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summaries

SIGMA INVESTMENT COUNSELORS

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The Expanding World of Investments

These past two months, the headlines have been dominated by the Dow Jones Industrial Average (DJIA) daily closing value. The large point swings we have experienced have been extraordinary. It is startling how such a simple number has come to represent the collective financial sense of well being for so many and also how it can reflect so much anxiety one day and jubilance the next.

But what is the DJIA? What does it really measure? Why do we care so much about where it closed? Is there a better index to follow? The DJIA is perhaps the most recognizable stock market index in the U.S. and in fact, it is the oldest index on record. In simplest terms, it is an effort to measure the performance of the broad stock market, as opposed to individual securities. The DJIA, established by Charles Henry Dow in 1896, tracked the average prices of 12 stocks, and closed at 40.94 on its first day of trading. Today, it represents 30 of the largest and most widely held public companies in the United States. It is price weighted, which means a 10% move in a company with a stock price of $100 can have ten times the impact on the index than the same percentage move in a company with a price of $10. It compensates for the effects of stock splits and other adjustments by scaling the divisor and can give investors a constant barometer of the market. However, since it only includes 30 stocks and there are issues with price weighting, it is arguably not the most accurate representation of overall stock market performance.

In 1923, the Standard Securities Corporation (now known as Standard & Poor's) constructed the first market-capitalization-weighted index, meaning each company is given representation in proportion to the total market value of that company's outstanding shares as a percent of the total market capitalization of the entire index. This is a more accurate mathematic representation of the underlying companies than price weighting. This index, a composite of 223 securities, later evolved into the Standard and Poor's 500 Index that is widely used today. The S&P 500 is widely regarded as the single best gauge of the U.S. equities market. It consists of 500 leading companies from a diverse range of industries. Companies must be based in the United States to be added to the index and it represents approximately 75% of the U.S. equities market. Only companies with larger than $4 billion of market capitalization are includible in the index, therefore small and middle capitalization companies are not represented.

There are a variety of indexes in the investment domain. They represent nearly every conceivable country, asset class, and investment style one might want to invest in. And although this plethora of choices reflects the growth of the investment industry and the importance given to quantifying investment results and processes, it also makes differentiation among the indexes difficult.

Indexes have expanded from beyond their original role as a general indicator of market sentiment and direction. They are routinely used to judge relative performance. When evaluating any investment, it is important to compare it to an appropriate benchmark. However, it has become increasingly complex to settle on a single investment benchmark for equity portfolios. If a portfolio is comprised of large, middle, and small capitalization equities along with international equities, is one index appropriate to gauge performance?

Sigma currently uses the Standard and Poor's 500 (S&P 500) as the benchmark index for the equity portion of client portfolios. While the S&P 500 can adequately reflect U.S. equity markets, and the majority of our clients liabilities are tied to the U.S. markets, we believe international investments are increasingly important in any diversified portfolio. Recently much has been written on the subject of the globalization of the markets. Thomas Friedman's *The World is Flat*, and more recently Fareed Zakaria's *The Post American World*, both address the move to a decentralized and interconnected world. The economy is shifting from one shaped and dominated by the United States to a truly global economy. Zakaria describes this as "defined and directed from many places and by many people." We believe it is necessary to invest globally to participate in this shifting economy.

Comparing international, small and middle capitalization investments to the S&P 500 can be like comparing apples to oranges. If a portfolio is comprised of 60% large cap domestic, 25% international, 10% mid cap, and 5% small cap, it can be difficult to understand portfolio performance relative to just a large cap domestic benchmark like the S&P 500. Sigma is currently reviewing its quarterly report options and will likely be adding information regarding other benchmark indexes including both international and domestic for portfolio comparison. These may include indexes similar to the MSCI World Index which includes a collection of stocks in developed markets around the world, the S&P MidCap 400 which includes domestic companies with a market cap between $1 billion and $4 billion, and the Russell 2000 index which includes 2000 domestic small cap companies with less than $1 billion in market capitalization.

