THE CORNERCAP® INVESTOR®

SPRING 2000 / VOLUME 22, NUMBER 2

The Beauty Contest

For over 20 years, we have worked to understand the market better. The current market has probably been the most difficult to understand and explain. Since we believe the market is moving into the final stage of this unusual period, we want to share with you our best thoughts on why things have moved to such extremes and what we can expect in the future.

Judging the Contestants

The best analogy that we have for the stock market over the last two years is a beauty contest. Beauty contests tend to focus more on the façade than the foundation. This beauty contest is held daily, and at the end of each day, they count the votes of the judges and easily see who won the contest for that day. Essentially, the same contestants come back the next day, parade themselves in front of the judges again and, hopefully, convince more of the judges to vote for them.

We are one of the judges, but there are many judges. In fact, there are so many judges that any one judge is not material. We want the contestant we choose to win. We are investing real money in the contestants whom we choose. In order to choose the best contestant, we spend a lot of time studying the cash flows, ROEs, relative pricing, etc. While we believe these qualities to be important, actually essential, most other judges have recently been looking for other qualities. The primary quality that the other judges look for is hope – what is the chance that someone will pay a higher price for this stock, and quickly. So, to be successful at picking the winning contestants in recent quarters, you would have had to focus more on the judges than on the contestants, thereby accepting a preference for the superficial over any measure of substance.

> If their goal were to win the beauty contest every day . . . , they would need to focus more on the judges than on the contestants. This is not long-term investing. It is really a trading strategy, and it is closer akin to gambling. We can accept some investors wanting to gamble with some of their money, but we see this happening too often with the lion's share of many individuals' retirement assets.

An attractive lady may win that year's contest because of her exceptional, external beauty, but the real winner will be determined by her fundamental worth on the inside. It is the same with investments. In today's market, an attractive company can move to an astronomical valuation almost overnight. The company can capture a lot of the votes. However, the company will not be a real winner over time unless it has a sustainable, competitive advantage that will generate sufficient cash flows that can be returned to

SEE PAGE 2

Hot Numbers

A friend of ours, a fellow investment professional, told a story about someone he had called on over the years. One day the prospective client, a pension officer with a large company operating in the Southeast, asked, "Why do money managers hate us?" "What do you mean by that," asked our friend. The pension officer replied, "We hire our money managers because they have great track records, and they immediately start under performing

Hot Numbers continued

technology-oriented, investments over the past nine months. Since March 10, this sector has declined dramatically, over 35% at one point. Clearly, the new cash flowing into this sector peaked coincidently with the peak in the stocks.

We have structured our emerging growth strategy so it can participate in new industries like e-commerce, but it is not limited to any single theme. We take growth where we find it, from technology to textiles. Our diversification prevents us from posting the kind of astronomical numbers that get one written up in *The Wall Street Journal*, but diversification also provides greater protection on the downside. The P/E's of small-cap growth funds like ours are high, but most of the funds' growth companies have real revenues and real earnings. As the Internet investment rose continues to lose its bloom, small-cap growth funds like ours will look compelling.

> Investors, attracted to good performance numbers, send new investment cash to the manager with the great track record. Most of the time investors learn the hard lesson of regression to the mean: recent outperformance does not automatically lead to continued outperformance.

Advice to Investors

Our commentaries have consistently stressed the importance of discipline to success in investments. In our view, a disciplined stock picker can give solid reasons why he owns a particular stock, or why he sold a particular stock. Discipline is just as important at the asset allocation level. This is a policy level decision led in our business largely by the client. For the individual investor, we have consistently stressed our belief that asset allocation should reflect one's age, earning power, risk tolerance, and income needs rather than the relative attractiveness of various market sectors. Asset allocation should be based on a strategic decision instead of a tactical decision.

Investors who spent the first quarter of 2000 reducing their exposure to old economy stocks and investing the proceeds in new economy stocks were pursuing a tactical asset allocation strategy. We believe this is not a winning strategy, and we always discourage this sort of behavior with our clients. We encourage investors to limit their concentration in any one area, regardless of how appealing the numbers and the story might be. Similarly, when you are on the down side, remember that time is on your side, and you normally are more successful by waiting for the rebound.

The Beauty Contest continued

the shareholders. That essentially defines long-term investing.

We realize that terminology like "long-term investing" is not popular or relevant with many of today's investors or judges. If their goal were to win the beauty contest every day or even every year, then, again, they would need to focus more on the judges than on the contestants. This is not long-term investing. It is really a trading strategy, and it is closer akin to gambling. Warren Buffett characterized the recent high tech run up as a Ponzi scheme. We can accept some investors wanting to gamble with some of their money, but we see this happening too often with the lion's share of many individuals' retirement assets.

