

INVESTMENT DISCIPLINE

This letter concerns two investment management fundamentals: asset allocation and diversification. Our firm strongly believes that investment success is tied closely to the sound execution of these two principles. Peter Bernstein, a long-time investment guru and author, always preaches that “risk management is the dominant tool for success in investing.” In his words, “you can try to be a shooting star if you choose, but the long history of markets demonstrates that the survivors are those who eschew maximization and manage their risks instead.”

In the hierarchy of investment management tools used to manage risk, asset allocation and diversification are ascendant. All markets fluctuate between periods of high prices when greed is pervasive and low prices dominated by fear (the trough of despair). Investors who have the discipline to stick to fundamentals rarely go through the agony of unacceptable loss. If you are disciplined, sooner or later the sun will shine in your front yard. It sometimes takes patience and devils those with aggressive personalities who want the next wonder growth stock. Long experience and history says be a survivor and stick to investment management fundamentals.

As background, we should start with Bob Kirby who passed away last year after a great career at Scudder, Stevens & Clark and The Capital Group. Both firms were/are grounded in ethics, the belief that clients come first, investment fundamentals, and research. The next several paragraphs are mostly from Kirby’s playbook.

Kirby’s after-work obsession was race car driving. He drove at Sebring, a twelve-hour race. He pointed out that in one of his races only twenty-eight of the seventy-two cars that started the race, finished. He made the analogy of car racing to money management. Finishing is two-thirds of the battle. How fast you go on any given lap is perhaps of less consequence than trumpeted on CNBC by Jim Cramer.

Kirby was brave enough to discuss some of the unfortunate truths of investment management. God put us in a business where 1) if there is a consensus, it is almost sure to be wrong, 2) if you have a product or service that is easy to sell, it is sure to harm your client, and 3) if you want to sell the right product, it is like making a kid take cod liver oil. Too many in the business are ambulance chasers and sellers of gimmicks. Our charge in life is to anticipate the future and to accept responsibility for managing our clients’ capital so as to protect them as much as possible from the vagaries and adversities of future change, while making hay on the upside. It is a tough charge because no one really knows what any market is going to do, particularly in the short/intermediate term.

Peter Lynch and Warren Buffett, two of the best investors ever, have honest quotes on the uncertainty of markets. Lynch, “I have no feeling for the direction of the market over the near term, or the next three to twelve months—and that has always been my position.” Buffett, “We don’t have, never have had, and never will have an opinion about where the stock market, interest rates or business activity will be a year from now.” They believe in stocks for the long-term, dismiss short-term price fluctuations, and spend their time finding outstanding companies at reasonable prices.

With so much uncertainty, why employ an investment manager? The investment reason is that good managers have disciplines that they stick to and that work over time. Most investors get swept up in fads and buy the next great thing at the top, get sidetracked in down markets and sell at the bottom, or take concentrated positions that crater (you get rich by concentration, you keep it by diversification). In the same vein, they forget about tax-efficiency; overreach for yield; fail to admit mistakes, take a loss, and find something new.

Asset allocation involves constructing a portfolio with a mix of holdings in different asset classes that in performance terms are not well correlated with each other. The traditional candidates include cash equivalents, bonds, common stocks, real estate, and commodities. A broader list is shown on the next page. Diversification suggests spreading out individual holdings in each asset class and avoiding concentrated positions.

David Swensen has a doctorate in economics from Yale and for the past twenty-one years has been the steward of the University's endowment fund (now worth over \$20 billion). He has one of the best sustained investment records around and is an outstanding person with a sense of mission for Yale and passion for investing. His recent book, "Unconventional Success—A Fundamental Approach to Personal Investment", stresses the importance of asset allocation and diversification.

The attached table is a simplified version of what Swensen believes is an appropriate investment mix for most investors. The asset mix is at the top in red, the performance of diversified indices are shown under each asset class, and the combined portfolio is on the right. Down years are shown in red and summary statistics are on the bottom. You can see how mixing different asset classes mutes risk to levels most people can tolerate (this portfolio would have been down only five years out of thirty-seven) and that the long-term numbers are competitive. The portfolio is invested 30% in five-year bonds and a lower or higher return could have been earned with less or more in stocks. The problem of a higher stock position is greater punishment in the down years. Only cast-iron belly investors can put up with experiences like the Standard & Poor's 500 price declines in 1973/4 or 2000-2003 with equanimity.

Covington's charge is to preserve our clients' principal and income in real terms and perhaps do a little more if we can without assuming unreasonable risk. We believe that something like Swensen's risk/reward proposition shown on the attached table is appropriate for most of our clients.

