

### **GOLIATH'S OPTIONS EXPIRE**

Everyone seems to be asking, "What went wrong?" What is wrong with the stock market, the research analysts, the management of our largest corporations, the auditors and institutions that check those corporations, etc? We felt like a lone voice in the wilderness when we were asking this question way back when the bulls were running full speed. The economics made no sense. But, making money made sense, so, rather than question the economics, the preference was to facilitate it. Now that people are losing money, there is great passion to find and punish those economic evildoers.

What went wrong? Could any of us have ever imagined the demise of companies the size of Enron and WorldCom, not to mention a Big Five accounting firm? Not since the Great Depression have we seen such distrust of corporate management, such challenges to the credibility of our financial reporting systems, and the resulting loss of faith in our capital markets. Are these truly unusual times? Or, on another level, does this cycle look a lot like previous cycles?

#### **Bypassing the Bear**

Before reviewing some of the cause and effect aspects of this cycle, we will briefly review the depths of despair that have been realized in the market. From their highs in early 2000 until recently (mid-July 2002), the S&P 500 Index is down almost 40%, and the more technology concentrated Nasdaq Composite Index has declined over 70%.

The good news for CornerCap clients is that we continue to have good, positive returns since the market decline began over two years ago. We were down this quarter but not as much as the market. In the world of investment management, there is nothing more pleasing than to be able to guide one's clients safely through a severe bear market.

Most equity investors have realized dramatic losses, and those losses seem to be continuing as the new quarter begins—as of this writing. We are beginning to see signs of blood on the streets. After market declines in both 2000 and 2001, it takes one back to note a few of the 2002 year-to-date (again, through mid-July) losses for so many major corporations:

AOL Time Warner	-59%	Intel	-43%
AT&T	-42%	IBM	-43%
EMC	-36%	Lucent	-50%
Home Depot	-43%	Oracle	-30%

These companies are being exposed to minefields like we have not seen in decades, and it is the mega corporations that are being hit. These Goliaths are more vulnerable than ever. Why are so many of these Goliaths of industry suddenly being toppled? Let us go back to the beginning and review this unprecedented investment cycle.

#### **The Saga**

Once upon a time, years ago, there was a line on a chart that moved strongly toward the northeast. The line ran far off the chart like a thundering stampede of bulls. In those times, the people were all merry. The leaders were given tremendous incentives and rewards for all the good things that they were doing. Those leaders and their companies were some of the most admired in the land—Enron, WorldCom, Tyco, Cisco, Xerox, Lucent, Qwest, Kmart, Global Crossing . . . .

The people in the land, being filled with joy and high spirits, greatly trusted and admired the leaders of those companies like Ken Lay, Bernie Ebbers, Dennis Kozlowski, Chuck Watson, and John Rigas. Those leaders bestowed great wealth upon themselves, and the people cheered.

And there were those who had been appointed to keep check on the leaders—auditors, investment bankers, research analysts, the SEC . . . . They were the best professionals in the land who were entrusted with grave responsibilities. They noted that the leaders were reporting Herculean feats to the people, and they wondered. But, alas, the people prospered and felt such pride in their leaders that the checkers decided to become protectors rather than inspectors of those great leaders.

Then, one day, a dark cloud appeared moving in a southward direction. The cloud grew like a giant bear with its back to the sinking sun. The trusting people began to turn on their leaders, especially those leaders who in earlier times always seemed to want more.

The checkers began to check once again but, this time, more penetrating and meticulous than ever before. Discoveries were made, and the people felt betrayed and were outraged. Severe punishment of those greedy and unscrupulous leaders was demanded.

### **Misguided Motivation**

The names, places, and circumstances have changed, but this story is not unique. It occurs in a similar fashion with every major market cycle. It is the cycle of greed and fear. In times of greed, people are trusting and tolerant as they live the good life and envision financial security. In times of fear, our current direction, people are suspicious and intolerant as they feel their financial foundations eroding beneath them.

What is different about this cycle? The one new and significant causal characteristic that we would single out in this cycle is stock options. The inappropriate accounting for and unconscionable availability of stock options provided the fuel for boosting corporate management greed to levels never before imagined.

Stock options proliferated in the 1990s. The rationale was to grant options to management so that it would be rewarded based on the performance of the stock. The theory was that this connection to the stock price would result in closely aligning the interest of management with that of the shareholder. Sounds reasonable. Shareholders wanted significant price appreciation and so should their representatives at the company, i.e., management. Good in theory, but like a lot of things, it did not work well in practice.

Management did exactly what it was compensated to do. The CEOs were the leaders, and they tried to do whatever they could to move the stock price up, as fast and as far as possible. In the many instances we have seen of either fraud or severe abuse, the CEOs were the primary ones who broke the rules or pressured or manipulated others to break or bend the rules. The board gave the CEO a specific date and amount for increasing the stock price. Like many white-collar criminals, they usually start with small lies and a modest manipulation of the books. As time passed and events unfolded, whether up or down, a number of once honest CEOs transitioned into confirmed corporate crooks. Of course, there are many high quality CEOs running excellent companies, and it is our job to find and allocate capital to them.

This motivational and behavioral problem has not been fixed. In America, the CEOs rule their corporate kingdom, even though they have frequently never bought a share of the company's stock with their own personal savings. Boards seldom go against the CEO. In most instances, the CEO, not the compensation committee or the board, controls his own compensation. We do not understand why so many boards continue to grant substantial stock options to their long-time, loyal CEOs, even though many of them already have extreme wealth, love their jobs, and would never leave the company unless forced to by the board.

Even though shareholders, the general public, and government regulators are now seriously questioning the personal integrity of CEOs, they continue to lobby Congress to keep the accounting for these instruments of greed, i.e., stock options, off the profit-and-loss statement. This non-reporting creates the illusion that stock options, which are being used to compensate the executives, are "free" to the corporation's shareholders. This is nonsense. But, most importantly, this type of accounting has encouraged the excess that has motivated these CEOs to break the rules.

### **The End**

When will all this end? Or, as some people are asking, is this the end? It is probably not the end, but we appear to be quickly moving toward it. We are simply moving through the unpleasant, but unavoidable, conclusion to the current major cycle saga.

We need to have more faith in the invisible hand of capitalism. Businesses need capital to grow and be profitable. The masters of business know this. When you lose investor confidence, the capital markets shut you out, and your business starts to die. Both fear and greed, even more than stock options, motivate corporate leaders to take corrective action and to keep the investor in the marketplace. We must endure the immediate pain, but it will end.

We can already see the beginning of the end. Professional investors who pursued growth at any price are returning to traditional, fundamental stock analysis. Rather than forecasting astronomical valuations, they are refocusing on boring things like financial accounting and corporate governance. Best of all, these investors continue their migration into the stocks that CornerCap believes are undervalued.