

MARKET AND INVESTMENT COMMENTARY: *“UNCHARTED WATERS” AND REGRESSION TO THE MEAN*

After the rescue of Bear Stearns by the Federal Reserve, former Treasury Secretary, Robert Rubin, noted that we are in “uncharted waters.” The Fed boldly tossed out its traditional playbook in monetary policy, going so far as to guarantee JP Morgan against losses from Bear’s troubled balance sheet and to allow nonbank financial institutions access to its short-term lending window. These Fed actions were dramatic and unprecedented. They underscore the tenuous nature of the credit markets and will take years to understand fully.

Will the Fed be forced to bail out others in similar fashion? Does it have the capacity to do so? Is recession looming, only to be worsened if banks refuse to make loans? Can the Fed balance inflationary pressures with a slowing economy? These questions underlie today’s headlines.

We don’t try to predict the future, but we do anticipate further headwinds as the housing and credit bubbles deflate. Some experts estimate that banks are perhaps 60% of the way through their write-offs as the subprime crisis moves on to delinquencies in consumer and commercial loans. Lower interest rates will probably do little to address the fundamental need for de-leveraging by consumers and financial institutions, and forced selling of illiquid credit securities may continue driving asset prices down further in housing and certain credit markets.

No surprise, then, that the credit markets remain extremely skittish, with many bonds’ spreads over Treasuries well above historical norms. Wide spreads imply high risk aversion. Institutions may continue to hold cash and avoid lending, which could crimp GDP growth, at a time when inflationary pressures persist. This process will likely take time to stabilize.

Fortunately, in our view, at least some of this is reflected in stock prices already. For all practical purposes, we believe several sectors (consumer-related, manufacturing, housing-related, etc.) are well into a recession. Echoing this sentiment, a Duke University/CFO Magazine

Business Outlook survey of 475 US CFOs shows that 80% believe we are either in a recession or will be before year-end. Data from the Institute of Supply Management indicates that the Manufacturing sector has been contracting for the past few months. And while unemployment remains in a comfortable 5% range, more recent employment numbers measuring the level of job creation show that jobs are being lost.

Our Message

Despite the turmoil—and arguably because of it—we believe attractive opportunities exist in select US stocks for long-term investors. Our proven discipline can help us create a balanced basket of stocks that in aggregate position our clients to take advantage of fear today.

Our message remains the same: 1) we will maintain our disciplined, value-oriented investment approach based on “regression to the mean” and 2) we tend to migrate to those “out of favor” stocks of good companies with healthy enough balance sheets to weather a reasonable storm.

In particular, our process is steering us further toward stocks in the Consumer Discretionary (i.e., companies tied directly to discretionary spending by consumers) and Industrial sectors, as well as select technology and financial stocks. Interestingly, we are not yet finding buys among core banking stocks, however.

Current Performance and Investment Activity

Broadly, our small-cap composite (i.e., a collection of small-cap stocks generally held in client accounts) had strong relative performance this quarter—while down -2.2%, it beat the major indices by 4% to 8%. In contrast, our large-cap composite, after a strong period of outperformance since the tech bubble, was down -9.8% for the quarter, slightly below the S&P 500 Index’s -9.4%.

MARKET AND INVESTMENT COMMENTARY (CONTINUED): *“UNCHARTED WATERS” AND REGRESSION TO THE MEAN*

To put this performance in context, both small- and large-cap composites had a difficult second half of 2007, as larger growth stocks surged (including energy stocks) and our more value-oriented stocks were avoided. Fears of recession weighed on consumer-oriented stocks (and even some industrials), and the credit crisis continued to hammer financial stocks. As you would expect, our research process began steering us further toward stocks in these penalized sectors.

Specifically, in keeping with our contrarian philosophy, we became incrementally more aggressive in Consumer Discretionary and Industrials, with three stocks added to the Buy list, including Darden Restaurants and international capital equipment manufacturer, Terex Corp. This action increases our “above-average” exposure to these sectors, relative to the S&P 500. We are also finding better value in information technology stocks, adding two stocks (international electronic components distributor, Avent, and a wireless equipment provider) and selling one (Orbotech), resulting in about average exposure to this sector, compared to the S&P.

Our view is that careful stock selection in these downtrodden areas has the best potential for “regression to the mean” over the next few years. The challenge, of course, is ensuring that the stocks we choose have healthy balance sheets and ample cushion to weather a challenging economy.

Touching on the Financials sector, where our clients tend to have average or slightly below-average exposure, we have not yet found a compelling reason to be more aggressive on the money center banks and investment banks, despite their group weakness. We sold Bear Stearns at \$80 per share on February 19 when our research process ranked it a “sell”, and sold Wachovia on March 5 during the recent rebound in that stock.

