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summaries

SIGMA INVESTMENT COUNSELORS

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All The Best to Sigma's "Woman up Front"

Many of you have had the pleasure of meeting, or speaking on the telephone to our resident comedian and administrative professional, Mary Wilson. No, not that one, but she is Supreme! Mary retired this August after 10 years as Sigma's "woman up front" greeting clients and guests when they arrived at our offices or when they called on the phone. Over the years we have received countless compliments on Mary's helpfulness, charm, and wit. We wish her many years of good health and joy as she exercises her well deserved retirement to spend more time with her family and significant other Joe. You will always occupy a special place in our hearts, Mary!

Fixed Income Focus

Most investment portfolios are comprised of cash, stocks and bonds. Whereas cash, or money market funds, provide a stable source of liquidity, stocks are expected to generate enhanced returns over a market cycle. Admittedly, in recent times, stocks have not lived up to this billing. Bonds, or fixed income securities, on the other hand, are generally viewed as safe investments, offering returns greater than money market funds but less than common stocks. These fixed income investments are typically included to provide an "anchor windward" to the portfolio, generate income, and perhaps, provide a future source of cash flow at the time of maturity.

In recent times, however, the fixed income landscape has changed dramatically. First, there has been a proliferation of fixed income securities, many of which have characteristics that are anything but safe and secure. Unfortunately, it took a market crisis to expose the risks inherent in many of these investments, and the damage may not be over.

For example, imagine that an investment bank owned a diversified loan portfolio. This loan portfolio may represent car loans, mortgages, liens on property and equipment, or other hard assets that serve as collateral. Moreover, assume that these loans had varying maturity dates between one and thirty years. Also assume that these loans varied in terms of risk, meaning that the risk of default was low for some of the loans and high for others.

Now, imagine a scenario where the investment bank divided the loan portfolio into various segments, or tranches'. One tranche may include the portion of loans that were rated investment grade whereas the other may represent the lower quality loans. As one would imagine, the lower quality tranche would receive a higher yield than the higher quality one where the risk was perceived to be lower.

Rather than sell the portfolio outright, imagine a scenario where an investment bank manages this portfolio in-house yet sells an ownership interest to other investors. As interest payments are made and the loans mature or default, the investors receive their share of the interest income, return of principal and/or capital loss, based on an agreed upon mathematical model that dictates who gets what, when. In doing so, the investment bank earns a commission at the time of issue and earns a management fee during the life of the loan portfolio. The investors receive an above average risk-adjusted yield on a diversified portfolio of asset backed fixed income assets.

Next, consider the possibility that the investment bank borrows money to increase the number of loans in the portfolio, thereby further enhancing the yield. Moreover, with the purchase of credit insurance, the investors' perceptions are that the portfolio may be at least partially protected in the event of defaults from some of its underlying credits. Thus, investors believe they are receiving above average returns at below average risk.

In this complex chain of events, the investors' risk and reward are not directly tied to the quality of the underlying assets. Instead, their risk and reward is more closely tied to the mathematical formulas and assumptions that are associated with their tranche. Thus, while the underlying portfolio may

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be asset-backed, there is not a direct correlation between the value of the tranche and the underlying asset base.

In retrospect, this investment strategy worked well during a period of economic prosperity, low interest rates and easy credit. However, this style of investing self-destructed once the economy faltered, the incidents of bankruptcies rose, the credit market shut down and yields increased.

As loans soured, the value of the portfolio fell and interest income declined. This negatively impacted both the investment bank and the investor. The demand for these products dried up and banks are now incurring large losses as they write down the asset values of these securities, forcing them to raise capital from outside investors to rebuild their balance sheets, thereby diluting existing shareholders' value.

The example highlighted above was meant to describe a collateralized debt obligation security, or CDO. This is one of the most common and highly popular synthetic fixed income securities that are now creating havoc within the bond market. Unfortunately, there are a myriad of other fixed income securities that are just as risky and contributing to the current financial crisis.

