<u>Dinosaur Talk</u>

An important part of most endeavors (from marriage to war) involves the tradeoff between offense and defense. It is a key consideration in the investment management business. Think of the Hippocratic Oath in health care. The Oath's first principle for the physician is "do no harm." Jack Nicklaus said his success on the golf course came because he failed a bit less than everyone else. Warren Buffett commented that you only have to do a very few things right in your life so long as you don't do too many things wrong. Just as turtles cannot get anywhere without sticking their necks out, some risk is appropriate and necessary. But risk needs to be properly managed and controlled.

It is a truth in the investment management business that as most portfolio managers go up in age, their appetite for risk tends to diminish. Most investors go through this same transformation. That is why in managing an investment firm, you need a range of ages among the investment professionals. Risk control as well as seeking opportunity are both parts of a successful investment culture. Mistakes are inevitable, but significant downside loss must be avoided. Above all else, Covington's investment strategies are set up to minimize the chance of catastrophic loss. We are willing to give up some upside opportunity to make sure this happens. Avoiding large losses is a key part of long-term success.

Asset allocation and diversification are the primary tools for controlling risk. We try hard to make sure our clients' mix of assets (cash equivalents, bonds, and equities) is appropriate for their temperament, desire for growth, tolerance of risk, need for liquidity, etc. Despite the poor performance of stocks in recent years, their long-term results are excellent. Investors, within their own risk parameters, circumstances and sleeping points, should have a bias towards equities. If you can select a diversified portfolio of superior business enterprises and hang with them for a five- to ten-year time period, performance typically beats other asset classes by a significant margin.

JP Morgan Chase has survived the current credit and banking crisis better than any of its large competitors. A recent book titled <u>Last Man Standing</u> discusses the risk adverse approach of its CEO, Jamie Dimon. Unlike his competitors' focus on growth at any price, Dimon studied the possible downside of significant actions and insisted on a fortress balance sheet. For example, he modeled what the financial landscape might look like if the jobless rate hit 10%. During the financial meltdown, because of balance sheet strength, JP Morgan was able to pick up two cheap acquisitions at the U.S. Government's behest, Bear Stearns and Washington Mutual, which significantly enhanced Morgan's franchise. The lessons to investors are: 1) pay attention to risk; 2) pay attention to liquidity—having cash in hard times is a buyer's dream; 3) be willing to take risk if the price is compelling. Awareness of potential downside was Dimon's most ingrained character trait and it paid off. He also took the long view and knew he would take heat when JP Morgan underperformed somewhat when high-risk banking was having its heyday. The payoff came when bad times left Morgan with cash and liquidity. The economy and Wall Street have cycles and those who are capital rich when markets stumble will see opportunities abound.

Over

The International Monetary Fund estimates that stock market bubbles happen about every thirteen years and housing bubbles about every two decades. It is so amazing that the majority of Wall Street firms were caught unaware by the credit debacle. If something happens with such regularity, why is everyone so surprised? We do not know exactly what will occur or when, but we do know bad things happen. If we are prepared, we cannot completely avoid the downside, but we can minimize the damage and capitalize on opportunities in the marketplace.

The institutional investment management business (large pension funds, college endowment funds, state and municipal pools of capital) is driven by third party consultants and is somewhat crazed. The consultants benefit from complexity and a focus on short-term relative performance. The truth is that the stock market is not predictable short term nor is there much linkage with day-to-day economic events. A five- or ten-year performance horizon is reasonable, but not quarter-to-quarter. Every firm, often for good reasons, will go through periods of under-performance versus benchmarks. If this happens in the institutional arena, you are usually fired.

Happily, individual investors tend to be driven by absolutes. The focus of absolute investors (dinosaurs) is on such issues as: 1) did my portfolio preserve value well in the down market? 2) did I participate reasonably on the upside? 3) is the income from my portfolio growing over the long term? These absolutes are what make sense to most of us who have spent long careers in the investment management business as opposed to complex quarter-to-quarter attribution analysis that leads to bad incentives for managers.

As a result of sub-par equity market results over the last ten years, most investors desire less volatility in their returns. They want consistency and predictability. People are appropriately concerned about the hot-stock approach, leverage funds, and gunslinger mentality. These high-beta strategies work in some periods, but get crushed in others. Craving for physics-style precision does not work in the investment market. There is no certainty because markets are driven by people, and people are reliably unreliable. The lumpiness of equity returns hurts and investors occasionally have to endure periods like 1973-74 and 2008. Long term, broad diversification and a focus on good companies priced at reasonable value work best. No one can be certain where equity markets are heading in the short term, but we are confident about the long term.

Looking at recent business headlines and listening to stock market pundits suggest that today's world is split on projections for 2010. About half are looking for another good year for stocks and the rest for a return to the downside. The optimists point to a recovering economy, inventory restocking, some upturn in capital spending, and demand from the middle class that has emerged abroad. The pessimists focus on high debt levels, significant unemployment, cautious consumer spending, tepid economic growth, and high valuations. We would be a lot more comfortable with higher dividend yields or lower valuations as an insurance policy against lower than expected earnings growth. The domestic stock market is not a fat pitch at the moment and our recommendation is for a continued moderate allocation to equities, with greater focus on the international sector.

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