

## PREDICTABILITY—KNOW WHAT YOU CAN'T KNOW

We are in the midst of a meltdown of a housing bubble. These bubbles happen every ten years or so, caused by housing prices getting too far ahead of people's incomes, excess liquidity supplied by the Federal Reserve, and bankers forgetting rational lending standards and allowing too much leverage. The current bubble was exacerbated by Wall Street packaging mortgages into debt instruments, and then selling them to hedge funds and others with the buyers often using leverage. It is now a little like musical chairs; we are slowly finding out who gets hurt and what the ripple effects will be for other sectors of the economy. Recession is a possibility.

Hyman Minsky, an economist who passed away a decade ago, argued that markets were inherently crisis-prone, susceptible to periodic bouts of excess and upheaval. "Minsky Moments" are characterized by good times when investors take on risk, then more risk, then too much. Eventually they reach a point where lenders begin to call in their loans and this forces investors to sell less speculative positions to make good. This severe demand for cash can lead to a collapse of asset values. The housing market seems to be in the midst of this spiral. U.S. residential real estate is a huge asset class. With an aggregate value of approximately \$21 trillion, it is the single largest wealth component of most households. Seventy percent of American families own their homes. It is difficult to predict the depth, duration, and consequence of the worsening housing slump.

Behavioral scientists teach us that the human psyche is not built well for fluctuating markets. Investors are often ruled by fear and greed, and they frequently go to irrational extremes. An overconfident personality is prone to lottery risk mistakes, the loss averse never get invested, and those who like to be with the crowd (the psychologists call it herding) will run off the cliff with their friends. Anchoring refers to the human tendency to take recent events and project them into the future in a straight line. We anchor our projections on some number or data we have recently seen and assume tomorrow will be like today. Investors should think probabilistically and not emotionally. Investment counselors try to understand these obstacles created by human emotions and guard against them. At times being contrary is a virtue and is captured in a saying: "buy when you are terrified, sell when you are satisfied."

In an uncertain world, what do we know, what is the hierarchy of an investment decision tree, what ingrained habits lead us astray, and what is the best strategy for managing investment capital? People should understand that markets are not very predictable short-term, but are much more so over the span of ten or twenty years. A longer time horizon should lead investors to have a bias toward stocks. Balanced portfolios containing a mix of cash equivalents, bonds and stocks, and diversification by sectors, geography, and holdings, address people's ingrained risk aversion. Each of us needs to know how much market downside we can comfortably stomach and these are the primary tools to manage risk.

Risk is inherent in investing, and every investment vehicle, including money market funds, has its issues. Stocks, by any historical examination, have a place, even in fairly risk-averse portfolios. Investors need to take a long-term view and not get swept up in the short-term noise of the moment. This confident statement is first backed up by the assumption that investors will spread out their holdings, that they will pay attention to price and the competitive strengths of the individual companies. The other source of our confidence is optimism about the long-term prospects for the

American economy and the rise of capitalism abroad with its growing middle class. Pillars of American strength include a strong tradition and adherence to a rule of law, private property rights, political stability, and a free-market economic system. We have a tradition of hard work and entrepreneurship. Our economy is diversified and can cope with change. America's higher educational system is the envy of the world. The U.S. economy and its stock market will do fine over the years. That is our prediction for the long term.

So, how bad can predictions get in the complicated and dynamic world of investing? Whitney Tilson is a good value investor. He revisited a feature article published in Fortune magazine in the summer of 2000. The headline was "10 Stocks to Last the Decade". Fortune tries hard and has good people, so this is no knock on them. From July 19, 2000 through September 7, 2007 the portfolio declined 39 per cent versus a small increase for stocks in general. Just to get even, the Fortune stocks will have to perform heroically over the next three years.

<b>Stocks to last the decade?</b>	
Here's how each of the Fortune picks would have fared had you bought on July 19, 2000 and held through September 7, 2007.	
Broadcom	-78.1%
Charles Schwab	-44.9%
Enron	-100.0%
Genentech	+110.7%
Morgan Stanley	-17.2%
Nokia	-36.1%
Nortel	-97.8%
Oracle	-45.3%
Univision	-36.0%
Viacom	-49.2%
<b>Average</b>	<b>-39.4%</b>
Russell 3000 (no dividends)	+3.5%

Source: Value Investor Insight

What went wrong? The first error was anchoring. It assumed high growth stocks would continue forever on the merry path of the 1990's. The second error was not paying attention to valuation. These were very expensive stocks in July 2000. A third negative is concentration. The stocks are focused on several themes; companies that benefit from an aging population, and positive momentum for media and entertainment industries. They simply were not spread out enough and missed the strength in foreign markets, energy, commodities, etc.

The valuation error is one that many have harped on and is well explained in Jeremy Siegel's book, "The Future for Investors." The book focuses on the fact that the best performing stocks in the Standard & Poor's 500 index since its inception in 1957 have been dominated by companies that sold at reasonable prices relative to earnings, book value, etc. He particularly emphasizes the importance of companies that pay dividends.

In conclusion, we promise to watch our herding and anchoring. We promise to pay attention to risk levels, to diversify, and to try to buy at reasonable prices. Don't expect us to make short-term predictions on interest rates, currency fluctuations, and the direction of the economy or stocks. We will try our hardest to be rational and not driven by human greed, fear, or emotions. You should know that despite the well-publicized market turmoil of recent weeks, stocks have performed well through September 30. So far this year, the Dow Jones Industrial Average is up 11.5% and the Standard and Poor's is up 7.6%. The sixty-four thousand dollar question is how much the problems in the residential housing industry will seep into other sectors of the economy. Will these problems trump the positives of strong economic performance abroad, low interest rates, strong corporate balance sheets, etc.? With humility towards this discussion of what is knowable in an uncertain world, Covington believes, for now, we should err a little on the side of quality and caution.

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