In our view, Wachovia has not been conservative enough in their balance sheet assumptions, lagging their peers in taking reserves against uncollectible accounts relative to nonperforming assets. Under more reasonable assumptions, we estimate Wachovia’s earnings could drop by 20% to 30%, which could force the bank to cut its dividend by 20% to 40%. We continue to own a few bank stocks across our client portfolios (Bank of America, US Bancorp, Comerica, Washington Federal), which we are monitoring. We did add two nonbank financial stocks (American Capital Strategies and Assured Guaranty) to offset our two sells.

As an aside, we highlight these actions to show how our investment process works during this tumultuous time. Our bottom-up research process continues to look across all sectors, since diversity is a key element of risk control. We therefore added five stocks in the Materials, Telecom, and Energy sectors to the Buy list this quarter, with several sell decisions as well, including Alcoa and Firstenergy which had been long term holdings for many accounts. Relative to the S&P 500, our clients generally have above average exposure in Materials, essentially average exposure in Health Care stocks, and below average exposure in Energy and Consumer Staples.

Conclusion

At some point, the US economy will return to growth, and the credit overhang will stabilize. Predicting how this will evolve is challenging and dangerous. Our long-standing clients know that we do not engage in such a guessing game. We therefore remain fully invested, using our proven screening system to buy stocks we believe to be on sale today, with ample cushion to survive a difficult environment. Such an approach allows us to outperform once fear and doubt subside for our selected stocks and sectors. Given the current uncertainty, it is the only way to invest responsibly, in our view.

AMAZING GRACE, THE HOLY GAIL, AND DO WE NEED A CLIENT SERVICE DEPARTMENT?

Probably only a few of our clients know Laura Hull. She keeps all of our 20-plus computers in high gear. Even on a late Thursday afternoon, if you need Laura, she is there. Even on Thursday evening, Saturday afternoon, Sunday morning, she's there. . . "Hey Laura (Thursday), we are hiring a new employee, so please move the computers and set up three offices." Sure. The following Monday, all is done, including new labels on every telephone in the office.

Our portfolio managers, Richard Bean, Doug Dougherty, Anno Hardage, and Jeff Moeller are stars. Richard, Doug, and Jeff do the investment research and make presentations to the investment committee, and Richard, Doug, Jeff, and Anno manage portfolios and conduct annual client reviews for over 280 of our client relationships.

When you call your portfolio manager with a list of charities that are to receive your benevolence, he selects the stocks. He then calls the charities' broker, transfers the stocks, tracks the transfer, notifies the charity and you when the transfer is complete. Or, does he? Who sets up your accounts: individual and retirement accounts, trust accounts, limited partnership accounts, limited liability corporate accounts, estate accounts, etc . . . and tracks the transfer of your assets? Who determines whether your assets have to be sold or whether they can be transferred in kind and how to transfer them? Who keeps our client informational databases current and accurate? Early on, it was Grace Wright who did that, and now Shannon Rebele ably assists her. Who maintains the corporate records, employee shareholder records, corporate and shareholder resolutions, as well as all shareholder agreements? Who handles the coordination of printing and the overseeing of advertising? Who handles and follows through with your administrative questions.

Grace has been with us a little over 11 years now. Her job has grown times four. In 1996, when she joined us, our assets under management totaled about \$150 million. Now, they are over \$600 million. At

CornerCap, we have always operated under the assumption that, if there is a problem, give it to Grace. Problem solved!

The engine at CornerCap is our investment research and discipline. We are and always have been averse to relying on outside research, and our structure in this way allows us to maintain our disciplined investment philosophy. Concurrent with research is portfolio management. Portfolio management, among other talents, includes maintaining the target allocation of diversification in accordance with your objectives, rebalancing, and structuring your account to permit income withdrawals. Our portfolio managers also answer your questions about investments and portfolio management whenever you call, and they will continue to do so, as this is one of the essential uses of their talents. To keep these talents focused on the best of the end results, we are formalizing a client service department. Toward that end, we have been searching for the Holy Gail.

Gail Marshak joined us on March 3. Prior to that, she was employed for 23 years by an investment counseling firm in New York much like ours in terms of client base and assets under management. Gail's resume is impeccable for everything we do in this area but also in operations. When we called Gail's boss at the investment counseling firm, he said that he had literally been shedding tears since the day she notified the firm of her resignation several months ago.

Gail's title is manager of client service administration, and our goal is that over time, you will feel as comfortable, if not more so, calling Gail about administrative matters as you were calling your portfolio manager, who will still be available to you at any time. We just want all you to know that Gail is here and that you may talk with her freely about all of your administrative needs, including money transfers and withdrawals.

AMAZING GRACE, THE HOLY GAIL (CONTINUED)

Shannon has been with us for two years now and assists Gail. This will enable us to deploy Grace in another important area as office manager. With respect to Amazing Grace and the Holy Gail, the key is to keep them busy only 60% of the time. That is because they will use their imagination for the other 40% and will make us an even better firm.

Going forward, CornerCap feels that the future will lie in continued client service to match the level of our research and portfolio management discipline, and that is what we promise.