

March 31, 2009

While the major US indices were down -11% to -15% for the first quarter of 2009, it was clearly a tale of two cities for equity investors. From January through early March, stocks slid to levels not seen in 12 years. Then, ignited by better than expected news from beleaguered banks like Citigroup and Bank of America, stocks roared back, posting gains of over 20% into early April.

This marks the second quarter in a row of a historically hard fall in stocks, followed by a rapid rebound (a 20% increase is generally deemed a “bull market”). The broad natural question is, can the current rally continue, or will we test new lows once again? And the question specific to us at CornerCap is, where is our research process leading us during this extreme volatility and uncertainty?

On Bulls and Bears

The bears argue that debt levels are too high relative to inflated asset prices, meaning that until debt falls to manageable levels, consumer spending must curtail, bank balance sheets will deteriorate, and deflation (i.e., falling prices and tight credit) will remain a high risk.

The bulls argue that the radical intervention by global governments—embodied in the US by a \$787 billion stimulus package, very low interest rates, and unprecedented monetary policy by the Federal Reserve—has helped thaw at least some areas of the credit markets. They note that by early March stocks were very reasonably priced at 11-times earnings for 2009, and suspect that catalysts like relaxed mark-to-market accounting rules could bolster bank balance sheets. On expectations that economic growth could improve by year end, they anticipate this to be a good time to be buying equities.

Reality is Somewhere in Between

Adhering resolutely to either argument does not best serve long term investors, in our view. A “one size fits all” view misses the inevitable opportunities and risks that are unfolding in unpredictable ways.

The bear case clearly has merit, considering that total consumer debt loads are 134% of disposable income. To return to more manageable levels of debt-to-income, consumers could have to pay down over \$4 trillion in debt—over 30% of GDP. That unwinding will take time.

Likewise, some level of government intervention is necessary to create a “soft landing” and avoid deflation. Whether our government has done too much, too late, will take time to determine (we think there’s a good chance it has, which will yield inflation down the road). Moreover, stocks have also been hammered, many near historic lows, which creates attractive entry points if you aren’t trying literally to call a bottom.

Capitalizing on Fear but Avoiding Landmines

In the coming quarters, we continue to expect some disappointing corporate and credit market news, which will likely bring extreme volatility to stocks. Only the best companies can raise debt on attractive terms, implying there will be more bankruptcies. Consumer delinquencies on mortgages continue to show worrisome trends, which will affect bank balance sheets and many areas of the economy. Municipal governments will have to address budget shortfalls.

The prudent course in our view is to seek ways to capitalize on this fear, while recognizing that landmines remain. We must avoid them as best we can, improving our odds by adhering to our investment philosophy, focusing on healthy balance sheets, and spreading risk through a basket of investments.

Staying on the sidelines, however, will miss the eventual upturn. Hiding in Treasuries, while comforting during this uncertainty, will succumb to inflationary forces over the long term.

Where Our Research is Taking Us

As our clients know, we do not invest for quarterly returns but for multiple years, so we can go for periods with strong or weak relative performance. We adhere to our investment philosophy and process regardless of what’s temporarily in favor.

After a challenging 2008, where we bought consumer and industrial stocks too early and did not follow herd mentality into energy and safe havens like staples, we have generally exceeded the major benchmarks rather significantly during this rally. We continue to have above average exposure to industrial, consumer and basic materials (e.g., mining companies, metal refiners, or chemical producers) stocks, which are out of favor.

Over the past year, we have paid exceptional attention to balance sheets and a company's ability to access credit markets. The goal is to find companies that can weather the storm and that trade at attractive valuations. We believe this will improve our returns when we exit recession, which we inevitably will.

Given our belief that inflation will prevail at some point (say, within five years), we have also followed our bottom up research process into greater exposure to energy stocks, and we have begun gradually moving away from low-yielding Treasury Bills (today's extreme safe haven) and into inflation-protected Treasury bonds ("TIPS"). Our bottom-up research has also uncovered opportunities in managed health care providers, as fear of onerous government policy has hit their shares.

As always, our goal in creating equity portfolios is to hold a diversified basket of value-oriented stocks, ideally where we can capitalize on fear and doubt, to drive attractive returns over time.