There are many reasons why the formerly staid and boring fixed income marketplace became such a risky sector in which to invest. For one, investors became greedy and demanded increasingly higher returns on their fixed income investments. No longer were investors willing to accept seemingly paltry returns of 4%, 5% and possibly 6% on their fixed income investments. Instead, investors wanted high single digit returns that are often associated with equity investing.

Investment bankers had a vested interest in creating a seemingly endless variety of bond like securities that provided attractive cash flows and above average yields as they received a commission upon the sale of the security and often received an ongoing fee for managing the underlying pool of assets.

Sadly, but not too surprising, few investors took the time to look under the hood of these investments to really understand what they were buying. Had they done so, they may not have even understood the fine print given the complexity of the securities, and if they truly understood the risks, they would have likely stayed away from many of these investments.

It recently became clear that even the rating agencies, including Moody's and Standard & Poor's, did not provide proper due diligence on many of these investments and they too did not accurately identify the associated risks.

Fortunately, Sigma did not invest client funds in these complex securities and, with the exception of some issues whose quality deteriorated after purchase due to collateral damage from the sinking fortunes of less than creditworthy borrowers, sidestepped most of the damage.

In the municipal bond arena, client portfolios have very high credit ratings; most are general obligation bonds, which are generally preferred over revenue bonds, and many have additional protection given existence of bond insurance. However, even if this insurance proves to be lacking, the underlying credit quality of the municipality, as a general rule, is still quite strong.

Interestingly, the incidence of default by municipalities has historically been quite low. Combined with the fact that so many municipal bonds are also protected by insurance, there simply wasn't the need to spend too much time worrying about the safety of an investment grade municipal bond. However, times have changed. First, as real estate values have fallen materially in recent times, real estate taxes are also falling, thereby reducing the tax revenues of many municipalities. Poorly managed municipalities may find themselves strapped as they wrestle with the negative impact of falling revenues and rising costs.

Compounding matters, many of the specialty line insurance carriers that provide coverage on municipal debt are not fiscally sound companies. Thus, if several municipalities were forced into bankruptcy within a fairly short time period, it is questionable whether the insurers would have enough capital to fully protect the interests of the investor. Thus, it is now necessary to spend an increasing amount of effort evaluating the creditworthiness of the municipalities as if no insurance ever existed. Thus far, it would appear that clients municipal bond holdings are sound and that obligations will be met, despite the financial troubles facing the insurance carriers.

By addressing these issues, Sigma wishes to convey the message that the firm has a fairly robust fixed income effort. In fact, over the past several years, Sigma has invested significant resources to strengthen and enhance its fixed income department. This includes the appointment of Cheryl Kotlarz to the role of Sigma's Fixed Income Manager, with oversight by Chief Investment Officer, Denise Farkas, CFA. Sigma's research effort and trading platforms have also been upgraded. Finally, the firm's network of bond dealers around the country has been materially expanded which improves market intelligence, expands investment choices and enhances the firm's competitive position when negotiating trades for clients.

Finally, Sigma recently updated and enhanced its fixed income policy guidelines. They are reproduced below for readers review.

Fixed Income Philosophy

The purpose of fixed income portfolios is to provide returns above inflation and taxes so that purchasing power is preserved over the long term. Principal preservation, certainty of principle value at maturity and certainty of ongoing cash flows is of paramount importance. Our clients do not desire to take undue credit, interest rate or other risks (ex: concentration risks, liquidity risks, etc.) in the fixed income markets.

Fixed Income Strategy

Our approach to building fixed income portfolios addresses both the goals and constraints of our philosophy as well as the unique needs and circumstances of our clients. This is accomplished though a diversified ladder of fixed income securities designed and constructed through an analysis of several factors in order to structure the portfolio for an optimum balance between risk and return. For smaller accounts, bond funds may be used to achieve the desired diversification in a cost effective manner.

Credit Risk

We do not wish to be exposed to substantial credit risks within client bond portfolios. Translation: There is a both a capacity and a tolerance to accept returns above treasuries. However, there is no free lunch. Where there is increased return, there is increased risk, whether real or perceived. While from time to time we may find pricing opportunities, reaching for yield to meet client needs is not our primary intent. This means we must continue to be intellectually honest with both clients and ourselves about expected returns from the bond market. For those clients who have indicated an appetite for increased yield, they too, must understand that with increased opportunity for return comes with increased risk.

