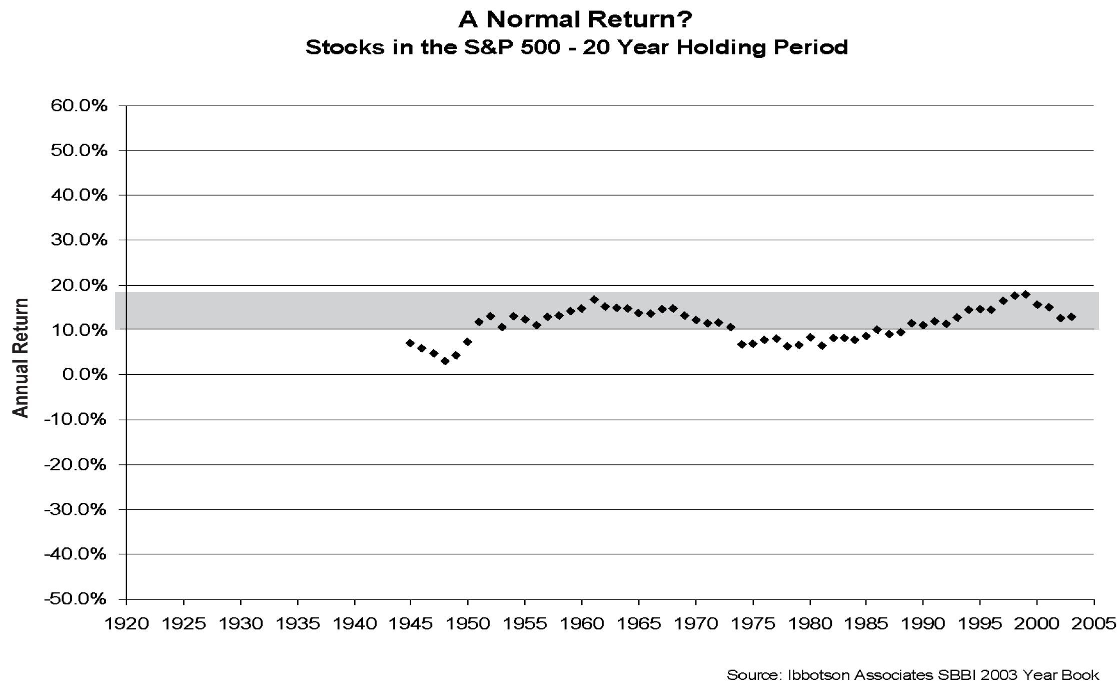


Making plans based on those rather wide ranges may seem a bit daunting, but surely returns are not random. My college professors taught me that the market is a rational trading mechanism that incorporates all relevant news items. I've reviewed some of the top headlines for 2003 and compared those headlines with the year to date returns for the S&P 500 at the time of the headline (see back page). There was not a lot of good news in the first nine months of the year. The news wasn't even just a little bit bad; it was terrible. We saw unemployment reaching 9-year highs, we witnessed suicide bombers with increased frequency, we fought a war with a major Middle Eastern foe, and we increased our budget deficits to levels not seen in over a decade. This was on top of the fact that the market had fallen for three straight years. Yet somehow, through all of this, the market kept rising. The markets do try to look forward, and apparently, the predicted relatively good news of the past three months of the year began to get priced into the stocks throughout the year.

How does one make predictions when the market seems to be so random? How can one make a sound financial plan investing in an enormously volatile market? Why have we been taught that the stock market is such a great long-term investment vehicle if it appears to just follow a random walk? The key phrase to remember is "long-term". Over long periods of time, the market acts a lot less random than the yearly numbers suggest.

Let's look at the first graph again, but with a holding period of twenty years instead of just one. Now, nearly all of the observations fall within the 5-15% shaded region.

