

More Questions Than Answers

The goal of most investors, individual and institutional, is to preserve principal and secure a stable income stream. Both income and capital need to grow over time to keep up with inflation. Rapid capital growth is great, but most understand it comes with high risk. In the investment markets the turtle often beats the hare.

The last decade has not allowed most investors to achieve their goals. This has happened before in history, but every time in the past, markets have recovered. Living through hard times, while keeping patience, reason, and equilibrium are difficult. Money is important.

There are four primary investment alternatives: real estate, cash equivalents, bonds, and stocks. There are subsets of each, plus ice cream and cake categories like diamonds, art, etc., that are off most people's radar screens. The traditional wisdom is to spread assets among the four main alternatives. The primary reasons to include stocks in an investment program are:

- 1) Stocks offer opportunities for long term growth in principal value and income.
- 2) Historically, equity investments have provided the highest return.
- 3) The continued expansion of American and global economies should lead to long-term growth in corporate earnings and dividends.
- 4) Inflation hedge—the companies represented by stock ownership can raise prices as costs go up. They can borrow, build, grow, and pay dividends to their owners.

Over the long sweep of history, cash equivalents have shown the poorest returns among the four investment vehicles. This makes sense from a theoretical standpoint because short-term investments have the least risk. Due to the open-ended nature of stocks and real estate, they have provided the highest returns, but price volatility is also greater. In a long-term oriented portfolio these interim fluctuations are not disruptive except psychologically. Our best judgment is that American and world economies will continue to grow and that common stocks are likely to outperform bonds and cash equivalents.

Investors have changed the relative portfolio weightings in asset class alternatives in response to changing investment environments. The last big one started in the 1950's when the previous dominance of bonds as the bedrock of portfolios shifted to the "cult of equities." The American and global economies grew well in the last half of the twentieth century and validated common stocks.

Equities, however, fell out of bed in the last decade and there is the honest question of whether their high weighting in investment portfolios should be maintained. Should risk be dialed down in favor of fixed income investments responding to the economic uncertainties of today? Government is taking a bigger role in the economy and that suggests lower rates of growth. They are concerned about the credit markets and are protective of fixed obligations as opposed to shareholder interests. Other considerations are the possibility of inflation due to all the stimulus programs, the probability of more rapid growth abroad versus the U.S., and the inherent

inventiveness and entrepreneurial spirit of Americans and their long history of facing and working through problems. Lots to think about and no sure answers.

Economic upheavals have happened before and will happen again. We are all aware of the tough domestic and global times that we are now experiencing. Particularly worrisome is the high and rising rate of unemployment, the ripple effects of too much debt and leverage, reduced consumer and capital spending, and the extreme pain in such traditional industries as banks, autos, housing, etc. Governments around the world are trying to restart their economic engines with massive fiscal and monetary stimulus. We believe it will work and the fact that one in ten Americans are now on food stamps says it better work.

On a relative basis, Covington clients have come through this period well. However, investment counselors are not magicians and there has been almost nowhere to hide. We started this decline underweighted in stocks and avoided many of the toxic miseries like sub-prime loans, heavy concentration in financials, housing, autos, etc. More important, the firm's basic investment tenets have held us in good stead. These tenets include emphasis on balanced portfolios with a mix of cash equivalents, bonds, and common stocks, diversification, and a blended equity platform containing a mixture of small and large capitalization stocks, domestic and global issues, and value and growth. We have seen some great investment firms get burnt by sticking to particular styles and being unwilling to change. Being light on your feet also includes a willingness to change styles and sell mistakes. Stock investing is a batting average exercise and mistakes have to be recognized as soon as possible and the capital reinvested elsewhere. This is the toughest part of portfolio management, but we do recognize the challenge and do our best.

What lessons should investors learn from this rocky environment?

- 1) Be humble and keep it simple.
- 2) Stick to good quality and marketability.
- 3) Have a plan that you are comfortable with and stick to it—know your sleeping point and don't disturb it.
- 4) Accept the fact of uncertainty and unexpected change.
- 5) Cash is not always trash. Keep some powder dry.
- 6) Watch out for high debt and leverage. Significant short-term debt on company balance sheets can be toxic.
- 7) The greater the complexity, the greater the chance of unrecognized risk. Never commit to something you do not understand (Madoff).
- 8) Stock dividends matter. They are a reflection of firm strength and an important part of total return.
- 9) The market frequently overshoots on the upside and overcorrects on the downside.
- 10) Waves of market boom and bust eventually smooth—focus on the long term. Cyclicalities of markets should be expected.
- 11) Nothing should ever be too big to fail.
- 12) Bull markets are more fun than bear markets.

Bear markets do come to an end. On a short-term basis, it has been great to have stocks rally (broad indices are up 20 to 30 percent in the last month) and the ammunition is available to drive them further. Investors have been frightened into holding huge balances in cash equivalents which yield almost nothing. Perhaps this can fuel further appreciation. Could this be a rally in a secular bear market or is this the end of the misery? Is this a sucker rally or a new bull market? No one knows for sure. Key questions are:

- 1) Will the economy and corporate earnings kick in to support the rally?
- 2) Has the secular investment world changed and should we permanently dial down our long term allocation to stocks?
- 3) Have investors reached the exhaustion stage of the stock cycle which usually precedes a market upturn?
- 4) Are stock valuations so cheap relative to investment alternatives that they can't be ignored, etc., etc.?

The important decision is when to change from defense to offense. For the moment, our judgment is not to be too early to the party.

<i>The Good News</i>	<i>The Bad News</i>
Over the 20-year stretches since 1871 (118 periods, starting at the end of each year), stocks typically returned 6.85% after inflation. The trend for 30-year periods (108) was similar.	Despite good median returns, 24 of the 133 five-year intervals were losers. Ditto for 13 of the 133 10-year periods.

STOCK MARKET RETURNS 1871-2008*

Performance of Intervals

	<i>30-Year</i>	<i>20-Year</i>	<i>10-Year</i>	<i>5-Year</i>
Highest	10.57 %	12.63 %	16.85 %	26.69 %
Top Quarter	7.68	8.55	10.31	11.84
Median	6.23	6.85	6.84	6.97
Bottom Quarter	4.99	4.32	3.54	2.31
Lowest	2.58	1.04	-4.11	-10.74

*Average annual, after inflation, pretax, reinvested dividends.