

## WEBS Virus Grips the Nation

*Over the last year, stock, bond, real estate, commodity and other markets have been devastated by fear and panic selling. The destructive forces leading up to this once-every-century bear market are analogous to a deadly virus. Essentially everyone has been affected by this market. Market cycles will continue, but probably will not be this severe again in our lifetimes. In light of this, we will offer some suggestions for investors to protect themselves in the future. We have always followed these same principles at CornerCap, which have served to buffer our results over the last three decades.*

The people of this great nation have been infected by an awful virus. This toxic virus has spread across our land more quickly and infected more people than any other virus in recorded history. While the virus started slowly and appeared relatively benign for years, once the fatal contaminants were triggered, the disease brought down its victims in just a few months. Where did the virus start? How does it spread and who are the most contagious victims? Can we control the spread of this terrible disease? We will explore each of these critical questions.

### Origins of the Virus

We have traced the origins of the virus to a small island in the Northeast by the Hudson River. The village that has evolved on this small island is truly unique. While it has realized exponential population growth over the years, its unique characteristic is the very high level of intellect and wealth of the inhabitants. With such a density of elite and well connected talent, our hope and expectation has been for this village to be a valuable source of creative ideas that will make our country more productive and globally competitive.

Sadly, this has not been the case. In essence, while they have been prolific with the new and creative ideas, whatever productive benefits were created flowed solely to them. They connected with other elites across the nation and around the world that were responsible for large pools of wealth (pensions, endowments, foundations, wealth managers, etc.) and enticed them with the same luring elixir – greed.

We have found that greed, which is an inherent component of everyone's DNA, is the infectious agent that originally created this terrible virus. And, like most human viruses, it is spread by carriers that extract blood from one victim and

transport it to the next victim. Rather than relying on physical contact, this virus has quickly spread around the globe via the Internet, global cell phones and other means of instant communications. To recognize the origin, connectivity and carrier nature of the disease, we have labeled it the WEBS Virus – Wall Street Elite Blood Suckers.

### The Virus Carriers

Are we being a little harsh? Probably so, but we are talking about a hugely destructive virus. We are also talking about our business, the investment industry. As Pogo the Possum said, "we have met the enemy, and he is us." At CornerCap, we believe that we remain virus free. The fundamentals of our business are completely transparent, and this can be shown by a full set of "X-rays" taken with a recent regular audit by the SEC.

On that note, the virus was most recently epitomized by Bernard Madoff who reportedly stole \$50 billion of investor money in a Ponzi scheme. It is difficult to comprehend how investors and regulators could have been duped for so long and so much. There is no rationale. The SEC reviews CornerCap in week-long audits every few years; we recently completed one. How is it that, year after year, they chose not to examine the Madoff firm? At least with the Madoff episode, accountability will be realized and worthwhile lessons learned. Madoff will probably go to jail and his trusting clients will lose almost all of their investments.

What about the other virus carriers in the investment industry? There are many managers, bankers, brokers, planners, etc. who were infected with greed that led to excess risk and poor advice. Bad advice is admittedly not stealing, but it can just as easily destroy value. Over-priced bad advice not only destroys value for the client, but it creates unwarranted wealth for the advisor. In other words, our most feared virus carriers are these investment industry advisors who seem to win even when their clients fail.

### Virus Strands

We have observed two strands of this WEBS Virus in recent years. The strands always involve the creation of a bubble in the marketplace. We have found these bubbles to be relatively easy to spot. There are 'greed-strand' bubbles which are the more frequent and toxic variety. They typically involve taking more risk than is expected or understood. There are also 'fear-strand' bubbles, which are also

unhealthy, and they usually involve a stampede away from an unexpected risk. We are actually in the middle of a fear-strand bubble with the rush to buy “safety” at any cost. This has caused a substantial over-valuation of US Treasury securities.

There have been several recent greed-strand bubbles. The on-going housing and subprime bubble involved investment bankers, mortgage brokers, and many others in the investment industry who were virus carriers. The tech bubble involved investment bankers, stock brokers, and a few other carriers. In a response to the tech bubble, we saw the buildup of the alternative asset bubble (hedge funds, private equity, leverage products, etc.) which involved most of the same characters. Not picking on any particular virus carrier, the investment bankers seem to be the best bubble blowers in the bunch.

As bubbles were inflating, most of these carriers created incredible wealth for themselves. Like Madoff, these virus carriers only needed to create the appearance of future profits without a commensurate amount of risk, and investors would be willing to reward them with substantial compensation from their pension funds, foundations, endowments, home equity, personal savings, etc. Like Madoff, much of the wealth promised to investors was lost. Unlike Madoff, the WEBS Virus carriers created and retained incredible wealth for themselves and broke no laws.

### **The Broader Issue**

This deadly virus seems to have become part of our society and culture. We used to be rewarded for making truly useful products. Today, we seem to be more in the business of leveraging, swapping, bundling, layering, and trading financial products with each other. We incur significant costs and waste much of our talented manpower with most products in the investment industry.

Most Wall Street people are honest, hard working professionals. They listen to investors and try to create the products that investors want to buy. These professionals usually believe in the products they are selling. They believe that their products adequately control risks. Their models confirmed that more and more leverage would not inordinately increase the risks. So long as investors continue to demand and pay for financial products that exceed reality, Wall Street will make models to redefine reality.

After each bubble bursts, Wall Street creates new products to solve the most recent problems. The post-tech bubble products were broadly labeled as alternative investments such as hedge funds, private equity, fund-of-funds, absolute value funds, market neutral funds, etc. These were all highly profitable products for Wall Street that offered high expectations for greater profits at more controlled risks for the investor. Few of those profits were realized, especially after paying Wall Street’s exorbitant fee. What will be the post-housing and subprime bubble products? Be assured, those products are already in the Wall Street research and development labs.

### **The Cure**

We do not see greed and fear being controlled, and as such, we see no permanent cure for the WEBS Virus. The cycle will continue to repeat itself. Uneducable investors will demand new products with promises of profits without the pain of the recent past. Wall Street will create those products and convince the institutional investors of their value. The new and exciting products will work well initially, and the message will quickly spread from the institutional market to Main Street and around the world. The new financial products will eventually lose their luster and self-destruct.

Successful investing is not about new and exciting financial products with promises of profits by slicing and dicing other financial products. It is about owning successful business enterprises that produce real profits by actually delivering something useful to their customers. Successful, virus-free investors will (1) not fall victim to unreasonable promises; (2) demand transparency and understand the product; (3) minimize costs; (4) avoid the use of leverage; and (5) choose morals and substance over promises from talented product purveyors.

At CornerCap, the portfolios that we build and manage for clients meet those criteria. Even though encouraged to do so by others, we avoided leverage, hedge funds, illiquid private equity funds, subprime investments or any security concentrations. Client success over time requires that risk be the principal focus. When the expectation of return is allowed to trump risk, the client will eventually be nailed by a Black Swan. However, the investment profession, our virus carrier,

will have accumulated sufficient wealth to move on to the next virus strand. Stay virus free by avoiding those soon-to-come offerings that appear too good to be true.