THE CORNERCAP® INVESTOR®

DECEMBER 2000 / VOLUME 22, NUMBER 4

REVERSION OR REVOLUTION?

It is fascinating to watch the daily struggle that is taking place in the equity market. The economic battle starts each morning at 9:30 a.m., and at 4:00 p.m. a winner is pronounced. The casualties for the losers are usually dramatic: a lot of blood on the streets. The winner is pleased, but there is no time for counting because the battle resumes in the morning.

The war is between two powerful investment theories. The revolutionists believe that there is truly a new economy and that major investments must be made in these areas of the new economy, even though their valuations appear to be in the stratosphere. The opponents believe in the theory of reversion to the mean. Although they believe that the economy is always changing, they do not believe that the fundamentals of financial analysis change. Because of the recent valuations, the mean-reversion followers are diametrically opposed to the revolutionists, believing that the new economy stocks should be avoided until they revert back to a more reasonable valuation. There is a lot riding on which theory wins the war. Some people believe so passionately in their theory that they have bet the ranch, i.e., their retirement.

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As you know, we are more in the camp of the mean reversion theory. This is also, essentially, what all of the great masters whom we follow believe. The only problem with the great masters is that they tend to be old, not unlike a few of us at CornerCap. In fact, a number of these senior investors were casualties of the great two-year war that appears to have ended on March 10 of this year. While the disparity in the returns between the revolutionist stocks (new economy) and reversionist stocks (low valuations) from day to day and month to month have been and continue to be dramatic, the tide clearly changed on March 10. Relative to the overall market, CornerCap's stocks have done exceptionally well since then—up nicely in a declining market.

Will this trend continue? Who will win this protracted war of investment theories? We have been believers in mean-reversion logic for over 20 years, and this will not change. However, although our stock selection process has had excellent results over those 20 years, we are mindful of humility and the need for common sense in the investment arena. Nothing is certain except that there will be major events in the future that no one can predict. Sometimes these events are more significant and extend longer than anyone would have imagined. For that reason, we always go with the highest probability of success, but we also try to hedge our bets, i.e., control risks. The following is a different way of looking at each investment theory and some concluding thoughts.

The Reversionist

While our great masters of investing prefer this theory, it is not popular in the press or with most individuals (although this is rapidly changing with the recent losses in the new economy stocks). When you are unwilling to buy into the new economy, it gives people the impression that you are old school, out of date, and unwilling to change with the times. We thought we would fearlessly reinforce this impression by summarizing some of the theories in the 1934 edition of the book Security Analysis by Benjamin Graham and David Dodd. We old timers call this book "the Bible" of fundamental analysis.

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There are five pages of the book devoted to the "New-Era Theory" that was so popular in the mania that developed in the late 1920s before the stock market crash. The similarities between the current market environment and the New-Era Theory are very

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disconcerting. This is not a prediction for a stock market crash, but it is a statement of concern about valuations and how some of those valuations will move back into equilibrium. The following is a quote from the New-Era Theory section of the Graham and Dodd book:

. . . the theory ran as follows: (1) The value of a common stock depends on what it can earn in the future. (2) Good common stocks will prove sound and profitable investments. (3) Good common stocks are those which have shown a rising trend in earnings. These statements sound innocent and plausible. Yet they concealed two theoretical weaknesses which could and did result in untold mischief. The first of these defects was that they abolished the fundamental distinctions between investment and speculation. The second was that they ignored the price of a stock in determining whether it was a desirable purchase.

Graham and Dodd followed these comments by blasting the investment trusts (called mutual funds now) of the 1920s. They noted that:

Their investment process consisted merely of finding prominent companies with a rising trend of earnings, and then buying their shares regardless of price. Hence the sound policy was to buy only what everyone else was buying—a list of highly popular and exceedingly expensive issues, appropriately known as 'blue chips.' The original idea of searching for the undervalued and neglected issues dropped completely out of sight.

They went on to discuss the absurdity of how the New-Era Theory promoted the desirability of a common stock independent of its price. They pointed out how ridiculously high the price/earnings multiples had risen, and the New-Era conclusion was not that the stock prices were now too high but merely that the standard of value had been raised. In effect, all upper limits had disappeared (Cisco might be our modern-day example). Graham and Dodd continued:

An alluring corollary of this principle was that making money in the stock market was now the easiest thing in the world. It was only necessary to buy 'good' stocks, regardless of price, and then to let nature take its upward course. The results of such a doctrine could not fail to be tragic. Countless people asked themselves, 'Why work for a living when a fortune can be made in Wall Street without working?' The ensuing migration from business into the financial district resembled the famous gold rush to the Klondike, with the not unimportant difference that there really was gold in the Klondike.

Many things have changed in the investing world since 1934. We are fortunate today to have many more controls in place to prevent anything like what occurred in 1929. However, some things have not changed. The value of a stock is still the present value of all future cash flows. If you decide to pay more than that price for the stock, then you are valuing the stock based on what you hope someone else will pay you. That is called speculation.

The other thing that has not changed over this time is the behavior of crowds. In the long run, stock prices will revert back to their normal valuations, i.e., the mean reversion theory. However, in the near term, greed and fear drive stock prices. As we watch the crowds, most of us can recognize greed. While we as individuals know that greed is not healthy, that it has consequences, and that we should not follow the crowd with this behavior, we cannot help ourselves. Investor envy takes control of us. We buy at the wrong time. This same uncontrolled crowd behavior will take place in the other direction—fear. We sell at the wrong time. As the cycle rotates from greed to fear, we continue to hope for a soft landing, but there is probably still more reverting left to be done.