As Peter Bernstein reminds us, "the value of an asset without cash flow is only what somebody else will pay you for it." Stocks with positive cash flows were down last year, whereas stocks with negative cash flows were up over 50%. This seems like a risky position for an investor to take. However, at least until the recent dramatic sell-off in the technology sector, acceptable levels of risk were being redefined higher almost daily. There is always a downside to higher risks in the market, and it is not a question of if but rather when it will be realized.

New Economy or New Judges

As we discussed in our last newsletter, we do not accept the new economy versus the old economy market explanation that has been so thoroughly discussed by the financial media. The economy is always changing. Even though these changes mean not owning a concentration in the hottest sector of the market. In other words, it is now risky not to own a high percentage in the tech stocks, regardless of their price or their ability to convert sales to earnings. We are always in the process of evolving a new economy, but, again, the most important thing with investments is that we have a new breed of investor.

An Absence of Balance

In the long run, we believe that it is a positive trend for individuals to become more involved in and educated about their investments. Similarly, as we increase our knowledge about our personal health, we may drive our doctors nuts and even get ourselves in trouble on occasion, but over time, the knowledge will be beneficial. In its simplest form, learning about good investing means learning about the efficient allocation of capital. General Electric allocates capital to its numerous divisions based on which lines of business will generate the highest returns for the least amount of risk. Like GE, individuals are becoming involved in and learning to do the same thing with their personal capital.

We are concerned that average individuals may not be as far up the learning curve as they now think they are. We are also not sure how much will be learned by listening to CNBC or reading "Heard on the Street." People will primarily learn the way they always have, by making bad choices and then having to live with the consequences of those choices. One consequence will be a potentially permanent loss of capital because of a decision to make concentrated bets on companies and/or sectors that offer what they believe is the opportunity to make a lot of money fast, i.e., raise their level of risk. In other words, investors make bad decisions because they have not learned that they must properly balance risk and return.

Conclusions

As this commentary suggests, we believe that we are in a unique period in the history of the US equity market. This unique market has resulted in many of our clients, especially our most recent clients, seeing CornerCap as being overly concerned about risk. It is true that all of our clients' assets must be there ten years from now, so risk control will always be important. Because of the extremes that exist in today's market, we believe that above-market returns are now available at below-market risks. Stated another way, the contestants who are receiving our votes now possess both inner and outer beauty. The other judges have been in agreement with us since March 10. Whether it happens on March 10 or on some later date, the laws of economics, old and new, will force this change to take place.

CORNERCAP HIGHLIGHTS

Charlotte Office Move

Gene Hoots and Kendrick Mattox have been on the move in Charlotte. They have relocated to a new building in South Park in the Morocroft Professional Center. These new facilities give them a better opportunity to host clients, prospective clients, and friends of the firm. Their address is 6836 Morrison Boulevard, Suite 204, Charlotte, NC 28211. Their phone number is still (704) 442-

ago, and it has performed well. As a mutual fund (versus a limited partnership), we will be able to allow more of our clients to participate in this investment strategy.

The Board also approved the change of the name in our CornerCap Growth Fund to the CornerCap Small Cap Value Fund. It was felt that this name change better reflects the current terminology for the investment strategy of the fund. Its ticker symbol has also changed from CGRFX to CSCVX.

Personnel

As many of you know, Mary Curtis Pizzano has been serving as the Transfer Agent and Fund Accountant for our mutual fund company. Mary Curtis and her husband George are expecting their first child in June, so she will be making a permanent career change in favor of motherhood. We hope all goes well. Karen Quinn, who joined our firm in early April, will replace Mary Curtis. Karen is a graduate of Carnegie Mellon University, and she has an MBA from Georgia State University.

The Timing of Taxes

One of the CPAs we work with told us a sad story about one of his clients. His client did investing in his spare time, and, until recently, he had done very well. In 1999, using margin and a number of momentum-based trades, his client successfully built his $50,000 nest egg up to $175,000 at its peak. It is of no surprise that his success and these trades created a large tax obligation that was due on April 15. However, it was a surprise when his leverage and the technology focused market crash that began on March 10 resulted in his investments declining to only $40,000. He had to liquidate all of his investments to pay off most (but not all) of his accumulated tax obligation. His only upside now is a significant tax loss for next year (tax year 2000), and since he will have no gains to offset this loss, he will have to carry forward into future years all but $3,000 of the loss.

CORNERCAP®
INVESTMENT COUNSEL
The Peachtree, Suite 1700
1355 Peachtree Street, NE
Atlanta, GA 30309
404-870-0700