Prepared by:

Covington Capital Management - 601 S. Figueroa St. Suite 4400 Los Angeles, CA 90017

Phone: (213) 629-7500 Fax: (213) 629-2990

Returns & Diversification 1970-2006

Allocation	0%	30%	30%	0%	20%	20%	100%
Year	90 Day T-Bills	5 Year T-Bond	S&P 500 Return	Small Cap	REITs	Foreign Equities	Portfolio
1970	5.94%	16.85%	4.03%	-17.43%		-11.66%	3.93%
1971	4.39%	8.74%	14.32%	16.52%		29.59%	12.84%
1972	3.84%	5.17%	18.98%	4.43%		36.35%	16.12%
1973	6.93%	4.61%	-14.67%	-30.90%		-15.52%	-9.11%
1974	8.01%	5.68%	-26.45%	-19.94%		-21.41%	-15.15%
1975	5.80%	7.82%	37.21%	52.80%		19.29%	24.45%
1976	5.08%	12.88%	23.85%	57.36%		47.58%	21.04%
1977	5.13%	1.40%	-7.18%	25.39%		22.42%	6.36%
1978	7.19%	3.49%	6.57%	23.47%		18.06%	11.61%
1979	10.38%	4.10%	18.44%	41.95%		32.62%	14.88%
1980	11.26%	3.90%	32.42%	38.55%		22.58%	20.29%
1981	14.72%	9.44%	-4.91%	2.00%		-2.28%	2.11%
1982	10.53%	29.10%	21.41%	24.93%		-1.86%	19.10%
1983	8.80%	7.41%	22.51%	29.10%		23.69%	19.84%
1984	9.84%	14.03%	6.27%	-7.27%		7.38%	11.75%
1985	7.72%	20.34%	32.16%	31.07%		56.16%	30.80%
1986	6.16%	15.13%	18.47%	5.67%		69.44%	27.80%
1987	5.47%	2.89%	5.23%	-9.36%		-3.66%	6.63%
1988	6.36%	6.10%	16.81%	24.96%		28.27%	15.22%
1989	8.38%	13.27%	31.49%	16.25%		8.84%	17.30%
1990	7.84%	9.73%	-3.05%	-19.52%		-15.34%	-5.75%
1991	5.60%	15.46%	30.15%	46.04%		35.72%	4.93%
1992	3.50%	7.20%	7.64%	18.42%		-12.17%	16.58%
1993	2.90%	11.24%	10.08%	18.89%		19.66%	16.58%
1994	3.91%	-5.13%	1.30%	-1.82%		3.18%	1.04%
1995	5.60%	16.82%	37.43%	28.45%		15.25%	21.57%
1996	5.20%	2.09%	23.08%	16.54%		5.97%	15.80%
1997	5.25%	8.38%	33.37%	22.37%		1.66%	16.76%
1998	4.85%	10.22%	28.58%	-2.56%		19.97%	12.13%
1999	4.69%	-1.76%	21.03%	21.26%		-4.62%	10.27%
2000	6.01%	12.59%	-9.09%	-3.03%		26.36%	3.53%
2001	3.51%	7.62%	-11.85%	2.49%		-21.21%	-2.95%
2002	1.59%	12.93%	-22.10%	-20.48%		-15.63%	-5.28%
2003	1.06%	2.40%	28.70%	47.30%		38.39%	24.09%
2004	1.52%	2.25%	10.87%	18.29%		19.73%	14.42%
2005	3.38%	1.36%	4.91%	4.57%		13.64%	7.29%
2006	4.91%	3.14%	15.80%	18.38%		26.88%	18.16%
Compound Return	6.00%	8.15%	11.23%	12.07%		13.93%	11.21%
Prob. of Losing \$	0%	5%	22%	27%		17%	14%
Growth of \$1.00	\$8.63	\$18.18	\$51.24	\$67.86		\$95.96	\$50.91

Source: Dimensional Fund Advisors, Russell, Ibbotson Associates, Morgan Stanley Capital International

Asset Classes

Domestic	International	Other
Equities	Equities	Real Estate
S&P 500	Global ex U.S. Developed Equities	Public REITs
Mega Cap Equities	Global ex U.S. Small Cap Equities	Industrial
High Quality Equities	U.K. Equities	Office
Growth Equities	European ex U.K. Equities	Retail
Value Equities	European Equities	Apartments
Mid Cap Equities	Pacific ex Japan Equities	
Small Cap Equities	Japanese Equities	
	Emerging Mkts Equities (Asia)	Hard Assets
	Emerging Mkts Equities (Europe)	Commodities
	Emerging Mkts Equities (Latin America)	Oil & Gas (Drilling)
	Emerging Mkts Equities (South Africa)	Oil & Gas (Properties)
		Timberland
		Currencies
Bonds	Bonds	
Corporate Bonds	Europe ex U.K. Bonds	
Treasuries	U.K. Bonds	
Inflation Linked Bonds	Japanese Government Bonds	
Tax Exempt Bonds	Emerging Markets Debt	
High Yield Bonds		
	Venture Capital	
	Venture Capital (Early stage)	
	Venture Capital (Expansion stage)	
	Venture Capital (Later stage)	
	Buyout Funds	
	Distressed Securities	
	Convertible Arbitrage	
	Merger Arbitrage	
	Capital Structure Arbitrage	