

REDEFINING RISK

In investment academia, risk is typically defined as price volatility or, stated another way, the standard deviation of a stock or portfolio's value over time. This is probably not a good definition of risk. Risk can have much more to do with the investor than with the investment.

At a recent conference sponsored by the investment society, Association for Investment Management and Research (AIMR), Jason Zweig of *Money Magazine* presented a few examples of number-one ranked mutual funds that reflect this redefinition of risk. One of the funds was the Robertson Stephenson Value + Growth Fund. On December 31, 1996, it was rated the number-one mid-cap fund for three-year return rankings by Lipper Analytical Services. The fund's superior performance was concentrated toward the latter half of that three-year return ranking period. As one might expect, new contributions poured into the fund during the last year of that high-performance period.

For the five-year period May 31, 1992 (inception), until May 31, 1997, the fund returned an excellent 27.7% per year. That was a traditional time-weighted return.¹ However, the fund declined dramatically in early 1997, at a time when the assets in the fund had peaked. When the fund's return was computed on a dollar-weighted² basis, it dropped from 27.7% per year to 3.6% per year. In other words, an investor in the fund did well if he invested his money in the beginning and held it there until the end of five years. Instead, investors waited to invest, missing the good performance and fully realizing the poor performance. Poor timing with investment vehicles

like that is not the exception but rather the general pattern of investor behavior.

Time-weighted rates of return over selected periods are the methodology required by our profession, and they are the appropriate returns to use when evaluating a fund or an adviser. However, time-weighted returns are not fully understood or appreciated by clients who are not in the investment business. Many clients simply want to know how

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much money they gave us and how much they have now. That is the period of time that we have our client's money to invest, so it is the only time for which we should consider

ourselves accountable. Or, is it?

BUY HIGH AND SELL LOW?

By definition, the majority of investors cannot be right in the long run. Witness the above mutual fund and the technology bubble that peaked early last year. The majority of dollars arrives and is in place at the peaks. Similarly, there is a severe scarcity of dollars invested at the bottom of the trough. This is why a contrarian investment approach works consistently over time but especially at the points of extreme.

This theory of investing is simple. We win by buying low and selling high. However, as noted above, it is the nature of investors to do the opposite, buy high and sell low. As professional investment advisers, we deal with this by having a contrarian investment philosophy and a buy/sell discipline that is based on fundamentals rather than feelings. This is what we

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“THE MARKET”

What do people mean when they say “the market” is down? They are probably talking about an index like the Dow, S&P or Nasdaq. They are also probably referring to the indices' last all-time high until today. Stock indices are constructed very differently, and the numbers can be all over the board. We will try to

avoid throwing out a long list of returns and time frames to prove our point.

Being true to our contrarian philosophy, we would argue that “the market” by our definition is not down, but rather it continues to be up nicely. If you just

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REDEFINING RISK (CONTINUED)

must do every day to try and get the best return possible during the time that our clients' assets are our responsibility.

We believe that our responsibility to our clients extends beyond the things we do to manage their investments. We must work as effectively with our clients as with their investments. This requires that we be good, credible communicators.

You will recall that we have redefined risk (and return) so that it has more to do with the investor than with the investment. Our goal is to maximize our clients' wealth at the appropriate level of risk. When our investments go through a difficult period, it is important that we convince our clients that the fundamentals of our firm and our investment process are sound. This is an ongoing, educational, selling and confidence-building process. We must be effective so our clients will not end up selling one adviser low (i.e., us) and buying another adviser high. We must help control both the investor risk and the investment risk.

HARD SALES JOB

It is not easy to sell a contrarian investment approach. With investments, being with the crowd is comforting. Going against the crowd is frightening. However, the risks are greater being with the crowd than they are going against the crowd. Like good physical health, good investment health requires an inverted logic. If it feels good (couch potato, stuffed potato), it is bad for you; if it feels bad (exercise, broccoli), it is good for you. It is a difficult sell.

The media exacerbate the problem. It is amusing (versus informative) to watch the talking heads on CNBC and other media. The faces are the same, but the words are new. A little over a year ago, they were justifying technology stock valuations and projecting rapid revenue and earnings growth. Today, in hindsight, these same people state that what happened to the technology stocks was obvious, and only a fool would not have seen it coming. You can question their conviction but not their enthusiasm.

The people in the media are simply doing a naive extrapolation of what has recently happened in the market. This is not just an affliction of the media but also of the masses. This extrapolation of the recent past is also what the public does, believes, and wants to hear. The media is


selling to the public, so this is what they are going to say. Say something different, and you are off the air.

History has also shown that most people in our profession suffer from this problem. Like the media, mutual funds and investment companies are selling their services to the public. You do not sell effectively by telling investors what they do not want to hear. Because the future is so uncertain, it is easy with investments to justify the current popular position, such as eToys' having a great future, Cisco's being undervalued, old economy stocks' being permanently dead money, etc. When an investment professional, or any honorable person, makes these statements often enough, he begins to believe them, passionately, even when they began as somewhat of a rationalization.

