

From ghoulies and ghosties
And long-legged beasties
And things that go bump in the night
Good Lord, deliver us!

- Traditional Scottish Prayer

Some Truths:

- “Nobody can predict interest rates, the future direction of the economy, or the stock market.” (Peter Lynch).
- Or as Mark Twain advised: “The art of prophecy is difficult, especially with respect to the future.”
- The investment professionals at Covington are experienced investors who have all lived through market cycles. As observers and students of the joys of rising markets and the despair of periods of decline, we all have learned that successful investors must have patience, flexibility, discipline, and strong risk management skills.
- Expect surprises and change. Expect economic and stock market cycles.
- Do not expect to be right all the time. If you make a mistake, make it a small one.
- “Risk management is the dominant tool for success in investing.” (Peter Bernstein). Investors should focus more on ways to avoid losing money as opposed to seeking top upside performance. It leads to consistency of return and levels of downside volatility that investors can tolerate. Risk is controlled by asset allocation (an appropriate mix of bonds, stocks and cash equivalents), diversification within each asset class, attention to price and comparative valuation, with focus on the long term. In sum, play good defense!

A History Lesson:

“Markets over the long term go up.” (Roger Ibbotson, a Yale University finance professor and hedge-fund manager). He says, “You can get that by having a diverse portfolio and holding it. You do not have to have timing magic.” U.S. stocks have finished in positive territory in more than 70% of calendar years over the past eight decades. In thirty-one of those years, the market’s annual return was greater than twenty percent. Stocks declined in twenty-three of those eighty years. Staying invested through the rough patches has been rewarding, with the U.S. stock market providing a 10.4% annualized total return for the entire period.

Time in the market has typically been more rewarding than timing the market. Day trading and market timing strategies have typically fallen short. Investors who impatiently switch in and out of investments, hoping to catch the next hot trend, stock, or asset class often cause themselves more harm than good. Those shaken by volatile market swings who are tempted to abandon carefully planned goals and objectives, should take a good look at the lessons of such long-term investors as Charlie Munger and Warren Buffett. Stocks historically have been one of the best-growing asset classes and have a place in most people's investment programs.

The Investment Background:

The concerns and issues in the current market environment have been well publicized. Housing price declines happen every ten to fifteen years, usually prompted by easy money, leverage, and prices that are too far ahead of the average person's income. Wall Street, as usual, exacerbated the problem, this time by packaging subprime loans and getting them rated as high-quality debt. Somehow many banks, hedge funds, retirement funds, etc, did not do their homework and loaded up on these instruments. A recession may happen, but it is not likely to be a disaster. A key is the durability of the American consumer. Other worries include a possible change in political parties in Washington and implications for higher tax rates, the value of the dollar, a squeeze on the middle class, etc.

The good news is that U.S. corporations, in general, are in excellent financial shape, have high profit margins, are benefiting from the spread of prosperity abroad through strong exports, and their stocks are priced at reasonable valuations. Interest rates are low so competition from the fixed income markets is not a hurdle. In sum, the economy may have indigestion, but it seems like business as usual.

Healthy Investor Behavior:

Common stocks have been wonderful long-term investments, significantly outperforming bonds and cash equivalents. Part of the reason for the extra return is that stocks fluctuate and make people scared. You get paid to be scared. Apocalypse is seductive. There is something about the thought of imminent mass ruin that really gets peoples attention. It plays to human nature and myopic loss aversion. A bearish thesis is two to three times as horrifying to investors relative to a positive forecast with a similar amount of gain. The lesson: when your barber or hairdresser says they are selling everything, it is time for you to buy. Investing is part an emotional exercise and managers need to maintain rational perspective and a long-term orientation or performance can be seriously damaged.

At least in the past, remember that there has never been a stock market correction that has not proven to be a buying opportunity. The trick is to ferret out attractive names and to decide when to execute. Investors should try to develop a counter-emotional approach since this leads to buying low and selling high. Most of the time, risk bearing works out just fine. Balanced, diversified portfolios enable investors to make it through the periodic stock market low points and prosper over the long term.

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