

## Ghosts of Christmas Past, Present, and Future

In the fall of 1843, Charles Dickens wrote “A Christmas Carol.” It is a story of goodwill, generosity, and the value of love and human life that all of us can relate to. One of Dickens’ quotes applies to the current situation of many markets: “Nature gives to every time and season some beauties of its own; and from morning to night, as from the cradle to the grave, it is but a succession of changes.” In this vein, the following explores the investment markets past, present, and future.

The Past. Markets, as Dickens said, go through cycles with prices driven by investor concepts of central values overlaid by extremes of euphoria and troughs of despond. Market behavior has been likened to the path of a metronome with prices seldom directly correlating with central value. Usually, drastic price movements are isolated to particular markets or asset classes and universal misery or joy is unusual. The decline in 2008 was politically correct and all inclusive. The only asset classes that ducked the misery were gold and U.S. Treasury obligations. The red ink went further than almost anyone forecasted. The economy fell off a cliff driven by debt, leverage, and complexity. Housing finance was a particular culprit with ripple effects on banks, brokerage firms, and some insurance companies. We warned of many of the negatives in previous quarterly letters. For Covington clients, we were defensive and did avoid most of the obvious blunders such as housing, sub-prime instruments, concentrations in many areas of the toxic financial sector, Madoff, etc., but no one escaped unscathed.

Has the investment world changed? Covington has always placed important emphasis on risk management. After the experience of the last year, attention to risk will be a major focus for everyone in the future. Hard dollar return (bond coupons and dividends) has always been a significant component of the total return from investment portfolios. On the stock side, over the last eighty years, dividends have accounted for approximately forty percent of total return. Hard dollar return is a primary reason individual and institutional investors have investment portfolios in the first place. School endowment income provides operating capital to run the institutions, and income return from individual portfolios provides living expenses during retirement.

For most years prior to the 1950s, yields on stocks were higher than bonds. Stocks are the riskier investment category and people were distrustful of paying a premium for problematic future growth. The Great Depression and World War II made investors cautious. Slowly, the cult of growth investing grew and the economy, by and large, supported it. Up to the 1950s, bonds were the bedrock of most portfolios. Stocks have been primary since that time. Are we back in a bond/hard dollar return world? For the first time in fifty years the dividend yield on companies in the Standard & Poor’s 500 is greater than ten-year U.S. Treasury bonds. If investors cannot make a case for decent future economic and earnings growth, will their appetite for risk be curtailed and instead shift to a primary focus on income investing?

The Present. Independent investment management firms (the “buy side”) are stewards of other people’s money. Their independence and lack of brokerage and underwriting

operations gives them objectivity and lets them focus on the individual needs and circumstances of each client. Wall Street firms (the “sell side”) provide important liquidity to our economic system, but their investment management arms sometimes have problems with separating their investment banking and proprietary investment operations from the interests of their investment management clients. The Bernie Madoff episode has important lessons, the most significant being that safety and soundness of client assets is paramount. Covington client assets are held at Schwab and several trust banks. These assets are entirely separate from Covington and the custodian can only distribute cash or securities to accounts authorized by the client.

The stock market is clearly searching for a base. A major positive is the huge amount of cash available. Americans are estimated to have \$8.9 trillion in various forms of cash equivalents, roughly equal to 74% of the market capitalization of the entire U.S. stock market. This is the highest percentage of cash in over twenty years. How low do interest rates and stock prices have to go to tempt investors back into equities? Money is clearly available to fund a significant rally.

The work in progress is the economy. The credit freeze and financial crisis continue to ease, helped by massive fiscal and monetary pump priming. Someone suggested that the current situation is the equivalent of a cattle prod on a dead cow. We believe otherwise, but time will tell. Housing is important and a sign of pricing stability would be welcome. Employment needs to stabilize. Many believe economic recovery will be subdued and will have to wait until 2010.

The Future. We are firm believers in the positive long-term prospects for America, our economy, and our various markets. Down markets and economic cycles happen and 2008 was bad. The U.S. has a long history of facing problems and solving them. America’s basic strengths have been well discussed in previous letters.

Stocks are down significantly and dividend yields are attractive relative to many fixed income alternatives. The question remains whether equities have discounted all the economic/earnings misery that is likely. Cash is available to drive the market, but trust and confidence need to be restored. More bad economic news is in front of us so any stock market recovery may take time. The consumer and the housing market are key. We like high-quality intermediate-term municipal bonds, but are not ready to concede to the long-term supremacy of bonds over stocks. The flight to safety has driven Treasury yields artificially low and some stock valuations are tempting. Corporate bond yields provide more competition. As Dickens suggests, markets are cyclical and an important influence on investor spasms of fear and greed. If sluggish economic growth is in our future, perhaps somewhat less risk and more focus on yield is appropriate. We continue to believe that long-term investors will be rewarded if they stick to the guiding principles of asset allocation that fit their objectives and risk tolerance, diversification, and selection standards that focus on quality, strong finances, sustainable business platforms, and reasonable valuations.