Thus, the key to establishing a sound financial plan is to make sure you are thinking about the appropriate time horizon for your investments and to balance your need for growth with your ability to tolerate the random gyrations of the market. In his book, *Investment Policy*, Charlie Ellis best sums it up. He writes, "The perspective within which to test yourself is not from the calm armchair of the market historian who can see 'how it all worked out.' Instead, you'll want to think very carefully about the way you would feel and might react to the dreadful experience of a severe bear market at its worst moment, when the next stage is not known and may even be worse!"[1]



We all have now had the "benefit" of seeing a severe bear market. Think about how you felt during some of the lows. It's best to set your target allocation to stocks based on your honest assessment of how you felt near the end of 2002 and not on how well you are feeling based on the past year's recovery. This insight might help you think about long-term investing and the more predictable returns that come with it. Then you'll have the fortitude to sail through the yearly highs and lows as you keep your eyes on the relatively calm and stable horizon of long-term investing.

Written by:
Anthony D. DiGiovanni, CFA

[1]Investment Policy – How to Win the Loser's Game, Charles D. Ellis, 1985 pg. 71.

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

2003 Year in Review[1]

Headlines vs. S&P 500 Return

		YtD Ret.
1/15	Expected Deficit $200B for 2003	+4.4%
1/28	Bush Presents Case for War in Iraq	-2.4%
1/30	Shoe Bomber Sentenced	-4.0%
2/1	Space Shuttle Explodes	-2.2%
3/5	Suicide Bomber Strikes Bus	-5.6%
3/7	Large Job Losses Recorded in February	-5.7%
3/20	War in Iraq Begins	-0.4%
	US Troops Strike in Afghanistan	
4/9	Baghdad Falls	-1.5%
4/10	National Alert System Created	-0.9%
4/28	Wall Street Firms Settle with U.S. $1.4B Fine	+4.0%
5/1	Combat Over in Iraq	+4.2%
5/2	Unemployment Ticks Up to 6.0%	+5.8%
5/12	Suicide Blasts Kills Dozens	+7.5%
5/20	Mad Cow Discovered in Canada	+4.6%
5/28	$350B Tax Cut Bill Passes	+8.4%
6/4	Martha Stewart Indicted	+12.2%
6/6	Unemployment Hits Nine-Year High (6.1%)	+12.3%
6/21	Harry Potter Flies off Shelves	+11.6%
6/25	Fed Cuts Rates – Lowest Since 1958	+10.9%
7/3	Unemployment Hits Nine-Year High (6.4%)	+12.1%
7/8	Microsoft Ends Options Program	+14.6%
7/14	North Korea Announces Plan for 6 Nuclear Bombs	+14.2%
7/15	Expected Deficit $455B for 2003 or 4.2% of Economy	+13.8%
7/22	Hussein's Sons Killed	+12.4%
7/28	Two Banks Settle in Enron-Related Case	+13.3%
8/12	Virus Attacks Computers	+11.5%
8/14	Massive Blackout Darkens Northeast and Midwest	+11.9%
8/19	Devastating Suicide Bombing Threatens Peace Plan	+14.0%
9/7	Bush Seeks $87B to Help in Iraq	+17.3%
9/10	Bin Laden Appears on Videotape	+15.0%
9/17	NYSE Chairman Steps Down	+16.7%
9/26	Number of Americans Living in Poverty Up to12.1%	+13.4%
	Uninsured Americans Increased to 43.6 Million	
10/5	Employment Increases for First Time Since January	+17.6%
10/7	Davis Out, Schwarzenegger In	+18.2%
10/31	Economy Rebounds in Third Quarter +7.2%	+19.5%
11/6	Unemployment Declines to 6.0%	+20.3%
11/22	Congress Passes Medicare Bill	+19.6%
12/1	US Manufacturing Figures Rise	+21.7%
12/4	Bush Reverses Steel Tariff	+21.1%
12/5	Unemployment Falls again to 5.9%	+20.7%
12/13	Hussein Caught	+21.5%

[1] Source: www.infoplease.com/spot/03yearinreview.html