Rationalization is rampant amongst investment professionals. Most firms are able to articulate clearly their investment philosophy and investing disciplines. However, in 1995 the lion's share of investment firms was labeled as "value" investors. Five years later (2000), the distribution had shifted and value firms were a rarity. Even with those few firms that stated a value-oriented philosophy in the late 1990s, we were surprised at how many were redefining their valuation criteria so that stocks like Amazon and Cisco were considered reasonably priced. We have not seen such radical rationalization since the 1980 oil stock bubble.

While CornerCap's equity investments have been up significantly over the last two years, almost all of the stock indices have been down. Many investors are experiencing severe pain and are becoming disillusioned. Given the lingering belief that "it will come back," the pain will probably be around for a while. Before the market actually does come back, there needs to be fewer believers than exist today. Also, when it comes back, the "it" will look much different.

THE OPPORTUNITY

We believe that "the crowd" gives us the opportunity to identify and reside in the minority more easily, where returns are higher and risks are lower. We have been fortunate in convincing many of our clients of the benefits of joining us on the road less traveled. We know where the road is leading us, but we do not know the length of the trip or the difficulty of the terrain. When the trip is particularly long and difficult, it is our challenge to keep the objectives in clear focus and to filter out the noise from the crowds along the way. 

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¹A **time-weighted** rate of return measurement of a portfolio's performance is one that calculates a return for a relatively short time period, say one month, and then geometrically links the returns from each time period together for a specific length of time. The return for each time period receives the same equal weighting. This time-weighted rate of return more accurately measures the effectiveness of the portfolio manager, regardless of the dollars invested, and it is the calculation that is considered appropriate by the investment management profession.

²A **dollar-weighted** rate of return measurement of a portfolio's performance gives more weight to the time period when more dollars are in the account and less weight to the time period when fewer dollars are in the account. This dollar-weighted rate of return more accurately measures how well the dollars have performed and not necessarily how well the portfolio manager has performed.

“THE MARKET” (CONTINUED)

eliminate the technology and telecommunications sectors from the indices, the disaster disappears. Also, with their elimination, the huge run up in “the market” prior to its peak in March 2000 disappears.

CornerCap’s equity returns have been up dramatically over the last year. Over this 12-month period, “the market” (as measured by the S&P 500) has been down 15%. However, our high returns become less spectacular if you accept our redefinition of “the market.” If you essentially removed the effect of these hugely overpriced technology and telecommunications stocks by equal

weighting the S&P 500, the index would have been up 15% over the last year.

We prefer some definition of the market that substantially lessens the inflated weightings that were given to technology and telecommunications. Over the last five years, which covers the inflation and deflation of the bubble, CornerCap has been able to deliver good, steady returns every year.

... “the market” by our definition is not down, but rather it continues to be up nicely.

However, most investors, which include institutions, individuals, and, by default, index funds, opted for the rumble and tumble of the technology roller coaster. The newspaper headlines and the indices have to

include this brief aberration in the market, but we try not to include this behavioral anomaly in our definition of the market. ▲

CORNERCAP HIGHLIGHTS

CORNERCAP’S SPONSORSHIP OF THE GEORGIA SHAKESPEARE FESTIVAL

For the past two years, CornerCap has been a sponsor of the Georgia Shakespeare Festival, located in the Conant Performing Arts Center at Oglethorpe University in Atlanta. The festival has an extensive program for students. During the school year, the son of a CornerCap employee took the six-month acting course, Shakespeare Ensemble for Teens. This summer, he is serving as a volunteer usher at performances.

The summer repertoire includes Shakespeare’s *As You Like It* and *The Winter’s Tale* and *Amadeus* by Peter Shaffer. In the fall, CornerCap will be sponsoring the production of *Julius Caesar*, which runs October 12 through November 4 (look for the CornerCap banner at the entrance to the arts center). ▲

STAFF ADDITIONS

CornerCap recently added two new employees to its staff. Sean Durity heads up our internal systems development efforts. He worked with us several years ago, and we are excited about having him rejoin the

team. Sean works with Laura Hull and Ed Porter, who have been focused on our Web site and hardware/software maintenance, and with Huett Britt, who serves as a technology consultant to the firm.



Sean Durity



Sean Durity, Huett Britt, and Laura Hull

CORNERCAP HIGHLIGHTS (CONTINUED)

Aletha Hardy-Lester joined us as an operations assistant. Aletha is working with John Hackney, director of operations, and Karen Quinn, manager of mutual fund

and accounting operations, to become quickly integrated into our client accounting and record-keeping systems.



Aletha Hardy-Lester



Karen Quinn, John Hackney, and Aletha Hardy-Lester



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