The Revolutionist

If they were alive today, Graham and Dodd would not be impressed with the believers in the new economy. But it has many supporters. Even among professional investors, there are probably more believers in the new economy and in the need to value stocks differently than in years past. The revolutionists have a persuasive argument.

We do not have an agricultural- or industrial-based economy today. Technology, telecommunications, and medical discoveries are the drivers of today's economy. The assets of companies that will generate the future cash flows are not land, plants, and equipment. The assets of today are bright people, their ideas, and then converting those ideas into products for the marketplace. Microsoft created ideas for using the personal computer. Cisco created ideas for using our computers to get to the Internet. Even Home Depot, a hardware and building supply retailer, was a technology story; the same with Wal-Mart. They created ideas and technologies for buying and selling products more cheaply and conveniently than the competition.

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Many important company fundamentals have changed over the years, such as book value. In the new economy, successful companies are now able to keep book value, i.e., long-term capital investments, to a minimum. Other company fundamentals have also changed. Companies now pay very little dividends. Higher taxes are part of the reason, but more importantly,

because stock price appreciation has been so high since the early 1980s, companies do not see the need to pay shareholders dividends in order to attract capital in the public markets. Companies can invest in new markets, buy another company, or simply promise (and sometimes deliver) a stock repurchase program. The Graham and Dodd analysis put a great deal of emphasis on the price of a stock relative to its book value and its dividend history.

In addition to the growth story and the changing characteristics of company fundamentals, the revolutionists can also justify their investments based on macroeconomic factors. Since the early 1980s, inflation has dropped to a nominal rate. Of greater importance is the fact that investors have lowered their expectations for future inflation. This has a profound effect on stock valuations, and it creates a preference for high growth stocks having little or no earnings over low growth stocks, i.e., value stocks, even though they have good current earnings. If inflation stays down, the present value of the future cash flows from the rapidly growing company becomes a much larger number.

Similarly, a lower effective marginal tax rate favors growth stocks, the stocks with the highest earnings prospects. Since the Reagan tax cuts of the mid-1980s, the marginal tax rates, especially in combination with the rate of inflation, have been coming down. Also, an easing regulatory environment and a lessening of trade restrictions favors large growth stocks, and this continues to be the direction in the US. Therefore, the new economy theorist would argue that prices are clearly up, but they are justified by the changes in the economic environment.

> We will always lean in the direction that we believe offers the greatest opportunity for future returns at a lower risk. In our opinion, this is in line with the mean reversion argument."

The Realist

It is certainly more likely that the future revenue growth opportunity will be higher for a large new economy stock like a technology company than for a large old economy stock like a basic materials company. But what about price? Are the revolutionists saying, buy these new economy stocks at any price, or are there fundamentals that justify the prices being paid? And what about competition? Are the revolutionists being investors or speculators in their assessment of how these new business models will result in (1) continued high growth rates for many years to come and (2) eventually high profit margins?

There is validity to both of the warring theorists. Whether you are talking about opposing nations, spouses or investment theorists, seldom is one combatant right on every count. With investments, there are probabilities, relativities, and degrees of correctness. We do not want to "bet the ranch" on any one stock, sector, or theory. We will always lean in the direction that we believe offers the greatest opportunity for future returns at a lower risk. In our opinion, this is in line with the mean reversion argument. However, we also want to buy growth and to participate in the new economy. Our fundamental investment approach has always allowed for this and will permit our participation in the new economy stocks when the valuations are appropriate. Many of these stocks have now dropped 50% to 90% from their highs earlier this year, and we are seeing a number of attractive investment opportunities emerge.

CornerCap Highlights

New Members of the Team

CornerCap has recently added two new employees to the firm. In October, Jeff Moeller (pictured on the right) was hired as the trader. He will also be working as an investment research assistant, as time permits. Jeff grew up in Tennessee and Oklahoma, and he graduated from Oklahoma State with a BA in Finance and International Business. His outside interests include golf, fishing, and travel.

In September, Andrea Purcell joined the firm as an Operations Assistant. She replaced Ruthie Brown who left the firm after many years to become a full time housewife and mother. Andrea is from Cary, NC, and she has a BA in Economics from the University of North Carolina in Chapel Hill. In addition to UNC sports, Andrea enjoys running and traveling. Andrea is shown here working with John Hackney, Director of Operations.

The "Reel" Man at CornerCap

Kendrick Mattox in our Charlotte office is actively involved in Trout Unlimited. Because of his volunteer work and his contribution to the organization, his 600-member chapter named him the 2000 "Reel Man" of the year. This award is in addition to Kendrick's being named CornerCap's 2000 "Real Man" of the year when he was able to get married and to pass the CFA Level 2 exam at the same time.

CornerCap's Web Site

Laura Hull in our Systems Department has completed the first phase of our web site, which we encourage you to visit at www.cornercap.com. It includes information about our people, products, and services. It also has recent newsletters, commentaries, and the current net asset value (NAV) for each of our mutual funds. A planned enhancement for 2001 is to make current balance and recent activity data available on the web site in a secure area for our private clients and mutual fund clients.

Cleanup After the Party

What a ride. In just one year, the dot-com bubble explosion came and went. As this is being written, the tech-heavy NASDAQ Composite is back to where it was a year ago, and the Dow Jones Internet Index is below where it made its debut in February 1999. Rational fear has replaced irrational exuberance. The rational fear is progressing toward irrational. Technology and the Internet are here to stay. Competition and economics are squeezing out the poor business models and the weaker companies. Our research at CornerCap is beginning to identify a few good buying opportunities in this area. When the fear becomes so intense that you know it is for real, you know that you are in the midst of a real opportunity.

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