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summaries

SIGMA INVESTMENT COUNSELORS

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Beyond Comparisons

In our November 2008 newsletter, we introduced the topic of selecting appropriate equity indices for benchmarking purposes. Benchmarking with indices is using an index as a comparison to gauge a portfolio's performance. We began with a review of the Dow Jones Industrial Average and Standard & Poor's 500 index*. While these are perhaps the two most cited indices for domestic equity performance, they are distinctly different, both by composition and in the methodology used to measure returns. For benchmarking purposes, the S&P 500 is widely considered the superior index and is perhaps the most often cited index to measure domestic equity performance.

Equities are generally categorized by country and/or by market capitalization (number of shares of stock times the price of a share). In November, we discussed the globalization of equity investments where mid cap, small cap and international stocks are now playing an increasingly larger role in diversified portfolios. Through the use of exchange traded funds (ETFs) and related securities, investors can readily invest in a large array of investment classes such as country-specific funds, commodities and currencies.

As investment choices have grown over the past decade, Sigma has used this opportunity to compliment our core large cap equity portfolios with additional asset classes. Our portfolios include not only large U.S. companies, but also smaller and medium sized U.S. companies, as well as various sized companies located throughout the rest of the world.

Our attraction to these other asset classes is due to the fact that market segments do not always move in tandem with one another. This lack of synchronization provides additional levels of diversification. The volatility (risk) of a properly diversified portfolio tends to be less than the average volatility of each individual security. A successful diversification strategy may be able to enhance the returns and lower the volatility of a portfolio when measured over a multi-year period.

If a portfolio is comprised of securities from multiple asset classes, the use of a single index such as the S&P 500 for benchmarking purposes may not represent a suitable comparison. For example, consider a portfolio that is comprised of 60% large cap domestic stocks, 20% in international stocks of developed markets, 10% in mid cap domestic stocks and 5% in both emerging markets as well as small cap domestic securities. While the S&P 500 may serve as a suitable benchmark for the 60% exposure in large cap domestic stocks, the S&P 500 is likely to be less correlated to 40% of the remaining portfolio.

We have chosen to deal with this issue by adding two additional indices to our quarterly performance reports. The first benchmark that we are including is the S&P 600 Small Cap Index. This index is a market cap weighted index that covers approximately 3% of the domestic equities market. It currently tracks publicly traded U.S. equities with capitalizations in the range of $200 million to $1 billion.

The other benchmark is the MSCI EAFE (Europe, Australasia, and Far East) Index. This is also a market cap weighted index and is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. This currently consists of twenty one countries across the globe.

With the addition of a small cap and international index to our quarterly reports, we feel that we have taken a significant step in the right direction, but our work is not yet complete. The solution highlighted above does not take into account other market segments that we are currently using or may use in the future. As we further refine this process, our goal is to provide timely and relevant data to assist in the evaluation of relative performance, favoring simplicity and transparency over complexity whenever possible.

In a previous newsletter, we also reiterated the importance of achieving one's absolute and risk-adjusted returns over the pursuit of achieving positive relative performance. As an extreme example, consider the market returns of 2008. Where many investors saw declines of 40% within their equity portfolios, it would be doubtful that an investor who lost only 30% would take much comfort in this favorable relative performance.

Our goal as investment advisors is to ascertain what the required risk adjusted returns are for each of our clients and to build a portfolio to achieve those results. We recognize that most investors likely fell short of their absolute goal last year given the extraordinary nature of the capital markets. However, over a market cycle, there is no reason that most of our clients' absolute returns cannot still be met. Our goal is to help our clients understand their risk tolerance, build a financial plan using reasonable and attainable assumptions, and help our clients stay the course during periods of extreme volatility.

In closing, we wish to invite our clients to provide us feedback on the usefulness of the additional benchmark information on our quarterly reports. We believe that we are ahead of the curve in this area and we will remain vigilant with other ideas to provide timely and relevant tracking information for the benefit of our clients.

A Little Fiduciary Responsibility Goes a Long Way

In the wake of the Bernard Madoff scandal and other abuses within the financial services industry, there is a growing initiative underway in

Washington on how to best regulate fee-based registered investment advisors (RIAs) and commission-based broker-dealers. This task is complicated by the fact that RIAs are primarily regulated by the Securities and Exchange Commission (SEC). They are also governed by laws set forth in the Investment Advisers Act of 1940. In contrast, the brokerage community is regulated by both the SEC and its own self-regulatory organization known as the Financial Industry Regulatory Authority (FINRA), and subject to the Securities Exchange Act of 1934.

The significance of these distinctions rests in the obligations the RIA and the broker have to their respective clients. For example, the RIA has a "fiduciary" responsibility to put the client's interest ahead of its own. In addition, all potential conflicts of interests must be fully disclosed in Part II of the investment advisor's registration statement (Form ADV). A copy of this document is offered to the client on an annual basis. In contrast, a broker is only required to recommend investments that are "suitable" for their clients. Broker documentation of potential conflicts of interest is not always required.

This is not to suggest that RIAs categorically provide better advice than brokers. It does raise questions about whether the advice rendered by the broker is truly independent and in the best interest of the client. There can be a high correlation between a product's expense ratio and the broker's commission. For example, there may be an instance where a broker is recommending the purchase of a mutual fund or insurance policy to meet a stated goal. This fund or insurance policy may be suitable for the client but there may be other funds or policies that would provide similar benefits at a lower cost. The client may not be provided information on less costly alternatives.

The SEC and FINRA have expressed their desire to remove the differences and require the same rules for both the RIA and broker. However, as is often the case in politics, there are issues surrounding power and control. The SEC believes it is best suited to govern, citing its power to enforce the "fiduciary" relationship that exists between the RIA and client. FINRA believes it is better equipped to conduct frequent audits and its "suitability" standard is sufficient.

There is agreement among members of the SEC and FINRA that more audits are on their way, particularly for RIAs. Past audit cycles for RIAs have been as long as five to ten years versus a maximum of two years for broker-dealers. Given the high costs associated with these audits (now paid by taxpayers), there is also discussion that advisors may be required to pay for the cost of independent audits. It is likely more attention will be placed on the importance of the compliance effort. There is discussion of placing greater accountability on a senior officer within each company to vouch for the adequacy of the firm's internal controls. This is similar to the Sarbanes Oxley Legislation of 2002, requiring senior executives of public companies to attest the validity of internal controls and financial information released by the company.

Another change we believe may be forthcoming is the SEC may elect to contact clients and other third parties directly to verify the account balances on clients' statements. This more rigorous audit procedure will likely occur in routine audits as a means to protect the clients' best interests and to reduce the chance of fraud.

Sigma takes a very proactive stance with regard to our compliance activities. It is a part of our culture and a process that receives continuous attention from all members of our staff. We are a registered investment advisory (RIA) firm and use multiple third-party broker-dealers (primarily Schwab and Fidelity) to custody our clients' assets. This arrangement allows for "checks and balances" which are not always readily apparent with a traditional commission-based broker-dealer industry. We are closely monitoring developments in Washington that protect our clients' best interests and will embrace any forthcoming decisions.

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