

January 10, 2008

Family and friends filled our home during the holidays, bringing great joy. The evenings often went like this: somebody fixed supper, we shared a meal, some of us walked in the neighborhood to look at Christmas lights, some parents with toddlers or babies gave them baths followed by someone reading books to grandchildren, followed by their parents putting them to bed. The hushed living room and constantly burning fireplace beckoned five dogs to stretch all the way out and convinced my wife, Anne, and her friend Emily that it was safe to begin knitting. I can tie any knot known to man, but knitting escapes me. Still, I love listening in on their chatter while they knit, feeling the warmth of the fire and watching over sleeping dogs, one of which sooner or later will chase a rabbit in his dreams.



I learned that for the two scarves the girls are knitting, each knitter pulls yarns from two separate balls; one a hand-spun silk with a tight twist to it and the other a metallic thread from a tightly wound spool. I learned that keeping the two respective threads untangled and preventing them from becoming tangled in the other knitter's threads requires constant effort.

One evening as the girls were winding up their work, Emily said, as if to no one in particular, "This same patience is required of a weaver when warping (laying the foundation yarns) on a loom." It was then that I, who more than thirty years ago had the privilege of learning under a very wise client who was a pioneer in the textile industry, roused myself to hear more. Without noticing my interest, she continued, "The warping is not the aesthetically gratifying part of the process. The beauty of the woven piece emerges in the weaving, not in the warping, but diligent patience and careful craftsmanship are essential to the warping process to ensure that the weave is successful as well as delightful."

Still thinking about the mechanics of knitting and weaving after our friends left, I wrote Emily seeking further illumination. In her thoughtful reply, I learned that the large throw she designed and has been working on for several years (a 24" x 18" section is pictured above) has several yarns going at the same time in each row. I learned she measures off the length required for each color, keeping each wound into a small ball, releasing the yarn from the ball as she goes. I learned if she doesn't do that, that the yarn would (and has) become snarled, requiring more of her time to untangle than the time it would have required to patiently keep them separated in the first place.

"So it is with managing yarns when knitting," she concluded, "these beautiful patterned pieces require working with several yarns at one time. The privilege of working these complex pieces requires patience in managing the yarns. Complex beauty does not come easy or fast. There must be joy in the process for there to be beauty in the result. And so it is with anything we undertake."

Managing Yarns and Stocks

The persistence, process and work required to knit or weave a blanket or scarf is similar to our work of managing a portfolio of stocks and funds. We lay a foundation for what types of companies we want to own (and at what prices we want to own them) and then operate within that foundation. To do this, we are

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required to sort through the strands of economic data, business metrics and investor psychology (all-the-while untangling fact from fiction and fundamentals from emotions) to make sound investment decisions.

In doing this process, there will be dropped stitches and broken yarns here or there. But, like our friend's knitting project that looks a bit disorganized and uninspiring in the short-term when viewed close up (see right), we aim to stick to our knitting and look forward to realizing the long-term picture as a whole (as seen on page one).



Recession or Not?

Mark Twain once said, "The past may not repeat itself, but it sure does rhyme." We see a lot of rhyming in the economy and market these days. But the difference between what is unfolding now and the Crash of 1987, or the problems with the hedge fund Long-Term Capital Management in 1998, is that those first two events were confined to Wall Street, whereas the current economic issues extend to Main Street and to the value of the most important asset many consumers will ever own, their home.

As usual during periods of high economic uncertainty, the odds are stacked against the economy; there are difficult conditions such as rising energy prices, geopolitical uncertainty, trade deficits, the falling dollar, a presidential election, etc. The fear of a recession is palpable. Fear dominates both headlines and stock trades. Consequently, 2007 turned out to be a very volatile year – even with many indices posting moderate gains. However, all three major indices posted a loss for the fourth quarter, and many hedge funds, investors in financials, and participants in the credit markets lost substantial sums.

We think it's very likely we'll see more of the same in 2008. Stock prices will be volatile, while the credit markets continue to be cleansed and purged of their excesses. It's likely that banks and brokerages will continue to announce large write-downs and that lending will contract. These actions, coupled with a consumer whose home value may be falling, could very well lead to a contraction in consumer spending and possibly, a recession.

But all is not pumpkins and mice... As the legendary investor, Sir John Templeton, once wisely noted, "For those properly prepared in advance, a bear market in stocks is not a calamity but an opportunity." We've had nine recessions since 1950. A recent study by Morningstar shows that if you had put \$1 in the S&P 500 every month since 1950, your \$695 would be worth approximately \$11,000 today. But if you had broken up the \$695 into nine equal chunks, buying the S&P 500 at the outset of those nine recessions, you would have about \$13,000 today, or 20% more. What we've learned is that putting your money to work in the market prior to and during a recession sure would have been better than taking it out and stuffing it under a mattress or even keeping it in US Treasury bills.

Just as the right thing to do in 2002 was to buy what everyone was panicked about, we think the greatest gains over the next 5 years will be made in those stocks people are panicked about today. During the 2002 Bear Market, AES Corp traded under \$1. In 2007 it generated over \$1 of *cash flow* alone and is up 20 times from the lows of 2002. But in 2002, fear set its price.

Markets fluctuate and yarn gets tangled. Undervalued markets often get more undervalued, just as overvalued markets often get more overvalued. Those are facts of life. It's whether we stay patient and disciplined when fear is rampant that makes all the difference in the long-term picture.

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