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SIGMA INVESTMENT COUNSELORS

the official newsletter of sigma investment counselors

March 2008

A Perspective From The "Trenches"

Since the beginning of the year, turmoil in the credit markets and weakening economic news have taken their toll across stock and bond, domestic and international markets. To make matters worse, the well-known index averages (Dow Jones Industrial Average [DOW] and the S&P 500) are capitalization-weighted meaning that they are dominated by the activities of the largest stocks. Equal weighted indexes are down more than the DOW and S&P averages, implying that the average stock is down more than these well known averages. Success in this market has required a concentrated as opposed to diversified portfolio with significant overweighting in some of the smaller industry sectors. While many are aware of the market activity in the abstract, for those who are not accustomed to checking their balances on a regular basis or don't have the ability to check their balances on their computers, the arrival of the first quarter statements in a few short weeks will provide at a minimum a dose of reality and likely a bit of shock. This underscores the principle that equity markets are for long-term investments and should not be comprised of funds that are needed to be used within a short to intermediate term time frame.

In good times one can never own enough equities; the reverse is true in challenging markets. While we all know bear markets come (and go), market timing has never proven to be employed in a consistent and sustainably useful manner for long-term investors. Often, the end of a bull market is accompanied by what is, in retrospect, the bursting of a speculative bubble. In the late 1990's, it was the dot.com era. Currently, it is the culmination of a period of inflating real estate values (in part caused by a regulatory system that encouraged poor lending standards and practices) combined with excessive leveraging of mortgages into complex financial instruments. In other words, complex and highly leveraged financial instruments were created, and their viability was predicated upon a continuation of inflating real estate values. Clearly, this did not materialize.

A bear market is usually accompanied by the unwinding of a speculative bubble. Once a bear market begins, market analysts provide scenarios to explain why "this time is different" and why this time investors will suffer a longer and deeper market correction and longer and deeper economic recession. Each bear, and for that matter each bull market, has its own set of characteristics that make it unique and different in substance but similar in form. In that regard, this time is not different. Painful as it is, the reality is bear markets are part of the experience of being an investor.

While the jury is still out as to the length and depth of the pain to be experienced, we do find the unique characteristics of this market sobering. The bursting of the real estate bubble in and of itself would be enough to create a difficult economic and market environment. The pervasiveness of poor lending standards contributed to the excesses and the now declining real estate markets. Overlaid on this has been the "deleveraging" that has taken place as deteriorating credit quality (which we wrote about last spring) has unfolded in dramatic fashion. Last year the market seemed to be showing no regard for risk. A year later the pendulum has swung dramatically the other way, as markets have no tolerance for risk. This has created an environment where lending has seized up and normal credit relationships that drive the behavior of lending institutions, borrowing institutions and investors to the credit markets have ceased to exist on a go forward basis as each player attempts to determine the value of the assets they hold.

This liquidity freeze has had a dramatic effect on the financial industry. In the case of the financial institutions, many of the write-offs are due to what is called "mark-to-market" accounting rules. While there has been deterioration in the pricing of assets, primarily mortgage pools, many of the underlying securities are still of good quality. However, these pools are either not trading or they are priced as if they were very high-risk assets. In other words, investors currently are not discriminating between different levels of risk. Financial institutions have no choice but to mark those assets to current prices, regardless of what the quality of the underlying security might be. Once investors begin to acknowledge that not all risks are the same, we expect prices on some of these assets to rise. Financial institutions (and others) will have to write-up the assets to reflect what we expect to be upward movement in prices in the market place.

The Federal Reserve has been lowering interest rates in an effort to calm markets, provide liquidity and increase investor confidence. However, its toolbox is not well suited for the complex securities and global markets in which we operate today. At the time of this writing, the Federal Reserve has worked within their system to create additional signals from which the market can gain confidence by announcing they will accept a broader array of collateral against loans made to the banking system. This creativity, combined with the synchronization of tactics as recently announced by various central banks around world, should result eventually in increased investor confidence and an ability to begin to discriminate for actual differences credit risk.

Our approach to the bond market at Sigma Investment Counselors has always been to maintain high quality securities, which has been important in this market environment. Our focus in the equity markets, during both bull and bear markets, is to focus on those sectors of the market and those companies which we believe have the franchises, managements, financial stability and valuations to provide above market returns over the long term. We welcome your comments and questions during this very challenging environment.

Denise M. Farkas, CFA
Chief Investment Officer

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