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summaries

SIGMA INVESTMENT COUNSELORS

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Where do we go from here?

Wow! The New Year has brought the continuation of the strong equity markets experienced in the fourth quarter of 2006. Despite some trepidation in the first few trading days of the year, investor perception of an overall stable economic environment and a seemly calm geopolitical arena have led to gains thus far in 2007. Given the strong market run the question becomes, where do we go from here? As your investment counsel and trusted advisor that is the question we are charged to answer each day on your behalf. In this commentary we answer that question within the context of today's markets. However, in doing so we will also share with you some of our philosophy and perspective about markets in general and equity markets in particular.

In making our assessment we need to review some of the underpinnings of the current market. First, investors abhor uncertainty. While the economic data continues to send mixed signals about the direction of the economy, there have been no significant (downside) surprises in the reported economic data. Further, there is a sense that the Federal Reserve Bank has once again been a master navigator. While the economy has slowed slightly, we are not headed into a recession or into a period of inflation. This is important as a stable environment provides companies with increased earnings visibility, which leads to increased investor confidence and willingness to invest. This confidence provides one of the underpinnings to the strong equity markets we are currently experiencing. As long as the no surprise rule remains in effect and the economic growth remains moderate (2-3%), markets will continue to benefit.

Even with good visibility, all equities are not created equal. Management teams, which continue to demonstrate good stewardship over the assets entrusted to them by shareholders, will see their efforts rewarded by an increase in the price of their stock. Conversely, investors will also ferret out management teams that fritter away corporate assets or make poor decisions and will punish their stock prices accordingly. The focus of our equity selection process is on those companies that demonstrate improving levels of corporate profitability and also appear undervalued based on our projections of future cash flow. In other words, we seek companies demonstrating solid corporate performance where the benefit of that performance has yet to be properly valued by investors.

Our analysis of corporate profitability is based on cash flow return on investment (CFROI) which is driven by three factors: revenue streams, the ability of a company to manage their margins, and productivity enhancements. When we find a company with strong corporate performance we delve into an analysis to understand which of these three factors are the key drivers of corporate performance. Based on our knowledge of the company and the industry in which they operate, we then apply our judgment to assess management's ability to sustain current profitability levels, the opportunity for management to reinvest in the business at increasing profitability levels, and the value of that cash flow stream to investors.

Overlaid on the individual stock analysis is our assessment of themes that we expect to play out in the markets over the next twelve to eighteen month period. For example, energy and other commodity stocks in 2004 and 2005; international investing and mergers and acquisitions in 2006. As we continue in 2007 the question arises, where do we go from here? What will be the sectors or themes that will dominate market activity in the coming year? Like 2006, we expect the themes will be of a more eclectic nature as opposed to a market dominated by a particular industry or sector. Determining the themes will be one of the keys to above market performance.

For U.S. investors the dollar's decline has had a positive impact on international investments as the value of the foreign currency they were holding rose relative to the

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dollar. Our expectation is that companies with sales and operations overseas will benefit as foreign profits are translated back at higher dollar values. This will be of particular benefit for mid and large-cap companies in the U.S.

A second theme we see from our analysis is the valuation differential between small and large-cap stocks. It is typical for smaller stocks to outperform their large-cap peers coming out of a recession. That out performance has continued for about seven years. At this point our valuation models indicate large-cap stocks are now attractive relative to their smaller cap peers. We note this theme dovetails nicely with our comments regarding the dollar.

The strong cash flow generated by corporations has been put to work through dividend increases, stock buyback programs and the headline news of mergers and acquisitions. Our expectation is that announcements regarding dividend increases and stock buybacks will continue albeit at a slower pace than the last two years. We do, however, expect merger and acquisition activity to continue as corporations seek to reinvest cash flows into profitable growth opportunities.

We will continue to monitor the struggle between slower economic growth versus higher inflation. The behavior of the equity markets in the second half of 2006 and into 2007 indicate equity investors are expecting continued moderate economic growth with low inflation. The expectation is reflected in the yield curve, which at the time of this writing, remains slightly inverted. Rates on shorter-term instruments, 1 year or less, are above 5% while rates on longer-term securities, 2-30 years, are below 5%. An inverted yield curve can portend a looming recession; however, given the tightness of the range in spreads on the yield curve we do not view this as a likely probability. Our expectation is for reported economic data to indicate mild economic growth, which should result in lower rates from the Federal Reserve by midyear. While lower inflation and a more normal yield curve are positives for investors, it may lead to slower economic growth which will lead to a slowdown in earnings for various companies and industry sectors. This issue will be addressed as part of our stock analysis and selection process.

One new theme is the effect the change in control of Congress may have on the economy and hence, the markets. Issues such as changes in tax policy in the form of higher tax rates or a culture of increased government regulation, would not be viewed favorably by investors. While we have no immediate concern, this is an area to be watched as the new Congress begins to shape its agenda.

So, where do we go from here? In short, while we have some concerns about a slower growth economy, overall we are optimistic about the direction of interest rates and investment opportunities in the equity markets. We will use a disciplined process to look for opportunities to take advantage of the existing market themes and continue to watch for new themes that emerge. Finally, our equity selection process will focus on those companies demonstrating the ability to improve their cash flow return on investment and grow their business in a profitable manner.

In closing I want to take this opportunity to thank my new colleagues for their kind welcome and support. I am fortunate to have the opportunity to work with the group of investment and administrative professionals assembled at Sigma. I look forward to meeting Sigma's clients and working with them towards achieving their long-term financial objectives. I also look forward to meeting with the other professionals and individuals that make up the Sigma community. Your comments and questions are welcome at any time so please feel free to call or e-mail me (dfarkas@sigmainvestments.com) and let me know what is on your mind.

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