Portfolio structure should be implemented in a consistent manner while at the same time ensuring that clients' unique needs and preferences are considered and incorporated in the portfolio design.

Interest Rate Risk

In a laddered portfolio of high quality bonds, we can reduce the interest rate bet inherent in the structure of the portfolio by simply extending the ladder in a consistent and uniform fashion. We may deviate from this strategy if the yield curve provides a compelling reason to do so. However, we do not want the bond ladder to become so lopsided that performance could be materially and negatively impacted if our interest rate bet did not play out as expected.

Diversification

The concept of diversification is just as important in our bond portfolios as it is in our stock portfolios. Thus, we intend to diversify our portfolios by industries and sectors when dealing with corporate bonds and we are seeking geographical diversification within our municipal bond portfolios unless instructed otherwise by our clients.

The Economic and Market Environment

In Sum: The see-saw pattern of common stock prices continued through late summer. Interest rates have held steady as the positive impact of falling energy prices is currently weighed against the consequences of Russia's recent military foray into neighboring Georgia. Economies in most developed and developing nations are showing signs of persistent sluggishness and no longer have the tonic of declining interest rates. Nonetheless, securities markets will soon begin to discount the likelihood of improving economic growth.

Geo-political: Add Georgia, the country, and Russia to the roster of "actors" on the rapidly changing geo-political stage. Armed conflict in early August erupted in the border town of South Ossetia, a Georgian republic said to identify more closely with the Russians versus the Georgians. Nonetheless, the west quickly condemned Russia's military intervention. Of more importance, analysts are attempting to gauge the motivations and ambitions of a newly industrialized and wealthy Russia. The renewal of Russian global prestige has been built upon a resurging, energy dominated economy and this facet suggests that, unlike the unpredictable actions of those rogue countries led by religious zealots, continued global pressure and the threat of economic disruption will prompt Russia to temper its military activities.

Economic: Headlines in the major global daily newspapers point to a generalized continued weakening of global

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

economic growth, save for China. The Financial Times of London, August 12 issue: US Mood Contrasts Sharply with Eurozone Gloom [pertaining to the strengthening US dollar]; Singapore and Malaysia Struggle as US Stalls; Japanese Property Feels the Pinch; Wall Street Journal, August 12 issue: U.K. Data Show Signs Inflation is Easing [primarily due to a contraction in retail sales]; China's Power Woes Threaten Growth. With the recent rapid easing of energy prices, economic growth may get a prop in the near term, and with stable prices, should contribute to a reacceleration in growth over the longer term.

Monetary: The Federal Reserve Board continues to exercise caution in the conduct of monetary policy, leaving interest rates unchanged again at its late July meeting. Central bankers from other nations have cited inflation concerns as dominating their deliberations and have made the prospects of further material easing that much more unlikely. As mentioned above, falling energy prices provide some relief in inflation pressures.

Fiscal Policy: The thrust of near term fiscal policy in the US becomes clouded until the outcome of the presidential election is known. Even then, campaign rhetoric gets weighed against practical reality, and it will be several months into the new year before conclusions about taxation and spending priorities can be drawn.

Equity Markets: Equity prices have see-sawed throughout the year, bottoming in March and then rising through the spring, only to skid again in late June and early July to test the March levels, with a recovery into August. Most of the movements were lockstep reactions to sentiment that has been heavily influenced by the unfolding (and worsening) global credit crisis and the whipping action of energy prices. Both factors are major ingredients in determining near term economic prospects and corporate profitability. Notwithstanding the current pessimistic outlook, given the sharp and sustained decline in stocks the world over, it would still seem likely that the next major move in global equity prices is up.

Fixed Income Markets: Interest rates paid on government and investment grade corporate bonds remained relatively stable during the past several weeks. The decline in energy prices have been tempered by expectations that economic growth may firm.

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