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# summaries

SIGMA INVESTMENT COUNSELORS

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# Maintaining Calm During the Storm

This past week, the Dow Jones Industrial Average (DJIA) fell by a staggering 18%, registering its single worst week of its 112 year history. For the year, this commonly cited index is down more than 36%. Broader indices, both here and abroad, have also posted substantial declines this year, as evidenced by the S&P 500 (-38%), NASDAQ (-38%), EAFE Int'l (45%), and Emerging Markets (52%).

There are myriad reasons for this broad based decline. At the core though, is that the average consumer went on a buying binge in recent years, encouraged by easy credit, low interest financing, and soaring home prices. This excess was particularly acute in the 2005 and 2006 time period when interest rates were at historically low levels and real estate values were reaching their peak.

In retrospect, one could argue that the consumer should have known that low interest rates, easy credit and soaring home prices would not last forever. What wasn't factored into the equation, in our opinion, was the extent that higher interest rates would impact one's monthly mortgage payments. In addition, many homeowners did not appreciate how inflated home prices had become and did not anticipate the magnitude of the decline.

Thus, as mortgage payments rose and housing prices fell, many homeowners found themselves in a precarious situation. That is, they were making payments on a house where the market value was less than the outstanding mortgage. Either unable or unwilling to wait for a recovery, many homeowners have elected to default on their mortgages, putting a strain on the banks and thrifts who own these securities on their balance sheets and on investors who have bought mortgage-backed securities for their investment portfolios.

As the value of these securities has fallen, financial institutions which have been holding much of this debt have realized substantial losses on their investments. This has weakened their balance sheets and oftentimes has resulted in a lowering of their bond rating. To remedy the situation, these financial institutions have raised a substantial amount of capital this year via Sovereign Wealth Funds and other deep pocketed investors. However, capital is becoming scarce and the bailouts are becoming more expensive.

Thus, what we have created is a panic on Main Street as banks don't want to extend credit nor lend to other banks. Credit-worthy customers are finding that their bank lines of credit are being reduced or eliminated. This tightening of credit has spilled over into the commercial paper market as well, another significant source of capital to fund daily operations for major corporations. With consumer spending expected to drop significantly, and manufacturing having a difficult time financing day to day operations, the economy is likely to face both higher unemployment and a decline in production in the months ahead.

This panic has also found its way on Wall Street. Not only are stocks retreating due to the fear of a recession, stocks are also being sold indiscriminately as frightened investors are heading for the exits, en masse. This panic-selling tends to beget yet additional selling from newly panicked investors, creating still another waive of selling and further depressing share prices.

Without undermining the seriousness of these developments, we believe it is important to note that the current administration, Congress, the Federal Reserve and Treasury have taken bold and aggressive steps to address many of the structural issues facing our economy. This is evident by their rescue of AIG, their financial backing of the Bear Stearns and Washington Mutual mergers by JPMorgan Chase, the takeover of Fannie Mae and Freddie Mac, and increasing the level of FDIC insurance for bank deposits.

The government is also providing mechanisms for banks to offload problem loans from their balance sheet and re-establish the flow of commercial paper to credit worthy customers. Certain deposits of money market funds are also being insured, reducing the chance that brokerage accounts will experience a "run on the bank." As these and other measures start to take hold, we believe that the markets will stabilize and more rational pricing will return to the capital markets.

Defensive measures are also being taken by global agencies including the International Monetary Fund (IMF), central banks and leading financial institutions around the world, reflecting how widespread these problems are. These measures, both individually and collectively, should restore confidence in the capital markets and stem the panic selling that we have witnessed in recent weeks.

In times like these, Sigma understands that even the most even-keeled investor, with the strongest of stomachs and longest of investment time horizons, may question his/her faith in the underpinnings of the capital markets. We also acknowledge that it will take time for the economy to work through the excesses of the past and regain its former positive momentum. Yet, as we may now be in the midst of a market capitulation, when securities are being sold based on fear and not fundamentals, we would not recommend a radical change in one's asset allocation.

Rather, we recommend that each client re-visit his/her short, intermediate and longer-term investment goals and investment objectives. In addition, now is a good time to revisit one's risk tolerances. We find that some individuals may have a high tolerance based on one's intellectual understanding of risk but a low tolerance of risk on an emotional level. Ideally, both should be on the same plane.

In the event that a change in asset allocation or investment strategy is in order, it is likely that this change will result in a more conservative investment posture given recent events. Given our belief that the market appears "oversold" at current levels, we would recommend that investors allow for a modest recovery in prices before embracing a more conservative posture. Moreover, just as we often "dollar cost average" into the market when building an equity portfolio from cash, we can also "dollar cost average" out of the market using the same principles.

In closing, we understand that developments regarding the current financial crisis are unfolding on a daily basis. Thus, by the time we edit, review for compliance and submit for production, this particular Sigma Summary may already appear somewhat dated. To address this issue, we have elected to post market commentaries on our website, www.sigmainvestments.com, on an as needed basis. We suggest that you check our website regularly to keep abreast of our thinking.

## Doing Our Part

In order to do our part to be more "eco-friendly" we now offer our monthly Sigma Summaries electronically - via email and by publishing it on our website. If you are currently receiving your copy through the US mail and wish to convert to electronic delivery, please call Shari at (248)223-0122 or send her an email at sbilkie@sigmainvestments.com. This not only improves the timeliness of delivery, but also enhances your ability to store and retrieve the document for future reference. Of course, this helps all of us reduce our "carbon footprint." As with all your contact information, your email address will be kept private.



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