

Navigating the Tempestuous Seasons

The stock market is cyclical and unpredictable. Despite the down cycles, history has been kind to long-time owners of equities. They have finished in positive territory in more than 70% of calendar years over the past eight decades and the compound annual return since 1926 has been 10.4%. Stocks historically have been one of the best growth asset categories. If stocks are rationally diversified, they represent a great way to piggyback on corporate growth at home and abroad.

A balanced portfolio, spread across stocks, bonds, and cash equivalents according to each account's risk tolerance, has been the best way we know to achieve client investment objectives. For those who understand and can tolerate risk, it makes sense to have a bias towards stocks. Investors have to understand that bear markets happen, are stressful, and few go through them unscathed.

Market timing (significant changes in percentage stock positions) is a tempting strategy. Experience and academic work suggest this is an impossible game to play. The stock market is tied to too many variables and short-term uncertainties are too high. We try to moderately adjust our equity positions in periods of particular optimism or pessimism, but long-term objective guidelines will always dominate. So far we have not seen anyone who can consistently time the market. Charles Ellis, author and head of a large investment consulting firm, had a great quote on the subject: "The evidence on investment managers' success with market timing is impressive – and overwhelmingly negative."

Misery in various markets can usually be related to high debt levels and easy credit that encourage lenders and investors to take unprecedented risks with borrowed money. From a long-term context, leverage in America has been building for many years. Coming off the experience of the Depression of the 1930s, no one would borrow anything in the 1940s and early 1950s. We were a country of savers. By the end of the century this aversion to debt was completely reversed. Individual, corporate, and government debt all escalated to numbers few of us can count. We became a leveraged society and we now have to de-leverage: more bills paid in cash, pay down of credit card debt, no more using home equity (if there is any) as an ATM machine. This process has implications for consumer spending and bank lending. The transition to less debt and a better economy has begun and will take time.

We remain strong optimists about the future. John Templeton was one of the great investors of the 20th century who sadly passed away this month. He recently stated, "Throughout history, people have focused too little on the opportunities that problems present in investing and in life in general. The 21st century offers great hope and glorious promise, perhaps a new golden age of opportunity." The print and TV media should listen and get off their steady stream of negatives.

A list of positives that we believe important would include: Life spans/health — the average person born today can expect to live longer than at any time in human history. People are healthier and have never had more effective medicines. Wealth — Americans hold about 60% of the world's capital. More than one-quarter of the wealth created in America since our founding was created in the last seven years. Incomes — unemployment is relatively low and average pre-tax income per worker hit a record \$48,957 in April, 11% above the year 2000. Consumer pleasures — more and better things than ever; better cars, color TVs, computers, home appliances. What about the poor? 80 percent of poor households have air conditioning, 97 percent own a color TV, and 31 percent own two or more cars. Thanks to taxpayers help and the underground economy, poor people often consume more than they earn. Homes — more Americans than ever own their homes. More than 94 percent of Americans with mortgages meet their monthly obligations. Miscellaneous — the U.S. is still the world's third-largest oil producer. American elections are wide open and fair. Our universities remain the world's best and we lead the world in cutting-edge technological innovation. We are a shining light, a meritocracy where no one is above the law. More immigrants seek out America than any other nation in the world. From a global standpoint, a huge positive is the flood of people entering the middle class.

Long-term trends are positive — overwhelmingly so. It is remarkable that they are not commented on more by the mainstream media. Bad news sells. Americans have a long history of rolling up their sleeves and meeting challenges. The remedies for our current maladies require a moderate curbing of our extravagant lifestyles and heavy consumption. We can curb these excesses.

Richard Russell recently published the following work by Jon Strebler. It shows price increases of various items since 1950, 1967, and 1980. It illustrates in long timeframes how well stocks have done versus a number of other categories. Today these items cost X times as much as in 1950, 1967, and 1980:

	<u>1950</u>	<u>1967</u>	<u>1980</u>
Gasoline:	16x	12x	3.3x
Gold:	25x	25x	1.4x
Homes:	28x	12x	4.3x
Incomes:	18x	7x	2.8x
Stocks (S&P 500):	77x	15x	12x
Inflation (CPI):	9x	7x	2.6x

Stock market corrections are no fun, but clients of Covington have come through this period well. We strongly believe that long-term patterns will, in time, assert themselves. Time in the market, not timing the market, is ultimately the more profitable strategy.