

## Up, Down; Round and Round

The U.S. stock market had a great run from 1982 through 1999. Since then, there has been an up/down pattern with little overall progress over this ten-plus year period. At the mid-point of 2010, the strong upturn that began in March 2009 is being tested.

All markets go through cycles and the current situation is not unusual. This long, flat period is dispiriting and is a natural time to review the place of stocks in a portfolio and the basic investment principles that guide our work.

Covington's core investment beliefs include:

- 1) Covington believes that successful investing is a marathon, not a sprint. Benjamin Graham (the founder of modern investment theory) said that in the short term, investing in the market is a voting machine, while in the long run it is a weighing machine. Short-term fluctuations in the stock market are not predictable and no one has consistently excelled at this. The long term lends itself to better analysis and proper focus. Sell-side Wall Street and the media have a prolonged history of investment musical chairs. A short time horizon fits their profit platform and news cycle. It has proven a tough way for an investor to make money. We believe in a long-term focus.
- 2) Covington believes that managing risk is the first consideration in portfolio management. Investors need to understand their own willingness to accept downside volatility and work with their advisors to have a written plan. The primary tool in risk management is diversification; a spread of capital among different asset categories and within each category. David Swensen of Yale University, who has a superior long-term performance record in managing the school's endowment fund, has written and spoken extensively on the benefits of a diversified "endowment" model for individual investors. His recommended portfolio includes all the primary asset classes including stocks (both domestic and foreign), cash equivalents, bonds, real estate, and commodities. The search is for uncorrelated asset classes that can smooth performance over time and lend consistency to portfolio results. Above all, investors need to know their own sleeping points so they can grit their teeth and hang on during each of the one-hundred-year stock market floods that seem to come along every ten years or so. The message—spread out.
- 3) Pay attention to valuation. A cheap price can offset lots of economic misery. Fat pitches usually present themselves in times of turmoil. Look for low valuation metrics and high sustainable current yield. Keep in mind the low correlation between what is happening in the economy and the performance of the stock market. Jay Ritter of the University of Florida analyzed one hundred years of data from sixteen countries that showed that there was no positive correlation between GDP growth and stock market return. Prospects for attractive stock market returns are primarily dependent on cheap purchase prices.

- 4) Pay attention to the absolute return from a portfolio and the production of relatively stable income streams from a wide variety of sources. Quarter-to-quarter relative performance to some benchmark is one performance measurement tool, but not primary. More important is portfolio volatility in down markets and the production of current income. Portfolio upside will take care of itself.
- 5) Keep it simple. Invest in what you understand. Stick to quality for most of a portfolio and the production of current income. Bonds and cash equivalents are the anchor to the windward and usually produce decent income streams. Keep maturities within ten years. Stocks and real estate are the riskier assets and historically have provided the highest rates of return. They also create the most mischief. Within the risk parameters of a portfolio, stocks long term have an important role. People like Warren Buffett have shown wonderful results derived from a focus on a portfolio of common stocks bought with a long time horizon comprising of companies with competitive and financial strength, good prospects for future earnings and dividend growth. If a diversified group of such companies can be acquired at reasonable prices and held over a period of five or ten years, the performance results in most market environments have been excellent.

Stock market investment styles are partly age related and partly driven by the investing environment. All money managers need to be honest, flexible, bright, able to evaluate masses of information, understand that mistakes are part of the business, and humble enough to take losses quickly. Successful investors are risk averse.

Two or perhaps three broad styles of investing have evolved. These were spelled out (in paraphrased and modern vernacular) by Adam Smith in his book, "The Money Game," when the Great Winfield said:

"Show me a portfolio, I'll tell you the generation of the portfolio manager. The really old generation, the graybirds, they're the ones with Abbott, McDonalds, General Mills, Procter & Gamble. The middle-aged generation has Intel, Microsoft, Amgen and sometimes listens to rock-and-roll music. The swinger set stocks frighten all the other generations. They are into science stuff (Research in Motion, Akamai Tech., Cirrus Logic), small biotechnology firms, and computer game companies like NVIDIA."

Jeremy Siegel's book, "Stocks for the Long Run," makes a strong case for the graybirds. Some of us who were kids in the 1950's had to save up to go to the movies. Thrift was a virtue that we did not forget and colors our investment style. Covington believes in cheap prices, balance sheet strength, strong competitive positions, and decent dividend payout for investors. But don't call us graybirds.

Let not your heart be troubled. If you stick to good companies, diversify, have bonds and cash to hold risk to acceptable levels, the sun will eventually shine.

Addendum: This was written by one of our portfolio managers in 1974 during a terrible two-year decline in stock prices. It was meant to encourage a large pension plan to take the long view and hold onto their equity positions. Stocks eventually bottomed and subsequently provided excellent returns. Thankfully, the manager kept his job.

### The Secular Case for Common Stocks

There are four primary investment alternatives: real estate, cash equivalents, bonds, and stocks. The traditional wisdom has been to spread assets among the four alternatives. The primary reasons for including stocks in an investment program are as follows:

- 1) Stocks are open-ended. They 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 the American economy should lead to long-term growth in dividends and corporate earnings.
- 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. Because of 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 the American economy will continue to grow and that common stocks are likely to outperform bonds and cash equivalents.