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summaries

SIGMA INVESTMENT COUNSELORS

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Ponzi Schemes

In December of last year, Bernard Madoff was arrested by the FBI for allegedly master-minding one of the largest Ponzi schemes on record. A Ponzi scheme represents an illegal investment operation whereby investors believe that they have earned an extraordinary return on an investment. When an investor receives a cash payment reflecting this "return", the payment is actually the cash or principal that has been deposited by other investors. As long as the flow of money that is coming into the portfolio is greater than the amount that is flowing out, this scam can continue indefinitely. However, when the manager is unable to attract new deposits to offset withdrawals, the scheme quickly unravels.

What is stunning in the Madoff Ponzi scheme is the size of the fraud as well as the duration of the alleged scam. For example, initial estimates have suggested that investors may have lost as much as $50 billion in this scheme. Moreover, it appears that this scam had continued for more than a decade and possibly two decades, a rarity in cases like these. Finally, it was alarming to learn the large number of seemingly sophisticated investors who lost money in the deal. Clearly, there was a lack of due diligence and checks and balances by those involved.

Following the disclosure of the Madoff scandal, quite a number of other Ponzi schemes and related scams have come to light. In such an environment, Sigma is proud of its investment operations and the safeguards that are in place to protect its clients from similar fraudulent activities.

First and foremost, Sigma does not "hold" any client assets, nor does it produce year-end 1099 tax documents. Instead, the assets are held in SIPC-insured brokerage accounts, with firms such as Fidelity Investments and Charles Schwab and Company. These third party custodians provide daily pricing, monthly statements and year-end tax reports. Moreover, while Sigma employees can request that client funds be distributed directly to the client, in most circumstances Sigma does not have direct access to client funds or securities. Procedures are in place at Sigma as well as at the custodian firms to prevent access for misuse or manipulation.

True, Sigma does provide quarterly statements, website access, etc. However, the third party custodian providers facilitate the data feeds received. Sigma clients can easily reconcile Sigma statements to their own custodian statements.

Another important distinction is that Sigma's clients can "see" what they own. Clients can monitor transactions within their accounts and view their holdings, which are priced daily. For Bernard Madoff's clients, their assets were not as

transparent. Instead, he purportedly "cooked the books" and did not provide full disclosure to his clients. Thus, clients were dependent upon Madoff to tell them how they were doing. Investors, who chose to withdraw their assets before this fraud became public, were paid out with money from new investors, not from the growth in their investment. Early defectors from Madoff funds were made whole with other people's money, creating the appearance that the stated returns were real.

Equally distressing, the SEC failed to follow up on complaints filed against Bernard Madoff as far back as 1999. Notably, the SEC has audited Sigma twice in the past nine years, most recently in 2005. Each audit is conducted onsite and can last from several days to about a week; no stone is left unturned. By design, Sigma commits substantial efforts to its compliance obligations. Chief Compliance Officer, Cheryl Kotlarz, leads the entire charge. Irrespective of the degree of enforcement, Sigma attempts to conduct itself with the utmost ethical standards. To this day, Sigma's compliance effort remains an integral part of our culture as the firms staff continues to evaluate processes and procedures to insure that the organization is conducting its operations in an appropriate manner and maintaining clients' interests ahead of its own.

As is always the case, we invite clients and guests to call if they have any additional questions regarding this sensitive subject or if we can be of assistance in any way.

The Economic and Market Environment

In Sum: With the unfolding severe global economic downturn, heads of state around the world are singularly focused on adopting measures to bring stabilization. Diplomacy in foreign relations is largely centered on coordinated policy actions. Three facets of the present environment bear watching: monetary policy, fiscal policy and trade policy. Global equity prices remain weak, while debt of credit-worthy sovereign nations is the primary object of investor demand.

Geo-political: Geo-political concerns in the short term are taking a back seat as policy makers around the globe are riveted on finding solutions to economic concerns. U.S. Secretary of State Hillary Clinton has turned her early sights on China (an important economic partner) and North Korea (in China's backyard) for diplomatic patronage.

Economic: While this economic contraction may be prolonged and painful, we do not believe we are entering a period such as the Great Depression. Rather, we believe that the consumer is in hibernation, stung by his sudden loss in net worth and lack of job security. This sudden change in circumstances has resulted in an equally sudden decline in both discretionary and non-discretionary spending. However, non-discretionary spending on such things as food, basic health care, education, transportation and shelter cannot be curtailed forever. Moreover, big ticket discretionary

purchases for such things as automobiles, appliances, major home repairs, etc. should be positively impacted by the underlying replacement demand for these goods and services. Finally, the consumer will one day return to discretionary spending, unwilling to put off that vacation, dining out and buying non-essential clothing and miscellaneous household items.

The massive stimulus package is meant to hold this fragile economy together until the underlying organic demand, highlighted above, can take root. Our analysis suggests that we won't see signs of this recovery until the end of 2009 or early 2010, at the earliest.

Trade policy also bears watching. Most economists agree that trade barriers erected in the 1930's exacerbated the downturn. Murmurings of trade restrictions have surfaced although a pronouncement from the recent G-7 Global Finance Ministers Summit in Rome explicitly addressed the need for nations to avoid protectionism. At the summit, U.S. Treasury Secretary Timothy Geithner commented that "All countries need to sustain a commitment to open trade and investment policies which are essential to economic growth and prosperity."

Monetary: Central bankers around the world have pushed interest rates lower and provided massive amounts of financial liquidity to spur lending. In addition, bailouts and the backstopping of commercial lenders' problem loans have enabled financial institutions to modestly increase credit expansion.

Fiscal Policy: In the U.S. alone, a nearly $800 billion stimulus measure was recently passed by both Houses of Congress, and President Obama is expected to promptly sign the bill. About 25% of the spending is expected to make its presence felt in the economy within a few months.

Equity Markets: The global equity markets have been locked in a protracted bear market that began in late 2007. The activity since late November has been within a trading range where market lows continue to be retested. The more times market lows are successfully tested, the stronger the indication that a base is forming from which the markets can progress higher.

Fixed Income Markets: U.S. Treasuries are sporting generationally low yields, and virtually all other non-insured, non-government backed instruments carry materially higher interest rates as investors continue to shun risk. That said, credit markets are beginning to thaw as demonstrated by the reduction in rates in higher quality corporate and muni bonds.

The views in this publication are as of February 2009 and are for informational purposes only. Keep in mind that each sector of the market entails risk. Statements concerning financial market outlook are based on current market conditions, which will fluctuate.

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

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