An alternative to benchmarking with an index is establishing a "benchmark" that represents the return needed to fund a client's liabilities. While this is a somewhat untraditional approach, it can make sense for many, if not most, clients. This involves determining the required return of the portfolio and the level of volatility or risk the client can withstand in order to achieve that return. In this process, the question is no longer how a portfolio is performing relative to certain indexes, but instead is the portfolio providing a return in excess of what is required to fund its goals and objectives? Through thoughtful planning and using programs such as our Sigma Wealth Management Tool, each client can essentially develop their own individual "benchmark" incorporating their own unique goals and objectives as well as risk tolerances.

In these uncertain financial times, it is more important than ever for individuals to revisit their goals and objectives. Once established, we believe that emphasis should be placed on achieving one's absolute targeted risk adjusted rate of return and secondarily focus on the relative performance of the portfolio versus an agreed upon index. We invite our clients to contact us to discuss this issue of benchmarking or if we can be of assistance in any other financial matter.

Tax Loss Harvesting

Sigma is in the process of "harvesting" losses on some securities in our client portfolios. In so doing, we are replacing the sold securities with similar investments. Our purpose in doing this is to shelter future gains from taxes with the losses we can realize today. These losses can be carried forward indefinitely until they are used up. In addition to offsetting future gains, up to $3,000 per year of the losses can be used to offset ordinary income. As mentioned, we are immediately reinvesting the proceeds so as to ensure that we maintain exposure for the ultimate market recovery, whenever it occurs.

The Economic and Market Environment

In Sum: Autumn 2008 will mark a watershed period in contemporary global history. First, the election of the first African American to the US presidency carries its own distinctive quotient. In addition, the global perception of Obama's foreign relations policies portends prospectively better international relations following the Bush Administration. The securities markets meltdown in the fourth quarter of 2008 could usher in a period of subdued consumerism in the United States. Over the long term, this is a positive development as it puts consumers on a more solid financial footing. However, such a change suggests potentially harmful economic consequences if global demand does not offset reduced US demand. Monetary and fiscal policy has been coordinated by the governments throughout the industrialized world to combat what could become a severe economic recession. Government bonds have been virtually the only source of positive returns in 2008.

Geo-political: With the election of Barack Obama as president of the United States, the dynamics of international relations are set to change. Thomas Friedman, a New York Times columnist respected for his views on foreign policy suggests that Obama does not fit the model of nemesis to hostile regimes in the Middle East, including Syria and Iran. President Medvedev of Russia wasted no time in taunting the president-elect though, by suggesting repercussions if the US carries through on plans to stage missiles in Eastern Europe. Irrespective of whether one agreed with Bush doctrine, it would appear that on balance, US relations with other nations will improve.

Economic: The twin shocks of the global equity market meltdown and credit freeze-up that accelerated in early October 2008 proved a "gut punch" to businesses, investors and consumers. Indicators of economic activity in early November reflected these blows as retail sales plummeted and unemployment jumped. The US economy is most certainly in recession, and one can only conjecture how long and deep the recession goes.

Monetary: The Federal Reserve Board recently engineered a sharp cut in the federal funds rate and most central banks around the world have taken similar actions. The Bank of England, which until very recently was holding rates steady to demonstrate anti-inflation resolve, also cut interest rates. The concerted action removes the specter of dramatic currency adjustments.

Fiscal Policy: "Katy, bar the door." The governments of the US, Germany and China, as well as a host of other countries are opening their fiscal stimulus spigots to combat the slowing global economy. Such moves in the past have proven an adequate remedy to declining output. It would appear reasonable to expect these actions to again reverse the course of the global economies although the timing at achieving a successful outcome is indeterminable.

Equity Markets: Global equity markets are in the midst of a serious phase of contraction, exceeding the average declines of most of the post-war bear markets. Fear overtakes reason during such periods, and traditional measures of valuation fail to quell such fear. Hence, valuation and dividend yields, while compelling, have not yet inspired the confidence that would precipitate a reversal of sentiment. A disciplined approach to investing, and a fair amount of fortitude and patience, are a necessary requirement to withstanding the punishing environment.

Fixed Income Markets: "Flight to quality" describes the process of bond investors shunning any type of risk in fixed income instruments and demanding only the safest of such instruments, including US government securities. These issues are fairly low yielding at present, while reasonably secure, corporate and municipal bonds are providing yield premiums over these aforementioned issues, of historic proportions. It would appear fruitful for fixed income investors to consider positions in high quality corporate and investment grade, general obligation municipal bonds.

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